October 26, 2012

"How many things we regarded yesterday as articles of faith that seem to us only fables today?"
- MICHEL DE MONTAIGNE, FRENCH RENAISSANCE PHILOSOPHER

Land of the setting yen? After nearly 34 years in the investment business, one strongly and widely held view—clutched with almost religious fervor by millions of investors, academics, and policymakers—still leaves me incredulous: the belief that markets are efficient. Unquestionably, markets are often reasonably accurate processors of available information. But, as Warren Buffett has observed, there is a vast difference in believing they are *usually* efficient and believing they are *always* efficient.

My perception is that almost countless biases and misconceptions frequently distort market valuations. Often, these can go on long enough that they become essentially self-validating. The long-lasting bubbles in tech stocks in the late 1990s and real estate from 2004 through 2007 are merely two examples. The longer these stay inflated the more rationales are created to justify their continuation. And, after all, bubbles are a blast—until they blast apart.

Kyle Bass was one of the handful of hedge fund operators to get the sub-prime mortgage disaster right. His short positions in that now-infamous asset class made a fortune for his investors and, naturally, given the usual "2 and 20" hedge fund structure, himself. (If I sound a tad jealous given that Evergreen is a "1 and 0" traditional money manager, well, I am only human!)

Recently, though, Kyle, like many of those who hit the jackpot on "The Big Short," has struggled with some of his current bets. To wit, Mr. Bass has been a frequent guest on CNBC explaining why he thinks Japanese bonds are a massive bubble on a collision course with a sharp instrument. Yet, despite compelling reasoning, it continues to further inflate and has, thus far, remarkably avoided bumping into even the slenderest needle.

Similarly, one of the craziest broadly held beliefs, in my opinion, is that the Japanese currency is a safe haven. Thus, whenever something bad happens (and given the perilous state of the world these days, that's a fairly recurring event), the yen rallies. This also tends to support Japan's bond market where the sub-1% yield on its 10-year government debt makes US Treasury rates seem positively mouth-watering. The incongruity of the yen being seen as a safe harbor given Japan's rapidly eroding fiscal condition, an abysmal economic growth rate, and disastrous demographics is right up there, in terms of nonsensical investment conclusions, with believing that housing prices never go down.

In this month's guest EVA, our good friend and close ally, Grant Williams, weighs in on this subject. I think you will find his reasoning of why this bubble is close to its implosion point to be most fascinating.

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THINGS THAT MAKE YOU GO HMMM...
Grant Williams

he Government Pension Investment Fund, Japan (GPIF) does pretty much exactly what it says on the tin, i.e. it is the pension fund for Japanese public sector employees.

It is also the largest such institution in the world and has assets under management that total a

truly staggering ¥108 trillion ($1.5 trillion). To put that sum in perspective, it is roughly the same as the GDP of Canada... or Russia.

The first three quarters of 2011 weren't so kind to GPIF, unfortunately, and, as at December 31, 2011 (the Japanese fiscal year ends on March 31) their AUM (assets under management) had shrunk by a not insignificant ¥2.87 trillion or 2.54% (to continue the GDP comparison, that is like vaporizing the entire Lithuanian economy in nine months). Not good.

A look at the performance of the various investments held by the GPIF demonstrates just how hard it is to invest in the current environment as they showed losses in domestic stocks (-15%), international stocks (-16%) and international bonds (-4%). Fortunately, the one bright spot in their portfolio happened to be their single largest allocation; domestic bonds, which gained a comparatively whopping 2.5%.

A look at the breakdown of GPIF's portfolio is highly illustrative (*See Figure 1*):

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As you can see, almost 70% of the ¥108 trillion in the GPIF's coffers is sitting in domestic bonds.

That's roughly ¥75 trillion or $1 trillion in Japanese bonds which sat quietly on GPIF's balance sheet.

Historically, GPIF has been one of the largest buyers of Japanese government debt and has done more than its fair share to confound those who have predicted Japan's day of reckoning; including Kyle Bass who has been waiting an awfully long time for his view on Japan to play out as he expected.

In his letter to investors dated November 2011, Bass wrote:

We believe the debts of the following nations, among others, are not sustainable in the current economic environment: Greece, Italy, Japan, Ireland, Iceland, Japan, Spain, Belgium, Japan, Portugal, France and, have we mentioned Japan?

No mixed messages there.

As can be seen from the names on that list, despite Japan’s stubborn refusal to play ball, Kyle still has a pretty good batting average, but on Thursday, his chances of looking very good indeed increased significantly when one of Japan’s biggest poachers announced that they had turned gamekeeper, or, more accurately, one of Japan’s biggest buyers of government debt had rather troublingly, turned seller:

(Bloomberg): Japan’s public pension fund, the world’s largest, said it has been selling domestic government bonds as the number of people eligible for retirement payments increases.

"Payouts are getting bigger than insurance revenue, so we need to sell Japanese government bonds to raise cash," said Takahiro Mitani, president of the Government Pension Investment Fund... *"To boost returns, we may have to consider investing in new assets beyond conventional ones," he said in an interview in Tokyo yesterday... The fund needs to raise about 8.87 trillion yen this fiscal year, Mitani said in an interview in April. As part of its effort to diversify assets and generate higher returns, GPIF recently started investing in emerging market stocks.*

Japan’s demographic nightmare has always been the bedrock of the case outlining why the country’s massive debt—accumulated over twenty painful years—would eventually cripple it, but the problem with demographics as an investment case is that most people can’t even begin to think that far ahead and will readily assume that, because such events are decades in the future, they will be solved long before they become a real problem.

Let’s take a look at the dynamics (for want of a better word) of Japan’s population.

According to official figures published in July 2011, the population of Japan is 127,368,088 (quite an accurate estimate, I think you’ll agree) which makes it the 10th most populous nation on Earth and the table to the left gives the breakdown of the various components of that number. (*See Figure 2*)

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So far, so good.

But when we dig a little deeper, Japan’s problems start to bubble to the surface as the numbers in this next table demonstrate. (*See Figure 3*)

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Japan’s birth rate per thousand places it, interestingly enough, just ahead of Germany, Singapore and Hong Kong, but then the tail-enders really kick in with Christmas Island, Niue (who knew?), Tokelau, Pitcairn Islands and Norfolk Island—all amazingly enough sporting a negative birth rate of exactly 9 per 1000—firmly bringing up the rear.

How far down the pecking order does Japan’s birth rate standing of 216th place it? Well the UN officially recognizes 192 countries while the US State Department includes 2 more in its 194.

he change in the structure of Japan’s population over the past 50 years is starkly reflected in the country’s population pyramid which looks ever more shaky with each passing year while the forecasts for 2050 are, frankly, frightening. (See Figure 4, below)

By 2050, Japan’s population is projected to fall to 90 million. Incredibly, as recently as 1990, the number of working Japanese was three times that of both children AND the elderly.

In 2011, Japan’s budget for social welfare was ¥90 trillion but that was at least ¥1 trillion short of where it needed to be, precipitating further issuance of government bonds and that, on top of the increased strain caused by the Kansai tsunami has Japan’s bond market teetering on the edge of implosion—still.

A 2011 report from the National Institute of Population and Social Security Research (could that BE any more Japanese?) shed some light on just how fast things could deteriorate from here:

The proportion of children under 15 will shrink from 14.6% of the population in 2000 to 12% in 2021, 11% in 2036 and 10.8% in 2050.

Meanwhile, those of working age (15-64) amounted to 68.1% of the population in 2000, and their proportion is expected to decline to 60% in 2020, 58% in 2035 and 53.6% in 2050.

The only clear rising trend is the aged (65 and above), who will grow from 17.4% of the population in 2000 to 25% in 2014.

The number of elderly will continue to rise while the total population drops so that in 2050 the aged will account for a whopping 35.7% of a population estimated to number only 101 million.

Trouble, folks.

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The wonderful Dylan Grice of Société Générale in London is, in my opinion, one of the most astute observers of the Japanese meltdown and, to boot, he has a gift with words that borders on the sublime. Here he is, waxing lyrical on Japan's problems in his 'Popular Delusions' piece under the title 'A Global Fiasco Is Brewing In Japan':

Japan's government borrows from Japanese households and has done for decades. But Japanese households are retiring, and traditionally retirees run down their savings. So who will fund Japan's future deficits, which are already within the range identified by inflation historian Peter Bernholz as hyper-inflation 'red flags'? Twenty years ago, who could predict long-term JGB yields below 1%? Who sees uncontrolled inflation as the primary risk facing Japan today?

Don't listen to fiscal scare stories - Japan proves that governments can borrow for as long as they like! Or does it? In the past, the Japanese government had a captive domestic market in which to place its debt. A large pool of domestic savers, made cautious by prior painful experience with risk assets and an increasingly fragile economy, was happy to own as much government debt as possible. After all, the JGB market was the one consistently good performer.

But those savers are now retiring, and running down their assets. Who will finance Japan's government deficit in their place?

Who Indeed? Oh, perhaps I ought to point out that Dylan wrote this particular piece way back in 2010... these things really do tend to go on longer than even the brightest minds imagine.

But as long as Japan has tantalized and confounded those who have called for a dramatic collapse, this week's startling admission by the GPIF may well come to be seen as a turning point.

Whilst the heavy domestic funding and negligible foreign holdings of Japan's government debt have been its saviour over the last twenty years, it was always going to be the case that when Japan's pension funds began to need to sell their holdings, the problems would multiply in their complexity very quickly. We appear to have reached that tipping point—albeit very, very quietly. (*See Figure 5*)

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Exacerbating the situation are Japan's other problems; stagnating tax revenue and rapidly-diminishing savings rates which, as the graph (*Figure 6, below*) shows, have plummeted from 25% in 1989 to just above 0% today. The rate dropped precipitously in 2008 and briefly went negative in 2009/2010 before inching higher again.

6

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Should Japan need to fund itself externally, it is every Japan-watcher's base-case that it will need to offer substantially higher rates in order to be able to do so and, with the mountain of debt under which Japan is currently foundering and the tiny amount of room it has before its tax revenues are eaten up by its debt-servicing costs. It currently spends over 50% of those tax revenues in such a fashion and it would only take an increase in borrowing costs to 2% for that

figure to reach 100% (*Figure 7, below*). At that point, you can finally stick a fork in Japan.

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The fact that this year Japan has recorded its first year-on-year trade deficit since 1980 (*Figure 8, below*) has just thrown another log on the smouldering embers just waiting to ignite beneath the Land Of The Rising Sun.

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As Japan’s savings have declined, its current account surplus has also deteriorated to the extent that, this past May saw the smallest such figure (¥215 bln) since 1985 as rising energy costs in the wake of the post-Fukushima shutdown of Japan’s nuclear industry and the continued strength of the Yen as a ‘safe haven’ combined to form a dangerous one-two punch that is exacerbating Japan’s precarious situation.

Want more? Well, take a look at Japan’s debt maturity profile (*Figure 9, below*) which demonstrates the sheer weight of debt they have coming due in the next few years, along with an average maturity of 6 years (shorter than that of Portugal, Ireland, Italy, Greece and Spain—someone really ought to come up with a snappy acronym for those guys—oh, and... France).

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In fact, over the next five years, 60% of Japan's massive debt burden will need to be rolled over and it really is as simple a matter as 'the market' suddenly and arbitrarily deciding that it wants Japan to pay more to borrow money. Once that cycle starts in earnest, as my friend P-Man would say, "it's Katy, bar the door"!

Still not had enough? Well the chart to the left (*Figure 10*), from Plan B Economics shows two worrying trends in motion; declining government revenues and increasing debt service. The chart only goes as far as 2010, but those two lines are moving inexorably towards each other and when they meet, it's BIG trouble.

10

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Ultimately, the country's fate may not even be in its own hands as contagion from a bond market meltdown in Europe could quickly spread to Japan and tip things over the edge; markets can just be capricious sometimes. Yes, Japan has a printing press that it has used in the past and

will undoubtedly use again, but this time, Japan is not alone in pursuing QE and so the world may not be so forgiving once they turn on the presses full speed.

When asked by an Australian journalist earlier this year how he thought Japan's denouement would look, Dylan Grice had a clear vision; hyperinflation.

(Money Morning): Ask the average strategist what will happen in Japan and your eyes will glaze over long before your mind can process the technicalities and ifs and buts of the answer. Ask Dylan and he'll tell you that it will end in a hideous bout of hyperinflation that will take the Nikkei from its current level of 9,662 to 40,000. The country is basically bankrupt, has awful demographics (too many old people, not enough workers), and already spends over 50% of tax revenue servicing its debt. So it is heading for a fiscal crisis, a money-printing binge and an endgame that comes with a currency collapse à la Israel in the 1980s.

I ask when this will kick off. He doesn't know – this kind of stuff isn't predictable. His best guess? "Within the next five to ten years." So is there a way that Japan can stop this happening? What would he do if he were in charge? He "would resign." ...Under those circumstances he would note that Japan is an "undertaxed economy" and he would gradually raise taxes – first consumption tax and then property taxes. He'd phase it in over a number of years to minimise the pain. He would "effectively engineer a depression."

Any way out that doesn't involve a depression? No. And even if there were, Japan's politicians would mess it up. They are, says Dylan, so dysfunctional that even just after the nuclear disaster they were "trying to score points off each other." If you want to have even an outside chance of sorting out Japan, you need political consensus. But Japan is "light years" away from that. So while it is horrible to suggest something is inevitable, in Japan, hyperinflation, "the path of least resistance for all politicians", probably is. "I just can't see a way out."

So, according to one of the most astute observers of Japan, either a depression or rampant hyperinflation is heading their way at some point in the next five to ten years. Based on the country's debt dynamics, the state of the rest of the world and, as of this week, the fact that the domestic selling of government debt appears to have begun, I'd have to say I agree with him.

Casting my mind back to my years spent living in Japan in the late 1980s/early 1990s, two phrases leap to the front of my mind:

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Google them.

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