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Maybank

FX Insight

Where Do We See The JPY Heading To?

Analysts
Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com.sg

Alan Lau
(65) 6320 1378
alanlau@maybank.com

Fiona Lim
(65) 6320 1374
fionalim@maybank.com.sg

Shaun Lim
(65) 6320 1371
shaunlim@maybank.com

In December, the Bank of Japan (BOJ) gave us a surprise by deciding to widen the YCC band from +/-0.25% to +/-0.50%. Almost immediately, we saw the USDJPY make a sharp move downwards. Since then, speculation remains rife about whether the BOJ is now embarking on a tightening cycle. In this piece, we look to explain our views regarding this and its impact on the JPY.

Are We Expecting a Shift in the Direction of the BOJ?

There are a whole host of complex factors that have to be examined when determining whether the G7's most dovish central bank is about to make a shift in its policy path:

The inflation trajectory: Both headline and core CPI have been picking up strongly in Japan in 2022 with the numbers having exceeded the BOJ's 2.00% target for much of the year. Whilst the numbers on the outset look encouraging and there has been some broadening in inflation, the majority of categories still fall below the 2.00% level (see chart 1). Supply side pressures also appear to predominantly drive inflation and such pressure is likely to diminish with time. Meanwhile, there is no clear sign that demand factors would contribute more given wage growth is not showing a pick-up (see chart 2). Hence, from an economic perspective, there isn't a strong case for a BOJ pivot.

Side-effects of the YCC policy: There appears to be increasing speculation about the sustainability of the YCC after the recent Yomiuri report that the BOJ is looking to review the side-effects of its easy monetary policy. As it stands, there are a number of concerning side-effects.

The first is that the bond market is becoming increasingly illiquid (see chart 3) and more so in January as the central bank continues to aggressively buy the JGBs in order to keep the 10 y yield below the cap. The cap has in fact been breached on multiple occasions since Dec and this only serves to raise the question if the BOJ's actions is even able to meet its objectives. The BOJ's continued actions in effect is wiping out any outside appetite for the JGB 10 y.

The other side-effect from the BOJ's YCC policy is that it can risk distorting the JGB yield curve. The risks are rising that the yield on the longer tenures could end being much lower than maturities shorter than it. A yield curve of this sort as we know would have its impact on loans tied to the short term rates and also make long term lending challenging.

Stance of new governor: The stance of the three front runner candidates – Masayoshi Amamiya, Hiroshi Nakaso and Hirohide Yamaguchi all differ to quite a degree. Current deputy governor Amamiya is seen as more of the dove whilst former deputy governor Nakaso is less of one. Meanwhile, former deputy governor

Chart 1: Number of CPI Categories Above And Below 2.00%

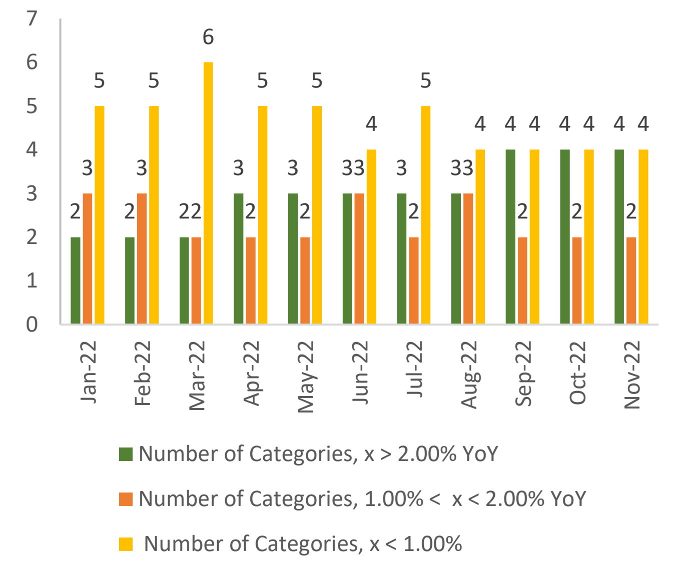
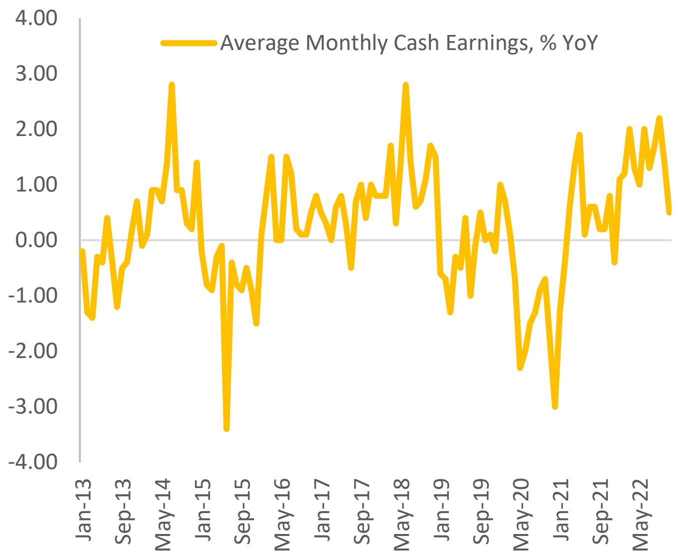


Chart 2: Average Monthly Cash Earnings, % YoY



Source: Bloomberg, Maybank FX Research & Strategy

Taking these factors together, the economics is not supportive of a tightening but the bond market is coming under intense pressure as the YCC turns the JGB 10 y market increasingly illiquid and risk distorting the yield curve. Under such circumstances, it becomes challenging for the BOJ to keep clinging on to YCC. We don't believe though that they would just abruptly abolish YCC given that it is highly uncertain how yields would immediately behave. Instead, we see them taking a more incremental approach to exit YCC to avoid any shocks from a quick move.

Hence, our expectation is that the BOJ may make incremental tweaks to its policy in 2023 which could involve widening the YCC band by another 25bps in both directions to +/- 75bps. We are cognizant that bond market pressure may remain even after such a move but it is still a form of relief and the pressure should reduce overtime as Fed rates peak and UST yields fall.

Aside dealing with the YCC, we would like to note that the BOJ can also consider an exit from the negative interest rate policy (NIRP). Whilst we don't rule this as an option, the economic conditions may make this a less favourable option for now. As mentioned, further actions on the YCC is likely to be driven by bond market functionality issues rather than economic issues. The other actions they can look at undertaking include changing the forward guidance for interest rates to be more data-dependent of which there is a possibility this may be done. Raising the 10 y yield target is another action which could be considered this year too but they are more likely to focus on adjusting the band.

Chart 3: Bloomberg JGB Securities Liquidity Index

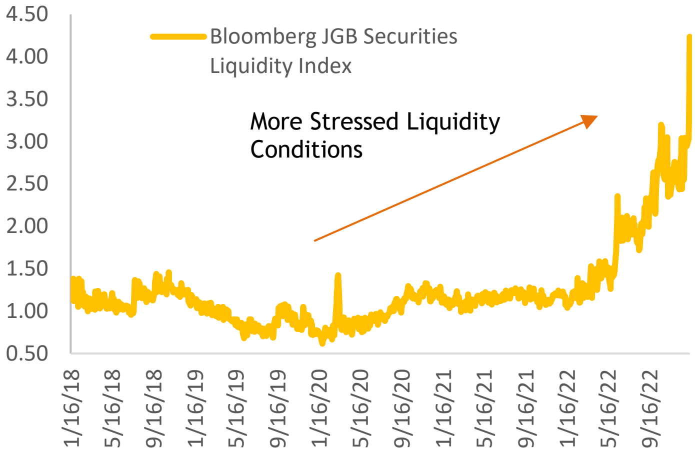
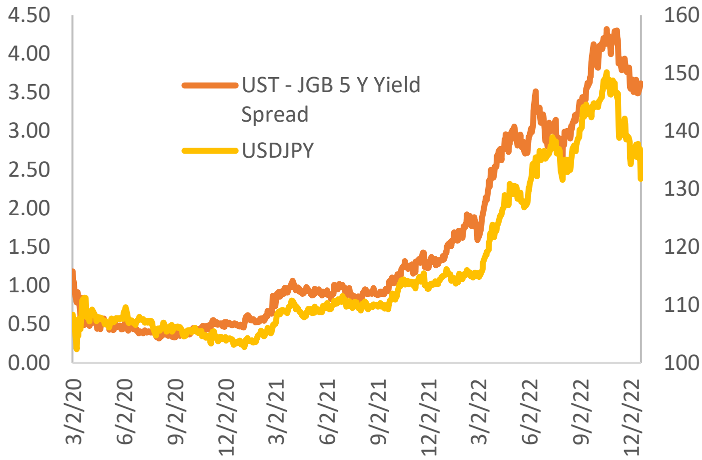


Chart 4: USDJPY and UST 5 Y - JGB 5 Y Yield Spread



Source: Bloomberg, Maybank FX Research & Strategy

So Where is the JPY Heading To?

In this section, we would be explaining how the USDJPY would perform under various scenarios. These scenarios are status quo, widen the band by another 25bps to +/-75bps and full abolishment of the YCC. We believe there is usefulness in explaining the outcome in all three scenarios given we can't rule out any possible action by the BOJ. As mentioned in the previous section though, widening the band by another 25bps to +/- 75bps is our base case.

Status Quo (10% probability)

We see this as an unlikely scenario given the stress that the bond market is already facing. Based on a Bloomberg survey that ran from 6 Jan to 11 Jan, 58% of respondents believed that the BOJ would change its main policy settings this year. Regardless, we can't rule out the possibility that the BOJ may keep to status quo if they feel that the Dec move suffices and continue to heavily focus on achieving their inflation objectives. In this scenario, the BOJ would have to make clear that the Dec move is a one and only. This could involve appointing a new dovish governor in addition to jawboning that further actions would not be undertaken. This would then take the speculative element off the JPY and keep the currency very closely correlated to the UST – JGB rate differentials. At the same time, this should also stabilize the JGB yield curve. A downward trend for the pair though would still be intact throughout 2023 given our house views that UST yields would end the year lower. Under such circumstances, the USDJPY would likely trade at 136.00, 132.00, 128.00and 126.00 for 1Q 2023, 2Q 2023, 3Q 2023 and 4Q 2023.

Widen the band by another 25bps to +/-75bps (60% probability - base case)

This is our base case scenario as per our explanation in the previous section. However, incremental adjustments such as this by the BOJ to the YCC though isn't likely to bring about a major downward shift to the USDJPY. As a whole, as long as the BOJ chooses to continue to cap JGB 10 year yields at a fixed level, appetite for the JPY would still heavily be determined by the UST yields movements. However, at the same time, the JPY could receive an additional boost from market speculation given that the move could be perceived by investors as another step in the direction of normalization. Taking all these factors into account, our forecast for this scenario would therefore stand at 132.00, 128.00, 125.00 and 122.00 for 1Q 2023, 2Q 2023, 3Q 2023 and 4Q 2023.

Full Abolishment of The YCC (30% probability)

As mentioned, whilst we are not ruling it out, we think this scenario is less likely to happen given the uncertainty in how JGB yields would behave across the curve if the YCC was abruptly abolished. It is though also this point that makes it extremely difficult to determine how the USDJPY would perform in this scenario given it is hard to see where the fair value for JGB yields would be at. However, one way to determine the fair values would be to examine how prices behaved pre – Abenomics. This would be a reasonable way to look at it given that the abolishment of YCC may get interpreted by the market as a discrediting of Abenomics. By analysing this period therefore, we estimate the fair value for the JGB 10 Y yield to stand at 1.37%, 1.28%, 1.20% and 1.15% for 1Q 2023, 2Q, 2023, 3Q 2023 and 4Q 2023. Consequently, we forecast the USDJPY to be at 110.00, 106.00, 103.00 and 101.00 for 1Q 2023, 2Q 2023, 3Q 2023 and 4Q 2023. We do warn that this is a very hypothetical scenario and that estimations here are more of a guideline.

Forecast Update:

Following an adjustment in our view in this piece, we are providing an update to our USDJPY forecast.

Forecast	1Q 2023	2Q 2023	3Q 2023	4Q 2023
USDJPY	**132** (135)	**128** (130)	**125** (125)	**122** (122)

Previous Forecasts in Parentheses

Overall, we suggest going short USDJPY for 2023 given our forecasts and the high downside risk to the pair. At this point, the probability is more skewed towards the BOJ undertaking further action rather than the Fed u-turning on its downshift.

Summary Table

Scenario	Likelihood (% probability in brackets)	USDJPY Forecast	Comments	Bloomberg Survey 6 Jan - 11 Jan:
Status Quo	Unlikely (10%)	1Q 2023: 136.00 2Q 2023: 132.00 3Q 2023: 128.00 4Q 2023: 126.00	• BOJ to undertake no further actions and to signal very clearly of this intention to markets	58% believe the BOJ will change its main policy setting this year, 20% believe they will do it in 2024 whilst 21% think it will happen beyond 2024
Tweak to YCC - Widen Band to +/- 75bps	More Likely, (60%) (Our Base Case Scenario)	1Q 2023: 132.00 2Q 2023: 128.00 3Q 2023: 125.00 4Q 2023: 122.00	• BOJ to undertake another widening of the YCC band by 25bps both directions • Market speculation to boost JPY given the move could be perceived by investors as another step putting the central bank on a tightening path	22 out of 147 responses think the BOJ would further widen the yield-target range as its first additional action to adjust policy in the future
Full Abolishment of YCC	Less Likely (30%)	1Q 2023: 110.00 2Q 2023: 106.00 3Q 2023: 103.00 4Q 2023: 101.00	• Could be perceived as an exit our of Abenomics • Hypothetical scenario and estimations are only a guideline	37% believe it is very likely or likely that the BOJ would abruptly abandon YCC, 44% think it is unlikely or very unlikely and 19% think it is hard to tell

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Malayan Banking Berhad
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Foreign Exchange

Singapore

Saktiandi Supaat
Head, FX Research
saktiandi@maybank.com.sg
(+65) 6320 1379

Fiona Lim
Senior FX Strategist
Fionalim@maybank.com.sg
(+65) 6320 1374

Alan Lau
FX Strategist
alanlau@maybank.com
(+65) 6320 1378

Shaun Lim
FX Strategist
shaunlim@maybank.com
(+65) 6320 1371

Indonesia

Juniman
Chief Economist, Indonesia
juniman@maybank.co.id
(+62) 21 2922 8888 ext 29682

Myrdal Gunarto
Industry Analyst
MGunarto@maybank.co.id
(+62) 21 2922 8888 ext 29695

Fixed Income

Malaysia

Winson Phoon
Head, Fixed Income
winsonphoon@maybank.com
(+65) 6340 1079

Se Tho Mun Yi
Fixed Income Analyst
munyi.st@maybank-ib.com
(+60) 3 2074 7606

Sales

Malaysia

Zarina Zainal Abidin
Head, Sales-Malaysia, Global Markets
zarina.za@maybank.com
(+60) 03- 2786 9188

Singapore

Janice Loh Ai Lin
Head of Sales, Singapore
jloh@maybank.com.sg
(+65) 6536 1336

Indonesia

Endang Yulianti Rahayu
Head of Sales, Indonesia
EYRahayu@maybank.co.id
(+62) 21 29936318 or
(+62) 2922 8888 ext 29611

Shanghai

Joyce Ha
Treasury Sales Manager
Joyce.ha@maybank.com
(+86) 21 28932588

Hong Kong

Joanne Lam Sum Sum
Head of Corporate Sales Hong Kong
Joanne.lam@maybank.com
(852) 3518 8790

Philippines

Angela R. Ofrecio
Head, Global Markets Sales
Arofrecio@maybank.com
(+632 7739 1739)