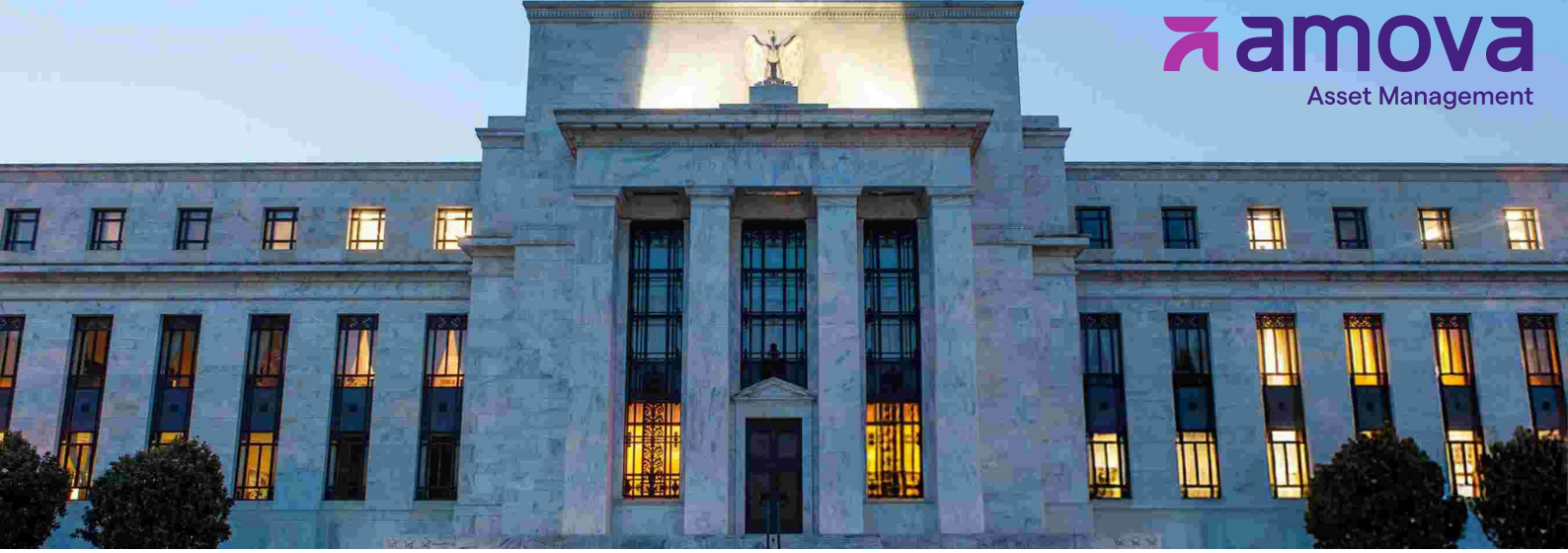


The Fed's hawkish hold, risk tolerance and carry trades

Signals from the Fed encounter fragile geopolitics and carry-driven markets

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As widely expected, the Federal Reserve (Fed) announced on 17 June that it had left interest rates steady in a 3.5–3.75% range. However, the policy statement, Summary of Economic Projections (SEP) and Chair Kevin Warsh's inaugural statement were collectively seen as hawkish. Not only was the statement's easing bias removed, but the Federal Open Market Committee (FOMC)'s median forecast for 2026-2027 was moved higher. In line with his reluctance to provide forward guidance, Warsh declined to submit his own outlook—which was also reflected in the brevity of the statement.

Of the 18 officials who submitted projections, nine expected at least one rate hike in 2026, while six projected two, marking a more hawkish outlook than the previous SEP. At the same time, growth and unemployment projections offered a moderately weaker forecast for the economy, albeit from still-robust levels. In contrast, both headline and core CPI projections showed a material shift higher across the range of forecasts compared to the March SEP. Accordingly, the dollar rose, the 2-year US Treasury sold off sharply and emerging currencies weakened. That said, dollar/yen still shows signs of carry appetite, with markets once again focusing on US-Japan yield differentials.

Hormuz developments giving rise to risk-on hopes

The reported signing of a US-Iran memorandum of understanding (MOU) on the Strait of Hormuz has prompted markets to reassess the immediate oil-risk premium. This development between the US and Iran may indeed be a positive, but it does not indicate a full resolution. Transit flows through the Strait are yet to fully resume and the 60-day nuclear negotiation window is unresolved. Although a mutual off-ramp is visible, its still-fragile state could be a source of volatility in the coming days.

Meanwhile, additional inflationary pressure persists in the background. Even with de-escalation, delays in reopening the Strait and lagged pass-through of energy price rises and supply shocks can keep inflation expectations elevated. As a result, the Fed is unlikely to consider the inflation shock resolved until the Strait is fully reopened, and CPI and PCE data confirm that restored traffic is positively impacting inflation.

Dollar/yen: carry still dominant but risk/reward is changing

In the near-term, yield differentials continue to support dollar/yen. This is particularly noticeable in the sharply higher US front-end pricing after the Fed's statement. The reaction by the US front-end contrasted with the muted market response following the Bank of Japan's policy decision earlier in the week, even though the Japanese central bank actually delivered a rate hike. However, over time, hawkish central banks may ultimately become a headwind to carry trades, because tighter financial conditions could reduce leverage and risk appetite. Needless to say, this is not how markets currently perceive the situation.

Intervention risk becoming more relevant

The drivers of dollar/yen strength are now less easily explained by oil/petrodollar demand. With risk premia expected to fall after the Hormuz MOU signing, the renewed focus on relative yield differentials appears inconsistent. At the same time, speculative positioning has become stretched, raising the risk of intervention. According to Bloomberg/CFTC data, leveraged investors' net yen short positions have reached their highest levels since July 2024, a period when Japanese authorities intervened in the currency market. Even if carry does not unwind organically, intervention could force a sharp position squeeze.

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