Kimura Dreamvisor Newsletter Summary 4th December 2006

ISM index broke 50 level for the first time in the past 3 years and 8 months

US economy should further slowdown by New Year’s start. For any equity investor monthly published ISM index is an extremely important advance indicator. In Japan the most relevant advanced indicator is BOJ Tankan DI published on a quarterly basis. Such advance indicators are extremely reliable as they are based on direct industries poll and objectively gathered from business sources. In short, if ISM stays above 50 level we are in expansionary phase, below that level points to slowdown. BOJ Tankan is considered as a ‘barometer’ of real situation appreciation degree. Both are very comprehensive indexes. November’s ISM was announced 1st of December and broke the 50 level first time since 3 years and 8 months. Usually industrial production growth rate fall follows with a 3 months lag. It is clearly a negative indicator for equity pieces and earnings. On the reverse it means easier monetary policy ahead therefore positive for bonds. US securities relative attractiveness is decreasing as a whole which in turn triggers US $ weakness. ISM announcement had little if no impact on stock market therefore I believe most market participants had already discounted the announcement.
Up to now US industrial sector earnings were pretty good, aircraft large orders came in and industrial production index rose 5 % YOY. I had forecasted 2 % growth back in April; I thought growth rate would decrease toward 0 in September as the denominator expands. However to show a real slowdown US must register negative growth rate for a full 6 months period and I do not believe it will go that far. Consequently it looks OK to say that the US long expansion cycle is close to ending.
ISM figure comes against FRB optimistic statements and even more optimistic FED regional branches surveys. I believe we are already experiencing the impact of individual’s consumption slowdown as house prices stopped rising and housing starts decreased. Home equity loan balance increase helped consumption expands. Reverse impact cannot be taken softly. It has been barely a month since ISM broke 50 level, according to experience large expansionary phases end in a relatively short period of time, I believe an increasing negative news flow from US is unavoidable specially after New Year’s eve.

Nnext problems are Chinese authorities…

There is a strong correlation between Japanese exports and ISM index. Japanese exports should weaken. Japanese exports toward US totalled 8,4 trillion Yen between April and September which is no more than 22,4 % of whole Japanese exports but considering that 48 % of exports are geared toward Asia and that a substantial portion is linked to indirect Asian exports toward US then the real degree of dependence toward US is close to 40%. This is obviously not positive for exporters earnings. This must be interpreted as bad news for equipments investment related stocks. Exports toward US supported the world investment in equipments boom. Therefore slowdown impact looks unavoidable for car makers with 70 to 80 % local production ratio and companies like Shinetsu chemicals who’s US sub is a top maker of chloridization vinyl for example. However companies like Toyota motor still increasing US market share should easily bypass this difficulty. This said we speak about big money, US nominal GDP is 13,3 trillion US $ (1540 trillion Yen). Japanese exports to US are 17 trillion Yen, not a huge number but individual impact on earnings should be monitor on a case-by-case basis.

Above all China foreign reserves utilization should be closely monitored; this is an important economic management tool. Currently most Chinese current surplus is invested into US treasuries short to long term. This acts like a foreign exchange stabilizer but sooner or later China will have to face the same dilemma that Japan experience in the past. In a word trying to maintain exchange level unilaterally which bears the danger of violent readjustment by foreign exchange markets. If US economy further weakens then freshly elected democrats will certainly raise Chinese Yuan parity subject.

In addition Chinese high growth rate and ballooning current surplus brought side effects: saving rate soaring + 40 % nor to mention soaring prices and salaries mostly for wealthy coastal parts. For those reasons Chinese growth rate regional discrepancies reached unsustainable levels. In china setting one price to one good may have became nearly unfeasible (excluding goods marketed at same price like transport). The environmental problem is become acute (soaring energy and raw materials prices, insufficient water resources) to the point private sector just cannot cope. Economic policy steering has become extremely difficult.