



**BoJ: The phantom menace**

The BoJ is likely to be more sensitive to an appreciating yen than to other deflationary developments such as falling energy prices. This is consistent with the focus of Abenomics shifting from an unconditional inflation target to (also) a nominal growth target: a stronger yen is harmful in reaching either target, whereas falling energy prices are negative for inflation only.

Luckily for the BoJ, the exchange rate is a less evasive policy target than inflation. True, a bold expansion of QQE would have limited FX follow-through even if it could be done in size, which it probably cannot. The depreciation in the broad yen of autumn 2014 was possible because the BoJ enjoyed the first-mover advantage. Yet even in a sharply competitive global FX space, conventional tools can still be effective in capping appreciation against the dollar. At the very least, Kuroda's capacity for jawboning remains high. Last week's talk of Japan not being out of deflation was perhaps a shot from the hip, but a European-style reconsideration of the zero lower bound or explicit concerns over regional beggaring-thy-neighbour tactics would go a long way toward reinforcing the Abe put. Hence, although the BoJ lacks the firepower to engineer a significantly weaker yen, it probably has adequate tools to defend the 118 level against more than transitory risk-off shocks.

**Fed: The return of the Jedi**

While Japanese dip-buying and BoJ alertness should put a floor under the cross from the Japanese side, any upside needs to come from the US. Bulls need not rely on a strong broad dollar, with which USD/JPY historically has a tenuous link in the medium-term. The main correlation is with US yields, which are nicely cushioned by two factors. First, market pricing for two Fed hikes is extremely dovish and the risk is for the market to converge with the Fed. The threat to the US economy pertains to growth, whereas the buoyant labour market probably calls for tighter policy than the market prices. Second, although global term premiums have taken a hit as China exports deflation and uncertainty, the PBoC's reserve run-down also acts as an automatic stabilizer to yields. Similarly, the drag on inflation expectations from oil is offset by reserve draw-down in oil-producing economies. The risk to US yields, in our view, is the PBoC capitulating against outflows and allowing CNY to find a new equilibrium quickly. Yet in light of the degree of intervention in December this amounts to an improbably extreme regime break.

**Positioning: The attack of the longs**

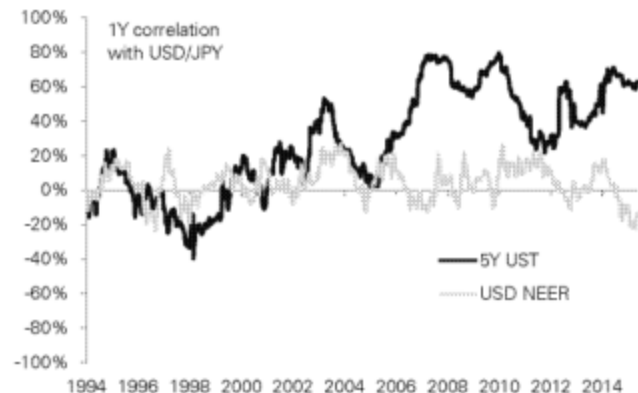
Positioning in the yen last week flipped to marginal longs for the first time since October 2012. Three-month risk reversals are as a result stretched on any measure. Skew aside, we like buying USD/JPY at current levels, viewing it as the lower-end of a 118-126 range for this year.

4: Weaker USD/JPY would require converging real rates



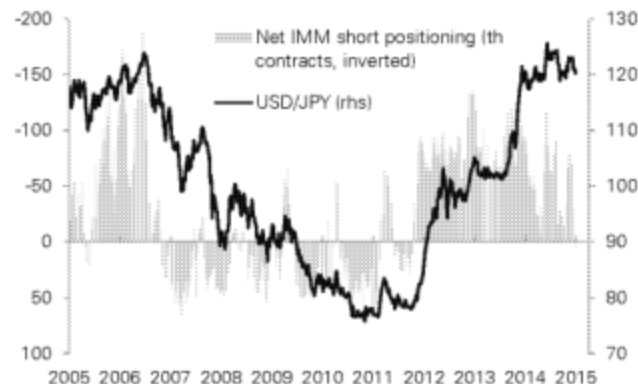
Source: Deutsche Bank, Bloomberg Finance LP

5: USD/JPY strongly correlates to US yields rather than the broad dollar



Source: Deutsche Bank, Bloomberg Finance LP

6: Positioning is now marginally long; vol skew is too high



Source: Deutsche Bank, Bloomberg Finance LP

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