

The Seasonal Effects Of The Japanese Fiscal Year

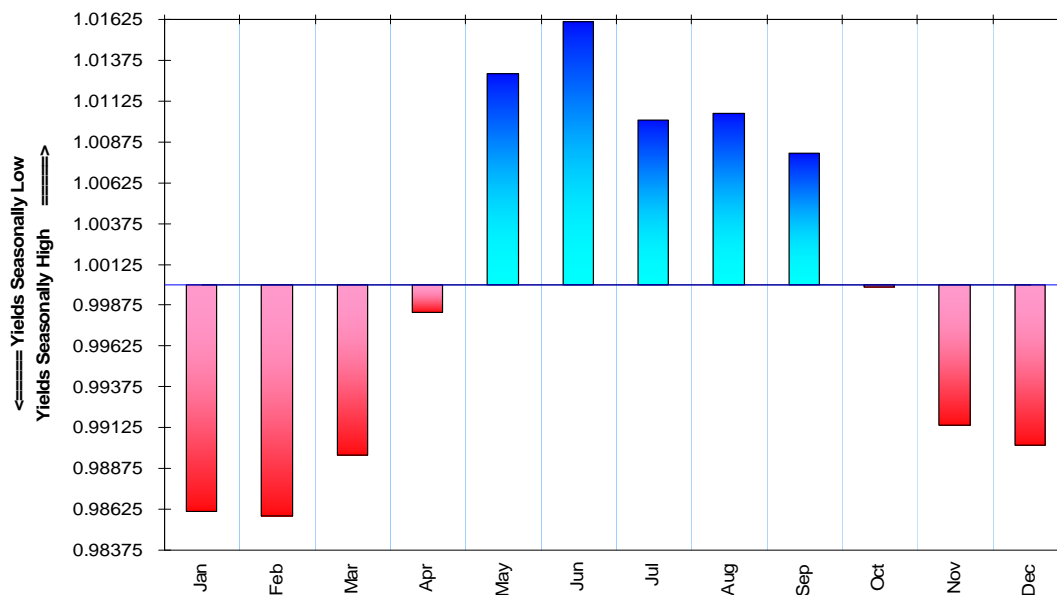
When you think of the month of March, what comes to mind? Do college basketball tournaments, coming in like a lion and going out like a lamb and little birds returning to the mission at San Juan Capistrano start ringing bells for you? All of these are valid, but unlike the birds, another effect kicked around for years by financial pundits, the influence of the March 31st closure of the Japanese fiscal year, can be hard to swallow.

While financial markets do have valid seasonal effects, some readily understandable and some bordering on nothing more than coincidence, seasonality more often than not is simply a distraction. As a *reductio ad absurdum*, if seasonality were in fact the driving force behind markets, all we would need to trade and invest successfully is a calendar. As this does not appear to be a common practice, let's assume traders' actions outweigh analysts' words.

Worse, seasonality itself is misunderstood, and we are not referring to the lamentable reality those who sell in May and go away seldom stay away. Seasonality is more than the arithmetic data-mining of a time series; no, it is the decomposition of same into trend, cycle and irregular components. And this process is subject to standard statistical tests for significance. Without such rigor all we have are a few monthly averages, some of which will almost by definition be higher/lower than others, but whose inter-monthly deviations and actual regular seasonal content could be no more than random.

It is the regular cycle components we wish to isolate. They form the seasonal factors, or divisors, we need to apply to an economic series to make those infamous seasonal adjustments we see everywhere. The statistically significant factors for U.S. constant-maturity U.S. ten-year notes from April 1953 onwards indicate yields are seasonally high between May and September and seasonally low from October through April. We should note in passing these seasonal patterns themselves can and have shifted over time; as recently as 2010, the strong and weak periods had been April-October and November-March, respectively.

Seasonal Factors For Ten-Year Treasury Yields



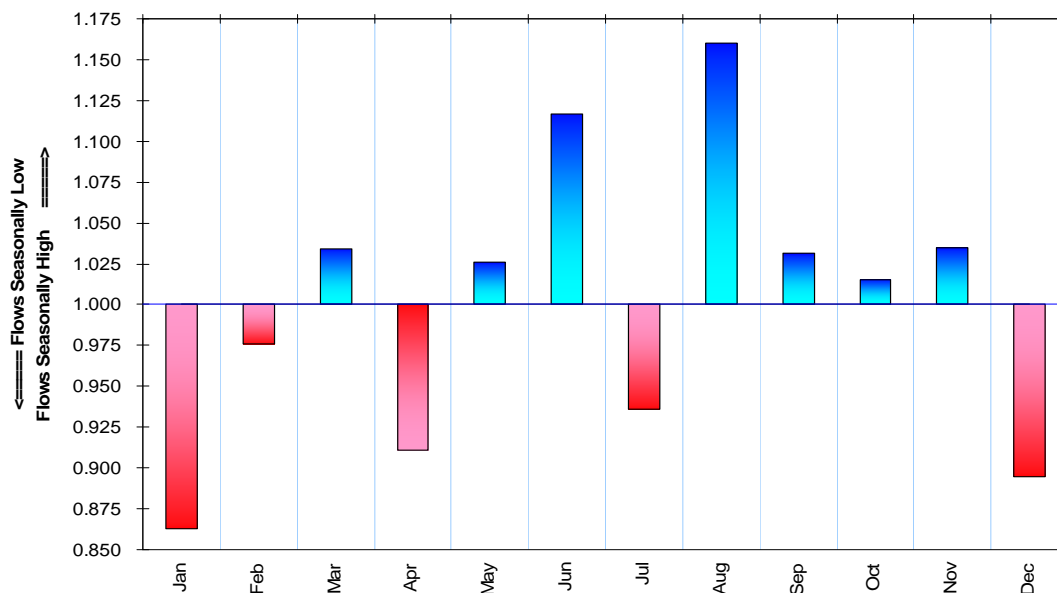
Japanese Flows

The motivation behind imputing a seasonal flow to Japanese investments is easy to understand; anyone who has observed how federal funds become tight around bank reporting periods or how mutual fund managers engage in end-of-quarter window dressing can understand it. The Japanese banks need to tidy up their balance sheets at the end of the year; whether this is done to delude others or to delude themselves is subject to debate.

As Japan has been at or near the top of creditors to Uncle Sam for the better part of a quarter-century, the notion they would sell some portion of their highly liquid Treasury holdings and drive up the yields thereon is easy to grasp. As capital is fungible, let's add agency securities, corporate bonds and U.S. stocks to the mix of assets the Japanese might purchase or sell.

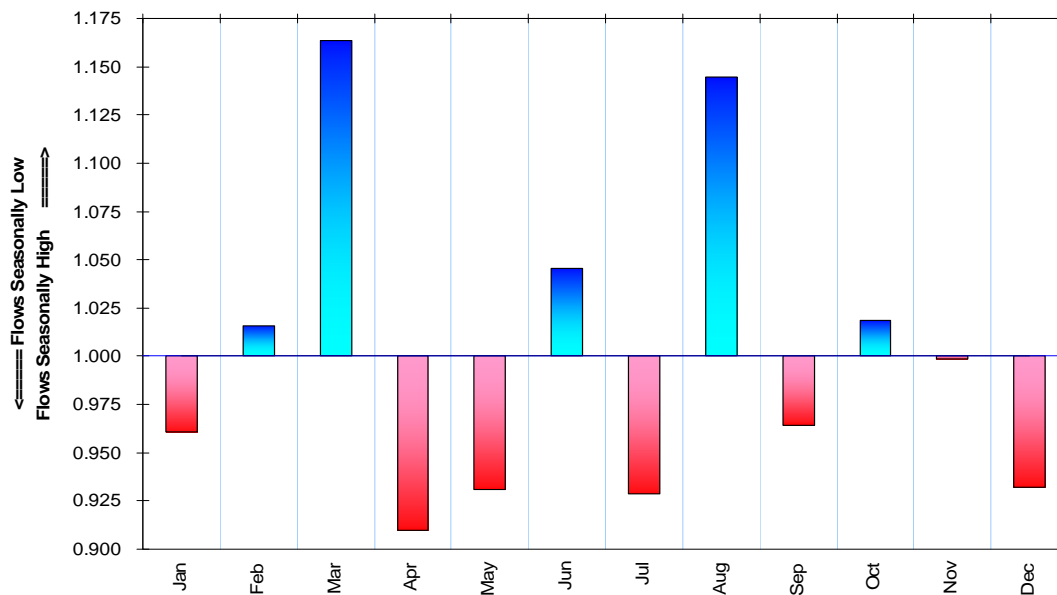
Purchases are seasonally strong in March, May and June, and August-November; if the Japanese were in fact shoring up their balance sheets in March, we should expect this to be a weak month for purchases and we should expect April to be strong on the rebound. This thesis is coming apart already.

Seasonal Factors For Japanese Purchases Of U.S. Financial Assets



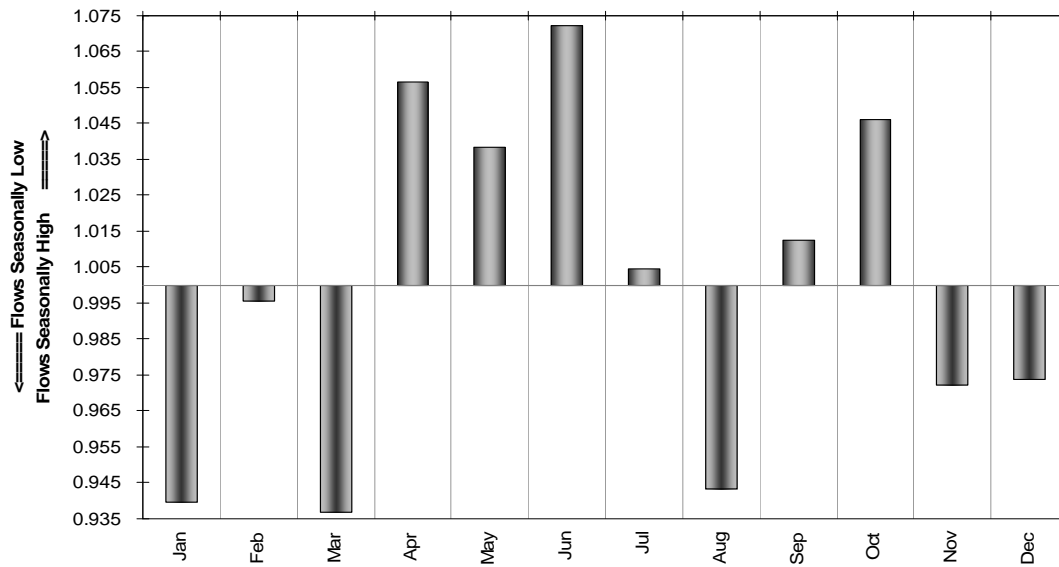
What about sales? Here February and March are seasonally strong months for the sale of U.S. assets by Japanese investors, but another month of significance for money to hop a plane back to Tokyo is August. At least nothing in the sales seasonality contradicts the original hypothesis of March being a significant month for Japanese financial flows.

Seasonal Factors For Japanese Sales Of U.S. Financial Assets



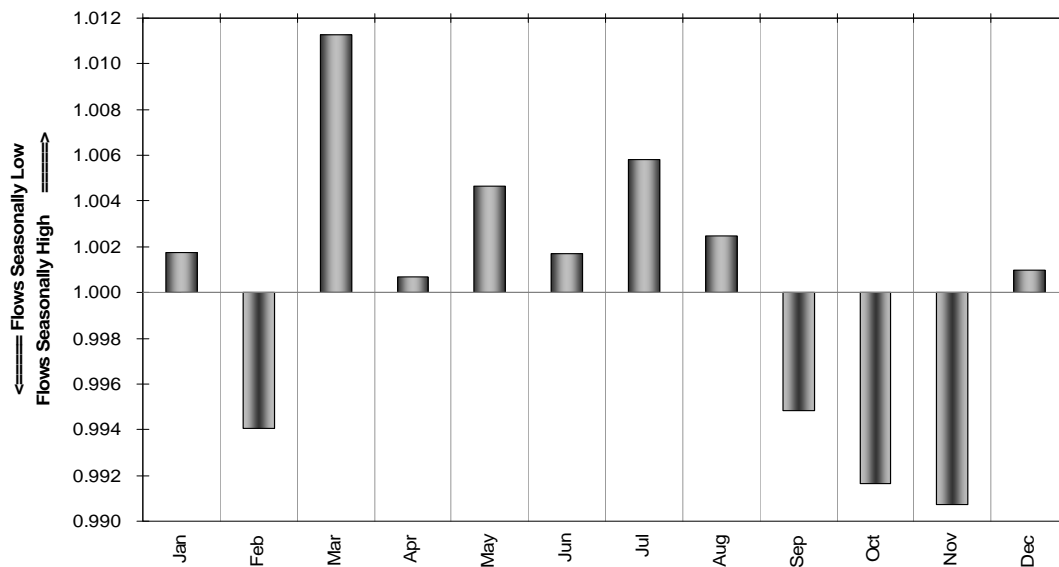
What happens, though, when we combine the purchase and sale data into a net flows number? Here statistically significant seasonality disappears. While net flows are weak in March, the real answer is they are random; this is the portion so many commentators leave out for one reason or another.

Seasonal Factors For Net Japanese Activity In U.S. Financial Assets
(Not Statistically Significant)



Finally, if Japanese investors are converting their dollar assets back into yen, we should expect the yen carry into the dollar, the total return for borrowing three-month yen LIBOR and lending in three-month dollar LIBOR, to drop like a rock in March. It does nothing of the sort. First, the seasonality is statistically insignificant and therefore no better than random. Second, it is the dollar that is (insignificantly) stronger in March; the yen's strength, such as it is, comes in September-November.

Seasonal Factors For Yen Carry Into Dollar
(Not Statistically Significant)



One of the odder and indeed more infuriating aspects of market analysis is how patterns work until they are recognized. A famous example of this was the so-called January Effect of small-capitalization stocks outperforming their larger brethren in January, presumably as the result of tax-loss selling creating bargains. Once traders started to anticipate the Effect, they logically started to buy small stocks in December.

It is quite possible the Japanese fiscal year has created a similarly self-defeating behavior: If you anticipate the Japanese selling in March, you sell first in February and buy their sales in March. In fact, it would be rather odd if non-Japanese traders did not engage in such behavior. The net result of all this is the Japanese may be engaging in window-dressing while everyone else is undressing in that same window, like the image or not. Restated, just

because one set of traders is acting seasonally does not mean the net result will be observable in the market as a whole.