Is Abenomics Going to Put Japan Back on the Map?

John Mauldin | May 8, 2013

In a special *Outside the Box* today, Keith Fitz-Gerald, Chief Investment Strategist for *Money Morning*, dissects "Abenomics," the radical, not to say outlandish, fiscal moves that the newly installed government of Japan is making. And Keith has a ringside seat: he spends much of each year in Japan.

In an attempt to cut the Japanese a little slack, Keith comes up with four things that will have to happen for Abenomics to work – but when all is said and done, he says, Abenomics is a recipe for disaster. That does not mean, however, that there is not plenty of opportunity here for short-term profit, and Keith offers a play that is a potential money maker in this volatile Japanese environment.

For a limited time, *Outside the Box* readers can receive a 60% discount when they subscribe to Keith's *Money Map Report.* You can check it out here.

Our Strategic Investment Conference last week was over the top. It will take me several weeks to think through the presentations, and I will likely spend a few weeks writing about what I learned. But Japan was definitely a big topic, as was Europe. The focus on central banks is appropriate, if frustrating.

The consensus is that massive global QE will end in tears, but the final act may take quite some time to arrive in the US. Today, many central bankers are looking at the currency wars of the 1930s, and the lessons they are drawing from the Great Depression are clear. In a speech to the Economic Club of New York in early 2013, Fed Chairman Bernanke boasted, “In fact, the simultaneous use by several countries of accommodative policy can be mutually reinforcing to the benefit of all.” Bernanke argued that rather than call unconventional policies and devaluations “beggar-thy-neighbor” policies, they should be called “enrich-thy-neighbor” policies. That’s taking the lessons from the 1930s a step too far, but when it comes to unconventional policies and devaluations, Chairman Bernanke believes the more the merrier. And so do his fellow central bankers, apparently.

By the way, a theme is percolating in my mind, which I will develop at a later point. Briefly, the problems with “austerity” in Europe are not so much due to governments cutting back as they are to membership in the euro itself. In essence, the euro is a gold standard. In the '30s, when governments on a gold standard devalued they saw a boost to their economies. But since Eurozone members cannot devalue, they are left with deflation and depression. Then they blame others for not lending to them and forcing “austerity” upon them, when the primary culprit is their own inability to deal with their trade flows and labor costs. If the market cannot adjust currency values, the only choice left is a reduction in labor costs, which in the real world translates into higher unemployment.

But since the euro is a political and not an economic currency, you can’t address your national problem without leaving the euro, and that is not politically feasible. It is a conundrum.

I am really thinking about going to Cyprus in late June, and if any readers have suggestions for people to meet, I am interested.

I am learning more about marble and flooring than I ever thought I would know. We are getting closer to actually beginning construction, but I am ready to *finish* already, for a variety of reasons. Hotel internet is not always the best, and where I am here in Dallas it can really get slow. The weather here in Dallas is perfect, and I think I will walk to my next meeting. In a few short months, stepping outside will be like walking into an oven, but right now it couldn't be nicer out.

Have a great week.

Your up to my eyeballs in information analyst,

John Mauldin, Editor
Outside the Box

Is Abenomics Going to Put Japan Back on the Map?

By Keith Fitz-Gerald

On the surface, Abenomics – the radical unlimited stimulus plan put in place by newly elected Japanese PM Shinzo Abe – appears to be working.

The Nikkei is up 68% since July, 2012, the yen has weakened by 26% over the same time frame, and Japanese consumer confidence is up sharply to the highest levels in six years.

The theory behind Abenomics is that the rising stock market will create capital, and the falling yen will make Japan’s export-based economy more competitive in global markets, while newly profitable companies will hire more workers.

Don’t hold your breath.

As I noted during a recent interview on NHK, Japan's national public broadcasting network, the beleaguered island nation faces significant challenges:

- Japanese debt is *already* nearly 500% of GDP when you add up public, private, and corporate obligations. That's the highest on the planet and makes Europe's spending look positively miserly. Mimicking Bernanke's helicopter hijinks won't help on anything more than a short-term basis.
- More money does not equal greater innovation. Many Japanese companies are struggling to remain competitive in industries they once dominated. Examples include Sony, Matsushita, and Fujitsu.
- Japanese utilities literally can't produce enough power to fuel a Japanese recovery . Only three out of 54 nuclear reactors are running, and the national LNG import bill hit ¥621 billion in March. That's more than double pre-quake limits, according to the Ministry of Finance. These costs will continue to rise as the yen weakens further. I doubt very seriously that any increase in export sales will be enough to offset rising energy costs, because margins are going to get pinched.
- Formerly deep trade surpluses are now deficits.
- Prices in Japan are rising faster than income at the same time that taxes are being raised. That's a lethal combination that is serioiusly pinching consumers.
- Japanese corporations, once keen to return profits home, are now expanding overseas and keeping money outside Japan.
- Japan's population is aging so fast that, effectively, there are no new workers, a problem that is compounded by the near complete lack of a workable immigration policy.

The bottom line?

Japan is making the same mistakes we're making … or we're making the same mistakes they've already made – it's hard to tell.

Either way, the bottom line is pretty simple: You give me a trillion yen and I'll give you a good time, too.

In order for Abenomics to work, four things have to happen:

1) Japanese banks cannot hoard money the way big banks have in the US. They have simply got to keep it moving right through to Japanese citizens and small local businesses.
2) Japanese bond market participants have to be willing to maintain bidding as the Bank of Japan conducts "market operations," which is Fed-speak for interfering with normal pricing dynamics in an effort to maintain stability. If bidders walk away, the bond market will fail and the government will have to contend with offshore derivatives traders who are already lining up to play the same games they did in Italy, Spain, Greece, and the balance of the EU.

3) Japanese consumers have to engage. If wages fail to increase, living standards will decline and Abe will be up a creek without a paddle – and yes, I mean THAT creek.
4) The international banking community has to allow Japan to debase its currency without punitive repercussions. So far the G20 has acquiesced, but their tacit approval doesn't really mean much. They have no choice but to go along with Japan's moves. Kuroda, who is Bernanke's equivalent at the Bank of Japan and Abe's sidekick, has made it clear he is fully committed to the program, no matter what the West thinks.

Longer-term, Abenomics is a recipe for disaster – have no illusions about that. Japan, as John Mauldin likes to say, is a bug in search of a windshield. No nation in the history of mankind has ever bailed itself out on anything more than a short-term basis by pursuing a course like Japan's.

But short-term … that's another matter entirely, and therein lies opportunity.

Historically, every 10% drop in the yen versus the dollar has translated to a 0.3% rise in Japanese GDP the following year, noted Kiichi Murashima, chief economist at Citi in an FT interview.

You cannot say the same thing about Japanese stocks.

Since the Japanese market's initially collapse in 1991, the world has watched with bated breath as the Nikkei has risen … and plunged with alarming regularity.

If you're going to buy and sell like a trader and you're nimble, you can ride the Japanese equity bull – pun absolutely intended. Most investors aren't so equipped, though, -and so the "buy and hope" approach they favor is far more likely to leave them disappointed than profitable.

Japanese bonds are probably of dubious value, too. So far they've been stable, because Japan has been able to issue mountains of debt to its own dutiful citizens. The cost of debt service has been negligible, because nearly all of it was held domestically.

Now, however, Japan has got a very different situation on its hands. Any rise in long-term rates, let alone a significant one like Kuroda is planning, is going to dramatically hike the cost of debt service to unsustainable levels. Factor in Japan's rapidly aging population and dwindling workforce, and you're looking at a far smaller pool of bond buyers.

My expectation is that Japan will be forced into international bond markets no later than 2015, which will effectively double their capital costs. Without meaningful social security reform and spending cuts, that's going to really impact things.

That's why I'd rather short the Japanese yen.

Stocks are fickle. Abe doesn't care whether they go up or down. Bonds are a part of Kuroda's repurchasing agenda, so those are covered, too. But the yen stands on its own.

In that sense, it's the key to the proverbial castle.

In order to conduct any sort of serious financial reform, Abe is going to have to move the yen's needle. Everything in corporate Japan depends on it.

Since I first brought this trade to everybody's attention in *Money Morning* in February, 2012, the yen has dropped by 30%, and the investment vehicle I recommended, the ProShares UltraShort Yen Fund, is up more than 60% as it flirts with the psychologically important ¥100/$1USD level.

Now, having come close enough to that target for government work, I think the next stop is ¥125 to the dollar, which means that even if you missed the first part of this trade, it's not too late to get on board.

And if you're already holding Japanese equities?

Don't look a gift horse in the mouth.

Hedge the snot out of them or sell into strength – equity markets are not as directly connected to central banking stimulus efforts. But they are absolutely linked to traders' expectations, which can and do change all too frequently on nothing more than a whim or an errant "tweet," as we have recently seen.

You don't want to be left holding the bag.

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About the Author: Keith Fitz-Gerald is a seasoned analyst, expert media contributor, and futurist with decades of experience in global markets. In his capacity as Chief Investment Strategist for *Money Morning* and Chairman of the Fitz-Gerald Group, he appears regularly on financial television programs around the world on the Fox Business Network, CNBC Asia, NHK, BNN, and more. He's been called on for his extraordinary ability to see future trends in such publications as *Wired UK* and the *Wall Street Journal.* Forbes.com labeled him a "Business Visionary." Even Mensa has called him to their stage. Mr. Fitz-Gerald splits his time between homes in Oregon and Japan, with his wife and two boys. He travels the world extensively in search of investment opportunities others don't yet see or recognize.

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