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INVESTOR ALERT

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The Relative Irrelevance of Japan's Latest "Recession"

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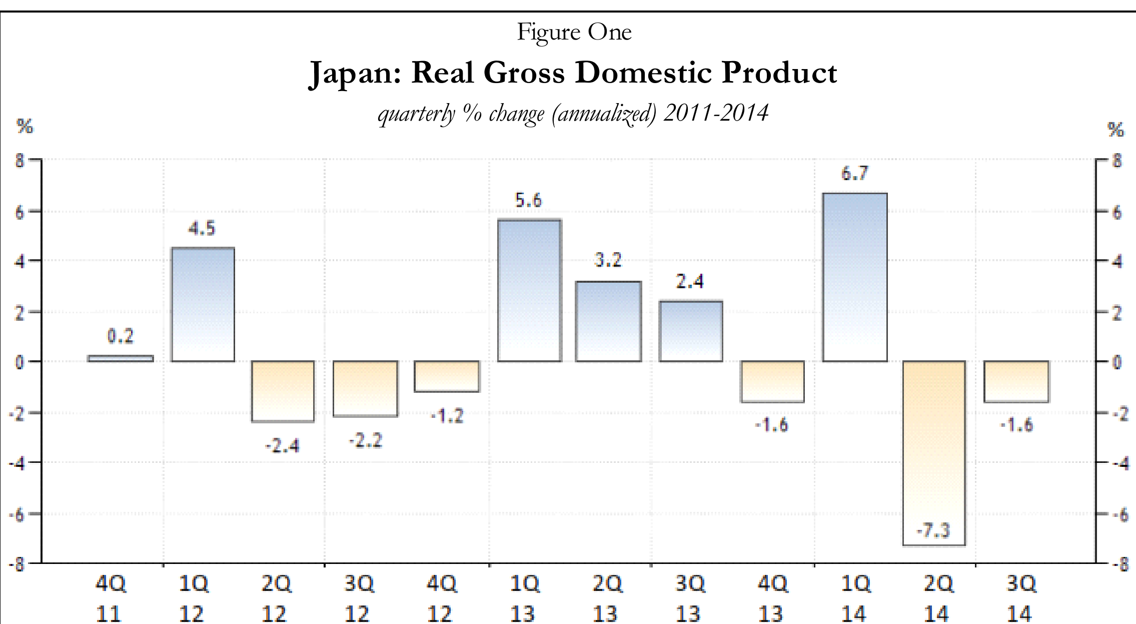
As the nearby chart (Figure One) illustrates, Japan once again has fallen into recession – officially defined as two or more consecutive quarters of declining real GDP. Japan's GDP contracted 1.6% in the third quarter just ended, after shrinking 7.3% in the previous (second) quarter. Who among global investors should care about this supposed news – and why? After all, Japan's economy also contracted in 2012 (and in 2008-2009), yet its NIKKEI equity index has increased 100% over the past three years, by 88% over the past two years, and by 15% in the past year.[1] IFI presciently forecasted NIKKEI gains of 23.1% in 2012, 7.4% in 2013, and 6.7% in 2014; also, our models now project a gain of 8-9% over the coming year.[2]



For some reason this latest GDP contraction was "unexpected" to many observers,[3] although its main cause – a cause widely-reported and well-known – was the 60% hike in Japan's value-added tax (VAT), from 5% to 8%, which took effect last April (having been approved legislatively in October 2013, along with a further scheduled hike in the VAT, to 10%, in October 2015). Japan's consumers, not being idiots, in 1Q14 anticipated the April VAT hike and spent inordinately in advance[4] (thus the 6.7% rise in GDP in Figure One), expecting to radically reduce their spending in 2Q14 (thus the 7.3% decline in GDP). Japan's GDP mostly shifted *temporally*. Even with the latest GDP decline, it's still up by +1.7% since the end of 2012, versus +4.6% for the U.S. and +0.8% for the euro-zone.

This is not to say, of course, that VAT hikes in Japan are innocuous. They aren't. Japan first adopted its VAT (at 3%) in April 1989, which, together with an inverted yield curve (thanks to the Bank of Japan) terminated a decade of economic prosperity and robust stock gains. Japan

[1] Granted, this performance is inflated by the three-year 32% plunge in the yen's dollar value; the NIKKEI in U.S. dollars has increased by 36% over the past three years, 33% over the past two years, and 2% over the past year.
[2] "*The InterMarket Forecaster*, InterMarket Forecasting, Inc., October 31, 2014, p. 10.
[3] Keiko Ujikane and Toru Fujioka, "Japan Unexpectedly Enters Recession as Abe Weighs Tax: Economy," *Bloomberg News*, November 17, 2014.
[4] See Charles Riley, "Japan GDP Growth [in 1Q)] Hits 5.9% Amid Massive Shopping Spree," *CNN.com*, May 15, 2014. Subsequently, GDP growth in 1Q14 was revised upward, from 5.9% to 6.7%.

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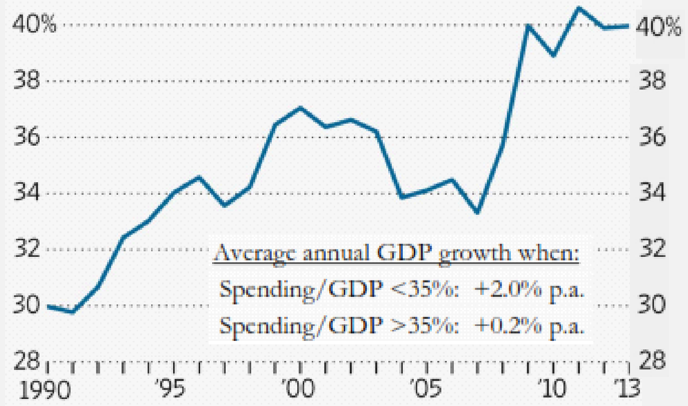
raised its VAT yet again in April 1997 (to 5%) and yet again its real GDP fluctuated wildly, quarter to quarter, while dropping a full 3% from 1Q97 to 1Q99. VAT hikes can be as deleterious to economic-financial performance in Japan as an inverted yield curve, government deficit spending, debt monetization (QE), ZIRP, and currency debasement. Yet this is precisely the policy mix adopted by Japan for much of the past quarter-century; it wasn't a response to prolonged economic stagnation but the *cause* of it.[5]

Figure Two

So-Called Keynesian "Stimulus"

Japan's Government Has Spent a Rising Share of Output, Which Has Lowered GDP Growth by 90%

Govt. Spending as % Share of GDP, 1990-2013



Japan's decades-long Keynesian policy mix was only *intensified* by Prime Minister Shinzo Abe after his election two years ago, under the guise of "stimulus" and debt reduction. He ramped up spending. The result: GDP has contracted in three quarters out of seven (43% of the time). This should not be surprising, given the history: since 1990 GDP growth in Japan has been much lower (0.2% p.a.) whenever the government has spent more than 35% of national income, compared to GDP growth (2.0% p.a.) when government has spent below that (see Figure One). Meanwhile deficit spending has boosted debt, not growth: Japan's Gross Govt. Debt/GDP ratio was 76% in 1994, 166% in 2004, 217% when Abe began in 2012, and is now 230%, on the way to 240% or so by the end of 2015.

With today's news that Japan's GDP has contracted for two straight quarters, Prime Minister Abe called for a new election – to obtain, no doubt, further popular mandates for maniacal, anti-prosperity policies, even though a new election isn't required until 2016; Abe also pledges to seek a postponement of the next VAT hike in October 2015, even though he should be looking to *cancel* that hike and to rescind the VAT hike imposed last April.

Table One

Corporate Profits & Equity Performance in Japan

Select periods: peaks and troughs in profits, 1989-2014

Yr/QTR	Corp. Profits, (100 million yen)	NIKKEI	Cumulative Changes: Profits	Cumulative Changes: NIKKEI
1989Q4	¥393,196	¥38,916		
1994Q2	¥212,431	¥20,644	-46%	-47%
2001Q2	¥397,904	¥12,975	1%	-67%
2002Q2	¥303,927	¥10,966	-23%	-72%
2007Q2	¥612,657	¥18,001	56%	-54%
2009Q3	¥236,107	¥10,322	-40%	-73%
2014Q2	¥630,055	¥15,132	60%	-61%

Sources: Japan's Ministry of Finance, Tokyo Stock Exchange

Why have Japan's equities perform so well over the past three years (as our forecasting models predicted), despite real GDP contracting 60% of the time (i.e., six out of the last ten quarters)? Equities reflect not GDP numbers but *actual profits* discounted at *interest rates* – and corporate profits in Japan have been robust since the recession of 2008-2009. Indeed, as per Table One, corporate profits increased by 167% from 3Q09 to 2Q14 (from ¥236,107 to ¥630,055), while the NIKKEI increased by only 47% (from ¥10,322 to ¥15,132). Obviously, Japan can record

[5] For previous IFI reports on Japan, see: "Japan's Persistent Push to Print Prosperity" *Investment Focus*, September 30, 2013; "Central Bankers Say Price Stability is Best, But Condemn Japan for Actually Achieving It," *The Capitalist Advisor*, July 8, 2013; "The U.S. & Japan: Money-Printing vs. Money-Making," *Investment Focus*, October 31, 2012; "Fed Policy Mirrors the Bank of Japan – and Thus Depresses T-Bond Yields," *Investment Focus*, August 20, 2010; "The Paradox of Profligacy," *The Capitalist Advisor*, July 16, 2010; "Profligate Public Finance: U.S. versus Japan," *Investment Focus*, March 16, 2010; Oil's Impact on Japanese Equities," *Investor Alert*, August 13, 2004; "A Stronger Yen is Bullish for Japan," *Investor Alert*, October 3, 2003; and "Japan Doesn't Need *More* Yen – It Needs a *More Valuable* Yen," *Investor Alert*, March 23, 2001.

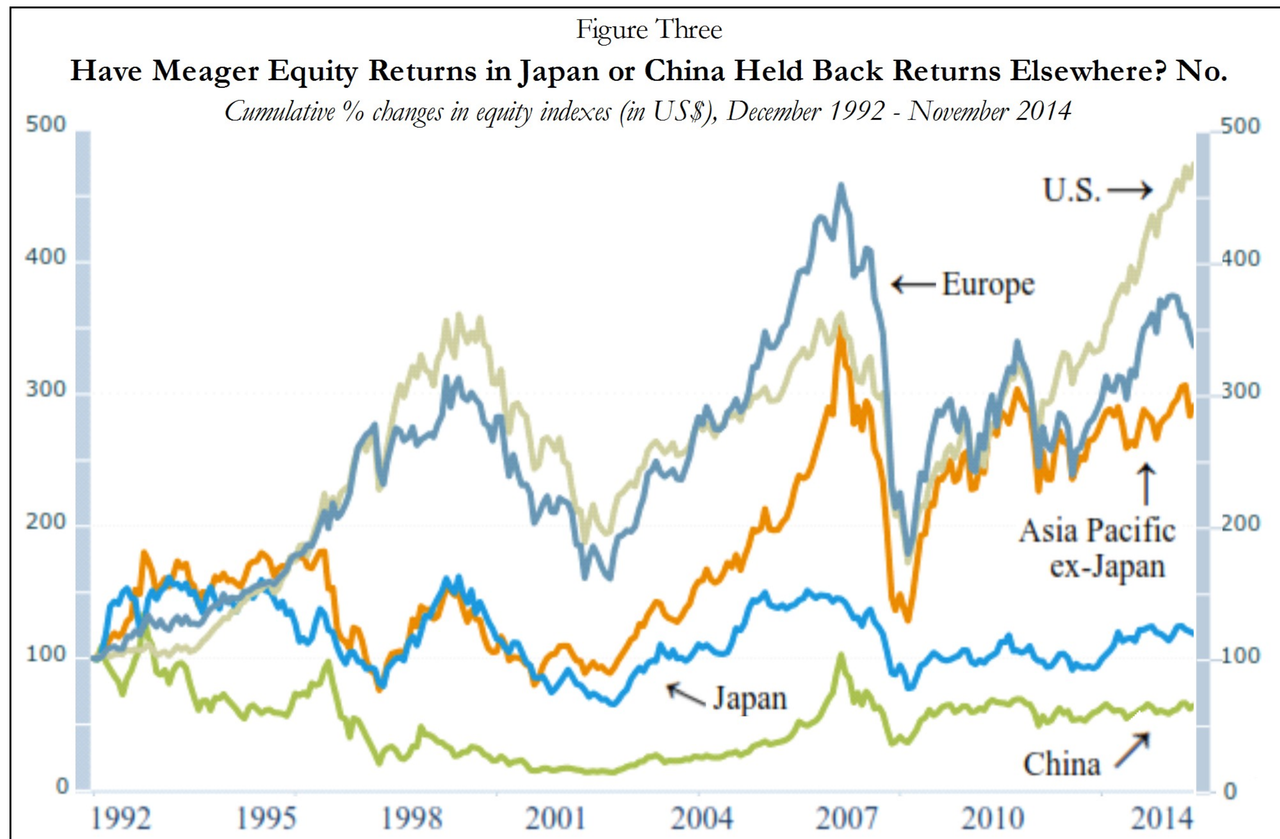


Figure Three

Have Meager Equity Returns in Japan or China Held Back Returns Elsewhere? No.

Cumulative % changes in equity indexes (in US$), December 1992 - November 2014

solid aggregate profits with the help of exporters reaping profits from better growth abroad. When the NIKKEI peaked at near ¥40,000 in late 1989 profits were ¥393,196; today profit level is higher by 60%, while the NIKKEI is lower by 61%. The NIKKEI has moved up and down with profits, but secularly, investors have assigned ever-lower valuations (multiples), in our judgment due to the deleterious effects of repeated (and failed) Keynesian policies.

Even if Japan's GDP swings were directly relevant to its equity returns, one might worry about high correlations between such returns and those on equities elsewhere, especially in the U.S. But if history is a guide, no such concern is warranted. Figure Three makes clear that since 1992 equities in the U.S., Europe, and even in the major nations of Asia *other* than Japan, have moved on their own power, by their own fundamentals. Put simply, equity moves in Japan in recent decades have exerted no discernable influence on equities abroad. Yes, equities in Japan and China have moved closely together ("moved" really means "stagnated"), but no investor in U.S., European, or non-Japan Asian equities should base his outlook on what happens (whether for good or ill) with Japan's equities.[6]

Another look at the evidence of recent decades (since 1971) reveals that, if anything, Japan tends to *follow* economic-financial developments in the U.S. Table Two (page 4) reports high and positive *contemporaneous* correlations for equity and economic performance (50-69%), but when it comes to leads and lags, there are higher correlations for the U.S. leading Japan than for Japan leading the U.S. Indeed, there are some *negative* correlations for Japan leading the U.S., which means bad performance in Japan often precedes good performance in the U.S.

That Japan tends to be far more impacted by the U.S. than the other way around, is visible in the magnitude of economic-financial responses observed at the extremes. For example, Table Two shows how Japan recorded equity declines in 16 years of the 43 years from 1971 to 2013, with an average decline of -17.3%; but during those same years U.S. equities declined by an average of only -1.7%. In contrast, the U.S. has registered equity declines in 11 years since 1971, with an average decline

[6] See also "China's Alleged Influence on U.S. Equity Performance," *Investment Focus*, InterMarket Forecasting, Inc., March 5, 2007.

of -14.6, and in those same years the decline in Japan's equities also was large, averaging -13.2%. It is likewise for industrial output: Table Two shows how Japan's output declined by an average of -6.4% p.a. in the 12 years that it declined since 1971, but in those years U.S. output declined by an average of only -0.3% p.a.; in contrast, U.S. industrial output declined by an average of -3.9% in the 10 years it declined since 1971, and in those years Japan's output declined almost as materially, by an average of -2.5% p.a.

Table Two

Japan More Often *Follows* the U.S. Than the Reverse

1971 - 2013

(annual % changes)	Correlations, U.S. & Japan: Contemporaneous	U.S. 1 Yr Ahead	Japan 1 Year Ahead
Equities:	50%	-7%	-7%
Industrial Production:	69%	5%	-6%
Real GDP:	50%	21%	8%

Equities:	
average for the 16 years when Japan decreased:	-17.3%
average for U.S., same 16 years:	- 1.7%
average for the 11 years when U.S. decreased:	-14.6%
average for Japan, same 11 years:	-13.2%
Industrial Production:	
average for the 12 years when Japan decreased:	- 6.4%
average for U.S., same 12 years:	- 0.3%
average for the 10 years when U.S. decreased:	- 3.9%
average for Japan, same 10 years:	- 2.5%
Real GDP:	
average for the 6 years when Japan decreased:	- 1.8%
average for U.S., same 16 years:	+ 1.3%
average for the 7 years when U.S. decreased:	- 0.9%
average for Japan, same 7 years:	+ 0.7%

Japan's latest "recession" reflects not so much a drop in real production but rather an opportunistic, temporal shift in consumer spending, due to the VAT hike last April. Moreover, those concerned with Japanese equities should focus not on GDP but on profits, and profit growth has been robust in recent years, and should continue to be so in the coming year. Finally, even if one doubts that Japan's equities can perform well over the coming year, that doesn't mean equities in the U.S., Europe and even non-Japan Asia can't perform well; high correlations with Japanese equities simply don't exist any longer.