Sumitomo Mitsui DS Asset Management

Japan's bond yield surge nears 3%: What's driving it and where does it go next?

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Japan Equity Research Team

SMDAM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

Key takeaways:

- Japan's long-term interest rates have climbed sharply over recent weeks, reflecting a combination of Bank of Japan (BOJ) rate hikes, fiscal concerns, and inflation risks linked to higher crude oil prices.
- We expect the BOJ policy rate to reach 1.75% by June 2027, a scenario that appears largely reflected in current market pricing today.
- Despite this, upward pressure on long-term yields remains due to elevated energy prices and fiscal concerns, underscoring the need for a credible government commitment to fiscal discipline

Why Japan's long-term rates are rising so quickly

As the BOJ announced its latest rate hike on September 18, the yield on the benchmark 10-year Japanese government bond (JGB) briefly rose to 2.945%, surpassing the 2.930% level reached the previous day.This marked the highest level in roughly 30 years, since September 1996, and reminded global audiences that a fundamental macro regime change is now well-underway in Japan, the significance of which needs to be underlined. Selling pressure also spread across super-long-term JGBs, including 20-, 30-, and 40-year maturities.

Several factors appear to be driving the increase: the BOJ's now entrenched shift toward policy tightening, concerns about fiscal deterioration under expansionary government policies, and fears of rising inflation linked to higher crude oil prices amid worsening Middle East tensions. Rising U.S. Treasury yields, influenced by fiscal concerns, increased war-related spending, and large-scale debt issuance, have also contributed to upward pressure on yields globally, with Japan being no exception.

What have markets already priced in?

To assess the outlook for long-term rates, it is important to examine market expectations for BOJ policy. Since early August, the overnight index swap (OIS) market has increasingly anticipated an earlier 25-basis-point rate hike. As of August 18, markets had broadly priced in three additional rate hikes by the June 2027 BOJ meeting, implying a policy rate of about 1.75%. Since then, the BOJ has delivered a further rate increase, reinforcing the view that the tightening cycle remains on track.

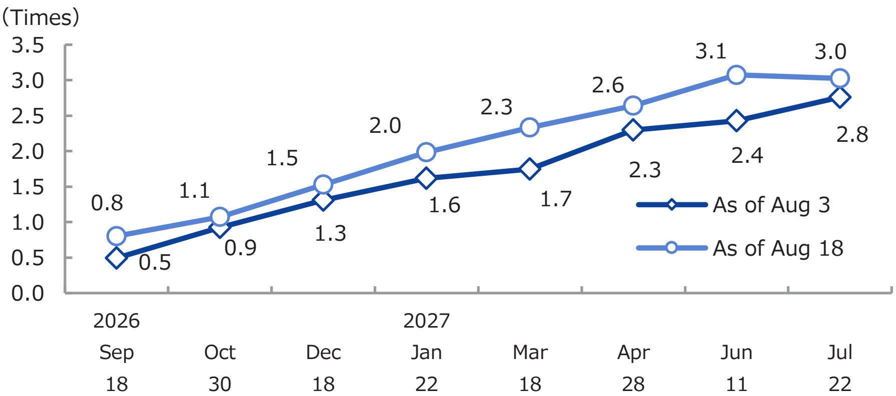
We recently revised our BOJ outlook, concluding that coordinated foreign exchange intervention by Japan and the United States has increased the likelihood of earlier tightening. We now forecast further 25-basis-point rate hikes in January 2027 and June 2027, compared with our previous expectation of hikes in December 2026, June 2027, and December 2027. We continue to expect the terminal policy rate to reach 1.75%, close to the midpoint of the BOJ's estimated nominal neutral rate range of 1.1% to 2.5%

Next risk: Fiscal credibility and the chance of 3% yields

Because markets have already priced in a policy rate of 1.75% by June 2027, the upward impact on long-term rates from expectations of earlier BOJ tightening is likely to diminish. However, concerns about fiscal deterioration remain significant, keeping the term premium elevated.

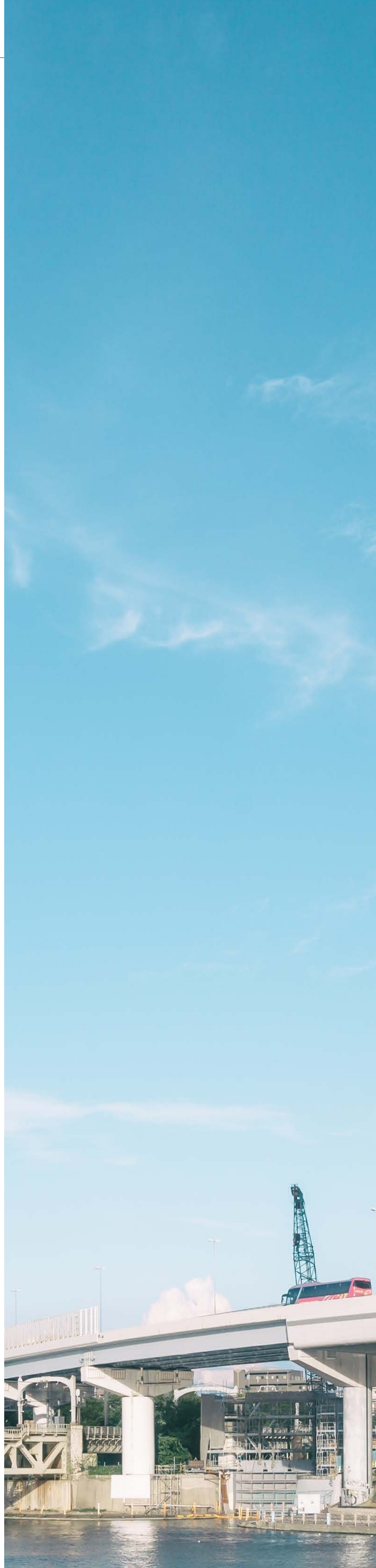
To alleviate these concerns, the government should clearly outline funding sources, planned JGB issuance, and spending controls linked to crisis-management initiatives and growth investments. With crude oil prices elevated once again and overseas bond yields rising, the 10-year JGB yield does now look highly likely to move past 3%.

Figure 1 - Number of BOJ rate hikes priced in by the market



Note: Dates on the horizontal axis indicate the second day of each Bank of Japan Monetary Policy Meeting. The chart shows the number of 25-basis-point rate hikes in the uncollateralized overnight call rate implied by overnight index swaps (OIS). One basis point (bp) equals 0.01 percentage point.

Source: Sumitomo Mitsui DS Asset Management, based on Bloomberg data.



The question now is: how far could this go?

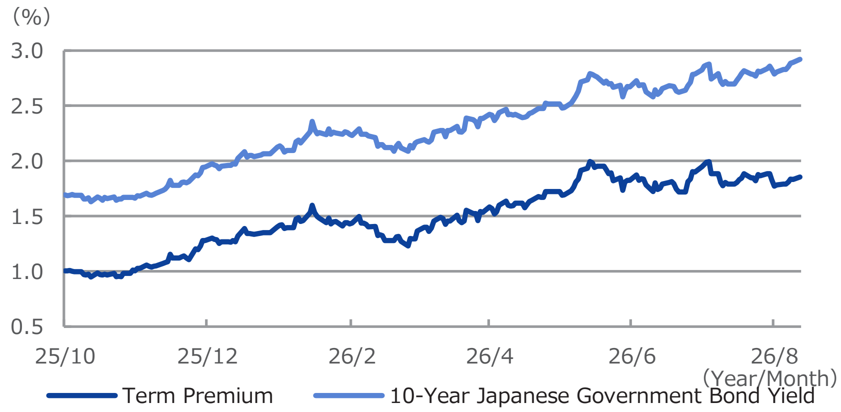
Indeed, yields are ticking up daily as the global macro environment becomes steadily more fractious, underscoring how quickly borrowing costs are repricing and lending greater urgency to the need for credible fiscal policy. Nevertheless, if the government demonstrates a strong commitment to fiscal discipline, particularly in the FY2027 budget, a disorderly rise in long-term rates can likely be avoided.

Meanwhile at the Federal Reserve

The U.S. Treasury announced on August 19 that it will increase the size of its long-term Treasury buyback operations from USD 2 billion to at least USD 4 billion per operation between September 9 and November 4.

The program targets older 10- to 30-year Treasury securities to improve market liquidity and is viewed as an effort to ease upward pressure on long-term yields amid concerns over fiscal deterioration and inflation. Following the announcement, long-term Treasury yields fell, U.S. stocks posted modest gains, and the U.S. dollar weakened against most major currencies.

Figure 2 - Term premium and the 10-Year Japanese Gov. bond yield



Note: Data covers the period from October 3, 2025, to August 17, 2026. October 3, 2025, was the day before the Liberal Democratic Party leadership election held on October 4, 2025. Source: Sumitomo Mitsui DS Asset Management, based on Bloomberg data.

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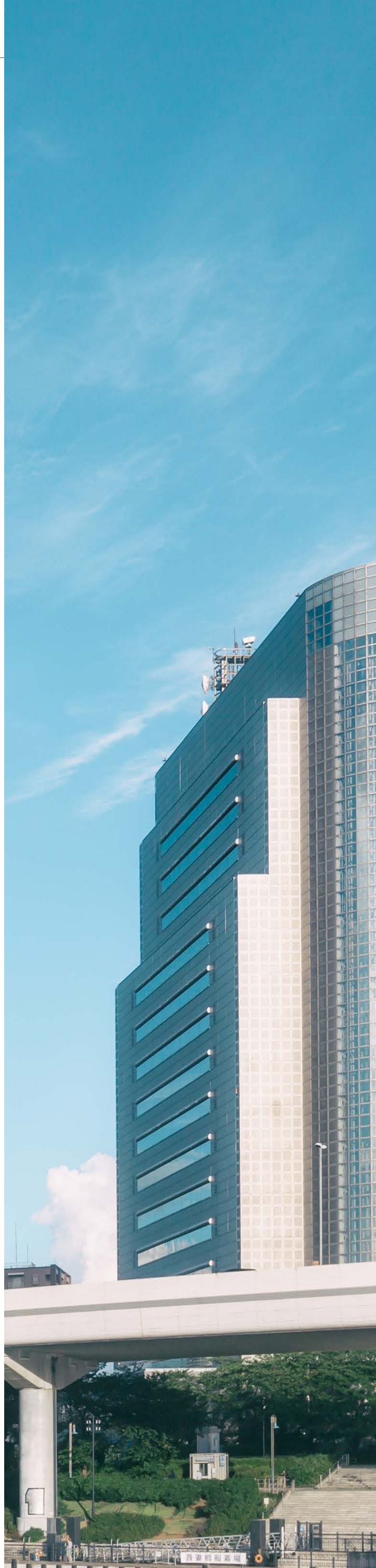
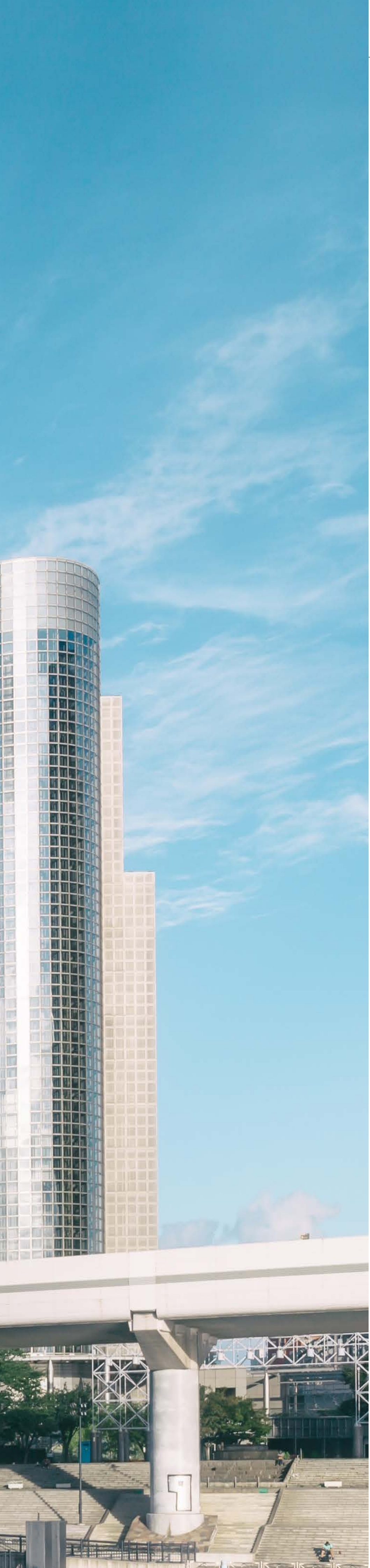
While the buybacks may provide short-term relief for Treasury yields, they do not address underlying fiscal deficit concerns, meaning their impact could be temporary. Lower U.S. yields may help limit rises in Japanese bond yields and reduce pressure on the yen, but sustained stability will depend on appropriate action by the Bank of Japan and the Japanese government. Stable rates could support Japanese equities, although AI and semiconductor-related stocks are likely to remain volatile.

Bottom Line

Our view is that much of the expected BOJ tightening cycle is already reflected in market pricing. Going forward, the trajectory of Japan's long-term interest rates is likely to depend less on monetary policy expectations and more on fiscal credibility, energy prices, and developments in global bond markets. While yields are likely soon to be above 3%, recent increases in JGB yields following further BOJ tightening highlight how rapidly Japan's rate environment is changing.

A clear commitment to fiscal discipline could help prevent a sharper and more sustained surge in borrowing costs. However, this is all part of a much broader global trend for higher rates, and the fact remains that Japan's borrowing costs still look favourable relative to many other developed countries.





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