



Theme#6: Don't Toshin the towel – buy USD/JPY

- It's too early to turn bearish USD/JPY. Japanese dip-buying and BoJ alertness should support USD/JPY around 118 though offer limited upside. Buy USD/JPY but take profit at 125.

Japan's current account: The force awakens not Japan's balance of payments continues to support USD/JPY and has not turned bearish. On the trade side, although the trade deficit has shrunk to close to zero, this is largely because falling energy import prices have offset the export drag from stuttering growth and depreciation in developing Asia. As oil prices approach rock-bottom, the windfall should peter out, while export headwinds from Asia persist. On the hedging side, the recent widening of the cross-currency basis acts as a new deterrent to currency hedging which corporates have been foregoing over the last year even in the face of a stalling USD/JPY uptrend.

Even without a contribution from trade, the current account posts a comfortable surplus thanks to vast investment income. Yet the entire current account surplus is used up by net FDI abroad. Indeed, retained earnings comprise a large chunk of both the current account surplus and FDI outflows. These are offsetting accounting entries rather than cross-border flows, and their sheer size stabilizes the CA/FDI ratio. For now, Japanese corporates enjoy the earnings power to keep investing. Hence, FDI flows will give little impetus to the yen in either direction.

GPIF: The empire can strike back
 Portfolio flows therefore are the potential swing factor on Japan's BoP. Although monthly volatility has picked up, the quarterly trend of large net outflows is intact. Dollar demand from the GPIF and other institutional investors is less consistent and price-sensitive than in the halcyon days of the re-allocation trade. The GPIF is soon to reach its benchmark allocations to foreign assets, completing the mechanical rotation. Nonetheless, it retains some firepower, and the discretionary bands around the benchmarks allow for tactical trading. Other institutional investors also continue to buy dips in the cross, and retail demand through toshins has become more than a secondary force. The contrarian tactic of Japanese investors also means, however, that they tend to take profit on squeezes. This underpins our view that USD/JPY will stay range-bound over the next four months, though short-term volatility could remain high. Japanese investors continue to buy USD assets at the expense of other currencies, especially in fixed income. Hedging ratios remain low. One reason is the widening basis. Indeed the flipside is that foreigners have liked synthetic exposure to JGBs funded in yen. These inflows have at times offset Japanese portfolio outflows on the BoP but are in fact FX-neutral.

1: Japan's trade deficit has been closed by import compression, largely thanks to the energy windfall



Source: Deutsche Bank, Bloomberg Finance LP

2: Portfolio outflows are the swing factor on the BoP and the trend remains robust if slowing



Source: Deutsche Bank, Bloomberg Finance LP

3: Portfolio outflows continue to weigh on the basic balance



Source: Deutsche Bank, Bloomberg Finance LP