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Market views and strategy

Ostrum ASSET MANAGEMENT

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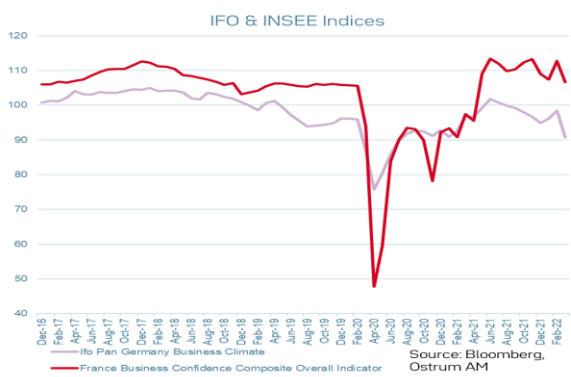
Topic of the week: A peek at the yen weakness

- **The sharp decline in the yen to 125 fuels expectations of currency intervention by the Japanese MoF;**
- **The yen no longer acts as safe haven;**
- **The yen is deeply undervalued with the real effective exchange rate 31% below long-term average;**
- **Yield targeting adds to yen weakness as the BoJ steps up bond buying with 10-year JGBs near 0.25%;**
- **Deeply negative carry and short speculative interests point to downside risk in the near term.**

Market review: Biden aims at cheaper oil

- **Biden taps SPR to help crude prices down;**
- **Euro area inflation hits record high 7.5% in March;**
- **Yields dip as credit spreads ease ahead of quarterly close;**
- **Sovereign spreads well behaved in otherwise volatile markets.**

Chart of the week



Whilst PMI surveys in France (54,7; -0,1pp) and Germany (56,9; -0,7pp) proved resilient in March, the message from national surveys was more downbeat.

The IFO index plunged in March and is now fully 10 points below its long-term average. The INSEE gauge lost 6 points last month although the institution stopped just short of validating a turning point. Contrary to PMIs, national indices include expectations in their headline indicator. New orders, higher input prices and supply chain issues may nevertheless bring down PMI readings in months ahead.

Figure of the week

0.6

Source : Ostrum AM

The percentage of the Euro area IG credit index with negative yield.
The proportion was 49% last August.

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Topic of the week

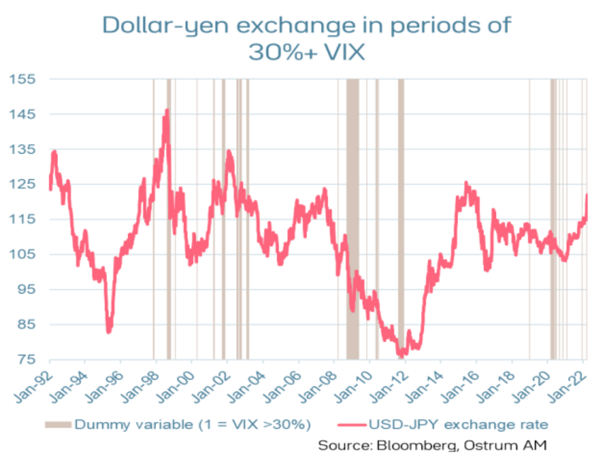
A peek at the yen weakness

The Japanese yen is trading near seven-year lows as the Bank of Japan bucked the global trend for tighter monetary policy. The yen exchange rate indeed hit a low point at 125 against the US dollar stoking speculation that the Japanese Ministry of Finance could intervene to support the currency for the first time since 1998. Selling pressure is intense as the yen lost as much as 7% in March. The yen decline also appears traceable to positioning whilst cheap valuation failed so far to provide a floor on the currency.

Sharp depreciation in the yen

Safe haven no more

The Japanese yen is usually thought of a safe haven, a low-risk asset that can be helpful to hedge out spurts of investor risk aversion. There are multiple examples in the past thirty years of solid gains in the yen at a time when uncertainty, proxied by 30%+ VIX is elevated.

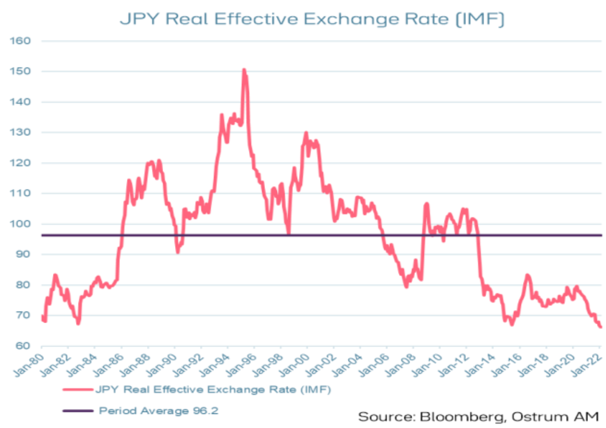


In fact, the Japanese yen failed to respond to warfare in Ukraine and the ensuing drawdown in world equities this time round. Expected capital repatriation at the end of the fiscal year in March also failed to provide support to the Japanese currency. Since the beginning of the war on February 24th, the yen drifted from 115 to 122 at present against the US dollar. The greenback was indeed the sole beneficiary of the geopolitical risk premium.

Economic fundamentals

The fall in the Japanese currency is even more surprising as the yen is deeply undervalued on several fair value estimates. Real effective exchange rates (REER) measure the value of a currency using a trade-weighted basket of currencies. Price level differences are accounted for. The sharp rise in energy costs in the aftermath of the war in Ukraine certainly caused a deterioration in the terms of trade for Japan. Consequently, the current account balance took a turn for the worse. In January, the balance turned sharply negative at JPY -1.2Tr compared with a JPY 1.5Tr surplus on average in the 2015-2020 period.

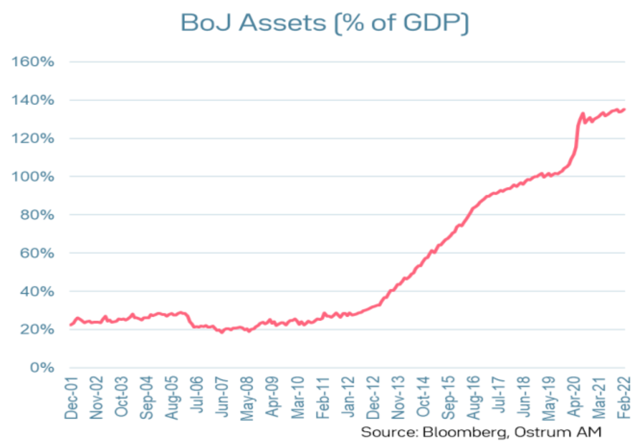
On IMF REER estimates, the Japanese currency trades at its cheapest level on record. The yen is 31% below the average since 1980.



Bank of Japan bucking the tightening trend

The pitfalls of YCC and conditional monetary easing

The Bank of Japan has maintained a highly accommodative policy for the better part of the past three decades, with varying degrees of monetary stimulus, in an attempt to promote higher inflation. In April 2013 and January 2016, Governor Haruhiko Kuroda launched quantitative and qualitative monetary easing (QQE) and QQE with negative interest rate policy (NIRP) to prop up consumer price inflation. However, after three years of QQE, the inflation rate was still below 2 percent. In September 2016, the BOJ introduced QQE with yield curve control (YCC), a new program that targets both short-term and long-term policy interest rates, aiming at an inflation overshoot beyond the 2% goal. The yield targeting regime however *slowed* the growth of the balance sheet between 2016 and the pandemic outbreak in 2020 as the credibility of the Bank of Japan was enough to keep yields in line with the target most of the time. The size of the BoJ balance sheet nevertheless hovers about 134% of Japan's GDP, a much higher number than other major central banks (For instance, Fed assets total 38% of US GDP).

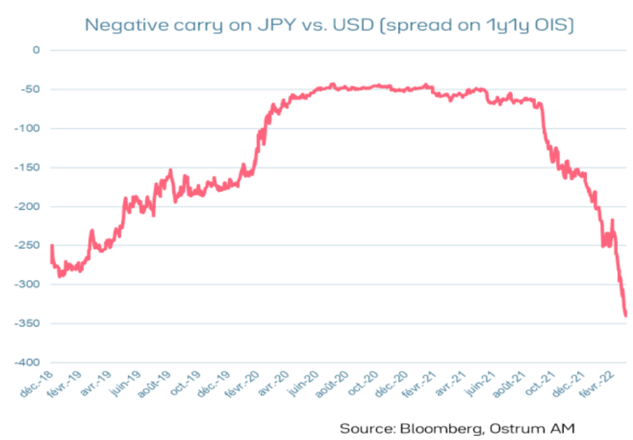


The policy objective under YCC is to keep the yield on 10-year JGBs close to zero. The yield targeting regime differs from quantitative and qualitative easing in the sense that there is no commitment from the monetary authorities to pump a pre-determined amount of liquidity in the economy until 2% inflation is reached. Hence, the accumulation of BoJ assets slowed since YCC was introduced although money issuance kept growing faster than nominal GDP in Japan. Furthermore, the BoJ's yield targeting framework focusses solely on 10-year bonds, leaving some room for longer-dated bonds to reflect economic and financial conditions at home and abroad. Policymakers chose a range around the 0% objective allowing for deviations either way of up to 25 bp. The target range on 10-year JGBs has originally been set at +/- 10 bp. By design, BoJ monetary policy easing must thus accelerate to lean against upward pressure on bond yields. As markets requires higher yields to keep the currency value unchanged, the issuance of additional reserves only worsens the imbalance. This is an unintended consequence of YCC near the upper end of the target range. The quick fix would be to enlarge the range to, say, +/- 50 bp but it's unclear whether the BoJ would be willing to tighten monetary conditions at this juncture.

Forever negative carry

Inflation has risen everywhere prompting most central banks to adopt a more hawkish monetary stance, winding down asset purchase programs and raising interest rates. Inflation in Japan increased, albeit to a much lesser extent than in other developed economies. Japan annual CPI inflation stood at 0.9% in February compared with 7.9% in the US for instance. But the global inflation backdrop meant that upward pressure on bond yields across developed markets reverberated in JGB markets. Breakeven inflation rates did move up in Japan. As stated above, the BoJ had to step up to lean against high JGB yields. To that end, on Monday 28 March, the BoJ conducted unlimited purchases of 10-year JGBs, contributing to push real yields lower.

The BoJ's steady hand also meant that (actual or the promise of) monetary tightening elsewhere augmented the negative carry on the Japanese yen. The spread between 1-year forward 1-year overnight swap rates has turned more negative as the Fed now hints at multiple hikes this year and next. The negative carry turned the yen into the global funding currency again, replacing the US dollar as the Fed abandoned its ultra-accommodative monetary stance.



The possibility of currency intervention

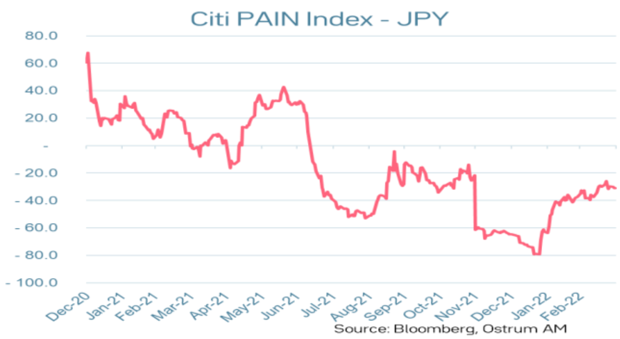
The BoJ's negative rate policy is designed to maintain a stable positive term premium for banks and local financial institutions holding long-term JGBs. It is unlikely that policy rates will be raised in the foreseeable future. Thus, should yen weakness become an issue (for consumer confidence, importers and so on), supporting the yen would require direct intervention in currency markets (yen purchases/dollar sales operated by the BoJ using funds from the Ministry of Finance).

Currency intervention has been commonplace in Japan. However, most of the recent currency operations aimed at *depreciating* the Japanese yen. The last market intervention to support the yen dates back to 1998. The Ministry of Finance then sold US dollars at around 130. A yen exchange rate around 125 is believed to be around the edge of policymakers' tolerance. In June 2015, the last time it traded at 125, BoJ Governor Kuroda was calling the yen 'weak and unlikely to depreciate further'. Before intervening, the BoJ may try to talk up the yen and even call an emergency meeting to discuss the matter, especially if the yen accelerates to the downside. Yet, for the time being, the BoJ stance inferred from Governor Kuroda's comments recently is that yen weakness is supportive of the Japanese economy.

Flows & positioning

Broad short base

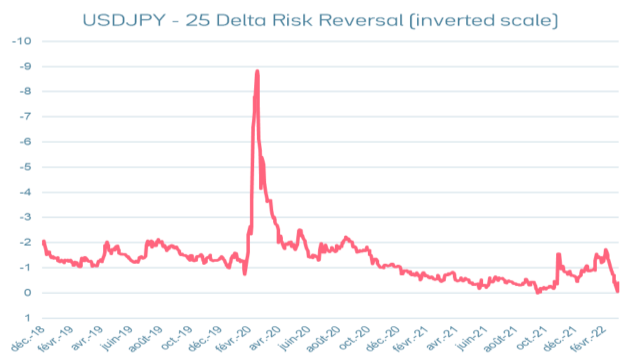
The latest price action is unsurprising considering the long-standing short base of leveraged accounts. The Citigroup's PAIN index is helpful to derive implied investor positioning from currency managers' returns. A positive reading suggests that traders have been net long the currency and a negative reading suggests that traders have been net short the currency. This investor community has run a short position since the middle of last year and if anything, the short bets have increased early on this year reaching a maximum at the end of January. Positioning has eased in the recent period so that the recent acceleration to the downside is not traceable to speculators jumping on the bandwagon. Positioning in commodity-related currencies have increased as the war started suggesting that the terms of trade argument is the chief factor behind yen weakness.



CFTC data paints a similar picture. Leveraged funds hold a significant short yen position. Likewise, non-commercial positions (speculators or risk takers as opposed to currency hedgers) also hold a short position equivalent to 41% of the open interest in futures and options (option positioning is a delta-adjusted futures equivalent). If anything, speculators have increased their short bets in the past few weeks (likely eyeing technical levels).

Losing safe haven status: risk-reversals pointing to downside tail risk

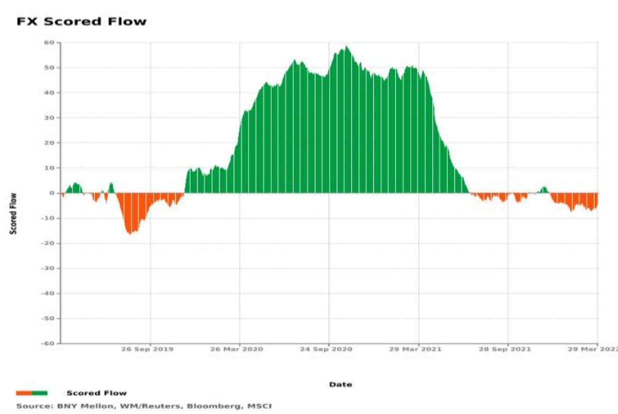
Furthermore, option markets reflect the change in the status of the Japanese yen. The implied volatility spread between calls and puts with the same delta (i.e. the sensitivity to change in the underlying USD-JPY exchange rate) is an indication of the riskiness of the FX pair. A risky usually high yielding currency is vulnerable to risk-off reversals which shows in higher implied volatility on the downside (put) than on the upside (call). To that end, we monitor so-called 25-delta risk reversals. It costs more to hedge higher-yielding foreign exchange positions. Conversely, safe haven currencies should be characterized by positive asymmetry in the implied volatility. The change in the status of a currency should thus be reflected in the changes in risk-reversals. The chart below indeed suggests that the yen exhibited considerable positive asymmetry until recently.



Source: Bloomberg, Ostrum AM

Flows point to selling pressure

BNY Mellon data offers some perspective on flows in foreign exchange markets. Unsurprisingly, the flow picture has started to deteriorate for the Japanese yen around the middle of last year. This is consistent with early signals of a shift in Fed policy towards removing accommodation.



Conclusion

Recent yen weakness has stoked expectations of currency intervention as deeply negative carry and YCC operations fuel short positioning. Besides policy aspects, the deterioration in the terms of trade for Japan and the loss of a long-standing safe haven status of the Japanese yen have magnified the drawdown to 2015 lows.

Axel Botte

Market review

Biden aims at cheaper oil

Biden taps SPR, quarter-end close favorable to rates and credit

Financial volatility remains elevated in part due to asset allocation shifts as the quarterly close approaches. After a difficult trading session on March 31, the S&P closed down 5% in the first quarter as changes in the Fed's monetary policy outlook and higher commodity prices took a toll on equities. The US dollar remains the most reliable safe haven. Europe underperformed due to its greater dependence on Russian fossil fuels. The issue with the payment of Russian gas imports in rubles, that Putin wants to impose, caused another bout of volatility. The CBR, whose foreign assets are frozen, needs an onshore flow of currencies to stabilize the ruble. At the same time, Russia's military strategy in Ukraine remains unreadable, even if the financial markets welcome any sign of de-escalation. A Russian withdrawal from the Kyiv region is mentioned, but the concentration of forces in Donbass also raises fears of a new aggression. In fact, no one believes the Russian military's word. In Asia, lockdowns in Shanghai and Shenzen due to Covid outbreaks point to a significant slowdown in the Chinese economy in the spring.

The drop in the price of oil is a priority for Joe Biden looking out to the mid-term elections, even if it means offending the progressive wing of the democratic Party. The United States will draw on its strategic reserves to the tune of 180 million barrels over the next six months and the Administration is urging US oil companies to act. OPEC+ will produce an additional 432k barrels from May but ongoing tensions in the Gulf make this target uncertain. Crude price nevertheless eased towards $100.

At this stage, US economic growth shows no signs of slowing down. The labor market is extremely tight. Job creations reached 431k in March with the unemployment rate down to 3.6%. Inflation is high but hourly wages (+5.6%) are rising rapidly. The ISM manufacturing index came in at 57 in March, in line with regional surveys. The contrast is striking with Europe where the INSEE and IFO indicators weakened markedly in March. The rise in consumer prices accelerated further in March to a 7.5% record high. The rise in energy prices is feeding through the economy so that core inflation moved up to a unheard-of level of 3%.

Despite high inflation, the upward pressure on interest rates eased as end-of-quarter allocation flows provided support to fixed income markets in the United States. The T-note closed below 2.40% at the quarter-end before resuming its upward path on Friday, encouraged by strong employment statistics. Strong growth is keeping the yield curve flattening under pressure as market participants reassess the possibility of 50bp rate hikes at the upcoming FOMC meetings. In this context, 2-, 5- and 7-year bond auctions drew subpar demand. The 2s10s yield spread trades close to zero. End-of-month duration extensions and end-of-quarter reallocations fueled the curve flattening, which essentially builds on the inversion of the term structure of inflation expectations. Real yields (-0.38% at 10 years) will have to go up if the Fed really intends to fight inflation. In the euro area, the German 10-year bond fluctuated wildly between 0.52% and 0.73% last week, jolted by both inflationary tensions and uncertainties linked to the cycle and the war in Ukraine. The Schatz briefly moved back into positive territory for the first time since 2014 and the introduction of a negative ECB deposit rate. The 2s10s spread reversed the steepening trend observed so far in March. Sovereign spreads changed little with the Italian 10-year BTP around 150 bp and the Spanish bond trading near 91 bp. The increase in the open interest in Italian futures suggests that new long positions have been implemented recently. On short maturities, spreads are at their tightest so that peripheral debt no longer represents value compared to the core sovereign debt. The good behavior of spreads is also explained by the negative net redemptions expected for April (taking into account the APP net purchases). On the other hand, swap spreads appear slow to normalize (68bp on the Bund), which seems consistent with the amounts of supranational bonds to be issued.

The selling pressure on European credit markets eased twoards the end of the quarter. The euro IG spread (124 bp against Bund) fell by 11 bp in five trading sessions and by 15 bp in March. Appealing valuations are once again attracting flows into corporate credit funds. February cash outflows have been fully recouped. The primary market remained active this week with total issues of €9 billion in non-financial sectors and €19.8 billion in financials, including €6.5 billion for covered bonds. The maturities issued are concentrated in the intermediate sector (3-7 years) as borrowers react to the previous steepening of yield curves and credit spread curves. On high yield, the average spread eased below the 400 bp threshold against Bunds at quarterly close. Protection buying is being unwound so that the iTraxx crossover narrowed below 340 bps. The return of investor interest for global high yield funds resulted in the first week of inflows after fully twelve weeks of uninterrupted fund outflows.

On foreign exchange markets, the dollar remains the best hedge against geopolitical risk and financial volatility. The euro is strengthening somewhat, particularly against the Japanese yen, which is pulled lower by the BoJ's ongoing monetary accommodation.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	04-Apr-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.08%	+3	+65	+54
EUR Bunds 10y	0.51%	-7	+58	+68
EUR Bunds 2s10s	58.3bp	-11	-7	+15
USD Treasuries 2y	2.44%	+11	+96	+171
USD Treasuries 10y	2.4%	-6	+67	+89
USD Treasuries 2s10s	-4.2bp	-17	-29	-82
GBP Gilt 10y	1.55%	-7	+34	+58
JPY JGB 10y	0.21%	-4	-4	0
€ Sovereign Spreads (10y)	**04-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	49.83bp	+7	+7	+12
Italy	156.46bp	+4	+7	+21
Spain	94.63bp	+7	+6	+20
Inflation Break-evens (10y)	**04-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.82%	+7	+25	+72
USD 10y Inflation Swap	3.03%	-11	+10	+26
GBP 10y Inflation Swap	4.56%	+2	-9	+39
EUR Credit Indices	**04-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	130bp	-8	-17	+35
EUR Agencies OAS	62bp	+3	-4	+13
EUR Securitized - Covered OAS	70bp	+3	-6	+24
EUR Pan-European High Yield OAS	393bp	-20	-54	+75
EUR/USD CDS Indices 5y	**04-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	71bp	-8	-11	+23
iTraxx Crossover	333bp	-28	-63	+91
CDX IG	65bp	-7	-9	+15
CDX High Yield	365bp	-3	-24	+72
Emerging Markets	**04-Apr-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	400bp	-52	-83	+31
Currencies	**04-Apr-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.099	0.046	0.567	-3.3
GBP/USD	$1.311	0.199	-0.877	-3.1
USD/JPY	JPY 123	0.929	-6.437	-6.2
Commodity Futures	**04-Apr-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$106.1	-$3.4	-$8.3	38.84
Gold	$1 933.9	$11.1	-$36.9	5.72
Equity Market Indices	**04-Apr-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 571	-0.11	5.59	-4.1
EuroStoxx 50	3 951	1.65	11.11	-8.1
CAC 40	6 731	2.16	11.05	-5.9
Nikkei 225	27 736	-0.74	6.74	-3.7
Shanghai Composite	3 283	2.19	-4.78	-9.8
VIX - Implied Volatility Index	19.31	-1.63	-39.62	12.1

Source: Bloomberg, Ostrum AM

Additional notes

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