

MARKET INSIGHT REPORT

Japan: Steady as She Goes?

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By John R. Taylor, Jr.

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Although the Chinese are tightening credit as their economy threatens to overheat, and the Australians are moving overnight interest rates higher to slow a housing boom, the Japanese are staying at roughly zero, right where they have been for 11 years. Does this mean that nothing is going on in Japan, that everything is the same? The most obvious answer is yes: the economy is in a perpetual slow growth mode, wages are stagnating, deflation is present everywhere, the population is shrinking, and exports are the only growth area. Many nominal statistics on production and GDP are very similar to the average levels of the 1990's. With a shrinking population and deflation, an unchanged nominal growth means real growth per capita. In fact, on some measures Japanese growth during the last decades outpaces that of the United States and the Eurozone. The change that catches everyone's attention is the persistent and increasing growth of government debt, which some have forecast will grow to 250% of GDP by the end of 2012. As this would far exceed the largest government debt burden ever carried by any country, there are many that expect a Japanese collapse in the near future. So, everything in Japan is slow and steady, hunky-dory, and then boom, the end! How likely is that?

As money managers, it is important to have some way of judging how much debt is too much. Japanese debt at just under 200% today feels much safer than Argentina's debt level which is just about a quarter of Japan's. To insure this debt with a Credit Default Swap (CDS) in Japan it would cost 79 basis points, while for Argentina it would be 1100 basis points, paid up front (which makes it even higher relative to Japan). Japan is no Argentina, but it is judged riskier than Germany at 44 and the United States at 50 basis points. Norway, the safest of all is at 19 basis points. Considering that a Japanese five-year note earns about half a percent, less than the cost to insure it, buying one makes no sense unless you are a Japanese investor with few safe options, looking for a yield. The world's opinion of Japan, expressed in the CDS market, plus the low yield of its government debt, means that only 5% of the debt is owned by foreigners. The Japanese have funded their government debt themselves, and this is probably the only way that a country could reach the 200% level. Also, the exceedingly low average coupon on the debt means that interest payments take up only about 20% of government revenue. This debt burden would be intolerable if 10-year rates rose to 2.0% in 2012, as interest alone would take about 40% of the government tax revenue. Foreigners would demand a higher return, so if the Japanese can not buy their own debt, the country is in trouble. This is an issue point, as Japan is aging rapidly and wages are stagnating, dropping saving levels down to levels that are positively American. Where will they get the cash to buy more government bonds?

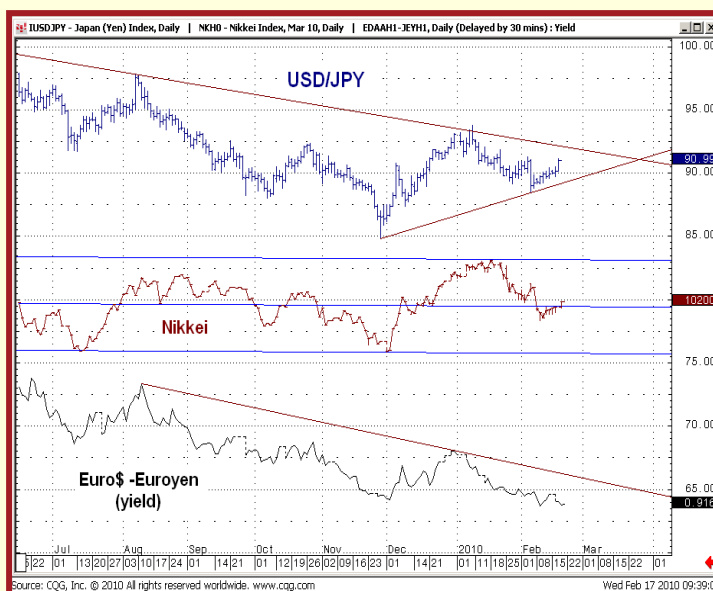
At some point they won't but that point is probably four to seven years away. Japan's other defense is its powerful export sector and the tremendous stash of US dollars they hold as reserves. The export sector needs a weak yen and the asset horde earns more yen, if the yen is weak, so the Japanese would strongly favor a weak yen. However, if the situation deteriorates and the government needs to reduce its dollar assets to lessen its borrowings, the repatriation and conversion of the dollars to yen would drive the yen sharply higher. So, a recession in the developed world, cutting exports and forcing reserve liquidation would tend to strengthen the yen, compounding the strength from risk aversion. The Japanese outlook in the years ahead should be far from placid, and Japan could be buffeted by economic trauma far from its shores.

CURRENCY – Asia Long-Term View

USD/JPY Direction; Are You an Optimist or a Pessimist?

By Jonathan Clark

Attempting to determine the overall direction of the dollar/yen is similar to trying to ascertain if the global economy will expand or contract. We don't make this claim based on an economic analysis of Japan, as fundamental analysis is a notoriously bad way to predict currency movements, but rather base our view on various quantitative analyses. The two best predictors of the value of dollar/yen are the performance of the Nikkei and the direction of US interest rates. If you know which way these are going, you don't need to know anything else. Although the Nikkei has the highest correlation with dollar/yen,



equity indices in almost all of the major countries are nearly as good. This implies that if the global economy is expanding, corporate profits will rise, and equities will trend higher. If the global economy is expected to expand then the dollar/yen will strengthen, and if the recovery stalls then dollar/yen should weaken. It is also clear that the interest rate on the US 2-year Note exerts a significant influence on dollar/yen, but why? One reason is that in a low inflation environment rising interest rates in the US would mean the economy is expected to grow, while falling interest rates mean the economy is expected to slow. Our research shows that interest rate differentials are powerful predictors of exchange rates, particularly at the shorter end of the yield curve. Since short-term Japanese interest rates are pegged close to zero the movement in the interest rate differential between the US and Japan is almost entirely a function of the movement in US interest rates. Therefore, our conclusion is that global optimists should be bullish on dollar/yen and global pessimists should be bearish on dollar/yen.

We are clearly in the bearish camp, so we would buy yen. Our cycles argue that equities either peaked in January (now our favored scenario) or will peak around the middle of March, and interest rates will move with equities. The cycles call for USD/JPY to peak in the next few days and should hold below the 91.20 to 91.60 area. The dollar will then turn lower and decline into the week of March 1 and will fall to 89.25. Following this low the dollar should recover through mid-March before beginning the more aggressive leg of its downtrend. Any close below 89.25 turns the outlook very negative. The dollar is then headed lower into the summer, and our target is at least the 85 area.