

FX Morning Adviser

Japan's Oil Woes

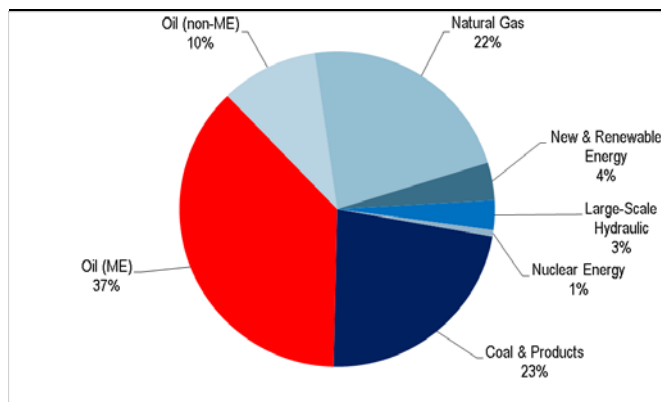
FX

Global

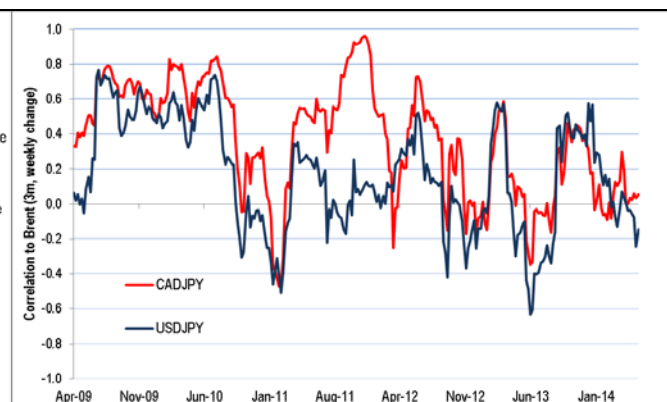
Oil shocks hurt Japan, but consequent risk aversion could still help USDJPY

With the crisis in Iraq showing no sign of abating, the global economy is bracing for a period of elevated oil prices – hardly welcome while individual countries are still growing below trend. In addition, central banks in particular will have to manage challenges relating to counter-cyclical price shocks as headline and core inflation diverge for the worse. Japan is uniquely exposed given its deep reliance on energy imports, compounded by the adverse inflation dynamics induced by Abenomics. Strong (equity-driven) risk aversion could follow any worsening in economic expectations for Japan, but we still believe being long JPY is the wrong trade for such a scenario.

The recently published revisions to Japanese energy supply dynamics (up to 2012 available) show an even heavier reliance on oil due to ongoing problems with the country's nuclear industry after the 2011 earthquake. EIA figures show that close to 80% of Japan's oil imports is sourced from the Middle East, which indicates close to 40% of Japan's total energy supply is dependent on the region. The timing couldn't have been worse: Japan's import prices have finally stabilised after sharp FX-related increases driven by the effects of QQE. If input costs suddenly rebound, the second-round effects into wage gains that Abenomics envisaged will be extremely hard to achieve lest corporates risk significant margin erosion. Equity markets will be the first place to price in problems, but even if there is risk aversion we believe the JPY-funded carry will be stable or even improve. Firstly, central banks at present are not in the business of tightening in reaction to transitory inflation spikes. With the Fed and BoJ the big marginal liquidity providers, USDJPY volatility will find a ceiling. Secondly, an oil shock would only accelerate trend decline in Japan's current account, undermining the structural case for the JPY. Finally, concerns over domestic performance could accelerate the portfolio reallocation process being encouraged/enforced by Abenomics.

Figure 1: Japan total primary energy supply


Source: METI, EIA

Figure 2: USDJPY, CADJPY vs. oil


Source: Bloomberg, UBS FX Strategy

We acknowledge that traditional reaction functions are hard to dislodge, not least in yen, which explains why for now USDJPY is not showing a positive correlation to changes in oil prices (Figure 2). For a 'purer' oil shock play, however, there may be value in being long CADJPY – whose oil correlation tends to have a more positive bias. The present vol-compression environment favours carry trades in general and the Canadian economy is enjoying a good run of data form. As Norges Bank has taken krone out of the equation, FX markets are quite squeezed for positive oil plays and CAD is probably the only liquid alternative where longs do have scope to run.

Technical FX

EURUSD	BEARISH	The latest upside moves appears to be just a recovery phase within a downtrend. Resistance should hold at 1.3677. There's scope for resumption of downside to test support at 1.3477 and then 1.3248.
USDJPY	NEUTRAL	The pair has been consolidating under resistance at 103.02. Any further downside should find supports at 101.43 and then 100.76.
GBPUSD	BULLISH	With the trending indicators bullish, there's scope for further upside to eventually test significant resistance at 1.7332. Setbacks in the interim will be limited in time and extent, with first support at 1.6923.
USDCHF	BULLISH	As bullish conditions persist, downside will be limited to support at 0.8908. While this holds, there's potential for an upside move to resistance at 0.9082 and then 0.9156.
AUDUSD	BEARISH	Strong resistance focus is at 0.9461. While this holds, there's risk for extension of the range trading that has been in place since April. Support is at 0.9322 ahead of 0.9203.
USDCAD	BEARISH	The pair failed to close below support at 1.0731 and there's scope for a short-term recovery to unwind overextended downside conditions. Resistance should hold at 1.0810. Next support is at 1.0650.
EURCHF	NEUTRAL	The important near-term directional triggers are at 1.2205 and 1.2141. A closing breakout through one of these levels will determine the next leg.
EURGBP	BEARISH	Following tests of support at 0.7960 earlier last week, the cross has been consolidating. But strength should be limited to resistance at 0.8032. However, a close below 0.7960 will be further bearish, opening 0.7755.
EURJPY	BEARISH	The latest recovery doesn't change the bearish picture and look for rejection from higher resistance levels marked at 138.90 ahead of 140.09. Support is at 137.71 ahead of 136.23.

*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	Freq.	UBS	Prev/Rev	Cons.	Actual
United States	22:30	Fed's Williams Speaks					
Japan	23:50	PPI Services (May)	y-o-y	n/a	3.40%	3.30%	3.60%
Australia	03:00	RBA's Lowe Speaks					
Germany	06:00	GfK Consumer Confidence (Jul)	index	8.6	8.5	8.6	
Switzerland	06:00	UBS Consumption Indicator (May)	index	n/a	1.72	n/a	
Euro Area	08:00	ECB's Costa Speaks					
UK	10:00	CBI Reported Sales (Jun)	index	n/a	16	23	
United States	11:00	MBA Mortgage Applications (Jun-20)	m-o-m	n/a	-9.20%	n/a	
Euro Area	12:00	ECB's Linde Speaks					
United States	12:30	GDP Annualized (Q1 T)	q-o-q	-2.00%	-1.00%	-1.80%	
United States	12:30	GDP Price Index (Q1 T)	q-o-q	n/a	1.30%	1.30%	
United States	12:30	Core PCE (Q1 T)	q-o-q	n/a	1.20%	1.20%	
United States	12:30	Personal Consumption (Q1 T)	m-o-m	1.80%	3.10%	2.40%	
United States	12:30	Durable Goods Orders (May)	m-o-m	-0.70%	0.60%	0.00%	
United States	12:30	Durables Ex Transportation (May)	m-o-m	0.00%	0.30%	0.30%	
Euro Area	13:00	ECB's Weidmann Speaks					
United States	13:45	Composite PMI (Jun P)	index	n/a	58.4	n/a	
United States	13:45	Services PMI (Jun P)	index	n/a	58.1	58.0	

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