Daiwa Securities

Daiwa's View

FICC Research Dept

Revising forex outlook to reflect pickup in carry trades

- Increase in speculative trades as monetary tightening winds down accelerating yen's slide, building impetus for yen appreciation in the future

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Yen's slide continues

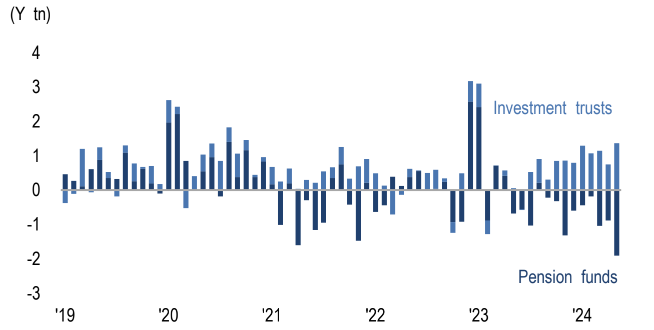
The yen continues to weaken. USD/JPY again broke above the key Y160 level on 26 June and sailed past the Y160.24 level reached just prior to the government and Bank of Japan's (BOJ) 29 April forex market intervention. The yen then continued to be sold, approaching the Y162 level for the first time in around 37.5 years (since December 1986).

The effects of the previous forex market intervention lasted less than two months. On 24 June, Vice Minister of Finance Masato Kanda commented on the yen's move toward Y160, the trigger for the previous intervention, that "the market is focused [on this level] and is on high alert for a potential intervention, but the level itself does not matter". On 26 June, he acknowledged the yen's unchecked slide and stated that the government would take the necessary action to address any overshoot. Mr. Kanda stated that he views the yen's recent moves on 2 July as reflecting a considerable impact from speculative trading, but there was little sense of urgency among market participants and the yen continued to be sold.

On 28 June, the Ministry of Finance (MOF) announced that Mr. Kanda would be replaced by Atsushi Mimura, Director-General of the International Bureau, at end-July. This appointment was expected and not a surprise, but some (mainly overseas) investors appear to think that the announcement will make it more difficult for the authorities to intervene before the change in the vice minister responsible for forex interventions. Whatever the thinking behind this view, we hear from some market participants that the growing market impact of the yen carry trade has prompted a move from hedged to unhedged foreign bonds, though this is also a “carry trade” in the broader sense.

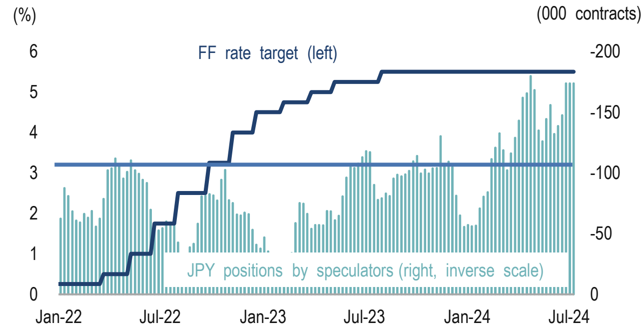
We think structural changes in supply-demand driven by the start of the new NISA scheme are contributing to yen weakness by creating an environment in which investors feel safe about putting on yen carry trades, but in our view speculators are the main driver of the yen’s slide. MOF’s International Transactions in Securities data (from designated reporting investors) has prompted much market debate given that Jan-May buying of overseas securities through investment trust management companies already exceeds the 2023 total; however, pension funds’ net selling of overseas assets offset a considerable portion of the selling pressure on the yen from households (Chart 1). While the demand to sell the yen triggered by the revamped NISA scheme will have a non-negligible impact on medium-term market trends, it would be misleading to claim that it has driven the yen's YTD slide.

Chart 1: Outward Investment in Securities



Source: MOF; compiled by Daiwa.
Note: Pension funds = Banks and trust banks (trust accounts).

Chart 2: JPY Futures Positions at IMM



Source: CFTC, Bloomberg; compiled by Daiwa.
Note: Positive indicates yen buying/dollar selling, negative indicates yen selling/dollar buying.

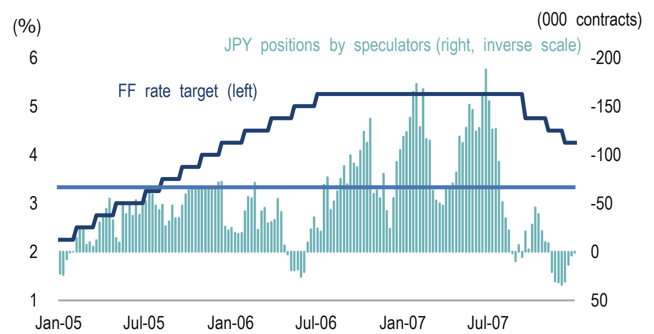
Speculative trades rife in final phase of monetary tightening

Speculators have further increased their JPY short positions in 2024 (Chart 2). IMM currency futures positions as of 25 June show 173,900 net yen short contracts for "non-commercial" (speculative) traders, the highest since 23 April, just ahead of the BOJ's April MPM. Speculators' yen short positions did not rise far beyond 100,000 contracts through 2023, but have consistently exceeded this level since February 2024.

Speculators have in the past increased their yen carry trades when US monetary tightening winds down, the most prominent example being just ahead of the global financial crisis (GFC; Chart 3). The Fed's last rate hike ahead of the GFC was in June 2006. Speculators substantially increased their yen short positions during the subsequent 14-month period when the Fed kept interest rates flat. Their yen short positions peaked at just over 70,000 contracts during the rate-hiking cycle that followed, but from summer 2006 the number jumped by more than 2.5X at some points (to up to 188,000 contracts), with an average of around 100,000 contracts.

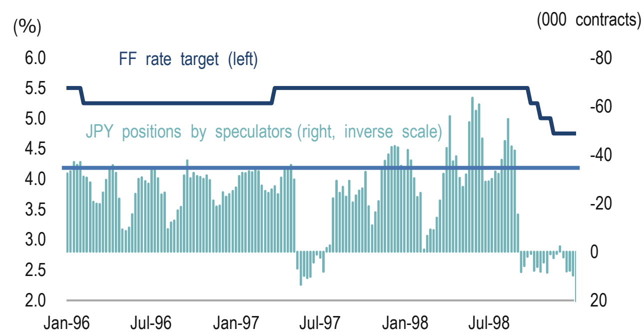
The yen carry trade peaked in the mid-2000s, but also saw a boom in the latter half of 1990s driven mainly by US and European hedge funds. Speculators' yen short positions topped out at just under 40,000 contracts in 1996, but the figure jumped in mid-1998 to up to 63,000 contracts, more than 1.5X the previous level (Chart 4). The BOJ's published data on inter-office accounts at foreign bank branch offices in Japan may give a clearer picture of the yen carry trade at the time.

Chart 3: JPY Futures Positions at IMM (before GFC)



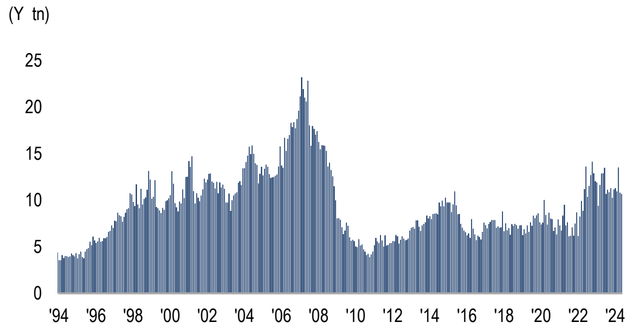
Source: CFTC, Bloomberg; compiled by Daiwa.
Note: Positive indicates yen buying/dollar selling, negative indicates yen selling/dollar buying.

Chart 4: JPY Futures Positions at IMM (in latter half of 1990s)



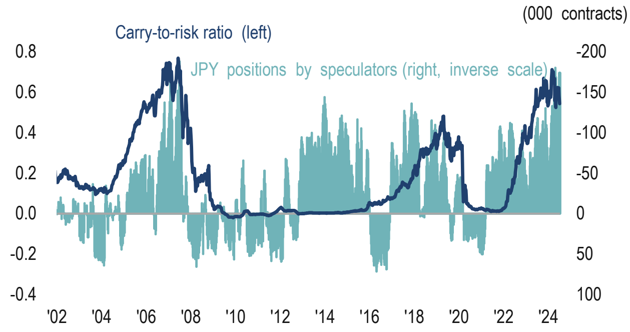
Source: CFTC, Bloomberg; compiled by Daiwa.
Note: Positive indicates yen buying/dollar selling, negative indicates yen selling/dollar buying.

Chart 5: Inter-office Accounts at Foreign Bank Branch Offices in Japan



Source: BOJ; compiled by Daiwa.

Chart 6: Carry-to-risk Ratio, Speculators' JPY Positions



Source: CFTC, Bloomberg; compiled by Daiwa.
Note: The carry-to-risk ratio is calculated using the 3-month US/Japan interest rate gap and the 3-month USD/JPY implied volatility. Regarding speculators' JPY positions, positive indicates yen buying/dollar selling, negative indicates yen selling/dollar buying.

The yen carry trade typically involves hedge funds borrowing yen funds raised by foreign banks in Japan and investing those funds in foreign bonds. When such trading activities become more active, the assets in the inter-office accounts at foreign bank branch offices in Japan tend to swell. We can actually see a significant increase in such accounts at foreign banks in Japan during the latter half of 1990s and we can confirm a sharp increase in the mid-2000s as well (Chart 5).

Speculative positions that can be ascertained through IMM currency futures positions and inter-office accounts at foreign bank branch offices in Japan are only a part of the total. As such, grasping the actual conditions is difficult. However, it is clear that speculative yen selling is currently increasing. We cannot say with certainty how much room is available for accumulating additional speculative positions going forward. That said, unless the (short-term) interest rate gap between Japan and the US or other countries narrows to a reasonable degree, we should be on guard for further yen selling. Meanwhile, the current speculative yen selling can be viewed as a reservoir of potential yen-appreciation pressure from the future unwinding of those positions.

Why does the yen carry trade dominate the market in the final phase of US monetary tightening? The carry-to-risk ratio, which is calculated by dividing the interest rate gap by the expected currency fluctuation rate, is regarded as an important indicator for carry trades. While unable to say for sure, when organized from a carry-to-risk ratio perspective, the interest rate gap between Japan and the US will have widened to a sufficient level once the rate hiking phase ends. There is also a tendency for forex volatility to decrease during a "pause period," and such a development would make carry trades increasingly attractive (Chart 6).

While we can point to the possibility that such mechanisms are at work, it is hard to tell for sure. For now, all we can say is that interest rate gaps are important and, in the past, some kind of financial shock brought the yen carry trade to an end.

That was the case in the mid-2000s. In July 2007, concerns about the worsening subprime mortgage crisis resurfaced. Then, during his testimony before the Senate on 19 July of that year, then-Fed Chairman Ben Bernanke estimated that losses related to subprime mortgages would range from $50bn to $100bn. Then, on 9 August of that year, BNP Paribas announced that it had suspended redemptions from three mutual funds invested in US subprime debt ("Paribas Shock"), which caused financial market turmoil to strengthen. Against that backdrop, all yen short positions were unwound over an eight-week period from the 26 June 2007 peak and the USD/JPY pair suddenly dropped from the Y123 level to the Y111 level.

In the case of the late 1990s, the Russian government declared a 90-day suspension of foreign debt payments on 17 August 1998 (de facto default declaration). On 2 September of that year, Long Term Capital Management (LTCM) revealed huge losses, sending tremors across the market. Through a series of developments, yen short positions were wiped out over a four-week period and the USD/JPY dropped from the Y147 level to the Y132 level.

Revised our forex outlook to a weaker yen

In the current case as well, we can probably for now envision a 10-20% decline for the USD/JPY as yen short positions are erased over a period of roughly four to eight weeks, in the event of some kind of shock accompanied by a sharp drop in share prices that causes the unwinding of the yen carry trade. However, this will depend on position trends in the future.

Conditions will be hard to predict in a situation where there is no such shock and the Fed cuts rates in preparation for a soft landing. In that case, past experiences may not apply without some tweaking. However, if interest rates are repeatedly lowered, the interest rate gap, which is important for carry trades, will shrink, reducing the attractiveness of holding such positions.

We do not believe there are strict thresholds for the US policy interest rate (or US/Japan interest rate gap) or carry-to-risk ratio that would stimulate carry trades. However, once the rate-cutting phase begins, there will probably be a gradual reduction for yen short positions to about the average size up until last year. In that case, we expect the overall yen short position to be roughly halved with the USD/JPY level declining moderately by about 5-10%.

Based on the above considerations and our new interest rate outlook, we revised our foreign exchange outlook to a weaker yen. The change for our interest rate outlook is minor and most of the outlook revision this time reflects the flourishing yen carry trade. While revisions in the case of the "main scenario (soft landing)" (Chart 7) were large, only near-term figures were revised in the case of the "alternative scenario (hard landing)" (Chart 8).

Chart 7: Forex Outlook (Main scenario: Soft landing)

						Outright forward			
	SPOT	Sep-24	Dec-24	Mar-25	Jun-25	Sep-24	Dec-24	Mar-25	Jun-25
USD/JPY	161.28	158	155	150	147	159	157	155	153
EUR/USD	1.0812	1.07	1.07	1.07	1.08	1.09	1.09	1.09	1.10
GBP/USD	1.2760	1.25	1.26	1.27	1.28	1.28	1.28	1.28	1.28
AUD/USD	0.6726	0.67	0.67	0.68	0.68	0.67	0.68	0.68	0.68
DXY	105.13	106	105	105	103				
EUR/JPY	174.37	169	166	161	159	173	171	170	169
GBP/JPY	205.75	198	195	191	188	203	201	198	196
AUD/JPY	108.47	106	104	102	100	107	106	105	104

Source: Bloomberg; compiled by Daiwa.

Chart 8: Forex Outlook (Alternative scenario: Hard landing)

						Outright forward			
	SPOT	Sep-24	Dec-24	Mar-25	Jun-25	Sep-24	Dec-24	Mar-25	Jun-25
USD/JPY	161.28	160	155	140	130	159	157	155	153
EUR/USD	1.0812	1.06	1.05	1.03	1.01	1.09	1.09	1.09	1.10
GBP/USD	1.2760	1.26	1.25	1.20	1.14	1.28	1.28	1.28	1.28
AUD/USD	0.6726	0.66	0.65	0.62	0.61	0.67	0.68	0.68	0.68
DXY	105.13	106	107	107	108				
EUR/JPY	174.37	170	163	144	131	173	171	170	169
GBP/JPY	205.75	202	194	168	148	203	201	198	196
AUD/JPY	108.47	106	101	87	79	107	106	105	104

Source: Bloomberg; compiled by Daiwa.

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** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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