

Sayonara, zero

Japan enters a new era



After a decade anchored near zero, Japan's government bond yields have risen sharply. 10yr government bond (JGBs) yields have climbed from 0.2% in 2021 to 3% today, with little signs of levelling off. For decades, Japan's close to zero interest rate pushed Japanese capital into overseas markets in a hunt for higher yields, making Japan the largest foreign holder of US Treasuries and a major holder of European debt today. Therefore, the question of how much further Japanese yields can rise has significant implications for global bond markets.

Japan is looking more like the rest of the world

For more than two decades, Japan was stuck in a deflation trap, a difficult environment of 'zero': zero inflation, low growth and zero interest rates. Even when the late PM Abe introduced large-scale fiscal and monetary stimulus (dubbed Abenomics) to pull Japan out of this trap, it did not work. For years, it felt as if nothing was changing in Japan.

In the end, it was not Abenomics but the external inflation shock after Covid and the energy crunch following the war in Ukraine that triggered a genuine shift in Japan's inflation. Importantly and unusually the policymaker wanted to allow inflation to become more sustained to break out of the deflation trap. And it worked. Japan is starting to look less like the Japan of the past two decades and more like the rest of the world.

Sayonara, deflation

Historically, Japan has been stuck in a deflationary trap for several reasons. It began in the early 1990s when growth collapsed after the asset price bubble burst, eventually tipping the economy into deflation. Households held back on spending, expecting prices to be lower in the future. With weak demand, companies had little pricing power and wage growth stayed lacklustre. Remarkably, those dynamics have now reversed: both household inflation expectations, Chart 1 and wage growth, Chart 2, are rising sharply.

Chart 1: Japanese households are now expecting higher inflation



Source: Bloomberg

Chart 2: Wage negotiations have resulted in sharply higher wage growth

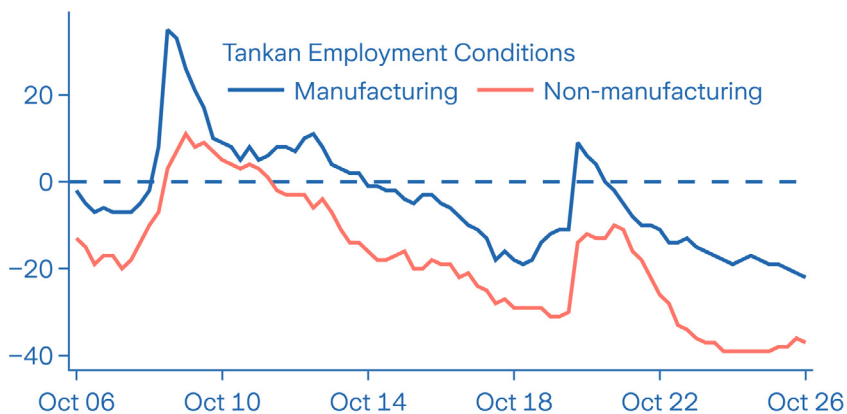


Source: Bloomberg

What about the ageing population? Isn't a shrinking population a natural pull towards deflation, driven by chronically weak demand? The concern is valid, but the impact of an ageing population on inflation is not a one-way street. Fewer people mean lower aggregate demand but also a smaller labour supply.

In the past, when growth was depressed, a tight labour market did not bite hard. Now that inflation is encouraging people to spend more and companies need to step up hiring, labour shortages have become a real constraint, putting upward pressure on wages. Chart 3 shows how severe those shortages are, particularly in services. With that, we believe Japan can finally say 'Sayonara' to deflation.

Chart 3: Surveys suggest firms face chronic labour shortages



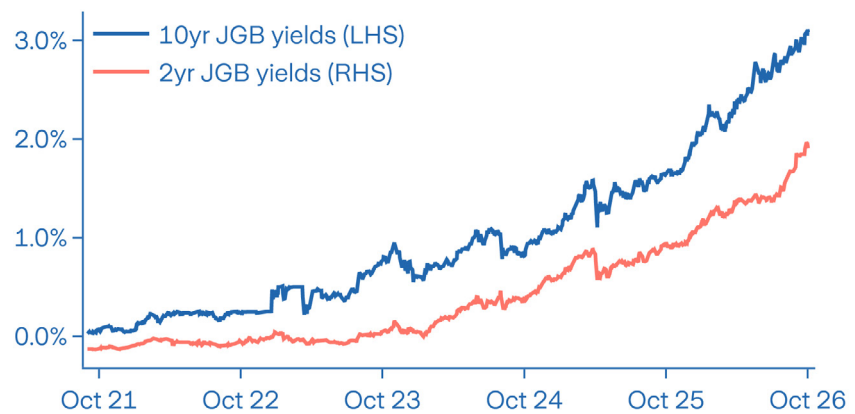
Source: Bloomberg

Sayonara, zero interest rates

When inflation first arrived, the BoJ was in no hurry. It held rates near zero, letting price pressures work through the economy before responding. Only in 2024 did it finally step out of its sub-zero era, and it has since lifted the policy rate from -0.1% to 1.25%, with further increases expected.

When short-term interest rates rise, long-term rates tend to follow. Chart 4 shows that 10yr yields have broadly tracked 2yr yields. Since 2yr yields are highly sensitive to market expectations for the BoJ's policy rate, this suggests higher 10yr yields largely reflect higher short-term rates in Japan. That said, 10yr yields have risen even faster than short-term rates, steepening the yield curve, a sign that markets expect a stronger growth environment in Japan.

Chart 4: Long-term and short-term interest rates are moving in lockstep



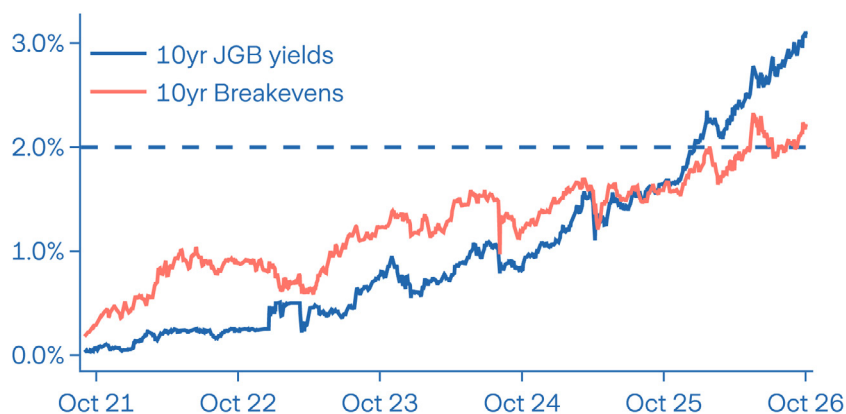
Source: Bloomberg

Investors are demanding compensation for higher inflation

An investor who invests in a long-term government bond demands that the interest received at least keep up with inflation over time. If inflation is only temporary, most investors can live with it. If inflation looks like it will stay high for longer however, it starts to change what people expect for the future.

One way to see these inflation expectations is through inflation-linked bonds, where the interest payments are adjusted for inflation. The gap between the yields on nominal JGBs and inflation-linked JGBs implies investors inflation expectations (known in technical terms as the “breakeven”). Chart 5 shows that nominal yields have risen hand in hand with inflation expectations as they moved towards 2%. The repricing of inflation expectations reflects a simple reality: inflation has taken hold in Japan and is proving far more persistent than in the past.

Chart 5: Inflation expectations hit 2%



Source: Bloomberg

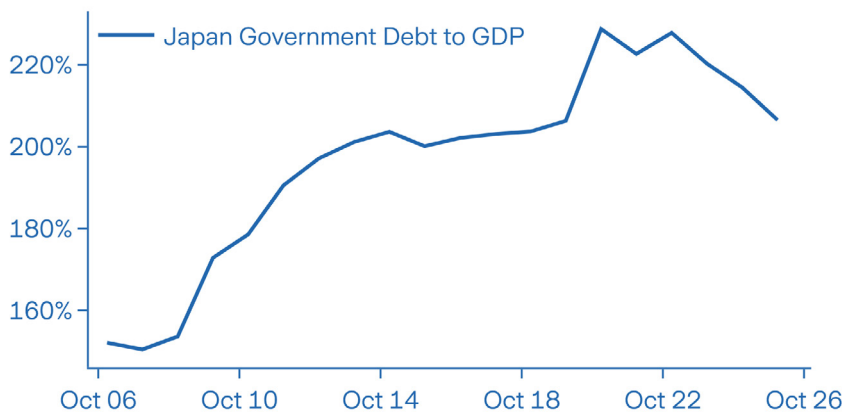
Rising yields won't break the government finances yet

Japan is well known for its eye-watering debt load, with debt-to-GDP above 200%, making it one of the most indebted governments in the world. The jump in 10yr JGB yields from near zero to around 3%, and even higher for 30yr and 40yr bonds at above 4%, is therefore a nightmare for a government carrying that much debt. Investors lending to Japan's government today have understandably started to worry.

This concern, however, is overblown. With around 90% of government debt held domestically, and close to half held by the BoJ itself, a sovereign debt crisis is simply not the likely scenario for Japan. More importantly, rising yields are not yet hitting the government's wallet as it is still paying very low interest on its older, low-coupon bonds.

Meanwhile, as inflation has picked up, Japan's fiscal deficit has improved meaningfully, with robust tax receipts helping to narrow the gap between spending and revenue. According to IMF estimates, the government's effective cost of debt is currently just 0.7% while Japan's nominal growth in FY2025 was 4.3%. With growth now outstripping the cost of debt, debt-to-GDP is falling, as seen in Chart 6.

Chart 6: Government debt-to-GDP is falling notably



Source: Bloomberg

Near-term resilience masks long-term vulnerability

While debt sustainability is not a major concern for Japan in the near-term, fiscal dynamics remain vulnerable over the long-term. Japan's public finances will continue to carry the heavy burden of caring for a rapidly ageing population. More than 30% of spending goes to social welfare while around 25% of the budget goes to debt service (Budget FY2026). With an average maturity of around seven years on IMF estimates, most of Japan's debt stock will need to be refinanced over the next 5-10 years, taking the average coupon from today's 0.7% towards prevailing market yields. Anyone buying a 10yr JGB today needs to consider such convergence. It explains why investors are increasingly demanding higher yields to compensate for duration risks.

Fiscal appetite will continue driving yields higher

Unlike the previous administration, which focused on controlling fiscal spending, PM Takaichi has shown clear intention to revive "Abenomics": a large fiscal programme funded at low rates. However, unlike the Abe's era when Japan grappled with a deflation trap, the country now faces inflation. Reviving Abenomics could therefore trigger a sharp rise in inflation expectations.

Even so, the government appears to be dismissing higher bond yields. It has announced a series of fiscal packages, ranging from food and energy subsidies and sales tax cuts to defence spending of 2% of GDP, as well as a long-term infrastructure programme of unprecedented size. With issuance showing no signs of slowing and the BoJ reducing its purchases of long-dated bonds as part of its monetary policy normalisation, upward pressure on yields remains and we expect these dynamics to continue.

Higher bond yields will act as a lid on government spending

Despite the government's growing appetite for spending, we think the bond market will set the limit. Higher yields raise the cost of every new fiscal package, making each one harder to justify than the last.

Overall, we suspect bond yields need to rise a bit further from here for that mechanism to kick in. **That level could be around 3.5%.** Beyond that point, a further large fiscal expansion could risk triggering a disorderly rise in long-term yields, which would be a clear political risk to the administration.

What would change our view

Several developments could push yields lower than we expect. The most obvious is a collapse in inflation, driven by an economic shock that tips Japan into recession, breaking the wage-price loop and returning the country to its previous era of deflation. A second is accelerated repatriation of overseas assets by Japanese investors, which we discuss below.

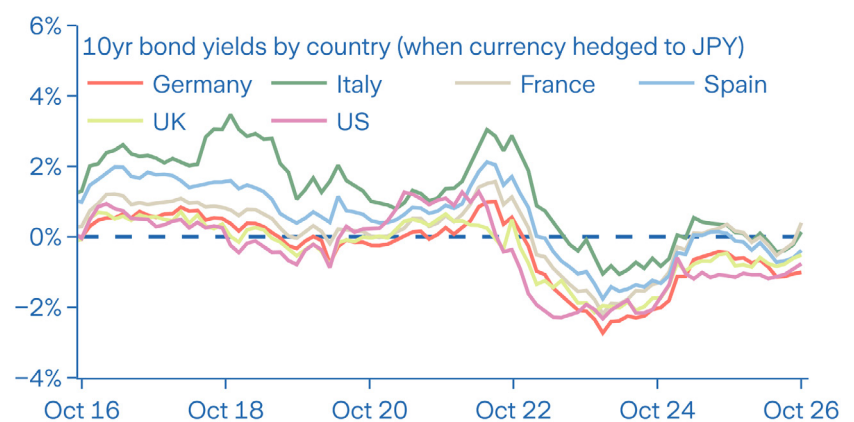
On the flip side, yields could rise further if growth turns out to be much stronger than expected. A less favourable scenario would be one in which the government pushes ahead with large-scale unfunded spending, a 'Liz Truss' moment for Japan. Even then, we would expect the BoJ to step in to restore orderly market functioning. Another trigger would be sustained political pressure that visibly compromised the BoJ's reaction function, leaving inflation expectations de-anchored.

Repatriation: a gentle rise, not a tsunami

With trillions of dollars sitting in overseas markets, Japanese money flowing home would be the most powerful source of demand to pull yields lower in Japan but ratchet up yields in the global markets. Contrary to what many have feared, those flows are gradual rather than a rush home.

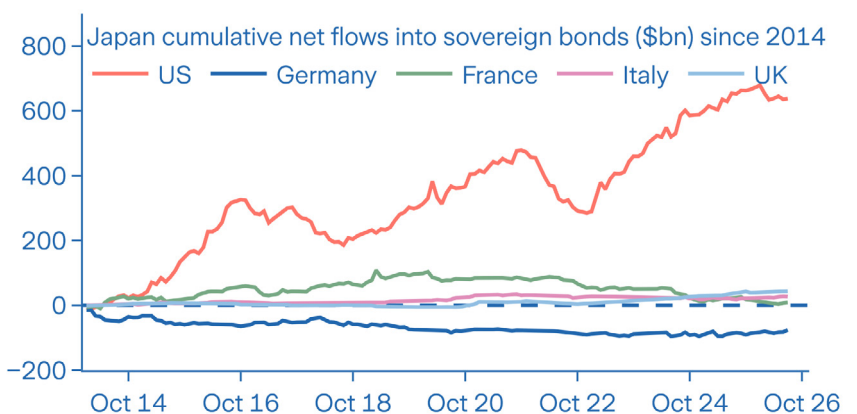
Chart 7 shows that on a fully hedged basis (currency risk hedged via short-dated swaps linked to short-term rates), Japanese yields already look more attractive than overseas alternatives. Yet, with the yen having lost more than 40% of its value over five years, investors have dropped currency hedges rather than bringing money home. Flow data in Chart 8 show only a gradual retreat from foreign bond holdings.

Chart 7: JGB yields are already attractive on a fully hedged basis



Source: Bloomberg, ZIG, Note: 3-month FX hedge

Chart 8: Repatriation flows remain gradual



Source: Bank of Japan

What would it take for Japanese investors to repatriate faster? The answer is the currency needs to strengthen notably, probably from the current level of close to 160 to around 140-145, levels last seen during the unwinding of the carry trade in 2024. That scenario, however, remains unlikely. With the BoJ doing little more than keeping pace with the Fed, yield differentials have barely moved compared to last year.

A second trigger is political pressure on public pension funds to bring capital home. The Government Pension Investment Fund (GPIF) holds more than USD 1tn in assets, with around a quarter in foreign government and corporate bonds, and it has signalled its willingness to use the $\pm 6\%$ deviation band around its foreign bond allocation. Its strategic asset allocation review, however, is not due until 2030, which caps the near-term scale of any repatriation. The trend is under way, but it remains a gentle tide rather than a tsunami.

Conclusion

After more than two decades in a deflation trap, Japan is entering a regime where inflation sustains itself. It took a pandemic and an energy shock to do what 20 years of stimulus could not. The rise in Japanese yields is therefore not a distress signal. It is the price tag for a normal economy. With inflation stable at 2% and the central bank slowly moving rates back to where they should be. Japan is starting to look less like the Japan of old and more like the rest of the world. Sayonara, zero.

The side effect, however, reaches well beyond Japan. For decades, Japan was the world's cheapest lender. Its savers helped fund mortgages, governments and credit markets abroad in a hunt for higher yields. That dynamic has shifted substantially. Japan's bond yields have become attractive enough to encourage some repatriation. Fortunately, that shift has been glacial so far. That said, even a slow burn is a burn, and overseas markets will keep feeling it as Japan enters the new era of normalisation.

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