Market Review: FX Themes, Valuation & JPY Flow Update

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Bank of Tokyo-Mitsubishi UFJ Ltd
A member of MUFG, a global financial group

1. Current FX Themes

1. FX Themes – Crude oil price drop & global impact

US best positioned after oil price plunge

1) Positive global economic impact

- → IMF estimates a 0.5% boost to global growth from crude oil price drop last year.
- → Assumption is that price drop more down to supply than demand. Oil price down 30% 5mths to OPEC announcement, 37% 5wks after OPEC announcement.
- → US, China & India all big beneficiaries.

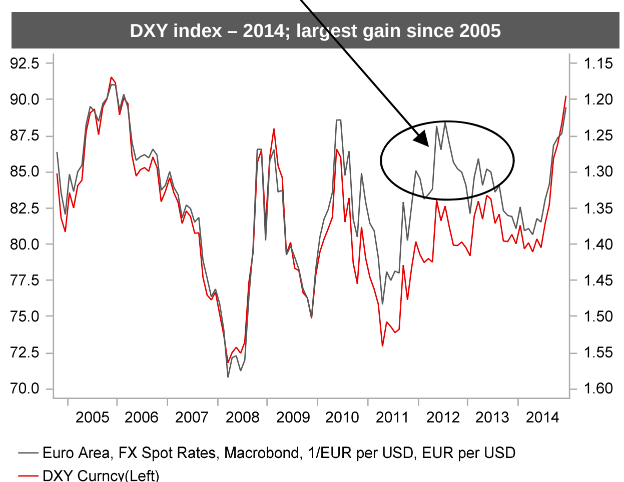
2) US consumer set to drive growth

- → Wholesale gasoline price close to 60% lower from end-June 2014 level. USD 120bn annualised boost to disposable income.
- → Personal consumption nearly 70% of US GDP. Investment in mining (Petroleum & Gas) about 1% GDP
- → However, 8 most energy-intensive US States have accounted to 2mn jobs since end of 2009, some 20% of total employment growth.

3) USD a clear beneficiary

- → US trade position – a big US dollar positive.
- → Big shift in global capital from producing to consuming nations.
- → DXY to gain by about 10% in 2015 after 13% gain in 2014.

EUR crisis in focus

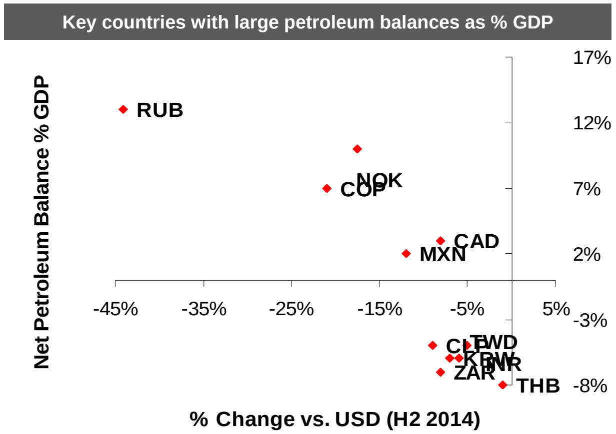


Source: Macrobond

1. FX & crude oil – the winners and losers

	% Change in Spot vs. USD in H2 2014	Net Petroleum Bal in 2013 as a % of GDP
RUB	-44.1%	13%
NOK	-17.7%	10%
COP	-21.0%	7%
CAD	-8.2%	3%
MXN	-12.1%	2%
CLP	-8.8%	-5%
INR	-4.5%	-5%
KRW	-7.3%	-6%
TWD	-5.6%	-6%
ZAR	-8.1%	-7%
THB	-1.4%	-8%

Source: UNCTAD



Source: UNCTAD & Bloomberg

- In G10 space, CAD was best performer in H2 2014 and NOK was worst performer.
- Asia as a region benefits most. China & India’s economies still very energy intensive.
- Euro-zone had a petroleum deficit of 3% of GDP in 2013.

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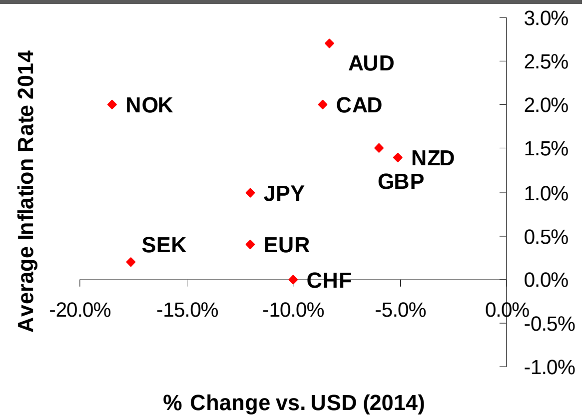
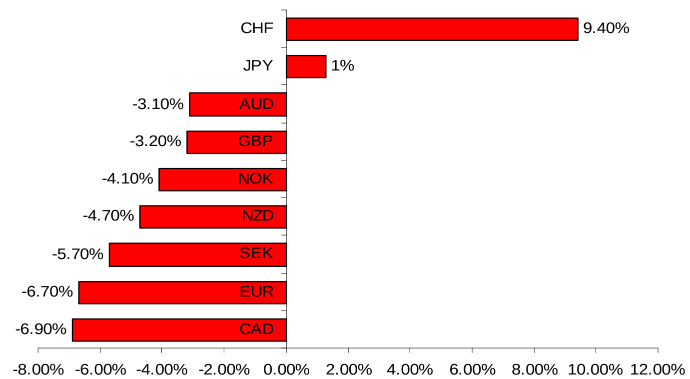
2. FX Themes – central banks' battle to lift inflation

G10 FX performance vs Avg inflation rate (2014)



G10 FX performance 2015 YTD (spot 27th Jan)



Source: Bloomberg

- 50% drop in crude oil has seen sharp drop in inflation and inflation expectations.
- Net positive for growth in part stems from central bank's ability to ease monetary policy.
- Central banks most willing to act where FX under-performs – SEK, EUR, CHF & JPY worst performers after NOK.
- EUR & CAD worst performers of 2015 & CHF the best so far reflecting central bank policy shifts.

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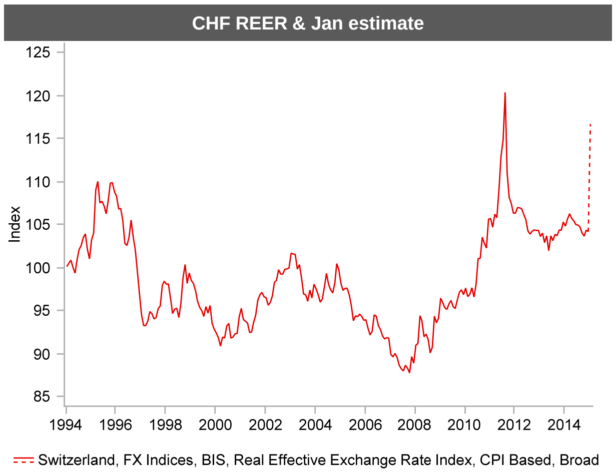
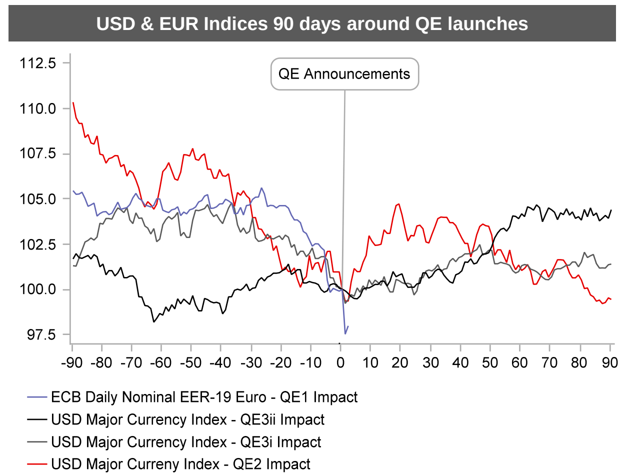
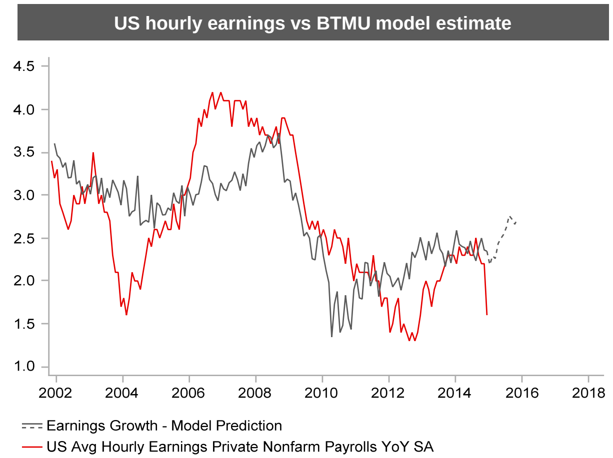
2. SNB abandons policy as ECB QE is launched, but could EUR rebound?

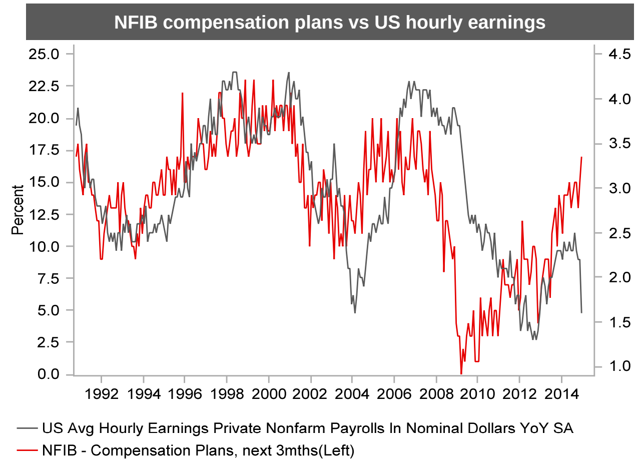




- By abandoning the EUR/CHF floor, the SNB accepts the inevitable deflation shock for Switzerland.
- SNB hoping that a “more pronounced” monetary policy divergence with US will ease over-valuation going forward.
- Greater FX influence in anticipation of QE announcements evident from US episodes.
- Initially the US dollar recovered after QE2 & QE3i & QE3ii announcements.

3. FX Themes – US wage growth & Fed lift-off





- Response to Dec employment report suggests hourly earnings growth will be key determinant of market expectations.
- BTMU US wages regression model estimates +2.8% hourly earnings growth in H2 2015 (lower profile due to lower CPI est).
- NFIB Small Business survey showed employee compensation in Nov at highest level since Oct 2007.

4. FX Themes – the politics of Europe

Political landscape changing in Europe

1) Syriza victory against austerity in Greece

→ Syriza victory was well anticipated in the foreign exchange market.
→ Measures put in place since periphery sovereign debt crisis has eased existential fears and contagion risks.
→ Negotiations to follow. The economics of Greece's position point to a compromise deal being reached.

2) Spain & Portugal go to the polls this year

→ General election in Spain must take place by 20th December.
→ Podemos continues to perform well in opinion polls. Recently polling at 28% after gaining 8% of vote in EU elections last year.
→ But recovering economy may work against Podemos. Apart from US, Spain was the only 2015 IMF forecast that was revised higher.
→ General election in Portugal in September/October.

3) UK general election on 7th May

→ Another hung parliament likely.
→ UKIP, SNP or the Unionists in Northern Ireland could hold the power.
→ Tory/UKIP/DUP alliance would mean EU in-out referendum being brought forward from 2017 to 2016.

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2. FX Momentum, Positioning & Valuation

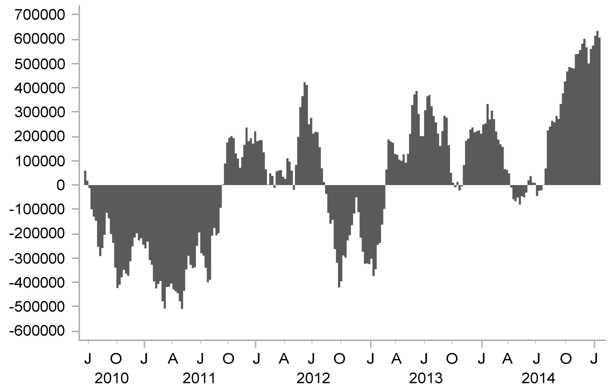
Oil no longer driving FX momentum as Central Banks take over

Strongest momentum currencies - last 6 weeks

	G10 FX	EM FX	Asia FX
1	EUR	HUF	SGD
2	SEK	CZK	MYR
3	CAD	RON	KRW
4	GBP	PLN	INR
5	NOK	TRY	THB
6	CHF	RUB	TWD
7	NZD	COP	CNY
8	AUD	BRL	VND
9	JPY	ZAR	IDR
10		CLP	
11		MXN	

Source: Bloomberg & BTMU – Spot rates to week ending 23rd Jan 2015

IMM Total Implied USD speculative positioning



- G10 momentum now driven more by central bank responses to deflation threat rather than oil specifically.
- In EM and Asia, most top momentum currencies related to ECB & EUR/USD momentum.
- Positioning (to 20th Jan) favours the dollar on global macro view. EUR accounts for 39% of total, JPY just under 20%.
- MXN, CAD & AUD account for a further 28%.

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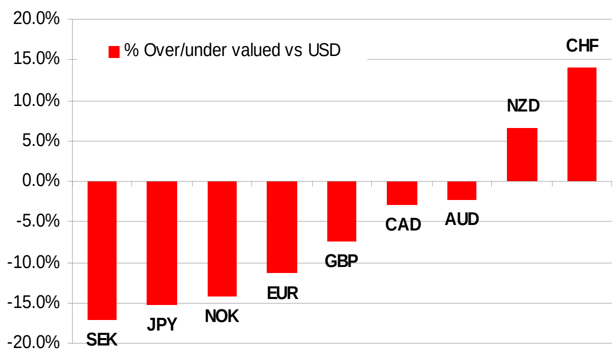
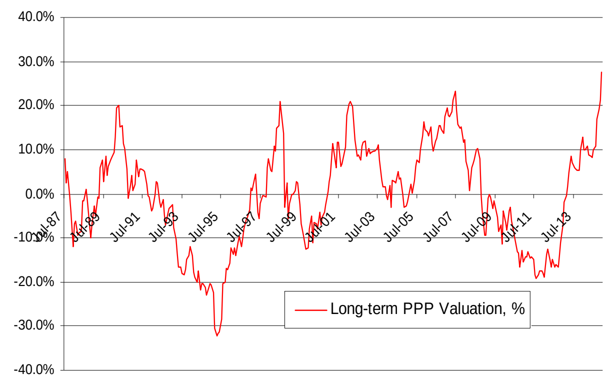
G10 valuation shifting from extreme overvalued (2011) to undervalued

G10 Numerous valuation models combined



Source: Bloomberg & BTMU – Spot rates 26th Jan 2015

USD/JPY over/under Valuation vs BTMU PPP model



Source: Bloomberg & BTMU – Spot rates – end-2014

- Valuation estimates for all G10 now all within +/-15%, part from CHF (+14.0%) after SNB announcement on 15th Jan.
- On a PPP only valuation estimate USD/JPY is at a record +27% to fair-value, surpassing previous highs around +20%.
- SEK the most under-valued G10 currency.
- BTMU Short-term Valuation model, EUR/USD spot divergence of 3.8% - after ECB QE and Greek election result

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3.Yen flows

“Abenomics” yet to trigger large capital outflows

GPIF Outflows

BOJ QQEII inflows

Deficit to surplus

JPY 100mn	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
Japan Investor										
Equities	-8,278	6,259	23,759	19,770	4,666	7,466	11,627	9,326	-38	10,482
Bonds	-49,276	35,466	36,138	-12,660	10,456	12,552	13,130	2,908	13,459	-29,027
Money Mkt Inst	1,529	3,590	3,537	1,211	533	2,243	761	83	1,055	73
Total	-56,025	45,315	63,434	8,321	15,655	22,261	25,518	12,317	14,476	-18,472
Total Ex-M Mkt	-57,554	41,725	59,897	7,110	15,122	20,018	24,757	12,234	13,421	-18,545
Foreign Investor										
Equities	-25,688	10,627	7,175	34,369	6,947	-5,401	5,629	6,120	26,471	1,778
Bonds	-2,903	6,116	53,018	30,307	10,631	18,189	24,198	12,280	12,893	5,134
Money Mkt Inst	3,367	16,581	-24,971	13,266	26,729	-5,043	-46,657	22,719	10,184	-19,637
Total	-25,224	33,324	35,222	77,942	44,307	7,745	-16,830	41,119	49,548	-12,725
Total Ex-M Mkt	-28,591	16,743	60,193	64,676	17,578	12,788	29,827	18,400	39,364	6,912
Total Net Flow										
Net Equity	-17,410	4,368	-16,584	14,599	2,281	-12,867	-5,998	-3,206	26,509	-8,704
Net Bonds	46,373	-29,350	16,880	42,967	175	5,637	11,068	9,372	-566	34,161
Net Money Mkt	1,838	12,991	-28,508	12,055	26,196	-7,286	-47,418	22,636	9,129	-19,710
Net Total (1)	30,801	-11,991	-28,212	69,621	28,652	-14,516	-42,348	28,802	35,072	5,747
Net Total Ex-M	28,963	-24,982	296	57,566	2,456	-7,230	5,070	6,166	25,943	25,457
Current Account (2)	-8,187	3,571	16,344	17,664	4,016	2,498	9,830	8,334	4,330	5,000
FDI (3)	-22,706	-33,221	-19,172	-39,784	-8,899	-6,133	-4,140	-16,553	-14,231	-9,000
Sum (1 to 3)	-92	-41,641	-31,040	47,501	23,769	-18,151	-36,658	20,583	25,171	1,747

Source: Japan MOF. Japan Investor, + = Outflow, - = Inflow
Dec 2014 CA & FDI estimates

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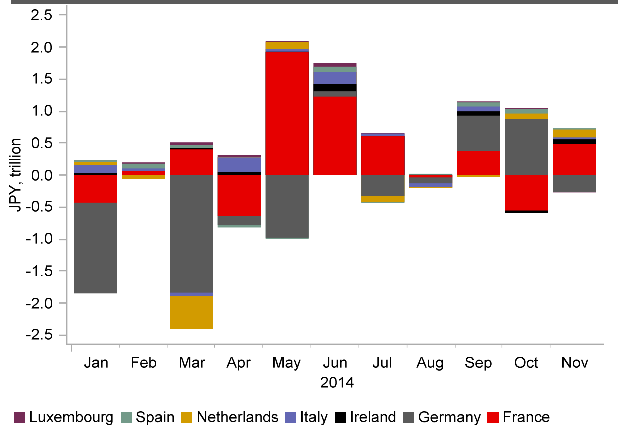
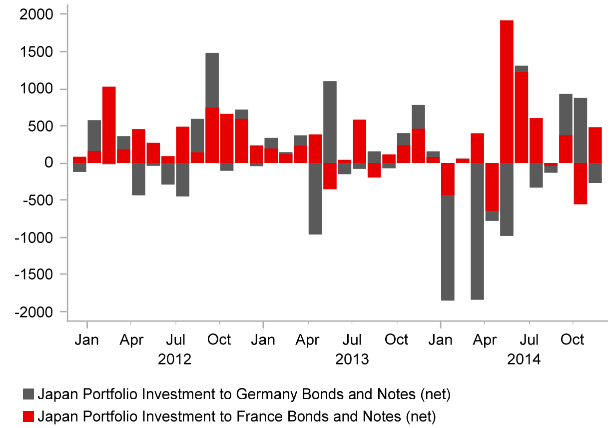
Japan investors’ preference for French debt over German debt continues

Japan BOP data – Outflows to key EZ debt markets

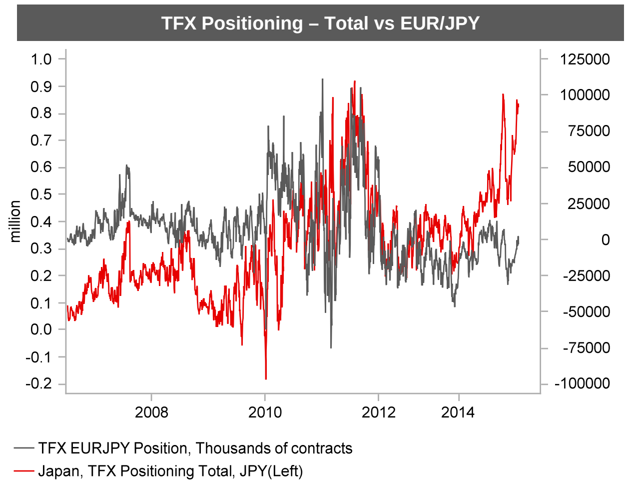


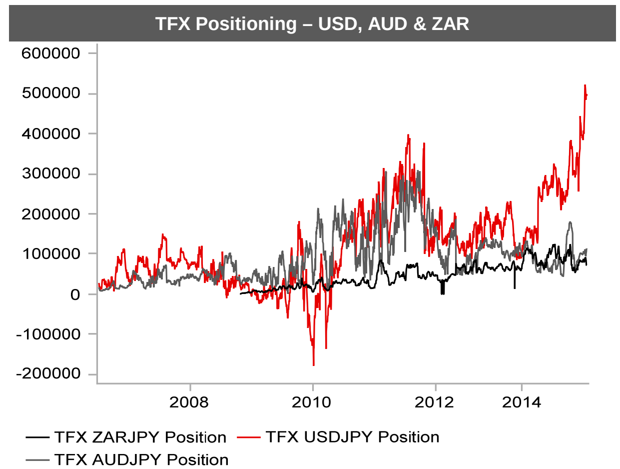
Japan BOP data – Outflows German vs French bonds, JPYbn



- 2014 saw Japanese investors first reduce German bund holdings and then increased French bond holdings.
- For all 2014 to Nov, Japanese investors sold JPY 3.55trn worth of German bunds and bought JPY 3.48trn of French bonds. Both the German bund selling and French bond buying has been clear since OMT in 2012.
- In three years 2012-14, Japanese investors have sold JPY 2.1trn worth of bunds and bought JPY 10.5trn of French debt.

Mrs Watanabe returns but not to the euro!

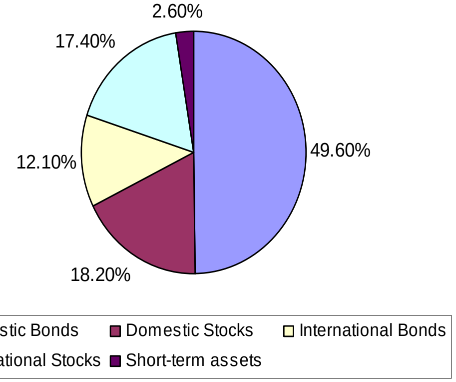




- Margin short EUR vs JPY reversed after QE announcement, but now re-establishing EUR shorts again.
- Short yen positioning in total jumped from 300k contracts to a peak of 870k in October.
- Yen shorts versus USD at a record high accounting for 60% of total followed by AUD (12%) & ZAR (11%).
- Japanese retail short positions in CHF were modest.

3rd Arrow Reform – Will GPIF outflows encourage households?

GPIF asset allocation – Sep 2014 (JPY 130.9trn)



Source: Government Pension Investment Fund

GPIF asset allocation targets & ranges – new versus old

OLD	Domestic Bonds	Domestic Stocks	International Bonds	International Stocks	S-T Assets
Target Allocation	60%	12%	11%	12%	5%
Permissible Range	+/- 8%	+/- 6%	+/- 5%	+/- 5%	
NEW					
Target Allocation	35%	25%	15%	25%	
Permissible Range	+/- 10%	+/- 9%	+/- 4%	+/- 8%	

Source: Japan government

- New targets announced on 31st October, coinciding with QQE2 BOJ announcement.
- Aggressive shift into riskier assets – domestic & foreign stocks could make up 50% of portfolio.
- But top of new range (45%) not too far away now with Q3 JGB holdings at 49.6%.
- International securities holdings to rise from 29.5% in Q3 2014 to perhaps 40% - JPY 13trn potential outflow.
- Cross border flow data shows some increased foreign equity buying in Q3 and Q4.

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