



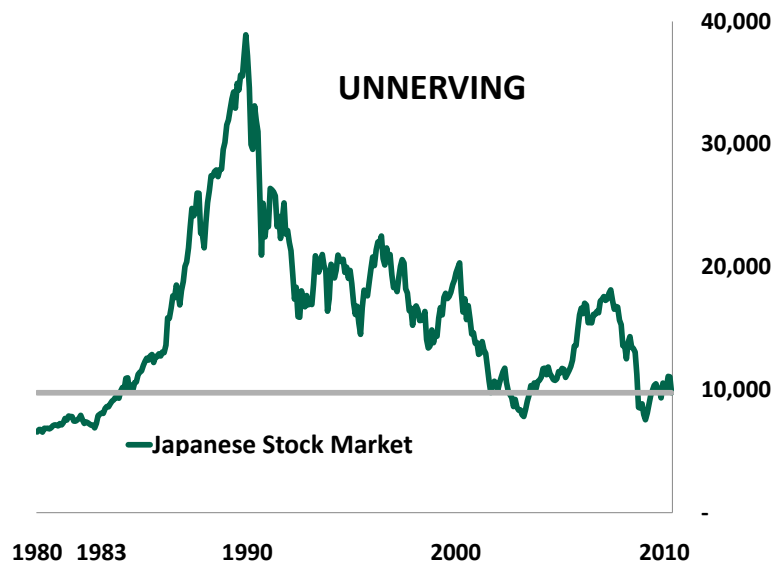
### INVESTMENT POLICY MEMO

June 28, 2010

## LOST

Not long ago, Japan lost a decade. “Japan once invited admiration” said The Economist in a 1998 article, “Now, however, it invites despair, as it fails to escape from the economic stagnation of this lost decade.” Since then Japan has had another dozen years of negative equity returns and real GDP growth of less than 2% annually: another lost decade. In the meantime the US has had its own property bubble burst, which set off a financial crisis. The parallels to Japan’s experience are inescapable. Real estate and banking were central to each collapse. If negative equity returns and economic growth less than two percent define a lost decade, then the S&P 500 stock index loss of 5% and annual real GDP growth averaging 1.6% the past 10 years marked a lost decade for the US. The US is likely to follow Japan and lose the present decade as well.

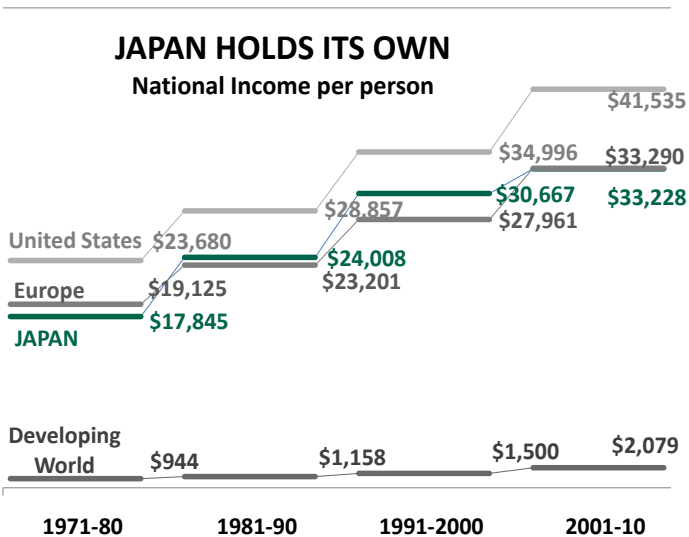
For an equity or property investor, a review of Japan’s experience is unnerving. Japan’s benchmark stock index, the Nikkei 225, peaked in December 1989 at over 38,900; two decades later the index hovers around 10,000 down more than 70% or an average loss of approximately 6.5% each year. The Nikkei first reached the 10,000 level in late 1983 so investors in Japanese stocks have earned close to nothing for the past 27 years. Land values remain more than 50% below their peak in 1990.



Of course, equity prices tell only a small and distorted part of the story. Beyond the experience of investors in stocks and real estate there has been little else that would ‘invite despair’ as The Economist lamented. Through two lost decades Japan has continued to make progress on many fronts, most of them are not usually measured in money although some certainly are.

By 1990 Japan was already one of the world's most prosperous nations. During the lost decades, life expectancy in Japan continued to increase and remained highest in the OECD club of prosperous nations. Infant mortality continued to decline. Increasing proportions of young adults in Japan attended colleges and graduate schools. Japan's remarkably low crime rate declined further. And suicide rates also declined. The United Nation's Human Development Index combines some of these measures along with income growth into a single statistic to measure a country's well-being. Japan's rating has continued to rise in line with other developed nations. This is not all due to what might be considered the softer quality of life measures. Real income per person in Japan has continued to grow as well, helped by minimal population growth. National income per person increased in Japan nearly as fast as in Europe, although noticeably slower than in the United States and far behind the rapid growth in developing countries.

So during two decades widely accepted as having been lost, the Japanese achieved broad improvements in the quality of life. The fall in equity prices and land values continued for twelve years, producing a cumulative loss of 1,500 trillion Yen in wealth (roughly 10.5 trillion dollars at the time or three years worth of Japan's GDP). During the Great Depression (1929-1939) the United States lost wealth equal to about one year of GDP, in part because the decline in asset prices ended after three years. In both situations, businesses responded by reducing investments in order to pay down debt. In the Great Depression this decline in business



spending contributed to nearly a 50% decline in GDP. Japan not only avoided negative real GDP growth but modestly increased its GDP throughout its lost decades primarily by having the government borrow and spend much of the money corporations were not spending. This was done on a far greater scale than the United States in the 1930's.

Japan's policy has caused a rapid increase in government debt from 70% of GDP in 1990 to about 200% today. Because this increase in debt was only about half the decline in

private wealth and debt, Japan's unemployment rate still doubled as businesses in Japan cut back hiring along with investment. Having a job is an important factor in quality of life, although the UN does not include it as part of the Human Development Index. The withering of job skills and increased anxiety and despair that result from unemployment are costly to society as well as the unemployed and their families.

So what are the lessons for the US as a likely second lost decade looms? Government debt is almost certain to rise, but perhaps the US can support higher government debt levels as Japan has done. Certainly we can increase incomes and other quality of life measures in a slow growth environment as Japan did. Lower growth can even mean more sustainable growth as resource consumption and environmental damage are reduced. But Japan's experience with unemployment suggests a serious problem. Already the US unemployment rate is more than double what it was in 2007 and double the rate in Japan.

Macroeconomics was developed as a distinct discipline in the 1930s to find ways of reducing high unemployment everywhere during the Great Depression. Unfortunately, economists, at least those in official positions, seem to have forgotten this and have focused instead on the concerns of the financially and politically powerful. In the wake of the housing crisis, as some of our recent memos have shown, policy makers bailed out banks and financial institutions whose risky actions were responsible for the crisis, while policies directly benefiting homeowners were dismissed with the claim that homeowners could not be helped as they had to be held accountable for their decisions. While policies helping homeowners directly would also have supported the banking system, supporting banks has done nothing to help homeowners. Unemployment is already a significant problem in the US, yet few are advocating a public policy response aimed directly at hiring people.

On the contrary, many are calling for reduced taxes on businesses. Businesses do not need additional tax cuts anymore than a drunk needs another drink to get his car started. Not only is business benefiting from rapidly falling cost pressures and low interest rates, executives have for the most part been expert at cutting costs in response to the short-term incentive structure that determines their rewards. Having stripped company balance sheets of tangible assets in prior decades, managements have spent recent years cutting costs such as research & development, training programs and investment spending. The pattern is clear. Any expense directed at increasing the long term value of a business is cut. It is no surprise that the same business executives and corporate boosters propose tax cuts that would lead to lower spending on roads, bridges, education and other investments to enhance our future.

Now, on top of the previous cost cutting, companies have responded to the financial crisis by rapidly reducing payrolls. From an individual business perspective this has led to record profit margins, surging output per worker, and all-time high earnings expectations for US stocks in 2011. For the economy as a whole, it leads to a classic fallacy of composition: what is good for individual companies when done by all companies leads to falling revenues, more cost cuts and an ongoing downward spiral, or more concretely, rising unemployment.

Here is a straight forward proposal for economic policy makers. There is a simple lesson to learn from Japan to help the US avoid another lost decade. Focus on employment. When banks do not want to lend, the government is the lender of last resort. When businesses do not want to borrow, the government is the borrower of last resort. Now, when corporations do not want to hire, the government should be the employer of last resort. It has been done before, in

1933 the CWA created four million jobs in three months. If there are more jobs, businesses will do just fine. We all benefit when everyone who is willing and able to work has a job.

We repeat that all of this gloom for Main Street does not necessarily translate into the equivalent for Wall Street. Since our last memo however, global stock markets have succumbed to the risks that are increasingly likely to affect them as well as Main Street. In particular, the crisis in the European Monetary Union (EMU) has been correctly perceived as a large and long-term threat to the global economy and financial markets. On the one hand, the EMU and the broader political coalition represented by the European Union have no capacity to enforce budget discipline on any country in Europe or to enforce a system of relief payments from wealthier countries to those in greater distress. Countries like Greece or even Spain are unlikely to achieve the fiscal targets mandated by the EMU in the face of understandably severe political opposition.

On the other hand, it is nearly impossible to imagine how Greece or Spain could leave the EMU without even worse chaos and disruption. So we are left with the prospect of Europe, as large or larger than the United States by most measures, literally disintegrating, but at a slow pace over many, many years. Of course Europe will not suffer alone. Weakness in the Euro and in European growth will affect every other country in the form of weaker exports as well as the global impact of a once again severely impaired system of bank lending in Europe. At the same time, partly as a result of the Europe-centered sovereign debt crisis, popular support is increasing across the world for those who would very mistakenly implement spending cuts and tax increases.

In response to these developments, we have substantially reduced exposure to stocks in client portfolios over the past few months. Proceeds from these sales have gone into cash and to a lesser extent into bonds, which have already done quite well but would still benefit if a renewed recession or a deflation were to take place. The stocks we retain are largely concentrated in the United States and Japan. We maintain a modest exposure to most sectors. Our largest group of investments are in information technology which continues to grow in a sluggish economy by taking increasing shares of advertising, retail, financial and other transactions as well as corporate investment and consumer durable expenditures.

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