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INSIDE THIS ISSUE

FEATURES

SPECIAL REPORT TITLE

- THE US LOOKS A LOT LIKE JAPAN – The Update
 - Similar Bubbles – Similar Results
 - Debt Explosion
 - Definition of Insanity
 - Maybe Demographics Are A Problem
 - Why This Time Is Different
 - Similarities In Markets

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The US Looks A Lot Like Japan by Lance Roberts



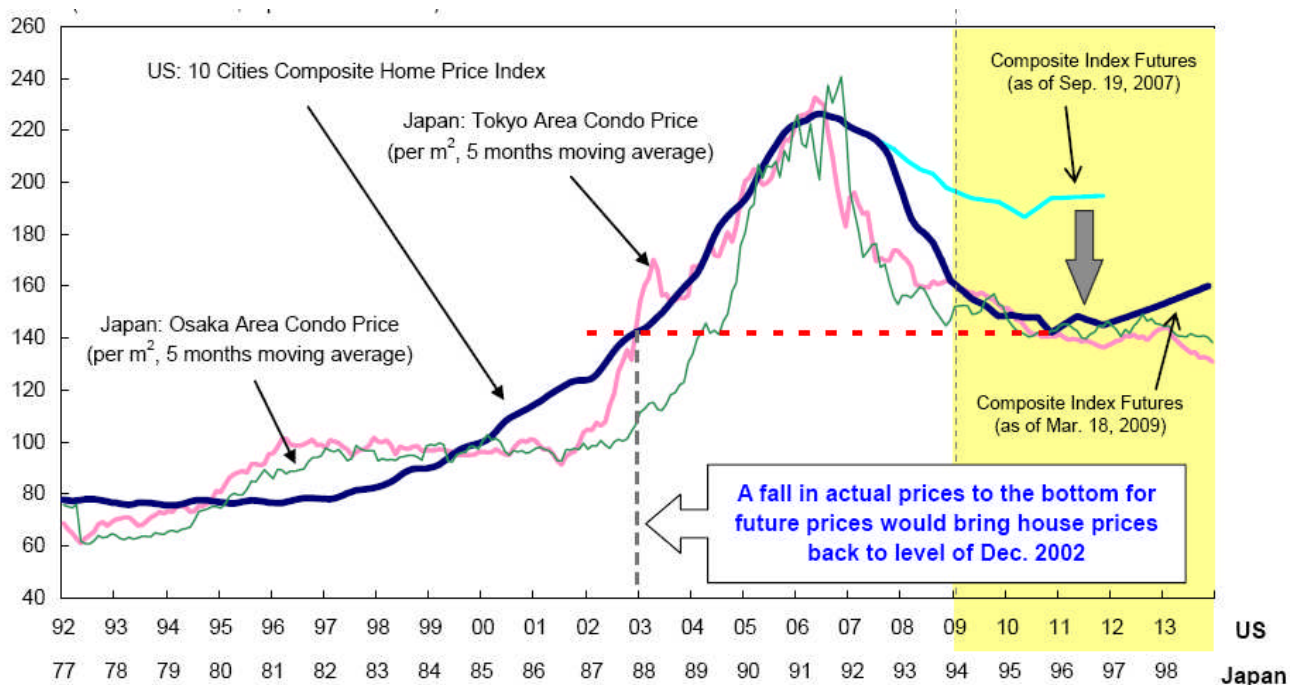
The US Looks Like Japan – The Update

It is hard to believe sometimes how quickly time goes by. I wrote an article during the Thanksgiving Holiday in 2009 about how the US was beginning to look more and more like Japan in many ways and as I reread the article many of the things that we wrote then have continued on exactly the same course. Yes, there are some differences, at the moment, such as the aging population in Japan which is currently offset here by the immigration that we have in this country. However, when looking at the economic policies that we have adopted to solve our issues there are many frightening similarities to which our policy makers are hoping for a different result.

Much has been written about the credit crisis, the government stimulus response, the mountains of debt and the possible resulting emergence of a new world order, but as yet no one can say with any certainty whether we have, in fact, yet escaped the prospect of a global economic collapse. However, the term “global economic collapse” is a bit too strong a term and should be reserved for the “doomsayers” trying to sell you gold bullion and bullets. There are, however, varying degrees of collapse, from severe interruptions in the pace of progress, to a scenario more like a global economic meltdown, with unthinkable consequences. We are not that pessimistic.

While we believe the greatest danger is past, we also recognize that the price of our salvation, if that is what you want to call it, has yet to be paid. Our basic economic recovery scenario is one of very slow recovery for the global economy, a good chance at a secondary, but not as deep, recession, government debt at all-time highs and continued booms and busts in markets combined with very low long term returns from equities.

In particular this week we want to take a look at strategies for what we believe may be a Japanese-style (non) recovery. A Japanese-style recovery implies persistent government debt, economic anemia, low interest rates and weak equity markets. We would not qualify expanding government debt as a bubble. However, we do believe it represents a threat to future economic growth, constraining governments’ freedom to spend and most likely requiring tax increases, which could in turn hold back consumption, thereby holding back production. It is a vicious economic circle that we are playing with here which will be caused by the inevitable and lengthy period of deleveraging which lies ahead.



Sources: Bloomberg, Real Estate Economic Institute, Japan, S&P "S&P/Case-Shiller® Home Price Indices", as of Mar. 18, 2009.

We currently have a lot more things in common with the mistakes made in Japan over two decades ago than most economists and main stream thinkers would like to admit. Unfortunately, China is in the process of making the same mistakes but that is an article for another weekend.

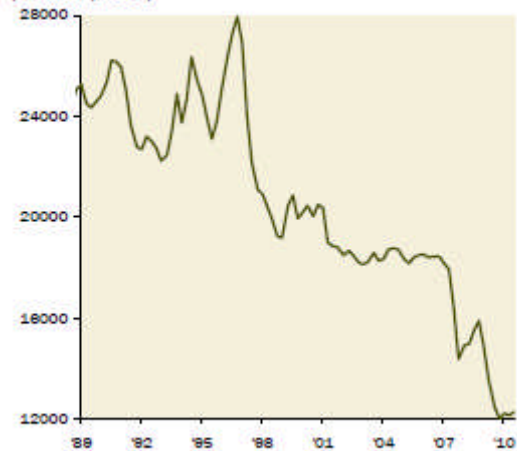
As you will see in the chart above the bubbles in both real estate and equity markets were nearly identical. The chart shows that the 6 city Japan real estate composite is almost EXACTLY the same as the Case Shiller 10 city Composite.

However, it is not just home prices that were in a bubble, and as opposed to what Jim Cramer was touting last week that home prices have now bottomed, which he also said in June of last year, we are also experiencing similar declines in private residential spending (which as we have discussed before is a huge driver of economic growth) and housing credit which is also a big driver of economic growth. Without these two in play you cannot have an organic economic recovery and, as we have stated before, we are just beginning the second decline in housing prices in order to get valuations back to long term trends.

Real Private Residential Spending

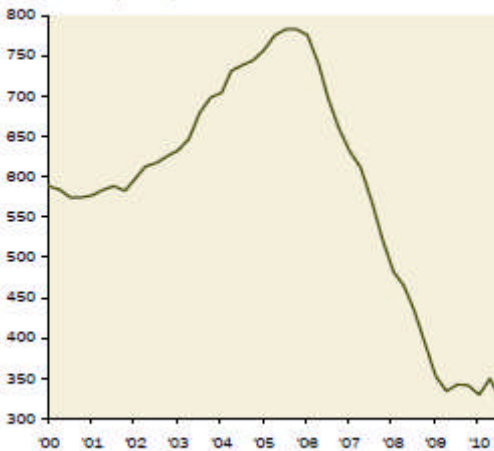
Japan

(¥ billions, 2000)



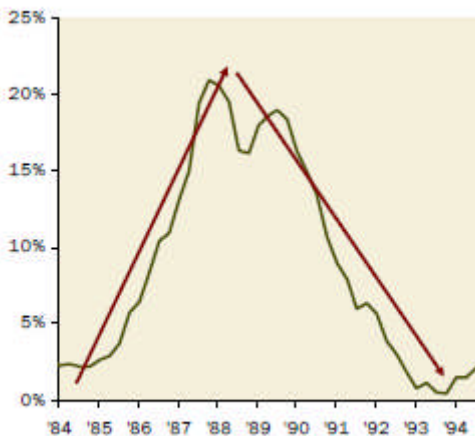
United States

(US\$ billions, 2005)

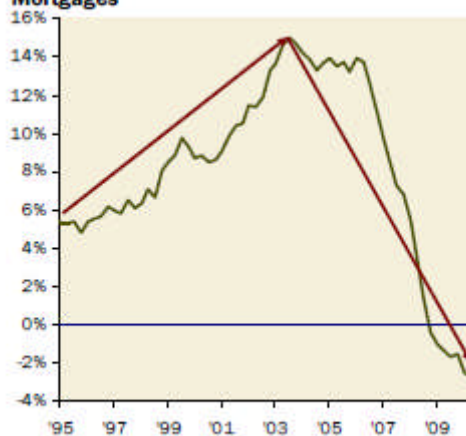


Source: Haver Analytics, Gluskin Sheff

Japan: Domestic Bank Lending: Housing Credit



United States: Household Liabilities: Home Mortgages

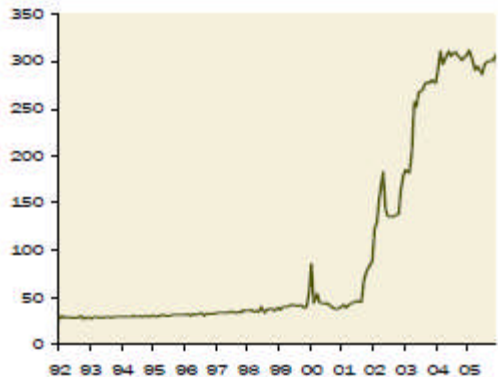


Source: Haver Analytics, Gluskin Sheff

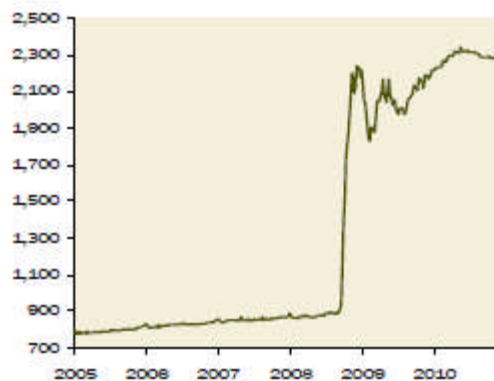
The same story holds true in the equity markets as we will show you. The inflation adjusted prices over the decade prior to the peak were identical. Also, notice the expansions of the Fed Balance Sheet as compared to the Bank of Japan's balance sheet in the chart below.

Reserve Bank Credit Outstanding

Japan
(billion ¥)



United States
(billion US\$)

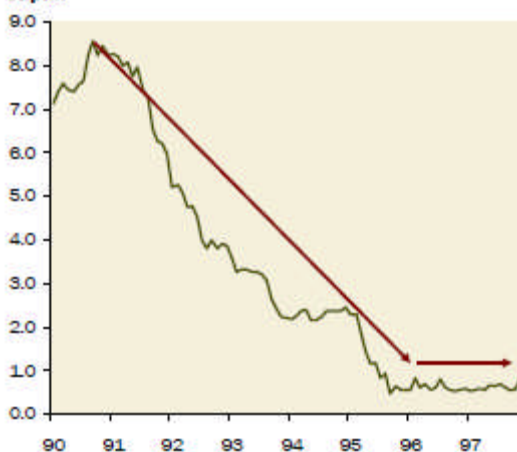


Source: Haver Analytics, Gluskin Sheff

Both countries tried to combat a debt collapse by lowering interest rates to near zero, flooding the system with liquidity and trying to cover up bad debts with accounting mechanisms rather than dealing with the issues.

Three Month Bill Yield (percent)

Japan



United States



History has shown us this is not the way; but yet we follow the same path...this, of course, begs the question as to whether we should expect the outcomes to be any different?

Keiichiro Kobayashi, Senior Fellow at the Research Institute of Economy, Trade and Industry is the latest economist with an in-depth understanding of Japan, who says the U.S. and U.K. are making all the same mistakes:

"Bad debt is the root of the crisis. Fiscal stimulus may help economies for a couple of years but once the "painkilling" effect wears off, US and European economies will plunge back into crisis. The crisis won't be over until the nonperforming assets are off the balance sheets of US and European banks."

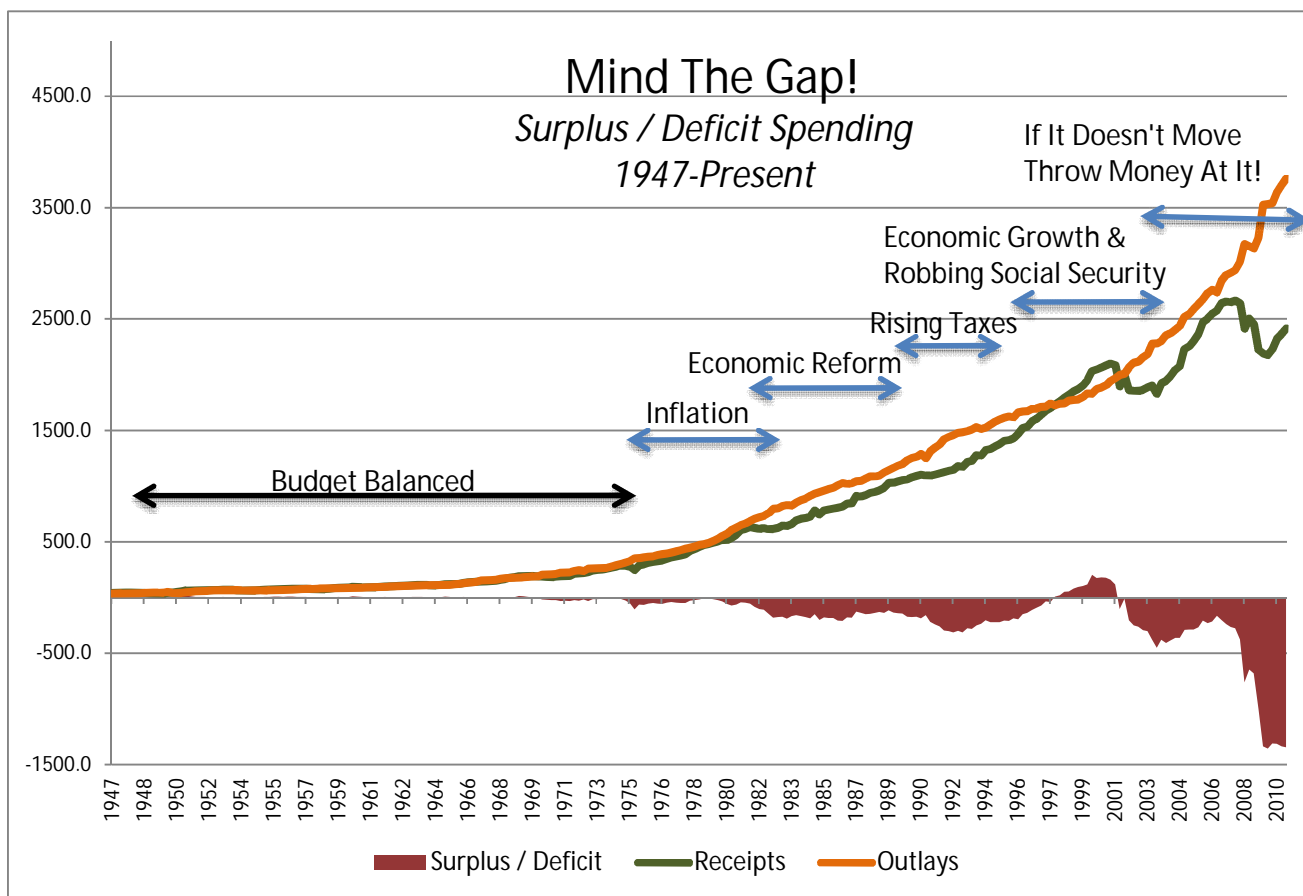
The main issue, as Kobayashi elaborates on, is that the U.S. is ignoring our debt problems rather than confronting them. This reactive approach to deleveraging is very similar to the ways Japan dealt with their financial crises. They swept problems under the rug hoping the economy would improve, but it never rebounded substantially. Low rates and quantitative easing didn't attack the problem of too much debt. Kobayashi sums it up beautifully:

"So long as people hold onto the expectation that recovery could be brought about by fiscal measures, no national consensus can be built to proceed with the painful disposition of nonperforming assets. It is necessary to learn by firsthand experience that fiscal measures are only makeshift. In this context, the enormous fiscal deficit that will be built up in the US in the coming months may be the political cost for consensus building, which would be a replay of what Japan went through in the 1990s."

Up until several years ago, the US and European countries had repeatedly criticized Japan's policy responses for being too slow. But it might be the case that US and European policy responses are just as slow as those of Japan when it comes to tackling the daunting task of solving nonperforming asset problems. By studying Japan's experience, foreign policymakers have an excellent example from which they can learn what not to do. Yet, the recent developments show just how difficult it is to learn from the mistakes of others. We, as human beings, are by nature probably unable to take to heart anything having negative implications unless we learn its lesson the hard way through firsthand experience."

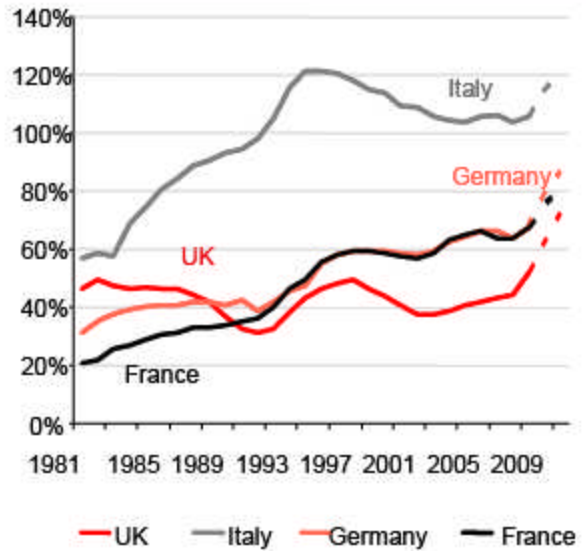
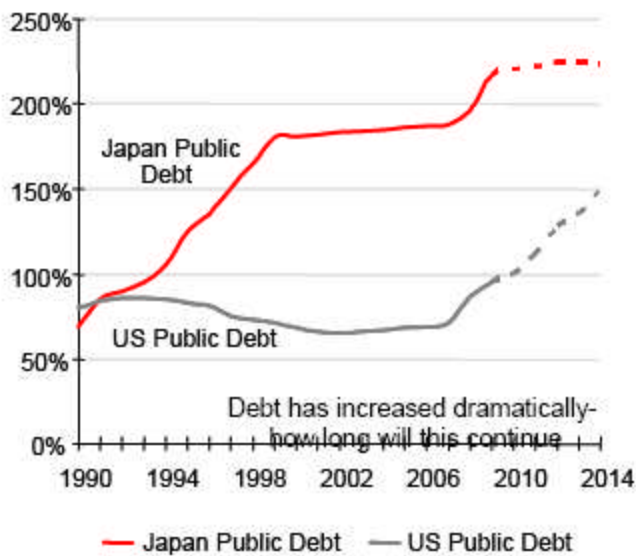
Debt Explosion In 2010

That title is correct, I do mean 2010. In the past two years we have more than doubled the debt and that pace shows no sign of abating soon. With US Government debt approaching 100% of GDP by this year, signs of a constrained recovery are becoming more apparent as the trillions of dollars in various stimulus packages continue to show very little effect on the overall economy, other than an explosion in the stock market, not unlike what was seen on the Nikkei. Government receipts are plummeting while expenditures are increasing to all-time highs. Simple math will tell you that this formula will ultimately not work out well.



In a recent report from Societe General they believe that; "Further transfer of debt from the private sector to the state and rising healthcare costs, particularly for ageing baby boomers, are among the factors behind soaring US public debt. These poor demographics and the complexity of the current crisis serve as reminders that we may not have escaped the prospects of a lost decade, implying years of sub-par economic growth ahead. The US is not the only country facing such a gloomy outlook for public finances. In Europe also, public debt to GDP should exceed 100% within a few years".

Public debt as % of GDP



Source: SG Cross Asset Research, FMI

"The problem facing governments is that if they cut off the fiscal stimulus too soon, we could fall back into recession, but if the gap is not closed rapidly, there would be a risk of high inflation and high interest rates by 2011. Taking an extreme view, US debt could result in a collapse in the dollar as large US debt holders reduce their exposure and inflation rises as a result. We do not see this as a likely scenario over the next 12 months as debt is currently an issue in practically all developed countries, so no other currency could realistically replace the dollar at the moment.

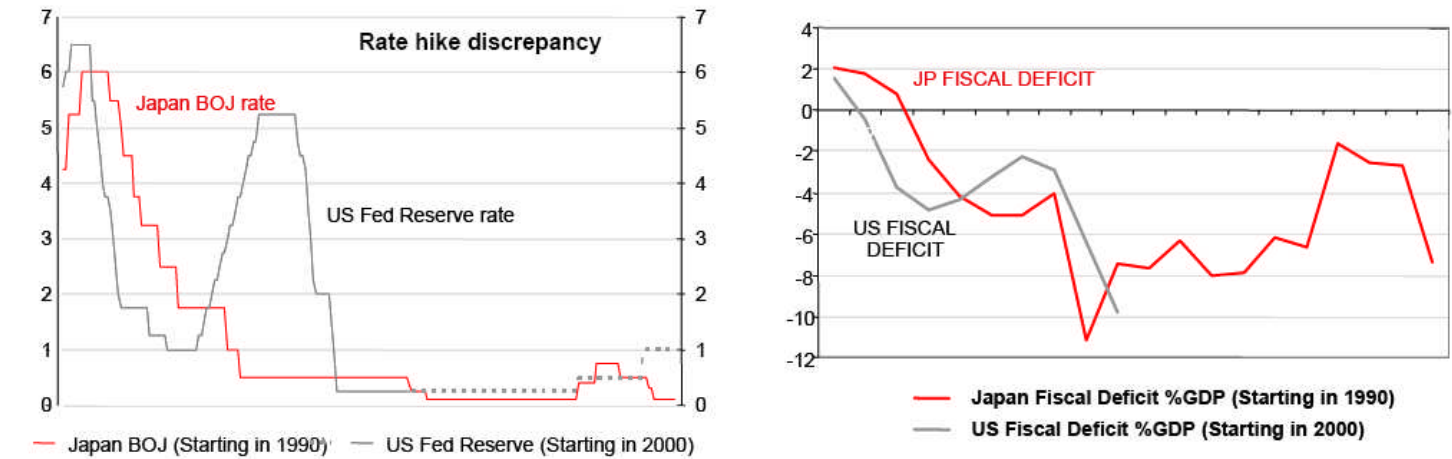
The current economic crisis displays compelling similarities with Japan in the 1990s. A return to recession would bring echoes of Japan's lost decade. As highlighted in the following chart, there are striking similarities between that period and the decade starting with the dotcom crisis in 2000/2001 and ending with the current crisis seen in the US from 2007."

	Japan Lost Decade 1990	(US 2007- Present + US 2000/2001)	US New Millennium crisis
Ballooning public debt	XX	xx	XX
Banking Crisis	XX	xx	XX
Property bubble	XX	xx	XX
Corporate debt crisis	XX		xx
High valuations going in	XX		xx
Stock market crash	XX	x	x
Low Interest Rates	XX	x	x
Slow government reaction	xx		

The Definition Of Insanity

Take a look at the following chart. If you shift forward Japan's rate hikes and debt deployment trends by 10 years and then compare these with the current US experience it underlines the huge risks ahead if the US continues to make full use of unconventional measures to support the domestic economy. Trying the same thing that was done before and expecting a different result....

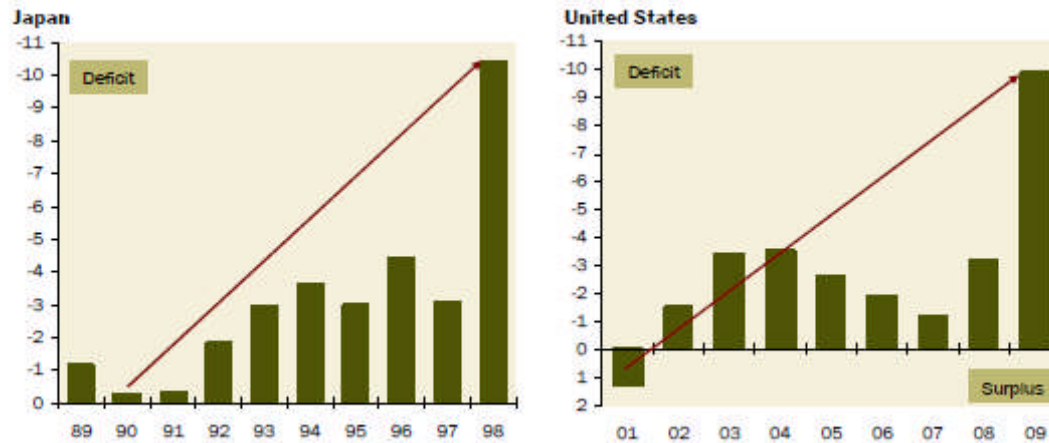
Shifting forward Japan's interest rates and debt by 10 years suggests a similar story



Source: SG Cross Asset Research

The US, unfortunately, is headed in the same direction.

Government Deficit as a share of GDP (percent, inverted scale)



Source: Haver Analytics, Gluskin Sheff

Maybe Demographics Are A Problem

I stated at the beginning of this article that we are looking a lot like Japan in many ways except for the demographic problem on an aging population. One of the big issues that Japan is facing is that they do not have a large immigration base to offset the reduction in offspring from individuals to keep the employment rate at a substantially high enough level to fund the pensions of the aging workforce. Individuals in Japan are waiting much longer to have children and are having fewer than what has been the historic trend. Furthermore, more and more of the Japanese population are opting to live at home with parents rather than venturing out on their own and creating economic prosperity. It is a real issue for Japan.

In America, the difference is that we do have a large level of immigration (both legal and illegal) into this country which does help, to some degree, offset the issue of the baby-boomer generation moving into retirement. However, like Japan, our youth are waiting longer to have children, having fewer of them and are opting for short cuts to living rather than following traditional paths.

IT'S 2011 WHAT'S MISSING?

DO YOU HAVE:

- RISK MANAGEMENT
- A COMPREHENSIVE INVESTMENT STRATEGY
- INDEPENDENT RESEARCH
- INCOME GENERATION
- ALTERNATIVE INVESTING

-IF NOT-

IT MIGHT JUST BE THE TIME
FOR US TO TALK

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We have stated previously that one of the things that MUST be done in order to salvage the economy in the long run is to restructure immigration policy to make it easier for people to legally immigrate into this country, get jobs and pay taxes. One of the current reasons for the high levels of illegal immigration is due to the lengthy (up to 10 years) and cumbersome process, not to mention extremely expensive, of becoming a US Citizen.

Most immigrants simply cannot afford to become citizens which throws them into the situation of residing here illegally. It is a real problem that needs to be addressed and soon.

Even with immigration our demographic makeup is not offsetting the problem that we have relative to future economic progress. Employment is the key to economic survival and while recent reports have touted that jobs are being created in the United States (mostly through make believe and wishful thinking) the hard truth comes in the form of the employment levels relative to the population.

As in Japan, this ratio is heading into dangerous territory and quickly. The reason is somewhat simplistic – while we are seeing some very mild job creation, mostly in areas affected by government stimulus payments, the NUMBER of people in the population is growing at a much faster rate. On average we must be creating between 150-250,000 jobs a month JUST to stay even.

Employment-Population Ratio (percent)



Source: Haver Analytics, Gluskin Sheff

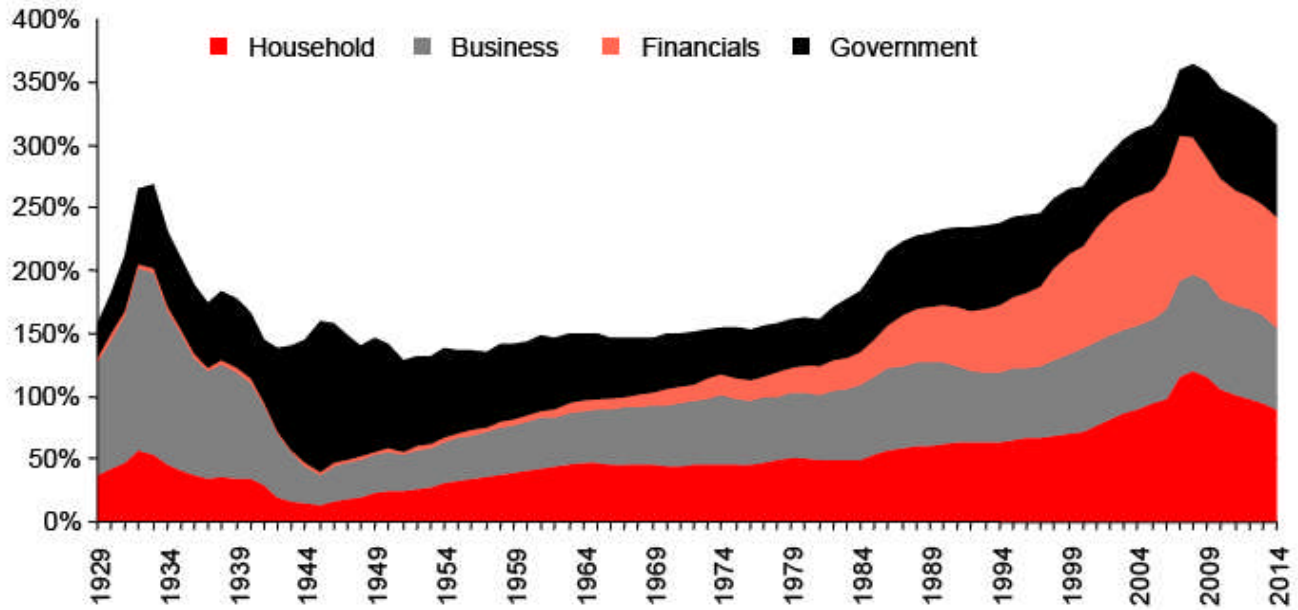
At our current levels of unemployment we need to create closer to 500,000 jobs a month just to start putting a dent in the unemployment levels in a meaningful way.

Why This Is Different From Previous Post WWII.

While we are in the process of comparing the US to Japan – it is almost ironic that the mainstream media will only analyze THIS recession with any recession SINCE World War II where we dropped the bomb, twice, on Japan. Maybe, this time, we have dropped the bomb on ourselves?

However, there is one HUGE difference between this recession and every recession since World War II. See chart on next page.

Historical and projected breakdown of US debt by category



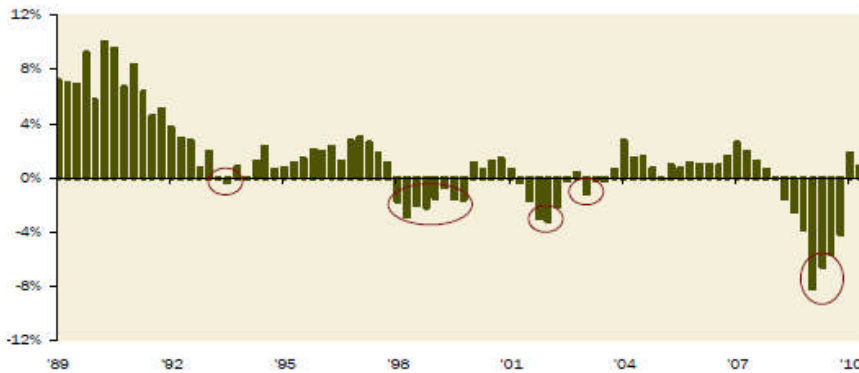
Source: SG Global Strategy, Bloomberg , US Federal Reserve

As you will see in 1929, before the start of the “Depression” debt was reaching a peak of 250% of GDP. When the proverbial “back of the camel” broke and the crash occurred the economy slid into a massive DELEVERAGING cycle which included massive reductions in debt through default, bankruptcy, write-offs, bank failures, etc. The debt deleveraging cycle ended in 1944.

EVERY recession since World War II ended has been with debt leveraging. SO, as the economy went through normal expansion and contraction phases the world continue to operate by substituting debt for income when needed which kept consumption and production going.

However, we are now entering into the second great DE-Leveraging cycle which makes all comparisons to previous post-WWII recessions virtually worthless. What is important to note here is that in order to stave off a prolonged deep-recession such as occurred between 1932-1937 debt needs to be contracted not expanded. By expanding debt we prolong the process of deleveraging which would get the US into a place where we could then start using debt to our advantage to minimize economic recessions as we did from the mid-40’s through the 90’s. This is also why, like Japan, we will continue to foster rolling recessions into the foreseeable future until we began to come to grips with our debt issues.

Japan: Gross Domestic Product (year-over-year percent change)



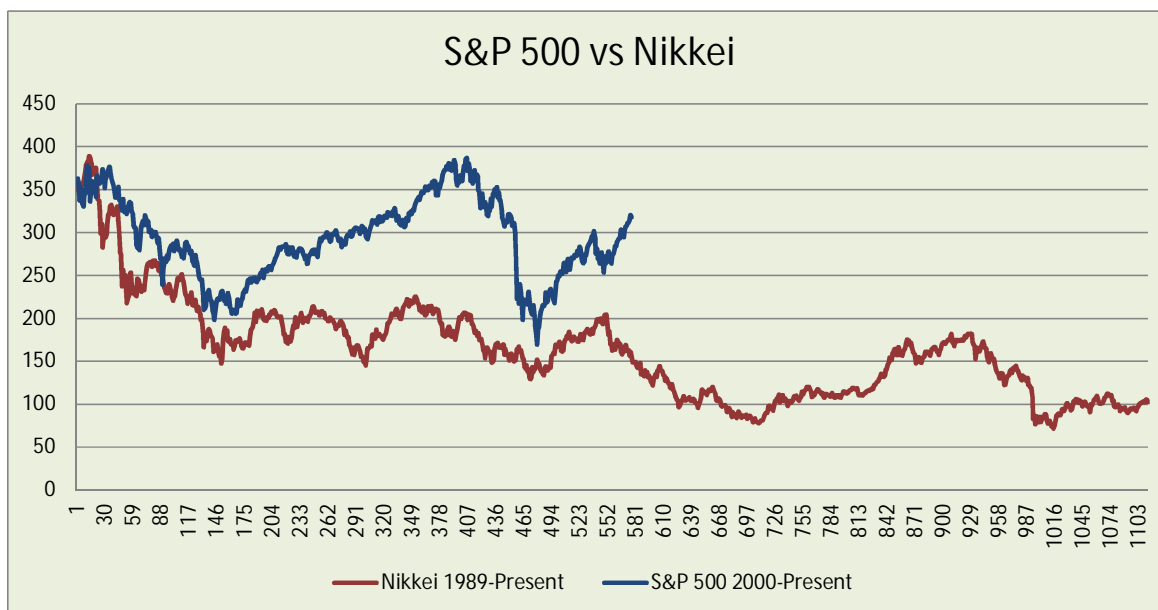
Source: Haver Analytics, Gluskin Sheff

Similarities In Markets

This is starting to get a bit long and I want to cover the areas we should be looking at investing in and where we are looking to continue to allocate client assets for what we think the future will continue to look like.

From Societe General: *"If we accept the idea of a two-stage crisis (taking as our starting points 2000/01 + 2007/08), we have probably reached a situation similar to that of Japan in the 1990s. This analogy would suggest that we are now exiting a bear market rally, which was fuelled by restocking and fiscal stimulus. If the fiscal incentives boosting auto consumption are reduced, normal consumer spending will be unable to pick up the running so long as unemployment remains depressed."*

This goes a long way with our contention that what we have witnessed so far is a strong countertrend market bounce following a very sharp decline. The problem, and our contention has been, that due to continued bad policy by the current administration we are almost certainly consigned to repeating a similar fate. Not one in which I particularly enthused about which is why we need to look at where we should be allocating assets to not only weather the potential similar outcomes but MOST importantly conserve the purchasing power parity of investment dollars in the future.



In fact Edwards just recently stated that; *"Our Ice Age thesis called for a long secular equity valuation bear market, just like Japan. Most reject the comparison with Japan, especially with regard to the US having better demographics. Indeed I felt that beyond the lost decade and secular bear market, the US outlook was much more upbeat than Japan's. But now, I am thinking I might have been too bullish."*

The recent surge in the markets has not been a function of a return of economic prosperity but rather Bernanke's idea that higher stock prices will boost wealth and confidence, spurring spending, which in turn would lead to higher incomes and profits that would further support economic growth. Therefore, Bernanke and the Federal Reserve have launched several programs from Quantitative Easing (1.9 Trillion to date), Permanent Open Market Operations (2 Trillion plus and counting) and several other programs to monetize debt and move funds into the stock market.

Edwards summed it up perfectly regarding the latest rounds of QE; *"And so it came to pass. From the end of August stocks rallied. Leading indicators recovered. Spending increased. Jobs picked up. A virtuous circle indeed...Unfortunately, though, policy makers have yet to learn the lessons of the Great Recession. Basing economic growth on loose monetary policy driving up asset prices is simply doomed to failure."*

Portfolio Allocation Considerations

Back in 2000 when we started writing this letter we discussed secular bear markets and the long term implications of market over valuation and long term returns under this current market scenario. Since then we have continued to discuss and analyze the impacts to portfolio returns due to continued government largesse, poor monetary policy and speculative market investing.

Unfortunately, nothing has changed as we continue down the same, long, slow and depressing path. We continue to see, and expect, the secular equity bear market unfold, now eclipsing its tenth year in its estimated lifespan of 18 years, punctuated by sharp cyclical rallies that lead investors back to the trough for eventual slaughter.

So, if you buy off on my madness and insanity theory, then the question becomes what asset classes would most likely benefit from the outcome of such an environment? Wow...that is good question. I am so glad you asked.

One caveat: These are suggestions of things to be considering. Not recommendations to go and buy tomorrow. While these are broad ideas specific investments should be timed to maximize returns and minimize risk.

- Sell The Dollar – no real surprise here. As we print an enormous amount of the debt the government is in favor of a weaker dollar to purchase back the debt in the future. Also, high debt levels make us less of a credit worthy investment so money moves to stronger to countries weakening our dollar.
- Buy Fixed Income – we have been and will continue to be big buyers of fixed income. Over the last 10 years bonds have outperformed stocks on a total return basis by a wide margin. This will most likely be the case going into the future for the balance of this decade and most likely the next.
- Minimize Equity Holdings – the European market, like the US has already priced in a full recovery, which won't happen, which leaves equities in general VERY vulnerable to another large corrective move. This combined with extremely high valuations will combine to provide very low equity returns in the future.
- Buy Commodities – commodities will be the beneficiary of the decline in the dollar in the future as aggregate demand increases due simply to population growth will continue to put pressure on supply thus increasing price. We have been positioned, and will continue to be, in commodities based on this assumption. Agricultural commodities, precious metals (fear trade), and oil and gas will most likely be the biggest beneficiaries.

With these macro themes in mind it is important understand the "WHEN" to invest in them is almost as important as the what. Given the fact that most of these asset classes have already run up during the recent stimulus driven rally I would suggest waiting until a good pullback occurs before adding NEW positions to a portfolio. IF you are already long positions in these areas wait for corrective price actions to add exposure at favorable, risk reduced, points.

So, until the next bust from the artificial boom comes I think I will go grab some sushi, brush up on my Japanese and wait to see what happens next week.

すばらしい1週間前の場合は、必要があります。
(*May you have a wonderful week ahead of you.*)

Lance Roberts

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