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USDJPY’s dip belies its oversold state

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Last week's sharp fall and subsequent bounce in USDJPY suggests that while the medium-term environment favors further downside, the pair appears oversold in the near term. Market expectations for US rate cuts appear too dovish, and long-JPY market positioning appears unsustainable in our view. We think that USDJPY is more likely to gravitate toward a range of 143-147 and we favor selling the pair near 147 for a medium-term decline to 138 in 12 months’ time.

The sharp dip in USDJPY during last Wednesday’s Asia morning session from around 142.40 to a low of 140.70 was broadly in line with the pair’s trend since the middle of July when it began its fall from above 160. Indeed, we expect USDJPY to continue trending lower to 138 in 12 months’ time. It is also worth pointing out that the JPY’s real effective exchange rate (REER) remains at 2.1 standard deviations below the 10-year average, indicating that the fundamentals also provide scope for medium-term yen appreciation.

But the subsequent bounce in USDJPY off its intraday low to just shy of 143 last Thursday highlights that in the near term, the prospect of further USDJPY downside appears to be limited. Indeed, the selloff in USDJPY appears to be somewhat overdone, for the following reasons.

US Treasury yield declines have been too rapid. Since early August, yields across the US Treasury curve have fallen quite sharply. The 2-year yield has fallen from 4.25% to 3.66% while the 10-year yield has fallen from 4.10% to 3.67%. This has already run ahead of our December 2024 forecasts of 3.75% and 3.85% and, in our view, suggests that the downside pressure on the USD’s carry will taper off in the near term at least.

Market expectations on US policy rate cuts have also run ahead of our forecasts. We see the Fed cutting rates by a total of 175 bps by September 2025 while the futures market has priced in 240 bps by that time. This has added to the downside pressure on the USD in the near term, but leaves the market vulnerable to a scaling back of rate-cut optimism.

Long-JPY market positioning appears unsustainable. The leveraged FX market appears to have turned net-long JPY, which in our view is unsustainable given the net carry loss of a long-JPY position. Historically, long-JPY positions have only managed to persist in global risk-off periods, such as in 2016 and 2020, when Fed rates were also at very low levels.

We thus think that USDJPY is more likely to gravitate toward a range of 143-147 in the near term, and we favor selling the pair near 147 for a medium term decline to 138 in 12 months' time.

We expect that Japanese equities will continue to be volatile, primarily due to the JPY's gyrations. Investor risk appetite has been muted thanks to weak seasonality for both the Japan and US markets in September, plus the uncertainty ahead of the Fed's interest rate-cutting cycle and the US presidential election in November. We think valuations now look attractive for long-term investors given Japan's structural transformation, even if volatility persists in the near term. We expect a sustained share price recovery to commence once the 1H FY24 (2Q24-1Q25) earnings results for Japan and the US election are behind us. Amid near-term uncertainty, investors should focus on fundamentals and quality. We recommend a well-diversified exposure to domestic and exporter stocks to potentially capture the recovery phase.

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