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2 June 2015

Global Strategy
Alternative view
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Global Strategy Weekly

Finally! The yen breaks 30-year support - a new round of currency turmoil begins

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The yen has just moved back centre stage. Back in September last year, when the yen broke below the 15-year trendline around ¥105, we highlighted the dollar/yen chart as *the* most important chart investors should be watching. We followed that up in November just after the dollar trade-weighted index (DXY) broke its 30-year downtrend, saying that if the 30-year support level for ¥/$ of ¥120-122 also broke, the yen would quickly fall to ¥145/$. The break of ¥122 took much longer than I expected but it has just occurred and I think yen weakness will become a dominant driver of markets and economies. We reiterate the particular vulnerability of China to yen weakness – in a replay of the events that led up to the 1997 Thai baht devaluation. China has big deflationary problems and cannot tolerate any further rise in the renminbi. Indeed, on one key measure, China is already in outright deflation.

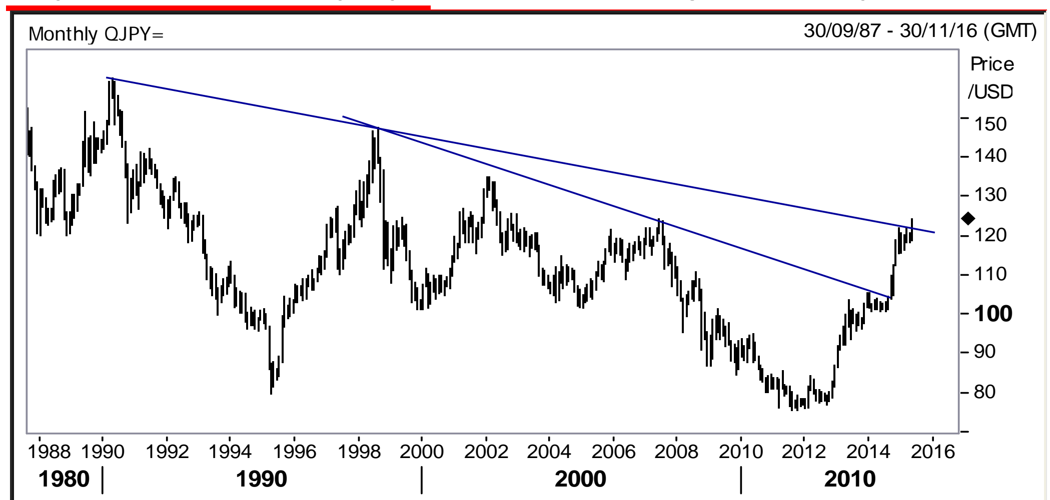
- They say if you are going to make a prediction never attach a date to it, and our November 2014 forecast that the yen would fall to ¥145 against the dollar by end-March 2015 is a good example of the pitfalls. What happened since we made that forecast is the yen reached the support level of ¥122 in early December, yawned, and then spent the best part of six months consolidating in a tight range to work off a massively oversold position (including an extreme net speculative short on CFTC data).

- We said in November *"It seems entirely plausible to me that once we break ¥120 (we revised that break-point to ¥122 on advice), we could see a very quick ¥25 move to ¥145, forcing commensurate devaluations across the whole Asian region and sending a tidal wave of deflation westwards."* Having finally crashed decisively through ¥122 last week (see chart below), what has changed since November? Two things - deflation fears in the west have ebbed away recently but the economic situation in China has become more precarious. **The most important thing as the yen sets off another round in the global currency war is that China in now in outright deflation and cannot tolerate renminbi appreciation.** As the yen drags down other regional currencies, and the renminbi is forced to participate in a competitive devaluation, deflation fears will surely quickly reignite in the west.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

The yen has now broken the key 30-year support of Y122/$ (rising bars = weaker yen)



Source: Reuters

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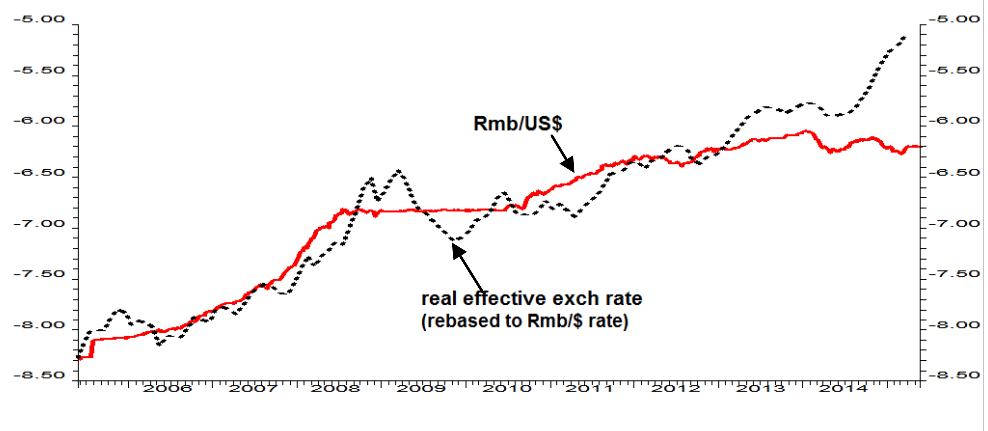
Our prognosis last September as the yen broke ¥105 still stands: *"Staring long and hard at the yen/$ chart, I think that in the current circumstances the yen/$ will head to 120 pretty quickly – perhaps after a short reinvigorating retracement. And if the dollar's ascent is given extra impetus by the DXY also breaking out, a decline in the yen below ¥120 will see an end to its 30y uptrend – a trend that has relentlessly exported deflation from the west to Japan. Sound far fetched? One of the few things I have learnt over 30 years in this industry is that* ***when traders decide the ¥/US$ starts to move it can jump by ¥10 or ¥20 very quickly indeed."***

While the yen has now spent the last six months consolidating in a tight ¥118-122 range, investors have decided that major currency swings are being driven either by dollar strength (as the Fed teases us with a rate hike), or euro weakness (as the ECB conducts QE). But we believe that what Japan is doing in terms of QE is totally off the scale and it is the yen, not the dollar or euro, we should be watching. Indeed in a dramatic intervention, the IMF recently advised the BoJ to *increase* its QE stimulative measures *still further* as the economy failed to achieve either a take-off in wage inflation or anything close to its 2% core inflation target - link.

Yen weakness at this juncture reminds us of events before the 1997 Asian crisis. Back in the mid-1990s, a period of undervalued Asian currency pegs to the dollar had stimulated strong growth in the region and large balance of payment (BoP) surpluses. Then the whole process went into reverse as inflation picked up, real exchange rates soared, competitiveness was lost and BoP surpluses turned to deficits. That process has happened again in EM economies in general but importantly, also in China. Their real trade-weighted exchange rates continue to rise, even as the bilateral dollar rate remains stable (see chart below).

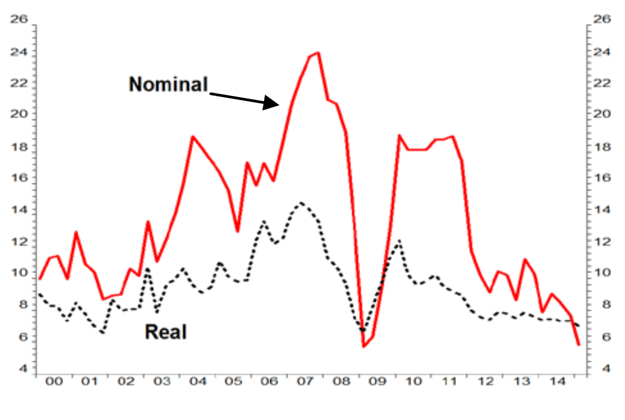
Despite renminbi stability against the dollar, the real trade-weighted measure is still soaring



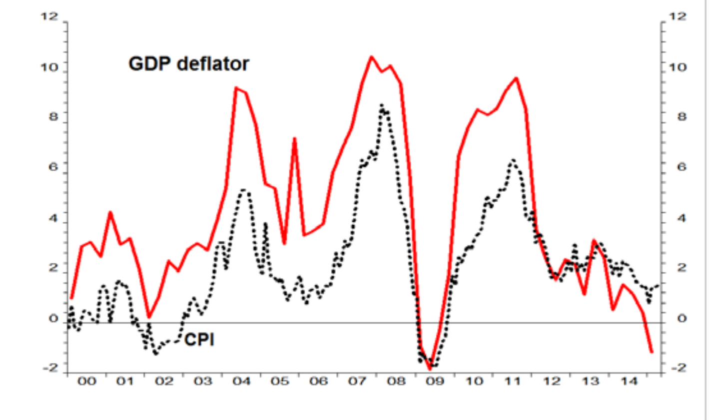
Source: Datasteam

I have a confession to make. At the time of Chinese Q1 GDP release I was in Japan and I missed the incredibly important fact that China's GDP deflator had lurched into deep deflation, declining 1.2% yoy (see charts below) – my apologies for that.

China's Q1 nominal GDP growth has dipped below real....



...which means that on this key measure China is in deflation



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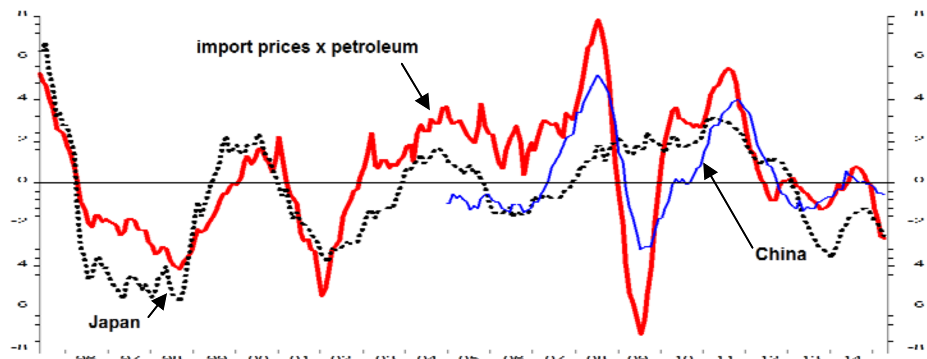
Why is China's lurch into deflation on the GDP deflator, but not the CPI measure, so important? We have pointed out before (unfortunately we don't have space for the chart here) that in Japan during the 1990s the thing to watch to see the havoc that deflation was wreaking on nominal revenues and debt/income loads was not the CPI, but rather the GDP deflator, which fell far faster than the CPI. Economic agents produce far more than just consumer goods and services and the GDP deflator is a much wider basket of goods and services and includes exports and investment goods. Clearly the descent into outright GDP deflation in China explains the more aggressive, even slightly panicky, policy easing measures there.

We also pointed out last week that China's move into BoP deficit imposes a substantial monetary headwind on the economy. China may wish to keep the renminbi stable at this time while the IMF is currently considering including it in the SDR currency basket. But the economy is simply not in a position to withstand a major yen decline bringing down the currencies of its competitors in the region (and the additional deflationary impulse). I remain convinced that China must start guiding its currency down against the dollar and it can do that easily now it has a BoP deficit by doing absolutely nothing (ie not intervening any longer to hold it up)! China will also take the IMF's recent declaration that the renminbi is no longer undervalued as justification for these actions - link.

Worrisome deflation is *already* being imported into the US, especially from Japan (see chart below). China (blue line) has yet to participate, but a further round of Asian devaluations will inevitably see waves of deflation heading westwards – as in 1997/98. Watch this data closely.

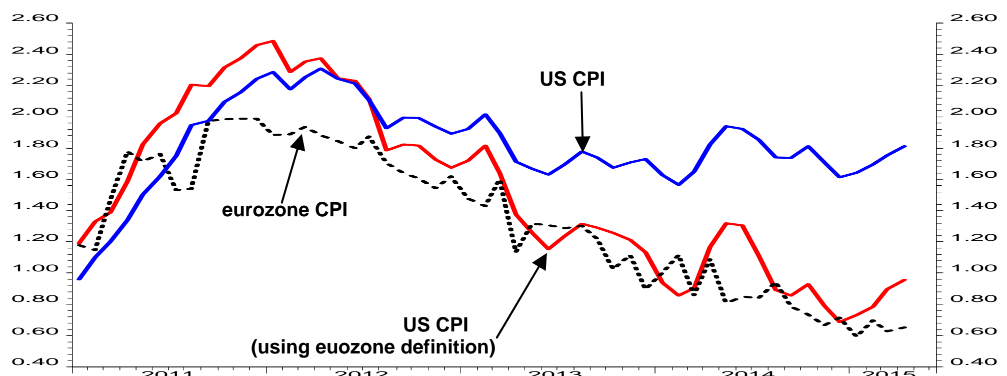
One good measure of deflationary pressure in the US is import prices (yoy%)



Source: Datastream

Ironically, these developments occur just at a time when deflation fears have receded somewhat in both the US and eurozone. Yet, eurozone core CPI inflation remains at only 0.6% yoy, and although the core US CPI picked up to 1.8% yoy, if you measure US CPI as in the eurozone (by excluding imputed owner occupier rent), US core inflation is at 1%. The US and eurozone remain a hair's breadth from outright deflation. A weak yen could push them over the edge into deflation proper as China is forced to finally join the global currency wars.

Measure US CPI like the eurozone and core CPI is similar (yoy %)



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