JAPANESE EQUITIES

The onset of a bull market

WEAKENING YEN MEANS A RALLY FOR STOCKS

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As the yen continues to weaken and the rally of Japan's stock index, the Nikkei, persists, it is time to start adding exposure to its stock market. With the country's current account surplus worsening, it is getting more difficult to finance the budget deficit of around 9 percent of gross domestic product, coupled with a sovereign debt amounting to 240 percent of GDP — both figures being roughly double that of Lebanon's equivalent statistics.

BONDS...JAPANESE BONDS

Japanese establishments have always been the biggest and most reliable buyers of Japanese government bonds (JGBs), but they have recently been conveying that they lack the funds to keep buying at the scale of previous years. The Bank of Japan needs to step in and buy government bonds with newly printed yen so the supply of yen will have to rise drastically in the coming few years. This would lead to price levels in Japan moving from a deflation of slightly below zero to an inflation of around 2 percent, the target set by the newly appointed government and the Bank of Japan. The resulting weaker yen would be a new scenario for Japan as the country's currency has been one of the world's best performing for the past 20 years.

Additionally, Japan's major life insurance companies act as pension funds for the Japanese community, which has a high propensity to save, with these savings being channeled into investment in domestic and foreign assets. Because of the yen's positive performance over the years, these life insurance companies have hedged part of their exposure to the currency by buying yen against their foreign holdings. The recent drop in the yen might force the hand of these institutions to unwind part of their hedges by buying tens of billions of dollars and simultaneously selling yen. Many other institutions, from pension funds to industrial companies, are in a similar position and will have to react in a comparable fashion. As a result, demand for JGBs will likely decrease, threatening the big Japanese banks as they have large holdings in JGBs. To counter this, the Bank of Japan will need to intervene and buy more bonds, thereby increasing the supply of yen even further.

GRABBING STOCKS BY THE HORNS

Japan's dangerous game of weakening its currency — given that it is a policy which could eventually backfire as more than one nation can play this game — is nonetheless very beneficial to Japanese manufacturers and exporters and bullish for Japanese stocks as the recent rally in the Japanese index Nikkei indicates. Japanese equities have been in a bear market since 1989 with investor sentiment constantly deteriorating. The consistent drop in prices and sentiment over the years, with Japanese equities losing three quarters of their value in the past 23 years, has led to the country's stocks being competitively priced relative to their international counterparts.

On the other hand, the value of the bond market in Japan has risen by around 400 percent. A major switch from bonds to stocks is already underway and an acceleration of this process could create a major bull market in the country's equities as Japanese and foreign investors scramble to buy stocks. In my opinion, the best way to benefit from such a scenario is by buying a currency-hedged electronic traded fund such as the WisdomTree Japan Hedged Equity fund listed in the United States under the symbol DXJ.

Given the explosive nature of both the rally in Japanese equities and the dramatic drop in the yen in recent months, I believe that in the short term the call is overstretched and warrants caution. However, given my extreme bullishness on Japanese equities and bearishness on the yen for the next two to three years, I would recommend keeping an eye out for a major correction, which should be used as an entry point to add exposure to what could be the onset of a bull market for Japanese equities.