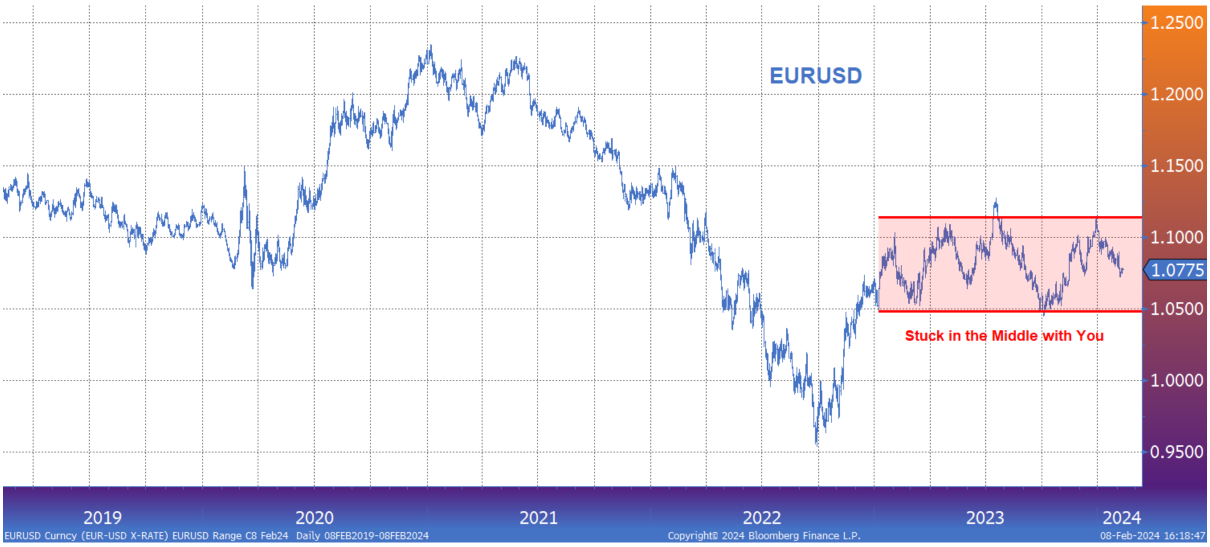
Turning Japanese

In December, we published an FX Special Focus piece which served the double purpose of examining the principal drivers of EURUSD valuation and explaining how MI2 prepare the ground for strategic positioning and hedging opportunities in Foreign Exchange.

EURUSD is the biggest component of most Trade Weighted USD Indices (like DXY). In terms of long-term opportunities, EURUSD remains in a broader range and in so doing has continued to validate our considered observation and conclusion at the time.



In this short note, we want to run our screen across Japan. There are both political and monetary changes afoot which are worth examining from a longer-term perspective, although (spoiler alert) this will take time to work through.

Highlights:

- JPY strength into year end was sharp but of a lesser order of magnitude to past episodes.
- Low growth, low inflation, low inflation expectations has seen the Japanese economy disappoint for decades.
- Demographics continue to challenge potential growth.
- Japanese Equities have chronically underperformed developed market peers since the bubble burst in 1989.
- Recent Nikkei strength has been undermined by JPY weakness for international investors, but positive developments continue behind the scenes.
- Japanese debt to GDP has grown to epic proportions. BoJ's YCC policy (Yield Curve Control), which has helped contain JGB yields in the recent past, is being phased out. Debt service costs are low but face the risk of rising sharply as yields rise.
- Carry has been a tailwind to JPY weakness. Forward interest rate differentials (especially vs USD) have started to narrow. Monetary policy is under review with Governor Ueda taking the reins of BoJ.
- Sentiment, positioning and technical analysis suggests some patience will be required.
- Room for significant disruption remains. Remain vigilant! Japan will reward your focus in 2024.

Of Escalators and Lift-shafts

In our introductory research note released in December, we noted how JPY as a funding currency had generated both carry and capital gains for strategic short positions. Given that the carry differentials are well known, the market had steadily increased its short JPY exposure leaving it vulnerable to sharp and sudden reversals of fortune. This we refer to as the "up the escalator, down the lift-shaft" effect. There have been plenty of examples in the past where the yen has suddenly appreciated, causing surprise and distress. While we engaged in USDJPY downside in our C8 portfolio to some modest degree, the episode in December was more muted than usual. Nevertheless, it challenged some leveraged JPY short positions into year end with a 7.5% JPY rally, about half of its 2023 spot return. That said, once carry had been added, the net drawdown was of less significance. For context, the Oct 2022 to Jan 2023 "lift-shaft" episode was just over 16% and roughly half of the spot gains from Jan 2021 to Oct 2022.

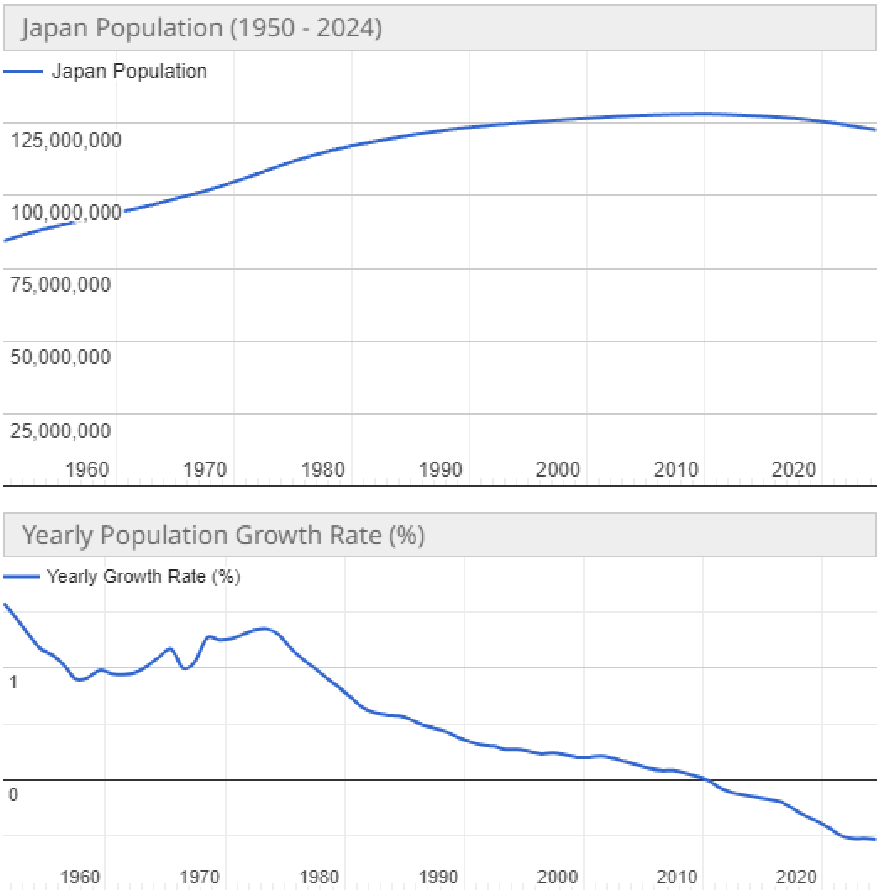
"Harvesting" carry is a popular trading strategy across all asset classes. Volatility selling is another well-trodden example. Often, option selling strategies double dip by selling volatility on assets or currencies where carry characteristics pertain. This is something we try to pick up in our analysis. Implied volatility and risk-reversal pricing (which you will find below) can throw some light on this phenomenon.

The rest of this piece will consist of a series of long-term charts for historical context and short-term charts for market set-up. We will return with specific long-term trading recommendations when we perceive the opportunity set as being ripe for action. Understanding our process will help develop a degree of confidence in our approach which in turn may contribute to the effectiveness of your own decisions.

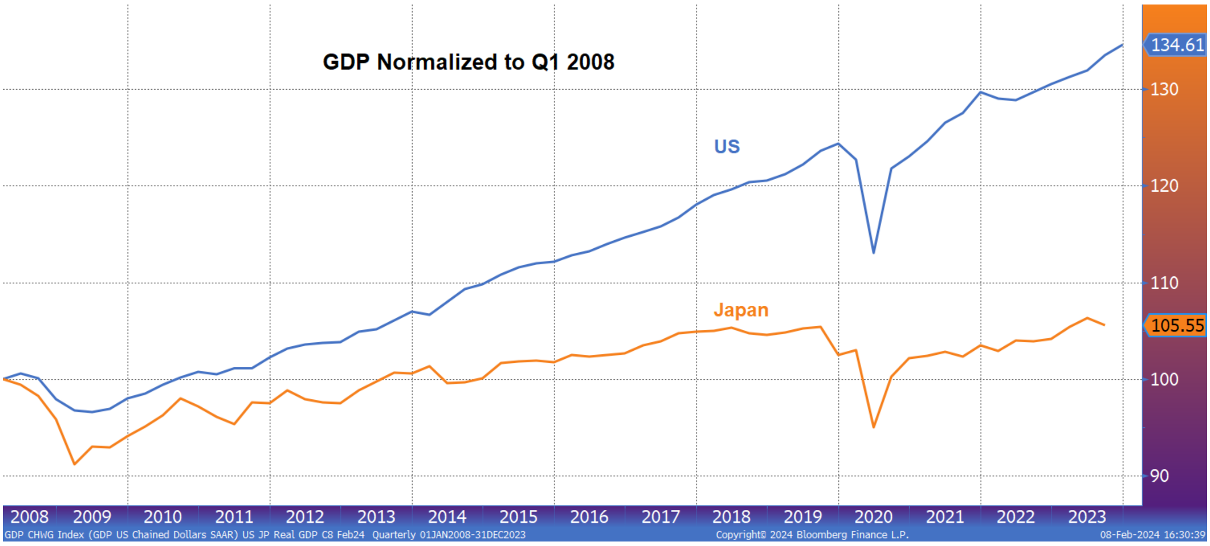
Rehearsing the Past: Long term Macro Factors

For years, Japanese GDP in real and nominal terms has been disappointing. Much of the blame is traditionally laid at the door of Japan's more advanced demographic cycle. Population growth turned negative in 2010. The current population of ~123 million is aging rapidly, the work force is shrinking, which in turn reduces potential growth. Consumption patterns are changing accordingly.

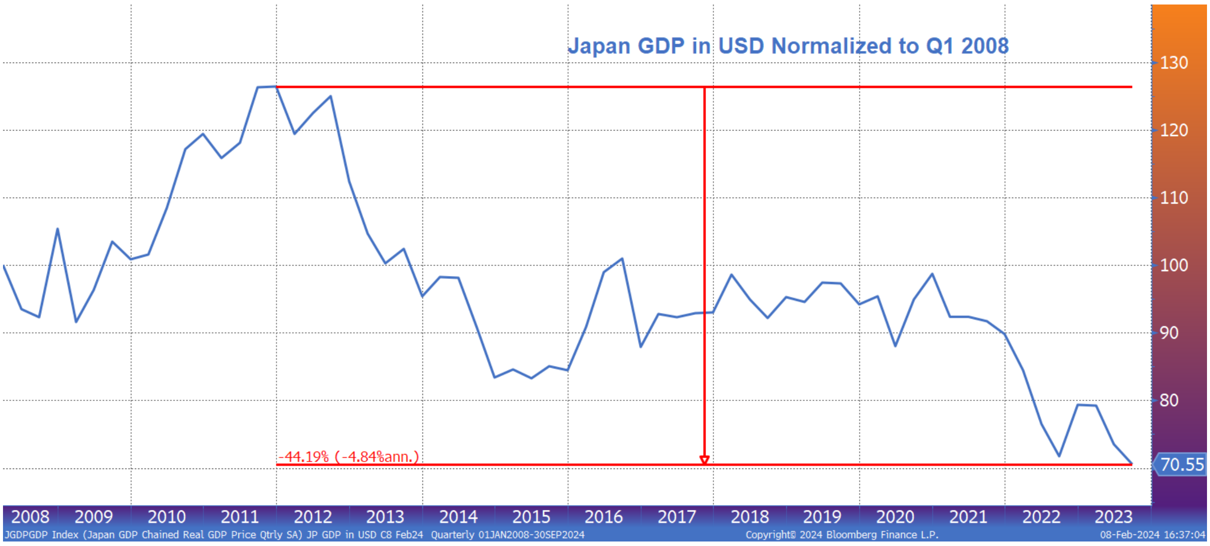
[Japan Population (2024) - Worldometer (worldometers.info)]



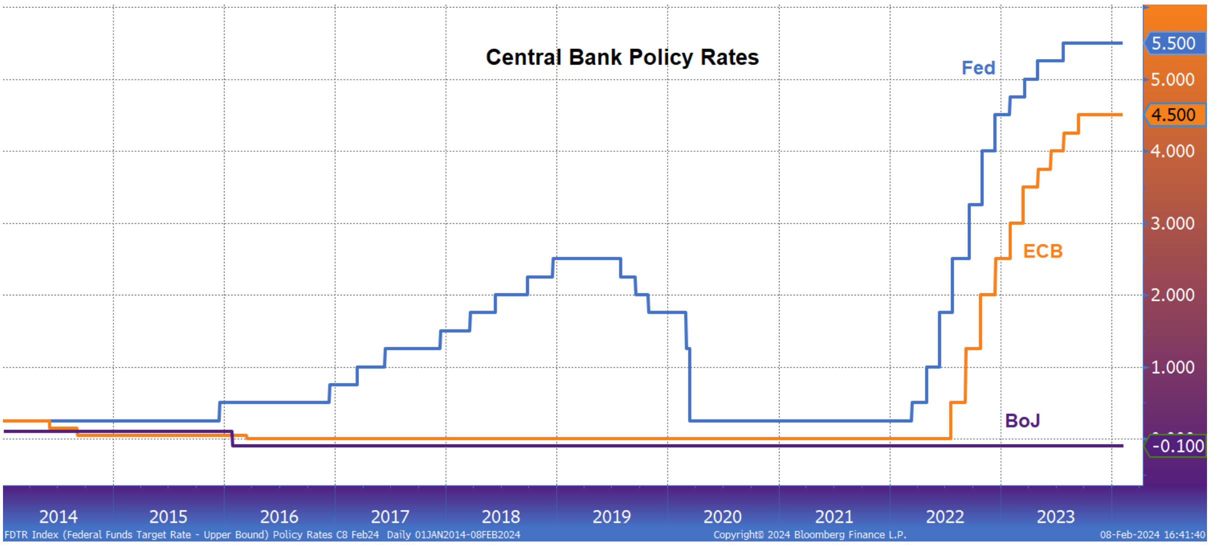
In domestic terms, the diminished potential growth trajectory and associated low growth outcomes have seen Japan lag other more dynamic economies, most obviously the G7 outperformer, the USA.



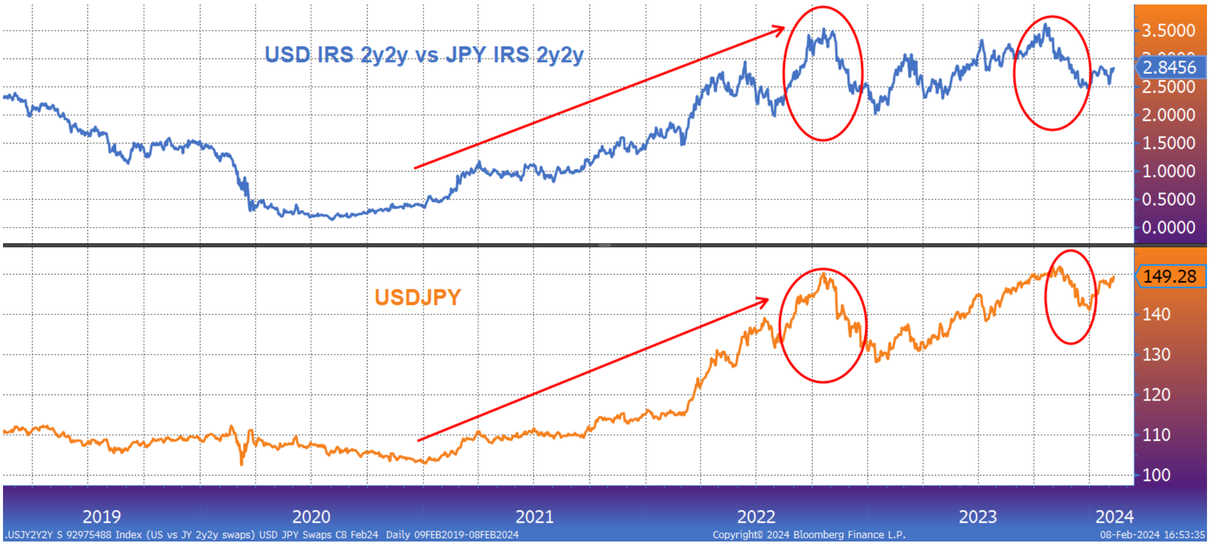
Worse still, looked at in USDs, the weakening of the yen has left Japanese GDP a pale shadow of its peak in 2012.



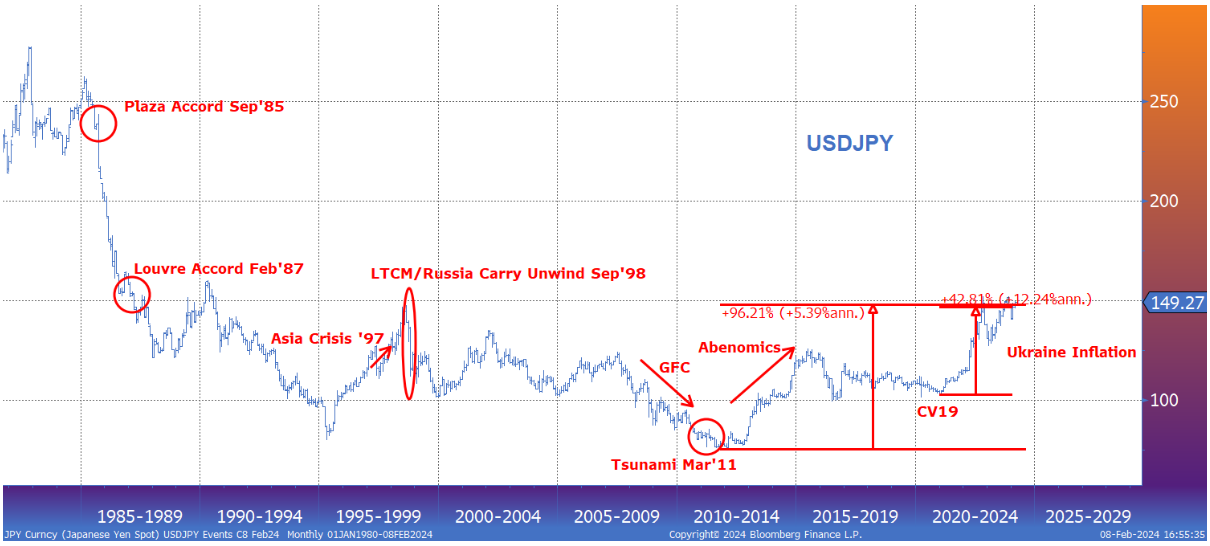
The persistently low growth trajectory and both low inflation and low inflation expectations has been reflected in the BoJ's reluctance to follow the rate tightening cycle of the other developed market Central Banks. Indeed, NIRP (Negative Interest Rate Policy) and YCC are only recently under review since Governor Ueda took the reins of the BoJ in April last year.



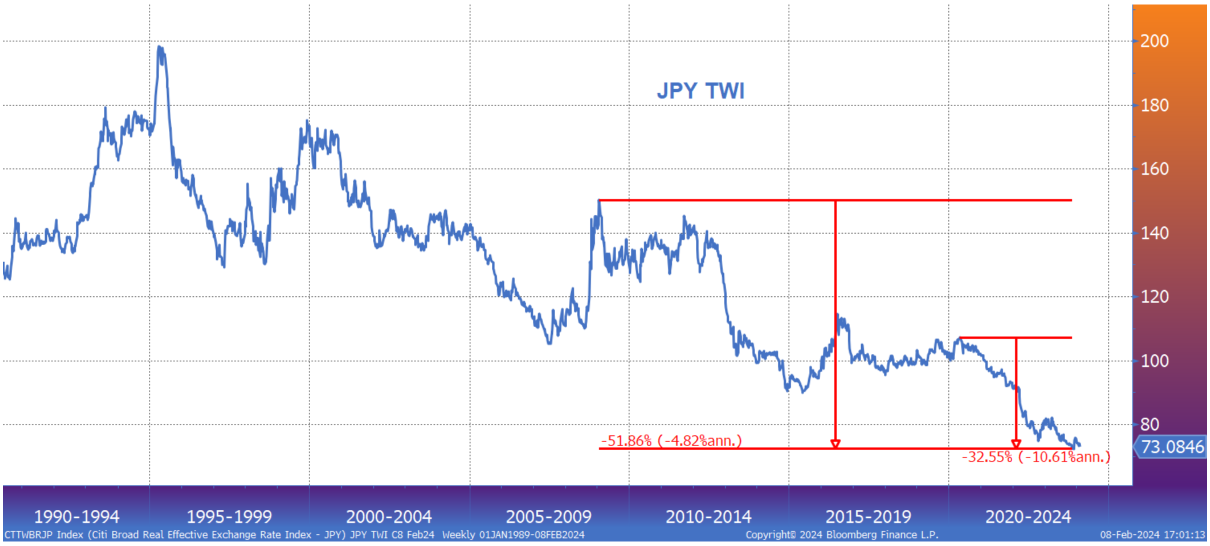
That said, as expectations of aggressive Fed easing have been priced into the front end of the market and talk of the end of NIRP has picked up, 2-year interest rate differentials have narrowed about 100 bpts. This narrowing was a major contributory factor in the USDJPY sell-off at the end of last year. The behaviour of the spread will be a key determinant of next steps in engaging with USDJPY.



Below we chart the fortunes of USDJPY over the last 40 years with some key events highlighted. The scale of moves has been substantial and remains a significant risk factor for corporates and investors alike.



Further, on a Real Effective Trade Weighted basis and charted back to1989, JPY is over 30% below its Covid highs and 50% below its 2009 GFC highs.

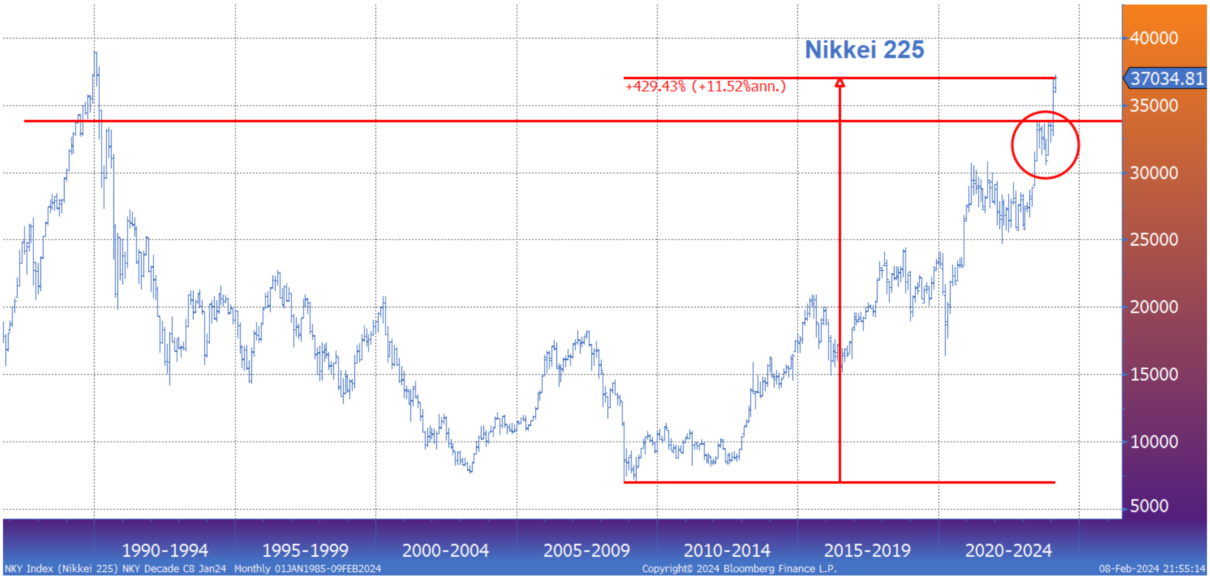


Currency effects need to be a major component of all asset allocation decisions with an effective hedging strategy in place.

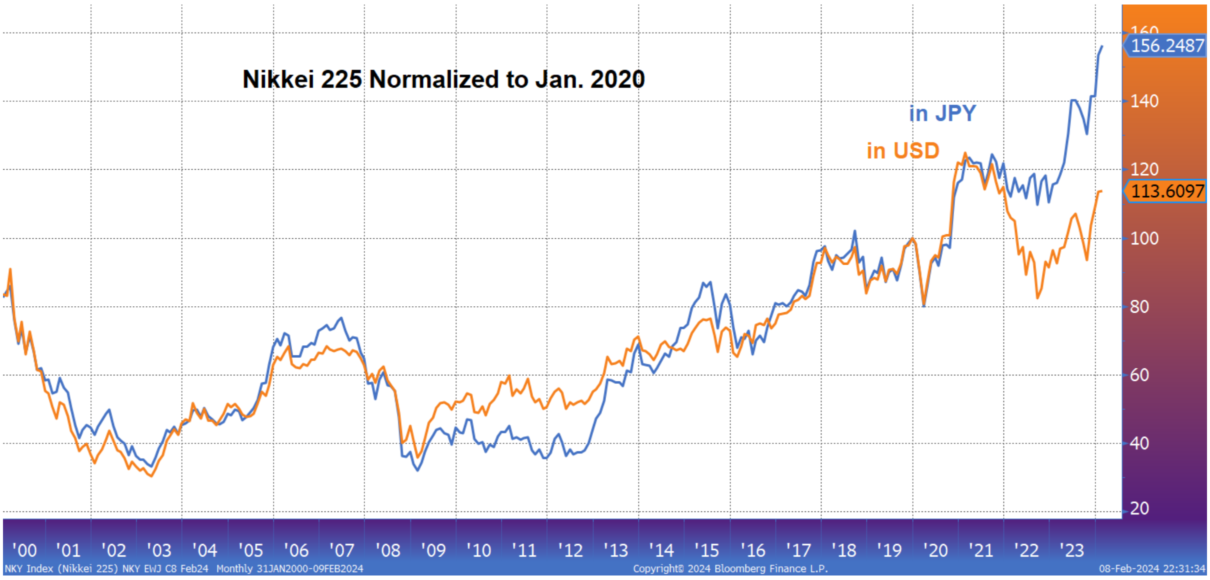
Market Pricing

Equities

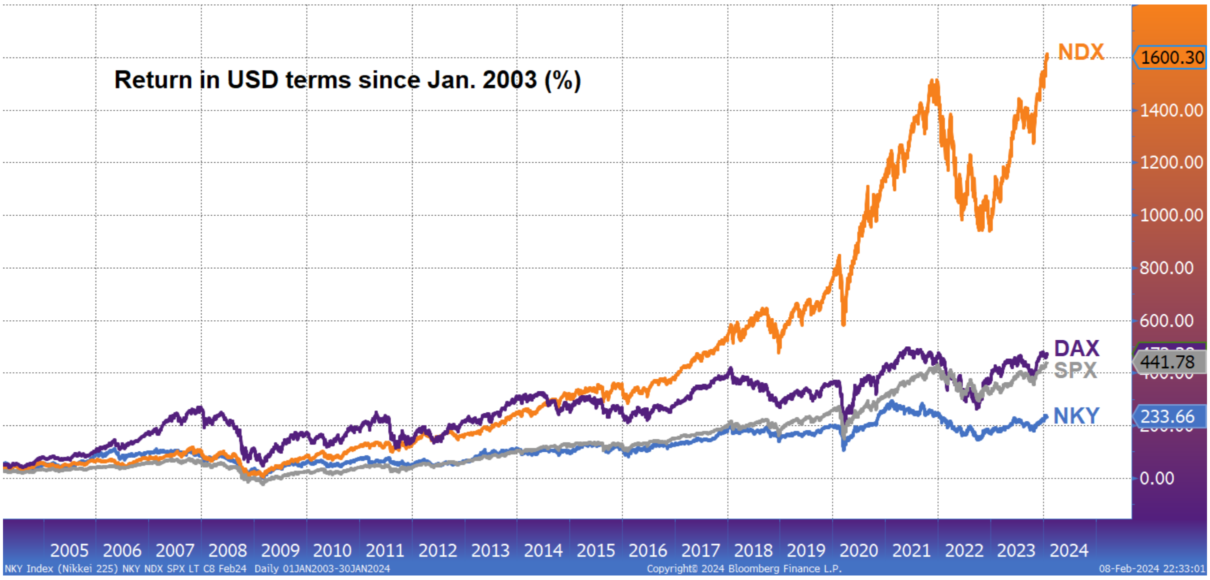
The Nikkei has been pressing on to multi-decade highs in JPY terms and appears to have good momentum…



…the picture is less rosy for overseas Nikkei investors who chose not to hedge their currency exposure, especially since the beginning of Covid. Much of the nominal performance has been washed away by the weakening of JPY.

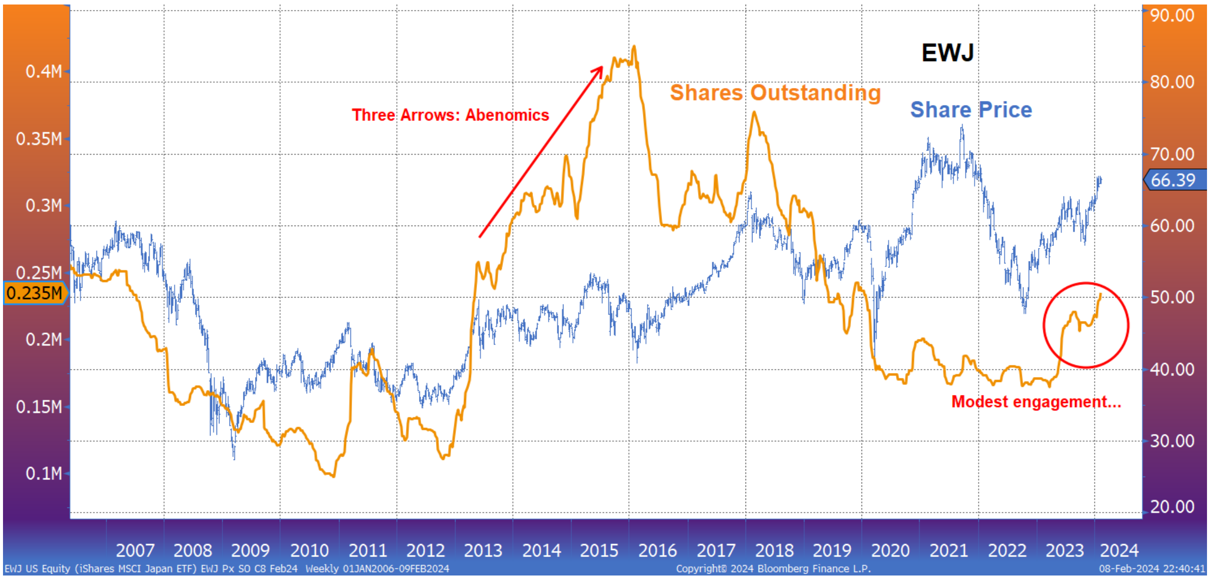


Thus, in JPY terms the Nikkei is 430% off its GFC lows but in USD terms it's only 220% off those lows and worse, only around 275% off its 2003 lows. Unimpressive to say the least on a comparative basis!



The last time Japan enjoyed a bit of a renaissance (the 3 Arrows / Abenomics hype of 2013-15), international capital flooded to Japan. But this time round not so much.

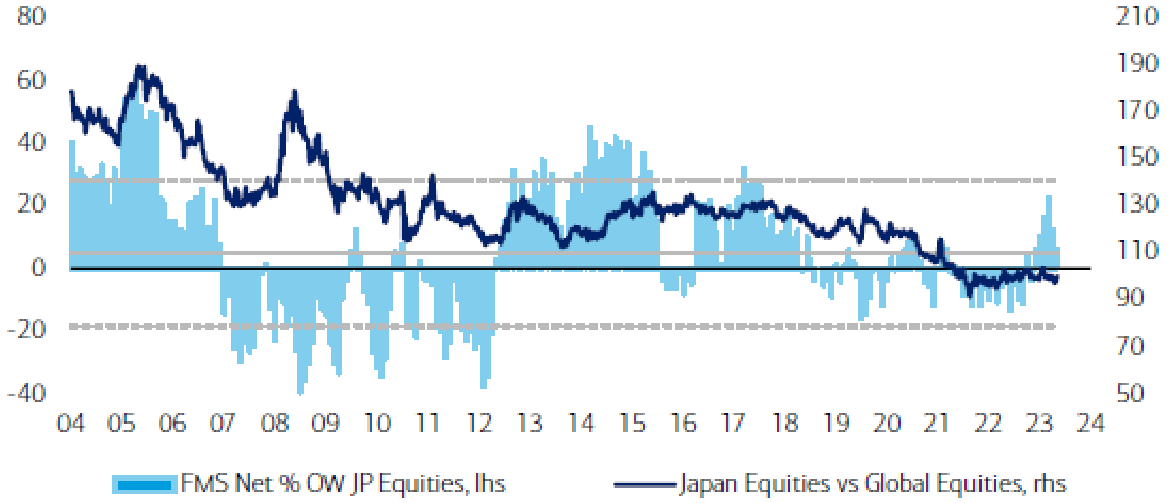
EWJ is a US Japanese Equity ETF which carries currency exposure. The orange line shows shares outstanding in this relatively popular trading instrument and are nowhere near as enthusiastic as in the earlier episode.



Similarly, survey respondents in the excellent BoAML Global Fund Manager Survey began to build Japan overweights early last year…

Chart 47: Net % AA Say they are overweight Japanese Equities

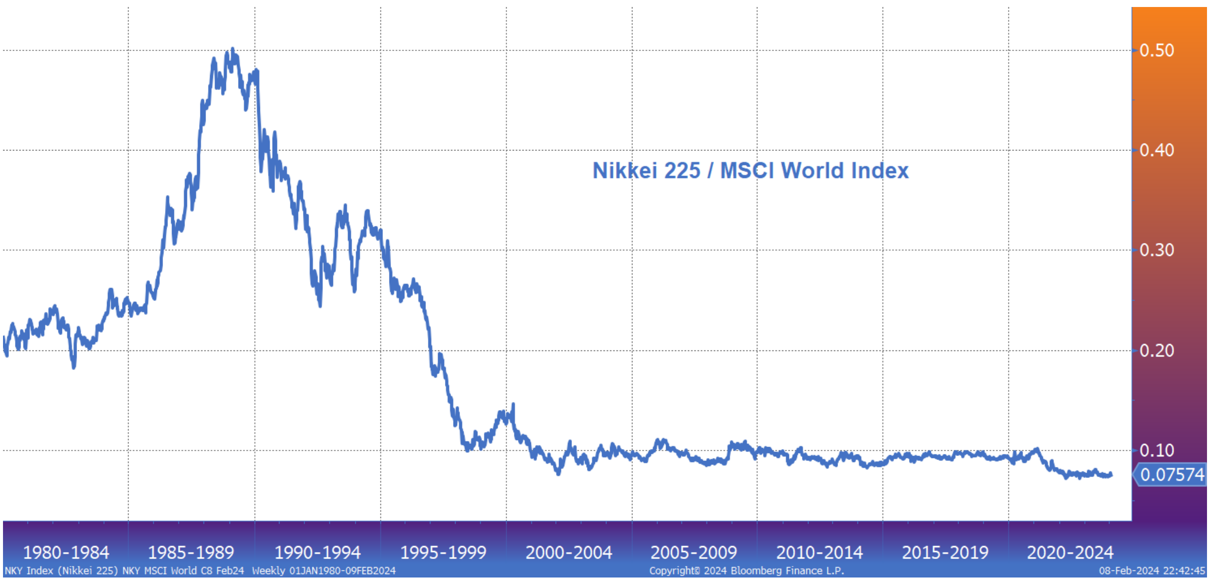
Net% of FMS investors overweight Japanese equities



Source: BofA Global Fund Manager Survey, Datastream

BofA GLOBAL RESEARCH

…but this international capital seemed happy to take a quick profit despite (or perhaps because of) the Nikkei 225 pushing to multi-decade highs. This is unusual in the sense that capital is often attracted to momentum and breakouts. Might we simply put this down to behavioural conditioning? Namely they were so pleased (surprised?) to have ***any*** profit in Japan that they were quick to book it. Certainly, you can barely see the bounce on the long-term relative chart where Japan remains mired at a paltry 1/7th of its peak relative valuation vs MSCI World and obviously far worse vs US indices.



At MI2 we have specialist, detailed and more granular analysis of Japan and Japanese equities. Given that this is an FX focus piece, we will confine ourselves to summing up the equity outlook as follows:

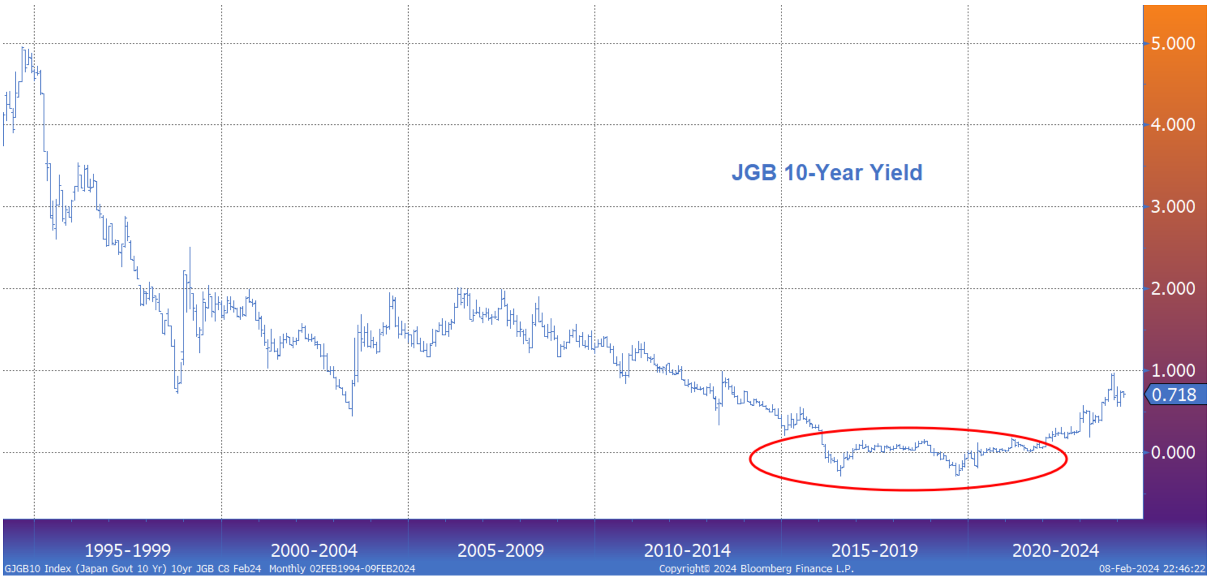
"The Japanese corporate sector has survived decades of deflation and balance sheet recession. We are now moving into a period of inflation and balance sheet expansion. The businesses that have survived have genuine global competitive advantages and are significant players in their markets. They will be able to replace Chinese productive capacity and will do very well in the process. Importantly, many are very cheap and very under-owned, both globally and locally. Japan killed its equity cult in the 1990s. Sensible investors would do well to prepare themselves to take advantage of a market that is on the cusp of an important bull run."

Please contact us direct if you would like more Japan specific and Japanese equity related information.

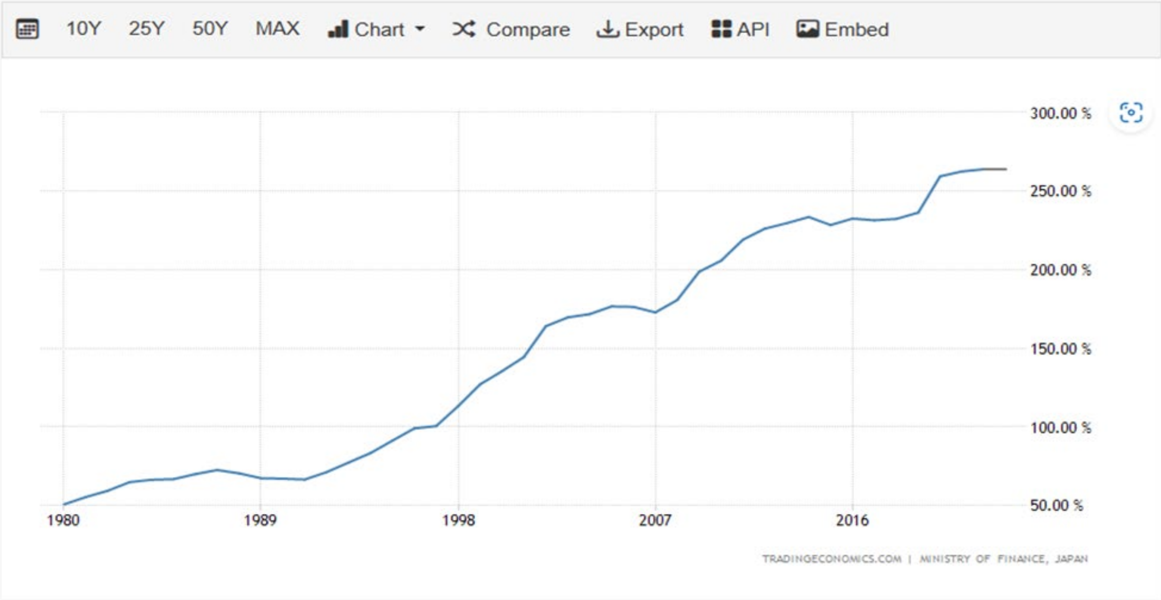
support@mi2partners.com

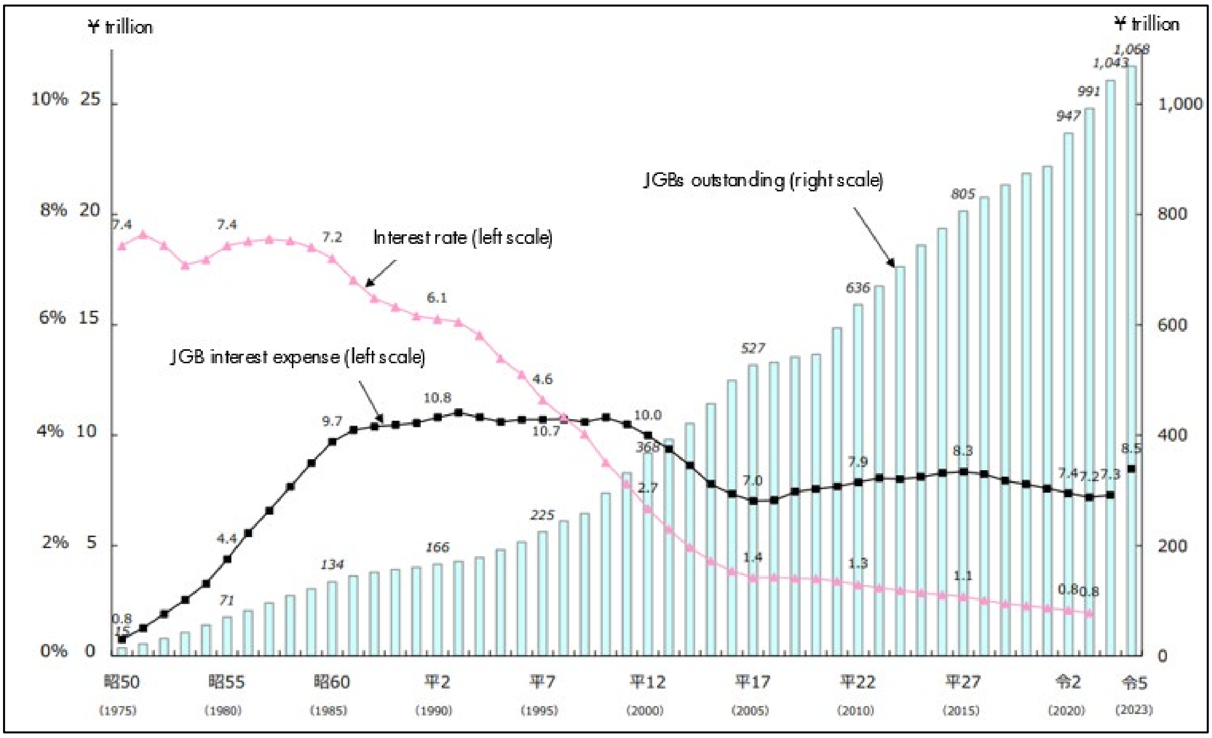
Bonds

Despite extraordinary and rising debt to GDP dynamics, JGBs probed into negative yield territory for a number of years. Even as government debt to GDP expanded and expanded (Government debt to GDP is >260%, more than 3 times what it was before the Japanese equity bubble burst at the end of the 1980s), the high level of domestic savings and both deflation and seemingly infinite deflationary expectations kept Japanese bond yields first below 2%, then below 1% and until relatively recently even sub-zero.



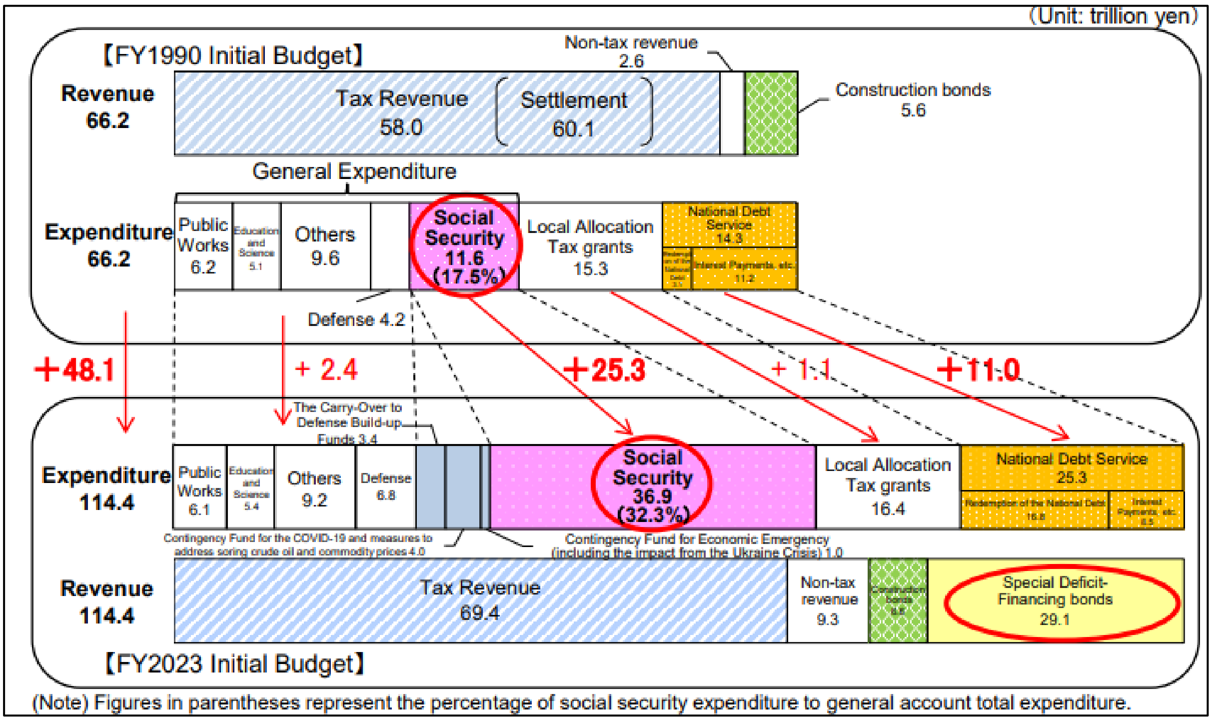
Japan recorded a Government Debt to GDP of 263.90 percent of the country's Gross Domestic Product in 2022. Government Debt to GDP in Japan averaged 146.28 percent of GDP from 1980 until 2022, reaching an all time high of 263.90 percent of GDP in 2022 and a record low of 50.60 percent of GDP in 1980. source: Ministry of Finance, Japan





As you can see from the chart above, the combination of the BoJ's aggressive YCC policies and a continuation of a deflationary mindset among domestic Japanese investors, meant that in FY 2023 (year ending March 31, 2024), the government has been able to borrow more than six times as much money as it did in FY 1990 (year ended March 31, 1991) while paying 21% less interest. If rates go back to more normal levels, JGB interest payments will rise sharply. In the government's annual budget, National Debt Service includes both interest and the cost of redeeming maturing bonds. Consider how this has changed between FY 1990 and FY 2023:

Composition of National Budget FY 1990 vs. FY 2023



Source: Ministry of Finance

What to watch in 2024:

The new Governor of the BoJ, Ueda, seems keen to end NIRP. This has been a major focus of market participants and analysts alike who are jockeying position for hikes at the BoJ meetings in March, April or June. Ueda has, however, a tricky balancing act to pursue with a number of economic and political crosscurrents.

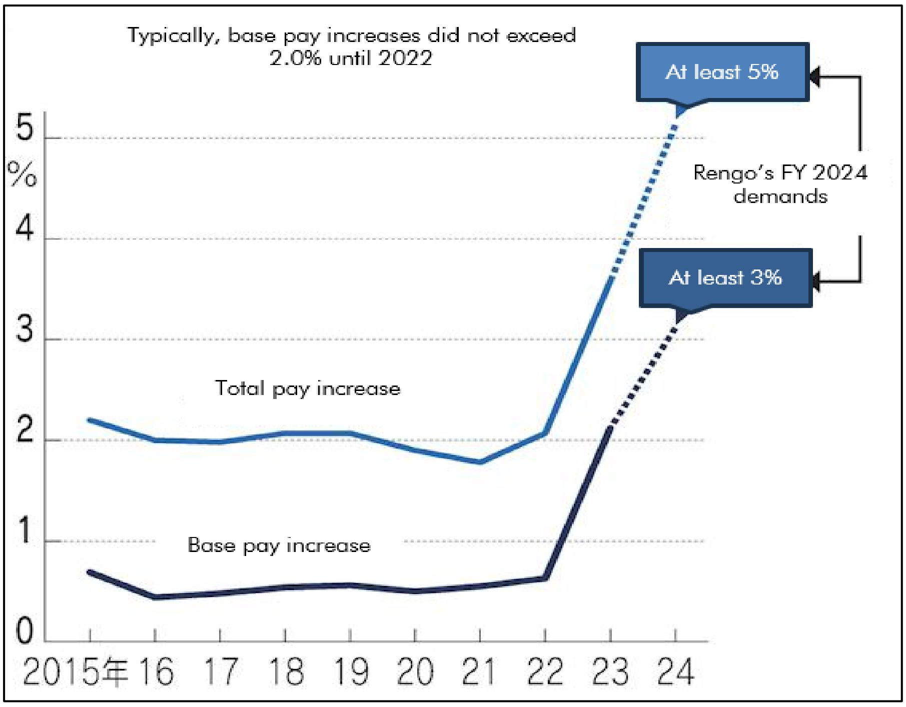
In macro terms, he is keen to wait for information supporting the idea that deflation risk has been vanquished. A major contributory factor in being able to feel confident that the landscape has changed will be wages.

Wages

In Japan, most companies negotiate wages and other compensation annually during what is called the "Spring Wage Offensive." Whereby, negotiations begin in earnest during December with a deal between employers and unions settled typically by the end of March, so that the new wage structure is in place for the start of the fiscal year on April 1. In 2023, Japan's largest companies raised worker compensation by an average of 3.99% YoY, the largest increase since 1993. The good news is there is lots of pressure from the government, labour unions, and the BoJ to deliver even more for FY 2024 (year ending March 31, 2025). The bad news is that because bonuses are a significant part of total compensation, there is an even greater emphasis on base pay. Hence, the BoJ will need to see even bigger increases in base pay before they believe the wage-price spiral is self-sustaining and call time on NIRP.

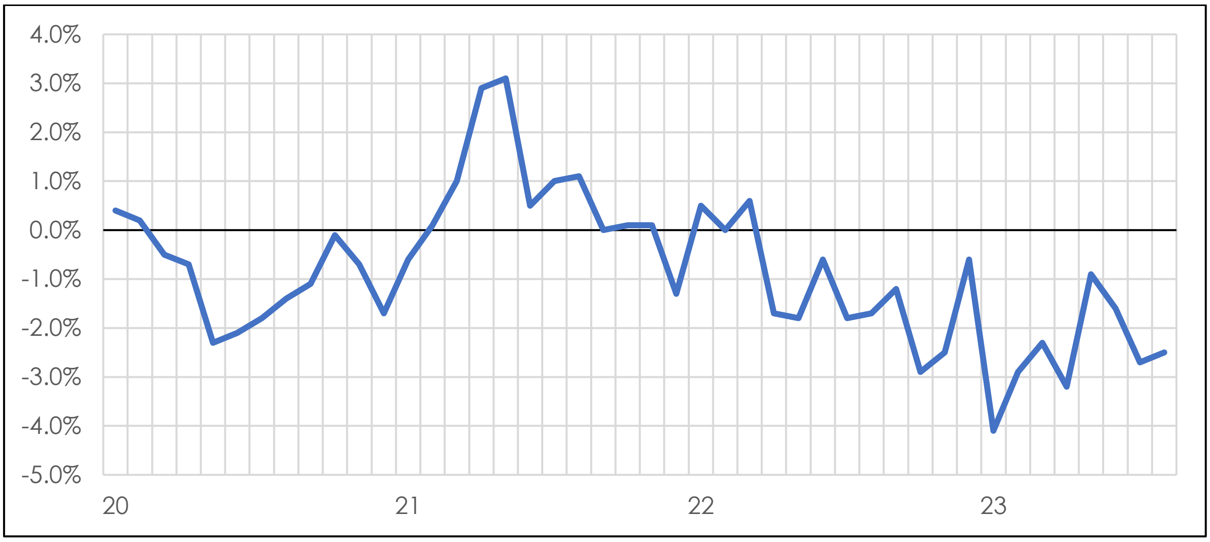
In terms of timing, Ueda will not have the wage data he needs until the April meeting at the earliest. Moreover, the BoJ currently has no fear of falling behind the curve. Ueda is convinced that raising rates too soon has the potential to be very costly, but that there is little cost associated with waiting. Consider this comment from the "Summary of Opinions" from the 18th-19th December 2023 Board meeting,

"*Given that the wage growth rate has not caught up with the inflation rate to date, even if next spring's wage hikes are considerably higher than expected, the risk that this will cause underlying inflation to significantly exceed 2 percent is small. The Bank is currently not in a situation where it would fall behind the curve if it did not rush to raise policy interest rates. It would not be too late even if the Bank makes a decision after it sees developments in labour-management wage negotiations next spring.*"



Source: Nikkei from Rengo data

Annual Change in Real Wages All Companies Surveyed



Source: Ministry of Health Labor and Welfare

On 8th February, Deputy Governor Uchida also poured some cold water on those hoping for early rate hikes. The speech was wide ranging but this snippet captures the tone.

“…the Bank does not project that inflation will significantly exceed 2 percent…the current situation is that Japan's real interest rates have been substantially negative and financial conditions have been highly accommodative. This situation is not expected to change much.”

https://www.boj.or.jp/en/about/press/koen_2024/data/ko240208a1.pdf

In essence, Governor Ueda may want to hike but he is not going to be hurried. He still lacks the smoking gun of higher wages to steel his resolve.

Earthquake aftermath

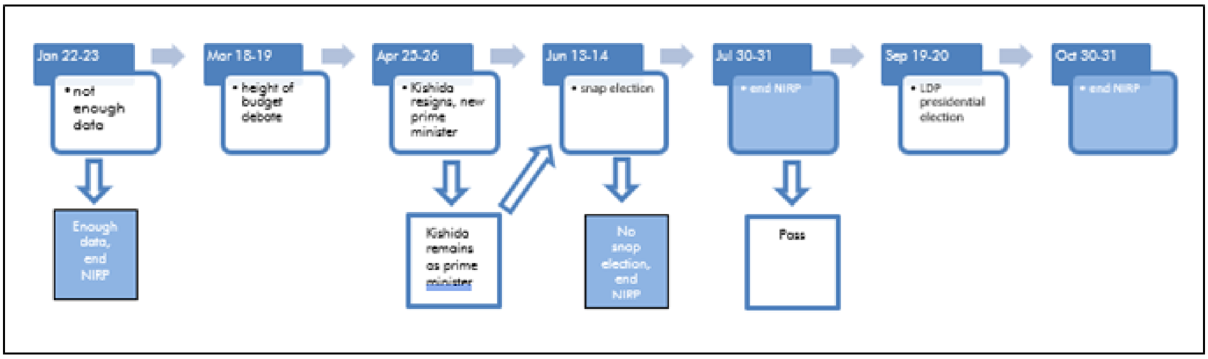
But the BoJ does not operate in a vacuum. Other factors have intervened to make even the April meeting less likely. On January 1st, the Noto Peninsula on the Japan Sea coast was rocked by a deadly earthquake. Although there were no tsunamis, large sections of the peninsula were devastated, and a major reconstruction effort will be required. The Noto Earthquake does not compare to the Tohoku Earthquake of 2011, but large sums will still be needed to fund recovery and reconstruction. Given these circumstances, it is likely to temper any enthusiasm for rate hikes at the Bank of Japan.

Politics

Even more significant is a major political fundraising scandal that has shaken the ruling Liberal Democratic Party (LDP) to its core. In short, several factions within the LDP were caught red-handed accepting political donations without registering them or reporting them to the authorities. The factions were able to hide this money and use it as a slush fund for faction members. There is no grey area here. The slush fund was unambiguously illegal.

The likelihood of Prime Minister Kishida surviving all this is increasingly remote. Making a material change to monetary policy during political crisis is, let’s say, awkward. This additional complication makes both the March and April BoJ meetings less likely to be the meetings when NIRP is finally confined to the dustbin of history. It might, however, be possible to continue with the phasing out of YCC now that the market has got used to a less interventionist BoJ in the JGB market. (The bands and tolerance for 10-year yield changes are already much looser.)

Decision Tree for End to NIRP



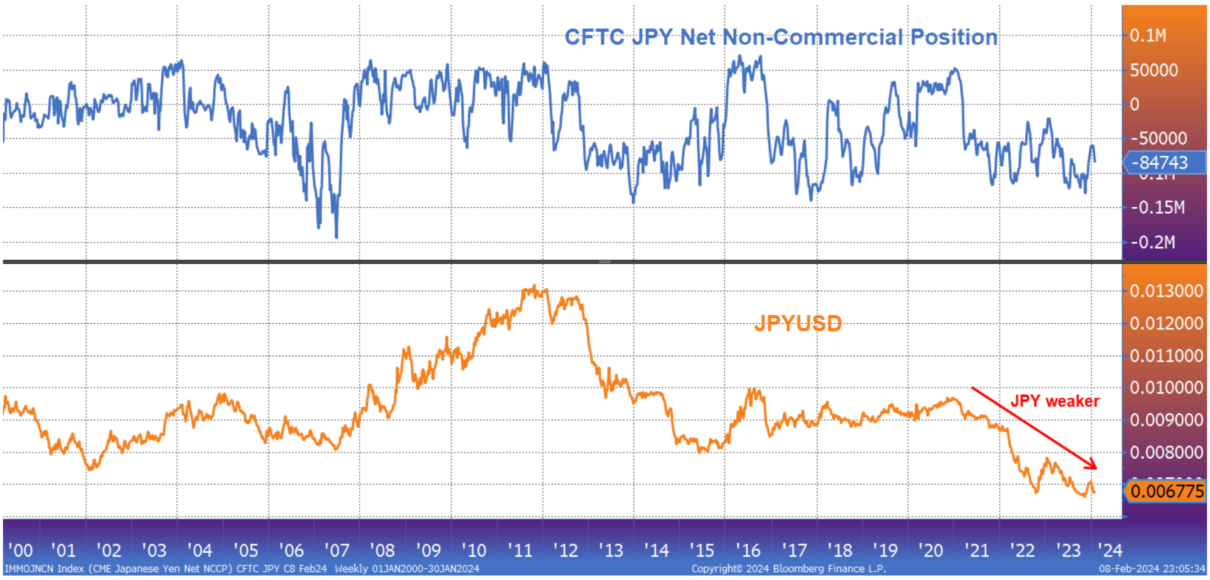
Source: MI2 Partners

Long-term Currency: To hedge or not to hedge JPY assets?

Below we briefly run through the technical and market-based variables which we include in our currency management process.

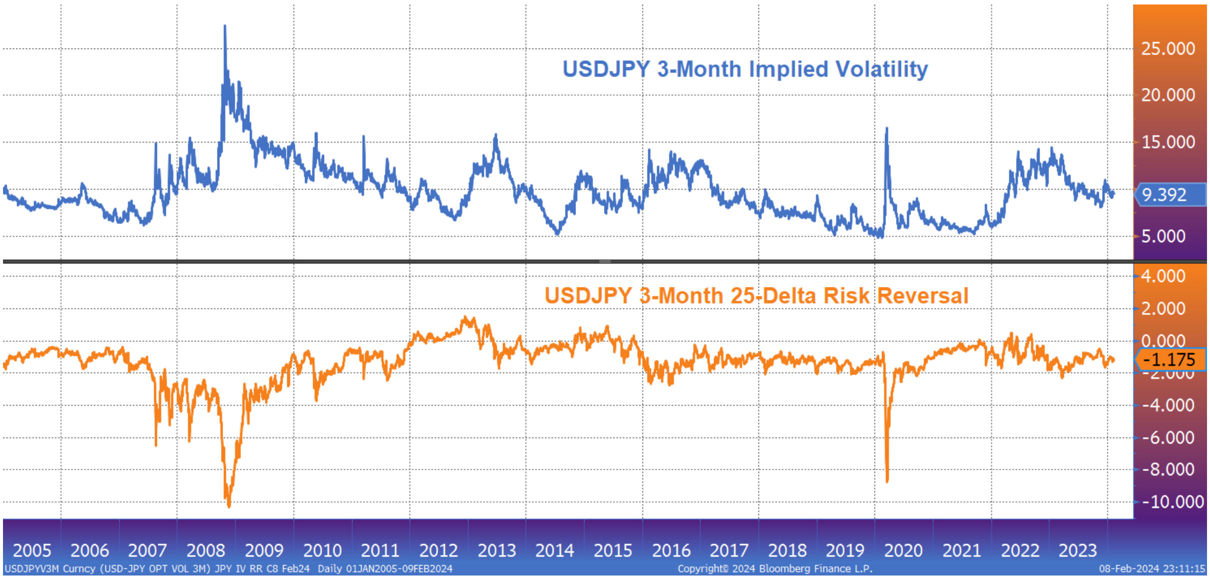
Commitment of Traders: Neutral

While currency speculators on the CME are only a relatively insignificant subset of currency positioning, extreme readings or rapid changes in the net positioning of non-commercial futures and options traders can alert us to potential imbalances in the broader market. The chart below shows how the market was increasingly confident in the JPY carry trade as we progressed through 2023. The correction into year-end clearly washed out a proportion of these shorts and the current position is fairly neutral.

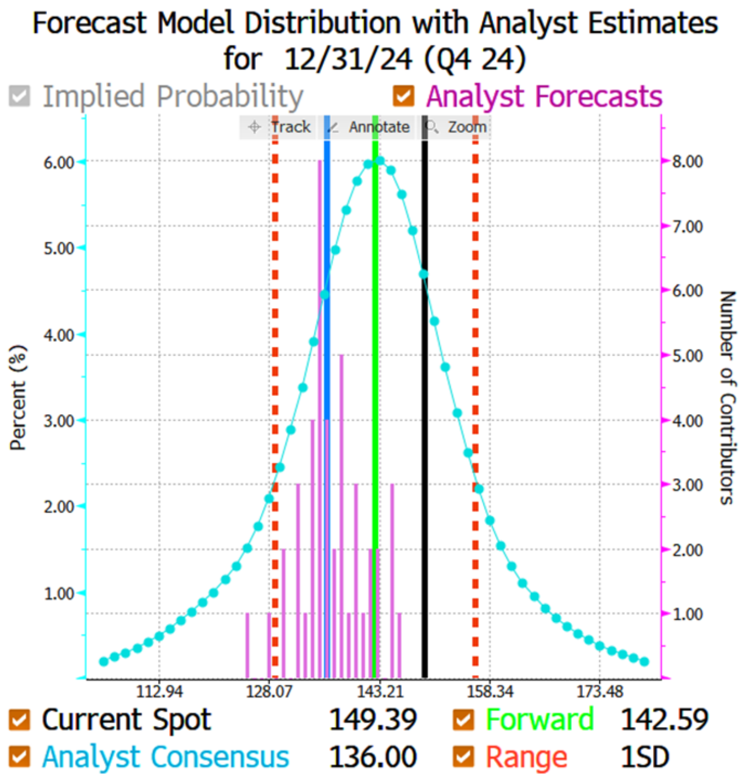


Option Pricing: Neutral

Implied volatility tends to spike in "risk-off," JPY strength episodes. The squeeze at the end of last year was modest. 9.5% 3-month implied volatility is fairly neutral and the 25 delta risk reversals at between 1% and 2% are within historical ranges of relative indifference. In other words, those who are enjoying the carry of being long USDJPY don't mind paying a bit of a premium for USDJPY downside and clearly didn't get spooked enough by the modest JPY strength in Q4 to pay up aggressively for protection.



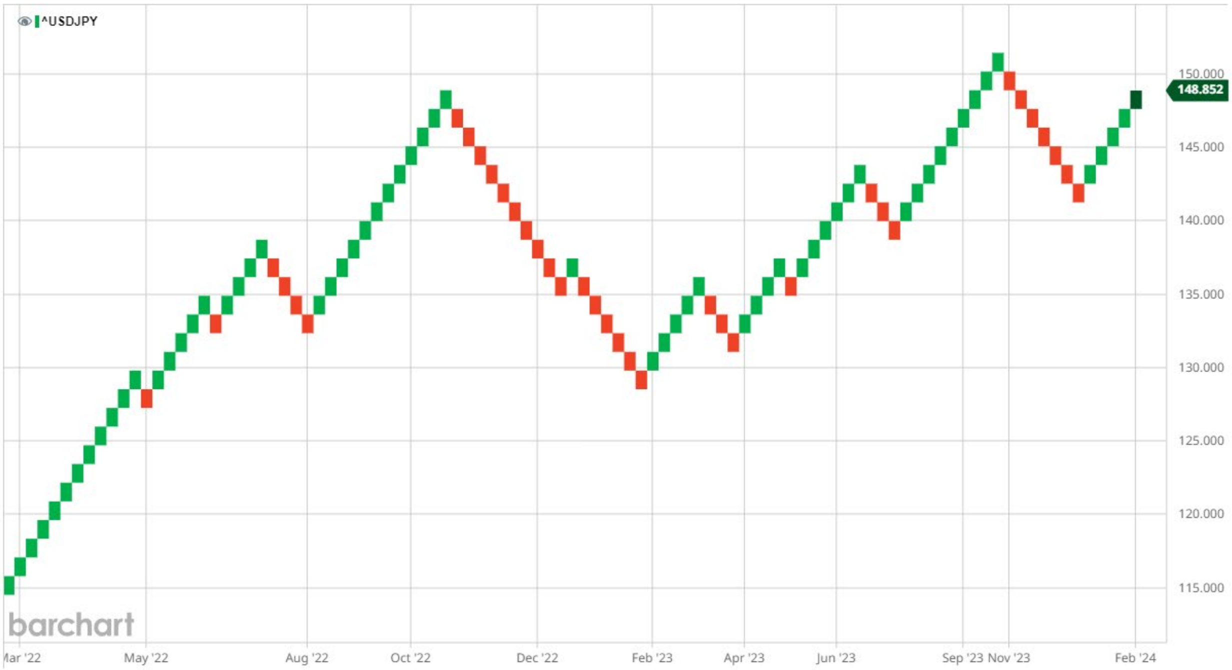
More interesting is the chart we produced in December's introductory piece. More often than not, analysts cluster around the forward price in their projections. Consensus forecasts for USDJPY are firmly to the ***downside***. Spot USDJPY is 149.39, forward outright to 31st Dec 2024 is 142.59 and the median analyst consensus somewhat lower than the forward price. However, with one or two exceptions, all analysts are within the 1 standard deviation bands. This suggests to us that the forecasts are simply reflecting a probabilistic approach, skewed with a similar degree of risk factor that we can see in the risk reversals. No one is sticking their neck out.



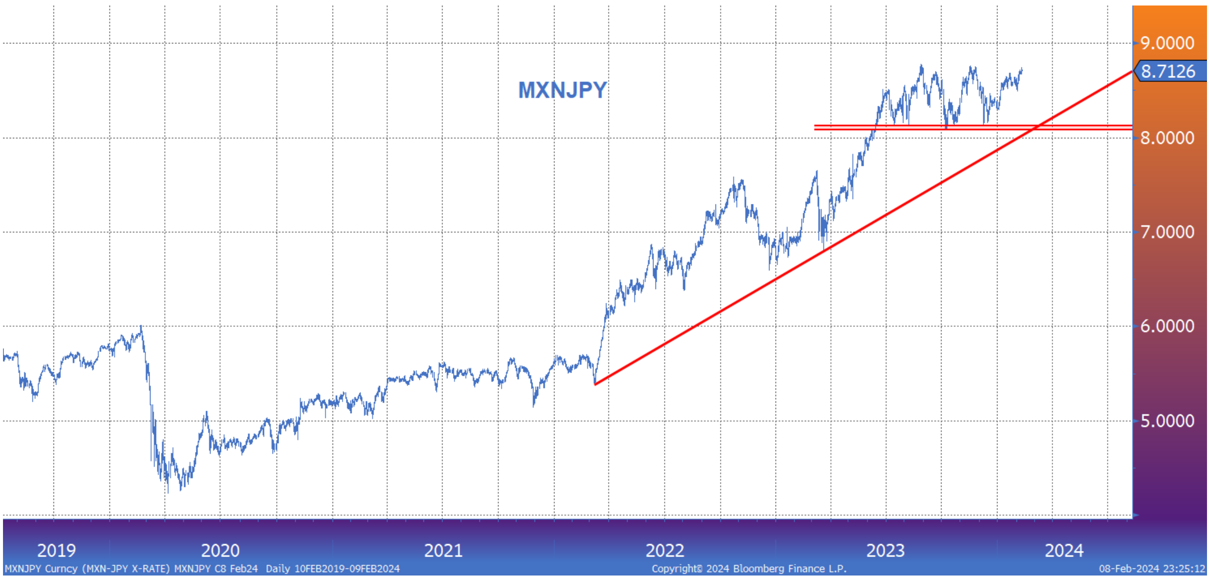
Technical Analysis: Neutral

USDJPY has bounced strongly from its year-end lows and continues to enjoy the carry. More marginal carry traders were likely washed out, but more strategic positions were not challenged.

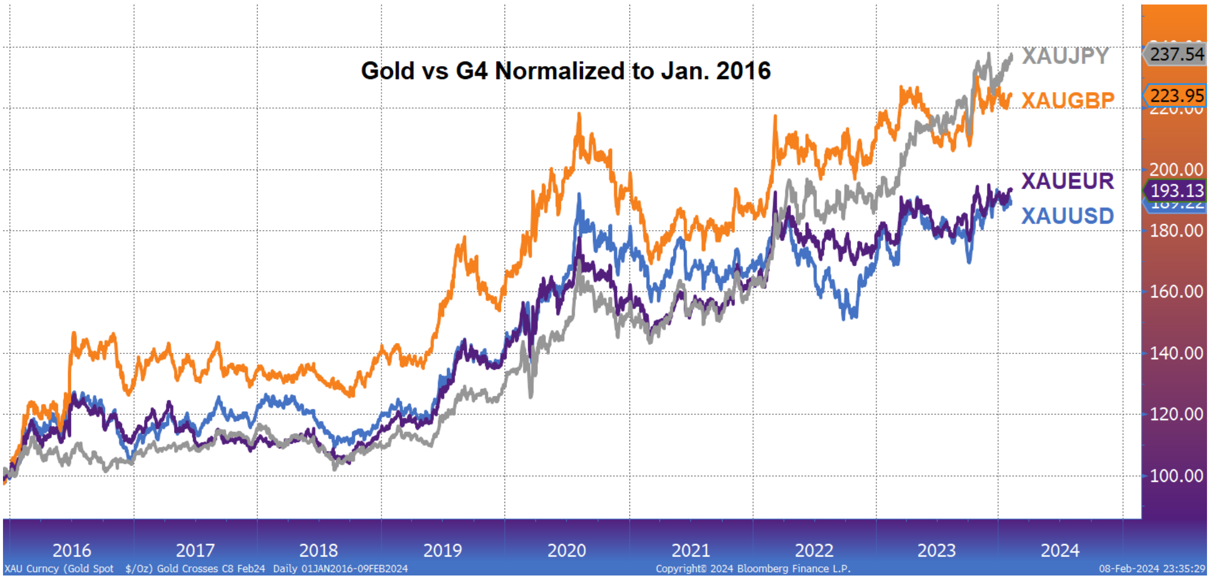
Using Renko analysis (favoured by some Japanese traders), USDJPY is on the verge of asserting the next leg of the bull. It would clearly be a pain trade for the above-mentioned analyst community, but grist to the mill for carry traders. The Daily Renko is testing the downtrend that started in November 2023. We are getting close to a trend reversal (bearish to bullish) which would be confirmed with a daily close above 150.15. If we get that move higher, we would likely look to initiate a downside hedging strategy rather than run with the momentum of the break to the upside.



The carry trade *par excellence* since Covid has been Mexican Peso long, JPY short. The chart shows you spot MXNJPY but add the 10%+ carry achieved and it is a wonder to behold. We know the trade is crowded but will simply observe for now. In a risk-off environment this will be both a canary in the coalmine and a potential trading opportunity.



Lastly, it will come as no surprise that in the Gold vs fiat money race, Gold vs JPY is the outperformer. As central banks continue to support the gold market by adding reserves, the non-participation of asset allocators is even more painful in Japan than elsewhere.



Summary

Japan is likely to come into increasing focus this year. With bond yields now being allowed to rise as the BoJ's Yield Curve Control experiment comes to an end, the BoJ's roadmap to ending NIRP (if things go to plan), the multi-decade underperformance of Japanese equities still fresh in asset allocators' minds (despite some promising upside momentum) and a chronically weak currency, (especially on a real effective, inflation-adjusted trade-weighted basis), there is plenty of potential for disruption.

As our focus here is foreign exchange, volatility adjusted carry and positioning metrics will be key components of our strategy approach. Our research will concentrate on a range of macro variables to assist in developing our expectations of the timing and scale of policy moves (both BoJ and other G7 Central banks). In combination, these will provide the parameters and catalysts for our strategy implementation.

In conclusion, MI2 remains sidelined for the time being in terms of major currency trends. Patience and range trading remains the order of the day. Nevertheless, ***we are very much in the unstable equilibrium camp and anticipate the likelihood of market disruption to be higher than consensus expectations***. How to balance these two ostensibly incompatible insights will determine how best to take advantage of the opportunities that 2024 promises. We will continue to convey our thoughts to you as the year progresses.