Daiwa's View

Implications from 20yr LCH-JSCC spread, more negative swap spreads

- 20yr swap spread deeply negative, 20yr LCH-JSCC spread below -2bp
- Signals attractiveness of asset swaps, superlong JGB auctions' potential reliance on arbitrageurs
- May also indicate need to issue shorter maturity JGBs

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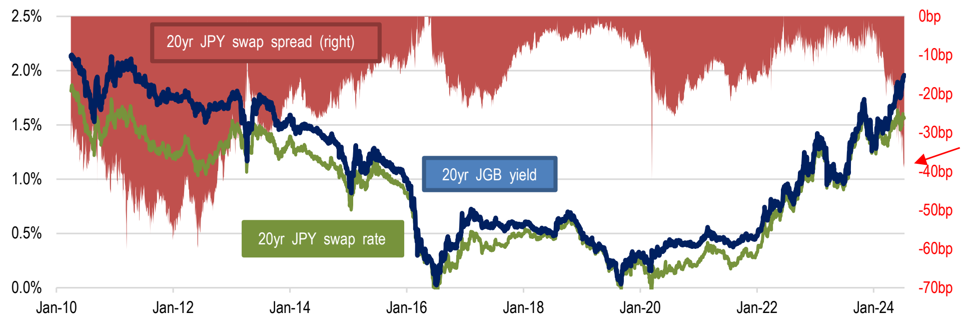
A key recent hallmark of the JGB market is the widening spread between superlong JGB yields and the Overnight Indexed Swap (OIS) rate (broadly equivalent to the swap rate); i.e., swap spreads are widening.

Wider swap spreads
We used the 20yr JGB yield (simple) vs. the 20yr JPY OIS rate (six-month compound) to gauge the overall trend in swap spreads, as per common market practice; the spread between the two is at its most negative since the 2011-2012 European debt crisis.

The caveat is that the trajectory of the base rate differs from 2011-2012. Strong downward pressure on swap rates resulted in more negative spreads during the European crisis; in contrast, rising JGB yields are driving the current widening in swap spreads.

20yr JGB Yield, Swap Rate, Swap Spread



Source: Bloomberg; compiled by Daiwa.

Increasingly negative clearing (LCH-JSCC) spreads
Interestingly, 20yr and 30yr LCH-JSCC spreads fell sharply to below -2bp ahead of this rapid widening in swap spreads (see figure overleaf). There was no comparable move in 10yr spreads (the 10yr LCH-JSCC spread remained near to zero), which offers a useful hint in gauging base yields for superlong JGBs.

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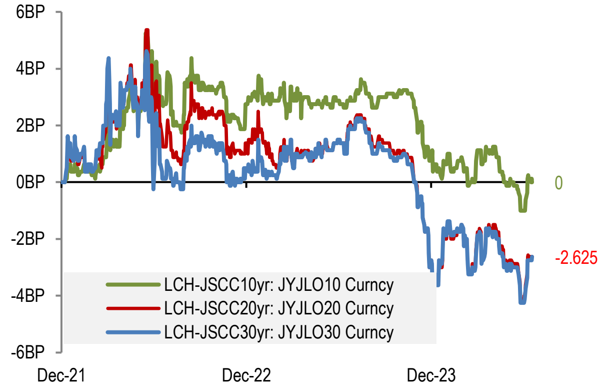
LCH-JSCC Spread (10yr, 20yr, 30yr)



Source: Bloomberg; compiled by Daiwa.

20yr Swap Rate (LCH, JSCC)

Source: Bloomberg; compiled by Daiwa.

The law of one price suggests that settlement prices at LCH (the clearing house most commonly used by overseas investors) and JSCC (the Japan Securities Clearing Corporation, used mainly by Japanese investors) ought to be the same. A sustained and meaningful spread between the two implies that there may be a marked divergence between domestic and overseas investors' trading behavior (supply-demand) for yen interest rate swaps. Recent trends in the superlong spread may indicate that Japanese investors skew relatively strongly toward swap payers (i.e., they are short yen rates).

We look below at the possible reasons for this.

Implies growing risk premium for superlong JGB yields

One interpretation would be that Japanese investors are working to reduce their interest-rate risk. However, this would ordinarily result in a similar move for the 10yr LCH-JSCC spread, which has in fact only fallen to near zero (normalized), as the left chart above shows. Moves to reduce interest-rate risk do not adequately explain the current distortion of the increasingly negative LCH-JSCC spread only for superlong issues.

Another possible explanation is that Japanese investors had long positions for superlong JGBs, which have risen to extremely high levels, combined with short arbitrage positions (asset swaps) for swap rates, meaning that they skewed relatively heavily toward payers in the swap market.

As we confirmed on page 1, the simple spread between the 20yr JGB yield and 20yr swap rate is currently -39bp. This is around 30bp more negative than the roughly -5bp spread between the 10yr JGB yield and 10yr swap rate. This also makes little sense in terms of the law of one price.

The 5yr/5yr OIS rate is currently above 1.4% and the 20yr swap rate above 1.5%, which we think reflect market expectations for a roughly 1.5% terminal rate. However, the 20yr JGB yield has recently risen to 1.96%, suggesting a risk premium for JGBs to reflect worsening supply/demand. Investors are able to capture this premium via arbitrage positions (asset swaps) that combine JGB longs with swap shorts. We think an increase in these trades has likely driven up settlement prices at JSCC more than at LCH.

Implies need to issue shorter-maturity JGBs

While Japanese investors' demand for these asset swaps nominally appears to come from hold-to-maturity investors, it in fact reflects arbitraging behavior by these investors. This casts doubt on their reliability as ultimate investors who can consistently absorb JGB supply.

Waseda University professor Junko Koeda noted in a December 2022 column that when limited demand for JGBs from hold-to-maturity investors creates a need for arbitrageurs to absorb superlong JGB supply, this drives up superlong yields and causes the yield curve to steepen. The Study Group on Government Debt Management has already discussed the need to reduce the interest-risk in the market resulting from JGB supply by issuing shorter maturities and floating-rate JGBs; if asset swaps by Japanese investors (for arbitrage purposes) are truly resulting in a consistently and deeply negative LCH-JSCC spread, this may also imply a need to issue shorter-maturity JGBs.

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