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FX Focus: JPY – Still on a path of further gradual appreciation

FIGURE 1: FX Forecasts

Forecast (May 2025)	Spot	0-3m	6-12m	Long-term
USDJPY	144.75	145.00	138.00	130.00

Source: Citi Wealth Investments as of June 2025.

USDJPY's movements from the lows of ~142.00 in late May to a 148.00 high in late June before reversing to sub 145.00 most recently, highlights the sharp rise in volatility in the pair over the past month which may be discouraging for Yen bulls. This volatility spike is likely due to 2 reasons –

1. Market concerns about rising oil prices from Mideast tensions which, if sustained, could damage Japan's terms of trade (ToT) in a manner similar to what occurred following the outbreak of Russia – Ukraine hostilities in early 2022.
2. The Bank of Japan (BoJ) at its June meeting announcing its intention to slow the pace of balance sheet contraction from April 2026 onward by trimming its bond buying by JPY 200bn per quarter instead of JPY 400bn per quarter.

But market concerns about rising oil prices may be overdone as Mideast tensions have already started to de-escalate and if the rise in oil prices is not sustained then the damage to Japan's Terms of Trade (ToT) is likely to be limited. In any case, rising oil prices represent a double-edged sword for the Yen – on the one hand, if sustained, would admittedly damage Japan's ToT (a Yen negative) but on the other, higher oil prices would likely also boost inflation which would allow the BoJ to re-calibrate its hiking cycle to a faster pace of yield compression with USD (Yen supportive). At the June meeting, BoJ Governor Ueda appeared more hawkish by mentioning upside risks to Japan's inflation several times while citing downside risks from tariffs and tying the case for the next rate hike to the degree of "certainty" that the BoJ's forecast for growth and inflation are realized. Governor Ueda suggested that those may now be easier to hit.

That said, with Japan – US trade talks still a long way from an actual deal and with Japan's Upper House elections due in July, a near term BoJ rate hike looks unlikely. Instead, JPY rates now discount a 50% probability of a BoJ 25bp hike before year-end from around September when there will likely be more clarity about the impact of tariffs on Japanese exports to the US. Q4'2025 could also be when the Fed may start to further cut rates, a possible 50-75bp contraction in USD – JPY short rate spreads could be the trigger to take USDJPY another significant leg lower.

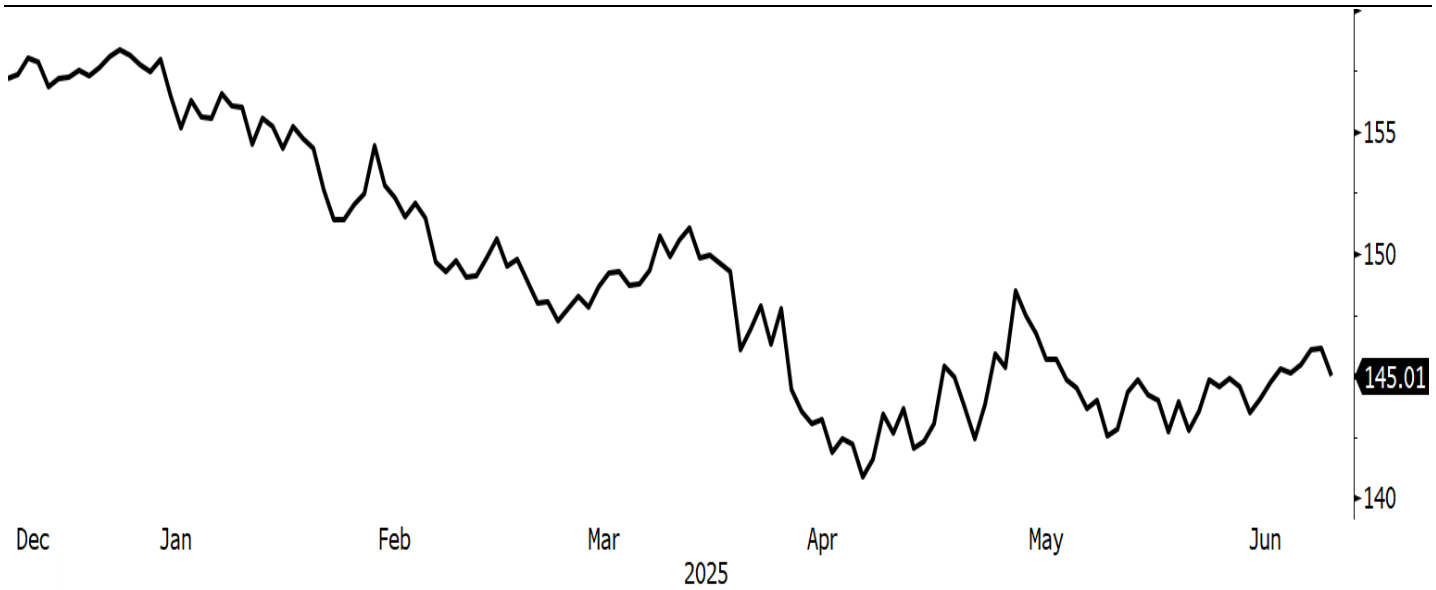
The June meeting also saw the BoJ board flagging a reduced pace of balance sheet contraction from Q2'2026 onward with Governor Ueda stating - "we made our decision to ensure we're not cutting purchases too fast in a way that would cause a negative impact on the economy through abnormal volatility in yields." While the announcement essentially means that the BoJ would be reducing money supply at a slower pace next year and is likely marginally dovish, it could yet turn Yen positive over the medium term given the BoJ's objective is to prevent undue volatility in the JGB market through an undesirable spike in longer term bond yields.

Yields in the longer JGB maturities have been volatile of late because markets fear the BoJ may be withdrawing too quickly from its JGB bond purchases. By slowing the pace of withdrawal, the BoJ clearly wants to signal its displeasure about the volatility spike in longer maturity JGBs while trying to stabilize the bond market. If successful, this would likely make JGBs more attractive for Japanese funds and potentially increase repatriation flows into JGBs from US Treasuries over the long term. Such a move is also likely to prove supportive for the Yen over the longer run.

Currently, the BoJ holds 46% of all JGBs and as it scales back its purchases (albeit more gradually), the role of domestic private-sector banks, life insurance companies and pension funds becomes more critical. As of the end of last year, Japanese banks held just 14.5% of JGBs (including treasury discount bills), insurance firms 15.6%, and foreign investors 11.9% so there is a great capacity for Japan's private institutions to absorb more JGB supply.

Ultimately, BoJ's actions on rates and balance sheet should be seen from the lens of an alignment between Japanese and US policy makers about strengthening JPY vs USD over the longer term as part of an US – Japan trade agreement which leaves USDJPY's overall trajectory still heading south. While the pace at which the Yen strengthens will continue to remain non-linear, it is evident that JPY has already begun to make higher highs/higher lows vs USD this year.

FIGURE 2: The peak in USDJPY has steadily fallen from ~160.00 at the start of this year to sub 150.00 in May and now closer to the 146.00 – 148.00 level in June



Source: Bloomberg, June 24, 2025.

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