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# Daiwa's View

## Our near-term view of the USD/JPY

➢ Increased risk of yen depreciation is only temporary

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### Our near-term view of the USD/JPY

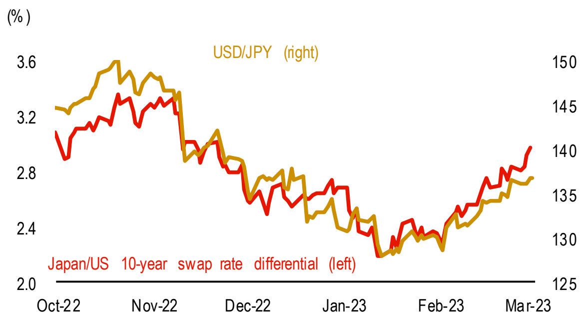
**Increased risk of yen depreciation is only temporary**

After peaking at 151.95 on 21 October 2022, the USD/JPY dropped back to nearly Y130 toward the end of the year in response to the lower-than-expected CPI in November and the BOJ's surprise policy change in December. The yen continued to strengthen in early January, and the USD/JPY declined to as low as 127.23 on 16 January in anticipation of the BOJ's January policy meeting. The USD/JPY stopped declining when the BOJ decided at that meeting to keep policy unchanged, and then turned to a rising trend in early February.

As shown in Chart 1, the exchange rate generally followed changes in the Japan/US rate spread during that time. US interest rates had been in a declining trend since November whereas JPY rates rose from mid-November until mid-January. This shrank the Japan/US swap rate differential by about 1ppt and led to a decline of more than Y20 in the USD/JPY. JPY rates were generally flat in February while US rates continued to climb, resulting in nearly a Y10 increase in the USD/JPY.

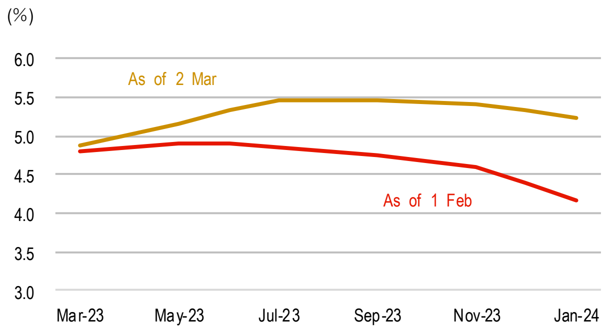
The US economic data announced starting in February, led by the January jobs report, increasingly showed strength in economic activity and the labor market, raising the risk that inflation would prove sticky. The markets, forced to revise their outlook for US rate hikes, partially priced in a 50bp rate hike at the March FOMC meeting. Assuming 25bp rate hikes, the market has almost fully priced in rate hikes until June, and nearly half of market participants have priced in rate hikes from July. The terminal rate now reflected in the market has risen by about 50bp since early February and is now at around 5.4% (Chart 2).

**Chart 1: USD/JPY, Japan/US 10-year Swap Rate Differential**




*Source: Bloomberg; compiled by Daiwa Securities.*

**Chart 2: Market Pricing in Fed Rate Hikes**




*Source: Bloomberg; compiled by Daiwa Securities.*

In Japan, both the rise in JPY rates and the yen's value, sparked by speculation of a BOJ policy change, peaked prior to the BOJ's January policy meeting and have been declining since. It was announced on 10 February that former policy board member Kazuo Ueda would be nominated to be the next BOJ Governor. Mr. Ueda does not seem to be hawkish compared with the previously reported candidates. His confirmation hearings in the two houses of the Diet also suggested he would adhere to the BOJ's current assessment of the economy and prices and not rock the boat. While acknowledging the side effects from the large-scale easing implemented thus far, he indicated an intention to keep policy accommodative, and none of his comments were likely to fuel a sharp appreciation of the yen.

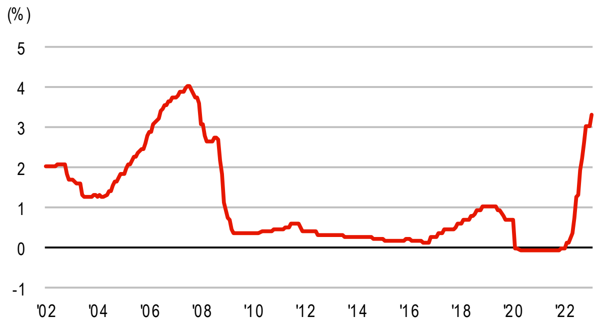
As the intermittent rise in the economic surprise index suggests, the unexpected strength of the US economy is forcing the market to expect the Fed to maintain a hawkish monetary policy stance. A growing number of market participants are backing off from the view of yen appreciation driven by a weakening US economy and declining US interest rates, and some are now expecting the USD/JPY to rise above 140. Now above Y136, the USD/JPY has already retraced 38.2% of the decline from its high on 21 October to its low on 16 January, and with the halfway point at Y139, Y140 could be seen as a key level in technical analysis, as well. After it regains half of its decline, the next key level would be a 61.8% retracement to the mid-Y142, and this is one possible target to keep in mind.

As we have noted in previous reports, the strength of Europe's economy, helped by the warm winter, together with China's economic reopening have increased the likelihood of global economic growth accelerating in 1H 2023. Such an economic environment makes it easier to engage in the yen carry trade.

With many of the world's central banks hiking rates last year, the weighted average policy rate for the G10 central banks stood at 3.3% in February, close to where it was prior to the global financial crisis in 2005-2007, at the height of the yen carry trade (Chart 3). Meanwhile, although the BOJ started the process of modifying policy, its short-term policy rate is still negative at -0.1%. The yen's position as a funding currency is unchallenged by other currencies, and it would not be surprising to see an increase in trades targeting the interest rate differential.

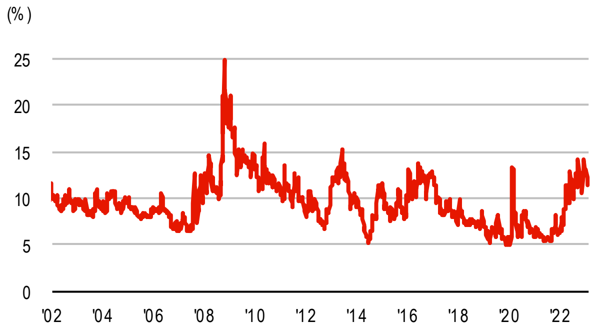
One difference with conditions in 2005-2007 is the high degree of expected FX volatility (Chart 4). A time series of that period shows a low degree of yen volatility, even compared with that of other currencies. Recently, however, the yen has been more volatile than other currencies, including on a time series basis. Normally, one requirement for the carry trade, in addition to a large interest rate differential between the investing currency and the funding currency, is low currency volatility. Therefore, although the interest rate differential has been large enough for the yen carry trade recently, high volatility is somewhat of a deterrent.

**Chart 3: Policy Interest Rate at G10 Central Banks**




*Source: IMF, BIS, central banks; compiled by Daiwa Securities.*
*Note: This is a composite policy rate weighted by each country's share of purchasing power parity-based GDP according to the IMF.*

**Chart 4: USD/JPY 3-Month Implied Volatility**




*Source: Bloomberg; compiled by Daiwa Securities.*

Either way, the risk of a near-term increase in the USD/JPY is rising. If the February jobs report and inflation data for the US again shows strength, US interest rates could rise further. The market is already pricing in a fairly hawkish Fed and terminal rate of 5.25-5.50%, but if more market participants take the view that the real interest rate must increase to nearly 2%, the 10yr Treasury yield is likely to test the 4.33% level it reached on 21 October last year. In that case, we would expect the USD/JPY to rise above 140.

If the Fed prioritizes recent labor market imbalances and inflationary pressures and significantly raises its terminal rate, the consequences of its action (a hard landing) would also become clear. If it goes too far, the economy's decline would become that much deeper.

The current strength of the economy and labor markets can be attributed to policy time lag, which explains why the tightening effects from the Fed's large rate hikes in 2022 have yet to materialize. Our economists still expect the US economy to enter a recession in 2H 2023 and the Fed to begin cutting rates by the end of the year. It is possible that if the February data comes in strong, the Fed will continue hiking rates until June and not start cutting rates until around March 2024, and although there is an increased risk of dollar appreciation over the near term, our broader expectation over the longer term is for US interest rates to converge to their neutral level, which would correct dollar strength and lead to a decline in the USD/JPY.

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