Letter from SuMi TRUST - The Bond Vigilante in Japan

By Katsutoshi Inadome, Chief Strategist

Introduction

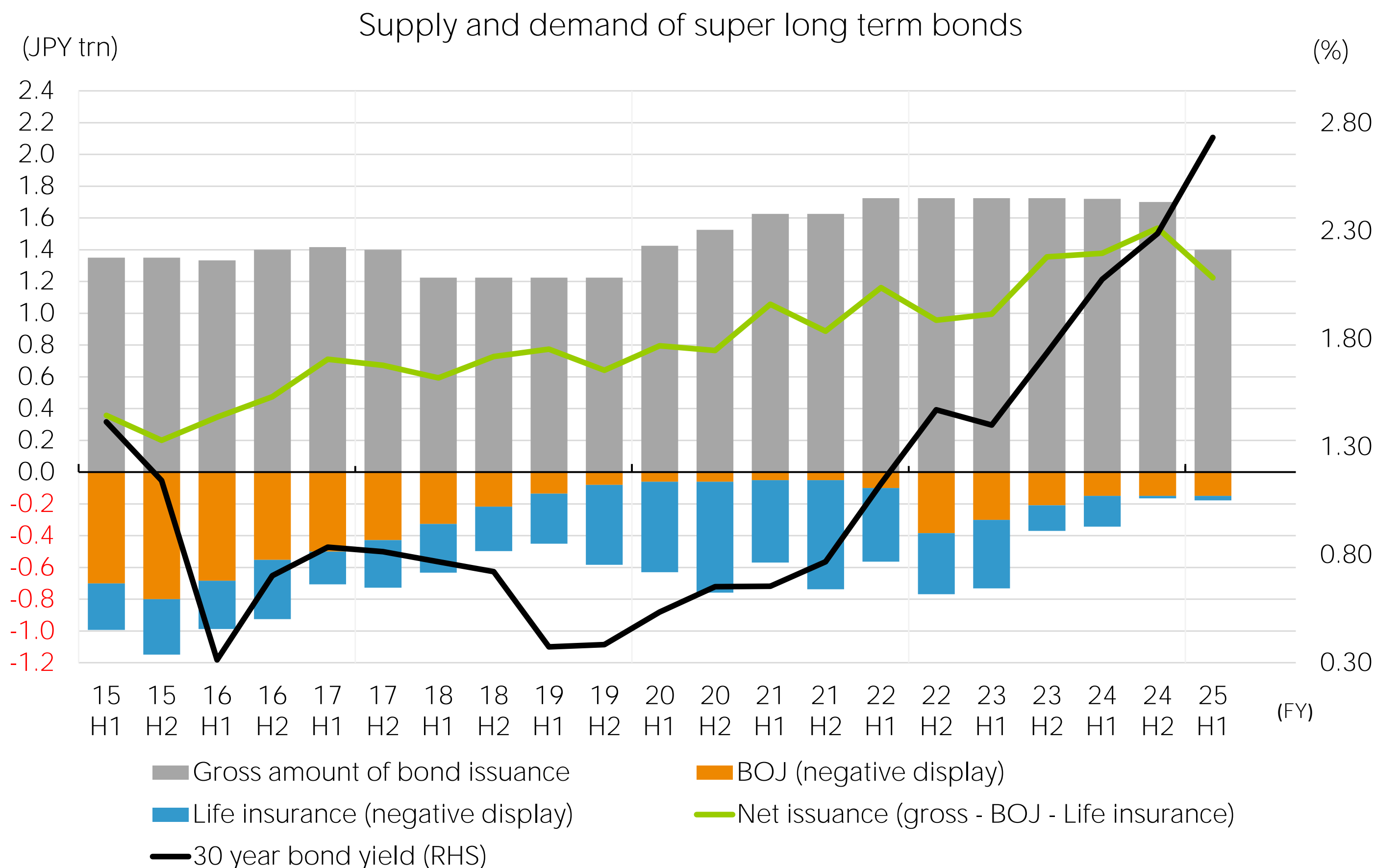
In March 2024, the Bank of Japan ended a significant era of monetary easing, which began in April 2013, by lifting its negative interest rate policy and abolishing yield curve control. As financial authorities aim to normalize monetary policy, Japan's economy is gradually returning to a world of positive interest rates - but not without its challenges. Individuals face higher mortgage rates, increasing their monthly payments. Companies may hesitate to spend on capex or explore new business ventures due to higher borrowing costs.

The government will also face constraints. As yields on newly issued Japanese government bonds (JGBs) rise, so will interest payments. Japan's fiscal condition is characterized by persistent deficits, with government debt exceeding double its GDP. Recently, the bond market has begun to signal concerns over the government's fiscal practices. We will examine the JGB market and its prospects.

Surge in ultra-long-term yields; supply-demand imbalance

Since President Trump announced reciprocal tariffs on April 2, global bond markets have been in turmoil. In Japan, ultra-long (20 to 40-year) bond yields have surged. This shift was triggered by fiscal expansion proposals, like cash handouts and consumption tax cuts, suggested by politicians following the tariff announcement. Meanwhile, yields on medium- to long-term (5 to 10-year) bonds, declined due to concerns over an economic downturn, creating a rare steepening of the yield curve. We believe this surge in ultra-long yields has been fundamentally driven by a structural supply-demand imbalance.

In recent years, the primary buyers of ultra-long bonds have been the Bank of Japan (BoJ) and Japanese life insurance companies. In July 2024, the BoJ decided to reduce bond purchases as part of its tapering process. Life insurers, having completed their capital regulation-driven asset duration extensions, have withheld additional ultra-long bond purchases this year. We view the issuance of ultra-long bonds as excessive amidst this structural decline in demand. Excluding the BoJ and life insurers, demand for 30 and 40-year bonds is approximately ¥0.8 to ¥1 trillion per month. Although this year's issuance is expected to be lower than last year, we estimate a further ¥0.3 trillion reduction is necessary to balance the supply and demand.



Source: Bloomberg, SuMi TRUST AM

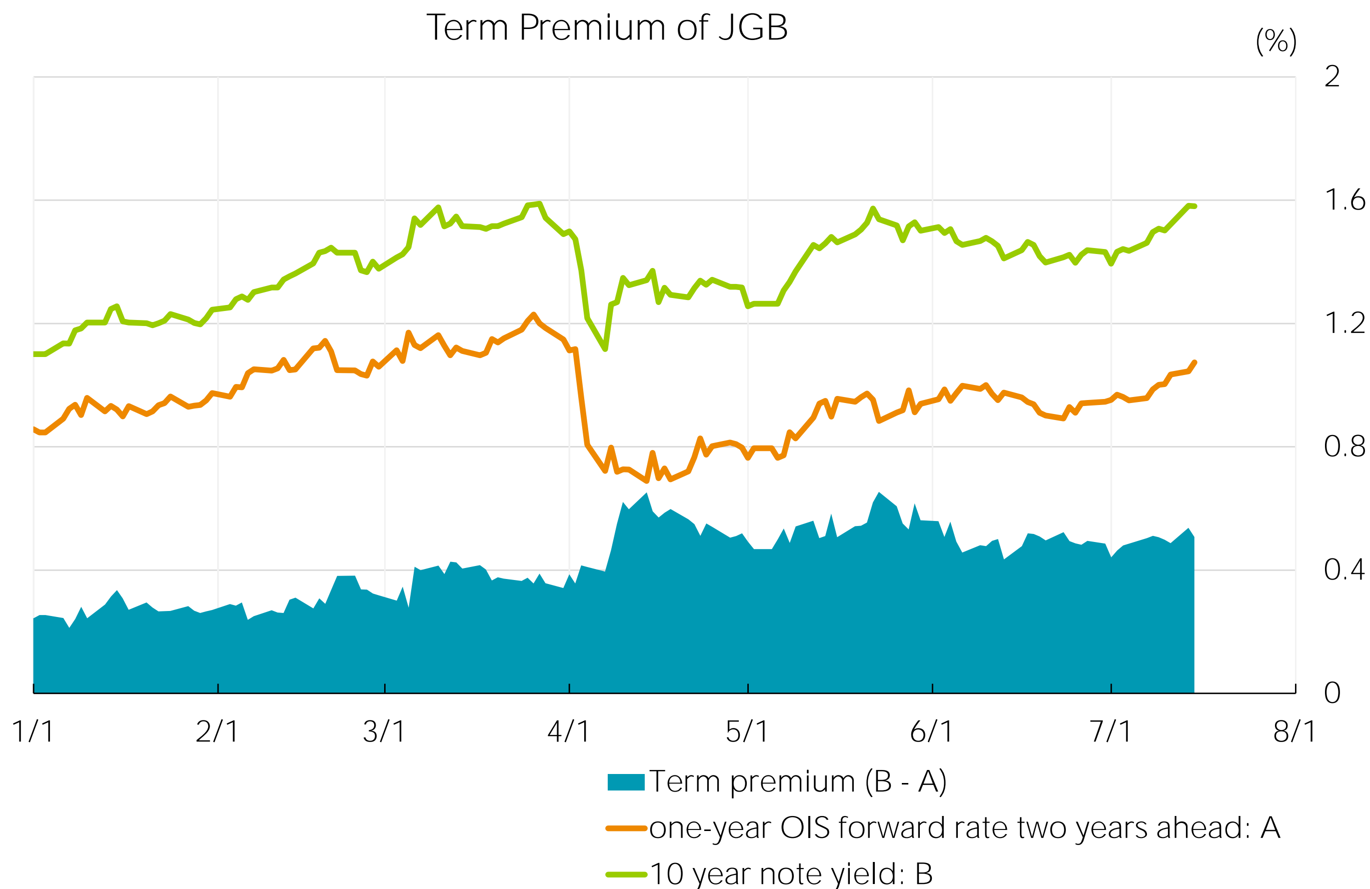
In response to the bond market disturbance, the government revised its FY 2025 bond issuance plan on June 23, further reducing ultra-long bond issuance. Even so, the structural imbalance between supply and demand remains unresolved, and given the inherent low liquidity, volatility is likely to remain high for the foreseeable future. This episode underscores the constraints that will significantly limit the government's funding flexibility going forward.

Changes in long-term yields; expansion of term premium

The 10-year JGB bond yield has maintained its pre-tariff levels. However, a closer analysis reveals a shift in factors driving yields higher. As the BoJ pursues monetary policy normalization, the 10-year JGB yield has gradually risen from around 0.5% to 1.5%. Previously, 10-year yields were primarily influenced by the policy rate outlook. Thus, as expectations for the BoJ's rate hike endpoints increased, so did yields.

Since tariffs were announced, risks associated with holding bonds have driven yields higher. This is known as the term premium, calculated by subtracting the expected policy rate endpoint (one-year OIS forward rate two years ahead) from the 10-year yield. Our estimates indicate a rise in the term premium from around 0.3% at the beginning of the year to approximately 0.6% currently. The term premium incorporates predictions about future fiscal health, with the bond market seeking additional returns amid concerns over fiscal discipline. Both ruling and opposition parties proposed expansive fiscal policies ahead of the July upper house elections. As

policymakers and the public remain reliant on a zero-interest rate environment and debate fiscal expansion, the bond market appears to be issuing a warning.



Source: Bloomberg, SuMi TRUST AM

We forecast a gradual rise in 10-year JGB yields towards year-end, anticipating eventual rate hikes by the BoJ. Even then, with inflation (CPI) expected to be calm, we don't foresee long-term rates exceeding 2%. However, continued fiscal expansion could heighten market sensitivity to bond-holding risks, potentially causing an unexpected rise in bond yields.

Conclusion

We believe Japan is entering an era of positive interest rates, and Japanese Government Bonds (JGBs) are becoming an increasingly attractive asset for both domestic and international investors.

However, fiscal discipline remains a risk factor that must be carefully considered. While we have observed the widening of the term premium, political debate as seen in last month's Upper House election, continues to focus on tax cuts and subsidies. With the ruling coalition now a minority in both houses of the Diet, it will be necessary to incorporate opposition party views into the legislative process. If a consumption tax cut is implemented, it could lead to a downgrade of JGBs by credit rating agencies and trigger an unexpected rise in interest rates. To avoid such a scenario, it will be essential for the new coalition government, once formed,

to engage in cabinet-level discussions on medium-term fiscal strategies, including how to manage rising defence and social security costs.

In the ultra-long-term bond market, where yields are particularly sensitive to fiscal conditions, demand remains weak due to structural factors on the investor side, and there is no clear prospect for significant supply cuts. Liquidity in this segment also remains low, suggesting that elevated volatility is likely to persist for some time. This stands in contrast to bonds with maturities of less than 10 years, which benefit from a more diverse investor base and greater market liquidity.

Even if the Bank of Japan proceeds with interest rate hikes, we do not expect the 10-year JGB yield to exceed 2% within this year. In such a case, the impact on the real economy such as personal consumption and capital investment, —is expected to be limited. As a result, we foresee no significant disruption to Japan's path of stable economic growth.

About Writer

<u>Katsutoshi Inadome, Senior Strategist</u>

Katsutoshi joined SuMi TRUST AM in February 2023, his primary focuses are market analysis and research, with a particular focus on interest rates, currencies, and fixed income markets.

Katsutoshi has about 18 years' experience in the financial industry. Before joining SuMi TRUST AM, he was a bond strategist at Mitsubishi UFJ Morgan Stanley Securities, where he was responsible for developing fixed income portfolio management strategies.