Daiwa's View

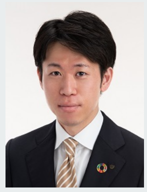
JPY weakness not justified by real demand

- JPY now less vulnerable to supply/demand factors

FICC Research Dept

Kenta Tadaide
81-3-5555-8466
kenta.tadaide@daiwa.co.jp

Daiwa Securities Co. Ltd

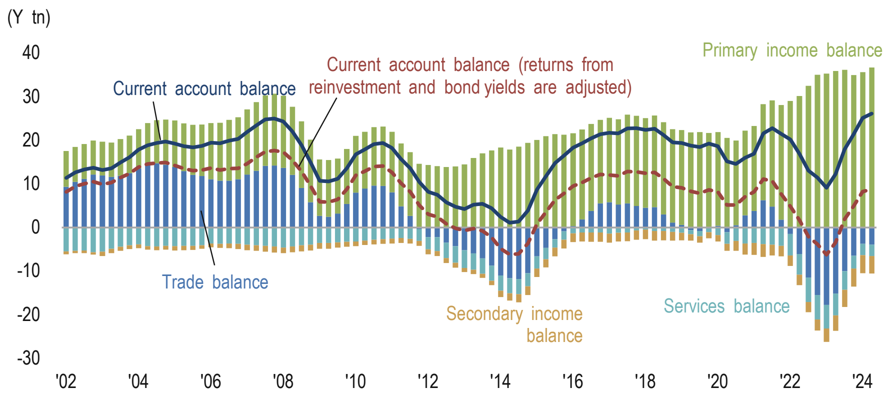


The Ministry of Finance (MOF) released 1H 2024 balance of payments data on 8 August, just as financial markets were regaining their composure. There has been a lively debate about whether real demand or speculation is the main driver of this year's JPY weakness; below, we revisit JPY supply-demand conditions using balance of payments data (the most basic data for analyzing supply-demand).

Japan's 1H 2024 current account surplus was Y12.6817tn, up sharply from Y7.9668tn in 1H 2023. It continues to run a trade deficit, but the 1H figure of Y2.6118tn nearly halved versus the previous year's Y5.182tn. The services deficit also shrank to Y1.7511tn from Y2.0689tn. The primary income balance, which reflects returns on past investments, reached a surplus of Y19.1969tn in 1H (the highest ever half-year figure) due to factors such as the yen's historic weakness, resulting in a substantial current account surplus.

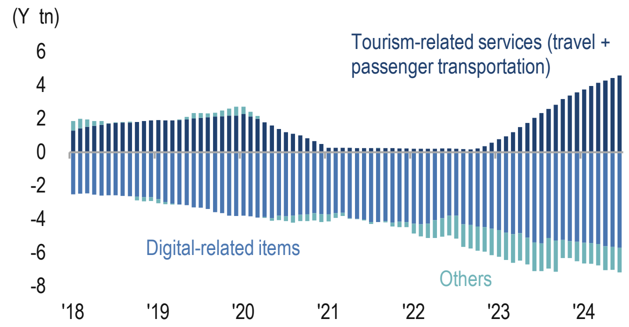
However, as has often been noted in recent years, the key consideration in terms of forex impact is whether or not this data translates into market flows. For example, we think around half of the primary income surplus (returns from reinvestment, some bond yields) is being reinvested without being converted into yen. Adjusted for this, we estimate the current account balance at Y3.7912tn; this is far lower than MOF's announced figure, but still back to a surplus following the Y69.5bn deficit in 1H 2023 (Chart 1).

Chart 1: Current Account Balance



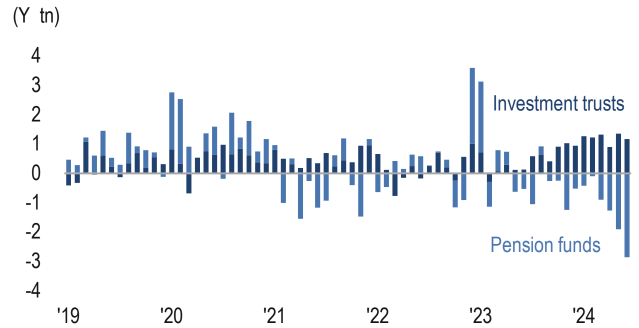
Source: MOF, BOJ, compiled by Daiwa.
Note: 4-quarter moving totals.

Chart 2: Breakdown of Services Balance



Source: MOF; compiled by Daiwa.
Note: 12-month moving totals.

Chart 3: Overseas Securities Investment



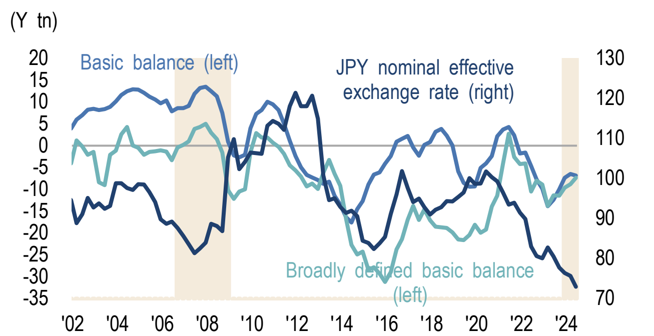
Source: MOF, BOJ; compiled by Daiwa.
Note: Pension funds indicate banks and trust banks (trust accounts).

One reason that has often been cited for this year's yen weakness is the digital deficit. This is a component of the services balance with a growing deficit, which at the current pace is set to exceed Y6tn in 2024 (Chart 2). However, Japan's inbound tourism boom is driving a substantial surplus for tourism-related services. Growth in this "inbound surplus" is offsetting the digital deficit, resulting in the narrowing service deficit we mentioned above.

Alongside the digital deficit, another new driver of yen weakness is households' selling of JPY as a knock-on effect of the revamped NISA scheme. As of end-1H, overseas securities investment via investment trusts and other vehicles already exceeded the 2023 total, and investment is on pace to set a new yearly record. However, pension funds' record net selling of overseas assets is offsetting the impetus from yen selling driven by households' investments (Chart 3). While the new demand to sell JPY created by the revamped NISA scheme could affect medium-term market trends, it does not appear to have driven the yen's slide YTD.

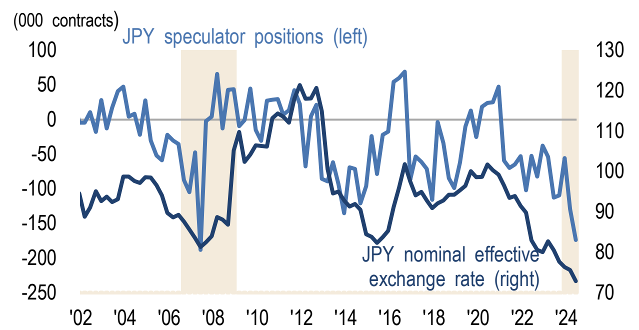
The combined current account and direct investment balance is sometimes referred to as the basic balance. We think this reflects the textbook definition of real demand for the forex transactions that are required for economic activity; the deficit in this basic balance peaked in spring 2023 (Chart 4). While companies' overseas direct investment remains upbeat despite the weaker yen, the current account balance is improving at a faster pace. A pickup in the kind of inward direct investment by overseas firms that has recently been in the headlines would also imply less selling pressure on JPY.

Chart 4: Japan's Basic Balance, JPY Nominal Effective Exchange Rate



Source: MOF, BOJ; compiled by Daiwa.
Note: 12-month moving totals for balance of payments statistics. Current account balance, direct investment, and overseas securities investment are adjusted using assumptions for forex transactions and hedging ratios. Shading indicates periods around yen carry trade booms.

Chart 5: JPY Speculator Positions, Effective Exchange Rate



Source: BOJ, CFTC; compiled by Daiwa.
Note: Shading indicates periods around yen carry trade booms.

Capital transactions involve far larger forex transactions than trade or other normal-course business transactions, and many observers therefore expect them to have a greater impact on short- to medium-term forex movements. We think a broad definition of the basic balance[1] that adds in overseas securities investment can be said to capture real demand in a wider sense that includes both households' JPY selling and pension fund flows.

Both the basic balance and broadly defined basic balance imply that selling pressure on JPY driven by real demand has been easing since spring 2023 (Chart 4). Trends in the basic balance/broadly defined basic balance and forex rates also suggest that the direction of change is the key factor, rather than the absolute level (surplus/deficit). This suggests that the yen ought to have strengthened somewhat more than it has since 2023.

We think the (broadly defined) basic balance largely tracks forex trends, but the two often move in opposite directions, as has been the case in the past year. This reflected off-balance-sheet transactions that are not included in the balance of payments data. JPY speculators' IMM currency futures positions are a well-known example of off-balance-sheet forex trades, and these flows explain the divergence between the basic balance and forex to some extent (Chart 5).

While Japan's economic structure undeniably creates a supply-demand bias toward selling JPY, real demand over the past year does not justify the yen's one-way slide. Also, while not included in the basic balance, the MOF has spent Y15tn YTD on intervening in forex markets by buying JPY; supply/demand including this factor skews even more heavily toward a stronger yen. While we cannot rule out the potential for the yen's slide to gather momentum again in the event of a pickup in selling by investors focusing on interest-rate spreads, JPY's vulnerability to supply-demand has lessened considerably.

[1] It is important to assess whether forex flows associated with securities investment are hedged or not. We therefore adjust the overseas securities investment included in our broadly defined basic balance using assumptions for forex transactions and hedging ratios, and exclude inward securities investment on the assumption that it is mostly hedged.

Daiwa Securities

IMPORTANT

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association