Is Kyle Bass Wrong About Japan?
By Robert Huebscher
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It’s standard practice for short sellers to kick dirt on their targets, and Kyle Bass is doing just that by asserting that Japan’s economy is on the verge of a financial crisis. In a talk on May 3, he said that Japan’s demise is imminent. So far, though, Bass has been wrong – and he has his detractors, who are far less certain of Japan’s destiny.

Bass is the founder of Hayman Capital, a Dallas-based hedge fund. He was featured prominently in Michael Lewis’ book, The Big Short, for profiting from investments during the sub-prime crisis, which he accurately predicted. He spoke at the Strategic Investment Conference in Carlsbad, CA, which was sponsored by Altegris Investments and John Mauldin.

Bass reiterated the same points he made in a talk he gave at the University of Virginia in November last year and which he has given on other occasions, including a speech at Jim Grant’s conference a month ago.

Bass’ predictions have not been accurate, at least so far. In his UVA talk, Bass said Japan was “already in checkmate” without policy options and that a crisis would unfold in the next 18 months. Now, six months later, Bass said “the beginning of the end has begun in Japan.” He again stated that it will be 18 months to two years before a full crisis unfolds.

You can read my earlier account of Bass’ UVA talk to understand why he thinks Japan is doomed. Let’s now look at why others – many of whom spoke at the Strategic Investment Conference – think he may be mistaken.

Nouriel Roubini

Nouriel Roubini, an economist and professor at NYU, laid out a scenario whereby Japan would avert a crisis. He said that a five-part plan would be necessary:

1. Aggressive monetary easing through 2014.
2. Fiscal stimulus this year, followed by some austerity in the next two years to stabilize deficit growth.
3. An agreement within the next four years to increase wages and boost domestic demand.
4. Structural reforms, which he said would be announced in June, to deregulate its economy.
5. The Trans-Pacific Partnership, which would boost trade and productivity.

If all five strategies are implemented, Roubini said Japan could benefit from a weakening yen, a rising stock market, an end to deflation and stabilization or modest GDP growth. But if all five are not implemented – for example, if the first two steps are taken (which Roubini said were easy) but the others postponed – then Japan “will eventually have a disaster,” he said.

“They have created a plan that if it is implemented in a holistic way can get them out of the hole,” he said.

Roubini also dismissed claims that if Japan were successful in creating inflation, it would also face increasing nominal interest rates that would impair its ability to service its debt. Japan will not achieve 2% inflation right away, he said, and deflation will persist for at least the next two years. More importantly, Roubini said that the Bank of Japan’s quantitative easing efforts will result in it purchasing 70% of all debt issuance, which will limit interest rates, as in the U.S. and the U.K.

Negative real rates would be an incentive for consumption and help Japan's economy, according to Roubini.

Japan’s debt-to-GDP ratio of 240% is misleading, Roubini said. Since virtually all its debt is held by Japanese institutions and individuals, its net debt is much lower. Japan’s debt is in its local currency, so Roubini said its situation more closely resembles that of the U.S. than the Eurozone countries.

Japanese citizens are unlikely to sell their yen and buy foreign currencies in quantities that would lead to a crash in the yen, he said, “The risks of a bond crisis in Japan, in my view, are overstated.”

Mohammed El-Erian

PIMCO CEO and co-CIO Mohammed El-Erian said Japan’s newly announced quantitative easing efforts amount to “the biggest experiment of its postwar economics.” In relative terms, he said it is three times what the U.S. has undertaken.

For its QE efforts to succeed, Japan must lower the value of the yen significantly – and El-Erian said that rest of the world would not accept that. El-Erian said that South Korea, for example, has already taken measures to subsidize its export sector in response to Japan’s QE efforts.
El-Erian said there is an incredible overlap between the export sectors in Japan and Germany, which will likely result in QE efforts by the European Central Bank to retain its export competitiveness.

El-Erian reiterated Roubini’s statement that Japan is in a special situation because its debt is held internally. “The home bias of Japan is enormous,” he said.

Other views

Anatole Katelsky, a journalist and economist who also spoke at the conference, said Japan will benefit from its “incredibly powerful sense of nationhood.”

Monetization is an option, he said, and Japan can undertake it without doing serious damage to its economy. He said that cash can be viewed as a bond with infinite duration and a zero coupon. Most Japanese hold their savings in 30-year bonds that yield 1%. It would not require much of a sacrifice to convert those bonds to cash, he said.

“That is a sacrifice the Japanese will be willing to make to allow their country to avoid default,” he said.

Japan could transform its bond market to a huge expansion in its money supply, which Kaletsky said would achieve 2% inflation. The restrain on unlimited monetization, he said, is a currency collapse. But that will not happen, according to Kaletsky, as long as all developed central banks are pursuing similar QE policies.

Martin Wolf

Martin Wolf of the Financial Times has written about the possibility of a Japanese collapse. The underlying problem, according to Wolf, is that Japanese corporations are accumulating too much cash. In the short term, its QE will lower the value of the yen and maintain negative real interest rates, which will stimulate exports and internal consumption.

But for QE to work in the long-run, Japan needs structural reforms that would lower corporate savings: a huge reduction in depreciation allowances, a punitive tax on retained earnings (possibly combined with incentives for higher investment) and reform of corporate governance to give more power to shareholders. Wolf considered it unlikely that those reforms would be undertaken.

Is Bass right?

Bass has said that the Japan’s collapse will not be gradual. It will get to a point where the qualitative behavior of market participants will change virtually overnight. That happened in
Greece, he said, when it went to a “five-alarm fire” in just a few days. A similar scenario unfolded when the Mexican peso was devalued in 1994.

When Japan announced its new QE program, Bass said the cracks started to appear in the Japanese government bond (JGB) market. Trading was temporarily halted because market limits were reached. “You are starting to see cracks in the façade of the qualitative belief system of the participants,” he said. “It is really important to track some of those cracks because they are happening right now and they haven’t ever happened before.”

So far, though, none of Bass’ dire predictions have come to pass, and Japan’s downfall has taken longer than he predicted. Bass’ dissenters have credentials that are at least as distinguished as his, and they have sound reasons why events may not proceed as Bass predicted.

Unlike his dissenters, Bass is betting his and his investors’ capital on his predictions. But because the market still considers the likelihood of a Japanese collapse unlikely, the cost of placing that bet is not high. Bass said he is using only 1% to 1.5% of his capital to bet against Japan – a low-risk and potentially high-return investment.

A full bond crisis would be disastrous, according to Bass. “We estimate that if we are right, the average Japanese person will lose 30% to 40% of their purchasing power at a point in time in their life where they can't afford to lose it,” he said. “That is destabilizing for the region. It will most likely lead to true conflict, which is a terrible thing to say, but it's the way the world works.”