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Eurozone is starting to look Japanese

By Richard Milne

Amid the topsy-turvy nature of markets in recent weeks, one extraordinary event almost went unmarked. Short-term German interest rates, represented by two-year bond yields, fell below their Japanese equivalents last week for the first time in more than two decades.

It is confirmation of what some have suspected for a while: the eurozone is turning Japanese.

The fear of emulating Japan's experience over the past quarter of a century has been a constant worry ever since the financial crisis broke in 2007. The reason is simple – it will have massive implications for asset allocation.

The signs are already there, and not just in short-term German rates. Benchmark 10-year Bund yields on Wednesday fell to 1.63 per cent, an all-time low. John Paulson, the famed hedge fund manager, may have logic on his side in his bet against Bunds as nearly everyone expects Germany to foot the bill to the sovereign debt crisis one way or another.

But if the eurozone really is following in Japan's path one big lesson is that yields can go lower, a lot lower. After Japanese 10-year yields fell below 2 per cent in 1997 they have scarcely risen above that level again and have even moved under 1 per cent at certain periods, including recently.

The outlook for equities under a Japan-style scenario is gloomy, even after their long period of suffering in Europe. The continent's bourses have significantly underperformed their US rivals in local currency terms. The Euro Stoxx 50 is up 30 per cent since its post-crisis low from March 2009 against a 105 per cent gain for the S&P 500.

A true Japanisation of the eurozone would lead to a further hollowing out of European equity markets. Assets under management in European equity funds slumped by nearly a half from their 2007 level by the end of last year, according to rating agency Fitch.

The similarities with Japan are most apparent on the economic front. Peripheral eurozone countries could be facing a decade of sub-par growth and austerity as they struggle to overcome their debt burdens.

As a sign of what this could mean, analysts at UBS point out that nominal GDP growth in Japan from 1980 to 1990 was 85 per cent. Over the next 20 years it was only 8 per cent. It is that lack of growth that is most worrying, not the coincident rise in Japan's debt pile.

In terms of policy response, the European Central Bank may not have opted for quantitative easing by name as Japan did but its programme of cheap loans for three years to banks does the same thing by the backdoor. Despite periodic chatter of "exit strategies", it is clear to most in the markets that the ECB will have to be involved for years to come in one way or the other.

The cheap loans, known as longer-term refinancing operations (LTROs), come with the big danger of creating a swath of zombie banks, not just in the periphery, but in parts of the core as well. The fact that 450 German banks tapped the second LTRO demonstrates the degree of over-banking in the eurozone's largest economy.

Elsewhere, Spanish and Italian banks' stocking up on their own domestic government debt using LTRO cash links their fates ever more inextricably to that of their own states, scarcely a good thing.

If the economic part looks cloudy, there may be some small silver linings from the markets. Japan went into its lost decades with incredibly expensive equities and fairly cheap bonds compared with the eurozone. The Nikkei 225 peaked at almost 39,000 and was trading on Wednesday at just 9,667.

The UBS analysts found that equity valuations in Japan at the peak in 1989 were 103 per cent their historical average in price/earnings terms. In Europe in 2007 they were just 12 per cent higher. Even on the closest measure, Japan's price-to-book ratio was 64 per cent above the historical norm while Europe's was 35 per cent. Similarly, government bonds were cheaper in Japan. At the Nikkei's peak, 10-year Japanese debt yielded 5.74 per cent and subsequently rose as high as 8.23 per cent. German 10-year yields, by contrast, were 4.56 per cent on the day of the Dax 30's 2007 peak and have fallen fairly consistently since then.

The starting point for markets may perhaps lessen the impact but the outlook is still grim. If US equity markets suffer a correction after their recent run, Europe is unlikely to avoid a similar fate despite its underperformance.

The extent of the eurozone's problems – stretching from Spain's deficit to Italy's debt stock and France's banks – could signify, as Matt King at Citi argues, that a dramatic policy response such as in the US in 2008 and Sweden in the 1990s would not work. Muddling along then becomes the least worst option to avoid triggering a chain reaction of defaults across the continent.

But it also suggests that a Japan-style slump in stocks and rise in bond prices could well be a best-case scenario.