Japan as the Fuse, US as the Bomb

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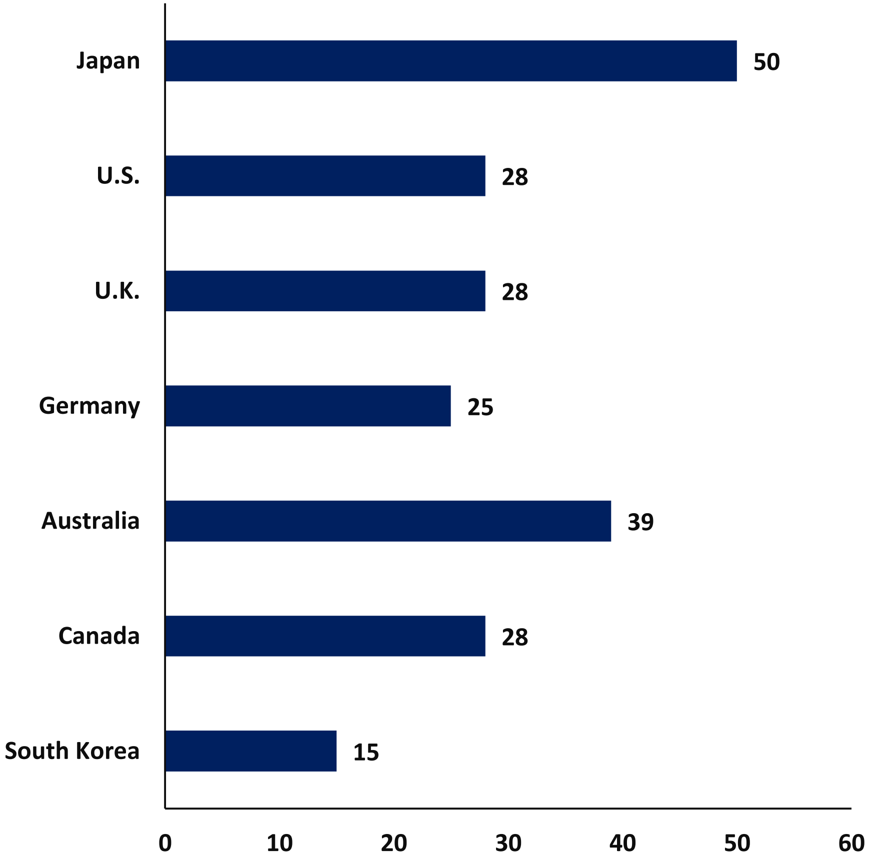
Fact Check

- Bank of Japan (BOJ) introduced Yield Curve Control (YCC) in 2016, to cap 10-year JGB yields ~ 0%, aiming to fight deflation & revive growth
- Unlike QE, which fixes asset purchase amounts, YCC targets a specific interest rate
- BOJ became the dominant player in the bond market, eventually holding ~52% of all JGBs
- BOJ was always committed to buying "as much as necessary" to maintain the yield level
- Policy began shifting in 2023: 10Y yield band widened from ±0.25% to ±0.5% in July, and 1% upper limit became a flexible reference in October
- In Mar'24, BoJ ended its negative rate policy, with two rate hikes of 25bps, highest since 2008
- July 2024 marked the start of Quantitative Tightening (QT), with a phased ¥400 billion quarterly cut in bond purchases
- **Result:** rising long-end yields and heightened bond market volatility, with IMF warning Japan of spill overs from rising foreign market volatility could affect liquidity conditions
- US Debt-GDP ratio has exceeded 100% with U.S. 10 & 30-year yields surging amidst debates over tax cut bill
- Rising US Treasury yields have ripple effects on global borrowing costs and debt servicing
- Rising JGB yields are incentivizing capital repatriation, especially by insurers and pension funds

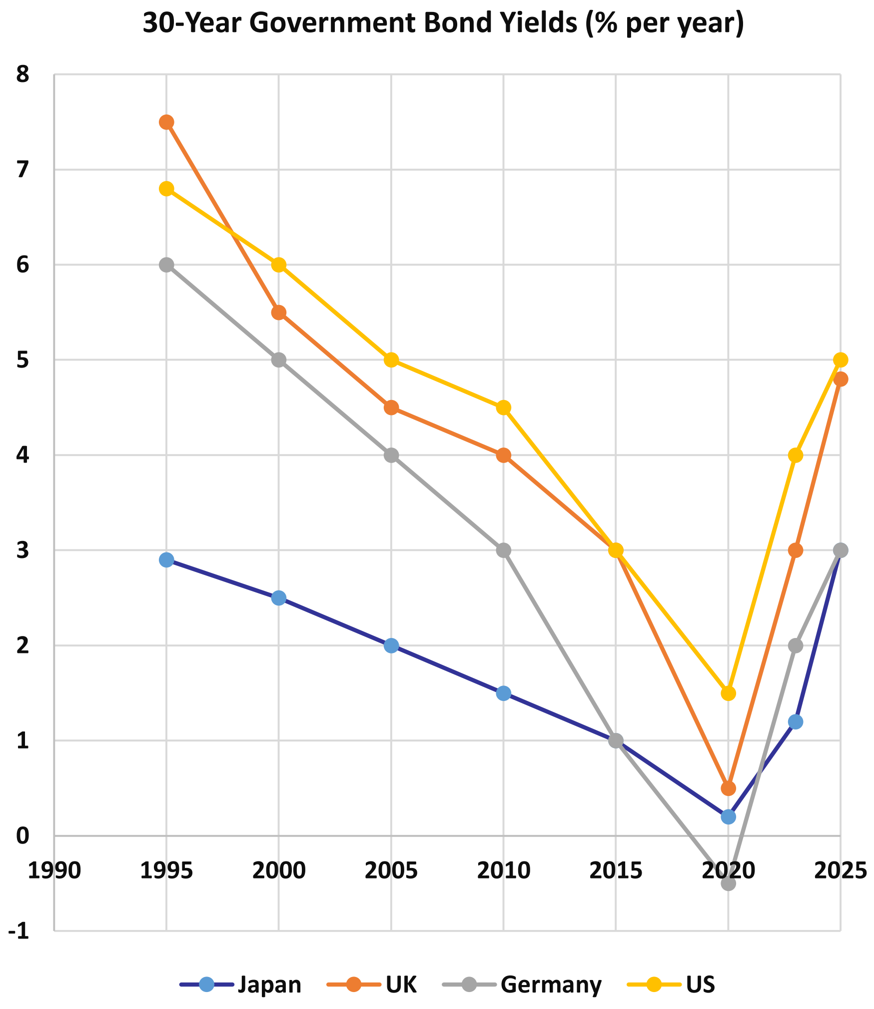
Japan Driving the duration crash
Rise in 30 year government bond yields over the past month (Basis Points)



Source: RTRS

Global Debt Pressures

- Japan's inflation is 3.6%, well above BoJ's 2% target and up from 2.7% a year earlier as of March 2025
- Japan's Debt-to-GDP ratio stands at 234.9%, among the highest globally, with nearly 25% of Japan's national budget is now allocated to debt servicing
- Japan avoided crisis due to its large domestic investor base and status as a net international creditor with strong foreign reserves
- 90% of public debt is held domestically by banks, pension funds, and insurers, reducing exposure to foreign creditor
- Japan holds over $1.1 trillion in U.S. Treasuries, making it the largest foreign holder of U.S. government debt
- Moody's downgrading US credit rating intensified investor scepticism
- Rising JGB yields incentivize Japanese investors to repatriate capital, reducing exposure to foreign assets like U.S. Treasuries leading to a shift in capital to domestic bonds
- This trend poses risks to U.S. bond markets, especially with rising Treasury issuance expected from Trump's proposed tax cuts
- Demand for long-duration U.S. Treasuries is weakening with erosion in global confidence in the U.S. dollar's reserve status adds further strain to Treasury demand
- Japan's portfolio rebalancing could exacerbate upward pressure on U.S. yields and increase global bond market volatility

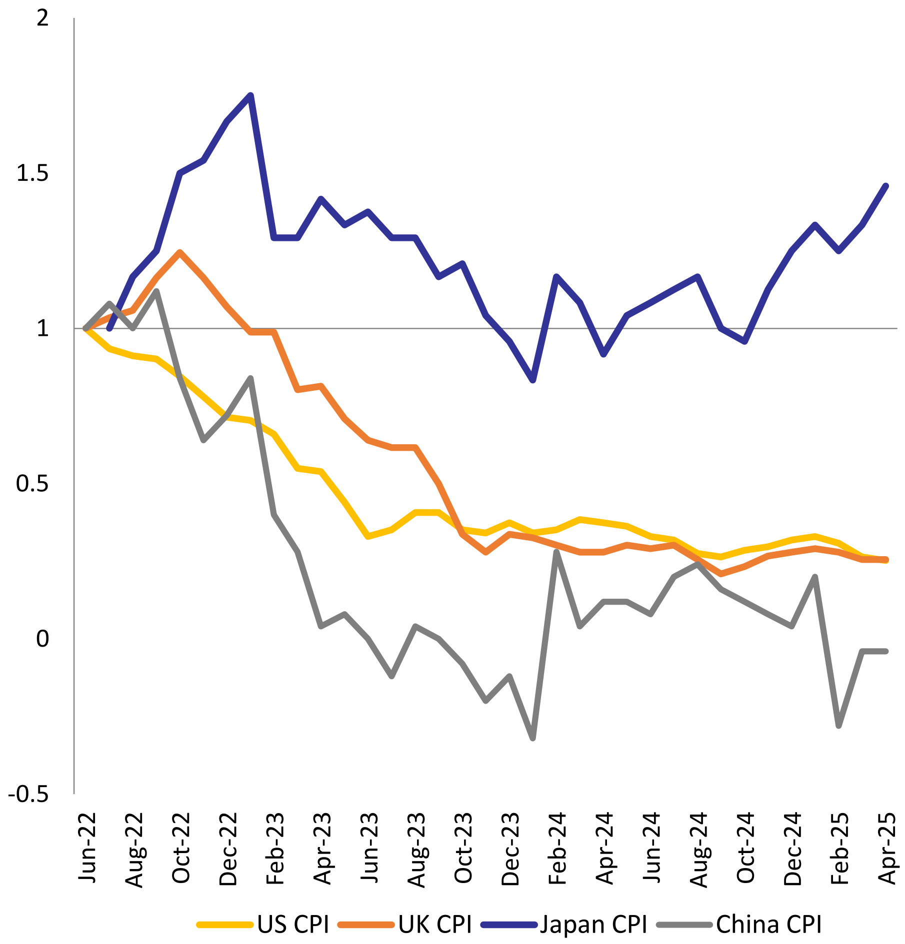


Source: RTRS

Investor Sentiment

- Situation in Japan is mirrored in US, where Treasury auctions are also showing signs of strain
- 30-year Treasury yield breached 5%, reflecting concerns over rising deficits and long-term borrowing capacity
- Moody's downgrading US credit rating intensified investor scepticism
- Similar fiscal strains are evident globally, with countries like the UK forecasting substantial deficits and experiencing rising bond yields
- Historical trends suggest prolonged yield spikes can slow economic growth and trigger recessions
- The bond sell-off signals investor uncertainty about the US fiscal path and inflation control.
- Investors are quite cautious, shifting from bonds to alternative assets amid uncertainty
- Intervening could undermine BoJ independence, blurring line between monetary and fiscal policy
- Non-intervention risks an uncontrolled yield spike, which could rapidly destabilize Japan's debt sustainability
- Japan's Debt-to-GDP ratio stands at 234.9%, among the highest globally, with nearly 25% of Japan's national budget is now allocated to debt servicing
- The most plausible path forward: inflate the debt away — accept above-target inflation, keep real rates negative, and reduce debt burdens gradually

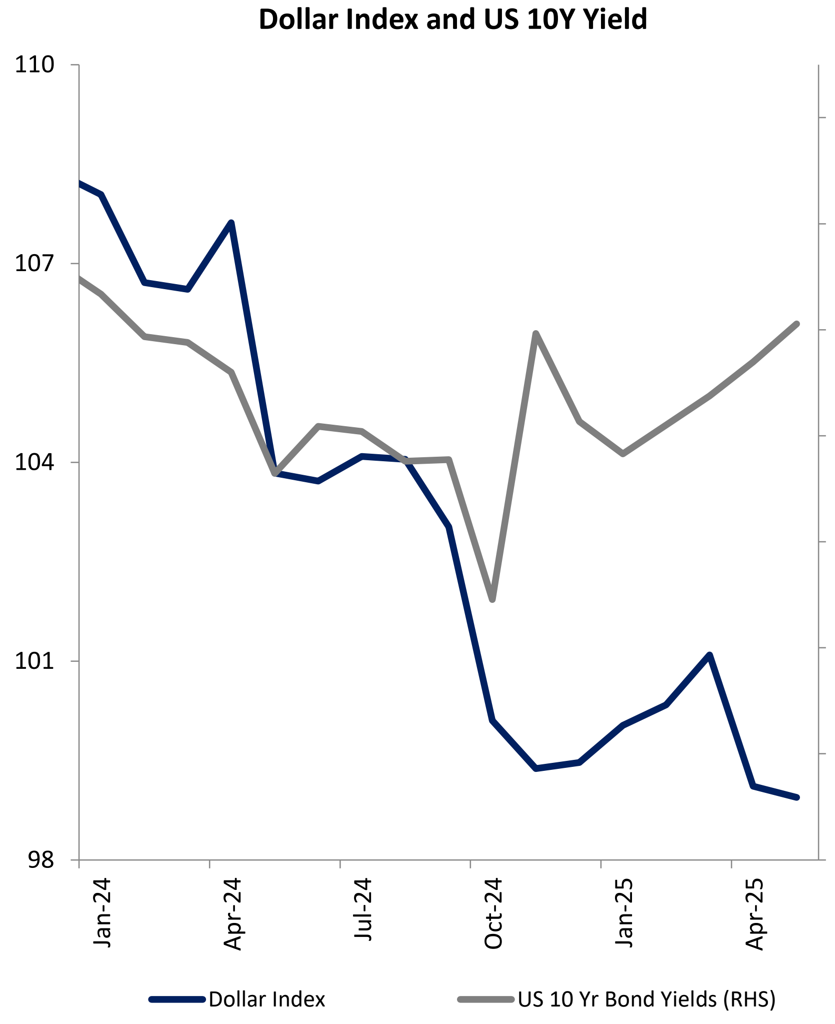
Inflation Trends of Major economies (Jun'22=1)



Source: RTRS

Outlook

- Japan's inflation is 3.6%, well above BoJ's 2% target and up from 2.7% a year earlier as of March 2025
- They avoided crisis due to its large domestic investor base and status as a net international creditor with strong foreign reserves
- Japan holds over $1.1 tln in U.S. Treasuries, making it the largest foreign holder of U.S. government debt
- This trend poses risks to U.S. bond markets, especially with rising Treasury issuance expected from Trump's proposed tax cuts
- Most plausible path forward: inflate the debt away — accept above-target inflation, keep real rates negative, and reduce debt burdens gradually
- Risks aren't confined to Japan — a disorderly JGB selloff could ripple through global markets
- At the same time, demand for long-duration U.S. Treasuries is weakening with erosion in global confidence in the U.S. dollar's reserve status adds further strain to Treasury demand
- Japan's portfolio rebalancing could exacerbate upward pressure on U.S. yields and increase global bond market volatility
- In an extreme scenario, this dynamic could trigger a flight to safety, resulting in a surge in demand for the U.S. dollar and precious metals, and weighing on riskier assets.



Source: RTRS

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