Maybank

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Global

FX Insight

JPY - Looking For Even More Weakness

Analysts

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

Leslie Tang
(65) 6320 1378
leslietang@maybank.com.sg

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

Christopher Wong
(65) 6320 1347
wongkl@maybank.com.sg

JPY Strength So Far But Not For Long

The JPY has been among the top performers against USD so far this year, having risen by 5.53% against the USD year-to-date, just behind the KRW, TWD and INR. Since the start of May, the JPY has gained 0.6% against the USD. Much of the gains so far can be in part attributed to safe-haven flows due to global risk aversion. Political turmoil in Europe, US and South America and geopolitical tensions in Middle East and the Korean peninsula have so far kept risk in the limelight. The recent scandal in the US engulfing Trump is resulting not only in a re-positioning of long-USD bets but also a sell-off in UST. This sell-off in the UST and its concomitant dip in yields had narrowed the yield differentials with JGB, weighing on the USDJPY. We do not believe that global risk sentiments will deteriorate persistently given that European political risk has already faded with the "uneventful elections" in the Netherlands and France; and geopolitical tensions in North Korea and the Middle East appears contained for now.

Drivers Of Higher USDJPY

One driver is the medium term improvement in the global risk environment. The return of global calm refocuses attention back to earnings of Japanese firms and their stocks, and hence the Japanese stock markets. This is important as foreign investors usually hedge their equity purchases against further JPY depreciation by short-selling the JPY. Thus, once global risk aversion fades, we can expect even more inflows into Japanese equities and hence more upside to the USDJPY. Next, the continuation of its ultra-loose monetary policy, including low domestic interest rates, as long as the 2% inflation target is not achieved should also put downward pressure on the JPY. Finally, further monetary policy divergence between the US and Japan is expected and this should eventually still push yield differentials between the UST and JGB further apart. This in turn should weigh on the JPY and support the USDJPY. In addition, global reflation trades could re-emerge should Trump manage to push through his ambitious tax reforms and infrastructure spending program. The resulting widening of the yield differentials between the UST and JGB should also be supportive of a higher USDJPY.

USDJPY To Climb Higher in 2017

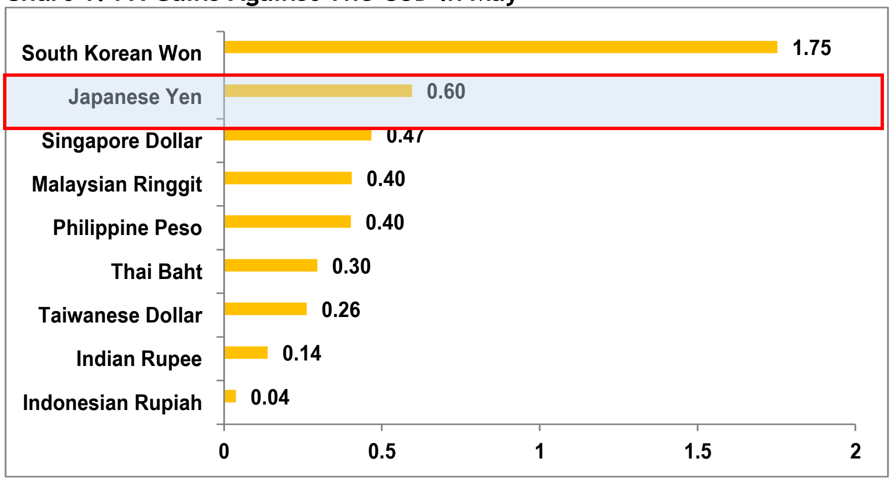
We remain bearish on the JPY. Our expectations of dissipating safe-haven plays ahead should be supportive of further inflows into Japanese equities and provide more upside to the USDJPY. This together with the continuation of the ultra-loose monetary policy by the BOJ and expectations of further widening of the yield differentials between the UST and JGB should see the USDJPY climb higher from current levels. We now expect the USDJPY to climb higher to 116 by end 2Q before ending the year at 120.

We are bias to buy the USDJPY on dips towards 110 targeting a move towards 116- and then 118-levels. Stop-loss at 109.

Safe-Haven Flows Lifting JPY Higher

The JPY has been among the top performers against USD so far this year, having risen by 5.53% against the USD year-to-date, just behind the KRW, TWD and INR. Since the start of May, the JPY has gained 0.6% against the USD. Much of the gains so far can be in part attributed to safe-haven flows due to global risk aversion. Political turmoil in Europe, US and South America and geopolitical tensions in Middle East and the Korean peninsula have in so far kept risk in the limelight. The recent scandal in the US engulfing Trump is resulting not only in a re-positioning of long-USD bets but also a sell-off in UST. This sell-off in the UST and its concomitant dip in yields had narrowed the yield differentials with JGB, weighing on the USDJPY.

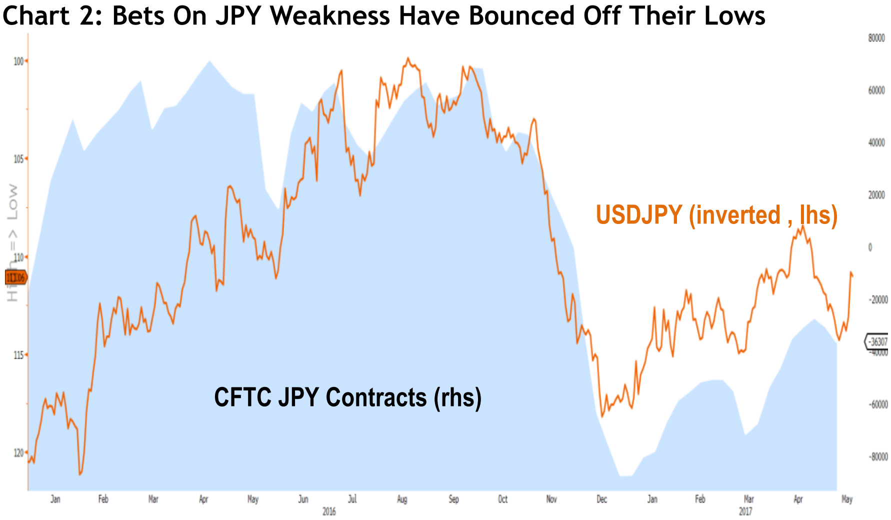
Chart 1: FX Gains Against The USD In May



Source: Bloomberg, Maybank FX Research

While long-USD positions are receding, the same cannot be said for JPY bets. Recent CFTCC data showed that speculators are still positioned for JPY weakness ahead. The number of short-JPY contracts as of 9 May (78,942 contracts) continue to outweigh long-JPY ones (42,635 contracts). The net JPY bets continue to be short-JPY, though they remain off the recent Dec 2016 highs as seen in Chart 2 below. Though these net contracts have come off mildly, we still think that there could be room for further net short-JPY bets ahead.

Chart 2: Bets On JPY Weakness Have Bounced Off Their Lows



Source: Bloomberg, Maybank FX Research

We watch for a re-pricing of Fed rate hike expectations. A continuous climb in UST yields with JGB at least holding steady around current levels could lead to further increases in net short-JPY bets. Such bets should provide the USDJPY with another leg up in 2017.

Global Risk Aversion Should Fade, So Too Will JPY Strength

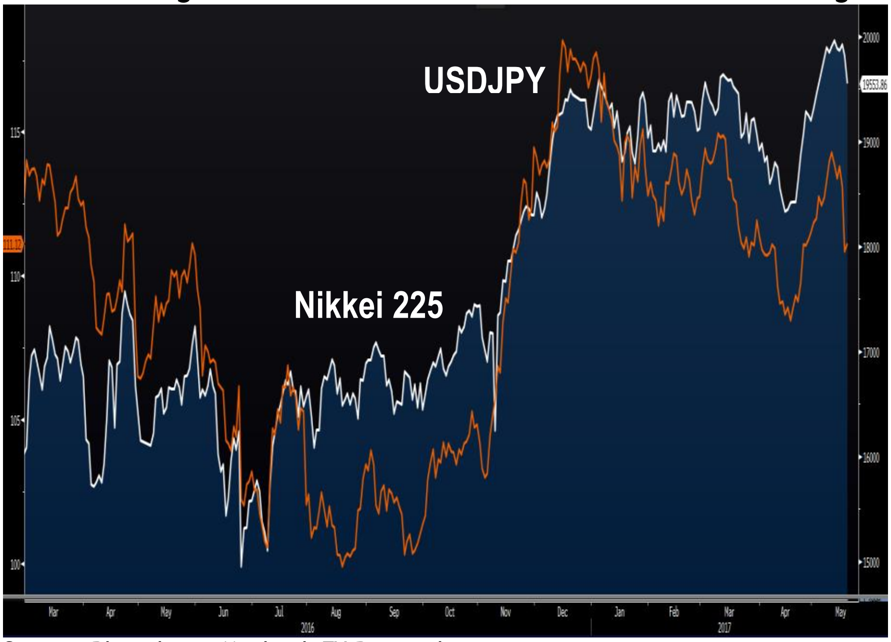
Yet despite the recent strength in the JPY so far in the year, we remain bearish on the outlook for the JPY. We do not believe that global risk sentiments will deteriorate persistently given that European political risk has already faded with the “uneventful elections” in the Netherlands and France; and geopolitical tensions in North Korea and the Middle East appears contained for now.

Even the turmoil enveloping Trump at the moment is unlikely to lead to his removal from office at this point in time, unless more damning information emerges, and should eventually recede. That said, intermittent jump in the JPY due to global risks aversion is to be expected, though these should eventually subside as well and should not stem the depreciating tide of the JPY against the USD.

The improvement in the global risk environment is particularly important to the JPY. The return of global calm refocuses attention back to earnings of Japanese firms and their stocks, and hence the Japanese stock markets. The stock index as such can be used as a proxy for the global risk environment in this context.

Chart 3 below shows the strong correlation between Nikkei 225 Index and the USDJPY. This is because foreign investors usually hedge their equity purchases against further JPY depreciation by short-selling the JPY. Thus, once global risk aversion fades, we can expect even more inflows into Japanese equities and hence more upside to the USDJPY.

Chart 3: Foreign Inflows Into The Nikkei Should Lift The USDJPY Higher



Source: Bloomberg, Maybank FX Research

The calm in the global risk environment encourages foreign fund inflows seeking higher returns from Japanese equities. In the first three months of the year, the sell-off by foreign investors of JPY2.04tn in equities had dragged the USDJPY from its Dec 2016 high of 118.18 to around the 111 levels by end-Mar 2017. The pair had slipped lower to the 108-levels in early Apr before bouncing off that low as foreign buying of Japanese equities returned. Since Apr, foreign investors have purchased JPY1.74tn in equities.

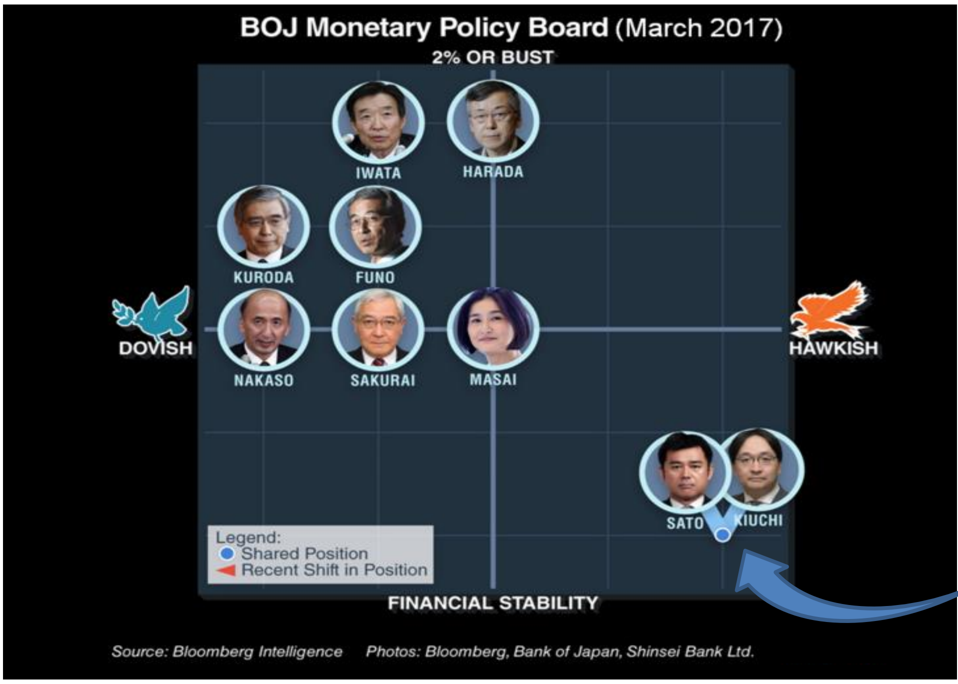
The inflows of foreign funds into Japanese equities have help to lift the Nikkei within striking distance of the high seen in Jun 2015 (20868; currently at 19554). Further inflows into the Nikkei should be supportive of the USDJPY ahead.

Current BOJ Policy Provides Underlying Support For Weaker JPY

Market rumblings about the need for the BOJ to articulate an exit strategy aside, we doubt that the central bank is anywhere close to ending its ultra-loose monetary policy. BOJ governor Kuroda comments on 20 Apr that the BOJ's "very accommodative monetary policy" will continue and the current pace of asset purchase to be maintained for some time reinforces our view. These comments suggest that the BOJ is in no hurry to provide an exit strategy. The governor had further reiterated that monetary policy was not constrained by "the fact that (the BOJ has) acquired 40 percent of JGBs already or that (its) balance sheet is about 80 percent of GDP". Thus, the policy bias remains for the continuation of existing monetary easing and low domestic interest rates for as long as the 2% inflation target is not achieved. This then should continue to put downward pressure on the JPY.

More importantly, the governor's view is given even more credence by PM Abe's appointment of two additional policy doves to the Monetary Policy Board of the BOJ (Chart 4). Hitoshi Suzuki - banker with commercial banking and financial markets expertise in Japan and abroad - and Goshi Kataoka - an economist viewed as a reflationist - are set to replace the last two policy hawks on the board, namely Takahide Kiuchi and Takehiro Sato, when their term ends on 23 Jul. With these two joining the board in Jul, there will be no known hawks on the board. This should ensure that the ultra-loose monetary policy continues unabated as long as the 2% inflation target is not achieved.

Chart 4: The Doves Are Set To Increase Their Domination Of The BOJ



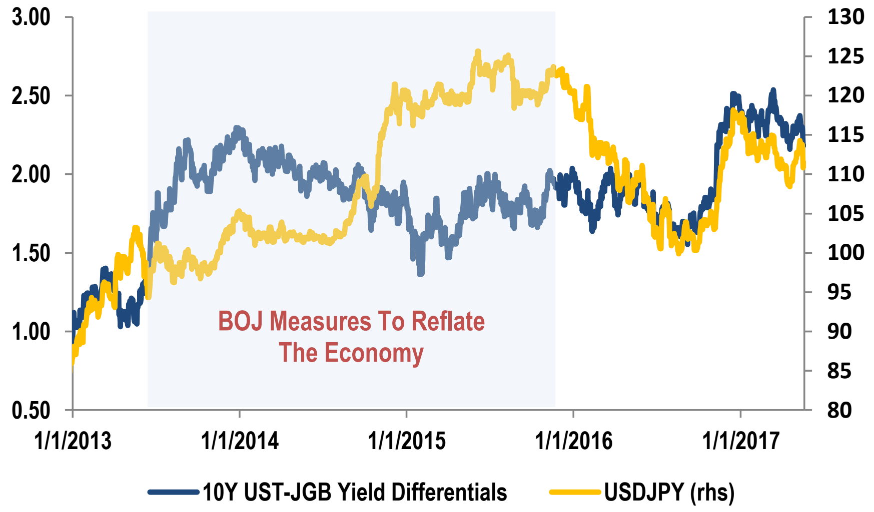
Hitoshi Suzuki - a banker with commercial banking and financial markets in Japan and abroad - and Goshi Kataoka - an economist viewed as a reflationist – are set to replace Takahide Kiuchi and Takehiro Sato (term ends 23 Jul) on the Monetary Policy Board

Source: Bloomberg, Maybank FX Research

Widening Yield Differentials Should Be Supportive Of The USDJPY

As our discussion above has shown, the BOJ remains on an aggressive easing mode. In contrast, the Fed is still on a tightening bias and remains on track to hike its short-term policy rate at least twice more this year. This suggests then that further monetary policy divergence between the two can be expected. Even if the Fed does not tightened even more aggressively, this divergence in policy amid supported risk sentiments should still push yield differentials between the UST and JGB further apart. This in turn should weigh on the JPY and boost the USDJPY. In addition, global reflation trades could re-emerge should Trump manage to push through his ambitious tax reforms and infrastructure spending program. The resulting widening of the yield differentials between the UST and JGB should also be supportive of a higher USDJPY.

Chart 5: Widening UST-JGB Yield Differentials Amid A Backdrop Of BOJ Easing Are Supportive Of Higher USDJPY



Source: Bloomberg, Maybank FX Research

We do not expect the BOJ to embark on additional easing measures for now but such moves cannot be ruled out completely. We expect the BOJ to stay on course for now, maintaining its Quantitative and Qualitative Easing (QQE) with Yield Curve Control. But should inflation fail to gain traction going into 2018, we cannot discount the BOJ unleashing even more easing measures to lift inflation towards the BOJ's 2% target. The easing measures could include cutting interest rate further to -0.3% (from -0.1% currently) and increasing asset purchases of ETFs and J-REITs and other instruments to JPY10tn and JPY6tn. Further measures should provide a boost to the USDJPY.

Upgrade To USDJPY Forecast

We remain bearish on the JPY. Our expectations of dissipating safe-haven plays ahead should be supportive of further inflows into Japanese equities and provide more upside to the USDJPY. This together with the continuation of the ultra-loose monetary policy by the BOJ and expectations of further widening of the yield differentials between the UST and JGB should see the USDJPY climb higher from current levels. We now expect the USDJPY to climb higher to 116 by end 2Q before ending the year at 120 (Chart 6).

Chart 6: Maybank USDJPY Forecast

Forecast	2Q 2017	3Q 2017	4Q 2017	1Q 2018	End-2018
USDJPY	116 (108)	118 (110)	120 (113)	120 (113)	120 (118)

Previous forecasts in parenthesis

Strategic Trade Idea

Chart 7: Daily Chart - Near-Term Bearishness; Buy On Dips

Source: Bloomberg, Maybank FX Research

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Saktiandi Supaat	Christopher Wong	Fiona Lim	Leslie Tang
Head, FX Research	Senior FX Analyst	Senior FX Analyst	Senior FX Analyst
saktiandi@maybank.com.sg	wongkl@maybank.com.sg	Fionalim@maybank.com.sg	leslietang@maybank.com.sg
(+65) 63201379	(+65) 63201347	(+65) 63201374	(+65) 63201378