

From Japan with love: New policy stance creates both market opportunities and liquidity risks

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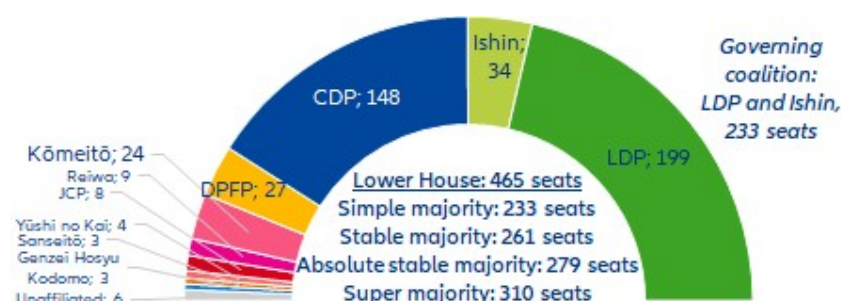
In Summary

- **The major sell-off on the long end of the Japanese sovereign yield curve is not a “Truss moment” but signals a bumpy final stage of Japan’s monetary normalization.** Just three months into her premiership, Prime Minister Sanae Takaichi dissolved the Lower House, aiming to convert her high personal approval ratings into a firmer mandate for her governing coalition and approve a more expansive FY2026 budget bill by 31 March. Snap elections will be held on 8 February. But her campaign promise to suspend the food tax, alongside potentially higher defense spending, could send Japan’s debt-to-GDP ratio up to 228% by 2050 (vs. 189% expected under the current draft budget and 200% in 2025), sparking market fears about Japan’s debt sustainability and the potential inflationary impact of the government’s fiscal stance. The long end of JGB yield curve shifted up 20-30bps in one session. If sovereign yields remain at current forward rates, the debt-to-GDP ratio would rise to 209% by 2050 under the FY2026 draft budget scenario, or 254% under the more expansive fiscal policy scenario.
- **Japan being a major external creditor means domestic bond market pressures can be exported to the global financial system through the liquidity channel.** Its Net International Investment Position of around +110% of GDP raises the risk of a JPY-driven deleveraging. If JGB yields remain this high and volatile, we could see a downside scenario emerge where a JPY-led deleveraging wave forces sales of US treasuries and sell-off in US equities. We see the breaking point in a sudden shift of US Treasuries to around 5%. The biggest risk remains the depressed funding conditions in Japan, which are already at levels that coincided with US equity sell-offs (-15% per month) and volatility spikes in the past.
- **Positioning on the JGB curve: from the “widow maker” to the Takaichi trade.** For decades Japan was “Zeroland”: zero policy rate, zero bond yields, zero borrowing cost. With the BoJ controlling the entire yield curve, betting against the Japanese bond market was known as the “widow maker trade”. But the tide is turning following the normalization of monetary policy that began in 2024. We expect a terminal rate of 1.5% by end-2027; quantitative tightening should continue while FX interventions should be balance-sheet neutral. After the recent bond market sell-off, we see short-term opportunities in the context of the BoJ’s normalization and Takaishi’s likely upcoming policies: We expect some flattening at the long-end of the JGB curve, while issuance pressure shifting to the 5y to 10y segment should result in some steepening pressure on the belly. Holding Japanese bonds also becomes a carry-yielding hedge against macro volatility as they would benefit from a global risk-off and carry-trade deleveraging.
- **With recent central bank interventions, the JPY has also returned to the center stage of global FX markets. But this is not the only reason for USD weakness.** It is rather the latest episode of an underlying USD depreciation trend reflecting a mix of rising policy uncertainty, de-dollarization, fiscal dominance fears and global deleveraging.

Prime Minister Takaichi’s risky gamble: snap election on 8 February

Just three months into her premiership, Prime Minister Sanae Takaichi has dissolved the Lower House of Japan’s National Diet, with a snap general election to be held on 8 February. The timing is tight, especially as the FY2026 budget needs to be approved by the end of March (ahead of the start of the new fiscal year), and the official campaign period will last just 16 days (the shortest since World War II). Takaichi aims to convert her unusually high personal approval ratings into a firmer mandate for her new Liberal Democratic Party (LDP) – Japan Innovation Party (Ishin) governing coalition, framing it the vote as a plebiscite on her economic and security agenda, and the coalition’s “responsible and proactive” fiscal line.

Figure 1: Current composition of the Lower House of the National Diet of Japan



LDP = Liberal Democratic Party; Ishin = Japan Innovation Party; CDP = Constitutional Democratic Party; DPFP = Democratic Party for the People; JCP = Japanese Communist Party

Sources: national sources, Allianz Research

The most likely scenario is that the governing coalition will strengthen its currently razor-thin majority, though fall short of a super majority (see Figure 1). First, Takaichi’s personal numbers are strong (around 60-75% across major polls) and the short campaign favors an incumbent who can set the agenda. Second, party-level polls and district-by-district maps still suggest a narrow path to a landslide. At the same time, the LDP’s popularity (around 30%) trails far behind Takaichi’s, and its road to a standalone majority is likely tight as the new Centrist Reform Alliance (composed of the Constitutional Democratic Party and Komeito – the LDP’s former long-time coalition partner) improves opposition-candidate coordination in single-member districts and keeps the race competitive in urban and suburban seats. All in all, the ruling LDP-Ishin coalition is most likely best positioned to strengthen a working majority (at least 233 seats), but a two-thirds super-majority (at least 310 seats) – needed to overturn a decision by the Upper House, where the ruling coalition does not hold a majority – looks unlikely. Should Takaichi lose her snap election gamble and the LDP-Ishin coalition lose its majority in the Lower House, the government would have to cooperate with opposition parties to pass key bills, reviving the coalition arithmetic that has dogged Japanese governance since 2024. Cooperation with the opposition could potentially lead to further fiscal spending, as occurred during the FY2025 supplementary budget negotiations in late-2025, when the government conceded the abolition of the gasoline tax surcharge to the opposition.

Japan’s fiscal policy will become more expansive...

The dissolution of the Lower House will postpone the start of the FY2026 budget approval process, which must be concluded by late March. The draft bill was originally expected to be presented at the opening of the Lower House ordinary session on 23 January, marking the start of deliberations. However, parliamentary debate will now not be able to begin until mid-February after the snap election, leaving very limited time for both chambers to examine the bill, as the Lower and Upper Houses each have 30 days to deliberate. If the FY2026 budget cannot be passed by the 31 March deadline, the government will need to adopt a provisional budget while discussions continue, a situation that has occurred in the past.

The latest version of the FY2026 draft budget was officially approved by the Cabinet in late December 2025 and projected a primary surplus of JPY1.3trn (0.2% of GDP) – though that is unlikely to remain the case once the governing coalition extends its majority. Overall, expenditures are expected to reach JPY122.3trn (18.6% of GDP), 56% of which is allocated to social-security expenditures, while revenues (excluding bonds) are expected to reach JPY92.7trn (14% of GDP) and bond issuance to reach JPY29.5trn (4.6% of GDP). The FY2026 draft budget’s focus

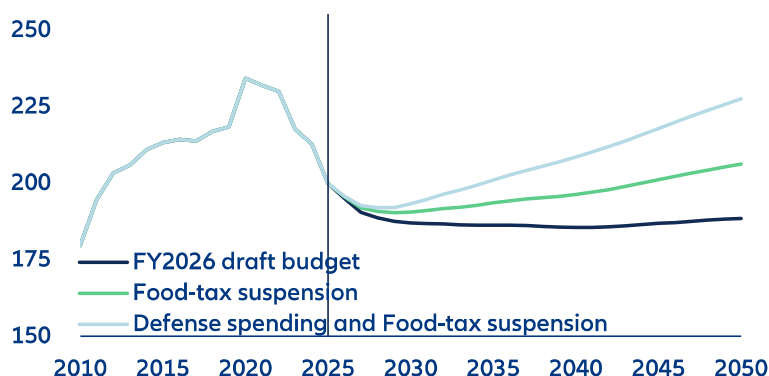
points are in line with measures enacted under the FY2025 supplementary budget, with additional spending devoted to free education measures (including expanded tuition grants and free school lunches) and significantly increased allocations to the energy special account, which rises to JPY2.8trn (0.4% of GDP). Within this account, most of the additional funding is directed toward AI and semiconductor-related initiatives. Finally, despite being frequently cited as a core government priority, the defense budget does not see a substantial increase in the FY2026 draft budget and remains at 1.4% of GDP, representing 28% of the non-social security expenditures after a sizeable JPY1trn rise (+0.2% of GDP) already incorporated into the FY2025 budget.

The food-tax suspension, promised by Takaichi when announcing the snap election, would cost JPY5trn (0.8% of GDP) per year and we expect it to become permanent if implemented. During a recent pre-electoral intervention, Takaichi vowed to suspend for two years the 8% food consumption tax, which applies on a category of goods already benefiting from a reduction from the 10% general rate. As the food tax accounts for 7% of government revenues under the FY2026 draft budget, we estimate the measure will create a shortfall of JPY5trn (0.8% of GDP). This would widen the primary deficit to -0.6% of GDP in 2026 and -1.1% in 2027. If implemented, we do not expect the government to reinstate the tax in 2028 as doing so would be politically costly; the measure would therefore continue to weigh on Japan's public finances beyond the initially announced two-year window.

A reinforced governing coalition under Takaichi will also likely push for further defense spending, aiming for 3% of GDP by 2030 (from 1.4% currently). Among future policy priorities, the new Diet composed of a stronger governing coalition is likely to place greater emphasis on defense expenditures, particularly to achieve the stated target of 2% of GDP by 2027, as the FY2026 draft budget currently allocates only 1.4% of GDP. Further discussions are expected around June 2026 during the annual long-term growth strategy review, while additional increases could be introduced toward the end of 2026 as part of the supplementary budget process. All in all, we expect the final FY2026 budget to include upward adjustments in line with recent campaign commitments and government objectives. Beyond 2026, we also anticipate that Japan will continue to strengthen its defense posture, with spending rising toward 3% of GDP by 2030, broadly in line with the trajectories observed in other advanced economies, following the US lead.

While the FY2026 draft budget still allows the debt-to-GDP ratio to decline in the coming few years and stabilize in the long run, the food tax cut as well as increased defense spending would bring debt-to-GDP back to its pandemic highs by 2050. Compounded with higher sovereign yields as implied by current forward rates, the debt-to-GDP ratio would reach fresh record highs by 2044 in the most expansive scenario. From 200% in 2025, we expect the debt-to-GDP ratio to reach 189% in 2050 under the current FY2026 draft bill. The forecast would increase to 206% if the food-tax suspension goes through, and further to 228% if defense spending is also raised to 3% of GDP (see Figure 2). By 2030, the government's fiscal choices would result in a deviation of +5.1pps in the case of the food-tax suspension and +9.7pps in the combined scenario, relative to the current FY2026 draft budget baseline. However, fiscal policy in itself does not appear to be the only risk to Japan's debt sustainability. Recent campaign commitments by Takaichi have pushed 10-year forward rates higher, as markets grow concerned about the government's fiscal stance and the potential inflationary impact of the proposed measures. While we expect rates on the ultra-long end to ultimately ease, it is possible that recent developments have weakened market confidence in the government and in Japan's fiscal outlook. If sovereign yields were to remain at levels as implied by current forward rates, we estimate the debt-to-GDP ratio would rise to 209% by 2050 under the FY2026 draft budget scenario, and further to 228% under the food-tax suspension scenario and to 254% under the combined scenario (see Figure 3). A sustained loss of market confidence would therefore raise the debt-to-GDP ratio by roughly +25pps across all scenarios at the 2050 horizon, as higher rates result in costlier debt servicing.

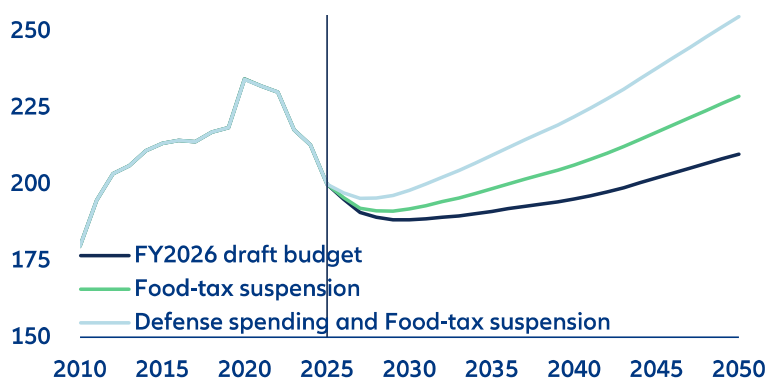
Figure 2: Debt-to-GDP ratio simulations



Notes: The food-tax suspension amounts to an additional +0.8pp of primary deficit every year, defense spending in line with the 2% of GDP target by 2027 and 3% of GDP from 2030.

Sources: Ministry of Finance, Allianz Research

Figure 3: Debt-to-GDP ratio simulations with interest rates as implied by forwards' rate



Note: Interest rates are adjusted using the 10yr forward rates for the first 5 years and remain flat thereafter.

Sources: Ministry of Finance, Allianz Research

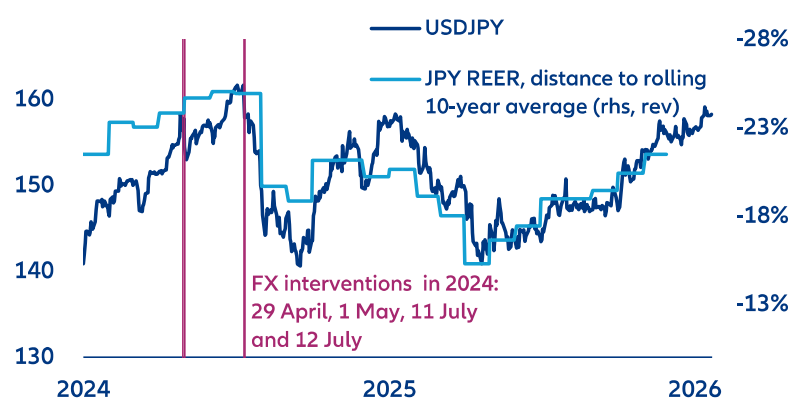
...while the Bank of Japan should maintain its rate-hiking path

The Bank of Japan stayed put at its 22-23 January monetary policy meeting but delivered a hawkish tone – in line with our scenario of another rate hike this year (potentially earlier than our current forecast of July) and a terminal rate of 1.5% by end-2027. Quantitative tightening plans are likely to be maintained, and likely intervention on the FX market to cap JPY weakness should be balance-sheet neutral. The Statement on Monetary Policy and the Outlook Report released after the 22-23 January meeting signaled confidence that underlying inflation will remain around (or slightly above) the 2% target as wage and service-price dynamics firm up. The BoJ's economic projections were revised up for both GDP growth and core inflation in FY 2025 and FY2026. Hard data also still support a gradual-tightening bias for the monetary policy: while nationwide CPI softened to 2.1% in December 2025 (from 2.9% the previous month), core inflation remained at a robust 2.4%. The wage backdrop is set to stay supportive and consistent with the BOJ proceeding with monetary policy normalization: Japan's largest union confederation Rengō is again demanding more than 5% wage increase in the 2026 shuntō, following two consecutive years of above 5% negotiated pay hikes. In this context, and with fiscal policy likely to be more expansionary after the snap election, our scenario for the BOJ remains unchanged: we expect the policy rate to be raised by 25bps in July 2026 (although recent news raise the risk of an earlier hike), followed by two further 25bps hikes in 2027, reaching 1.5% by end-2027. The exact timing of rate hikes may be adjusted, should FX dynamics or other factors materially alter the inflation outlook. Regarding the BoJ's balance sheet, we expect the central bank

to proceed with its announcement rhythm of quantitative tightening (QT) (i.e. JGB purchase rhythm to slow from current JPY3trn per month to JPY2trn per month by Q1 2027). QT has been a hidden driver of JGB long-term yields adding 100bps to the term premium since 2024 (Figure 7).

As central bank interventions to cap the JPY might become more frequent, Japan has returned to the center stage of global FX markets. History suggests USDJPY at 160 could be the intervention pain point. Mid 2024, the USDJPY pressed new 38-year highs and authorities confirmed JPY-buying rounds totaling JPY16trn (Figure 4). Following Takaichi’s snap election announcement, USDJPY had been trading around 158. On 23 January a suspected intervention (potentially joint with the US) as well as further communications from Japanese officials have brought down the USDJPY to as much as 153 (the strongest since early-November). The trade-weighted JPY is still well below long-run averages and beyond defending specific levels for the USDJPY, the aim of FX intervention may be to prevent rapid and disorderly movements in markets (Figure 4). Japan’s more active FX policy puts additional pressure on an already weak USD which is taken in a general depreciation trend reflecting a mix of rising policy uncertainty, de-dollarization, fiscal dominance fears and global deleveraging. Behind short-term moves, the USD weakness is increasingly driven by tighter bank intermediation (balance sheet constraints), with narrowing cross-currency basis spreads, reduced foreign recycling into US Treasuries and rising repo volatility. This reinforces a structural soft USD narrative determined by funding and collateral channels rather than pure macro policy signals.

Figure 4: USDJPY and JPY real effective exchange rate



Sources: LSEG Workspace, Bank of Japan, Allianz Research

Strong market reactions: not Japan’s “Truss Moment”, but a risk for global liquidity

A surge in JGB yields tightens global liquidity, increasing the risk of a rapid deleveraging wave. Following the announcement of snap elections, the long end of the Japanese Government Bond (JGB) yield curve (10y to 40y) saw a major sell-off, shifting up 20 to 30bps in one session. This is a very rare shock in G20 markets, reminiscent of the UK’s “Truss Moment” in the Gilt market. The spike in JGB yields was said to be a market reaction too increased fiscal policy risk. But given the low volumes that triggered the market move it resembled more a speculative squeeze. Either way, the typical debt-crisis framework does not apply to Japan. Unlike debtor countries such as the UK, Japan is a massive external creditor (net international investment position of +110% of GDP) so it can digest the pressure on its domestic bond market by exporting volatility to the global financial system via the liquidity channel. As long-dated JGB yields rise, Japanese banks absorb more JGB; their balance sheets shrink with falling asset prices and rising funding costs. With weaker balance sheet capacity, they demand fewer USD, which impacts JPY-funded activities via derivative markets, hedge funds and cross currency swaps, which in turn tightens global liquidity. This explains the strong relationship between the 30y JGB and US funding stress (i.e. repo volatility) (Figure 5)

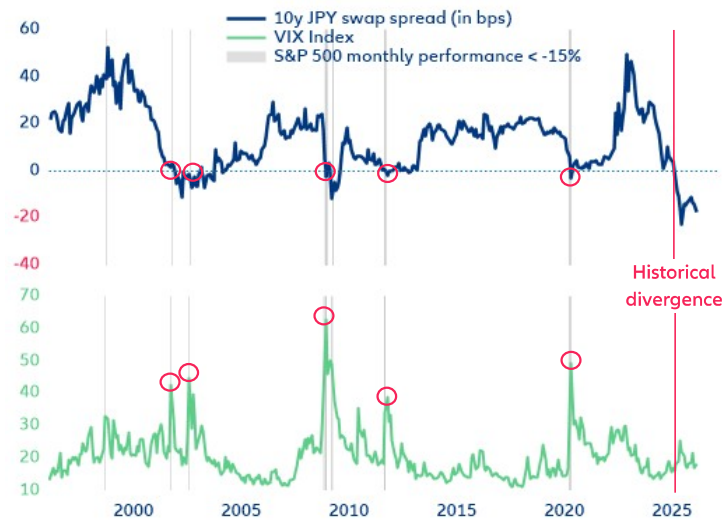
Figure 5: Stress in LGB markets is spilling over to global liquidity conditions



*Defined as 12-months volatility of the spread between USD 3M SOFR minus Effective Funds Rates
Sources: LSEG Workspace, Allianz Research

If JGB yields remain this high and volatile, we could see a downside scenario emerge where a JPY-led deleveraging wave forces sales of US treasuries and sell-off in US equities. We estimate that 1bps shock in 10y JGB causes a 0.3bps rise in US yields. The latest JGB sell-off therefore had a 10bps upside push for the US curve while recent economic data would have suggested the opposite. This is not yet enough to trigger a significant such risk-off moment (the breaking point would be sudden shift to around 5% vs 4.2% today). The biggest risk come from the depressed funding conditions in Japan (i.e. illustrated by the 10y swap spread). They are already at level that in the past coincided with US equity sell-offs (monthly performance below -15%) and volatility spikes (Figure 6). If they deteriorate further leverage could come down fast, investors sell risky carry assets and buy back the funding currency. For now, despite the recent FX intervention, the USDJPY level suggests short yen positions are not being covered yet. But every upside tick of JGB yields creates additional volatility pressure. The yield surge at the long end of the JGB curve is a risk gauge for equity volatility.

Figure 6: Weak JPY funding conditions usually trigger US equity volatility. Are we overdue?

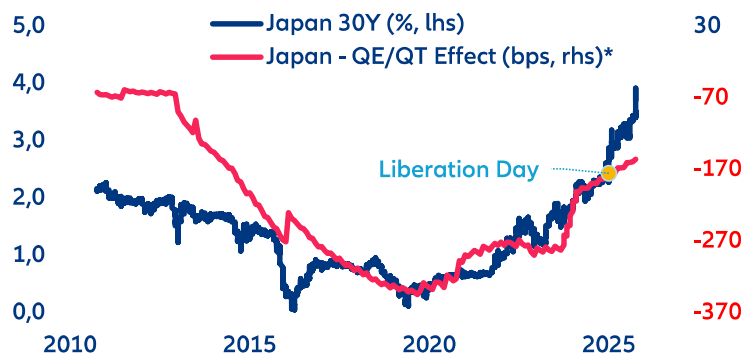


Sources: LSEG Workspace, Allianz Research

In the longer run, Japan's role in dampening volatility will diminish, contributing to a more fragile global financial system with structurally higher volatility as bond markets become more domestic again.

The meltdown of Japanese bonds also signals the final stage of the normalization experiment. With the BoJ still holding more than 50% of outstanding JGB volumes, yields are as much a message as a price. Until “Liberation Day”, the rise in JGB 30y yields was following duration re-injection operated by the BoJ through its quantitative tightening (QT). We therefore see the decoupling at “Liberation Day” not as a loss of control but as orchestrated or at least as a tolerated normalization experiment: let yields move higher, let banks earn the curve, incentivize reflows into the domestic market to support the JPY while building a buffer for the next downturn (Figure 7). The recent yield spike and the FX intervention are signals that the experiment may come to an end. We are already in a late-cycle moment with JGB yields at cyclical highs, peak equity market valuations and a weak JPY. However, with a 2y yield trading at 1.2%, the assumptions built on Japan staying pinned to zero forever are definitely priced out.

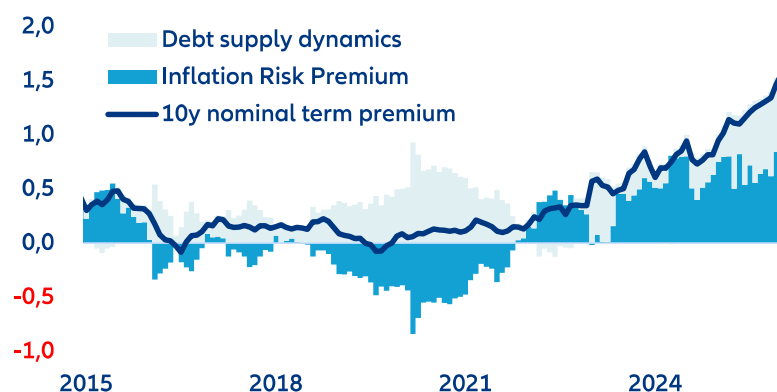
Figure 7: Surge of long-term JGB yield started with “Liberation Day”



*Based on AACMY term structure model (Abrahams et al. 2016) and Li and Wei (2013) model for QE impact
Sources: Bank of Japan, LSEG Workspace, Allianz Research

Markets are repricing increased inflation risks for now but believe that further fiscal support is needed to maintain inflation. The rise in long-term JGB yields since 2024 is mainly driven (75%) by the term premium, which embodies higher inflation risk and debt-supply pressure (incl. QT effect). The inflation component represents a larger proportion of the yield moves than for other G4 countries. Investors seem to price in Japan’s specific inflation strategy based on wage increases rather than short-term stimulus or price subsidies. This inflation proves stickier and seems to have altered the deflationary mindset for now. The question is whether this wage and demand push is self-sustained or needs to be continually stimulated by the government. For now, market seems to believe that maintaining inflation rates requires more debt issuance (Figure 8).

Figure 8: Decomposition of the term premium for 10y JGB yield (in pp)



*based on AACMY term structure model (Abrahams et al. 2016)
Sources: Bank of Japan, LSEG Workspace, Allianz Research

As long as this perception holds, this will sustain upside pressure on the long end of the JGB curve, preserve a steeper curve and decrease the absorption capacity of the banking system. But the JGB market is walking a narrow line. Deflationary pressures shaped by debt, demographics and subdued global growth have not disappeared. The BoJ and the new government have to find a delicate equilibrium: normalize too fast and deflation returns; stimulate too little and the wage experiment fails. The real fragility in the Japanese bond market is thus the possible return to a deflationary equilibrium. The fight against deflation is baked into the institutional DNA of the BoJ. As soon as this risk arises it will not hesitate to cut rates, ramp up bond buying, reopen liquidity channels and cushion the curve. Japan was the last to re-enter the positive yield world; it might be the first to pivot.

Positioning on the JGB curve: from the widow maker to the Takaichi trade. For decades Japan was “Zeroland”: zero policy rate, zero bond yields, zero borrowing cost. With the BoJ controlling the entire yield curve, holding up to 53% of the outstanding volume, betting against the Japanese bond market was known as the “widow maker trade”. Since the lift-off in 2024, however, the JGB curve has become increasingly attractive, especially for European investors, with some short-term opportunities to position for the policy changes expected under the new government led by Takaishi. We expect JGB issuance pressure to shift away from the ultra-long end to the 5y to 10y segment (to while the 2y yield should at least stabilize as the differential with the policy rate already prices an ambitious BoJ hiking path. This could lead to some steepening pressure on the belly. On the long end we expect some flattening since the spike on the 30y and 40y should at least partly reverse. Compared to other G4 curves, the JGB curve remains very steep with the 10y30y spread being twice as steep as its German or US counterparts (130 vs 60bps). In the mid-term we still consider the long end (20y to 30y) of the JGB curve to be attractive, especially for Euro investors. Holding Japanese bonds also becomes a carry-yielding hedge against macro volatility as they would benefit from a global risk-off and carry-trade deleveraging.

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