What thwarted yen weakness and what's changed now?

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What thwarted yen weakness?

- Strong investor home bias
  - High domestic real yields
  - Low inflation/Deflation expectations
  - Stable JGB market/Demographics
  - Financial crisis
- Large external surpluses
- Relative monetary policy at zero bound
- Valuation

Official cross-border flow data only partially explains yen movements

JPY 100mn	2005	2006	2007	2008	2009	2010	2011	2012
Japan Investor								
Equities	-14,936	-15,032	-1,579	-61,186	-34,859	-14,984	-4,779	20,535
Bonds	-158,522	-51,779	-52,987	-52,240	-121,656	-219,428	-59,020	-163,015
Money Mkt Inst	6,742	7,616	3,196	-2,292	-9,287	-1,940	5,863	729
Total	-166,716	-59,195	-51,370	-115,718	-165,802	-236,352	-57,936	-141,751
Total Ex-M Mkt	-173,458	-66,811	-54,566	-113,426	-156,515	-234,412	-63,799	-142,480
Foreign Investor								
Equities	126,241	80,981	41,419	-73,786	283	18,389	2,528	21,272
Bonds	62,324	64,969	99,941	-37,274	-69,900	6,125	45,379	21,676
Money Mkt Inst	845	35,633	93,347	14,655	-29,604	67,019	167,395	31,418
Total	189,410	181,583	234,707	-96,405	-99,221	91,533	215,302	74,366
Total Ex-M Mkt	188,565	145,950	141,360	-111,060	-69,617	24,514	47,907	42,948
Total Net Flow								
Net Equity	111,305	65,949	39,840	-134,972	-34,576	3,405	-2,251	41,807
Net Bonds	-96,198	13,190	46,954	-89,514	-191,556	-213,303	-13,641	-141,339
Net Money Mkt	7,587	43,249	96,543	12,363	-38,891	65,079	173,258	32,147
Net Total (1)	22,694	122,388	183,337	-212,123	-265,023	-144,819	157,366	-67,385
Net Total Ex-M	15,107	79,139	86,794	-224,486	-226,132	-209,898	-15,892	-99,532
Current Account (2)	182,973	199,141	249,341	166,618	137,356	178,879	95,507	54,192
FDI (3)	-47,400	-66,025	-60,055	-107,074	-58,725	-50,487	-87,275	-94,201
"Other Invest" (4)	-68,456	-203,903	-246,362	192,067	116,266	89	-44,010	-8,214
Sum (1 to 4)	89,811	51,601	126,261	39,488	-70,126	-16,338	121,588	-115,608

Hedged Outflows

Hedged Inflows

Un-hedged Inflow

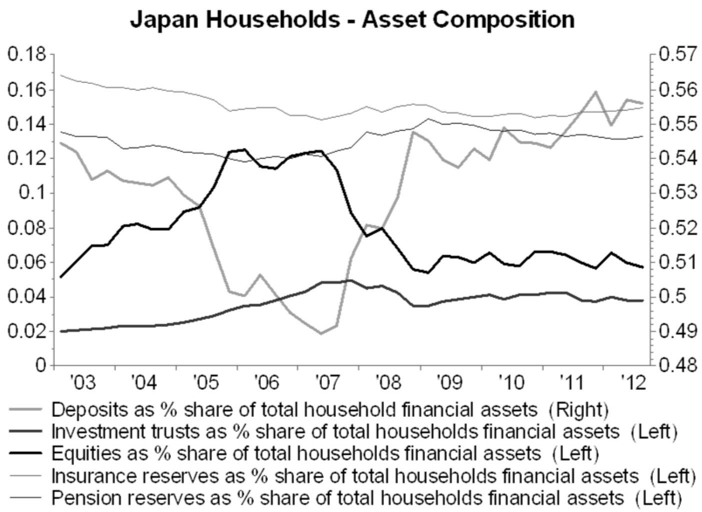
Carry Flow Gauge

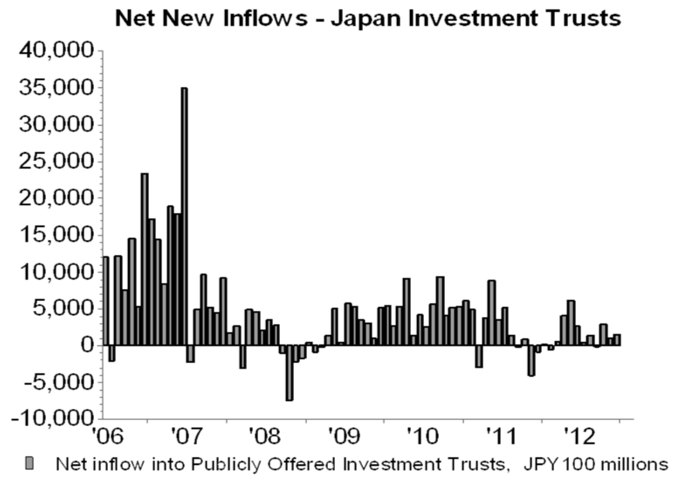
Major Shift in 2012

Source: Ministry of Finance

- Taking portfolio, current account, FDI and 'other investment' flows, historical data show modest surpluses during the pre-crisis yen depreciation period, deficits for some of the post-crisis yen appreciation period and a record deficit in 2012. Un-captured hedging and speculative/carry flows may explain this. The 2011-2012 massive shift from surplus to deficit totalled nearly JPY 24trn (USD 300bn).

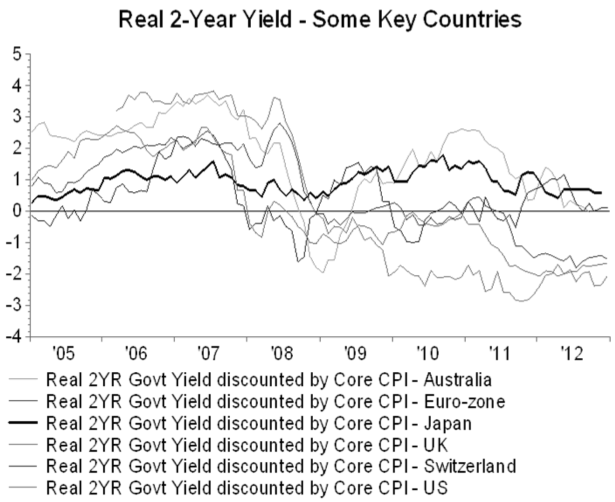
Japanese household risk appetite still muted, cash holdings close to record

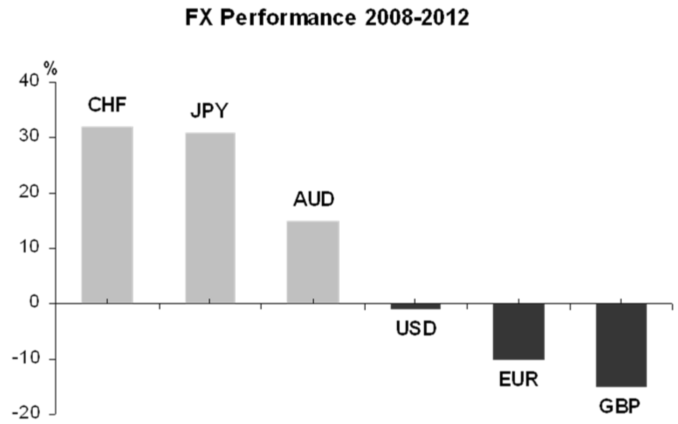




- Cash deposits with Japanese financial institutions are currently close to a record high 56% of total financial assets. Before the onset of the financial crisis, cash holdings accounted for less than 49% of total financial assets. This leaves banks flush with cash, some of which finds its way into foreign bond markets. Households' lack of appetite highlighted by limited inflows into investment trusts.

Real yield has been crucial driver of FX during the financial crisis

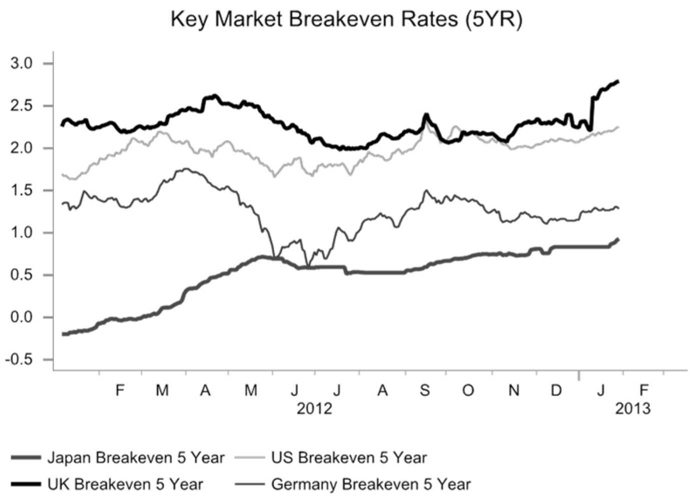




Source: Bloomberg & BTMU Calculations

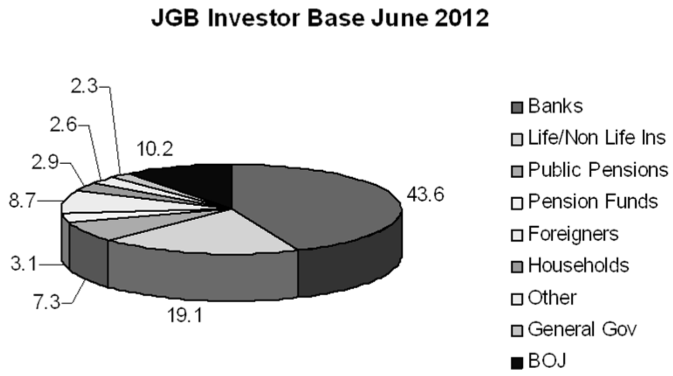
- Households' reluctance in investing abroad reflects the relatively attractive real rates of return at home. When the yen was weakening between 2005-07, Japan had one of the lowest levels of real returns, encouraging outflows and speculative yen selling. Since the crisis Japan has consistently offered on of the highest real rates of return.

Persistent deflation expectations has been key to underpinning the yen

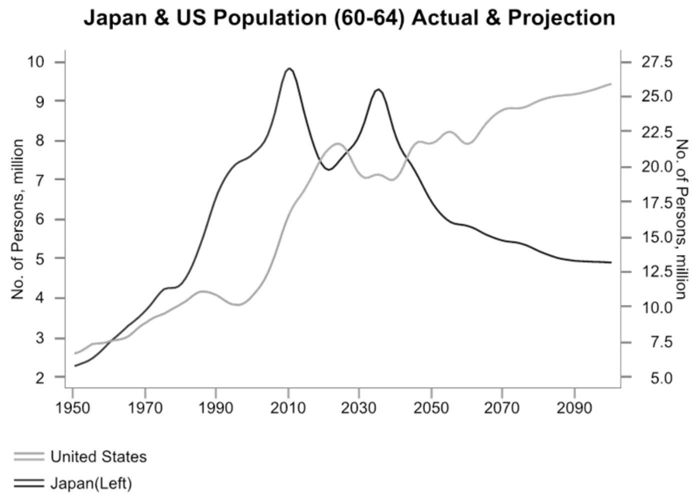


- 5-year inflation breakeven rates show until recently the very wide divergence in inflation/deflation expectations in Japan versus the other major economies. JGBi market somewhat distorted due to supply-demand issues after the government stopped issuing in 2008 – but JGB inflation-linked bonds returned 2.9% annualised in three months to mid-January.

JGB stability also explained by demographics

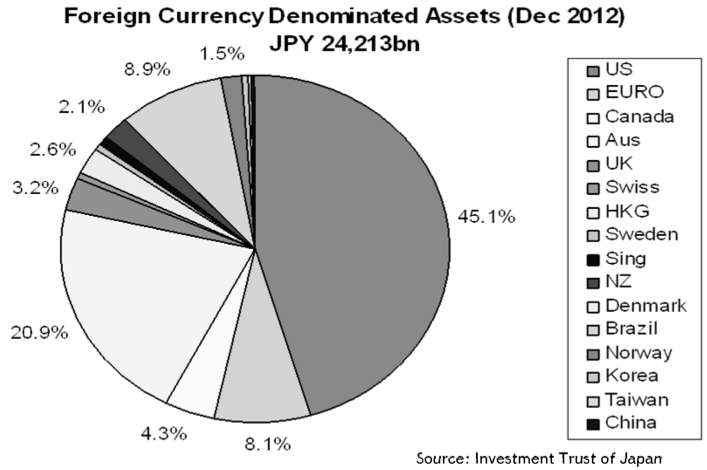


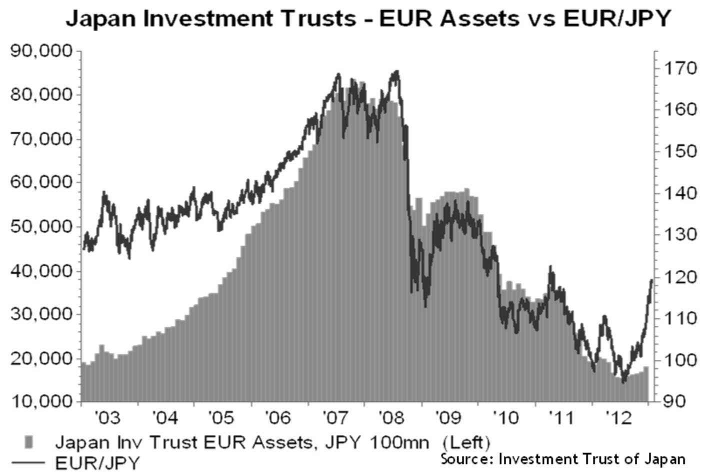
Source : Ministry of Finance



- The favourable demographic situation in Japan has helped underpin the domestic pool of available savings that supported JGB prices. An individual's level of savings is usually highest just before retirement and the portion of the population aged 60-64 in Japan has just peaked.

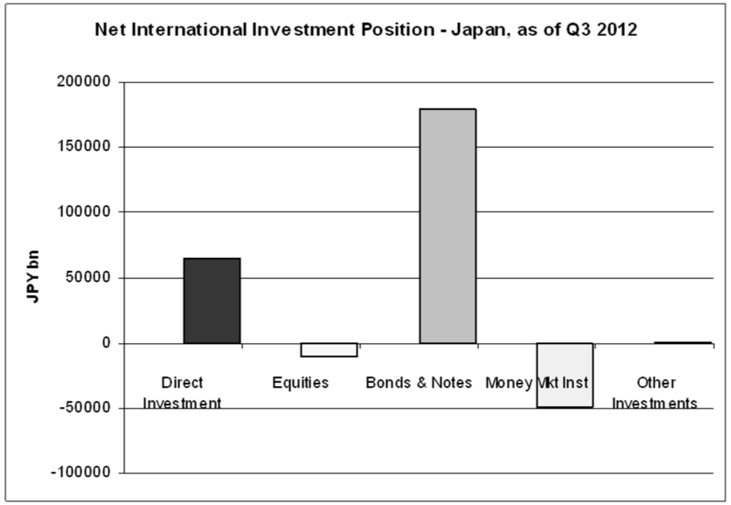
Foreign asset exposure – since the 1998 'big bang', a story of losses!





- The financial crisis triggered a number of consistent trends in Investment Trust flows. Firstly, the demise of the euro in foreign asset holdings from a pre-crisis peak of 26.8% (Q4 '08) to close to a record low of 7.8% in October. The second consequence of the crisis has been the overall decline in foreign currency denominated assets, from about JPY 37trn at the end of 2007 to JPY 24 trillion at the end of 2012, a 35% drop. Big losses underpins risk aversion.

Japan's strong external position supports yen, but turning less strong!



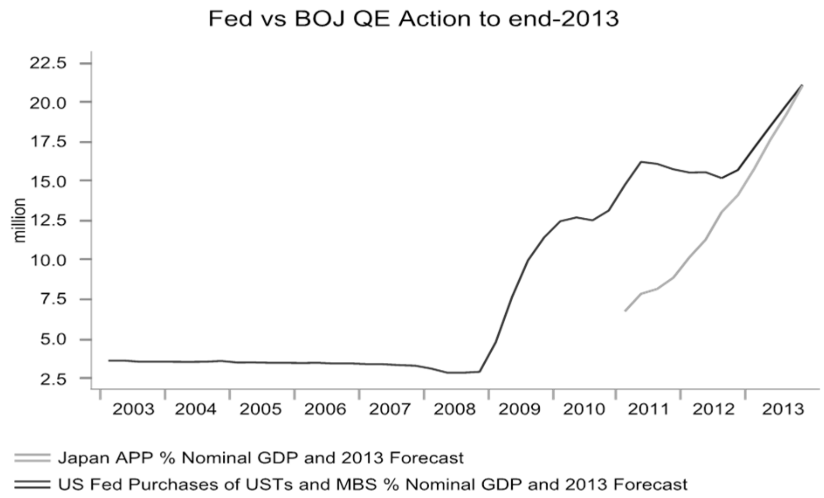
Source : MOF Japan

JPY 100mn	Investment Income Returns		
	FDI	Portfolio	Other
1995	6,282	34,781	1,144
1996	11,953	43,589	2,594
1997	14,642	53,477	2,239
1998	12,978	52,762	5,678
1999	4,342	49,364	11,991
2000	6,081	51,124	7,851
2001	15,433	62,269	6,355
2002	14,439	63,455	4,875
2003	9,431	68,209	5,310
2004	13,674	74,304	4,874
2005	23,063	86,097	4,798
2006	30,338	104,905	2,249
2007	35,656	121,113	6,569
2008	38,116	110,459	9,865
2009	34,602	83,434	5,253
2010	28,513	82,757	5,751
2011	38,135	95,374	6,837

Source : MOF Japan

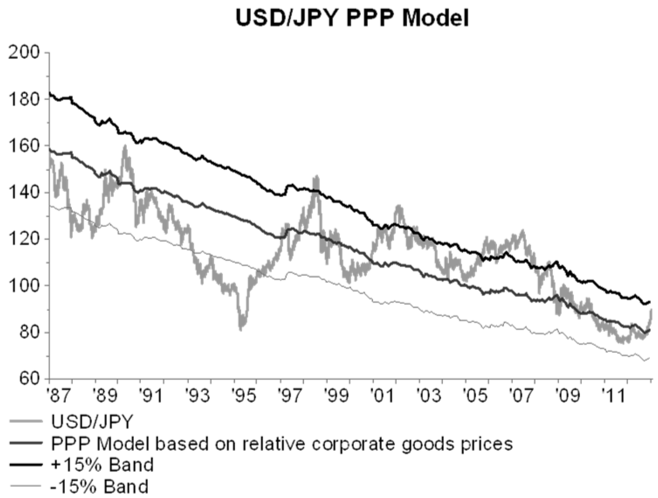
- The investment income surplus for 2012 is on track to surpass the JPY 14,035 billion posted in 2011 – that's about 3.0% of GDP and the 2011 reading was up from JPY 11,702 billion in 2010. Japan's overall net asset investment position stood at JPY 183.2 trillion as of September 2012 (39.5% of GDP). Yields on investments abroad are still higher than yields in Japan, although lower than before the crisis with FDI returns stable to higher.

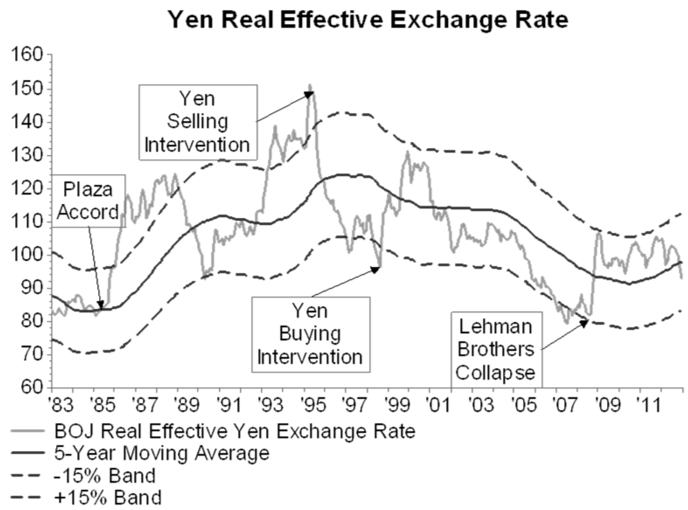
BOJ late to the ‘QE game’ but will catch up this year!



- The BOJ began its asset purchase program in October 2010 committing to purchase JPY 5trn by the end of 2011. The BOJ is now committed to buying JPY 101trn by the end of 2013 – an amount in % GDP terms equivalent to what the US will have purchased by the end of 2013 also – about 21%. For the first time the BOJ is easing on a par with the US and there’s more to come when a new Governor is appointed in April.

Long-term valuation metrics did not suggest excessive yen strength



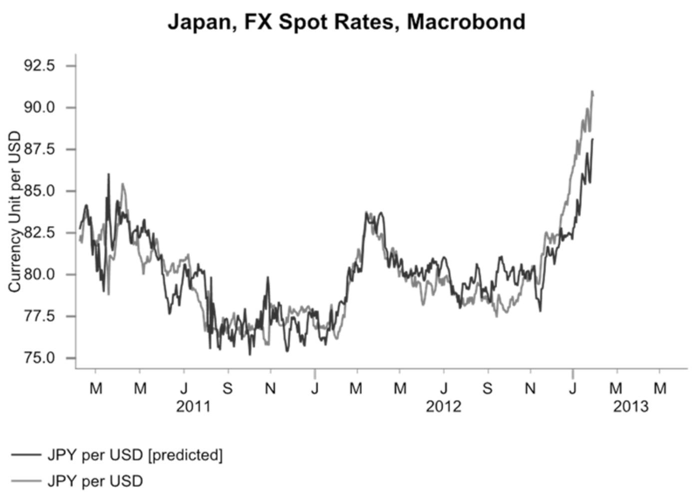


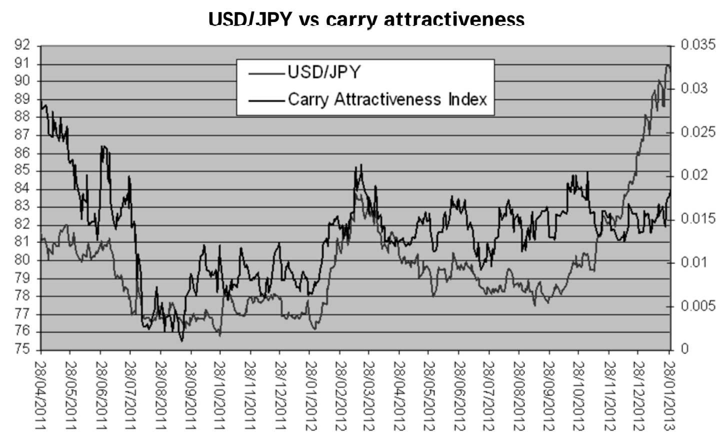
- Our in-house PPP valuation model suggests that the level the yen prior to the sharp depreciation in November/December was around 'fair-value' based on long-term PPI differentials. Our +15% PPP band comes in at 93.40. The real effective level of the yen also suggests no major over-valuation ahead of the sharp sell-off. Prior to the financial crisis, the real effective level of the yen was similar to the level ahead of the Plaza Accord in 1985 and is now below the level when USD/JPY was over 140.00 in 1998 that triggered yen buying intervention by the Japanese authorities.

What's changed now to warrant recent dramatic yen sell-off?

- The Abe impact
  - Driving a change at the BOJ?
  - Fiscal/Tax reform?
  - Concerted effort to 'fight the Fed'
- Shrinking external surpluses
- Easing of euro-zone financial crisis
- Brightening US economic outlook

USD/JPY short-term models suggest some retracement, too early for carry!





Source: Bloomberg & BTMU Calculations

- Our short-term regression models for the yen all indicate yen selling may have recently become over-extended based on previously reliable drivers of yen movements. The key element of the model – yield differentials – have turned – in particular the US-Japan 10-year government bond yield spread. Another driver, 'carry attractiveness' - based on yield return per unit of volatility - remains consistent with USD/JPY back at the mid-80s level.

Disclaimer

All Chart data sourced through Factset or Macrobond unless otherwise stated

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