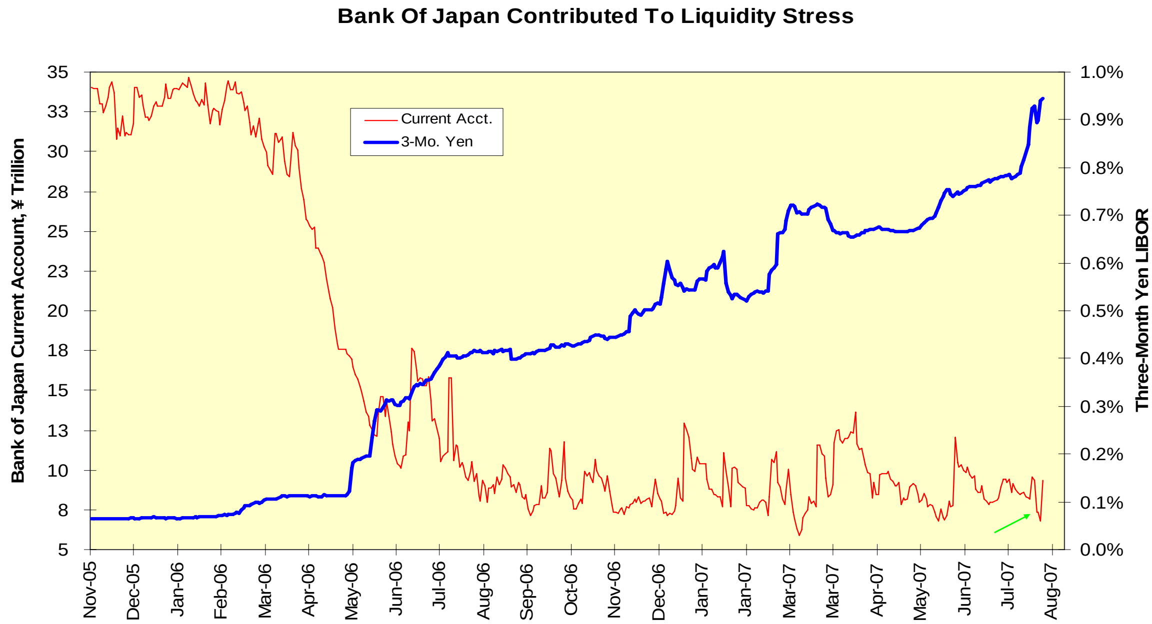
The Bank of Japan's Error

Here's a challenge for all you Internet search whizzes out there: Find out how many times I have used the word, "oafish" in print. My answer is just once, in a July 2006 column wherein I said:

> *Scrap all the focus on the Federal Reserve and the next move in the federal funds rate; focus instead on the oafish attempts by the Bank of Japan to manage the supply of money.*

The oafs are at it again. Immediately after liquidity infusions by the European Central Bank, the Federal Reserve and for all I know the Central Coconut Repository of Vanuatu between August 10-16, 2007, the BOJ heard the beat of a different drummer and let both the price of short-term yen as measured by three-month LIBOR rise and the quantity of excess yen, as measured by their so-called current account balance shrink, as marked by the arrow. Finally, on Friday, August 17, 2007, an 875-point drop in the Nikkei 225 induced them to open the taps a little. Their intransigence may have set the stage for the Federal Reserve's discount rate cut.

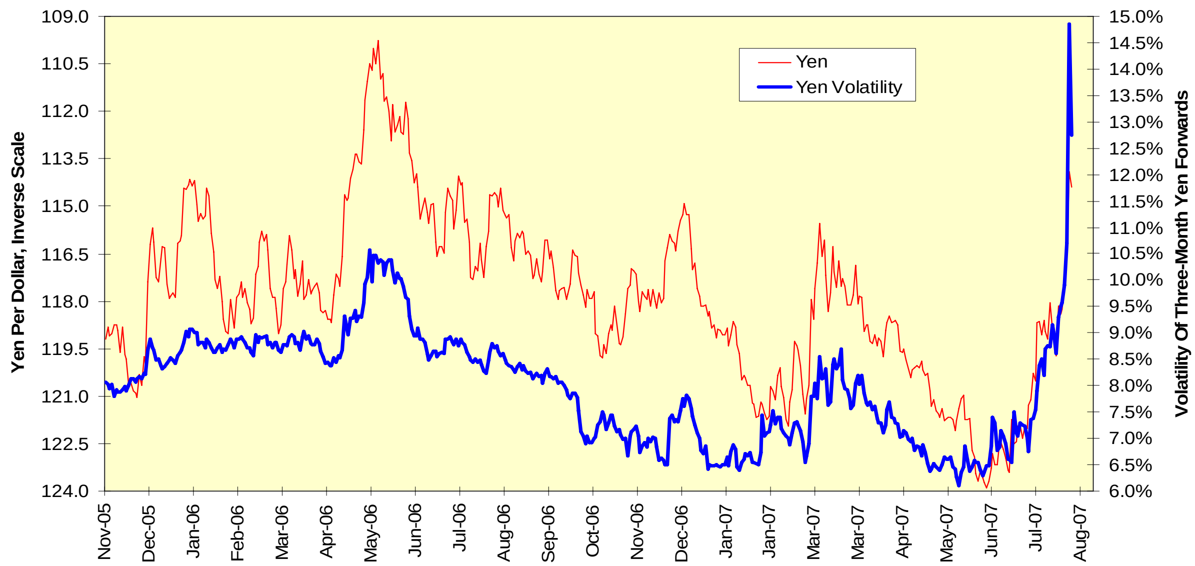


Those Who Carry Get Carried Out

In the middle of what appears to be the worst global financial disruption since August 1998 – and certainly the one with the greatest degree of macroeconomic risk, the BOJ appears to be taking a bad situation and making it worse. Higher interest rates for yen borrowings and a lower available supply of yen threaten the yen carry trade, described here most recently in January.

Those who have borrowed yen must repay their loans at some point and therefore are at risk to a stronger yen. We can measure the anxiety of those borrowers about prospective yen strength by looking at the volatility of three-month yen forwards; as panic increases, so does volatility. That volatility shot higher this past week as the BOJ's policies took effect. The currency market is pricing in a stronger yen to come. This is not quite the scenario I had in mind this past May when I called for a bottom in the yen, but the net result is the same.

The Great Yen-Buying Panic of 2007

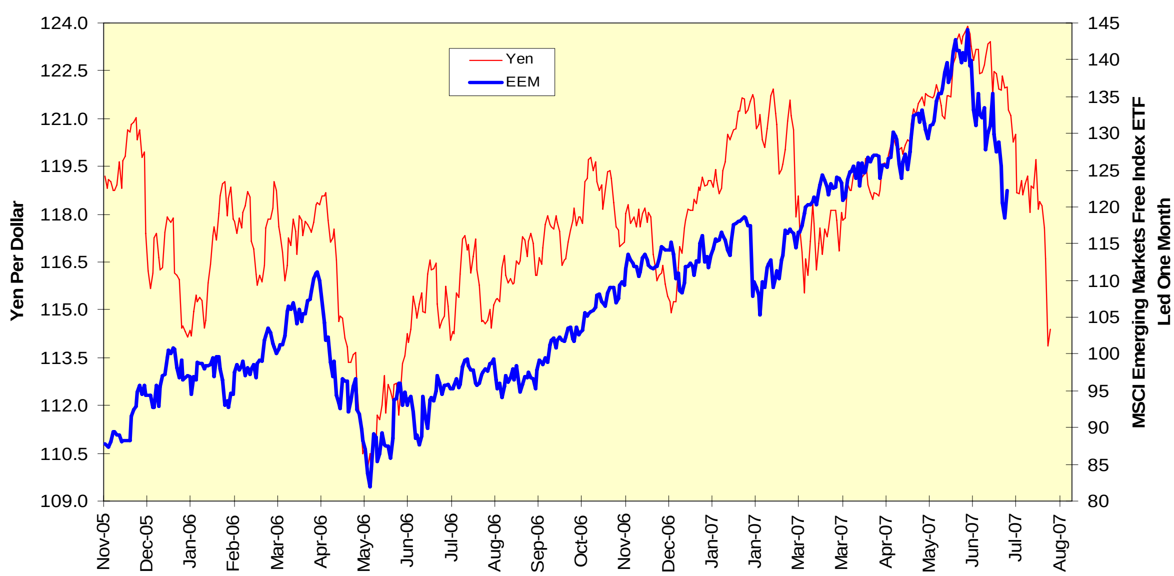


The Link To Emerging Markets

Even if you never have traded the yen, its strength affects large swaths of your portfolio. Let's take the case of emerging markets, which until the recent tumble had been on a tear. If we map the course of an ETF linked to the Morgan Stanley Emerging Markets Free index, the EEM, against the yen, we see a very clear leading relationship.

The yen leads the EEM by one month on average. As the currency continues to strengthen, we can surmise yen carry traders will close their emerging markets positions and drive these indices lower. These engines of global economic growth are threatened, clearly and directly, by the BOJ's policies.

Yen Strengthened In Advance Of Emerging Markets Break

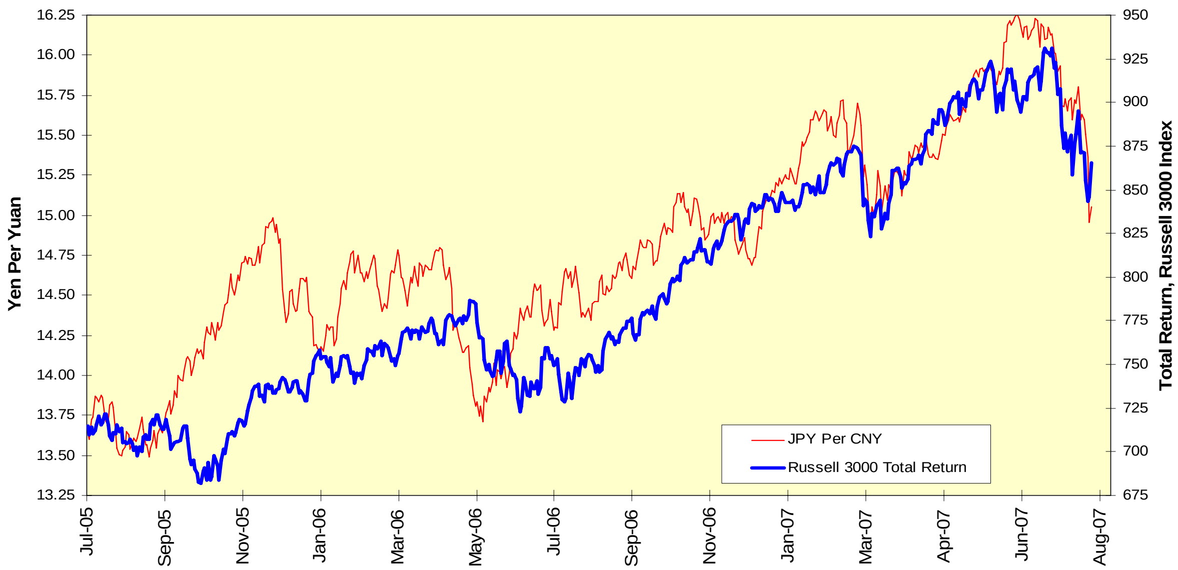


The Yen-Yuan Connection

I first discussed the impact of the cross-rate between the yen and the yuan on U.S. bonds in April 2006. The mechanism was straightforward: As the yen strengthened against the yuan, Japan felt it needed to restore its competitiveness by driving the yen lower by printing yen and selling them for American bonds.

That was a strong and demonstrable relationship. However, it is nowhere near as strong as the relationship between the yen-yuan cross-rate and the total return on U.S. stocks as measured by the Russell 3000 index. As the yen strengthens on the cross, U.S. stocks drive lower. Once again, the BOJ's policies are producing financial stress.

U.S. Stocks' Asian Currency Connection



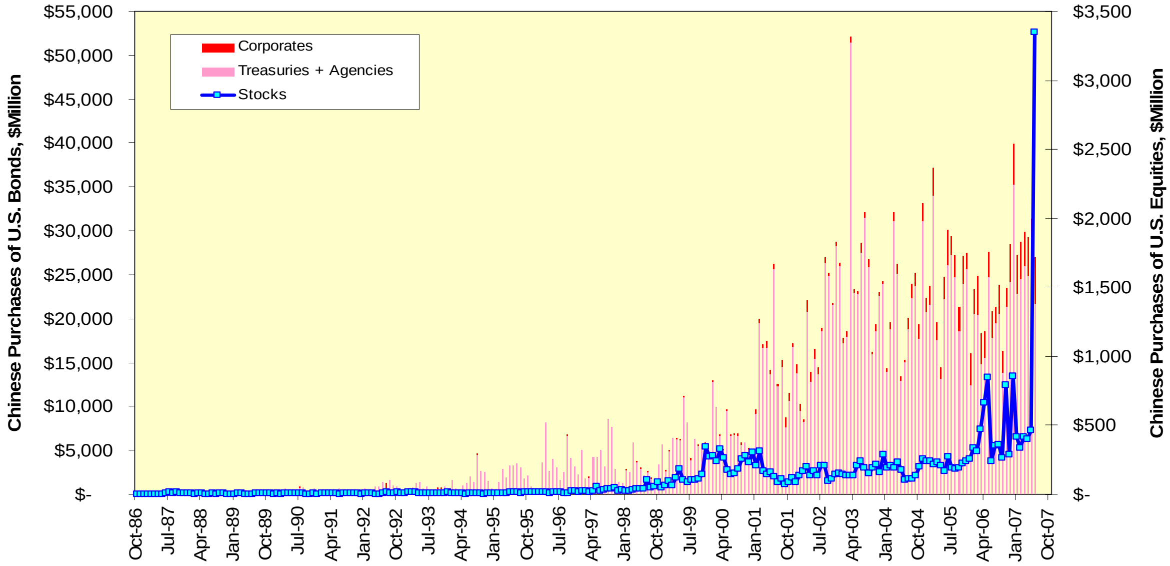
The Light At The End Of The Tunnel

The picture so far has been pretty gloomy. Is there a win-win solution somewhere? Yes and the answer is China. Our good friends in Beijing have $1.332 trillion in foreign exchange reserves and they have customers on this side of the Pacific who keep their factories humming and churning out all manner of wonderful products, none of which you should ingest without a Royal Taster by your side.

By the way, how much is $1.332 trillion? If you had spent $1.8 million per day every day since the Year 1, you would not have spent $1.332 trillion yet. It is a lot of money.

According to data compiled by the U.S. Treasury, China has been recycling its reserves into the U.S. primarily through purchases of Treasuries and Agencies, and to lesser extent corporate bonds. However, in June 2007, the last reporting month, their purchases of U.S. stocks shot higher.

Are China's Buying Habits Changing?



If you do not remember how their bid for Unocal ran into political resistance, they do. China has the means, opportunity and motive to buy U.S. equities. They have gone through channels, such as investing in Blackstone Group, but the simpler route for them will be to buy large blocs of shares in U.S. firms without setting off the political alarms associated with outright takeover bids.

Economic historians will note the U.S. did the same thing in Europe after World War I and Japan did the same thing in the U.S. in the 1980s. Money in abundance flows to where it is needed.

If the Federal Reserve and its sister central banks are not willing to bail out the miscreants of the subprime mess, maybe the Chinese will step into the breach. They will diversify their portfolio by buying everything; it is the only way they can keep you buying their exports.