November 2014

Equities: the “japanification” of Europe?

Fiscal policy: rising debt of private and public budgets

In recent years, the debt of private and public budgets has risen continuously in the Euro zone. It increased again significantly above all during and after the financial and Euro crisis. But unlike in the past, the funds borrowed were not primarily used to purchase productive capital goods. Instead, the outside capital borrowed was invested in the real-estate market or used for consumption purposes - the latter was practised extensively in particular by public-sector borrowers in individual peripheral Euro-zone countries. In both cases, the recurring income needed to pay for the debt incurred was lacking.

Monetary policy: low interest-rate policy to stimulate economic activity

In order to motivate industry to take out loans in its turn, many central banks cut their key interest rates in the wake of the financial and Euro crisis. And they did so to an unprecedented level. For many countries, the key interest rate cuts had a welcome side effect: they were able to finance their high levels of debt at low interest rates.

But the liquidity created by the central banks only fed through to the real economy to a limited extent. Instead it was hoarded by banks and other investors or invested on the stock market - primarily in equities and real estate. This is one of the main reasons why inflation in Europe is decreasing. Currently it stands at +0.3% and is thus way below the +2.0% target set by the European Central Bank.

The trend in monetary and fiscal policy in Europe is arousing the fear that European investments in equities may be facing a fate similar to that of the Japanese stock market at the end of the 1980s.

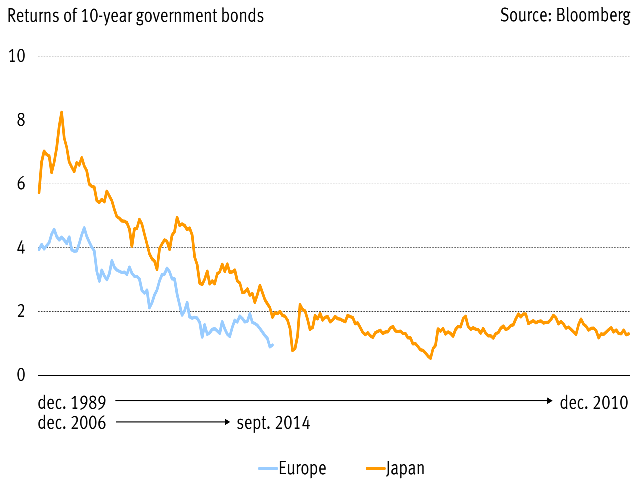
Japan: the Zaitech bubble

In the land of smiles, the earnings expectations of many companies were surpassing one another already in the late 1980s. At that time interest rates were at an exceptionally low level. Many companies were readily borrowing outside capital, which at the time was cheap, and investing it speculatively on the stock market - also known in the jargon as the “Zaitech bubble”. As a result, the prices of Japanese shares rose very rapidly in the 1980s and peaked at the end of 1989. Industry did not grow sustainably, however. In the next two years, Japanese stocks lost more than 50% of their value.

In the course of time, the Japanese government put together a bevy of different economic stimulus packages. They all failed to have an effect - the Japanese economy did not gain momentum. The Bank of Japan‘s monetary policy, on the other hand, was only slightly expansionary. Inflation declined significantly in the 1990s and resulted in a long period of deflation.

Is the comparison between Japan and Europe appropriate?

The trend prevailing in Japan at that time and the present situation in Europe do have some parallels: A high burden of debt in private and public budgets, insufficient income to pay off the debt, high asset and real-estate prices, and constantly-declining inflation in the consumer and capital goods sectors. Even the comparison of yields on 10-year government bonds is impressive. If one superimposes their performance in Japan from December 1989 to the end of 2010 on that of European government bonds from December 2006 to today, a surprising picture emerges. Both yields run virtually parallel. In addition, they end at a level that implies lower inflation expectations than the inflation targets generally pursued by the central banks.



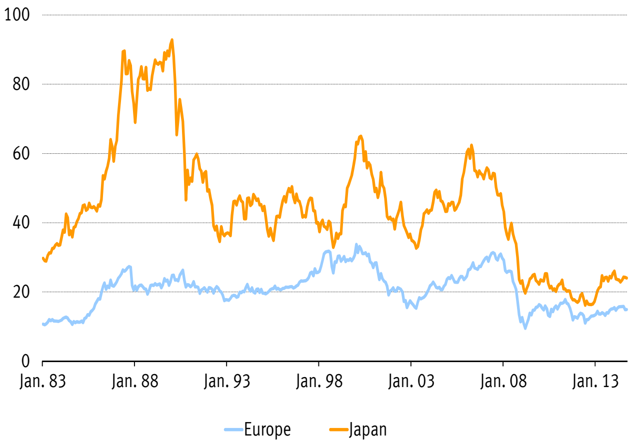
Another important similarity is demographic change. As in Japan at that time, the Euro zone is faced with a rapidly-ageing working population and a gradual decline in its numbers. In Japan, the age group of 15 to 67 year-olds has been deceasing since 1995. In the Euro zone it has been decreasing continuously since 2012. The consequence is that the macroeconomic production potential has been decreasing since then.

The subtle difference

Against this backdrop, the fear that European equities might suffer the same fate as Japanese stocks becomes understandable. They might, as it were, be “Japanified”. However, there are significant differences between European equities today and Japanese shares at that time. The most important one from our point of view is valuation. The striking depreciation of Japanese equities at the end of 1989 certainly cannot be explained soley by the unfavourable macroeconomic situation of the Japanese economy. Rather it should be seen against the background of the exceptionally high valuation of Japanese equities at that time.

Cyclical adjusted price-to-earnings ratio

Sources: Datastream, own calculations



Shares can be valued in various ways. One valuation concept that is particularly widely used empirically is Professor Robert J. Shiller's cyclically adjusted price-earnings ratio (PER). This measures the ratio of the current share price to average corporate earnings over the last 10 years. If one calculates the Shiller PER for the Japanese and European stock markets, some significant differences can be seen. Japanese shares have constantly been valued more highly than European equities since January 1983. The valuation differences were accentuated particularly in the 1980s and at the end of 1990s – at the time the Zaitech bubble burst, the valuation of the Japanese stock market was four times higher than that of European shares. The absence of excessive valuations in Europe thus points away from a repetition of the Japanese drama in Europe.

Instead we think it is more plausible that European equities will move in line with other global stock markets. The extent of long-term price gains is determined by the extent of the earnings recovery in European industry. In the long term we expect a gradual and moderate recovery of the profitability of European industrial companies.

Dreyfus Sons & Co Ltd, Banquiers
Aeschenvorstadt 16 | P.O. Box | 4002 Basel | Switzerland
Telephone +41 61 286 66 66 | Fax +41 61 272 24 38
contact@dreyfusbank.ch | www.dreyfusbank.ch