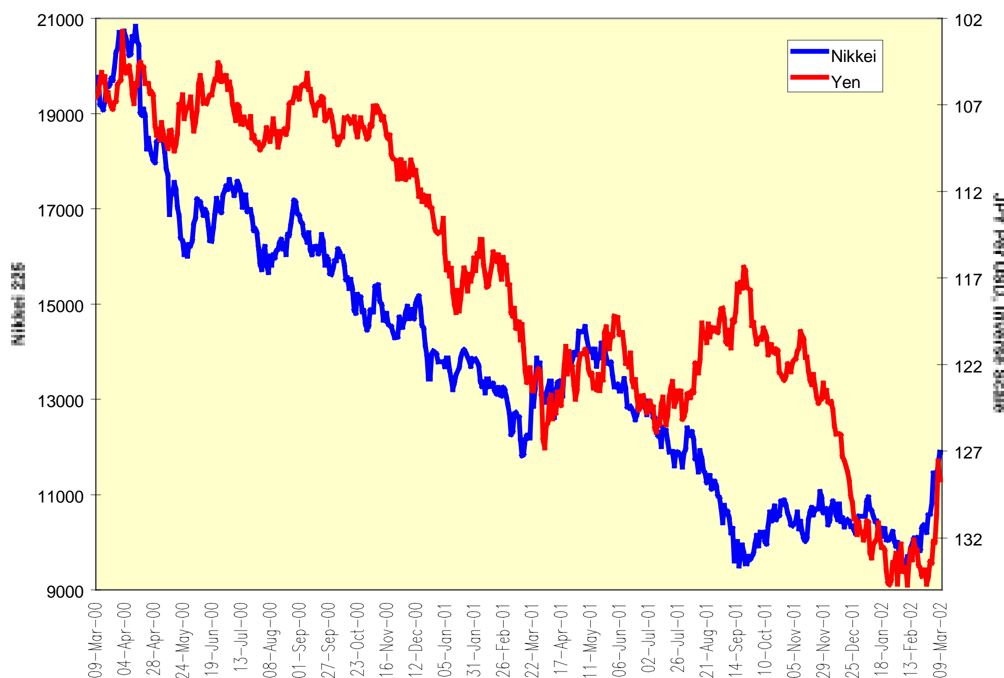
Countries Behaving Badly

If Japan was a four-year-old child, it would be sent to bed without dinner. After the once-fearsome Nikkei touched another 18-year low of 9420.20 last month, a level that would have required massive bank write-offs at the end of the March 31st fiscal year, the authorities decided they'd seen enough. In addition to the usual wink-wink, nudge-nudge from the Ministry of Finance, short selling was prohibited. What's next, publishing the names of those not fully invested in the *Nihon Keizai Shimbun* next to those of registered sex offenders?

Of course, market manipulation, whether done by Wall Street sharpies, governments, or precocious high school students in financial chat rooms, can produce unintended consequences. The Bank of Japan's (BOJ) quantitative easing policies over the past two years predictably have failed to ignite either the Japanese economy or the Nikkei. They did succeed in weakening the yen (JPY) however, and that brought a warning from China and other Asian exporters not to engage in competitive currency devaluation in an attempt to maintain exports.

The real winner in all of this may be the American investor in European markets, but I think we all saw that one coming. Why? It's the old yen carry trade of borrowing in Japan and lending elsewhere. In 1995 and 1996, the beneficiary of the BOJ's misguided largesse was the American market. Now, as we will see, shifting global interest rate cycles and currency differentials should benefit Europe.



Of Bonds And Bucks

While it's debatable whether the BOJ has an actual goal of weakening the JPY, it is safe to say that a strong JPY contributes to the deflationary pressures haunting Japan. The sharp revaluation of the JPY last week under the weight of funds being repatriated for Japan's farcical exercise in fiscal year window dressing sent ripples global financial markets, particularly in U.S bonds. Both the U.S. dollar (USD) and Treasuries were going to be vulnerable once a recovery began, as I wrote last November:

> What is in store for the greenback? Since credit demand is a lagging indicator of economic activity, and since plummeting credit demands will offset central bank policies here as they did in Japan. We should expect, therefore, a continuation of negative inflation and thus a strengthening dollar for several months into a new economic expansion, whenever that will be. Once an economic recovery is in place, rising

credit demands will lead to an abrupt expansion of total credit within the banking system. That will send out re-inflation signals and produce a weakening, and perhaps a catastrophic weakening, of the dollar.

Let's check out how the USD, as measured by the trade-weighted dollar index, is faring as the recovery gets underway:

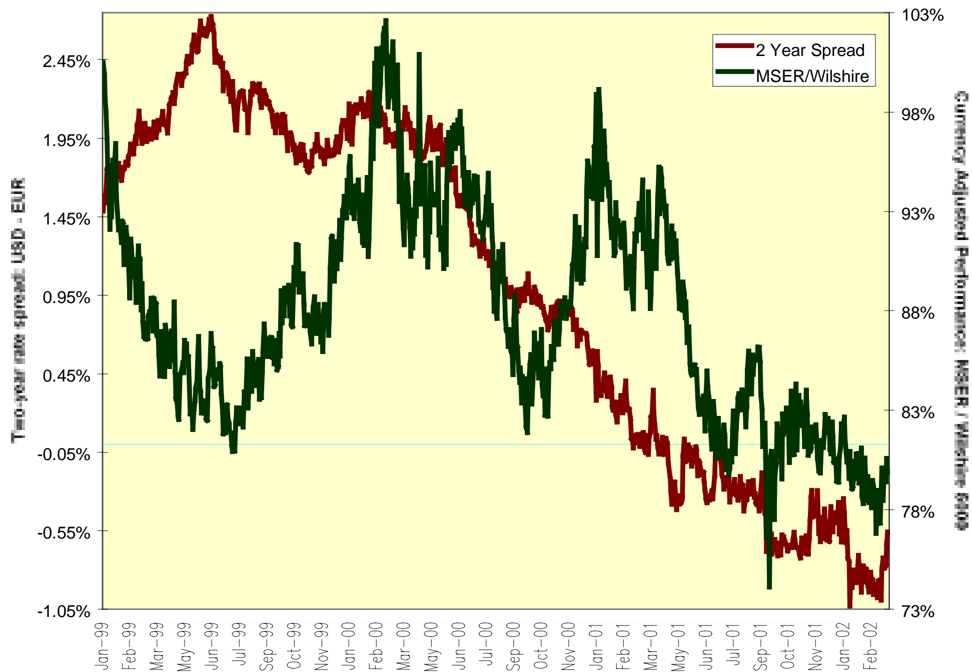
The USD break, while accelerated by the Trans-Pacific shenanigans, was going to happen anyway. As the U.S. economy firms, import demand strengthens and this raises the return on assets elsewhere. So, in an astonishing rebuttal to the normal theory of interest rate parity, the dollar is set to weaken even as interest rates in the U.S. rise.

This situation is hardly alarming for U.S. stocks, at least in the short run. A re-accelerating economy in 1987 produced a very powerful stock market rally between January and August 1987 in the face of steadily rising U.S. interest rates and a weakening USD. The subsequent crash in October 1987 had little to do with the weakness of the dollar; the tripwire for that disaster was the belief the Fed would keep raising interest rates indefinitely in an attempt to support the dollar.

Trans-Atlantic Opportunity

Now let's get down to the trade du jour, selling dollars and buying European assets. The euro (EUR) hasn't exactly set the world on fire since its inception in January 1999, but its time may be arriving at last. Since mid-1999, the interest rate spread between USD and EUR has moved more than 320 basis points in favor of the EUR. Just as the Fed in 1987 kept raising rates in a futile and ultimately disastrous attempt to support the USD, the European Central Bank and its core of veterans from the Bundesbank's *Scheisskopf* Brigade have kept EUR interest rates high during a recession to protect the overvalued currency.

Time For European Outperformance?



The result for American holders of European stocks has not been pretty. In currency-adjusted terms, the Morgan Stanley European Index (MSER) has underperformed the Wilshire 5000 by more than 20%. The name of this game is and always has been buy low and sell high. If the USD is about to head lower and returns for European exporters to the U.S. are about to get higher, and if the interest rate trend between Europe and the U.S. is about to reverse, then the trade of buying Europe against the U.S. will be attractive. Futures traders may wish to put this one on by buying Stoxx futures and selling the S&P 500 index.