Monday, February 2, 2009

Veneroso: Japan on the Edge of the Abyss

A reader chided me for not making note of the truly dreadful factory output figures released last Thursday, which showed a fall of 9.6%.

I have to confess that I have fallen into "Japan bad news" syndrome, in that I expect bad news out of Japan and therefore did not focus enough on the details. And while I do not aspire to covering every financial news story (that's what the MSM is for), the latest figures paint a grim picture, even by our new, desensitized standards.

It wasn't simply that December was truly awful, but it came on top of a nearly-as-bad November. From Bloomberg:
Japanese manufacturers cut production an unprecedented 9.6 percent last month, deepening a recession that's expected to be the worst in the postwar era.

The drop eclipsed the previous record of 8.5 percent decline set in November, the Trade Ministry said today in Tokyo. Economists predicted a month-on-month decrease of 8.9 percent....

The International Monetary Fund said this week that Japan's gross domestic product will shrink 2.6 percent this year, the bleakest projection for any Group of Seven economy except the U.K. That contraction would be Japan's worst since World War II.

Yes, the Baltic Dry Index, which some see as a proxy for international trade, picked up a bit from its near-death level in January, but that may be due to Chinese New Year-related spending.

A hedge fund correspondent sent Frank Veneroso"s latest piece, "The Yen: Will The Traders Push The Land Of The Rising Sun Off The Face Of The Earth?" which gives a sense of how bad things could get. Some excerpts:
1)The Japanese industrial production data and METI forecast was bad beyond all imagining. Industrial production might fall by 1/3 in the 12 months ending in January. It could fall in a mere four months between November and February by more than half the U.S. Great Depression decline which took almost four years.

2) Nothing like this has ever happened to a major industrial nation to my knowledge – not even during the 1929 – 1933 Great Contraction.

3) The trade weighted yen is by far the strongest currency in the world. Japan is losing competitiveness fast. Given the lags in trade matters will get worse.

4) The insane trader community continues to push the yen up as a safe haven. It is all so detached from reality I suppose they could take it higher.

Yves here. I only get the privilege of reading Veneroso now and again, but I cannot recall him taking a tone remotely like what follows:
I have been writing about an Asian black hole for almost two months now. I have been crying from the rooftops about an emerging depression in Japan. It has been as though a neutron bomb had gone off in the world. There was no one who seemed to notice, no one who seemed to listen.

Every week it gets worse and worse and worse. Today it was Japan....

THERE HAS NEVER BEEN DATA THIS BAD FOR ANY MAJOR ECONOMY – EVEN IN THE GREAT DEPRESSION. December industrial production came in down 9.6%, worse than the METI forecast. It is now down almost 21% year over year. METI forecasts a further 4.7% decline in February. The inventory to production ratio soared again. Maybe METI will be correct.

If it is, Japan industrial production will have fallen 28% (non annualized) in four months. It will have fallen by a third in about a year. Nothing in the history of major nations compares. A 28% decline in four months would be more than half of the entire decline in U.S. industrial production over the 3 years and nine months of the U.S. Great Depression.

It would be a greater decline in four months than in any 12 month period in the Great Depression in the U.S. We are literally looking at the unimaginable. (I am attaching the U.S. industrial production index from the Great Depression for comparison).

IT'S A DEPRESSION IN JAPAN – ALREADY – PURE AND SIMPLE.

Veneroso later turns to how markets are making matters far worse by pushing the yen to an unwarranted high level:
Financial markets have only one rationale in economic theory: to sift through all of the fundamental information that has a bearing on prospective returns to investments and thereby establish the set of "right" prices that will lead to an optimal allocation of real resources. Because of uncertainty and imperfect information, an optimum allocation will never be reached, but a second best allocation can. There is no other "social" rationale for financial markets.

When financial markets become nothing other than a casino, as they had during the bubble period, and market participants flee fundamentals for the witchcraft of technical analysis and other divinings of market dynamics, market participants will send prices flying about in ways that have nothing to do with prospective returns to real investments. The result will be a serious misallocation of real resources.

When bubblized markets go from a mere speculative casino to a casino in which pivotal players are driven only by the pursuit of short-run fee income by hook or by crook, you can get a more willful proliferation of "false" prices and an even worse misallocation of resources.

This is what has happened over the last ten years. The result is what economic theory says it should be: today's global financial, economic, and social catastrophe. The ruling maxim in such a regime seems to be that market participants will push prices to the point where they do the maximum financial, economic and social damage. I believe that, despite the massive losses to market participants that such behavior has now brought them, their behavior has not changed. Half a generation is enough to breed a cohort among market participants that knows of no other way. This cohort has been hurt and has had its wings clipped, but the markets have become commensurately less liquid. This cohort still runs the show.

Let us now apply this to the Japanese yen. According to the most recent economic data the land of the rising sun apparently risks falling off the face of the earth. Nonetheless, the Japanese yen soars. We hear the ludicrous mantra from all the investment banks and all of their speculator clients that the yen is a safe haven amidst the global chaos.

To my mind the real reason why the yen soars is because it soars. Except for a brief interlude in the mid 1990s the Japanese yen has been bounded on the upside by a ROUND NUMBER – 100 YEN TO THE DOLLAR. It bumped against the ceiling time and again. In recent months the unwinding of massive yen financed carry trades caused a powerful, though transitory, impetus on the part of yen debtors to panic purchase yen. This impetus broke the yen through its magic barrier of 100. Since everyone now ignores fundamentals and only looks at the witchcraft of charts and technical tools they now all have the next technical objective of 79 yen to the dollar on the brain. That was the spike high in the yen in that brief mid 1990s foray above the great ROUND NUMBER of 100. In my judgment it is this chart objective on the brain that explains yen strength today now that most of the panic buying by yen carry traders has abated.

Yves here. Veneroso does omit a couple of factor: first, that Japanese banks, unlike their US, UK, and Euro counterparts, have almost no exposure to the Anglo-Saxon debt binge. But they have their own issues. Japanese banks still have significant holdings of industrial companies. Under Basel rules, they can count 50% of market value as equity. Japanese stocks and the yen tend to move inversely, and the yen at current levels or higher has pushed the Nikkei to levels that make bank capital look less than solid. And now that the industrial side of the economy is falling off a cliff, the Nikkei is unlikely to soon even if the yen were to fall a fair bit.

Second, with Japan at tantamount to zero rates, its currency is not vulnerable to deprecation due to short-term interest rate cuts, which in theory makes it appealing. Back to his piece:

The yen is strengthening massively against currencies all over. On a trade weighted basis, it is by far the strongest currency on the planet. There are long lags between changes in currencies, exchange rates and trade. The recent take off in the yen is not yet fully reflected in Japanese exports. The lags are too long. The weakness we are seeing in Japanese exports today is in large part derived from aggregate demand weakness from its trading partners. It is the result of an earlier appreciation in the yen for perhaps 120 yen to the dollar to 110 to the dollar or 100 to the dollar. And perhaps, most importantly, it is the result of a secular trend in which its lower wage neighbors in Asia are making inroads – big inroads – into the global markets which it has traditionally dominated as an exporter.

When the long lags between the yen exchange rate change and trade and industrial production fully run their course the land of the rising sun may fall off the face of the earth. And with it will fall all the market participants who refuse to look at fundamentals and chase chart witchcraft and ephemeral market dynamics who have been the big bulls engineering that yen exchange rate that will maximally undermine the markets, economy, and social fabric of Japan.

It's a little early in the week for apocalyptic forecasts. One can only hope Veneroso is wrong, but it seems likely that the (considerable) damage of an overly high yen is already done.