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Financial markets and the yen: Roll forward or roll back?

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Abstract

The sudden sharp rise in the yen has shaken the financial markets. This could have been just an episode, but it doesn't have to be.

Zusammenfassung

Der plötzliche steile Anstieg des Yen hat die Finanzmärkte durchgerüttelt. Das könnte nur eine Episode gewesen sein, muss es aber nicht.

"I'm back here again, on my turf, never really been away, just hiding". Older German investors may have thought of this line from Marius Müller-Westernhagen's song when the markets crashed out of nowhere in August and the so-called *carry trade* made the rounds everywhere after a long time.

This trade describes how investors borrow money in a low-yielding currency in order to invest in higher-yielding currencies or supposedly promising investments. This also happens via detours. For example, professional investors can sell bonds in the low-interest currency short and invest the proceeds in a high-interest currency.[1]

The decisive factor here is not the interest rate of the respective loan and investment currency, but the difference. The greater the difference, the greater the buffer offered by the interest rate differential. What's more, if the borrowers of the two different currencies are in roughly the same credit rating range, then currency gains can be realised. After all, a higher interest rate with a similar probability of repayment attracts funds that drive up the price of a currency.

The Japanese yen is particularly popular as a lending or short-selling currency, as it almost traditionally costs little interest and is the only major currency to have escaped the general rise in interest rates since 2022.

Until recently. After the Bank of Japan dared to take the first triple step out of its negative interest rate policy in March and at the same time loosened its control over longer-term yields on government securities, it raised the key interest rate to 0.25 per cent at the end of July - which apparently came as a surprise to many investors.

Investors immediately closed their carry trades on the Japanese yen. This is exemplified by the speculative positions (futures) on the Chicago Merchantile Exchange (CME), which is decisive for this.

At the end of June, these were still almost at record lows on a net basis, which meant massive bets on falling yen rates (*short*), but on 6 August they turned close to zero. According to the latest available data as at 13 August, investors are now even clearly net *long*, i.e. positioned for a rise in the yen (Figure 1).

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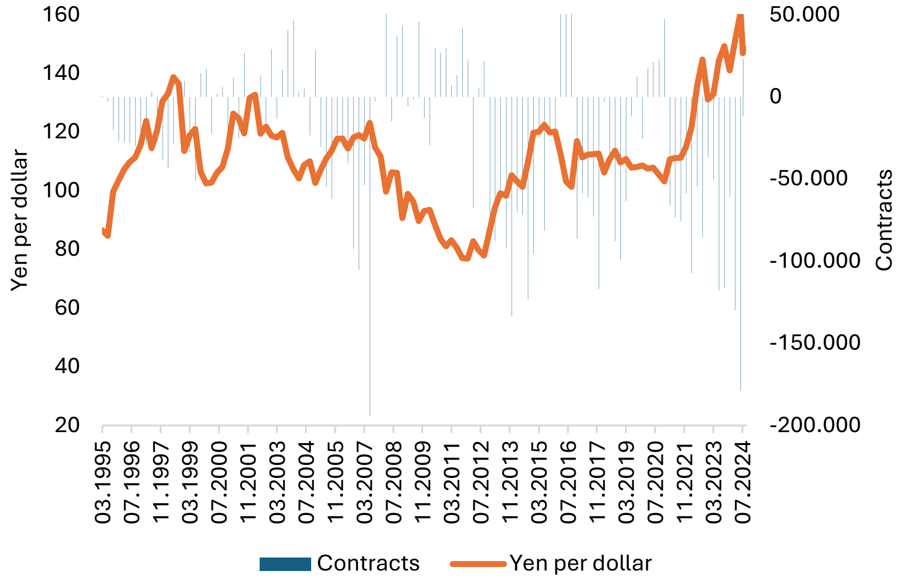
[1] There are also so-called swap transactions. In a currency swap, a lender provides dollars against yen, for example, with the promise to repay the yen at an agreed exchange rate when the swap matures. The dollar lender receiving the yen usually parks the yen proceeds in a safe yen security, such as a Japanese government bond. However, the yen can also be resold, again against the dollar or other currencies, so that the dollar provider has an unhedged yen obligation. He then speculates unhedged on a fall in the yen. The Bank for International Settlements (BIS) calculated swap volumes (FX and currencies) of over 97 trillion dollars as at the end of June 2022. According to market estimates, dollar-yen swaps are expected to represent around 14 trillion dollars. The BIS calls swaps a blind spot in the financial system.

Figure 1: Dollar-yen price and yen futures contracts on the CME (net)



Non-commercials positions, CME = Chicago Merchantile Exchange, a single futures contract represents 12.5 million yen, source: Bloomberg, CME, Flossbach von Storch Research Institute. As at: August 2024. **Historical performance is not a reliable indicator of future performance.**

This was preceded by a black Monday on the stock markets after the dollar abruptly ended its three-and-a-half-year rise against the yen, partly due to increased expectations of interest rate cuts in the USA.

The most frequently and highly traded top stocks on the US stock exchange plummeted by double-digit percentages within a few days, the Nikkei 225 lost a good twelve per cent in one fell swoop, the Mexican peso, which pays high interest in its home currency, was trading at its lowest level against the dollar since the beginning of 2023 and Bitcoin, praised by the crypto lobby as a *store of value*, crashed by almost 30 per cent from 29 July to 5 August.

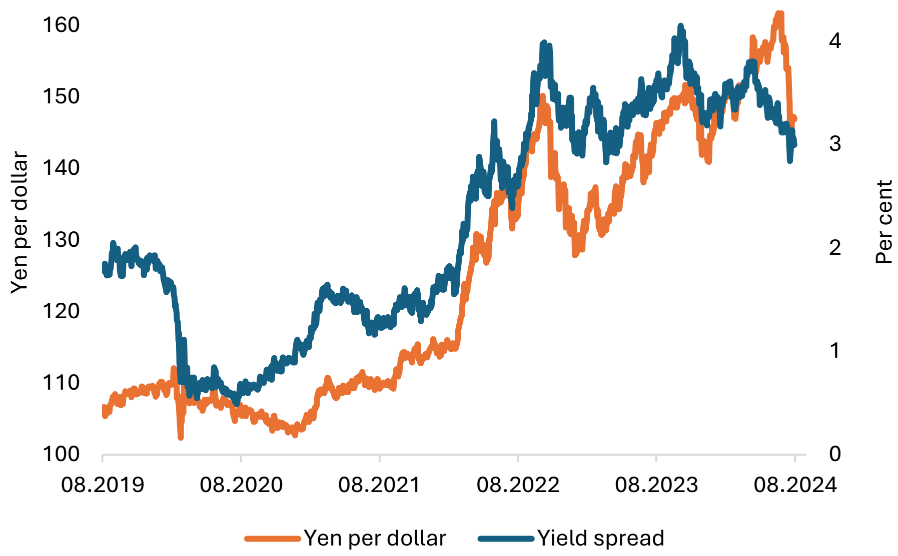
This was followed by a rapid recovery. The reason: market observers currently assume that the classic, more short-term financed carry trades, for example by hedge funds, have already been largely liquidated. J.P. Morgan Chase estimates that three quarters of the carry positions have been reduced. Citigroup considers the remaining exposures to be "not yet clean, but they are below the risk levels we monitor".[2]

[2] https://www.bnnbloomberg.ca/investing/2024/08/07/carry-trade-out-of-danger-zone-but-watch-yuan-citi-quants-say/

Interest rate differences are decisive

As the brief August earthquake showed, interest rates play a decisive role in such developments. The price of the yen against the dollar is closely linked to the difference between the yields of long-dated, safe US and Japanese bonds (Figure 2).

Figure 2: Yen-dollar price and yield differential between ten-year Japanese government bonds and ten-year US government bonds



Source: Bloomberg, Flossbach von Storch Research Institute. As at: August 2024. **Historical performance is not a reliable indicator of future performance.**

Carry Trade a known unknown

The yen carry trade is generally regarded as one of the *known unknowns*. These are the known major risks on the international financial markets, where the only question is usually when they will materialise. [3]

During the onset of the financial crisis in 2007/2008, which jeopardised dollar investments, yen futures turned massively from short to *long* (bets on rising prices). As a result, the yen gradually rose to a record high: at the end of 2011, the dollar cost less than 77 yen at times. Even now, investor positioning could turn in favour of the yen.

[3] https://www.flossbachvonstorch-researchinstitute.com/de/studien/die-known-unknowns-der-finanzrisiken/

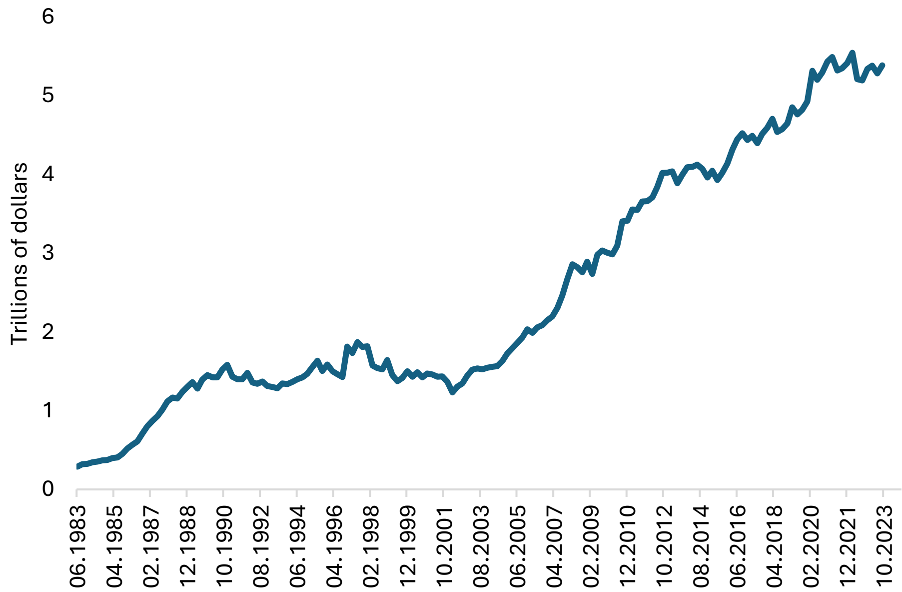
Japan as the world's largest creditor

The weak yen had inflated the value of Japanese investments in foreign stocks, bonds and other assets in recent years. Gross foreign assets held by the Japanese government, companies and private investors rose by 11.1 per cent to 1,488 trillion yen in the past fiscal year to the end of March, while foreign debt increased by 10.6 per cent to 1,017 trillion yen, according to the ministry at the end of May.[4] At the exchange rates at the time, this corresponded to the equivalent of 9,600 billion dollars in assets and 6,560 billion dollars in debt - a difference of a good 3,000 billion dollars.

Debt and investment master at the same time

With a good 250 per cent government debt to gross domestic product, Japan may be at the bottom of the list of major industrialised nations, but it is also the world investment champion. In a narrower survey by the Bank for International Settlements (BIS), which only covers investments in foreign bonds and equities, Japan recently invested just under 5.4 trillion dollars in both categories (Figure 3).

Figure 3: Cross-border portfolio investments Japan



Source: Bloomberg, BIS, Flossbach von Storch Research Institute. As at: August 2024.

[4] https://www.reuters.com/markets/japan-net-external-assets-hit-record-high-2023-remains-worlds-top-creditor-2024-05-27/

A good third of these investments are on the books of Japanese banks. No other country invests as much capital overseas as Japan.

Japan therefore has strong firepower to defend its currency for a long time to come, but after years of stagnation and temporary deflation, it is a prisoner of its own economic and central bank policies, which are closely linked.

This is another reason why there are good arguments in favour of only a temporary recovery of the yen. For example, the Bank of Japan's ability to act is in question.[5]

And after the ten-year Japanese government bond yielded more than one per cent per year for the first time since April 2012 on 22 May this year, it is currently yielding just over 0.8 per cent. This is unattractive for Japanese long-term investors such as pension funds and life insurers, who, according to market reports, are likely to be tempted to invest more money in Japanese bonds at two per cent. Two per cent is indeed available, but only for 30-year yen securities. However, this very long term is likely to be longer than the average duration of insurers' obligations.

However, alternatives such as longer-term dollar exposures are only worthwhile if they are entered into without hedging. The ten-year US government bond is currently yielding around 3.9 per cent a year. The hedging costs are 5.1 per cent.[6]

Arguments for and against the rise of the yen

The fact that the Bank of Japan has not only relinquished its strict controls but also plans to gradually halve its most recent bond purchases from 5.7 trillion yen per month to 2.9 trillion yen in the first quarter of 2026 speaks in favour of a rise in yields in Japan.

If the interest rate gap between Japanese and US yields continues to close and large investors such as the Japanese government, public and private pension funds and life insurers reduce their trillion-euro investments as a result, further upward pressure on the yen could materialise. However, this is likely to materialise less abruptly than gradually and in the medium to long term.

Liquidity would then be withdrawn from the dollar area in particular. This could lead to a reduction in the significant overweighting of US investments, particularly equities, in the broad indices.

Structural problems remain

[5] https://www.flossbachvonstorch-researchinstitute.com/de/kommentare/ist-der-japanische-yen-auf-erholungskurs-oder-droht-ein-dauerhafter-absturz/

[6] Measured by three-month dollar-yen forward contracts

It should not be forgotten that the yen faces unsolvable structural problems in the long term. The median age of the Japanese population is estimated at 49 years, while the birth rate in 2023 was just 1.2 children per woman.

Economic weakness and disinflation would argue against a yen appreciation in the coming months. In mid-August, however, Japan surprised with good economic data for the quarter from April to June. This should fuel the Bank of Japan's hopes of being able to drive inflation to its desired target of two per cent, which would justify further interest rate hikes that would support the yen.

But after the collapse of the Nikkei and the US markets, Shinichi Uchida, Deputy Governor of the Bank of Japan, responded with a remarkable statement: the central bank "will not raise its key interest rate if the financial and capital markets are unstable". [7]

Instability cannot be denied, and the Bank of Japan's interest rate policy, which runs counter to that of other central banks, has contributed to this. In any case, investors should not shelve the yen and the mini-crash and regard them merely as an episode.

[7] https://www.bloomberg.com/news/articles/2024-08-07/boj-won-t-raise-interest-rate-if-markets-unstable-uchida-says

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