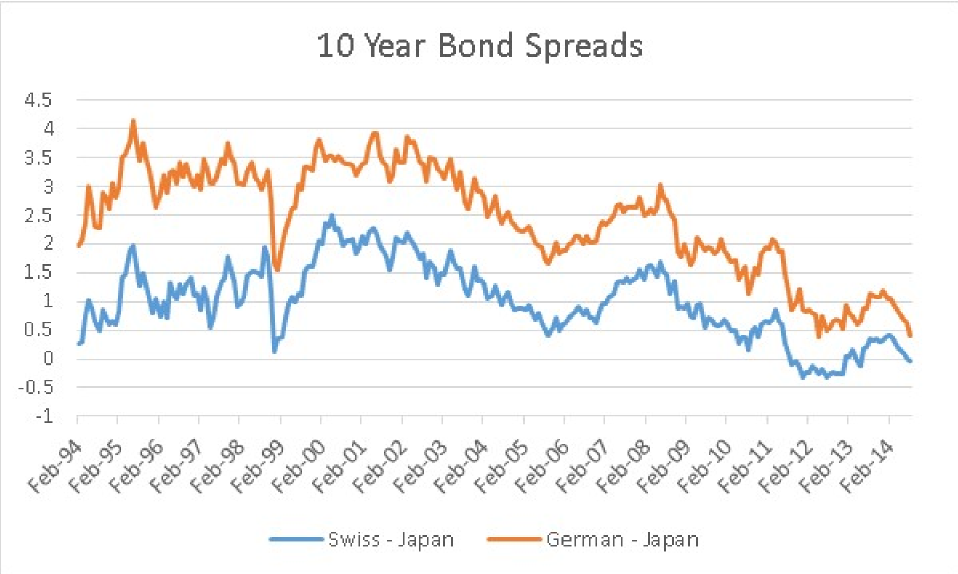
RETURN OF THE WIDOW MAKER – BUY CASE FOR JGBs

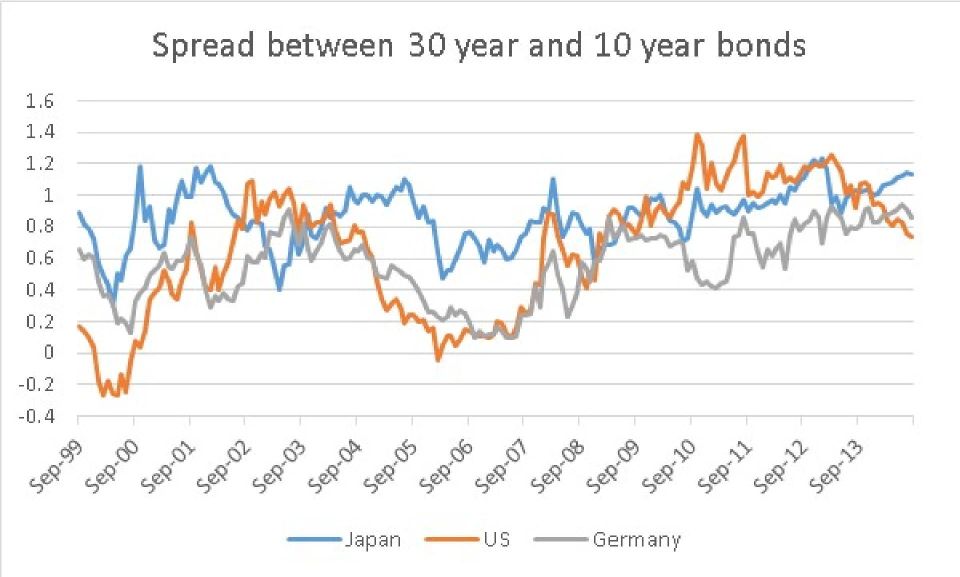
Over the years many investors have declared that Japanese bond yields were totally at odds with either domestic sovereign debt sustainability, levels of economic activity or were too low compared to yields in other markets. Many macro funds have shorted JGBs at various times, only to find yields moving even lower and causing losses. For this reason, the trade of shorting JGBs has been nicknamed the widow maker.

Recent policy action by the Bank of Japan to devalue the yen and bring inflation back to the Japanese economy has seemingly motivated a number of fund managers to at least think about putting the widow maker trade on.

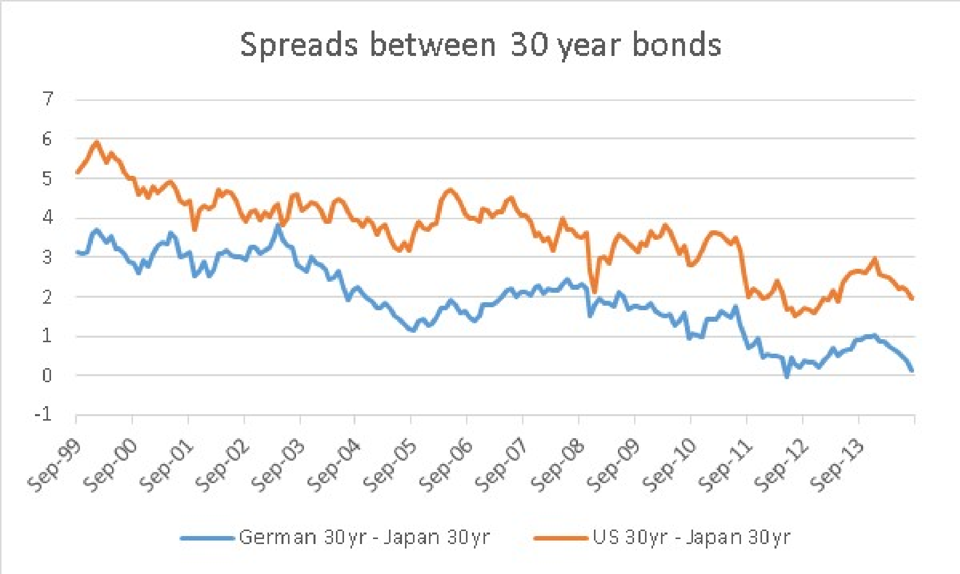
It seems to me that that the yield contraction in other markets make certain JGBs quite attractive. As can be seen below, the difference between Japan 10 year bond yields and German and Swiss bonds are now low or non-existent.



While most bonds have rallied significantly this year, one laggard has been 30 year JGBs. The spread between 10 year and 30 year JGBs is now larger than either the US or Germany.



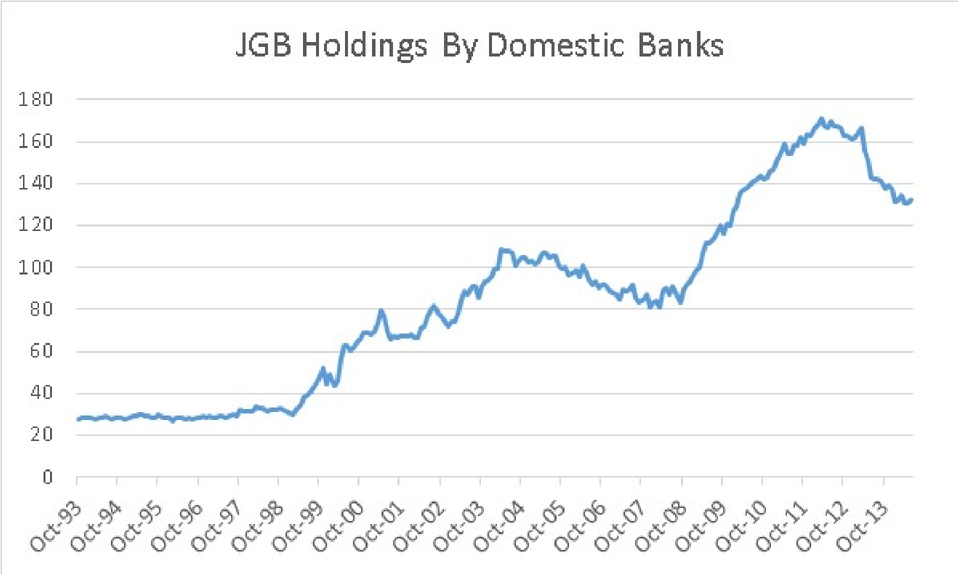
Spreads between Japanese 30 year bonds and 30 year bonds in the US and Germany have narrowed significantly, making 30 year JGBs more attractive than almost any other point in the last 15 years.



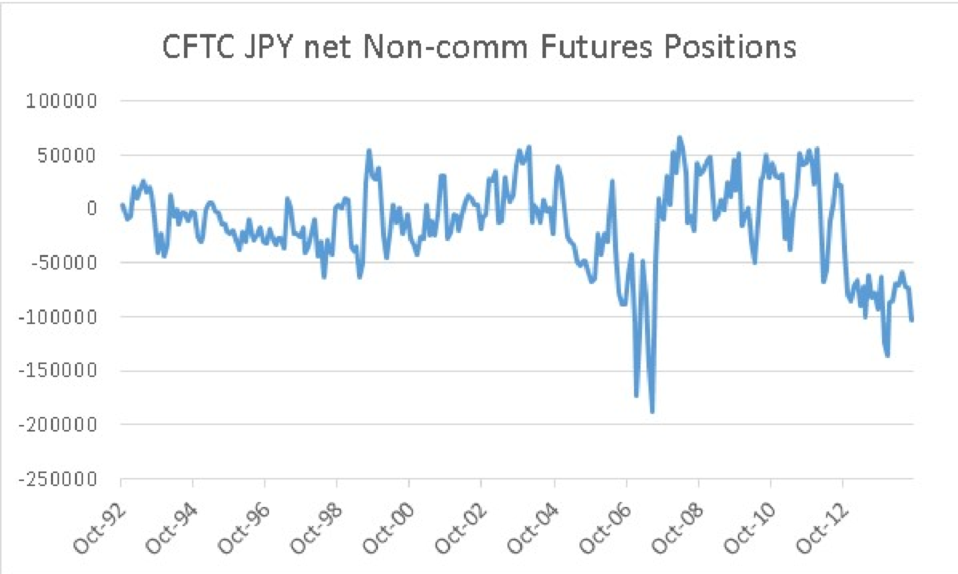
To my mind, the flattening of yield curves in Germany and US, plus the rally in bonds make 30 year JGBs interesting.

While various fund managers have expressed a bearish view on JGBs, it is quite difficult to find concrete numbers to determine whether there is a large short position in JGBs or not. There are however a few things we can use to give us a guide.

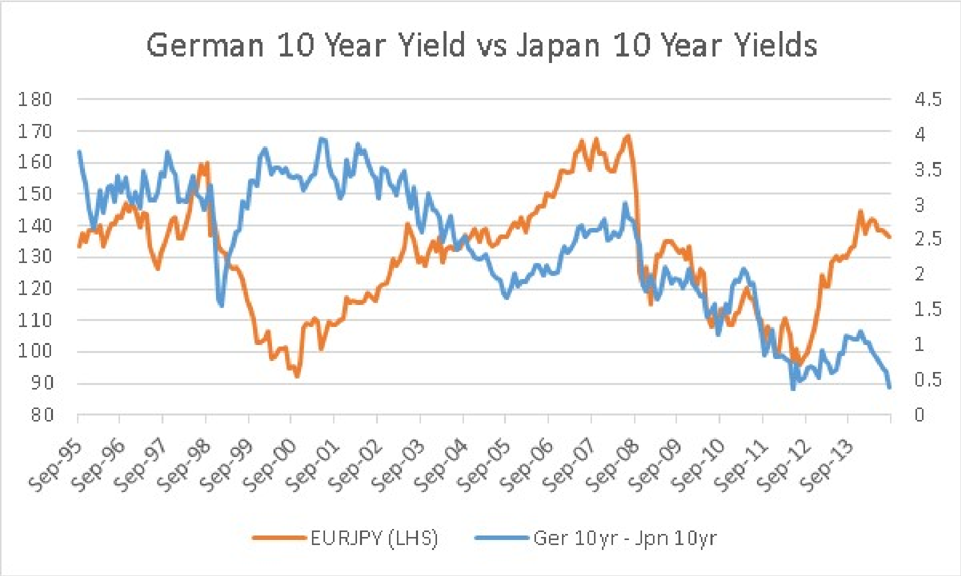
Japanese "City Banks" have tended to be big buyers and sellers of JGBs. Recent data would suggest that they have been sellers recently.



Whilst short positioning in the JGB market is hard to gauge, it seems to me that bearishness on JGBs tends to coincide with bearishness on the Yen – which, as can be seen below, is near record highs.



Historically, a rapidly appreciating Yen has been a trigger for a rally in JGBs. I note that moves in the Euro versus the Yen often coincide with changes in the spread between German bunds and JGBs.



We have already had a sharp move lower in the German yields but the Yen has now started to appreciate versus the Euro. This should be deflationary for Japan – and would suggest that either Bunds are a sell or JGBs are a buy. I think the latter looks more likely.

INFORMATION

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