Japan At The End Of The Line

"Well, it's happened, Alex boy, yes. Just as I thought it would, yes. Dear, dear, dear. Well, this is the end of the line for me…the end of the line, yes." – From *A Clockwork Orange*

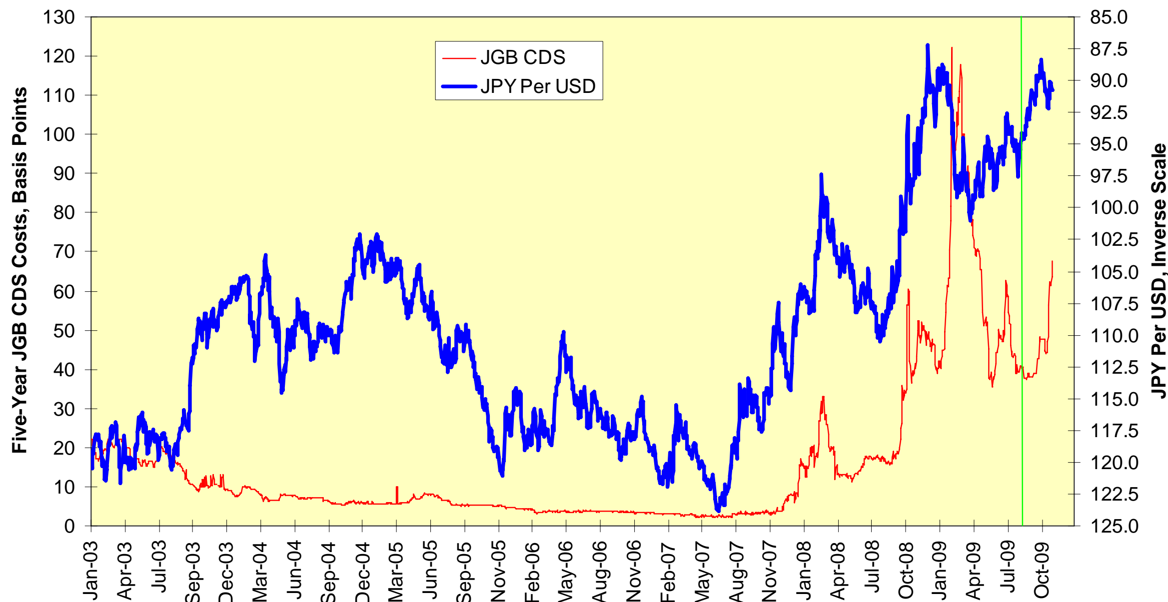
No gambit lasts forever, as the delinquent thug Alex found out in Stanley Kubrick's 1971 classic. He reached, yes, the end of the line. Or, to mix time and place to The Marshall Tucker Band's *Can't You See*, you will take a southbound, all the way to Georgia, till the train runs out of track.

This is where Japan finds itself today. 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 suffering through Japan's Lost Decade (you may wish to check the math here). They have tried everything to jumpstart both the economy and their financial markets and have failed on all counts. When your public debt is 170% of GDP, your interest rates have been near 0% for more than a decade and you started quantitative easing in March 2001 and restarted it in December 2008, what else can you do on the stimulus front?

Rising Default Risk

One of the scariest facets of the 2008-2009 financial crisis was deteriorating sovereign credit quality. However, as I noted back in August, this started to reverse in late February with a joint Federal Reserve-Treasury statement we can summarize as, "We can print it faster than you can lose it, so your Treasury bonds are safe." The final bailout of Citigroup and quantitative easings in March by Switzerland, the U.K. and the U.S. underscored this point; financial markets took off and have not looked back significantly since then.

However, something unusual has started to happen in Japan. 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, has started to rebound and is now near 68 basis points. The timing of this ascent, marked with a green line on the chart below, is no accident, either. It is related to the economics of the global carry trade.

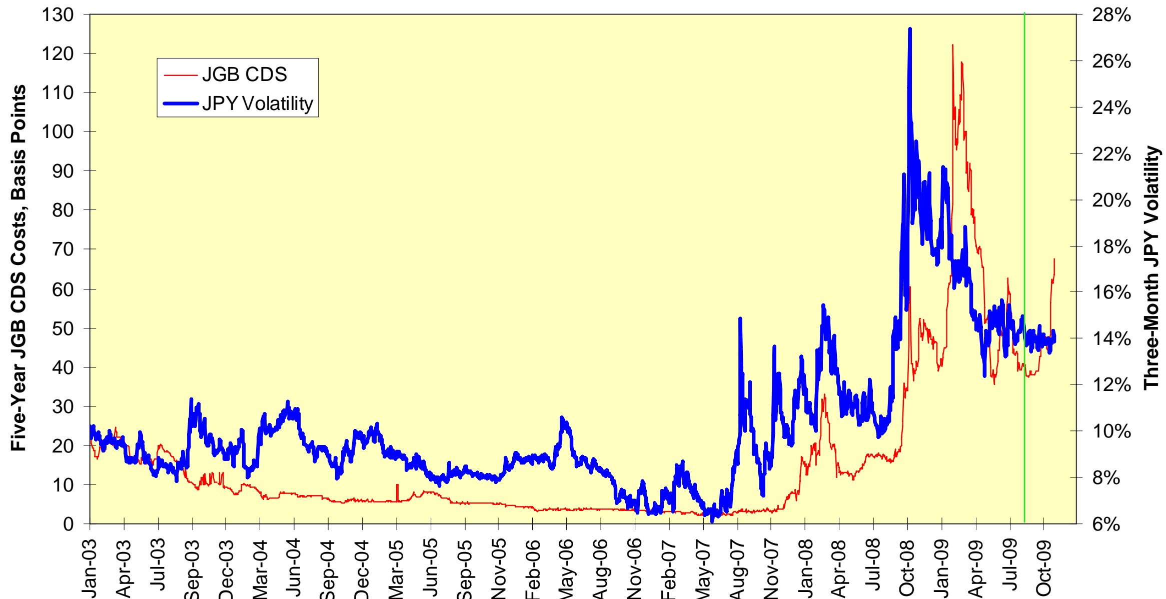


The yen had been the preferred funding currency for years in carry trades; it was borrowed, sold for another currency, and then lent or invested in that other currency. This meant the funds created in Japan went to finance other countries; it was no accident the global financial bubble of the late 1990s occurred as Japanese short-term rates plunged toward 0%, and it was no accident again our real estate bubble, amongst others around the world, occurred after Japan started buying massive amounts of U.S. Treasuries to keep the yen from appreciating in 2003-2004.

However, the U.S. and by extension China have won the race to the bottom, at least for now. The dollar and yuan became the preferred funding currencies in late August. 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 are wholly negative: A country whose export-dependence has been under assault by China for years finds itself with a rising currency and deteriorating sovereign credit quality.

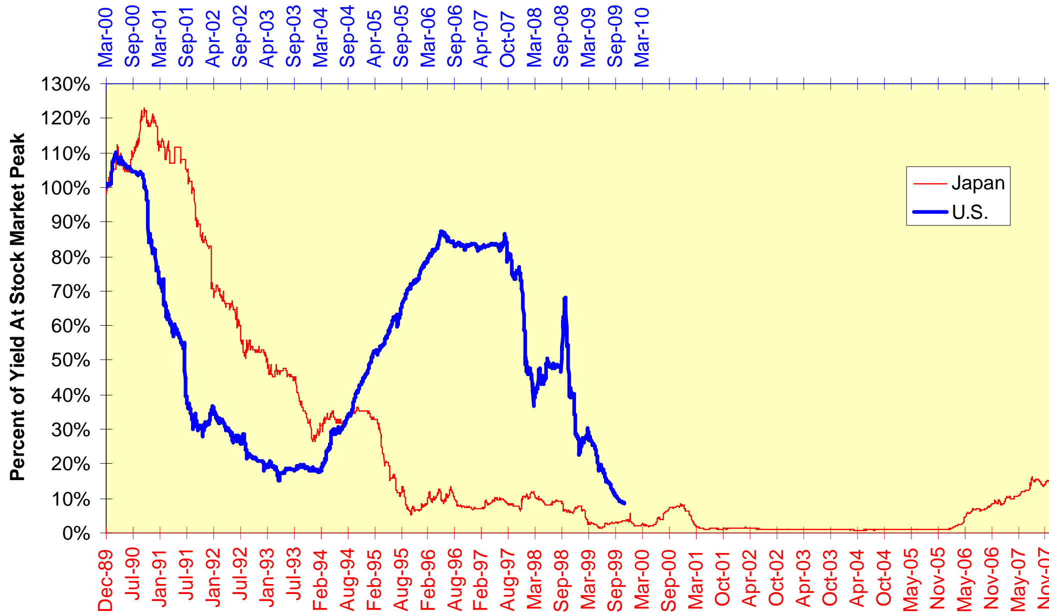
Moreover, there is some evidence this came as a surprise to the normally in-the-know currency traders of Japan. The volatility of three-month JPY forwards has tended to rise in advance of CDS costs. A perceived financial crisis led to an anticipation of yen carry trades unwinding. As currency traders anticipated closure of the yen carries, they bid the volatility higher. CDS costs tend to be more of lagging indicators of financial stress. A logical question is how the currency traders could get sandbagged like this. One answer may be no one ever anticipated seeing U.S. rates falling below Japanese rates and thus never anticipated any unwinding of carry trades.



U.S. Parallel

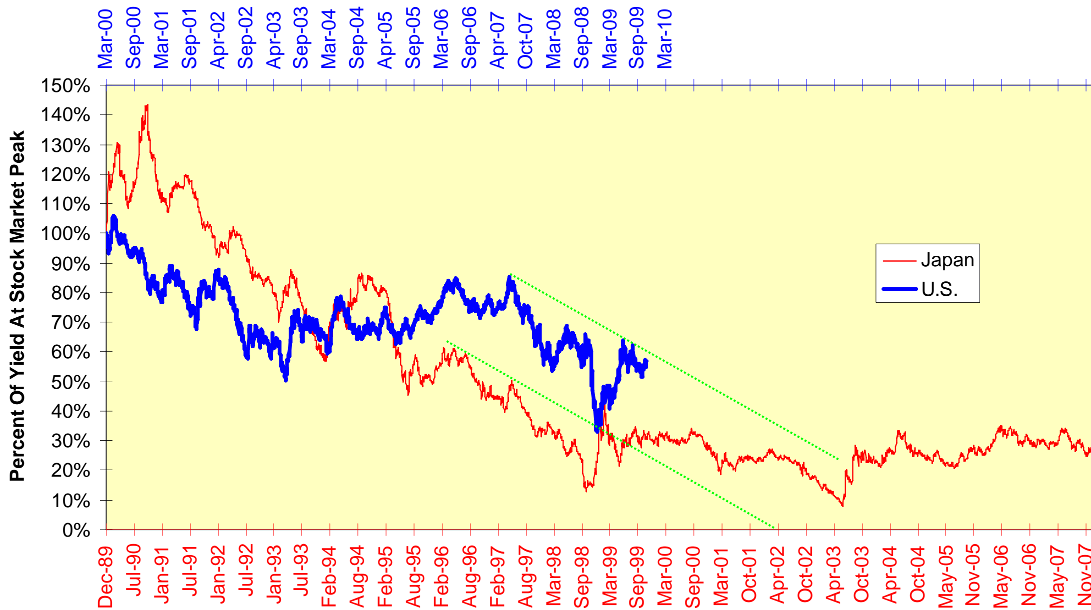
Now let's update a parallel between U.S. and Japan first introduced in October 2002. We can line up U.S. and Japanese long- and short-term interest rates as a percentage of where they were in March 2000 and December 1989, respectively. Six-month USD LIBOR fell further and faster into March 2004 than did six-month JPY LIBOR into March 1994; then our rates rose going into 2007. However, with the exception of the LIBOR dislocation in late 2008, our rates have plummeted and are now approaching the Japanese path.

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



The comparable path for ten-year rates looks much different. Our long-term rates, while in a declining channel roughly parallel to the Japanese channel as highlighted with the green trendlines, have not fallen as much. This can be interpreted in one of two ways: Either our rates embody much higher inflation or currency volatility expectations than theirs did at this point in time and will not fall, or our long-term rates may yet plunge to a Japanese path. I have to go with the former right now given the rising fears of forward inflation as embedded in markets such as gold.

U.S. Long-Term Yields Rising From Japanese Path



Either way, Japan has shown us the end result of twenty years of monetary and fiscal excess: Failure. Our short-term interest rates are on a Japanese path, and we are at unprecedented levels of monetary and fiscal stimulus ourselves. We have seen the proverbial Ghost of Christmas Future inviting us to change our ways. I think we should accept that invitation before we, too, reach the end of the line.