BNY

iFlow

MACRO MORNING BRIEFING

August 9, 2024

The Yen and the Long Carry Unwind

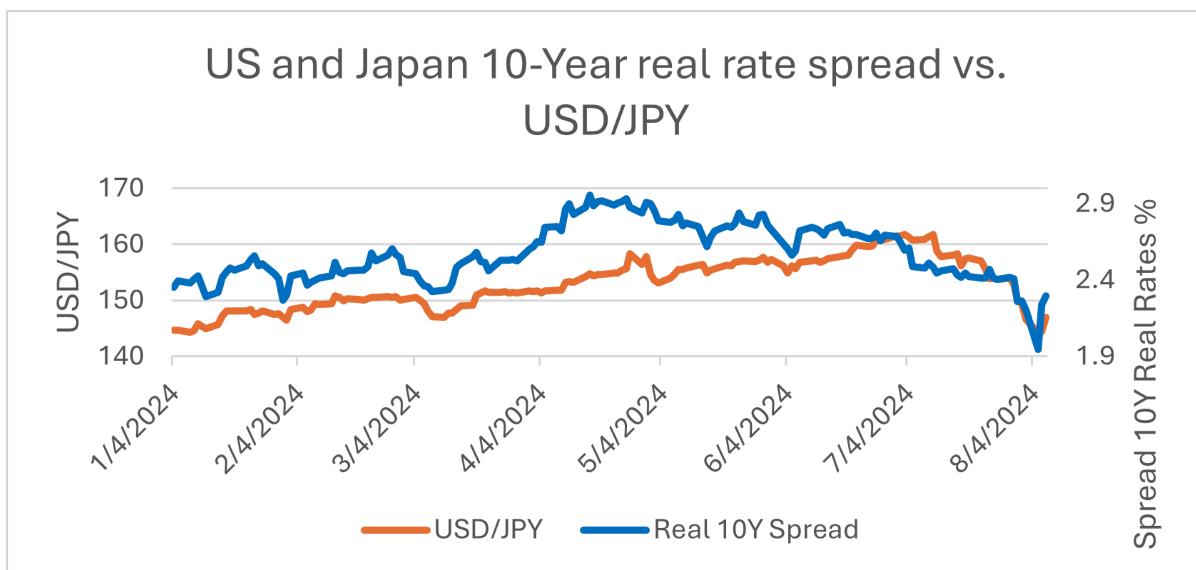
The relationship of USD/JPY to global risk hadn't been important to the markets until the Bank of Japan rate hike last week. The shock of FX as a driver for stocks and bonds makes asset allocation more complicated and adds to the VAR shock risks across assets. Even as the JPY remains undervalued, the move from 162 to 142 has changed the urgency function of fixing the mispricing problem for the Japanese. Further, the unwind of the Japan stock market shocked authorities and led the Bank of Japan's Uchida to play down the chance of another quick rate hike. Financial stability has returned as the third mandate for central bankers – with the US not immune – as markets this week rushed to price in over 100bps of easing from the FOMC in the next three meetings. The role of rate spreads between Japan and the US and other countries clearly matters to FX markets but the correlation with real rates frayed in June and July as politics began to matter more than monetary policy, starting with the EU elections, continuing to the French and UK elections, and also the Trump-Biden debate. How this factor centrality battle plays out will set the tone for 3Q returns as investors see models break and correlations flip. From our iFlow data we can see further risks into the end of August.

- We see our holdings in JPY as still significantly short at over two standard deviations from normal.
- We see US rate expectations as overdone – our data shows selling of US and EU short-term bills out to 2Y notes against buying of 5-7Y notes. This is counter to the current pricing accounting for expectations of emergency rate cuts. Further, it adds to the urgency for Japanese investors to hedge foreign exposures.

- The shift from FX to equity market risks by the BOJ highlights the role of foreign flows into Japan and the hedging of those risks, just as much as the narrowing of rate spreads should increase a home bias in Japan.
- The role of carry trades and risk will continue to be a key driver for understanding flows despite the recent reversals. Given the current environment, the unwinding of JPY will take many months to get to fair value again and that will make the US election and the US business and credit cycles key, along with Japan and its own economic growth.

When you look at US real rates against Japan you can see the correlation to USD/JPY works well, until June 2024. However, the breakdown of this relationship was short-lived as a result of Japanese MOF intervention, the change in US presidential polls and the monetary policy expectations around the FOMC following weaker US jobs and other data. The BOJ rate hike added to the drop in real rate spreads and restarted the correlation.

Exhibit #1: Real Rates Drive FX

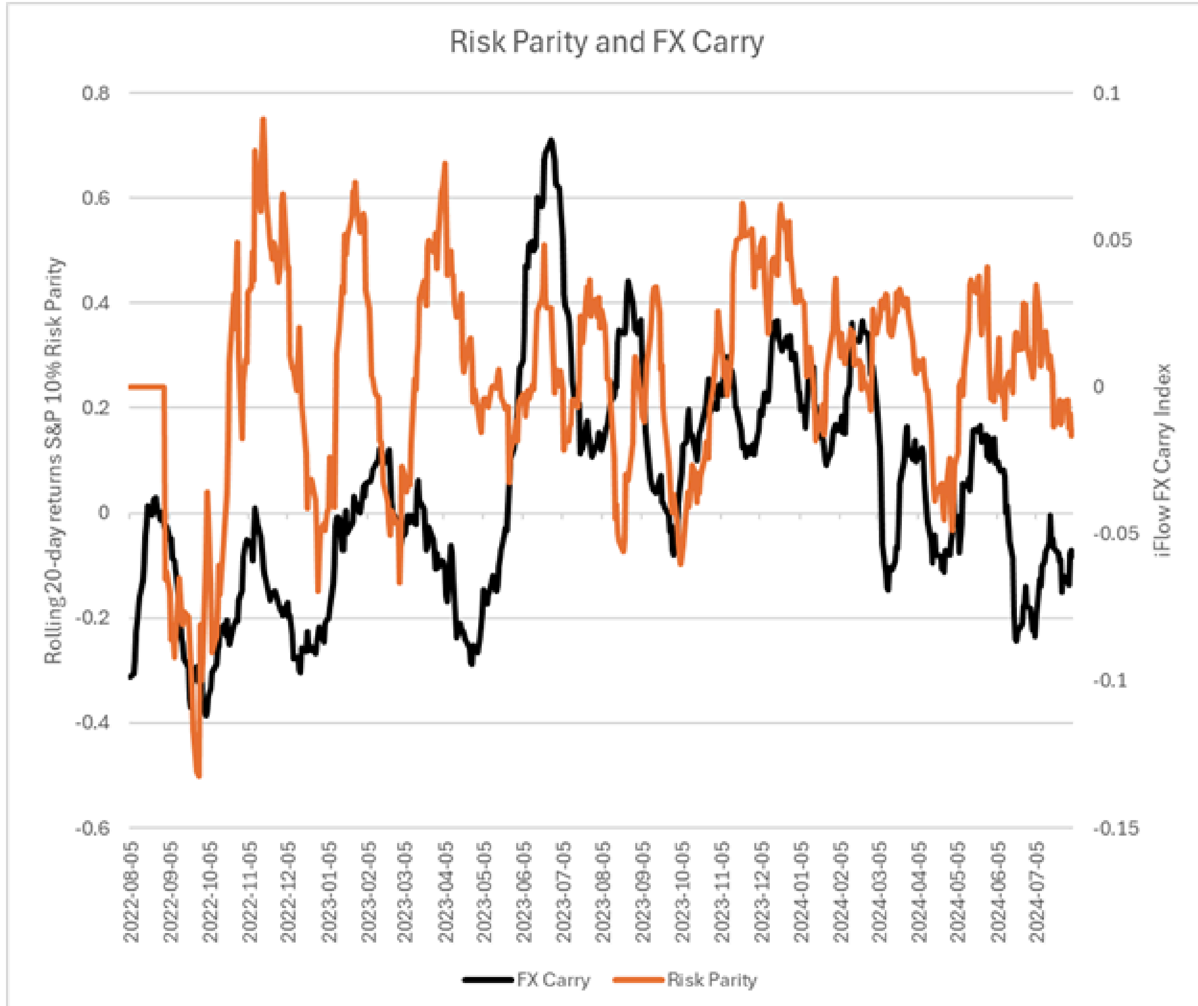


Source: Bloomberg, BNY

The FX carry index from iFlow has been in neutral zone for 32 days. It is in the 42% percentile of the 20-year history. The actual level of the index is -0.035 – slightly negative, still where it has been for almost eight weeks. Traditionally, carry trades work best when the index is not in extremes, but volatility plays a significant role in how carry trades work. VAR shocks blow up many such relative value plays to capture rate spreads. The recent increases in VIX and other asset indices for option volatility shut down positions, forced margin calls and led to the unwinding of carry trades. The correlation of risk parity programs to the iFlow Carry index is positive and

has been for months and over a decade holds slightly positive. Risk Parity captures the current volatility shock across markets and the correlation flips – at its heart, the quantitative trading program relies on monetary policy to preserve financial market stability. The BOJ words this week look likely to be evaluated again later.

Exhibit #2: Risk Parity and FX Carry Are Related



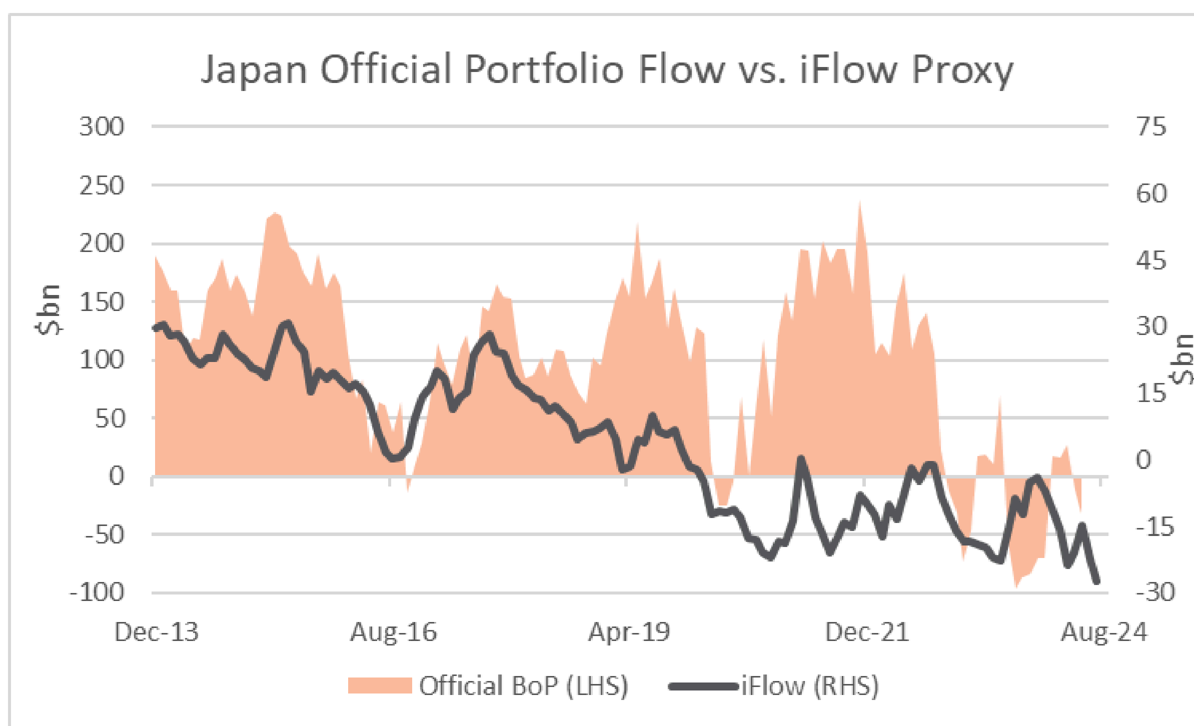
Source: iFlow, Bloomberg, BNY

Comparing JPY moves to S&P 500 volatility doesn't usually work, but the last week has brought a new reading to the lessons of 2007 and the JPY carry trade unwind then. Looking at the VIX is useful as well. Since its inception in 1990, the VIX daily average close is 19.5%. A VIX of 35.3% is two standard deviations above the mean, while 43.2% is three standard deviations above average. The VIX briefly touched 62 on Monday – a level it has previously reached only 0.8% of the time, during the worst events of the last 30 years. Looking at the JPY, the drop from 162 to 142 happened in 20 days – from July 10 to August 5 – which drove 1-month JPY volatility from 8.5% to 16% – back to 2013 highs. The sharp rise in volatility in equities and FX adds to the unwinding of "carry" trades everywhere as risk circuit breakers get triggered. The

moves in the last week usually require more than just a "bounce" back to average to unwind. Expect the pain for JPY shorts to remain in play for the weeks, if not months ahead.

For foreign investors into Japan, the rising volatility in JPY and the uncertainty of monetary and fiscal policy matters. The iFlow data shows that unlike the official balance of payments flows, the flow out of Japan in both equities and bonds has been steady from June, linked in part to JPY undervaluation concerns. The break of a weak JPY in helping exporters in Japanese shares is one factor that stands out. The noise in our data against the official set highlights the risks of post-pandemic data and underscores the role of home bias. The role of Japanese banks and asset managers in the JPY flows is clearly more important than the foreign hedging components. The recent flows in Japan from iFlow are worth watching, as our data shows some tentative buying back of equities but countered by selling in bonds.

Exhibit #3: Japan Balance of Payments vs. iFlow

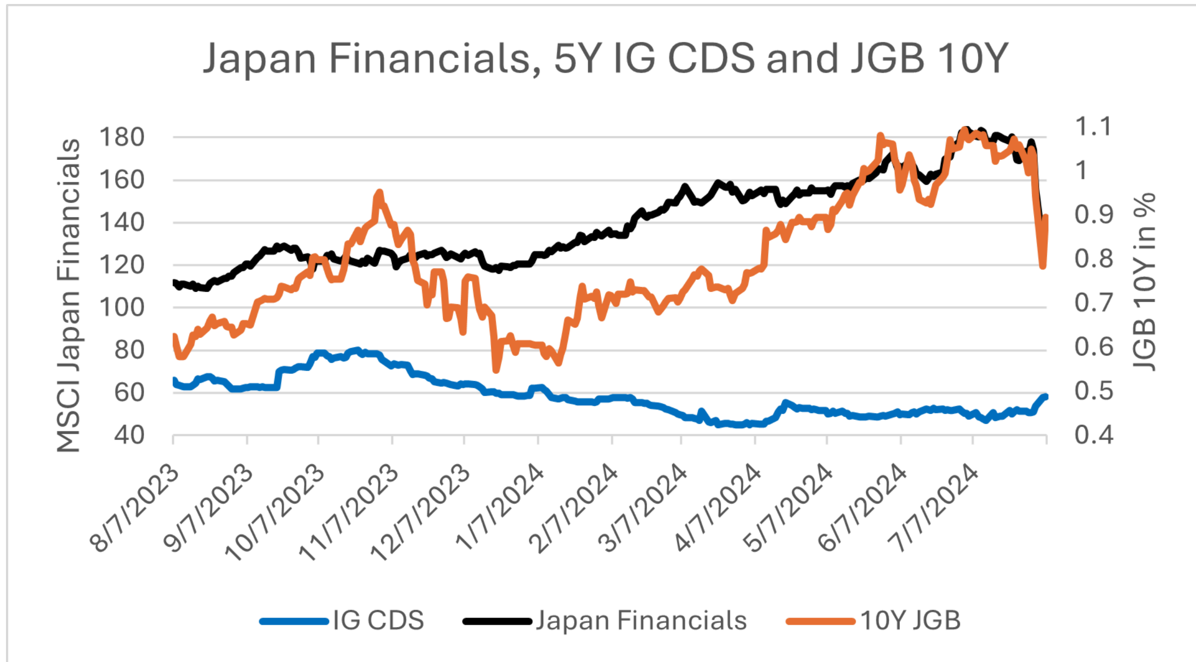


Source iFlow, BOJ, BNY

T he correlation of Japanese financials to JGB yields is significant – around 0.38 over the last 2-years – making it clear that the recent drop back in yields hurts many of banks. The link between Japanese and US yields is part of the story, the reversal of the JPY the rest. The link between regional banks needing dollars against global megabanks holding long USD positions the simple explanation for some of the price action in FX markets. The surprise from the rate hike by the BOJ is the drop in JGB

yields and the rise in Investment Grade Credit Default Swaps. The push for rate normalization in Japan has been a significant factor in driving the carry trade to unwind in JPY, but that is not something our data will capture given that we see mostly offshore flows. In fact, the structure of the Japanese asset flows domestically leaves most of the data with the BOJ weekly reports. The takeaway from the price action this week suggests that our bond selling flows were countered by significant domestic bond buying. The implications for JPY and stability are not encouraging.

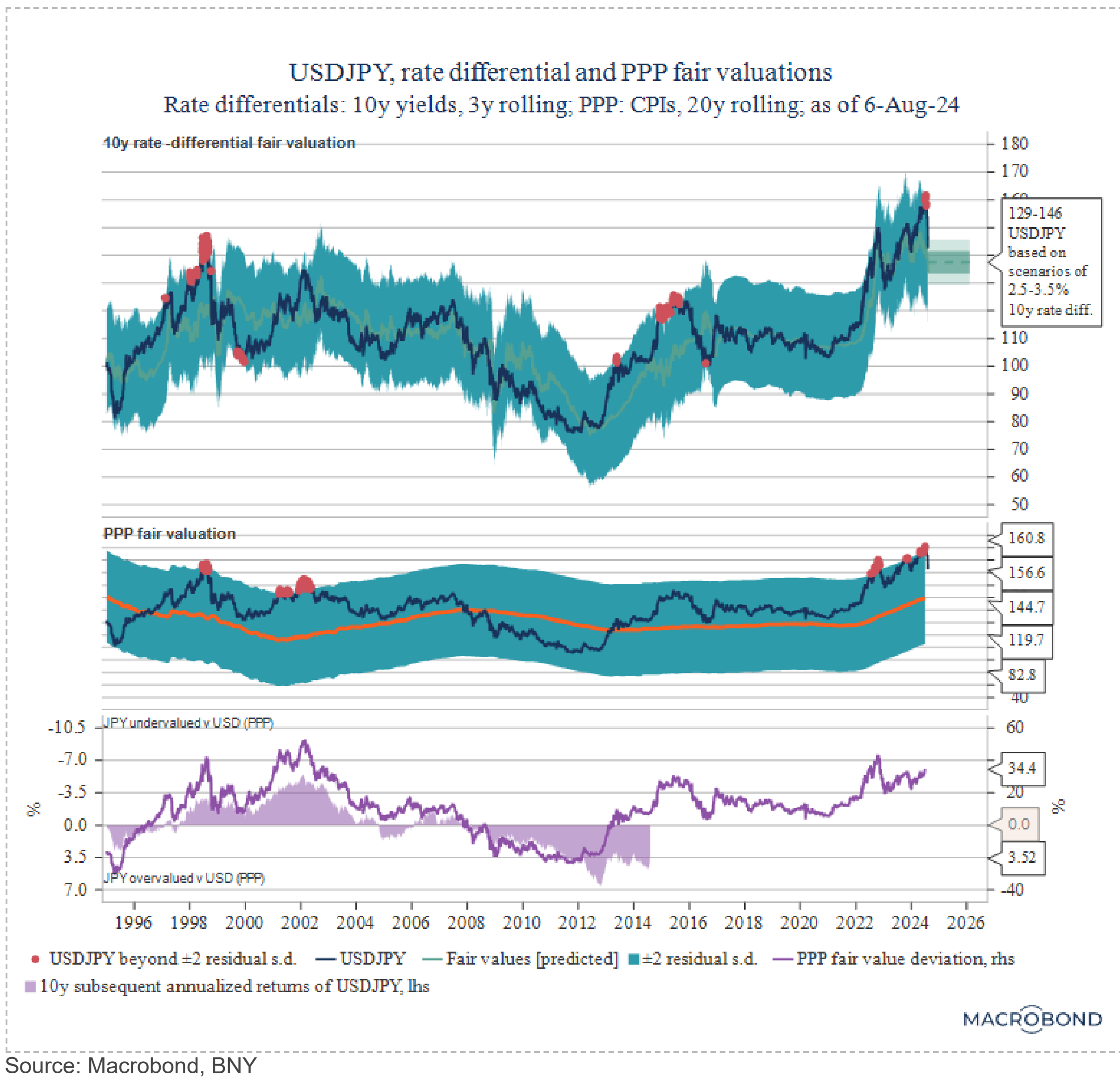
Exhibit #4: Japan Financials and JGBs Are Linked



Source: Bloomberg, BNY

Building out a fair value model for JPY was not important to investors at the start of 2024, but increasingly the search for a bottom to USD/JPY makes such a key for trading risk. We showed that 10-year rate spreads are important, but that could be broken out into nominal rates and a combination of PPI and CPI spreads. The long-term history shows that fair value now builds in clear assumptions about US-Japan terminal rates and inflation – something that since the pandemic look increasingly unstable. The risk of thinking that 130-150 JPY is the new target range for the BOJ could be wrong as economic data diverges in the months ahead. The Macrobond analysis of these models confirms that JPY even at 147 is 30% undervalued – suggesting that over time 100 JPY will be more likely. At the start of 2024 we warned that JPY bias for risk was 100, not 200, and in 1Q saw 160 as a temporary turning point. The question for markets in the weeks ahead is about the path to getting to fair value.

Exhibit #5: Yen Fair Value Models



Source: Macrobond, BNY

Bottom Line: The carry trade unwind has further to go as we can see from the G10 FX holdings and flows chart in Exhibit #6. The implications of this are clear – further risk reductions are going to follow – and August will continue to be a highly volatile month. The JPY, CHF and SEK are the main focus for safe-haven flows.

Exhibit #6: JPY Holdings Remain Significantly Short

G10

Holdings: overheld (top), underheld (bottom); axis values 3, 2, 1, 0, −1, −2

Flow: outflow (left), inflow (right); axis values −1, 0, 1

CAD, DKK, GBP, EUR, NOK, CHF, SEK, NZD, AUD, JPY

20d Flows, Holdings, and Profitability

Profitability

-10% 0 +10%

Clouds: distributions over trailing 1,000 days

Sources: Bank of New York Mellon, WM/Refinitiv

Data as of 2024-08-06

Source: iFlow, BNY

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

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