

## Rates Strategy

# JGBS: LOST IN TRANSITION

**AUTHOR**

**Chiara Cremonesi**  
Senior Rates Strategist  
chiara.cremonesi@animasgr.it

*We believe that investors' concerns about financial stability and debt sustainability in Japan, as well as the potential spillovers from JGBs to other global bond markets are overstated.*

*Our view is that the Japanese bond market is transitioning to a different regime compared to the one prevailing since the 1990s, characterised by:*

***A new yield environment.*** *JGB yields are returning to levels last seen at the start of the deflationary era in Japan (around 1995), reflecting on the one hand the rise in inflation and on the other hand, the Bank of Japan's ongoing monetary tightening.*

***A new ownership structure.*** *A structural change in ownership of JGBs is underway. The BoJ is gradually reducing its balance sheet, but domestic investors are less active than in the past in absorbing supply. This leaves foreigners, the most price-sensitive category, as marginal investors. As we have learned from the US and the Euro Area bond markets, a shift in ownership from price-insensitive to price-sensitive investors typically result in higher yields and higher term premiums.*

***Bottom line: We believe that JGB yields could rise further, especially at the long end. That said, we expect upward pressure on bond yields to remain largely a domestic phenomenon.***

*Against this backdrop, we would tentatively start gradually accumulating JGB at 2.50% (10Y).*

## Japan back in focus

**Volatility in Japanese assets and a sharp rise in JGB yields to levels last seen in the 1990s have revived concerns about Japan's financial stability and debt sustainability**, as well as fears that potential repatriation flows could trigger renewed volatility in global bond markets.

**We believe that investors' concerns about both are overstated**, for the following reasons:

- 1) We do not see an immediate threat to financial stability in Japan, but even if such a risk were to materialise, we believe this would prompt an intervention by the BoJ to restore market stability.
- 2) The fiscal outlook is improving, and even in case of additional fiscal easing we do not see a threat to debt sustainability.
- 3) We do not see evidence that repatriation flows are likely in the near future.
- 4) It is far from a given that, even if repatriation flows were to occur, they would have a material impact on global bond markets.
- 5) Even if foreigners increase their allocations into JGBs, we do not expect significant spillovers to the other developed bond markets.

Our reading of what is happening is the following.

**The Japanese bond market is transitioning to a different regime compared to the one prevailing since the 1990s in two ways:**

- 1) **JGB yields are returning to levels last seen at the start of the deflationary era in Japan** (around 1995), reflecting on the one hand, the rise in inflation and, on the other hand, the Bank of Japan's monetary tightening cycle.
- 2) **A structural change in ownership of JGBs is underway.** The BoJ is gradually reducing its balance sheet, but domestic investors are less active than in the past in absorbing supply. This leaves foreigners, the most price-sensitive category, as marginal investors. As we have learned from the US and the Euro Area bond markets, a shift in ownership from price-insensitive to price-sensitive investors typically result in higher yields and higher term premiums.

**Bottomline: We believe that JGB yields could rise further, especially at the long end. That said, we expect the upward pressure on yields to remain largely a domestic phenomenon.**

Against this backdrop, we would tentatively start gradually accumulating JGB at 2.50% (10Y).

## 1) Financial stability is not under threat

At the end of January, when the JGB sell-off accelerated on expectations of additional fiscal easing and on weak demand for ultra-long bonds, investors drew parallels with the UK stress episode during the Liz Truss government, when forced selling by pension funds triggered broad-based market dysfunction.

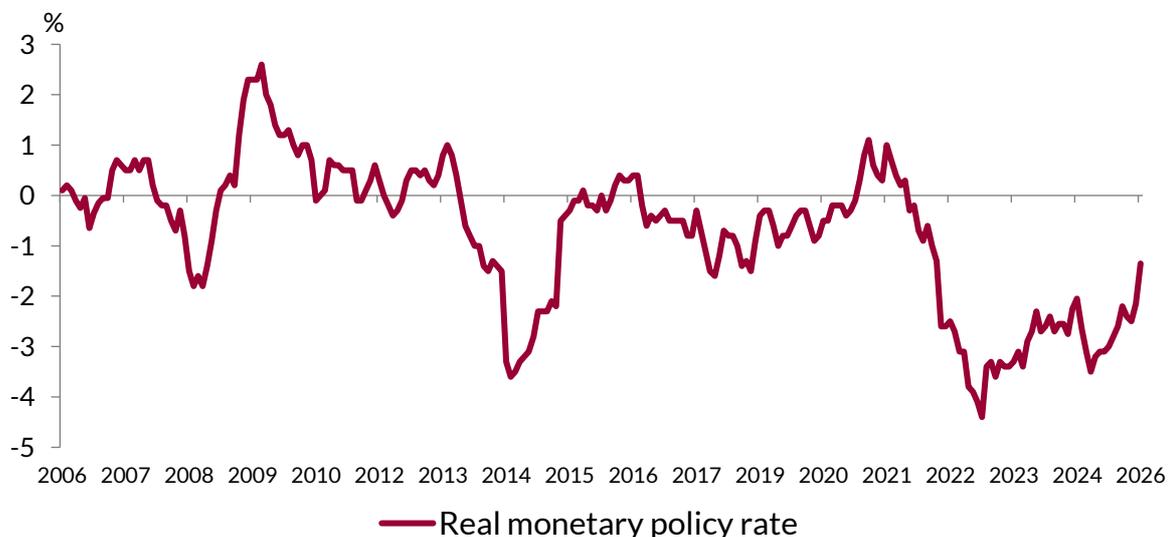
**We think that financial stability in Japan is not under threat**, for the following reasons:

- 1) Life insurers in Japan may be exposed to capital erosion coming from the increase in JGB yields via unrealised bond losses; moreover, according to the new solvency regulation, when JGBs sell off, life insurers may be forced to sell part of their JGB exposure to rebalance asset. That said, the risks of systemic instability are far lower than those observed in the UK in 2022, as life insurers do not use leverage on their JGB portfolios, and regulators are more proactive in assessing and managing risks.
- 2) The profitability of banks is robust. The interest rate hikes by the BoJ have improved their net interest margins, and they have also reported strong lending growth.
- 3) The corporate sector is generally in good health, with a solid liquidity position and moderate leverage.
- 4) Real yields are still deeply negative. Moreover, the gap between real interest rates and real growth remains significantly negative. Last but not least, the BoJ still holds around 45% of the JGB stock. This keeps financial conditions highly accommodative for the economy (Figure 1).

Finally, in the event of a domestic confidence shock, we believe that authorities would intervene promptly to stabilise markets, as occurred in the UK episode.

**Figure 1**

### Real policy rates in Japan remain in negative territory



Source: Bloomberg, ANIMA Research

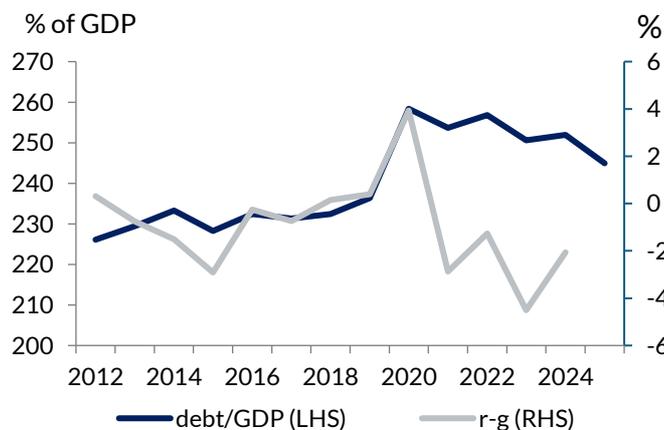
## 2) Fiscal outlook is improving

**Concerns about the deterioration in fiscal outlook in Japan are misplaced, as public debt metrics remain favourable,** for the following reasons:

- 1) The debt/GDP ratio has been on a declining trend since 2022, falling by 11pp over that period, and is expected to continue declining by a further 2-3pp over the next two years, due to a favourable differential between real interest rates and real GDP growth (Figure 2).
- 2) Fiscal deficit to GDP ratio is expected to remain close to 2% this year and next, while the primary balance (net of interest payments) is expected to be near balance (Figure 3). The cut to the consumption tax on food announced by PM Takaichi is expected to reduce tax revenues by up to 0.8% of GDP over two years, resulting in only a moderate impact on the deficit (likely starting from 2026). Moreover, according to the Ministry of Finance, the tax cut will not require additional JGB issuance.
- 3) Interest payments as a percentage of GDP remain very low compared with other developed economies, as do interest payments as a share of revenues (Figure 4). Furthermore, the latest projections from the Cabinet Office indicate that interest payments will increase only gradually, reaching around 2% by 2028.
- 4) The Ministry of Finance has demonstrated flexibility in responding to shifts in investor demand across the maturity spectrum. In 2025, issuance at the extra-long end of the curve declined both in absolute volume and as a share of total issuance, resulting in the shortest average maturity of new issuance since 2013 (Figure 5). According to the FY 2026 issuance plan, the trend of reducing supply at the extra-long end is expected to continue (Figure 5).

**Figure 2**

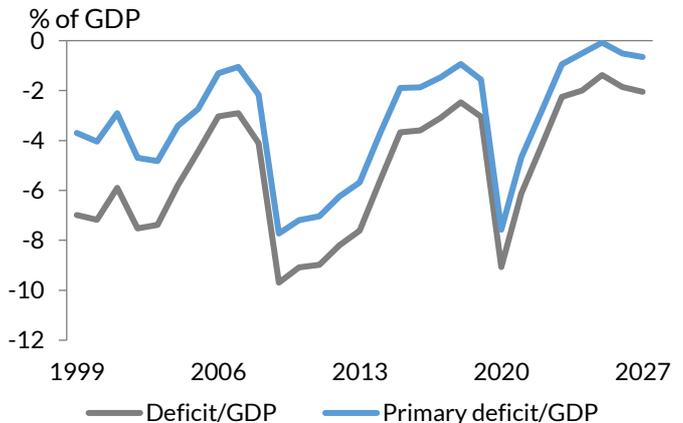
Debt declining on a favourable r-g metric



Source: Bloomberg, Haver Analytics, ANIMA Research

**Figure 3**

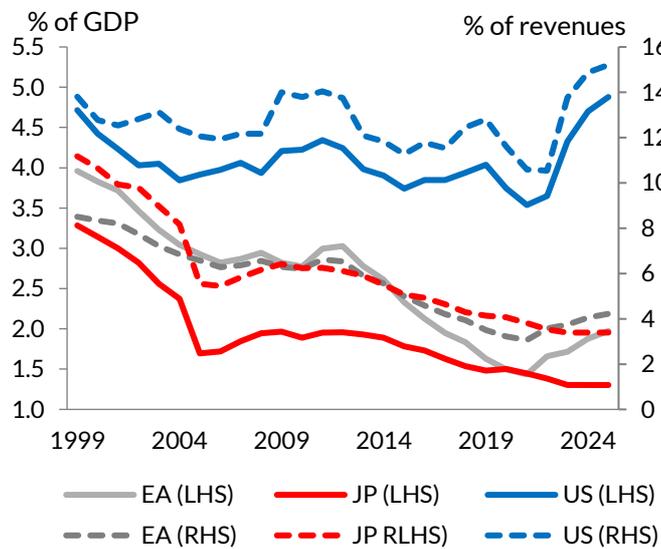
Fiscal deficits and primary deficits



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 4

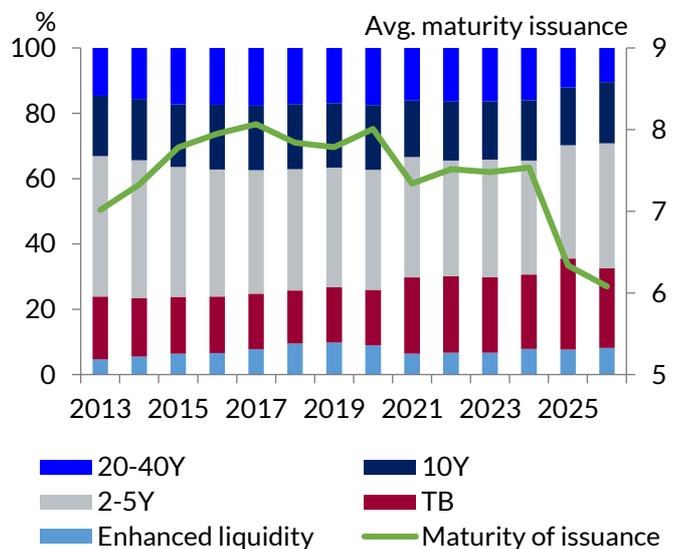
Interest payments are very low



Source: Bloomberg, Haver Analytics, ANIMA Research

Figure 5

Issuance declining at the extra long-end



Source: Bloomberg, Haver Analytics, ANIMA Research

### 3) Repatriation? Not yet

While JGB yields are trading near their historical highs, we do not see a compelling case for repatriation at this stage, for the following reasons:

- 1) Looking at the past, the necessary conditions for repatriation typically include:
  - a) Higher JGB yields relative to FX-hedged yields on foreign bonds.
  - b) A weak yen.
  - c) A broader environment of risk aversion.

At the moment, the third condition is not in place, and therefore the historical pattern for large-scale repatriation does not appear to be met.

- 2) The appetite of domestic investors for JGBs remains relatively subdued, particularly among the two largest investor groups: life insurers and banks.

Figures 6 and 7 show that over the past two years, as BoJ holdings of JGBs have declined sharply, domestic banks have only marginally increased their JGB exposure. Meanwhile, life insurers' holdings have fallen significantly. Only households and public pension funds have consistently increased their participation in the JGB market, although the scale of their demand remains modest and insufficient to offset the weak participation from banks and life insurers.

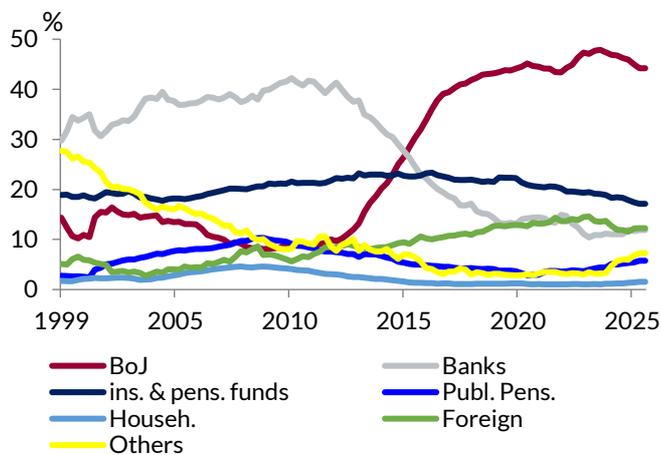
Going forward, we expect:

- ✓ **Banks remain reluctant to significantly increase their exposure to JGBs.** In the current environment of elevated volatility, JGBs are not a

reliable source of stable profits. Meanwhile, banks' profitability is being driven primarily by wider net interest margins and solid lending growth. Against this backdrop, banks are likely to resume meaningful JGB purchases only once volatility subsides and yields stabilise.

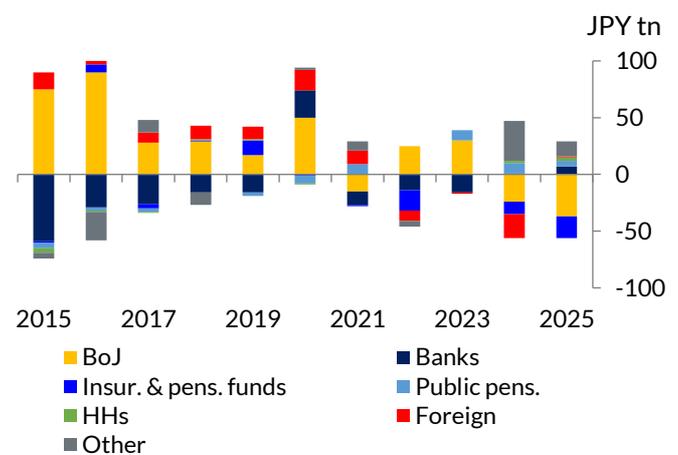
- ✓ **Life insurers not to increase their exposure to JGBs.** The new solvency regulation pushes life insurers to sell JGBs when yields rise, reducing their ability to accumulate duration risk. At the same time, life insurers are diversifying their profit sources, deploying most of their inflows abroad through M&A activity rather than increasing JGB holdings.

**Figure 6**  
Ownership of Japan public debt



Source: Bloomberg, Haver Analytics, ANIMA Research

**Figure 7**  
Who absorbed the net supply of JGBs?



Source: Bloomberg, Haver Analytics, ANIMA Research

#### 4) Evidence of a global impact from repatriation is weak

Even if repatriation flows were to materialise, we do not expect them to have either a sizeable or a lasting impact on global bond markets, for the following reasons:

1. Figure 8 shows that previous repatriation episodes have tended to reverse relatively quickly, suggesting that such flows are typically short-lived rather than structural.
2. Figure 9 indicates no clear evidence that past repatriation flows have exerted a meaningful influence on global bond markets, either in terms of yield levels or volatility.

Figure 8

## Japanese outward investment in various asset classes

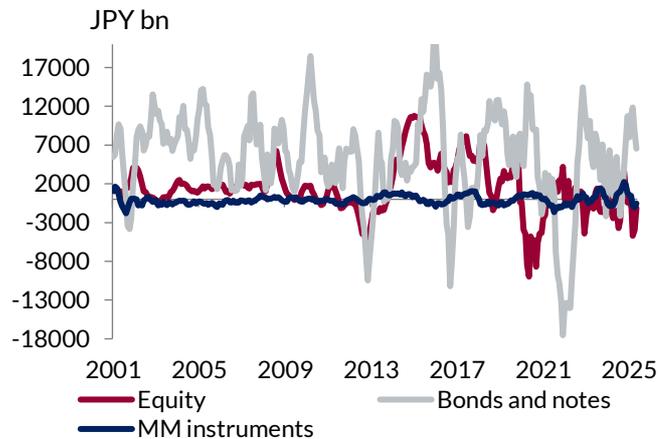
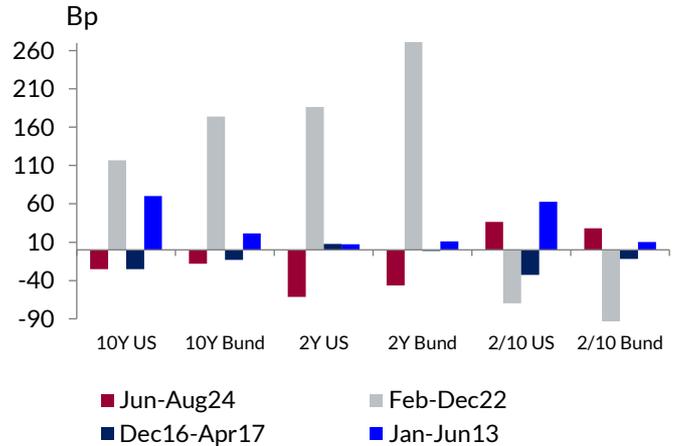


Figure 9

## No clear evidence of a global impact from repatriation



Source: Bloomberg, ANIMA Research

Source: Bloomberg, ANIMA Research

## 5) No sizeable global spillover from an intensification of foreign inflows into JGBs

Foreign investors, particularly private investors, have substantial room to increase their allocations to JGBs, for the following reasons:

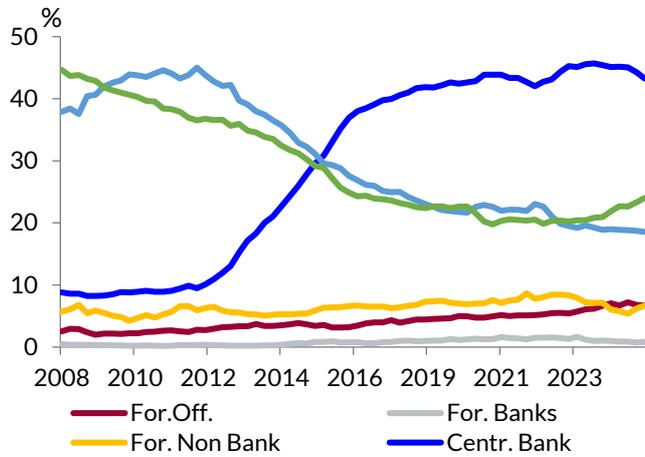
- 1) **According to the IMF, foreigners' holdings of JGBs are almost evenly split between foreign official institutions and foreign private investors.** This is reflected in the fact that most foreign holdings are concentrated in T-bills, while foreign private investors have very limited exposure to medium- and long-dated JGBs (Figure 10).
- 2) **Foreign trading activity in JGBs, both in the secondary market and in futures, is far larger than implied by their actual ownership share.** This indicates that foreign investors play a significant role in market liquidity and price discovery, despite holding a relatively small portion of outstanding debt (Figure 11).
- 3) **For US and Euro Area investors, holding FX-hedged JGBs remains more attractive than domestic bonds** (Figure 12), as long as volatility does not rise materially.

That said, even if foreign investors were to increase their inflows into JGBs, we do not expect sizeable spillovers to other developed bond markets. Even assuming foreign holdings return to their mid-2023 peak, the resulting inflows would amount to around JPY 35 trillion (USD 225 billion), an unprecedented increase in a single year, but still very small in a global context.

For comparison, last year domestic investors absorbed around USD 1.7 trillion of US Treasuries and euro-area government bonds combined (USD 1.3 trillion of USTs and USD 400 billion of euro-area government bonds). Against this backdrop, any reallocation into JGBs would divert only a marginal share of flows from other developed bond markets.

**Figure 10**

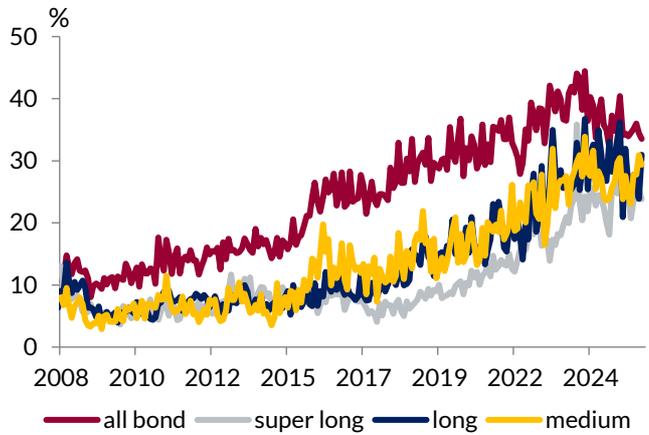
**Foreign officials represent half of JGB foreign holdings**



Source: Bloomberg, ANIMA Research

**Figure 11**

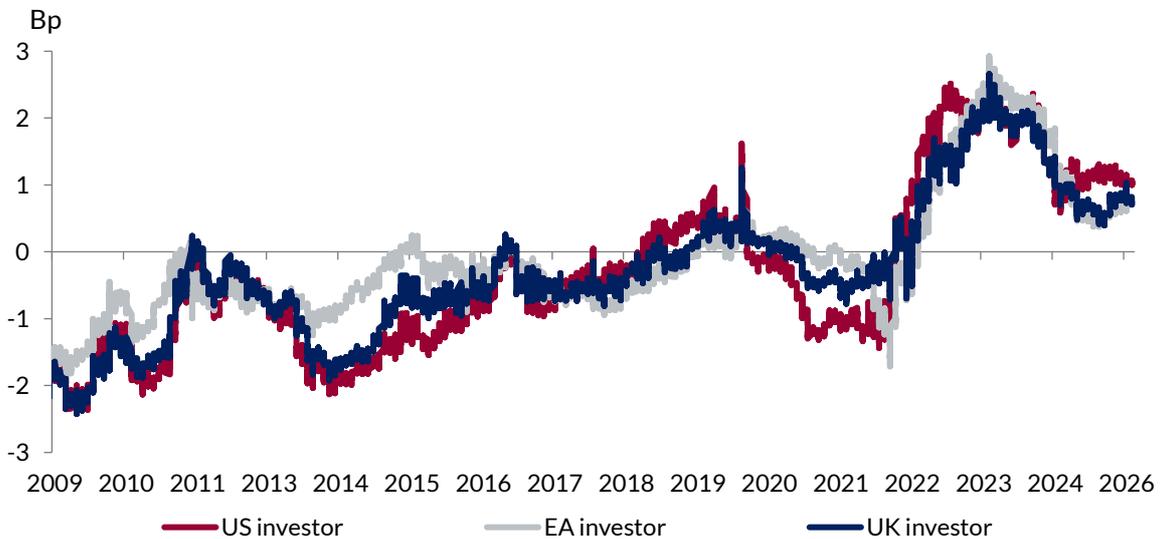
**JGBs traded by foreigners (purchases, % of total)**



Source: Bloomberg, ANIMA Research

**Figure 12**

**Yield of FX-hedged JGB relative to domestic 10-year bonds**



Source: Bloomberg, ANIMA Research

## 6) A regime in transition

Our reading of recent developments is the following: the Japanese bond market is transitioning to a new regime, distinct from the one prevailing since the 1990s, in two key ways:

1. JGB yields are returning to levels last seen at the start of Japan's deflationary era (around 1995), reflecting, on the one hand, the rise in inflation and, on the other, the Bank of Japan's ongoing monetary tightening.
2. A structural shift in the ownership of JGBs is underway. The BoJ is gradually reducing its balance sheet, while domestic investors are less active than in the past in absorbing supply. This leaves foreign investors — the most price-sensitive cohort — as the marginal buyers. As we have seen in the US and Euro Area bond markets, a shift in ownership from price-insensitive to price-sensitive investors typically leads to higher yields and wider term premia.

**Bottom line: We believe that JGB yields could rise further, particularly at the long end. That said, we expect the upward pressure on yields to remain largely a domestic phenomenon, rather than a source of global spillovers.**

Against this backdrop, we would tentatively start gradually accumulating JGB at 2.50% (10Y).

**ANIMA INVESTMENT RESEARCH****FABIO FOIS**

Head of Investment Research & Advisory  
[fabio.fois@animasgr.it](mailto:fabio.fois@animasgr.it)

**CHIARA CREMONESI**

Senior Rates Strategist  
[chiara.cremonesi@animasgr.it](mailto:chiara.cremonesi@animasgr.it)

**FRANCESCO PONZANO**

Junior Equity Strategist  
[francesco.ponzano@animasgr.it](mailto:francesco.ponzano@animasgr.it)

**MATTEO GALLONE**

Junior Macroeconomist  
[matteo.gallone@animasgr.it](mailto:matteo.gallone@animasgr.it)

**COSIMO RECCHIA**

Senior Equity Strategist  
[cosimo.recchia@animasgr.it](mailto:cosimo.recchia@animasgr.it)

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