Japan Market Insights

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Mitsubishi UFJ Trust and Banking Corporation

A member of MUFG, a global financial group

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BOJ Rate Hikes and the Yen Outlook

At its September monetary policy meeting, the Bank of Japan raised its policy interest rate from 1.00% to 1.25%. This marks the second rate hike in just three months, following the increase in June. Given that the U.S. government had been pressing Japan to address the weak yen and that this rate hike had been widely reported in advance, it came as no particular surprise. Governor Ueda reiterated his vigilance regarding upward pressure on prices. He stated that monetary policy would be managed appropriately in line with the outlook for the economy and price developments. In addition that should the likelihood of the Bank's projected outlook materialize increase, the Bank would continue to raise the policy interest rate and adjust the degree of monetary easing. It is expected that rate hikes will continue in the future.

Looking at the foreign exchange market, the trend of yen weakness appears to be reaching a turning point. Although USD/JPY rate temporarily rose to the 163-yen level in late July, it has since fallen sharply partly due to speculation surrounding efforts by Japan and the U.S. to reverse yen weakness. As of 18 September, it has corrected to around the 156-157 yen range. Although monetary policy meetings in Japan, the U.S., and Europe have recently concluded, downward pressure on the yen has not reignited to any significant extent. How, then, should we assess the outlook for the foreign exchange market? I would like to examine the future of the foreign exchange market after first analysing the factors behind the recent strengthening of the yen.

First, increased speculation of an early interest rate hike by the Bank of Japan (BOJ) can be cited as a key factor. While the prevailing view had previously been that the Bank of Japan would implement gradual rate hikes at a pace of once every six months. Following calls from the U.S. for an early rate hike, as well as rising risks of inflationary pressures stemming from yen weakness, high energy prices, and rising semiconductor prices, the prevailing view is now that the Bank of Japan will actively raise rates every four months, bringing the policy rate to around 1.8% by next summer (Exhibit 1). Given that the fundamentals of the Japanese economy remain broadly sound, and that monetary conditions are still accommodative—with the real policy rate hovering around -0.7%—the BOJ is likely to maintain its aggressive rate-hiking stance even after the latest hike. We expect the BOJ to raise the policy rate to 1.75% by next summer (we anticipate further rate hikes in January and June of next year). The policy rate differential with major overseas central banks is likely to gradually narrow. Furthermore, given that the People's Bank of China's 7-day reverse repo rate—its policy rate—stands at 1.4%, we believe there is a possibility that the funding currency for carry trades will shift in part from the yen to the Chinese yuan by next summer (leading to a decline in the popularity of the yen carry trade). Given that the market has already fully priced in the Bank of Japan's aggressive stance on rate hikes, we do not expect the yen's appreciation to accelerate further; however, we believe the Bank of Japan's aggressive rate hikes can still be expected to provide some support for the yen going forward.

The second point is currency intervention by the Japanese and U.S. governments. Following yen-buying interventions totaling 11.7 trillion yen between April 30 and May 6, 2026, the Japanese government further intensified its yen-buying stance with 15.4 trillion yen in interventions between July 30 and August 26. This marks a new record for the largest monthly yen-buying intervention. The cumulative total of intervention through August of this year reached 27.1 trillion yen, surpassing the 20.4 trillion yen recorded in 2003—when the government repeatedly intervened by selling yen and buying dollars to curb yen appreciation—and setting a new record for the annual total. As a result of the summer currency interventions, foreign exchange reserves stood at $1.21 trillion as of the end of August 2026, down from $1.29 trillion at the end of July 2026.: furthermore, holdings of securities (primarily U.S. Treasuries bonds) stood at $839.6 billion as of the end of August 2026, down from $927.3 billion at the end of July 2026 (Exhibit 2). Although foreign exchange reserves have declined significantly, it can be said that there remains ample room for further currency intervention. Furthermore, given that the U.S. government also conducted coordinated currency intervention with the Japanese government on July 31, the strong commitment of both the Japanese and U.S. governments to correcting the weak yen can reasonably be expected to continue to provide support for the yen going forward.

Third, there is growing speculation that the Government Pension Investment Fund (GPIF) will revise its asset allocation to increase the weighting of domestic bonds. As at the end of June 2026, the GPIF managed approximately 320 trillion yen in assets and had allocated them almost evenly across four asset classes: domestic bonds (25% ± 6%), foreign bonds (25% ± 5%), domestic equities (25% ± 6%), and foreign equities (25% ± 6%) (with 25% as the median and minor deviations above or below permitted). However, amid a sharp rise in Japanese government bond yields over the past few months, there have been growing calls for the GPIF to raise its allocation target for domestic bonds. Prime Minister Takaichi has argued that Japanese pension funds should increase their allocation of funds to the domestic market. The fact that the GPIF's Management Committee—its highest decision-making body—held an extraordinary meeting on August 21 at an unusual time has fueled market speculation that the GPIF will raise its allocation target for domestic bonds in the near future. Given that the GPIF's long-term investment target is "nominal wage growth rate +1.9%," there would likely be little need to significantly raise the domestic bond allocation target with long-term interest rates at around 3%. The author expects that, going forward, the GPIF will increase the weighting of domestic bonds (while reducing the weighting of foreign securities) to the current upper limit (31%) within its basic portfolio. In other words, the author anticipates a massive inflow of approximately 19 trillion yen from foreign securities into domestic bonds, which is expected to provide significant support for the yen.

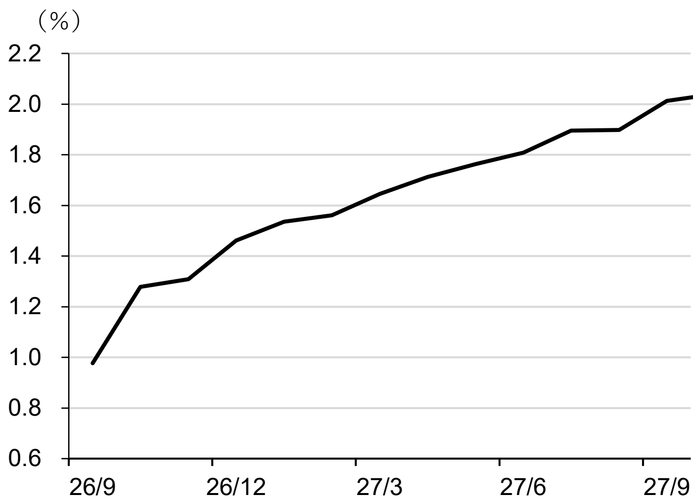
On the other hand, several factors contributing to yen weakness remain. Given that President Trump has stated the war with Iran will not end until after the midterm elections, high oil prices are likely to persist for the time being amid ongoing instability in Iran. Growing concerns over Japan's widening trade deficit are expected to act as a factor contributing to yen weakness. Structural factors contributing to yen weakness—such as concerns over the Takaichi administration's expansionary fiscal policy, the trend toward a widening digital trade deficit in Japan, and the growing trend of retail investors investing in foreign securities—remain firmly in place.

Based on the above, we expect USD/JPY to trade within a range centered around the mid-150 yen level, as factors supporting yen strength and those supporting yen weakness offset one another. Although structural factors supporting yen weakness remain, we believe the trend toward a weaker yen has paused, given the Bank of Japan's proactive stance on interest rate hikes and the strong commitment by the Japanese and U.S. governments to halt yen weakness. Looking at speculators' positions, while yen short positions had accumulated to historic highs in late July, they have recently shifted to yen long positions, suggesting that expectations of further yen weakness are beginning to subside (Exhibit 3).

Although the yen has strengthened recently compared with late July, at current levels (approximately 156-157 yen per dollar as of September 18), the negative impact on Japanese equities is likely to be limited. According to the Bank of Japan's Tankan survey (June 2026 survey), the assumed USD/JPY for large manufacturing firms (for FY2026) is 151.49; therefore, provided the exchange rate of USD/JPY remains within a range around current levels, there is limited scope to worry about downward pressure on corporate earnings. The momentum of profit growth for Japanese companies is likely to be sustained. If USD/JPY stabilizes at current levels, foreign exchange risk will diminish, and we expect demand for Japanese equities from overseas investors to pick up again.

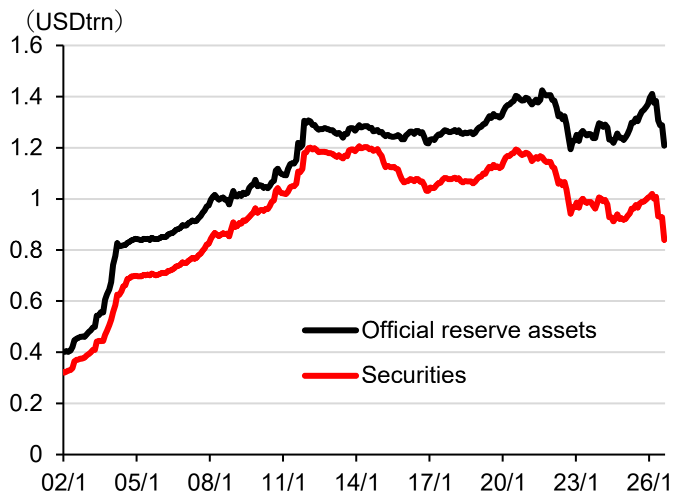
Given that the Bank of Japan is set to continuing raising interest rates, we maintain a bullish outlook on financial stocks for the time being. Furthermore, amid growing uncertainty surrounding the global economic outlook, small-cap stocks with low overseas exposure are also likely to perform well. Japanese small-cap stocks are resilient to yen appreciation and are relatively undervalued in terms of valuation (Exhibit 4).

Exhibit 1: The OIS Market's Outlook for the Bank of Japan's Policy Rate



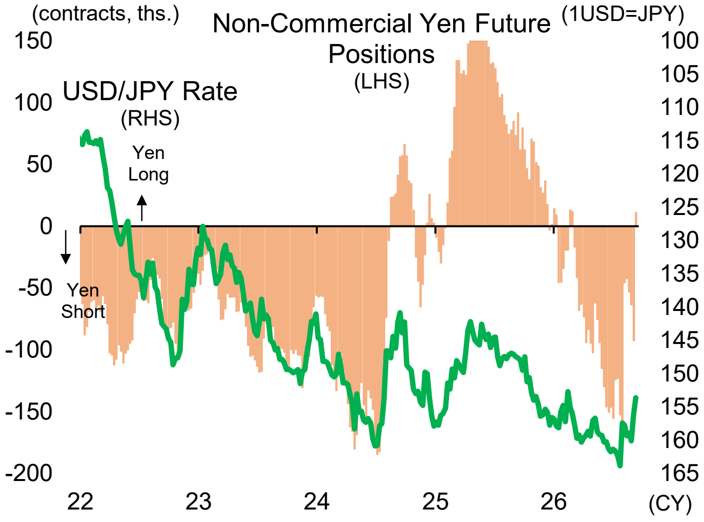
Source: Bloomberg, MUFG: Trust Bank
Note: As of September 17 2026

Exhibit 2: Japan's Foreign Exchange Reserves



Source: MoF, MUFG: Trust Bank
Note: As of August 31 2026

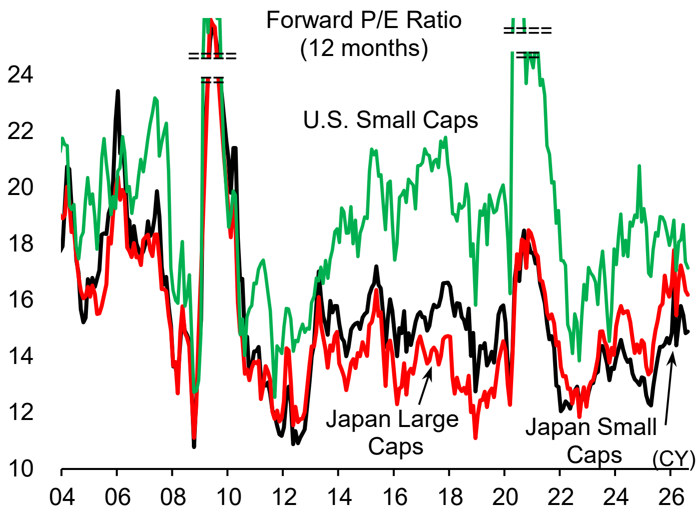
Exhibit 3: USD/JPY and Speculative Future Positions



Source: CME, Bloomberg, MUFG: Trust Bank

Note: As of September 8 2026

Exhibit 4: Valuations of Japanese and U.S. Stocks



Source: Factset, MUFG: Trust Bank

Note: As of August 31 2026

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