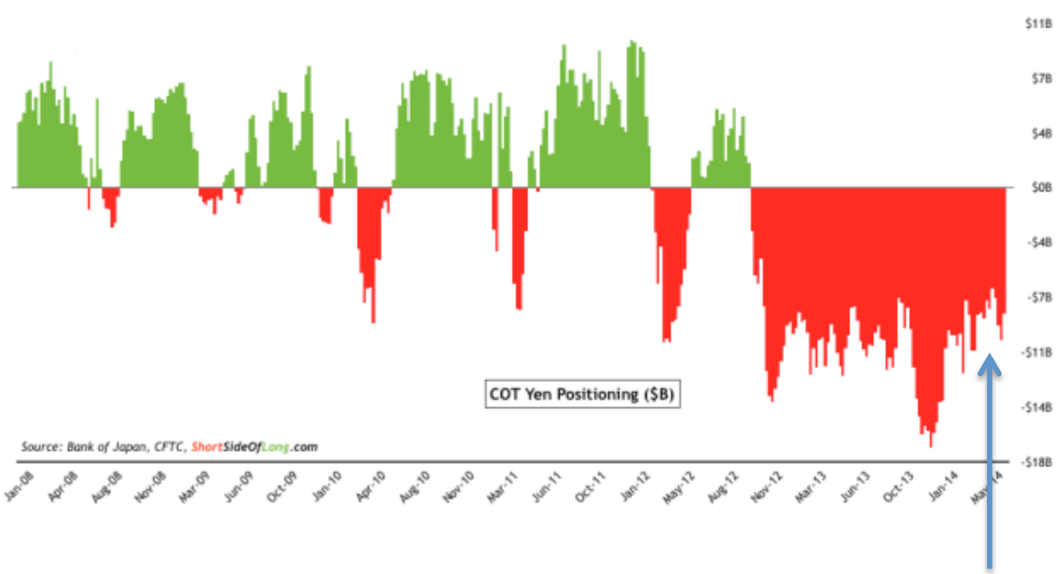
The Starboard Side Report

The week ending June 27, 2014

There is not an asset on the planet that is as universally hated asset as the Japanese Yen. History teaches us that crowded trades usually end in tears and being short the Japanese Yen in the form of a “carry trade” is one of the most crowded trades you will ever find. Carry trades are a popular hedge fund strategy where the fund mangers borrow in a country with low interest rates to fund purchases of higher-yielding assets elsewhere. This creates a vicious circle between that assets being purchased and the carry funding currency.

We all know that an unloved asset can stay out of favor for a long time. However, the contrarian opportunity becomes very interesting when the trend starts to turn and momentum starts to head in the other direction. We show below that we may be approaching such an important pivot point for the Yen. Again, this is important because the Yen has been used as a carry trade currency by hedge funds who have in turn used the funds to buy a whole host of risky assets throughout the globe. As we show below, the Russell 2000 Index has experienced major drawdowns over the past twenty years when faced with the technical set-up the Yen is showing at present. It is not necessarily that carry traders are buying the Russell 2000 Index, but it is a high beta asset that tends to sell-off more significantly when periods of “risk-off” hit the markets. As such it is a good barometer of risk appetite.

Hedge Funds are extremely short the Yen (and long risk)…...



Source: Short Side of Long

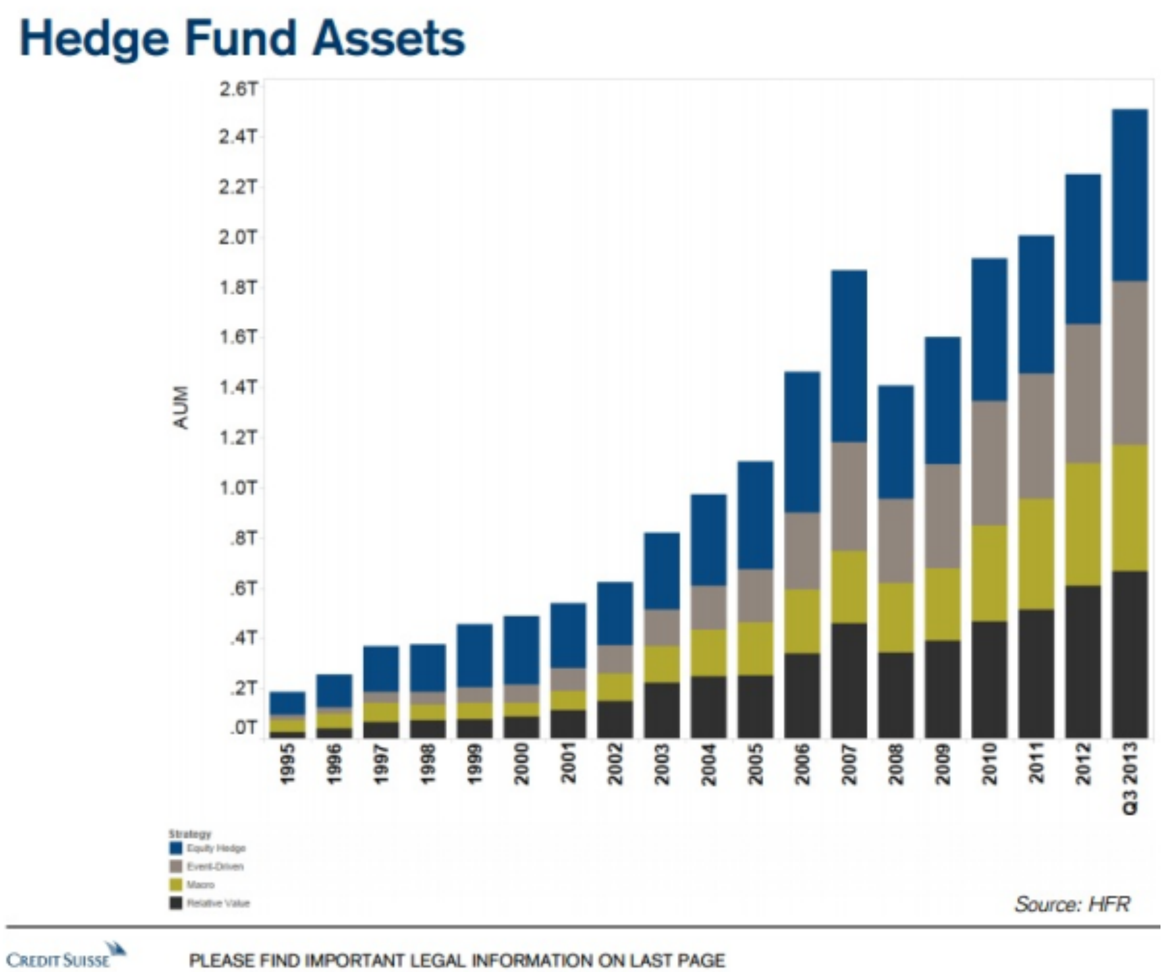
Red= net short position

The upside technical reversal we are starting to see in the Yen is evident in both a daily and monthly chart. First up, we show a 20-year monthly view that demonstrates a possible pivot point similar to the yellow highlighted periods in 1998, 2002 and 2007. The middle pane in the first chart shows the Yen itself, whereas the top and bottom panes highlight a shift in momentum after a two year downtrend. Those previous big pivot reversals higher in the Yen occurred as hedge funds scrambled to cover Yen short positions and sell risk assets. The second chart shows that our risk off barometer the Russell 2000 Index lost 38%, 38% and 68% in the prior three carry trade unwind episodes.

Japanese Yen Twenty-Year View

Russell 2000 Overlay

As mentioned, hedge funds are a primary player in the currency markets, so it makes sense to look at the level of total hedge fund assets under management during each Yen carry trade regime. As you can see in the next chart, hedge fund assets have gone from $300 billion in 1998, to $600 billion in 2002 to $2 trillion in 2007 to over $3.0 trillion today. This is important because it helps illustrate the magnitude of traders that are on the same side of the boat following the same strategy. It is not a coincidence (given the higher level of hedge fund assets) that the 2007-2008 unwinding of the Yen carry trade caused the biggest bust of the three. The fact that hedge fund assets are now 50% higher than 2007 and nine times higher than the first Yen drawdown episode in 1998 makes this analysis very important to the investment landscape should this one-sided trade start to unwind in force.



Source: HFR via Credit Suisse

We will close with the shorter-term chart of the Yen to further illustrate the key juncture that is upon us. After having negative momentum since late 2012 (as defined by the 50-day moving average crossing below the 200-day) the Yen is showing signs of life. We just had a breakout above the downtrend line and both moving averages. At the same time, the 50-day is just about to cross back above the 200-day moving average for the first time since December 2012.

Japanese Yen Two-Year View

The bottom-line is this. We thought it was a good week to discuss what we are seeing in the Yen because all of the hoopla surrounding hedge fund assets crossing the $3 trillion threshold for the first time ever just as the most popular hedge fund trade in the world is showing signs of breaking down. This introduces the possibility of major currency and "risk asset" volatility in the months ahead. If this comes to fruition you will no doubt be reading more about the Yen in the back half of 2014.