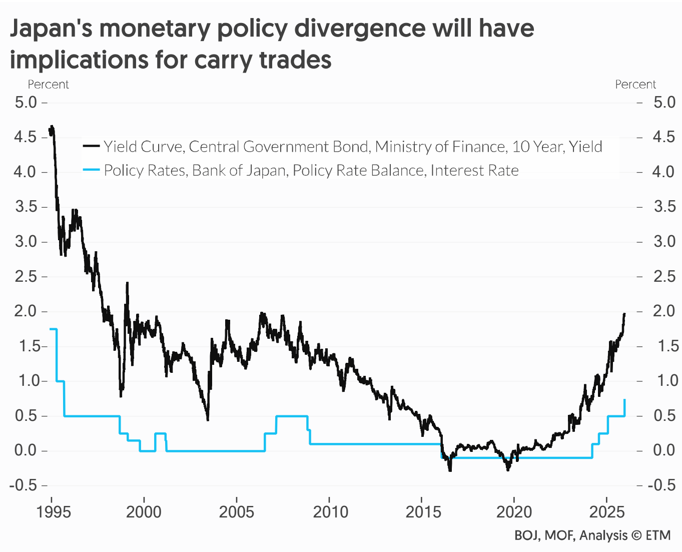
Key points

- On December 19th, the BoJ indicated that it had hiked rates by a further 25 basis points, to take the central bank rate up to 75 basis points, or the highest level in over thirty years. This is indeed a significant development, and one that should be closely monitored as it has far-reaching implications for currencies exposed to the carry trade.
- The ZAR is one such currency and it is worth trying to understand the implicatons for the ZAR better and whether this is something that might derail the performance of the ZAR, or whether it is just one more factor that will count against the performance of the USD, in which case the ZAR is in a strong position to be able to capitalise on its new found virtuous cycle that appears to have given the ZAR abn unfamiliar resilience.

BASELINE VIEW: Despite the BoJ's decision to protect the JPY over the longer term by dissuading carry trades funded in JPY, the ZAR appears to be in a strong position, implying that the ZAR will enjoy some ongoing resilience, regardless of what the USD-ZAR valuation charts show. This remains a constructive environment for importers.

BoJ hikes as it finally seeks to normalise monetary policy



Last week, the BoJ decided to hike rates a further 25 basis points to 75 basis points, the highest level since September 1995.

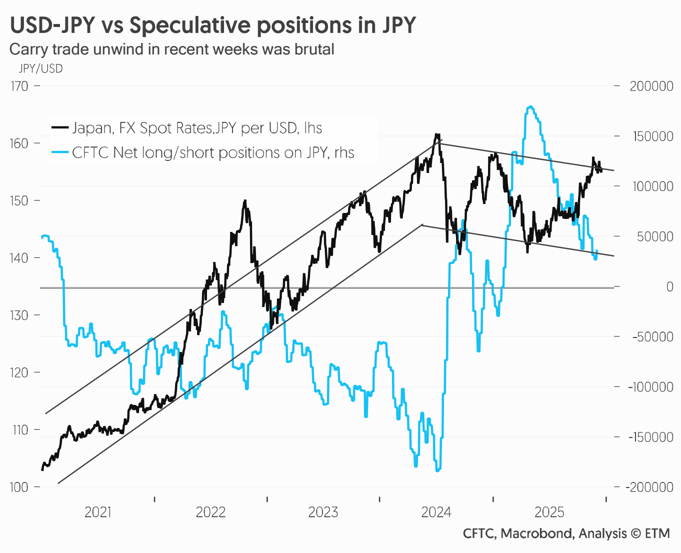
For over thirty years, the BoJ has persisted with ultra-loose monetary policy and briefly experimented with a period of negative interest rates during the pandemic.

In a world where most central banks are reducing interest rates, the Bank of Japan's decision to do the exact opposite will raise some eyebrows and interest.

It is a significant development that holds consequences not just for Japan, but for most other countries as well.

The reason this matters so much to a country like South Africa is that it holds significant implications for the carry trade. Over the past three decades, the JPY has become one of the world's most reliable funding currencies for several reasons. Carry costs were negligible, and the JPY always held an underlying bias towards depreciation, prompting the BoJ to threaten interventions on numerous occasions.

Carry trade naturally comes into question



It should therefore come as no surprise that the threat of rising interest rates and more conservative monetary policy, prompted speculators to adopt net long positions on the JPY, something they had only previously done at the start of the pandemic when Japanese investors pulled their funds from abroad and repatriated them into money market accounts for safekeeping.

The accompanying chart is clear. The larger the net long positions on the JPY, the greater the probability that the JPY will perform better, and indeed, this is one of the objectives of the BoJ.

Having lived through a continuous phase of JPY depreciation that lifted inflation rates, the BoJ felt it prudent to rein that in through more conservative monetary policy.

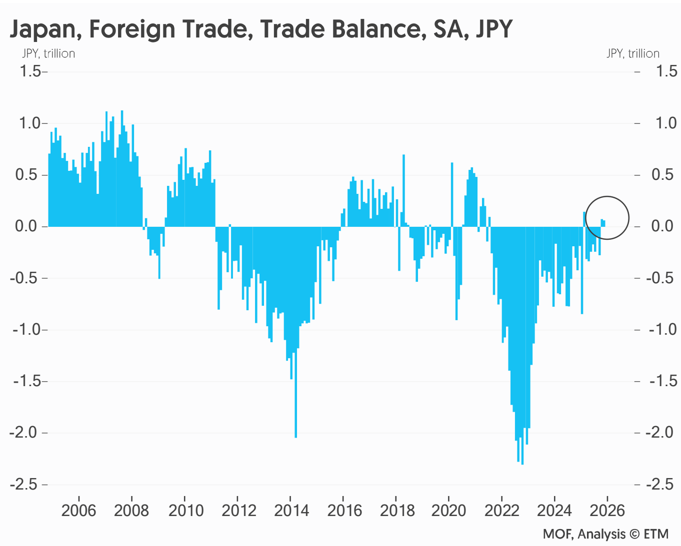
Promoting price stability over the longer term is important to all central banks, including the BoJ, which has lived with ultra-loose monetary policy and prolonged periods of deflation. The implication of all of this should be obvious.

If the probability of JPY depreciation is not what it was, and the cost of carry is negatively affected by higher interest rates, then the propensity to utilise the JPY as a funding currency for carry trades will wane.

This holds implications for the USD that has a very different set of realities to contend with, and in turn this holds implications for the ZAR as well. The ZAR has traditionally been treated as a carry currency.

For now the depreciation of the USD is masking any reduced speculation stemming from the BoJ's actions, but one wonders how much stronger the ZAR might've been had the JPY had remained the world's favourite funding currency.

Japanese Trade Balance



Notably, after a couple of years of heavy trade deficits, the Japanese trade balance has moved back into surplus.

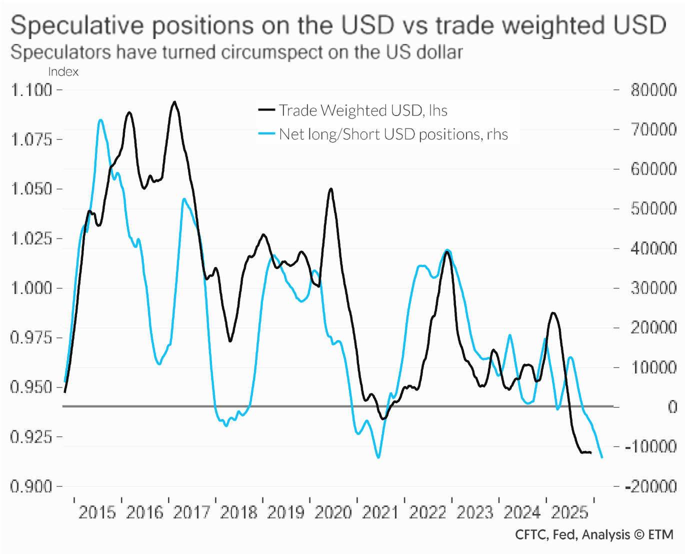
Two major drivers are responsible for this. The first is the general weakness of the JPY that will encourage Japanese exports and discourage imports.

Another factor that will discourage imports is the rising interest rates, which will curb consumer demand and ensure that the economy is once again living within its means.

If a trade deficit encourages speculators to bet against the JPY, the absence of one will prompt them to reconsider their prospects.

When considering a carry trade, one needs to consider all the dynamics that will influence the decision to borrow in one currency to purchase assets in another. There needs to be alignment of more than just one factor, and the news that the trade account has shifted into surplus should give speculators pause.

Speculation against the USD remains strong

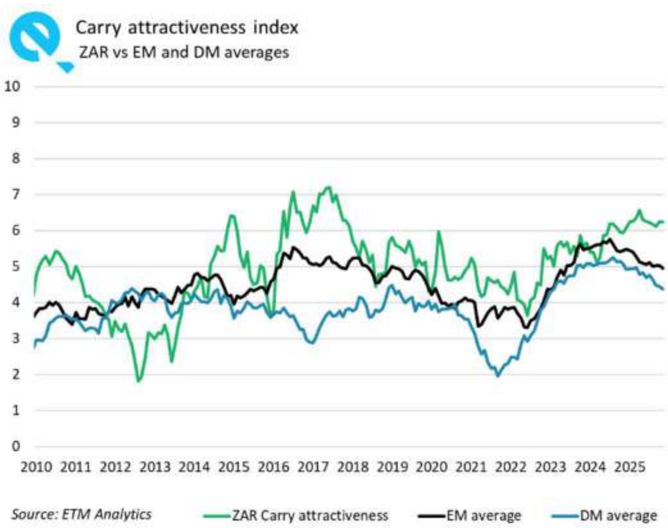


While investors anticipate that the BoJ may even hike one more time, they expect the Fed to cut at least two more times through 2026, and possibly even three times. The implication is a sharp compression in the spreads between US rates and Japanese rates.

Speculators have turned bearish on the USD as a result of these Fed expectations and the possibility that tariffs will be overturned, as well as the prospect that the cyclical slowdown will eventually gain momentum. For now, the USD is on the defensive, not only because of the unwinding of the carry trade, although it is one of the prominent reasons.

It builds the argument against the USD and holds implications for a currency like the ZAR, which enjoyed several tailwinds throughout 2026, some economic and some political.

ZAR outperforming both EM and DM peers



Against that backdrop of a shifting carry environment, it is worth assessing where the ZAR finds itself.

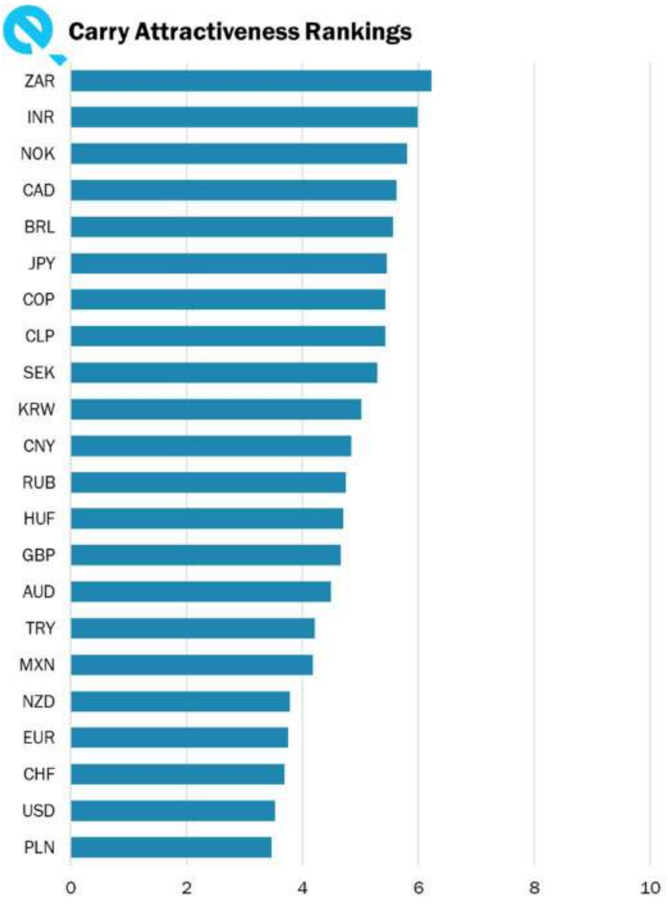
Recall that ETM's Carry Attractiveness Index measures carry attractiveness not just on the relatively attractive nature of SA yields over those of its trading partners, but also based on its current account viability, the volatility of its currency, and its terms of trade.

In other words, it is a holistic approach to assessing carry attractiveness and takes into consideration all the underlying factors that carry trade speculators will consider.

The accompanying chart shows that, on a scale of ten, the ZAR ranks comfortably above both the EM and the DM averages. It means that whatever SA has done, it is in a strong position to attract foreign capital, and even if the ZAR cannot rely on carry trades stemming from Japan, it has more than enough to offer other carry trade speculators.

This should offer some relief to investors who may be worried about the recent appreciation of the ZAR and whether it is sustainable. Judging by the ZAR's carry attractiveness score, one could argue that the ZAR is well-positioned to capitalise on this situation, especially in a world where speculators are actively selling the USD.

ZAR ranks number one out of twenty-two countries



Source: ETM Analytics

It, therefore, should come as no surprise that the ZAR finds itself at the top of the rankings. The ZAR is currently enjoying several tailwinds.

1. Improved fiscal performance
2. A more stable GNU
3. Greater political accountability
4. Improved business and consumer confidence
5. Economic reforms to favour the private sector
6. A lower inflation target of 3% aligning with EMs
7. Exit from the FATF greylist
8. A credit rating upgrade from S&P
9. Strong commodity prices and terms of trade
10. Low currency volatility

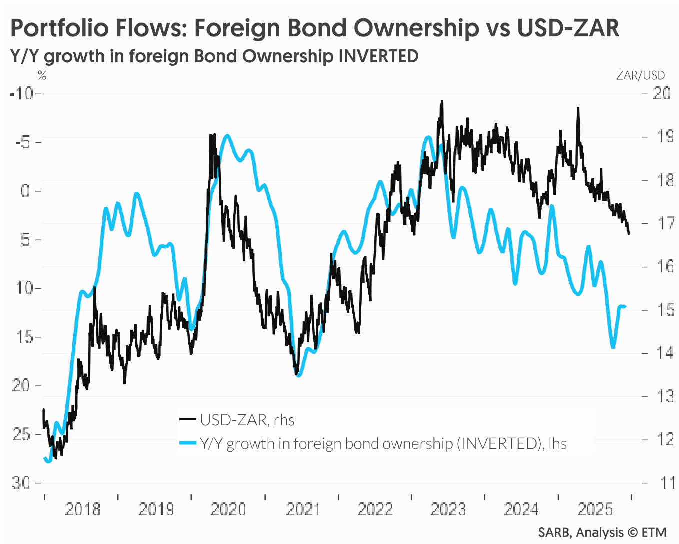
This is indeed a powerful list of tailwinds, which have helped generate a virtuous cycle.

As this virtuous cycle has materialised, SA has been able to attract foreign capital to its shores, which will always help strengthen the currency, especially against the backdrop of a balanced current account.

Being at the top of the carry attractiveness index with a score over 6/10 means SA contracts quite sharply with the USD, which ranks second from the bottom, or the EUR, which is fourth from the bottom.

Although the GBP ranks a little higher, it remains in the bottom half of this table and does not look particularly attractive either.

ZAR ranks number one out of twenty-two countries



Given the concerns about the carry trade and developments in Japan, one would be forgiven for being concerned that the ZAR might face some depreciative pressures. However, that does not appear to be the case.

A good barometer for whether the ZAR is feeling the ill effects of less carry trade demand out of Japan is the capital that bond markets are attracting.

The accompanying chart shows that SA is attracting very strong foreign capital inflows, as depicted by the blue line trending lower (inverted to reflect the fit to the USD-ZAR). The recent bout of ZAR appreciation simply appears to be catching up to where one might've expected the ZAR to be given such inflows.

This bodes well for these gains to be sustained through 2026. The US Fed is likely to be more accommodative than the SARB, while the global economy is likely to respond favourably to continuous rate cuts by major central banks. Resilient global growth will play into SA's hands through the country's exposure to commodity prices.

Analyst(s):

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