Far From The Crowd

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The Script For Yen

Summary

- ➜ G7 intervened in the Yen for the first time (18/Mar)
- ➜ The goal is to check Yen's persistent strength
- ➜ History suggests G7 will win - eventually
- ➜ But, the process could be arduous and lengthy
- ➜ *Strategy*: Short some Yen now, more on strength

Short Yen: A Sure Bet?

G7 governments intervened in the Yen market on the 18 March (G7 Statement). This is the first *multi-lateral* currency intervention since September 2000. The rarity of these events makes them significant and important, with long-lasting impact on the target exchange rate.

But, does it mean that shorting Japanese Yen now is a 'sure thing'?

Jim Rogers, the well-known global investor, has long espoused the view that going **against** the central bank is always profitable. In his book ***Investment Biker***, he emphasized: "*In all my years in investing, there's one rule I've prized beyond every other: Always bet against central banks and with the real world. ... When a central bank is defending something - whether it's gold at thirty-five dollars or the lira at eight hundred to the dollar - the smart investor always goes the other way. It may take a while, but I promise you you'll come out ahead.* ***It's a golden rule of investing.***"

What he did not explain, is how - and when - one should go against the central bank. A contrarian trader may well run out of resources long before central bank. Also, to bet against one central bank is one thing; to bet against seven central banks *simultaneously* is another thing altogether.

So, to clarify the matter, I briefly analyse past multi-lateral interventions and try to draw useful inferences from these episodes.

1. Sep'85: Plaza Accord. Target FX: USD

Figure 1 graphed the rise and fall of the **Dollar Index** in the mid-eighties. Note that the G7 intervention came *after* Dollar's strength peaked. The agreement to weaken the dollar simply reinforced an ongoing trend. Following the Accord, selling USD was truly a 'one-way bet'.

2. Feb'87: Louvre Accord. Target FX: USD

G7 intervened 15 months later. This time, to prevent Dollar's weakness from turning into a global rout. But it was hard work, perhaps due to the weakening US economy. Figure 2 shows that following a rebound, the greenback weakened rapidly into new lows again. The authorities had to intervene a number of times to check USD's downtrend.

Figure 1: **Plaza Accord (Sep.1985)**

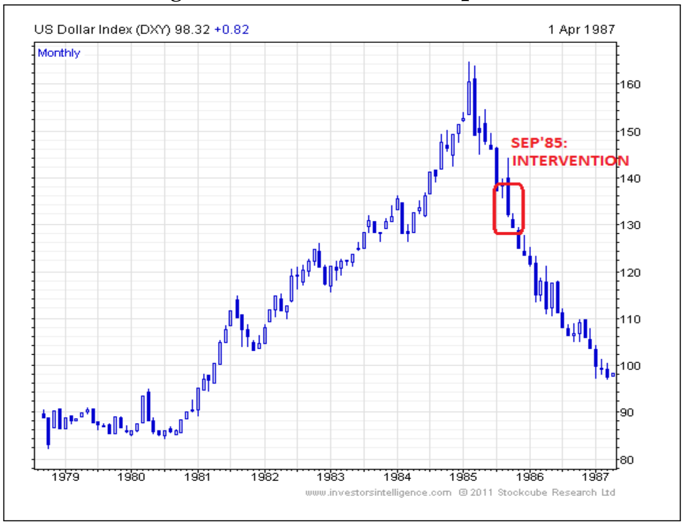


Figure 2: **Louvre Accord (Feb.1987)**

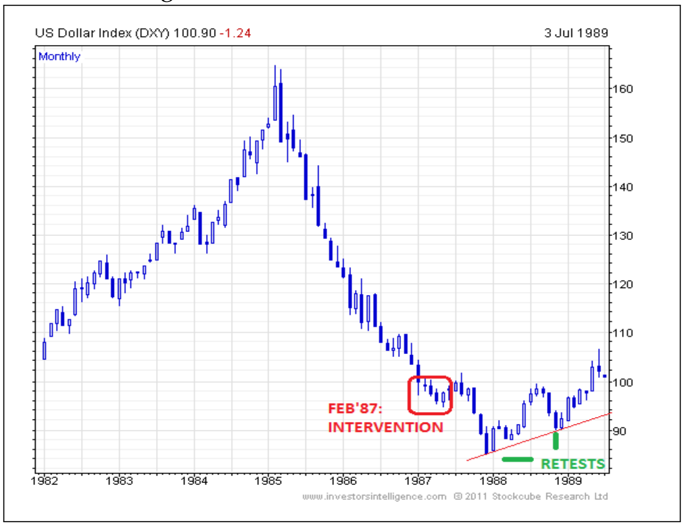
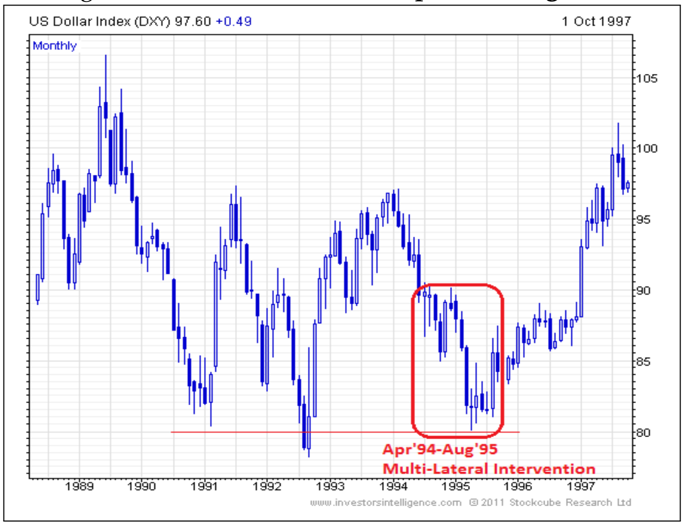


Figure 3: **US$ Intervention (Apr.1994-Aug.1995)**



3. Apr'94-Aug'95: Target FX: USD

Figure 3 shows that USD continues to languish near its long-term lows. The reserve currency was plunging against the Deutsche Mark (below 1.41) and Japanese Yen (below 83). The US Fed, along with its counterparts in Japan and Europe, had to intervene to prop up the Dollar. Like trying to turn around a supertanker, this process took several interventions, over several quarters, to bear fruit.

4. Sep'00: Target FX: Euro

The newly born currency was an unwanted baby. Its frailness was all too glaring - against the interest of all major countries. So G7 intervened to halt its decline (Figure 5).

However, it took them nearly 15 months to reverse the Euro's downtrend. After an initial bounce, the rate re-tested the lows to probe G7's defences. Traders who previously enjoyed large profits riding the Euro's decline will not surrender easily. Only after the rate failed to renew to the downside for many months did these speculators gave up; some reverse their positions, creating an upside breakout in mid-2002.

Inferences

What general inferences can we draw from these interventions?

(a) G7 FX interventions are rare, but largely successful, especially in capping the FX's trend prior to the agreement

(b) But, the battle between the authorities and market is often intense and lengthy

(c) The market will certainly probe G7's determination in holding key technical levels

(d) For an intervention to be truly successful and long-lasting, it needs to be supported by the economy and other measures

Figure 4: **Euro Intervention (Sep.2000)**

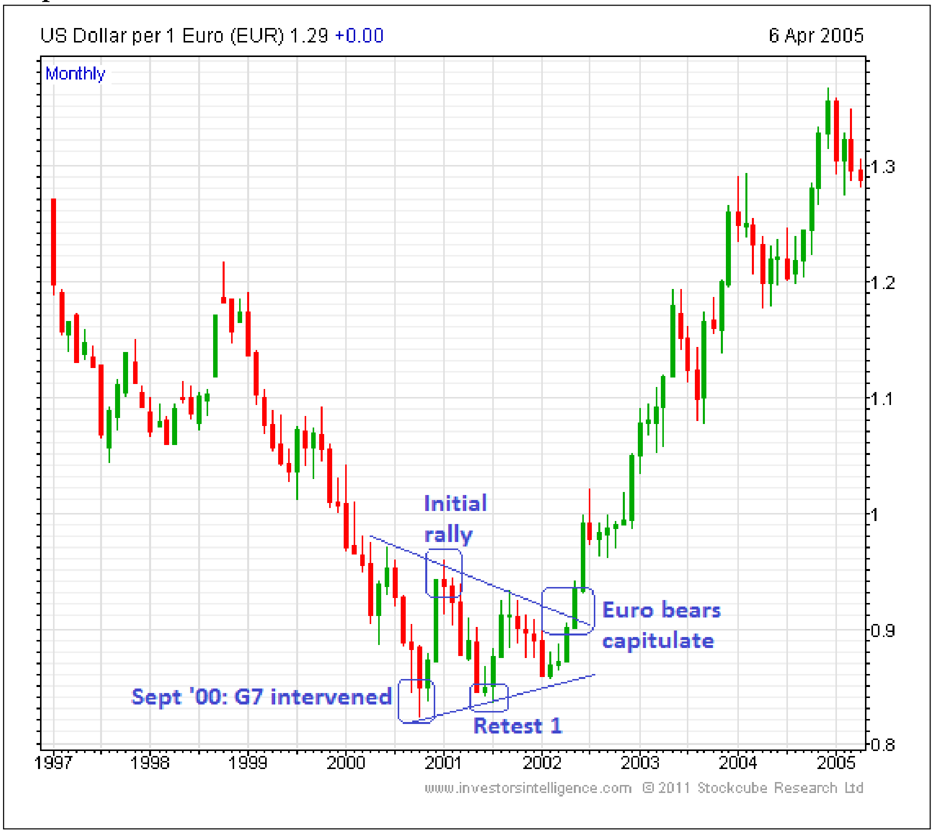


Figure 5: **The Sharp Plunge and Speedy Recovery (Mar.2011)**

Script For The Yen

Based on the above observations, the script for the Yen going forward may be similar:

1. Yen may enjoy a period of weakness after March's intervention, as traders rushed to close their large long positions. They then take a 'wait-and-see' attitude.
2. After this initial unwinding is over, Yen may strengthen again, possibly rising to the pre-intervention highs as traders test if G7 will maintain the agreement.
3. G7 battles to hold Yen's ceiling. The Yen's rate swings to and fro.
4. Yen weakens as speculators recognize their efforts are futile, creating self-reinforcing Yen decline. A bearish catalyst for Yen may emerge. The whole process may take several quarters.

Some may ask: Will G7 fail to reverse Yen's strength? After all, the Yen has been appreciating against many currencies for so long. Figure 6 shows the long-term strength of the Japanese currency. In 1972, one USD get ¥360. Now, a dollar changes hands for a mere ¥80.

Good question. But remember this. If G7 fails to succeed in this intervention, they will create a precedent. Next time they intervene, it will be a much harder task, less credible, and requires more resources. Hence, not an ideal solution. Unlike unilateral interventions, multilateral intervention is rare and G7 must make it work.

Another point worth mentioning is that Bank of Japan needs to follow up the intervention with other measures. One could be a *partial monetisation* of the Japanese Government Bonds (JGBs). For example, the domestic Japanese savings may struggle to fund the government spending in the years ahead (Figure 7). To fill this shortfall, BoJ could monetize JGBs - a process that will weaken the Yen. Right now, BoJ is resisting this measure. Weblink

Another measure is QE2. This fosters a "Yen carry trade" - a trade that weakens the currency naturally. For example, Figure 8 shows Yen's extended weakness against the Aussie Dollar during 2003-2007 when the Yen carry trade was booming.

Tactics

Tactically, I would open some short Yen positions now, to get foot in the door. But I would watch to short more Yen on strength, especially near its highs. On the **USDJPY** pair, 78-80 would be my second entry point, a level close to the initial intervention. For **GBPJPY**, short some at 130; more at 124-126 as this is the range support. For **EURJPY**, some short Yen positions may be opened at 115, to bet on a base breakout; watch to short more Yen at 110-105.

Of course, for this macro trade to work, one definitely needs ample capital to survive the choppy periods. And, lots of patience.

Figure 6: **JPYUSD's phenomenal long-term strength**

Figure 7: **JGBs: A Looming Bond Crisis?**

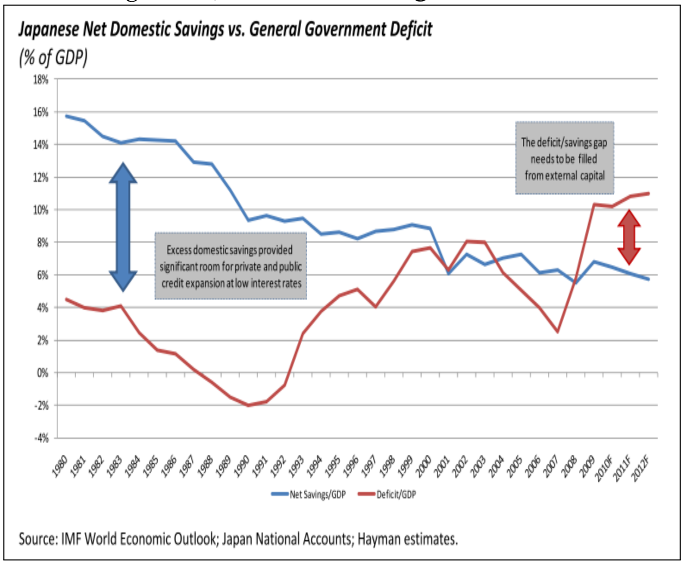
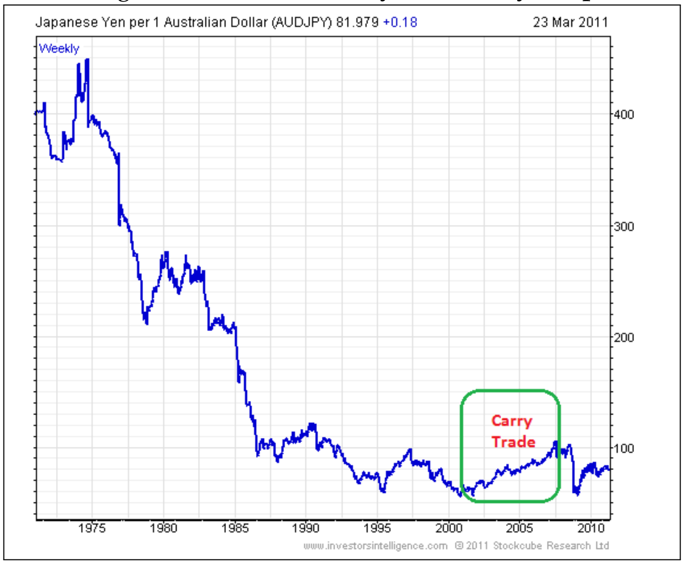


Figure 8: **JPYAUD: Carry Trade May Help**



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