



Meanwhile, at the long end of the curve...

Japan Macro Commentary - December 2025

SMDAM

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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.

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