FX Watch

USD/JPY may face policy resistance in spring

Structural weakness vs positioning & policy risk

We remain structurally bearish on the yen and we think the risk of a weaker yen in coming years has risen as structural outflow appears strengthening (see: Japan BoP: rising Toshin flow to USD & INR 08 February 2024). However, the tactical risk/reward of USD/JPY may not favor the upside heading into the spring as some parts of the market may become short-yen, making USD/JPY vulnerable to policy intervention risk.

Yen short positioning

In some measures, existing yen short positioning look less long-term oriented:

USD/JPY has outperformed vs rates spread – The latest rise in USD/JPY since the beginning of the year has not been supported by sufficient rise in the US-JP interest rate spread (Exhibit 1).

Yen short by spec traders (CFTC) becoming crowded – A part of the market may now be short yen as speculative yen short positioning appears among the most crowded in recent years, according to CFTC's statistics (Exhibit 2). While other indicators, including our proprietary indicators (see: Liquid Cross Border Flows: Dollar dependence 19 February 2024), do not suggest yen positioning as crowded, we cannot ignore it either as USD/JPY's peak in 4Q23 was followed by the peak yen positioning (though the direction of causation is another debate).

London has driven USD/JPY higher – The latest rise in USD/JPY has been led by London trading hours while USD/JPY's rise from 2022 to 2023 was led by Tokyo and NY trading hours when we think Japanese and US real money are more active than in London trading hours (Exhibit 3).

Rising hedged inflow to Japan equities – Rising inflow to Japanese equities should be supportive of JPY. However, some of inflow to Japanese equities may be hedged as implied by rising inflow to a major hedged Japan equity ETF (DXJ, Exhibit 4). If so, the strong rally in Japanese equities may have led to yen selling by hedged Japan equity funds.

BoJ's normalization – what may not be priced

The BoJ's dovish communication regarding rate hikes beyond the NIRP removal was one trigger for such yen-selling. While the BoJ's cautiousness on rate hikes would be negative for the yen over the long-term, there is higher degree of uncertainty about what the BoJ will do to its YCC and QE, which will impact the BoJ's bond buying operations and the long-end JGB yield in the near-term.

To the extent that risk assets and USD/JPY have risen in absence of expectations for significant policy changes by the BoJ especially on YCC and QE (Exhibit 6), the risk is that higher long-end yields caused by the BoJ's normalization measures could cause a correction in these markets, which have been more intertwined due to FX-hedging by foreign investors.

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G10 FX Strategy
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CFTC: Commodity Futures Trading Commission

BoJ: Bank of Japan

BoP: Balance of payment

NIRP: Negative interest rate policy

YCC: Yield curve control

QE: Quantitative easing

MoF: Ministry of Finance

MoF's intervention risk could rise

The MoF started verbal intervention as USD/JPY rose through 150. While officials' tone remains benign, Masato Kanda, the MoF's deputy chief said USD/JPY's 10-point rise since the beginning of the year had been too rapid on Feb 14. Compared to the most recent intervention episodes, USD/JPY's movement and volatility level appear still contained (Exhibit 5). The strength in Japanese equities may be another reason for officials to not intervene to the market.

However, letting the yen market free of control may be seen risky by policymakers when the BoJ is about to implement policy normalization (our economists' base case = Apr MPM (Apr 25-26) with Mar MPM (Mar 18-19) also possible; see: BoJ Watch: Jan MPM Summary of Opinions: further signals for Mar/Apr policy change 31 January 2024). If the market perceives the BoJ's policy normalization measures as too benign and encourages USD/JPY bulls, the pressure on the BoJ may rise. To prevent such a scenario, the MoF may have to be ready to intervene when the BoJ implements policy changes.

152 = key level, 152-155 key range

We think 152 would be the first key level as USD/JPY has failed to break it in October 2022 and November 2023 and has not been reached since 1990 (Exhibit 7). If this level is breached, then the 1990 high at 160 would be the previous peak and if that is broken, the preceding cycle peak was above 250 during 1980s. It is not surprising if policymakers want to defend 152 for the time being even though we acknowledge the risk that low vol and rising stocks may bring the intervention level higher.

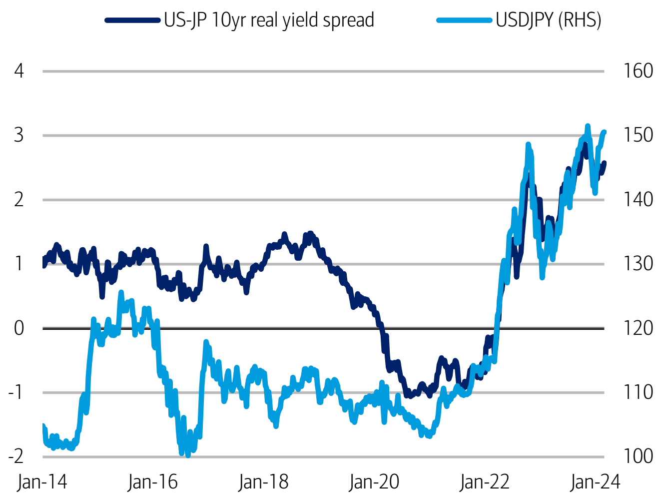
If USD/JPY rises to 155, then USD/JPY's 1m change would be 4.6% while USD/JPY had risen 4.5-5.2% before the MoF's intervention in Sep/Oct 2022 (Exhibit 5). Vol may have also risen if the spot moves to 155 in the near-term. The risk of FX intervention would emerge from around 152 and increases in the 152-155 range, in our view.

Implications

We agree with the market on the yen's fundamental weakness but we think the yen weakness should be more structural and long-term and it may not support all of USD/JPY's latest rise. Given policy intervention risk from the BoJ and the MoF in the spring, it may be worth taking profit if one is short JPY or hedge against USD/JPY's downside. We expect USD/JPY to correct to the 145-147 range in the spring on the BoJ's policy normalization.

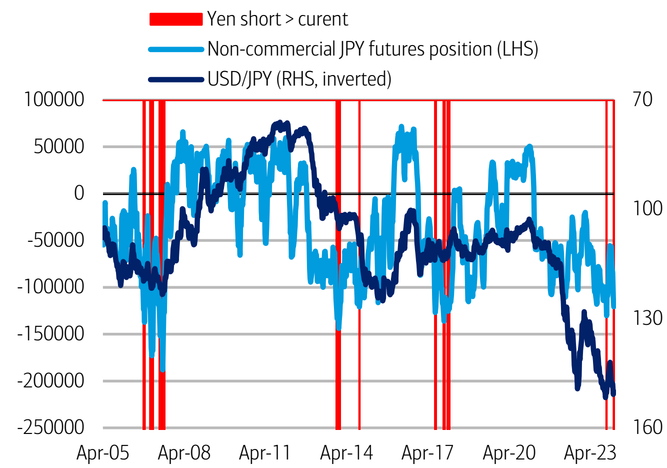
The risk of a sharp rise in USD/JPY in the near-term should come from more positive surprises on US economic and inflation data than the JPY side as the BoJ's dovishness on the front-end rate is balanced by uncertainty around its policy on the long-end part of the JGB curve and FX intervention risk by the MoF.

Exhibit 1: USD/JPY vs 10yr US-JP real bond yield spread (%)
USD/JPY outpaced rates spread



Source: BofA Global Research, Bloomberg
BofA GLOBAL RESEARCH

Exhibit 2: JPY futures position by non-commercial traders (CFTC, number of contracts) vs USD/JPY
Yen short becoming stretched



Source: BofA Global Research, Bloomberg
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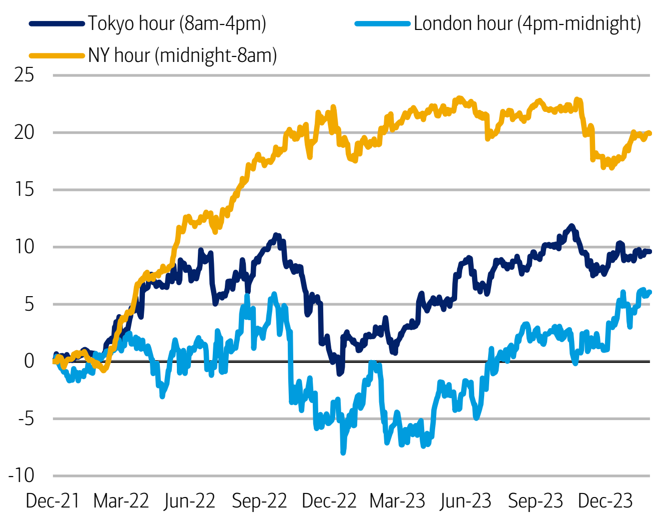
Exhibit 3: USD/JPY cumulative change by trading zone
London has driven USD/JPY higher in recent weeks



Source: BofA Global Research, Bloomberg
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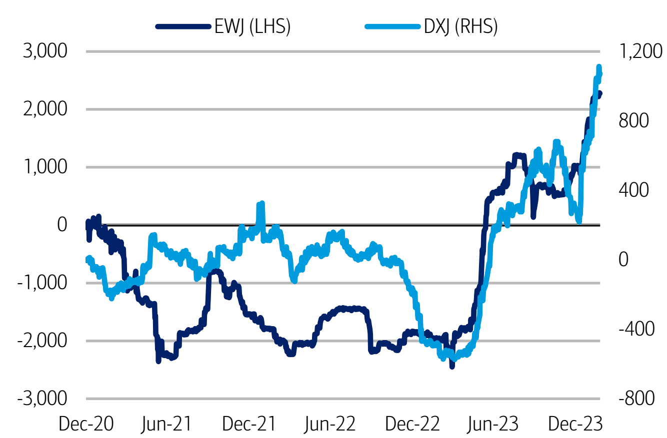
Exhibit 4: Estimated net cumulative flow to major Japan ETF (EWJ = unhedged, DXJ = hedged, $mn)
Hedged funds have also attracted inflow



Source: BofA Global Research, Bloomberg
We estimate net daily flow as AUM change not explained by price change
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Exhibit 5: % spot change and vol level before USD/JPY selling intervention in the fall 2022 vs today

Either spot or vol may have to rise before MoF's yen buying intervention

	1m spot % change*	2m spot % change*	Intraday spot % change	1m vol level
21-Sep-22	5.2	4.2	1.3	13.0
21-Oct-22	4.5	9.6	1.2	14.1
24-Oct-22	NA	NA	1.4	15.7
As of 26-Feb-24	1.7	5.8		7.3

Source: BofA Global Research, Bloomberg

*As of close of previous business day

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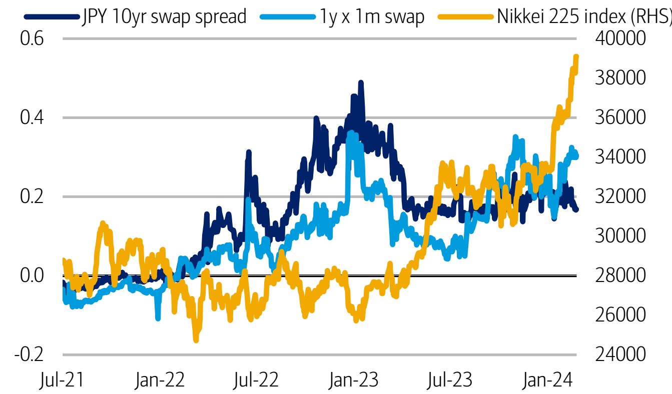
Exhibit 6: Nikkei 225 index vs pricing for BoJ policy changes

Japan equities have rallied amid benign pricing for the BoJ's policy changes



Source: BofA Global Research, Bloomberg

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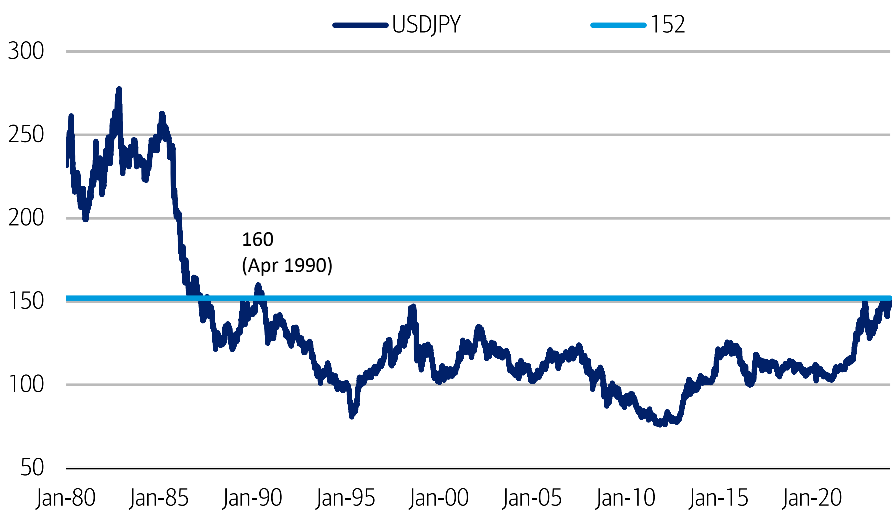
Exhibit 7: USD/JPY history

152 is a key level



Source: BofA Global Research, Bloomberg

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