LINDSELL TRAIN

December 2010

Observations From Japan

Following a recent visit to Japan, I provide below some observations that may hold lessons, or indeed implications, for the economies and markets in the West, particularly in respect of the banking sector.

Low Interest Rates and Quantitative Easing

Now that the US and UK are both employing quantitative easing (QE) as the main tool of monetary policy it is worth reflecting on how similar policies have fared in Japan since they were first introduced.

Low interest rates have been a tool of monetary policy since 1997 in Japan, with QE introduced in 2001 and continuing today. It is difficult to avoid the conclusion that neither policy has worked. Some 13 years on, there is no sustainable recovery in economic growth - indeed nominal GDP is 6.6% lower than it was in December 1997. Worse, pursuing such an experimental policy for an extended period of time has had some unintended and unhelpful side effects.

Low interest rates have cut interest bills for highly indebted companies, allowing these businesses to survive without restructuring. They continue to supply goods and services to the market, helping to intensify deflation and lower profits margins and productivity for healthy companies. Thus, low rates have preserved employment but at a cost to the most productive part of industry, because of the deferral of necessary downsizing.

The over 60's age group represents c.40% of Japan's population but owns c.80% of Japan's net household financial assets. Negligible interest rates have reduced interest income to such an extent that it is no longer sufficient to match interest payments on liabilities elsewhere in the economy, despite interest bearing assets exceeding liabilities by 2.8x. It is no surprise therefore that this important cohort of the population is so reluctant to consume.

Lower interest rates may allow a government to issue much more debt than normal in order to support demand in the short term. Nowhere is this better illustrated than in Japan, where through fiscal spending general government net interest bearing liabilities increased seven fold from 1991 to 2008, from 18% of GDP to 130%, while net interest payments have actually fallen. This has promoted huge fiscal indiscipline, which is a mounting problem as yet unaddressed by politicians and markets alike.

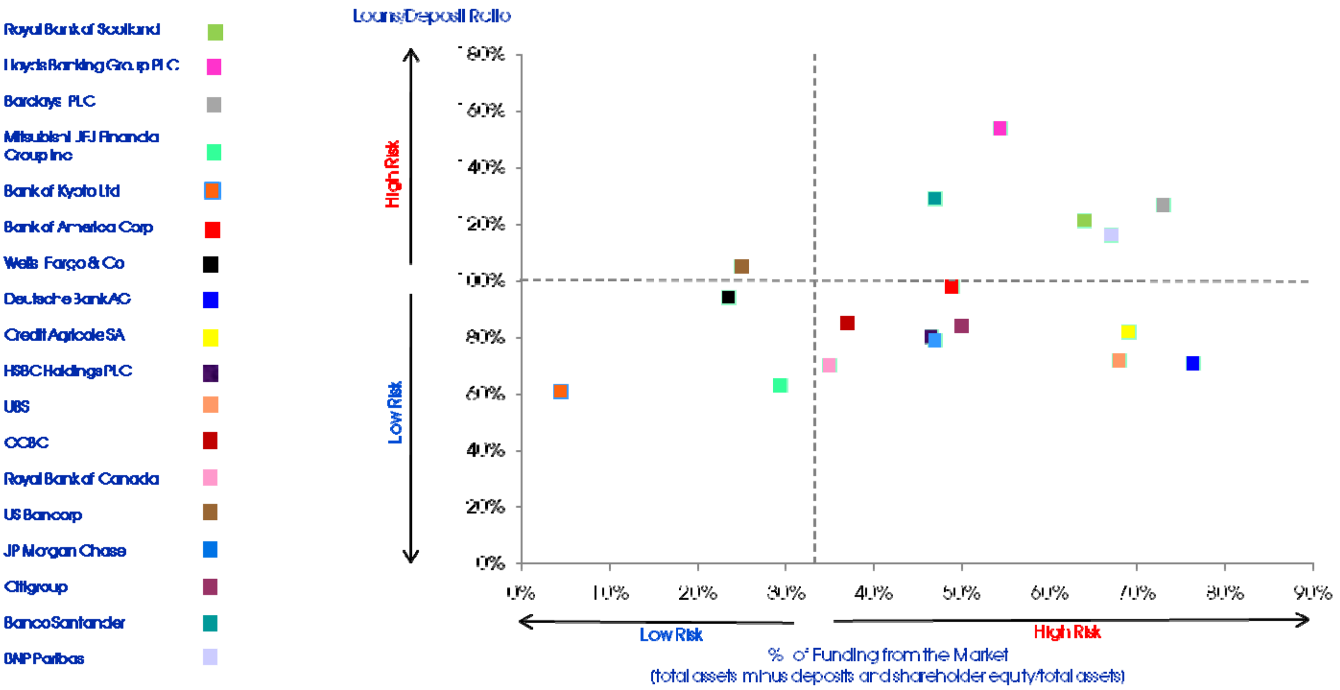
The initial effect of QE was to re-liquefy the banking system by depressing short-term rates and widening the spreads on lending. But soon after, long-term rates declined as much, if not more, which ultimately threatened the reverse, a narrowing of spreads. With spreads under pressure, banks become even more risk averse, choosing to invest in risk-free government bonds rather than extending commercial loans (that come with considerable default risk, especially while the economy is so weak). Worse, increased regulatory capital requirements introduced in response to banking crises constrain risk further, creating a vicious cycle. Now in Japan, the current levels of long-term interest rates (0.8% at 10 years, 0.2% at 5 years) are so low that, arguably, interest income alone is not enough to cover the annual costs of running a bank. Banks can hide from this perilous reality by boosting fee income, trading and relying on capital gains from longer maturities in the short term. But unless interest rates rise and spreads expand this only postpones the inevitable reality of losses and with it an intensification of the vicious cycle.

What is clear is that although low interest rates might have succeeded in bailing out the banking sector in the short term, they have not proved to be the hoped-for panacea for the economy. Any temporary relief has had its own costs and unintended effects over the long term and ultimately the problems low rates were designed to alleviate remain present and unaddressed. Maybe the scale of the problems facing Japan in the early 1990's made such a long drawn out resolution inevitable. Addressing structural problems quickly and rationally would not have been politically feasible in Japan in the early 1990's, just as it is proving hard in the Western world today. The question is: when will it become politically acceptable to face up to the issues? Of course, no-one can be sure but in Japan we might be nearer the point of finding out if the banking sector starts to suffer operating losses.

Risk in the Banking Sector

Looking at loan to deposit ratios together with the difference between total assets of banks and their deposits and shareholder equity (which, expressed as a percentage of total assets, represents the extent to which each bank is reliant on market-based funding) for a number of banks globally highlights some important differences. We have plotted these in the scatter graph below. Each plot illustrates the loan deposit ratio and the percentage each individual bank funds from the market. We have then split it into quadrants to illustrate more clearly each bank's "risk" based on these measures. We assume that a bank with a loan deposit ratio below 100% and a market funding ratio below 33% is most conservative and one with a loan deposit ratio above 100% and a market funding ratio above 33% most risky.

Funding Risk In Banks – June 2010



Source: Lindsell Train Limited and Bloomberg. All data as at June 2010 (BNP Paribas data as at December 2009)

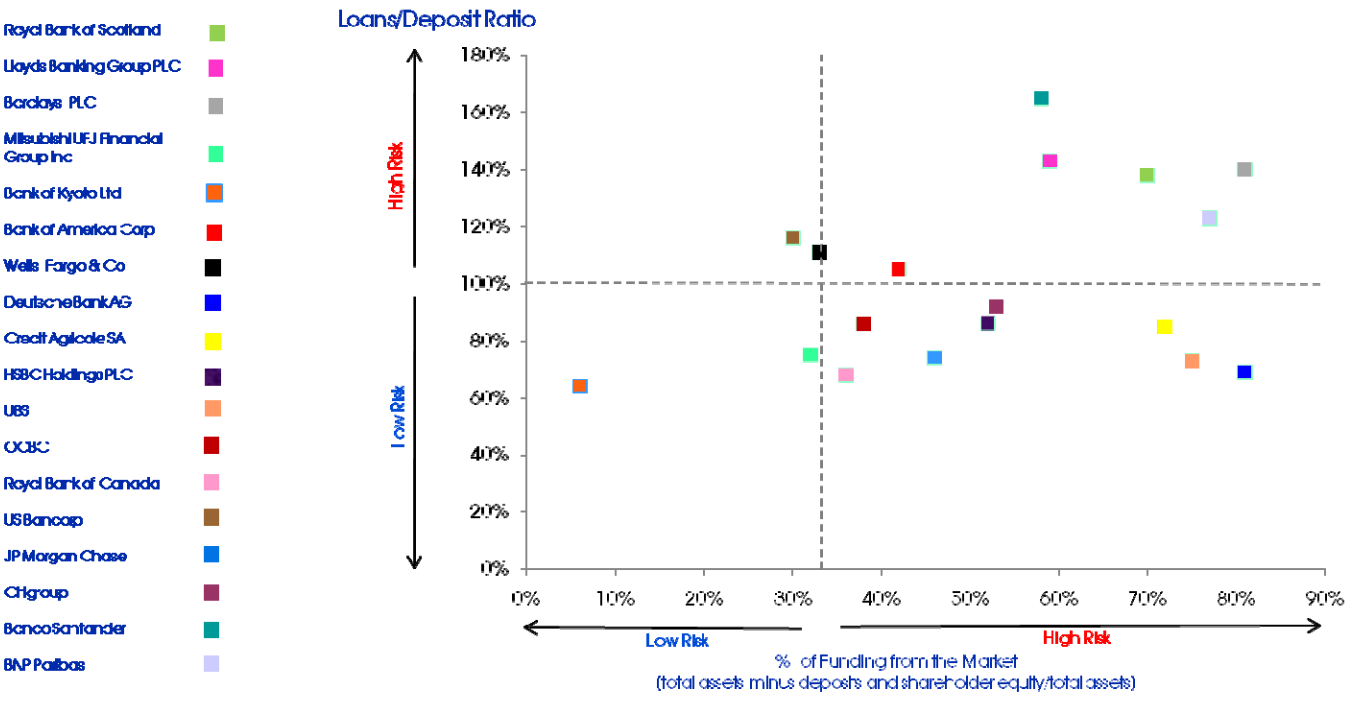
First it is interesting how conservative some Japanese regional banks rank on this assessment. The Bank of Kyoto (the only one in this sample but illustrative of the regional group) is almost totally funded by its own capital and its deposits and yet it retains substantial capacity to boost its lending as its loan deposit ratio is just 60%. Although Japanese bank loans are contracting overall, regional bank lending is growing as local governments make up tax revenue shortfalls by borrowing directly from banks. Despite this, lending growth is still less than deposit growth which forces banks to invest additionally in government bonds. The combination of falling yields from regular loans and rock bottom yields on government bonds hardly generates enough interest income to cover the cost of deposits and the operating costs of the bank as intimated above and thus gives the bank precious little cushion in the event of declining loan quality. Regional banks desperately need higher spreads or higher loan deposit ratios. If regional banks have a growth problem at least they are amply funded. Japanese mega-banks (the example here is Mitsubishi UFJ Financial Group ('MUFG')) share the regional banks' growth problems but for them profitability is even more of an issue. Loans are currently contracting at a rate of 5%, forcing more investments into low yielding government bonds. MUFG is also somewhat more dependent on market funding (29%). It is interesting that Wells Fargo is the only other bank that ranks conservatively, with a loan deposit ratio below 100% and market funding making up only 23% of the balance sheet. It may have lingering asset quality problems but it is far better positioned from a risk perspective than most other international banks. Maybe this is why Berkshire Hathaway holds a big position in it - as well as US Bancorp, whose loan to deposit ratio only just tips over 100%.

The British banks, Lloyds, Barclays and RBS occupy the opposite, most risky, quadrant. Here not only do loans exceed deposits, by a huge margin in the case of Lloyds, but also the banks are largely dependent on market-based funding, even after the scare of 2008 and the subsequent recapitalisations. These banks are just as vulnerable to the funding problems they faced then reappearing again. And the structure of their balance sheets is much the same as then other than their absolute size, which in the case of Barclays and RBS has contracted from December 2008 by 24% and 33% respectively. Despite this shrinkage, Barclays and RBS still have larger balance sheets than the US and Japanese banks, even though the domestic deposits of the UK are dwarfed by the size of those in the US and Japan. The European banks, Banco Santander and BNP Paribas, also occupy the same quadrant. BNP Paribas is particularly reliant on market funding.

Most of the sample congregates in the quadrant where loan/deposit ratios are below 100% but there is an over-reliance on market-based funding. This is particularly so for Credit Agricole, UBS and Deutsche Bank. The latter two also maintain balance sheets of an equivalent size to RBS and Barclays following shrinkage since 2008.

This analysis is of course limited as it says nothing about trends in asset quality and profitability, which may be more important in determining a bank's performance in the shorter term. However, it does reveal how structurally unsound many global banks remain and how much restructuring is needed for risk (on this narrow definition) to fall to more normalised levels. It is perhaps worth comparing a similar scatter graph taking values at the end of 2008. What is notable is how little the situation has improved despite multiple capital increases, central bank assistance and government bailouts. The problem is that the absolute size of some bank balance sheets, especially in the case of the UK and some European banks, which individually represent a material percentage of home country national income, restrict the potential for restructuring given the depressing effect such a policy would have on GDP growth itself. Perhaps another, very good, reason why any such resolution to these problems will be put off for some time.

Funding Risk in Banks – December 2008



Source: Lindsell Train Limited and Bloomberg. All data as at December 2008

Finally, a word on:

Deflation and Wages

One less widely recognised feature of Japan's two "lost decades" has been the fall in nominal wages. In the Depression in the 1930's in the USA there was a decline in wages of c.30% over a two year period and a similar decline in consumer prices. That was a one-off immediate shock and, together with the precipitous fall in the markets that preceded it, proved to be one of the defining features characterising the Depression. Arguably Japan has been subject to the same effect, only it has been drawn out over a far longer period in time. It has not been as acute but still continues today. Nominal wages in Japan are now down 15% from their peak and are still declining. Consumer prices have fallen as well, down 4% from the peak. The fall in wages is probably understated as this measure of wages only includes enterprises employing more than five people and most wage pressure has been felt by those employed in the smallest companies. An important feature of the last 20 years in Japan has been the boom in temporary employment. Today temporary employees make up 33% of the workforce, up from 20% in 1990, with their average salary only 28% of a permanent worker's basic wage. In others words, over the last 20 years many permanent jobs have been converted into temporary ones and this has provided the main impetus to the declining wages trend since 1997. Interestingly this same trend of growing temporary employment has begun in the USA. Part time workers there now amount to 9.4m - the highest since 1965 and well above the 6.7m peak in the recent past. This is simply a manifestation of the same issue as in Japan – companies are choosing to hire temporary workers (probably on a semi-permanent basis) to cut employment costs. It would not be surprising if this switch to temporary workers contributes to a decline in wage levels in the USA, although it is probably the case that US businesses are much more likely to cut permanent wages quicker than was the case in Japan.

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