

CURRENCIES: USD/JPY

RISK-REWARD IS BECOMING ATTRACTIVE FOR THE YEN

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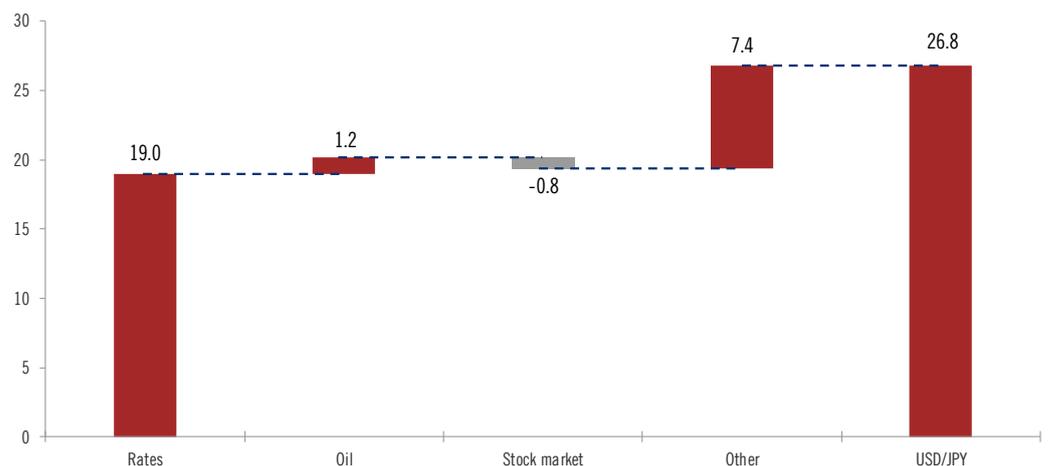
SUMMARY

- › We believe there is limited scope for rate differentials, the main reason for the yen poor performance, to turn any more negative in the months ahead.
- › While not the most probable scenario, a change in the Bank of Japan's ultra-accommodative monetary policy would likely lead to significant yen appreciation.
- › Our three-month projection remains at JPY132 per dollar, while our 12-month projection is at JPY120 per US dollar.

Rate differentials have hurt the yen hard

Despite weak global risk appetite, the defensive Japanese yen has been among the worst-performing developed-market currencies since the start of the year. The main culprits have been the stubbornly accommodative monetary stance of the Bank of Japan (still intent on lifting consumer inflation back to 2%) and, to a lesser extent, the deterioration in Japan's trade balance as a result of rising energy import prices. The differential in 10-year yields has been by far the most important factor in the USD/JPY exchange rate since May 2021, with changes in oil prices and global risk appetite less significant. How the interest-rate differential between the US and Japan evolves will likely remain the main determinant of the yen's performance going forward.

BREAKDOWN OF USD/JPY PERFORMANCE INTO KEY DRIVERS (SINCE APRIL 2021, IN BIG FIGURES)



Source: Pictet's wealth management division – CIO Office & MR, Refinitiv, 12 July 2022

Rate differential likely to turn more positive for the yen

The Bank of Japan's (BoJ) yield-curve-control policy (YCC, which caps the interest rate on the 10-year Japanese government bond (JGB) at around 0.25%) is unlikely to change in the short term. The BoJ can print as much money as it wants to buy JGBs and, in any case,

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its purchases are well below the amount issued by the government. This is in contrast to 2016, when the BoJ had increasing difficulty in finding enough paper to fulfil its hard commitment to purchase JPY80tn of JGB a year. Its ownership of around 50% of JGB's outstanding could destabilise the bond market's proper functioning, although, financial agents that responded to the BoJ's [monthly survey](#) in May did not express any major concerns in this regard. Finally, at an annual rate of 0.8% in May, so-called 'core-core' inflation in Japan (i.e. ex fresh food and energy) remains well below the BoJ's 2% target meaning that, unless we see a sustained rise in wage growth, there may be limited reason for the BoJ to change its monetary stance. Overall, in our view, while an inflexion of its YCC policy leading to significant yen appreciation is possible under Haruhiko Kuroda's governorship, it is not the most probable scenario for the next few months.

In the US, our central scenario of a mild recession by the first quarter of 2023 should put a lid on 10-year interest rates. Yet while US interest rates have already declined from their mid-June highs of 3.5%, the US dollar has not given up any of its recent gains against the yen. This may be due to factors other than the ones identified.

Balance of payment flows not helping the yen much

On the dollar side, growing fears about the global economic outlook, coupled with a hawkish Fed are strong tailwinds for the US dollar. As for the yen, its failure to outperform a number of cyclical currencies since mid-June suggests that some domestic factors are holding it back. One reason could be renewed large purchases of foreign debt securities by Japanese pension funds and life insurers, attracted by the higher yields to be had outside Japan and/or the lack of paper left to buy domestically as the BoJ ramps up its JGB purchases.

These domestic hurdles are hurting the yen at a time when other sources of capital flows are not providing much support either. Japan's current account has become more volatile since the shut-down of more than two-thirds of the country's nuclear reactors since the 2011 Fukushima disaster and is now deteriorating because of the rise in energy import costs. Also, net foreign direct investment outflows have been accelerating since 2010.

Risk-reward attractive for the yen

The deterioration in the economic outlook should put a lid on interest rates globally, potentially providing a more supportive environment for the low-yielding yen. In addition, the weak yen, a manifestation of the BoJ's ultra-loose monetary stance, is becoming a hot political issue as Japanese households grow increasingly concerned about the rising cost of living. The authorities may decide to combat the yen's sharp depreciation through intervention on the FX markets directly, but one should not exclude the possibility that the BoJ also changes its ultra-loose monetary policy under political pressure. We could also see a change in the BoJ's goal of 2% consumer inflation after Kuroda steps down as governor next April.

For all these reasons, we are keeping our positive view on the Japanese yen. Our three-month projection against the USD remains at JPY132, our six-month projection at JPY126 and our 12-month projection at JPY120.

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