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Japanese Valuations, Feudalism, Keynesianism, and a Worthless Euro

The bad side effects of successful ideas can way outlast the impact of successful bad men. The most glaring example is Manu Smriti, the corruption of which laid the foundation of the Indian caste system. The system was probably designed to spare the lives of conquered tribes by offering them menial jobs. But it wasn't designed to keep them in sub-human classification for 10,000 years. It took an infinite demand for talent by the likes of Infosys to erase the fault lines of Indian society.

But our concern is with securities markets. We have been covering Japan for about two years, and have modeled its valuations covering half a decade, and in that process have come to a unique understanding of that market, and to realize there is a risk that its characteristics might get replicated in other parts of the world, an outcome few would desire.

Micro Analysis

Regulation FD (Full Disclosure), the obligation of managements to widely disseminate information rather than offer it to favorite analysts, doesn't exactly apply in Japan. If you can get your call returned, you might just be handed internal estimates of corporate finance. But the ease of getting such information reflects its value. The real challenge in valuation lies in projecting corporate Capital Expenditure, which is systematically higher than that of US companies. The reason is that, as James Grant has pointed out, Japanese management has a platonic relationship with the stock price. They are in effect feudal lords, and are obliged by that status to protect their tribe. As a result, costs are cut through attrition alone. Since few Japanese salarymen switch jobs, attrition implies retirement. In the meantime, the required return from investment is kept low to avoid layoffs. This works as long as revenue growth can be kept positive. The market values companies by assuming that stable CapeEx is a fraction of the actual number, so value seems OK on backward looking measures, but cheap on a forward cash flow multiple.

However, when revenue shrinks from a recession, the delicate dance where attrition is the valuation driver goes out the window. Suddenly, workforce reduction becomes a matter of survival. In this case, the cost of mass layoffs kicks in. If a company recovers quickly, fine, things can go back to the 'Japanese normal'. But if revenue continues to struggle, the price of feudalism i.e. the generosity of redundancy packages, trashes the equity. In the early 1990's, when a US company announced layoffs, the stock would go up. As cruel as that may sound, this is a society that reinvented itself when faced with the PC revolution by reallocating 60% of its secretaries and middle management, and this led to 'above trend' growth for over a decade.

his wasn't some instilled belief in efficiency. Plenty of firms, including IBM, nearly hit the wall before they got religion.

The reason for US revival was two-fold - Chicago's academic work was encouraging boards to pay for performance, and Harvard's was driving the 'market for corporate control' - exemplified by a pair of bankers by the name of Wasserstein and Perella who were arranging hostile offers which one Michael Milken was 'highly confident' he could finance. Black-Scholes, the formula used to value options for managers, entered the lexicon. The likes of KKR and Blackstone were born, dedicated to LBO’s of underperforming firms, but in Japan, such gaijin were bought off with greenmail, or just brushed off. Investment bankers who moved to Asia had a lot of drinks in a lot of geisha houses, but not much got done. Corporate Japan's failure to rationalize after its crash in 1989 led to sub-par growth and nearly exterminated its stock market.

The last two years have been unkind to Japanese companies. Between the government's immediate reaction to the Fukushima nuclear meltdown, i.e. shutting down the nuclear power industry, and the floods in Thailand, where a lot of their manufacturing is based, business suffered from severe shocks. These had the result of taking the market down regardless of traditional risk measures i.e. whether you were a large or small cap or your margins were good or bad, you simply took a hit. From an investor's point of view, no matter how good the analysis, the results did not comply. For that matter, the bigger the firm, the more likely the exposure to Thai manufacturing and broad slowdown from electricity shortages. So payoffs from normal risk measures went topsy-turvy for a while. Since these were natural rather than economic shocks, managements did not respond at all the way they did to recession.

But going forward, the analysis in the initial paragraphs will get reapplied. Once our maintenance CapEx formula absorbed companies' excess investment, the overall returns in Japan improved modestly over 5 years. However, the modest change masked a huge improvement pre-Fukushima and in very recent periods, with market neutral returns approaching 20% from understanding company specific risks as well as the impact of high CapEx and contingent liabilities in a period of slow growth. The natural disaster period had reasonable but half the returns as managements were responding to events rather than economic change. Going forward, this tells us that the DCF model has latched onto the economics of corporate Japan in crystal clear fashion and the excess returns seen prior to natural disasters, including the recession (i.e. for a market neutral book, where shorts made money) would be expected to continue. Given that few people have valid explanations to offer on the behavior of the Japanese market, this is no small satisfaction.

Not that we wish what we foresee upon anyone: the next recession will force what Japan avoided doing since the 90's - mass layoffs. The changes coming up are structural - a massive shift from manufacturing prowess to user interface design which is global, rather than Japan specific, will be required to compete with the likes of Apple and Samsung. The good news would be a structural bottom in the stock market, as costs would finally get realigned with revenues and firms would focus on software. However, this will crush government revenues from corporate and wage taxes while the write-offs are carried forward and many people look for new employment. With government spending already at 200% of revenues, the risk to valuation from 'undertaxed' Japan (as the IMF would have you believe), is substantial.

Macro and Political Analysis

My recollection of undergraduate philosophy dims, but John Locke's basic point was that everyone embodies the devil, limited by reason and / or the social contract. People act for their own purposes, and yet, a system built on self-interest with checks and balances designed by three fellas called Hamilton, Jay, and Madison results in a $15 trillion economy that engines the globe. In Japan, managements can pretend to be altruistic Samurai overlords because they have little at stake: imported anti-trust laws busted remaining 'zaibatsu' families which had survived pseudo-military rule in the 30's and WWII; as a result banks took over the financing of Japan's post war growth. So the Ministry of Finance (MoF to the cognoscenti) and their central bank control the commercial banks which control public companies through their lending and stakes. If my paycheck is fixed, I would prefer to hallucinate that I am a Samurai rather than be a realist and socially unpopular cost-cutting manager, too. The US may well have overpaid its managers, who were given epithets such as Jack 'The Knife' Welch and 'Chainsaw' Albert Dunlap, but that was a lot cheaper than wiping out 20 years of growth. The cost structure in Japan is sufficiently ossified that the gaijin raiders of yore do not bother to come back. What Japan truly needs is for the central bank to stop printing money to support government expropriation which makes the marginal tax rate irrelevant, as well as a market for corporate control, which will be born when valuations get distressed and assets have to be shed. What, one wonders, might prove the catalyst for that? Our favorite candidate is a nascent collapse in exports to China and Europe....

Which brings us to John Maynard Keynes. The corruption of Keynes' ideas and socialism are a perfect marriage which threatens to beat the caste / feudal system's track record as the greatest destroyer of value in wealth and human dignity in history. Keynes believed that fiscal policy should be countercyclical. Fine. But I do not recall the surpluses from good times circa 2003-2007. The Democratic (the capitalization applies to US and European political parties as well as various Soviet states) interpretation is to spend more than you have in good times, and in bad times, spend even more. To be fair, many so-called conservatives went right along. So, it is not just Japanese management that suffers from inertia. The world's politicians, from France to the US Federal Reserve, remain latched on to this bizarre idea of 'growth'. They only need revisit Japan in light of our new prism. The government has spent 200% of revenues for a while, and forestalled private restructuring and investment despite taking the risk free rate to 'zero bound'. The political class of the world (and this term includes central bankers, an idea that took half a decade to sink in, to great cost) is bent on emulating them, likely resulting in the greatest willful destruction of wealth in recorded history outside the global housing bubble or a world war.

The economic analysis of macro hedge funds shorting JGB was blindsided by this simple fact: central bankers in a democracy might be independent, but they become a political class i.e. in order to fit into their professional community and be reappointed they can be focused on the tactical rather than strategic interest of a society. And, if they can print their own currency, they have an infinite capacity to support government profligacy, until the point of hyperinflation. For the United States, short and long term interests have diverged radically. In the very short term, we are like any other country, it pays to weaken the currency in a recession. However, in the long term, this becomes a strategic disaster for the global trading system established and maintained by the US since WWII. And in case someone has lived on the Upper East Side and paid $32 a pound for pre-cooked organic arugula for too long, a quick trip to an 'upstate' Wal-Mart will drive home the point that the US consumer remains the biggest direct beneficiary of the most efficient distribution system built since the Silk Road.

The rise in unemployment in Japan or more recently the west is not a result of a 'debt recession'. It is the result of continuing the habit of borrowing to spend on transfer payments i.e. 'welfare' and raising marginal cost of employment through the taxation required to fund these transfers and immense regulation. These habits take a long time to change - an entire generation of politicians has to lose elections first and the ideas driving their behavior have to die. Hence it takes longer than a single business cycle to repair such a political economy. The debt is the symptom, not the cause of long periods of sub-par growth. The Japanese do not really owe anyone anything. They are net creditors to the world and their internal accounting will be resolved by estate taxes if they can get a grip on the laws of Locke and Newton and grow meaningfully again.

Toddlers, Newton's Laws and the Mandarin State

Adults are boring. They have intuitively figured out Newton's laws of gravity and thermodynamics, and do not attempt to break them. Toddlers, on the other hand, do not really grasp the idea that if they stretch out too far from their perch to grab that ice-cream or model car, they will likely end up on their bottoms, or at least their diapers. Or that running into a brick wall or pulling a dog's tail seems to have undesirable reactions for no reason they can fathom. Their acceleration is unlikely to overwhelm the dramatically superior mass of a wall, and irritated animals, well.... After all, this is not how their parents behave, so why is the neighbor's dog so unreasonable?

Somehow, Democratic governments are bent on behaving like toddlers. Occasionally, their parent picks them up with a hug and a kiss on the cheek, also called a bailout, but changing behavior seems to take a while. On current trend of spending vs. private GDP, thanks to rational expectations, it will be a lot less than 10,000 years before hyperinflation kicks in. I am hoping my two year old proves a somewhat faster study than the French government, which just lowered the retirement age on many jobs, and is forcing Peugeot to keep people employed at above-global-market wages while asking for money from Germans who have been postponing their own retirements. This in the face of a shrinking working age population which supports pensions. At 75% marginal French taxes, we are about to find out how far the European elite are willing to go in sacrificing the value of their equity to keep their caste privileges. Their 'auditor', equivalent of the US Office of Management and Budget, has just reported that to retain access to capital markets, the required retrenchment in French spending is going to be the biggest ever. In the event, they test the patience of the German public, which might toss out

Merkel for being much too agreeable with neighbors, and elect someone who would just tear up the Euro and Atlantic alliances.

This is not encouraging for asset valuations. The only way to spend $1 trillion a year one does not have is to expropriate returns on equity. This is what the shorts on Japanese bonds or buyers of their equity did not grasp, and the longs on the S&P 500 fail to do as well. Japanese public companies are implicitly controlled by the central bank, and their mandarins were willing to simply give up returns for their idea of social stability. It isn't their money. Without any faith in markets to solve the problem of reallocation of labor, any bureaucrat would do exactly the same thing. The outcome is far more pernicious than the argument on the front pages about US taxes. Fortunately for the US, we had Carl Icahn, "If you want a friend on Wall Street, buy a dog." How do you translate that into Japanese?

In the meantime, German government bond yields are negative. Why not hold cash instead? Aside from the problem of requiring a really big mattress, the Euro is pretty much worthless. All that matters is the name Germans happen to call their currency. Today, it is the Euro, but obviously many Europeans have decided not to take the risk that they change their minds. Meanwhile, the Fed continues to co-operate, 'zero bound', forcing down a market driven cost of debt that would require a write-down of financial assets and restore rational allocation and growth. The ECB will head in that direction starting today. Global equities remain hostage to this political economy. The QE3 bounce in the S&P, if there is one, is likely to be its last high for a while, in many senses of the word.