Daiwa's View

Concerns about falling behind the curve, BOJ's actions/credibility

- Super-long JGBs stable despite receding expectations for rate hikes
- Fiscal factors, medium-term JGB supply/demand factors
- BOJ's actions/credibility put to the test

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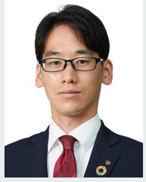


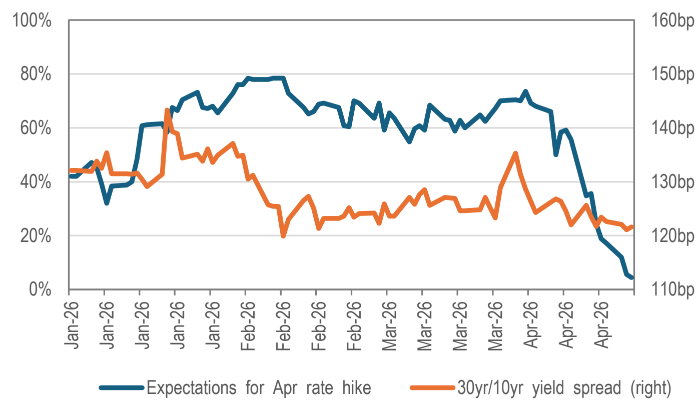
Market concerns about "falling behind the curve"

Even though expectations for a rate hike at the BOJ's April Monetary Policy Meeting have faded, super-long JGBs remain stable and concerns about "falling behind-the-curve" have not materialized. In addition to reduced fiscal uncertainty and supply/demand factors such as medium-term JGBs contributing to stable JGB yields, the BOJ appears to have largely succeeded in managing expectations regarding interest rate hikes. That said, given concerns such as rising inflation expectations, maintaining market credibility will entail the "likelihood of action" moving forward.

Receding rate hike expectations and market reaction

On 13 April, BOJ Deputy Governor Ryozo Himino read a speech delivered by Governor Kazuo Ueda at the annual Trust Companies Association of Japan conference. Following that speech, expectations for an interest rate hike at the April meeting have fallen sharply. Indeed, following several subsequent leaks, the market is currently pricing in no rate hike at the April meeting. Meanwhile, the 30yr/10yr spread has been narrowing slightly and, at the very least, there has been no sharp spikes for super-long JGB yields.

Chart 1: Expectations for Apr rate hike, 30yr/10yr Yield Spread

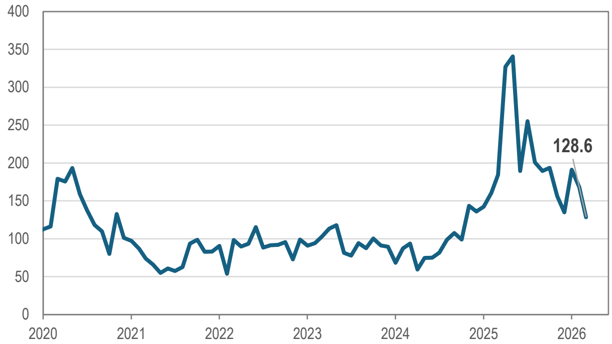


Source: Bloomberg; compiled by Daiwa.

Fiscal factors

Fiscal influences are a factor behind super-long JGB market stability. At a press conference on 19 January announcing the dissolution of the Lower House, Prime Minister Sanae Takaichi described a consumption tax cut, which would set the tax rate on food and beverages at 0% for a limited period of two years, as a long-cherished goal. Even though the 30-year JGB yield rose sharply, Takaichi's comments regarding the consumption tax cut were kept to a minimum during the subsequent election campaign. Also, even though discussions have begun at the National Council on Social Security, a number of challenges have come to light. These include the need to secure approximately Y5.0tn in funding each year, the political cost of raising tax rates again in two years, and technical issues such as adapting cash registers and accounting systems to handle the new consumption tax rates. The introduction of refundable tax credits is the main focus and the emphasis on the consumption tax cut itself seems to be waning. In fact, the Economic Policy Uncertainty Index (provides relative assessment of articles related to fiscal clarity based on newspaper reports) rose temporarily in January, but has been declining since March and it has not reached the levels seen during the sharp spike for super-long JGB yields last spring.

Chart 2: Japan Economic Policy Uncertainty Index



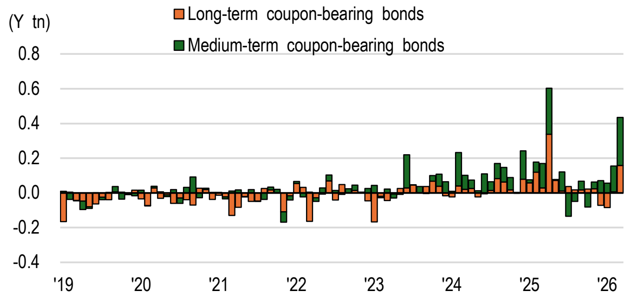
Source: Research Institute of Economy, Trade and Industry's Japan Economic Policy Uncertainty Index; compiled by Daiwa.

Supply/demand factors underpinning medium-term JGBs

Since the agreement reached in early April between the US and Iran aimed at a ceasefire, the situation in the Middle East has passed its peak of pessimism. The pause in the rise of overseas bond yields (mainly USTs) has also served as a factor supporting the entire JGB yield curve. Furthermore, while this is a different issue from that of super-long JGBs, supply/demand factors can also be identified within the medium-term zone. According to March statistics on JGB trading volume by category of investors, net purchases of medium- and long-term JGBs by life and non-life insurers reached their highest levels since April 2025 (Chart 3). As for life insurers, it was noted that demand for super-long JGBs has declined due to the completion of regulatory compliance efforts and the need to shorten asset durations in response to rising yields. In addition to these factors, there has been an increase in single-premium insurance policies, which are expected to have relatively short durations on the liability side. There is a possibility that demand from life insurers for medium/long-term JGBs is increasing (Chart 4).

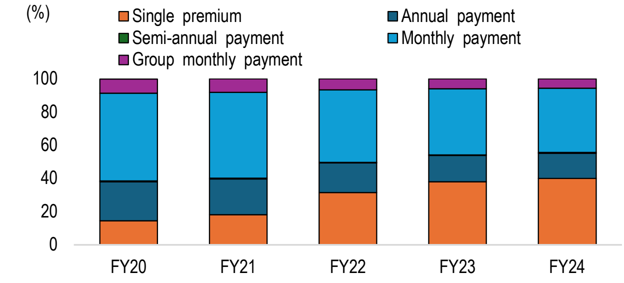
In addition to life insurers, during periods of rising stock prices and falling bond prices, bond purchases are expected to come from pension funds rebalancing their portfolios through trust banks. Driven by market optimism regarding the situation in the Middle East and expectations for AI-related demand, stock prices have resumed their upward trend. Trust banks are likely to continue purchasing core maturities on the index, such as 5-year and 10-year bonds. Given the current interest rate hiking phase, such demand trends are not expected to have enough impact to reverse the rising trend for medium/long-term yields. This is also likely to contribute to a certain sense of reassurance regarding yield stability.

Chart 3: Net Purchases of Medium- and Long-term Bonds by Life and Non-life Insurers



Source: Japan Securities Dealers Association; compiled by Daiwa.

Chart 4: Breakdown of Life Insurers' Premium Income by Payment Method (individual insurance)



Source: Life Insurance Association of Japan; compiled by Daiwa.

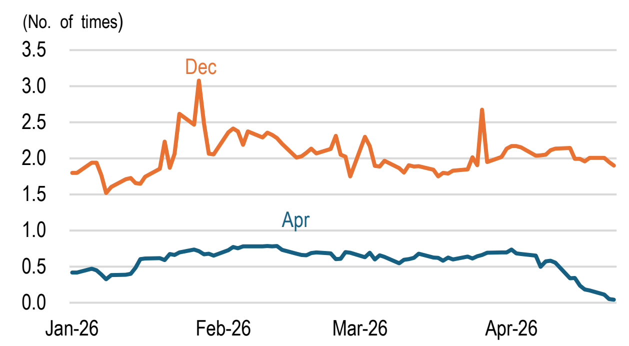
Skillfully managing rate hike expectations

And, above all, it appears that the BOJ has skillfully succeeded in managing market expectations at this juncture. Even though the probability of a rate hike in April has fallen significantly, the market continues to price in nearly two rate hikes by the end of this year. According to sources familiar with the matter, in addition to postponing a rate hike in April, the Bank is reportedly considering raising the inflation forecast in its April *Outlook Report*. Also, at Governor Ueda's press conference following the G20 summit, he maintained the Bank's rate-hiking stance, based on the assessment that real interest rates, including those in the medium-term zone, remain extremely low. Given the extremely high level of uncertainty surrounding the US/Iran negotiations, which changes on a daily basis, and with major central banks (US, Europe, and UK) also expected to keep their policy rates unchanged in April, a BOJ decision to hold off on hiking rates would not be surprising at all. The market understands that this does not raise concerns about "falling behind the curve."

Inflation expectations as cause for concern

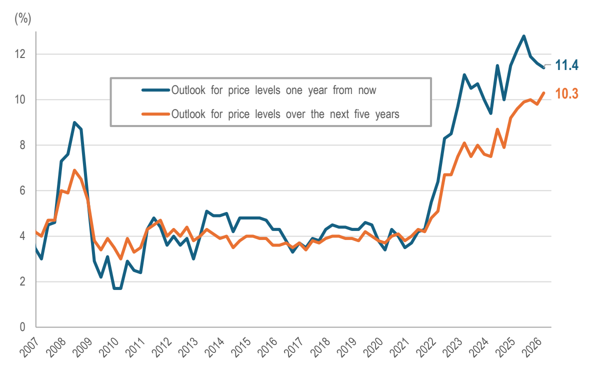
Meanwhile, there are also some causes for concern. According to the Opinion Survey on the General Public's Views and Behavior released on 20 April, while short-term inflation expectations have declined, long-term inflation expectations have risen again, reaching their highest level since these records started. The survey period was from 4 February to 9 March and it has not been disclosed whether the responses were collected before or after the start of the Iran conflict, which erupted on 28 February. That said, given that survey responses tend to be concentrated in the first half of the survey period, it is possible that inflation expectations were rising regardless of the conflict. Of course, we cannot draw definitive conclusions based on a single set of soft data. However, the rise for long-term inflation expectations, even as short-term expectations stabilize, suggests that inflationary sentiment may be taking a firm hold amid sustained price increases exceeding 2%.

Chart 5: Number of Implied Rate Hikes by Apr and Dec Meetings



Source: Bloomberg; compiled by Daiwa.

Chart 6: Consumer Inflation Expectations



Source: BOJ; compiled by Daiwa.

Actions/credibility put to the test

As such, the BOJ has gained some breathing room until its 15-16 June meeting. By that time, the main scenario is likely to be that negotiations between the US and Iran will have made progress, ensuring a certain degree of freedom of navigation in the Strait of Hormuz, which currently serves as a bottleneck for the global economy. Expectations cannot remain indefinitely. As our Chief Market Economist Kenji Yamamoto noted in his 23 April *Daiwa's Economic View*, credibility can only be secured through concrete action. Personally, the authors believe that a 10-year JGB yield in the mid-2% range offers good investment value, provided that the BOJ proceeds with rate hikes at an appropriate pace and fiscal policy remains sustainable. Next week's monetary policy meeting, held just before Japan's Golden Week holiday, will be a critical moment in which the market will test the likelihood of the BOJ "taking action."

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