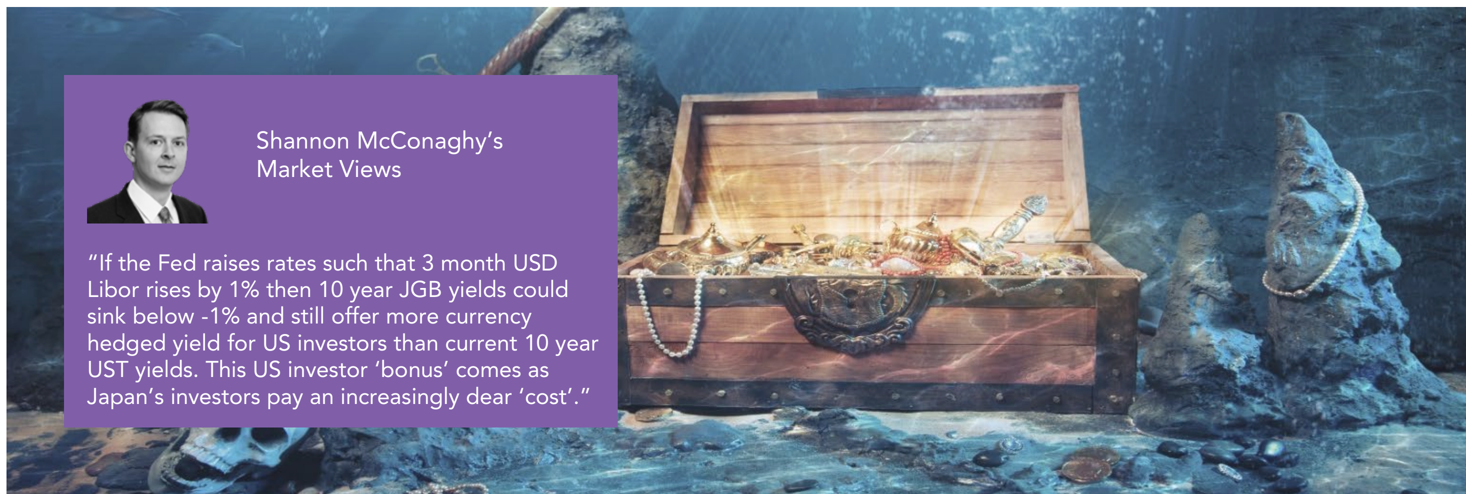
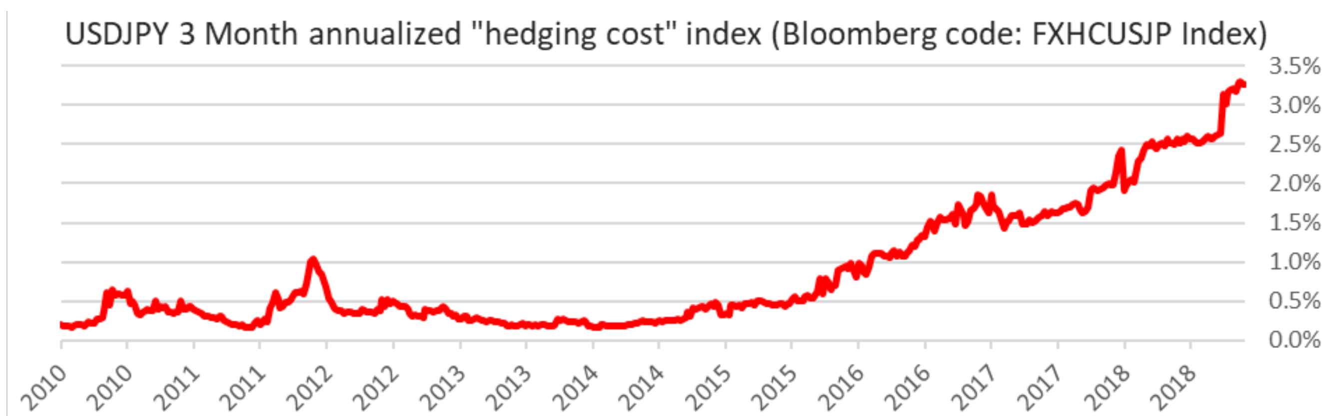
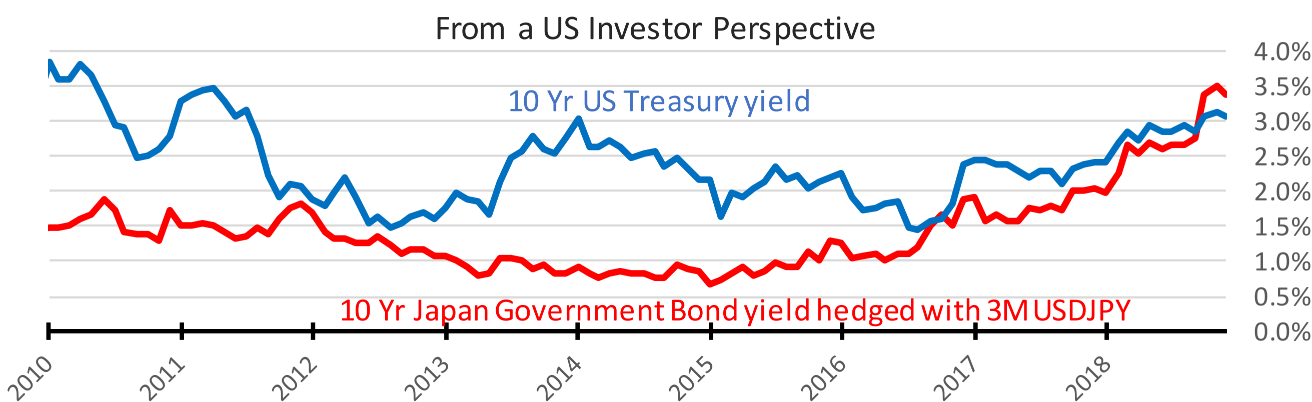
JGBs MAY BE ATTRACTIVE AT -1%



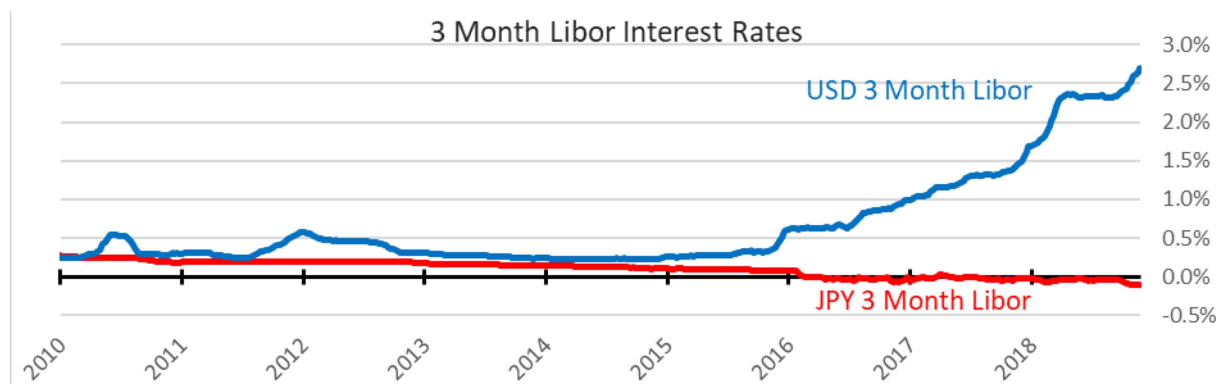
Rising USDJPY "hedging costs" have pushed 10 year US Treasury (UST) yields into negative territory for Japanese investors when they hedge out their currency risk. I have written of the problems this creates for Japan's already critically weak regional banks and how they are shifting into higher risk USD assets like CLOs to cover the "hedging cost". To make it easier for casual observers to track the rising "hedging cost" on an annualized basis, Bloomberg has created a USDJPY 3 Month annualised "hedging cost" Index.



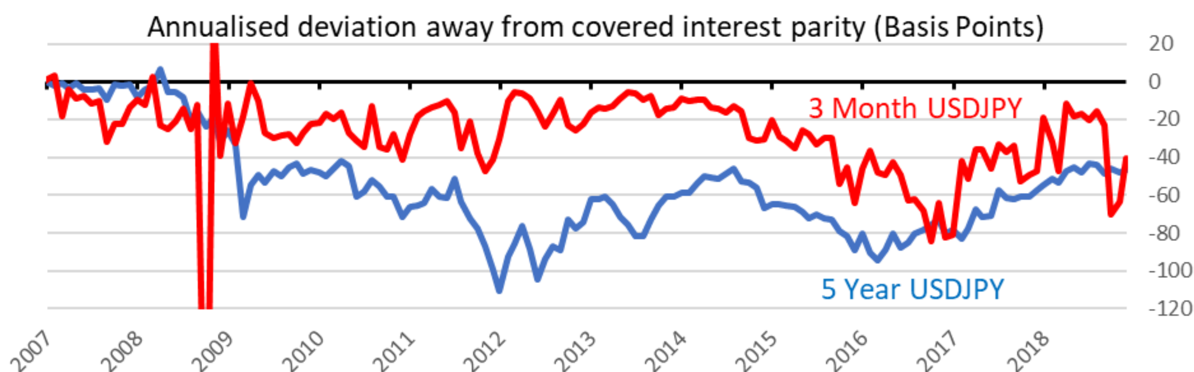
Today, we look at the other side of the story, which is the "hedging bonus" received by USD denominated investors. As per the chart below, US investors can now receive a 33bps higher yield in 10 year Japanese Government Bonds (JGBs), when currency hedged, than they receive in 10 year USTs.



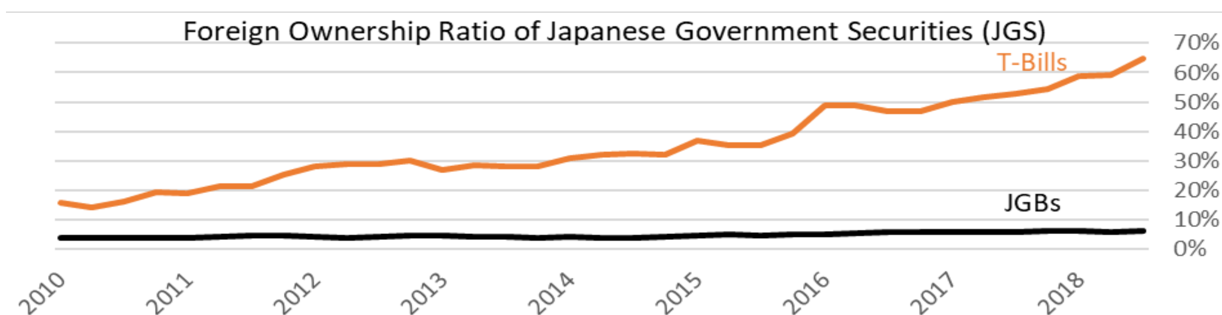
I expect this "hedging bonus" will rise further, as a key input is the differential between 3 month Libor rates in the US and Japan. The Fed's dot plots indicate another 1.175% (median estimate) of additional policy rates hikes over the coming two years, which should push up 3 month USD Libor. Meanwhile the Bank of Japan (BOJ) plans on maintaining its "current extremely low" policy rate for "an extended period of time".



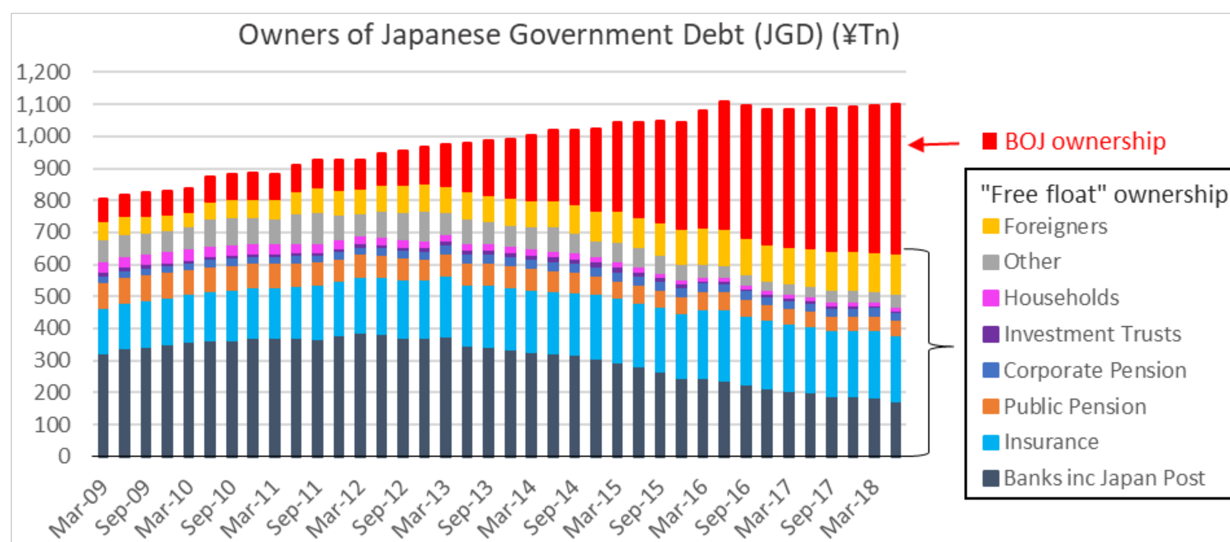
The other input behind the "hedging bonus" is the dislocation of forward currency markets. Over the last decade a wall of outbound investment from Japan, requiring currency hedging (essentially buying the Yen back on a forward basis), has overwhelmed traditional market counterparties (foreign banks with increased capital constraints) in their ability to sell a commensurate amount of USDJPY forwards at a rate reflecting the differential in interest rates (the principle of covered interest parity). This dislocation is driven by demand exceeding supply, it is likely demand for hedging will continue to grow as Japan's near record current account surplus adds to the wall of money sent overseas requiring currency hedging. The supply side can be rather seasonal in the shorter dated 3 month USDJPY forward rate as foreign banks require further premium to carry the risk over financial year end reporting. As such, I have also included the 5 year USDJPY forward rate where perhaps we can now see signs of a structural widening in the dislocation again.



For those who are surprised by my suggestion that foreigners might buy Japanese Government Securities (JGS), perhaps they should consider that foreigners have already become the largest owners of the shorter dated Japanese Government T-Bills, as can be seen below. This has come about as foreigners have increasingly taken advantage of the extra currency hedged yield that has been available at the short end of the JGS curve over the course of this decade. Interestingly, foreign demand has pushed the 3 month T-Bill yield to -0.29%, which is meaningfully below the BOJ's negative overnight policy interest rate of -0.10%.



The implications of foreigners increasingly snapping up longer dated JGBs could also be profound for the supply/ demand balance that exists in that market at the moment. As can be seen below, the reduction in the "free float" of JGS, or those which are not in the hands of the BOJ, has dramatically slowed. This is largely because Japanese banks have slowed the rate at which they reduce their JGS holdings as they approach a level they are required to hold for collateral purposes. Further to this, foreigners have been increasing their holdings of T-Bills and to a lesser extent JGBs, as shown above. This has meant that the BOJ has been able to slow its net annual increase in JGS holdings to a level roughly in line with the government's net annual increase in JGS outstanding. In this environment JGB Yields have remained firmly under the BOJ's "control". An increase in foreign purchases of longer dated JGS could push that out of kilter and push JGB yields down, unless the BOJ is willing to begin increasing the "free float" of JGS, an interesting thought given the BOJ is trying to portray itself as the most ultra-loose central bank in order to keep the JPY weak.



It is also interesting to consider just how comparatively attractive JGBs could become for US investors. Let us suppose, the 3 month JPY Libor and 3 month USDJPY basis dislocation remain at current levels. In that environment every basis point rise in the 3 month USD Libor rate would increase the USDJPY "hedge bonus" by a commensurate amount. If the Fed raises rates such that 3 month USD Libor rises by 1% then 10 year JGB yields could sink below -1% and still offer more currency hedged yield for US investors than current 10 year UST yields. This US investor "bonus" comes as Japan's investors pay an increasingly dear "cost". While that may be an extreme way of looking at things, it does demonstrate that we could see downward pressure on JGB yields, even if UST yields were to remain where they are or even rise.

INFORMATION

Issue Date: 27th November 2018
Source: Bloomberg, unless otherwise stated
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