Sucden Financial

FX Monthly Report - JPY

October 2023

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FX Monthly Report

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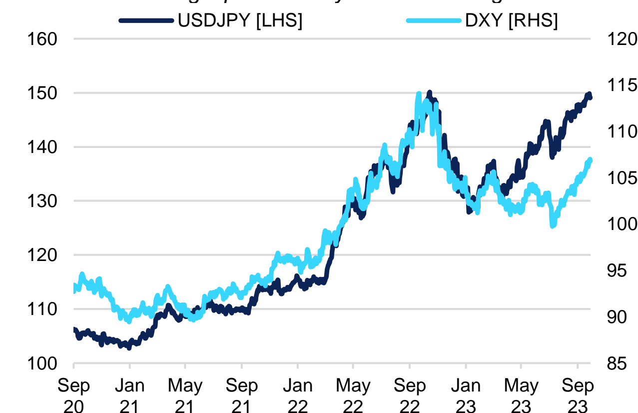
Japan Focus

The Japanese yen is near the three-decade low against the dollar, reigniting speculation over another round of interventions from the government. Last year, for the first time since 1998, authorities stepped in as the local currency was approaching the 150 level. With the yen now fluctuating just below this level, will there be another move from the BOJ to intervene and push the currency higher?

USDJPY vs. the Dollar

Recent dollar strength pushed the yen to test the high of 150.

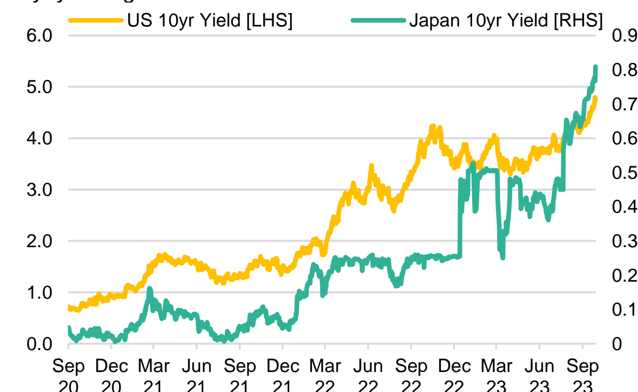


Source: Bloomberg

The yen has been under pressure due to a widening yield gap with the US, where the 10-year yield touched the 2007 high of 4.70% on bets that interest rates will remain higher for longer. The BOJ, on the other hand, is the last major central bank to keep key interest rates negative and has not joined the global trend towards monetary policy tightening. The central bank insists that stimulus must continue and is pushing back against speculation of a near-term interest rate hike. Still, the market is on edge in regard to the timing of the ultra-loose policy end. Growing speculation that the BOJ will tweak its policy framework again after making the yield-curve control more flexible in July has spurred Japanese yield growth, with the benchmark 10-year now at the 2013 high of 0.76%.

US vs. Japan 10yr Yield

Growing expectations of monetary policy tightening pushed Japan's 10yr yield higher.

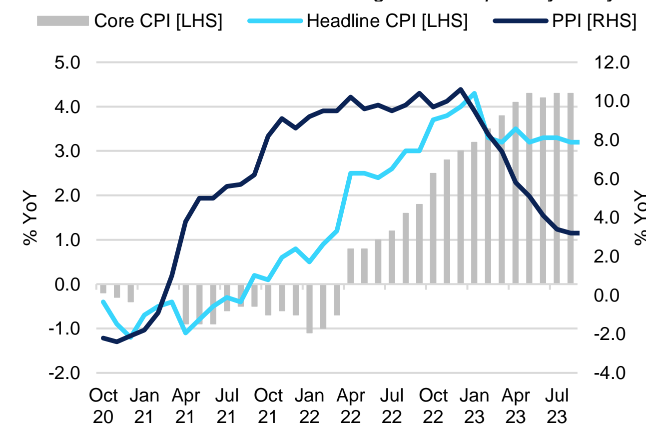


Source: Bloomberg

Inflation in the economy has been key in driving the narrative for monetary policy tightening, as it has been stickier and stronger than the BOJ had expected. Core reading grew by 3.3% YoY in September, higher MoM, with gains in processed food costs continuing to be the biggest factor behind inflation. The pickup of price activity has raised questions about the BOJ's view that inflation will peak later this year and will fall below the 2.0% target in the following years. We believe that inflation growth will remain sticky due to volatile components such as food and oil prices trickling through to core performance. Indeed, a rebound in oil prices and a drop in the yen are throwing a wrench into the headline inflation dynamics because both developments make imports more expensive and hit consumers. More than 6,600 food items are expected to see price hikes in September and October. On the other hand, Japan, as one of the major exporters, sets to benefit from lower currency valuation, as it brightens the earnings outlook for exporters. Confidence among large manufacturers picked up once again in Q3 2023, to 9.0 from 5.0, as a weaker yen boosted spending power for inbound consumers.

Headline vs. Core CPI and PPI

Both headline and core inflation readings remain upwardly sticky.

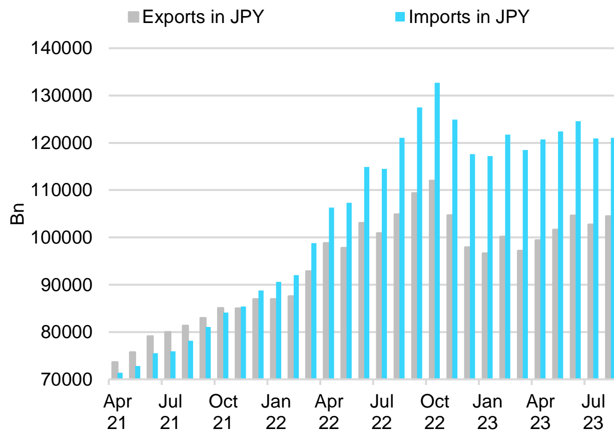


Source: Ministry of Internal Affairs and Communications

The BOJ has been trying to spark sustainable inflation for more than a decade. Governor Ueda insists he must see more evidence of sustainable price growth accompanied by rising wages before he pares back stimulus. We do not expect the latest sentiment readings to shake the BOJ's resolve to hold policy settings steady for now, even if authorities upwardly revise official inflation forecasts. The survey continued to reflect expectations for steady inflation, with the three-year price growth projection for all industries steady at 2.2%. To ease the pain of inflation, the government has extended gasoline subsidies to the year-end and is putting together a fresh round of economic measures to support the economy. Recent indicators suggest Japan's economic growth is slowing down from the second quarter as companies and consumers cut back on spending. However, with the domestic economy underperforming in the face of global monetary policy tightening, policymakers became increasingly more aware of the pains that come from a weak currency.

Japan Exports vs Imports valued in JPY

The value of exports in JPY is rising thanks to lower currency valuation.



Source: Bloomberg

The markets are speculating about the need for Japan to implement another intervention to contain the effects of currency depreciation, as the level is now at the same level as in Q3 2022, the last time the intervention was implemented. Policymakers have indicated their readiness to intervene, but little guidance was given as to the timing and scale of the move. We believe the intervention is more likely if the 150 level is abruptly breached, but until then, Japan will likely try to ride out the currency weakness as it waits for a change in monetary policy perspective. The Fed's forward guidance will be key in driving the narrative for yen strength, and as we approach the period of cuts next year, this puts less pressure on the yen as it battles the dollar's strength. The market is struggling above the 150 level, suggesting investors remain cautious above this level. Only overly hawkish data from the US, or vice versa for Japan, has the potential to push the currency above this level. We expect the narrative for further tightening in the US to shift around the December period. Until then, a verbal warning from BOJ's policymakers should cap the upside but keep the markets elevated, near the 150 and 152 levels, respectively.

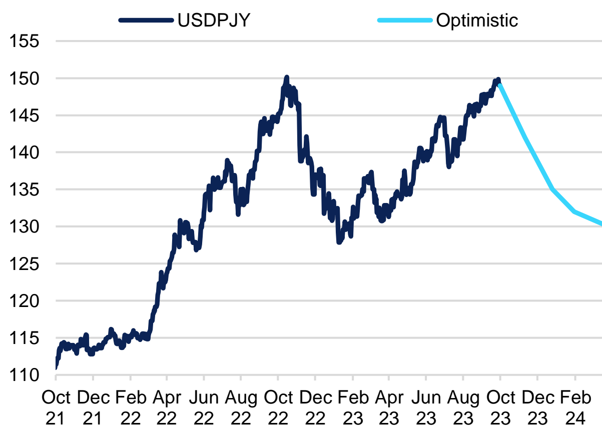
While the intervention is a clear way to tell speculators that policymakers will not allow the currency to go into free fall, it is only going to be a temporary fix unless economic fundamentals driving the trend are also addressed. As Treasuries see their worst selloff in a year, one catalyst to stop the rout will be the BOJ coming strongly to defend its yield curve control, which is most likely to be addressed this month. According to a Bloomberg survey conducted in September, half of the economists forecast the end of the BOJ's negative interest rate in H1 2024. What will be crucial is the preparation to lay the groundwork for an exit from the current monetary policy. These will include improvements in market functioning and communication with market participants. Governor Kazuo Ueda stated that the size of the BOJ's balance sheet would not impede policy changes such as an exit. While the governor said there was still some distance to the target, the speech fits in with a picture of the BOJ starting to tentatively pave the way toward a departure from its massive stimulus programme.

Our view for the yen is that of marginal weakness, testing the 150 level, as we believe the recent gains in the dollar have been overbought, and we might see some retracement in the near term. Over the longer term, we hold a constructive view of the yen in 2024.

Scenarios and Respective Impact on the Yen

Our view for the yen is that of marginal weakness, testing the 150 level, as we believe the recent gains in the dollar have been overbought, and we might see some retracement in the near term. Over the longer term, we hold a constructive view of the yen in 2024.

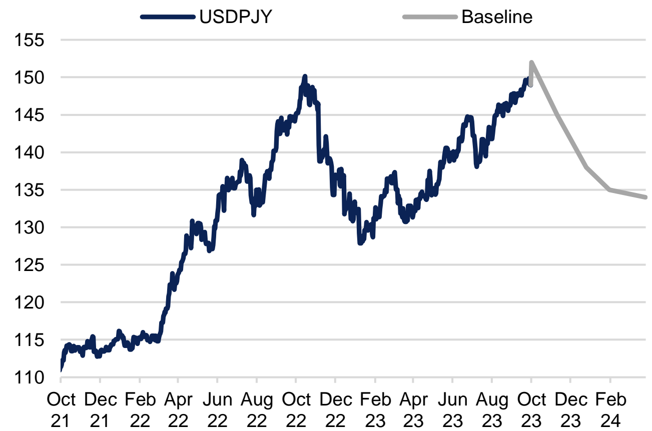
Optimistic Scenario



Source: Bloomberg, Sucden Financial

- A sharp currency intervention from the BOJ, followed by a subsequent hike of key interest rates
- A dovish tilt from the Fed earlier than expected, urging the dollar to decline
- Stronger than expected Japanese economy

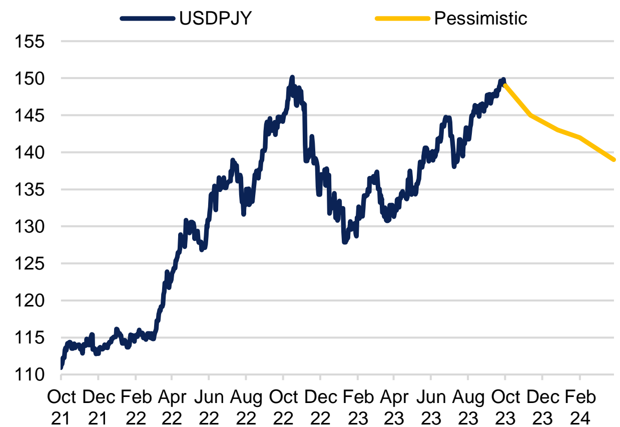
Baseline Scenario



Source: Bloomberg, Sucden Financial

- BOJ intervention above the 150-152 level
- Higher-for-longer rates in the US; however, the case for cuts is started to be priced in Q1 2024
- Yield curve control from the BOJ but little monetary policy tightening until Q2 2024

Pessimistic Scenario



Source: Bloomberg, Sucden Financial

- Market remaining cautious above the 150 level, meaning that the yen is riding out the weakness naturally, without central bank intervention
- Higher-for-longer interest rates from the Fed with uncertainty about an additional hike in November/December
- No yield curve control or a hike from the BOJ

Desk Comments

GBP

Momentum from last month has continued into October. GBP has weakened further with technical support level at 1.2310 doing little to halt the slide. Inflation has eased throughout the month and there are signs of stabilisation in wage growth prompting the BOE to keep rates on hold. Market is now pricing the BOE to remain on hold throughout 2024. Governor Bailey also recently corroborated the BOE are getting close to the top of the hiking cycle. This makes it hard to be long GBPUSD with the USD trending higher and still room for the FED to hike as the data remains robust.

While major Central banks remain on hold, macro data needs to post extremely wide deviation from estimates to sway market expectations that central banks are not simply in hold mode. With this in mind, we expect vols to remain low and GBP to trade within 1.1825 – 1.2315 range with a downside bias.

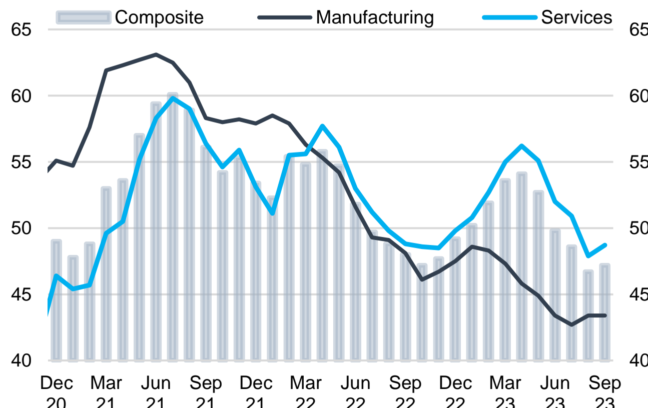
We see a more attractive play to go long GBP on the crosses due to a carry perspective and the upward revision by the Office of National Statistics. The UK GDP is 1.8% above pre covid levels meaning it no longer lags every other major industrial nation in its recovery from the pandemic.

EUR

ECB delivered 25bp hike in September, but it was combined with a dovish message with very limited rhetoric for further hikes in the statement. We see the ECB's approach now focusing much more on the time horizon for rates being at 4.5%. The new projections kept the forecast for headline and core inflation in 2025 above 2%, so the ECB is likely to keep rates at elevated levels for longer. We now see the next move being gradual cuts starting in mid-2024.

Eurozone PMIs Performance

Service performance is seen softening in recent month, catching up with the manufacturing.



Source: Markit

The EUR remains on the backfoot against the USD. Steadily declining since mid-July. Any retracements are short lived and seen with an opportunity to add to shorts. The dilemma is whether to add to a break of 1.0520 (technical level), it has been broken several times but has yet to close on a weekly timeframe. Data suggests it will break lower. US yields are rising in the back end and there are important domestic factors too. Growth remains sluggish, fears are rising about Italy's bloated government debt. Moreover, geopolitical risks have increased over the wknd with the surprise attack by Hamas on Israel leading to more USD buying. Energy prices are also rising reviving concerns of inflation and could be the catalyst for more EUR selling.

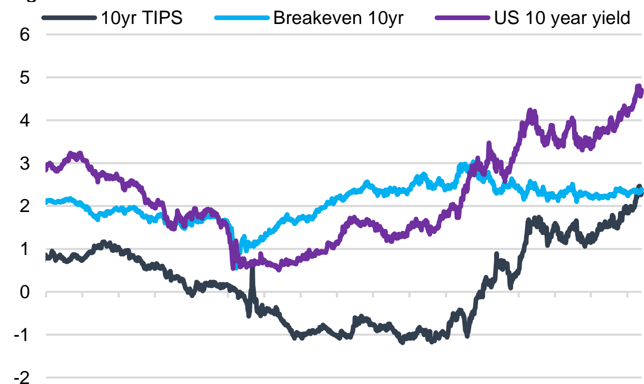
USD

USD index continued to strengthen throughout September as market participants price in Interest rates remaining higher for longer in the US. We have seen bear steepening in the US curve following Fed Powell speech which has fuelled the Dollar; now higher in 10 of the past 11 weeks. US Data continues to remain strong especially compared to other regions, further laminated by US Nonfarm payrolls this month which showed labour market are not loosening. Furthermore, uncertainty from the escalation in the war between Israel and Hamas has added to investors flocking to the safety of the dollar.

Option markets are also pointing to more bullish sentiment in the dollar with one month 25D risk reversals differential vs the euro at its highest in 6 months in favour of calls on the dollar.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Breakeven yield continues to drift lower as US real yield pushes higher.



Source: Federal Reserve

The tight monetary policy environment coupled with, geopolitics tensions, US exceptionalism vs other regions, slowing Chinese economy, rising oil prices, and growing expectations of global economic slowdown, is all going to continue supporting the Dollar. Whilst we expect dollar strength against most of the G7 countries we believe it will be EM currencies which will likely bear the brunt of this dollar strength in the coming months.

History has taught us when everything is aligning as they are in favour of the USD, market participants may look to test USD bulls resolve; so, we could see some sharp pull backs on the way higher. Threat to this long-term bullish USD narrative would be if we see sudden change in data, which we experienced last November following a bearish CPI figure or a change in Fed narrative.

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