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Has the Yen Fallen Too Far?

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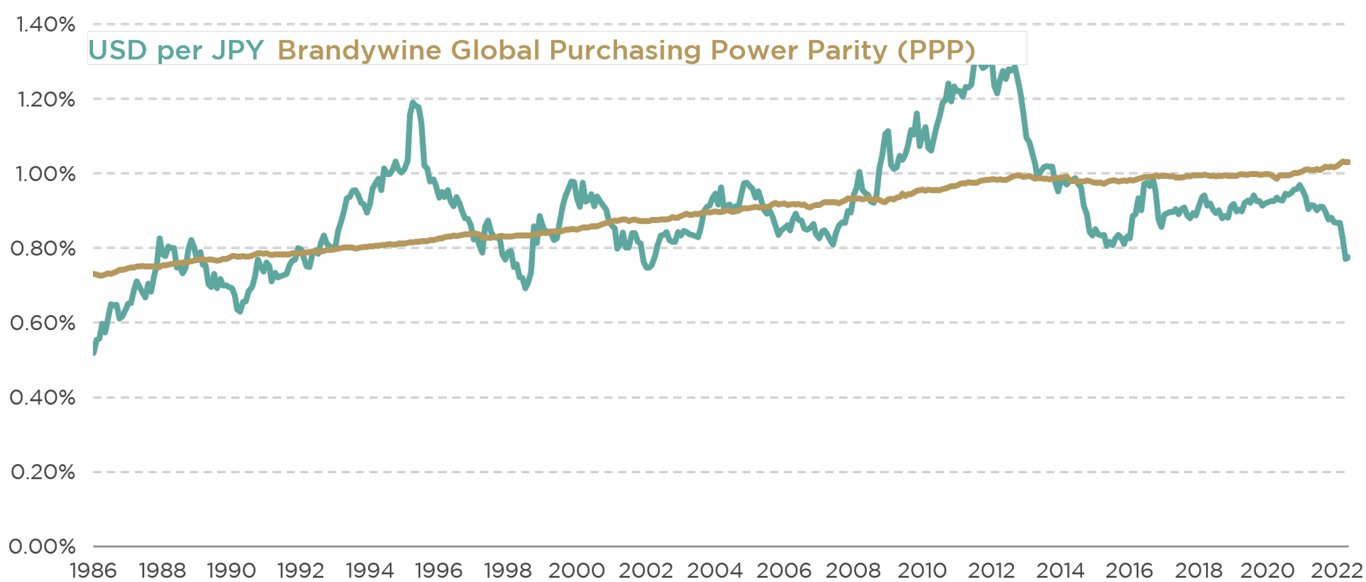
The Japanese yen has fallen dramatically since the beginning of 2021 and has not been this cheap relative to the U.S. dollar since 2002. From a purchasing power parity (PPP) or real effective exchange rate perspective (REER), it looks like a bargain, potentially undervalued by approximately 25% relative to the U.S. dollar (see Chart 1).

1 **The Japanese Yen Is Cheap vs. the U.S. Dollar**
% (USD/JPY), As of 5/1/2022



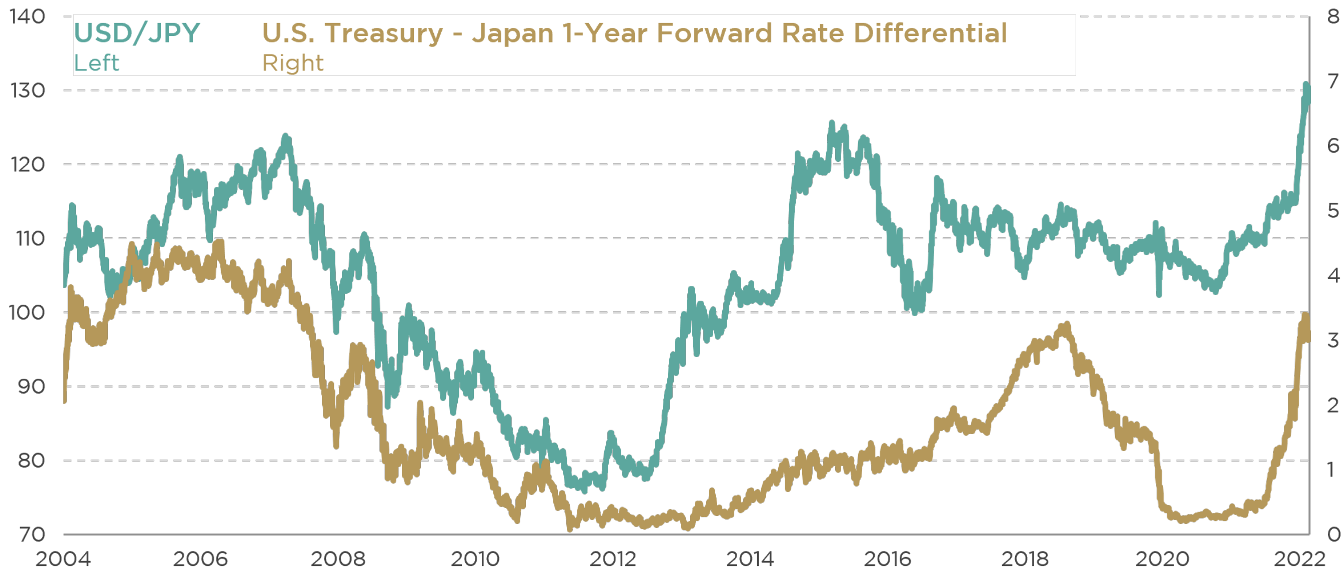
Source: Macrobond, Brandywine Global

The dollar-yen spot price tends to track the one-year yield differential between the U.S. and Japanese yield curves. This relationship is evident over the long term (see Chart 2), although certainly many factors also play into this story.

2

USD/JPY Spot Price and One-Year Yield Differential, Tandem Moves for Decades

% (Right), Last Price, As of 5/16/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

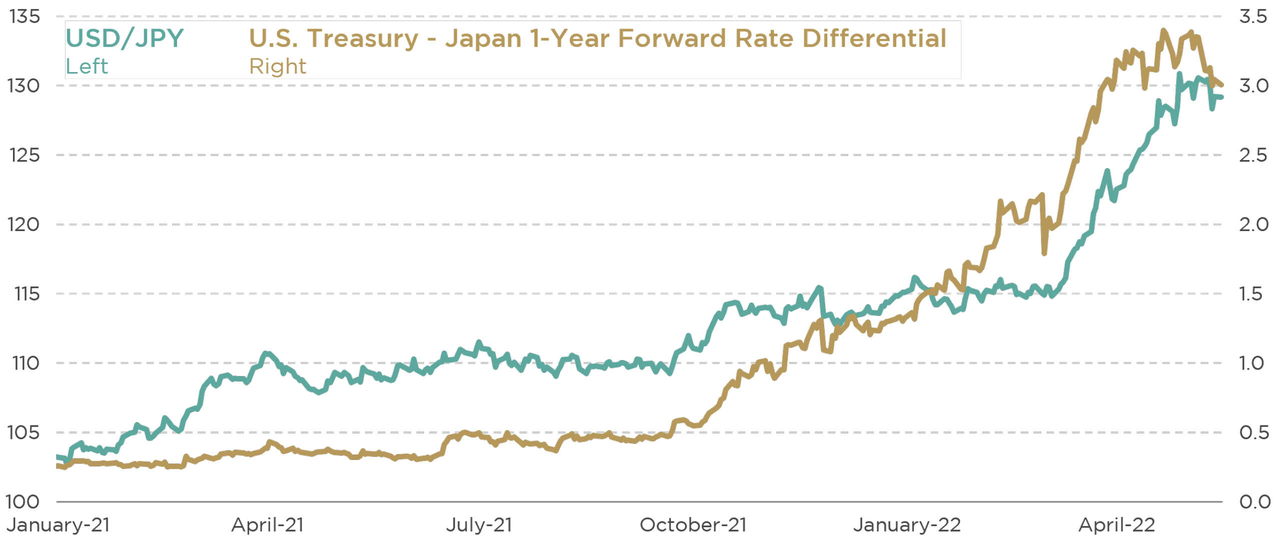
Recently, with inflation skyrocketing and markets pricing in 10 hikes by the Federal Reserve (Fed) over the course of the next year, the dollar has surged. Meanwhile in Japan, inflation has remained stubbornly low, and the Bank of Japan (BOJ) has continued with highly accommodative monetary policy. The resulting growing yield spread has moved in lockstep with the USD/JPY (see Chart 3).

However, anecdotal evidence is mounting that perhaps there are whiffs of price increases in Japan, too, especially apparent in imported goods, food, and energy. In fact, a recent Reuters Corporate Survey suggests that 76% of firms report they cannot tolerate yen weakness at current levels. If the Fed disappoints, or the BOJ must address inflation in Japan, we could see this yield differential—and the USD/JPY—retrace quickly. Even with only incipient reflation, political pressure in Japan could mount quickly. Carol Lye's recent blog, "Awakening Japan's Sleeping Giant", mentioned the potential political backlash that could pressure the BOJ's negative interest rate policy if imported inflation combines with already rising food and energy prices to produce generalized price increases, to which Japan's elderly population is sensitive.

3

USD/JPY and One-Year Yield Differential Have Mapped Closely since the Start of 2021

% (Right), Last Price, As of 5/16/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

Low inflation and growth in Japan have resulted in large yield spreads between the Japanese and U.S. yield curves that are unlikely to evaporate quickly. Therefore, the yen could remain under pressure, and this uncertainty suggests caution. However, there are other reasons why the yen could find a bottom, and the current anomaly could revert. If global and U.S. recession fears mount, not only could markets quickly temper their expectations for Fed rate hikes, Japanese investors also could move assets back onshore—into yen—with alacrity. Other potential drivers could include a regional/Chinese uptick in economic activity, a prolonged risk sell-off accompanied by a flight to safety favoring the yen, or a reversal of outsized short positions currently held by traders.

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