Long Term investment (5)

'Defeasance': what makes Japanese (a decade ago) and US (current) taxpayer's money so different? Actually a lot.

Nomura's economist R. Koo recently appeared in several public seminars vowing that now was high time to implement a policy based on Japanese experience dealing with massive amounts of bad debts. Like others he could not help but making a parallel between Japanese past experience and current US crisis stressing similarities especially lack of long-term vision in handling the crisis. Good timing! 2 days later Treasury secretary Paulson outlined the defeasance scheme that everyone was waiting for.

But what are the key issues? 10 years ago Japanese authorities could not decide major taxpayer's money injection until ordinary citizen was feeling real pain. Same underlying logic applies to US case. Bear Stearns rescue was a mistake not repeated with Lehman Brothers.

The chart loaded at the end of this newsletter*was published on Nikkei BizPlus setting a parallel between Japanese banks lending viewed form corporate borrowers (1985-2007). During bubble time Japanese banks recklessly made loans. Then from 1989 BOJ tightened abruptly, short-term money market rates shoot up to 8%. Japanese economy went in massive slowdown mode and banks lending collapsed. In 1995 Japanese banks started again to lend on a massive scale but at that time both Japanese currency and stock market weakened leading to a second wave of banks inability to perform normal lending operations. Banks were trapped with a falling equity ratio. In order to recapitalize Japanese banks tightened further which led to chain reaction financial bankruptcies. At that point only did ordinary people started to feel real pain and authorities decided to inject a first wave of massive taxpayers money (march 1998) but banks were reluctant to accept public money. By March 1999 authorities decided a second wave of massive taxpayers money injection, which finally ended banks reluctance to lend. In the end it proved to be the right strategy. US treasury secretary Paulson is perfectly aware of Japanese historical background. However his stance was to leave it to private sector for time being, clearly he changed his mind. Ironically every professional knows that Japanese officials probably suggested him to apply this strategy during the last G7 informal meetings!

If any lesson can be drawn from past Japanese example it is time frame. During a decade Japanese companies kept repaying all outstanding liabilities. Total liabilities had reached Y30 trillion (equivalent to 6 % Japanese GDP at the time). Despite Japanese rates were kept at zero for the whole period, Japanese companies paid back outstanding debts and banks could not take advantage of the margin between close to zero cost funding and interest charged. Japanese authorities were left with the sole prospect of injecting taxpayer's money in the banking system (two waves: march 1998 and march 1999). Coming back to current American crisis American officials came to the conclusion that injecting taxpayer's money into the banking system was the sole option left. I guess they know that otherwise American banks inability or unwillingness to lend will get worse and worse. Ordinary citizens do not care about Bear sterns or Lehman brothers whose executives were paid up to 100 times average Japanese (and American) citizen earnings.

This said American officials couldn't take too much comfort from past Japanese crisis, as situation is totally different. Large differences between current US crisis and previous decade Japanese experience do not allow same remedies. US crisis is really a '**cash crunch'** case. Loss making companies can survive provided cash flow remains positive but even profitable companies go under if vital day-to-day liquidity cannot be secured. Lehman is typical case. This never was the case in Japan. Japanese bubble burst collateral damages were due to financial authorities policy failure in addition to awful timing. During late eighties MOF over-tightened rules for construction, real estate and housing sectors. Those three sectors were cut off vital financing capital and felt into anemia, in the end market crashed leading to chain reaction bankruptcies in those 3 particular sectors. Meanwhile Japanese individuals remained solvent. American individuals subprime led insolvency crisis is totally different in essence.

Another large difference with current US situation is Japan's high saving rate; despite high short term rates Japanese people could still afford to spend. Contrary to current US bubble burst this did not lead to a 'cash crunch'. Japan was undoubtedly awash with excess liquidity however this did not lead to systematic financial risk as is now happening in the United States. Japan's US$14 trillion individual savings played a key role.

The Japanese ‘tragedy’ was rather complete political mess; incapable civil servants who did not have a clue about what was needed to fix the situation then populated MOF, the situation was made worse by political instability (Hosokawa cabinet lasted 8 months), which impacted badly financial policy.

US and Japanese economic environments differ too much to draw simplistic conclusions.

The long, long case (part 9)

Fund flows reversal also means new opportunities for pure Japanese equities invested publicly distributed investment trusts. Back in 2003 foreign securities specialist investment trusts represented 22 % of Japanese publicly offered investment trusts universe, 30 % in 2004 and reached 50 % of total in 2007. The trend seemed unstoppable until 2008 but Yen implied volatility reversal changes the equation. Pure Japanese domestic equities investment trusts are making a comeback. It is yet too soon to draw conclusions but capital repatriation is already having ripple effects with onshore asset managers launching new domestic products .16th of September US financial department published July US securities supply demand figures. Japanese US securities holdings were down 2,5 % from May at US$578,7b. Chinese US securities holdings were down 2,3% at US$506.8b. A global crisis of such scale inevitably triggers a complete realignment of relative strengths country by country. Incidentally Euroland managers have a unique window of opportunity to take immediate advantage and expand. (Personal view).

Now what to buy?

Again whatever angle you look at it on a worldwide comparison basis Japanese equities offer value if combined with Yen implied volatility (historic) reversal.

Bloomberg published a chart analysis ‘ buy signal based on Japanese equities dividend yield’. Any professional knows that Japanese companies dividend payments are steadily increasing. Based on current market level the spread between 10 years JGB yield and average dividend yield reached new historic high.

Anyone can draw this simple chart showing TSE 1st section TOPIX relative to yield gap. Based on Bloomberg data 18th September dividend yield was 2.13%, 10 years JGB yield was 1.5% translating into 63 bps spread (1 bp = 1.01%).

Both foreign and Japanese brokers strategists have been pointing at this indicator for a while already. Domestically capital shift did not materialize so far (I previously mentioned the many psychological reasons explaining this). Again market strategists have been pointing at TSE 1st section average PBR declining to 1.22x on 18 Th of September plus the fact that 60 % of TSE 1st section stocks are trading at less than book value (PBR<1).

Historically Japanese equities dividend yields surpassed long bond yield only 3 times. In June 2003 when Japanese market touched what I still believe is a historic bottom. Spread widened to 60.5 bps, and then TOPIX rose 30 % for 12 months in a row and eventually doubled in 4 years time. October 1998 and July 2005 showed same pattern with TOPIX up at least 30 %.

Besides expected short cover buy backs recent daily trading volumes already increased substantially since 19th September which can be translated by some long-term money inflows. Above-mentioned 63 bps yield gap automatically triggers pension type money inflows.

J-REITS; hidden value or *value trap*? (2)

Japan domestic land prices recovery, which materialized last fiscal year, is coming to a sudden halt. Recent high profile bankruptcies testify, sponsor hunt is becoming suddenly very difficult. Suruga Corporation in June, Urban in august went bust. Foreign capital inflow targeting Japan domestic estates have all but dried up recently. GE Real Estate (Tokyo, Minato-Ku) who planned to buy up toY300b of estate during fiscal 08 backpedalled. Japan Single Residence ex-Lehman Brothers related REIT just cancelled planed acquisition of land plot in Kyoto.

Japan residential land prices decreased 1.2 % YoY down for the 17th year in a row. This said downside risk is very limited considering Japan long-term cycle complete disconnection from worldwide asset inflation bubble.

(8986) Re-Plus residential Investment Inc, a Japanese horror story!

I already wrote on this website regarding 'value trap' for Japanese equities but it applies to undervalued J-REITS. Shareholders' interest dilution looks awful when new shares are issued at discount to increase capital. Back in august Residential REIT Re-Plus residential lowered mid-term expected dividend by Y5766 to Y10, 321. Utilization rate had improved at 94,1%, income stream did not halved, as this figure would suggest. The investment manager (Re-Plus REIT Management) said this dilution was aimed at strengthening financial structure and acquire reserves for potential acquisitions. For this purpose Re-Plus REIT created 70,000 new shares priced at Y175, 000, the problem is this private placement was achieved at a shocking 65 % discount to real assets value per share (Y499, 365). US Oak Tree Capital Management who subscribed to the capital increase also announced they acquired shares at Y 260,000.

Re-Plus REIT was yielding 11,23% on the 12th august however after capital increases expected return felt to 5,81 %! How on earth can Japanese individuals be convinced about purchasing cheap high yield REITS considering such disgrace. Based on this some Japanese analysts reacted by downgrading severely REITS trading at heavy discount to book value ratio (PBR <1) are cheap in theory but growth prospects are poor.

Unlike other companies REITS usually distribute all earnings in dividends and rely on capital increase to replenish reserves. The Japanese financial press wrote a lot about this unacceptable dilution of shareholders rights.

Increase buildings capacity at the expense of investor's rights is meaningless. The sole winners are the REIT sponsor worried about developed estates stock disposal or the bank keeping a close eye on loan repayments. Another source of mistrust toward Japanese real estate investment trusts.

23rd of September MOTHERS listed (8936) Re-Plus Inc (the investment manager) finally announced it was filing for bankruptcy with debt totaling Y32.47b as of September 24th. The company will be delisted 9th of October. End of the story.

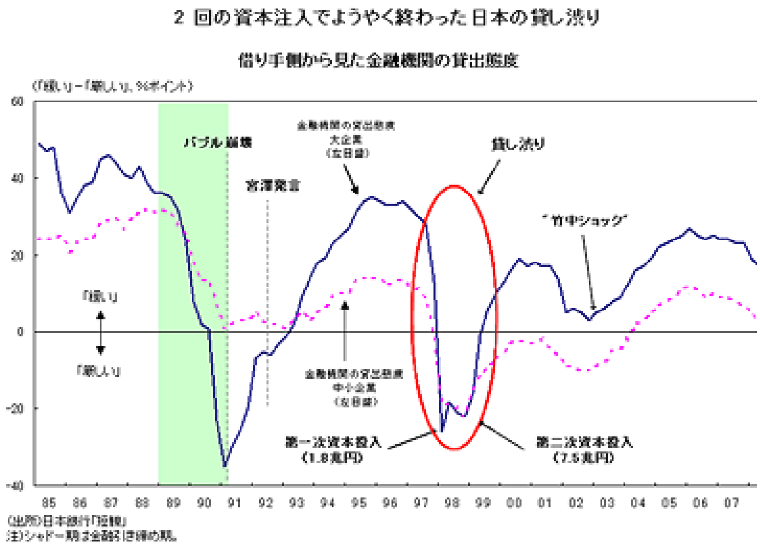
Chart comparing 1985- 2007 Japanese banks lending (source Nikkeibiz plus, click to enlarge)

Blue line: financial institutions lending to large companies

Dotted line: financial institutions lending to small companies

Red circle: 1st wave of taxpayer's injection Y1.8 Trillion (March 1998)

2cd wave of taxpayer's injection Y7.5 Trillion (march 1999)



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