U.S. Is Japan's Yen Safety Valve

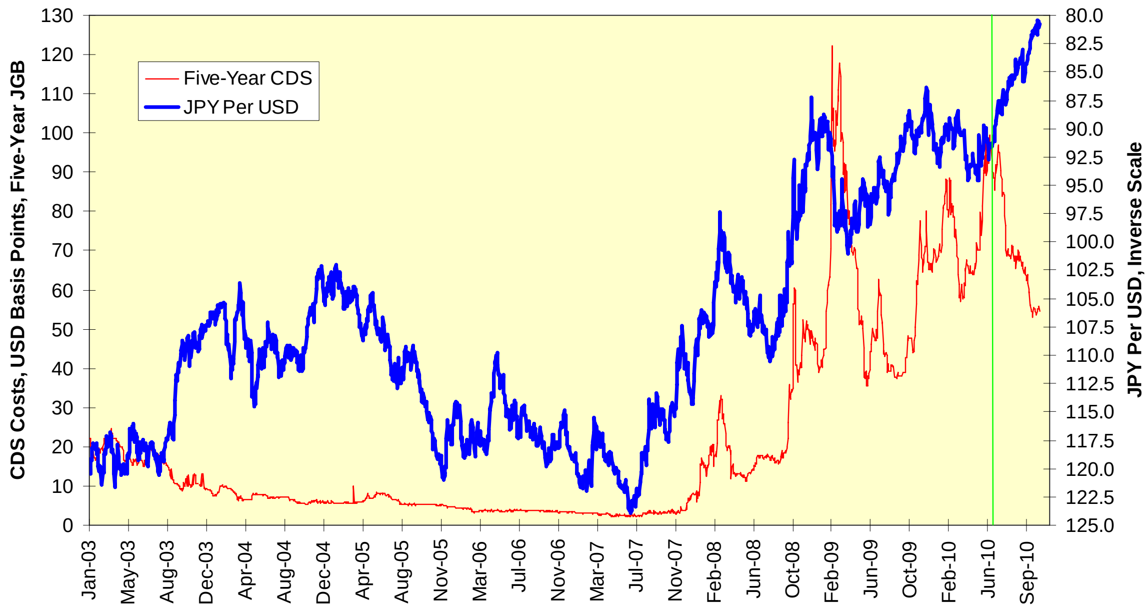
Japan has been unable to shake out of its economic doldrums for the past two decades no matter how low their interest rates go or how big their deficits get or how much money they print. One of the few things they clung to was a belief a weaker yen was going to allow them to export their way out of their mess, as if high-cost Japan could compete with low-cost China.

Rising Sun, Rising Yen

The yen began to strengthen against the dollar back in 2007 when the Federal Reserve began cutting rates. Coinciding with the yen's strength was an increase in credit default swap costs for Japanese government bonds; the idea was a stronger yen would increase Japan's problems and decrease the government's ability to service its own debt.

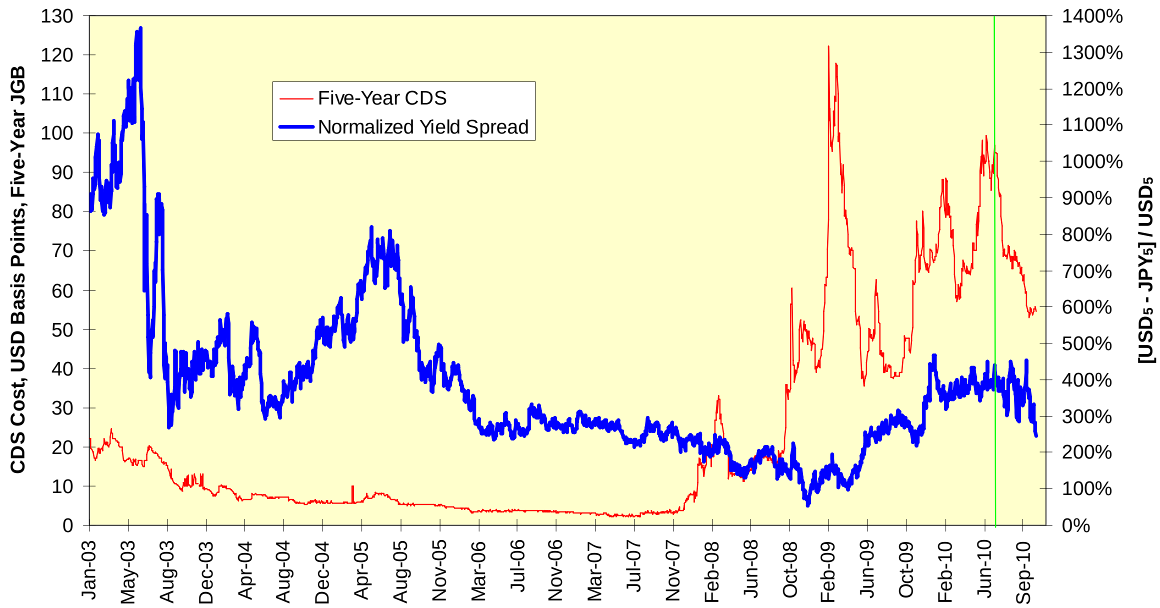
But note in the chart below what happened to this relationship right after China began to allow a modest revaluation in the yuan this past June. The yen strengthened as China began buying yen-denominated bonds, and this same move pushed CDS costs lower on the solid notion Chinese flows into Japan would lower sovereign credit risk.

Yen's Strength Continues



Also note how the yen stopped rising just before 80. Japan could take capital inflows and print whatever else it desired and send them over to the U.S. If we map the normalized yield spread between the U.S. and Japan, we see how U.S. yields have fallen relative to Japanese yields since the yuan revaluation began.

Credit Risk Of Japanese Five-Year Bonds Declining



Over and above whatever the Federal Reserve is printing, these capital inflows from Japan and from China via Japan are going to keep fueling U.S. capital markets. The only thing that would slow the conveyor belt is if the U.S. deficits contracted and shut off the demand for external financing.

I am going to go out on a limb and state that in the absence of tax increases and spending cuts on the fiscal side and on the absence of a surge in U.S. exports on the trade side, the U.S. is going to do just fine in providing a home for these flows.

The J-Curve

Finally, what will happen if the Chinese yuan strengthens (stop laughing; we have to ask these questions)? The U.S. trade deficit with China will expand, not contract as some would have it because of something called the J-curve. This operates by Chinese imports' prices rising, which increases the total bill for Chinese goods before any adjustments can be made in the form of domestic production or non-Chinese sourcing.

The J-curve is supposed to close, but in the case of Japan has failed to do so for more than 35 years. The stronger yen led to Japanese direct investment in the U.S. and to increased imports from sources such as Mexico, Taiwan and China, but the U.S. current account deficit as a percentage of GDP never closed and will not close regardless of whatever reasonable level the yuan reaches.

This combination of expanded deficits and continued reliance on foreign creditors will serve capital markets more than the non-financial sectors of the economy. Score a victory for Wall Street over Main Street, at least for the time being.