Daiwa Securities

Daiwa's View

FICC Research Dept.

Takaichi elected LDP leader: Bond market impact

- Takaichi's surprise win was barely priced in by market; we think 30yr yield could rise around 10bp at start of week
- Initial overreaction could unwind given appointment of former finance ministers to key LDP positions, political constraints facing minority government

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Introduction

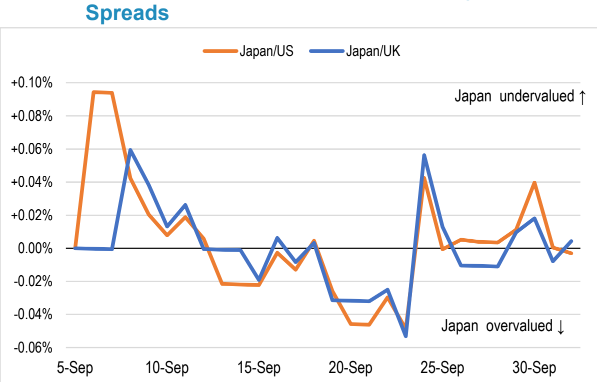
On 4 October, Japan's Liberal Democratic Party (LDP) appointed former economic security minister Sanae Takaichi as its 29th president. She is the first female LDP president and looks likely to be selected as Japan's first female prime minister in a 15 October extraordinary Diet session. However, the greater shock to financial markets than this historic event came from the surprise election outcome that diverged sharply from the consensus.

Prior to the LDP leadership ballot, the bond market had seen Shinjiro Koizumi as likely to win based on media opinion polls and data from overseas prediction markets. A comparison of USD-based 30-year sovereign bond yields using changes in the spread between JGB and other sovereign yields to isolate yield movements caused by domestic factors confirms that while yields initially rose to price in the risk of a Takaichi win when the election was announced, the view soon took hold that Mr. Koizumi was the more likely candidate and the Takaichi risk faded. On Polymarket, a key reference for the bond market, Ms. Takaichi's chances of winning were around 30-40% when the election was announced, but the view subsequently gained ground that Mr. Koizumi had the advantage, and Ms. Takaichi's chances of winning were down sharply ahead of the ballot. We think the bond market likely only factored in a 10-20% or lower probability of her winning.

Bond market impact: Yield curve to twist-steepen

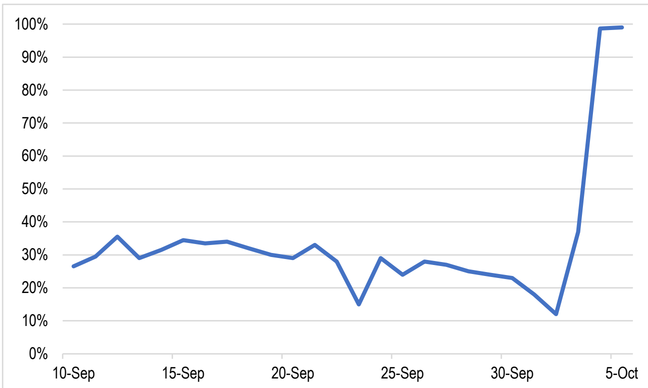
Following Ms. Takaichi's election win, we expect the yield curve to twist-steepen at the start of the week.

Japan/US and Japan/UK USD-denominated 30yr Bond Yield Spreads



Source: Bloomberg; compiled by Daiwa.

Takaichi's Winning Probability Trend (Polymarket)



Source: Bloomberg; compiled by Daiwa.

Ahead of the LDP leadership election, investors sold medium-term JGBs and bought superlong issues in anticipation of a Koizumi victory. Expectations for Koizumi to focus on fiscal discipline and encourage the Bank of Japan (BOJ) to normalize policy resulted in selling pressure on medium-term JGBs on concerns about rate hikes and buying pressure on superlong issues on expectations for fiscal consolidation. This caused the yield curve to twist-flatten. We think Ms. Takaichi's victory will cause this move to unwind.

Short- and medium-term yields mainly fall to reflect receding expectations for BOJ rate hikes. Ms. Takaichi has indicated a cautious stance toward further raising interest rates, which we think will drastically cool expectations for another hike at the BOJ's October Monetary Policy Meeting (MPM). Ms. Takaichi has made clear her position that the government is responsible for setting the direction of economic and monetary policy, which is dampening market expectations for a near-term rate hike. Medium-term JGB yields had risen on expectations for an October hike, but are now falling to factor in the view that political pressure will make the BOJ more cautious.

In contrast, we expect superlong JGB yields to rise on fiscal concerns. Anxiety about a potential increase in JGB issuance driven by Takaichi's aggressive fiscal policy stance and about looser fiscal discipline will put selling pressure on the superlong end. Specifically, we think the 30-year yield could rise by around 10bp from current levels. The market's 8 September reaction to the rising probability of a Takaichi victory featured a 1.0bp drop in the 2-year yield and 5.5bp increase in the 30-year yield. However, at that point the market was not pricing in even a 50% probability of Ms. Takaichi winning. It will now shift from pricing in a virtually 0% probability to 100% (an actual victory), and a back-of-the-envelope calculation suggests a potential impact of around 10bp or more on yields.

The results of the 30-year JGB auction scheduled for 7 October will be a key litmus test for future market trends. We expect the auction to result in considerable selling of superlong JGBs due to weak supply/demand alongside growing fiscal uncertainty. If the auction results are unfavorable, this could trigger a vicious cycle in which growing fiscal concerns drive a further increase in yields.

Takaichi's policy vision

Ms. Takaichi's economic policies are essentially a continuation of Abenomics. On the relationship between the government and the BOJ, she has explicitly stated that the government must bear responsibility for fiscal and monetary policy, implying the potential for greater political pressure on the BOJ.

Ms. Takaichi positions cost-of-living measures as the top priority in her economic policy package. She is considering scrapping the provisional gasoline tax, introducing tax cuts combined with cash transfers, raising medical and nursing care fees, and supporting wage hikes at lossmaking firms. While stating that she would not give up the option of a consumption tax cut, she did not include it in her LDP leadership campaign promises, indicating that she would instead prioritize other measures to tackle inflation for now.

On fiscal consolidation, Ms. Takaichi aims to gradually reduce net debt as a percentage of GDP. Net debt is defined as outstanding debt minus government financial assets, and will enable more flexible fiscal spending than the primary balance used by previous governments.

Quantitative assessment of fiscal policy, impact on superlong JGBs

A quantitative assessment of the fiscal policies that could be implemented under the Takaichi administration suggests that they could be on a much larger scale than the market expects. Our analysis suggests that the market is already pricing in policies that would worsen the government's finances by around 1% of GDP (around Y6tn). However, the combined impact of policies that are likely up for consideration would be far higher.

We think the government could consider effectively eliminating the consumption tax on food to counter rapid food inflation, which we estimate would have an annual impact of around Y5tn.

Scrapping the provisional gasoline tax would have a roughly Y1.5tn impact, and raising the annual income barrier would have an impact of up to Y3tn. Taken together, these measures could have a total impact of up to Y9tn-10tn, which is Y3tn-4tn higher than the Y6tn the market is pricing in.

Our analysis suggests that increasing fiscal spending by 1% of GDP causes the 30-year yield to rise by 20-30bp. Based on this relationship, we think widening the fiscal deficit could boost yields by up to 10-20bp.

The caveat is that our simulation assumes full implementation of the government's policies. In reality, Ms. Takaichi has made some concessions to fiscal policy, including leaving a consumption tax cut out of her LDP leadership campaign promises. The negotiations with opposition parties that will be essential to implementing these policies could also result in them being scaled back. As we discuss in detail in the next section, Ms. Takaichi faces considerable political constraints, and we would also bear in mind that superlong JGBs' initial overreaction could unwind over time.

Political constraints, outlook for coalition strategy

Ms. Takaichi faces considerable political constraints. The LDP's loss of its majority in both houses means that it will need opposition parties' cooperation to pass a budget. This political constraint will have a major impact on the viability of her fiscal policies and will be a key checkpoint for the superlong bond market.

The coalition framework involves a complex set of dynamics. Komeito is strongly opposed to bringing in the Japan Innovation Party (JIP), and the Democratic Party for the People (DPP) is calling for an increase in the annual income barrier and the abolition of the gasoline tax. The Constitutional Democratic Party of Japan (CDP) has criticized the lack of clarity on funding, and interestingly cited the example of Italian prime minister Giorgia Meloni. Prior to her election, Ms. Meloni garnered support for her far-right pronouncements, but since becoming PM she has plotted an extremely pragmatic course toward fiscal consolidation.

There are signs that Ms. Takaichi is shifting to a more pragmatic stance in appointing LDP officials. She is reportedly considering LDP General Council Chair Shunichi Suzuki as Secretary-General and former prime minister Taro Aso as Vice-President, both of whom have experience as finance ministers and prioritize fiscal discipline. Mr. Suzuki served as finance minister from 2021 through 2024, and the appointment of a fiscal discipline advocate as party Secretary-General could reassure the superlong JGB market to some extent.

The appointment of a new finance minister will also be a key focus for the superlong market. If Ms. Takaichi appoints a minister who prioritizes fiscal discipline, this would convince the market that she has shifted to a more pragmatic stance and cap the uptrend in superlong JGB yields. However, the appointment of an aggressive fiscal policy advocate could magnify fiscal uncertainty and accelerate selling of superlong JGBs. The possibility has also emerged that the extraordinary Diet session scheduled for 15 October could be pushed back, implying that it is taking time to discuss potential changes to the coalition, agree on key personnel appointments, and firm up specific policies.

Investment strategy: Approaches need to factor in timeframe

Based on the above analysis, we think it is important to bear in mind the timeframe when considering bond investment strategies.

In the near term, we think superlong yields are likely to rise sharply due to the surprise from Ms. Takaichi's win and concerns about fiscal policy. The 7 October 30-year JGB auction will be the first litmus test. We think selling could accelerate if the auction result is unfavorable. We think a "Takaichi trade" that is short superlong JGBs and long medium-term issues should be effective at this point.

However, the market could revise its view in the medium term in response to specific policies and the emergence of political constraints. As per our above analysis, we think it is entirely possible that Ms. Takaichi could shift to a more pragmatic stance given her choice of former finance ministers for key party positions, her decision not to include a consumption tax cut in her campaign promises, and the tough reality of a minority government. If she appoints a fiscal discipline advocate as finance minister and the supplementary budget is confirmed to be smaller than the market currently expects, this could reverse the initial overreaction and create buying opportunities for superlong JGBs.

However, we would also bear in mind that it will take time for policy changes to ease market concerns. Given the political constraints facing Japan's minority government, it will take several months to understand how Ms. Takaichi intends to bring the LDP together and build cooperative relationships with opposition parties. This could require nimble footwork to respond to a potential increase in market volatility.

Conclusion

We expect a drastic bond market reaction to Ms. Takaichi's appointment as LDP leader at the start of the week. Superlong JGBs in particular are likely to be sold heavily on fiscal concerns. However, the more important focus is the political constraints Ms. Takaichi faces and the potential for them to create medium-term investment opportunities.

We think Ms. Takaichi is entirely likely to emulate Italian prime minister Giorgia Meloni's shift from pre-election rhetoric to a more pragmatic course. There are already signs of this, including her appointment of former finance ministers to key LDP positions and the fact that she did not include a consumption tax cut in her LDP leadership campaign promises.

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