USD/JPY: End of the Carry Trade?

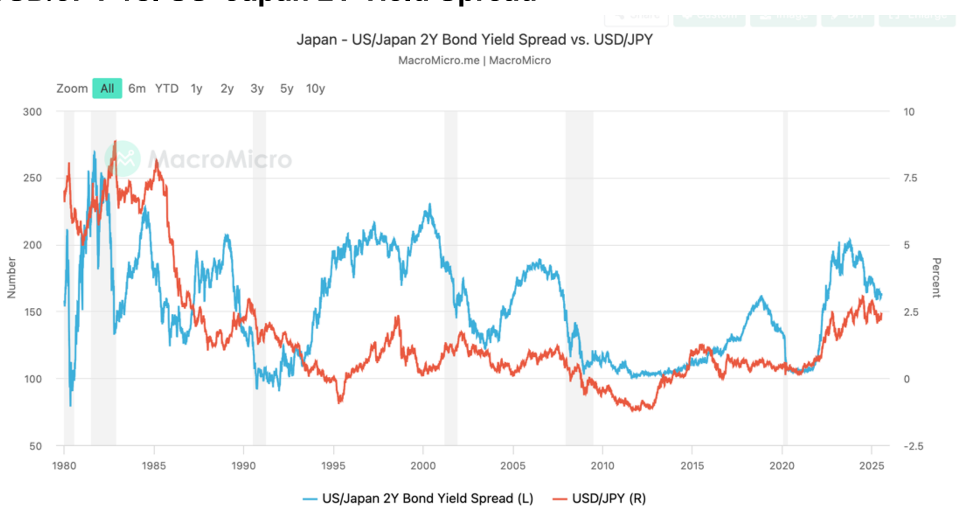
July 12th, 2025

Highlights

For the past two years, the USD/JPY trade has become one of the most reliable expressions of macro divergence, built on the solid foundations of carry. With U.S. interest rates soaring in response to inflationary pressure and the Bank of Japan clinging to its ultra-loose stance, the trade was simple: borrow in yen, invest in dollars, and collect the spread.

But the tides may be turning. A convergence in U.S. and Japanese monetary policy, driven by political developments, inflation dynamics, and structural shifts, could signal the end of this era. If so, the implications for global FX markets could be profound.

Figure 1: USD/JPY vs. US–Japan 2Y Yield Spread



The chart shows a strong historical correlation between the USD/JPY exchange rate (red, right axis) and the U.S.–Japan 2-year bond yield spread (blue, left axis). Periods of widening yield differentials have driven USD/JPY higher, while narrowing spreads typically precede yen appreciation. The recent compression in the spread signals potential downside risk for USD/JPY if the interest rate gap continues to close post-Trump re-election and amid BoJ normalization.

The Classic Carry Framework: USD Long, JPY Short

The fundamental thesis behind the carry trade is straightforward: exploit interest rate differentials. For much of the post-COVID period:

- **U.S. short-term rates** climbed above 5.5% under the Fed's inflation-fighting regime.
- **Japanese rates** remained pinned at or near zero, with the BoJ only reluctantly exiting Yield Curve Control (YCC) and raising its policy rate to a token 0.1%.

The result was a **massive interest rate differential**, driving USD/JPY higher and making it attractive to go long USD/JPY, collect carry, let the trend do the rest.
Hedge funds, CTAs, Japanese institutions with unhedged U.S. Treasuries, all contributed to a structurally long USD/JPY market. But now, several elements threaten to unwind this thesis.

Trump 2.0: Policy Pivot and Fed Pressure

Trump's return to office brings a **more interventionist approach to economic and currency policy**. Markets are already pricing in the likelihood of:

- **Pressure on the Federal Reserve to cut rates**, possibly under the guise of boosting growth or re-industrialization.
- **A weaker-dollar stance**, intended to support U.S. exports and manufacturing competitiveness.

  Expansionary fiscal policy, including tax cuts or tariffs, which may be inflationary in the long term but tighter financial conditions.

This changes everything:

- A structural **re-pricing of forward points** and hedging costs.
- Increased appetite from Japanese investors to **repatriate capital**, as home yields become relatively more attractive.

The net effect? **Markets anticipate earlier and deeper rate cuts**, especially if the Trump administration installs Fed governors with dovish leanings. **Terminal rate expectations are falling**, and real U.S. yields could compress significantly.

Japan: From Policy Laggard to Inflation Survivor?

Meanwhile, Japan is facing a new structural environment:

- **Service-sector inflation** is persistent, with wages rising amid demographic constraints.
- **BoJ has ended YCC**, and modest rate hikes are now part of its toolset.
- **Governor Ueda** has emphasized inflation sustainability over backward-looking data, raising the chance of a **measured normalization path**.

If Japanese policy rates rise to 0.5–1.0%, still extremely low globally, but high by Japan's standards, and U.S. rates fall to 3% or below, **the yield differential shrinks dramatically**.

Once **U.S.–Japan differentials collapse below 1.5%**, the long USD/JPY trade becomes unattractive.

- No more passive inflows into long USD/JPY

Positioning and Volatility Risk

USD/JPY long positioning is **deeply crowded**:

- Hedge funds and CTAs are heavily net long.
- Option markets are skewed toward upside USD calls.
- The volatility term structure is flat, suggesting **complacency**.

In such an environment, any shift in rate expectations or BoJ signaling can trigger **sharp, convex reversals**. Traders should expect:

- Spikes in **implied volatility**.
- Breakdowns in **technical levels** (e.g. below 155).
- **MoF or BoJ intervention** to gain more traction as markets become less one-sided.

Trade Implications

The Trump 2.0 area adds policy fuel to an already evolving macro narrative. Traders and macro funds should consider:

- Reducing or exiting USD/JPY longs as rate differentials compress.
- Positioning for yen strength via long JPY call spreads or delta-neutral gamma trades.
- Watching for a "policy convergence regime" that ends the dollar-dominance cycle of 2022–2024.

Final Thought: The Regime Has Changed

Under Trump 2.0, the dollar is no longer sacred. Rates are no longer sacred. And the BoJ is no longer asleep.

This makes USD/JPY less of a “set-and-forget” carry vehicle, and more of a two-way, volatility-rich macro trade. The carry premium may still exist today, but its days are numbered. The unwind, when it comes, could be disorderly.

The era of long USD/JPY as a low-volatility carry anchor is ending. A new chapter, while one of rebalancing, repatriation, and reversals is beginning.

Trade Idea:

Short USD/JPY:

Key Drivers:

- **US Rate Outlook:** The Fed may be approaching the end of its hiking cycle, and Trump's influence could prompt looser fiscal policy, potentially leading to lower real rates and yield curve steepening.
- **Japan Policy Shift:** The BOJ is no longer anchored at ultra-accommodative levels, rate hikes are now a scenario under consideration, particularly if inflation becomes persistent.
- **Positioning & Valuation:** USD/JPY remains near multi-decade highs; speculative net longs are elevated, making the pair vulnerable to a reversal on any shift in macro narrative.
- **Reversal of Carry Premium:** If the perceived US-Japan yield spread compresses, the carry premium that supported USD/JPY could erode.

What to trade?

Ratio put to profit from skew + directional view.

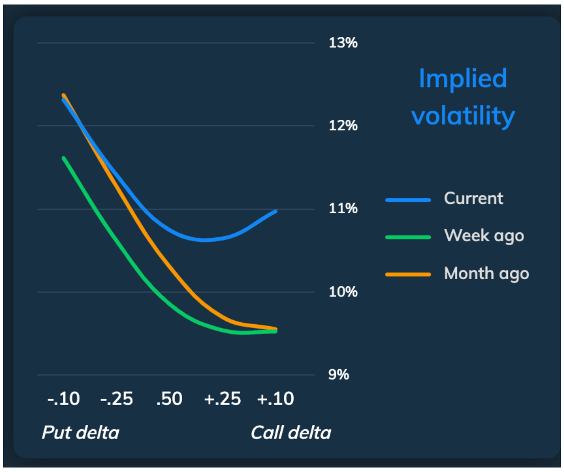
 Sell 2x OTM puts (e.g., -25Δ) with elevated vol

 Buy 1x deeper put (e.g., -10Δ) to benefit from skew

 You monetize the rich skew and express a bearish view

USD/JPY Options expiring 2025-08-19

Sources : Investing.com



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