Daiwa's View

FICC Research Dept.

How far will superlong JGB yields fall?

- MOF's cut to superlong issuance could drive down 30-year yield to 2.5-2.7%.
- Review of issuance midway through fiscal year unusual; likely game-changer for superlong JGB market

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Unusual action by MOF

On 26 May, Japan's Ministry of Finance (MOF) sent a questionnaire to investors indicating that it is considering revising the composition of maturities in its FY25 JGB issuance plan. The questionnaire is unusual in that it went out to a broad group of institutional investors, not just the members of MOF's Meeting of JGB Market Special Participants (primary dealers meeting) and Meeting of JGB Investors. The broad scope of the questions—from the appropriate volume of issuance for each maturity to current market conditions—also illustrates MOF's strong sense of urgency.

An official primary dealers meeting is scheduled for 20 June, which we expect to feature a full-scale debate on rising superlong JGB yields. MOF is considering reducing issuance of superlong JGBs based on the outcome of this meeting. However, it intends to maintain total issuance at Y172.3tn and adjust for any reductions by increasing issuance for other maturities.

Structural changes in superlong JGB market

MOF's actions reflect the drastic worsening of superlong JGB market supply/demand. The 20 May 20-year JGB auction featured the largest tail since 1987, and 40-year and 30-year yields reached record highs. Receding demand from life insurers—among the biggest buyers thus far—has resulted in a lack of buyers in the market.

30yr JGB Yield Trend

Source: Bloomberg; compiled by Daiwa.

There are no signs that supply/demand has improved since the April start of the new fiscal year, despite the fact that the initial issuance plan MOF drew up in December 2024 already reduced scheduled 40-year and 30-year JGB issuance. This implies structural changes in the superlong JGB market rather than transitory issues with the supply-demand balance. The balance has worsened sharply since the BOJ scrapped its yield-curve control (YCC) policy and embarked on quantitative tightening (QT), which coincided with the decline in demand from life insurers.

Potential further decline in yields and its drivers

We would expect superlong JGB yields to fall sharply if MOF reduces issuance. We see 2004-2012, prior to the BOJ's introduction of qualitative and quantitative easing (QQE), as a reference in quantifying the impact. The main buyers during this period were life insurers and other buy-and-hold investors, making it a useful reference in gauging the market outlook after a potential cut in issuance.

The 30-year yield in 2004-2012 was around 2.5%. This is broadly consistent with the 2% upper bound for the "understanding of medium- to long-term price stability" the BOJ unveiled in 2006, plus Japan's potential GDP growth rate of 0.4-0.5%. Applying the same approach to current conditions, Japan's potential growth rate of 0.5-0.6% combined with the BOJ's 2% inflation target implies a fair value of 2.5-2.6%.

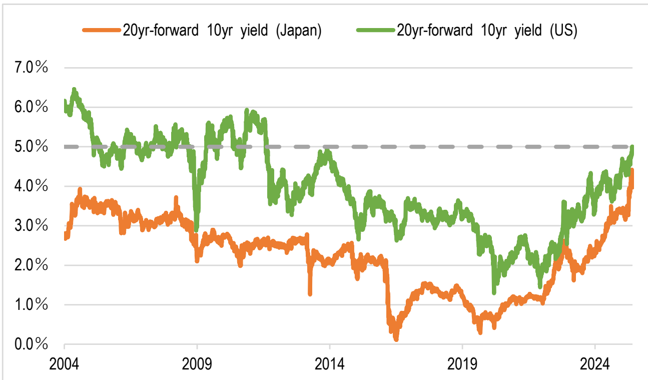
Our analysis of superlong JGB yields results in a similar conclusion. Assuming that 2004-2012 superlong forward yields of around 3% still represent fair value, our simulation suggests a 30-year yield of around 2.5% based on the current 10-year yield of around 1.5%.

However, the US-Japan yield spread implies a somewhat higher level. The 20-year-forward 10-year (20yr10yr) yield spread between Japan and the US was previously around 2ppt, reflecting the gap between the two countries' potential growth rates. Assuming that potential growth rates are now 2% in the US and 0.5% in Japan, the spread between the two has narrowed to around 1.5%. The US 20yr10yr yield is currently 5%, and subtracting the 1.5% spread between the US and Japan's potential growth rates implies a value of around 3.5% for Japan's 20yr10yr yield. Adding this to the current 20-year yield of around 2.3% implies a 30-year yield of around 2.7%.

Trends of Superlong Forward Yields

Source: Bloomberg; compiled by Daiwa.

20yr-forward 10yr Yield Trends in Japan and US



Source: Bloomberg; compiled by Daiwa.

Significance of policy shift

To sum up, the above analysis suggests that the 30-year yield could fall to around 2.5% if investors focus on domestic factors or around 2.7% if they consider the impact of the US fiscal risk premium. This implies downside of 10-30bp from current levels of around 2.8%.

Actual yields will depend on how far MOF reduces issuance, trends in the US fiscal risk premium, Japan's fiscal policy after the July Upper House elections, and the pace of the BOJ's QT. It is nevertheless highly significant that MOF is embarking in earnest on managing the maturity composition as part of its government debt management policy.

We think MOF's move to directly address the glut of issuance that is the root cause of rising yields should dispel supply-demand concerns. The sharp drop in superlong yields on 27 May suggests that the market welcomed its action. The unusual move to review planned issuance midway through the fiscal year signals MOF's commitment, and we think superlong yields have likely already peaked. This policy shift could act as a true game-changer for the superlong JGB market.

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