Bonds And The Dollar: 32nd's Over Tokyo?

Oh no, they say he's got to go go go Godzilla
Oh no, there goes Tokyo go go Godzilla

History shows again and again
How nature points up the folly of men

– Blue Oyster Cult, "Godzilla"

Isn't it nice to know that the Bank of Japan and the much-feared Ministry of Finance can take time out of their busy schedules to engage in currency intervention? The blue-suit brigade was out there selling yen and buying dollars last week, and I'm sure they'll bring the same deft savvy to this endeavor as they have to their primary task of extending the Japanese recession into its second decade.

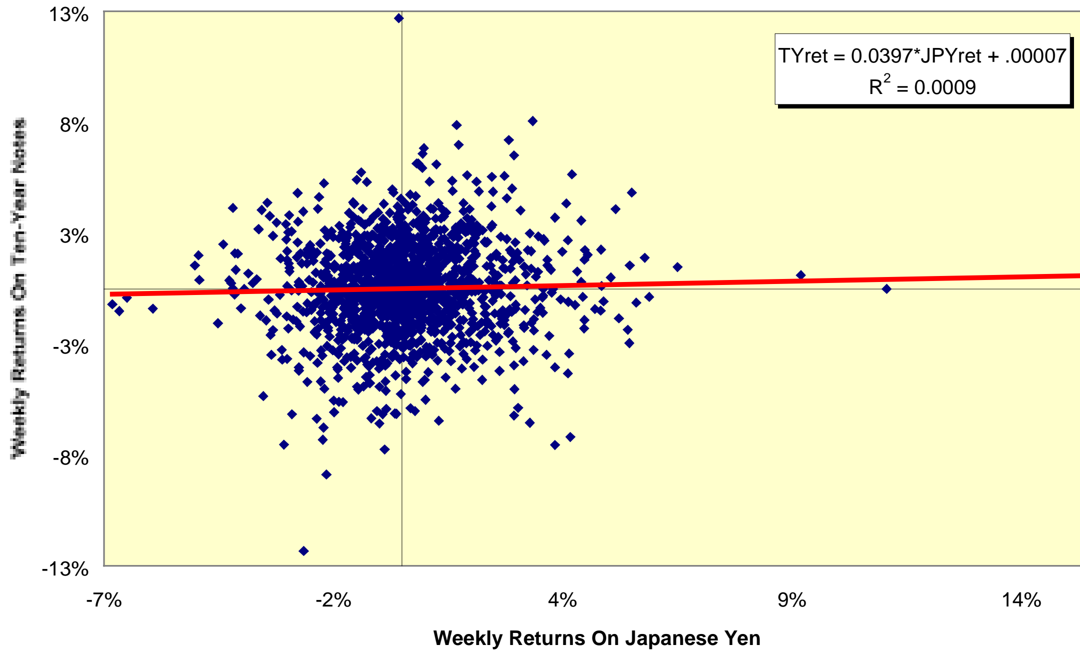
We need not fear movements higher or lower in the dollar or in any other major currency so long as they reflect the market's assessment of underlying economic fundamentals. If, however, the world's central banks return to their loser's game of currency interventions, I'm going to put on a turban, pay cash for a one-way ticket to Afghanistan, and find a little fixer-upper of a cave to call home until sanity is restored.

Just The Facts, Ma'am
I provided thirty years of data – the entirety of the modern international monetary experiment in floating exchange rates – to support my argument that not one episode of U.S. stock market weakness coincides with a period of dollar weakness. Did this calm a rising tide of fear, or can Procter & Gamble and Kimberly-Clark continue to look for growth in adult diaper sales in the vicinity of Wall & Broad streets?

No, the Fear Factor is now spreading to the bond world on the basis of the following argument: A weaker dollar will raise the cost of imports and provide a cover for American manufacturers to raise their own prices. Moreover, foreign investors will demand a risk premium for holding onto dollar assets much the same way that you would for buying Argentine bonds. Are there any facts behind these arguments, or are they just one more burst of early summer hot air?

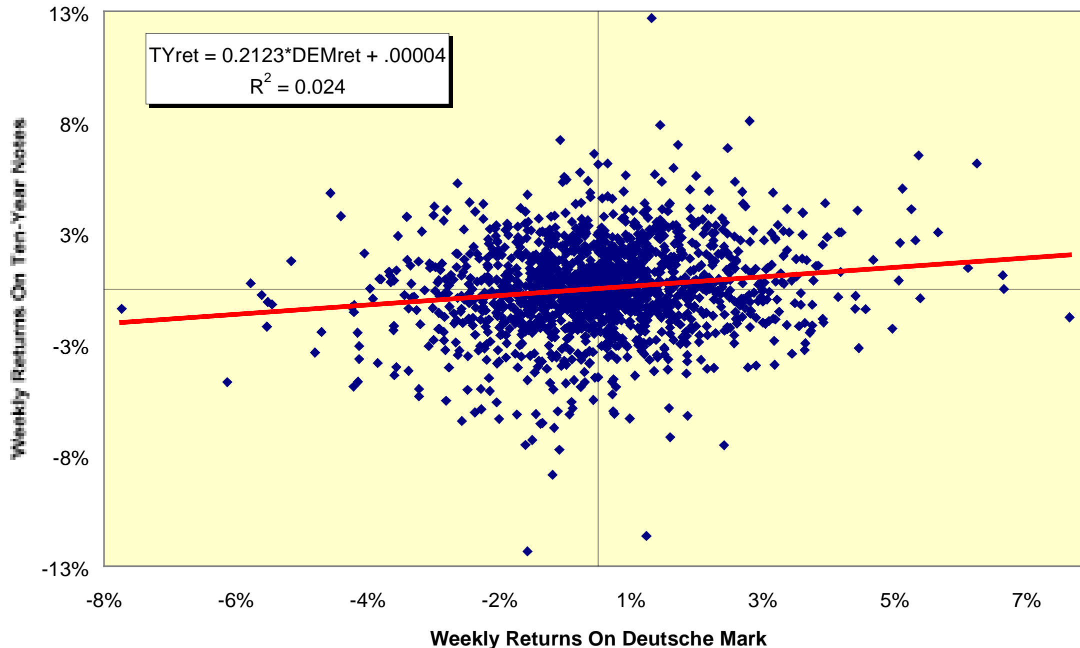
Hardly: If we take the weekly returns on the Japanese yen and compare them to the weekly percentage changes in Ten-year note yields, with a drop in yield expressed as a positive, we find no statistically significant relationship. The r-squared, or amount of Note variance explained by the yen, is a trifling .09%. And, the slope of the line is slightly positive, which would imply that Ten-year note yields have a tendency to fall as the yen strengthens.

A Negative Relationship?

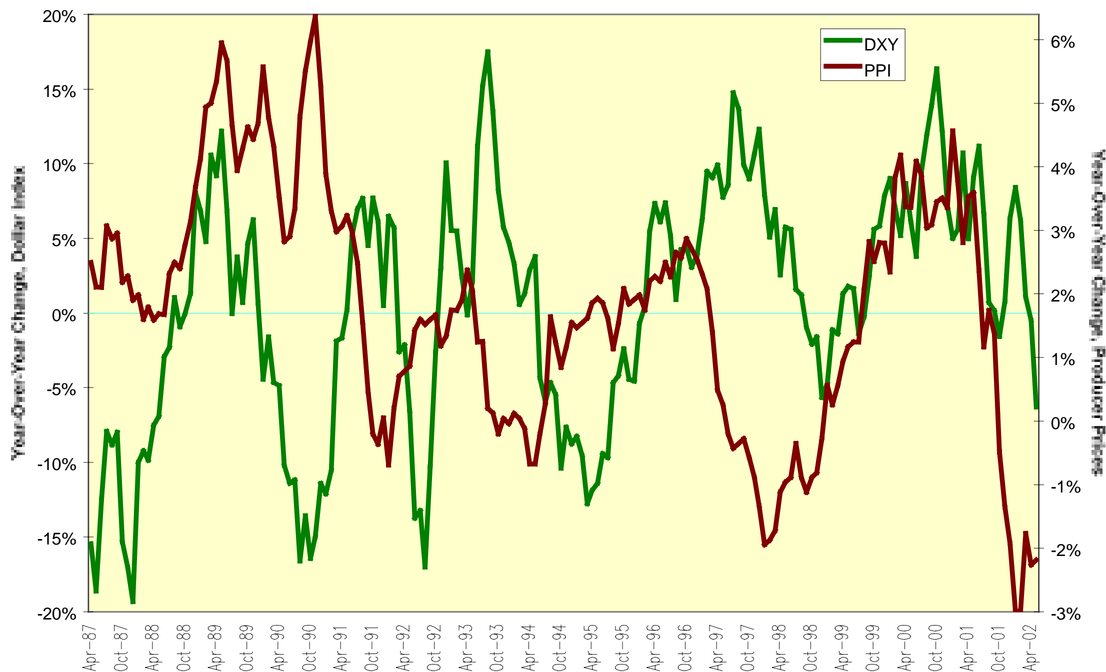


Is it any different for the European currencies? Of course not: If we take the weekly returns on the Deutsche mark, which is still quoted in a relationship to the euro, we see an even stronger relationship suggesting that a weak dollar is accompanied by falling note yields. Neither of these relationships should be surprising: A slower economy leads to both lower expected returns on dollar assets and to lower interest rates. The opposite holds true as the economy strengthens.

You Vill Buy Notes, Ja?

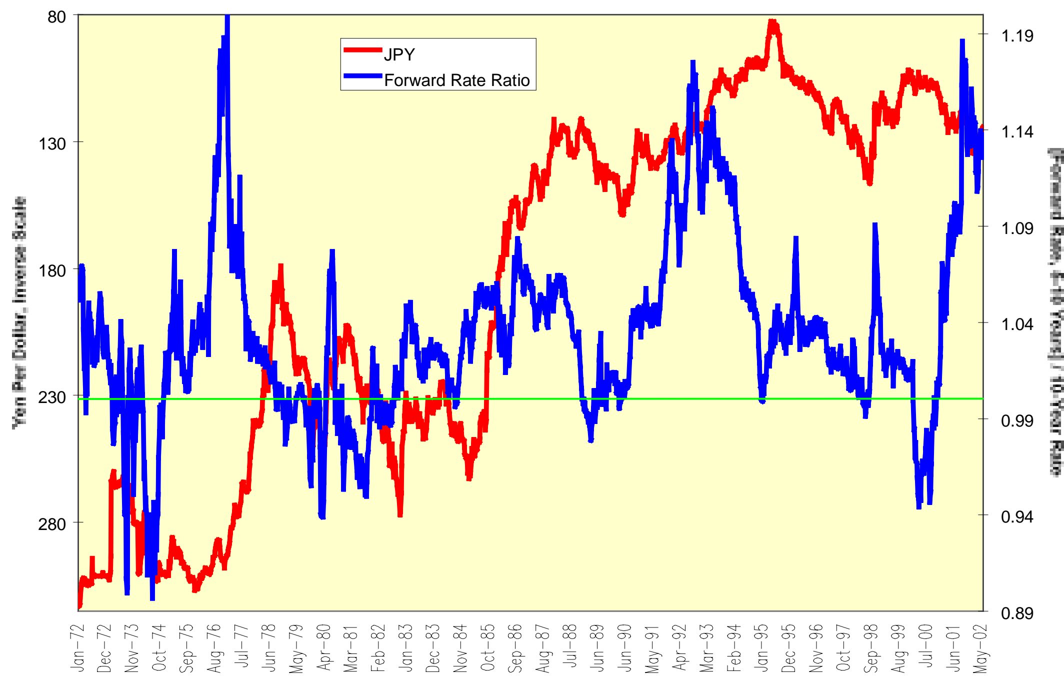


What About Inflation?
Let's shine some light on the question of whether a weakening greenback leads to higher inflation or not. If we chart the year-over-year changes in the trade-weighted dollar index and in the producer price index since 1987, we see that falling producer prices tend to lead a falling dollar. The length of this lead is about one year on average. Given the precipitous decline in producer prices over the past year, which also tends to be associated with both low returns on assets and lower interest rates, it is hardly surprising for the dollar to be in a weakening phase.



The yield curve offers another way to look at the question of whether a stronger yen / weaker dollar combination shows up in U.S. inflation data. We can calculate the liquidity premium in the mid-range of the yield curve, here measured by the ratio of the forward rate between 5- and 10-year Treasury notes to the 10-year rate itself. This forward rate is the rate at which we can borrow money for five years starting five years from now; a number is strong excess of 1.00 implies strong inflationary expectations.

The Yen and Longer-Term U.S. Inflation Expectations



The forward rate ration, while high, has been dropping recently, and the yen does not appear ready to duplicate either of its two historic surges, the ones between 1976-1979 and 1985-1988. Those two surges took place when expected returns on Japanese assets were quite high, a situation that certainly does not obtain at present.

There's a lot to be concerned about right now with respect to our present state of economic mismanagement, but simplistic worries about the course of the dollar unsupported by data does not qualify for this list. The whole thing makes me mad enough to rent a giant lizard suit and chase Paul O'Neill and Bono around Africa for a few yucks.