JAPAN ASIA INVESTMENTS
1001 BOUL. DE MAISONNEUVE O., BUREAU 950, MONTREAL, CANADA H3A 3C8
TEL: (514) 939-2221 FAX: (309) 417-0942
e-mail: sidklein@sidklein.com
www.sidklein.com

# JAPANESE EXPLOSION!
# *(SHOCK & AWE)*

**March 31, 2003**
Nikkei Index: 7972 - (3:13 a.m. EST)

While commentaries are regularly scheduled for the first weekend of each month, apart from recent interim reports, next week's comment has been advanced to this day to coincide with the unusual events transpiring in Japan at its yearend (March 31) and the US' quarter-end.

Name change: We shall deem this author's market commentaries to have again metamorphosed through these many years. Once known for many years as Sid Klein's Daily Fax (SKDF), these letters became weekly commentary and, hence, Sid Klein's Weekly Comment (SKWC). Today, with the advent of these missives having become monthly commentaries as a result of special projects that have been alluded to over these past months, these reports will now be known as the Sid Klein Comment (SKC). While I have been writing commentaries for most of 21 years, mostly over the past 15, it may be said that the metamorphosis of the nomenclature of these letters is now complete.

## JAPAN:

## Summary:

Japan is removing debt at a staggering pace.

Simultaneously and in conjunction with this, a problem that is just as great as debt is being resolved. The Bank of Japan (BoJ) is fulfilling the oft-stated opinion of these reports that bank stock over-ownership will be entirely eliminated and, with it, crossholding unwinding, thus alleviating a bank burden as great as non-performing loans.

Typical of the Japanese psychology that creates **shock and awe** by timing dramatic measures and events to coincide with one another, paralleling the above, it seems that hundreds of billions of dollars are about to be unleashed into the world of Japanese financial assets.

SKDF and SKWC repeatedly forecast the type of "proposed and enacted changes" resulting from Big Bang of that sort that should shortly be ratified in the Diet budget that will result in massive liquidity being made available for financial assets. When expressed, those opinions were viewed as being out on a limb but the imminent changes to <u>gift and inheritance taxation</u> will bring all the wealth quite down to earth. As commented in the Report on Business ***(ROBtv)*** interview (see homepage), Japan's problems will be resolved with the "*strokes of pens*"!

Another term that SKDF and SKWC often used in reports and interviews is the "plans are in the drawer". Sophisticated investors will find it evident that the following dramatic changes, along with so many others in Japan, could not have been dreamt up overnight, particularly since Japan is a society that moves deliberately and by consensus, further evidencing the fact that officials are in harmony.

**<u>Stocks</u>:**

*Please see Banking below regarding anticipated and significant stock price bolstering measures, as well as measures that may cause hundreds of billions of dollars to flood into financial assets.

Gift and inheritance taxes are experiencing overwhelming changes that will allow people to pass on capital to children and grandchildren while still alive at very low tax rates, as long as the gift giver is 65+ and the recipient is 20+. Gift tax rates were so outrageously high (70% and now declining to 20%!) that children who themselves had children over 30 were still not receiving monies that would only become available to them until their own parents' deaths.

SKDF used to argue that the demographics of Japan were actually bullish in that a great deal of money would be put into the hands of few, due to the low birth rate, spurring luxury item purchases and investment. This too was considered radical. It is now upon us.

If requests for specifics regarding gifts and inheritance are received, SKC will delve into the details of the discussed changes next month. A few statistics follow but a conclusion that we may draw now is that the 20-40 year old generation is about to have a party!

Particularly for new housing and quality financial assets, a great deal of Japan's $11.7 trillion US (no misprint) in 0% or near-0% savings will now be liberated. This also explains the realization that is yet to be of these letters' forecasts for higher interest rates (as less capital is held on deposit and driving up the Yen further!), against a backdrop of an improving economy and higher asset prices.

The key point to bear in mind is that $5 trillion US of the $11.7 US trapped in 0% savings is in the hands of those who own the top 10% of assets. In other words, those in the tax brackets that will reap the greatest benefits of this unfolding change will make enormous sums available, as what forced them into savings is removed. I believe that this was intentional, wishing to unleash capital only once the deflation was deemed largely over. Remember, this is a “team-spirit” nation.

People old enough to have great grandchildren haven’t made any gifts to any members of the younger generations due to the prohibitive tax treatment that has existed to date. The mattresses are just waiting to relieve themselves of savings that have been around for too long and at 0% interest, no less. What happens, then, if even 5% of the $5 trillion US were liberated into the economy and investment world? **$250 billion would pour into the economy and financial markets.**

**<u>Investors, we are on the cusp of what SKDF & SKWC has written about for so long: The death of deflation in Japan and the full fledged commencement of a massive secular bull market that will skyrocket prices and sustain them for decades to come</u>!**

On top of everything else, Japan’s coffers will enjoy a boost in the near term, due to the 20% gift tax.

Separately, stock investment trusts appear to have decreased but only due to the declines in equity valuations. In fact, February marked one full year of uninterrupted monthly net stock investment trust capital inflows!

On yet another note, the time premium values of Japanese index options had completely collapsed at the recent lows. This was a point of critical importance as I had been pointing out to bankers that this was creating an extremely rare opportunity. Specifically, put options could have been purchased with a negative delta to hedge stocks with low betas but superior profit potential, in order to create an extraordinary, high profit-to-**<u>defined</u>** and limited risk scenario (go explain that to a provincially minded banker in this town). Anyway, with the Nikkei at the low, put premiums took off, forecasting the month-end’s rally, along with SKWC’s March 13th commentary.

**<u>Banking</u>:**

*<u>Debt Crash</u>*

Japan’s overwhelming inclination to pay down debt is evident across the board!

Why are interest rates low? As so often explained here, Japan hold about 40% of the planet’s savings and doesn’t need to borrow anyone’s money. Financial companies reduced liabilities last year by around 14 trillion Yen, while recording (understandably) a net surplus of around 15 trillion Yen.

Even when examining numbers that exclude the financial sector, the statistics are mind boggling, as Japan's national will is applied to debt resolution. Total public debt increased by around 40 trillion Yen, while non-financial debt crashed a record amount, a bit over 30 trillion Yen! The economy's net debt increase was 7-8 trillion Yen, which, as a percent of GDP, was the least in about **35** years.

*Bank of Japan share repurchases*

SKC has repeatedly forecast that the BoJ will expand its purchases of stocks from the banks that presently hold about **7 trillion** Yen too much, in order to be in line with new legislation that forces banks to not own more public equity than their Tier 1 capital by Sep. 1 2004. The BoJ is presently committed to buying **2 trillion** Yen of shares (the BoJ is also prohibited from putting back onto the market any of the shares that it purchases before Sep. 2008, though it is more likely that it would hold such stock for about 10 years or more, anyway). SKWC consistently wrote that it would be self-defeating to signal in advance its full purchase plan (duh). In any event, this stock over-ownership problem will go away. Period.

Guess what?

The new BoJ governor, Toshihiko Fukui, in his first official address to the Diet said that additional purchases later cannot be ruled out (they have to finish buying the 1st 2 trillion Yen of stock). If that weren't enough, he added that the government could pitch in and make purchases from its Bank Stock Buying Institution.

**Following this, to confirm what has been forecasted in these pages and which SKC further confirms it fully expects will continue, the BoJ indeed announced, on March 25th, that it is already expanding its stock purchase programme commitment by another 1 trillion Yen!** The central bank simultaneously announced that it would go on making abundant cash available on the money markets to spur borrowing.

Perhaps most telling is the "apparent" change of heart by the BoJ and the government (finance Ministry) in terms of how they are going to proceed, namely that they are going to cooperate. On March 25th, the New York Times quoted a Lehman Brothers economist, Paul Sheard, as saying, "Instead of the mutual finger-pointing, they are saying, 'Let's get on with it'….The message now is that this central bank will be proactive, and we can expect more to come." The "change" is more apparent than real, as SKWC always warned that these entities are fully united, their policies coordinated and well-planned in advance. Note the following from the March 2, 2003 letter:

***"SKWC has always been of the view that one should always expect action in Tokyo to be coordinated between politicians, monetary authorities and bureaucrats, despite the fact that the show for Westerners may give the contrary impression. Now, the Japanese are coming out and showing it as the market may be preparing to absolutely erupt, as evidenced by the risk averse DDOVS. The "gang" is openly expressing the need and willingness to broaden fiscal and monetary stimulus.***

***"Along with BoJ bank share repurchase programmes, as so often forecast and analyzed as positive by SKWC (despite the contrary and foolish analysis of foreigners), the government appears prepared now to broaden tax cuts and the social safety net, further pushing Japan out of deflation, something from which it is closer to being rescued, much as foreigners don't seem to know it, except, of course, for smart institutional money that is successfully finding safe haven in Japan, as witnessed by the reversal of foreign fund flows".***

On a lesser note, an interesting February statistic is that the number of liabilities of 10 million Yen or more fell for the $6^{th}$ month in a row but liabilities were up for the $2^{nd}$ consecutive month, which is also the next-to-last month of the Japanese fiscal year. Taken together, is this another sign of an improving situation as the number of difficulties diminishes, while write-offs accelerate?

**Economy:**

Going forward, employers will be saddled with higher social security costs. This makes sense given Japan's aging population. It is also true that companies will be enjoying greater R&D tax deductions. On balance, the 2 measures may result in a net revenue increase for the government. The R&D treatment change is also sensible.

Firstly, it will most positively impact on those focusing more heavily on R&D, which these days are, most of all, drug and technology companies. The former is very much related to the theme of Japan's aging population and therefore are expected to make critical contributions to this evolving theme. Secondly, technology, however battered of late in terms of valuations, still represents the "new era of innovation" (in Kondratieffian terms).

Therefore, apart from the fact that the government is proceeding in a fiscally conservative manner and notwithstanding the fact the more R&D focused companies are set to make critical humane and technological contributions (including auto companies), longer term, the combination of the preceding 2 measures ought to result in greater government revenues and an expanded economy. Recent comments forecast greater fiscal stimulus and we're presently seeing creative changes that certainly should result in win-win situations.

It has been pointed out in these pages that cash flow measurements are in constructive valuation territory in Japan, very much so compared to the US. Indeed, cash flow has been positive since 2000 but this has flown in the face of difficult economic and earnings environments since 2001. In fact, the economic backdrop includes positive free cash flow, debt repayment, increased and increasing (!) share buybacks (a Marty Zweig indicator favourite), cash flow from investments and capital expenditures generally being maintained within operating cash flow, thus making borrowing unnecessary. Certainly, these positives are, generally speaking, far more so the case with **DDOVS**.

On the employment front, February statistics reflected the highest job offers-to-applicants ratio in a year, while the unemployment rate itself has now pulled back to 5.2 from 5.5.

## **CONCLUSION**:

With each passing month, the marketplace in Japan experiences yet another major bullish event as per SKC forecasts and analyses. These events have driven Domestic Demand Oriented Value Stocks higher, while the rest of the world, including the Nikkei, has languished (thus far). We suspect strongly that the strength of recent months in **DDOVS** will have paled in comparison next to the power their performances will yet illustrate forthwith.

Japan will prove its counter-cyclical aspect with a vengeance such as the investment world has never before seen, as the country harmoniously, logically and in coordinated fashion resolves its debt burdens, while unleashing unimaginable and pent up buying power into its investment world.

Sid Klein