The Yen And U.S. Treasuries

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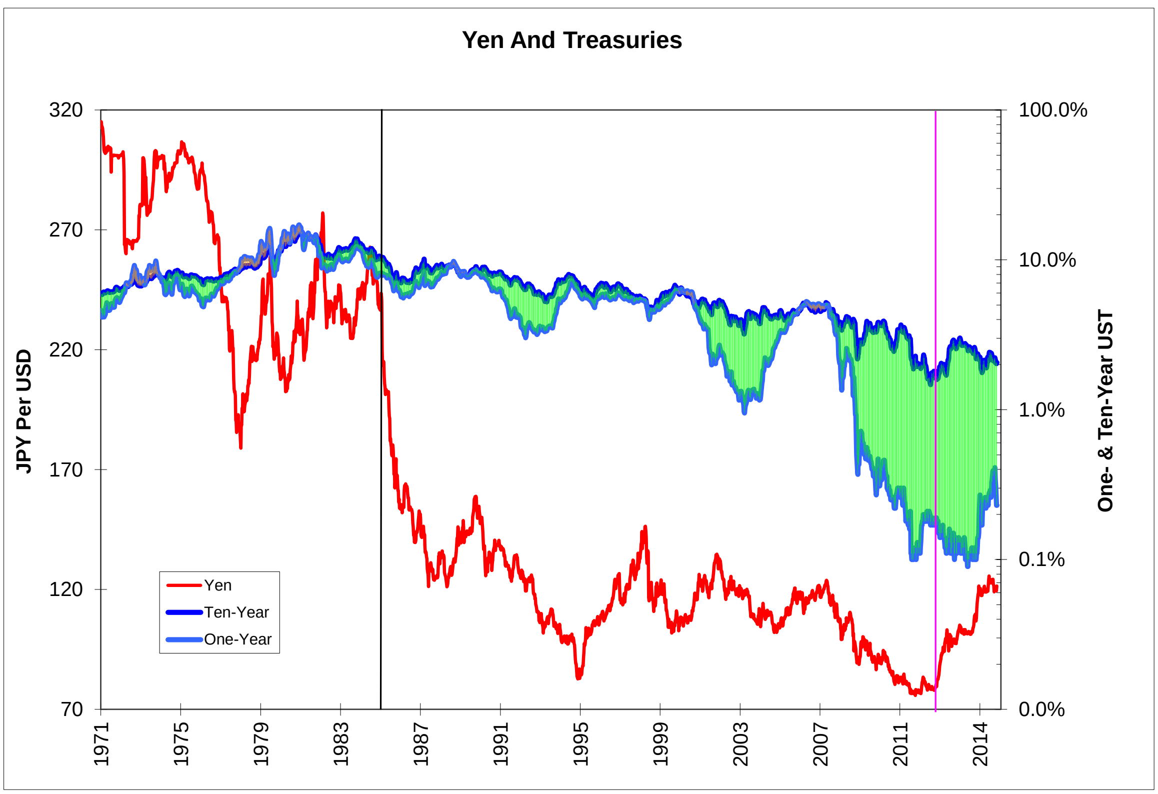
Japan remains the largest external holder of U.S. Treasuries; this assumes, of course, the country of beneficial ownership and the country of domicile are one and the same. The Federal Reserve is the largest actual holder of U.S. Treasuries and the central bank's decisions about rolling its portfolio forward will come to dominate discussions of Treasury holdings over the next five years, if not longer.

The days when the U.S. obsessed with Japan's bilateral trade surplus, the strength of the yen and the willingness of Japanese investors to hold U.S. securities are gone. A long-term map of the JPY against constant-maturity one- and ten-year Treasury yields can be divided into three eras. The first, extending from the start of the floating exchange-rate era to the September 1985 Plaza Accords was characterized by extreme and two-way yen volatility and rising U.S. Treasury yields, often accompanied by an inverted yield curve (orange shading).

The second era, extending to the start of the Abe government's campaign to drive the yen lower was characterized by a secular firming of the JPY and declining UST yields, accompanied by several increasingly large steepenings of the yield curve produced by U.S. monetary ease.

The expanded JPY:USD carry trade created by Abenomics came to a halt in early June 2015 when the Bank of Japan signaled the JPY's decline had gone far enough. The flattening of the U.S. yield curve as measured by the forward rate ratio between one and ten years ended three months later as the Federal Reserve did not follow through with its signaled intentions to raise short-term interest rates. The end of this yield curve flattening meant a long-term portfolio of U.S. Treasuries could be financed with short-term USD; the currency risk of a yen carry trade was not necessary.



The non-dependence of long-term UST on the yen carry trade can be seen in the rolling three-month correlation of returns between the JPY:USD carry return index and the returns on 7-10 year UST net of three-month borrowing costs. This measure has been negative since the November 2012 downside breakout of the JPY. An expansion of the yen carry trade via another round of Japanese QE thus would not redound to the benefit of long-term UST.