Peter Tasker
05 SEPTEMBER 2022

Arcus

CURRENCY CRUNCH: GET READY FOR A STRONG YEN

The US dollar is surging against all major currencies except the Russian rouble and the Swiss franc. The yen has been weak this year, even against the struggling British pound and euro. Yet Japan has significantly lower current and expected inflation than other countries, including even Switzerland. The result is a large competitiveness gain for Japan.

Country	CPI YoY %	Date
Netherlands	10.3%	Jul-22
UK	10.1%	Jul-22
Belgium	9.9%	Aug-22
Sweden	8.5%	Jul-22
United States	8.5%	Jul-22
Italy	8.4%	Aug-22
Germany	7.9%	Aug-22
Canada	7.6%	Jul-22
Singapore	7.0%	Jul-22
India	6.7%	Jul-22
Australia	6.1%	Jun-22
France	5.8%	Aug-22
South Korea	5.7%	Aug-22
Indonesia	4.7%	Aug-22
Switzerland	3.5%	Aug-22
China	2.7%	Jul-22
Japan	2.6%	Jul-22

CPI: Consumer Price Index; Source: Bloomberg data as of 5th September 2022

If sustained over time, this would result in higher profit margins for exporters, re-onshoring of production by Japanese companies, a greater likelihood of foreign companies choosing Tokyo as a regional hub and the mother of all tourist booms - assuming that Covid restrictions are scrapped at some point.

Bank of Japan ("BoJ") Governor Haruhiko Kuroda has so far been able to weather speculative attacks on the yen and the Japanese bond market because, in stark contrast to George Soros' coup against the unsustainably overvalued British pound in 1992, the BoJ's current policy settings are doing no obvious damage. In market speak, there is no "pain trade."

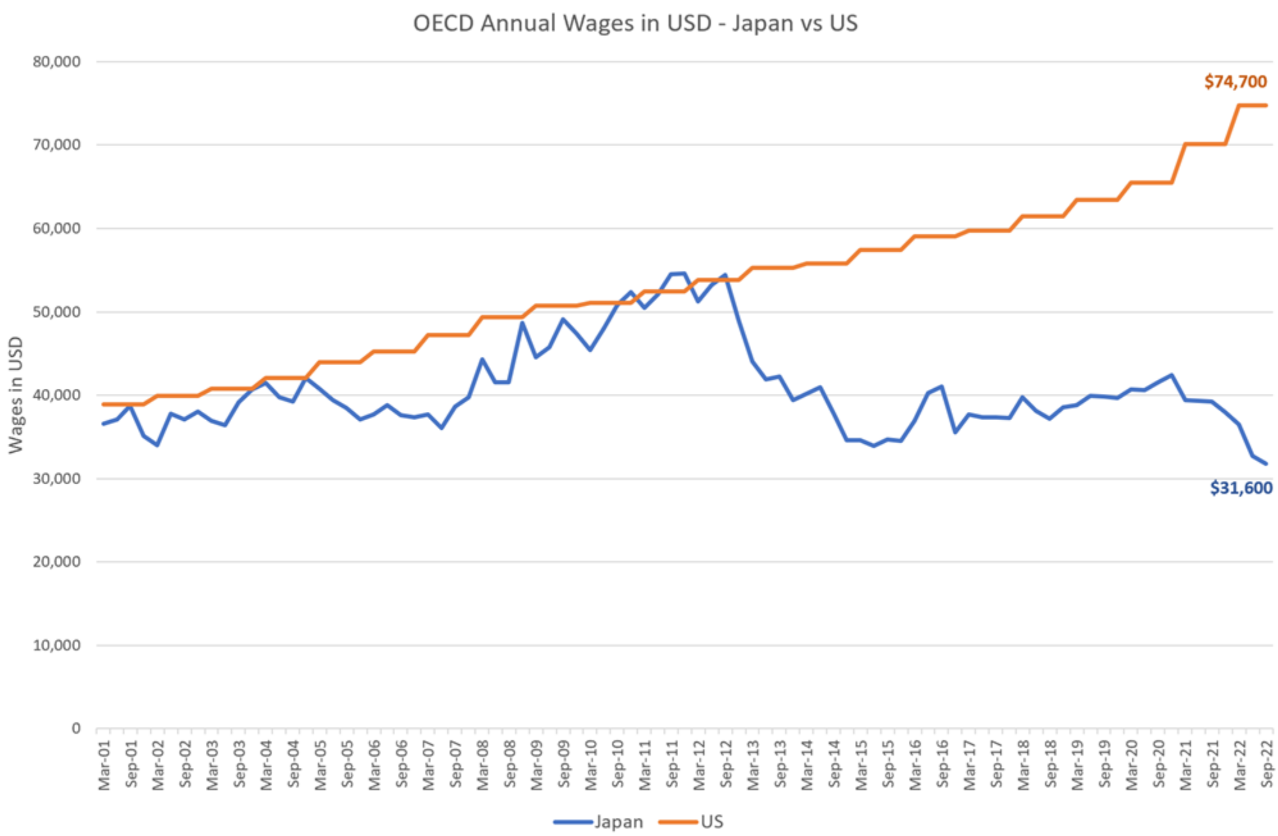
Of course, if Japanese inflation were to take off in a meaningful way, that would be a different story. At the moment, though, inflationary pressures in Japan are largely imported and there is little sign of an escalation in wages and salaries, as seen in the United States and elsewhere. More than likely, 2023 will see a drop-off in CPI inflation to below 1% as the year-on-year comparisons flatten out.

Kuroda's term as BoJ Governor will end in the spring and his successor may well tweak policy settings, but drastic change is unlikely. In 2013, the BoJ undertook to achieve a 2% inflation target "sustainably". It has yet to succeed. Even if the target is halved, which is one possible face-saving measure, stimulative policies will still be necessary.

Even so, there may be turbulent times ahead in the currency markets, with the yen fully involved. Indeed, at some point the Japanese monetary authorities may find themselves with a familiar problem on their hands – how to cope with an excessively strong yen. They may even have to counter a slide back to deflation, bizarre as that may seem in today's world.

There are two reasons why this could happen. The first is fundamental value. The Japanese yen has spent most of the last 40 years being grossly overvalued. Now it is grossly undervalued, to the tune of 40%, according to the Organisation for Economic Co-operation and Development's ("OECD") estimate of purchasing power parity versus the dollar. In other words, the yen is as almost as undervalued now as it was overvalued at the maximum in 1995.

What that means in practical terms is illustrated by the huge gap in wages that has opened up when viewed in common currency terms. A decade ago, average wages in Japan and the United States were roughly the same. Now US wages are more than double.

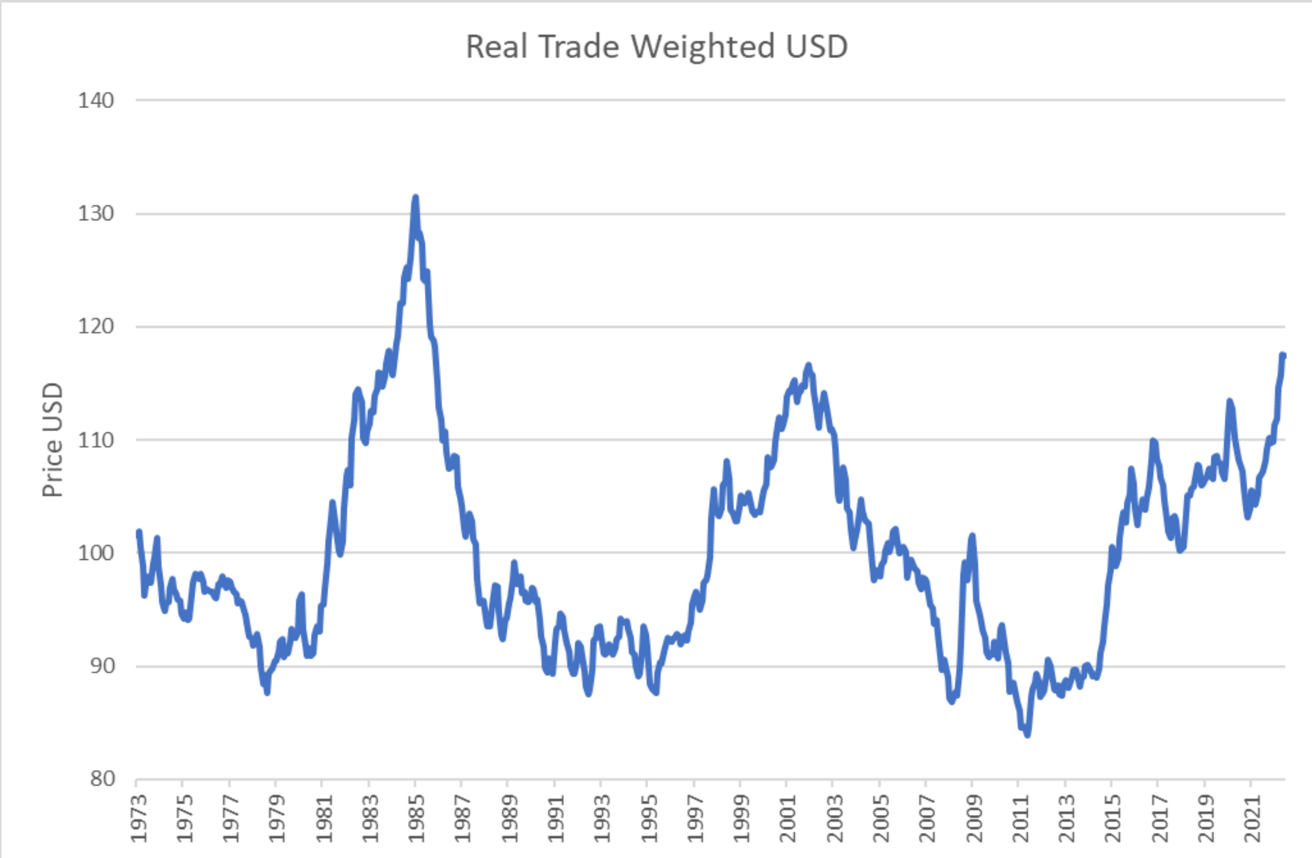


OECD: Organisation for Economic Co-operation and Development; Source: OECD data as of 5th September 2022

Fundamental value is a notional anchor, but currencies can remain far from fair value for years, decades even, which was the case for the yen from 1987 to 2013. More important is the political backdrop, which is to say the interests of the United States, the prime mover of the yen dollar rate and other sensitive exchange rates.

The history of the last 50 years is of powerful, momentum-driven surges and collapses in the American currency. The end of the Bretton Woods system of fixed exchange rates and the shift to floating currencies was itself a mechanism for devaluing the dollar.

Since then, there have been two sharp rises in the dollar – shown below in real trade weighted terms – and two equally sharp declines. We embarked on the third ascent in 2014, which makes it already long in the tooth by previous standards.



Source: US Federal Reserve data as of 5th September 2022.

In 1983-4, the Reagan-Volcker squeeze offered real interest rates of 7-10% to attract foreign capital. From 1995 to 2002, US real interest rates were in the 2-4% range. There is nothing like that available today. On the contrary, the real yield on US bonds is deeply negative. In such a world, the concept of yield differentials as a guide to currency movements makes no sense at all.

What we do know is that on the two previous occasions, the collapse in the real trade-weighted dollar wiped out all of the gains of the preceding bull run. In the late 1980s, it fell 25%. Between 2002 and 2011, it fell 28%. Those are "real" declines, adjusted for the effect of inflation. **The nominal declines were much worse – estimated to be 50% and 40% respectively.**

There is no reason why it cannot happen again. It is only a matter of time before the US's currency-driven loss of competitiveness becomes a hot political issue.

In 1971 John Connally, President Nixon's Treasury secretary, memorably commented to a group of European finance ministers that the dollar is "our currency, but your problem." The world is much bigger today, but the dynamics of the currency markets have hardly changed - and are unlikely to do so until a crisis too big to patch up demands a new financial architecture.

Disclaimer

Peter Tasker is a Strategist for Arcus.

Arcus Investment Limited ("AIL"), Arcus Research Limited, Japan Branch ("ARL"), Arcus Investment Asia Limited ("AIAL") or Arcus South East Asia ("ASEA"), collectively referred to as "Arcus" or the "Arcus Group".

The views and opinions expressed in this document are those of the author's alone and do not reflect the opinion of Arcus nor are they an offer to sell nor a solicitation of any offer to buy shares in any Fund.

Unless otherwise state, data source: Bloomberg.

Past performance should not be construed as an indicator or a guarantee of future results.