Mizuho Brief: Japan

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Why the BoJ Must Endure JPY Carry Risk

"There is nothing more deceptive than an obvious fact.**" – Sherlock Holmes, The Bascombe Valley Mystery**

In a Nutshell:

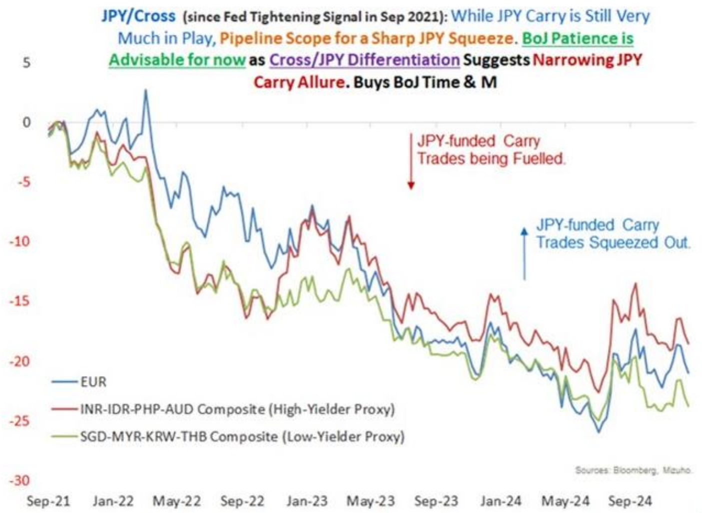
- **Despite higher volatility** that typically deters carry trades, **JPY carry trade** is **far from** being **dead** and buried.
- First, because **"Trump 2.0" is a JPY suppressant, despite being a source of uncertainty-volatility**, counter-intuitively *accentuating the allure of JPY-funding*.
- Specifically, **adverse global trade impact from Trump 2.0 tariffs will, all else equal, compromise the JPY**.
- And so, the *probability of sharp JPY strength from market-driven volatility** amidst Trump 2.0 is meaningfully diminished*.
- Second, the **shifts in Fed-BoJ policy divergence** are now **more likely to weaken the JPY** (boost, not drag the USD/JPY).
- The upshot is, the **BoJ must fully expect, and arguably endure**, the *soft JPY accentuating JPY-funded carry* to be a policy dilemma.
- Crucially, because **policy patience will pay off**. *Especially in mitigating the greater threat from policy over-steer risks*.
- *Moreover, the* **BoJ has the benefit of policy space to accommodate a softer JPY** *from confluence of;*
  - i) *MoF-BoJ intervention to manage JPY pressures;*
  - ii) *wider JPY carry allure dimmed as pressures build on other currencies (e.g. AUD, NZD, BRL, MXN, AXJ) dent Cross/JPY, and;*
  - iii) *potential for relatively more dovish Fed shifts down the road such that Fed-BoJ spreads are likely to backstop, if not buoy JPY.*
- The ***"obvious fact"*** **of higher volatility burying JPY-funded carry trades** is indeed ***"deceptive"***. **But a BoJ response** (via tightening) would **merely be another "obvious fact deception"**.

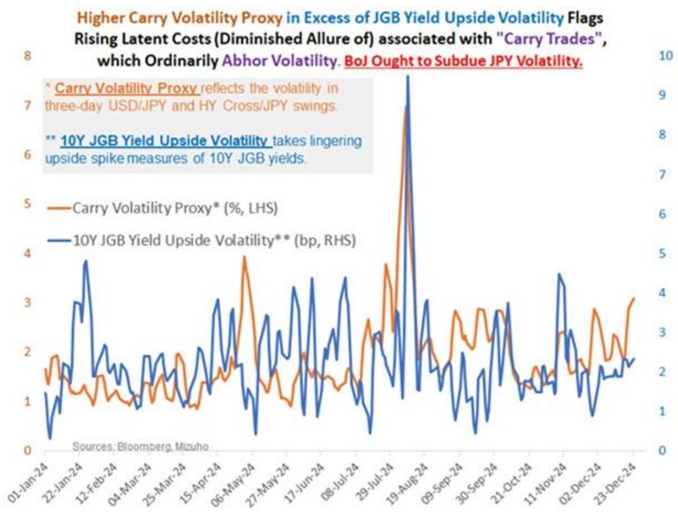
Why the BoJ Must Endure JPY Carry Risk

- The **BoJ will have its policy dilemma accentuated** *as JPY carry trades* could defy *volatility*, which typically significantly dampens "carry", **amid the quirks of Trump 2.0**.
- The hope, and likely *consolation*, is that this may be an **interim discomfort, not a sustained tyranny** of US exceptionalism at the expense of partners (Japan included).
- Admittedly, likelihood of **prolonged**, **accentuated volatility** amid *heightened uncertainty around Trump 2.0 trade tariffs* **ought to deter "carry" trades**; at least in theory.
- This is because **acute volatility to the underlying funding currency/liability** against the "carry" currency/asset **could more than wipe out typically smaller (but steady) "carry" gains**.

- And this potentially poses a disproportionately larger risk as carry trades are leveraged – which is likely amongst more aggressive speculators, who want to juice "carry" returns.
- *Nonetheless*, **JPY carry trade*** is **far from** being **dead** and buried. And this is owed to two fundamental factors that are owed to geo-politics.
- First, because the **"Trump 2.0" is not purely a source of uncertainty-volatility** that exclusively deters "carry" trades. ***Instead*, it is a JPY suppressant**, that also *accentuates the allure of JPY-funding*.
- Specifically, **adverse global trade impact from Trump 2.0 tariffs will, all else equal, compromise the JPY**.
- And so, the *probability of sharp JPY strength from market-driven volatility** amidst Trump 2.0 is meaningfully diminished***.
- In turn, this **mitigates "capital loss" risks** (associated with sharp and sudden JPY squeeze), which in turn **lowers the volatility-induced risks to JPY carry trades**.
- Second, the **shifts in Fed-BoJ policy divergence** are now **more likely to weaken the JPY** (boost than drag the USD/JPY).
- Point being, the *Fed has turned markedly less dovish*, **on expectations of Trump 2.0 accentuating US exceptionalism**.
- On the other hand, the *BoJ is justifiably less hawkish* (far more guarded about further tightening) **amid disproportionate exports headwinds associated with tariffs that threaten to exacerbate fragile domestic confidence**.
- And so, **JPY carry trades could, in defiance of a step-up in volatility/uncertainty, remain** in play **as** two critical factors – *supported "carry returns*" and *mitigated capital risks* (of JPY squeeze) – *conspire favourably*.
- As ***entrenched Fed-BoJ wedge keeps "carry" returns underpinned*** (delaying and diminishing the decay of "carry spread) and;
- Also, given ***disproportionate "capital loss"*** (from sharp **JPY squeeze**), which is ordinarily an effective deterrent for carry trades, is ***effectively mitigated*** **by the peculiarities of Trump 2.0 volatility and US exceptionalism** (at Japan's expense weighing on JPY).
- Consequently, the *BoJ's policy dilemma* – caught **between sufficient policy accommodation to cushion trade shocks***** **and defend against excessive JPY pressures** – is likely *set to be carry on* (pun intended!).
- To be sure, which way the balance tips may be a "live" decision for the BoJ caught between excessive JPY strength and critical "policy insurance" for potentially dire, exports-directed, economic risks. But **some consolation is at hand**.
- First, expect **MoF**(-BoJ) **FX intervention** (verbal and direct) to be a tool **to backstop JPY and alleviate unnecessarily costly policy trade-off, or worse, mis-steps**.
- Second, **significant downside risks/pressures to FX** (e.g. EUR, AUD, NZD, BRL, MXN, AXJ) elsewhere will **check unmitigated and overly aggressive JPY-funded carry**. In other words, **Cross/JPY may be less buoyant**, and hence less compelling.
- Finally (and this is a longer shot, admittedly), **if we are right about Fed rate cuts being ramped up into mid-2025**, then **sustained JPY pressures will reverse sharply, squeezing out carry**. In any case, relative Fed-BoJ shifts should buoy JPY, all else equal.

- And so, the **BoJ must fully expect, and arguably endure**, the *soft JPY accentuating JPY-funded carry* to be a policy dilemma. Possibly problematic.
- Point being, **patience, complemented by other FX-specific tools to manage JPY slippage**, **will pay off**. *Especially in mitigating the greater threat from policy over-steer risks*, which expose the BoJ to a more damaging prospect of sharp JPY strength.
- The ***"obvious fact"*** **of higher volatility burying JPY-funded carry trades** is indeed (in this case) ***"deceptive"***. **But a BoJ response** (via tightening) would **merely** be **another "obvious fact deception"** *that flirts with unnecessary economic pain.*





* JPY carry trades, more precisely refers to JPY-funded "carry" trades. Which involves borrowing JPY at lower rates to buy higher-yielding foreign currency assets (USD included) – thereby making the spread. In which case, sharp JPY appreciation could result in capital losses that more than wipe out the "carry" (rate differential) gains.

** The key exception to this is a "Plaza Accord" type move by Trump to revalue the JPY considerably higher. This is a "fat tail" risk that cannot be dismissed with Trump 2.0.

*** What may not be sufficiently appreciated is that Japan's vulnerabilities to exports shocks is far greater than elsewhere in the G4, and especially compared to the US. Exports shocks can quickly reverberate to hit fragile households via income (exports earnings to wages) shocks and balance sheet damage. Hence, wage-price spirals risks as assessed on current wage increase are almost surely overstated and hazardously backward-looking.

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