

THE STRONG YEN, THE WEAK DOLLAR, A SHAKY WORLD

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“Danger always strikes when everything seems fine.” From the movie “Seven Samurai” (Akira Kurosawa, director; 1954)

CONCLUSION

The Japanese Yen has remained powerful relative to other currencies “in general” since autumn 2010. On an effective exchange rate basis, as well as against the United States dollar in particular, the Yen is around major resistance. However, the Yen probably will advance further over the next several months. Though many intertwining variables influence currency levels and trends, the fragility of the current worldwide recovery and the continuation of the global financial crisis that erupted in 2007 will play a key role in the continued Yen rally.

Assume America resolves its current battles related to the federal debt ceiling. Proposals likely to be enacted, though representing progress in cutting deficits over the next decade, are modest. In addition, these Washington fiscal fixes will not be significant in relation to the scope of the underlying long run deficit problem. Therefore, any Yen weakness derived from short-term solutions of United States fiscal deficit issues probably will be temporary.

EARTHQUAKES AND YEN ASCENTS

Japan’s March 2011 earthquake and nuclear disaster encourage theories regarding bringing money back home to Japan. Many recall the Yen surge for several months after the Kobe earthquake of mid-January 1995. On an effective exchange rate index basis (using Bank of England statistics; monthly averages), the Yen rallied about 15.6 percent from January 1995 to April 1995.

The Yen effective exchange rate crumbled sharply thereafter, falling about 37.2pc to its August 1998 bottom. Observers therefore should be cautious in the current environment regarding forecasting further Yen advances from this natural disaster perspective alone. As was the case prior to the 1995 earthquake, the Yen was already strong prior to March 2011.

Anyway, data so far does not indicate Japan currently is repatriating a noteworthy amount of funds due to its March 2011 tragedy. Japan is a major holder of US Treasury securities; look at US Treasury TIC data (major foreign holders of Treasury securities; 7/18/11). Japan held \$886 billion in January 2011 and \$912bb in May 2011, the most recent month. Though this increase is not substantial, it does not reveal a race to bring money back home to Japan. One of course can conjecture that derivatives and other hedging transactions indirectly have accomplished this transfer.

What about international transactions in securities from “major designated investors” (Japan’s Ministry of Finance statistics)? These statistics extend to recent weeks. They do not display Japanese carting of significant money back home via noteworthy net sales of foreign equities, bonds and notes, or money market instruments. One therefore should assess additional factors to explain recent Yen strength and potential for further rallies.

EUROPE, SOMEWHAT IN DESCENT

Problems elsewhere indeed encourage Yen rallies. Over the past year or two, the various episodes of the European sovereign debt (and banking) crisis have encouraged some players to reduce or abandon many European marketplaces (or to establish short positions in them). Or, troubles in the so-called peripheral countries of Greece, Portugal, and Ireland- and also in Spain and perhaps Italy- have inspired others to put their new (incremental) funds elsewhere. Yet arguably sovereign debt and fiscal deficit problems for Europe as a whole are not as bad as Japanese ones.

But even in the intertwined economic world, the ongoing big European problems from the Japanese viewpoint (relative to Japan) look relatively confined (“merely European”). According to the International Monetary Fund, the direct exposure of Japan’s banks to some of the peripheral European countries “is very, very small, about 1 percent of total bank assets”. (Transcript of teleconference call on its Article IV consultation with Japan; 7/19/11).

COMPARATIVE DECADENCE: US+JAPAN

Let’s focus on the United States in relation to Japan. Doesn’t Japan have some problems and policies rather comparable to American ones?

The long-running US Federal Reserve money printing festival, particularly the easing round that ended in June 2011, undermined the broad real trade-weighted dollar (“TWD”). So has its sustained regime of very low interest rates. But even if Japan arguably has not matched the Fed’s quantitative easing efforts, it likewise has long maintained an accommodative monetary policy.

Both the Federal Reserve and the Bank of Japan have been keeping short term government interest rates at ground level. Compare US 10 year Treasury rates versus the Japanese Government Bond (JGB). Nominal interest rate differentials further out the yield curve favor the US dollar. Look at a couple of key past points. The UST high on 2/9/11 was 3.76pc, with the JGB top on 2/16/11 at 1.36pc. The US 10 year government made a low at 2.33pc on 10/8/10, above that of the 10/7/10 JGB low at .83pc.

What about deficit debacles? From some vantage points, the magnitude of Japan’s difficulties surpasses those of the United States.

The International Monetary Fund’s recent “Spillover Report” on Japan (2011 Article IV consultation; dated 6/29/11, released July 2011; p20) speaks of Japan’s “currently unsustainable fiscal trajectory”. The “2011 Spillover Report- Selected Issues” stresses the risk of higher interest rates to debt sustainability projections (p26). Yet many wizards forecast major problems for the United States if it does not get its fiscal affairs in order. It too faces the danger of higher interest rates.

See the IMF’s “Fiscal Monitor Update” for overall fiscal balances as a percent of GDP. The Japanese and American deficits are fairly close according to that measure. Japan’s 2010 deficit was 9.6 percent, that for 2011 10.5pc; the forecast one for 2012 is 9.1pc. The US deficit in 2010 was 10.3pc. That for 2011 will reach 9.9pc, with 2012 at 7.8pc. Compare Japan and America’s with those for the world as whole: 2010’s deficit was 5.5pc deficit, 2011’s 4.6pc, and 2012’s 3.7pc. (June 2011; Table 1, 6/17/11).

The IMF’s “Fiscal Monitor” of April 2011 supplies information in addition to that of the June 2011 “Fiscal Monitor Update”. Though revisions eventually may alter the April 2011 statistics

somewhat, take them as a guideline. Look at general government gross debt as a percent of GDP (Statistical Table 7, p127). For advanced nations, those levels were 79.2 percent in 2008 (amid the financial crisis) and 96.6pc in 2010; they mount to 101.6pc in 2011 and 103.7pc in 2012. Japan's are much higher than average. Japan's gross debt as a percent of GDP was 195.0pc in 2008 and 220.3pc in 2010 (Greece's was less, 142.0pc in 2010). The IMF forecast Japan's will edge up to 226.1pc in 2011, reaching 250.5pc in 2016. These far exceed US levels. Note America's 71.2pc in 2008 (and 62.2pc in 2007). Debt grew to 91.6pc in 2010. The IMF predicts further US boosts: 99.5pc for 2011, with 102.9pc in 2012, and 111.9pc in 2016. One also can compare countries from the net debt view.

The IMF's general government net debt summary (Table 8, p128) shows a similar noteworthy difference between the US and Japan. For example, that in 2010 for the US was 64.8pc (the same for the advanced nations combined), whereas Japan's was 117.5pc. Net US general government debt rises to 72.4pc in 2011 and 85.7pc in 2016. Japan sustains a notable margin above the US, with levels of 127.8pc in 2011 (the more recent IMF Article IV consultation indicates that 2011's will be 130.0pc) and 163.9pc in 2016.

What about comparative real GDP growth? Maybe the US is hitting some of those dreaded headwinds now, which could cause some downward revisions regarding future growth. But in rough terms, the US growth horizon appears at least as good as Japan's. Use the IMF's "World Economic Outlook Update" as a benchmark (6/17/2011, Table 1). IMF gurus declare US GDP will increase 2.5pc in 2011 and 2.7pc in 2012. Japan slumps .7pc in 2011 (earthquake), but grows 2.9pc in 2012. The IMF recently forecast the fiscal cost of Japan's earthquake at two to four pc of GDP spread over several years (IMF Article IV consultation with Japan, 7/19/11).

CREDIT AND CREDIBILITY

To some extent, Japan's in much better shape than America. The foreign exchange cross rate between the Yen and the US dollar partly reflects this.

Besides, there's more to US dollar weakness than its relative unattractiveness relative to the Yen. The Japanese Yen strength (on both a Yen effective exchange rate and cross rate versus the dollar basis) partly reflects the broad real trade-weighted ("overall"; TWD) dollar's overall feebleness.

US policy makers preach their desire for a strong dollar from time to time. Their practices over many months, however, underline their desire for (or at least toleration of) a rather weak TWD. The weak dollar policy may help to boost growth and reduce unemployment, right? Don't many developing nations want their home currency to be relatively weak? One method by which the US can better compete with many developing (and other) nations, at least in some trade domains, is to depreciate its currency.

The Japanese fiscal mess, despite its current massive size and unhealthy long run outlook, is rather old news to many observers. Plus Japan ("Japan, Inc.") has not blown up yet from the problem. Japan somehow manages to get by. In contrast, America's debt quagmire of the past couple of years or so is relatively new news. But there's more to the dollar weakness story.

Roughly speaking, Japan is a creditor nation. Roughly speaking, and despite its wealth, America is a debtor nation.

Japan is in satisfactory shape, and will remain so at least for some time, in regard to its ability to pay its bills. Japan has long been running a current account surplus. America's current account deficit situation offers a dramatic contrast.

Note the IMF Japan "Spillover Report" review (July 2011). Japan "has enjoyed current account surpluses since the 1970s, helping the country to become the world's largest net creditor." (p3).

Scan the "World Economic Outlook" (April 2011; Statistical Appendix, Table A10, p216) on the current account dimension. America's current account deficit goes on and on. In 2010, it was \$470 billion. IMF clairvoyants indicate 2011's deficit at \$494bb, with 2012 at \$451bb, and 2016 about \$644bb. Compare Japan's ongoing surpluses: That of 2010 is \$196 billion, with 2011 a still-lofty \$145bb. It remains substantial for the near term- \$139bb in 2012, about \$132bb in 2016. What about the current account deficit (surplus) as a percent of GDP? The US deficit is 3.2pc in 2010, 3.2pc in 2011, 2.8pc in 2012, and 3.4pc in 2016. Japan's current account surplus is 3.6pc of GDP in 2010, 2.5pc in 2011, 2.3pc in 2012, and two pc in 2016. (See Table A11; p217; Japan's 2010 and 2011 updated via IMF Article IV consultation, 7/19/11).

In addition, Japan has massive savings which it can enlist to meet its interest rate obligations. Its three trillion dollar net international investment position reflects both official reserves (held mostly in US Treasuries) "and a large net private position in bonds." The private position of about \$1.5 trillion is primarily outward investments of banks, life insurers, and corporate pension funds in US Treasuries and US dollar and Yen corporate bonds ("Spillover Report", p6).

Moreover, most Japanese government debt is held by the Japanese. The "Spillover Report" (p7) emphasizes that the Japanese debt and equity marketplace is "primarily geared toward domestic investors. Only 5 percent of Japanese government bonds (JGBs) are held by foreign investors". Thus it is relatively difficult for a foreign exodus to move Japanese yields substantially higher.

Given that a substantial amount of US government debt is held by foreigners (in contrast to the situation for Japanese government debt), how happy are America's creditors with sustained dollar depreciation? How joyous would they be if the dollar slipped further while the Fed kept short-term rates at very low levels? In addition, picture longer dated US government debt instruments held by foreigners. Many notes and bonds were acquired with yields well above current ones. All else equal, as these securities mature, how eager will foreigners be to roll those securities over into new Treasuries of similar maturities?

The Federal Reserve's quest to create "sufficient" inflation (avoid deflation) via money printing does more than interrelate with its tolerance of a weak broad real trade-weighted dollar. Though the Fed wants modest inflation (and more economic growth and less unemployment), it also continues to fight to repress government yields. All else equal, relatively low nominal rates not only tend to assist the economy, but also help debtors (both public and private ones) to repay their debts. Some of the Fed creativity is via its manipulation of the Fed Funds rate. Buying a huge amount of Treasuries (even if via money printing), reduces government yields somewhat, at least for a while. Now, with the cessation of the Fed's QE2 extravaganza, how well will it be able to keep overall rates, and particularly those of longer term instruments, relatively depressed? Of course, a renewed recession probably will enable it to keep rates low- unless there is a major further dollar downturn.

The Fed's assorted accommodative policy programs, partly by inducing and sustaining a stock marketplace rally, seek to repair the severe injuries to US consumer net worth suffered in the economic crisis.

Almost everyone wants prosperity for all. But in practice, creditors and debtors often conflict in their interests. Creditors enjoy boosts in the real value of their debt. Deflation tends to encourage such appreciation in value, though the creditor wants the debtor to stay solvent enough to fully repay it. All else equal, debtors prefer the “real” cost burden of their debt to decline (depreciate). Sustained inflation assists this.

Thus, although one should not push the point too far, a creditor nation such as Japan has more interest in promoting deflation (or low inflation), whereas a debtor nation at least sometimes prefers to promote inflation. Though current central bank rhetoric is rather murky, it seems that the Fed is inclined to create inflation (but not too much), whereas Japan is fighting deflation.

Also, picture a nation such as the US, with a substantial share of its government debt (dollar-denominated) owned by foreigners. All else equal, dollar depreciation makes it cheaper to repay existing dollar debt to foreigners. Of course at some point, foreigners may respond to dollar feebleness by reducing their net buying, or by becoming net sellers, of their Treasury holdings (especially if inflation starts to accelerate).

Many would say that economic policy differences between key Japanese political parties (factions), especially currently, are less strong than those in America.

Japanese banks may be relatively less vulnerable than American and European (and American) ones to global banking debt problems. The “Spillover Report” says Japan’s “banking system is relatively isolated” from the cross-border bank claims perspective, “suggesting that bank spillovers are limited.” (p9, Figure 2). The IMF (transcript of teleconference call, Article IV consultation) says the exposure of Japanese banks to foreign assets generally is relatively low (7/19/11).

FLIGHTS TO QUALITY, TECHNICAL TIGHTROPES

US Ten year note yields had a final top on 6/13/07 at 5.32 percent. As the worldwide economic disaster unveiled itself, 10 year UST rates made another high at 4.10pc on 10/5/08. Then, in a frantic “flight to quality (safety)” as the crisis accelerated, yields collapsed to 2.04pc (12/18/08), making another noteworthy low at 2.46pc not long after the major low in the S+P 500 at 667 on 3/6/09. In a flight to quality context, quality involves creditworthiness issues (including inflation and currency risks) as well as liquidity considerations.

Since then, America has run up a huge fiscal deficit and engaged in a major money printing exercise. The United States is not the only nation to have done this, but it has been a clear leader of the process. America (its government debt) therefore probably is not as good a flight to quality haven as it was around three years ago. One cannot entirely separate credit quality from liquidity. Yet these days, when compared to 2007/08, people acquiring US government debt may be purchasing relatively more liquidity than quality. Also, note the recent interest rate jumps not only in Greece, Portugal, and Ireland, but also in Spain and Italy as fears grew regarding their sovereign debt situation. Thus US government debt yields- whether due to dismay over the near term (or long run) US fiscal deficit, inflation concerns, dollar depreciation, or some combination of these issues- are likely to move higher.

What are key Japanese Yen levels to monitor for the near term? Start with the cross rate versus the US dollar. The Yen made a major peak against the dollar about sixteen years ago, at about Y79.8 on 4/19/95. A five percent move under Y80 gives Y76. The 1995 pinnacle was not broken for a long time. However, the Yen, just after the earthquake struck, achieved a high versus the US dollar around Y76.3 (3/17/11). The dollar then rose for about a month, with the Yen making a low on 4/16/11 at Y85.5. The Yen resumed its advance, reaching around Y76.8 by the end of July. Sustained dollar weakness under the range of Y80/Y75, about the April 1995/March 2011 Yen summits, would reflect significant concerns about American economic policies and American (and worldwide) economic growth.

Recall that the Yen rallied versus the dollar over the mid-2007 to early 2009 stage of the worldwide financial crisis. The Yen rallied from Y124.1 on 6/22/07 to Y95.8 on 3/17/08. It then weakened to Y110.7 on 8/15/08. However, it recommenced its climb versus the dollar, reaching highs around Y87.1 (on 12/17/08 and 1/21/09). Thus Y87 is important support for the Yen.

In 2011, Japan represents about 7.5pc of the broad real trade-weighted US dollar. This is down from 12.8pc in 2000, and quite distant from the 16.5pc share of 1995 and 1986's 20.7pc. However, the Yen/dollar cross rate remains widely followed.

The Yen now is around very important levels on an effective exchange rate index basis (1990 equals 100; monthly average, Bank of England statistics). The April 1995 peak was around 171.0. It has hovered near that all-time monthly peak height for several months. Note September 2010's 169.2 to June 2011's 170.2 (a rebound from the April 2011 low 164.1). Reviewing Bank of England daily data (1990 equals 100), the 4/25/95 summit was 174.7. Thus the 170 to 175 range is critical. The Yen has edged slightly over that ancient peak, attaining 175.7 as of 7/28/11.

As a footnote to the effective exchange rate (real, overall rate), keep in mind that a key Bank of Japan effective exchange rate measure does not indicate that recent Yen strength has resulted in a challenge of those 1995 peaks. Why use Bank of England rather than Bank of Japan statistics? First, note the foreign exchange intervention in late 2010 to weaken the Yen as well as complaints by Japanese exporters as the Yen has continued to rally. These suggest worries about excessive Yen strength. In addition, current levels of the Yen/dollar cross rate relative to 1995 more closely mirror those of the Bank of England index than the Japanese one.

The dollar not only has trended lower against the Yen for many years. The TWD has fallen a long way from its February 2002 high at 112.6. What are key near term levels for the broad real trade-weighted dollar? The TWD in June 2011 reached a new record low around 81.3 (monthly average; 1973 equals 100). This is moderately under prior major support around 84.00. Recall bottoms of April 2008, July 1995, and October 1978 around 84.1. A five percent drop under 84 is 79.8, a 10pc fall 75.6 (two thirds of 112.6 is about 75.1). The dollar rallied to 96.7 in March 2009 in the depth of the financial crisis, so that is an important level (see also October 2008 around 93.7).

Note the rally in equities as the dollar weakened since March 2009. The strong dollar equals weak US stocks, weak dollar equals strong stocks hymn remains popular. Yet suppose the TWD slides under 79.8, and especially if it attacks 75.0. Might this degree of dollar weakness signal a downturn in the US- and perhaps elsewhere- and thus warn of the potential for equity price declines?