ETF Securities FX Research: Safehaven JPY boost transitory

Summary

- The Yen’s safehaven perception is keeping the Japanese currency supported as FX market volatility remains elevated.
- The strong Yen is placing downward pressure on Japan’s inflation outlook. We expect the central bank to add more stimulus at its July meeting, depressing the Yen.
- Real interest rate differentials indicate that the Japanese Yen is overvalued. Low yielding Japanese government bonds will prompt local saving to seek better returns offshore, weakening the Yen.
- Futures market positioning is hovering just shy of record high levels. An unwinding of futures net longs could spark a sharp decline in the Japanese Yen in coming months.

Japan safehaven?

Japan’s historically high savings ratio and surplus current account position are behind the ‘safe-haven’ perception of the Yen. However, despite recent Yen strength, the economic fundamentals of Japan are currently weak: growth is moribund, the government’s debt position is the highest in the OECD and deflation is ingrained. It seems that the JPY safehaven perception is probably more relevant for domestic investors. Investment flows stemming from repatriation are partly the reason for the local currency strength. Although JPY tends to strengthen during times of financial stress and rising volatility, the weak domestic economic backdrop would indicate that foreign investors are not accessing the Yen for its economic strength. Accordingly, the unwinding of carry trades seems to be a more likely explanation of the Yen’s current strength. Such portfolio rebalancing explains the stronger Yen in times of market uncertainty - as foreign investment positions are hedged or repatriated, upward pressure is exerted on the JPY. Indeed, the IMF asserts that the stronger Yen is likely due to ‘portfolio rebalancing through derivative positions’, which is to say domestic foreign positions being hedged against adverse Yen movements.

JPY strengthens on uncertainty

The Japanese Yen (JPY) has strengthened 15% against the US Dollar (USD) in H1 2016, as market uncertainty remains elevated and as the Fed has backed away from continuing on its tighter monetary policy path. Britain’s vote to leave the EU has kept investors on edge, boosting the value of perceived safehaven assets, like the JPY.

Volatility remains elevated in currency markets. Although volatility is at the upper end of the range of the past few years, it has moderated in recent days, and market sentiment appears to be stabilising. A continuation of this trend toward greater stabilisation should see the JPY pare its recent gains.

Central bank action

The recent strength of the Yen will prompt the Bank of Japan (BOJ) to act to implement further stimulus. The BOJ speaks of the ‘conversion of firms’ and households’ deflationary mindset has been progressing’, which is key to raising inflationary expectations and in turn achieving the inflation target. However, with import prices falling, the deflationary mindset is
likely to be maintained as long as the strong Yen continues to reduce prices. The BOJ has previously enacted policy to affect its currency, and despite overtures to the contrary, could do it again.

Import prices have a strong correlation with Japanese CPI, and import prices have a direct and significant impact on inflation in the country. With the stronger local currency, imports become cheaper and are therefore contributing to a weaker domestic price environment – Japan is importing deflation. Additionally, a strong Yen is a thorn in the side of Japanese exporters - a persistently stronger Yen is also likely to erode its export competitiveness.

There is little evidence that the BOJ’s move to reduce rates into negative territory in early 2016 is having any impact on the nation’s economy. Accordingly we expect, as the stronger Yen builds pressure on the central bank, that the BOJ will act to add further stimulus to the economy. The BOJ will act to boost the money supply in order to boost growth. In turn, we expect the next meeting to prompt Yen weakness. Newly appointed BOJ Board member Masai has noted that its undesirable for currency moves to not reflect underlying economic fundamentals. This appears a clear sign that additional stimulus is on the way from the BOJ. Indeed, current market pricing indicates an expectation of a rate cuts at the forthcoming BOJ meeting.

Market pricing

Futures market net long positioning has rebounded in recent weeks as the uncertainty surrounding the EU Referendum roiled financial markets. Net JPY longs now hover just shy of the record levels reached in April. Previous episodes of futures market unwinding have been accompanied by weakness of the JPY. The upcoming Bank of Japan (BOJ) meeting (July 28th-29th) will become increasingly important if the Yen maintains current levels. Options pricing confirms the market view of the bullish Yen mentality. The Yen, along with the Swiss Franc are the only G10 currencies expected to appreciate against the dollar over the next three months.

Real rates matter

Real rate differentials also suggest the Yen is extremely overvalued. Domestically held Japanese savings are lacking yield options - the JGB curve is recording negative yields to the 15-yr part of the curve. We expect the search for yield to again contribute to offshore investment flows in H2 2016 and into 2017. Once a greater degree of stability has returned to currency markets, the Yen is likely to be the main victim of carry trade related activity, depreciating sharply against the US Dollar.

Nonetheless, we expect that rate differentials and investors searching for higher yielding assets offshore will force the Yen to weaken during Q3, as volatility in currency markets begins to fade. The Bank of Japan’s upcoming meeting is likely to be the catalyst for a sustainably weaker Yen.
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