WHATEVER IT TAKES: RECENT EUROZONE AND JAPANESE ADVENTURES

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"What's not possible? The man is an artist. It's his best performance ever!" says the action hero Jack Slater (played by Arnold Schwarzenegger) in the film "Last Action Hero" (John McTiernan, director)

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CONCLUSION

The Euro FX and Japanese Yen for several months have been weakening together, both against the US dollar and on an effective exchange rate basis. This currency relationship and bear trend will continue. Despite the Eurozone's and Japan's brave quests to create sufficient inflation (escape deflation), their success probably will be limited; inflation and longer term government interest rates probably will not sustain significant increases. However, even if substantial currency depreciation and massive money printing manage to achieve an inflation goal (and higher interest rates), they likely will not generate sustained economic growth.

OVERVIEW

The European Central Bank currently confronts deflation risks, mediocre growth prospects, and sustained high unemployment. Its willingness to consider more extensive quantitative easing underlines its determination to escape these troubles. Japan's increasingly frantic effort to combat deflation dangers and ensure sustained significant economic expansion parallels that within the Eurozone. Right as America's Federal Reserve Bank finally quit tapering and actually ended its latest round of quantitative easing in end October 2014, a panicky Bank of Japan on 10/31/14 expanded its Qualitative and Quantitative Easing measures. At nearly the same moment, Japan's government unveiled a new policy asset mix for its Government Pension Investment Fund. In mid-November 2014, Japan's prime minister called a snap election for December 14 to delay a scheduled consumption tax increase.

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The continuing sustained decline in both Eurozone and Japanese 10 year government note yields in recent months strongly suggests that battles by central bankers (and politicians) to insure sufficient inflation (accompanied by other related policy objectives such as desirable GDP growth), even if they implement new measures, probably will fail in the near term. The German 10 year government note will not attack important resistance around 2.00 percent soon; neither will Japan's 10 year government bond, the JGB, march over one percent. After all, shouldn't an actual and persistent recovery (or at least hopes of one) generally be accompanied by increasing interest rates, even allowing for some residual central bank yield repression?

In this context, the decline of the United States 10 year Treasury note yield from its January 2014 summit fits a story of subdued international inflation and low global growth. Besides, despite several rounds of ardent Federal Reserve money printing, US inflation generally has remained under the Fed's beloved two percent target. In addition, despite the Federal Reserve's cessation of quantitative easing in October 2014, UST 10 year yields have failed to march decisively above noteworthy resistance around 2.40 percent. Thus given the economic weakness in Europe and Japan, as well as slowing growth in China, the recent buoyant American GDP figures probably will subside significantly as time passes.

And given Japan's extended experience with money printing and deficit financing, why should Europe's effort to escape "too low" inflation (or deflation) be any more successful than Japan's? Despite sustained low nominal interest rates, a long-running money printing campaign, and colorful Abenomics rhetoric, Japan recently slipped into recession. Though Japan's 2Q14 GDP slumped -7.3pc following the introduction of an increased consumption tax, 3Q14 dipped -1.6pc.

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Moreover, since around the middle of first quarter 2014, both the Euro FX and Japanese Yen have depreciated significantly relative to the US dollar (and for several months on an effective exchange rate basis relative to their trading partners in general as well). This roughly simultaneous Eurozone and Japanese currency feebleness not only reflects the comparatively unattractive growth prospects of those regions, but also the Fed's tapering and finally ceasing QE. The Euro FX and Yen probably will weaken further.

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Though the Eurozone probably will not readily achieve its inflation objectives anytime soon, an alternative scenario increases the odds of this. Many players anticipate some additional and significant quantitative easing from the European Central Bank. However, if this is gigantic, rapid, and sustained (in other words, more than most currently expect), inflation (and yields) would climb significantly from current levels (at least for a while). This campaign probably would intertwine with more Euro FX currency depreciation than many expect.

The European Central Bank's November 2014 cryptic "do what we must" comments may involve a substantial share of rhetoric rather than action. Recall its "do what it takes" wordplay of summer 2012 aimed at rescuing (rallying) the Euro FX and protecting the Eurozone's integrity. The ECB currently would prefer to avoid or delay enormous quantitative easing (as via buying Eurozone sovereign debt in the secondary marketplace). And the legality of any such ECB money printing via the government debt buying avenue remains open to question. Yet given the ECB's notable deflation (growth and unemployment) concerns (and related worries about social unrest), it might engage in unbridled QE (or at least threaten to do so) to achieve its inflation goal. In this process, it probably would tolerate a rather dramatic dive in the Euro FX from current levels.

Slippage from the current pace of European deficit reduction efforts would assist the rise in interest rates (inflation) and the Euro FX's deterioration.

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The current Japanese regime likely will triumph in the election. Postponing the consumption tax, particularly if accompanied by other deficit expanding efforts, may cause inflation and interest rates to rise. But encouraging additional big drops in the Japanese Yen may enhance chances of escaping deflation. But in any event, will there be much real GDP growth?

Even though Japan is a nation of savers, it arguably has little room to maneuver on the budget deficit side given its prodigious general government debt. Even though the Bank of Japan continues to gobble up Japanese government bonds, government rates could hop higher if the country faced a debt crisis. Or, the Yen could tumble significantly if yields remained repressed. Japan's general government gross debt was a towering 245 percent of GDP in 2014 (183pc in 2007) and is forecast to stay almost that elevated all the way out to 2019's 241pc (IMF, "Fiscal Monitor", Statistical Table 7). Japan's general government overall balance was -2.1 percent of GDP in 2007. Although the deficit peaked at -10.4pc in 2009, it still is a substantial -7.1pc in 2014, with 2015's forecast at -5.8pc also gaping (Statistical Table 1).

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Suppose the Eurozone and Japan both deluge their territories with money printing. As the history of many countries reveals, a noteworthy climb in interest rates joined by currency depreciation may reflect or result in inflation but not necessarily sustained economic growth or lower unemployment. Also, large government debt (deficit spending) alongside ongoing currency depreciation is by no means a guarantee of sustained economic growth. The Eurozone general government debt is high, that of Japan stratospheric. If sovereign creditworthiness decays substantially, interest rates (and perhaps inflation) may climb without adequate economic growth.

EUROZONE: NUMBERS AND WORDS

"He's never early, he's always late
First thing you learn is you always gotta wait
I'm waiting for my man". "I'm Waiting for the Man", a "Velvet Underground" song

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The Eurozone's November 2014 inflation of .3percent (annualized) was in line with recent months (Eurostat; 11/28/14), but down from .9pc in November 2013 and well below the ECB's inflation target of below but close to two percent. The all items level (akin to core; excludes energy and food) was up only .7pc in November. Euro area (18 nations) October 2014 unemployment was 11.5pc (October 2013 11.9pc; Eurostat, 11/28/14).

According to the International Monetary Fund (October 2014), Euro area real GDP growth reappeared in 2010 and 2011 (about 2.0 percent in 2010 and 1.6pc in 2011). However, recession emerged in 2012 and 2013 (-.7pc in 2012, -.4pc in 2013). In 2014, only mediocre growth returns, at merely .8pc, with 2015's only 1.3pc, with 2016's up 1.7pc.

Though overall Eurozone debt is rather high, it is considerably less than Japan's. According to the IMF, Euro area general government gross debt as a percent of GDP was about 66 percent in 2007. However, it climbs to 96.4pc in 2014, with 2015's 96.1pc little changed from that. It falls modestly to 88.2pc out in 2019. The Euro area general government balance as a percent of GDP also nowadays is in better shape than that of Japan. The Euro area deficit was -.7 percent in 2007. It peaked at -6.3pc in 2009, falling in 2014 to -2.9pc, with 2015's forecast at -2.5pc. Compare the United States general government debt level in 2014 of about 106pc; America manages only a small drop to 104pc by 2018 (and 2019). The US general government overall balance is -2.9pc in 2014, with the 2015 deficit at -2.5pc in 2015 (IMF; Fiscal Monitor, October 2014).

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The European Central Bank not long ago (6/5/14) introduced negative interest rates and devised Targeted Longer Term Refinancing Operations (TLTROs). To boost the size of its balance sheet, it rather recently (9/4/14) embarked on a money printing adventure via authorizing the purchase of asset-backed securities and covered bonds.

Yet to defeat the dragon of deflation (insufficient inflation), the ECB may elect to risk the consequences of enormous money printing. This fight against the evils of deflation may bring on substantial Euro FX depreciation, perhaps even the curse of an "excessive" currency fall.

After all, recall a famous ECB comment. “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” (Speech by Mario Draghi, President of the European Central Bank, 7/26/12). The Euro FX rallied against the dollar from around the time of that speech. From 7/24/12’s low at 1.2043, it marched to almost 1.4000 in 2014 (1.3967 on 3/13/14, 1.3993 on 5/8/14).

About two years later, on 11/21/14, the ECB President declared: “We will do what we must to raise inflation and inflation expectations as fast as possible, as our price stability mandate requires of us. If on its current trajectory our policy is not effective enough to achieve this, or further risks to the inflation outlook materialize, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases.” Would this composition include “sovereign bonds in the secondary market”? Perhaps eventually; see the specific reference to them in the Vice President of the ECB’s 11/26/14 speech.

For the near term, the ECB may prefer to wave its sword and talk rather than buy sovereign debt. But its language reveals a willingness to purchase it. The ECB is not the only worried institution on the continent. So are politicians. “Germany and France Aim To Avert a ‘Lost Decade’” headlines the NYTimes (11/28/14, pB5; referring to German and French economic ministers).

Whether such sovereign bond buying (even if in the secondary marketplace) falls within the ECB’s mandate is by no means clear, regardless of what the ECB’s leadership hints and however liberal its interpretation of its price stability mandate. Wouldn’t it in essence be monetary financing? On a related note, the world awaits adjudication on the legality of the summer 2012 introduction of the Outright Monetary Transactions (OMT) scheme, which involved both sterilization (supposedly no money printing) and conditionality.

THE EURO FX AND THE JAPANESE YEN: THEIR CURRENT DANCE

The Euro FX and Japanese Yen do not always move in the same direction against the US dollar or “in general”. However, both the Euro FX and Japanese Yen have been stepping lower more or less “together” against the US dollar since first quarter 2014. Having established a key low versus the dollar on 7/24/12 at 1.2043, the Euro FX cross rate against the dollar attained important highs on 3/13/14 at 1.3967 and on 5/8/14 at 1.3993. The Yen reached a major high against the dollar at Y75.4 on 10/31/11, depreciating from around Y77 in mid-year 2012. However, its depreciation against the dollar in 2014 resumed around the same time as the Euro FX’s began. Note the Yen’s weakening from the Y100.8 levels of 2/4/14 and 5/21/14.

However, though important, cross rates do not present the full breadth of currency moves. Judges should concentrate their focus on wider measures for the currency “in general”, such as that provided by the Bank for International Settlements. The BIS offers broad real (CPI based) effective exchange rate (“EER”) indices for the Euro area, Japan, and many other countries. (2010=100; 11/17/14 is most recent release, October 2014 the most recent month in the series).

The Euro FX EER was 101.6 in March 2014, the highest since April 2011’s 101.8. It slumped to 95.6 in October 2014. In regard to its current weakness, recall the 91.8 in July (and August) 2012, a crucial low reached alongside the ECB’s “whatever it takes speech” and OMT announcement during the European periphery crisis.

Another noteworthy low for the Euro FX EER is October 2000’s 82.3 bottom. Important highs include 110.3 in December 2004, slightly surpassed by April 2008’s 112.0.

The Japan EER for the first eight months of 2014 averaged about 76.9. For September and October 2014, it slipped slightly, averaging about 74.9. The current Japan EER high is about one-half of April 1995's all-time high of 150.3; therefore at end October 2014, it was at an important support level. The most recent two months for the Japan EER, though only modestly below the average of the first eight months of the year, stand well underneath the 105.7 October 2011 and 102.7 July 2012 highs. Note also the Yen EER's collapse after December 2012's 93.1 (Japanese election, more easing, Abenomics). To further highlight the current weakness, recall the relatively lofty January 2009 global economic crisis peak at 106.6 in January 2009 (and the July 2007 trough at 79.4 as the Goldilocks Era was ending).

Given that both the Eurozone and Japan suffer from low growth and deflationary challenges and fears, is weakness in the Euro FX connected with (encouraging that of) the Japanese Yen? Is the Yen's swoon helping to depreciate the Euro FX? Are Japan and the Eurozone (and other nations) engaged in competitive devaluations (currency wars) to bolster growth?

What about the US EER? It made a significant bottom in July 2011 at about 93.0. After staying under its June 2012 high at 99.7 for many months, the US EER steadily rallied from 97.0 in October 2013, voyaging above the June 2012 top with September 2014's 100.5 and October 2004's 101.5.

US TREASURY NOTE TRAVELS

One sign of the obstacles facing the Eurozone and Japan in their quest to boost inflation (and generate higher interest rates) is the recent behavior of the UST 10 year government note. American GDP recently has been robust, rising at an annual rate of 4.6 percent in 2Q14 and 3.9pc in 3Q14. However, the UST 10 year yield around 2.20pc remains well beneath its 1/2/14 top at 3.05pc. Admittedly the UST yield bounced up from the 1.86pc low of 10/15/14. But even since that mid-October 2014 depth, yields traveled up to only around 2.40pc, never piercing the important resistance around that level. The failure of UST yields to rally may signal future mediocre US (and worldwide) economic growth since yields generally advance during recovery (or hope of one).

Of course the Fed's yield repression (Fed Funds remain near the ground) subdues higher UST rates to some extent. And that heroic guardian only recently ended its money printing program; maybe rates will climb in the recovery, especially as the Fed allows its policy rate to rise. Also, in an interconnected global economy, perhaps the low inflation (deflationary forces) dragging Eurozone and Japanese (and many other) yields lower weighs heavily on UST marketplace yields. Further substantial sustained European and Japanese easing may allow government rates in those nations, America, and around the world to rise.

But perhaps not. Despite these strong US GDP numbers and the lofty S+P 500, the US economy may begin to slow down, especially given Eurozone and Japanese troubles, the deceleration of Chinese growth, and the past inability of US money printing programs to sustain adequate economic growth (UST yields fell after QE1 and QE2 ended).

COMMODITY ESCAPADES AND CONSEQUENCES

Take the broad Goldman Sachs Commodity Index (GSCI) as a benchmark for commodities "in general". It collapsed, of course aided by price dives in the petroleum complex, from 6/23/14's

interim high around 673 to under 520 recently. If sustained, this bloody price retreat will cut many statistical measures of inflation (and perhaps reduce inflation expectations). Thus it may encourage European and Japanese (and other) policy makers to embark on especially accommodative monetary policies. For example, the ECB may decide it has more need (justification) to quickly engage in massive QE, perhaps even by sovereign debt buying.

However, this GSCI weakness also may indicate underlying and ongoing risks to global economic growth as well as the difficulty of generating sufficient inflation in general. Moreover, sustained declines in petroleum prices may create crises in some producing nations that in turn spill over into other nations. For example, think of Russia (the ruble has moved over 50 versus the dollar), Nigeria, and Venezuela.

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