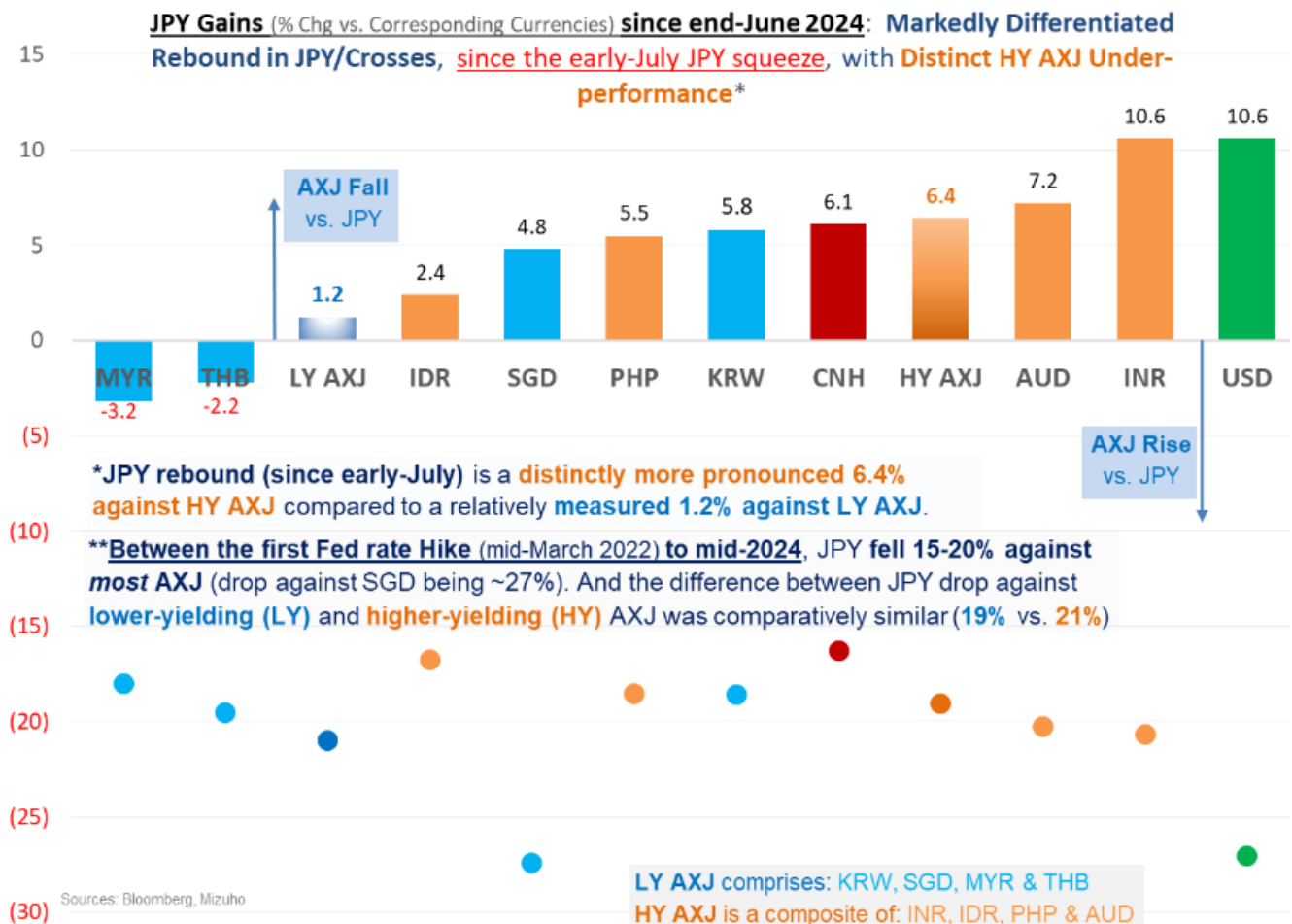


## AXJ: This Time It's Different(iated)



“The probability lies in that direction.” – Sherlock Holmes, *The Hound of Baskervilles*

**In a nutshell:** Regardless of CNH tailwinds accompanying China stimulus “risk on”, higher-yielding (HY) AXJ may still be relatively compromised vis-à-vis lower-yielding (LY) peers. Especially given the propensity for further JPY risks triggered by Fed rate cuts. Under certain circumstances, this may be exacerbated by JPY-(funded) carry unwind risks (which despite being mitigated are not eliminated). What’s more, UST yield curve steepening from Fed cuts also typically dis-advantages higher-yielding currencies (vis-à-vis low-yielders). The upshot is that **not all EM Asia FX boats will lift evenly on a rising JPY tide**. Or for that matter, a CNY tailwind. Which leaves **HY AXJ exposed to potentially stark under-performance** (vis-à-vis LY AXJ). At least the **probability lies in that direction**.

- **CNH-driven surge in AXJ amid China stimulus exuberance does not necessarily dislodge, risks of marked high-yield AXJ under-performance** ahead.
- Especially if a **forceful Fed pivot** in the works unleashes inadvertent but profound **JPY strength, and attendant out-performance** (vs. AXJ).
- This JPY out-performance is primarily, but not solely, *attributable to rate differentials invoked by policy divergence inevitably advantage the JPY*.
- We have seen **some degree of sweeping JPY strength coming through in the second half of 2024** (starting in early-July).
- *Although*, the **JPY remains well below pre-Fed rate hike levels**. (given some 27% drop in JPY from Fed hikes to mid-2024).
- Hence, *given ample scope for further JPY pick-up as the Fed cuts*, **general JPY out-performance over most AXJ will likely extend**.
- But crucially, *differentiation in JPY rebound vis-a-vis AXJ space may also be more pronounced*.
- Specifically, with *higher-yielding (HY) AXJ under-performing* lower-yielding (LY) AXJ markedly. Already this has played out.
- Accompanying **acute JPY surge since mid-2024** (up 10-11% vs. USD), was *nearly 6.5% JPY against HY AXJ in contrast to far more measured (just over) 1% against LY AXJ*.
- This reveals a conspiracy of **uneven macro risks that compromise HY AXJ**, which may be accentuated if Fed-BoJ tensions assert via JPY volatility.
- For one, **while the threat of further JPY carry unwind** may be mitigated, **it is clearly not eliminated**.
- And HY AXJ are inherently more vulnerable to adverse, “carry unwind”-JPY squeeze feedback spirals.
- Furthermore, (UST) **yield curve steepening associated with Fed rate cut cycles** also **tend to disadvantage HY AXJ vis-à-vis LY AXJ**.
- The upshot is the **low bar for further JPY upside through this Fed cut cycle**, exposes **HY AXJ to attendant under-performance**.
- Simply put, **through this Fed rate cut cycle**, the *probability lies in the direction* of **more JPY upside** that corresponds to **HY AXJ downside vs. LY AXJ**.

\* Given some ~27% drop in the JPY through the Fed’s tightening cycle has a long way to unwind even if it does not fully reverse

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