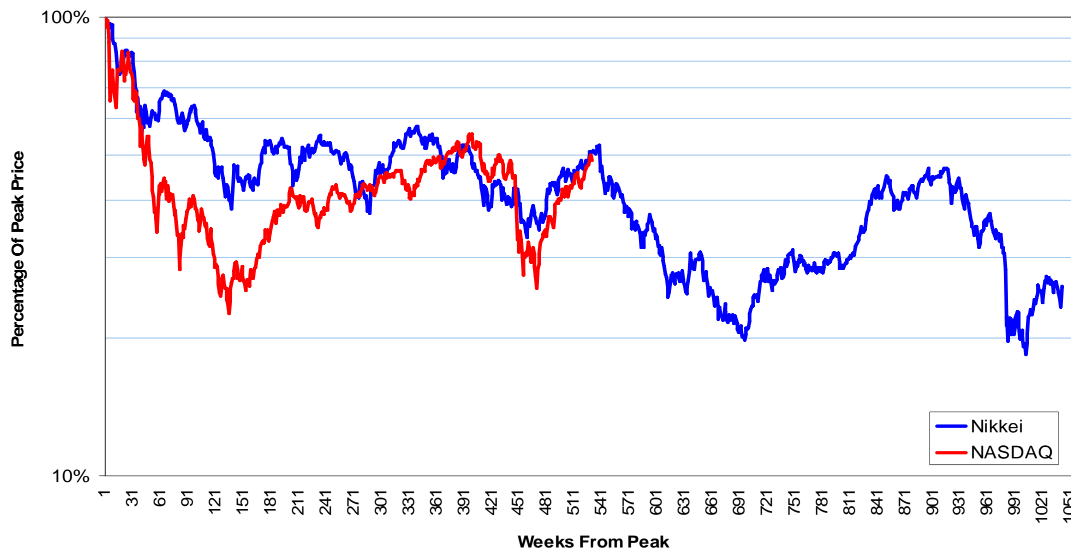
How Japan Lost More Than A Decade

As a new crop of freshmen heads off to school, their parents and others will be receiving e-mails along the lines of "today's freshmen have never dialed a phone, not had a microwave, were born when George Bush 41 was President, etc." No one may reference that today's freshmen never had to read 1980s-vintage articles and sit through management seminars telling them how Americans really needed to be more Japanese. Youth is well-served.

The Nikkei 225 hit its all-time high of 38,957 at the very end of December 1989, and has spent the next twenty years plus suffering through Japan's Lost Decade(s). They have turned themselves into a veritable laboratory of failed policies during that time by trying everything to jumpstart both the economy and their financial markets. Their public debt soared to more than 210% of GDP by mid-2010, their short-term interest rates have been near 0% for more than eleven years, and they began quantitative easing when George Bush 43's presidency was less than two months old.

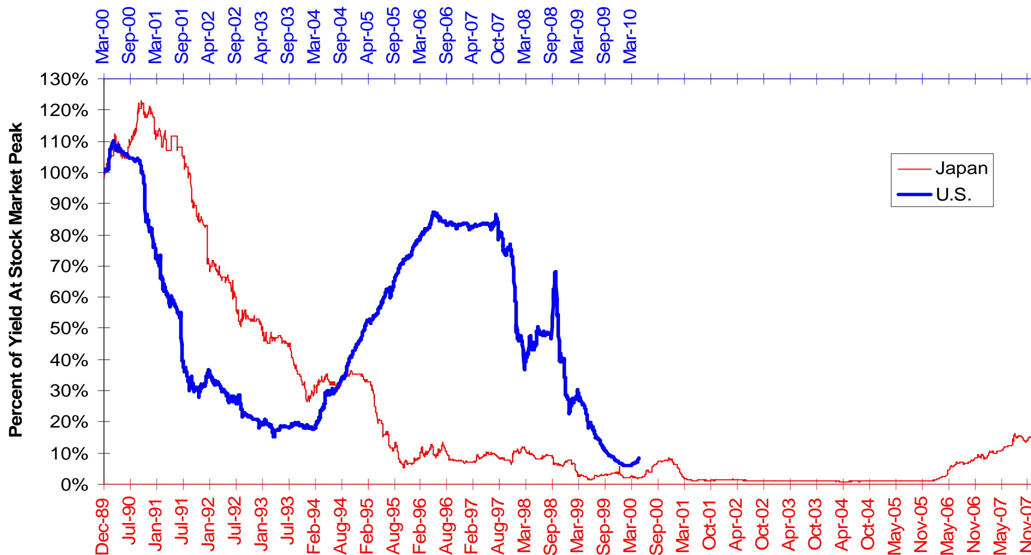
Analogies

Just as correlation does not imply causality, a good analogy really is not much more than some eye candy tossed before others (today's freshmen have never lived in a world without blogs…). However, the basis for technical analysis is the immutable nature of human behavior; this should mean market patterns line up over time regardless of the underlying markets, nations or cultural differences. Let's take one that first made the rounds (today's freshmen never lived in a world without e-mails making the rounds…) during the 2000-2002 bear market, the comparison between the Nikkei 225 and the Nasdaq Composite lined up peak-to-peak. The convergence of the NASDAQ to the Nikkei path by the 2008-2009 bear market is enough to make you question the entire concept of free will.



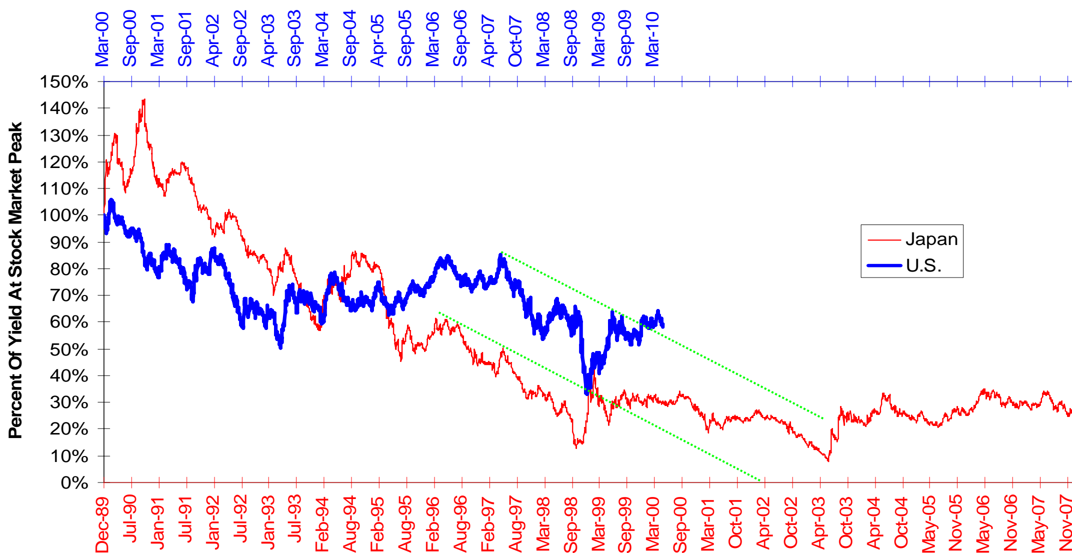
We can do a similar exercise for short-term interest rates. Here six-month USD and JPY LIBOR are re-indexed to their nation's respective stock market peaks in March 2000 and December 1989, respectively. U.S. rates fell further and faster after the dotcom bubble burst as the Greenspan Federal Reserve wanted to move more aggressively than had their Japanese counterparts in the early 1990s. Then the analogy broke as the Federal Reserve raised rates between 2004 and 2006. By 2009, however, U.S. short-term rates were falling down to their Japanese path. Once again, free will be damned (today's freshmen cannot believe money market rates once exceeded 15%).

U.S. Short-Term Yields Falling To Japanese Path



We can shift the playing field one more time, to comparative ten-year note yields, also reindexed to the times of the respective stock market peaks. Here the U.S. rates have yet to converge down toward their Japanese counterparts, but they have been moving in a parallel channel since late 2007.

U.S. Long-Term Yields Still Over Japanese Path



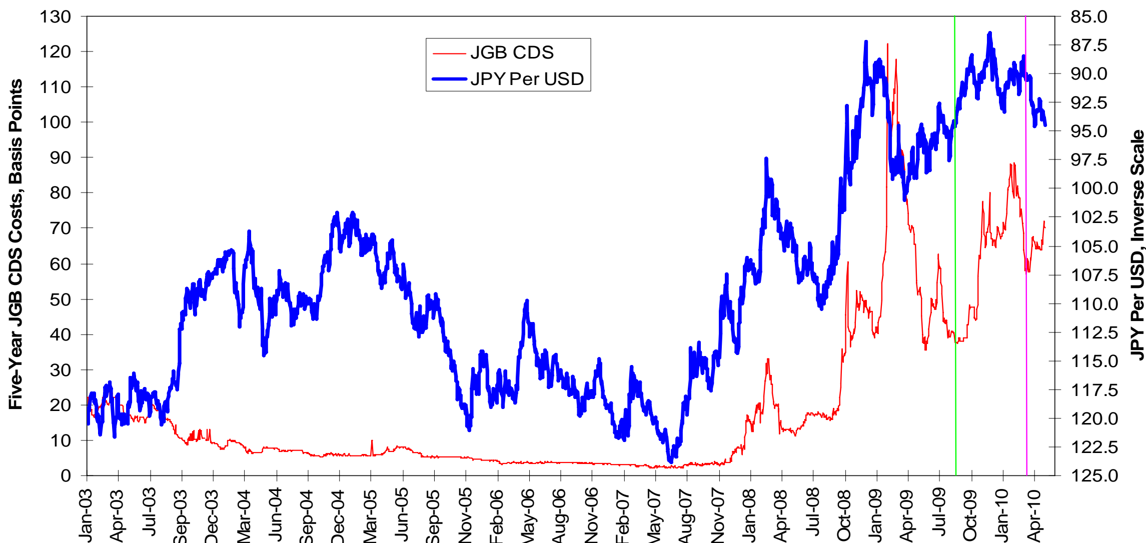
Japanese Sovereign Credit Risk

Now let's shift gears and take a look at Japan's real mess and what it may imply for others. Official responses around the world to the 2008-2009 financial crisis involved unprecedented public expenditures and policy decisions. As government balance sheets were extended, the result was deteriorating sovereign credit quality.

Incredibly, this started to reverse two weeks prior to the March 2009 stock market low as the Federal Reserve and the Treasury issued a statement we can summarize as, "We can print it faster than you can lose it, so your Treasury bonds are safe." The third and final bailout of Citigroup and quantitative easings in March by Switzerland, the U.K. and the U.S. underscored this point. Investors somehow were reassured by the notion they would be getting repaid in created money.

However, something unusual has started to happen in Japan in August 2009. The cost of insuring a five-year Japanese government bond against default, which had fallen from a peak of 122 basis points in February to 35.5 basis points in June 2009, rebound to 88 basis points with the first apparent passing of the Greek sovereign debt crisis in February 2010. The timing of Japan's slide was not accident. It is linked to the economics of the global

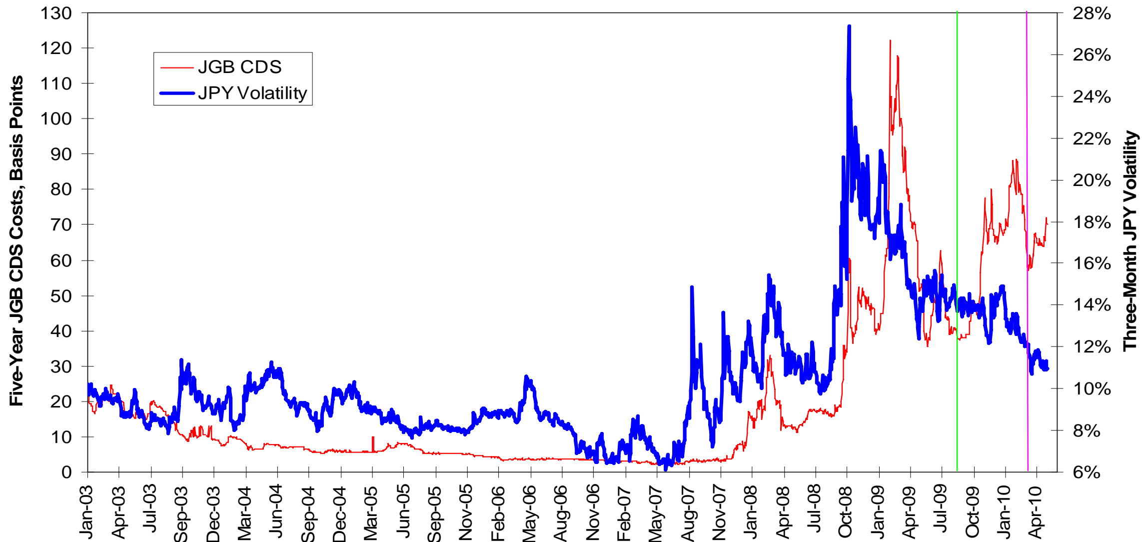
carry trade and specifically to the date in August 2009, marked with a green vertical line, when U.S. short-term interest rates slid below Japanese rates. U.S. short-term rates rose back over Japanese short-term rates by March 2010, marked with a magenta vertical line.



As we can infer from the short-term interest rate analog chart, the yen had been the preferred funding currency for years in carry trades; it was borrowed, sold for another currency, and then lent or invested in that other currency. This was one of the reasons why short-term interest rates were so ineffective at restarting the Japanese economy: The funds created in Japan went to finance other countries and were instrumental in producing the global financial bubble of the late 1990s. In addition, the global real estate and financial bubbles of 2003-2004 were kicked off when Japan started buying massive amounts of U.S. Treasuries to keep the yen.

The trouble with a race to the bottom is once you get there, someone can catch up to you. This happened when the U.S. and by extension China, whose yuan was re-pegged to the dollar in July 2008, caught up to Japan in August 2009. This led to an unwinding of yen carry trades and a move higher in the yen at the very same time CDS costs were rising. The implications for Japan were negative. The nation has been export-dependent ever since its post-World War II economic recovery, and can ill afford a surging yen. The combination of reduced export competitiveness and deteriorating sovereign credit quality is not sought by many.

We can infer Japan's normally savvy yen traders, many of whom have an unusually close relationship with the Ministry of Finance, were surprised by the events of August 2009. As a rule, the volatility of three-month JPY forwards rises in advance of CDS costs. Any perceived financial crisis leads to anticipation of yen carry trades unwinding. This means yen borrowed and sold have to be repurchased, so just as equity call options rise in front of a merger announcement, yen call option volatility rises in front of financial stress. CDS costs tend to be more of lagging indicators; they move after the fact. The quiet yen volatility in front of the August 2009 rise tells us no one ever anticipated seeing U.S. rates falling below Japanese rates and thus never anticipated any unwinding of carry trades.



Countries who adopted Japanese policies during the 2008-2009 financial crises have this warning in front of them: The end result of twenty years of monetary and fiscal excess is failure. Printing money to spend and borrowing in excess of the ability to repay creditors leads to long-term existence as a host parasitized by the rest of the world: All vital energies go to the parasites. This includes cheap money, manufacturing base, the capacity to consume the fruits of your own labors rather than to export them to your creditors and ultimately the national spirit. It is not a pretty picture, and the U.S., U.K. and others who thought they would take the easy way out of a long-term financial crisis should study it while there is still time to avoid Japan's multiple Lost Decades.