

Misunderstanding BoJ, Misgauging Risks

"There is nothing more deceptive than the obvious fact."

– Sherlock Holmes, the Bascombe Valley Mystery

Nutshell: Heading into the **BoJ** meeting, **overdone hawkish extrapolations** is a non-negligible risk. Especially as *strategic JPY-Policy de-coupling* and *front-running Fed pivot are misconstrued as unadulterated hawkish intent*.

Consequent, **JPY squeeze** from hawkish (mis-) interpretations could in turn **trigger more acute "carry" unwind** in the context of JPY's dominance as funding currency. *If unabated*, the **knock-on impact could trigger wider risk (asset) retrenchment** amid elevated JPY volatility.

Possibly *exacerbated if Nikkei also fumbles into a cyclical sell-off on negative JPY-Nikkei correlations* asserting; *underpinning JPY-AXJ correlations flipping to become negative*.

Despite conspicuously low-yields, **CNY is no white knight funding currency** that alleviates AXJ pain. Not only do **CNY inherent risks** mean it is ill-equipped to be a funding currency of scale, but persistent CNY pressures may **amplify rather than assuage AXJ pain**.

Deceptive Hawkish Bets

- At the BoJ meeting tomorrow, the **markets risk overestimating hawkish intent**.
- But such **"obvious conclusions" based on concrete tightening action(s)** could be as **misleading** as they are **misguided**.

- What's more, **overdone hawkish BoJ bets** entail **potentially adverse impact on risk assets** and **AXJ amid acute carry unwind**.
- Contrary to

Extrapolating Action, Missing Motives

- Trouble is, the **combination BoJ action(s)** may not only be **gauged**, but **extrapolated**, as **hawkish intent/momentum**.
 - QQE*: For the record, **cutting the monthly bond buying program by ~JPY1trln to JPY5trln appears to be the broad consensus**. As such, **should not surprise**.
 - Rates: **But** markets are split on whether the BoJ will deliver a rate hike. And so, **a hike will be construed as a hawkish flex**.
 - Signal: Moreover, even without a hike, **strong suggestions of an impending hike may be interpreted as a mild(er) hawkish cue**.

*QQE is quantitative and qualitative easing, which comprises the BoJ's bond buying and wider asset purchase program.

- Whereas **motivations driving any measured** (likely 10bp hike if one is delivered) **rate hike may be anything but aggressively hawkish**.

Decoupling from JPY

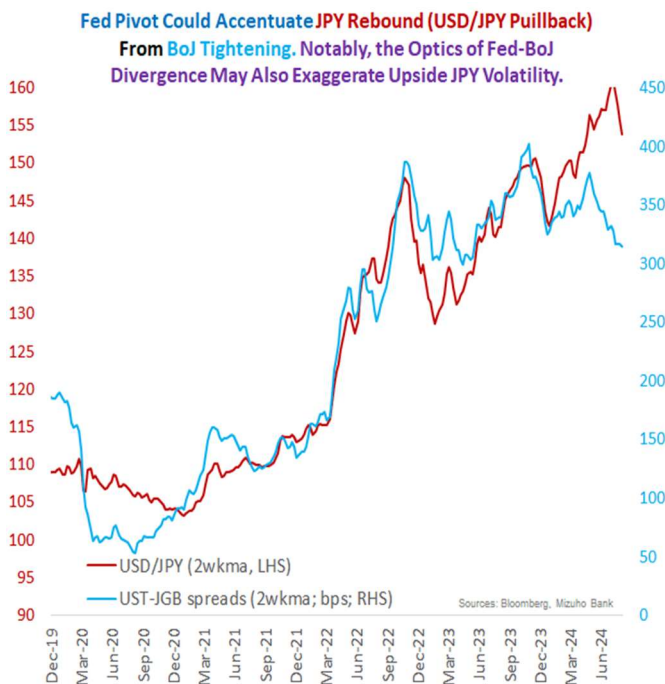
- For one, **in the context of sharp JPY gains** (up ~5% since 10th July) in the last 3 weeks, a **rate hike may be a strategic play to decouple rate decisions from JPY weakness**.
- The intent may be to diminish the speculative reflex to pressure JPY whenever market deem

the BoJ to be falling short of tightening expectations.

- So, in fact, the underlying intent maybe **to diminish undue (market) pressures to hike. Quite the opposite of unbridled hawkish inclinations.**

Front-running Fed Cuts

- In addition, the BoJ may also be acutely cognizant of, and keen **to avoid**, the **jarring optics of hiking when the Fed is cutting.**
- **Not just for solidarity or managing risk of blame if it is wrong-footed.**
- But crucially, **to avoid excessively sharp upside JPY volatility.**, which is **no less deleterious** than current (exact opposite) JPY weakness woes.



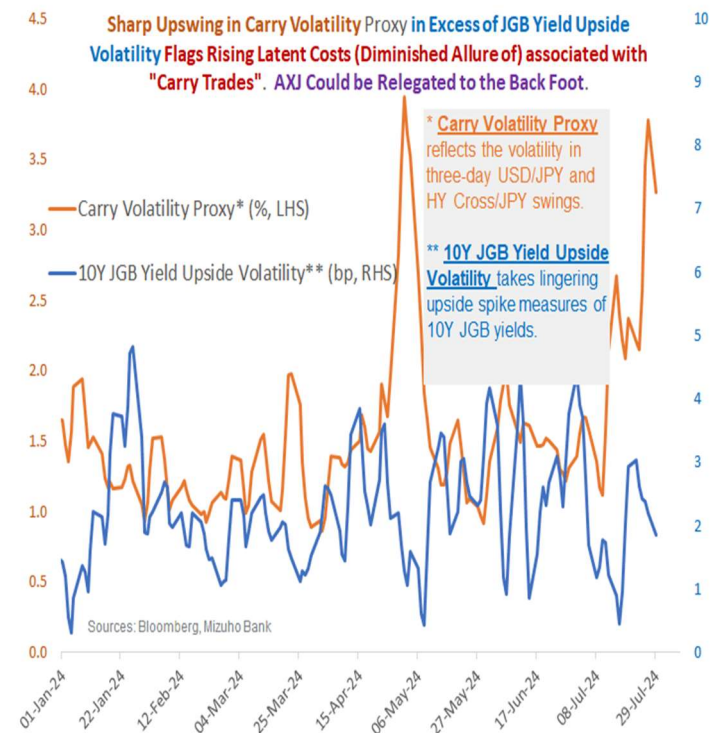
- Fact is, sharp and inconveniently timed JPY spikes **will damage the tentative exports-led recovery.**
- Worse, it **will not alleviate fragile household confidence** as income eroding inflation flips (back) into confidence sapping deflation.

Managing Political Noise

- **Calls for rate hikes by politicians complicates interpretations** of BoJ action further.
- Not yielding, in the interest of independence is one argument. Yet disregarding just to make a point is not healthy either. And may be a future policy liability.
- Hence, **managed hikes consistent with a gradual and measured normalization** may in fact be **optimal for enduring policy credibility/independence.**

Inciting Volatility

- But **to disregard such rich context to simply conclude unadulterated hawkish signals** from a hike may incite more volatility.
- To be sure, **interim JPY backstop**, if not **buoyancy**, is a **welcome respite for sharp BoJ policy trade-offs.**
- But **misconstrued BoJ intent warn of latent volatility** if future BoJ meetings “disappoint” unrealistic hawkish expectations.



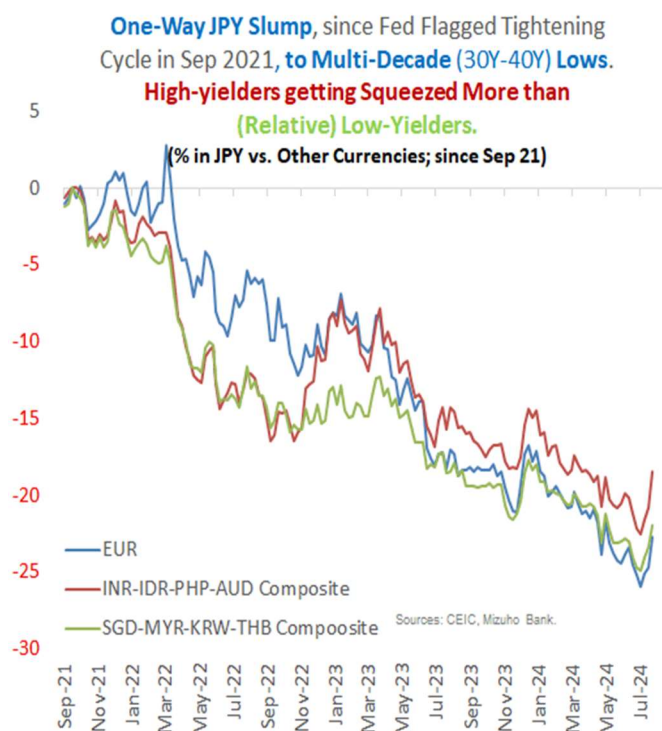
Carry Unwind Accelerated by JPY-Funding Concentration

- What’s more, **misplaced hawkish BoJ bets exacerbated by volatility**, will involve **attendant inadvertent “carry” unwind**.
- Notably, this pullback in carry trades is liable to be **accentuated by the increased concentration of JPY-funded carry trades**.
- Which needs to be appreciated in the context of **post-pandemic global rate hikes decimating the range of competing (G10) funding currencies** from the post-GFC era of ZIRP policies.

Amplifies Risk Retrenchment

- Consequent **JPY’s dominance**, if not effective exclusivity, **as the liquid funding currency inevitably amplifies the knock-on risk impact from “carry” unwind**.
- By extension, this ups the threat of **wider retrenchment of risk assets** being triggered if **carry unwind is unabated**.
- In other words, **BoJ-JPY induced “risk off”** events may be inadvertently rendered as a **more prominent risk**.

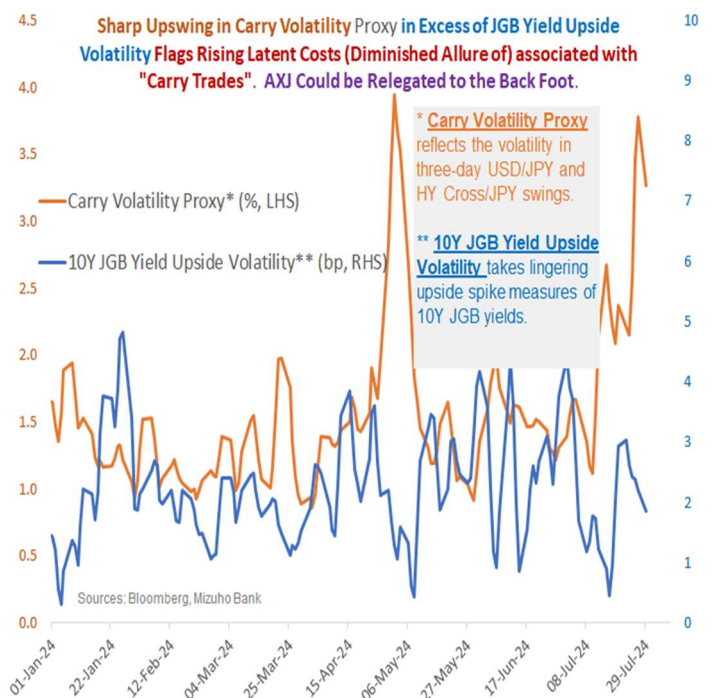
AXJ/High-Yielders Hurt as JPY Correlations Invert



- **High-yielding currencies** have been **worst hit** (vis-à-vis JPY) by the recent episode of carry unwind from sharp JPY squeeze.
- A sampling across MXN, BRL, NZD, AUD, ZAR, TRY, PHP, INR, IDR reveal **Cross/JPY losses as much as 9%** (and no less than 5%).
- Given persistent “carry” interest, high-yielders in particular remain notably vulnerable. AUD, NZD, INR, IDR and PHP are notable risks.
- Especially as the **JPY-AXJ correlations invert more emphatically as “carry squeeze” antagonism overrides supply-chain sympathies**.

CNY is No White Knight

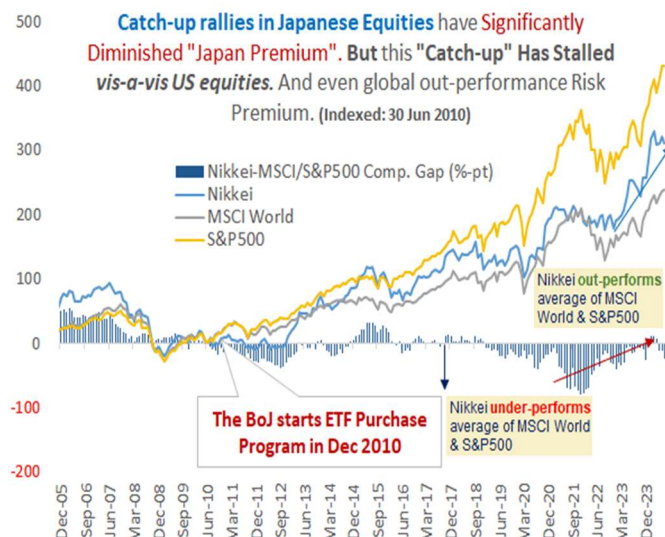
- And to be sure, the **CNY is no White Knight that could blunt potential AXJ pain**.
- Firstly, CNY **will not meaningfully displace JPY as a funding currency**; given gaps in liquidity.
- What’s more, persistent China risks – both economic and geo-political – suggest quite the opposite. That CNY may be a further drag on, not respite for, AXJ.



- Accordingly, **JPY-CNY wedge may have persistence, if not turn more prominent in the interim**, rather than evaporating imminently.

Watch JPY-Nikkei Negative Correlation

- But inadvertent pain from a strong JPY is not confined to EM assets/currencies.
- The **Nikkei could also lose some shine as the negative correlation between JPY and Nikkei re-assert.**



- More so, if sharp and sustained JPY strength flips the narrative from positive pricing power for firms to exports headwinds for Japanese exporters.
- For now, Nikkei has started to lag US equities again. And even the advantage gained against global equities is eroding at the margin.
- Admittedly, Japanese equities may remain compelling on the structural narrative.
- But a *cyclical stall/capitulation in Japanese equities is a distinct prospect if the JPY surges.*
- And in some cases, this could compound “risk off” from “carry” unwind.

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