

Daiwa's View

USD/JPY basis is becoming less negative

- US financial conditions are loosening slightly
- Selling of foreign bonds by Japanese investors has an impact on supply/demand of basis

Fixed Income Research Section
FICC Research Dept.

Strategist
Kengo Shiroyama
(81) 3 5555-8755
kengo.shiroyama@daiwa.co.jp

Senior FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp
Daiwa Securities Co. Ltd.

Due to loosening of US financial conditions, USD/JPY basis is becoming less negative

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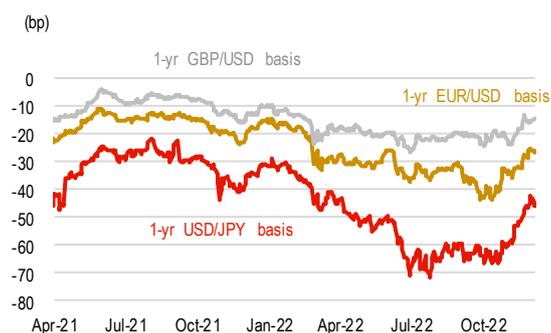
The USD/JPY basis is becoming less negative (Chart 1). With substantial narrowing of the USD/JPY basis, the EUR/USD basis and the GBP/USD basis are also narrowing. We attribute this partly to loosening of the financial conditions due to mounting speculation about slower rate hikes by the Fed (Chart 2).

During 2022, the trend with dollar appreciation and yen depreciation has moved together with widening of the negative USD/JPY basis (Chart 3). Deterioration in the yen's supply/demand conditions appears to have an impact on the currency basis. Since November, the USD/JPY rate has declined due to a pause in further appreciation of the dollar. This is probably one factor behind the USD/JPY basis becoming less negative.

Heavy selling of foreign bonds by Japanese investors

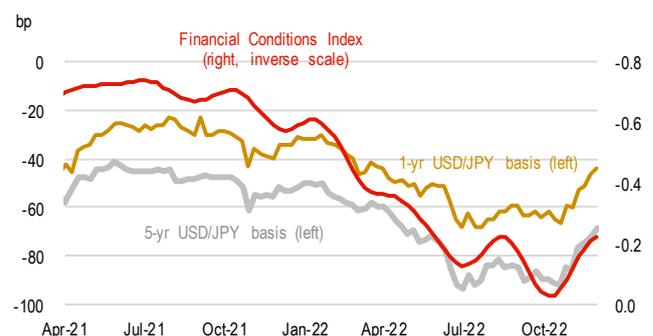
In terms of supply/demand conditions, we can point out heavy selling of foreign bonds by Japanese investors as a contributor to the USD/JPY basis becoming less negative (Chart 4). In June 2022, net selling of foreign bonds exceeded ¥4tn. Subsequently, a large amount of selling has continued, with the exception of August. When Japanese investors invest in foreign bonds, they seem to invest in hedged bonds at a certain rate, causing pressure that makes the USD/JPY basis more negative. However, hedging costs have risen substantially due to rapid rate hikes by the Fed since March 2022. This has led to selling of foreign bonds, which appears to have reduced the pressure making the USD/JPY basis more negative, in contrast to when bonds are acquired.

Chart 1: Dollar Basis vs. Major Currencies



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Financial Conditions Index (Chicago Fed), USD/JPY Basis



Source: Chicago Fed, Bloomberg; compiled by Daiwa Securities.

Chart 3: USD/JPY, USD/JPY Basis

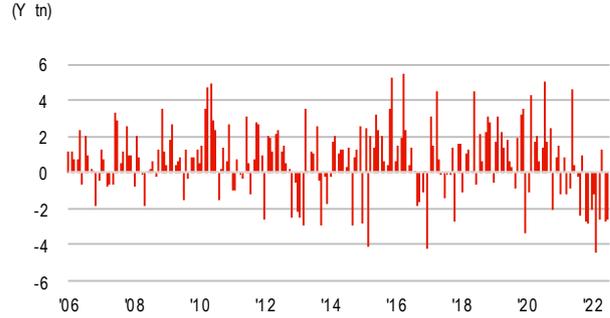


Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY basis is unlikely to continue to become less negative

Although we have started to see signs of slowing inflation, the Fed is still in the midst of monetary tightening. The central bank would not want to see overly accommodative financial conditions until it is convinced that inflation has subsided. Once we see peaking-out of the US long-term yield and a recession with further inversion of the yield curve, Japanese investors may once again become activate investment in foreign bonds, and the volume of currency hedging may increase once more. Given these factors, we think that both the loosening of the financial conditions and the USD/JPY basis becoming less negative will be temporary in the short term.

Chart 4: Japan Securities Investment Abroad Bond Net (intermediate/long-term bonds)



Source: MOF; compiled by Daiwa Securities.

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