Daiwa Securities

FX Pulse

Yen depreciation pressure persists even after coordinated Japan-US intervention

- Confidence in Japan's policy management put to the test

Kenta Tadaide
81-3-5555-8466
kenta.tadaide@daiwa.co.jp

Daiwa Securities Co. Ltd.

Confidence in Japan's policy management put to the test

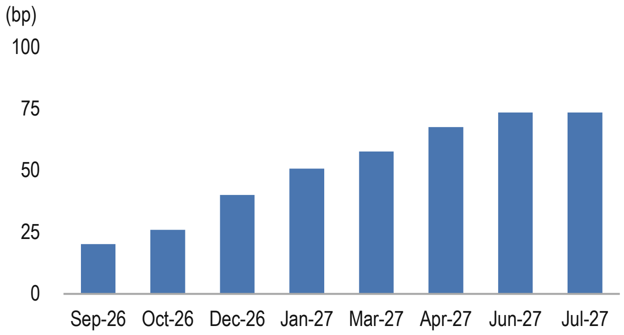
USD/JPY has been capped at around Y159.61, the 50% retracement level between the high of Y163.99 reached before the Japanese government and the BOJ intervened in the forex market on 30 July and the low of Y155.23 recorded on 3 August. In addition to caution over the possibility of further intervention, USD/JPY is likely to face considerable upside resistance as Y160 is viewed as an important psychological threshold and the 100-day moving average is also located at Y159.99. That said, if the pair decisively breaks above the upper Y159 range, a retest of around Y164, the 40-year high reached before the intervention, cannot be ruled out, in line with the market maxim that "a halfway recovery can lead to a full recovery."

In early August, the 38.2% retracement level of Y158.58 acted as resistance. However, after USD/JPY broke above this level on 10 August, it subsequently became a support level, with the exchange rate finding a floor at that level. Slightly below this level is the 200-day moving average of Y158.22, which USD/JPY was able to break below only following the coordinated Japan-US intervention. The exchange rate is therefore likely to remain well supported in the Y158 range. Moreover, support around Y155 is likely to be particularly strong, as USD/JPY was unable to break below this level either during the Golden Week intervention episode or following the extraordinary measure of coordinated Japan-US intervention.

On 10 August, the *Mainichi Shimbun* and Kyodo News reported that a decisive factor behind the extraordinary coordinated Japan-US intervention was BOJ Governor Kazuo Ueda's statement at his 31 July press conference that the BOJ "could accelerate the pace of rate hikes," which strongly suggested the possibility of an early rate hike from September onward. The market has fully priced in a rate hike by October, while the market-implied probability of a September hike has risen above 80% (Chart 1). Market expectations regarding the pace of rate hikes have also shifted from one hike every six months to one every three to four months, with approximately three rate hikes priced in by June 2027.

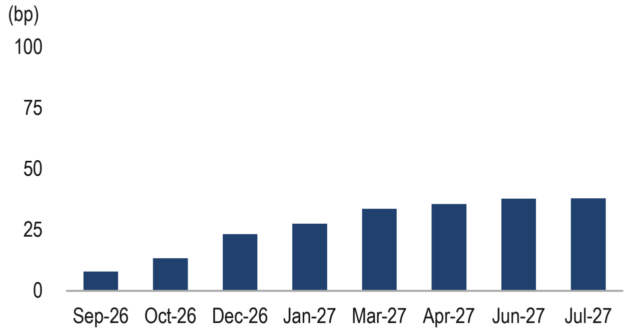
Meanwhile, the July US Consumer Price Index (CPI) was in line with market expectations, while the July US Producer Price Index (PPI) came in below market expectations, easing concerns about a renewed acceleration in inflation. Following these releases, market expectations of a rate hike at the September FOMC meeting receded (Chart 2). Both the CPI and PPI have begun to show price increases in categories associated with the AI investment boom, and it will take time to assess the inflationary pressure generated by AI-related demand. Neither release provided sufficiently conclusive evidence to determine the course of monetary policy, and the August data will also need to be assessed. The weak July US jobs report further suggests that the likelihood of a September rate hike has declined.

Chart 1: Cumulative BOJ Rate Hike Expectations (as of 14 Aug)



Source: Bloomberg; compiled by Daiwa.

Chart 2: Cumulative Fed Rate Hike Expectations (as of 14 Aug)



Source: Bloomberg; compiled by Daiwa.

Despite several yen-supportive factors, including diminishing expectations of an early Fed rate hike and the market pricing in a faster pace of BOJ rate hikes, USD/JPY has remained on a recovery trend. This appears to reflect constraints on the authorities' ability to implement measures to correct the yen's depreciation, including the limited scope for further intervention, as well as market skepticism about whether the BOJ will continue raising interest rates. More fundamentally, the persistence of upward pressure on the yen risk premium appears to reflect declining confidence in Japan's policy management.

On 10 August, Minister of State for Economic and Fiscal Policy Minoru Kiuchi emphasized that if the Takaichi administration's policy of "responsible and proactive fiscal policy" strengthened Japan's supply capacity and productivity, thereby increasing investment in Japan and yen-denominated assets, demand for the yen would naturally rise. He stated that he did "not believe the yen's depreciation will continue" and that the policy "could instead exert upward pressure on the yen." However, the market remains concerned that proactive fiscal policy could lead to increased JGB issuance and stronger inflationary pressure, potentially intensifying downward pressure on the yen instead. At the very least, these comments are unlikely to restore market confidence in the yen in the near term.

Meanwhile, Bloomberg reported on 13 August, citing government officials, that the government supported an early rate hike in order to preserve the effects of the coordinated Japan-US intervention and that the BOJ was considering raising its policy rate at its September or October Monetary Policy Meeting. However, because the market had already been strongly focused on the prospect of a September rate hike, the report also appeared to suggest that the hike might come in October rather than September. As a result, the market apparently did not interpret the report as a clear indication that the government was actively supporting the BOJ's policy normalization.

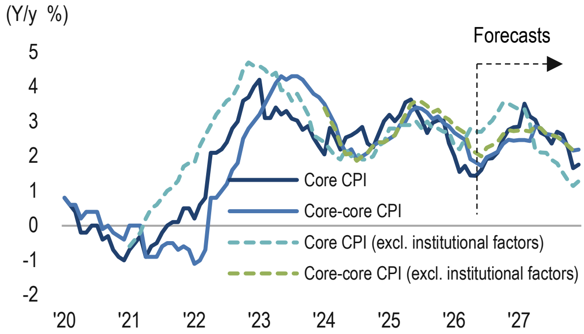
The yen's depreciation reflects not only concerns about delays in the BOJ's policy normalization and fiscal expansion, but also the resultant increase in market doubts about policy coherence between the government and the BOJ. However, there has still been only limited progress toward dispelling these concerns and restoring market confidence in Japan's policy management. If this remains the case, forex intervention and expectations of rate hikes alone are unlikely to fundamentally reverse the market trend.

If the BOJ proceeds with policy normalization at the pace currently priced in by the market and inflation slows as projected, the real policy rate is expected to move considerably closer to the natural rate of interest by around next spring (Charts 3 and 4). In that event, speculative pressure for yen depreciation should ease, and some of the factors that have supported the yen's excessive weakness could begin to dissipate. However, there are concerns that government interference may prevent the BOJ from raising interest rates as intended, while the inflation outlook is also subject to considerable uncertainty. What the forex market is seeking is not merely expectations of rate hikes, but evidence that the real policy rate is actually returning toward its neutral level. Until clearer evidence of such progress emerges, downward pressure on the yen is likely to remain persistent.

Chart 3: Japan's Real Policy Interest Rate

Source: BOJ; compiled by Daiwa.
Note: Nominal rate – Y/y core CPI (excl. fresh food and institutional factors).

Chart 4: Japan's CPI Forecasts



Source: Ministry of Internal Affairs and Communications; compiled by Daiwa.

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Investment Management Association of Japan, Type II Financial Instruments Firms Association, Japan Security Token Offering Association