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Forex Flash

The yen dominates, the dollar falters

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Weekly Note

Research Department

Rates, FX & Commodities Research

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- The foreign exchange market is experiencing a period of high volatility driven by uncertainty over the monetary policies of the major central banks. The BOJ is set to raise rates, whilst the Fed may hold steady.
- The Japanese yen is dominating the scene, driven by a combination of expectations of a BOJ rate rise and a potential pause by the Fed. The dollar is vulnerable in the short term, especially if Friday's employment data proves weak.
- The pound and the Canadian dollar are benefiting from the greenback's weakness, whilst the Swiss franc remains the outlier, having weakened over the quarter.
- Next week (ECB meetings, followed by the FOMC and BOJ mid-month) will be decisive in shaping new currency trends.

Monetary Policy Divergence

The four major G7 central banks are on deeply divergent monetary policy trajectories. The Bank of Japan is accelerating a cycle of rate rises, with the market pricing in a 97 per cent probability of a hike in September and a terminal rate of 2.20 per cent; the Fed is split 50/50 on a possible first rate rise in three years, the ECB is preparing to raise rates for the second time in a row (but then pause), and the BoE is under pressure to raise the Bank Rate to 4 per cent.

Federal Reserve – The Great Uncertainty

The Fed is at the centre of a profound dilemma. **Fed Chair Kevin Warsh** had recently adopted a distinctly hawkish tone, stating that *"sternly staring at inflation until it melts before our withering gaze is not an option"*, pushing the probability of a rate rise to 70 per cent. **Fed Governor Christopher Waller** turned the picture on its head yesterday, calling for *"giving disinflation a chance"* and stating he was inclined to keep rates unchanged if the August inflation figures confirmed a slowdown. However, he also warned that he would raise rates if inflation were to accelerate. The market is now literally split down the middle: the decision on 16 September could hinge on a single figure (the August CPI).

One underestimated risk is the shift in the ownership structure of the US Treasury market. China held 14 per cent of Treasuries in 2011; it now holds just 2 per cent. In their place, hedge funds hold USD 2,600 billion in Treasuries, with gross exposures of USD 4,000 billion and USD 1,600 billion in short positions. The **50 largest funds** account for around 90 per cent of total exposure. This creates a potentially more unstable environment, making the market more vulnerable to volatility shocks – particularly relevant in a context of global monetary divergence.

Bank of Japan – The Hawkish Acceleration

The BOJ represents the most pronounced divergence. Whilst other central banks are pondering their next moves, Tokyo has shifted into a higher gear. Board member **Hajime Takata** stated that the BOJ should implement rate rises *'nimbly'* to counter inflationary pressures, rather than adhering to a fixed half-yearly schedule. The markets are pricing in **three rate rises by April 2027** and a terminal rate of **2.20 per cent**.

The yield curve has **flattened markedly** (bull-flattening), with long-term yields benefiting from domestic demand and speculation that the **GPIF** (Government Pension Investment Fund) will increase its allocations to yen-denominated bonds and assets.

European Central Bank – Rate Hike Likely, Then a Pause

The ECB is set to raise rates for the **second consecutive time** at its meeting on **9–10 September** in Berlin, but the consensus among economists suggests this will be the last hike in the cycle – *"but then done"*, according to a Reuters poll.

Arguments in favour of a rate rise

- Inflation in the Eurozone remains above the 2% target, fuelled by soaring energy prices (Brent at **USD 95.52 per barrel**, up 45% year-on-year) and the escalation of US-Iran tensions,
- The yield on **the 10-year Bund** has risen to **3.353 per cent** – up by around 33 basis points over three months – signalling that European bond markets are already pricing in monetary tightening,
- The ECB had already raised rates at its previous meeting; a second consecutive hike bolsters its credibility in combating inflation.

Arguments in favour of a pause after September

- The Eurozone economy is showing signs of a slowdown, making further tightening risky,
- High energy prices act as a supply shock rather than a demand shock – monetary policy has limited effectiveness against imported inflation,
- The global landscape is changing: with the Fed likely to hold steady and other central banks at different stages of the cycle, the ECB risks tightening too much.

ECB Communication Calendar

The Governing Council has a busy schedule of announcements in the coming weeks, which will provide the market with valuable insights into *forward guidance*.

Date	Event	Significance
4 September	Speech by Chief Economist **Philip Lane** (Dublin, ISWE Conference)	Potential insights into the macro outlook
8 September	Fireside chat with **Frank Elderson** (Jacques Delors Centre, Berlin)	Pre-meeting context
9 September	Speech by President **Christine Lagarde** at the Bundesbank's official dinner	Political tone
9–10 September	**Governing Council meeting** (Berlin, hosted by the Bundesbank)	**Interest rate decision**
10 September	Post-decision **press conference** (12:45 GMT)	Key forward guidance
11 September	**Lane's** speech at the DEW Economic Policy Conference (Wexford)	Explanation of the decision
23 September	**Lane's** speech at the Graduate Institute (Geneva)	Update on monetary policy
28–29 Oct	**Next Governing Council meeting** (Frankfurt)	Review of the pause
29 Oct	Post-meeting press conference (12:45 GMT)	-

Central Scenario and Risks

Base-case scenario (high probability): A 25-basis-point rate rise on 10 September, followed by an extended pause. Lagarde's press conference will emphasise a *'data-dependent'* and *'meeting-by-meeting'* approach, avoiding any future commitments.

Upside risk (hawkish): If Eurozone inflation for September (released in late September/early October) comes in higher than expected, the ECB could signal openness to a third rate rise at its meeting on 28–29 October.

Downside risk (dovish): A marked deterioration in economic activity or a de-escalation in energy prices could lead the ECB to signal a longer pause and even to consider rate cuts in 2027.

In summary, a rate rise at the September meeting is almost a *foregone conclusion*. Market attention will be entirely focused on **the press conference on 10 September** to gauge whether the ECB will definitively rule out further rate rises or leave the door slightly ajar.

Bank of England – Pressure for Rapid Rate Hikes

The BoE's chief economist, **Huw Pill**, has made unequivocally *hawkish* statements, saying that:

- The Bank Rate is expected to rise to **4 per cent**
- A *'prompt'* rate rise could *'serve to head off some of the potential insidious "catch-up" dynamics'*
- *Second-round* effects on inflation *"will be stronger than estimated in the 'halcyon days' of inflation targeting"*.

Long-term gilt yields continue to rise, reflecting **fiscal jitters** under the Burnham government. High oil prices are fuelling a *'higher for longer'* inflation scenario. As rates in other developed economies converge with those in the UK, the **yield advantage** that had been supporting the pound is set to diminish.

Risk scenarios for the FX and bond markets

Scenario	FX Impact	Bond Impact
BOJ raises rates, Fed holds	USD/JPY heading towards 152–155; DXY below 98	JGB yield curve flattening; brief UST rally
BOJ raises rates, Fed raises rates	USD/JPY stable at 155–160; EUR under pressure	Global bond sell-off; gilts vulnerable
ECB raises rates, then pauses	EUR range-bound at 1.15–1.17	Bunds stabilising at 3.30–3.40
BoE raises rate to 4 per cent	GBP/USD supported but weak against the JPY	Gilt curve under pressure; fiscal concerns

Japanese Yen (JPY) – The Star of the Show

The yen has been the best-performing currency in recent days, with an explosive rally of +2.64 per cent over three months, almost all of which took place in the last week. USD/JPY plummeted from 158.70 (2 September) to 155.79 (3 September), a move of over 300 pips in a single session. Markets are pricing in a **75–80 per cent** probability **of a 25 basis point rate rise by the BOJ** at its 17–18 September meeting, with a further rise in October considered a 35 per cent possibility. The sudden appreciation of the yen has fuelled speculation about official Japanese intervention, but the BOJ has not confirmed any direct action. However, Japanese currency diplomat **Atsushi Mimura** stated that he remains vigilant regarding market developments. The quarterly range for USD/JPY was 155.21–163.90, highlighting extreme volatility.

US Dollar (USD) – Under Pressure

The dollar has depreciated significantly this week. The Dollar Index fell by 0.69% to **98.91**. **Fed Governor Waller** stated that he was inclined to keep rates unchanged if the data confirmed a slowdown in inflation, calling for "giving disinflation a chance".

The probability of a **Fed rate rise on 16 September** has fallen to **50.4 per cent** from 63.2 per cent the previous day and from around 70 per cent at the start of the week. The 10-year Treasury yield fell by 3.8 basis points to **4.756 per cent**, after hitting a high of 4.818 per cent the previous day (the highest level since November 2023).

Euro (EUR) – Resilient but *range-bound*

EUR/USD is trading at **1.1622**, up slightly by 0.13% over the past three months, but the path has been far from straightforward. The pair hit a **quarterly low of 1.1324** on 24 June before recovering to a **high of 1.1679** between 19 and 25 August. The **next key event is** the **ECB** meeting **on 10 September** in Berlin, with a press conference the following day.

Sterling (GBP) – The Strongest After the Yen

GBP/USD at **1.3528** marks a 0.81 per cent appreciation over three months, with a steady strengthening trend from the low of 1.3137 on 24 June to the high of 1.3675 on 21 August. However, the rise in the pound should not be confused with any real intrinsic strength of the currency – the movement is largely driven by the weakness of the dollar and the rally in the yen. The next event of note is the BoE's interest rate decision on 17 September.

Canadian Dollar (CAD) – On the Rise

USD/CAD fell to **1.3801**, marking a 0.83 per cent appreciation of the CAD over three months. The high for USD/CAD (CAD weakness) was reached at 1.4248 on 25 June; since then, the *loonie* has recovered significantly, falling below 1.38. The **Canadian employment report** for August, due today, could influence expectations regarding the Bank of Canada's policy.

Swiss Franc (CHF) – The Exception

The Swiss franc is the only G7 currency to have weakened significantly against the US dollar over the quarter, with USD/CHF rising from 0.7894 to **0.8088** (+2.46 per cent). The pair hit a high of 0.8206 on 29 July before pulling back. The **SNB meeting** is scheduled for **24 September**, with a monetary policy *assessment*.

Calendar and Upcoming Events

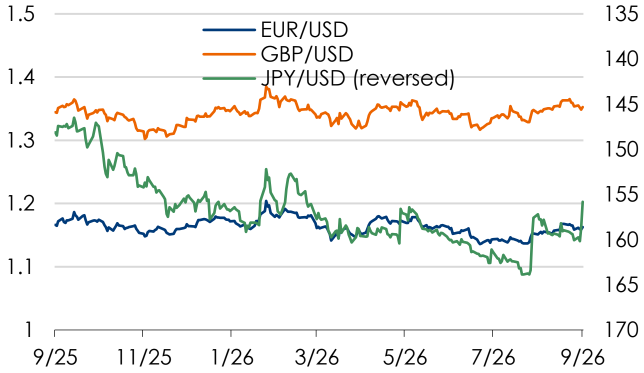
Date	Event
4 Sep	US Non-farm Payrolls, Canadian Employment Figures
10 Sep	ECB meeting (Berlin), BOJ's Masu speaks in Fukui
15–16 September	FOMC meeting – interest rate decision
17 September	BoE interest rate decision
17–18 September	BOJ meeting – interest rate decision
24 September	SNB assessment

In summary

The monetary divergence in September 2026 is the most complex in the last three years. The **BOJ** is emerging as the dominant catalyst, with a structural transformation of Japanese monetary policy reshaping global capital flows. The **Fed** is teetering on a decision that could hinge on a single decimal point in the August CPI. The **ECB** appears close to the end of its cycle, whilst the **BoE** faces a unique combination of energy-driven inflationary pressures and fiscal fragility.

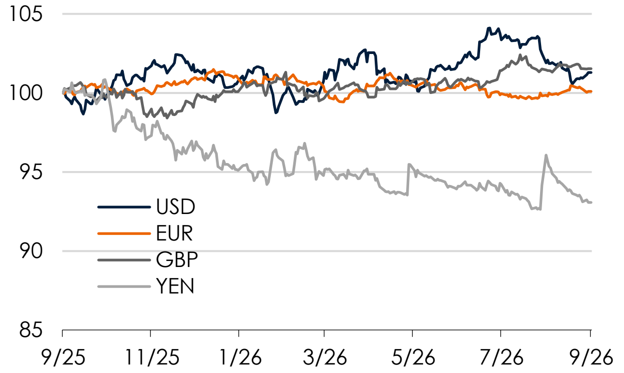
The week of **15–18 September** – with the FOMC, BoE and BOJ decisions coming thick and fast over just three days – is likely to be the period of greatest cross-asset volatility in 2026.

Euro, Pound, Yen vs USD



Source: WS Datastream

Nominal Exchange Rate (BIS, rebased 04/09/25=100)

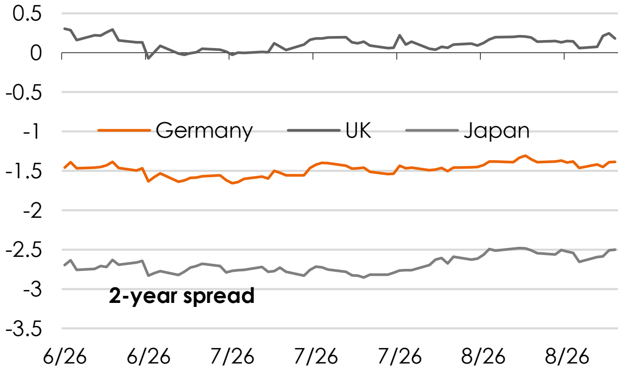


Source: WS Datastream

G10 Forex Forecasts

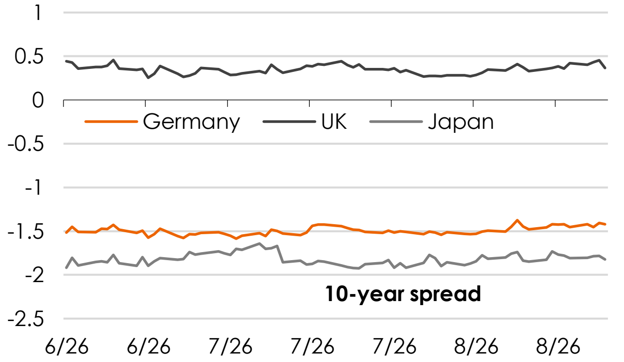
	Q3 2026	Q4 2026	Q1 2027	Q2 2027	Q3 2027	Q4 2027	Q1 2028	Q2 2028
WD EUR/GBP	0.8563	0.8684	0.883	0.8866	0.8911	0.8923	0.894	0.8944
WD EUR/NOK	11.0345	10.9309	10.8257	10.726	10.6706	10.6158	10.5509	10.4964
WD USD/CAD	1.4066	1.4319	1.433	1.4105	1.3954	1.3934	1.382	1.357
WD USD/JPY	159.7091	159.7902	159.5413	155.7251	149.7483	145.6032	143.5761	140.5335
WD EUR/CHF	0.9284	0.9243	0.926	0.9219	0.9209	0.9193	0.9183	0.9164
WD EUR/SEK	10.9652	10.8592	10.7283	10.5072	10.3504	10.2194	10.1496	10.1012
WD USD/CHF	0.81	0.8196	0.82	0.8043	0.7952	0.7947	0.7884	0.7728
WD AUD/USD	0.7053	0.7047	0.7049	0.7142	0.7185	0.7147	0.715	0.7249
WD GBP/USD	1.3386	1.2986	1.279	1.2927	1.2997	1.2964	1.3029	1.3258
WD NZD/USD	0.587	0.5878	0.5993	0.6186	0.6299	0.6314	0.6346	0.6465
WD EUR/AUD	1.3593	0.7946	0.7962	0.8187	0.8321	0.8268	0.8328	0.8596
WD EUR/CAD	1.6122	1.6148	1.6185	1.6166	1.616	1.6119	1.6096	1.6091
WD EUR/JPY	183.0808	180.1947	180.1875	178.4847	173.4246	168.4352	167.2297	166.638
WD EUR/NZD	1.5374	0.6629	0.6769	0.709	0.7295	0.7305	0.7392	0.7666
WD EUR/USD	1.1459	1.1277	1.1294	1.1462	1.1581	1.1568	1.1648	1.1858

Yield spread vs UST2Y



Source: WS Datastream

Yield spread vs UST10Y



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