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Arcus

What is the yen telling us

Summary

- The yen has recently been extremely volatile especially versus the US dollar
- The Bank of Japan is seeking to kill off a long-term deflationary mindset
- Its monetary policy will probably remain out of sync with the rest of the developed world
- Potential problems in high interest rate countries might well allow the yen to rally

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Peter Tasker is a Strategist for Arcus.

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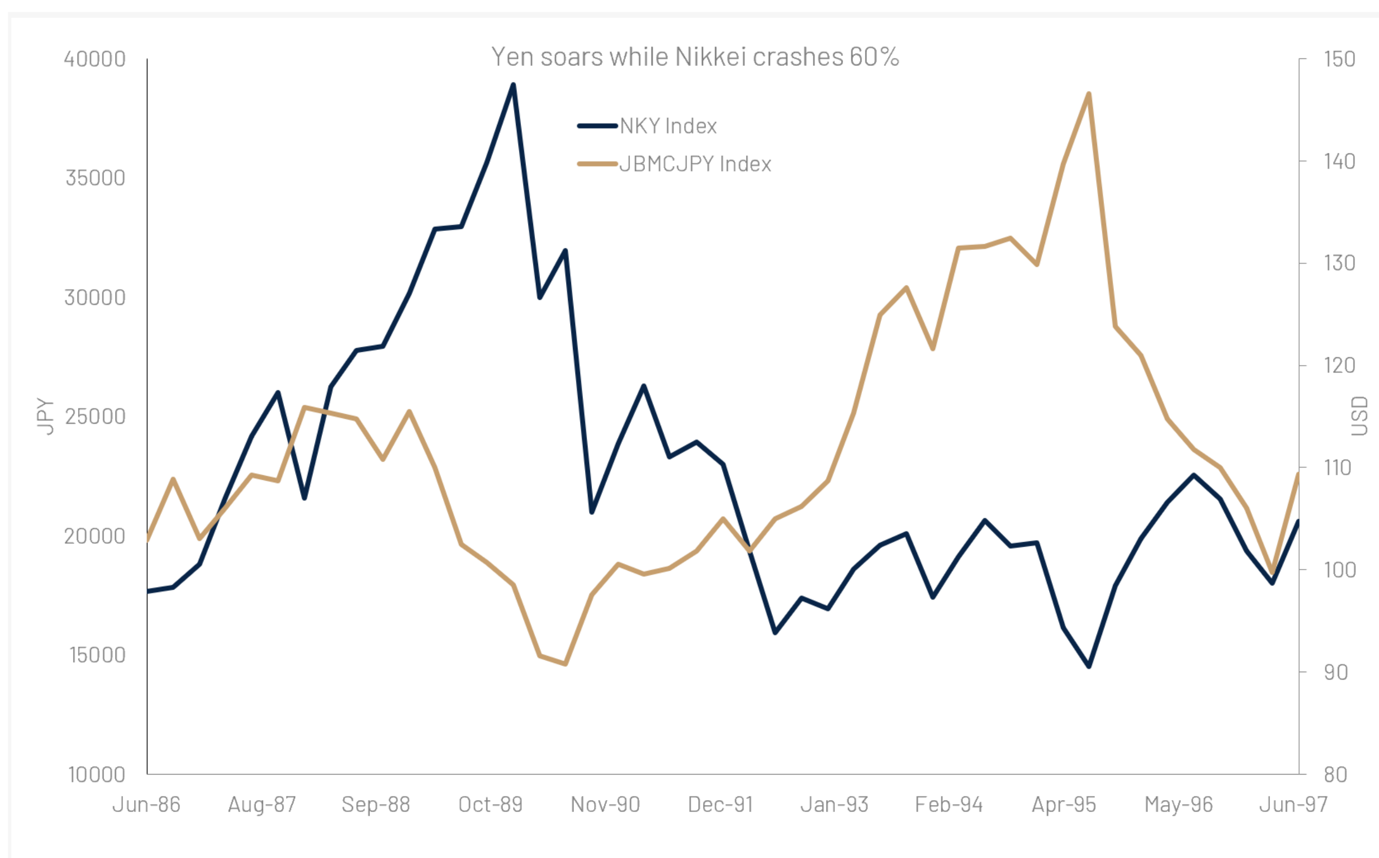
In March 2020, the yen briefly touched 100 to the US dollar. Two and a half years later, the Japanese currency had slumped to 150. Since then, it has moved rapidly up, then down and up again.

It is tempting to derive some grand narrative concerning the competitiveness of nations from this epic roller-coaster ride, but such efforts are doomed to failure.

For one thing, economic fundamentals in developed countries change too slowly to account for the gyrations of currencies. (Admittedly, the Brexit vote was an exception.)

For another, the currency markets are often "wrong" in these terms. The all-time high for the yen versus the dollar in nominal terms is 76. Bizarrely, that peak came in 2012, less than a year after the triple disaster of earthquake, tsunami and nuclear meltdown had delivered a devastating body-blow to the Japanese economy causing all nuclear reactors to be taken offline for the foreseeable future.

Likewise, the all-time high of the yen in real trade weighted terms adjusted for inflation took place in 1995. At the time, the stock and real estate markets had already collapsed, and the banking system was about to implode.



Source: Bloomberg, quarterly data from June 1986 until June 1997. NKY index = Nikkei 225 Index. JBMCJPY Index = JPMorgan Japan CPI-Based Real Broad Effective Exchange Rate. Past performance should not be construed as an indicator or a guarantee of future results.

In brief, currencies are not forecasting machines, nor even mirrors held up to current economic conditions. When the UK pound soars against the Japanese yen, as it has in recent months, it doesn't herald good times for Britain and bad times for Japan. It merely signifies that the Bank of

England has a much more serious inflation problem and has had to drive up interest rates to a much higher level.

As we know, the Bank of Japan ("BoJ") has a remit which is the polar opposite of the Bank of England's – to raise the rate of inflation on a sustainable basis, thereby saying sayonara to the many years of deflationary stagnation. During former BoJ Governor Haruo Kuroda's ten years in office, that never looked like happening, but his successor, Kazuo Ueda, has been dealt a better hand.

Since he took over in April, expectations for inflation over the next ten years, as measured by the difference between inflation-protected bonds and regular bonds, have doubled. Interestingly, the gap between US and Japanese inflation expectations has shrunk significantly. Investors are betting that Japanese and US inflation will tend to converge in years to come, with Japanese inflation rising as US inflation drops.

Of course, these expectations are simply consensus guesses and are open to the same criticism as currency market trends. The evidence needed to back the thesis that the structural shortage of labour in Japan is translating into higher wages has yet to appear in government statistics, though private sector sources indicate that dispatched workers are seeing significant pay hikes.

BoJ officials will need to see more than that before withdrawing stimulus, especially if global conditions remain soft. As things stand, they have a once-in-a generation opportunity to kill off Japan's deflationary mindset. Why risk messing it up by acting prematurely?

While the machinations of central banks and the reactions of investors and speculators dominate currency markets in the short and medium term, over the long-haul, fundamentals should come to the fore. To put it another way, there is a limit to how far the external value of a currency - as set by the foreign exchange markets – can deviate from its internal value, which is its domestic purchasing power.

All things being equal, the currency of a high inflation country should be weaker than the currency of a low inflation country. That is not how markets have behaved in the Covid and post-Covid era, but it would be a mistake to assume the current configuration is permanent. Over the decades, there have been several yen-dollar "regimes" but none have lasted more than a few years. In the late 1980s, the most closely watched metric was the US trade deficit. In the mid-1990s, it was relative growth of the US and Japanese money supply. Now it appears to be nominal interest rate differentials. At some time, this will pass too.

In the meantime, the likelihood is that Japan remains out of sync with the rest of the developed world, but in a different manner. At some stage in the next twelve months, the BoJ will be modestly tightening monetary policy while the rest of the world has called a halt. That would be conducive to a stronger yen.

There is also a non-trivial possibility of problems in the high interest rate countries - related to property prices, private equity or political turmoil - that force an end to tightening well before inflation re-enters the target zone.

In such a scenario, the yen's purchasing power might make a comeback allowing the yen to rise substantially.