



Japan's Long-Term Yield Surge: What's driving it and what it means ahead

Japan Macro Commentary - May 2026

Makoto WATANABE

Senior Macro Strategist

*Economic Research Group,
Investment Department*

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:

- Japan's long-term yields have risen sharply, with the 10-year JGB yield climbing to above 2.7% in just over three months. The move reflects the simultaneous emergence of a more hawkish Bank of Japan (BoJ), heightened Middle East tensions, and growing concern over fiscal expansion in Japan and abroad.
- The underlying issue is the fragility of JGB market supply-demand conditions. Large-scale bond supply from BoJ quantitative tightening (QT), combined with an expansionary fiscal stance, has made the market increasingly vulnerable to upward pressure on yields.
- Globally, fiscal expansion has become more entrenched, driven by geopolitical pressures and redistribution demands. That is lifting term premia across markets and adding to the rise in Japanese yields.
- With a series of fiscal events still ahead, a move in long-term yields toward 3% is no longer a distant possibility. It is increasingly a credible near-term upside risk.

We have previously considered the possibility that Japan's long-term yields continue to rise, and that these might even reach 3% one day soon. At the time, the 10-year yield stood at 2.24% (February 5th). It has since risen to 2.72% (May 15th) in just over three months, bringing 3% much closer into view (Chart 1). This report reviews the drivers of the recent surge and reassesses the implications from here.

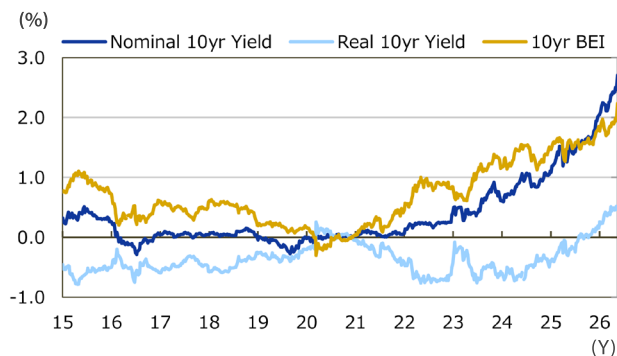
Unexpected shocks and latent risks converged

Since February 5th, the bond market has been driven by three factors: (1) a more hawkish BoJ, (2) escalating Middle East tensions, and (3) mounting concern over fiscal expansion at home and abroad. Of these, the BoJ's hawkish shift and the outbreak of conflict involving Iran were, frankly, not in our base case. By contrast, domestic fiscal expansion had already been flagged as a risk in our February note, and fiscal concerns overseas were hardly implausible. What changed was that unexpected shocks and previously identified risks materialised at the same time, driving the sharp rise in yields.

A more hawkish BoJ

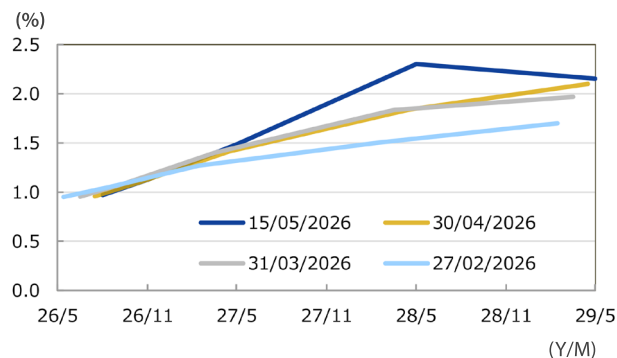
We discussed the change in the BoJ’s stance in our May 1st report, Reading the BoJ’s Rate-Hike Stance (Part 1). A string of hawkish signals from the BoJ pushed market pricing for the terminal policy rate roughly 25bp higher (Chart 2). Applied to a model that explains the 10-year yield using U.S. yields and two-year-forward OIS, that shift implies an increase of nearly 20bp in Japan’s long-term yields.

Chart 1: Japan’s 10yr Nominal/Real Yields and Inflation Expectations (BEI)



Note: Weekly data from Jan 2, 2015, to May 15, 2026.
Source: SMDAM and Bloomberg

Chart 2: BoJ Policy Rate Pricing in Financial Markets



Note: OIS-implied expectations as of each date.
Source: SMDAM and Bloomberg

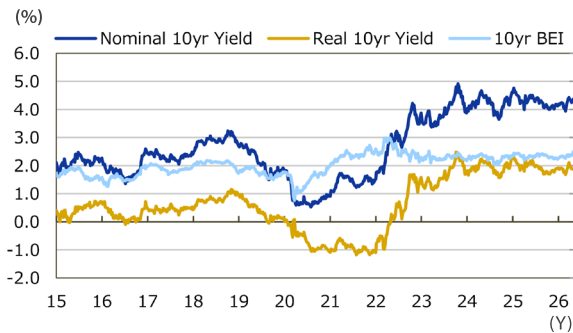
There also appears to have been a second-round effect. After repeated hawkish signals, the BoJ ultimately left rates unchanged at its April meeting, prompting concern that it was falling behind the curve. That, too, likely contributed to the rise in long-term yields. Higher oil prices driven by the Middle East complicate policy: they push inflation higher while also weighing on growth.

Conflict in the Middle East

The biggest surprise was the conflict involving Iran, which pushed oil prices sharply higher and weakened the yen, materially lifting Japan’s inflation expectations. The 10-year breakeven inflation rate rose from 1.72% before the conflict (February 27th) to 2.24% as of May 15th, an increase of just under 50bp (Chart 1). With the Strait of Hormuz effectively remaining closed and oil prices staying elevated, concerns that the BoJ is behind the curve have intensified, helping drive inflation expectations higher.

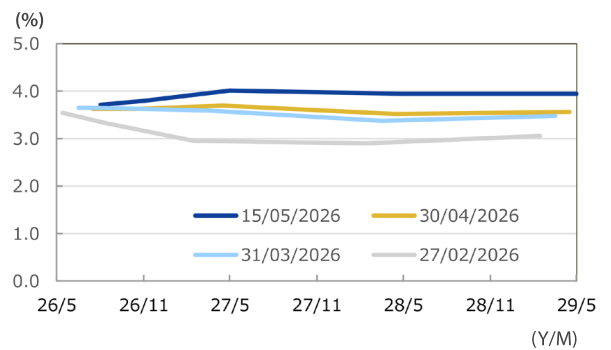
Higher overseas yields have also added to the rise in JGB yields. In the United States, inflation concerns have not only pushed out expectations for Fed rate cuts but have also led markets to price in the possibility of further hikes. Rising U.S. yields are helping to create a broader global backup in rates (Charts 3 and 4).



Chart 3: U.S. 10yr Nominal/Real Yields and Inflation Expectations (BEI)

Note: Weekly data from Jan 2, 2015, to May 15, 2026.

Source: SMDAM and Bloomberg

Chart 4: Fed Policy Rate Pricing in Financial Markets

Note: OIS-implied expectations as of each date.

Source: SMDAM and Bloomberg

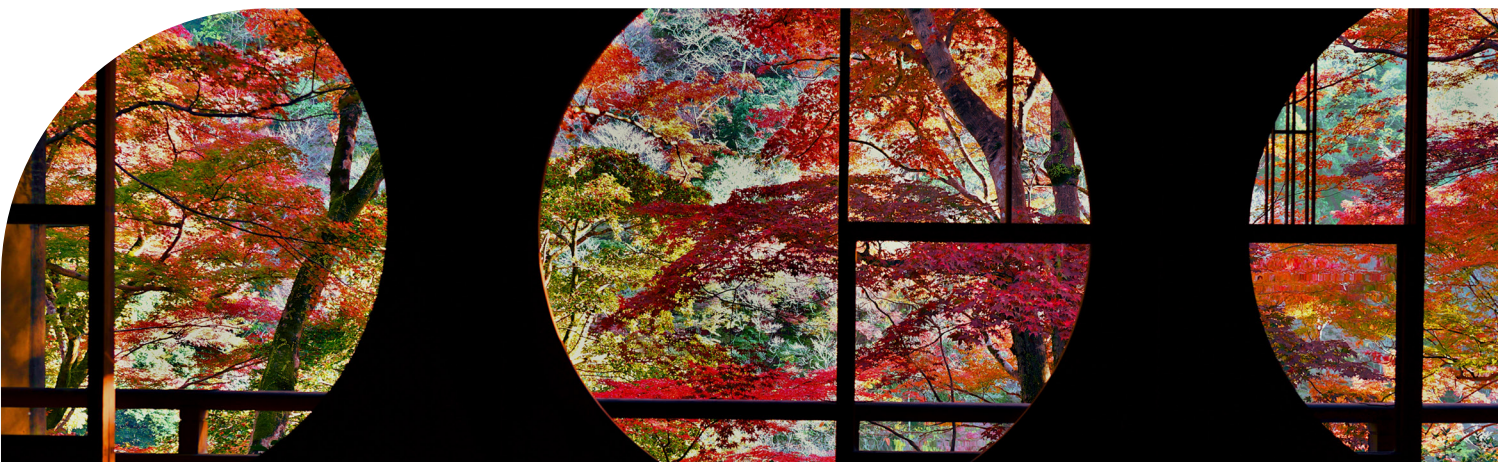
Fiscal concerns and fragile JGB demand

Japan's fiscal response to higher oil prices has also contributed. The Takaichi administration's gasoline subsidy measures added to upward pressure on long-term yields. As the Middle East situation has become more drawn-out and there is still no clear path to normalisation in the Strait of Hormuz, the subsidy period has been extended. Reports that the government is also considering a supplementary budget for electricity and gas subsidies through the summer have further unsettled the market.

That said, the administration is not currently discussing a large supplementary package. The reason market concern has nonetheless intensified lies in the fragility of JGB demand. As noted in our earlier Macro View, BoJ QT is effectively releasing around JPY12tn of JGBs into the market each quarter, or roughly JPY48tn annualized. Adding government net issuance of around JPY20tn–30tn per year brings total annual supply to roughly JPY70tn–80tn. At present, the domestic private sector cannot absorb this volume on its own, leaving the market reliant on foreign investors. Those investors typically demand a higher risk premium, making the market structurally more prone to rising yields (Chart 5).

QT is a powerful form of tightening

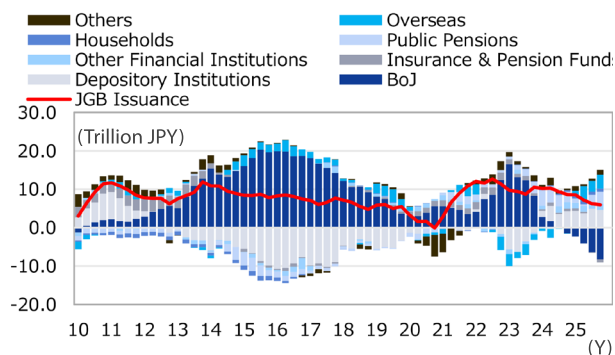
It is worth underscoring just how powerful QT is. The large stock of JGBs purchased during the Kuroda easing era is now maturing in large volume, with redemptions running at roughly JPY20tn per quarter, or JPY80tn annualized. Meanwhile, BoJ purchases have been scaled back under QT, from JPY5.7tn per month before QT began to around JPY2.7tn currently, or JPY8.1tn per quarter (Chart 6). The gap between redemptions and purchases—around JPY12tn per quarter—effectively becomes net supply to the market.



Importantly, this pressure is set to persist. Quarterly redemptions of around JPY20tn are likely to continue, while the BoJ remains inclined to reduce purchases further under QT. In other words, supply-demand conditions in the bond market are likely to worsen from here. Even if the BoJ were to stop reducing purchases immediately, net JGB supply of roughly JPY48tn per year would continue unless it actively increased purchases (Chart 7). QT is therefore a powerful tightening tool whose effects persist even if the taper itself stops.

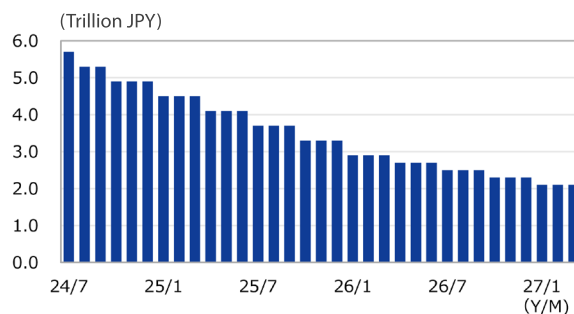
Adding government net issuance to this gives total net JGB supply from the government and the BoJ to the market (Chart 8). Any supplementary budget financed by additional bond issuance would worsen that imbalance further. Under the fiscally expansionary Takaichi administration, long-term yields have risen more quickly because expectations of increased issuance have made private investors more cautious, exposing the underlying fragility of JGB demand.

Chart 5: JGB purchases by sector (4-Quarter moving average, flow basis)



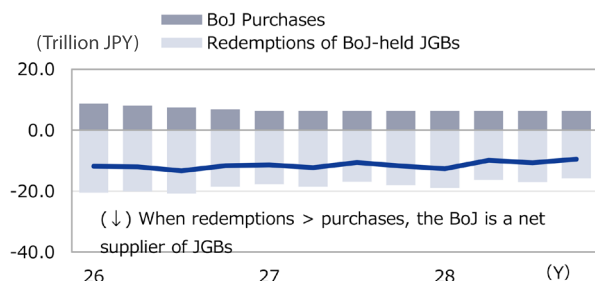
Note: Data from Q1 2010 to Q4 2025.
Source: SMDAM and BoJ

Chart 6: BoJ's scheduled monthly JGB purchases



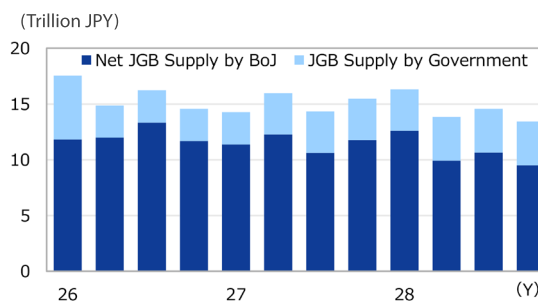
Note: Data from Jul 2024 to Mar 2027. Figures from Jun 2026 are scheduled amounts.
Source: SMDAM and BoJ

Chart 7: BoJ JGB purchases and redemptions of holdings



Note: Data from Q1 2026 to Q4 2028. Assumes purchase tapering continues until Q1 2027, then halts. Future redemptions are our estimates.
Source: SMDAM and BoJ

Chart 8: Net JGB supply by the government and BoJ



Note: Data from Q1 2026 to Q4 2028. BoJ net supply from Chart 7. Gov supply estimated by us based on Cabinet Office and MOF data.
Source: SMDAM, BoJ, MoF and Cabinet Office

The challenge is QT's rigidity

The difficulty is that even stopping QT would not fundamentally change the structure described above. To improve supply-demand conditions meaningfully, the BoJ would need to increase purchases. But if it were to do so just as it sees sustained and stable achievement of the 2% inflation target coming into view, markets could interpret that as political pressure from the government. Any hint of debt monetization would risk pushing long-term yields higher, not lower.

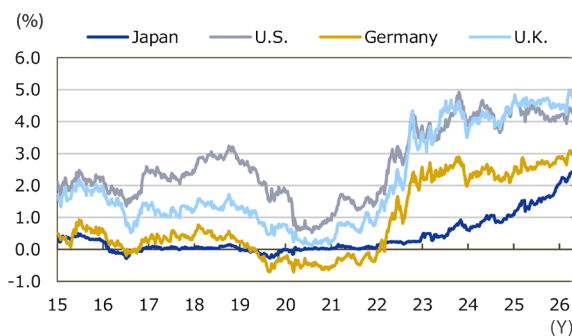
Put differently, QT also acts as a constraint on fiscal policy. From the BoJ's perspective, if the economy is moving back toward normal conditions, continued QT is consistent with the 2013 joint statement—provided the government is steadily advancing efforts to establish a sustainable fiscal structure. That is a reasonable position. But QT remains a very strong form of tightening. As the summer policy agenda takes shape—including the annual policy guidelines, growth strategy, and proposals related to consumption tax cuts—the market may become even more focused on the underlying weakness in JGB demand.

Overseas fiscal concerns and global spillovers

Cross-market linkages have also contributed to the rise in Japanese yields. As noted above, U.S. yields have moved higher on Middle East-related inflation concerns. More recently, U.K. yields have risen sharply after the ruling Labour Party's defeat in local elections raised concerns that political instability could increase the risk of fiscal slippage. Together with the rise in Japanese yields, this has reinforced the broader global move higher in rates (Chart 9).

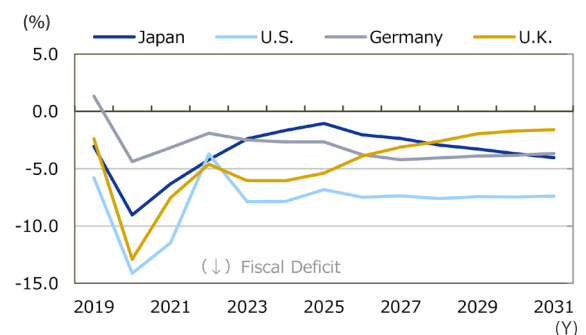
The deeper backdrop is the fading peace dividend and growing political fragmentation. Across many economies, fiscal expansion has become more persistent, driven by higher defence spending and demands to address inequality. This synchronised fiscal shift is lifting term premia globally and creating a fragile rates environment in which a rise in one country's yields can spill over easily to others through currencies and cross-market channels (Chart 10).

Chart 9: 10yr Yields of Japan, U.S., Germany, and U.K.



Note: Weekly data from Jan 2, 2015, to May 15, 2026.
Source: SMDAM and Bloomberg

Chart 10: Fiscal Balance Outlook (% of GDP) for Japan, U.S., Germany, U.K. (IMF Forecasts)



Note: Data from 2019 to 2031. Figures from 2026 are IMF forecasts.

Source: SMDAM and IMF



Japan's JGB market was already structurally vulnerable to higher yields under QT. A more hawkish BoJ, the Middle East shock, and rising fiscal concerns at home and abroad then arrived in quick succession, producing a sharp increase in yields.

Upside risks remain alive

The immediate question is whether this trend will continue. The Middle East situation remains deadlocked, and political uncertainty in the U.K. is likely to persist. Japan also faces a crowded fiscal calendar. Near term, markets will focus on the scale of subsidy measures related to the Middle East shock. By mid-year, attention will shift to the annual policy guidelines, growth strategy, and interim proposals on consumption tax cuts. Later in the year, revisions to the three key defence documents could signal higher defence spending, followed by cabinet approval of next fiscal year's initial budget. Together, these events will clarify what the Takaichi administration means by "responsible proactive fiscal policy."

If markets conclude that the emphasis is on the "proactive" rather than the "responsible," nervousness could persist and the move toward 3% could accelerate. Conversely, if Middle East tensions ease, political uncertainty in the U.K. recedes, and Tokyo leans more clearly toward fiscal discipline, the rise in yields could slow.

The backdrop for rates has changed

Even if markets stabilise in the short term, the structural tightening created by QT will not disappear. The underlying bias toward higher yields remains in place. Moreover, the recent sequence of events has made investors far more aware of the fragility of JGB supply-demand conditions and the event risk around further increases in yields.

In our February note, we argued that a move to 3% in the 10-year JGB yield would likely take time. But given the fiscal events still ahead, that level can no longer be treated as a distant prospect. It is increasingly a realistic near-term upside risk.



Contact Details

Sumitomo Mitsui DS Asset Management (UK) Ltd.

100 Liverpool St., London EC2M 2AT, United Kingdom

www.smd-am.co.uk
uksales@smd-am.co.jp



Richard HAXE
Managing Director, Head of Business Development

+44 20 7507 6431
richard_haxe@smd-am.co.jp



Alex BARRY
Executive Director, Head of Sales, UK and Ireland

+44 20 7507 6419
alex_barry@smd-am.co.jp



Chloé CHOQUIN
Director, Business Development

+44 20 7507 6424
chloe_choquin@smd-am.co.jp



Thomas CARTWRIGHT
Director, Business Development

+44 20 7507 6440
thomas_cartwright@smd-am.co.jp



General disclosure:

The material is intended for professional and institutional investors only.

This material is intended for information purposes only without regard to any particular user's investment objectives or financial situation and should not be construed as an offer, solicitation, recommendation, or advice to buy or sell securities or pursue any investment strategy in any jurisdiction. Any examples used, charts, and graphs are generic, hypothetical, and for illustration purposes only. Any forecasts, figures, opinions, or investment techniques and strategies contained are for information purposes only, and are based on certain assumptions and current market conditions that are subject to change without prior notice. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. Nothing in this material constitutes accounting, legal, regulatory, tax or other advice.

No representation or warranty is made as to the accuracy, completeness, fairness or timeliness of the statements or any information contained herein. This material is not legally binding and no party shall have any right of action against Sumitomo Mitsui DS Asset Management (UK) Limited, including our affiliates, in relation to the accuracy or completeness of the information contained in it or any other written or oral information made available in connection with it. The views expressed are those of the author at the time of the writing. The material is correct to the best of our knowledge at the date of issue and subject to change without notice.

The intellectual property and all rights of the benchmarks/indices belong to the publisher and the authorised entities and individuals. All right, title, and interest in this material and any information contained herein are the exclusive property of Sumitomo Mitsui DS Asset Management (UK) Limited, except as otherwise stated.

This material is issued by Sumitomo Mitsui DS Asset Management (UK) Limited. Registered in England and Wales. Registered office: 100 Liverpool Street, London, EC2M 2AT, United Kingdom; registered number 01660184. Authorised and regulated by the Financial Conduct Authority.

This material and the information contained may not be copied, redistributed, or reproduced in whole or in part without the prior written approval of Sumitomo Mitsui DS Asset Management (UK) Limited.

Risk warning: Investment involves risk, including possible loss of the principal amount invested, and the value of your investment may rise or fall. Past performance is not a reliable indicator of future performance and may not be repeated. An investment's value and the income deriving from it may fall, as well as rise, due to market fluctuations. Investors may not get back the amount originally invested.