Global Strategy Weekly

What are the wider market risks of Japan's economic collapse? Watch the Yen

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The rapidity of the collapse in the Japanese economy has shocked the investment community. The economic pain has been magnified by the Yen becoming the strongest major currency in the world. The Yen is seriously misaligned with economic reality. I believe the phase of Yen strength has now ended and it will begin a pronounced slide. It matters to the rest of the world that Japan will get considerably more competitive. It will also hasten a Chinese devaluation.

■ Investor familiarity with weak economic data has reached new heights of vulgarity. We have reached the point now where utterly horrific US housing starts data hardly get noticed. The 16.8% mom decline in January starts announced yesterday comes after a 14.4% mom decline in December and a 14.6% mom decline in November. This took starts to a record low of 466,000 units, massively lower than the 530,000 economists had expected. Starts are now down 56% yoy, the fastest rate of meltdown since the US housing peak at the end of 2005. That an intensification of the US housing catastrophe merits so little shock value any longer is a sign of just how bad things have become!

■ Japan's 3.3% decline in Q4 GDP did, however, shake the markets. News of the collapse even reached mainstream news bulletins in the UK. Japan is now clearly set to fall into depression (defined as a peak to trough decline in GDP of 10%). The jury is still out on the US and the UK but I feel very confident that both these Ponzi-based economies will suffer the same fate, as will the Eurozone, increasingly weighed down by problems to the east.

■ Amid the global economic carnage and avalanche of government stimulus measures, it is easy to miss a key event that might have far reaching economic and market implications. I believe that, unnoticed, just such an event has occurred. The Yen has just begun to unwind its long period of strength since mid-2007, associated with an unwinding of the carry trade and risk aversion. Since mid-2007 the Yen became unusually detached from the economic cycle (see chart below). This is now ending. A weak Yen has major global implications.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	35
Bonds	20-50	35	50
Cash	0-30	5	15

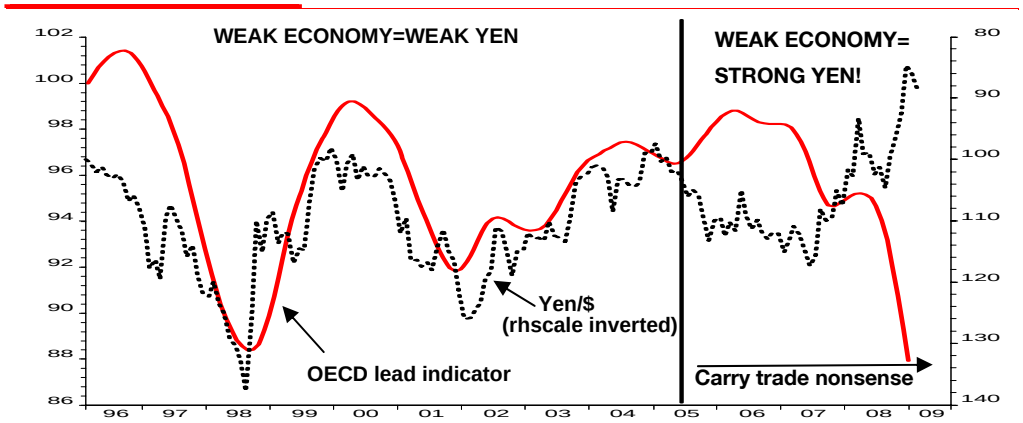
Source: SG Equity Research

Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont Europe
Underweight	Japan Emerging mkts
Very Underweight	

Source: SG Equity Research

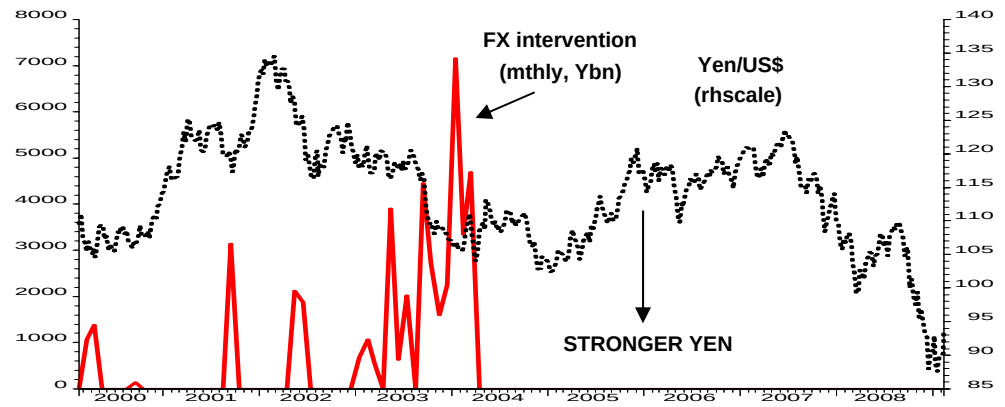
The Yen traditionally a very cyclical currency, until the carry trade nonsense started



Source: Datastream

Japan was a central participant in the global risk bubble from 2003 to mid-2007. Economic weakness at the start of that period had led the government to order the Bank of Japan (BoJ) to intervene in *MASSIVE* quantities in the foreign exchange markets to stop the Yen strengthening and strangling the tentative economic recovery. In Q1 2004 the BoJ spent $150bn to draw a line in the sand (see chart below). The BoJ had been fighting with the FX markets in the back half of 2003 too, but the order of magnitude of the Q1 1994 intervention stunned the markets, which only discovered its extent after the event - link. Unlike FX intervention to *support* a declining currency, where the central bank can run out of reserves, *upward* currency pressure can be comprehensively defeated if the central bank chooses - but only as long as the authorities are willing to print unlimited supply of reserves and deal with the monetary consequences thereof. When the FX markets saw the incredible resolve of the BoJ, they retreated cowed and whimpering into the naughty corner.

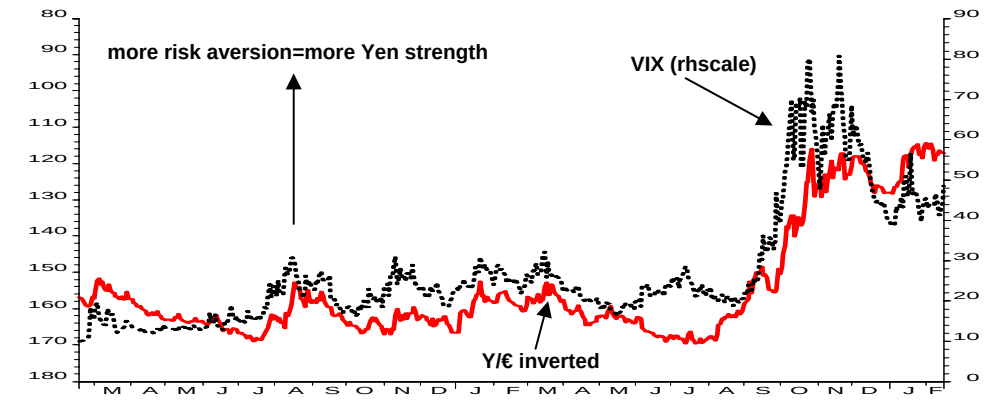
Japanese FX intervention to stop the Yen strengthening



Source: Datastream

Japan is now suffering from the unintended consequences of those actions in early 2004. For once the FX traders saw the Yen had become a one way bet downwards, the Yen carry trade (borrowing in the falling Yen to purchase risk assets abroad) became an easy source of additional liquidity for the global markets. Consequently, until mid-2007 the Yen weakened despite the cyclical upturn (see chart on cover). This suited the Japanese.

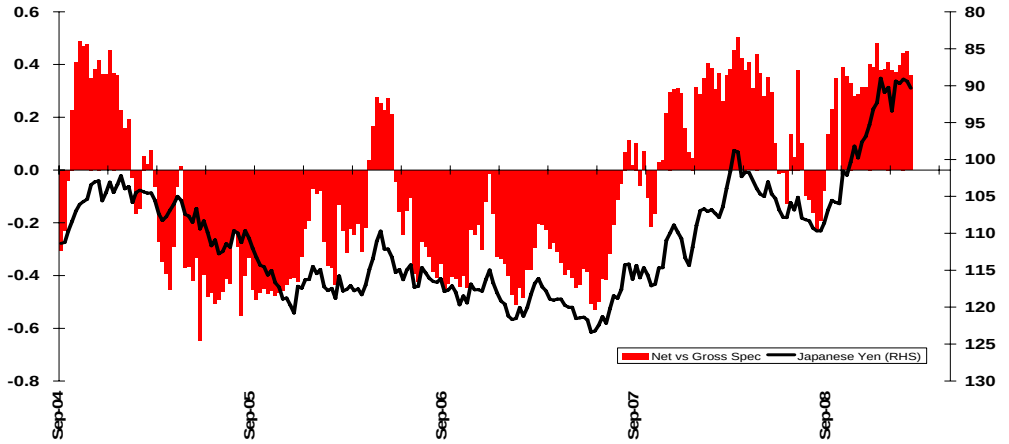
Yen rises every time risk aversion rises



Source: Datastream

Conversely the period since mid-2007 marked a reversal of this process. The implosion of risk assets led to an unwinding of the carry trade causing an unusually strong Yen at a time when the economy was already weakening (again see cover chart). This has led to the Yen being seen as a 'safe-haven' every time risk aversion spiked higher (see chart above). Hence speculative long trading positions in the Yen have reached extreme levels (see chart below)

Speculative long Yen positions at extreme highs (Net verses gross speculative & the Y/$)



Source: CTFC

A much overlooked part of Fed Chairperson Bernanke's famous November 2002 helicopter speech is his assertion that FX intervention to drive down one's currency is a successful route to exiting deflation – link. He said then that *"… it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34… The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly."*

To the extent that recent Yen strength has been driven by speculative trading activity rather than the unwinding of the carry trade, the Yen is now massively vulnerable to the BoJ once again drawing a line in the sand. **Looking at the Y/$ chart from a technical viewpoint it seems pretty clear to me that the Yen has begun to break decisively downwards in recent days.** Maybe the beleaguered Japanese authorities have at last reacted to the economic carnage that the strong Yen has brought and the BoJ has *already* intervened in the FX markets. Like in March 2004, perhaps we will only find out after the end of this month! If they have *yet* to intervene there is no better time to do it than when a new trend is heading in the direction they wish to follow in any case (e.g. Plaza accord in 1985). Once traders see Yen strength will no longer be tolerated it will become a one-way bet downwards, massively undermined by the weak Japanese economy and current high level of speculative longs.

If the Japanese authorities do begin to reverse the 30% rise in the Yen effective exchange rate over the last 18 months, this will have huge global consequences. Japan is a far larger economy than many people suppose. (Most comparisons of country GDP is done on PPP exchange rate comparisons which, as the IMF have highlighted (link), is wrong in finance.) Even including the 2008Q4 GDP collapse Japan is still a considerably larger economy than China. And therein lies the rub. For the Yen is one of the last few remaining regional currencies that has not been devaluing against the also buoyant Yuan (the Yuan effective exchange rate has risen 12% over the last 18 months). As a sliding Yen properly reflects Japan's current dreadful fundamentals, pressure for a Chinese devaluation will surely rise to breaking point.