



The Last Shogun

Japan has been ruled by the Yamato dynasty for nearly 2,700 years, the longest continuous monarchy in the world. From Jimmu to Akihito, 125 emperors have held the Chrysanthemum Throne. But while the emperor has always been the titular ruler of Japan, he has not always held the ruling power. For more than 250 years beginning in 1603, the Tokugawa families were the true power in Japan.

Ieyasu Tokugawa consolidated power by creating a working balance between powerful families (the *daimyo*) and a centralized government. The *daimyo* controlled their respective semi-autonomous regions while conceding ultimate authority to the Tokugawa rulers in the city of Edo. The emperor remained in his palace in Kyoto, but Edo became the seat of government.

Part of the socio-political balance struck with the *daimyo* was to freeze social mobility. The four classes—warriors (*samurai*), landowners, artisans and merchants—were not permitted to marry outside their class, and the peas-

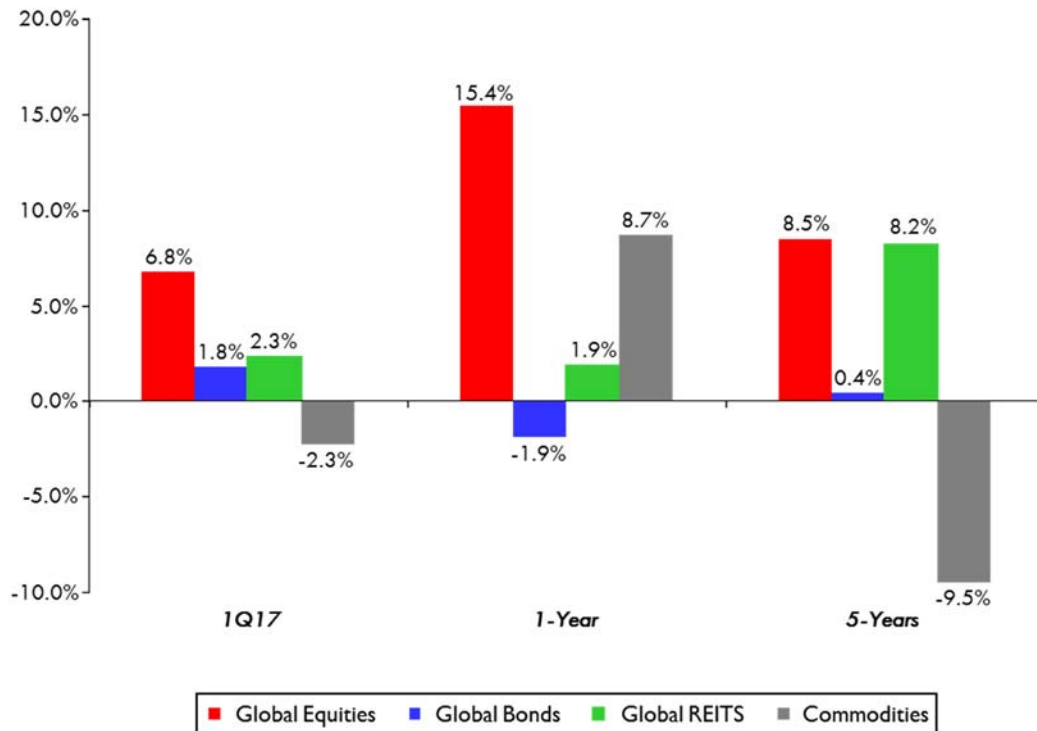
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Chart 1 Capital Market Performance



ants, who made up 80% of the population, were required to work the land. This arrangement pleased the *daimyo*, as it protected their favored positions, and over time, Japan grew richer. But much of the new wealth was created by the merchant class, and the samurai and landowners, whose incomes were tied to agricultural production, saw their relative wealth fall. By the time Commodore Perry brought his Black Ships into Edo bay in 1853 to force Japan to grant trading rights, the social fabric was fraying, from peasant revolts to demands from the *daimyo* to curtail the wealth of the merchants. Perry's cannons shook Japanese society, demonstrating how far behind Japan was to the rest of the world. In the ensuing years, Japan was forced to grant further concessions to the Western powers, extracting more wealth from the *daimyo*, who began to agitate for an overthrow of the Tokugawa dynasty in favor of direct imperial rule.

American gunboats exposed Japan's technological weaknesses, but also brought to the surface the latent tensions in its society. Japan's economy was prosperous, but its social fabric was unraveling, leading, in time, to a political upheaval.

Parts of the Western world today are in the throes of social turmoil and political unrest, turning to populist saviors to restore a more just order. In the mid-19th century, the Tokugawa dynasty faced its greatest challenge to its 250-year rule. A wise and powerful ruler was desperately needed to ensure the dynasty's survival. A leader who would institute the necessary economic and political reforms to address the grievances of a growing number of both peasants and samurai, and re-build the family's military power. Fortunately, such a leader was found.

Much of the “Trump bump” — higher stock prices, higher bond yields, higher dollar—reversed in the first quarter of the new year. Stocks were the exception to the correction, although the weaker dollar helped non-US markets to outperform. India, Spain and Hong Kong all posted mid-teens gains in the quarter. Bahrain jumped 18%, although its near-neighbor Oman fell 10%, the worst in the world. Best of all in the quarter was Argentina,

soaring 35%, placing its one-year gain of 30% as best of all markets. At the bottom of the one-year ranking is Ghana, off 31%, probably because the price of its chief export, cocoa beans, is down about the same (Chart 2). Good news for chocolate connoisseurs, but vanilla lovers are not so fortunate: a major storm wiped out most of the Madagascar crop, sending prices 200% higher (Chart 3).

Chart 2 Cocoa Beans, 2015-2017



CCN7 Comdty (COCOA FUTURE Jul17) Daily 06May2012-05May2017
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Chart 3 Vanilla Beans, 2015-2017

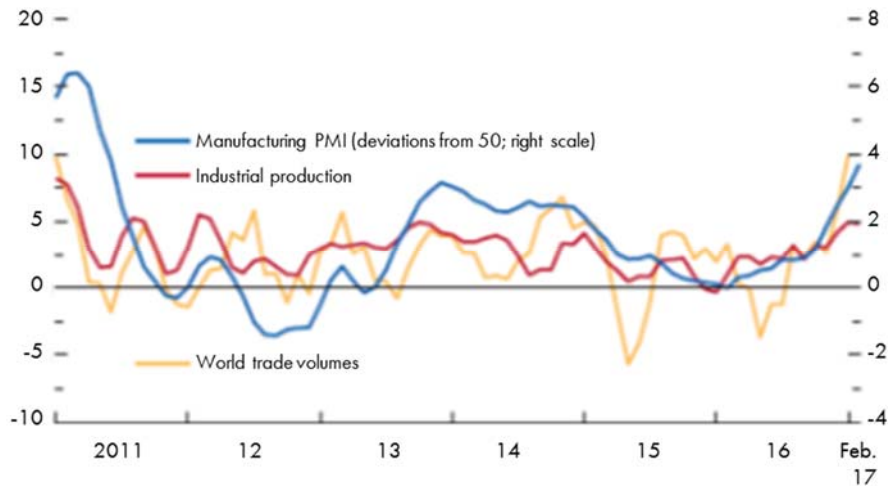


VNBOTAM1 Index (Vanilla Whole Black (FOB-Tahiti)/Spot Flat) Daily 05MAY2015-05M
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The buoyancy of the equity markets mirrors the global economy, where macro risks are down and the data are heading higher. Trade, industrial production and

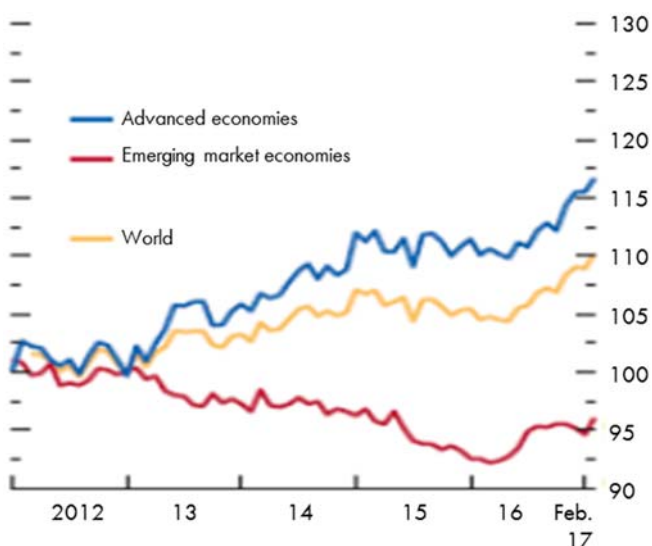
manufacturing are all advancing (Chart 4), as is consumer confidence, especially in the developed world (Chart 5).

Chart 4 World Trade, Industrial Production, and Manufacturing PMI
(Three-month moving average; annualized percent change unless noted otherwise)



Source IMF, WEO April 2017

Chart 5 Consumer Confidence (Index, 2010 = 100)



Source: IMF, WEO April 2017

Economists will cite future concerns over rising corporate leverage in the US, approaching previous highs (Chart 6). Costs of servicing that debt remain below historical averages, but are rising much faster than the pace of interest rates (Chart 7).

Rising leverage seems to be of greater worry in China, where debt is growing at a historic and ominous pace (Chart 8). Rising leverage, by corporations and governments, is indeed a concern, but a worry for the future. Today the data are positive, and nowhere is the current strength of the economy better seen than in the employment data.

The unemployment rate fell to 4.5% in the first quarter, the lowest in a decade. New payrolls averaged about 180,000 per month, in-line with the pace of the past year. Over the last year, the labor force expanded by 1.4 million new workers, but with 2.1 million new jobs created, the unemployment rate fell. Other components of the broad employment data show similar strength: initial jobless claims fell to the lowest level since 1973, when just 85 million people were in the labor force

Chart 6 Net Leverage of S&P 500 Companies
(Ratio of net debt to EBITDA)

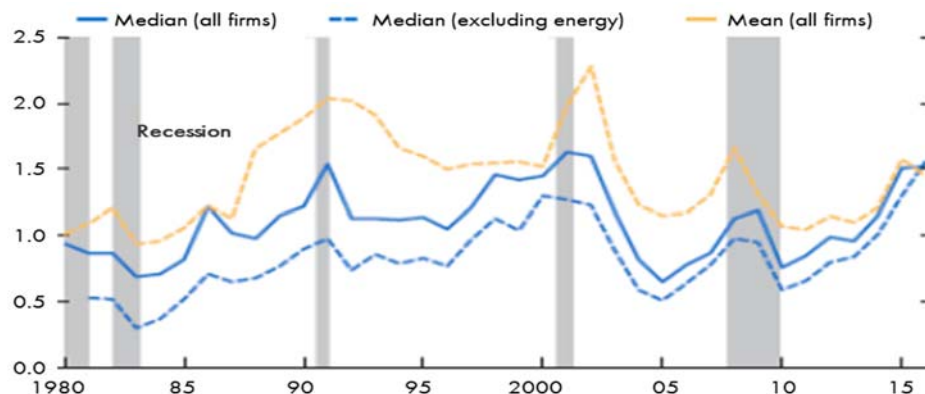


Chart 7 Corporate Debt Service and Interest Rates

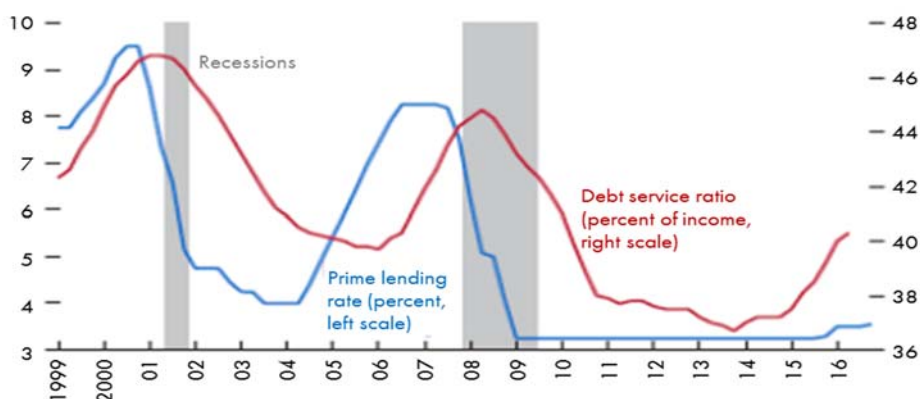
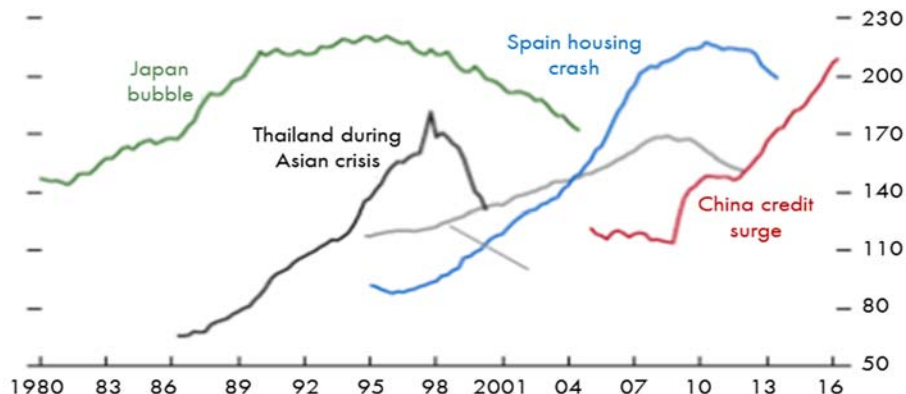


Chart 8 Fast Credit Growth and Past Major Crises
(Percent of GDP)



Source for above charts: IMF, GFSR, April 2017

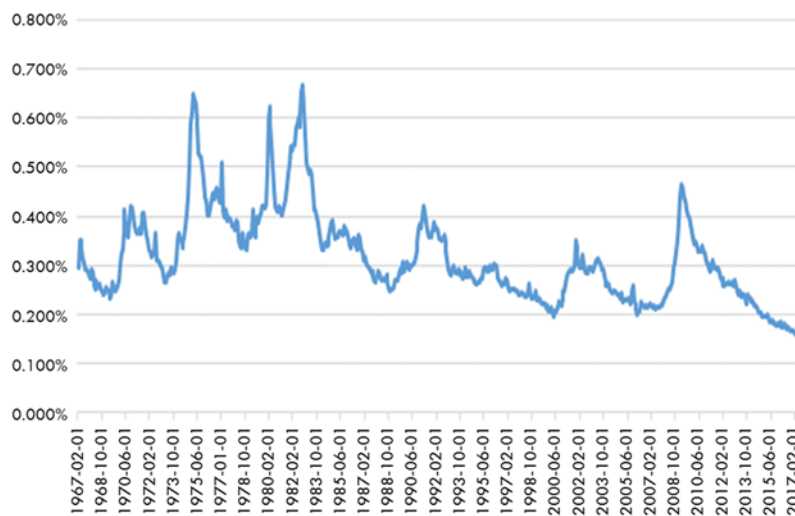
versus 153 million today (Chart 9). The BLS' Job Openings and Labor Turnover Survey ("JOLTS") shows the hiring rate and quits rate the highest in a decade, the job openings rate near an all-time high, and the firings rate at a new record low.

This is all excellent news, and the US labor market can safely be characterized as at full employment. But

that's really not the full story, and there are two troubling trends over the past few decades that mar the rosy employment picture. The first is labor's declining share of national income, which has been falling for the past four decades (Chart 10).

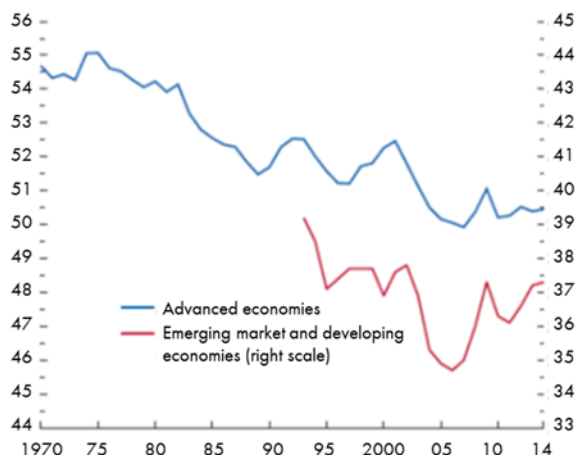
The implication of this trend is that gains in wages lag productivity growth, and there are two ways for that to occur. The favorable path is through strong gains for wages and even more for productivity. Sadly, it is the second path we find in most economies: weak growth in productivity, and even weaker gains in labor's share of national income.

Chart 9 Jobless Claims as Pct Labor Force, 1967-2017



Source: U.S. Department of Labor

Chart 10 Evolution of the Labor Share of Income (Percent)

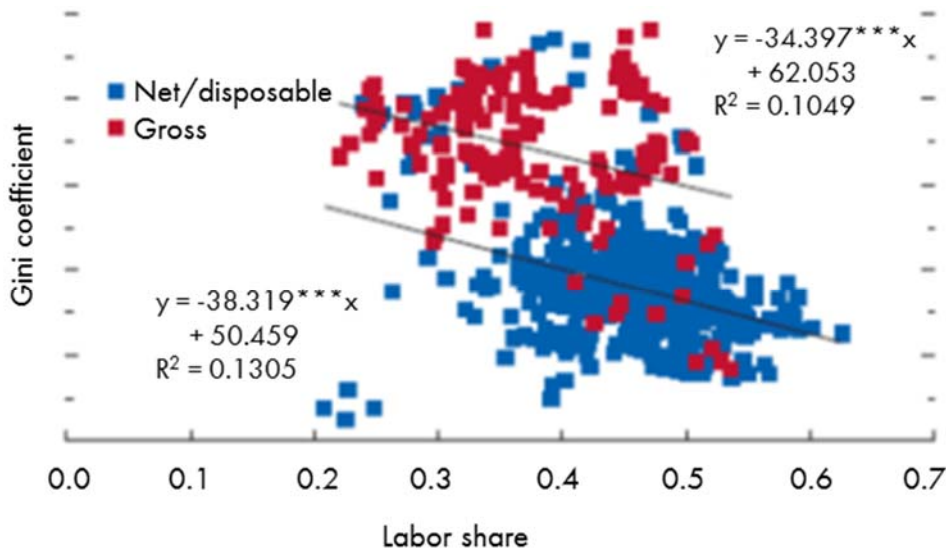


The labor share of income has been on a downward trend in both advanced economies and emerging market and developing economies.

Source: CEIC database; Karabarbounis and Neiman (2014); national authorities; Organisation for Economic Co-operation and Development; and IMF staff calculations.

Note: For advanced economies the figure shows averages weighted by nominal GDP in current U.S. dollars. For emerging market and developing economies the figure shows year fixed effects weighted least squares regressions (using nominal GDP weights) that also include country fixed effects. Year fixed effects are normalized to reflect the level of the labor share in 2000.

Chart 11 Labor Shares and Income Inequality

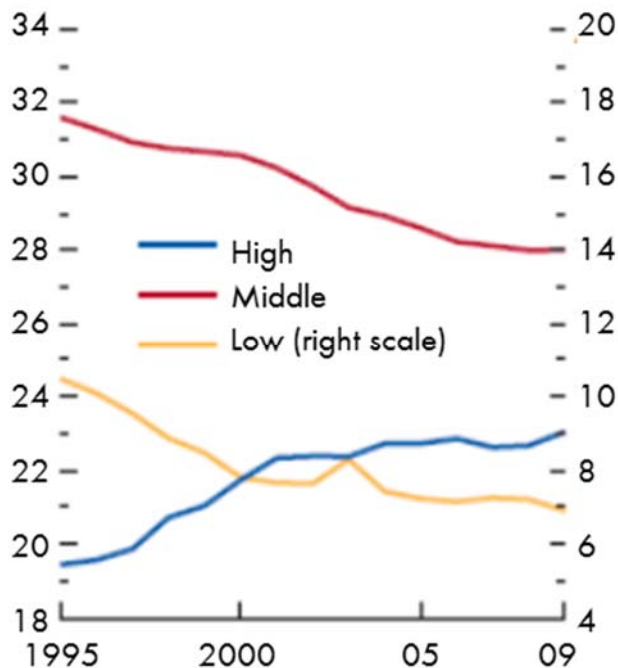


Source: IMF, WEO, April 2017

Coincident with this income share decline is a rise in income inequality (Chart 11), and it's likely the two are linked. The loss in income share has been most pronounced among middle-income earners (Chart 12). Additionally, capital ownership is concentrated with high-income earners, and as capital's share of national income rises, income inequality is exacerbated. There is evidence tying income inequality with lower economic growth, which magnifies inequality, and so forth, risking a turn to protectionism, which further retards growth. In-

come inequality may be a moral challenge, but it's also an economic one.

Chart 12 Labor Share Evolution in AEs



Source: IMF, WEO, April 2017

The second stain on the employment picture is the low participation rate, that is, the percentage of the population in the labor force. We would expect this percentage to decline as the population ages, and this is what we find. But demographics aside, we see a worrisome drop in prime-age workers (ages 25-54). Over the past decade, the percentage of this group in the labor market has declined 1.8%, or about two million prime-age people who are not working or looking for work. They represent reduced economic output, but also much more than that.

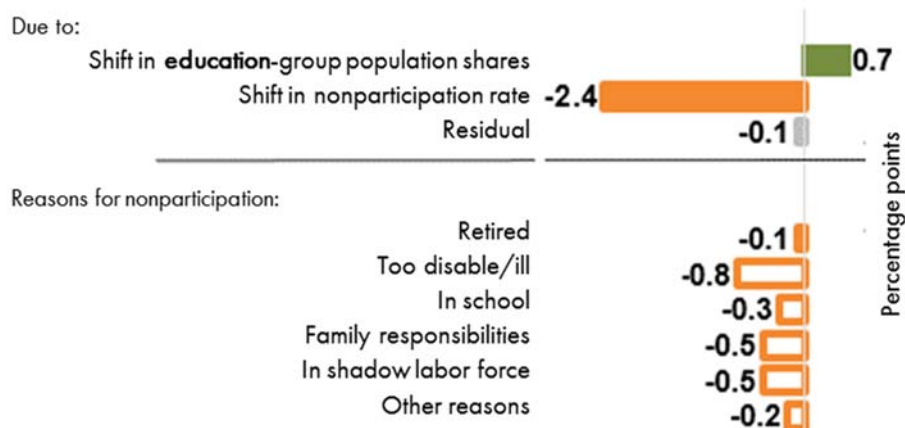
Many in this group have decided to stay in school, but that's accounted for in the data (Chart 13— education attendance rose by 0.7%, offsetting a 2.4% fall for other reasons, thus netting the 1.8% decline in the prime-age participation rate). The biggest reason cited by prime-age workers for dropping out of the labor force entirely is health/disability, which rose from 4.6%

of the population in 1999 to 6.1% at the end of 2016. Ageing accounts for only about one-third of this rise in disability, as we see disability higher across all age groups.

Trade and technology have been cited by some as explaining the loss of jobs and prime-age workers dropping out of the workforce altogether. But the decline in the participation rate in

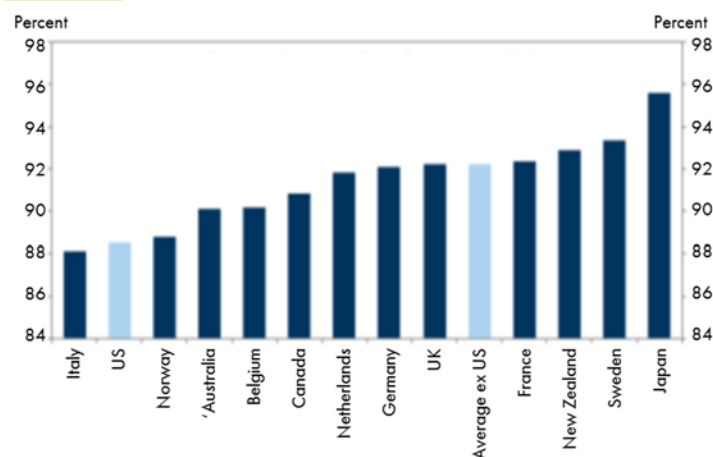
the US has been much more severe than in other advanced economies, which are also subject to disruptions from trade and technology. The US has the second lowest participation rate among developed countries (ahead of only Italy— Chart 14), and this is true for both men and women across all age groups.

Chart 13 Behind the Decline in Prime-Age LFPR, 2007-16



Source: Current Population Survey, BLS, Atlanta Fed calculations

Chart 14 Prime Age Male Labor Force Participation in 2016



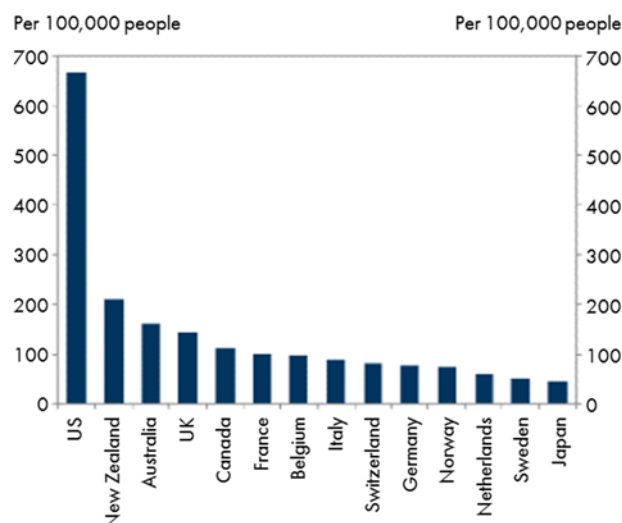
Source: Haver Analytics. Goldman Sachs Global Investment Research

Part of the explanation for the low participation rate in the US is our propensity to incarcerate people (Chart 15). It's not just the more than two million in prison and another nearly five million currently on probation, it's the cumulative numbers that are striking. Approximately 20 million men, about one in eight adults, have a felony conviction in their history, and it's a lot harder to find work with a felony conviction.

The other glaring contrast in the United States is the rise in mortality rates for non-Hispanic whites, even as other

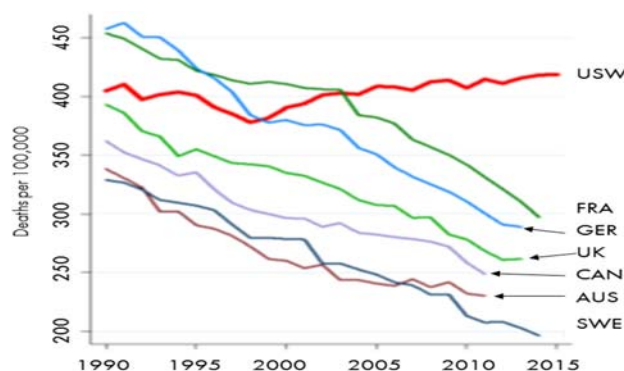
countries have seen steep declines (Chart 16), as Anne Case and Angus Deaton of Princeton have documented. Nearly half of all prime-age men who are not working, about seven million in total, are taking a daily pain medication. Especially stark is the steep increase in drug, alcohol and suicide mortality among middle-aged whites, an epidemic that has spread from the Southwest to Appalachia to across the country, in rural and urban areas alike (Chart 17).

Chart 15 Prison Population Rate, By Country



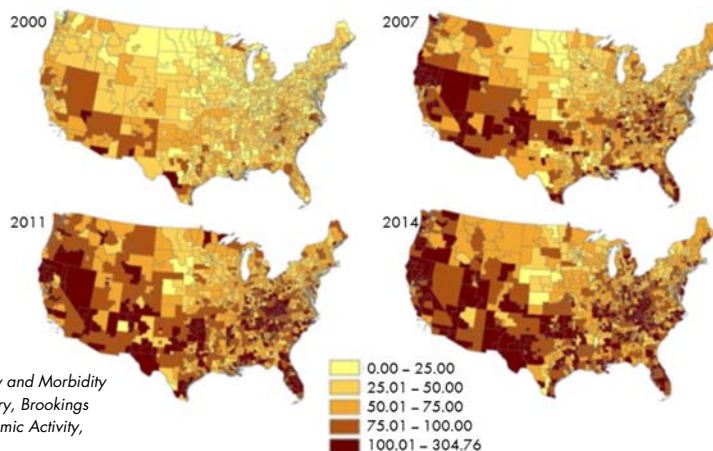
Source: World Prison Brief, Bureau of Justice Statistics.
Goldman Sachs Global Investment Research

Chart 16 All-cause mortality rates ages 45-54



Source: Mortality and Morbidity in the 21st Century, Brookings Papers on Economic Activity, March 2017

Chart 17 Drug, alcohol and suicide mortality, White non-Hispanics ages 45-54



Source: Mortality and Morbidity in the 21st century, Brookings Papers on Economic Activity, March 2017.

Most measures of economic well-being today are encouraging: job growth, industrial output, consumer confidence, stock prices are all at or near record highs. But widening gaps in wealth and income, health and mortality, are tearing our social fabric. In response, large numbers agitate for a leader who will reverse the tides of disorder and restore balance in society. One hundred fifty years ago, Japan faced a similar test.

Yoshinobu was born in 1837, son of the *daimyo* of Mito, one of the families eligible to be selected as shogun. He was groomed for this role by his father, steeped as a boy in the literary and martial arts and in the ways of governing. When the boy reached his teenage years, his father arranged to have him adopted by the Hitotsubashi family, then ruling Japan, as a way of increasing the odds that Yoshinobu would one day be selected shogun.

In 1858, the shogun died, and a political battle for succession ensued. Yoshinobu was passed over for an infant, enabling the ruling council to continue in power as regent. Yoshinobu withdrew, but political and social tensions throughout Japan grew. Peasants revolted, and the *daimyo* agitated against the growing trade concessions to foreigners. When the boy shogun died in 1866, the families turned to Yoshinobu to defend the Tokugawa dynasty.

He began immediately to enact reforms, granting greater political power to the *daimyo*, improving literacy and rights for the peasants, and turning to the French to modernize the army. All were positive developments, but failed to satisfy the most radical samurai, who sought the end of the Tokugawa dynasty and the elevation of the Emperor as the sole political leader of Japan. When a group of samurai seized the Kyoto palace in 1868 and announced the restoration of direct imperial rule, Yoshinobu chose not to thrust the country into civil war, and resigned.

But supporters of the Tokugawa dynasty refused this decision, forced Yoshinobu to remain as shogun, and took up arms against the rebellious samurai. War ravaged the country for eighteen months, until Yoshinobu, again, stepped forward to end it. Emperor Meiji was restored to sole power in Edo, which was then renamed Tokyo ("Eastern capital"), and Yoshinobu was banished to Shizuoka province.

The Tokugawa elite missed an opportunity to install an enlightened leader in 1858, when Yoshinobu may have pushed through the necessary political and social reforms to preserve the Tokugawa dynasty. They failed to acknowledge, or appreciate, the growing tensions in Japanese society, pursuing only their narrow self-interests, turning to Yoshinobu only when it was too late.



When the ruling elite ignore the growing divisions and tensions in society, they risk not only their own interests, but threaten the basic cultural order, which is failing more and more people.

The Meiji Restoration succeeded in modernizing Japan. Universal education was provided.

ed, with an emphasis on Western learning. The first railroad in the country was built in 1871, a bicameral legislature (Diet) was created in 1889, and foreign concessions were re-negotiated. The Meiji Restoration also militarized Japan. Universal conscription was implemented, and victory over Russia in the 1905 war marked Japan's entry as a world power. This militarization continued to build in the decades ahead, eventually entirely engulfing the country as it sought to conquer half the world. The process that began in 1869 ended in 1945 with two atomic bombs.

Yoshinobu spent his years as an accomplished painter and photographer. In 1902, he was given the title of prince, and invited to serve in the upper house of the Diet. He died peacefully in 1913. The history of Japan, and of the world, may have been different had the ruling elite turned to Yoshinobu earlier. He was to be Japan's last shogun. It was a missed opportunity for the Tokugawa dynasty, and for the world, and a lesson for elites everywhere.



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