Scotiabank
Global FX Strategy

FX SNAPSHOT
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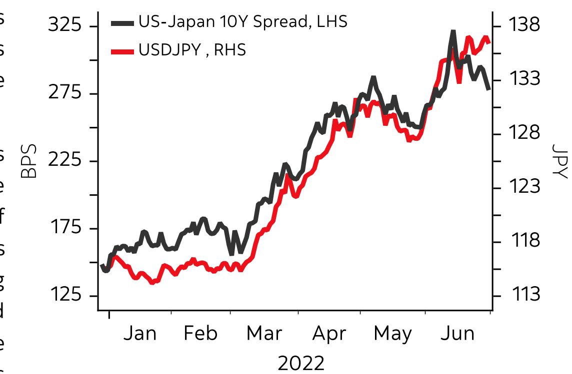
JPY Slide May be Slowing

The JPY is the worst performing currency among the majors so far this year. Against the USD, the currency has dropped more than 15% through Q2, its worst 6-month run since 2013. We have detailed a number of issues weighing on the JPY in previous updates (negative terms of trade, weaker external accounts and tighter Fed monetary policy versus ongoing policy accommodation from the BoJ). Beyond a modest trading bounce, it will take a clear improvement in the JPY's fundamental backdrop to trigger a significant rebound.

Narrower Spreads Should Steady JPY



Source: Macrobond, Scotiabank FICC Strategy

We do think, however, that there are some tentatively positive (or less negative) signs developing for the JPY which should at least limit additional losses. Firstly, US yields have retreated significantly from recent peaks. US 10Y yields are dealing around 3%, 50bps off their mid-June high. We have noted in other reports that the short-term US yield curve has repriced Fed risks quite significantly over the past couple of weeks, with futures removing around 25bps of implied tightening now, suggesting that the Fed funds rate will peak around 3.5%. US-Japan nominal spreads have narrowed sharply as a result which should provide some support for the JPY at least. Note that Japanese bonds offer superior real returns (+0.04%) relative to the US (-3.18%), based on core CPI data. High or higher US yields may not provide the USD with much more additional support.

Japan's weak terms of trade—reflecting high commodity prices remain a drag on the outlook for the currency, even if the overall situation has improved somewhat relative March when terms of trade developments were at their worst. But developing signs of slowing global trade suggest that Japan's weaker trade position may not improve dramatically for the foreseeable future even if imported raw material prices decline.

Still, we think that the apparent cap on US yields should be modestly JPY supportive and help stabilize the recent yen decline. The CHF's reaction to the more hawkish SNB policy stance earlier this month gives some hint as to what could occur if the BoJ tightens monetary policy even modestly. Although we think this is unlikely in the near term, markets may start to look ahead to the potential for a new policy direction next year when Governor Kuroda's term comes to an end (April).

In our technical note earlier this week, we noted that USDJPY spot trends (higher highs) is diverging with the daily RSI (lower highs). This divergence is a classic sign that a move may be poised to reverse. There are scant signs of a reversal in terms of pure price action, however. Firmer resistance is developing in 136.75/00 but the USD will have to trade below 134 at the moment in order to signal some (even modest) downside pressure is developing. Given the extent of the USD rally so far this year, we are attentive to signs of a more significant reversal ahead of the 140 zone which we think may be around the limit of the USD rise in this cycle.