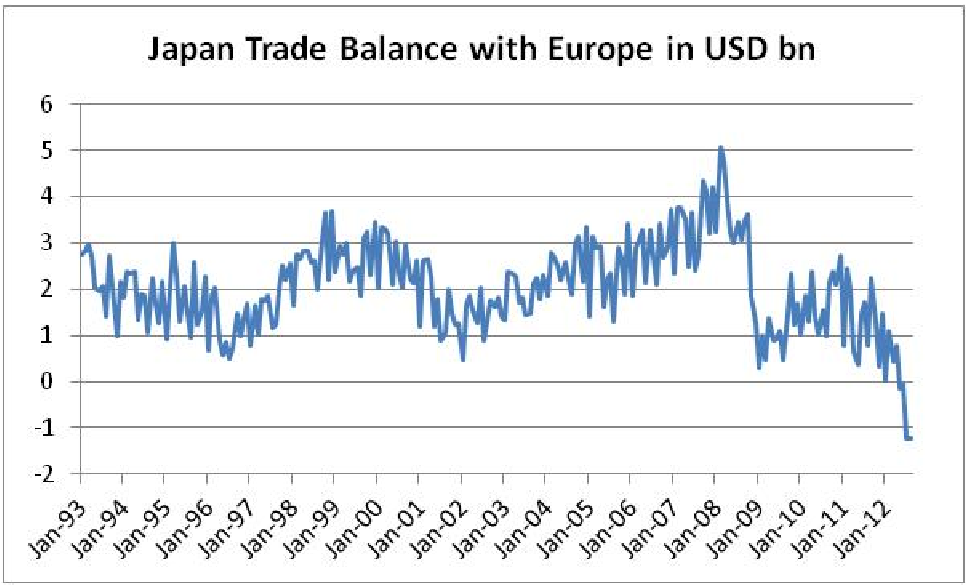
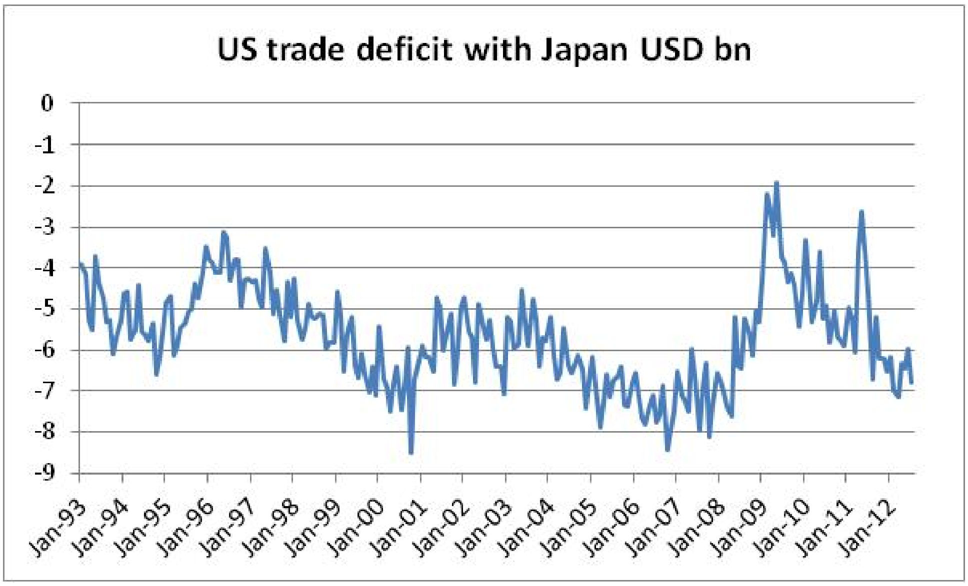
LESSONS FROM JAPAN

One of the most amazing things about the investment industry is how it can get things repeatedly wrong over many years and then never pause to reflect on where it went wrong. The most extreme example of this is the market for Japanese yen and Japanese government bonds (JGBs). While the yen and JGB are now more popular than they were, for most of my working career most fund managers have been very bearish on the yen and Japanese bonds. Despite market bearishness the yen and JGBs have been good investments. There are three reasons in my view. Firstly, is the current account surplus which has meant that Japan has not needed foreigners to fund their government spending and hence Japan has been very much in control of its own destiny. Secondly, a relatively high savings rate has meant that the Japanese have had the ability to soak up the supply of JGBs issued by the government. Finally, a mildly deflationary environment has made bonds attractive to domestic investors.

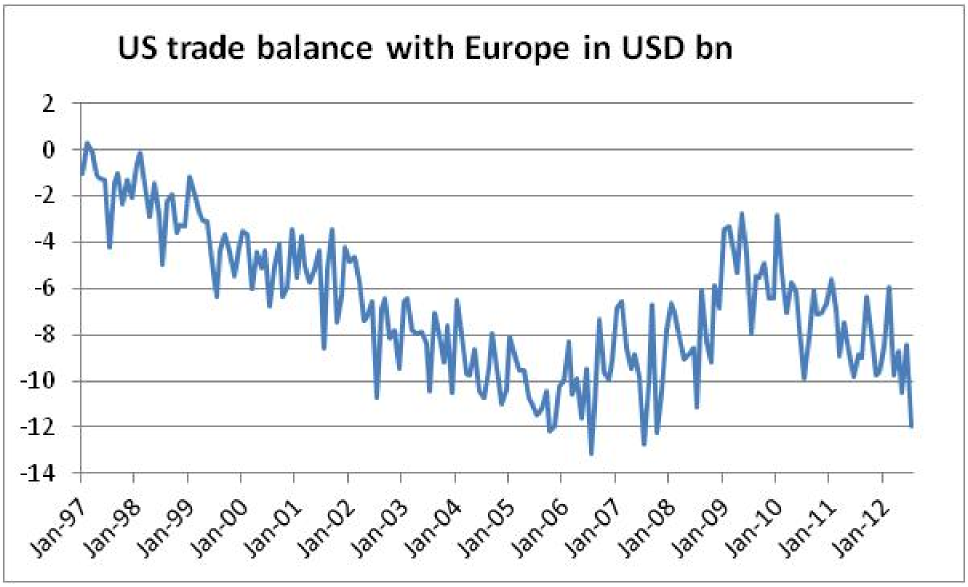
In my view, the market is about to make a similar mistake in terms of the Euro and European bonds. I believe that market values follow economic trends, and the biggest returns are available to investors when they look for break in trends, which in turn will lead to long term changes in the markets. One of the most interesting trend changes in the last year has been the disappearing trade surplus of Japan with Europe.



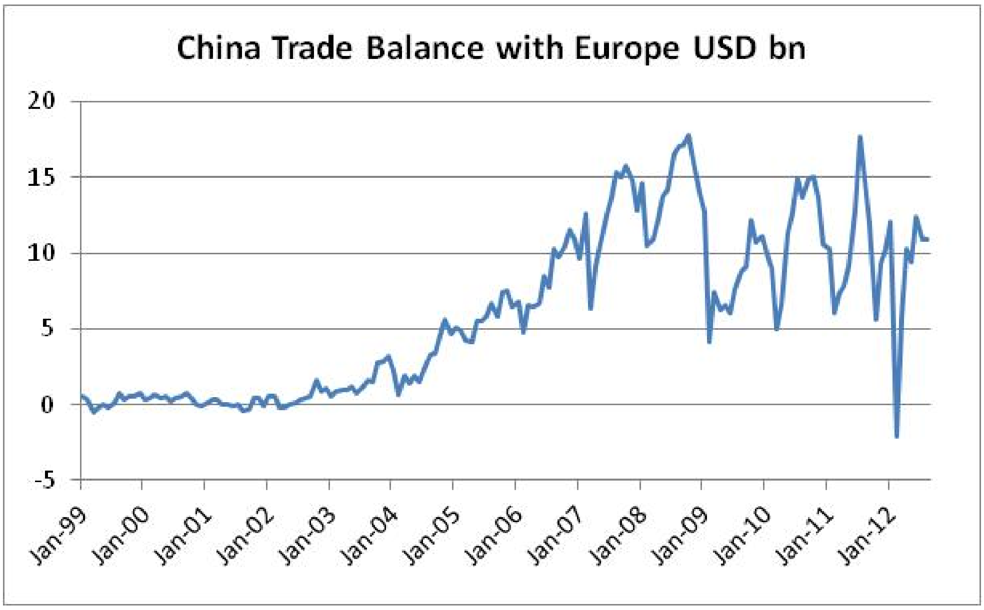
As can be seen Europe is running a trade surplus with Japan. This is the first time in at least 30 years. Intriguingly, the US trade deficit with Japan has not seen a similar decrease, suggesting a massive improvement in European competiveness.



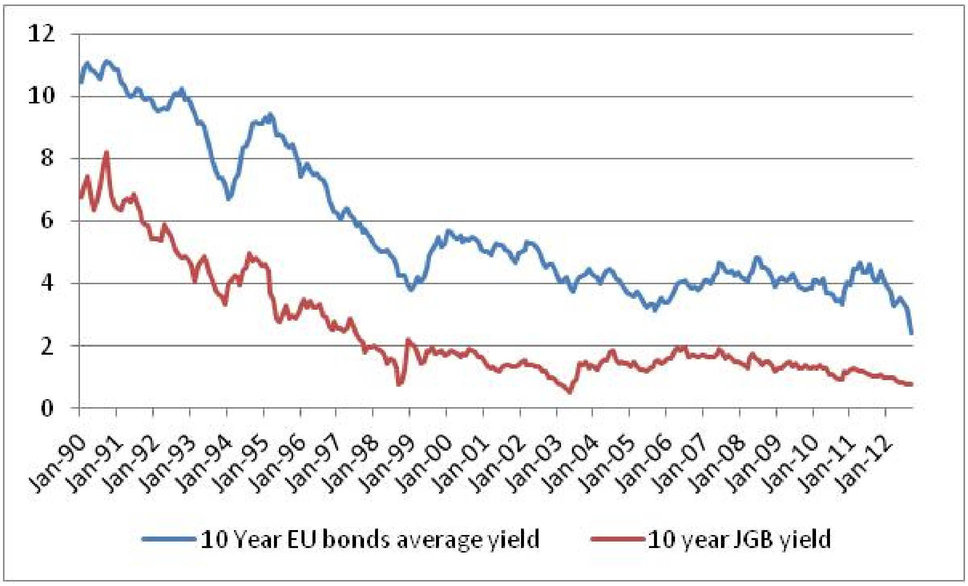
Europe has also managed to move back to close to all time high trade surplus with the US.



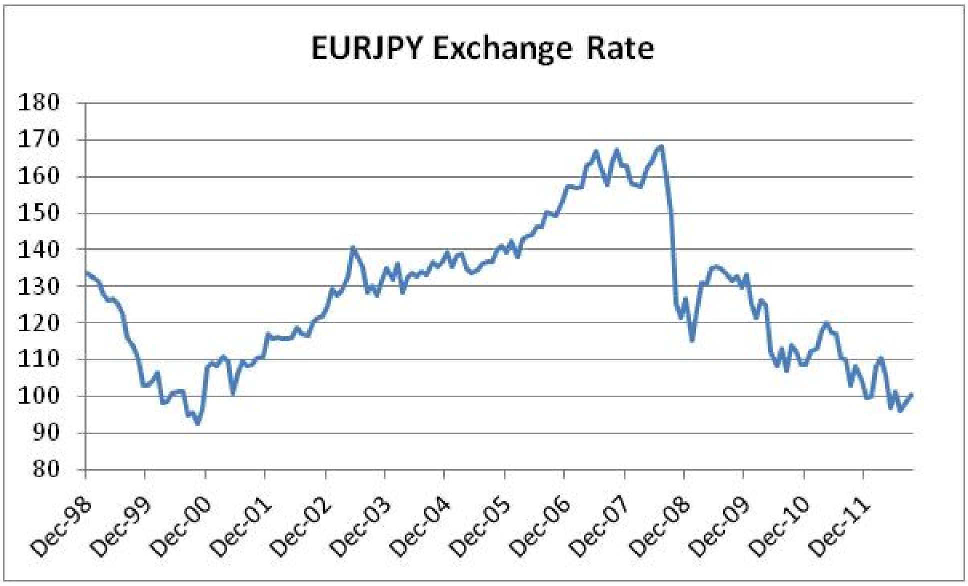
And has managed to improve its trade deficit with China.



The European data is also reflecting a dramatic improvement in the current accounts of peripheral Europe, with Italy, Spain and Portugal all reporting best current accounts for many years. The combination of an improving current account, slowing population growth, high domestic savings rate and the prospect of a prolonged deleveraging cycle in Europe all lead me to believe that Europe is closely resembling Japan. To my mind the trade data is suggesting that European bonds offer much better value than Japanese bonds. Compared to Japanese bonds, yields have a long way to converge.



It is also suggestive that the Euro is more likely to become a safe haven currency going forward. Certainly it looks too cheap versus the yen.



In my view, much like JGBs were seen as a bad investment 10 years ago, with yields too low and the currency destined to be weak, the trade data is suggesting that European bonds and the Euro are likely to be much stronger than the market expects.

INFORMATION

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