Daiwa's View

Upside risks to the terminal rate and growing market caution: Can BOJ hit the brakes?

- Market participants wary of policy rate hikes exceeding 2%
- BOJ Himino's speech: Is BOJ able to step on the brakes if necessary?
- FY27 budget compilation and its market impacts

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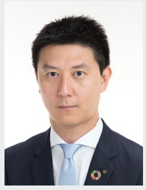


Upside risks to the terminal rate and growing market caution: Can BOJ hit the brakes?

As the market watches the 10-year JGB yield rise, attention is now focusing on both monetary and fiscal policy. According to the QUICK's monthly survey of bond market participants, there are expectations for a higher terminal rate and the market is gradually beginning to factor in the risk of policy rate hikes exceeding 2%. The BOJ is also stepping up its vigilance against the risk of inflation rising more than expected. That said, what the market is really focused on is whether the BOJ will be able to implement sufficient monetary tightening if inflation rises above the target. Meanwhile, on the fiscal front, it is highly likely that the policy of fiscal expansion accompanied by growth strategies will continue. Speculation about an increase in JGB supply is also pushing up the 10-year JGB yield. This report summarizes the pressures driving up JGB yields from both the financial and fiscal perspectives.

Risk of rate hikes exceeding 2% (monthly QUICK survey) and investment stance

The QUICK's monthly survey of bond market participants has included a question regarding terminal rate forecasts since its June survey. As of the August survey, in addition to the forecast average rising by 14bp from the July survey to 1.90%, the mode has also shifted from 1.50% to 1.75%. It appears that market participants' expectations are being revised upward. Furthermore, the fact that the median has remained unchanged while the mean has risen indicates that more participants are submitting higher figures on the upper side of the range. As such, even though forecasts still appear to center on a range of 1.50% to 2.00%, we can conclude that an increasing number of market participants are anticipating a rate hike exceeding 2%.

Due to the uncertainty surrounding these terminal rate forecasts, investors are becoming increasingly cautious. The QUICK survey asked asset managers about the current weighting of domestic bonds in their portfolios and their near-term investment stances. The "Current Weighting Index," which is calculated by weighting five options ranging from "significantly overweight" to "significantly underweight," with "neutral" set at 50, came to 37.2 points as of August, marking its lowest level since 1997.

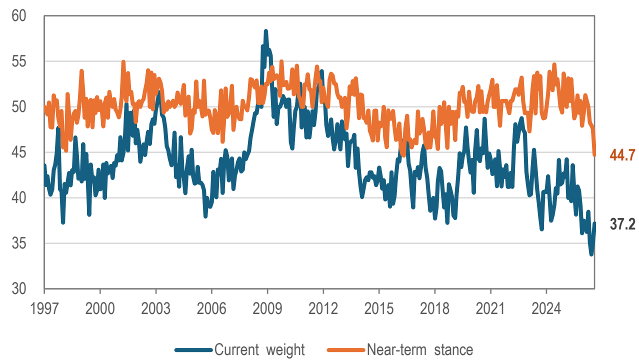
Similarly, the "Near-term Stance Index," calculated based on five response options ranging from "raise significantly" to "lower significantly," came to 44.7 points as of August. It has fallen to levels not seen since 2016, when negative interest rates and YCC were introduced. In addition to uncertainty surrounding monetary policy, we believe that a combination of various factors, including fiscal concerns, inflation risks, and rising government bond yields overseas, is having a comprehensive impact and bond investors are adopting a much more cautious investment stance than in the past.

Chart 1: QUICK Monthly Survey: Expected Terminal Rate

		Jun survey	Jul survey	Aug survey
Arithmetic mean	(%)	1.70	1.76	1.90
Standard deviation	(ppt)	0.40	0.37	0.44
Median	(%)	1.50	1.75	1.75
Mode	(%)	1.50	1.50	1.75
Minimum	(%)	1.00	1.00	1.25
Maximum	(%)	4.00	4.00	5.00
Number of valid responses		113	116	113

Source: QUICK; compiled by Daiwa.

Chart 2: QUICK Monthly Survey: Investment Stance on Domestic Bonds (index: 50 = neutral)



Source: QUICK; compiled by Daiwa.

Himino's speech and monetary policy as a brake

At the BOJ's Monetary Policy Meeting in June, when a decision to raise the policy rate was made, the "risk that underlying inflation could rise above the 2% price stability target" was mentioned. Similarly, in BOJ Deputy Governor Ryozo Himino's speech on 27 August, the use of the wording, "Given the movement of these indicators, I believe we are entering a phase where we will also need to bear in mind the possibility of underlying inflation exceeding 2% in addition to these considerations when making policy decisions." This suggests that the assessment for higher-than-expected risk is increasing.

Meanwhile, as for Himino's speech, what caught our attention was the explanation of the reasons for possible policy rate hikes. In the context of consistency with the government's growth strategy, the long-standing wording "adjusting degree of monetary easing" is being maintained rather than "tightening." Even more symbolic was the fact that, in the latter half of his speech, Himino compared the conduct of monetary policy to driving a large bus and described the current policy stance as "easing off the accelerator."

◆ **BOJ Deputy Governor Ryozo Himino (27 Aug 2026)**

- Following the policy interest rate hike in June, I was asked about the consistency between the rate hike and the government's efforts to bolster public and private investment and raise Japan's potential growth rate, as the rate hike may work to restrain investment. On this point, I would first like to stress that **the rate hike is an adjustment in the degree of monetary accommodation**, not a tightening.

- Although the speed of the bus has been fluctuating because of the frequent changes in the slope of the road, the speed which would be realized should the road stay flat (underlying inflation) has been approaching the target speed set in advance (2 percent). As we are still pressing on the accelerator (financial conditions have been accommodative), I believe **we will need to ease off in a timely manner** (continue to raise the policy interest rate and adjust the degree of monetary accommodation) while carefully checking the road conditions ahead, the weather forecast, and other information (developments in economic activity and prices as well as financial conditions).

This wording may reflect not only a desire to carefully assess various risks as the policy interest rate reaches 1%, but also a need to communicate with the administration, which is viewed as cautious about raising rates, and to show consideration for the addition of two policy board members who are perceived to hold reflationary views.

Meanwhile, based on the survey results mentioned above and the pricing of the 2-year forward 1-year OIS rate, which is viewed as reflecting market expectations for the terminal rate, the market is starting to price in the risk that underlying inflation will exceed 2%. Furthermore, should such a situation arise, there are concerns as to whether the BOJ would be able to implement a tightening policy rate hike of more than 2%, given its relationship with the government. If we liken the current situation to a large bus, the question is whether, when the speed of the bus exceeds the target speed, can the BOJ not only ease off the accelerator but also step on the brakes.

Under our main scenario, we expect the inflationary shock caused by higher food prices and the situation in the Middle East to subside, with the CPI inflation rate expected to gradually decline starting next year, causing the policy interest rate to plateau at around 1.50%-2.00%. However, in addition to the improving output gap, if proactive fiscal policies continue, we cannot rule out the risk that upward pressure on prices could increase. In that case, what the market will be watching for at that time is whether the BOJ can not only ease off the accelerator, but also step on the brakes if necessary. Concerns about the BOJ "falling behind the curve" have not yet been completely dispelled.

FY27 budget process and its impact on 10yr JGB yield

In an interview with the *Yomiuri Shimbun* on 27 August, Prime Minister Sanae Takaichi indicated that the government intends to limit new JGB issuance under the FY27 budget to Y40tn, broadly in line with the FY25 level (Y33tn after FY26 supplementary budget). Meanwhile, our Senior Economist Koji Hamada noted in his report that, after factoring in the impact of bridge bond issuance to finance the new investment framework covering 17 strategic areas, which is not included in new JGB issuance, calendar-based market issuance in FY27 could increase by between the mid-Y10tn range and nearly Y20tn from FY26.

The report titled "Medium- to Long-Term Economic and Fiscal Projections under Japan's Growth Strategy"[1] submitted to the Council on Economic and Fiscal Policy on 24 June, was simulated based on the assumed annual additional fiscal spending of Y10tn, combined with the issuance of bridge bonds for strategic fields covered by the new investment framework. This assumption was maintained in the medium- to long-term projections released in July[2].

As such, we believe that the fiscal scale resulting from proactive fiscal policy is projected to be Y10tn plus a little extra. This has also been factored in and reflected in the rise for the 10-year JGB yield since late June. In that sense, we do not feel particularly uncomfortable with this budget process or the increase in calendar-based JGB issuance amounts for the next fiscal year. However, all told, this does not alter the assessment that, while the current administration emphasizes fiscal discipline, it is also pursuing proactive fiscal policies.

[1] Shun Otani (25 Jun 2026). *Daiwa's View: Y370tn investment and JGB market uncertainty: Growth, fiscal policy divergence.*
[2] Shun Otani (31 Jul 2026). *Daiwa's View: Medium/long-term fiscal estimates under "responsible proactive fiscal policy" and confidence in JGB market.*

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