Market Comment_01 Sep 2022

USDJPY may continue to depreciate and look towards 145, JPY/CAD may appreciate.

1. Financial markets collapse sharply after the Jackson Hole conference.

In a hawkish monetary policy speech at the Jackson Hole conference, Fed Chairman Jerome Powell said he would insist on continuing to raise interest rates to control high inflation and was prepared for a slowdown in the economy and employment, and would not relax his stance until he saw a sustained and significant fall in inflation. It is still too early to discuss a rate cut, and a 75bps hike in September may be appropriate. As a result, the market now expects that the path of interest rate hikes in the second half of this year could be 75 basis points in September, 50 basis points in November, 25 basis points in December and 25 basis points to 4% in February next year, after which interest rate hikes may stop. Interest rate cuts may be discussed starting in the second half of 2023.

From 26-29 August, the USDJPY depreciated sharply by 300 pips, or 2.17% (136.10-139.10), while the Nikkei depreciated sharply by 1,050 pips, or 3.65% (28,800-27,750). Japanese 10-year bond yields rose by 9% (0.22%-0.24%). The US Dollar index surged 1.87% (107.20-109.20), while the three major US stock indices, the Dow Jones, plunged 1785 pips (33450-31665), the S&P 500 dropped 235 pips (4210-3975), and the Nasdaq plunged 970 pips (13200-12230). The other non-US currencies fell by around 100-250 pips against the US dollar.

2. The divergence in monetary policy between the Fed and the Bank of Japan may continue to drive the depreciation of USDJPY and look towards 145.

The USDJPY has depreciated by 2,580 pips, or 22.73% (USDJPY: 113.50-139.30), since the beginning of the year, while the US dollar index has appreciated by 15.55% (94.50-109.20). Under the constraints of the "impossible trinity" theory, the Bank of Japan insisted on "preserving bonds and abandoning foreign exchange" to hold the upper limit of the yield range of 0%-0.25% for Japan's 10-year bonds as a pursuit of monetary policy independence. Stabilising the yield on Japan's national debt will allow Japan's huge stock of national debt of up to JP¥1,200 trillion to be free from the risk of default and to keep borrowing new debt to repay old debt as stabilising the yen's status as an international safe-haven currency. The " impossible trinity" theory refers to the dilemma that a country's financial policy must face: 1)free movement of capital in financial markets, 2) guaranteeing the independence of monetary policy and 3) stabilising the exchange rate, of which only two, but not all three, can be achieved at the same time. Japan has for many years sacrificed "exchange rate stability" to maintain the free flow of capital and the independence of its monetary policy. Therefore, the Bank of Japan rarely intervenes in the foreign exchange market, keeping the benchmark interest rate unchanged at -0.1% and the 10-year Japanese government bond yield target unchanged at around 0%. The Governor of the Bank of Japan, Haruhiko Kuroda, recently (21 July) said: “ He is not considering raising interest rates at all and has no plans to extend the upper range of the 0.25% yield curve control (YCC). Whether or not former Prime Minister Abe dies, there will be no change to the policy stance of aiming for a stable, sustainable inflation target of 2%. ”

As of 01 September, 10.30 am, USDJPY is quoted at 139.50, and the market may now be waiting for the release of the US non-farm data on 02 September, as well as the "significant" US CPI for August, which will be released on 13 September, and is being digested in anticipation of a 75-basis point rate hike at the Fed's interest rate meeting on 22 September. In the rest of the year, from author’s view, it may reach a maximum test range of 140-145, after which the USDJPY may move to a range of 132-135, and in 2023 it may return to around 125.00, the mid-point of the USDJPY range over the past ten years.

(Source: tradingview)

Since this year, the USDJPY has depreciated by 2,580 pips or 22.73% (USDJPY: 113.50-139.30) and may reach a maximum of 140-145 in the rest of the year, after which the USDJPY may move to 132-135, and may return to around 125.00 in 2023, the mid-point of the USDJPY range over the past ten years.

3. Japan's CPI exceeds the 2% inflation target for the fourth consecutive month, but BOJ's accommodative monetary policy remains unchanged.

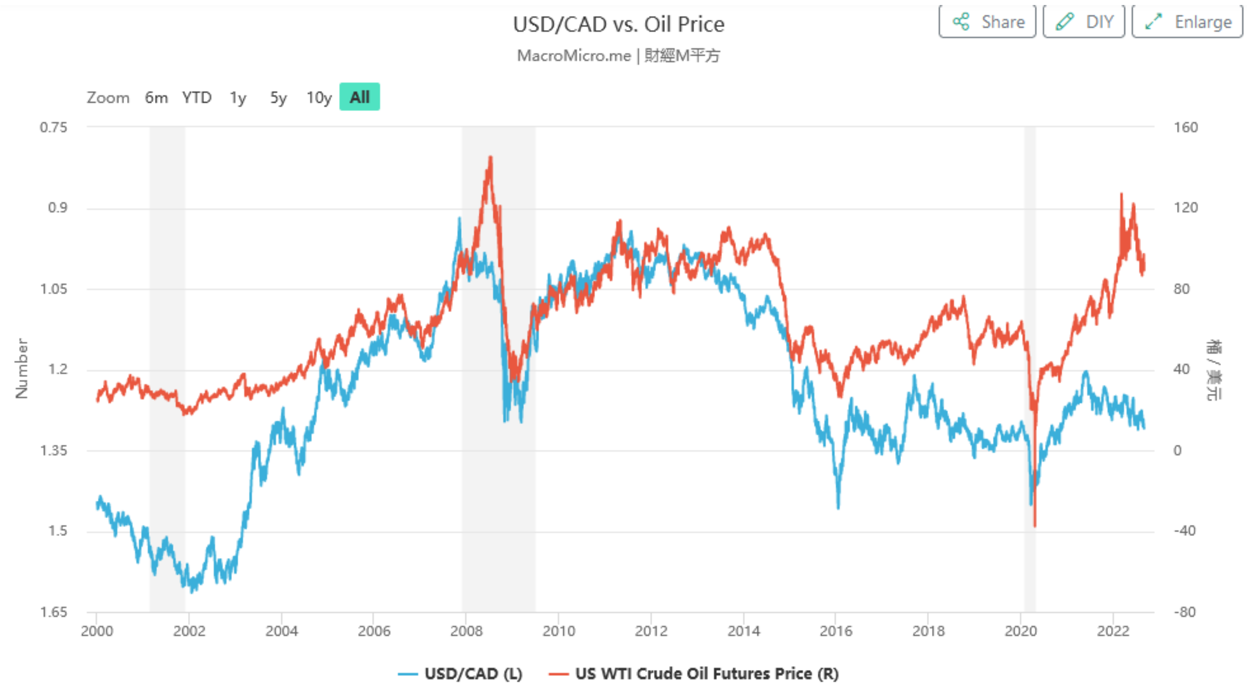
After a long period of low inflation and even deflation, Japan finally reached and exceeded the Bank of Japan's inflation target of 2% for the fourth consecutive month amidst an overall rise in global inflation. The overall CPI in Japan rose by 2.6% in July, with energy costs accounting for around half of the increase in the core CPI. Even after excluding food and energy costs, Japan's CPI rose by 1.2% year-on-year in July, the highest level since 2015. However, Bank of Japan Governor Haruhiko Kuroda has repeatedly said that the current inflation, driven by rising commodities, is temporary. That more substantial wage inflation is needed to achieve the positive growth cycle the Bank seeks. Japanese analysts, Mari Iwashita believe that “if core inflation reaches 3% this year, the market pressure on the BOJ will increase, and the more pressure the BOJ will be under to maintain its policy.”

4. Japan has run a trade deficit for 14 months in a row, and the BOJ may continue not to intervene in the depreciation of the USDJPY.

Japan's quarterly merchandise trade deficit hit a record high of JP¥2.13 trillion in July, driven by a surge in the cost of international energy, such as crude oil, coal and liquefied natural gas. It was also the 14th consecutive month of a trade deficit in Japan. Although Japan's GDP grew by 0.5% in the second quarter (Q2) of this year, as recently announced, and the recently released Reuters sentiment index for Japan's manufacturing and service sectors improved in August compared to July, the continued widening of the trade deficit may hinder the speed of recovery of the Japanese economy. Japan's domestic economy has suffered from a lack of momentum due to an ageing population and sub-replacement fertility, so the government is looking to overseas export markets to boost economic growth. The core of Abenomics is the depreciation of the yen to enhance the competitiveness of Japan's exports, thereby boosting corporate profits and, in turn, the growth of the Japanese economy. Against this backdrop, the Bank of Japan may continue to refrain from intervening in the depreciation of the USDJPY.

5. A discussion on the opportunity to short CADJPY

CADJPY is a very popular yen-related cross-currency pair from USDCAD+USDJPY. Canada is a major exporter of raw materials and the third largest oil reserve in the world, with crude oil affecting close to 10% of its GDP, so a rise in oil prices will always have a considerable boost on the Canadian dollar. Therefore, Japan has virtually no natural oil reserves and is heavily dependent on crude oil imports. In fact, 99% of its crude oil is imported. As a result of this relationship, there is a positive correlation of over 80% between the price of crude oil and the USDCAD (Oil vs USDCAD) and between the price of crude oil and the CADJPY (Oil vs CADJPY), based on charts since 2005.



Source: MacroMicro

The blue line represents USDCAD, and the red line represents WTI OIL prices, which have been positively correlated with the USDCAD by more than 80% since 2005 (The left axis coordinates are reversed in the same direction in the picture). When crude oil rises, the Canadian dollar tends to appreciate; when crude oil falls, the Canadian dollar tends to depreciate. Between 2008-2009 and 2014-2015, the Canadian dollar has even turned ahead of oil prices in the past.

The USDJPY may continue to fall, but to a lesser extent than non-US currencies or the US dollar. After all, the USDJPY has fallen 22.73% since the beginning of the year. At the same time, the euro, pound, Australian dollar, New Zealand dollar and Canadian dollar have fallen 13.10%, 14.65%, 10.45%, 12.52% and 5.65%, respectively, against the US dollar. The CADUSD has fallen the least and CAD is the strongest of the G7 currencies outside the US dollar. With the US government taking the lead, international oil prices have begun an orderly decline since mid-June, and the USDCAD has risen by around 5.2% (1.2500-1.3150) since mid-June, which means that the Canadian dollar has depreciated by 5.2% against the US dollar. The CADJPY, on the other hand, has oscillated sharply between 102.00 and 107.50 since mid-June and is currently quoted at 106.05. If oil prices continue to fall and stabilize at around 70-80 in the future, this may indicate weakness of CADJPY.

Source: tradingview

In the chart, the orange line represents WTI OIL, and the green line represents CADJPY. We see that CADJPY in 2022 has a low of around 90.00 and a high of about 107.50. Since mid-June this year, crude oil prices have dropped significantly by 27.87% (124.50 - 89.80). The price of crude oil has fallen dramatically by 27.87% (124.50-89.80) since mid-June this year, while the CADJPY has not changed much. The first target is Fibonacci 78.6% retracement at 103.75, and the second target is Fibonacci 61.8% retracement at around 100.80 if CAD turn weak against JPY.

Central banks attending Jackson Hole may continue to follow the Fed's hawkish rate hike policy amidst expectations of slower global growth and the dual pressure of "high inflation and currency depreciation against the US dollar". As the Fed nears the end of its rate hike, Japan, the world's third-largest economy, may be slow to resume growth and push the yen to strengthen against the US dollar and non-US currencies before the end of the year. A Bloomberg survey of analysts polled by Bloomberg suggests that the USDJPY will rise to 132 by the end of this year. USDJPY is quoted at 139.50 at 10 am on 01 September Singapore time. The author's view is that in the rest of the year, it may reach a maximum of 140-145, after that the USDJPY may pull back to 132-135, and in 2023 it may return to around 125.00, the mid-point of the USDJPY range over the past ten years.

6. Short-term risks this month: We need to focus on the upcoming US non-farm payroll data for August on 02 September, the US CPI data for August on 13 September and the Federal Reserve interest rate meeting on 22 September. These three events may cause significant rallies and falls in financial markets, which should be closely monitored.

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01 Sep 2022 11.10 am SGT time