Daiwa's View

Things to watch for in 2023 (2): Shifts in two major drivers of yen depreciation

- Reversal in both yield spread and supply/demand factors

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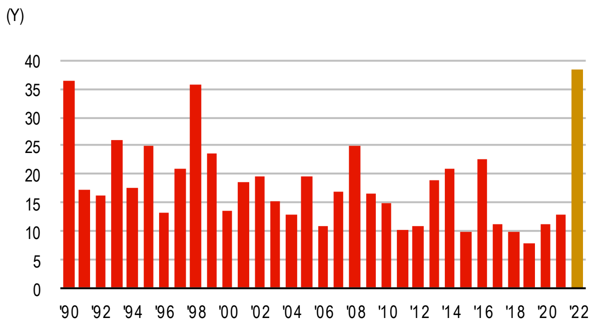
Reversal in both yield spread and supply/demand factors

The yen has weakened considerably in the forex market in 2022. The USD/JPY rate rose close to Y152 at one point, and the YTD range is Y38.48 (ranging from a low of Y113.47 to a high of Y151.95, Chart 1). We haven't seen these kinds of rapid fluctuations since 1998. The yen has weakened due to two major factors: (1) a wider yield spread between Japan and the US, and (2) a wider trade deficit in Japan. However, we are seeing signs that these drivers of yen depreciation will turn into drivers of yen appreciation in 2023.

Since 2021, the USD/JPY rate has been correlated with the yield spread between Japan and the US. However, the rise in yields and dollar appreciation driven by the Fed's hawkish stance have clearly peaked out (Chart 2). This is because monetary tightening by the Fed has generally approached an appropriate level, and tightening has reached the point where the only thing that will be left in 2023 will be slight adjustments. At this point, the Fed will not tolerate a loose financial environment that would impede measures for reining in inflation, so yields are unlikely to decline substantially right away. However, if inflation slows in line with expectations, the Fed will gradually become more concerned about an economic downturn. It is highly likely that US yields will decline and return to neutral levels around the time when we confirm that inflation is subsiding and the Fed is pivoting. Therefore, appreciation pressure on the yen vs. the dollar is expected to increase.

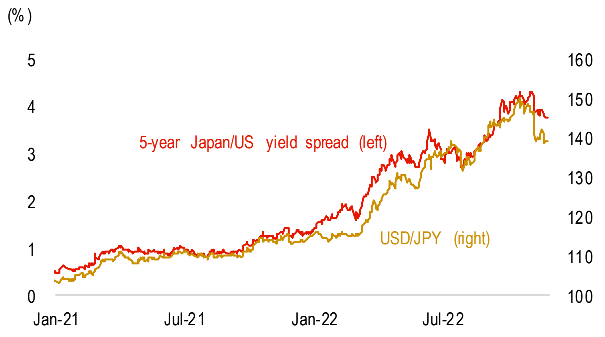
Deterioration in Japan's trade balance and the Japan/US yield spread are often pointed out as factors behind yen depreciation. Japan's trade deficit started to widen around the summer of 2021, and it has widened sharply since spring 2022 due to a surge in energy prices, which has accelerated because of the war in Ukraine. The shift to a trade deficit has changed the supply/demand structure of the yen market, which is serving as structural selling pressure on the yen. However, it is currently viewed as a factor that has further accelerated yen depreciation caused by widening of the Japan/US yield spread.

Chart 1: Range of USD/JPY Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: USD/JPY Rate, 5-year Japan/US Yield Spread



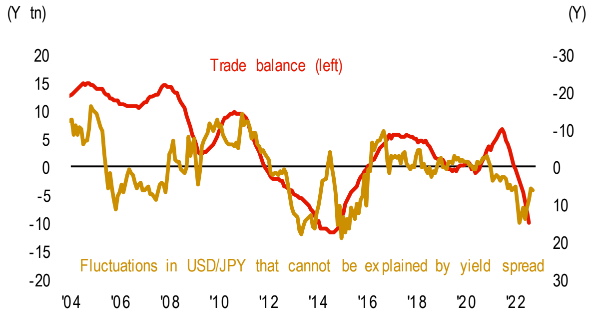
Source: Bloomberg; compiled by Daiwa Securities.

Chart 3 shows that fluctuations in the USD/JPY rate that cannot be explained by the Japan/US yield spread have been correlated with the trade balance. In short, if the Japan/US yield spread narrows going forward, the yen will return to an appreciation trend against the dollar, but that trend is expected to be partially offset by Japan's trade deficit.

On 17 November, the Ministry of Finance announced that the October trade deficit came in at Y2,166.2bn. The seasonally adjusted value of the trade deficit was Y2,299.2bn, exceeding Y2tn for the fourth consecutive month. It becomes apparent how massive and unprecedented the size of the current trade deficit is when we consider that even when the trade deficit was widening in 2014, it only exceeded Y2tn once.

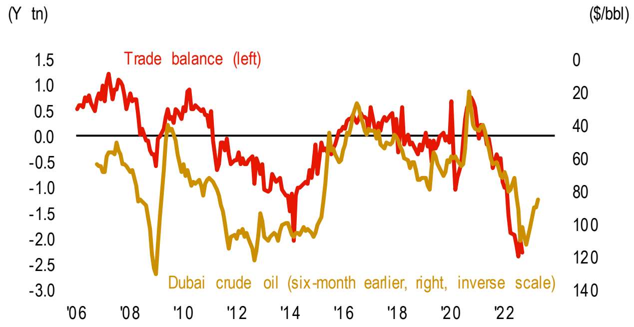
The widening trade deficit is caused by increased energy imports in which a major contributor is rising import prices, rather than increased import volume. That said, the price of commodities (incl. energy) peaked out in June, and the impact from this is expected to be reflected in import prices, after a time lag (Chart 4). The declining price of crude oil may be gradually pared back due to cuts in output by the OPEC Plus, but such price trends are probably not sustainable given that concern about a global economic slowdown is a factor behind lower crude oil prices. If that is the case, the current record-high trade deficit is at its peak. Next year is expected to see easing of depreciation pressure on the yen in terms of supply/demand factors due to Japan's trade deficit. One of the things to look out for in 2023 will be shifts in the two major drivers of yen depreciation that attracted much attention from the public this year.

Chart 3: Trade Balance, Fluctuations in USD/JPY Rate That Cannot Be Explained by Japan/US Yield Spread



Source: MOF, Bloomberg; compiled by Daiwa Securities.
Note: 12-month backward moving totals are shown for the trade balance. The residual is the difference with the estimated value based on the 5-year Japan/US yield spread.

Chart 4: Crude Oil Price, Trade Balance



Source: MOF, Bloomberg; compiled by Daiwa Securities.

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