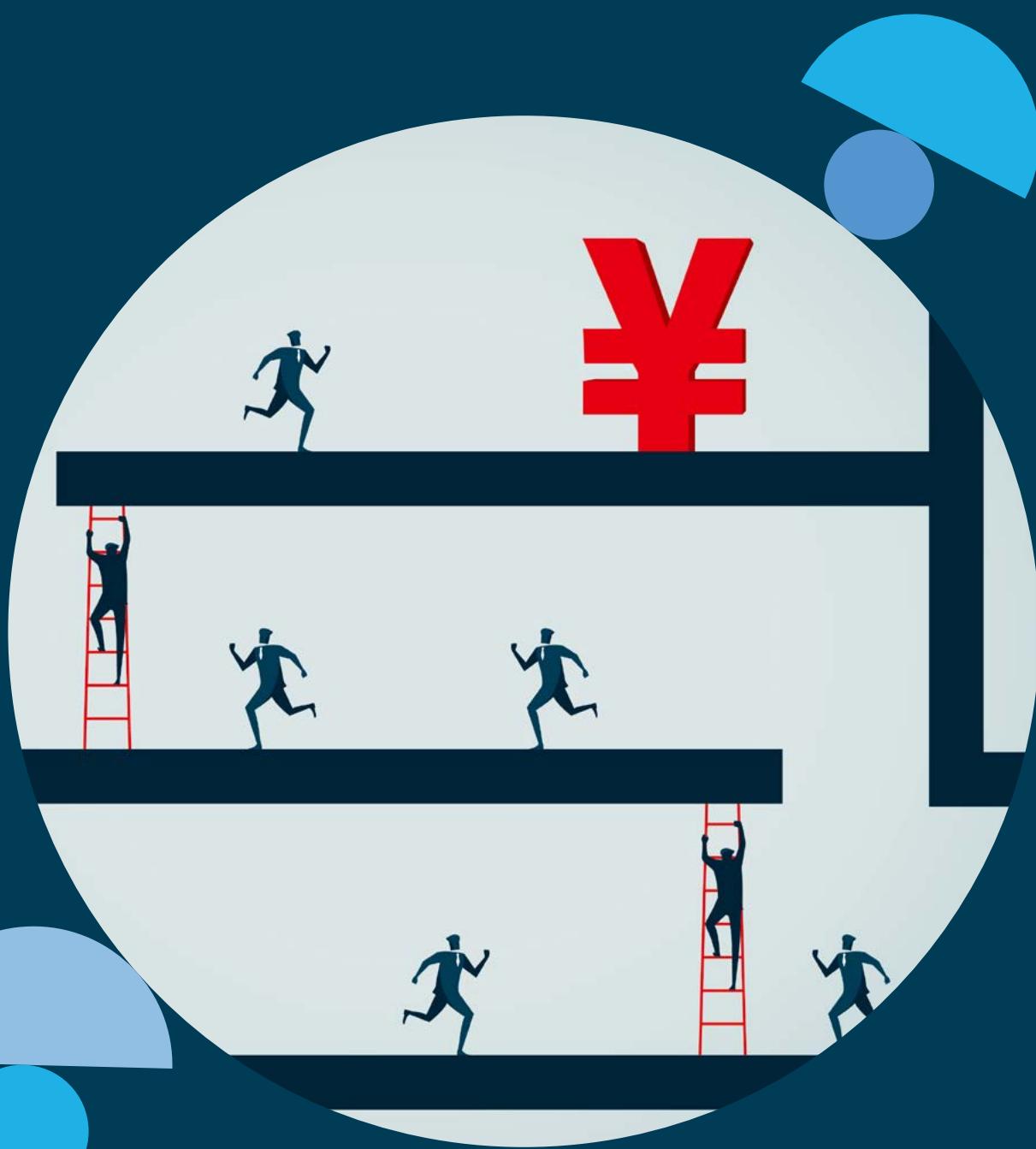


The Widowmaker



Since the early 1990s, betting on rising Japanese Government Bond (JGB) yields has been known as the “widowmaker” trade. Given Japan’s enormous public debt-to-GDP ratio and low growth rates, textbook logic suggested JGBs were an obvious “short”. Many investors positioned their portfolios to benefit from an anticipated rise in bond yields and corresponding drop in bond prices. No such luck. For decades, the markets continuously confounded this supposedly obvious premise, stacking up losses for those holding the trade. Yields continuously moved lower and lower. This has recently reversed in stunning style. Ten-year debt yielded close to zero pre-Covid and now trades above 2%. Forty-year bond yields are now close to 4%, levels not seen in Japanese debt since 1994. No longer a widowmaker, this trade has finally worked.

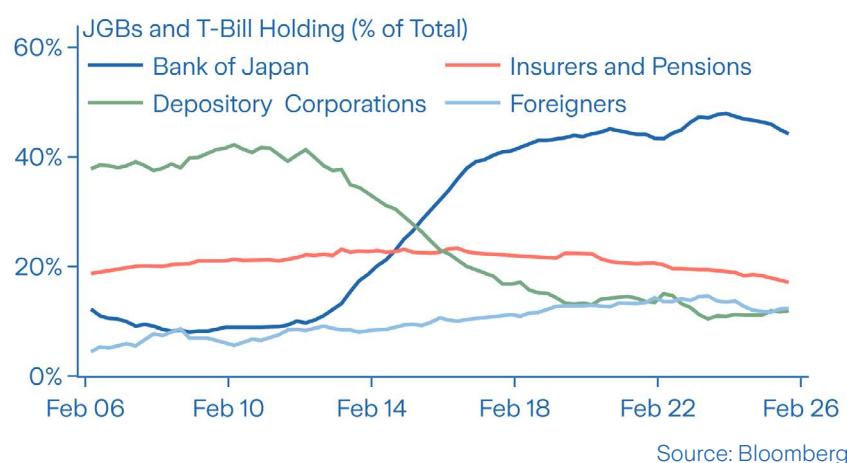
Rising bond yields raise several understandable concerns. Japan’s fiscal vulnerability is front and centre. Government debt-to-GDP is close to 240%, and Prime Minister Takaichi promises further fiscal expansion. Yet, Japan has escaped deflation, and rising nominal growth has improved the fiscal position. Many are concerned by hidden risks to the financial system as banks and insurers are facing unrealised losses from their large JGB holdings. Despite that, we think financial institutions are well equipped to manage these challenges. Lastly, Japanese investors have historically bought significant amounts of foreign bonds. Higher JGB yields may entice flows back home, weakening everything else. But Japanese foreign investment behaviour has already structurally changed, limiting a sudden impact. In summary: don’t panic.

Japan is exiting an era of suppressed bond yields

For years, long-term JGB yields stayed suppressed, held down by the Bank of Japan’s (BoJ) heavy hand and steady demand from banks and insurers. Yield Curve Control (YCC), the strict form of quantitative easing (QE) that pinned 10yr yields at 0.25%, along with relentless demand from financial institutions for longer maturities, built a powerful buyer base and kept term premia abnormally low. Nearly 90% of JGBs are held domestically, with almost half sitting on the BoJ’s books (Chart 1).

That regime is now changing. The BoJ has removed YCC, is tapering QE, and lifting its policy rates. Institutional investors, dealing with unrealised losses, no longer chase long-dated bonds. With new bond issuance coming to the market and less structural demand, JGB yields now need to trade with a true, market-driven, premia. That explains why the ‘widowmaker’ trade is has finally made a comeback.

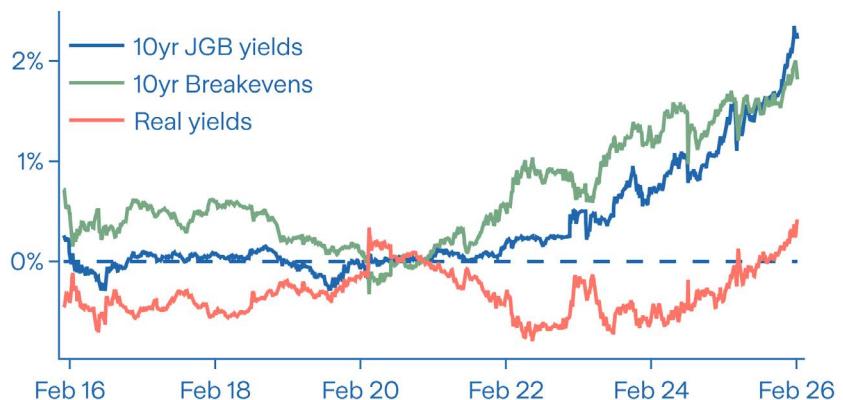
Chart 1: new marginal buyers wanted



Inflation expectations reset

A useful way to understand the repricing of bond yields is to break down nominal yields into real yields and inflation expectations. Chart 2 shows that most of the surge in nominal bond yields is tied to inflation expectations in Japan, while real yields have risen gradually but remain low. Pricing in the inflation swap market and the 'breakeven' inflation rate (the difference in yield between inflation-linked bond and a standard version) both points to 10yr inflation expectations at 2%.

Chart 2: inflation expectations reach 2% for the first time in decades



Source: Bloomberg

This shift in expectations is closely linked to the evolution of inflation and recent significant shifts in Japan's monetary and fiscal policy. Overall, there have been three phases. The first, from 2021 to early 2023, saw the BoJ deliberately stay behind the curve, keeping its ultra-loose policy to let inflation take hold. The second phase began in 2024, when the BoJ ended YCC and negative rates, moving inflation expectations up to around 1.5%. The most recent phase was sparked by a leadership change, with Prime Minister Sanae Takaichi reviving the Abenomics playbook of fiscal expansion. If market pricing keeps inflation expectations anchored at 2%, it marks genuine progress for the BoJ, which has worked for decades to reach this target.

Inflation is here to stay

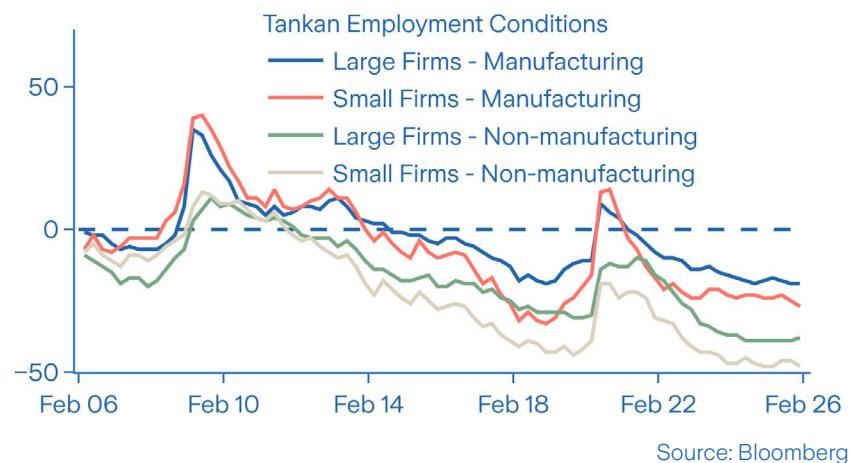
A key question for Japan is whether it can sustain inflation amid a shrinking population. We believe the answer is yes. Japan is likely to maintain stable inflation around 2%, supported by a mindset shift among consumers and firms regarding inflation expectations, as well as ongoing labour shortages.

Japan had been stuck in a deflationary spiral for decades, with falling prices discouraging spending and leaving firms with little pricing power and extremely weak wage growth. The Covid pandemic and the Bank of Japan's ultra-loose policies led to inflation persisting for over four years. This appears to have been long enough to shift behaviours and the formerly pervasive disinflationary mindset: consumers are spending despite the rising cost of living, firms are raising prices, and inflation expectations are increasing.

Encouragingly, inflation has finally translated into wage growth, now at its strongest in decades. Robust demand has exposed chronic labour shortages, especially in services, due to a shrinking workforce. Although increased participation from women and seniors masked the issue for years, both groups are now near peak levels, and immigration remains restricted. The latest Tankan Survey confirms persistent, widespread labour shortages across sectors and firm sizes (Chart 3).

With fiscal expansion likely to boost demand further, inflation should remain anchored. Although headline inflation may ease temporarily due to subsidies and lower food prices, we expect underlying inflation to stay near the BoJ's 2% target.

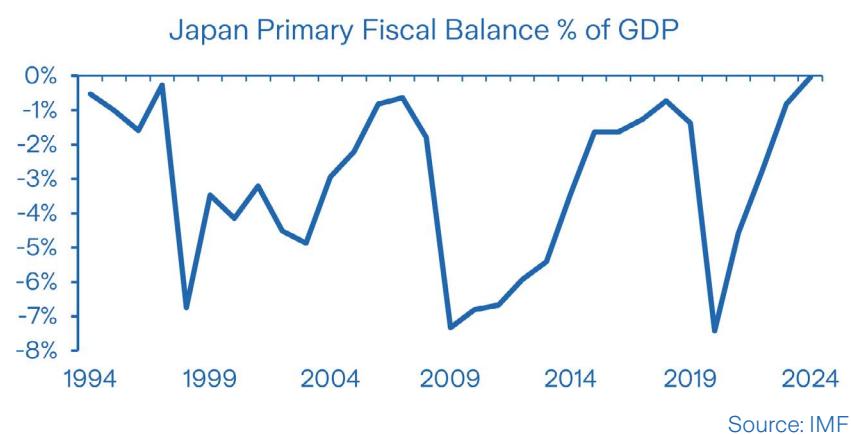
Chart 3: Tankan Survey confirms persistent, widespread labour shortages



Talk of Japan's fiscal vigilantes is overdone

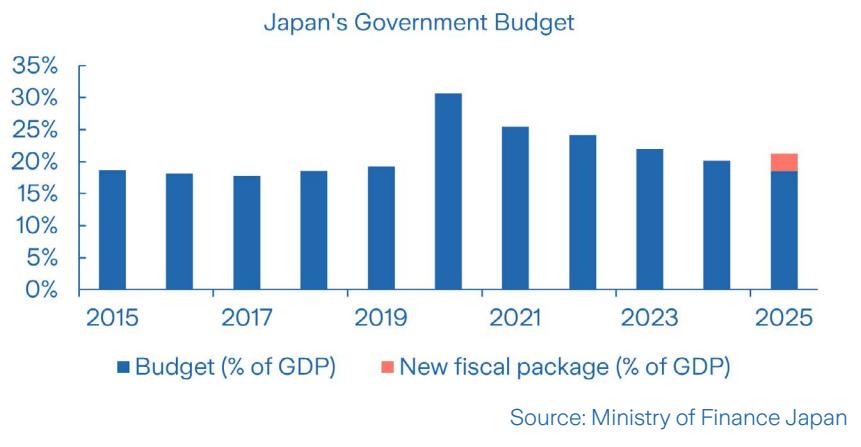
With bond yields rising, it's natural for concerns about Japan's fiscal sustainability to resurface. However, fears of a UK-style 'Truss moment' are overstated. As mentioned above, the increase in nominal yields is mainly being driven by a repricing of inflation expectations. Inflation acts as a tailwind for public debt dynamics. Higher prices boost tax revenues, and nominal growth outpaces low interest costs, meaning debt grows slower than GDP. As a result, the primary budget deficit has dropped to 0.4% of GDP in 2024, a thirty-year low (Chart 4). With an average debt maturity near 10 years, Japan has time before higher rates impact debt servicing.

Chart 4: the primary budget deficit is at a thirty-year low



As inflation can make it challenging to assess fiscal risk, a clearer approach is to compare real yields with real growth. From this perspective, fiscal stability appears solid. Japan's 10yr inflation-adjusted yield is only 0.2%, well below the 2% in the US. Real rates also sit comfortably below Japan's long-term trend growth of 0.6–0.8%, highlighting sufficient fiscal space. Most importantly, we think fiscal spending is essential to keep demand steady and inflation on target. While there's uncertainty about how far the government will go, we think the government will maintain a responsible fiscal stance as PM Takaichi is committed to maintaining a stable debt-to-GDP ratio. In fact, the latest supplementary budget, though over 3% of GDP, is not unusually large (Chart 5).

Chart 5: fiscal spending remains in line with historical norms



Crucially, we expect the bond market will act as a powerful brake, naturally limiting excess spending. Nearly 90% of JGBs are held domestically, minimizing risk from foreign capital flights. Meanwhile, foreign ownership is heavily concentrated in short-duration T-bills as the BoJ's latest data suggest. As a result, we do not expect a significant impact from foreign flows on long-end bond yields. Even when in crisis mode, the Bank of Japan stands ready as the lender of last resort, ensuring market stability. The bottom line is that Japan's fiscal foundations are much sturdier than the headlines suggest and fears of instability are overblown.

How far could yields rise?

We expect 10yr JGB yields to rise modestly this year but remain capped below 3%. With inflation likely stabilising around 2%, inflation expectations appear anchored. This means further increases in nominal yields will mainly reflect higher real yields, driven by ongoing BoJ policy normalisation and a modest fiscal premium. We anticipate that the BoJ will tighten policy faster than the market currently expects, helping to keep inflation anchored. While we do not foresee excessive fiscal spending, markets are right to price in policy uncertainty, especially as the LDP's majority gives the Prime Minister greater fiscal flexibility.

Nonetheless, 10yr yields should stay below 3%, with real yields under 1%. Should real yields approach 1%, and exceed real growth, fiscal vulnerability will become more pronounced. At that point, we expect the government to respond pragmatically, with BoJ intervention likely to prevent any destabilising surge in yields.

Fundamentals suggest a stronger yen

Alongside the rapid repricing of JGBs, the yen has also weakened, though recent currency moves have been less dramatic than those in the bond market. The yen's initial decline was driven by widening yield differentials as the BoJ kept rates low while the rest of the world raised theirs between 2022 and 2023. Since early 2024, as the BoJ began tightening, the yen briefly strengthened with narrowing yield gaps. More recently, however, the yen has depreciated back toward 160. This recent weakness provides insight into market expectations. Investors are pricing in the possibility of more expansionary fiscal policy and are questioning the BoJ's willingness to raise rates enough to contain resulting price pressure.

However, we believe these concerns are overstated. As mentioned, we think fiscal expansion is likely to be responsible and the BoJ remains focused on its inflation mandate, making the current sell-off in the yen appear overdone. Looking ahead, we see a fundamental appreciation bias for the yen. Real yield differentials point to the currency being undervalued (Chart 6), and potential Japanese asset repatriation could provide further support. However, the path for yen appreciation is expected to be volatile.

Chart 6: the Yen looks cheap when compared to the real yield difference in the US and Japan



Source: Bloomberg

Financial jitters kept in check despite recent rate shocks

Bonds with maturities from 10 to 40 years have seen their yields surge by between 2-3% over the past four years, implying significant capital losses. In the case of the longest maturity bonds, price drawdowns exceed 50%. With pension funds and insurers holding about 20% of all JGBs and banks another 10% (Chart 1), unrealised losses could be significant, especially for institutions with large portfolios of super-long bonds.

However, for now, systemic risk looks manageable. Many banks and insurers hold a substantial portion of JGBs in held-to-maturity accounts, shielding their books from market repricing. As interest rates rise, liabilities are also adjusted downward, helping cushion rate shocks unless there's a major duration mismatch. Strong equity gains and ongoing portfolio rebalancing further offset bond losses. Major banks have benefited from a steeper yield curve and robust loan growth, boosting profitability. Market confidence remains firm, as reflected in strong financial sector stock performance recently.

That said, pockets of vulnerability remain. Rising yields could expose weaker players, particularly those with duration mismatches or limited capital to absorb losses. Should pressures mount, the BoJ is likely to step in as a backstop, significantly lowering the risk of broader financial contagion.

Homeward bound?

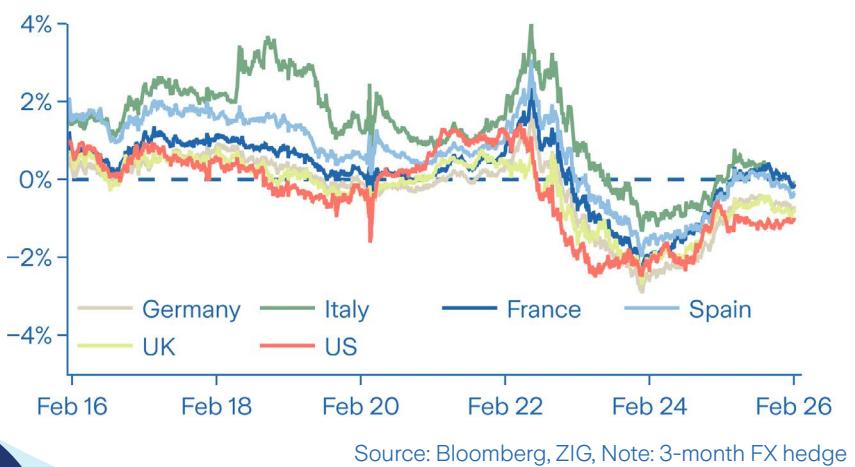
Higher JGB yields increases the risk that Japanese investors repatriate their foreign assets and that international investors move from other markets into JGBs. The fear is that this would cause upward pressure on yields in other markets. This is of particular concern as large central banks unwind long-standing QE programs, while governments commit to ever greater spending. We think the risk of significant upward pressure is low, as international markets have already adjusted to structurally lower Japanese demand for their debt.

Japanese investors are significant creditors to global governments. Japan's holdings of US Treasuries (UST) across various institutions, including the Ministry of Finance (MoF) reserve portfolio and Post Bank, make it the single largest foreign holder of USTs at USD 1.2 trillion. Japan has also long been seen as a source of dependable inflows for Eurozone debt. As an example, the USD 1.9trn Government Pension Investment Fund (GPIF) is estimated to own around 1% of outstanding European Government Bond (EGB) issuance through a combination of its current ~24% allocation to foreign bonds and classifying currency hedged foreign bonds as part of its separate ~26% domestic bond allocation.

Our assessment of the risks is fourfold. Firstly, international bonds have been unattractive to JPY-based investors for over three years now. Despite this, they have continued to buy international fixed income. This suggests diversification matters. Secondly, the major beneficiary of recent Japanese flows has been US Treasuries, and likely on a currency unhedged basis. Should Japanese institutional investor begin to significantly favour JGBs it is likely to have a larger impact on USTs and the USD than on other assets. Thirdly, the assumption that Japanese investors are an important source of demand for Eurozone sovereign debt is outdated. They have been net sellers of EGBs since 2014. Lastly, while foreign buying of JGBs has increased marginally, neither the current volatility nor valuations are conducive to large JGB inflows. Foreign ownership of JGBs increased slightly to 6.6% in Q3 2025 from 5.4% a year earlier, but conditions do not suggest a sudden acceleration.

Chart 7 shows yield differences compared to 10yr JGBs for a JPY based investor hedging their foreign currency risk. A positive number means foreign bonds are attractive, while a negative number means the opposite. The data shows a clear structural shift. A long period of attractive international bonds ended dramatically towards the end of 2022 and not with the recent JGB sell-off. Many central banks rapidly increased interest rates while the BoJ stayed put, significantly increased the cost of currency hedging. In most cases higher currency hedging costs far outstripped the increase in bond yields in those foreign markets. Previously enticing yield pick-ups in Italy and Spain have been eroded through strong performances in those markets. France, once seen as a dependable source of yield enhancement with a stable credit rating, has lost both of those attributes. The US Treasury market screens as particularly unattractive on a hedged basis. Taken together, one crucial motivation for Japanese investors to buy foreign bonds has not stood for over three years.

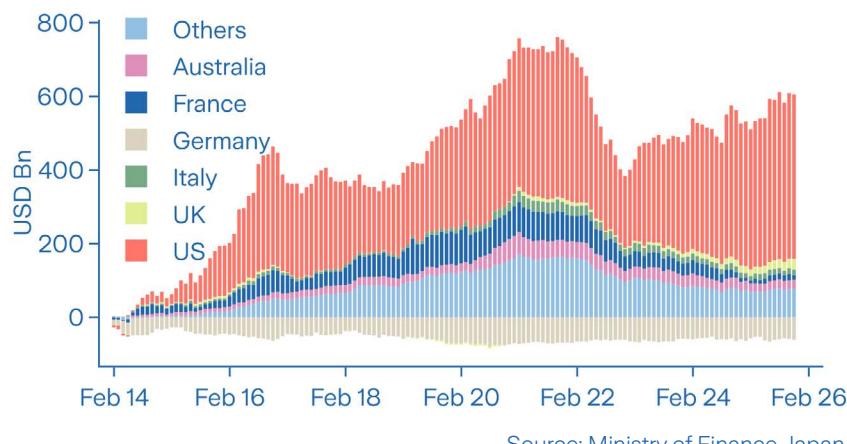
Chart 7: 10yr bond yields for Japanese investors when currency hedged to JPY



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

Yet, they have been buying. Data from Japan's Ministry of Finance in Chart 8 shows significant net bond selling coinciding with the broad global bond sell-off in 2022. Buying began again as global yields stabilised at the end of 2022. When compared with Chart 7 above, this suggests that a significant portion of the buying is done on an unhedged basis. It is likely that Japanese investors were buying USTs for a combination of high outright yields and deliberate USD currency exposure. Here lies the clearest risk. These positions are likely to have made significant profits from a combination of capital appreciation and favourable USDJPY moves. Given higher JGB yields and a weak JPY, these institutions could reasonably shift their allocations to favour domestic assets. US Treasuries and the USD are likely to comprise the bulk of any resulting sales. In the case of pension funds, we think a reasonable scenario is that any benchmark changes are likely to be single digit percentage point tweaks, rather than a full deallocation. This limits the impact of such a move. Separately, for any selling of official reserve holdings, the impact is likely to be felt more in JPY appreciation rather than overseas bond weakness. This is because reserve assets tend to be held in short-dated maturities.

Chart 8: cumulative net purchases/sales of foreign bonds by Japanese investors since 2014

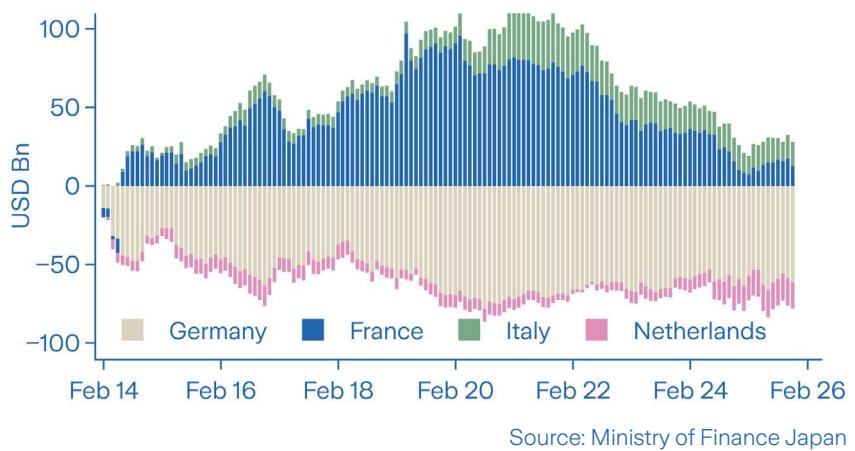


Source: Ministry of Finance Japan

From Paris to Milan

A deeper dive into Japanese international bond flows shows that old assumptions about structural flows are now outdated. This is particularly true in Europe. Chart 9 shows the cumulative Japanese net purchases of four major EGB markets. Flow data suggests Japan became a significant net seller of EGBs in April 2022 after an eight-year period of accumulation. The scale of that selling has been greater than the buying since 2014. While a partial deallocation out of foreign bonds could add some further pressure on the EGB market, European debt issuers have not relied on net new Japanese flows for several years now. While further sustained selling is possible, hedged valuations are not unreasonable – and certainly more attractive than US Treasuries. Lastly, Japanese buying flows have mattered more for spreads within the region than the outright level of duration demand. The data show a clear reduction in French debt holdings since 2022, coinciding with French bonds weakening against European peers. While France and Italy continue to screen as slightly attractive, French debt is unlikely to benefit in the near term given debt and political concerns.

Chart 9: cumulative net purchases/sales of EGBs by Japanese investors since 2014



Conclusion

Taken together, Japan's bond market transition should not be a cause for alarm. Rather, it marks the long-awaited return to a more balanced equilibrium, one where yields reflect fundamental forces. Market volatility is likely to persist as investors adjust to new fiscal and monetary realities, but the underlying system remains robust. The path ahead may be bumpy, yet it is ultimately a sign of normalisation rather than crisis.

From the international perspectives, higher domestic yields may gradually redirect flows back toward JGBs, but the impact on global sovereign markets is likely to be uneven. Japanese investors' demand patterns have evolved significantly over recent years: diversification motives remain strong, UST exposures are more sensitive to currency dynamics than yield differentials, and Eurozone bond allocations have already been structurally reduced for years.

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