AMRO

ASEAN +3 MACROECONOMIC RESEARCH OFFICE

Market Insights

Japan Trip Notes: Trends and Views of Market Participants[1]

November 11, 2022

I. Introduction

1. **AMRO staff met with market participants in Tokyo during our visit in early November to seek their views on recent developments in Japan's financial markets and risks to the outlook.** Specifically, we engaged with strategists, traders, investment bankers, and economists covering corporate credit, fixed income, exchange rates, and equities, to discuss the weakness of the Japanese yen, expectations around the Bank of Japan's (BoJ's) policy stance, the Japanese Government Bond (JGB) and corporate credit markets, and perceived domestic investor behavior.

2. **Market participants appear to be relatively "comfortable" with the current market situation but acknowledge risks going forward.** Their main focus is on yen weakness, with analysts expecting the BoJ to remain dovish in the foreseeable future, although they are wary that any shift to a hawkish stance would be disruptive to financial markets. We also learned that investors are becoming increasingly concerned about the valuation of banks' securities portfolios. Several market participants flagged the potential risks to the corporate bond market, whose function has been adversely impacted by the distorted JGB yield curve.

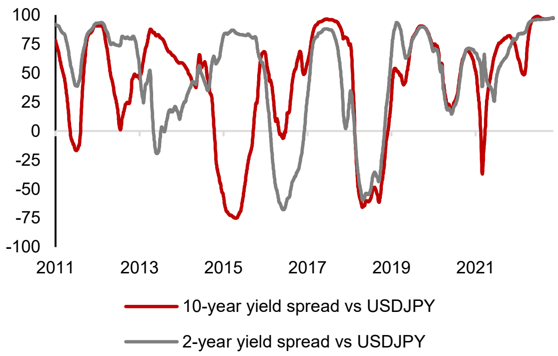
II. The Weakness of the Japanese Yen

3. **Market participants broadly agree that the monetary policy divergence between the US and Japan is the primary reason for the yen's weakness, but fundamental and technical factors also matter.** Some analysts expect the recent strong relationship between the yen and yield differentials with the US to be temporary or unstable (Figure 1). They observe that the surge in commodity prices, especially oil, has led to the widening of Japan's trade deficit (Figure 2), which, along with the border control measures, has added to the depreciation pressure on the yen. Analysts also note that importers are rebuilding their foreign exchange hedging positions—which is contributing to the weaker yen—and are

[1] Prepared by Prashant Pande (Financial Surveillance); reviewed and authorized by Li Lian Ong (Group Head, Financial Surveillance). The author would like to thank Siang Leng Wong for useful comments. The views expressed in this note are the author's and do not necessarily represent those of the AMRO or AMRO management.

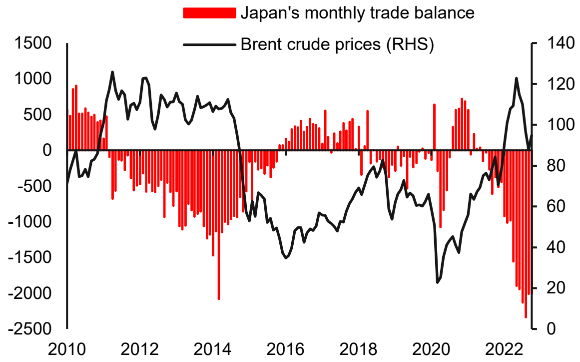
expected to continue doing so for a few more months.[2] Most interlocutors believe that the overall impact of a weaker yen is positive for the economy, although they acknowledge that rising consumer prices could be politically challenging.

Figure 1. One-Year Rolling Correlation between US-Japan Yield Differentials and USDJPY
(Percent)



Sources: Bloomberg Finance L.P.; and AMRO staff calculations.
Note: The one-year rolling correlation between US-Japan yield differentials and USDJPY is calculated on daily levels.

Figure 2. Japan: Trade Balance
(Billions of Japanese yen, US dollars per barrel)



Sources: Bloomberg Finance L.P.; and AMRO staff calculations.

4. **The yen is expected to reverse part of its weakness next year.** Some recovery in the yen exchange rate is forecast for 2023, as the US Federal Reserve ("Fed") reaches the end of its monetary tightening cycle and the BoJ moves closer to a hawkish pivot. The recent fall in oil prices could help narrow the trade deficit and, along with the easing of border control measures, provide support for the yen. However, there is a wide range of expectations around peak USDJPY levels in the near term. Although some expect the peak to be around current levels (148–150), others see the yen bottoming against the US dollar beyond the 160 level.

5. **However, a sustained appreciation of the yen is expected only after the BoJ starts tightening monetary policy.** Some retracement in USDJPY is expected next year but beyond that, analysts continue to forecast yen depreciation over the medium term. Even though the yield differentials between the US and Japan could narrow in 2023, US Treasury yields will remain higher than those of JGBs', providing a conducive backdrop for a weaker yen. Market participants are of the view that during periods of low volatility, investors will resume using the yen as the funding currency for their carry trade operations. Hence, any extended yen strength against the US dollar would be possible only if the BoJ becomes hawkish. Alternatively, uncovered interest rate parity suggests that the yen could appreciate against the US dollar over the longer term if the Fed is unable to sustainably curb US inflation.

6. **Investors assess the exchange rate intervention by Japan's Ministry of Finance ("JMoF") to have been effective in curbing speculation and expect it to continue if the yen weakens further.** Market participants generally agree with the stance of the authorities against one-sided and excessive moves in the exchange rate, while not trying to defend any

[2] Importers typically enter multi-year hedges through options to guard themselves against a stronger US dollar and to cheapen the cost involved, they sell knockout options at much higher strikes. The recent weakness of the yen was unprecedented, and it triggered these knockouts, deeming the option hedges worthless. Over the past few months, the importers are rebuilding these hedges.

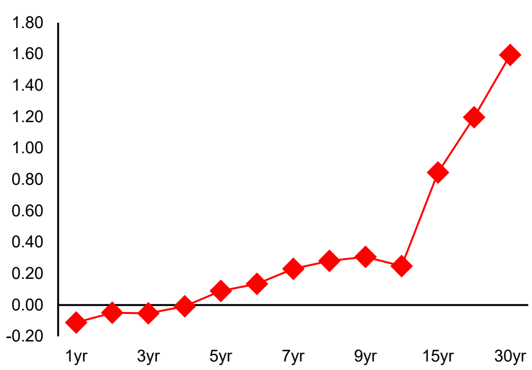
specific level. The first round of intervention was not expected by markets, which are now increasingly expressing a long US dollar view against currencies such as the euro and the British pound, instead of the yen, and reducing speculative short positions in the yen. However, some participants believe that as the surprise element of the interventions diminishes, there is a risk that their effectiveness also lessens. Speculators may, in fact, start using suspected intervention episodes to re-initiate short yen positions.

7. **The broad consensus is that the BoJ will maintain its accommodative monetary policy stance in the foreseeable future, but markets lack insight into the path and timing of any tightening.** Investors are confident that the conditions are not ripe for the BoJ to commence tightening and that any such move would be effected in a very gradual and transparent manner to minimize any negative impact on financial markets. That said, markets lack clarity on the sequence in which monetary policy will be tightened and there are some participants who think that there is “no soft exit” for the BoJ. They are concerned that any rise in interest rates will cause severe disruptions. Institutional investors that have large exposures to JGBs—notably, banks, pension funds, life insurance companies—are expected to start hedging their exposures but may still face increased stress if yields shoot up rapidly. In this regard, some banks have already started reducing the duration of their JGB holdings to guard against any sizeable rise in yields.

III. Spillovers from the JGB Market to Corporate Bonds

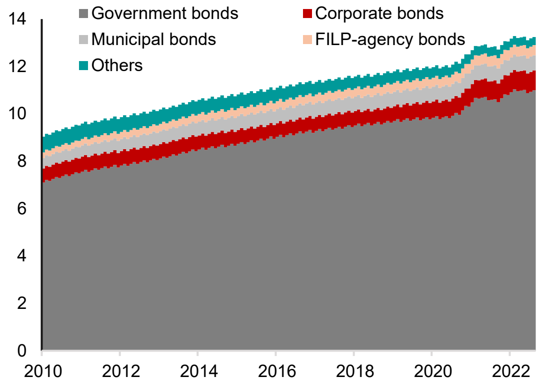
8. **Although the lack of liquidity in the JGB market is not considered an issue presently, it has affected the issuance of yen-denominated corporate bonds.**[3] Issuers and investors typically prefer the 2-year, 5-year, and 10-year tenors, but they have struggled to price 10-year corporate bonds, with 10-year JGB yields anchored by the BoJ’s Yield Curve Control (“YCC”). Specifically, the depressed 10-year yield and a distorted yield curve (rich 10-year yields compared to 9-year and 15-year) have made it difficult to accurately benchmark credit spreads (Figure 3). Hence, corporates have, in recent years, focused their debt issuances on tenors of up to 5 years. The issuance of shorter tenor bonds has also been encouraged by the BoJ’s corporate bond buying program for bonds with tenors up to 5-years. Interlocutors are of the view that the BoJ can generally afford to “ignore” the corporate credit market because of its small size relative to the JGB market (Figure 4).

Figure 3. Japan: JGB Yield Curve
(Percent)



Sources: Bloomberg Finance L.P.; and AMRO staff calculations.

Figure 4. Japan: Yen Denominated Bonds Outstanding
(Trillions of yen)



Sources: Haver analytics; and AMRO staff calculations.

[3] Analysts note that the worsening liquidity in government bond markets is not restricted to Japan—other advanced economies, such as the US and Europe, are also experiencing reduced liquidity in bond markets.

9. **Nonetheless, the BoJ's policy support and low interest rates have resulted in a significant rise in corporate bond issuances.** Analysts note that the proceeds from bond issuances have been applied to meeting working capital needs and repaying maturing debt during the COVID-19 pandemic. Issuances have fallen since the BoJ started scaling back its corporate bond support measures (Figure 5), with only energy companies—grappling with high fuel costs—increasing their issuances. However, the heavy issuances at the shorter end may expose corporates to rollover risks in the coming years.

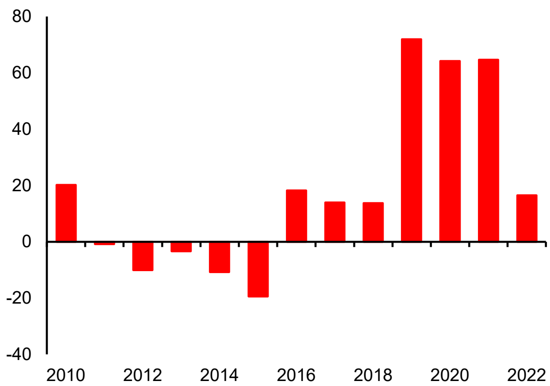
10. **The companies that issue debt in foreign currencies typically hedge their exposures and are hence well-placed despite the yen depreciation.** High-grade companies are not seeing any refinancing issues in foreign currency debt as yet, and most of their exposure to yen depreciation is fully hedged. However, some market participants are concerned that any sovereign rating downgrade for Japan—if the government does not consolidate its fiscal situation—could adversely impact the cost of foreign currency issuances by domestic corporates.

IV. Behavior of Japanese Domestic Investors

11. **Japanese retail investors have been seeking higher yields, which has pushed them toward riskier assets.** Traditionally, Japanese retail investors have been conservative. However, a prolonged period of low interest rates domestically and in other advanced economies, have made investments in emerging market fixed income funds more attractive. Investors have also used structured investments, such as emerging market funds with a currency overlay, to enhance their returns. Investors have also started putting their money in funds focused on global equities, Environment, Social, and Governance (ESG) investments, and the technology sector. Furthermore, some interlocutors observe that there has been a rise in margin trading among Japanese retail investors.

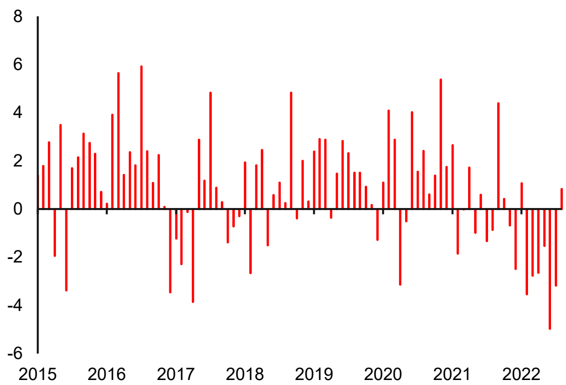
12. **Japanese institutional investors generally prefer diversifying their assets and are typically prudent in hedging their risks.** However, analysts note that investors who fully hedged their exchange rate risks are the ones who are suffering large losses during the recent episode of market turbulence—attributable to the fall in the values of global bonds and equities as a result of rising global interest rates, while missing out on FX gains from a weaker yen. This development is cited as one of the primary reasons for falling foreign bond ownership by domestic investors (Figure 6).

Figure 5. Japan: Change in Outstanding Corporate Bonds
(Billions of yen)



Sources: Haver analytics; and AMRO staff calculations.

Figure 6. Japan: Change in Foreign Bond Holdings of Domestic Investors
(Trillions of yen)



Sources: Bloomberg Finance L.P.; and AMRO staff calculations.