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MACROCOSM

I Knew Japan -- You Are No Japan

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With the Fed ultra-easy, there's no way the US is going down Japan's deflationary road.

Update to strategic view

US MACRO: Comparisons of the US economy to that of Japan in the 1980s are misguided, despite superficial similarities. That "lost decade" of stagnation and monetary deflation, and its remaining legacy today, were the product of a persistently too-tight Bank of Japan. The Fed was not tight even before the present crisis, and as the crisis has unfolded has gotten progressively easier -- to the point now of extreme ease, where the real concern should not be deflation, but inflation. **US BONDS:** Misguided disinflationary expectations, and an intense preference for liquidity, have driven TIPS spreads to impossibly narrow levels. We expect those spreads to widen considerably as the credit crisis eases, and inflation comes back to the forefront of concern.

[see Investment Strategy Dashboard]

As US credit markets continue to be roiled in chaos stemming from the busted housing bubble and associated blowback in mortgage securities, the notion is taking hold in some quarters that America's financial problems are of the same type and degree as that suffered by Japan in its "lost decade" of the 1990s. Increasingly common are such sentiments as those of one analyst who was quoted by Bloomberg last week proclaiming, "The current US situation is the same as Japan's…. The economic slowdown and credit crunch are creating a downward spiral." Another economic spokesman for a major international bank offered, "Deflation looms. It certainly does loom. The cycle in which debt destruction and asset price destruction reinforce each other clearly has a very, very, strong negative effect on the economy."

This analysis expresses a common fallacy that asset price declines give rise to economic weakness, and that the effect is therefore deflationary -- "deflation" not a synonym for "contraction," but rather denoting a sustained decline in the overall price level, *i.e.*, the opposite of inflation. But there is no evidence to suggest that deflationary influences are now at work in the US economy. The Japanese deflation is something we know very well, having been the first to recognize it and name it for it was. We wrote about it in a lengthy op-ed in the *Wall Street Journal* in 1995, and were exposed to intense public criticism by the Bank of Japan for a diagnosis that history has judged to be entirely correct (see "Where the Bank of Japan Errs" *Wall Street Journal*, April 21, 1995). Aside from some superficial similarities, the current financial market disturbance bears no resemblance to the economic misery that afflicted Japan for more than a decade, and in important ways continues to linger there. In fact, the comparison should provide some comfort in the current circumstances. US monetary conditions are nearly the exact opposite of the devastating deflation that characterized the Japanese experience. Yes, the US had its real estate bubble

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through the first six years or so of the current decade -- and on the surface, that might seem comparable to the real estate bubble that preceded Japan's decade of deflation. This bubble had its roots in the Fed's exceptionally accommodative monetary policy, a situation not unlike Japan through the late 1980's, when the Bank of Japan was also too easy for too long. But unlike the Fed, the BoJ turned toward tightness with a vengeance, apparently with the objective -- at least initially -- of pricking the bubble. Japanese land prices began their long fall in 1991 on the heels of a sharp currency appreciation in 1990, with the yen soaring nearly 20% against both the dollar and gold. And that was just the beginning. The yen/dollar rate would peak at ¥82 in 1995, versus nearly ¥160 in early 1990, a total appreciation of nearly 50%. Although that was the peak, the deflationary cast of policy would remain in place for a number of years. The yen price of gold dropped to about ¥30,000 at the same time, down from more than ¥60,000 in 1990, and it would remain below ¥40,000 through most of the decade, actually falling below ¥30,000 before decade's end. The relentless rise in the currency's purchasing power magnified the real burden of yen debt, crushing borrowers and crippling the Japanese banking system.

Contrast that with the US experience, in which the decline in real estate values would coincide not with a deflationary appreciation of the dollar but an inflationary depreciation. From the time home prices peaked in mid-2006 through the currency's lows last spring, the trade-weighted value of the dollar fell by some 18%. Over the same period, the price of gold rose by about 75%. While the dollar has rebounded moderately in the last several months, by any objective measure it remains in a weak position. On a trade-weighted basis, it has returned to its levels of about a year ago. But up to that point, it had never been weaker. At around $870 in gold terms, the dollar is only a little stronger than at its weakest point when gold reached above $1,000 last March.

It's also instructive to compare the relative damage to real estate values between the US and Japan. Thus far, US home prices have fallen about 12.5% from their peak, but they remain about 40% above their 2000 levels. Although the evidence is not yet conclusive, over the last several months there have been tentative signs that the lows may have been reached. The median existing home sale price in August was some 4% above its lows in February. In Japan, by earlier this decade the destruction of values brought land prices down to about half their levels of the late 1980s.

The US housing downturn and associated financial market turbulence is attributable not to tight monetary conditions, but to an unsustainable speculative bubble triggered by loose monetary conditions. This is not to minimize the potential for serious adverse economic consequences in the current crisis. If credit markets remain so impaired for any length of time, a recession is virtually inevitable, at least a shallow and short-lived one (see "Fear Itself, Volume 2" September 23, 2008). When economic actors do not have access to credit, economies cannot grow. But unlike Japan, the US economy will not have to dig its way out of a debilitating, long-lasting monetary deflation.

Quite the contrary, in fact, the current economic climate is marked by a considerable upswing in inflation, with headline CPI now running at about 5.4%, up from less than 2% a year ago. The decline in crude oil prices will moderate the reported rate for a few months. But once oil stops falling, the underlying inflationary influences will reassert themselves, and we expect no sizeable long-lasting decline in reported inflation for the foreseeable future. This suggests that current bond market inflation expectations, with the spread between nominal 10-year Treasuries and CPI-indexed TIPS currently at about 150 bp, is sharply mispriced for the inflation outlook. The 5-year TIPS spread at about 100 bp is simply absurd. These spreads impound not only faulty disinflationary expectations -- but also a liquidity premium during this period of extreme risk aversion, reflecting the relative illiquidity of TIPS compared to otherwise similar nominal

Treasuries. As disinflationary expectations are defeated, and as liquidity ceases to command such a premium, we expect TIPS spreads to widen significantly in the months to come.

BOTTOM LINE: Comparisons of the US economy to that of Japan in the 1980s are misguided, despite superficial similarities. That "lost decade" of stagnation and monetary deflation, and its remaining legacy today, were the product of a persistently too-tight Bank of Japan. The Fed was not tight even before the present crisis, and as the crisis has unfolded has gotten progressively easier -- to the point now of extreme ease, where the real concern should not be deflation, but inflation. Misguided disinflationary expectations, and an intense preference for liquidity, have driven TIPS spreads to impossibly narrow levels. We expect those spreads to widen considerably as the credit crisis eases, and inflation comes back.