BANZAI !

Never have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk.

–Bill Gross, PIMCO, 14 May 2013

This week we again focus on Japan. Their stock market has been on a tear, and their economy grew 3.5% last quarter. Is Abenomics really the answer to all their problems? Is it just a matter of turning the monetary dial a little higher and voila, there is growth? Why doesn't everyone try that? And what would happen if they did?

We tend to think that the next Japan is pulling on the trigger to the next global crisis !

Will Japan Face a 'Abe-geddon' Scenario?

http://plus.cnbc.com/rssvideosearch/action/player/id/3000172782/code/cnbcplayershare

Japan grew at a 3.5% annual pace last quarter, the fastest pace in a very long time. Of course, government officials see this development as vindication of their new policies and will no doubt decide that even more of the same will be needed in the future.

Retail sales in Japan are soaring as a "wealth shock" electrifies the economy. The Nikkei index has risen 70% since November, with foreign hedge funds among the first to jump on the bandwagon. The chart below provides some perspective on that rise. I can see several similar moves in the past 20 years. If this were a one-year rather than a 30-year chart, would everyone be so eager? I'm not saying that the move isn't real. A lot of money has been made, at least on paper.

The weaker yen is already delivering a powerful punch, accounting for almost half the growth in the recent quarter. The currency has dropped 30% against the dollar and against China's yuan since August, and 37% against the euro. Currency manipulation is against the G7 and World Trade club rules. Japan, they contend, is merely engaged in a domestic policy move to try to stop deflation and kick-start the economy. So anything that happens on the currency front is a complete coincidence.

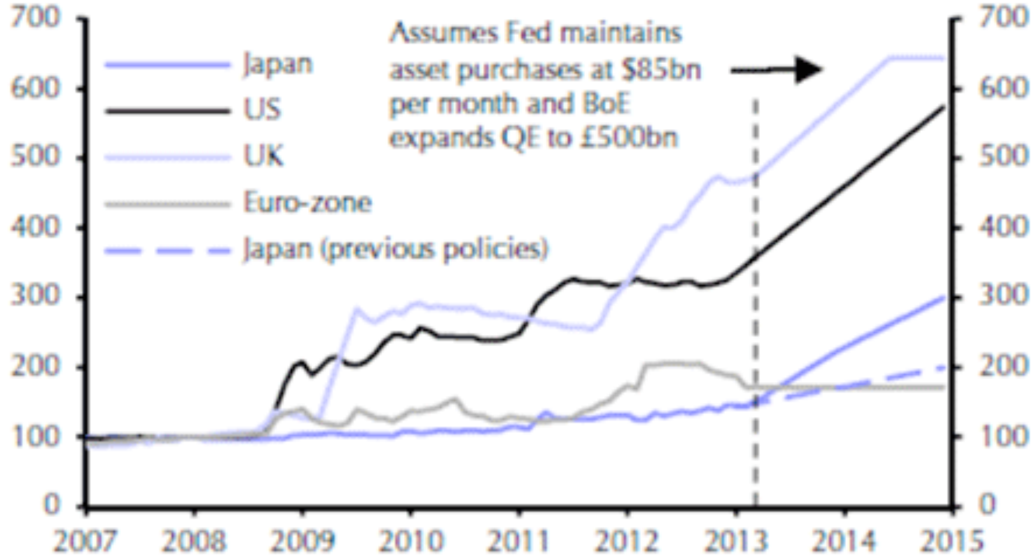
Except that it isn't.

Japan has been in a deflationary slump for over two decades. Nominal GDP has not grown. Government debt-to-GDP is now over 240%. Interest rates have been stuck at the zero bound. There has been no control of the fiscal deficit. The trade deficit has been rising. All this led me to start calling Japan "a bug in search of a windshield" a few years ago.

Prime Minister Abe has committed to a "three-arrow" approach to solve Japan's problem. The three arrows in his quiver are more-credible fiscal plans, aggressive monetary easing, and a growth strategy based on structural reform. The monetary easing is the easy part. Essentially, the Bank of Japan is engaging in almost as much quantitative easing as the US Federal Reserve but in a country 1/3 the size of the US.

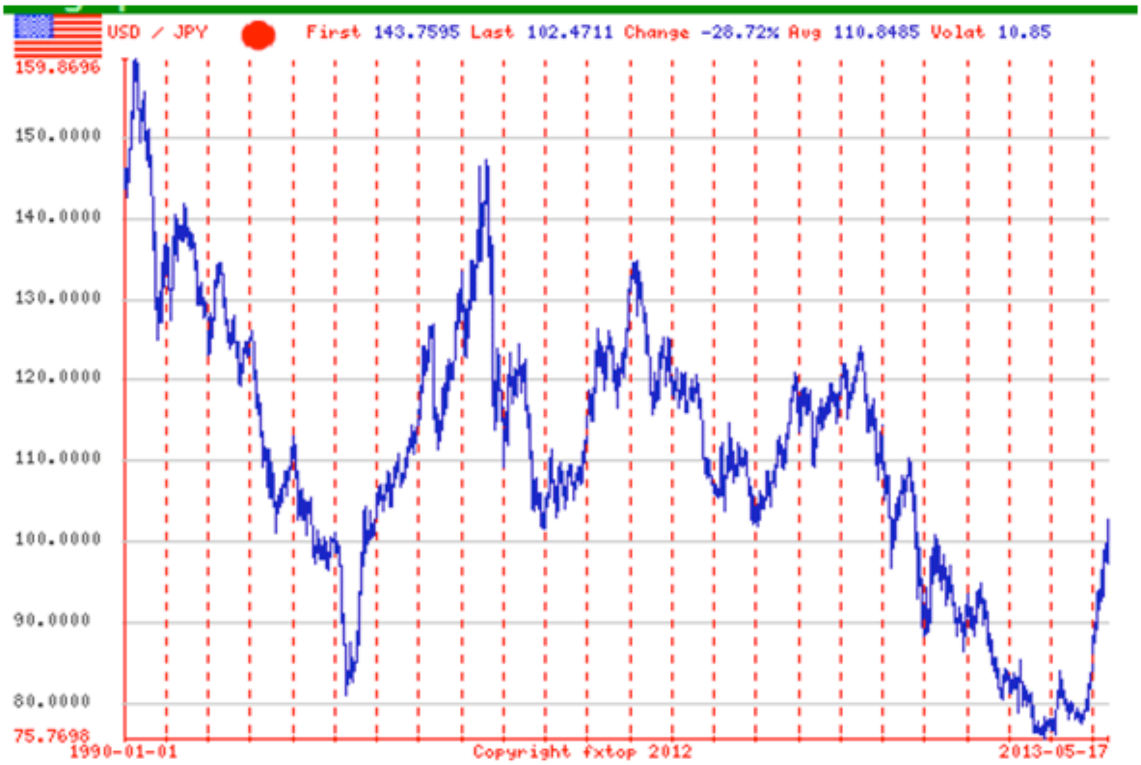
And while the headline number is rather startling, the Bank of Japan has a long way to go to catch up in the QE department. The UK and US are WAY ahead of Japan, as this chart from Capital Economics makes clear. (For those reading in black and white, the line that just reaches 300 in 2015 is Japan's current policy projection.)

CHART 9: MONETARY BASE (JAN. 2008 = 100)



Sources – Thomson Datastream, Capital Economics

Let's quickly review a few charts on the history of the yen. The first is the yen against the US dollar since 1990. Yes, the yen has fallen 35% or so against the dollar in its recent move, but it must fall another 20 yen to get back to where it was just six years ago. It traded at over 350 yen to the dollar when I was in school, back in the Dark Ages. The yen's four-decade appreciation of some 470% against the dollar puts the recent move of less than 25 yen into historical perspective.



The team at Mauldin Economics sent out this note:

Let's put the recent drop in the yen in context. The Nihon Keizai Shimbun, the main Japanese business newspaper, has reported that every one-yen fall in the yen/dollar rate will translate into a $2.7 BILLION increase in profits for the 30 largest Japanese exporters.

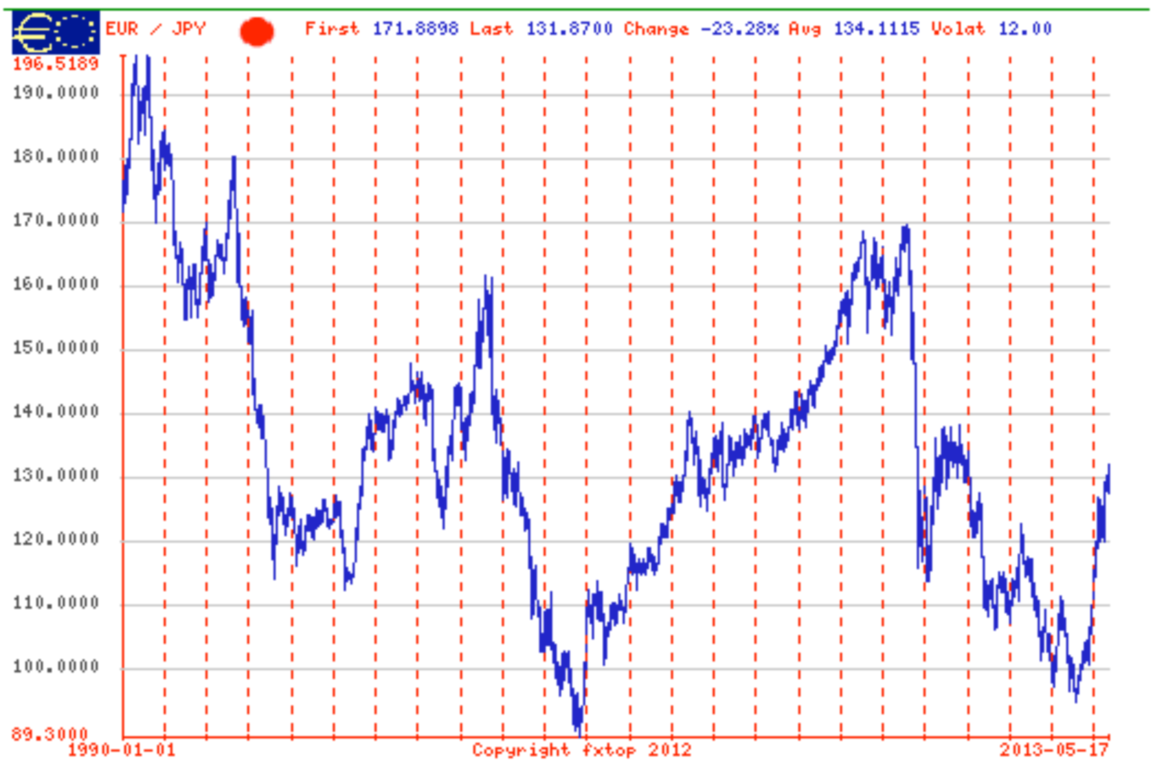
For every one yen the currency drops in value against the dollar, Toyota estimates that its profits will increase by $340 million. PER ONE-YEN DROP! Toyota reported $3.33 billion in profits last quarter, so that additional $340 million of profit per one-yen fall could send its second-half profits – and its stock – to the moon.

But those profits don't just magically appear; they come from sales. Sales that are in large part due to better terms of trade and lower costs. Those profits are from sales that might have gone to other companies based in other countries and that might have been valued in euros, dollars, yuan, or won. Which is why businesses and finance ministers all over the world are not happy with Japan.

China is becoming an ever larger part of global trade as the country continues to develop. And who exports the most to them? Japan, of course, and Japan competes directly with Korea, Hong Kong, and Taiwan for that business.

Profits in companies in Korea, Hong Kong, and Taiwan are getting hammered, as those companies have to lower prices to compete with resurgent Japanese firms. While the government of Japan will never publicly admit it, it will not be long until the yen is at 120 and then moving even higher, although the road to enyasu will get bumpier as the yen falls ever more and other countries respond. Japanese monetary policy is almost irrevocably committed to continuing to devalue the yen for a very long time at what will be an ever-increasing rate.

The next chart shows the euro-yen rate over the last 23 years. If the yen moves back to where it was just six years ago, Germany et al. are in deep schnitzel as far as their export trade is concerned.



Go back up to the chart that compares monetary bases. That will help you understand the muted response of the US and the UK to Japan's moves. We have heard from EU ministers, notably in Germany, who are very vocal in complaining about Japan. The ECB has an inflation mandate that is theoretically limiting them from quantitative easing on the scale of the US, UK, or Japan. I say theoretically because, when Germany joins France in a serious recession that is due in part to "currency tensions" (or at least that is where the finger will be pointed, because gods forbid we blame our own policies), I fully expect those very creative people at the European Central Bank to come up with a "legal" way to join the QE party. And everyone knows that when Draghi decides to stir things up, he does so with style and with a full orchestra in accompaniment. And the Bundesbank will be playing the bass fiddle and drums.

Let's Export Our Deflation

The number one export that Japan is offering is its deflation. It is trying to push deflation on every country that competes with it for trade. That is rather the point of an inflation target of 2%. It is just as if the leaders of Japan had got together and said, "We can't seem to get rid of our deflation. Let's see if we can export it." Capital Economics writes this interesting note on that goal:

Is 2% inflation achievable? This doesn't mean that inflation won't head towards 2% soon. There were two periods when inflation topped 2% even during the lost decades – when the consumption tax was last raised in 1997 and when the costs of imported oil surged in 2008.

Indeed, we expect inflation to climb above 3% in 2014 as a result of the planned consumption tax hike next year. However, the Bank of Japan will look beyond any tax effects when gauging progress towards its inflation target. While we do expect inflation excluding tax effects to pick up as well, this would largely be a result of the pass-through of yen weakness to import costs rather than any sustained increase in underlying inflation.

And that is the problem. Japan can generate inflation if it depreciates its currency. But that inflation will have particularly harsh effects on retirees. Energy and food (which are largely imported) and any other item that needs resources not found in Japan will rise in cost as the value of the yen falls. Those living on fixed incomes will be hurt the most, and that is a very large and growing part of the population of modern Japan.

Abe's reforms require significant economic growth. Japan has had none for two decades, and now conditions for growth are even more difficult. Growth in GDP comes from two (and only two) sources: growth in productivity and growth in (working-age) population. Japan's population is actually shrinking, and its working-age population is falling even faster as the country rapidly ages.

Because of the demographic problems of an aging Japan, economic growth will require even greater productivity growth than normal. Where is that going to come from? Real productivity growth (as opposed to nominal growth due to inflation) is not something you can just dial up with government policies and quantitative easing. It is incremental in nature. If you want 3% GDP growth in a country whose population is shrinking by 1%, you need 4% productivity growth, give or take. That just doesn't happen on a sustained basis in a developed country.

And even with that growth, it would not be easy to achieve 2% inflation in Japan. Roubini Global Economics noted yesterday:

However, consumer service sector price deflation, arguably the most important gauge of general price level trends, accelerated for a third straight quarter, corroborating the weak CPI data we have seen so far this year. There is still a long road to sustained positive inflation.

The first thing that jumped out at us was the negative sign in front of the private nonresidential investment growth rate. At -0.7% q/q, private investment in plants and equipment recorded a fifth straight sequential contraction, a particularly ignominious result…. Given the slack still evident in the economy through Q1 (recall that deflation worsened over the quarter), this result isn't so surprising. The pace of contraction was considerably slower than H2 2012, and we expect to see this series return to growth in Q2. Still, this persistent weakness underscores the challenges to Japan's longer-term outlook. The pace of private nonresidential investment is now more than 17% below its Q1 2008 peak. (www.roubini.com)

What is one of the primary sources of increasing productivity? It is private capital investment (and yes, government can also be a source of capital and infrastructure). And as Roubini noted, private investment fell last quarter. The growth that occurred came from currently available industrial capacity. Clearly, Abe and company have decided that the spare capacity in Japan must be utilized (which will increase productivity because of past investment) so that new investment and a new growth cycle can start.

The Hard Part: Structural Reform

But new growth will also require concerted political and structural reform, something that Japan has been reluctant to tackle in the past. They would not restructure their banks or their debt after the bubble burst in 1989, and their failure to do so has been a main cause of the economic malaise of the last 24 years. The history of Japan since 1989 has been that they avoid real reform, preferring the easier option of more government spending.

The third arrow of Abenomics is a growth strategy based on structural reform. The challenge here will be to raise growth even though the working age population will be falling by up to 1% per year over the next ten to twenty years. The government has identified several priorities, including deregulation (with a focus on the labour market, energy sector and healthcare), reforming the corporate tax regime, and trade liberalization (notably by seeking to join the Trans-Pacific Partnership). However, the jury is still out on whether this administration will be any more successful in raising Japan's productivity than its predecessors, which were also mostly led by the LDP. Announcing another fiscal stimulus for 2013 and persuading the Bank of Japan to loosen monetary policy were relatively easy wins.

What Could Go Wrong?

In summary, "Abenomics" surely represents the right mix of policies to tackle Japan's problems. But at the risk of sounding perennially gloomy, there are still a number of things that could go wrong. In particular:

i. the consumption tax hikes could derail the recovery, but if they are delayed the government would lose credibility, including with the Bank of Japan;

ii. JGB yields could take off, although we are sanguine about the increases that have taken place so far;

iii. prices could rise well before wages and other incomes, depressing consumer confidence and spending power. Indeed, few households view the prospect of an end to deflation quite as positively as businesses and investors, while in Japan's case the wealth effects from higher equity prices are relatively small;

iv. the broad money and credit aggregates could remain subdued, despite the rapid expansion of the monetary base, undermining confidence in the effectiveness of the Bank of Japan's bold policy easing;

v. companies could still be reluctant to invest and hire in Japan itself, especially if the global backdrop deteriorates and local costs surge – the latter due in part to the slump in the value of the yen;

vi. the LDP-led government could disappoint on structural reform – again."

In short, the Japanese government has embarked upon an economic experiment in Keynesian theory that is breathtaking in its promised scope. They are betting that they can gear up enough growth to overcome deflation and demographics, allow the country to balance its budget, find an inflation level that will allow the Japanese debt to shrink relative to GDP, make Japan even more of an export powerhouse, and increase productivity on a scale never before seen in a developed country.

Krugman tempted to support Abe : Not Enough Inflation

Japan is a bug in search of a windshield

The recent volatility in Japanese markets is breathtaking but characteristic of what one should come to expect from a country that is on the brink of fiscal and economic disaster. I don't mean to be trite, from a global perspective; Japan is not Greece: Japan is the third-largest economy in the world. Its biggest banks are on a par with those of the US. It is a global power in trade and trade finance. Its currency has reserve status. It has two of the world's six largest corporations and 71 of the largest 500, surpassed only by the US and comfortably ahead of China, with 46. Even with the rest of Asia's big companies combined with China's, the total barely surpasses Japan's (CNN). In short, when Japan embarks on a very risky fiscal and monetary strategy, it delivers a serious impact on the rest of the world. And doubly so because global growth is now driven by Asia.

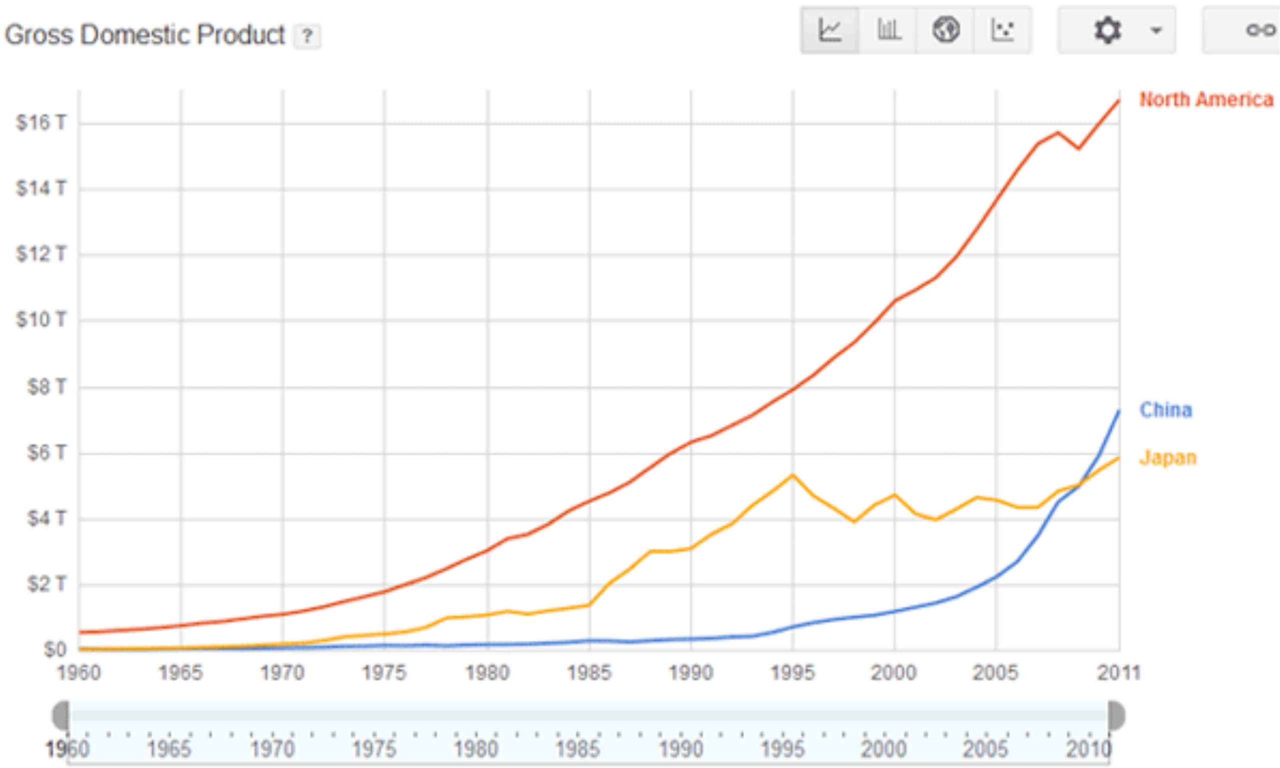
Japan has fired the first real shot in what future historians will record as the most significant global currency war since the 1930s and the first in a world dominated by true fiat money.

At the risk of glossing over details, I am going to try and summarize the problems of Japan in a single letter. First, a summary of the summary: Japan has painted itself into the mother all corners. There will be no clean or easy exit. There is going to be massive economic pain as they the Japanese try and find a way out of their problems, and sadly, the pain will not be confined to Japan. This will be the true test of the theories of neo-Keynesianism writ large. Japan is going to print and monetize and spend more than almost any observer can currently imagine. You like what Paul Krugman prescribes? You think he makes sense? You (we all!) are going to be participants in a real-world experiment on how that works out.

The Mother of All Painted-In Corners

In no particular order, let's look at some facets of the daunting task facing Prime Minister Abe and the country of Japan.

After the collapse of what might still be the largest economic bubble in history, in 1989, Japan is still mired in a 24-year non-recovery. Nominal GDP in 2011 was almost exactly what it was 20 years earlier, in 1991 (MeasuringWorth.com). You can find other ways to measure nominal GDP which indicate limited growth; but compared to the US and China, nominal growth in Japan has been paltry.



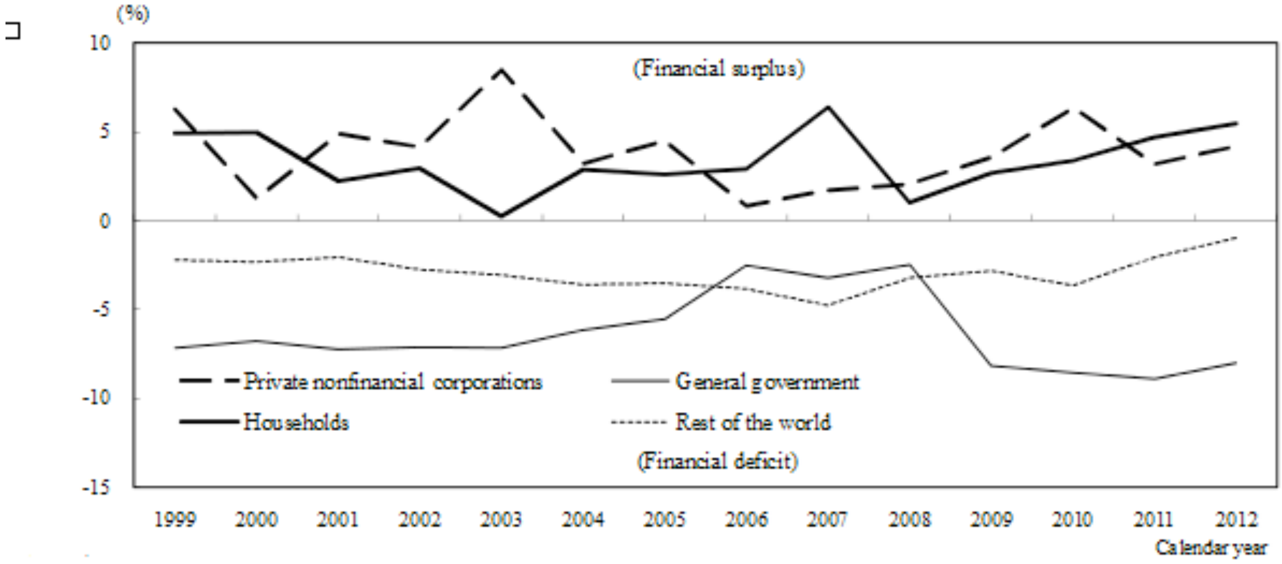
That lack of growth takes on special importance because when we measure national debt-to-GDP we use nominal GDP as the denominator. If debt is growing and the economy is not, that debt-to-GDP ratio can grow very rapidly. From the Financial Times at the end of March:

Japan's central bank governor has told parliament that the government's vast and growing debt is "not sustainable," and that a loss of confidence in state finances could "have a very negative impact" on the entire economy. The warning comes as Shinzo Abe's administration attempts to drag Japan out of more than a decade of deflation with aggressive monetary and fiscal stimulus.

In January, weeks after taking office, the government unveiled a Y10.3tn ($109bn) spending package while leaning on the Bank of Japan to buy more of its bonds – a strategy described by Morgan Stanley MUFG Securities as "print and spend". Speaking to lawmakers on Thursday, BoJ governor Haruhiko Kuroda noted that, while the government bond market has been "stable," Japan's gross debt to GDP ratio – expected to top 245 per cent this year, according to estimates by the International Monetary Fund – is "extremely high" and "abnormal".

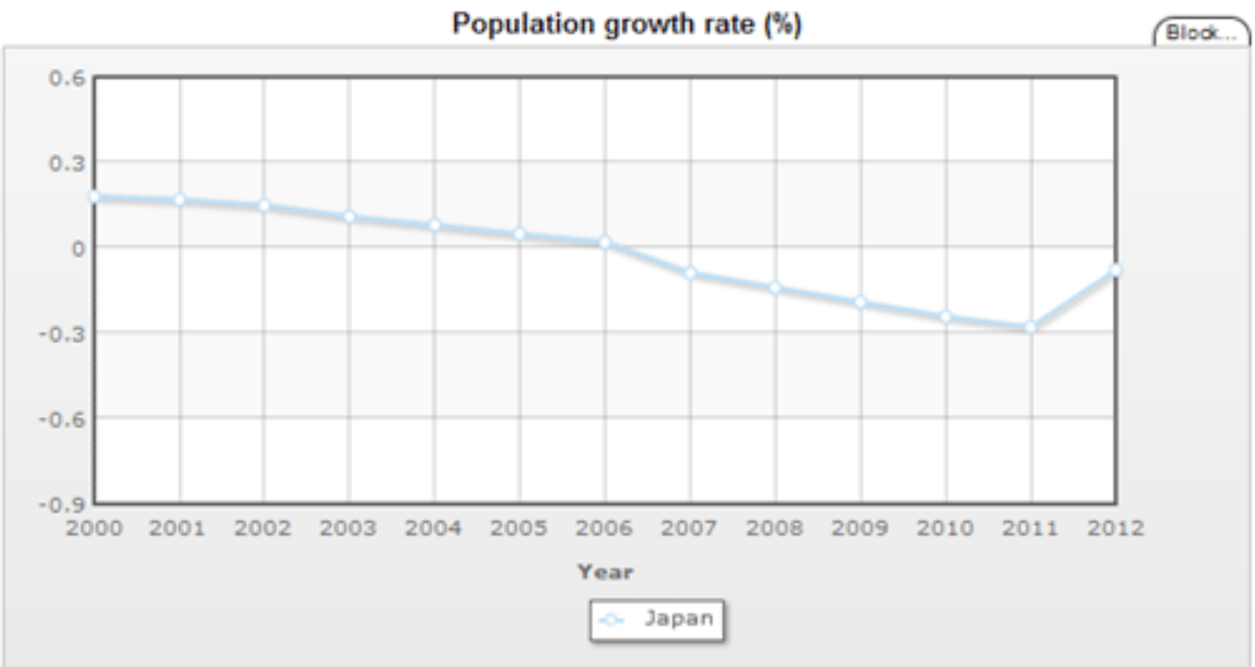
Japanese households and corporations are saving even as the government runs deficits close to 10%. As a way to compare, a 10% deficit in the US would be $1.6 trillion.

Japan

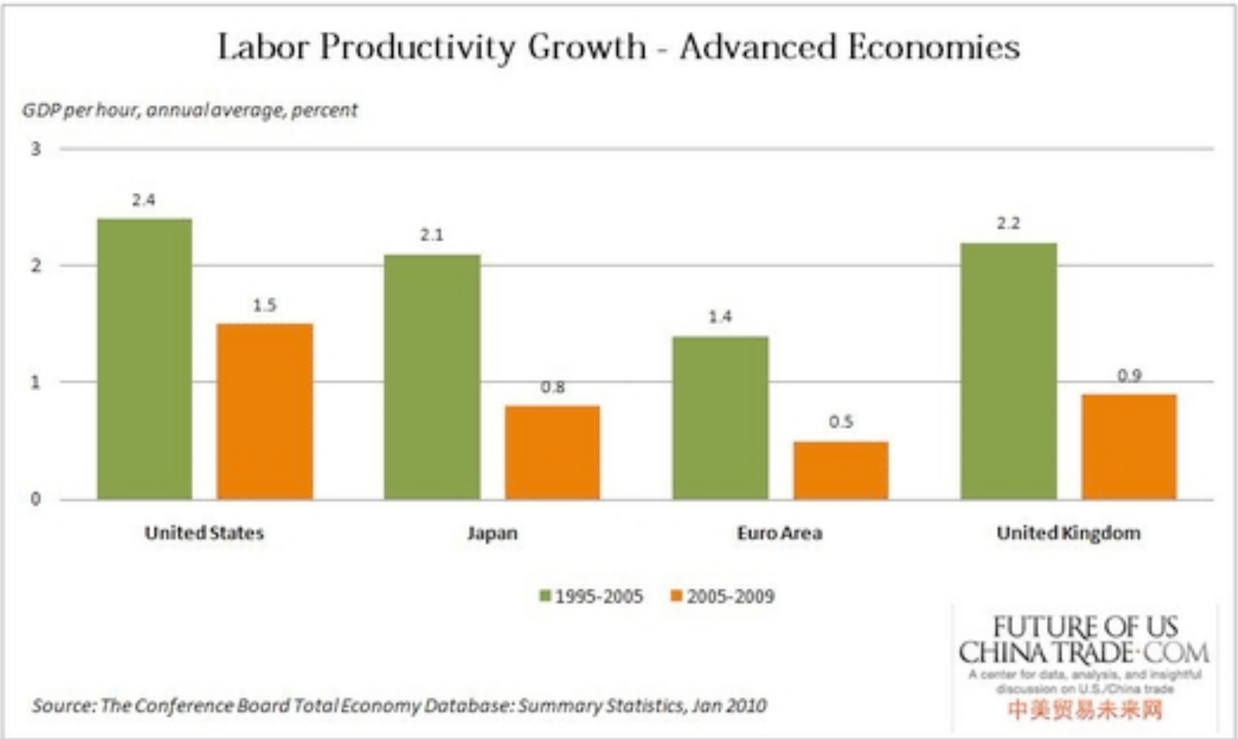


Damn the Torpedoes, Full Speed Ahead!

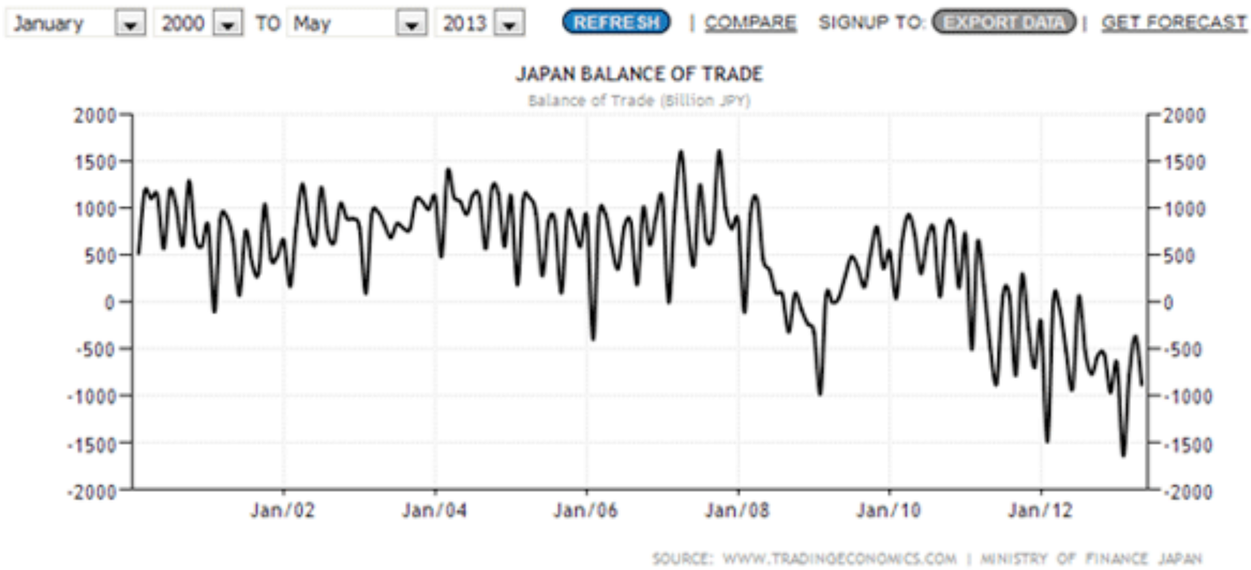
There are two and only two ways to grow an economy in real terms. You can grow your working population, or you can increase your productivity. That's it. Japan does not have the option of growing its population (or has not chosen to), and it is actually quite difficult for an industrial economy to grow its productivity. If your population is actually shrinking (see chart below) and productivity growth is less than 1%, then real GDP growth is just not possible. We are going to revisit this uncomfortable fact later.



Labor Productivity Growth - Advanced Economies (Graph)



Japan ran a massive trade surplus for years. Now it is running a large trade deficit. If you run a trade deficit and a fiscal deficit, either private savings has to make up the difference, or the central bank has to print massive amounts of money. That is an accounting identity; there are no other choices. Absent massive monetization, you suck all the available investment capital from your private economy. But Japan needs growth to get out of its fiscal and economic morass. That means it desperately needs more exports, since its aging population cannot be the source of significant increases in consumer spending. The Japanese elderly are savers and hoarders, almost by definition.



The Abe government and the Bank of Japan under Kuroda-san have targeted 2% inflation. Even with nominal GDP growth last quarter of 3.6% (annualized), the country was in deflation. They have been trying to generate inflation for 24 years. How will they now get 2% inflation? One way is to increase the cost of their imports. The problem is that Japan imports only about 16% of its GDP, according to recent World Bank data. That means to get to 2% inflation they would need their currency to drop by about 15-20% a year (as the effects are not one-to-one, but that takes a whole letter to explain). Easy enough: the yen has fallen that much since just the beginning of this year (see chart below). The problem is that you have to do that every year, on a trade-weighted basis, with all your trading partners.

This chart shows the fall of the yen against the US dollar. The yen closed around 101 today, from 75 less than a year ago. So mission accomplished, right?

Well, not so fast. Japan trades with the world, and what matters is the trade-weighted yen (just as the trade-weighted dollar is what makes the difference in the trade balance of the US). And while the trade-weighted yen is down over 20% against the average of the currencies of Japan's key trading partners, that is not as much as it is down against the dollar (see chart below). Australia and other Asian countries are just beginning to respond to Japan by lowering exchange rates and by other means, so the “easy” devaluation of the yen has already happened. The hard work is just starting, as other countries will increasingly feel forced to respond. No major country can export its deflation to the rest of the world without the rest of the world seeking to redress the balance.

For Japan to get that 15-20% a year currency depreciation for the next five years would be such a tectonic-plate shift for the world that it is difficult to express the magnitude of the task. That would put the yen at 200 to the dollar by 2018 or sooner. If you are Germany, can you deal with that? Korea? China?

It will not be long before you can buy a Lexus cheaper than you can buy a Hyundai, and a Panasonic flat screen will be half the price of a Samsung or LG. But of course Japan does not act in a vacuum. As I wrote last week,

Let's put the recent drop in the yen in context. The Nihon Keizai Shimbun, the main Japanese business newspaper, has reported that every one-yen fall in the yen/dollar rate will translate into a $2.7 BILLION increase in profits for the 30 largest Japanese exporters.

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But those profits don't just magically appear; they come from sales. Sales that are in large part due to better terms of trade and lower costs. Those profits are from sales that might have gone to other companies based in other countries and that might have been valued in euros, dollars, yuan, or won. Which is why businesses and finance ministers all over the world are not happy with Japan.

Six Impossible Things

Abe and Japan are in an almost ridiculously impossible situation. Let's look at what they have to do in the light of what we just read.

They cannot continue to grow their debt at the current rate. There is a limit. No one knows for sure what that is, but it is getting closer. And they know it. So they have to get their fiscal deficit below the growth rate of nominal GDP.

To do that they have to have both real growth and nominal growth. Real growth in a country with a shrinking population requires productivity increases on a scale not seen in any industrial country anywhere for any sustained period of time. So they have to get nominal growth, which means they absolutely must have inflation or their country will collapse in a massive debt deflation, with skyrocketing interest rates.

But 2% inflation implies that interest rates on Japanese bonds must be at least 2% if not 3% or more. That is double what they are now after the recent spike in the yield of JGBs (Japanese government bonds) from 0.5% to 1%, which sent the Japanese stock market into a tailspin on Thursday – down 7.3 percent.

As Kyle Bass and others have amply demonstrated, if JGB interest rates rise 2% in Japan, then the government must pay almost 80% of its revenues (as currently received) just to cover the interest on its debt. That is, of course, not a viable business model. Even a 1% rise would be fiscally devastating.

The Abe government plans to raise taxes. Japan's current sales tax is 5%, due to increase to 8% next year and 10% by 2015, although they will look at economic data in October to decide whether taxes will indeed rise. That is a large tax increase, and it will, of course, hurt consumer spending. But the government has to reduce its fiscal deficit at some point. The question is when and how. For two decades the answer has been "Next year." Next year may actually arrive ahead of time if the bond market starts to get nervous. Look at the drop in 10-year JGB bond prices this week (through Thursday, hat tip The King Report). While such drops have happened in the recent past, you can be sure this is cause for concern in Tokyo. There are limits, even for Japan, to what bond investors will endure.

Japanese 10-year continuous futures contract – the biggest downside trend break in at least 7 years

Reducing fiscal spending will by definition (an accounting identity again) reduce GDP or at the very least make it more difficult to attain inflation of 2%. Remember, austerity is not a punishment but a consequence of past failures to control spending.

Unwarranted Humility

The solution that Abe and Kuroda arrived at, to the applause of mainstream economists, is massive quantitative easing. Let’s look at a paper just published by UC Berkeley Professor Christina Romer, former chairwoman of the President’s Council of Economic Advisors. (Hat tip Barry Ritholtz at The Big Picture.) I will summarize, but you can read the paper here.

Basically, Romer (with a nod to Krugman, et al.) suggests that Abe and Kuroda have initiated what she calls a regime shift and that "it just might work." And then she proceeds to compare what Japan is doing to the policies of Roosevelt in the early '30s. Quoting from the introduction:

Last week, we witnessed one of the most exciting developments in monetary policymaking since the 1930s. The Japanese central bank staged an honest-to-goodness regime shift. The Bank of Japan went beyond vague promises and cheap talk. As I will describe in more detail later, it took dramatic actions and pledged convincingly to do whatever it takes to end deflation in Japan. The theoretical reasons why this regime shift may be important are well understood by economists. Persistent deflation and anemic growth suggest that Japan continues to suffer from a shortfall of demand. But their policy interest rate is already at the zero lower bound. Furthermore, riskier, long-term rates are also very low – suggesting that unconventional policies such as large-scale asset purchases are unlikely to do much to further reduce nominal rates. As discussed by Paul Krugman, Gauti Eggertsson and Michael Woodford, and others, if unconventional monetary policy can raise expected infl ation, this can push down real interest rates even though nominal rates cannot fall. This, in turn, can raise aggregate demand by stimulating interest-sensitive spending.

And in the conclusion she suggests that bold policies must be aggressively pursued:

In a recent paper, David Romer and I discuss that such views are potentially very destructive. We show that what are widely viewed as the two largest errors in Federal Reserve history – inaction in the wake of banking panics early in the Depression, and inaction in the face of high and rising inflation in the 1970s – were both borne of unwarranted humility. Fear that policies might not work or might be costly led policymakers to conclude that the prudent thing was to do nothing. Yet there is now widespread consensus that action would have been effective in both these periods.

We have nothing to fear but fear itself: this is the heart of Keynesian thinking. And if it is good for Japan then what of the rest of the world?

Earlier in the paper, Romer writes, after discussing recent US Federal Reserve policy actions:

But the truth is even these moves were pretty small steps. With its most recent action, the Fed has pushed the edges of its current regime. And I am sure that given the opposition in Congress and the difference of opinion within the FOMC, even those measures were a struggle. Nevertheless, the key fact remains that the Fed has been unwilling to do a regime shift. And because of that, monetary policy has not been able to play a decisive role in generating recovery. To paraphrase E. Cary Brown's famous conclusion about fiscal policy in the Great Depression: monetary policy has not been a strong recovery tool in recent years not because it did not work but because it was not tried – at least not on the scale and in the form that was necessary to have a large impact.

Wow. Double wow. Breath-taking triple wow. Read this paper. Absorb it. And then bookmark it and come back in five years. I give Romer this: she shows no unwarranted humility in this paper. She goes "all in" in backing this Japanese policy.

But I do agree with Professor Romer about one thing: this is the most serious and radical economic experiment undertaken in my lifetime by a major economic power. And the rest of the world must pay attention. If this has succeeded in working five years from now, if Japan is growing and its debt relative to GDP is shrinking and the rest of the world has allowed the yen to drop in half, then let me state here and now that I will have to rethink my understanding of economics.

But ironically, if I were Abe and faced with the question, "What do I do now with what I have inherited," I am not sure that I could do anything else. He is a politician and a Japanese one at that. The Japanese are serious hometown players, as are the citizens of most countries. You do what is best for your hometown and don't worry about the neighbors all that much. You want to stay friends, but your first responsibility is the hometown.

If you're Abe, what are your choices? They are nothing but ugly. Perhaps the best of a very, very ugly-bad lot is that you have to try and inflate away that debt. Monetize as much as you can and then just "poof" it away. You destroy your currency in the process, but you have to destroy something. And maybe your derring do gives your exporters a boost and a competitive advantage, so you at least salvage that. Why not export your deflation? And then gamble that maybe Romer and Krugman are right. It could work! Damn the torpedoes, full speed ahead!

There Is No Turning Back

Now, some investing consequences. Let me repeat what I wrote months ago, that the largest single position in my personal portfolio, since January 1, is short Japan. Let me clarify that, as I am not short Japanese companies or businesses but rather short Japanese government economic policies. (I am executing that trade primarily through hedge funds, although there are ways to explore that trade in a more conventional manner.) I think the yen will still be under pressure for some time (this is a long-term trade) and that Japanese interest rates will be under pressure. But do NOT run out and short JGBs (see below)! First, let me agree with Joyce Poon of GaveKal, commenting on the recent violent moves in the financial markets in Japan (which echoes what I heard from Louis Gave at my conference):

No doubt many investors are wondering if this is the first hint that the emperor in fact has no clothes – that Abenomics is just a flash in the pan. We think it is just a reminder that riding a bull is never smooth; surely more market drawdowns lie ahead. But as Anatole recently wrote the fiscal and monetary expansion already implemented has been so extreme that there is no turning back from Abenomics. Unless Japan can achieve much faster economic growth, Prime Minister Shinzo Abe's radical experiment with macroeconomic stimulus will create a debt and monetary overhang so huge that it will bankrupt the financial system and quite possibly trigger hyper-inflation. This is why Abe's radical reforms will go forward, and in time aggressive monetary policy will be need to be backed up by larger structural reforms.

This brings us to a second, and potentially more dangerous, type of volatility in Japan: in JGBs. With Japanese banks holding huge JGB portfolios, a sharp rise in yields would generate capital losses. Indeed, according to the Bank of Japan, a 100 basis point increase in interest rates across all maturities would lead to mark-to-market losses of 20% of Tier 1 capital for regional banks and 10% for the major banks. As banks play a key role in the transmission mechanism in quantitative easing and reflationary economics, a damaged bank balance sheet can significantly reduce the effectiveness of Abenomics.

One problem is that the BoJ's purchase operation is also crowding out other players in the JGB market, and this amplifies interest rate volatility. The reduction in JGB liquidity means that financial institutions are finding it difficult to quickly find counterparties to buy or sell large volumes of the bonds. The risk is that higher interest rate volatility could in turn induce further JGB sell-offs, completing a vicious circle of capital destruction for the banks.

To prevent a catastrophic crash of the JGB market, more BoJ action is needed. This is likely to include increased flexibility in liquidity injections, a broader range of purchase tactics and better verbal communication with the market. But shrinking liquidity, higher volatility, and even potential spillovers from rising yields globally, could continue to put upward pressure on JGB yields. Remain hedge !

Let me repeat the most important sentences, with which I totally agree:

...The fiscal and monetary expansion already implemented has been so extreme that there is no turning back from Abenomics. Unless Japan can achieve much faster economic growth, Prime Minister Shinzo Abe's radical experiment with macroeconomic stimulus will create a debt and monetary overhang so huge that it will bankrupt the financial system and quite possibly trigger hyper-inflation. This is why Abe's radical reforms will go forward, and in time aggressive monetary policy will be need to be backed up by larger structural reforms.

The government of Japan has no choice. They are painting themselves into the Mother of All Painted-In Corners, yet they must continue to paint or collapse. They have fired the first shot in what will be the first real currency war of our lives, not the little sandbox versions we have experienced so far. There is NO historical analogy. None. The last major currency war, in the 1930s, happened when the world was largely on a gold standard. We now live in a world awash in fiat currency. Can Europe sit by and watch the yen fall 50% from where it is today? Will Germany allow it?

What will China do? If they respond in kind, they risk inflation. If they don't, they risk losing export sales and jobs. Malaysia is on a borrowing binge to finance its real estate growth. Indonesia? And Korea certainly can't sit idle and watch its chaibols (the Korean version of the Japanese keiretsu) get hammered, can it?

For a time, then, major central banks are going to have to sit on their hands and do nothing, as they can't stop printing or using monetary policy to improve their internal economic dynamics. Japan is in reality just catching up in terms of quantitative easing-

Japan intends to export its deflation. And with the approval of the economic cognoscenti, it is going to do so in a manner and to an extent that the world has never experienced before. The old saw of "in for a dime, in for a dollar" will be the rule of the day. Japan cannot back down without suffering massive financial upheaval. I think they are likely to suffer no matter what they do, but this is the path to suffering they have chosen. So be it. All we can do is try and stay off the dance floor when the elephants are dancing. Or find a really good dance partner who knows the moves and follow! This will not be an environment in which to take dancing lessons. The Arthur Murray Dance School does not know the steps that will be in vogue at this party.

I can't with any reasonable certainty tell you how all this will play out, as we are simply in uncharted territory. But I do know I want to own assets that central banks can't print. Their actions will affect those assets, to be sure – we are going to see more volatility than we would like. But that creates opportunity. Of course, we are going to continue to look at the implications of these developments in future letters.