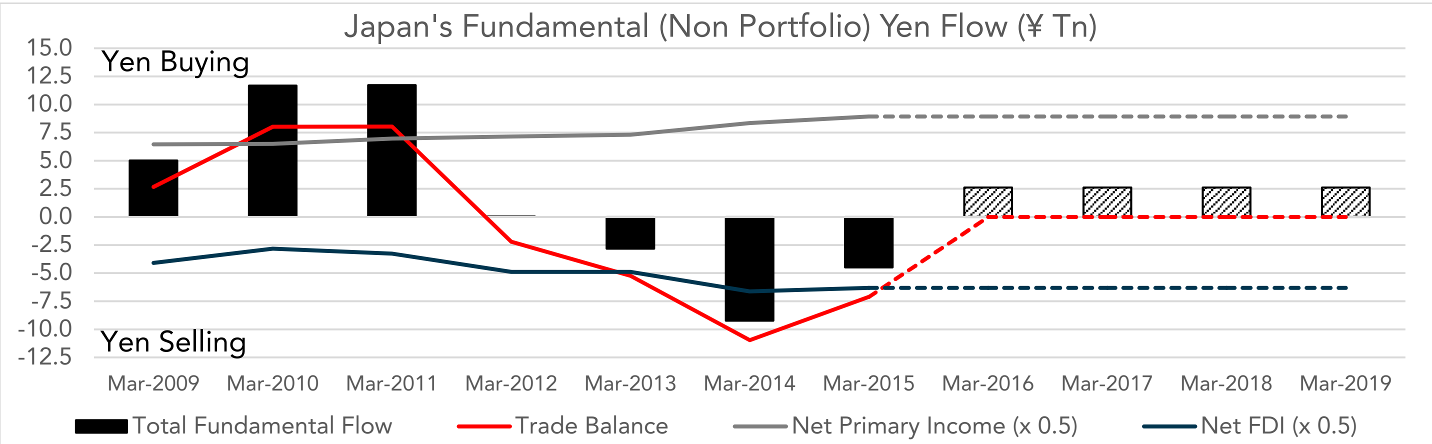
HORSEMAN CAPITAL MANAGEMENT

Market Views – **March 2015**

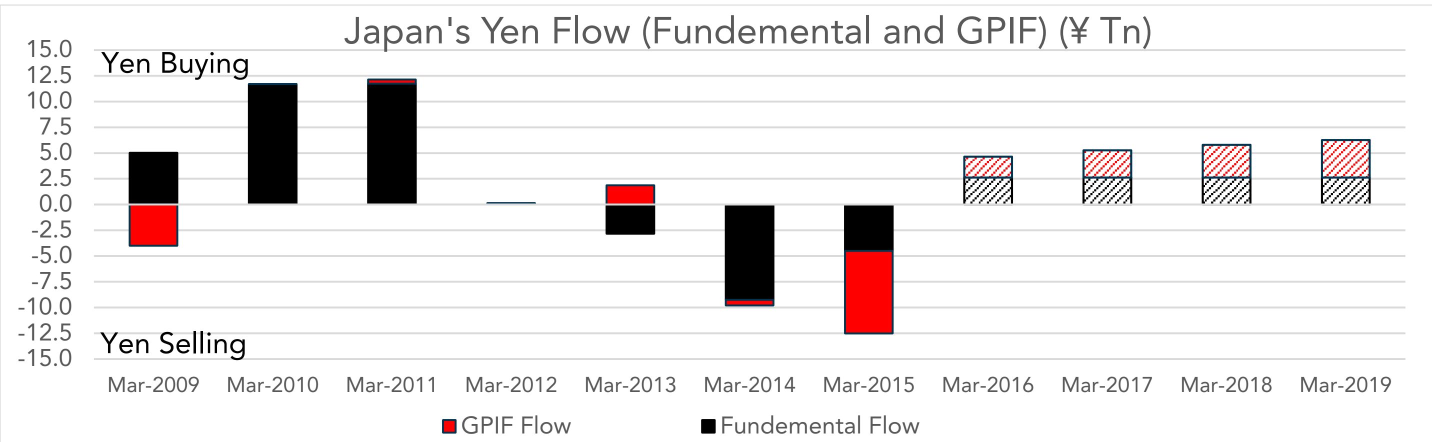
Japan – The Fierce Yen Seesaw

As a father of young children I have seen some rather pained faces when bigger kids suddenly shift weight on a seesaw. One of the fiercest seesaws I know of in markets is the Japanese Yen. With millions of small players and some super heavy weights. For the last few years we have seen a confluence of events stacking the seesaw for Yen weakness. The super heavy weights are now leaping for the other side.

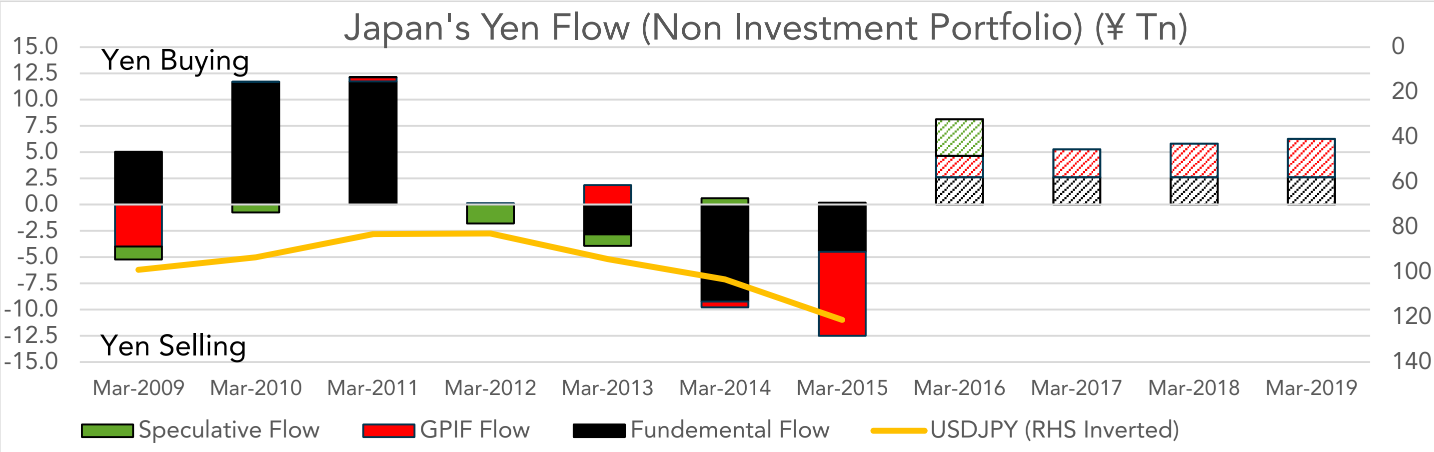
Historically the largest consistent Yen flows in Japan came from what I call the "fundamental" lines in the Balance of Payments, which are those flows not completely driven by portfolio investment changes. For the last four years the "fundamental" flows were net selling the Yen to fund the trade deficit with nuclear plant shutdowns and high energy prices. With energy prices now falling by half and nuclear plants to restart, the trade balance will soon return to positive territory and total "fundamental" flows will return to the usual Yen strengthening bias+.



The black bars above reflect the parts of the balance of payments which are not portfolio investment flow. I have added the most dominant portfolio investment flow of late below. The Government Pension Investment Fund, which has been selling Yen to buy overseas assets, this will soon reverse as the GPIF starts selling foreign assets and buying Yen to cover the growing pension shortfall (per my recent note on GPIF selling).

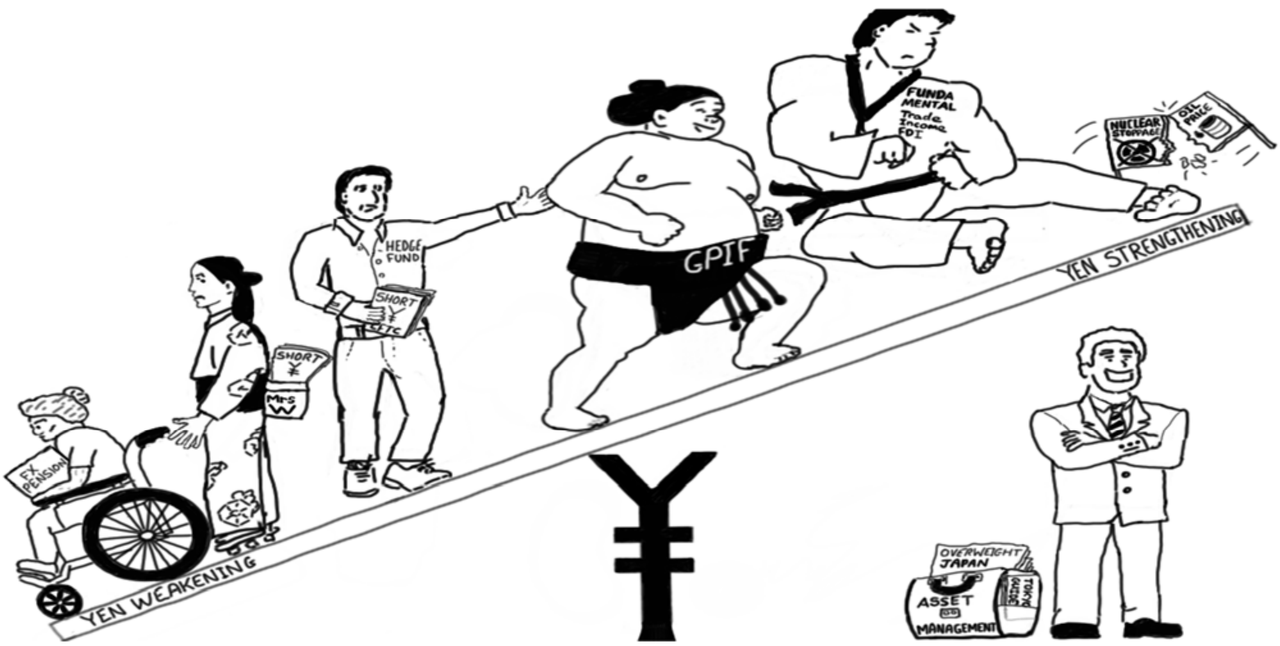


It is always important to factor in speculator portfolios such as the fabled "Mrs Watanabe" housewives that dominate retail margin trading (reflected by FFAJ Retail FX Margin Positions) and foreign hedge funds stacked on the Yen short trade (reflected by CFTC Net Yen Non Commercial & Non Reported Yen positions). These speculators increased net shorts in 2012-13 to near record levels, then recently reduced these positions by around a third from peak levels. I have added the combined speculator flow to the chart below, March 2016 reflects a scenario whereby the remaining short positions are closed to neutral. I think it is fair to say that as a group speculative currency investors are heavily influenced by news. News of GPIF and "fundamental" Yen buying would be highly concerning for their still large short positions.



As the chart above shows these flows have a strong relationship with the direction of USDJPY and indicate that we are set for sustained Yen appreciation. Flows which are not included in this chart largely relate to non-speculative overseas investment. These investors in Japan mainly consist of pensioners, or those soon to be, with those aged over 60 owning 91% Net Household Assets according to the Ministry of Health Labour and Welfare. There are too many investment types to summarise in this short note other than to say there has been a resurgent trend for pensioners to shift money overseas in search of yield to live off in retirement. This has come via increasingly creative and opaque yield enhancement products. Russell and I have written a few notes on these products, some offer above 30% dividend yield. Essentially the "targeted" dividends are only sustainable whilst new inflows continue to create capital gain by pushing up the underlying asset prices and currency of denomination. When the inflow stops and the currency/asset price increases stops then the dividends begin to rapidly consume the capital base, selling the asset/currency and buying Yen. Japan is the world largest net foreign creditor and much of this flow has gone into smaller high yielding economies. We see some signs of inflows stopping and many of the favoured carry currencies have declined this year against the Yen (including the BRL, TRY, MXN, ZAR, AUD and NZD). Investors need to be selling at least ¥4.6tn of Yen a year (and rising) to offset the GPIF and "fundamental" Yen buying inflow, just to keep Yen flat. As well as potentially offset an additional ¥3.5tn from speculators buying Yen to cover their shorts. This is difficult to see given pensioners face similar pressures to the GPIF, to sell foreign assets to pay for retirement. I wouldn't be surprised if pensioners are catapulted onto the Yen buying side as their overseas pension fund values collapse. The incentive to move into more developed economy investments is far lower than a year ago when the 10 year US Treasury offered a 2.15% higher yield than 10 year JGBs, it is now only 1.66% higher. Some European bonds offer less yield than JGB equivalents.

Foreign investors into Japanese equities have increasingly currency hedged their positions. Evidence of this is that the Wisdomtree Japan Currency Hedged fund has raised the vast majority of its ¥1.8tn ($15.5b) AUM in the last two years. Foreign investors into Japanese equities with currency hedges are technically not on the currency seesaw, but they will likely see some of the greatest pain from reversing Yen flows as stocks in Japan often fall by more than the currency rises. We continue to see attractive shorts in carry currencies and Japanese equities.



⁺ Primary Income & Foreign Direct Investment reflect 50% of the Balance of Payment numbers, as around half of overseas investment income is traditionally reinvested & half of overseas FDI is financed by foreign earnings. Using 100% of BOP would show even more Yen buying to come.

INFORMATION

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