Sumitomo Mitsui DS Asset Management

Meanwhile, at the long end of the curve…

Japan Macro Commentary - January 2026

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.

Japan's 10-year government bond yield continues to climb higher. At Sumitomo Mitsui DS Asset Management (SMDAM), we have long argued that fundamentals such as Japan's exit from deflation and Bank of Japan (BOJ) policy normalization would eventually push yields higher. However, the pace has outstripped expectations, with the 10-year already approaching 2%. It briefly exceeded 2% in 1998 and touched it in 2006; if 2% becomes sustained, however, it would be the first time since 1997. As yields fell below the 2% level when the economy slipped into deflation, their recovery back up toward 2% is consistent with Japan's effort to exit deflation and anchor expectations of 3% nominal growth. In this note, we summarize SMDAM's baseline and the key drivers for the 10-year looking ahead.

The Takaichi administration is well-known to favour expansionary fiscal policy paired with accommodative monetary policy. Yen depreciation has reinforced the rise in market inflation expectations, and a higher expected terminal policy rate has pushed up real rates. Index swap pricing now suggests the market-implied BOJ terminal rose from about 1.3% pre-inauguration to above 1.5% currently. This repricing has supported the increase in real rates.

Decomposing the 10-year into a risk-neutral rate and a term premium (based on Daiwa estimates informed by a New York Fed model), the term premium has driven the recent increase, while the risk-neutral rate has been relatively stable. Precise drivers are hard to pin down, but fiscal expansion and firmer inflation expectations are plausible contributors. Supply–demand dynamics also matter, with Flow of Funds data pointing to net government bond supply just under ¥10 trillion per quarter. With BOJ purchases scaled back and its holdings declining, increased foreign buying has filled much of the gap. Foreign investors typically demand a higher term premium; greater reliance on them can therefore keep the premium elevated. If "responsible, proactive fiscal policy" sustains net supply at this pace, the term premium may prove sticky.

With the 10-year nearing 2%, SMDAM have been led to re-estimate the fair value for Japan's long rate. Previously we modeled the 10-year using expected policy rates and the U.S. 10-year, estimating separately for pre- and post-quantitative easing periods; as fit deteriorated, we now use the full sample since 1990. Assuming structural stability is a strong assumption, but pooling inflation and deflation regimes is reasonable if Japan is indeed re-entering an inflation regime as we believe it is.

On current inputs the U.S. 10-year in the low-4% range and the BOJ terminal around 1.5% we estimate fair value close to 2%, broadly consistent with current yields. Allowing for model error and the term premium, upside risk remains.

If the long rate rises above 2%, fiscal concerns naturally arise given Japan's national debt burden and the expansionary nature of Takaichi's fiscal stance. We have previously flagged 2% as a cautionary threshold investors should watch for. Debt sustainability hinges on the balance between the interest rate and nominal growth. Plugging the latest IMF outlook into the debt-dynamics framework suggests the effective-rate (interest payments/debt stock) threshold to stabilize the public-debt-to-GDP ratio is about 2.2%; if the primary balance were to worsen by ~1ppt under the Takaichi administration but nominal growth reached 3%, the threshold would still be around 1.9%. The current effective rate is below 1%, so even with the 10-year above 2% it would rise only gradually, leaving 2% some way off. That said, if expansionary fiscal policy persists and materially lifts the term premium, fiscal stress would gradually intensify.

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.

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.

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.