RATHBONES

Weekly Digest

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Playing the long game: reflections on the yen from the terraces

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There's a striking parallel between football club Sheffield Wednesday's difficult season and the Japanese yen's recent weakness: both have hit historic lows, before showing tentative signs of recovery with a little outside assistance.

For those following clubs in the English Football League, last weekend saw the opening games of the new season. As a long-suffering Sheffield Wednesday fan, it was encouraging to see the team start on a positive note, with a win at Leyton Orient.

The game was the first of a new era after the club entered administration and suffered relegation last season. Wednesday set several unwanted English football records, including the earliest relegation (22 February), the longest run without a league win (39 games), and the fewest points (zero). With new ownership and a new squad, it's very much the case that 'things can only get better'

Quick take:

- The yen is at a four-decade low, prompting rare coordinated intervention from Japan and the US.
- Nearly all exchange rate models agree: the yen is significantly undervalued.
- We're holding Japanese equities unhedged, confident the yen will strengthen over the long run.

The yen's difficult year

In markets, the Japanese yen has also had a tricky past 12 months. Among the G10 group of the most heavily traded developed market currencies, it's by far the worst-performing – down more than 8% against both the US dollar and sterling at the time of writing. At the end of July, the weakness was sufficient to prompt the Japanese Ministry of Finance (MoF) to intervene in the market to support the yen for what's thought to be the third time this year.

I can already see eyes rolling at the seemingly tenuous analogy. But stick with me on this. After the result over the weekend, while pondering topics for my guest slot writing the Weekly Digest, I realised that there are useful parallels.

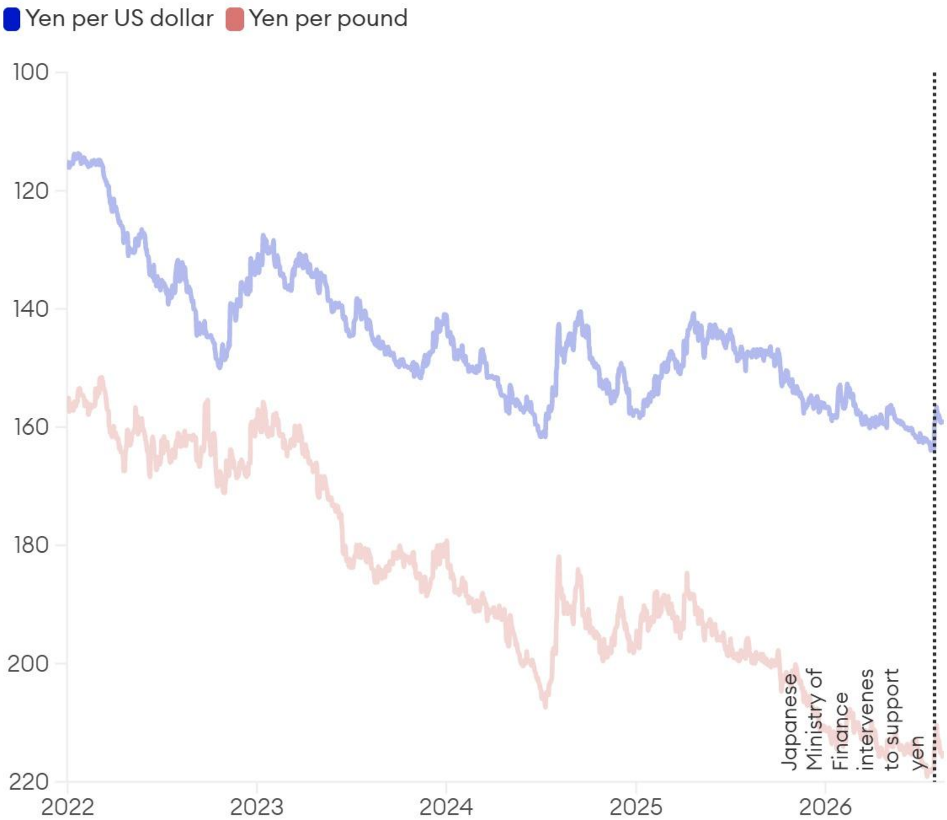
Ups, downs, and tentative turnarounds

As any Sheffield Wednesday fan will attest, the past few decades have delivered more than our fair share of ups and downs. Late last season, things were bleak. Then, with a bit of assistance from a new American owner, there were tentative signs of a turnaround with a win on the final day. The situation still isn't great – we were still relegated, after all. A near-term turnaround is far from guaranteed, either. Football never fails to surprise, and there will undoubtedly be obstacles ahead. However, if the new management continues to make the right decisions, I think most fans believe we'll one day make it back to the promised land of the Premier League. Some fundamentals, such as a large support base and a strong historical reputation, are in our favour.

Back to currencies – the yen has also hit lows lately. From around 147 against the US dollar a year ago, it reached its weakest in four decades on 23 July, at close to 164. Intervention then pushed the yen back up to almost 157 on 3 August, before it slid back to around 159, where it has remained for the past week or so. The chart gives more context, including against sterling.

The US has also helped drive the near-term turnaround in the yen. The US Treasury sold euros to buy yen alongside Japan's MoF in July. This type of joint

Land of the falling yen



Source: LSEG, Rathbones

action is unusual – the last time the US intervened to support the yen was back in 1998.

A chequered history of intervention

Like football takeovers, currency market intervention has a chequered history of success. On the one hand, some coordinated attempts, such as the Plaza Accord in 1985 – when five nations agreed to depreciate the value of the US dollar – have achieved their stated aims. But there are plenty of other examples of failure, including the repeated attempts by the MoF to support the yen in recent years.

It's too early to know whether the latest intervention will prove successful. The coordinated nature may boost credibility, making speculators think twice before betting against the yen again. That said, as with individual football results, short-run moves can be unpredictable. This is largely down to the sheer number of factors affecting an exchange rate and the varying importance of these factors through time. Indeed, there is a strand of academic literature that can be traced back to a 1983 paper by American economists Richard Meese and Kenneth S. Rogoff, finding that exchange rate models struggle to reliably beat the simple prediction of 'no change' over short time horizons.

Taking the long view

In contrast, we believe there is value in taking a view on exchange rates over longer time horizons. Academic research suggests that 'equilibrium exchange rates' can be helpful for making predictions. By this, we mean a 'fair value' defined by economic fundamentals, to which it's assumed the actual exchange rate converges over multi-year periods of time. In short, while we tend not to take a strong view on the exact route taken, we do take a view on the eventual destination.

There are numerous approaches to estimating equilibrium exchange rates. We maintain our own Behavioural Equilibrium Exchange Rate (Beer) model and monitor others'. At the simplest end of the spectrum are those based on the assumption that exchange rates, adjusted for relative inflation in different economies, should revert to a long-run average. At the other end are complex statistical models maintained by central banks and sell-side research teams.

The yen looks undervalued

Perhaps the clearest message almost all these models are sending right now is that the yen is undervalued. That's true on our own Beer model. It's also true for most of the complex third-party models we see. And it's true using simple mean-reversion approaches. Macroeconomic fundamentals can't explain how weak the yen has become.

These models essentially confirm what any recent visitor to Tokyo or Osaka will have noticed. Japan is now a cheap destination for its level of development. Deutsche Bank's latest 'Mapping the World's Prices' report illustrates this, finding that the cost of a date in Tokyo (clothes, public transport, dinner, a couple of drinks, cinema tickets, and a taxi home) is now almost half that in London. It's also less than one in Istanbul, Bangkok, Mexico City, or São Paulo.

Reasons for cautious optimism

A return to 'fair value' for the yen isn't guaranteed. Some are concerned that the Bank of Japan (BoJ) isn't raising interest rates fast enough, perhaps in part due to government pressure. Others are worried that Prime Minister Sanae Takaichi is pursuing a fiscal policy that's a bit too loose (i.e. borrowing too much). As with Wednesday's new management at Hillsborough, Japan's government needs to pursue sensible policies to keep investors onside.

Reassuringly, though, the BoJ has struck a more hawkish tone of late and reports last week suggested the government is supportive of a rate hike. We also aren't overly concerned about Japan's fiscal position, despite high government debt.

All told, given the clear undervaluation of the yen, we're comfortable continuing to hold Japanese equities, including without hedging the currency exposure. Investors should be prepared for volatility along the way, just as I'm preparing for poor performances and the odd bad season in supporting Wednesday. But we think that, over the long run, the yen is more likely to strengthen than weaken. Let's hope the same is true for Wednesday.

Regional highlights

UK. The UK is in the midst of a flurry of economic data releases. The biggest was Q2 GDP, released last week. It showed UK output rising by 0.4% quarter-on-quarter, broadly in line with expectations and suggesting that the economy was weathering the energy price shock caused by the Iran conflict quite well. While it makes sense to judge the quarterly numbers with some caution, given the trend of a strong first half of the year and weak second half that has begun to emerge, it is reassuring that the year-on-year growth rate also picked up, from 0.9% in Q1 to 1.2%. That's nothing to write home about in absolute terms, but not bad given the backdrop.

The breakdown also included some interesting information on the composition of growth. It is encouraging that growth is no longer as reliant on public spending, with the private sector responsible for all the quarterly expansion. Perhaps most notably, the main driver of growth in investment was information and communication technology and other machinery and equipment, especially hardware. So AI-related investment could be showing up in the UK macro data now, as we've seen for some time in the US.

We also had the latest set of labour market data early this week. The main takeaway was that the UK labour market was still weakening slightly in the three months to June. The survey-based measure joined the PAYE-based data in showing a decline in employment, while vacancies edged down too. Reflecting this, pay growth eased on a year-on-year basis. That lends support to our view that the risks to market pricing of more than two 25bp interest rate hikes in the next year are to the downside.

US. GDP and labour market data tends to be timelier in the US than the UK, but there was still no shortage of economic releases across the pond last week. The key focus for most investors was the consumer price data for July. The headline rate of CPI inflation ticked down from 3.5% to 3.4%, while the core rate eased from 2.6% to 2.5%, both in line with consensus expectations. A development worth noting was the clear evidence of AI-related cost pressures showing up for consumer electronics – computer prices rose 3.5% on the month as Apple price hikes fed through. (Look out for more on this in an upcoming Investment Insights piece.)

Producer price data released one day after CPI also provided more evidence of AI investment putting upward pressure on prices of certain goods, but was otherwise relatively benign. Taken together, they provide a good steer on what the Fed's preferred measure of inflation (PCE) will be when it's released at the end of the month. On balance, a slight easing seems likely.

Elsewhere, retail sales data were much worse than expected, falling 0.6% month-on-month. However, much of this was due to a change in the timing of Amazon's Prime Day, alongside lower petrol prices. The underlying picture was broadly unchanged. Taking all this data together might give the Fed slightly more reason to hold off hiking interest rates in September, but unlike in the UK, we think the risks to market pricing of one or two 25bp hikes over the next 12 months are balanced on the whole.

Europe. Things were quieter on the data front in Europe again last week. The second estimate of eurozone GDP confirmed that growth was 0.4% quarter-on-quarter in Q2. As in the UK, that's encouragingly resilient given the energy shock. In the same release we also got the first estimate of bloc-wide employment last quarter, which showed a 0.1% increase. Although that's close to stagnation, the labour market on the continent is tight by historical standards.

The only other release of note was the eurozone ZEW economic sentiment index for August, which posted a fourth consecutive gain and is approaching the levels recorded before the Iran conflict began. Admittedly, this is a survey of investors and financial professionals, so some have linked the optimism to strong stock market performance when the survey was conducted. However, there has been a broader improvement in other 'soft' data on the continent of late. Other surveys such as the PMIs and the Sentix mentioned in last week's highlights have been picking up too. So we're inclined to think there is signal here and that the European economy is doing reasonably well by recent standards.

China. As we highlighted in this section of the previous Weekly Digest, the strength of

AI and green tech-related trade growth in China is not representative of the broader economy. Activity and spending data for July, released on Monday, support that view. Retail sales growth slowed from 1% to 0.6% year-on-year, missing expectations for a recovery and reflecting the ongoing softness of household consumption – something that was reinforced by the weakness of household borrowing in data released last week. Investment disappointed too, declining sharply. Admittedly, severe weather probably played a role. But the latest house price data suggested that the property market is yet to find a bottom. And while AI-related industries remained a bright spot, the fact that aggregate industrial production growth still slowed demonstrates how this isn't sufficient to fully offset domestic factors.

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