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**New Year: Return of the Old Yen
An Ode to Mrs Watanabe**

A new fiscal year is about to begin for Japan. The yen is likely to depreciate in the year ahead. The driving force may not be a further reduction in risk aversion, though the appetite for risk may remain robust. It is unlikely to be a result of intervention, though given the deflationary conditions and the internecine tension between the Ministry of Finance and the BOJ few will want to rule it out altogether. Nor will the anticipated yen weakness be necessarily the result of a new economic contraction in Japan, but that remains a distinct possibility, especially nominal GDP.

The yen's decline will have everything to do with interest rates and relative slopes of yield curves. The underlying reason is a key feature of the international political economy, namely uneven development. Japan had near zero interest rate policy before the 2007-2009 financial crisis. Other countries adopted near zero interest rate policy during the crisis. These economies are recovering and over time will be normalizing policy.

Talk of the *new normal*, Japan's economy, led by exports and capital expenditures to produce more exports, is recovering but deflationary forces continue to have a choke hold on the country. The return on capital in Japan—interest rates, equity market, profitability—is dismally low in Japan. When capital is free too, it will seek the best risk-adjusted return. That is outside Japan.

Take Mrs Watanabe over IMM Speculators

The yen strengthened 3% against the dollar in January. It gave back nearly the whole amount in the first 2 ½ weeks in February. Japanese businesses are believed to have taken advantage of the pullback in the yen to repatriate. The yen rallied from mid-Feb through early March; pushing the dollar to its lows since before Xmas, just above JPY88. It is from there that the dollar has soared to almost JPY93.

The speculative positions in the IMM currency futures market have been net long yen since the middle of last year, with the exception of late-January through late-February. However, they were caught long again in this recent yen sell-off and have likely been forced to reverse positions.

Mrs Watanabe, the proverbial money manager of the Japanese household, knows better. She has accelerated sending her savings abroad. And more is going to be coming.

To the extent that the speculative market took notice of the Japanese government's recent decision to increase the deposit caps at Japan Post Bank, it was thought to be bullish long-dated Japanese bonds because that is where the Post Bank invests the deposits.

However the real Post Bank story is quite different. Mrs Watanabe has an estimated JPY40 trillion (~\$430 bln) of investments at the Post Bank that will mature this year. This is roughly twice as large as last year's maturities and the largest since 2001. For the record, the yen was the weakest of the G10 currencies that year, depreciating a little more than 13% against the dollar.

The "fixed amount" time deposits, generally three years and longer, offered by the Post Bank generate an annual yield of 11 basis points. This is simply abysmal and not acceptable; not when there are alternatives.

Mrs Watanabe has been busy while the currency speculators dithered. According to data from the Investment Trusts Association of Japan, Japanese holdings of foreign currency denominated mutual funds jumped by 31% in January and another 25% in February to JPY27.3 trillion (~\$305 bln).

Of particular interest, Mrs Watanabe likes Brazilian bonds. Holdings of Brazil fixed income instruments stood at JPY1.34 trillion in February, nearly a third more than last February. Consider that a Brazilian real money market pays her 6% a year, 55 times more than she can get if she takes advantage of the government's relaxation of the deposit limit. Some reports also suggest keen interest in Chinese equities, but Japanese investors have a clear preference for bonds over equity, according to Ministry of Finance capital account data.

It is about Money

US interest rates are rising now after falling for in the first several weeks of the year. Japan's interest rates have been more stable. Over the past month, for example the Japanese 2-year yield has risen 2 bp and the 10-year yield has risen by 6 bp. The yield on similar US notes rose 26 and 25 bp respectively.

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To be sure this still leaves the 2-year interest rate differential at about 85 bp, or six basis points lower than the start of the year. The 10-year differential is around 253 bp, essentially unchanged during Q1 09. However, to dismiss it is not to appreciate the sharpness of the more recent move or the power of the underlying trend.

In this context, one noteworthy statistical development here in 2010 has been the much tighter correlation between the dollar-yen exchange rate and US-Japanese interest rate differential. The correlation (percentage change daily data) between the spot fx movement and the 2-year interest rate differential is 70% this year, compared with less than 43% last year. The correlation with the 10-year bond spread is almost 75%. It was nearly 44% in 2009.

The dollar-yen rate appears particularly related to interest rate differentials, but not just to US-Japanese differentials. It is more correlated with the spread between US-German interest rate differentials that is the euro itself. Consider that year-to-date the dollar-yen rate is correlated 32.6% with US-German 2-year rate differentials and nearly 59% with 10-year differentials. The comparable correlations with the euro are almost 20% and 10% respectively.

Moreover, it is not simply that yield spread for the same duration. Mrs Watanabe's strategies may be more sophisticated. What counts, from her perspective, is her cost of capital. In this case, the more apt comparison may be the spread between the Japanese short-end and the US rate. So for example, one Japanese bank noted that a client could buy the US 30-year Treasury bond and hedge the currency risk and still earn twice what she could in Japan.

Stocks

Foreign investors have increased their purchases of Japanese shares this year. The new flows are about 50% above Q1 09, which while sounding impressive, is a smaller increase than most of the Asian markets are experiencing.

Some investment houses have recommended Japanese equities on valuation grounds as the Nikkei is the laggard within the G7 over the past year. However, Mrs Watanabe is not convinced. She has tried in the past to get involved, but the unfortunate fact of the matter is that the Nikkei peaked 20-years ago. Full stop.

Mrs Watanabe also knows that the interlocking share ownership structures are being unwound. This means that companies are selling their equity holdings in other companies. Some link this to accounting rules that are likely to be adopted in the coming years. The new rules involve comprehensive income and adding the value of securities to net income. It would add an extra element of volatility into earnings. Others relate the sales more to the competitive pressures and efforts to enhance the returns on investment.

In any event, it appears that Japanese companies were net sellers of domestic stocks during the fiscal year that is ending for the first time in six years. Through February companies sold roughly JPY400 bln of Japanese shares. And both explanations would suggest that the selling may continue into the new fiscal year.

The future of Japan, and maybe dollar-yen to some extent, is in the hands of Mrs Watanabe. Ministry of Finance figures suggest Japanese retail accounts for a full quarter of the yen turn-over in Tokyo. The challenge for Japanese policy makers is to tap into the wisdom of Mrs Watanabe by getting her into the work force. Women's participation in Japan's work force is extremely low by international standards.

By facilitating this transformation, Japan would begin to reverse the decline of its workforce. What's it going to be: women, immigrants, robots, or continued diminution? Employing Mrs Watanabe would arguably boost income, standards of living, and the demand for goods and services. This could revive the economy and end deflation in a way that the orthodox and unorthodox policies have thus far failed to do.

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