Daiwa's View

Revising FX forecasts: Yen carry trade collapses

- Moving up our forecast timeline

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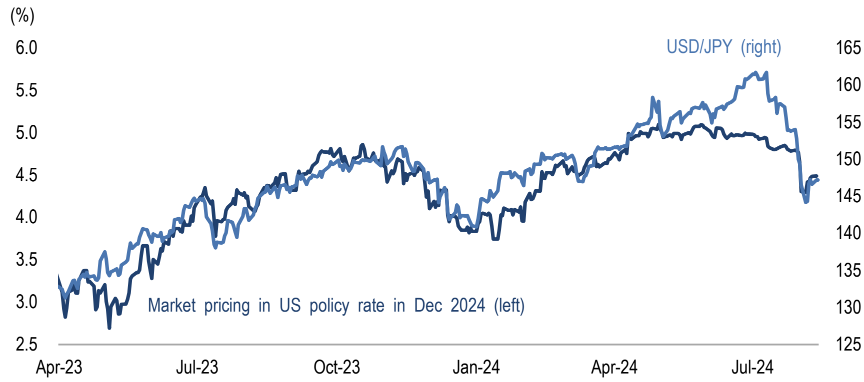
Yen carry trade collapses

JPY has strengthened against all other currencies since mid-July. While the move began following forex market interventions by Japan's currency authorities, it reflected a confluence of factors, including the unwinding of the Trump trade after Joe Biden's exit from the US presidential race, the Bank of Japan's (BOJ) July rate hike, and concerns that US employment conditions may be rapidly worsening.

USD/JPY at one point traded between 141.5 and 141.9 on 5 August, having rallied by roughly Y20 in the less than one month since the Ministry of Finance's 11 July intervention, before which it traded at 161.5-161.9. This also meant that in the space of around a month, JPY unwound its slide from around 141 at the beginning of 2024 to above 161 six months later.

The yen's YTD weakness versus the US dollar had gone beyond levels implied by the US-Japan yield gap, but its slide only gained bubble-style momentum after the BOJ's April Monetary Policy Meeting (MPM). BOJ Governor Kazuo Ueda's press conference spurred selling of the yen, leading the government to intervene in forex markets as it did in 2022. Speculative selling subsequently prolonged the yen's unbroken slide, but the recent sharp rebound has caused the market to refocus on US monetary policy (Chart 1).

Chart 1: USD/JPY, Market Pricing in End-2024 Fed Funds Rate



Source: Bloomberg; compiled by Daiwa.

New forex outlook: Frontloading

In our *Daiwa's View* reports, we have revised our Japan and US monetary policy and yield forecasts to factor in recent drastic market movements. We also update our forex outlook to reflect our new yield projections, essentially moving up the timeline versus our previous forecasts.

At a press conference following the July FOMC meeting, Fed Chair Jerome Powell stated that if overall data meets its expectations, "a reduction in our policy rate could be on the table as soon as the next meeting in September." He indicated that the Fed is not thinking about a first cut of 50bp. However, weak July US payrolls sharply increased concerns about a US recession, and we think a 50bp rate cut is entirely possible depending on future data.

The soft-landing scenario we discuss in our *Daiwa's View* reports assumes that the Fed makes a first cut of 25bp in September, continues cutting at every meeting through March 2025, and then makes one cut per quarter thereafter. We now expect the policy rate to reach 4.00-4.25% in March 2025, six months early than our previous forecast.

The abrupt unwinding of the yen carry trade has increased forex volatility. Given that the market is unlikely to return to its previous state after this upheaval, we do not expect a major resumption of yen selling in the near term. The start of a Fed rate-cutting cycle from September would narrow the US-Japan yield spread that is key to the carry trade, making it difficult for all investors to aggressively sell JPY with confidence.

However, the market is pricing in four 25bp rate cuts by the Fed within 2024. In short, it expects a 50bp rate cut at one of this year's three remaining meetings. Compared with the interest rate forecasts we discuss in our *Daiwa's View* reports, we think the market is pricing in somewhat excessive rate cuts, suggesting scope for the yen to weaken in the near term.

Chart 2: Forex Outlook (Soft landing scenario)

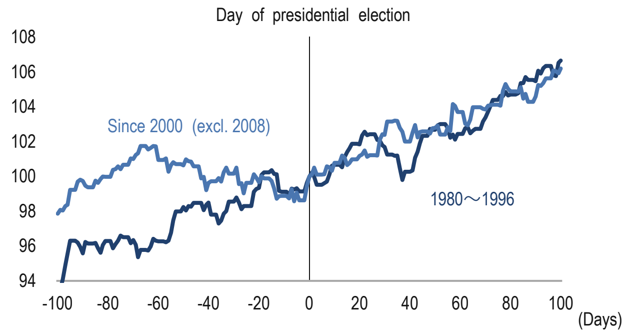
						Outright forward			
	SPOT	Sep-24	Dec-24	Mar-25	Jun-25	Sep-24	Dec-24	Mar-25	Jun-25
USD/JPY	147.21	148	150	147	145	146	144	143	141
EUR/USD	1.0931	1.07	1.07	1.07	1.08	1.10	1.10	1.10	1.11
GBP/USD	1.2770	1.25	1.26	1.27	1.28	1.28	1.28	1.28	1.28
AUD/USD	0.6586	0.67	0.67	0.68	0.68	0.66	0.66	0.66	0.66
DXY	103.14	105	105	104	103				
EUR/JPY	160.91	158	161	157	157	160	159	158	157
GBP/JPY	187.98	185	189	187	186	187	185	182	181
AUD/JPY	96.95	99	101	100	99	96	95	94	93

Source: Bloomberg; compiled by Daiwa.

In order for the US economy to avoid a recession, it is crucial to eliminate the potential for a negative feedback loop caused by recent drastic market movements. If the stock and corporate bond markets continued to correct and financial conditions began rapidly tightening, this would sharply increase the risk of a recession.

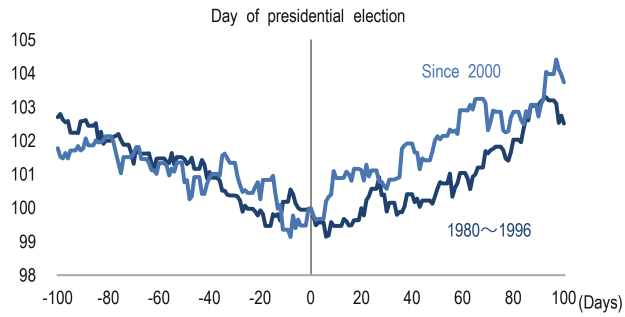
The 5 November US presidential election is a key focus given the potential major impact on financial markets, but it could also mark a turning point in terms of dispelling concerns about a US recession. Financial markets frequently move into risk-on mode after US presidential elections, and stock markets in particular tend to rise after the election, possibly due to receding uncertainty (Chart 3). Similarly, while USD/JPY tends to rise after presidential elections (Chart 4), this is not the case when the US has already entered a recession when the election takes place, as it did during the 2008 global financial crisis. A key watershed will therefore be whether the US economy remains resilient until the election.

Chart 3: Share Prices Around US Presidential Elections (average of S&P500)



Source: Bloomberg; compiled by Daiwa.
Note: Show average values based on day of presidential election = 100

Chart 4: USD/JPY Around US Presidential Elections (average)



Source: Bloomberg; compiled by Daiwa.
Note: Show average values based on day of presidential election = 100

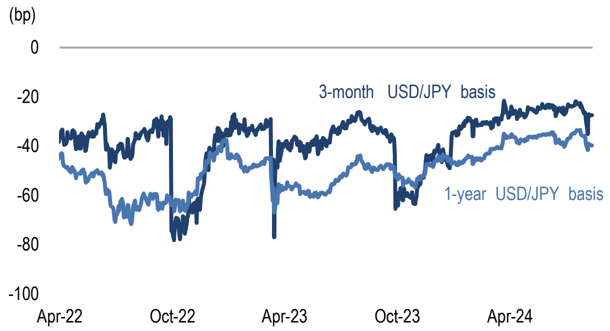
In the hard-landing scenario we discuss in our *Daiwa's View* reports, we expect the Fed to repeatedly cut rates by 50bp from September, resulting in the equivalent of ten 25bp cuts through March 2025. We would then expect the Fed to continue cutting rates at each subsequent FOMC meeting, bringing the policy rate well below the neutral rate as of mid-2025.

Former New York Fed president William Dudley argued in a 24 July Bloomberg column ahead of the July FOMC meeting that "The Fed should cut, preferably at next week's policy-making meeting." He concluded that "Although it might already be too late to fend off a recession by cutting rates, dawdling now unnecessarily increases the risk." In our hard-landing scenario, these fears would become reality.

Our hard-landing scenario previously involved the Fed beginning to cut interest rates in early 2025, but we now move this forward to September. We expect the yen to strengthen to near Y130/$ within FY24 as US yields fall sharply, bringing forward the timing for a rapid dip in market risk sentiment and triggering the unwinding of accumulated JPY short positions.

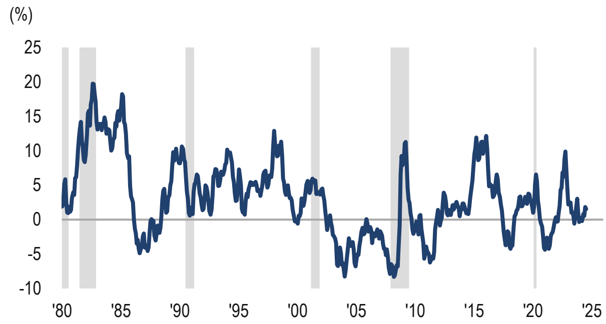
However, we note that USD weakened during the market's rapid recent risk-off move. While the currency basis became somewhat more negative (Chart 5), there was no evidence of the kind of major increase in USD funding pressure that tends to accompany financial market turmoil. USD has strengthened at some point during all of the six US recessions since the 1980s (Chart 6). While it tends to strengthen most at the peak of market pessimism, recent trends suggest that this is unlikely to occur when the Fed begins cutting rates in September, and we therefore expect the dollar to rally around year-end or early 2025.

Chart 5: USD/JPY Basis



Source: Bloomberg; compiled by Daiwa.

Chart 6: USD Nominal Effective Exchange Rate (divergence from two-year average)



Source: Fed, NBER; compiled by Daiwa.
Note: Shaded areas indicate recessions.

Chart 7: Forex Outlook (Hard landing scenario)

						Outright forward			
	SPOT	Sep-24	Dec-24	Mar-25	Jun-25	Sep-24	Dec-24	Mar-25	Jun-25
USD/JPY	147.21	140	134	128	125	146	144	143	141
EUR/USD	1.0931	1.09	1.04	1.01	1.07	1.10	1.10	1.10	1.11
GBP/USD	1.2770	1.25	1.19	1.14	1.17	1.28	1.28	1.28	1.28
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AUD/JPY	96.95	92	84	78	79	96	95	94	93

Source: Bloomberg; compiled by Daiwa.

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