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Currency Profile for the Japanese Yen

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JPY performance against the U.S. dollar:

*Current bias for the JPY: **Neutral***

JPY set a two-week low in early February

Past week: -0.21%

Past month: +1.73%

Year-to-date: +1.62%

Sources of JPY strength:

The rally in risk assets since March that has kept the yen vulnerable to carry trade-related selling looks overstretched at current levels. Any pullback in optimism would see investors unwind carry trades and cover short JPY positions.

Additional steps by China to slow its economy's expansion through monetary tightening will fan worries about undermining a key driver of global recovery. The reduction in risk appetite should favor lower yielding currencies like the yen.

Sources of JPY weakness:

The Bank of Japan's 0.10% lending rate, the lowest in the industrialized world, leaves the yen vulnerable to carry trade selling in favor of higher yielding and riskier assets, especially as market sentiment and investor optimism improve.

The BOJ's foray into quantitative easing with the outright purchasing of longer-term government and corporate bonds threatens a flood of newly printed yen into the financial system

Recent signs of stabilization in the global economy have tempted investors out of traditional safe harbors like the Japanese yen and into higher yielding and riskier asset classes.

U.S. Treasury bond yields rose above their corresponding Japanese bond yields, making funding carry trades with dollars marginally more expensive than using JPY as a funding currency.

Officials' recent aggressive stance against deflation suggests that further monetary easing through non-standard policy tools could be in the pipeline.

Japan's new finance minister has sounded a somewhat more traditional tone with his opposition to excessive moves in exchange rates.

Monetary Policy: The Bank of Japan cut its overnight call rate by a total of 40 basis points since the start of the global financial crisis to just 0.10%, its lowest level since 2006. With lending rates at essentially zero, traditional monetary tools at the BOJ's disposal have all but been exhausted. As a result, the Bank of Japan began outright purchases of government and corporate bonds as well as commercial paper from banks with the hope of keeping longer-term rates low and at the same time, keeping banks' balance sheets flushed with cash. The use of unconventional policy tools by the Bank of Japan evolved from the need to continue stimulating the economy, even after traditional policy tools had become exhausted. Recent figures from the world's second largest economy have shown signs of very gradual stabilization in the wake of its deepest recession on record. The PMI manufacturing index has signaled expansion in the sector in every month since July and industrial production has risen sharply in every month since March. However, much of the rebound in Japan's economy appears to be the result of short-term stimulus fueled inventory replenishment, not from an organic improvement in final demand. In fact, retail sales have fallen in every month since September 2008 and the year-over-year CPI has been in negative territory for 10-straight months. While Japan's closely watched Tankan survey of manufacturers' sentiment rose in Q4, the report forecast a record drop in capital expenditures, a key driver of the nation's economic activity. Consequently, The Bank of Japan will keep monetary conditions very accommodative for the foreseeable future to ensure a sustainable recovery gains traction.

JPY Outlook: *Balance of market opinion: **Negative***

The Japanese yen has long benefited from its status as a refuge during times of economic and financial market uncertainty, regardless of the long list headwinds facing its economy. During the height of the market chaos associated with the financial crisis, the yen rose to decade and in many cases, multi-decade highs, even in the face of steadily deteriorating economic news. Most recently, in the wake of Dubai's debt crisis, the yen soared to a 14-year peak against the dollar as a result of the sharp rise in investor risk aversion. In recent weeks though, the yen has suffered as a result of the rise in U.S. Treasury bond yields, in part due to improving optimism about a U.S. recovery, which have made funding carry trades with U.S dollars marginally more expensive. As a result, the yen has regained its title as the market's favorite funding currency for trades in higher yielding investments. The yen has also suffered from recent aggressive talk by Japanese policymakers against deflation, which the market took as a commitment to keeping monetary conditions very accommodative for the foreseeable future. Going forward the yen should continue to suffer from selling against higher yielding assets amid a backdrop of an accelerating global recovery but could be underpinned by reduced risk appetite stemming from increased measures by China to limit the expansion of credit and apply the breaks on its economy's recovery.

Upcoming critical events:

Feb 9: JP December Machinery Orders

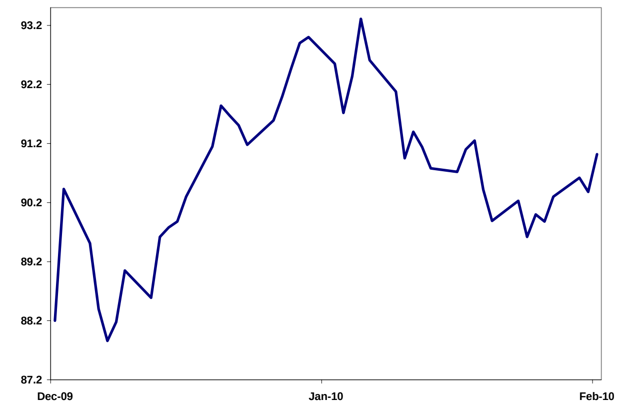
Feb 14: JP Q4 GDP

Feb 18: BOJ MPC Meeting

Feb 23: JP January Trade Balance

Feb 25: JP January CPI

Economic indicators	JPY	USD
3-month Deposit Rate	0.10%	0.22%
GDP (annual rate)	0.3%(Q3)	5.7%(Q4)
Inflation (annual rate)	-1.9%	2.7%
Unemployment	5.2%	10.0%
Trade Balance (US$)	+27.9 bln	-523.9 bln



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