Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Carried Away

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David Gitlitz

Solid growth statistics trump the long-expected closing of Japan's free money spigot.

Update to strategic view
US MACRO: This morning's brief market panic seems to have been triggered by news suggesting the end of the yen carry trade. But the fundamentals-driven growth of the economy is not contingent on such free-money opportunities. Data suggests that last quarter's inventory correction is already over, and that growth is reaccelerating.
[see Investment Strategy Dashboard]

In one sense, it was difficult to see how the overnight remarks of a Japanese finance bureaucrat -- suggesting that the yen carry trade should no longer be considered a one-way bet -- could be seen as shocking enough to spur the kind of panic seen at the opening of US markets today. That the era of Japanese free money has come to an end is not news, nor is it news that the Bank of Japan is embarked on a course toward a more normal policy posture. As the Japanese policy rate rises steadily from its current levels at 0.5%, up from 0.25% just last week, and the Japanese yen strengthens in turn, the carry trade can only become progressively less attractive as a free money bet. Nothing new there. Indeed, the same thing has already happened to the dollar carry trade in the US as the Fed has raised short-term rates here.

But the Japanese official's comments can be seen playing into the mix of factors now at work that appear to be contributing to a significant sentiment shift regarding the risk environment. Just as Tuesday's equity sell-off was apparently sparked by a steep overnight slide in the Shanghai market which seemed to have little direct consequence for anything bearing on US market capitalizations, it's not the notion of a potential unwinding of the yen carry trade in and of itself that has great market significance. Rather, it is the prospect of an end to the speculative free lunch which has motivated many markets, and which the yen carry trade had come to symbolize, that seemed to be accentuated by the finance ministry official.

We have maintained for months that the extraordinarily low price of risk reflected in the sharp contraction of high yield debt spreads, emerging market credits, and any number of other speculative instruments was due for a reversal at some point. Our analysis suggested that such a reversal was most likely to come through an inevitable Fed response to a significantly greater inflation uptick than either the markets or the Fed are now contemplating. The Fed's still-accommodative posture has been part and parcel of the asset price appreciation seen in these liquidity-driven markets. We continue to believe that an eventual tightening of the Fed's liquidity posture holds the greatest potential downside for these markets. That's not to say that there isn't more than enough global liquidity *now* to absorb event risks such as rising defaults in the subprime market (see "Subprime Time" February 26, 2007). But prospectively, there's no question that anticipation of a more restrictive tone in one source of risk-bearing, the yen carry

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

trade, can have a marginal impact on liquidity-driven markets. While we don't expect these markets to undergo a major bear episode as a consequence, this should be enough to put the brakes on further upside.

The impressive recovery of US equities off their opening lows, and reversal of the bulk of the early gains in fixed income suggests that positive economic fundamentals continue to overpower such marginal influences. Today's reversals came as a string of economic releases pointed to the economy maintaining a significantly more robust profile than recent data had led some to suggest. Probably most welcome was the ISM manufacturing survey, which at 52.3 comfortably exceeded expectations for the release printing at the break-even 50 line. Despite yesterday's declaration by the *New York Times* that manufacturing has slipped into recession, the upbeat ISM release supports our analysis that recent softness in the sector has been attributable to an inventory overhang which has been largely worked off (see "Paper Tiger?" February 22, 2007). The inventory component of today's release jumped from 39.9 to 44.6. At the same time, new orders rose from 50.3 to 54.9. And personal income and spending also exceeded expectations, again showing no inkling of the bears' long-awaited retrenchment in consumption. Meanwhile, not so positively, the core personal consumption deflator registered a monthly gain of 0.3%, according with our view that the Fed's task remains incomplete in rooting out the inflationary impulses that have become embedded as a result of it remaining too easy for too long.

BOTTOM LINE: That markets were thrown for a loop early today says less about the fears of the unwinding of the yen carry trade, as such, than a sense that the free-wheeling era of speculative gusto may be nearing an end. The strong bounce back of US stocks, however, suggests that markets will continue to be steered primarily by the fundamentals of an economy that shows little signs of slippage from a healthy pace of expansion. TM