Sucden Financial

FX Monthly Report– JPY

March 2024

FX Monthly Report

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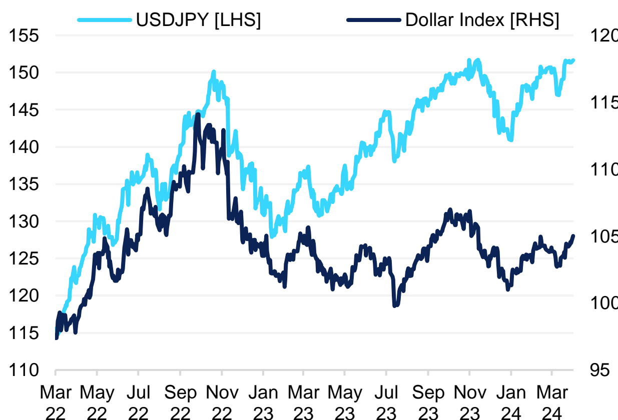
Japan Focus

After months of speculation, the Bank of Japan (BoJ) finally concluded its era of negative interest rates, increasing borrowing costs for the first time since 2007. Although an interest rate hike typically leads to currency appreciation, the yen weakened following the monetary policy announcement. Given that the current interest rate range is set at 0.0-0.1%, one could easily argue that the monetary policy remains extremely accommodative. With investors anticipating further actions by the central bank, what is the outlook for the yen?

USDJPY vs. the Dollar

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



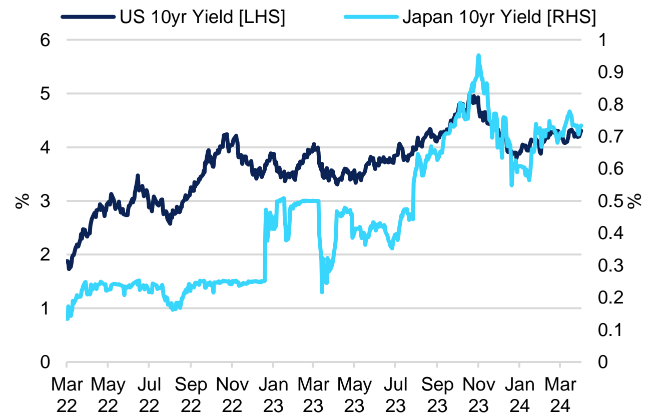
Source: Bloomberg

At the start of March, as investors awaited signals of monetary easing from the Fed, a contrasting sentiment emerged across the Pacific. In Japan, the largest wage increases in 33 years fuelled market speculation that the era of ultra-loose monetary policy might be nearing an end. Japan remained an outlier with its continued use of negative interest rates as it grappled with persistent deflationary forces driven by years of minuscule wage growth and a cultural inclination towards saving. These factors dampened both demand and price increases, even in the face of the BoJ's forceful monetary stimulus measures of negative interest rates. The large disparity in bond yields between the US and Japanese yields has put significant pressure on the yen, leading to a 7% appreciation in the USD/JPY pair since the beginning of the year.

On March 19, as anticipated, the BoJ initiated a normalization process by adjusting its borrowing rates from the prior benchmark of -0.1% to a new range of 0.0-0.1%. Additionally, Governor Kazuo Ueda declared the end of the yield curve control (YCC) policy, which was designed to regulate the yield curve by establishing a target yield for 10-year Japanese Government Bonds (JGBs), effectively capping long-term interest rates. By eliminating these controls, the BoJ has allowed market dynamics to have a more significant influence on JGB yields. However, the policy's shift is unlikely to trigger shifts in global investment flows. Despite removing YCC, the BoJ plans to continue purchasing JGBs at a rate of about ¥6 trillion per month. This indicates that while the BoJ is adjusting some aspects of its monetary policy, it remains committed to injecting liquidity into the economy to support borrowing and spending. By maintaining significant bond purchases, the BoJ aims to keep overall interest rates low and encourage economic activity. The decision underscores the BoJ's assessment of the Japanese economy, which continues to show signs of weakness.

US vs. Japan 10yr Yield

Albeit narrowing, disparity remains between the 10yr yields.

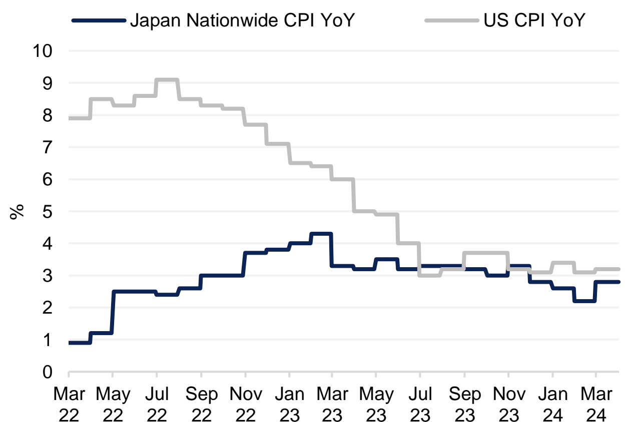


Source: Bloomberg

Despite the shift to positive interest rates, Governor Ueda indicated that significant increases in borrowing costs are unlikely as inflation expectations have not stabilized at the 2% target. In the final quarter of 2023, Japan's economy experienced marginal growth of just 0.1% due to subdued consumption, and the recent sharp increase in prices, initially seen as a positive shift from prolonged deflation, seems to be subsiding. The removal of energy subsidies, in effect since last February, led to a rise in headline inflation to 2.8% in February, up from 2.2% the previous month. However, the weighted median inflation rate, which reflects the middle price changes across various goods and services after being ranked and weighted by their economic significance, slowed to 1.4% in February from 1.9% in January. This deceleration suggests a moderation in the rate of price increases, hinting at a less widespread inflation across the economy, as this measure filters out the most extreme fluctuations to highlight more representative price movements. Additionally, the trimmed mean inflation rate, which removes the most extreme values from both ends of the price distribution, dropped to 2.3% in February from 2.6% in January, marking the lowest year-on-year rise since September 2022. This pattern indicates that the BoJ is likely to maintain a cautious approach to any near-term adjustments in interest rates.

Japan vs US CPI

Inflation in the two countries has recently been hovering around the 3% level.

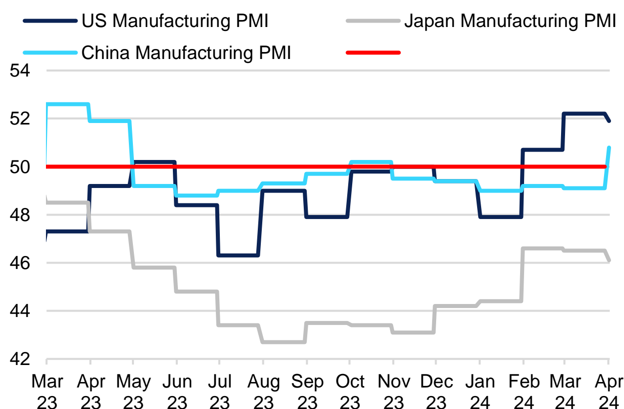


Source: Ministry of Internal Affairs and Communications, Bureau of Labor Statistics

Major Japanese companies have awarded their employees the largest wage increase since 1991, with an average raise of 5.28%. However, it remains to be seen whether this will lead to a significant boost in consumption. The Governor has stated that the Bank will continue its supportive monetary stance until there is clear evidence that the wage increases are fuelling consumer spending, which in turn would affect prices. Although the BoJ seems to advocate for a beneficial cycle of rising wages and prices, the situation is intrinsically more complicated and may not be sustainable. The core problem lies in the dependence on monetary policy adjustments rather than on authentic economic growth to spur wage hikes and overall economic advancement. Japan faces significant structural obstacles, including an aging population, a declining birthrate, substantial public debt, and modest growth rates. These challenges diminish the likelihood of the economy receiving a significant uplift, leaving little scope for substantial interest rate hikes.

US vs Japan vs China Manufacturing PMI

Factory activity in Japan has been stuck in contraction.



Source: S&P Global

Following the rate increase in March, the market showed a muted response, with the yen dropping 0.8% to ¥150.33 against the dollar and the 10yr Japanese Government Bond yield decreasing to 0.725%. There's a lack of confidence among investors that wage increases this year will sufficiently drive consumption to ensure a steady economic upturn. Even if the central bank decides to raise interest further, we do not expect the yen to gain strength in the short term. The yen's pivotal moment will more likely coincide with the Federal Reserve's expected reduction in interest rates around mid-year. Our attention will remain on the Fed's decisions across the Pacific, as they could be key to the yen's future appreciation. The expected 25bps cut in the Fed's rates by June could lessen the stark yield disparity between US Treasuries and Japanese bonds, setting the stage for the yen to approach the ¥140 mark once again against the dollar.

Desk Comments

GBP

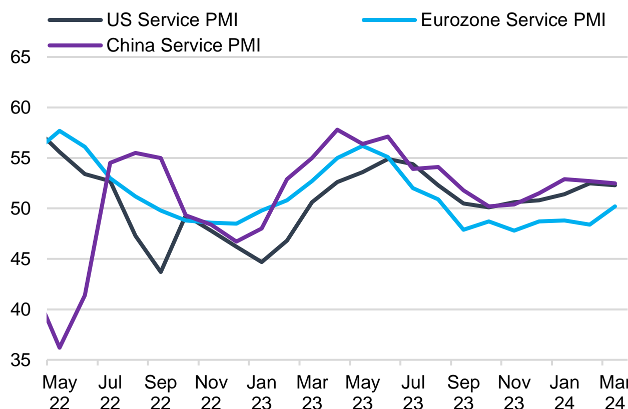
BOE again left the bank rate unchanged as expected at 5.25%. There is still a split committee but with a more dovish stance, the two hawks Haskel and Mann voted for no change with one member voting for a 25bp cut. In addition, Bailey struck a dovish tone in the statement sending GBP lower on a reduction in yields. A 20bp cut is priced in by June down from 12bp before the rate decision.

The UK did fall into a technical recession in the second half of 2023. Monthly GDP for January suggests it will be short lived as lead indicators point to growth being sustained during Q1. The monetary policy easing and tax reductions after the UK budget did little to spur the market at release, but the prospect of tax reductions will likely have a lagged inflationary effect. Therefore, Q3 could give GBP some upside momentum as price pressures and consumer spending are maintained.

GBPUSD tried and failed to close above 1.2800 resistance and is now trending within the recent range in place since end of Q4 2023. While we expect inflation and wage growth to ease in the UK in the short term, we foresee major central banks to ease monetary policy within a few months of each other, so market reaction is likely to remain muted. We favour selling EURGBP rallies and being short gamma due to the continued strength of the underlying UK economy compared to the EU, namely the divergence in the recent PMI data. With implied volatility in EURGBP remaining on the lows, we prefer to be positioned short gamma.

Global Service PMIs Performance

Eurozone PMI performance continues to lag behind other major economies.



Source: S&P Global

EUR

The ECB bank rate remains at 4.5% as the central bank left rates unchanged for a 6th consecutive month. In its most recent statement, it left a hawkish interpretation on inflation. CPI has fallen in recent months, but the central bank took the view the softer inflation was only a mechanical reaction to lower energy prices. The domestic, internal situation is more difficult. Strong wage growth and

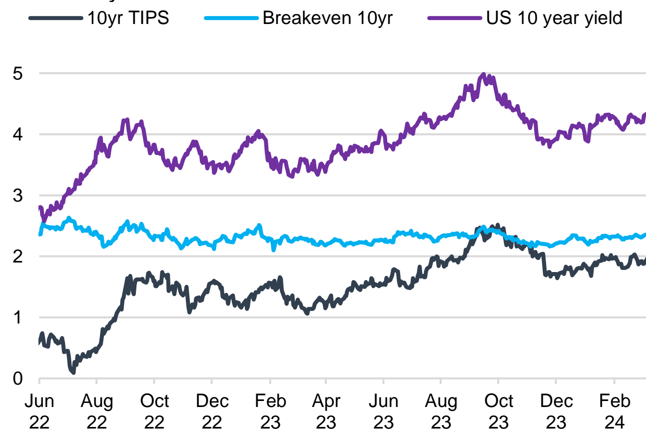
core price pressure are still a concern and they stated that rates need to be maintained for a sufficiently long duration until they could achieve their inflation goal. How long depends on the banks commitment to driving inflation below 2% or will certain members consider near 2% to be close enough as some members of the ECB council have different risk tolerances. The market is now pricing 94bp of cuts by year end down from 162 bp at the start of the year.

The change in narrative and increase in medium term yield has seen EUR test but fail to break the upper technical resistance at 1.10. The negative growth and lack of momentum means the pair traded back within 1.07 – 1.10 range. Weekly implied volatility remains near 3-year lows. We favour being short gamma and short delta against EM to benefit from the carry. EURGBP volatility has fallen to the lowest level since its introduction. Current 1-week implied volatility is at 2.90% as weekly ranges decline further. If volatility remains low, we look to buy on a week with the potential for data surprises. Notably PMI data, which has seen an increase in realised volatility compared to its historical release.

USD

The US Dollar, after a shaky start, bounced strongly in March following better than expected Non-Farm Payrolls numbers, a hot PPI print, and as the Fed left Dot plots unchanged for 2024 at 75 basis points (a minority were expecting them to reduce to 50 basis points prior to the meeting). The USD index also benefited from a shift in global rate expectations after the Swiss central bank surprised the market by becoming the first G10 central bank to initiate its cutting cycle, reducing rates by 25 basis points, striking a more dovish tone across European currencies, inadvertently benefiting the USD.

10yr TIPS vs 10yr Breakeven vs 10yr Yield
US nominal yields remain above the 4% level.



Source: Federal Reserve

The Fed kept the median dot plot unchanged but adjusted 2025 down from 100bp to 75bp, indicating that the easing cycle will take a lot longer, as inflation remains elevated. Fed minutes showed that most officials expressed caution against moving too quickly on rate cuts. Yields over the last month has been volatile, with short-term yields rising, and markets still pricing in first cut in June/July.

We expect the dollar to remain in a range in Q1 and then weaken in Q2 against other Majors. USD's performance against EM will be determined on the magnitude of slowdown in the US at time monetary policy starts easing.

Our Outlook

USDJPY

Technical Analysis

GBPUSD

GBPUSD broke below white downtrend after testing and failing to break above cluster of resistance levels around 1.29. On the downside, the close below white trendline opens the door to declines down to 1.25. A break below 1.25 support level would likely lead to further declines to green trendline, a close below could pave the way for a deeper move down to 1.18, with support beyond there coming at 1.1420 (61.8% fib). On the upside, a close above the 200-week moving average likely to lead to retest of 2023 highs at 1.3142, with a break above could see the cross target 2022 highs @ 1.3749.

EURUSD

EURUSD over the last month has continued to trade between the 2 trend lines. On the downside, close below the triangle and 1.0712 could see the retest of 1.05 / 1.0448 (lows from Sep), with a break below likely to lead to further declines to 1.02 (61.8% Fib). On the upside, a break above white trend line could see market test Red trendline/200day Ma, with a close above leading to market testing highs from July @ 1.1276, with resistance beyond there coming at 1.1495/1.1500.

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