Market Letter

Japan Bond Market Update

"Appropriate Monetary Policy Management" to Be Explicitly Included in the Government's Basic Policy

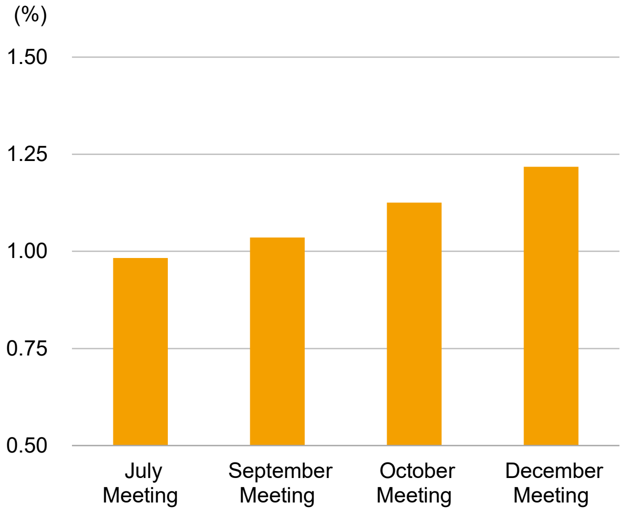
July 3, 2026

Economic Activity and Inflation Support Further Rate Hikes, but the Basic Policy May Constrain Further Tightening

The government has released a draft of its Basic Policy on Economic and Fiscal Management and Reform ("Basic Policy"), which is expected to be approved by the Cabinet as early as July. The draft strongly reflects Prime Minister Takaichi's policy agenda, including a plan to encourage more than 370 trillion Yen in public and private investment in 17 strategic sectors by FY2040. On monetary policy, the draft states that "appropriate monetary policy management is also extremely important for realizing a strong economy." It further calls on the Bank of Japan to "work closely with the government in line with Article 4 of the Bank of Japan Act and the spirit of the Joint Statement of the Government and the Bank of Japan." The market has generally viewed this wording as a message cautioning against further monetary tightening by the BOJ.

Nevertheless, recent economic developments have generally supported the Bank of Japan's path toward further policy normalization. The June Tankan survey, for example, showed an unexpected improvement in the business conditions DI for large manufacturing firms, despite concerns over the impact of developments in the Middle East. On the inflation front, there is growing concern that underlying inflation could remain above the BOJ's 2% target, driven in part by structural factors such as persistent Yen weakness. Based on economic and inflation fundamentals alone, additional rate hikes at roughly six-month intervals—as currently anticipated by the market—appear justified, with the risks skewed toward an earlier move. While we expect the next rate hike to occur at the December Monetary Policy Meeting, given the government's stance—which, as reiterated in the Basic Policy, could be interpreted as a caution against rate hikes—it is also necessary to be mindful of the risk that the hike could be delayed. In assessing the Bank of Japan's monetary policy, it is clear that political factors must now be considered alongside economic fundamentals. Against this backdrop, while the market has not fully priced in a 100% probability of an additional rate hike this year, long-term and ultra-long-term interest rates are facing upward pressure due to concerns over fiscal policy and inflation.

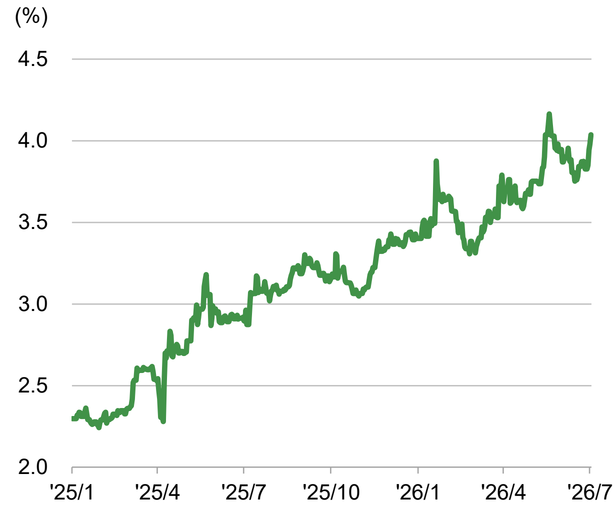
Market-Priced Policy Interest Rate Level



※As of July 2, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

30-Year Government Bond Yield



※Latest figure as of July 2, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

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