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Monday Macro Highlight: Wacky Ideas, Wacky Trades and a Wonderful Dinner

10th September, 2018

I had the rather fortunate pleasure of being invited to a dinner recently where my dinner companions were the chief economists, heads of investment strategy and portfolio managers who ply their skills and services for the crème-de-la-crème of London's hedge funds and asset managers. We were all gathered that evening to listen to one of the greatest analysts you have never heard of. His knowledge of the world and current events was remarkable; a great storyteller who gave honest answers and asked probing questions of his audience. I walked away from the dinner very full with knowledge.

As more wine flowed, the audience loosened up and began to ask more 'interesting' questions which our host parried with ease. The debate was fun. However, things got rather wacky and out of hand when someone brought up the Japanese yen. At this point all common sense disappeared and the room was full of conspiracy theories and hidden agendas. I was rather taken aback and would not have been surprised if at some point someone had screamed, "I challenge you to a duel!".

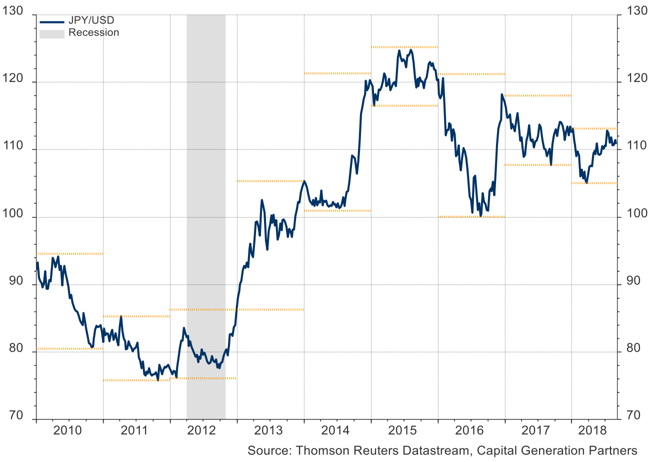
But it got me thinking. It reminded me of an academic paper from my university days about analyst recommendations. The premise of the paper goes like this: two equally qualified analysts who have access to exactly the same data and the same models may come up with two diametrically opposed views and these views are expressed as buy or sell recommendations. If my memory serves me right, this was the example: after several years of economic growth and rising inflation, the central bank continues to raise interest rates. One analyst sees this as a great opportunity to buy equities because goods prices are rising and therefore profit margins are growing. The fact that rates are rising acts as a signal that the economy is running hot. The other analyst issues a sell warning. The economy is running hot and the central bank is trying to slow the economy by raising rates, inflation will fall and so will nominal GDP. Besides, the higher interest rate means a larger discount on future dividend payments which means that equity prices should fall. Both are equally valid views and it is the difference between these views that creates a buyer and a seller and consequently, enables the existence of a market in financial assets.

Now back to the dinner. We have approximately 15 people, all of whom have access to the same research and the same data; the crux of the argument was the direction of the yen. Some believed it should go higher, others lower and one or two others sideways. Examples of the arguments and the counter arguments were such statements as "We are still in a risk-on environment" with a retort of "How can you say that? Asia excluding Japan, emerging markets and China are in bear markets", "The government pension fund is selling yen at an alarming rate to buy foreign equities", "But wait, foreigners are buying Japanese government fixed income paper", "The government is deliberately manipulating the currency to save its largest companies. I know because I was told". The room goes silent and looks confused. Our host then immediately asks us to change topic. No longer does it feel like there is going to be a duel, more like an execution.

Truth be told, many of the arguments that were presented were decent enough and very defendable. The yen has depreciated a little this year and surprisingly, it is more volatile this year than last even though it is trading in a narrower range (see chart). Regardless of what is going on with President Trump's trade war with China and the rest of the world, the yen has not rallied despite maintaining its status as a safe haven asset. The Japanese economy is at its most reflationary in years but the commitment from the Bank of Japan to continue easing for several more years does explain the currency's failure to rally. On the other hand, the government pension fund is selling yen to buy foreign equities but year-to-date, among government bonds globally, Japanese government paper is actually making a positive return for investors so there are significant flows into Japanese fixed income assets.

All said and done, no one was right and no one was wrong (except one person). What the little episode taught me was that the yen market will continue to trade just fine because there were both buyers and sellers around the table. The price seeking mechanism may not be as efficient as some would hope but hopefully someone can profit from those inefficiencies.

JPY



Source: Thomson Reuters Datastream, Capital Generation Partners

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