U.S. May Surpass Japanese Money Machine

If you ever wondered whether your professors asked set-up questions to which they knew the answers and knew you would fall for the bait, the answer is, "Yes," especially if they were like me. One of my favorites in the early part of this decade was to present the short-term interest rate curves of selected countries, such as the U.S., the U.K., Japan, Canada and the Eurozone and ask which curve embedded the greatest expectations for an interest rate increase over the next year. The answer was, "Japan," and that answer remained the case for years.

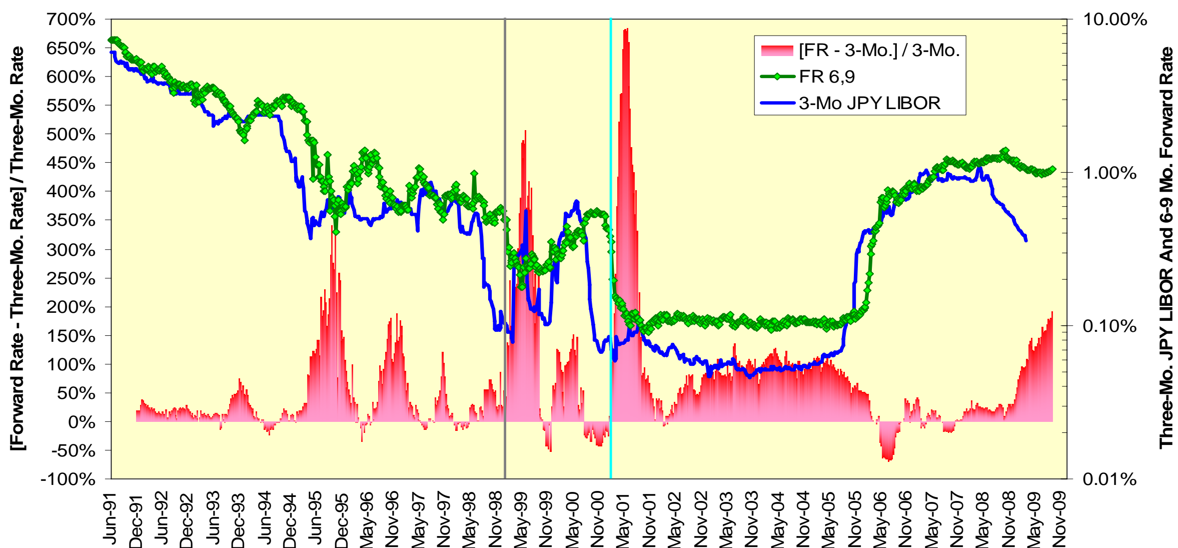
As an aside, this is one of the things that prompted me to develop the U.S. – Japan interest rate analog at the very bottom of the 2001-2003 bear market. While these charts are not updated here, please be assured parallels remain in the interest rate histories of the two countries.

The U.S. now occupies high interest rate slot previously occupied by Japan in my question. As I noted back in July, the very steep Eurodollar forward rate structure embedded expectations for future short-term rates to be much higher than they are now, but as I noted last week, the willingness of the central banks in general and Federal Reserve in particular to keep short-term interest rates unnaturally low can maintain what would otherwise be an unstable situation for a surprisingly long time. Like the never-ending Israeli-Palestinian conflict, instability can be stable.

Markets Measure, They Do Not Forecast

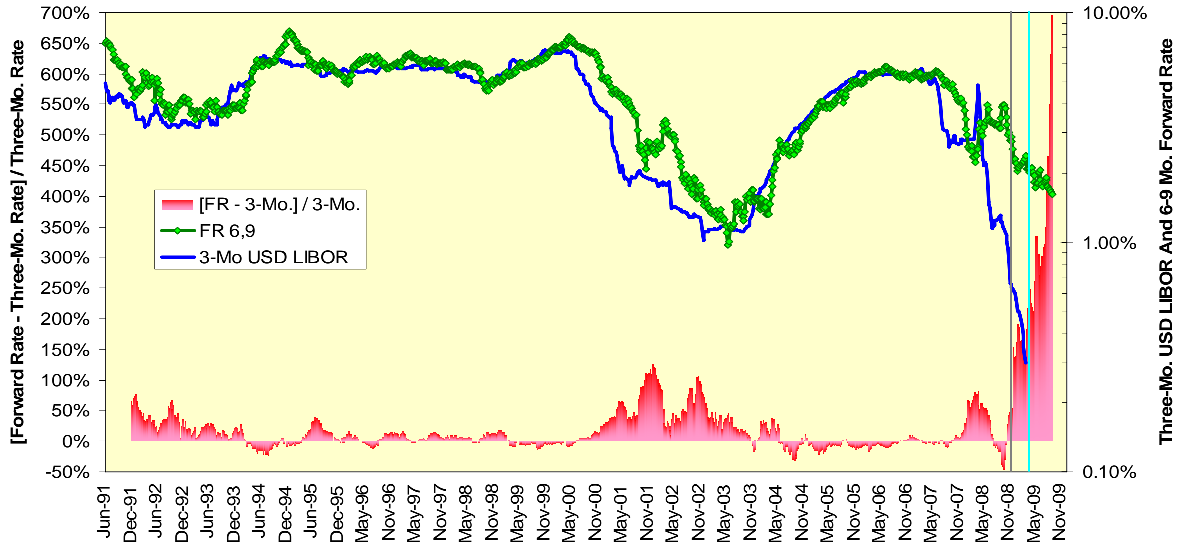
Forward-rate agreements (FRAs) allow borrowers and lenders to fix rates for a given period starting at a point in the future. If we compare the three-month forward rate for LIBOR starting six months from now, designated as FR6,9 on the charts below, to what three-month LIBOR actually was for over that period of time, we can get a very good measure of how a central bank was able to keep three-month LIBOR below market expectations.

Let's take Japan first. They embarked on a policy of 0% interest rates in February 1999 and began quantitative easing in March 2001; these are marked on the chart with gray and turquoise vertical lines, respectively. The gap between the expected FR6,9 and actual three-month yen LIBOR exploded higher after each central bank move and approached 700% of the three-month rate itself by June 2001. The Bank of Japan had succeeded in driving rates below the market's expectations.



Now let's take a look at where we are today in the U.S. We went to near-0% interest rates in December 2008 and to quantitative easing in March 2009; these, too, are marked on the chart with gray and turquoise vertical lines. Now look at that red column representing the normalized rate gap. It is slightly higher than the Japanese gap was in June 2001. Three-month LIBOR in the U.S. is now 0.299%; six months ago, the FR6,9 was at 2.378%. The Federal Reserve quite clearly has succeeded in driving rates below the market's expectations and is promising more of the same.

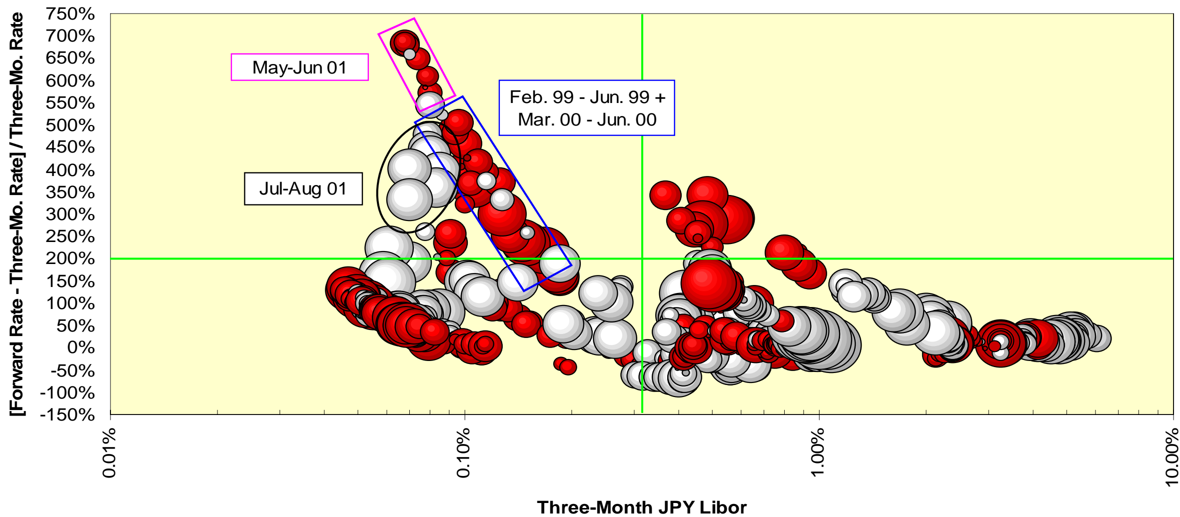
The Newfound High Bias Of U.S. Forward Rates



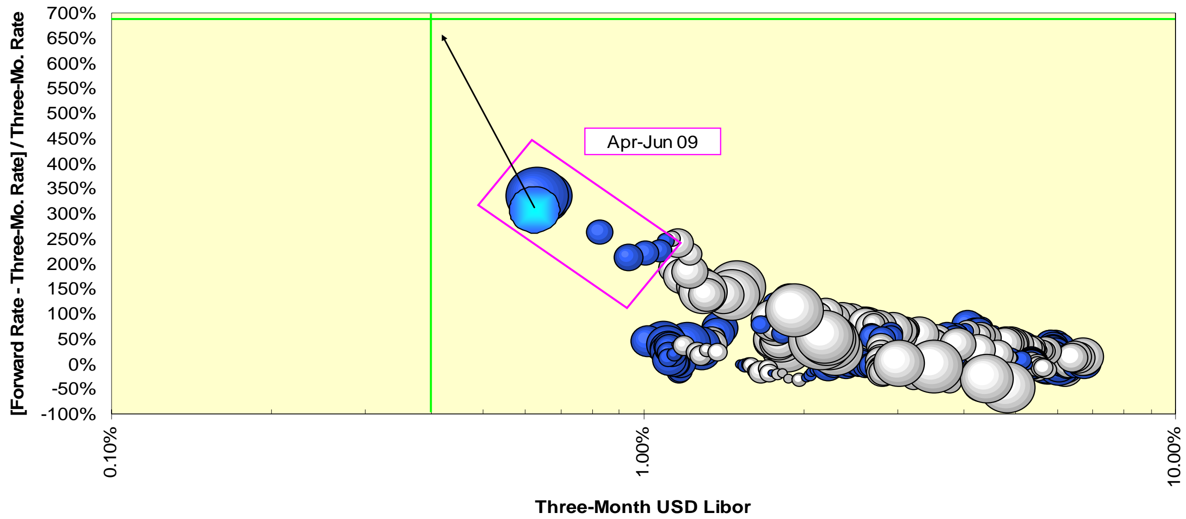
Equity Market Impact

What happens to three month-ahead stock market returns after such a burst of money mania? The Japanese experience is sugar-buzz economics propels stock returns higher in the short-term. If we map the normalized rate gap against three-month yen LIBOR led six months and then display stock market returns over the next three months as bubbles (colored bubbles are positive returns; white bubbles negative returns, with the size of the bubble representing the return) we see two clusters of colored bubbles over the May-June 2001 period and the amalgamation of the February-June 1999 and March-June 2000 periods. Offsetting these is a cluster of white bubbles or negative forward equity returns, from the July-August 2001 period; this corresponds to the sugar-buzz wearing off after six months. The current reading environment is at the intersection of the two green lines; we cannot know what the return of the Japanese stock market will be over the next three months.

Japanese Three Month-Ahead Equity Returns As A Function Of
Three-Month LIBOR And Forward-Rate Gap



Now comes the fun part. The American experience with money mania on a Japanese scale is new. If we construct the same map for the U.S. as we did for Japan, we find two things. First, the April-June cluster, the only one for which realized three month-ahead equity returns are available, is strongly positive. The second is where the current environment lies at the intersection of the green lines. Please note the arrow from the starting point to the current environment. We are only beginning to feel the full weight of the monetary tsunami; the big wave is yet to come.



If the Japanese analog holds, a statement and not a prediction, the sugar-buzz will dissipate sometime next spring or summer. Of course, when the Japanese were engaged in their experiment, they were alone in the world. We have company. As money once created must find a home, the resulting asset bubbles could get rather impressive before their inevitable bursting.