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FX Focus: US lowers tariffs on Japanese goods but political uncertainty hits the Yen

FIGURE 1: FX Forecasts

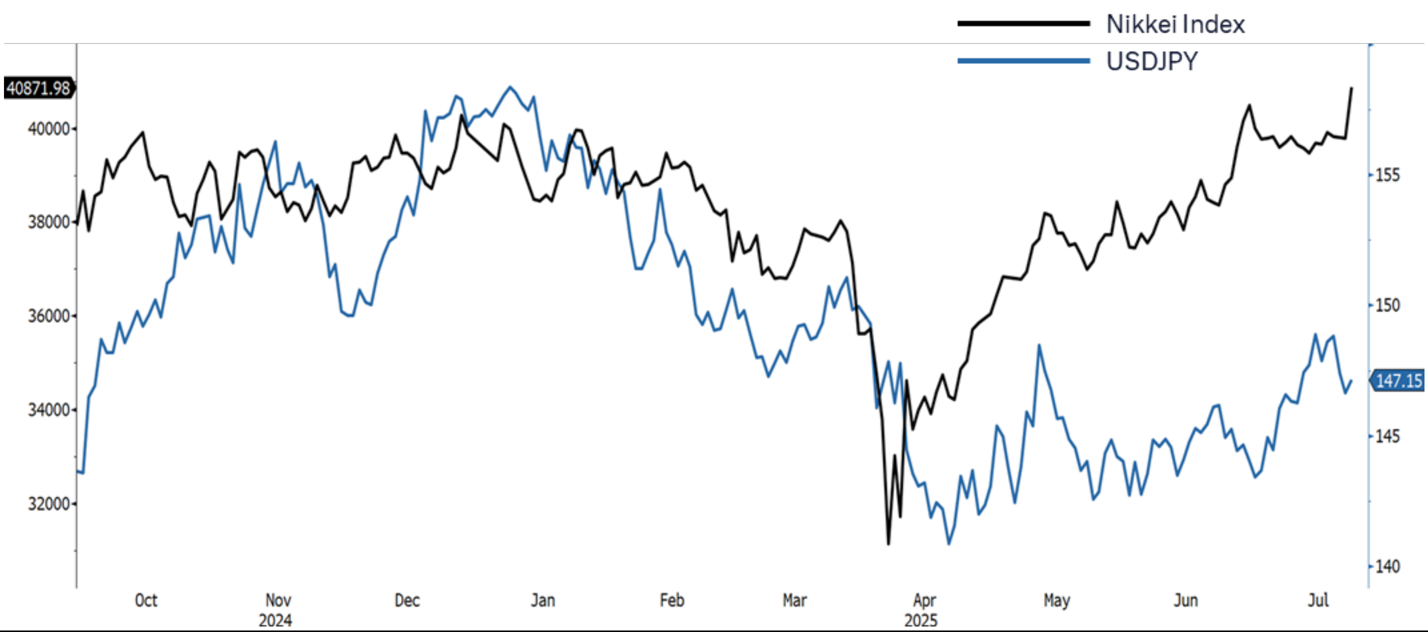
Forecast (July 2025)	Spot	0-3m	6-12m	Long-term
USDJPY	146.00	145.00	138.00	130.00

Source: Citi Research, July 16 2025

US President Trump's decision to reduce Japan's reciprocal tariffs from 25% to 15% on Japanese goods failed to reduce political and fiscal policy uncertainty in Japan which means near term headwinds for the Yen remain. But the medium- to longer-term outlook still favors the Yen on expectations for a continuation of the narrowing in USD vs JPY rate spreads as the US Federal Reserve (Fed) cuts and Bank of Japan (BoJ) tightens further.

- President Trump also said Japan will invest USD550 billion into US and open more goods channels, including its fiercely guarded rice and agricultural markets.
- Japanese markets reacted positively to the announcement with stocks up and longer-dated government bond yields (JGBs) also rose as flows shifted from risk-free bonds into risk assets while short-dated yields also rose. This puts BoJ tightening expectations back on the radar and moderately strengthened the Yen.
- Japanese short rates now raise the probability of a 25 basis point hike in September to ~20%, and to 80% by the end of the year. But higher rates are more likely to help to cap further JPY weakness beyond the 150.00 mark than drive further Yen strength in the short term.
- The positive market reaction over a trade breakthrough appears to have done little to remove concerns about Japan's political uncertainty. The ruling LDP/Komeito coalition has lost in majority in both the upper and lower houses of the national legislature, and this could lead to political gridlock. Local media has reported PM Shigeru Ishiba has decided to resign, although there has been no official word of his departure yet.
- Elevated political risks represent a risk to Japanese markets via two sources –
  - Fiscal uncertainty: PM Ishiba is fiscally conservative but the opposition favors stimulus. Japan's agreement to open up to US products risks voter backlash. While this can be countered through additional fiscal spending, further borrowing will likely hurt an already jittery JGB market concerned about additional spending. Volatility in JGBs could discourage much needed Japanese repatriation, potentially creating a near-term headwind for the Yen.
  - Monetary policy uncertainty: a Japanese recession may have been avoided by the tariff deal but potential successors to PM Ishiba seem to be monetary doves. Delays in BoJ tightening may also add to the near-term headwinds for the yen.
- However, the medium to longer term outlook is still likely to favor Yen strength for three reasons:
  (1) Expectations for a continuation of a narrowing in USD vs JPY rate spreads as the Fed cuts and BoJ (eventually) tightens further.
  (2) Japan exporters becoming more active to hedge their offshore earnings that are now more vulnerable to exchange rate risk due to USD weakness.
  (3) The likelihood of an informal US – Japan agreement to strengthen the Yen – perhaps the easiest concession for Japan to make in any trade agreement with the US, as strength in Japanese equities is no longer as critically dependent on a weaker Yen as it was prior to the first tariff announcement in early April.

FIGURE 2: Since Liberation Day in early April, Japan equities have diverged from USDJPY. The Nikkei and the Yen have both been strengthening



Source: Bloomberg, July 23, 2025. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results.** Real results may vary.

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