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INDIA | ECONOMICS | THEMATIC RESEARCH

JM FINANCIAL

Global Yields

Incremental carry-trade unwinding to be gradual

- Policy tightening by BoJ and Fed's easing may propel US yields
- Safe haven flows in US Dollar expected to moderate
- Indian yields well behaved; Weak Dollar aided INR

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Incremental carry-trade unwinding to be gradual

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Bank of Japan's policy tightening is sending shock waves globally through the unwinding of the yen carry trade. Although the quantum of the carry trade is not clear, our assessment of valuation of the yen on REER basis and Japanese investment in the US treasuries indicates that the unwinding could be sizeable. Post the end of yield curve control in 2024, the initial unwinding, mainly speculative, has already played out while the structural unwinding is still in the pipeline. However, the recent political developments in Japan and BoJ's quantitative tightening schedule are unlikely to lead to a surprise uptick in yields. However, rate hikes in Japan coinciding with the US Fed's rate cuts will accentuate outflows from the US. We expect a moderation in safe haven flows for the US dollar due to elevated debt and unstructured policies. This will support EM currencies, including INR; we maintain our expectation for the INR at 85.5 to 87.5/USD. Overall, we expect the incremental unwinding of the yen carry trade and its impact to be gradual on India.

- **Unwinding of carry trade:** Amidst rising yields in Japan, markets are concerned on the unwinding of the yen carry trade and its likely impact on global yields, including India. While the quantum of the carry trade is not crystal clear, our assessment of the real effective exchange rate (REER) of the yen and the Japanese investments in the US treasuries (USD 1.1trln) indicate that the unwinding can be sizeable. However, we believe that the recent political developments in Japan and the elevated debt levels (250% of GDP) could push Bank of Japan's (BoJ) policy tightening further to the end of 2025. We believe that the anticipated rating downgrade should not be a concern in the immediate near term due to Japan's resilient current account surplus. Hence, the negative impact of the unwinding of carry trade would be gradual.

- **What is driving this?** Japanese yields have been on a uptrend, reaching levels (1.5%) not seen in the last 1.5 decades. Rising yields in Japan were engineered by the BoJ over the past decade, most precisely since 2019 when it tinkered with yield curve control (YCC), allowing yields to move +-0.1%, and when the central bank ended the YCC in 2024. However the BoJ has ensured that the policy tightening will be predictable, avoiding any surprise to the markets. The quantitative tightening (QT) schedule has been well laid out (Ex 11), which removes any surprise element.

- **Impact on US yields and dollar:** US treasury yields are also on an uptrend due to elevated debt levels (125% of GDP). Moreover, the unstructured policy formulations by the Trump administration and the likely negative impact of elevated tariffs on consumption (68% of US GDP) will drag economic growth in a scenario where the incremental tariffs are fully passed on. Such a scenario would be negative for the US dollar and the yields in our base case. However, actual impact could differ; we observed that the movement in yields and the US Dollar Index differed in all three rating downgrades in the past (Ex 27). But considering the sizeable investment in US treasuries by Japan (12.6% share of US treasuries), paring of even 10-20% of USTs by Japan and the possibility of BoJ's rate hikes coinciding with the US Fed's rate cuts could accentuate reversal of flows to Japan, the unwinding if not gradual could be notable on the yields and the dollar index. We expect reduced safe haven flows in the US dollar, going forward.

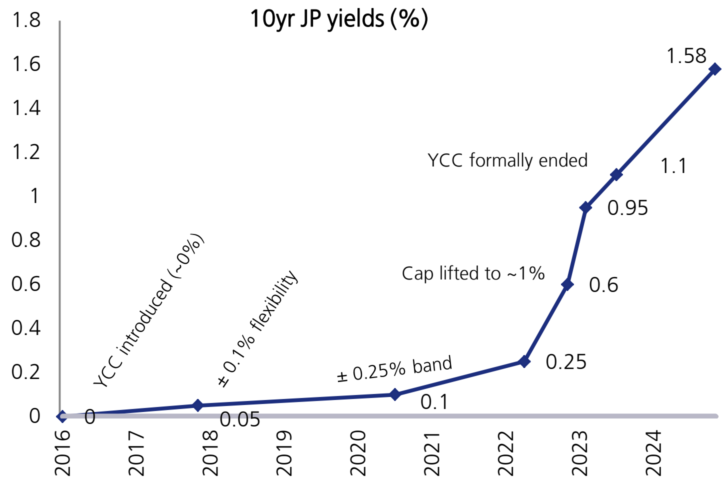
- **Appreciating bias in INR:** Yields in India have been well behaved due to the strength in macro fundamentals – comfortable inflation, easy monetary policy, ongoing fiscal consolidation and moderate growth expectations. Broadly, the benchmark yields moderated, except post the RBI's larger-than-expected rate cut in Jun'25 and the active liquidity management recently leading to a ~20bps spike in yields to 6.4%. This indicates that the markets have built in an end to the rate cut cycle. We believe that the liquidity management by RBI should be seen as fine-tuning of liquidity to align call money rates with the repo rate. On the unwinding of carry trade, we expect an appreciating bias in emerging market (EM) currencies including INR (85.5 to 87.5/USD), due to the INR's reasonable REER, positive growth differential with the US and the weakening bias in the US dollar.

Key Highlights:

- BoJ's policy tightening and the resultant rise in yields has triggered an unwinding of the carry-trade.
- Initial unwinding has already played out – mainly through speculative positions.
- Recent developments would delay BoJ's rate hikes however even a 10-20% sell off in US treasuries by Japan could lead to a rise in US yields.
- Strength in macro fundamentals aided Indian yields and INR; Weak Dollar would support INR.
- We expect a gradual unwinding of the carry trade from here on.

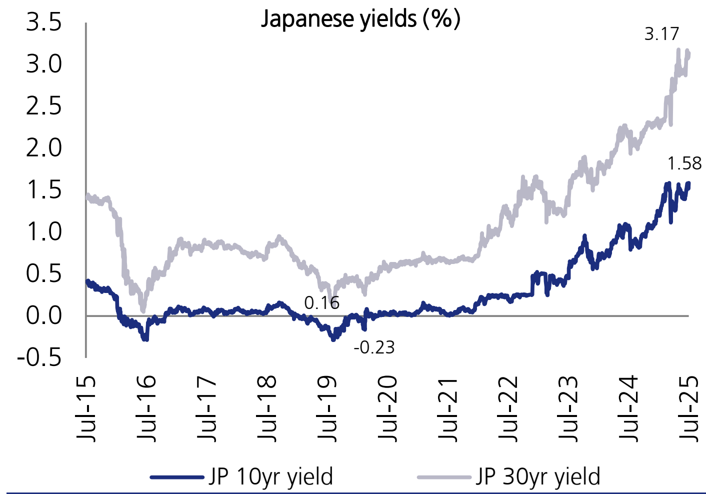
Story in Charts

Exhibit 1. Evolution of Japanese yield under yield curve control



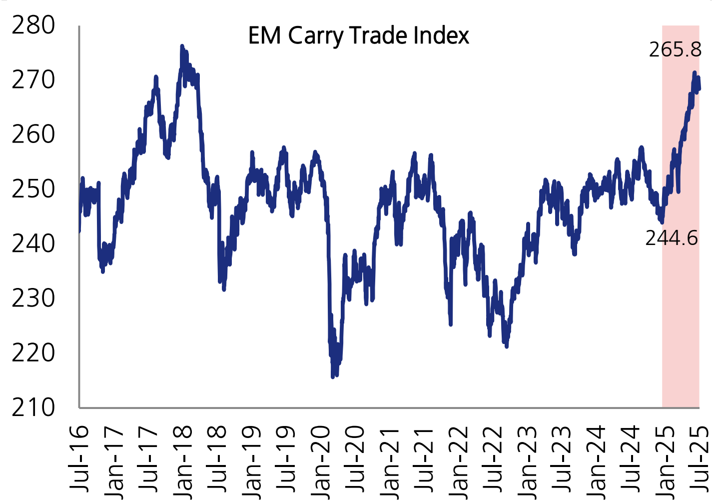
Source: Bloomberg, JM Financial

Exhibit 2. Decisive uptrend in yields from –ve to +ve territory



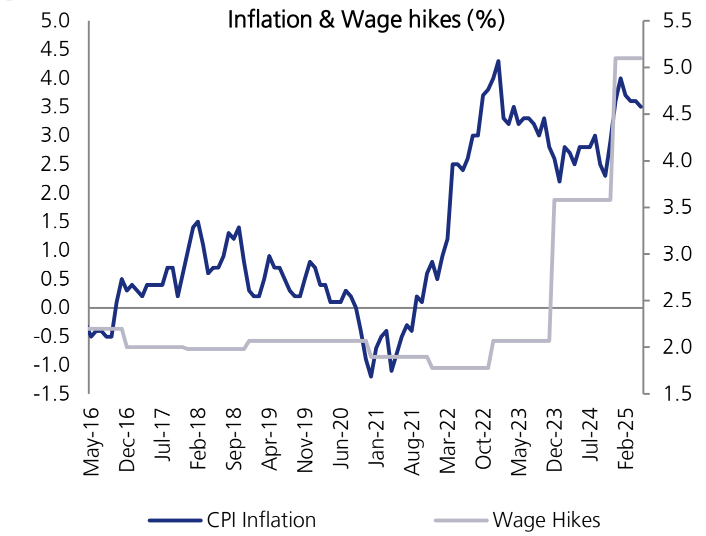
Source: Bloomberg, JM Financial

Exhibit 3. Ex-JPY, returns on EM currencies improved vs. USD



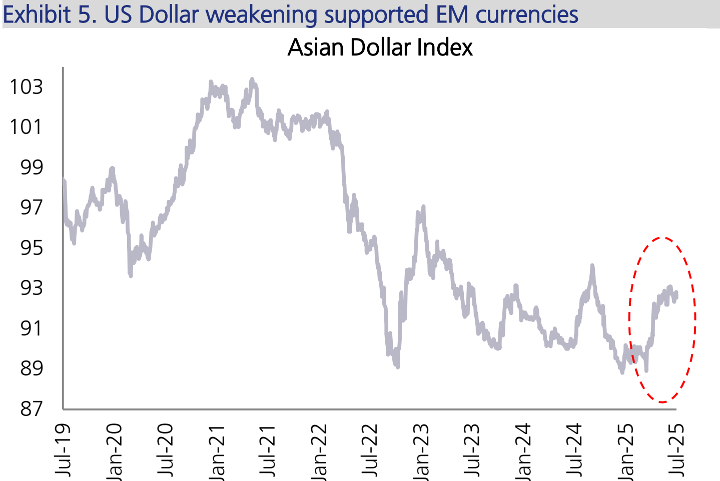
Source: Bloomberg, JM Financial Total return on long 8 EM currencies Ex JPY with equal weight with a short on USD

Exhibit 4. Japanese wage hikes align with inflation



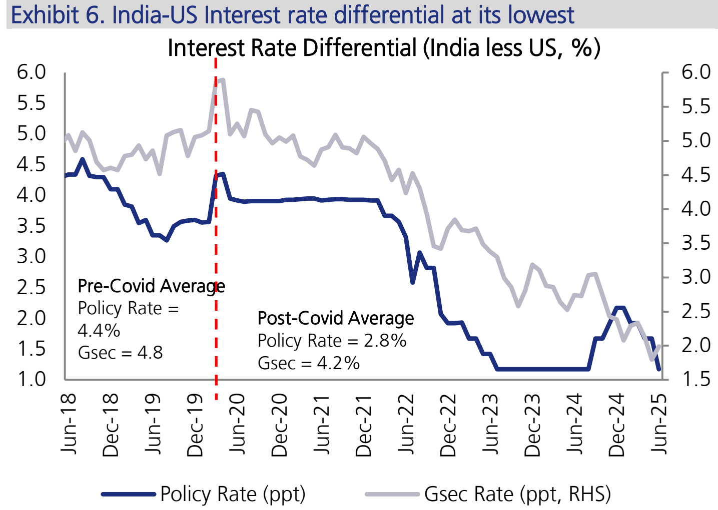
Source: Bloomberg, JM Financial

Exhibit 5. US Dollar weakening supported EM currencies



Source: Bloomberg, JM Financial

Exhibit 6. India-US Interest rate differential at its lowest



Source: CEIC, JM Financial

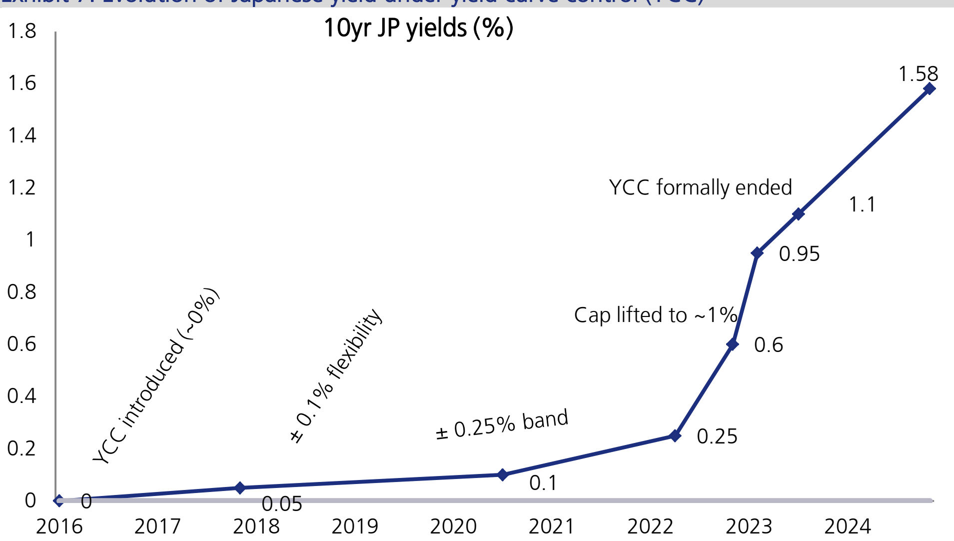
Upward trajectory of Japanese yields

The sharp rise in Japanese yields is threatening the unwinding of the carry trade (proceeds of borrowing in cheap currency –yen, invested in other currencies) which flourished for decades due to the negligible to negative yields on Japanese bonds. The yields have reacted to the Bank of Japan's (BoJ) policy pivot, exerting pressure on the carry trade. The initial unwinding has already been undertaken by the asset allocators (mainly speculative) across the globe, but how much more is in the pipeline? Market estimates range from USD 800bn to USD 1trln, but is it actually quantifiable? Can the current valuation of the yen or the status of Japanese investments in US treasuries throw some light? Will this impact Emerging Markets (EMs) including India? We make an assessment in this note. But first, a brief background on why Japanese yields are rising.

Here's why

Japanese yields have been on an uptrend since Sep'16 (most decisively since 2018), when the BoJ decided to tinker with yield curve control (YCC) in its fight against deflationary pressures in the economy. Currently, the 10Yr yields are at levels (1.58%) not seen in the last 1.5 decades (Apr'09), and the pace of this uptrend caught bond holders off guard, especially the insurance companies, which owned upward of 40% of long-dated (20-40yr) Japanese government bonds, leading to unrealised losses to the tune of ~USD 60bn (~8.5trln yen in FY25).

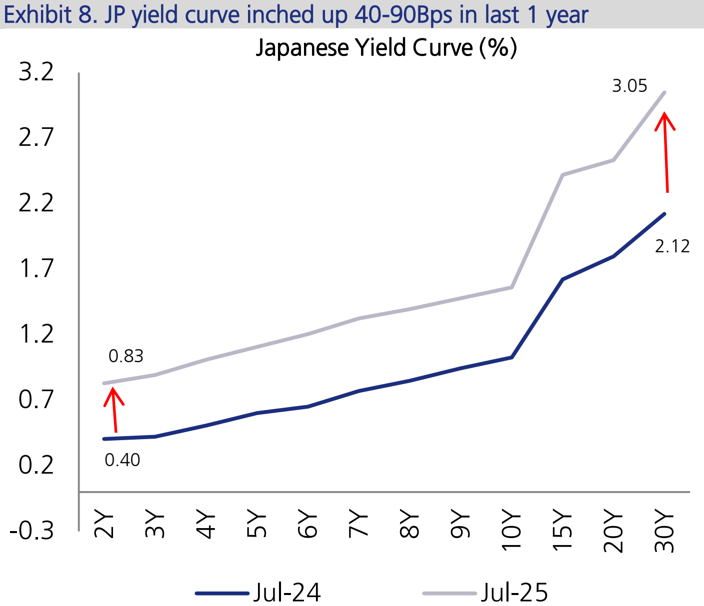
Exhibit 7. Evolution of Japanese yield under yield curve control (YCC)



Source: Bloomberg, JM Financial

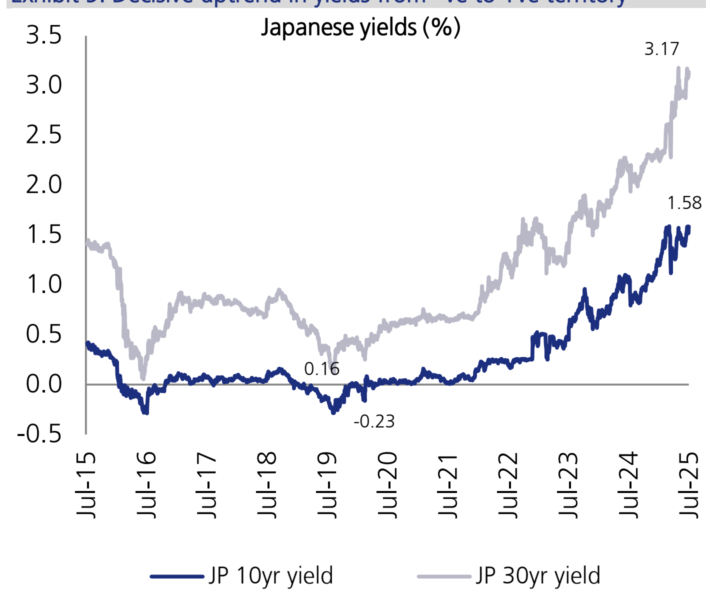
It is well documented that the uptick in yields was engineered by the BoJ over the years. The BOJ started the YCC policy in Sep'16, targeting two interest rates with different maturities: a) overnight policy interest rates at -0.1% and b) the longer-term 10Yr JGB yields at zero %, with a fixed but adjustable fluctuation allowance range (the evolution of YCC is represented in Ex 7). In Jul'24, the BoJ presented a form of 'quantitative tightening' by introducing a reduction in its monthly purchases of Japanese government debt by JPY 400bn per quarter, from JPY 5.7trln in Aug'24 to JPY 2.9trln in 1Q-2026, reducing the quarterly purchase further to JPY 200bn from Apr'26 (Ex 11). The BoJ carefully loosened its grip on the bond market with reduced intensity in quantitative tightening, in order to reassure the markets that the tapering will be gradual. Going forward, the central bank is hinting at further rate hikes considering that the inflation trajectory has been inching upward; however, it is yet to align with the BoJ's 2% inflation target. The annual wage negotiations (Shunto) have also been on an uptrend in recent years (Ex 12), which gives a good indication of improving income scenario in the economy, eventually supporting consumption demand. Hence, higher demand should aid the economy in decisively reverting to the inflationary zone, which needs to be countered through calibrated policy tightening.

Exhibit 8. JP yield curve inched up 40-90Bps in last 1 year



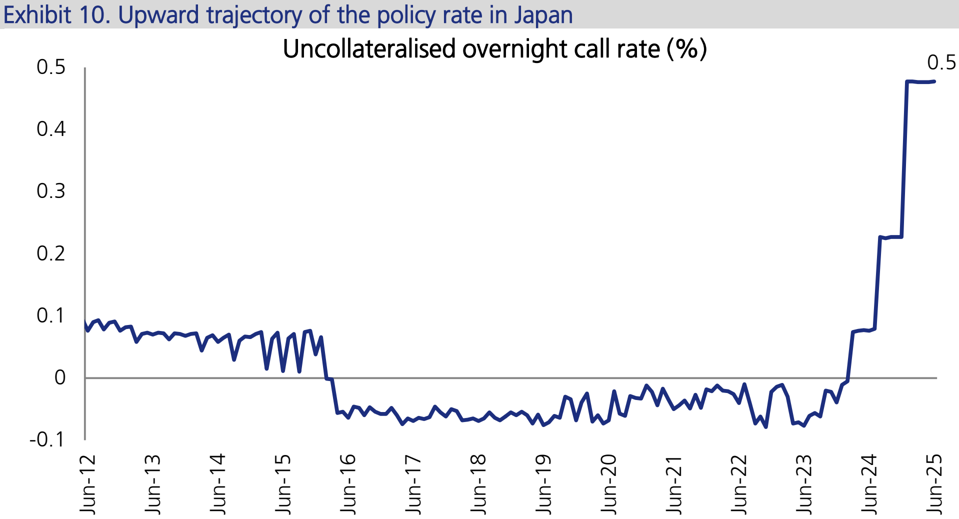
Source: Bloomberg, JM Financial

Exhibit 9. Decisive uptrend in yields from –ve to +ve territory



Source: Bloomberg, JM Financial

Exhibit 10. Upward trajectory of the policy rate in Japan



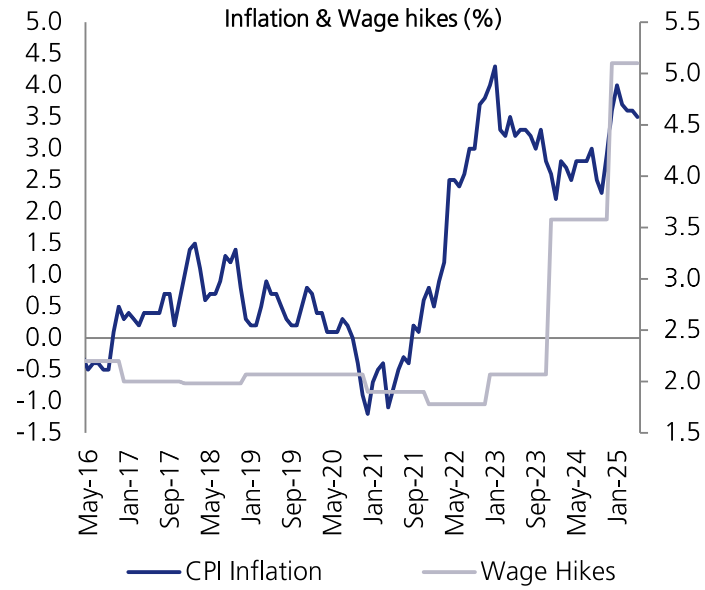
Source: BoJ, JM Financial

Exhibit 11. Bank of Japan's QQE tapering schedule

Period	Monthly Purchase of JGBs (Tn Yen)	Reduction/qtr. (Bn Yen)
Jul-24	5.7	400
Aug-Sep-24	5.3	400
Oct-Dec-24	4.9	400
Jan-Mar-25	4.5	400
Apr-Jun-25	4.1	400
Jul-Sep-25	3.7	400
Oct-Dec-25	3.3	400
Jan-Mar-26	2.9	400
After Apr-26	2.0	200

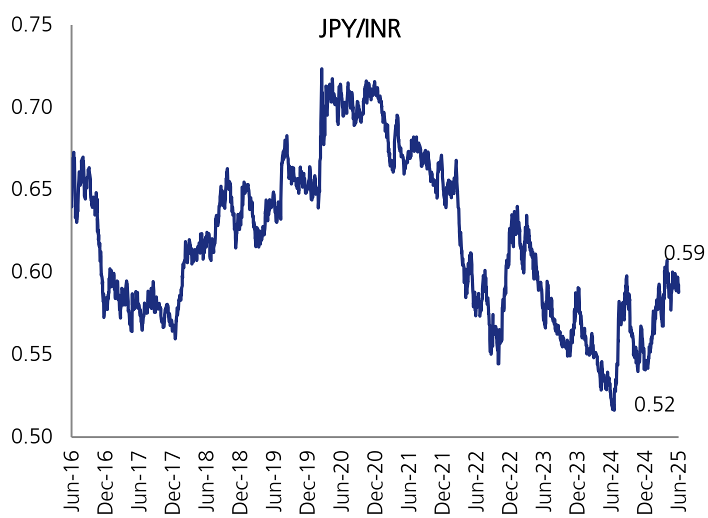
Source: BoJ, JM Financial | QQE = Quantitative and Qualitative Easing

Exhibit 12. Japanese wage hikes align with inflation



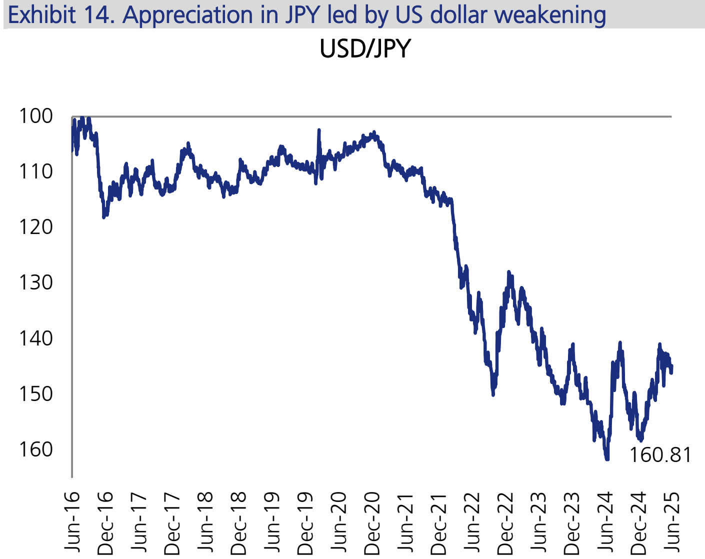
Source: e-stats Japan, Bloomberg, JM Financial

Exhibit 13. JPY's depreciating bias recently vs. INR



Source: Bloomberg, JM Financial

Exhibit 14. Appreciation in JPY led by US dollar weakening



Source: Bloomberg, JM Financial | inverted chart

Can the BoJ continue with policy tightening?

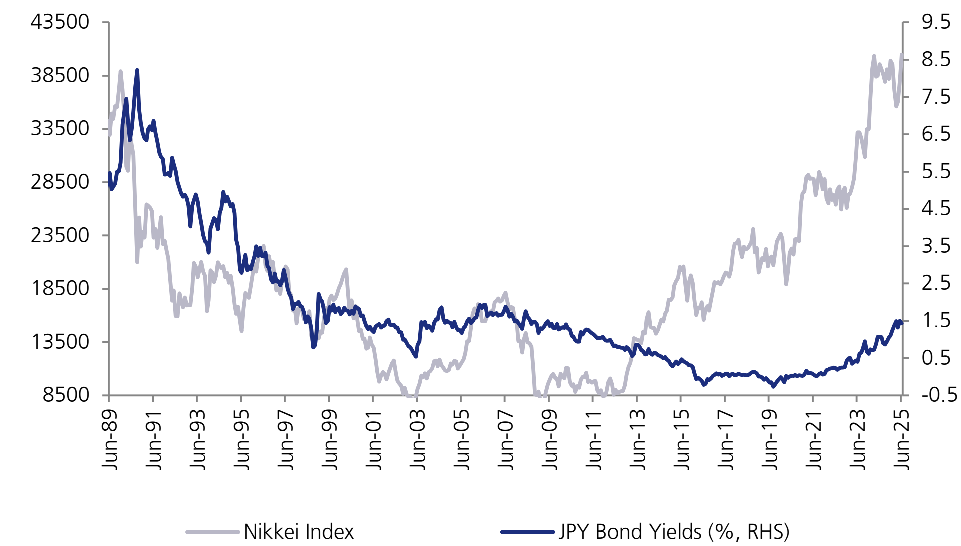
Japan's deteriorating fiscal health (debt) and political pressures can derail BoJ's progress till now, if the policy tightening is stalled before its objectives are achieved. The stretched debt position of Japan is so grave that it dwarfs the situation in the US. At 250% of GDP, Japan's debt position is at dangerous levels when compared to the 123% of GDP in the case of the US. Debt at these levels has pitted the BoJ and the political parties against each other. While BoJ is in the midst of reviving domestic demand and normalising the bond markets, the political parties are concerned with the increasing interest cost (at 2% of GDP in FY25), which is expected to inch up further to ~2.5% of GDP (~JPY 29bn) in FY28 due to further rate hikes.

Weaker election mandate / Rating downgrade could stall BoJ's efforts

The results of the recent election reflected a weaker mandate for the ruling coalition (Liberation Democratic Party) in both the upper and lower houses. Prime Minister Ishiba vowed to continue, despite the recent loss in both the upper and lower house election. A weaker mandate generally leads to a populist tilt in fiscal policies, which may include cash hand-outs and reduction in consumption tax, eventually exerting pressure on the country's fiscal position. Hence, the weaker mandate in the latest election could also influence monetary policy decisions as it may stall or delay BoJ's policy tightening. However, as of now, BoJ is expected to deliver yet another rate hike by the end of 2025.

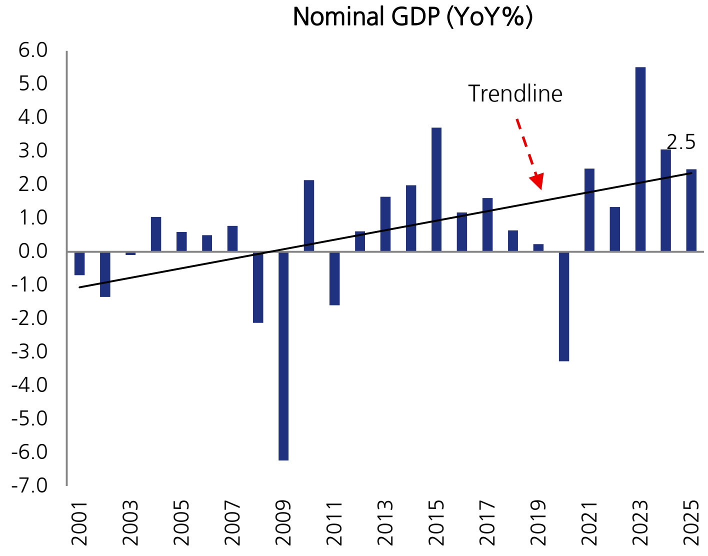
Moody's Ratings recently indicated that it is assessing the impact of potential cuts to Japan's consumption taxes (10% currently) on its sovereign debt rating. Japan has been assigned a credit rating of A1 with a stable outlook since Dec'14 (Fitch A – stable); the rating agency has warned of a possible downgrade if the fiscal deficits worsen significantly. A credit rating downgrade would have far reaching implications, which could reflect in a sell-off in bonds, currency (yen) and stocks, and increase the cost of dollar funding for banks. However, we are not building in a rating downgrade in the immediate near term, considering Japan's high per capita income (USD 33,956 in 2025), exceptionally strong external position (current account surplus of 3.6% of GDP) and full capital market access.

Exhibit 15. Equity markets sensed the change in BoJ policy in advance



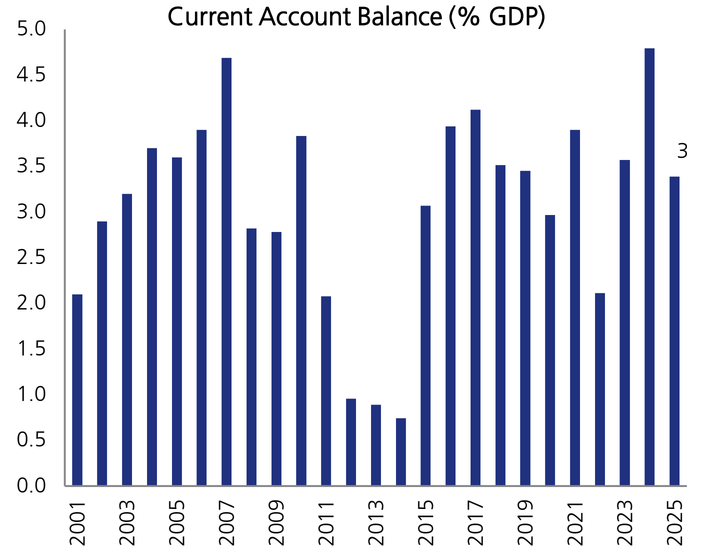
Source: CEIC, JM Financial

Exhibit 16. GDP growth on an uptrend



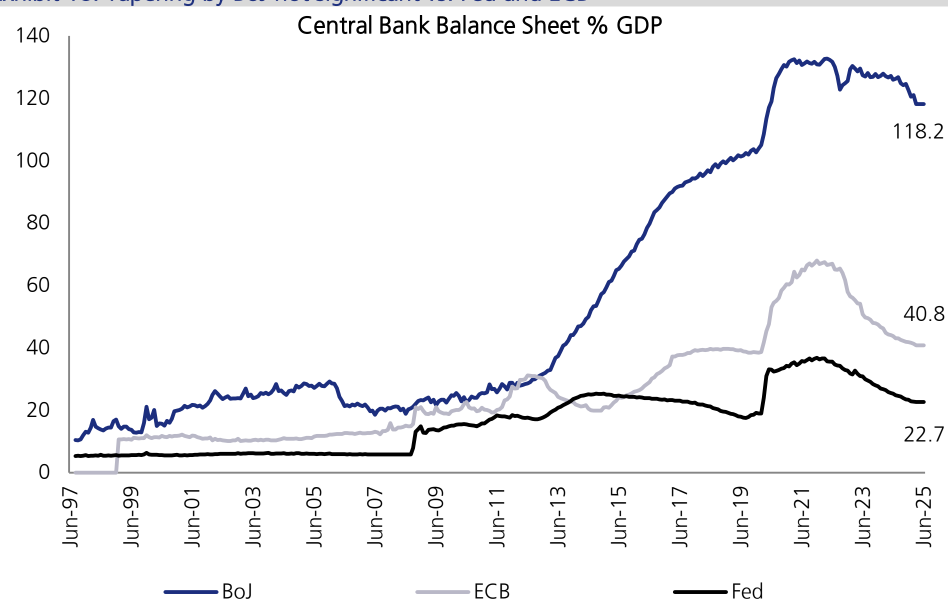
Source: CEIC, JM Financial

Exhibit 17. Current account in surplus position



Source: CEIC, JM Financial

Exhibit 18. Tapering by BoJ not significant vs. Fed and ECB

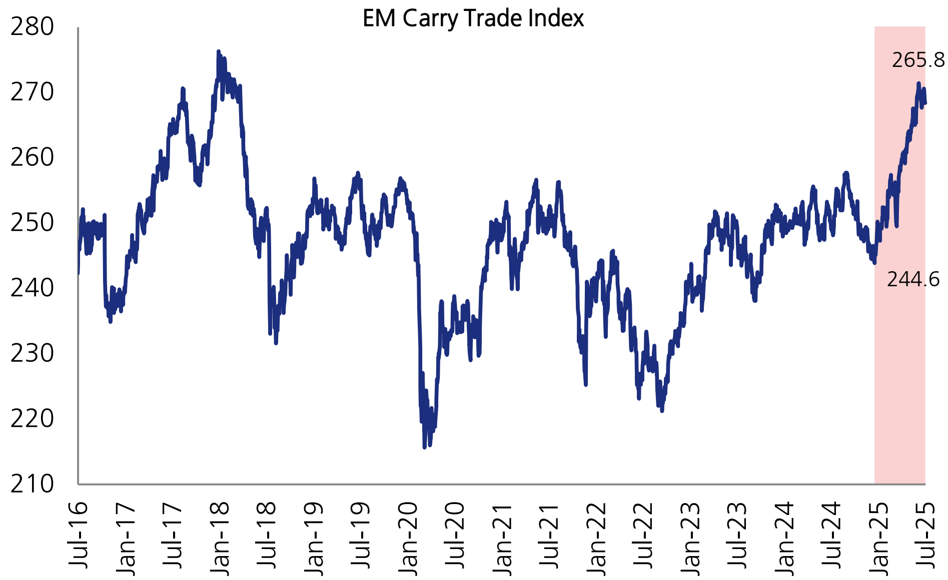


Source: Bloomberg, JM Financial

The unwinding of carry trade to be gradual

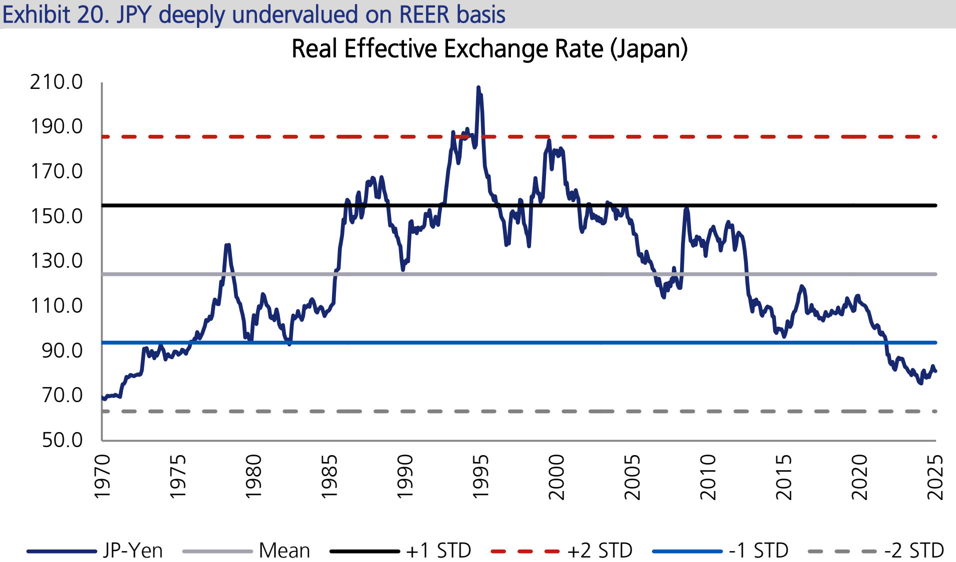
The unwinding of the yen carry trade started in Aug'24 when the central bank discontinued its Negative Interest Rate Policy (NIRP) and the YCC, triggering a rise in yields, strengthening of the yen and a sell-off in the global markets. Market estimates of the quantum of the carry trade are not crystal clear; markets anticipate it to be as high as USD 2trln. We believe that the extent of undervaluation in the yen would decide how swift the unwinding would be, going forward. Yen remains deeply undervalued on REER basis (closer to -2 standard deviation from the long-term mean), indicating that the carry trade could still be lucrative and the initial unwinding would have been majorly done by the reversal of speculative positions, while the structural trades would still be active. The rate hikes in Japan coinciding with the US Fed's easing policy is expected to eventually trigger fresh unwinding of the carry trade; however, we expect it to play out in a gradual manner.

Exhibit 19. Ex-JPY, returns on EM currencies improved vs. USD



Source: Bloomberg, JM Financial | Total return on long 8 EM currencies Ex JPY with equal weight with a short on USD | Note: Brazil, Mexico, India, Indonesia, South Africa, Turkey, Hungary, Poland

Exhibit 20. JPY deeply undervalued on REER basis

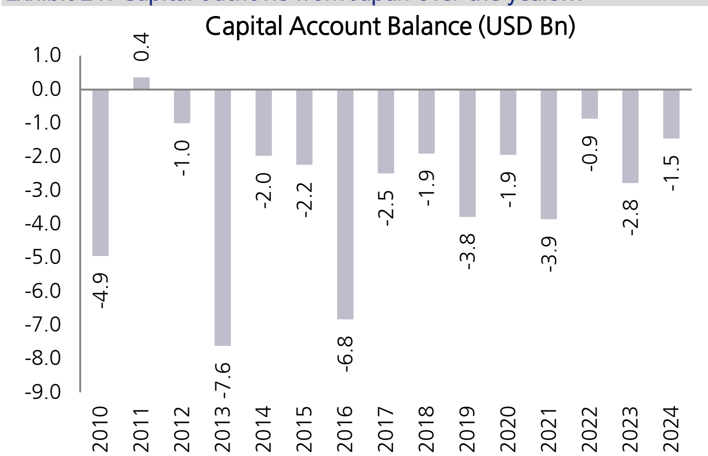


Source: OECD, JM Financial

Global flows: Revert back to Japan?

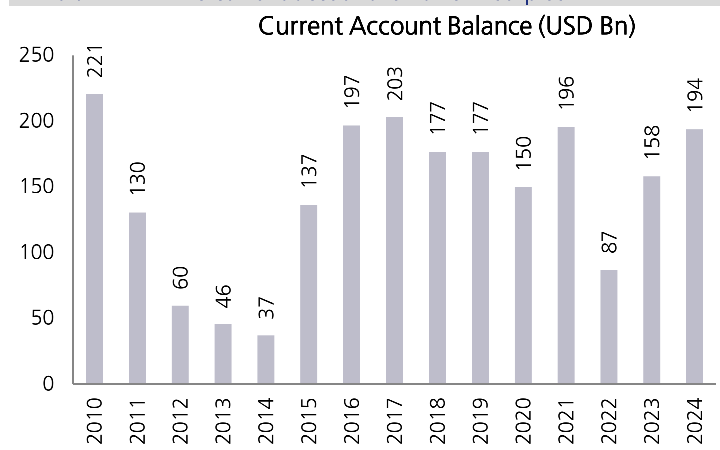
The negative interest rate regime in Japan led to capital outflows in search of returns as reflected in the consistent capital account deficit (Ex 21). This is also visible in the US treasury holding where Japan is the largest holder with USD 1.1trln, 12.6% of total US treasuries. Other than the US, EMs have also been a part of the carry trade due to their higher return profile. However, as Japanese yields rise, it will reverse the flow of capital inwards as the local flows find its way back home. Although this reversal will cushion Japanese yields, its negative impact can be felt in the global yields (uptick) mainly in the US and in EU. China has significantly reduced its holding in US treasuries over the years from USD 1.3trln in 2011 to USD 756bn in May'25 (Ex 28) while Japanese investments have been stable ~USD 1.1trln in the last decade. The reversal of Japanese investments in US treasuries even to the extent of 20% would have a notable impact on US yields. The BoJ has already signalled its intent for further tightening, which will lead to pre-positioning by global asset allocators.

Exhibit 21. Capital outflows from Japan over the years…



Source: CEIC, JM Financial

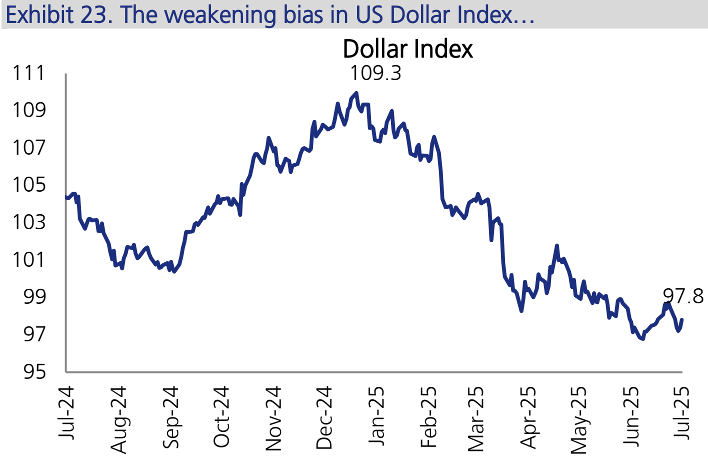
Exhibit 22. …while current account remains in surplus



Source: CEIC, JM Financial

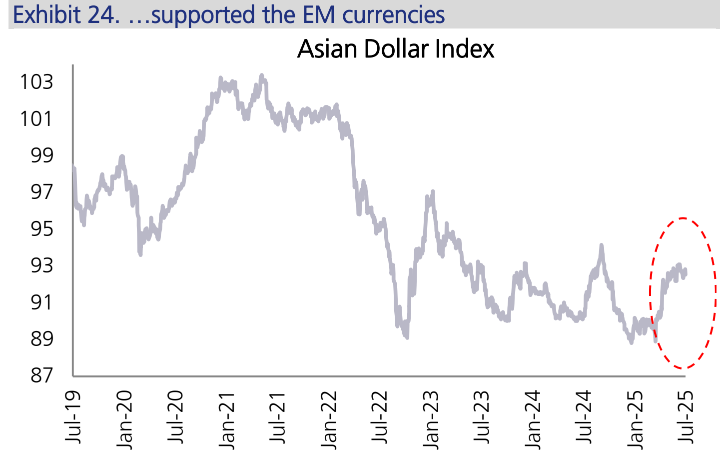
We believe that with the easing of geopolitical tensions, the demand for the US dollar in the form of safe haven flows should decline. This, in itself, should reduce incremental flows in the US. Moreover, considering the unstructured approach of the Trump administration in policy formation, the non-diplomatic way of dealing with geopolitical issues and the likelihood of continued policy flip flops in remainder of the Trump presidency, the US dollar will remain volatile with a depreciating bias. Pressure on the US dollar will be positive for EM currencies including INR. On the Japanese yen, the US has publicly signalled its discomfort with the weakening yen below the 160 level (146 currently), as it leads to unfair trade advantage to Japan – worsening the US trade deficit.

Exhibit 23. The weakening bias in US Dollar Index…



Source: Bloomberg, JM Financial

Exhibit 24. …supported the EM currencies



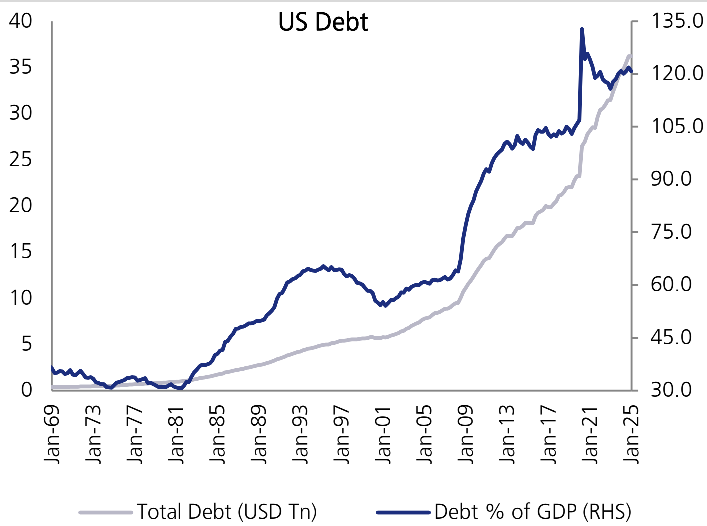
Source: Bloomberg, JM Financial

How will this impact US yields?

The US treasury yields are on an uptick, reaching levels (4.9% in Oct'23, 4.4% currently) not seen since Jul'07, due to the elevated debt levels. The situation in the US differs from that in Japan. The US market is concerned over the ballooning debt situation (USD 37trln, 124% of GDP) which is elevated although comparatively better than that of Japan (250% of GDP). The Trump administration's new "One Big beautiful bill" will, on net basis, continue to add to the debt burden (USD 3.4trln as per the CBO). Moreover, the policy flip flops in the US around tariffs is also exerting pressure on the US economy. It is not yet clear who will bear the brunt of elevated tariffs; if it is being fully passed on to customers then the higher price tag would reflect in the inflation print and dampen consumption demand, eventually exerting pressure on economic growth as consumption forms 68% of the GDP.

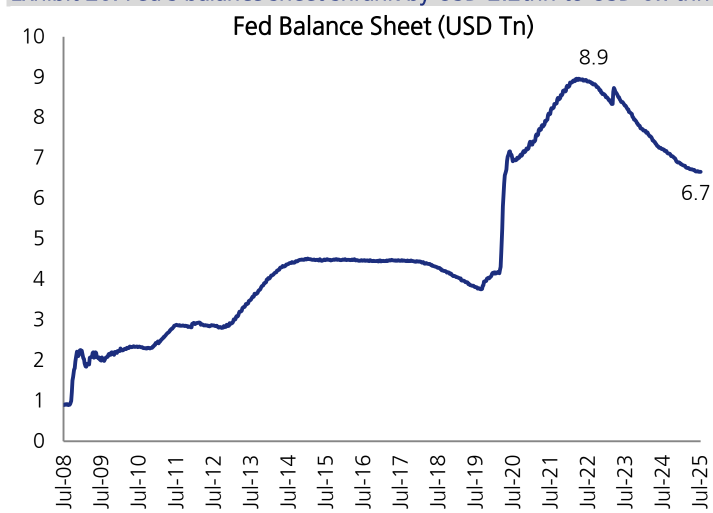
With the recent rating downgrade from (AAA), the US lost the investment grade rating from all three rating agencies. However, our assessment of the movement in yields (30yr) and US Dollar (USD) during the past downgrades reveal that the reaction in USD and yields differed on all three occasions. After the first rating downgrade by S&P in 2011, yields fell 20bps while the dollar index strengthened (0.3%). Post the Fitch downgrade in 2023, yields (8bps) as well as the dollar index gained (0.3%). However, after the latest rating downgrade by Moody's in 2025, the dollar index weakened 0.7% while yields went up by 4bps.

Exhibit 25. US debt of USD 37trln forms 123% of GDP



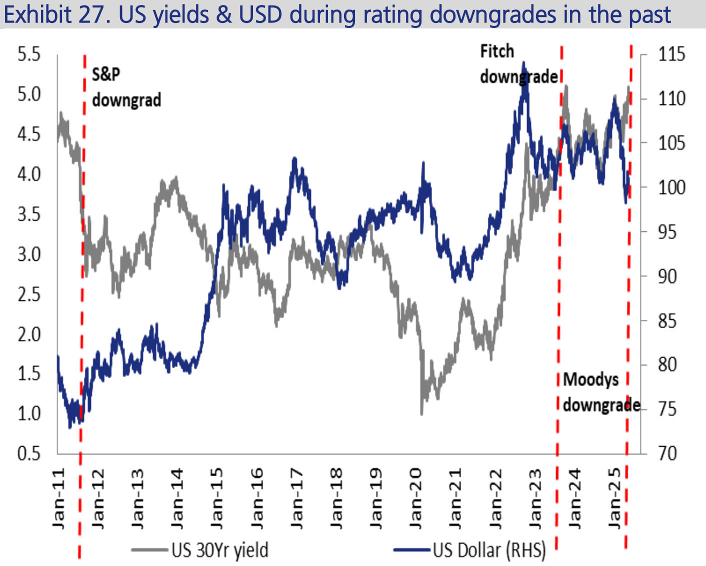
Source: Fred, JM Financial

Exhibit 26. Fed's balance sheet shrank by USD 2.2trln to USD 6.7trln



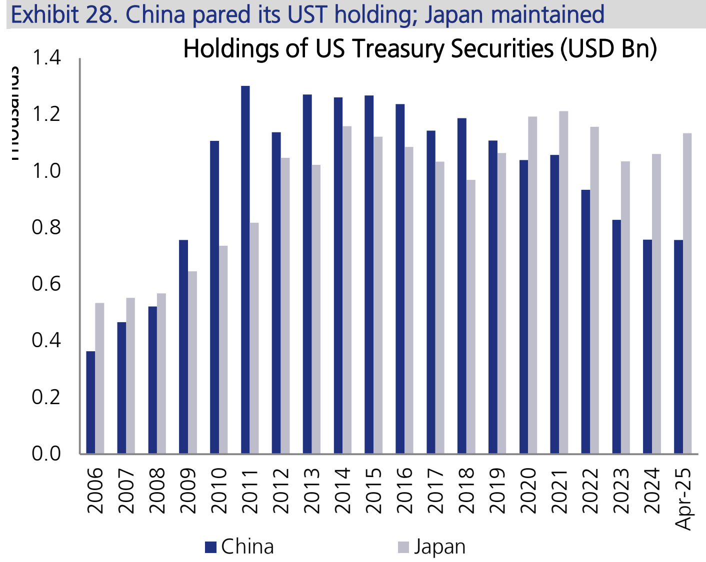
Source: Fred, JM Financial

Exhibit 27. US yields & USD during rating downgrades in the past



Source: JM Financial | monthly file

Exhibit 28. China pared its UST holding; Japan maintained



Source: US Treasury, JM Financial

Monetary policy expectation in US

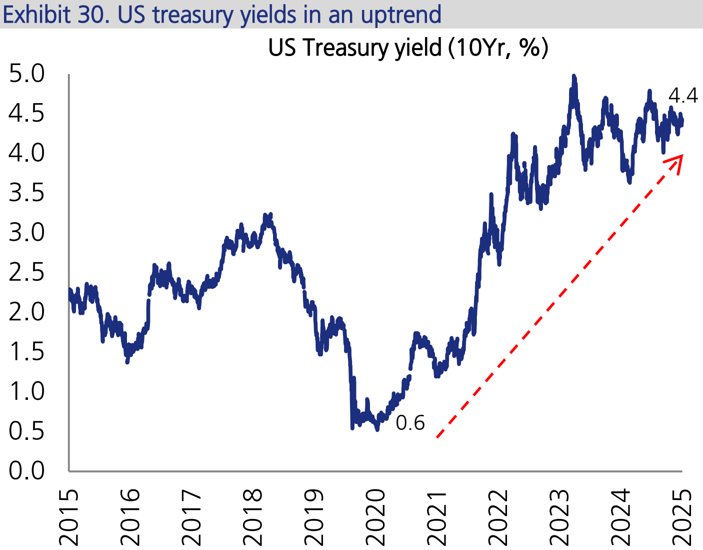
US markets have reduced their rate cut expectation to two by the end of 2025 vs. three rate cuts a month ago which aligns with our expectation. Market chatter around US Fed Chairman Jerome Powell's term not being extended beyond May'26 is logical; however, the idea of a shadow Fed chair (floated by the treasury secretary) during the interim has sent dovish signals in the markets. The possibility of the new Fed chairman being aligned with the Trump administration has raised hopes of an accelerated rate cut cycle to stimulate growth. On the growth front, the GDP Nowcast by the Fed Atlanta is indicating a reversal in the sluggishness reported in 1Q 2025; GDP growth in 2Q is expected to be 2.4% (18th July). Even Powell had hinted at the reversal in (frontloaded) imports in 2Q, which would cushion the downward pressure on growth. Surprisingly, the higher tariffs did not reflect in the inflation prints in Jun'25 except in case of apparels and medical care, while the custom duty collection in US more than doubled to USD 27bn in Jun'25. The impact of tariffs on inflation will reflect in a phased manner until the pre-tariff inventory in the system is replenished with new inventory.

Exhibit 29. Markets factoring in two more rate cuts in 2025

FOMC Meet	300-325	325-350	350-375	375-400	400-425	425-450
Jul'25	0.0%	0.0%	0.0%	0.0%	3.1%	96.9%
Sep'25	0.0%	0.0%	0.0%	1.9%	61.7%	36.4%
Oct'25	0.0%	0.0%	0.9%	30.0%	49.8%	19.3%
Dec'25	0.0%	0.6%	19.2%	42.4%	30.6%	7.2%
Jan'26	0.2%	6.8%	26.9%	38.5%	22.8%	4.8%
Mar'26	3.4%	16.7%	32.6%	30.8%	14.0%	2.4%

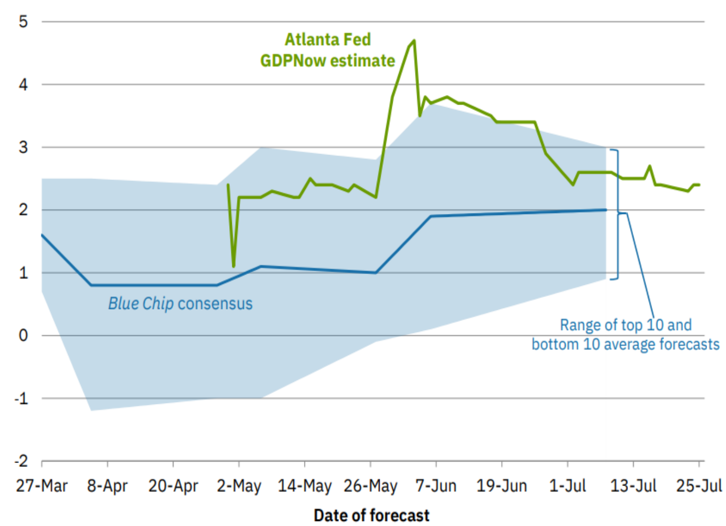
Source: CME Fedwatch, JM Financial

Exhibit 30. US treasury yields in an uptrend



Source: Fred, JM Financial

Exhibit 31. US GDP expected to grow 2.4% in Q2 2025



Source: Fed Atlanta, JM Financial

Indian yields: Uptick post the 50bps rate cut

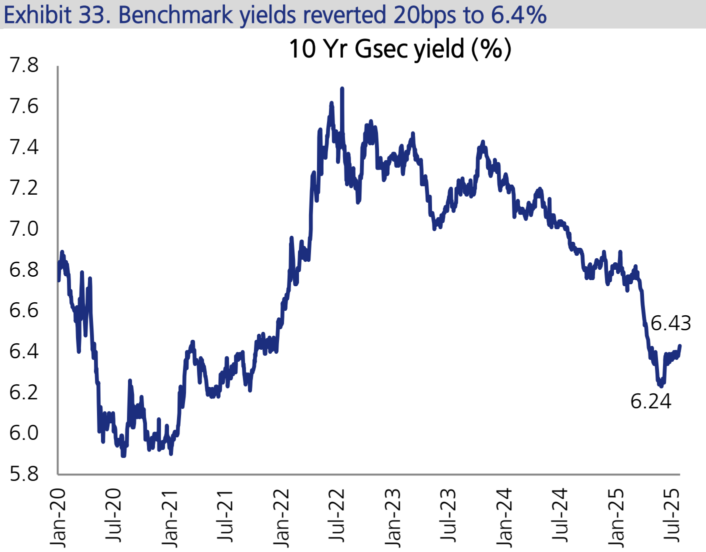
Yields in India have been well behaved due to the strength in the macro fundamentals, be it comfortable inflation, easy monetary policy, on-going fiscal consolidation and moderate growth expectations. The benchmark (10yr) yields have been trending lower to 6.24% (Jun'25) from 7.5% in Jun'22. However, the larger-than-expected rate cut in Jun'25 led to a ~20bps spike in yields to 6.43, indicating that the markets have built in an end to the rate cut cycle. Policy easing and moderating inflation has exerted downward force on benchmark yields, except post the VRRR (Variable Rate Reverse Repo) action when the yields spiked 10-15bps at the lower end of the yield curve. A section of the market believes that the RBI has pivoted and there would be a policy shift towards tightening, We reiterate that the RBI's recent policy action were with an intent to fine-tune liquidity and should not be considered as liquidity withdrawal measures – Link to our Note. From here on, RBI will actively monitor and align the call money rates with the policy repo rate.

Exhibit 32. Liquidity fine-tuning through VRRRs by RBI in July

Date	4-Jul	9-Jul	11-Jul	14-Jul	18-Jul	23-Jul	24-Jul	25-Jul	29-Jul	Sub Total
Announced	1,00,000	1,00,000	2,50,000	1,00,000	2,00,000	-50,000	-50,000	1,25,000	50,000	8,25,000
Offers accepted	1,00,010	97,315	1,51,633	57,450	2,00,000	-50,001	-1,421	1,25,008	46,058	7,26,052
Cut off Rate (%)	5.47	5.49	5.49	5.49	5.49	5.53	5.51	5.49	5.49	

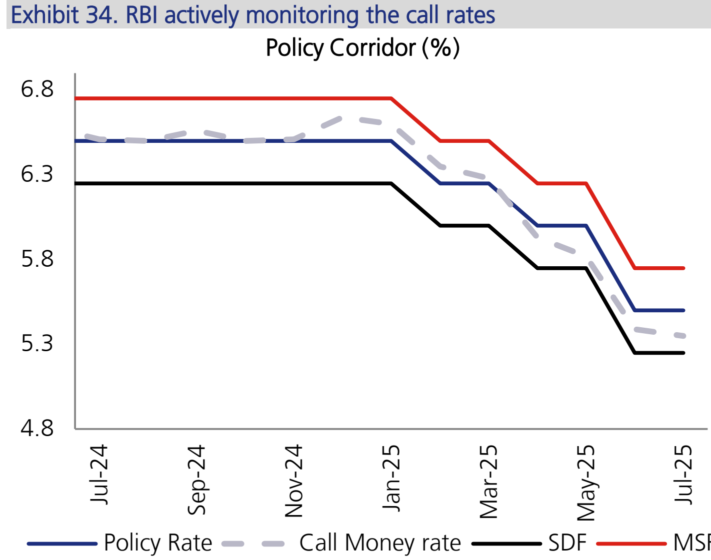
Source: RBI, JM Financial | Negative figures denotes VRR

Exhibit 33. Benchmark yields reverted 20bps to 6.4%



Source: CEIC, JM Financial

Exhibit 34. RBI actively monitoring the call rates

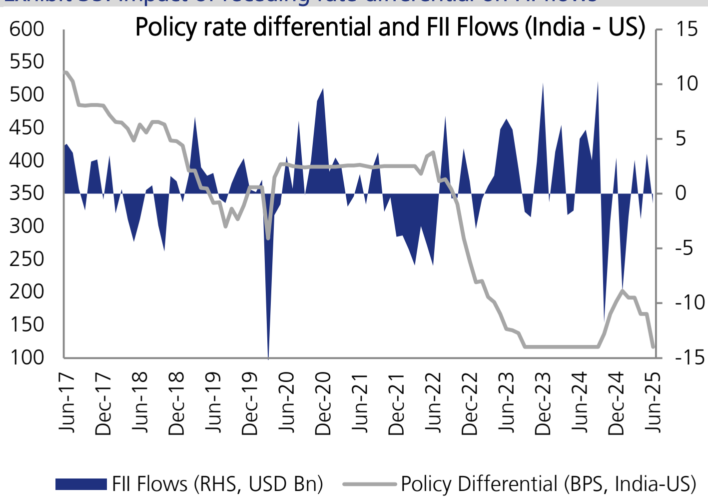


Source: CMIE, JM Financial

Growth differential (India-US) to support flows

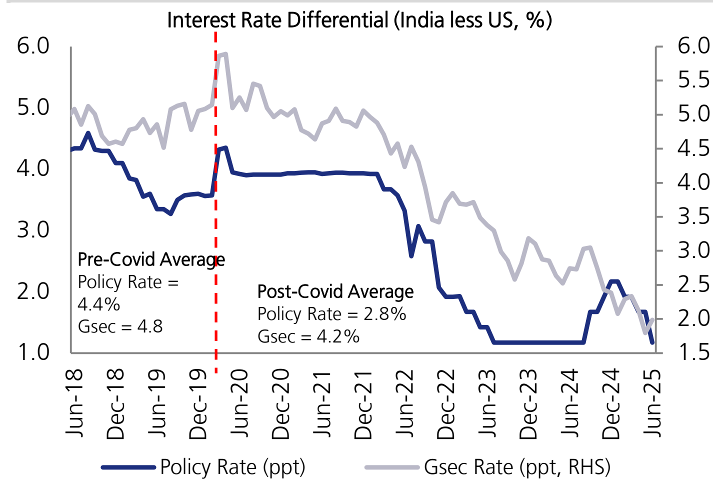
Our analysis of the interest rate differential between India and the US revealed that in the long run, its impact on flows has not been notable and, consequently, the recent moderation in interest rate differential to lows of ~120bps is unlikely to impact flows on its own, hence it should not be seen in isolation. We highlight that the growth differential between India and US continues to improve and is in favour of India, which should aid flows going forward. Ex 35 shows that the growth differential between India and US has been on an uptrend, averaging 370bps. The overall yield curve has been bull steepening in the last 6 months. However, we believe that with limited room for policy easing and with significant moderation in inflationary pressures, the yield curve would flatten going forward.

Exhibit 35. Impact of receding rate differential on FII flows



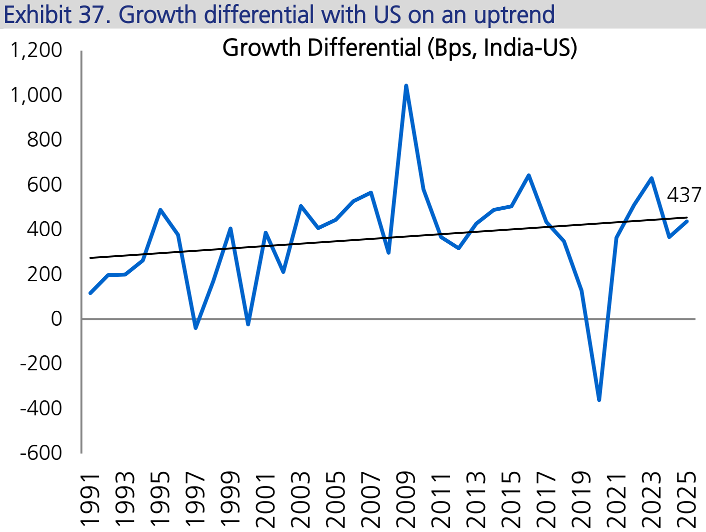
Source: Bloomberg, JM Financial

Exhibit 36. India-US Interest rate differential at its lowest



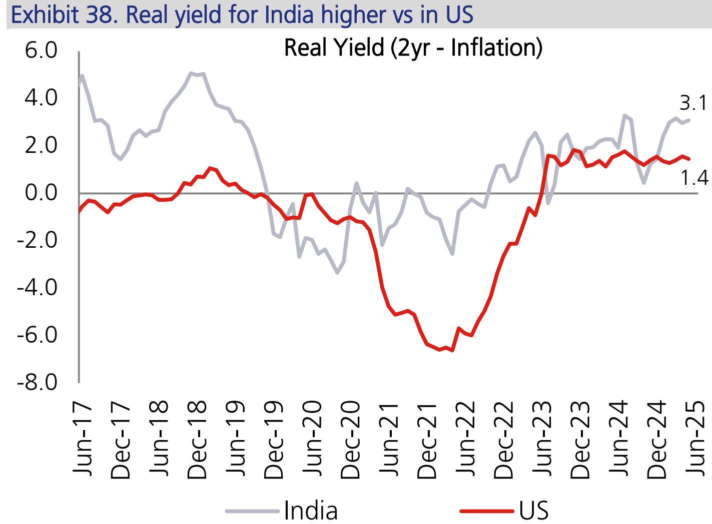
Source: Bloomberg, JM Financial

Exhibit 37. Growth differential with US on an uptrend



Source: Bloomberg, JM Financial

Exhibit 38. Real yield for India higher vs in US

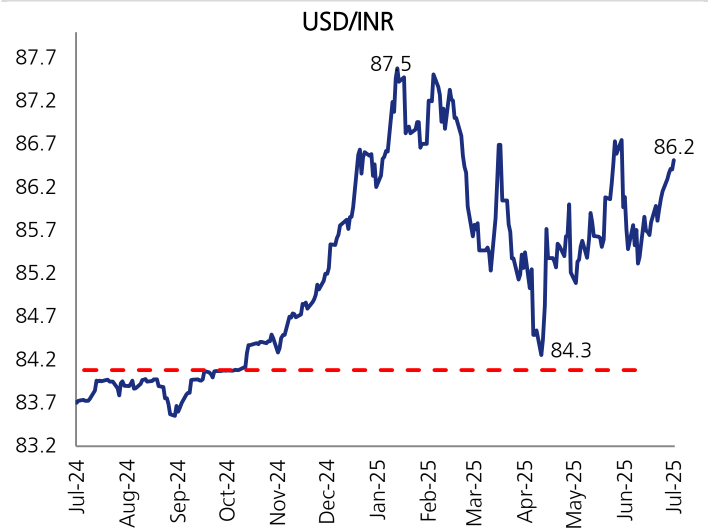


Source: Bloomberg, JM Financial

INR cushioned by weak USD

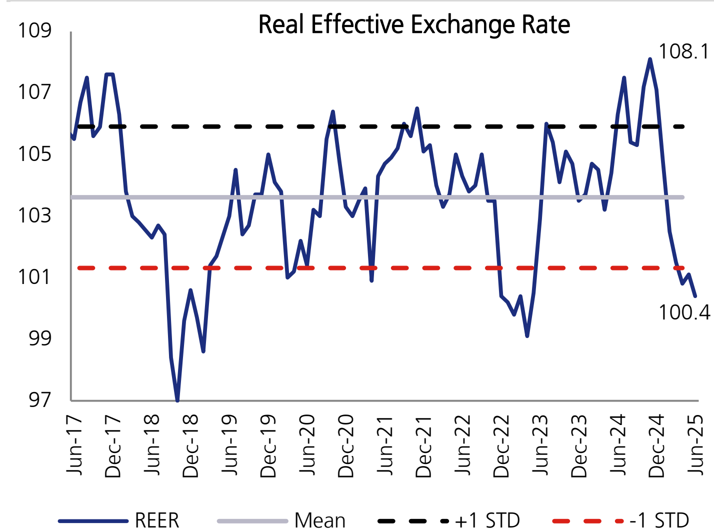
Domestic monetary policy will be guided by the inflation trajectory and the tariff policy in the US. While the domestic inflation trajectory is expected to remain under control (3%-3.5% in FY26), the elevated tariffs in the US will prove to be a drag on the US economy; hence, it would be negative for the US dollar. Despite the valuation concerns (21.5 X 1-Yr forward PE), relatively robust macros for India vs. its Asian peers will attract flows into India. We believe that as the impact of the initial unwinding was not noteworthy, the subsequent unwinding of the carry trade is likely to be gradual considering the rate hikes in Japan would be in a phased and predictable manner. As a second-order impact, EM currencies including INR will reflect an appreciating bias. On a REER basis, INR does not look stretched currently. We continue to see INR in the range of 85.5 to 87.5/USD in 2025 (Outlook 2025).

Exhibit 39. INR to trade ~85.5-87.5 in 2025



Source: Bloomberg, JM Financial

Exhibit 40. INR does not look stretched on REER basis



Source: CMIE, JM Financial

APPENDIX I

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Hold	Price expected to move in the range of 10% downside to 10% upside from the current market price for stocks with market capitalisation in excess of INR 200 billion and REITs* and in the range of 10% downside to 15% upside from the current market price for all other stocks, over the next twelve months.
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