

FX Focus

Quiet FX, Loud Signals

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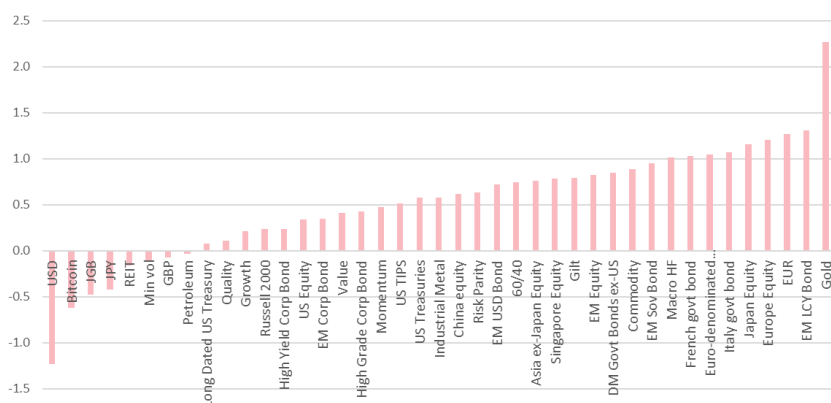
- The USD outlook turns more balanced in 2026 after a turbulent year. The buildup in short USD positioning could clash with resilient US data, suggesting further USD downside should be limited despite lingering policy noise.
- Buying USDJPY looks unattractive at current levels, yet the JPY story remains conflicted. Fiscal concerns under new political leadership continue to distort the usual relationship with rate differentials.
- The AUD is riding renewed rate-hike optimism. Australia's economic resilience and a US–China trade truce leave scope for further upside, even as markets debate how far RBA rate repricing can run.
- FX volatility: Current calm in FX supports carry trades—for now—but also sends a loud signal to insure against abrupt risk-asset weakness when suppressed volatility eventually reawakens.

Major surprises, and lessons for 2026.

Reviewing the major surprises of 2025 offers valuable lessons for navigating markets in 2026. While history rarely repeats exactly, it often rhymes – making the ever-evolving market both challenging and rewarding to follow.

Asset class returns in 2025: USD down, gold up

2025 Asset Class Returns (z score)



Note: Z-scores are calculated using 20-year volatility window. All asset class returns are in USD terms except for currency. Currency returns refer to returns of nominal effective exchange rate.

Source: Bloomberg, OCBC Group Research

Key unexpected developments last year included:

- 1) The USD sharply declined in the first half of 2025, but its weakness stalled as the AI investment boom and tariffs rollback supported resilient US growth.
- 2) The JPY weakened relative to G10 peers despite the Bank of Japan (BoJ) being the sole major central bank to hike rates.
- 3) Precious metals rallied strongly even as the USD's decline lost momentum.
- 4) The AUD and NZD started to gain as market focus shifted from rate cuts to early rate hikes.
- 5) FX volatility hovered near multi-year lows, reflecting expectations of a benign global outlook.

These surprises highlight the importance of staying adaptable and attentive to evolving market dynamics!

USD outlook: More balanced in 2026 after a tumultuous year.

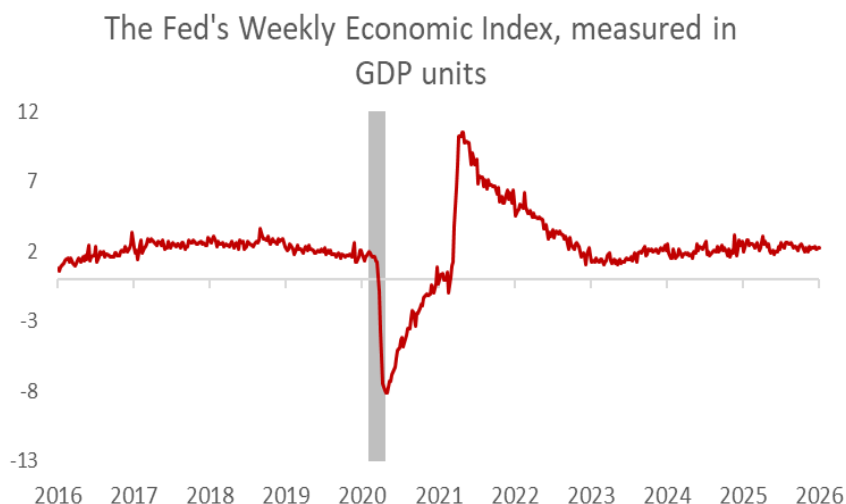
The USD (i.e. DXY) should enter 2026 on steadier footing after a 9.4% slide in 2025—the sharpest drop since 2017—driven by tariff shocks, Fed uncertainty, and Germany's fiscal pivot. We see only modest USD weakness in 1H26, with the DXY likely finding a floor near 96 in 2H26.

The year opens with three pivotal US decisions:

1. President Trump's nomination for the next Federal Reserve (Fed) Chair.
2. Supreme Court rulings on the legality of Trump's tariffs.
3. Whether Fed Governor Cook remains in office amid a mortgage probe.

These outcomes could prolong concerns over a more dovish Fed and weigh on the USD early in the year. An IEEPA ruling could come as soon as this Friday. A potential strike-down of IEEPA-based tariffs could revive fiscal concerns and temporarily pressure the USD, although the Trump administration has signalled its intent to re-impose tariffs through alternative legislative pathways. The scale of USD weakness should be far smaller than in 2025. The US economy is entering 2026 in good shape, with weekly data for GDP showing no signs of a significant slowdown in the US economy. Improving US growth prospects could temper expectations for further Fed easing beyond the one final 25bp cut we anticipate in 1Q26. Additionally, stronger-than-expected US growth poses a risk to the build-up in short USD positioning driven by dovish Fed expectations.

US economy enters 2026 in good shape



Note: Grey shaded area denotes recession

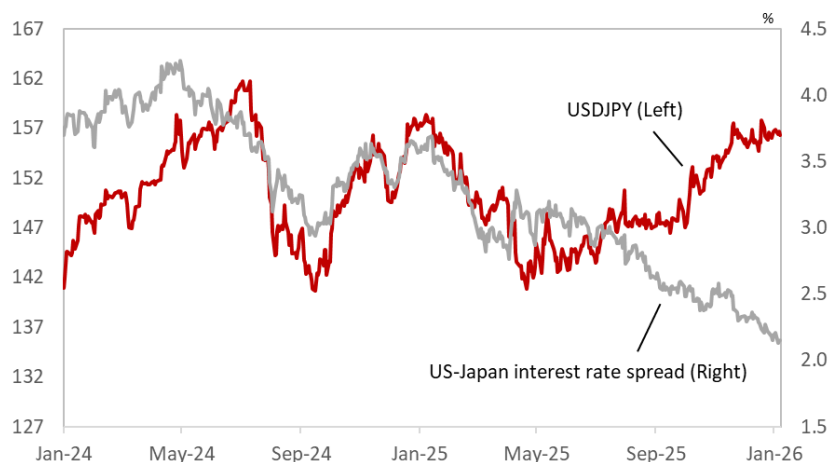
Source: Bloomberg, Dallas Fed, OCBC Group Research

JPY: Policy trade-offs limit upside.

Our initial view anticipated a strong JPY in 2025, driven by the Bank of Japan (BoJ) bucking the global rate cut trend. But the JPY has lagged due to renewed fiscal concerns under new political leadership. Current levels make USDJPY unattractive to buy, with rising risks of action by the BoJ and Ministry of Finance (MoF) to curb excessive JPY weakness. While the precise USDJPY intervention threshold is unclear, the MoF last stepped into the market around the 159–162 region in July 2024.

That said, the JPY outlook remains mixed. Tolerating modest rate hikes or FX intervention is not the same as committing to sustained forward-beating JPY strength. The JPY is increasingly vulnerable to higher JGB yields, reflecting renewed fiscal concerns. While narrowing US-Japan rate differentials would typically suggest a lower USDJPY, fiscal worries have distorted this relationship, weakening the link between USDJPY and yield spreads. Bond market unease also reduces the scope for BoJ to turn more hawkish.

Fiscal concerns have distorted the relationship between USDJPY and US-Japan rate differentials

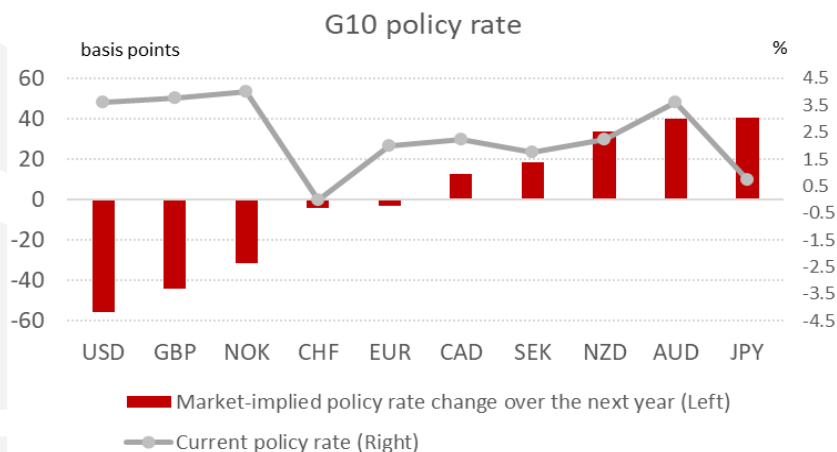


Source: Bloomberg, OCBC Group Research

AUD: Riding rate-hike hopes.

Markets have shifted from rate-cut expectations in 2025 to pricing in renewed hikes amid stronger growth and persistent inflation. Australia and New Zealand now have more than one full hike priced in, while Sweden and Canada see partial hikes. We remain cautious about chasing this repricing too far but believe rate-hike optimism can keep AUD supported. AUD also benefits from easing US-China trade tensions, Australia's loose fiscal/tight monetary mix, and its strong fiscal standing among G10 peers. The Bank of Canada (BoC) may have finished cutting rates. But CAD faces headwinds from heightened trade policy uncertainty around USMCA negotiations, which could keep the BoC more cautious than other central banks.

Markets have shifted from rate-cut expectations in 2025 to pricing in renewed hikes



Source: Bloomberg, OCBC Group Research

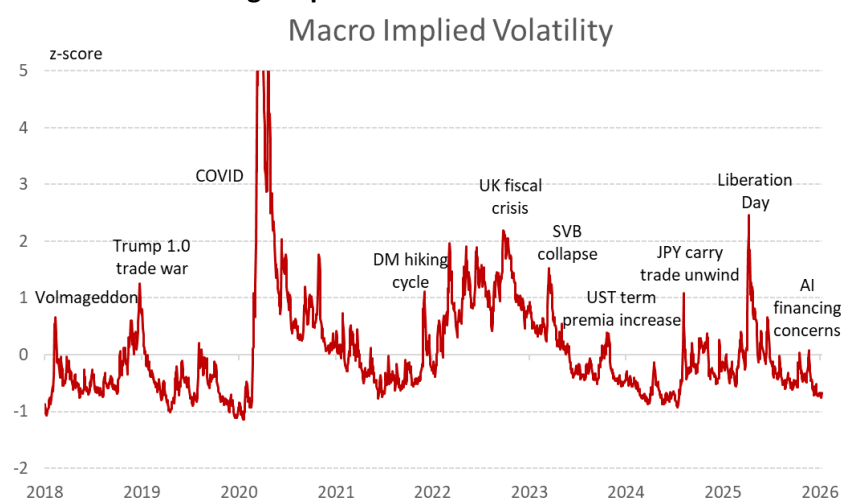
FX volatility: Stillness in FX – for now.

There has been a big drop in most market volatilities in 2025. Despite US foreign policy surprise – as shown most recently by developments in Venezuela – implied FX vol remains at multi-year lows, signalling markets see low odds of outsized moves. From such depressed vol levels, downside looks limited, while the risk of a reversion higher looms—though timing a vol spike remains tricky. Our base case: subdued FX vol persists into early 2026, supporting carry trade performance. Still, unexpected shocks can trigger sharp swings.

Key risks to watch (list not exhaustive):

- AI-driven risk-off correction
- US-China trade war reignites
- New Fed leadership overstimulates economy, leading to overheating
- US labour market weakness deepens, fuelling recession fears
- Geopolitical flashpoints: China-Taiwan tensions or Russia-Ukraine peace negotiation fails

There has been a big drop in most market volatilities in 2025



Note: The z-score for macro implied volatility refers to the average of risky assets of equity (VIX), credit (VIXHY), FX (JPMVXYGL) and commodity (OVX)

Source: Bloomberg, OCBC Group Research

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