A Fed's rate hike would be suicidal.
Could the BoJ throw in the towel first?

A suicide is not an option

In the last few months the Fed has been talking of a possible rate hike, and the markets expect it to come some time later this year. However, a mere 25 basis point hike of the Federal Fund rate will definitely lift rates along the entire curve, crush the bond market and see sharp increase of debt defaults. The collapse of the bond market will inevitably bring down the equity market. The strength of the stock market has been largely driven by the excess liquidity and share buybacks, rather than higher corporate earnings. One of the reasons why share buybacks have been so popular is that companies do not see much of capital investment needs simply because the recovery this time is very weak.

The Fed ceased the third programme of Quantitative Easing (QE) at the end of last October, and buybacks have already seen their peak. For these reasons, the stock market looks vulnerable.The Fed's 6-year long policies, namely the zero interest rate and QE, which are an act of desperation, have failed to produce sustainable recovery. A minimum rate hike would trigger the collapse of the asset price bubble which is the sole fruit of their policies.

Lack of supporting data for higher rates

Despite the strong employment data, the Fed's must be well aware of the fragility of the economy, and that is the very reason why it has been reluctant to hike rates. If the underlying economy were showing unarguable strength, then the market rates would have gone higher ahead of the Fed's move. In fact, there are quite a few signs of weakness in the real economy.

The Fed has led itself into a cul-de-sac: Damned if they do, damned if they don't. What they have actually been doing is not to analise macro economic data and determine policies based on them. Instead, they have been selecting data which justify their action of sending a signal of raising rates. This is the very reason why they have been playing the words with 'significant', 'patient' or 'removing 'patient' does not mean 'impatient'. This is utter nonsense!

Currency manipulation is the last resort

The Fed has been sending the signal of rate hike since H2 last year to the markets, and their ultimate objective is to maintain confidence in the dollar. Central banks, sovereign wealth funds and large institutional investors who hold the Treasuries must be seeing the QEs not as pure stimulus to the economy but as the US government debt financing and the dollar devaluation. The dollar index has indeed declined since the QE began. If those investors gave up on the Treasury, i.e, the petro-dollar recycling, the US would be forced to declare a default. Unlike the Bank of Greece, the Fed can of course print more money, but it would be a way to self-destruction. It needs to have the dollar appreciated to prevent this. That is why they keep 'talking up' the dollar.

The Fed has been looking forward to a soft landing while they keep buying time. However, the demand has been weak domestically as well as globally. 'The strong dollar is in the American interest'. When the authority mentions this, it is the very time when the dollar is not well supported. They would not have to say it otherwise. One way to buy time is to get the BoJ and ECB take the QE baton and weaken the Yen and Euro respectively which in turn would take the dollar higher. However, the Fed has exhausted their accomplice.

The Fed is not able to manipulate corporate earnings and must expect a huge backlash from the bond market distortion which their manipulation has brought about. Under these circumstances, in the near term, Washington is likely to be sowing seeds of conflicts or war to make the dollar as a safe haven, particularly after it spectacularly lost politically in the Asian Infrastructure Investment Bank tug of war: It needs to show 'strong America' and 'the strong dollar' to the rest of the world. The US administration might strike back toward the end of June when the Greek crisis is expected to climax. The real objectives of its short-term strategies would be quickly revealed, however, and the US isolation would be made clearer in the international stage.

The BoJ to throw in the towel first?

Whether the BoJ gave in to the pressure from or was encouraged by the Fed is not clear. But it boldly ventured into the unchartered waters. Whatever the real motive may be, Governor Kuroda chose to follow the path the Fed took and has led the BoJ to its own trap.

Kuroda seems to be well aware of the danger their policy will eventually lead to: Apparently he mentioned at the government financing committee the future risk of the

JGB market collapse, but his comment was removed from the minutes. This was rather quietly reported. Sensible policy makers and economists must know the BoJ has to exit from their QE sooner rather than later, but they all have kept silent so far. No one will dare endanger their future career!

On 15 January the Swiss National Bank decided to de-peg the Swiss Franc to the Euro. It carried out its QE for nearly 3 years, not to buy Swiss government bonds but to buy the Euro. The size of its QE has grown to 85% of the Swiss GDP. It could have continued but the SNB feared that unless it stopped then, further deterioration of its balance sheet, and the risk of sudden devaluation of the Swiss Franc and future hyper-inflation would have been unavoidable.

The size of the BoJ's QE has already surpassed 60% of the GDP and getting ever closer to the Swiss level, although the 85% limit is completely arbitrary. Meanwhile, the BoJ lowered the CPI expectation number for FY2015 from 1.5% to 1%. This is its undeniable admission that the QE failed to raise the figure.

The BoJ is sandwiched between the persistent deflation, and potential hyper-inflation and the collapse of the Yen. Their best way out would be stagflation which means a status quo, which is in turn to equivalent to a slow decline.

Whatever the definition of the term may be, the BoJ's QE is directly financing government debt, just like the Fed's did. There seems to be no 'unconventional' exit strategy. When such a perception spreads widely in the markets, the BoJ will lose its credibility, and thereby the Yen and asset prices will collapse. This risk looks like becoming ever higher by the day.

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