Sharp JPY Slide Amid Talk of Large Portfolio Shift

The JPY correlates quite consistently and negatively with risk but the currency's large, intraday move lower Wednesday was out-sized relative to the rather modest gain in stocks on the day. Japanese GDP data earlier in the week was disappointing and the USD gains did break some technical levels which may have added to USD short-covering through the mid 110s but the scale of the move—and its persistence—suggests that other factors may be at play. JPY weakness is, however, very much in line with seasonal trends wherein the USD usually does better in Q1 of the calendar year before trends reverse—very consistently—through Q2/Q3.

The JPY's decline Wednesday was not completely surprising in the context of the gain in stocks (and declines in US yields) on the session. The JPY correlates negatively and fairly consistently with equity market performance and acts as a safe haven in times of market volatility. Equally, periods of pro-risk trading are often associated with JPY softness. But yesterday's 0.5% or so gain for US stocks (S&P 500) would only have driven a roughly 0.1% drop in the JPY on the day if the "normal" relationship between these two markets seen over the past year had been respected. Instead, the JPY lost 1.4%.

Technical factors (USSDJPY's clear break above the 110 resistance area defined by a multi-point trend line off the 2015 USD high) prompting USD short-covering, fundamental developments (weak Japanese data) and seasonal considerations (the USD general strengthens fairly consistently in Q1 and into March especially—the second best month of the year for the USD—before reversing in Q2/Q3) also help explain the JPY's sudden lurch lower—at least to some extent. But speculative accounts are already short JPY while weak GDP data—albeit a result of an October sales tax hike and strong typhoons—released Monday barely prompted any JPY reaction at all earlier this week despite missing expectations markedly.

So other factors may be at play in the JPY sell-off. One issue that has emerged over the past 24 hours which might help explain what looks to be a larger than might be expected move in the exchange rate is a potential change in the asset allocation mix of the Japanese Government Pension Investment Fund (GPIF) and speculation that the fund—one of the largest pension managers in the world—may increase its foreign bond allocation. With around USD1.5 tn in AUM, even modest changes to the portfolio represent potentially significant flows into (or out of) assets over time.

The GPIF typically sheds little light on its asset allocation mix; the "basic portfolio" currently targets an asset mix of 35% Japanese bonds, 25% Japanese stocks, 15% foreign bonds and 25% foreign stocks (although there are varying degree of flexibility around those core allocations). Market speculation suggests GPIF's allocation to foreign bonds could increase to 25%. GPIF announced last year that it would reclassify FX-hedged foreign bonds as part of its domestic debt holdings. As such, we think any expansion in fixed income holdings is likely to come mainly in unhedged bonds which likely favours higher yielding sovereign debt in the G-10 space—essentially the US, but also Canada perhaps.

The last major asset allocation revamp undertaken by GPIF occurred in late 2014 when significant asset allocation changes (doubling exposure to local stocks and foreign bonds) was co-ordinated with another round of Bank of Japan stimulus. The effect was a sharply weaker JPY over the following few weeks. Weak Q4 GDP growth, which has lifted recession concerns, may be prompting expectations that the authorities could concoct a similar response this year. GPIF is expected to confirm

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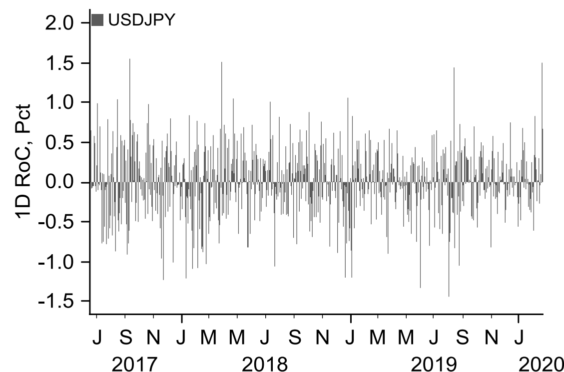
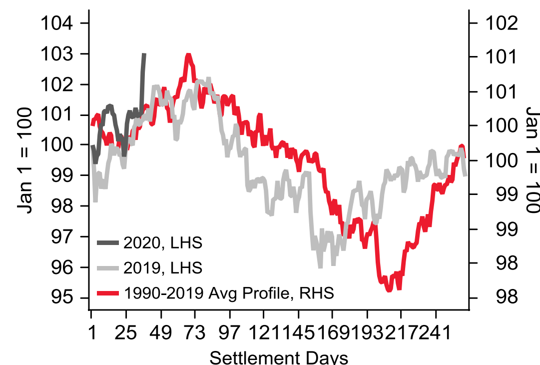
USDJPY Spikes 1.5% Wednesday



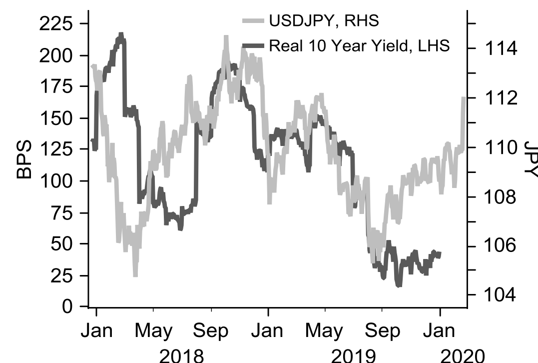
Source: Macrobond, Scotiabank FICC Strategy

USDJPY - Seasonal Profile



Source: Macrobond, Scotiabank FICC Strategy

US-Japan Real Yield Spread Vs. Spot



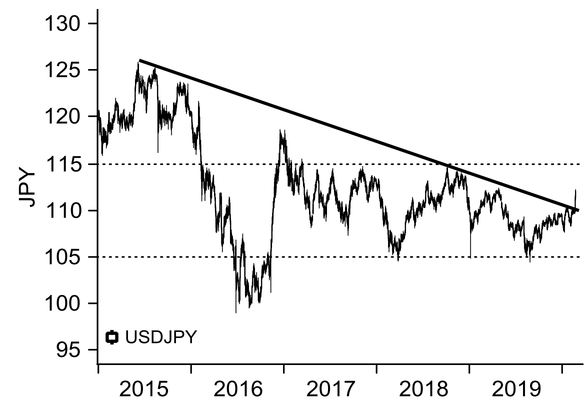
Source: Macrobond, Scotiabank FICC Strategy

portfolio changes by the end of March.

We had anticipated USDJPY edging gradually lower through the course of this year, reflecting narrower nominal—and real—yield spreads between the US and Japan. And we rather thought that selling USD gains through the 110 area was a good trade to hedge against a degree of complacency that has settled over markets generally. Clearly, the choice of the entry point was incorrect but the logic may still apply. Moreover, the JPY's recent losses appear to have overshot real yield differentials significantly. There is little reason to expect the JPY to rebound soon. Recovery may have to await Q2.

We still think there are merits to the JPY's safe haven status and we have no doubt that a sharp increase in market volatility will lift the currency to some extent. For now, however, risks are geared towards more JPY weakness—in keeping with the seasonal trend—and USDJPY edging towards the 115 area in the next few weeks.

USDJPY Trend Break Exposes 115



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