Liquidity And The Return Of The Yen Carry Trade

Be careful what you wish for, we are told, usually by people not in a position to grant us anything. If we could condense the experience of the last two months – and yes, global equity markets hit their highs just two months ago – into a tee-shirt slogan, it might read, “Money lubricates everything.”

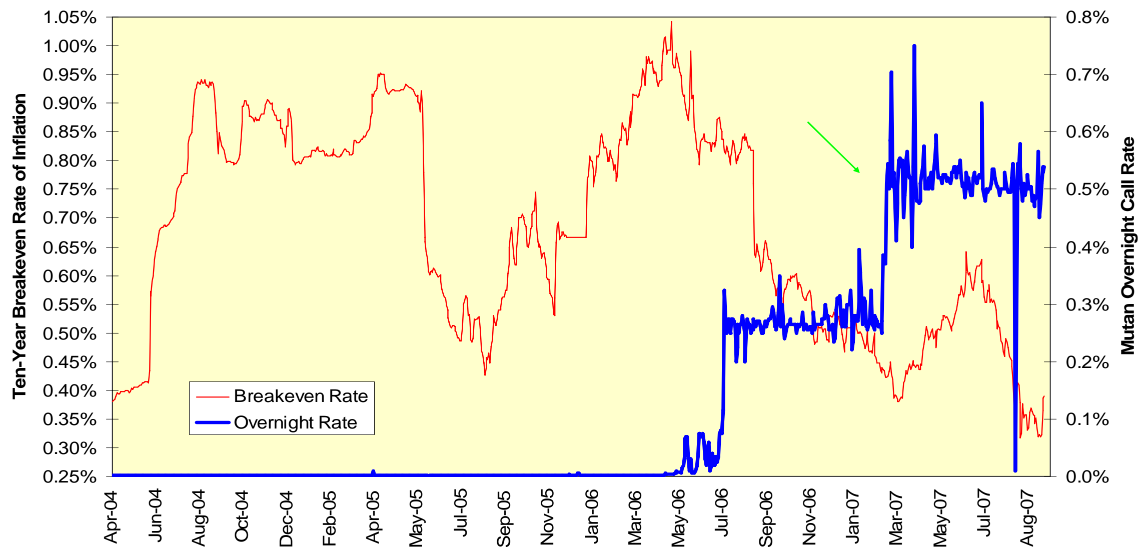
Financial markets included.

Just one month ago I excoriated our good friends at the Bank of Japan (motto: Making the Fed look good, aren’t we?) for withdrawing excess liquidity from their current account at the very moment the world was discovering it was in a credit crunch. The end results of that boneheaded move have included a stronger yen and a drop in long-term inflation expectations in Japan to the 0.391% level…and that is up from 0.32% the previous week.

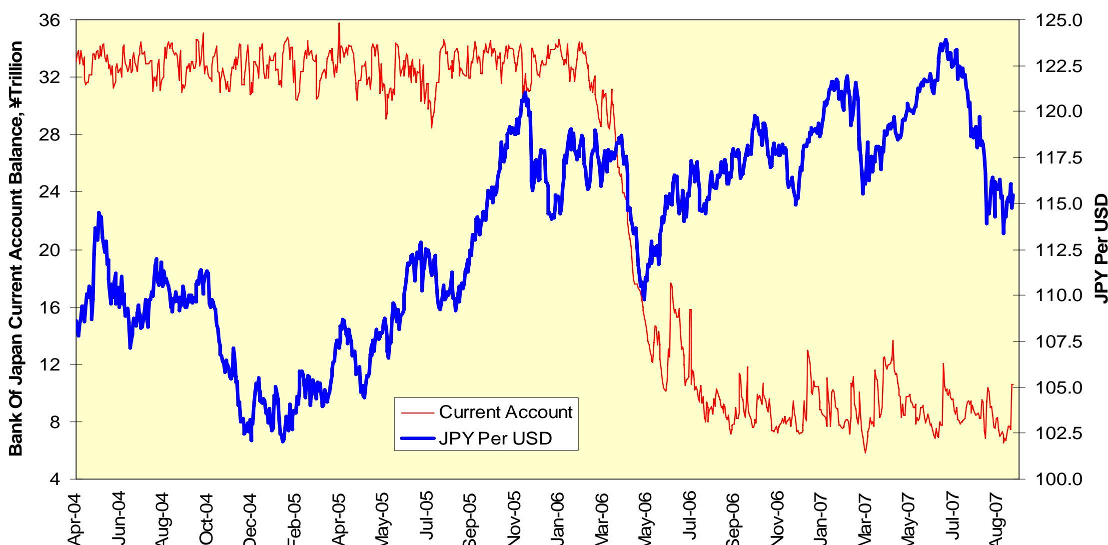
A disaster? Hardly. The good news, if we may call it that, for risky assets is an environment conducive to Japan turning the liquidity taps back on and reigniting the global yen carry trade that financed so many of the world’s asset price bubbles over the past dozen years. If we throw in a few moves such as the Federal Reserve’s 50 basis point rate cut and the Bank of England’s de facto nationalization of Northern Rock, we have the makings of a pretty good inflationary party, don’t we?

Small Changes, Big Impacts

Lest you think this is nothing but a broadside against the BOJ and the politicians at the Ministry of Finance, let’s grant them their due in two matters. First, the last increase in overnight “mutan” rates occurred in late February, marked with a green arrow in the chart below. This was well after ten-year breakeven rates of inflation had declined to just over 0.43%. A subsequent rebound to 0.64% in early June suggests the February rate hike is not to blame for the current state of the Japanese inflation market.



Second, while the BOJ has reduced the excess funds in its current account balance, the overall level simply is near the low end of its range over the past year. The yen weakened substantially with the current account balance near its present level of ¥10.62 trillion, so we cannot blame the current bout of yen strength on liquidity withdrawals.

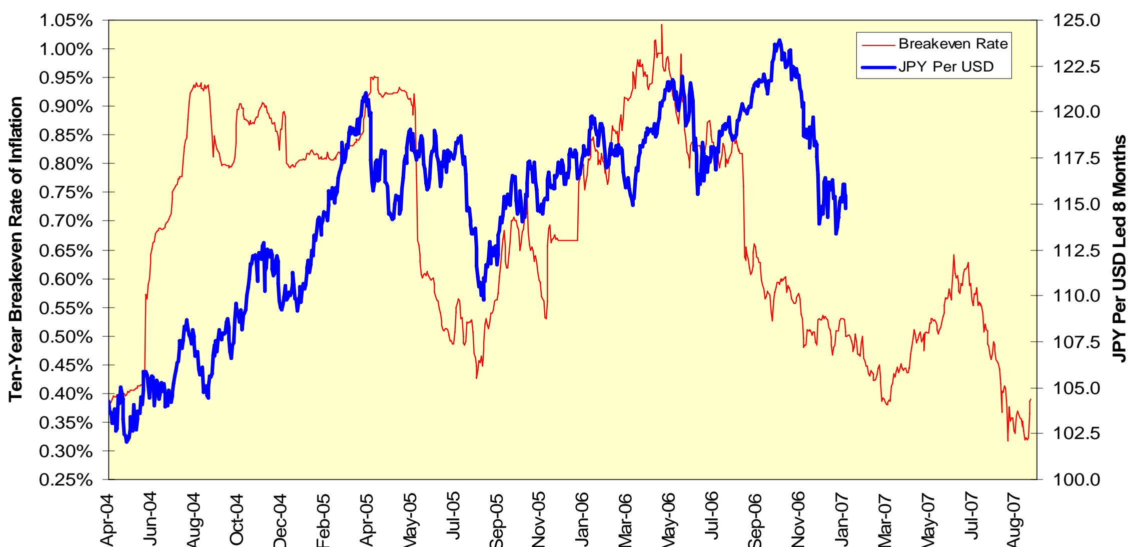


What we can conclude, however, is a combination of minor increases in Japanese short-term interest rates and minor decreases in excess liquidity was sufficient to produce a substantial increase in the yen. All risk-averse traders who had borrowed yen to finance positions elsewhere in the yen carry trade needed to believe was the overall direction of Japanese policy was friendly no more.

Inflation Expectations And The Yen

Now let's return to the rapid decline in Japanese inflation expectations and ask whether they will affect the course of the yen at all. We should expect the answer to be "Yes;" after all, the interest rate parity model of currency markets implies the currency with the lower expected rate of inflation should rise vis-à-vis the currency with the higher expected rate of inflation, all else held equal.

In addition, we should not expect the relationship to be instantaneous, but rather one where inflation expectations lead changes in the currency by 6-9 months. The actual lead time calculated here is eight months.

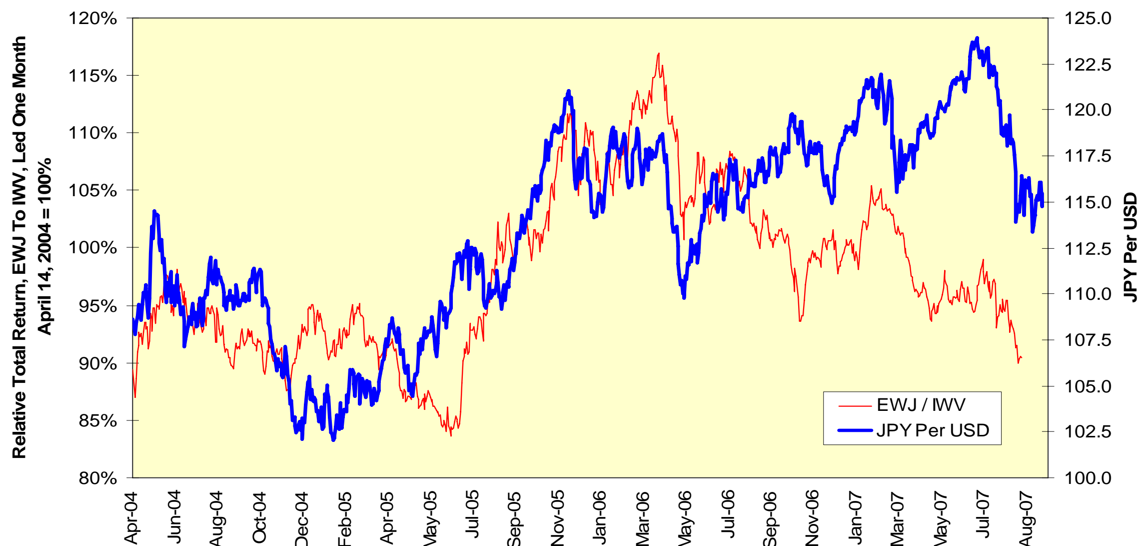


Given this, the recent strength in the yen has been a reaction to the observed decline in Japanese inflation expectations in January. Restated, unless the Japanese take affirmative measures to expand liquidity, they will be looking at a stronger yen into mid-2008 at the very least.

Implications For Japanese Equities

As discussed in April 2006 and again in August, Japanese monetary policy often appears designed to weaken the yen in a competitive devaluation with China and other Asian exporters. While no one can devalue their way to prosperity, there is little question the relative total returns of Japanese equities relative to American equities decline in the face of a stronger yen.

An American investor holding an ETF on the Japanese market such as the iShares MSCI Japan index fund (EWJ) would see returns relative to the iShares Russell 3000 index (IWV) decline with a one-month lag after the yen strengthened. It is somewhat odd to think that American investors in a dollar-denominated Japanese fund benefit from a weaker yen, but that is the case. And if the forecast above for a stronger yen barring Japanese action to weaken it comes true, you should stay away from Japanese shares into mid-2008 at least.



Implications For U.S. Equities

Now let's turn to the U.S. stock market and ask what the net industry group impact of a stronger yen is. We will use an analysis first introduced in February 2005 on assessing the impact of factor prices on S&P industry groups, and add the twist introduced in November 2006 on weighting these factors by the groups' representation in the index. Then we can construct a table of groups both helped and hurt by a stronger yen at a 90% confidence interval.

There are 16 industry groups in the S&P 500 accounting for 7.88% of the index' capitalization with a statistically significant negative beta to a rising yen. If we multiply them by their betas to the currency, we get a weighted beta of -0.89%. These stocks are concentrated in the Consumer Discretionary and Consumer Staples sectors. There are 9 groups with a statistically significant positive relationship to the yen, accounting for 2.45% of the index' capitalization. They have no particular concentration in any economic sector. Their weighted beta is 0.58%, for a net weighted beta of -0.31%.

Japanese Yen Beta-Weighted Impact On S&P 500

	SPX Weight	JPY Beta	Weighted Beta		SPX Weight	JPY Beta	Weighted Beta
Integrated Telecommunications	3.13%	0.088	-0.27%	Homebuilding	0.79%	0.272	0.21%
Drug Retailers	0.79%	0.136	-0.11%	Diversified Metals & Mining	0.56%	0.277	0.16%
Hypercenters & Superstores	1.00%	0.100	-0.10%	Gold	0.12%	0.737	0.09%
Wireless Services	0.56%	0.134	-0.08%	Home Furnishings	0.27%	0.189	0.05%
Department Stores	0.53%	0.130	-0.07%	Computers & Electronics Retailers	0.16%	0.160	0.02%
Automobile Manufacturers	0.27%	0.232	-0.06%	Other Diversified Financial Services	0.27%	0.070	0.02%
Apparel & Accessories	0.27%	0.139	-0.04%	Communications Equipment	0.13%	0.102	0.01%
Publishing & Printing	0.29%	0.100	-0.03%	Trading Companies	0.06%	0.131	0.01%
Food Distributors	0.16%	0.174	-0.03%	Diversified Banks	0.09%	0.072	0.01%
Home Entertainment Software	0.13%	0.183	-0.02%				
Specialty Stores	0.23%	0.093	-0.02%				
Motorcycle Manufacturers	0.09%	0.191	-0.02%				
Leisure Products	0.12%	0.131	-0.02%				
Specialty Chemicals	0.19%	0.061	-0.01%				
Photo Products	0.06%	0.175	-0.01%				
Commercial Printers	0.06%	0.129	-0.01%				
				Subtotal:	2.45%		0.58%
Subtotal:	7.88%		-0.89%	**Total:**	**10.33%**		**-0.31%**

On balance, the rising yen is something of a non-factor for U.S. equities.

The real kick will come if the Japanese look at their declining inflation expectations and rising yen with alarm. They could then do what our Federal Reserve has feared to do, which is ease aggressively. In a global capital market, the source of the funding is immaterial; only the presence of excess liquidity matters.

If you consider the consequences of excess liquidity, reputed to be asset bubbles of one sort or another, to be a good thing, remember to be careful what you wish for.