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Japanese report: 6 October 2023

Daiwa's View

USD/JPY hedging costs have finally reached 6%

➢ USD/JPY basis has started worsening

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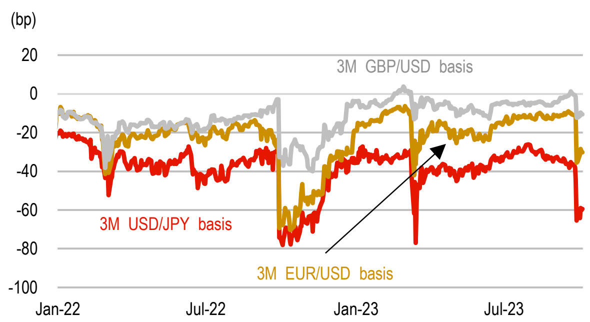
◆ Basis

At the end of September, the 3-month USD/JPY basis became significantly more negative. Similarly, the EUR/USD basis and GBP/USD basis also became more negative (Chart 1). This is because global systemically important banks (G-SIBs) tend to avoid currency basis transactions during the Oct-Dec period in order to avoid a rise in scores used for determining G-SIBs surcharges.

Moreover, in addition to the short-term basis, such as the 3-month basis, the bases for one year or longer periods have also recently started to fall further into negative territory (Chart 2). This is because financial conditions have started to tighten due to a sharp rise in the long-term UST yield since the beginning of September. After the bank shock in the US and Europe in March 2023, the basis had become less negative until July, with the bank shock subsiding and financial conditions loosening amid spreading optimism about the strength of the US economy.

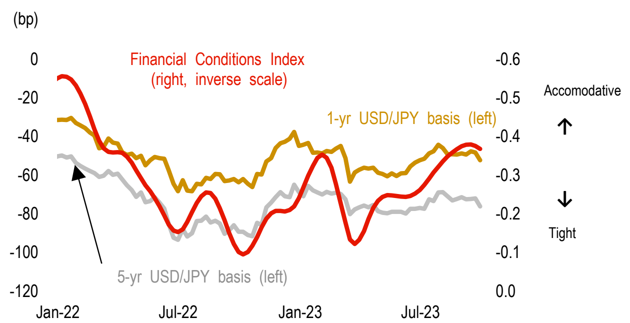
Due to the rise in US yields, the stock market cannot sustain the firmness it saw until July. Volatility indices, such as VIX and MOVE Index, are rising. Furthermore, corporate bond spreads and CDS spreads, both of which had been tightening despite the softness of the stock market, have begun widening since September (Chart 3 on next page). With further appreciation of the dollar, rising US yields are producing the effect of tightening all aspects of the financial market. With US yields having risen sharply in a short period of time, these developments may let up. However, as the Fed has demonstrated a stance of keeping the policy interest rate at a high level for the long term, financial conditions are expected to remain tight going forward.

Chart 1: 3-month Basis of Major Currencies vs. USD



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Financial Conditions Index, USD/JPY Basis



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

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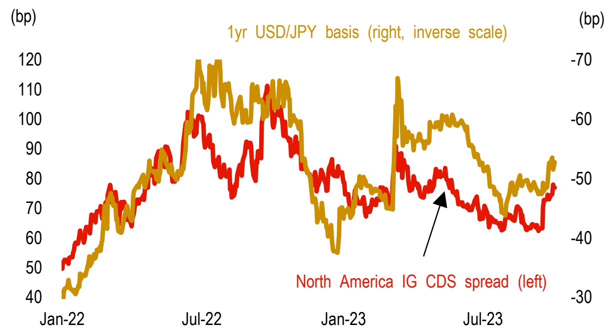
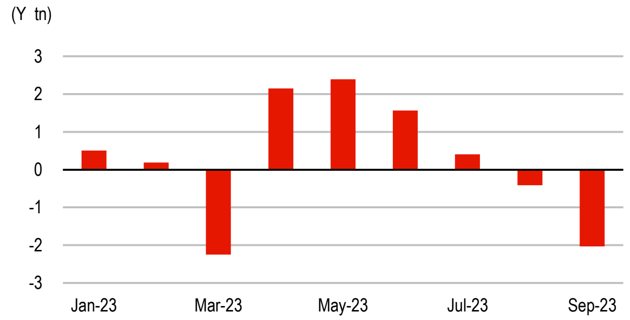
Chart 3: CDS Spread, USD/JPY Basis



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: Net Trading Value of Japanese Stocks by Overseas Investors



Source: JPX; compiled by Daiwa Securities.
Note: Total of two major markets.

As hedging costs remain high, Japanese life insurers are not aggressively investing in hedged foreign bonds. Therefore, foreign bond investment by Japanese investors is not contributing to the widening of the negative basis. Meanwhile, overseas investors (who can make use of the widening negative USD/JPY basis) are not increasing investment in Japanese bonds, either. Therefore, there are no factors to make the basis less negative.

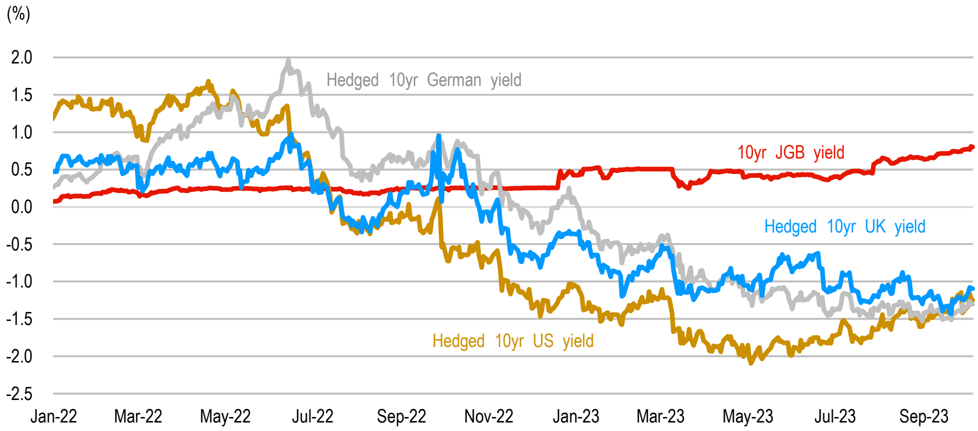
However, it is possible that the softness of the Japanese stock market is having an impact on the widening of the negative USD/JPY basis in terms of supply and demand. During April-June, when Japanese stocks were solid, net buying of Japanese stocks by overseas investors was significant, at about Y2tn/month (Chart 4). At that time, it was highly likely that overseas investors hedged currency risk when buying Japanese stocks, which contributed to tightening of the negative USD/JPY basis. However, overseas investors became net sellers in August, with net selling amounting to as much as Y2tn in September. When they sell Japanese stocks, they unwind currency hedging at the time of purchase, leading to an opposite impact on the basis.

◆ Hedging costs

In line with the widening of short-term yields between Japan and the US due to rate hikes by the Fed, and partly due to the widening of the 3-month USD/JPY basis in negative territory, 3-month USD/JPY hedging costs reached 6%. As JGB yields have been rising in line with the rise in US long-term yields since September, hedged US yields remain less attractive for Japanese investors than JGB yields (Chart 5 on next page). However, as the extent of the US yield inversion has narrowed substantially, hedged US yields have risen significantly. Moreover, if speculation were to grow that the BOJ was going to enter a tightening cycle by raising the policy interest rate, the JGB yield curve would flatten. In that case, hedged US yields would be expected to become more attractive due to a decline in hedging costs.

Furthermore, due to the continuing US yield inversion until June 2023, US yields had also not been attractive for investors holding euros and UK pounds. This is considered to be one factor behind the rise in US yields led by the term premium due to deterioration of supply and demand among non-US investors (refer to our 3 Oct report *Daiwa's View: Ongoing rise in US Treasury yields led by term premium*). As shown in Chart 5, as the extent of the US yield inversion shrinks, the levels of US, German, and UK yields (after considering hedging costs) have been converging. This is likely to serve as a factor in improving the supply and demand of US Treasuries.

Chart 5: 3-month Hedged Yields for Japanese Investors



Source: Bloomberg; compiled by Daiwa Securities.

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