Daiwa's View

Signs of yen appreciation beyond race to hike interest rates

➢ Start of a global interest rate cutting cycle in 2H 2023?

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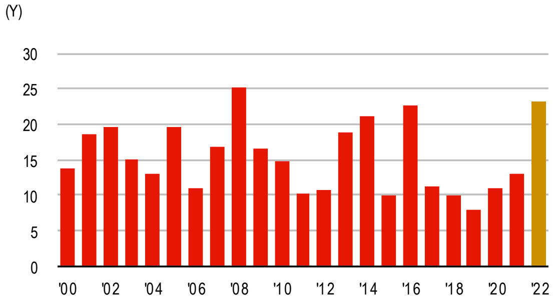
Start of a global interest rate cutting cycle in 2H 2023?

The first half of 2022 is coming to an end with many areas of Japan experiencing an unusually early end to the rainy season. Looking back over the past six months, the phrase “bad yen depreciation,” in regards to exchange rates, really stands out. Up until just a few months ago the yen was holding to a roughly USD/JPY105-110 range, but quickly depreciated to the USD/JPY115 level in Oct-December 2021. Then, rapid yen depreciation started from around the middle of March 2022. Indeed, the Japanese currency depreciated nearly Y20 over just the past three and a half months to reach its weakest level in 24 years. Soaring prices for crude oil and other raw materials have led to a series of price hikes for daily necessities. Public dissatisfaction with the yen's depreciation, which has spurred on these price hikes, has even become a major point of contention in this summer’s Upper House election.

The USD/JPY trading range so far this year is Y23.24 (high: USD/JPY136.71, low USD/JPY113.47), which is the largest range since the Lehman shock in 2008 (Y25.07) (Chart 1). Since 2000, there have been four occasions in which the USD/JPY trading range exceeded Y20 (2008, 2014, 2016, 2022). This trading range was formed in about four months in the case of 2008 and 2014 (BoJ’s “Halloween easing” shock) and roughly eight months in the case of 2016 (US presidential election and Great Britain’s decision to leave the EU). As such, the 2022 trading range formation has been on par with or perhaps even more tumultuous than that following the Lehman shock and Halloween easing shock.

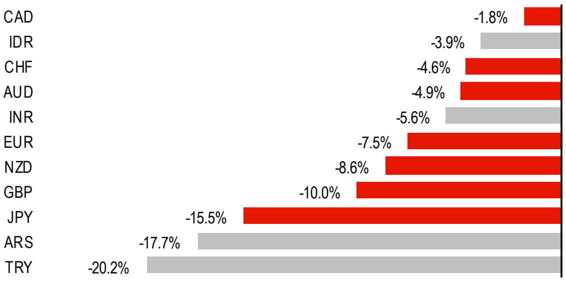
Since the start of this year, most currencies have weakened against the US dollar. Basically, the US dollar is being bought for the most part as the FRB makes curbing inflation its top priority, but selling of the yen has been particularly pronounced. Indeed, the yen has been sold more than any G10 currency. Even compared to major emerging economy currencies, only the Turkish lira and the Argentine peso have lost more value than the yen (Chart 2). Simple comparisons between regulated currencies and the yen, which can be freely traded (sold), are not possible as conditions differ. Still, yen depreciation on par with that for the currencies of countries with inflation of more than 60% is shocking.

Chart 1: USD/JPY Trading Range



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Currency Performance since Start of 2022



Source: Bloomberg; compiled by Daiwa Securities.
Note: Performance vs USD, as of 28 Jun.

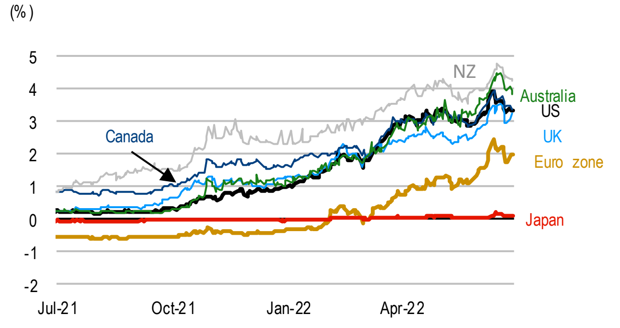
The ongoing depreciation of the yen since 2021 is essentially the result of the different monetary policy stances adopted by Japan and the US. Since the second half of 2021, global markets began to gradually factor in the likelihood of future interest rate hikes. However, the world suddenly changed with Russia's invasion of Ukraine in February 2022. Surging resource prices produced inflation around the globe and the central banks of each country took clearly more hawkish stances to combat high inflation (Chart 3).

At its May FOMC meeting, the FRB decided to make its first 50bp rate hike since May 2000. Starting with that decision, the 50bp rate hike seems to have become the global standard. Indeed, the atmosphere is now such that the 25bp rate hikes used so far are now seen as overly modest. The Fed then made a sudden and almost comical turn during the (media) blackout period before its June FOMC meeting, at which it decided to raise rates by 75bp, the largest hike since November 1994. Countries around the world are now in a race to raise their interest rates. We have even encountered phrases like “reverse currency war,” in which countries aim to strengthen their currencies to suppress their import prices. The simultaneous hawkish turn by central banks could lead to a “fallacy of composition” (false assumption that parts of a whole represent the whole) and further raise concerns about the likelihood of hard landings for their respective economies.

Meanwhile, the BoJ has maintained its position that it will not participate in this competition. Speculation that the BoJ will revise its monetary policy to arrest yen depreciation continues to smolder. However, the Bank has made clear its intention to tenaciously maintain its current monetary easing until the negative output gap is eliminated and visibility for sustainable price and wage increases improves. Forward guidance reflecting the impacts of the novel coronavirus outbreak could be revised. Still, with the output gap in negative territory, labor supply-demand conditions are not contributing to accelerated wage growth. The likelihood of BoJ policy corrections (tightening), such as a rate hike or changes to its yield curve control policy, is also small.

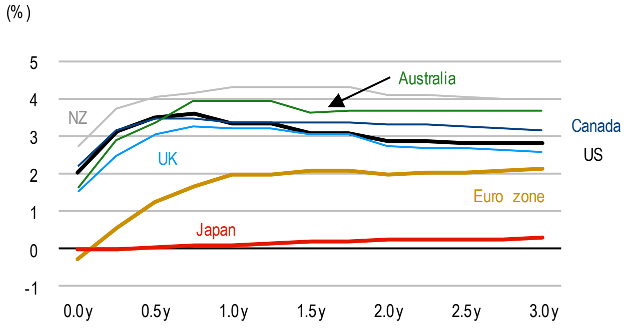
Amid this global trend of rising interest rates, the BoJ's stance of doing everything it can to hold down interest rates stands out and is likely to spur on yen depreciation over the short term. That said, we have concluded that the rise for US interest rates has peaked[1]. This is because the Fed's "unconditional" commitment is expected to curb the rise in expected inflation that drove up interest rates until now. Also, the Fed is prepared for the economy to fall into a recession if necessary and, with it meaningfully moving forward the timing of its rate hikes, the main scenario is a gradual recession for the US economy starting around mid-2023, with a preemptive rate cut expected in the fall of next year.

Chart 3: Factoring in Rate Hikes (three-month OIS forward rate in one year)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4:Three-month OIS Forward Rate



Source: Bloomberg; compiled by Daiwa Securities.

Even the market is assuming that the Fed will start to cut rates a year from now, but only very gradual and modest rate cuts are being factored in (Chart 4). Even for the UK, which took the lead in the global rate hiking race, there are expectations that a rate-cutting phase will start one year from now. However, many countries are expected to maintain their interest rates at those elevated level after making their last hikes in about a year from now.

[1] For details, refer to US rates outlook for 2022 (revised) by Eiichiro Tani *(Daiwa's View* dated 28 Jun 2022*)*.

While recession fears are on the rise, markets have yet to meaningfully factor in that possibility. However, in light of the trend for moving forward the interest rate hiking cycle schedules this time, the timing of full-blown recession fears could also be earlier than expected. Given the high inflation rates, a global interest rate cutting "cycle" (if not a "race") could start by the second half of next year. The BoJ's failure to keep pace with the current global rate-hiking cycle leaves little room for easing during a rate-cutting cycle. This will result in the arrival of the long-awaited yen appreciation.

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