



SMDAM's take: How serious is the rise in Japanese long-term rates?

Japan Market Insights - August 2025



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SMDAM as at August 2025

The rise in yields on long-dated Japanese government bonds has been both exceptional and unprecedented. The yield on the 20-year government bond soared from around 1.9% in January to a temporary high of 2.6% in May, and meanwhile the 30-year spiked from 2.3% to 3.2%. This represents the highest level seen so far since the start of 30-year issuance back in September 1999, but how should this be interpreted?

Long-term rates compress a huge amount of information into a single number. This is why they are watched so closely; it also means they must be carefully interpreted. Our take is that those commentators focusing only on the negative consequences of the rise in yields are underemphasizing several important features of this situation. To recycle some commonly used notation, with **r = nominal yields** and **g = rate of growth**, debt sustainability essentially boils down to: is $r > g$ or not? The doom-mongers have chosen to pair the rise in nominal yields with a fixed growth rate for the remaining tenure of existing JGBs. This assumed fixed growth rate is problematic, and we have a different, more plausible, perspective on this.

Can we consider r in isolation from g?

A key starting point is that r and g should be seen not as fully independent variables, but as in some ways inter-related and even co-determined. Short-term rates are less mysterious than their long-term counterparts. Money market or short duration rates reflect immediate expectations for price changes and how much savers demand to be compensated for lending their cash over a short-term time horizon.

Long-term rates, on the other hand, crystallize investor expectations for growth and inflation over much longer, and therefore less forecastable, time horizons. This means the term premium naturally increases providing a meaningful signal about the macroeconomic direction and pace of travel. The simplest example of this would be the so-called inverted yield curve, commonly seen as an early harbinger of recession for its counterintuitive skewing of the risk premium towards short-term rather than long-term lending. Long-term rates can therefore be thought of as telegraphing aggregate market expectations about the future growth trajectory of the economy. Whilst this could mean fiscal sustainability comes under pressure, this would only be true if growth remained subdued, and this is not how we are reading the data at present.

At SMDAM we believe that it is possible to interpret higher long-term rates as primarily the result of higher expectations for both growth and inflation – ultimately a strong bullish signal, and one that contrasts favourably with the previous decades in Japan of low rates, low inflation and low growth.

Who's afraid of the invisible man?

Another commonly cited negative side-effect of the surge in yields are the capital losses born by holders of long-dated bonds. Whilst all fixed-income investors regardless of currency have recent and painful memories of this phenomenon, it should be remembered that the institutional investors who predominantly buy long-dated bonds in Japan seldom need to mark their positions to market regularly, or for anything other than accounting purposes.

Losses are therefore 'paper' losses, with no need to be crystallized via sale into cash terms. Also true is that the present value of the liabilities that the insurers who hold these instruments must cover have also declined due to the increasing discount rate. Arguably the capital losses are not the most salient feature of the situation, and need to be seen in the context of where the macro economy is heading.

What about real yields?

As explained, we see the surge in long-term rates as just another part of the ongoing 'normalization' of Japanese monetary conditions. This is because crucially the 10-year real yield is still within negative territory, putting the recent increase into proper context. With real yields still negative despite the surge in nominal rates, this seems to imply wide-spread expectations that growth and inflation will keep pace over the long-term.

What could this mean for equities?

Lastly, it is worth considering how this dynamic could impact equity valuations. Simplifying a lot, part of the Eurozone's problem over the past decade has been persistently low expectations of both growth and inflation relative to the US. Any commentator who primarily or exclusively read this differential in yields (higher in the US, lower in the Eurozone) as a function of a greater risk of insolvency in the US than the Eurozone would have been missing the key fact that these economies have been on fundamentally different growth trajectories. With inflation and growth expectations persistently higher in the US than Europe, the US's superior growth outlook effectively necessitated higher yields.

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Therefore, if we are in fact witnessing the emergence and consolidation of substantially higher Japanese yields, this could be read as a symptom of growth and inflation reigniting. Japanese equities might then be set for an equally substantial revaluation. This follows because whilst higher inflation may affect corporate earnings in the short-term, as the time horizon expands, the likelihood that companies can pass inflated costs along to consumers in the form of higher prices rises. Ultimately, as Japan-watchers know all too well, the opposite – persistent deflation – is incomparably worse for equity markets and the economy than it's inverse image.

If the rise in real yields can be interpreted as signaling a long-term and structurally-entrenched rise in growth and inflation expectations, that might be less to fear than some commentators have suggested.

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