Scotiabank™
Global FX Strategy

FX SNAPSHOT

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Analyst Team

Shaun Osborne
Chief FX Strategist
416.945.4538
shaun.osborne@scotiabank.com

Juan Manuel Herrera
FX Strategist
416.866.6781
juanmanuel.herrera@scotiabank.com

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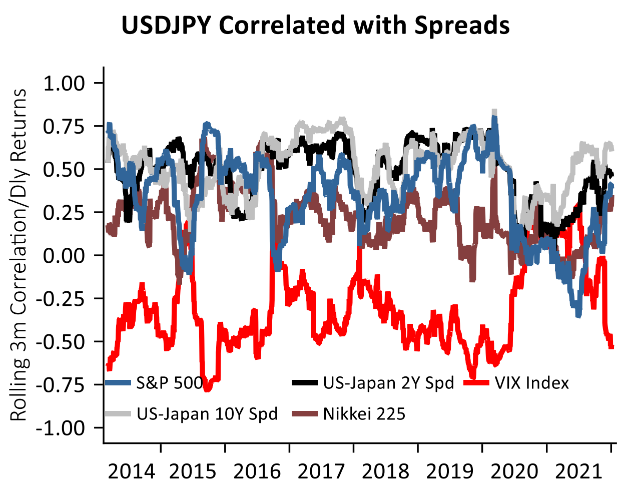
JPY Underperformance Poised to Extend

The JPY was the weakest among the major currencies last year, losing more than 10.5% against the USD. The JPY plunged sharply in Q1 2021, reflecting the jump in US 10Y yields from a little above 1% in January to a peak near 1.75% at the end of March. The yen consolidated through Q2/Q3, reflecting the pullback in US yields, but weakened again into the latter part of last year as US yields picked up again. JPY weakness has extended in early 2022, taking USDJPY above 116 to its highest in some five years.

We expect the JPY to remain under pressure in 2022 primarily because US yields are poised to remain elevated as the Fed dials back asset purchases—relatively quickly—and starts to lift the Fed Funds target. We forecast 100bps of Fed tightening this year and expect US 10Y yields to reach 2.15% (more hikes and a 10Y yield of 2.40% is forecast for 2023). This will contrast with steady BoJ policy over the same time period as the BoJ expects relatively flat economic activity in the near term and CPI holding around zero. The BoJ's 2% inflation goal is likely to remain elusive for the foreseeable future. Another JPY-negative consideration is the impact of firm/firmer commodity prices which confer a negative terms of trade effect on the currency.



Source: Macrobond, Scotiabank FX Strategy

After a period of relatively low correlated activity through 2020, JPY correlations with stocks, volatility and spreads are showing signs of picking up again. This trend highlights the risks facing the JPY from the rising trend in US yields, but also signals some potential sources of support for the JPY—if perhaps only from a short-term point of view. Firm or firmer stock market trends will add to headwinds for the currency but a clear risk amid a reduction in central bank support this year is that market volatility turns up more significantly. This may provide sporadic, rather than sustained, support for the JPY in the months ahead, the more so perhaps as speculative positioning/sentiment is bearish on the JPY, but not excessively so. Net non-commercial positioning is currently short 53k contracts—elevated but well below recent years' peaks.

Technically, we note that USDJPY has traded above all its main short, medium and long-term moving averages on the daily weekly and monthly charts. For Japan-based investors, USDJPY's bullish developments on short, medium and long-term "cloud" charts will add to the technically bullish outlook for the USD. USD gains have brought spot to major trend resistance around 116.50 on the monthly chart—the origins of which can be traced back to the 1970/80s. That might provide a temporary foothold for the JPY but we have to think that a sustained break above the mid 116s in the next couple of months would make our 118 forecast for this year look conservative. A final point to consider is that a weaker JPY might suit the Japanese authorities as they try to coax prices higher while a stronger USD will help restrain price growth in the US. Stronger USDJPY gains may not encounter the verbal intervention that has curbed sharp JPY moves in the past.