Is Britain Going the Same Way as Japan?

November 2008

Japan's asset price bubble in the late 1980s was founded on an unprecedented stockmarket and property boom. Asset prices inflated to such an extent that they lost any anchor with incomes. At the peak of the boom, mortgages were granted worth 8-10 times incomes and shares traded on an average dividend yield of just 0.5%. The bust that followed left a mountain of bad debt that resulted in losses at Japanese banks through the 1990's of as much as 25% of 1990 GDP. The legacy of debt crippled the banking sector that is still moribund after 18 years. Even today the vestiges of the bad debt remain on Japanese banks' balance sheets, posing a threat to bank net worth. Although a government sponsored recapitalisation occurred in 1998 and massive provisions followed, the failure to purge the banks of all their bad loans and crucially their volatile equity cross-shareholdings (when share prices fall, capital is depleted creating a negative feedback loop and vice versa) led to an ongoing constraint on credit availability. Bankers learned to hoard precious capital against the prospect of its depletion in economic downturns like today's. Japan's latest downturn has only just begun and MUFG, Japan's largest bank, has already signalled the need for new capital, twenty year after the crisis first erupted.

In response to the weak economy, the threat of deflation and the need to alleviate over-indebted bankers and borrowers alike, the Bank of Japan cut interest rates to almost zero in 1998 where they have remained since. Over time, this policy has had the effect of penalising the household sector, which earned a pitiful return on its prodigious savings, but conversely benefited the economy's debtors (the government and the corporate sector), whose debt service costs remained minimal. This policy has not only depressed consumption but also encouraged massively inefficient government spending. At the same time it supported those corporations with debt financed business models whose continued existence depressed the investment returns of more efficient corporations. Government debt increased from 60% of GDP in 1990 to 180% in 2005, one measure of the direct cost of the bubble to the economy.

Another well known casualty of the bubble was the stockmarket, which after almost 19 years is valued at less than 25% of its peak. Less well recognised is the comparative cost of no growth. Today Japan's nominal GDP is just 5% higher than in 1994 and remains 2% below its peak over 11 years ago, in 1997. In every sense it has been two lost decades; a time of repair and deleveraging. And, what is worse, it is not over yet for Japan because strong exports, the only sector of consistent growth, are now decelerating fast in response to the world-wide slowdown, revealing just how weak domestic demand has been all this time. Profits are collapsing, the equity market is marking new post 1989 lows and banks are once more short of capital. The government may well have to support banks again. Japan needs a transformative policy response, including recapitalisation of the banks and innovative supply side reforms such as deregulation and restructuring to stem the decline. There is no sign of such initiatives as yet but, paradoxically, the worse the environment becomes the more likely change will occur and with it the opportunity for Japan to emerge from the gloom.

The UK's bubble has had much more to do with property than stocks, but unlike Japan two decades ago, the bubble has been exacerbated by excessive investments in securitised products. Having been a close observer of the situation in Japan, it was eerie for me to watch how property values had cast adrift from incomes in exactly the same way and to a similar degree to Japan. Rental yields plummeted as well, to below long-term government bond yields, as amateur 'buy to let' landlords flooded the market with rental property, bought on the assumption of guaranteed capital appreciation. The fall-out from these excesses will be considerable and the prognosis for property prices is severe for some time. It will not be like 1974 or 1991, similarly deflating times for property in the UK, because then inflation was rife, helping to depreciate the real cost of debt financing. Today there is likely to be little or no inflation and thus the nominal decline in prices will be closer to the real decline, much worse than those earlier periods and much more like the experience in Japan in the early 1990s. Property prices in Japan are still down 52% from peak 1991 levels in nominal terms and 51% in real terms. It is unlikely that it will be that bad in the UK - after all, property yields in Japan were lower at the peak - but declines of more than 30% are certainly possible.

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Most worryingly, it is not the excesses of the UK property market that are directly affecting the financial sector right now, those concerns will come later as the economy weakens. It is the bubble in structured finance and derivatives and the now broken banking models relying on wholesale funding. The fall in value of securitised products has depleted bank capital, making it necessary for governments to provide support. The problem is that the complicated structure of these products, and their lack of transparency make them difficult (if not impossible) to value and the need to reduce reliance on wholesale funding leads to asset disposals that at the margin act to further depress asset prices, including securitised products. Even if the recent capital injections from governments are adequate today to shore up bank capital, banks face a moving target both from the changing value of securitised products and the threat from a tsunami of real economy related provisions, making them most reluctant to countenance any new lending. Thus, like Japan, the UK's banking problems may only be partially addressed and as a result the risk must be that credit availability will remain constrained until bankers have total confidence that what precious capital remains will not be depleted by future losses.

Now that commodity prices have fallen and there are obvious signs that the UK economy is weakening fast, interest rates are likely to be cut aggressively. It is unclear if such cuts will be passed onto businesses and consumers as very few borrowers are able to access government controlled rates. Most consumers and businesses are required to pay substantial premiums over government controlled rates to account for the implicit risk of default. However, when short rates fall decisively beneath long-term bond yields, banks will be tempted to invest in longer-term government bonds financed by borrowing from the government in the short-term money markets and should thus provide the fuel for a substantial bull market in long-term government debt. Again this was similar to Japan's experience, when bond yields fell from 5% to 1% from mid 1993 to 1997, despite massive issuance of government debt. At the moment the long end of the UK gilt market is restrained by a combination of fears of excessive supply, the legacy of last year's inflation and poor historic value. Soon, we think, collapsing inflationary expectations and lower short-term rates could spark off a significant rally - as it did in Japan. It is conceivable bond yields could approach levels below 3%, last seen after the Second World War.

The UK government's latest initiative to spend its way out of recession is unnervingly like the public works spending binge in Japan in the 1990's. We doubt it will work other than in the very short term because, as in Japan, the higher the debt to GDP ratio the lower the contribution a unit of debt makes to supporting economic activity. Between 1990 and 2005 Japanese government debt expanded from Y360 trillion to Y900 trillion for an increase of just Y100 trillion of GDP. Now the UK is expanding debt to support the financial sector a similar expansion of debt here seems most probable in the years ahead.

One difference is that the problems of the UK financial sector and economy are unravelling faster than in Japan two decades ago. It is hardly surprising: Japan was then able to rely on expanding global demand from the rest of the world to shield and delay its problems. Today the recession in the UK is part of a global problem with almost all countries affected to a greater or lesser extent.

Unfortunately, the similarities are more numerous and all too apparent, so our conclusion is that until proved otherwise, Britain is going the same way as Japan.

Michael Lindsell, Portfolio Manager
Lindsell Train Ltd

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LTL 000-070-6   6 November 2008

Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

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