

Reflection and Outlook: Animal Spirits, Demography, Structural Reform and Japan in 2017



January 4, 2017

The end of year is a time for reflection on the year that has passed. From a business perspective, this has been one of the busiest and most exciting years in the close to 40 year history of Weiss. From a markets perspective and political perspective, anyone reflecting on this year will most likely leave it shaking their head in amazement due to the shocking outcomes. Believe it or not, the year started as the worst on record for U.S. equities. If you would have taken a survey in early February for how 2016 would finish, few would have predicted a 27% rally off the lows. However, if you knew about Brexit and the outcome of the U.S. Presidential election before taking the survey, it is safe to say there may have been some calls for the SPX to be down >50%, not up 27%! The word *reflection* for 2016 for many is humbling. You would think that after the shocking outcomes of 2016, there would be reluctance for people to have confidence in the coming year. However, as I read outlooks and listen to market participants, there seems to be high conviction in 2017.

There is a broad view that stocks will be up, the dollar will be stronger, oil will be up, bond yields will be higher and old school macro trading is back. From a sector basis, everyone seems to love financials, transports and industrials. On the other side, everyone hates interest rate sensitive sectors, and dividend payers. The optimism is shared by the strategists, investors, and it's even showing up in newsletters measured by Investor's Intelligence numbers. It is built around expectations of tax cuts, infrastructure spending, deregulation, increased jobs and fairer trade, all of which would lead to growth and reflation. It appears that people have these outlooks without any reflection on the crazy year that just ended. Even if the consensus scenario plays out in 2017, I am willing to state that the path will be equally as difficult this year. In this world of technology and eliminating inefficiencies, the value of being in the consensus just has not paid on a risk adjusted basis, and I do not think the Donald Trump presidency will change that. Therefore, I will try to locate some areas that will surprise this year and add value to investors from a return to risk basis.

Obviously, the current mood of the market is driven by the presidential election results. It is based on the hope that lower taxes, less regulation and some fiscal spending will lead to more

growth and inflation through increased confidence. It is difficult to see how anyone can argue these thoughts without being politically biased. All of these should build confidence and potentially lead to some increase in risk taking at individual and corporate levels. Given the negative sentiment that existed for most of this year, the increased risk taking should drive cash on the sidelines back to work since it was not prepared for the increased fiscal policy support in the coming year. As the markets move higher, cash will be put to work, and as time passes we will realize there may be some negatives to the President's policies. I expect that reality to set in early in the year. The first reminder is likely to be what had most investors worried about in 2016; from the very start of the year, most of the negative rhetoric was focused on valuations. Although earnings will likely be higher in 2017, and corporate taxes will likely be lower in the future, the market rally is already building in that news which will leave valuations as a big question mark. Add in the fact that investment grade yields are rising and even the interest rate support for higher valuations gets challenged. At the same time, we will have a Fed in play and a dollar already on the rise. At some point, these are likely to act as headwinds. Most importantly, we enter 2017 with sentiment at a much different place. Last year, the bar was set very low in terms of expectations, and this year, there is little room for disappointment.

To highlight the rapid shift in sentiment at the sector level, look at the financials sector. Early in the year, we saw the panic from negative rates and flatter yield curves around the globe which led to a mass exodus from the sector. Q1 2016 was the worst quarter for global banks since 2008. Brexit delivered the final knockout blow. It was difficult at that point to find a person who liked financials. Fast forward to the day after the U.S. election and it's difficult to find a person who doesn't like the sector. This is after the sector outperformed the SPX in the final quarter by 17%. Believe it or not, this quarterly outperformance for the financial sector in the SPX was larger than any annual outperformance since 1989, except for the year 2000. What is also surprising is how everyone seems to think this is some longer term contrarian view. Since the end of 2011, the best performing sector in the SPX has been financials. When the pendulum of sentiment shifts this fast, it is worth taking a deep breath and thinking clearly because it is never as easy as it seems. As I mentioned in my [post-election paper](http://www.gweiss.com/Insights/A-New-Market-Regime-The-Pendulum-of-Dispersion-Will-Swing-Faster.aspx)¹, I think the real story of 2017 is to expect more uncertainty given unknowns on the fiscal and monetary side, and also because it seems we will be renegotiating our relationship with the world. A commitment to renegotiate trade, questions about our existing post World War II defense policy, and changes to immigration will likely increase rhetoric and retaliation. Remember, since the 1980s foreign profits as a percentage of total profits have grown significantly. None of this is necessarily bad but it will likely lead to pockets of market disruptions that could impact expectations of economic growth and earnings. That is why I believe it is important for investors to remember the surprising outcomes of 2016, and remember our job is to find the best reward-to-risk opportunities, with a heavy appreciation of positioning.

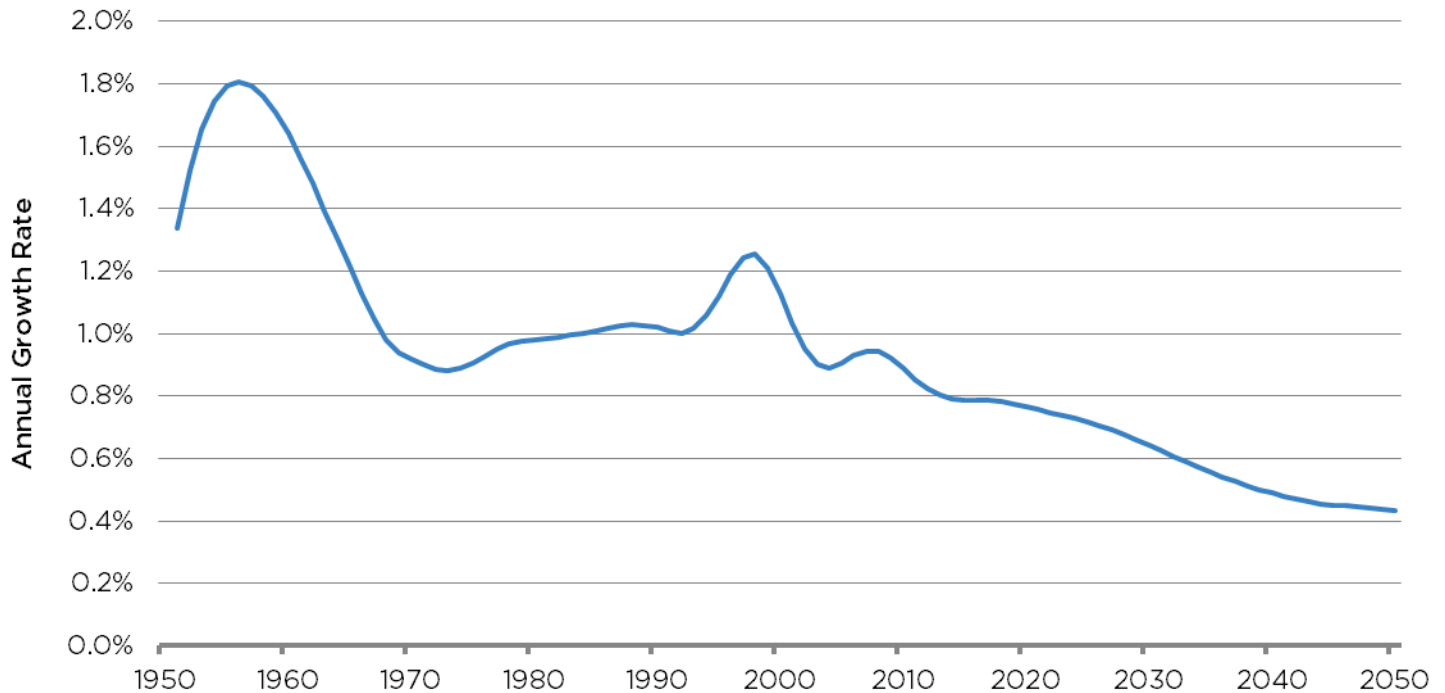
¹ <http://www.gweiss.com/Insights/A-New-Market-Regime-The-Pendulum-of-Dispersion-Will-Swing-Faster.aspx>

With all of this in mind, I want to say that I do expect equity markets to be stronger this year on the back of the Donald Trump election result. In my opinion, there is no doubt that Washington has become dysfunctional and that some sort of shakeup and change was needed. I also think it reinforces the need for governments around the world to continue to focus on structural reforms that can help growth, and not austerity. Whether or not this focus will do any good in the long term is difficult to determine but our jobs depend on what markets do in the near term and I think global equity markets will have a very good year in 2017, even if the path is volatile. In terms of an outlook along those lines, I expect the current trends to continue in Q1, as cash on the sidelines is still the story. As negative as U.S. investors were, I personally found that global investors were even more negative. Despite the fact that short term surveys are showing optimistic sentiment, the cash levels in surveys still suggest that longer term slower allocators will be buyers on weakness in the first quarter. With earnings increasing, credit spreads continuing to tighten, and PMI numbers rising, market participants have enough fundamental backing to justify being aggressive early in 2017. In addition, I fully expect Donald Trump to shake up Washington and be aggressive in Q1, moving expectations forward and adding accelerant to the expectations. Given the view in equities, I also expect most of the recent popular “Trump trades” to continue in Q1. However, I do believe the majority, if not all, the returns for US equities will be in that first quarter.

So far I have focused much of this paper on my view for equities. However, it is in rates and the dollar that I hear the loudest opinions. In the past five years due to incredibly low volatility in interest rates, macro has been a challenged area for returns. Post-election, it is very hard to find an active manager who does not expect rates to move higher. To be honest, since I came into the markets in 1992, it is normal to hear people calling for higher rates at this time of year. However, this time the chorus is much more vocal because of the Trump victory. Given many managers believe long term rates would not be here absent central bank manipulation, a Trump victory is the long awaited day of reckoning. There is celebrating amongst the macro managers who believe the increased volatility and rising rates means macro is back. Aside from rates volatility, another reason for this excitement was put best in a Financial Times article on December 20th titled *Ray Dalio: Unleashing ‘Animal Spirits’ will be Key for Trump*. It is not just Ray Dalio talking about animal spirits. ‘Animal spirits’ is a phrase which has been used more recently by market participants than I can ever remember. I can agree there will be more volatility for interest rates in 2017 but the hope for bringing back animal spirits to me is just hope. Short term confidence and risk taking is different than changing the long term psychology of people. As much as I want to believe that this will occur, I find this whole belief of going back to the 1980s is just not possible for two main reasons. The first is simply the change in the overall demography of the United States. The median age in the country today is 38 and it was 30 in 1980. The second reason is the reality of the generational shift in who would need to be driving the animal spirits bus. In 1980, the baby boomers were the driver as the age range for them was 15-34. Today, it is 51-70. The replacement animal spirits group is the Millennials. This group is very different than the baby boomers. They live at home with their parents. For the first time in 130 years, adults 18-34 are

more likely to be living at their parents' home than with a spouse. They are starting their lives in debt with huge levels of student debt specifically. From the 2011 census, the median net worth for Millennials in 2011 was \$6,676, while the median net debt was \$45,300. An amazing 81% have some form of long term debt. At the same time they witnessed the Great Financial Crisis and the pain it brought their parents who did not save. This generation is also growing up in the sharing economy, always looking for the lowest price with less interest in ownership. Finally, the election results themselves show this group did not vote for Donald Trump. Approximately 55% of Millennials voted for Clinton while Trump received 37%. If it was only the Millennials who voted, Clinton would have won the election with 473 electoral votes. As a father of a Millennial, depending on *that* group for animal spirits is a reach to me.

It was surprising to me that demography and entitlement reform were not a major part of this election, but because of interest rates, I think it will be critical for the markets this year. If long-term interest rates are lower or even unchanged at the end of 2017, many of the ideas people have entering into this year will be a bad place to be. If you take anything from this paper to include in your thought process for 2017, it would be the question "How will my portfolio do if long term rates are lower this year?" What I find most amazing about the macro managers calling strongly for higher rates, is that most of them already learned this lesson of the difficulties of regaining animal spirits in the 1990s with Japan and Japan Government Bonds ("JGBs"). The structural forces of demography are too powerful for everyone to believe low long term rates are solely about the Fed. We all know Japan's population is shrinking, but then we are headed down a similar path. In terms of population growth in the U.S. for 2016, it was the lowest annual percentage of population growth rate since 1937 during the Great Depression.

Exhibit 1*US Population Growth Rate*

Source: United Nations

As [Exhibit 1](#) shows, it may never get better. If you add in what looks to be peak immigration, this chart may end up being worse. Just the fact that people believe animal spirits can come back despite these structural headwinds means people have not accepted the reality that Japan has accepted. Remember how much money people lost shorting JGBs in the 1990s? As a reminder, when 10-year JGB yields peaked in 1990, the median age of persons in Japan was 37.4 years old. In the U.S. today, the median age is 38 years old. Demographics is one of the arguments used by Larry Summers as he talks about secular stagnation. The person who introduced us to the phrase ‘secular stagnation’ was Alvin Hansen, an economics professor from Harvard. In 1938, he gave a speech to the American Economic Association titled *Economic Progress and Declining Population Growth*. Within this speech, he stated:

“Thus, with the prospect of actual contraction confronting us, already we are in the midst of a drastic decline in the rate of population growth. Whatever the future decades may bring, this present fact is already upon us; and it behooves us as economists to take cognizance of the significance of this revolutionary change in our economic life.”

Remember that 2016 was the lowest population growth rate for the country since the year before Hansen’s speech. McKinsey expanded on this thought about the importance of population

growth on GDP, in one of their great publications titled *Global Growth: Can Productivity Save the Day in an Aging World*.

“Our broad finding is that, in the face of declining population growth that is putting pressure on the pool of available labor, the rate of GDP growth is set to be 40 percent lower than its rate over the past 50 years. To compensate fully for weakening labor growth would require productivity growth to accelerate by 80 percent from its historical rate. Employment growth will decelerate, and peak employment is in sight. Over the next 50 years, growth in employment in the 20 countries is expected to decline from 1.7 percent per annum to 0.3 percent.”

To combine these points of slowing population growth and the current demography, over the next 50 years employment growth will drop by a staggering 80%. On top of the economic problem this brings to growth, there is also the pension liability situation associated with the demographics. As I have mentioned in a [prior paper](#)², I am spending more time with insurance companies and pension funds to better understand their situation and how to help. The reality of the aging process is bringing to surface the fact that, as Citi put it in a report this year titled, *The Coming Pension Crisis*, the world faces a retirement crisis. This is an excerpt from that report:

“How much of a problem is it? According to our estimates, the total value of unfunded or underfunded government pension liabilities for twenty OECD countries is a staggering \$78 trillion, or almost double the \$44 trillion published national debt number. Corporations have also not consistently met their pension obligation and most US and UK corporate pension plans remain underfunded with an aggregate fund status in the US of just 82%.

Social security systems, national pension plans, private sector pensions, and individual retirement accounts are unfunded or underfunded across the globe. Government services, corporate profits, or retirement benefits themselves will have to be reduced to make any part of the system work. This poses an enormous challenge to employers, employees, and policymakers all over the world. In many ways, the math is simple. The solutions are not.”

These are real issues which cannot be forgotten when thinking about how to invest now and in the future. They affect the psychology of anyone depending on these plans for retirement and, given the median age is 38, this is already a real story today. It is possible that for the first time in history, we will hit peak population before some of the debt outstanding matures. Think

² <http://www.gweiss.com/Insights/Going-Outside-The-Imaginary-Box.aspx>

about what that concept means for growth and markets when shorting long term bonds this year. What all of this means to me is that given the sentiment and positioning we should expect early in 2017, we should look for opportunities on the other side of animal spirits. Because of this view on long term rates and growth being held lower, I believe the focus for this year should be on the areas of structural reform and not the belief in returning to a time when the world was younger.

Overall, I expect global equity markets to do well for 2017, with much of the U.S. rally to occur in Q1. I expect rates to peak in the first quarter and the trades to offer the best return-to-risk will be centered on flatter yield curves, a weaker dollar and investments outside the U.S. I also think commodities are stable but not higher, and I think crude will move lower. Despite this expectation of lower crude prices and its outperformance this year, I think the energy sector will do very well again next year. The sector came out of a recapitalization year and should see their earnings headed higher. Unlike the loved financials sector, energy has been the worst performing S&P 500 sector over the last five years. Because of my view on energy and my view on rates, I like MLPs as well. MLPs this year reminds me of 2010 for REITs. I continue to love emerging markets as well, despite all the Trump fears, and see this as a great entry point for the next stage of EM's recent rallies in 2016. Positioning fell considerably for this group following the election, and will be helped significantly if rates stay stubbornly in check. Ironically, for those who believe that Donald Trump's trade views will hurt emerging markets, the likely outcome will be that these countries will come out stronger in the end having recognized the need to reinforce structural reform in order to be less dependent on global trade and commodities. Donald Trump renegotiating trade pacts may help in that process, and should keep governments worried about disappointing their voters.

The concept of structural reform leads to my favorite idea for 2017, which I referenced in my [Hamilton paper](#): Japan. Unfortunately, from an entry point perspective, things have worsened. On the back of the weaker yen from the Trump stronger dollar trade, the Nikkei has moved sharply higher since my paper in October 2016. It's not surprising with the weaker yen from expectations of a stronger dollar going forward that hedge funds have become optimistic on Japan. It is personally difficult to recommend something as a favorite idea with sentiment this high. However, the driving factor for hedge fund optimism is the belief in higher rates and a stronger dollar. But I believe that will change in the first quarter. I believe Japan will be a surprise this year because I expect much higher stock prices and a stronger yen following the end of the first quarter. The reason behind this is similar to why I don't think U.S. rates are headed higher. It is because Japan is ahead of all of us in dealing with its demographic reality by focusing on structural reform rather than trying to focus on growth. An already shrinking population, less global trade, a stronger China and now a Donald Trump presidency has sped up Japan's structural reform and put it ahead of the curve in the global preparation for peak population. This is the year I believe investors start to recognize the significance of these reforms.

The following quote by Abe is from a speech in September 2016 and highlights his focus on demography and the need to be aggressive on reforms for his "third arrow":

Prime Minister Shinzo Abe said Japan's aging, shrinking population was not a burden, but an incentive to boost productivity through innovations like robots, wireless sensors and Artificial Intelligence.... "I have absolutely no worries about Japan's demography," Abe said in a prepared speech at a Reuters Newsmaker event, noting that nominal gross domestic product had grown despite losing 3 million working-age people over the last three years."..."Japan may be aging. Japan may be losing its population. But these are incentives for us," he said. "Why? Because we will continue to be motivated to grow our productivity," Abe added, citing robots, wireless sensors, and Artificial Intelligence as among the tools to do so. "So, Japan's demography, paradoxically, is not an onus, but a bonus."

When Abenomics first started to get investors excited about Japan in 2013, it was driven by what is easy to see; fiscal expansion, monetary policy and inflation targeting. However, as things moved to the “third arrow” of structural reforms, investors became skeptical. It did not help that oil prices collapsed at the same time driving global inflation numbers lower, but it’s also because the benefits of structural reform are not readily apparent in the near term. I think the most important catalyst for Japan and structural reform was the victory for Abe in the July elections. Throughout the world this year, incumbent governments had trouble. Next year we will likely see similar results in France and Germany. There was no global spotlight, relative to Brexit and Trump, but Abe’s win has allowed him to be more aggressive on the reform front in recent weeks. On the labor side, he continues to focus on wages and women in the workplace. Getting the labor force participation rate higher for women has been part of the labor focus, and [Exhibit 2](#) shows the success it has had. On the tax side, there was a recent announcement to make changes to tax rules on controlled foreign corporations. In addition, there were income tax changes regarding spouse’s income deductions which should help. He was also able to pass a pension reform bill on December 14th 2016. As I mentioned in the *Hamilton* paper, tourism is one of my favorite stories in Japan ([Exhibit 3](#)). That was before the recent approval of the casino bill. This is estimated to be a US \$40 billion revenue industry. However, to highlight the potential importance, the pachinko business in Japan had US \$196 billion in revenue in 2015. The Asia gaming pie will be growing each year because of GDP per capita growth and from a distance perspective for gamblers, remember Shanghai is only a three hour flight from Tokyo. Passing the casino bill is a major accomplishment on many levels. On top of the gambling pie is the powerful knock-on effect like real estate demand, conferences and arts events. It’s hard to find someone who wouldn’t like a trip to Japan, and with the Olympics coming up, more and more people will be inclined to go. Go back and read about the impact the 1964 Japan Olympics had on the country. Tokyo plans to make visitors awestruck with what they will see, as evidenced by this statement:

“The Olympic Games is a sports festival, but also it’s a chance to show the innovation of scientific technologies,” says Toshiro Muto, chief executive

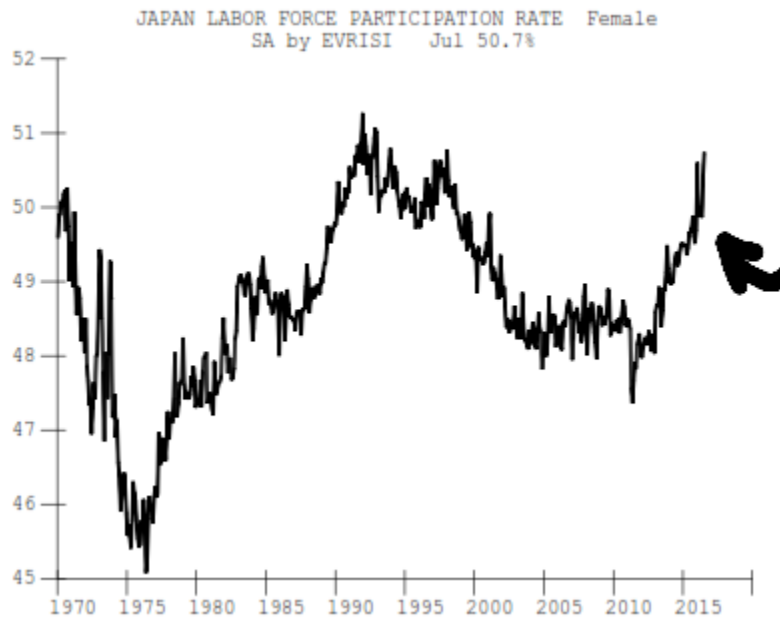
of Tokyo's organizing committee. He says the committee is planning high-tech features like hydrogen-powered vehicles for athlete transportation and smartphone tools to aid tourists. "We have the potential to make this Olympic Games wonderful [and one] that the people of the world are going to admire."

They plan to shuttle people around the city in self-driving taxis. This will be a reminder to all that Japan is one of the leaders in innovation. In addition to innovation, Japan is the leader in dining. Tokyo just won the crown for the city with the most Michelin star restaurants in the world for the 10th year with 227. Third was Paris at 92. Second was Kyoto, so Japan had the first and second. One of the most important trends in consumption patterns is the move to experiential, and Japan is second to none in the customer experience in my opinion. I have yet to meet someone who did not love Japan after they visited.

CIO PERSPECTIVES

Exhibit 2

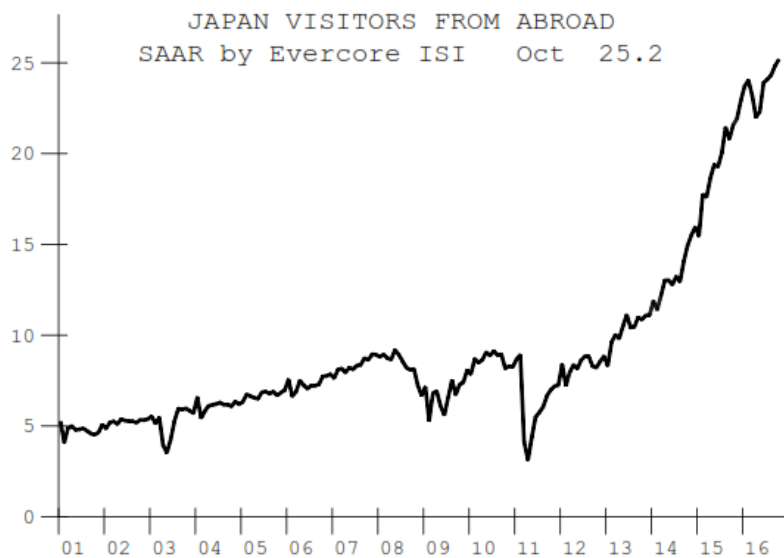
Japanese Women in the Workplace



Source: Evercore ISI

Exhibit 3

Tourism Booming in Japan



Source: Evercore ISI

Another great story from structural reforms is on the private equity side. For years, Japan's private equity market was held back by deflation, a poor economic environment, and a hostile corporate culture. Corporate structural reform is a big part of Abenomics and aside from lowering corporate taxes from 38% to below 30%, in 2014 the government issued a stewardship code and Principles for Responsible Institutional Investors which was based on the U.S. code. It allows for constructive dialogue between companies and investors to maximize shareholder value and return on capital. This has led to activists getting more involved. Last year Dan Loeb of Third Point took a big stake in a Japanese company and stated this would be "one of the most crucial tests for the success of corporate governance reform in Japan." Buybacks, dividends and IPOs continue to grow supporting the story. In addition, demographics are helping, as over 50% of Small and Medium-Sized Enterprises ("SMEs") have CEOs over 65 making succession planning an opportunity. Private equity funds are raising capital. Last month, KKR completed a record buyout in Japan. It was not just the size that was important but the fact that it was in the sacred auto sector.

One of the biggest stories in Japan is how cash rich its companies are today. More than 50% of nonfinancial companies in the Topix are net cash. As a comparison, only 20% of SPX companies and 25% of FTSE companies are net cash. The overall cash in Japanese stocks is about 44% of GDP while in the U.S. it is approximately 11%. Combining the cash with short term securities and the corporate sector in Japan has retained earnings of 125% of GDP. [Exhibit 4](#) shows the corporate profits chart. The cash has been there a long time but what is changing is the desire for companies with the cash to internationalize and bring their proven concept overseas. All this cash and desire by Abe to force companies to think about shareholder value will be reinforced by the Japan Revitalization Strategy of 2016. This corporate focus will be on productivity through the promotion of the "fourth industrial revolution" centered on artificial intelligence, robotics, and big data. All this cash, aging CEOs, an empowered and driven government for change, a focus on improved productivity and already present signs of increased corporate shareholder focused activity makes this a globally unique and combustible situation.

Exhibit 4

Soaring Corporate Profits in Japan

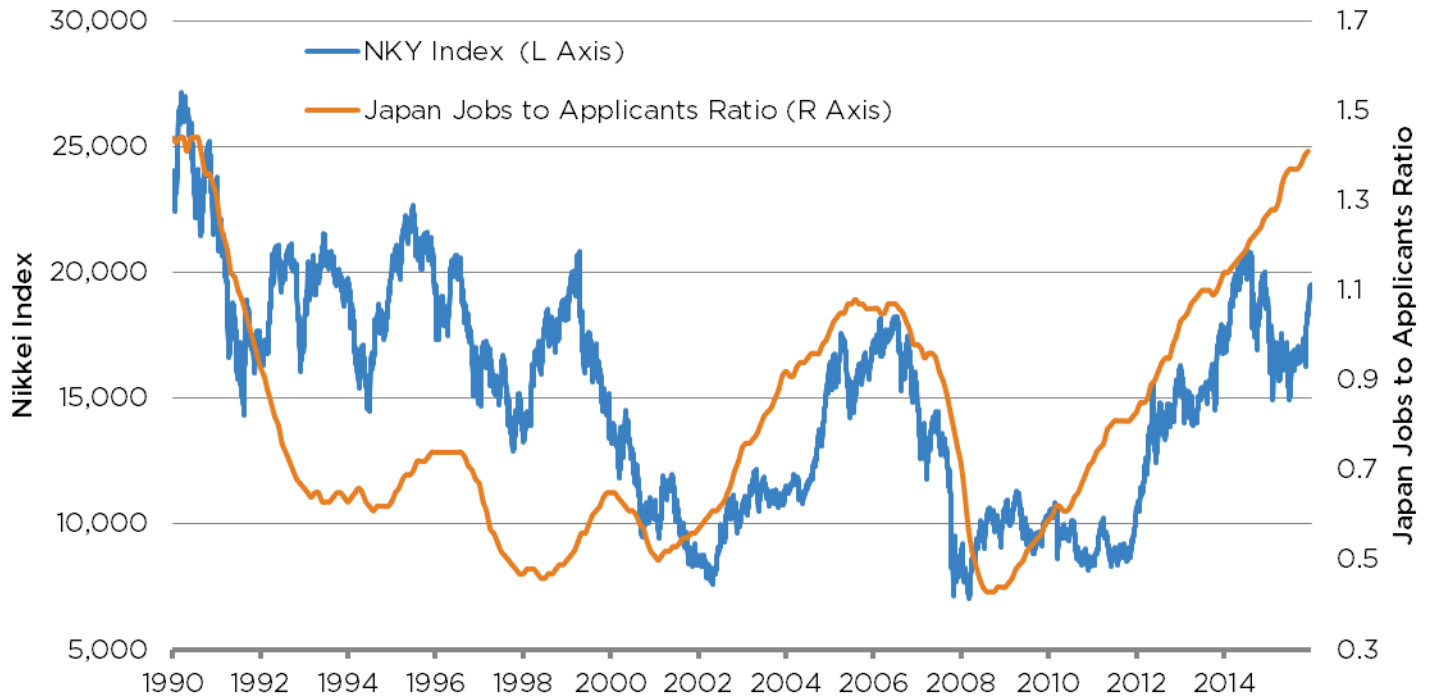
Source: Evercore ISI

From a top down macro structural basis of how Japan looks relative to the world, it starts with government stability. In a world of governments getting thrown out with polarizing politics around immigration and terrorism, Japan stands out as a relative winner. In recent years, it also has been helped significantly in terms of trade. Since 2011, two large components of Japan's terms of trade have improved dramatically. Brent oil has gone from 107 to 55 and the yen has gone from 77 to 117. I continue to believe oil will be headed lower in the years to come. At a minimum it looks to me like a significantly weaker dollar trend is less likely in the future, with Donald Trump's policies and a Fed tightening cycle, so I view these, at a minimum, as no longer being headwinds for Japan. From a valuation basis, the P/E on Nikkei is similar to the SPX. Dividend yields are similar. Buyback yields are lower in Japan but total yield (earnings yield + div yield + buyback yield) compared to corporate yields makes Japanese stocks very cheap relative to U.S. stocks. You continue to have government support in purchasing ETFs currently at about \$50 billion dollars a year. Also, the country's Government Pension Investment Fund is still moving money into domestic equities. They are currently at less than 22% with a target of 25%, or about \$30 billion dollars to buy. In addition to high levels of corporate cash in Japan, cash at the household level at the end of Q2 2016 stood at \$9.1 trillion dollars with negative yields. **Exhibit 5** shows how the relationship to the jobs market to stock returns over time with the Job to Applicant ratio overlaid with the Nikkei back to 1990. Tokyo condo prices are up 10% YoY hitting a 23-year high which will help keep the deflation fears at bay. **Exhibit 6** from Nautilus Investment Research (<http://www.nautilus-cap.com/technical-analysis/>) tells an interesting story which suggests something different in the way local investors are thinking about the market. Recently, the Nikkei was up nine days in a row. They ran this back test to show other times we have seen this, and what is interesting is that from 1990 to 2008, there were no instances of the Nikkei being up for nine consecutive days. All of them were before 1990 and after 2008. The final exhibit,

Exhibit 7, highlights the sentiment through September 2016 put together by Bloomberg. Through September 2016, foreigners had sold more Japan equities than any year since 1987. Technically, although DOW 20,000 gets all the press, Nikkei 20,000 looks far more important of a level. For what it is worth, I see a large Japan outperformance of U.S. equities beginning this year and expect to see new all-time highs in the Nikkei in the next few years, which would mean a 100% increase.

Exhibit 5

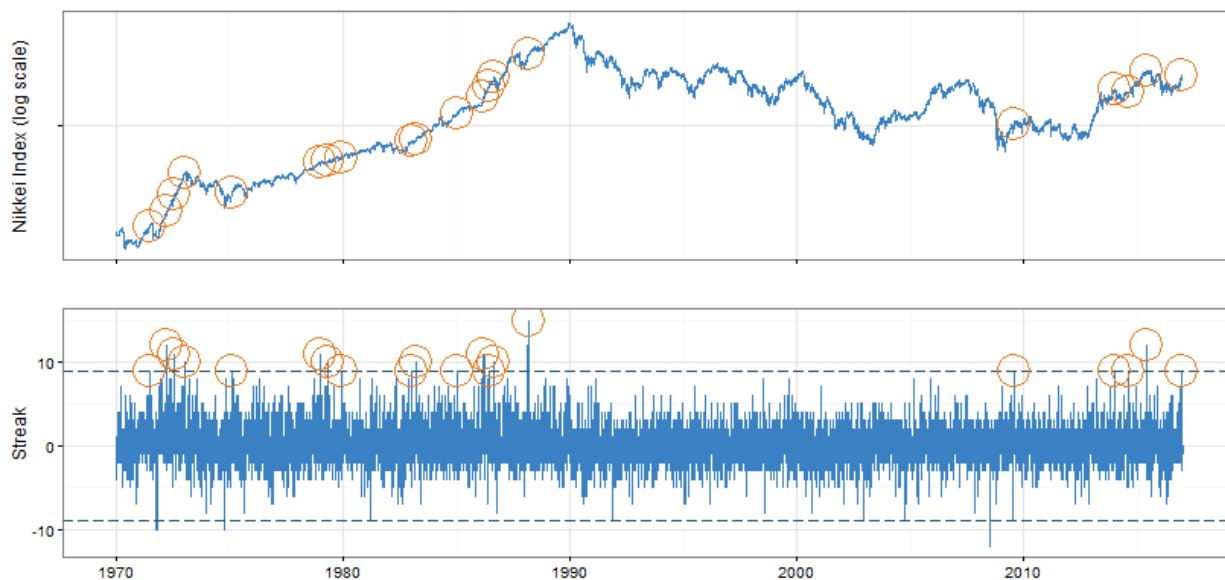
Japanese Stocks vs. Jobs Market



Source: Bloomberg

Exhibit 6

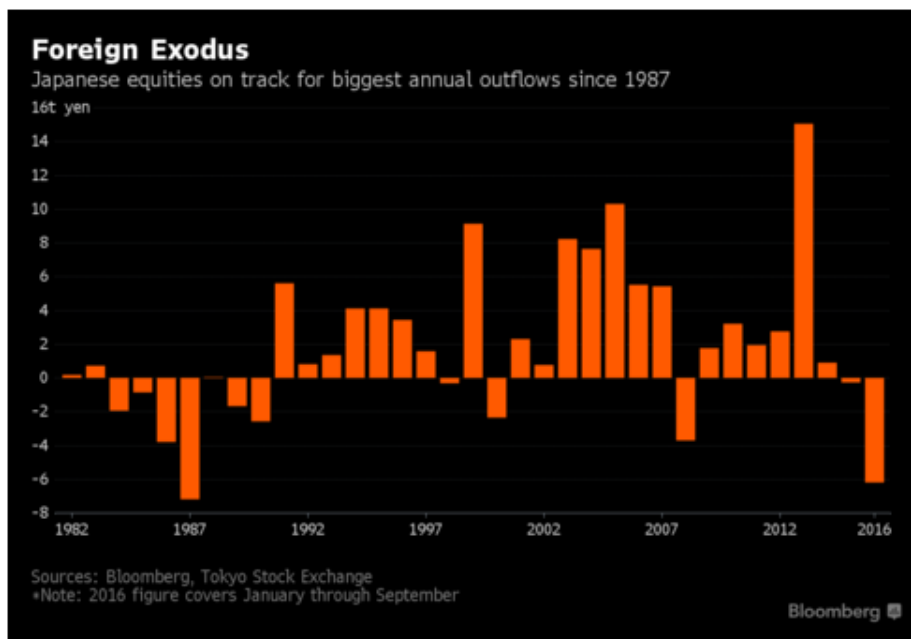
Japanese Equities on a Winning Streak



Source: Nautilus Investment Research, Weiss

Exhibit 7

Foreign Sentiment is Bearish



Source: <https://www.bloomberg.com/news/articles/2016-10-18/global-money-is-fleeing-japan-stocks-at-fastest-pace-since-1987>

Spending time thinking about Japan in recent months has helped remind me about how important it is for us to think about the issues of demographics and structural reform in an aging world. In the excerpt from Abe's September 2016 speech, there is no mention of a focus on trade

or manufacturing or going back in time. It is all about facing the problems of the future with a focus on productivity and innovation. Japan is about the best example I can think of for the concept of “Adapt or Die”. We all like to believe we can waive a magic wand with monetary and fiscal policy and get the animal spirits to come back, but Japan has been an example for 25+ years of how difficult that battle can be. For a short time, I am sure we will see some of the benefits of a shakeup in US politics and increased confidence. But at the same time, the sentiment going in to 2017 is ignoring the reality of an aging world, and seems to be forgetting the unpredictable outcome of 2016. I would be careful about being in the consensus, and to instead look for ideas you won’t find on CNBC every day. In terms of animal spirits, I feel very strongly that people are underestimating the psychological impact of the U.S. getting older. To finish, I will leave you with a reminder of the famous children’s book *The Giving Tree*, to which most of us were read, and which we eventually read to our children. These are some excerpts to highlight what happens to animal spirits as you get older.

*“I want toys. I need money to buy them.”
The boy was so excited.”*

*“I don’t have time to play. I have to work for my family. We need a house for shelter.”
So the man cut all the branches off the tree and left happily.*

*“I am sad and getting old. I want to go sailing to relax myself. Can you give me a boat?”
So the man cut the tree trunk to make a boat. He went sailing and didn’t come back for a long time.*

*“I don’t need very much now,” said the boy.
“just a quiet place to sit and rest.
I am very tired.”*

Happy New Year and all the best in 2017.

-Jordi

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