Daiwa's View

Two interpretations of USD/JPY detachment from US/Japan yield gap

- (1) Concerns about forex intervention, (2) Different factor driving UST yield rise
- 2-year UST/JGB yield differential to become more important if focus shifts to expected short-term interest rate changes
- Yen depreciation close to peaking if cause driving higher UST yield factored into USD/JPY?

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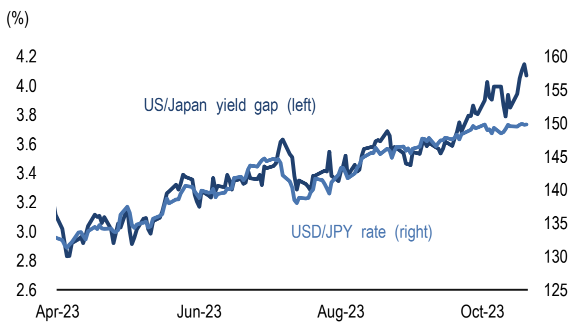
Since July 2021, the USD/JPY rate has generally moved in line with the 10-year UST/JGB yield differential. However, over the past month there has been a decoupling with the USD/JPY trading sideways despite further expansion of this yield differential (Chart 1). There are probably at least two interpretations of this decoupling.

Interpretation 1: Concerns about forex intervention
The first interpretation involves concerns about forex intervention. Since early September, monetary authorities have ramped up the tone of their verbal intervention. Indeed, on 19 September, US Treasury Secretary Janet Yellen clarified that Washington could be understanding if Japan intervened in the forex market, saying, “We usually communicate with them (Japan-side) about these interventions and generally understand the need to smooth out following undue volatility.” She made similar remarks at the end of June. While the US did not explicitly state that it would accept Japan-side forex intervention, coordination between Japan and the US on this front is already in place. This statement was a reminder that MOF is positioned to act at any time.

In late September, when the yen was marking fresh lows for the year against the dollar, trading near USD/JPY150, Finance Minister Shunichi Suzuki made repeated verbal intervention with such comments as “excessive volatility is undesirable” and “we will respond appropriately without ruling out any options.” On 3 October, the yen depreciated beyond USD/JPY150 for the first time in roughly a year, but the pair soon declined (yen appreciation) close to three yen as the market started buzzing with speculation about forex intervention. Suzuki and Vice Finance Minister Masato Kanda have made no comments on whether or not MOF will intervene in the forex market, but the market is very wary of potential intervention around the USD/JPY150 line. As such, the pair remains stuck just below that level.

Chart 1: US/Japan Yield Gap, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Language Concerning Future Interventions Categorized by Warning Level

Warning level	Language
1	Stable exchange rates are desirable We are watching market moves closely
2	An overshooting of yen depreciation is undesirable Rapid market changes are undesirable
3	Yen depreciation has gone too far recently Movement in JPY exchange rates have been unidirectional
4	We will respond appropriately to excessive yen depreciation We will watch the market trend closely and respond appropriately
5	We will respond resolutely to excessive moves We do not rule out implementing a variety of measures to deal with excessive market moves

Source: Nikkei Telecom, Bloomberg; compiled by Daiwa Securities.
Note: The likelihood of forex market intervention increases approaching warning level 5.

Many market participants have tried to arrange past verbal intervention comments into "warning levels" to gauge the distance until actual intervention is executed. In past editions of this report, we likewise organized intervention expressions into warning levels. Based on our ranking system, we are currently at Warning Level 4 (second highest; Chart 2). There was the statement (from Suzuki) that "We will take appropriate action to counter excessive volatility without excluding any options." As such, we can probably assume the highest Warning Level 5 has already been reached. However, strong wording such as "We will respond resolutely" has been avoided, with authorities only going so far as to say "We will respond appropriately."

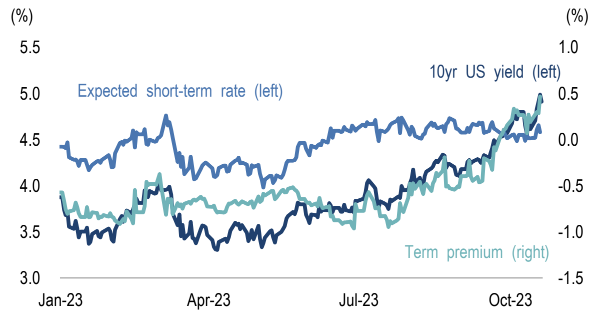
However, authorities may believe that they can maximize the effects of forex intervention by catching the market by surprise. If that is the case, they could possibly avoid the expression "respond resolutely" and execute intervention without any rate checks. Furthermore, speaking at a NIKKEI Financial online seminar on 19 October, Kanda touched on how the MOF might announce future intervention, explaining that, "Our basic stance is not to say anything as to whether or not we foray in the market." He said that Japanese authorities would not make any announcement immediately after intervening in the market as that in itself would cause noises in the market and there is nothing to be gained from that approach. If forex intervention is executed in the future, it is highly likely to be in the form of "stealth" intervention.

Interpretation 2: Different factor driving UST yield rise
The second interpretation is that higher UST yields are being driven by a different factor than before. The 10-year UST yield can be broken down into (1) a portion that reflects the expected short-term interest rate path and (2) a term premium that reflects risk compensation for future uncertainty and supply-demand imbalances. Until now, the expected short-term interest rates have led the 10-year UST yield higher, but recently we can see the term premium portion becoming a stronger driver (Chart 3).

Chart 4 shows the market's expectations for the US policy rate as of end-2024 and the USD/JPY rate. In this regard, the factoring in of the Fed's "higher-for-longer" strategy has reached an end for now and the USD/JPY is moving sideways as expectations for the FF rate path have stabilized. In other words, this implies that the USD/JPY rate has been moving, focusing more on the change in the expected short-term interest rates rather than the other US long-term rate components.

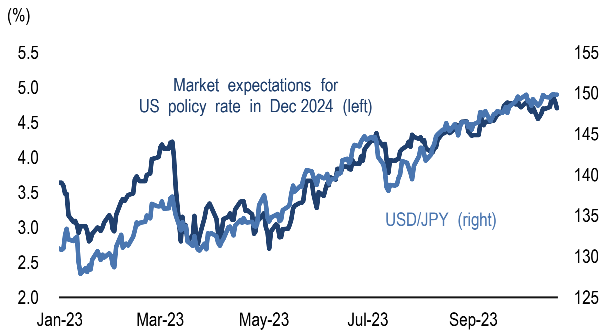
The increased concern about forex intervention and the change in the factors behind the 10-year UST yield rise have occurred at about the same time. More time is now needed to determine the background for the decoupling of the USD/JPY rate from the 10-year UST/JGB yield differential. However, if changes in the expected short-term interest rate have become a more important factor for the USD/JPY rate, the pair could start to move more in tandem with 2-year UST/JGB yield differential and other short maturities that impact the expected short-term interest rates more than the 10-year UST/JGB yield differential.

Chart 3: Expected Short-term Rate, Term Premium



Source: NY Fed, Bloomberg; compiled by Daiwa Securities.

Chart 4: USD/JPY, Market Expectations for US Policy Rate



Source: Bloomberg; compiled by Daiwa Securities.

Yen depreciation nearing peak if focus turns to US expected short-term interest rate changes?

In response to the recent 10-year UST yield spike, several Fed officials have issued a coordinated message that a higher 10-year UST yield could reduce the need for a rate hike. In other words, the Fed has the willingness to respond by suppressing expected short-term interest rates (weakening "higher-for-longer") in the event that a significant increase in the term premium could cause financial conditions to tighten excessively. Accordingly, yen depreciation vs the dollar may be nearing its peak if the USD/JPY moves after factoring in causes for the higher US yields.

Of course, if unexpectedly persistent inflation in the US economy is confirmed, more sufficiently restrictive monetary conditions could be needed in order to deter inflation. Fed Chairman Jerome Powell expressed caution about upside risks to growth in a speech last week, leaving additional rate hikes as an option going forward. In that case, the 10-year UST yield would likely be led by the expected short-term interest rates and the USD/JPY would likely target Y155 or even Y160.

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