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FX Insight

JPY - Will The Sun Set on Abe In 2019

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PM Abe Faces Domestic And External Landmines Ahead

The path ahead for PM Abe is unlikely to be smooth but lay with domestic and external landmines. Abe could face recrimination from powerful agriculture group should he allow for greater access for US agricultural products in his drive to reach a trade deal with Trump. Further erosion of public support could come from the implementation of the 2%-point increase in the consumption sales tax that could result in an economic slowdown. The greater danger to PM Abe's hold on power is his obsession with amending the country's pacifist constitution to allow for a more assertive and outward looking foreign and defense policies

Headwinds Could Potentially Push Abe Out Of Office

These headwinds could undermine PM Abe's hold on power in 2019, culminating in sharp losses in support in the regional gubernatorial and Upper House elections in Apr-May and Jul 2019 respectively. The failure to retain a two-third majority in the Upper House election in the face of public angst over the LDP handling of the trade deal with the US, the expected hike in the consumption sales tax, and plans to amend the pacifist constitution could lead to more vocal opposition to PM Abe's continued leadership and trigger moves to oust him.

The JPY Returning To The 90-95 Levels Cannot Be Ruled Out

Should Abe leave the political arena, BOJ's ultra-loose monetary policy could be unwound. This should lead to flows back into Japanese assets, particularly government bonds, as yields rebound with the BOJ beginning to taper its asset purchases. The repatriation of funds could support the JPY. Then as the BOJ begin to taper its asset purchases, yields should rebound. Narrowing yield differentials between UST and JGB should further weigh on USDJPY. In addition, growing concerns that global growth could slow in 2020, could lead to a re-rating of risk conditions and results in a global equity sell-off. Safe-haven FX-proxy plays including the JPY could be in demand. The unwinding of Abenomics could thus see the USDJPY back to the 90-95 levels - the level prior to the implementation of Abenomics.

Risk of Sun Setting on Abe

The re-election of PM Shinzo Abe to a third term as president of the ruling LDP on 20 Sep 2018 signalled the continuation of Abenomics, including the BOJ's extra-easy monetary stimulus programme. But this optimism may be misplaced.

The path ahead for PM Abe is unlikely to be smooth but lay with domestic and external landmines. These headwinds could undermine PM Abe's hold on power in 2019 and possibly even push him out of office. The unwinding of Abenomics could see the USDJPY back to the 90-95 levels – the level prior to the implementation of Abenomics.

Domestic Landmines Ahead

The drive by PM Abe to reach a trade deal with the Trump administration by allowing greater access for US agricultural products to Japanese markets could leave the ruling party exposed to recrimination particularly from powerful domestic agricultural groups. Negotiations are scheduled to start in mid-Jan 2019. This could see support for the ruling LDP and PM Abe wane. Further erosion of public support could come from the implementation of the 2%-point increase in the consumption sales tax. The Abe government hopes to avoid another recession by implementing a slew of measures. All of these measures though do not guarantee that consumers will not come under pressure again, especially should wage increases lag the tax rate hike. Together these could weaken PM Abe and increases the risk of him losing his grip on power.

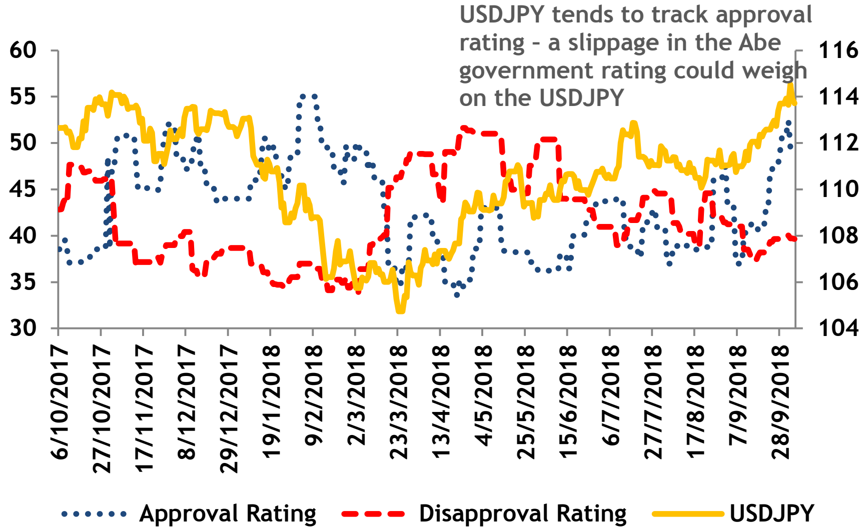
Amendment Of Pacifist Constitution Could Be PM Abe's Undoing

The greater danger to PM Abe's hold on power is his obsession with amending the country's pacifist constitution to allow for a more assertive and outward looking foreign and defense policies. To do so will require not only the approval of two-third of the lawmakers in both houses of the Diet, but also a majority in a referendum. While he could easily pass the constitutional amendment in both houses of the Diet since the LDP and its coalition partner - the Komeito Party - have a comfortable two-third majority, PM Abe could face a greater hurdle in convincing a skeptical public to amend the constitution, who worry that this could lead to Japanese involvement in global armed conflicts. A loss in the referendum could trigger calls from LDP lawmakers for new leadership.

Regional and Upper House Election Losses Could Seal PM Abe's Fate

Public discontent with PM Abe's handling of the Japan-US trade agreement, the implementation of the consumption sale tax increase and attempts to amend the pacifist constitution could manifest in a sharp loss of support in the regional gubernatorial and Upper House elections in Apr-May and Jul 2019 respectively. While the LDP defeat in several gubernatorial elections is unlikely to force PM Abe to step down, it could lead to disquiet among LDP lawmakers and members regarding PM Abe's leadership. More important is the outcome of the Upper House elections. The failure to retain a two-third majority in the face of public angst over the LDP handling of the trade deal with the US, the expected hike in the consumption sales tax, and plans to amend the pacifist constitution could lead to more vocal opposition to PM Abe's continued leadership and trigger moves to oust him.

Chart 1: An Extended Slippage In Approval Rating & Rise In Disapproval Ratings Could Doom PM Abe & Drag The USDJPY Lower

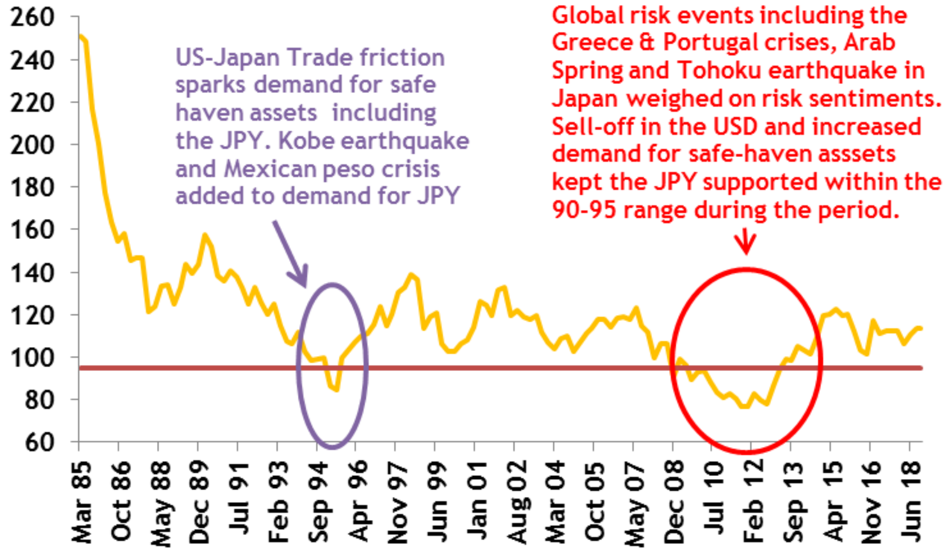


Note: (1) graphs above are 10-day moving averages of the Abe government's approval and disapproval ratings; polls were weighted by sample size adjusted for the number of days since a poll was published.
(2) Major opinion polls conducted by Japanese media outlets were aggregated to provide a more accurate picture of the Abe government's public approval rating.
Source: Sasakawa Peace Foundation USA, Maybank FX Research & Strategy

Some Risk of JPY Back To 90-95-Levels Against The USD

Should the driving force behind Abenomics leave the political arena, it is unlikely that the BOJ under Kuroda would feel obliged to continue with its inflation target of 2% amid concerns the existing monetary policy has on financial institutions earnings. This should suggest that the BOJ's ultra-loose monetary policy could be unwound. This should lead to flows back into Japanese assets, particularly government bonds, as yields rebound with the BOJ beginning to taper its asset purchases. The repatriation of funds could support the JPY. Narrowing yield differentials between UST and JGB should further weigh on USDJPY. Previously under the ultra-easy policy, yields had been suppressed, forcing Japanese financial institutions to seek higher returns overseas, which in turn bolstered the USDJPY.

Chart 2: Demand For Safe-Have Assets Supported The JPY Within The 90-95 Range In 1995 And In The 2009-2013 Period



Source: Bloomberg, Maybank FX Research & Strategy

Unwinding of QE To Weigh On Equities & USDJPY

Investor reaction to the risks of Abe's departure from the political stage and the concomitant reversal of Abenomics could reassert downward pressure on Japanese assets prices, particularly equities. The sell-off in equities should lead to the unwinding of hedges with investors buying back the JPY and selling the USD, thus dragging the USDJPY lower.

JPY Could Lose Status As Funding Currency Of Choice

Thereafter, the risk of the BOJ ending its ultra-loose monetary policy could see the JPY losing its status as the funding currency of choice. The unwinding of stale net short JPY positions that has been in place since end-2016 is expected to result in a sharp demand for JPY. This should provide further impetus for JPY strength and could push the USDJPY closer towards the 100-levels.

Risks of Global Slowdown in 2020 Another Drag For USDJPY

There are growing concerns that global growth could slow in 2020. This could lead to a re-rating of risk conditions and results in a global equity sell-off. Safe-haven FX-proxy plays including the JPY could be in demand. This should put the USDJPY under even more pressure. We cannot rule out a move by the USDJPY back toward the 90-95 levels by end-2019 in such a scenario.

Chart 3: Unwinding Of Net Short JPY Positions Could Spur JPY Demand

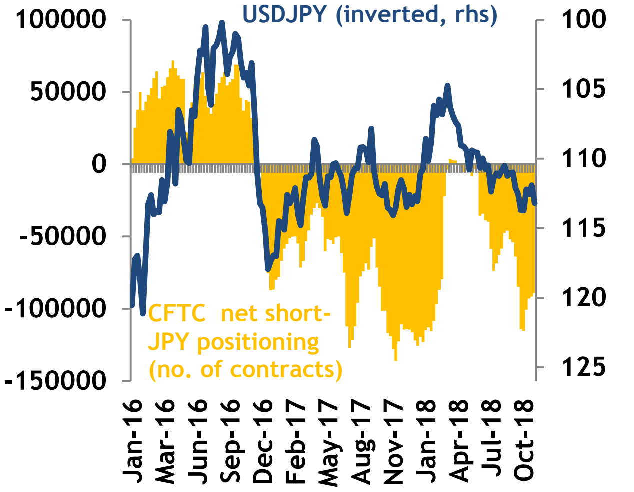
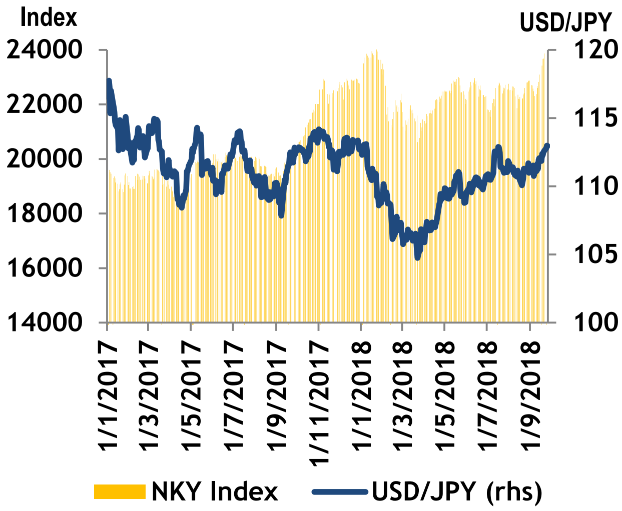


Chart 4: Sell-Off In The Nikkei Could Drag USDJPY Lower



Source: Bloomberg, Maybank FX Research & Strategy

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