



The “Japanization” of Europe?

Market Comment, October 2019

Quantitative monetary easing, falling interest rates, low valuations of banking stocks and “financial repression” – all these developments now evident in Europe are familiar to us from many years ago in Japan. The conclusion is that cash is becoming even less attractive, and that without diversified risks it is unlikely that positive returns will be possible.

Current financial and economic developments in Europe exhibit many characteristics that we already witnessed some time ago in Japan. This is in contrast to the situation in the US, which is experiencing another form of parallelism altogether, as flagged up in our Market Comment “20 years on from 1999 – a comparison of economic cycles” a few weeks ago. Indeed, closer inspection reveals that it is not unreasonable to talk of a “Japanization” of Europe. Why? Although Japan experienced these developments some time ago, the parallels with what we are now seeing in Europe are striking. It all began with the Nikkei stock market boom in the 1980s, which was led by Japanese banking stocks and reached its peak in 1990. The Japanese banks, which were subject to little in the way of regulation, were able to increase their profits dramatically in an era of numerous corporate transactions, and accordingly became the “darlings” of investors. But then came the sharp correction and increasing regulation, which weighed heavily on the banks’ profitability. The weighting of Japanese banks in the market as a whole rose from some 5-6% to 16% and ultimately as much as 20%. The subsequent correction extended to both profits and valuations. After a phase of overvaluation, Japanese banking stocks lost a huge amount of value – not overnight, but gradually over many years, ultimately receding some 90% from their peak. Although there were various recovery phases during this period, they were never sustainable due to declining profitability. Banking profits fell for three reasons: higher capital requirements (declining returns on equity), fewer transactions and less proprietary trading, and above all sharply falling interest rates. Fast forward some 15 years and we are seeing the precisely the same scenario playing out in Europe. Back in 2007, European banking stocks peaked thanks to transaction revenues (particularly in investment banking)

and handsome interest income fuelled by a healthy (i.e. not too low) interest rate environment. Thereafter European banking stocks likewise slumped by some 80-90%, albeit punctuated by three temporary phases of recovery against a backdrop of rising interest rates. Here too, the dominant factor was structural weakness in the face of increased regulation, more rigorous capital requirements, and therefore lower valuations for a prolonged period – precisely the situation that had unfolded in Japan.

“As the example of Japan shows, the price of financial repression is more volatile financial markets – in all asset classes, and for many years.”

Gérard Piasko, Chief Investment Officer

In Europe too, the weighting of financial stocks as a proportion of the overall market rose to some 20% just before the financial crisis, and has been steadily declining ever since. And as (unlike in the US) no other innovative sectors such as technology/communication have exhibited dynamic growth and healthy profitability, the DJ Eurostoxx 50 equity index has never returned to its absolute peak (in 2000) and slightly lower peak (in 2007), much as Japan’s Nikkei 225 index has never been close to rescaling the peak recorded in 1990. This stands in stark contrast to the innovation-driven highs of the S&P 500 index in the US, which has set record after record in recent years – driven above all by the healthy profitability of its communication/technology sector, which has easily the highest weighting of any sector in the S&P 500. Ten years after the Nikkei peaked, Japan had to resort to quantitative easing after the failure of traditional measures to stimulate the economy in the form of numerous interest rate cuts. This involved the Bank of Japan initiating bond purchase programmes to bring down longer-term market interest rates, i.e. bond yields. As these extreme measures bore little fruit, the BoJ even launched equity purchase programmes. In summary, while Japan had no great success in stimulating its econo-

my, it proved very profitable for investors who increased their bond and equity weightings at the expense of cash: The Bank of Japan's asset purchase programmes made cash less appealing as an asset class, while adding an additional direct source of demand for other asset classes. Japanese institutional investors (e.g. pension funds) also increased their equity weightings and purchased more corporate bonds in order to avoid negative inflation-adjusted returns. The alternative monetary policy instrument of quantitative easing ("QE") has also been part of the European Central Bank's toolkit ever since 2015. Just a few weeks ago, the ECB announced that it would be launching a new round of QE in November, the aim being to purchase market securities up to a total volume of EUR 20 billion. Interestingly, no time limit has been set for the asset purchase programme this time around. In Japan, the benchmark yield on 10-year government bonds fell below 2% for the first time in 1997, while with the exception of 2014 inflation has never reached the desired 2% level – it currently stands at around 0%. In the Eurozone too, inflation has continually receded from the target level of 2% since the 2011/12 crisis, and currently stands at 1%. The benchmark yield on 10-year German government bonds fell below 2% for the first time in 2012, and is now below

0%. So what should we learn from Japan's experiences when it comes to the ongoing asset purchase programmes of the ECB? On the one hand financial repression, which means it is only logical to take on debt to invest in securities or residential property. By contrast, those attemptings to save by holding liquidity (cash) can hardly hope to generate a positive return once inflation is taken into account. Institutional investors are having to take greater (diversified) risks to generate positive returns, e.g. by investing in real estate, corporate bonds, or equities. But at times they will have to take profits in order to benefit from the likely increase in volatility triggered by financial repression. Private investors too will recognize that positive returns simply cannot be generated in such an environment without the assumption of risk, because the price of financial repression is more volatile financial markets – in all asset classes, and probably for many years to come.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.



Modular investments with Maerki Baumann

The topics of the current market comment concern following focus modules:

Equities Switzerland	Equities USA	Bonds CHF	Global Balanced
Small & Mid Caps Switzerland	Equities Emerging Markets	Bonds EUR	Commodities
Equities Eurozone	Equities Global	Bonds USD	
Equities Germany		Bonds Emerging Markets	

Please contact your client advisor for further information or visit our website.
www.maerki-baumann.ch/modular-investments

IMPORTANT LEGAL INFORMATION: This publication is intended for information and marketing purposes only, and is not geared to the conclusion of a contract. It only contains the market and investment commentaries of Maerki Baumann & Co. AG and an assessment of selected financial instruments. Consequently, this publication does not constitute investment advice or a specific individual investment recommendation, and is not an offer for the purchase or sale of investment instruments. The future performance of investments cannot be inferred from past price performance. In other words, the value of investments may increase but may also decrease, and the investor may be required to make additional payments for certain products. In certain circumstances, figures may refer to reporting periods of less than five years, which could reduce their validity. Predictions for the future are always non-binding assumptions. Figures presented in foreign currencies are also subject to exchange rate fluctuations, which can affect their performance. The information in this publication is in no way to be understood as an assurance

of future performance. Maerki Baumann & Co. AG does not provide legal or tax advice. In addition, Maerki Baumann & Co. AG accepts no liability whatsoever for the content of this document; in particular, it does not accept any liability for losses of any kind, whether direct, indirect or incidental, which may be incurred as a result of using the information contained in this document and/or arising from the risks inherent in the financial markets.

Editorial deadline: 4 October 2019

Maerki Baumann & Co. AG
 Dreikönigstrasse 6, CH-8002 Zurich
 T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch