Markets & Investing

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Peter Tasker
INSIGHT

Japan can find positives from the horror to help it rebuild

The earthquake that struck Japan on Friday with such devastating human cost was powerful enough to shift the earth on its axis and move the Japanese land mass six feet. It is human nature to assume that an event of such destructive force must have powerful lasting effects on stock markets too, but that is not necessarily the case.

Equities are long duration assets that discount corporate earnings far into the future. Furthermore, listed companies in Japan, as in many other countries, now have a globalised earnings stream, with substantial exposure to the developing world.

The value of that earnings stream will be affected little by the terrible events on the North East coast.

To be sure, the obvious precedent is not encouraging. After the Kobe earthquake of 1995, Japanese stocks entered a six-month bear market in which the Topix index fell 22 per cent.

The tragedy that hit north-east Japan has claimed more victims, is spread over a much larger geographical area, and has wreaked havoc on a nuclear power station, raising questions about the nation's energy strategy. On that reading alone, a decline at least equivalent to the post-Kobe sell-off might seem justified. However, the investment fundamentals of Japan in 2011 are quite different from the Japan of 1995. Most obviously, the Topix bottomed out in June 1995 at 1,190, a level 40 per cent *higher* than today's Topix.

Japan's listed companies now have a globalised earnings stream with substantial exposure to the developing world

In other words, Japan's de-bubbling process was a long way from complete when Kobe was hit.

With regards to corporate earnings power, there is no comparison. The trailing earnings per share (EPS) on the Topix index today is three times its best level of the mid-1990s. The value that investors are getting is far superior to what was available then.

What about the currency markets? Then, as now, the nominal value yen was skirting around Y80 to the dollar, but in real terms the situation is completely different.

Y80 in 1995 was well through the pain barrier, equivalent to about Y55 today.

What has not changed is Japan's status as a major creditor nation, which makes its currency the destination, rather than the departure point of any flight to quality.

Concern that Japanese institutions will need to repatriate capital from overseas drives the yen higher.

If the rise becomes unruly, the authorities have a simple expedient at hand. They can intervene – as they eventually did in June 1995, thus kicking off an explosive rally in the stock market.

Similar considerations apply to Japan's government bond market. The prospect of substantial new issuance to finance reconstruction and infrastructure spending might have been expected to trigger a sell-off, but investors' first reaction was to bid bonds higher. In spite of the dark mutterings of the rating agencies and the bond bears, the Japanese government bond market has remained well bid for the past 15 years.

The BoJ has purchased some listed Reits, which sparked a rally, and gave itself capacity to buy exchange traded funds

In the event of a sell-off, the Bank of Japan can fill its boots without any adverse consequences; the rate of inflation implied by Japanese bond prices is – uniquely in today's world – still negative.

The level of policy activism by Japan's government probably holds the key to the direction of its market in the coming weeks.

Last autumn Japan's central bank launched its own version of quantitative easing, which, although small in scale, contained the unusually radical idea of taking on to its balance sheet not just government bonds, but private sector assets too.

Already the BoJ has made some purchases of listed Reits (real estate investment trusts), which sparked off a rally in the sector, and it also gave itself the capacity to buy ETFs (exchange traded funds) based on stock market indices.

Prime Minister Naoto Kan has already described these terrible events as Japan's greatest emergency since the end of the second world war.

If that's not enough to tilt the BoJ towards greater activism, then nothing will be.

The full ramifications of what has happened are not yet clear.

Given the visually shocking media coverage and travel warnings from foreign governments, the first instinct of investors is to focus on worst-case scenarios.

Another more positive interpretation is possible: that the safety systems worked as well as they could, given the extraordinary double punch of an 8.9-magnitude earthquake and a 30-foot tsunami; that Japanese anti-quake construction technology is in a class of its own; that the Japanese public remains as disciplined and stoic as ever; that the Japanese government still has plenty of fiscal and monetary leeway; and that Japanese stocks are great value.

The verdict will be in fairly soon.

Peter Tasker is an analyst with Arcus Research in Tokyo

Europe debt deal spurs relief rally

Euro jumps with peripheral bonds

Investors cite fall in Greek bail-out rate

By David Oakley

The euro and eurozone peripheral bond markets rallied on Monday in response to moves by European policymakers to tackle the region's 18-month debt crisis.

The Brussels' agreement to increase the size and scope of the eurozone's rescue fund and the reduction of interest rates for Greek bail-out loans were singled out by investors and strategists as the main positives for the eurozone.

The euro jumped against most currencies, rising 0.7 per cent to $1.40 against the dollar, while European bank stocks were up amid hopes that the Brussels' deal would help steady the currency club's beleaguered financial sector.

Greece was the biggest beneficiary among the peripheral economies as its stock market rose 5.15 per cent – the largest rise since May 10 last year, the day the international community announced the €750bn "shock and awe" rescue package.

The Greek bond market saw its biggest leap in two months. Greek 10-year benchmark yields, which have an inverse relationship with prices, fell half a percentage point to 12.43 per cent.

The leap in Greek bonds was even greater in shorter-dated maturities as these had sold off more sharply last week because of rising worries that Athens would default. This followed the multi-notch downgrade of the country's debt by Moody's, the rating agency. Greek three-year yields fell 64 basis points to 17.58 per cent.

Rallies in the other peripheral bond markets on Monday were more limited, while their stock markets finished the day mixed, as many investors warned the boost to sentiment could prove short-lived.

Irish 10-year benchmark yields fell 15 basis points to 9.49 per cent and Portuguese 10-year yields dropped 16 basis points to 7.44 per cent.

The rally was also not strong enough to alter market expectations that Portugal will have to seek bail-out loans, or change views that Greece would end up defaulting on its government bonds.

For example, the fall in Portuguese two-year bond yields to 6.32 per cent, a 30 basis point drop on the day, still leaves the country's short-term cost of borrowing far too high to be sustained without external help, say strategists.

The chance of a Greek default over the next five years also remains above 50 per cent as measured by credit default swaps. The consensus market view is that Athens will not be able to grow strongly enough to reduce its record high public debt.

It is also significant that bond yields peak at three years in the Greek debt market. This is because investors and strategists fear the risk of default is greatest beyond the summer of 2013 when the permanent crisis mechanism, the European stability mechanism, takes over from the temporary rescue fund, the European financial stability facility.

It is at this point that investors will be expected to share some of the burden of potential sovereign defaults.

Elsewhere, the International Swaps and Derivatives Association is looking at whether credit default swaps for Ireland should be paid out following the country's bail-out.

Expectations had been low for agreement between Angela Merkel and her fellow eurozone leaders AFP

Scepticism remains in spite of fund move

News analysis

The measures are welcome, but there is a feeling that a day of reckoning is being delayed, say **Richard Milne** and **David Oakley**

Unexpected, yes, but is it a "game-changer"? The initial reaction from investors to the deal agreed by eurozone leaders at the weekend was above all surprise that anything at all had been achieved so low had been expectations.

That helped explain a relief rally that saw borrowing costs fall for the peripheral eurozone countries but far less than they did after the "shock and awe" rescue plan was unveiled last May. "We are certainly in a better place than we were last week," says Padhraic Garvey, strategist at ING.

But it did not take long for scepticism to set in. The deal, which extends the eurozone's bail-out fund, eases rescue terms for Greece and increases policy co-ordination, is for many investors merely an extension of the eurozone's current strategy of trying to buy time by pushing the problem down the road rather than embarking on something more radical.

"The latest eurozone deal follows a long line of announcements that are yet to change the game," says Tamara Burnell, head of sovereign and financials analysis at M&G Investments, the UK investor.

Mark Thomas, a business strategy specialist at PA Consulting, says: "This fits into the narrative of trying to postpone the day of reckoning for a few years. My instinctive feeling is that it won't be enough."

Yet many of the measures were by themselves cheered by investors. An increase in the European financial stability facility from its current effective size of about €250bn to €440bn should ease concerns about its ability to cope with potential future rescues of Portugal and even Spain, investors say, even if the details on how it will be expanded remain unclear.

David Mackie, head of western European research at JPMorgan, says the deal shows the euro will endure: "After this weekend, no one should doubt that euro area leaders are committed to ensuring the survival of monetary union."

Equally a reduction in the interest rate paid by Greece on its €110bn bail-out and a lengthening of the loans is viewed as ameliorating the harsh effects of its May rescue package. "The original bail-out didn't look like a sustainable position," says Mr Thomas.

Some mystery surrounds the announcement that the EFSF and its successor, the European stability mechanism, will be given the powers to buy government bonds in the primary markets, provided the issuing country agrees to austerity measures. That means the EFSF could participate in debt auctions but not in the secondary market, where it would purchase bonds from investors directly.

Philippe Waechter, head of economic research at France's Natixis Asset Management, highlights the final main area of agreement as particularly important: policy co-ordination.

He sees the move as probably representing a first step towards fiscal union, something seen by many investors as a prerequisite for the euro to survive in the long term.

"It is the first step but not the last one. Six months ago, nobody really spoke about co-ordination. Now we have an agreement on fiscal policy co-ordination," he says.

In spite of the weekend deal, the questions in the minds of most investors remain the same: will Portugal need a rescue? Will Greece restructure its debt? And can Spain be spared?

For Mr Waechter the answers remain the same as well. "Portugal will have to ask for a bail-out. For Spain, the situation is manageable ... Greece will probably have to restructure," he says.

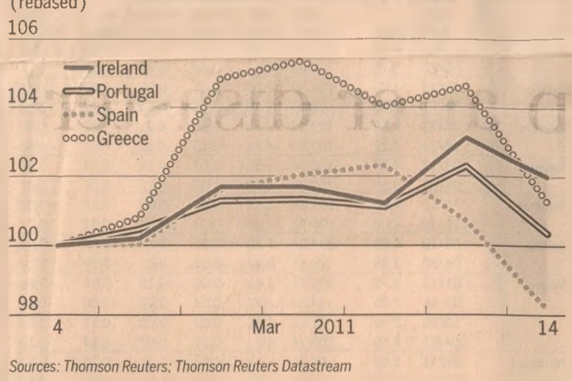
Other risks remain. Considerable details need to be fleshed out before another meeting of eurozone leaders at the end of this month. Many investors are worried that an interest rate rise by the European Central Bank, which could come next month, will only worsen the situation for peripheral countries. "It will not help matters," says one Italian chief executive.

Some investors are also eyeing the switch in 2013 between the temporary EFSF and permanent ESM with nervousness.

EFSF loans rank equal to other bondholders but ESM loans will be senior. Ms Burnell says: "The confusion over how to achieve preferred creditor status for the ESM makes it clear that nothing has been thought through. Creditors would be crazy to buy EU sovereign debt while the legal status of that debt is unclear."

Any hope from eurozone leaders that a "grand bargain" sufficient to end the crisis has been struck seems to have been crushed. Mr Garvey says all the measures agreed are "good" but he adds that market conditions remain very difficult for peripheral nations: "The announcements at the weekend do not solve the crisis itself."

Relief rally: eurozone bond yields fall...
10-year government bond yields (rebased)



...and euro rises on Brussels agreement
Euro against the dollar ($ per €)

Sources: Thomson Reuters; Thomson Reuters Datastream

Mideast tensions push oil prices near 30-month highs

COMMODITIES

By Javier Blas in London and Gregory Meyer in New York

Oil prices hovered near their highest in 2½ years on Monday as tensions in the Middle East surfaced again after Saudi troops entered neighbouring Bahrain to support the tiny Gulf kingdom's embattled royal family against a widespread surge in protest.

The political crisis in the Middle East and north Africa, with battles continuing in Libya, outweighed concerns about a drop in oil demand in Japan, the world's third-largest oil consumer after the US and China, following Friday's devastating earthquake.

In afternoon trading, ICE April Brent, the global benchmark, traded 5 cents higher at $113.89 a barrel. Earlier, Brent touched a session high of $114.18 a barrel.

Nymex April West Texas Intermediate was down 38 cents to $100.79 a barrel.

"It seems the market is careening from event to event, and we have had some major events in the last few weeks," Andy Lebow, senior vice-president for energy at brokers MF Global, said.

The market will take direction on Tuesday from the International Energy Agency, the western countries' oil watchdog, which will update its supply and demand forecasts for 2011. The market will look for signs that Saudi Arabia, the Opec oil cartel's de facto leader, and other members of the group are increasing their production to offset a shortfall in Libya.

Oil price
Brent front-month ($ per barrel)

Source: Thomson Reuters Datastream

Jan Stuart, oil analyst at Macquarie in New York, said that "the very real and significant supply interruption involving Libya's civil war tightens the global supply demand equation" as he revised up its forecast for Brent crude oil prices in the second half of the year to more than $120 a barrel.

The Paris-based IEA estimates that Libya's oil output had fallen to about 500,000 barrels a day, from a pre-crisis level of 1.58m b/d.

The sharp drop in production pushed Brent prices briefly to nearly $120 a barrel last week, the highest level since mid-2008. But some analysts said the market appeared less reactive to every political problem in the Middle East.

Tom Bentz, director at BNP Paribas Commodity Futures in New York, said: "The market was already starting to give back some of its gains, and then the Japan earthquake became the more dominant concern. It's going to take a good amount of economic activity out of the market."

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Hutchison South China ports offering set to raise $5.5bn

By Kevin Brown in Singapore

Hutchison Whampoa, the Hong Kong conglomerate chaired by Li Ka-shing, will raise $5.5bn from an initial public offering of units in a trust holding its South China ports after setting the price in the middle of the IPO range.

The amount raised is about 6 per cent below the top of the target range of $4.9bn to $5.8bn announced when the IPO of Hutchison Ports Holdings Trust was launched in Singapore two weeks ago.

However, the sale of the group's Hong Kong, Shenzhen and Pearl River assets is easily south-east Asia's largest IPO. It comfortably exceeds the $4.1bn raised by Petronas Chemicals in Kuala Lumpur last year.

The final price of $1.01 per unit is just above the middle of the initial indicative range of 91 US cents to $1.08. It is at the mid-point of a tighter range of 99 cents to $1.03 communicated to investors last week.

The price, announced in Singapore after the closure of the retail offer on Monday, was said by people close to the transaction to reflect demands from investors for the highest possible dividend yield.

A high yield was one of the main attractions of the Singapore business trust structure chosen for the IPO by Hutchison Port Holdings, the Hutchison group subsidiary which is the world's largest container port operator by throughput.

The unit price implies a yield of just below the mid-point of the indicative range of 5.5 per cent to 6.5 per cent for 2011, with the implied yield for 2010 also just below the middle of the indicative range of 6.1 per cent to 7.2 per cent.

The people close to the transaction said there was a possibility that the IPO's over-allotment option might be triggered, which could raise a further $800m if exercised in full. They said no decision would be taken, however, until after the stock begins trading on the Singapore Exchange on Friday.

$4.1bn
South east Asia's previously largest IPO

$1.01
Final price per unit decided for the Hutchison IPO

A greenshoe offering would be a surprise against the current background of market nervousness caused by rising inflation in Asia, high oil prices and unrest in the Middle East.

Hutchison Port Holdings will retain control of the port assets through a stake of 25 per cent in the listed trust, which is sufficient to prevent any challenge to its right to appoint the trust's management company.

There was no comment on the IPO from the investment banks managing the offering, Deutsche Bank, Goldman Sachs and DBS Group of Singapore. Canning Fok, Hutchison Whampoa's group managing director, said last week, however, that the proceeds would be used for debt repayment and capital investment.