

FX Monthly Report

June 2022



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BOJ Focus	3
Currency View	4
Desk Comments	5
Euro	5
USD	5
GBP	6
Technical Analysis	7
Disclaimer	8

Published by:
Sucden Financial Limited
June 2022

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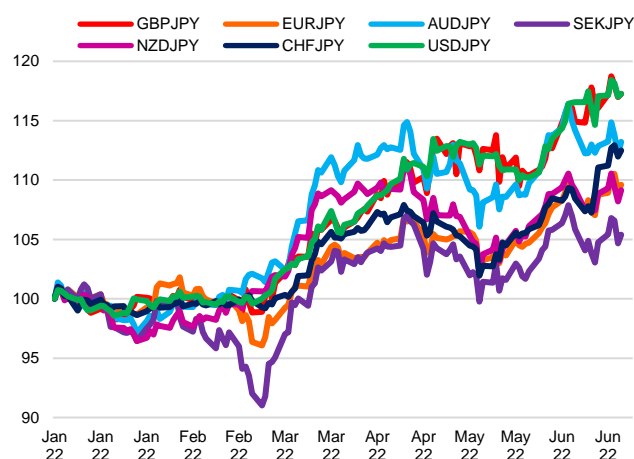
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BOJ Focus

The JPY has been decimated in 2022, as they continue to control the yield curve and have not raised rates. Against the U.S. the JPY has depreciated 15.36%, 8.54% against the EUR, and 6.45% vs GBP. The BOJ has remained impressively stubborn and has not pivoted away from its yield control policy and bond purchases. CBs have taken centre stage due to inflation rising above expectations and confirming that they are not 'transitory'. Exogenous events outside of C.B.s control have certainly not helped, and supply chains will likely remain congested until Q1 2023 at the earliest.

JPY vs Major Currencies Indexed January 2022

JPY has been heavily sold so far this year.



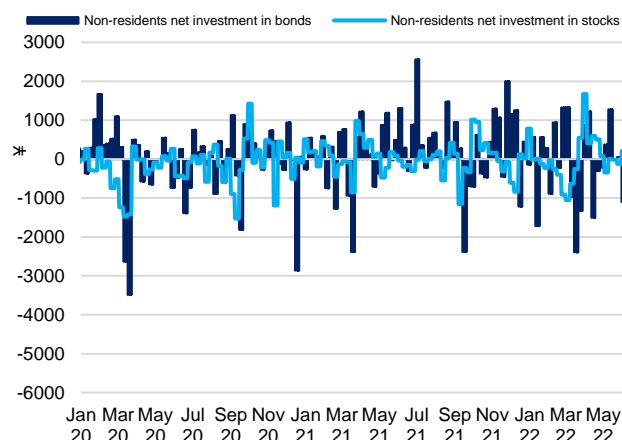
Source: Sucden Financial

According to Deutsche Bank, if the BOJ continue at their current pace, they will print 10trn Yen in June; this figure is unsustainable. The BOJ recent stated they would purchase an unlimited amount 10yr notes. This caused the spread between futures and bonds to widen significantly. Traders are now betting on the BOJ abandoning their 0.25% cap on yields; this would cause a sharp correction in the JPY and JGB yields to surge higher. Arbitrage trades of short bonds and long futures have come under significant pressure as futures have weakened; this is expected to remain the case as the BOJs resolve is tested and investors bet on a change in yield cap.

The divergence in rates across the global economy and Japan's comparatively low-interest rate and dovish outlook has compounded the issues. The 10yr yield for JGBs stands at 0.255% as of June 22nd, which will mean greater spending from the central bank. Futures have recovered but remain under significant stress, as shown by the net investment from the BOJ, which reached ¥4,804.bn on June 17th, bringing this month's total to ¥5,848.8bn; this is expected to break ¥10,000bn. Their commitment remains; however, recent comments from the former head of FX policy at the finance ministry have caused the yen to strengthen; Takehiko Nakao indicated that "unilateral intervention shouldn't be eliminated as a possibility". The risk-reward is undoubtedly against the USD, but the stubbornness of the BOJ cannot ignore, comparatively neither can the cost of capping the yield curve.

Non-Resident Net Investments in Bonds and Stocks

Net investments from the BOJ are at an unsustainable level.

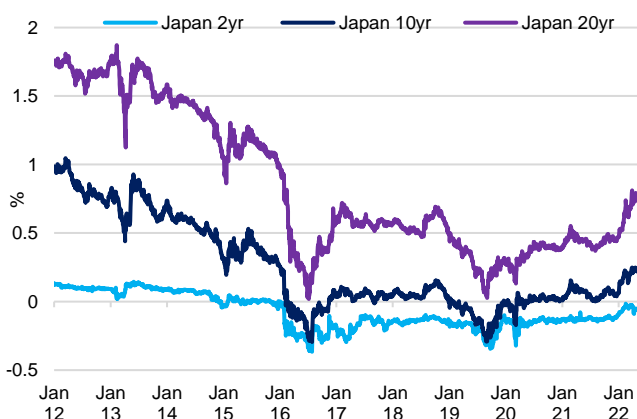


Source: Ministry of Finance Japan, Sucden Financial

A moderate shift in policy would trigger a considerable correction in JPY; even though we would not anticipate a change in interest rates, the higher yield would prompt JGB futures to sell off sharply and the JPY to strengthen across currencies. According to the CFTC CME JPY positioning, the non-commercial short stands at 102,887 as of June 14th, and we expect this to fall as more funds become less bearish on the JPY. The max short position in 2017 was 185,000 contracts; we do not expect the market to reach this level. We continue to watch a shift in gross long positioning, which increased by 13,876 to 33,971, leaving the net position for non-commercials at -68,916. The JPY is likely to remain a target for the carry trade due to low-interest rates and cheap capital, and this will cap gains but if there is a change in language from the BOJ, there will be a swift snapback and reversion in the USDJPY, GBPJPY, and EURJPY.

Japan Yield Curve

The spread between 2yr and 20yr has widened significantly. The year yield continues to test the BOJ cap.



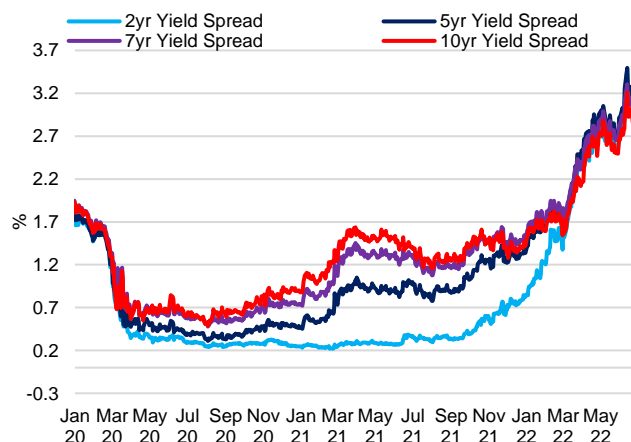
Source: Ministry of Finance Japan, Sucden Financial

Economic data indicate that the Japanese economy is on thin ice. Manufacturing PMI has declined in June to 52.7, this remains expansionary, but the trend firmly favours the downside. Inflation is low compared to the rest of the global economy, standing at 2.5% in May, despite JPY weakness and higher commodity costs. This also allows the BOJ to remain dovish on their policy and control the yield curve. Consumer confidence has improved in recent months,

reaching 34.1, up from 32.80 in March; this is represented in retail sales data, which is still growing, 1% M/M in April and 3.1% Y/Y. Industrial production has declined in recent months, down 4.9% Y/Y and 1.5% Y/Y. GDP remains contractionary on a Y/Y and M/M basis at -0.5% and -0.1%. The leading indicator for the economy has been increasing and reached 102.9.

Spread between U.S. and Japanese Bonds

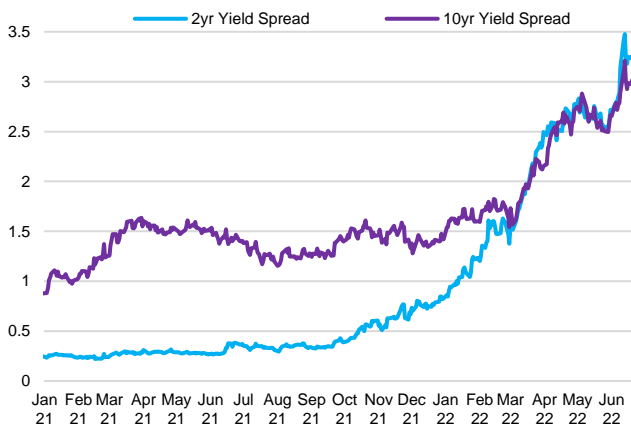
The spread between U.S. and Japanese bond yields continues to widen as U.S. rates rise sharply.



Source: Ministry of Finance Japan, Sucden Financial

Spread between U.S. 2yr and 10yr and Japanese 2yr and 10yr Bonds

The spread between U.S. and Japanese bond yields continues to widen as U.S. rates rise sharply. A change in BOJ rhetoric will cause a sharp correction in the spread.

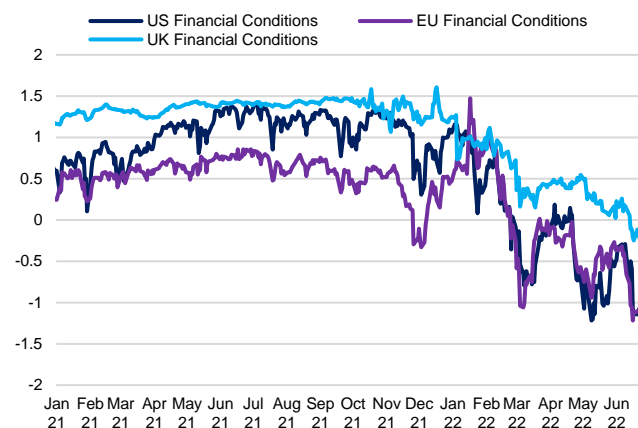


Source: Ministry of Finance Japan, Sucden Financial

Currency View

U.S., and Europe Monetary Policy Conditions

Financial Conditions have declined sharply in the last few months as rates rise and monetary easing is stopped.

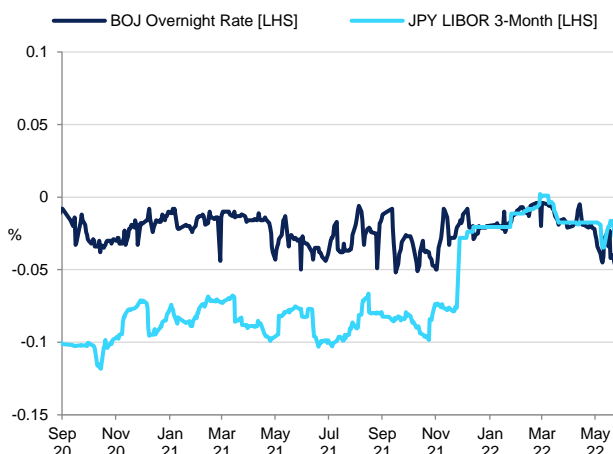


Source: Bloomberg

While the pressure is mounting on the BOJ to intervene as the JGB 10yr yields reach the cap, the JPY continues to weaken. The current pace of bond purchases and weakness in the JPY will mean that the BOJ will likely intervene if the JPY weakens to 145. The correlation between USDJPY and the 10yr UST/JGB yield spread was strong between March and May $R^2=0.9674$, according to CitiVelocity. The weakness in USDJPY in the immediate time has coincided with a sentiment that the BOJ will intervene, U.S. yields have weakened in recent sessions, and this could have accentuated the relationship as the spread narrows, causing the JPY to firm. If this relationship breaks down and the U.S. 10yr yield breaks back towards 3.35%, and USDJPY does not strengthen, this could outline a change in the relationship. We previously noted that economic data in the U.S. could prompt the 10yr yield to top out sooner and not break towards 3.75% even though Fed futures indicate a 4% yield by December 2022. We remain constructive on USDJPY and still favour owning USDJPY in the near term, but a change in tactic from the BOJ is increasingly likely as JGBs and JPY edge towards extreme levels. Governor Kuroda gave a pessimistic outlook on the Japanese economy, and as a result, a change in monetary policy would be detrimental at this point, especially given the high PPI, which could be harmful to trade and income.

BOJ overnight rate vs JPY LIBOR 3-month

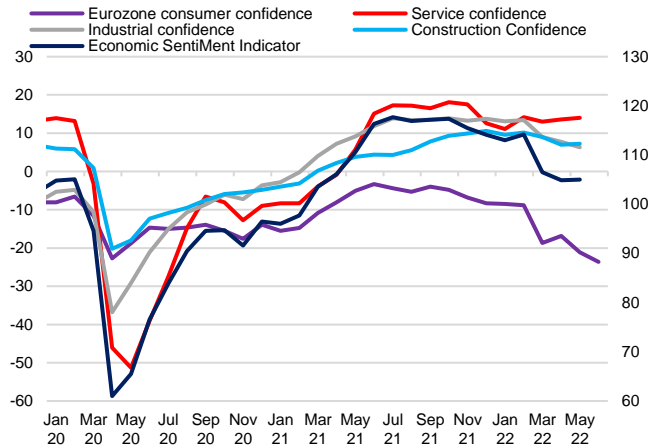
JPY LIBOR has increased in recent months, but the BOJ overnight has remained constant, suggesting JPY is certainly still a funding currency.



Source: Ministry of Finance Japan, Sucden Financial

European Sentiment

European sentiment has nosedived in the last few months, we expect this to continue.



Source: Bloomberg

Desk Comments

Euro

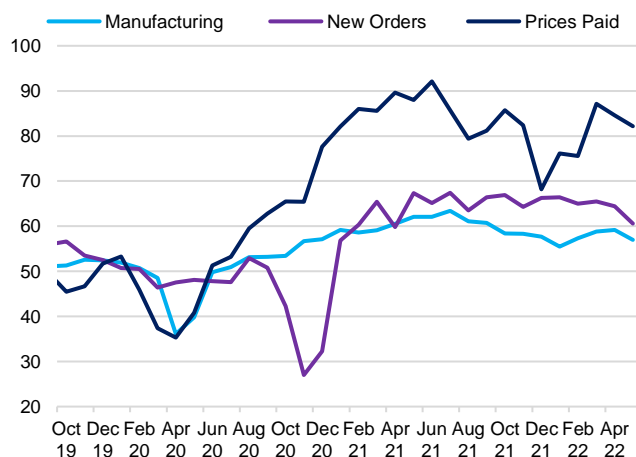
The heightened pressure of near-term inflation means it's reasonable to expect the ECB to act earlier than previously stated. Inflation reached new record highs of 7.5% in April, significantly higher than expectations. Risks are skewed to the upside with further disruptions to the supply of gas and oil from Russia and slowing demand as China goes into lockdown. Several governing council members have become more vocal, sending a message of urgency to the market. The neutral members of the council are favouring the hawks. However, with no evidence of wage growth, the ECB will need to act cautiously. As a result, we are now expecting rates to be lifted as early as July, followed by several 25bp hikes at a much slower pace than the US but we do expect rates to be positive by the end of the year.

USD

The Fed Continued raising rates this month, increasing their base rates by 75 basis points. Chair Powell delivered an ambiguous message which was not as hawkish as many expected going into the rate decision. Powell indicates the Fed is likely to be deciding between 50 and 75 basis points in July and step down in rate hikes will be dependent on evidence of Inflation moderating. Our expectations are very much in line with market consensus; We are expecting 75 basis point Hike in July, 50 basis point in September, 50 basis point in November and 25 basis points in December bringing rates to 3.75% by end of year. It's difficult to envisage rates greater than this by year end and in our opinion, risks are to the downside for USD. By end of Q3 we should see some evidence of inflation moderating and end of Q4/Q1 we are likely to see drastic slowdown in growth and inflation numbers as rate hikes bite leading to rate cuts in the later part of 2023. Hence, we expect Dollar index to peak in next month or 2 before we see a significant correction down to 95-97 area.

Manufacturing vs New Orders vs Prices Paid

Prices paid remain high but new order are falling along with the manufacturing PMI.



Source: Markit, Institute for Supply Management

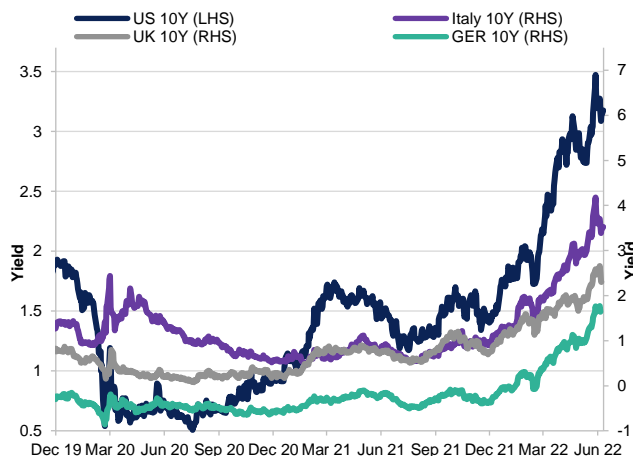
GBP

Inflation in the UK is at 9%. Slightly higher than in the US and EU. BOE hiked 25 bp at the last meeting as expected. Members voted 6-3 slightly more hawkish. In addition, inflation is forecast to rise to 11% by the end of October when the cap on energy bills expires so we now expect 50bp at the next meeting in August. Implied rate to be at 3% by year end. The BOE has reiterated they will act more aggressively if needed but current hikes will take 12-18 months to have an impact.

GBP weakened with the uncertainty surrounding the political situation in the UK. Johnson won a confidence vote but with 148 MPs of his own party voting against him, its enough to wonder how much authority he can continue to command. Theresa May won a confidence vote by a larger margin than Johnson but was still out within the year. Johnson could go a long way to appeasing voters in how he deals with the cost-of-living crisis.

US, UK, Italian, Germany, 10yr yields.

Yields have rallied significantly as rates have increased, but slower growth could cap gains in H2 2022.



Source: Bloomberg

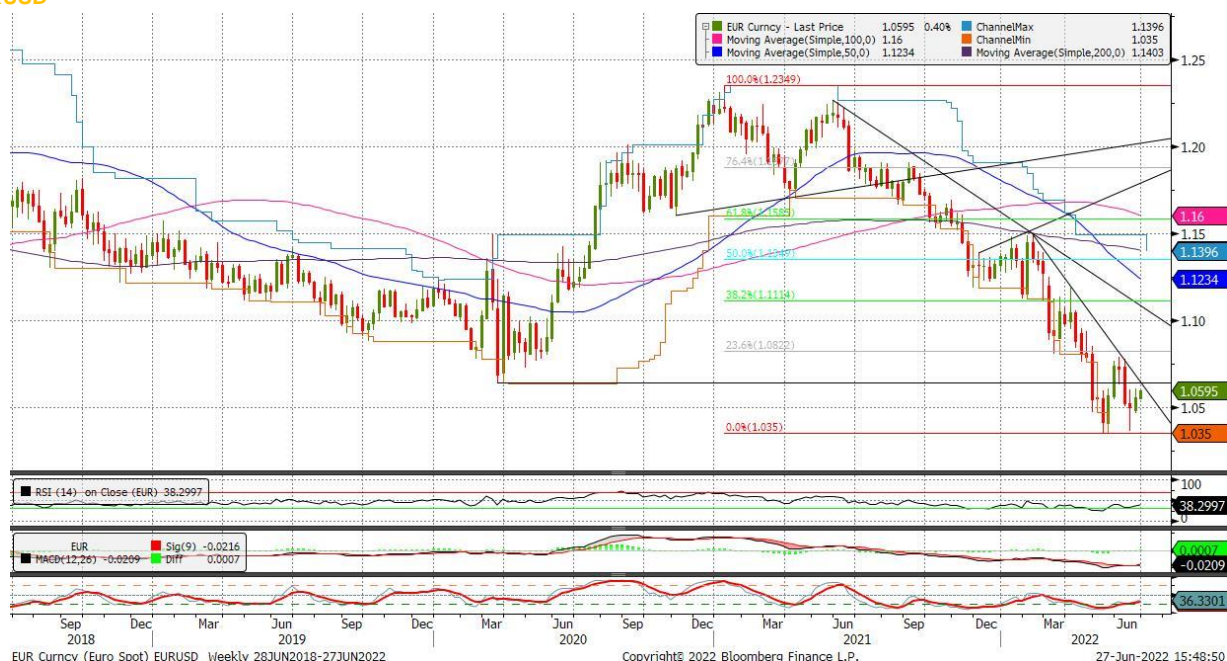
Technical Analysis

GBPUSD



GBPUSD is consolidating after failing to close below 76.4% FIB 1.2081/1.2076 line and psychological 1.20 Level. Last month we did not believe market would close below these levels as we believed the move to be overextended after reaching z score of over 3. However, now we are at an inflexion point, so while GBPUSD remains below green trend line, another test 1.20 psychological and 1.1934 low is likely. On the Downside, a close below 1.20 could lead to further downward move to 1.15 and the low from March 2020 @ 1.1412. On the Upside, a break above the trend line would see a period of consolidation between 1.2682 and 1.20.

EURUSD



EURUSD has been consolidating after testing lows from Jan 2017, but downside biases remains while green down trend remains intact. A sustained close below 1.0341 open doors to further losses down to 1.02 (low from 2002) and psychological parity level. On the Upside, a break above 1.0787 could see EURUSD test down trendline(green) with a close above the trendline indicating a large pull back to 1.1349 (50% Fib) and resistance @ 1.15.

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