



Elstree

**Welcome to
planet Japan.**

- Japan is another planet for gaijin credit analysts: defaults are about half the rest of the world and credit margins are much lower than global equivalents.
- We've always been intrigued by Japan financial dynamics and we have suspicions that the rest of the world is heading towards a 'decaf soy latte' version of Japan (or the Larry Summers term for it: "secular stagnation")
- If that trend occurs, there will be low defaults, big falls in credit margins and very disappointing equity market outcomes.

Defaults; try explaining that S&P and Moodys

You won't find many kind words said about the Ratings Agencies, but we think they are very good at assessing corporate ratings, not structured products and not sovereign debt, not insurers, just plain old operating companies. One of the chief tenets of their offering is that ratings are cross consistent i.e a BBB rating indicates a certain level of credit risk across the cycle, regardless of industry, size, domicile of company, time etc etc. For example, all ratings of Australian entities have to get run through New York where the experts will decide whether Wesfarmers A- credit rating is comparable to Alfa Laval (a Swedish industrial machinery manufacturer). And by and large it is true. Long term European defaults and downgrades are consistent with US defaults and downgrades and we are getting to be able to say the same about Australia. So the point is if you hold, say BBB securities, you should get similar default experiences.

Global and Japanese default experiences differ

The charts below shows the default experience by term and credit rating for Japan compared to the rest of the world. We've taken global and Japanese specific default data from both S&P and Moodys and averaged them. The Japanese data has less data points than the global data (from 1970 and 1990 respectively). The first chart (chart 1) shows the cumulative default rate experience for Japan and the world by credit rating and term, while the second chart (Chart 2) highlights the difference between the global default experience and the Japan default experience. The way to read the chart is that the horizontal axis is the holding period and the vertical axis shows the average cumulative default over that period (i.e) if you held a portfolio of "BBB" rated bonds for 5 years, your cumulative default rate is just under 2% for global "BBB"s compared with Japan's "BBB" default experience of only 1.25%

Chart 1

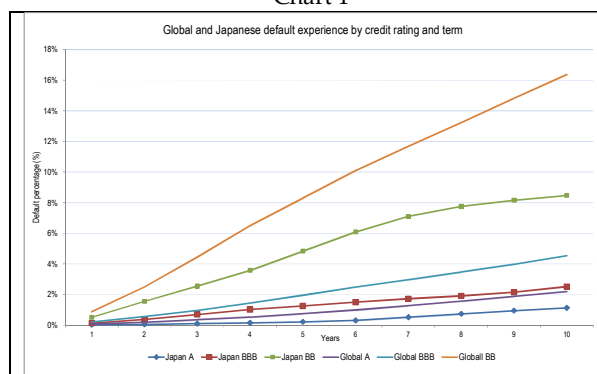
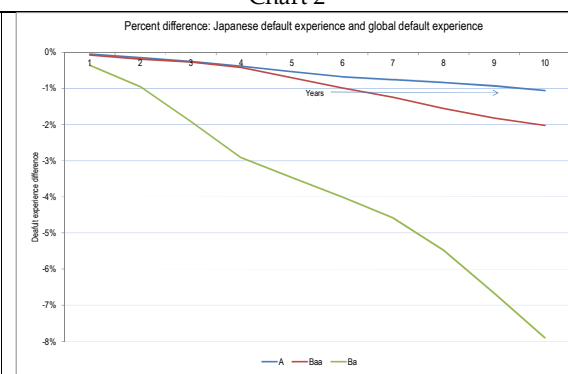


Chart 2

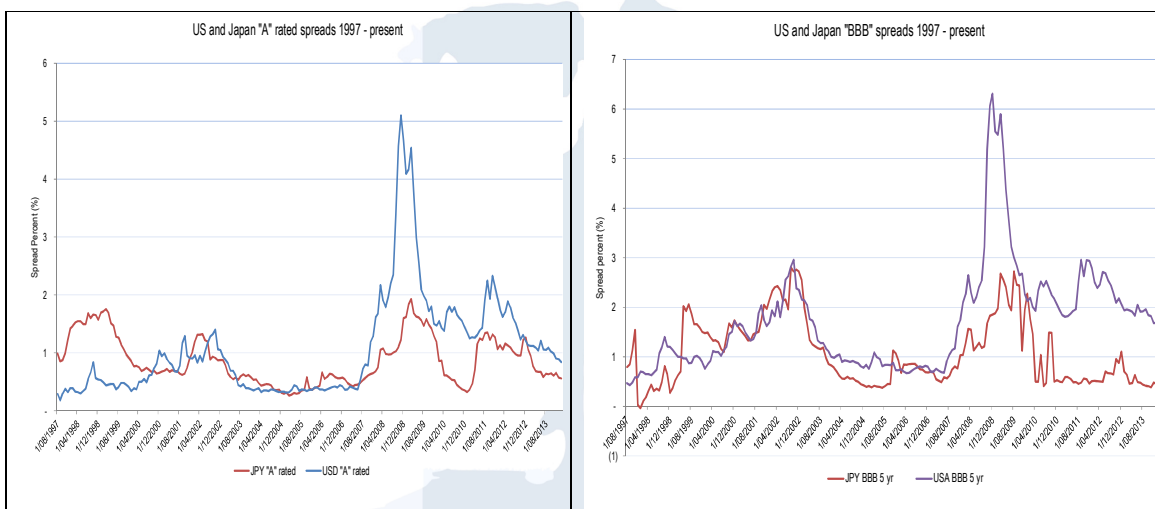


What do the charts tell me?

- Japanese defaults are always lower than their similarly rated global peers over all terms and all credit ratings.
- The average is 48% lower than the global peer group. This is a material difference.
- There is something in the air in Japan that makes Japanese companies less risky.
- The Ratings Agencies can't explain it. They are conspicuously silent.

Margins

Credit investors receive a margin over risk free debt to compensate for both default and all the other risks. Theoretically, if Japanese companies default less, margins should be a little lower and less volatile than the rest of the world. The charts below shows margins over swap for "A" and "BBB" rated corporate debt for both Japan and the US



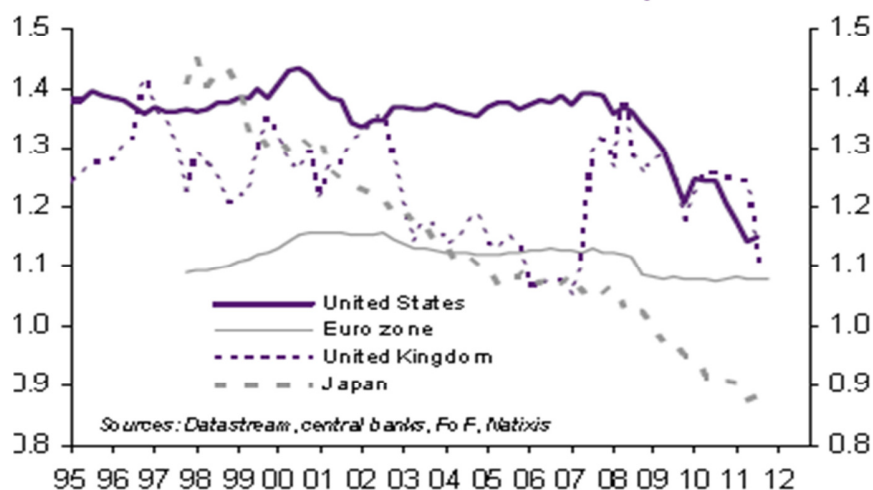
More than lower default risk going on here

Over the past decade, Japanese margins are not only lower by more than the reduced default risk component, but they are much less volatile. Variations of this magnitude get everybody scratching their heads looking for answers; no one can put their hand on their heart and say they are super confident about the reasons. We'll have a go, but with the same caveat.

Japanese Banks don't lend anymore

The proximate cause is that Japanese banks haven't been lending in the traditional sense: they have been buying securities instead. The Loan to Deposit ratio has fallen over the past decade and sits around 80%. Banks have excess deposits. The chart below shows the development of loan/deposit ratios for the major economies and it shows the ratio falling everywhere after the GFC, but with the growth economies still experiencing loan demand higher or greater than deposit supply. Japan is the opposite.

Chart 1A
Ratio: Total bank loans/total bank deposits



I'm a Japanese banker with too many deposits; what do I do?

Japanese bankers face a conundrum with their excess deposits. They can place surplus cash with the BOJ and receive nothing, or they can buy government and corporate bonds at higher yields, or they can lend offshore, or they can get creative and imitate what JP Morgan did with their excess deposits: start up an internal investment office to bet on futures and other investments. While there has been some movement to overseas lending, the easy solution is to simply buy government and corporate bonds and that is exactly what is happening. Some regional Japanese banks have balance sheets with 30% holdings in government bonds. This extra layer of demand helps to explain why corporate paper is always well bid and the buy to hold strategy means that there is less volatility during market dislocations. You can see this in the muted reaction in Japanese yields during the GFC.

Why has the loan to deposit ratio fallen?

This is where it gets interesting, but more complex and less certain, because we think that it revolves around a lack of investment and the whole world is now following Japan's experience of insufficient investment. The chart below shows the savings investment gap for the 3 largest G7 economies (and Australia). When the series is above zero it indicates that investment is higher than savings and in general, the banking system will make loans rather than buy lower yielding bonds and corporate securities.

Investment savings gap selected economies - 1990 to present



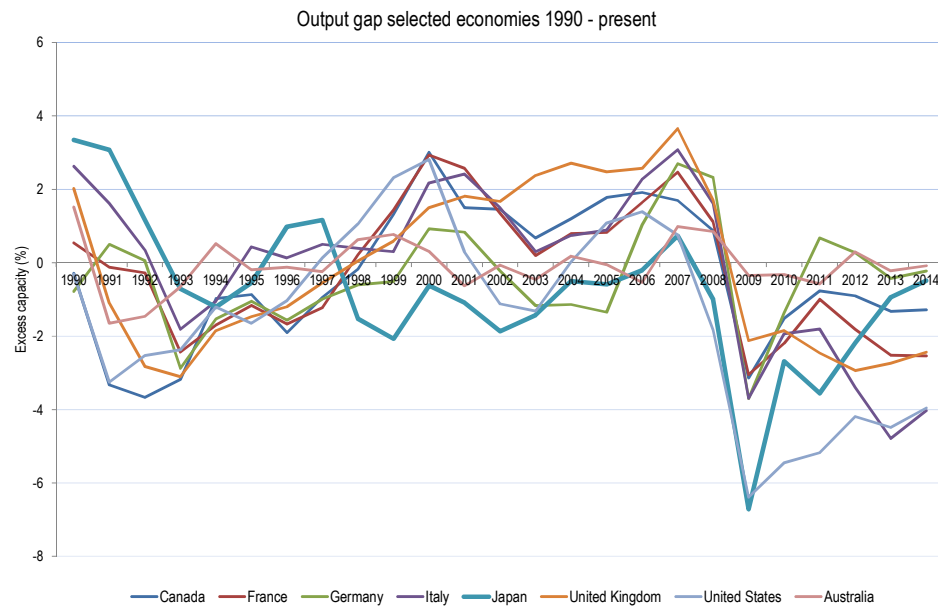
Planet Japan, the outlier

It's a normal that a growing economy does more investing than saving and that's been the case for most economies, albeit the gap has narrowed since the GFC. It's more of a surprise to note that Japan has been doing less investing than saving since the 1990s. In very simplistic terms that is showing up in high bank deposits and low investment yields. There are numbers of reasons why this may not be fully repeated in the rest of the world. Japan has a shrinking and rapidly aging population (which discourages investment and encourages savings), an overvalued currency (which discourages investment), and prior overinvestment (which discourages investment) etc, but there are some parallels with what is happening in the rest of the world.

More and more signs pointing to secular stagnation

The chart below shows the output gap of some of the largest economies. The output gap is a dodgy theoretical calculation of the difference between actual GDP and potential GDP. It should be taken with many grains of salt, but the trends are undeniable. During the pre GFC overconfidence bubble, there was a positive output gap as economies grew above their capacity. The collapse in GDP experienced during the GFC saw the emergence of excess capacity and in general, economies are still operating with more excess capacity than they have at the end of recessions and we are now almost 5 years after the end of the last one. Investors will not invest much if there is too much excess capacity. Anecdotal evidence abounds. The global car industry has capacity to make c110m cars a year and demand is around c60m. Australian bank lending to business (i.e for business investment) has been running at less than GDP levels for the past 5 years. US capital goods orders have only just surpassed 2001 levels despite 13 years of economic growth and inflation. It doesn't look like we are going to see an investment boom anytime soon. Of course, savings can fall, which has the same effect on security pricing as increased investment, but that doesn't seem likely either.

So what happens to asset returns in low growth environments?

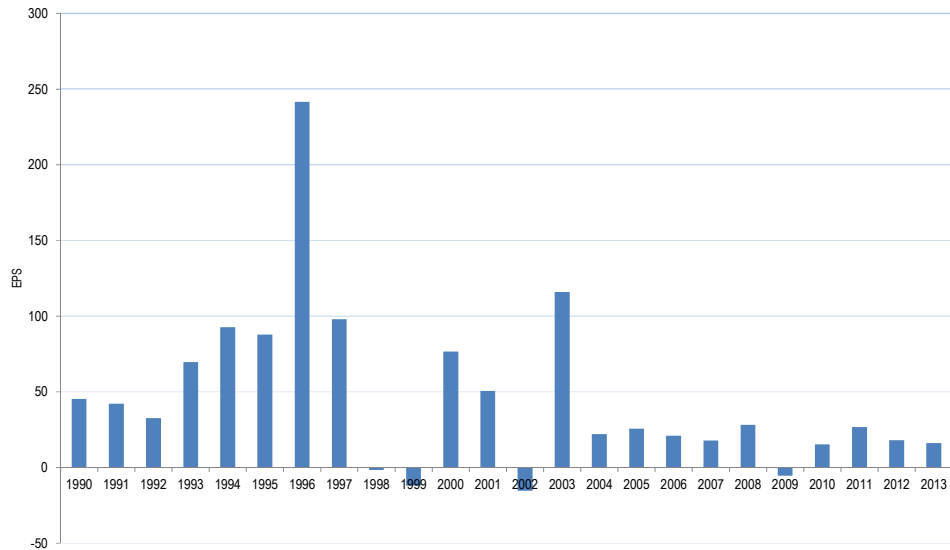


We really have no idea what will happen 10 years into the future, but if we do get a continuation of secular stagnation, we think we'll see the following influences.

- Nominal cash: rates stay low. Real cash rates stay compressed until investment occurs.
- Bonds; nominal rates stay low. Real rates stay low and the yield curve flattens
- Equities: prices increased by lower discount rates (lower cash and bond rates) and lower real return expectations, but reduced by lower growth. Which one ends up dominating is anyone's guess.

To send shivers down equity investor's spines if we do go full Japan, we've charted the Japanese market's earnings per share (EPS) and equity yield (which is the inverse of the PE) since 1990.

Japan Equity Market: earnings per share (EPS)



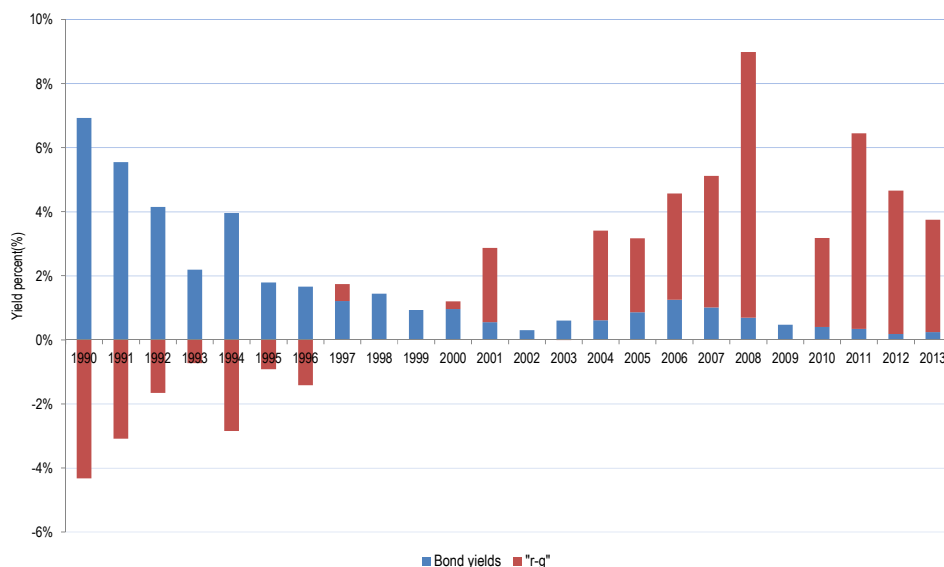
Japanese EPS data enough to put you off buying equities

Caveat; aggregate earnings data is hard to find and it looks like there are some problems with its relation to “underlying” earnings. However, even considering the problems, the earnings per share data would be enough to put you off investing in shares; it’s negative around 15% of the time and highly volatile at other times. The volatility has fed into the yield investors require and it has changed from being below the bond yield (i.e investors think it’s not that risky or there is EPS growth coming through) to being strongly positive (it’s risky or low or negative growth is expected) and above the bond yield. Australia traditionally operates with equity yields lower than bond yields.

Breaking down the equity yield

In the chart below we’ve broken the equity yield into the two parts: the bond yield and the “r-g” factor which measures the equity premium investors (the “r”) need versus the growth (“the “g”) they expect. The red bars in the chart are the “r-g” factor and demonstrate what happens when you get negative or volatile earnings; markets become very cheap compared to bonds. The blue bars are the bond yields. The equity yield is the sum of the 2 parts.

Equity yield (inverse of PE) Japan 1990 - present



Implications

Should the global economy remain in its low investment mode, margins of all credit assets have the propensity to contract. Currently, credit spreads are around their long term average margin but against a backdrop of zero interest rates, sluggish output growth, excess capacity and low investment they have scope to narrow still further. The only issue is that this environment typically co-exists with low inflation and that is bad for financial institutions, both from the enormous inbuilt leverage that they operate with and the higher bad debts that come from stable or falling asset prices.

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