Daiwa Securities

Daiwa's View

FICC Research Dept.

Market reaction to Takaichi's appointment as LDP President, inflation risks

- Stock prices soar while JGBs, yen both fall
- Concerns minimal as long as equities keep rising, but if equities, JGBs, and yen all turn lower, fears of "falling behind the curve" could emerge, necessitating close monitoring of market trends
- Unlike early days of Abenomics, fiscal stimulus more likely to increase inflation amid current labor supply constraints

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There is the saying that, "Politics remains unpredictable until the very last moment." On the first day of trading following Sanae Takaichi's surprise election victory over heavily favored Shinjiro Koizumi, equities rose (Nikkei Stock Average 45,770 → 47,944, +2,175 points), the yen depreciated (USD/JPY 147.47 → 150.29, +Y2.82), and the JGB yield curve twist-steepened (2yr JGB yield -4.5bp, 30yr JGB yield +13.5bp).

However, compared to the stock and forex markets, the JGB market apparently reacted relatively calmly to Takaichi's victory. The current OIS market has factored in rate hike probabilities of 24.3% for October, 28% for December, and 36.4% for January 2026. While October saw the biggest probability decline compared to the end of last week (when probabilities were 56% for October, 18% for December, 18.5% for January 2026), the probabilities remain largely unchanged from a month ago (24.6% for October, 21% for December, 28.1% for January 2026). Market participants continue to place trust in the BOJ's messaging that it will not rule out the possibility of hiking rates, provided economic and price developments remain on track, even amid the domestic political turmoil following Prime Minister Shigeru Ishiba's resignation announcement. Amid some growing market speculation that the emergence of the Takaichi administration may hinder the BOJ's progress toward normalization, maintaining confidence in these "timely and appropriate rate hikes" remains crucial. This is particularly important from the perspective of managing "behind the curve" risks that have worried some market participants.

Etsuro Honda interview

On the evening of 6 October, comments regarding BOJ rate hikes were reported in an interview with former Special Cabinet Advisor Etsuro Honda, who is considered one of Takaichi's economic advisors. The report noted that Takaichi believes the BOJ should proceed cautiously with rate hikes, stating, "There is no specific timing. It's not a matter of 'now is wrong' or 'later is right.'" Honda added that implementing a rate hike at the 29-30 October meeting, shortly after Takaichi's expected mid-October inauguration as prime minister, would be "quite difficult." However, he also stated, "Depending on the macroeconomic environment, raising rates by 25bp would be acceptable under current conditions." It has been reported that Honda said, "Even if it took place in December, the US is still a concern, but it (rate hike) should be fine as long as conditions do not become too chaotic." If Honda currently holds a key position in terms of formulating Takaichi's economic policies, then this statement may effectively imply a request from Takaichi regarding the timing of monetary policy adjustments by the BOJ. (*We do not currently possess sufficient information regarding Honda's position.)

That said, just like politics, the market remains unpredictable until the very last moment. Looking ahead, alongside economic and price trends, we should keep a close eye on equity prices and forex market movements.

Upside risks

With investors anticipating fiscal stimulus from the new Takaichi administration, Nikkei Stock Average Futures have already climbed to around 48,600 as of the morning of 7 October. This appears to reflect awareness of the "potential for larger-than-expected risks to the economy and prices accompanying fiscal expansion" that a relevant party pointed out on 9 September. Also, the BOJ's branch managers' meeting report (6 Oct) also suggested that the domestic economy and price outlook are on track. Considering the September Tankan survey and information from such hearings, the "upside risks" mentioned by policy board members Naoki Tamura and Asahi Noguchi are likely gaining greater weight for the BOJ, which has temporarily paused rate hikes following the April tariff shock.

Caution does not equal inaction

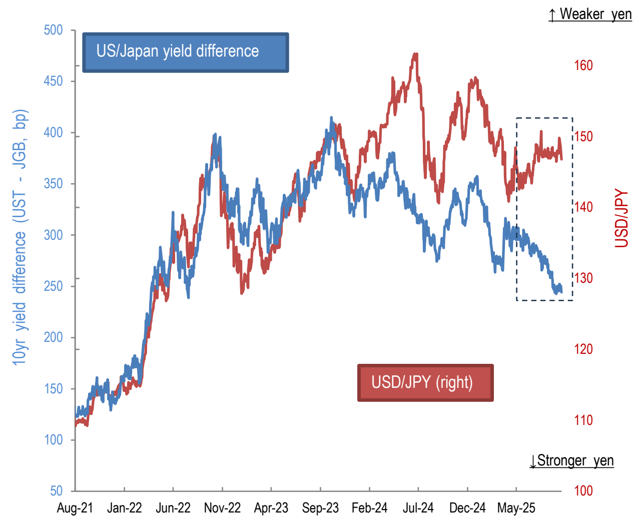
When "upside risks" carry significant weight, caution does not necessarily equal inaction from the perspective of risk management approaches. Rather, balance becomes important. So far, the stock price reaction has been very positive, suggesting that concerns about "falling behind the curve" are not particularly significant. However, if market reactions going forward include falling stock prices along with yen depreciation and rising JGB yields (steepening) seen thus far, the situation may change somewhat.

In terms of factors that could change the situation going forward, we should keep an eye on two points: (1) forex and (2) the US (especially President Trump's visit to Japan and remarks from US Treasury Secretary Bessent).

Forex

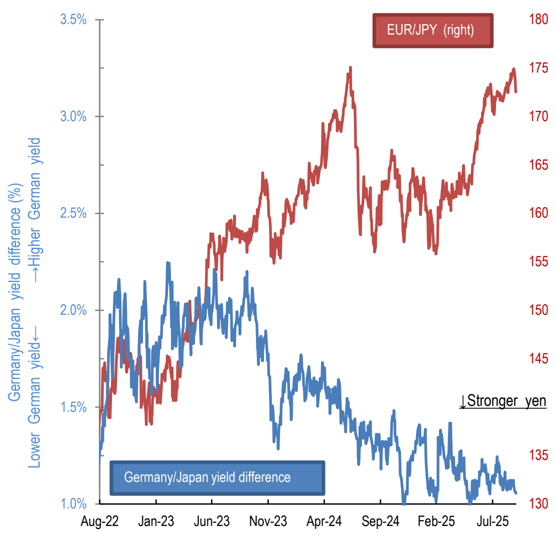
We looked at the relative yield differential, as well as the USD/JPY and EUR/JPY pairs. Here, the yen's depreciation is clearly progressing in a manner contrary to the narrowing of the relative yield differential. The EUR/JPY pair in particular broke into the EUR/JPY176 range for the first time since July of last year to set a new all-time high. The current situation where the USD/JPY rate has already exceeded USD/JPY150 appears to be exceeding the projections in surveys such as the Tankan. However, if the BOJ were to hold off on hiking rates at its October meeting, suppressing opposition from three or more policy board members, and if this were to cause the yen to weaken further, we could not rule out that the optimal positioning within the risk management approach could change in response to the increased upside risk.

USD/JPY Rate, US/Japan Relative Yield Differential



Source: Bloomberg; compiled by Daiwa.

EUR/JPY Rate, Germany/Japan Relative Yield Differential



Source: Bloomberg; compiled by Daiwa.

Trump to visit Japan, Bessent comments

Also, preparations are underway for US President Trump's visit to Japan, scheduled around 27-29 October, marking his first visit in six years (US-Japan summit meeting is reportedly being arranged for 28 Oct). Trump is a tough negotiator and it is unlikely that he would visit Japan simply to congratulate Takaichi. What demands will he impose on Takaichi and on what points will he concede?

Of course, various topics will be discussed, but what concerns us is that on 14 August, US Treasury Secretary Scott Bessent said (as his own opinion) regarding the BOJ, "They're behind the curve. So, they're going to be hiking. The Japanese have an inflation problem." Bessent said that rising super-long JGB yields are also impacting (pushing up) the 30-year UST yield.

These remarks can be interpreted as cautioning that the BOJ's excessive delays for hiking rates could trigger yen depreciation (offset part of tariffs) and a sharp rise in super-long JGB yields (term premium), thereby adversely impacting the US. For example, if Japan excessively delays hiking rates and the adverse effects spill over to the US due to rising concerns about "falling behind the curve," Japan may risk being forced to make concessions in other areas during the US-Japan negotiations. If delaying an imminent rate hike by just a small margin could risk undermining negotiations on larger issues, that would not be a favorable move from a cost-benefit perspective.

Macroeconomic environment differences

We sometimes hear people say that, "Takaichi is the successor to Abenomics and will naturally call for fiscal expansion and monetary easing." However, Japan's current macroeconomic environment differs from that during the early stages of Abenomics. As such, formally implementing the same policies will not yield the same policy effects. This is an important point, so we want to use some formulas to thoroughly review the fundamentals.

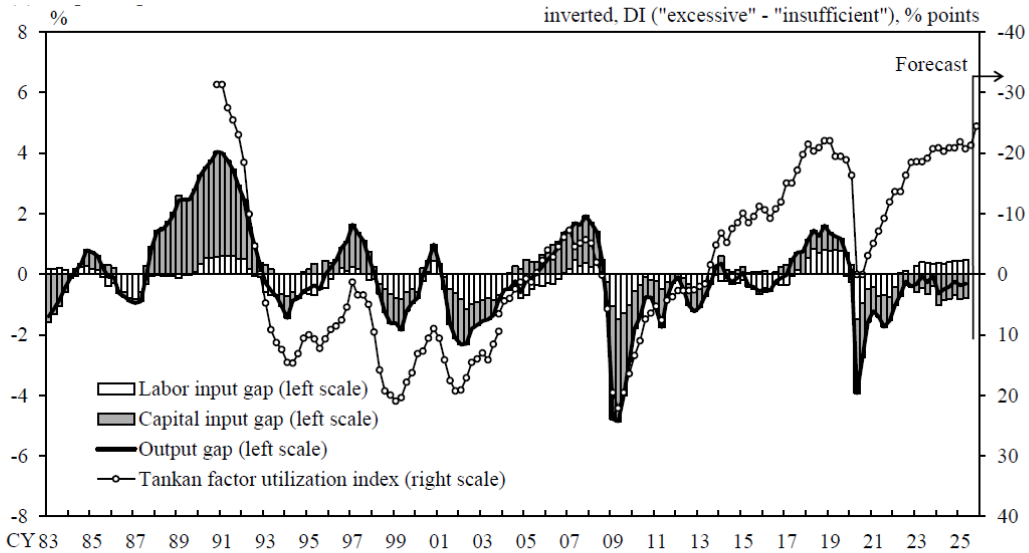
Assuming a standard Cobb-Douglas production function, a country's GDP is represented as $Y_t = A_t L_t^{\propto} K_t^{1-\propto}$. Here, "A" is total factor productivity, "L" is labor input, "K" is capital input, and "α" is the labor share. Potential GDP is expressed as $Y^* = A^* L^{*\alpha} K^{*(1-\alpha)}$.

Taking the logarithms of these formulas and expressing them in lowercase letters, the GDP growth rate is expressed as $y_t = a_t + \propto l_t + (1 - \propto) k_t$ and and the potential growth rate is shown as $y^* = a^* + \propto l^* + (1 - \propto) k^*$. That is, the "output gap" is expressed by the following equation.

$$y_t - y^* = (a_t - a^*) + \propto (l_t - l^*) + (1 - \propto)(k_t - k^*)$$

The key point is that, unlike the early days of Abenomics, in the current case where supply constraints have emerged in the labor market, if fiscal expansion were to further exacerbate labor market tightness, that would tighten the output gap through an expansion of the labor input gap $(l_t - l^*)$. Looking at the output gap presented by the BOJ on 3 October, the labor input gap is already in positive territory (see chart on next page).

Output Gap



Source: Reprinted from BOJ's "Output Gap and Potential Growth Rate."

Next, the standard (simplest) inflation function (Phillips curve) is shown below (where π_t^e is inflation expectations and μ indicates the sensitivity of the inflation rate to the output gap). As is evident from the following equation, a tightening of the output gap $(Y_t - Y^*)$ will lead to rising inflation.

$$\pi_t = \pi_t^e + \mu(Y_t - Y^*)$$

The crucial point is that, unlike the early days of Abenomics when the labor input gap was negative, Japan now faces supply constraints with a positive labor input gap. Under such conditions, expanding demand (Y) through fiscal stimulus carries a significant risk of fueling inflation.

Of course, if Taro Aso, who is known for his strong commitment to fiscal consolidation, becomes the LDP Vice President as reported, it is highly likely that Takaichi's fiscal stimulus measures will be appropriately restrained. Therefore, any excessive concern could be unfounded. That said, the macroeconomic environment surrounding Abenomics at its inception differs from that of today. Therefore, it is crucial to recognize that depending on the "Sanae-nomics" prescription, Japan could easily find itself in a situation prone to triggering inflation. Given such a structure that makes inflation more likely to rise than before, it is crucial for the BOJ to maintain greater freedom of action than ever before.

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