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MAY 2015

Japan and the Contagion of Monetary Madness

"Now, here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!"
Through the Looking Glass by Lewis Carroll

It will not have escaped your notice that the financial markets are at a point that we, as investors, have not seen before, such that we have become used to reading of events that would have been unthinkable in normal functioning markets. It is the stuff of history books or hypothetical textbooks or perhaps more like a Lewis Carroll novel, a topsy-turvy world. The most obvious fact is that central banks have become considerably more activist and interventionist in terms of monetary policy with the first quarter of 2015 witnessing 24 separate central bank reductions in interest rates in one form or another. There is little doubt that the pace and scale of easing has increased dramatically in a short time frame. This acceleration in policy is important as it lays out a map for how the future is likely to unfold.

In spite of this monetary excess we are constantly told that inflation is subdued or non-existent and yet we know that house prices have increased dramatically in many countries and especially in our location of London. The cost of living has also risen so that we talk of the *"squeezed"* population although this is not acknowledged by the official numbers. Maybe this is what Vladimir Lenin had in mind when he said:

"The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation."

From the Chicago Tribune 1934

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Certainly there is a feeling of the casino about the London property market with international investors attracted from all over the world to take their seat at the table and play with expensive housing chips. It all has an air of unreality to it.

Recently Picasso's *"Women of Algiers (Version O)"* painting was sold for a world record for artwork at auction, selling for US$179.4 million and a sculpture by Alberto Giacometti set a record for the world's most expensive sculpture, at US$141.3 million. In spite of these record prices there were very few who questioned the sums involved perhaps because we have become used to these sorts of numbers being bandied about – they no longer shock or cause you to draw a sharp intake of breath. After all, the money being created by central banks around the world has to go somewhere and the numbers just reflect the scale and madness of the money creation.

At this point you may be thinking that you are aware of the current state of the markets, of European quantitative easing that arrived in force this January and you are no doubt fully informed about negative interest rates that apply across many European countries and along the spectrum of the bond yield curve. You will also know that the monetary under-pinning of markets was set into motion many years ago, with Alan Greenspan as head of the US Federal Reserve riding to the rescue at every crisis point – he was known for creating the *"Greenspan put"*, which simply meant that he would intervene to support markets whenever Required thereby taking away risk and allowing leveraged bets to be taken with impunity. These policies have been extended by Greenspan's successors and markets are now so geared that the world relies on a continuance of the status quo – anything else would spell disaster for the financial system on which our whole system of government, taxation and welfare is based.

However, we will now fast-forward to the last days of October 2014 when the US central bank brought its own quantitative easing (QE) and bond buying programme to an end (at least for the moment). This was on the 30th October 2014 and just one day later the Bank of Japan announced its own shock and awe QE programme to assume the mantle of chief money creator – talk about incredible timing! Although the financial pages have obviously covered this fact in some detail it is not widely understood by investors that the scale of the QE that the Japanese announced meant that each bond issued by the government's Ministry of Finance would now be purchased by the Japanese central bank with around US$60bn of money created per month in order to do so. In other words Japan announced a full debt monetisation programme and they have been publicly stated their aims in doing so. There is something deeply disturbing about complete debt monetisation as it reveals the central bank to be party to a fraudulent transaction, although this is still to dawn on most people.

The Japanese want to boost their lacklustre inflation rate to 2% and at the same time boost growth, which all seems very reasonable except that Japan has existed in a deflationary spiral for decades. This has been their policy goal for years and yet all previous monetary injections have failed to have the desired effect – why would it be different now? The fact that they were also open about wanting to devalue their currency, in order to become more competitive internationally, shows that they want to export their deflation to the rest of the world. In other words Japan has marked the moment when the gloves came off and the currency race to the bottom began for real.

Why is it a race to the bottom? Well, as each competing country attempts to devalue their own currency and maintain some sort of level pegging with each other, the downward spiral continues with no winners – all are losers as it is a zero sum gain. The Japanese move is why we have seen Europe start their own QE programme, which is also the reason why the Swiss decided to end their currency peg with the euro, as the flood of money arriving into Switzerland and the cost of maintaining the peg would have become unsustainable in the end (more on the Swiss later). Other central banks have been forced to join the frenzy of rate cutting and QE and especially noteworthy is the fact that China is also joining in. It is not difficult to understand that an export-driven country like China has to keep in step with a major trading partner like Japan and will be forced to meet the Japanese head-on.

In fact investors should maintain their focus very firmly on the Bank of Japan, because they have raised the stakes in this devaluation game and yet they are not achieving what they had intended (why should this time be different as we said above?). At their last meeting which took place on 30th April, the central bank adjusted the timing for achieving the 2% inflation target and set the new date at the end of September 2016. This is a significant adjustment because they had targeted reaching this 2% figure by fiscal 2015 i.e. around about now. Goldman Sachs said that this slip in the targeted time for achieving its 2% goal made it unlikely that we would see further easing from the Bank of Japan (BoJ) at the July meeting. They may be correct but it does not really make sense especially when you look closer at the inflation statistics. Albert Edwards of SocGen has pointed out that:

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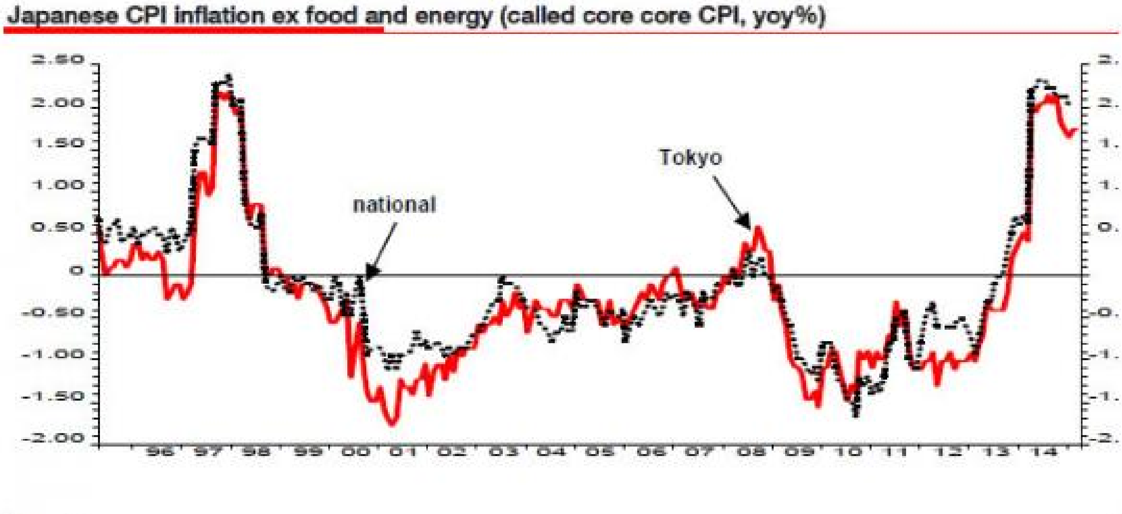
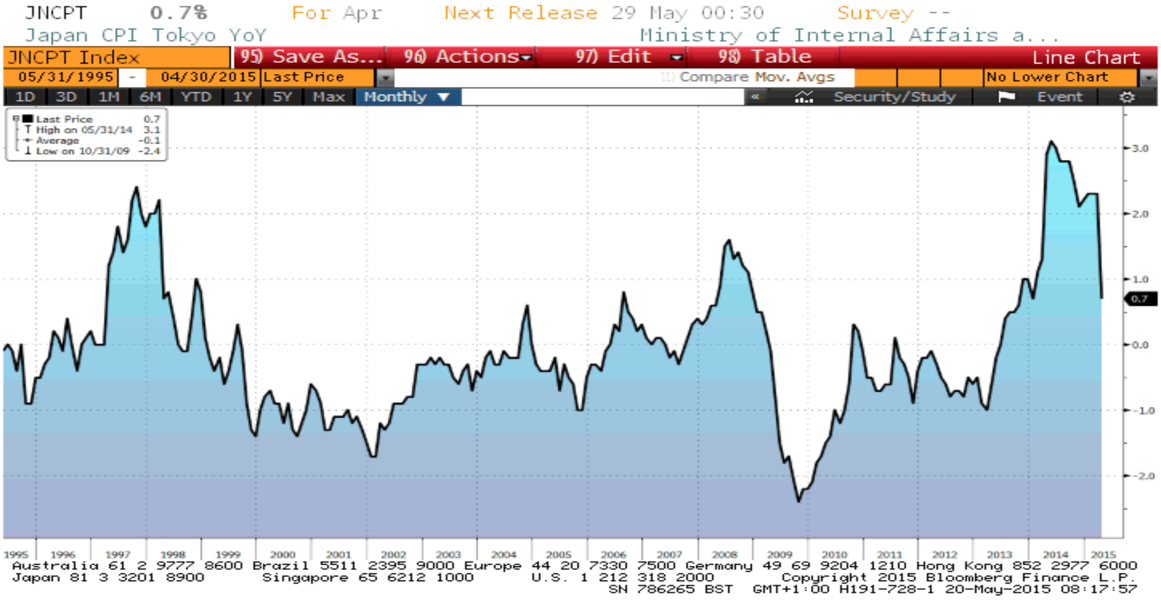
"When the BoJ started QE in April 2013 they stated that they wanted to hit their 2% inflation target for core CPI at the "earliest possible time, with a time horizon of about two years?". Well that is now! Yet most key measures of CPI inflation are set to crash to, or even below, zero in the months ahead as the estimated 2% effect of last year's VAT hike is set to drop out of the year-on-year calculations. Core CPI inflation that the BoJ targets, which excludes just fresh food, has been running at 2% year-on-year in February (March data out this Friday). But I prefer to focus of the readily available CPI ex-food and energy (known in Japan as core core CPI), which for some peculiar reason does not get followed that closely by the market. At the same time as the March national CPI is published, April's CPI data for the Tokyo area also will be released. The headline and core (ex-fresh food) CPI will be just above zero year-on-year. But the core core Tokyo CPI (ex-food and energy) is likely to have dipped below zero as VAT drops out as the rate in March was already only running at 1.7% (see chart below)."



Source: Datastream

With the national inflation numbers likely to follow the Tokyo numbers down towards zero in the coming months the Goldman view is that the Japanese have given themselves additional time to achieve their 2% inflation level. However, Edwards neatly points out that once you start on the QE route you cannot stop and Japan is beyond a point where they can change their minds and go into reverse. To shift policy now would be a dramatic failure and failure is not an option! If we consider the fiscal situation it becomes obvious that they cannot pay back the country's 260% of GDP debts (or its 140% of net debt). Inflation has to be engendered in order to pay back in devalued money, as this is the only option open to them and therefore inflation has to be created at any cost.



Tokyo CPI year-on-year monthly. Source: Bloomberg

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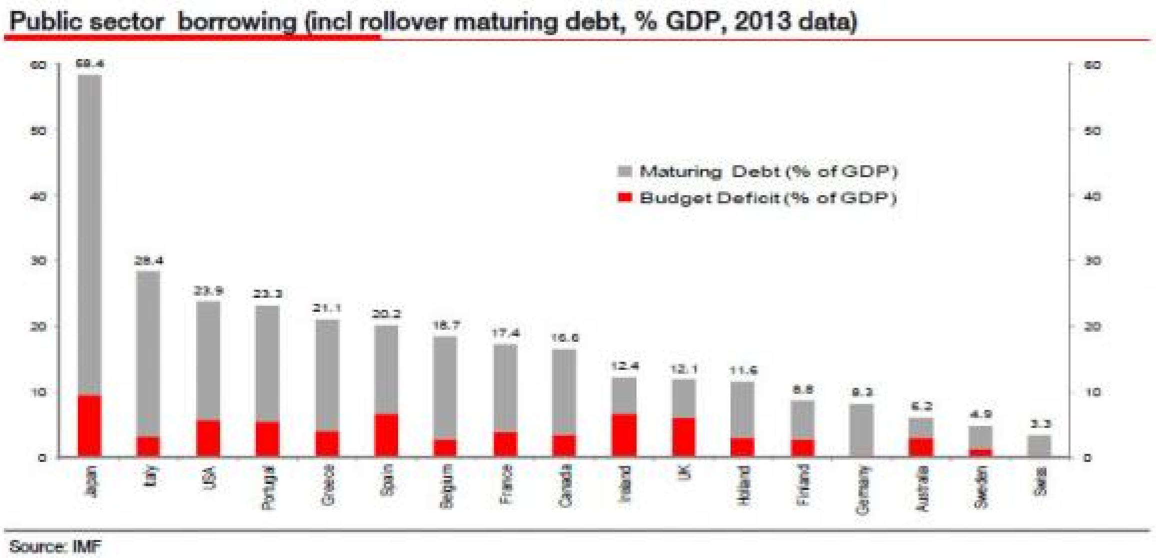
The chart below shows clearly the true enormity of Japan's avalanche of bond issuance in 2013. The problem is not the ongoing deficit racing at 10% of GDP (now down to 7% of GDP) but instead it is about the rapid roll-over of existing debt which has a short average maturity. The government has to approach the capital markets in order to roll over close to 60% debt issuance relative to GDP each year and this makes further quantitative a certainty (or else default and collapse which will either come now or later). Without QE how will the bonds be rolled forward? Debt monetisation is the only way.



The yen has been flirting with the 120 level to the US dollar after having weakened off considerably. There will be further large scale QE from Japan and with an eventual break of the long-term resistance level of 122, Edwards predicts that there will be a rapid decline to 145. This would bring pressure on other countries to reduce the value of their own currencies in order to retain competitiveness.

Japanese yen versus US dollar – targeting a weaker yen. Source: Bloomberg

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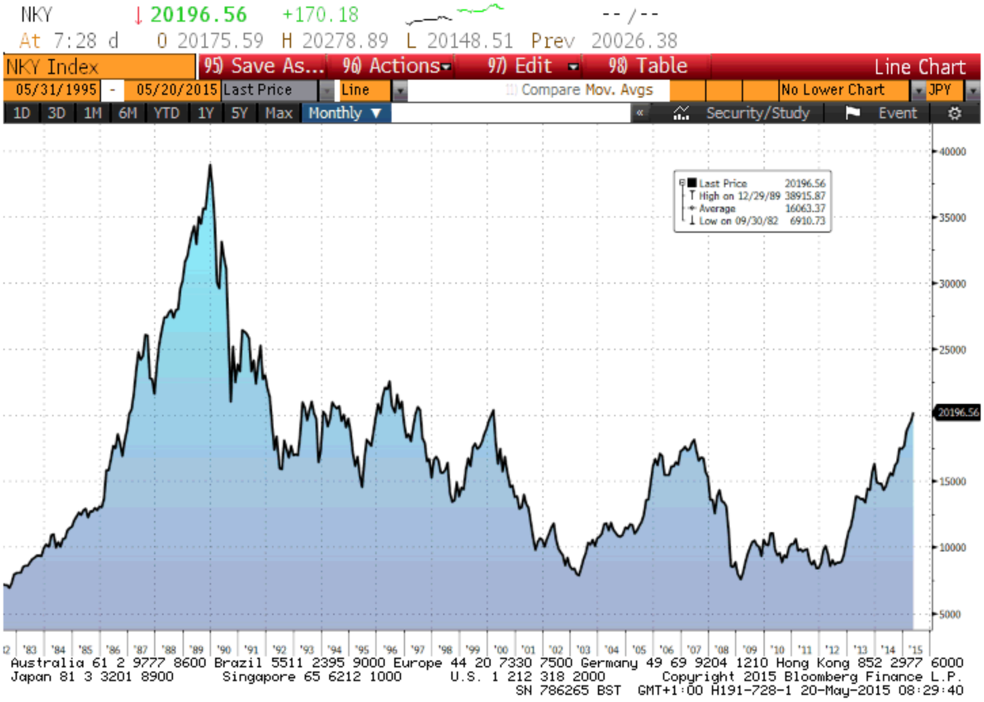
Edwards also referred back to a note that he wrote in 2010 when he said that the authorities in Japan would lose control of inflation and the Nikkei would surge to 63,000,000. Truly an extraordinary number but historically there are precedents for this to happen. Whether this target is realistic or not remains to be seen, but what is important for us all today is the stages that the markets take to head in this direction. With QE to continue one of the key factors is to recognise that the nominal value of the stock market will rally, as we have seen already. The Nikkei has hit 20,000 for the first time in fifteen years and looks to be heading higher.



Nikkei 225 Index in yen – 1982 to present. Source: Bloomberg

For investors in Japan who think that the index will shoot higher in this way it is absolutely key that they hedge the currency risk as failure to do so will diminish or even nullify the gains made in yen terms. If Japan does surprise the markets with more monetary excess (what else can they do?) then others will have to respond in kind as we have already witnessed in 2015. Therefore, if the target is for a much higher Nikkei, then equity prices will continue to be driven higher.

It is worth remembering the definition of inflation as put forward by Ludwig von Mises of the Austrian School of Economics:

"In theoretical investigation there is only one meaning that can rationally be attached to the expression inflation: an increase in the quantity of money (in the broader sense of the term, so as to include fiduciary media as well), that is not offset by a corresponding increase in the need for money (again in the broader sense of the term), so that a fall in the objective exchange value of money must occur."

Basically, the more money that is created, in excess of the demand for money, the more the purchasing power of the money will fall. All paper fiat monetary systems are destined to one fate - they must inflate or die, there can be no other way. Paper fiat's own self-destruction is inherent within its inner nature - as form follows function.

With stock markets aiming higher investors should remember the dangers of money illusion. Markets may go significantly higher but in relative terms they may not perform as well as other asset classes. To illustrate this we have added the following chart of gold, the S&P 500 index and the FTSE100 running from 2000 to the present date with each at a starting base of 100. Each has performed positively but the chart speaks for itself. Ultimately, in a period of greater monetary expansion it is the hard assets that cannot be printed into existence that will perform best of all while equities will outperform a debased currency.

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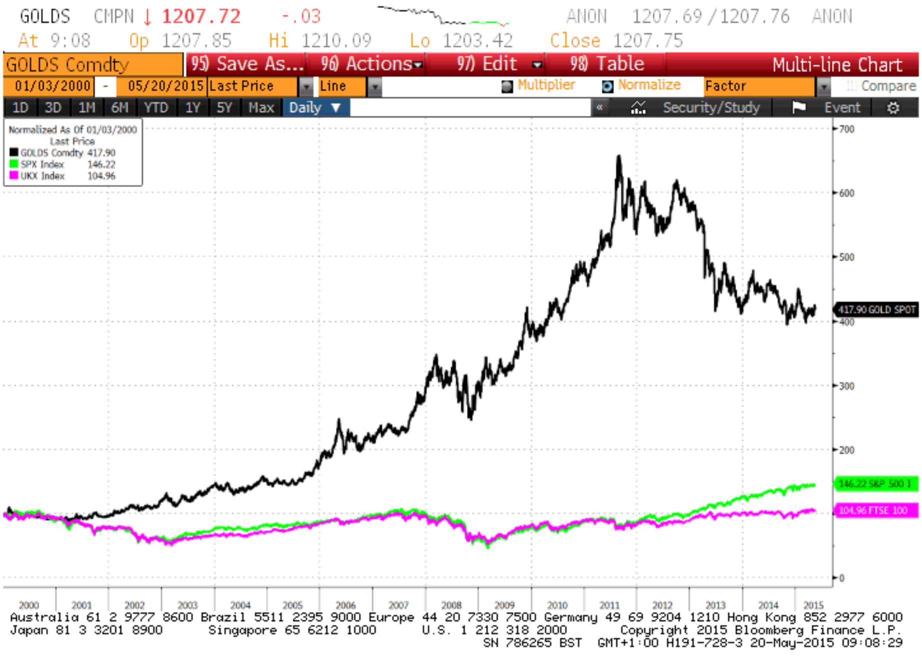

Gold, S&P500 and FTSE100 from base of 100 in 2000 to present. Source: Bloomberg

The Swiss National Bank

We did say that we will return to the Swiss situation earlier in this report and we would like to draw attention to the recent annual report for the central bank 2014.

	31.12.2014	31.12.2013	Change
Sight Deposits and call money	17 524.2	68 458.9	-50 934.7
Time Deposits	4 809.3		+4 809.3
Claims from repo transactions	14 932.0	8069.9	+6 862.1
Money market instruments	11 263.3	2 835.5	+8 427.8
Bonds	388 109.2	295 681.2	+92 428.0
Equities	73 424.4	68 229.0	+5 195.4
Total	510 062.4	443 274.5	+66 787.9

Breakdown by investment type in CHF millions. Source: Swiss National Bank

For a central bank to be engaged in the equity markets ought to be shocking although we doubt that many people are going to be surprised by this. However, is this really the pursuit of sound monetary policy or are they simply showing us the way? With 15% of the balance sheet in equities they clearly think this is an appropriate asset class for them – welcome to the new world! (They have a bloated balance sheet because of the huge amount of money spent on maintaining a currency peg to the euro. The peg is no longer in place after the bank decided that it was too costly to defend it but the legacy of the policy remains i.e. huge sums of created money).

Note the CHF 67bn increase in the balance sheet which is an increase of 15%. If you care to look into their holdings they also own close to 9 million shares of Apple, the 64th largest shareholder according to the latest filings.

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The annual report explains the selection policy for the equities held:

"The equity portfolios in the foreign currency investments were comprised of shares from mid-cap and large-cap companies (excluding banks) in advanced economies and, to a lesser extent, shares of small-cap companies. The SNB does not engage in equity selection; it only invests passively. Thus, equities are managed according to a set of rules based on a strategic benchmark comprising a combination of equity indices in various markets and currencies. This results in a globally well-diversified equity portfolio of over 5,800 individual stocks (around 1,500 mid-cap and large-cap companies and roughly 4,300 small caps). Replicating indices ensures that there is no underweighting or overweighting at operational level in individual sectors or companies. In the long term, equity holdings contribute to both a higher potential return and a more balanced risk profile of the assets."

In The Swiss central bank is at least open about their holdings but what of other central banks? What do they own on their books? We highlight this simply to emphasise that we need to understand that the money creation in the world is driving all sorts of investors into investment decisions that would never have been considered before and draw conclusions from this.

Lewis Carroll must be laughing into his hat as the world is stranger than even he could have imagined!

"But I don't want to go among mad people," Alice remarked.
"Oh, you can't help that," said the Cat: *"we're all mad here. I'm mad. You're mad."*
"How do you know I'm mad?" said Alice.
"You must be," said the Cat, *"or you wouldn't have come here."*

Alice's Adventures in Wonderland by Lewis Carroll

We look forward to speaking with you soon.

With kind regards,

Colin Moor & the SUNARES team

Risk Warning