TS Lombard

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Economics / Politics / Markets

Global Financial Trends

THE JAPANESE PUT?

Shweta Singh/ Konstantinos Venetis

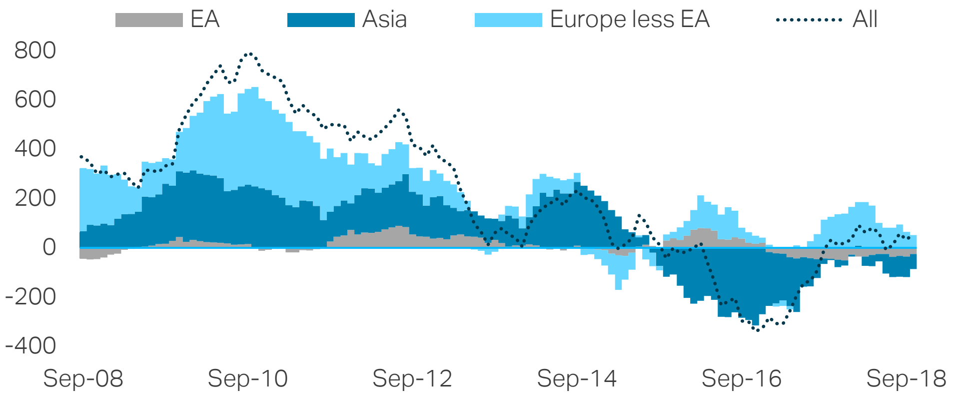
- Cross-border capital flows are in retreat and will remain under pressure
- But foreigners are piling into Japanese debt, even though yields are among the lowest globally. Why?
- Japanese investors' have huge dollar funding needs, like European banks in 2007
- Elevated $-hedging premia have made Japanese debt attractive for US investors, facilitating the BoJ's 'passive taper'
- But JPY investors are now shifting their allocations to Europe
- Japanese investors could dampen EA yields but may also exacerbate Italian risk
- Crucially, the Europeans are less likely to support the BoJ's passive taper
- The BoJ is indeed locked into perma-QE

Summary — Key points

Summary	Key points
Capital flows	• Cross-border capital flows are in retreat and will remain under pressure • Foreigners losing interest in USTs and EM assets • End of ECB QE set to push term premia higher • EA residents have already scaled back their purchases of foreign assets
The JPY exception	• Japanese residents' net acquisition of foreign assets peaked in 2016 • But foreign investors continue to be large buyers of Japanese fixed income securities • Their appetite is strong even though JPY yields are among the lowest in the world
$-repack	• Foreigners have been buying JGBs because the Japanese have been avid buyers of US debt • The US investor 'parks' the yen she gets from swapping her dollars into JGBs ($-repack) • The huge dollar demand from Japanese investors has widened the cross currency basis • Dislocations in the swaps market and the negative yen Libor make the $-repack a profitable trade for the dollar-based investor • But Japanese residents are no longer keen on US assets due to excessive hedging costs. So is the re-pack dead?
€-repack	• The re-pack is still alive, but has shifted from dollar-based investors to euro-based investors • Japanese investors are increasing their holdings of EA debt because of attractive hedged returns • At the same time, it is profitable for euro-based investors to re-pack their swapped yen into JGBs (€-repack) • Still, a euro-repack returns less than a dollar-repack, so a sustained bid for Japanese paper is far from assured
Italian risk	• Inflows from Japanese investors could help to hold down EA yields when the ECB normalises policy • But it could widen Italian spreads if JPY investors continue to prefer Spanish BONOs and offload Italian BTPs

Foreigners take flight

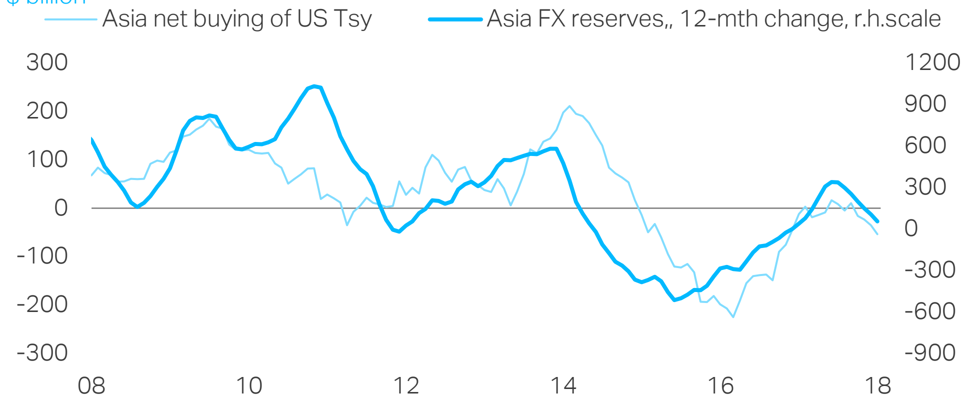
Diminishing net purchases by foreigners
Non-residents' net purchases of UST, by countries/regions, 12-mth sum, $ bn



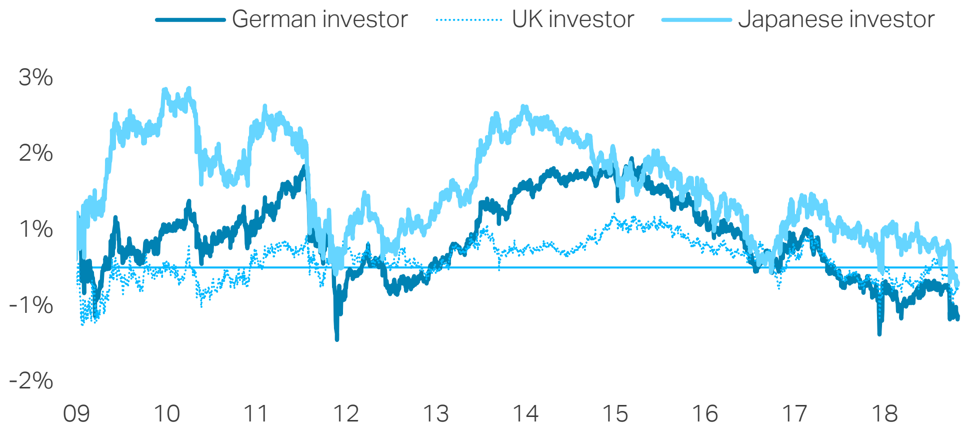
In the last GFT, we highlighted that the end of global QE, Fed tightening, regulations and trade disputes could keep cross-border capital flows under pressure. Foreigners have reduced their net purchases of USTs due to a decline in emerging market FX reserves and the diminishing hedged US yield pick-up available to DM investors. Portfolio inflows into EMs have been receding. With the ECB ceasing its QE programme at the end of this month, euro area investors will also reduce their purchases of foreign assets.

But Japan seems to be an exception.

Falling FX reserves dampen UST demand
$ billion



DM investors' hedged US returns disappear
Hedged US yield pick-up for foreign investors

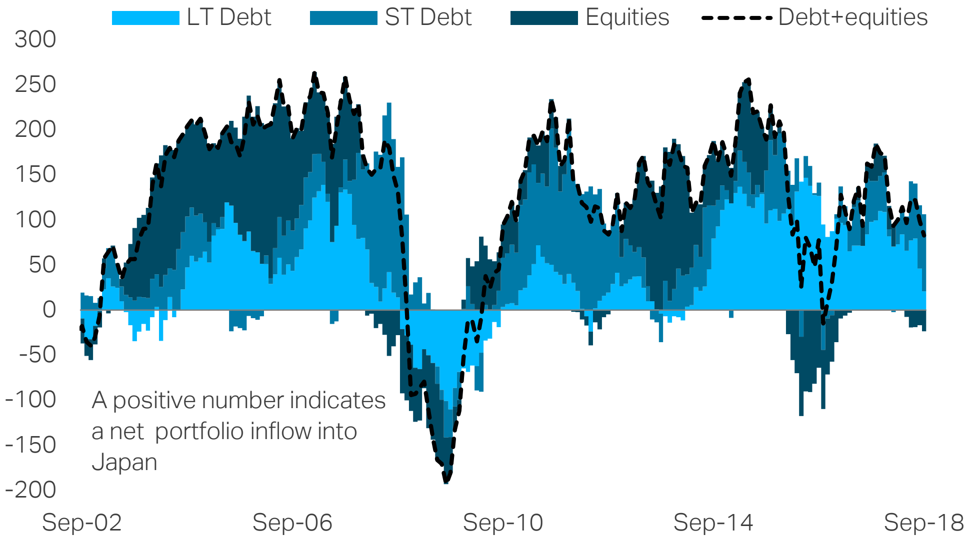


Source: Datastream, Bloomberg, ECB, TIC, TS Lombard

But Japan is an exception

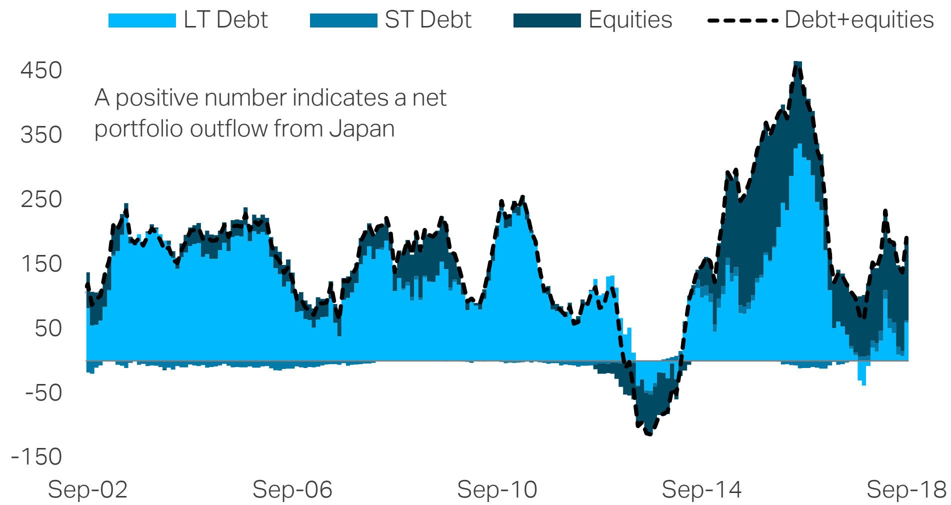
Non-residents continue to be interested in JPY assets

Net acquisition of Japanese assets by foreigners, 12-mth sum, 100bn yen



Japanese residents acquiring foreign assets at a slower yet decent rate

Net acquisition of foreign assets by Japanese investors, 12-mth sum, 100bn yen



Foreign investors continue to be large buyers of Japanese fixed income assets even though yields on JPY debt are among the lowest in the world. In fact, foreigners' net purchases of JPY fixed income securities since the start of the latest round of BoJ QE in 2013 are larger than during similar periods before 2013.

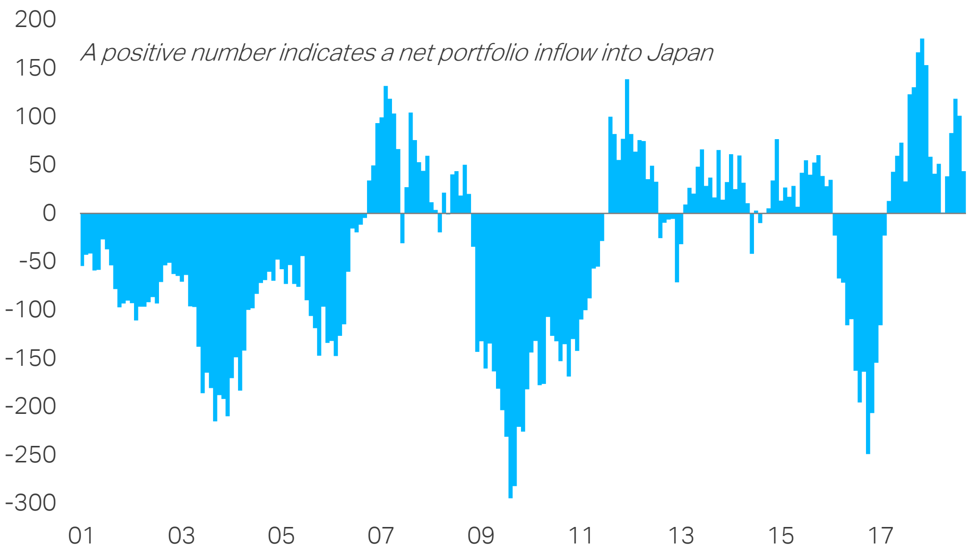
Meanwhile, Japanese residents' net acquisition of foreign assets peaked in 2016 although they are still buying at a decent rate.

Source: Datastream, Bloomberg, BoJ, TS Lombard

Net debt inflows into Japan despite BoJ QE

Net debt inflows into Japan in spite of BoJ QE

Net debt portfolio flows, 12-mth sum, 100 bn yen

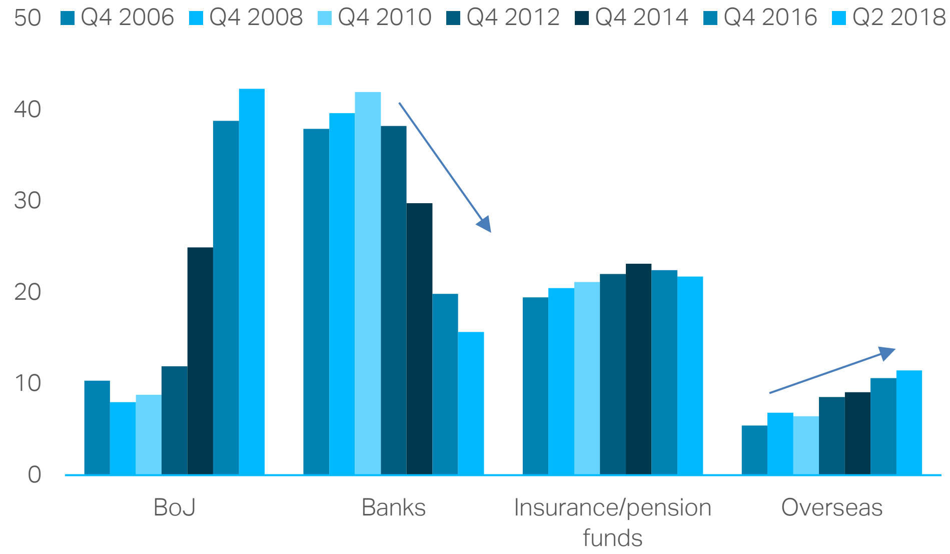


As a result, there has been a net portfolio inflow into Japanese debt for most of the period since 2013. This in sharp contrast to ECB QE, which drove a historically large net debt outflow from the euro area. The debt exodus remains substantial even though the ECB is set to complete its asset purchase programme at the end of this month.

The year 2016 was an exception: the BoJ introduced its negative interest policy in January, triggering a surge in Japanese purchases of foreign fixed income assets. But the net outflow from Japanese debt has reversed since then.

Steady increase in overseas ownership

Holdings of JGBs and Japanese T-bills by sector since Q4 2006, %



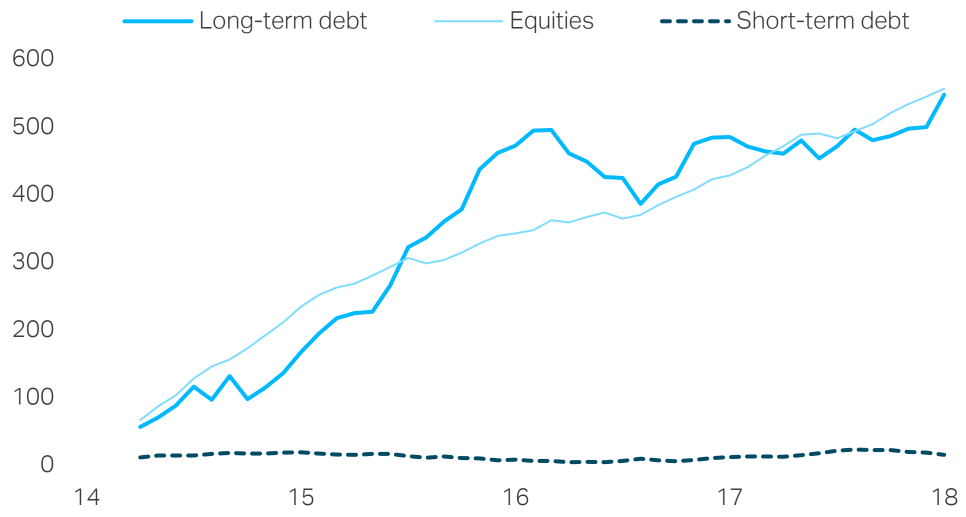
Non-residents have continued to increase their holdings of JGBs despite depressed/negative yields. Their appetite for Japanese paper may help the BoJ as it passively tapers its QE programme, but the support from foreign buyers may not last for long.

Source: Datastream, Bloomberg, BoJ, TS Lombard

The dollar re-pack

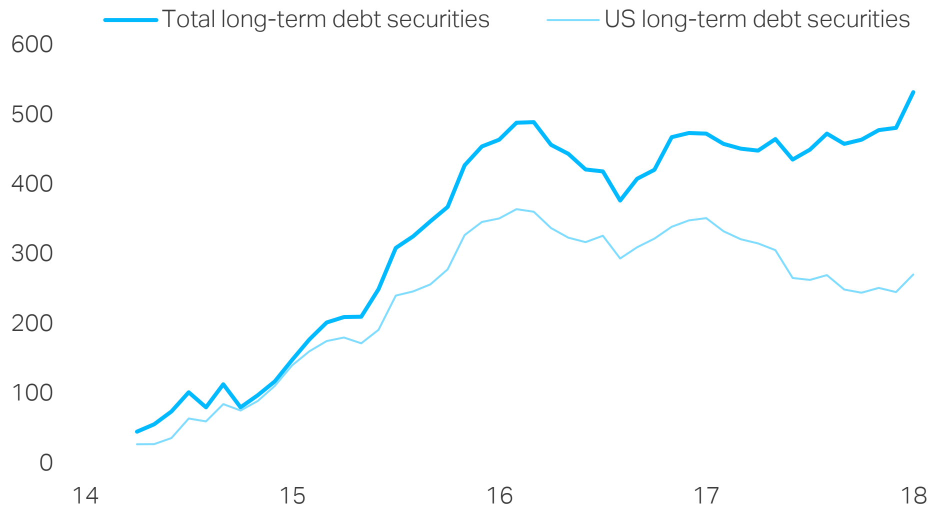
Japanese residents' net acquisition of foreign assets

Japanese investors' net purchases of foreign assets, cumulative since Jan-14, 100bn yen



Japanese residents' net acquisition of foreign paper

Japanese investors' net purchases of foreign long-term debt securities , cumulative since Jan-14, 100bn yen



Why are foreigners interested in JPY debt? The answer lies in the overseas assets that Japanese residents have been acquiring. JPY investors have been avid buyers of foreign long-term debt (chart above). US securities have accounted for a major share of these purchases as they offered Japanese investors a meaningful hedged yield pick-up.

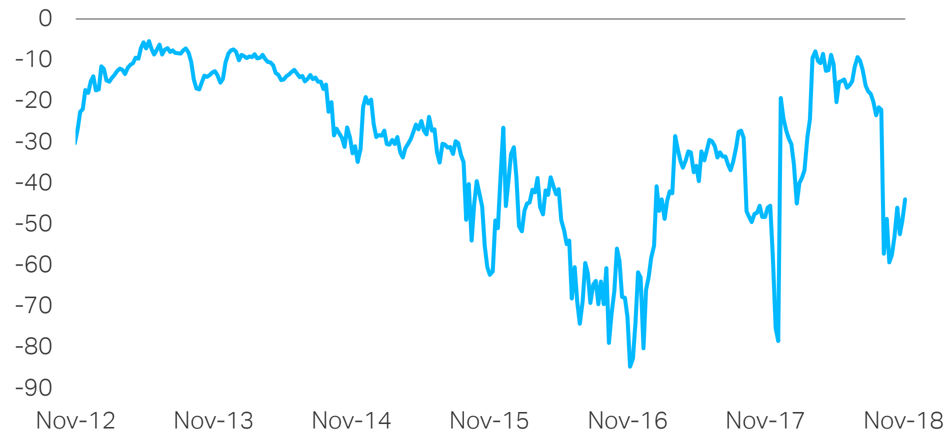
The US accounts for just over 50% of all foreign long-term paper that JPY investors have bought since 2014 (chart above). The share reached 78% in early 2017 before the relative yield advantage for a JPY investor began to fade (more on this on slide 9).

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

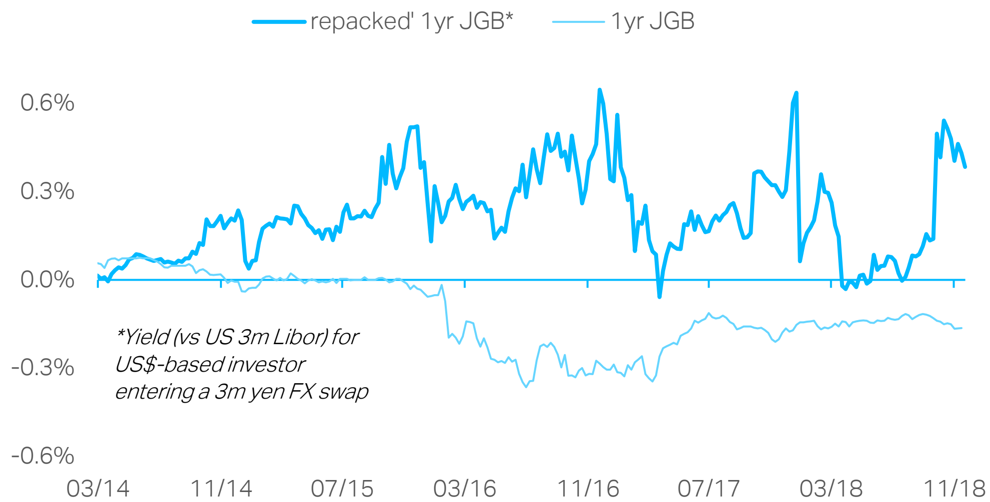
The dollar re-pack

The $/yen cross-currency basis adds to $ hedging costs

3-month USD JPY cross-currency basis



The $ repack



Meanwhile, there has been a strong hedging demand from Japanese residents. For instance, Japanese lenders' dollar funding needs have surged since the global financial crisis in a reach for yield. Their $-borrowing of JPY banks is larger than those of the European banks, which played a decisive role in the subprime crisis. This has fuelled dislocations in the FX forwards market, exacerbated by money market reforms and Basel regulations. The dislocations are reflected in the widening of the cross-currency basis (CCB) (chart above).

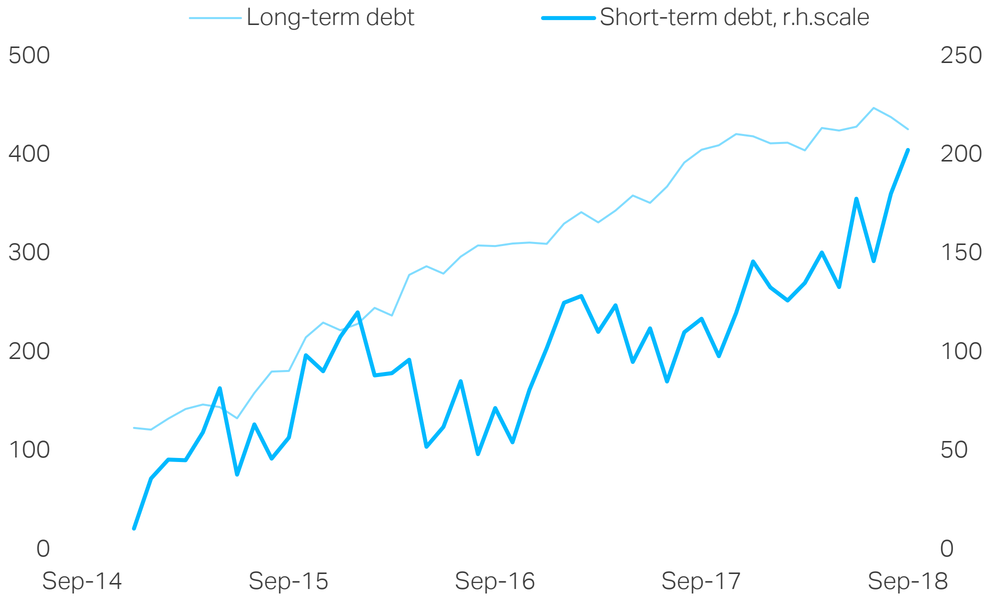
In a currency swap, the USD/JPY CCB is the premium charged by the dollar-lending counterparty, i.e. it is the additional cost on top of the interest rate differential between the two currencies (JPY and USD in our case). Strong hedging demand from Japanese investors in their reach for foreign yield has led to a sharp widening of the CBB. The wider the basis, the larger the premium pocketed by the dollar-lending counterparty. Thus, the dollar lender earns the basis, profiting from the dislocations in the swaps market.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

‘Parking’ yen in Japanese paper

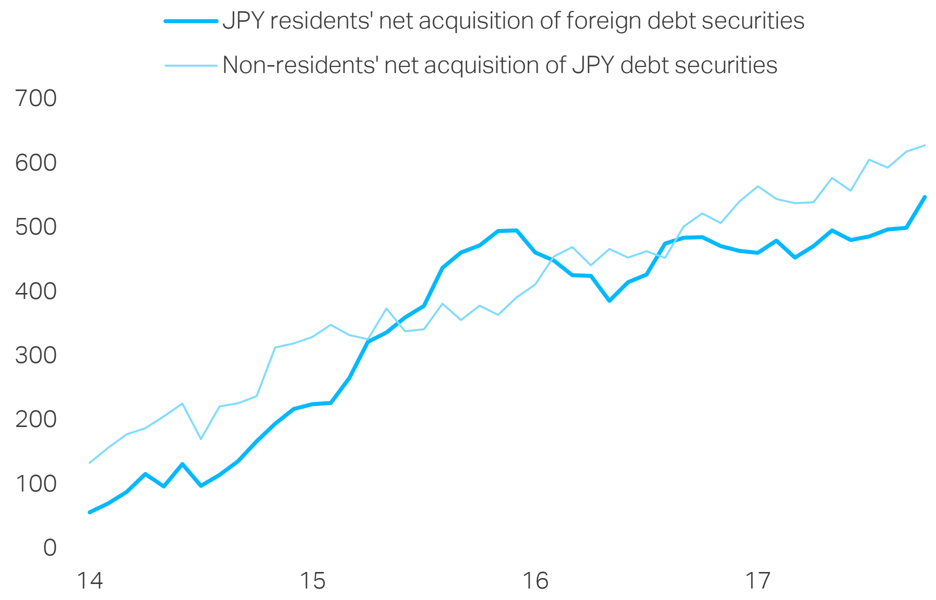
'Parking' yen in Japanese paper

Foreign investors' net acquisition of Japanese assets, cumulative since Jan-14, 100bn yen



Japanese foreign assets and liabilities both increase

Cumulative since Jan-14, 100bn yen



Having received yen as part of the swap, the dollar-based investor can then ‘park’ the yen in Japanese paper, earning the JGB interest rate plus the basis (right-hand chart on the previous page). This is effectively a ‘repackaging’ of Japanese paper into a synthetic US fixed rate security that can offer extra yield: the US investor ends up owning a JGB with a US Treasury yield, i.e. US Libor plus an extra pick-up from the re-pack.

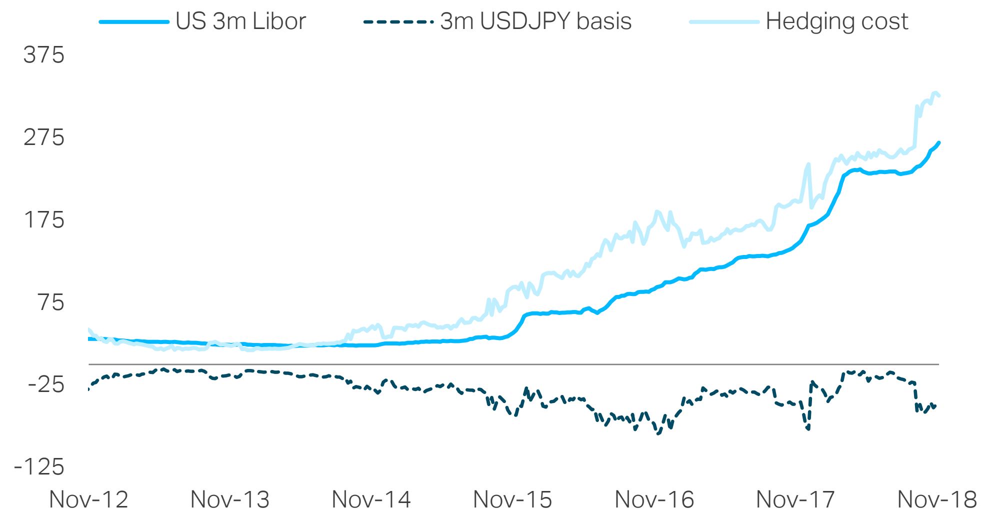
As a result, we see a continued increase in non-resident holdings of JPY paper (charts above). Their acquisition of JPY fixed income securities has generally outstripped Japanese investors’ purchases of foreign debt since 2014. Thus, with a decent foreign appetite for Japanese paper, the BoJ needs to buy fewer JGBs than it would otherwise to keep yields down.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

But hedging the dollar has become too expensive

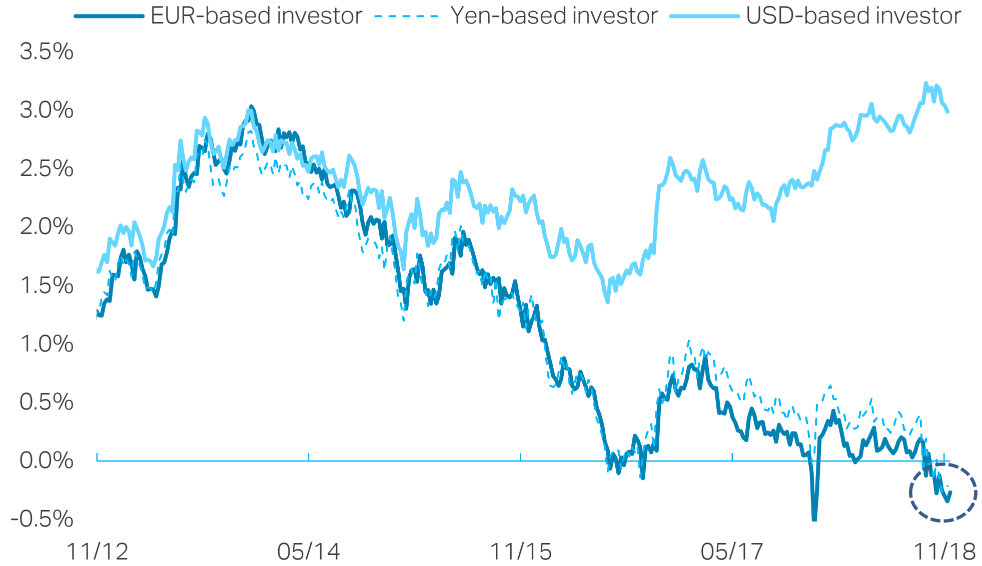
Rising cost of hedging US$ exposure

For a yen-based investor, basis points



Yield pick-up in the US has dried up

10yr US Treasury yield, FX-hedged for euro- and yen-based investors



But dollar-hedging costs have now become exorbitant, driving hedged US long yields for euro- and yen-based investors down to unattractive levels. Long US yields have risen substantially since they bottomed out in September 2017, but the increase has been accompanied by a flatter US curve (thus offering less carry) and periodic widening of the cross-currency basis (which adds to hedging costs).

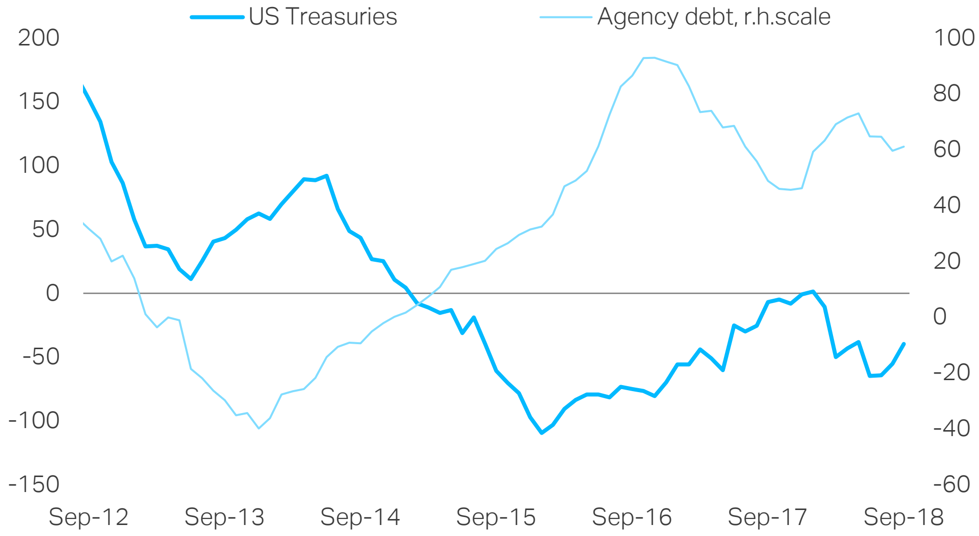
Prohibitive dollar-hedging costs have led Japanese investors to consider reducing their FX-hedged exposure to US Treasuries and/or to go down the risk spectrum. Some large insurers also plan to start raising their holdings of super-long (e.g. 30yr) JGBs as these yields creep higher.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

The unwinding of the dollar re-pack?

Japanese investors turn to US Agency Debt

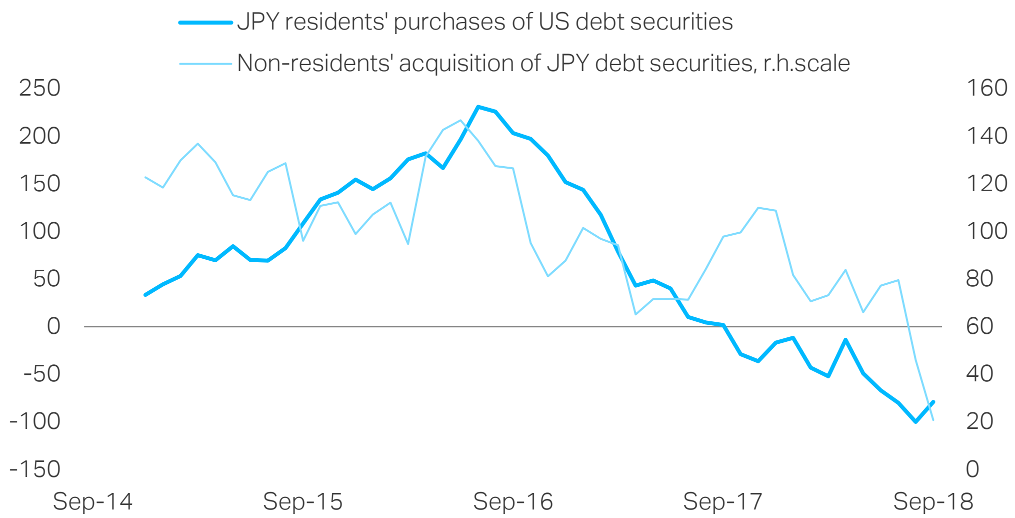
Net purchases of US debt by Japanese investors, 12-mth sum, $bn



Faced with heavy hedging costs, Japanese investors are turning to relatively higher-yielding assets such as US Agency debt and corporate paper while reducing their holdings of US Treasuries.

Is the dollar re-pack unwidning?

12-mth sum, 100bn yen



Even so, JPY residents' acquisition of US fixed income assets has been on a downward trend since they peaked in late 2016. The pullback has coincided with the deterioration in the hedged US yield pick-up (right-hand chart on the previous page).

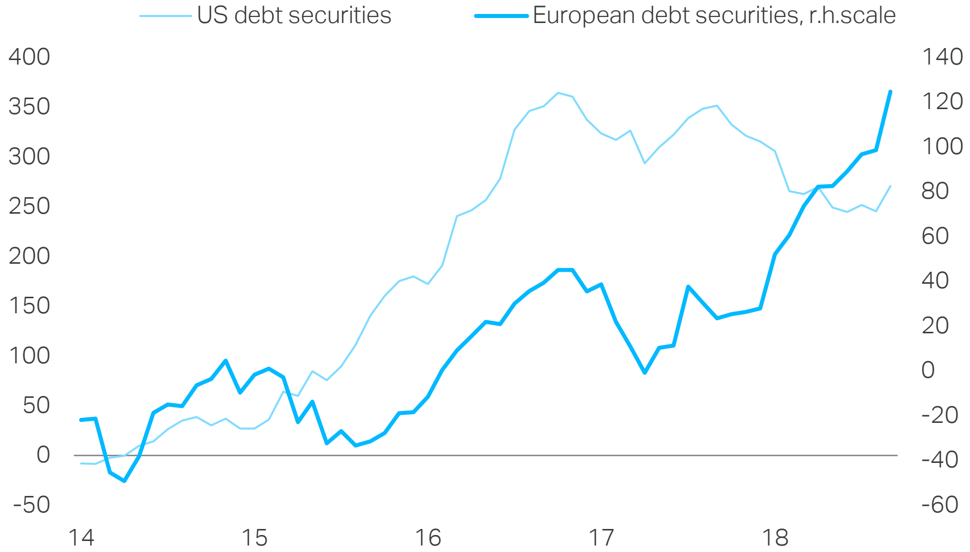
Non-residents' purchases of JPY debt has also turned lower as the dollar re-pack trade fades. In other words, with less interest from JPY investors in USD assets, there is less yen available for dollar-based investors to park in Japanese paper (chart above).

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

Japanese investors turning to European bonds

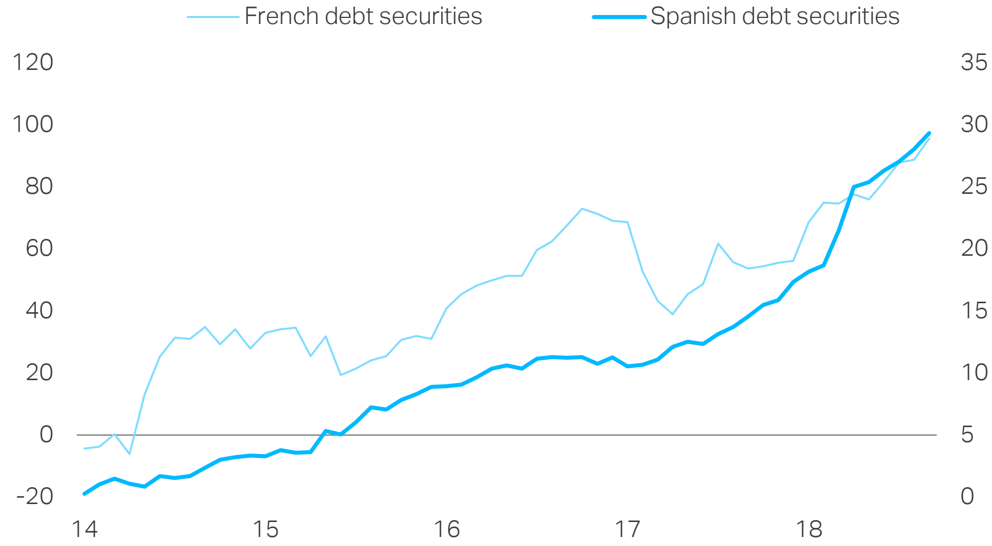
Shift to Europe

Japanese residents' net acqusition of foreign long-term debt securities, cumulative since Jan-14, 100bn yen



Shift to French and Spanish paper

Japanese residents' net acqusition of foreign long-term debt securities, cumulative since Jan-14, 100bn yen



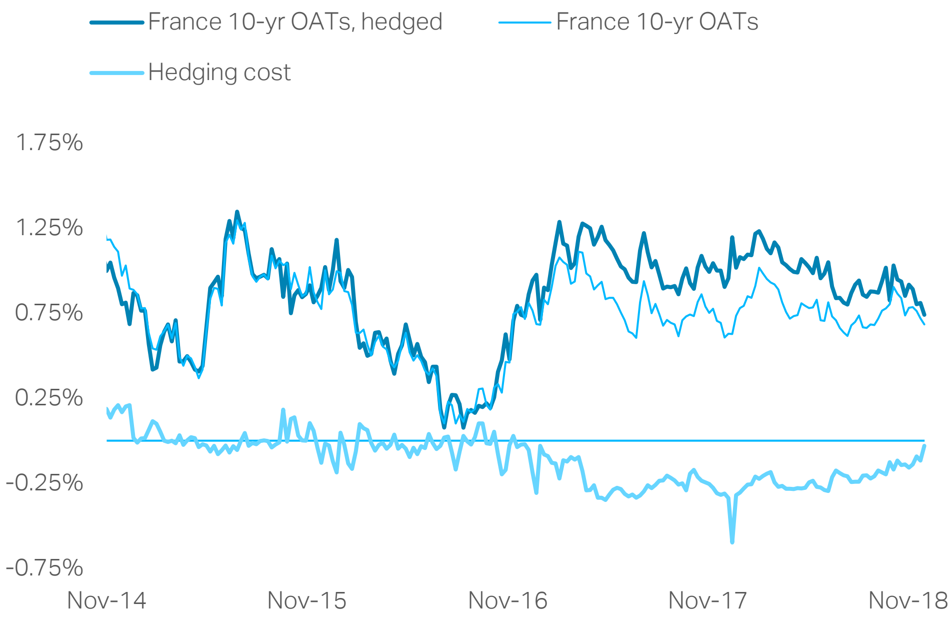
The re-pack trade is not dead. It is shifting from the dollar to the euro. Because FX-hedged US yields are no longer appealing, Japanese investors have been shifting capital to the European bond market, where yields are still decent.

Japanese residents have become particularly keen buyers of French and Spanish paper (chart above), just as the ECB has been trimming its asset purchases.

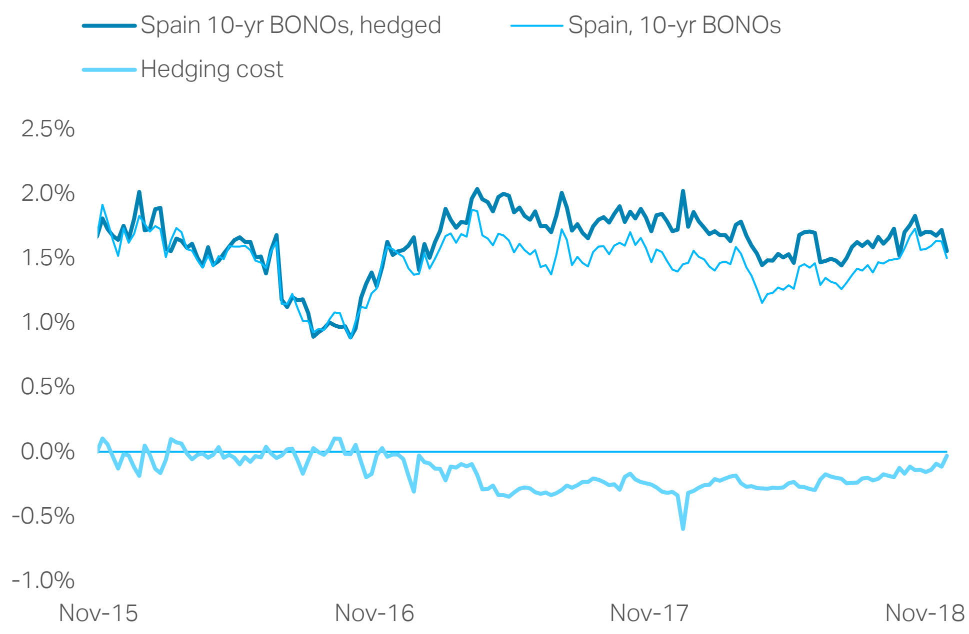
Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

Japanese investors getting paid to hedge the euro (thanks, ECB)

Yields for yen-based investors buying French OATs



Yields for yen-based investors buying Spanish BONOs



Japanese interest in EA securities is not surprising. French and Spanish paper offers a meaningful yield pick-up on a hedged basis for a yen-based investor.

For example, the FX-hedged French 10yr sovereign yield currently stands at around 0.80%, 20bp more than a 20yr JGB (chart above). This is because euro-hedging costs are negligible for yen-based investors, courtesy of the ECB's negative interest rate policy: in fact, Japanese investors are still getting paid to hedge out euro risk.

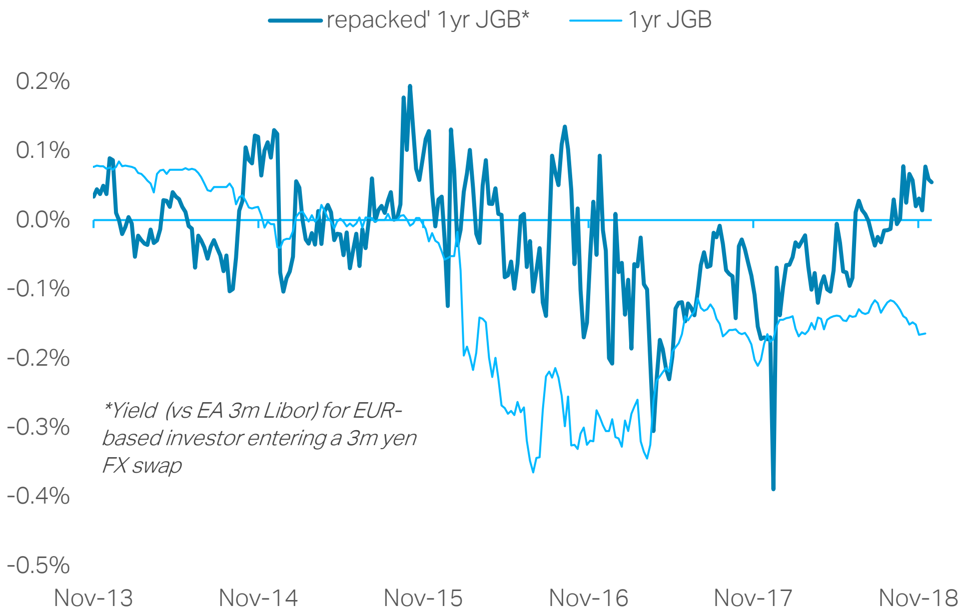
Similarly, Spanish 10-yr paper yielding 1.7% on a hedged-basis offers a 110 bp pick-up over a 20yr JGB (chart above).

Sustained Japanese capital flows into EA debt can therefore be expected to dampen some of the upward pressure on EA yields as the ECB retreats from QE. But, as we show later, it could also amplify divergences within the euro area (see slide 15).

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

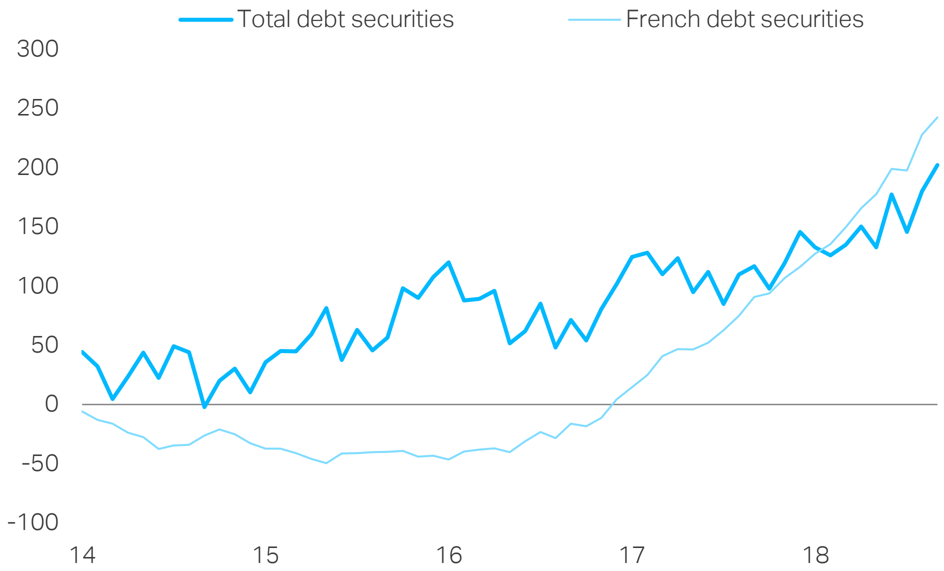
The euro re-pack

EA investors gain from parking yen in JPY assets



French investors re-packing their yen into JPY paper

Non-residents' net acquisition of JPY short-term debt securities, cumulative since Jan-14, 100bn yen



Like US investors, EA residents stand to gain from re-packing their yen holdings into JGBs (see chart above). The European re-pack is evident, for instance, in the increase in the net acquisition of Japanese paper by French investors (chart on the right).

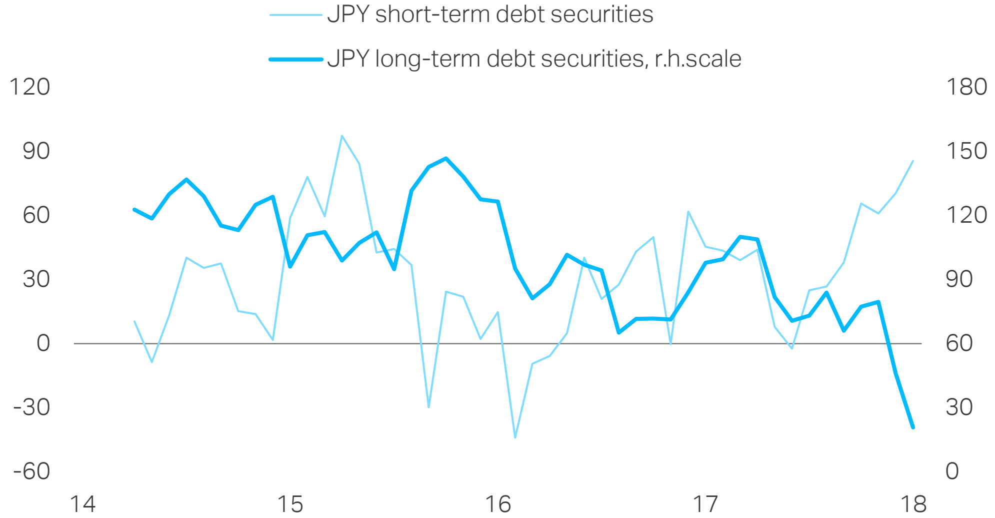
To be sure, the large role of UK as a financial hub distorts the exposure of European investors to JPY debt by nationality. Still, it is clear that the high cost of hedging dollars is deterring JPY investors from buying US securities. And this is encouraging the shift of the re-pack trade from dollar-based investors to euro-based counterparties.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

What duration risk?

Non-residents shift into short-dated JPY securities

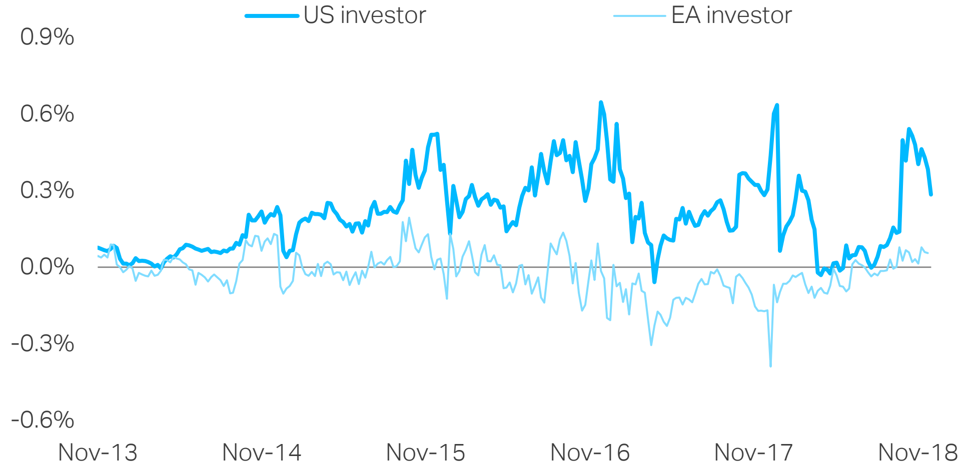
Non-residents' net acquisition of JPYdebt securities, 12-mth sum, 100bn yen



Separately, there has been a shift towards short-dated JPY securities given the lower duration risks entailed, especially since the BOJ introduced its yield curve control policy in September 2016.

Re-packing yen into Japanese paper less lucrative for an EA investor than for a US resident

Yield pick-up in 1-year JGBs (vs domestic 3m Libor) for investors entering a 3m FX swap with yen-holding Japanese investors



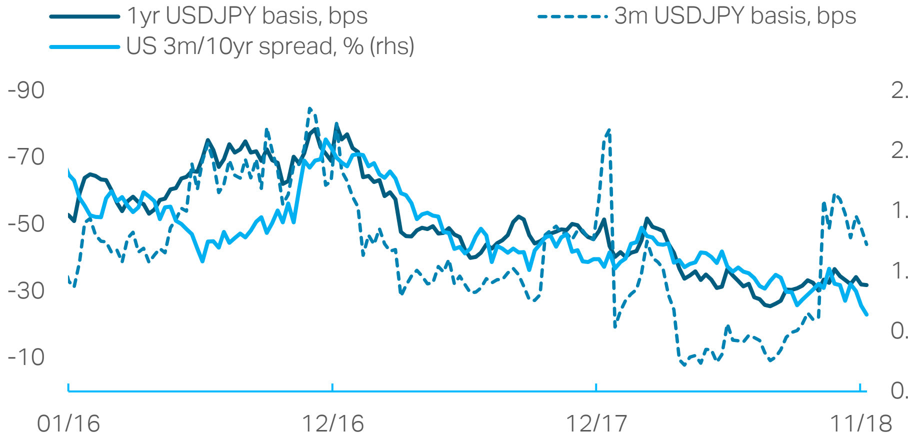
But the yield pick-up from a re-packed JGB for a euro-holding investor is small, and much less than that for a dollar-based investor. Thus, the parking of yen in JPY paper may ease, potentially taking away some support for Japanese debt.

Still, the additional yield from doing a re-pack is attractive for both dollar- and euro-based investors entering a yen swap. So long as this remains the case, they will continue to facilitate the BoJ's passive taper, but to a lesser extent than before.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

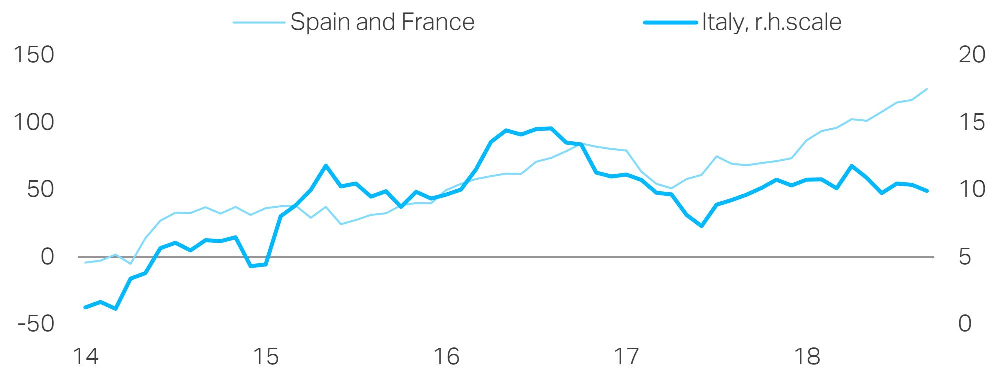
Japanese investors could push out Italian spreads

Flatter US curve tends to narrow the basis



Japanese investors could worsen the Italian spread

Japanese residents' net acquisition of foreign long-term debt securities, cumulative since



We think 'Operation Untwist' is likely to play out in the US Treasury market going into 2019, with the curve steepening from both ends. This would make US long yields more attractive. But this would also raise FX-hedged demand for US assets, thereby causing the basis to widen and hedging costs to increase. Thus, the bar is still high for JPY investors to pile into US debt on a hedged basis. JPY residents could buy US fixed income securities un-hedged. But, given the growing headwinds for the dollar, this is unlikely.

Instead, JPY investors are more likely to further raise their holdings of euro area debt. This could be good news for EA yields, especially because the ECB is set to end its QE programme this month, thereby removing the main source of demand for EA paper. But continued interest from JPY investors could also lead to a further widening of the spread between the yields on Italian assets and debt in the rest of the EA.

For starters, ECB QE has led to a slump in the share of outstanding central government bonds held by the private sector, especially in Germany, the Netherlands and Finland. According to ECB estimates, only 10% of German bunds were in private hands in September 2017. Our strategy team estimates that the share could fall to 4% by the end of this year. Crucially, while there is still a 'scarcity' of German Bunds, the supply of Italian BTPs, Spanish BONOs and French OATs is still abundant.

An exit from QE would thus widen the gap between the yields on Bunds and non-German EA debt, especially Italian BTPs. Moreover, Italy's proposed expansionary fiscal policy would add to the net supply of sovereign paper. The preferences of JPY investors could well exacerbate the resulting impact on spreads. As we see in the chart above, Japanese residents have been raising their holdings of French and Spanish paper, but they are offloading Italian assets at a rapid clip.

Source: Datastream, Bloomberg, ECB, BoJ, MoF, TS Lombard

Authors

Shweta Singh
Managing Director,
Global Macro

Konstantinos Venetis
Senior Economist