Daiwa Securities

Daiwa's View

Growing expectations for a September rate hike: The 10-year yield may test 3%, but further upside appears limited

- Summary of Opinions at the July meeting points to a September rate hike
- A September rate hike could raise the 2-year yield by about 20bp, but the 10-year yield is expected to rise only modestly

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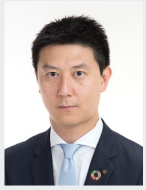


Possibility of a September rate hike and the outlook for long-term yields

Expectations for a September rate hike have increased following BOJ Governor Kazuo Ueda's remarks at the press conference after the July Monetary Policy Meeting (MPM) regarding a possible acceleration in the pace of rate hikes. In this report, drawing also on the Summary of Opinions from the July MPM, we consider the likely level of long-term yields if the BOJ raises rates in September. We estimate that the 2-year yield would rise by around 20bp. Although the 10-year yield could temporarily reach 3%, we do not expect the rise to be sustained. Rather, the rise in the 10-year yield is expected to remain modest through a tightening of the 10-year/2-year spread.

Summary of Opinions at July MPM increases the likelihood of a September rate hike

The Summary of Opinions at the July MPM, released on 10 August, contained a notable number of comments in favor of rate hikes, reflecting upside risks to underlying inflation. Opinions on monetary policy included the views that "It could be considered that the pace of policy interest rate hikes will be faster than market expectations" and "The focus of monetary policy has shifted from 'lifting underlying CPI inflation to 2 percent' to 'avoiding further upward deviation in underlying CPI inflation.'"

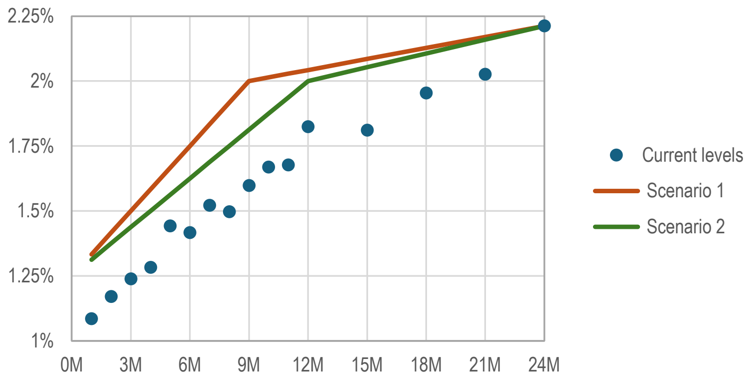
Another change from the June meeting was the departure of Board Member Junko Nakagawa and the addition of Board Member Ayano Sato. Sato, together with Board Member Toichiro Asada, who voted against a rate hike in June, is viewed as a strongly reflationary member appointed by the Takaichi administration. The section on monetary policy in the Summary of Opinions contained 13 opinions, suggesting that each of the nine Policy Board members submitted at least one opinion. However, we did not identify any comments expressing strong opposition to monetary policy normalization itself.

Furthermore, the opinions submitted by the Cabinet Office in July were more balanced than those in April, when the government-BOJ accord was mentioned, and those in June, when the need for accountability regarding rate hikes was explicitly stated. Specifically, the July opinions included a reference to "fiscal sustainability." In light of these changes, the possibility of a rate hike at the next meeting in September should be kept firmly in mind. From the perspective of bond investment strategy, it is important to consider how the yield curve might move in the event of a September rate hike.

Fair value of the 2-year yield

Chart 1 shows the 1-month forward yields calculated from the OIS market as of August 10 (blue dots). The forward curves indicate that the market is pricing in rate hikes at a pace of roughly three times per year over the next 12 months. Thereafter, the curve becomes somewhat less steep, with the forward yield reaching 2.21% two years ahead.

Chart 1: N-month Forward 1-month OIS Curve: Current Levels and Two Scenarios



Source: Bloomberg; compiled by Daiwa.

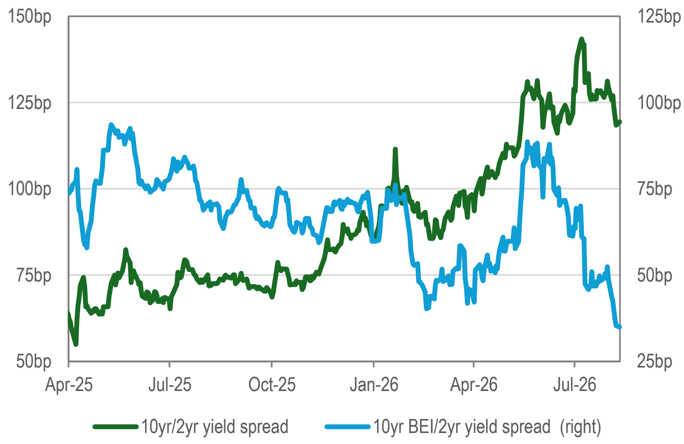
If the BOJ were to raise rates in September, only three months would have elapsed since the previous rate hike in June, potentially prompting the market to price in four rate hikes per year. In Scenario 1, we assume that, following a September rate hike, the BOJ implements three additional rate hikes over the subsequent nine months. After the policy rate reaches 2%, we assume that it rises gradually through the two-year horizon. In Scenario 2, by contrast, we assume that the pace of rate hikes remains unchanged at three per year and that, after reaching 2% in one year, the policy rate rises gradually thereafter.

To estimate the fair value of the 2-year yield, we calculated the average of the 1-month forward yields over the coming two years. The results indicate an increase of 23bp from the current level in Scenario 1 and 18bp in Scenario 2. Therefore, if the BOJ were to raise rates in September, we estimate that this would push up the 2-year JGB yield, currently at 1.62%, by around 20bp.

The level of long-term yields and the 10-year/2-year spread

To assess the likely level of long-term yields, we next examined the spread between the 10-year and 2-year yields (Chart 2). Although the spread had widened since last October, it has remained broadly unchanged since May 2026. After exceeding 140bp in early July, it has recently narrowed to 120bp. Moreover, the spread between the 10-year BEI (breakeven inflation rate) and the 2-year yield, the spread has narrowed by about 50bp since May. These market movements may indicate that, as the likelihood of a rate hike increased and the BOJ actually raised rates, the resulting decline in inflation expectations, as reflected in the BEI, helped restrain the rise in long-term yields. This, in turn, may have been reflected in the narrowing of the 10-year/2-year spread.

Chart 2: 10yr/2yr Yield Spread, 10yr BEI/2yr Yield Spread



Source: Bloomberg; compiled by Daiwa.

Assuming that the BOJ raises rates in September and that the 2-year yield rises to around 1.80% (approximately 20bp above its current level), the 10-year yield would rise to around 3% if the current 10-year/2-year spread of 120bp were maintained. On the other hand, if the market responded positively to the rate hike and the spread narrowed by 10–20bp, the 10-year yield would likely remain at around 2.80–2.90%. Therefore, if the BOJ raises rates in September, the 10-year yield could temporarily test 3%, but we do not believe that the rate hike itself would drive a sustained rise in long-term yields. We expect the rise from the current level to be limited to around 10bp.

Two considerations: Terminal rate and fiscal risk

However, there are several points to bear in mind regarding the above assumptions. First, in calculating the fair value of the 2-year yield, we assume that the 2-year forward 1-month yield remains unchanged from its current level. The current 2-year forward 1-month yield is 2.21%, broadly in line with the 2-year forward 1-year yield of 2.25%, widely used by market participants as a point of reference for the terminal rate. We therefore assume that the terminal rate would remain unchanged even if the BOJ raised rates in September. However, the 2-year forward 1-year yield has continued to rise and now exceeds 2%, indicating that the market is considering the possibility of rates being raised to a restrictive level. Attention should therefore be paid to the possibility that the terminal rate could rise further if underlying inflation surprises to the upside or if policies that boost demand are implemented.

We also assume that the 10-year/2-year spread remains unchanged. We believe that fiscal risk has already been priced in to some extent, reflecting the process of formulating the Basic Policy on Economic and Fiscal Management and Reform in June and the Y370tn investment initiative. However, budget requests without spending ceilings will be submitted in August, while the possibility of a cabinet reshuffle and changes to senior LDP posts has also been noted. Regarding the latter, since the inauguration of the Takaichi administration, the presence of former finance ministers such as Deputy Prime Minister Taro Aso and LDP Secretary-General Shunichi Suzuki has been viewed by the market as providing a degree of reassurance regarding fiscal discipline. If personnel changes were interpreted as signaling a further shift toward expansionary fiscal policy, the risk that a rise in the term premium could push the 10-year yield above 3% cannot be ruled out.

A September rate hike is expected to have only a modest impact on long-term yields

Kyodo News has reported that the US side welcomed Governor Ueda's reference at his 31 July press conference to the possibility of accelerating the pace of rate hikes and that this proved decisive in the decision to undertake coordinated forex intervention. In the forex market, the yen initially appreciated from around Y164 against the dollar before the intervention to below Y156 at one point. By the beginning of the following week, however, it had weakened back to the Y159 range amid a rise in US yields, suggesting that the effects of the intervention were already beginning to fade. If the BOJ's willingness to raise rates was an important factor in the decision to conduct coordinated intervention, a renewed weakening of the yen would increase the likelihood of a September rate hike.

In this report, amid the growing likelihood of a September rate hike, we have considered the likely level of long-term yields if the BOJ actually raises rates. We conclude that the 2-year yield could rise by around 20bp, while the rise in long-term yields is likely to remain modest. Rather than the September rate hike itself, an upward revision to the terminal rate or a change in the market's assessment of fiscal policy is likely to be the more important factor determining the direction of long-term yields.

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