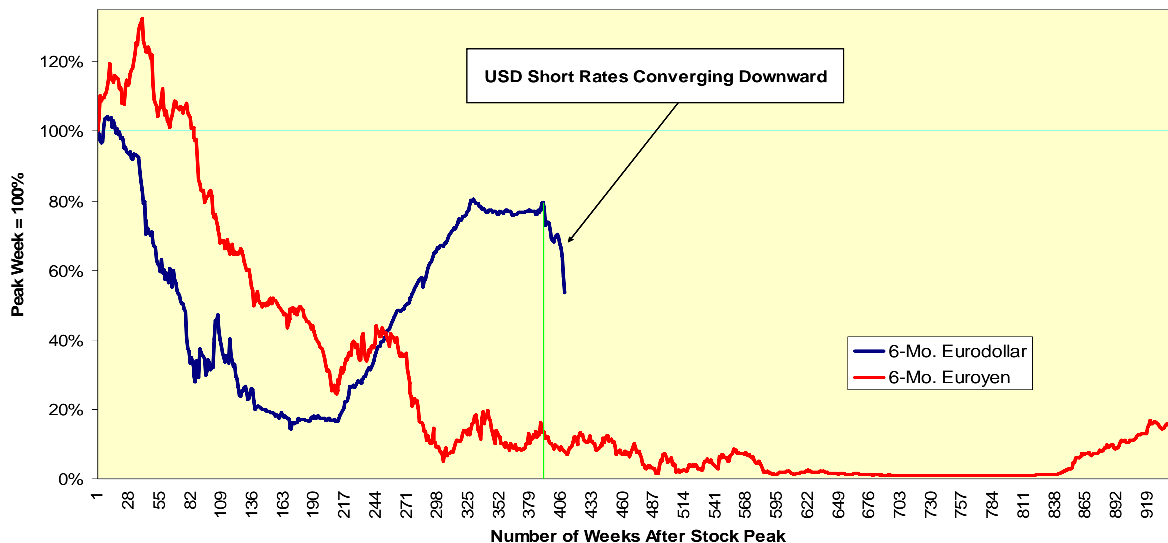
We Are Japan Now

Sometimes you want to tiptoe around an issue; sometimes you just have to deliver the bad news unvarnished. Here is the bad news: The United States has descended into the same path as Japan did in the early 1990s. Note the using of the present perfect tense. This process has been underway and is likely to continue with tragic inevitability.

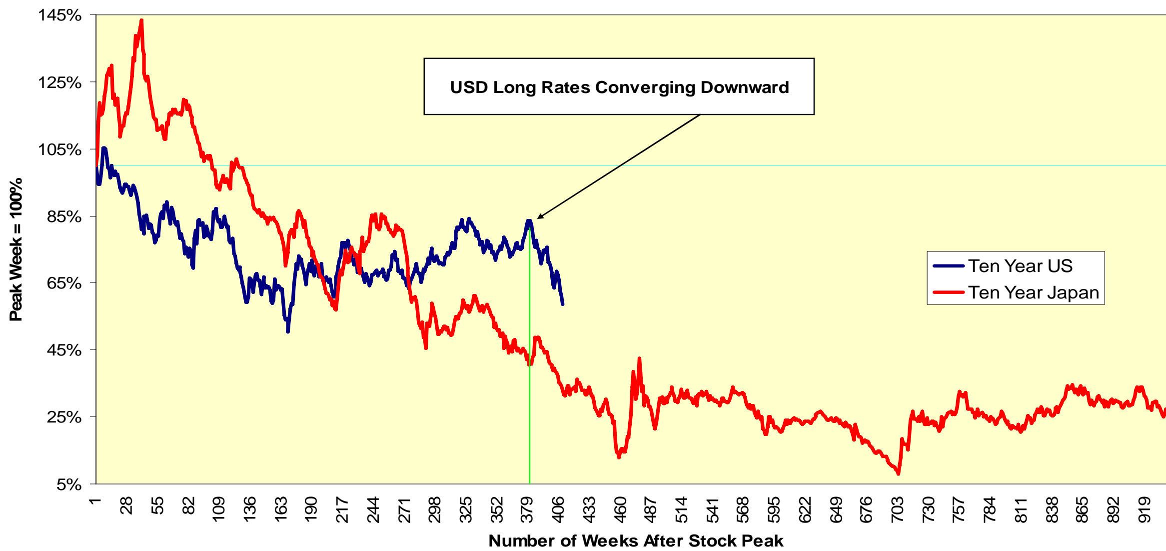
Interest Rate Analog

Let's revisit two charts from an October 2002 column comparing the paths of U.S. and Japanese six-month LIBOR and ten-year government interest rates. Both markets are re-indexed to their respective bull market peaks of December 1989 for Japan and March 2000 for the U.S.

I noted in October 2002 that U.S. rates had fallen further and faster than their Japanese counterparts at this stage. The paths diverged for six-month LIBOR by late January 2005; this was in the midst of those seventeen consecutive rate hikes between June 2004 and June 2006. We are now collapsing downward at a rate unseen in the Japanese experience.



The divergence in ten-year government yields occurred in July 2005. Indeed, U.S. long-term yields seemed poised to re-enter a bear market by June 2007. The drop in ten-year note yields has rejoined the Japanese trajectory and indeed is collapsing faster now than in the Japanese experience.



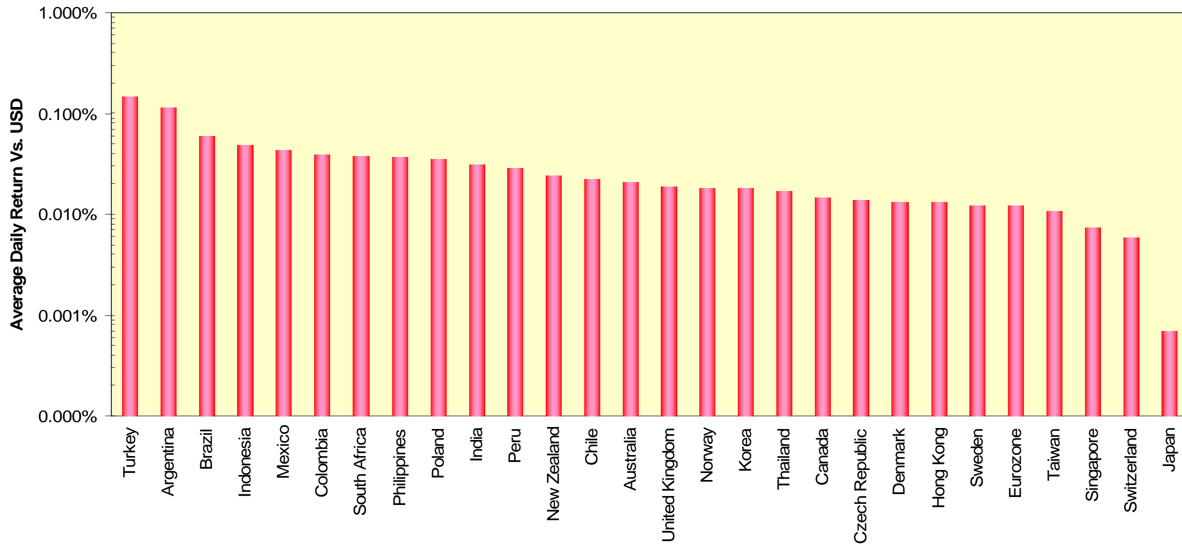
Now for the scary part: This point in the history of post-bubble Japan maps out to April 1997. They did not begin their quantitative easing until March 2001 when the Bank of Japan decided its zero interest rate policy was not easy enough. That is almost four years. Those who believe all that is required for the market to head north and for flowers to bloom and birds to sing is one more rate cut by the Federal Reserve are invited to ponder this history.

The Dollar Carry Trade

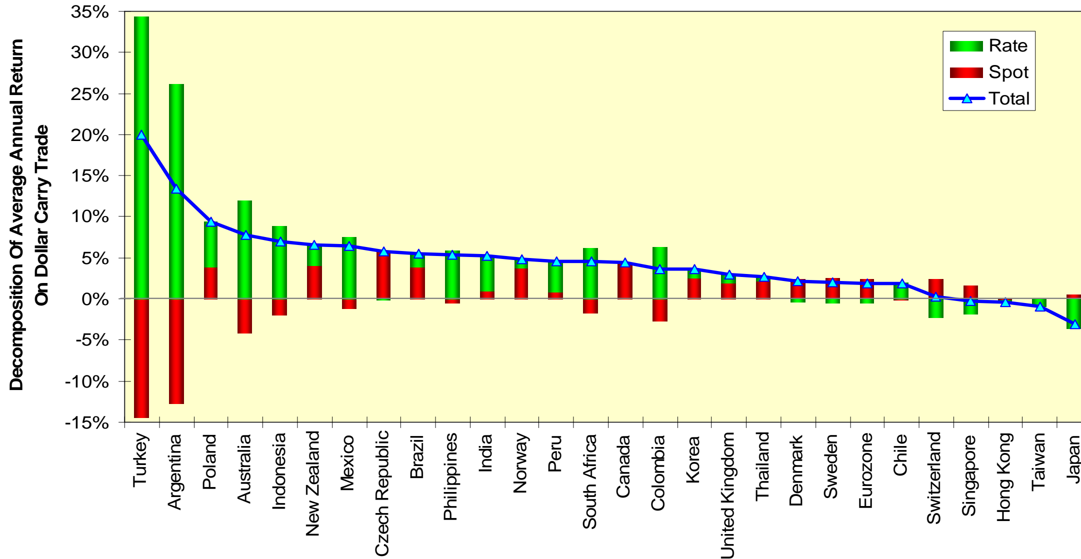
Just as I invited everyone to start thinking about the unthinkable two weeks ago in the context of the Federal Reserve, here is another mind game. What if a "dollar carry" trade emerges to parallel the yen carry trade ongoing since 1995? Such a trade would involve borrowing the dollar, selling it and then buying assets denominated in other currencies.

Let's use the present perfect tense once again. That trade has been underway ever since the advent of the euro in January 1999. Let's revisit the analytical framework used in January 2007 for the yen carry trade to quantify just how this dollar carry trade has been working.

The chart below depicts the average daily return on the interest rate spread of borrowing three-month dollars and lending in three-month instruments elsewhere.



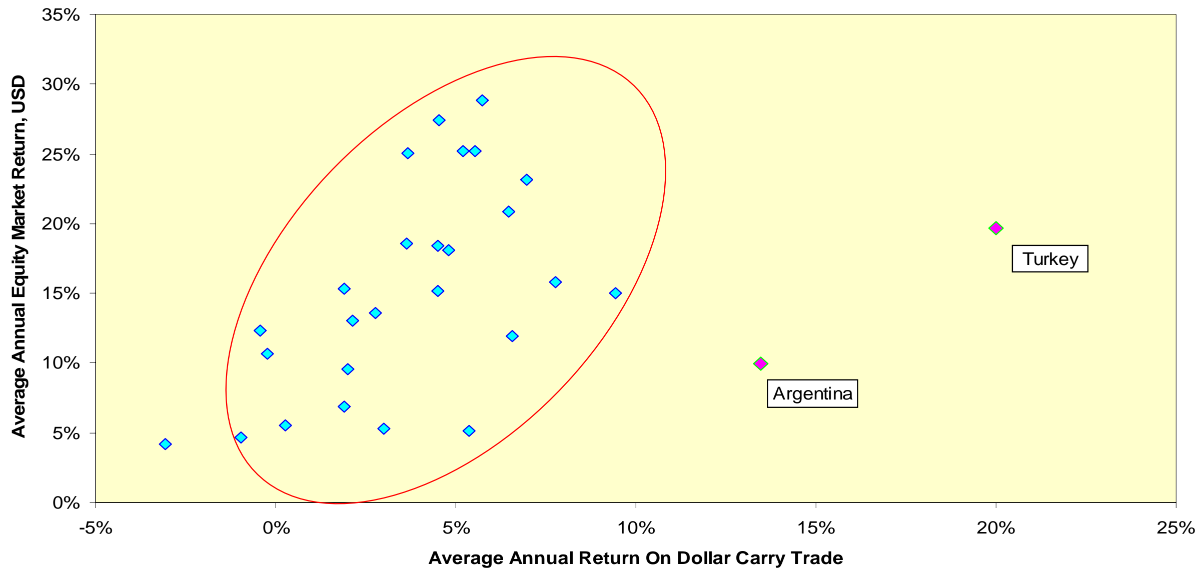
Of course, interest rates are but one part of any currency trade. What good does it do to earn an interest rate spread and lose that much or even more on the currency's spot rate? Let's add the spot rate and the interest rate spread together to get the total return for the dollar carry trade in each of these 28 currencies.



The results are astonishing. The dollar carry trade has been profitable for all currencies except the yen, and three Asian dollars, those of Singapore, Hong Kong and Taiwan, since January 1999. If U.S. short-term rates continue to plummet, the dollar will be a funding currency just as the yen has been.

Stock Market Impact

Just as we saw last year in the case of the yen carry trade, a positive correlation exists between average annual total returns for various stock markets and the average annual return on the dollar carry trade. If we consider Argentina and Turkey as statistical outliers, we can demonstrate a regression beta of 1.46 for this relationship.



Once again, the implications are grim. As the dollar cannot have a positive carry against itself, we must conclude the U.S. is condemned to underperform the world for years just as Japan has underperformed the world for years. I put a chart in a November 2007 column of country returns relative to the Morgan Stanley Capital International World index since May 2001. The two worst performers were Japan and the U.S.

In fact, the Nikkei 225 is at levels first reached in February 1986, and the S&P 500 is at levels first reached in March 1999. Japan pioneered the misbegotten policy of trying to stimulate its domestic economy with lower interest rates. When its policies failed, it shifted to doing more of the same. Japan succeeded in funding a global asset boom with its funding trade.

Einstein famously defined insanity as "doing the same thing over and over again and expecting different results." The previous American attempts at macroeconomic management through lower short-term interest rates produced the 1990s stock market bubble and the 2003-2006 real estate bubble. We can predict with 100% confidence the current attempt will exacerbate the dollar carry trade and lead the U.S. down the same path as Japan. Why 100%, you ask? The answer lies in that present perfect tense: The dollar carry trade has been underway; predicting something that exists already is not much of a stretch.

If we use the Japanese experience as our guide, we should underweight the U.S. in our equity portfolios and overweight it in our bond portfolios. While returns in a global bear market are going to be under pressure regardless of the broad-based instrument, you might want to investigate the MSCI World Ex-U.S. exchange-traded fund (CWI) as a core equity holding going forward.

Oh, one final word is in order. As someone who is quite patriotic and well-traveled enough to consider the U.S., in Lincoln's words, "the last best hope of earth," it pained me personally to reach these conclusions. You can live here, but maybe your investments should live elsewhere.