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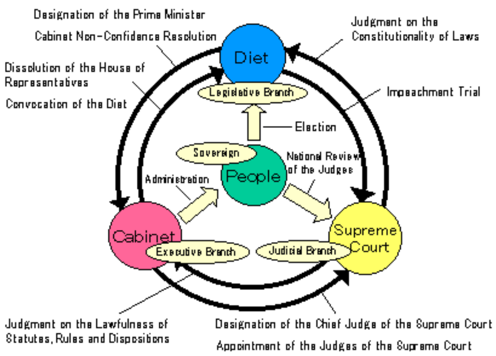
Basic Information

Nominal GDP (Tn)	3.4
YoY Real GDP (Q4 2025)	0.1%
M2 (USD Tn) (Nov 2024)	8.19
CPI (YoY)	2.1%
PPI (YoY)	2.4%
Con. Confidence (Dec 2024)	+37.2
Currency	Yen (JPY)
Exchange Rate (USD/JPY)	154.9

Source: Trading Economics

Chart info

Figure 1: Separation of Powers under Constitution of Japan



Source: Prime Minister's Office of Japan

Overview of Japan

Political System & Parliamentary Structure

- Japan is a constitutional monarchy in which the Emperor serves as a symbolic head of state, while political authority rests with elected institutions. Executive authority is exercised by the Prime Minister and Cabinet, nominated by the Diet and formally appointed by the Emperor. Japan's judiciary is independent and headed by the Supreme Court (Figure 1).

- The National Diet is Japan's highest legislative body and operates as a bicameral parliament composed of the House of Representatives (HOR) and the House of Councillors (HOC). The House of Representatives (lower house) is the more powerful chamber, with 465 seats and a four-year term, although it can be dissolved for early elections. A majority in the Lower House typically determines the prime minister, and the chamber can override the Upper House with a two-thirds vote. The House of Councillors (upper house) has 248 seats, fixed six-year terms, and cannot be dissolved; half its members face election every three years. Legislation must pass both chambers, though the Lower House holds procedural dominance.

Monetary Policy & Policy Normalisation

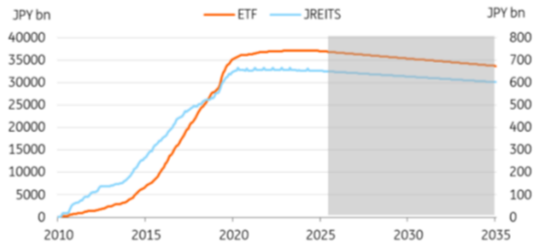
- The Bank of Japan (BoJ), led by Governor Kazuo Ueda, is responsible for price stability, defined as achieving and sustaining 2% inflation. In assessing underlying inflation dynamics, the BOJ monitors a wide range of indicators including core-core CPI, wage outcomes from the annual spring 'shuntō' negotiations, output gaps, inflation expectations, and the impact of yield movements on import prices.

- BOJ policy operates through several core instruments. Its primary tool is the target for the uncollateralised overnight call rate, which anchors short-term interest rates and sets the stance of monetary policy. This is complemented by government bond purchases, which the BOJ uses to guide yields and ensure smooth market functioning, adjusting the pace of purchases depending on liquidity conditions. Historically, the Bank also relied on Yield Curve Control (YCC), under which it capped the 10-year JGB yield to maintain accommodative financial conditions, although this framework has now been phased out as part of the normalisation process.

- After nearly a decade of unconventional easing - including Quantitative Monetary Easing (QQE) in 2013, negative rates in 2016, and the introduction of YCC - the BOJ began preparing for exit from crisis-era settings. It widened the YCC band in December 2022, allowed further upward flexibility in July

2023, and formally ended both negative rates and YCC in March 2024. Subsequent policy adjustments, including the December 2025 rate hike to 0.75%, marked the next stage of normalisation as the BOJ gradually moves toward a neutral-rate regime.

Figure 2: ETF/J-REIT sell at a glacial pace

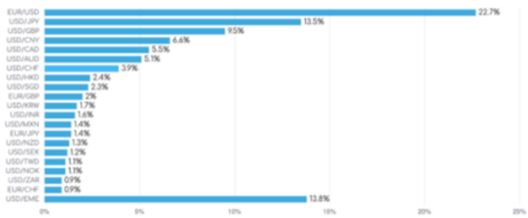


Source: ING

- Policy Normalisation: Balance sheet policy is also shifting. The BOJ announced it would begin unwinding its holdings of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs), transitioning from halting new purchases to a runoff regime where assets mature without replacement. Sales are planned at a measured pace - 0.05% of daily trading value, amounting to roughly ¥330bn in ETFs and ¥5bn in J-REITs annually, with flexibility to adjust should market conditions deteriorate (Figure 2). Together, these steps signal a broader retreat from extraordinary stimulus tools toward a more conventional policy framework.

Foreign Exchange Regime

Figure 3: Most Traded Exchange Pairs



Source: BIS

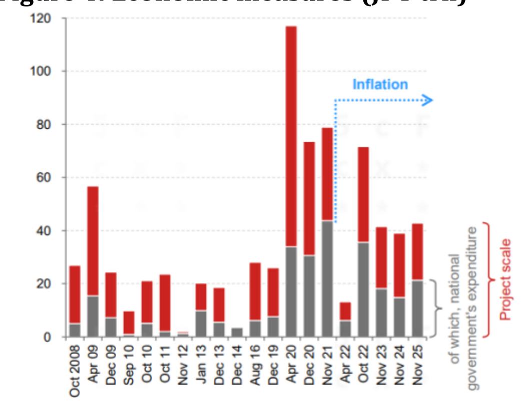
- The Japanese yen is one of the most traded global currencies, with USD/JPY accounting for 13.5% of global FX turnover (Figure 3), supported by Japan's role as the world's largest net creditor and the yen's safe-haven status. Japan operates a managed floating exchange-rate system: the yen is allowed to trade freely, but the BoJ intervenes when volatility threatens economic or financial stability.

- Foreign exchange intervention is legally conducted by the Minister of Finance, with the BOJ acting as agent through the Foreign Exchange Fund Special Account (FEFSA). Japan has accumulated substantial foreign assets in the FEFSA over decades of past yen-selling interventions. These reserves are managed with priority on safety and liquidity, while minimising market disruption. Although the yen floats in normal conditions, the authorities stand ready to intervene when sharp or disorderly moves risk amplifying economic pressures.

Summary of events in the past 6 months

Political Developments

Figure 4: Economic measures (JPY trn)



Note: 1. The horizontal axis shows the timing of the cabinet decision of economic measures.
2. The 'project scale' other than expenses by the national government includes expenses by the local governments, Fiscal Investment and Loan Program (FILP) and private investment expected to be induced by economic measures.

Source: Nomura

- Sanae Takaichi became Prime Minister on 4 October after winning the LDP leadership race, marking Japan's first female premier and signalling a return to a more explicitly pro-stimulus stance reminiscent of "Abenomics." Markets reacted immediately: expectations for BOJ tightening were pushed back, the yen weakened, and JGB yields slipped as investors interpreted her victory as favouring easier fiscal and monetary conditions.

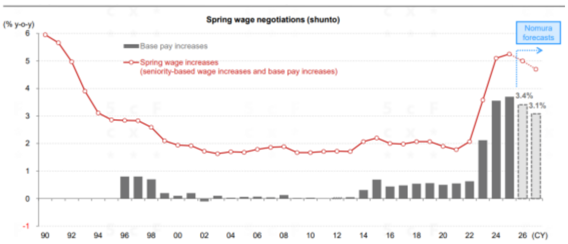
- Takaichi's early policy agenda has leaned heavily on fiscal support, reflecting her commitment to cushion households from ongoing cost-of-living pressures. Her administration has moved quickly to deploy one of Japan's largest stimulus packages in recent years, combining targeted subsidies and direct support for vulnerable households with broader price-relief measures. The Takaichi cabinet officially determined the first economic package on 21 November 2025, with a project scale of JPY 42.8 trillion, or roughly 6.7% of GDP (Figure 4). Japan has continued to adopt large-scale economic packages even amid an inflationary environment, and the latest measures focus squarely on easing energy, food and basic living costs - underscoring Takaichi's preference for an activist fiscal stance in the early phase of her premiership.

- Her administration, however, operates with a more fragile political footing. The long-running LDP–Komeito coalition collapsed in October 2025, leaving the LDP short of a majority in the Lower House (196 seats). Takaichi has since formed a working alliance with Nippon Ishin, allowing the bloc to secure 231 votes in key parliamentary sessions, but still two seats shy of a standalone majority. The arrangement gives her enough support to pass budgets and headline legislation, though the government must still negotiate across parties on an issue-by-issue basis, constraining how far her fiscal and structural agenda can go. Ishin's influence also tilts economic policy toward more targeted spending, deregulation, and a focus on efficiency rather than broad social transfers.

Figure 5: Wage growth in Japan

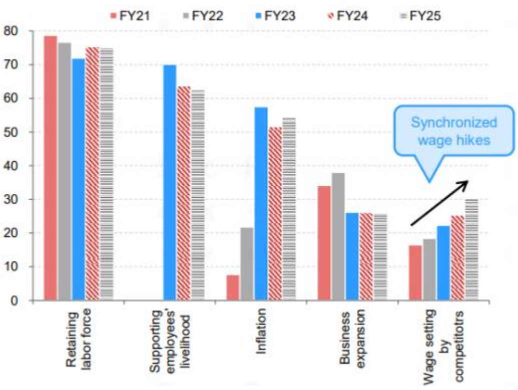
Source: *Apollo Global Management*

Figure 6: Projected base pay and spring wage increase



Source: *Nomura*

Figure 7: Reasons for wage hikes



Source: *Nomura*

Inflation Trends & Wage Dynamics

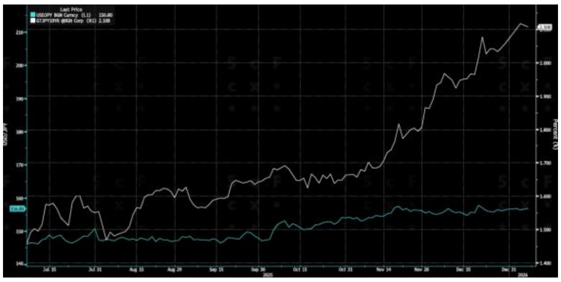
- Inflation dynamics have softened at the headline level, largely due to renewed government subsidies and lower energy and rice prices. Headline CPI eased to 2.0% YoY in December, down from 2.7% previously, and is expected to slip below 2% in the first half of 2026 as winter energy subsidies take effect. Underlying inflation remains firmer: core inflation excluding both fresh food and energy slowed only modestly to 2.6%, and is projected to remain sticky as it gradually edges lower.

- The BoJ continues to place strong emphasis on the durability of wage growth as it assesses the path ahead (Figure 5). The spring *shuntō* negotiations - already a key factor behind the December rate hike - are expected to deliver another year of solid pay hikes, with major unions targeting increases above 5%, signalling that momentum at larger firms remains intact (Figures 6 & 7). The Bank is now focused on whether this strength broadens to small and medium-sized enterprises, where wage-setting tends to lag and is finalised in the summer 2026. BOJ surveys in July 2026 will offer the first clear read on SME wage behaviour, and if the pass-through from wages to prices becomes more evident, additional rate hikes could follow.

Monetary Policy Actions & Rate Outlook

- The BOJ delivered a widely expected 25bp rate increase, raising the policy rate from 0.50% to 0.75% - its highest level since the mid-1990s. Despite the move, the real rates remain deeply negative and that policy is still below neutral, which it estimates to lie somewhere in the 1–2.5% range. The Bank signalled it is prepared to continue raising rates if the inflation and wage outlook evolves as projected, though without committing to a specific timeline.

Figure 8: USD/JPY & 10Y JGB

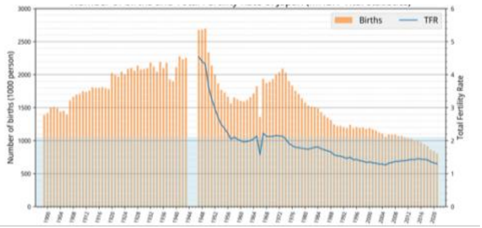


Source: Bloomberg

- Market reaction was mixed: USD/JPY moved higher after Governor Ueda's press conference. Long-end yields continued to climb, with the 10-year JGB approaching 2.1% as the curve steepened toward +100bp (Figure 8)

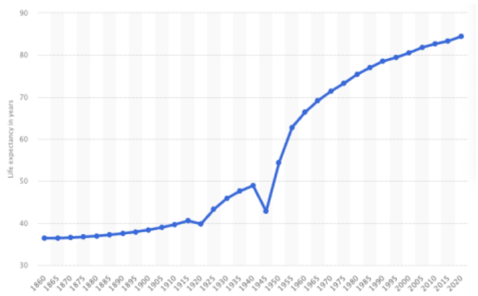
- Looking ahead, policy trajectory remains data-dependent: a renewed bout of yen depreciation could accelerate the timetable for the next hike, while a firmer yen and subdued energy prices would give the BOJ room to proceed gradually. Most forecasters now expect one to two additional hikes this year, taking the policy rate to roughly 1.25% by year-end, with further gradual tightening likely into 2027 as we do not view 1.25% as the terminal rate.

Figure 9: Japan Births and Total Fertility Rate



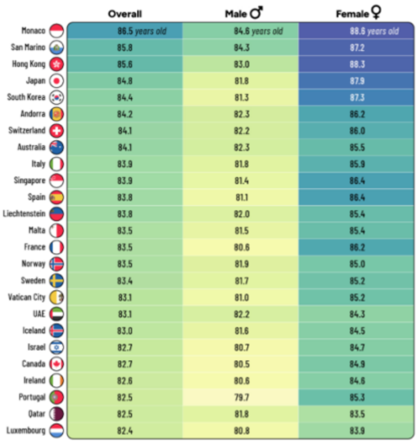
Source: *WHLW Vital Statistics*

Figure 10: Japan life expectancy



Source: Statista

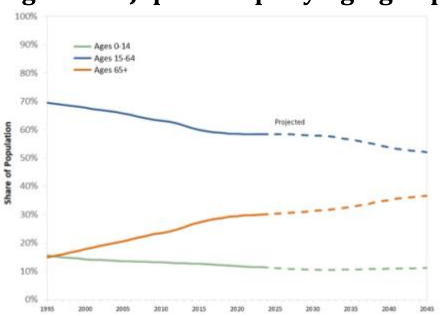
Figure 11: Life expectancy globally (ranked)



	Overall	Male ♂	Female ♀
Monaco	86.5 years old	84.6 years old	88.6 years old
San Marino	85.8	84.3	87.2
Hong Kong	85.6	83.0	88.3
Japan	84.8	81.8	87.9
South Korea	84.4	81.3	87.3
Andorra	84.2	82.3	86.2
Switzerland	84.1	82.2	86.0
Australia	84.1	82.3	85.5
Italy	83.9	81.8	85.9
Singapore	83.9	81.4	86.4
Spain	83.8	81.1	86.4
Liechtenstein	83.8	82.0	85.4
Malta	83.5	81.5	85.4
France	83.5	80.6	86.2
Norway	83.5	81.9	85.0
Sweden	83.4	81.7	85.2
Vatican City	83.1	81.0	85.2
UAE	83.1	82.2	84.3
Iceland	83.0	81.6	84.5
Israel	82.7	80.7	84.7
Canada	82.7	80.5	84.9
Ireland	82.6	80.6	84.6
Portugal	82.5	79.7	85.3
Qatar	82.5	81.8	83.5
Luxembourg	82.4	80.8	83.9

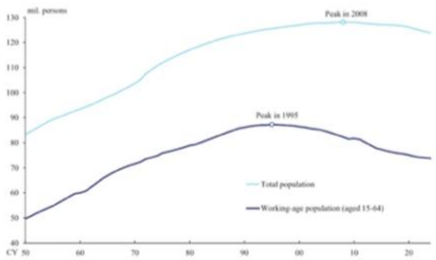
Source: *Visual Capitalist*

Figure 12: Japan's Rapidly Aging Population



Source: *Federal Reserve Bank of St. Louis*

Figure 13: Japan's Population Trend



Source: Ministry of internal Affairs and Communication

Japan's Structural Demographic Headwinds

Japan's long-running macroeconomic constraints are rooted in a demographic profile that has shifted faster and more dramatically than almost any other advanced economy. The combination of a persistently low fertility rate and steadily rising life expectancy has pushed the country into a structurally aging society, shaping growth, public finances, and asset-market dynamics.

A Rapidly Aging Population: Low Fertility and Longer Lives

Japan's demographic pressures stem from two reinforcing trends. First, the fertility rate fell below the replacement threshold of 2.1 in the mid-1970s and has continued to decline for decades (Figure 9). Today, births are running at record lows, and the fertility rate remains far below levels seen in other major economies. Second, life expectancy has risen sharply. From roughly 78 years in 1890, average life expectancy in Japan is now above 84 years, one of the highest globally (Figure 10 & 11).

As a result, Japan has transitioned into an aged society faster than any major economy. The share of the population aged 65 and above reached 18.4% in 2000, and the ratio has since climbed to 30.2% in 2024, with projections pointing to 36.7% by 2045 (Figure 12).

These demographic forces have reshaped Japan's population structure and placed mounting pressure on both the labour force and the government balance sheet.

Economic Stagnation from a Shrinking Workforce

Japan's economic performance over the past three decades reflects these demographic shifts. The country reached its peak working-age population in the mid-1990s; since then, the workforce has contracted almost every year (Figure 13). With fewer workers producing goods and services, potential growth has steadily drifted lower.

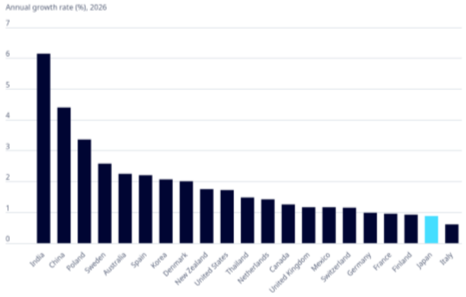
<u>(1) Gross Domestic Product (GDP)</u>
Japan's real GDP growth averaged 0.5% per year between 1991 and 2020, placing Japan among the slowest-growing advanced economies (Figure 14). By 2019, real GDP was only around 23% higher than in 1995. In contrast, the U.S. economy expanded by ~75% over the same period, while South Korea grew by ~150% and China by ~800%.

<u>(2) Equities</u>
Japan's equity market also mirrored this macro reality. The Nikkei 225 peaked in 1989 and remained below that level for more than three decades (Figure 15). Corporate profits were weak, capex was subdued, and domestic demand remained flat (Figure 16). Demographic drag - fewer workers, slower household formation, and lower trend consumption, kept earnings in low gear. Only in the 2020s, supported by corporate governance reforms, a more competitive yen, and stronger global integration, has the market meaningfully recovered.

Large and Persistent Social Security Deficit

An aging society has also placed Japan's social security system under sustained stress. Social security finances - covering pensions, health insurance, long-term care, and unemployment benefits, have been in

Figure 14: Real GDP Forecast for 2026

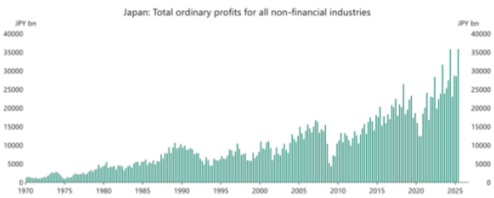


Source: *OECD*

Figure 15: Nikkei 225 vs S&P 500

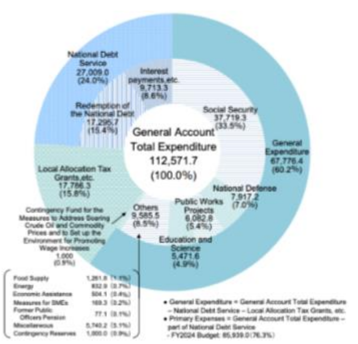
Source: *Investing.com*

Figure 16: Corporate profits (across all industries)



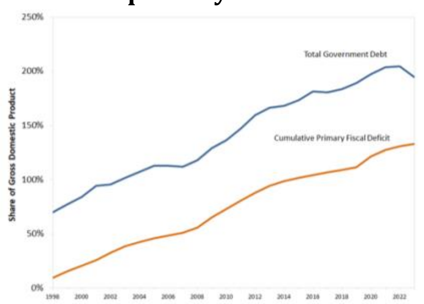
Source: *Apollo Global Management*

Figure 17: Japan General Account budget (bn yen)



Source: *Ministry of Finance, Japan*

Figure 18: Japan government debt and cumulative primary fiscal deficit



Source: *Federal Reserve Bank of St. Louis*

persistent deficit as more retirees draw benefits and fewer workers contribute.

As retirees increase and wage growth moderates, this imbalance has widened. Social security spending now accounts for 33.5% of total general account expenditures (6.04% of Japan's GDP) (Figure 17). While reforms in the early 2010s helped slow the pace of deterioration, the deficit remains large and structural.

The Primary Fiscal Deficit and Dependence on Government Debt

Japan's general government has run a significant primary fiscal deficit for decades, averaging 5.1% of GDP since 1998. Notably, the primary deficit is smaller than the social security deficit, implying that Japan would likely have been running a fiscal surplus with the absent of social security pressures.

Despite consolidation efforts, including the 2014 and 2019 consumption tax hikes, the deficit remains too large to stabilise debt without continued borrowing. Notably, the trajectory of Japan's general government debt closely mirrors that of its cumulative primary fiscal deficit (Figure 18). As a result, government debt has climbed from 70% of GDP in 1998 to 236% of GDP in 2024, one of the highest in the world. Japan is now the only major advanced economy with a higher debt-to-GDP ratio than the U.S. - yet without experiencing any sort of debt crisis.

High Debt Driven by Deliberate Policy Choices

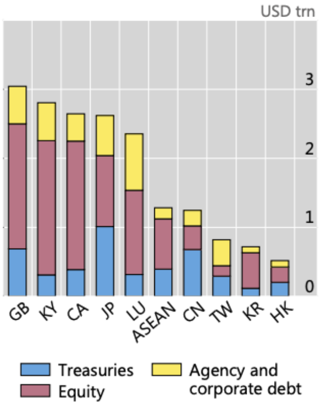
Japan's debt dynamics are also the product of deliberate policy decisions, with policymakers favouring bond issuance and state-directed financing vehicles over drawing down public reserves - choices that systematically pushed government debt higher over time.

<u>(1) Bond issuance instead of using Social Security Reserves</u>
Japan's elevated debt burden is not solely the result of demographic pressures; it also reflects a set of deliberate policy choices over the past two decades. Rather than draw down its social security reserves to cover deficits, the government chose to issue JGBs to cover the shortfall. The reserves were instead invested in higher-return assets including domestic and foreign equities, and overseas bonds, particularly after the reforms in 2012 that broadened the investment mandate in Japan. For instance, as one of the largest buyer and holder of U.S. treasury bonds, Japan's prominent position in U.S. Treasury holdings illustrates how its reserve funds have been actively invested in higher-yielding foreign bonds (Figure 19). This strategy allowed the social security reserve fund to grow from ~36% of GDP in 1997 to ~60% of GDP in 2024, despite persistent deficits.

Had the social security reserves been drawn down to offset the persistent social security deficits, the stock of outstanding government debt would be meaningfully lower today. Instead, policymakers effectively separated the financing of social security from the management of its reserves, supporting long-term return generation at the cost of a higher public debt trajectory.

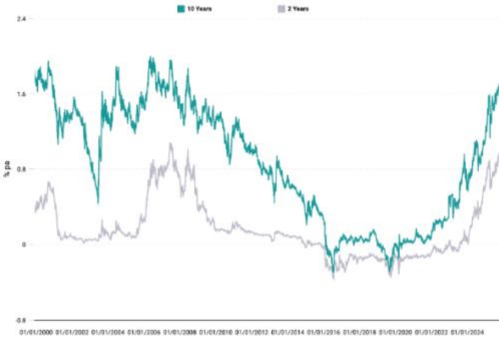
<u>(2) Fiscal Investment and Loan Program (FILP)</u>
Japan's debt trajectory has also been shaped by its historical reliance on alternative funding channels beyond conventional bond issuance. For much of the pre-2000 period, the government made extensive use

Figure 19: Foreign holders of US Securities



Source: BIS

Figure 20: Japan Government Bond (JGB) Yield



Source: CEIC

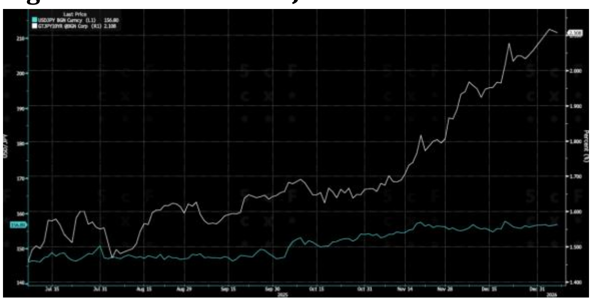
Figure 21: Japan CPI

Source: Apollo Global Management

Figure 22: Inflation expectations in Japan

Source: Apollo Global Management

Figure 23: Yen and 10Y JGB Yield



Source: Bloomberg

of the FILP, a large state-directed lending framework that financed public investment through targeted loans. FILP was primarily funded by postal savings and social security assets, and at its peak in the late 1990s, its loan book exceeded 100% of GDP. As postal savings were gradually privatized in the early 2000s and FILP's traditional funding base diminished, the government increasingly shifted toward the bond market to sustain these activities - adding further upward pressure to overall public debt

Why High Debt Has Remained Sustainable

Japan's consolidated public sector balance sheet paints a more nuanced picture of its fiscal position. In 2024, net public liabilities stood at only 78% of GDP, far lower than the gross liability figure of 270% of GDP. This reflects the government's sizeable asset holdings of approximately 192% of GDP, built up across public pension funds, the BoJ, and other public financial institutions.

A large share of these assets is allocated to higher-return investments, while liabilities are concentrated in low-yield instruments such as bank reserves and government bonds. The Bank of Japan has played a central role in this dynamic, having expanded its balance sheet significantly by using short-term liabilities to fund long-term and even riskier assets. This structure creates a durable positive return spread: between 2013 and 2023, the public sector earned returns exceeding its funding costs by more than 6% of GDP per year. This sizeable positive carry has allowed Japan's net liabilities to grow much more slowly than its gross government debt, helping sustain what would otherwise appear to be an unsustainably high debt burden.

Bond Yields: Why Rising JGB Yields Haven't Triggered Stress

Japan's bond market has recently experienced a repricing, with yields rising to multi-decade highs on expectations of further BoJ tightening (Figure 20). However, several features limit the market impact.

<u>(1) Real yields remain deeply negative</u>
Even with nominal yields rising, inflation hovering around 2 to 3% keeps real JGB yields firmly negative, and with inflation expectations drifting higher as well, the real return profile remains unattractive (Figure 21 & 22). As a result, the pickup in yields has not been strong enough to draw capital back into Japan or generate meaningful yen appreciation (Figure 23). Investors continue to find higher real returns abroad (Figure 24), which is why the yen carry trade has remained largely intact (limited unwinding) despite the move in JGB yields.

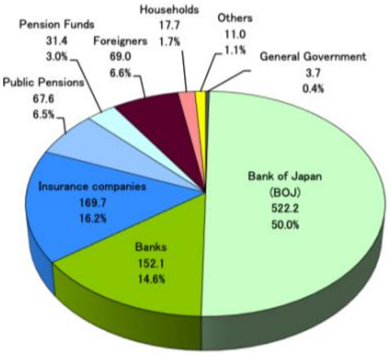
<u>(2) Weak structural demand for duration</u>
Historically, Japan's life insurers and pension funds formed the core domestic demand base for long-dated JGBs, given the need to match their long-term liabilities with stable fixed-income assets. That structural bid has weakened. Part of the decline is mechanical - these institutions already hold large bond portfolios accumulated during years of ultra-low yields.

But the deeper shift is demographic. As the large boomer cohort ages and mortality begins to rise, the duration of pension and insurance liabilities is shortening. At the same time, younger cohorts are much smaller, and with fewer workers participating in defined-benefit pension schemes, the traditional structural bid for long-duration JGBs has weakened. Together, these demographic forces have reduced the

Figure 24: 10Y Yield comparison

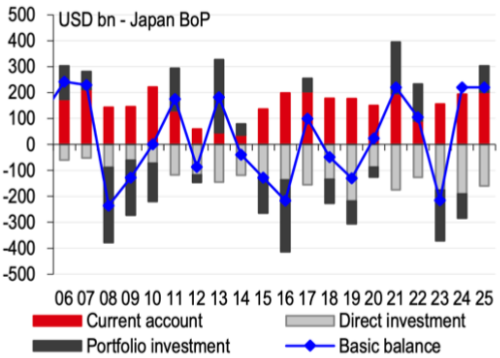
Source: *Apollo Global Management*

Figure 25: JGB Holders



Source: *Ministry of Finance, Japan*

Figure 26: Japan BoP

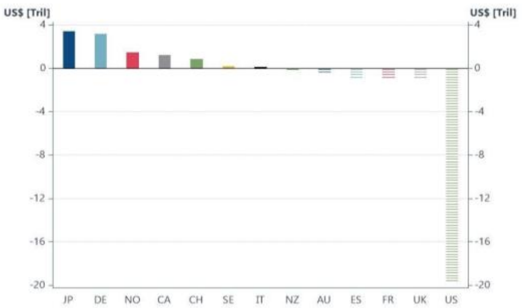


Source: HSBC

Figure 27: Japan primary Income (Trillion Yen)

Source: *Haver Analytics*

Figure 28: NIIP (Trillion USD)



Source: *Haver Analytics*

natural demand for long-dated JGBs. As a result, the recent rise in JGB yields has not triggered the typical rotation out of foreign risk assets and back into domestic bonds.

(3) Losses Are Socialised Through the BoJ

Higher yields imply lower bond prices, which would typically raise solvency risks for holders. But half of all JGBs are owned by the Bank of Japan (Figure 25), meaning losses are absorbed by the central bank, not the private sector. However, the BoJ cannot default on yen liabilities and can expand its balance sheet as and when needed. However, for other institutions like insurers and pension funds, the rise in yields is more complicated: many accumulated JGBs when yields were near zero, exposing them to mark-to-market losses as prices fall. Regulators are closely monitoring balance-sheet resilience and hedging practices, and if stress were to emerge, policymakers could intervene - as they have in the past through tools like yield-curve control to relieve pressure.

Japan's Balance of Payments (BoP)

Japan's BoP position looks very different from that of a typical Asian economies. Under the globalization regime, emerging economies are usually the exporters. In other words, they usually keep Sustainable current account surplus to support abundant net exports. Japan, however, stands out: while it does run a surplus in goods during certain periods, the *structural* driver of its current-account surplus is not exports, but net primary income (NPI), which reflects the income Japan earns from its enormous stock of overseas assets.

Recent Rise in Current-Account Surplus

Japan's current-account surplus has widened meaningfully since early 2023, reaching about $200 Billion by 2025 (Figure 26).

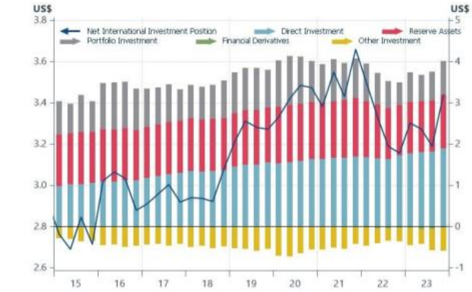
Part of this improvement comes from a narrowing goods deficit as terms of trade improved and export volumes picked up. For instance, its goods trade deficit decreased to about 3.6 trillion yen ($23 billion) over the period.

But the deeper anchor of the surplus is NPI, which has remained exceptionally strong, hovering around 35 trillion yen in 2024 (Figure 27). This income stream comes from decades of outbound investment: Japanese firms, banks, and institutional investors have accumulated a vast portfolio of overseas direct investments, foreign subsidiaries, and portfolio holdings, which continue to generate substantial dividends, reinvested earnings, and interest payments.

Japan as the World's Largest Net Creditor

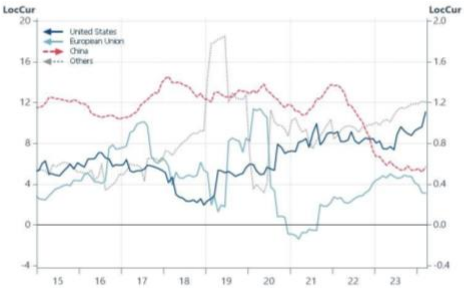
Japan's strong NPI is reflected clearly in its Net International Investment Position (NIIP). As of 2024, Japan held the largest net asset position in the world, about USD 3.4 trillion, in sharp contrast to economies like the US, UK, France, Spain, and Australia, which all sit in net liability territory (Figure 28). This position is underpinned by the composition of Japan's external income: NPI is driven mainly by returns on direct investment, while portfolio investment provides a secondary but still meaningful contribution (Figure 29). By comparison, income from other investments, smaller primary sources, and employee compensation play only a minor role, underscoring how

Figure 29: Breakdown of Japan NIIP (Tr USD)



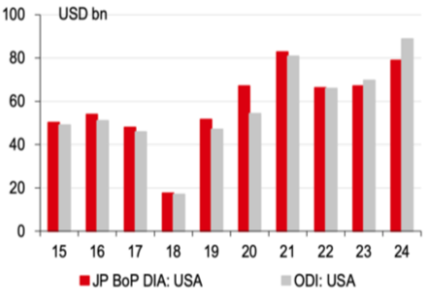
Source: Haver Analytics

Figure 30: Japan's FDI (Trillion Yen)



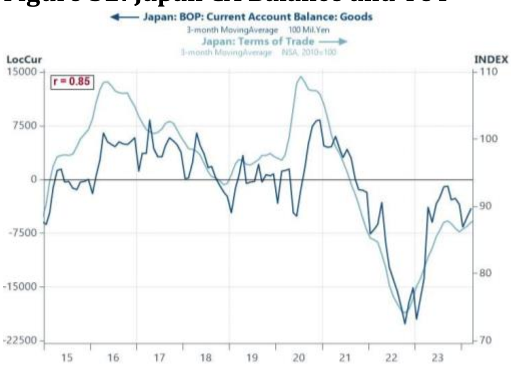
Source: Haver Analytics

Figure 31: Japan's Outward investment to US



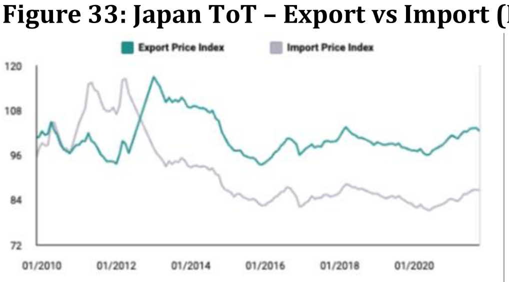
Source: HSBC

Figure 32: Japan CA Balance and ToT



Source: Haver Analytics

Figure 33: Japan ToT – Export vs Import (Prices)



Source: CEIC

central long-term overseas assets have become to Japan's external surplus (Figure 30).

Outbound FDI as a Primary Income Engine

Japan earns a large share of its primary income from the sizeable stock of long-term assets it holds abroad, and recent trends in outbound FDI underline how central these investments have become to its external balance - a key reason why FDI income now dominates the current account.

Over the past few years, Japan's direct investment flows have increasingly tilted toward the United States, with outflows climbing to roughly USD $88 billion by 2024 (Figure 31). By contrast, investment into China has been steadily retreating since early 2022, and flows to the European Union have softened as well, reflecting a broader recalibration of Japan's global economic ties amid shifting geopolitical alignments. This pivot toward the US has been reinforced by the large bilateral investment plan announced in October 2025, under which Japan committed to deploy USD 550 billion into US projects in exchange for a reduction in base tariffs on Japanese imports. The package spans critical energy infrastructure, advanced power equipment, AI systems, optical fibre, and next-generation electronics, and represents a step-change in the scale of Japan's direct investment footprint in the US.

Recent Improvement in the Goods Balance

On the goods side, the recent improvement in Japan's current account has been helped by a rebound in the terms of trade (ToT) (Figure 32). Export prices have risen faster than import prices, allowing Japan to buy more imports for each unit of exports sold. Export volumes have also strengthened in key categories such as vehicles, auto parts, and integrated circuits, while the drop in global energy prices has reduced import bills (Figure 33). It is worth noting that even without changes in trade volumes, ToT shift alone would have improved the goods balance.

Trade Idea (1) - JPY 2s10s OIS Steepener

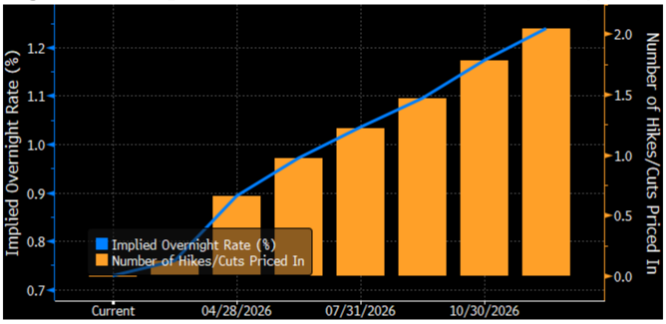
My Take: The short end is already well-priced under a gradual, data-dependent BoJ. Political–policy friction and sticky wage-price dynamics leave the long end exposed. With 2s anchored and term premium rebuilding, the 2s10s curve should steepen.

Rationale

(1) Rate Hikes Largely Priced In

My view is that the 2-year will stay anchored despite uncertainty over the exact sequencing of hikes. The path of policy normalisation is highly data-dependent, depending on the yen. We believe if yen depreciation feeds back into import prices, the next hike could arrive sooner; conversely, a firmer yen and softer energy prices would allow the BOJ to proceed more gradually. While the precise timing is uncertain, the direction, which is further incremental tightening toward roughly 1.25% by year-end, is broadly priced in (Figure 34), and much of the expected hiking cycle is already reflected in short-dated rates.

Figure 34: Implied ON rate and number of hikes/cuts



Source: Bloomberg

(2) Risk of policy friction

The growing divergence between the Takaichi administration's fiscal priorities and the BoJ's policy normalization path introduces a layer of uncertainty that is usually reflected at the long end of the curve.

From the government's perspective, maintaining relatively low yields, or at least ensuring that rate hikes proceed only gradually, is essential to sustaining its expansionary fiscal agenda. Large stimulus packages require significant bond issuance, and a sharp rise in long-term yields would directly increase debt-servicing costs, squeeze future budgets, and constrain the scope for continued fiscal support. However, the BoJ operates under a different mandate. With inflation above target and wage momentum strengthening, the Bank remains committed to a gradual normalization cycle.

Governor Ueda's reluctance to provide explicit guidance on the timing and magnitude of further rate hikes likely reflects sensitivity to political pushback from the Takaichi administration. While his remarks in the press suggest that incremental tightening remains the base case, the absence of firm forward guidance indicates the BoJ may not be fully confident of securing political tolerance for sustained rate increases.

Figure 35: BOJ key events calendar

Date Time	A	M	R	Event
02/26				BOJ Board Member Takata Speaks in Kyoto
03/02				BOJ Deputy Governor Himino Speaks in Wakayama
03/19				BOJ Target Rate
03/25 07:50				BOJ Minutes of Jan. Meeting

Source: Bloomberg

Figure 36: Shuntō Calendar

2026	Early Jan	New Year's meetings at three business organizations (announcement of stance on wage hikes)	25/1/7
	Early–mid Jan	BOJ branch manager meeting and Regional Economic Report (Sakura Report)	25/1/9
	Mid–late Jan	Keidanren publishes policy paper setting out basic stance on 2026 spring wage negotiations	25/1/21
	Within Feb	Workers at each company decide on demands, begin negotiations with management	In Feb 2025
	Early Mar	Rengo publishes overall wage hike demands	25/3/6
	3/17–19	Peak for company responses	25/3/11-13
	3/23	Rengo publishes first set of negotiation results	25/3/14
	Late Mar	Rengo publishes second set of negotiation results	25/3/21
	Early Apr	Rengo publishes third set of negotiation results	25/4/3
	Mid–Apr	Rengo publishes fourth set of negotiation results	25/4/17
	Early May	Rengo publishes fifth set of negotiation results	25/5/8
	Early Jun	Rengo publishes sixth set of negotiation results	25/6/5
	Early Jul	Rengo publishes seventh (final) set of negotiation results	25/7/3

Source: Nomura

Figure 37: Unemployment data release

	Date Time	A	M	R	Event
21)	03/03 07:30				Jobless Rate
22)	03/03 07:30				Job-To-Applicant Ratio
23)	03/09 07:30				Real Cash Earnings YoY
24)	03/09 07:30				Labor Cash Earnings YoY
25)	03/31 07:30				Jobless Rate

Source: Bloomberg

<u>Near-term Catalysts</u>

Date	Description
End Feb onwards (Figure 35)	A "gradual normalisation" and emphasis on data dependent approach to rate hikes should keep front end anchored and leave duration to clear via term premium.
Early Mar (Figure 36)	If Shuntō wage settlements exceed ~5%, stronger wage-price dynamics reinforce a sticky inflation narrative, lifting medium-term term premium.
Mar 3 & 31 (Figure 37)	A tighter January labour print (<2.6% unemployment) signals sustained wage pressure, prompting long-end repricing.
Mar 11 (PPI)	A firm core PPI (~0.2% m/m) supports the BoJ's "no rush to hike" stance, enhancing steepening asymmetry via the long end.

<u>Key Risks</u>

(1) Bear Flattening Risk

A BoJ hawkish surprise, such as pulling forward the next hike to earlier than April, could trigger a bear-flattening, with the 2-year segment repricing sharply higher and compressing the 2s10s spread.

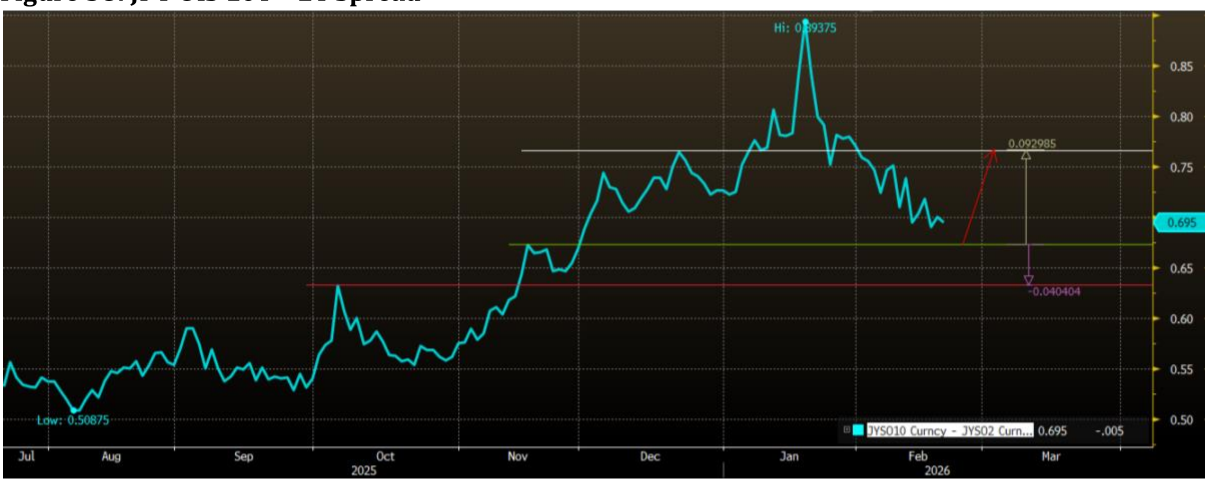
(2) Quick resolution to Fiscal Uncertainty

A quick resolution of fiscal uncertainty could also compress term premium and keep the long end supported, limiting steepening potential.

<u>Trade Setup (Figure 38)</u>

Trade idea	Pay JPY 10Y OIS / Rec JPY 2Y OIS
Horizon	~6 weeks
Entry	67bps *(only enter once it hits that level – currently at 69 bps)*
Target	76bps
Stop	63bps
RR	2

Figure 38: JPY OIS 10Y – 2Y Spread



Source: Bloomberg

Trade Idea (2) - Short USD/JPY

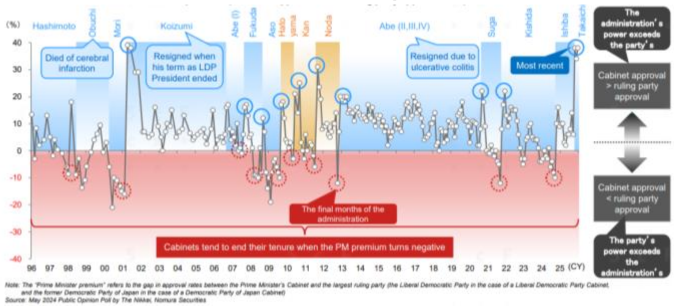
My Take: USD/JPY could extend lower from recent highs of 160 as diminishing policy risk in Japan, narrowing US–Japan yield differentials, and structurally yen-supportive BoP flows reinforce a bearish outlook for the pair. These domestic drivers add to global tailwinds from Fed easing expectations, Japan MOF intervention and renewed safe-haven demand, strengthening the case for further yen appreciation.

Rationale

(1) Diminishing Policy Risk

Japan's initial policy mix under Prime Minister Takaichi, such as the stimulus package passed in November 2025 and her public preference for proactive fiscal support over aggressive tightening – helped weaken the yen by reinforcing expectations of a looser overall stance and a slower pace of monetary normalisation. That perception created a "prime minister premium" (Figure 39), where investors priced in sustained fiscal expansion and potential political pressure on the BoJ, weighing on Yen.

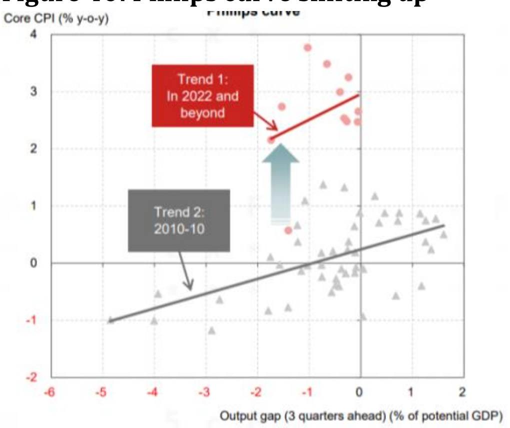
Figure 39: Prime Minister Premium
(= cabinet approval ratio – ruling party approval ratio)



Source: Nomura

However, the macro backdrop is evolving. The apparent upward shift in the Phillips curve since 2022 suggests that underlying inflation dynamics are firmer than in the past, reducing the necessity for repeated demand-side stimulus (Figure 40). If fiscal expansion begins to feed into higher and stickier inflation, policy constraints tighten: further large-scale stimulus becomes harder to justify, and the BoJ's gradual normalisation path regains credibility. As political uncertainty fades and markets reassess the need for continued fiscal largesse, the premium embedded in the yen could unwind, which can further strengthen the case for Yen appreciation .

Figure 40: Philips curve shifting up



Source: Nomura

(2) Narrowing Yield Differentials

The yen carry trade becomes less attractive as rate spreads compress, prompting investors to unwind USD longs funded in yen. Historically, sharp unwinds of carry positions have also amplified market stress, and in such episodes, investors rush to repay yen funding, creating abrupt demand for the currency and reinforcing the case for yen appreciation.

(3) Structural Flow Dynamics

Japan' BoP remains structurally supportive for the currency. Strong net primary income from overseas investments generates steady inflows, and when earnings are repatriated or hedged, they create underlying demand for yen, hence pointing to a constructive medium-term backdrop for JPY strength.

Figure 41: Dollar (DXY) 1M Chart

Source: TradingView

Near-term Catalysts

(1) Dollar Weakness and Safe-haven Flow

Broad-based US dollar weakness adds another layer of support for the yen (Figure 41). This effect is amplified by the yen's traditional role as a defensive asset during periods of global uncertainty. In risk-off environments, capital tends to rotate out of higher-yielding positions and back into funding currencies like the yen, reinforcing the case for further yen appreciation.

(2) Intervention Risk

Upside in USD/JPY appears capped by both policy and technical constraints. As the pair approaches the 150–160 range, the risk of Ministry of Finance intervention rises materially, limiting further dollar strength.

Trade Setup (Figure 42)

Trade idea	Short USD/JPY
Horizon	~3 months
Entry	*155.10*
Target	148.01
Stop	157.21
RR	3.36
Annualised Carry	-3.0%

Figure 42: USD/JPY 1W Chart

Source: TradingView

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