21 February 2025

Global Markets Research

Research Alert

Jump in Japan's inflation reaffirmed our bullish JPY view

Maintain our view for further BOJ hike this year; ending 2025 at 0.75%
Foresee upside risks to end-2025 USDJPY forecast of 146; 140 is a plausible level
Narrowing rates differential, safe haven appeal and reverse yen carry trade to support JPY
Trump's tariff could (or could not) weigh on the Japanese economy & currency

Overview

Overnight, we saw USD/JPY breaking below the 150-handle, on expectations that a jump in Japan's inflation will spur more Bank of Japan (BOJ) rate hikes this year. True enough, Japan's CPI accelerated to 4.0% y/y as expected, its highest in 2 years. Not only will this keep the BOJ on track for more rate hikes, but also reaffirms our bullish view on the JPY, as the core drivers for an appreciation (JPY's safe haven appeal, narrowing interest rate differential and continued unwinding of yen carry trades), remain intact, and stakes are high for the BOJ to let JPY weaken. At the point of writing, USDJPY has rebounded somewhat to hover around 150s, after hitting a low of 149.29 this morning.

BOJ may prefer a stronger JPY to help contain imported and cost-push inflation

As mentioned, stakes are too high for BOJ to let the JPY weaken as exchange rate developments are, compared to the past, more likely to affect prices. Based on our calculations, the inflation rate has a strong 0.88 correlation with USD/JPY, and every 100 pips increase/decrease in USD/JPY, could increase/reduce the inflation rate by approximately 0.1ppts, within 1-3 months' lag (Refer to Figure 1).

As such, BOJ may prefer a stronger JPY to help contain import prices and cost-push inflation. Lower inflation, coupled with higher wages, will help cushion any loss in consumers' purchasing power and ultimately boost consumer spending amidst a normalising monetary policy cycle.

Fundamentals support a stronger JPY view as well

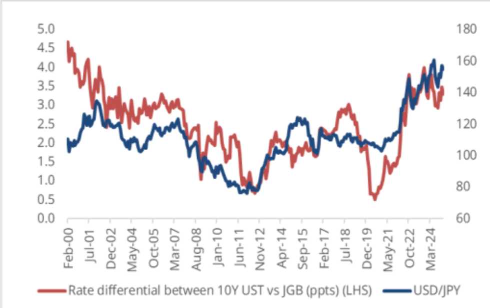
While uncertainties persist especially on the global trade front, we, as well as the Japanese officials, expect the Japanese economy to keep growing above its potential growth rate while underlying CPI inflation, is expected to moderate gradually to a level that is generally consistent with the price stability target of 2.0% by fiscal 2026.

With this, we have pencilled in another 25bps rate hike, if not more, by the end of 2025, making it less attractive to borrow from Japan, likely resulting in a continued unwinding of yen carry trades. It should be noted that at 0.50%, the policy rate remains below the neutral level of at least 1.00% eye-balled by the central bank.

Figure 1: Stronger JPY could help contain imported inflation

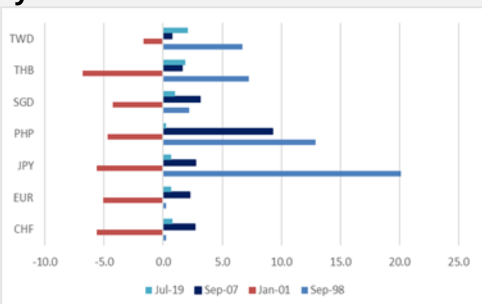
Source: Bloomberg; HLBB Global Markets Research

Figure 2: Narrowing interest rate differential to support JPY



Source: Bloomberg; HLBB Global Markets Research

Figure 3: Potential currency winners based on past easing cycles of the Fed



Source: Bloomberg, HLBB Global Markets Research

At the same time, major central banks including the Fed are on their easing cycle, and the policy divergence is poised to not only narrow the yield differential between the BOJ and other major central banks, but also support an appreciation for the JPY (Refer to Figure 2).

In fact, in our article "Revisiting what happens when the Fed cuts?" dated 12 September 2024, we have already highlighted that potential winners from Fed's easing cycle alone, include haven currencies like JPY and CHF, as well as EUR amongst G10. These currencies have strengthened three out of the past four easing cycles. (Refer to Figure 3)

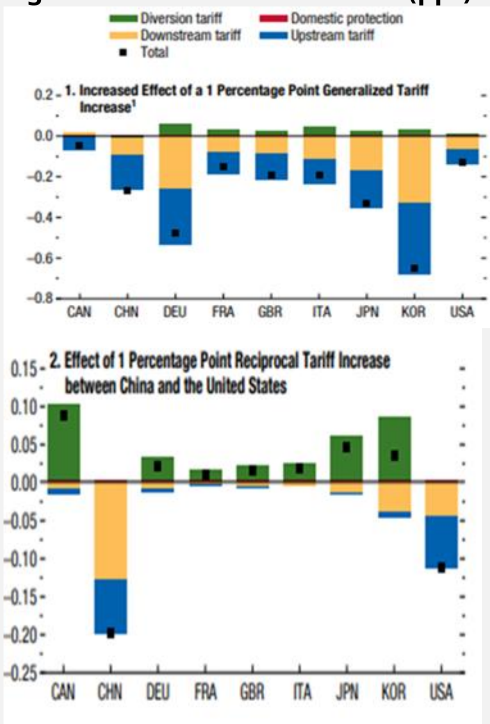
Trade tension could pose downside, as well as upside risks, to JPY

Impact of trade uncertainties on the economy and indirectly JPY, remains debatable at this juncture, depending on whether Japanese goods are in the direct firing line of Trump's tariffs plan. If history is any reflection, Japan's economy (and thus JPY) will be hit hard if tariffs on Japanese goods are implemented (Trump has said that he is considering 25% tax on autos and chips), but could benefit from trade diversion if the tariff hikes are discriminatory to only selected countries, namely US-China (Refer to our article "Potential impact from US tariffs – a revisit" dated 5 February) (Refer to Figure 4).

From our study as well, arguments for a weaker JPY to support exports, may prove futile. This is because historically, export growth has low correlation of 0.1ppts to the currency, probably due to the inelasticity of demand for its products, its good relationships with trade partners and/or diversified market destination.

In short, we remain bullish on JPY given JPY's safe haven appeal, narrowing interest rate differential and reverse yen carry trade, expecting USD/JPY to close 2025 at 146, or approximately 3% upside from the current level of 150.38 at the point of writing. If history is any reflection, the upside target remains conservative, as the pair has: 1) fluctuated in tune to +/-30% per annum from though-to-peak historically, suggesting more room for USD/JPY to manoeuvre. 2) USDJPY traded within the 140-162 levels for the past year (+/-15%), and we opine that the ***140 level remains plausible this year given a better economic outlook and higher policy rates expected for 2025 in Japan.***

Figure 4: Tariff effects on GDP (ppt)



Source: IMF

Figure 5: House view on USDJPY and BOJ target rate

	1Q25F	2Q25F	3Q25F	4Q25F
USD/JPY	158	155	150	146
BOJ (%)	0.50	0.50	0.75	0.75

Source: HLBB Global Markets Research

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