

GLOBAL MARKETS

Oh so long ago

INVESTMENT CONCLUSION

In the post-bubble era in Japan, although government deficits and debt rocketed upwards, government bond yields stayed very low and JGBs outperformed other government bonds through the 1990s. This was because of Japan's high domestic savings cushion. It will be different this time, because Japanese household savings have collapsed causing Japan's external surplus to turn into deficit. So there are less funds available to finance rising government dissaving and its debt mountain. And there is no external protection for the yen as the state approaches insolvency.

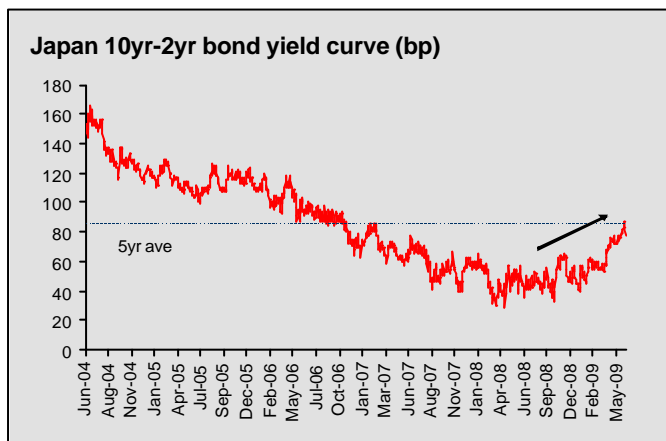


Figure 1. Source: Datastream

We expect JGB yields to move up sharply and would buy interest-rate caps on ten-year bonds (Figure 1). We are also extending our currency longs against our existing yen short position beyond the euro and the Norwegian krone to include the Singapore, Kiwi and Aussie dollars.

ANALYSIS

A long time ago, I wrote a carefully crafted paper that was completely wrong (*Letter from Japan*, 10 November 1995). The report investigated the labyrinthine world of hidden funds and deficits of the opaque world of Japanese public finances. It concluded that the post bubble economy would see massive deterioration in public finances (correct); and JGBs were junk bonds in drag and their yields would rocket (dead wrong).

As so often in matters Japanese, the foretelling of a macro event could be right and the investment conclusion drawn from it quite wrong. In fact, JGBs turned out to be one of the best performing bond markets in the world during Japan's 'lost decade' (Figure 2).

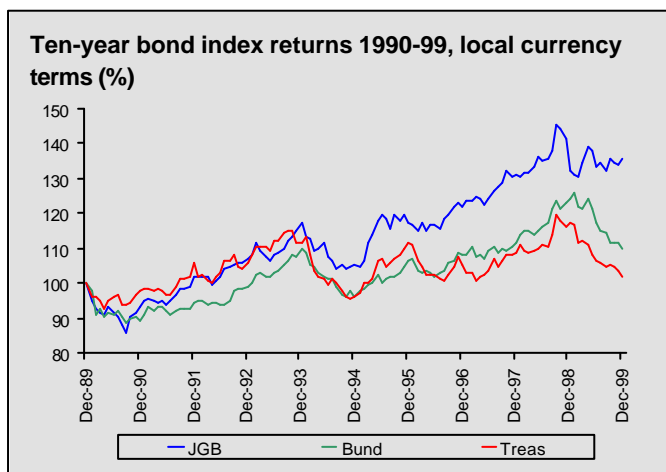


Figure 2. Source: Datastream

11 June 2009

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What stood between those two conclusions was the weird behaviour of Japanese savers. At the time, the household savings rate was over 12% of disposable income. And Japan still has the largest stock of household savings per capita in the world, over double that of the US (Figure 3).

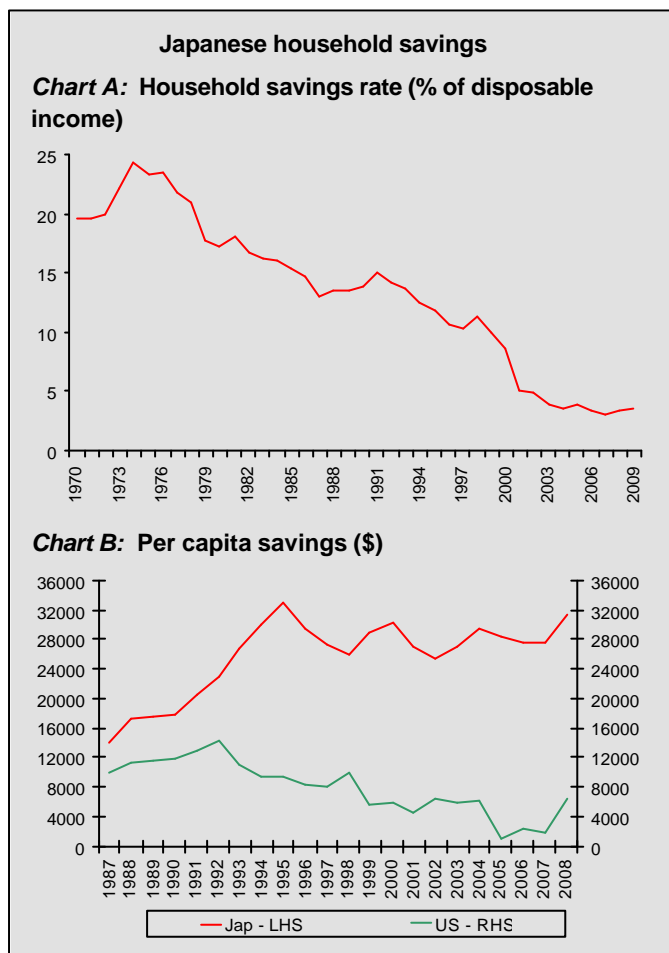


Figure 3. Source: Datastream, Independent Strategy

Then, as now, about two-thirds of those savings were accumulated by old people over 55 (now 60 or more). The old folk, being risk averse, caused two-thirds of all household savings to be deposited in banks (many of them were bust but were prevented from going so by government) at vile interest rates (0.1% p.a. deposit rate was the norm!).

The BoJ also supplied limitless additional free money, which the bankers added to household savings and, having no borrowers worth lending to, they invested the lot in JGBs. This yielded a risk-free (almost infinite) rate of return to the banks, as the cost of the borrowed money was almost zilch and they had to use almost none of their own capital.

Of course, such massive inflows into JGBs kept yields incredibly low (Figure 4). This is what saved the government from bankruptcy. And that's saying something when, in the years of post-bubble fiscal profligacy, the budget deficit blew out to 10% of GDP and gross debt to GDP topped 120% (Figure 5).

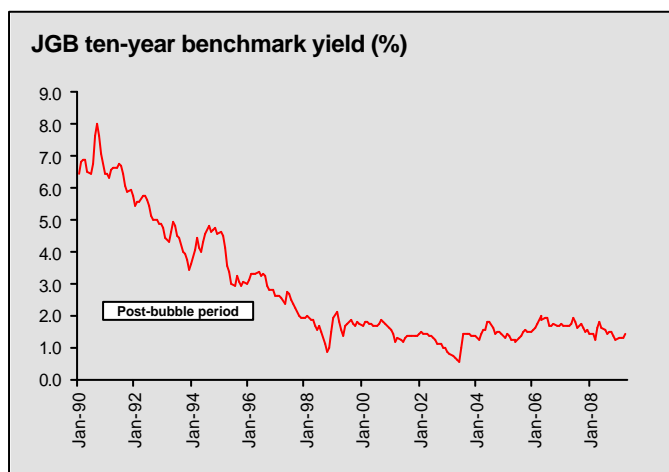


Figure 4. Source: Datastream

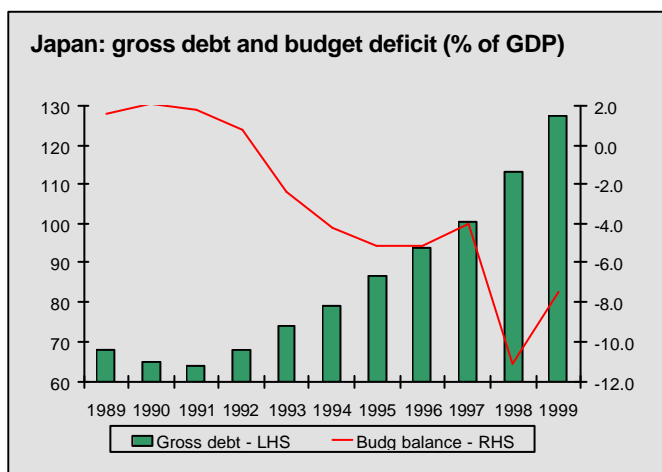


Figure 5. Source: Datastream

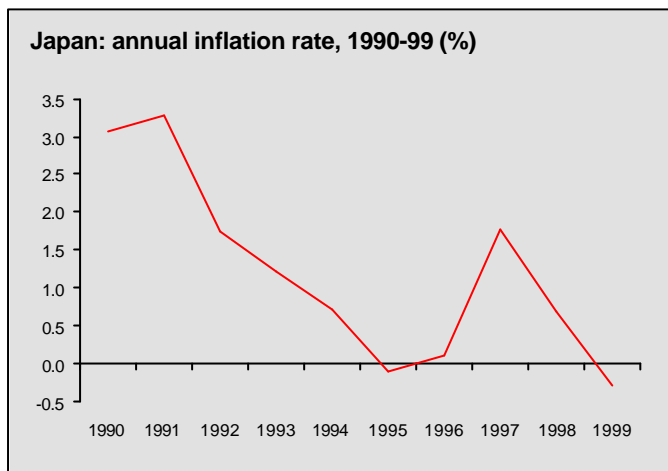


Figure 6. Source: Datastream

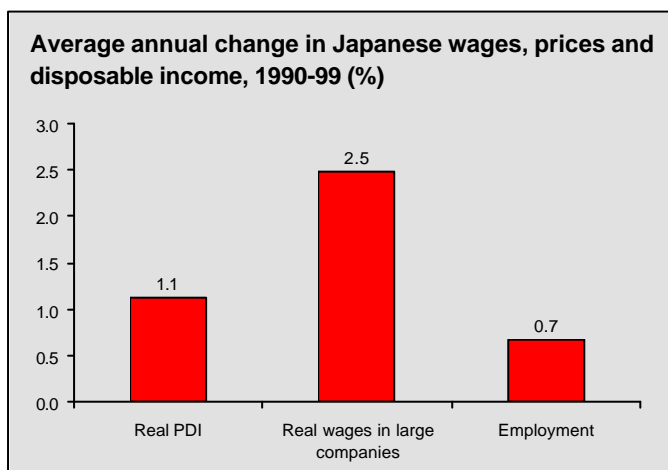


Figure 7. Source: Datastream, Independent Strategy

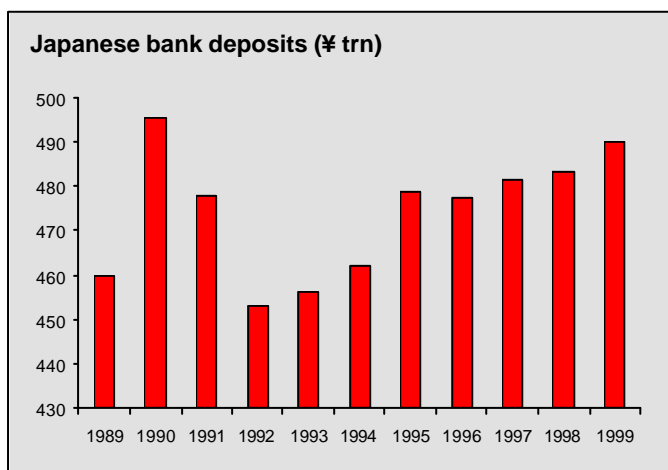


Figure 8. Source: Datastream, Independent Strategy

But how could Japanese savers be so stooooopid? I mean, why accept such terrible returns on so much hard earned savings? Of course, the Japanese weren't stupid at all. The post bubble collapse meant consumer prices fell to zero from 3% per year (Figure 6). This stopped any significant erosion of the real value of their savings. Indeed, when inflation hit zero, the real value started to rise, despite meagre interest receipts.

Moreover real and nominal wages in Japan continued to rise and job creation continued apace (Figure 7) — because the social contract prevented labour markets from functioning as all sensible free-market models say they should!

The Japanese did fine out of this. Their income from work and the real value of their savings rose steadily during the post bubble disaster. Bank deposits initially fell after the bubble burst, but then rose steadily (Figure 8). In their lost decade(s), that terrible era of 'deflation' that the US authorities now fight (valiantly) to save us all from once again, the Japanese got progressively richer and kept their jobs. The economy never had a down consumption quarter. America had five of them.

Comparisons get even more extreme if a little currency adjustment is introduced. For the whole of the post bubble period (1990-99), expressed in the common currency of the yen, ten-year JGB returns averaged 6% p.a. compared to less than 1% in yen for US treasuries. And the yen value of Japanese household wealth increased by 25% compared to 20% for US households.

If economies are there to serve the people, the Japanese economy did a damn good job for one supposedly hovering on the brink of oft-foretold decade-long collapse. The Armageddon scenario was, of course, well deserved — seeing as Japan had all those reform deficits compared to our great liberal market paradigm that gave us our superior crime rates, unbridled greed, excessively conspicuous consumption and filthy cities.

In fact, come to think of it, for dyed-in-the-wool apostles of the free market, it is galling that two of the world's three richest economies, Germany and Japan, emerged from the ashes of war to become wealthy, clean, civic, honest, polite and a few other pleasant things, without scant reference to our market-knows-best econo-culture.

But enough of history — it is over. Turn this report over! Write the present Japanese household savings rate on sheet of paper. Turn back! It is 3% — half that of the US today and only one-quarter of Japan's rate in the post-bubble era.

This means that the fiscal arithmetic of Japan's post-bubble economy cannot be repeated. Of course, that won't stop Japan's brainless political leadership (at least all our Dear Leaders have that neutralising quality in common) trying to do so.

Markets will ultimately stop them, because this time there is nothing to finance fiscal profligacy with. The huge domestic cushion of household savings is no longer there. The old folk are spending it on themselves and passing on less to their descendents. Thank cuts in pension payments and the advent of the nuclear Japanese family for this collapse in thrift, especially among old people.

Alas for the politicians, they need even more money this time round. The budget deficit is set to blow out to near 10% of GDP (Figure 9). Public debt to GDP is no longer 60% (when the bubble burst) or 120% (when the crisis was over). It is now 190% and set to rise towards 220% by end-2010!

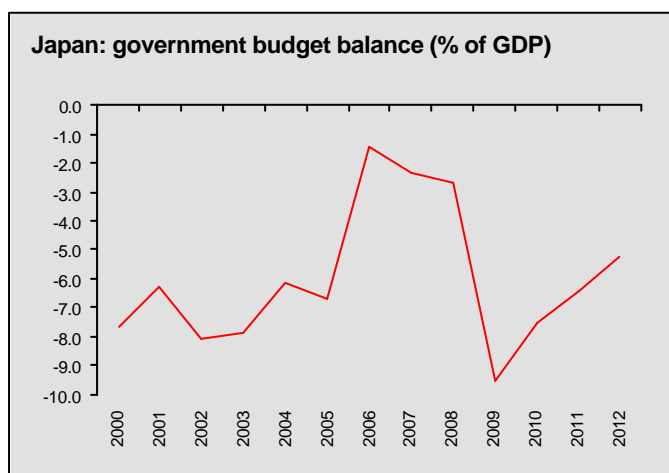


Figure 9. Source: Datastream

If such fiscal nonsense is to be pursued, who will buy the bonds? There are several options and as many investment conclusions.

Households — no way, for reasons of declining thrift and because the existing stock of household investments (that part which banks and savings institutions have not already invested in JGBs on behalf of savers) is most unlikely to be heavily redirected to JGBs. It is important to distinguish between the stock and the flow of household savings. The stock is still massive as Figure 3B shows. But it is fully invested, much of it indirectly in the massive government debt stock. The

flow of savings is what must finance new government deficits and that is less than one-third the government's funding needs.

Bank of Japan: the most obvious unwilling buyer would be the BoJ. That would be the same sort of monetisation of government deficits and debts as the Fed is indulging in. The result would be the same, although in Japan's case, given the size of required rollovers of the outstanding stock of government debt, monetisation might be proportionately bigger. The result would be directionally the same: a chronically weak currency against any sanely managed one such as the euro, Norwegian krone, Kiwi, Aussie or Singapore dollars. Ultimately, this policy would result in inflation and constitute an attempt to get rid of government debts that way. I doubt that JGB yields would be where they are today if that crime against savers were to be attempted!

Banks — the BoJ could revert to stuffing the banks with free yen so that they would buy the JGBs. This is just backdoor monetisation of government debt and would have the same effect. I doubt that the banks would be willing to cooperate this time around. Japanese bankers have now become bankers. The banks are no longer the sick men of global banking, stuffed with bad assets in need of free BoJ money and round-tripping JGBs to earn their way back to health. Indeed on the global scale, they are now winners not beggars. So “no go” for this option.

Insurance and other financial institutions — it is unlikely that the dearth of Japanese household savings flows will provide the wherewithal for these institutions to boost their JGB holdings massively. And as for the stock of savings they already control? Well, they are fully invested too — much of it in JGBs. So one bond would have to be sold to buy another.

No solution there I'm afraid.

So in the end and for the first time, it looks like funding the Japanese budget deficit is going to need foreigners big time! However, Japan's basic balance of payments (the current account plus long term private capital inflows) is now heavily in the red to the tune of 10% of GDP (Figure 10). This tells us that the amazing paradigm of the post-bubble years, when the twin surpluses of excess domestic savings and the basic balance of payments kept the yen rising, government deficits sated and public funding costs at rock bottom, cannot be repeated.

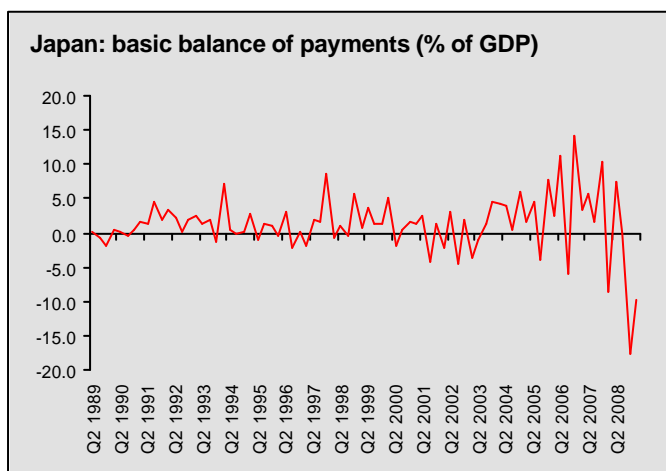


Figure 10. Source: Datastream

Now Japan will have to attract foreign capital to balance both its balance of payments and its government books. The chronic external payments deficit is likely to mean a weak currency and higher interest rates, including JGB yields.

Moreover, the external funding of the budget deficit and debt rollovers will have to be achieved against competition from other OECD governments which all together need to raise \$8trn a year, or nearly 20% of OECD GDP (including rollovers). With the yen doomed by its own deficit arithmetic to being a weak currency, there is no way this can be done at yields more than 200bp below Germany!

So maybe my original description of Japanese government debt as '*junk bonds in drag*' will finally come right! In any case, I am making yield caps on ten-year JGBs a favourite global position. And we are adding yen shorts against our basket of sane currencies (Singapore dollar (new), Norwegian krone, Aussie and Kiwi dollars and the euro).