Daiwa's View

Impact of Lower House election on JGB market

- Fiscal deterioration has effect of pushing up term premium
- LDP-Komeito coalition failing to win majority would be a bull-steepening factor
- The greatest risk is market instability under QT

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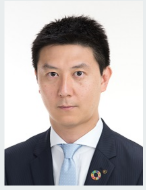

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Market theme is fiscal risks associated with elections in Japan and US

Ahead of Japan's Lower House election on 27 October and the US presidential/congressional elections on 5 November, political events serve as a major market theme. In the US, the increasing likelihood of a "red sweep" is creating fiscal concerns, leading to a rise in the term premium. Regarding Japan's Lower House election, the possibility of the LDP-Komeito coalition losing its majority is being pointed out. The market seems to assume that expansion of the coalition framework to include other parties would increase the pressure to expand fiscal policy[1].

Impact of fiscal deterioration on JGB term premium

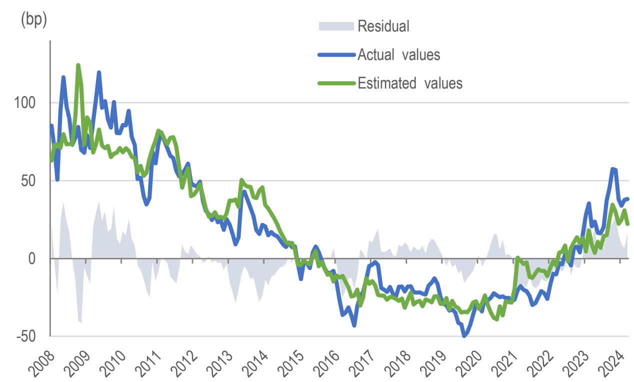
How much will fiscal deterioration impact JGB yields? In our 4 June report, the author analyzed factors influencing the 10-year JGB term premium that is estimated by Daiwa, pointing out that the outstanding amount of JGBs is an important factor, in addition to JGB volatility, the US term premium, and the amount of JGBs held by the BOJ. Simulations regarding the impact of changes in the outstanding amount of JGBs on the term premium (Chart 3) show that an increase of Y50tn from the current level would raise the term premium by about 17bp, and an increase of Y100tn would raise it by about 32bp.

Chart 1: Estimation Results

Independent variables	Dependent variables JGB term premium: TP_JGB	
JGB-version VIX Index	**4.683**	***
JGBV	(0.000)	
UST term premium	**0.1866**	***
TP_UST	(0.000)	
Outstanding JGBs (log)	**358.9**	***
LN_AM_JGB	(0.000)	
Amount of JGBs held by BOJ (log)	**-66.88**	***
LN_BOJHold	(0.000)	
Constant	**-2062**	***
Intercept	(0.000)	
Determination coefficient	0.8877	

Source: Compiled by Daiwa.
Notes: (1) One, two, and three stars indicate statistical significance at the 10%, 5%, and 1% level, respectively.
(2) Monthly data from Apr 2008 to Mar 2024.
(3) TP_JGB figures are our estimates. Other data derived from BOJ and Bloomberg.

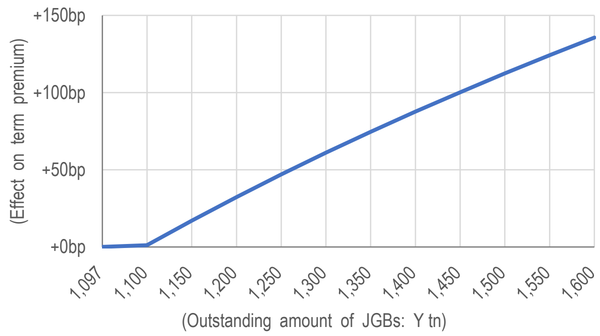
Chart 2: Actual and Estimated Term Premiums



Source: Compiled by Daiwa.

[1] Politics Watch: *Asahi Shimbun* reports ruling coalition could lose majority; would increase push for fiscal stimulus (Koji Hamada)

Chart 3: Impact of Amount of Outstanding JGBs on Term Premium



Source: Compiled by Daiwa.

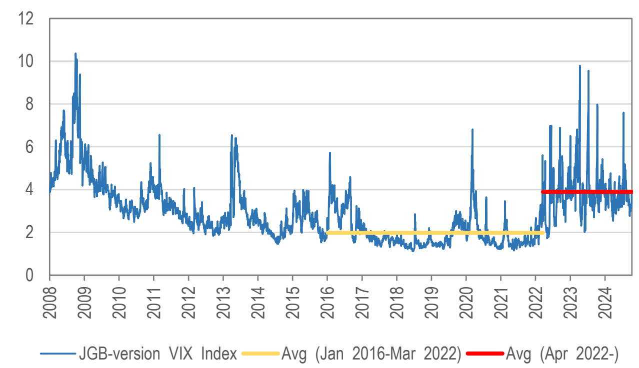
LDP-Komeito coalition failing to win majority would be a bull-steepening factor

If the LDP-Komeito coalition fails to retain a majority, the impact on the JGB market would be complicated. A story of "forming a coalition with additional parties → expansionary fiscal policy through policy compromises → an increase in JGB issuance" entails various uncertainties. That said, fiscal finance would not immediately worsen in the form of an increase in the outstanding amount of JGBs. In addition, if the market judges that the BOJ's rate hikes will be pushed back due to political uncertainty, the risk-free yield would decline, putting downward pressure on yields. As risk-off sentiment is assumed as a whole, bull steepening could be expected as the initial reaction.

Caution needed for deterioration in market environment

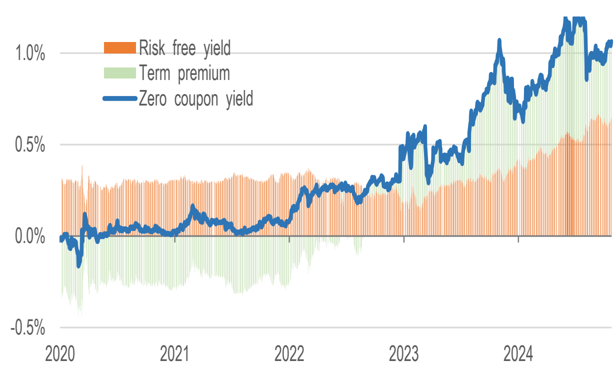
Moreover, caution is needed regarding market instability. The above-mentioned analysis shows that a 1 unit rise in the JGB VIX index pushes up the term premium by about 5bp. The JGB VIX index, which remained low, averaging 1.97, during the large-scale monetary easing period from January 2016 through March 2022, has risen to an average of 3.88 since April 2022, when the market started to sense an exit (Chart 4). In addition, the BOJ started reducing its balance sheet in August 2024. The above-mentioned regression analysis also indicated that the amount of JGBs held by the BOJ is an important factor for the JGB term premium. Initially, QT is proceeding at a slow pace, but fiscal spending can be no longer covered by JGB purchases by the BOJ alone. When the administration changed in September 2009 and December 2012, we did not observe a rise in volatility in the JGB market. However, market volatility surged in April 2013 due to the major regime change in monetary policy—i.e., the introduction of QQE—following the start of the Abe administration. For example, the Constitutional Democratic Party is now calling for a change in the BOJ's price stability target from 2% to just over 0%. This is just a tail risk, but a certain degree of caution is needed for a rise in volatility associated with political uncertainty.

Chart 4: JGB-version VIX Index



Source: Bloomberg; compiled by Daiwa.

Chart 5: 10yr Term Premium, Risk-free Yield



Source: Compiled by Daiwa.

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