Daiwa's View

Things to watch for in 2023 (4): Will selling of the yen increase due to investment in unhedged foreign bonds by life insurers?

➢ Continued decline in the currency hedge ratio

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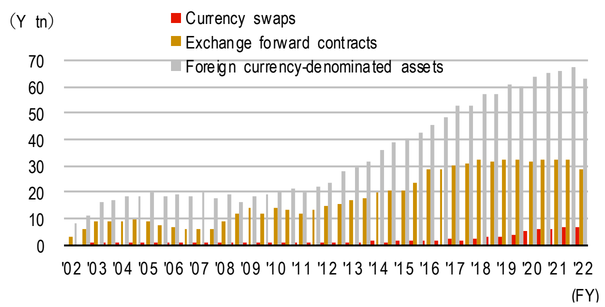
Continued decline in the currency hedge ratio

In 1H FY22 (Apr-Sep 2022), the currency hedge ratio related to investment in foreign bonds by life insurers continued to decline. The outstanding amount of foreign security investment at nine major Japanese life insurers came in at Y62.9tn, a Y4.7tn drop from Y67.6tn at end-FY21 (Mar 2022, Chart 1). Meanwhile, currency hedging (exchange forward contracts and currency swaps) for these investments stood at Y35.3tn, a Y3.4tn decline from Y38.6tn at end-FY21. As a result, the currency hedge ratio declined from 57.1% at end-FY21 to 56.1% (Chart 2).

Life insurers' currency hedge ratio has been declining remarkably among hedge transactions using exchange forward contracts (currency swaps). The currency hedge ratio at life insurers tends to move in line with the curves of overseas yields. The extent of the decline in the currency hedge ratio seems to be limited compared with the degree of flattening of the curve. Nevertheless, the currency hedge ratio was at 45.0% at end-1H FY22, the lowest level since end-1H FY08 (Apr-Sep 2008, Chart 3 on next page). As overseas central banks are expected to continue with rate hikes from January 2023 onwards, the currency hedge ratio may decline further amid further flattening of overseas yield curves.

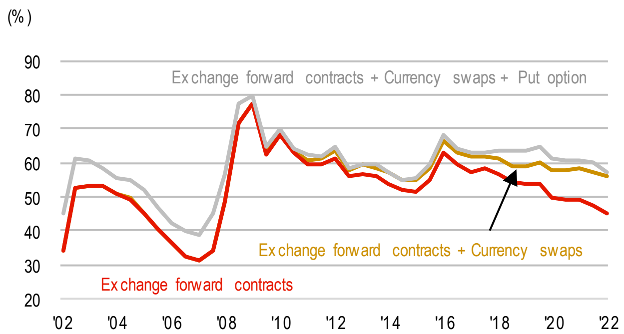
Meanwhile, the outstanding amount of currency swaps, which are frequently used when hedging credit investment, has been continuing to increase, hitting a record high at Y7.0tn at end-1H FY22. This is consistent with the FY22 investment plan for hedged foreign bonds, in which desire to invest in sovereign bonds diminished in anticipation of a rise in hedging costs while desire to invest in credit products increased.

Chart 1: Currency Hedging, Outstanding Amount of Foreign Security Investment at Major Life Insurers



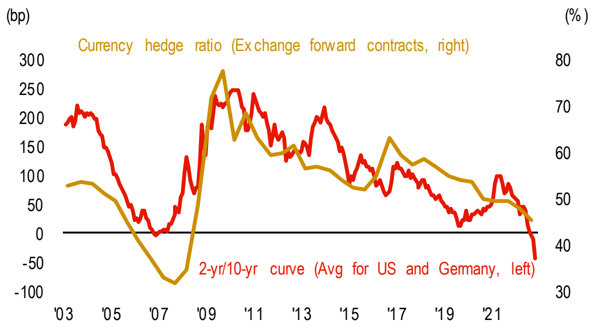
Source: Major life insurers' earnings results materials; compiled by Daiwa Securities.

Chart 2: Currency Hedge Ratio at Major Life Insurers



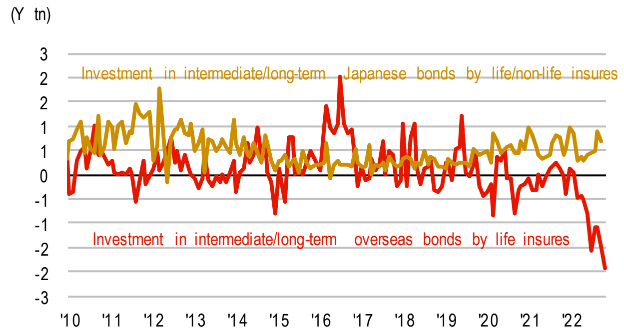
Source: Major life insurers' earnings results materials; compiled by Daiwa Securities.

Chart 3: Currency Hedge Ratio, Yield Curve (Avg for US and Germany)



Source: Major life insurers' earnings results materials, Bloomberg; compiled by Daiwa Securities.

Chart 4: Investment in Yen and Foreign Bonds by Major Life/Non-life Insurers



Source: MOF, Japan Securities Dealers Association; compiled by Daiwa Securities.

Hedged foreign bonds have been offering a negative carry, reflecting aggressive rate hikes by overseas central banks. Under the circumstances, life insurers sold a large amount of foreign bonds in FY22 similar to other institutional investors (Chart 4), while maintaining a reasonable level of investment in yen bonds. This is probably because yen bonds are becoming more attractive than hedged foreign bonds, as well as the fact that investment increased to the highest level in the past few years due to a rise in superlong JGB yields in line with overseas yields.

In late October, life insurers announced their 2H FY22 investment plans (Chart 5 on next page). Many firms indicated policies with increased investment in Japanese bonds through decreased investment in foreign bonds, mainly hedged bonds. The amount of investment in yen bonds in 1H was not small compared to past figures. However, some life insurers indicated their intention to accelerate investment in 2H in superlong bonds, which had been constrained in light of the outlook for higher yields. As such, forward-looking investment behavior for JGBs is anticipated. Many firms indicated a cautious stance regarding unhedged foreign bonds, albeit less cautious than that for hedged bonds. This is probably because life insurers are aware of the risk of yen appreciation from now on, despite the fact that overseas yields are at attractive levels.

That said, sharp depreciation of the yen, which had intensified this year, has been unwound since late October. This appears to have reduced the risk of yen appreciation, which is a concern when trying to shift to unhedged foreign bonds. Since the market is aware of concerns about a stronger yen, it is hard to imagine a large amount of investment being made. However, in a situation where hedged foreign bonds, mainly US Treasuries, are expected to offer negative returns over a long period of time, we should focus on whether investment in unhedged foreign bonds will cause selling of the yen. This is also important when watching the yen market.

Among hedged foreign bonds, a shift from sovereign bonds to credit investment may continue in order to secure yields higher than hedging costs. The implications for the USD/JPY basis are that the short-term zone will face narrowing pressure and the intermediate/long-term zone will face widening pressure. That said, it would be hard to imagine the extreme case of life insurers' investments in all foreign bonds being shifted to credit investment. Therefore, they are likely to consider buying hedged US Treasuries, investing in European bonds (French government bonds, in particular), or buying unhedged foreign bonds as mentioned above.

Chart 5: 2H FY22 Investment Plans at Major Life Insurers

	Japanese bonds	Foreign bonds		Market outlook		
		Hedged	Unhedged	10-yr JGB yield (%)	10-yr US yield (%)	USD/JPY rate (Y)
Nippon Life Insurance	Increase	Decrease	No change or decrease	-0.25～0.25 (0.20)	3.00～5.00 (4.00)	131～159 (145)
Dai-ichi Life Insurance	Increase	Depends on yield levels	Depends on forex rate levels	-0.10～0.40 (0.25)	3.30～4.50 (3.80)	135～155 (145)
Meiji Yasuda Life Insurance	Increase	Decrease in sovereign bonds Increase in corporate bonds	No change	0.15～0.25 (0.20)	3.30～4.00 (3.70)	139～149 (142)
Sumitomo Life Insurance	Increase	Decrease	No change	0.00～0.30 (0.20)	3.00～4.50 (3.75)	130～160 (145)
Taiyo Life Insurance	Increase	Decrease		0.00～0.25 (0.25)	3.00～4.50 (3.60)	135～155 (140)
Taiju Life Insurance	No change	Decrease	Increase	0.10～0.30 (0.25)	2.90～3.90 (3.40)	139～149 (144)
Fukoku Mutual Life Insurance	Increase	Decrease		0.00～0.50 (0.25)	3.00～5.00 (4.50)	130～160 (150)
Daido Life Insurance	Increase	Decrease		0.15～0.25 (0.25)	3.00～4.50 (3.40)	135～155 (142)
Asahi Mutual Life Insurance	Increase	Decrease		0.10～0.25 (0.25)	3.00～4.50 (4.00)	135～155 (145)

Source: Major life insurers' earnings results materials; compiled by Daiwa Securities.

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