ARCULUS CAPITAL
MACRO RESEARCH

Japan at the Turn

The outlook for inflation, growth, unemployment and interest rates

22 July 2026 · Prepared by Arculus Capital · For institutional and wholesale clients

> *Japan has not escaped its debt problem; it has changed the currency in which that problem is paid. The adjustment is running through the exchange rate and the price level, not through the bond market. That is a slower crisis, and a more insidious one.*

Executive summary

Japan is roughly eighteen months into the most consequential macroeconomic regime change of any developed economy since the global financial crisis. The Bank of Japan abandoned yield curve control in March 2024, raised its policy rate to 1.00% on 16 June 2026 — the highest level since September 1995 — and is running a multi-year balance sheet reduction that will cut its JGB holdings by roughly a third by 2030. At the same time, the Takaichi government has, in its first Basic Policy blueprint approved on 21 July, removed the phrase "fiscal consolidation" from official policy and replaced the primary balance target with a multi-year debt-to-GDP objective. Monetary policy is tightening into a fiscal expansion. The yen is the release valve, and it is under sustained pressure.

Our central case is not a crisis. It is something more awkward for portfolio construction: a persistent, grinding repricing of Japanese duration and the yen, punctuated by episodes of disorder around fiscal events. We expect the BoJ to hold at 1.00% on 31 July, hike to 1.25% in October, and reach 1.50% by mid-2027. We expect the 10-year JGB at 3.10–3.30% and the 30-year at 4.25–4.50% by year-end. We expect measured core inflation to trough in the middle of this year and reaccelerate toward 2.5% by Q4 as energy subsidies roll off and a stale corporate FX assumption is marked to market.

House view in brief

- **Inflation.** Measured core CPI is being held roughly 50–70bp below its underlying rate by energy subsidies and the retail gasoline cap. Corporate inflation expectations have anchored above target — the June Tankan has firms at 2.7% one year ahead and 2.6% at both three and five years. Underlying inflation is at, not below, target.
- **Growth.** Q1 was strong (+0.5% q/q, +1.8% annualised) but the composition was poor — net exports and consumption carried it while business investment contracted 0.7%. We look for roughly 0.7% calendar-year growth in 2026, with the AI-linked capital expenditure cycle the single most important domestic swing factor.
- **Unemployment.** At 2.5% the unemployment rate is close to uninformative. Japan's labour market clears through hours, participation and wages, not through the jobless rate. The signal is in the vacancy ratio (1.17, falling) and the Tankan employment diffusion index (−37). We expect 2.5–2.7% through 2027.
- **Interest rates.** Hold in July, hike in October, 1.50% by mid-2027, terminal 1.75–2.00% this cycle. The more important call is the curve: we expect continued bear steepening driven by term premium and supply, not by policy expectations.
- **The yen.** Intervention controls the pace of depreciation, not the level. The Ministry of Finance spent a record ¥11.73trn in April–May and USD/JPY was back through the intervention level inside six weeks. We look for a 158–168 range with the risks skewed to the topside absent a hawkish reaction-function reset.

Later in this paper we set out where we differ materially from the prevailing bearish commentary on Japan — specifically the claim that unsupported Japanese long-end yields would be in double digits. We think that claim is built on a premise that has been overtaken by events, and on an analogy to the 2020 European periphery that does not survive contact with the difference between local-currency and foreign-currency-equivalent sovereign debt. Our own estimate of fair value for an unsupported 30-year JGB is 4.75–5.75%. That is a serious number. It is not ten per cent.

The starting point: Japan in July 2026

Before forecasting, it is worth being precise about where the data actually sit, because the narrative around Japan has run some distance ahead of the prints.

Exhibit 1. Japan macro dashboard, as at 22 July 2026

Indicator	Latest	Comment
Policy rate	1.00%	Raised 25bp on 16 June 2026, 7–1 (Asada dissenting). Highest since Sep-1995.
Headline CPI (national)	1.5% y/y	May. June print due 24 July; consensus core 1.6%.
Core CPI (ex fresh food)	1.4% y/y	May. Fifth consecutive month below the 2% target.
Tokyo core CPI	1.6% y/y	June. First acceleration in eight months.
Real GDP	+0.5% q/q	Q1 2026; +1.8% annualised (revised down from 2.1%).
Business investment	−0.7% q/q	Q1 2026, revised from +0.3%. The soft spot in the accounts.
Unemployment rate	2.5%	May, unchanged. Employment at a record 68.82m.
Jobs-to-applicants	1.17	May, down 0.01. New openings −8.9% y/y.
Nominal cash earnings	+3.2% y/y	May. 53rd consecutive month of growth.
Real wages	+1.4% y/y	May. Fifth consecutive positive month.
Shunto 2026 (final)	5.01%	Rengo final tally, 5,368 unions. Third year above 5%. SMEs 4.69%.
10y JGB	~2.90%	Highest since Sep-1996. Nine consecutive up-days in early July.
30y JGB	~4.00%	20y at ~3.85%, highest since Jul-1996.
USD/JPY	~162	40-year low of 162.84 touched in mid-July.
Tankan capex (large firms)	+11.5%	FY2026 plans, versus +3.3% in March. Recurring profits −6.7%.

Sources: Statistics Bureau of Japan, Cabinet Office, MHLW, Bank of Japan, Rengo, Reuters. Arculus Capital.

Three features of that table deserve emphasis.

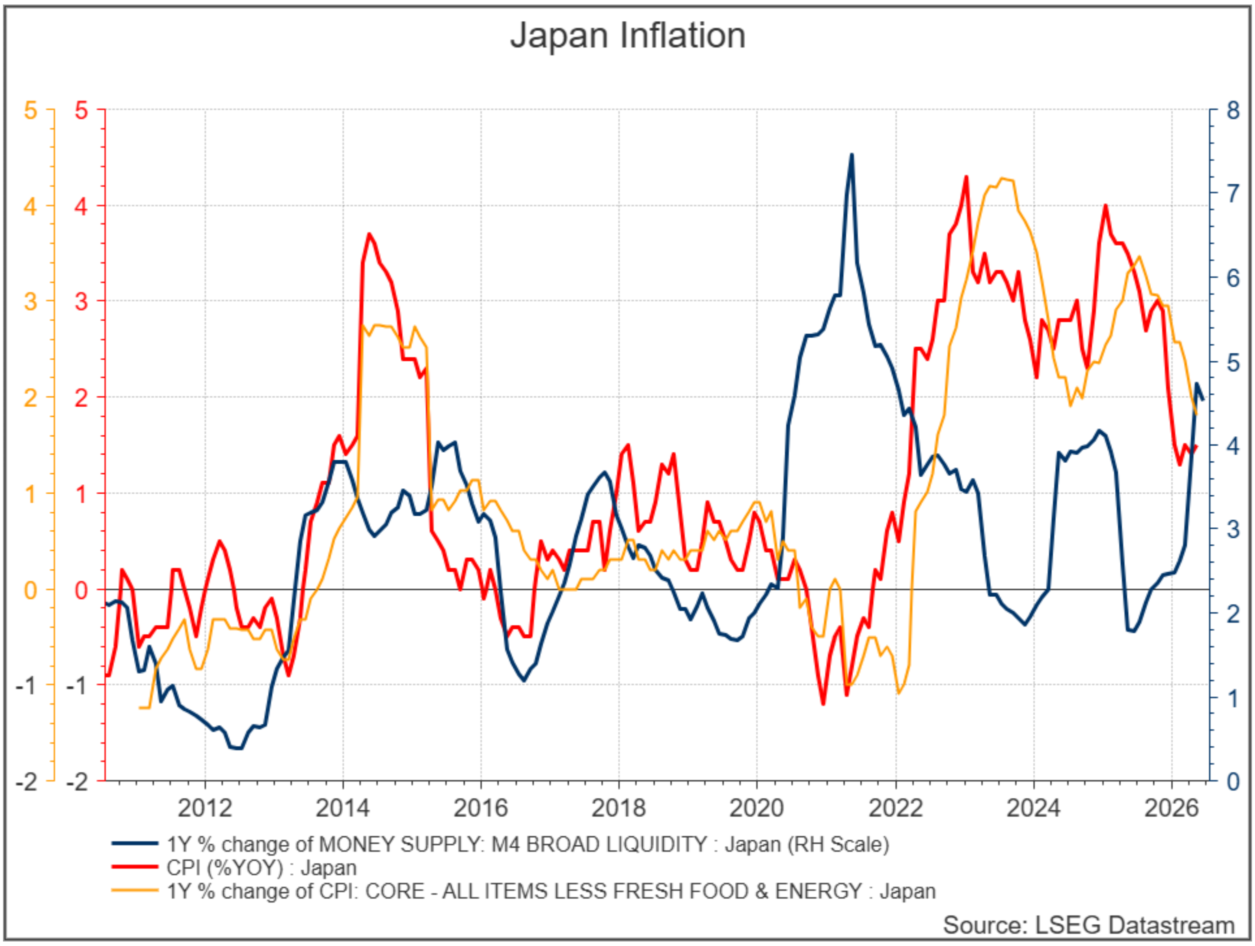
First, measured inflation is below target while wage growth runs above 3% and the spring wage round has now cleared 5% for a third consecutive year. That combination is not equilibrium; something has to give, and what is giving is the measurement, not the economy.

Second, the labour market is at full employment on any reasonable definition, and has been for years.

Third, the long end of the JGB curve has already done a great deal of repricing — the 30-year at 4.00% is not a suppressed yield by any historical standard.

Inflation: the subsidy illusion

The single most important thing to understand about Japanese inflation in 2026 is that the headline series is being actively managed. Government energy subsidies — worth roughly 0.5% of GDP — and a retail gasoline price cap near ¥170 per litre have held electricity and gas prices deeply negative in year-on-year terms even as the US–Iran conflict pushed crude and petrochemical feedstock costs sharply higher. In March, with headline at 1.5%, electricity was running at −8.0% y/y and gas at −5.2%. Those are policy numbers, not market numbers.

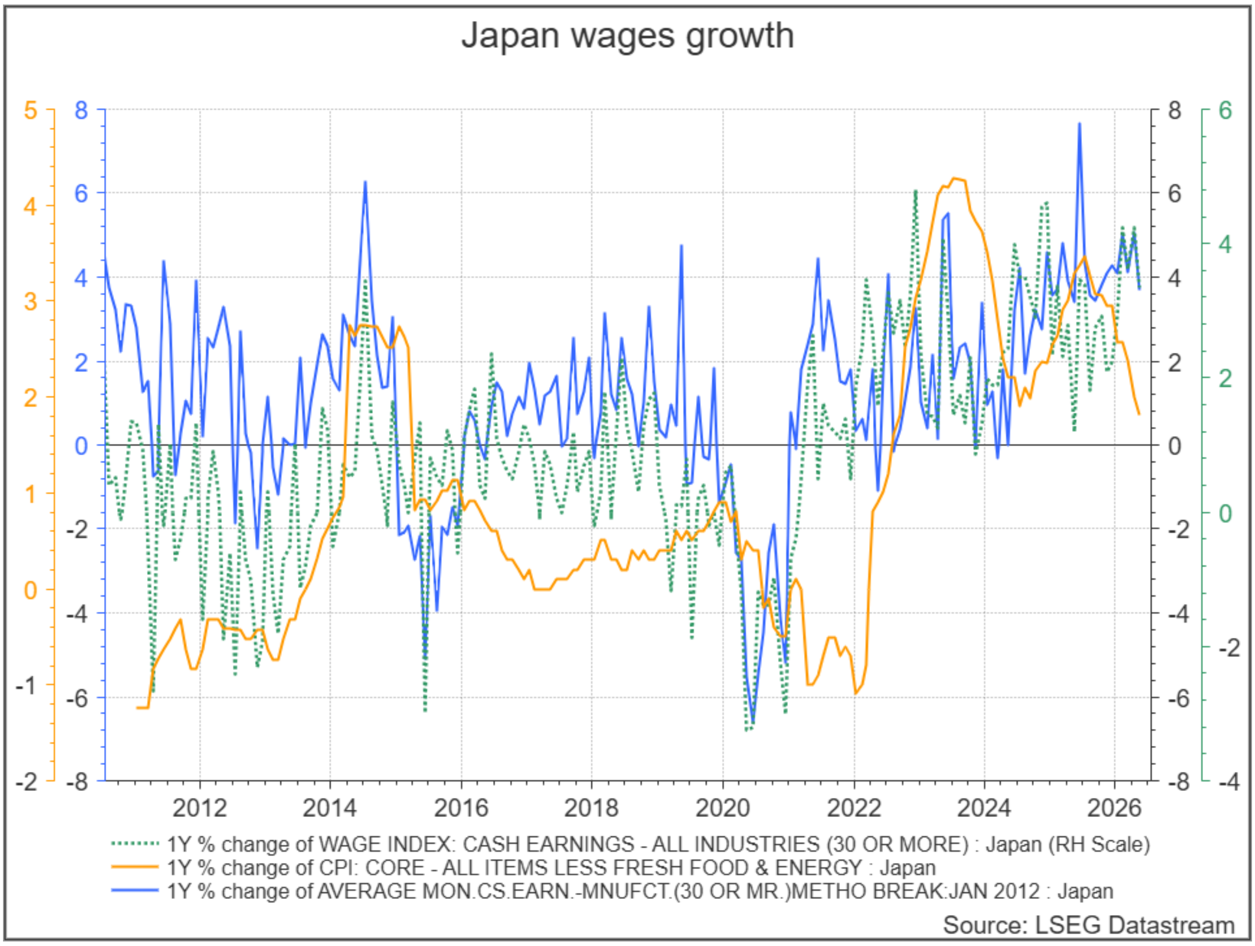


Strip the subsidies out and the picture inverts. Core-core inflation — excluding both fresh food and energy — was running at 1.9% in Tokyo in June against a core reading of 1.6%. The gap between the two is the subsidy. Our working estimate is that measured core understates underlying inflation by roughly **50 to 70 basis points**. That is a judgement, not a measurement, and we flag it as such — but it is consistent with the wedge visible in the core-core series and with the scale of the subsidy programme relative to the CPI energy basket.

The wage channel is now self-sustaining

The 2026 shunto round concluded on 3 July with a weighted average increase of 5.01% across 5,368 Rengo-affiliated unions — ¥16,400 per month. That is down from 5.25% in 2025, but it is the third consecutive year above 5%, and critically, base pay gains (as distinct from seniority-based increments) averaged around 3.85% in the initial tally. Small and medium enterprises settled at 4.69%, up slightly on the year, which is the more remarkable number given that SMEs are where Japanese wage transmission has historically broken down.

This is now showing up in the official data. Nominal cash earnings rose 3.2% in May, the 53rd consecutive month of growth, with base pay at 3.0%. Real wages rose 1.4%, the fifth consecutive positive month. The thirty-year battle to break deflationary wage-setting norms appears, on the evidence, to have been won. The debate has shifted from whether wage growth is sustainable to whether it is now too fast to be consistent with 2% inflation.



The stale FX assumption

The most actionable single data point in the June Tankan is not the sentiment index. It is the currency assumption. Surveyed firms are planning fiscal 2026/27 on an average USD/JPY of 152.57. Spot has been trading near 162. Corporate Japan is running its cost base and its pricing on an exchange rate roughly six per cent stronger than the one it is actually transacting at.

> *A six per cent gap between the planning rate and the traded rate is not a forecasting error. It is a pipeline of cost pass-through that has not yet reached the shelf.*

That gap has to close, and it closes through import costs and then through selling prices. The Tankan tells us firms are willing to pass costs on: they lifted their own inflation expectations across every horizon in the June survey, to 2.7% at one year and 2.6% at both three and five years. Those are the highest readings in the series' history and they are the numbers the BoJ cares most about, because they measure whether inflation has become embedded in price-setting behaviour rather than merely observed in the data.

Inflation forecast

We expect core CPI to have troughed. The June national print, due 24 July — two days after this paper — is expected at 1.6%, up from 1.4%, on energy and on revisions to medical service fees. From there we look for a steady climb through the second half as the FX pass-through lands and as the base effects from the 2025 energy subsidy programme become unfavourable. Our profile is core CPI at roughly 2.2–2.5% by Q4 2026, averaging 2.0–2.2% across fiscal 2026 and holding near 2.0% in fiscal 2027.

One complication cuts the other way. The government has committed to deciding by early August whether to cut the consumption tax on food and beverages from 8% to 1%, for two years, with effect from April 2027. If enacted, that is roughly 0.8% of GDP in fiscal cost and a mechanical one-off reduction in measured CPI of the order of 60–80bp from April 2027 — followed by an equal and opposite base effect two years later. **We would expect the BoJ to look through it entirely.**

Growth: good headline, poor composition

Japan's first quarter looked strong and was, on inspection, more fragile than the headline suggested. Real GDP rose 0.5% quarter-on-quarter, 1.8% annualised after revision from an initial 2.1%. The revision came entirely from business investment, which was marked from +0.3% to −0.7%. Growth was carried by net exports — with exports up 1.8% on strong auto and machinery demand — by private consumption at +0.3%, and by public investment rising for the first time in three quarters.

On a year-on-year basis the economy grew just 0.4–0.6%. That is the relevant frame. Japan's trend growth rate, on the Cabinet Office's own numbers, averaged 0.4% across fiscal 2021 to 2025. The Honebuto blueprint approved on 21 July sets a target of sustained real growth above 1% and nominal growth above 3% "as early as possible." Those targets require roughly a tripling of the realised trend. We would treat them as aspirational.

The AI capital expenditure cycle is the domestic swing factor

The most important positive in the Japanese economy right now is a genuine, broad-based investment cycle driven by semiconductor equipment and data centre construction. It is visible in the equity market — Tokyo Electron and Advantest are the two largest weights in the Nikkei 225 — but the more useful evidence is in the June Tankan, where large firms lifted fiscal 2026 capital expenditure plans to +11.5% from +3.3% in March, beating a +10.5% consensus.

Two cautions. First, large firms are simultaneously forecasting recurring profits down 6.7% over the same fiscal year. Firms are investing through margin compression, which is constructive for growth but tells you the investment is strategic rather than cash-flow-driven, and therefore more vulnerable to a financing shock. Second, small firms are going the other way, planning an 8.3% capex decline against an expected 4.5% fall. The corporate sector is bifurcating along exactly the line you would expect when the cost of capital rises: large, cash-rich, export- and technology-linked firms are expanding; small, domestically-oriented, leveraged firms are retrenching.

Fiscal impulse: announcement versus execution

The Takaichi government has been prolific in announcements. A ¥21.3trn stimulus package in November 2025. A fiscal 2025 supplementary budget that reached ¥18.3trn after roughly ¥4trn was added to the Ministry of Finance's draft at the Prime Minister's direction. Energy subsidies at around 0.5% of GDP. A planned consumption tax cut on food worth 0.8% of GDP. An ambition to lift defence spending from roughly 1% to 3.5% of GDP. And now a headline commitment to unlock ¥370trn of combined public and private investment by fiscal 2040 — around 4.6% of GDP per annum if delivered evenly, which it will not be.

The gap between announcement and disbursement in Japanese fiscal policy is wide and historically persistent. Supplementary budgets routinely carry forward. Nominal GDP growth is running well ahead of the deflator assumptions embedded in revenue forecasts, so tax receipts are buoyant and the realised deficit is consistently better than the announced deficit. **Our working assumption is that the growth impulse from announced fiscal policy will disappoint, while the bond supply implications will not.** That asymmetry — weaker growth transmission than advertised, full supply transmission — is the single most bond-negative feature of the current policy configuration.

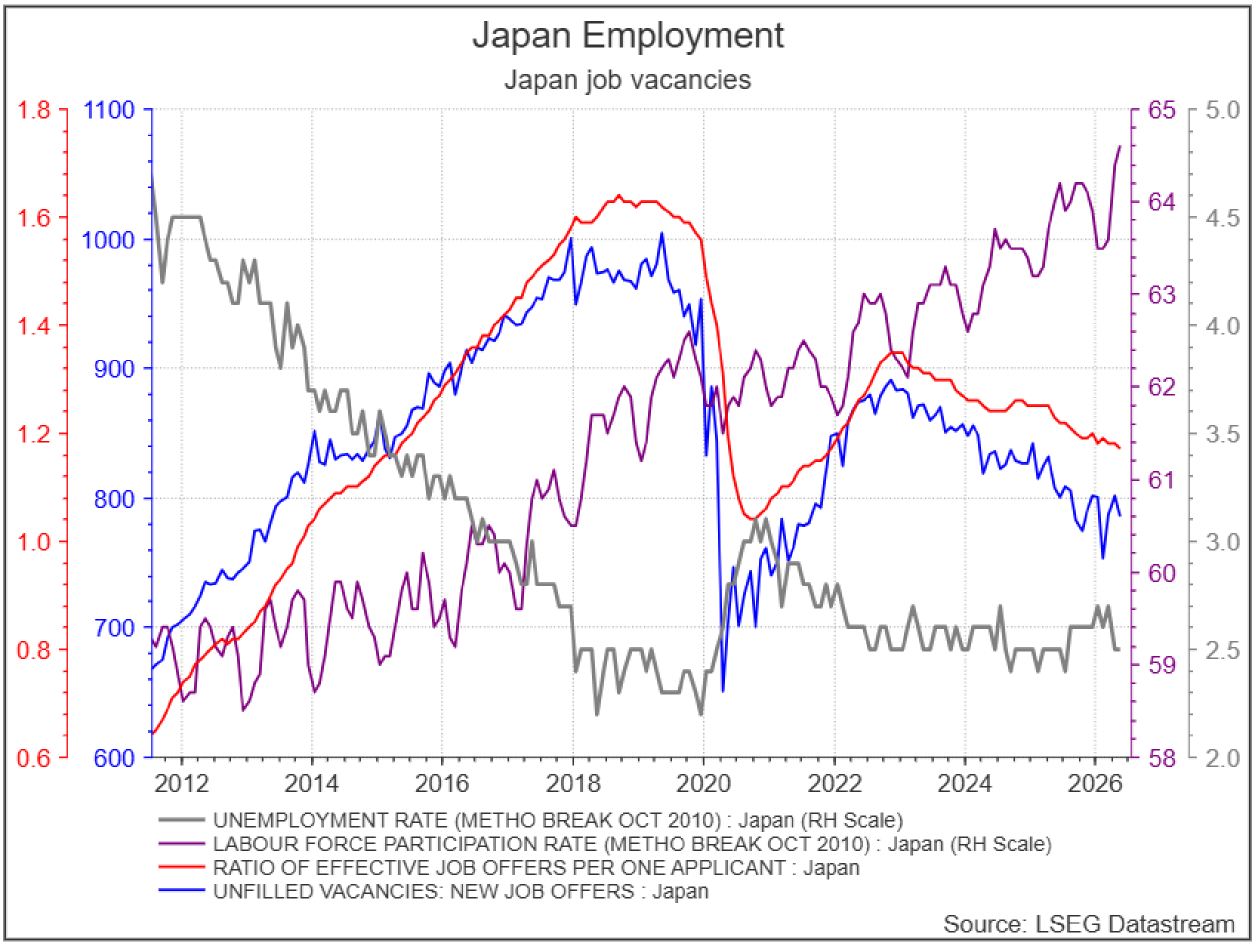
Growth forecast

We look for around 0.2% quarter-on-quarter growth in Q2, consistent with the Japan Centre for Economic Research consensus of 0.45% annualised, and roughly 0.7% for calendar 2026 as a whole. The Bank of Japan cut its fiscal 2026 growth forecast to 0.5% in April from 1.0% in January, and is reported to be considering a modest upgrade at the July meeting on the strength of AI demand and lower fuel costs. We would put fiscal 2026 at 0.6–0.9% and fiscal 2027 at 0.8–1.0%.

Unemployment: the wrong indicator

Japan's unemployment rate has been between 2.4% and 2.7% for four years. It was 2.5% in May, unchanged, with employment at a record 68.82 million. It will very likely still be between 2.4% and 2.8% in two years' time regardless of what happens to growth. Forecasting it is close to a null exercise, and building a policy framework on it is worse than useless.

The reason is demographic. Japan's working-age population is contracting and immigration is not offsetting it at scale. Labour supply falls roughly as fast as labour demand in a downturn, so the jobless rate barely moves. The Tankan employment diffusion index sat at −37 in June, essentially unchanged from −38 in March, indicating acute and persistent labour shortage across firms of every size. Adjustment in the Japanese labour market happens through hours worked, through elderly and female participation, and — increasingly, and this is the regime change — through wages.



What to watch instead

- **Jobs-to-applicants ratio.** 1.17 in May, down 0.01 and the first decline in two months. This turns before the unemployment rate does. Regional dispersion is extreme — Fukui at 1.74 against Osaka at 0.95.
- **New job openings.** Down 8.9% year-on-year in May. This is the genuinely soft number in the labour data and the one that would give the BoJ pause if it persists. It is consistent with the small-firm capex retrenchment in the Tankan.
- **Active applicants.** Up 0.7% in May, driven by workers seeking better conditions and rising elderly participation. Voluntary job-switching is itself a wage-inflationary mechanism and a sign the labour market is functioning more like a Western one.

Our forecast is unemployment at 2.5–2.7% through the forecast horizon, drifting marginally higher as small-firm retrenchment bites, with no macroeconomic significance to the move. The important labour-market call is that wage growth persists at 3%-plus even through a growth slowdown, because the constraint is supply, not demand. That is what allows the Bank of Japan to keep tightening into a soft patch.

Interest rates: policy, the balance sheet, and the curve

The policy rate

The Bank of Japan raised its policy rate to 1.00% on 16 June by a 7–1 vote, with Toichiro Asada — one of two reflationist economists appointed to the board by the Takaichi government — dissenting in favour of a hold. Governor Ueda was absent from that meeting. The statement committed to further increases in response to economic developments, and Bloomberg's survey consensus following the decision was for a further move to 1.25% by year-end.

We expect a hold at the 30–31 July meeting. The BoJ is reported to be preparing a modest upgrade to its fiscal 2026 growth forecast and a small downgrade to its near-term core inflation forecast on lower oil, and will retain guidance for further hikes without committing to timing. That combination — better growth, lower measured inflation, unchanged hawkish framing — is a deliberately ambiguous signal, and we would expect it to be read as such.

Our path is 1.25% in October, with the July and August CPI prints (21 August and 18 September respectively) as the decisive inputs, and 1.50% by mid-2027. We see the terminal rate for this cycle at 1.75–2.00%. That is above the median sell-side path and reflects our view that underlying inflation is at target now, not below it, and that the labour market cannot provide disinflation.

The balance sheet is the more important instrument

At the June meeting the Bank completed its interim assessment of the bond taper and set out the plan beyond March 2027. Monthly JGB purchases fall to about ¥2trn from April 2027 and remain there. The projected path of holdings is set out below. Naoki Tamura dissented, arguing for a faster reduction of ¥200bn per quarter through to early 2028 on the grounds that long rates should be set by the market.

Exhibit 2. Projected Bank of Japan JGB holdings

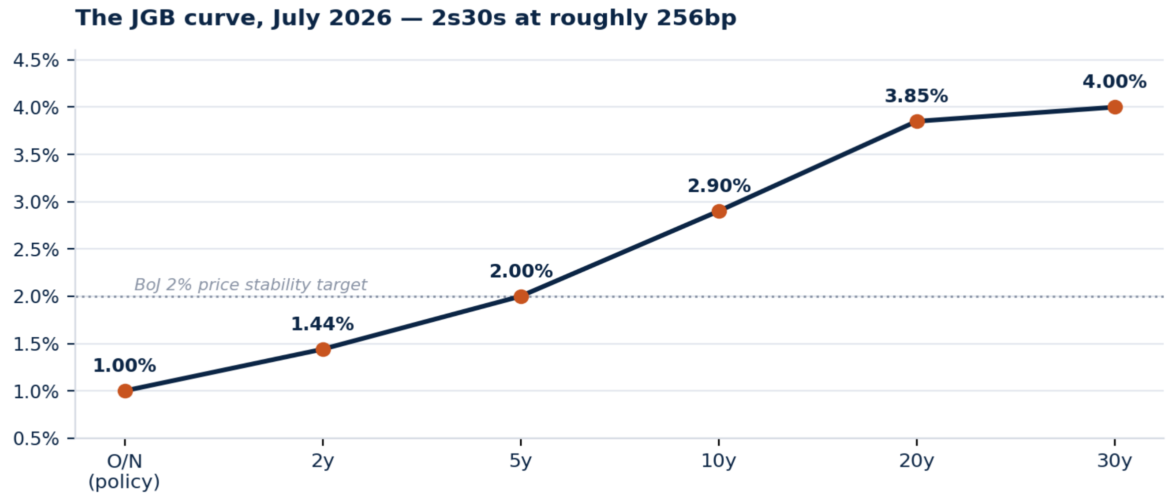
As at	Holdings	Reduction from June 2024
End-March 2027	~¥480trn	~17%
End-March 2028	~¥430–440trn	~24–25%
End-March 2029	~¥390–400trn	~31–32%
End-March 2030	~¥350–370trn	~36–39%

Source: Bank of Japan, Statement on Monetary Policy, 16 June 2026. Assumes monthly purchases maintained at approximately ¥2trn.

This matters more than the policy rate for anyone holding Japanese duration. The Bank is withdrawing from roughly a third of its position over four years, into a rising net issuance profile, at a moment when the government has explicitly de-emphasised fiscal consolidation. The marginal buyer of the JGB long end has to be found in the private sector, at a price the private sector sets. Auction evidence is already showing the strain: the 10-year auction on 2 July had its tail widen to 0.2 points from 0.05 at the previous sale.

The curve

The JGB curve as at mid-July is set out below. What is striking is not the level of the 10-year but the shape: roughly 256 basis points of 2s30s slope in a market that had essentially no term premium three years ago.



Source: Reuters JGB market prints, 2–13 July 2026; Bank of Japan policy rate (16 June 2026). Arculus Capital.

Our forecast is for further bear steepening. We look for the 10-year at 3.10–3.30% and the 30-year at 4.25–4.50% by year-end 2026. The drivers are term premium and supply, not policy expectations — the two-year at 1.44% is already pricing close to our terminal rate, so the front end has limited work left to do. The long end has a great deal.

The shadow-yield question: where we differ

A strand of commentary now argues that Japan is in a concealed debt crisis: that the Bank of Japan is forced to buy bonds continuously to cap yields, that without those caps long-end yields would be in double digits, and that the European Central Bank's March 2020 experience — when President Lagarde said it was not the ECB's job to close spreads and periphery spreads gapped — demonstrates how violent the repricing would be. We think the conclusion is directionally right about the yen and substantially wrong about the bond. Four points.

(i) The premise has been overtaken by events

Japan does not currently cap yields. Yield curve control was formally abandoned in March 2024. The Bank is in quantitative tightening, not quantitative easing, and has published a schedule taking purchases to ¥2trn per month and holdings down by roughly a third by 2030. The 30-year JGB has repriced from under 1% in 2021 to 4.00% today. The 20-year is at its highest since July 1996 and the 10-year since September 1996.

The cross-sectional argument — that a debt-to-GDP regression on "clean" G10 countries implies Japan's 30-year should be 300bp higher — is worth taking seriously as an anchor. But it should be applied to a starting point that is already current. **Against a 30-year at 4.00%, a 300bp gap has largely been closed by the market over the past three years, not suppressed.**

(ii) The stock effect is real; the flow effect is not the mechanism

The stronger version of the argument is not about caps at all. It is about the stock: the Bank still holds something in the order of ¥550–580trn of JGBs, roughly half the market, concentrated in longer maturities. That stock genuinely compresses term premium, and it will be released only slowly. We would put the stock effect on the 30-year at somewhere between 100 and 200 basis points. That is a large number and it is the right way to frame the risk. It is not, however, a cap, and its unwinding is scheduled, publicised and gradual — which is precisely the condition under which markets do not gap.

(iii) The ECB analogy does not transfer

The 2020 periphery episode was a credit event in embryo. Italy and Spain issue in a currency they cannot create; a loss of central bank support raises genuine default probability, and default probability is the thing that gaps. Japan issues in a currency the Bank of Japan creates. The Japanese sovereign cannot be forced into nominal default. The adjustment mechanism is therefore not the credit spread — it is the exchange rate and the price level.

> *In a foreign-currency-equivalent regime, the bond breaks. In a local-currency regime with a printing press, the currency breaks. Japan is the second case. That is why the yen, not the JGB, is where the stress is showing.*

(iv) The debt-service arithmetic is slower than it looks

At gross public debt above 200% of GDP, a 100 basis point rise in the average coupon on the entire stock is worth over 2% of GDP in annual debt service. But the average maturity of outstanding JGBs is around nine years, so that repricing arrives at roughly a tenth of the stock per year. Meanwhile nominal GDP is growing at 3% or better, which is doing real work on the denominator — this is precisely the mechanism the Takaichi government has now formalised by replacing the primary balance target with a debt-to-GDP objective. Critics are right that inflating away the ratio is a low-quality form of consolidation. They are wrong that it does not work arithmetically.

Our estimate

Taking the stock effect at 100–200bp on top of a 30-year currently at 4.00%, and allowing for the fiscal risk premium that the removal of the consolidation language has introduced, **we estimate fair value for an unsupported 30-year JGB at 4.75–5.75%.** We stress that this is an estimate with wide error bars and it is offered for adjudication rather than as a settled house number. What we are confident about is the sign of the difference from the double-digit claim: a 10% JGB long bond implies a default or redenomination risk premium that has no mechanism in a local-currency issuer with a captive domestic investor base and a central bank explicitly committed to nimble intervention in the event of a disorderly rise in long rates.

The yen: why intervention cannot work

Here we agree entirely with the bearish case. The Ministry of Finance deployed a record ¥11.73trn — roughly US$73bn — across April and May 2026, nearly double its largest prior effort, after USD/JPY breached 160. The pair was back above the intervention level within six weeks. Unlike the four previous intervention windows since 2022, there was no follow-on catalyst — no yield curve control adjustment, no carry unwind — to extend the effect.

Yen /USD on the 21st of July 2026 broke down to a new low. In the chart above the purple arrow points to the intervention by the Japanese Treasury to buy the Yen taken when the Yen touched the same point where there was a rapid unwinding of the Yen carry trade in 2024. Subsequently the Yen has broken this support point and despite jawboning from the government a new floor of support has not yet been established.

Finance Minister Satsuki Katayama's subsequent call for Japanese pension funds to invest more domestically is a variant of the same error. Repatriation is a stock reallocation. It can produce a one-off flow, but it cannot change the ongoing incentive that generates the outflow. And the incentive is not simply the rate differential — Lazard's work notes that through 2023 the US–Japan differential explained roughly 90% of the variance in USD/JPY, and that explanatory power has since deteriorated markedly.

What is left when the differential stops explaining the currency is a risk premium: compensation for holding the liabilities of a sovereign whose debt trajectory has no anchor. On 21 July the Takaichi cabinet removed the phrase "fiscal consolidation" from the Basic Policy, abandoned the single-year primary balance target, and created an investment allotment under which ministries can submit budget requests without upper limits. Whatever the merits of that as industrial policy, as a signal to the currency market it removes the last remaining anchor.

We look for USD/JPY in a 158–168 range over the balance of 2026, with topside risk. Three things would change the trajectory durably: a Bank of Japan that resets the market's perception of its reaction function by hiking faster than the data strictly require; a credible medium-term fiscal framework; or a sharp fall in US rates. The first is possible, the second is now less likely than it was a week ago, and the third is outside Japan's control.

Scenarios

Exhibit 3. Scenario framework to end-2027

Scenario	Prob.	Description	Market expression
Base — grinding normalisation	55%	BoJ to 1.25% in Oct, 1.50% by mid-2027. Core CPI 2.0–2.5%. Growth ~0.7–1.0%. Fiscal delivery lags announcement.	10y 3.10–3.30%, 30y 4.25–4.50%, USD/JPY 158–168. Continued bear steepening.
Honebuto-shokku	20%	Food tax cut confirmed alongside an uncapped FY2027 budget request round. Fiscal risk premium repricing without a growth offset.	30y through 4.75%, 2s30s beyond 350bp, USD/JPY through 170. BoJ forced into unscheduled purchase operations.

Scenario	Prob.	Description	Market expression
Hawkish reaction-function reset	15%	BoJ hikes in July or accelerates to consecutive moves, explicitly citing the currency. Terminal repriced to 2.25%+.	Front end sells off, curve bull flattens from the long end, USD/JPY to 145–150. Global carry unwind.
Stagflationary energy shock	10%	Hormuz re-closure or Gulf escalation. Headline inflation above 3%, real incomes squeezed, BoJ caught between mandate and growth.	Curve twists, yen weakens on terms-of-trade shock, equity de-rating. Worst outcome for Japanese assets.

Probabilities are Arculus Capital estimates and are subjective. Source: Arculus Capital.

Forecast summary

Exhibit 4. Arculus Capital forecasts for Japan

	Current	Q4 2026	Mid-2027	End-2027
Policy rate	1.00%	1.25%	1.50%	1.75%
Core CPI (y/y)	1.4%	2.2–2.5%	2.0%	1.8–2.0%
Real GDP (y/y)	0.4%	0.7%	0.9%	1.0%
Unemployment	2.5%	2.5%	2.6%	2.6%
10y JGB	2.90%	3.10–3.30%	3.40%	3.50%
30y JGB	4.00%	4.25–4.50%	4.60%	4.75%
USD/JPY	~162	158–168	155–165	152–162

Ranges reflect genuine uncertainty rather than forecast precision. Source: Arculus Capital.

Implications for Australian fixed income portfolios

Japan matters to Australian fixed income through three channels, in descending order of importance.

(i) The AUD/JPY channel into the long end of the ACGB curve

Our long-standing house view is that the steepening of the Australian long end is driven by the unwind of the yen carry trade through the AUD/JPY channel, rather than by any shift in domestic inflation expectations. Nothing in the current Japanese configuration challenges that view; if anything it reinforces it. As JGB yields rise, the hurdle for Japanese institutional investors to hold hedged offshore duration rises with them. A domestic 30-year at 4.00% — soon, we think, 4.25–4.50% — competes directly with hedged Australian ultra-long paper for the balance sheets of Japanese life insurers and trust banks that have historically been price-insensitive buyers at the back end.

The practical expression is a preference for the front end and belly of the ACGB curve over the ultra-long, and a structural bias toward curve steepeners. The trigger to monitor is AUD/JPY, not Australian breakevens.

(ii) Carry unwind risk

The hawkish-reset scenario in Exhibit 3 carries a 15% probability and is the one that transmits most violently to Australian assets. A Bank of Japan that abandons gradualism to defend the currency would trigger the same mechanics as the August 2024 episode: yen-funded positions unwound at speed, correlated selling across high-carry currencies and credit. AUD is a primary carry destination and would bear a disproportionate share of that adjustment. Portfolios with credit beta and duration in the same book should be sized with that correlation in mind.

(iii) Terms of trade and the energy channel

The stagflationary scenario runs through energy. Japan's dependence on imported LNG and crude, and Australia's position as a supplier, means a Gulf escalation is simultaneously negative for Japanese growth and supportive for the Australian terms of trade — a rare configuration in which the two economies' fixed income markets should decouple. In that world we would expect AUD/JPY to rise on the terms-of-trade differential even as risk appetite deteriorates.

Positioning summary

- Underweight ultra-long duration in both markets. The Japanese term premium repricing is not finished, and it is the principal source of contagion into the ACGB back end.
- Prefer the front end and belly. The two-year JGB at 1.44% already prices close to our terminal rate; the equivalent is not true at the long end in either market.
- Maintain curve steepeners as the cleanest structural expression of the thesis.
- Monitor AUD/JPY as the trigger variable for the long-end steepening thesis, and treat a sharp yen appreciation as a de-risking signal for credit, not a benign one.
- Floating rate exposure remains the defensive allocation in a term-premium-driven selloff, since the shock is at the long end rather than in the policy rate.

Calendar of catalysts

Date	Event
24 July 2026	National CPI for June. Consensus core 1.6% versus 1.4% in May. The first confirmation of our reacceleration call.
30–31 July 2026	Bank of Japan Monetary Policy Meeting and quarterly Outlook Report. Hold expected; watch the FY2026 growth upgrade and the framing of the inflation downgrade.
Early August 2026	Government decision on the consumption tax cut on food and beverages, for implementation from April 2027.
21 August 2026	National CPI for July. Key input to the September meeting.
18 September 2026	National CPI for August. Key input to the October meeting, which is our expected hike date.
Q4 2026	FY2027 budget request round under the new uncapped investment allotment. The principal Honebuto-shokku risk window.

Review of prior house calls

In the interest of keeping the record honest, our 2024-vintage note on Japan made four calls. Three have played out and one has not.

- **Correct.** That the Bank of Japan would begin tightening for the first time since 1990 and that it would prove a sustained cycle rather than a single adjustment. The policy rate has gone from negative to 1.00% and the Bank has committed to more.
- **Correct.** That union wage claims would drive a wage cycle grounded in labour shortage rather than in inflation expectations. Three consecutive shunto rounds above 5%, with SME settlements at 4.69%, have vindicated that.
- **Correct.** That Japanese investors would cease to be marginal buyers of US Treasuries. The rise in domestic yields has done exactly what we said it would to the hedged-return calculus.

- **Wrong.** That the yen would stop depreciating. It has not. USD/JPY has gone from the 150s to a 40-year low near 163. Our error was to assume that the start of a tightening cycle would be sufficient to stabilise the currency. It was not, because the fiscal side moved in the opposite direction at the same time and at greater speed. That lesson is embedded in the analysis above: the currency responds to the policy mix, not to the policy rate. It is important to understand that at some point the Yen will stop falling and when it begins to rise (after a change in economic policy and the economic outlook) then the shift out of foreign bonds and currencies will accelerate. While we were wrong about the timing the risk has only increased.

Judgement calls flagged for adjudication

The following are analytical choices made in this paper that are genuinely contestable and are flagged rather than resolved.

Judgement	Basis and alternative
Measured core CPI understates underlying inflation by 50–70bp	Inferred from the core / core-core wedge and the scale of the energy subsidy relative to the CPI basket. A defensible alternative is 30–50bp if one assumes weaker subsidy incidence.
Fair value for an unsupported 30y JGB is 4.75–5.75%	Built from a 100–200bp balance sheet stock effect plus a fiscal risk premium. The bearish case argues for double digits; a purely regression-based approach would suggest closer to 4.50%.
Terminal policy rate of 1.75–2.00%	Above the sell-side median of roughly 1.50%. Rests on our view that underlying inflation is at target now. If the subsidy adjustment proves smaller, 1.50% is the right terminal.
Fiscal announcements will underdeliver on growth but fully deliver on supply	Historical pattern of Japanese supplementary budget carry-forward. The alternative — that the uncapped investment allotment materially accelerates disbursement — would raise both growth and inflation forecasts.
20% probability on Honebuto-shokku	Subjective. The market has already repriced substantially, which cuts both ways: less room for surprise, but a lower threshold for disorder.

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