Treasuries Will Not Get A Yen Carry Trade

One of the more memorable lines in *The Producers* was Max Bialystok bellowing, "Do you know who I used to be!?" This sort of summarizes Japan's ever-shrinking role on the global economic stage; anyone who lived through their meteoric ascent in the 1960s and 1970s, followed by their twin bubbles of the 1980s, remembers how they seemed to have all of the world's surplus funds. A big fear of the ever-wrong economic nationalists of the time was the U.S. would have to keep raising interest rates to have Japan finance our deficit.

Oh, well.

More Of The Same That Has Yet To Work

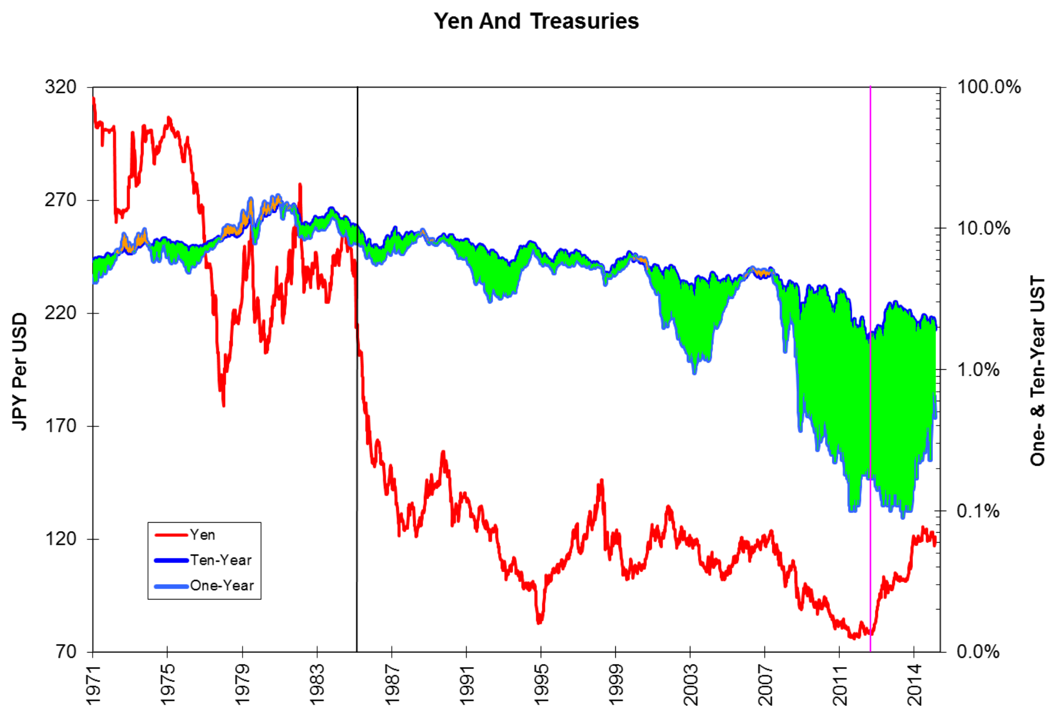
Japan's move toward negative interest rates last week would not have been necessary if their zero interest rate policy from 1999 onwards and their various quantitative easings since 2001 had been effective. Yes, you can say something similar about the Eurozone, Switzerland, Sweden and Denmark; none of them have enjoyed the rip-snorting American success story that allowed the Federal Reserve to end seven years of ZIRP in December.

However, if one of their policy objectives is to induce higher domestic inflation via the currency debasement mechanism, something I might have ascribed to an enemy of Japan during my benighted youth, they will need the assistance of the world's carry traders. Can Japan hope their newly created yen will be borrowed, sold for dollars, and lent into the U.S. Treasury market? In a word, "No." If you want multiple words, keep reading.

A long-term map of the JPY against constant-maturity one- and ten-year Treasury yields can be divided into three eras. The first, extending from the start of the floating exchange-rate era to the September 1985 Plaza Accords was characterized by extreme and two-way yen volatility and rising U.S. Treasury yields, often accompanied by an inverted yield curve (orange shading).

The second era, extending to the start of the Abe government's campaign to drive the yen lower was characterized by a secular firming of the JPY and declining UST yields, accompanied by several increasingly large steepenings of the yield curve produced by U.S. monetary ease.

The expanded JPY:USD carry trade created by Abenomics came to a halt in early June 2015 when the Bank of Japan signaled the JPY's decline had gone far enough. The flattening of the U.S. yield curve as measured by the forward rate ratio between one and ten years ended in December 2015 as the market came to doubt the initial Federal Reserve rate hike would be followed in short order by a second one. A continuation of a steep yield curve flattening means a long-term portfolio of U.S. Treasuries can be financed with short-term UST; the currency risk of a yen carry trade is not necessary.



The non-dependence of long-term UST on the yen carry trade can be seen in the rolling three-month correlation of returns between the JPY:USD carry return index and the returns on 7-10 year UST net of three-month borrowing costs. This measure has been negative since the November 2012 downside breakout of the JPY. An expansion of the yen carry trade via thus would not redound to the benefit of long-term UST.