CitiFX Strategy Weekly | July 13, 2017

CitiFX Weekly: $/¥: To buy or not to buy, that is the question

In this week's issue:

- While a short-term correction in USDJPY can materialize, the overall trend here is now higher and a break through the recent high at 114.37 can open the way towards 119-120 over the medium term. JPY weakness, in our view, is likely to be driven by the below factors:
- The BoJ is determined to maintain accommodative policy and the JPY NEER is not at levels where the BoJ is likely to tighten. We suspect the Fed and the ECB will in fact welcome this to keep the global Fixed Income selloff from accelerating even further
- This is likely to keep JPY under pressure, especially as US yields may be setting up for an upside break which could lead to USD appreciation
- We expect a recovery in investors' risk preference backed by the strength of equities to encourage hedging operation to sell the Yen by domestic and overseas real money investors

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$/¥: To buy or not to buy, that is the question

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- While a short-term correction in USDJPY can materialize, the overall trend here is now higher and a break through the recent high at 114.37 can open the way towards 119-120 over the medium term. JPY weakness, in our view, is likely to be driven by the below factors:

- The BoJ is determined to maintain accommodative policy and the JPY NEER is not at levels where the BoJ is likely to tighten. We suspect the Fed and the ECB will in fact welcome this to keep the global Fixed Income selloff from accelerating even further.

- This is likely to keep JPY under pressure, especially as US yields may be setting up for an upside break which could lead to USD appreciation.

- We expect a recovery in investors' risk preference backed by the strength of equities to encourage hedging operation to sell the Yen by domestic and overseas real money investors.

In the near term, USDJPY could correct to 112, but we expect it to then return to an uptrend and to rise beyond its recent high at 114, while it remains soft against EUR and CAD as well.

Our original outlook for USDJPY this year was for a fall from 118 to around 108 in Q1 followed by a range formation around 110 in 2Q and 3Q, and then a return to a long-term uptrend that takes it above 115 in 4Q. However, we now think that the trend we had expected in 4Q may be emerging earlier than thought for four reasons below.

The first reason is the growing monetary policy gap to the rest of the world. The Fed is likely to start the B/S normalization process in September, and the ECB and the BoE have recently expressed their willingness to lessen monetary accommodation. The BoC hiked rates this week for the first time in the last seven years. On the other hand, with its fixed-rate operations implemented last Friday, the BoJ has shown its strong intention to maintain the present yield curve target and thereby distinguishes itself from its overseas counterparts.

Some investors may assume that the Fed and ECB would be dissatisfied with the BoJ's accommodative policy, but we totally disagree with such a view. The reason is that if the BoJ were to tighten monetary policy and Japanese interest rates started to rise, world interest rates would lose their anchor opening the risk of an unexpectedly large increases in US and European bond yields. This could ultimately result in the failure of the Fed's and the ECB's exit strategies. As such, we believe **the other central banks are, as a matter of a fact, welcoming the BoJ's accommodative policy to continue.**

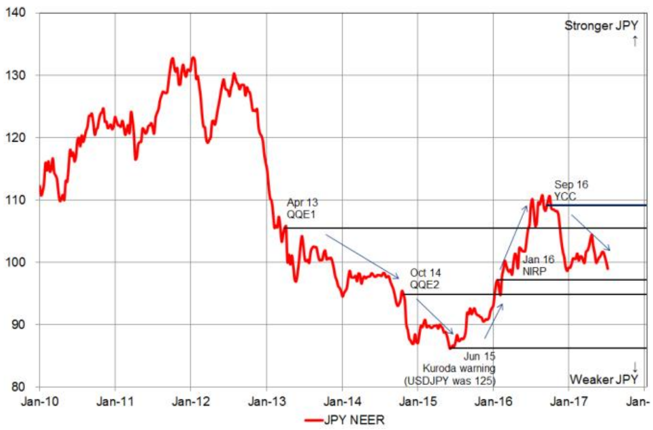
The second reason is the JPY NEER (Nominal Effective Exchange Rate). The recent weakness of JPY relative to EUR and AUD means the NEER has weakened levels seen when USDJPY was at 118 late last year (Figure 1). For the BoJ to initiate policy tightening, we suspect it would need to decline below the level that it was at when the Bank introduced the NIRP (Negative Interest Rate Policy) last January. That level is an important watershed which also equates to the level when the BoJ introduced the QQE2 in Oct 2014. For us it's apparent that the Japanese central bank had an intention to depreciate its currency or depress its appreciation.

In addition, the current depreciation in the JPY is mainly on cross rates such as EURJPY, while USDJPY has recently rebounded to 114 but is still below the 118 high of early 2017. This has a political importance, because JPY depreciation against the USD can easily escalate into a diplomatic issue between the two nations across the Pacific. But **JPY weakness against EUR is neither an economic nor political problem** while Japan's trade with Europe accounts for no more than 15% of the total.

The third reason is subdued oil prices. In the long term, low oil prices are positive for the JPY via improvement in Japan's trade balance. However, in the near term they depress the BEI (Break-even Inflation) in the US bond markets, so real US interest rates could be bolstered even if nominal yields are constant. This is expected to be a tailwind for USDJPY in the near term, which has become more correlated with real yield spreads over recent years rather than nominal yield spreads (Figure 2).

The final reason is the recent strength of the investors' risk preference globally. The Nikkei 225 remains firmly above 20,000, so overseas real money investors who invest in Japanese equity markets are likely to increase their sales of JPY to keep FX positions neutral. In addition, there are now signs that USDJPY basis can stop shrinking. We expect some real money investors to seek yield enhancements by shifting to FX-hedged investment in Japanese equities to enjoy USD premium in the swap market, and this will also result in JPY selling against USD in the spot market. Japanese long-term investors like lifers would join them while risk tolerance recovery, coupled with wider basis and prospect for the Fed tightening, will be encouraging them to reduce their hedge ratios.

Figure 1. JPY NEER



Source: BoJ, CitiFX

Figure 2. USDJPY & US/Japan real interest rate (TIPS yield) spread

Source: Bloomberg, Citi FX

To examine this more closely we look at a relative equity signal to trade USDJPY using the NKY. Given the strong positive correlation between USDJPY and NKY our signal is to be long USDJPY when the NKY is above its 3m moving average and short otherwise. The signal is executed the following day at London 4pm WMR fixing and includes transaction costs and carry. We find that the signal has performed well over a long period of time and currently points to further USDJPY upside as investors take advantage of the rising equity market while being currency neutral.

Figure 3. Correlations between Weekly Changes in Nikkei Index and JPY-crosses

	1Y	5Y	10Y
USDJPY	69%	62%	56%
EURJPY	65%	41%	49%
GBPJPY	52%	54%	54%
CHFJPY	68%	28%	37%
CADJPY	63%	58%	57%
AUDJPY	59%	54%	60%
NZDJPY	47%	47%	54%
NOKJPY	65%	47%	52%
SEKJPY	65%	42%	48%

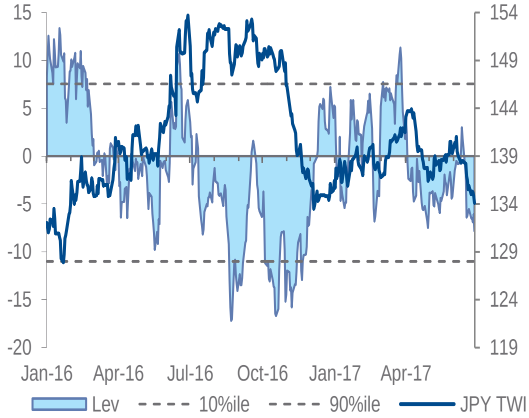
Source: Bloomberg, Citi FX, Sample Jan-06—Jun17

Figure 4. Cumulative Return in Trading NKY Relative Equity Signal (200dMA Crossover) in USDJPY

Source: Bloomberg, Citi FX, Sample Jan-04—Jun17

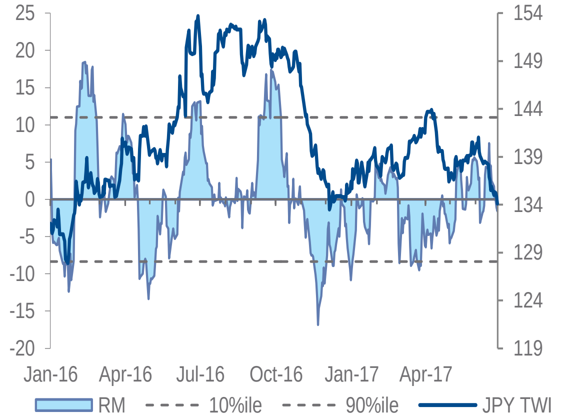
Furthermore looking at our flow data we see there is plenty of room for USDJPY to potentially move higher, and this will likely be driven by the divergence between hedge funds and real money flows. We see that Leveraged investors have turned into sellers of JPY in the recent weeks while Real Money have also reduced their longs to neutral levels. If risk appetite remains stable then the increased selling of JPY from Real Money hedging should see their flow turn further negative and follow hedge funds in adding to JPY downside.

Figure 5. Net JPY 4-week Flow: Leveraged Investors



Source: Citi FX, Sample Jan-16—Jun17

Figure 6. Net JPY 4-week Flow: Real Money Investors



Source: Citi FX, Sample Jan-16—Jun17

Looking at the technicals…

Figure 7. USDJPY Weekly

Source: Aspen Graphics/Bloomberg 07.13.17

On USDJPY, we have a potential double bottom with a neckline at 114.37 that targets 119.61, in line with a re-test of the trend highs. A weekly close above the neck line would be needed to confirm the pattern. This setup is developing off key support at the 55 week moving average (currently 109.30). We would also expect this level to hold on any corrections lower (see arrows) though our current bias is a dip that deep is unlikely. With respect to risk more broadly, we've recently had a bearish break on Gold which to us suggests that investors now have a (relatively) higher appetite for risk and this should be supportive of a move higher in cross-JPY. We are also on the cusp of breaks on US nominal yields, which if they were to occur, would suggest an accelerated move higher in US yields.

Figure 8. US 5 & 10 year yields

Source: Aspen Graphics/Bloomberg 07.13.17

The pattern in the US 5 year yield seen since December clearly looks like a consolidation before another move higher. A close above resistance at 1.95% would confirm a double bottom and ultimately argue for a move to 2.20% with good interim resistance coming in at 2.15%, the trend high seen in March. On US 10 year yields, we have another meaningful resistance level nearby at 2.42%. A weekly close above there would also suggest extended gains back towards the 2.63-2.64% trend highs. If we were to see an accelerated move higher in US nominal yields (our bias), it would most certainly put upward pressure on USDJPY as differentials move in favor of the USD.

This week's highlights

BoC cycle will pull CAD buyers from the sidelines – Link

We have been constructive on CAD previously targeting 1.25 for USDCAD. Today's shift in policy further support the thesis, and could gain further traction in the coming weeks. We expect USDCAD to move toward 1.20 in the next six months.

We should see a steeper curve into 2018/2019 and more follow-through in CAD FX. As long oil does move significantly lower, rate differentials (and policy expectations) should be the primary driver for CAD. Therefore data will be important, and given the BoC downplayed near term relevance in inflation prints, real variables will matter most (retail sales, GDP, jobs)…

Ran Ren

Weekly Roundup: The Great Brexit Pounding – Link

Historical dynamics continue to suggest that GBPUSD could see levels in the area of 1.05-1.07 over the medium term. Interim supports are nearby at 1.2110 and 1.1880 ahead of this. Although we continue to believe that the USD is likely to rally from here, we also think that any meaningful move lower in GBPUSD will largely be driven by broad based GBP weakness as a result of "Brexit uncertainty" and poor economic data.

As illustrated in the UK Economic Surprise Index, UK data has continued to come in under expectations. Adding to those concerns is the fact that these downside surprises have largely been driven by deteriorating data, not overly exuberant expectations and our Techamentals suggest this trend is likely to continue. If we were to see a continuation, this should spell trouble for the GBP and it should help drive UK yields lower.

CitiFX Technicals

End of Japanese investors' repatriation – Link

According to balance of payments data for May that the MoF released this morning, the current account surplus (after seasonal adjustments) decreased to JPY 1,400bn from JPY 1,807bn in April, while the median expectation was JPY 1,629bn (Figure1). Though the CA has shown a surprising resilience with the recovering export volume as the main driver, it is eventually deteriorating as the recovery in the oil and other commodity prices, though it's very gradual, are being passed to Japan's import prices (Figure2). Consequently the trade account in May fell in a deficit of JPY 115bn.

Osamu Takashima

What USD price action tells us about Yellen and CPI – Link

The weak side on today's testimony by FOMC Chairman Yellen and the later CPI is on the downside for the dollar. Overnight price action shows that investor sensitivity to more dovish outcomes outstrips that to hawkish ones. Asymmetric response to Fed speak appears to reflect the impact of softer underlying data flow. A stronger CPI could begin to change the narrative on recent weaker price pressure, but this would likely be a slow process, so the USD remains vulnerable. As such, we favor short positions on USD approaching the releases.

Todd Elmer

Alert: FX Funds Flip to Short EM – Link

Currency managers on the CitiFX Access platform have gone short EM FX for the first time since the start of 2017. Their conviction in EM has faltered relatively quickly over the last month, with the EM Positioning Indicator having fallen from +1 (1x previous average position) to -0.25 currently. FX funds' aggregate positon in emerging markets FX can be useful for determining the future performance of EMFX. In fact, we can use the EMFX positioning indicator to filter out periods of under-performance in a passive EM carry strategy. The current signal from such a strategy is to be short EMFX.

CitiFX Quant

Tuesday snapshot: Deja vu for Kiwi – Link

The NZD fall is now gaining momentum and some decent technical setups on NZDUSD and AUDNZD are coming into play. NZDUSD has formed a short term double top after a 7.7% rally that looks very similar to those seen in July-September last year and December – February. It should fall to 0.7160 in the short term, then to just below 0.71, and possibly even lower over time. AUDNZD is rallying through the channel top today. We have a level at 1.0552 which should be watched closely - it is the reverse head and shoulder neckline and a close above there should open the way for a rally to 1.0740.

CitiFX Technicals

Hedge Funds Buy EUR, Sell GBP… Will Real Money Follow? – Link

This week we look at the divergence between investor behavior in EUR and GBP. As the Chart of the Week below illustrates, hedge funds have been consistent net buyers of EUR while real money has sold. GBP, on the other hand, has seen the opposite with real money buying but leveraged accounts flat sterling.

Therefore, recent gains in EURGBP have been primarily driven by leveraged flows which opens up the possibility of whether real money will follow. We note that historically a split in investor flows can be a good signal to follow the direction of leveraged accounts. In this case, this favors long EURGBP which is also a position for our G10 Strategy team

CitiFX Global Flows

Why weak wages hasn't hit the USD – Link

Jobs data encourages the move higher in core yields. Subsequent USD performance suggests markets are weighing more heavily the growth signal and length of the cycle. FX follow-through depends more on data next week than Fed speak. We continue to favor long EUR expressions but short-term outperformance may be better targeted short GBP, CHF or JPY.

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Week ahead – ECB, BOJ, UK CPI/Retail, CA CPI/Retail, AU Jobs, NZ CPI

North America

Only secondary data on US calendar next week. Housing data is on Wednesday and some survey indicators are released. On politics, the US will announce the objectives on the Nafta negotiations around July 17th. Following through from CPI and development on the political front should be major drivers.

CPI and retail sales by end of week will be important release for Canada. The Bank of Canada downplayed the relevance of short term inflation so real variables will matter the most (link). If strong it could reinforce the expectation of a hiking cycle at the BoC.

Ran Ren

Europe

The ECB is the main event in Europe next week and concentration is language surrounding asset purchases. We expect the July press conference to be light on details and largely talking up the economy. EUR FX, equities and rates have arguably tightened financial conditions since June. Still, the influence on the policy trajectory seems quite modest such that policymakers would have a hard time pushing back against it credibly. This mutes downside risks for EUR over the ECB.

Inflation data is released in the UK alongside retail sales. BRC retail sales were supported but in part due to higher food prices. The ONS measure is a 'real' series, rather than nominal such that price effects should have a smaller impact. Better numbers on either could push markets to price greater hike risk for November, with August largely seen as a pass.

Finally the Riksbank releases minutes from the July policy meeting where the rate path removed the easing bias but left the first hike in mid-2018. Comments around reinvestment and inflation are most relevant. We see limited scope for the event to be a material FX influence. While the long SEK theme is strengthening, absence of more material catalysts should slow the pace of recent appreciation.

Josh O'Byrne

Asia

The BoJ will hold the monetary policy meeting on July 19-20, where the Bank is broadly expected to leave its policy unchanged. The updated outlook report will be submitted to the board and the Bank is expected to upgrade the economic assessment more or less given Kuroda's remark at the branch chief meeting this Monday that suggested a bit more optimistic view on the economy. In the regional economic report, or the "Sakura" report, submitted to the Monday meeting, the five districts out of nine strengthened the assessment for each district economy. Nevertheless, given the lackluster inflation developments, the BoJ is quite unlikely to make any significant step toward a monetary tightening following the other G5 central banks in the near future. At the press conference following the board meeting, BoJ Governor Haruhiko Kuroda will likely emphasize his strong will to maintain the target for the yield curve at the present level, using the fixed-rate purchase operation, or the “Sasine” operation if necessary.

According to the BoJ website, no official’s speech is scheduled besides Kuroda’s press conference next week. The Cabinet Office is scheduled to release its monthly economic report on Wednesday. The Custom Office will publish the trade data for Jun on Thursday, and the median expectation for the trade surplus (after seasonal adjustments) is a marginal decrease to JPY 116bn from JPY 133bn in May.

Australia jobs and New Zealand CPI are the highlights in Oceania. On the former, small pull back is expected after the staller print last time. RBNZ’s inflation projection lags behind that by private economists. Continued strength could increase topside risk that the RBNZ will shift rhetoric.

Osamu Takashima

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