DrobnyGlobalMonitor

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3701 Highland Ave, Suite 302, Manhattan Beach, CA 90266 andres@drobny.com *(310) 545-6996*

Biases:

EQUITIES:
BONDS:
FX: ****Bearish Yen***
EMG: Bullish Asian EMG FX; Bearish Asian EMG interest rates;

Current Exposure:

EQUITIES:
BONDS:
FX: ****Short JPY vs KRW (Jan 31);***
Long Euro/SFr (Sept 12);

The Yen Debate & Asia/Yen ****Please note latest changes to biases and/or exposure***

There's an interesting split within our circles regarding the Yen. The bears site the move to a trade deficit and an improved global risk climate as a good reason why the Yen TWI should start to depreciate on trend. And, for them, the location is especially attractive as we are near levels where intervention took place last quarter.

The Yen bulls argue that the trade deficit is old news, and that trade flows are swamped by a surplus in the capital account. Moreover, yield compression has cut significantly into the attractions of using the Yen as a carry vehicle. Typically, these Yen bulls are bearish the global outlook; Yen bears are bullish the global outlook.

And, it is true that there's been a pretty consistent correlation between the Yen and US rates (10yr Treasury and Yen, below). Thus, the friendly FED announcement last week

last week pushed down rates across the US curve and, predictably, this resulted in a move back down in USD/Yen with the Yen TWI returning towards the highs again.

Yet, there must be a price of the Yen TWI, and/or specific Yen cross rates, where the underlying pressures on the Yen will reverse. Economically speaking. At some point, at some Yen price, trade and capital inflows will be undermined sufficiently to make underlying flows no longer Yen positive.

Notice that the same can not be said about interest rates, though. We've seen how they can converge towards zero, yet the impact on activity can still be hard to discern. That's what happens in a liquidity trap. When deleveraging takes place, low rates help forestall defaults, hold up the system and make it easier to service debt. But, low rates are like pushing on a string. They seem unable to rekindle growth.

And, this means that the Yen/rates correlation should at some point start to unravel. Perhaps not with USD/Yen, which may remain tied to US rates and the USD trend itself. But, with the Yen TWI.

And, there is good reason to think we are there……....now. The idea that Japan has moved to a trade deficit is, indeed, well known. Yet, this is a flow effect which is likely to persistent which means reduced underlying inflows into the Yen. Month after month; year after year.

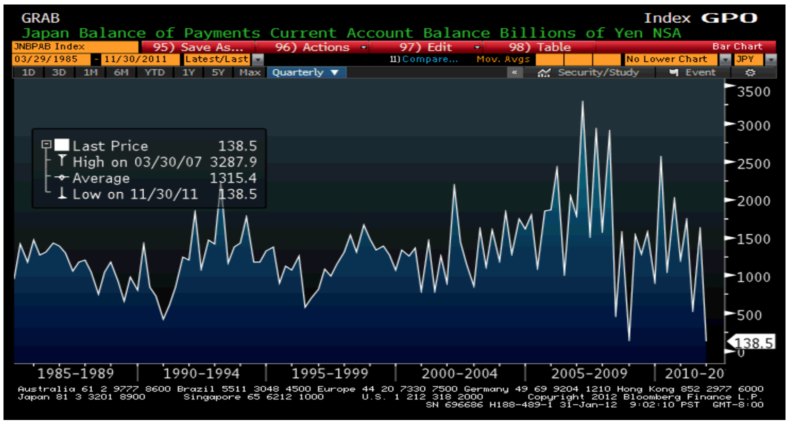
And, Japan's exports last year were down pretty hard, at a time when virtually all countries enjoyed higher exports. Even after the strong recovery in 2010, Japan's exports to Asia are still down 5% from their peak values, and that's with most of Asia enjoying pretty strong growth since mid-2009 (below). And, Japans export earnings from China are flat despite very rapid growth in China since 2009 and sharply higher imports into that country. Not from Japan! All signs suggest Japan has lost competitiveness. And, in a crucial region, where more than 50% of Japan's exports go.

Now, of course, as a net creditor, Japan's trade surplus is only one component of their total C/A position. Remittances from abroad have been strongly positive for years. That makes for a positive current account balance even with trade turning to a deficit.

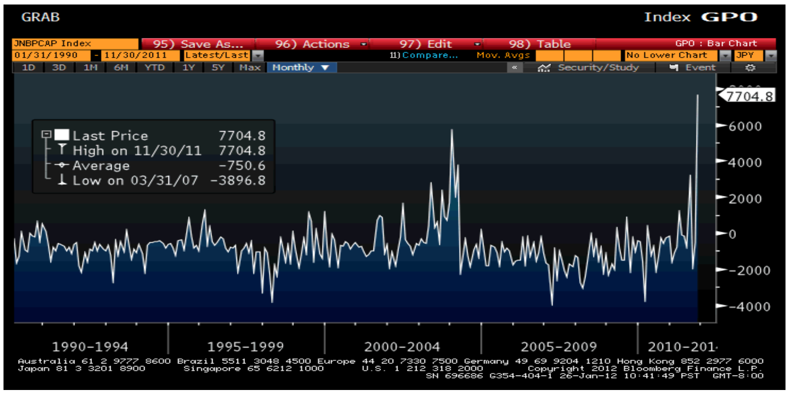
Yet, this factor has also been undermined by the strong Yen. The Yen is up more than 60% since the lows of mid 2007 (TWI below). That's incredible. This rise reduces the Yen value of any capital inflows from abroad. The strong appreciation of the Yen means that both Japanese export earnings and capital inflows are now smaller in Yen terms for each unit of exports or each dollar earned from assets held abroad.

Upward pressure on the Yen from both these underlying flows is thus much less nowadays. The C/A surplus is already at the lowest levels in decades, and is already running at close to zero (below). That's a lot less than in 2007, 2008, when the big bull move in the Yen TWI got going.

OK, then, given all these factors, how is it that they Yen TWI appreciated by some 10% in H2 of last year? That's a pretty big move for a TWI. How can that be?



Well, look at the picture below, which shows the capital and financial account in the Japanese Balance of Payments data. It surged higher in September and then more so in November of last year. This seems to reflect a one-off inflow of capital, similar than what happened in late 2003, which also was associated with a jump up in the Yen TWI.



This suggests that a likely factor behind the recent strength of the Yen was capital flight into the Japan last autumn of historic proportions, which is what in turn prompted sizeable MoF intervention. They can probably see it better than we can. Capital account data is notoriously hard to follow, comes with a lag, and is typically hard to reconcile. But, the timing and magnitude sure seem to fit the idea of capital flight from the Euro area as things seemed to deteriorate in the autumn, before the big policy innovations in December. And, Euro/Yen experienced pretty big drops in September and November last year, which coincides with the jump in capital flows into Japan in those months. It's circumstantial evidence, to be sure. But, it has a ring of truth to it.

If this little hypothesis is correct, then the trade implications are pretty clear. The Yen has probably overshot, at a time when underlying trade and capital flows are much less Yen positive than in many years. It also suggests that any further rally in the Yen TWI should be associated with another event that prompts capital flight back to Japan. This would thus likely only occur if there is another big leg down in either bond yields or equity values. It suggests selling the Yen and buying either equity puts or T bond calls against it.

On the short Yen side, an important question is what to buy against the Yen. The popular trades have been to buy either USD/Yen, or USD linked currencies like the CAD, MXN or BRL against the Yen. That is, there seemed to be a bullish USD bias to the short Yen story being pitched out there.

But, if the US yield curve keeps coming down, the USD should remain under downward pressure and this would likely include USD/Yen. The Japanese authorities would probably fight this trend, which in turn should generate Yen weakness on the crosses.

Which crosses? Well, arguably the most egregious levels are found in NJAsia/Yen. The Yen surge of the past few years took place as many other Asian currencies actually weakened. Despite the fact that their economies have remained relatively strong and, in many cases, inflation has remained elevated.

Many of those currencies went down hard in the crisis of 2008 as the USD scarcity problem hit. And, at one point late last year they started to look very vulnerable again. It was the introduction of those USD swap lines at the end of last year seemed to turn things around. That also means that a run on the NJAsians is less likely to be repeated if things start to go wrong again.

Yen strength and NJAsia FX vulnerability combined to produce a remarkable drop in NJAsia/Yen values. Korea/Yen or Sing/Yen, for example, reached remarkable lows at the end of 2011, previously achieved in the 2008 crisis and, before that, during the Asian crisis of 1997-1998 when the NJAsian currencies collapsed (Sing/Yen shown below). The Yen has gained 25% against the SGD since early 2008, and 50% against the KRW.

That's why Japan's export performance has been so lousy recently, and this has to be holding back Japan's growth rate. It means that the Japanese historic surpluses with many of the Asian countries (deficits with China, Malaysia and Indonesia) are coming down on trend despite relatively strong growth in most of those neighboring countries. The strong Yen is now really starting to bite, which shouldn't really be a surprise after a 60% rally in 4 years.

What should be a surprise, though, is if the Yen continues to appreciate, without a corresponding crash in either equity values or bond yields. If the world is OK, then there is likely to be very little, if any, upward pressure on the Yen going forward, especially on the Asian crosses. And, if the world isn't OK, the Yen may not have much upside in any case, though admittedly a volatile burst higher and then back down seems possible in such circumstances. That's why the hedges are probably necessary in selling the Yen here.

But, the trend appreciation of the Yen TWI, after a 60% move, shows all the signs of being exhausted. It's increasingly a question of finding the right currency to buy against it. And, it's within Asia where the biggest anomalies, in terms of growth, FX levels, and outlook, seem to lie.

Andres Drobny

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