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Is it Time to Take on the "Widow Maker"?

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In a research note last week analysts at Nomura asked this question: is it time to take on the "widow maker"? The "widow maker" is a well known trade in Japanese trading circles where one shorts Japanese Government Bonds (JGBs). The trade has picked up some popularity in recent years as investors have latched onto the sovereign debt crisis in Europe and extrapolated out to other parts of the world that have similar sovereign debt dynamics. We feel this position is misguided and we think that understanding the institutional structure of the monetary system and the macro picture (using Orcam's approach) can help one from entering into this potentially fatal trap.

Wall Street's 20 year Widow maker- Shorting Japanese Government Bonds....

Why the "Widow Maker" is Dangerously Misunderstood.

This trade has gained increasing popularity in recent years thanks in large part to Kyle Bass of Hayman Capital. Bass became quite famous after betting against the housing bust. But I don't feel his thesis on Japan is based on a sound understanding of the monetary dynamics.

In 2010 when Mr. Bass began to publicly express his concerns over a potential Japanese sovereign debt crisis I said in response:

"He compares Japan to the European sovereigns without recognizing that the monetary systems are entirely different….You would think that 20 years of this failed argument would have silenced it completely, but people still fail to understand that a nation with monetary sovereignty that is the supplier of currency...

in a floating exchange rate system never has a problem funding itself. In fact, contrary to popular opinion, the funding mechanism is the currency supplier itself. Such a system is not unlike an alchemist who simply makes gold from essentially thin air. To be specific, in the USA the government is always able to harness its banking system to procure funds. This is how the system is designed."

This is, in our opinion, a crucial understanding. Those of your who are familiar with my work on Monetary Realism will understand the institutional structures that make up the US and Japanese monetary systems. In essence, the systems are designed with Europe's fix already in place. That is, these systems are designed in such a way that the governments use the banking systems as their funding agents backed by a central bank (which can always guarantee funding). In the USA the Primary Dealers are required to bid at Treasury auctions and maintain a sizable market in the secondary bond market. The USA does not have trouble funding itself due to this unique relationship where banks are essentially bribed into doing the government's bidding with a central bank backstop. Europe does not have this design structure so to compare Japan or the USA to a European nation is flawed. Another way of saying this is that Japan and the USA cannot "run out of money" while a nation like Greece most certainly can. There is a very real solvency constraint in Greece so bond traders have different concerns than they might in Japan or the USA.

It's been widely reported that Hayman's funds have suffered substantial losses in the last few years in large part due to this trade. The flaw in the Kyle Bass thesis is that interest rates will surge due to market fears over high debt. But seasoned bond traders know that solvency is not the concern in a nation like Japan or the USA. They know that these nations cannot run out of money due to institutional design. So the focus then, is always inflation. And the reason Japan's bond market has continued to rally throughout the years is due to persistent stagnant economic conditions and low inflation as a result. We feel that the environment in the USA is remarkably similar to the environment in Japan. But more importantly, we must note that it is crucial to understand this institutional design structure before entering into potentially misguided trades based on an apples to oranges (Europe vs Japan) comparison.

Proper risk management is not just about using non-correlated assets and hedging products, but also about properly understanding the dynamics of the monetary system so you can avoid devastating investments. We feel that this is a prime example of a case where superior understanding served as its own form of risk management.

If you have questions or would like to inquire about Orcam's other products and services please don't hesitate to contact us.

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