Daiwa's View

Yen is strengthening at a fast pace

➢ Appreciated by Y7 in two weeks; USD/JPY rate might have hit a peak at a level just below Y140

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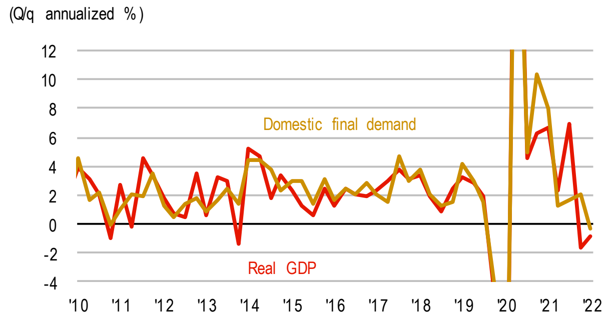
The USD/JPY rate momentarily declined to the mid-Y132 level at the end of last week, and the yen hit the strongest level since 17 June, about one and a half months ago. Apr-Jun US real GDP (released 28 Jul, preliminary) fell 0.9% q/q annualized, posting negative growth following -1.6% in the Jan-Mar quarter. This created concerns about an economic recession, leading to increased selling of the dollar. The yen has strengthened by nearly Y7 against the dollar in the roughly two weeks since 14 July, when the rate logged a high of Y139.38.

Negative growth for two consecutive quarters is considered a 'technical recession.' However, it is not clear whether the National Bureau of Economic Research (NBER) will formally decide that the US economy has entered a recession. The NBER determines the turning points for economic expansions and recessions based on the trends of various economic indicators, such as personal consumption, labor market data, and industrial production, and it puts particular emphasis on employment conditions. In this respect, the labor market is currently solid and private consumption is still increasing. Therefore, it is premature to come to the 'mechanical' conclusion that the US economy has entered a recession based solely on the result of negative growth for two consecutive quarters.

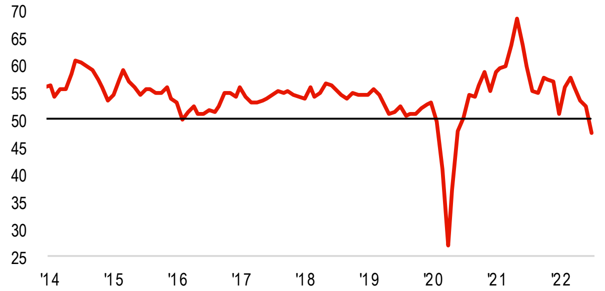
That said, domestic final demand fell 0.3% q/q annualized (up 2.0% in Jan-Mar), the first decline since the outbreak of the COVID-19 pandemic. As such, the momentum of domestic demand has been weakening (Chart 1). In the recently announced US PMI for July (flash data), the services sector index and the composite index fell below 50, the dividing line between economic expansion and contraction. In addition, consumer sentiment has also been cooling, ahead of corporate sentiment. Therefore, it is true that the US economy is steadily approaching a recession (Chart 2).

Chart 1: US Real GDP, Domestic Final Demand



Source: Bureau of Economic Analysis; compiled by Daiwa Securities.

Chart 2: US Composite PMI



Source: Markit; compiled by Daiwa Securities.

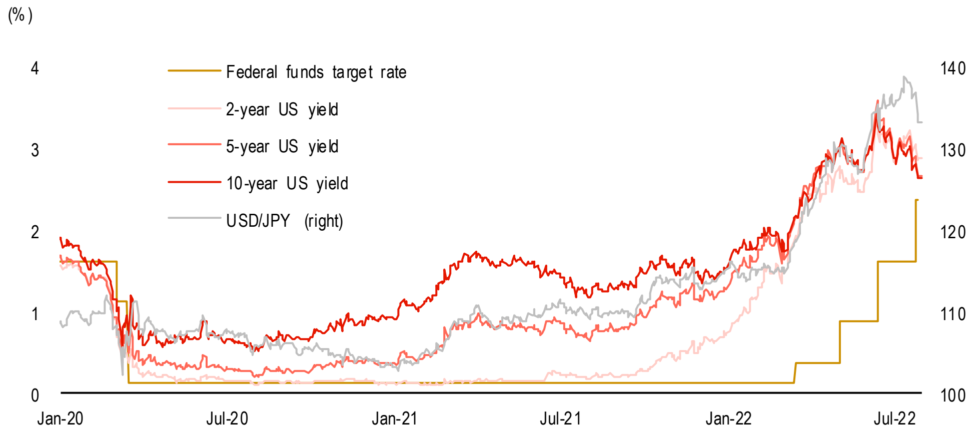
However, the Fed's greatest focus of interest now is inflation. At this point, chances are slim that the Fed would take action indicating a shift towards a dovish stance by the central bank. Price and employment data suggests that broad inflation pressure is continuing, bolstering the outlook that the Fed will continue with rate hikes, moving towards a more restrictive stance.

Moreover, the recovery in risk assets (such as stock prices and high-yield corporate bonds) since the June FOMC meeting is also delaying the shift by the Fed towards a more dovish stance. At this point, the decline in the Chicago Fed's National Financial Conditions Index (NFCI) is only small (in an accommodative direction). However, as the rise in risk assets diminishes the tightening effect with financial conditions, which is essential for taming inflation, the Fed will be forced to continue taking a hawkish stance.

If aggressive rate hikes to rein in inflation cause economic deterioration, and if inflation remains high, the timing of rate cuts could be delayed and dollar appreciation could continue in the forex market. As the market has started to factor in rate cuts from the beginning of 2023, real yields in the short-term/intermediate zone have fallen into negative territory once again. However, these movements in anticipation of the Fed shifting towards a dovish stance at an early stage are somewhat excessive. With the pace of both yen appreciation and the decline in US yields feeling like a 'speeding violation,' we need to brace for a certain degree of swing back in the short term[1].

Meanwhile, the USD/JPY rate might have hit a peak at a level just below Y140. As the Fed is expected to continue raising interest rates in 2022, moves to buy the dollar will probably occasionally take the lead due to the rise in the 2-year yield, which strongly reflects the federal funds rate and trends in current monetary policy, as well as other factors. That said, the market consensus for the terminal rate under the current rate-hike cycle by the Fed has been largely established at around the mid-3% level. Therefore, the US yield uptrend, which has caused the rise in the USD/JPY rate thus far, appears to have almost peaked out[2]. While opinions on the timing vary somewhat, speculation is emerging about rate cuts in 2023. Accordingly, the downtrend in intermediate/long-term yields is likely to continue, and the yen will very likely shift towards appreciation against the dollar.

Chart 3: US Yields, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa Securities.

[1] For details, refer to Decline in US yield to the 2.6% level by Eiichiro Tani *(Daiwa's View* dated 29 Jul 2022*).*
[2] For details, refer to US rates outlook for 2022 (revised) by Eiichiro Tani *(Daiwa's View* dated 28 Jun 2022*).*

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