The Depth Report

Sovereign Debt Defaults – Japan vs the Bond Vigilantes

Introduction:

This week's 5 Things to Know included a mention of Japan's potential sovereign debt default. It hasn't happened yet, but there is a possibility of a death spiral. You may be reading a lot about this in the coming months, so we'll include a description of a death spiral, bond vigilantes, and the implications for contagion. Defaults can trigger other defaults as well.

The key point is that in the short and medium-term, a central bank can print more currency, and keep interest rates below market levels. In the long-run, the market will get its say, and unsustainable fiscal policies will lead to disaster.

The Death Spiral:

We've just gone through a roughly 12-year period when the major industrialized economies took on enormous amounts of debt and held interest rates around or below zero. Central banks were able to enforce artificially low interest rates which enabled excessive spending. The low rates also hid the impact of all the additional borrowing. While governments were adding trillions of new debt, the low rates ensured that the costs didn't affect budgets in the way it should have. In addition, for reasons I still don't understand, these same central bankers didn't issue 100-year treasury securities when rates were at all-time lows.

Now, interest rates are rising again in an effort to try to control the inevitable inflation. As the low-cost debt rolls off the government balance sheet, it needs to be replaced with higher-cost borrowing. Interest expense as a percentage of government budgets is increasing, and governments in the US, the UK, the EU, and Japan are apparently shocked that they aren't able to issue unlimited amounts of debt at zero cost forever.

These governments are all running huge deficits and refuse to even consider reducing spending. In turn, the increased interest expense leads to higher deficits which need to be paid for by more money printing/currency creation. That leads to even more inflation which causes the central banks to need to raise interest rates. As we pointed out in our 5 Things, play this cycle out a few times, and the end result can be a sovereign debt default (which may be preceded by hyperinflation as the central bank tries to print its way out of trouble).

The Bond Vigilantes:

In the US, we're accustomed to the Federal Reserve setting interest rates. However, as bond holders have found out in the last year, when interest rates rise, the value of those bonds can collapse.

Year-to-date chart of the 20-year treasury bond. Chart from TIKR.

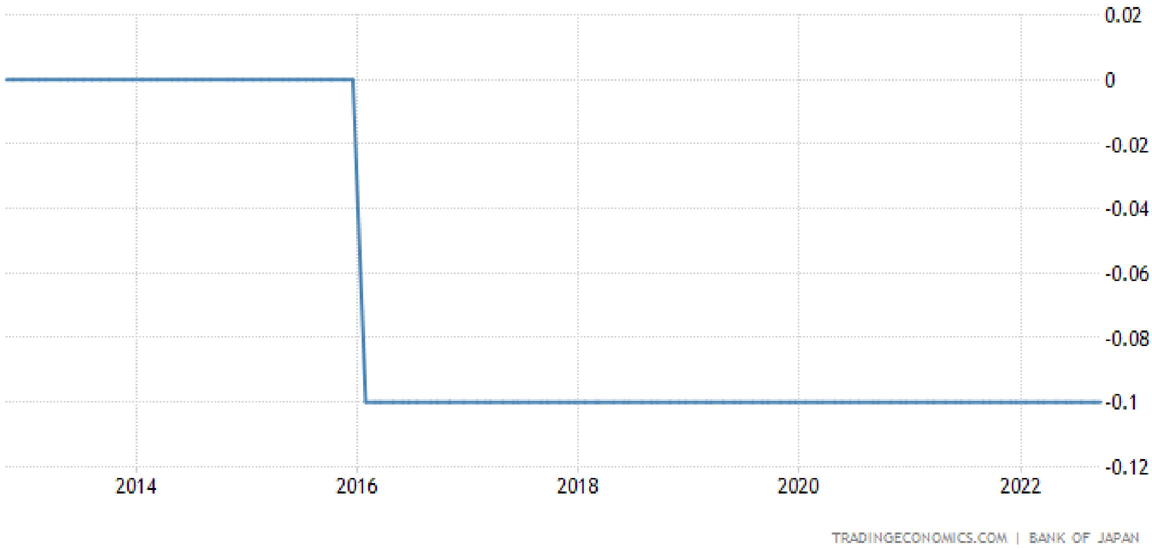
The Fed might set the fed funds rate, but the market can then decide it will only buy treasury securities at a discount to the face value (implying higher interest rates). Bond market participants can sell treasury securities and only buy them back when the yield is to their liking forcing the central bank to contend with market-determined rates rather than their own budgeted (or dictated) preferences. When bond traders force the central banks out of their preferred yield range, they're called bond vigilantes.

Think about this like being a little kid at home. There's a certain amount of roughhousing and raised voiced you can engage in without attracting too much attention. However, once there's a broken vase and screaming, parents are going to enter the room and put a stop to the fun. The Fed and other central banks can exercise a certain amount of discretion for a while, but eventually the bond vigilantes (the parents in this case) are going to decide what is acceptable behavior in the house.

The place we're seeing this stress in the market right now is in vanishing liquidity. In the US, the Treasury Department recently contacted large banks and asked if they wanted more liquidity in the market (meaning they were offering to buy treasury securities). In the UK, the Bank of England just had to step in and buy billions of pounds of their 30-year gilts to avoid pension funds collapsing due to their own death spiral issues caused by leverage. And in Japan, there are many days that the ONLY buyer of Japanese treasury securities is the Bank of Japan. The central banks are desperately trying to provide liquidity in their markets as bond investors avoid the sector.

The Situation in Japan:

As of now, Japanese debt to GDP is over 260%, the highest in the industrialized world. As central banks all over the world start to raise interest rates, the Bank of Japan has kept its version of the fed funds rate around (and below) zero.



This is the Japanese version of the fed funds rate. Chart by TradingEconomics.com.

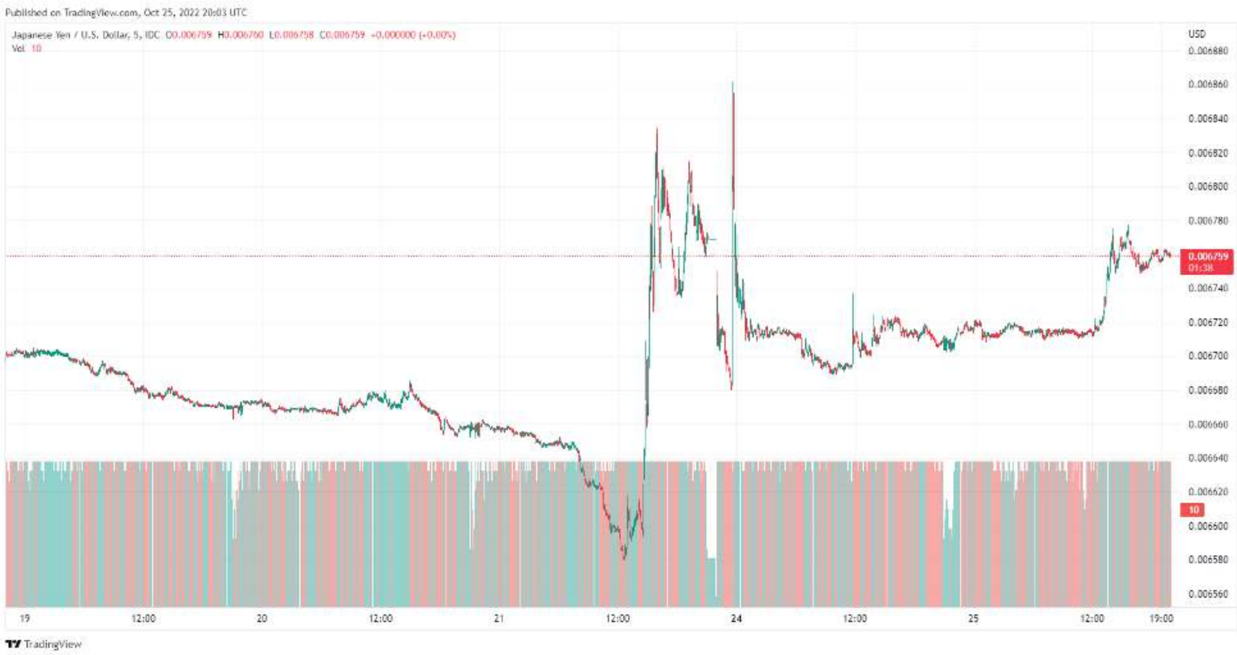
The Bank of Japan has basically said that it will spend any amount of money defending the 25bp line. That means that the BoJ will sell foreign currency reserves and buy the yen (or yen-denominated debt) to keep the yield on these securities at or below .25%. As we keep pointing out, while the central banks have a lot of power, eventually the market will get its vote.

Because other central banks are raising rates, demand for those currencies has increased. Simply stated, while you might not have wanted to buy a 10-year treasury bond when it offered you a return under 1%, you might be more interested when it offers you a return of more than 4%. Because you need to have dollars to buy that treasury bond at the new more-appealing rate, the dollar will get stronger (and theoretically, help reduce inflation). The obvious result here is a selloff of the yen as the BoJ has continued to defend artificially-low interest rates.

This is a chart of the Japanese yen vs the US dollar year-to-date. It doesn't look good if you're the BoJ. Chart from TradingView.com

So, what we see here is the Japanese central bank can run up huge debt and can try to defend its artificially-low interest rates, but it can't control its currency as well. (The DKI/Heisenberg Uncertainty Principle of Foreign Exchange Rates?) Japan owns [$1.2

[trillion](#) of US securities, and is blowing through those reserves in an attempt to defend its currency. The problem for Japan is every time it does this, it runs the balance of those reserves lower. At some point, if the BoJ can't keep throwing other countries' currency at the problem, the market will take the yen down even further or interest rates will have to rise (or both).



To give you a sense of how futile the exercise is, this is a one-week chart of the Japanese yen vs the US dollar (also from TradingView.com). You can see exactly where the BoJ started using its US dollar reserves to defend the yen. But look back at the prior chart and see how little difference it made. To put things in a more familiar way, the actions by the BoJ took the number of yen needed to buy a dollar down from 152 to the current 148. That's a big change in a day, but at the beginning of the year, it only took 114 yen to buy a dollar. The real move is a huge devaluation of the yen and the BoJ is fighting a losing battle.

<u>What Are Japan's Options:</u>

Like every other country, Japan won't do the one thing they really need to do which is spend less than they receive in taxes, and start paying down their debt. So, the question comes down to who has more firepower: the Bank of Japan, or the bond vigilantes? The BoJ may be able to hold off the bond vigilantes for a while (or even years), but at some point, the yen will collapse or the BoJ will have to raise rates. At that point, we're in death spiral territory – see above.

What About Contagion:

We've seen sovereign debt defaults many times in countries such as Argentina and Greece. But we haven't seen this in a world leader in decades. However, contagion can be a real issue. Japan can sell over $1 trillion of US treasury securities before it has to abandon its defense of the yen. With central banks taking up most of the liquidity in the market, Japan could raise borrowing costs here in the US by taking over for our own bond vigilantes as it sells our bonds.

When central banks all start selling their own foreign exchange reserves, we could see a credit collapse. Right now, there is too much credit in the system so reducing that isn't necessarily a bad thing. But if it happens as part of a cascading credit collapse, we could see an international depression. When you see people talking about coming deflation, this (or just a massive credit reduction) is one scenario they're envisioning.

US investors tend to not pay much attention to these things. There is an assumption that "this couldn't happen here" referring to a default or other such financial disaster. That will be true until it isn't true. We offer two examples. First, only a few decades ago, Japan had the second largest economy in the world, and people in the US were concerned that they would displace us as the world's leading economic power. There were all kinds of stories about how some tiny plot of land in Tokyo was worth more than Rockefeller Center or all the property in San Francisco.

Second, many of us are familiar with the phrase, "When America sneezes, the world catches a cold." Here in the US, we've felt isolated from the consequences of our bad policy decisions as the post WWII Bretton Woods agreement and the 1970s negotiated petrodollar deal provided enormous support for the dollar. As a result, US politicians (of both parties) have spent far more than was wise, and ran up debt that could lead to our own version of a death spiral (or hyperinflation) if the Fed has to keep raising rates.

For those of you who think we're being a bit dramatic, perhaps you're right. We'll just note that the original version of the line above was written about 200 years ago. The first version was "When Paris sneezes, Europe catches a cold." No one stays on top forever.

We'll always be cheering for the US to succeed, but in this case, that's going to require a better approach to spending, debt, and manipulated interest rates and markets.

Conclusion:

It's possible the BoJ, the EU central bank, the Bank of England, and the US Federal Reserve have enough dry powder to run another lap of low rates and QE money printing and credit expansion. It's also possible that we're looking at the first of multiple sovereign debt defaults as the greatest economic powers in the western (and western-aligned) world collapse due to unsustainable debts. In this scenario, there will either be a complete and painful restructuring of the entire financial system, or the existing currencies will remain in place with hyperinflation destroying any value that people have saved. There are a lot of reasons we remain heavily hedged right now, and this is one of them.

As always, we're trying to take on very complicated topics in an approachable format. If any of this requires further explanation, or you have any follow-up questions, reach out at IR@DeepKnowledgeInvesting.com. We're here for you.

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