BULL AND BEAR BULLETIN

Currency Wars: A Race to the Bottom

One of the most significant market moving events over the past month has been the topping of the Japanese markets. Through the growing global interdependence, the wild swings in the Japanese yen, the Nikkei Index, and Japanese government bond yields, there have been a spillover effect on many global exchanges. This month we will discuss how Japan's decision to seek economic growth through the destruction of its currency has generated ripple effects throughout the world.

Over the past six months, the Japanese stock market has been on an uninterrupted upward path following initial reports that the country's Prime Minister and the Bank of Japan's Governor were drafting a plan to end the country's two decade battle with deflation and to reinvigorate its stagnant economy (Chart 1). The government's plan consisted of three main thrusts: monetary policy, labor market reform and tax reform. While Japan's central bank previously attempted monetary policy action, the latest announcement was modeled after the U.S. Federal Reserve's Quantitative Easing playbook and marks the country's most aggressive attempt at devaluing its currency to date.

By announcing a money printing program designed to lower the nation's currency, Japan is hoping to boost foreign demand for its products. If the country can stimulate its export business, government officials hope that they will experience renewed economic growth and effectively combat the deflation spiral. An investor only has to look at the 33% decline in the value of the Japanese yen since November to see that the initial response to the plan has been a success (Chart 2).

Similar to any political or economic policy, the Japanese currency policy has been accompanied by some unintended consequences. Perhaps one of the biggest impacts from the currency destruction is the capital flight scenario. Japanese investors, along with other foreign investors, have used the declining yen to seek out higher returns in other nations. By leveraging a declining currency, investors can benefit from investing in foreign markets that may be experiencing a corresponding increase in their currency versus the yen (eventually closing out the position with a dual benefit from the gain in the non-Japanese investment and having to repay the Japanese loan at a cheaper yen value). The U.S. stock market has been a major source and benefactor of the capital flight created by a weaker yen, having rallied over 25% over a similar timeframe (Chart 3).

Unfortunately, this yen fueled rally has hit a speed bump after the latest announcements by the Japanese Prime Minister lacked substantial changes and investors begin to question whether the recently enacted policy will be sufficient to provide a long-term benefit to the Japanese economy. This lack of confidence has resulted in a 20% drop in the Nikkei 225 Index and 6% strengthening in the yen. Perhaps more important to U.S. investors is the possible unwinding of those "capital flight" investments that helped create an additional class of U.S. equity investors.

Working against the simple plan to reduce its currency is the aging Japanese population. With the country's population projected to decline 1.0% annually through 2030 and the ratio between the number of retirees per active workers projected to increase from 27 retirees per 100 workers in 2000 to 50 retirees for every 100 workers by 2020, Japan is limited by its citizens' diminishing desire to spend. Traditionally, retirees spend less in retirement, excluding healthcare costs, than during their working years. As the population grows older the aggregate demand of the nation will ultimately decline. The decline in demand will lead to excess capacity within the economy, which will ultimately be accompanied by deflationary pressures. In order to offset the decline in domestic demand, Japan has to maintain its weak yen efforts to stimulate its export business.

Looking forward, Japan will have to assess whether its existing policy action will be successful in delivering long-term economic prosperity or if the nation's population demographics will continue to act as a deflationary anchor and prevent economic growth. To make matters worse, Japan will eventually be forced into a fiscal balancing act as its debt-to-GDP ratio surpasses 245%, which will only expand if the recent money printing fails to stimulate long-term economic growth.

The side effects associated with currency shifts will continue to play out as Japan looks to resolves its two decade struggle with growth and deflation. With the U.S. economy currently acting as the "best of the worst", U.S. investors need to be aware of how market volatility may be influenced by more than just our domestic economy. Unfortunately, Japan's actions are only the beginning of what could eventually lead to a global currency war, as foreign central banks around the world look to gain economic growth through currency manipulation.

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Chart 1

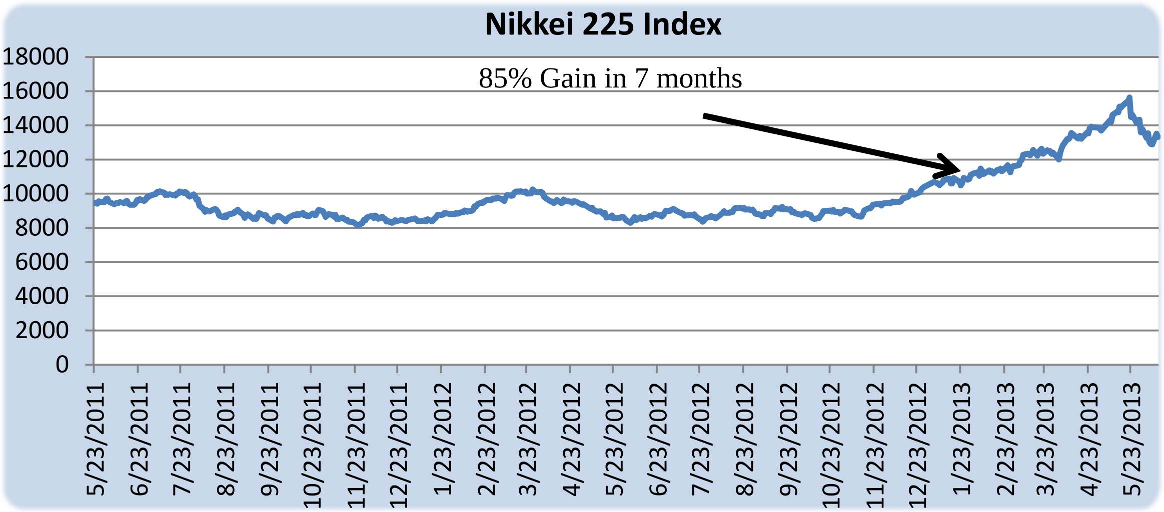

Chart 2

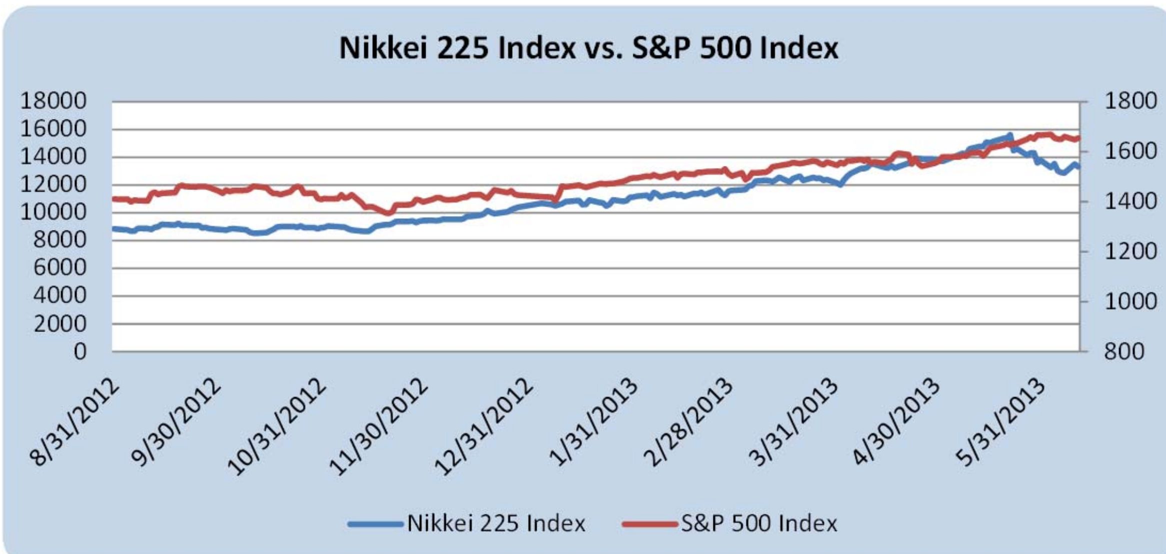

Chart 3