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Investments - Flash

EMPLOYMENT INCREASES THE RISK OF A CARRY TRADE SHOCK

Interest Rate Differential and Repatriation of Japanese Assets

The deterioration in the U.S. labor market has come to light with the plunge to –23k nonfarm payrolls in July and the downward revision of –103k for the previous month (from 57k to just 20k in June), which should reinforce the anticipated stagflation scenario. The sharp contraction in U.S. job creation and the significant downward revisions confirm that the world's largest economy is losing steam. This deteriorating trajectory is forcing a sharp adjustment to the Federal Reserve's monetary policy expectations, leading to a decline in very short-term U.S. bond yields. This expected mechanical narrowing of the yield spread with Japan is boosting interest in the yen and may destabilize major currency pairs. Today's developments are amplifying an already extremely tense monetary environment following recent targeted interventions by the Fed and the BoJ. These institutions had taken investors by surprise by selling the euro against the yen to contain the yen's depreciation without directly disrupting the Treasury market. It is extremely important to note that this was the Fed's first intervention of this kind in 28 years, resulting in a correction from 164 to 155 yen per dollar. But beyond the immediate reaction in the forex market, the real shockwave lies in the potential acceleration of the unwinding of the carry trade. The gradual rise in the Bank of Japan's policy rates and the increase in Japanese government bond (JGB) yields are now prompting major local institutional investors, such as the giant pension fund GPIF and large life insurers, to orchestrate a structural shift to repatriate their capital back to Tokyo. For these domestic investors, the rise in domestic rates, combined with the now-high cost of hedging currency risk, makes the real net return on foreign bonds negative compared to local sovereign investments. This potentially massive and sustained repatriation trend is depriving the U.S. financial sector of its traditional fuel: virtually unlimited access to ultra-cheap Japanese liquidity used to fuel highly leveraged speculative strategies on risky dollar-denominated assets. Caught between the rapid appreciation of the yen and the erosion of U.S. yields, hedge funds will likely have to adjust their positions in major stock indices and government bonds to pay off their yen-denominated loans. The combination of a marked slowdown in the U.S. economy and the monetary policy shift in Tokyo is thus creating sustained downward pressure on the exchange rate while generating an increased risk of a liquidity shock in the U.S. The combination of a sharp slowdown in the U.S. economy and the shift in monetary policy in Tokyo is thus creating sustained downward pressure on the exchange rate while increasing the risk of a liquidity shock across global markets.