The Yen Carry Disaster That Wasn't

"Yea, though I walk through the valley of the shadow of death, I will fear no evil." -- Psalm 23
"What a long, strange trip it's been" – The Grateful Dead

If any one us were to tote up all the things that were supposed to kill either us or our portfolios, in the order of your choosing, we would all certainly be where Lord Keynes would place us in the long run, dead.

This was brought to mind by a query sent to "Ask Our Pros" asking for comment on the yen carry trade. If you can remember back to early February – and I can, thanks to secret government training – this was the next in the long chain of events destined to put the United States into financial servitude. You know the drill: Manufacturing will leave the U.S, our stores will be filled with cheap goods from China and sold to us by illegal immigrants, and our financial profligacy will be financed by foreign governments.

Yeah, right, like that could ever happen.

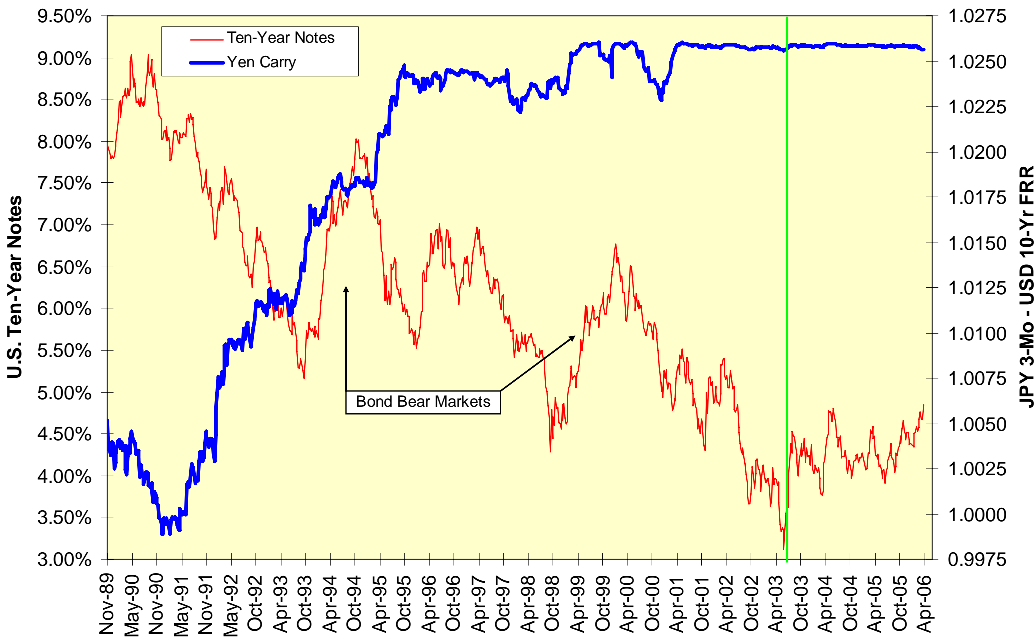
The Yen Carry Trade
The yen carry trade is simple and has been happening in one form or another since 1995. Japan drove its short-term interest rates toward zero in the hopes its insolvent banks would take the hint, borrow at these low rates and lend the funds back out to Japanese customers. It never happened, of course, since those very same insolvent banks were in no position to lend, Japanese corporate borrowers faced excess capacity and a nominal interest rate of zero in a deflationary environment is not cheap.

Who borrowed, then? As the noted sage James Carville observed in another context, "drag a $100 bill through a trailer park, and you'll never know what you'll find." The world's financial operators allegedly borrowed these funds and sent the world on the speculative spree of the late 1990s. After that ended badly, the Bank of Japan embarked on a program of quantitative easing in early mid-2001, just after the Federal Reserve started to get serious about cutting rates. Quantitative easing is to monetary policy what force-feeding is to the ducks and geese destined to supply *foie gras*: Keep adding funds even when no one wants them. This, too, was alleged to provide the monetary fuel for the speculative rebound seen worldwide in 2003.

What got the financial hysterics excited in February was an announcement by the Bank of Japan they were ending quantitative easing… but maintaining the zero-rate policy. This is like an alcoholic forswearing passing out but maintaining legally drunk status. This policy change, according to the usual gang of worthies whose prominence exceeds both their track record and their willingness to do their homework, was going to collapse the global financial system like the house of cards it surely is. All manner of risky assets, including but not limited to stocks, Treasuries, real estate, commodities, emerging market debt and Hummel figurines were going to be sold like there was no tomorrow.

The Evidence
We can quantify the yen carry trade by taking the forward rate ratio between 3-month yen and 10-year U.S. Treasuries. This is the rate at which we can finance a ten-year note by continuously borrowing yen, divided by the ten-year note rate itself. The more the number exceeds 1.00, the more profitable the yen carry is. If we map this measure against U.S. ten-year note yields themselves, we see just how non-dependent the U.S. bond market has been on the yen carry trade. Our yields bottomed in June 2003, marked with a vertical line, and have risen erratically since then while the yen carry barely has budged. We also had a couple of very bad bear markets in bonds in 1994 and 1999 while the level of yen carry was high and rising.

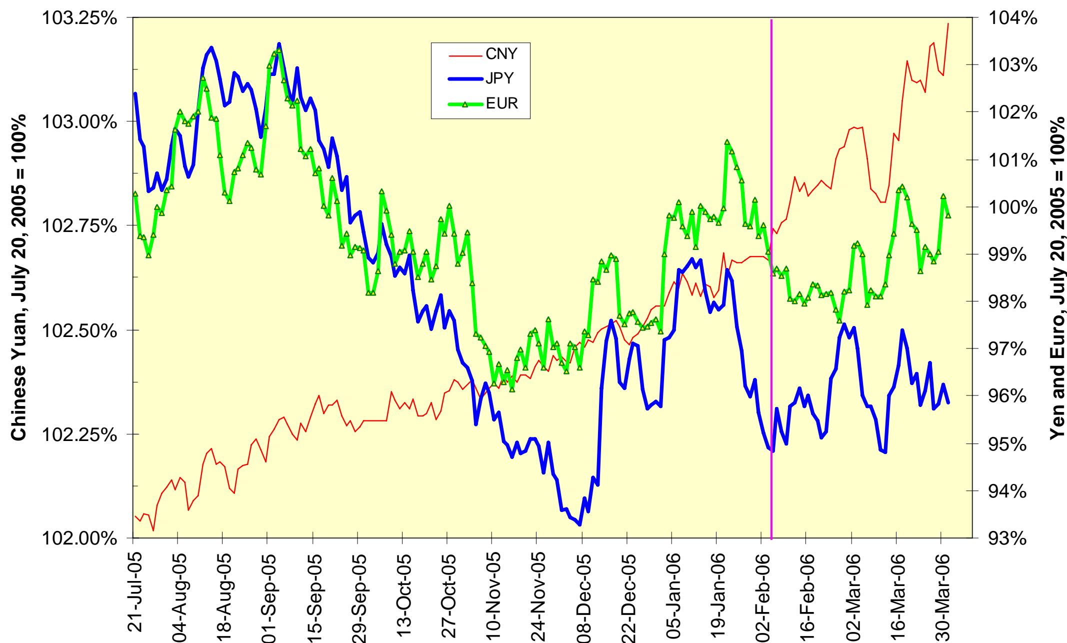
Did The Carry Trade Matter In The Long-Term?



The Real Cause For Concern

Various protectionists have suggested all would be right with the world if China simply would allow the yuan (CNY) to strengthen against the dollar, as if there were some exchange rate capable of neutralizing China's cost advantages. Lost in all the noise is the reality that the CNY has in fact appreciated 3.2% against the dollar since their gradual float began last July. Both the euro (EUR) and the yen (JPY) have weakened, by 0.2% and 4.1%, respectively, since that time. The JPY was firmed only modestly since the February announcement, but the CNY has strengthened considerably.

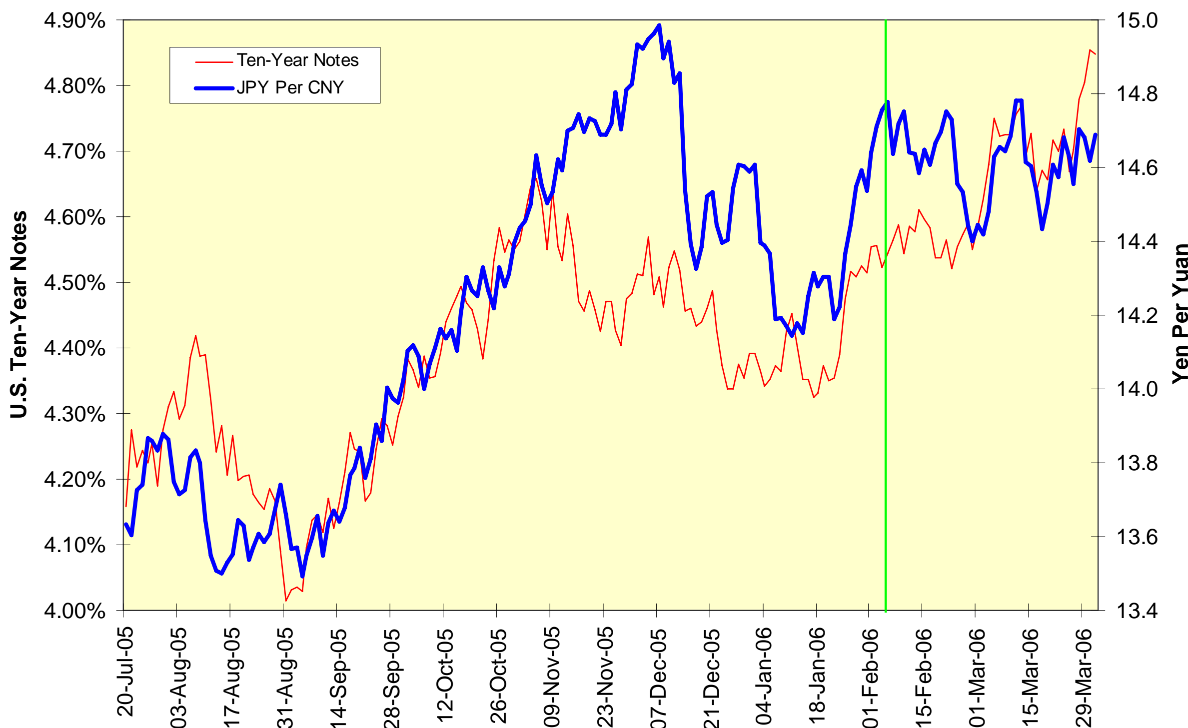
Comparative Currency Strength After Yuan Peg Loosened



Why is this significant in the discussion of the yen carry trade and its impact on U.S. Treasury yields? While Americans tend to view the world in dollar terms, we must be mindful that other countries have significant

competitive relationships with each other. The Japanese long have sought to prevent drastic appreciation of the yen against the dollar, and as we saw throughout the mid-2003 – early 2005 period, were willing to purchase vast amounts of U.S. bonds to execute this policy. They have similar concerns with China: As Japan is a much costlier place to do business than China, they are working toward a weak JPY-CNY cross-rate.

If the JPY per CNY rate rises – the yen weakens against the yuan – Japan feels no great urge to buy U.S. bonds to suppress the JPY. And since the JPY-CNY cross-rate has been stable since the February announcement, U.S. ten-year note rates have jumped. To be sure, other reasons exist for higher U.S. yields, but this cross-rate is an interesting piece of the puzzle.



Moreover, the long-term prospects for the CNY to appreciate against both the dollar and the JPY are strong. This suggests the U.S. will be facing higher prices for its imports from China. That is a much bigger story than the yen carry trade with much more profound long-term implications.