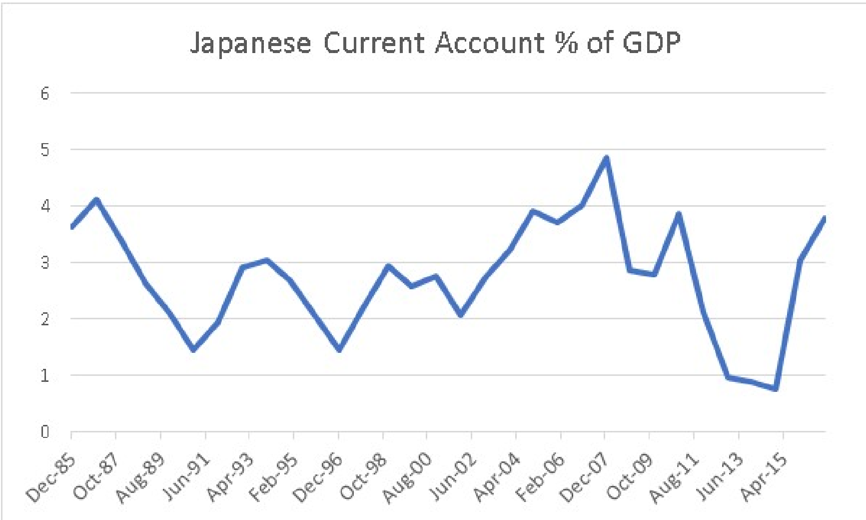
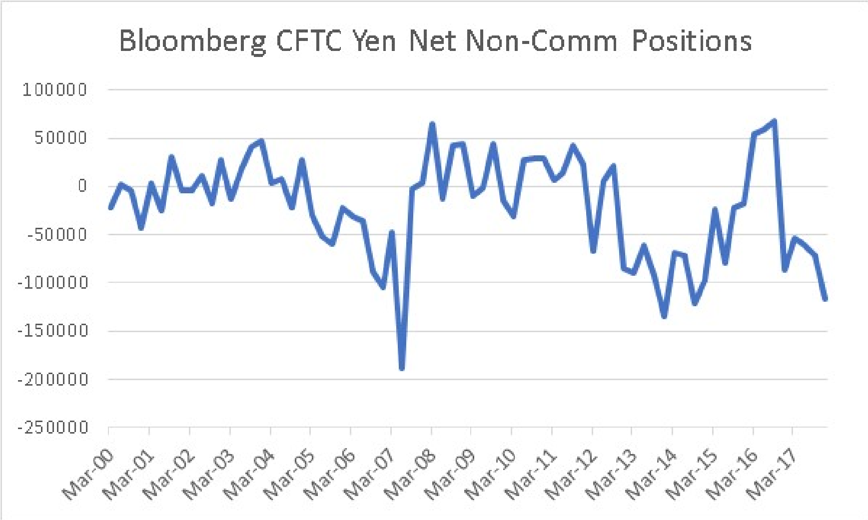
WHERE TO NEXT FOR YEN?

In the 1980's and 90's the Japanese Yen surged in value versus the US dollar. In 1983, you needed 250 Yen to buy a dollar, and at its peak in 1995, you only needed 80 Yen to buy a dollar. Over the past two decades, Yen has traded in a large range of between 150 and 75 to the dollar.

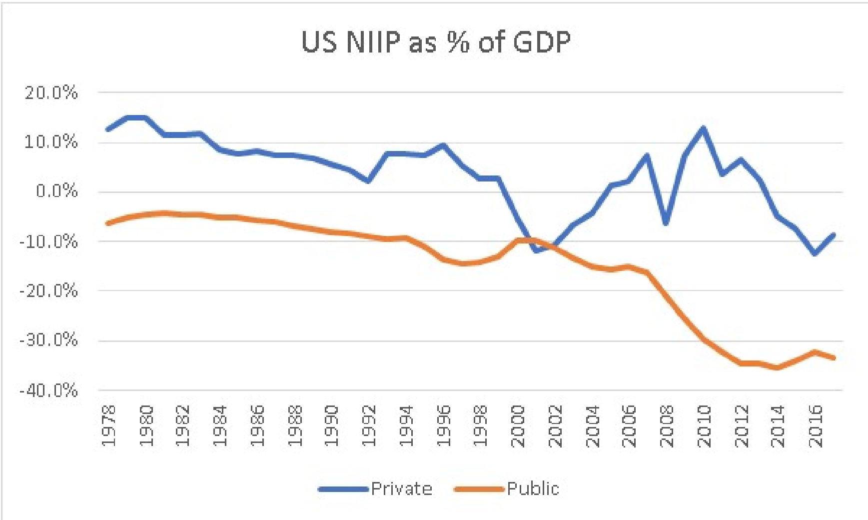
A large part of the Yen bull case in 80s was driven by the large structural current account that Japan ran over the period. Recent numbers have the Japanese current account back to 4% of GDP, a number last seen in 1986 and 2007. Between 1985 and 1988 the Yen exchange rate moved from 250 to 125, while 2007 to 2012 saw the Yen exchange rate move from 120 to 76.



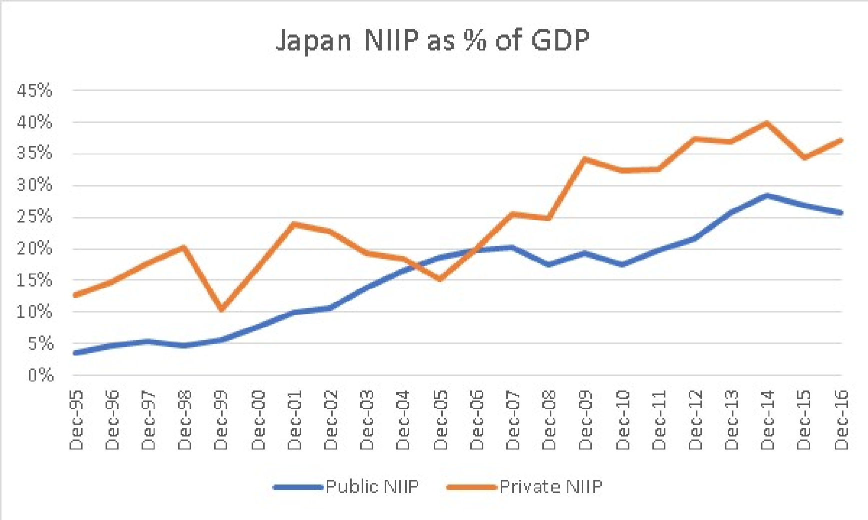
In the 1980s Japan began to deregulate capital markets, so US investors could begin to invest in Japanese assets. In 2007, years of very low interest rates had made the Yen the currency of choice for funding carry trades. This can be seen by the extreme position in Bloomberg CFTC data. Recently traders have again renewed their love affair of shorting Yen.



When analysing currencies, I like to look at the Net International Investment position (NIIP). I make an adjustment to the usual NIIP, by adjusting for foreign reserves. Foreign reserves are government to government positions. When we take them out of NIIP calculations we can see how the private sector is positioned. This has a better record in predicting currency weakness than NIIP in my experience. Doing this analysis for the US, we can see that the world has never been longer US public sector assets, and is close to a record on private sector assets. This is calculated by taking the NIIP data from Bureau of Economic Analysis, and foreign treasury holding data from the US treasury.

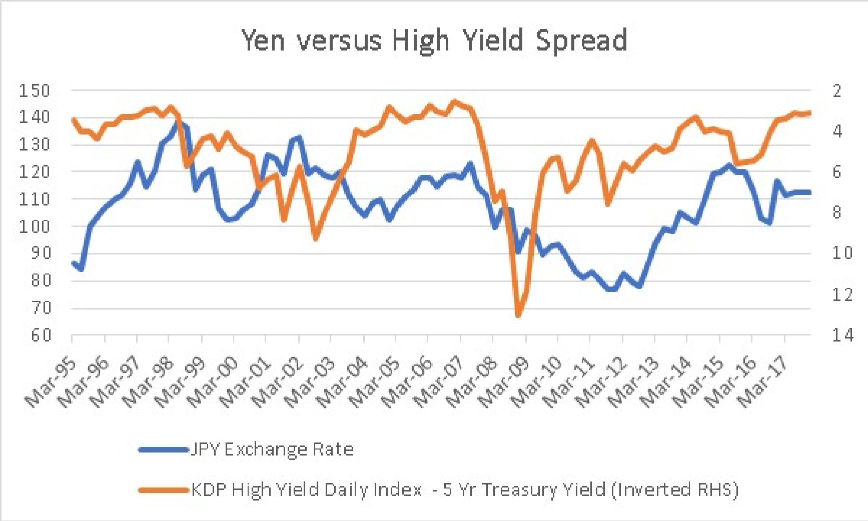


When we do a similar analysis we find that the Japanese have never been longer foreign assets, or the world shorter of Japanese assets, both on the private and public NIIP.



Dollar weakness and Yen strength seem likely to me. What makes me think extreme Yen strength is likely is that on a trade weighted basis the Yen remains even weaker than it was in 2007, while the private and public sector positioning is even more extreme.

From a timing perspective, I have found Yen strength seems to coincide with widening of corporate bond spreads in the US. This makes intrinsic sense if you think of the Japanese as the largest providers of capital to the US.



Given the record tight spreads on high yield, the Yen may move up against the dollar. Historical position by traders and investment flows would suggest a 50% move, as such we may be approaching a new all time high in the Yen versus the dollar.

INFORMATION

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