Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

A Yen for a Mortgage

JOHN MAULDIN | May 3, 2014

IN THIS ISSUE

For some time I have been saying that I was going to close the mortgage on my new apartment and then hedge it in yen. I promised to tell you the story, including what type of loan I got and how I am doing the hedge. This week I was finally able to pull the trigger. This topic will also let us re-examine why I think the Japanese yen is a screaming short. I am going to make this a shorter letter, as Amsterdam is calling, and it is a beautiful day. This is not a big think piece, but I think many of you will find it interesting. It outlines how I put my economic thinking into actual practice, and names names, if you will, of those who helped me do it.

A little background might be in order for those who want to know about the house. Others might skip to the next heading, An ARM and a Leg. I bought my last home in 1991 and sold it around 1998. I bought during the savings and loan crisis, which gave us the Resolution Trust Corporation, which sold me my hew home. I paid about 35% of the original asking price only two years earlier, at the high-water mark, so I got a good deal. (Which was partially offset by the fact that I had to bring a check to the closing from the home I sold to get the new one.) Homes in some parts of Texas were literally being auctioned on the courthouse steps and paid for with credit cards.

For that home, I actually offered $50,000 less than several other offers on the table, but I attached a large nonrefundable cashier's check, as a deposit, to the offer, while other bidders wanted the harried RTC clerk to make some much-needed repairs (the pool was green, fire ants had chewed through wiring, there had been flooding, etc.). But he had a monster stack of homes on his desk to sell, and my offer involved the least work, so he simply took it. I didn't make all that much when I sold the home seven years later, by the way, but I did OK.

Rental properties in Texas at that time and up until recently have been good deals, in my opinion. For me, the cost of renting was much lower than the total cost of buying a home. About six years ago I moved to downtown Dallas after 40 years on the Fort Worth side of the metroplex. I moved first into a high-rise (with some of the kids) and then later rented a larger home in Highland Park during the Great Recession, when larger homes simply couldn't find buyers. It was stunningly cheap for the value. I was quite happy with my long-term set-up, but in January the owner called from California and offered to let me out of my lease if I would move in 45 days so he could sell the home in the spring. The market had finally come back, and homes in the "Park Cities" were selling within a few weeks of going on the market.

I was not really interesting in moving, but I had been to an apartment that a good friend of mine (David Tice of Prudent Bear fame) had renovated, in what is called the Uptown area of Dallas. He bought two apartments on the 22nd floor of a high rise, basically taking the whole south side, then knocked down interior walls and made one large, open apartment He really did it quite nicely. I fell in love with his place, which is rather unusual for me, as I have been in fabulous homes all over the world; and while I admired many of them, none had ever "spoken" to me. But the views of downtown Dallas and the surrounding area just seemed so full of energy to me; and as a writer, I need to feel the energy. It recharges me. (I know, some people want beaches or mountains or a cave, and I have written this letter from many corners of the planet, but I do like a place with energy.)

So I called David's realtor. Amazingly, two adjoining apartments were just coming on the market. They were basically apartments that had been bought on spec during the crisis, and the market had now come back enough that the owners were ready to sell. One of the apartments had never been lived in or rented. They were the two three-bedroom apartments on the east side of the building, but they had the downtown views as well as northern ones.

Dallas has plenty of high rises, but oddly there are very few larger apartments except for penthouses. And the penthouses command a LARGE premium for what is still just basically floor space. I checked all the local similar offerings to get an idea of relative value, and I again put in a below-market offer for the two apartments. After a lot of negotiating by my realtor, Nancy Guerriero, my offer was accepted. Then the hard part began, and that was getting a mortgage. Because I was going to renovate and because there was a tenant in one of the apartments, I could not get anything like a traditional mortgage. My mortgage broker, Ron Schulz, must have shopped several dozen banks. Basically, banks don't like high rises and homeowners' associations, as their local experience has not been good. Without going into details, I had to get three different loans to do the deal, and finally got help from a local banker, Joe Goyne, president of Pegasus Bank. Joe is a throwback to the old personal bankers we used to have here in Texas.

We started on the design almost as soon as I committed to the place. I was lucky in that my niece, Jen Mauldin, had trained with one of the largest architectural design firms in the country and done major design projects all over the world (the estates of Abu Dhabi princes, commercial developments in Macau, high-roller suites in Vegas, Ritz-Carltons, etc., plus lots of very nice homes). She had gone out on her own and was available. We set budgets and timelines. (Cue laughing from all my friends. They were right to laugh.) The planned 120 days of construction stretched into 180+ days – and forget about the budgets. Then there was the shock when it developed that new mortgage rules basically meant that I had to go to a 70% loan instead of the 80% I had been told I would get.

Plus, I was a rookie and did not check a "small" detail. I asked if I could get my construction costs rolled into the new loan. The answer was yes, but what they meant was that I could get the construction loans rolled in but not my out-of-pocket costs, because Texas has a law that you cannot get money out of your mortgage when you refinance, and what I paid out of pocket was considered getting money back. Oops – I had paid a lot out-of-pocket just to move things along, when I should have gone to Joe and upped my construction loan. Silly me.

All told, I had to come up with way more cash than I thought I would when I started. The difference was large enough that I would not have done the deal if I had known. But I really like my place, so in a sense I am glad that I didn't know. (You can see some of the work on the place at Jen's website.)

An ARM and a Leg

But then came the time to get a takeout mortgage. Joe had lent me the total amount at 3.75% for one year.

It soon became apparent I would get only a 70% loan, which would basically take me out of the construction loans. I got lucky in that the appraisals turned out higher than my cost basis, as values have actually moved up. First feelers were not encouraging, so I began to shop.

I wanted a 5-year adjustable-rate mortgage (ARM) with a 30-year amortization. My feeling is that there will be a recession within the next five years (if we do not have one, it will be the longest span on record with no recession in the US) and that rates will once more go way down – and I can then lock in whatever I want, probably a 15-year fixed, at that time. My risk is that we may never again see rates as low as they are today, but that is a chance I am prepared to take. (I really do eat my own "cooking.")

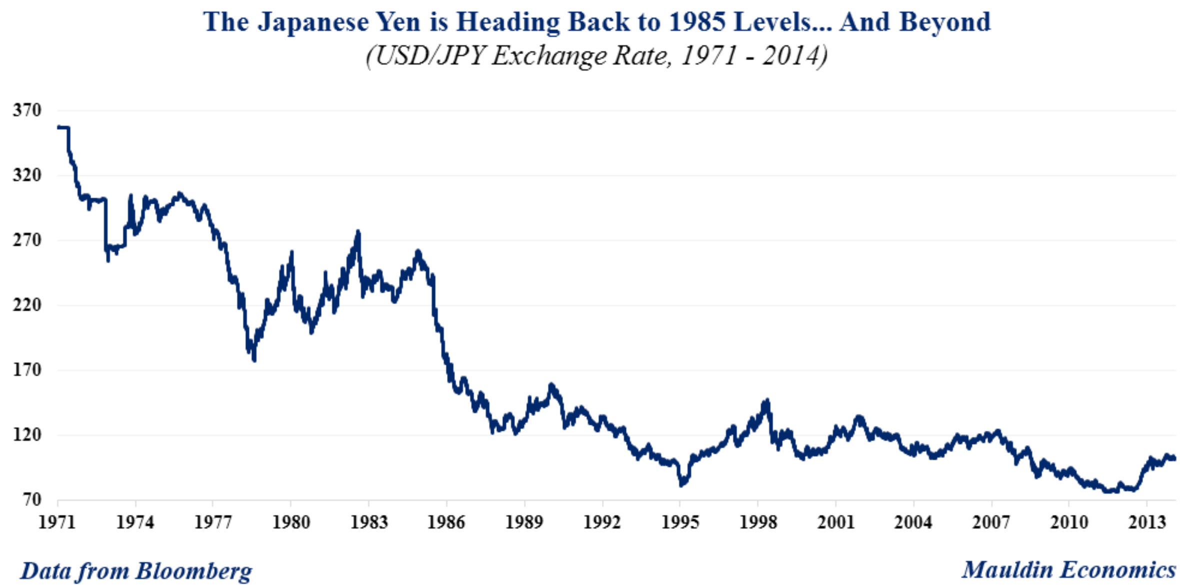
Two personal connections turned up offers in the 4.5% range. Ron was beginning to get feelers in the high 3% range. I called my broker at JP Morgan (more below), and Travis Moss in his office went to work and got me an offer for the 5-year ARM at 2.875%; but it was not clear they could actually do the deal, as high-rise financing is complicated in Texas. About that time, my regular bank, Capital One, changed loan officers. The new guy gave me a courtesy call; and upon finding that I needed a mortgage, he jumped into the process. Rather than a loan that they would securitize, they were looking for a loan to put on the books. They matched the JP Morgan offer and really dropped the closing costs. No points, etc. I sheepishly told Travis (who is a friend) that I was getting a better offer, and within a day he had matched it. We decided to go with JP Morgan, as that is where I am going to do my yen hedge, but it was hard to turn down Clinton Coe from Capital One. He really wanted that loan. When we had our crisis in Texas back in the early '90s, we "lost" our banks to national banks and lost a lot of that personal touch I had known for the first part of my career. It is nice to see bankers like that again in Texas.

I signed the closing papers and had literally just stood up from the table when I took a call from the banker at Capital One, offering to cut the rate to 2.75% and axe a few other costs as well. WOW. Now, in Texas you can cancel a loan commitment for up to three days. I was tempted for a minute, but decided that because I had told Travis I would do the deal, I was not willing to take that back. But I did call Travis and tell him what had happened, joking about it. He said "wait a minute." He hung up, then quickly called me back and said, "We will match it. Go cancel your loan." When was the last time your banker tore up your loan and then lowered the rate for you five minutes after you signed the deal?

So I rescinded the first loan and then had to wait another 30 days (the rules) but finally closed on the way to the airport to come to Amsterdam.

A Yen for Mortgages

Long-time readers know I am a huge bear on the relative value of the Japanese yen versus almost any currency, but especially the dollar. I have been saying for some time that I expect the yen to one day be at 200 and maybe even higher. But that journey is going to take a long time. Forty years ago the yen was at 357 (or thereabouts), and then it rose over time to the high '70s last year, when it started to fall again. The chart below goes back 43 years. Think, by the way, how your businesses would react if the value of the currency in which you trade rose by a factor of four over 40 years.



Later in the letter I will go more into my reasoning as to why I think the yen will fall over time, but for now let's look at how I got a "yen mortgage."

I asked readers to help me find a "pure" yen mortgage. I said I thought the market for such a mortgage would be huge, and I would help build it. I must admit, I was somewhat surprised when nothing really turned up. Ten-year government paper in Japan is at 0.6%. You would think that getting 2% for a 15-year mortgage would appeal to someone, but running a few connections still brought me nothing. I even found a US bank that would agree to a takeout and mortgage guarantee, but still no takers. I guess a billion isn't as big a deal as it used to be.

The basic concept is that if the yen falls by 50% (my bet) and I have my loan structured in yen, then I pay less in dollars. Perhaps a lot less. But since no pure yen loan is available that I can find, a synthetic one will have to do.

There are lots of ways to do it. Futures are the obvious way – simply selling the yen short. But I have no way of knowing timing on the yen, and in my view there will be some significant "corrections" along the way, so using futures would be a constant battle of margins, rolling into forwards, paying commissions with every new contract, etc. And given the new Dodd-Frank rules, it is *#$%W$#$* hard to simply tell a broker to execute a trade. To do the trade I ended up doing (see below), I had to be on the phone in the middle of the Amsterdam night to verbally confirm that I was sane and really, really did want to do the trade. But given my travel schedule and possible technological issues, updating my futures trade could have been problematic.

So I elected to keep it simple and do a 10-year put option. I want Abe-san and Kuroda-san to pay for about half my mortgage. I will gladly pay the other half. All they have to do is print yen to fulfill their part of the transaction – and they seem pretty committed.

Warning: Don't try this at home, kids. This is a VERY risky bet, even though my losses are limited to my entire investment. And while my logic might be compelling, at the end of the day I am trading/betting/gambling (all essentially the same thing) that politicians in a country and a culture I don't live in and don't truly understand are going to act in a certain way. They might choose another path with different disastrous results that would make the trade go against me. They have no good choices, only disastrous ones, because they have overleveraged their government and cannot possibly meet their obligations without some kind of default. Rather than outright default to their own retirees, I think they will print and inflate and monetize away that debt. But that's just me making a trade to counter what I think they will do (and what they tell us they will do). With that preface, let's look at what I am doing.

To execute the trade, I went to The Plumber. That is my rather affectionate name for Erick Kuebler, a JP Morgan broker here in Dallas. Darrell Cain introduced us, with a rather effusive (for Darrell) endorsement. Having met a few brokers over the years, including some really good ones, I just listened and watched. But as Erick is part of that downtown TCU-grad mafia (a local thing – he was in the same frat with Kyle Bass and a group of guys), he kept showing up at places where I was.

Over time, I realized that Erick understood the workings of the market better than anyone I personally knew. Not the normal things you and I think about, but what really happens when you execute a trade. I simply want to go to a screen and buy or sell, in much the same way that I go to a faucet and turn it on and get water. I expect water to come out when I twist the handle.

The Plumber knows what happens when I do that. He knows where the water comes from, who purifies it, what tank it was stored in before it got to me, whether it will be hot or cold, and what the pressure is. He knows whether to use copper or PVC pipe in the construction. He knows who charges what at each step along the line. I have learned a lot from The Plumber. (Simple ETF trades, for instance, are not all that simple. Especially in size.) For the record, I am a registered broker with my own firm, and you would think I would know this stuff. I kind of knew but had no real idea how many toll gates there are if you are not paying attention. Erick specializes in larger trades for clients trying to avoid those tolls. He laughs at the HFT guys.

Plus, Darrell chose Erick and JP Morgan to handle my self-directed defined-benefit pensions plans (which deserve a whole letter – for the right small business they are a marvelous tax preference vehicle), so Erick was the logical choice to help me do this yen trade.

Buying "in-the-money" or close-to-spot options is expensive. While I have no way to know what the yen will be one or two years from now, I truly think that over ten years Japan has no choice but to print massively. So, if I think the yen will eventually get to 200, I can buy an option that allows me to exercise the put at a strike price of 130. If I do a million dollars notional, that means if the yen goes to 200 I make about $700,000. The rules keep me from disclosing how much that put option costs me, but let's just say that I end up with a nice multiple if I'm right.

Of course, if the market is right (in its current state of unwavering faith) and the yen doesn't even top 130, I lose all of my option premium. ALL OF IT. 100%.

I will eventually add two more trades, one option at 140 and another at 150, but as I am notoriously bad at timing, I am going to "feather" those trades in over the next few months. I can see the yen dropping below 100 or going above 105 quickly (it is at 102 and change today); but since I don't know, it just seems better to me to take some time to put the whole trade on. I now have until May 5, 2024, for the yen to rise above 130 … or I take the loss.

Given that I think 200 is where we're going – it doesn't really matter all that much if we start at 98 or 105; but I think that in general it's good practice to pace your investments when it's practical to do so.

A Bug In Search of a Windshield

I wrote about four years ago that Japan was a bug in search of a windshield. In January 2013 I actually started to invest personal assets in the "short Japan" story (mainly through funds), and with this week's action I'm doing so more aggressively. The position represents an outsized portion of my personal portfolio, and it's one I would not suggest that most people take in such size. But then, you ask, why am I doing it?

I guess I'm a true believer. Japan has a government debt-to-GDP ratio of at least 221% and perhaps as high as 245%, depending on your data source and how you account for certain securities. The interest rates on the Japanese 10-year bond is at 0.6%, yet interest-rate expenses eat up some 23% of total government revenue. (Debt service accounts for 46% of government tax revenue.) If interest rates were to rise to OECD levels, or another 2%, interest-rate expense would eat up 80% of government revenue. That is not a workable business model.

My friends over at Hayman Advisors (Kyle Bass's fund) sent me the following pieces of data: Added together, Japanese debt service and social security (nondiscretionary spending) exceed government tax revenue and have done so for each of the last five years. The fiscal deficit has been greater than 10% of nominal GDP in each of the last five years. Japan has ~¥1.1 quadrillion of total government debt (~¥1,100 trillion) compared to nominal GDP of ~¥481 trillion (a 221% ratio).

Japan has consumed the savings of multiple generations through the sale of government bonds. Japan now has less than 5% of its government debt sourced outside Japan. But the country does not "owe it to itself." It owes it to the tens of millions of savers and retirees who have played the game correctly, worked hard and saved all their lives, and now want to use those savings in retirement.

The largest pension funds are no longer net buyers of Japanese bonds (JGBs). They are now selling, and that tide will swell with a vengeance, since Japan is rapidly aging. Further, the largest pension funds are starting to roll out of JGBs and into equities. Which makes sense, as who wants to own a 10-year JGB at 0.6% if inflation rises to 2%? What rational investor would choose to do that?

Japan cannot afford interest rates to rise all that much. So there must be a good market for JGBs. But who will buy?

Two weeks ago, there was a day and a half when the Bank of Japan was not in the market for 10-year JGBs. Even though they are buying in size every month with their latest aggressive round of QE, there are times when they are not "in the market."

During my recent speeches, I have been asking the room how many JGBs they think traded during the period when the BoJ was out of the picture. Make your guess now.

No one gets it right. For that day and a half, the bond market had zero trades. The Bank of Japan is now the market. Think about that! (See: reuters.com/japan-jgb.)

Given the reality of Japanese finance, I think they BoJ will continue to "hit the bid" in order to hold interest rates down. They will space out their buying more to keep those no-trading days out of public view. They will give us a song and dance from time to time to try and keep the valuation of the yen from rising too fast, but in the end they are going to monetize more in absolute terms than the US did in an economy three times Japan's size. Perhaps as much as $8 trillion over an extended period. That's the relative equivalent of the US Fed buying $30 trillion and putting it on its balance sheet. If you thought the Fed was going to do that, what would you do now?

What do you think Japanese investors will do when they realize what is happening? Buy equities, of course, but also diversify internationally. This move is going to play havoc with cross-border capital flows into all sorts of markets.

This is a brief synopsis of the Japan story. For a much fuller read, I point you to some of my past letters, or better yet, the full story in chapters two and three of Code Red.

I urge you to be cautious about putting on a "yen hedge" for your own mortgage. It is hard to do and more expensive for options with a notional value of less than $1 million, so it might not fit into your portfolio all that well. Talk with your financial advisor or broker, and really do your own homework. There are very smart people who, like me, are yen bears but who think that 140 or 150 is about as high as the yen will go. When I start talking 200, they think I'm smoking some of the stuff sold in the coffee shops here in Amsterdam. If they're right, my trade will be in the money but not all that good over time, considering the risk and use of capital.

Amsterdam, Brussels, Geneva, San Diego, and Tuscany

I am in Amsterdam today, and it is beautiful. I will soon be off to the new ship museum and other sites before – if all goes well – I rent a car and take a leisurely Sunday drive through the countryside to Brussels, something I have always wanted to do. I may try to get lost, at least for a few hours. Who knows what I might stumble on?

I will be speaking Monday night in Brussels for my good friend Geert Wellens of Econopolis Wealth Management before we fly to Geneva for another speech with his firm, and of course there will be the usual meetings with clients and friends. I find Geneva the most irrationally expensive city I travel to, and the current exchange rates don't suggest it will be any different this time.

I come back for a few days before heading to San Diego and my Strategic Investment Conference, cosponsored with Altegris. I have spent time with each of the speakers over the last few weeks, going over their topics; and I have to tell you, I am like a kid in a candy store – about as excited as I can get. This is going to be one incredible conference. You really want to make an effort to get there; but if you can't, be sure to listen to the audio CDs. You can get a discounted rate by purchasing prior to the conference.

I had lunch today with Eddy Markus, the founder and chief economist of ECR, one of the more respected research shops that analyze European credit and currency markets. We have communicated over the years, and he politely sends me a note every so often to broaden my limited understanding of the world. I always listen.

Eddy has a somewhat different view of the problems facing Europe. He and I see the same issues (debt, impossible-to-keep government promises, no fiscal union, banking capitalization woes, etc.), but he thinks the euro will break up, not in just a few years but much further down the road, in ten years, perhaps. It is his view that the dream of a unified Europe will be chased by politicians all the way to the bitter end. They will kick the can down the road much further than some of us think possible. He believes they can hold it together longer with promises and halfway measures, promises to fix things at the next meeting, etc. I admit to wondering just how they can accomplish that, and we spent a few pleasant hours over lunch on the canals as he explained his views.

Ten years? Wow. A lot of things will change in 10 years, but Keynes is right about this: the markets can stay irrational longer than you can remain solvent. I find it hard to believe that France can stall that long; but then again, we are talking politics, not economics.

It really is time to hit the send button. Have a great week. I am off to ponder how human beings could pile into such small ships and dare the oceans. (I get seasick relatively easily and find a storm at sea to be such an awful idea that I have a hard time even thinking about getting on a boat.) I therefore find it fascinating that it seemed like a good idea at the time and that so many did it. But then again, I am shorting the yen – who knows what craziness true believers will get up to?

Your still trying to think about Europe in 10 years analyst,

John Mauldin

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