The Investor

In our 26th year of free service to the South African investing public!

In search of a better, safer world monetary system!

By Richard Cluver

Writing In the April issue I detailed why I believed that the century-long experiment with socialism was rapidly coming to an end, noting that whether it is ethically or morally desirable or not, the collapse of the system is now inevitable. The ending of the Gold Standard created a situation in which central banks could print money at will in order to artificially prolong an unaffordable experiment and it is now simply a matter of time before the world's monetary system bursts at the seams. Hopefully, I argued, sanity will prevail before this apocalyptic event ushers in social chaos…the ultimate blood on the streets nightmare.

It was based upon the argument that the collective government debt of the leading nations had reached completely unsustainable levels in the immediate aftermath of the 2007 financial crisis and, notwithstanding the austerity that has been forced upon the world since then, those debts continue to escalate at a frightening rate with no end in sight.

We have, furthermore, witnessed in the past month a dress rehearsal in Cyprus where the banking system was partially closed to the public for a fortnight with only limited ATM pay-outs possible. And while finance ministers in numerous countries then scrambled to assure their public that Cyprus was a special case, we note that Canada has just introduced legislation which would allow it to deduct money from its citizen's bank accounts in a similar manner to that of the Cyprus Government. No doubt other governments will soon follow that lead.

Can it really be that bad? Well if you doubt me, consider that the latest round of printing money began with an episode known at the time as the Asian Flu when the economies of Pacific Rim countries collapsed and the United States wet to their rescue pouring in dollars in much the same way as they have done since 2007 to prevent “too big to fail” banks from collapsing. Before the late 1990s the world had been living through a period of austerity known as the Volker round as central banks tried to tame a tidal wave of inflation that arose from the OPEC oil crisis of the 1970s.

We need to look at the track records of just two commodities that signify the world’s monetary health to see what happened through that period. The oil price bottomed in December 1998 at just $9.09 a barrel while the gold price bottomed in April 2001 at just $258 an ounce. Since then, while retaining its value as a finite store of monetary worth, gold has been gaining in value by 17 percent compound annually. Oil has been rising, albeit in a more volatile manner at compound 15 percent which between them I offer as proof that globally money has been LOSING value at the same rate.

Averaging those two numbers, it does not require any rocket science to understand that the buying power of the money in your pocket is halving every four and a half years. That is surely a terrifying thought for anyone trying to survive on a fixed income: for pensioners who have not taken the opportunity during their working lives to build up investments to supplement their pensions.

Readers can take some consolation from the fact that the world has been in this position before…many times before.Throughout history, rich and poor countries alike have been lending, borrowing, crashing--and recovering--their way through an extraordinary range of financial crises. And each time, the experts have chimed, "this time is different"--claiming that the old rules of valuation no longer apply and that the new situation bears little similarity to past disasters.

So have we learned anything from these past disasters? Well apparently not. Time and time again ordinary folk have been stripped of their life savings by irresponsible governments that have so badly managed monetary policy that the system has come apart at the seams leaving ordinary folk to pay the price.

Well we have learned something. US academics Carmet Reinhart and Kenneth Rogoff of Harvard University have in the past few years constructed a database covering 70 countries in Africa, Asia, Europe, Latin America and Oceania covering more than 90 percent of global GDP and going back two centuries in their history in order to study serial default and banking crises cycles. And what they discovered should hardly surprise anybody. In essence it showed that whenever a nation’s total debt has risen above 90 percent of Gross National Product it has signalled the beginning of a monetary crisis that has significantly slowed economic growth and pushed people out of work.

Equally unsurprisingly, the study made it clear that debt default should be the last resort of governments. Which explains why central bankers have struggled so determinedly to prevent Greece from defaulting. And the reason for that is the simple observation of contagion. Had Greece defaulted on its debts at the height of the 2007 monetary crisis it would have heightened lending risk and thus caused investors in sovereign debt to demand higher compensatory interest from everyone else. That in turn would have pushed countries like Spain, Portugal, Italy and Ireland over the brink for they in turn would not have been able to afford the costs of servicing their debts. It could have led to a domino effect of unimaginable consequences that could conceivably have toppled the economies of most countries in Europe.

The Rogoff Reinhart study was used as justification by many financial leaders who took a hard line, forcing austerity on Greece, Ireland, Iceland and others on the edge of default, demanding that in return for temporary cash bail-outs they cut back on spending with the consequence that millions of people have lost their jobs all over Europe with unemployment rates now as high as they were during the Great Depression of the 1930s.

Politicians and academia were, however, divided about the desirability of this remedy. Opponents argued that austerity would cause recession which would in turn reduce tax income and hence prevent governments from repaying debt. The opposition has, furthermore, been given fresh wind lately following a discovery of a spread-sheet error in the Rogoff Reinhart study which has led to a very un- academic slanging match.

The truly alarming fact, however, is that nobody really knows how to solve the mess the world is in and so we are likely to see a lot more of the same. Governments, taking the uproar over the Rogoff Reinhart study as an excuse to reflate further, can be expected to print money on an ever-increasing scale which effectively offers them the only way out of their troubles. So much money has been destroyed in the recent past that for now the red-hot printing presses are producing no obvious inflation. The problem with inflation, however, is that it is a bomb with a very slow-burning fuse. But whenever governments have abandoned monetary discipline and printed money, the eventual result has always been the same: a tidal wave of inflation. Why should this time be any different?

All of which brings me back to what the ordinary investor can do to insulate himself as far as possible from the consequences of this mess…and perhaps to offer a solution that could prevent such events happening again in the future:

Just about everyone knows that in a monetary crisis there is nothing better than gold to fall back upon as the ultimate store or monetary wealth. Its very scarcity – as opposed to the plentifulness of paper when central banks start printing money – is what has always kept gold and a few other precious metals in that position. Others put their trust in antiques and rare works of art. But as anyone can testify who had relatives living in the Weimar Republic of Germany between the two world wars, jewellery and rare art works served for little when people were queuing with wheel-barrow loads of money outside the grocery stores trying to exchange them for loaves of bread.

But gold…now that was another commodity that everyone understood. However for modern world governments another store of wealth needed to be found for the simple reason that there is just not enough gold around. Gold imposed too harsh a discipline upon everyone because of its sheer lack of flexibility. To offer readers a simple example, let us assume that a century ago when the gold standard still applied, our government decided upon a grand project that would give everyone work; assume they decided to dig a canal from Cape Town to Johannesburg so ships would be able to deliver their goods directly to the Reef . It would have been a great plan for it would have employed everyone who had nothing better to do.

Assume also that this government sent many chests of gold to Europe at the same time to order and pay for a large number of steam shovels and other equipment necessary for the project. The real problem with the gold standard would then have arisen for having sent all their gold out of the country, when they went to the bank to draw money for the workers' wages, there would be no more coin left….because it had all been sent to Europe to pay for steam shovels.

For modern governments this would have posed no problems. They would simply have cranked up the printing presses and churned out enough bank notes to meet the payroll requirements. Of course that would have caused a deficit and the auditors would have complained. But no problem there; they could simply have issued treasury bonds…except the lenders would have wanted to be paid back in gold…and once again there would have been a shortfall.

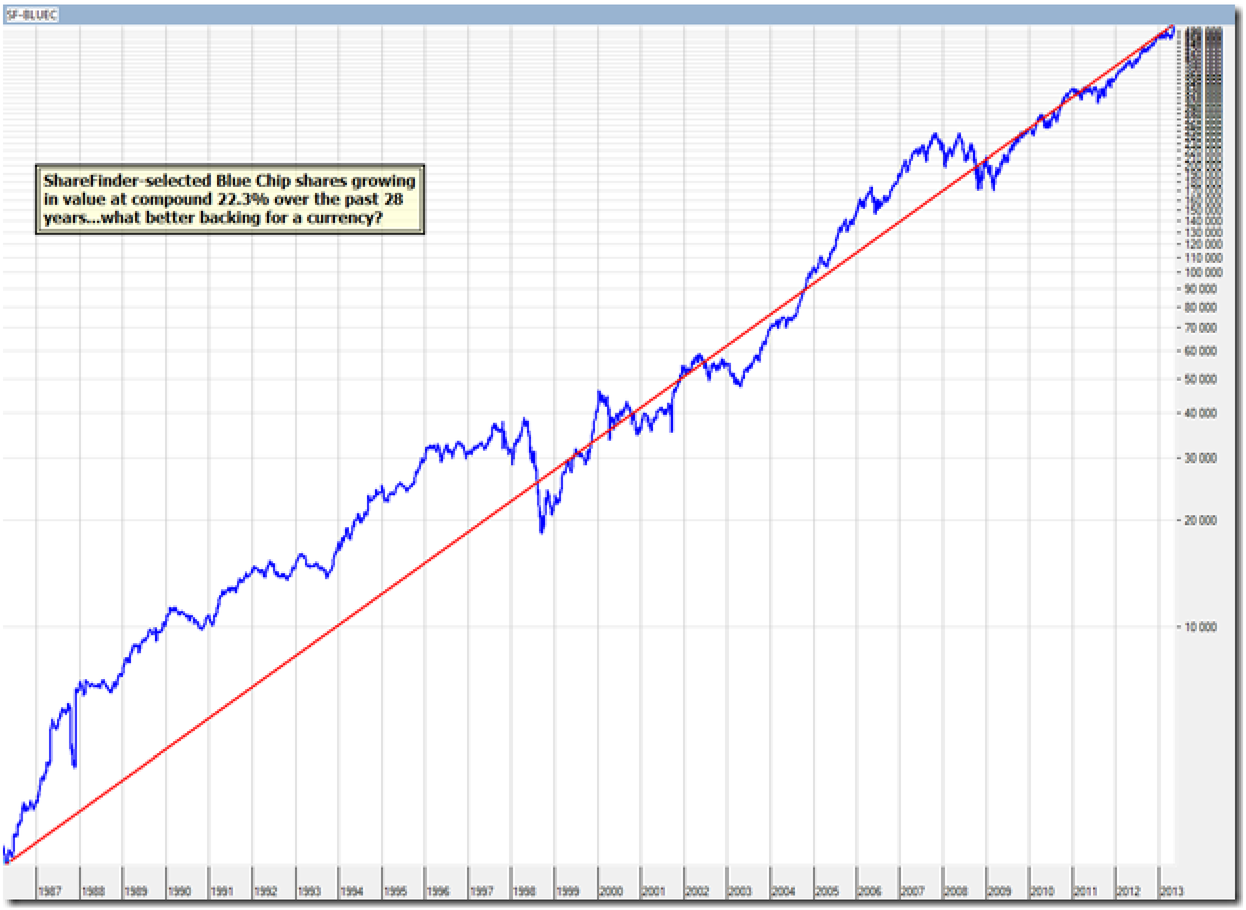
OK I am oversimplifying, but hopefully you get the message: The gold standard was simply too exacting a system which placed too many constraints upon the politicians. But ever since the world went off the gold standard the global monetary system has been subject to ever-increasing pressures because there is no longer any form of discipline restraining central banks .

Recently Bitcoinage has surfaced as a beguiling answer to the problem. Its attraction is that no central banks have any hand in its creation so it does have a scarcity value. But it lacks the credibility that "real cash" has always enjoyed in the hands of ordinary folk.

So might there be a credible alternative to the Bitcoin idea? Well my humble solution would be the equivalent of a unit trust: a currency backed by the shares of a raft of global blue chip companies. That's a currency I would trust and it would enjoy the double advantage of both earning dividend income and achieving value growth for those who saved such a coinage…watch this space!

Going back briefly to the Rogoff Reinhart study, the reason why nations really cannot afford to default on their debts is the fact that defaulters are no longer trusted as borrowers much in the same was as bankrupt persons are blocked from obtaining credit. Russia was one the noted defaulting nations of recent times. After the revolution it defaulted on loans raised by the Tzars and for the next 69 years it was locked out of the sovereign debt market. Similarly Greece defaulted in1826 and it was shut it out from international capital markets for 53 years.

Whether or not a country was punished by such exclusion appears to have quite a lot to do with how many others were in default at that time. For example, during the Napoleonic Wars a large number of countries were in default. Then between 1820 and 1840 nearly half the nations of the world were in default including ALL of Latin America The third episode began in the 1870s and lasted two decades. The fourth began with the Great Depression of the 1930s and extended through to the early 1950s when nearly half of all countries stood in default. World War Two was both the result and the solution to that crisis. The fifth episode encompassed the Emerging Market debt crisis of the 1980s and 1990s is what I have just referred to!



I conclude my argument with the graph above. It tracks my ShareFinder-selected Blue Chip shares that have been growing constantly in value at compound 22.3% over the past 28 years. And, furthermore they have on average delivered a dividend yield of better than three percent throughout that time. What better backing for a currency?

The Ten Minute Millionaire

What yield do international investors expect from a share?

Subtract South Africa's 6 percent inflation rate from the 6.365 percent yield on the R157 long bond and you get a "real" return of just 0.365. In contrast, subtract the US inflation rate of 2.7 percent from the 1.87 yield of a ten-year US treasury bond and you get a negative -0.83 real return. So it appears that on a relative real yield basis, the investment markets, nomatter how unfairly, confirm the relative risk rating laid upon this country by the ratings agencies.

All of which brings me to the required yields on South African shares when viewed by international investors whose buying and selling actions largely determine what local share prices should be. Here we can ignore inflation because both bonds and shares are being bought in the same country and so each are equally exposed to inflation.

Name	Return	DY	5YrGro	5YrDiv	Grade
Averages:	16.53	3.4	13.14	32.85	763.2
Blue Chip Index Average:	17.16	3.0	14.13	20.35	570.6
Rising Star Index Average:	15.65	3.9	11.75	47.92	1 031.5
Grand Old Favourites					
Group Avg.	20.26	2.6	17.66	26.35	791.2
CAPITEC BANK HLDGS LTD	42.46	2.0	40.43	47.39	1 292.0
SHOPRITE HLDGS LTD ORD	35.99	1.6	34.34	31.23	786.6
CLICKS GROUP LIMITED	29.96	0.8	29.18	27.71	700.3
GROWTHPOINT PROP LTD	15.82	5.3	10.52	9.41	68.1
SABMILLER PLC	15.45	1.9	13.58	14.51	696.9
SASOL LTD	8.74	4.0	4.74	19.76	1 023.9
BHP BILLITON PLC	6.92	3.0	3.89	25.48	1 036.5
WILSON BAYLY HLM-OVC ORD	6.72	2.2	4.57	35.32	725.7

So, noting that the yield on a top quality South African long bond, one whose repayment is guaranteed by the South African taxpayer, is currently yielding interest at 6 percent, one would expect that an ultra blue chip share such as the category of shares I label the Grand Old Favourites should yield a very similar return. I have extracted the accompanying table from the ShareFinder programme Quality List from which you can deduce that the average dividend yield of the Grand Old Favourites was 2.6 percent at the time of writing and on average these shares were rising in price at a compound annual average rate of 17.66 percent. Add those two figures together and we get a “Total Return” of 20.26 compared with the total return of 6 percent offered by one of the safest of South Africa’s long bonds.

The implication is that the marketplace currently would regard a portfolio consisting of equal value quantities of the seven safest of all Blue Chips as 3.37 times riskier that the safest long bond. Now, in the April issue I compared the 6 percent current interest yield on a Republic of South Africa long bond - traditionally regarded as the safest of all investments on the local market – with the 20.26 percent average Total Return of the Grand Old Favourite blue chip shares selected by the methods I have outlined in this series in order to conclude that blue chips were at the time of writing offering a 3.37 times better return.

Name	DY	Return	Grade	Risk
Averages:	3.4	16.53	763.2	1.73
Blue Chip Inde...	3.0	17.16	570.6	-2.83
Rising Star In...	3.9	15.65	1 031.5	8.07
Grand Old Favourites				
Group Avg.	2.6	20.26	791.2	0.00
CAPITEC BAN...	2.0	42.46	1 29...	49.65
SHOPRITE HL...	1.6	35.99	786.6	-5.10
CLICKS GROU...	0.8	29.96	700.3	12.78
GROWTHPOIN...	5.3	15.82	68.1	-16.92
SABMILLER PLC	1.9	15.45	696.9	-26.49
SASOL LTD	4.0	8.74	1 02...	-13.06
BHP BILLITON ...	3.0	6.92	1 03...	-3.80
WILSON BAYL...	2.2	6.72	725.7	2.94
Mid-Cap Companies				
Group Avg.	2.5	36.41	849.9	17.17
FAMOUS BRA...	2.5	36.41	849.9	17.17
Tightly Held Mid-Cap Companies				
Group Avg.	1.9	16.51	925.7	-8.28
EOH HOLDING...	1.5	31.89	1 35...	12.57
SYCOM PROP...	0.0	8.87	608.6	-27.52
HUDACO INDU...	4.1	8.76	818.0	-9.88
Blue Chips				
Group Avg.	3.3	15.61	455.4	-3.80
MR PRICE GR...	2.4	38.52	733.3	38.11
WOOLWORTH...	2.9	28.78	540.3	43.77
INVICTA HOL...	3.2	27.36	619.0	10.29
TRUWORTHS ...	3.1	24.97	680.8	6.72
NASPERS LTD...	0.6	23.49	232.9	-0.83
CASHBUILD LTD	2.8	22.70	566.7	-5.84
THE FOSCHIN...	3.4	21.18	414.2	22.90
SPUR CORPO...	3.9	18.60	456.2	6.72

If you think that this ratio is improbable then note that if you subtract South Africa's 6 percent inflation rate from the 6.365 percent yield on the R157 long bond you get a "real return" of just 0.365. In contrast, subtract the US inflation rate of 2.7 percent from the 1.87 yield of a ten-year US treasury bond and you get a negative -0.83. Thus, in absolute terms the difference between the real yields of a US Treasury Bond and a South African gilt is 2.7 percent which implies the probability of the South African Government reneging on its debts is nearly three times greater than the probability of the US Government reneging. Furthermore, as I have demonstrated, the ratio of US indebtedness to that country's gross domestic product is now greater that 200 percent while the South African equivalent is just 35.6 percent.

Putting those observations together would suggest that the risk involved in buying a blue chip South African share is something of the order of six times greater than the risk of buying a long-dated US treasury bond.

Fortunately we can put the absurdity of this view to the test by the simple measure of dividend yields. Wall Street has its own blue chip share list in the shape of the shares chosen for inclusion in the Dow Jones Industrial Average which at the time of writing consisted of 30 shares whose average dividend yield was 2.9 percent. My own ShareFinder Blue Chip dividend yield average on the same date was 3 percent. So investors on opposite sides of the planet were on the same day demanding an almost identical dividend yield for the same class of shares.

And on the London stock exchange, shares selected for the ShareFinder blue chip list there offered the same 3 percent average dividend yield on the same day.

If it seems surprising that there was such a correlation between all three markets on the same day, readers should understand that operating on the stock exchanges of the world are people known as arbitrageurs who make their living by buying on one exchange and selling on another taking advantage of any difference in the pricing of individual shares across various markets. So there seldom exist big differences in the pricing of individual shares in different stock exchanges. But there can be very significant differences in the yields of sovereign debt depending upon a world view of the risk of individual governments defaulting upon their borrowings.

However, the important inference is that although there exists a significant yield disparity between the world's bond markets, there is little of no difference between the pricing of shares nomatter where the principal operations of the underlying companies are located. And of course to a greater or lesser extent the majority of blue chips are now international operators.

Nevertheless the link between shares and bonds should not be entirely dismissed. In the graph composite below I have tracked the price performance of the world's second largest brewer SAB Miller with below that SAB Miller shares dividend yield and below that the daily yield over the same period of the RSA 157 long bond.

Here we should note that Breweries shares were cheapest in March 2009 and the RSA157 was similarly cheapest three and a half months later. Both securities then rose steadily over the next 40 odd months with the Breweries dividend yield falling from 3.85% to 1.79% and the R157 yield falling from 8.78% to 5.38%: so bonds and shares move in tandem though not necessarily in equal value.

All of which brings me to a measure beloved of multi-billionaire Warren Buffet, reputedly the world's most successful share market investor; the bond-relative calculation. The calculation is simple. It asks what should the price be of a chosen share such that its Total Return, i.e. the sum of its dividend yield and its compound annual average growth rate should equal the return of a long bond. Thus in my example you can see that the highest graded share in ShareFinder's Quality List was standing at the time of writing at the close of the market at a price of R212.50. In order for this share to deliver the same after-tax return as the R186 long bond it should thus be standing at an actual price of R289.13.

Name	DY	F.Und/Ov	Grade	Return	Close	GltRel	GltRel%
Averages:	3.4	-394.52	763.5	16.54	88.93	160.67	60.00
Blue Chip Index ...	3.1	224.76	571.0	17.20	105.14	167.01	68.72
Rising Star Index...	3.9	-1 243.15	1 031.7	15.62	66.35	151.85	47.86
--- Grand Old Favourites ---							
Group Avg.	2.7	159.43	801.0	22.25	209.30	376.83	82.64
CAPITEC BANK H...	2.0	0.64	1 291.0	42.43	212.50	289.13	73.50
SHOPRITE HLDG...	1.6	107.70	786.6	35.93	164.00	156.00	105.13
CLICKS GROUP L...	0.8	370.31	700.3	29.97	55.90	66.23	84.40
GROWTHPOINT ...	5.5	594.52	68.1	16.02	25.29	18.68	135.38
SABMILLER PLC	1.8	102.49	696.9	15.42	367.62	345.64	106.36
SASOL LTD	4.2	-39.55	1 023.9	8.94	375.00	1 086...	34.51
BHP BILLITON PLC	3.1	-20.09	1 040.0	7.01	264.82	675.55	39.20

Expressed another way, Capitec shares were at the time of writing standing at only 73.5 percent of their gilt relative value. They were thus significantly underpriced. But now go to the averages at the top of the example and you would see that on average investment grade shares were at that time selling at R88.93 each but on a gilt relative basis they should have been standing at R160.67 and were thus collectively standing at only 60 percent of their gilt relative value.

In my observation this extent of share underpricing using the Warren Buffet gilt relative calculation has been a constant feature of the Johannesburg Stock Exchange for as long as I have been observing it, making it in my view irrelevant except in a relational valuation exercise. It is something that is important to know about but largely to be dismissed. The important caveat here is, of course, the fact that it highlights as ridiculous the requirement of South African regulatory authorities that pension funds should conform to the so-called Prudential Rules; that is that the pension capital of pensioners should for their own protection be spread so as to achieve one third in bonds, one third in property and one third in shares. If shares are consistently cheap relative to bonds, the logical inference is that pensioners money should be saved in shares not bonds.

What this all adds up to is that the average South African Blue Chip share is greatly undervalued at the time of writing. Furthermore, long term observation shows that this is generally the rule rather than the exception

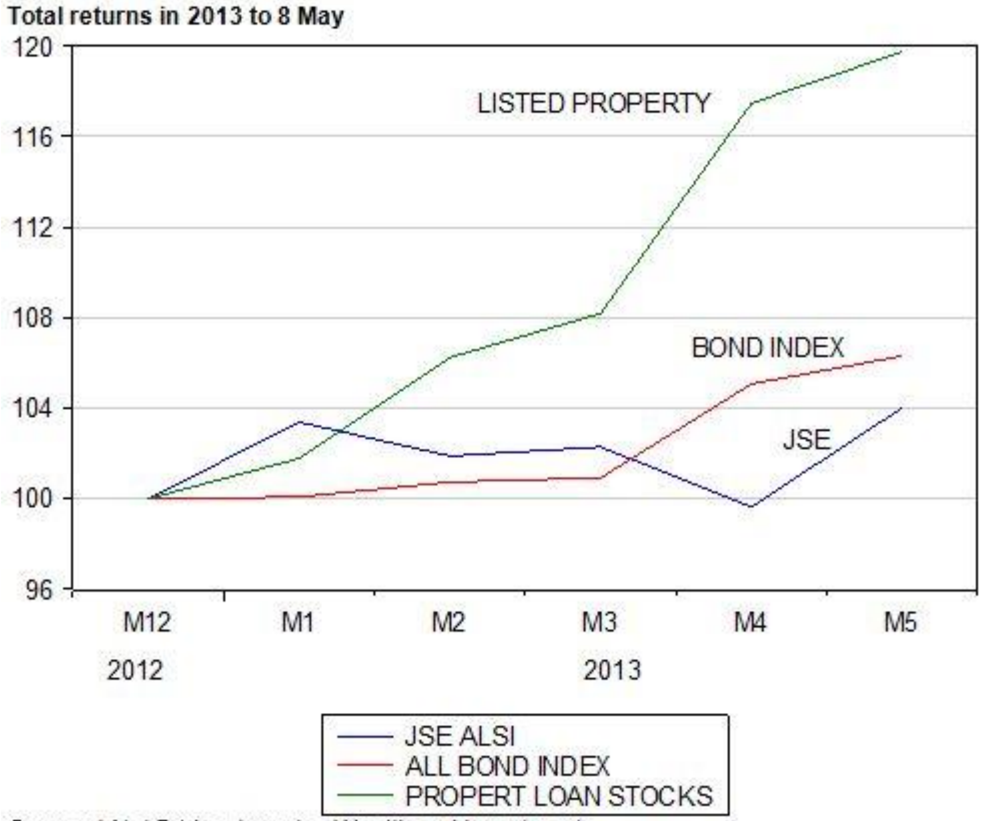
Listed JSE property continues to surprise. Can it continue do so?

by Brian Kantor

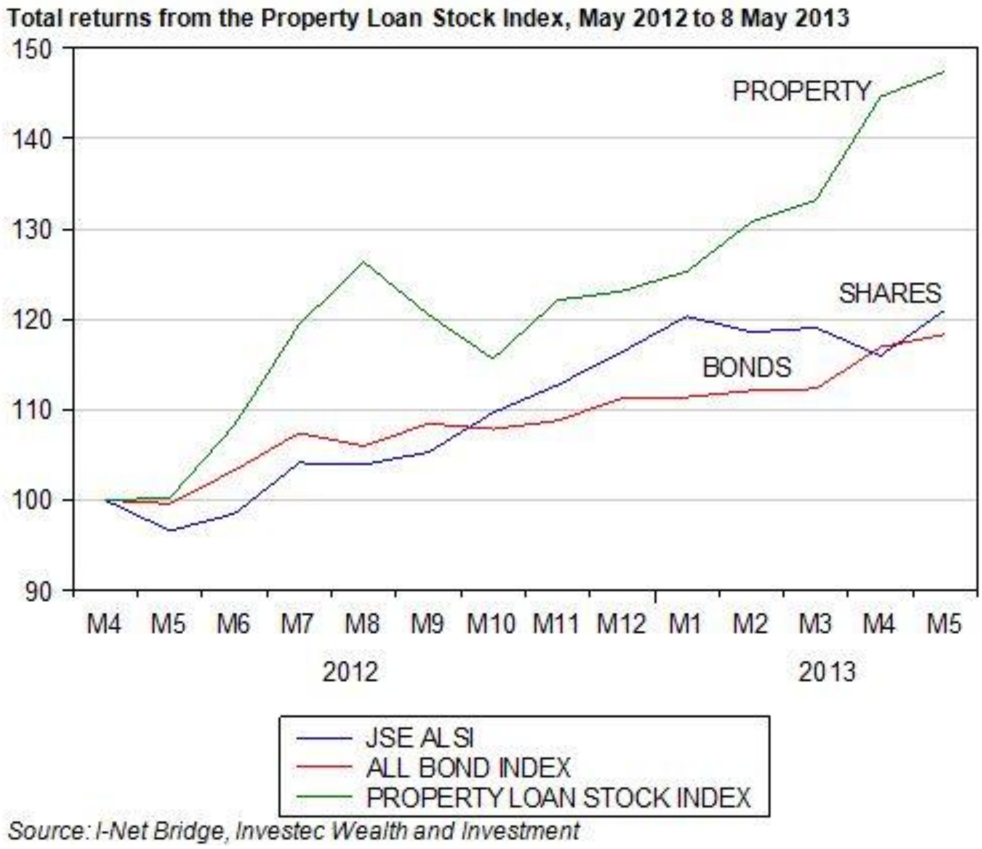
Exceptional returns all over again.

Property stocks listed on the JSE have again confounded the market place. From the beginning of the year to May 2013, the Property Loan Stock (PLS) Index returned nearly 20% compared to 5% from the All Bond Index and 4% from the JSE All Share Index.

Since 30 April 2012 the returns provided by the PLS Index in capital appreciation and dividends have been even more spectacular. The PLS Index returned over 47%, over a period when the All Share and All Bond Indexes also provided still very good total returns of 21% and 18% respectively. Between January 2000 and May 2013 The PLS Index provided average annual returns, calculated monthly, of 23.4%, compared to an average 15.5% for the All Share Index, 11.9% average from the All Bond Index and about 8.8% average returns from the money market. Annual inflation averaged about 5.8% over the period.



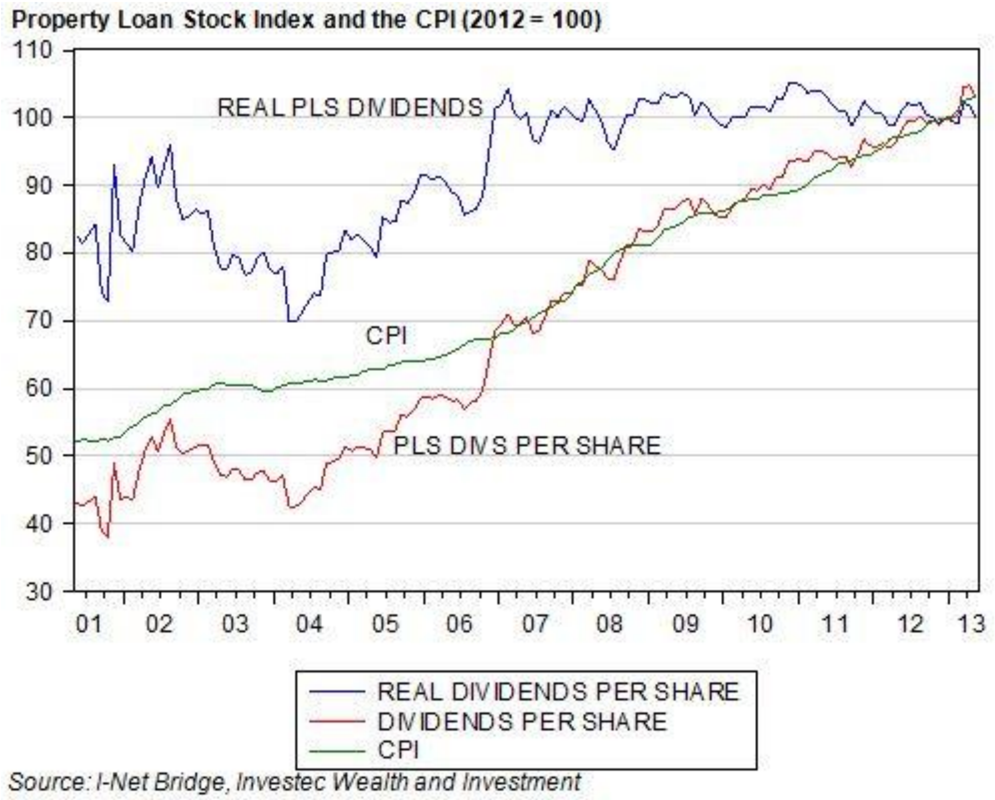
Source: I-Net Bridge, Investec Wealth and Investment



What has the market missed when valuing JSE listed property? Interest rates and / or property fundamentals?

The extra value attached to listed property could have come from unexpectedly good rental income and / or unexpected declines in the rates at which those rental flows are discounted. Listed property valuations have very clearly had the benefit of unexpected declines in interest rates. Less obvious may have been unexpectedly good or perhaps also unexpectedly consistent growth in rental incomes after costs. Expected dividends are not made explcit like interest rates and interest rate expectations. At best they can only be inferred from market movements themselves.

In the figure below we show how the dividends distributed by the companies represented in the PLS Index, weighted by company size, have grown over the years. Over the extended period the dividends paid have fully kept up with the Consumer Price Index (CPI). Having lagged behind the CPI between 2002 and 2004, the PLS Index's dividends per share had caught up with inflation by 2006. Since then they have matched inflation almost perfectly. Such consistent growth in distributions, despite the global financial crisis of 2008 that had a particularly severe impact on listed property elsewhere, might well have taken investors by surprise and justified something of a rerating for the sector. However no such re-rating has occurred.



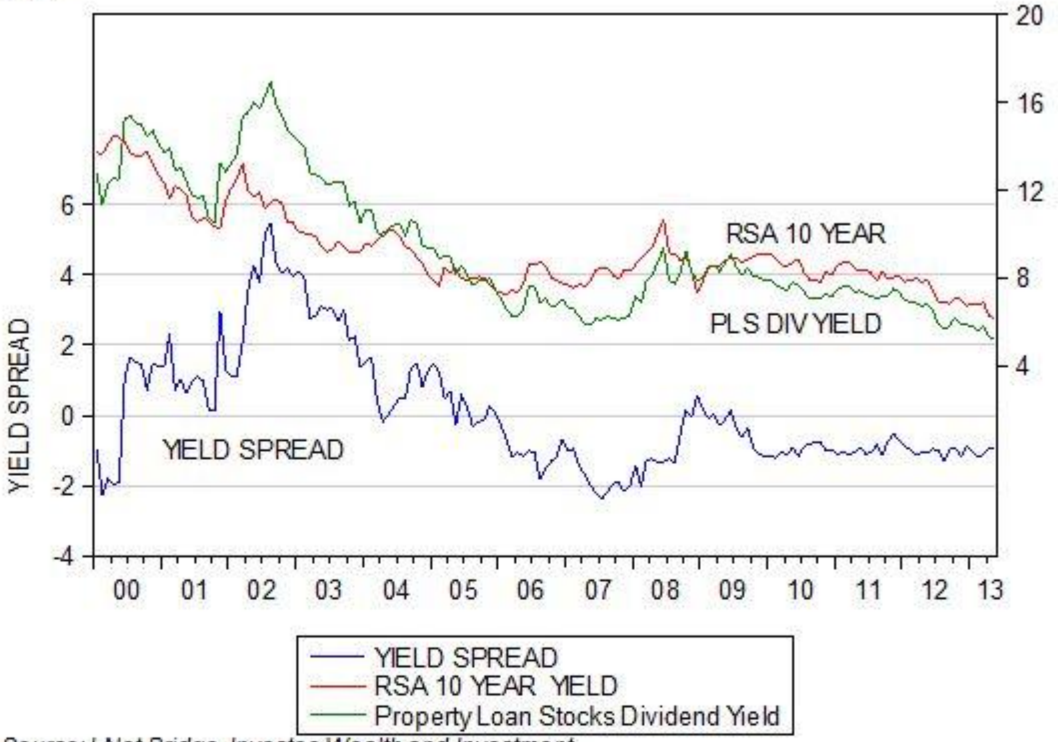
The benefits of lower interest rates for property valuations

The value of JSE listed property companies has been very clearly assisted by unexpected declines in SA interest rates. As interest rates come down, property companies benefit in two ways. Firstly, their bottom lines benefit from less interest expensed. Secondly, the discount or capitalisation rate attached to expected rental income goes down and values go up with lower interest rates.

As we show in the figure below, long term interest rates and the PLS dividend yield have declined in more or less lock step. We also show the difference between long RSA bond yields and the initial PLS dividend yield. This yield spread represents the rating of the PLS. A widening spread indicates less market approval (a de-rating) and a narrowing spread indicates a more favourable rating (a re-rating). This spread widened to the disadvantage of the property sector in 2002-03. It then narrowed significantly from a +5% spread to a -2% by 2007. Thereafter the spread widened as interest rates rose in 2008 and narrowed again in 2009. This risk spread has remained highly stable since then.

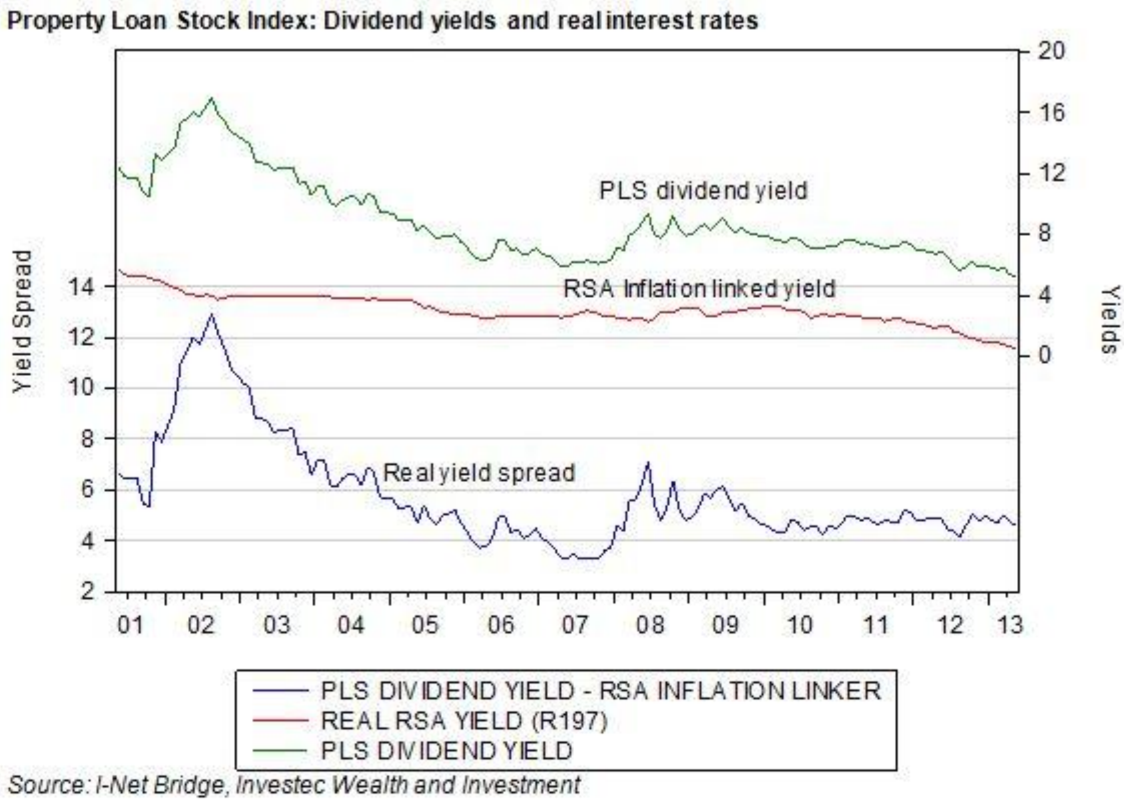
It may be concluded therefore that the sector has not improved its rating relative to long term bonds since 2009. The improved property returns since then can be attributed to interest rate movements rather than to any sense of improved property market fundamentals.

Property Loan Stocks and interest rates: Spread between the PLS dividend yield and RSA 10 year interest rates



Source: I-Net Bridge, Investec Wealth and Investment

Given that PLS dividends have kept pace with inflation (and may be expected to maintain this pace), the PLS dividend yield could then be regarded as a real inflation protected yield. Thus a comparison can be made with the real, fully inflation protected yield offered by RSA inflation linkers. The yield on the R197, an inflation-linked 10 year bond, has fallen dramatically over the past 12 months. Yet the spread between the PLS dividend yield and the inflation-linked R197 has remained largely unchanged as may be seen in the figure below. This “real” spread, the extra rewards for holding listed property, has not declined in recent years. This provides further proof that higher PLS values have been driven by interest rates rather than improved sentiment. No re-rating of the PLS sector has taken place according to these metrics.



Making the case for the PLS sector at current levels and yields.

The listed property sector is highly sensitive to interest rate movements. We calculate that for every 1% move in the All Bond Index, the PLS Index can be expected to move in the order of 1.5%. We have shown that the major force acting on the PLS Index in recent years have been lower interest rates. As we have indicated, there is little sign in the market place that expectations of the property sector have become more demanding. It is lower interest rates rather than faster growth in expected rental income (and the dividends associated with better underlying economic performance) that have driven the PLS Index higher.

What then are the required returns that will drive property valuations and development activity in SA over the long run? Our sense is that that the normal risk premium for a well diversified, listed and well traded SA property portfolio should be of the order of extra 2-3% per annum over long term interest rates on RSA bonds.

If that is the case, the expected risk-adjusted return on listed property would now be of the order of 9-10% per annum, that is about 3% above the current 10 year RSA bond yield of 6.13%. The current PLS Index dividend yield is 5.2%. Expected inflation implicit in the RSA bond market is 5.56% - being the difference in the nominal yield on a generic RSA 10 year bond of 6.13% and the equivalently dated inflation-linked RSA197 that currently yields 0.57%.

Adding inflation equalling growth in PLS dividends of 5.57% to the initial PLS dividend yield of 5.2% gives us an expected return of 10.77% per annum, or a PLS risk premium of 4.64% per annum. This is a risk premium significantly higher than our estimate of a required risk premium of 2-3%. It suggests that if we are right about a normal risk premium there is still some upside for the PLS Index at current interest rates.

Subtracting the RSA inflation linked yield of 0.6% from the 5% PLS dividend yield gives us real risk premium of the same magnitude, of about 4% plus. Again this seems too generous a reward for the risks in well diversified real estate.

The fundamental case for investing in JSE listed property today is that the current risk premiums available in the market place are larger than necessary for attracting funds to the sector. Yet it should be appreciated that regardless of the long term case for investing in JSE listed real estate (that may or may not prove compelling), the short term movements in the PLS Index will be dominated by movements in interest rates. In the short, if not the long run, the property sector remains a play on the direction of interest rates, regardless of the investment fundamentals.

How profitable are platinum miners?

By David Holland and Brian Kantor

Behavioural studies have shown that humans exhibit a strong anchoring tendency. When the world changes, they remain anchored to the one they know instead of adapting to the new order. Evidence for this behaviour is ubiquitous when parsing through government and labour comments about the ability of mining companies to pay more or hire increased numbers of workers. This is undoubtedly a reason for delay and lack of resolution in discussions between government, organised labour and Anglo American Platinum about the company’s need to reduce costs and investment.

We would like to take a step back and assess how profitable platinum miners are, and calculate the expectations embedded in their market prices. Once we understand those expectations, we can focus on the best way forward for the businesses and their stakeholders.

The platinum industry has been one of great hope and now disillusionment. We aggregated the historical financial statements of the five largest South African platinum miners (Anglo American Platinum, Impala, Lonmin, Northam and Royal Bafokeng) and calculated the inflation-adjusted cash flow return on operating assets, CFROI, which is the real return on capital for the industry. From 1992 to 1997, platinum miners were generating an unattractive return on capital, which slumbered below the cost of capital. The years 1999 to 2002 provided the first wave of extraordinary fortune for platinum miners. The real return on capital exceeded 20%, making it one of the most profitable industries in the world at that time (the average CFROI for global industrial and service companies is 6%). The rush to mine platinum and build company strategies around this effort was on, e.g., Lonmin bet its future on platinum.

The second wave of fortune occurred during the global commodities “super cycle” from 2006 to 2008. Again, platinum mining became one of the most profitable businesses in the world. The good times ended abruptly with the onset of the Great Recession in 2009, and platinum miners saw their real return on capital drop to 1% - well below the cost of capital, i.e., the return required to justify committing further capital to the industry.

Unfortunately, operating returns have not improved much and have remained below the cost of capital throughout the global slowdown due to increasing labour, electricity and excavation costs, and lower platinum prices. By cost of capital, we mean the minimum return required of an investment in an industry with proper regard to the risks involved in its operations and financial constraints. The greater the risks, the greater the return required to sustain or expand the industry. Firms or sectors of the economy that prove unable to satisfy their cost of capital decline while firms that beat their cost of capital are strongly encouraged by shareholders and other capital providers to expand and to raise the finances necessary to do so.

The 2012 CFROI in the platinum sector of the SA economy was a miserable minus 0.6%, which is the lowest return on capital since 1992 when our calculations on realised returns in the sector begin. Suffice to say, platinum miners aren’t producing sufficient returns to satisfy shareholders or the market place to support their operations. This has resulted in unavoidable cost-cutting, lay-offs and deep cuts to capital expenditure plans. These are natural economic consequences when a business is destroying economic value by not meeting its cost of capital.

And what does the future hold? We’ve taken analyst expectations for 2013 and 2014 and estimated the real return on capital. It remains very poor at a value destructive level of 0% for 2013 and a depressed 3.4% until 2017. There is no hint of a return to superior profitability in the share prices of platinum miners. The market has them valued to continue to realise a real return on capital of less than 6%, which is the average real return on capital for industrial and service firms throughout the world.

In a nutshell, South African platinum miners are destroying value and are expected to continue to do so. They are in a very dire economic state. To survive they have to reduce costs. Demands for wage increases that far exceed inflation are now totally unrealistic and cannot be fulfilled. These demands are anchored to a past that no longer exists. The tragedy is that for the workers who are bound to lose their jobs mining platinum, there are no forms of alternative employment that will provide them with anything like the same rewards.

All parties should focus on what is realistically possible and economically feasible. A wage freeze, reduced hours or some form of deferred pay are called for to minimise the pain. The workers and the unions already subject to retrenchment and very poor job prospects would surely be wise to focus on job retention rather than further gains in real employment benefits. Deferred pay offers the potential for an inventive compromise where pay is exchanged for share options. It would be in all parties' best interest for productivity to improve and for the shares to appreciate.

Unless the industry can come to deliver a cost of capital beating return, its value to all stakeholders will surely decline further and its prospects deteriorate, perhaps even to the point where nationalising the industry with full compensation might seem a realistic proposition. It may cost relatively little to take over a failed industry. Nationalisation however will not solve the problem of poor labour relations and the decline in the productivity of both labour and capital in the industry. It would simply mean that taxpayers, rather than shareholders who will have lost so much, carry the can for the failures of management and unions that must share the blame. The government and its agencies have many alternative and much better uses for tax revenues than to subsidise the already well-paid workers in a difficult, capital-intensive industry that is likely to realise poor returns.

The unions might think (correctly) that management subject to the discipline of taxpayers rather than shareholders would be a softer touch. Government and its taxpayers should be very wary of signing a blank cheque. All parties need to focus on what is realistically possible and economically feasible. By taking stock of the poor economic performance of the platinum mining industry and its depressed expectations, all parties can negotiate from a shared set of financial and economic facts. These are difficult times and creative approaches are needed. All parties need to be anchored in the right bay, signaled by today's reality and expectations.

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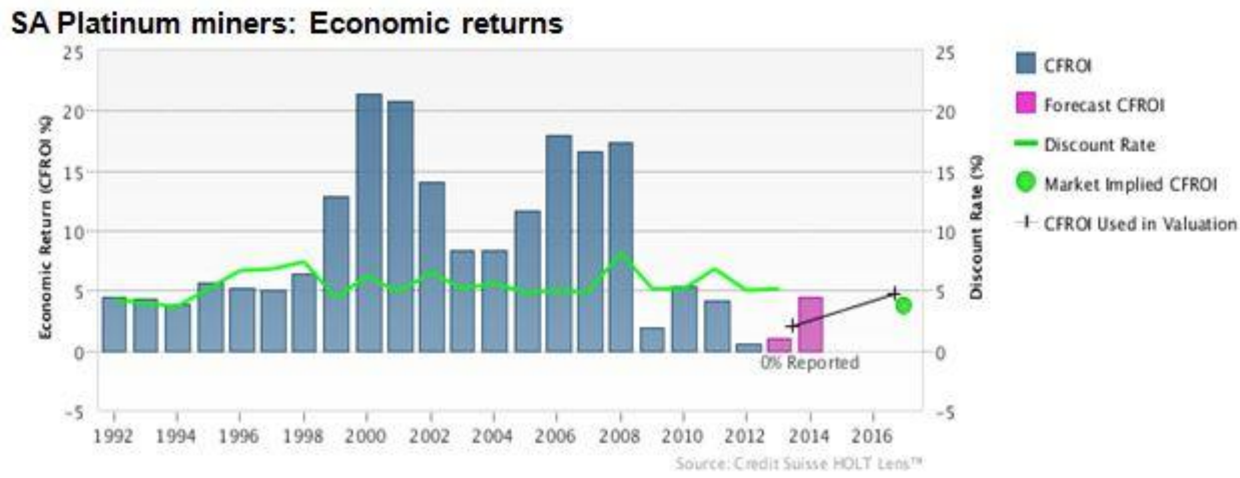


SA unwittingly following German lead

By Cees Bruggemans, FNB Consulting Economist

There is a structural change underway in SA reminiscent of Germany in the 1990s. By the late 1980s, Germany had accumulated a very comprehensive regime of social welfare and labour market legislation that had the effect of boosting business costs and restricting more flexible hiring practices, systematically eroding the global trade-competitiveness of its champion export businesses.

The geopolitical changes after 1989 fundamentally changed this picture. Germany took back Eastern Germany, and in addition its businesses gained unprecedented access to the East European and Russian economies. On the supply side this meant regions without the same cost-boosting and restrictive features as the home base.

With Germany remaining a major export-oriented economy, these geopolitical changes made it possible for German business to achieve two things. It became possible to outsource production to lower cost hinterland border regions on a significant scale and simultaneously win reform concessions allowing the trade-competitiveness of the home base to be improved as well.

This phenomenon was but a small component of a larger one called globalisation. This had been underway for centuries. Its main post-WW2 features included US businesses creating a supply base in Europe to get behind the protective trade barriers newly erected there, Japan and South East Asian countries targeting Western exports as their main demand engine, and Western businesses identifying China and other locations as the lowest cost bases from which to supply their global markets.

So the German development in the 1990s was really only a regional one, and not particularly exceptional, given the dimensions of these other developments.

What stood out about the German phenomenon, however, was the way it assisted in transforming its home base, giving it new trade-competitive advantages (unlike much of the Anglo-Saxon experience where industrial activity simply melted away, migrating generally towards Asia, and in the US case also to Mexico and points south, whereas for Britain it was also mainly towards Europe).

So what is the modern SA experience?

The home base is increasingly becoming crippled by steeply rising infrastructure and labour costs and operational inflexibility and restrictions on the supply side while demand is underperforming our potential by a growing margin (no pun intended).

Whereas earlier outward waves of migration by the larger SA corporate groups in the 1990s were particularly associated with long-term political calculations, often apparently welcomed nearly equally by all the many diverse interests involved, the developments of the past decade fall in another category altogether.

Early forced business migrants were for instance the construction groups, starved at home from new project work and forced to go elsewhere in search of work, not least the then oil-booming Middle East.

Other adventuresome businesses explored wider afield in Africa, then still very much an early frontier proposition in terms of risk and reward.

But as time went by, two opposing realities created an ever starker proposition.

The dynamic growth was apparently not to be found at home, but dynamic costs were, with the sky the limit in some respects, as government regulation proliferated, labour demands escalated and growing infrastructure shortcomings offered their own brownout magic.

In contrast, greater Africa had started to experience an impressive growth revival after a long dormant post-colonial interval in which it had to redefine itself.

This greater African revival coincided and was pushed by the great post-Mao Chinese industrial leap forward, requiring commodity access on an unprecedented scale.

Australia, the Middle East, Canada, Russia and Latin America were natural beneficiaries, but Africa turned out the big, if late, new discovery.

The money flows set in motion were such that greater Africa started to generate escape velocity growth speeds in the 5%-10% range.

It may have started slow, but SA business did wake up to the potential as much as Chinese, Indian, European, Mediterranean, Brazilian and other interests did, with the advantage of being closer and often knowing the continent more intimately.

Yet identifying foreign growth markets is one thing, with some of our more remarkably entrepreneurial businesses going further afield and taking even China and Europe by storm through big investments.

It is something else entirely when a general sense comes to prevail that the home base has become stagnant and devoid of genuine dynamic growth potential, at least for an interim period potentially lasting a very long time until society finally comes to its senses in its post-apartheid directionless stupor.

But while all this plays out, many of us do not have the luxury of taking a collective gap year, decade or century until things have finally settled down at home. Necessity, dictated by financial investor demands, requires new outlets for capital and resource deployment in order to maintain acceptable rates of return.

And so what started out as a supplementary growth story (the incursion into African growth markets in the 1990s) has increasingly acquired a life of its own and many now be supplanting the main home base growth story where high costs and growth stagnation is apparently increasingly the prospect while society tries to recast itself during which painful confrontation the economy takes a backseat.

Investors are focused on returns, and businesses are nothing else but accumulations of resources aiming to achieve economic returns for their stakeholders, as much their employees as their owners. And so they go where the greatest risk-reward tradeoffs favour them.

If the home base becomes so tied up in knots as to not being able to find sensible policy mixes supporting strong economic performance, private initiative drains away towards other destinations more rewarding in their common sense and performance.

This, though, can lead to other outcomes as well.

The old apartheid and Latin American response, and also long a characteristic of the poorer performing societies in Europe, would be to turn more protectionist and controlling. So capital controls to keep the wandering production managers at home and high protective walls to keep the foreigners out, with special directives to favour certain home bases over others to complete social engineering objectives.

It is the ultimate formula for stasis, and we have already regressed quit some way on this path after the reforms of the 1980s and 1990s attempted to dismantle many of the old apartheid follies.

The alternative outcome (call it the German lead) is that the ability of our producers, big and small, to co-opt the African continent as growth dynamo could assist in transforming the home base reality along more common sense lines as originally intended post-1994.

This would suggest the need for more reform allowing cost reductions and faster demand growth, making the home base more attractive again and allowing it to successfully compete for greater infusions of fixed investment.

This is not a foregone outcome. It worked for the Germans that way, not least because its government ultimately also saw the need for reforms reinforcing this outcome.

Whether the duel between the forces opposing each other in SA society today (each favouring quite different outcomes to their efforts) will be ended quickly looks currently doubtful. There is flux, for sure, but knock-out blows may not occur, and the argument may remain a grinding one taking a number of years before tiredness and lack of progress sees more compromise and possibly even a new synthesis emerging.

The outward migration of our productive effort draining into the African continent could be an important catalyst in this process. Whereas before it was mostly just plain politics, the grinding reality of home base under-performance and the available alternative of seeking rewarding returns elsewhere may eventually assist in our society coming to its senses earlier than if it were to be left purely to its own devices.

Time will tell, but increasingly critical mass in family fortunes (with family members migrating elsewhere into Africa pursuing work and business opportunities), small and medium business orientation and the effort put into regional diversification by the larger businesses is something that will define the stagnating departed home base as much as the welcoming dynamic African continent opportunities.

Our growth machine is emigrating, a fact that one hopes our politicians, progressives and powerful NGOs understand. Indeed, SA may suddenly find that it is no longer the most important economy in Africa. Any chair at G20 may then go to our big rival Nigeria, and also any chair waiting at the UN Security Council, not even talking about the World Bank and IMF or of BRICs (BRINC).

We need more reform, less cost pressure, more flexibility, a greater sense of awareness that our SA opportunities are passing us by. And yes, our businesses need to be profitable, for otherwise they fail, will not pay taxes and will not offer work opportunity to their labour forces and their dependents.

All Japan, all the time

by John Mauldin

The evils of this deluge of paper money are not to be removed until our citizens are generally and radically instructed in their cause and consequences, and silence by their authority the interested clamors and *sophistry of speculating, shaving, and banking institutions. Till then we must be content to return, quo ad hoc, to the savage state, to recur to barter in the exchange of our property, for want of a stable, common measure of value, that now in use being less fixed than the beads and wampum of the Indian, and to deliver up our citizens, their property and their labor, passive victims to the swindling tricks of bankers and mountebankers*. –Thomas Jefferson, in a letter to John Adams, 21 March 1819

I am definitely bullish. The budget deficit is shrinking massively. Guys who are short, they better have a shovel to get out of the grave. –David Tepper, Appaloosa Management LP, CNBC, 14 May 2013

Never have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk. –Bill Gross, PIMCO, 14 May 2013

We can rightly declare victory on the housing front and (reduce) our purchases, with the aim of eliminating them entirely as the year wears on. I believe the efficacy of continued purchases is questionable. –Richard Fisher, president of the Dallas Federal Reserve Bank, National Association for Business Economics, 16 May 2013

It will take further gains to convince me that the "substantial improvement" test for ending our asset purchases has been met…. We could reduce somewhat the pace of our securities purchases, perhaps as early as this summer. Then, if all goes as hoped, we could end the purchase program sometime late this year. –John Williams, president of the Federal Reserve Bank of San Francisco, Reuters, 16 May 2013

The balance of risks of prolonged very low interest rates and unconventional policies is shifting. The costs are growing in relation to the benefits. –BIS, Reuters, FT Alphaville, 16 May 2013

Jefferson was lamenting the woeful state of the dollar 200 years ago because the country was beset by fiscal problems, not because someone in the government wanted to ruin the value of the currency. Today, however, we find ourselves in a situation where it is the national policy of multiple countries, including the United States, to reduce the value of their currencies. My friend Mohamed El-Erian chided me on stage at our recent conference not to say “currency wars” but to use the more polite term “currency tensions.” But no matter what you call it, there are clearly governments whose intent is to pursue a mercantilist trade policy to the detriment of their trade partners by manipulating the value of their currencies.

I predicted in *Endgame* that the latter half of this decade would see the most serious currency wars since the end of WWII. The opening shots have been fired. This will not be just a continuation of the currency skirmishes we have seen in recent decades. No, the real artillery is being brought to the front. And as in any war, it is best not to have your valuable personal possessions anywhere near the field of conflict. But which way to run? Who are the good guys to run to? Are there any good guys at all? Maybe the better question to ask is, who will win? Will there be any winners? Do you really want to look like Rocky Balboa after his first winning fight?

This week we again focus on Japan. Their stock market has been on a tear, and their economy grew 3.5% last quarter. Is Abenomics really the answer to all their problems? Is it just a matter of turning the monetary dial a little higher and voila, there is growth? Why doesn’t everyone try that? And what would happen if they did?

All Japan, All the Time

Japan grew at a 3.5% annual pace last quarter, the fastest pace in a very long time. Of course, government officials see this development as vindication of their new policies and will no doubt decide that even more of the same will be needed in the future.

Retail sales in Japan are soaring as a “wealth shock” electrifies the economy. The Nikkei index has risen 70% since November, with foreign hedge funds among the first to jump on the bandwagon. The chart below provides some perspective on that rise. I can see several similar moves in the past 20 years. If this were a one-year rather than a 30-year chart, would everyone be so eager? I'm not saying that the move isn’t real. A lot of money has been made, at least on paper.

The weaker yen is already delivering a powerful punch, accounting for almost half the growth in the recent quarter. The currency has dropped 30% against the dollar and against China's yuan since August, and 37% against the euro. This causes Ambrose Evans-Pritchard over in London to worry:

The yen-slide – or "Enyasu" – has raised concerns that Japan is exporting deflation through a "beggar-thy-neighbour" push for export share, a claim rejected by Tokyo.

Stephanie Kretz from Lombard Odier said the falling yen looks like a replay of the mid-1990s before the onset of the East Asian crisis, when external funding dried up in a "sudden stop".

It poses a direct threat to Malaysia, Vietnam, Thailand, Korea and others with a high trade gearing, as well as for China, though foreign debts are lower this time. She warned that the trade surpluses of these countries could evaporate, "silently planting the seeds for the next Asian crisis down the road".

Albert Edwards from Societe General said "Enyasu" may be the catalyst that pops China's credit bubble. He warns that loss of exchange competitiveness after years of soaring wages leaves China vulnerable to a deflationary monetary squeeze and should ring alarm bells. "This closely echoes the situation in the run-up to the 1997 Asian currency crisis." *(The Telegraph)*

Currency manipulation is against the G7 and World Trade club rules. Japan, they contend, is merely engaged in a domestic policy move to try to stop deflation and kick-start the economy. So anything that happens on the currency front is a complete coincidence.

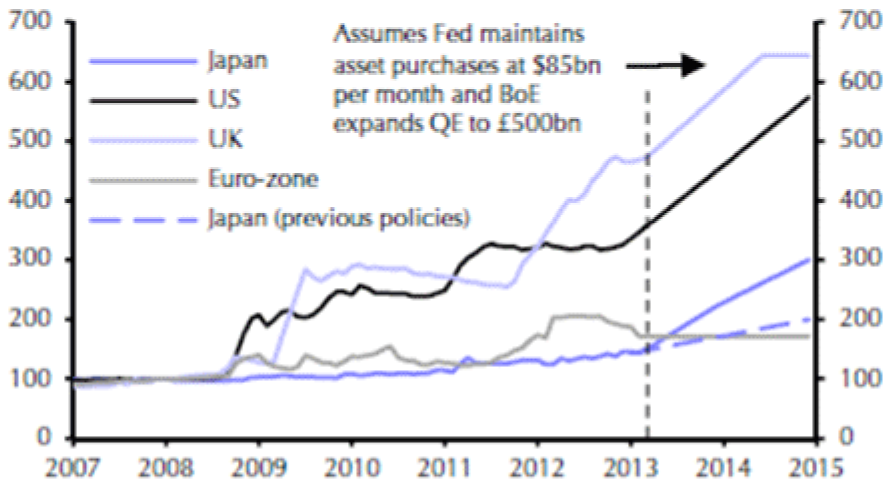
Except that it isn't.

Japan has been in a deflationary slump for over two decades. Nominal GDP has not grown. Government debt-to-GDP is now over 240%. Interest rates have been stuck at the zero bound. There has been no control of the fiscal deficit. The trade deficit has been rising. All this led me to start calling Japan "a bug in search of a windshield" a few years ago.

Prime Minister Abe has committed to a "three-arrow" approach to solve Japan's problem. The three arrows in his quiver are more-credible fiscal plans, aggressive monetary easing, and a growth strategy based on structural reform. The monetary easing is the easy part. Essentially, the Bank of Japan is engaging in almost as much quantitative easing as the US Federal Reserve but in a country 1/3 the size of the US.

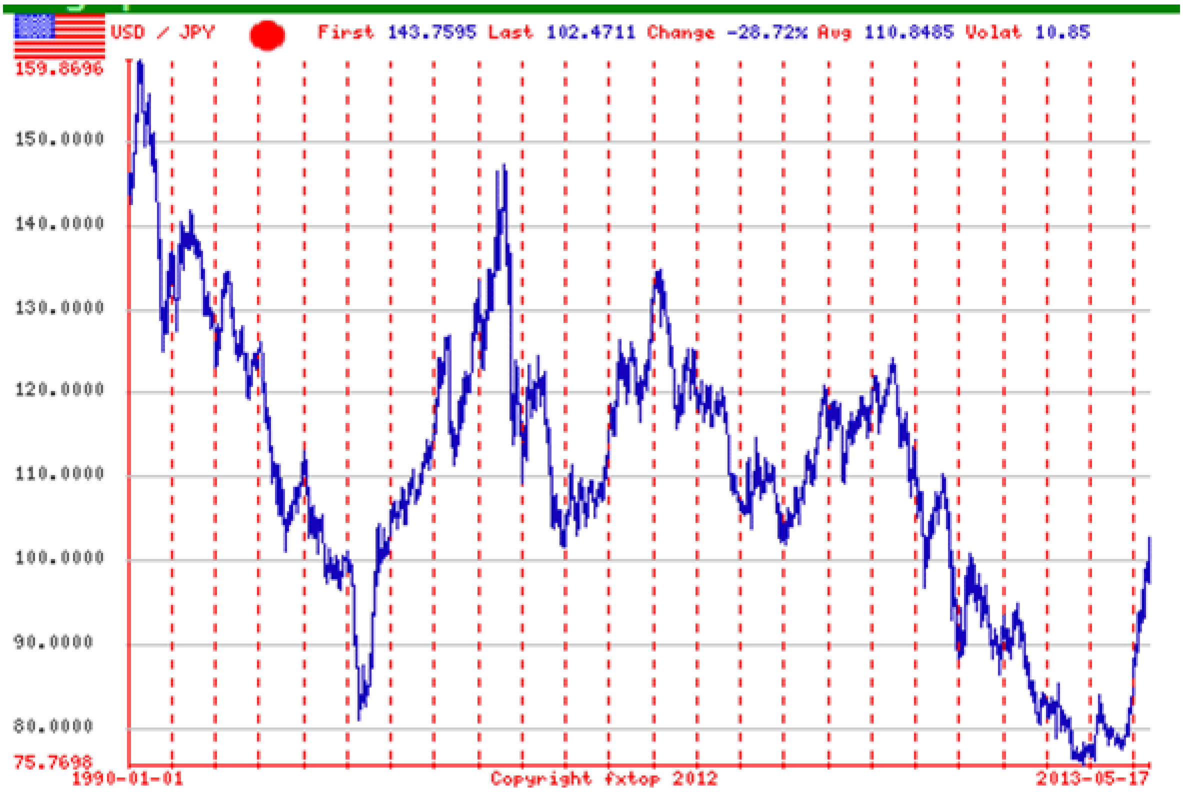
And while the headline number is rather startling, the Bank of Japan has a long way to go to catch up in the QE department. The UK and US are WAY ahead of Japan, as this chart from Capital Economics makes clear. (For those reading in black and white, the line that just reaches 300 in 2015 is Japan's current policy projection.)

CHART 9: MONETARY BASE (JAN. 2008 = 100)



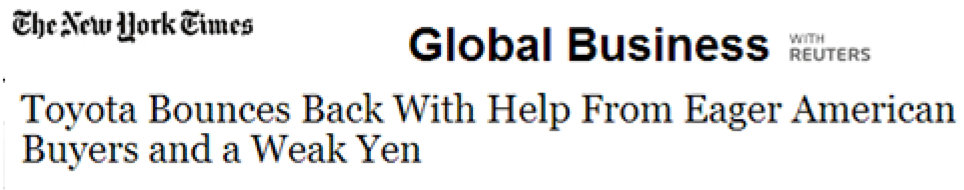
Sources – Thomson Datastream, Capital Economics

Let's quickly review a few charts on the history of the yen. The first is the yen against the US dollar since 1990. Yes, the yen has fallen 35% or so against the dollar in its recent move, but it must fall another 20 yen to get back to where it was just six years ago. It traded at over 350 yen to the dollar when I was in school, back in the Dark Ages. The yen's four-decade appreciation of some 470% against the dollar puts the recent move of less than 25 yen into historical perspective.



The team at Mauldin Economics, writing in [*Just One Trade*]() this week, sent out this note:

Let's put the recent drop in the yen in context. The *Nihon Keizai Shimbun,* the main Japanese business newspaper, has reported that every one-yen fall in the yen/dollar rate will translate into a $2.7 BILLION increase in profits for the 30 largest Japanese exporters.


The New York Times

Global Business WITH REUTERS

Toyota Bounces Back With Help From Eager American Buyers and a Weak Yen

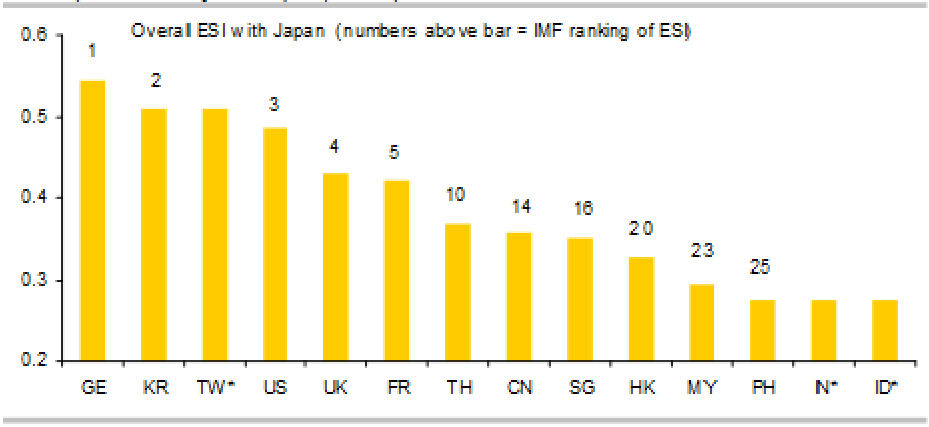
For every one yen the currency drops in value against the dollar, Toyota estimates that its profits will increase by $340 million. PER ONE-YEN DROP!

Toyota reported $3.33 billion in profits last quarter, so that additional $340 million of profit per one-yen fall could send its second-half profits – and its stock – to the moon.

But those profits don't just magically appear; they come from sales. Sales that are in large part due to better terms of trade and lower costs. Those profits are from sales that might have gone to other companies based in other countries and that might have been valued in euros, dollars, yuan, or won. Which is why businesses and finance ministers all over the world are not happy with Japan.

A rather useful analysis of the competitive relationships between Japan and its Asian neighbors was recently published by Charlie Lay at Commerzbank . In it he has a chart from IMF data that examines export similarity with Japan. Germany is the country whose exports are most similar to Japan's, followed by Korea and Taiwan, then the US, UK, and France.

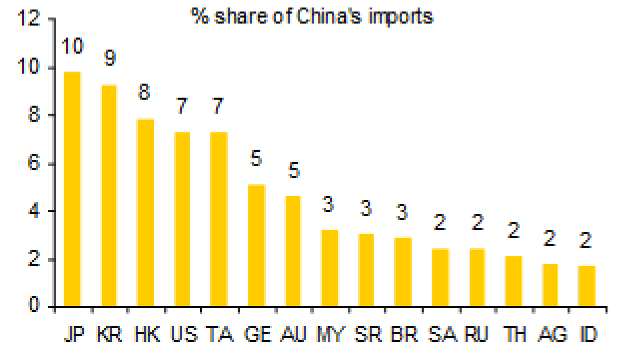
Chart 1: The ESI captures the high export overlap between Japan and Korea & Taiwan
IMF Export Similarity Index (ESI) for Japan



Source: UN Comtrade, IMF, *Commerzbank Estimates

China is becoming an ever larger part of global trade as the country continues to develop. And who exports the most to them? Japan, of course, and Japan competes directly with Korea, Hong Kong, and Taiwan for that business.

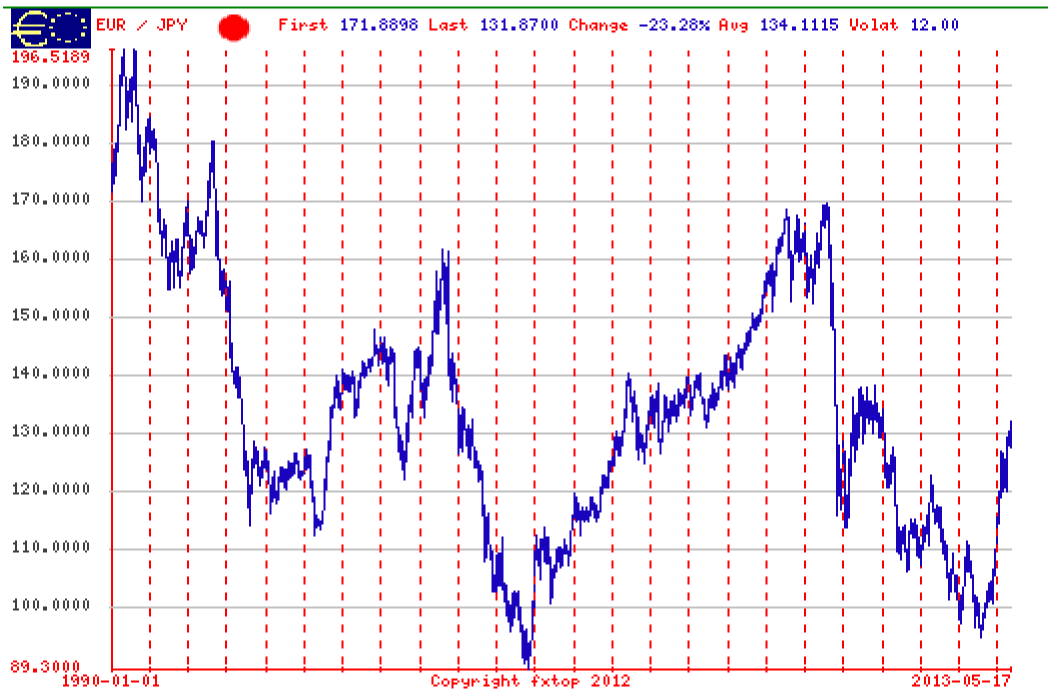
CHART 7: **JP & KR are competitors for the China market**
% share of China's imports, by country of origin



Source: Commerzbank Corporates & Markets

Profits in companies in Korea, Hong Kong, and Taiwan are getting hammered, as those companies have to lower prices to compete with resurgent Japanese firms. While the government of Japan will never publicly admit it, it will not be long until the yen is at 120 and then moving even higher, although the road to *enyasu* will get bumpier as the yen falls ever more and other countries respond. Japanese monetary policy is almost irrevocably committed to continuing to devalue the yen for a very long time at what will be an ever-increasing rate.

The next chart shows the euro-yen rate over the last 23 years. If the yen moves back to where it was just six years ago, Germany et al. are in deep schnitzel as far as their export trade is concerned.



Go back up to the chart that compares monetary bases. That will help you understand the muted response of the US and the UK to Japan's moves. We have heard from EU ministers, notably in Germany, who are very vocal in complaining about Japan. The ECB has an inflation mandate that is theoretically limiting them from quantitative easing on the scale of the US, UK, or Japan. I say theoretically because, when Germany joins France in a serious recession that is due in part to "currency tensions" (or at least that is where the finger will be pointed, because gods forbid we blame our own policies), I fully expect those very creative people at the European Central Bank to come up with a “legal” way to join the QE party. And everyone knows that when Draghi decides to stir things up, he does so with style and with a full orchestra in accompaniment. And the Bundesbank will be playing the bass fiddle and drums.

Let’s Export Our Deflation

The number one export that Japan is offering is its deflation. It is trying to push deflation on every country that competes with it for trade. That is rather the point of an inflation target of 2%. It is just as if the leaders of Japan had got together and said, “We can’t seem to get rid of our deflation. Let’s see if we can export it.” Capital Economics writes this interesting note on that goal:

Is 2% inflation achievable? This doesn’t mean that inflation won’t head towards 2% soon. There were two periods when inflation topped 2% even during the lost decades – when the consumption tax was last raised in 1997 and when the costs of imported oil surged in 2008.

Indeed, we expect inflation to climb above 3% in 2014 as a result of the planned consumption tax hike next year. However, the Bank of Japan will look beyond any tax effects when gauging progress towards its inflation target. While we do expect inflation excluding tax effects to pick up as well, this would largely be a result of the pass-through of yen weakness to import costs rather than any sustained increase in underlying inflation.

And that is the problem. Japan can generate inflation if it depreciates its currency. But that inflation will have particularly harsh effects on retirees. Energy and food (which are largely imported) and any other item that needs resources not found in Japan will rise in cost as the value of the yen falls. Those living on fixed incomes will be hurt the most, and that is a very large and growing part of the population of modern Japan.

Abe’s reforms require significant economic growth. Japan has had none for two decades, and now conditions for growth are even more difficult. Growth in

GDP comes from two (and only two) sources: growth in productivity and growth in (working-age) population. Japan’s population is actually shrinking, and its working-age population is falling even faster as the country rapidly ages.

Because of the demographic problems of an aging Japan, economic growth will require even greater productivity growth than normal. Where is that going to come from? Real productivity growth (as opposed to nominal growth due to inflation) is not something you can just dial up with government policies and quantitative easing. It is incremental in nature. If you want 3% GDP growth in a country whose population is shrinking by 1%, you need 4% productivity growth, give or take. That just doesn’t happen on a sustained basis in a developed country.

And even with that growth, it would not be easy to achieve 2% inflation in Japan. Roubini Global Economics noted yesterday:

However, consumer service sector price deflation, arguably the most important gauge of general price level trends, accelerated for a third straight quarter, corroborating the weak CPI data we have seen so far this year. There is still a long road to sustained positive inflation.

The first thing that jumped out at us was the negative sign in front of the private nonresidential investment growth rate. At -0.7% q/q, private investment in plants and equipment recorded a fifth straight sequential contraction, a particularly ignominious result…. Given the slack still evident in the economy through Q1 (recall that deflation worsened over the quarter), this result isn't so surprising. The pace of contraction was considerably slower than H2 2012, and we expect to see this series return to growth in Q2. Still, this persistent weakness underscores the challenges to Japan's longer-term outlook. The pace of private nonresidential investment is now more than 17% below its Q1 2008 peak. (*www.**roubini**.com*)

What is one of the primary sources of increasing productivity? It is private capital investment (and yes, government can also be a source of capital and infrastructure). And as Roubini noted, private investment fell last quarter. The growth that occurred came from currently available industrial capacity. Clearly, Abe and company have decided that the spare capacity in Japan must be utilized (which will increase productivity because of past investment) so that new investment and a new growth cycle can start.

The Hard Part: Structural Reform

But new growth will also require concerted political and structural reform, something that Japan has been reluctant to tackle in the past. They would not restructure their banks or their debt after the bubble burst in 1989, and their failure to do so has been a main cause of the economic malaise of the last 24 years. The history of Japan since 1989 has been that they avoid real reform, preferring the easier option of more government spending.

We will close with this analysis from Capital Economics:

The third arrow of Abenomics is a growth strategy based on structural reform. The challenge here will be to raise growth even though the working age population will be falling by up to 1% per year over the next ten to twenty years. The government has identified several priorities, including deregulation (with a focus on the labour market, energy sector and healthcare), reforming the corporate tax regime, and trade liberalization (notably by seeking to join the Trans-Pacific Partnership). However, the jury is still out on whether this administration will be any more successful in raising Japan's productivity than its predecessors, which were also mostly led by the LDP. Announcing another fiscal stimulus for 2013 and persuading the Bank of Japan to loosen monetary policy were relatively easy wins.

What Could Go Wrong?

In summary, "Abenomics" surely represents the right mix of policies to tackle Japan's problems. But at the risk of sounding perennially gloomy, there are still a number of things that could go wrong. In particular:

i. the consumption tax hikes could derail the recovery, but if they are delayed the government would lose credibility, including with the Bank of Japan;

ii. JGB yields could take off, although we are sanguine about the increases that have taken place so far;

iii. prices could rise well before wages and other incomes, depressing consumer confidence and spending power. Indeed, few households view the prospect of an end to deflation quite as positively as businesses and investors, while in Japan's case the wealth effects from higher equity prices are relatively small;

iv. the broad money and credit aggregates could remain subdued, despite the rapid expansion of the monetary base, undermining confidence in the effectiveness of the Bank of Japan's bold policy easing;

v. companies could still be reluctant to invest and hire in Japan itself, especially if the global backdrop deteriorates and local costs surge – the latter due in part to the slump in the value of the yen;

vi. the LDP-led government could disappoint on structural reform – again."

In short, the Japanese government has embarked upon an economic experiment in Keynesian theory that is breathtaking in its promised scope. They are betting that they can gear up enough growth to overcome deflation and demographics, allow the country to balance its budget, find an inflation level that will allow the Japanese debt to shrink relative to GDP, make Japan even more of an export powerhouse, and increase productivity on a scale never before seen in a developed country. It leaves one to wonder whether they might not solve global warming in their spare time.

They will do all this while hoping that the rest of the world sits idly by and watches Japan take export market share through quantitative easing. Meanwhile they're picking a fight with China over islands that are basically piles of rocks, a dispute which will cost them massive amounts in lost sales, far more than the worth of the islands, even if there is substantial oil in the surrounding waters. Japan is also betting that the technology landscape in its key industries won't change too fast. How could anything go wrong here?

We do live in interesting times.