Daiwa Securities

Daiwa's View

Conditions for USD/JPY rate to exceed Y130—from the standpoint of diverging monetary policies between Japan and US

- It is only a matter of time before USD/JPY rate reaches Y125.86, the highest value under Abenomics, but there are considerable hurdles to the yen weakening to levels above Y130
- Y130 would come in sight if the Fed implements aggressive monetary tightening to a level far above the neutral rate

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Conditions for USD/JPY rate to exceed Y130—from the standpoint of diverging monetary policies between Japan and US

USD/JPY rate of above Y130 requires monetary tightening by the Fed to substantially above the neutral rate

Yesterday, the USD/JPY rate rose to Y125.77 at one point, marking the weakest level for the yen in six years and ten months. The pace of yen depreciation since the beginning of March is striking, recording nearly Y10 depreciation within a single month. Consequently, more people now anticipate a weaker yen. The USD/JPY rate is approaching Y125.86, the highest value logged on 5 June 2015 under Abenomics. Many media reports say that the next target is Y130, while some say that it is as high as Y150.

The current stage of yen weakness started in 2021, driven by diverging monetary policies between Japan and US as well as concerns about a wider trade deficit due to rising resource prices. In *Daiwa's View* issued on 7 April[1], we discussed depreciation pressure on the yen associated with supply/demand. An additional aspect is that rising prices of resources, centering on crude oil, are boosting inflation in the US further, which is leading to speculation of tighter monetary policy. It is not easy to distinguish whether the current depreciation of the yen is caused by supply/demand or the awareness of the divergence of Japan/US monetary policies. In practice, the depreciation is probably caused by both factors. In any case, we think that the monetary policy trends in Japan and the US will be a major driver for the USD/JPY rate in the near term. Thus, in this report, we consider conditions for the USD/JPY rate to exceed Y130 and the possibility of such an occurrence from the standpoint of diverging monetary policies between Japan and the US—in short, their yield differences.

Since 2021, the yen has weakened largely in line with the yield difference between Japan and the US (Chart 1). Basically, Japanese yields do not fluctuate substantially, and, therefore, US yield movements determine the yield difference between Japan and the US. Regarding the outlook for Japan's monetary policy, there are no prospects for movements toward normalization. Since February 2022, some market participants have speculated that the BOJ may tolerate higher yields due to concerns about the weaker yen. However, the BOJ showed a strong stance of decisively maintaining the upper limit of the 10-year yield target, as shown by the first implementation of fixed-rate purchase operations for consecutive days on 28 March. As such, the BOJ dismissed the notion of accepting higher yields due to 'bad depreciation' of the yen. Unless the underlying inflation rate rises led by the sort of wage hikes in Japan that the BOJ would like to see, the BOJ is unlikely to take action such as adjusting parameters of the yield curve control policy or removing the negative interest rate policy.

[1] Refer to *Daiwa's View: Yen supply/demand outlook for 2022 ~ Foreign exchange supply/demand consistent with weaker yen* by Kenta Tadaide (issued on 7 Apr).

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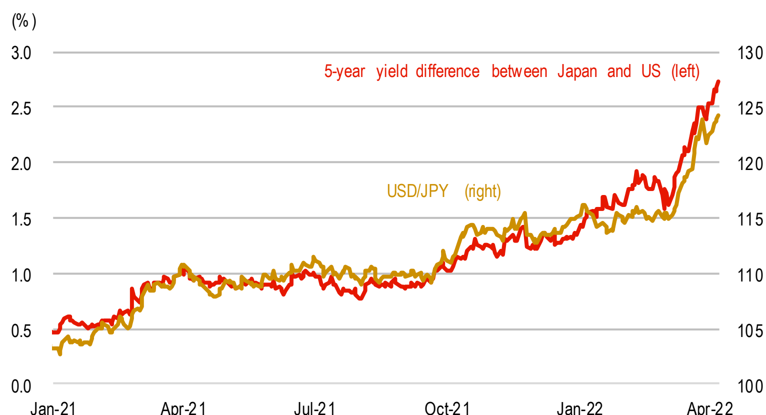
Chart 1: USD/JPY, Yield Difference Between Japan and US



Source: Bloomberg; compiled by Daiwa Securities.

Meanwhile, US yields have risen since 2021 due to the progress of COVID-19 vaccinations and expectations for additional economic measures by the Biden administration. Initially, the market only half believed monetary policy normalization in the US. However, speculation of tapering gradually increased, reflecting inflation at an accelerated pace. Then, the Fed started a rate hike amid a surge in inflation.

In *Daiwa's View* reports, we forecast that the Fed will quickly return the policy rate to the pre-pandemic level by around summer, then slow the pace, and suspend the rate-hike cycle after raising the policy rate to 2.25-2.50%, which is around the neutral interest rate projected by the FOMC, toward mid-2023. In addition, we anticipate two preventive rate cuts (mid-cycle adjustments) from 2023 onwards. Under this main scenario, our US yield outlooks for end-2022 are a federal funds rate of 1.875%, a 5-year yield of 2.1%, and a 10-year yield of 2.2%[2].

That said, it has been difficult to forecast the persistence of rising inflation. In the case that the PCE deflator does not fall below 4% in 2023, we point out a risk of "ongoing increases" to "restrictive" levels above the neutral level as an upside scenario. Looking at the past cases, the 5-year real yield needs to be raised to around 1% in order to rein in strong inflation. In this case, the nominal yield is calculated at 4.5-5.0%. Thus, if the policy interest rate is raised to 5% and maintained for a necessary period of time, it may be reasonable to expect inflation to be calmed, even in the upside scenario.

Recently, Fed Chair Jerome Powell pointed out the case of a soft landing of the economy in 1994, when the policy rate was raised to cool down the overheated economy (monetary tightening beyond the neutral rate). In addition, the dot plots from 2023 onwards show a rate-hike path higher than the longer-run projection for the policy rate. St. Louis Fed President James Bullard, who advocated a 50bp rate hike at the March FOMC meeting, has proposed that the Fed should raise the rate to a level above 3% by the end of the year.

The March FOMC meeting minutes and other information gave us the strong impression that the Fed intends to return the rate to the neutral level "expeditiously." Accordingly, hikes to the neutral rate may be implemented faster than the above-mentioned main scenario via measures such as a 50bp rate hike at the July meeting. Regarding the ceiling (terminal rate) of the current rate-hike process, there is also a growing possibility that the above-mentioned upside scenario will be realized as the focus is put on measures to tame inflation.

[2] Refer to *Daiwa's View: US yield outlook for 2022 (revised)* by Eiichiro Tani (issued on 28 Mar).

Chart 2 shows a matrix compiled based on the relationship between the USD/JPY rate and the 5-year Japan/US yield difference (from start of 2021 to end-Mar 2022), showing the conditions for the USD/JPY rate to exceed Y130 from the standpoint of yield difference between Japan and the US. Looking at this, a rise in the USD/JPY rate to the Y130 level requires a 5-year JGB yield of -0.4% if the 5-year US yield is 3%. That said, JGB yields are now also facing upward pressures in line with rising US yields, making it unrealistic to assume that the 5-year JGB yield will hit a record low in this situation.

Assuming that the 5-year US yield rises to 3.5%, the USD/JPY rate is estimated at Y132 when the 5-year JGB yield is 0% and the rate is estimated at Y130 when the 5-year JGB yield rises to 0.2%, both of which appear to be fully possible. On the other hand, a rise in the 5-year US yield to 3.5% requires rate hikes to a level far above the neutral level, which is shown in our upside scenario. This means rate hikes by the Fed to a level far above the most hawkish rate-hike projection shown in the current dot plots (3.625% in 2023). This scenario could happen, depending on the extent to which inflation rises. However, the market has not yet gained sufficient reason to price in this scenario at this moment.

It appears that the USD/JPY rate reaching Y125.86, the highest value under Abenomics, is a matter of time. However, there are considerable hurdles for the yen to weaken to a level above Y130. Meanwhile, amid uncertainties regarding the Fed's stance (the Fed seems to be confused as to what rate-hike path would be required to successfully rein in inflation), if the Fed implements aggressive monetary tightening to a level far above the neutral rate, Y130 would come in sight.

In the long run, the relationship between the Japan/US yield difference and the USD/JPY rate is not stable. We thus think that the correlation since 2021 will collapse at some point. That said, given recent growing interest in US monetary policy, we think that the matrix would serve as a useful reference for the near-term level.

Chart 2: Relationship Between USD/JPY Rate and Yield Difference

USD/JPY		5-year US yield (%)				
		1.5	2.0	2.5	3.0	3.5
5-year JGB yield (%)	-0.4	118	122	127	131	135
	-0.2	116	121	125	129	134
	0.0	114	119	123	128	132
	0.2	113	117	121	126	130
	0.4	111	115	120	124	128

Source: Bloomberg; compiled by Daiwa Securities.
Note: Calculated based on relationship between USD/JPY rate and Japan/US yield difference since beginning of 2021.

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