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Next Stop for USDJPY: 100-110

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Bottom line*: We believe there is further upside to USDJPY and JPY-crosses in the coming weeks. Prior to the onset of the Great Recession, USDJPY actually traded above 120 for parts of H1 2007, when Japan's CA surplus approached 5.0% of GDP. Since then, safe haven and other counter-cyclical flows have weighed on USDJPY, pushing it to a low of 77 in Q3 2012, despite the recovery in most of the other asset prices, and despite the fact that Japan's balance of payments (BOP) position had deteriorated significantly, with its CA surplus having shrunk to below 1.0% of GDP. The argument for a rebound in USDJPY higher, back toward 120 does not seem outlandish. Measuring the rise in USDJPY from its absolute low point is as meaningless as saying that the SnP has risen by 130% from its cycle low, or AUDUSD has risen by 70% from its low. Japanese policy makers will most likely continue to pursue Abenomics with aggression, and will try to pacify Japan's G7 partners by toning down their verbal interventions. Having said all of this, however, whether USDJPY stays high will depend on the effectiveness of the BOJ's policies in the coming months in rekindling economic growth and generating 'good' inflation. But since investors won't know how effective the BOJ's policies will be until later this year, at the earliest, the immediate risks to USDJPY are biased to the upside, particularly if Japanese institutional funds alter their strategies in the new fiscal year.*

USDJPY has risen dramatically since last October. JPY, in general, has experienced a broad-based depreciation against a wide range of currencies since then. The G20 meetings are unlikely to single-out Japan and the wording of the Communiqué will unlikely be too restrictive for Japan to continue with its espoused policies. We believe the risks remain biased to the upside for USDJPY in the coming weeks. However, whether USDJPY can *stay high* will depend on how effective the BOJ policies turn out to be later this year.

Reasons to expect an even higher USDJPY. Much has been written on the yen, and we will not dwell on the familiar arguments. Here are some thoughts we add to the discussions.

Thought 1. USDJPY is still meaningfully below the 2007 levels. In H1 2007, prior to the Great Recession, USDJPY was trading around 120. The subsequent global recession and the sell-off in global equities between 2008 and 2009 weighed on USDJPY. However, as the global risk assets and the economy began to recover in 2009, USDJPY continued to drift lower, almost unilaterally.[1] As the global economy slowly heals and as risk appetite recovers, why should USDJPY not trade back to the pre-Great Recession levels? One factor has undoubtedly been the Fed's policies. Further, since 2007, Japan's BOP position has deteriorated sharply, with its CA surplus falling from 5.0% of GDP in 2007 to less than 1.0% now, and falling. Moreover, there has been no improvement in Japan's fiscal position. All else equal, therefore, one would think that there is scope for USDJPY to trade *at least* back to the pre-crisis levels of 120. It is in this context that we think investors should interpret the description by the Japanese policy makers that USDJPY is still in a 'correction' phase from being mis-priced. The magnitude of the rally in USDJPY from its cycle-low of 78 is mis-leading.

Thought 2. Japan hasn't done anything others haven't done. On the monetary policy, Japan has essentially followed the Fed's footsteps by raising their QE targets. Unlike the other Asian countries, in the past few months, Japan has not intervened in the currency markets. It has conducted verbal interventions, unlike the US. However, the BoE has been talking down the pound. This is why it was so difficult for the G7 to find the proper wording to fault Japan. The key message we took from the G7 statement released earlier this week was that it was green light for Japan to continue with its new monetary and fiscal policies, but Japan should refrain from being too blatant with their verbal interventions. That, we believe, Japan can easily do and still drive down the yen. Incidentally, one reason we believe the yen has been so surprisingly responsive to Japan's policies is the *collective credibility* of central banks. For much of the period 2009-2012, the Fed tried to convince the market that its QE policies were just and able to push risk assets higher. The Fed has succeeded. After its announcement of the 1.20 floor in EURCHF, the SNB was initially challenged by the markets. But it, too, has succeeded in convincing

[1] The Swiss franc had a similar experience, appreciating unilaterally. That trend was only halted by the SNB's floor on EURCHF imposed in August 2011.

investors that they are to be taken seriously. Finally, Mr Draghi of the ECB engineered arguably the most successful verbal intervention in modern history. When the BOJ was ready with its more aggressive stance, few investors would stand in the way. Our point is that, had the BOJ tried to impress on the markets a year earlier, the impact of their rhetoric and policies on the market might have been significantly less. It was the immense collective credibility of central banks that helped make the BOJ so effective, we suspect.

Thought 3. Eradicating the 'bunting mentality' in Japan. We have long been skeptical of the potential impact of the Fed's QE operations on the real economy of the US, and, for that matter, the BOE's QE operations on the UK's real activities. However, the story might be quite different in Japan. The key difference, in our view, has to do with the general risk-taking attitude amongst Japanese citizens. Not limited to risk-taking in financial investments, but at a fundamental level, *risk-taking propels an economy*. Investing in plants and equipment, starting a business, looking for new jobs all entail risk-taking. The sensitivity of the Nikkei to USDJPY reflects, in our opinion, more than the mechanical impact of a weak yen on the profit margins of Japanese exporters. Rather, it is a reflection of the Japanese attitude toward risk. We have long described Japan's collective mentality in the past decade as a 'bunting mentality', borrowing a term from baseball, that, instead of swinging for the fence, Japanese may have adopted a low-risk attitude toward many economic and financial activities. A powerful Keynesian shove now could potentially push Japan out of that psychological funk. Japan faces hostile and powerful demographic headwinds that will be difficult to overcome. (Please see Appendix 1 for a brief discussion on Japan's growth potential.) However, we suspect the scope for 'positive contagion' could be as meaningful as that seen in the US following QE1 in 2009 and what is witnessed in Europe now, following the 'Draghi Put.' The BOJ's policies could indeed lead to positive real GDP growth. Furthermore, the territorial dispute with China has fueled nationalist sentiment in Japan, compounding the pent-up frustration of Japanese exporters ceding market share to Korea.[2] All of these emotions could converge to have a positive impact on real activities. We are not psychiatrists. But we do believe there is a genuine change in the collective psychology in Japan and that this could allow the BOJ to make a material difference for the economic outlook.

[2] We have argued in a previous note ('Diaoyu Islands and the Japanese Yen,' January 24, 2012) that the conflict is net-net yen-negative. China is Japan's biggest export market, while Japan accounts for only 6% of China's exports. Continued tensions over these territories would not be good for either countries, but would probably be more damaging for Japan, through exports.

Thought 4. Risk-reward faced by PM Abe. In the past seven years, Japan has had seven prime ministers.[3] Reflecting his hawkish stance toward China and his dovish economic policies, PM Abe has seen his approval rating rise since he took office on 26 December 2012 (from 65% to 71% now), in contrast to most of the previous administrations who saw their approval rating peak on the inauguration day. Backing down now on either the economic or the political front would not make much sense. PM Abe himself is unlikely to have a 'bunting mentality' in formulating his policies. In other words, it seems that Mr Abe is incentivized to be more risk-taking with his policies than having a 'bunting mentality'

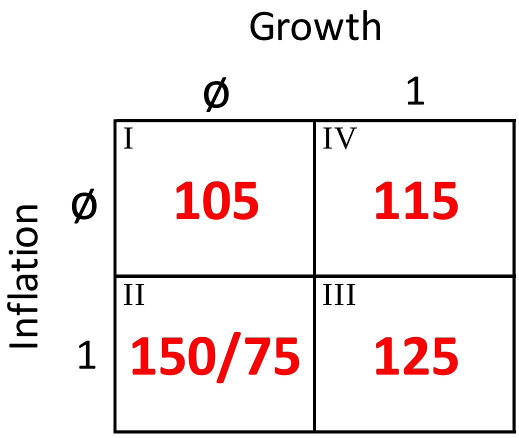
Thought 5. A potential shift in the currency strategy of Japanese institutional funds. We think of the rise in the yen-crosses as a two-stage rocket: stage one is foreign levered accounts propelling USDJPY higher, but stage two – which is more powerful and more important than stage one – will be the Japanese institutional accounts. The timing of the appointment of a more dovish team of BOJ Governor and Deputy Governors is perfect as it will coincide with Japan's fiscal year-end (March 31), when the key decisions on the hedge ratios for the coming year will be decided. (Please see Appendix 2 for the potential firepower of Japanese households in buying either foreign currencies or Japanese equities.)

First and second phase of USDJPY movements. While USDJPY could go higher in the coming weeks and months, whether it *stays* high will be a function of the effectiveness of the BOJ policies. There are many possible scenarios. Suppressing all the external variables (e.g., the pace of the recovery of the global economy, potential policy shifts by the other central banks, and the performance of global equities), we think it may be helpful for investors to think in terms of the following scenario diagram.

In our opinion, whether the BOJ is successful at generating inflation and/or economic growth will be important in dictating what happens to USDJPY, after the initial surge. Indeed, it is the general doubt that the BOJ's new policies will make any difference for either inflation or growth that has held back the Japanese investors in participating in the recent depreciation in the yen. We suggest four distinct scenarios, defined by whether the BOJ succeeds in

[3] Abe (2013), Noda (2011-12), Kan (2010-11), Hatoyama (2009-10), Aso (2008-09), Fukuda (2007-08), Abe (2006-07), and Koizumi (2001-06).

generating inflation and inflation expectations, and whether it is able to generate real economic growth.



Scenario I is where the BOJ's policies prove to be impotent on both fronts. In this case, USDJPY could merely trade back to the levels that are closer to (but still lower than) the pre-crisis levels. The move in USDJPY from 78 to potentially 105 – which is our guess as to where USDJPY might trade to in this scenario – would by and large reflect a partial 'normalisation' process in USDJPY, with no material change to the economy. We believe 105 is a conservative guesstimate. If, in addition, the US economy continues to recover, leading to a re-consideration in the Fed's QE operations, USDJPY could rise further.

Scenario II is a complicated and ambiguous one, we think. If the BOJ is able to only generate inflation but not growth, then the JGBs could be jeopardized, while the Nikkei could be undermined. A potential bursting of the JGB bubble could be terrible for the yen (150). Alternatively, such a bursting of the JGB bubble could be so bad that it wipes out the capital base of Japanese banks and triggers an outright bear equity market in Japan. USDJPY could, then, equally likely go down as safe haven flows dominate. We are not sure whether USDJPY goes higher or lower in this scenario, when the dust settles.

Scenario III is where the BOJ is able to generate both inflation and growth. The exact mechanism through which the BOJ's QE operations might stimulate the real economy will be a nebulous one, one that will be heavily driven by how the general risk sentiment in Japan might be altered, as suggested above. In any case, we think this would be the most favourable scenario for the Nikkei, and in turn for risk appetite and risk taking in general. The overall public debt-to-GDP ratio should also, in theory, decline (Appendix 3). More risk taking = a weaker yen. We guess, for the sake of this discussion, USDJPY could easily reach 125 in this risk-on scenario.

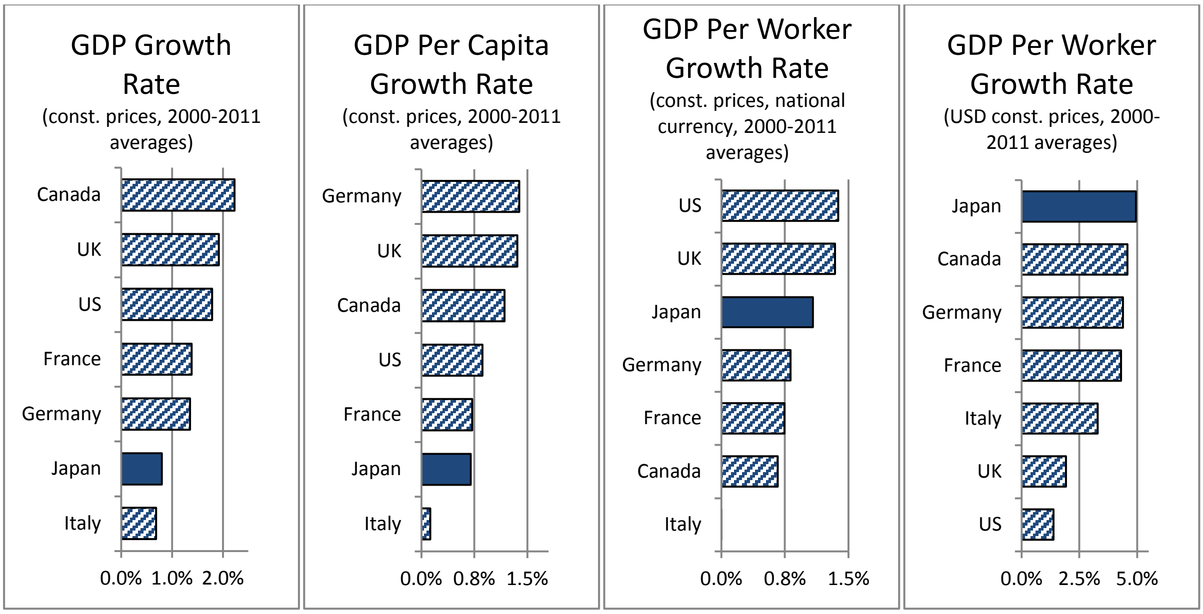
Scenario IV is where the BOJ is able to generate growth but somehow not inflation. It is a milder version of Scenario III, and we think USDJPY should be higher, but not as high as in Scenario III.

Since investors will not find out whether the BOJ's policies will be effective or not until 9 months or a year from now, USDJPY will, in the meantime, trade on expectations. Eye-balling the 2x2 matrix, one sees that the weighted average USDJPY across the four scenarios is higher than the current spot exchange rate. While this is not a scientific exercise, we hope it helps to illustrate that (i) the bias of risk to USDJPY in the coming weeks is skewed to the upside and (ii) what happens in a few months' time will be a function of the effectiveness of the BOJ's policies.

Bottom line. We concur with the Japanese policy makers that USDJPY seems to be in the process of normalizing and reverting from a misaligned position. USDJPY at 100-110 would be closer to the level that prevailed prior to the Great Recession, but there are other reasons to believe that yen could weaken even further.

Appendix 1. Japan has Respectable Labour Productivity Growth

This is an observation we made in a previous note ('Robots, Demographics, and the Labour Markets,' July 30, 2012). As the charts below show, compared to the G7 countries, Japan's economic growth has been quite dismal. However, measured in terms of per capita GDP growth, Japan ranks reasonably well relative to the other countries. However, ranked by real GDP growth per worker, Japan looks pretty good in comparison.



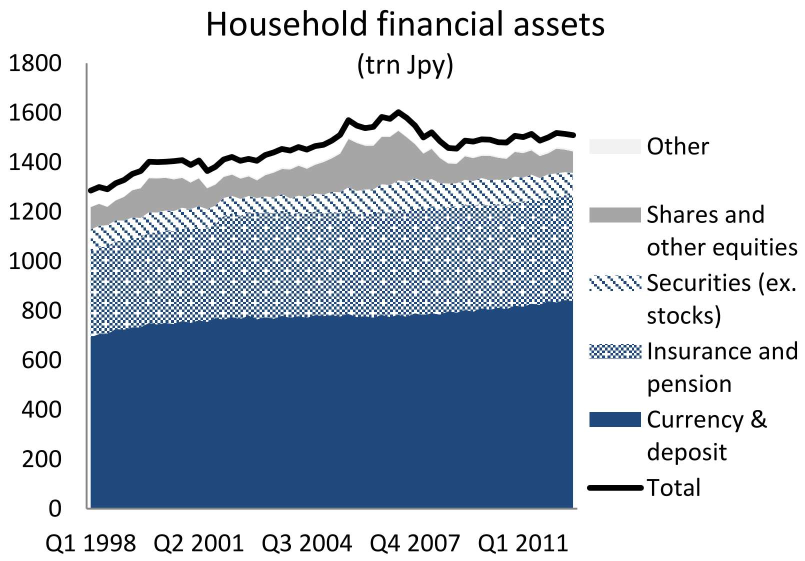
Source: Datastream and SLJ Macro Partners LLP

There are two points here. First, contrary to popular presumption, Japan's labour productivity growth has been quite high. Capital deepening and the use of better technologies have helped enhance the labour productivity of Japan. Second, however, consistent with popular presumption, Japan faces very hostile demographic headwinds that even the high labour productivity growth has struggled to overcome.

The average GDP growth rate of Japan over the last few years has been around -0.1%. This means that labour productivity growth roughly offsets the demographic headwinds, and that the BOJ may indeed be in a position to help generate positive economic growth, if general risk appetite could be rekindled.

Appendix 2. Japanese Households hold ¥840 Trillion (177%) of GDP in Cash; Less than 1% Held in Foreign Currencies

The Japanese government may be poor, but the Japanese households are rich. The chart below shows that Japanese household have about ¥1,500 trillion worth of liquid financial assets, ¥840 trillion of which is held in cash.[4]



Source: Datastream and SLJ Macro Partners LLP

Out of ¥840 trillion in cash holdings, only ¥6 trillion (0.7%) is held in foreign currencies. The potential for the Japanese household sector to raise their foreign currency exposure is, therefore, substantial.

Alternatively, Japanese households could also hold more equities. Currently, Japanese households hold only 6% of their liquid financial wealth in equities (excluding the claims on pension funds). This compares with about 28% for the US.[5] Therefore, the scope for Japanese households to buy more equities is also quite substantial.

If the BOJ could reignite Nikkei and assist the depreciation of the yen, Japanese households have ample capacity to further propel these trends. In turn, a buoyant Nikkei encourages more risk-taking, and more capital outflows. A positive feedback loop between the yen and the Nikkei could easily become a powerful trend.

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[4] This means that, even at 236% of GDP, Japan's public debt could in theory be discharged by using three-quarters of the households' liquid financial holdings. The government may be deeply indebted, but the country is in surplus.

[5] Average since 1998.

Appendix 3. Debt-to-GDP Ratio Projections for Japan

The best-case scenario for Japan's fiscal outlook is higher inflation and higher real growth (Scenario 3 mentioned in the main text).

The table below provides 5-year-ahead projections for the Japanese debt-to-GDP ratio statistics using the standard government debt dynamic model. Four key variables that affect the future path of debt are; inflation, real GDP growth, long-term interest rates (i.e. 5-10y), and the primary balance-to-GDP ratio. While higher interest rates and higher primary deficits increase the future debt-to-GDP ratio for Japan, higher inflation and higher GDP reduce future debt-to-GDP ratio.

The worst case scenario in these simulations is that the debt-to-GDP ratio of Japan keeps going up toward 351% from it is current level of 236%. This happens under the assumption that primary deficit remains at its current high levels (such as -9%), growth and inflation levels remain at near-zero levels, and interest rates spike towards 5%. Under this scenario, even if interest rates go just towards 2%, the Japanese debt-to-GDP ratio easily inflates above 300%. The best scenario happens under positive growth and inflation, with controlled deficit and low interest rates. However, even in this best case scenario, the debt-to-GDP ratio barely deflates from 236% towards 217%.

Current Debt GDP Ratio	
2012	236%
Debt GDP Ratio	
Years Ahead	5

		Primary Balance/GDP Ratio			Primary Balance/GDP Ratio			Primary Balance/GDP Ratio		
		-9%	-6%	-3%	-9%	-6%	-3%	-9%	-6%	-3%
		Growth			Growth			Growth		
		0%	0%	0%	1%	1%	1%	2%	2%	2%
Interet Rate	Inflation	5Y Ahead Debt-GDP Ratios under Different Assumptions: JAPAN								
5%	0%	351%	334%	318%	336%	320%	303%	321%	305%	290%
3%	0%	321%	305%	290%	307%	292%	276%	294%	279%	263%
1%	0%	294%	279%	263%	281%	266%	251%	269%	254%	239%
5%	1%	336%	320%	303%	321%	305%	290%	307%	292%	276%
3%	1%	307%	292%	276%	294%	279%	263%	281%	266%	251%
1%	1%	281%	266%	251%	269%	254%	239%	257%	242%	228%
5%	2%	321%	305%	290%	307%	292%	276%	294%	279%	263%
3%	2%	294%	279%	263%	281%	266%	251%	269%	254%	239%
1%	2%	269%	254%	239%	257%	242%	228%	245%	231%	217%

Source: IMF WEO October 2012 and SLJ Macro Partners

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