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# Japan Rates and FX Watch

# JPY: no news is bad news

22 June 2023

FX and Rates
Japan

**Shusuke Yamada, CFA**
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com

## Revise up USD/JPY forecasts by 2-4%

We have been bearish on JPY for its negative carry, and we revised up our USD/JPY forecasts further by 2-4% through 3Q24 as our US team revised their Fed call in a hawkish direction (two more hikes, and later rate cuts; see: World at a Glance: Halftime 21 June 2023). We expect USD/JPY at 147 at end-Sep (vs 143 previous, 132 consensus) and 145 at year-end (vs 140 previous, 129 consensus) (Exhibit 1).

## No news is bad news for JPY

Given elevated G10/JPY carry, no news is bad news for JPY. The combination of sticky US inflation, which keeps the Fed from reversing rate hikes, and a patient BoJ, which limits the extent of policy normalization, could prolong the yen weakness. While our economists expect the BoJ to tweak YCC in the Jul MPM and remove NIRP and YCC in mid-2024, these moves may be too marginal to be a game changer for JPY especially as we expect no additional hikes in the positive territory by the BoJ through 2025 (see: BoJ review: Watching and waiting 16 June 2023).

## Fed slowing down rate hikes = lower vol = yen carry trade

A decline in USD/JPY volatility has possibly been as significant for JPY as hawkish repricing in the G10 space in June. While the momentum in policy divergence has decelerated in 2023 as the Fed has slowed down the pace of rate hikes, it also means lower market volatility and higher carry/vol ratio for G10/JPY. As USD/JPY's 3m implied volatility has fallen below 10, its carry/vol ratio has exceeded the 2019 high and is marching toward the peak level in 2006 (Exhibit 2). The stickiness of US inflation could limit downside volatility in US short-end rates.

The market may find the yen hard to sell given its valuation, but this lower yielder is even harder to hold when market volatility remains contained and the basic balance of payments is no better than neutral (see: Japan BoP: finally balanced 08 June 2023). We think we could see a repeat of the 2H06-1H07 period, which was negative for volatility and bullish for cross-yen, as the rates market is pricing in a steady Fed soon while more hikes are priced for the ECB and other G10 central banks (Exhibit 3, Exhibit 4).

## The Japan trade

A carry trade regime would be negative for JPY and positive for Japan's risk assets. USD/JPY's carry is at 6% while the TOPIX index yields 8.3% for USD-based investors (2.3% dividend yield + extra 6% from USD/JPY hedging; see Exhibit 5). There has been some evidence of foreign investors' USD/JPY buying and Japanese equity purchases in 2Q23. Inflow to Japanese equities has been strong and non-commercial traders have increased short JPY positions. USD/JPY and the Nikkei 225 index have also regained their positive correlation (Exhibit 6). The BoJ may be comfortable with a weaker yen and higher equities as it wants to see more evidence of sustainable inflation before starting policy normalization, and Governor Ueda has said the risk of premature tightening remains bigger than the risk of falling behind the curve. Note our equity strategy team remains constructive on Japan (Japan Equity Strategy 12 June 2023).



Timestamp: 22 June 2023 01:48AM EDT

## Some signs of yen-carry trade, but far from crowded

We do not think short-yen positioning is stretched. The market may have turned short-yen, judging from the CFTC's statistics. However, our proprietary positioning indicator shows both hedge funds and real money are not short-yen yet (see: Liquid Cross Border Flows 19 June 2023). Investors say "the best Japan trade" is either short yen rates (BoJ policy normalization) or short USD/JPY (US recession hedge) while only a small minority call for yen-carry trade (see: FX and Rates Sentiment Survey 09 June 2023). Japanese retail FX traders remained long-JPY at the end of May (Exhibit 7).

## Risks: US recession vs households' rebalancing

The risk against our bearish yen view is the US economy's hard landing in 2H23. A hard US recession would lead to expectations for the Fed's accelerated rate cuts and a potential rotation out of US risk assets, weighing on USD. But our US economists expect the economy to go through a mild recession in 1H24 and the Fed to not start cutting rates until May 2024 (see: US Economic Weekly 16 June 2023). Moreover, the OECD's leading indicators suggest global economic cycles may not be so synchronized this time (Exhibit 8). Relative weakness of the US indicator may imply a weaker USD into 2024; but a full-blown global recession, which would lead to a sharp JPY rally, appears less likely.

Meanwhile, households' asset rotation poses a yen-negative risk. Japanese households still hold more than half their gross financial assets in deposits. In a time of no inflation, yen deposits kept their purchasing power well. However, rising inflation after the pandemic has reduced yen deposits' purchasing power by around 5% in less than 2 years (Exhibit 9). When households become wary of the yen's falling purchasing power, they may start to rebalance out of yen cash. We do not expect this shift as a base case given inertia, but this is a risk to monitor over the long-term especially if inflation becomes sticky in Japan. The government is going to expand the NISA (Nippon ISA) program in 2024, which could also incentivize households to increase or start financial investments (see: Japan's push for retail investments – risk or opportunity for JPY? 16 December 2022).

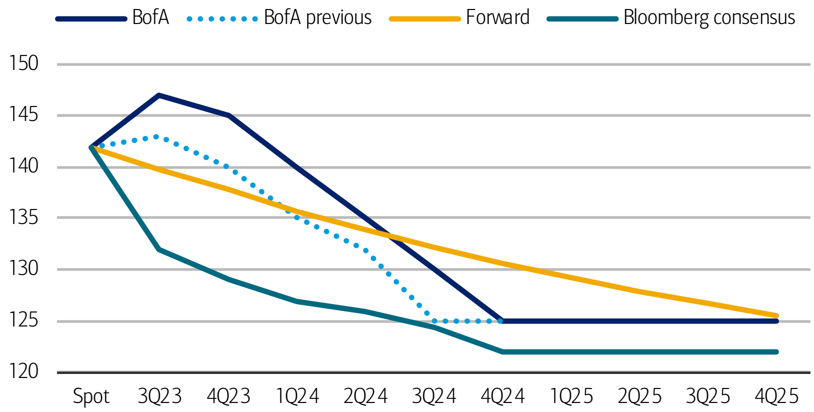
## Jul MPM = a dovish catalyst if the BoJ does not act

Near-term, the BoJ's July MPM is likely to be a key event. Until the June MPM, no change by the BoJ had been considered as a less market-moving event, and the market has regarded the BoJ's MPMs as potentially a yen-bullish / JGB-bearish event. However, for the July meeting, we think no change can catalyze a sharp JGB rally and JPY sell-off in Aug/Sep for two reasons: (1) domestic institutions have been waiting but may not wait until the fall to buy JGB; (2) even higher carry for G10/JPY for longer after recent repricing in the G10 front-end rates (see: BoJ review 16 June 2023).

If the BoJ holds in the July MPM, the market may assume no change in the Sep MPM (without the outlook report) and the next focus could be Oct MPM with the outlook report. Yen rates are likely to rally as domestic investors may have to start adding JGBs even if they still wait for the BoJ to tweak YCC later. In the FX market, the yen-carry trade could accelerate on lower JGB yields and a later YCC tweak. USD/JPY could rise toward 150. Our economists' base case remain that the BoJ will tweak YCC in July by shortening the YCC target from 10yr JGB to 5yr JGB, which we think will have only a short-lived and limited impact on JPY.

FX intervention may be on the cards if USD/JPY exceeds 145 and heads toward 150 with rising volatility. But we think the weak yen's cost-benefit balance has improved since last year thanks to the lower oil price and reopening of inbound tourism, which may be reflected to a negative JPY-equity correlation. Unless the move is drastic, we think the government will refrain from FX intervention with USD/JPY below 150 (see: Japan Viewpoint: Yen weakness in '22 = headache for MoF; Yen weakness in '23 = tailwind for BoJ 07 June 2023). The Japanese markets are likely to remain hot this summer.

**Exhibit 1: USD/JPY forecasts**
BofA remains bullish on USD/JPY




**Source:** BofA Global Research
Bloomberg consensus as of June 16
We made the revisions in the July World At A Glance report (published on June 21, 2023)

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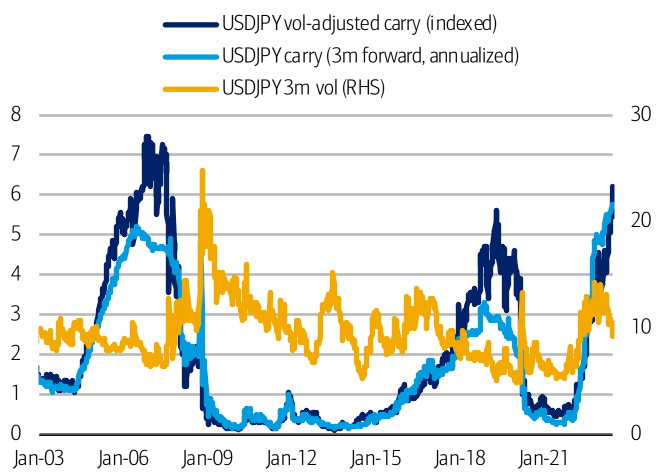
**Exhibit 2: USD/JPY: vol, carry, and carry/vol ratio**
Decline in FX vol to boost USD/JPY's carry/vol ratio




**Source:** BofA Global Research, Bloomberg

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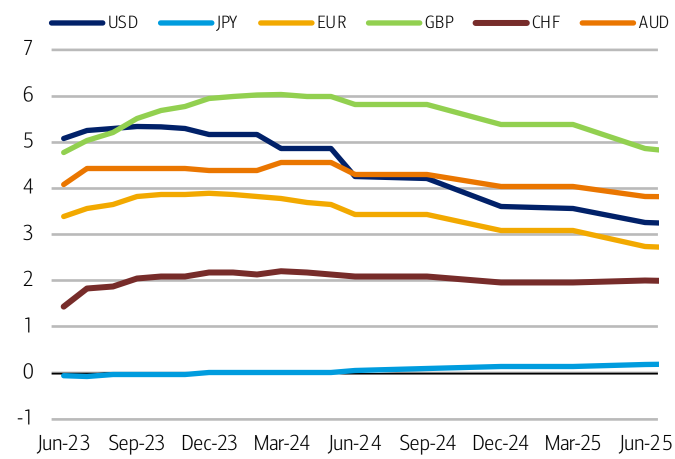
**Exhibit 3: OIS curve (forward x 1m)**
G10/JPY carry to be high for long




**Source:** BofA Global Research, Bloomberg

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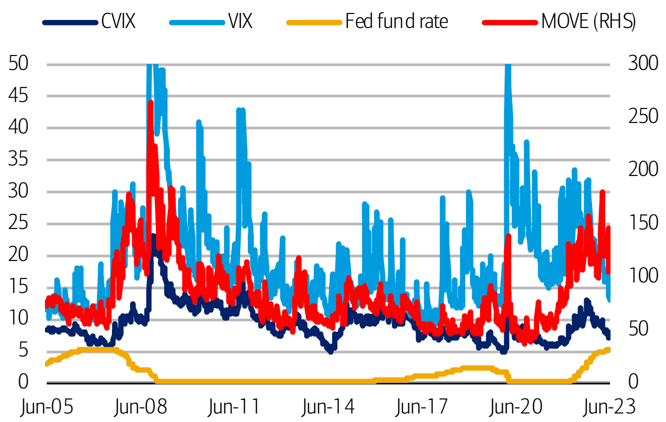
**Exhibit 4: FX, equity, rates volatility and Fed policy cycle**

Market volatility on a falling path as Fed gets closer to the end of hiking cycle




**Source:** BofA Global Research, Bloomberg

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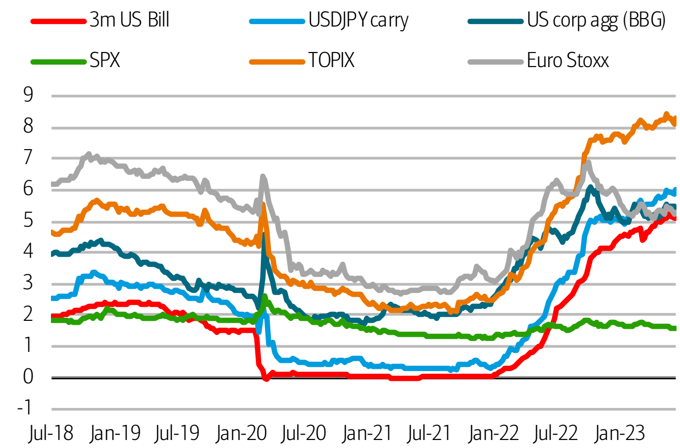
**Exhibit 5: Yield for USD-based investors* (annualized)**

USD/JPY and Japanese equities provide attractive carry




**Source:** BofA Global Research, Bloomberg

USD/JPY carry = 3m forward

TOPIX and Euro Stoxx = dividend yields + FX-hedging (by 3m forward)

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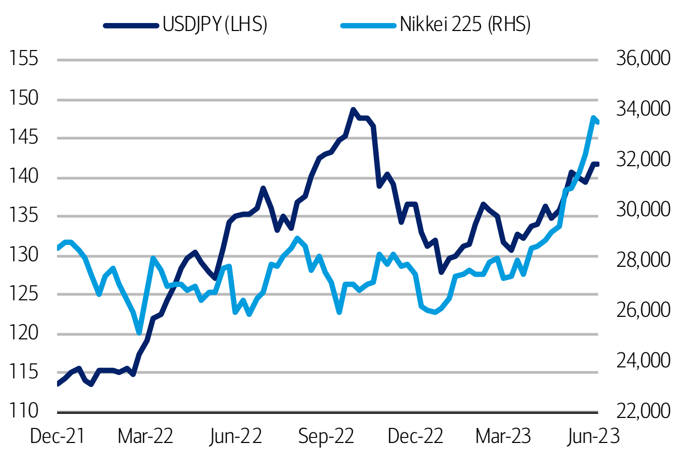
**Exhibit 6: USD/JPY vs Nikkei 225**

Positive correlation has returned




**Source:** BofA Global Research, Bloomberg

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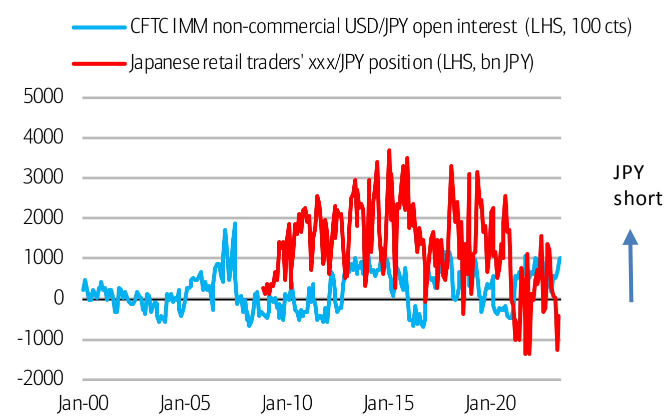
**Exhibit 7: Measures of yen-carry trade balance**

Some signs of yen-carry trade among spec traders but Japanese retail traders remained long JPY as of end-May




**Source:** BofA Global Research, Haver

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**Exhibit 8: OECD leading indicator by region**

Global economic cycles may not be as synchronized this time

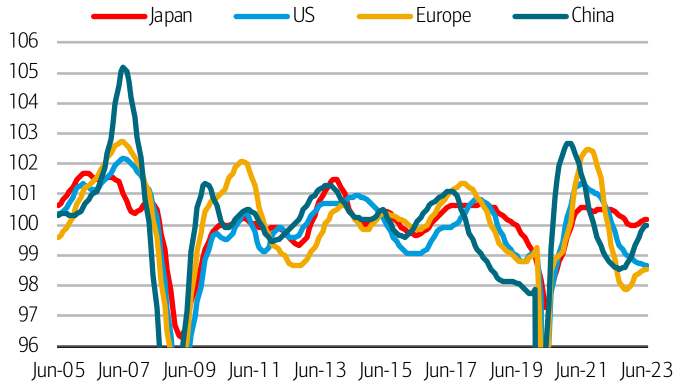


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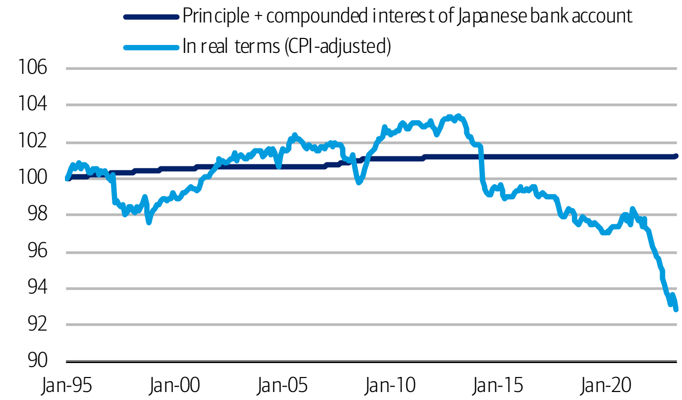
**Exhibit 9: Yen deposit's total return and purchasing power (Jan 1995 = 100)**

Yen deposit's purchasing power is deteriorating quickly

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