Correlation between US and Japanese markets? : Gaijin/Japanese knowledge gap is substantial to say the least

This knowledge/forecast gap is an opportunity gap.

Some observers are concerned about the recent ***undue*** correlation between US and Japanese markets (on a chart basis S & P and TOPIX show the same pattern).

The US market has entered a typical reverse earnings phase while Japanese stock market is still at early stage of earnings growth nor to mention financial tightening cycle.

For those, including myself, who solely focus on Japanese equities this looks totally abnormal; when market efficiency fails opportunity knocks! Japanese individuals and institutional investor's recent inactivity can explain partly this undue correlation between both markets. However I do not believe this can last for very long considering the domestic alternative (fixed income yielding 1,8 %).

Even more interesting is the substantial forecast gap between foreigners and Japanese investors: foreign investors have been bullish on Japan for calendar 2006 but views for 2007 are rather divided. However Japanese investors bullishness increases toward 2007 although somewhat less positive than foreigners for the second half of 2006. After the 14th of July having discounted ZIRP end Japanese institutional investor's mood may have entered earnings driven phase market leaving the financial easing cycle behind and such mood turnaround increase volatility for the short run.

I recalled in my previous newsletter that Nikkei published a front page article in the 23rd edition stating that Japanese listed companies ROE had reached average 9,2% (20 years high). This list was based on 23rd July closing for companies capitalized at above 100 billion Yen and current profit level above the net. The ranking gave names such as Sumitomo Metal Mining (36,7%), Isuzu Motor (29,3 % selected on PEDY based list), JFE Holdings (28,6%), Nippon Steel (24,0 %) etc

This survey excluded new growth market listed shares, by extending such screening to mid size caps (under 100 billion yen) average ROE would exceed 12 % .Considering the current Japanese long yield environment (1,8 %) it looks quite clear that the shift to risk assets by Japanese investors has started albeit at a snail pace or with pitfalls on the way.

Based on Toyo Keizai current estimates a quick ROE sector based screening give:

The article also mentioned that Japanese listed large companies average ROE still lagged the European listed average (10 %) and S & P 500 average ROE (16%) but that's misleading as one must consider the dynamic trend : upward in Japan, flat or downward for US. (Euroland has been dead flat for a while...) nor to mention that Japan is surrounded by Asian dynamism.

Without capitalization level restriction a basic screening of FY05 (March 2006) sector based listed Japanese companies ROE above 8 % give:

Industry/manufacturing	563
Trading	218
Transport/telecommunications	155
Services industry	114
Financials	75

Within such a universe I am convinced that interesting long term investment targets comparing nicely by global standards can be spoted.

This said it is true that the legacy of bubble burst shifted the core Japanese financial activity to other products (compared to risk assets) for the past 10 years and if the domestic massive shift to risk investments has already started it is long haul !. Therefore one must not get discouraged by recent lack of volumes. and rather look at it from the opportunity angle.

Shareholders activism back on the agenda.

Steel Partners the US shareholder activist fund has been taking advantage of the low valuation of some large caps and increased further its holdings in (7762) Citizen the 21st of July at 8,13 %.

Tower Investment, seemingly the sole onshore shareholder activist fund left around further increased its already heavy holdings in some mid caps like (8896) Ryowa Life Create now trading at 5,71 times (!) current fiscal year earnings (17,39 % ROE) at 33,43 % by 10th of July.