Philequity Corner (April 15, 2013)
By Valentino Sy

Out of the Sandtrap

On an early Wednesday morning (March 13, 2013), Washington Sycip, one of Philequity's directors, called our fund manager, Wilson Sy. Mr. Sycip said that he had just attended a dinner of then-incoming and now Bank of Japan (BOJ) Governor Haruhiko Kuroda at the latter's residence in Makati. Mr. Sycip believed that what Kuroda told him was very important, prompting him to call our fund manager. Kuroda explained that the Japanese economy has been caught in a sandtrap for more than two decades and they could not get out of it. Like a frustrated golfer, they kept trying but failing to pitch the ball out of the sandtrap. However, this time around, Mr. Sycip believes that Kuroda, with his abilities and determination, will get Japan out of this sandtrap.

The Importance of Having Uncle Wash

Washington Sycip is a man with a long-term vision. He can foresee what others do not immediately see. This has allowed him to contribute immensely not only to the Philequity Board but also to the country. At 91 and still active, he is easily one of the wisest persons we know (*Wisdom of Our Sage at 88*, July 6, 2009 and *Happy 90th Birthday, Uncle Wash*, July 21, 2011). Mr. Sycip usually calls or meets our fund managers when he has important news or insights to share. We summarize below some of the important things that Mr. Sycip has shared with us.

1. In one of our board meetings in 2008, before a full-blown financial crisis erupted, Mr. Sycip warned that based on his analysis, a major US bank would probably collapse. Back then, it was unthinkable that the US government would allow a major US bank to fall. In fact, many brushed Mr. Sycip's prediction aside. Yet, Mr. Sycip's prediction came true when Lehman Brothers fell, triggering a global financial crisis.
2. In 2010, when Mr. Noynoy Aquino (PNoy) was elected as President, Mr. Sycip told everyone at the Philequity Board that he was more confident about investing in the Philippines. Putting his money where his mouth is, he added to his personal investment in the Philequity Fund right after PNoy was elected. In less than three years, Mr. Sycip has more than doubled his money.

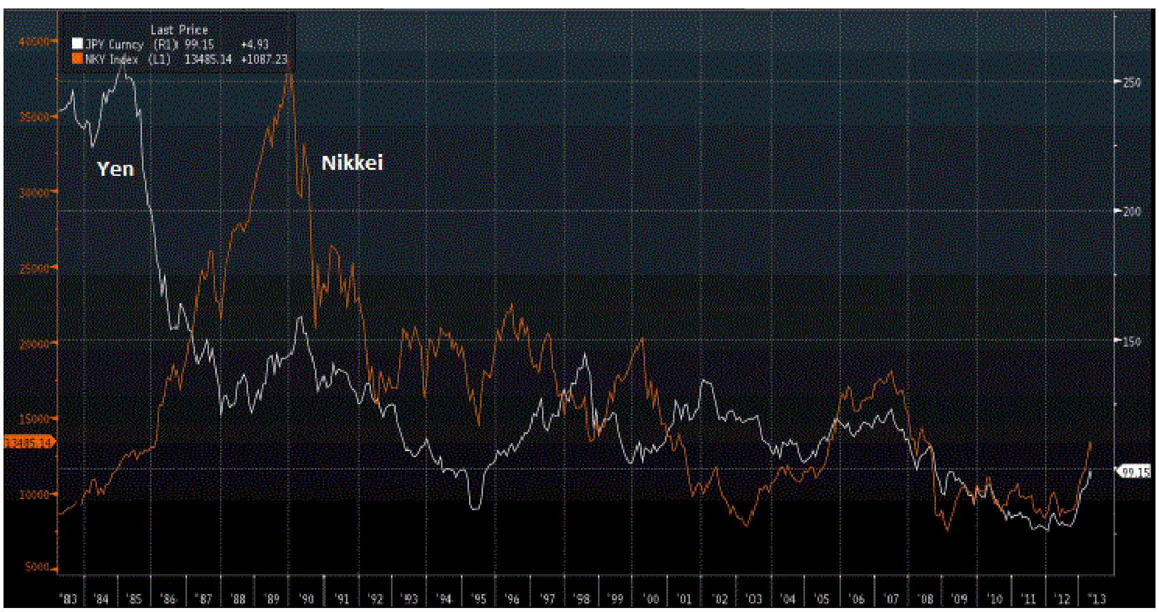
   Mr. Sycip is a visionary. He said that PNoy's honesty and anti-corruption campaign will inspire the country, lead to a better government and result in a more robust economy. Last Friday, the PSE Index again closed at a new all-time high. Moreover, our GDP growth has been very strong and all indicators point to sustained economic growth moving forward.
3. This time around, Mr. Sycip shared with us his thoughts about Japan and his confidence in Kuroda. We share the belief of Mr. Sycip that Kuroda's actions will have far-reaching implications to the global economy and global stock markets, including the Philippines. Since Mr. Sycip's dinner with Kuroda and the phone call that he made to our fund manager, the Nikkei has surged 9.5% and the yen has depreciated by 2.4%.

The Sandtrap

After experiencing strong economic growth in the 1980s, Japan's economy tanked and stagnated for the next two decades. This abrupt reversal of economic trend was triggered by a financial crisis caused by the bursting of asset price bubbles in Japanese stocks, bonds and property. And while the whole world has been experiencing economic growth, Japan has never fully recovered from the debilitating blow that it was dealt. Instead of sparking a recovery, a series of policy mistakes and lack of structural reforms brought about a prolonged period of subpar economic growth, persistent deflation and a downward spiral in its stock market. The term "lost decades" is used to describe this period.

The Overly Strong Yen and the 23-Year Nikkei Bear Market

One important factor that contributed to the weakening of the Japanese economy was a persistently strong yen. At one point in time, when the Japanese economy was still doing very well, the yen traded at 250 to the dollar. The Plaza Accord of 1985 changed this when it called for the devaluation of the US dollar against major global currencies. One of the effects of the Plaza Accord was the sharp appreciation of the yen. At first, the yen's appreciation positively contributed to Japan's economy and its stock market. However, the continued strengthening of the yen eventually caused more harm than good. The overly strong yen greatly contributed to the weakness of Japan's export sector. This was particularly damaging because Japan is an export-driven economy. It was this economic damage that eventually precipitated a 23-year secular bear market of the Nikkei. In the chart below, we show how the Japanese yen and the Nikkei have moved since the 1980s.



Source: Bloomberg

Our country should learn from the example of Japan. Like what happened to Japan in the mid-1980s, the stronger peso has so far been positive for the Philippine economy and the local stock market. However, if the peso strengthens too much and too quickly, it might start doing more harm than good.

Bold and Brave

Following the unprecedented policy moves of Fed Chairman Ben Bernanke and ECB President Mario Draghi (*The Great Global Monetary Easing*, October 22, 2012), Kuroda promises that Japan will do its part to revive its economy. In the latest BOJ meeting last April 3-4, 2013, Kuroda said that the BOJ will engage in bold quantitative easing that will double the monetary base by end-2014, increase purchases of Japanese government bonds to Y7.5T per month and increase purchases of Japanese Exchange Traded Funds (ETFs) and Real Estate Investment Trusts (REITs). Kuroda said that these measures are aimed at attaining their inflation target of 2% within two years.

Many say that Japan's inflation target will be hard to attain even with the BOJ's bold moves. However, the immediate impact would be a stronger Japanese stock market and a significantly weaker yen. Note that the Nikkei has surged 60% since mid-November 2012. Moreover, the yen has significantly weakened vs. the US dollar from 80 in mid-November 2012 to 98.37 last week. While it is still uncertain if Japan's impending quantitative easing will indeed work, we believe that Kuroda's determined efforts will give them a very good chance of reviving Japan's zombie economy. It will certainly be better than not doing anything or doing something half-heartedly.

Good for Japan, Good for the Philippines

Most global investors already know what Japanese Prime Minister Shinzo Abe, Kuroda and the BOJ will do as they have made repeated public announcements about their plans. However, Kuroda's face-to-face conversation with Mr. Sycip – a conversation that showed Kuroda's dedication, determination and conviction – has made us believers. Moreover, Mr. Sycip's confidence in Kuroda and the analogy of the sandtrap has led us to conclude that Kuroda's actions will ultimately have positive implications for our own country. We enumerate some of these below.

1. If Kuroda implements what he said he would do, then the Japanese stock market will continue going up. If the Nikkei continues to move up, positive contagion will come into play as the Japanese stock market lifts other global stock markets higher (*10 Keywords*, March 18, 2013). This will ultimately benefit Asian stock markets such as ours.
2. The BOJ's massive monetary policy easing will cause the Japanese yen to continue depreciating. This will contribute to the strengthening of the US dollar, thereby providing a respite to the peso's strengthening. This may even be an important factor that can reverse the peso's appreciation (*Win-Win for the Peso*, April 8, 2013).
3. If the yen continues to depreciate and Japanese bond yields continue to remain low, Japanese investors may have to invest outside their home country. This will drive down yields of bonds all over the world and lift stock markets globally (*Global Bull Market*, January 7, 2013).

We fervently hope that Japan gets out of its 20+ year sandtrap. It is important to note that Japan has consistently been one of our country's major trade partners, both in terms of imports and exports. Any improvement in the Japanese economy will therefore redound to our economy. And if the Japanese economy starts getting better, we will be a possible destination of Japanese investments considering our stable currency, skilled labor force, strong economic growth and improving fundamentals. We foresee that this will not only lead to increased portfolio investments in Philippine stocks and bonds but also to increased foreign direct investments.

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