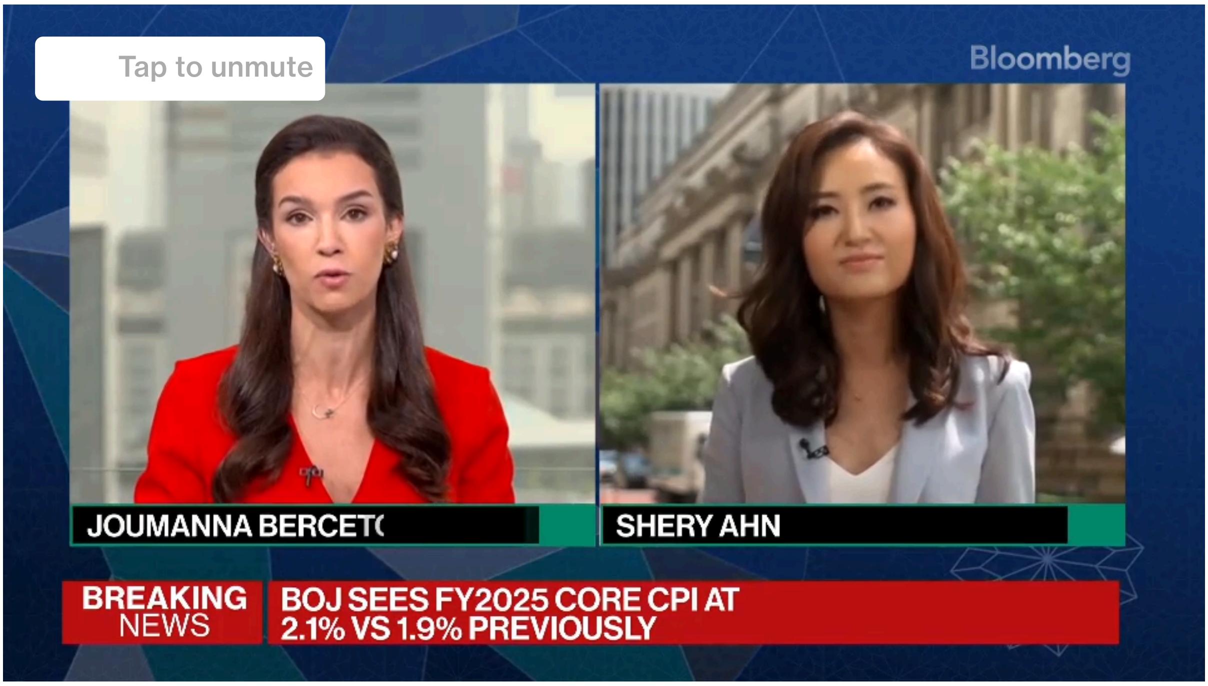
Markets

Yen Soars to Strongest Since March as BOJ Reignites Rally

- Move ramped up as rate gap with US seen diminishing over time
- Japan raised rates and unveiled plan to cut bond buying



Bank of Japan Raises Interest Rates for Second Time Since 2007

By Masaki Kondo, Mia Glass, and Alice Atkins
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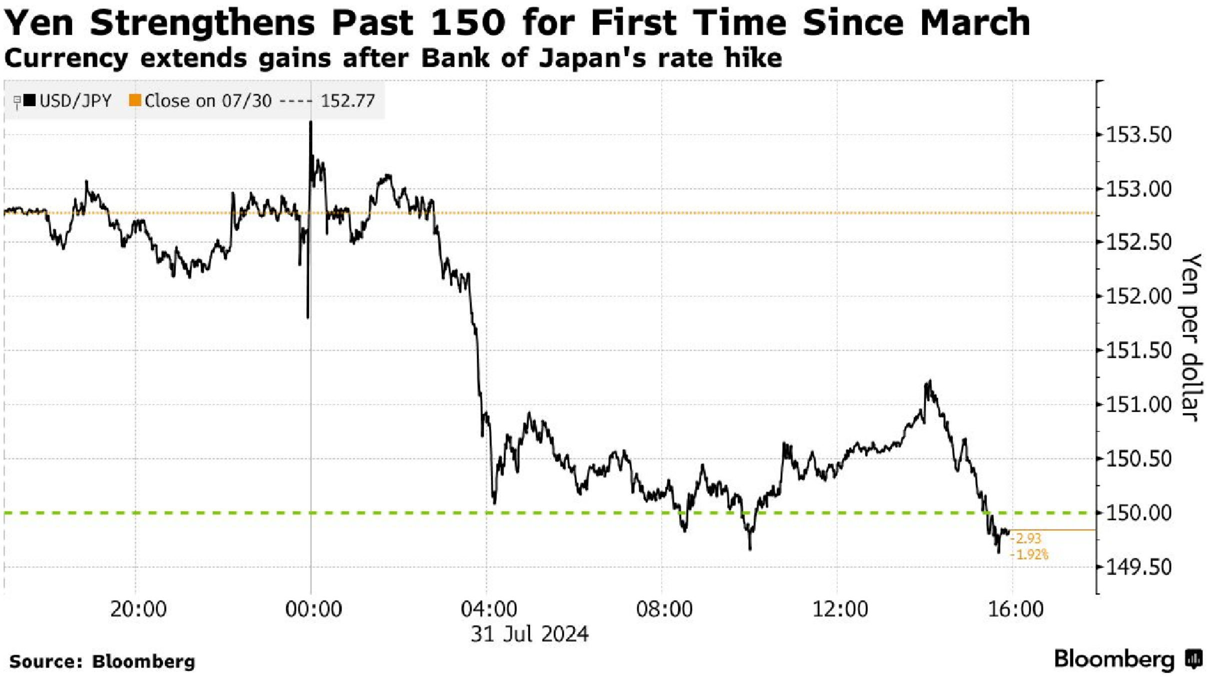
The yen surged to the strongest since March versus the dollar after the Bank of Japan raised interest rates and announced plans to cut bond purchases, reigniting an aggressive rally.

The currency climbed as much as 2.1% against the greenback, punching through the key 150-per-dollar level – and adding to a rapid advance that began earlier this month in anticipation of a hawkish decision by the central bank. Japanese government bonds tumbled in the wake of the announcement, with the yield on two-year notes climbing to the highest in 15 years.



The yen has benefited in recent days from a rapid unwind in carry trades, a strategy that uses low-yielding currencies like the yen to fund purchases in higher yielders such as the Mexican peso. That capitulation has seen the currency rally more than 7% from a 38-year low versus the dollar reached July 3.

“From the Japan side, the BOJ’s hike to 0.25% is still a small step, but could eventually be seen as the start of a larger trend,” said Yusuke Miyairi, a currency strategist at Nomura International Plc. “If the market expectation becomes more hawkish, then there’s more scope for the yen to strengthen.”

The yen extended its rally to touch 149.61 versus the dollar in New York afternoon trading. The yield on benchmark 10-year bonds rose as much as 8 basis points to 1.083%, while the yield on two-year notes climbed to 0.456%, the highest since 2009. Meanwhile, the Topix stock index closed 1.5% higher, led by a surge in banking shares.

Traders also kept an eye on the Federal Reserve’s path. US central bank chief Jerome Powell said policymakers could lower rates as soon as September, though they kept borrowing costs steady Wednesday. Such a move would further curtail the rate gap between the US and Japan, aiding the yen. The Japanese currency also gained on safe haven appeal as geopolitical risk in the Middle East again rose to the forefront.

"The Bank of Japan is firmly on a path to monetary policy normalization. That allows the safe-haven yen to catch a bid," said Kathleen Brooks, research director at XTB. "The yen hasn't been reacting as much to geopolitical tensions, and now it can."

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JPMorgan Chase & Co. estimated on July 26 that around 40% of carry trades in G-10 currencies have been unwound in recent weeks, and data published Friday showed the biggest retreat of bets against the yen since 2011.

Strategists at Wells Fargo see this reduction in bearish yen positions as a factor limiting the yen's gains going forward. There "may be better value in buying dollar-yen at or around these levels" as the pair finds its footing around the 150 level, the bank's Erik Nelson and Jack Boswell wrote Wednesday.

Options traders are positioning for a possible rebound by the dollar against the yen, with two times more demand for options to buy the dollar than for options to sell the greenback.

The BOJ raised its policy rate to around 0.25% from a range of 0 to 0.1%, according to its statement Wednesday. It also said it would reduce its monthly pace of bond buying – both actions that underscored its determination to normalize policy.

While only about 30% of central bank watchers had expected a rate hike this week, more than 90% had seen the risk of such a move, according to a Bloomberg survey. Comments from Japan's new currency chief, who said recent yen weakness had done more harm than good for the Japanese economy, had added to the anticipation.

The initial pace of the BOJ's cuts to bond buying was a touch slower than some expectations but the plan looks more aggressive than other market forecasts for a halving of purchases over a two-year period.

BOJ Governor Kazuo Ueda said any additional hikes this year would be data dependent and would be undertaken only after gauging the impact of Wednesday's move as well as the March rate increase.

Asked if the bank could lift rates beyond 0.5%, Ueda said, "If you're asking if we view that as a wall, we don't really have that sense."

> What Bloomberg Strategists Say...
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> "The yen has more upside from here, because the short-term drivers of the currency have been provided by what the BOJ delivered, even if its underlying policy choices may turn out flawed. Governor Ueda backed up an interest rate hike with a full-fledged attempt at being hawkish, and that shouldn't be dismissed lightly."
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> —Mark Cudmore, MLIV Executive Editor in Singapore

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– With assistance from Robert Fullem, Winnie Hsu, Ken McCallum, James Hirai, Constantine Courcoulas, Anya Andrianova, and Carter Johnson

(Updates yen move, Fed decision. A previous version corrected reference to BOJ plans to cut bond purchases.)