



Adviser Soapbox

Global Macro Hedge Funds Eye Japan

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Global macro issues have once again taken center stage with the dramatic breakdown of the U.S. dollar over the past several days. The dollar now stands at a 20-month low against the euro and a 14-year low against the British pound, and the suddenness of the decline has reignited concerns about the health of the U.S. economy. Declining home prices (and worries about their impact on consumer spending) and recent weak U.S. manufacturing data stand in sharp contrast to the continuing economic strength in Europe and Asia. Meanwhile, the strength in the long end of the U.S. yield curve and the dollar's sharp move lower has spooked equity markets around the world, and there is rising concern that the U.S. dollar weakness will result in competitive pressures for non-U.S. corporations. This seems to have been at least one of the contributors to the underperformance of Japanese equities this year; the Nikkei stock index is down 0.2% year-to-date, compared to gains of more than 17% for German stocks and nearly 12% for U.S. stocks.

Given the poor showing of Japan in 2006, it is hardly surprising that previously bullish investors are throwing in the towel. According to the most recent Merrill Lynch Survey of Fund Managers, Japanese stocks are nearly as unloved today as they were adored this time last year--sentiment toward Japanese equities is now at a three-year low by some of the survey's measures. And net purchases of Japanese stocks and bonds by foreign investors may fall this year for the first time in four years, according to the Nihon Keizai newspaper.

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However, we see opportunity where others are pessimistic. The Japanese economy has long been export-dependent and is even more so today at 16% of GDP than it was in the mid-1980s. But unlike the late 1980s, when Japan primarily exported to the U.S. and Europe, trade with the more buoyant economies of Asia now makes up 45% of the country's total--a number that seems likely to increase given the positive momentum of free trade agreements in the region and the strength in Asian economic growth. Less dependency on the U.S. and greater access to the fast-growing economies of Asia is without question a positive in light of the risk that a protracted slowdown in the U.S. housing market might adversely impact the erstwhile insatiable appetite of American consumers. Importantly, this development also makes Japanese equities less correlated to the performance of the Yen/USD exchange rate.

The recent performance of Japanese stocks has also caught our eye: The Nikkei has rallied 3.4% since Nov. 21 while the dollar index has fallen 2.7%. A turning point could be at hand.

Seeing the Forest for the Trees

There are several factors that look especially bullish for Japan right now, including real short-term interest rates near zero, an exceptionally cheap currency (trade-weighted Yen is near its lows even in the face of U.S. dollar weakness), and an economy that could very well prove to be the strongest of the G3 countries next year. With sentiment on Japanese equities having turned decidedly negative, we see the potential for a strong 2007 in Japan's numerous structural and fundamental positives:

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--**Growth-oriented reforms** have been instituted, perhaps most significantly the privatization of the postal savings system and plans to revise rules concerning share swaps for mergers and acquisitions.

--**Corporate earnings** are still growing at a double-digit pace, and capacity utilization is at the highest level in nine years. What is more, recent data out of the Bank of Japan shows that debt owed by the non-financial corporations (borrowing from banks, corporate bonds, etc.) rose 1.5% year-over-year in the second quarter, the first upturn since 1998 and the sharpest increase in more than thirteen years. Toyota reported October sales up 13.6% year-over-year--its best October on record, Mitsubishi, UFJ Financial recently raised its full-year profit estimate by 16%, and Fuji Film Holdings Corp. reported quarterly profits up 11%.

--**Free-trade agreements** are gaining momentum. Japan plans to start free-trade agreement negotiations with India and Australia next year, and with China in 2009. Japanese exporters stand to benefit--likely candidates include Sony, Canon and Kyocera.

Outlook '07: Exaggerated Concerns = Potential Catalysts

Given these big picture positives, it is reasonable to ask what went wrong for Japan in 2006:

--**Concerns about tighter monetary policy** spooked investors following the Bank of Japan's decision in March to end its unprecedented five-year policy of quantitative monetary easing (QE). The risk of Japan repeating the mistakes of the past decade was further flamed by recent comments from Bank of Japan Governor Toshihiko Fukui, who said earlier this month that the bank needed to act "in advance" to stave off excessive capital investment and asset inflation. But the extent to which recent Bank of Japan comments have been very hawkish about the risks of ultra-low interest rates bears a striking resemblance to the rhetoric of numerous U.S. Federal Reserve policy makers earlier this year. In fact, rather than being blind to the mistakes of the past, it seems more likely to us that the Bank of Japan is taking a page out of the Fed's book: using tough language while taking a gradual approach to normalizing policy.

--**Weakening domestic demand** and wage growth data called into question the momentum of Japan's remarkable multiyear economic recovery (now going on nearly 60 months and the longest since the 1960s). But domestic analysts think that high year-end bonuses in Tokyo will provide a lift to domestic demand, and Japanese retail stocks have risen nearly 7% over the past five trading sessions--this bears watching, as we would expect to see retailers perform better in advance of improving domestic demand. And it is very significant in our view that, after showing signs of recovery in 2005, land prices in Japan's three largest cities finally rose in 2006 for the first time in 16 years, when the real estate bubble in Japan began to deflate, with some neighborhoods in downtown Tokyo posting price gains in excess of 25% year-over-year. Further evidence of a meaningful recovery in real estate comes from the performance of Japanese REITs, which are up more than 15% year-to-date, versus a small decline for the Nikkei.

As it stands now, we think that these fear-inducing factors are likely already reflected in Japanese stock prices, and that gives them the power to be catalysts for future gains, as positive developments unfold and the risk aversion surrounding these fears dissipates.

What is the best way to take advantage of this opportunity? All is explained in the latest issue of Inside Global Markets.

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