

## Does Japan's higher rate cap materially hurt Treasuries?

The Bank of Japan allowed its 10yr yield to rise, just as the US 10yr yield broke above 4% and the curve started to dis-invert. Was that the causation? We think not. The lowering of the US rate cut discount is the biggest driver. Bigger deficits impact here too. The BoJ move is certainly pushing in the same direction, but it's far from the dominating influence



### When any developed market 10yr yield rises, it impacts others through relative valuation

There has been much speculation on the importance (or not) of the elevation of the Bank of Japan's 10yr yield cap for US Treasuries. The Bank of Japan's move is explained in detail [here](#), but cutting through the messy BoJ language, essentially there is a route for the 10yr Japanese Government Bond (JGB) to move towards 1%. It's currently at a little over 0.6%. In all probability there is far more upside than downside, and pressure has certainly built for a more material move higher.

As a stand-alone input, this places upward pressure on all competing yields. In the world of

developed market rates there is a spectrum of alternatives for players to choose from. And most of the time US Treasuries have tended to be one of the higher yielding of the developed market choice set. The major exceptions were when the Federal Reserve engaged in aggressive rate cutting and quantitative loosening as the Great Financial Crisis (GFC), and the pandemic a decade and a half later, unfolded.

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Leaving aside exceptional shocks, developed market rates are highly correlated. And if there is a tendency for any of them to rise, it impacts the relative valuations of the others. In that sense, higher JGB yields has an impact, as it narrows the spread to US Treasuries, or the relative benefit of being in Treasuries from a yield enhancement perspective. And as JGB yields get higher still, they become that bit more attractive for players that need to be denominated in JPY.

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*But the BOJ impacted narrowing seen is not significant in the big scheme of things*

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But the narrowing seen is not significant in the big scheme of things. The rates spread in the 10yr area had widened from 100bp to 350bp before the BoJ had made its recent move. That 250bp of widening mostly came from the tightening of policy in the US. The subsequent 10-25bp of impact from higher BoJ yields is small fry in comparison. It becomes a larger issue should the BoJ allow the 10yr JGB to trek towards 1%. But still, the dominant impact on spreads versus US Treasuries comes from the US side.

## **Higher hedge costs for players looking to replicate JPY have been penal for some time**

But there is another angle to this – funding costs. For literally decades, the Japanese yen (JPY) has been a funding currency of choice for many. In other words if you wanted to get the lowest borrowing costs, you would borrow in yen. And then switching those holdings of JPY into other currencies facilitated a yield pickup. This is the classic carry trade, where there is a yield enhancement, and where the biggest risk lies in an unexpected appreciation of the JPY (as these would need to be bought back).

From the point of view of the Japanese investor looking to replicate a JGB denominated asset base, they would look at this through two angles. First, they would benefit from a yield advantage from being in US Treasuries over JGBs. But second, in order to be sure they were replicating a JPY investment, they would have to hedge the position back to JGBs. If the cost of this hedge was less than the yield advantage, then they would lock in a nice improvement over simply holding JGBs outright.

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*The JGB replication trade through Treasuries looked great during the pandemic*

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And in fact, this was a great trade during the periods where the Fed had cut the funds rate to zero, both during the GFC (and aftermath) and during the pandemic. By buying the 10yr Treasury and hedging back to JPY, some 100bp of yield enhancement was attainable. But here's the thing, that hedge cost is effectively a function of the policy rates interest rate differential. The lower the differential, the lower the cost (lower implied forward JPY appreciation). With the Fed on the floor, the hedge cost was too.

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*But Fed hikes ended that. The subsequent BoJ impact is small in comparison*

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Once the Fed started to hike though, the hedge cost began to balloon. With the Fed at super low levels the hedge cost was at times less than 50bp annualised. With the Fed where it is now, the hedge cost is at over 5.5%. That is so high that it is prohibitive to set this trade, as the cost of the hedge is some 2.5% more than the yield enhancement. That has pretty much brought the replication of JPY through longs in US Treasuries to an end. This has been a brewing story ever since the Fed started to hike rates, most notably from mid 2022 to early 2023. But again, it's all come from the US side. Not the Japan one.

### **So, the BoJ move is not insignificant in effect. But it's far from the key US curve re-steepening impulse**

So is the move by the BoJ important for US Treasuries?

It is in the sense that it pushes in the same direction as other factors that have forced the US 10yr above 4%. We've noted the downsizing of future US rate cut expectations as key here. See [here](#). That is acting to keep short dated yields elevated, and has rationalised rises in longer dated yields. Also the Fitch downgrade, while not a key issue in itself, reminds us of the supply pressure ahead to finance large fiscal deficits.

The move higher in JGB long dated yields is a contributory factor, but it not the determinative one.

In any case, the combo will keep the US 10yr Treasury yield above 4% for now. Only a break in the economy, and a move of the 2025 forward discount convincingly below 4% will allow the 10yr Treasury yield to even consider getting back below 4%. See [here](#). It will come, but we'd need the economy to break first.

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