Bullish on Japan

When share prices catch up to the Japanese economy, the markets should boom

BY ARTHUR B. LAFFER AND THOMAS J. MARTIN

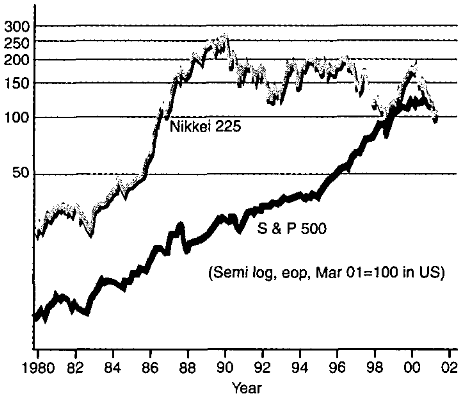
THE ECONOMY

Now is the time to take advantage of Japan's depressed stock market. After years of bad economic policy, Japan's political structure is finally in flux. Pro-growth reforms have been moved center stage with the election of an unlikely new prime minister. Junichiro Koizumi campaigned as a radical free-market reformer and the voice of change.

We believe Japan is an enormous buying opportunity, especially when juxtaposed against the U.S. Japan has much more upside potential and far less downside risk. In our view, Japan could easily be a two-fer, three-fer, or four-fer in the next five years, yet there's no way from here to Sunday that the same could occur in the U.S.

Japan's devastating financial collapse, which began in 1989 following decades of unprecedented prosperity, has been truly amazing. Figure 1 shows the Japanese Nikkei index, as measured in dollars, plotted against the U.S. S&P 500. Performing even worse, especially in recent years, has been the Japanese small capitalization equity market, which is probably more reflective of actual economic conditions in Japan than the Nikkei 225. Many of the Nikkei's companies are actually global enterprises headquartered in Japan.

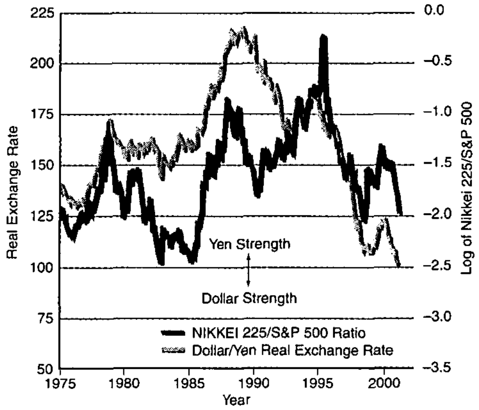
1. THE '90s WERE BRUTAL FOR JAPAN'S MARKET, GREAT FOR U.S.



The erosion of asset values has pushed posted land prices down some 40 percent from their peak—and strained the balance sheets of major Japanese banks. According to the Financial Services Agency, Japanese banks carry $1.2 trillion in problem loans on their books, which equates to 22 percent of total lending and 30 percent of GDP.

The real yen/dollar exchange rate throughout this 12-year period of Japanese demise has mirrored the relative performance of Japanese and U.S. equity prices, as shown in Figure 2. This should come as no surprise. With declining low returns on Japanese assets and high and rising returns on U.S. assets, asset owners try to move their assets out of Japan and into the U.S. The only way this transfer of assets can occur is by having the Japanese run greater trade surpluses (capital deficits) and the U.S. run greater trade deficits (capital surpluses). The easiest way for this to happen is for the dollar to appreciate relative to the yen.

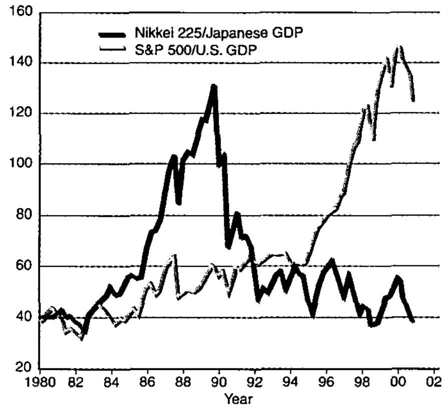
2. THE DOLLAR-YEN EXCHANGE RATE MIRRORS RELATIVE JAPANESE AND U.S. EQUITY PRICES



Japanese assets are very, very cheap relative to assets in the rest of the world and to historical asset prices in Japan. But cheapness in and of itself is no indication of a smart buy. The critical question is the potential for the appreciation of those cheap Japanese assets. Today, the Japanese Nikkei index of 225 stocks stands at around 13,500 versus its high in December of 1989 of almost 39,000. A rise back to its previous high of a dozen years ago would produce close to a 200 percent return.

In spite of a two-thirds decline in Japanese stock prices since late 1989, Japanese GDP is 35 percent higher than it was 12 years ago. Figure 3 is a plot of Japan's stock market relative to GDP. For comparison purposes, the U.S. stock market as a share of U.S. GDP is plotted as well. With any reversion to the mean, Japan should be in for an asset market move of historic proportions.

3. AS A PROPORTION OF GDP, JAPANESE EQUITIES ARE HUGELY UNDERVALUED COMPARED TO THE U.S.



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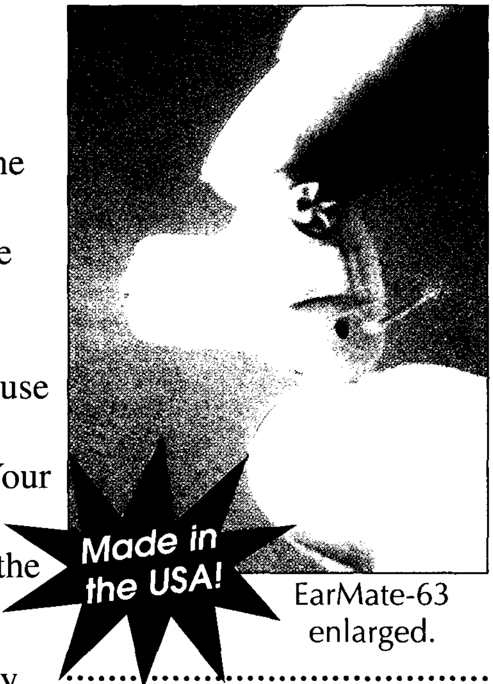

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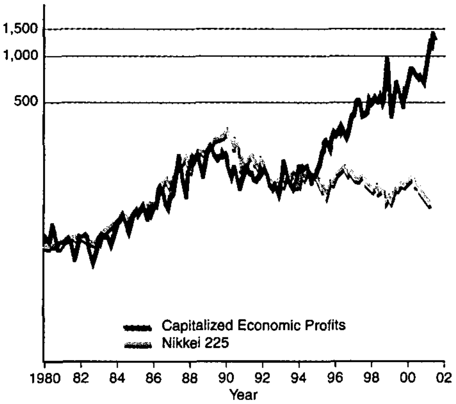
If the Nikkei 225 index had kept pace with the Dow Jones Industrial Average since December of 1989 the Nikkei would be at 145,000 instead of 13,500. This gap between what is and what could be provides Japan with a lot of room to grow.

Last month we showed how to use the capitalized economic profits of "USA Inc." to establish the appropriate value of the U.S. stock market. Essentially we do this by dividing U.S. corporate profits by the long-term interest rate. This same technique using Japanese capitalized economic

4. THE NIKKEI SHOULD CORRECT UPWARD TO TRACK CAPITALIZED PROFITS OF JAPAN INC.



profits and the Nikkei index presents greater challenges. That said, Figure 4 is very revealing. There is a radical disconnect between stock prices and capitalized economic profits starting about 1994.

If the Nikkei today had the same relationship relative to capitalized economic profits it had in the first quarter of 1985, and with interest rates and profits as they are today, then the Nikkei today would stand at 46,245, or 3.4 times its level today. There is serious appreciation potential no matter how you slice it.

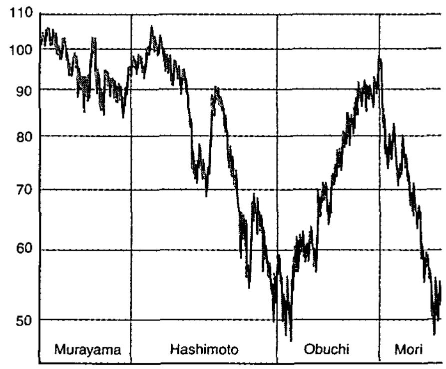
That isn't to mention the potential for appreciation of the yen. With the recent decline in U.S. asset values, investment is on the decline. Asset values incentivize people to save more and consume less. With less investment and more saving in the U.S., the U.S. trade deficit will decline (the U.S. trade deficit is driven by capital flows), which can happen only if the dollar weakens compared to other currencies, including the yen). Remember that the Japanese stock market historically has risen relative to the U.S. stock market when the yen strengthens relative to the dollar.

Why do we think the new Japanese government may trigger this potential for recovery? It has happened before. Japan was in the throes of economic chaos in late 1998 and early 1999. Then new LDP leader Keizo Obuchi cut the highest marginal tax rate on personal income (federal and prefectural combined) from 65 percent to 50 percent, and cut the highest corporate tax from 50 percent to 42 percent. He suspended the stock transactions tax, abolished the 1 percent per annum pension fund tax, and set up two commissions to study the implications of a shift from defined benefit plans to defined contribution plans, one for Japanese social security and one for private Japanese pensions. The Japanese stock and foreign exchange markets went crazy. As I wrote at the time in my paper "Godzilla: The Modern Saga of Japan Takes a Turn for the Better":

> The Obuchi government has cut taxes...by large amounts and in the right way...reminiscent of the Reagan era here in the U.S.... In every regard Japan is following the correct fiscal mix to assure a solid foundation for a healthy economic future.

Unfortunately for Japan, in early 2000 Crown Princess Masako had a miscarriage and then in April Prime Minister Obuchi had a stroke and died. The surging Nikkei collapsed (Figure 5). It was the end to a brief but glorious

5. POLICY MATTERS: JAPANESE MARKET RISES AND FALLS WITH CHANGING ADMINISTRATIONS



time for Japan. A darkness spread over the land.

Now, perhaps Japan's worst prime minister of all time is gone and a new start is in the offing. The most obvious way to profit from the coming prosperity in Japan is to invest in Japanese equities. And, as such, any global portfolio should overweight Japan by a lot. The Nikkei index, however, is not a 100 percent Japanese portfolio.

You can improve your exposure to the nascent Japanese prosperity by focusing on more domestically oriented Japanese companies. When the Japanese economy responds, a Japanese small-cap stock portfolio should outperform an overall index like the Nikkei. Also, because the yen will appreciate, creating less favorable terms for Japanese exports, Japanese industries involved in the production and sale of non-traded goods will tend to outperform Japanese industries involved in traded products.

In the course of the recovery, Japanese interest rates should increase. This increase in interest rates will not reflect higher expected inflation but rather higher expected real returns on Japanese assets. Higher real interest rates in the U.S. during the 1980s were the direct consequence of Reagan's tax cuts, and higher real interest rates in Japan during the coming decade will also be the direct consequence of the resurgence of the Japanese economy.

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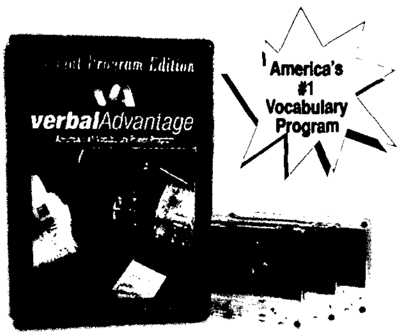

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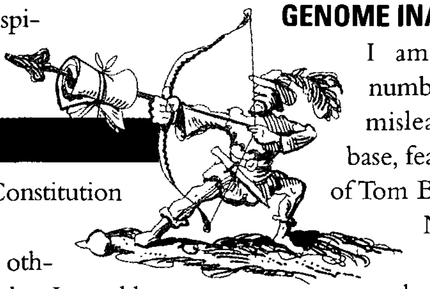
IT'S A STEAL

I am a new subscriber to *The American Spectator* and must say I am thrilled to be getting it. I read it virtually cover-to-cover. My problem is that I generally receive it quite late; i.e., I just got the March issue on April 5th. I strongly suspect that someone at the Post Office may be taking it home and reading it before delivery. I feel that my suspicions were confirmed when I noticed that the center spread for the U.S. Constitution lithograph was missing.



While I appreciate that others might want to read it also, I would prefer to be able to read it first. I live in a strongly Democratic community, so perhaps this subversive reader does not want others know to of his/her interest in conservative matters. Considering how you may feel about the P. O.'s proposal to suspend Saturday deliveries, that may be doubly so.

I don't know if it's possible, but I was wondering if you could send my *TAS* to me in a plain manila envelope so as to camouflage it so that I might have an opportunity to read it first.

And to whoever is out there coveting my *TAS*: If you'll just call me, I will gladly share *after* I read it. Plus, if you are working for the USPS, I am fairly sure that you could afford your own subscription.

JENNIE COX, CYNTHIANA, KENTUCKY

I am very happy to tell you how much I like the new *TAS*. I noticed an intriguing change in the February 2001 issue, but when I began to read the March 2001 issue I was simply bowled over. This is so good I hardly know where to begin. The magazine is now very appealing visually and I love the cartoons, but what really gets me going is the content. I've always looked forward to Tom Bethell, John Corry, and Ben Stein, but they have risen to new levels in these last issues. When you add contributions by the likes of George Gilder, the magazine is just amazing. I am not sure I can read it before bedtime anymore because it gets my mind going so that I have a hard time getting to sleep (of course living in the great state of California, this may not be a problem since I may not be able to turn a light on to read by anyway). Keep it up!

JONATHAN LIST, CARMICHAEL, CALIFORNIA

GENOME INACCURACIES

I am appalled at the number of inaccuracies, misleading slant, and base, fear-mongering tone of Tom Bethell's "A Map to Nowhere" (*TAS*, April 2001). I have become accustomed to reading inaccuracies and misstatements about scientific work in the popular press and usually take no notice. However, in this case I feel I must respond. I cannot be bothered to correct all the problems with this article but I will provide you with refutation of at least a few so that you can be confident that I am not merely ranting because I do not like the author's tone. In the interest of accurate reporting and creation of a high quality magazine I think you should consider having your scientific articles fact-checked by people with scientific training and experience.

"I am appalled at the number of inaccuracies, misleading slant, and base fearmongering tone..."

First, the subtitle of this article contains an obviously inaccurate statement. By saying "we can't read" the code, you are not only incorrect, but later portions of your article reference the publications where you can literally read the genome.

Second, your statement "With many of these diseases the defective gene has indeed been discovered. The problem is that a cure is still no closer" defies logic. While acknowledging that, through the study of the human genome, we have determined the causes for many diseases, you assert that we are still no closer to finding effective treatments or cures. It is in fact the case that increased understanding of the source of a disorder does lead to improved therapies. Consider the example of Muscular Dystrophy. This disease was not well understood until the sequence causing the disorder was found in 1986. Currently a gene-therapy trial is underway (see www.mdausa.org/news/990902genetherapy.html). That trial would not be possible without knowledge of the sequence of the gene in question. See www.med.upenn.edu/ihgt/info/cfvector.html for information on a possible therapy for Cystic Fibrosis.

There are many other inaccurate statements in your article, which I do not have time or inclination to refute. I sincerely hope that you will practice more responsible journalism in the future. The serious danger of a "knowledge divide" between science and the public can be prevented by accurate, clear reporting of scientific issues. Inaccurate reporting of these issues can only do harm to your readers. There is ample room for criticism of the genome project, however it must be done with facts—not empty, inaccurate assertions.

BRAD LANGHORST, EXETER, NEW HAMPSHIRE

TOM BETHELL RESPONDS:

Mr. Langhorst is appalled "at the number of inaccuracies" in my article but he does not have "time or inclination to refute them." He feels he "must respond," but then "cannot be bothered to correct all the problems." What a cheap shot.

The one "obviously inaccurate statement" that he finds is the claim that "we can't read" the genome. The genome has been reduced to a string of over 3 billion nucleotides. The overwhelming majority of them, perhaps 98 percent, remain cryptic. We do not know what the sequence means. Therefore we