Euro And Yen: You Gotta Know When

Each generation's life has a defining moment in memory, such as where you where when you heard about the attack on Pearl Harbor, the John F. Kennedy assassination or the events of 9/11. Chances are no one will remember where they were or what they were doing on August 24, 2009, when three-month dollar LIBOR traded under three-month yen LIBOR, or on March 5, 2010 when the situation reversed and yen once again became cheaper to borrow. These dates are marked with green and magenta vertical lines, respectively, in the charts below.

The yield inversion of August 2009 was critical for the continuation of the global bull market; not only did it open the much larger pool of lendable American funds up to global yield hogs for purposes of investment and general merrymaking, it opened up global carry trades to the even larger pool of lendable Chinese reserves. The switch in funding for these carry trades had some adverse effects on Japan, including an unwelcome appreciation of the yen and a rise in its sovereign CDS costs.

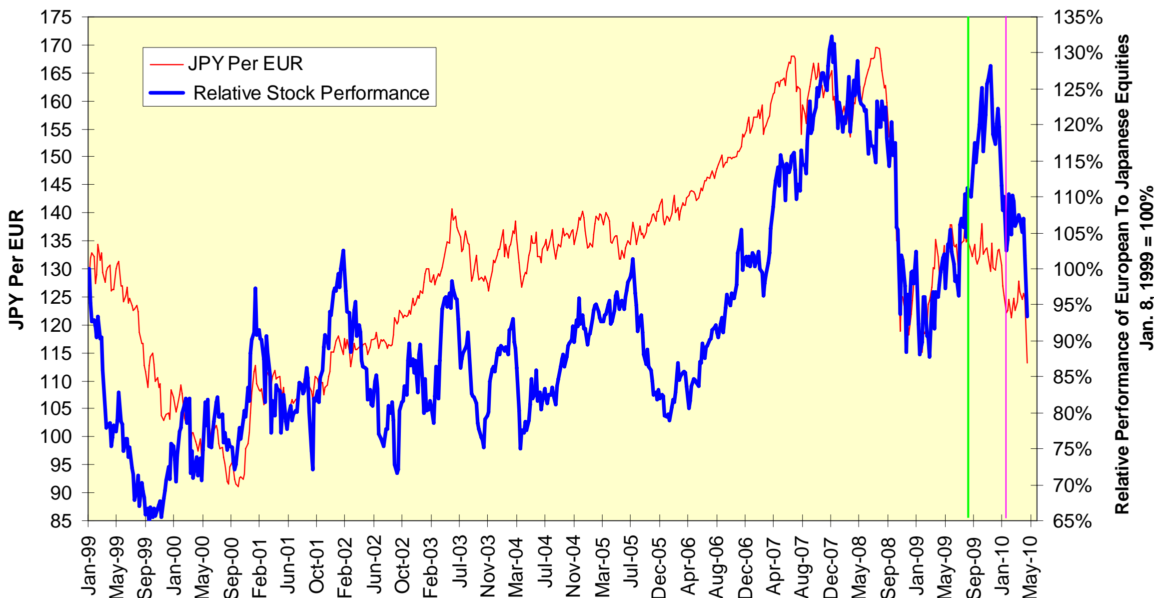
The return trip in March preceded the incipient move by China to revalue the yuan by about three weeks; this is a coincidence as much as Pearl Harbor or 9/11 were accidents. All previous moves by China with respect to the timing and pace of yuan levels have been choreographed carefully behind the scenes with us, *inter alia*; those who protest this is not how things should be run in a democracy are advised to grow up and stop dreaming.

Once the yen became cheaper to borrow, dollar/yuan-based carry trades started to be unwound. Unfortunately, this unwind intersected with the euro's weakness, and the unwinding of carry trades into the Eurozone and related blocs started to feed on itself as these unwinds always do. Put a lot of corn in a yield hog's mouth and you will be um, amazed, at journey's end.

The Euro-Yen Cross-Rate

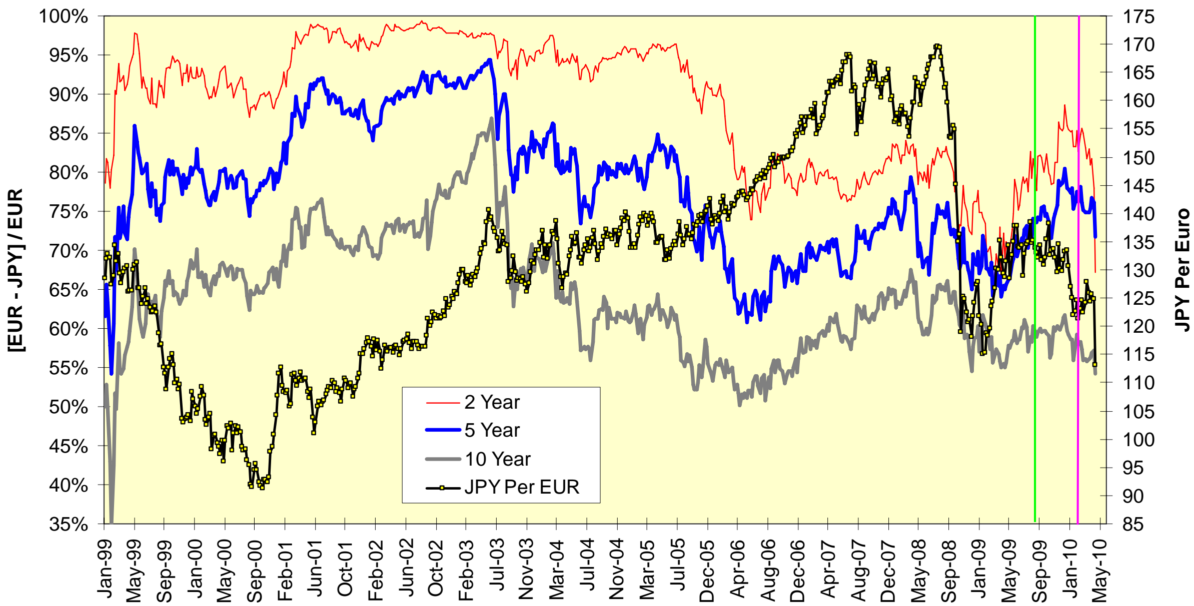
The linkages between the yen carry trade into the euro and global bourses (I love that word. Bourses; bourses, bourses, bourses) became very direct after mid-2007 when global interest rates started their decline toward zero and all assets started to become priced in ersatz money. They weakened somewhat between August 2009 and March 2005 as the dollar became cheaper to borrow, but things have reasserted themselves over the past two months.

Relative Equities Diverged After Carry Trade Switch To USD



The effect is different for normalized fixed-income differentials, defined here as the yield spread between benchmark Eurozone (read German) bonds and Japanese bonds, divided by the Eurozone yield. The linkage between the euro/yen cross-rate and this measure is most pronounced at the two-year horizon; the ten-year horizon scarcely is affected.

The Cross-Rate And Note-Rate Differentials



The most important takeaway, though, is this cross-rate is neither a leading nor a lagging indicator of risk preferences. It is a coincident measure by the statistical standards of Granger Causation. Restated, it is a good indicator of itself and tells you what is going on outside of your window at the moment, but it will not put you in the right direction for tomorrow or the day after.

And what is going on outside of your window is an unwinding of global carry trades produced by central banks' collective belief that pushing rates to zero, counterfeiting their own currencies and encouraging risky behavior is the answer to all problems. Maybe they believe past performance does not predict future results.