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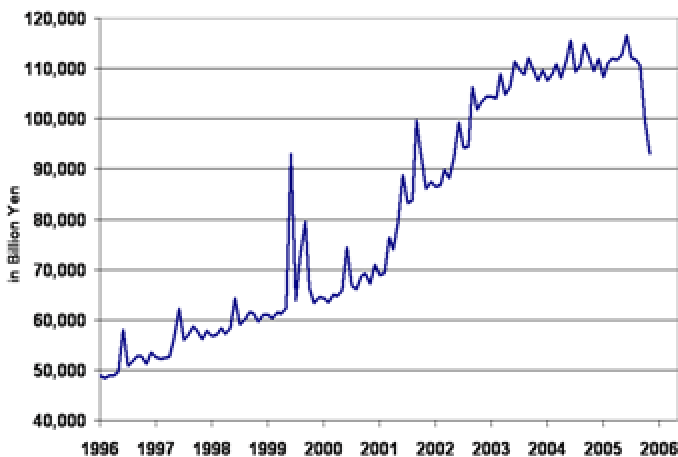
June 30 , 2006

## The Bank of Japan Affects All Markets

U.S. markets go into the Fourth of July weekend content that the Federal Reserve did a fabulous communications job Thursday. But the Fed's credibility is no more solid, nor is its message any clearer than it has been all year. And inflation is still the ugly elephant in the room that everybody notices but nobody really knows how to address. As the first half of 2006 draws to a close, the market is experiencing the second +200 Dow Points move in two weeks. Both moves came on a Thursday. The first rally took place on June 15, one day after the low of the year had been reached. The second rally this past Thursday was inspired by a "dovish" FOMC statement. But the dovish statement follows intensely hawkish "Fedspeak" throughout most of late May and June. That rhetoric, in turn, however, was designed to undo the Fed's perceived dovish tone in April. You follow?

The behavior of markets constitute manifestations of mass psychological phenomena. In other words, markets are usually an assembly of psychopaths who sometimes even use logic or analysis as their decision-making tools. In any event, Ben Bernanke can not win. Bond- and stock-markets will interpret his words according to the cycles. If markets are oversold (like they have been for the last two weeks) then anything Bernanke says will serve as an excuse to rally. If markets are overbought (like they were in May) anything Bernanke says will serve as an excuse to sell off. Does that mean that stock markets move without regard for fundamental circumstances? No! Fundamentals do matter! The question is, which fundamental data set we choose to explain market action.

Japanese Monetary Base (In Yen)



Japanese Monetary Base (In Dollars)



Central banks around the world are hawkish these days. Everyone is looking at the U.S. central bank, but the key development took place in Japan. [A quick historical reminder](#): Japan's banks were insolvent ever since the 1990s. To rescue the country from its deflationary spiral, the BOJ had to force-feed the economy with cheap money. The chart on the left shows how the Japanese Monetary Base more than doubled between 1997 and 2003. What was meant to benefit the domestic economy ended up benefiting international speculators. Japanese banks did not engage in business lending at home but became financiers to the speculators of the world. Anyone who in the past ten years had borrowed Yen to invest outside of the Yen area would have had an excess return of some 4% per year. The last time anyone lost money being short the Yen was in 1999. These are powerful incentives which attracted a lot of interest from investors in Japan, especially since the BOJ practically guaranteed a stable exchange rate by maintaining the Yen spot exchange rate around a band of ¥105-120 per US\$. After a while international players started to believe the BOJ rhetoric regarding "welcome" and "unwelcome" currency exchange rates and figured out ways to tap into the yen-carry trade as well. Pretty soon, the Bank of Japan (BOJ) became the biggest liquidity generator for the credit system and financial markets of the world. The combination of Japan's quantitative easing policy + zero interest rate policy + FX stabilization policy, led to a

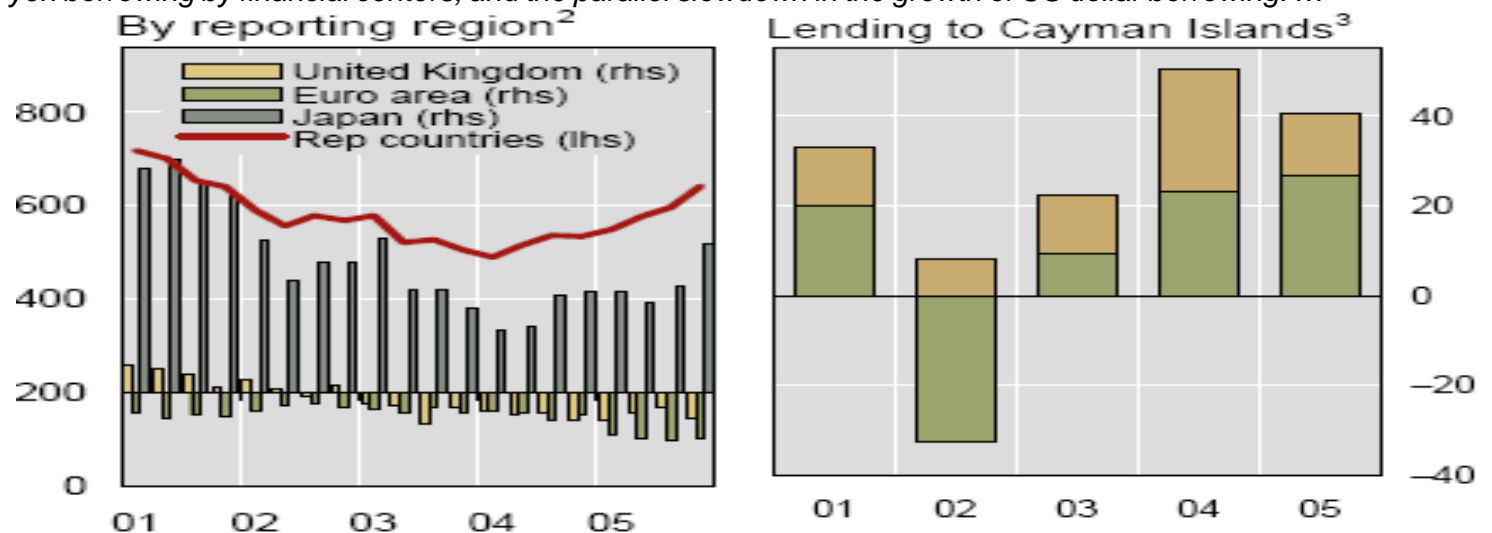
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massive export of capital by Japan to the rest of the world, to an enormous bull market in fixed income instruments everywhere and from there, to a bull market in most other asset classes.

So far so good. All this has been known for many years. What is becoming clearer however is, how this liquidity generator is fooling central banks around the world by distorting their domestic statistics. The Bank of International Settlements issued its Quarterly review on June 12<sup>th</sup> and remarked on page 12 “... *The stock of outstanding yen-denominated claims rose noticeably in the fourth quarter of 2005, in line with a trend evident since mid-2004. On the lenders’ side, this has largely been driven by banks in Japan. Over the last seven quarters, claims of these banks accounted for three quarters of the \$161 billion increase in reporting banks’ yen-denominated claims. Roughly \$120 billion of this increase was channeled to borrowers in international financial centers, most notably banks in the United Kingdom and Singapore and non-banks in the Cayman Islands. This pickup in yen borrowing provides some evidence, albeit incomplete, of a rise in yen-funded carry trade positions.* A carry trade is the combination of a short position in a low-yielding currency and a long position in a higher yielding currency, and is profitable to the extent that exchange rate adjustments do not counterbalance the nominal yield differential. Thus, an increase in carry trade activity is a potential factor behind the recent growth in yen borrowing by financial centers, and the parallel slowdown in the growth of US dollar borrowing. ...”



The growth of financing in cheap interest rates, wherever they may be found (today in Japan, tomorrow in Europe?) raises an important question: could the low Japanese interest rates and easy Japanese monetary policy be undermining the tightening of monetary policy undertaken by the Fed? I am afraid so. Thanks to globalization only financial actors with no access to foreign funding (US homeowners for example) are impacted by the rise in short rates. Meanwhile, companies, financiers, high net worth individuals etc. are able to finance themselves at the cheap rate (today in Yen) and continue to prosper on the carry trade. ([Recent Update by Howard Simmons](#)) The US housing sector has been slowing dramatically. This slowdown should have impacted the economy by now and restrictive central bank measures around the world should have lead to a global slowdown on all continents. The ironic thing is that, since October, US housing has been slowing, central banks around the globe raised interest rates ... and yet global growth has continued to boom! China’s GDP grew by 9.9% in 2005 and grew by 10.2% during the first quarter 2006. No slowdown here. However, the Chinese statisticians complained about “... renewed pick-up in capital inflows ...”, in other words, speculators are still investing in China. Bernanke might discern an economic slowdown in the US, but international prices are still rising and international growth is still accelerating. Japanese easy money is distorting everybody’s statistics. Economic slowdown will manifest itself only when the BOJ removes liquidity and raises interest rates. In late March it announced the end of quantitative easing and said it was targeting a neutral bank-reserve position, with reserves of about six trillion yen. At that time reserves were ¥30 trillion. Now they’re under ¥13 trillion. In dollar terms, the BOJ withdrew \$200 billion. The first steps are being taken, but only hesitantly. Japan’s hesitancy in raising interest rates and removing liquidity might cause other central banks to over-tighten their own domestic policies because they fail to realize that their own domestic economies are much more reliant on outside stimulus than anybody thought possible. The danger that Central Banks around the world overdo it again and thereby cause a financial accident is real.

Hermann Vohs