THE DECOY OF THE FALLING DOLLAR REVISITED

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I have received the following letter from a reader of my column:

Mr. Fekete:

I have been reading your work for a number of years and always look forward to your thoughts, particularly when they run counter to conventional wisdom. In your latest piece you suggest that the falling dollar (or rising yen) actually strengthens the yen carry trade. My chartwork argues otherwise, and your logic escapes me. I would welcome clarification of one particular paragraph of yours, especially on the last sentence that, I believe, is central to your analysis. You wrote:

> „This is where I take issue with conventional wisdom… What they miss is the fact that the bear market in the dollar actually helps rather than hurts the yen-carry. The terms of trade for those who sell yens to buy dollars is improved immensely by the fall of the dollar. The yen carry trade can be described as arbitrage with short leg in the yen bond market and long leg in the dollar bond market. Profits on the long leg increase faster than losses on the short as a result of dollar devaluation."

I don't follow this. Yes, borrow yen at 1 percent and go long dollar bonds at 4 percent. But over the holding period you lose on the dollar's depreciation.

I agree that a falling dollar means that over time you can buy more and more dollars with borrowed yens. But for borrowers, who short the yen, the ever more 'favorable' terms of trade work the opposite way in the end. It costs you more and more dollars — and then some — to buy those yens back and repay the loans (assuming that finally you do close the trade).

Concerning the last sentence quoted, it is true that as long as the US longer term rates stay low or, better still, fall further, there are capital gains that might override forex losses. You don't explain it that way, though, so I am not sure that this is what you mean. If so, it is not the falling dollar that assists the carry, but the falling US interest rate. And I question whether long rates are are as closely tied to forex rates as short rates sometimes are.

Appreciatively,

Peter Bond

Dear Mr. Bond:

The paper of mine you have quoted from was written two and one half years ago. You take me to task for saying that, contrary to widespread belief, the weak dollar helps rather than hurts the yen carry trade, adding that your chartwork argues otherwise.

The fact is that during the past two and a half years the dollar lost quite a bit of ground, yet the yen carry trade was not visibly hurt. If anything, it was further emboldened. In other words, my 2005 insight turned out to be correct. The question you should ask is whether there is any explanation, other than mine, of the conundrum that dollar bonds do not weaken, and may even strengthen marginally, in the face of the falling dollar.

Please notice that I am not an investment advisor and I am not writing manuals for the benefit of small time bond and forex traders. I am writing for the benefit of the intellectually curious, who want to understand the markets as they unfold under the global regime of irredeemable currencies. In doing so I am painting a broad-brush picture, ignoring minute details such as the question how bond bulls cover their forex risks through dynamic hedging or otherwise.

You would be justified to ask the question whether I still stand by my 2005 analysis, or whether I see reason to modify it in view of events in the interim. My original paper had the title „The decoy of the falling dollar", suggesting that the real show is the bond market. The forex market is a side show at best. Neither market is free, far from it. Both markets are dominated by extremely powerful players (among which you can count China with a better than one trillion dollar stake). They are the puppet masters of the other show in the forex market. It is not in their interest, nor will it be in the foreseeable future, that the dollar be scuttled. Controlled decline, yes; collapse, no. They want to, and can, make sure that their long position in dollar bonds will continue to be profitable enough to cover losses on their short position in yen bonds. For these reasons I stand by my predictions of 2005. The bond bull is still alive and kicking. It may get ready to resume his charge. The dollar is sick, yes, in all likelihood terminally so. It is on the life-support system for the time being by a powerful clique of bond bulls that can well afford to keep the comatose dollar alive. They will pull the plug when it is no longer profitable for them to continue the yen carry.

The main point is that the sliding dollar helps rather than hurts the yen carry trade. *That's just the clever part of it*, which confounds even experts such as Pimco's Bill Gross. As I said in my 2005 article, the terms of trade for those selling yens to buy dollars is being improved as the dollar falls. Never mind how the arbitrage will be unwound eventually. As long as the dollar is not collapsing it hardly matters. Positions can be rolled over, while forex losses are taken care of through dynamic hedging. This is a cat-and-mouse game. Cats are the bond bulls. Mice are the dollar bears. You guess who will gobble up whom in the end.

Please don't misunderstand. This is not an investment advice to you, or to anyone, to buy US dollar bonds. I am merely sharing my insight into the operation of the deceitful world of irredeemable currencies. In the end, like in games children play, "they all fall down". But there are differences. Differences in the timing of the fall, and also differences in the way they fall. Some may fall hard on a rock; others may have a soft-landing on a pillow.

Is it possible that I am wrong and the dollar will succumb sooner rather than later? While not impossible, it is unlikely. Why? Because the clique of the bond bulls has a vested interest in the charade to continue. Most importantly, it has the power to make its wishes stick. Its members were lucky enough to start riding the charging bond bull early. Make no mistake: China has been in it from start, since 1981 when US interest rates were over 16 percent. Don't be fooled: the one-trillion-dollar kitty is not all trade surplus. So much of it is profits from China's bond trading portfolio. Other bond bulls are similarly sitting on mountains of paper profits. In spite of appearances, the Chinese are not stupid. They will keep the game of musical chairs going. They are calling the shots. The music will stop when they stop it. But not yet.

The yen carry trade in my view still has a long way to go. It is the main prop that keeps the dollar from collapsing. It may even cause the price of US bonds rise some more. Why? The Bank of Japan will continue to feed the yen carry because it could not afford to let interest rates rise for fear of bankrupting the Japanese government, to say nothing of the Japanese banking system. The Fed will feed it because it is cornered: the alternative is 'sudden death' for the dollar. The yen carry represents the only steady and reliable international demand for dollars since America has effectively de-industrialized itself when the exporting of paper turned out more profitable and less bothersome than exporting manufactured goods. International speculators want the unilateral dollar export to continue and to stoke the furnaces of the yen carry trade.

If you try to rebut me saying that it smacks of a conspiracy between the Federal Reserve and the Bank of Japan, the answer is: „you have said it".

Best regards,

A. E. Fekete

Reference

The Decoy of the Falling Dollar, February 2005