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Investment Strategy Bulletin

Why is the yen roaring ahead, and is its rise sustainable?

Investment Solutions

January 2019

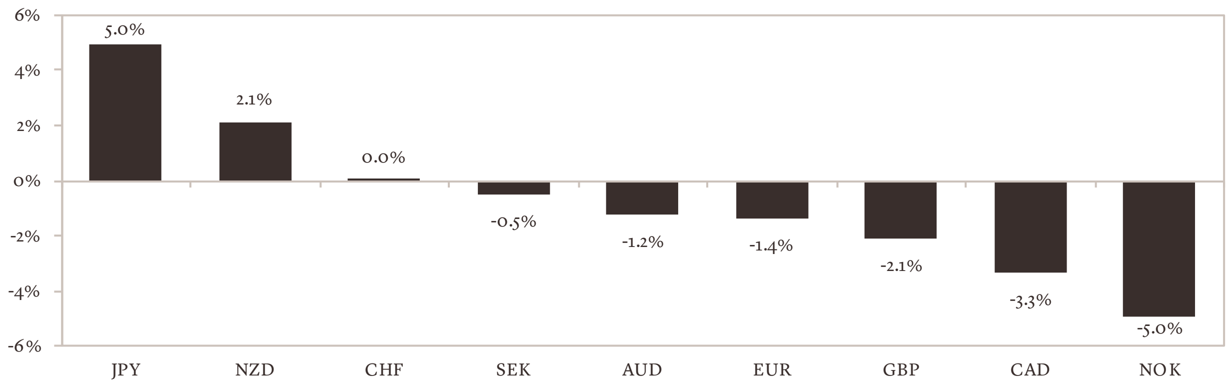
- USDJPY has fallen by 5% over the last three months, with most of the move concentrated in December
- This dramatic drop was primarily driven by the sharp rise in risk aversion in late 2018 that forced investors into safe haven assets
- The decline in USDJPY is in line with our expectations, although it seems to be have happened too fast
- Similar moves in the past were followed by short-term periods of stabilization and even modest rebounds
- Near term, the currency pair is likely to consolidate…
- …but medium term, we hold on to our bearish view: the yen is still undervalued against the USD (although less than it was back in 3Q18) at a time when the US cycle is very mature, the odds of a rate hike pause by the Federal Reserve have increased, and risk appetite is likely to remain volatile throughout 2019

During the last quarter of 2018, we fleshed out our bearish outlook for the dollar and advocated that one of the most straightforward ways to express this view was via short USDJPY. Our reasoning was based on the following arguments:

1. USDJPY was substantially overvalued, to the tune of nearly 15% at the time
2. Increasing signs of rising volatility in risk sentiment (due to the maturity of the US cycle and enduring incoherent and potentially damaging policies by the US administration), which would trigger demand for safe-haven assets
3. Stretched short yen positioning by the speculative community
4. Expectations of hawkish twists in BoJ communication (later in 2019) that would lead the market to position for more material policy changes in 2020
5. Spill-over effects from a broad-based dollar decline as the market refocuses on the US twin deficit given fading fiscal impulses and the compression of US-Rest of World (RoW) rate differentials from exceptionally wide levels

I. Spot performance since beginning of 4Q18

All currencies vs. the USD



Sources: Bloomberg, Lombard Odier

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Data as of 8 January 2019 unless otherwise stated.

Since the beginning of October 2018, USDJPY has fallen by 5% and the trade-weighted (TW) JPY has appreciated by more than 6%. Though the direction matches our view, the move has been too rapid as it was mostly concentrated in December, which merits an analysis of its causes and a discussion of future implications.

Causes

Some of the reasons we cited above played a role – to varying degrees - but the advent of others surprised us somewhat.

Valuation might have been partly responsible for the yen outperforming all G10 FX peers against the USD (see chart I. page 1), but is difficult to pin down its precise impact, especially for such a short period. Regardless, USDJPY is now less misaligned with long-term fundamentals (around 12%), suggesting that yen undervaluation will continue to play a role (pushing JPY higher), albeit with a decreasing impact.

The primary reason has most likely been the rising volatility in risk appetite. Uncertainty surrounding the US-China trade dispute, increasing evidence of a global growth slowdown, alongside signs of renewed political turbulence and dysfunctionality in Washington, all compounded to boost investor angst and send global equity markets into a tailspin. The VIX (the equity volatility gauge implied by the S&P500 options market) rose from 16% to 36% between early and late December, while the MSCI equity index fell by more than 10% over the same period, in its worst monthly performance since May 2010 (see chart II). As market participants grappled with such enormous gyrations, demand for safe haven assets rose hastily and the yen surged.

An additional – and related – factor (and one that, admittedly, took us by surprise) was the very steep decline in US yields. Following the peak of 3.23% in early November, US10Y yields retraced rapidly and significantly lower, to below 2.65%, effectively reversing about 70% of their increase over the past twelve months. The move in US rates came as fears of a global meltdown drove investors to price out tighter monetary policy by the Fed for 2019. Correlations of USDJPY with US10Y yields (and the US10Y-JN10Y rate differential) remained tight throughout the period, with rate movements explaining a significant portion of the USDJPY variation (see chart III).

Finally, positioning was also an issue, although to a lesser extent. After months of piling onto dollar longs and yen shorts, the speculative community started cutting back on JPY-bearish bets (based on CFTC data – see chart IV), compounding to the JPY appreciation. But these cuts have been very marginal so far and JPY shorts remain extended by historical standards.

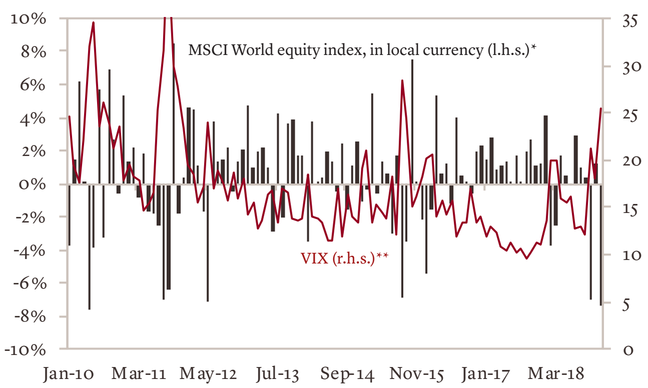
What lies ahead?

Near term, we believe some consolidation in USDJPY is likely (we would not rule out even a modest temporary rebound towards 110). This is because the move was too abrupt in our view, sending USDJPY into oversold territory from a short-term perspective. A number of technical indicators suggests that the currency pair's decline has been too extreme, and historical evidence shows that similar moves have been followed by near-term reversals.

Furthermore, it is likely that risk appetite will receive a reprieve. The reserve rate requirement (RRR) cut by the People's Bank of China recently (by a full percentage point for all domestic banks) is very likely to be seen as bullish for risk assets because it signals that authorities are undertaking action to halt the economic slowdown, in this case through more liquidity. The trip of US officials to Beijing in order to kick-start negotiations on the trade discussions could alleviate some of the trade war concerns. Finally, recent remarks by Fed governor Jerome Powell appear to be having a soothing effect on the market. Mr Powell said that due to the forward-looking nature of the markets, investors have been pricing downside risks to growth lately. He notably highlighted that the Fed is listening carefully and sensitively to markets, and would take into account these downside risks in its assessment of

II. Worst monthly performance for equities since May 2010

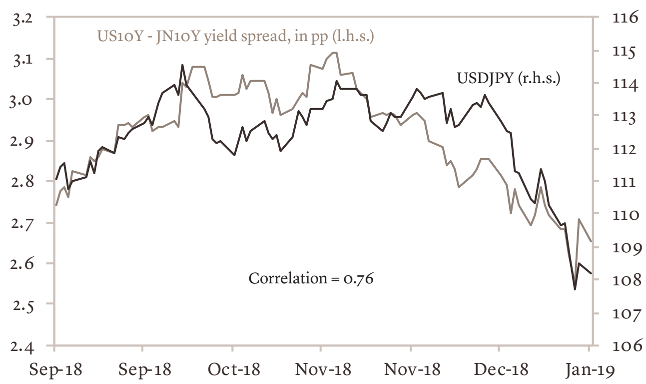
VIX is implied equity volatility, in %



* left hand scale, ** right hand scale
Sources: Bloomberg, Lombard Odier

III. USDJPY and yield differential

A tight correlation throughout the period



Sources: Bloomberg, Lombard Odier

monetary policy. Overall, the confluence of these factors could constitute a catalyst for a risk-asset rally (at least near term) that would moderately penalise safe-havens, especially those that have seen very sharp moves recently (such as the JPY).

That said, our fundamental medium-term view remains unchanged. The yen is still undervalued (although now less so than before) at a time when the US cycle is very mature, the odds of a Fed pause have increased, and risk appetite is likely to remain volatile throughout 2019.

In this environment, what makes JPY an interesting case is that its upside is not so much state-dependent. More specifically, if on one hand we assume a "garden variety" global slowdown (our central scenario) rather than the deeper contraction the market seems to have been pricing in, the room for RoW rates being repriced higher is bigger (relative to the US), resulting in a compression of the US-RoW rate spread.

This is because the current US-RoW rate spread is still at extremely wide levels (see chart V) not reflecting adequately the relative economic developments (as captured by unemployment rate differentials). This has been mostly due to the fact that, in general, RoW yields did not move materially higher during the period of the upswing, resulting in a big wedge with underlying fundamentals. A narrowing of the US-RoW rate differential should be dollar-negative, especially at a time when the US fiscal impulses will have faded and expose the US' vulnerability to its mounting twin deficit; the JPY should appreciate in such a scenario.

If, on the other hand, the world economy falls into a deeper contraction (or a recession), then yen appreciation seems inevitable due to safe-haven demand – and the room for Japanese yields to fall from here is much more limited than those of the US.

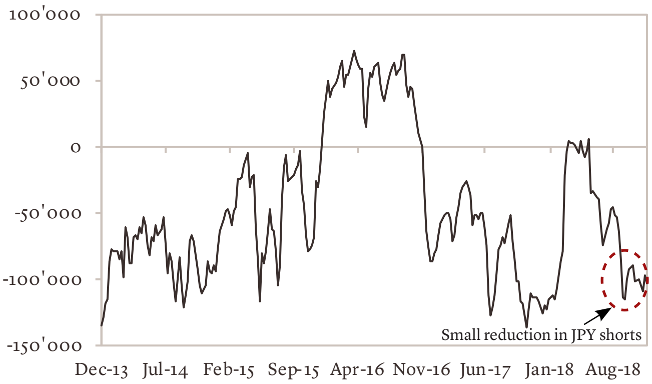
In sum, we think that the odds are slightly in favour of some near-term consolidation, while further JPY strength over the medium term (albeit at a slower pace) remains our central scenario.

The main risk to our core view is if US exceptionalism continues for another year. This would result in diverging growth rates amongst industrialised economies, with the US outperforming again and potentially forcing the Fed into aggressive tightening. This would support the dollar across the board.

Vasileios Gkionakis,
PhD Global Head of FX Strategy

IV. Speculative positioning in JPY vs. USD

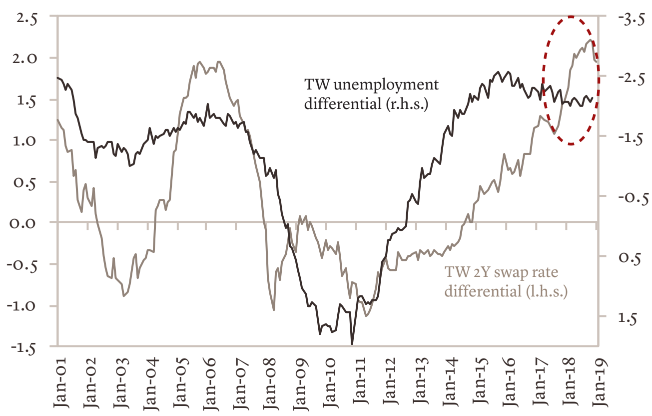
Number of futures and options contracts



Sources: Bloomberg, CFTC, Lombard Odier

V. US-RoW rate and unemployment differentials

RoW figures are calculated using the seven major trading partners of the US



Sources: Bloomberg, CFTC, Lombard Odier

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