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# Is Abenomics Going to Put Japan Back on the Map?

By Keith Fitz-Gerald

On the surface, Abenomics – the radical unlimited stimulus plan put in place by newly elected Japanese PM Shinzo Abe – appears to be working.

The Nikkei is up 68% since July, 2012, the yen has weakened by 26% over the same time frame, and Japanese consumer confidence is up sharply to the highest levels in six years.

The theory behind Abenomics is that the rising stock market will create capital, and the falling yen will make Japan's export-based economy more competitive in global markets, while newly profitable companies will hire more workers.

Don't hold your breath.

As I noted during a recent interview on NHK, Japan's national public broadcasting network, the beleaguered island nation faces significant challenges:

- Japanese debt is *already* nearly 500% of GDP when you add up public, private, and corporate obligations. That's the highest on the planet and makes Europe's spending look positively miserly. Mimicking Bernanke's helicopter hijinks won't help on anything more than a short-term basis.
- More money does not equal greater innovation. Many Japanese companies are struggling to remain competitive in industries they once dominated. Examples include Sony, Matsushita, and Fujitsu.
- Japanese utilities literally can't produce enough power to fuel a Japanese recovery . Only three out of 54 nuclear reactors are running, and the national LNG import bill hit ¥621 billion in March. That's more than double pre-quake limits, according to the Ministry of Finance. These costs will continue to rise as the yen weakens further. I doubt very seriously that any increase in export sales will be enough to offset rising energy costs, because margins are going to get pinched.
- Formerly deep trade surpluses are now deficits.
- Prices in Japan are rising faster than income at the same time that taxes are being raised. That's a lethal combination that is serioiusly pinching consumers.
- Japanese corporations, once keen to return profits home, are now expanding overseas and keeping money outside Japan.
- Japan's population is aging so fast that, effectively, there are no new workers, a problem that is compounded by the near complete lack of a workable immigration policy.

The bottom line?

Japan is making the same mistakes we're making … or we're making the same mistakes they've already made – it's hard to tell.

Either way, the bottom line is pretty simple: You give me a trillion yen and I'll give you a good time, too.

In order for Abenomics to work, four things have to happen:

1. Japanese banks cannot hoard money the way big banks have in the US. They have simply got to keep it moving right through to Japanese citizens and small local businesses.
2. Japanese bond market participants have to be willing to maintain bidding as the Bank of Japan conducts "market operations," which is Fed-speak for interfering with normal pricing dynamics in an effort to maintain stability. If bidders walk away, the bond market will fail and the government will have to contend with offshore derivatives traders who are already lining up to play the same games they did in Italy, Spain, Greece, and the balance of the EU.
3. Japanese consumers have to engage. If wages fail to increase, living standards will decline and Abe will be up a creek without a paddle – and yes, I mean THAT creek.
4. The international banking community has to allow Japan to debase its currency without punitive repercussions. So far the G20 has acquiesced, but their tacit approval doesn't really mean much. They have no choice but to go along with Japan's moves. Kuroda, who is Bernanke's equivalent at the Bank of Japan and Abe's sidekick, has made it clear he is fully committed to the program, no matter what the West thinks.

Longer-term, Abenomics is a recipe for disaster – have no illusions about that. Japan, as John Mauldin likes to say, is a bug in search of a windshield. No nation in the history of mankind has ever bailed itself out on anything more than a short-term basis by pursuing a course like Japan's.

But short-term … that's another matter entirely, and therein lies opportunity.

Historically, every 10% drop in the yen versus the dollar has translated to a 0.3% rise in Japanese GDP the following year, noted Kiichi Murashima, chief economist at Citi in an FT interview.

You cannot say the same thing about Japanese stocks.

Since the Japanese market's initially collapse in 1991, the world has watched with bated breath as the Nikkei has risen … and plunged with alarming regularity.

If you're going to buy and sell like a trader and you're nimble, you can ride the Japanese equity bull – pun absolutely intended. Most investors aren't so equipped, though, -and so the "buy and hope" approach they favor is far more likely to leave them disappointed than profitable.

Japanese bonds are probably of dubious value, too. So far they've been stable, because Japan has been able to issue mountains of debt to its own dutiful citizens. The cost of debt service has been negligible, because nearly all of it was held domestically.

Now, however, Japan has got a very different situation on its hands. Any rise in long-term rates, let alone a significant one like Kuroda is planning, is going to dramatically hike the cost of debt service to unsustainable levels. Factor in Japan's rapidly aging population and dwindling workforce, and you're looking at a far smaller pool of bond buyers.

My expectation is that Japan will be forced into international bond markets no later than 2015, which will effectively double their capital costs. Without meaningful social security reform and spending cuts, that's going to really impact things.

That's why I'd rather short the Japanese yen.

Stocks are fickle. Abe doesn't care whether they go up or down. Bonds are a part of Kuroda's repurchasing agenda, so those are covered, too. But the yen stands on its own.

In that sense, it's the key to the proverbial castle.

In order to conduct any sort of serious financial reform, Abe is going to have to move the yen's needle. Everything in corporate Japan depends on it.

Since I first brought this trade to everybody's attention in *Money Morning* in February, 2012, the yen has dropped by 30%, and the investment vehicle I recommended, the ProShares UltraShort Yen Fund, is up more than 60% as it flirts with the psychologically important ¥100/$1USD level.

Now, having come close enough to that target for government work, I think the next stop is ¥125 to the dollar, which means that even if you missed the first part of this trade, it's not too late to get on board.

And if you're already holding Japanese equities?

Don't look a gift horse in the mouth.

Hedge the snot out of them or sell into strength – equity markets are not as directly connected to central banking stimulus efforts. But they are absolutely linked to traders' expectations, which can and do change all too frequently on nothing more than a whim or an errant "tweet," as we have recently seen.

You don't want to be left holding the bag.