Japan Market Insight

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Mitsubishi UFJ Trust and Banking Corporation

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Upward Trend in Japan's Long-Term Interest Rates is Set to Pause

While long-term interest rates in Japan rose notably in 2026, they appear to have leveled off recently (Exhibit 1). While I believe there remains some risk that the upward trend in Japanese long-term interest rates could resume, the phase of the rising long-term rates has essentially paused for the time being. The reasons for this can be summarized as the following five points.

First, the Japanese government has shown a certain degree of consideration in response to concerns regarding fiscal health. Although the Takaichi administration has decided to lower the consumption tax rate on food items from the current 8% to 1% for a limited period of two years starting in April 2027, it has indicated that it will secure the necessary funding—not through deficit-financed government bonds—but through a review of subsidies and special tax measures, as well as additional non-tax revenues. Furthermore, the Takaichi administration has set a fiscal consolidation target of reducing the debt-to-GDP ratio and is likely to conduct policy management with an eye toward fiscal sustainability (Exhibit 2).

Second, the U.S. Government is stepping up its intervention efforts to curb the rise in long-term U.S. interest rates. On July 31, the Japanese and U.S. governments jointly conducted foreign exchange intervention to curb the pressure for a weaker yen and a stronger dollar. In the case of unilateral foreign exchange intervention by the Japanese government, there is a risk that Japan would sell large quantities of U.S. Treasury bonds held as foreign exchange reserves, the U.S. government may well have cooperated with the intervention for this reason. Furthermore, on August 19, the U.S. Treasury announced an expansion of buybacks targeting long-term bonds (10–20 years and 20–30 years), clearly signaling its intention to curb the rise in U.S. long-term interest rates. From September 9 to November 4, the Treasury plans to double the maximum amount per operation from the previous $2 billion to at least $4 billion. Given the recent surge in corporate bond issuance by U.S. companies to finance large-scale investments in AI and data centers, the supply-demand balance for U.S. Treasuries is unlikely to improve dramatically through buybacks alone, however, we believe that if upward pressure on U.S. long-term interest rates eases, upward pressure on Japanese long-term interest rates will also weaken. The underlying trend in U.S. prices does not suggest a resurgence of inflation, and in addition to the growing likelihood that the Fed will refrain from raising rates this year, the U.S. Government's intensified efforts toward fiscal consolidation will likely provide some support for U.S. Treasuries (I expect the Fed to hold off on policy changes for the time being).

Third, with the U.S. mid-term elections approaching on November 3, 2026, the situation in Iran is highly likely to stabilise as President Trump seeks to recover his flagging approval ratings. President Trump's approval rating has fallen to 33%—its lowest level since the start of his second term (according to an Ipsos survey conducted August

14–17)—and he likely believes that lowering oil prices as quickly as possible is necessary to recover his approval rating. If the situation in Iran stabilizes, upward pressure on long-term interest rates stemming from inflation concerns will likely ease.

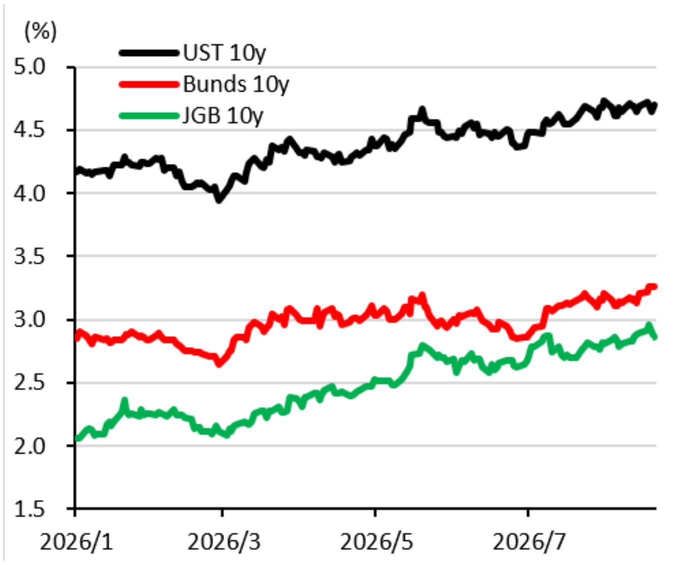
Fourth, against the backdrop of upward price pressure risks stemming from yen weakness and high oil prices, as well as calls from the U.S. Government for interest rate hikes, the market has already fully priced in aggressive rate hikes by the Bank of Japan. The market is pricing in the possibility that the Bank of Japan will raise interest rates by 0.25% by October, with the policy rate ultimately raising to around 2.4% (Exhibit 3). Although there is a risk that the BOJ could raise rates more aggressively than currently priced in by the market if the weakness of yen accelerates once again, given the stance of Japanese and U.S. authorities on currency intervention, the likelihood of a renewed acceleration in the yen's depreciation is low; therefore, we view the market as having already fully priced in the BOJ's aggressive rate hikes (I expect the BOJ to raise rates in September).

Fifth, there is a growing likelihood that tax incentives for retail government bonds will be included in the tax reform for the fiscal year 2027. One major factor behind the recent rise in interest rates has been the reduction in the Bank of Japan's holdings of government bonds, as well as the decline in demand for government bonds from domestic financial institutions—such as banks and life insurance companies—compared with the past. Looking ahead, if even 10 percent of the approximately 1,100 trillion yen in cash and deposits held by households were shifted to government bonds, demand for government bonds could exceed 100 trillion yen (Exhibit 4). Given that the outstanding balance of government bonds exceeds 1,000 trillion yen, the impact on supply and demand would be substantial.

Recently, against a backdrop of fiscal concerns under the Takaichi administration, the Japanese market has frequently seen simultaneous yen weakness and falling bond prices (rising interest rates). In other words, it would be natural to expect that if the rise in long-term interest rates were to pause, the trend of yen weakness would also take a breather. Regarding USD/JPY exchange, we expect it to stabilize within a range centered on the upper 150-yen level as upward pressure eases, driven by heightened vigilance regarding currency intervention and the easing of fiscal concerns under the Takaichi administration.

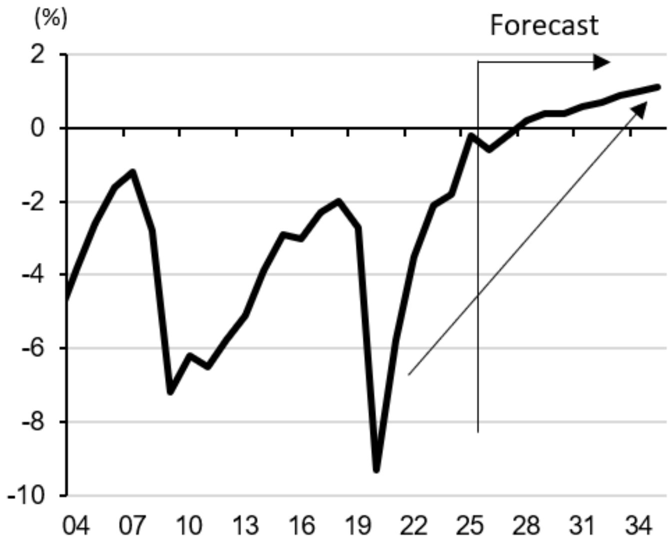
We view the pause in the rise of long-term interest rates and stabilization of the foreign exchange market as positive developments for the Japanese equity market. This is because, for some foreign investors who do not hedge currency exposure, the acceleration of yen weakness had become a major risk factor for investing in Japanese equities. Furthermore, should long-term interest rates continue to rise, this would pose a risk of significant valuation corrections for growth stocks—such as those in the semiconductor and AI sectors—, while real estate stocks would face an increased risk of deteriorating earnings due to rising borrowing costs. Looking ahead, given that the earnings of Japanese companies are generally solid, we can expect foreign investors to actively invest in Japanese equities, while we may also see a rebound in real estate stocks, which have been underperforming.

Exhibit 1: Long-Term Interest Rates in Japan, the U.S. and Germany



Source: Bloomberg, MUFG: Trust Bank

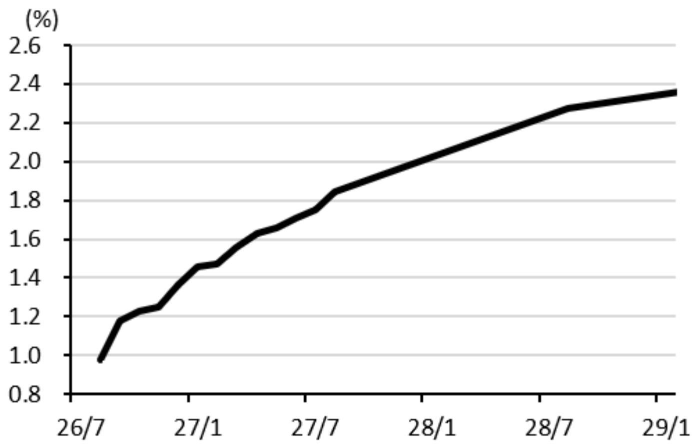
Exhibit 2: Japan's Primary Balance



Source: Cabinet Office, MUFG: Trust Bank

Note: A case of the Takaichi administration's growth strategy being put into practice

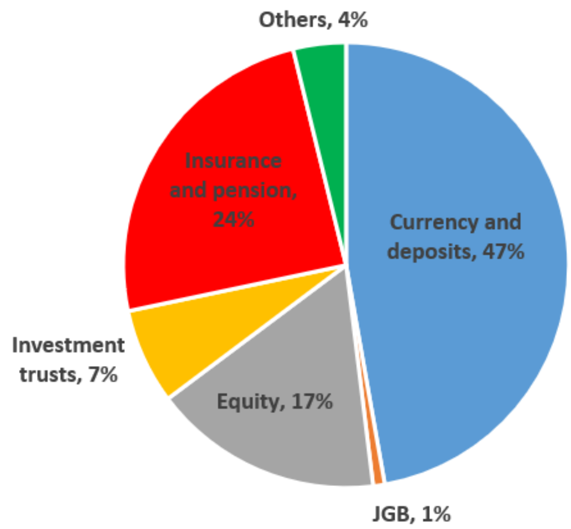
Exhibit 3: The OIS Market's Outlook for the Bank of Japan's Policy Rate



Source: Bloomberg, MUFG: Trust Bank

Note: As of August 20, 2026

Exhibit 4: Composition of Household Financial Assets (As of March 2026)



Source: BOJ, MUFG: Trust Bank

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