Paper Proposal:

Japanese Institutional Investors & Bond Markets - Stuck Between a Rock & a Hard Place

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Introduction

Over the last two decades, Japanese investors have been prolific buyers in overseas markets. At their peak in early 2020, Yen-based investors held an estimated $3 trillion in overseas bonds (Setser and Etra, 2023). Indeed, as a proxy for international exposure amongst Japanese institutional investors, the Japanese Government Investment Pension Fund (GIPF) has a 25% exposure to foreign-denominated bonds in their portfolio (as of March 31, 2023). Much of this foreign investment exposure, particularly amongst larger pension clients is conducted on a currency-hedged basis in order to reduce the inherent volatility associated with currency markets (Setser and Etra, 2023). However, the evolving global monetary policy backdrop has created significant disruption within both foreign and domestic-bond markets as Japanese investors find themselves caught between a rock and a hard place.

Monetary Policy Backdrop

The U.S Federal Reserve (the Fed) have embarked on their most aggressive rate hiking cycle since the 1970s with the effective Fed Funds Rate rising by 525bps since June 2021. The Fed's hiking cycle has not been conducted in isolation; between them the 15 developed market central banks have conducted 141 rates hikes since June 2021. Conversely, the Bank of Japan (BoJ) have sought to benefit from this period of global monetary tightening to artificially import inflation overseas via the trade channel in order to end the country's three-decade long deflationary spiral. As of December 2023, the BoJ are the only developed market central bank to have refrained from adjusting interest rate policy in response to higher inflation. Furthermore, they are the sole central bank to continue to be utilizing negative interest rate policy.

While the effectiveness of the BoJ's policy in igniting inflationary spirits is outside the scope of this paper, their impact on financial markets has been significant. Most notably, the dramatic divergence in short-term interest rates has seen currency hedging costs increase materially. As of June 2021, the effective cost for a Japanese investor to hedge their currency exposure for one year was 15 basis points, as of December 10, 2023 it was the equivalent of 555bps.[1] As demonstrated in chart one, such dramatic hedging costs fundamentally change the attractiveness of overseas government bonds and pose a significant conundrum to Japanese investors and global policymakers alike.

Paper Summary

Exorbitant hedging costs have the potential to trigger a prolonged portfolio rotation amongst Japanese private investors, potentially having disruptive effects on the functionality of domestic bond markets and increasing fiscal challenges in foreign markets, particularly U.S Treasuries. This paper will look to explore these movements and identify the risks for both policymakers and financial market practitioners alike.

[1] Calculated as the yield differential between 3-month U.S Treasury Bills and 3-month Japanese Government Bond Yields.

Appendix

Currency hedge-adjusted yield of the U.S 10-year treasury for a Yen-based investor

Weekly

Source: Thomson Reuters Eikon. Calculations are the U.S 10-year yield minus the implied hedging costs which are the yield differential between 3-month U.S Treasury Bills and 3-month Japanese Government Bond.