

The Rising Yen—A View from Tokyo

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Last Thursday, the yen surged to an intraday high of ¥107.67, a level that effectively erases all of the yen's depreciation since "Kuroda's Halloween surprise" in late October 2014 (when the Bank of Japan (BOJ) unexpectedly stepped up its quantitative easing (QE) program). **From a Japanese perspective, the major forces for this reversal of fortune are:**

- Perceptions that BOJ monetary policy has reached its limit: negative rates have backfired and forced a "risk-off" rather than "risk-on" response from domestic and global investors. Specifically, the tax on deposits is raising fears of margin squeezes in the banking system, which in turn triggered a rush to lock in profits on global or local risk asset investments. This is true for portfolio securities as well as retained earnings from U.S. operations. In short: repatriation flows.
- Perceptions that U.S. growth is weakening, with Fed chair Janet Yellen reported to delay further interest rate hikes. Moreover, here in Japan the relative weakness in U.S. car sales from January to March is seen as a potential leading indicator for more weakness to come. Either way, Japanese investors now expect no added rate hike this year, with several pro desks of the mega-banks happy to speculate that the next Fed move will be down, not up.
- Perceptions that global country risk is rising, which manifests itself in rising "home country/home currency bias" across global savers.
- Perceptions that both G7 and G20 policy makers have reached a new powerful consensus that seeks to minimize the risk of currency wars and competitive depreciations in general, and Chinese devaluation in particular. While this does not have a direct impact on currency flows, it significantly changes perceptions about possible policy tools—in Tokyo, everyone believes it has become impossible for the Ministry of Finance to intervene to stop yen appreciation (so once flows and momentum change, speculators see the potential for an unlimited "bet").

As always with currencies, many complex forces come together; but now momentum has reversed by so much that the vast majority of portfolio managers and CIOs here in Tokyo appear to expect further yen strength ahead. In contrast, by the end of 2015, a vast majority was comfortable predicting dollar strength as a key thematic for this year. In my personal view, the contrarian indicators appear to have swung from one extreme to the other. This should build a base for the next cycle of yen depreciation before long. Ultimately, the BOJ holds the key to the yen's next move. We do not expect added forays into deeper negative rate territory, but do expect rising visibility of capital outflows from Japan, as the reality of negative rates begins to feed portfolio reallocations. Greater clarity on the U.S. economic and policy outlook is the other key element.

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