SMBC Capital Markets, Inc.

fxPoetry

September 7, 2022

Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

Niagara Falls

Niagara Falls
Has nothing on Japan's yen
As to its decline

Source: Bloomberg

When something in the markets falls as far and as fast as the Japanese yen has done over the course of this year (that's 21.3% if you can't read the chart), it raises more than eyebrows. It raises questions about the sustainability of the move and forces market participants, as well as market officials, to seek hidden issues beyond the obvious. It also results in official responses that attempt to address the issue without actually doing anything. In fact, the yen has a long history of sharp movements forcing various levels of verbal intervention and we currently find ourselves in just such a situation.

In 2019, Bloomberg published an article that was a sort of Rosetta Stone for BOJ commentary on the yen (A Trader's Guide to Japanese Policy Makers' Language on the Yen - Bloomberg) and based on the most recent comments, "*The government will continue to watch forex market moves with a high sense of urgency and take necessary responses if this sort of move continues*," we are somewhere between steps 6 and 7 on the 8 point scale. 8 represents time for intervention.

The thing about intervention is that it has a terrible history with respect to preventing the decline in a currency. Generally, a currency declines for very good reasons; either there is a fundamental problem with the economy (inflation, recession) or there is a significant difference between monetary policy stances of the two countries in question. One other thing to note is that if you consider the four combinations of policy stance that might exist (as below):

		Monetary Policy	
Fiscal Policy		Tight	Loose
	Tight	$ ↔	$ ↓
	Loose	$ ↑	$ ↔

There is a long history of the combination of a tight monetary and loose fiscal policy strengthening a currency and vice versa. When both policies are either tight or loose, the currency tends to be subject to other forces. And guess what? In the US we have the perfect combination of policy for a strong dollar with the Fed extremely aggressive and the Biden Administration seeking to spend as much money as possible in their effort to support Democrats in the mid-term elections. At the same time, Japan is virtually on the opposite trajectory with the BOJ insisting that NIRP and YCC are here to stay while the Kishida government has been impecunious in its spending habits (on a relative basis).

In other words, it should be no surprise that USDJPY continues to make new highs on a virtual daily basis, with last night no exception as the yen weakened a further 1.4%, leading the way lower for virtually all currencies.

The question, of course, is how long can this continue? As the American economist Herbert Stein explained in 1985, "If something can't go on forever, it will stop." (Yes, he is comedian Ben Stein's father). So, can the yen weaken forever? Obviously not. But that doesn't mean it cannot fall further still. My observation throughout my career is that when G10 currencies move in this fashion, they elicit an official response. Intervention by the BOJ will clearly not be enough to stop this move, although it would certainly have a short-term impact. This move can only be stopped by policy adjustments.

Looking at the players involved, it certainly doesn't appear that the Fed is ready to change its stance, at least not for another 18 months, so tight monetary policy in the US seems stable.

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.

Knowing all politicians, it is also very clear that austerity is not going to be a hallmark of the current US administration. This leads us to the Japanese side of things. Japanese measured inflation remains lower than almost anywhere else in the world at 2.6%, although Kuroda-san is insistent that this is a "transitory" phenomenon and not sustainable. It is this reasoning that is driving his policy decisions to maintain NIRP and YCC. But…what if CPI were to begin to rise a bit more aggressively in Japan? Would that be enough to change Kuroda's view? My sense is that is absolutely the case, so let's keep a close eye on the CPI report from Tokyo on the 19th.

If I had to map out how this will evolve, we are likely to see ever more strident language from the BOJ and MOF in defense of the yen. At some point after that, I anticipate the BOJ will enter the market to try to suppress the move, which will be a temporary situation. But I expect that at some later point the Fed and Treasury are going to decide that a too weak yen is not helping the US economy and we are going to move toward a concerted G10 response to the dollar's recent strength. Think a Plaza Accord II. But that is unlikely to occur before sometime in the middle of 2023 is my initial guess.

In the meantime, risk remains under pressure overall as yesterday saw weakness in US equity markets and that fed through to the Nikkei (-0.7%) and Hang Seng (-0.8%) although Shanghai (+0.1%) was little changed. Europe (DAX -0.3%, CAC -0.35%, FTSE 100 -0.4%) are also under some further pressure despite, arguably, some slightly better than expected data (Italian Retail Sales +1.3%, Eurozone GDP 0.8%). US futures, which had been modestly higher earlier in the overnight session have since turned red as well, down about -0.2% at 7:40am.

After a complete bond market rout yesterday, we are seeing a very modest rebound with Treasuries (-1.3bps) although better performance in Europe (bunds -4.3bps, OATs -5.9bps, Gilts -8.5bps, BTPs -9.0bps). The market discussion is focused on tomorrow's ECB meeting where they are having the same 50bp/75bp debate that appears to be taking place at the Fed. Certainly, the inflation data in Europe points to 75bps being appropriate, but given the much more tenuous economic situation due to the energy crisis, there is great concern that many companies (and countries) would not be able to tolerate rates that 'high'.

Oil prices continue to suffer, down a further 0.4% this morning with NatGas (-2.1% and <$8/MMBtu) also softening apparently on the back of growing concerns over a recession in the US and, generally, around the world. Gold is basically unchanged this morning while copper (-0.85%) and aluminum (-0.9%) are both pointing to weaker global economic growth.

And finally, the dollar remains king of the hill. Beyond the yen, the pound (-0.8%) is suffering on the back of concerns that the new Truss government is going to spend more than the UK can afford to address the energy crisis there. The mooted amount has grown to £200 billion, all of which would be borrowed and would result in a 10% increase in the amount of debt outstanding. The antipodeans (NZD, AUD -0.4%) are also under pressure and, in truth, the euro (-0.1%) is top dog today. In the emerging markets, KRW (-0.85%) is the worst performer as the broad risk-off sentiment and weakness in other currencies, notably the yen and renminbi, force weakness here. ZAR (-0.7%) is next on the list with commodity prices under pressure and the recession story also a drag. I have to mention the renminbi (-0.35%) because it is back very close to 7.00 and the PBOC has been starting to push back against the weakness via its fixing mechanism. Last night the fix was nearly 5 big figures below (stronger CNY) than the market would have calculated based on the alleged basket. On the other side, HUF (+0.5%) is the only gainer on the day as the market responds to news that President Orban may be considering policy changes in order to get cash from the EU.

On the data front today, the Trade Balance (exp -$70.2B) comes at 8:30am and then we get the Fed's Beige Book at 2:00. We also hear from four Fed speakers (Barkin, Mester Brainare and Barr) although all eyes are on Powell's speech tomorrow morning.

So, the beat goes on. I am growing increasingly concerned that the dollar is due a much more substantial correction in the next days and weeks, although until policies actually change, the dollar remains the place to be.

Good luck, good weekend and stay safe
Adf

PS, I will be out of the office the rest of this week so no poetry until Monday September 12.