Why the Yen has Depreciated, And What To Expect Going Forward

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WHY THE YEN HAS DEPRECIATED

AND WHAT TO EXPECT GOING FORWARD

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MANAGEMENT TEAM

Ed Lalanne - Chief Investment Officer

Experience
- Tse Capital Management (NYC) – Investment Analyst for a $1 billion+ global macro hedge fund
- Bloomberg (NYC)
- Macro Risk Advisers (NYC)
- Lehman Brothers (NYC)

Education
- MBA – Kellogg School of Management at Northwestern University (2008)
- BA – Dartmouth College (1999)

Interesting Facts
- Avid sailor: competed on a top-10 nationally ranked team in college
- Sailed across the South Pacific for six months
- Married to Natasha Lalanne
- Has 1 daughter (Julie Mae Lalanne)

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Stephen Buehler - Founder, Chief Operating/Compliance Officer

Experience
- Blackstone (NYC) – Managing Director & Chief Operating Officer of a $9.5 billion business within the hedge fund division
- Merrill Lynch (NYC)
- KPMG (Memphis)
- Arthur Andersen (Memphis)

Education
- MBA – Kellogg School of Management at Northwestern University (2008)
- BA/BBA – Mississippi State University (2000)

Interesting Facts
- SCUBA on Great Barrier Reef & ran with bulls in Pamplona, Spain
- Named one of the "Top 100 Graduates in First 100 Years of MSU's College of Business"
- Married to Jennifer Stieber Buehler
- Has 1 daughter (Bethany Maria Buehler)

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FIRST THINGS FIRST...WHY DOES THIS TOPIC MATTER?

- Direct relevance =>> Currency trading implications
- Indirect relevance =>> Spillover to many asset classes

  - Japan has the **3rd largest GDP** in the world at ~ $5 trillion (in USD terms) behind only the USA and China (1)

  - The Japanese government bond market ("JGB") is 1,224 trillion (Yen) which equates to almost **$9 trillion** in USD terms

**Takeaway:** The demand (or a change in demand) for the Yen and for Japanese assets has material relevance on other assets and asset classes

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(1) Source: The World Bank and the Bank of Japan ("BOJ")

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USD VS. YEN - WHERE ARE WE TODAY?

- The Yen has fallen to multi-decade lows vs. the US Dollar

- Largely due to the widening interest rate differential between Japan and the rest of the world

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USD VS. YEN - WHERE ARE WE TODAY?

- What has caused the widening interest rate differential? Relative inflation rates

![U.S.-Japan Inflation Paths Diverge](source: Bloomberg)

- Whereas the US Federal Reserve is actively increasing rates to combat inflation, the Bank of Japan wants inflation to remain above the elusive 2%+ rate

![Japan CPI YoY](source: Bloomberg)

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USD VS. YEN - WHERE ARE WE TODAY?

- In fact, inflation expectations in Japan have a long way to go.

  ![Graph of Japan 10Y Breakeven Inflation Expectations](source: Bloomberg)

- And Core Inflation isn't yet to 1% in Japan.

  ![Graph of Japan Core CPI YoY](source: Bloomberg)

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USD VS. YEN - WHERE DO WE GO FROM HERE?

- In April, the BOJ said it would **buy as many bonds as needed** every business day to protect the ceiling on 10-year debt yields.

- The BOJ's goal is to **keep interest rates low**. The new policy was tested in mid-June.

- The BOJ holds over **50% of JGBs** outstanding. This compares to the Fed’s ownership of around **25% of USTs outstanding**.
  - This difference is set to widen as the BOJ persists with Quantitative Easing, while the Fed has embarked on Quantitative Tightening.

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USD VS. YEN - WHERE DO WE GO FROM HERE?

• But this is where the 2nd order (indirect) impact comes into play.

• Traditionally, the Yen and JGBs are considered "safe haven" assets in times of global slowdown (and recession). However, with the relative interest rates being so widely divergent between JGBs and other safe havens (USTs), we may not see as much capital shifting to Yen/JGBs as we have historically.

• Therefore, we believe the path of least resistance for the Yen is lower (vs. the USD)

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USD VS. YEN - WHAT COULD CHANGE?

What could prompt the BOJ to change course?

1. Achieving the 2% inflation target in a sustainable manner

2. Further sharp decline in JPY, for example to the 150 level in USD/JPY over the next couple months

3. Speculators testing the BOJ’s resolve around its yield curve control policy, forcing the central bank to buy yet more JGBs

What steps could the BOJ take to tighten policy?

- In terms of sequencing, it may start by unwinding the most recently implemented unconventional easing programs

- A first step could be to adjust the yield curve control policy, possibly by increasing the 10Y yield target, or by targeting the 5Y yield instead

How might markets react?

- First-order effect: JGBs medium-term yields could rise

- Second-order effects:
  - USD/JPY could fall as carry trades unwind (signaling the end of a decade-long monetary easing campaign is a big event)
  - Global yields could rise further as the last major central bank capitulates to higher yields. Additionally, Japan life insurers and pensions may sell foreign portfolio holdings in anticipation of buying yen assets as domestic yields rise

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SUMMARY TAKEAWAYS

The Yen has fallen to multi-decade lows vs. the US Dollar

The difference in US/BOJ reaction to local inflation is causing material differential in UST/JGB interest rates

Given the desire to maintain 2%+ inflation, the BOJ will remain accommodative; thus we believe the path of least resistance for the Yen is lower (vs. the USD)

Global, multi-asset class investors should be aware of first and second order effects that the Yen and Japanese debt have. Should the BOJ change course in its objectives, this could be a seismic shift

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