Crisis Notes 2.0.1 – The Greatest Risk is Here

4/10/2023

Markets are oblivious to the greatest risk it has faced in decades

It's so bad, it's good: markets think that our rate hikes, with their impact on banks and attendant slowdowns in lending, will lead to a recession, which will force Powell to cut rates. So, they appear to be frontrunning the rate cuts by buying stocks, ignoring the possibility of recession.

The most important story of last week, from Bloomberg (attached, I can't find a link), was ignored by most. The story is titled "***A $3 Trillion Threat to Global Financial Markets Looms in Japan"*** (attached)***.*** However, this underestimates the size of Japan's contribution to risk. A subsequent story, "**BOJ's Kuroda Leaves $11.7 Trillion 'Shock and Awe' Experiment to His Successor", more appropriately sizes the risk.**

https://www.bloomberg.com/news/articles/2023-04-05/kuroda-s-boj-legacy-ueda-inherits-task-of-exiting-japan-easing-stimulus

Markets and economists are oblivious to the biggest risk faced by the US and Global Economies – the deleveraging that will occur from simultaneous cutting of US rates while Japan raises rates. This will guarantee Global Recession.

Kuroda retired from his post on 4/9/2023, this past Sunday, and as of today, Kazuo Ueda is the new Bank of Japan governor. So far, he is saying that negative interest rates and yield curve control remain appropriate, but this, and Japanese inflation, needs to be closely monitored.

The risks to markets and asset prices have never been higher.

The US markets, asset prices, and economic activity, have been funded by the Yen Carry Trade since the 1990s. I described the events leading up to this transformational change in how Economics works in '**All Roads Start with Paul Volcker**'.

In 2007, in my first Crisis Note, I warned of the deleveraging that would occur from the unwinding of the Yen Carry Trade if Bernanke cut rates. He did, and triggered the GFC, and Japan withdrew its capital.

Yen Carry trade - this is the $1 trillion question mark - how much and how rapidly will this unravel?

** Anecdotal evidence suggests that Japanese housewifes have supported this heavily with retail savings (so called "Mrs Watanabes") everytime the dollar has strengthened, selling more Yen and buying $ and USTs. Will*

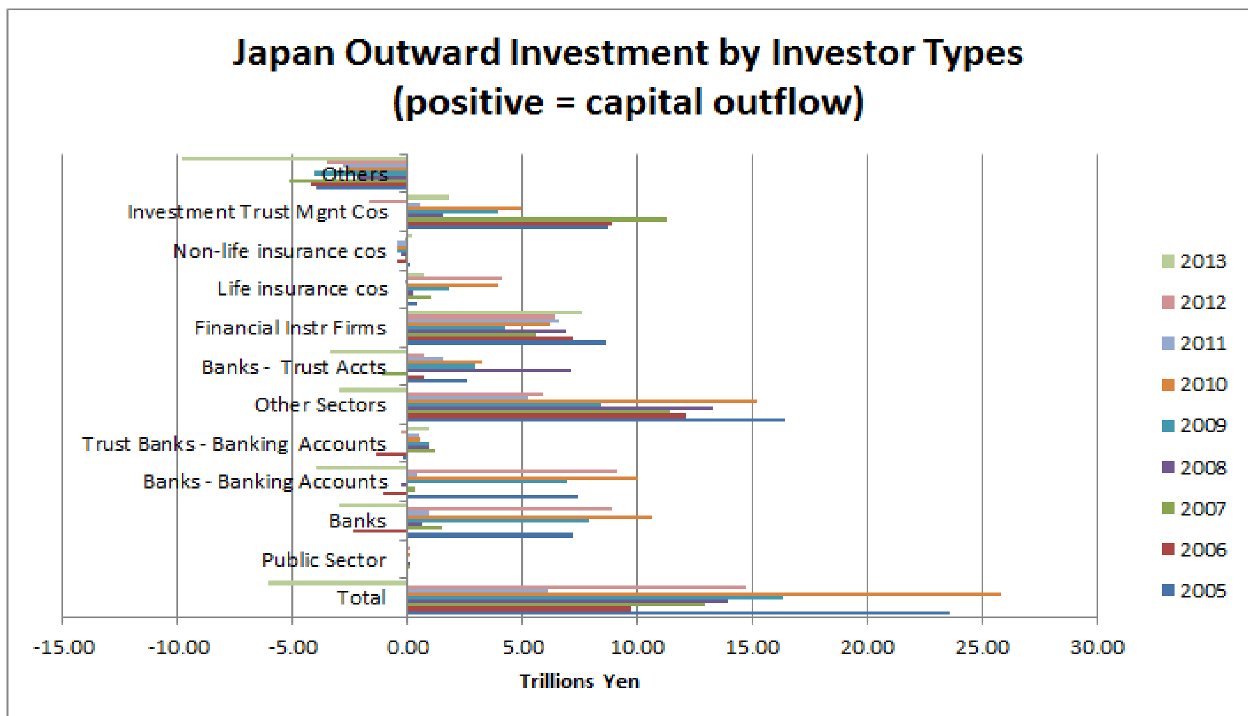
they come to the rescue? Or with USTs rallying, and rates rising in Japan, will they give up and buy back the Yen?
** I STRONGLY BELIEVE THAT THE YEN CARRY TRADE IS THE REASON THE FED CANNOT CUT RATES.*
** The system may not be able to handle an additional 1 trillion of deleveraging. The graph below shows an incredible correlation between the S&P and the Yen. I have heard many anecdotal stories about how the US stock markets are dominated by program trading, and I suspect that the programs are funding or hedging their purchases and sales with Yen.*

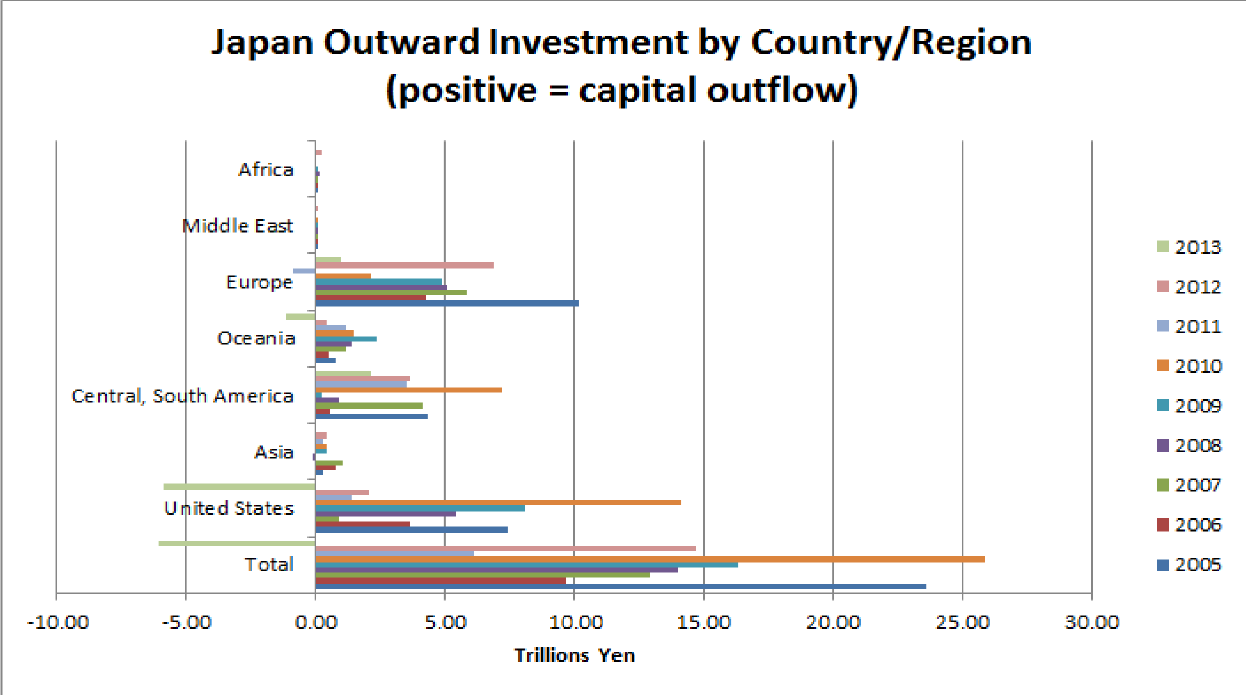
At the time, the majority of US financial institutions got both their long-term and short-term funding (almost their entire balance sheets) from Japan (Samurai bonds and interbank transfers of Call Money from the BOJ), and they were unable to roll their debt, thus having to flood the markets with assets (that had been created and help on balance sheet to arbitrage the cheap leverage that was available). This financing led to the quadrupling of the size bank balance sheets between 1999 and 2005, well above and beyond what was needed by the economy.

Once Japan started QE in 2002, by buying US Treasuries, that capital too ended up in the US, and helped create assets in the US, drove economic indicators such as Durable Goods Orders, and drove up US asset prices and PE ratios.

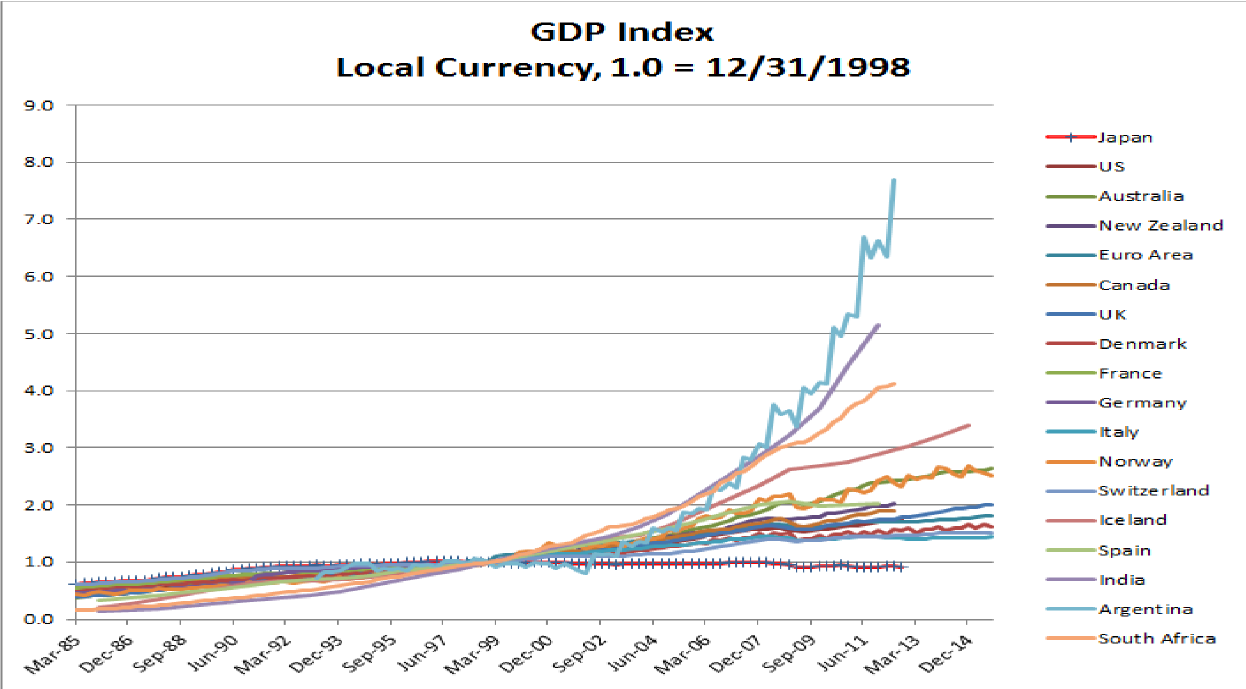
I researched this extensively in 2016's '**The Failure of Macro Economics – Carry Trades, Money Flows and The Pricing of Assets'**, and described the precise and Pavlovian manner in which Japan responds to interest rate differentials to export and re-import its capital. Micro economics works with precision, and undoes Macro and Central Banking wishes through cross-border flows, making interest rate policy work in reverse.

Graph 15 shows the capital exporters of Japan (everyone) and Graph 17 shows the recipient countries of Japan's Carry Trades (primarily the US).

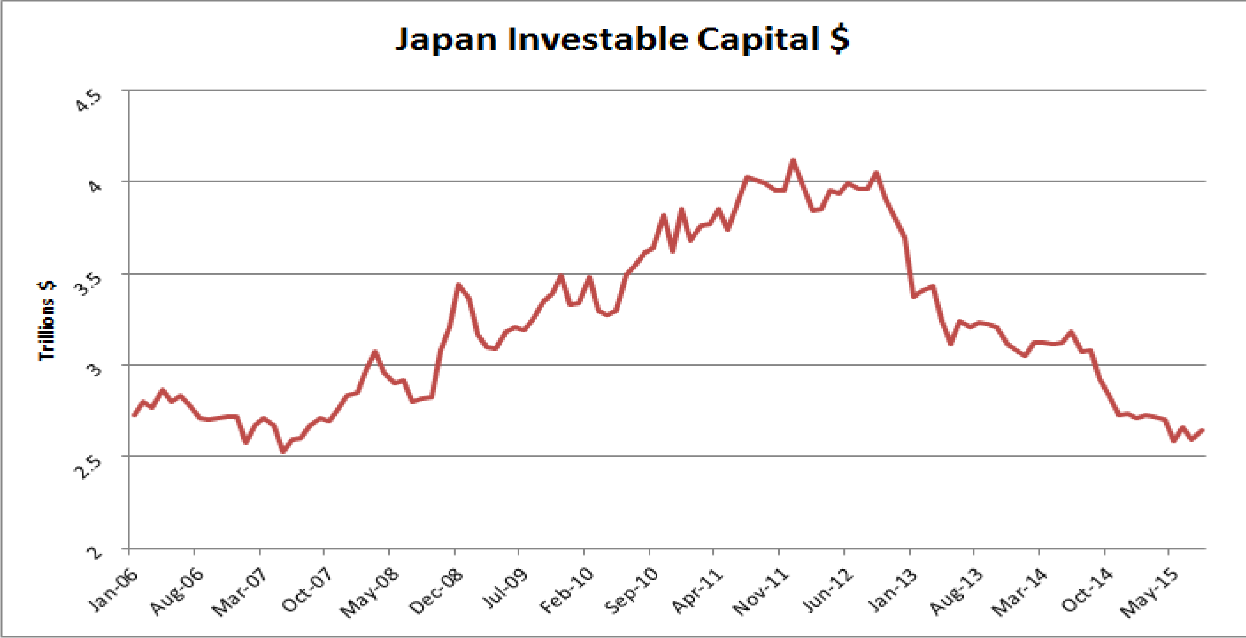




The net result for Japan of its Monetary Policy and resulting capital export has been stagnation for Japan, while the rest of the world, especially in their financial sectors, have benefited.



Graph 93, from Failure of Macro, shows the GFC in one picture – the increase in Japanese M3 – M2 reflect the repatriation of capital by Japan from August 2007, from the delivering triggered by Bernanke cutting rates.

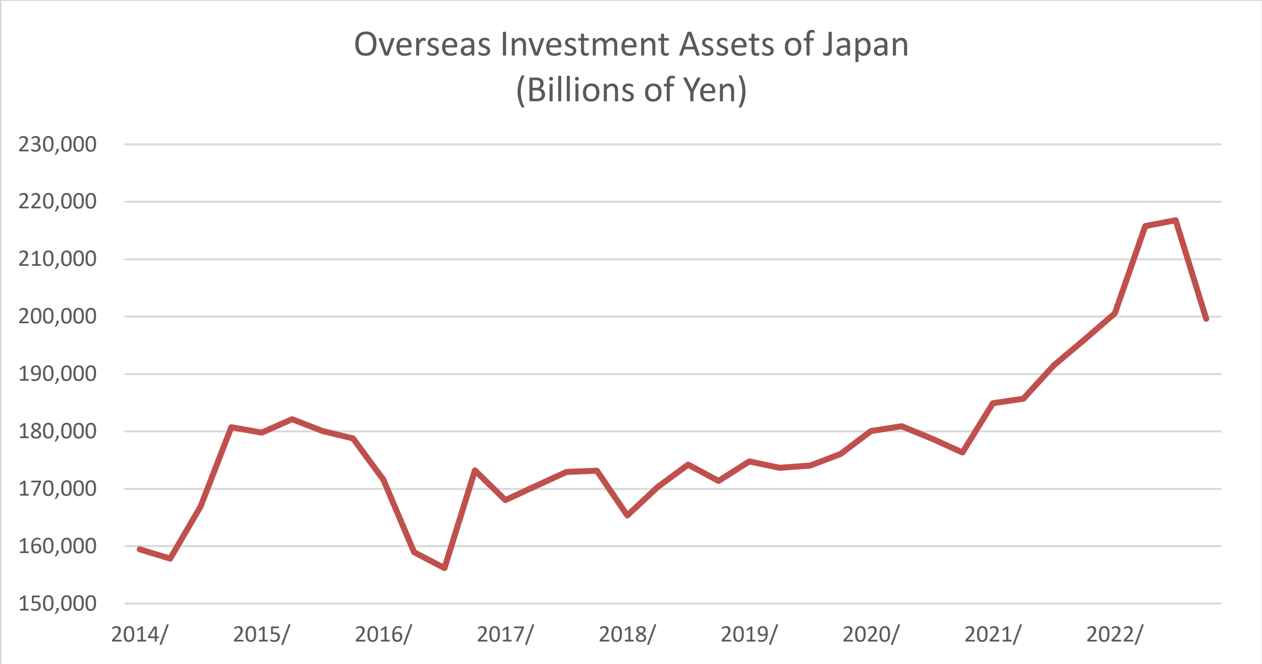


The data on capital exports from Japan are easily found in the Ministry of Finance (MOF) data, which is very granular (and the opposite of the US Fed, who stopped measuring M3 as they could not understand why it kept growing more rapidly than M2.)

https://www.mof.go.jp/english/statistics/index.html.

You can also see this on Statistica: https://www.statista.com/statistics/649756/japan-overseas-assets/

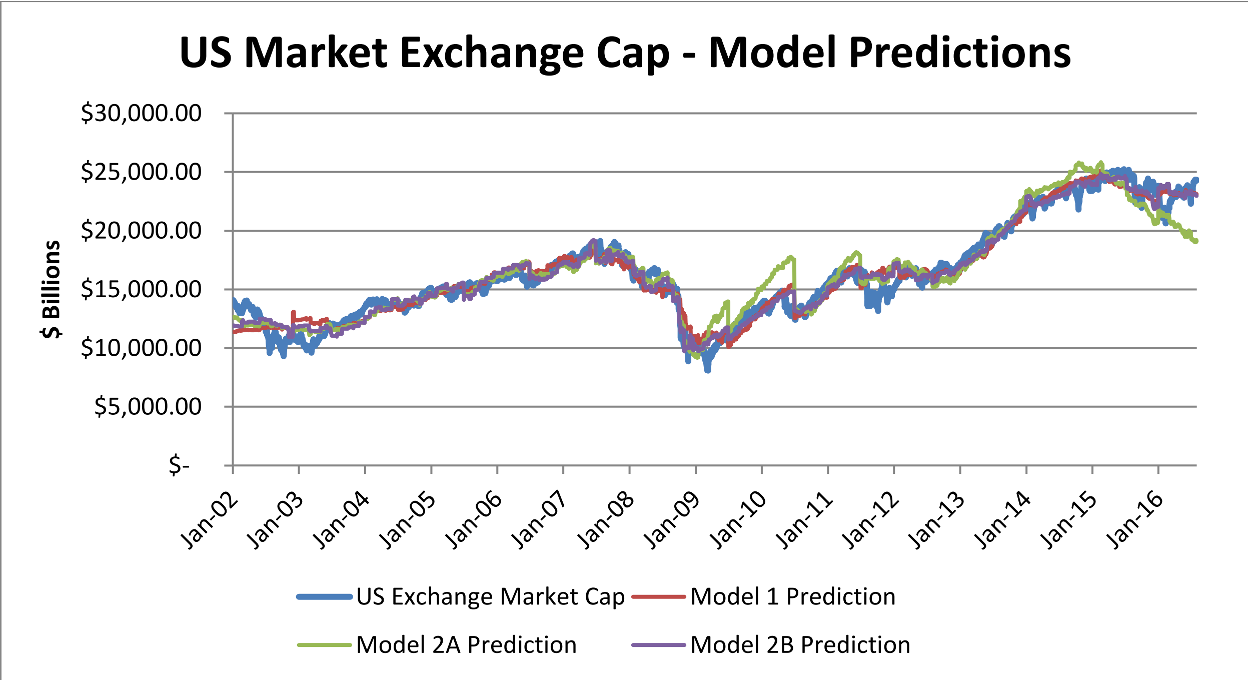
As of Dec2022, at 130Y/$ the Japanese have $10.2T (Y1.33 Million Billion Yen) in foreign asset investments, of which the Central Bank is only $1.53T, with $8.7T is from 'Other than CB'! This is the component that the Fed cannot control (by asking the BOJ not to sell its USTs), and which has the potential for being repatriated if the Yen Carry Incentive shrinks, either by the US cutting rates, Japan raising rates, or both.



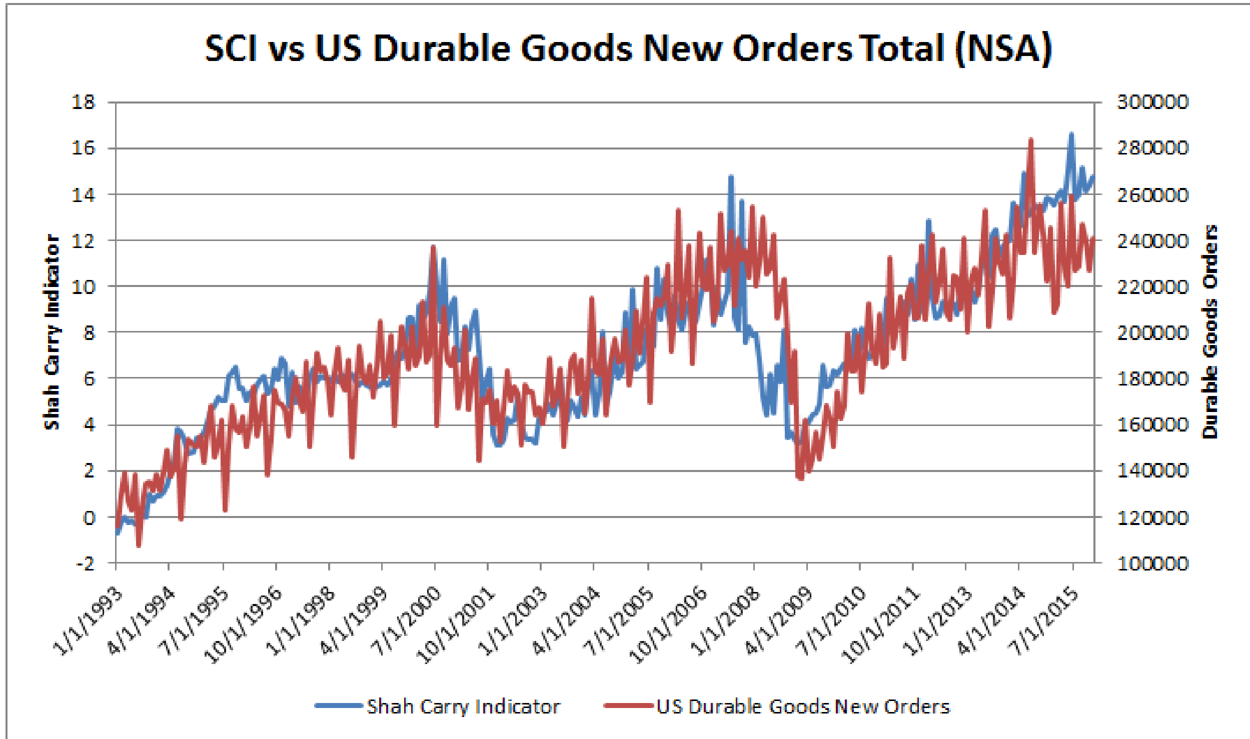
Corroborating the Bloomberg stories I referenced, we can see that this amount declined in the last quarter of 2022, as Japanese rates rose, while, prior to that, it had been growing as the US raised rates.

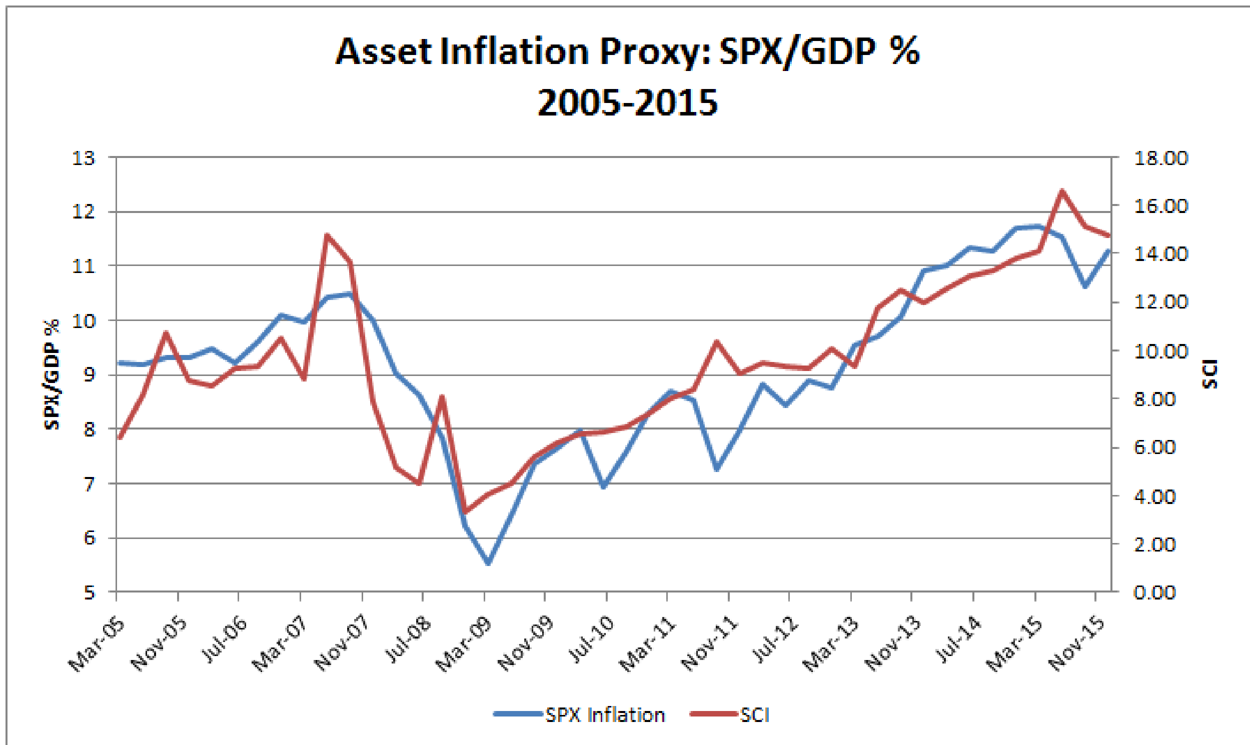
While some of it is trade related (receivables, etc), more than half of this is securities - Equity, Debt, Foreign bank deposits, Investment Funds, and Portfolio Investment.

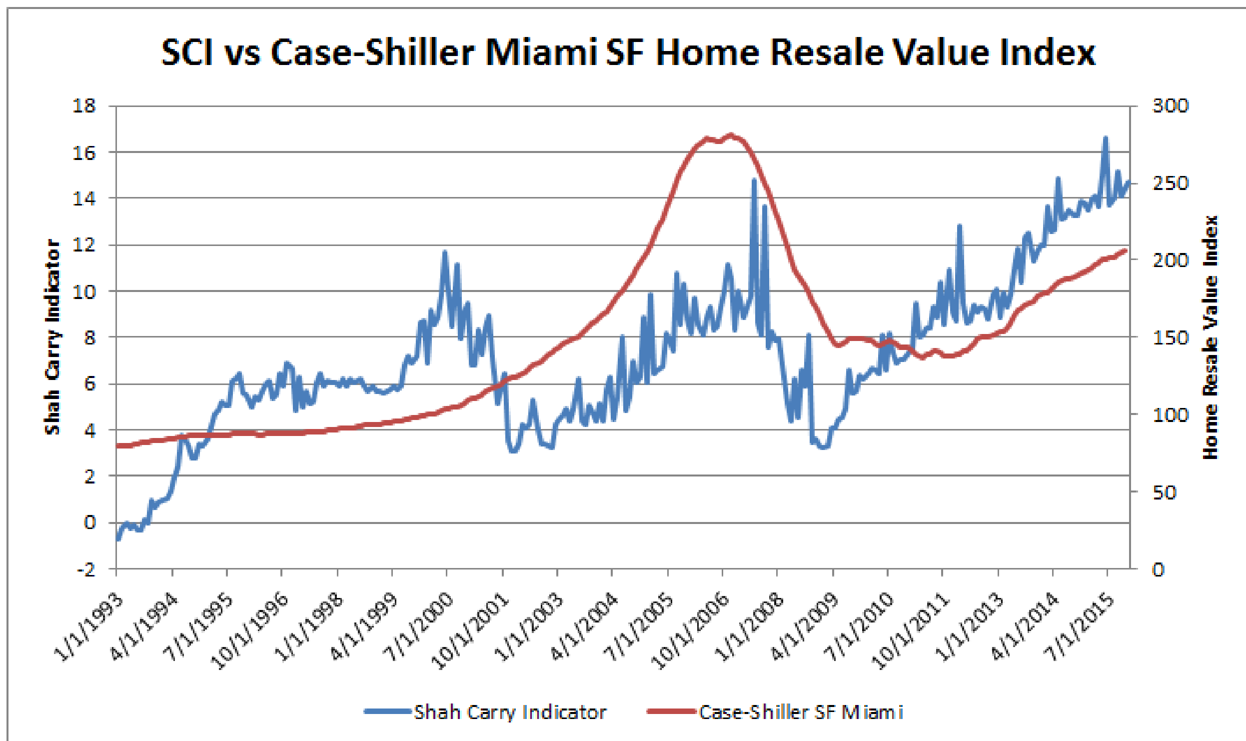
I modelled the impact on Asset Prices of Central bank policies (interest rate differentials and QE) in **Understanding Beta** . The resulting model has a 0.96 Adjusted R-Squared. There are no Black Swan events in my understanding of the world.



Here are a few more graphs from The Failure of Macro. There is no question to me that the wealth effect created by the Carry trade (and QE) drives US Economic output.







The past 15 years of abnormal GDP growth in the US have been a result of 3 flows of capital - US QE, Japanese QE and European QE, most of which has come to roost in the US. In addition, interest rate differential carry trade flows continued, in spite of low US rates, as Europe and Japen went to negative rates.

In my conclusions in Failure of Macro, I wrote: ***"When a large economy enters a Liquidity Trap, its citizens rationally export much of their available capital to seek higher yields, thus linking Micro-economic decisions with Macro-Economic implications. Recipient Countries of this Carry-driven money supply lose control of their domestic interest rate policy, and their attempts to control money supply result in outcomes that are the opposite of what is desired. Economic output in these countries rises to the point of saturation of needs (a subject for further research), after which the money supply results in Asset Price Inflation, Bubbles, and creation of excess assets to meet the need for investment. Traditional financial valuation models cease to be useful and rationalizations abound for investing in assets with inflated prices."***

This continues to describe our current status. **With bank prop trading limited by the Volcker Rule, this capital has largely gone to private markets and public equities, creating asset inflation.**

Private Equity, and the LBO market, for example, would not have grown as much as they did without the largess of Japanese fishermen: their pension manager, Norinchunkin Bank ("Nori") – is the world's largest CLO buyer.

https://en.wikipedia.org/wiki/Norinchukin_Bank

https://www.bloomberg.com/news/articles/2022-10-17/clo-giant-norinchukin-halts-purchases-as-uk-volatility-spreads

In Failure of Macro Economics, I also discussed Japanese Reflation. (There is also more on social implications, etc).

> ***"Japanese Reflation" - seems to have been a "Trade-du-Jour" of Macro Funds***
>
> ***The "Japanese Reflation Trade" will not work under current economic system and economic policies.*** *In order for this to happen, significant policy changes need to be made to repatriate capital back to Japan in an orderly manner, allowing its money supply to inflate and thus create domestic inflation. Negative rates certainly will not accomplish this.*
>
> ***It will be trivial for Japan to reflate, if it learns from this paper. All the BOJ has to do is raise the deposit/call rate, say to 5%.*** *The world will experience a sucking sound like it has never heard before, as all the capital in the world rushes to Japan.*
>
> *Doing this, however, will result in huge implosions in global capital markets in the rest of the world, as their assets delever and prices collapse.* ***This is why I believe that Japan poses the greatest risk to financial markets and economies. One has to follow Japan if one is investing.***

If we get either of the 3 whammies – the US Fed cuts rates, Japan's BOJ raises rates, or both, the markets will delever, as Japan withdraws its capital.

While raising rates and reducing the interest rate differential in an orderly manner is critical to prevent GFC II, I am not confident that it is possible to do it in an orderly manner - the PV process of investment managers will cause havoc. The following are a sampling of outcomes in that case.

- The Yen will strengthen. Last time around, I rode Yen from 125 to 78, and it would have gone to 50 had the BOJ not intervened around 80.
- The portfolio companies of PE firms – in other words – most of the levered loan and high yield markets – will have a hard time rolling their debt when it comes due – there is no chance their earnings can be accumulated to pay off debt.
- Everything leveraged will get thrashed. REITs, public PE firms, brokerage firms, banks, stocks etc – see my March 2020 letter to clients for shorting ideas.

Stock market and quant funding and leveraging of equities has probably continued using short term carry funding. This relationship looks less strong now due to the COVID largess from the US government, which ended up in equities as well, but becomes evident in market selloffs as the Yen strengthens (no, talking heads and WSJ, it is not a "haven", its deleveraging).

One of Powell's objectives will be met however – housing inflation will end, and the rental homes hoarded by the Buy-to-Rent private strategies will get released into the markets.

Another moving variable is the Euro. Europe has also been exporting capital to the US via its large asset managers. There is no easy data to figure out these flows, so one can only look at the price of the Euro vs USD to infer flows (I

did something similar in Predictions 2017). I suspect that the recent US stock market strength is a result of CS's failure and lack of confidence in European and Swiss asset managers, resulting in flows into the US.

We appear to have reached this point of maximum risk – where the probabilities of these deleveraging events has never been higher.

People don't seem to understand the concept of risk. Risk is a probability. The event of concern does not need to happen and timing can be variable. Asking 'when will this happen' cannot result in an answer.

For example, a partial attempt to cut rates (US) or raise rates (Japan) could result in a different rate path as resulting asset crash might make the central bankers backpedal.

However, history suggests that the Fed does not understand how interest rate policy works, and will cut rates even further and faster than they intended if asset prices decline, as Greenspan did in 2001-2002, Bernanke did in 2007, and Powell did in 2020, which will lead to the Carry trades unwinding, and US asset prices (and M3) collapsing.

As in 2007, there is not enough balance sheet to absorb levered assets. (try reading these early Crisis Notes, Rate Cuts will not work 8/29/2007, Zombies in Disneyland, 11/7/2007, and Where's the Balance Sheet? 12/13/2007)

In 2005, I was looking to start my own broker dealer, and spent significant time with Kaupthing Bank discussing a partnership with them. This is when I discovered the Yen Carry Trade that had financed the global economy – this infamous Icelandic bank, at the time the #5 fastest growing bank in the world, was funded by the Carry trade.

As I researched Carry Trades, I realized that the risk of the Yen Carry Trade unwinding was becoming more likely, and this risk was not in the consciousness of markets. In 2006, I started to raise a fund to capitalize on this, and started warning my clients as well, and started writing posts that became the Crisis Notes. I got nowhere in fund raising, but realized that my clients would need a more robust counterparty than any broker dealer that I could capitalize with my own money. So, I went looking for a brokerage partner with capital but no 'bad balance sheet', and discovered Man Financial (later renamed MF Global), who had capital but did not use their futures client deposits for risk taking. They did not trade bonds and had no infrastructure to do so. I convinced them to let me build a bond/MBS trading business there, and created their infrastructure and Fixed Income brand, opening them to over 500 MBS buy side accounts based on my relationships. When the markets blew up in 2007, as the Yen Carry Trade unwound after Bernanke cut rates in August, I was there to provide liquidity and help my clients protect capital. I built MF Global's most profitable business and Fixed Income brand while being fair to the clients that my desk traded with, which, ironically, allowed Corzine to join a turn-key fixed income trading shop to expand into other Fixed Income markets, which he then bankrupted from incompetence, impatience, hubris, and greed.

I also discovered that many buy-side investment managers were not interested in protecting capital, but rather in maintaining AUM and fees. This is somewhat understandable – when a long-only manager moves to cash to protect capital, clients tend to withdraw the cash, leaving the manager with an ethical quandary – to move to cash

or not. I have experienced this myself, except that I take the concept of being a fiduciary seriously, and will and do move to cash to protect my client's capital, in spite of the risk of withdrawals by doing so, waiting for the right re-entry point to invest.

Today, global leverage is deployed largely through post-Dodd-Frank non-bank suppliers of private capital. There will be a different menu of shorts to take advantage of this opportunity compared to 2007, when leverage was deployed through large banks. But the opportunity is the most sizable there has ever been, the mirror image of the current greatest risk ever. Anticipation of the risk also requires different thinking in portfolio construction, and a different liquidity profile compared to whatever portfolio might have been constructed for you until now.

Most investment managers are focused on the trees rather than the forest. The primary risk in investments is Beta risk, not valuation risk. Managers tend to be focused on valuation and have no models for understanding Beta. If even a valuable company like Apple can decline 30+%, their focus is misguided.

Since the mid-1990s, Beta risk has been primarily driven by injected capital flows from Central banks. We have an excellent model for this, understand it, and have a demonstrated history of anticipating Beta risk and protecting client capital through innovative thinking.

I set up MBS Mantra to bypass the investment managers who were not necessarily focused on the client's interests, by investing and advising directly for investment clients.

I can help investors of all types directly through 3 mechanisms:

- **investing directly, in separate accounts or a fund;**
- **being an external CIO or portfolio manager for their portfolio; or**
- **providing consulting on risk and portfolio construction, through a retainer fee-based structure.**

My signature line below lists the entities through which I can do so. I'll also point out our trademarked investment and thought process, **"Alpha Through Analysis"®**, which drives our investments and advice.

Please call anytime with questions or to just chat.

Regards, Samir Shah

April 10, 2023

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A $3 Trillion Threat to Global Financial Markets Looms in Japan
2023-03-30 00:00:37.177 GMT

By Ruth Carson, Masaki Kondo and Michael Mackenzie
(Bloomberg) -- Bank of Japan Governor Haruhiko Kuroda changed the course of global markets when he unleashed a $3.4 trillion firehose of Japanese cash on the investment world. Now Kazuo Ueda is likely to dismantle his legacy, setting the stage for a flow reversal that risks sending shockwaves through the global economy.

Just over a week before a momentous leadership change at the BOJ, investors are gearing up for the seemingly inevitable end to a decade of ultra-low interest rates that punished domestic savers and sent a wall of money overseas. The exodus accelerated after Kuroda moved to suppress bond yields in 2016, culminating in a mountain of offshore investments worth more than two-thirds Japan's economy.

All this risks unraveling under the new governor Ueda, who may have little choice but to end the world's boldest easy-money experiment just as rising interest rates elsewhere are already jolting the international banking sector and threatening financial stability. The stakes are enormous: Japanese investors are the biggest foreign holders of US government bonds and own everything from Brazilian debt to European power stations to bundles of risky loans stateside.

An increase in Japan's borrowing costs threatens to amplify the swings in global bond markets, which are being rocked by the Federal Reserve's year-long campaign to combat inflation and the new danger of a credit crunch. Against this backdrop, tighter monetary policy by the BOJ is likely to intensify scrutiny of its country's lenders in the wake of recent bank turmoil in the US and Europe.

A change in policy in Japan is "an additional force that is not being appreciated" and "all G-3 economies in one way or the

other will be reducing their balance sheets and tightening policy" when it happens, said Jean Boivin, head of the BlackRock Investment Institute and former Deputy Governor of the Bank of Canada. "When you control a price and loosen the grip, it can be challenging and messy. We think it's a big deal what happens next."

The flow reversal is already underway. Japanese investors sold a record amount of overseas debt last year as local yields rose on speculation that the BOJ would normalize policy. Kuroda added fuel to the fire last December when he relaxed the central bank's grip on yields by a fraction. In just hours, Japanese government bonds plunged and the yen skyrocketed, jolting everything from Treasuries to the Australian dollar.

"You've already seen the start of that money being repatriated back to Japan," said Jeffrey Atherton, portfolio manager at Man GLG, part of Man Group, the world's biggest publicly traded hedge fund. "It would be logical for them to bring the money home and not to take the foreign exchange risk," said Atherton, who runs the Japan CoreAlpha Equity Fund that's beaten about 94% of its peers in the past year.Coming Home Bets for a shift in BOJ policy have eased in recent days as the upheaval in the banking sector raises the prospect that policy makers may prioritize financial stability. Investor scrutiny of Japanese lenders' balance sheets has grown, on concern they may echo some of the stresses that have floored several regional US banks.

But market participants expect chatter on BOJ tweaks to resume when tensions dissipate.

Why Japanese Banks Are Well Placed to Withstand Banking Crisis

Ueda, the first ever academic to captain the BOJ, is largely expected to speed up the pace of policy tightening sometime later this year. Part of that may include further

loosening the central bank’s control on yields and unwinding a titanic bond-buying program designed to suppress borrowing costs and boost Japan’s moribund economy.

The BOJ has bought 465 trillion yen ($3.55 trillion) of Japanese government bonds since Kuroda implemented quantitative easing a decade ago, according to central bank data, depressing yields and fueling unprecedented distortions in the sovereign debt market. As a result, local funds sold 206 trillion yen of the securities during the period to seek better returns elsewhere.

The shift was so seismic that Japanese investors became the biggest holders of Treasuries outside the US as well as owners of about 10% of Australian debt and Dutch bonds. They also own 8% of New Zealand’s securities and 7% of Brazil’s debt, calculations by Bloomberg show.

The reach extends to stocks, with Japanese investors having splashed out 54.1 trillion yen on global shares since April 2013. Their holdings of equities are equivalent to between 1% and 2% of the stock markets in the US, Netherlands, Singapore and the UK.

Japan’s ultra-low rates were a big reason the yen tumbled to a 32-year low last year, and it has been a top option for income-seeking carry traders to fund purchases of currencies ranging from Brazil’s real to the Indonesian rupiah.
“Almost definitely it contributed to a significant decline of the yen, a massive dysfunctioning of the Japanese bond market,” former UK government minister and Goldman Sachs Group Inc. chief economist Jim O’Neill said of Kuroda’s policies.

“Much of what happened in Kuroda’s time will partially or fully reverse” should his successor pursue policy normalization, although the banking crisis may cause authorities to proceed more cautiously, he added.

The currency has pulled back from last year's lows, helped by a view that normalization is inevitable.
Add to that equation last year's historic global bond losses, and Japanese investors have even more reason to flock home, according to Akira Takei, a 36-year market veteran and money manager at Asset Management One Co.

"Japanese debt investors have had bad experiences outside the country in the past year because a substantial jump in yields forced them to cut losses, so many of them even don't want to see foreign bonds," said Tokyo-based Takei, whose firm oversees $460 billion. "They are now thinking that not all funds have to be invested abroad but can be invested locally."

The incoming president of Dai-ichi Life Holdings Inc., one of Japan's largest institutional investors, confirmed it was shifting more money to domestic bonds from foreign securities, after aggressive US rate hikes made it costly to hedge against currency risks.

To be sure, few are prepared to go all out in betting Ueda will rock the boat once he gets into office.

A recent Bloomberg survey showed 41% of BOJ watchers see a tightening step taking place in June, up from 26% in February, while former Japan Vice Finance Minister Eisuke Sakakibara said the BOJ may raise rates by October.

A summary of opinions from the BOJ's March 9-10 meeting showed the central bank remains cautious about executing a policy pivot before achieving its inflation target. And that was even after Japan's inflation accelerated beyond 4% to set a fresh four-decade high.

The next central bank meeting, Ueda's first, is scheduled to take place April 27-28.

Richard Clarida, who served as Vice Chairman at the Federal Reserve from 2018 to 2022, arguably has more insight than most after having known "straight shooter" Kuroda for years and weighed Japan's impact on US and global monetary policy. "Markets expect pretty early under Ueda that yield-curve control is dismantled," said Clarida, who is now global economic advisor at Pacific Investment Management Co. From here Ueda "may want to go in the direction to shrink the balance sheet or reinvest the redemptions, but that is not one for day one," he said, adding Japan's tightening would be a "historic moment" for markets though it may not be a "driver of global bonds."Gradual Shift

Some other market watchers have more modest expectations of what will happen once the BOJ rolls back its stimulus program. Ayako Sera, a market strategist at Sumitomo Mitsui Trust Bank Ltd., sees the US-Japan rate gap persisting to a degree as the Fed is unlikely to deliver large rate cuts if inflation remains high and the BOJ isn't expected to raise rates substantially in the near term.

"It's important to assess any tweaks and outlooks of the BOJ's whole monetary policy package when thinking about their implication on the cross-border fund flows," she said. Ryosuke Oshima, deputy general manager of product promotion group at Mitsubishi UFJ Kokusai Asset Management Co. in Tokyo, is eyeing yield levels as a potential trigger for a shift in flows.

"There might be some appetite for bond funds when the rates move higher, like 1% for the 10-year yield," he said. "But looking at the data, it is unlikely they reverse all their investment back home suddenly."

For others like 36-year markets veteran Rajeev De Mello, it's likely only a matter of time before Ueda has to act and the consequences may have global repercussions.

“I fully agree with the consensus that the BOJ will tighten
— they’ll want to end this policy as soon as possible,” said De
Mello, a money manager at GAMA Asset Management in Geneva. “It
comes down to central bank credibility, it comes down to
inflation conditions being increasingly fulfilled now —
normalization will come to Japan.”

--With assistance from Winnie Hsu, Ayai Tomisawa, Hideyuki Sano,
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