Daiwa Securities

Daiwa's View

Will USD/JPY hedging costs reach 6%, as expected?

➢ Temporary easing of basis in Goldilocks market

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Temporary easing of basis in Goldilocks market

Will USD/JPY hedging costs reach 6%, as expected?

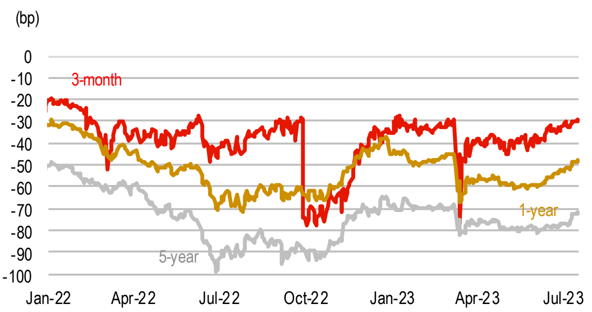
◆ Basis

When the banking shock happened in the US and Europe in March 2023, the USD/JPY basis became substantially more negative (Chart 1). However, thanks to the prompt response of authorities, the acute shock in the financial market calmed and the basis recovered partially from the drop. Then, partly due to caution about the US debt ceiling issue, the basis remained roughly flat, despite the favorable performance of the US stock market. However, after the debt ceiling issue was resolved, optimism about the US economy became a market topic once again, and the short-term basis recovered to where it had been before the banking shock. The medium/long-term basis (over 1 year) is also on a recovery trend, but still lower than what it was before the banking shock.

In February and March, before the banking shock, a "no landing" scenario for the US economy became a topic. With people now arguing that the neutral interest rate could be on the rise, market optimism about the economy is very similar to views at that time. This is consistent with the fact that the short-term basis, which strongly reflects market sentiment, is almost at the same level.

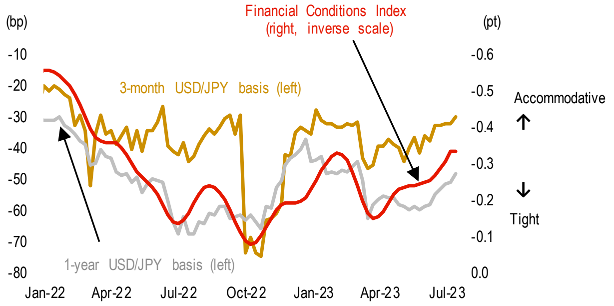
We attribute the short-term basis becoming less negative to the fact that (1) the VIX Index remains at a low level, reflecting optimism in the stock market and (2) spreads have been low with US corporate bonds and CPs. Although the short-term basis becomes more negative when circumstances look like they are about to become critical (i.e., cash shortage), the short-term money market is stable at the moment.

Chart 1: USD/JPY Basis



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: USD/JPY Basis, Financial Conditions Index



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

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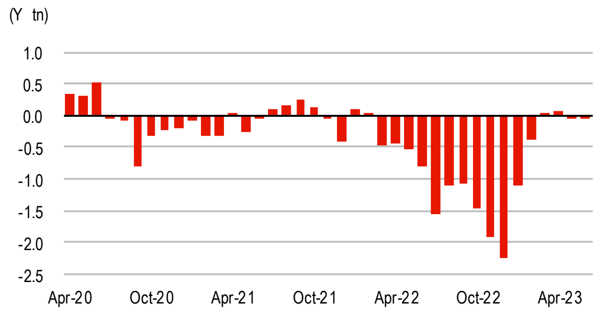
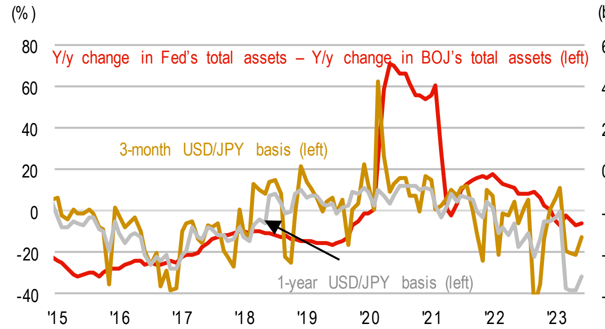
Chart 3: Japan Securities Investment Abroad Bond Net (life insurers, intermediate/long-term bonds)



Source: MOF; compiled by Daiwa Securities.

Chart 4: Central Bank Balance Sheets, USD/JPY Basis



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

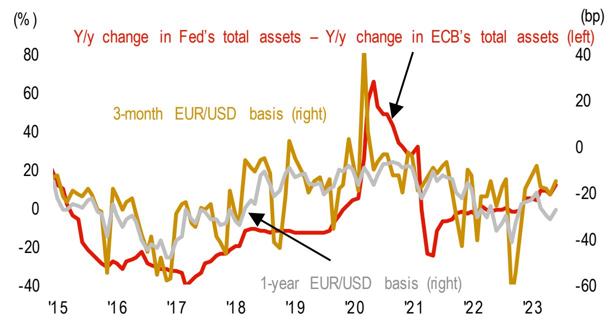
Not only the short-term basis, but also the medium/long-term basis is becoming less negative, which is likely partly because US financial conditions have been becoming accommodative despite rate hikes (Chart 2 on previous page). This appears to be influenced by the fact that the Fed's balance sheet reduction is not proceeding as planned. In addition, in terms of supply/demand conditions, the fact that life insurers, which use currency hedging, are continuing to hold off on investing in foreign bonds is likely a factor behind widening pressure on the basis not being stronger (Chart 3).

That said, the Fed's balance sheet reduction is continuing, although it is not proceeding as planned. The Fed is expected to maintain its tightening stance by keeping high policy interest rates until it is clear that inflation is going to slow to 2%. Amid a slowdown in price-related indicators, the US economy currently remains firm, centering on consumption and the labor market, and risk assets are performing well. However, we must admit that the Fed, which conducted rapid monetary tightening after falling behind the curve, could, by prioritizing price stability, fall behind again and fail to cut rates at the appropriate time. If so, financial conditions would tighten substantially at some point. As the difference in the rate of change in the BOJ and Fed balance sheets is correlated with the USD/JPY basis (Chart 4), it is estimated that the basis will eventually become more negative provided the Fed continues to reduce its balance sheet.

Meanwhile, the difference in the rate of change in the ECB and Fed balance sheets suggests that the EUR/USD basis will become less negative (Chart 5 on next page). The ECB is reducing its balance sheet by decreasing the balance for APP and TLTRO. The BOJ and ECB have substantially different stances regarding their balance sheet policies. The EUR/USD basis may continue to become less negative, but US financial conditions will tighten going forward. However, if further tightening of financial conditions leads to critical circumstances for the economy and the financial market, demand for the dollar will increase substantially. If that were to happen, we would see the dollar appreciate and the EUR/USD basis become more negative at the same time.

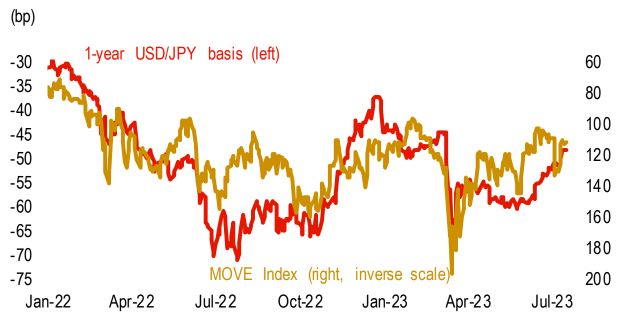
Moreover, although this is not the main scenario in *Daiwa's View* reports, if US inflation were to pick up once again towards the latter half of the year, the terminal rate priced in by the market may be revised upwards substantially. In that case, if the Fed's balance sheet were not fully reduced, the financial market would become volatile, which would likely cause the dollar to appreciate and the USD/JPY basis to become more negative at the same time. In fact, the MOVE index rose until October 2022, in line with greater uncertainty in the bond market amid the market pricing in a rise in the terminal rate (refer to our 15 Nov 2022 report *Daiwa's View: MOVE index pointing to end of USD appreciation?*). Under the circumstances, the basis had become more negative, but these movements reversed course, reflecting weaker-than-expected US October CPI (Chart 6 on next page). In any event, the USD/JPY basis is likely to become more negative.

Chart 5: Central Bank Balance Sheets, EUR/USD Basis



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

Chart 6: USD/JPY Basis, MOVE Index

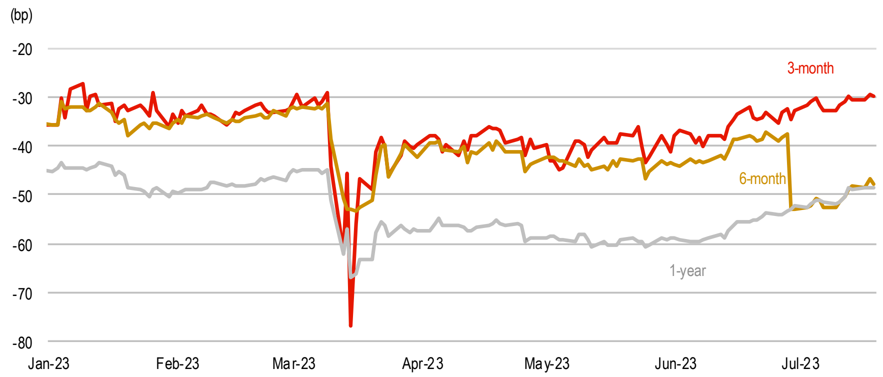


Source: Bloomberg; compiled by Daiwa Securities.

- USD/JPY hedging costs
  While the Fed is maintaining high policy interest rates, USD/JPY hedging costs are expected to remain high. Currently, the market is fully factoring in a 25bp rate hike within the year, but it has not fully priced in a second rate hike. If it were to price in two or more hikes, US short-term interest rates would rise further. This would widen the Japan/US interest rate spread and raise hedging costs.

  Moreover, movements to secure the dollar during the change of year serve as a factor in widening the short-term basis. The 6-month USD/JPY basis has already widened to the level of the 1-year USD/JPY basis (Chart 7). At end-September 2023, the 3-month USD/JPY basis is also expected to widen substantially. Currently, the spread between the 3-month USD/JPY basis and the 1-year USD/JPY basis is about 20bp, suggesting that this will serve as a factor in raising 3-month USD/JPY hedging costs by at least around 20bp. If the market were to factor in two or more hikes in the US, hedging costs at the 6% level would likely begin to be seen, combined with widening of the basis. For the time being, JGBs will likely remain more attractive than hedged foreign bonds for Japanese investors.

Chart 7: USD/JPY Basis



Source: Bloomberg; compiled by Daiwa Securities.

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- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

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