JPY: Finely balanced

- **The window for much further upside in USD/JPY should slowly close this year. The best chance for a rally will probably be in 1Q18, when US Treasury yields rise.**
- **BoP position looks finely balanced, where Japan's growing current account surplus is being re-cycled offshore via FDI outflows. Portfolio flows will be key.**
- **Taking a view on real yield spreads will be key for the USD/JPY trajectory. We suspect JPY real yields rise later in the year, as inflation expectations fall.**

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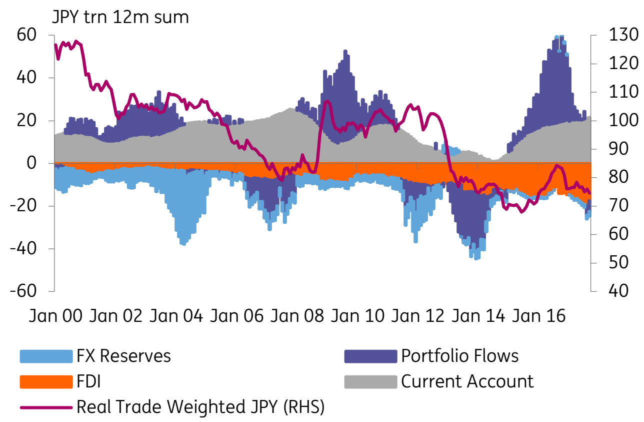
Frankly we're a bit disappointed that the JPY did not fall further on the crosses in 2017. True we saw a nice 7-10% rally in the Europe/JPY crosses but we were expecting a little more. One engine of potential JPY weakness never fired up. That was the engine of Japanese investors, feeling a little more comfortable about their personal circumstances, starting to invest offshore again. That never happened.

In fact Japanese Balance of Payment (BoP) data shows a finely balanced situation. The positive for the JPY is the large and growing current account surplus – well above 3% of GDP and maintaining Japan's position on the US Treasury's Monitoring List for unfair currency practises. And a huge chunk of that surplus comes from investment income flows into Japan – dividends from Japan's large stock of foreign assets. The Yen's safe haven status looks assured.

Less reported is the large pick-up in Japan's net FDI outflows. These now offset around 85% of Japan's current account surplus. Most of Japan's FDI outflows go to Europe (43% in 2016) and the rest largely go to US (30%) and increasingly to the Asean region. With Japanese corporate profits performing well, expect these FDI trends to continue.

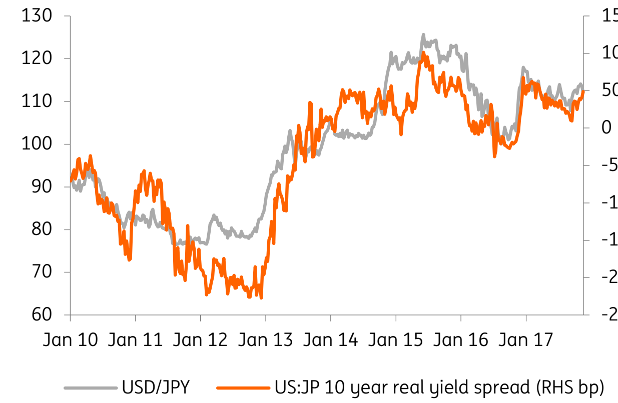
Portfolio inflows should be a swing factor here. And we still wouldn't completely rule out a rather belated acceleration in outflows – triggering the kind of JPY weakness seen 2006/07 and 2013/14 – but that is far from guaranteed.

Current account surplus offset by net FDI outflows



Source: Bloomberg

If you know where real yield spreads are going……



Real Yield = Sov. Yield deflated by 5Y5Y inflation swap
Source: Bloomberg

Instead perfect foresight on 10 year US : Japan real yield spreads would have been useful in forecasting USD/JPY trends over recent years. These spreads seem to have a stronger relationship with USD/JPY than, say, the FX hedged yield available in the US.

> *"Perfect foresight on the US : Japan real yield spread would have been helpful in forecasting USD/JPY"*

Our forecasts for real yield spreads tends to favour a profile that sees USD/JPY gently higher earlier in 2018, but coming under more pressure as the quarters pass. From the US side, 1Q18 could see real yields push up when US corporate pension buying of Treasuries abate. Later in the year – and as the business cycle matures - rising US inflation expectations could limit any further upside in the real yield.

115 May be the best level of the year for USD/JPY

From the Japanese side, the Bank of Japan (BoJ) has long struggled with inflation expectations. We doubt these will rise much above 0.5% and 10 year JGB yields look anchored near zero.

As we move ever closer to the 2019 rise in the Japanese consumption tax, it would be no surprise were inflation expectations to fall, real JPY yields to rise and downward pressure to be exerted on USD/JPY. Thus 115 may be the best level of 2018 for USD/JPY.

We are not looking any significant changes in BoJ policy to drive USD/JPY in 2018. There has been some speculation over the BoJ raising its 10 year JGB yield target to 0.25% from 0.00% +/- 10bp. However, our team does not see the merits in that ahead of the 2019 consumption tax hike and very few signs that inflation is on a sustainable trajectory to the 2% target.

We suspect that heading into 2019, the third year of a US Republican presidency and a period where the withdrawal of liquidity will start to bite more, USD/JPY will be biased towards fair value readings in the 100/105 region.

> *"The JPY remains the safe haven currency of choice"*

Of course Japan's large net foreign asset position maintains the JPY's position as the safe haven currency of choice. Any material escalation in the North Korean dispute, e.g., direct contact between opposing forces, could easily send USD/JPY to 105.

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