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Japan shows itself a better growth bet than emerging markets

By Richard Bernstein

Earnings offer promise of Tokyo's budding competitiveness

Most investors readily admit the global credit bubble is deflating, but they have not significantly altered core investments accordingly.

Many still place developed market equities as underweight relative to credit-related assets. Emerging markets, real estate, commodities, gold, hedge funds and private equity significantly outperformed stocks during the bubble because these asset classes were more sensitive to credit creation and overstimulated demand. Every major credit-related asset class has underperformed equities since the bubble began to deflate.

Investors nevertheless embrace credit-sensitive asset classes in the hope that their outperformance will return. In some cases, such as with alternative assets, investors have increased their allocations. This slow recognition of the changing leadership within the financial markets suggests equities may still be highly attractive in spite of their outperformance.

One of the biggest opportunities in the post-credit global economy is Japanese equities because Japan has the potential to increase competitiveness versus the emerging markets. Observers of Japanese stocks tend to focus on Prime Minister Shinzo Abe's policies, but such analyses might be overlooking a larger, even more favourable issue.

Overcapacity builds

Bubbles create capacity that is no longer needed when a bubble deflates, and the global credit bubble was no exception. Tremendous productive capacity was built in many emerging markets under the assumption that growth in these economies would accelerate. Those forecasts proved incorrect, and overcapacity is indeed building as the credit bubble deflates.

Overcapacity typically leads to commodity pricing and market share competition. Many recent studies have highlighted that global productivity growth is slowing. In the absence of improving productivity, countries that want to gain market share must now do so primarily by depreciating their currencies.

The strong yen made it difficult for Japanese companies to compete given the country's demographic trends and poor productivity. Japan is now engineering a weaker yen that could allow its goods to be priced competitively. From recent highs, the yen has fallen roughly 33 per cent versus the dollar and around 40 per cent versus the euro.

Japan may have a considerable advantage over the emerging markets as the fight for market share intensifies. A consequence of currency depreciation is inflation, and inflation is indeed accelerating in Japan. However, faster inflation is more welcome in Japan than it might be in other nations because the Japanese economy has suffered for many years from deflation. The average 12-month inflation rate from 1999 to mid-2013 was -0.3 per cent.

Even with the significant devaluation of the yen, Japan's inflation rate is still only 1.6 per cent. Current account deficits and a continued lack of significant inflation suggest Japan still has considerable cause and flexibility to further devalue the yen.

The emerging markets do not have the same exchange rate flexibility as Japan. The major emerging markets now have the highest rates of money growth and inflation. Inflation is at least 3 per cent in India, Indonesia, Turkey, Russia, Brazil, South Africa, and others.

Strategy working

Japan's market share strategy may be starting to work. One major Japanese company recently announced it was moving some production from the emerging markets back to Japan. Admittedly, this is one company, but a trend could easily form if the yen continues to depreciate and if civil unrest and political instability continues to dominate emerging market news.

Japanese exporters might benefit from this changing environment. However, such a simplistic strategy might not be as successful as one that attempts to avoid companies that export unfinished goods to the Asian supply chain. Companies that focus on final demand, rather than intermediate goods, might perform better.

Analysts' earnings estimates are perhaps starting to reflect Japan's budding competitive advantage. The current one-year bottom-up earnings growth projection for Japan is 17 per cent, versus 12 per cent for emerging markets as a whole, and only 8 per cent for the Bric countries.

Secular earnings forecasts are also starting to favour Japan. The bottom-up long-term projected earnings growth rate for Japan is now 15 per cent, versus 12 per cent for emerging markets and 14 per cent for Brics.

Japan is a better growth story than the emerging markets. Investors may find it beneficial to abandon the old leadership, and accept the realities of the post-bubble global economy.

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