

Equity Research

Global Strategy **Weekly**

People say the US isn't like Japan 10 years ago. I agree. Actually *it's WORSE!*

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We have long believed that when the US bubble finally burst, there would be key lessons that could be learnt from Japan's experience a decade ago. Until recently most have dismissed our comparisons. But despite having a more pro-active central bank, with the US now entering its second recession since the stock-market bubble burst and with a pronounced credit crunch unfolding (just like Japan had), clients are more willing to listen to our gloomy story.

■ With one of the biggest credit bubbles in history now bursting, many of the big beasts in the investment world have stated we are heading for the deepest economic downturn since the War (i.e. also since the Great Depression). In these troubled times it is very difficult to look back in US history and find adequate route maps for similar sized bubbles bursting.

■ We have always believed that when the multiple bubbles the US enjoyed over the last decade (e.g. stock-market, economic and credit bubbles) finally burst, the Japanese experience would provide a useful template for investors. The vast majority of clients have always vigorously rejected this comparison. However, though the comparisons are not exact, there are essential similarities in the de-bubbling process.

■ Many seek comfort that the Fed is well aware of the mistakes Japan made a decade ago and they have at the helm an expert on the Great Depression. But that does not mean they can muffle the huge sucking sound as debt excesses unwind.

■ Where the US is in a *much* worse state than Japan a decade ago is in its consumer finances. When Japan went into its Ice Age in 1990, the household savings ratio stood at a lofty 15% (see chart below). Hence as income declined, consumers were able to run down savings to maintain living standards. In contrast, the US consumer is a spent force. So as US employment now slumps ("flexible economy" and all that), the US saving ratio is more likely to rise, causing a far deeper slump in GDP than we saw in Japan a decade ago.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	40
Bonds	20-50	35	45
Cash	0-30	5	15

Source: SG Equity Research

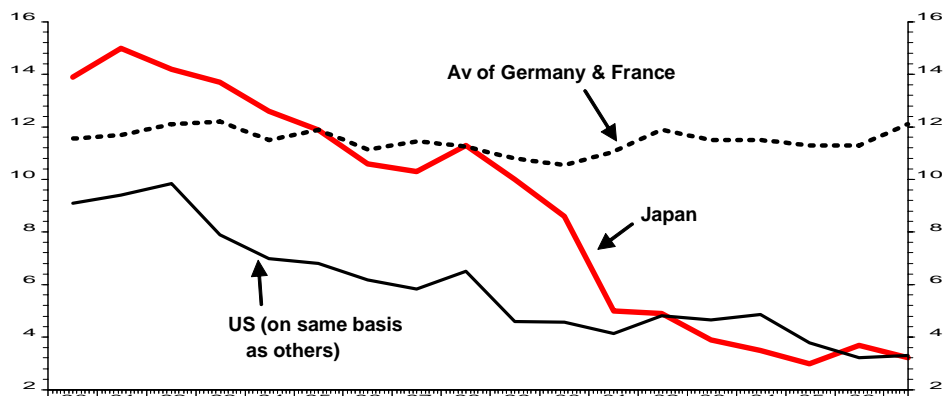
Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont Europe
Underweight	Japan Emerging Mkts
Very Underweight	

Source: SG Equity Research

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Household Sector Saving Ratios (as % of disposable income, defined gross of depreciation)



Source OECD, Datastream

Regular readers know that we have always seen Japan as our template for the US bubble bursting. The main comparison we make in learning from Japan's Ice Age is how, once their stock-market bubble burst in 1990, Japanese equities' P/Es relentlessly de-rated on a secular basis despite declining bond yields. We see the same now occurring in the US.

But we can also see useful comparisons in the real economy. During the last few years many have said to us one big difference between Japan and the US was that the US real estate situation was extremely robust and the US banks were in good shape. No longer! But we also note that actually in Japan, despite real estate slumping from 1991 onwards, banks were not *perceived* to be a problem (as evidenced by lack of underperformance – see chart below) until the second recession in their own Ice Age began to unfold – just like the US now.

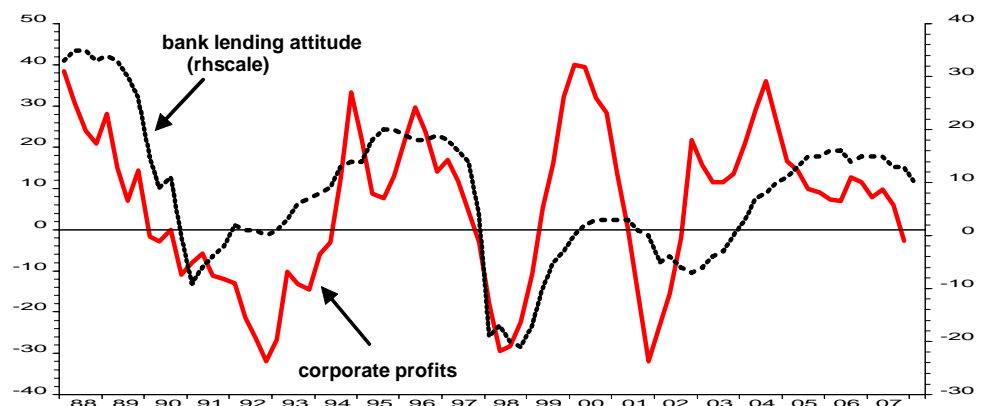
Japanese land prices (yoy %) and Japanese banks relative to total market



Source: Datastream

Similarly a devastating economy-breaking credit crunch did not hit Japan until the *second* Ice Age recession (see chart below), contributing to a second devastating fall in corporate profits - just like the US is about to suffer. Were banks the cause of the problems or were they a victim? Our own view at the time was that banks were a symptom and not the cause.

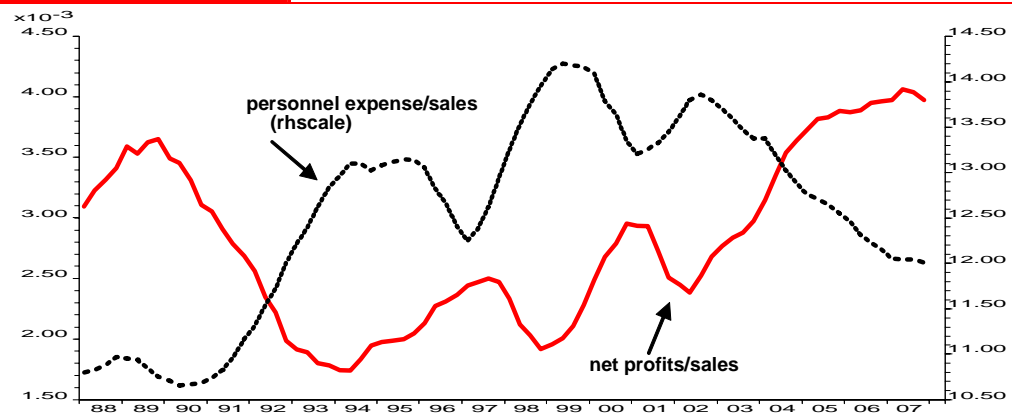
Japanese whole economy profits (yoy %) and Tankan measure of credit conditions



Source: Datastream

There is much debate as to whether more rapid bank write-downs (which we are seeing by contrast in the US) and a more liquidationist approach to excess capacity would have resolved Japan's crisis far sooner. My own view is that it would not have. There were numerous aggressive attempts to write down loans (e.g. in the five years to March 1998 some ¥37½tr were written off, or 7¼% of GDP). But bad loans just kept accumulating. The problem was that deflation (both property and general CPI) was wreaking havoc with the nominal revenue line leading to unusually massive slumps in nominal profits in economic downturns. The argument that Japan's banks should have pulled the plug from the zombie companies they were lending to (throwing good money after bad), would actually have probably led to a deflationary depression. Similarly the liquidationists complained that Japanese companies were very slow to shed excess labour and so profits margins slumped (see chart below).

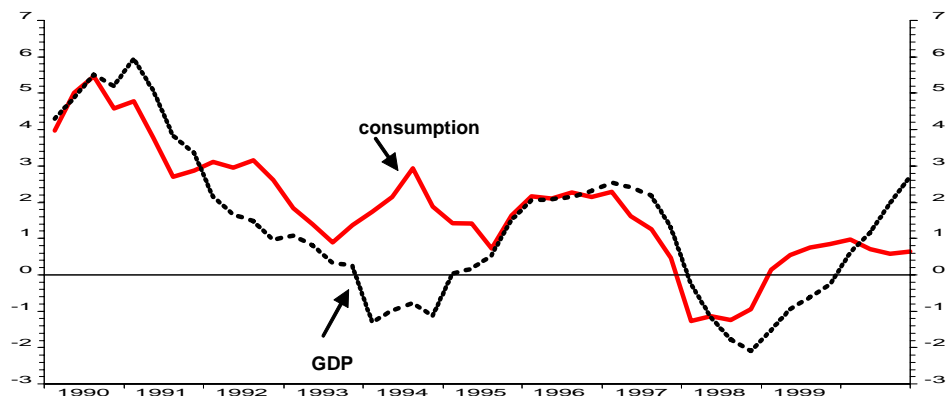
Japanese profit margins and personnel costs as % of sales



Source: Datastream

Japan's first post-bubble recession was investment-led as companies reduced their excess borrowing. Like in the US, the Japanese consumer escaped during the first Ice Age recession. But even despite the reluctance to fire labour and a very high saving ratio, Japan suffered a consumer recession in its second Ice Age downturn (i.e. similar to the US situation today). With the lack of a high saving ratio, the US consumer and GDP slump is likely to be much worse.

Japanese consumers expenditure and GDP growth (1990-2000, yoy % 4 qtr mav)



Source: Datastream

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