Popular Delusions

Nikkei 63,000,000? A cheap way to buy Japanese inflation risk

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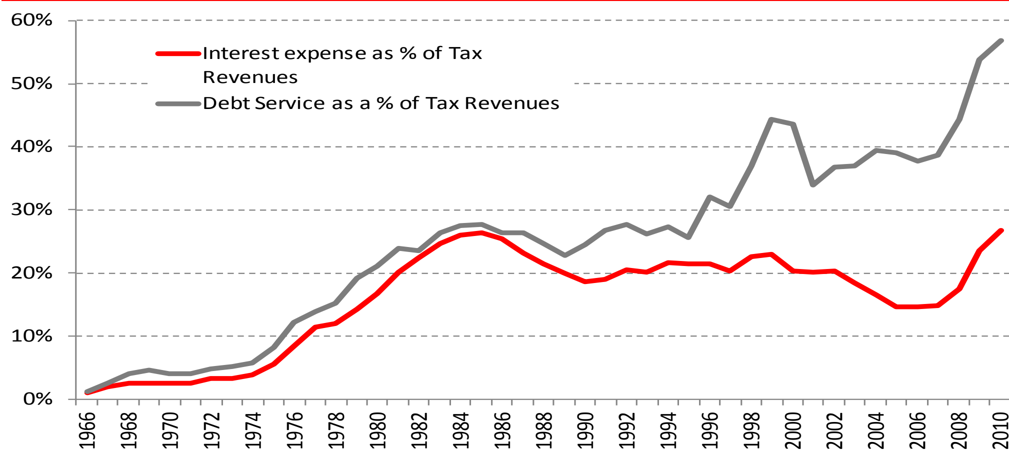
Japan is no Zimbabwe. Neither was Israel, yet from 1972 to 1987 its inflation averaged nearly 85%. As its CPI rose nearly 10,000 times, its stock market rose by a factor of 6,500 … Regular readers know that I don't generally make forecasts, but that every now and then I do go out on a limb. This is one of those occasions. Mapping Israel's experience onto Japan would take the Nikkei from its current 9,600 to 63,000,000. This is our 15-year price target.

- Despite the Japanese government paying a mere 1.5% on its bonds, interest payments amount to a hair-raising 27% of tax revenues. Including rolled government bills (which Japan's MoF defines as debt service) takes the share to an eyebrow-singeing 57% (see chart below).

- Any meaningful repricing of Japanese sovereign risk would push yields to a level the government would be unable to pay. Moreover, since the domestic financial system is loaded up to the eyeballs with JGBs (first chart inside), a crisis of confidence there would soon transmit itself beyond the public sector.

- So the path of least political resistance will presumably be to keep yields at levels which the Japanese government can afford to pay, and to stabilise JGBs at levels which won't blow up the financial system. This will involve the BoJ buying any/all bonds the market can no longer absorb, probably under the intellectual camouflage of "a quantitative easing program" aimed at breaking Japan's deflationary psychology. Economists might applaud such a step as finally showing the BoJ was "getting serious about Japan's problems". In fact, it will be the opening chapter of a long period of inflation instability.[1]

Yikes! Japan's debt payments are eating up a *lot* of tax revenues …



Source: SG Cross Asset Research, Japanese MoF

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[1] Albert and I have contributed with a group of other strategists and hedge fund managers to a book we hope will raise some much-needed money for charity. It's called "The Gathering Storm" and has a collection of essays with views on the recent crisis and thoughts about the next ones. It's an easy read and we hope an enlightening one too, and can be purchased at www.thegatheringstorm.info

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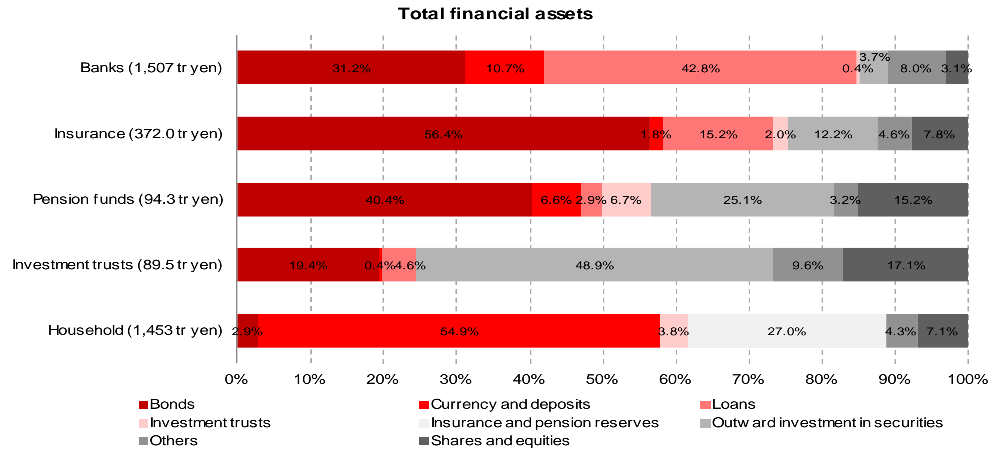
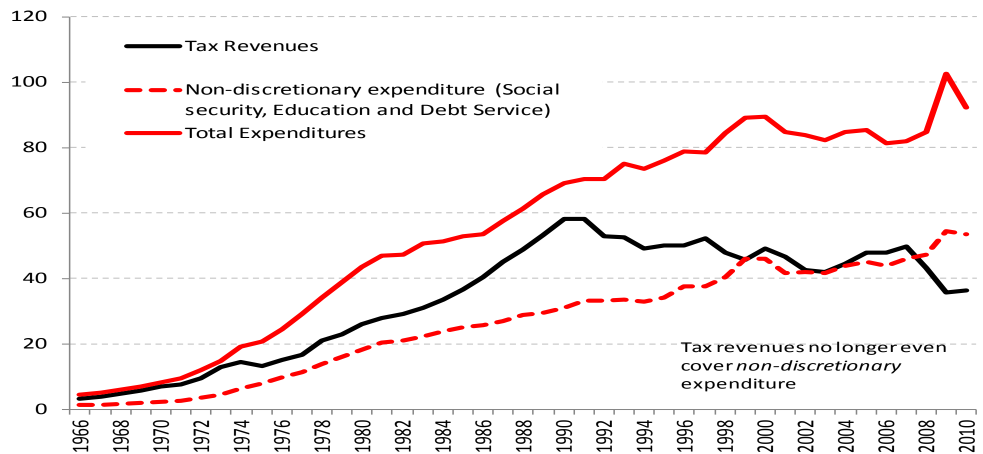
Japan's financial system depends on JGB stability (while Japanese equities are under-owned!)



Source: SG Cross Asset Research, BoJ

It is often pointed out that in Japan's aging population there is no constituency for inflation, which is why there is insufficient pressure on the BoJ to monetise. However, the same demographic dynamic ensures there is no political constituency for reductions in health expenditures. Yet Japan's tax revenues currently don't even cover debt service and social security, persistent and growing fiscal burdens. Therefore, once the BoJ is forced into monetisation of government deficits, even if only with the initial intention of stabilising government finances in the short term, it will prove difficult to stop. When it becomes the largest holder and most regular buyer of JGBs, Japan will be on its inflationary trajectory.

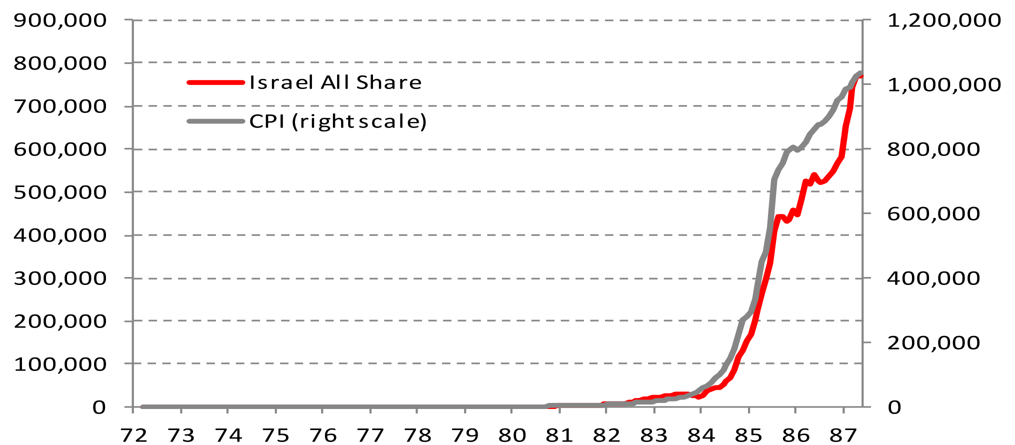
Japan's government tax revenues no longer cover its bare necessities



Source: Japanese MoF. SG Cross Asset Research

It is said that where democracies are developed and institutions robust, hyperinflations don't take hold. In the 1970s, for example, while developed economies exhibited a degree of the political breakdown that usually fosters high inflation, their experience was relatively mild in comparison to the more pathological inflations seen in politically malfunctioning economies such as Zimbabwe or Weimar Germany. Problematic 1970s inflation in the developed economies was controlled before it became too problematic … except in Israel, which saw its problematic 1970s inflation explode into a hyperinflationary 500% by the mid 1980s.

Israeli shares exploded in nominal terms during its 1980s inflation crisis (1972=100)



Source: SG Cross Asset Research, GFD

Think about that for a moment. Japan is an advanced economy, a developed democracy and certainly no Zimbabwe. But Israel was all of those things too. It simply found itself politically committed to a level of expenditure – military and social – which it couldn't fund. Instead of taking the politically unpalatable course of cutting that expenditure, it resorted to the tried-and-tested tactic of buying time with printed money. Between 1972 and 1987 Israel's CPI rose by a factor of nearly 10,000. Inflation averaged around 84% and peaked at an annualised 500% in early 1985.

In real terms equity prices fell (chart above), failing to keep pace with the rise in the CPI. But in nominal terms they *exploded* rising by a factor of around 6,500 over the period, in keeping with experiences of nominal share indices in Argentina, Brazil or Weimar Germany during their inflationary crises. A couple of clients have told me they think the trigger for a forced BoJ monetisation of the government's balance sheet *can only occur* when Japan starts running current account deficits, pointing out that sovereign defaults have only occurred in current account deficit economies. So long as Japan maintains its current account surplus it will be safe. But I'm still not convinced why this *must necessarily* be the case just because it has been in the past. Current account deficits would be critical for government funding if the swing government bond investors were from overseas, which they nearly always are. But in Japan today they're not. The households effectively are. Why should the current account deficit even be relevant to what is effectively an internal issue?

Reinhart and Rogoff say that one of the tell-tale early signs that governments are struggling to maintain market confidence is when debt maturities decline. This is what is happening in Japan today. And the BoJ announced last week (to loud acclaim) that it was going to adopt a more Anglo-Saxon style of quantitative easing. The process is arguably underway. My concern is that once the door to QE has been passed through, it slams shut behind.

The truth is we can't know when this will happen. We suspect only that the writing is on the wall, and the further out we look, the bigger and bolder that writing becomes. But if Japan was to follow a similar trajectory to Israel's, the Nikkei would trade at around 63,000,000 (63 million) by 2025. How much do you think 15y 40,000 strike call options would cost? I'm not sure either (though I'm sure I could get interested parties a quote), but call options are generally cheap, and "melt-up" calls especially so, and I'd be surprised if you couldn't buy that risk for a few basis points a year. Is there a cheaper way to hedge Japan's coming inflation?

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