TrendMacrolytics

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Shorting JGB's: Tricks of the Trade

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Last week we pointed out an opportunity to profit from Japan's economic crisis and its solution, by shorting Japanese government bonds. As the **Bank of Japan** is forced to inject liquidity into the Japanese economy to shore up a failing banking system and arrest a decade-old monetary deflation, yields on JGBs will rise as deflationary expectations begin to be reversed, and the value of the yen will continue to fall on forex markets.

In implementing this trade, a dollar-based investor who wants not only short exposure to the JGB *but to the yen, as well*, has to be sure to implement the trade in such as way as to deliver both objectives. Shorting the JGB does *not* automatically create short yen exposure.

If you short physical JGBs, remember that you start by borrowing them, and then you sell the borrowed bonds for yen proceeds. When you unwind the trade, you use the yen proceeds to buy back the bond, and you return the bond to the lender. There is no currency exposure on the principle amount of the trade. Therefore, if you want short yen exposure as an element of this trade, you have to deliberately create it by shorting the yen in either the futures or forward markets.

If you short JGBs in the futures markets, the bottom line is the same. You are establishing a position in a yen-denominated contract that produces no direct currency exposure except for the small amount of initial margin that you will be required to post in yen to initiate the position. So, again, if you want short yen exposure you will have to short the yen in either the futures or forward markets.

In both physical and futures markets for the JGB, even though there is little or no currency exposure arising from the *principle value* of the trade, the *amount of your profit or loss* from the position *does* entail currency exposure. Profits and losses will be earned in yen, and will eventually have to be repatriated back to dollars for a US-based investor. They would be reduced somewhat if the yen has depreciated and enlarged somewhat if the yen has appreciated. Since you don't know in advance whether you will have a profit or a loss (or the amount of either one) this small residual currency exposure in the trade cannot be accurately hedged.

The "model position" we have developed for this trade assumes that short exposure to both the JGB *and* the yen is desired -- and in the same principle amounts. Some investors may wish to execute only one (or the other) part of the trade; others may wish to execute both, but in different relative sizes.

We assume that JGBs are shorted in the futures market, and that the desired short yen exposure is created in the futures markets, as well. JGB futures trade most actively on the **Tokyo Stock Exchange** (TSE) although they are also traded (in some cases much less actively) on the **Singapore Exchange** (SGX), the **London International Financial Futures Exchange** (LIFFE), and the **Chicago Mercantile Exchange** (CME). TM

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