Daiwa's View

FICC Research Dept.

Market fragmentation or new normal?

- Foreign investor net buying of super-long JGBs reaches "largest-ever" level
- Reflects super-long JGB price leader change (= new normal)?

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In our 22 April report, we introduced three recent "largest-ever" records. Of these, we focused on "largest ever" yen-buying position held by speculators. In this report, we want to focus on the "largest ever" foreign investor net buying of super-long JGBs (Y2.18tn) in March.

Market fragmentation or new normal?

In our 10 April report, we briefly touched on our sense that the recent JGB yield/JGB market price formation should be described as "market fragmentation." This is not a yield curve change. Curve trading is a strategy based on the assumption that continuity exists between each maturity in the bond market and that changes in the way the bonds are connected provides trend ideas (source of alpha). However, there is a sense on the current JGB market that the connection between the long-term and super-long JGB zones has been lost or diluted.

Is this really just a temporary phenomenon? Or will it continue? We think the average and median assessment among the current market participants is that this is a temporary (transitory) collapse of supply/demand conditions in the super-long JGB zone. That said, we feel that when looking back at the present time from the distant future, the "largest ever" net buying of super-long JGBs by foreign investors may be remembered as a symbolic event that reflected structural changes and a "new normal" for the JGB market. (See our separate report for details on the impact of the foreign investor share on the JGB market.)

Price leader change

The net buying of super-long JGBs to the tune of Y2.18tn in March was large enough to clearly convey the increased presence of foreign investors in the super-long JGB zone. Here, the key point to keep in mind is that there could have possibly been a shift in price leadership from yen-based investors, specifically "domestic life insurers" with a home country bias, who have been the price leaders in the JGB super-long zone, to non-yen-based investors, or "foreign investors" without a home country bias toward Japan (= seeking extra risk premiums).

As for the super-long JGB supply-demand balance, we often hear market participants say that while Japanese life insurers have largely completed their response to the new regulations and demand from yen-based investors is declining, the issuance of super-long JGBs has not been reduced to a degree that matches the decline in demand from life insurers. Perhaps that is true.

Trading Volume of Over-the Counter (OTC) Bonds (Foreigners, Y bn)

	Super-long-term			Long-term			Medium-term		
	Buy	Sell	Net	Buy	Sell	Net	Buy	Sell	Net
Oct -24	5,476.7	5,014.7	462.0	6,736.0	5,695.7	1,040.3	9,362.8	9,213.2	149.6
Nov -24	4,703.8	5,207.9	-504.1	5,887.0	5,333.5	553.5	9,286.1	8,633.7	652.4
Dec -24	3,608.1	3,999.9	-391.8	6,974.5	6,162.1	812.4	8,191.2	7,741.2	450.0
Jan -25	5,664.0	5,302.5	361.5	6,720.5	6,674.2	46.3	10,526.0	9,102.2	1,423.8
Feb -25	5,965.9	4,725.3	1,240.6	7,829.5	7,042.5	787.0	11,630.4	11,151.2	479.2
Mar -25	7,741.0	5,558.2	2,182.8	8,631.6	7,938.7	692.9	13,712.5	10,563.0	3,149.5

Source: Japan Securities Dealers Association; compiled by Daiwa.

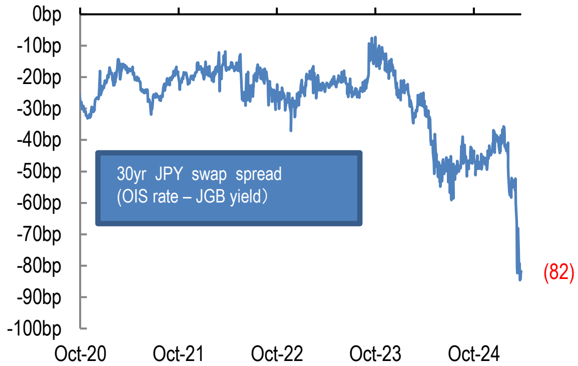
However, will the reduction in super-long JGB issuance actually fall in line with the declining demand among life insurers? (Can that be considered an implicit assumption?) Japan's fiscal problems and other factors could create a new need to structurally rely on foreign investor demand to absorb the huge JGB bids at a time when Japan is unable to achieve sufficient reductions in issuance. In that case, the JGB market price leader could change to foreign investors.

Taken in this context, it is no wonder that different pricing than before has been observed in the JGB short/medium-term zone and super-long zone. Recently, swap spreads have also become suddenly more negative. This is not a temporary phenomenon such as a "collapse," but rather a shift in the JGB market from the past when yen-based investors dominated prices to a new era in which price formation is led by foreign investors who demand extra risk premiums. In other words, this demand for extra JGB risk premiums may reflect a shift to a "non-yen-based investors" basis.

5yr/30yr JGB Yield Spread

Source: Bloomberg; compiled by Daiwa.

30yr JPY Swap Spread



Source: Bloomberg; compiled by Daiwa.

Role of BOJ

If that is the case, then the BOJ should be cautious about expanding its direct involvement in the market, even if there is a somewhat large price action (of course, limited involvement in times of shocks such as the British "Truss Shock" is an option that should be considered separately from the perspective of financial system stability and other factors). As Japan moves away from monetary easing and into a world with interest rates, if the BOJ were to mistake a reasonable change in the risk premium level due to such a change in price leaders as a decline in market functioning, and then intervene in the market through operations and other means, it would be going against the objective of restoring market functioning.

If JGB issuance is reduced to the point where it is in step with the demand of domestic investors, the risk premium would decrease. Issuers, not the BOJ, are the ones in a position to change their behavior in a manner that impacts the risk premium over the medium to long term (up to Treasury Secretary Scott Bessent, not Fed Chairman Jerome Powell, in the case of the US).

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