Weekly Market Flash

Japanese Bonds, a 2026 Wild Card

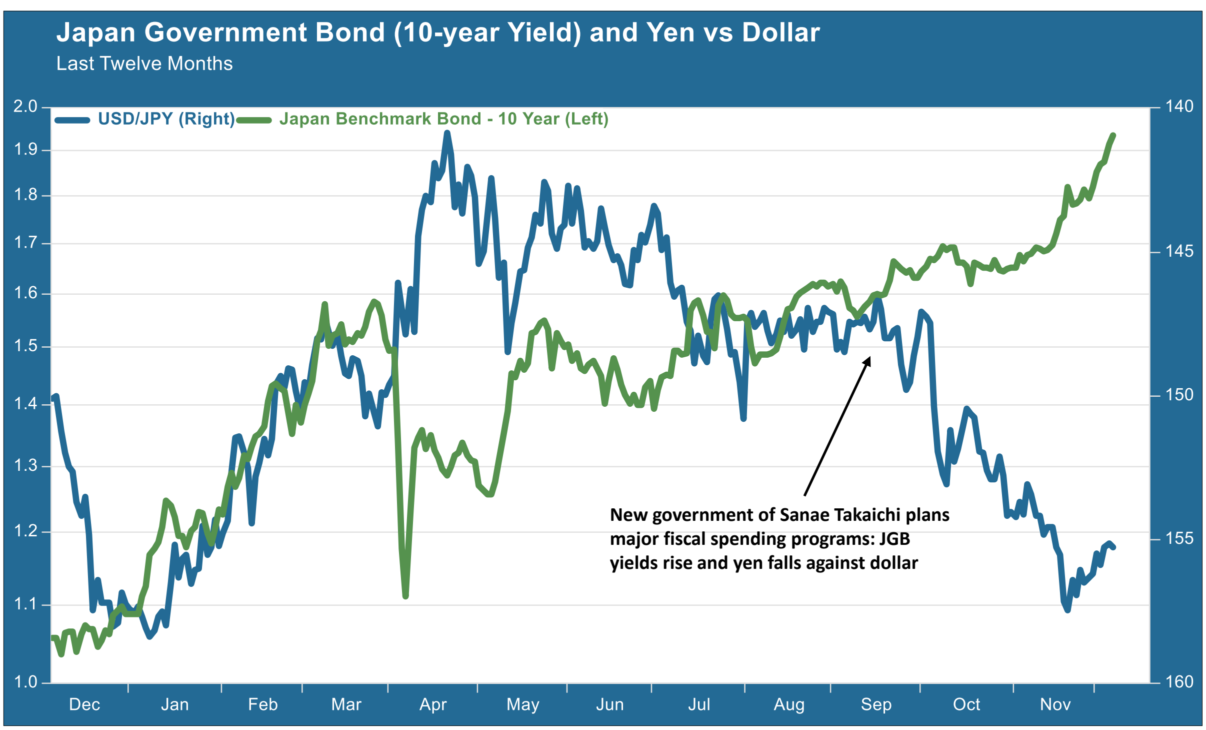
December 5, 2025

Happy December! It's the last month of 2025, which has been a strange year in oh so many ways. It is also the month when, by custom and tradition, our leading financial institutions tell us, in very specific terms, how the S&P 500 and the Nasdaq and the Dow will all fare in 2026. Please. You will have just as much insight into what the US stock market will look like twelve months hence if you ask the question of your friendly neighborhood psychic. Or your dog, for that matter.

Rather than trying to pin a number on something that is entirely unknowable, let us instead think about what some of the wild cards might be that buffet assets hither and yon next year. One that we have been paying attention to recently is the Japanese bond market. It was not too long ago – little more than a year in fact – when the most notable feature of this market was negative yields. Under the hyper-stimulatory policies of the Bank of Japan, investors in Japanese government bonds (JGBs) not only received no interest income, but those interest payments actually went in the other direction.

Takaichi-nomics

Those days are gone. The 10-year Japanese government bond yield has nearly doubled since the beginning of the year, with much of the growth spurt coming in the past two months as the new government led by prime minister Sanae Takaichi came into office with big plans for some major fiscal stimulus to shake Japan's economy out of its recent lethargy. At the same time the Japanese yen, which had risen sharply against the US dollar earlier in the year, has plunged by around seven percent against the greenback.



Source: MVF Research, FactSet

The Bank of Japan has already raised rates three times since March 2024, at which time the benchmark policy rate was still negative. The BoJ meets again next Thursday (one day after the Fed holds its December meeting), and analysts are now expecting that this meeting will produce another rate hike. BoJ Governor Kazuo Ueda suggested as much in public comments earlier this week, and swaps markets are now pricing in around a 70 percent probability of another hike.

The policy action stems from concerns that the new Takaichi government will be tapping the debt market for sizable supplemental issuances next year in order to fund a massive budgetary program to promote economic growth. Investors have grown wary of longer-dated bonds recently, with a collective holding of breath and then a measure of relief when a 20-year JGB auction this week managed to scrape out enough demand to cover the issue. Observers worry that the government's plans will prove too ambitious for the market to swallow, particularly if the size of the government's budget necessitates going back to those shaky longer maturities. The same concerns have been behind the recent pronounced weakness in the yen against other major currencies.

Carry That Weight

The other major implication for bond markets outside Japan is the way higher yields upend the carry trade, a long-standing and arguably stabilizing factor in global credit markets. In a world of ultra-cheap Japanese yields, investors borrowed in yen and invested in higher-yielding opportunities elsewhere. Japanese financial institutions are among the world's largest creditors, and in recent years Japan surpassed China as the largest international holder of US Treasuries. But the prospect of higher rates in their home country may drive the Japanese financial institutions to repatriate a meaningful part of their overseas holdings, which in turn could drive rates higher elsewhere. Including, yes, the US Treasury market. And equity markets, as we all know, are downstream from and highly affected by changes in fixed income yields.

This could be one catalyst for a very messy year in global credit. There are plenty of other reasons to not be looking forward to bond markets next year. Here at home, latter-day bond vigilantes have been trying to steer the White House away from turning the Fed into a supplicant to the president's monomaniacal desire for ultra-low interest rates. Dissension among Federal Open Market Committee members has been a factor of the past several FOMC meetings, a trend which could turn even sharper in the months to come.

But even in the event that the administration were to get its way and start pushing the Fed funds rate ever lower, the forces affecting longer-term rates – i.e., the ones that have more impact on real-world economic activity – are much less easy for politicians to control. Such as, for example, a sizable exit by Japanese banks from their US Treasury holdings in response to the higher yields back home. This may not come to pass, of course. But it will require close attention in the weeks and months ahead.

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