

UBS Investment Research

FX Morning Adviser

ECB Lessons for BoJ

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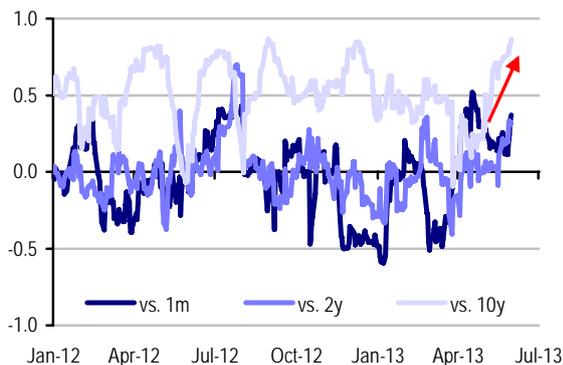
The Bank of Japan pledged last week to increase the frequency of JGB purchases again to reduce volatility in government bond markets. Avoiding repeats of the corrections seen in Japanese equities and undue attention to the country's fiscal position – both of which are leading to financial instability – are the main drivers behind such changes. However, upon greater introspection and BoJ will probably be even more concerned that barely two months into their QQE programme, the efficacy of their policy is at risk of being seriously curtailed. Many of the destabilising factors are beyond their control, but in terms of expectations management, perhaps they could take a leaf from the ECB's book.

Of course, current standards are certainly different compared to 2012: the JPY had already weakened significantly well before Kuroda's appointment, while the ECB's 'elimination of tail risk' which stabilised the EUR is far more preferable to break-up driven falls in the currency. However, it is forward policy that matters, especially if the Federal Reserve is also about to embark on qualitative changes to its policy path. This environment of higher US yields should even help amplify easing efforts by the ECB and BoJ via wider policy differentials through rate cuts and/or balance sheet measures. Charts 1 and 2 show that for both USDJPY and EURJPY, 10-year yield differentials still have the strongest correlations with currency performance (rolling 4-week correlations of daily returns), with EURUSD enjoying a particular 'beta' surge of late. However, monetary policy is directly transmitted through *short-term* interest rates, and there will be greater 'value' in policy changes for currencies if this part of the term structure becomes more sensitive. This is also 'working' for EURUSD but not USDJPY: the pair is becoming less responsive to wider short-differentials, and it's worth noting rate spreads *did widen* in May (mostly US-led) despite the volatility witnessed.

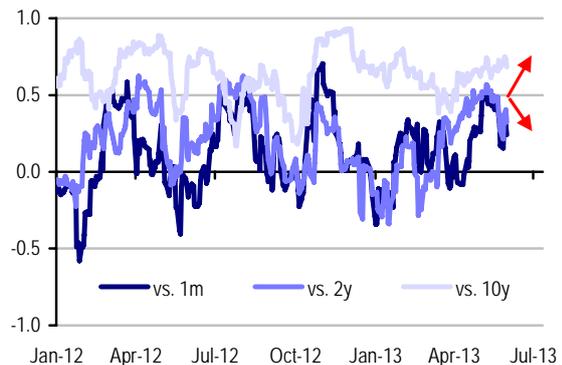
It is unfair to say the BoJ has under-delivered as QQE is already radical and significantly surpassed expectations. The central bank may have underestimated rates volatility but this is being addressed. Is this enough? Like the ECB, the BoJ perhaps needs to threaten to do 'more' without actually doing anything. Our rates team has repeatedly pointed out that cuts in the ECB refinancing rate would not materially affect front-end rates due to excess system liquidity, but the lingering threat of a deposit rate cut is serving this purpose. Comments from various Governing Council members with the same threat are enough to keep euro-longs at bay, while rising US yields do the work to encourage dollar longs. Implicitly, holding down the currency matters much more to the BoJ so similar 'threats' to maximise currency impact are worth considering: JGB yield caps in store?

Chart 1: Fed & ECB policy impact 'normalises'

Chart 2: Short-term JGB volatility causing divergence



Source: Bloomberg



Source: Bloomberg, UBS Calculations

FX Technicals

EURUSD	BEARISH	The recent strength does not change the broader bearish picture and the risk is for resumption of downside. Resistance is at 1.3073 ahead of 1.3194. Support is at 1.2934 ahead of 1.2797.
USDJPY	NEUTRAL	The potential is for extension of the correction phase. The next important support is at 99.58 ahead of 97.02. Resistance is at 101.80 ahead of 103.74.
GBPUSD	BEARISH	There is a major resistance at 1.5308. As long as this holds, the pair is vulnerable as bearish conditions prevail and a break below 1.5111 would expose 1.5009.
USDCHF	BULLISH	With bull trend in place, the recent downside move should be limited in time and extent which has tested support at 0.9527. A closing break below would prolong the correction to 0.9431. Resistance is at 0.9651 ahead of 0.9791.
AUDUSD	BEARISH	The immediate risk is for a short-term upside before the broader bear trend resumes. Resistance is at 0.9723 ahead of 0.9843. Support is at 0.9528 ahead of 0.9388.
USDCAD	BULLISH	As long as support holds at 1.0266, the potential is for resumption of the bull trend. Resistance is at 1.0421 ahead of 1.0524.
EURCHF	BULLISH	There is scope for resumption of upside as bull trend persists. Resistance is at 1.2573 ahead of 1.2661. Strong support is at 1.2370 ahead of 1.2283.
EURGBP	NEUTRAL	There is an important resistance at 0.8607. A break above which would extend the strength to 0.8656. Support is at 0.8522 and 0.8475.
EURJPY	BULLISH	Focus is on the momentum tools as a closing cross higher would end the recent consolidation phase and resume the broader bull trend. Resistance is at 132.34 ahead of 134.38. Support is at 129.97 ahead of 128.19.

***NOTE:** The trend for each currency pair as defined in the table is determined by our proprietary model and is independent of our discretionary interpretation of price action

Source: UBS FX Strategy

Key Events

Country	GMT	Release/Event	Frequency	UBS	Prev/Revised	Consensus	Actual
United States	18:00	Fed's Bernanke Speaks					
Australia	23:30	AiG Performance of Mfg Index (May)	index	n/a	36.7	n/a	43.8
Australia	00:30	TD Securities Inflation (May)	m-o-m	n/a	0.30%	n/a	0.20%
Australia	00:30	TD Securities Inflation (May)	y-o-y	n/a	2.10%	n/a	2.20%
China	01:00	Non-manufacturing PMI (May)	index	n/a	54.5	n/a	54.3
Australia	01:30	ANZ Job Advertisements (May)	m-o-m	n/a	-1.30%	n/a	-2.40%
Australia	01:30	Retail Sales sa (Apr)	m-o-m	0.20%	-0.40%	0.30%	0.20%
China	01:45	HSBC Manufacturing PMI (May)	index	n/a	50.4	49.6	49.2
United States	01:50	Fed's Yellen Speaks					
Japan	05:00	Vehicle Sales (May)	y-o-y	n/a	2.00%	n/a	
Australia	06:30	RBA Commodity Index sdr (May)	y-o-y	n/a	-6.50%	n/a	
Sweden	06:30	Swedbank PMI Survey (May)	index	n/a	49.6	n/a	
Norway	07:00	Norway PMI sa (May)	index	n/a	48.9	49.5	
Switzerland	07:30	PMI Manufacturing (May)	index	n/a	50.2	50.4	
Germany	07:55	PMI Manufacturing (May F)	index	49.0	49.0	49.0	
Euro Area	08:00	PMI Manufacturing (May F)	index	n/a	47.8	47.8	
UK	08:30	PMI Manufacturing (May)	index	50.5	49.8	50.3	
United States	11:20	Fed's Williams Speaks					
United States	12:58	Markit US PMI Final (May)	index	n/a	n/a	52.0	
United States	14:00	Construction Spending (Apr)	m-o-m	n/a	-1.70%	1.00%	
United States	14:00	ISM Manufacturing (May)	index	n/a	50.7	50.5	
United States	14:00	ISM Prices Paid (May)	index	n/a	50.0	49.5	
United States	21:00	Total Vehicle Sales (May)	units mn	n/a	14.9	15.1	
United States	21:00	Domestic Vehicle Sales (May)	units mn	n/a	11.8	12.0	
UK		Halifax House Prices sa (May)	m-o-m	n/a	1.10%	0.30%	
UK		Halifax House Price (May)	3m/year	n/a	2.00%	2.50%	

Source: UBS Global Economics, Bloomberg LP, Reuters LP, Reuters, Market News International