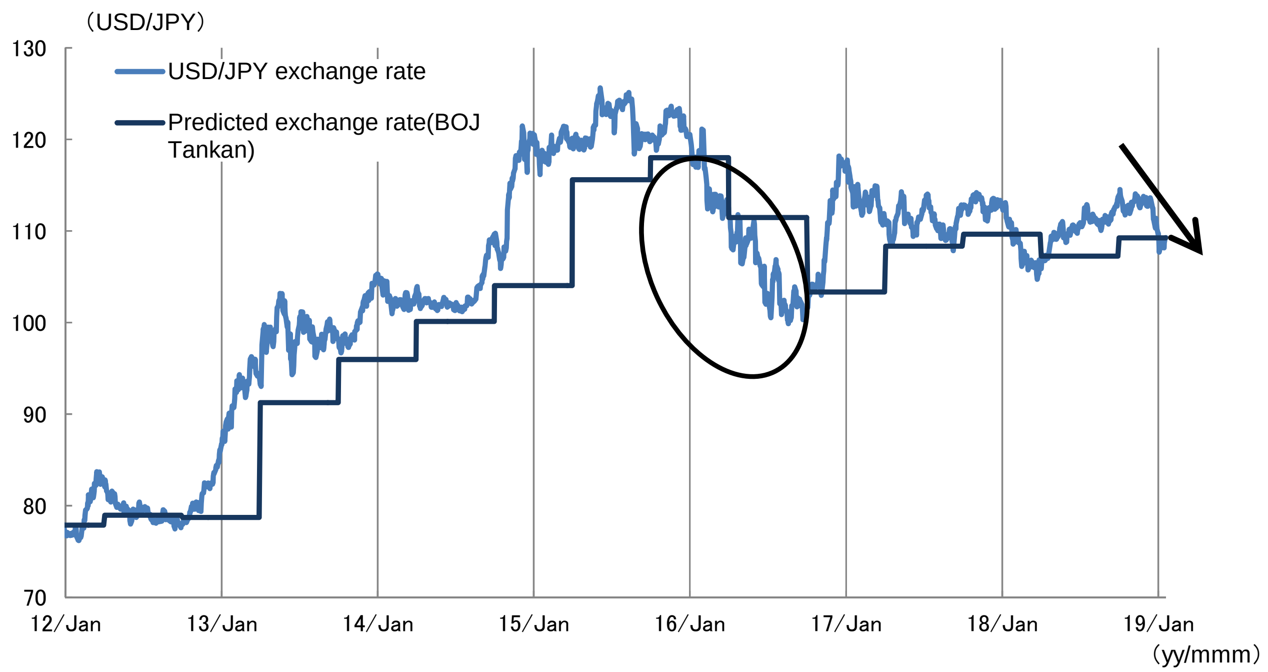
Market Insight **January 10, 2019**

Risk of sharp appreciation of the yen ← contraction in US-Japan interest rate spread + trade concerns

Hajime Takata, Chief Economist

2018 was a tumultuous year in both Japan and overseas, yet the foreign exchange markets were surprisingly stable. The range of fluctuation in Japan-US exchange rate movements was less than 10 yen, which was the lowest range since the floating exchange rate regime came into effect in 1973. This lack of movement despite the various events throughout the year indicates a buildup in the potential for future movements. The constant appreciation of the yen since the beginning of the year also suggests that this potential is starting to be unleashed. Since the end of 2018, we reported on concerns about a return to 2016. The conditions since the beginning of 2019 have only strengthened such concerns. **Chart 1** illustrates the predicted exchange rates of large enterprises (manufacturing) and the actual exchange rate movements. An achievements of Abenomics since 2012 stems from the virtuous cycle for stronger stock prices due to the weaker than predicted exchange rate for the yen. To put this another way, stagnation since the burst of the Heisei bubble caused a vicious cycle of an excessively strong yen and asset

[Chart 1: USD/JPY exchange rate and the predicted exchange rate]

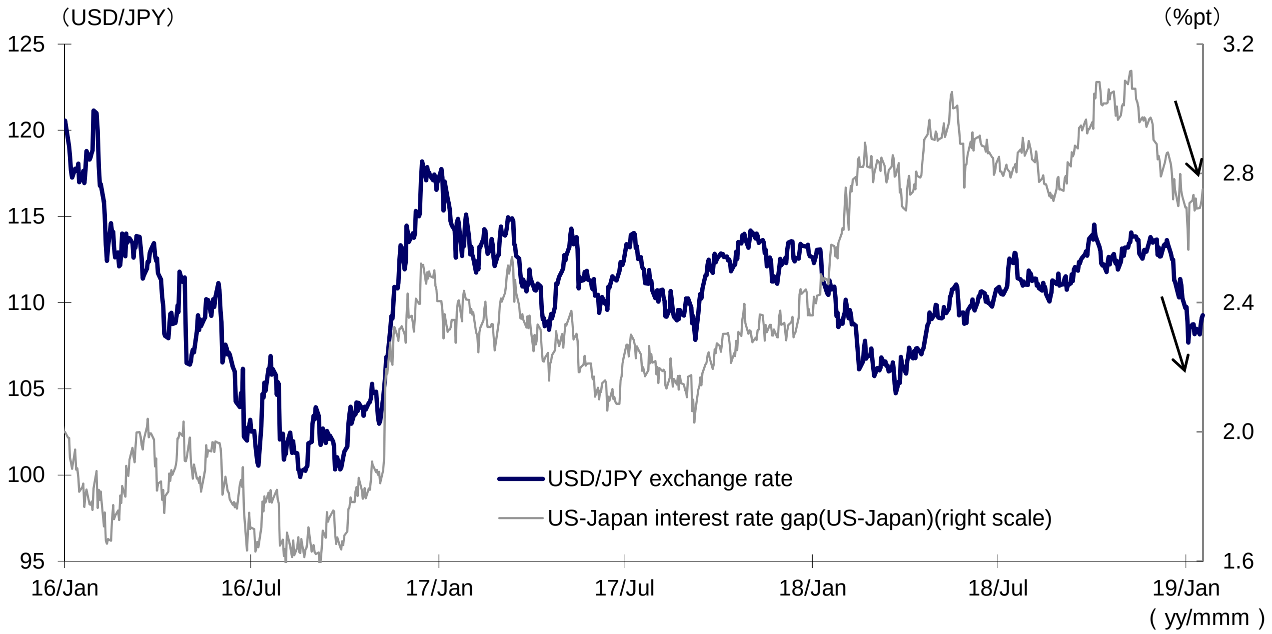


Note: The predicted exchange rate is taken from the Bank of Japan, *Short-term Economic Survey of Enterprises in Japan* (*TANKAN*), large enterprises (manufacturing) base. The first half refers to the predicted exchange rate in the June survey, while the second half refers to the December survey.

Source: Made by MHRI based upon Bank of Japan and Datastream deflation, whereas Abenomics successfully turned around this vicious cycle of an excessively strong yen and weak stock prices through ultra-accommodative monetary policy. The virtuous cycle since 2012 was first disrupted in 2016, yet there was a reversal with the dawn of the Trump administration at the end of 2016. Nevertheless, the predicted exchange rate for the second half of FY2018 was 109.26 yen and the market has been below this level since the beginning of 2019. The biggest risk scenario for 2019 is that the virtuous cycle will be disrupted as it was in 2016 due to an excessively strong yen. Expectations for US interest rate hikes have changed with the deterioration in the global economy while the decline in US long-term interest rates has led to a sharp contraction in the US-Japan interest rate spread.

The US Fed hiked interest rates for the ninth time on December 19, but of most interest to the writer was the additional comments in the FOMC statement: "*The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.*" Similar comments have not been seen since January 2016. The Fed hiked interest rates for the first time following the Lehman shock in December 2015 and the market had anticipated successive interest rate hikes in 2016. However, the Fed substantially undermined the market in January 2016. At the time, the Fed put the brakes on interest rate hikes due to the slowdown in the Chinese economy, the sharp drop in the price of crude oil as well as lower stock prices and the weak credit markets . There are many similarities with the current conditions. **Chart 2** illustrates the movement in the US-Japan interest rate spread and the USD/JPY exchange rate. 10-year US Treasury yields have plummeted since the beginning of the year and even dipped to the 2.5% level. Yields in the short-term zone also priced in the next move by the Fed to be an interest

[Chart 2: US-Japan interest rate spread (10-year government bonds) and USD/JPY exchange rate]



Source: Made by MHRI based upon Bloomberg rate cut. The decline in US long-term yields since last year caused the US-Japan interest rate spread to contract and exacerbated the risk of a stronger yen, which has been considered the biggest risk for the Japanese economy in 2019 and this risk is now becoming a reality. Furthermore, the instability in domestic and overseas credit markets that exacerbates the degree of market fluctuations also needs to be monitored.

Chart 3 compares the economic conditions in 2015 to 2016 with today. The appreciation of the yen since the beginning of the year means all five conditions are the same. The risk of a return to 2016 appears to be becoming a reality.

[Chart 3: Comparison of the factors causing economic slowdown in 2015 to 2016 with the current conditions]

Factors causing economic slowdown	Current conditions
Stagnant Chinese economy	Slowdown in the Chinese economy (entering a period of stagnation)
Deterioration in IT cycle	Growth in semiconductor sales has turned to a slowdown
Plummeting oil prices	Recent plunge in oil prices
Weak dollar (from 120 yen to 100 yen)	Weak dollar since the end of 2018
European political instability (Brexit decision)	Instability in the UK, Italy and Germany, etc.

Source: Made by MHRI