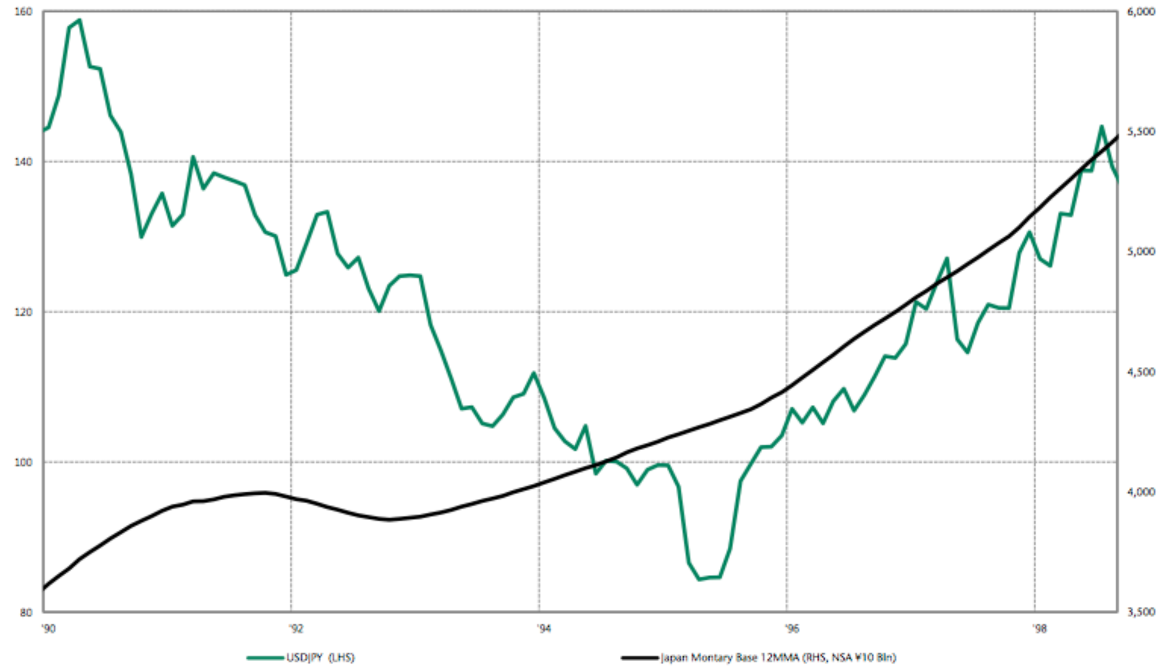
The Japan redux – 1995 to 1998 all over again

In early 1995 I made my first trip to Japan. At the time, as a young market strategist at Swiss Bank Corporation in London, I had just seen USDJPY cart out nearly every levered trader on its freefall from 105 to 80. And when I arrived in Japan that Spring, I quickly realized how easy it was to hate the level of the Yen.

After taking a 1 hour taxi ride from Narita to the Okura Hotel for $300, I got to my room and ordered a $35 cheeseburger from the room service menu. I had never seen a $35 cheeseburger so I was pretty excited – it was sure to be amazing. Of course I was deeply disappointed, it was one of the worst cheeseburgers I ever had – a small overcooked ground beef patty between two pieces of soggy toasted white bread and a slice of tomato on the side. Pathetic, and even the fries were soggy! There was something seriously wrong with this place.

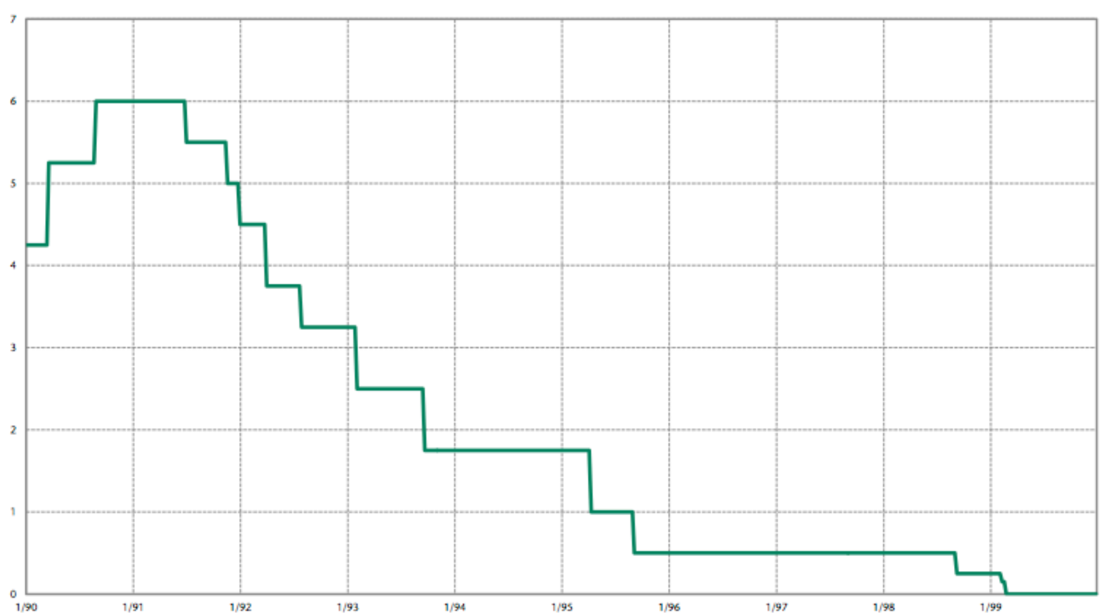
It turns out, as is usually the case, the problem with Japan in the mid 90s could be easily traced back to inappropriate and foolish government policies. From 1990 to 1995 Japan's property and equity bubble crashed. Over those 5 years, the Nikkei fell from 39,000 to 14,000 and house prices in central Toyko could not find a bid down 80 percent. In fact, the Nikkei initially traded down to 14,000 as early as 1992, before recovering somewhat and then dropping again to 14,000 in 1995. It was an absolutely brutal crash with massive destruction of Japanese wealth. At the time, insurance companies that had sold 6 percent fixed rate annuities, and banks that lent against any property, were swiftly heading towards insolvency. All the while, the BoJ struggled to cut rates quickly and the monetary base barely grew (see the two charts below). Bizarrely, by 1993 the BoJ had basically stopped easing even as the economy was still in a tailspin.

Dollar/Yen & Japan's Monetary-Base



Source: BoJ and Bloomberg

BoJ Policy Rate (%)



Source: BoJ and Bloomberg

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Deflation was taking hold in Japan, and 1.75 percent overnight rates combined with 2+ percent deflation, creating real rate spikes of over 4 percent. Of course the last thing the Japanese economy needed was +4 percent real rates, it needed -4 percent, or even less. But the BoJ just stood on the sidelines watching with a pathetic 1930s style approach. They undertook modest rate cuts while jawboning a recovery and focusing on their commitment to price stability. The typical claim from the BoJ was- "its not our problem, the politicians must act with more effective fiscal measures to fight the crisis". Well, after nearly 25 years of leaving it to the fiscal authorities to stimulate a recovery, what does Japan have to show for it? A 230 percent debt to GDP ratio and zero cumulative growth rates. That should be a warning to all central bankers who claim that its up to fiscal policy to do the heavy lifting! The reality is that only way to fight a debt/deflation spiral is with aggressively easy monetary policy and highly negative real rates. We should all be very thankful that our colonel back in the USA gets it!!

Now there were some occasions over the last 23 years when the BoJ decided to "briefly" let loose with accommodation blasts. By mid-1995 – after the Yen pushed to 80 and the already wrecked economy was hit by a tragic earthquake – the changes at the BoJ were significant. Rates were taken down to 50bps and more importantly the monetary base was expanded rapidly (look at the attached charts again). The BoJ had actually started to stabilize the situation and I remember very clearly in early 1997 everyone was once again excited about a Japanese recovery. The most important driver of the optimism came from USDJPY which, off a base of 80, was well on its way to 140 (are things starting to sound familiar yet??).

But stability in Japan did not come without some catastrophic side effects. Along the way in 1995-1998, Japan's export competitors were destroyed. While the BoJ got religion, the move in USDJPY from 80 to 140 crushed nearly all NJA countries. Indonesia, Thailand, Malaysia, Korea and finally Russia dropped like dominos. The important lesson here is that when the Japanese decide to turn the ship around and go for it, the wake generates a tsunami for ALL mercantilist nations. Of course, it was a home run for non-mercantilist consumption junkies like the US – we enjoyed a massive positive terms of trade shock that everyone misinterpreted as a productivity miracle. The 90s in the US was about every one of the nations we import from stepping over themselves to stock the Walmart shelves with cheaper stuff. It was then that Goldilocks became an icon and the Maestro was born. Good days for the US but a disaster for every EM exporter across the globe. The moral of this story is don't underestimate how significant a massive turn by the BoJ can be for others. What is happening right now is a rerun of 95-98 in Japan. The BoJ has religion – AGAIN!! Its great news for the US, and terrible news for export driven EM. It may not last if the BoJ gets cold feet as it did in 00s, but right now there is NO reason to stand in the way of this massive policy change, and there is every reason to run with it!!

But there are some important caveats here. To be sure it wasn't just a Japanese competitive devaluation that triggered the destruction throughout the EM world in 95-98. China's peg move from 3 to 8.63 a few years before, and higher USD interest rates, also worked to crush heavily indebted EM countries across the globe. But as we sit here with USDJPY up from 78 to 102, there are signs that China is about to ease significantly, and some further signs that US rates are heading higher – the writing on the wall for EM is actually pretty frightening. Of course, it has been no picnic owning EM over the last few quarters, as smart money has already made some of the connections suggested above.

Nevertheless, there is likely plenty more blood letting to come. While to some EM valuations may look cheap, history suggests it could get a whole lot worse. The BoJ is taking us right down the 95-98 highway – all we need is a white house sex scandal and it would be deja vu all over again!!

There are however two important differences between the current period and 95-98 as it relates to Japan and EM. First is China and the second is EMU. Back in the mid 90s China was a $500b economy and today its a $7.5 trillion economy. How China reacts to a BoJ with aggressively easy monetary religion is highly uncertain. But my guess is that whatever they do, it will add insult to injury for the rest of NJA (and most of global EM). Further, it could have much more serious global repercussions given the size. To me, the Chinese reaction function as it relates to Japanese policy remains one of the most complicated wild cards for global macro investing.

Now, with EMU it is much more clear cut. Back in 95-98 there was no EMU. But today, what Japan is doing is actually hugely positive for the internal stability of EMU. YES POSITIVE. The German economic data has been softening for some time now. Its no coincidence that the massive upmove in EURJPY, and the BoJ accommodation moves more generally, are hitting the German economy. Germany is the ultimate mercantilist – and it has created a weak domestic currency by associating with EMU riff-raff. But if the Japanese are going to play hardball, the Germans will need to back away from all the foolish ECB policies which have failed to deliver effective accommodation to the Eurozone. Associating with riff-raff will not be enough – the Germans will be forced to do the right thing and pull the rip cord on "uber" easy money, something the rest of Europe desperately needs. In fact, seeing the recent easing moves by the ECB, with virtually no German complaints, suggests Japan may just have been the catalyst to save EMU. In the end, anything that stops the German stranglehold on the ECB balance sheet is great news. The best thing for Europe is to see the German economy roll over. And it looks as though the Japanese may be just the folks to get the job done! So while the Japanese may create difficult times ahead for EM, it looks like they may be bringing on more good times for DM.

And to be sure, the recent price action is cooperating with this view. The Nikkei is ramping hard (up 40 percent YTD and up 6.7 percent last week); spoos closed at record highs last Friday; and EM remains soft. In addition, Gold continues to be crushed suggesting expected real returns to risk taking are being revised MUCH higher. Our baseline theme that spoos are for lovers, gold is for haters and the Nikkei is for Sybarites is working perfectly. However, in the coming weeks/months we may have to add one more asset class to this list – long dated government bonds. And who are those for? I can't think of a better word than "fools". JGBs, USTs and Bunds are eventually going to crack under all this reflationary pressure. It may take a little longer, but those who buy long dated govvy bonds, and accept 1 to 2 percent coupons for extended periods of time, are going to see their real wealth destroyed. It might happen slowly via financial repression and negative real rates for many years, or the markets just might gap!! Either way there will be no bond holders allowed through the gates of Sybaris!

Spoos are lovers, gold is for haters, the nikkei is for Sybarites and government bonds are for fools. A simple set of rules to live by. Good luck trading.