Daiwa Securities

Daiwa's View

Yen short positions are at their highest level since outbreak of COVID-19 pandemic

➢ Wary about unwinding of positions

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Wary about unwinding of positions

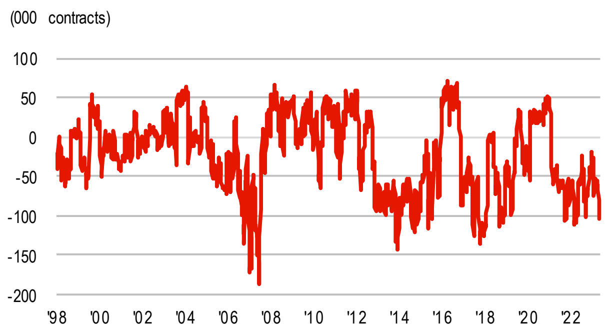
As of 6 June, yen futures short positions in the IMM exceeded 100,000 contracts in the non-commercial division (Chart 1). This suggests that the yen carry trade may have become more active. This is also indicated by the fact that the amount of assets in accounts at the main offices and branches of foreign banks in Japan is once again increasing, after having been on the decline between October 2022, when it hit a recent peak, and February 2023.

The biggest factor behind the increasing attractiveness of carry trades is likely the widening of the interest rate differential between Japan and other nations amid continued rate hikes by many nations, not just the US. The fact that volatility in the financial market is more stable now compared to what it was before October 2022 also seems to be exerting an influence.

Currently, the short-term money market is pricing in the view that the Fed will end its rate hikes after implementing one more rate hike (25bp). If an additional one or two rate hikes are implemented, depending on economic and inflation conditions, the entire yield curve in the US is expected to rise in line with a rise in short-term yields. That said, if the market is only going to price in several more rate hikes, that is unlikely to lead to a rise in market volatility, which should make carry trades more attractive.

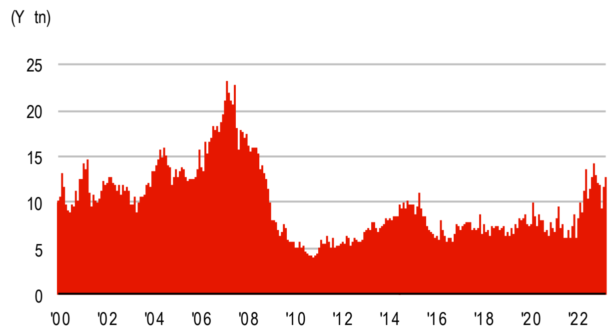
Moreover, the differential between Japan's policy rate and the global policy rate has widened to around 4%. As rate hikes in the US create depreciation pressure on currencies in other nations, it is easier for other nations to follow suit by raising rates, as shown by the fact that the Reserve Bank of Australia and the Bank of Canada implemented hawkish rate hikes in early June. This also serves as a factor in widening the interest rate differential between Japan and other nations.

Chart 1: Speculative Positions in Currency Futures in IMM



Source: CFTC; compiled by Daiwa Securities.

Chart 2: Assets in Accounts at Main Offices and Branches of Foreign Banks in Japan



Source: BOJ; compiled by Daiwa Securities.

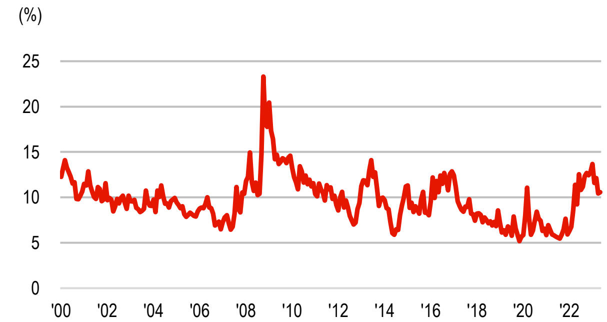
However, yen short positions have now accumulated to their greatest extent since the outbreak of the COVID-19 pandemic, with the number of contracts considerably large, even when viewed over a time frame going back as far as the Global Financial Crisis (GFC). Furthermore, although the interest rate differential between Japan and the US is widening substantially, the volatility of the USD/JPY rate, while having calmed slightly, remains high (Chart 3). The USD/JPY carry-to-risk ratio (i.e., interest rate differential / currency volatility) is not as high as it was during the pre-GFC period when yen carry trades were popular (Chart 4). Current circumstances do not suggest further accumulation of yen short positions via carry trades.

It is possible that the USD/JPY rate will rise further due to a slight accumulation of short positions. However, we should be more wary of a decline in the USD/JPY rate in the short term due to the unwinding of short positions. As long as the market's outlook for the economy and monetary policies does not change significantly, the USD/JPY rate is unlikely to stay in the Y140-145 range for long, although it could move in that range for a short period of time.

However, if the market starts to price in more rate hikes in order to cope with inflation or a delay in the timing of rate cuts, volatility with bonds and currency exchange rates may increase once again as the market becomes more unstable, as happened during the period that continued until last year. If that were to happen, carry trades would not necessarily become attractive. However, we would expect to see selling of the yen in anticipation of capital gains via trading, which we anticipate would boost the USD/JPY rate further. In fact, as pointed out by a *Bank of Japan Review* report, the transaction volume in FX trading by individual investors has increased substantially beyond the average monthly position compared to the past. Therefore, there may be an increasing trend towards conducting trades in anticipation of short-term capital gains rather than conducting trades aimed at achieving gains from the interest rate differential.

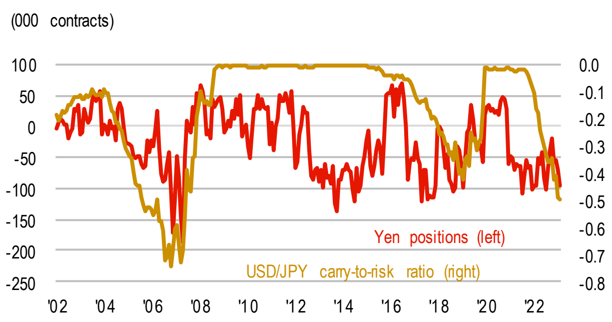
If yen short positions were to accumulate further due to a change in the outlook for US monetary policy, the number of contracts could reach more than 150,000, comparable to what it was before the GFC. Since Japan tends to post a trade deficit, there is expected to be less downward pressure on the USD/JPY rate than before when US yields decline towards the neutral level. However, in many cases, positions held by speculative investors entail leveraging, and, therefore, the unwinding of positions would cause sudden purchasing of the yen. In fact, in 2007 and 2008, the yen strengthened by more than 20% due to the unwinding of huge positions. Accumulation of yen short positions would support the USD/JPY rate in the short run, but it could serve as a factor in substantially pushing down the rate in the long run.

Chart 3: USD/JPY Implied Volatility (3 months)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: Yen Short Positions, Carry-to-risk Ratio



Source: CFTC, Bloomberg; compiled by Daiwa Securities.

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