



MACROMATRIX

# The Unwinding of the Yen Carry Trade



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## Executive Overview

Global financial markets are entering a decisive transition phase marked by an unusual and consequential policy divergence: Japan is exiting its ultra-low interest-rate regime just as the United States pivots toward monetary easing. This reversal directly challenges one of the most persistent macro strategies of the past two decades—the yen carry trade. For years, investors borrowed at near-zero rates in Japan and redeployed capital into higher-yielding U.S. assets, particularly U.S. Treasuries. This strategy thrived on three conditions: ultra-low Japanese funding costs, relative stability or depreciation of the yen, and materially higher U.S. yields. Together, these forces suppressed global borrowing costs, reinforced demand for Treasuries, and supported elevated valuations across risk assets.

That equilibrium is now breaking. Rising Japanese interest rates increase funding costs and incentivize domestic capital repatriation, while U.S. rate cuts compress yield differentials that once made the trade attractive. The result is a structural tightening of the yen–U.S. yield spread, raising the probability of carry trade unwinds. Critically, this unwind does not remain confined to currency markets. As yen-funded positions are reduced, U.S. Treasuries—often the primary destination of carry flows—face selling pressure. Treasury prices fall, yields rise, and global borrowing costs reset higher, even as the Federal Reserve cuts policy rates. This creates a paradoxical environment where monetary easing coincides with tighter financial conditions driven by market mechanics rather than central bank intent.

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### Key Takeaway

*What is unfolding is not a tactical adjustment, but a structural repricing of liquidity, leverage, and the global cost of capital—one with direct implications for bond markets, equity valuations, and cross-border capital allocation.*

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## The Global Macro Backdrop: A Structural Shift in Interest-Rate Regimes

For more than a decade, global capital markets operated under a clear monetary asymmetry. Japan maintained near-zero or negative interest rates, while the United States offered meaningfully higher yields across Treasuries and credit markets. This divergence created fertile ground for the yen carry trade, anchoring global liquidity and suppressing volatility. The durability of this framework conditioned investor behavior. Yen funding became embedded in hedge-fund strategies, bank balance sheets, and institutional portfolios. U.S. Treasuries, viewed as both safe and yield-enhancing, absorbed a steady stream of foreign capital. Over time, this dynamic compressed global yields, lowered discount rates, and inflated valuations across equities and real assets.

That regime is now undergoing a structural reversal. Japan's move toward rate normalization, combined with a Federal Reserve pivot toward easing, disrupts the interest-rate hierarchy that sustained global carry flows. This shift is not cyclical; it represents a reordering of relative monetary anchors. As the spread between Japanese and U.S. rates narrows, the incentive structure that once supported leveraged capital flows begins to unwind.

**Figure: Japan's 10Y Government Bond Yield Climbed to the Highest Level Since 1999 After the Rate Hike Announcement by the BOJ**



Source: LiveMint

## Japan's 'Ultra-Low' Rate Era: Origins and Global Spillovers

Japan's ultra-low interest-rate policy was a rational response to domestic challenges—persistent deflation, weak wage growth, and sluggish demand following the collapse of its asset bubble in the early 1990s. Over time, the Bank of Japan adopted increasingly unconventional tools, including zero interest rates, quantitative easing, yield-curve control, and negative policy rates. While these measures stabilized domestic conditions, they produced powerful global spillovers. Japan became the world's cheapest

source of funding. The predictability of low rates and a structurally weak currency transformed the yen into a global funding currency, supporting carry trades across asset classes.

However, this framework also hollowed out domestic capital formation and distorted price discovery in Japanese bond markets. As global inflation surged post-pandemic and domestic wage dynamics improved, the cost of maintaining ultra-low rates increased. Japan's policy pivot reflects not only inflation pressures, but a recognition that prolonged financial repression carries systemic risks.

## The Mechanics of the Yen Carry Trade

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At its core, the yen carry trade is simple: borrow yen at low interest rates, convert into foreign currency, and invest in higher-yielding assets. Returns depend on the interest-rate differential, leverage, and currency stability. As long as the yen remains weak or stable and Japanese rates stay low, the trade appears low-risk and highly scalable. In practice, the trade became deeply institutionalized. Japanese investors sought yield abroad, while global funds used yen liabilities to amplify exposure to U.S. duration and risk assets. These flows reinforced themselves—yen weakness attracted more carry, while inflows into U.S. assets suppressed volatility. The vulnerability lies in asymmetry. Gains accrue slowly, but losses materialize rapidly if funding costs rise or the yen appreciates. Because positions are often leveraged, small shifts in rates or FX can force abrupt unwinds, turning stability into reflexive instability.

**Japan's Rate Normalization and Capital Repatriation.** Japan's gradual rate hikes signal the end of its role as a perpetual funding engine. Even modest increases materially alter the economics of carry trades. Domestic investors now face more attractive risk-adjusted returns at home, especially when currency risk is considered. At the same time, higher Japanese rates raise funding costs for global investors still running yen-denominated liabilities. This creates persistent pressure to reduce leverage and unwind positions. Importantly, markets are now forced to reprice Japan as a "normal" interest-rate economy rather than a permanent outlier—an adjustment with outsized global consequences.

**The Federal Reserve's Pivot and the Compression of Yield Differentials.** While Japan tightens, the Federal Reserve is easing. As U.S. inflation moderates and labor markets soften, rate cuts compress Treasury yields, directly narrowing the spread that once made yen-funded investments attractive. This compression matters because carry trades rely on relative advantage, not absolute yield. As U.S. rates fall and Japanese rates rise, the carry evaporates. Moreover, easing in the U.S. does not necessarily translate into looser global financial conditions when another major central bank is tightening. Instead, policy divergence introduces friction, volatility, and unintended tightening through market channels.

## Unwinding Dynamics: From FX Stress to Treasury Volatility

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Carry trade unwinds are rarely orderly. Rising Japanese rates increase funding costs, prompting deleveraging. Yen appreciation accelerates losses, forcing further position reductions. This feedback loop typically hits the most liquid markets first—U.S. Treasuries.

As investors sell Treasuries to repay yen liabilities, prices fall and yields rise. Because Treasuries serve as collateral throughout the global financial system, even modest selling can tighten liquidity conditions broadly. These dynamics can overwhelm the stimulative intent of Fed rate cuts, creating episodes where yields rise despite easing policy.

### Implications for Treasury Yields, Global Borrowing Costs, and Equities

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An unwind of yen-funded flows places upward pressure on U.S. Treasury yields, particularly at longer maturities. Higher yields reset the global risk-free rate, increasing borrowing costs for governments, corporates, and households worldwide.

For equities, the implications are significant. Higher risk-free rates reduce the relative attractiveness of stocks, especially long-duration growth assets. Increased volatility forces deleveraging across systematic strategies, amplifying downside risk. Crucially, such stress may emerge even in the absence of deteriorating economic fundamentals—driven instead by funding and currency mechanics.

### Conclusion: The End of Cheap Global Leverage

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Japan's rate normalization marks the end of an era in which cheap yen funding quietly underpinned global asset prices. Combined with U.S. easing, this shift destabilizes the carry trade that compressed yields and volatility for over a decade. The resulting unwind represents a form of market-driven tightening—a shadow tightening that operates independently of central bank intent. Whether this transition unfolds gradually or through sharp dislocations will depend on currency stability, positioning, and policy communication.

*What is clear is that global investors are entering a regime defined by higher and more volatile capital costs, reduced tolerance for leverage, and greater sensitivity to policy divergence. Understanding the unwinding of the yen carry trade is essential for navigating the next phase of global markets.*



## About us

RCK Analytics is a global provider of high-quality investment research, investment banking support, PE/VC insights, Gen AI solutions, market research, analytics, and assurance services. We serve a diverse client base including investment firms, PE/VC funds, asset managers, hedge funds, investment banks, consulting firms, and corporates across sectors. Backed by a skilled team, we deliver data-driven insights and strategic support to help clients make informed decisions and drive financial outcomes.



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