

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 17, No. 8

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

By Howard L. Simons (847) 304-1511

March 3, 2006

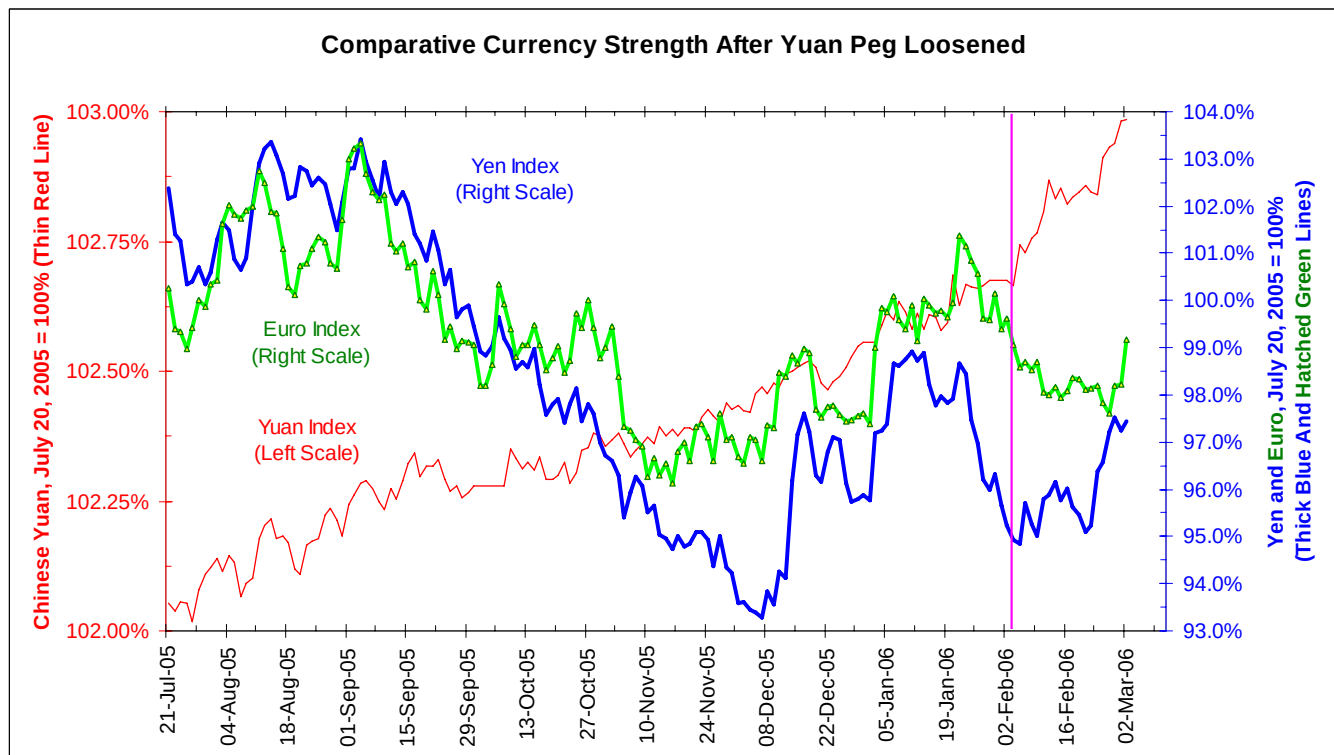
The Yen Carry Does Not Drive U.S. Note Yields

The financial panic *du jour* is an end to the Bank of Japan's quantitative easing program will lead to selling in the U.S. Treasury market as "yen carry" trades, discussed below, are unwound. Never mind that an increase of 350 basis points in the U.S. federal funds rate since June 2004 and the resulting negative carry along much of the U.S. yield curve has failed to produce higher U.S. interest rates, the first 25 basis point increase in Japanese rates will be a disaster.

We disagree. The long descent and continued low levels of Japanese short-term interest rates from 1991 onwards has met with periods of both rising and falling U.S. long-term interest rates. The present scare is simply another entry in the long history of made-in-Japan bond selloffs, none of which can withstand any scrutiny whatsoever.

The present situation is best viewed through the prism of currency trading mechanics and the competition between Japan and China, not of trans-Pacific interest rate carry mechanics. The course of the Chinese yuan is a critical part of this story.

While the Chinese yuan (thin red line) has strengthened against the dollar since its peg to the dollar was loosened last July, both the yen (thick blue line) and the euro (hatched green line) have weakened against the dollar. The chart below truncates the 100% index base date of July 20, 2005 to emphasize the yuan's path. While the yuan's rise prior to February 3, 2006 was gradual, it accelerated after this date (magenta vertical line). This date is critical; we will return to it later.



The Yen's Recent History

A recurring theme in our monthly [Treasury International Capital Statistics](#) report is how official Japanese purchases of U.S. Treasury securities, especially during 2004, best are viewed as currency interventions. So long as the yuan remained pegged to the dollar, the Bank of Japan strove to prevent the yen from strengthening too much against the dollar-yuan combination by selling yen and buying dollars.

The perceived urgency behind this trade lessened in mid-2005 as the Chinese acceded to U.S. pressure and began to let the yuan trade within a tight range and at a constrained rate. This gradual loosening removed much of the fear China would shift a portion of its massive reserves quickly into other currencies.

The world appeared safe and indeed increasingly profitable for the yen carry trade. The trade involves borrowing the yen at very low cost, swapping the yen into dollars and lending them at higher U.S. rates. The risk of this trade is a stronger yen when the loan needs to be repaid. Hedging this risk erodes the economics of the trade, and many traders try to time their hedges, hedge partially or engage in a variety of option trades to reduce the cost.

Fortunately for carry traders who did not hedge fully, the yen weakened against the dollar into late 2005

as the interest rate differential between the countries expanded.

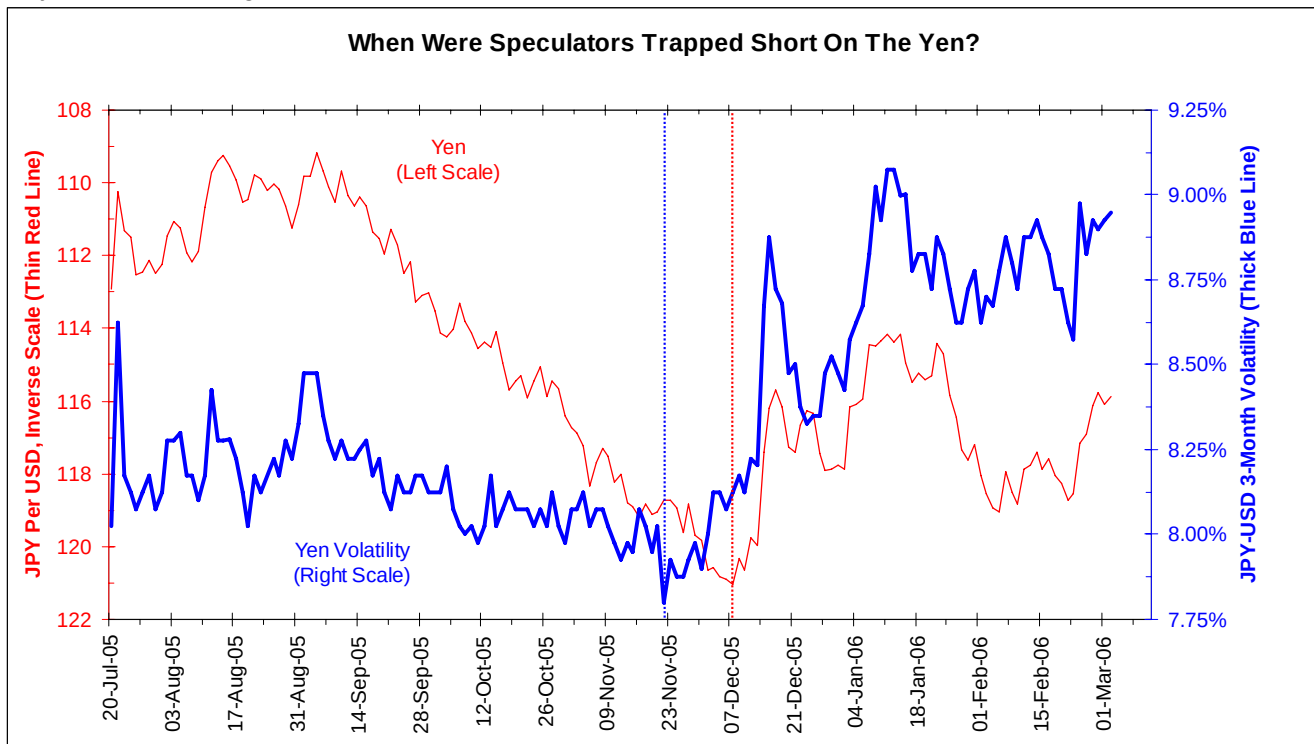
Caught Short?

This changed suddenly, as things frequently do in the yen market, on November 23, 2005. Volatility on three-month yen forwards (thick blue line) jumped higher and continued moving strongly higher into mid-January. The spot yen (thin red line, inverse scale) bottomed on December 7th. Both measures continued to firm on December 15th when the Bank of Japan first warned it might have to end its quantitative easing program.

The timing of the respective market bottoms, noted in dotted vertical lines, well prior to the news might seem a little suspicious, but that is a story for another time and place.

If the market was short the yen, as it must have been given the obvious trend, then the rise in option volatility should be interpreted as currency traders buying insurance against a stronger yen.

Option volatilities have remained near their January highs, which suggests that those short the yen fear further strength in the currency. The purchase of option protection on the yen rather than exiting the carry trade outright makes sense as the yen carry trades are still highly profitable.



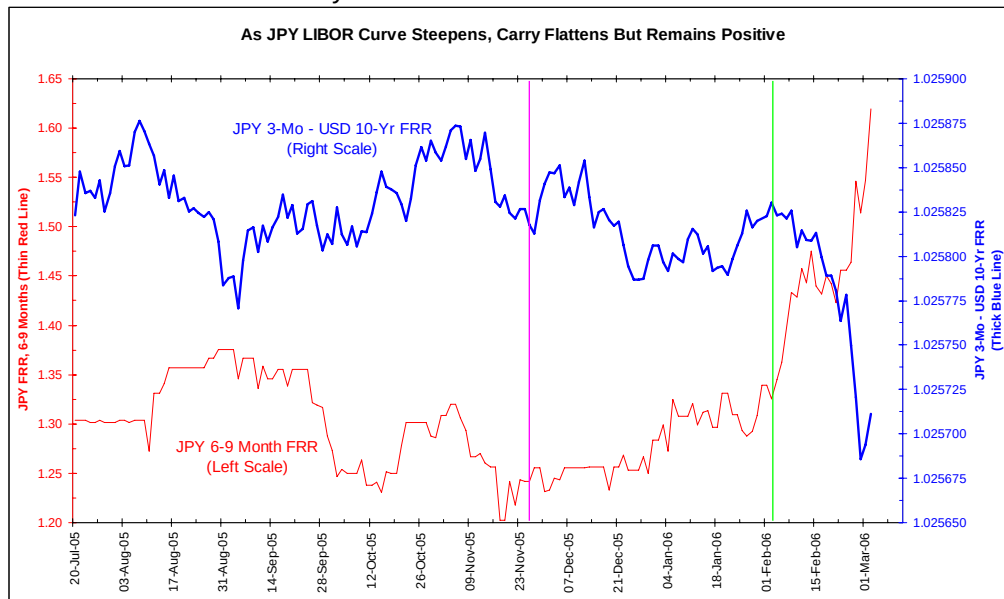
Divergent Yield Curves

We can compare the movements of different yield curves across different maturity segments via the [forward rate ratio](#) (FRR). Any threat to end quantitative easing in Japan should affect the FRR along the money market curve, especially the 6-9 month segment (thin red line, following page). This indeed occurred right at the time yen option volatility began to rise in November (magenta vertical line).

This FRR began a **steepening** which accelerated on Feb. 3rd, the same date at which the yuan's climb against the dollar began to accelerate (green vertical line). This **steepening** was accompanied by a **flattening** of the FRR between 3-month yen LIBOR

and 10-year U.S. Treasury yields (thick blue line). As the yen curve **steepened**, indicating expectations for short-term rate hikes in Japan, the yen carry curve **flattened** even as U.S. rates rose.

If our so-far correct assertion in a December 2005 [Commentary](#) that long-term bonds can remain attractive even in a U.S. yield curve inversion holds, we can expect the trade of borrowing short-term yen and lending long-term dollars to remain profitable. The FRR confirms this trade is still profitable and the jump in yen option volatility confirms traders are buying insurance against yen strength.



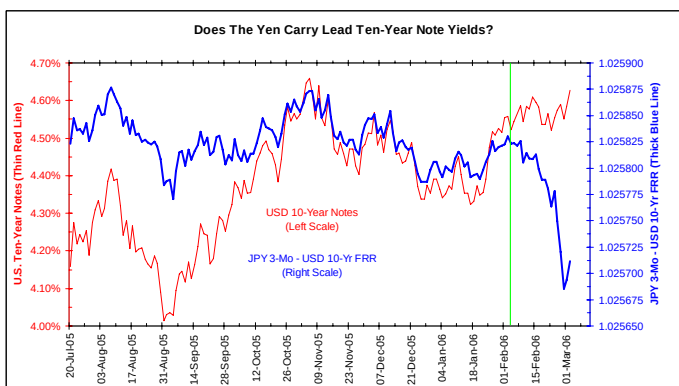
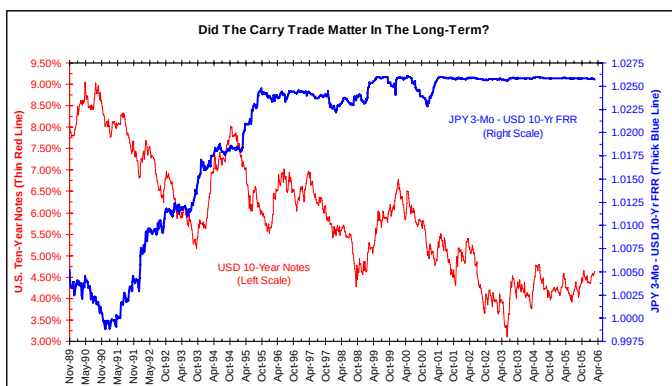
The Chinese Connection Revisited

We have one final piece of the puzzle to analyze, and that is whether the yen carry as defined by the FRR used above is related to U.S. note yields. Over the long-term, U.S. ten-year note yields (thin red line, left-hand chart) exhibit no relationship to the FRR (thick blue line).

Over the short-term (right-hand chart), the answer is mixed. Prior to the February 3rd date (green vertical

line), a wider FRR (thick blue line) and 10-year note yields (thin red line) were correlated positively. After February 3rd, the correlation became negative. As the yuan strengthened, Japanese short-term rates rose faster than did U.S. long-term rates.

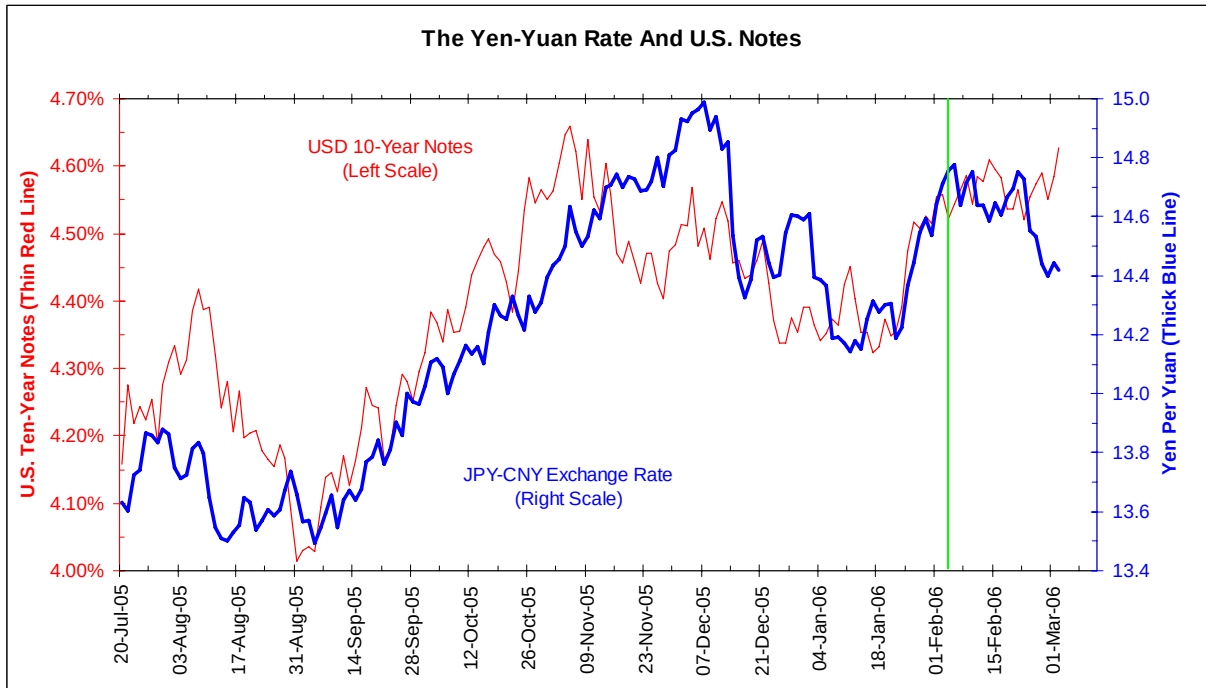
Fundamental economic relationships do not reverse on a whim. Which side of February 3rd is the correct one? The answer depends on the outlook for the yen-yuan exchange rate.



If we overlay the yen-yuan exchange rate (thick blue line below) on U.S. ten-year note rates (thin red line), we see a fairly strong directional correlation between the beginning of the yuan's controlled float in July 2005 and February 3rd. **The more the yen weakened against the yuan, the higher U.S. note rates rose. A cynic might assume the Japanese were content with this competitive devaluation and therefore felt less need to intervene in the currency market by buying U.S. Treasuries. And**

if the yen firmed, as it did after December 7th, the interventions resumed.

The yen is now firming against the yuan. With the dollar cheaper in yen terms and with the yen carry trade still profitable, why would the Bank of Japan not start buying dollars again? It serves the interests of all three countries.



Conclusion

The bond market's resilience in the face of 350 basis points of rate hikes in the U.S. and the loss of positive carry should encourage traders to stand firm in the face of the first increase in Japanese short-term rates. Instead, the reaction has been one of fear.

Currencies and bonds form a unified and multilateral system across all segments of the yield curve. As both the Japanese yield curve and yen option volatility suggest, the markets have been

discounting the upward move in Japanese short-term rates and a stronger yen. **This process began in November 2005 and accelerated in January 2006. To suggest a 10 basis point increase in U.S. note yields in March is the resulting of these previous market adjustment smacks of searching for a cause after the fact.**

We suggest the yen carry trade will remain intact and profitable. Until and unless Japan is willing to accept a stronger yen vis-à-vis the yuan, Japanese purchases of U.S. Treasuries will accelerate.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511

Fax (847) 304-1749

e-mail: research@biancoresearch.com

<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599

James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 625-1860

Fritz Handler fritz.handler@arborresearch.com

Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560

Fax (847) 304-1595

e-mail inforequest@arborresearch.com

<http://www.arborresearch.com>

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602

Daniel Lustig dan.lustig@arborresearch.com

Phone (866) 877-0266

New York Sales Office

The Chrysler Building

405 Lexington Ave

New York, NY 10174

Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326

Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

Director of International Sales (847) 756-3510

James L. Perry james.perry@arborresearch.com

London Sales Office

4 Broadgate

2nd Floor

Room 57

London England EC2M 2QY

Phone 44-207-965-4784

Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com