FOREX FOCUS: Time To Carry The Yen Down

25 Jan 2011, 13:31

By Nicholas Hastings
A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--The yen is about to be carried lower.

For the last three years, the Japanese currency has largely ignored fundamentals as the global financial storm boosted its attraction as a safe haven.

Despite a continued threat of Japanese deflation, record levels of Japanese monetary easing and repeated efforts at fiscal stimulation by Tokyo, the yen was pushed steadily higher, especially against the dollar.

After rising to nearly Y125.00 in the middle of 2007, the U.S. currency fell to nearly Y80 by the end of 2010.

See how the dollar has performed against the yen in recent years:
http://www.dowjoneswebservices.com/chart/view/5336

So far, the yen has spent much of the new year in limbo, trading in a narrow range and showing little real direction.

However, there are distinct signs that positive factors won't continue to work in the yen's favor.

For a start, safe havens are swiftly losing their star status as the global recovery becomes more widespread and the risk of a major debt crisis in the euro zone starts to fade.

Unusually heavy investor demand Tuesday for a debut syndicated bond issue by the new European Financial Stability Facility, designed to provide debt bailouts, was a clear signal of growing confidence among the investment community that the worst is over.

There are even signs that the U.S. recovery may finally be picking up, with the U.S. Federal Reserve expected to give an upbeat economic assessment at its latest FOMC later this week.

By contrast, the outlook for Japan remains fragile despite efforts by the Bank of Japan to paint a more optimistic picture.

In its latest report earlier Tuesday, the central bank preserved its virtually zero interest rates and left its program for quantitative easing unchanged. It revised higher its forecast for growth in the current fiscal year but suggested that the recovery has "paused."

This pause could also prove longer than expected, especially if the global upturn, which will be vital for Japan's recovery, doesn't prove as strong as anticipated.

The bank also forecast that inflation will return but admitted that deflation persists "due to the substantial slack in the economy as a whole."

This raises the possibility that while other major economies are contemplating tightening their policy later this year, Japan may well be forced to consider further easing. Given the size of Japan's massive public debt, chances are that further fiscal stimulation for the economy is now no longer an option.

For the yen, this can only be bad news.

If interest rate differentials start to move against the Japanese currency now, just at the point at which the yen's safe-haven status is no longer providing support, the carry trade could return.

In other words, the low-yielding yen will find itself being sold as investors use it to fund their flows into higher-yielding currencies elsewhere.

Economists at BNP Paribas say these flows might prove even more intense if the acceleration in global inflation encourages Japanese banks to increase lending rather than parking their funds in Japanese securities, as they have been doing in recent years.

This will make the yen even more of a target for the carry trade and improve the dollar's chances of rallying back to Y90 later this year.

Bloomberg	TNI FRX POV
Reuters	USD/DJ
Thomson	P/1066 or P/1074

January 25, 2011 07:31 ET (12:31 GMT)