T. Rowe Price

Ahead of the Curve
The San Andreas fault of finance shakes the markets

From the Field
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Key Insights

- Bank of Japan monetary tightening and its impact on the flow of global capital is far from simple, and it will have a large influence over the next few years.
- While yen strengthening and crowded trades were a handy explanation for early August's volatility, my sense is it was the start of something, not the end.
- From a Japanese domestic perspective, modestly higher Japanese yields could draw large flows back into the country in the longer run.

Arif Husain
Head of Fixed Income and Chief Investment Officer, Fixed Income

Thin summer liquidity conditions coupled with crowded leveraged positions across the market set the kindling for a potential market shock. And so in early August, all it took was a spark to ignite an extraordinary volatility shock. The Bank of Japan's (BoJ) move to tighten monetary policy provided that catalyst.

The yen carry trade

At a recent T. Rowe Price Board meeting, one Board member quipped that over the last few days they had suddenly become an expert in the "yen carry trade." Many fingers have pointed to this leveraged set of positions as the culprit for triggering the collapse in markets and the spike in the Chicago Board Options Exchange Volatility (VIX) Index. In my opinion, while the yen carry trade certainly played a part, it is more a convenient ex-post narrative to explain the price action than a true driver of the volatility. The scapegoating of the yen carry trade ignores the start of a bigger and deeper trend.

When talking with clients in 2023, I sometimes referred to the BoJ as the San Andreas fault of finance. That was early, but I believe that we have just seen the first shift in that fault, and there is more to come.

BoJ loosens yield curve control

The BoJ has started gradually hiking rates. The Japanese central bank has also loosened its yield curve control policy, which uses Japanese government bond (JGB) purchases to essentially cap yields. The BoJ moved the upper bound of its benchmark interest rate to 0.1% in March from -0.1%—where it had been since early 2016—and raised rates again at the end of July, bringing the upper bound to 0.25%.

At its June policy meeting, the BoJ said that it will start to "significantly" scale back its asset purchases from its current JPY 6 trillion monthly pace over the next one to two years. The BoJ took a step further at its July meeting by saying it would slowly reduce the buying pace, aiming to halve its current monthly amount by early 2026. But the massive amount of JGB issuance needed to fund the country's deficit means that the central bank likely won't stop its purchases or let its balance sheet run off by not reinvesting the principal from maturing bonds, as the Federal Reserve has been doing since June 2022.

Not surprisingly with this backdrop, JGB yields have been rising. In late August, a 30-year JGB hedged to the U.S. dollar provided a yield greater than 7%. To put that into context, the 30-year U.S. Treasury yield was roughly 4%. One would need to stretch far down the credit ratings scale to low investment-grade or even high yield to match the dollar-hedged JGB yield in the U.S. credit markets. In a world of massive debt issuance where different issues are competing for a limited amount of funds, yield matters!

Higher yields to draw Japanese domestic investors back to JGBs...

From a Japanese domestic perspective, what if modestly higher Japanese yields draw large flows back into the country in the longer run? At some point, higher Japanese yields could attract the country's huge life insurance and pension investors back into JGBs from other high-quality government bonds, including U.S. Treasuries and German bunds. In effect, this would rearrange demand in the global market. I believe an overweight allocation to JGBs would benefit from this shift.

...and away from U.S. and German government bonds

In my view, a corresponding underweight position in U.S. Treasuries would benefit from upward pressure on Treasury yields as Japanese institutional investors move out of the U.S. and back into Japan. Other factors—including the country's deteriorating fiscal situation and the accompanying elevated levels of new Treasury issuance—also lead me to expect higher U.S. yields on the longer-term horizon.

Faster inflation could lead to more aggressive BoJ tightening

Of course, this approach isn't without risk. Japanese inflation could wind up higher than expected in the second half of the year in the event of continued weakness in the Japanese yen or unexpectedly strong wage growth. This could lead the BoJ to raise rates again at its October meeting and slow its asset purchases further.

Weakness in the Japanese yen could, all else being equal, lead the BoJ toward more rapid tightening. But rate cuts from other developed market central banks would offset that to some degree. Earlier in 2024, the yen hit its weakest point against the U.S. dollar since the mid-1980s and its lowest versus the euro since the introduction of the eurozone currency in 1998. But with the Fed seemingly eager to lower rates and the European Central Bank having already started to loosen policy, the BoJ won't be under as much pressure to make Japan's interest rates more competitive.

Shifting capital flows, dissipating tailwinds

Overall, while the yen carry trade was again a convenient explanation, my sense is that the broad market volatility on August 5 was the start of something as opposed to the end. BoJ tightening and the impact it will have on the flow of global capital is far from simple, but it will have a large influence over the next few years. However, in the context of other mega-trends such as unsustainable fiscal expansion in a number of developed countries, volatility shouldn't be a shock—it should be more the norm.

Put a different way, there were several tailwinds that had existed for investors since the global financial crisis. Like it or not, the wind has changed, and the next few years could be tougher. The shifting global capital flows resulting from the BoJ's tightening is one of those changes, and astute investors should be aware of the impacts.

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