



October 31, 2008

The unwinding of Yen carry trades

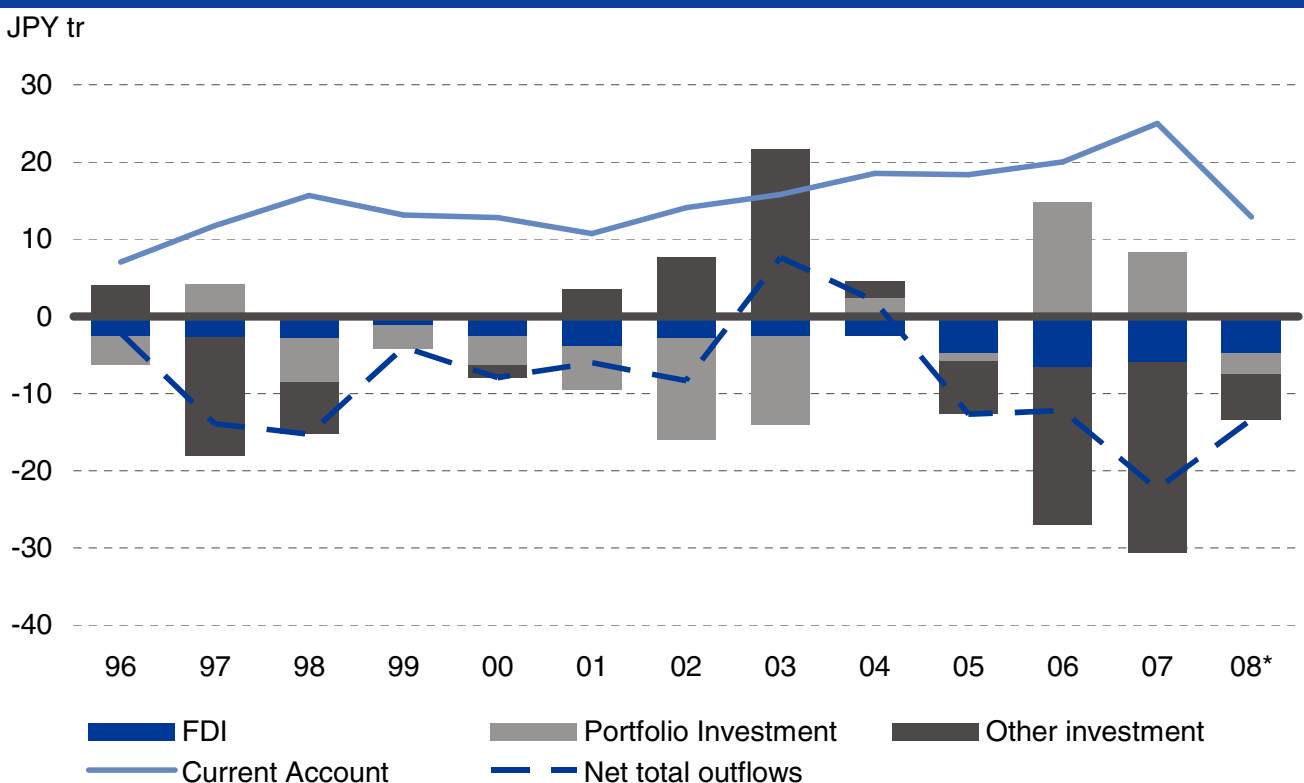
Some empirical evidence

Chartbook

Global Risk Analysis

- Many years before the sub-prime crisis hit global financial markets, JPY funded carry trades were said to be popular among investors that were willing to take risks. A yen carry trade describes a strategy in which investors borrow cheaply in JPY to invest in higher-yielding assets such as US stocks or Australian bonds. During times of strong global growth, abundant global liquidity, strong risk appetite, surging asset prices and low financial market volatility, yen carry traders benefited both from exchange rate gains and a positive interest rate differential.
- With the credit bubble having burst and spill-over effects spreading to the world economy, the Japanese currency has appreciated massively against most major currencies, in particular vis-à-vis the high-yielding Australian and New Zealand dollar. This appreciation can be attributed to higher global risk aversion and a shrinking interest rate differential of the JPY against major currencies.
- Although the Japanese economy is headed for recession and not at all doing better than most of its peers in terms of GDP growth, the interest rate differential should narrow further as the BoJ has only limited room to trim interest rates (the BoJ trimmed its overnight target call rate this Friday to 0.3%) while other major central banks are set to cut rates even more aggressively over the coming months.
- Although global yen carry trades are difficult to track, empirical evidence (as e.g. gauged by balance-of-payments data, net JPY future positions from the US Commodity Futures Trading Commission and foreign banks' borrowing in Japanese money markets) suggests that the activity of JPY funded carry trades has clearly softened since mid-2007. While the amount of foreign assets held by Japanese households shrank with the start of the credit crisis, it is not clear to what extent this reduction is due to yen appreciation and how much it is driven by net foreign asset selling. However, borrowing by foreign banks in Japanese money markets has decreased significantly. Moreover, US future markets moved from net short to net long positions in JPY.
- Given heightened global risk aversion and a further shrinking interest rate disadvantage, the JPY may trade sideways or even appreciate further over the short to medium term against the USD and the EUR even after its recent rally. However, the issue of the sustainability of the recent strength of the yen and the Japanese currency's long-term prospects are a completely different story.

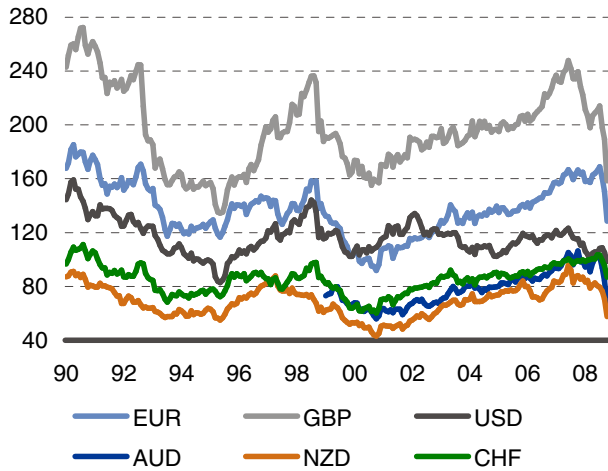
Net capital outflows from Japan have declined in 2008 ytd



* year-to-date (as of August 2008). (-) indicates outflows, (+) indicates inflows. Sources: DB Research, Global Insight

Broad-based yen appreciation since mid-2007

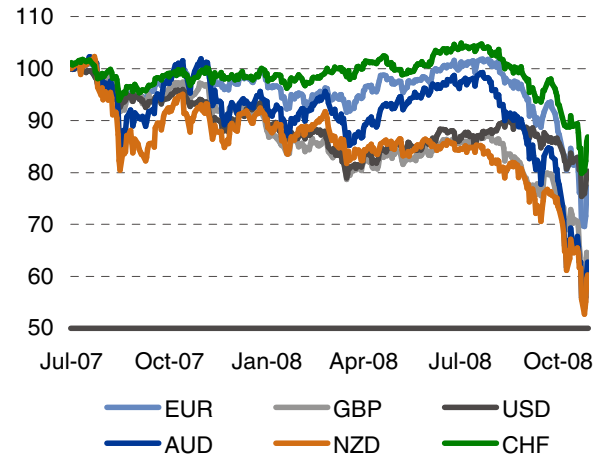
JPY per foreign currency



Sources: Global Insight, DB Research

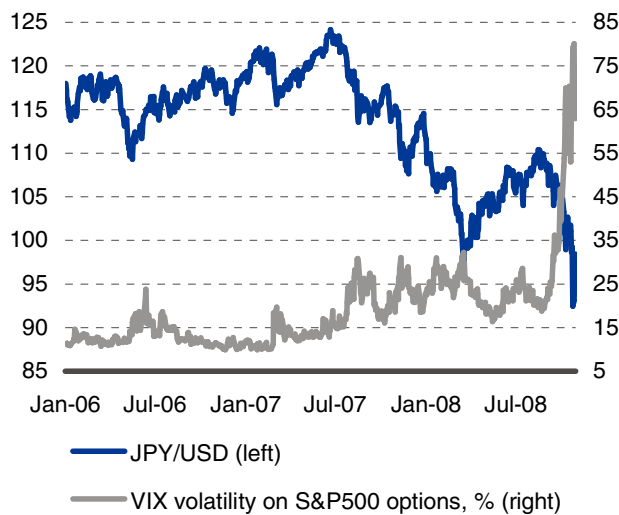
Strongest appreciation vis-à-vis high-yielders, smallest fall against Swiss franc

JPY performance, Index: July 2007 = 100

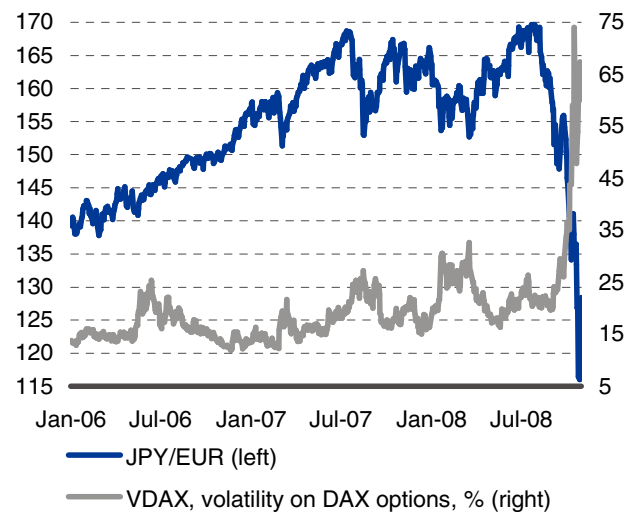


Sources: Global Insight, DB Research

Rising global risk aversion led to sharp yen appreciation



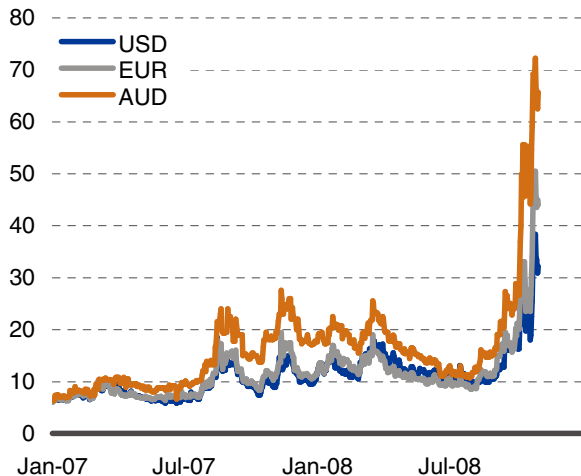
Sources: Global Insight, Bloomberg



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Implied FX market volatility: High, higher, highest!

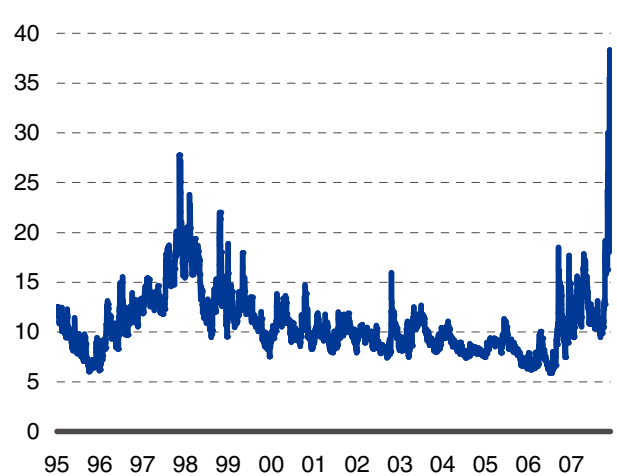
1-month implied JPY volatility vs other currencies, %



Source: Bloomberg

JPY/USD exchange rate volatility has surged above 1998 highs

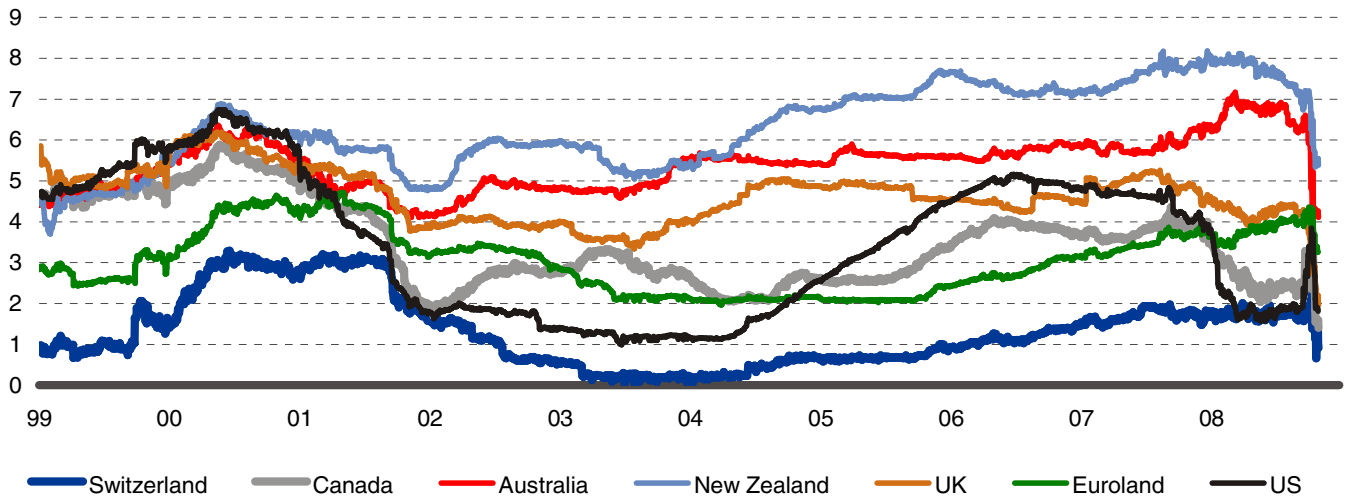
1-month implied JPY/USD volatility, %



Source: Bloomberg

Recently, interest rate differentials between major economies and Japan have diminished considerably at the short end...

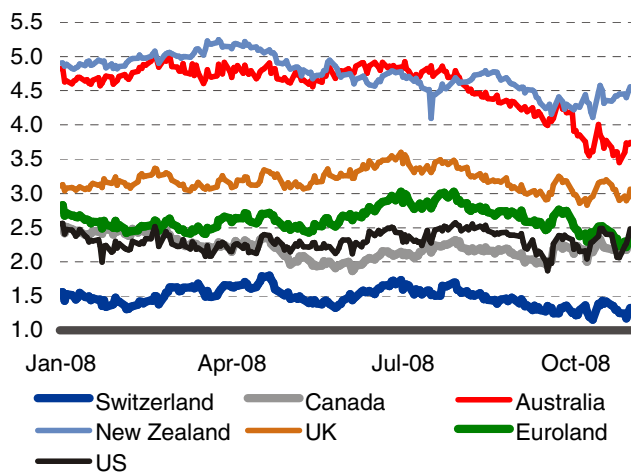
Spreads of 3-month interest rates over Japan, percentage points



Sources: Global Insight, DB Research

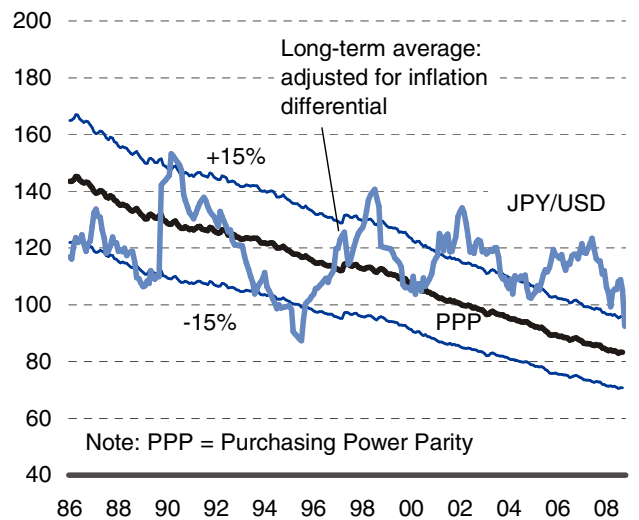
...as well as at the long end of the yield curve

Spreads of 10-year government bond yields over Japan, percentage points



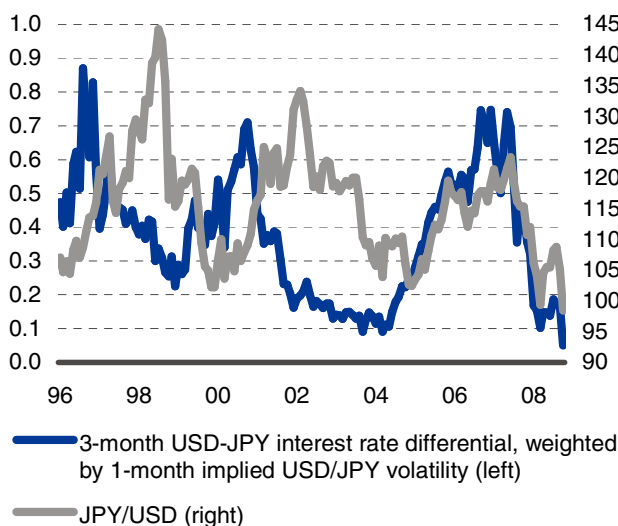
Sources: Global Insight, DB Research

JPY has started to return to its long-term exchange rate fundamentals in terms of PPP

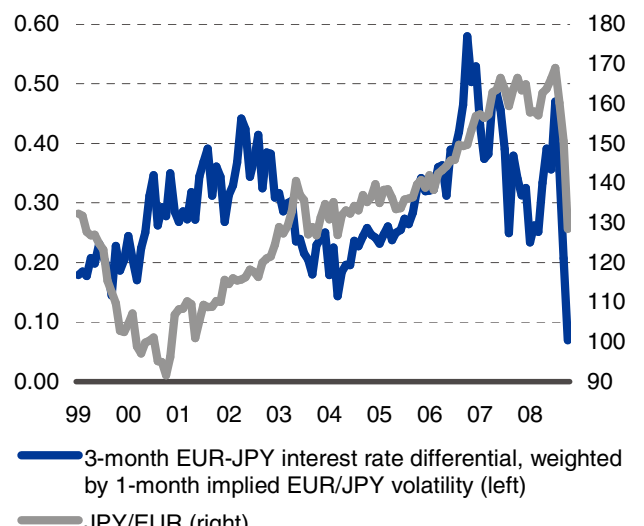


Sources: Global Insight, DB Research

Yen gained on spike in FX volatility and shrinking USD (EUR) / JPY interest rate differential

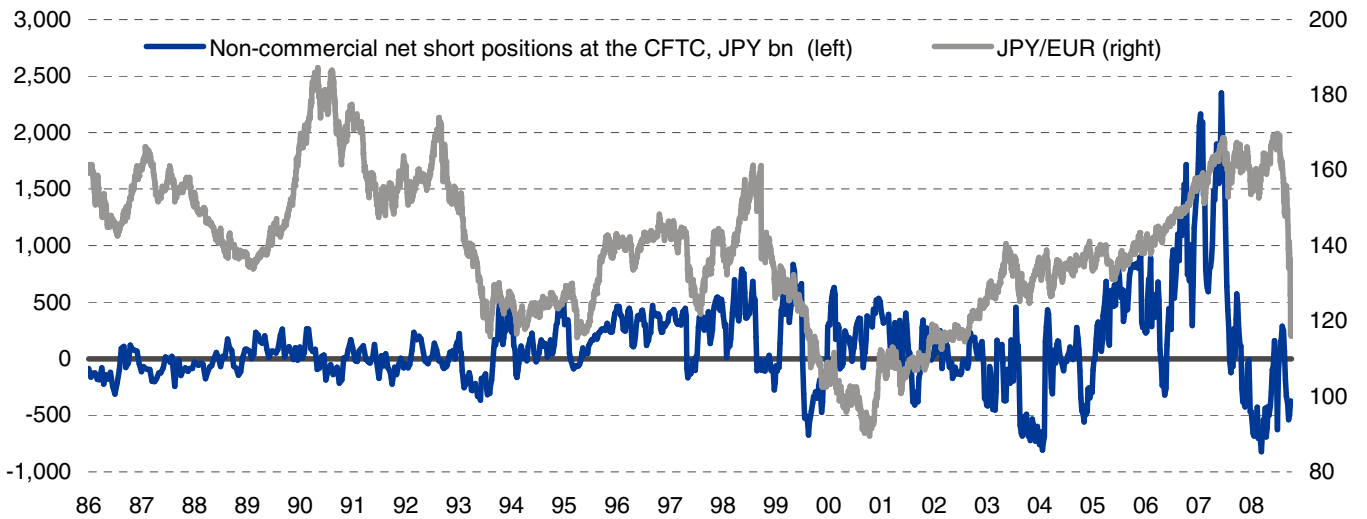


Sources: DB Research, Global Insight, Bloomberg



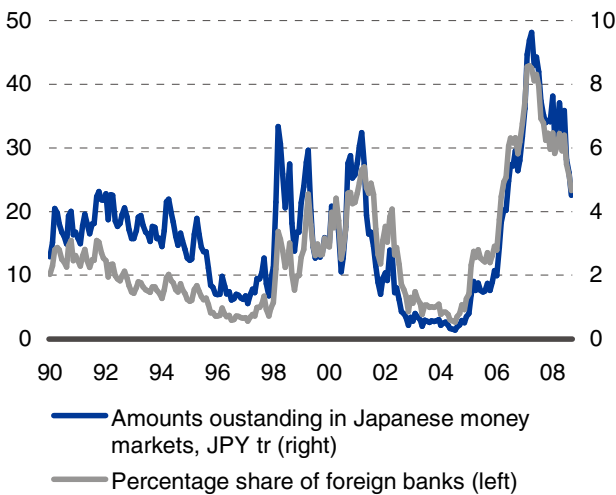
Sources: DB Research, Global Insight, Bloomberg

US CFTC future markets JPY positions: From net short to net long



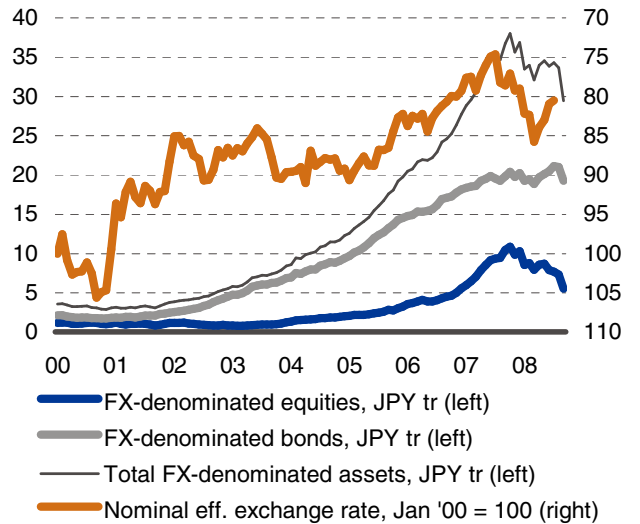
Sources: CFTC, DB Research

Foreign banks have reduced their JPY borrowing in Japanese money markets



Sources: BoJ, DB Research

Japanese investors hold large stocks of FX assets



Sources: Global Insight, Jap. Investment Trust Association

JPY funded carry trades have brought massive losses since mid-2007

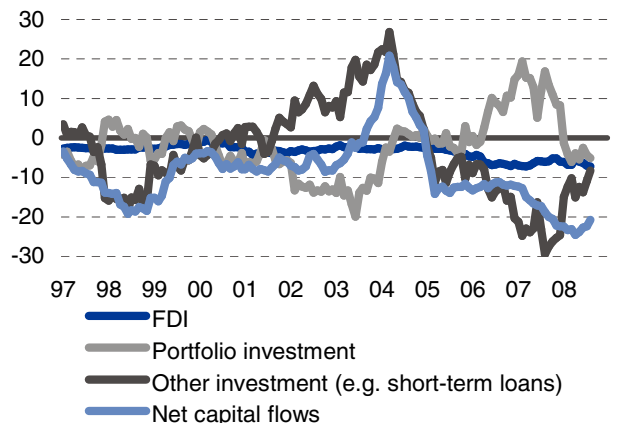
Returns from JPY funded carry trades (buy and hold strategy), Index: 01.01.2006=100



Long basket: USD, EUR, GBP, AUD and NZD with equal weights. Short basket: JPY. Base currency: EUR. Source: Bloomberg

Net capital outflows have decreased recently due to other investment/short-term loans

International net capital flows to Japan 12-month trailing sum, JPY tr

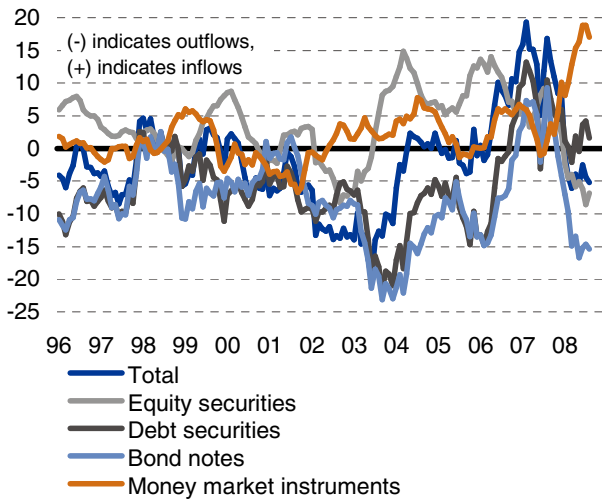


(-) indicates outflows, (+) indicates inflows

Sources: Global Insight, DB Research

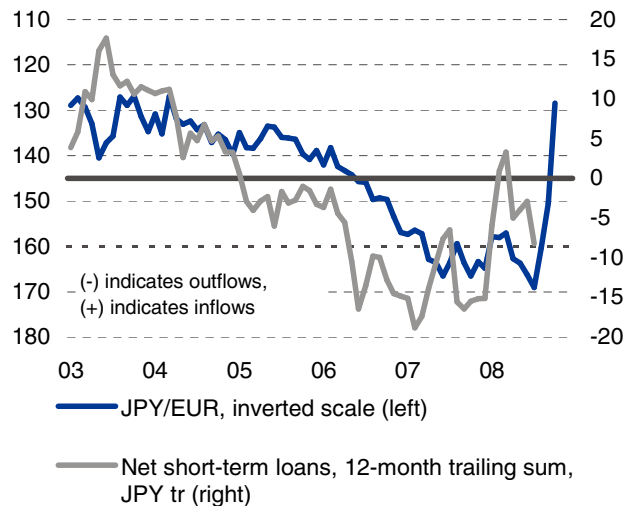
Portfolio investment flows still negative for now

Net portfolio investment, 12-month trailing sum, JPY tr



Sources: Global Insight, DB Research

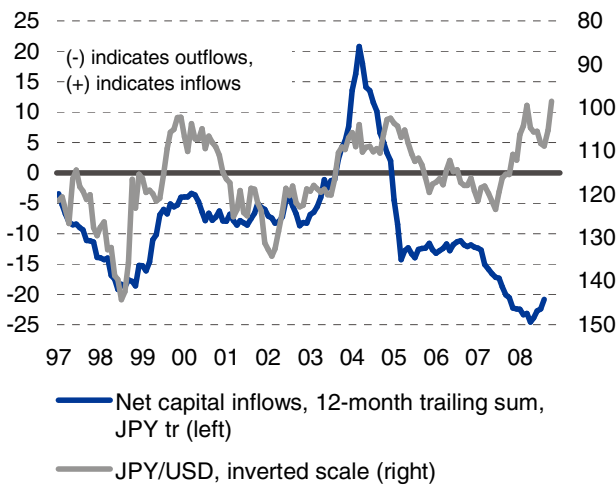
Net short-term loans have weighed on the yen for many years



Sources: DB Research, Global Insight, Japanese Ministry of Finance

Still large net capital outflows from Japan to the rest of the world...

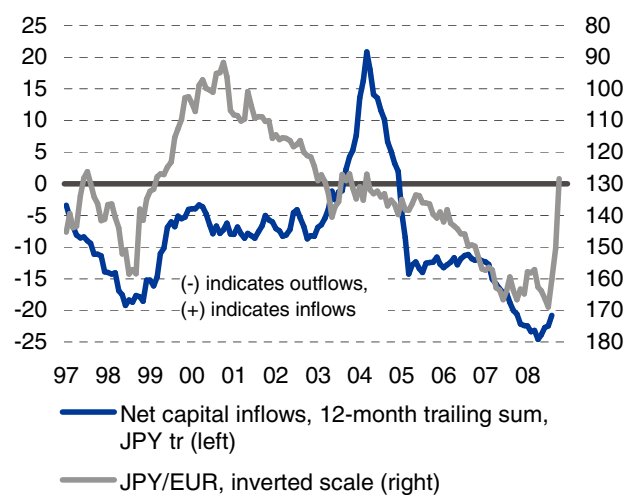
JPY exchange rates and net capital flows



Sources: Global Insight, DB Research

... but rapid JPY appreciation against most major currencies

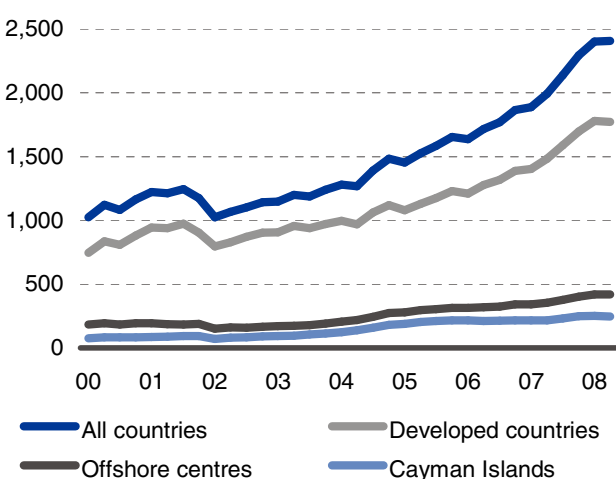
JPY exchange rates and net capital flows



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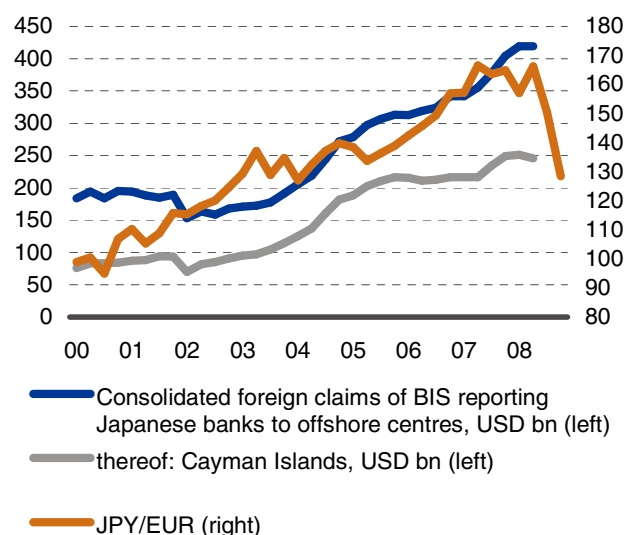
Net consolidated claims of BIS reporting Japanese banks to RoW has surged

USD bn



Source: BIS, October, 23, 2008. BIS data as of Q2 2008.

Is the recent fall of the JPY/EUR exchange rate due to a fall in foreign lending?



Sources: Global Insight, BIS, October, 23, 2008. BIS data as of Q2 2008.

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