



Sayonara Deflation, Konnichiwa Yen Carry-Trade

November 2012



M W G A V E K A L

For the past five years, the only opportunity in Japan has been bottom-up



Environment

- Export driven economy with double earnings gearing due to yen/risk relationship
- Low productivity economy with many companies persisting on thin margins
- Malinvestments rising after 15 years of low interest rates
- New and volatile demand sources from Chinese industrialization
- Unprecedented demographic situation
- Political power shift
- Government debt levels make maintenance of status quo unlikely

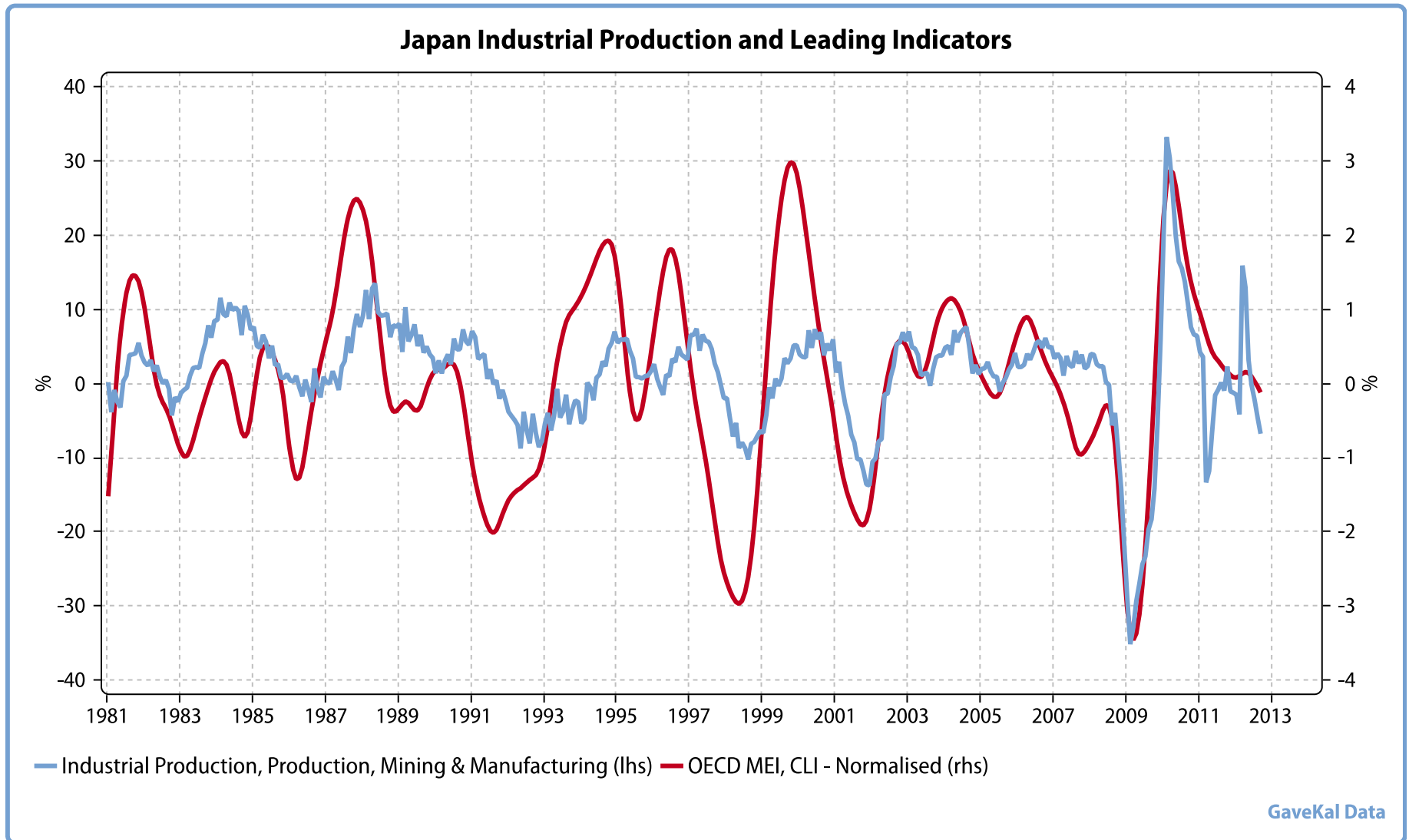
Result

- Corporate changes accelerating as companies face widening gaps in competitiveness
 - Intrinsic value diverging from stock prices in both directions
 - Retirement of lifetime employment era workers increases strategic options for management
 - Higher levels of intra-sector stock dispersion
- Recapitalizations needs persist

Opportunity

- Many assets need repricing
- Material room for differentiation and stock selection
- Winners/losers market
- Deals & corporate action creates both investment and trading opportunities
- Volatility creates opportunities to trade around investment positions

But things are now on the moves - the first wake-up call is that Japan is going into recession yet again



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The second wake-up call is that China is becoming more assertive around the region – so the “slow decline” route may not be an option for Japan?



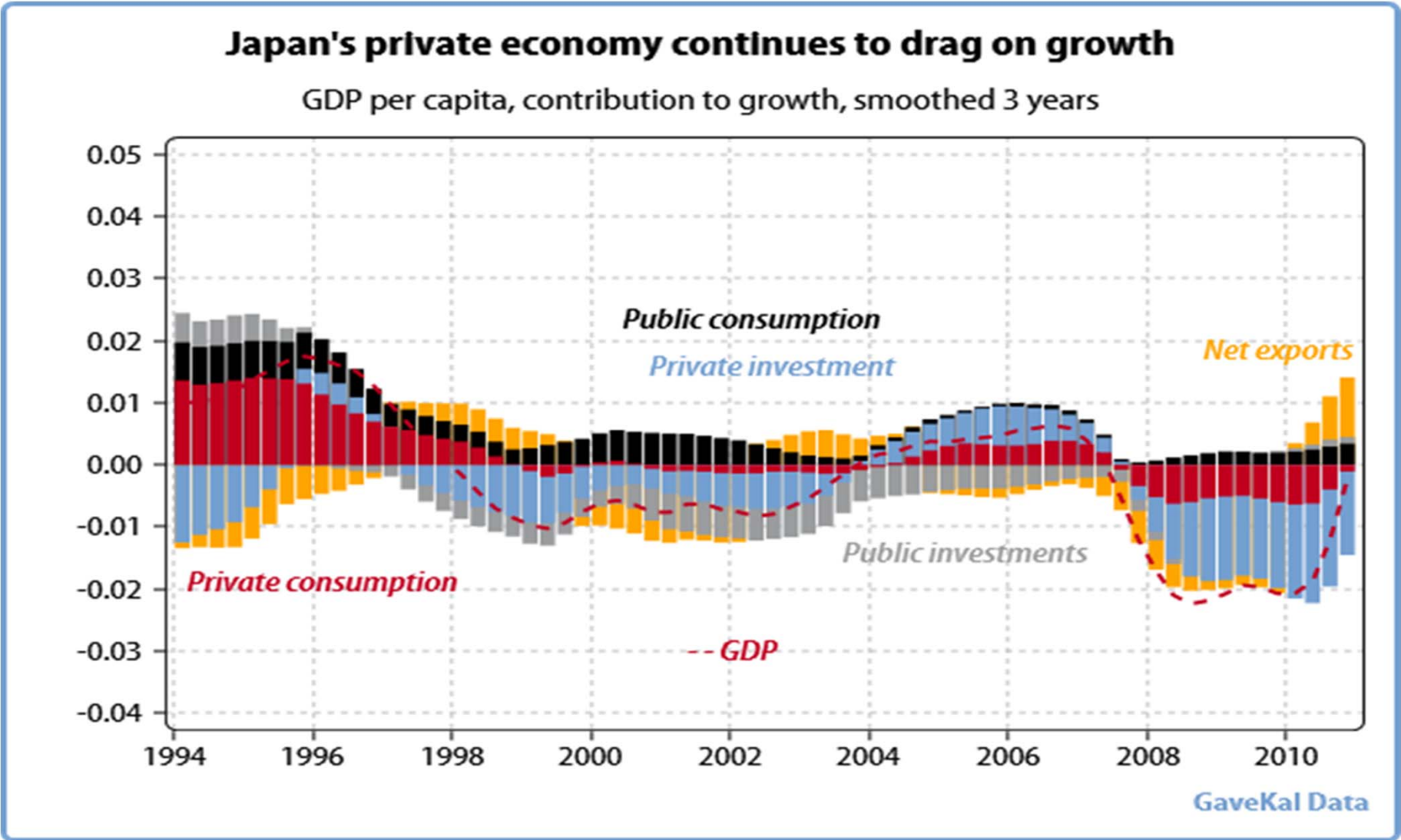
The recent tensions with China further bring another problem as China is around a fifth of Japan's total exports

Japanese Exports to China Relative to Total Exports



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With most of Japanese growth coming from exports, the tensions with China are more than a little problematic

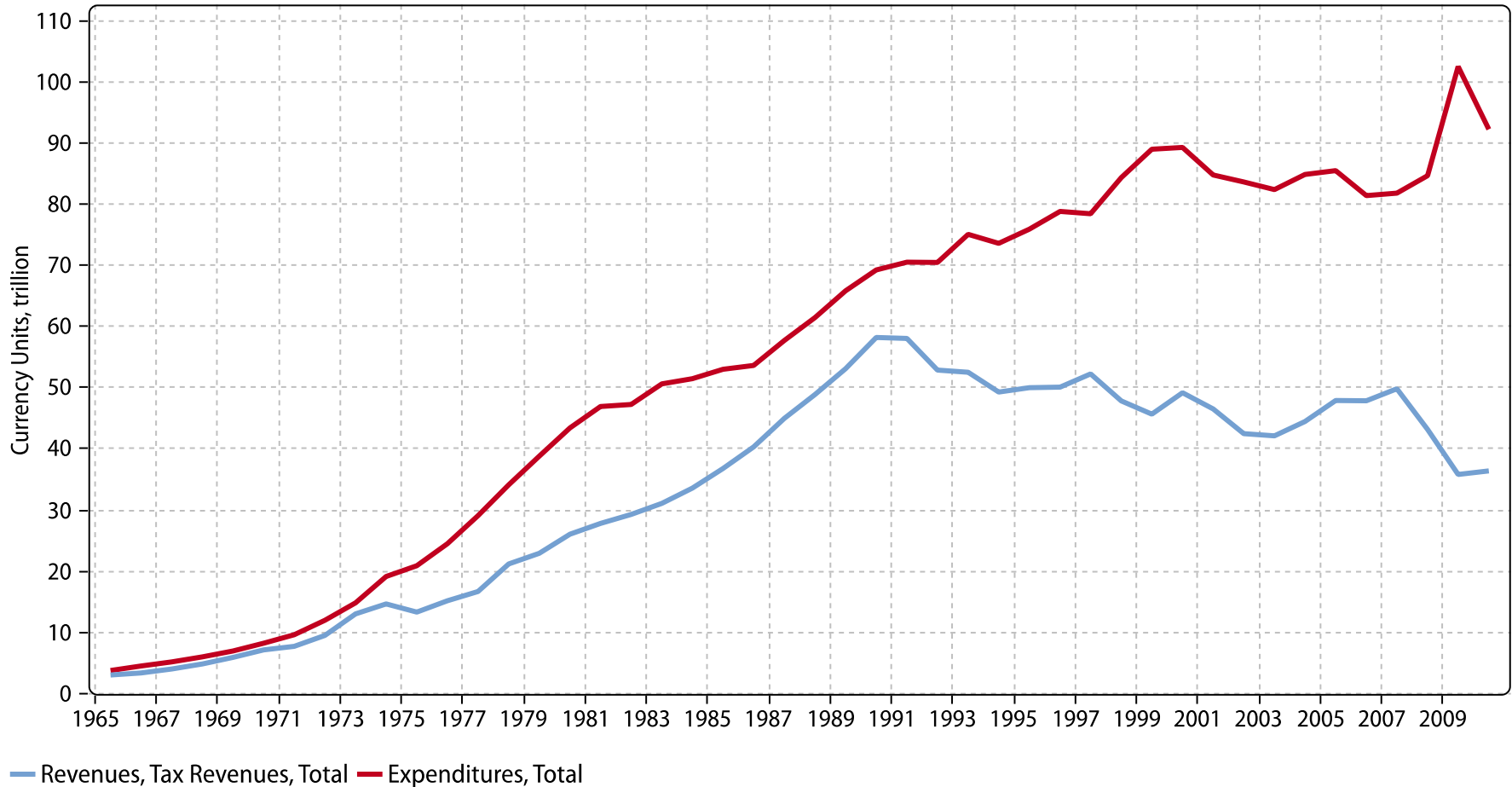


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The first proposed solution: increase government spending by Y200tr over a decade – that's up to 4% of GDP per annum after the Dec 16th LDP victory



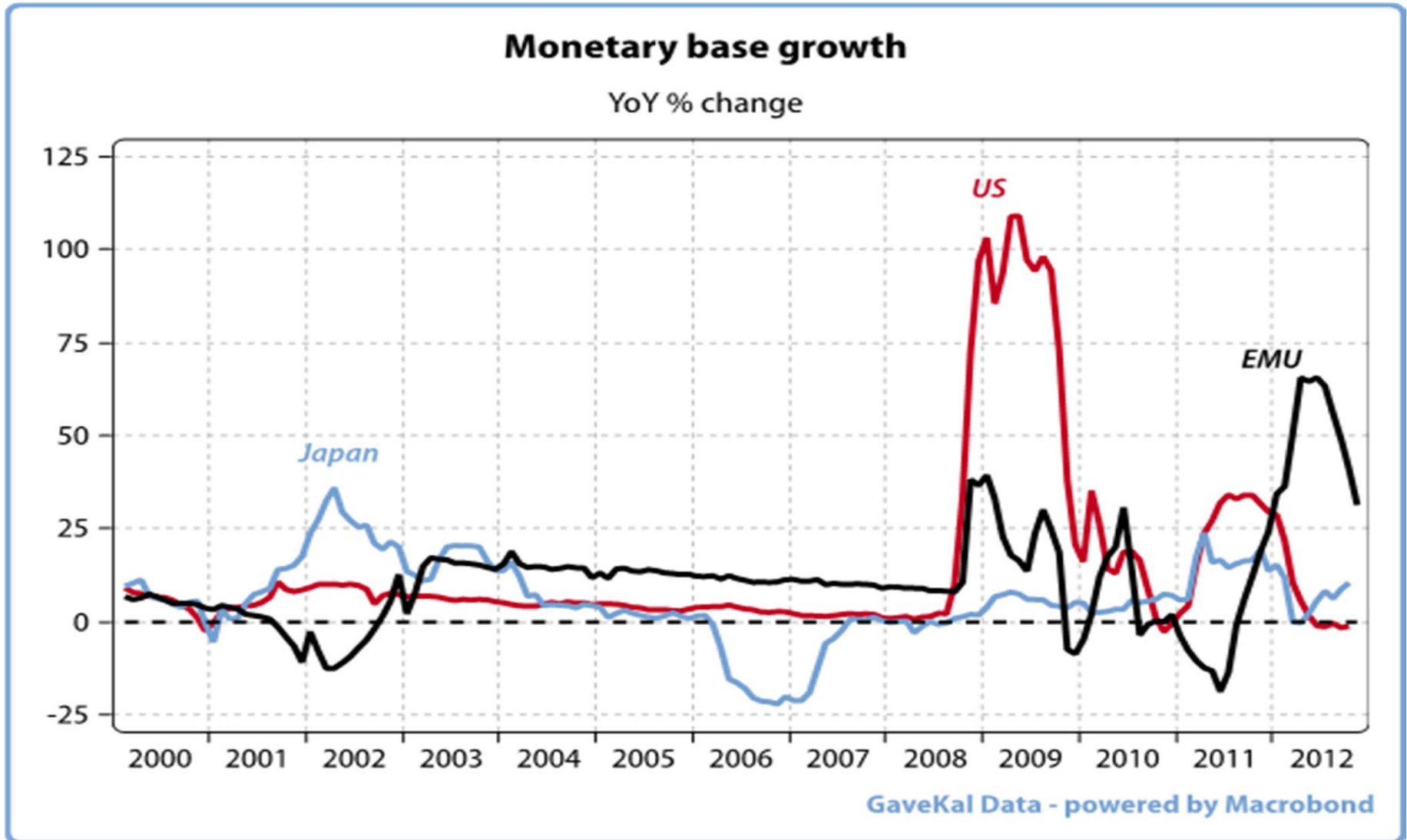
Japan, General Government Budget, JPY



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The second opportunity: use the retirement of Shirakawa from the BoJ to place a dove (Katsu?) at the helm

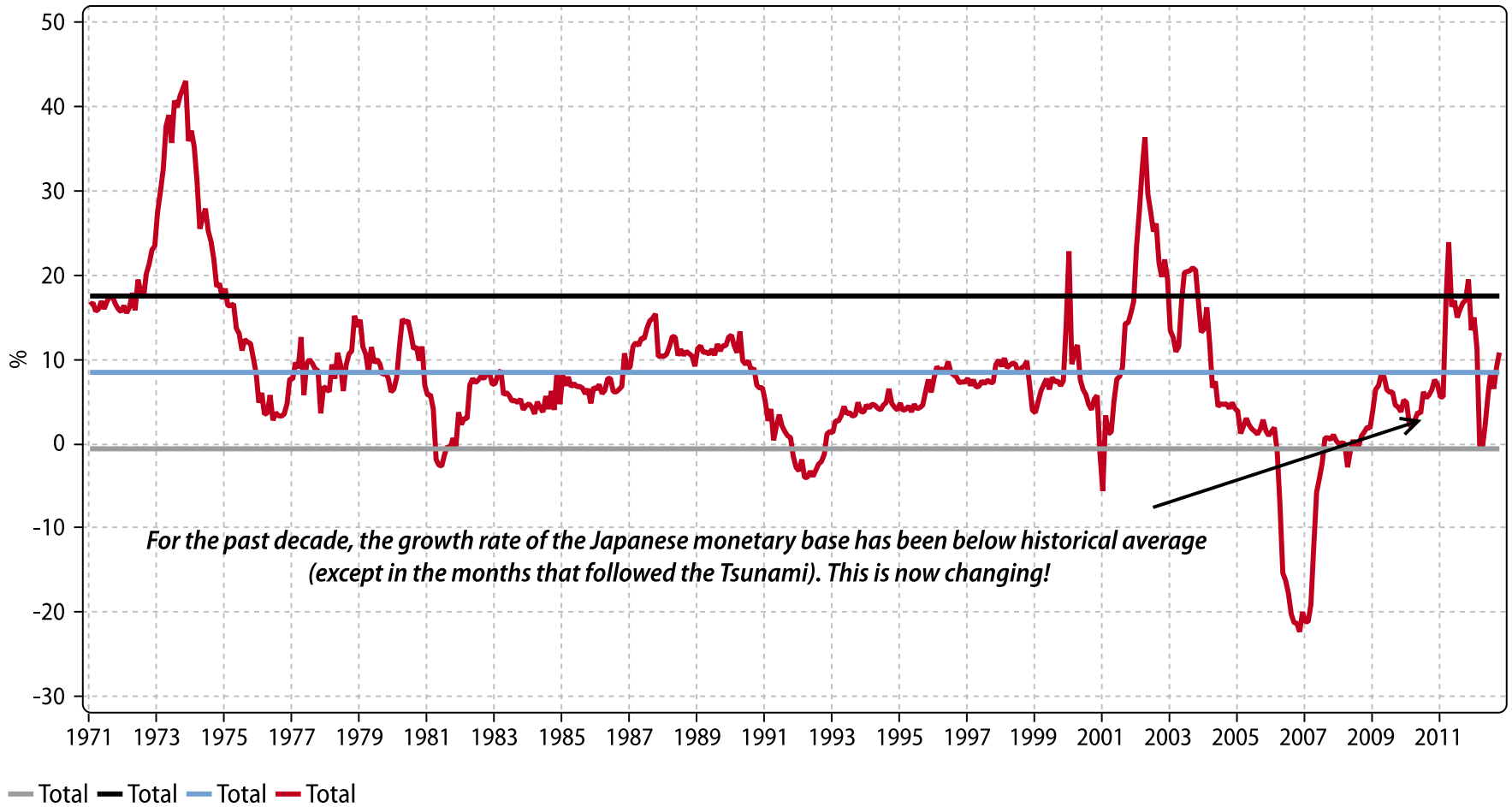


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Zero-ing in on the Japanese monetary base



Japan, Monetary Aggregates, Monetary Base, JPY



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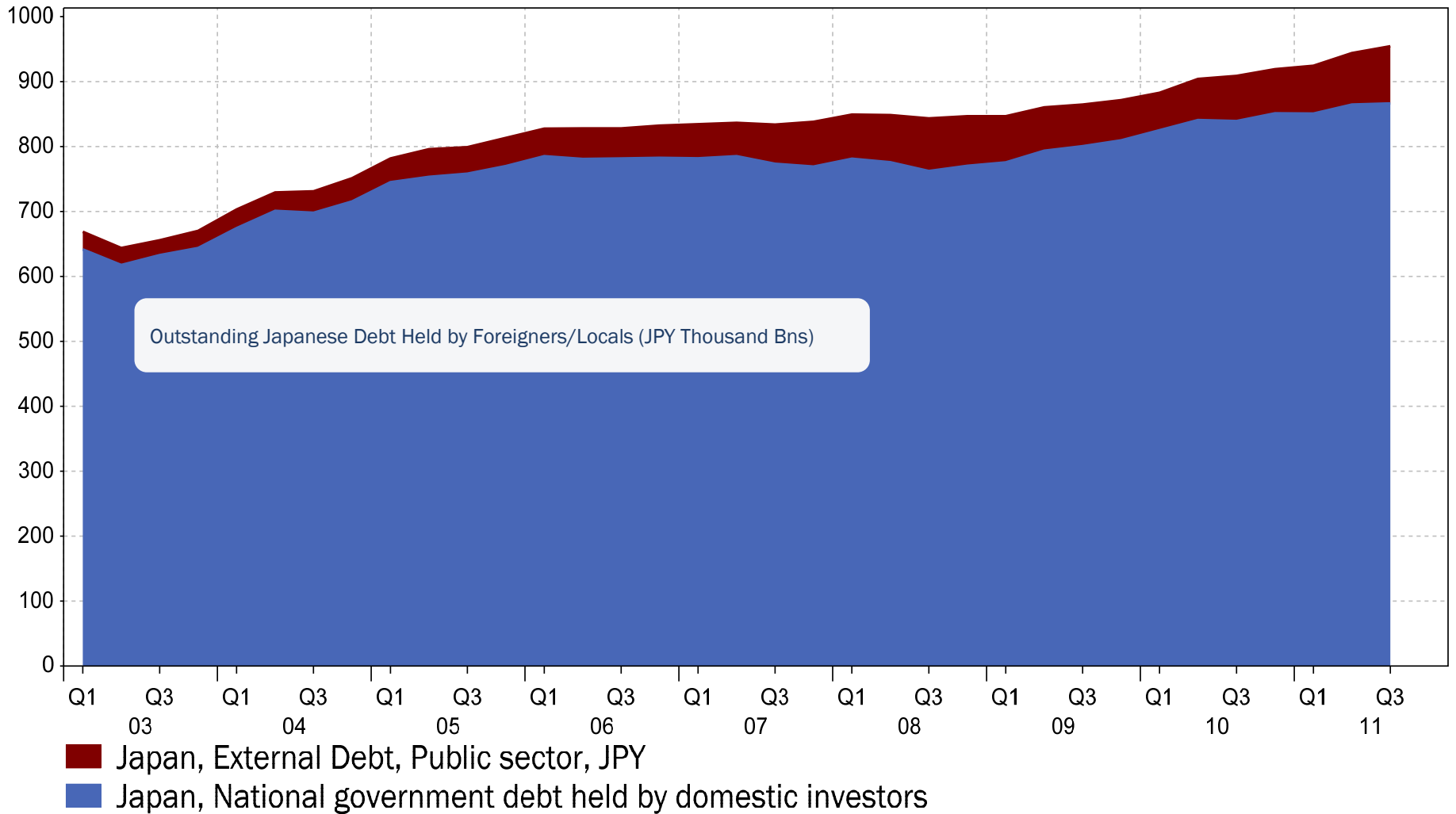
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Obviously, Japan has options that GIPSI countries do not have



	Greece	Japan
Debt to GDP	High	High
Demographics	Poor	Very Poor
Exchange Rate System	Fixed	Variable
Budget Deficit	Negative	Negative
Ability to Raise Taxes	Non-Existent	Very High
Current Account	Negative	Positive
Inflation	Positive	Negative
Private Sector Capital Flight	Yes	No
Financing of Debt	Foreigners	Locals
Private Sector External Assets	Debtor Country	Creditor Country
Central Bank Reserves	Non-Existent	Very High

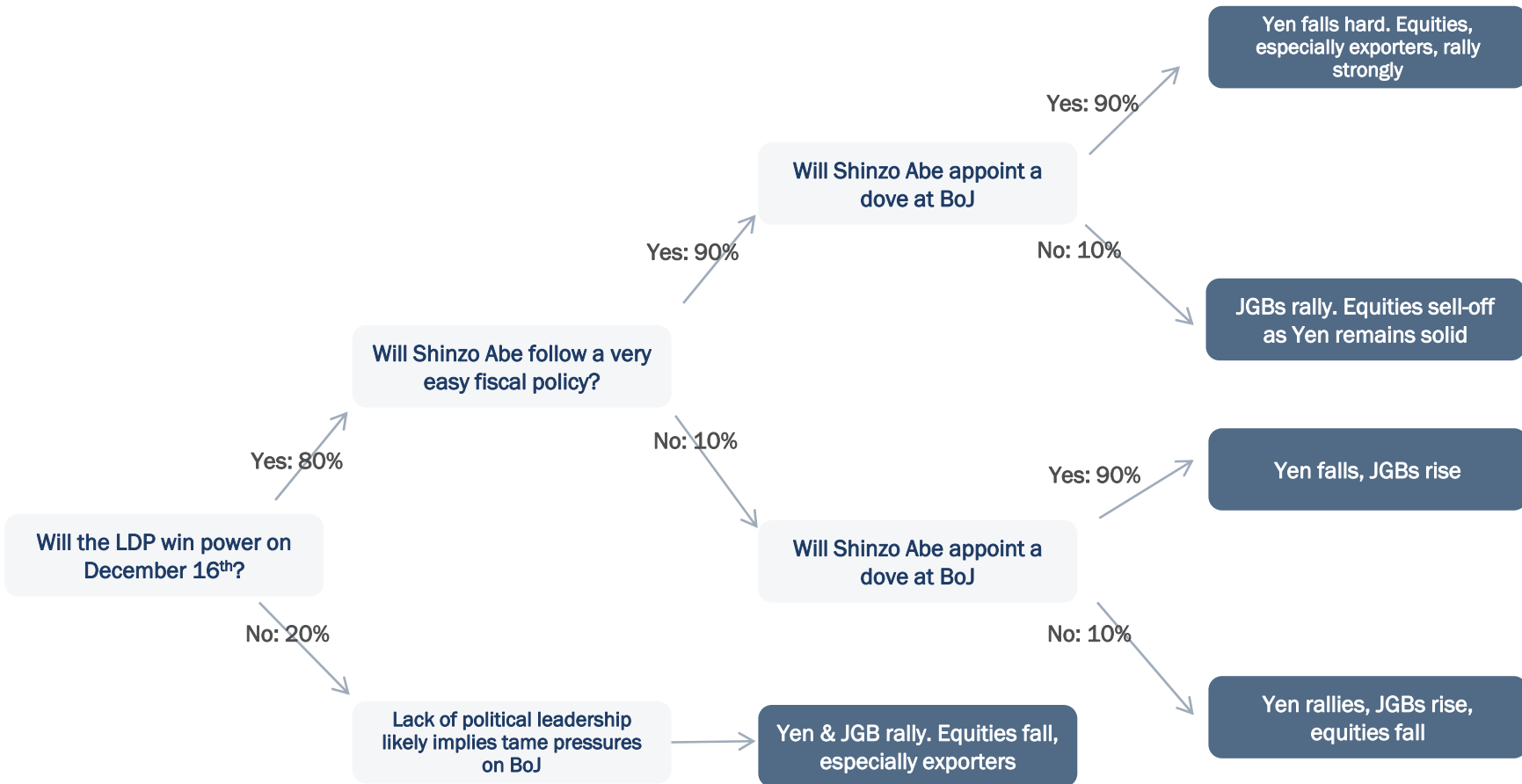
Most of the debt is still domestically owned



Reuters EcoWin

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Japan's policy decision tree



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How will the policy changes impact the Yen?



Japan, FX Indices, BIS, Nominal Effective Exchange Rate Index, Broad



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Japan Macro Opportunity – Shorting the Yen



Shorting the Yen – Is it Time?

- Over the past five years, the Yen has been the strongest of the G7 currencies. As a result, the currency is now more than one standard deviation overvalued against most of Japan's largest trade competitors (Korea, China and Taiwan at the low end, Germany, Sweden and the US at the high end).
- This overvaluation, combined with the terrible 2011 earthquake/tsunami, has pushed Japan into running a full-year trade deficit for the first time in 35 years. Moreover, on current trends, Japan will be running a current account deficit by 2014 at which point Japan will be dependent on foreign savings if the current equilibrium is to be maintained. Given how foreign savings have fared in Japan, this seems like an unlikely scenario.
- Of course, one of the reasons for the Yen's strength in recent years has been constant capital repatriation by Japanese financial institutions and private savers. But the difference response in the FX market to the 2011 earthquake from the 1994 earthquake perhaps highlights that the ability/willingness of Japanese savers to repatriate capital is wearing thinner? So what could be the potential catalysts for a weaker Yen:
 1. The most obvious catalyst would be a widening of interest rate spreads between Japan and the rest of the world, for this would likely invite Japanese private savers to once again export capital, rather than repatriate.
 2. Another potential catalyst would be a further deterioration in the trade balance, most likely through rising energy costs.
 3. A third potential catalyst is the growing pressure China is placing on its neighbours to settle its trade in RMB and use the dim sum HK RMB offshore bond market to accumulate RMB reserves. Indeed, in recent years, Asian central banks have been large buyers of Yen. But regional central banks may decide to switch more of their assets into RMB from Yen over the coming quarters.
- There are two main ways to profit from a likely Yen weakness environment: options and the spot market. Given our level of conviction, we are more inclined to play the coming weakness through the spot market rather than the options market.

How will a change in policy affect relative asset classes?



Japan Bond Yield & Dividend Yield



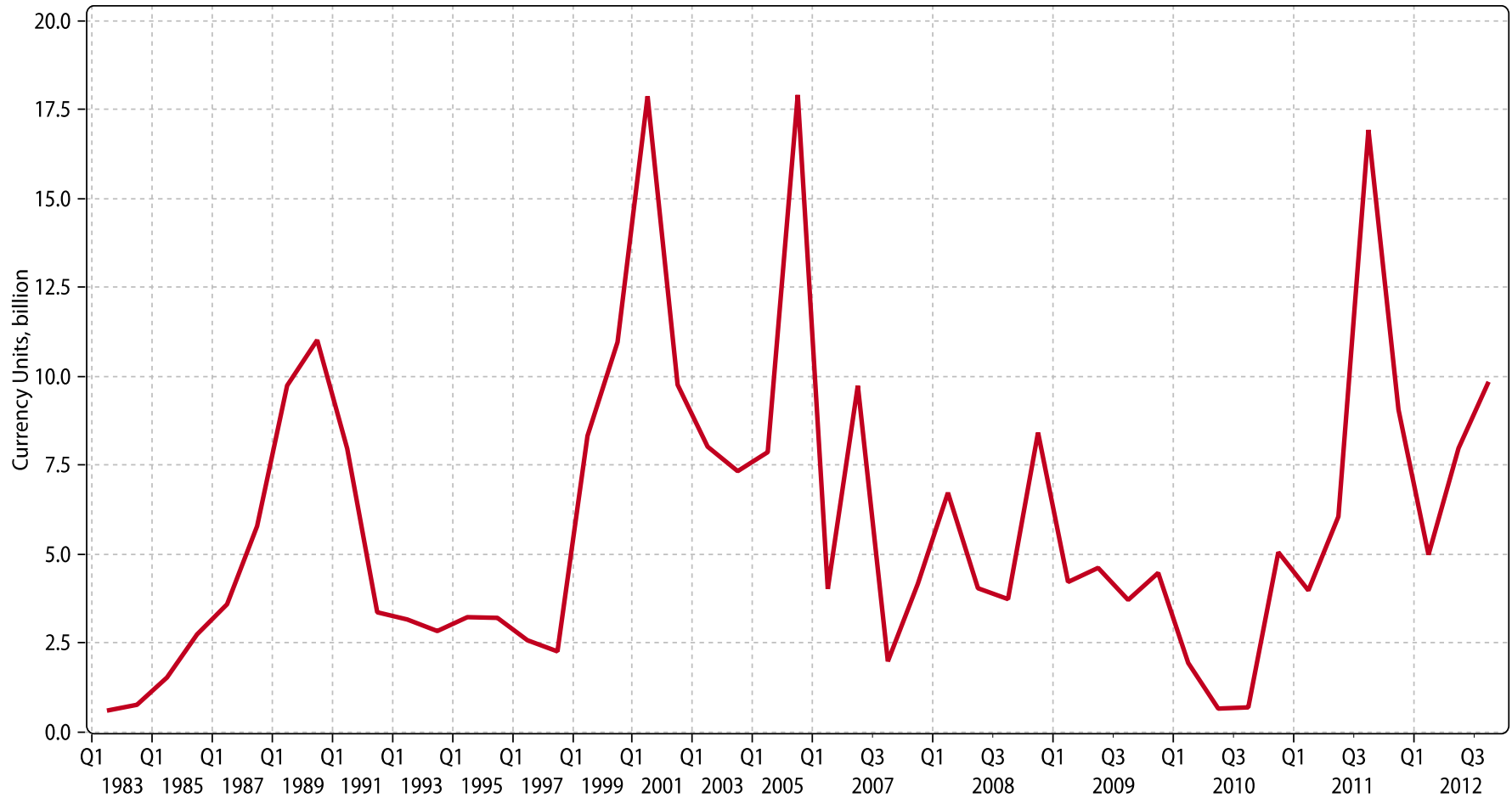
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If the yen starts to weaken structurally, will Japanese private savers once again export capital? If so, where?



Japan, Foreign Direct Investment, By Region, Outward, World, EU, USD



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Contact



Marshall Wace GaveKal Asia Limited

23/F LHT Tower
31 Queen's Road
Central
Hong Kong

Website: www.mwam.com

For non-US enquires please contact:

Telephone: +44 (0)20 7316 2280

Facsimile: +44 (0)20 7316 2281

Email: ir@mwam.com

For US enquires please contact:

Telephone: +1 203 625 3200

Facsimile: +1 203 625 3299

Email: ir-us@mwam.com



Speakers' Biographies



RODERICK REHNBORG

Fund Manager

Rod joined Marshall Wace in October 2007 to develop the firm's manager-led strategies and build its presence in Asia and consequently in July 2008, was appointed the product manager of the MW GaveKal Japan strategy. Rod was made a partner of Marshall Wace in December 2011.

Previously, Rod had been the portfolio manager of the Rosehill Saisei Fund from March 2004 to August 2007, a long/short fund of AUM US\$160m focused on delivering risk-adjusted returns from undervalued Japanese companies. Before this, for 6 years Rod headed fundamental research at Rosehill Capital Management, a fund management company specialized in Japan long/short.

Rod studied History at U.C. Berkeley and has an MBA from UCLA.

LOUIS-VINCENT GAVE

Fund Manager

As CEO of Marshall Wace GaveKal Asia, Louis oversees development of this initiative and reports into both GaveKal and the Marshall Wace Partnership Committee. Louis co-founded independent research firm GaveKal in 1999.

Formerly, he worked for Paribas where he was an equity research analyst (1997-1999).

Louis studied Economics, History and Mandarin at Duke University and Nanjing University.

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