Amplifying Global FX Capital

November 2, 2015

BoJ and ECB open door for lower EUR/JPY

In the last two weeks the ECB has taken steps towards more monetary easing and the BoJ has taken a step back. This has resulted in a further fall in the rates spread to a record low for the EUR/JPY. The cross does not look cheap on a longer term perspective and we see a higher risk of a significant fall over the next few months. A short strategy in this pair has the advantage of being less-affected by developments in the US economy that may cause sharp moves in the USD, such as over the payrolls report this week.

Contrasting central bank steps

On Friday, the BoJ held policy unchanged at its major semi-annual forecasting round, suggesting policy is likely to remain stable for the foreseeable future and less responsive to events over the next six months. A week earlier, the ECB said it was likely to expand its monetary easing at its next quarterly forecasting round on 3 December to bolster its forecast for achieving 2% inflation over the medium term. This contrast suggests scope for EUR/JPY to fall further. As a strategy it has the advantage of being little affected by developments in the US that might influence the USD or global risk appetite.

While the BoJ is still conducting an aggressive policy easing which given enough time may generate the inflation it intends, the BoJ actions last week contrast from the actions it took a year ago and the actions that appear to be intended by the ECB next month.

The ECB plans to respond to lower oil prices and weaker emerging market growth. The BoJ has instead lowered its near term inflation and growth forecasts and decided to treat lower oil prices as a transitory effect that it can look through. Kuroda has moved forward the expected date for reaching his inflation target by effectively six months to March 2017. This embodies greater risk that a more sustained period of sub-target inflation reduces inflation expectations, dampens spending and wage growth, raises real interest rates and sends the BoJ off course in pursuit of rising inflation.

The BoJ's Kuroda may feel he has achieved a rising inflation trend and he does not need to respond with further policy easing at this time, promising to still act further if required. Nevertheless, the events over the last two weeks shifts the path of policy outlooks towards more easing at the ECB and less at the BoJ. This may result in further significant downside in EUR/JPY in the next few months.

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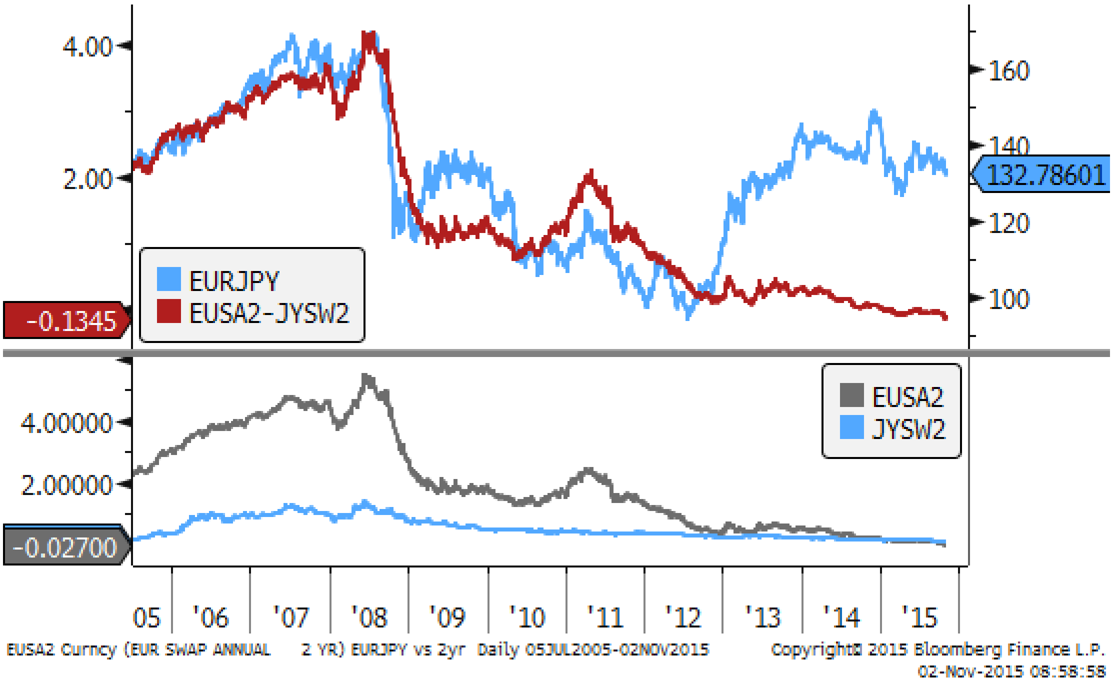
The rates spreads between the two currencies reflect this development. The ECB is expected to further reduce its deposit rate (effective floor rate for money market rates) deeper into negative territory from -0.2%, along with expansion and extention of its asset purchase plan. The BoJ has long targeted cash rates at +0.1%. The 2-year swap rate spread between the two countries fell to a new record low, driven by a significant fall in Eurozone 2yr swap rates now below zero. The chart below shows the 2yr swap rates, the spread and currency pair.

The connection between the rate spread and the currency pair has not been particularly strong since the BoJ established its QE policy in 2013, but with the ECB now ensconced in a similar policy with the added aspect of negative rates, the EUR/JPY does not appear particularly cheap on a longer term scale.

EUR/JPY and 2yr swap rate spread



The decision by Kuroda not to further ease policy at this time leans on his assessment that he can see progress in the domestic economy whereby rising company profits and a tightening labour market have lifted wage growth in the last year and generated higher inflation expectations and price-setting behaviour.

The Bank's preferred underlying inflation indicator, CPI less fresh food and energy has risen significantly over the last six months from around 0.5%y/y to 1.2%.y/y, a high in over two decades excluding the effect of consumption tax hikes.

This outlook and strategy suggests that the BoJ is unlikely to respond to global developments including a moderately stronger JPY until it sees the outcome from the next annual wage negotiations around Q2 next year. Instead Kuroda plans to rely more on persuading executives to raise wages.

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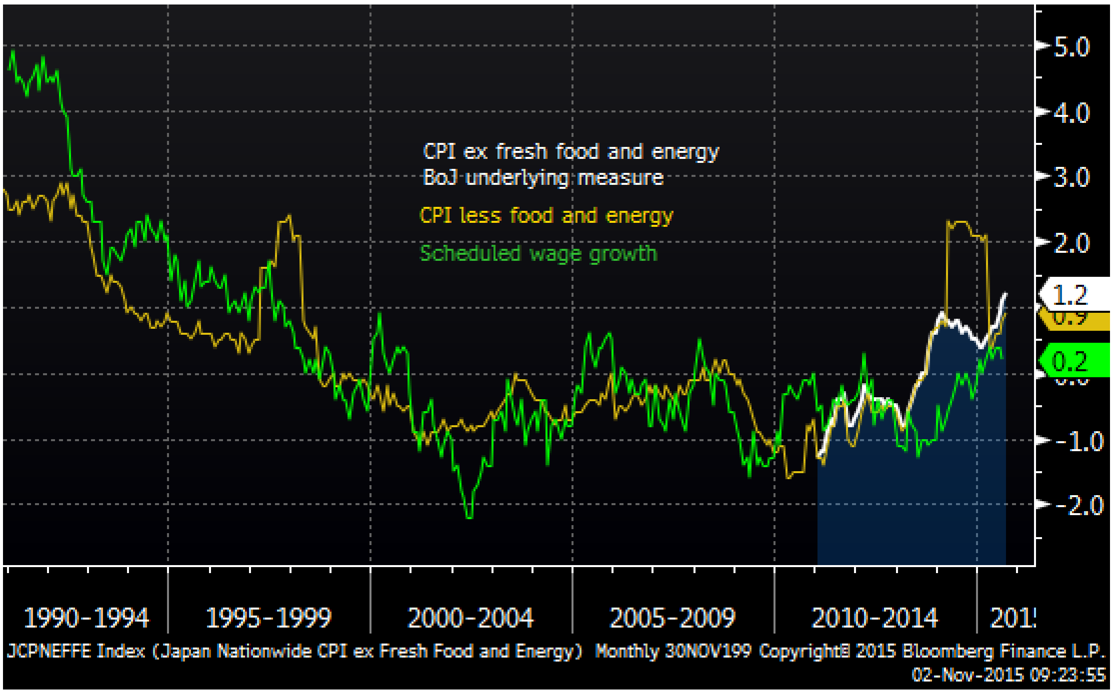
In the BoJ semi-annual Outlook for Economic Activity and Prices, it said this progress on tightening labour markets and higher capital utilization had contributed to higher wages growth last year. But in what appears to be part of its effort to pressure companies to act further it said, “Nevertheless, it should be noted that, given that firms have been seeing record profits and the unemployment rate has declined to the range of 3.0-3.5 percent, the pace of improvement in wages has been somewhat slow.”

Scheduled wage growth, an underlying measure excluding bonuses, rose only 0.2%y/y in August. As the chart below illustrates this measure of wage growth has historically been around the same level as inflation, or above inflation before 1995, suggesting indeed wages growth has been well below what is required to achieve sustainably higher inflation.

Japan underlying inflation and wage growth



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