SHINZO ABE'S MISSION ACCOMPLISHED OR MORE ROOM FOR POTENTIAL YEN WEAKENING?

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Without actually doing much besides using rhetoric, I believe that Shinzo Abe, the newly elected prime minster of Japan, has single-handedly changed the psychology of the yen's exchange rate and set it on a potential fast track to depreciation—it fell from under 80 yen to the U.S. dollar to 90 yen to the U.S. dollar in the last two months (as of January 15, 2013).[1] The more yen it costs to buy US$1, the weaker the yen's value. Abe has been relentless in a multi-pronged approach to weaken the yen. He has called for targeting inflation of 2%, set an aggressive nominal GDP growth target, threatened to change the Bank of Japan's (BOJ) mandate (and has the power to do so[2]) and discussed introducing more fiscal stimulus measures as well as the creation of a large investment fund to buy foreign bonds (to weaken the yen even more)[3]. Thus far, the yen has weakened versus the U.S. dollar strictly in anticipation of all these measures, as each of them will take time to be implemented. This brings to mind Hank Paulson's famous line during the financial crisis of 2008, when he said, "If you have a bazooka in your pocket and people know it, you probably won't have to use it."[4] Abe's "bazooka" has been particularly effective in getting the market to adjust its expectations and has done much of the heavy lifting to accomplish his goals regarding a weaker yen in very short order—without Abe even firing any shots yet (i.e., without seeing discussed policies through to full implementation). **When is Abe's mission accomplished?** Currency movements are hard to predict. In economic terms, currency moves theoretically are tied to relative inflation rates through a concept called purchasing power parity. Abe is certainly trying to change Japan's economic course from being primarily characterized as "deflationary" to "inflationary" (with a specific goal of at least 2%). Inflation expectations have crept up slightly, but they are still well short of even just a 1% target—a policy actually set in February of 2012. Based on Bloomberg estimates, Japan's five-year estimated inflation rate is just over 83 basis points.[5] This rate is well short of Abe's 2% target, but earlier in the 2012 calendar year, Japan's estimated five-year inflation rates were a negative 60 basis points—meaning that investors in five-year government bonds collectively expected price levels in Japan to fall approximately 60 basis points per year for five years. Japan thus has managed to get inflation expectations to increase somewhat, but to be fair, much of these gains came earlier in 2012, when the Bank of Japan announced a 1% inflation target during the month of February and before Abe called for more aggressive targets. The moves we've seen in the yen thus illustrate, at least to me, how much the yen's value is tied to market sentiment. And sentiment undoubtedly has changed with Abe's rhetoric. One place this sentiment can manifest itself is in the resumption of global carry trades. The yen was once used as a universal funding currency for global carry trades. That is, because interest rates were so low in Japan and higher almost everywhere else, Japan was a favored currency to borrow in to increase exposure in higher-yielding, risky assets. During the financial crisis, many of these global carry trades were unwound and the yen became a favored currency that appreciated during periods when risky assets such as stocks and commodities sold off. With expectations being adjusted for a depreciating yen, a pickup in global carry trades can add further fuel to the depreciation trends[6]. A number of analysts initially reported 90 yen to the U.S. dollar as an ultimate target level for yen depreciation. That level has practically been reached, leaving some to wonder how much more the yen has to weaken. Nissan CEO Carlos Ghosn said that the yen was still too high, despite the weakness we've already seen. Ghosn considers "neutral territory" to be around 100 yen to the dollar.[7] I believe much of the yen's strength over the last five years was not caused by true fair value of the yen appreciating—much of it was sentiment driven. With sentiment having now changed dramatically, I would not be surprised to see the yen ultimately overshoot back above 100 yen to the U.S. dollar. There will be volatility in the near term, as the market trades on each statement from Japan's policy makers about how close they are to accomplishing their mission to weaken the yen. But I believe it is clear the period of relentless yen appreciation we saw prior to Abe's election is over. **Time to invest in Japan? (Video)** [1]Source: Bloomberg. Specific period 11/13/2012 to 1/15/2013. [2]Refers to the greater than two-thirds majority held in Japan's Lower Diet by Abe's Liberal Democratic Party and his power to appoint a new head of the BOJ as well as a few other officials on the monetary policy committee. [3]Hilary Whiteman, "Shinzo Abe: The Answer to Ailing Japan's Problems?" CNN.com, 12/26/2012. [4]See Caroline Baum's Bloomberg article "Paulson's `Bazooka' Turned Out to Be Pea Shooter," August 27, 2008. [5]Source: Bloomberg. Basis point: 1/100th of 1 percent. Measure's the five-year break-even inflation rate implied from yields to maturity on inflation-adjusted Japanese government bonds and five-year nominal Japanese government bonds. Since both bonds are issued by the Japanese government, they have equivalent credit risk, and the only difference in yield-to-maturity value should relate to the fact that the nominal bond must compensate the investor for inflation. "Yield to maturity" refers to the return derived from the bond's current price accounting for scheduled payments of interest and principal between the present and the bond's maturity. [6]When investors borrow in yen, it has an equivalent impact as though they were selling the yen, which depresses its value. If the yen depreciates, investors can pay back their loans with currencies that become worth more compared to the yen; conversely, if the yen appreciates, investors must pay back their loans with currencies that become worth less compared to the yen. [7]Adam Westlake, "Nissan CEO Ghosn Calls on Abe to Continue Weakening Yen, Stabilize China Relations," Japan Daily Press, January 4, 2013.

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