FX Viewpoint

Currencies
Global

USD-JPY outlook for 2025

- We believe the JPY will not be an exception to broad USD strength in 2025, but it should not bear the brunt again
- Downside risk to USD-JPY could stem from domestic inflows
- Upside risks could come from a dovish BoJ or a hawkish Fed

Our view on the JPY for 2025 is that it will not be an exception to broad USD strength, but it should not bear the brunt like it did over the past few years. We do not see it as one of the currencies in the front line of US tariff risks.

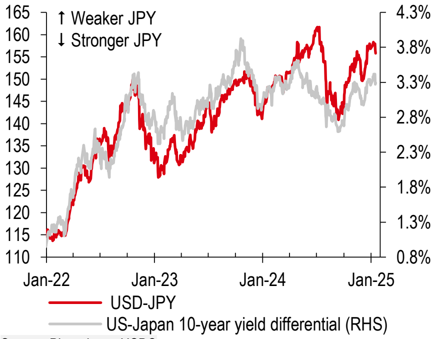
JPY-funded carry trades are less viable now

The main challenge for the JPY is still a deeply negative interest rate differential with the US. This has been affecting the JPY since 2022 (Chart 1) and fundamentally undermines the JPY via capital outflows and high FX hedging costs for residents. But there are some nuances this time around: (i) JPY-funded carry trades (i.e., selling the JPY to fund the purchase of higher-yielding assets) are not as popular as before given high market volatility, and (ii) the JPY is no longer the lowest yielding G10 currency (that would be the CHF, when looking at longer tenors).

The BoJ is expected to normalise its policy gradually, serving as a "circuit breaker" for upward USD-JPY momentum

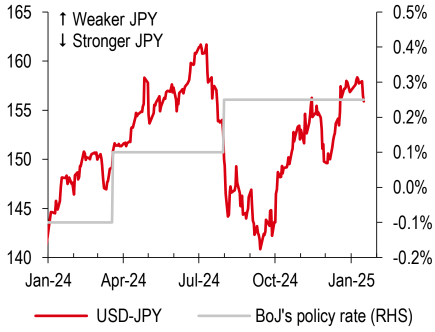
Additionally, **both Japan's Ministry of Finance (MoF) and the Bank of Japan (BoJ) are unlikely to welcome further JPY weakness** because of the public's discontent over the loss of purchasing power, and the negative impact of imported inflation. **The MoF may defend the JPY** if the exchange rate diverges from fundamentals. **Rate hikes by the BoJ could also serve as a "circuit breaker" for upward USD-JPY momentum** (Chart 2). Indeed, the JPY has strengthened recently following the BoJ's remarks by Deputy Governor Ryozo Himino (14 January) and Governor Kazuo Ueda (15 January), noting "encouraging messages on wage increases" from companies, and **markets now see a higher chance for a rate hike at the 23-24 January meeting** (from c50% chance at the start of the year to c85%) (*Bloomberg*, 16 January 2025). Lower US yields after a slight downside surprise in US December inflation data also helped.

1. USD-JPY and its yield differentials



Source: Bloomberg, HSBC

2. BoJ's policy rate and USD-JPY



Source: Bloomberg, HSBC

USD-JPY is likely to drift higher gradually, but the path could be bumpy

We expect USD-JPY to show a gradual upward drift but the annual high-low range for USD-JPY can be very wide, i.e., 29 yen on average in the most recent three years. The main **upside risks to USD-JPY** could come from the risk of rate hikes by the Federal Reserve and a dovish BoJ. Conversely, **downside risks to USD-JPY** could arise if US-centric risk aversion arises, or if there is a domestic pivot in Japan's Government Pension Investment Fund's (GPIF) five-year asset allocation (the plan will be announced in the coming months). The last two reviews announced in March 2020 (for FY2020-24) and October 2014 (for FY2015-19) led to a sharp increase in the portfolio allocation to foreign bonds (from 15% to 25%) and foreign equities (from 12% to 25%), respectively.

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