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Long Term investment (8)

' Nine, The red gains, odd and misses, broke the bank!'

Individual's money finally called bottom but in less than 5 months Japanese fundamentals took a severe beating. Let's go deeper.

Trying to call a bear market bottom is daunting but not irrelevant. I initially thought Nikkei 225 and TOPIX testing new post-bubble low was a very remote possibility implying long bear trend which started late 90s in Japan had not ended in 2003. So far Nikkei did hit intra-day new low of 6994.90. In local currency terms Japanese market is down 42 % but only down 20 % in Euro terms (and down 32 % in US$ terms) which unfortunalty made it easy sell target for cash hungry foreign investors.

Now we have entered the new fiscal year let's have a closer look at the 'state of the archipelago':

If by March 09 end we consider 1,706 listed Japanese companies as a sole 'Japan Inc' (excluding new growth markets) December 2008 equity ratio was 34,9% down 1.6 bps compared to March 08. December 2008 total profits balance was Y191trn down Y14trn compared to March 08 (Earnings potential loss: Y1trn, Yen relative strength impact on foreign subsidiaries: Y1trn, securities holding losses: Y5trn).
Another useful indicator is Japan Inc's DOE (Debt to Equity Ratio), by December 2008 DOE was 0.88x down 12 bps from March 2008. DOE is declining but remains far above 2005 level and also compares well with US 1.64x and UK's 1.40x (although these figures are for year 2006 and need update)

Shareholder friendly Japan: toward seven years cycle end?

Japan Inc dividend payout ratio rose to 300% last fiscal year however March 2009 will register first dividend decrease in 7 years and Japanese companies are actually paying more dividends than they can afford.
Out of 1,809 listed companies (excluding high growth markets) Nikkei calculated March 2009 dividend payout ratio at 34%, which represent 3 times Japan Inc. total net profit. Dividend payout ratio was 23% in 2004, 30% in March 2008, therefore despite current recession Japan Inc dividend payout ratio surged to 340% in March 2009. Considering total net profit balance collapsed 92% up to March 09 this looks very high indeed. Japan Inc total dividends balance is expected to reach Y5,367trn by March 2009 down 11% on a year basis. Clearly previous fiscal year stock buy-back operations impacted dividend output. For January - March 2009 stock buy-back is already down 50% compared to last year. However 1st section listed stocks dividend yield kept going up until last year to 2,6% up 1,2 bps from March 2002 level. This led to a reverse yield gap since autumn 2008 (Japan 10 year JGB yield 1,4%). However Doe is forecasted to decrease to 2.5% first time in 7 years.

To continue with my previous Japan US comparison, 8th of April Standard & Poors announced that no less than 367 US listed companies decreased dividend payment during January - March 2009 which is 4 times previous year number (84). Only 283 companies increased dividend half previous year figure.

This said Japanese companies are now faced with a dilemma: how to arbitrage declining earnings between labor and shareholders. It should be interesting to see what comes next.

Three scenarios:

Considering Nikkei 225 components as a sole 'Japan Inc' and gathering analyst's consensus estimates for March 2010 gives 3 possible outcomes:

Bullish scenario: Nikkei 225 March 2009 net profit balance was Y1, 250trn, if net profits were to grow 6.4 times that level at Y8, 20trn then Nikkei should reach 11,000 – 12,000 which was year 2005 average.

Mid-range scenario: if Nikkei 225 net profit balance increases 2.6 times at Y3.320trn but still below March 2008 level (Y4.200trn) then Nikkei should trade around 8000.

Worse scenario: if Nikkei 225 net loss balance is Y1.30trn then no doubt post bubble low (7075) will be revisited at some point.

Japanese individuals eventually stepped in during October market selloff. Some observers suggest individuals are trying to compensate for decreasing income by showing their rights as shareholders considering Japanese companies labor relative share keeps going down.
Fact is there has been a surge in on-line brokerage account opening during October 2008 selloff: compared to September SBI securities registered 23,026 additional openings, Rakuten securities 13,054 openings, Matsui securities 8,834 openings, Kabu.com 6,412 openings. Excluding special situations like mergers this is the biggest jump in account opening since June 2006. Half those account-opening requests came from absolute beginners.

Looking back at September – October 2008 Japanese individuals poured massive amounts of money into domestic equities. Japanese Individual's market share increased from 20-21 % in September to 24.5% during October 5th trading week. Long-term money undoubtedly entered stock market, individuals mostly bought oversold blue-chips, some observers pointed out that during late 90s while labour's relative share (employers income/national income) rose, ROE declined however this trend peaked late 2001 then reverse phenomenon occurred up to present time (that is labour relative share to national income going down and ROE trending upward). Some also point at the fact this is first time pre-war that Japanese individuals wake up to the risk of not being an active shareholder. However recent market downturn may recall them the risk of, indeed, being an active shareholder. This is a cruel world!
Figures speak for themselves; during late 90s labour relative share to national income was as high as 66,6 % and (year basis) ROE was then 18,1%. IN 2001 labour relative share rose to 74,4% and ROE decreased to 6,6 %. During fiscal year 2006 labour relative share had decreased to 70,9 % and ROE upward to 11,4 %.
To summarize supply-demand figures for 2008 Foreigners sold massive amounts unseen for past 19 years while Japanese individuals poured money at a level unseen for past 18 years. For calendar year 2008 Foreigners sold Y8.177trn and continue to do so in 2009 (in March 2009 foreigners sold net Y1.883trn). A shift in shareholders relative market share is underway (foreigners to Japanese individuals) but this should take time. I recently spotted interesting facts: Japanese individuals shareholding of Canon (7751) has reached 8% first time in 12 years (while foreign investors holding is declining).

Now what to buy?

First of all Japanese market seems to be technically close to bottoming out (at least from a purely technical point of view). 31st of March Nikkei average closed at 8109 translating into a 35% fall for fiscal year 2008, the largest fall in 8 years. Nikkei average is showing mid-term turnaround situation, the gap with 25 days moving average has reached + 10%. Since 2000 this only happened twice (last was March 2002). Comparison with year 2002 makes sense as this was IT bubble collapse last bear leg. After having reached 20,000 in March 2000 Nikkei average collapsed 63% up to 28th April 2003 at 7,607. However looking closely at March 2002 when 25 moving average gap reached +10% Nikkei enjoyed a 26% technical rebound from 6th of February to 11th of March, when Nikkei finally bottomed out in April 2003 it then embarked into a 4 year bull trend up to year 2007.

Clearly when companies are in make-or-break mode stock picking is the only viable strategy. Japan remains full of 'hidden jewels' but in depth research is paramount as has always been the case with this market. Generally speaking professional investors are currently switching gears investing in battered export-driven stocks and selling domestic-demand shares. Personally I remain a stock picker spearheading a wide range of business fields with no correlation to export or domestic led demand.

March 2010 forecasts season already kicked off, analyst consensus is rather pessimistic. March 2009 quick consensus DI is at minus 80 (down 1 bps) but as usual it would be very unwise to follow the herd; I shall update. As I write FY2009 last Tankan suggested large Japanese companies are forecasting –11% current profit decline (first half –33,5% second half +73,5%). Out of 2051 companies surveyed 299 already lowered forecast.

Pascal Jeannenot