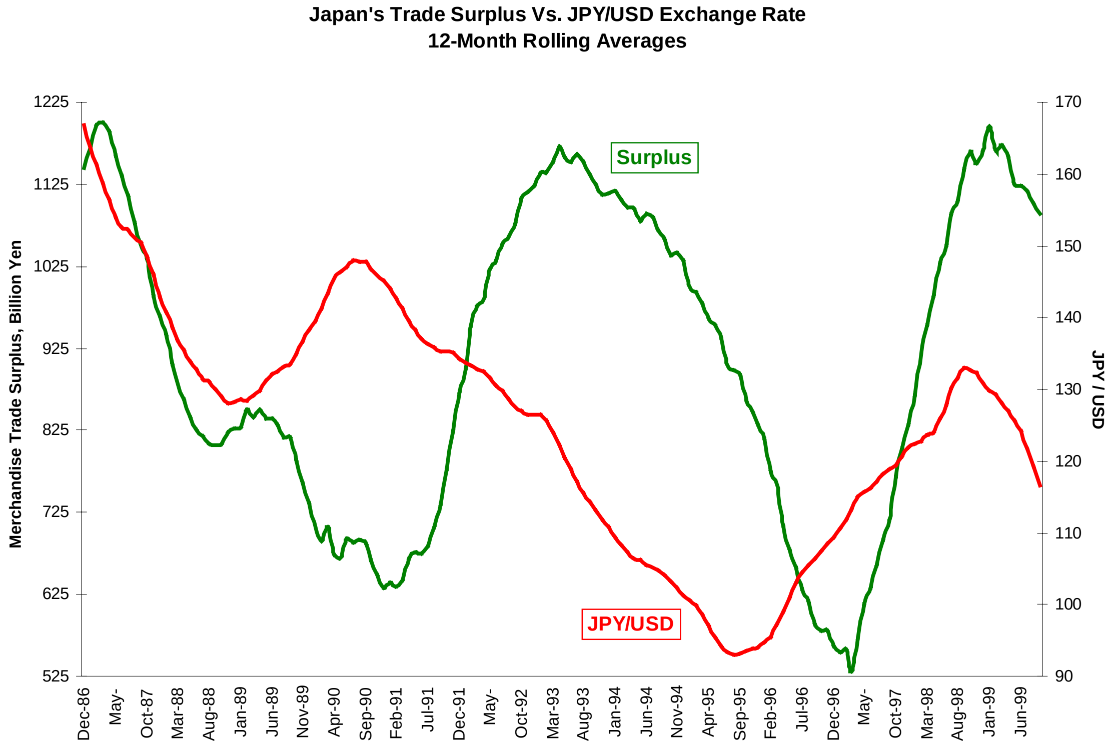
Strange Currency

Should we encourage an apparent drunk to have a few more for the road? Of course not, unless, trained in the fine points of semantics seven years into the Clinton administration, we picked up on the key word "apparent." Things are not always as they seem, especially in the dollar-yen exchange rate market.

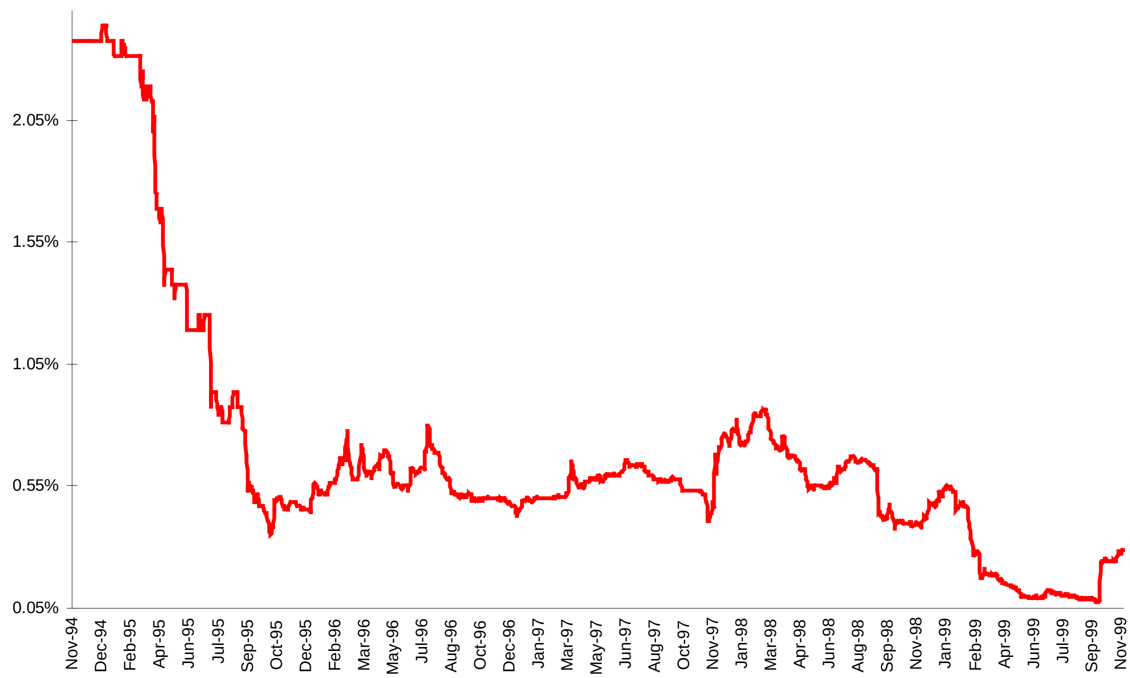
This market has been a political playground since the advent of floating exchange rates in the 1970s. While trades surpluses by themselves do not guarantee a strengthening currency, as has been the Brazilian experience, and persistent trade deficits do not guarantee a weak currency, as has been the American experience, there should be some fundamental relationship between a current account balance and the demand for a currency. The intractable Japanese trade surplus with the world at large and the U.S. in particular has led protectionists to call for a stronger yen amongst other measures. The notable lack of success from this strategy can be seen in the graph below; no consistent lead/lag or inverse relationship is visible.



Of course, one important factor in Japan's persistent trade surplus has been its decade-long recession; this has reduced both the need to maintain export revenues and the demand for imports. Japanese domestic policy, for better or worse, has been a combination of massive and misdirected public spending combined with an apparently expansive monetary policy.

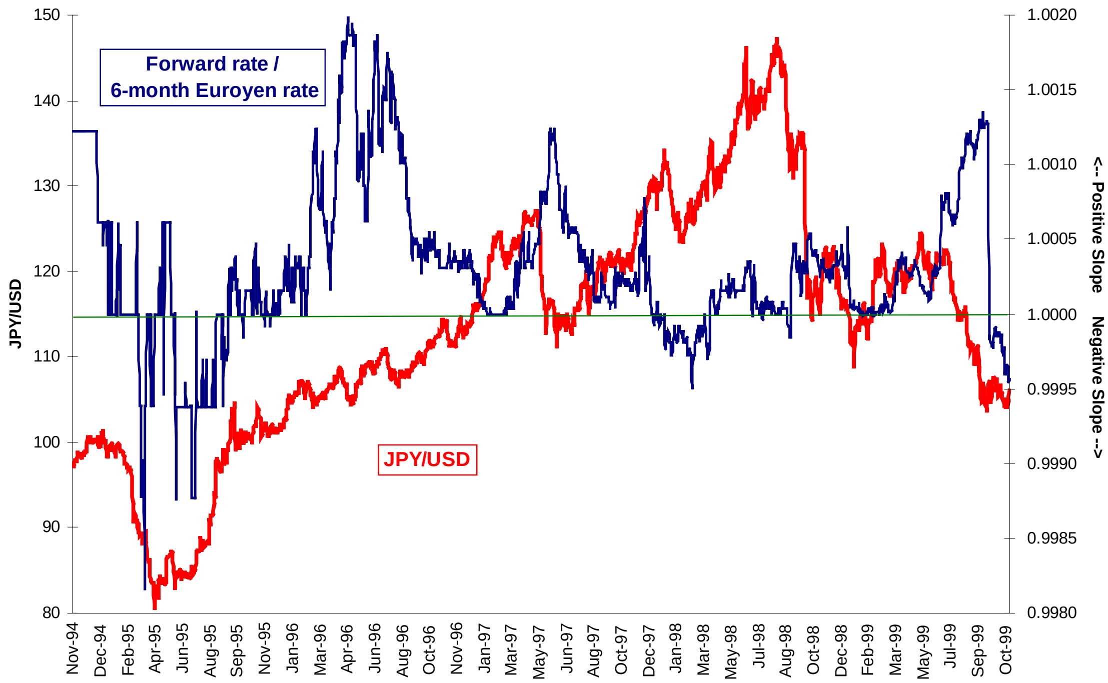
Japanese interest rates have been driven to near-zero levels in an attempt to strengthen bank balance sheets. The Bank of Japan has stopped short of driving interest rates negative by imposing penalties on deposits, but they have driven yields down to near-zero nominal levels over the past five years. Some would argue, with merit, real rates have been too high in Japan as evidence by persistent deflationary pressures. This argument is interesting, but fails to account for the yen's weakness between April 1995 and October 1998.

3-Month Euroyen Rates



Markets, of course, are driven as much by expectations as by current states. We can account, in part, for the yen's weakness over this period by looking at the shape of the euroyen yield curve, specifically the relationship between the forward rate between 3 and 6 months and the 6-month rate itself. If the forward rate is higher, the curve is sloped positively, which reflects the market's expectations of higher interest rates and inflation in the future. The opposite is true, if the forward rate is less than the 6-month rate; the curve is sloped negatively, which reflects the market's expectations for deflationary pressure.

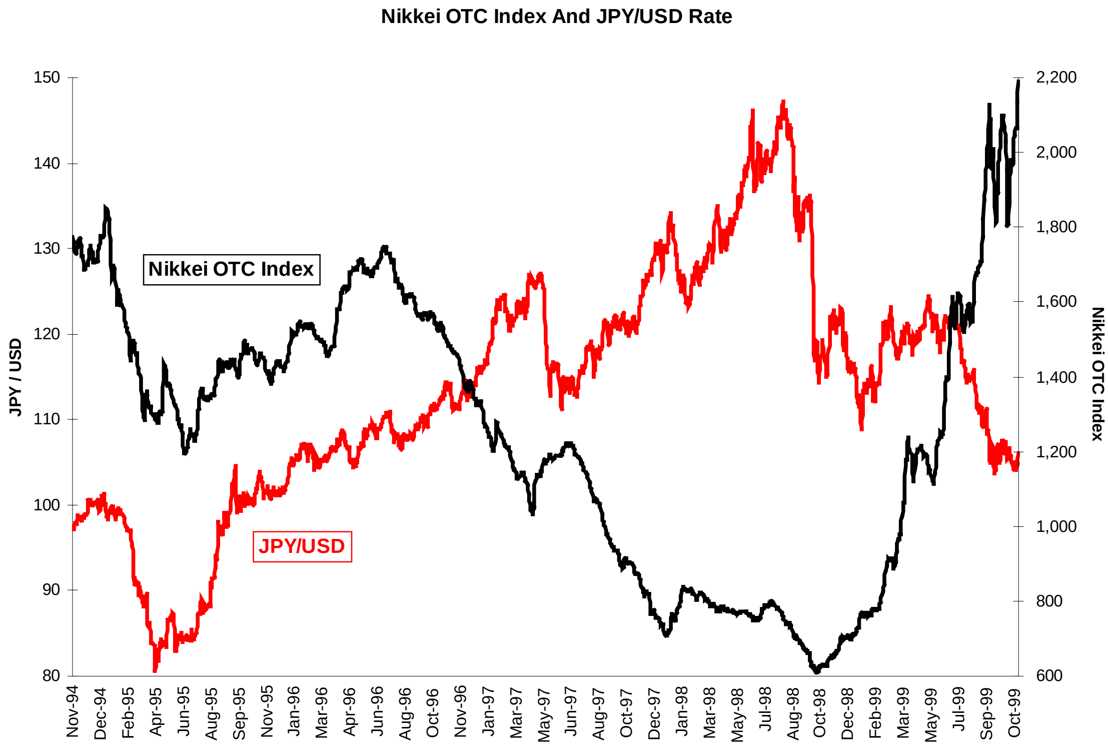
JPY/USD And Euroyen Yield Curve



Where Do We Go From Here?

The recent move toward an inversion in the euroyen curve is accompanied by an increase -- more than a tripling, in fact -- in the 3-month euroyen curve since the end of September. If the Japanese trade surplus and fiscal stimulus are reinforced by a higher expected return on yen deposits, then we could be in for a catastrophic revaluation of the yen. A challenge of the 1995 high of 80 yen per dollar, 1.25 on the spot yen futures contract, is likely.

As an interesting aside, the last period of yen strength was accompanied by one of the many bouts of weakness in Japanese equities during the 1990's. The exact opposite is happening now, especially for the long-moribund OTC market in Japan. Since the yen's low in October 1998, the Nikkei OTC market has more than tripled.



Several factors account for this rational exuberance. First, smaller companies in Japan are less dependent on export revenues than are Nikkei 225 members. Second, the prospects for the end of Japan's long recession and banking crisis are stronger than they have been in years. Finally, and perhaps most important, the Big Bang of financial deregulation will allow small Japanese companies better access to capital markets.

The combination of long Japanese stocks, long yen, and short euroyen could be one of those very rare trades where all components work in unison for a very long period of time. After all, how would you have reacted 10 years ago if someone told you to sell the Nikkei at 39,000 and buy the S&P at 350?