THE YEN AND YUAN LIKELY TO MOVE ANOTHER 25%

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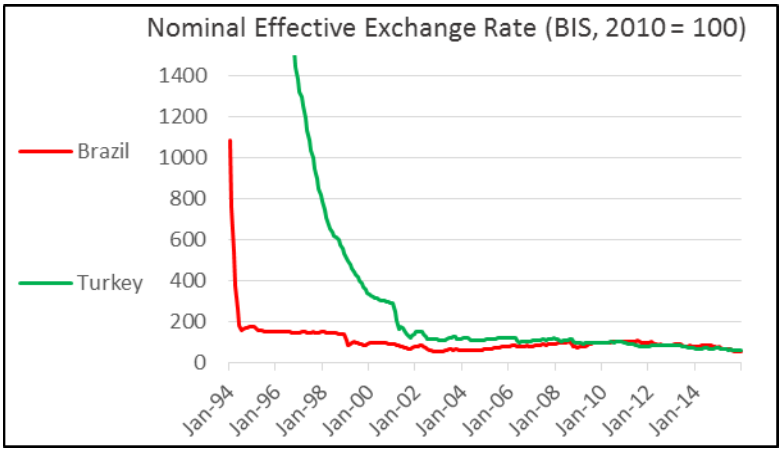
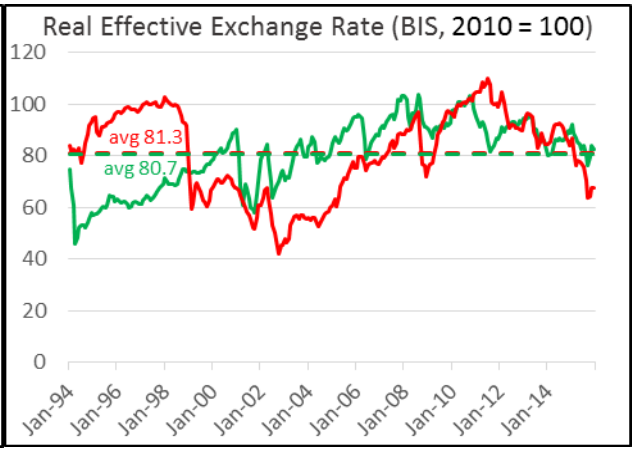
Market Views

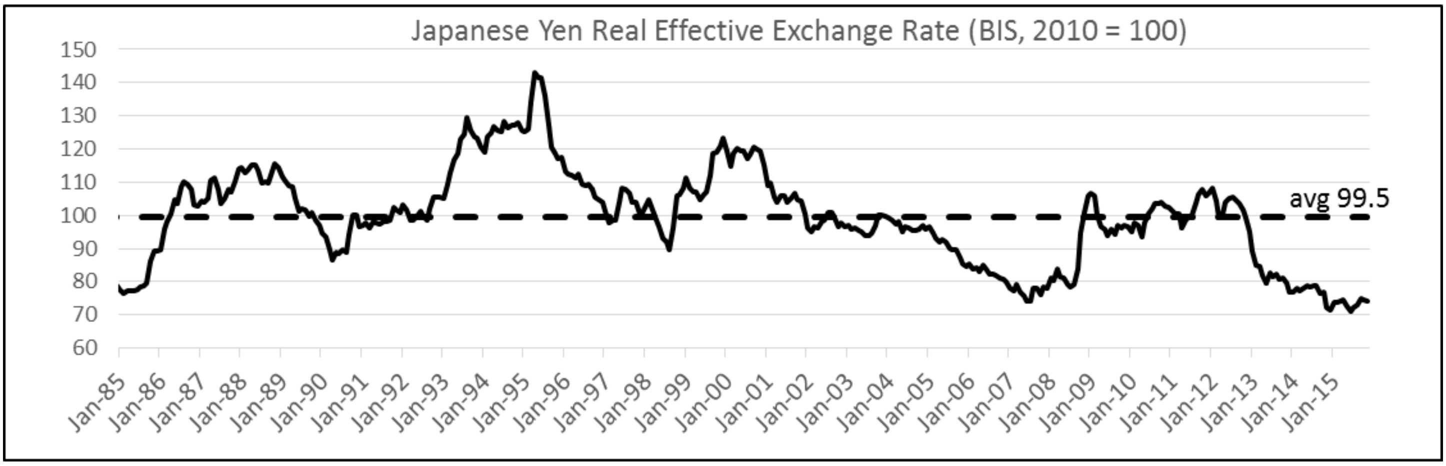
"The Yen has excessively weakened against its long term real effective exchange rate during "risk-on" periods, as Japan has embarked on tremendous overseas carry trades (providing debt to emerging markets). This trend tends to reverse swiftly during "risk-off" periods as the debt goes sour. The Yen looks 25% too cheap, with potentially a long way to strengthen yet."

A nation's currency should primarily adjust around its relative inflation rate, with high inflation offset by a depreciating currency. The Bank of International Settlement's (BIS) **nominal** effective exchange rate (NEER) data below shows two currencies that have significantly devalued in **nominal** trade weighted terms over the last two decades. Meanwhile the inflation adjusted **real** effective exchange rates (REER) have oscillated around their long term averages. If currencies didn't adjust for inflation then a Caipirinha in Rio or Kebab in in Istanbul would become impossibly expensive for the rest of us … as would the local labour markets.

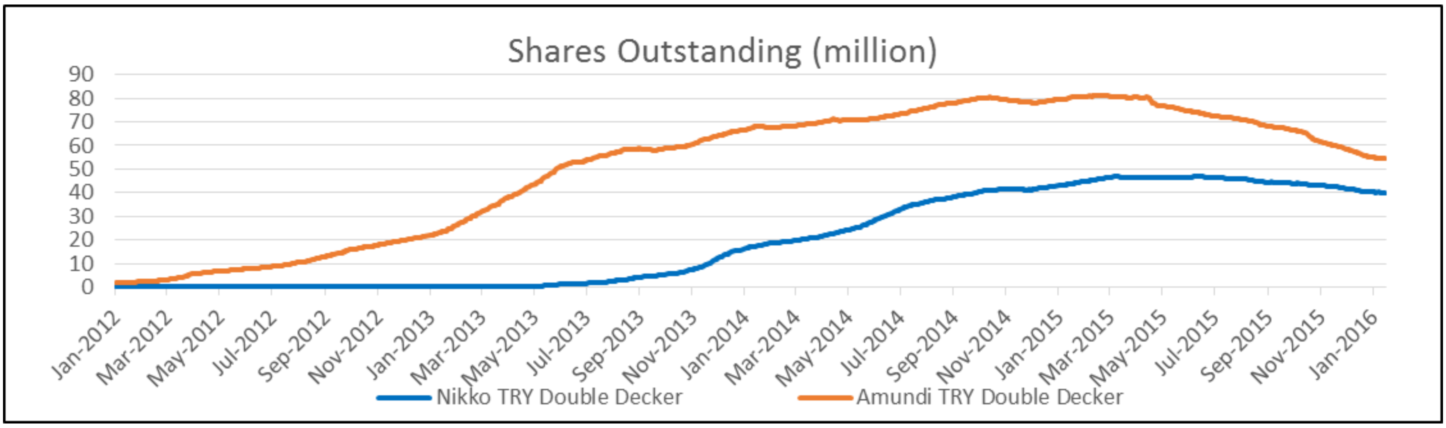




The reverse is true for low inflation countries like Japan, whose currency should appreciate against higher inflation trading partners over the long term. Currencies can get out of kilter during debt up-cycles as asset imbalances build during "risk-on". This century the Yen has excessively weakened against its long term REER during "risk-on" periods, as Japan has embarked on tremendous overseas carry trades (providing debt to emerging markets). This trend tends to reverse swiftly during "risk-off" periods as debt goes sour. The Yen looks 25% too cheap, with potentially a long way to strengthen yet as emerging markets struggle.

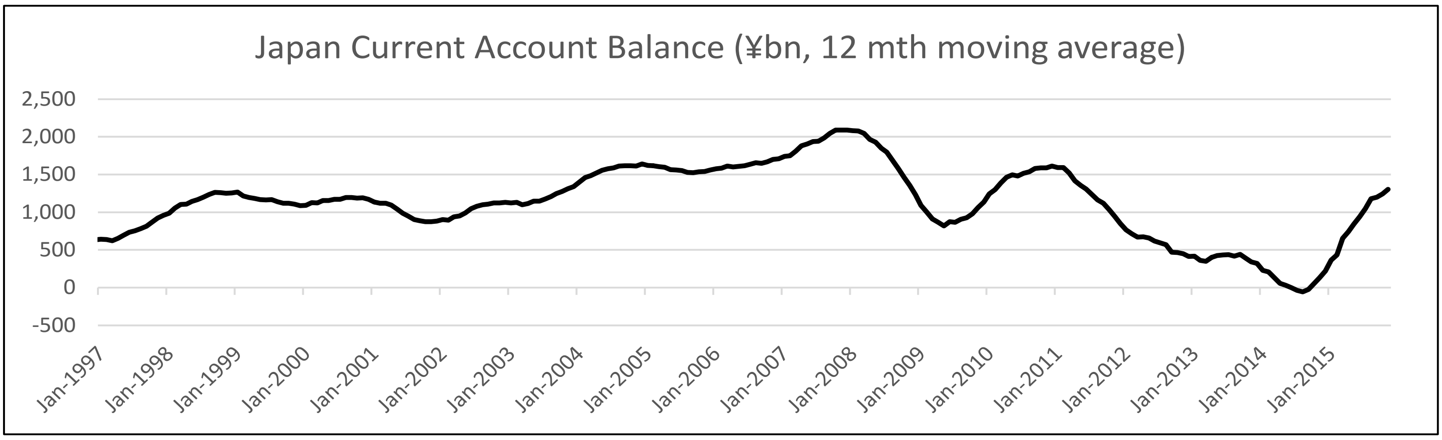


As we have previously written we think Yen carry positions are back above 2007 record levels. Much of it is invested via complex structured products such as the Turkish Lira Double Decker Toshin, the top selling fund last year at Japan's largest broker. The chart below shows that the Japanese are swiftly exiting these funds, understandable as the NAV's have fallen by over 40%.

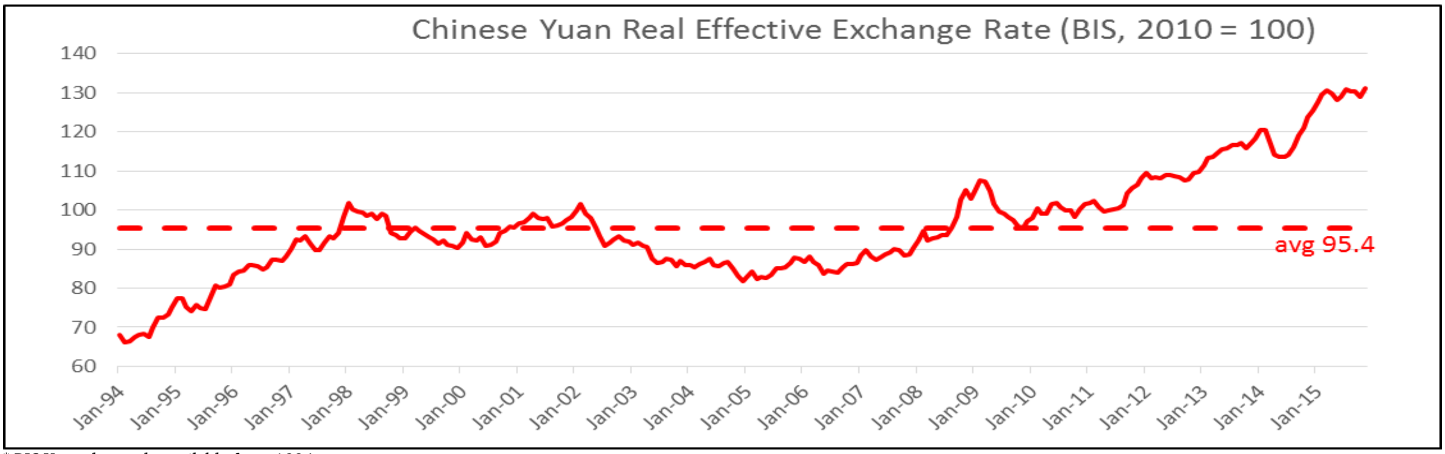


This is just one of a myriad of structured carry products offered in Japan that leverage high yield bonds with additional high yield currency overlays such as BRL, ZAR, MXN and AUD. Whilst the underlying assets have already seen large declines in value, further outflows will worsen the debt sustainability of the emerging market borrowers. Associated currency weakness will bring further import inflation in a vicious cycle. If Japan, as the world's largest net foreign creditor, steps up its carry trade exit the flows out of these assets and back into Yen could be the dominant flow this year. Our on the ground research indicates it is largely pensioners in Japan who purchase these products for the monthly dividend. Dividend cuts tend to follow NAV declines by a few months.

Japan's fundamental Current Account flows have also returned to a strengthening bias, after being in an unusual weakening bias during a nuclear shutdown amidst high energy prices (Link: The Fierce Yen Seesaw). With Oil prices having fallen a further 30% since the most recent data below and reactor restarts only just beginning in earnest, Yen's strengthening bias looks set to increase.

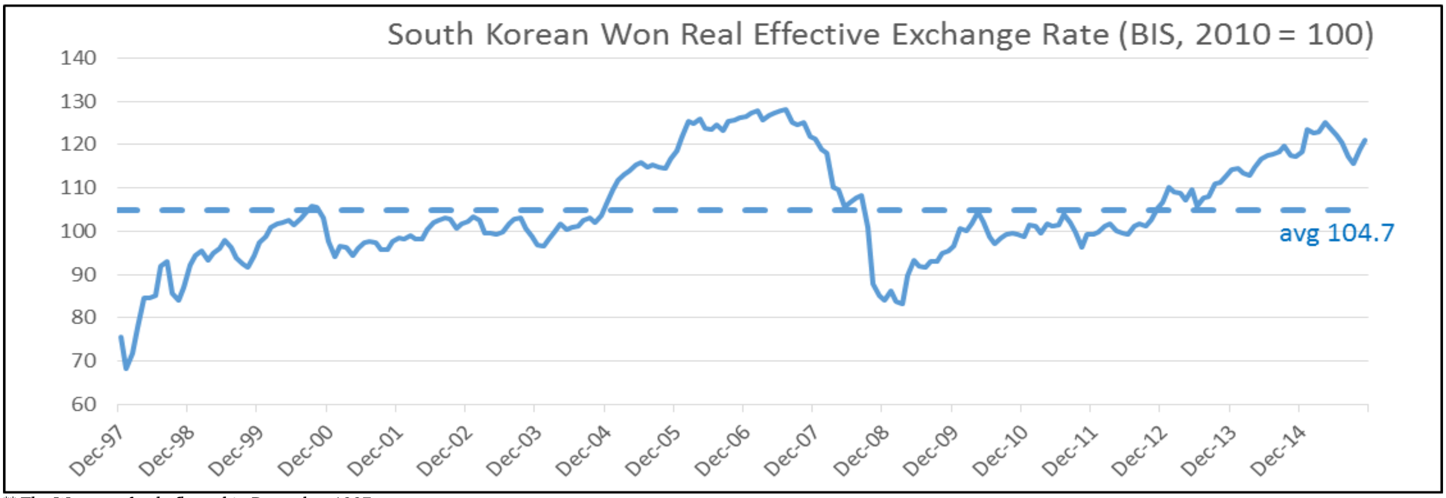


It is not just the high yielding carry currencies that are likely to devalue against the Yen. The Chinese Yuan is around 35% overvalued against its long term real effective exchange rate*. China is Japan's largest trading partner.



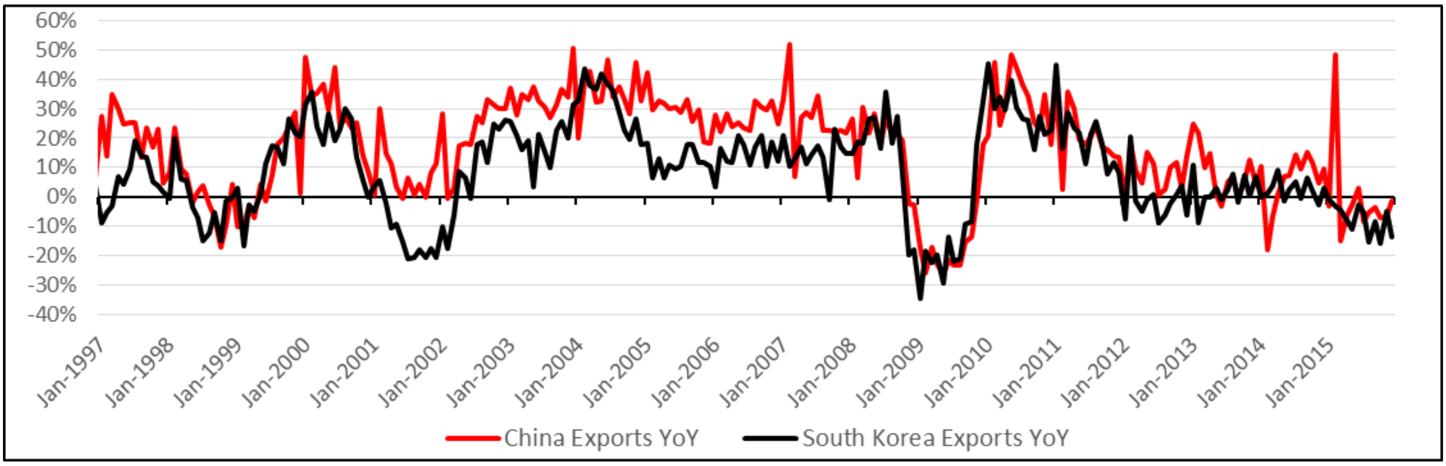
* BIS Yuan data only available from 1994.

The South Korean Won is 15% overvalued against its long term real effective exchange rate**. South Korea is Japan's third largest trade partner. The Won is a classic example of a currency that depreciated swiftly through its long term REER in the last debt crises.

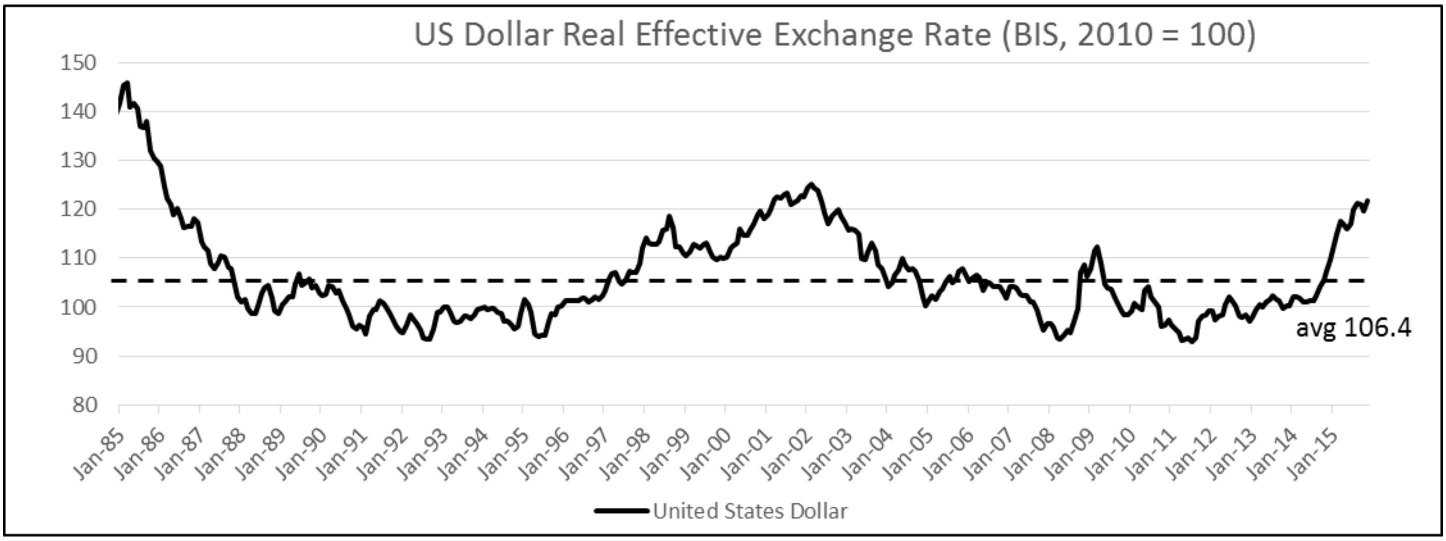


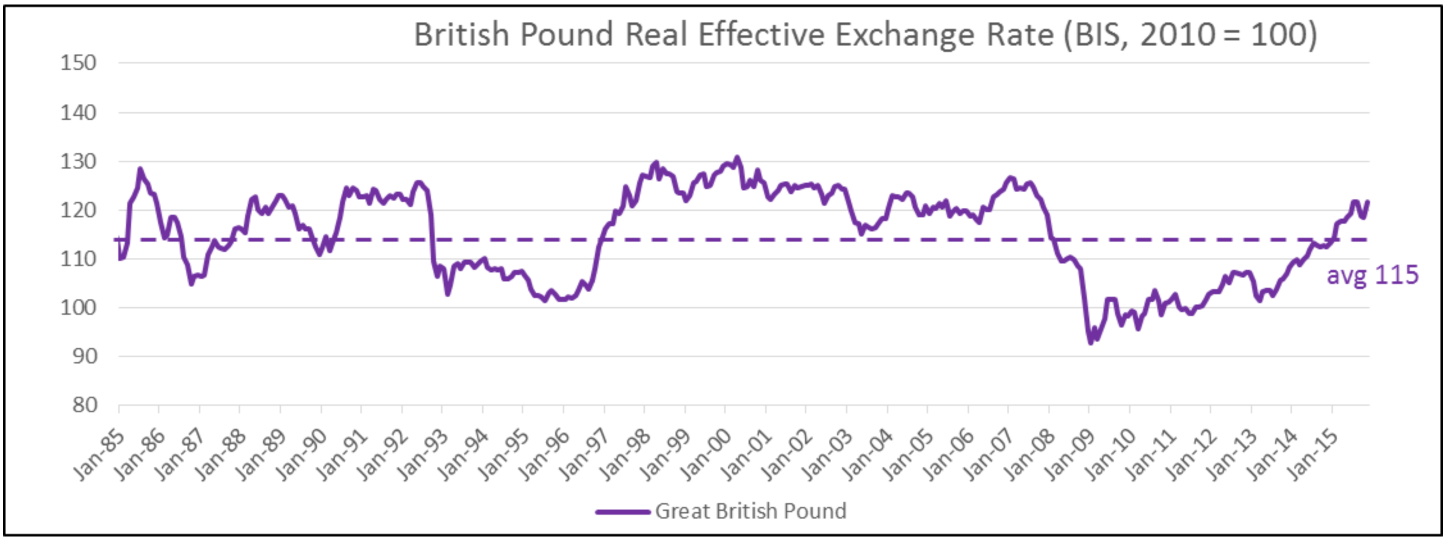
** The Won was freely floated in December 1997.

The Chinese Yuan and South Korean Won strength have recently coincided with highly concerning declines in exports for both of these countries. Given that Japan competes with these countries in many export industries it would not be surprising if these countries wanted to lower their exchange rates against the Yen.

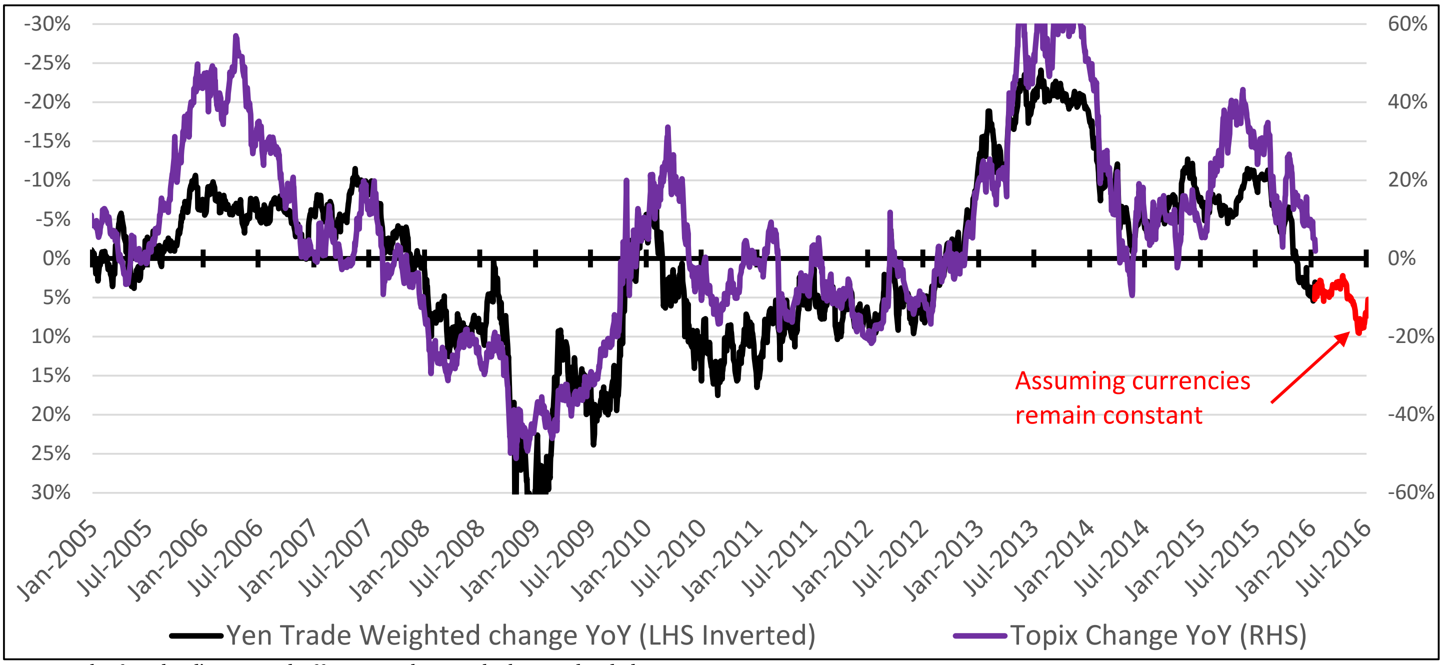


The US Dollar and British Pound, would also likely weaken towards their long term REER's in a debt crises, even if it is an emerging market centred debt crises. Much has been made of the US and UK potentially raising interest rates, a feat which is highly unlikely if already weak global economic conditions deteriorate further under a fully-fledged emerging market debt crises.





To assess the potential impact on Japanese equities of continued Yen appreciation, we can see that over the last decade the Topix Index has moved at a roughly 2:1 ratio to the Yen. Such that a 20-30% appreciation in the Yen would imply a 40-60% fall in Topix Index. Currencies bring a leveraged impact to earnings, with lower translated foreign revenues applied against fixed domestic costs. Japan has particularly high fixed domestic costs with ridged employment laws and priority given to employees over shareholders. It is interesting to note that for the first time since 2012 the Yen is already stronger year on year (YoY). If currencies remain constant it will be 10% stronger YoY by summer, which will bring with it company earning declines YoY and company forecast reductions.



Note: Bank of England's Nominal Effective Exchange which provides daily prices.

Japan is the only major economy this century to consistently see an appreciation of its currency during a debt crises. This amplifies Japan's cyclicality and it is not surprising that Japanese equities fall more than other markets during "risk-off". It appears that Japan is heavily involved in emerging market debt, where the crises and outflows may have only just begun. Conditions are in place for a sustained "risk off" with global debt levels at record highs and negative OECD leading indicators. Japan is the ideal market to be short of for amplified returns in a down turn.

P.S. Many of you will probably be thinking, "won't Japan will just do more QE?". I remain of the view that Japanese QE does not actually increase money supply as the vast majority of "liquidity" created just ends up being placed back on overnight deposit at the Bank of Japan or stuffed under the mattress. Japan is also near the limit of its bond purchasing program as outlined in my previous note [Japanese QQE Costs And Side Effects]. It is most interesting to see that since this note, Japanese bond yields have displayed characteristics of an asset class in severe shortage and cash hording has accelerated. The Bank of Japan Governor Kuroda recently stated "I don't have plans for further monetary easing at the moment" (Link: [Reuters 14 Jan 2015]). With inflation rates dramatically underwhelming this must imply he and/or a majority of his board also feels that Japan Government Bonds purchasing has reached its limits. The markets realisation of this could see a rapid unwinding of the short Yen / long Japanese equities trade, this flow would amplify returns in shorting Japan.

INFORMATION

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