Liquid Insight

Yen-carry trade redux

17 April 2023

Rates and Currencies Research
Global

Key takeaways

- Environment looking similar to past yen-carry trade phase but BoJ's policy uncertainty stands in the way.
- With YCC tweaks widely expected/priced, key will be BoJ's stance on the front end. Our base case = no NIRP removal in 2023.
- As market has cut pricing for Apr MPM, a change next week could lead to knee-jerk JPY rally. But JPY's rally should be sold.

By Shusuke Yamada, Izumi Devalier, Tomonobu Yamashita, and Tony Lin

Chart of the day: Major scenarios for April BoJ MPM and expected market reactions
BoJ's policy tweak without a hawkish pivot on the front end could eventually be negative for JPY

Scenarios	Policy		JGB			FX	Equity
	YCC / long-rate target	Front-end (NIRP) + guidance	5yr	10yr	30yr	USD/JPY	TOPIX
Apr base case	Unchanged	Unchanged + dovish guidance	No change	No change	No change	Rally to 134-135 with limited follow through (focus shift to June)	Flat to mildly positive (TOPIX: up to 2,050)
Risk scenario	YCC 10yr ceiling raised to 1%	Unchanged + dovish guidance	40bp	75bp	145bp	Fall to 129-131 but recover quickly to initial level	Dip to 1,950 - 1,990; Lifers and banks slightly outperform
	YCC target shortened from 10yr to 5yr or 2yr	Unchanged + dovish guidance	50bp	80bp	150bp	Fall to 128-130 but recover quickly to initial level and higher	Dip to 1,950 - 1,990; Lifers and banks slightly outperform
	Remove YCC, move to flexible QE	Unchanged + dovish guidance	45bp	80bp	150bp	Fall to 125-127 initially, followed by a rebound but stabilizes below 130	Decline to 1,930 - 1,970; Lifers and banks outperform
Tail risk	Remove YCC, move to flexible QE	(Signal to) remove NIRP	55bp	85bp	155bp	Fall to 120-125, USD/JPY to enter sell-on-rally phase	Drop up to 1,900; Defensive & financials outperform

Source: BofA Global Research; (spot ref as of Apr 17: USD/JPY 133.8, TOPIX 2020, 10yr JGB 0.48)

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Yen-carry trade awaits BoJ's policy tweak

In this note, we discuss:

(1) As the Fed is expected to finish rate hikes in May while the ECB is expected to continue rate hikes into the fall, the global monetary policy cycle appears to enter a phase similar to 2H06-1H07 when the yen-carry trade accelerated.

(2) However, yen-carry trade has not been built up yet. The key domestic reason is the uncertainty around the BoJ's policy shift under the new governor. The BoJ's policy tweak on YCC (yield curve control) with dovish forward guidance on the front end could be seen as a greenlight for yen-carry trade.

(3) The market has cut pricing for the BoJ's policy shift in April. Policy changes in the April MPM could surprise the market timing-rise and lead to a sharper JPY rally, but the rally should be sold unless the BoJ turns hawkish on the front end.

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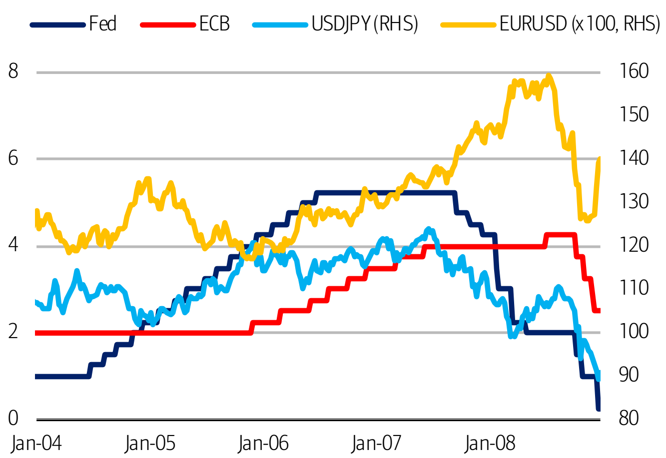
Yen-carry trade redux

With the Fed expected to deliver the last hike in May but the ECB expected to continue hiking rate into the fall, the global monetary policy cycle may enter a phase reminiscent of the 2H06-1H07 period (Exhibit 1). As the Fed approached the final hike of the rate hike cycle in June 2006, USD/JPY corrected in the spring of 2006. However, the yen resumed weakening soon after even though USD weakened against non-yen major currencies while the Fed was on hold. Cross-yen pairs generally rallied until two months before the Fed's first rate cut in September 2007.

The current market pricing for global policy rates may imply a weaker USD as the Fed is expected to pause after May and start cutting rates in the fall before other central banks (Exhibit 2). The priced shortness of the Fed's holding period is a concern for the yen-carry trade, but our economists believe the Fed's rate cut will not come before March 2024. As the BoJ is unlikely to enter a rate hike cycle this year, yen-carry trade would enjoy elevated and rising carry.

Exhibit 1: Fed, ECB policy rates, USD/JPY, EUR/USD from 2004 to 2008
JPY remained weaker than USD even after the Fed ended rate hikes in June 2006



Source: BofA Global Research, Bloomberg

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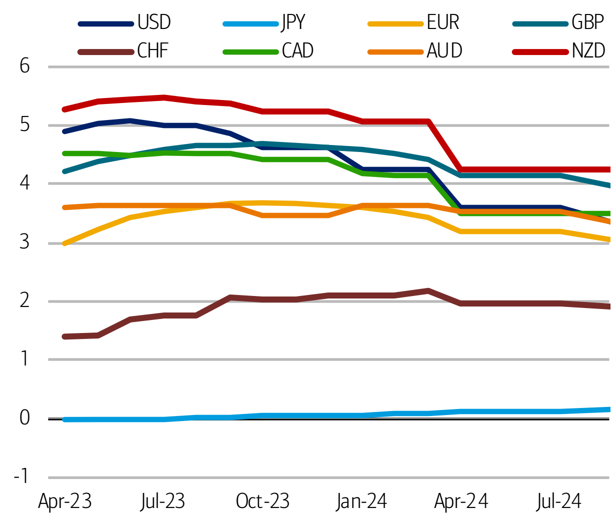
Exhibit 2: Forward 1m OIS
Fed priced to start cutting rates first among major central banks



Source: BofA Global Research, Bloomberg

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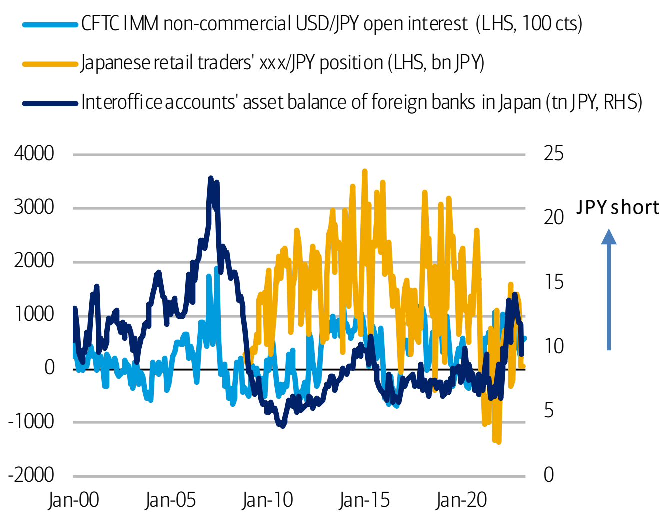
But BoJ's policy uncertainty has stood in the way

However, the market has stayed away from the yen-carry trade. Measures of onshore and offshore yen-carry trade balances show the market positioning is far from yen short (Exhibit 3). Our conversations with clients also suggest the market is at least neutral on JPY. Part of this is due to elevated financial stability risk in the US and Europe. But even before the risk dominated the market, the market had not been short yen.

We believe this is due to the BoJ's policy uncertainty given the leadership transition and strong consensus that YCC is unsustainable with the current parameters capping the 10yr JGB yield at 0.5%. Our clients have pointed to the BoJ as a key reason to be long JPY or to not implement their bearish yen view yet.

Exhibit 4 shows USD/JPY's volatility-adjusted carry, a key variable to consider when implementing a carry trade, is lower than in 2006 and 2019. With USD/JPY's 3m implied volatility (10.7) staying notably higher than EUR/USD volatility (7.7), the BoJ's policy on the front end and visibility for the future policy path would be crucial for the yen-carry trade.

Exhibit 3: Measures of yen-carry trade volume
Market positioning is far from yen-short



Source: BofA Global Research, Bloomberg, Haver
Retail traders' positions are against USD, EUR, GBP, AUD, CHF, CAD, NZD, ZAR

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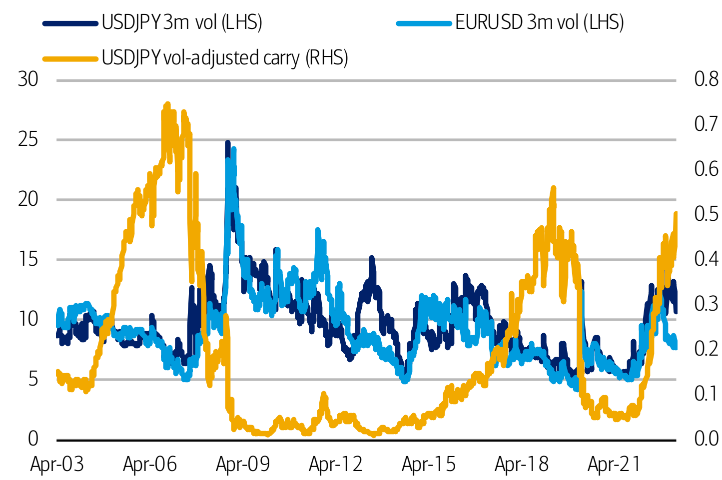
Exhibit 4: FX volatility and USD/JPY vol-adjusted carry*
USD/JPY's vol-adjusted carry contained by elevated JPY vol



Source: BofA Global Research, Bloomberg
*3m forward, 3m implied vol

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Market pricing – YCC tweaks mostly priced but April may be a surprise

How is the market priced for the BoJ's policy shift? In terms of the timing of the BoJ's policy shift, the FX market has somewhat reduced pricing for April and increased relative pricing for June/July after Governor Ueda's press conference on April 10 (Exhibit 5). JPY has accordingly weakened. The BoJ's policy change in the April MPM would be a surprise to the market to some extent.

However, Ueda has not committed anything for the April MPM and he said in his parliamentary hearing in February surprises at policy changes are at times inevitable as the central bank updates its economic and inflation outlook based on new information between MPMs. Vice governor Shinichi Uchida also noted it would be difficult to let the market price in changes to YCC in advance given the nature of YCC in his parliamentary hearing in March.

Our economists expect the BoJ to tweak YCC by the July MPM, with the June MPM being the base case but do not rule out changes at the April or July MPM (see: [BoJ review: Governor gone, challenges remain 10 March 2023]).

In terms of what policy changes are expected by the market, our conversations with clients suggest they are convinced that the BoJ would make changes to YCC in the near term but views are split on whether the BoJ would raise the 10yr ceiling from 0.5% to, for example, 1%, shorten the target maturity from 10yr to 5yr (or 2yr), or, to a lesser extent, remove YCC.

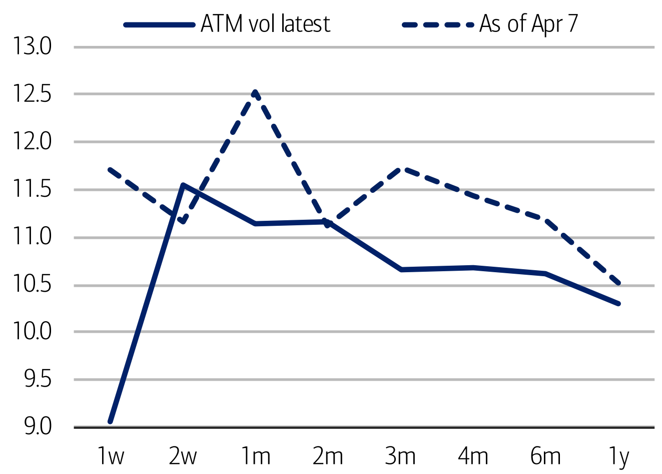
Swap spreads (OIS-JGB) have tightened across the curve lately, led by the 10yr (Exhibit 6). This likely reflects lower underlying JGB yields without YCC given lower US yields on financial stability concerns and a marginally later expected date (from April to June/July) of policy changes rather than reduced likelihood of the BoJ's policy change near-term.

Our estimate of the 10yr JGB yield without YCC is 0.7-1.0% (see: Liquid Insight: What if BoJ hikes YCC rate? 25 November 2022). The current 10yr swap rate of 0.67% seem to almost fully price in some form of YCC tweak as still elevated financial stability concerns in the US would likely leave JGB yields toward the lower end of the estimated range without YCC.

On the front end, the market pricing for rate hikes has been scaled back in recent weeks but the market still assigns residual chance of rate hikes in 2023 with 6m x 1m OIS trading 5bp above the 1-week OIS.

Exhibit 5: USD/JPY options vol term structure (latest vs April 7 - before Ueda's press conference)

FX market has somewhat priced out April and priced in July



Source: BofA Global Research

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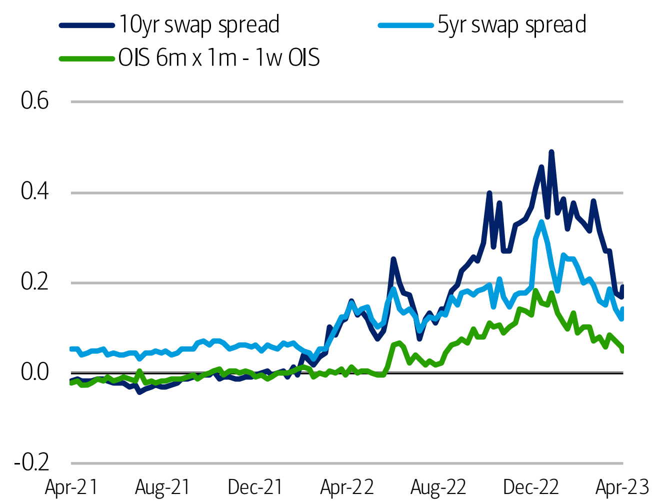
Exhibit 6: JPY 10yr, 5yr swap spread and 6m x 1m OIS – 1w OIS

Swap spreads have tightened lately on external risk and market expectations for rate hikes have also been reduced



Source: BofA Global Research, Bloomberg

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BoJ scenarios: front-end policy will be key for JPY

How would the BoJ's policy change impact JPY? We think the key is front-end policy and its visibility. A more dovish and more visible front-end rate path would be most bearish for the yen as it makes JPY a credible funding currency over the medium term.

We do not expect policy tweaks to YCC by the BoJ to have any material impact on JPY, as it has been almost fully expected by the market and the BoJ is still likely to control yield curve with JGB purchases even if it loosens or removes YCC, though to a lesser extent. The BoJ's YCC removal could be more positive for JPY, although we think dovish guidance on the front-end rate and commitment to flexible QE providing implicit support for JGBs would prevent JPY from continued appreciation. If the BoJ removes YCC and turns hawkish on the front end, signaling to enter a rate hike cycle in 2023, JPY should rally and the market may enter a buy-on-JPY's dip phase with the risk of USD/JPY falling below 120 in 2023.

In terms of the timing, a policy change in the April MPM could surprise the market and amplify the initial reaction, bringing JPY higher first. Chart of the day summarizes our expectations for market reactions to various BoJ scenarios at the April MPM meeting.

Risk is skewed to a weaker JPY medium-term

Governor Ueda's inaugural press conference on April 10 suggests the BoJ would be patiently dovish on the front end. While he said the recent development on the spring wage negotiation appears constructive and also hinted he would be more forward-looking in formulating policy, he also stated it is important to confirm the positive inflation trend to be entrenched.

Then in a separate occasion of speaking to the press on April 12, he pointed to the difference in inflation between Japan and the rest of the world and said that the BoJ should still be more attentive to downside risk in inflation.

These are consistent with our economists' view that the BoJ will wait until 2024 before removing NIRP and YCC (see: BoJ review: Governor gone, challenges remain 10 March 2023). While it would be harder for the market to completely price out rate hikes on the front end, the BoJ can be more credibly dovish on the front end than on YCC. We continue to expect USD/JPY to rise to 138 despite our expectations for a generally weaker USD, implying higher cross-yen (see World at a Glance 30 March 2023).

Implications: carry to drive JPY weaker; sell JPY's rally if YCC tweaked in Apr

We think the BoJ's policy uncertainty has kept the market away from the yen-carry trade despite rising carry. However, the BoJ is unlikely to turn hawkish on the front-end while YCC tweaks are well anticipated/priced. The BoJ's April move as opposed to June or July could be a surprise to the market in terms of the timing and could lead to a JPY rally. We think that rally should be sold as long as the BoJ accompanies YCC tweaks with dovish guidance on the front end. As the policy cycle implies a weaker USD, we like cross-yen pairs and especially AUD/JPY with our constructive stance on AUD (see: Liquid Insight: AUD – external green shoots 23 March 2023).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the IMF, **Global FX Weekly**, 14 Apr 2023
- Finger on the pause button**, Global Rates Weekly**, 14 Apr 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

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