8 March 2018

NZD/JPY: The Case For Further Downward Pressure

- **Over a month ago we upgraded our view on the yen and it has been the best performing major through the year to date. We outline the case for further yen strength.**
- **Our thesis is that the yen remains super cheap in a long-run historical context. BoJ monetary policy has all but reached its physical limits. Going forward we expect the yen to be more influenced by economic fundamentals – such as growth relative to trend and its large current account surplus – than by BoJ policy.**
- **We estimate a model which shows NZD/JPY would be 64 in the absence of the BoJ's QE policy. Over coming years, we expect the cross to gravitate towards the high 60s.**
- **Importers should consider lowering their target hedge levels to account for the possibility of a much weaker cross than accustomed to over the past 12 months. Exporters likely see the recent fall in the cross as an attractive level to top up some hedging. We can't disagree with that but we'd be mindful of further downside risk on the cross over coming years which argues for exporters to keep hedging cover lighter than normal.**

Earlier this year (see NZD Corporate FX Update) we turned more bullish on the yen, revising our NZD/JPY forecasts significantly lower to show a trend decline in the cross through the next few years, taking it to 68 by the end of 2020. Since then we've already seen a 3-4% move lower in the cross from 80 to 77, moving down at a faster pace than projected (which is not unusual when it comes to currency forecasting!). In this note we flesh out our positive yen story.

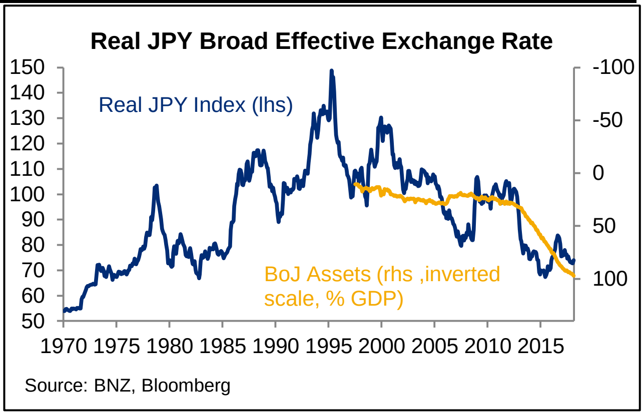
The yen is super cheap in a historical context with Japan's real effective exchange rate near the bottom end of its range of the past 50 years. A big lurch down in the yen from 2012 coincided with the Bank of Japan's ramping up of its Japanese government bond (JGB) purchase programme. This saw a leap in the size of the BoJ's balance sheet from about 2012 onwards, from 25% of GDP to currently near 100%.

A weaker yen, while not a direct target, comes with the BoJ's policy strategy – drive up the size of the monetary base, buy Japanese government bonds to suppress interest rates and effectively debase the currency to help drive inflation higher. A more logical strategy might be to print money and buy foreign assets instead, selling yen in the process. But this is seen as politically unpalatable, being a more blatant sign of currency manipulation, and would raise the ire of other trading nations.

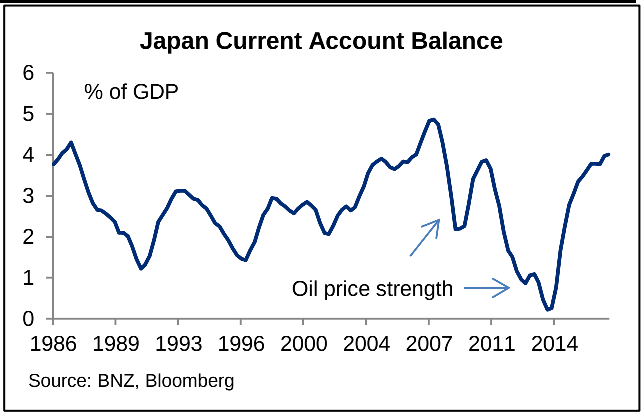
The cheap yen has helped drive Japan's current account surplus to near historical highs at 4% of GDP, another indicator of a cheap currency.

An interesting question is when does a more conventional monetary policy stance develop? At the end of last week, Governor Kuroda gave the first verbal sign of an exit strategy. He had previously shut down any questions on the exit strategy. In front of lawmakers he said that the central bank would start thinking about how to exit its unprecedented monetary stimulus around the fiscal year beginning April 2019, the same time the BoJ expects to reach its 2% inflation target.

Yen is Super Cheap in a Historical Context

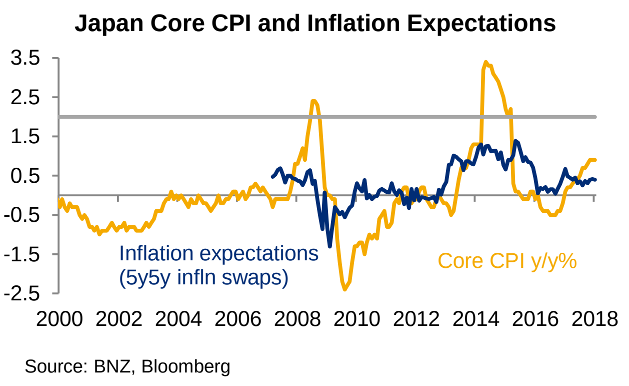


Japan Current a/c Surplus Near Historical Highs

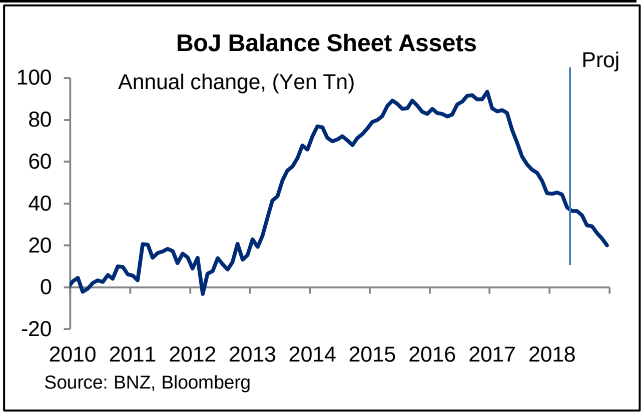


National Australia Bank

Inflation Target Elusive



BoJ is Tapering Asset Purchases



He further clarified his comments, repeating the promise to keep increasing the size of the monetary base until 2 percent inflation was achieved and stable. But he also noted that a change to interest rate policy could come before that point. Economic theory says that it is real interest rates that matter. So if inflation (strictly, inflation expectations) rose then nominal rates could increase without necessarily tightening financial conditions.

We are sceptical that the BoJ will meet its 2% inflation target. Apart from periods where GST has risen, both headline and core CPI inflation haven't been close to 2% since the early 1990s, more than a quarter of a century ago.

Despite the cheap yen and unprecedented monetary stimulus, nationwide CPI ex fresh food (the BoJ's target) was just 0.9% y/y in January. Excluding energy as well, inflation was an even lower 0.4% y/y. Market-based inflation expectations – measured by 5-year/5-year forward inflation swaps – currently sit at an annual 0.4%. The market doesn't appear to believe that the BoJ will come close to meeting its inflation target either.

Inflation is being held down by big structural forces such as demographic trends and technology rather than a lack of domestic demand. The BoJ's current estimate of the output gap is +1.4% of GDP after a period of growth running well in excess of potential. Japan's unemployment rate is down to 2.4%, its lowest level since 1993. It seems to us that the BoJ is fighting a senseless battle to get inflation higher. We're not sure what the problem is that the BoJ is trying to solve.

The BoJ has effectively reached the limit of monetary policy stimulus. The central bank already owns over 40% of outstanding JGBs, a ratio that has steadily climbed from 10% since the ramp up in bond purchases, and will continue to increase.

The BoJ's short-term policy rate is minus 0.1% and it is well acknowledged that negative rates are an issue for commercial banks and there is no appetite to reduce that rate further into negative territory. The BoJ's yield curve control policy is to purchase JGBs so that the 10-year rate remains around zero percent (in practice that means keeping it at or below 0.1%). Cutting this interest rate target into negative territory makes no sense either.

Officially, the BoJ's policy is still to conduct JGB purchases "at more or less the current pace – an annual pace of increase in the amount outstanding of its JGB holdings of about 80 trillion yen". But the recent annualised run rate for JGB purchases has already dropped to 45 trillion yen. It makes no sense to have both a quantity and price target so it seems only a matter of time before the BoJ drops the annual 80 trillion yen purchase "target". One might argue that the BoJ has been rather clever, as it has managed to keep interest rates suppressed and the yen cheap despite, in fact, significantly "tapering" its JGB purchase programme.

As the BoJ's influence on the JGB market increases, evidenced by its massive holdings, less and less purchases seem to be required to keep rates suppressed. To be sure, the BoJ's monetary base will continue to rise, but now at a much slower pace, meaning a less negative force on the yen.

With monetary policy close to its physical limits we see the BoJ's ability to keep the yen depressed as nearing the end of its course. Going forward, we expect the yen to be more influenced by economic fundamentals – such as growth relative to trend and its large current account surplus – than influenced by any actions by the BoJ.

So in a way, we think continual inflation undershooting and BoJ policy guidance are secondary issues to the behaviour of the yen over coming years. To be sure, future BoJ missives might have some short-term currency impact, but we see the yen's behaviour as largely out of its control.

NZD/JPY Implications

The corollary to a cheap yen is that NZD/JPY is richly priced in a historical context. Apart from the depths of the GFC, NZD/JPY has been expensive relative to our long-term purchasing power parity estimate for the past 15 years. Our current long-term fair value estimate is JPY 67. However, our PPP model uses a 15-year filter, which biases that estimate upwards when considering recent trends so that probably overstates fair value. Something closer to a 60-65 range would be comparable to a more traditional PPP estimate.

For an alternative model of fair value we modelled NZD/JPY as a function of risk appetite, the NZ-Japan 2-year swap rate differential and an NZ commodity price index. We estimated the model from 1995 to 2012 under an era of more conventional monetary policy. This enables us to see the impact of the ever-expanding BoJ balance sheet on fair value.

The model does a good job of explaining NZD/JPY over 2002-2012, and struggles a little with the earlier period. But it also highlights the significant impact of the BoJ's highly stimulative policy on depressing the yen over the past five years. The model says that without the BoJ's influence on QE policy, fair value for NZD/JPY is closer to JPY 64. This is the sort of level one would expect the currency to gravitate towards as the BoJ's monetary policy stance becomes less influential on the yen. However, the process would be expected to be fairly gradual and take a number of years.

Our NZD/JPY forecasts published over a month ago showed year-end targets of 76 for 2018, 74 for 2019 and 68 for 2020. While we are always reluctant to change forecasts too regularly, the balance of risk is that these targets will be hit much sooner than previously projected. If the market believes that the BoJ is on the verge of changing its policy stance, then large outflows that left Japan since the BoJ started printing money could be repatriated and boost demand for the yen. As we saw with EUR last year, this sort of theme can easily snowball and generate much larger moves in FX.

Technical charts show that near-term support at 76 looks threatened. We saw a breach of that level, albeit temporarily, earlier this week. Importers should consider lowering their target hedge levels to account for the possibility of a much weaker cross than accustomed to over the past 12 months. Exporters likely see the recent fall in the cross to the bottom of its annual range as an attractive level to top up some hedging. We can't disagree with that but we'd be mindful of further downside risk on the cross over coming years which argues for keeping hedging cover lighter than normal.

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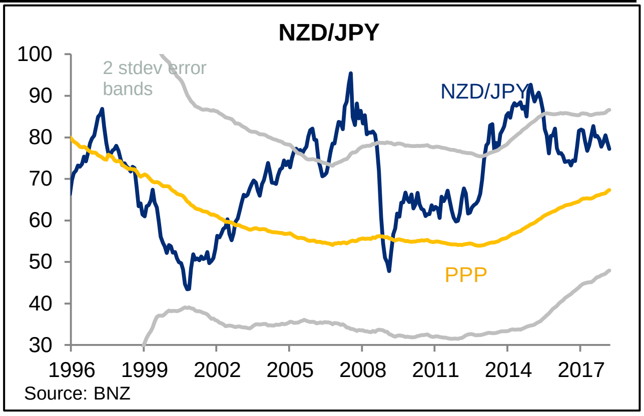
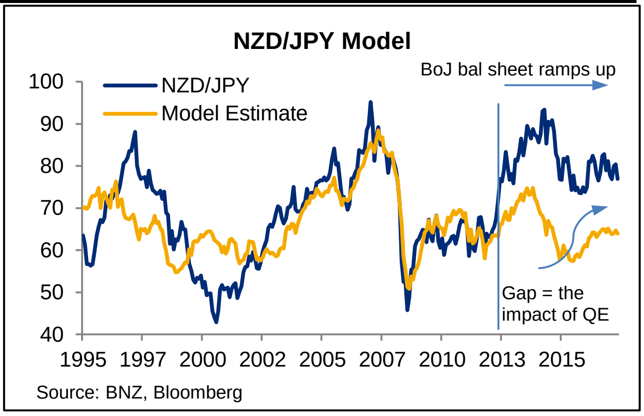
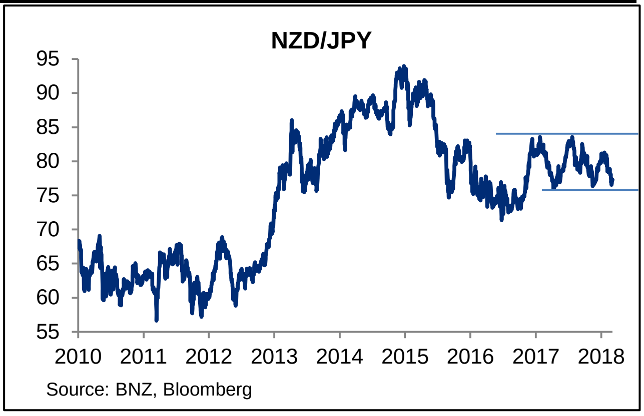
NZD/JPY Richly Priced Versus Long-Term PPP Model



BoJ QE Policy Has Kept NZD/JPY Higher Than Normal



Downside Support at 76 Threatened



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