<u>**2008 REVISITED: JAPANESE YEN STRENGTH, GLOBAL ECONOMIC WEAKNESS**</u>

(c) Leo Haviland, 646-295-8385 June 4, 2012

"In a mad world only the mad are sane." From Akira Kurosawa's famed film "Ran"

****

<u>CONCLUSION</u>

Venture a glance at the paths of the Japanese Yen and the overall international economic situation since the global economic crisis erupted in mid-year 2007 up to now. Sometimes the Yen rallied, sometimes it descended; and sometimes more against one currency than another. Occasionally the global economy (or key regions within it) looked rather dreadful, occasionally the universe seemed to be doing ok, and occasionally the world appeared to be pretty strong and healthy.

The long running bull march in the Japanese Yen from early summer 2007 to the current time generally coincides with a continuing worldwide economic crisis. The Yen's robust strength mirrors the failure by central bankers and politicians around the globe to cure the lamentable financial ills. National policies often differ. The international guardians frequently coordinate their rescue and stimulus programs. Yet measures such as deficit spending, money printing, efforts to keep government interest rates near the floor, and struggles to maneuver currency rates merely have patched and postponed severe problems, not genuinely repaired them. Worrisome debt and leverage issues revealed in 2007-08 lurk on in various forms.

The rally in the Japanese Yen on an effective exchange rate basis since around July 2011 warns that an acceleration of the worldwide crisis, as in mid-2008, may be underway or very near to commencing. Significantly, the climb in the Yen cross rate versus the US dollar since mid-March 2012 also fits the ongoing international economic weakness story. Recall that as the world economy deteriorated more and more quickly around mid-2008, not only did the US dollar rally on a broad real trade-weighted basis, but also the dollar weakened relative to the Yen. The strong dollar equals weak stocks (and weak commodities in general), weak dollar equals strong equities (and bullish commodities) chant remains popular.

The world and perspectives on it are not immutable, so 2012 does not precisely duplicate 2008. Yet given the experience of 2008, what does a rally by the dollar in general, if accompanied by a rally in the Yen (effective exchange rate), and especially if the Yen also marched higher against the dollar on a cross basis, portend? This would hint that the disturbing international crisis is in the process of becoming more fearful. And since March 2012, that seems to be what has been happening.

<u>THE NUMBERS GAME</u>

The Yen's travel over the past five years has many twists and turns, but its general direction has been upward. Reviewing its effective exchange rate provides a more comprehensive view of this voyage than a focus on individual cross rates against the US dollar, the Euro FX, and so on. From its 114.4 valley in July 2007 (monthly average, Bank of England statistics), it soared 41.1 percent to its January 2009 high at 161.4. After slipping to 145.6 in June 2009, the Yen resumed its ascent, moving up 27.5pc to reach its January 2012 height of 185.6. The impressive bull charge since 2007 totaled 62.2pc.

The monthly average Yen effective exchange rate remains rather close to the January 2012 summit. It slipped to 171.5 in March 2012, but edged higher in April 2012 to 174.1. Note that these levels still hover above the major peak over 25 years ago in April 1995 at 171.0. As of the 6/1/12 marketplace close, there was no monthly average published for May 2012. However, published daily effective exchange rate data (Bank of England) can generate an estimate. Thus for May 2012, the average effective exchange rate rose 3.2pc versus April to 179.7.

****

Reviewing daily levels of the Yen's effective exchange rate generates an even sharper perspective on the currency's importance as a guide for other financial marketplace trends during the ongoing global economic crisis. **Placing the Yen's adventures in the context of the US dollar's broad real trade-weighted level as well as the Yen/dollar cross rate highlights the importance of overall Yen trends and levels in the current international situation**.

From its bottoms on 6/22/07 at 113.1 and 7/9/07 at just over 113.0, the Yen daily effective exchange rate rallied to 3/17/08 at 136.3. It gradually slumped to about 122.2 on 8/7/08.

The broad real trade-weighted US dollar ("TWD"; monthly average) rallied as the financial crisis worsened, from 84.1 in April 2008 (compare the timing of the 3/17/08 Yen interim top) to 96.9 in March 2009. The TWD was 86.7 in August 2008 and 88.8 in September 2008. The S+P 500's final high was 5/19/08 at 1440 (major pinnacle 10/11/07 at 1576), its major low 3/6/09 at 667.

Everyone recalls the awful worsening of the worldwide economic crisis in late summer 2008 and thereafter. Yet focus closely on the Yen since its August 2008 low. The Yen's effective exchange rate steadily advanced from 122.2 as the global economic situation deteriorated, as equities fell, commodities cratered, and players scrambled in flights to quality to safe haven government securities such as US Treasuries. On 10/3/08 it was 132.6. The next trading day, it leaped over its 3/17/08 height of 136.3 to about 140.4. It peaked at 168.6 on 1/21/09, 49.2pc above the summer 2007 low.

Very significantly, beginning in August 2008, as worldwide financial troubles dramatically worsened, not only was the Japanese Yen's effective exchange rate climbing. As the US dollar (TWD, and most of its cross rates) bull move continued, the Yen rallied sharply in its cross rate against the dollar, leaping about 21.3 percent. On 8/15/08, the Yen versus the US dollar was around Y110.7. It soared powerfully to Y87.14 on 12/17/08 and Y87.13 on 1/21/09 (the extra decimal point reveals the timing match with the 1/21/09 Yen daily effective exchange rate low at 168.6).

****

History is not destiny. However, the summer 2007 to end 2008/early 2009 period warns that notable strengthening of the Yen's effective exchange rate can signal (reflect) renewed (ongoing) worldwide economic weakness. So can a bull move in the US dollar. However, the period from August 2008 to end 2008/early 2009 provides an additional benchmark to assess (warn of) worsening worldwide economic conditions. Watch the Yen versus US dollar cross rate. Suppose the US dollar (TWD) is generally rallying. Assume the Yen effective exchange rate level is lofty and that its trend likewise is bullish. If also the dollar cross rate against the Yen is fairly feeble, and especially if the Yen is advancing even further versus the greenback, the global economic problems not only are ongoing, but also probably will worsen.

****

But how can the Yen be so strong, whether in late 2008 or in the 2012 landscape? Isn't Japan full of troubles? For example, it engages in massive deficit spending and has a huge government debt.

Japanese economic growth is unremarkable. Its policy interest rates have been near the ground for ages. In recent years, like many others, Japan has embraced substantial quantitative easing (money printing). Its stock marketplace is way below its all-time peak.

One reason for Yen strength is that from the international perspective, Japan is a major creditor nation, not a big debtor one. Note the International Monetary Fund's Japan "Spillover Report" review of July 2011. Japan "has enjoyed current account surpluses since the 1970s, helping the country to become the world's largest net creditor." (p3).

Japan has enormous savings which it can enlist to satisfy its interest rate obligations. Its three trillion dollar net international investment position reflects both official reserves (held mostly in US Treasuries) "and a large net private position in bonds". The private position of about $1.5 trillion is primarily outward investments of banks, life insurers, and corporate pension funds in US Treasuries and US dollar and Yen corporate bonds ("Spillover Report", p6).

Moreover, most Japanese government debt is held by the Japanese. The "Spillover Report" (p7) stresses that the Japanese debt and equity marketplace is "primarily geared toward domestic investors. Only 5 percent of Japanese government bonds (JGBs) are held by foreign investors". Thus it is relatively difficult for a foreign exodus to move Japanese yields substantially higher.

Japanese banks may be relatively less vulnerable than American and European (and American) ones to global banking debt problems. The "Spillover Report" says Japan's "banking system is relatively isolated" from the cross-border bank claims perspective, "suggesting that bank spillovers are limited." (p9, Figure 2). The IMF (transcript of teleconference call, Article IV consultation) remarks that the exposure of Japanese banks to foreign assets generally is relatively low (7/19/11).

Finally, despite its internal political squabbles, Japan is relatively politically unified.

BACK TO THE PRESENT

"Well Georgia Sam he had a bloody nose
Welfare Department they wouldn't give him no clothes
He asked poor Howard where can I go
Howard said there's only one place I know
Sam said tell me quick man I got to run
Ol' Howard just pointed with his gun
And said that way down on Highway 61". Bob Dylan, "Highway 61 Revisited"

****

What about the Yen's daily effective exchange rate since 1/21/09's 168.6 elevation? The Yen has been powerful.

First, the low since then is only 143.1, on 6/12/09 and 8/7/09. These 2009 points stand well above 3/17/08's 136.3 high. Moreover, the Yen rate climbed to its January 2009 summit by around mid-August 2010 and managed to stay within a few points of that for several months. Then it blasted off in early July 2011, and from that key 168.6 level of 1/21/09. The Yen effective exchange rate bull move reached 185.2 on 10/4/11 (compare the S+P 500's 1075 low that day), edging higher to 187.5 on 1/16/12. It tumbled to 168.9 on 3/20/12, but then held that memorable 1/21/09 level. Late last week on 5/31/12, it was 185.3, right around the 10/4/11 height and rather close to the January 2012 high.

****

Focus very closely on several intertwined marketplace trends since around March 2012. Not only has the Yen's effective exchange rate rallied since 3/20/12's 168.9. What about the Yen/dollar cross? The Yen has rallied since its 3/15/12 low at Yen 84.18. Although the dollar remains above its Y75.35 (10/31/11) and Y76.03 (2/1/12) lows, its current level around Y78 is not very distant from them. Compare the 6/22/07 cross rate of Y124.14 at the dawn of the financial crisis 124.14.

This rally since mid-March 2012 in the Yen/dollar cross rate- as was the case beginning in August 2008 and for several months thereafter- has occurred in the context of a strengthening broad real trade-weighted dollar. Admittedly the TWD is relatively weak from some long run perspectives. Yet it gradually has stepped higher and higher since it reached a record low near 80.6 (monthly average) in July 2011. It was 83.8 in March 2012 and 85.4 in May 2012.

The nominal broad TWD, which has daily data, offers a similar perspective. After making a top near 101.3 on 10/4/11 (recall the S+P 500 low that day; see also the daily TWD highs just under 101.5 on 11/25/11 and 12/14/11), the nominal TWD sagged to about 97.7 on 2/7/12. **Yet since end February's 97.9 (2/29/12), the nominal TWD has advanced, by late May 2012 moving over October 2011 and other 4Q11 highs.**

The Euro FX versus US dollar minor high was on 2/24/12 at 1.3487. As the Euro FX has deteriorated, it currently is challenging its lows against the dollar made at the depths of the 2008 crisis period (1.2330 on 10/28/08; 1.2457 on 3/4/09; recall the S+P 500's early March 2009 major bottom).

With the European sovereign debt and banking crisis grabbing headlines for some time, does anything appear in the Japanese Yen/Euro FX relationship of note in regard to the time around March 2012? **The Yen/ Euro FX cross rate established a minor low (weaker Yen) on 3/21/12 at 111.44. The Euro FX thereafter collapsed, and the cross dove under 100; it now lurks near the 1/16/12 low at 97.04.** The Yen is much stronger relative to the Euro FX than it was in the late 2008/early 2009 chapter of the economic crisis story. The Yen high (strongest level) during the financial crisis at that time was 113.64 (10/27/08; the major low in China's stock marketplace/Shanghai Composite was 10/28/08 at 1665) and 112.09 on (1/21/09). Recall how strong the Euro FX was versus the Yen on the eve of the global economic disaster; its 7/23/08 pinnacle was 169.96, with 9/22/08's 156.84 the edge of a cliff.

Venture a look at the marketplace trends and timing in a couple of "flight to quality" debt marketplaces with these currency trends in view. Around mid-March emerges again as a key time. The German Bund 10 year yield has plummeted from its 2.07 percent high on 3/21/12. The US Treasury ten year high likewise nosedived again from its 3/20/12 top at 2.40pc. Keep an eye on credit spread relationships.

Key stock marketplaces have nosedived alongside (not long after) these significant Yen strength (and dollar rally) trends since "around" mid-March 2012. After an interim peak at 10255 on 3/27/12, Japan's benchmark Nikkei index declined. Incidentally, the Nikkei's modest March 2012 high stood below the highs of 2010 (4/5/10 11408) and 2011 (2/17/11 at 10892). The downtrend of China's stock marketplace (Shanghai Composite benchmark) since its 8/4/09 high at 3478 is noteworthy; note its resumed decline from around mid-March 2012 (3/14/12 high 2476 was just under 2/27/12's 2478). An index of 600 European stocks (SXXP on Bloomberg) similarly made a mid-March 2012 high (3/16/12 at 272.9). Finally, underline the S+P 500 pinnacle of 4/2/12 at 1422 (close to the May 2008 final top at 1440). The S+P 500 has eroded roughly 10 percent since then.

Commodity trends "in general" (use the broad GSCI as a weathervane) as they have for several years, continue to roughly track those of the S+P 500 benchmark. The broad GSCI suffered a bloody decline beginning 7/3/08, not long after May 2008's final high in the S+P 500. It commenced a major bull rally on 2/19/09, shortly before S+P 500's March 2009 major bottom. The broad GSCI made its major high in spring 2011 around 762 (4/11/11 and 5/2/11); the S+P 500 made an important but not final high on 5/2/11 at 1371. Admittedly the S+P 500 made new highs in 2012. But keep in mind that European (and Japanese and Chinese) stocks did not. The SXXP's ceiling since its March 2009 low was in 2011 (2/18/11 at 292.2, with a final high 5/2/11 at 285.2).

In any event, what does the period of "around March 2012" reveal in regard to the broad GSCI? The broad GSCI made a noteworthy high on 3/1/12 around 717.

PRICES AND POLICIES

"You say you got a real solution
Well, you know
We'd all love to see the plan
You ask me for a contribution
Well, you know
We're doing what we can", sing The Beatles in "Revolution"

****

Financial prices and trends- whether for the Yen, the dollar, the S+P 500, interest rate instruments such as government notes, or petroleum- intertwine with perceptions regarding economic conditions. Those interrelated prices and trends thereby reflect and help to determine economic and political policies. The Japanese probably do not want the Yen to achieve new peaks on an effective exchange rate basis. Exports obviously still matter a great deal to Japan. In this context, Japan probably will battle vigorously to defend the benchmark cross rate versus the dollar around Y75. They also probably will not be pleased to see the Yen reach new highs against the Euro FX.

****

In an intertwined global economy with its interrelated currency, equity, debt, and commodity marketplaces, the current "European" sovereign debt and banking crisis is no more isolated than was the "United States" subprime (housing) crisis that emerged in 2007. Around the globe, the economic crisis is a political crisis (finds its parallels in politics). In numerous nations, a sign of this political (economic, social) crisis is growing pressure from (increased strength of) left wing and right wing crews, increasing unease within the middle class, and diligent efforts by the wealthy to preserve their assets and advantages.

Debt and leverage problems do not confine themselves to one region. The European situation is another chapter in the ongoing economic crisis story, not a brand-new book. American consumer balance sheet net worth in nominal terms still hangs well under the happy heights of 2006 and 2007. Though many focus on European sovereign indebtedness issues nowadays, the US fiscal situation likely will come more and more into the limelight as the 2012 election campaign heats up. How many American politicians plan to completely slash the tax breaks currently in place?

What actions, if any, will US leaders soon take to resolve the country's substantial long run fiscal deficit problem?

****

The international banking system perhaps is stronger than it was in 2007-08. However, recent events, including the rally in both the Japanese Yen and the dollar, underline that the financial system (like the world economy) remains under substantial pressure. On the economic front, assorted nations have embraced money printing, low interest rates, deficit spending, and other strategies (Operation Twist; LTRO) but these apparently have not permanently fixed problems.

The notable bank deposit withdrawal trends from (at least) Greece and Spain are worrisome. So is the widespread flight to quality (safe haven) debt securities offering low nominal and even negative real yield. One motivation to own relatively high quality government securities, including American, German, and Japanese ones, is that they are an alternative to placing money in bank deposits. Unlike the United States, Europe does not have a Europe-wide deposit insurance program. And the US deposit insurance plan is not unlimited. And faith in even massive American banks probably is not unlimited. "The unit at the center of JPMorgan's $2bn trading loss has built up positions totalling more than $100bn in asset-backed securities and structured products- the complex bonds at the centre of the financial crisis in 2008. These holdings are in addition to those held in credit derivatives which led to the losses and have mired the bank in regulatory investigations and criticism." (Financial Times, 5/18/12, p13).

****

Europe eventually, and perhaps fairly soon, may implement sufficient changes to mitigate and perhaps partly (or at least temporarily) resolve its dimension of the international crisis. Think not only of an even larger financial firewall or some form of bank deposit insurance. Consider some further (not just the LTRO route) roundabout money printing by the European Central Bank (perhaps via a channel involving the International Monetary Fund). To preserve an endangered Eurozone, might the ECB finally blink harder and find a way to print money? Since the EuroFX has slumped in part due to the "European" sovereign debt and banking problems, it probably would rally against both the dollar and the Yen if authentic progress seemed to be underway. Around the time of the ECB's LTRO operations, note the EuroFX rally against the dollar (1/13/12 at 1.2634 to 2/24/12's 1.3487); and relative to the Yen (Yen sagged from 1/16/12 just over 97 to over 111.4 on 3/21/12).

The Federal Reserve during the 2007-present crisis has shown a willingness to act dramatically to spark, bolster, and accelerate recovery. Its valiant quest includes battles not only to boost growth, create sufficient inflation, and reduce unemployment, but also to support the US stock marketplace. Although the S+P 500 has fallen only ten percent from its spring 2012 peak, and though it stands far above its October 2011 low, its sharp decline since early April (especially in the context of the international crisis and other stock, interest rate, and currency domains) probably worries the Fed.

Developing and emerging nations and their marketplaces are not islands apart from the so-called advanced (OECD) countries. Growth in China and India has slowed recently. Perhaps China may be increasingly willing to embark on new stimulus plans.

The North Sea/Brent crude oil peak was 3/1/12 at 12840, with the final high for NYMEX crude oil (nearest futures continuation) also that day at 11055. Petroleum prices have since suffered a bloody drop. Yet key oil producers such as Saudi Arabia (and even Russia) may be willing to tolerate lower petroleum prices than those currently prevailing (and under 100 dollars per barrel for North Sea/Brent) to help support the global economy. Monitor North Sea/Brent lows of 9874 (8/9/11) and 9911 (10/4/11). However, given fears about even a partial reprise of the 2008 petroleum price collapse (Brent/North Sea low at 3620 on 12/24/08), Saudi Arabia, Russia, and other crude producers probably do not want North Sea/Brent crude oil to sustain retreats way beneath 90 dollars (8958 was the 5/3/10 high). Fears of a dramatic oil price decline might encourage many oil producers to contribute to financial rescue plans, whether via the IMF or otherwise. Yet at present, for oil as well as for other marketplaces, keep the Japanese Yen and US dollar strength beginning in August 2008 in view alongside the Yen and dollar strength since March 2012. Besides, only around two years ago, Brent established much lower lows than 9000. Recall 5/25/10's 6815 depth. As the Federal Reserve began to unveil its wonderful second round of quantitative easing in late August 2010, Brent bottomed at 7175 on 8/25/10 (alongside the key low in the S+P 500 on 8/27/10 at 1040).

****

The current dangerous situation in the ongoing worldwide economic crisis, if it further worsens (and it probably will worsen to some extent, even if the deterioration is not nearly as severe as in 2008), will be sufficiently severe to induce policy makers around the globe to take further substantial steps in their struggles to provide long-lasting remedies. Perhaps such actions by central bankers and political leaders may occur relatively soon. These may issue from individual nations in somewhat piecemeal fashion. Yet there is a substantial chance that intervention will be relatively coordinated, especially if an encore of second half 2008 looks more and more to be underway.

But in the meantime, for the near term, the Japanese Yen probably will keep rallying on an effective exchange rate basis; it probably will breach the 1/16/12 daily low of 187.5. The Yen likely will retest the Y75 level against the dollar. However, the US dollar (TWD) will remain fairly strong. The bear trend in worldwide equities and commodities in general therefore probably is not over. Renewed sustained weakness in both the Yen and the dollar would indicate an easing of the current stage of the global crisis.

****