Daiwa's View

Market reaction after Upper House election, outlook for JGB market liquidity

- Upper House race resulted in significant loss of seats for ruling parties, but not as damaging as feared
- Expect downward pressure on super-long JGB yields if JGB liquidity index (that deteriorated sharply before election) improve
- With election now over, next key topics are tariff negotiations and BOJ interest rate hikes

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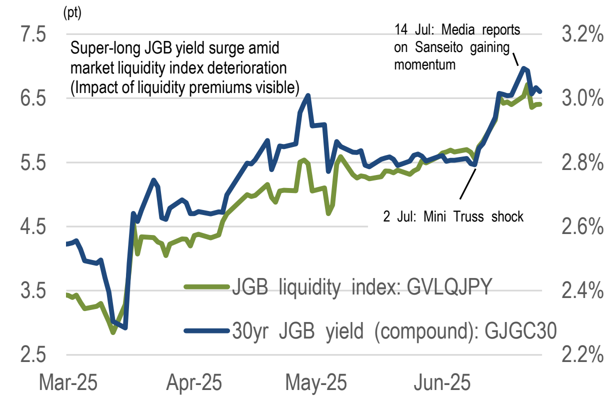
In the closely watched Upper House election on 20 July, the ruling parties suffered a significant loss of seats, dropping below the majority line. Criticism of the administration and its policies mainly bolstered the Democratic Party for the People (DPP) and Sanseito, which both increased their number of seats by 13. High prices led to dissatisfaction among the electorate, which led to criticism of the government. However, the ruling parties' defeat was not as severe as had been feared and the yen strengthened to a low USD/JPY147 range. (For details on the Upper House election, please see today's "Daiwa's Economic View" prepared by our senior fiscal policy strategist Koji Hamada).

JGB market after Upper House election: Improving phase for liquidity premium

So, how will the JGB market react to the election results? We expect the 10-year JGB yield and super-long JGB yields to decline in line with improvements for JGB market liquidity, which had deteriorated prior to the election (assuming that JGB liquidity index returns to its level before the "mini-Truss shock," the target would be 2.8-2.9% for the 30-year JGB yield on a compound basis).

Since April of this year, the deterioration of JGB market liquidity (GVLQJPY) and the sharp rise in super-long JGB yields have been closely linked (see chart below). In particular, the sharp rise in super-long UK gilt yields following the 2 July "mini-Truss shock" and concerns about a crushing defeat for Japan's ruling parties in the Upper House election (cautious stance among investors) appear to have caused a spiral of deteriorating liquidity in the JGB market since July. However, as mentioned in last week's report, we believe that attributing the higher yields entirely to fiscal risk premiums without taking into account the existence of liquidity premiums in the current super-long JGB bond market is an exaggeration of fiscal risks.

JGB Liquidity Index, 30yr JGB Yield



Source: Bloomberg; compiled by Daiwa.

In other words, during the sharp rise for the 10-year JGB yield in mid-July, the expansion of the liquidity premium due to a decline in market liquidity was likely a significant underlying factor. More specifically, if concerns about a possible crushing defeat for the ruling parties were the cause of this extreme decline in market liquidity and if the market perceives that the actual election results were not as bad as the defeat feared by the ruling parties before the election, we could expect some buying back of JGBs, similar to the yen's strengthening vs the USD.

Of course, this merely points to the possibility of a reversal for the recent excessive super-long JGB yield surge driven by liquidity premiums and in no way asserts that concerns about "fiscal policy," a major theme since the pandemic, have disappeared. The rise of populism, and fiscal expansion, as well as concerns about sovereign rating downgrades that these two factors could bring about, will continue to underlie market sentiment.

Next themes: Tariff negotiation progress and additional interest rate hikes

Also, with last weekend's Upper House election now behind us, attention in the JGB market will likely return to (1) the degree of progress for US-Japan tariff negotiations and (2) BOJ interest rate hikes. Regarding the US/Europe tariff negotiations, on 21 July US Treasury Secretary Scott Bessent said, "The US/EU trade relationship doesn't have to get ugly." With regard to Japan, it will be important to keep an eye on future developments, as tariff negotiations are likely to accelerate now that the Upper House election is over. The situation is such that the BOJ will probably need to raise the price outlook in its July *Outlook Report*. Also, once the fog surrounding tariffs clears, we need to keep in mind that the Bank may clearly signal its intention to further hike interest rates. Of course, as long as uncertainty surrounding tariffs persists, it will be difficult to raise interest rates. However, it is important to recognize that the situation is developing in such a way that tariff negotiation progress could lead to interest rate hikes.

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