

Japan Rates and FX Watch

Yen carry trade still attractive after BoJ's YCC tweak

YCC tweak not a game changer

The BoJ tweaked YCC on July 28 and we see mixed commentaries on JPY in the market (for the detail, see: [Japan Macro Watch: BoJ flexibilizes yield curve control—quick take 28 July 2023](#)). We maintain our view that any YCC tweak would not be a game changer for JPY and USD/JPY's dip would be shallow and short-lived (see: [BoJ's one-off policy tweaks may unleash yen-carry trade 27 February 2023](#)). We continue to expect USD/JPY to rise to 147 by Sep. We provide three reasons why.

No immediate repatriation, still patient BoJ, lower vol

We answer three questions to explain why we think the YCC tweak is not a game changer for JPY:

- **Does the YCC tweak lead to capital repatriation by Japanese investors?** – We do not think so, at least for this fiscal year, as Japanese investors spent last fiscal year preparing for the BoJ's policy normalization. Both banks and insurers sold record amount of foreign bonds in 2022 and their selling appeared to have run its course by this spring (Exhibit 1).
- **Does the YCC tweak signal multiple rate hikes?** – We do not think Friday's action itself reflects a clear change in the BoJ's stance though it may reflect their recognition of upside risks in inflation as Governor Ueda re-iterated his patient stance: "there is still a long way to go before we [the BoJ] can raise the short-term policy rate from the current negative level". While our economists note growing risks that the NIRP removal would happen earlier than their expectations of mid-2024, they note the earliest timing would be 1Q24 and it would depend on incoming data. We also note that the distance between the NIRP removal and rate hikes in the positive territory could be long.

As Exhibit 2 shows, the market pricing in the front-end has not moved much despite a clear increase in the 10yr swap rate and JGB yield, suggesting the BoJ can be credibly dovish on the front-end for now as the market shares the memory of the lack of Japan's inflation for the past few decades. The front-end rate is likely to remain contained and G10/JPY carry elevated at least until the BoJ's October MPM and possibly for the rest of 2023.

- **Does the YCC tweak increase market volatility?** – USD/JPY implied volatility has actually declined (Exhibit 3). It makes sense as there is not much the BoJ can do beyond what they implemented last week for the rest of this year unless one expects significant upside surprises on Japan's inflation.

Vol-adjusted carry new high after BoJ's MPM

At the end, the combination of (expectations for) elevated USD/JPY carry and lower market volatility has lifted USD/JPY's volatility-adjusted carry (carry/vol ratio) to new highs for some measures since 2006 (Exhibit 4).

31 July 2023

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BoJ: Bank of Japan

MPM: Monetary Policy Meeting

MoF: Ministry of Finance

NIRP: Negative Interest Rate Policy

YCC: Yield Curve Control

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Timestamp: 31 July 2023 02:54AM EDT

3 things to watch

We reiterate our bearish JPY view but we would also monitor three catalysts which could challenge our view in the next few months.

JGB reaction to MoF auction

While the JGB market's reaction to the BoJ's YCC tweak last week has been limited so far, the market needs to digest monthly auctions starting with the 10yr JGB auction on August 1. As the market may still be in a price discovery mode, we expect the 10yr JGB yield to grind higher as the market absorbs supply. We think the 10yr yield can rise up to 0.7%. For the next few weeks, USD/JPY may be sensitive to the 10yr JGB yield. However, we expect the rise in the JGB yield to be orderly and any disorderly move would be countered by the BoJ's bond buying operations.

Verbal intervention

As we noted in our preview report, we thought the FX rate may have been one reason why the BoJ wanted to keep optionality for the Jul MPM, possibly influenced by the government's FX strategy as FX intervention this year has a higher hurdle in our view (see: [Japan Rates and FX Watch: JPY – key themes before BoJ MPM and for summer 24 July 2023](#)). If that was the case, the government is likely to resume verbal intervention as USD/JPY rises toward 145.

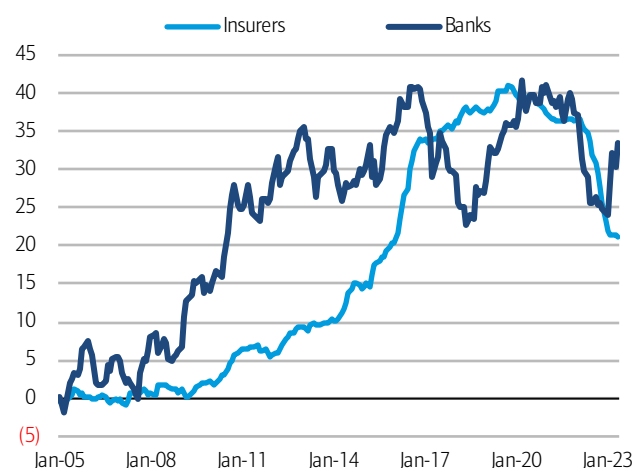
However, we do not think 145 will draw a hard line in the sand as (1) FX intervention remains difficult for the government to justify this year with a strong equity market and economy and (2) FX intervention does not impact USD/JPY carry.

Inflation data

This is fundamentally the most important factor for JPY as strong inflation could eventually lead to the BoJ's rate hike and diminish USD/JPY's carry. As we noted above, however, the surprise must be strong and may need to include indication for the next spring wage negotiation – likely only available toward year-end – to lead to expectations for multiple rate hikes by the BoJ in 2024. Our economists have been bullish on Japan's inflation for some time but even they expect a NIRP removal sometime from 1Q24 to 3Q24 with no subsequent rate hikes in the positive territory through 2025 as their base case.

Exhibit 1: Cumulative foreign bond investment by Japanese insurers and banks (¥tn)

Insurers and banks reduce exposure to foreign bonds in 2022 in preparation for the BoJ's policy normalization

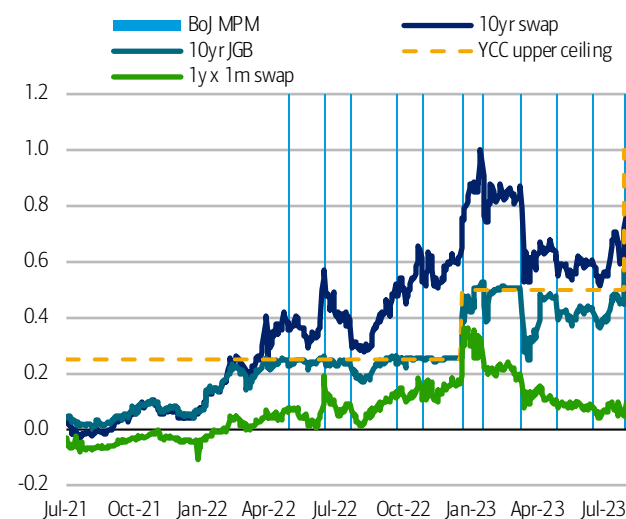


Source: BofA Global Research, Haver

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Exhibit 2: 10yr JGB yield, 10yr swap rate, 1y x 1m forward swap rate

Front-end reaction to 10yr interest rate has fallen

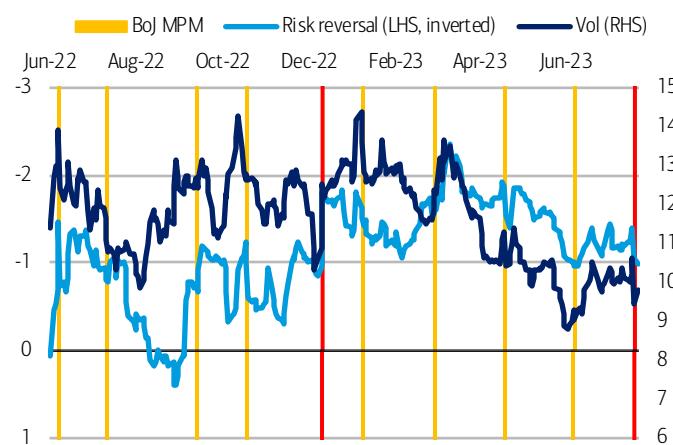


Source: BofA Global Research, Bloomberg

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Exhibit 3: USD/JPY 3m volatility and risk reversal

USD/JPY vol has declined after BoJ's Jul MPM

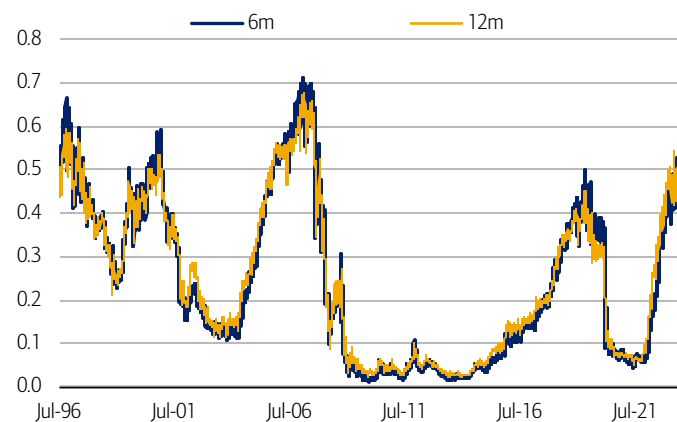


Source: BofA Global Research, Bloomberg

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Exhibit 4: USD/JPY vol-adjusted carry (carry/vol ratio*)

USD/JPY carry new highs after BoJ's Jul MPM



Source: BofA Global Research, Bloomberg

*6m = annualized 6m carry / 6m implied vol; 12m = 12m carry / 1yr implied vol

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