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Hedge Funds Had Bets Against Japan

Even Before the Disaster, Big Investors Were Wagering on Economic Problems

By GREGORY ZUCKERMAN And TOM LAURICELLA

The catastrophe in Japan has placed renewed focus on the country's already fragile economy—and brought unexpected profits to investors who have long bet that the nation eventually will be dragged down by its debt problems.



Zuma Press

Investors profited off Tokyo Electric troubles; shown, a worker March 3.

In recent years, a chorus of voices has warned that Japan is facing an inevitable crisis to be brought on by a stagnant economy, a shrinking population and the worst debt profile of any major industrialized country.

Hedge-fund managers from Kyle Bass of Hayman Advisors LP in Dallas to smaller firms like Commonwealth Opportunity Capital have made money since the earthquake on long-held bets on Japan's government and corporate bonds.

Though the economic toll of the earthquake is far from clear, the immediate response in the financial markets has been a decline in stock prices, with the Nikkei Stock Average down 7.8% in two days (including Friday, when the quake hit near the

end of the trading day). The price for insuring against a default by Japan on its government debt, a popular way to position for a financial crisis in Japan, has jumped. But in a move that runs counter to the expectations of some long-term Japan bears, the yen has strengthened on expectations that Japanese investors and corporations will be buying yen as they bring money home in coming weeks and months.

The price for insuring \$10 million of Japanese sovereign debt for five years in the credit-default-swap market soared to \$103,000 on Monday, from \$79,000 on Friday, according to data provider Markit.

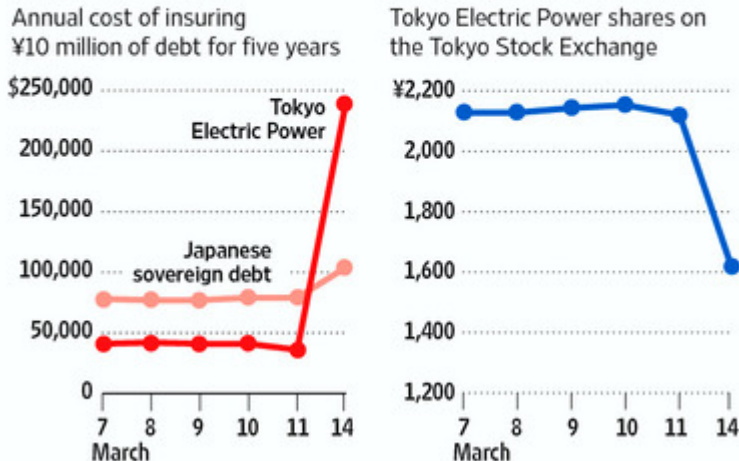
Reflecting the skepticism about Japan's outlook, even before the disaster, the net notional amount of Japanese debt being insured in the swaps market had surged to \$7.4 billion from \$4.1 billion a year ago, according to data from the Depository Trust & Clearing Corp. through March 4. The number of contracts outstanding has more than doubled.

Fresh DTCC data are due on Tuesday and will include only the early effects of the earthquake.

Credit-default swaps of many corporate bonds have become even more valuable, rewarding those that bet on them. Among the biggest moves was in [Tokyo Electric Power Co.](#), owner of the nuclear-power plants crippled by the earthquake.

Raising Alarm

Investors pushed up the cost of buying debt protection on some Japanese bonds, and drove down Tokyo Electric Power stock amid rising concern about a nuclear disaster.



Sources: Markit; Thomson Reuters

Commonwealth Opportunity Capital, a \$90 million hedge fund in Los Angeles, made a profit of several million dollars on Tokyo Electric on Monday, from an investment of less than \$200,000. The annual cost of protecting \$10 million of Tokyo Electric's debt jumped to \$240,000 on Monday from \$40,700 on Friday.

"Nobody wants bad things to happen to people," said Adam Fisher, who helps run Commonwealth Opportunity Capital. He said the firm has been betting against Japanese corporate bonds for two years. "But it shows how fragile that heavily levered nation is; there's very little margin for error."

Betting against Japan has been a losing proposition for many investors for years.

Despite all the debt problems, bond prices have continued to move higher partly because deflation, not inflation, has been the concern. Also, domestic investors own most of the government's debt and have been reluctant to sell.

But now, facing at least a short-term hit to the economy from the earthquake and the likely need to issue more debt to pay for reconstruction efforts, Japan is seeing its problems magnified.

"Japan's choices are very, very bad," said John Mauldin, president of Millennium Wave Advisors. "Japan has an aging population, which is saving less, their savings rate will go negative sometime in the next few years at which point they will have to significantly reduce their spending, increase taxes or print money or some combination of the three.

"In the grand scheme of things, does the earthquake technically move it up further? Yes, but they were already well down the path."

Mr. Bass and others are wagering against the yen and Japanese government bonds. They also are buying options that pay off if volatility in Japanese debt and currency markets increases.

Even though Japanese debt rose in price on Monday, volatility increased, as did cost of protecting the debt, helping Mr. Bass score a profit on the day, according to a person familiar with the matter. In a note to his clients late Monday, Mr. Bass said the price moves in his investments yesterday were "moderate."

Hugh Hendry of London's Eclectica Asset Management LLP, holds bearish positions from a view that Japanese companies will be hurt as the Chinese economy weakens. He recently told conference attendees that his trade has "cost me money." It isn't clear if he profited on Monday.

"My trade presupposed that a slowdown in China could trigger a re-evaluation of the preposterously low cost of corporate [credit-default swaps] in Japan," Mr. Hendry said in an email. "The events of the last few days reinforce the premise that the banking sector has massively miscalculated. My trade anticipates a deflationary shock that jeopardizes the viability of the financial system."

Some investors, like Commonwealth, have focused their bearish positions on heavily indebted Japanese corporations that aren't big exporters. Their assumption: As Japan's debt issues become more thorny, the yen would come under pressure. That would help exporters, whose products become more competitive, and do little for utilities and financial companies, which could have trouble accessing financing markets.

"Demographics are really the nail in the coffin as far I am concerned," said Vishaal Bhuyan of Nariman Point LLC, which manages less than \$20 million and has put all its money on bearish Japanese corporate-bond trades.

As recently as last week, it generally cost just \$500,000 annually to insure \$10 million of debt from a range of Japanese companies. Monday, that cost shot up to \$650,000, traders said.

—Mark Gongloff
contributed to this article.

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