PREPARE FOR A STORM

In late February Alan Greenspan warned of the possibility of a recession. The next day the markets took a dive. Since then anxiety has set in and market volatility has increased. Even Panglossian brokerage houses have warned that if a recession occurs, house prices could tumble 10% this year and the stock market could decline by 30%.

We must, of course, add to this noise some nasty facts about subprime lending, which constituted as much as 20% of U.S. mortgage lending in 2006. And that's not all: Another 13% of mortgage lending was to borrowers with only slightly better credit than subprime. There's a tendency for these borrowers, and their lenders, to live in a delusional world in which an inability to service the debt is papered over with refinancings and creative repayment schedules.

With default rates on the rise, mortgage-lending standards being tightened and $500 billion in adjustable-rate mortgages to be reset in 2007, we can expect the return of a half-million houses to a bloated inventory of unsold homes in the next six months. The collateral damage from the housing market is already baked in the cake: Expect a continued slump in residential construction activity and employment, lower house prices that will force more subprime lenders to the wall and put strains on the most leveraged parts of the financial system and a slowdown in consumption expenditures.

These bits and pieces suggest that enough evidence is around to justify preparing for a storm. Based on the recent course of events, one business-cycle scenario that merits consideration was fully developed in the 1930s by Friedrich von Hayek, a Nobelist and leader of the Austrian school of economics. For Hayek and the Austrians, things go wrong when a central bank sets short-term interest rates too low and allows credit to expand artificially. The result is an asset-price boom. Asset-price booms sow the seeds of their own destruction: They end in slumps.

During the slumps the economy is vulnerable to what Austrians termed a "secondary deflation," where banks call in loans and are stingy about extending credit. Households produce their own version, liquidating riskier assets (like stock mutual funds) and moving into cash and government bonds. In the economy at large, investment and consumption suffer.

So much for the scenario and theory. Just how can an investor prepare for such a storm? In other words, are there investments that will do well if the economy deteriorates?

Amid the credit-boom phase of the present business cycle, the Japanese yen has been weak across the board, and is 25% undervalued against the dollar. One reason for this is that the Japanese government engaged in massive intervention to push down the value of the yen in late 2003 and early 2004. Investors thought that the government was committed to a weak yen policy. That, and the fact that interest rates in Japan are some of the lowest in the world, meant that investors thought they had a free lunch in the form of the carry trade—borrowing in low-rate yen, investing the proceeds at higher rates in other currencies.

Amid the credit-boom phase of the present business cycle the Japanese yen has been weak across the board, and it is 25% undervalued against the dollar.

The yen carry trade has become wildly popular, accounting for perhaps $1 trillion of yen-denominated borrowings, traders speculate (no one knows the true figure). The carry traders, of course, immediately sell the borrowed yen to acquire high-yielding assets of the other currencies. All this selling has kept the yen artificially weak.

But that could change very rapidly. Yen carry trades are risky and can reverse very quickly.Then, the yen violently appreciates. Just consider the most recent unwinding. On Feb. 26 the yen was trading at ¥120.50 per dollar. Then a stock market tumble in Shanghai precipitated a worldwide selloff of risky assets. Carry traders undid their positions, buying yen and repaying their loans. By Mar. 5 the yen had spiked up in value to ¥115.15 to the dollar.

In preparing for a coming storm investors should anticipate further unwinding of yen carry trades and a significant appreciation of the yen. One way to play this is to purchase out-of-the-money call options on the yen traded on the Chicago Mercantile Exchange. I recommend a December call at a strike price of 90.

Anticipating an eventual reversal of Swiss franc carry trades, and a sharp appreciation of the Swissie, I recommended (Sept. 4, 2006) selling a Euro/Swiss futures contract. At present, the position is losing 2%. Relax and continue to hold it. F

Steve H. Hanke is a professor of applied economics at the Johns Hopkins University and a senior fellow at the Cato Institute in Washington, D.C. Visit his home page at **www.forbes.com/hanke.**