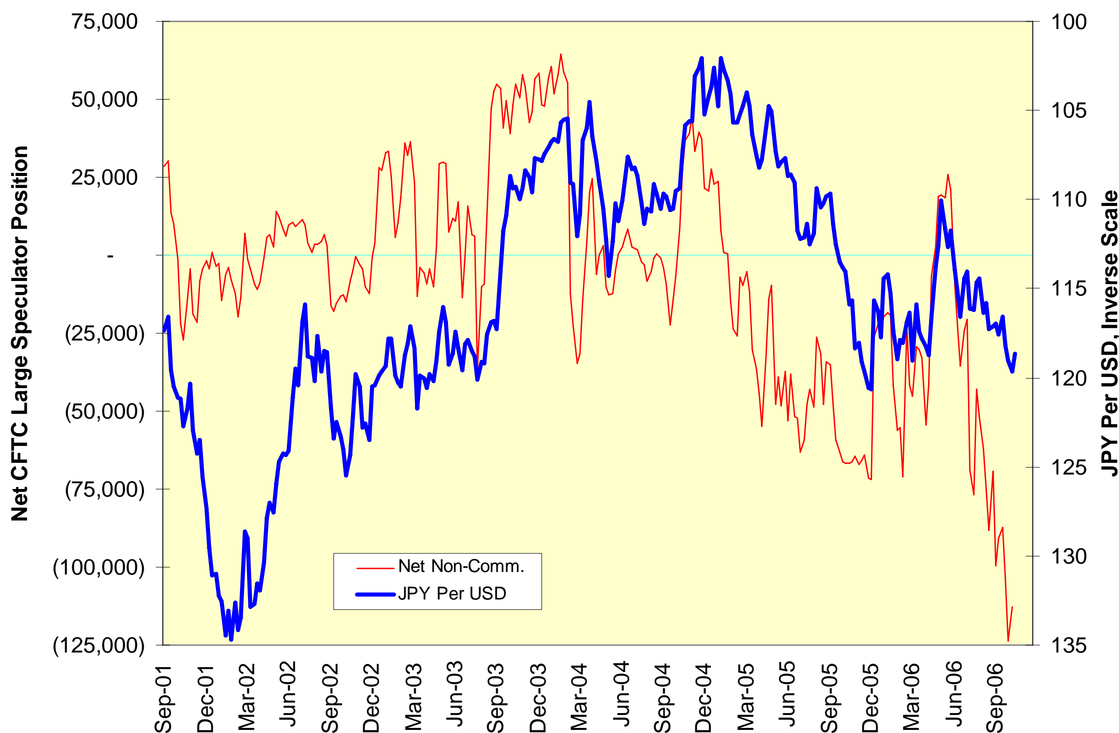
When Will The Yen Bottom?

"Who's that knocking on my door / It's gotta be a quarter to four" – Rod Stewart

The Bank of Japan managed to scare traders last Wednesday morning by checking banks to see who was doing the yen carry trade, discussed here last April. The panic was short-lived; unless the Bank of Japan raises short-term interest rates to the point where borrowing the yen, selling it, and then lending the proceeds in a higher-yielding currency is unprofitable, the trade will persist and the yen will remain under pressure.

Still, it is instructive to remember no trend lasts forever, especially when too many traders get on one side of it. The latest Commodity Futures Trading Commission data show a record net short position by non-commercial traders. It would not take much to trigger a reverse stampede out of these positions, as occurred in October 1998 when the exchange rate moved 11 yen to the dollar stronger in one night.

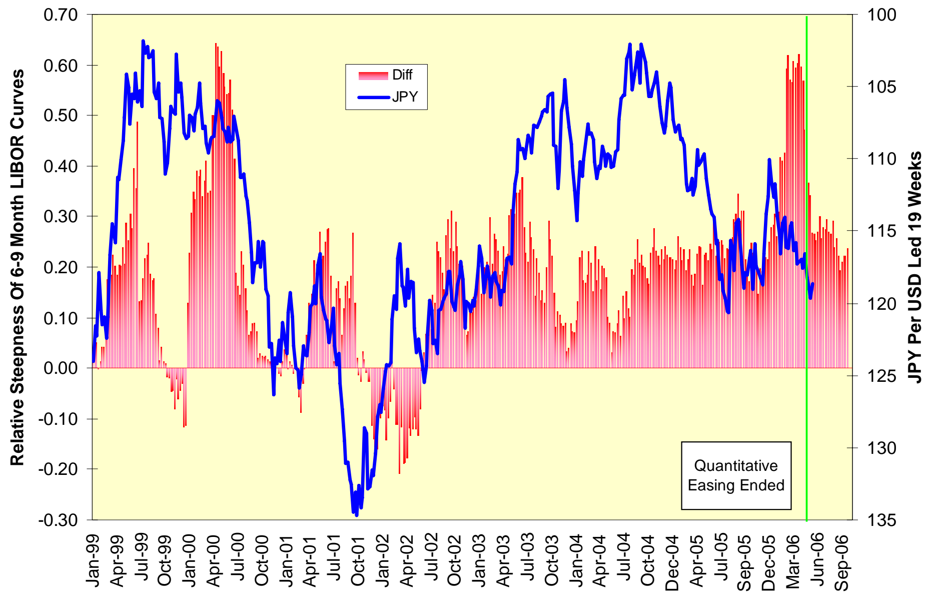
An Imbalanced Position



Timing Is Everything

Simply noting a preponderance of speculative positions tells us nothing about the timing of any trade. Let's revisit an analysis presented a few weeks ago for the euro. We can compare relative monetary policy expectations between the U.S. and Japan by comparing the forward rate ratios between six and nine months for each currency. These are the rates at which you can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the money market curve and presumably to looser the monetary policy. If we subtract the FRR for the yen from that of the dollar, we how Japanese monetary policy prior to May 2006 was far looser than was American monetary policy. That changed abruptly with the end of quantitative easing in Japan, discussed in early July.

Short-Term Rate Expectations No Longer Favor Dollar As Much

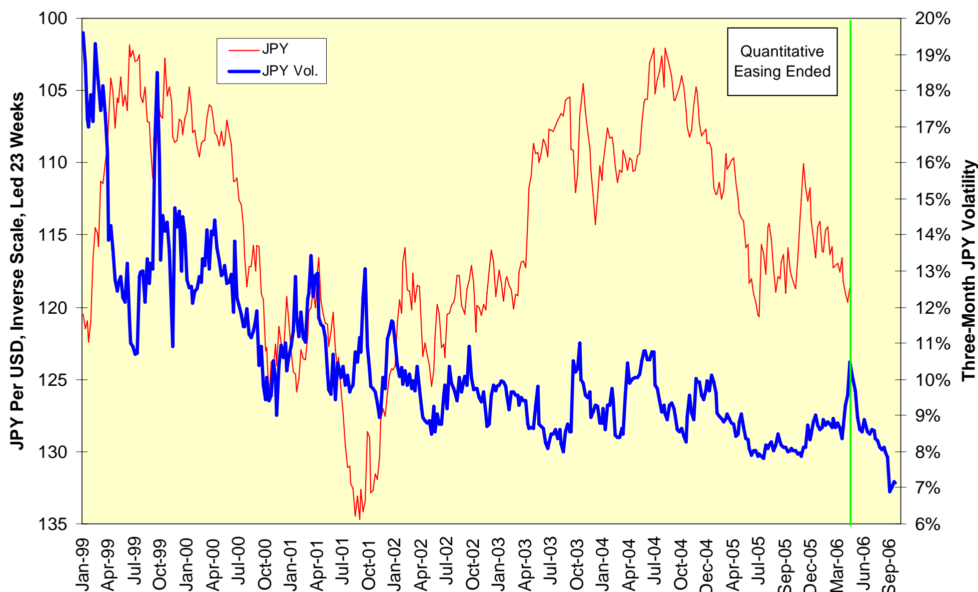


This forward rate ratio differential has led movements in the yen by 19 weeks on average. That would place a support time for the yen in late February 2007. Can this movement be confirmed by any other time-based indicators?

Hedging The Yen Carry

Let's assume the world's currency speculators are anything but a collection of fools. They know their borrowed yen will have to be repaid at the end of the trade, which makes the trade at risk to a stronger yen. If they hedge this risk completely, they lose the rate pickup achieved by lending in another currency, so they favor incomplete hedges based on options. As in all option trades, the cost of the insurance purchased is based on volatility, and with the prominent exception of a jump in yen volatility when quantitative easing was ended, this measure has been declining for years. Quite simply, no one in the currency market is convinced the Bank of Japan is going to embark on a "defend the yen" trade anytime soon.

Price Of Insuring Against JPY Appreciation Plummeting

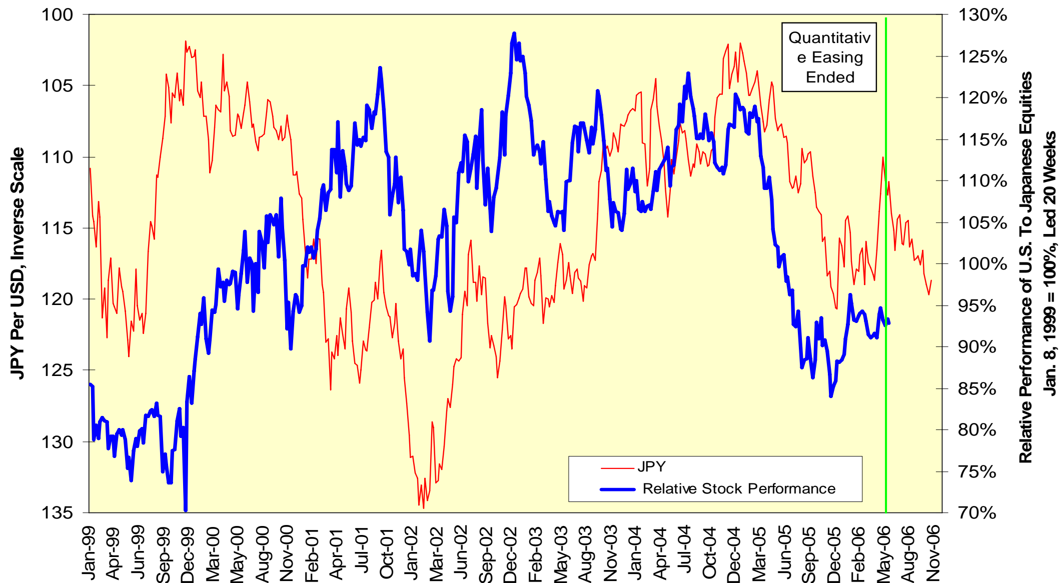


Changes in yen volatility lead changes in the yen by 23 weeks on average. That would place the timing of yen stabilization in March 2007.

The Japanese fiscal year ends March 31st. Japanese corporations often repatriate funds during March, and Japanese banks often acquire reserves aggressively during this month to meet various capital standards and reporting requirements. Regardless of the present dynamic, March often is a seasonally strong period in Japanese markets.

Taking Stock

For those who are not inclined to dabble in the yen – and of all the major currencies, this is the most difficult to trade – are there any stock market relationships you can use? Interestingly enough, movements in the yen lead the relative performance of U.S. to Japanese stocks by 20 weeks on average. In a pattern seen across many currency-equity combinations, the Japanese market has been supported by a weaker yen; critically for Japan, it is relatively weaker against the Chinese yuan as well as the dollar.

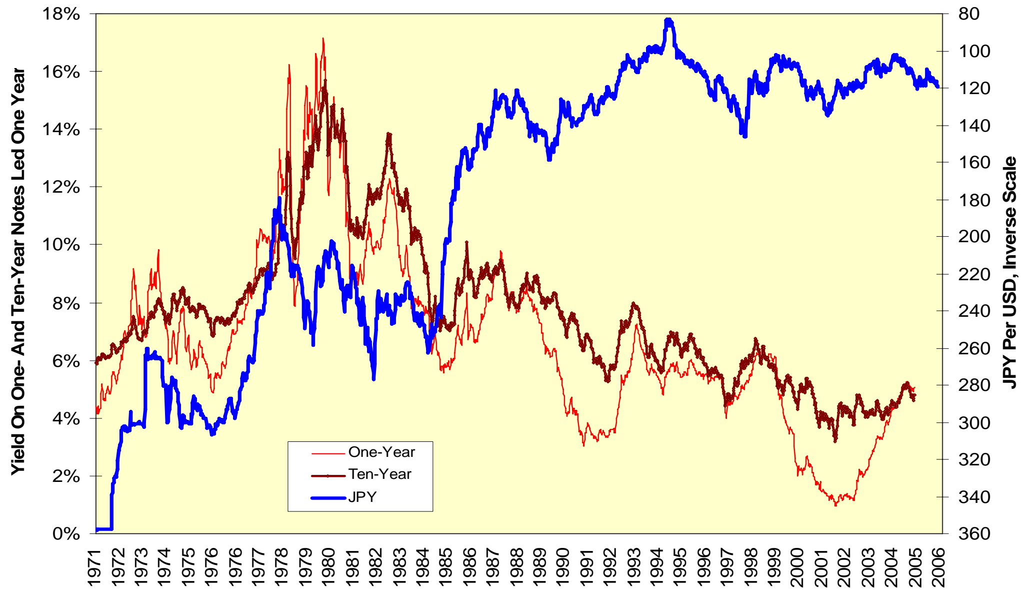


If the yen does in fact start to stabilize and move higher in the late winter, with or without credit tightening by the Bank of Japan, we should see Japanese stocks lag American stocks. Restated, American investors in Japanese equities should look to lighten their holdings in any yen rally next year.

A Final Thought

Recent moves higher in wheat and other grains recall market conditions prevailing during the 1970s. One of the indelible impressions of that era was that a strong Japanese yen led to higher interest rates in the U.S. Many still hold this belief and fear each episode of dollar weakness will prompt Japanese creditors to unload their portfolios.

That relationship may have held into the early 1980s, the beginning of Japan's combined stock and real estate bubbles. After the dollar broke in 1985, both short-term and long-term interest rates in the U.S. began a two-decade downtrend while the yen remains in a prolonged trading range. The conclusion that U.S. interest rates are driven by the yen-dollar exchange rate simply is unsupported by the facts.


Does The Yen Drive U.S. Interest Rates?
Yield On One- And Ten-Year Notes Led One Year
JPY Per USD, Inverse Scale
One-Year
Ten-Year
JPY
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
80
100
120
140
160
180
200
220
240
260
280
300
320
340
360
1971
1972
1973
1974
1975
1976
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006