A Trans-Pacific Drubbing

"Democracy is the theory that the common people know what they want, and deserve to get it good and hard." -- H.L Mencken

Take our government officials, please. Senators Schumer and Graham have been on a nonstop campaign to annoy the Chinese into letting the yuan rise. Treasury Secretary Paulson has been ineffective both in protesting his virtue and in maintaining his street cred on the matter of the dollar.

The dam broke last week; the world collectively said they were as mad as hell about the U.S. abusing its privilege of printing the world's primary reserve currency and were not going to take it anymore. The Federal Reserve's policy of attempting – unsuccessfully – to deal with the credit mess created by its last spate of easy money first and worrying about the dollar later is failing.

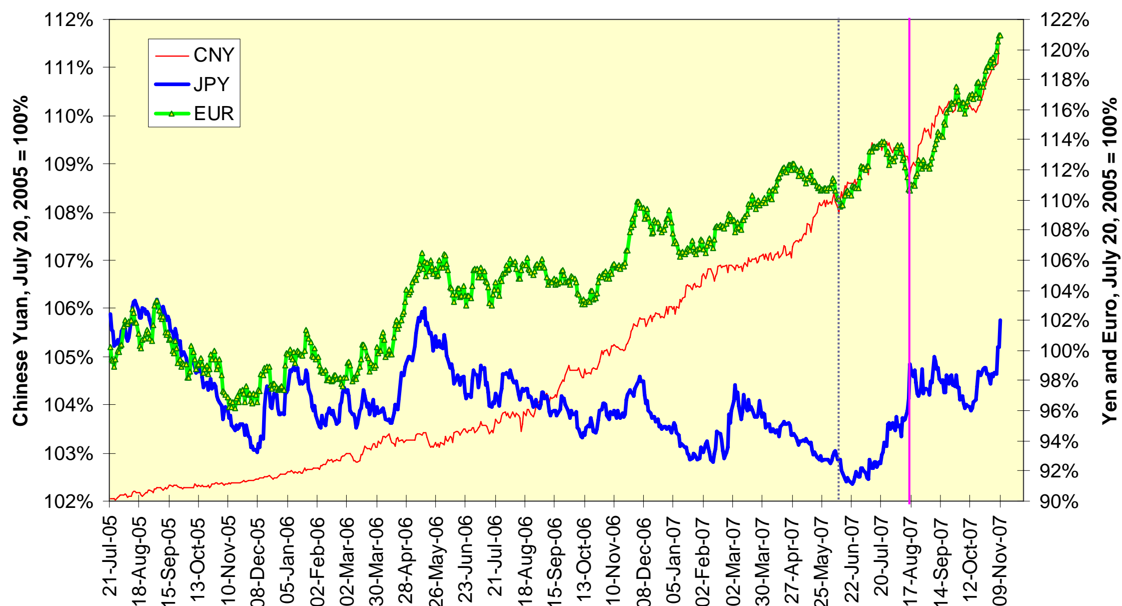
This might be amusing if it were not so tragic. The dollar's decline constitutes an impoverishment of the American consumer as the greenback becomes a weaker claim on the world's productive capacity. Inflation – and we have to talk about actual inflation, not the government gimcrackery so off-base it would make an Enron accountant blush – represents a similar impoverishment.

Both a weaker dollar and higher inflation are de facto taxes on the American citizenry. Lower asset values in the form of lower housing prices and now stock prices represent balance sheet impairment. And if you believe statutory tax rates are going to fall after the 2008 elections, please see me immediately after class.

One immediate consequence of all this will be a much stronger Japanese yen.

The Yuan's Ascent

First, let's map the relative courses of the yuan, the yen and the euro since July 2005, when the managed revaluation of the yuan began. And just as a personal comment, I think the Chinese have been foolish and short-sighted in maintain the yuan artificially weak; the historic experience with mercantilist currency policies is clear in that the manipulator suffers.



Please note how the relative gains of the yuan suddenly matched those of the euro beginning on the very day in June when U.S. long-term interest rates hit their high for the past five years; this is marked with a dotted vertical line.

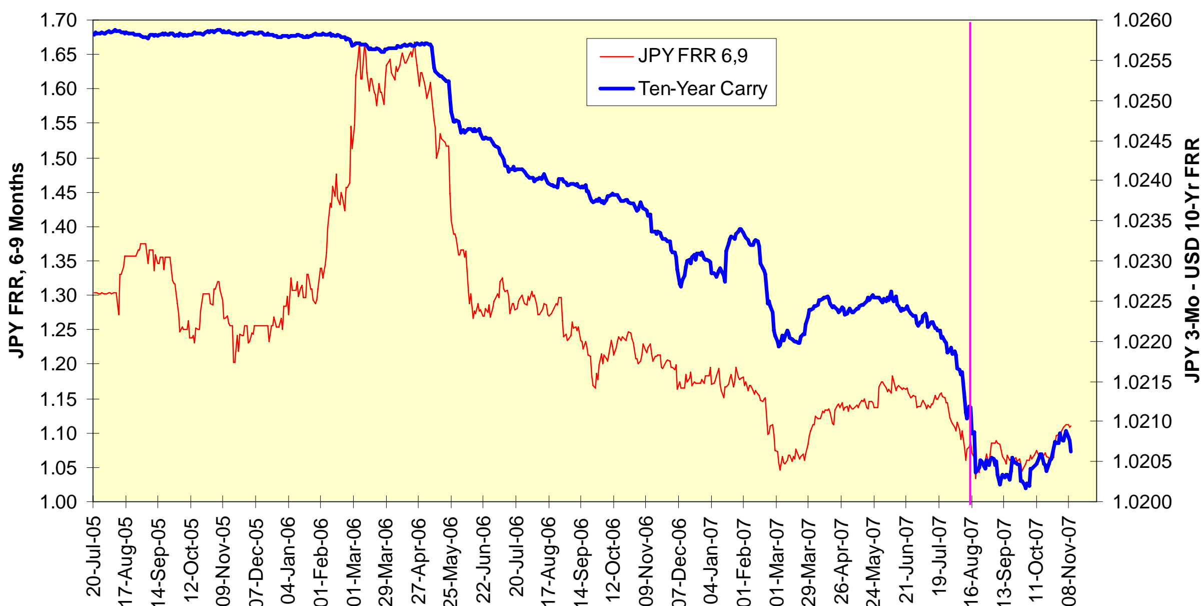
In addition, note how the yen, the fuel for the on-again/off-again yen carry trade last discussed in September, began to rise soon thereafter. It paused after the Bank of Japan rectified its mid-August error in withdrawing liquidity, but

shot higher last week with a vengeance. The magenta vertical line here and subsequently marks the August 17th date of the Federal Reserve's cut in the discount rate.

The Yen Carry And Japanese Interest Rates

If the yen is rising, we cannot blame it on any Bank of Japan policy changes. Indeed, the Japanese money market curve has steepened since mid-August, with three-month rates remaining low relative to six-month rates, and six-month rates remaining low relative to nine-month rates. The latter relationship, measured by the forward rate ratio (FRR) between six and nine-month yen LIBOR – the rate at which you can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself – is the critical one for currency trades. A rising FRR indicates that while Japanese monetary policy is expected to tighten in six months, a lifetime in these markets, it remains loose today.

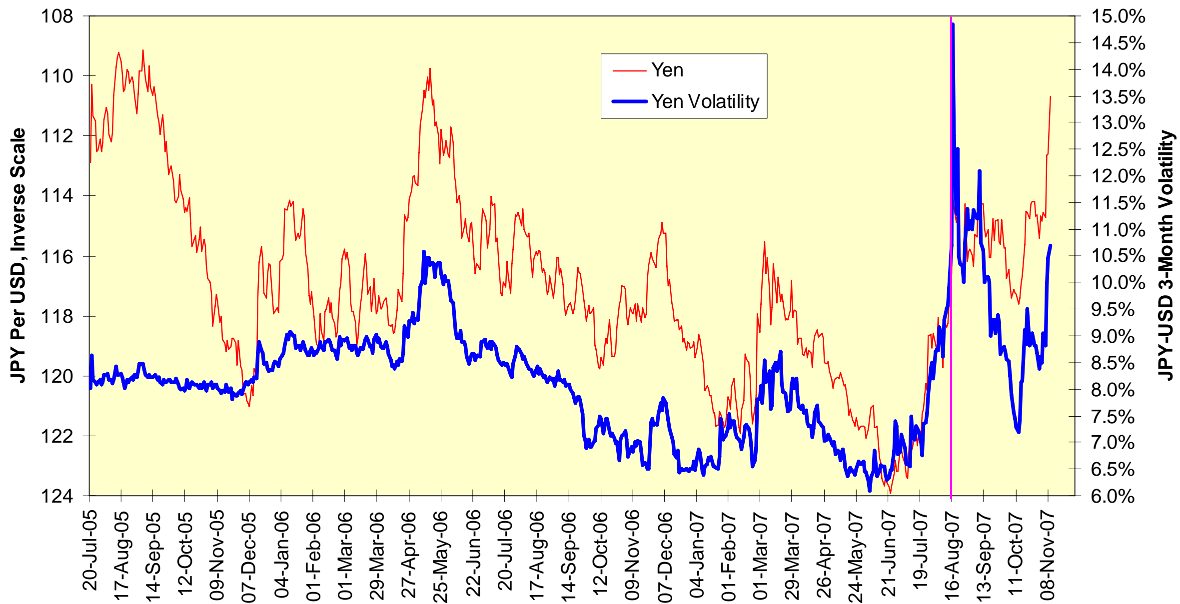
A second confirmation of loose Japanese monetary policy comes from the FRR between three-month yen LIBOR and ten-year Treasuries. That ratio has opened up – meaning the yen carry trade is still economic – even as U.S. ten-year note rates have fallen to their lowest levels this year.



Protection Matters

An additional confirmation of the yen's course comes from the volatility on three-month yen forwards. Those who borrow the yen and sell it as part of a carry trade have to repay the loan and are at risk to a stronger yen. While that volatility has not jumped to the level seen during mid-August, it is on par with the first tightening of credit in Japan in May 2006.

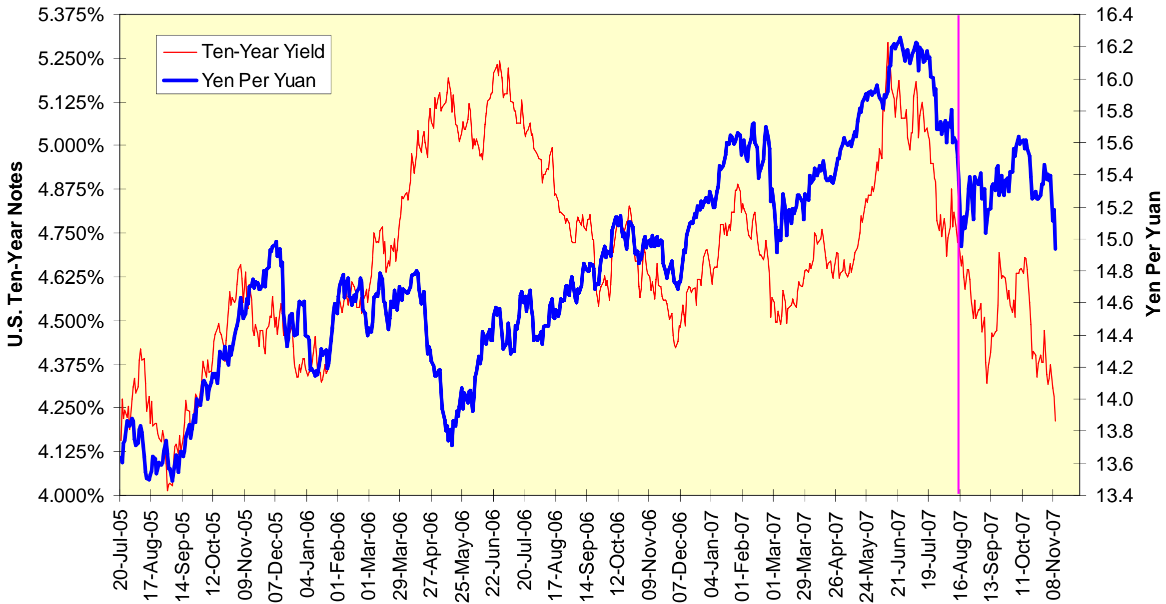
Fear Of Yen Appreciation Rising Again



The Yen-Yuan Rate And U.S. Markets

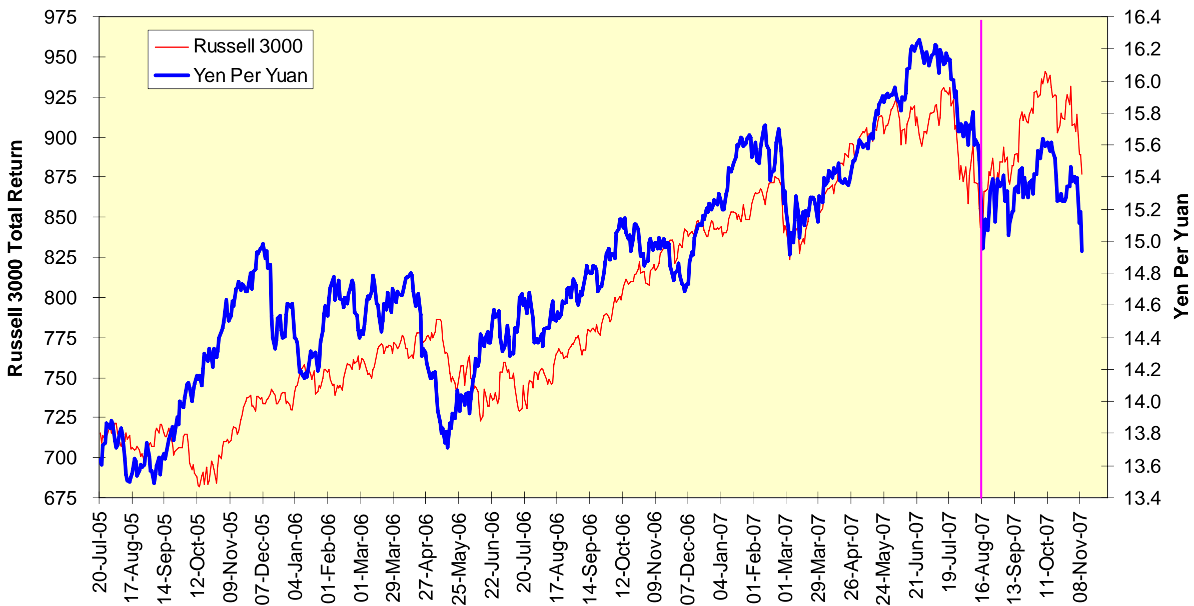
The yen has been appreciating against the yuan, too, and that scares the Bank of Japan. Even though Japan has no more chance recapturing export markets from China than I do, their national policy is and always has been one of competitive devaluation. This is why a stronger yen-yuan rate, as first discussed here in April 2006, always prompts Japanese buying of U.S. assets in an attempt to drive the yen lower.

The Yen-Yuan Rate And U.S. Notes



That's the good new for American investors. The bad news is the yen seems to strengthen and ten-year note yields seem to fall only when the world is in crisis mode. If we map the total return of the Russell 3000 index against the yen-yuan cross-rate, the correlation is unmistakable and statistically strong. It has an r-squared, or percentage of variance explained, of .79.

The Yen-Yuan Rate And U.S. Stocks



How will all of this end, you ask? The answer could be, "Quite badly." Even though the yen carry trade remains open, the risks of further yen appreciation are likely to scare risk-seeking investors away from this trade. Until, of course, the price of those risky assets falls sufficiently to make their purchase attractive. A defensive posture is warranted until the yen reverses course and moves higher.

Oh, and you might want to ask your local government official why he or she decided it would be a good idea to slash your purchasing power for an indeterminate purpose.