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Shock and Awe from the BOJ

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Following a roller coaster ride through September and October, global equity markets closed the month with a bang, courtesy of shock and awe from the BOJ.

For the record, the S&P 500 fell 9.8% from its intra-day high of 2019 on 16 September to 1820 at its intra-day low on 15 October. It then rose 10.9%, like a rocket, to close October at 2018.05. In Europe we saw even steeper declines with Italy falling nearly 22% and Germany 16%, peak to trough. Interesting to note that most European markets had peaked in June and are still well below those levels. This canary sang in French, German and Italian and it was both a most haunting and deflationary tune!

I am not going to spend too much time discussing the gyrations of the market and the feeding frenzy we saw in the last two weeks. Suffice to say we saw massive volatility across all asset markets, with dramatic declines in oil and gold, with the US dollar soaring at month end.

Interesting to note, however, that my three favoured markets, China, India and Indonesia were far less volatile than their counterparts in America or Europe, with peak to trough declines between 5 and 6%. Since their respective correction lows, India has made an all- time high and the Shanghai Composite is at a 21 month high. Indonesia is just 3% below its all-time high. I continue to believe that these three markets will perform well in the months ahead.

The surprise announcement by the Bank of Japan to significantly increase its QE programme, was accompanied by the news that the Japanese Government Pension Investment Fund (GPIF) would more than double its exposure to equities at the expense of Japanese government bonds. In essence the BOJ will, in effect, buy all the bonds that the GPIF plans to sell. This is massive news!

Just as the world's financial markets were mourning the passing of American QE and wondering if life would ever be the same again, the BOJ stepped into the breech with Kuroda style monetary shock and awe of epic proportions. Wouldn't Mario Draghi just love to be Governor Haruhiko Kuroda for just one day?

You never know, 'Super Mario' might get his way one day, but for the moment 'Hero Haruhiko' has stolen the show.

Turning to matters more mundane, the US economy continued to perform strongly with third quarter GDP rising 3.5%. Consider the following numbers and spot the odd one out, 4.5 3.5 –2.1 4.6 and 3.5. These are the last five quarters of growth in America, with the outlier being the weather impacted first quarter reading of minus 2.1%.

As I have said for some time now, the US economy is firing on all cylinders and will continue to confound the pessimists. It is noteworthy that, so far this year, the average monthly gain in non-farm payroll is 227,000, which is the strongest since 1999, and we are likely to see another strong employment report this coming Friday.

The Chinese economy grew 7.3% in the third quarter and the evidence of a slowdown in the property market continues to impact the broader economy. I am hoping that next year the Chinese authorities abandon their practise of targeting GDP growth. Given the desire to encourage a greater role for market forces, it really makes no sense for the government to continue with their 'top down' fixation on a given growth rate. With the slowing in the property market, which to date is reasonably orderly, and the very benign inflationary environment, I see some scope for the central bank to ease monetary conditions further. Similarly, the strength of the RMB, on a trade weighted basis, opens the door for a decline in official rates. Since mid-year the RMB has been the only major currency in the world to rise against the US dollar. In this regard, the shock and awe unleashed by Kuroda at the BOJ may have been welcomed by equity investors but it would have not amused policy makers in Beijing who see Tokyo pursuing a deliberate policy of currency devaluation.

In 2015 we will see China report a growth rate with a six in front of the decimal point. But, as I have said countless times, this is perfectly acceptable, as by then it will be a $10 trillion economy.

I continue to be impressed by the quality of the leadership in Beijing; the changing composition of the economy; the crusade against corruption and pollution and the liberalisation of the financial system. In view of all of the above, and given the compelling equity valuations, I see further stock market gains ahead.

The major 'blot' on the global economic landscape remains Europe. We are potentially just a few inflation reports away from an outright decline in headline CPI for the eurozone, and, given the 20% decline in oil prices, this is not just possible but probable. Consumer prices are now falling in eight European economies and the 'Japanification' of Europe is rapidly becoming the consensus view.

In fact the fear of deflation in Europe was, in my view, the principal cause of the plunge in bond yields and equity markets in mid-October. It is also worth noting that there is a growing divide between the Bundesbank and Mario Draghi as to the need for full-fledged QE, with recent reports suggesting that Draghi is barely on speaking terms with his counterpart at the German central bank.

As you may recall I was very negative on Europe in 2010-2012 and became more positive in late 2012. Today, I would have to admit that the omens are not looking good and things are more likely to get worse before they get better.

But I don't want Europe to be the main focus of this report as there are exciting times ahead for investors in Asia.

Some of you may recall that I turned positive on the Japanese stock market in December 2012, due to my expectation that the BOJ would launch a turbo-charged monetary policy. Please see my report, published on 14 December 2012, 'The Rubber Meets the Road.' Through 2013 the Nikkei rose a stunning 57% and hence it is not surprising that it has spent most of 2014 digesting that out-sized gain with an extended period of consolidation. The move last Friday, however, saw the Nikkei make new highs for the current cycle and I now believe we can set our sights on the 2007 highs above 18,000. This equates to a rise of about 10%. In short, the 'technical' picture in Japan looks very promising.

Some of you will no doubt say that the extraordinary actions taken by the BOJ smacks of desperation. And yes, you would be right as they have literally thrown everything at the problem, including the kitchen sink. But when you think that, remember that's what you thought in early 2013.

Also, it is perhaps worth considering what you would do if you faced the interminable challenges that Japan faces today.

In all of my speeches over the last two years I have said that the 'times they are a changing' in Japan and that we would see a mass migration from bonds to equities. The first wave was undoubtedly led by foreign investors, particularly hedge funds, that had the foresight to recognise a massive opportunity when they saw it. This time we could see both foreign and domestic investors returning to the Japanese stock market.

At the start of this year, in various speeches that I gave, I pointed out how many equity benchmarks used by investors were ex-Japan as if the place didn't exist. That might sound a bit simple to the sophisticates amongst you, but perhaps it simply confirms how massively underweight most portfolios are when it comes to having an exposure to Japan.

All of this clearly supports the story I have been telling this year, and hence, of course, why I am repeating it here, that 2014 will be a year of volatility in the west and opportunity in the east.

I know the majority of you just cannot accept the notion that Asia could somehow be some kind of safe haven as the western prism through which you view the world has 'hard-wired' you to reject such a preposterous proposition.

This is not to say I am negative on the US. Far from it as I have been more positive than most. It is just that the fashionable and consensus trade has been to be overweight the western developed markets. Let's be frank for a moment. Do you think France is a better bet than my preferred markets in Asia?

I must say I find it particularly ironic that commentators increasingly speak of the 'Japanification' of Europe, at a time when Mario Draghi would love to be 'Japanified.'

And on that note I will be backing the Japanese horse, Admire Rakti, in the Melbourne Cup with a bit on Mutual Regard too.

All the very best,

Jonathan Pain