Daiwa Securities

Daiwa's View

BOJ stands pat, ECB provides hawkish surprise

➢ However, the FX market's reaction wound up being a stronger yen and flat euro

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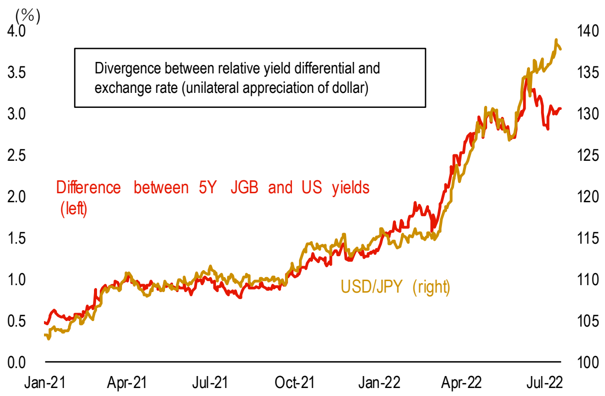
◆ FX market reacted with a stronger yen and flat euro

Both the BOJ and ECB held policy meetings yesterday. As expected, the BOJ provided no surprises, but the ECB decided to launch its transmission protection instrument (TPI) and raise policy rates by 50bp, a more hawkish move than the consensus view but within the range of expectations (we provide a more comprehensive assessment of the BOJ in a separate report). What is interesting from the market perspective is that although the above central bank decisions initially sparked a weakening of the yen and strengthening of the euro, as theory would suggest, the overnight FX market later reversed direction, resulting in a slightly stronger yen and flat euro. Although this yen appreciation was in part reflecting the significant decline in US rates (the 10yr Treasury yield declined 15bp, from 3.03% to 2.88%), interest rate moves in the US do not by themselves explain why the yen outperformed the euro.

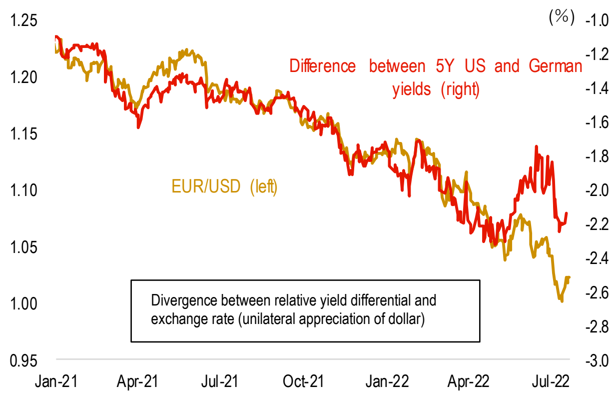
What appears to be more important here, as our FX strategist Kenta Tadaide has pointed out, is the growing divergence of exchange rates from interest rate differentials. This divergence has become increasingly clear since the June FOMC meeting when the Fed announced it would "unconditionally" fight inflation. It may be that although rate hikes in line with the fundamentals will strengthen the home currency, that currency's strength will not be sustained by forced rate hikes that go against the fundamentals. At his press conference yesterday, BOJ Governor Kuroda commented that "a small increase in interest rates is unlikely to stop the yen's decline," and that "a rate hike large enough to defend the yen would do substantial damage to the economy." Judging from recent market moves, a small rate hike would not change anything and if rates were hiked enough to damage the economy, the action could wind up weakening rather than strengthening the yen.

Japan/US Interest Rate Differential, USD/JPY



Source: Bloomberg; compiled by Daiwa Securities.

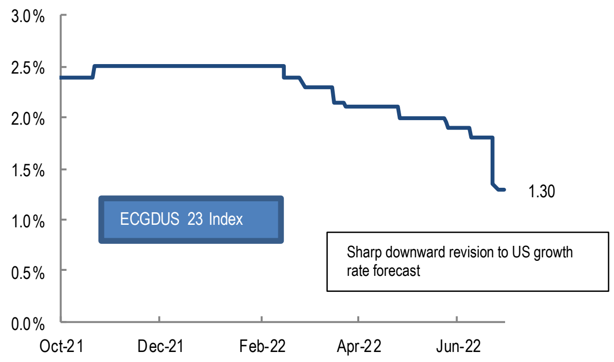
Europe/US Interest Rate Differential, EUR/USD



Source: Bloomberg; compiled by Daiwa Securities.

Likewise for the US economic growth rate, which has far outstripped growth in other economies. In response to the Fed's stance of unconditionally fighting inflation, the consensus (Bloomberg) forecast for US economic growth next year has dropped sharply, to 1.3%.[1] Amid downward revisions to growth forecasts, including by multilateral institutions, as well as declines in market-based inflation expectations (BEI), US long-term rates, as we reported previously, have already peaked and the 2yr/10yr spread is now inverted by more than 20bp. We expect the spread between the 3-month yield and the 18-month forward 3-month yield, a yield curve measure watched closely by the Fed, to invert by around September. If it is fundamentals that are driving dollar strength, then a change in the outlook for US fundamentals should, after a time lag, cause a topping out of the dollar's rising trend.

2023 US GDP Forecast (BBG consensus)



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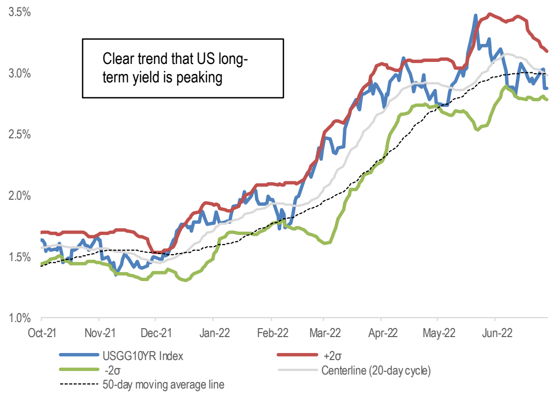
US Long-term Yield



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◆ The rising trend in JGB yields may be approaching a turning point

The above-noted developments seem to clearly indicate that the market is moving away from the previously dominant themes of a strong economy, rate hikes, rising US interest rates, and yen depreciation. If that is the case, it may be necessary to brace for the possibility that the rising trend in JGB yields that has been driven by rising Treasury yields and expectations of BOJ policy adjustments is approaching a turning point. There is of course still the Japan-specific factor of the Kuroda era ending to consider, but the topping out of the rise in US interest rates and increased downward revisions to US growth forecasts are critical changes to the external environment that reduce the likelihood of the BOJ modifying policy (hiking rates) when a new BOJ governor takes over in April 2023.

[1] Multilateral institutions have also been lowering their US growth forecasts for 2023, the OECD down to 1.2% and the IMF down to 1% (y/y).

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