Rodney's Take

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Uncontrolled Yen Clients

Central banks want orderly capital, interest, and currency markets. When it comes to interest rates, central banks want positive yield curves at reasonable rates; to make that happen, they are willing to manipulate rates using policies like buying or selling government bonds. This process is called yield curve control (YCC). It's a great idea, unless your investors don't play their part. When it comes to the yen, instead of YCC we're likely to get UYC, uncontrolled yen clients.

As Mundell explained in the early 1960s, you can control two legs of the central bank barstool, but not all three. China gives the illusion of controlling all three, but at the expense of foreign investment. Given that China has the second-largest economy on the planet, more countries and companies should be using yuan to settle transactions, but they're not. The Chinese peg the yuan while setting interest rates and controlling capital flows, which could wreak havoc with the values of foreign investments in China and foreign reserves held in yuan. The same can't be said of the Bank of Japan (BoJ) and yen.

The BoJ has held interest rates artificially low for decades, which led institutions to borrow funds in yen and use them to invest in currencies that paid high rates. Selling one currency and using the proceeds to invest in another is called a carry trade. Such a trade pays off handsomely if you're leveraged and hedged against currency risk, as long as everything stays the same. If the BoJ suddenly raised overnight rates, then people who borrow in yen would find themselves in losing trades. As the BoJ held overnight rates low, investors began betting against the yen carry trade, only to see the BoJ cut the overnight rate instead of raising it. This went on for decades, until the BoJ cut the overnight rate to zero. Betting against the carry trade seemed like a sure thing, until the BoJ cut the overnight rate to negative 0.10%.

Since the early 1990s, betting against lower Japanese government bond yields has been called the widowmaker trade, because everyone who tried it died, at least on that trade. But this time might be different. (I know, famous last words.) Japan went through two decades of no inflation and sclerotic growth. The executives of a company that makes a treat for children made a video to apologize for raising the price eight cents on a $1.50 item. These people take—or took—their pricing power seriously! But that was then.

The Japanese have real inflation, but without rising rates the yen has fallen relative to the buck. Where the BoJ used to be okay around 110 yen per dollar, it's now around 145 yen per dollar (as I covered in October). The 10-year JGB (Japanese government bond) used to trade around 0.10%; now it's closer to 0.75%. And yet Japanese overnight rates still sit at -0.01%, essentially zero. This could turbocharge the carry trade, but only if it remains the same. With the yen losing value, the Japanese people are feeling the pinch on foreign products. To help them, the BoJ would need to raise overnight rates at the least and let investors know that the central bank won't interfere if long-maturity bonds trade with higher yields. This would bring Japanese investment dollars back home to capture the yield in the home currency and force trillions of yen in carry trades to unwind.

Nobody knows what would happen then, because we've never seen manipulation on this scale. If the BoJ plays it just right, they would take the froth out of the carry trade but not cause panic. The last investors in would be toast, but long-time carry traders would have big profits that could be used to lessen the pain. I'm not sure that's how investors work. I think it's more likely that when the carry trade loses its luster, everyone will run for the door at the same time.

That's the problem with manipulation. Eventually, no one knows what is caused by market forces vs. what is based on intervention. The BoJ has done this for 30 years. Japan has an entire generation of financial professionals ages 50 and younger who have never seen their markets without manipulation. To say they know what will happen is laughable.

While the Fed has not manipulated our economy as long as the BoJ has been manipulating Japan's, it has been 15 years. We can't be sure what is real and what is manipulation in the bond market, because never before has a central bank printed $9 trillion and then tried to reel some of it in. Will the process be steady or proceed in fits and starts, marked by panic? I don't claim to know the answer, but I'd imagine we're about to find out.

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Got a question or comment? You can contact us at info@hsdent.com