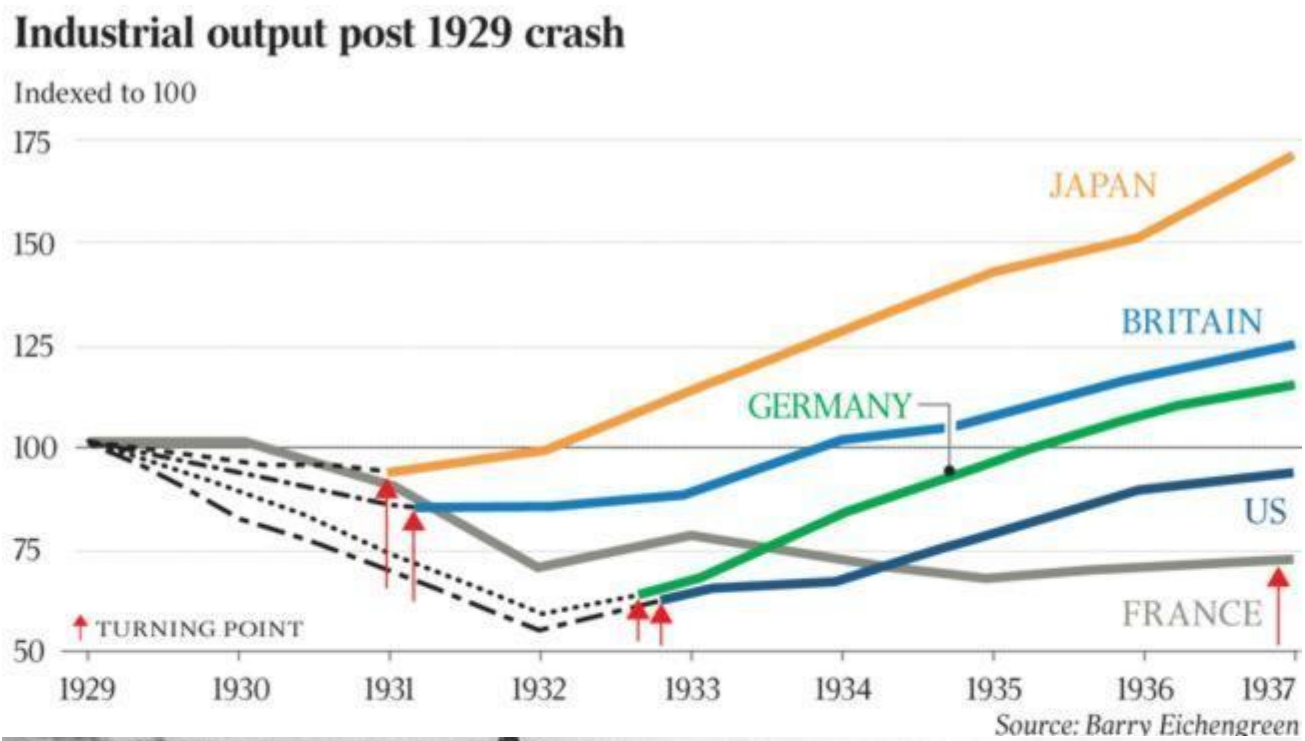
Positive thinkers stick with Abe



Japanese industry was to quick to recover after the Wall Street crash as shown by this picture of Tokyo's Ginza in 1930. Getty Images

By **Stirling Larkin**

JAPAN is an economy that both excites and scares institutional and affluent investors alike.

Many Australians remember reading something similar in 1984 and recall the Orwellian conclusion to that story, which led Australia towards the “recession we had to have”.

However, 2014 is not 1984 and 30 years on many Australian ultra -high-net-worth investors recognise the important differences that these new and exciting times bring.

The attentions of those sitting on the frontline of the investment battlefields have been squarely pegged on the plight of the Japanese Prime Minister Shinzo Abe’s reform policies, known as “Abenomics”.

They know that, without these important reforms, Australia’s future prosperity is as much under threat as those in the land of the rising sun.

No matter how much attention is redirected to the Chinese “Phoenix” story, Japan continues to be critically important to us.

Australia’s economic fabric, terms of trade and investment markets remain deeply engaged with those of Japan’s.

In particular, the stability of the Australian dollar, often considered a hot currency, relies on the relative stability of the yen both as a transactional and reserve currency.

If we think foreign exchange is volatile today, contemplate a world without the yen.

The chief executive of the Australian Industry Group, Innes Willox, who is also a Australian Standfirst advisory board member, believes that Japan is Australia’s forgotten economic and security partner. “It remains one of our top three trade partners and is a source of significant long-term investment,” Mr Willox said. “There are over 140 Japanese companies operating in Victoria alone. It is a major destination for Australian investment.

A well-crafted free-trade agreement that opens up Japan to Australian agribusiness, in particular, has enormous potential as Japan seeks to grow its economic base.”

This week's FTA, the first in 30 years and fittingly dubbed the "Cows and Cars" accord, backs this statement.

Psychologically, investing in the Japanese story is much harder for many Australians in comparison with the new Chinese opportunity. This may well be because many of us remember being burnt by the 1990-91 collapse, and to date have not yet experienced any significant downside in riding the Chinese ascent.

However, it appears, anecdotally, many Australian ultra-high-net-worth investors have been able to bury the hatchet and have returned to revisit the renewed Japanese opportunity set.

This might be because this investment community has had plenty of experience with the risk-and-loss paradigm and can now better manage their memories of past performances in juxtaposition to those of future opportunities. Even despite two lost decades, the size of Japan remains impressive.

For an economy with only the 10th largest population in the world, it continues to support the second-largest equity and bond markets globally while remaining an economic powerhouse in technology, cars, electronics, machinery and, of increasing importance, robotics.

What animates this revived opportunity set is Abenomics, in effect, reflation measures.

These new efforts are attempting to redress the stagnancy of the Japanese economy by advocating "three arrows" — fiscal stimulus, monetary easing and structural reforms.

Within this mix, monetary easing is already having a significant impact on all asset classes both in Japan and abroad.

Since December 2012, the correlations between American and Japanese unorthodox monetary policies and the value of the Australian dollar have been strong (we will discuss another time what is really influencing our currency).

Even though the two arms of government, fiscal and monetary, should remain independent, the Japanese central bank, The Bank of Japan, has been very much toeing the government's line.

UHNW investors have differentiated themselves by relying on excellent advice.

The advice provided to this community in December 2012 was that Abenomics followed the blueprint left by the Depression-era Japanese finance minister Korekiyo Takahashi. He was, bravely, the first to abandon the gold standard, in December 1931, thereby devaluing the yen overnight. This sparked the first of the modern era currency wars.

Once this was accomplished, the Japanese government then ran large fiscal deficits.

The combination of these two factors successfully restarted their industrial output and helped Japan in becoming the world's best equity market performer between 1931 and 1939.

For fear of oversimplifying history or economics, Abenomics is attempting to achieve the exact same results.

We today call this constructive inflation or reflation.

UHNW investors have therefore been advised to own Japanese assets that the Central Bank cannot print, namely, equities.

Honda Motors (7267. T), Sumitomo Mitsui Financial Group (8316. T) and Daikin Industries (6367. T) are worth keeping an eye on this year, to name but a few.

As we also know that all boats rise with the tide, Japanese listed real estate investment trusts will see momentum towards the upside coupled with increased volatility in the Corporate Bonds market.

With increasing pressure on domestic Japanese pension fund managers to reallocate away from heavy Japanese government bond allocations, the Nikkei-225 and other inflation-sensitive assets (including commodities) will see this momentum continued.

With the advent of exchange- traded funds, more Australian investment communities can now actively participate in these broader asset class themes than they could have in 1984, which is good news all around.

We discussed previously the effect reflation had on US stock markets, which saw a 30 per cent rise in 2013. Well, to highlight the scale of the Abenomics unorthodox monetary easing, the Japanese Nikkei 225 Stock Market saw a 57 per cent rise during the same year. This is phenomenal by anyone's standards.

Moreover, it was also the Nikkei's best year since 1972. This has significance in that 1972 was also the first year after the famous "Nixon Shock", when US president Richard Nixon ended the Bretton Woods link to gold. This then in effect floated the US dollar which immediately saw devaluation in the yen.

The recurring theme here is currency devaluation rewards global investors.

Everyone is watching China, but the smart money has not forgotten the importance of Japan and they have chosen their path with Abenomics.

However, if any nation in history has demonstrated its resolve to bounce back it is the Japanese, and in an ever more globalised economy there are many ways we, too, can invest in this story.

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