

FX Pulse

FICC Research Dept.

Return of the yen carry trade?

- Yen's slide accelerates on dovish view of BOJ MPM
- FX markets to test Takaichi government's tolerance for weaker yen?
- Government should allow BOJ discretion to act

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Yen weakens again

USD/JPY rose to around 154.5 last week, its highest level in around eight and a half months (since 13 Feb). The caution expressed by Fed Chair Jerome Powell about a December rate cut and the lack of a clear signal from the Bank of Japan (BOJ) that it will raise rates in December added impetus to the yen's slide. The agreement at the US-China leaders' meeting to cut the US's fentanyl tariff from 20% to 10% also boosted USD/JPY.

FOMC divided on December rate cut

The FOMC opted to cut interest rates by 25bp at its 28-29 October meeting, as in September. It also announced that it will conclude its balance-sheet runoff (quantitative tightening, QT) on 1 December. As at the previous meeting, Federal Reserve Governor Stephen Miran voted against a 50bp rate cut, while Kansas City Fed President Jeffrey Schmid opposed it and supported maintaining current policy.

On 31 October, Schmid issued a statement explaining his reasons for opposing a rate cut. He noted that "I do not think a 25-basis point reduction in the policy rate will do much to address stresses in the labor market that more likely than not arise from structural changes in technology and demographics," but "a cut could have longer-lasting effects on inflation if the Fed's commitment to its 2 percent inflation objective comes into question."

At his post-FOMC press conference, Fed Chair Jerome Powell emphasized that "a further reduction in the policy rate at the December meeting is not a forgone conclusion—far from it." He also noted that "there's a growing chorus now of feeling like maybe this is where we should at least wait a cycle." Dallas Fed president Lorie Logan commented on 31 October that "this economic outlook didn't call for cutting rates." She stated that "I did not see a need to cut rates [at the FOMC] this week. And I'd find it difficult to cut rates again in December unless there is clear evidence that inflation will fall faster than expected or that the labor market will cool more rapidly."

On the same day, Cleveland Fed president Beth Hammack also noted that "we have inflation, and it is too high," and that "I would have preferred to have held rates steady at this meeting". At the same event, Atlanta Fed president Raphael Bostic stated that while he ultimately supported a rate cut at the October FOMC, "we can't really forget that inflation is a significant problem, and we have to get that back down to our 2 percent target." Ms. Logan and Ms. Hammack do not have the right to vote at FOMC meetings this year, but will next year.

While several FOMC members were voicing their opposition to rate cuts, Fed Governor Christopher Waller commented that "the biggest concern we have right now is the labor market" and that "we know inflation is going to come back down, so this is why I'm still advocating that we cut policy rates in December, because that's what all the data is telling me to do."

Yesterday (3 Nov), Mr. Miran stated that “the Fed is too restrictive, neutral is quite a ways below where current policy is.” Chicago Reserve Bank President Austan Goolsbee said that “my threshold for cutting is a little bit higher than it was at the last two [FOMC] meetings,” while San Francisco Reserve Bank President Mary Daly indicated she would approach the December meeting with “an open mind,” and Fed Governor Lisa Cook expressed the view that the December meeting would be “live.”

While FOMC members are divided on the need for a rate cut at the December meeting, the interest rate futures market continues to price in a nearly 70% probability of a cut in December and nearly 3.5 cuts from 2026. Whether or not these rate cuts materialize as expected will be the key focus for US yields and USD/JPY heading into 2026.

BOJ unable to halt yen's slide

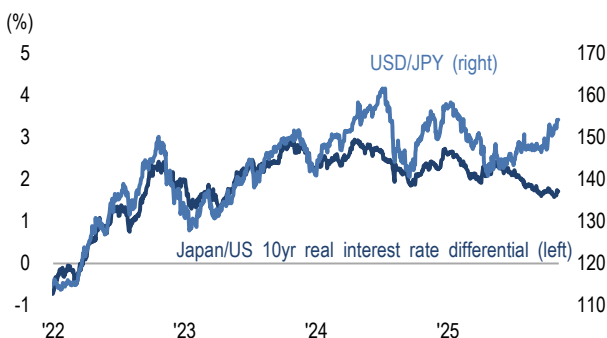
The BOJ kept its policy rate at 0.50% at its 29-30 October Monetary Policy Meeting (MPM). As at the September MPM, policy board members Hajime Takata and Naoki Tamura proposed a hike to 0.75%, but the move did not spread to other members. Governor Kazuo Ueda commented at his regular press conference that visibility on the outlook has improved, but noted his desire to confirm the initial momentum of FY26 spring labor negotiations.

While we do not think the BOJ's October MPM was unduly dovish, we think many (especially FX) market participants expected either more votes against remaining on hold or a strong signal of a December hike. Governor Ueda fielded questions at his press conference about whether the BOJ had held off on raising rates in the early days of the new Takaichi administration and whether it was prepared to push through hikes even if the prime minister opposed them. In the near term, we think the FX market will test the Takaichi administration's tolerance for a weaker yen given the view in some quarters that the BOJ is seeking to appease the government (even if this is not the case).

On 29 October, US Treasury Secretary Scott Bessent posted on X (formerly Twitter) during his visit to Japan that “the government's willingness to allow the Bank of Japan policy space will be key to anchoring inflation expectations and avoiding excess exchange rate volatility.” A 28 October readout from his 27 October meeting with Minister of Finance Satsuki Katayama also stated that “Secretary Bessent highlighted the important role of sound monetary policy formulation and communication in anchoring inflation expectations and preventing excess exchange rate volatility, as conditions are substantially different twelve years after the introduction of Abenomics.”

At a 21 October press conference, her first since taking office, Prime Minister Sanae Takaichi stated her view that “the government is ultimately responsible for macroeconomic policy” while emphasizing that “the approach to monetary policy should be up to the BOJ.” Given the perception of Ms. Takaichi as synonymous with reflationary policy, we think the market will increasingly sell JPY unless she walks back her view that the government is also “ultimately responsible” for monetary policy.

Chart 1: Japan/US 10yr Real Interest Rate Differential, USD/JPY



Source: Bloomberg; compiled by Daiwa.

Chart 2: USD/JPY Risk Reversal, USD/JPY



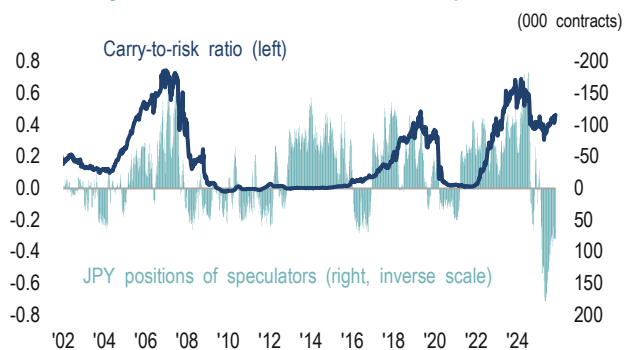
Source: Bloomberg; compiled by Daiwa.

Can BOJ prevent emergence/collapse of yen carry trade?

USD/JPY has recently moved in the opposite direction to the narrowing US-Japan yield gap, in an echo of the yen carry trade that emerged and collapsed in spring 2024 (Chart 1). The BOJ's April 2024 MPM spurred yen selling that caused the government to intervene in the FX market, but unabated speculative selling continued to weaken the yen. A further intervention in July was accompanied by the BOJ's decision at its July MPM to reduce JGB purchases and raise interest rates. Readers will recall that the 2 August release of weak July US employment data was followed by a historic slump in the Nikkei Stock Average on 5 August, the start of the subsequent week. USD/JPY had remained at 161.5-161.9 until the Ministry of Finance's (MOF) 11 July FX market intervention, but subsequently fell to 141.5-141.9 at one point on 5 August, a move of around Y20 in less than a month.

While it is difficult to confirm speculators' current positions given the lack of IMM currency futures data during the US government shutdown, risk reversals (divergence between implied volatility for yen puts and yen calls) imply growing expectations for the yen to weaken and a consequent increase in speculative yen short positions (Chart 2). The carry-to-risk ratio, a key indicator of the carry trade, remains low compared with mid-2024 but is now at its highest since August 2024 (Chart 3). Since last year, the Fed has cut rates and the BOJ has gradually raised them, causing the US-Japan yield spread to narrow from over 5% to 4%. However, this is still high in absolute terms, and volatility is down to its lowest level since mid-2024, making the carry trade reasonably attractive (Chart 4).

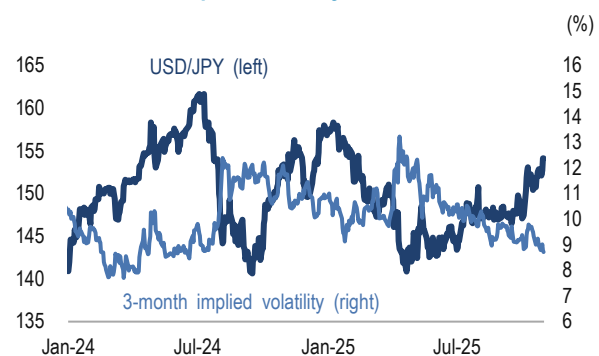
Chart 3: Carry-to-risk Ratio, JPY Positions of Speculators



Source: CFTC, Bloomberg; compiled by Daiwa.

Note: The carry-to-risk ratio is calculated using the 3-month interest rate gap and the 3-month USD/JPY implied volatility.

Chart 4: USD/JPY Implied Volatility



Source: Bloomberg; compiled by Daiwa.

Based on the relationship between the carry-to-risk ratio and speculative yen positions shown in Chart 3, we would not be surprised to see the latter increase to around 100,000 contracts, in which case we would expect USD/JPY to approach 160. Ms. Katayama has already verbally intervened, stating on 31 October that recent moves have been one-way and sudden, but we will be watching to see if she adopts a stronger tone.

While investors might expect stronger rhetoric to be followed by an actual intervention, Mr. Bessent has expressed the view that the yen will find its own level if the BOJ follows "proper monetary policy," implying that Japan will struggle to convince the US of the need to intervene. The Japanese government's promised Y80tn investment in the US could also mean that it lacks the funds for interventions.

A weakening yen would pressure the BOJ to hike at the December MPM and force the government to accept higher interest rates to curb inflation. The concern is that if the Takaichi administration maintains it is "ultimately responsible" for monetary policy, this could lead to an escalating yen carry trade, the collapse of which would risk triggering a slump in USD/JPY and share prices. If a policy error by Japan despite Mr. Bessent's warnings were to destabilize global financial markets, this could both worsen relations with the US and increase criticism of the government inside Japan. Before this happens, we think the Takaichi administration needs to clearly indicate that the BOJ is responsible for the management of monetary policy, not just the approach.

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