FX Flash

JPY Safe Haven Appeal Returns As Japanese Banking Sector Holds Up

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- **Concerns have emerged regarding Japanese banks due to their large bond holdings**
- **Japanese Banks overall have an exposure that is predominantly domestic**
- **Major banks have the largest foreign bond holdings but they have already been shortening duration**
- **Japanese banks have to be more concerned about domestic than foreign interest risks**
- **Even so, major BOJ tightening is a long way away given economic conditions and we only see a 25bps YCC widening this year, of which effects are less material**
- **The JPY has recently again been more attractive as a safe haven amid falling yields and the relatively better standing of the Japanese bank sector**
- **USDJPY is currently hovering around our end 1Q 2023 forecast of 132.00 and directionally we see it heading lower this year amid a possible softening Fed stance**

Japanese Banking Sector in Relatively Better Standing

Within Asia, Japanese banks look to be the most exposed to both Europe and US. Aside that, Japanese banks also have a shared characteristic with SVB in the sense that they have substantial holdings of bonds. This creates concerns that Japanese banks face the risk of ending up in a similar situation amid the high interest rate environment. However, based on our analysis, we don't necessarily see that this risk as significant for a few reasons.

If we look at the books of the Japanese banks, we find that a substantial amount of the holdings are held in Yen denominated bonds across the entire banking sector. All three types of banks – the major banks, regional banks and the shinkin banks all predominantly still hold Yen denominated bonds. This implies that the nature of their exposure is more domestic than it is foreign. Japanese regional banks have also been known to have already sold some of their foreign bond holdings last year as they took profit given the Fed's hawkish tilt.

We are aware though that this does not mean that they do not have a reasonably size exposure to foreign holdings except that it would be mistaken to believe it as outsized. Major banks in particular still have large holdings of foreign bond, mainly in USD with much less Euro exposure. However, according to the October 2022 BOJ Financial System Report, these banks have actually been shortening the duration of their bond portfolio in anticipation of Fed hikes. The same report also notes that the value-at-risk (VaR) for major banks (when there is a 200bps rate increase) is at about 2.8trillion Yen with regards to their foreign bond holdings. This compares to the total overall assets held by the domestic branches of all Japanese licensed banks at 1,365,534trillion yen as of end Jan 2023, making the VaR less material a matter. If anything, given the possibility of the Fed softening its stance amid the current banking crisis, falling yields are now working more in favour of these major banks. We do note that the strengthening JPY does imply lower gains from these foreign bond holdings. (For interest sake, BIS data shows that Japanese banks have a net exposure of $68.7bn to US banks as of end Q3 2022).

Additionally, Junichi Hanzawa, Chairman of the Japanese Bankers Association and the chief executive of MUFG Bank has mentioned that major banks are known to have hedged their positions in foreign bonds, protecting them from aggressive interest rate hikes from the Fed.

As it stands, Japanese banks would have to be more concerned about domestic interest rate risks rather than what has been happening overseas. However, a significant major tightening move by the BOJ may still be some time away especially given economic conditions. Whilst inflation has been higher in recent times, it also has been more supply rather than demand driven. Wage growth is not generally picking up and that has been a crucially watched factor in gauging whether inflation can more sustainably rise. That said, Japan's key labour unions and their employers have recently reached a preliminary agreement to raise overall wages by 3.8% - the most since 1993 and above economists' expectations of 2.95%. Whilst the number is impressive, we continue to watch closely if it can even eventually feed into higher sustainable inflation.

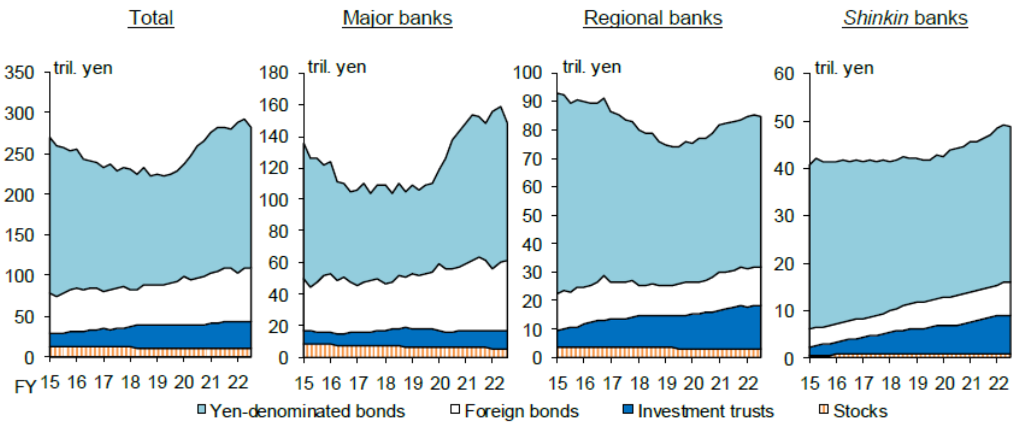
The new incoming Governor – Kazuo Ueda at the same time also appears to be a supporter of negative interest rates based on his past comments although he is much less supportive of the YCC. We think it possible that he could widen the YCC by 25bps to +/-0.75% this year as a first step to gradually exit the policy but that would also depend on how conditions evolved. Based on BOJ numbers from their October 2022 Financial System Report, a 25bps increase would only imply a VaR of about 2.5trillion yen, again making the rise less of a material matter. Overall, it appears Japanese banks generally are spared from the bonds stress associated with higher interest rates.

What does this imply for the JPY?

Recently, the JPY has been seeing a renaissance as a safe haven with the currency having strengthened since the onset of the banking crisis. Aside the fall in UST yields likely having given it support, the relatively better standing of the Japanese banking sector could have also played a part in raising the appeal of the JPY. This contrasts to the other two alternative safe havens of CHF and USD, which have been directly and heavily exposed to the recent banking crisis, making them less in favour. Currently, the USDJPY is also hovering close to our 1Q 2023 forecast of 132.00. Directionally, we are expecting the USDJPY to continue to head downwards towards the 128.00 by end 2Q 2023 on top of the possibility that the Fed may have to soften its stance given the risks related to financial sector stability. Our year end forecast stands at 122.00. We therefore continue to hold our recommendation of short USDJPY this year.

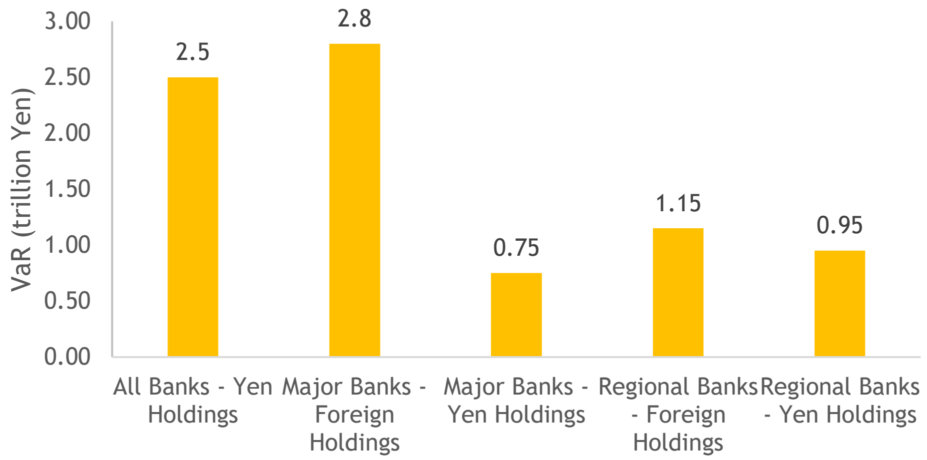
Looking at the elasticity of Asian currencies (see chart 4), we find that the KRW, THB and PHP show the highest sensitivity to JPY movement. This comes as little surprise given the close trade links between Korea and Japan and the large presence of FDI inflow from Japan into Thailand and the Philippines (directly or via Singapore). The IDR in fact also has a reasonable level of sensitivity with respect to the JPY movement given the high level of FDI from Japan into Indonesia too. Meanwhile, the MYR's high sensitivity to the JPY we believe could be due to both the economic links between Japan - Malaysia and also coincidence as the two currencies can be heavily affected by USD movements concurrently. As for the other currencies, other factors could be playing a larger role in their movements even if they may have strong economic links with Japan.

Chart 1: Investment Securities of Japanese Banks



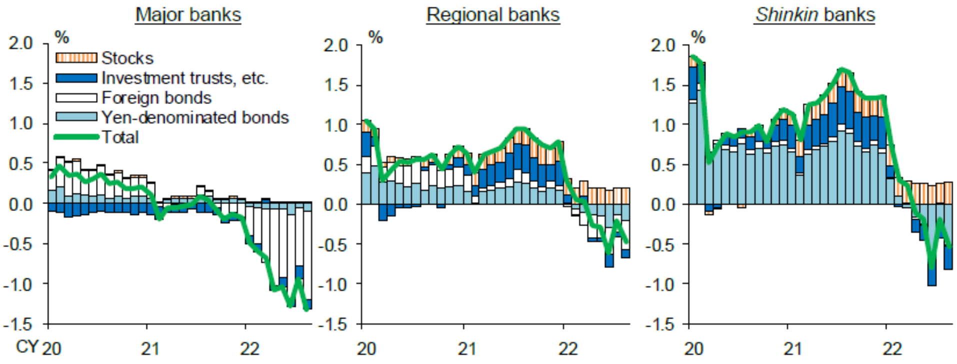
Source: October 2022 BOJ Financial System Report, BOJ

Chart 2: VaR of Japanese Banks with respect to type of Bond Holdings



Source: October 2022 BOJ Financial System Report, BOJ, Maybank FX Research and Strategy
Note: VaR for foreign holdings refers to a 200bps increase whilst for Yen holdings, it refers to a 25bps increase

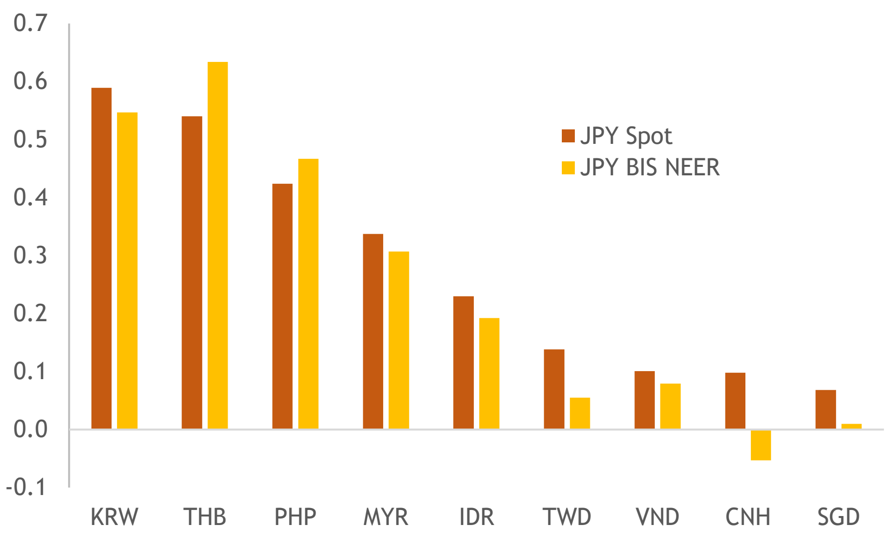
Chart 3: Valuations Gains/Losses On Securities Holdings



Source: October 2022 BOJ Financial System Report, BOJ

Note: All data for chart 1 – chart 3 is as of August 2022 and we still view the data as possibly implying a very stressed scenario for Japanese given it is unlikely they accumulated more holdings of foreign bonds amid the rising rates

Chart 4: Asian Currencies Elasticities to JPY Spot and JPY NEER



Source: Bloomberg, BIS, Maybank FX Research & Strategy
Note: Elasticities are calculated based on an OLS of Asian Currency-USD on JPYUSD or BIS JPY NEER during the period of 2 Jan 2018 – 20 Mar 2023

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