Daiwa Securities

# Daiwa's View

FICC Research Dept

## USD/JPY outlook after Fed starts cutting rates

- Risk of rising US rates if Fed's outlook is on track
- Assume exchange rate in upper USD/JPY140 range if likelihood of soft landing increases
- Sharp yen appreciation if Fed cuts rates in earnest due to hard landing

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### Fed more hawkish than market despite large rate cut

At its September FOMC meeting, the Fed made a 50bp interest rate cut. The market's view on the size of the rate cut was split right up until the final decision was announced. Apparently, Fed Chairman Jerome Powell's judgment and leadership ultimately led to the 50bp rate cut. However, Powell balanced this view at his post-meeting press conference by positioning the large interest rate cut in such terms as, "I think you can take this as a sign of our commitment not to get behind," stressing that the 50bp interest rate cut is not "the new pace," and adding that "there's no sense that the Committee feels it's in a rush (to cut rates)."

Turning to the policy interest rate outlook (dot chart), which has attracted attention along with the size of the interest rate cut, the end-2024 median is 4.375%. This suggests that the Fed will cut interest rates by a another 50bp before the end of this year. However, of the 19 FOMC members, two expect the rate to be unchanged and seven expect one rate cut, so almost half (nine members) expect less than two rate cuts by the end of this year. The market has factored in the possibility of a 25bp cut and a 50bp cut for the remaining two FOMC meetings to around 80%. That would suggest that the Fed is more hawkish than the market.

Also, the dot chart median for end-2025 is 3.375%, indicating a path of four more rate cuts. As for the median for end-2026, the path suggests that two interest rate cuts will be implemented toward the upwardly revised longer-term neutral interest rate of 2.875%. The market has already factored in a policy interest rate cut to 2.875% by the end of 2025 and the dot chart can generally be viewed as hawkish.

To reiterate, the market has already factored in a much larger rate cut than the Fed's dot chart suggests. If we assume a soft landing for the US economy, there would not seem to be much room for a further decline for US interest rates. A meaningful interest rate cut before the end of this year could be justified as a "front-loading" strategy. However, if this results in avoiding a recession, there may only be a gradual interest rate cutting pace next year, given the inflation target commitment. Perhaps the market is currently factoring in concerns among some participants about a possible hard landing. An easing of those concerns could apply upward pressure on interest rates.

The most important data for the Fed's policy decisions continues to be the employment indicators (unemployment rate). As Powell mentioned, the Fed will have two jobs reports to examine before the next meeting. The results of these reports will likely determine whether or not the Fed is forced to make additional large interest rate cuts. That said, the "soft landing" scenario will remain unchanged as long as there are expectations that this large interest rate cut will curb the risk of a serious rise in unemployment. It seems that there is not much room for interest rates to fall, just as we thought.

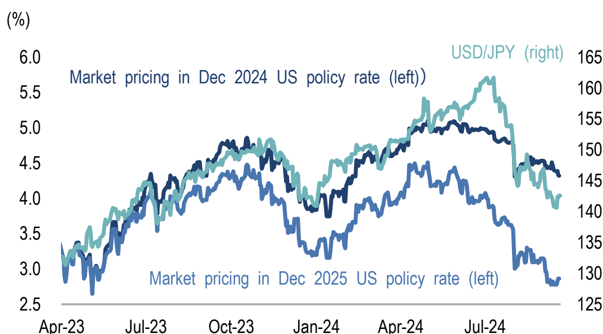
## Narrow gap between a soft and a hard landing

There was a significant adjustment for the USD/JPY level due to the unwinding of yen carry trades from mid-July (Chart 1), which brought about a return to a market that is more focused on US monetary policy. Compared to US dollar depreciation on the forex market overall, the decline for the dollar versus the in the yen has been relatively small, but it seems as if the dollar has been gradually coming under more downward (depreciation) pressure vs the yen since the middle of August (Chart 2). However, as mentioned above, if we assume a soft landing for the US economy, there would be the sense that factoring in interest rate cuts has proceeded a bit too far, suggesting there is room for the yen to weaken over the short term.

The current situation is a state of oscillation between a "soft landing" scenario and a "hard landing" scenario, as described in previous editions of this report. So, the USD/JPY rate is expected to hover around the lower USD/JPY140 level for now. The yen could depreciate to the upper USD/JPY140 range if there are catalysts that cause the factoring in of further Fed rate cuts this year or next year to recede. Even though it is not our main scenario, if the Fed were to immediately move up the timing for lowering its policy interest rate to a low 4% range by the end of this year and then maintain that level, there could be a period when yen carry trade momentum picks up again. In that case, the BOJ could move up its timing for hiking rates, provided the forecasts for Japan's economy and inflation are on track and the risk of higher-than-expected inflation due to yen appreciation increases.

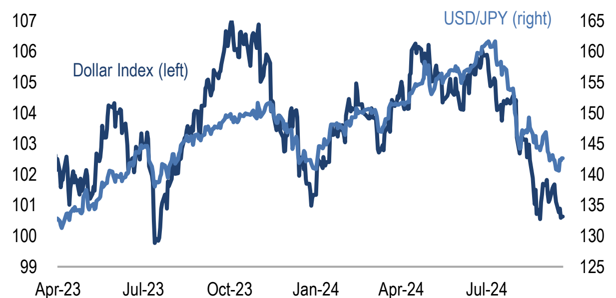
Meanwhile, if the US unemployment rate continues to worsen from next month onwards (according to US jobs report) and if financial markets do not stabilize despite the Fed's significant interest rate cut, the Fed could start earnestly cutting rates to address a hard landing. In that case, if the USD/JPY targets the USD/JPY130 level, and if the interest rate market starts to factor in a terminal rate lower than the long-run rate, we could probably expect a more rapid appreciation of the yen.

**Chart 1: USD/JPY, Market Pricing in US Policy Rate**




*Source: Bloomberg; compiled by Daiwa.*

**Chart 2: Dollar Index (DXY), USD/JPY**




*Source: Bloomberg; compiled by Daiwa.*

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