Will The Yen Hold Its Low?

As Humble Pie is not on the dessert menu at most Wall Street eateries - lack of demand, I guess - it is a good idea for all of us in the business to serve it to ourselves. This can include, as is the present case, not throwing a do-it-yourself ticker-tape parade down Broadway on those occasions when a market forecast proves correct.

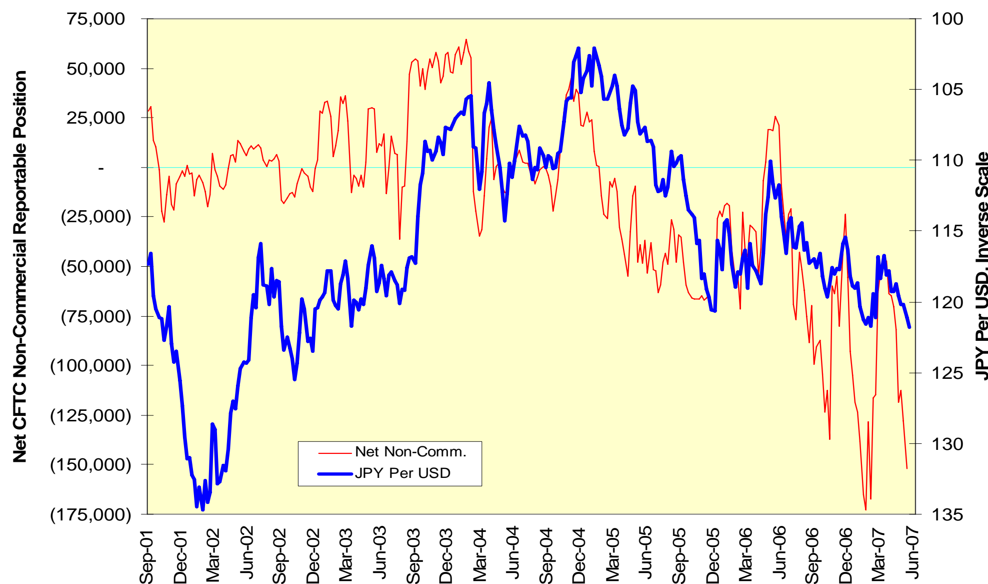
You have to keep those valuable karma points in the bank; you always need them sooner than you imagined.

For this reason, the correct forecast made last October that the yen would find support in late winter was allowed to pass without comment when the yen did in fact make a mid-February low near 122. This was a week before the Bank of Japan raised interest rates to 0.50% and two weeks before an unwinding of the yen carry trade, last discussed here in January, was proffered as a reason for the global market hiccup of February 27, 2007.

Fundamentals Remain Negative

Let's update the analysis from last October. First and foremost, the yen remains hated by non-commercial futures traders, a crowd not known for winning popularity contests. The Commodity Futures Trading Commission data show the net short position of these traders is moving back toward levels that produced spasms of short-covering twice within the past seven months. While more evidence than this is needed to say a bottom is in place, we can say it is never a good idea to ignore the presence of everyone on one side of the boat.

The Imbalanced Position Remains



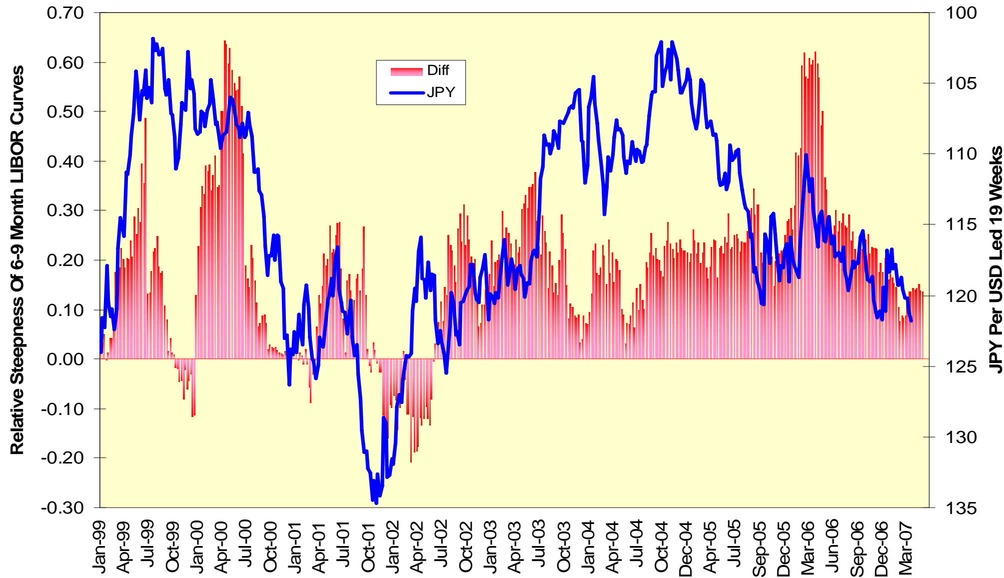
Relative Interest Rate Expectations

The CFTC data may not be deterministic, but they are easy to understand. The opposite obtains for the next indicator. We can compare relative monetary policy expectations between the U.S. and Japan by comparing the forward rate ratios (FRR) between six and nine months for each currency. These are the rates at which you can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the money market curve and presumably to looser the monetary policy.

If we subtract the FRR for the yen from that of the dollar, we how the Japanese FRR was steeper that the U.S. FRR prior to the May 2006 tightening of credit in Japan; this meant expectations for Japanese short-term interest rates were rising faster than those for U.S. short-term rates. Once this differential collapsed, so did the yen.

The present situation has the differential slowly but surely moving back in favor the Japan. The Bank of Japan would like to renormalize its ultra-low interest rates, while the Federal Reserve is stuck on neutral despite the twitchy proclamations of numerous Fed-watchers each time a new economic datum is released. This movement in the FRR differential, which statistically leads movements in the yen by 19 weeks on average, is supportive of the yen.

Short-Term Rate Expectations Not Hostile To Yen

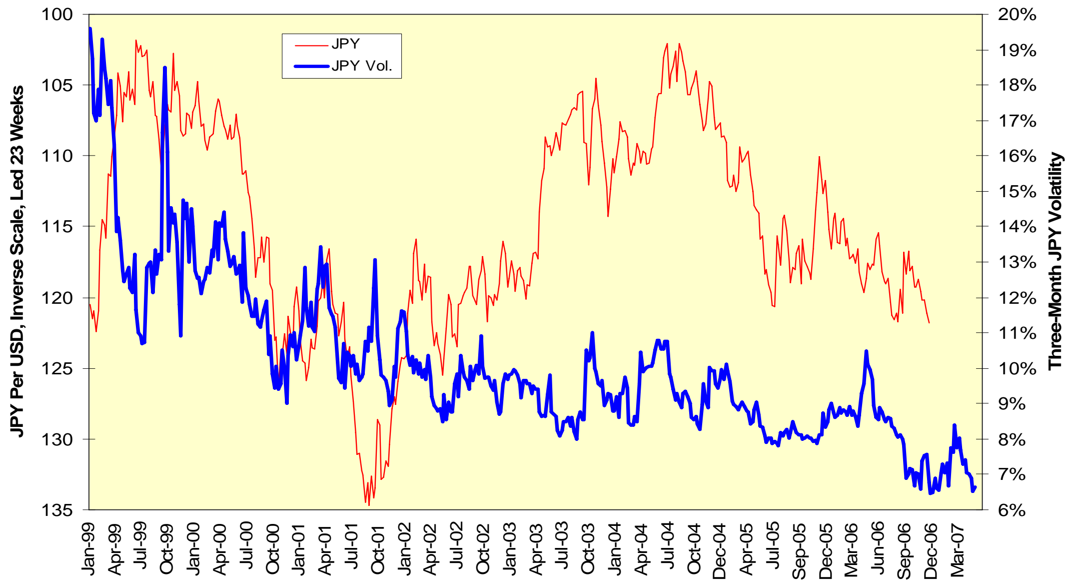


What, Me Worry?

While our good friends at Mad magazine remained coyly silent on the question whether Alfred E. Neuman was engaging in the yen carry trade, yen volatility readings say the gap-toothed mascot is borrowing yen, swapping them into other currencies and remaining unconcerned about any quick yen revaluation. This is the same sort of imbalance seen above in the CFTC data, and should be sufficient to sound a few alarm bells somewhere.

The volatility of three-month yen forwards is the price of buying insurance against such a rally; statistically, it leads movements in the yen by 23 weeks. It has drifted down toward its December 2006 lows, and if the January-March jump in yen volatility remains predictive, we should see buying pressure moving into the yen soon.

Price Of Insuring Against JPY Appreciation Holding At Low

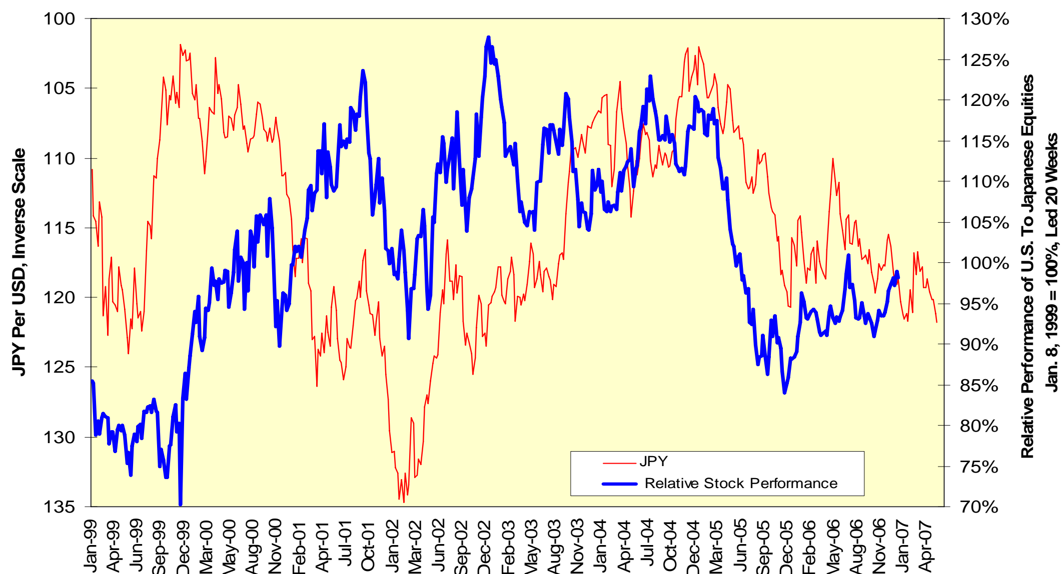


Relative Stock Market Movements

Financial market spies from an alien civilization who landed in Tokyo three years ago would report back to their home planet there was no bull market on earth. Any way you slice it, Japan has underperformed and now has to suffer the indignity of watching a giddy bubble in China.

We noted last October how the yen tends to lead the relative stock market performances of the U.S. and Japan by 20 weeks on average. That pattern held between October and today; the Russell 3000 index' performance relative to that of the Nikkei 225 has followed the ups and downs of the yen.

The Yen Leads Relative Stock Market Performance

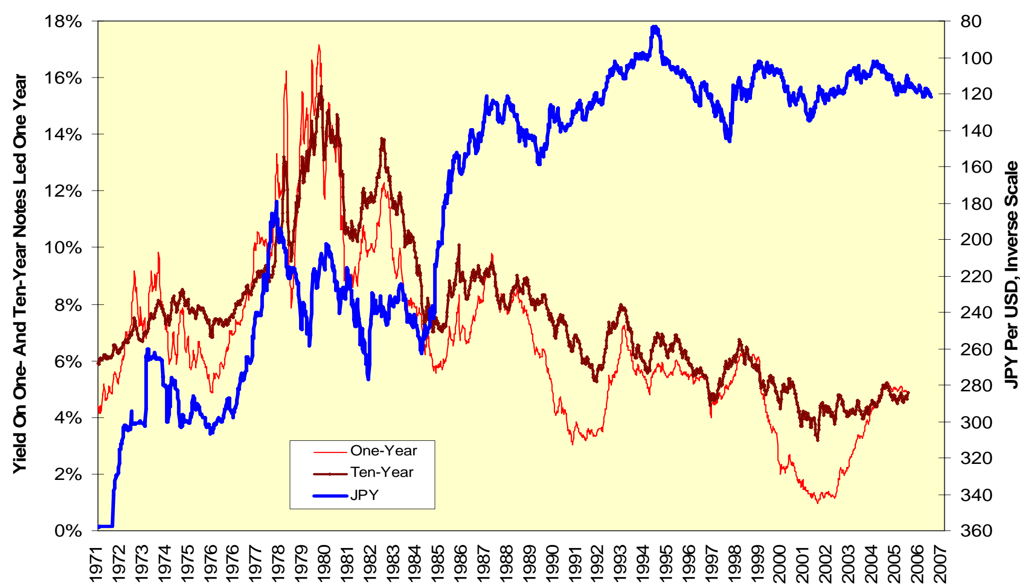


If this pattern continues to hold, the next few weeks should see relatively weakness in the U.S. market relative to Japan, followed by a strong relative rally later in the summer.

The Final Dismissal

Let's end with one more sneer at those always-wrong, never-silent worrywarts who fear that one day a weak dollar will prompt foreign investors to dump their entire portfolios of U.S. Treasuries. If we go back to the start of the floating exchange rate era, we find at best a one-year lead-time between the year and both one-year and ten-year U.S. interest rates. As the yen has been in a broad trading range for almost two decades, a little commented-upon fact, and as U.S. rates have in general declined over this period, we defy anyone, anywhere to demonstrate to us a causal relationship between the strength/weakness of the yen and weakness/strength in U.S. bonds.

Does The Yen Drive U.S. Interest Rates?



Humble Pie will be served to those who can answer this challenge.