Daiwa Securities

Daiwa's View

FICC Research Dept.

Outlook for JGB yields

- We have raised our 10-year yield forecast for end-FY25 to 1.65% due to progress with US-China trade talks
- Yields are likely to be pushed up by the expected terminal rate and widening of term premium

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Revision to yield outlook: We now expect 10-year JGB yield to be 1.65% at end-FY25

In this report, we have revised our projection for the 10-year JGB yield at end-FY25 to 1.65%. We had projected that it would be 1.5% in the previous report (before Trump's "reciprocal tariffs" were announced), but we have revised it upwards in response to changes in the market environment in light of rapid developments in US-China trade relations. Major factors behind the rise in yields are: (1) the fact that, due to progress with US-China negotiations, there is once again an increased chance of the BOJ's terminal rate reaching 1%—a probability that had declined after Trump tariffs were announced—and (2) widening of the term premium.

Shift in market environment due to improved US-China relations

With trade talks between the US and China progressing more rapidly and significantly than expected, the market has quickly shifted into risk-on mode. During the period of turmoil after the Trump administration's announcement of "reciprocal tariffs," the expected value of the terminal rate declined throughout the entire market, including our forecast. However, following the agreement to reduce tariffs, the market has again started to price in a terminal rate of around 1.0%, and the long-term yield has risen to about 1.5%. With concerns about a US recession having receded substantially, some financial institutions have withdrawn their previous projections of a US recession.

Although the BOJ has pushed back the timing for achieving its price target in its latest *Outlook Report*, it is basically maintaining its stance of raising interest rates to a neutral level. We still forecast that the policy interest rate will reach 1.0% at end-FY26. Based on this assumption, it would be possible for us to forecast, as before, that the 10-year yield will be 1.5% (terminal rate + 50bp), but we have revised it upwards to 1.65% given the changes in the market environment.

JGB Yield Outlook

(%)		Apr-Jun		Jul-Sep		Oct-Dec		Jan-Mar	
		Range*	Term-end	Range*	Term-end	Range*	Term-end	Range*	Term-end
Japan	Policy rate		0.50		0.50		0.50		0.75
	2yr	0.60 ~ 0.90	0.75	0.65 ~ 0.95	0.80	0.70 ~ 1.00	0.85	0.75 ~ 1.05	0.90
	5yr	0.75 ~ 1.40	1.00	0.80 ~ 1.45	1.05	0.85 ~ 1.50	1.10	0.90 ~ 1.55	1.15
	10yr	1.10 ~ 1.90	1.50	1.15 ~ 1.95	1.55	1.20 ~ 2.00	1.60	1.25 ~ 2.05	1.65
	20yr	1.95 ~ 2.75	2.35	2.00 ~ 2.80	2.40	2.05 ~ 2.85	2.45	2.10 ~ 2.90	2.50
	30yr	2.50 ~ 3.30	2.90	2.50 ~ 3.30	2.90	2.50 ~ 3.30	2.90	2.50 ~ 3.30	2.90

Source: Compiled by Daiwa.
**Estimated fluctuation range of 20-day moving average in main scenario.*

Two factors supporting higher yields

First factor: Terminal rate once again has an increased chance of reaching 1%

After Trump tariffs were announced, the expected value of the terminal rate declined to around 0.75% as the probability of suspended rate hikes increased due to concerns about the negative impact on the economy. However, progress with US-China negotiations has raised expectations for progress with US tariff negotiations with many countries, including China. Therefore, we are once again seeing an increased probability of a scenario with continuous rate hikes.

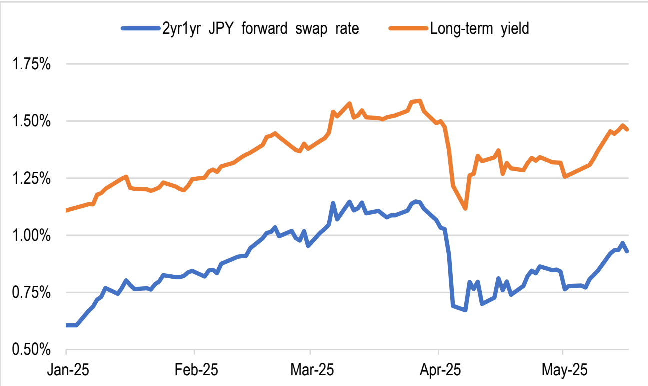
It is still true that, with tariffs imposed, trade conditions are worse than they were before the Trump administration. However, while the impact from this may gradually appear in hard data going forward, if tariff negotiations progress further, it is likely the market will disregard the hard data, which is a reflection of past tariff conditions, as something it has put behind it, and is seeing in the rearview mirror. Furthermore, as there are still positive factors for the economy, such as deregulation and tax cuts, forward-looking expectations will likely continue if the environment allows market sentiment to remain favorable.

Second factor: Widening of term premium

The 10-year yield is considered to be the sum of the priced-in terminal rate (the yield curve starting from the policy interest rate) and the term premium. However, the term premium has now expanded beyond the previously assumed 50bp. This reflects the impact of superlong yields pushing up the long-term yield.

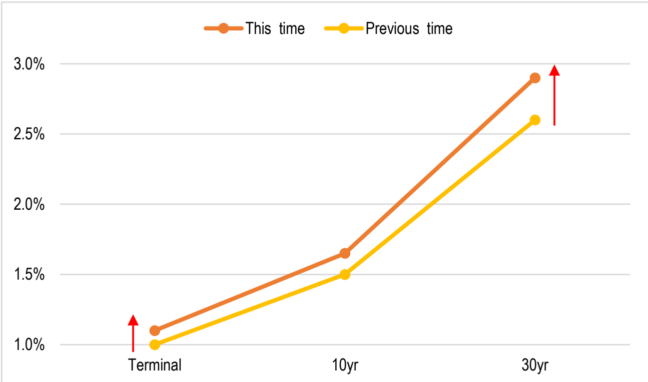
Since the Trump tariff shock, superlong yields have remained significantly diverged from the priced-in terminal rate and the long-term yield. The superlong JGB market had already been experiencing worsening supply/demand conditions due to demand for life insurers to comply with regulations running its course. On top of this, we saw the addition of an unprecedented risk in the form of Trump's tariffs, leading to a decline in hedging function and a deterioration in risk appetite. As a result, the market has become aware of the risk premium on superlong bonds, and the yield spread between swap and cash bonds has widened unexpectedly. This widening of the risk premium in the superlong zone is spreading to the long-term yield.

Terminal Rate, Long-Term Yield



Source: Bloomberg; compiled by Daiwa.

Long-term Yield Pushed Up from Both Ends of Yield Curve



Source: Compiled by Daiwa.

Outlook for market developments

With the market having resumed pricing in rate hikes, it is now at the beginning of an upward yield trend. In light of the progress with US-China negotiations, we think the market is now at the early stage of a new upward cycle. If the current market sentiment were maintained, the previous high of around 1.6% would be well within reach. This level factors in a terminal rate of around 1.1%, which is higher than our projection (1.0%).

Market participants have less psychological resistance to levels that have been reached in the past, so those levels tend to be reached more easily the second time around. In fact, the market might not view 1.6% as the goal, and could set its sights even further ahead. Considering the "beauty contest" aspect of the market, it is highly probable that yields could rise above their theoretically appropriate levels.

We expect the BOJ to maintain the status quo with regard to its "interim assessment" of the pace of QT, which is scheduled for the June BOJ monetary policy meeting. As the market largely shares this view, the impact on the future yield outlook will likely be limited. As noted in our previous report, the impact from QT is nonlinear, and we think the market has already factored in most of it.

Conclusion

We expect the 10-year JGB yield to be 1.65% at end-FY25. This level is the sum of the 1.1% terminal rate expected by the market and an expanded term premium of 55bp. While the market environment has changed substantially due to the tariff policies of the Trump administration and progress with US-China trade talks, our forecast for the BOJ's terminal rate of 1.0% remains unchanged.

For the time being, the market is likely to be driven mainly by developments resulting from policy changes, such as tariff negotiations. The changes in sentiment associated with these developments will influence the yield level. Given the widening of the term premium, as well, we believe that the 10-year yield will likely reach a level higher than our previous forecasts.

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