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DSI Vice Chairman Commentary

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2010 may be the beginning of a glorious decade.

～But will the “Greenspan conundrum” become a problem once again?～

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Happy New Year.

Thank you very much for your support in 2009. I look forward to providing you with highly useful information and insights again in 2010.

It was only six months ago that I left Deutsche Securities to go out on my own. Since then, my goal has been to examine economic and market developments thoroughly based in my motto of providing “historical and international perspectives based on solid logic and independent thinking.” My highest priority has been to exchange views with even more people in order to formulate viewpoints that are even more incisive. I am very happy to say that I am close to reaching this goal. I firmly believe that history has been redirected in the right direction many times by the knowledge and courage of mankind. Events taking place in countries and our lives are not pre-determined. The direction we take is instead determined by our knowledge and willingness to tackle new challenges. If we can make effective use of our knowledge, there is reason to be optimistic about the future. It is my wish that the Musha Reports play even a small role in shaping the events that define the times.

Following the so-called Lehman Shock, the world witnessed a once-in-a-century financial panic. But the turmoil is mostly behind us. Now that the global economy has been revived, I think that 2010 will be a period when we should aggressively take on new challenges. This is the year to abandon the pessimism that we still hear so frequently. Musha Research anticipates the following events in 2010: (1) a robust U.S. economic recovery; (2) an increase in the dollar’s value; (3) a rapid rebound of the Japanese economy backed by strong exports and a weaker yen; (4) a sharp rally in Japanese stock markets; and (5) a gradual upturn in long-term interest rates. Japan experienced the world’s steepest economic downturn last year even though the impact of the financial crisis was less than in any other country. Why? Because of a negative spiral fueled by deflation as the yen appreciated. Deflation was very harmful to industries dependent on internal demand and on regions far from Japan’s large metropolitan areas. The reason is that these industries and regions have little potential for boosting productivity. In 2010, though, I expect to see internal-demand industries in Japan come back as deflationary pressure fades away. Based on this outlook, I am confident that 2010 will be a year when investors who aggressively take on risk will be rewarded.

(1) 2010 will be the sweet spot of the short-term cycle

The sweet spot of the real economy

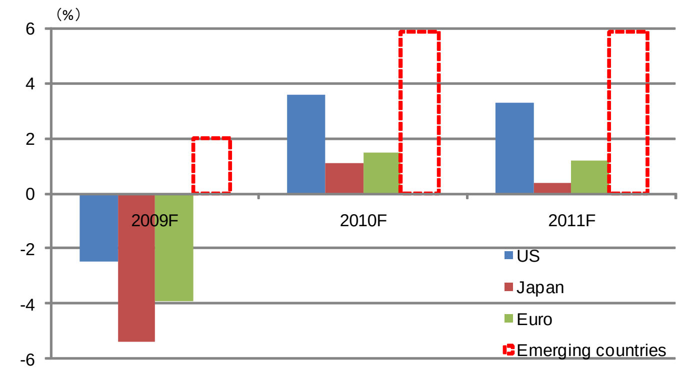
I believe that 2010 will be viewed as the sweet spot of the global economic cycle. The first reason is that all necessary conditions are in place for a powerful cyclical recovery of the real economy. In the United States, which holds the key to a global economic recovery, we have seen remarkable progress in the corrections in three categories: companies, households and housing. Never in the postwar era has the U.S. economy been this lean. Furthermore, economic growth rates in China and other emerging countries are increasing.

The unprecedented streamlining of the U.S. economy

As I stated in an earlier Key Strategy Issues report (KSI No. 285), the improvement in U.S. economic fundamentals has been astonishing. To repeat, I said that we have seen unprecedented progress by companies in streamlining operations and by households in cutting expenditures. Furthermore, the undervaluation of houses has reached an unprecedented level. All three of these events are the result of an excessive contraction fueled by panic. In sum, the correction of the U.S. real economy has gone far enough. I concluded that the positive impact of the correction following these excessive events may be much greater than anyone can imagine. Furthermore, the rapid recovery of China's domestic demand (November imports up 26.7%, new car sales up 96.4% and industrial output up 19.2%) will probably make a big contribution to economic recoveries in the U.S. and other industrialized countries.

Collectively, I expect these factors to spark a powerful economic recovery in the U.S. in 2010. Deutsche Bank also foresees a strong U.S. rebound. Economists at this bank forecast 3.6% growth for the U.S. economy in 2010 compared with 1.5% for the EU, 1.1% for Japan and 5.9% for emerging economies. The outlook for a solid recovery also means that the U.S. will be most likely be the first to end the period of extreme monetary easing. Naturally, this will make the dollar stronger.

Figure 1 : Economic growth forecasts for major countries



Source:Deutsche Bank Global Market Research, Musha Research

The sweet spot of the financial cycle

The second reason that 2010 will be viewed as the sweet spot of the global economic cycle is that the financial cycle will produce excellent investment opportunities. As Figure 2 shows, stock price movements are closely linked to the yield curve (difference between very-short-term interest rates). Typically, stock prices reach a bottom between six months to one year ahead of a yield curve peak. Moreover, stock prices often reach a peak several months before the yield curve hits bottom. Right now, the yield curve is just about to climb to a peak. That means the stock market rally has only begun. The rally will not end until the yield curve hits bottom, a process that will require a considerable period of interest rate hikes. Consequently, stock prices will probably continue to climb for one to two years, or perhaps even longer. This is why 2010 is likely to be a sweet spot for investors from the standpoint of the financial cycle, too.

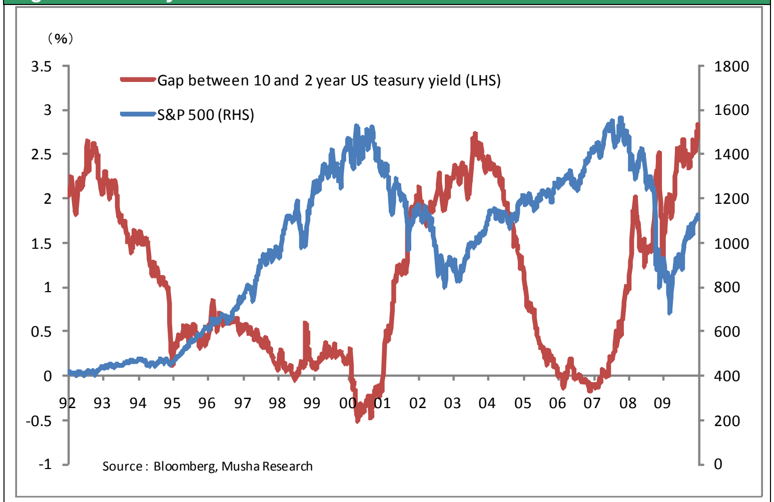
Big interest rate spreads encourage risk-taking

When the yield curve becomes steep, investors can earn more interest income from the big gap between short and long-term rates. Capital at financial institutions increases along with financial income, allowing these institutions to supply capital for taking on risk. Gaining access to this capital allows investors to significantly bid up prices of stocks and other asset categories that come with various forms of risk. There is a high correlation between the U.S. yield curve cycle and stock prices in Japan. Because of this, 2010 may be an unexpectedly good year for Japanese stocks, too.

No need to worry too much about sovereign risk

Sovereign risk is a major source of concern in financial markets. After all, governments have taken on private-sector risk to end the financial crisis. As a result, investors now fear that rising yields on government bonds of major countries will block an economic recovery. This may be true in some emerging countries with weak economies. But I do not think this will happen in major countries like the U.S. and Japan. Funds available for investments were plentiful prior to the crisis and there is still no shortage of capital. Most significantly, the sum of U.S. household and corporate savings currently stands at a postwar high. So where will this money go if households and companies sell their government bonds? More investments in assets with risk would produce a beneficial upturn in interest rates. The result would be strong support for the real economy.

Figure 2 : The yield curve and S&P 500



(2) The end of the decade of structural stagnation (2000-2009)

The decade's stock returns were the worst ever

As I just explained, 2010 will be a favorable period from the standpoint of the short-term economic cycle. But investors have good reason to be wary from the standpoint of structural factors. During the past decade, stock markets posted their worst-ever performance. On December 21, 2009, The Wall Street Journal reported that U.S. stocks returned 0.5% between the end of 1999 and 2009. This was the lowest return since the 1830s, which is when these statistics were first compiled (Figure 3) (based on data from Yale University professor William Goetzmann).

But this should come as no surprise. Two debacles caused stock prices to plummet: the bursting of the IT bubble and the credit bubble. Even during the 1930s as the Great Depression brought down the U.S. economy, stocks declined only 0.2% for the decade as a whole. By comparison, between the end of 1999 and 2009, bonds had an annual return of 5% to 8% and the price of gold climbed at an annual rate of 15%. Obviously, stocks were the worst asset category of the decade for investors.

Of course, we must remember that returns in the past decade were held down because 2000 coincided with the peak of the IT bubble. Stocks were extremely overvalued (PER was an all-time-high 40). As it turned out, stock prices were unable to return to their 2000 highs for the remainder of the decade. (I would like to take this opportunity to point out that I was one of the very few people in Japan who constantly issued warnings about this bubble. In his book "Can You Trust Economists?" (2003, Bunshun Shinsho), journalist Satoshi Higashitani ranked 25 prominent economists. I received the highest ranking (Aaa). Mr. Higashitani remarked that he was impressed with my accurate predictions concerning excitement caused by the IT revolution.

The worst is now behind us

Having come to this point, it is too late for people to adopt pessimistic views simply because of all the problems in the past decade. Enormous turmoil took place in credit markets in late 2008 and early 2009. Prices plunged to a level that factored in a worst-case scenario including a bankruptcy rate higher than even during the Great Depression. A crisis exceeding even this scenario is impossible to imagine. Consequently, stock prices as well fell to a long-term bottom as well about one year ago. If investors believe this was actually the bottom, they should also believe that stock markets may now be on the verge of a new era.

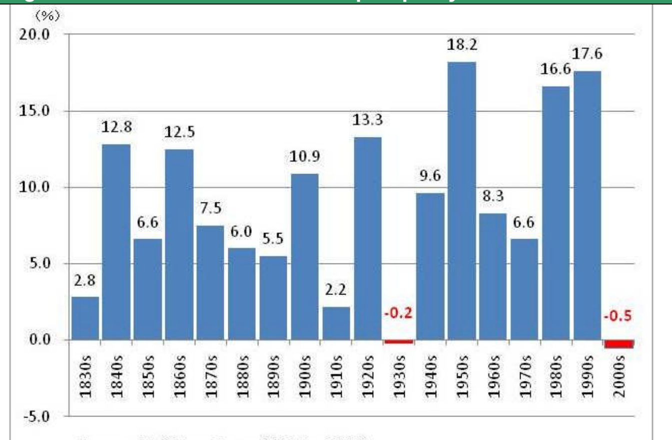
A comparison of the past two decades

During the 1990s, U.S. stock prices climbed steadily as investors were enamored by two big dreams: economic globalization and the Internet/information revolution. A bubble emerged as expectations continued to grow. The 2000s turned out to be the decade that deflated stocks that had been overpriced by placing too much faith in these dreams. But in the real economy, we started to see a new vision of prosperity backed by steady advances in globalization and the Internet/information revolution. The major players of both themes were already on the stage. However, the markets had to undergo a correction to eliminate excessive expectations. This is precisely what happened when the IT bubble and credit bubble markets came to an end.

Will this be a decade of prosperity?

As we begin a new decade, I believe the dreams that propelled stock prices higher 10 years ago are about to come true in the real economy. At the same time, though, stocks have suffered a dramatic correction. So we must ask ourselves exactly what type of prosperity economic globalization and the Internet/IT revolution will produce in 2010. Isn't it possible that the coming decade will be a time when stock prices consistently factor in the emergence of this long-awaited prosperity?

Figure 3 : Will this be a decade of prosperity?



Source: Wall Street Journal (21 Dec 2009)

(3) The ultra-long-term stock cycle: Will prices climb again (the Greenspan conundrum)

Why was it so easy to end the financial crisis?

To formulate an outlook for the coming decade, we must first look at the reason that markets and economies bounced back so smoothly after the crisis. The world was rocked by a once-in-a-century financial panic. Almost everyone expected a severe economic downturn and bleak future for the world. Instead, we were surprised to see a recovery that was almost too easy. Pessimists are convinced this is a false dawn. They say the crisis has not ended and a second bottom lies ahead. If nothing changes, this is a natural conclusion.

Is finance really this simple? Did fiscal and monetary initiatives alone really bring the crisis to an end? Pessimists all agree that governments did nothing more than transfer risk from the private sector to the public sector. That makes the insolvency of governments inevitable. They foresee the following chain of events: (1) a recovery in demand for capital as economies become healthy again; (2) growing public-sector budget deficits; and (3) rising fears about inflation. Pessimists believe this will produce a steep upturn in interest rates that will stop the economic recovery. This is the sovereign risk scenario.

Zero sum or plus sum?

I think the pessimists are wrong. To determine who is right, we must first decide whether or not the outlook should be based on a zero-sum game. On the negative side, we can assume that that there will be no growth in productivity, the economy, personal income or capital. In this case, risk will go back and forth as many parties compete for a piece of a pie that stays the same size. At some point, this process will produce strain that leads to a catastrophe. But the outlook changes if we assume that economies will grow along with the amount of capital. In this case, there will be no strain and everyone will prosper.

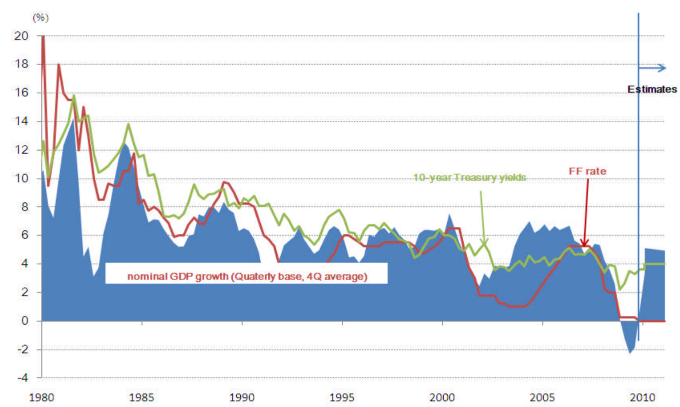
The surprising performance of U.S. companies in 2009

Two events were behind the big recovery in U.S. stock prices last year. First was the historic decline in personnel expenses as a percentage of earnings. Second was a historic increase in the amount of liquidity on corporate balance sheets. Both events are irrefutable proof that the economic pie is growing and labor productivity is increasing. There are two causes: economic globalization and the Internet/information revolution. Normally, governments would find it almost impossible to deal with a crisis of this magnitude. However, these historic tailwinds made it easy for governments to take the actions needed to end the global financial crisis.

Long-term interest rates are critical to the outlook for 2010

If this is true, then the direction of U.S. long-term interest rates holds the key to the economy's health in 2010. Will government red ink cause a rapid increase in long-term rates that brings economic expansion to a halt? Or will the economy to continue growing as interest rates remain flat? I think sustained economic growth is much more likely to occur. But if the economy does expand, I expect to see a reappearance of the Greenspan conundrum, which many people have already forgotten. As you can see in Figure 4, long-term interest rates did not rise between 2004 and 2007 despite monetary tightening and economic growth. The result was rampant risk-taking and the housing bubble.

Figure 4：The Greenspan conundrum: U.S. long-term interest rates, the FF rate and nominal economic growth rate



Source: US Department of Commerce, Bloomberg, Musha Research

The Greenspan conundrum still warrants our attention

Why didn't long-term interest rates climb during a period of robust economic growth? There is still no answer that satisfies everyone. The conventional explanation is that too much monetary easing triggered excessive risk-taking. But this isn't the real answer. No one can deny that increasing leverage fueled by rampant risk-taking caused a sharp drop in the risk premium as investors rushed to buy assets with risk. However, if this explanation is true, long-term interest rates should have moved in the opposite direction. After all, taking on more risk means that investors are borrowing (or selling) risk-free assets to buy risk assets. This selling should push up interest rates on risk-free capital (long-term interest rates).

The Greenspan conundrum and historic tailwind

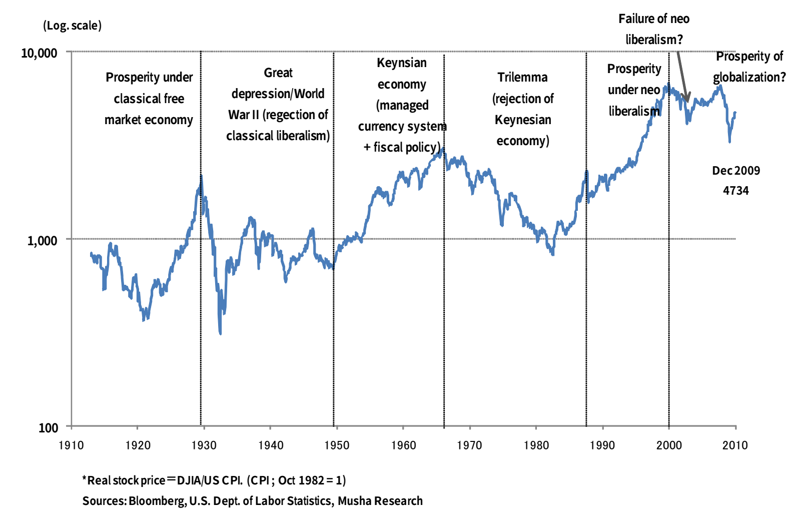
Two factors were responsible for holding down U.S. long-term interest rates in the middle of the past decade. First, there was a large volume of excess capital. Second, excess (windfall) profits were the source of these funds. This is the golden scenario that I described in my 2007 book *The New Imperialism*. Fed chairman Ben Bernanke in 2005 pointed to the global saving glut as the reason that long-term interest rates remained flat. But I think the real reason for flat long-term interest rates is the historic global upturn in productivity that caused the global saving glut.

My position is that rising productivity made possible by economic globalization and the Internet/information revolution are responsible for the Greenspan conundrum. Furthermore, the benefits of these two trends did not end with the financial crisis. If I am right, a powerful economic recovery is inevitable and there will be no big increase in U.S. long-term interest rates that would hinder economic growth.

Sustained economic growth without higher long-term interest rates would lead to a new economic era. Figure 5 shows real U.S. stock prices for the past century, a chart that I have been watching for 20 years. The chart clearly shows the different periods of the U.S. economy.

1) Growth until 1929 ⇒ Classic prosperity under a free market economy (gold standard)
2) Downturn from 1930 until about 1945 ⇒ Great Depression, World War II, the demise of the classic free market economy
3) Growth from about 1945 to 1967 ⇒ Prosperity produced by Keynesian policies (managed currencies, fiscal policies, IMF oversight)
4) Downturn from 1967 to 1982 ⇒ The economic trilemma and demise of Keynesian policies
5) Growth from 1982 to 2000 ⇒ A new free market economy fuels prosperity
6) Stagnation from 2000 to 2009 ⇒ Excesses of the new free market economy stop economic growth
7) Starting in 2010 ⇒ Advanced capitalism (combination of free markets and Keynesian policies), prosperity of global empires?

Figure 5 : Real U.S. stock price (DJIA/CPI) and economic periods



A new decade and a new economic regime

If the Greenspan conundrum reappears in 2010, we may see the beginning of prosperity for global empires. Exactly what kind of prosperity would this be? A rough idea, without any analysis, is that we would enter an age of more advanced capitalism. Essentially, this period would combine the principles of free markets and Keynesian economics. In terms of international finance, I think there would be a currency system in which many countries support a framework centered on the dollar. My position is that the absence of a mechanism for recycling funds from excess profits was responsible for the death of the new free market system in the past decade. The widely held belief that uncontrolled greed was responsible is simply not true. Since financial markets failed to create a reinvestment mechanism, excess profits ended up creating asset and credit bubbles as capital was squandered. This was a period that required forceful government policies to direct excess capital to endeavors that could create demand. I believe this can be accomplished by using an advanced form of capitalism that combines free markets and Keynesian economics.

(4) Will 2010 be a good year for Japan?

A positive cycle has started with the U.S. recovery and yen's decline

Shifts in the global economic regime that I have just outlined will produce a tailwind for Japan's economy. The most important point may be the combination of the end of the dollar's fall and the resumption of speculative activity that brings down the yen's value. During 2009, the dollar weakened as speculators used the dollar to procure funds at extremely low interest rates. This generated substantial outflows of capital from the U.S. On the other hand, investors bought the yen because Japan was forced to raise short-term (real) interest rates in response to deflation. But procuring funds in dollars is becoming increasingly risky as unmistakable signs of a U.S economic recovery appear. As a result, speculators are turning their attention to the yen. Japan is unlikely to end its zero-interest-rate policy soon because the country has the poorest prospects for economic growth among the world's industrialized nations. The yen is thus likely to replace the dollar as the primary currency for procuring funds for the carry trade. As capital flows out of Japan, we may see an unexpectedly large decline in the yen's value.

Japanese stocks will quickly catch up with the rest of the world

A weaker yen would be very good news for the struggling Japanese economy. Japan's economy suffered the most damage from the financial crisis even though the impact of the crisis in Japan was smaller than in other industrialized nations. The cause was the damage inflicted by a negative cycle driven by a stronger yen and deflation. Industries linked to internal demand and the economies of regions from Japan's large cities were hurt because there is little room for further improvements in productivity. But we may see a reversal of the yen in 2010. Deflationary pressure would probably diminish significantly if the yen weakens. I think this would bring Japan's domestic-demand industries back into the limelight.

Naturally, a global economic recovery is also likely to produce a rapid upturn in Japan's exports. A sharp improvement in earnings of export-dependent manufacturers would almost certainly follow. This is why I believe that 2010 will also be a year that rewards aggressive risk-takers who buy Japanese stocks.

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Reference: Excerpt from KSI No. 277 (November 2008)

The following section is an excerpt from my November 2008 report (KSI No. 277, pp6, 12-16) that I wrote during the worst days of the financial crisis. In this report, I examined the subject of whether or not the crisis signaled the emergence of a new global economic paradigm.

"(1) A quick correction of excessive U.S. leverage will end the economic downturn in the first half of 2009

The crisis has not changed the paradigm for economic growth
Putting this financial crisis in historical perspective is vital to predicting what will happen next. We can adopt either of two viewpoints. The first is that the financial crisis is nothing more than a market correction. A recovery will occur after corrections in over-leveraged loans and the temporary upturn in demand fueled by these loans. In this case, the speed of a recovery will depend on two factors: the length of time required to cut leverage to a reasonable level and the severity of this correction. The second viewpoint is that the financial crisis signals the beginning of an entirely new paradigm. If we believe this, we can expect to see the crisis become even more serious. Investors would have to prepare themselves for an economic "dark age" that lasts for many years. People who expect a paradigm shift believe that (1) the financial model backed by U.S. investment banks has been destroyed, (2) neoliberalism has been discredited, and (3) the dollar-centered currency system is no longer viable.

Of course, it is too early to reach a conclusion because the financial crisis is not yet over. But to repeat my prediction, I believe that the financial crisis will not reach the point of creating a new paradigm. I believe that a severe economic downturn can be avoided. Eventually, corrections in excessive leverage and debt will run their course. At that point, prospects will be excellent for a return to economic growth fueled by a gradual recovery in the use of leverage. The most important reason for my position is the fact that most of the extreme leverage in the United States occurred in the financial sector. In other business sectors, leverage is not as bad as most people believe and the correction will end relatively soon."

"(2) Will the paradigm change?

In this section, I will examine the possibility of three paradigm shifts that could result from the financial crisis. In all three cases, I conclude that we are not seeing changes of a magnitude that could bring an end to the current paradigm for economic growth.

1) Possibility of the demise of U.S. financial capitalism
Since enactment of the new U.S. banking law (the Gramm-Leach-Bliley Act of 1999), defects in the regulatory system has allowed banks to maintain excessive interest rate margins. Earning these high margins prompted financial institutions to take on too much leverage and risk, which produced the asset bubble. We must establish a level playing field based on fairness and transparency in order to eliminate the cause of these excessive margins. However, the role of investment banks must be preserved. This is because there is no change in the fundamentals of the finance business, which involves direct financing, securitization schemes, arbitrage using current values of different asset categories, and other activities. No one knows who major players will be in the future. At first, the players will probably be the universal banks, which can diversify their exposure to risks. After that, it is unclear who will take over.

Despite this uncertainty, global wholesale banking will probably remain a growing industry, particularly with regard to equities. After all, uncertainty is the source of financial income, and equities are more uncertain than credit instruments. Bankruptcy rates are the source of credit income. Profit margins are small because this rate can be statistically calculated. But reliable predictions are impossible for cash flows, which are the source of income from equity investments. Equity investments are thus costly because they rely on research performed by securities analysts. This is why equities will probably become the chief source of financial income. Equities include many activities associated with stock investments, like M&A and private equity. The essence of the asset management business, which is the nucleus of the financial sector, is to convert the cash flows of companies into the yields that investors seek.

As I have explained, there will continue to be many sources of financial innovation. But the United States is best suited to be the driving force of this innovation. This country has an overwhelming edge in terms of its unfettered markets, creativity, respect of property rights and other strengths, including the dollar's position as the world's core currency.

2) Possibility of the demise of economic neoliberalism
The abandonment of liberalism spawned the bubble. Furthermore, regulatory systems could not keep pace with changes in the financial sector resulting from financial globalization and new technologies. We must redesign and rebuild regulatory frameworks and ensure appropriate oversight of financial institutions. But the perception that markets sparked the financial crisis is not entirely correct. Mistaken regulations played an even greater role. Many problems involving the entire financial system created distortions in how markets functioned. One problem is an uneven playing field. Examples include differences between banks and securities companies, public and private offerings, and hedge funds and institutional investors. Another problem involves the lack of transparency for housing policies (are they social or economic policies?) used by government-sponsored enterprises. One more issue is pro-cyclical regulations that fuel market and economic cycles. For instance, there is no coordination among accounting standards, financial regulations (BIS) and the regulatory agencies of individual countries.

Economic liberalization began in the 1980s with themes like smaller governments, deregulation, more emphasis on using market forces, and economic globalization. Even now, there are no signs of any changes in this trend. Technology and globalization are undoubtedly making markets, and so-called "invisible hands," more efficient. Some people believe that the combination of the economic regime that has existed since the 1980s and neoliberalism will create an age of antithesis. But I think this view is oversimplified. Just as the Clinton Administration retained the economic policies of the preceding Bush Administration, the incoming Obama Administration is very unlikely to impose regulations that would impede creativity.

Consequently, I believe it is too soon to declare that the long-term upturn in stock prices that began in the 1980s has come to an end.

3) Possibility of the end of the dollar's supremacy
Although it is counterintuitive, the financial crisis has made the U.S. dollar stronger. The reason is a shortage of dollars. Primary causes are a shrinking U.S. trade deficit, a shift in overseas investments back to the United States, and actions to offset losses from investments in dollar-denominated assets. The euro's value dropped quickly and countries with emerging economies are seeing their currencies become unstable. Even gold, which should be popular during a crisis, has become cheaper. Other than the yen, the dollar is now the world's strongest currency. Increasing value during a crisis is proof that the dollar is still at the center of the global economy. Everyone shares the fantasy that the dollar is the last safe haven. Ultimately, the world turns to the dollar to settle its accounts.

No currency has the potential to replace the dollar in the foreseeable future. Investors gladly hold large amounts of U.S. dollar debt and spend dollars because the United States has (1) considerable power and influence, (2) massive purchasing power, and (3) a worldwide presence. The euro is viewed as a possible replacement. But after appreciating to a bubble-like valuation this year, the euro is currently in a downward correction.

The tenuous beliefs of dollar bears
Dollar bears point to the falling share of dollars in foreign currency reserves as a sign that countries are running away to other currencies. This view is completely wrong. The share of dollars in foreign currency reserves automatically fell as the dollar weakened. As you can see in the figure, dollars would have remained the same as a percentage of global foreign currency reserves if there had been no change in the dollar/euro exchange rate. Dollar bears also point to the enormous amount of U.S. debt held by foreigners. But the United States actually has a large surplus (through the second quarter of 2008) in its income balance with other countries. Obviously, overseas debt is not a burden for the U.S. economy. This explains why the low U.S. long-term interest rates and the absence of market pressure to reduce the volume of dollar-denominated debt.

But the dollar does not have an absolute position of supremacy now that exchange rates can move freely. Under a "managed float" exchange rate system, the situation would be quite different. Dollar supremacy would be impossible without continuous dollar financing in the form of currency market interventions by Japan and China, which hold vast foreign currency reserves. In fact, the support of Japan and China for dollar-based global economy played an instrumental role at this month's economic summit (G20).

No significant concerns exist about the dollar's supremacy. But the world is now experiencing a dollar shortage that creates a classic liquidity dilemma. Difficulties in maintaining the dollar's value will cause inadequate dollar liquidity that would weaken the global economy. But if priority is placed instead on economic growth, worries about the dollar will increase. When this dilemma surfaced in the past, the United States always put the provision of liquidity first. This time as well, the priority is liquidity. Assets on the Fed's balance sheet have ballooned, with dollars supplied to other countries through currency swaps accounting for about half of this growth. When the bubble burst, the circulation (liquidity) of the dollar became blocked much like when a blocked artery prevents the flow of blood. The Fed was determined to restore this circulation in every part of the world. I believe that this liquidity dilemma will be resolved by international monetary easing and the Fed's supply of liquidity."

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