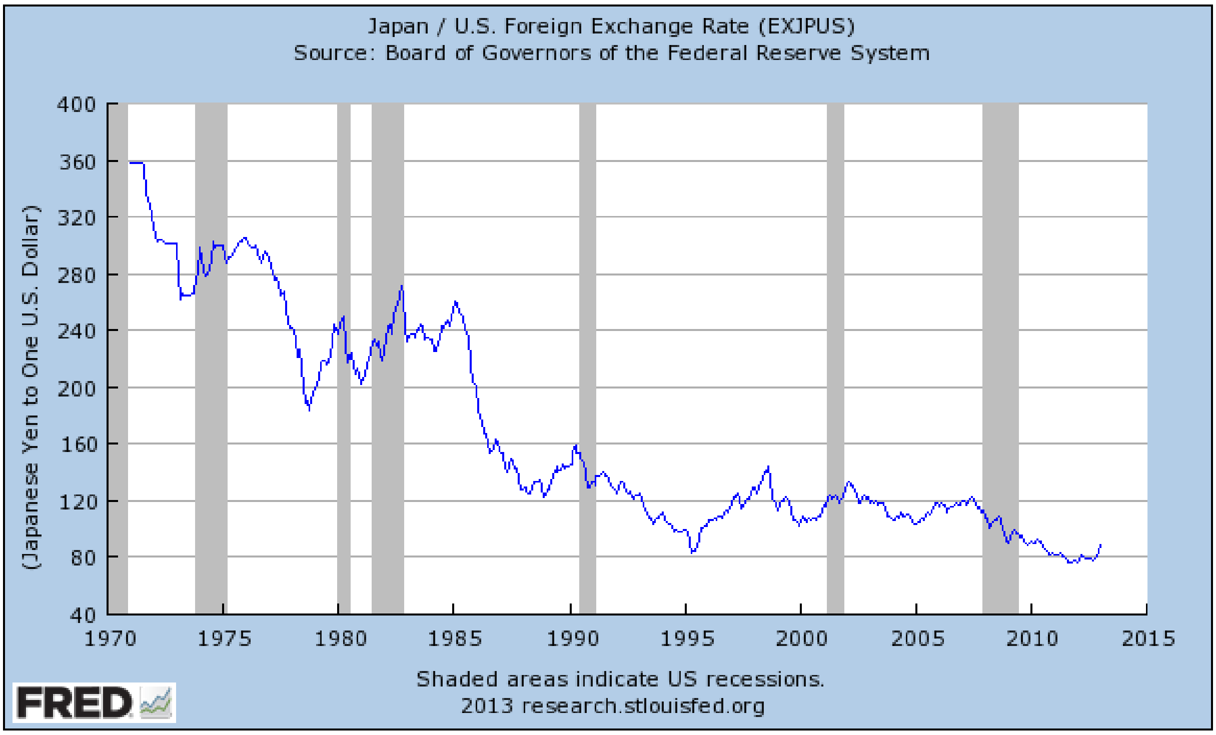
Yen Trap?

Here’s the Yen vs. the US dollar monthly since exchange rates were freed in 1971:



The chart title says ‘Japan / U.S. Foreign Exchange Rate’ but in fact that shown is USD/JPY, as JPY is quoted second in the pair:

so down on the chart is down for the US dollar, and up for the Yen

and vice versa

an upward move on the chart is up for the US dollar, down for the Yen.

(Note that for all major currency quotations the Yen is the second stated of the pair:
EUR/JPY GBP/JPY AUD/JPY USD/JPY CHF/JPY CAD/JPY NZD/JPY, so a downward move on a currency chart involving Yen always means the Yen is strengthening and an upward move on a currency chart involving Yen always means the Yen is weakening. The ‘up’/‘down’ and ‘high’/‘low’ terminology gets tricky when discussing Yen.)

As you can see, *endaka* has been a lengthy, ongoing process with little respite. The period of the chart covers the maturing years of Japan’s postwar economic renaissance, and its double-decade and counting recession. The true period of *endaka* based on economic success ended in the nineties. There was then a sideways move with accompanying economic malaise and… somehow in the financial crisis of 2008-2009 the Yen was boosted as a ‘strong’ currency, a safe haven.

Of course we who live here all know by now that the Yen has no real reason to be considered a safe haven—because of the massive government debt: GDP (worse that Italy, worse than Greece); because of the demographics (not enough young people coming into the workforce to support an ageing population; population over 65 forecast to be 38% by 2055 etc.); because of relative industrial decline (Samsung 1, Sony 0); because of a balance of trade tipped negative by energy importing needs, now that post-tsunami most of Japan's nuclear reactors are offline.

On the chart we can see the Yen continue to strengthen into 1995 (when in April it just edged past 80 for a day or two), and go sideways into a contracting triangle pattern. Japan's zero-interest rate policy ('ZIRP') also dates from that year. Nice idea: revive the economy by offering cheap money. But not necessarily correct as one of Japan's problems had been over-investment into zombie companies. The companies couldn't use the money constructively. But foreign banks and investment houses could: they borrowed at interest rates of 0.5% or so and invested it at 6% or 7%, in USD, or AUD or whatever. A guaranteed profit, year on year, and magnified by the leverage currency markets offer. This was the carry trade.

And the carry trade carried on nicely until the financial crisis of 2008 provoked a sharp cut in USD and AUD and whatever interest rates. At which point the banks and investment houses did the rational thing, encashed their no longer performing currency investments and paid back the lender, in Yen, as it was Yen that had been borrowed. So suddenly in a financial crisis vast amounts of Yen were repatriated and produced a false observation: financial crisis = stronger Yen, with the false conclusion that therefore the Yen must be a strong currency. And this movement had follow-through, until 31st October 2011, which was *the* low.

Since then we have seen two engineered weakenings that didn't really stick, and now, with the introduction of Abenomics, a sustained move—which is being confirmed by the early resignation of the Governor of the Bank of Japan and will be further confirmed if the LDP win the July upper-house election. Economic change (trade deficit), political change and an international change in perception of the strength or not of the Yen make it highly likely that we have now seen the end of *endaka*: and next will be *enyasu*.

What does this mean for you, as someone living and earning in Japan, and for you as an investor? Investing outside Japan from Yen since 2008 has been a negative experience for many as whatever investment growth there has been has not compensated for the decline in the investment currency exchange rate. This equation is being reversed. Portfolios that were minus in Yen terms are now becoming plus: the move in the Yen since 31st October 2011 is 24.2% and since the beginning of the current move (13th September 2012), 21.7%, as of current writing. Prepare for USD/JPY 100, then 120 (which may be regarded over the last three decades as a 'par' rate) and, at the outside, 147—the extreme of the post-1995 contracting triangle, a point reached in July 1998, little more than three years after the April 1995 low. That's a weakening of 32/59/94%. Nothing unusual: the Yen is a volatile currency. And remember, it's been done before: April 1995 to July 1998 was a move of 84%.

Those are shorter-range targets. Shorter-range only. Longer-term, Japan is in danger of falling foul of its fiscal problems: 25% of the annual tax-take spent on servicing a debt costing—on 10-year Japanese government bonds— approximately 0.8% p.a. to service, meaning the entire national tax-take would be absorbed by debt service if rates go over 3% (compare with Italy and Spain in trouble at 6%). While it is true that other currencies also have their problems, Japan runs the risk of economic debacle. In which case expect the Yen to weaken beyond that USD/JPY 147 line, and into the territory of the 1970s. This would of course be accompanied by massive inflation and the negative feedback-loop of wincingly higher interest rates.

The immediate question for people sitting on uninvested and non-rainyday Yen cash is no longer whether to move it into other currencies, but when. A timing issue. Currency movements are largely up-and-down affairs. But every now and then there are strong moves that are not retraced and shift the operative range. I claim no crystal ball, but think this is one of those occasions. The fundamentals, politics and perceptions are changing. The next FX conundrum is going to be for people who were aiming to get out of Yen but were waiting for the Yen to strengthen a little bit further. The price action since September 2012 is beginning to trap them. USD/JPY 93 is not as good as USD/JPY 80 last October, agreed, but last October is no longer available. Two possible retracement points are January's USD/JPY 88-90 and—for the brave—November/December's 81-82. But Abenomics could get out of hand/the July election could consolidate a radical economic gambit, and we could be permanently back over 100 before summer is out. Not an easy decision to finesse. But a decision that needs to be made.