Daiwa's View

FICC Research Dept

Narrowing of Japanese and European swap spreads: Signaling end of yield uptrend?

- Japanese and European swap spreads regressing toward pre-pandemic mean
- May signal end of yield uptrend for Japan and Europe, which have weaker growth potential compared to US
- Must consider to two aspects of (1) JGB yield moving closer to swap rate and (2) swap rate moving closer to JGB yield

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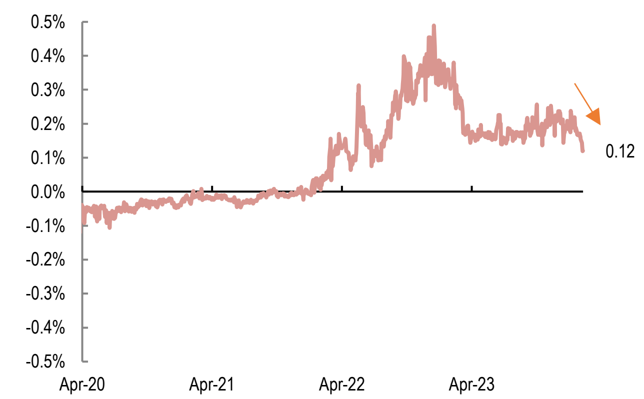
On 6 March, there was a pronounced narrowing of swap spreads (≈ OIS rate-JGB spread, T-L spread, asset swap spread) on the JPY rate market.

The swap spread, which is formed by the difference between two instruments, JGBs and swaps, reflects the individual supply-demand residuals for these two instruments, respectively. As such, analyzing swap spread changes is not easy and perfect considerations are difficult to achieve.

Knowing that, we can most likely attribute the 6 March price movements to position adjustments ahead of the BOJ's March Monetary Policy Board meeting, at which the Bank will discuss making the first interest rate hike in 17 years. On 6 March, the LCH-JSCC spread turned negative for the first time since January 2022 and we suspect that foreign investors may have unwound their swap hedging positions in anticipation of higher interest rates. One factor that may have contributed to this trend was the investment stance expressed by a major investor in some media reports.

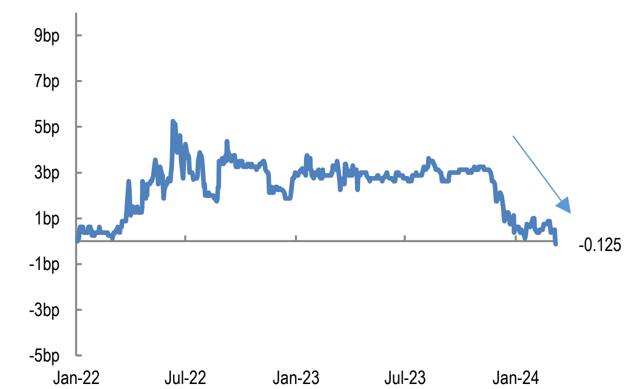
That said, if we become too caught up in the details, we could lose sight of the big picture (can't see the forest for the trees). When viewing Japanese and European swap spreads side-by-side, they actually follow generally the same trend. It is possible that factors commonly associated with the euro and the yen may be aligning swap spreads in Japan and Europe.

JPY Swap Spread (10yr)



Source: Bloomberg; compiled by Daiwa.

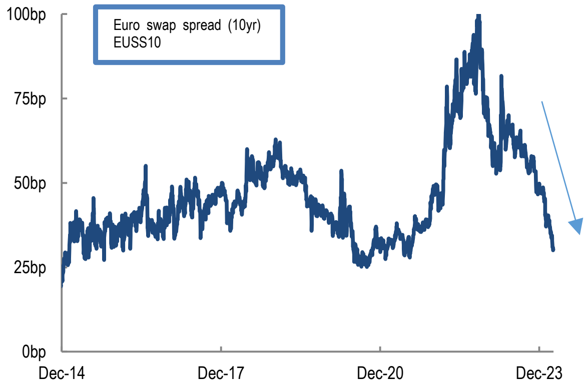
LCH-JSCC Spread (10yr)



Source: Bloomberg; compiled by Daiwa.

The 10-year EUR swap spread (EUSS10) was generally 40bp before the pandemic, but it expanded to 100bp at its peak in October 2022 and has since narrowed to the current level of 30bp. Naturally, there are also some detailed supply and demand factors to be pointed out here, but when observed over a slightly longer horizon, we can sense that this could reflect a trend. Anticipating the start of the ECB's rate-hiking cycle, there was hedging using swaps, which have lower transaction hurdles than government bonds in terms of capital burdens and other considerations. However, this time, a reversal of supply and demand conditions may have occurred in anticipation of the start of the ECB's interest rate cuts this year.

Euro Swap Spread



Source: Bloomberg; compiled by Daiwa.

Unlike the US, Europe's growth is roughly as weak Japan's growth. There is the possibility that interest rates could be lowered all the way to the neutral area once cuts start.

The 10-year JPY swap spread was around +10bp before the pandemic, but expanded to around +40bp between late-2022 to January 2023 when speculators ramped up pressure on the BOJ to revises its yield curve control (YCC) policy. This spread then trended around +20bp even after the BOJ, under Governor Kazuo Ueda, on two occasions added more flexibility to YCC. However, in anticipation of a BOJ interest rate hike, this spread has contracted sharply over the past month to +12bp, approaching the pre-pandemic level. The speed of this contraction was indeed remarkable, and there is the temptation to attribute this to individual factors (individual supply and demand factors). However, from a more macroscopic perspective, this may reflect the completion of the role of hedging positions in anticipation of the end of the yield uptrend and a reversal of supply and demand conditions.

Of course, we believe it was widely anticipated among market participants that swap spreads would "eventually" revert to their average historical means. That said, we are somewhat surprised that this narrowing is already in full swing at this point in which the BOJ has not even yet started raising interest rates. However, in light of global market trends, it is not surprising that the timing is somewhat earlier as compared to when considering only Japan-specific factors. It is probably fair to say that some of the media reports on 6 March triggered a change in the supply-demand balance.

We would like to add one additional point. Specifically, the case in which swap spreads that had widened to exceptional levels, especially for the 10-year and shorter maturities, where the level of "swap rates > JGB yields" have become entrenched. We should assume movements in terms of (1) not only JGB yields rising as a result of the JGB yield moving closer to the swap rate along with the BOJ reducing its regular JGB purchase operations (as we have pointed out in previous reports), but also (2) swap rates, for which hedging positions were built up ahead of time, moving closer to the JGB yield level along with the unwinding of the hedging positions. In this sense, as the market anticipated only the above-mentioned first movement, it may have somewhat overestimated the upside JGB yield potential so far.

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