Sumitomo Mitsui DS Asset Management

Looking through the volatility: Where are medium- and long-term rates headed in Japan?

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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.

Highlights:

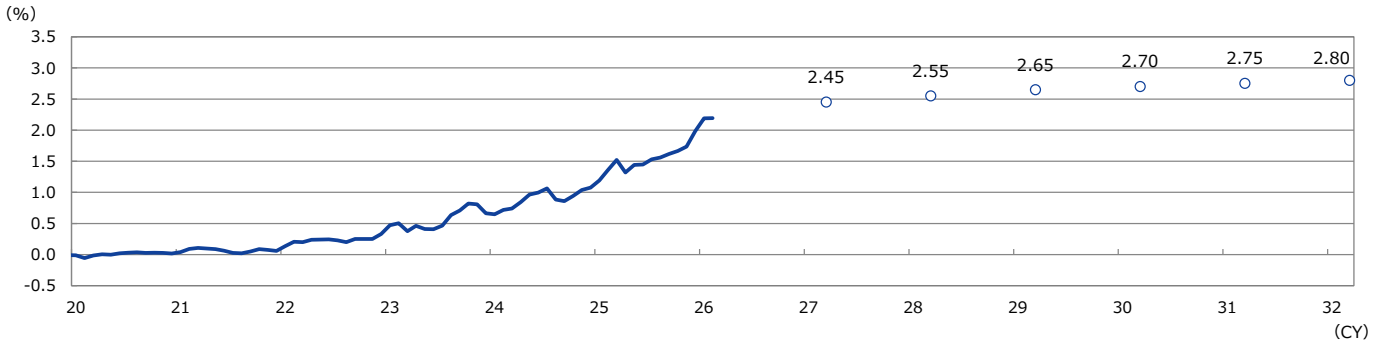
- The pre-existing debate over how Prime Minister Takaichi's fiscal agenda would interact with Japan's substantial national debt has taken on a new urgency over the past month. With large-scale and potentially long-term disruption to energy supplies now expected due to the crisis in the Middle East, Japan's situation as a heavy net oil and gas importer has cast a shadow over the market.
- In this rapidly evolving situation, we have modelled our expectations for Japan's long-term interest rates as benchmarked by the 10-year government bond (JGB) yield. We expect this rate to continue to rise gradually, reaching 2.80% by the end of fiscal 2031.
- This is mainly due to a phenomenon we identify as a type of "diminishing stock effect" triggered by higher inflation in the medium to long term, which means the existing stock of JGBs falls in relative value.
- If a surge in interest payments triggered by the rise in long-term rates and fiscal sustainability is further put into question, there is a risk that this will in turn set off further increases in the rates.
- Whilst the risk of a negative debt spiral is considerable, considering the composition of outstanding government bonds by remaining maturity, it is probable that the feed-through from higher yields to higher rates across the board will only take place incrementally, making it unlikely that such risks will surge or become systemic immediately.

What is the outlook for the 10-year JGB?

Japan's long-term interest rate as measured by the yield on the 10-year JGB rose to the 2.3% range in January 2026, before temporarily dropping below 2.1%. Just a few years ago such levels would have been unthinkable, but today the market has taken these elevated levels relatively in its stride. Recently, the 10-year yield has risen again due to concerns over the Middle East conflict and other factors, hitting 2.38% on March 27th, the highest level in 27 years. Although a great deal of uncertainty remains about the future trajectory of this conflict and what sort of political settlement could be reached eventually, our current near-term outlook forecasts that this rate will rise to around 2.45% by the end of fiscal 2026.

As can be seen in the chart and table below, our expectations for a slow and steady yield increase over the coming years with the bulk of the 'heavy lifting' to get Japanese rates back to positive territory already having been completed.

Fugure1: 10-year Government Bond Yield



Note: Data covers the period from January 2020 to March 2032. The figures from March 2026 onwards are forecasts, showing the values at the end of each fiscal year (indicated by unfilled markers).

Source: Compiled by SMDAM based on Bloomberg data.

Figure 2: Forecasts and Assumptions for the 10-Year Government Bond Yield

	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
10-Year Government Bond Yield	2.45	2.55	2.65	2.70	2.75	2.80
Policy interest rate	1.25	1.75	1.75	1.75	1.75	1.75
2y1y OIS forward rate	1.75	1.75	1.75	1.75	1.75	1.75
BOJ's holding ratio of long-term government bonds	41	36	31	27	24	21
U.S. 10-year government bond yield	4.10	4.10	4.10	4.10	4.10	4.10

Note: End-of-period values (%) .
Source: Compiled by SMDAM based on data from Bloomberg, the Bank of Japan, and the Ministry of Finance.

For investors, excitement over the fiscal expansion promised by Takaichi is intermingled now with heightened fears over the fiscal path Japan is on now that rates have normalized.

Having recently secured her historic victory in the House of Representatives elections, Takaichi moved swiftly to announce a policy to break the long-standing trend of excessive austerity and underinvestment – her so-called "responsible proactive fiscal policy." Additionally, expectations remain high that the administration will go ahead and cut the consumption tax on food and is prepared to consider similar demand-stimulating measures elsewhere. The return of expansionary fiscal policy to a country with a comparatively large debt burden has caused some alarm in the markets, although Takaichi has been mostly successful in her endeavours to reassure investors that her approach won't veer into recklessness. A key promise in this regard has been her commitment to steadily reduce the government's debt-to-GDP ratio over her term in office, implying a firm break on how loose fiscal policy could become. In spite of this we believe that the fiscal risk premium associated with Japan is somewhat likely to rise in fiscal 2026.

Which factors will drive volatility in Japan's long-term rates?

To better analyse the factors behind fluctuations in long-term rates, we modelled the situation as it has existed over the past two decades below. Figure 3 below shows our estimates of the values attributable to various factors which we propose to be either net positive or net negative for Japanese rates. Our house view is that these fluctuations in the rate can be largely explained by the following factors:

1) the Bank of Japan's holding ratio of long-term government bonds,

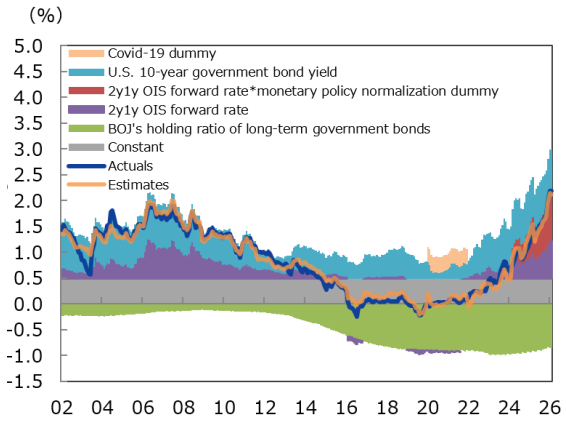
2) 2y1y OIS forward rate (the one year rate starting in two years, this closely follows the 5-year JGB rate),

3) the U.S. long-term interest rate, and

4) the COVID-19 dummy.

Among these, 4) is a special hypothetical factor. For the medium- to long-term outlook of the long-term interest rate, we focused on the future prospects of 1) to 3) and their impacts.

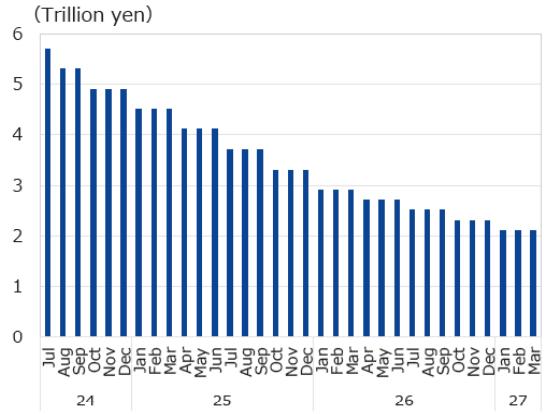
Figure 3: Estimation of the 10-Year Government Bond Yield



Note: Data covers the period from January 2002 to February 2026. The estimation formula is as follows. 10-year government bond yield = 0.48 - 0.02*BOJ's holding ratio of government bonds+0.42*2y1y OIS forward rate+0.57 *2y1y OIS forward rate*monetary policy normalization dummy+0.18*U.S. 10-year government bond yield+0.30 *COVID-19 dummy, R2=0.97 estimation period: January 2002 to February 2026. The monetary policy normalization dummy is set to 1 for March 2024 onwards, and 0 otherwise. This dummy takes into account the possibility that the impact of the 1-year interest rate two years ahead on the long-term interest rate has strengthened since the lifting of the negative interest rate policy. The COVID-19 dummy is set to 1 from January 2020 to December 2021, and 0 otherwise.

Source: Compiled by SMDAM based on data from Bloomberg, the Bank of Japan, and the Ministry of Finance.

Figure 4: Scheduled Monthly Purchase Amount of Long-Term Government Bonds



Note: Data covers the period from July 2024 to March 2027.

Source: Complied by SMDAM based on data from the BOJ.

The estimated values shown in the chart above are the output of our proprietary in-house models and aim to capture the movements of long-term rates and decompose them into their constituent elements. Superimposed over these factors affecting JGB rates are the blue and orange lines representing the actual rate and the estimated rate our model forecast for that point in time.

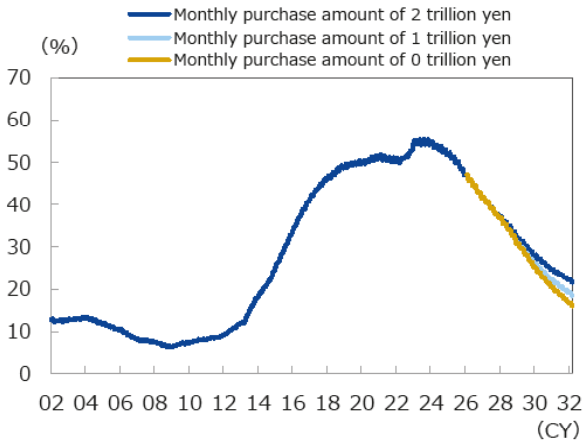
One thing that stands out immediately is that the green area symbolizing the Bank of Japan's (BOJ) level of holdings of long-term bonds initially increased and in effect dragged down actual rates from circa 2009 forwards. However, from 2024 forwards the central bank has shifted towards reducing its holdings of JGBs, and this has coincided with the period of rising rates as increased selling has created upwards pressure on rates. Using data over approximately a quarter of a century, we can see a clear pattern emerge around the multi-year decline in rates that has now reversed so sharply. Moreover, the predictive power of our model is highlighted by the fact that the estimated value as of February 2026 is 2.12%, and the deviation from the actual figure is only -0.07 percentage points.

How has the "stock effect" interacted with long-term rates?

One of the most significant drivers of the recent shift in the interest rate regime has been the decline in the Bank of Japan's (BOJ) holding ratio of long-term Japanese government bonds (JGBs).

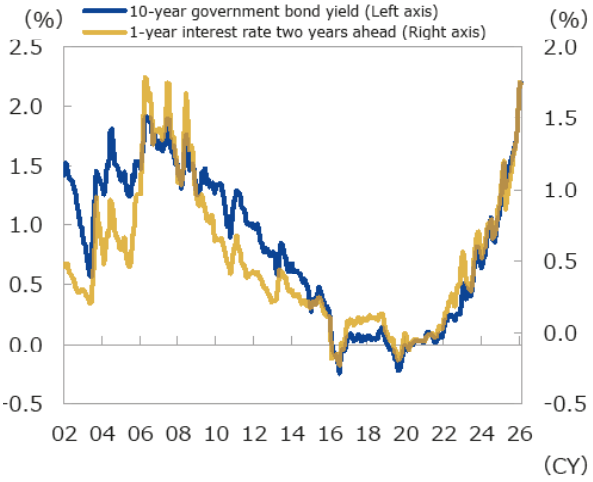
In July 2024, the BOJ announced a plan to reduce its purchases of long-term government bonds, followed by an interim review in June 2025. Under the current plan, monthly purchases will be reduced by about ¥400 billion every quarter until the January–March quarter of 2026, and by about ¥200 billion per quarter from April–June 2026 onward, reaching around ¥2 trillion by January–March 2027 (Figure 4). As a result, the BOJ's holding ratio of long-term JGBs is on a clear downward trend as can be seen in Figure 5 below.

Figure 5: BOJ's Holding Ratio of Long-Term Government Bonds



Note: Data covers the period from January 2002 to March 2032. Compiled by SMDAM based on data from the Bank of Japan and the Ministry of Finance.
Source: SMDAM and Cabinet Secretariat.

Figure 6: 10-Year Government Bond Yield and 1-Year Interest Rate Two Years Ahead



Note: Data covers the period from 2012 to 2023.
Source: SMDAM and Cabinet Secretariat.

In our long-term interest rate outlook, we assume purchases stabilize at ¥2 trillion, the plan's endpoint. Under this assumption, the BOJ's holding ratio is expected to fall to 21% by the end of FY2031. The annual decline is projected at about 5 percentage points until FY2028, slowing to roughly 3 percentage points thereafter.

According to Figure 3, a 1 percentage point decline in the BOJ's holding ratio raises long-term interest rates by around 0.02 percentage points. As the stock effect diminishes, long-term rates are expected to rise by about 0.1 percentage points per year until FY2028, with a smaller—but still positive—impact thereafter. Overall, this suggests a gradual upward trend in long-term interest rates.

The BOJ is scheduled to conduct another interim review in June 2026. Minutes from the June 2025 Monetary Policy Meeting included views favouring a gradual reduction of purchases to zero, or at least to around ¥1 trillion, at which point BOJ purchases would likely cease to be a major market focus.

Figure 5 also illustrates scenarios in which final purchases fall to ¥1 trillion or zero. However, by FY2031 the holding ratios in these cases (18% and 16%, respectively) differ only modestly from the ¥2 trillion scenario. This reflects the fact that the holding ratio is largely driven by redemptions of existing bonds, meaning the final purchase volume is unlikely to materially affect long-term rates via the stock effect.

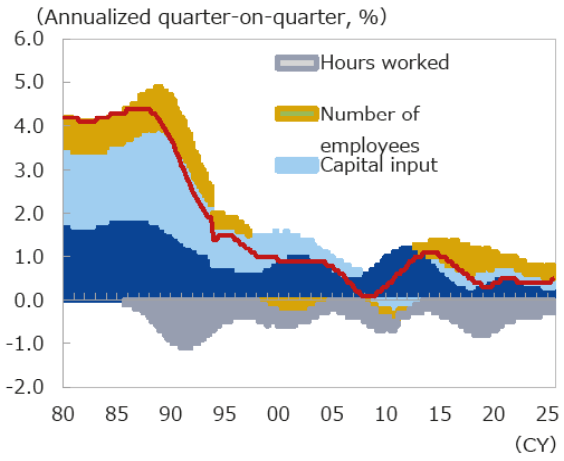
How significant are U.S. long-term rates for Japanese yields?

For U.S. long-term interest rates, we assume they stabilize slightly above 4% over the medium to long term, resulting in a broadly neutral impact on Japanese yields. However, upside risks remain, including persistent inflation that could prompt a more hawkish Federal Reserve, as well as concerns over fiscal deficits and potential de-dollarization. Figure 3 indicates that a 1 percentage point increase in U.S. long-term rates lifts Japanese long-term rates by about 0.18 percentage points. If U.S. rates were to rise toward 5%, Japan's long-term rates could approach 3% by the end of FY2031.

Could the BOJ change the policy target level?

Looking ahead, there is a question as to whether the policy interest rate target could change. Figure 3 shows that since the lifting of the negative interest rate policy, a 1 percentage point change in the 2y1y OIS forward rate has translated one-for-one into long-term interest rates. Attention therefore turns to the potential growth rate. The Cabinet Office estimates this at 0.5% for the October–December 2025 quarter, and a significant revision could affect rate-hike expectations (Figure 7). However, our main scenario assumes this risk is limited.

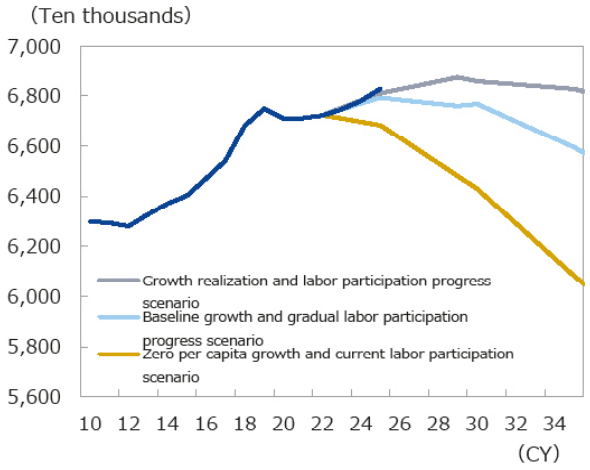
Figure 7: Potential Growth Rate



Note: Data covers the period from the April-June quarter of 1980 to the October-December quarter of 2025.

Source: Compiled by SMDAM

Figure 8: Number of Employees



Note: Data covers the period from 2010 to 2035. The data for each scenario is based on the "Estimates of Labor Supply and Demand for Fiscal 2023" (The Japan Institute for Labour Policy and Training).

Source: Compiled by SMDAM based on data from the Ministry of Internal Affairs and Communications and The Japan Institute for Labour Policy and Training.

Some expect the government's growth strategy, to be formulated this summer, to raise the potential growth rate. Yet given past policy outcomes, it is difficult to make an upward shift the central scenario. Conversely, there are persistent concerns that a decline in employment could lower potential growth. In practice, employment continues to rise. Recent figures slightly exceed even the most optimistic "growth realization and labour participation progress scenario" from the FY2023 labour supply and demand estimates by the Japan Institute for Labour Policy and Training (Figure 8). That scenario anticipated increased participation by women and the elderly due to improved childcare and longer healthy life expectancy, but actual participation has progressed even faster.

While demographics imply that employment will eventually decline, during the period through fiscal 2031 the number of employed persons is highly likely to remain resilient.

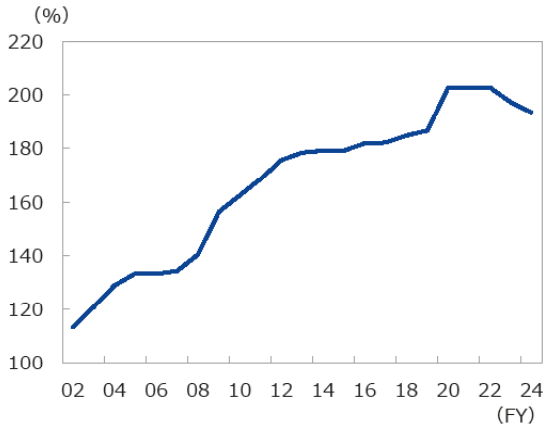
If the potential growth rate remains broadly unchanged, it is reasonable to expect the policy rate to rise to around 1.75% during the current tightening phase and then stabilize. Under this assumption, the future impact of rate-hike expectations on long-term interest rates should remain limited.

The delicate balance between long-term rates and fiscal expansion

We forecast Japan's long-term interest rate to reach 2.80% by the end of FY2031, raising questions about fiscal implications. A surge in interest payments could undermine fiscal sustainability and further pressure yields. The debt-to-GDP ratio remains a key indicator (Figure 9), and declining this ratio remains central to maintaining market confidence.

After peaking at 203% in FY2022, the debt-to-GDP ratio fell to 197% in FY2023 and 194% in FY2024. Year-on-year changes can be approximated as: Change in debt-to-GDP = (effective interest rate − nominal GDP growth rate) × debt ratio + primary balance.

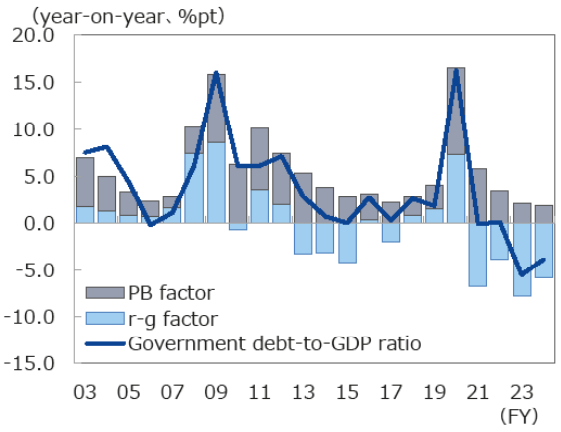
Figure 9: Government Debt-to-GDP Ratio



Note: Data covers the period from fiscal 2002 to fiscal 2024.

Source: Compiled by SMDAM based on data from the Cabinet Office.

Figure 10: Breakdown of Factors for the Government Debt-to-GDP Ratio

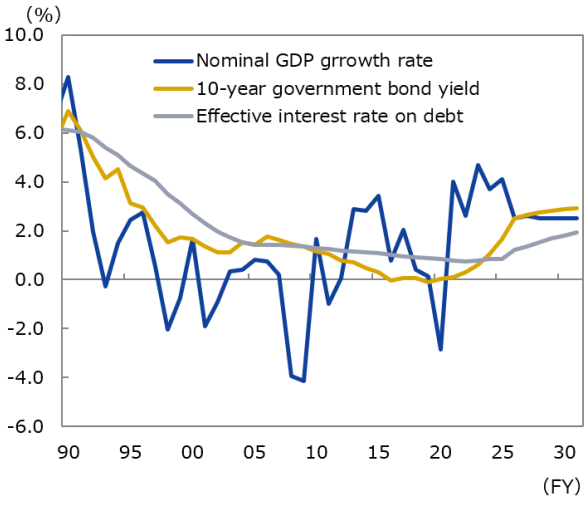


Note: Data covers the period from fiscal 2003 to fiscal 2024. Since the breakdown of factors for the debt-to-GDP ratio is based on an approximation formula, the change in the debt-to-GDP ratio does not necessarily match the sum of each factor.

Source: Compiled by SMDAM based on data from the Cabinet Office.

Decomposing this into the "r–g factor" and the "PB factor," the recent decline has been driven mainly by the r–g factor (Figure 10). Robust nominal GDP growth exceeding the effective interest rate on debt has weighed on the ratio (Figure 11).

Figure 11: Nominal GDP Growth Rate and Interest Rates



Note: Data covers the period from fiscal 1990 to fiscal 2031. The figures from fiscal 2025 onwards are forecasts.

Source: Compiled by SMDAM based on data from the Cabinet Office, the Ministry of Finance, and Bloomberg.

Figure 12: Composition of Outstanding Ordinary Government Bonds by Remaining Maturity

Remaining maturity	Composition (%)
Over 20 years	13.8
Over 10 to 20 years	19.3
Over 9 to 10 years	4.0
Over 8 to 9 years	5.4
Over 7 to 8 years	4.8
Over 6 to 7 years	4.7
Over 5 to 6 years	4.2
Over 4 to 5 years	6.2
Over 3 to 4 years	7.2
Over 2 to 3 years	6.8
Over 1 to 2 years	9.6
1 year or less	13.8

Note: Data is for fiscal 2024.

Source: Compiled by SMDAM based on data from the Ministry of Finance.

Looking ahead to FY2031, nominal GDP growth is based on our forecasts through FY2027, then assumed at 2.5% thereafter. The effective interest rate on debt is expected to rise gradually to around 1.9% by FY2031, preserving the favourable “r < g” relationship. Even with long-term rates reaching 2.80%, the r–g factor should continue to support a declining debt ratio, though the effect will diminish.

Over the longer run, the effective interest rate is likely to converge toward long-term market rates, increasing the importance of credible fiscal discipline. That said, the analysis suggests Japan retains some time before this pressure becomes binding.

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