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MARKET CALLS

BoJ Watch: Putting on the JGB Short Trade

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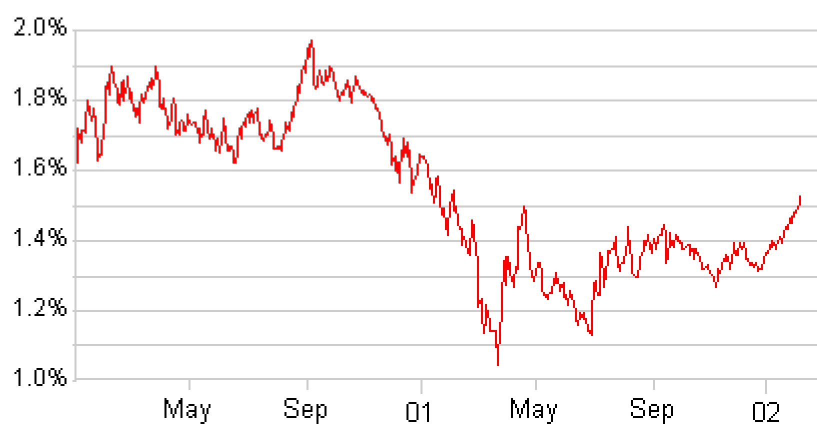
The 10-year Japanese government bond has now pierced the1.5% plateau for the first time in a year, and in the midst of Japan's increasingly frightening economic and financial meltdown, appears poised for significant additional near-term losses. Press reports are tying the rise in JGB yields to the mounting woes of the so-called "reformist" prime minister **Junichiro Koizumi**, whose plunging popularity has helped send Japanese equities to fresh 18-year lows over the past few sessions. Over the course of Japan's long economic nightmare, however, government debt has often served a safe-haven function during periods of high stress. The fact that Japanese bonds are eroding in the face of such strains suggests instead that the selling pressures on JGBs are repelling even the flight-to-safety bid that would normally be seen. We see conditions as ripe for shorting the JGB.

As we have suggested since late November, long-term JGBs posting such abnormally low yields could only be supported by expectations that Japan's long-running monetary deflation will be sustained indefinitely. To be sure, Japanese authorities continue to send conflicting and at times confusing signals about whether they are prepared to overtly countenance the aggressive additions to yen liquidity that would conclusively break the back of the deflation. At the same time, though, it is becoming apparent that while an optimal anti-deflationary policy course has not yet been set, a mix of supply and demand factors are marginally easing the yen's scarcity premium.

10-year Japanese Government Bonds
Yield, daily close



On the supply side, the **Bank of Japan's** balance sheet has expanded consistently at double-digit annualized rates since it began using "quantitative" targets for liquidity injections last spring. It seems a "tipping point" may have been reached in which the BoJ's reserve additions are finally creating a modicum of excess liquidity. And while there is little good that can

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otherwise be said about it, Japan's precipitous economic descent at least is providing a measure of relief from excess yen demand. In that regard, there is also a sense that given the increasingly dire straits confronting the deflation-wrecked Japanese financial system, monetary authorities could soon be faced with little choice but to flood the market with yen liquidity to forestall outright systemic implosion. Such a calculation undoubtedly is contributing to a marginal decline in demand for yen balances.

All in all, in other words, a shift against expectations of sustained price-level deflation is surfacing, of which the recent sell-off in Japanese government debt is one early indication. Although displaying considerable volatility in recent sessions, the yen/dollar rate at current levels just above134/$ is near 40-month lows and seems unlikely to reverse directions any time soon. And, helped by the surge in dollar/gold to levels above $290 per ounce, the yen price of gold – at just below Y40,000/oz. – is within about 5% of the level we posit as representing rough price-level stability. Whether Japanese policymakers would be prepared to maintain that level if the dollar price of gold retreats again to its earlier ranges below $280/oz. is open to serious question. For the Japanese "smart money," though, yen/gold at these prices appears to have strong appeal, as Japanese buyers have been among the most active gold market participants the past few weeks. For yen-based investors, of course, a bet on gold is primarily a bet against the home currency. For our purposes, that looks to be a bet that will best pay-off by taking a short position in JGBs. TM