Trade Idea – Foreign Exchange
Japanese Yen to come under fire
19th November 2015

**Japanese economy suffers**

- The current economic outlook for Japan is austere. The Japanese economy slipped into a technical recession in the third quarter while its headline inflation fell to 0%. Despite not taking action at its latest monetary policy meeting, the Bank of Japan (BoJ) acknowledged the fragile state of the economy, lowering its growth and inflation projections and extending its inflation target deadline by six months to March 2017. Despite this, the JPY has recently been appreciating against the EUR, rising 6% over the last five months (Source: Bloomberg) as European Central Bank (ECB) president, Mario Draghi, has repeatedly hinted at a possible expansion or extension of the current quantitative easing (QE) programme. We believe that recent moves have made the JPY expensive against the Euro and it is likely that the pairing will be subject to an upward correction in coming months.

**Short term real yield differentials suggests impending correction**

- The growing difference between short term real yields in Europe and Japan has, until recently, helped pressure the JPY lower against EUR (see Figure 1). However, since June this year this relationship has reversed, as rhetoric from Draghi has caused the market to price in additional monetary stimulus in 2015, generating downward pressure on the EUR. This has left the currency pair considerably lower than the real rate differential would imply, suggesting that risks of an upcoming correction are skewed to the upside.

**Figure 1: EURJPY to climb?**

![Figure 1: EURJPY to climb?](image)

Real Yield Differential = (Inflation linked German 2Y Yield - Inflation linked Japanese 2Y Yield), %
Source: Bloomberg, ETF Securities

**Japanese inflation expectations fall**

- Japanese inflation expectations have also been subdued. In the absence of a considerable pickup in consumer spending the inflation picture is unlikely to improve in near term. Looking at the trend in the forward 5yr breakeven inflation rate (good proxy for medium inflation expectations), expectations of price growth in Japan appear to have fallen to depressed levels (see...
Figure 2). This could spur the BoJ into taking imminent monetary action and place the JPY under considerable pressure against the EUR.

**Figure 2: Inflation expectations fall**

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- ETFS Short JPY Long USD (SJPY)

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- ETFS 3x Short JPY Long EUR (JPE3)
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- ETFS 3x Short JPY Long GBP (SYP3)
- ETFS 3x Long JPY Short USD (LJP3)
- ETFS 3x Short JPY Long USD (SJP3)

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