Daiwa's View

Hedging costs in 2024

- Major change on the US economy and Fed monetary policy outlooks
- Could there be a significant decline in hedging costs from 2025?

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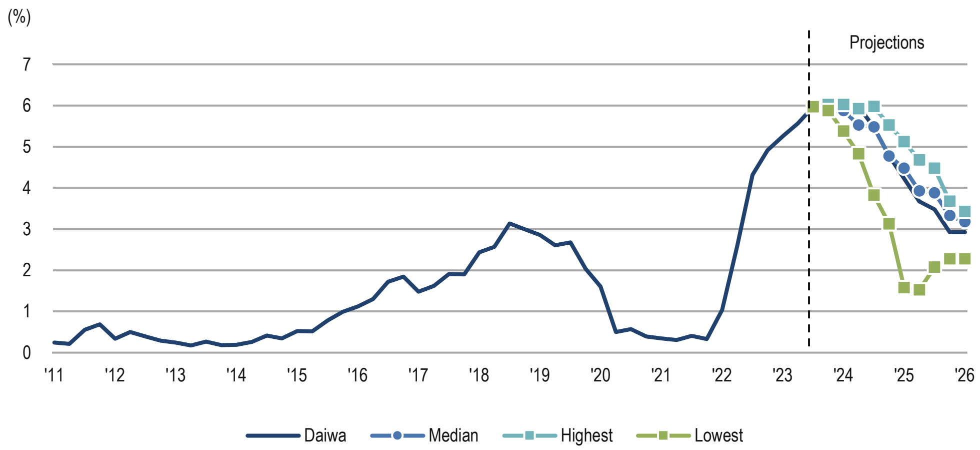
Could there be a significant decline in hedging costs from 2025?

US long-term rates declined rapidly as expectations that the Fed will stop hiking rates gained traction in the market. The number of trades anticipating US rate declines in 2024 in response to Fed rate cuts appears to be increasing, but the story is not that simple for Japanese investors, given the costs of hedging and the risks from exchange rates (yen appreciation). In this report, we estimate 3-month hedging costs in 2024 and beyond using the private-sector policy interest rate forecasts in a Bloomberg survey, primarily in the USD/JPY market.

Forecasts for the USD/JPY market in 2024 are widely divergent, and likewise forecasts of hedging costs differ greatly depending on the outlooks for the US economy and the Fed's monetary policy path. Hedging costs are of course determined by both interest rate differentials and currency basis. Interest rate differentials account for a particularly large share of hedging costs at times like these amid aggressive policy rate hikes by central banks, and this only makes policy rate outlooks that much more important.

We form our outlook for hedging costs under various scenarios, using the median, highest, and lowest values from Bloomberg's survey of policy rate outlooks across economies. Under the median scenario, we expect the 3-month USD/JPY hedging cost to decline to 4.8% by end-2024, more than 1ppt lower than the current level of just under 6%, and then down to 3.3% by end-2025 (Chart 1).

Chart 1: Projections for 3-month USD/JPY Hedging Costs



Source: Bloomberg; compiled by Daiwa.

Under the highest value scenario, we expect hedging costs to remain high next year, ending 2024 at 5.5% and then finally start declining, down to 3.7% by end-2025. Our hedging cost outlook under the lowest value scenario is a decline to 3.1% by end-2024 and further decline to 1.5% by Apr-Jun 2025.

Hedging costs are of course determined by both interest rate differentials and currency basis. The issues we consider and assumptions we use to make each of the above estimates are shown below. Although not covered in this report, our estimates of the key cross-yen hedging costs are shown at the end of this report

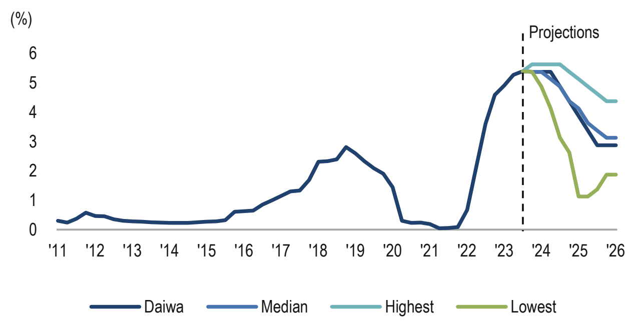
Interest rate differential

The most important factor determining interest rate differentials is the policy rate outlook. The interest rate differential in 2024 depends on the respective economic outlooks. Specifically, the policy rate path will differ substantially depending on whether the US experiences a soft landing (the most likely scenario according to the market), no landing, or a hard landing.

Although not exactly, the median US monetary policy outlook in the Bloomberg survey probably maps to a soft landing, the highest value to a no landing, and the lowest value to a hard landing. The median outlook is for Fed rate cuts totaling 1ppt in 2024 and further cuts that bring the policy rate target down to 3.00-3.25% by end-2025 (Chart 2). The highest value outlook is for rate cuts to begin in Oct-Dec 2024 but not bring the policy rate any lower than 4.25-4.50% by end-2025. In contrast, the lowest value outlook is for a rapid pace of rate cuts in 2024 that brings the Fed's policy rate down to 2.50-2.75% by Oct-Dec 2024 and then to 1.00-1.25% by Jan-Mar 2025.

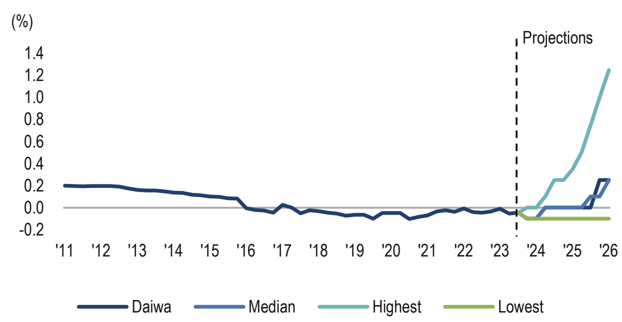
The point at which the BOJ exits its negative interest rate policy (NIRP) is gradually drawing closer and rate hikes by the BOJ would cause the basis cost to shrink. However, the lowest value outlook for the BOJ's policy rate is for no NIRP exit and no rate hikes, while the median outlook is for a very gradual pace of rate increases, starting with NIRP exit in Apr-Jun 2024 and rate hikes eventually to 0.1% by Jul-Sep 2025 (Chart 3). The highest value outlook is for the BOJ to raise its policy rate to 1.25% by Jan-Mar 2026, but only to 0.25% by Oct-Dec 2024 as it waits until 2025 for more aggressive rate hikes.

Chart 2: Projections for Fed's Policy Interest Rate



Source: Fed, Bloomberg; compiled by Daiwa.

Chart 3: Projections for BOJ's Policy Interest Rate



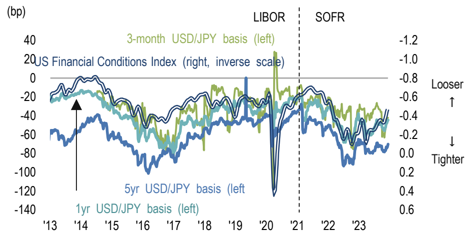
Source: BOJ, Bloomberg; compiled by Daiwa.

Chart 4: New York Fed DSGE Model Forecasts (%)

Forecast period	2023	2024	2025	2026
GDP growth (Q4/Q4)	1.9 (0.2, 3.6)	1.1 (-4.0, 6.3)	0.7 (-4.4, 5.8)	1.2 (-4.2, 6.6)
Core PCE inflation (Q4/Q4)	3.7 (3.4, 3.9)	2.2 (1.5, 3.0)	2.0 (1.1, 2.9)	2.0 (1.0, 3.0)
Real natural rate of interest (Q4)	2.5 (1.3, 3.7)	2.2 (0.8, 3.7)	1.9 (0.3, 3.4)	1.6 (0.0, 3.3)

Source: New York Fed; compiled by Daiwa.
Note: As of 22 Sep 2023. The numbers outside parentheses are the mean forecasts, and the numbers in parentheses are the 68 percent bands.

Chart 5: US Financial Conditions Index, USD/JPY Basis



Source: Chicago Fed, Bloomberg; compiled by Daiwa.

Another factor to consider in forecasting the policy rate is the expectation for the natural rate of interest (neutral rate, equilibrium real rate). A popular topic around the time of this year's Jackson Hole symposium was the apparent rise in the short-term neutral rate, particularly in the US, caused by massive government spending. However, it appears to be the majority view that the long-term neutral rate has not increased. Using the New York Fed's DFGE model, the equilibrium real rate is 2.5% for 2023 and is forecast to decline by about 0.3ppt per year until 2026 (Chart 4). If the New York Fed's estimates are correct, the Fed would not have much scope for cutting rates under a soft landing or no landing scenario.

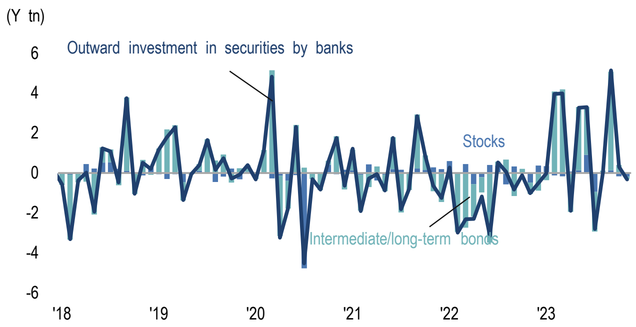
Currency basis

The key factors determining the currency basis trend are US financial conditions and supply-demand (including seasonality). The past correlation between the US financial conditions index and the USD/JPY basis has been that a tightening of financial conditions made the basis more negative and an easing of financial conditions made the basis less negative (Chart 5). The short-term currency basis also tends to become more negative when financial markets lean heavily toward risk-off mode. When a rapid increase in US recession risk creates financial market turmoil, there is a risk of the 3-month USD/JPY basis becoming substantially more negative.

The seasonality of the currency basis is such that as the end of the year draws near, the basis covering dollar funding from January becomes more negative. This is because end-December levels are used for calculating bank capital buffers for global systemically important banks (G-SIB surcharges), and G-SIBs tend to refrain from making currency basis transactions in Oct-Dec to avoid an increase in the score that determines their surcharges. Over the past five years, the 3-month USD/JPY basis has become sharply more negative at end-September and then reversed substantially from around the middle to the end of December.

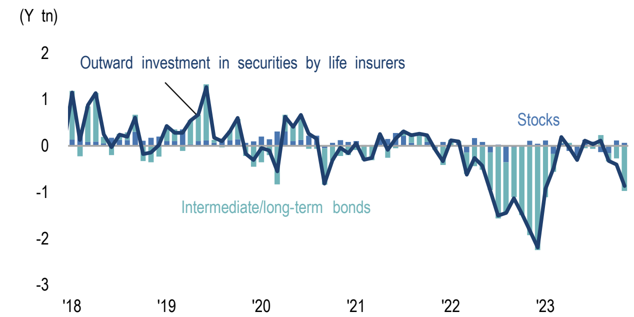
Supply-demand is heavily affected by foreign bond investments made by Japanese investors, and the trend at the banks and life insurers is especially key. Because foreign bond investments by the banks, particularly the major banks, are primarily a way to manage foreign-currency funds, they likely have little impact on the spot FX market, but their impact on currency basis is significant.

Chart 6: Outward Investment in Securities by Banks



Source: MOF; compiled by Daiwa.

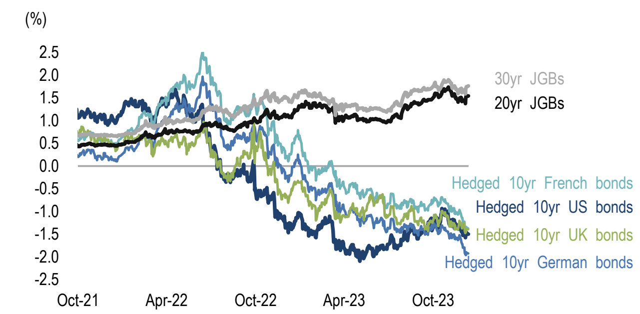
Chart 7: Outward Investment in Securities by Life Insurers



Source: MOF; compiled by Daiwa.

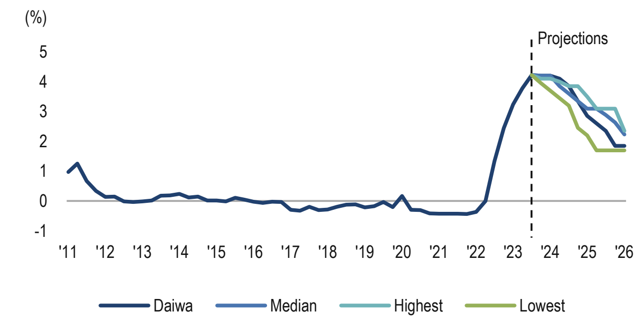
The Fed and many other central banks aggressively hiked rates in 2022 to suppress inflation, pushing overseas interest rates substantially higher, and Japanese investors became net sellers of intermediate to long-term foreign bonds by a large margin. Although the banks started buying at the beginning of 2023 (Chart 6), the life insurers became heavy net sellers again in reaction to the summer 2023 rise in interest rates (Chart 7). The overall investment plans of the major life insurers, partly because of the significant rise in superlong JGB yields, are to continue investing in Japanese bonds. With the yields on foreign bonds after hedging having turned negative (Chart 8), we think it would be rational for the life insurers to increase their holdings of JGBs rather than take on the forex risks and forex hedging costs of foreign bond investments. If the life insurers constrain their trading volume of hedged foreign bonds, it should limit any impacts on currency basis.

Chart 8: JGB Yields, Yields of Hedged Foreign Bonds



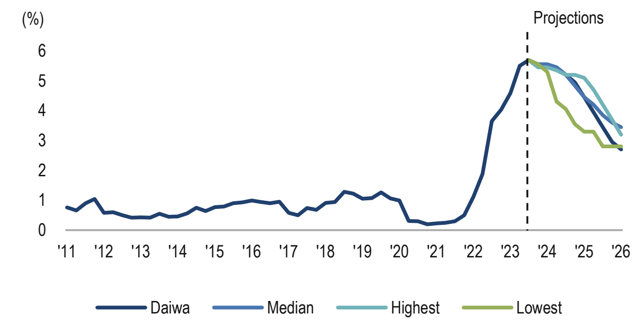
Source: Bloomberg; compiled by Daiwa.

Chart 9: Projections for 3-month EUR/JPY Hedging Costs



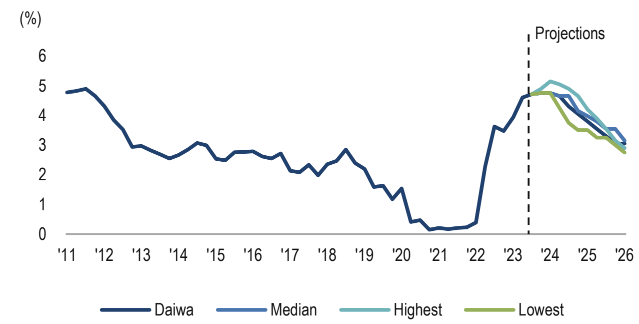
Source: Bloomberg; compiled by Daiwa.

Chart 10: Projections for 3-month GBP/JPY Hedging Costs



Source: Bloomberg; compiled by Daiwa.

Chart 11: Projections for 3-month AUD/JPY Hedging Costs



Source: Bloomberg; compiled by Daiwa.

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