MV CAPITAL MANAGEMENT

Weekly Market Flash

Japan Led Us All to Wonderland

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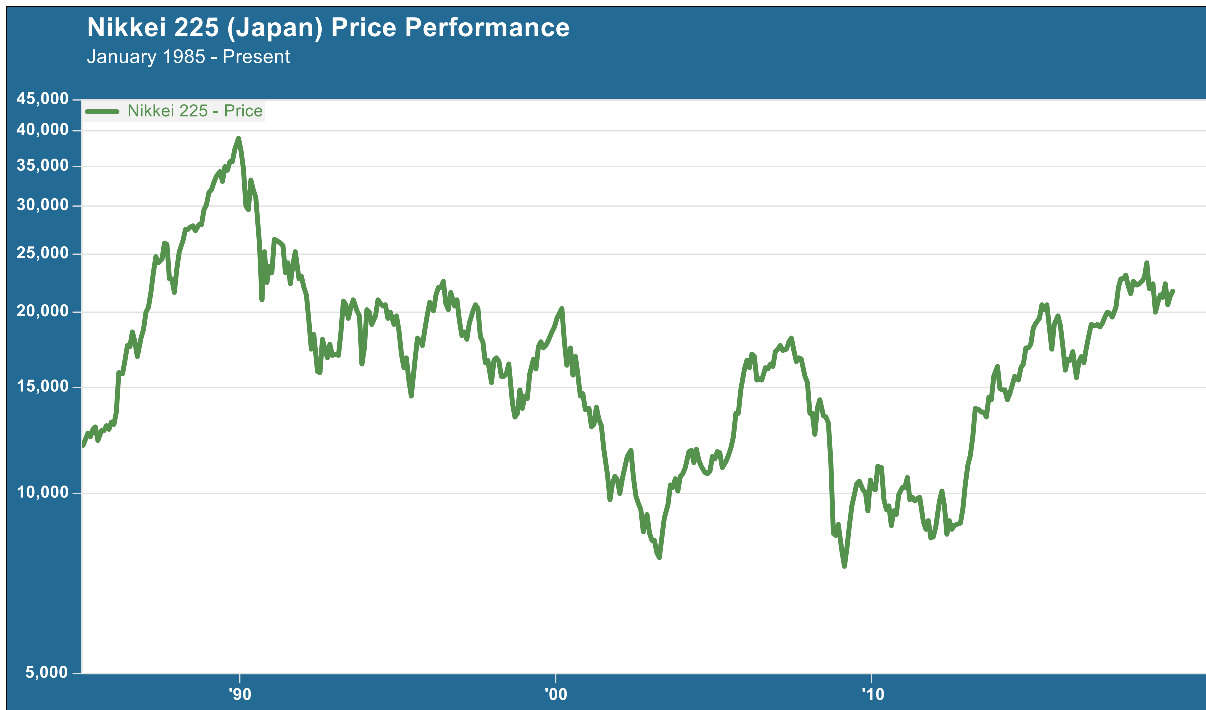
Before the iPhone, there was i-mode. Seven years before Steve Jobs turned the world on its head with the iconic Apple product, a much stodgier company produced the world's first smartphone. In 1999 NTT, the incumbent Japanese telecom provider and a byword for "lumbering bureaucracy," launched a mobile phone service with Internet access through a subsidiary called DoCoMo. I-mode, as the new service was called, went viral. Barely two years after the service was launched, i-mode had gained an 80 percent penetration rate and had considerably brightened the multi-hour commutes of Japan's legions of office workers. Mind you, this was all happening right at the turn of the 21st century, before even the iPod, let alone the iPhone, had entered the lexicon of modern technology.

Leading Where We Don't Want to Follow

What point are we making with that little history lesson about the birth of the smartphone? Only that while we tend not to think of Japan as much of a leader when it comes to economic trends, there are times when the world's third largest economy paves the way. In the case of the smartphone, that was probably a good thing. But when it comes to monetary policy – another area where Japan has been a world-beating, ahead-of-the-curve pioneer – the rest of the world may be ruing the day we all had to follow the leader.

Japan rode the crest of an asset bubble in real estate and stock prices for about five years before the bubble burst in 1990. As the chart below shows, it has been an unhappy 30 years for anyone who put money into Japanese equities at the peak of that bubble.



Source: MVF Research, FactSet

Today the Nikkei 225, the broad market benchmark for Japanese equities, stands at a little more than half of its value, in nominal terms, at the market peak of December 1989. For much of the time since then, the country's economy has been mired in a mix of slow growth, recession, deflation and population decline. To try and combat these chronic, structural problems the Bank of Japan started throwing stimulus money at the economy throughout the 1990s. In 1999 – the same year as the DoCoMo i-mode launch – the BoJ became the first central bank in the developed world to establish a zero-bound interest rate policy. Two years later it launched another innovation – quantitative easing. These unconventional policy approaches lurked silently in the background as world markets fell down the rabbit hole in the 2008 market crash.

Bonds Today, Stocks Tomorrow

The Bank of Japan didn't take its foot off the innovation pedal while the US Fed and the ECB made their own first forays into unconventional QE policies in the wake of the recession. In 2010 the BoJ put on another hat – equity investor. It now has a policy of investing around $55 billion annually in equity ETFs with the stated goal of providing volatility reduction in risk asset markets and encouraging investor psychology. This activity makes the central bank the owner of about 5 percent of the total market capitalization of the Japanese stock market. It is a top ten shareholder in some 40 percent of all Japanese companies with listed common shares. And despite the fact that nearly ten years of equity purchases don't seem to have had much of a positive effect on the economy at large – Japan's macro headlines remain largely underwhelming – the program shows no signs of slowing down.

Japan led the world to zero interest rates, to QE and, more recently, to negative interest rates. Will the ECB, the Fed and the Bank of England follow down the yellow brick road yet again and start actively buying stocks? The idea is certainly in the mainstream discourse, if not yet actual policy. This week featured several articles in the Financial Times, a redoubt of establishment economics, weighing the various aspects of this approach for the ECB. For their part, investors appear to be fixated on central bank policy actions to the exclusion of just about everything else that happens in the world. It is not hard to imagine that the market's abject dependence on the monetary stimulus drug reaches a point where only direct investment in risk assets like commons stocks will be strong enough to have a palliative effect. We're not there today. But call us absolutely unsurprised if, come 2022, the Fed is buying S&P 500 ETFs and the ECB is siphoning up shares on the DAX and the CAC-40. We all live in Wonderland now.

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