June 5, 2013

Abenomics: Lost in Translation?

After traveling through Japan for the past couple of weeks and with their economic experiment at the forefront of the financial press, it is an appropriate time to give an update on Hayman's current thoughts regarding the island nation. My travels took me from Kyoto, the cultural heart of Japan to Tokyo, Japan's financial epicenter. I met with all kinds of thoughtful and wonderful people throughout my trip – from tea service with Zen priests in Kyoto to the metaphorical Zen priests of finance in Tokyo. The Japanese people are some of the most inviting, respectful, and thoughtful people with whom I have ever had the opportunity to spend time. There is no doubt that culturally and historically, Japan is one of the richest countries in the world.

Unfortunately, I had this overriding feeling of sorrow and empathy for most of the people with whom I met because my conclusions regarding their potential financial fate were reinforced on this trip. Most large and complex problems do not have a single cause, and there are countless decisions and circumstances that have led Japan to its current situation. While there is no formulaic determination for the solvency of a sovereign balance sheet (despite many attempts to develop one), the inescapability of economic gravity remains constant. Japan and its leadership face an unsolvable equation in my opinion. The structural problems in Japan have existed for years and were evident during our original analysis of the situation in late 2009, but it is fascinating to observe the progression of the decline over time and the recent broad acknowledgement of their plight.

The Rational Investor Paradox

Abe, Kuroda, Nakaso and their staffs are facing a fascinating paradox as they implement the three "arrows" of their new strategy: i) private sector investment inducing growth strategy ii) flexible fiscal policy, and iii) bold monetary policy. On April 4th, Kuroda announced plans to purchase 60-70 trillion yen of JGBs per year for the next two years which effectively doubles the monetary base for a country that was already moving M3 at a brisk pace of over +3% per year. The BOJ "temporarily" abandoned the self-imposed Bank Note Rule and told investors they will extend the duration of their purchases which effectively monetizes the curve and allows longer dated purchases. JGB investors responded to the BOJ's "shock and awe" plan by immediately reducing their exposure to JGBs, the first real crack in the facade of investor confidence and panglossian beliefs. JGB futures locked limit down (i.e. Japanese government bond contracts tripped exchange circuit breakers) twice during the day on April 5th, which is technically counterintuitive to the central banking orthodoxy's expectations. This prompted the BOJ to revise the implementation of its asset purchases in order to provide more consistent support to the JGB marketplace, now effectively participating in every other day of trading going forward. Make no mistake, there's a new sheriff in town.

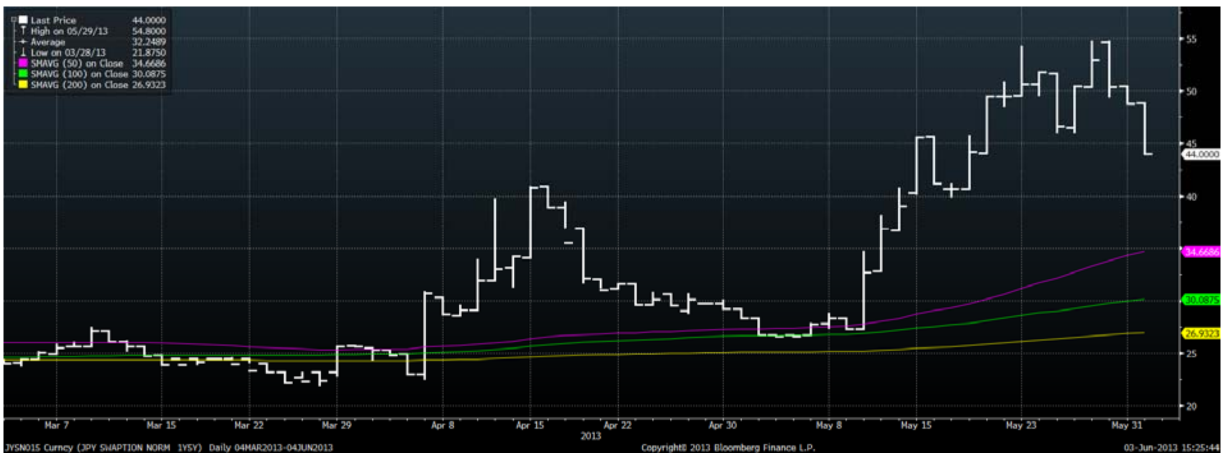
They should be careful what they wish for. It is impossible for the Japanese Government to spin the recent volatility as anything but undesirable for JGB owners and the BOJ. As institutional investors explained to me in Tokyo, they believe in the BOJ's new plan to generate CPI inflation and nominal growth in Japanese GDP. Successful achievement of these policy goals would normally lead to upward pressure on interest rates and lower bond prices. Therefore, institutional investor actions (selling a portion of JGB holdings – for example, according to the Japanese Securities Dealer's Association, the major city banks sold over 2.7 trillion yen of JGBs in April alone, on top of over 4 trillion yen in the fiscal year ending March 31) should be considered a perfectly rational response to the new plan – sell JGBs to purchase Japanese equities and foreign bonds with much higher nominal and real yields. This "rational" behavior is exactly what complicates things for JGB investors and the BOJ.

We are going to need a bigger boat

The financial community's focus should be on the quadrillion (a thousand trillion) yen of debt. If the Japanese government is going to run the largest fiscal deficit of any developed nation in FY2013 at north of 10% of GDP or roughly 50 trillion yen, the BOJ's war chest seems to be inadequate. If 5% of JGB holdings (another 50 trillion yen) are sold due to "rational" responses to the new monetary plan, the sales will overwhelm the BOJ's ability to purchase them. If their plan is to purchase 60-70 trillion yen of new bonds each year (assuming all existing debt rolls without event), the fiscal deficit will absorb 50 trillion yen, and the cushion will be a paltry 10 trillion yen of additional capacity. It looks to me like they need to double the new campaign at the very least if they think they can effectively keep rates from exploding higher. If the large holders allow their short-dated maturities of bonds to simply roll off (something we expect them to do), the BOJ will be overwhelmed, and the plan that is in place will prove to be woefully inadequate. Effectively doubling the largest financial experiment the world has ever seen is not exactly risk-free, but it seems like an absolute necessity if the BOJ would like to maintain any optionality aside from checkmate.

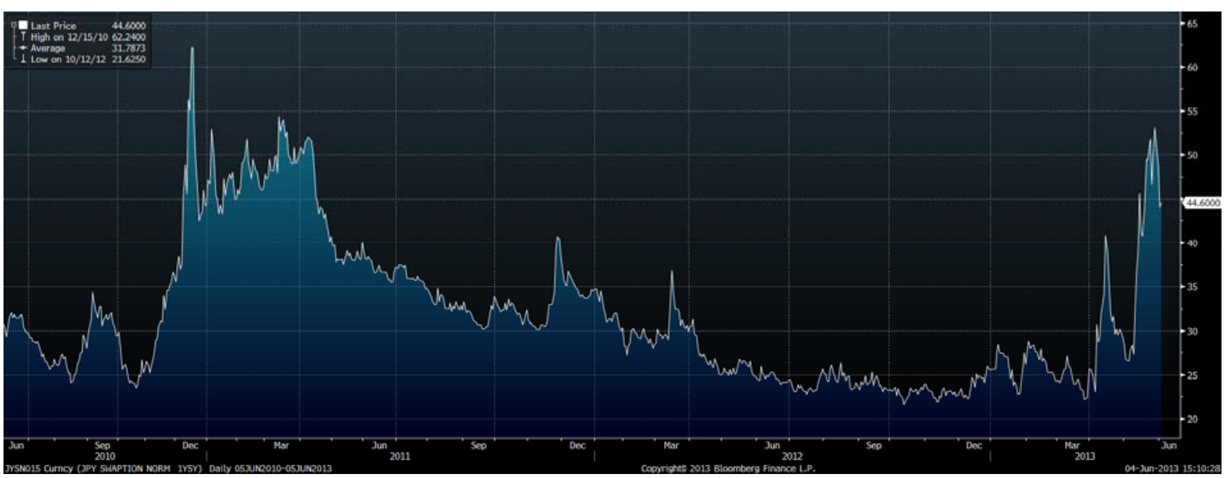
Surely, the BOJ also has some fail-safe plans that they are working on if Plan A does not meet expectations. I would assume that they have a plan to peg rates by being the buyer of last resort of substantially all JGBs at certain yield ceilings on the curve. One argument I hear opposing our views on the JGB rates marketplace is that any central bank that prints its own money can peg rates indefinitely by setting a cap on rates analogous to the US rate cap of the late 1940s and 1950s. Unfortunately, we cannot compare that apple to this orange. If the BOJ is forced to implement rate caps, there will be a volatility explosion which will leave many casualties in the streets. I do not think a preemptive rate cap is in the cards. Incidentally, if a rate cap were to be implemented, it would put the floor on the dollar/yen move, and the BOJ's game of whack-a-mole would be in full swing.

1-yr / 5-yr Swaption Volatility (last 3 months)



Source: Bloomberg.

1-yr / 5-yr Swaption Volatility (last 3 years)



Source Bloomberg.

JPY vs. USD Currency Volatility – 1-yr ATM Volatility (Jan 2012 - Current)

Source: Bloomberg.

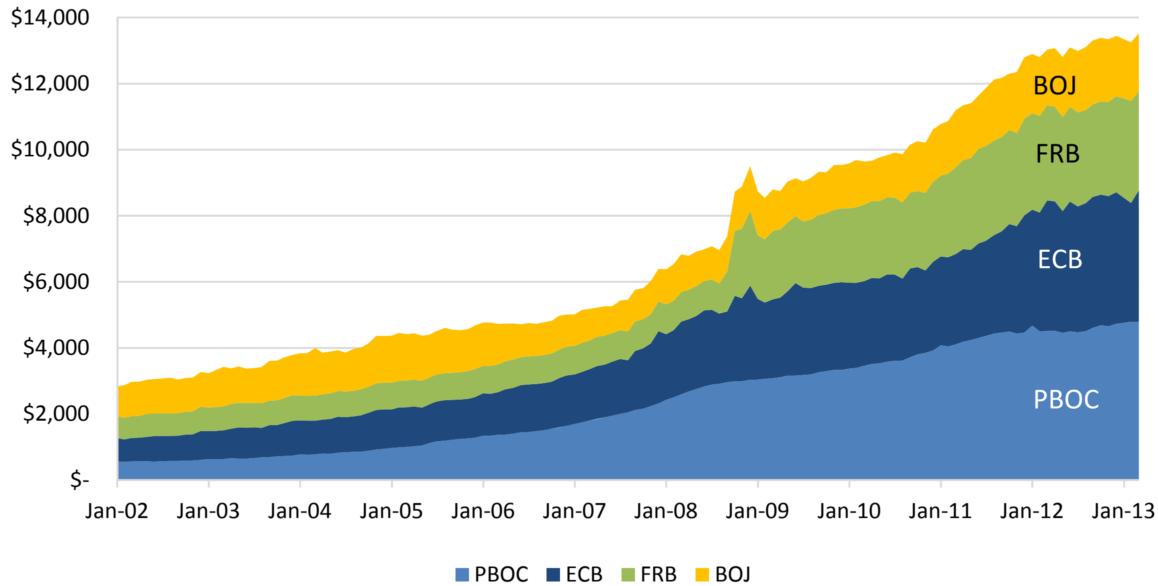
Japan 10-yr Bond Future – Current Contract JBM3 (February 2013 – April 2013)

Source: Bloomberg.

Coordinated Diminishing Marginal Utility

As central banks move to an unlimited expansion of their balance sheets, the marginal efficacy of these actions approach zero. In our opinion, the only reason the BOJ's new monetary policy actions have had such a positive effect is due to the unexpected size and scope of the announcement in relation to their economy and history (and in relation to other central bank plans). The bloom will fall off the proverbial rose, and they will be right back where they started with mountains of debt and anemic global growth.

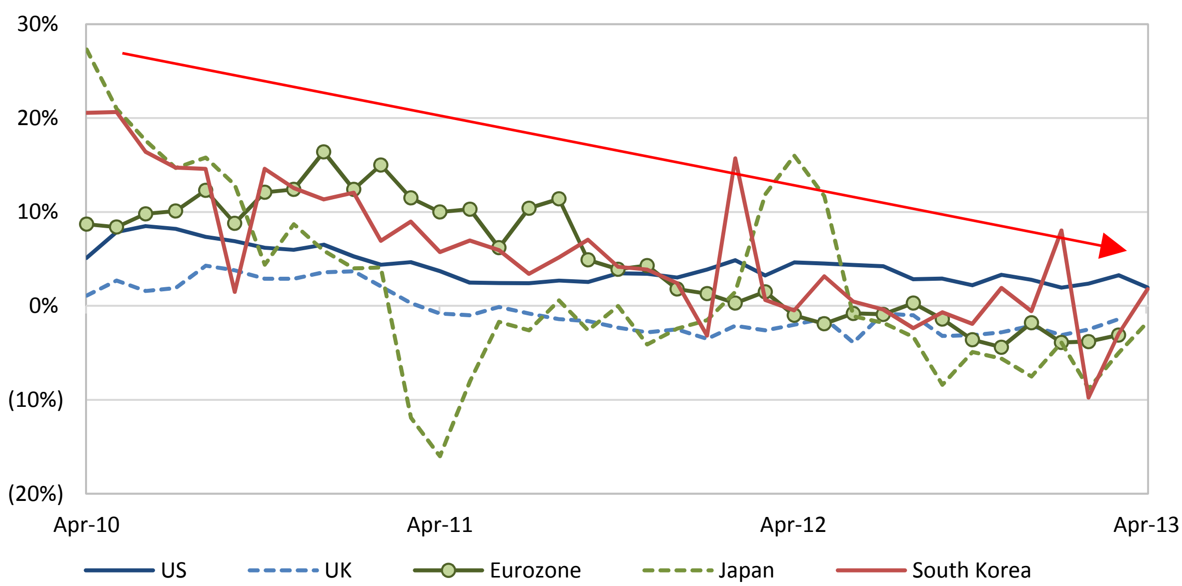
Total Assets of Global Central Banks ($ in Billions)



Source: Bloomberg.
Note: PBOC = People's Bank of China; ECB = European Central Bank; FRB = Federal Reserve Bank; and BOJ = Bank of Japan.

The G7's concurrent monetary easing has generated tepid and declining growth. Why should we expect more of the same to achieve a different result?

Global Industrial Production Y-O-Y Change (Last 3 Years)



Source: Bloomberg.

Moving all rates closer to zero may save over-levered companies from bankruptcy, improve earnings as interest expense is reduced, force P/E multiple expansion in equities as investors chase dividend yields for income, and generate fits and starts of confidence and inflation. However, in the end, if monetary policy is the only thing the world has to generate growth going forward, then we are all in for a rude awakening. Does anyone really think the U.S. Fed can ever willingly raise short rates again? At $150 billion per 100 basis points in annual interest expense, we do not think so. Outside of a ceremonial 25 or 50bps, we do not think Bernanke and the Fed will be able to move from the zero lower bound. In a 2004 paper, Bernanke, Reinhardt and Sack addressed the issue of leaving the zero lower bound and highlighted the uncertainty around an exit strategy:

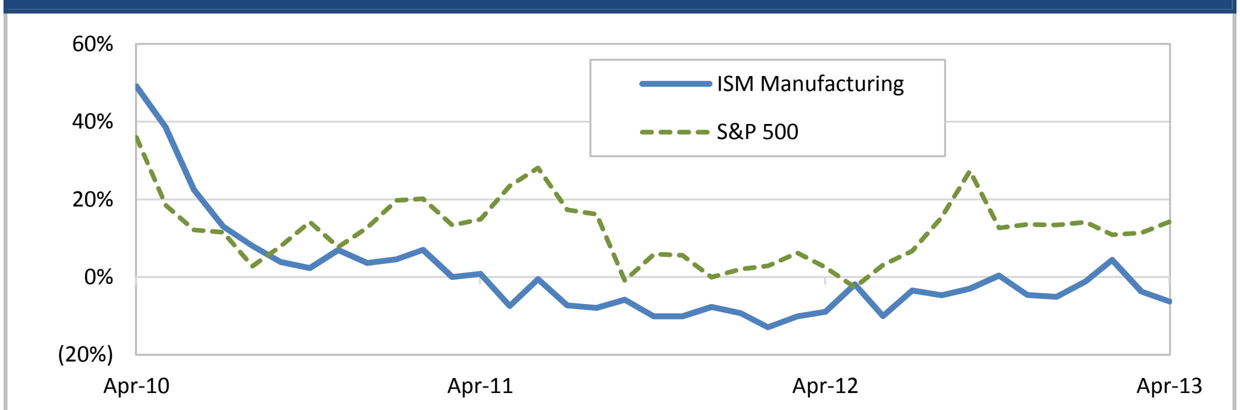
> *"However, such policies cannot ensure that the zero bound will never be met, so that additional refining of our understanding of the potential usefulness of nonstandard policies for escaping the zero bound should remain a high priority for macroeconomists"* [1]

The longer we are there, the harder it will be to ever move. When the U.S. rate complex does move, it will not be for a good reason. It will be cost-push and not demand-pull inflation at some point down the road.

The Largest Divergence Ever Seen

Global equities are exhibiting one of the largest divergences between true economic growth and prices. In fact, it feels similar to July 2007. Equities march higher and higher as P/E multiples expand while industrial production numbers tank globally. We are concerned about the possibility for substantial further correction in some overstretched equity markets.

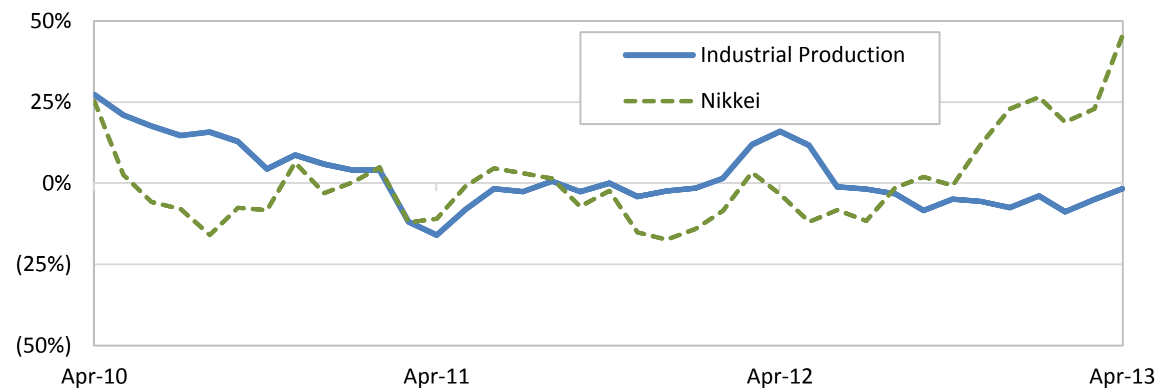
ISM Manufacturing vs. Stock Index Y-O-Y Change – United States (Last 3 Years)



Source: Bloomberg.

[1] "Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment" page ii (http://www.federalreserve.gov/pubs/feds/2004/200448/200448pap.pdf)

Industrial Production vs. Stock Index Y-O-Y Change – Japan (Last 3 Years)



Source: Bloomberg.

Big Trouble in Little China

We have become significantly more cautious regarding global growth and the potential for asset price appreciation in the second half of this year. China's growth appears to be stumbling dramatically. This has significant ramifications for individual markets and the world economy.

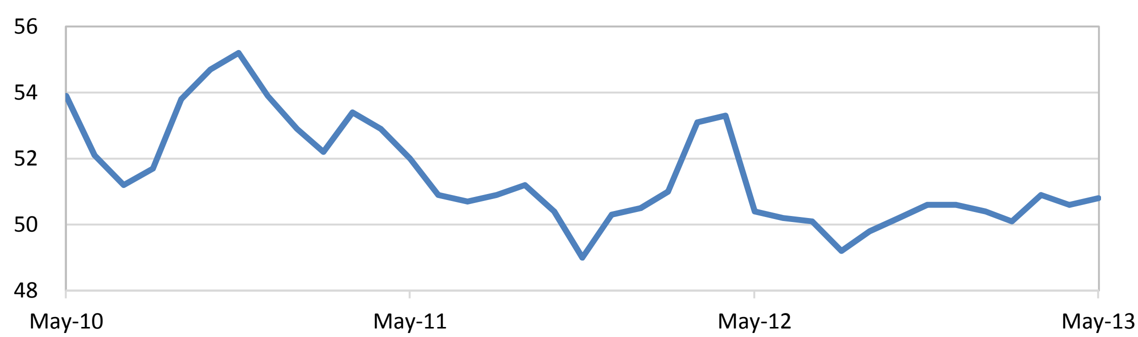
The scale and pace of credit expansion in China over the last 5 years is truly staggering. The compounded annual growth of bank assets as measured by the China Banking Regulatory Commission has been 30.8%. More recently, the Chinese authorities started publishing data that includes non-bank credit growth to capture the way in which the credit creation machine has moved beyond traditional methods. "Total Social Financing" is now growing at 21.7% year over year as of April. The total size of the Chinese credit system is now approximately 256% of total Chinese GDP. To give some perspective, a 30.8% compounded annual growth of credit in the U.S. equivalent over 5 years would be an expansion of $33 trillion. This rate of credit growth is 3 times the total credit system growth experienced in the U.S. at the peak of the bubble in 2006.

This massive credit growth has been the irresistible force that has driven growth and asset pricing in China throughout the global financial crisis and maintained robust (and by world standards, incredible) GDP growth during a period of global economic crisis and anemic recovery. The Chinese authorities share the faith of Bernanke and the Fed that liquidity and credit expansion are the ultimate cure-alls and that sufficient expansion is the tide that will lift all boats above the threatening rocks of structural inefficiencies and accumulated macroeconomic imbalances. They have relied time and time again on using reserve requirements and their influence over the major banks to encourage lending and then to slow it down as they deem necessary to avoid overheating. The resilience in the Chinese economy for the last 5 years is a testament to this model.

The story, however, is never that simple and eventually, as we have seen in major economies around the world, the inescapable law of diminishing marginal returns presents itself. As in the U.S. in the lead up to the credit crisis, the marginal utility of an extra unit of credit dropped dramatically. Initially small increases in nominal terms were enough to spur real GDP growth, but then ever increasing amounts were required to generate slowly shrinking amounts of growth. Eventually massive levels of credit expansion were required just to keep the economy on track. We believe an important limit has been reached in the capacity of Chinese credit expansion to deliver real economic activity growth and wealth creation.

From the beginning of the year to March, it took almost 18 trillion RMB to generate 5 trillion RMB of GDP growth. This ratio is the lowest it has been since the depth of the global crisis. So where has all the new money gone? The data available from the Chinese corporate sector indicates that a huge proportion has been used to fill operational shortfalls and to supply working capital. The debt-to-equity ratios of Chinese companies are exploding as they funnel new capital, not into yield returning investments, but into the black holes on their balance sheets that have been created by a slowing growth environment. In the industrial sector, there is even outright deflation as overcapacity finally takes its toll.

China Manufacturing PMI (Last 3 Years)



Source: Bloomberg.

The speed and depth of the Chinese policy response will help determine the severity and duration of this crisis. If the Chinese address the issue quickly and move decisively to rein in credit expansion and accept a period of much lower growth, they may be able to use the government and People's Bank of China's balance sheet to cushion the adjustment in the economy. If, however, they continue on the current path and allow this deterioration to reach its natural and logical limit, we will likely see a full-scale recession as well as a collapse in asset and real estate prices sometime next year.

China's direct contribution to global growth is enormous, but perhaps equally as important is its role in generating growth in developed and emerging economies. A slowdown, whether significant or extreme, in the Chinese economy heralds very bad news for asset prices around the world. A growth crisis centered in Asia will further exacerbate the instability and volatility in Japan and have a devastating impact on second derivative marketplaces such as Australia, Brazil and developing markets in South East Asia. The combination of rich valuations and further threats to growth has led us to dramatically reduce risk in the portfolio and actively position ourselves to withstand the uncertainty and instability ahead.

Inexorable

Despite the abundant quantitative data indicating the fragility of the financial system and the risks posed by further indebtedness, very few individuals in Tokyo have expressed a willingness to embrace the difficult choices required to resolve this looming crisis. During my trip to Kyoto, I was introduced to a Japanese phrase that encapsulated the strangely fatalistic viewpoint that many local Japanese market participants have toward the twin threats of debt and deflation. This concept explains a resignation to the unfolding of events and a willingness to submit to this unfortunate reality rather than to fight a seemingly inevitable or impossible challenge. It seems apposite to reprint it here as we watch the beginning of this endgame in the Japanese debt markets unfold:

"Shikata ga nai"

It cannot be helped.

Best Regards,

J. Kyle Bass

Managing Partner