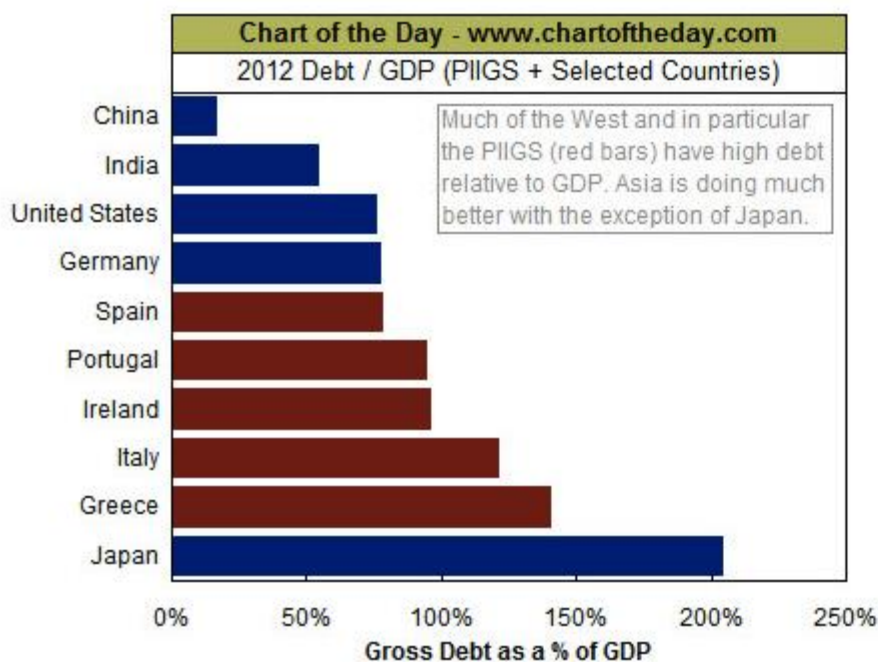
Action of the Bank Of Japan and what it might mean for Currencies, Bonds and Gold. 22nd April 2013

Japan has stunned the markets with the unprecedented move to mobilize the domestic savings base. We have viewed Japan as a fertile ground for the next credit crisis for some time now.

There are, in our opinion, many long-term risks to the Japanese strategy that will only become apparent over time, and will first materialize in the Bond and Currency markets. Japanese Government debt ratios are compounded by poor demographics and supported by an investor base that will eventually tire of funding an ever-deteriorating sovereign.



The Japanese governments expectation that the Japanese saver, who is aging, will suddenly start spending and generate tax revenues seems far-fetched. In addition, the notion of a central bank funding a government balance sheet that already has one of the world's highest debt to GDP ratios, is unsustainable and reeks of desperation. See chart.

Japan has also drifted to a balance of payments deficit position over the last few years - a crucial and negative development. The currency will be forcefully devalued to reclaim export market share away from the rest of Asia, something policymakers feel they have a right to do, and was a legacy of the strong Yen.

The question for the markets is what is all of this likely to mean?

The initial knee jerk reaction to the new, bold policy moves was to assume Japanese wholesale investors will switch immediately to offshore assets.

In our opinion this is unlikely to be the case, as the entire investment backdrop is too unstable. Japanese investors are very fixed income oriented- they will not, overnight, rush into international risk assets.

The global bond investor, on the other hand, will continue to sell out of Japanese bonds (JGB's) from an already low level of support. International rating agencies will likely take a negative view on Japan long-term currency ratings, and at a minimum large investors will assign their own internal (lower) rating, thus cutting their exposure even further. Once investors evacuate, it's incredibly hard to reinstate mandate allocations. Over the short term, JGB prices will stay elevated in price as their supply is soaked up by the BoJ. However, with heightened volatility as bona fide investors are replaced by the central bank and speculators engaging in short selling we expect that there will eventually be a huge downward price adjustment.

International currency managers with a sharp eye for a currency bear market will also sell the Yen. Once any central bank gives the green light to depreciate their own currency, the market will accept the one-way ride with gusto. Currency trading can be tough at the best of times, which means that a Central Bank sanctioned free kick will be impossible to pass up.

So, a Yen sell off to 105 -110 per USD will accurately reflect the level of BoJ intent, however and perhaps more importantly a collapse of the Yen in a few years to 150 + will reflect its policy failure. Note that the Yen can move a long way if conditions dictate –e.g. from 1995 to 1998 the Yen sold off from 80 Yen to over 147 per USD.

Global markets will therefore see a continued increase in volatility and performance dispersion on a country-by-country basis. As economic outcomes in countries' diverge, so too will the performance of their respective bond, credit, currency and equity markets.

This phenomenon is most apparent under the fixed exchange rate regime across EUR member countries. The cross border economic adjustments cannot be made via the currency channel so, the first round adjustment is made via bond prices. The second round adjustment must be made via fiscal austerity and the third and final round is bond write-downs and in a shoot–out the confiscation of deposits and assets.

The consequence of this high-risk policy is in our opinion likely to further support the strength of the US Treasury market and the US dollar. There was a round of US Treasury bond bear market prognostications in February and March however the fact remains global bond and Reserve managers (e.g. China) have nowhere else to invest their reserves except in US Treasuries. No other market offers such scale, liquidity and surety of repayment. The EUR suffers denomination risk and the Yen is no haven. Emerging Market bonds are a separate, often compelling market but once again, lacking credit stability and scale.

The US economic recovery has everyone's attention- and the role of currencies globally has been redefined again. The long-awaited demise of the USD has yet to materialize. In fact, the USD has slowly and gradually recovered against nearly every currency with the exception of the Yuan. So its restoration in the eyes of investors as a store of value has ramifications.

Finally, this leads us to comment on the recent gold move. This was a bubble bursting and the timing was a precision intersection of several key financial and behavioural factors and here are just a few:

- Concentrated ETF risk- the SPDR trust created a convenient conduit to express a leveraged bet on collective Central Bank policy failure spanning the last decade.
- The selling off of TIPS;
- The strong undertow of a recovering USD;
- US fiscal repair;
- The Bitcoin bubble bursting;
- Falling commodities (yes, they are priced in USD)

Gold is an alternative to cash, but it generates no yield and last we looked the SPDR costs 40 bp p.a. as an annual expense so you have to *pay* to hold it. The SPDR SP500 trust, on the other hand, has an expense of one quarter of this and actually pays a dividend of over 2%. In a perverse twist against conventional wisdom, lower inflationary expectations validate extending QE, thus making equities actually more attractive in the long run.

As a footnote, we believe the ongoing market volatility will continue and therefore, the need to actively manage investments remains paramount.

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