JPY: Peeling back the carry trade onion

USD/JPY is staying offered as US interest rates lurch lower. At work is also positioning downsizing as some crowded positions in US tech stocks and Japanese equities get unwound. In this short article, we look at traditional metrics on yen positioning but also delve a little deeper into the carry trade with a look at the boom in cross-border yen borrowing.

Stocks in Japan fell sharply and the yen rose in the wake of the Bank of Japan's rate hike this week

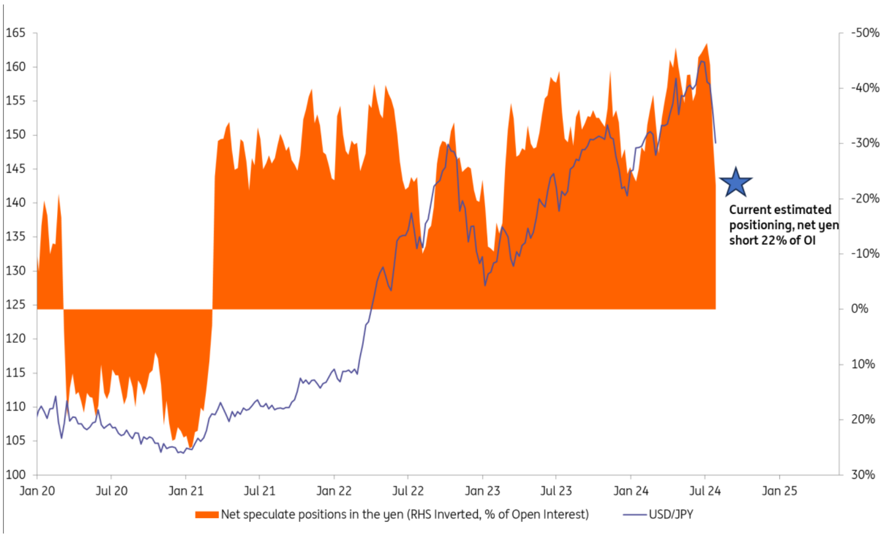
Unpeeling the carry trade onion

Financial market headlines have been dominated this year by the successful investment strategy of the carry trade. This strategy involves borrowing cheaply in yen - on the expectation that the yen will continue to fall - and investing in some high-yielding currency or asset preferably backed by a strong macro argument - like the Mexican peso. Over recent months this strategy has hit a brick wall both on the asset side (e.g. Mexican election results in June undermined the peso) and since last month, on the yen-funding side, too. Lower US rates, more strategic Japanese FX intervention and then this week's hawkish hike from the Bank of Japan have all added to the woes in USD/JPY.

Higher volatility levels across the board have also increased Value-at-Risk (VAR) metrics for financial institutions and forced the downsizing of positions. While there is no really good transparency on position sizing in FX markets, the analysis of speculative positioning in yen futures markets in Chicago provides some insights. We provide our estimates of that latest positioning below.

Using this year's relationship between the changes in USD/JPY, and the changes in both net speculative yen positioning and total open interest (the total size of positions), we estimate that with USD/JPY now trading at 149, the net speculative position has dropped to 22% of open interest. That compares to the very stretched 48% readings seen at the start of July. Arguably, positioning is better balanced now than it was at the start of July. However, the speculative market is still short yen and our back-of-the-envelope calculation had 152.50 as the average entry for USD/JPY speculative longs built between January and July this year.

USD/JPY versus net speculative shorts in yen futures contracts



Source: ING, CFTC

The carry trade goes deeper

But the carry trade is not just about short-term speculators such as hedge funds or Commodity Trading Advisors (CTAs) taking short positions in the yen. Low Japanese interest rates have caused a boom in cross-border yen borrowing as Dmitry Dolgin discusses below. Data from the Bank for International Settlements (BIS) suggests cross-border yen borrowing has increased by $742bn since the end of 2021. To what degree that international borrowing has been FX-hedged is impossible to know, but presumably the prohibitively expensive costs of hedging the dollar against the yen since 2022 mean that FX hedge ratios on this borrowing have remained low.

We mention this because these unhedged cross-border yen loans could represent another and substantial layer of the carry trade. And whether the sharp sell-off in USD/JPY and rise in volatility sparks a much deeper layer of FX hedging remains a risk. For example, that might start to show up in the FX options market, where the cost for one year hedging of USD/JPY downside has shifted to 0.46% vols over equivalent USD/JPY upside protection. These two options hedges had cost about the same at the start of July. Our FX options trading team thinks these extra costs to hedge USD/JPY downside could stretch to one full vol if this extra layer of FX hedging is drawn to action.

The above will have some say in whether this USD/JPY correction stretches all the way to 140 in the near term. We were witness to a 25 yen correction in USD/JPY back in October 1998 when macro hedge fund extreme short yen positioning was exposed by the Russian GKO (sovereign) default and then the Long-Term Capital Management crisis. In no way is that kind of financial stress-induced deleveraging apparent today - which makes us think a near-term USD/JPY drop to 140 is unlikely. But clearly, risk managers will have to be very agile and vigilant right now.

Enough about the markets. Please take a look at Dmitry's analysis of cross-border yen borrowing and let us know what you think.

Cross-border usage of JPY: a banking angle

International banking data could add an angle to the yen carry trade story. Cross-border lending in JPY, one of the contributors to the activity in the currency pairs, has been on the rise since 2010, and accelerating in the last couple of years. According to the data released by the Bank of International Settlements (BIS), banks' JPY-denominated cross-border claims reached JPY328tr (US$2.2tr equivalent) as of the end of March 2024, showing a 52% (US$742bn equivalent net of FX revaluation effect) increase compared to the end of 2021. Meanwhile, the headline numbers cover a sum of cross-border lending in opposing directions, i.e. from and to Japan, as well between parties outside of the Japanese currency area. Moreover, the same headline sum can be broken down by the type of borrower, including other banks (interbank lending), non-banking financials (NBFs), and other sectors.

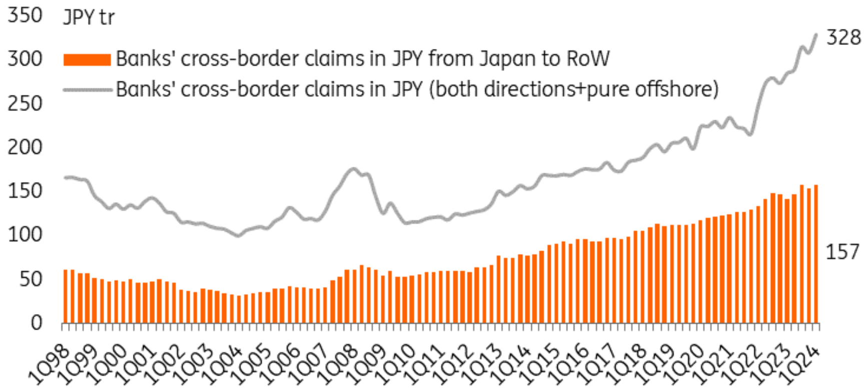
From the directional point of view, cross-border loans originating in Japan should be the most relevant for the carry trade (see the first chart below). The amount of such loans outstanding is JPY157tr (US$1.0tr equivalent) as of March 2024, and the growth compared to 2021 is 21% (US$181bn equivalent net of FX revaluation effect), but much like the overall volume, it also represents an acceleration compared to the trend seen before 2022. Looking at the banks' balance sheets from the borrower dimension (see the second chart below), it appears that the recent post-2021 pick-up in the cross-border JPY borrowing is led by the interbank segment, which reached JPY123tr as of March 2024, almost twice the JPY67tr seen at the end of 2021. Meanwhile, lending to NBFs has been growing steadily from a low base for a number of years now, reaching JPY126tr.

The overall observation would be that the accelerated cross-border lending in JPY, as well as weakness in the national currency, seem to coincide with the normalisation of monetary policy by the Federal Reserve and European Central Bank, which the Bank of Japan was unable to join. Another observation is that the previous historical rounds of sharp JPY de-leveraging were attributable to the 1997-98 Asian financial crisis and the 2008 Global Financial Crisis.

More details on BIS methodology can be found in this article in the BIS Quarterly Review

Stock of JPY-denominated cross-border bank lending by direction

International banks with HQs in Japan have been steadily increasing cross-border lending in JPY since 2010

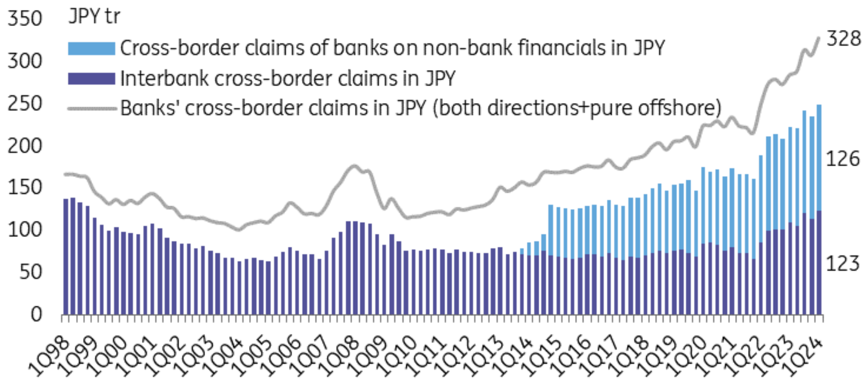


Source: BIS, ING

Total number denotes a sum of JPY-denominated cross-border bank claims from Japan on the rest of the world (RoW), from RoW on borrowers in Japan, and pure offshore lending (lenders and borrowers outside Japan). All data points are e.o.p.

Stock of JPY-denominated cross-border bank lending by borrower type

Non-bank financials have been active cross-border borrowers of JPY since 2015, banks - since 2022



Source: BIS, ING

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