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MARKET CALLS

Japan: Opportunity in Chaos

Tuesday, November 27, 2001
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Deciphering hints of potentially significant policy change in the opaque world inhabited by Japan's political and economic elite often is as much a matter of picking up on *what is not* said as *what is* in the cross talk among government authorities. The issue at the moment is the mounting political pressure bearing down on the **Bank of Japan** to take what its hide-bound bureaucracy considers dangerously radical steps to finally break the deflation that has had the Japanese financial system in its withering grip for most of the past decade. What's interesting is the response of senior BoJ officials who, while certainly not embracing the proposals, also have not rejected them out of hand. Yesterday, for example, when asked about the possibility of purchasing foreign bonds as a means of injecting large new supplies of yen liquidity into the system, **BoJ Governor Masaru Hayami** would only say, "I don't think it's something urgent." Hayami, who until very recently also treated with extreme skepticism the idea that allowing a real yen weakening is central to the task of monetary reflation, now suggests that foreign exchange levels are "up to the market to decide."

To be sure, under normal circumstances these would be thin reeds upon which to base a judgment that important policy change might be afoot. But with the Japanese economy entering its fourth recession in the past 10 years and the deflation-wrecked banking system cratering anew under the weight of mountains of nonperforming debt, these are anything but normal times in Japan. As the political class is now nearly unanimous in calling on the BoJ to take resolute anti-deflation action, such seemingly innocuous comments could well foreshadow a major shift. The BoJ achieved hard-won statutory independence from the political branches of government only relatively recently, but that doesn't mean it relishes the prospect of remaining politically isolated. Current thinking in the markets is that the BoJ meeting scheduled for Thursday is unlikely to yield substantive policy changes, but we would not rule out the possibility of a significant announcement.

In any case, it certainly is not premature to consider the opportunities that would be created by a concerted effort by the Japanese authorities to conquer and vanquish their chronic deflation. Japanese equities would in all probability respond strongly in yen terms, but dollar-based returns would be penalized in the currency translation. Certainly, short positions in the currency would be rewarded handsomely, at least initially. Probably the most compelling opportunity in a Japanese reflation play, however, would be found in shorting long-term Japanese government bonds. Ten-year JGBs now post yields of about 1.4%, a level reflecting both current deflationary conditions and expectations that those conditions are likely to be sustained long-term. A credible statement by the Bank of Japan, perhaps joined by the **Ministry of Finance**, announcing appropriate action to liquefy the financial system and reflate the currency would likely spur a sharp downdraft in JGBs. In recent years, government debt has made up an increasing proportion of the asset base of Japanese banks as a lone refuge from deflation's ravages. A believable anti-deflation policy would leave the banks facing potentially huge losses on these positions, and likely would precipitate a veritable rush for the exits. A quick and brutal sell-off could see 10-year Japanese yields rising to as high as 3.5% within weeks of a reflationary policy change, with commensurate gains available to those holding JGB short positions.

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