Daiwa Memorandum

FICC Research Dept.

Rising JGB term premium and its drivers

- 10yr JGB term premium exceeded 100bp at one point
- We conduct a model-based analysis of the factors involved
- Market excessively pricing in worsening fiscal conditions, increase in JGB issuance

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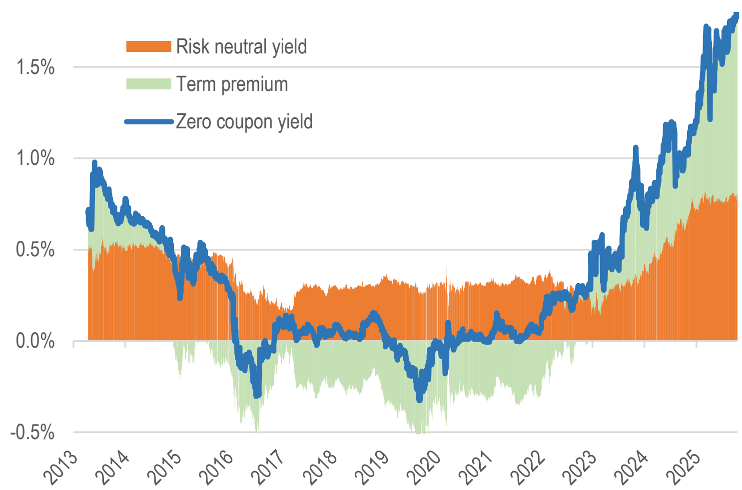
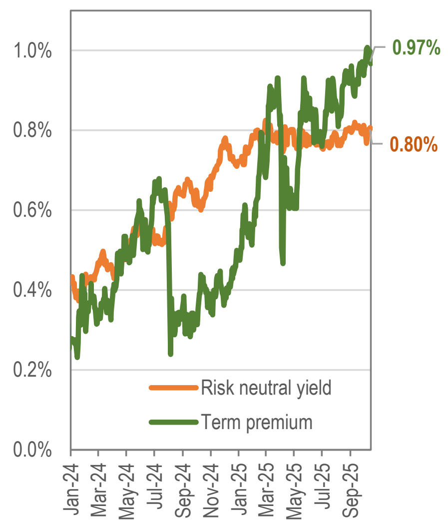
JGB term premium exceeded 100bp at one point

The term premium for JGBs is rising. It has continued to trend upward since the Bank of Japan (BOJ) began normalizing monetary policy, and our DWJGTP10 model suggests that it has trended above 100bp since 6 October, the trading day after the Liberal Democratic Party (LDP) leadership ballot. (As of the 15th, it had slightly decreased to 97bp.) Notably, this is the first time in the 16 years since 2009 that it has surpassed 100bp. The risk-neutral yield, an indicator of short-term interest rate expectations, has fallen slightly, reflecting expectations for the BOJ to postpone rate hikes and the risk premium to rise amid heightened political uncertainty. In this report, we therefore consider fair value for the term premium.

Chart 1: JGB Term Premium, Risk Neutral Yield (10yr)





Source: Compiled by Daiwa.

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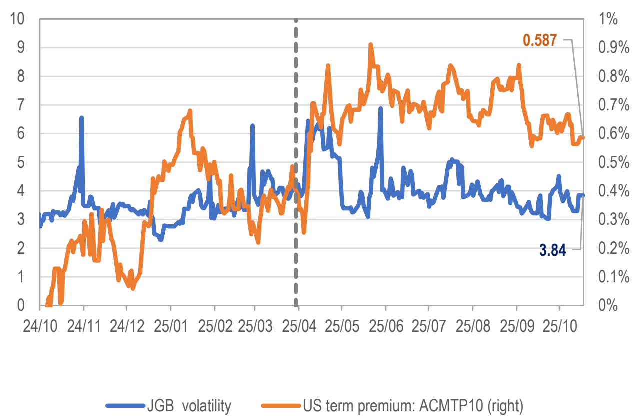
JGB term premium factor analysis

We see four key determinants of the JGB term premium: (1) JGB volatility (SPJGBV), (2) US Treasury term premium (ACMTP10), (3) JGB issuance, and (4) the value of the BOJ's JGB holdings. We presented our model for estimating the JGB term premium at the Ministry of Finance's (MOF) Study Group on Government Debt Management.

The JGB term premium has risen 15bp since end-March, from 81bp to 96bp recently. JGB volatility (one of our model's explanatory variables) fell by around 0.4ppt (from 4.23 to 3.84), while the US term premium rose 21bp (from 38bp to 59bp). Multiplying these by their respective coefficients results in around 2.3bp (≈ –0.4 ∗ 4.7+21 ∗ 0.2). The increase in JGB term premium that can be explained by volatility and the US term premium is therefore around 2.3bp.

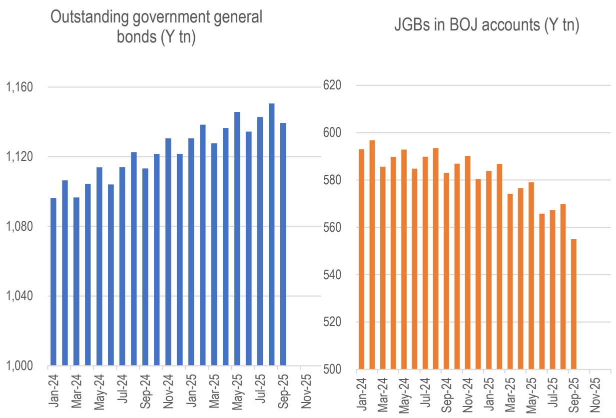
Even discounting for the Y11tn increase in JGB issuance from Y1,128tn at end-March to Y1,139tn and the roughly Y20tn decline in the BOJ's JGB holdings from Y574tn at end-March to Y555tn, the change in term premium implied by our model is only around 6.3bp, nearly 10bp below the actual level.

Chart 2: JGB Volatility, US Term Premium



Source: Bloomberg; compiled by Daiwa.

Chart 3: JGB Issuance Amount, Amond of JGBs Held by BOJ



Source: BOJ; compiled by Daiwa.

Chart 4: Changes in Estimated Term Premium and Explanatory Variables from March

	Term premium (model estimates)	JGB volatility SPJGBV	UST term premium ACMTP	JGB issuance amount (Y tn)	BOJ's JGB holdings (Y tn)
As of end-Mar	56.4bp	4.23	38.3bp	1,127	574
Latest	62.8bp	3.84	58.7bp	1,139 (end-Sep)	555 (end-Sep)
Difference	6.4bp	-0.39	20.4bp	12	-19

Source: BOJ, Bloomberg; compiled by Daiwa.

We think JGB issuance is the variable for which market expectations have likely changed. The potential shape of Japan's next government is in constant flux following the ruling coalition's loss of its majority in both the upper and lower houses, Prime Minister Shigeru Ishiba's subsequent announcement of his resignation, Sanae Takaichi's surprise win in the LDP leadership race, Komeito's withdrawal from its coalition with the LDP, opposition parties' move to explore an alliance, and the Japan Innovation Party's (JIP) start of discussions on a coalition with the LDP. All of the parties advocate policies that will increase fiscal spending; these include scrapping the provisional gasoline tax, increasing the basic income tax deduction (to address the "annual income barrier"), cutting the consumption tax, and cash transfers. We think this is resulting in concerns about worsening government finances and rising JGB issuance that are in turn driving up the term premium.

Based on our model, we estimate that the increase in term premium since end-March equates to JGB issuance of around Y1,414tn, Y250tn above the current actual figure. A simple calculation suggests that the term premium factors in a Y25tn decline in government finances, almost equivalent to total consumption tax revenue, over the next ten years. In his Daiwa Memorandum published earlier today[1], our strategist Ryoma Kawahara estimates the increase in fiscal spending from the combined policies of the JIP and Democratic Party For the People (DPP) at around Y10tn per year. Even factoring in concerning moves such as LDP president Sanae Takaichi seeking the cooperation of Sanseito, a party with numerous extreme policy positions, the current term premium seems somewhat excessive. We would naturally expect the risk-neutral yield, another component of long-term yields, to rise if the BOJ continues hiking. However, with US yields also falling, we think an entry point may be approaching from a risk hedging perspective.

[1] Ryoma Kawahara (17 Oct 2025). "*Daiwa Memorandum: LDP's coalition talks with JIP and impact on yields*."

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