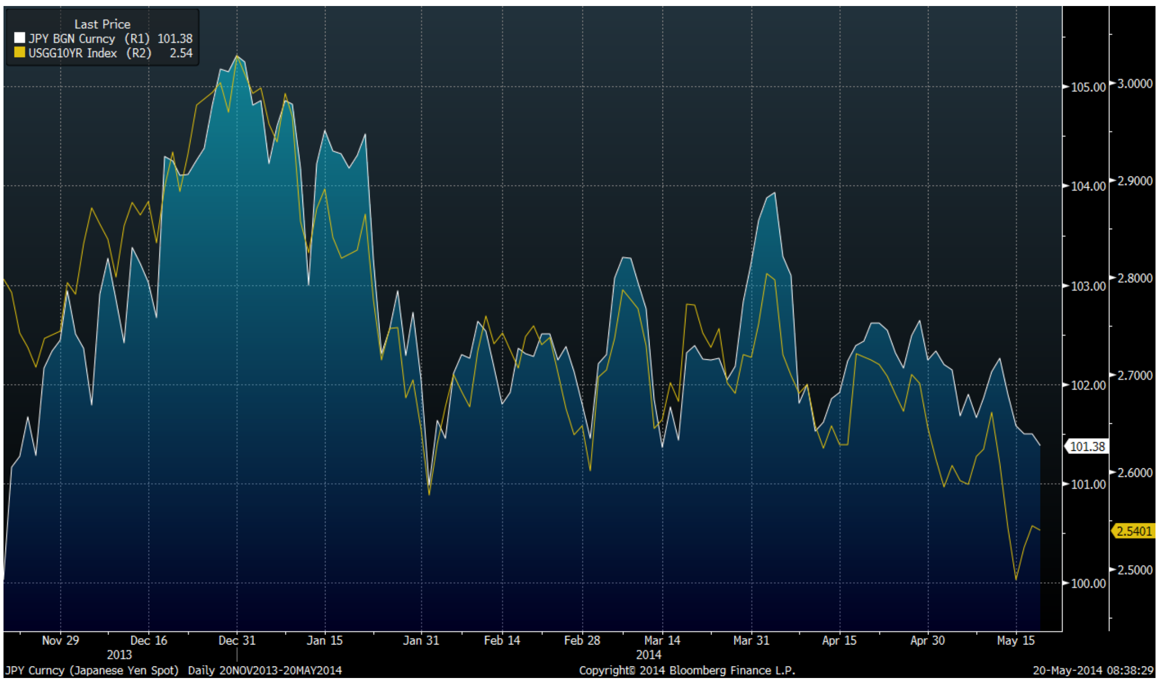
Classical Insights

Global Investment Analysis Based on the Classical Economic Model

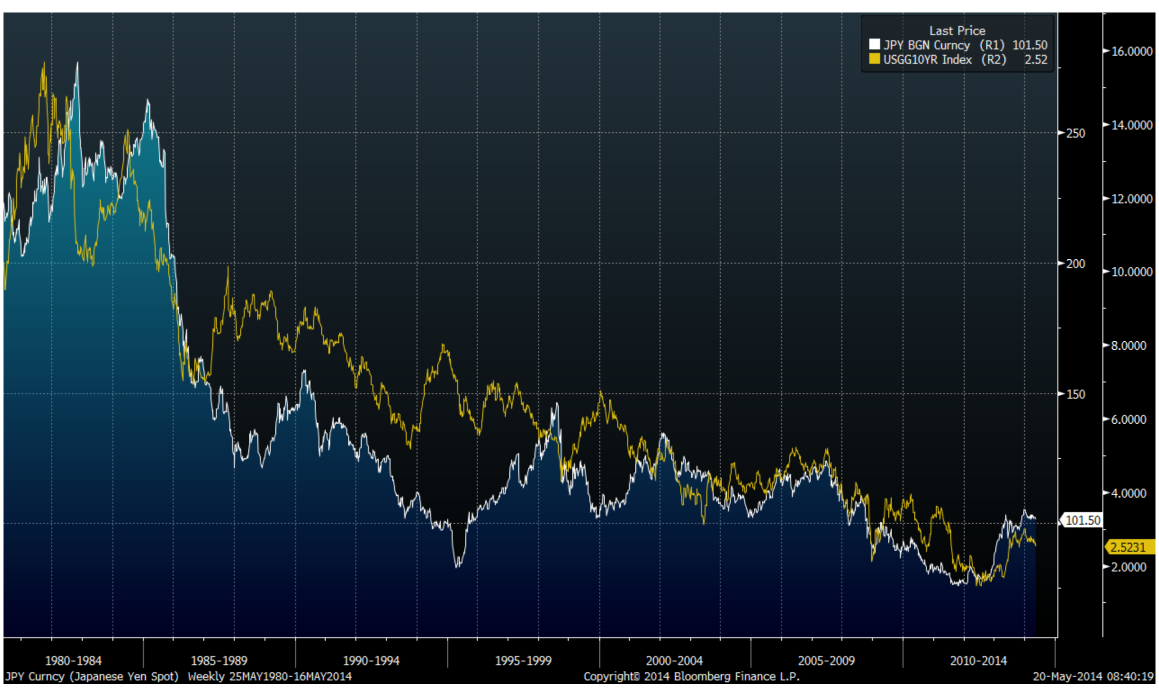
Classical Insights Bullet Points May 23, 2014

The Japanese yen shows a strong inverse correlation to US 10-year yield which, in turn, reflects moves in the fed-funds-rate equilibrium as determined by the Taylor Rule (now rising). As the equilibrium rate rises for fed funds, the yen's natural tendency over time *should* be to weaken. But there are two caveats: a) the entire US rate structure has been declining for 30 years and may continue to do so, and b) there are heavy short positions in the yen now. Points:

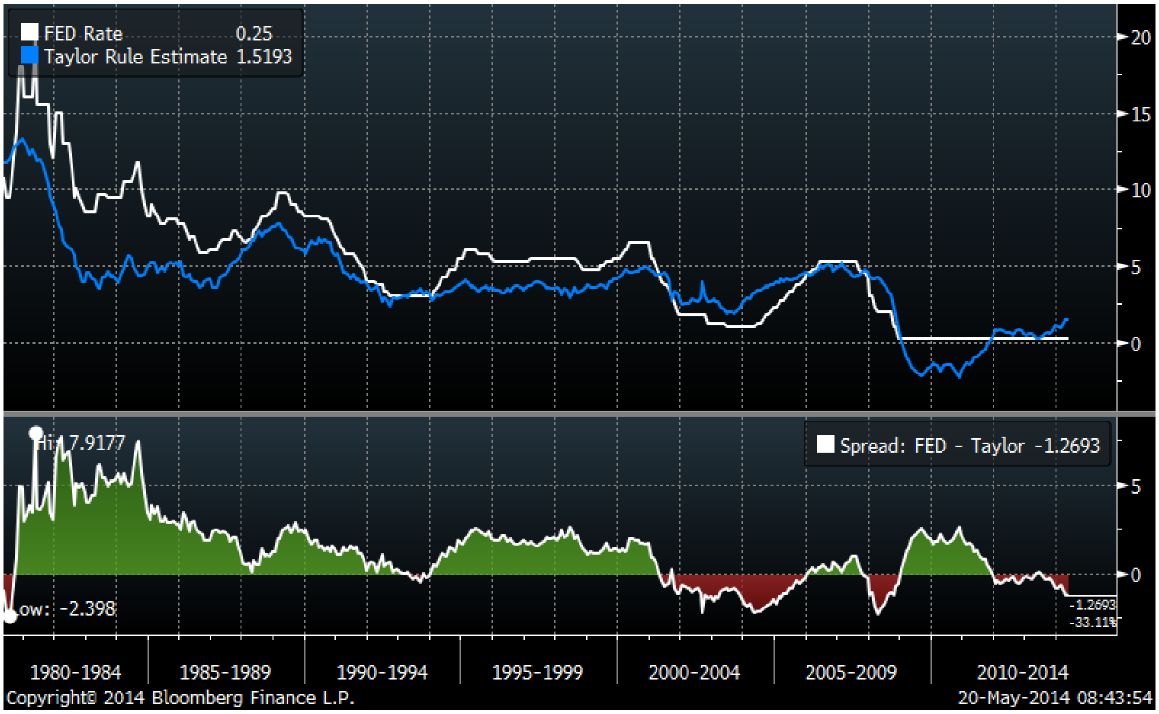
<u>1) The yen and US 10-year yield have moved in lock step over the past six months (*charts: Bloomberg*).</u> The yen is in blue.



Running the same chart back to 1980 shows the correlation still holds:



2) <u>Here is the Taylor Rule model as per Bloomberg.</u> It shows the Fed Funds rate being 1.3 percentage points below equilibrium. At some point, as the recovery lengthens, the Fed is going to lift the funds rate.

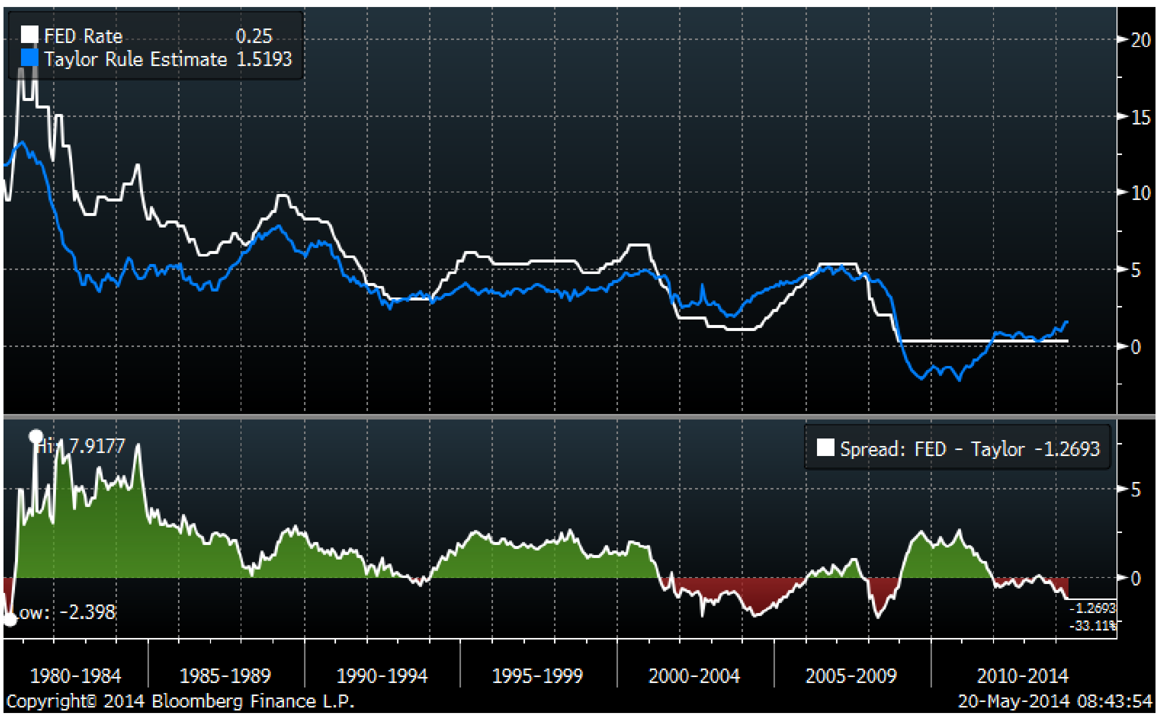


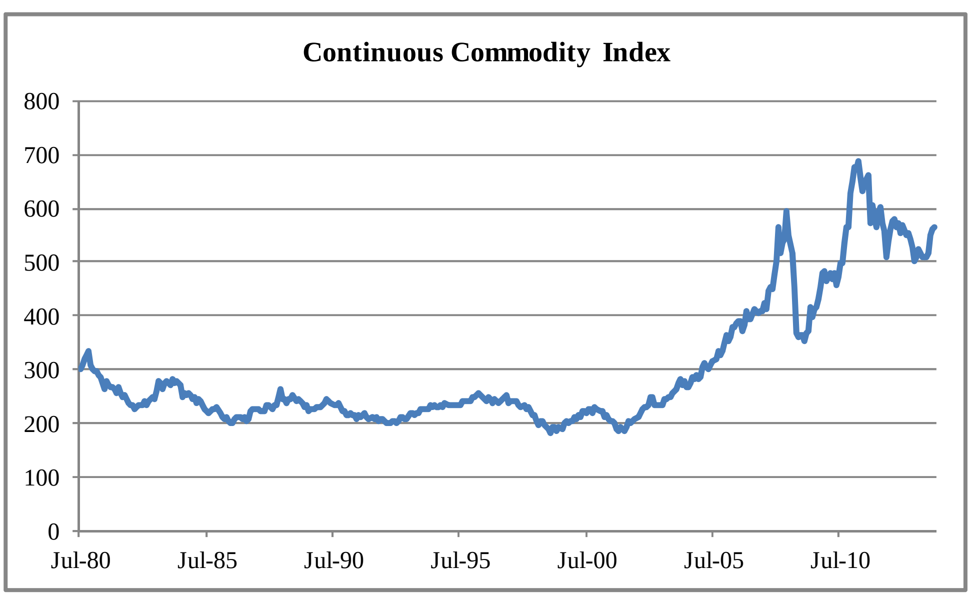
3) <u>Here is the US 10-year yield versus the US funds rate going back to 1975 (funds rate in yellow).</u> It shows that as economic recoveries lengthen, two things happen. First, the funds rate starts to rise. Second, the 10-year yield starts to rise in sympathy with the funds rate. It has happened every time.

4) <u>Of course, the other obvious trend in the chart above is a relentless downward movement of *both* rates since 1980.</u> That should give anyone pause in predicting a sustained upward

movement in US 10-year yields. Still, there is not one example in the past 40 years of 10-year yields falling after the onset of a rate-hiking cycle. Thus it would be hard to argue that 10-year yields should fall even further here.

5) There also is a strong correlation between the Taylor Rule and commodity prices. Below is the Taylor Rule chart again, followed by the Continuous Commodity Index. From 1980 to 2001 the funds rate was above the Taylor equilibrium, and during that period the Continuous Commodity Index fell from 300 to 200. Beginning in late 2001 the funds rate went below equilibrium and stayed there for five years. During that period the CCI nearly doubled. From 2006 to the present the relationship has been messier due to the crash and the impact of QE (which makes the funds rate moot as an indicator of Fed tightness). Now, though, with the QE period winding down, the funds rate can again be viewed as a measure of Fed tightness. As we see below, the Fed has been easy since the start of the year (funds rate below Taylor EQ) – and sure enough the CCI has risen 8% YTD.





6) Looking ahead, since we know Fed Chair Janet Yellen's plan is to keep the funds rate easy *vis a vis* the Taylor Rule for a while, we can be reasonably comfortable in assuming that's what will happen. On paper, at least, that should be good for commodity prices. I've left gold out of the equation for the moment out of concern that gold and commodity prices may have gotten a bit out of step with each other (i.e. gold too high relative to the rest of the commodity universe).

Bottom line: There is a very strong correlation between the yen and the US 10-year yield. It would be great to be able to say that the rising Taylor rate equilibrium implies an imminent rise in the US 10-year yield (and thus weakening of the yen) but that is too aggressive a statement given the relentless downward movement of the entire US rate structure over the past 40 years. What one can say with perhaps a bit more confidence is that the rising Taylor Rule equilibrium rate (relative to the actual funds rate) is itself a bearish force at the margin for the yen and a bullish force for commodities.

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