Daiwa Securities

Daiwa's View

Will USD/JPY rate reach Y140?

- It would be unlikely to stay there for long
- Resolution of US debt ceiling issue would boost USD/JPY rate

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Will USD/JPY rate reach Y140?

It would be unlikely to stay there for long

The USD/JPY rate has been rising once again in line with the rise in US yields (Chart 1). The rise in US yields has been caused by recent US economic indicators, which are stronger than market estimates, and receding concerns about an economic recession in the near term. At the same time, due to a series of hawkish remarks by Fed officials, more market participants are pricing in rate hikes in June and July, while fewer participants are pricing in rate cuts from September onwards.

Furthermore, volatility in the financial market has not risen despite concerns about the US debt ceiling issue. Volatility also remains low and stable with regard to the USD/JPY rate, as well as the stock and bond markets. Moreover, the USD/JPY risk reversal has been rising since April as the market factors in the June policy interest rate (Chart 2), which is reducing fears of near-term yen appreciation in the market. In short, volatility has been stable, while the Japan/US interest rate differential has been widening. Amid diminishing concerns about yen appreciation, the current environment is making it easier to engage in USD/JPY carry trades.

If the Fed were to raise the target federal funds rate to 5.50-5.75% by implementing a 25bp rate hike in both June and July (however, this is not the main scenario in *Daiwa's View* reports), the 10-year US yield could rise towards the 4% level once again. If that were to happen, given the recent relationship between currency rates and the interest rate differential, we expect the USD/JPY rate would rise to the lower half of the Y140 range.

Furthermore, if the debt ceiling issue were to be resolved without confusion before the X-date, the market would be expected to respond with a risk-on reaction. Considering that US yields have risen in a straightforward response to economic indicators and remarks by Fed officials and stock prices have been solid, even since the beginning of May when the debt ceiling issue started to garner a lot of attention in the market, we do not think that the market is fully factoring in the risk that the debt ceiling issue could end up unresolved. Nevertheless, since the debt ceiling issue is something that increases the risk of a near-term recession, if concerns surrounding the issue were eliminated, we would likely see a rise in yields and stock prices.

In that case, there would also likely be a rise in the USD/JPY rate. The rise in the USD/JPY rate would be supported by the reduced possibility of a sharp appreciation in the yen due to the unwinding of yen short positions resulting from a near-term recession being avoided as well as widening of the Japan/US rate differential via higher US yields. In fact, the yen is now temporarily moving as if it were a safe haven currency. Looking back on the US and European bank shocks in March 2023, we see that the yen strengthened more than the Swiss franc, which is regarded as a safe haven currency (refer to our 14 Apr 2023 report *USD and JPY during recessions*). At the time, both the price of gold and the yen surged (Chart 3). During the period from early April, when BOJ Governor Kazuo Ueda took office, to late April, when the Monetary Policy Meeting was held, expectations of early policy revisions by the BOJ receded. While the resulting rise in the USD/JPY rate caused a divergence from the price of gold, the correlation has been increasing once again since the beginning of May.

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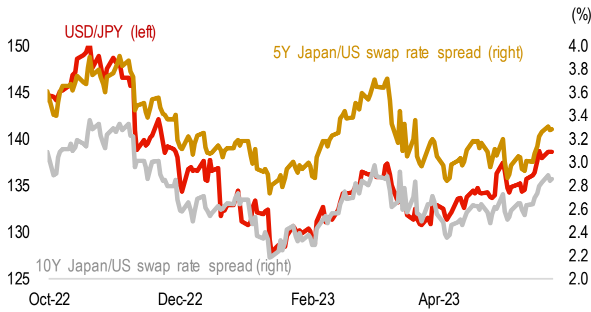
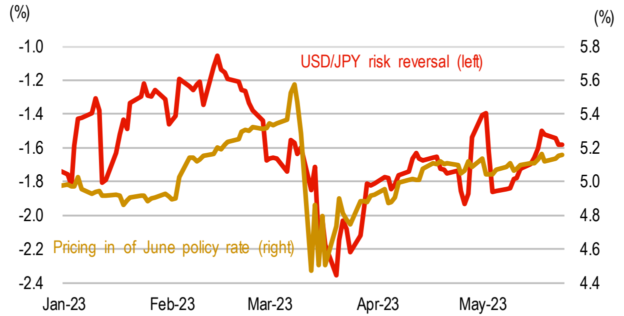
Chart 1: USD/JPY Rate, Swap Rate Spreads



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: USD/JPY Risk Reversal, Pricing in of US Policy Rate

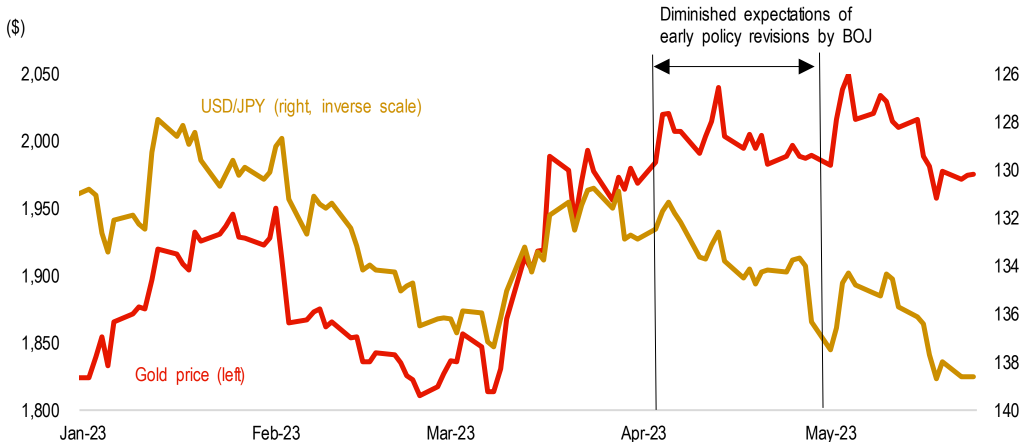


Source: Bloomberg; compiled by Daiwa Securities.

That said, even if the debt ceiling issue were resolved, that would simply avoid negative impact on the economy and market, but would bring no positive factors in itself. However, if the market's risk-on reaction were significant, higher stock prices in particularly would support consumption, and consumer sentiment would temporarily recover. Therefore, messaging from the Fed is likely to lean towards the hawkish side.

If we continue to see solid economic indicators together with a resolution of the debt ceiling issue without trouble, it is highly likely that US yields and the USD/JPY rate will rise. However, a rise in yields caused by resolution of the debt ceiling issue comes with no substantiation in macroeconomic terms. If the USD/JPY rate were to top Y140, it would be unlikely to stay there for long. With the outlook for a US recession to occur heading into 2H 2023 being unchanged, our view that the USD/JPY rate will decline in line with lower US yields is also unchanged.

Chart 3: Gold Price, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa Securities.

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