

# FOREX FOCUS: USD/JPY GOING TO 100

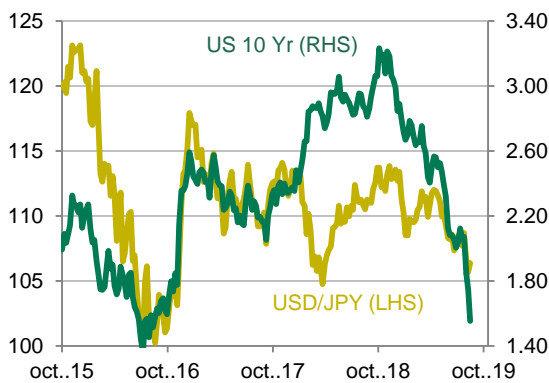
Marketing Communication | August 2019

## USD/JPY moving to 100

Since the beginning of May, USD/JPY has declined from levels of around 112 to current levels of around 106.50. We expect USD/JPY will continue to decline over the coming months to levels of around 100. Risks are firmly on the downside of 100. The combination of falling US yields, deteriorating global economic data and the lingering US-China trade dispute will combine to weaken the USD and also give a bid to safe haven currencies, which will benefit JPY. We do not anticipate imminent interventions from the Bank of Japan (BoJ) for reasons which we explain below.

### Chart 1: All about US ten-year yields

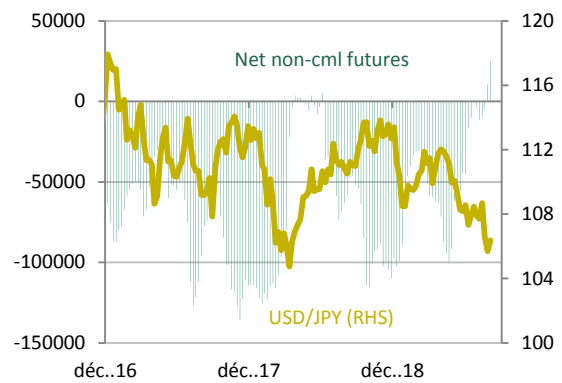
USD/JPY spot, US ten-year yield, %



Sources: UBP, Bloomberg Finance L.P.

### Chart 2: Investors have a small long JPY position

USD/JPY spot, IMM net non-commercial futures



Sources: UBP, Bloomberg Finance L.P., CFTC

## Recent price action – All about US ten-year yields

USD/JPY's decline from 112.00 to levels of around 106.50 did not surprise us. Regular readers will know that we have maintained a bearish stance on USD/JPY since the beginning of the year. Our view was (and remains) that USD/JPY would decline because of weaker USD exchange rates, compelling JPY valuations and Japan's robust current account surplus.

USD weakness has not manifested to the extent which we expected (when it does this will give an additional impulse for lower USD/JPY levels). The decline in US ten-year yields has dragged USD/JPY lower (chart 1). We think there is a risk that US ten-year yields can decline further, reflecting external growth and inflation concerns rather than domestic US growth / inflation concerns. If the rest of the world's bond markets illustrate negative yields then it stands to reason that US yields will also gradually decline. The significant decline in US ten-year yields suggests there is little chance of an aggressive USD/JPY up move (more on this below). Assuming that recent correlations hold, US ten-year yields of around 1.3% are consistent with USD/JPY trading at levels of around 102 (and lower).



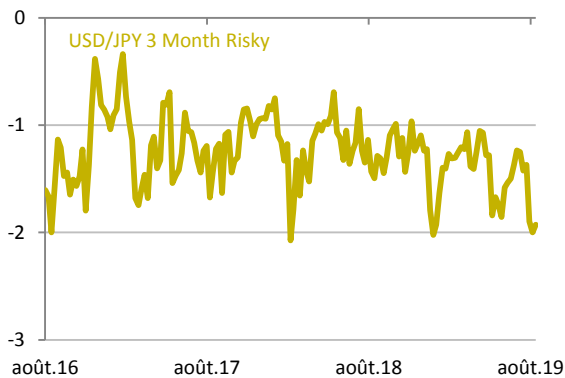
## Positioning & hedging costs

According to IMM data, investors maintained a broad short JPY position for most of the year (Chart 2). However, investors recently flipped their positions and net non-commercial positioning now illustrates a small long JPY position. Because the long JPY position is so small, this will not prevent further JPY appreciation (if there was a huge long JPY position it would be difficult for JPY to materially appreciate). USD/JPY risk reversals, which show the cost of a call compared to a put, show a significant bid to USD puts, which give the right but not the obligation to sell USD. The USD/JPY risk reversal curve reflects the markets' anticipation of further USD/JPY declines.

We note that Japanese investors purchased significant quantities of US equities in recent years (Chart 4). We believe that many of these positions are likely not hedged, because of elevated hedging costs in recent years. Investors face the double risk of aggressive USD/JPY declines and declines in the prices of underlying equity investments. As a result, we believe there are likely to be threshold effects for equity investors; if USD/JPY declines to levels of around 100, many equity investors may liquidate positions and repatriate their capital to JPY denominated assets.

Chart 3: USD/JPY riskies bid to JPY puts

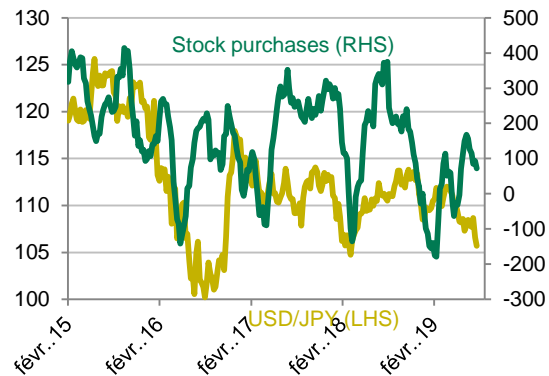
USD/JPY 25 Delta three-month risk reversal, %



Sources: UBP, Bloomberg Finance L.P.

Chart 4: Japanese purchase of US equities

USD/JPY, Jap. US equity purchases, 8 week MA, ¥



Sources: UBP, Bloomberg Finance L.P.

## The BoJ has been as quiet as a mouse

The BoJ has not responded to the USD/JPY down move with any sense of urgency or alarm. This is surprising, but when you think about it, it makes sense. The US Trump administration has made a big point about currency valuations and US criticisms of BoJ interventions would be unwelcome at the moment because the US and Japan are close to signing a trade agreement. Consequently, we do not anticipate imminent BoJ interventions. The G20 agreement to refrain from interventions is also likely to weigh heavily on the BoJ's thinking in this regard.

The BoJ may engage in some verbal interventions, but there is not a lot that it can realistically do because of the issues described above. The BoJ is unlikely to ease policy further because it has run out of policy options. The use of helicopter money as a policy option is unlikely to be considered unless inflation data disappoint severely. This is not the case; inflation data have stabilised around 1%. The stabilisation of Japanese inflation data indicate that deflation concerns are now in the rear view mirror. The Japanese Ministry of Finance (MoF) has run a comparatively tight fiscal policy (cyclically adjusted), and this could be eased in a downturn. The bottom line is that the Japanese authorities cannot do a lot about JPY appreciation. They have run out of tools to materially weaken JPY and the external trade environment is not conducive to FX interventions. At best, the BoJ can only hope that verbal interventions may slow the pace of JPY appreciation.

Some analysts have suggested that the government pension investment fund (GPIF) could engage in stealth interventions through the purchase of foreign assets to weaken JPY. This does not make a lot of sense. By definition, a country with a large current account surplus buys foreign assets all the time. GPIF purchases of foreign assets will not materially change Japanese current account / capital account dynamics. Moreover, the income earned from foreign assets will eventually be repatriated to JPY. It is the flow, rather than the stock, of foreign assets which has a marginal effect on short-run JPY valuations. Over the longer-term, the repatriated income from more foreign assets will strengthen JPY's current account. Put simply, GPIF purchases will not do a lot to weaken JPY. Governance issues are also important. It is not within the GPIF's remit to conduct FX interventions. That is specifically within the remit of the BoJ.

## A tale of two curves

The US-Japan 2-10 yield curve spread has tightened considerably in recent years (Chart 5), which is almost wholly explained by the flattening of the US yield curve. The recent inversion of the US 2-10 curve is interesting because the curve has flattened at low levels in an absolute sense. In 2007, the Fed funds rate was 5.25% and it is now 2.25%. Consequently,

any steepening of the long end (in an assumed recovery) will not be significant. This implies that there is little upside risk for USD/JPY.

We expect that the BoJ will continue with its yield curve control (YCC) policy. The BoJ has not made any noises about changing the policy in recent months and we do not expect any material changes. The BoJ may tweak its normal policy statements, but most agree that the BoJ has run out of policy tools. The authorities may consider helicopter money policies, but this would only be used as a last resort.

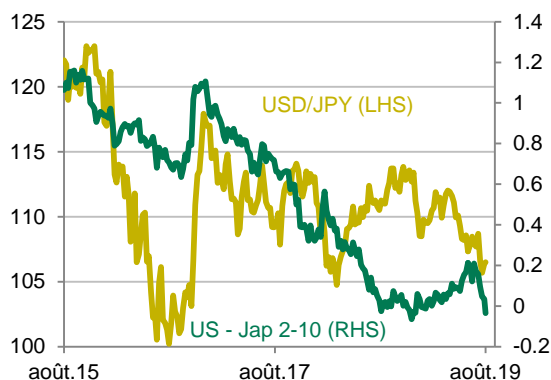
## Valuations

According to most fair value models, JPY is extremely cheap. In real effective exchange rate terms (REER), JPY is among the cheapest currencies in advanced and developing markets. This implies that further material JPY weakness is unlikely and also that JPY should gradually appreciate. PPP models show that fair value in USD/JPY is at levels of around 90. We believe levels of around 90 would be a stretch, but we can envisage a scenario where USD/JPY trades to levels of 100. The question for the BoJ is if this down move is aggressive and quick or a slow grind. The BoJ would prefer the latter.

In summary, we anticipate USD/JPY will continue to trade at lower levels and we recommend investors to pursue a sell on rallies strategy. Buying downside option structures is now expensive because of the risk reversal skew to USD puts, meaning that investors would have to sell leveraged downside puts to cheapen a long put position (put spread). The risk to such a strategy is that if the down move is sudden and aggressive, the mark to market would decline because of the short gamma profile. As a result of this, we prefer to sell USD/JPY on rallies and augment the position with simple downside USD puts.

Chart 5: US and Japanese curve dynamics

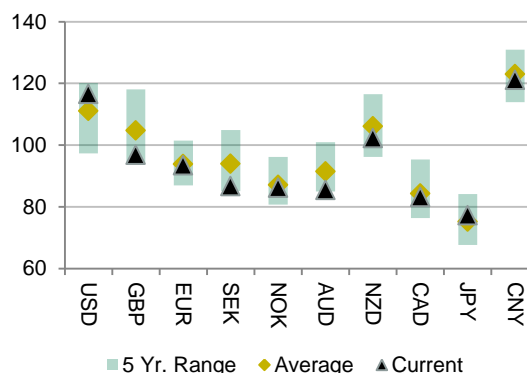
USD/JPY spot, US - Japanese 2-10 yield curve spread



Sources: UBP, Bloomberg Finance L.P.

Chart 6: JPY is exceptionally cheap

Real effective exchange rate (REER)



Sources: UBP, Bloomberg Finance L.P., BIS

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