6th June 2024

JPY: Liftshaft Alert

In February, we published an FX Special Focus piece titled *Turning Japanese*. In that piece we examined the monetary and fiscal position of Japan, the politics (a little) and the market set up. We introduced the elevator / liftshaft metaphor, whereby steady gains from carry and momentum have a habit of reversing violently. The conclusion at the time was watch and wait.

We now want to review whether we have moved closer to an inflection point in JPY and conclude by recommending initiating ***tactical*** hedges with a bias for JPY strength in the next few weeks.

Shorting JPY has been a great trade. It has had momentum and carry in its favour, has been relatively stable and has consequently generated excellent Sharpe's ratios. Put another way, the carry to historical volatility ratio has been a significant tailwind for JPY carry traders and the trade has become very crowded.

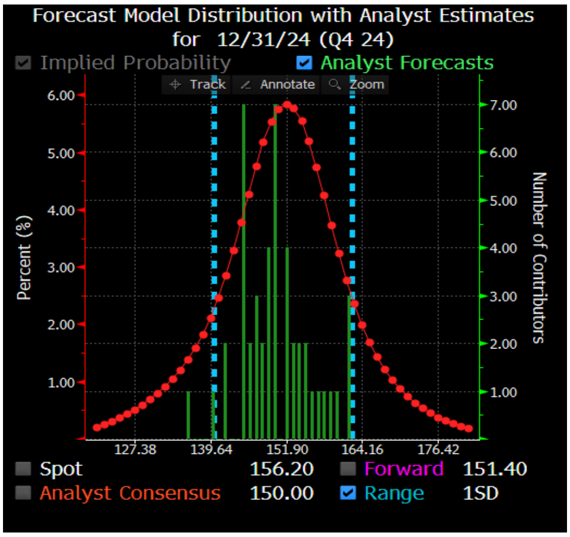
In this follow-up piece, we want to focus mainly on the technical set-up, we update some of the charts from the aforementioned piece and conclude that buying JPY here (and using USDJPY puts if you are able) has an attractive risk reward as well as providing a "cheap" tail hedge for those concerned about a more unstable FX environment or a more generalised "risk-off" episode.

Highlights:

- **Consensus Forecasts have followed the spot price higher**
- **Less Positive Carry**
- **More Extended Positioning**
- **Option Pricing on the cheap side of neutral**
- **Trade: Sell USDJPY. Buy USDJPY OTM Puts.**

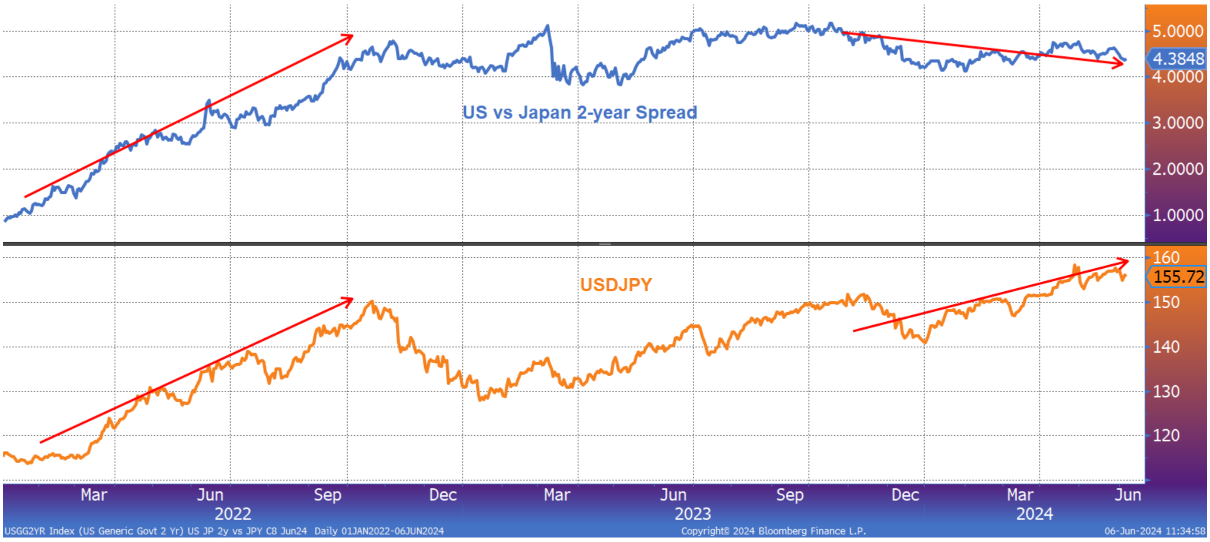
Consensus Forecasts have followed the spot price higher

Mainstream analysts' consensus for USDJPY at the end of 2024 has moved higher in line with the spot price since the end of last year. It is now very close to the forward price (whereas it was previously below it). Expectations remain largely contained within 1 S.D. of the current price, implying complacency.

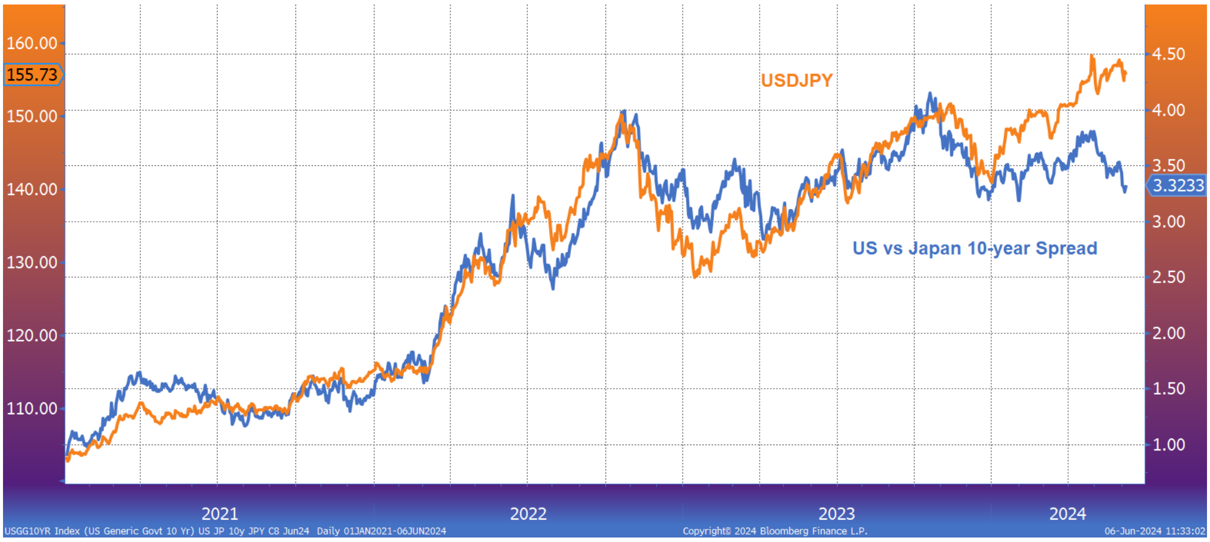


Less Positive Carry

Carry has reduced a little as BoJ has moved closer to raising rates. Thus far they have restricted themselves to removing YCC (which has allowed 10-year JGB yields to move above 1%) and reducing their QE JGB buyback programme. The 2yr USD yield spread vs Japanese 2yr yield has begun to narrow (marginally)

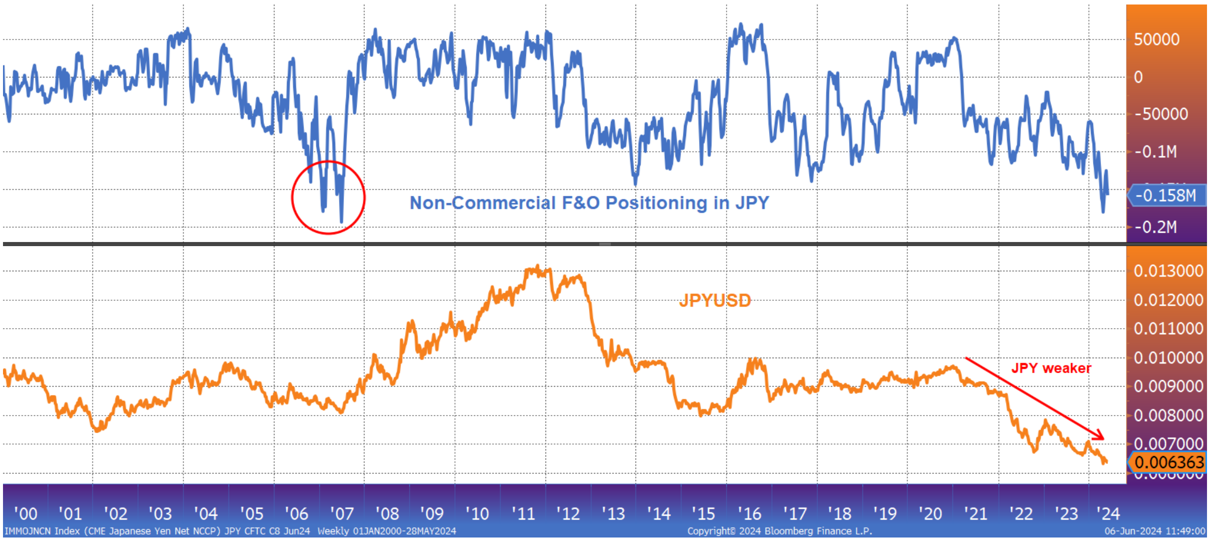


With the removal of YCC and the recent US 10-year rally, the 10-year Treasury vs 10-year JGB spread has moved more out of line with USDJPY. Any tendency for weaker data in the US will likely push this spread tighter.



More Extended Positioning

Despite this, positioning (here proxied by CFTC Commitment of Non-Commercial Traders in JPY with JPYUSD (i.e. USDJPY inverted shown beneath)) shows how JPY short positions have become more extended. You will observe that we last saw these levels of JPY shorts just before the GFC.

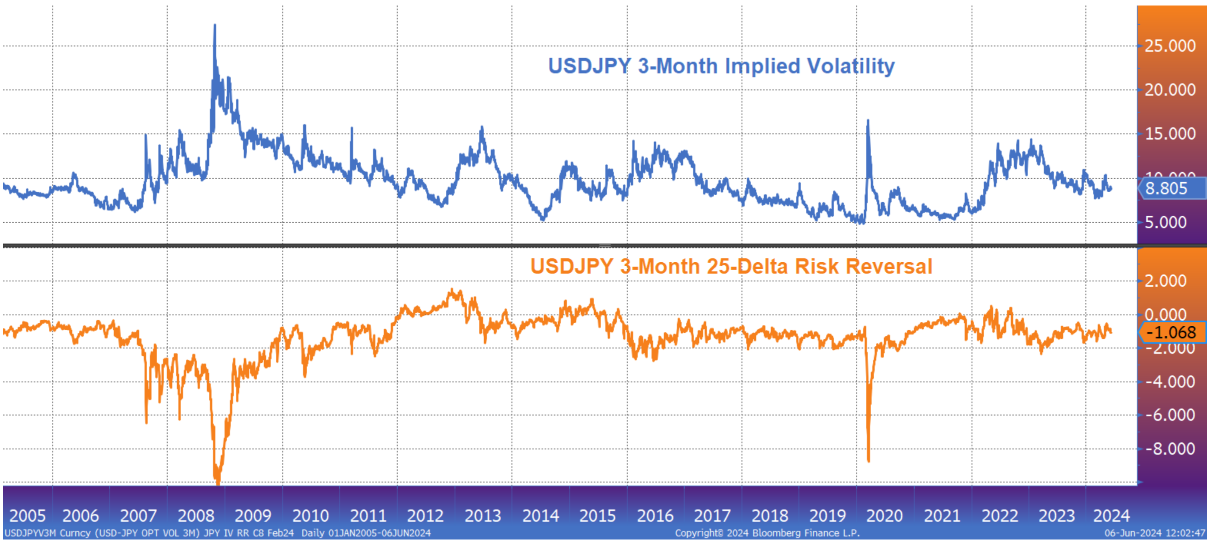


Famously, Mrs. Watanabe, the mythical FX carry-trading Japanese housewife, is also now very exposed to EM especially. She has done very well, but recently woke up to a rather violent move in MXNJPY, one of the most popular and successful carry trades of the last two years. The trigger was the landslide victory of AMLO's protégé, the left-leaning President Sheinbaum, in the elections held in Mexico last weekend.

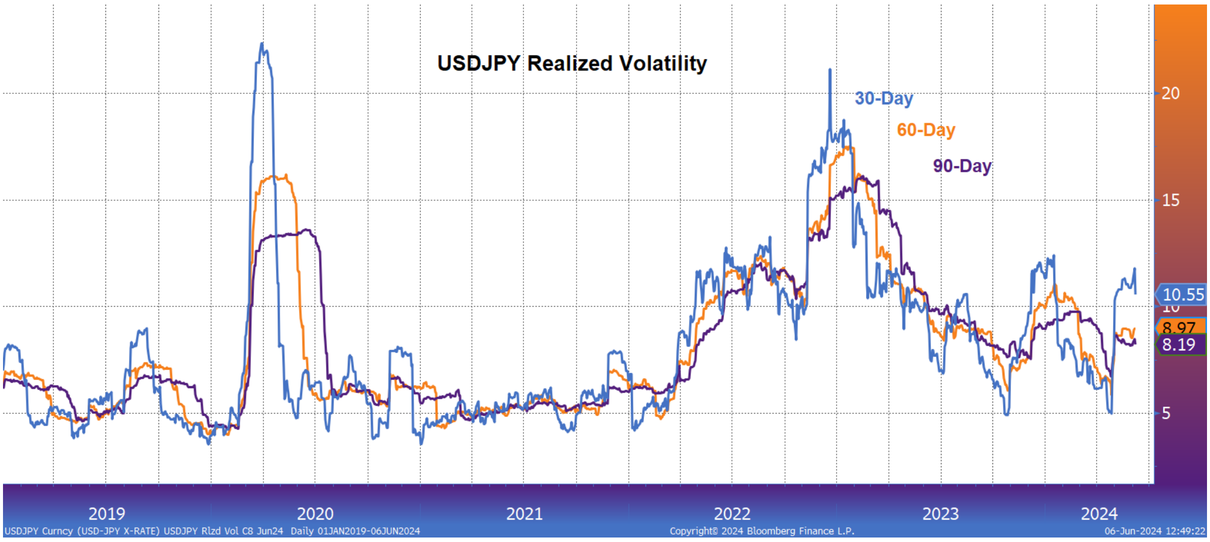
If you add carry to the spot price, the total gain since early 2022 was closer to 90% at the recent highs. It is hard to argue that the trend has conclusively broken. What is apparent, though, is this is a shot across the bow of the carry to vol argument and may have turned a few stomachs earlier this week.

Option Pricing on the cheap side of neutral

At <9%, USDJPY 3-month implied volatility is on the cheap side of neutral. Risk-reversals sit within their zero to -2% comfort zone…



… and realised volatility is within spitting distance of implied vol.



Trade:

Sell USDJPY at ~156. Target 150, then 143.70. Stop on a close above 158.50 or no material confirmatory price action within the next couple of weeks.

And / or:

Buy USDJPY 3-month 20 delta puts for ~10% implied, ~0.6% of notional. Look for an impulsive move <150 (around the 200d M.A.) to partially cover delta at which point there would likely be a decent kick in implied volatility. Secondary target ~143.70 (the 50% Fib of the 2023/24 escalator). Close on a move back above 158.50 (new closing highs) or no material confirmatory price action within the next couple of weeks. Risk no more than ½ premium.

Summary

There is a window emerging for position reduction in the widely held JPY carry trade. Positions are crowded at the same time that the rationale for the extension of the current benign regime is diminishing (carry, carry-to-vol, policy divergence, etc). There is no sense of danger within analyst expectations or embedded in option pricing.

While we lack an immediate catalyst, sometimes price can be its own trigger. With USDJPY around 156 and an easily defined stop loss, the risk reward of engaging with JPY strength is compelling. Escalator / liftshaft price action provides significant convexity. Crowded JPY shorts would also need to be covered in the event of a risk-off catalyst coming from other asset classes.

Owning USDJPY puts can be an attractive portfolio hedge for investors concerned about general market complacency or for more active tactical FX managers and traders.