Looming Euro Debt Quake Will Shake the Yen

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The next European sovereign debt crisis, like the last one (2010-11/12), will have strong links to the bursting of asset inflation around the globe. This time, however, these events will shake Japan's financial edifice and trigger a flight out of the yen. That is the inevitable consequence of Japan and Europe having pursued monetary radicalism to extremes in the second great asset price inflation of this century.

Both these global asset inflations have had their principal source in the Federal Reserve. The ECB and Bank of Japan contributed to the party in the first asset inflation (2003-7) by steering their monetary policies in line with the Fed. Their wild adaptation of US monetary experimentation in the second has driven speculative temperatures across several asset markets to record highs.

Asian credit markets have been this time an epicentre of bubble. The Japanese economy has gained passingly from this. The bill calculated in terms of mal-investment and financial system weakening has yet to arrive. The economic and financial proximity of Japan to the other epicentre – digitalization and its unicorns – will likely add to the eventual cost.

History does not repeat itself and the looming European sovereign debt crisis will fit into global asset deflation in ways different from the last. This time the global bust will feature prominently a collapse in the now tremendously bloated US and non-US BBB corporate bond markets, fanning out to junk bonds and private equity. That collapse would engulf by contagion the weak European sovereign debt markets starting with Italy.

Alternatively, the debt crisis in Europe could precede but hasten the crisis in BBB corporate bonds. A possible trigger is European political instability. Likely general elections this autumn in Italy and Germany could unleash forces which would bring a halt to the massive flow of negative interest funds from Frankfurt to Milan.

In contemporary financial markets many traders are conditioned Pavlov-style by past reward patterns to buy the Japanese currency on any sign of "risk-off". This induced reaction will prove disastrous when the big quake arrives.

The yen's strength in the last European debt crisis stemmed principally from the collapse of the currency carry trade which had been a big feature of the first global asset inflation of this century. Everyone everywhere had been borrowing zero rate yen to finance assets whether in Spanish housing or sub-prime mortgage debt. Global investors viewed financial institutions in Japan as relatively safe.

This time the yen carry trade has been a shadow of its former self. Meanwhile a bursting of the global credit bubble including BBB corporate bonds, French and Italian sovereigns, would lay waste Japanese savings. Many financial institutions have just about preserved outward appearances of normality in the context of interest income famine by immersing themselves in the bubble.

The bust will leave serious holes in an ageing Japanese population's provision for pensions. Those Japanese financial institutions which have ramped up short-term dollar funding in recent years to accumulate risky credit paper could find this suddenly hard to roll over. In currency markets this would mean a surge in demand for dollars.

In this situation it is hard to see why Japanese savers – or European savers for that matter – would repatriate funds. Rather they would intensify their accumulation of US cash and Treasury bonds. Japanese investors at the margin would be transferring funds from the European debt quake zone to the US. Global investors who had been slow to run down their reserve holdings in yen and euros in recent years would make up lost time, realizing that only the dollar now satisfied the criteria of an international reserve currency.

All of this would occur even though nominal rate spreads in favour of the dollar narrowed as the Fed cut rates. Rate differentials are far from decisive in international monetary choice as history reveals only too well.