Daiwa's View

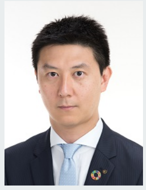
FICC Research Dept.

Mechanisms for inflation expectations (BEI)

- Inflation concerns emerge amid worsening Middle East situation
- Relationship between BEI and crude oil, forex rates, and JGB term premium
- Risks include yen weakness and delayed rate hikes

Shun Otani
81-3-5555-8764
shun.otani@daiwa.co.jp

Daiwa Securities Co. Ltd.

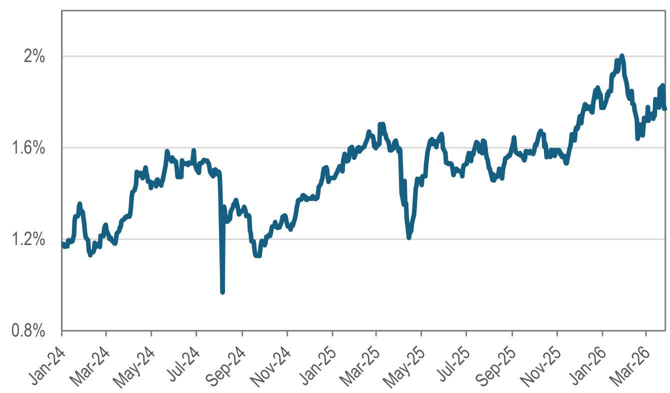


Inflation expectations (BEI) in Japan

It has been nearly a month since the outbreak of the conflict in Iran. President Donald Trump has indicated a positive stance towards resolving the situation, such as proposing truce talks, but no clear signal has been received from the Iranian side. This energy crisis, described by Executive Director Fatih Birol of the International Energy Agency (IEA) as a crisis combining the oil shocks of the 1970s and the natural gas shock of 2022, has heightened inflation concerns and rippled through markets in the form of rising global yields. Examining Japan's market-based expected inflation rate (10-year BEI) in this environment shows that, while it had been on a downtrend after temporarily reaching the threshold of 2% in late January, it has been gradually ticking upwards since the Iran conflict. Looking ahead, if passage through the Strait of Hormuz becomes restricted for a prolonged period of time and the market begins to price in full-fledged inflation, the possibility that long-term yields could rise significantly, driven by BEI, cannot be ruled out. Therefore, in this report, we examine the formation mechanisms for the BEI in Japan, referencing analysis by the Fed on US BEI.

To state the conclusion at the outset, with BEI showing a high correlation with the forex rate and the JGB term premium, in addition to energy prices, we should be mindful of the risk that continuing yen depreciation and/or concerns about being "behind the curve" could lead to higher yields via BEI.

Chart 1: 10yr BEI (inflation expectations)



Source: Bloomberg; compiled by Daiwa.

Correlation analysis with BEI

In our report on 2 March, immediately after the start of the Iran conflict, we referenced the FEDS Notes, which present analysis by Fed staff on a range of topics, to show that the US 5-year forward 5-year BEI has a correlation with crude oil futures, and also confirmed its negative correlation with the VIX Index and high-yield corporate bond spreads. In short, we reported that (1) long-term market inflation expectations are influenced by energy prices, as represented by crude oil prices, and (2) when the market prices in the risk of a recession in the future—such as the risk of a rise in stock market volatility or of a widening of credit spreads on low-rated corporate bonds—this acts as a factor pushing down inflation expectations.

Therefore, we conducted a similar analysis for Japan's BEI. For US Treasuries, the 5-year forward 5-year BEI, which uses 5-year and 10-year TIPS, is considered a key indicator of long-term market inflation expectations. However, in Japan, there are data constraints, as the issuance of inflation-indexed JGBs was temporarily suspended, so our analysis targets the 10-year BEI from October 2013 onwards.

Relationship with crude oil prices, stock market volatility, and credit spreads

The correlation between BEI and crude oil futures (WTI) is not necessarily high. For the period from October 2013 until recent data in February 2026, the correlation was relatively high at 0.53. However, when this period is split into the first half (2013-2019) and the latter half (2020-2026), the coefficient declines in the latter half, when inflation expectations began to rise in earnest. Similarly, no clear relationship can be confirmed between BEI and the Nikkei Stock Average Volatility Index (VNKY) or the CDS spread for investment-grade corporate bonds (iTraxx Japan)[1] over the entire period. However, for both, the coefficient has shifted slightly into the negative since 2020, making it possible to point out that inflation expectations tend to decline when market shocks intensify.

Forex rates and JGB term premium

Furthermore, the correlation with the forex rate (USD/JPY) contrasts with the correlation with crude oil futures. While no correlation is observed in the first half of the period, the forex rate shows an extremely high correlation of 0.96 in the second half. Presumably, the sharp depreciation of the yen since 2020 has heightened inflation expectations by evoking concerns over rising import prices. Similarly, a comparison with our estimate for the 10-year JGB term premium (DWJGTP) reveals a fairly high correlation throughout the entire period. While it is necessary to consider that both BEI and the term premium are components of the nominal yield (10-year JGB yield), the outcome of fiscal risks and the risk of being "behind-the-curve" embedded in the term premium is inflation, which can be seen as one of the reasons for their high correlation.

Chart 2: Correlation Coefficients with BEI

	WTI crude oil price	Nikkei Stock Average Volatility Index	CDS spread	Forex rate	Daiwa JGB Term Premium
		(VNKY)	(iTraxx Japan)	(USD/JPY)	(DWJGTP)
Entire period (Oct 2013-Feb 2026)	0.53	-0.01	0.04	0.76	0.89
First half (Oct 2013~Dec 2019)	0.65	0.19	0.31	0.05	0.93
Latter half (Jan 2020~Feb 2026)	0.44	-0.20	-0.10	0.96	0.92

Source: Bloomberg; compiled by Daiwa.

Risk factors for rising BEI

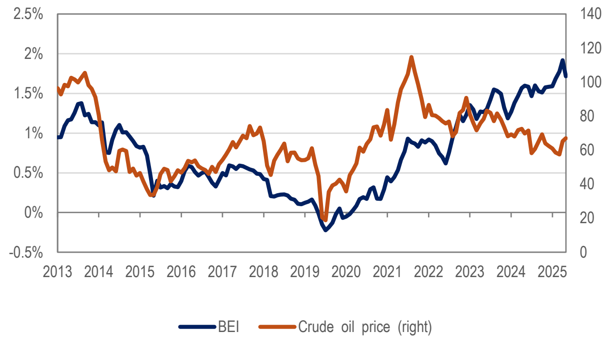
To summarize the mechanisms for market inflation expectations in Japan, while a correlation with energy prices can be confirmed, this relationship has been weakening somewhat. However, inflation expectations have been pushed up by the Covid-19 shock of 2020, global inflation, and subsequent rapid yen depreciation. Furthermore, with Japan's CPI continuously exceeding 2%

[1] In the Japanese market, the market for low-rated corporate bonds is small; for this analysis, we used a representative index of CDS spreads for investment-grade bonds.

since 2022, there is a possibility that the risks of fiscal expansion and monetary policy falling behind the curve are being reflected in market inflation expectations.

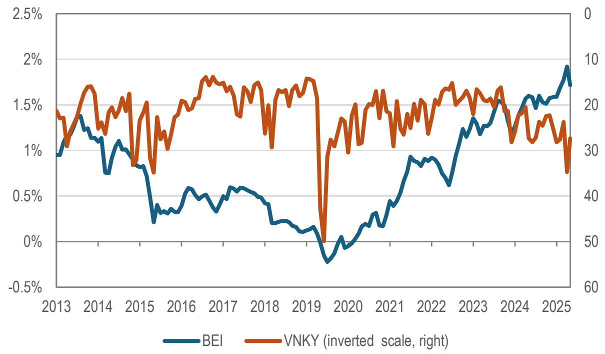
Since the Iran conflict, forex rates have been trending toward a weaker yen and stronger dollar, but caution regarding currency intervention has led to a lack of clear direction at just below the Y160 level recently. Nevertheless, the analysis presented earlier suggests that if the exchange rate were to move significantly towards a weaker yen, it would also apply upward pressure on Japan's BEI. These are the circumstances in which the BOJ will announce the results of the Monetary Policy Meeting on 28 April. While the author personally thinks at this point that a rate hike in April would be desirable, the OIS market is pricing in the likelihood of a rate hike being around 60%, indicating that views in the market are almost evenly divided. If the BOJ forgoes a rate hike and the market perceives that this was done out of "political considerations," we should be aware of the possibility that this could lead to a rise in the term premium and BEI due to concerns about falling behind-the-curve.

Chart 3: BEI, Crude Oil Price



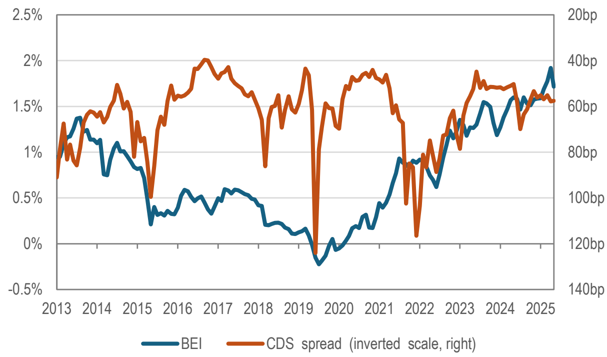
Source: Bloomberg; compiled by Daiwa.

Chart 4: BEI, Nikkei Stock Average Volatility Index (VNKY)



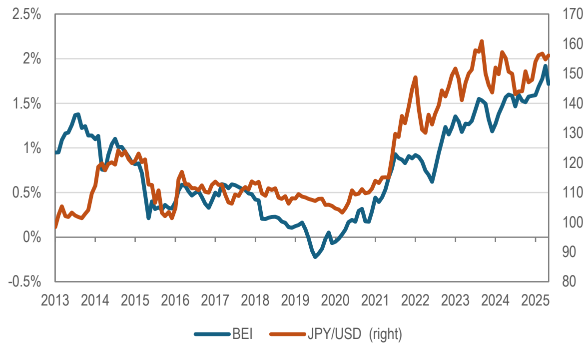
Source: Bloomberg; compiled by Daiwa.

Chart 5: BEI, Credit Spread



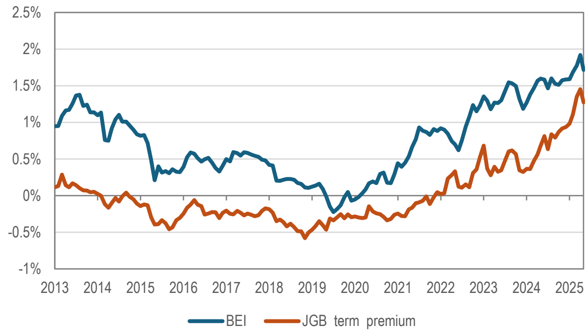
Source: Bloomberg; compiled by Daiwa.

Chart 6: BEI, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 7: BEI, JGB Term Premium



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