CAPITALIST EXPLOITS

INSIDER

Providing the world's Best Investment Ideas
from the World's Sharpest Investors.

16 April 2017

JAPANESE FINANCIALS: A BULL MARKET ON THE HORIZON

We believe that a bull market in Japanese equities and in particular Japanese financials is an ever increasing probability with limited downside, and investors positioning now stand to reap substantial rewards over the coming years.

Trade Thesis

Ask yourself this:

Who out there is even considering the possibility or plausibility that inflation and interest rates in Japan will do anything but continue their death spiral into the next decade and beyond?

No one in the world is considering the possibility of inflation and interest rates in Japan rising over the coming months. I've spilled a lot of digital ink discussing the changes that are taking place across the world. These changes will begin to impact global capital flows, central bank policies, and subsequently asset classes.

And this is where Japan is unique, largely because if we were to pick the poster child of central bank policies driving interest rates lower we land squarely on the doormat of the BOJ.

And yet early evidence suggests that inflation has begun to rise in the land of the rising sun. **Rising yields will be an accelerator to Japanese bank earnings.** After all that has been thrown at Japanese banks, it's almost unbelievable that they are today as profitable as US banks but trading at half the valuation. A depreciation in the Japanese yen, which we believe inevitable, is likely to further accelerate inflation in Japan. A long exposure to Japanese banks may well be one of the best ways to position for higher rates and inflation globally as well as a weakening yen.

In essence, we have a number of catalysts which are working in our favour all the while the cost of entry is very low. This means that if we're wrong, our downside is limited. These are the perfect sorts of setups that we look for.

Discussion

While no one talks of Japanese stocks these days, less than no one talks about Japanese banks. And it is precisely the areas where no one looks or has completely given up hope on that so often offer us the most upside.

Below is the long-term chart of the Topix Index. Given that it is at exactly the same level now as it was back in 1991, it is not surprising that few bother to talk about the long-term prospects of the Japanese stock market but great investing is actually more about limiting risk than it is about making huge returns.

The risks in currently owning Japanese equities are substantially lower than owning equities in many other global markets and, ironically, the upside is arguably higher.

Now, if you thought that the general Japanese stock market is a lost cause then look at what has happened to Japanese banks.

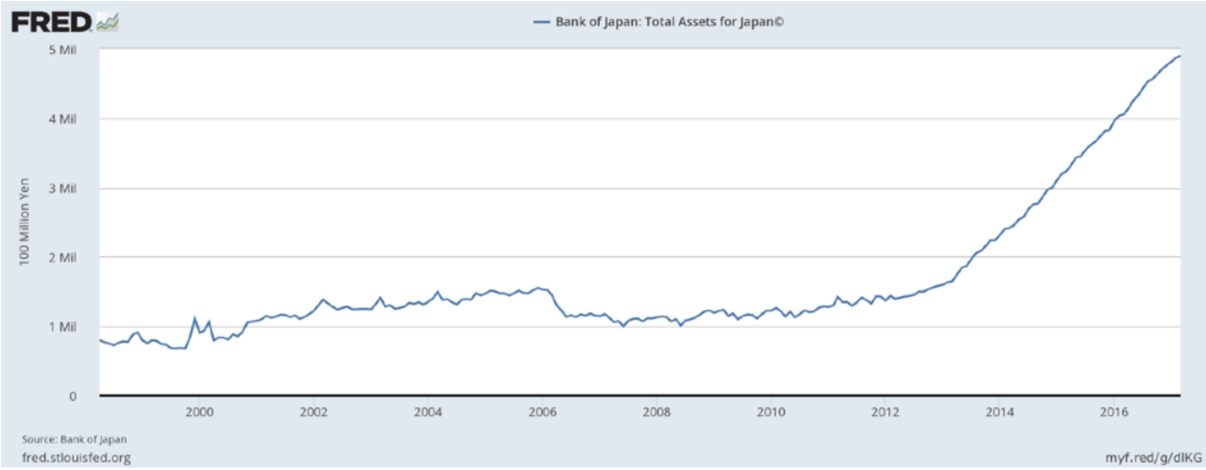
They are more or less at the same level as what they were in 1984 - about 33 years ago. Granted, this isn't including dividends.

Needless to say that Japanese banks have underperformed the Japanese stock market "dramatically" over the last few decades (about 75% since 1987).

Take a look at this:

Relative performance of Topix Banks Index and Topix Index

So we have a situation where no investor who has bought Japanese banks in the last 30 odd years has made money holding them and much of the answer to why this is the case lies in what you see here with the BOJ assets.



It's no coincidence that the BOJ asset base has exploded at the same time that financials have been hammered.

Financial institutions have an incredibly hard time making money when the cost of capital approaches or indeed falls below zero.

The BOJ, for their part, have effectively been systematically destroying the ability for Japanese financials and banks in particular to turn a profit.

With the completely unprecedented coordination between global central banks forcing rates lower and lower this is the outcome. The question you have to ask yourself is this: as the world moves rapidly towards a swathe of populist and nationalist leaders, how will this level of global coordination be kept in place?

The answer is that the period we've just been through where central banks have coordinated monetary policy and where governments have all come together in a show of unity really is a complete anomaly in the timeline of history. It is, in fact, something any sane investor would bet against taking place, and yet we have a situation where the entire world is betting with it. We believe this is foolish but are glad as it provides us with the asymmetry we're in search of.

Valuations

Let's now take a look at the valuations of Japanese banks. I picked the "big 5" Japanese banks (Mitsubishi, Sumitomo, Mizuho, Sumitomo, and Resona) and averaged the P/E (8.6x), P/Book (0.61x), ROE (7.82%), and dividend yield (3.4%). These valuations are very, very cheap.

But here is the "silver lining"...

After all the headwinds that Japanese banks have faced over the last 7 years or so, particularly over the last few with rates being essentially zero, they have managed to remain profitable with an average ROE just shy of 8%.

Now, let's hop the ditch and look at the top 5 US Banks whose average ROE is about 8.5%. And yet they have an average P/E of 14.42x and P/Book of 1.21x.

Japanese banks sport NPLs (non-performing loans) at historical lows around 0.8% to 1.0% and liquidity is backed by ample domestic deposits with the loan-to-deposit ratio around 66%.

So Japanese banks are just as profitable as their US counterparts but trade at about a 40-50% discount. And I don't think US Banks were expensive in the first place.

So when you consider the incredible headwinds Japanese banks have faced (low or zero rates) we ask ourselves the question: what if the very thing that has been a headwind to Japanese banks (low or zero rates) actually became a tailwind? What would happen to ROEs (profitability) in such an environment?

OK, let's "angle" things in another way.

Let's say you had been short Japanese banks for the last 7 years. Wouldn't you be wondering if Japanese banks have managed to register ROEs of 8% against a "very difficult" trading environment, then what is it going to take for those ROEs to fall?

It is difficult to imagine a multiple compression (the average P/Book falling if ROEs don't fall) given how low the average P/Book ratio currently is (0.61x). So if it is going to be very difficult to make money on the short side of Japanese banks, then it should be "easy" to make money on the long side with even just a marginal change.

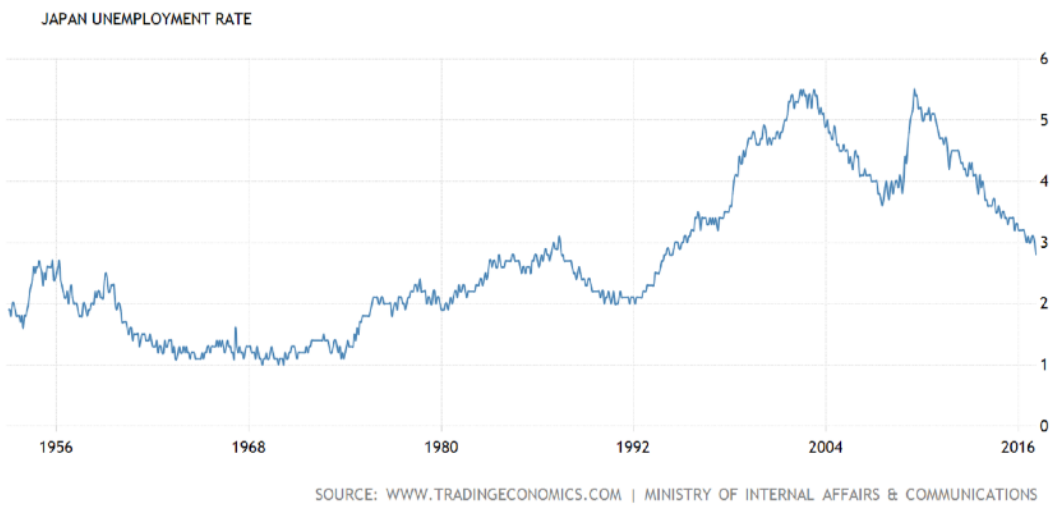
Before we go any further, it would seem that even if the status quo prevails for the next 5 years (yields and inflation in Japan remains unchanged), you will do OK by being long Japanese banks and it is difficult to see any material downside.

Now, let's explore the world of crazy as considered by the broad investing world, which is to say the idea of headwinds becoming tailwinds (i.e. yields and inflation rising).

I think it is fair to assume that everyone has given up on Japan and the Japanese government's aspirations for inflation. I can't blame the average investor for thinking that inflation in Japan is a delusional fantasy. Listening to Japanese policy makers reiterating their optimism about defeating deflation is like watching "reality TV" of a lunatic asylum.

As time goes by they continue to miss their inflation target yet again and then simply "re-engineer" their forecasts so that inflation remains just on the horizon. It is almost like the "boy who cried wolf" and investors are muttering *"fool me once and you won't make me a fool twice".*

But the Japanese economy is a lot closer to full employment than what the crowd seems to be factoring in. Check out the unemployment rate in Japan - falling and with no "end in sight":



My take on the chart above is that **Japan is quickly running out of spare workers.** On the one hand, we have near full employment and on the other, we have a demographic situation where labour is being extracted from the work force (retirement).

I know one should think twice about extrapolating the past into the future but should this "trend" continue then sooner or later the scarcity of labour in Japan will lead to wage rate rises and on the back of that rises in both inflation and interest rates. This seems like Economics 101 to me but it seems investors are looking the other way.

The other looming possibility that we haven't even discussed is the market stepping away from the Japanese bond market, which would be, to put it mildly, interesting. Where would the capital go? Equities.

Now, here is an interesting observation (if you're into this sort of thing). It seems to me that things were improving in Japan from early 2003 onwards and it was only the GFC that interrupted this substantially but briefly (for 2 years from early 2008 - late 2009).

We could look at things from another perspective - the ratio of job openings to applicants. Take a look at this:

And sentiment indicators would suggest Japan is booming:

Japan's Households Are Most Upbeat Since 1998

by Toru Fujioka
7 April 2017, 5:03 pm AEST

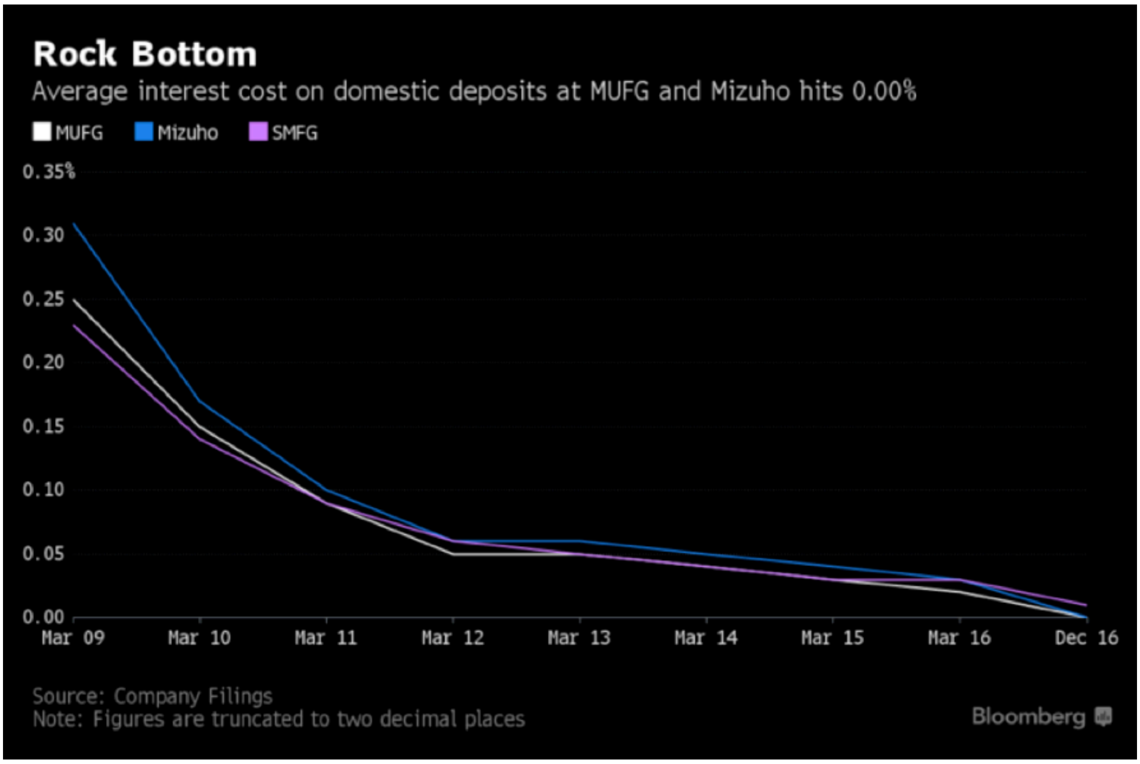
→ Views on livelihood, income, employment improved: BOJ survey
→ Households inflation expectations were unchanged, survey finds

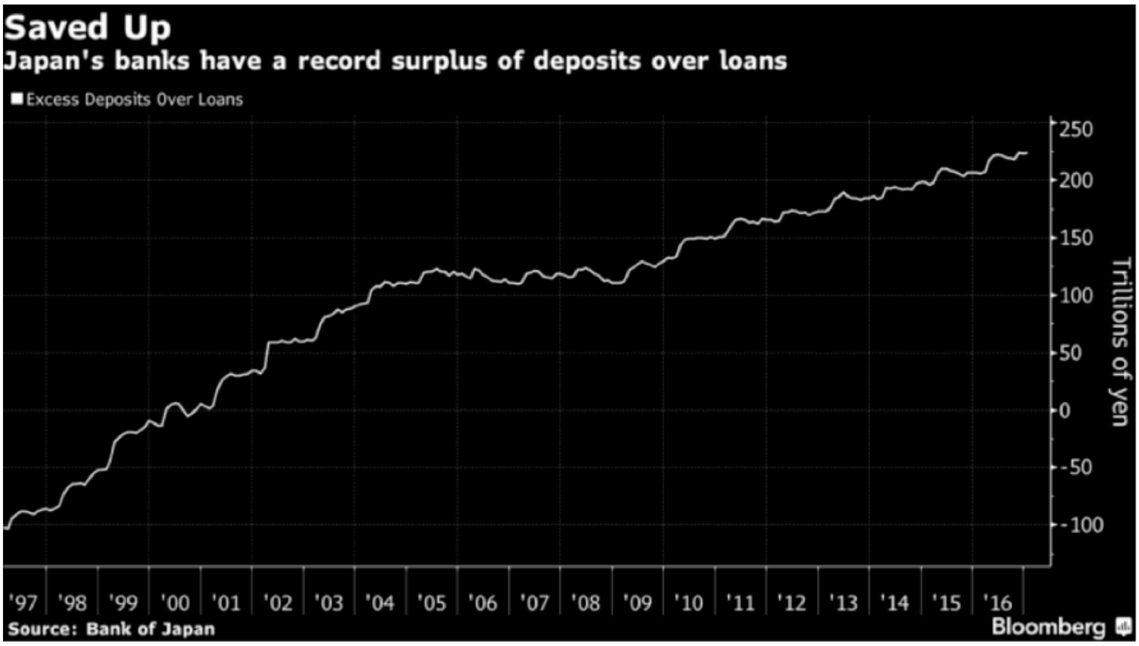
The labour market really does seem to be heating up. Sooner or later, employers will likely find themselves in a bidding war to attract labour, if this isn't already happening:

Japan raise for part-time work shows wage pressure

Published: Mar 15, 2017 12:21 p.m. ET

Positioning for inflation in Japan is arguably THE most lonely trade on the planet. In Japan deposit rates are essentially zero yet consumers continue to save and dare not spend. Decades of central bank policies driving rates through the floor have that effect.





None of this I'm showing you is new in the charts above, but think of it from this angle: positioning for deflation or at least no inflation in Japan continues to get more and more crowded.

If, or dare I say, when inflation in Japan starts to rise, there will be a simply colossal amount of capital looking for a home in "inflation hedging assets". If my experience is anything to go by, crises happen to assets that are in a crowded state, not when so few own them.

And here is another dimension to the inflation "delusion" in Japan. If wages pick up enough, this will spur inflation and that will mean a downward pressure on the JPY.

This will likely lead to a "self feedback loop" whereby a depreciation in the JPY will lead to exports picking up which will lead to the economy heating up some more and inflation expectations rising further, culminating in further depreciation in the JPY.

So how best to position in Japanese banks?

We're making a "sectorial call" that one should give strong consideration to buying the Japanese banking sector rather than any specific Japanese banks to buy.

The Trade

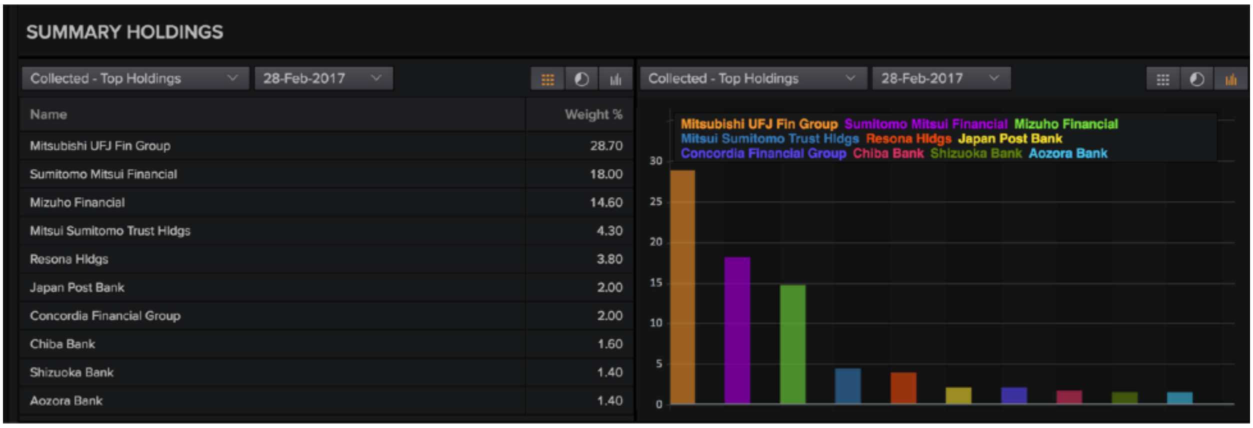
Buy Mitsubishi UFJ (MTU on the NYSE) and for those who can trade on the Tokyo Stock Exchange the Nomura TOPIX Bank ETF (1615).

For those who only have access to trade US listed securities I think the best trade will be a stock position on Mitsubishi UFJ's ADR (MTU) trading on the NYSE. Mitsubishi UFJ is the largest Japanese bank and accounts for about 30% of the Japanese Banking sector.

I have overlaid Mitsubishi UFJ (8306) with the Nomura TOPIX Banks ETF (1615) and indexed the time series to 100 as of 2006. It is hardly surprising that by buying Mitsubishi UFJ you are essentially buying the Japanese banking sector.

If you have access to trade on the Tokyo Stock Exchange, then you could buy the Nomura TOPIX Banks ETF (1615), which is the equivalent to buying URA to get exposure to uranium stocks or SEA for shipping on the NYSE.

Here is a summary of holdings of the ETF:



SUMMARY HOLDINGS

Collected - Top Holdings 28-Feb-2017

Name	Weight %
Mitsubishi UFJ Fin Group	28.70
Sumitomo Mitsui Financial	18.00
Mizuho Financial	14.60
Mitsui Sumitomo Trust Hldgs	4.30
Resona Hldgs	3.80
Japan Post Bank	2.00
Concordia Financial Group	2.00
Chiba Bank	1.60
Shizuoka Bank	1.40
Aozora Bank	1.40

There are options that trade on MTU. Unfortunately, while they're relatively inexpensive, they only go out to December 2017, which isn't great.

However, for those who want a "geared" exposure to MTU then buying an ITM (in the money) option for December 2017 expiry will do the trick. Currently MTU trades for 6.0. You can get the December 2017 strike call for 1.20. So if you were to buy 10 contracts it would cost you $1,200 but it would essentially give you $6,000 exposure to MTU (or about a 5:1 gearing).

Exposure: Up to 5% of risk capital (particularly if you are buying the Nomura Bank ETF).

When to Close the Trade: When there is a chorus of investors talking about the virtues of a long-term investment in Japanese banks. I think we're many years away from this so when to "take profit" isn't currently worth worrying about.

What about a stop loss? We would only quit the trade if we believed that Japan would be locked into a deflationary environment for the next 5-10 years. Clearly, this isn't our thinking (quite the opposite). So our "stop loss" or "take profit" point isn't based on the behavior of the stock prices of the assets.

Disclosure: *We own the Topix Bank ETF in the Asymmetric Opportunities Fund at an average price of JPY182.58 and will notify you should this change.*

Sincerely,

Chris MacIntosh

Founder & Editor In Chief, Capitalist Exploits Independent Investment Research
Founder & Managing Partner, Asymmetric Opportunities Fund

Unauthorized Disclosure Prohibited

The information provided in this publication is private, privileged, and confidential information, licensed for your sole individual use as a subscriber. Capitalist Exploits reserves all rights to the content of this publication and related materials. Forwarding, copying, disseminating, or distributing this report in whole or in part, including substantial quotation of any portion of the publication or any release of specific investment recommendations, is strictly prohibited.

Participation in such activity is grounds for immediate termination of all subscriptions of registered subscribers deemed to be involved at Capitalist Exploits. Capitalist Exploits reserves the right to monitor the use of this publication without disclosure by any electronic means it deems necessary and may change those means without notice at any time. If you have received this publication and are not the intended subscriber, please contact admin@capitalistexploits.at.

Disclaimers

Capitalist Exploits website, World Out Of Whack, Insider, and any content published by Capitalist Exploits is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. The information contained in such publications is not intended to constitute individual investment advice and is not designed to meet your personal financial situation. The opinions expressed in such publications are those of the publisher and are subject to change without notice. The information in such publications may become outdated and there is no obligation to update any such information. You are advised to discuss with your financial advisers your investment options and whether any investment is suitable for your specific needs prior to making any investments.

Capitalist Exploits and other entities in which it has an interest, employees, officers, family, and associates may from time to time have positions in the securities or commodities covered in publications or the website. Corporate policies are in effect that attempt to avoid potential conflicts of interest and resolve conflicts of interest should they arise, in a timely fashion.

Capitalist Exploits reserves the right to cancel any subscription at any time, and if it does so it will promptly refund to the subscriber the amount of the subscription payment previously received relating to the remaining subscription period. Cancellation of a subscription may result from any unauthorized use or reproduction or rebroadcast of any Capitalist Exploits paid publication/s, any infringement or misappropriation of Capitalist Exploits proprietary rights, or any other reason determined in the sole discretion of Capitalist Exploits.

Affiliate Notice

Capitalist Exploits has affiliate agreements in place that may include fee sharing. If you have a website and would like to be considered for inclusion in the Capitalist Exploits affiliate program, please email admin@capitalistexploits.at. Likewise, from time to time Capitalist Exploits may engage in affiliate programs covered by other companies, though corporate policy firmly dictates that such agreements will have no influence on any product or service recommendations, nor alter the pricing that would otherwise be available in absence of such an agreement. As always, it is important that you do your own due diligence before transacting any business with any firm, for any product or service.