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RICE

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Japanese shares: a time to buy?

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The Japanese stock market has encountered turbulent times in recent years. In the latter half of the 1980s the market soared, benefitting from Japan's booming economy and the ease with which people and companies could obtain credit. It also coincided with the continued appreciation of the yen, thus attracting large portfolio investment from overseas. But the market's rise soon lost all sense of reality, as steady long-term investment was replaced by short-term speculation. Like the housing market in the UK, the rise in the Japanese stock market grew out of control. Eventually the Bank of Japan had to raise interest rates to tackle inflationary pressures and the bubble burst – not just in equities but also in land prices. The stock market crashed. The speed of its fall caught many by surprise: the Nikkei lost more than half its value, plummeting from close on 39,000 in December 1989, to a low of 14,309.41 in August 1992.

This stock market fall contributed to (but by no means fully explained) Japan's economic slowdown in the early 1990s. It reduced the wealth of consumers, limited the ability of companies to borrow and invest and reduced banks' profits and thus their willingness to lend. For a country whose economic success had been built on frugal savings and long-term investment the bursting of the bubble was a necessary evil, despite the short-term pain.

Now the Japanese economy is on the mend, a key issue for investors is whether the equity market is set to take off? In my view, the answer is no, but long-term investors may now consider this an appropriate time to begin investing in Japan again. The exponential growth of the late 1980s is unlikely to be repeated, but the Nikkei Dow could experience a steady rise over a number of years.

MARKET RALLY

The market has already rallied from last August's low. The initial driving force behind the market was support from the Government, who encouraged public pension funds to buy stocks. This was soon reinforced by the expectation of economic recovery, which encouraged investors to buy. But over the summer the economy has continued to disappoint, preventing the stock market from rising. As equity markets around the globe have risen, the Japanese market has moved sideways.

Despite many pessimistic reports about the Japanese economy recently, the actual data suggests investors should not be downbeat. Although economic activity remains weak, the economy is past the worst and should recover towards the end of this year or early in 1994. It is important to note that recovery will be very weak by Japanese standards. This is largely because consumption and investment, which drove the economy in the late 1980s, remain sluggish.

Consumers are still cautious. After the excesses of the late 1980s people are thinking twice before buying a new car, or other consumer goods. Auto sales have been in a slump for over three years, forcing problems on the car industry and its many suppliers. Strange as it may sound, people are al[illegible] concerned about the labour market, even thou[illegible] Japanese unemployment is only 2.5 per c[illegible] compared with 10.4 per cent in Britain and e[illegible] higher on the Continent.

Japanese companies have also experienced a [illegible] difficult time recently. Many overstretc[illegible] themselves through excessive borrowing and h[illegible] investment in the boom years of the late 198[illegible]. Their problems have been exacerbated by the weakness of domestic demand, sluggish world growth and the speed and the scale of the yen's appreciation. This limited the scope for any recovery in corporate profitability and has reinforced the need for structural change.

The yen has continued to appreciate over a very long span. Against the dollar, for example, it has strengthened from around Yen 250 in the mid-1980s to Yen 105 now. The move against sterling has been equally dramatic, with sterling falling from above Yen 330 in the mid 1980s to Yen 155.

The stronger yen is hitting export competitiveness and further delaying investment plans. There has already been a significant slowdown in Japanese export growth in recent years, highlighted by news in August that the country's eight leading machine tool manufacturers had seen export orders drying up, contributing to an 18.8 per cent annual fall in orders in July. Also in August, Nissan announced it was accelerating the pace of a restructuring plan aimed at curbing costs on account of the stronger yen. One consequence is that Nissan is to reduce this fiscal year's capital spending plans from Yen 170 billion to Yen 150 billion.

In the mid 1980s, industry was in a far healthier state to cope with an appreciating yen. Now, Japanese industry is finding a strong yen harder to handle, for two main reasons: first, the speed of the yen's latest appreciation has been dramatic and caught many Japanese companies by surprise; second, unlike the late 1980s, companies' profits have not been cushioned by a booming domestic economy.

Now many companies are rescaling their operations in Japan, whilst continuing to invest heavily in overseas markets, particularly Asia but also in Europe. In some respects, Japanese companies are exporting jobs but their reward should be higher profits eventually. It should also help them overcome Japan's future labour shortage problem.

From an investment perspective, one should also realise that the huge overseas investment by Japanese companies is allowing them to be less exposed to problems in Japan and better able to take account of any upturn in the international economy – although any global recovery may be some way off.

POLITICAL FACTORS

Political stability has been an important positive factor for investment in Japan. The LDP's loss of power this summer for the first time in 38 years means that political uncertainty has increased. So far the new seven party coalition, led by Mr Hosokowa, has given the appearance of continued calm at the top. But if there were further economic difficulties, or the pace of political reform slowed, divisions could arise, prompting another election in the next year.

One of the most important factors for the economy and the stock market alike is that, when it is needed, the Government takes action to boost the economy. This was evident in August 1992 when the Government announced a Yen 10.7 trillion fiscal boost (equivalent to £43.4 billion at that time) and in April this year when an even bigger package of measures of Yen 13.2 trillion (or £75 billion) was unveiled.

The political upheaval in Japan is unlikely to alter the role the Government plays, although it may make some investors in the stock market nervous. The new coalition has already set in motion an Emergency Economic Council, which is to report on policy options to boost the economy and reduce Japan's trade surplus. This is likely to include a combination of short-term and long-term measures, involving a possible interest rate cut, another fiscal package and further deregulation, aimed at opening Japan's markets to exports. And over the next decade, Japanese Governments of any persuasion will aim to improve the 'quality of life' in Japan. This will require large-scale investment in Japan's infrastructure and social investment in education – factors which will further improve the economy's supply-side and so enhance its longer-term performance.

What does all this mean for the stock market? As one would expect there are a number of offsetting factors. Pointing to a stronger stock market is: the prospect of imminent economic recovery; the fact that Japanese companies are undertaking necessary restructuring; and that the Government is still taking a positive role in revitalising the economy.

Of these the most important factor is that corporate restructuring will allow Japanese companies to be in a very favourable position to benefit from an eventual recovery in Japanese and international demand. Deregulation and a strong yen will eventually open up all sorts of prospects for European companies hoping to export to Japan, but let no-one underestimate the extent to which Japanese companies will continue to adjust to competition.

WARNING BELLS

Still there are some warning bells that the stock market recovery will be weak by Japanese standards; expectations about profit growth are too optimistic; political problems could always emerge in 1994. Also, the world economy remains weak, which could limit the upside for equity markets outside Japan, in turn reducing sentiment on the Japanese stock market itself.

The fact that the stock market is too optimistic about immediate prospects for corporate profits is probably the biggest danger. The sharp recovery in profits that the market is discounting is unlikely to occur. Instead, profits are likely to remain sluggish. This could trigger a self-feeding fall in stock prices.

The disinflationary international environment, where world growth is weak and inflationary pressures are low, means that investors should be wary of investing in stock markets anywhere. But if you are to take a five to ten year view, the Japanese stock market has value. So, if you are going to buy Japanese shares now don't bank on selling for some time, but when you do, perhaps the profits may help you buy a Japanese Rolls-Royce made in Taiwan!

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