Daiwa's View

FICC Research Dept

Buying of Japanese stocks and selling of yen by overseas players

➢ Increase in yen-selling hedging due to rally with Japanese stocks

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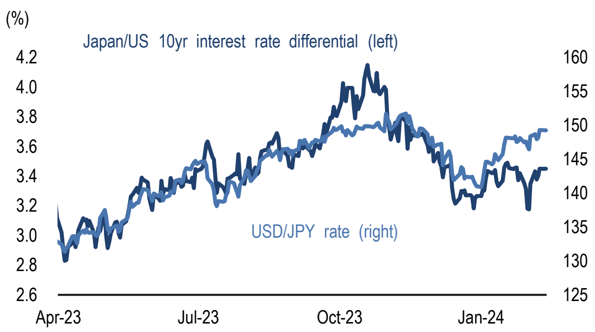
Since the beginning of the year, the USD/JPY rate and the Japan/US interest rate differential have been diverging further. Their divergence was also conspicuous in October 2023, but at that time it was occurring because the USD/JPY rate had not caught up with the widening of the interest rate differential. However, recently the USD/JPY rate has been rising amid little change in the interest rate differential. One factor is likely yen selling by households due to the start of the new NISA system. In addition to this, we can point to the buying of Japanese stocks by overseas players and stronger demand for hedging related to such buying.

Japanese share prices have been rising rapidly since the beginning of the year. On 9 February, the Nikkei Stock Average continued to rise, exceeding Y37,000 at one point. The Nikkei Stock Average hit the Y37,000 level for the first time in 34 years, with the last time it did so being 20 February 1990. The rally was the result of buying by overseas investors. According to the trading trends by investor type in January (combining two markets in Tokyo and Nagoya) released by the Japan Exchange Group on 8 February, net buying of cash stocks by overseas investors came in at Y2,069.3bn in January.

While overseas investors have been buying cash stocks on a net basis, their net selling of futures has been increasing markedly. This could create downward pressure on cash stocks from now on, and warrants attention. However, some say that the recent trend is similar to the rally of Japanese stocks in Apr-Jun 2023. At that time, net buying of Japanese stocks (cash stocks and futures) by overseas players amounted to Y7.4tn, pushing up the Nikkei Stock Average by 18%. We should watch to see if this kind of development occurs again.

Chart 1: Japan/US 10yr Interest Rate Differential, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 2: Cumulative Trading Value by Overseas Investors (since Jan 2022)

Source: Japan Exchange Group; compiled by Daiwa.
Note: Cash stock data from two major markets and futures trading data from Nikkei 225 Futures, Nikkei 225 Mini Futures, TOPIX Futures, and JPX Nikkei 400 Futures.

Regardless of what is causing overseas investors to have an increased interest in Japanese stocks, it is very likely that they are currently investing in Japanese stocks by hedging currency risks like last year. Generally speaking, due to the high volatility of stocks, currencies are often not hedged when investing in stocks. However, considering the interest rate differential between Japan and other nations, investors can gain carry income by hedging currency risks. Furthermore, yen depreciation can boost the earnings of Japanese companies, which is leading to higher stock prices. As such, it currently makes sense to invest in Japanese stocks via hedging.

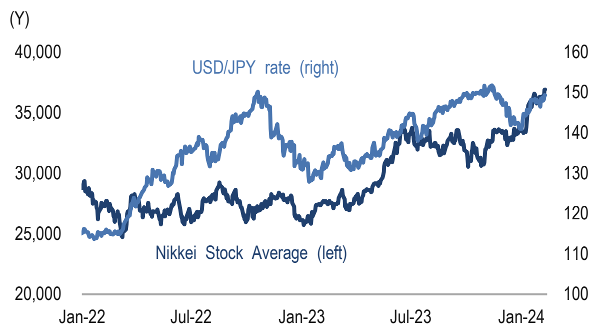
There has been a steady correlation between the Nikkei Stock Average and the USD/JPY rate since the beginning of the year, and a similar trend was observed in Apr-June 2023 (Chart 3). This kind of strong correlation is caused by a mechanism in which overseas players invest in Japanese stocks by hedging currency risks, and the rise in Japanese stocks necessitates yen selling in order to increase hedging. However, when Japanese stocks post a downtrend, the yen is repurchased.

The rally with Japanese stocks in Apr-Jun 2023 appears to have been influenced by multiple positive factors, such as the supply of a large amount of liquidity by the Fed following the collapse of Silicon Valley Bank, the Tokyo Stock Exchange's request to improve the price-to-book multiple to at least 1X, and the biggest wage hike in about 30 years during spring wage negotiations. We get the impression that positive factors are somewhat lacking at the moment. However, there is a deep-rooted view that Japanese stocks are the biggest recipient of money shifting out of Chinese stocks (Chart 4).

China's PPI in January (released on 8 Feb) declined by 2.5% y/y, falling for 16 consecutive months. The nation's January CPI was down 0.8%, declining for four consecutive months. The y/y decline in CPI increased partly because of the difference in the timing of the Chinese New Year, which fell in January in 2023, but occurred in February this year. However, it was shocking that the reading posted its biggest decline since September 2009, when it was affected by the aftermath of the Global Financial Crisis.

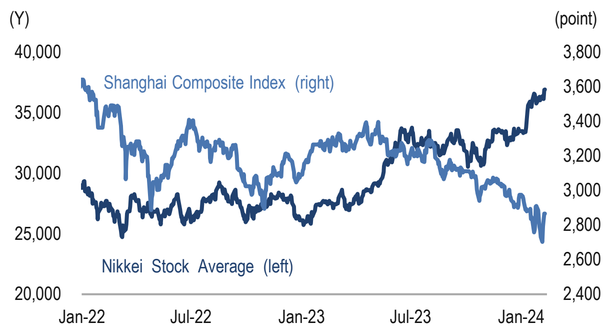
While China is facing concerns about deflation, the probability of an end to deflation is steadily rising in Japan. As such, the two nations find themselves in the opposite circumstances. It's not clear how long the easy-to-understand strategy of shifting from Chinese stocks to Japanese stocks will continue. That said, the Nikkei Stock Average appears to be on the verge of hitting a record high for the first time in 35 years. If stock prices remain high mainly in the US due to expectations of a Goldilocks economy and Japanese stocks head towards a record high, demand for yen selling may increase further. This situation warrants attention.

Chart 3: Nikkei Stock Average, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 4: Nikkei Stock Average, Shanghai Composite Index



Source: Bloomberg; compiled by Daiwa.

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