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Daiwa's View

Proactive fiscal policy and reassessment of terminal rate ~ Upside risk from perspective of Taylor rule

- Factors driving up UST yields and outlook: Limited further upside
- Japan's proactive fiscal policy and risk of higher-than-expected terminal rate

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Factors behind rising UST yields and Japan's terminal rate

The rising 10-year UST yield is thought to reflect not only high crude oil prices, but also uncertainty surrounding AI investments and monetary policy. However, the latest employment and price indicators do not significantly heighten market concerns about inflation and we believe there is limited room for further upside for the 10-year UST yield. Meanwhile, in Japan, market expectations for the terminal rate have been rising, with the 2-year forward 1-year OIS rate exceeding 2%. In this report, our focus is on the government's proposed Y370tn public-private investment plan, examining its impact on JGB yields from the perspectives of the output gap, the Phillips curve, and the Taylor rule. As a result, even though there is uncertainty regarding the actual scale of investment and the effectiveness of measures to boost supply capacity, we believe that large-scale investments under a proactive fiscal policy could be viewed as a factor pushing up the terminal rate that is now being priced in by the market.

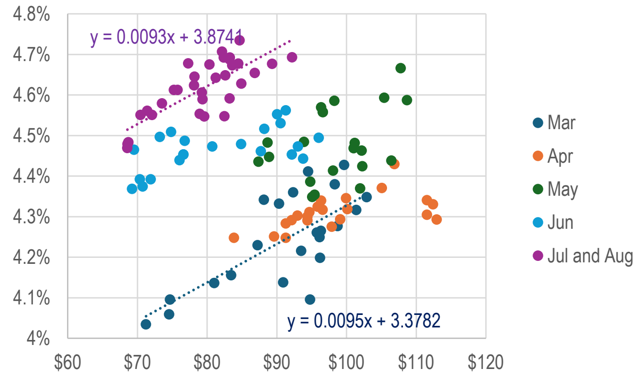
Factors behind rising UST yields

If we plot the monthly movements for the 10-year UST yield and crude oil futures (CLA) since March, when the Iran conflict began (Chart 1), we can see that while the relationship has generally remained upward-sloping, it has shifted higher. When comparing a simple regression equation for March and for July onward, there is no significant change in the relationship whereby a $1 increase in crude oil prices generally resulting in a 10-year UST yield to rise by about 0.9bp. Meanwhile, the y-intercept has increased by about 50bp.

An upward shift of about 50bp is a factor driving yields higher that cannot be explained by just the higher crude oil prices. Downside risks to the economy stemming from the situation in the Middle East are limited. Meanwhile, we believe that the expansion of aggregate demand driven by investments in new technologies, particularly AI, as well as growth expectations are contributing to higher 10-year UST yields. Also, under new Chairman Kevin Warsh, the Fed has been simplifying its communications, which includes scaling back its forward guidance. Some observers suggest that uncertainty surrounding monetary policy is also a factor driving up 10-year UST yields.

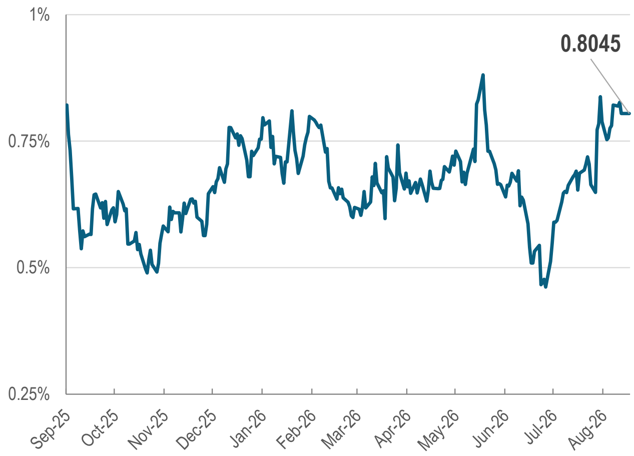
In particular, the committee left interest rates unchanged at both the June and July FOMC meetings while reiterating its commitment to the 2% inflation target, prompting some market participants to voice concerns that the Fed might be falling behind the curve. Indeed, the 10-year term premium calculated using the ACM model published by the New York Fed has risen by more than 20bp since the June FOMC meeting.

Chart 1: Relationship Between 10yr US Yield and Crude Oil Futures Prices



Source: Bloomberg; compiled by Daiwa.

Chart 2: 10yr US Term Premium (ACM model)



Source: Bloomberg; compiled by Daiwa.

During periods of disinflation, forward guidance (= announcing that low interest rates will continue) helped to stabilize the 10-year UST yield. However, in an inflationary environment, such methods usually do not work very well. Rather, it will be important for the new Federal Reserve leadership to demonstrate flexibility through its simple message of "price stability."

As the conduct of monetary policy and communication practices are reviewed under new Chair Warsh, it will likely take some time for the market to adjust to the new policy framework. During that process, volatility in the yield market may remain higher than usual.

We must continue to closely monitor the potential for increased demand and a rise in the potential growth rate resulting from AI investments. However, the latest employment and price indicators did not significantly heighten market concerns about inflation. We assume that there is limited room for further 10-year UST yield upside.

Japan: Rising terminal rate recognized by market

The 2-year forward 1-year OIS rate, which serves as a benchmark for the terminal rate, continues to rise. As of the end of last week, the rate stood at 2.27%. Given that many market participants estimate the neutral rate to be between 1.50% and 2.00%, attention is increasingly turning to the possibility that further rate hikes could take the policy rate into restrictive territory.

Chart 3: 2yr-forward 1yr OIS Rate

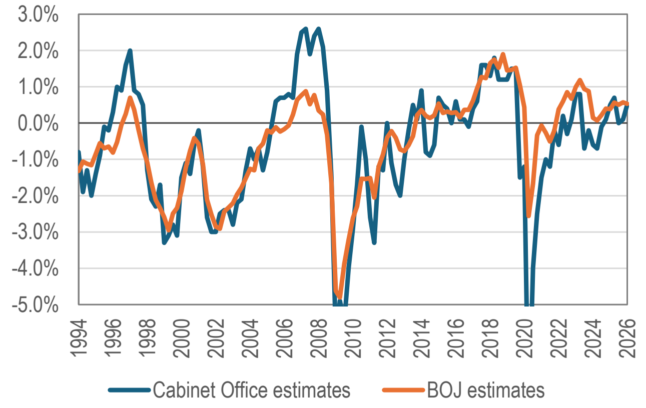
Source: Bloomberg; compiled by Daiwa.

The government's latest "Basic Policy on Economic and Fiscal Management and Reform" ("Basic Policy"), the first under the administration of Prime Minister Sanae Takaichi, included an announced plan to invest a total of Y370tn, from both the public and private sectors, in strategic sectors by FY40. Simply put, investments will be made evenly over a 14-year period starting in FY27 and the annual investment amount will come to roughly Y26tn. That would be roughly 4% of the nominal GDP for FY25 (Y669tn).

Looking at estimates from the Cabinet Office and the BOJ regarding the output gap (GDP gap), which compares potential supply and actual demand in macroeconomic terms, both indicate that the gap is currently in positive territory. Additional demand growth amid situations like this tends to increase inflationary pressures.

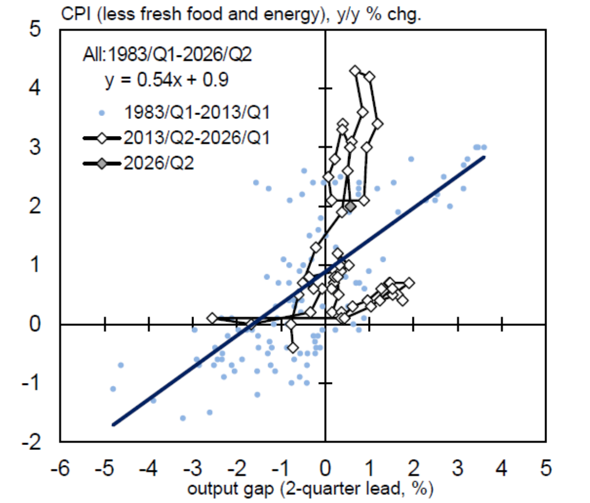
The BOJ's *Outlook Report* includes an estimate of the Phillips curve, which illustrates the relationship between the output gap and core CPI. The coefficient for all periods from 1983 to the present is 0.54. So, assuming that an additional investment equivalent to 4% of GDP would directly lead to an expansion in aggregate demand, that would push up core CPI inflation by approximately 2ppt.

Chart 4: Estimates for Output Gap



Source: Cabinet Office, BOJ; compiled by Daiwa.

Chart 5: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax rate changes and policies concerning the provision of free education (including the free school lunches starting in April 2026), and travel subsidy programs.
2. Figures for the output gap are staff estimates.

Source: Reprinted from Jul 2026 BOJ Outlook Report.

The Taylor rule, which is a well-known monetary policy rule, uses the difference between actual inflation and the inflation target, as well as the output gap, to determine the optimal policy interest rate. Even though there are various versions of the coefficients (α, β) for the inflation differential and the output gap, in the model proposed by John Taylor in 1993, β is set at 0.5. In other words, a 0.5ppt increase in the policy rate would be required for every 1ppt increase in the output gap. As such, if we apply this relationship mechanically, holding other factors constant, the 4ppt widening of the output gap resulting from the additional investment would raise the optimal policy rate implied by the Taylor rule by approximately 2ppt.

Of course, with regard to the Phillips curve and Taylor rule mentioned above, it is possible that their respective coefficients are changing as the economic structure changes. Also, regarding the Y370tn investment, it remains unclear whether an additional Y26tn will be invested in the first year. It is also important to consider trade-offs with other investment opportunities. More importantly, growth investments are not intended to close the output gap. Rather, as the overall supply capacity of the economy increases, inflationary pressures will ease. This structure is similar to how, while AI investments are initially expected to increase inflationary risks, future productivity gains are expected to act as a disinflationary factor.

As of this juncture, our main scenario for the terminal rate remains at 1.75%. If the policy interest rate is gradually hiked from the current 1%, we expect that the restraining effect on aggregate macro demand would gradually become apparent. Also, since the effects of monetary policy are subject to a certain lag, the effects of interest rate hikes, which are currently considered limited, may gradually become apparent. However, we need to be mindful that the expansion of public and private investment driven by proactive fiscal policy is a factor that could push the terminal rate higher.

Chart 6: Yield Outlooks for Japan and US (as of Aug 2026)

(%)		Jul-Sep		Oct-Dec		Jan-Mar		Apr-Jun	
		Range	Term-end	Range	Term-end	Range	Term-end	Range	Term-end
Japan	Policy rate		1.00		1.25		1.50		1.50
	2yr	1.40 ~ 1.80	1.60	1.70 ~ 2.10	1.90	1.75 ~ 2.15	1.95	1.75 ~ 2.15	1.95
	5yr	1.85 ~ 2.35	2.10	2.05 ~ 2.55	2.30	2.10 ~ 2.60	2.35	2.10 ~ 2.60	2.35
	10yr	2.50 ~ 3.10	2.80	2.50 ~ 3.10	2.80	2.50 ~ 3.10	2.80	2.50 ~ 3.10	2.80
	20yr	3.40 ~ 4.00	3.70	3.40 ~ 4.00	3.70	3.40 ~ 4.00	3.70	3.30 ~ 3.90	3.60
	30yr	3.70 ~ 4.30	4.00	3.70 ~ 4.30	4.00	3.70 ~ 4.30	4.00	3.60 ~ 4.20	3.90
US	FF rate (upper limit)		3.75		3.75		3.75		3.75
	10yr	4.30 ~ 5.00	4.60	4.30 ~ 5.00	4.60	4.20 ~ 4.70	4.50	4.10 ~ 4.70	4.40

Source: Compiled by Daiwa.

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