Yen Remains Hard To Drive Lower

Competing With Free Dollars Makes The Task Difficult

Official Japan, including the Ministry of Finance and the Bank of Japan, is convinced the nation would be better off if only it could destroy the purchasing power of its currency. The sentence you just read is not a joke; I wish it was, though. Japan is convinced a weaker yen would redound to the benefit of its export-oriented industries, including automakers such as Toyota Motor (TM) and Honda (HMC) and electronics exporters such as Sony (SNE). They also are convinced the best way to counter slack demand growth in their aging population is to create inflation.

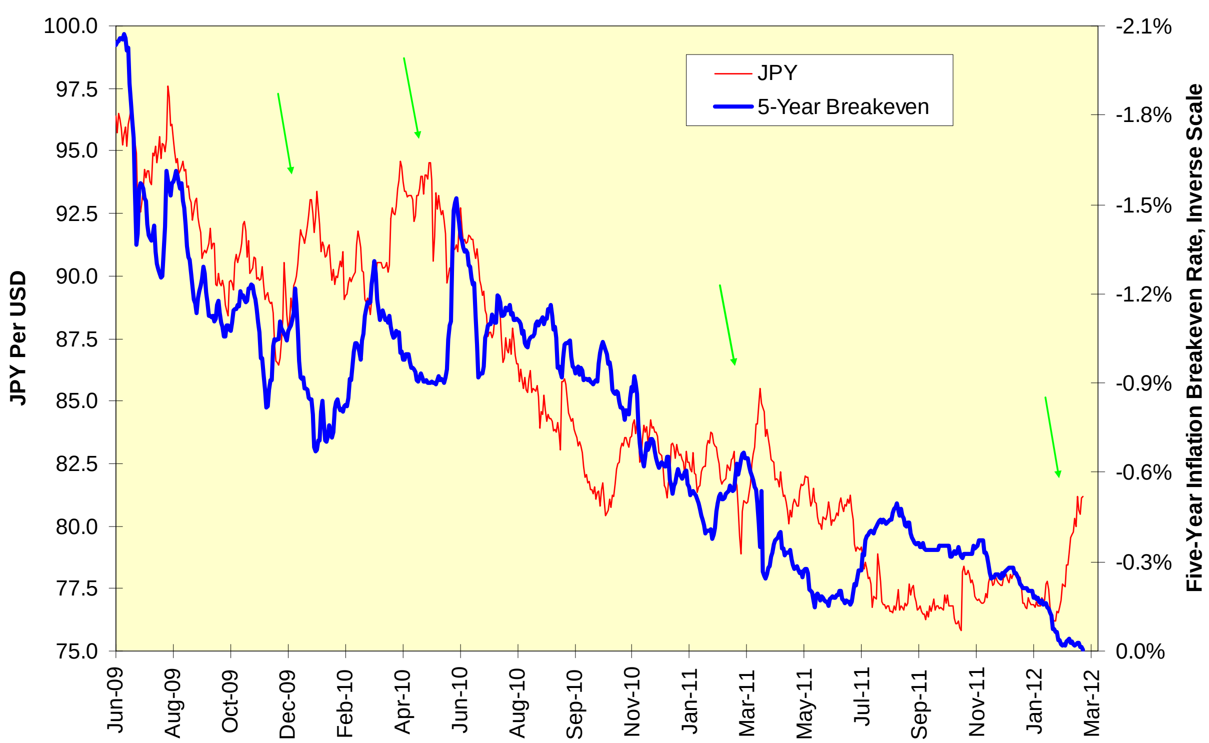
That they have been failing on both counts for years does not deter them from trying the same policies with a little more vigor and enthusiasm in direct contravention of Einstein's definition of insanity. After all, a country I used to admire greatly for its ability to parlay human capital and little else into a position of world economic leadership has completed two Lost Decades and is working its way through a third.

The complex fact of the matter – I cannot claim it to be a "simple" fact of the matter – is the Bank of Japan's expansion of the monetary base will not produce a rise in the money supply until and unless 1) the commercial banking system converts it into credit via an expansion of lending and 2) until the Japanese government stops hogging all of the money in bonds. I have argued elsewhere the best way for Japan to create inflation, a dubious goal if ever there was one, would be to raise short-term interest rates and drive cash into the banking system. Doing more of the same that has yet to work is pointless.

Yen And Inflation Expectations

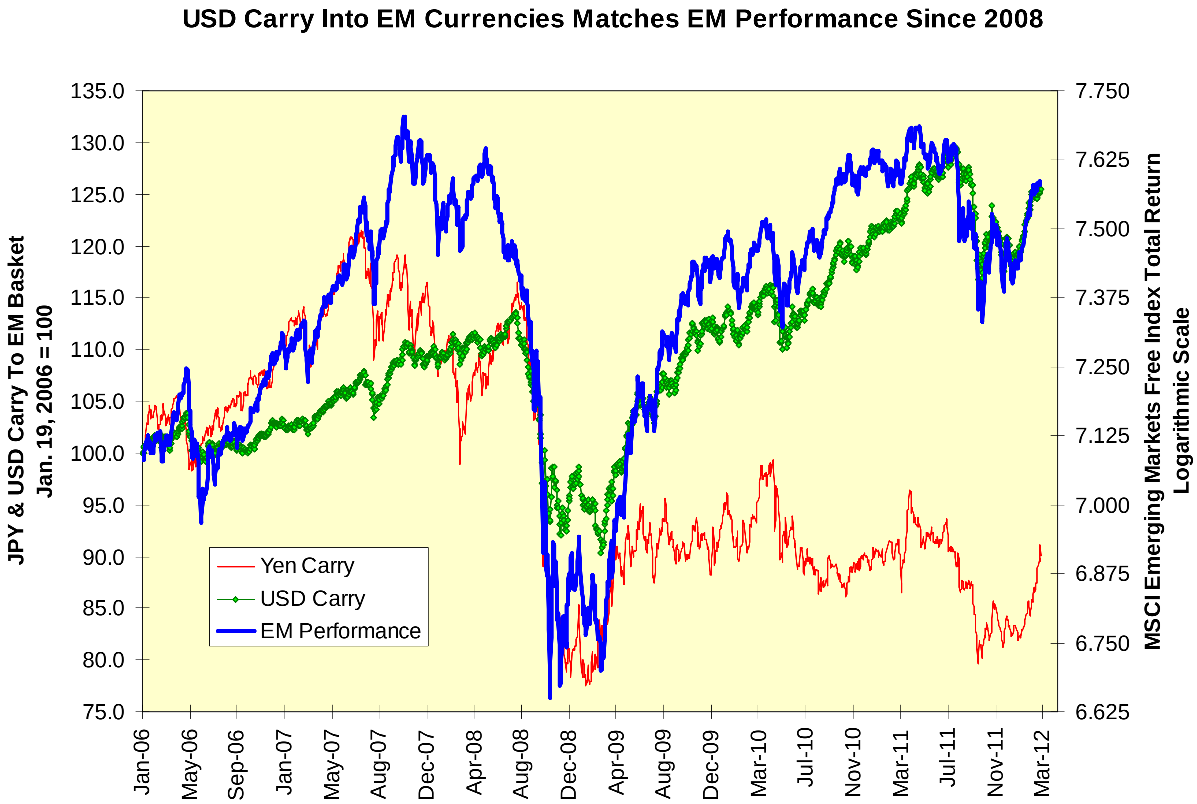
With a tip of the cap toward yesterday's comments on the distortion in inflation breakevens, let's map the yen against five-year breakevens in Japan since mid-2009. Two things become obvious quickly. First, five-year breakevens are negative. Second, the present weakness in the yen, engineered by massive asset purchases by the Bank of Japan, is but one of a series of failed selloffs in the currency; I have marked these with green arrows.

Yen's Dissociation From Inflation Expectations Not New



So long as real rates in Japan remain high, the currency will remain under upward pressure. The options market agrees with this assessment: Volatility for yen forwards has increased during the yen's recent selloff. Traders are buying insurance against a rising yen from better levels now.

The Carry Trade
The major hurdle toward yen weakness is the cheap dollar. Prior to the American adoption of zero interest rates in 2008, the yen carry trade helped finance equity markets worldwide. You borrowed the yen, sold it, and invested it elsewhere. You can now do the same trade in dollars and not run the risk of American deflation or an American trade surplus forcing importers to buy dollars. This has removed much of the selling pressure on the yen and helps explain its persistent strength in recent years.



Finally, if I am wrong and the yen does embark on a downtrend, add Japan to your portfolio via an ETF such as iShares MSCI Japan index fund (EWJ). The long-running and persistent pattern has been for the U.S. to underperform Japan during episodes of yen weakness.