Daiwa Securities

Daiwa's View

USD/JPY hedging costs at 6% level on the horizon

- USD/JPY basis continuing to remain less negative
- Fed's hawkish stance will tighten financial conditions
- USD/JPY basis is likely to widen again

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USD/JPY hedging costs at 6% level on the horizon

◆ Basis

USD/JPY basis continuing to remain less negative

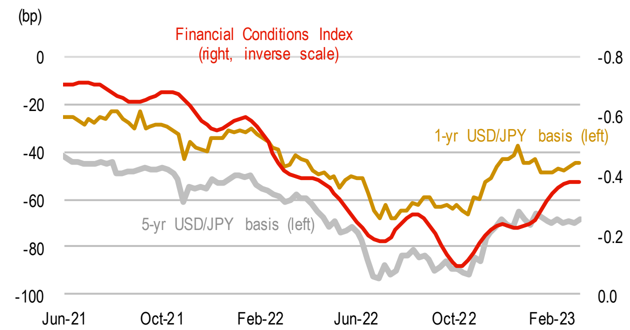
At the end of 2022, the USD/JPY basis became less negative. Since the beginning of 2023, the basis has remained roughly flat. This is in line with the loosening of financial conditions in the US **(Chart 1).** The EUR/USD basis and the GBP/USD basis rose more than the USD/JPY basis (Chart 2), which appears to be reflecting the difference in monetary policy stances at the BOJ, the ECB, and the BOE.

The fact that US financial conditions are accommodative is consistent with the VIX and CP spreads at US companies becoming stable at low levels (charts 3 and 4 on next page). This reflects the market's optimistic outlook for the global economy since the beginning of 2023 due to the reopening of the Chinese economy and stronger-than-expected US economic indicators. These conditions may continue for the time being. The USD/JPY rate has also shifted towards an uptrend because the Fed has become more hawkish once again given the continued solid performance of the US economy (refer to our 3 March report *Our near-term view of the USD/JPY*).

Fed's hawkish stance will tighten financial conditions

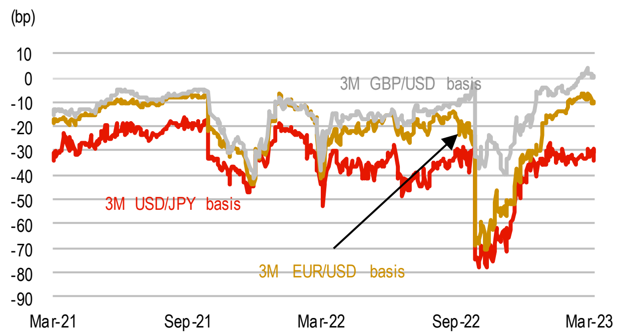
Last year, we saw a rise in the USD/JPY rate at the same time as widening of the negative USD/JPY basis. This was caused by the spread of a pessimistic economic outlook following the Fed's rapid monetary tightening. Now, however, we are seeing dollar appreciation together with an optimistic economic outlook, and the forex rate and the basis are moving in opposite directions (Chart 5 on next page). However, global monetary tightening since last year should push down the real economy, after a time lag. In addition, as indicated by Fed Chair Jerome Powell touching on the possibility of once more increasing the pace of rate hikes in his congressional testimony, the current loosening of financial conditions is temporary. Financial conditions are expected to gradually tighten going forward.

Chart 1: Financial Conditions Index, USD/JPY Basis



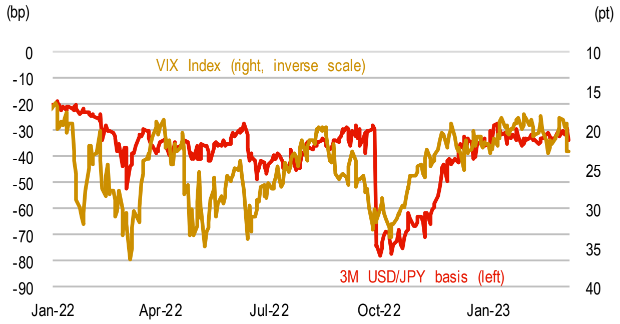
Source: Chicago Fed, Bloomberg; compiled by Daiwa Securities.

Chart 2: 3-month Basis vs. USD



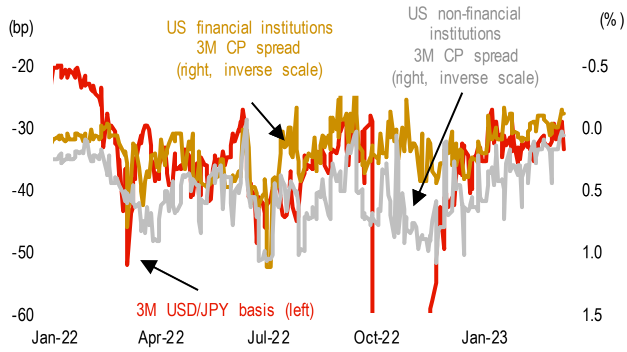
Source: Bloomberg; compiled by Daiwa Securities.

Chart 3: VIX Index, 3-month USD/JPY Basis



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: US Corporate CP Spreads, 3-month USD/JPY Basis



Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY basis is likely to widen again

Relative changes in the volume of the currency supply are thought to have an impact on the USD/JPY basis. In fact, it appears that the difference in y/y changes in the balance sheets of the BOJ and the Fed has been moderately correlated with long-term trends in the basis (Chart 6). While the Fed is continuing to reduce its balance sheet, in addition to implementing rate hikes, the BOJ is likely to keep its accommodative stance despite strong expectations for the removal of the yield curve control policy. Accordingly, from the standpoint of central banks' balance sheets, the gap between financial conditions in Japan and the US is also expected to gradually widen, and the negative USD/JPY basis to widen.

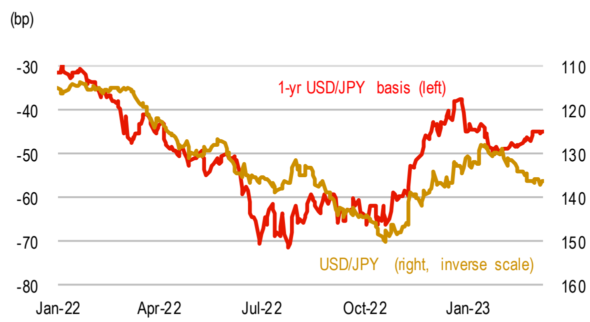
Moreover, even if the financial market remains optimistic, the negative basis may not shrink beyond its current level. This is because the selling of foreign bonds by Japanese investors, which appears to have contributed to tightening of the negative basis in terms of supply/demand, may have come to an end. Foreign bond positions at banks and life insurers appear to be at their lowest levels since the introduction of negative interest rates by the BOJ in 2016 (Chart 7 on next page). The amount of foreign bonds sold by these two groups is on a downtrend. Although the current situation is not suitable for aggressively accumulating foreign bonds, there will likely be reduced pressure tightening the negative basis, assuming that movements to reduce positions have played out.

◆ USD/JPY hedging costs

USD/JPY hedging costs are expected to rise further, with hedging costs at the 6% level on the horizon

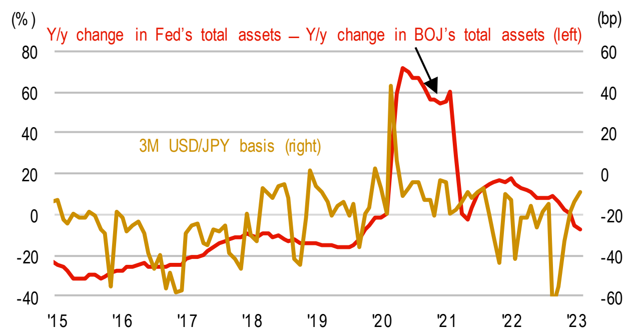
The Fed has adopted the stance of raising the policy interest rate further and maintaining restrictive levels for the time being. Accordingly, with the Japan/US short-term interest rate differential widening, USD/JPY hedging costs are expected to rise further (Chart 8 on next page), with hedging costs at the 6% level now on the horizon. Moreover, as the Fed has become more hawkish reflecting the recent solid economic indicators in the US, there are upside risks with hedging cost forecast levels. Therefore, Japanese bonds are likely to remain relatively attractive for Japanese investors.

Chart 5: USD/JPY Rate, USD/JPY Basis



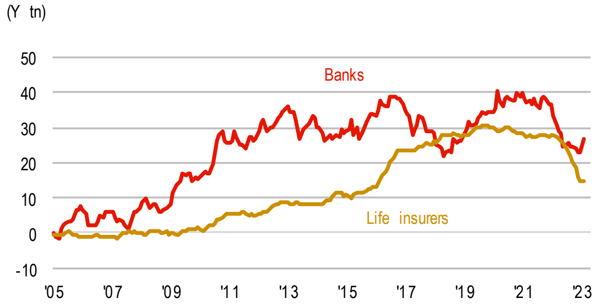
Source: Bloomberg; compiled by Daiwa Securities.

Chart 6: Change in Central Bank Balance Sheets, USD/JPY Basis



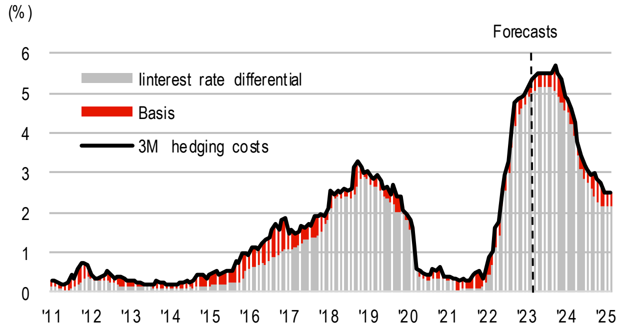
Source: Fed, BOJ, Bloomberg; compiled by Daiwa Securities.

Chart 7: Cumulative Net Buying of Foreign Bonds by Banks and Life Insurers



Source: MOF; compiled by Daiwa Securities.
Note: Net buying amount from Jan 2005.

Chart 8: Forecasts for 3M Hedging Costs



Source: Bloomberg; compiled by Daiwa Securities.

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- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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