

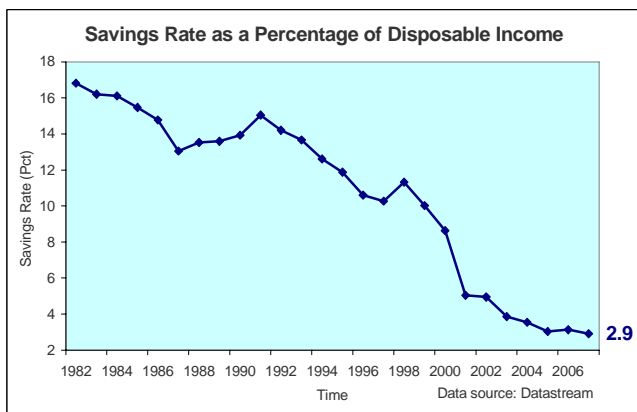
“I am a genius”

By Stewart Cowley

Newton Global Fixed Income Strategy

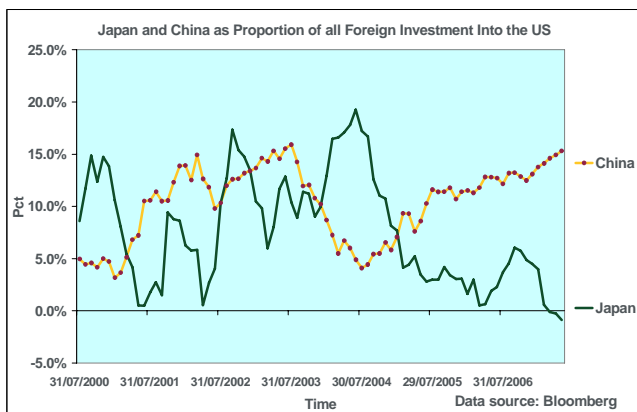
Increasing yen position using forwards

On the basis that “Talent borrows; geniuses steal”¹, I am going to declare myself a genius. We had Andy Lees from UBS round here last week talking about demographics and its effects going forward. To be fair, this is one of our themes at Newton and has been for some time. But Andy has come to some interesting conclusions, one of which should impact your and our thinking about the yen.



To cut a long story short, about seven million people will leave the workforce in Japan in the next couple of years and since the savings rate is cripplingly low (see first illustration) at around 3% of disposable income, we should expect the Japanese to stop sending money abroad and even start bringing it back home. This has consequences for stocks, bonds and currencies.

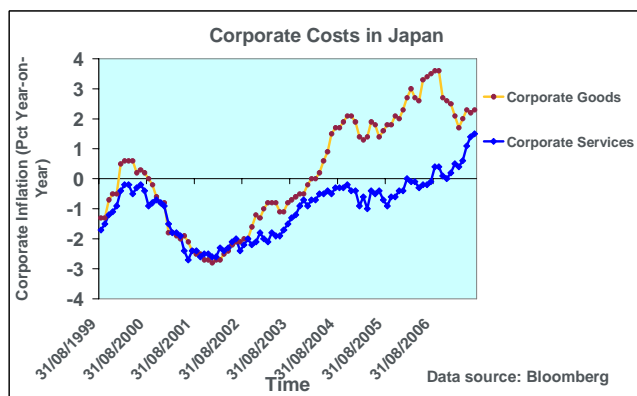
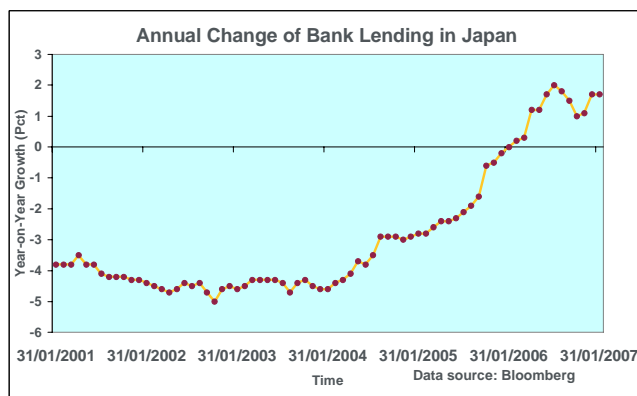
It was interesting that Andy’s analysis talked about ‘when’ this starts happening, but if you look at some of the data, it’s clear that it’s already begun (see second illustration).



If you look at the proportion of foreign investment into the US from Japan, as at May of this year, it went negative i.e. there were net sales on a year-on-year basis. Amazingly, as you can see, China has been taking up the slack and the total proportion coming from the two countries has stayed pretty much stable at around 15% for the best part of three years. But we shouldn’t count on this going on forever.

The Chinese have been making threatening noises about selling their US holdings in response to US tactics over the currency realignments, for instance. Moreover, as Andy points out, China’s own dependency ratio starts to rise by about 1% per annum from next year on so, at the very least, the rate at which it is exporting capital is set to slow as well.

You would think that the last thing the Bank of Japan (BOJ) would want to do is exacerbate the situation by increasing interest rates. But a brief trawl around the money and corporate costs numbers shows that bank lending is increasing again (see third illustration). Similarly, ‘corporate inflation’, in terms of goods and services, is running at 2%-3% per annum (see fourth illustration). Clearly, the BOJ will want to get ahead of this and (like the US Federal Reserve before it) give itself room to cut rates if the economy gets into trouble going forward, especially if the yen begins to rise. This explains its apparent desperation to raise interest rates.



We’ve always taken the Orwellian view that if you can distract the ‘proles’ with irrelevant trivia, you can deflect them from the real issues of the day. The real issue here is that while exporting capital from Japan has been officially sanctioned, it has been easy to keep the momentum of the carry trade going; any short-term appreciation of the yen has been seen as just a temporary setback. In some respects, the US sub-prime farce has only served to mask what is a fundamental sea change in global capital flows. Going forward, it’s going to become much more difficult for institutions and individuals to continue to sponsor the carry trade (either actually or tacitly) which leaves the yen vulnerable to a very sharp and systematic appreciation. It shouldn’t take a genius to work out that you will be short the yen at your peril in the future.

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¹Oscar Wilde, *if you were wondering*



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