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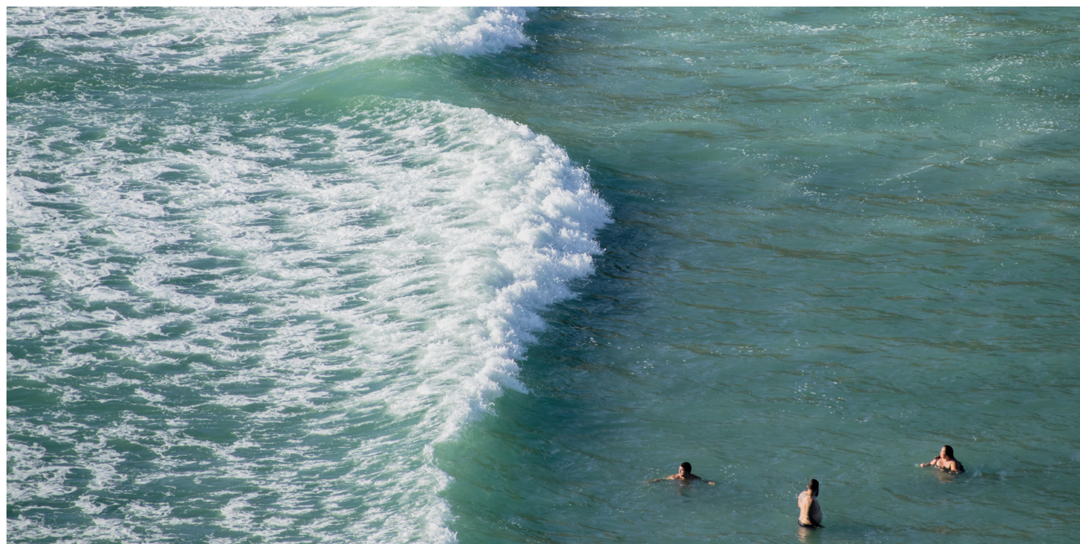
Liquidity Riptide: Japanese Capital Repatriation and QT

Bill Campbell | February 2023



Contrary to its reputation for aggressively accommodative monetary policy, the Bank of Japan is engaged in stealth tightening. The result is a sell-down of Japan's massive invested savings in foreign financial assets, compounding the drain of global liquidity under quantitative tightening by the world's central banks.

Over the past decade, central banks ventured into the world of nonconventional monetary policy as interest rates approached zero, a level that had been regarded as the lower bound of interest rates. In fact, many banks did lower interest rates into negative territory, engaging in bond purchase programs and funding for lending schemes to add sources of monetary easing to their respective economies. Traditional interest-rate policy had the benefit of transparency with rates charged to market participants on open display. However, the impact of unorthodox policy tools is more opaque, as these work outside ordinary channels of policy interest rates. These methods work through changing investor preferences for different assets, chasing investors out of safer areas of markets with low return potential and into asset classes with higher return potential but greater risk. One lens to bring into focus the overall impact of the current mix of orthodox and unorthodox monetary policies is to observe the so-called financial conditions in a country. In an attempt to quantify the impact of central bank policy actions, policymakers and market practitioners observe a composite of interest rates, credit spreads, equity prices, currency rates and other financial vectors.

The above is key to an assessment of the potentially significant impact of the Bank of Japan's (BOJ) policy mix on global markets. Today, the BOJ is regarded by many as one of the last holdouts among the world's major central banks that is maintaining easy monetary policy. Under the traditional way of assessing monetary policy, direct observation of interest rates, the BOJ does appear to be pursuing loose money. This is the view of the BOJ as well. The target rate remains firmly at negative 10 basis points (bps), unchanged for years. In addition, the BOJ continues to purchase bonds under its yield curve control (YCC) program. However, a closer examination of changes in Japanese investor base holdings, especially in international markets, reveals the impact of BOJ policy is stealth tightening. BOJ policy is contributing to a sell-down of Japan's massive invested savings in foreign financial assets, a drain of global liquidity at time when quantitative tightening (QT) by the world's central banks already is removing liquidity from the markets.

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Stealth Tightening at the Bank of Japan

In December, the BOJ Japan started to make changes around its YCC policy by widening the target band around the 10-year Japanese government bond (JGB) to +/-50 bps from +/-25 bps. In an effort to signal to market participants that this was not a tightening of its monetary policy but just a tweak to the YCC policy, the BOJ said it could make unlimited bond purchases to keep the 10-year JGB yield from rising above the new level. After a quick repricing higher of 10-year yields, the market settled, but yields across the JGB curve rose in sympathy with the change. This amounts to an effective tightening of domestic financial conditions.

At the BOJ's January meeting, BOJ Governor Haruhiko Kuroda kept the YCC band at +/-50 bps, but the BOJ introduced a new funding program to try to bring market participants back into the JGB market by offering funding to banks for pooled collateral to entice them to increase JGB purchases. Under the new program, which is designed to mitigate the tightening of domestic financial conditions, the BOJ offers loans with maturities of up to 10 years to banks but at variable rates rather than at a fixed rate of zero percent. The problem with the program in its current form is that it might not offer enough juice to entice participants into the JGB market, as 10-year JGBs currently yield around 40 bps to 60 bps. In order to make the program more attractive, I see two possible choices for the BOJ. It could lower the cost of funding, or it could widen the 10-year JGB target band potentially to +/-75 bps. Inflation in Japan at the last read in December was showing signs of picking up. The headline inflation measures printed 4.0% on a year-over-year (YoY) basis, and the "core-core" consumer price measure (excluding food and energy) came in at 3.0% YoY. These are the highest prints seen in years in Japan, making it difficult for the BOJ to implement a reduced or even negative funding rate on this facility. Therefore, a more elegant measure would be to widen the target band again, which is what many market participants expect. Such action would effectively amount to a further tightening of financial conditions.

The BOJ is set to have a new captain with the appointment of Kazuo Ueda as its next Governor. Both chambers of Japan's parliament, the Diet, are expected to approve the appointment on Feb. 24. With a Ph.D. in economics from the Massachusetts Institute of Technology, Mr. Ueda has taught at universities in Japan but also served as board member of the BOJ from 1998 to 2005. His exact stance on current monetary policy is unknown, so we will have to wait to see if he intends any policy changes.

Another consequence of the BOJ's policy has been an increase of foreign exchange (FX) hedging costs to domestic investors. By avoiding the kind of straightforward policy normalization underway at many other central banks, the BOJ has raised the cost of currency hedging for Japanese investors. When the Federal Reserve, European Central Bank (ECB) and other central banks raise interest rates, by remaining on hold, the BOJ has increased the cost to its domestic investors by roughly the difference between the foreign short-term rate and its domestic rates. As this spread dramatically widened throughout 2022, so, too, did FX hedging costs for domestic Japanese investors. *(Figure 1)*

U.S. Dollar/Japanese Yen 6-Month Hedging Cost
January 6, 2017 through February 20, 2023

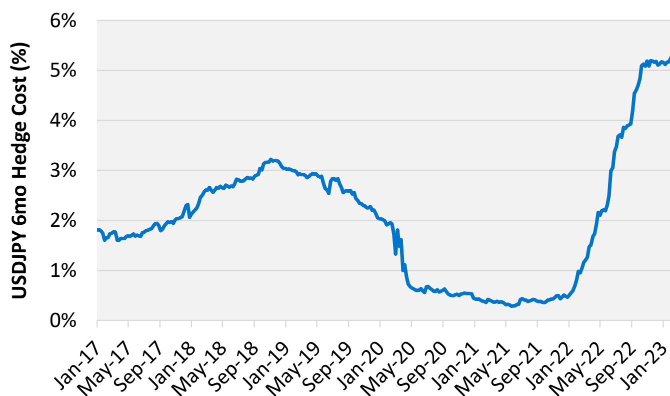


Figure 1
Source: Bloomberg, DoubleLine

Japanese Foreign Savings Repatriation

The Japanese investor base is very different than its U.S. counterpart. With decades of low interest rates and asset returns that have been impaired since the collapse of the great property bubble in the 1990s, Japanese investors have taken their savings offshore, investing in global markets in a big way. They have accumulated a massive position in foreign markets. For years, the Japanese investor invested abroad enjoyed something of a free lunch as lower interest rates worldwide suppressed interest rate differentials among G-7 countries and clapped a low if artificial ceiling on FX hedging costs. Consequently, Japanese investors were able to chase foreign assets without having to worry about the potential drag from FX hedging costs. This weighed on domestic asset prices as capital left the country's domestic markets.

One measure of the amount of assets the Japanese investor base holds in foreign assets is the net international investment (NIIP) reported by the BOJ. Japan has the largest pool of external savings per person in the world, as measured by its NIIP. Japan maintained a large NIIP of $3.6 trillion at the end of 2021 (or about 70% of gross domestic product).

Japanese investors sold ¥23.8 trillion in foreign sovereign bonds in 2022, compared to purchases of 1.9 trillion in 2021 and 20.5 trillion in 2020. 2022 was the first year of net sale of foreign sovereign bonds by Japanese investors since 2017, when they sold a mere ¥600 billion, and it is the largest annual sale seen in the data, released by the Ministry of Finance, which goes back to 1996. Last year, Japanese investors sold ¥15.7 trillion of U.S. bonds, following by sales of ¥1.8 trillion of French and ¥1.2 trillion of German government bonds.

For years, the BOJ has run ever-more aggressive monetary policy, culminating in YCC in September 2016. The impact of this policy has been seen across markets, but, in effect, Japan has outsourced its monetary policy to the United States, allowing the yen to serve as the adjustment valve. In the era of minor central bank adjustments worldwide from 2016 to 2021, the Japanese yen underwent little movement. This equilibrium broke in 2022 as inflation spiked across the globe, causing the central banks outside Japan to hike rates.

Tracked on a rolling one-year basis, Japanese investors have been selling foreign bonds at a greater pace this past year than at any time since the early 2000s. *(Figure 2)* The reason for this is likely that the cost of holding fixed income assets has risen dramatically as the cost of currency hedging these assets has risen. This year that dynamic should not be as big of a headwind given the weakening yen, as investors have been compensated to hold low hedge ratios. But if the yen starts to stabilize, that could increase pressure on Japanese investors to repatriate more capital.

Japan Holdings of U.S. Long-Term Securities
December 2016 through November 2022, Monthly

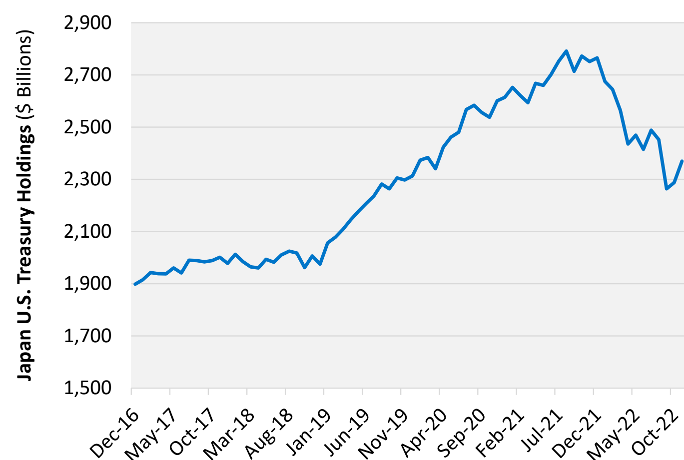


Figure 2
Source: Bloomberg, DoubleLine

Historically, the large pool of Japanese savings invested abroad served for decades to stabilize the yen. When global markets deteriorated, Japanese investors would repatriate cash in a flight-to-safety trade out of emerging markets into their home market. Today, we are seeing a steep decline in the foreign savings of Japanese investors as they pull out of non-Japanese fixed income. In a global environment where liquidity has remained challenged, this could lead to further pressures on international markets.

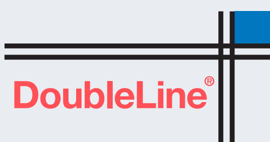
The cocktail of high hedging costs with lower potential returns offered for international investments may weigh heavily on Japanese institutions as they reach their fiscal year-end at the close of March. This is when many board meetings will take place, raising the potential for waves of further repatriations of Japanese global savings.

Riptide

The loss of Japan as a source of global liquidity comes at a dangerous time given markets are already under pressure from the removal of liquidity by most of the world's largest central banks. In the U.S., the Fed is reducing its balance sheet through QT, a process that policymakers likely intend to pursue well beyond after the federal funds rate reaches its terminal level. In Europe, the ECB has slowed the pace of its reinvestment policy, effectively reducing the amount of liquidity being provided markets. The Bank of England is actively selling bonds off its balance sheet. The net impact from these actions is a tightening of market liquidity conditions, a development exacerbated by Japanese capital repatriation.

This risk in today's market is akin to a riptide. In the wake of moderating inflation, the markets have priced in expectation of an end in 2023 to the current cycle of central bank rate hiking. That optimism is masking the lurking riptide of liquidity withdrawal from global markets.

Another mask over liquidity withdrawal is the U.S. Treasury. The Treasury has been drawing down its general account at the Fed as it enacts so-called emergency measures to stave off a default on the U.S national debt. When withdrawn, this cash increases liquidity into the system, counterbalancing to some degree the liquidity withdrawal due to QT by the Fed and other central banks, and Japanese liquidation of foreign holdings. The impact of these liquidity withdrawals might go unnoticed by the markets for a time. However, like a swimmer caught unaware in a riptide, investors who fail to pay attention to these trends could pay the price in the markets and get pulled under an offshore current of illiquidity. ■



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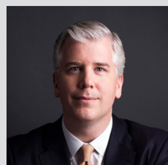

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Mr. Campbell joined DoubleLine in 2013. He is a Portfolio Manager for the DoubleLine Global Bond Strategy and is a permanent member of the Fixed Income Asset Allocation Committee. He covers Developed Markets, Central & Eastern Europe, Middle East and Africa (CEEMEA), and China. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Previous to that, he spent over five years with Nuveen Investment Management Company, first as a Quantitative Analyst in their Risk Management and Portfolio Construction Group, then as a Vice President in their Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a BS in Business Economics and International Business, as well as a BA in English, from Pennsylvania State University. Mr. Campbell holds an MA in Mathematics, with a focus on Mathematical Finance, from Boston University.

Basis Points (bps) – One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Federal Funds Terminal Rate – This rate is what economists call the "natural" or "neutral" interest rate. It is the rate that is consistent with full employment and capacity utilization, and stable prices.

Foreign Exchange (FX) – Foreign exchange (forex or FX) is the trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market, also known as the forex market.

G-7 (Group of Seven) – Forum of the seven countries with the world's largest developed economies whose government leaders meet annually on international economic and monetary issues. The member countries are: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Net International Investment Position (NIIP) – includes overseas assets and liabilities held by a nation's government, private sector and citizens. The NIIP is analogous to net foreign assets (NFA), which determine whether a country is a creditor or debtor nation by measuring the difference in its external assets and liabilities.

Quantitative Tightening (QT) – Reverse of quantitative easing (QE); a central bank that acquired financial assets under QE undertakes steps to reduce its balance sheet.

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