PICTET 1805

Flash Note

Currencies: Japanese Yen

US dollar likely to peak against the yen in the first half of 2018

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From 6 November to 28 November, the Japanese yen gained 2% against the US dollar, outperforming all G10 currencies but the euro.

In our view, the key driver of the USD/JPY rate is the 10-year real rate differential, especially since the introduction of the yield-curve-control framework by the Bank of Japan on 21 September 2016.

In 2018, our forecast for the US 10-year yield to rise could result in a decline in the yen towards JPY119 per USD, over the next six months.

The extreme fundamental undervaluation of the yen remains a big hurdle for further significant yen depreciation. And our scenario for 2018 of a deceleration in economic activity in the US and of a slightly less accommodative Bank of Japan should weigh on the USD/JPY rate. Our 12-month forecast is for a yen at JPY115 per USD.

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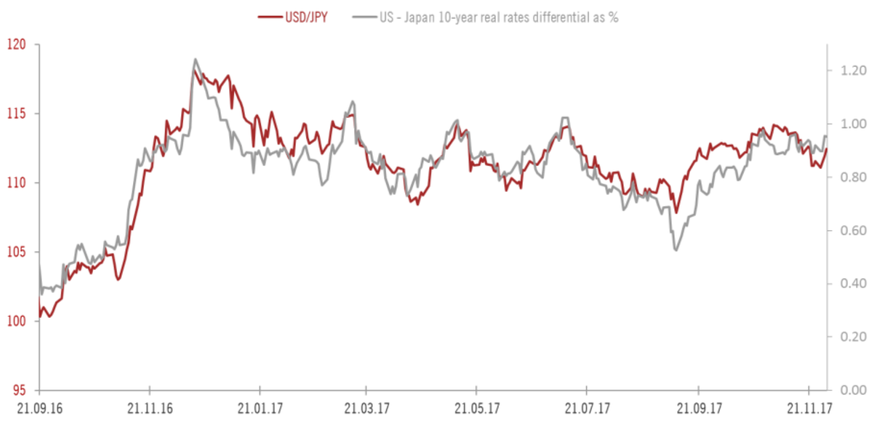
From 6 November to 28 November, the Japanese yen gained 2% against the US dollar and outperformed all G10 currencies but the euro. As the yen is widely used as a funding currency (given its low yield and high liquidity), the rise in stock market volatility in the second week of November may have helped its appreciation. However, renewed risk appetite since 15 November has not stopped the strengthening of the yen suggesting that other drivers were at play.

Long-term interest rate differential remains key

In our view, the USD/JPY rate has been significantly influenced by the long-term real interest-rate differential in recent years. The introduction by the Bank of Japan (BoJ) of its 'yield-curve-control' (YCC) framework on 21 September 2016 has even strengthened the relationship (*see chart 1*). By setting a target for the 10-year Japanese government bond (JGBs) yield at around 0%, changes in the US 10-year Treasury yield have a significant impact on the attractiveness of the yen relative to the greenback. The slight decline in the rate differential from 13 November to 28 November may explain the lacklustre performance of the yen against the US dollar despite the improvement in risk appetite.

Chart 1: USD/JPY rate and US-Japan 10-year real rates differential

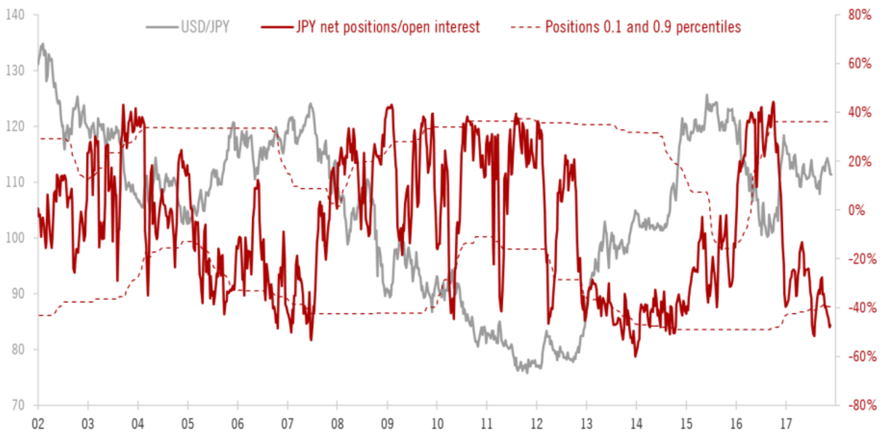


Source: Pictet WM – AA&MR, Bloomberg, November 2017

Limits to yen weakness

Another factor that could explain the strength of the yen against the dollar after mid-November is the extreme net short speculative positioning on the yen (*see chart 2*). Such positioning makes the yen vulnerable to bouts of appreciation if short-term bets on a weaker yen have to be unwound.

Chart 2: CFTC net JPY non-commercial FX positions (based on futures only)



Source: Pictet WM – AA&MR, Bloomberg, November 2017

Speculative positioning mostly matters only for short-term currency moves. A more long-term hurdle to prolonged yen weakness is the extreme fundamental undervaluation of the yen. CPI-based purchasing power parity suggests that the yen is more than 20% undervalued relative to the US dollar. Consequently, the scope for significant yen weakness seems limited, especially given our scenario of a slight slowdown in economic activity in the US next year.

Dollar likely to peak against the yen in the first half of 2018

Going forward, we continue to think that the long-term real rate differential will shape the evolution of the USD/JPY rate.

In Japan, although the new monetary policy framework announced on 21 September 2016 also included a commitment to overshooting its 2% inflation target, the BoJ is likely to gradually normalise its very accommodative monetary policy before the 2% target is reached. In our view, the BoJ could revise upward its target for the 10-year JGB yield when consumer price inflation (ex fresh food) reaches 1% (September CPI was 0.70% year on year). As our inflation projections suggest that this threshold could be reached around the middle of 2018, the BoJ is unlikely to change the parameters of its YCC before then. Consequently, in the first half of 2018, the Japanese 10-year real interest rate is likely to decline slightly given a stable nominal rate and the slow rise in inflation.

With the Japanese nominal 10-year yield unlikely to change in the next few months, its US equivalent is more likely to determine the fate of the USD/JPY rate. In our opinion, strong economic activity in the US should favour a rise in the US 10-year rate towards 2.6% in 2018 (compared to 2.38% at present), setting the scene for potential US dollar outperformance relative to the

Japanese yen. That being said, our central scenario of a deceleration in the US economy in the second half of 2018 should limit the rise of the US 10-year yield.

Putting all these factors together, we see scope for the yen to weaken towards JPY119 per US dollar in the next six months (from JPY112 at November 29), when it will suffer from upward pressure on long-term US yields and the BoJ's unchanged monetary policy. Further out, the likely deceleration in US activity and a less accommodative BoJ should improve the relative attractiveness of the undervalued yen. Our 12-month projection is for a rate of JPY115 per USD.