Daiwa's View

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USD/JPY hedging costs are likely to enter downtrend

- USD/JPY basis tends to narrow in line with loosening of US financial conditions
- Slowdown in pace of QT is expected to contribute to loosening of financial conditions
- Rate hikes by BOJ would also contribute to a decline in hedging costs, but pace of Fed rate cuts is more important

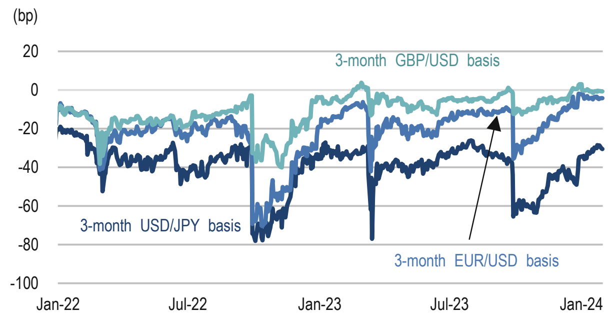
Currency basis

At the end of September 2023, the 3-month USD/JPY basis became more negative due to year-end factors. However, it became less negative once again around the year end and beginning of 2024 (Chart 1). This kind of movement is usually also seen every year with the basis for other currencies against the dollar, not just the USD-JPY basis.

However, in addition to the short-term basis, the over 1-year basis has also been becoming less negative since October 2023 (Chart 2). We attribute this partly to the loosening of financial conditions due to the decline in the long-term UST yield following the pause in the surge that started around summer and continued until October 2023. A major factor behind the decline in US yields has been the shift that the Fed made away from its hawkish stance following the remarks made by Fed Governor Christopher Waller. With inflation slowing, the market is once more viewing the US economy as being firm. Favorable performance in the stock market and a decline in market volatility are making financial conditions accommodative.

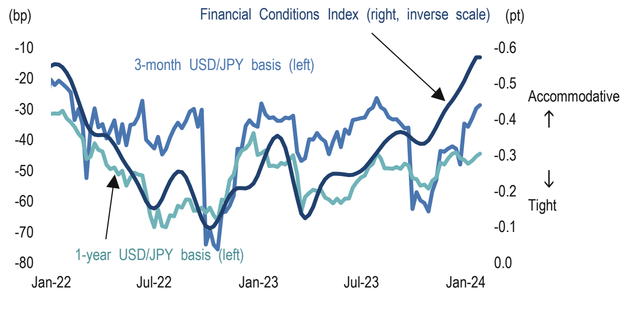
The next action expected to be taken by the Fed is a rate cut. If the US economy were to successfully achieve a soft landing, financial conditions would not tighten going forward, which would continue to put tightening pressure on the basis. The Fed has also suggested a slowdown in the pace of QT. Since balance sheet reductions are continuing, we need to carefully watch the impact this has. However, the slowdown in the pace of tightening eases widening pressure on the basis.

Chart 1: 3-month Dollar Basis vs. Major Currencies



Source: Bloomberg; compiled by Daiwa.

Chart 2: USD/JPY Basis, US Financial Conditions Index



Source: Chicago Fed, Bloomberg; compiled by Daiwa.

That said, when the pace of QT slowed before in 2019, the basis actually widened (Chart 3). At the time, the Fed was forced to change its policy stance and conduct preventive rate cuts in response to the rapid tightening of financial conditions since autumn 2018. A slowdown in the pace of QT was another measure that was considered together with preventive rate cuts. Despite these measures, financial conditions became tight.

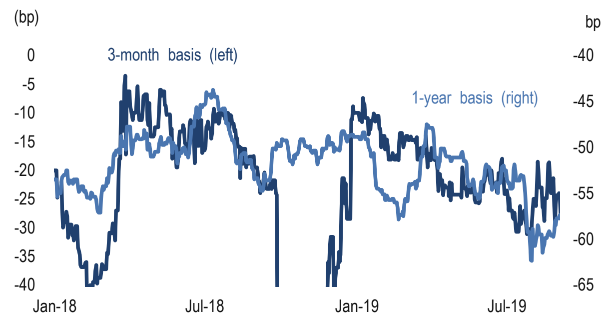
Looking back at what happened during the previous QT, it started in October 2017 with reductions proceeding at a pace of $30bn in USTs and $20bn in MBSs per month. After the plan to slow the pace of QT was announced at the FOMC meeting in March 2019, the slowdown started in May 2019. In March, QT was scheduled to end in September, but in the end it was decided to stop QT in August at the July FOMC meeting. In this way, in the first half of 2019, the monetary policy was adjusted in an accommodative direction both in terms of the policy interest rate and the balance sheet. However, financial conditions were tight due to the external environment (such as the US-China trade war), more than offsetting the effects of these adjustments.

This time around, if there were to be a slowdown in QT, the aim would be the smooth distribution of liquidity due to the fast pace of the decline in ON RRP, rather than to cope with the tightening of financial conditions. If anything, with financial conditions starting to loosen in line with lower yields, adjustments in monetary policy would likely lead to a loosening of financial conditions, which would put tightening pressure on the basis in a straightforward way. However, if the US economy were to fail to achieve a soft landing, financial conditions would tighten rapidly, and the basis could also widen substantially. As long as the market assumes a soft landing, the basis will tighten. However, we need to be aware of the possibility that the basis could move significantly in the opposite direction should this assumption be abandoned.

Hedging cost

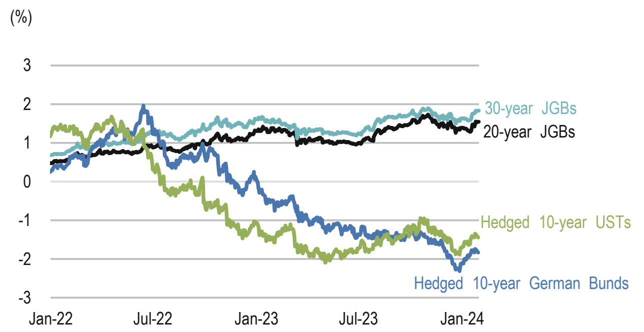
With the Fed's rate cuts having been factored in by the market, the US short-term interest rate has been declining. Unless inflation resurges, we can view the time of rising USD/JPY hedging costs in line with the rise in the US short-term interest rate (due to the Fed's rate hikes) as being over. The pace of the decline in hedging costs depends on the speed of the Fed's rate cuts, which is factored in by the market. Compared to JGB yields, yields of currency-hedged foreign bonds remain very low. However, as the spread tightens, investment in foreign bonds by Japanese investors is likely to gradually become more aggressive (Chart 4).

Chart 3: USD/JPY Basis (Jan 2018-Aug 2019)



Source: Bloomberg; compiled by Daiwa.
Note: Figures are on a Libor basis.

Chart 4: JGB Yields, Yields of Currency-hedged Foreign Bonds



Source: Bloomberg; compiled by Daiwa.

As it is too early to declare victory over inflation, the Fed is unlikely to conduct rate cuts as fast as the market is currently pricing in. Therefore, it is difficult to see hedging costs declining substantially right away. We could also anticipate a slight rebound in hedging costs as the market stops pricing in rate cuts. However, the downtrend in hedging costs is unlikely to change.

With hedging costs being the total of the Japan/US short-term interest rate differential and the USD/JPY basis, we need to consider trends in the short-term interest rate in Japan. The BOJ's rate hikes from now on will contribute to the narrowing of the interest rate differential. That said, the BOJ is now taking the stance of carefully checking economic and price trends, and, therefore, the chance of it conducting rapid rate hikes is small for now. The degree to which hedging costs decline due to Japanese factors is likely to be limited.

Furthermore, if the global economy were to experience a hard landing centered in the US, the basis would widen, which would contribute to a rise in hedging costs. However, in the case of a hard landing, the Fed would be expected to conduct substantial rate cuts. Therefore, the Japan/US interest rate differential would be expected to narrow to a greater extent than the widening of the basis. Either way, hedging costs are likely to decline.

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