

# Japan Event Flash

December 16, 2024

Mitsubishi UFJ Trust and Banking  
Corporation

A member of MUFG, a global financial group

Naoya Oshikubo, Chief Market Economist

Global Asset Management Business Office

+81-80-7408-7952

naoya\_oshikubo@tr.mufg.jp



## How much room is there for domestic long-term interest rates to rise?

After Trump's victory in the U.S. presidential election, the U.S. long-term interest rate temporarily rose to the 4.5% level in November 2024 as the prospect of lower interest rates due to progress in interest rate cuts receded in the United States. In Japan, the market consensus continues to be for a gradual rise in interest rates on the back of rate hikes. According to the Bank of Japan's Bond Market Survey (November 2024), securities firms and major institutional investors expect a gradual rise in domestic long-term interest rates, averaging 1.20% at the end of June 2025 and 1.32% at the end of March 2026. In this report, we will discuss the outlook for domestic long-term interest rates in 2025.

The author expects a gradual rise in domestic long-term interest rates in 2025, and thinks there is room for an increase to 1.4%-1.5% by the end of December 2025. The path of domestic long-term interest rates in 2025 will depend mainly on (i) trends in U.S. long-term interest rates, (ii) the BOJ's interest rate hikes, and (iii) QT (reduction in JGB purchases).

(i) We expect U.S. long-term interest rates in 2025 to remain in a range centered in the upper 4% to mid 4% range.

The U.S. economy will continue to be on a recovery path led by consumer spending against the backdrop of a favorable employment environment. We believe that consumer spending will continue to be strong due to the effects of the Trump tax cuts, in addition to the rising U.S. stock market on the back of the incoming Trump administration's economic policies and deregulation (Exhibit 1). Under a generally strong U.S. economy, we assume that the Fed will continue to cut interest rates to 3.75%-4.00% policy rate before halting rate cuts in mid-2025, as the incoming Trump administration's tariff policies and immigration curbs raise concerns about a resurgence of inflation.

Academically, it is defined as “long-term interest rate = policy rate outlook (average of policy rate levels over the next 10 years) + term premium (supply and demand factors, etc.)”. The Federal Reserve Bank of New York publishes estimates of each component of the U.S. long-term interest rate (Exhibit 2). According to the Federal Reserve Bank of New York, the policy rate outlook is currently over 4%, a level that already incorporates an early halt to interest rate cuts. Under the assumption that interest rate cuts will cease in mid-2025, the policy rate outlook component will continue to hover around 4%. As for the term premium, it briefly rose to the 0.3% level following Trump's victory in the November U.S. presidential election. Since the incoming Trump administration's measures are expansionary in terms of fiscal expansion, the term premium is expected to rise as the supply of U.S. Treasuries increases. On the other hand, given the emphasis on fiscal discipline by incoming Treasury Secretary Scott Bessent and efforts to curb wasteful government spending by Elon Musk as head of the Department of

Government Efficiency (DOGE), we believe that the scale of fiscal expansion will be halted to some extent, and the term premium is not expected to rise above the peak level of the past 8 years (0.5%). We expect the U.S. long-term interest rate in 2025 to remain in a range around the low-4% to mid-4% range. Although U.S. long-term interest rates usually have a large impact on the level of Japanese long-term interest rates through the flows of Japanese investors, we do not expect the level of Japanese long-term interest rates to change significantly due to factors affecting U.S. long-term interest rates in 2025, since Japanese long-term interest rates corresponding to the range of U.S. long-term interest rates have been in the low 1% range based on the correlation over the past six months. Therefore, we do not believe that the level of Japanese long-term interest rates will change significantly due to fluctuations in the U.S. long-term interest rate.

(ii) We expect Japanese long-term interest rates to rise moderately in 2025 as the Bank of Japan steadily raises interest rates.

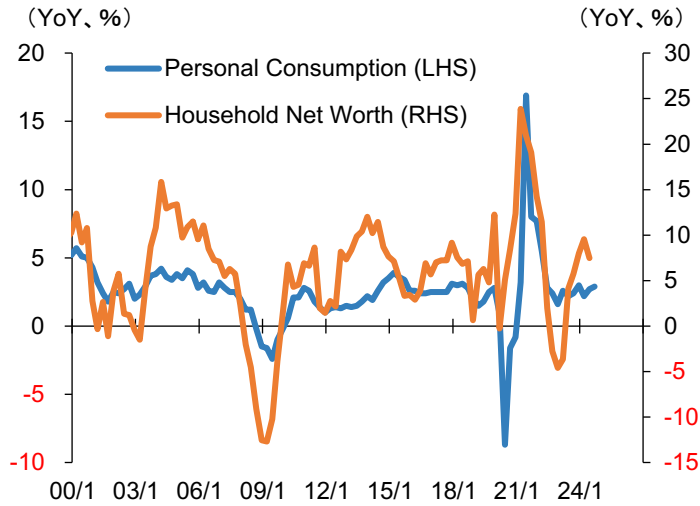
As discussed in detail in “Will the BOJ raise interest rates while the U.S. and Europe cut rates? (November 25, 2024),” the BOJ will continue to raise interest rates, albeit cautiously, toward a neutral rate (a rate level that neither overheats nor cools the economy), as wages rise in Japan, pushing up prices, while overseas economies follow a moderate growth path. We expect the BOJ to gradually raise the policy rate to 1% every six months at a cautious pace of 0.25%, so as not to disrupt the virtuous cycle between wages and prices. In the yen OIS market, the assumption is that the BOJ will raise rates only to about 0.8% in two years (Exhibit 3). Given the market's somewhat conservative assumption regarding a BOJ rate hike, there is a strong possibility that Japanese long-term interest rates will rise moderately in 2025 as the BOJ steadily raises interest rates. Based on the correlation between the yen 2y1m OIS rate and Japan's long-term interest rates, if the yen 2y1m OIS rate rises to 1%, Japan's long-term interest rates have room to rise to about 1.3% in calculation.

(iii) The BOJ's gradual pace of reducing its JGB holdings will also be a factor in a slight increase in Japanese long-term interest rates on the supply-demand side.

The BOJ decided to reduce its JGB purchases (QT) at the July 2024 Monetary Policy Meeting, finally shrinking its huge balance sheet in Japan. In principle, the BOJ will reduce its JGB purchases by 400 billion yen each quarter, and the pace of purchases is expected to slow to 2.9 trillion yen per month in January 2026 (4.9 trillion yen per month in December 2024). The BOJ's JGB holdings are expected to decline gradually from 590 trillion yen as of November 30, 2024 to around 550 trillion yen as of December 30, 2025 (Exhibit 4). According to the Bank of Japan's working paper “The Bank of Japan's Large-Scale Government Bond Purchases and the Formation of Long-Term Interest Rates (September 10, 2024)”, the Bank of Japan's large-scale JGB buying policy has pushed long-term interest rates down by about 1% (Exhibit 5). Calculated using the model disclosed in that paper, the BOJ's QT is expected to have only about a 0.1% impact on interest rates over the next year. In the medium- to long-term, we assume that the BOJ will reduce the balance of JGBs outstanding at a moderate pace, and thus the short-term supply-demand impact will be negligible, although there is likely to be continued upward pressure on Japanese long-term interest rates on the back of an easing supply-demand balance for JGBs due to the BOJ's reduced presence in the JGB market.

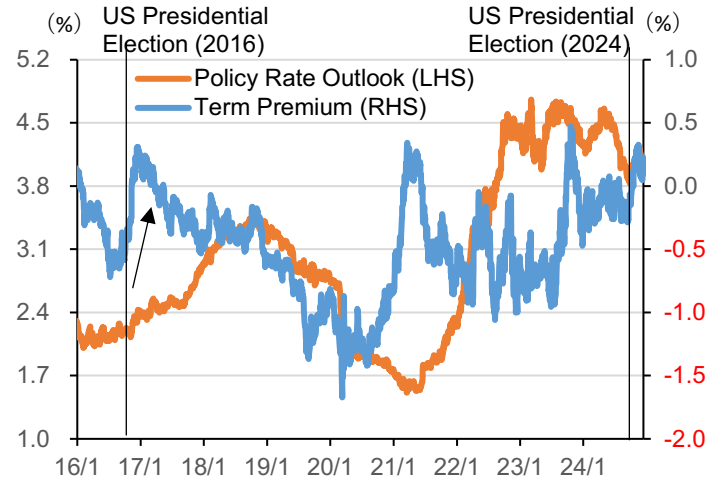
Based on (i) through (iii) above, we expect Japanese long-term interest rates to rise moderately in 2025 against the backdrop of the persistently high U.S. long-term interest rates, the Bank of Japan's interest rate hike, and reduced purchases of JGBs, but the room for increase will be limited to the mid-1% range. We do not believe that higher interest rates will cause a correction in Japanese equities in 2025, as we expect Japan's nominal GDP to continue to grow by nearly 3% in FY2025 and Japanese corporate earnings to remain strong. We do not believe that higher interest rates will cause a correction in Japanese equities in 2025.

**Exhibit 1: U.S. Personal Consumption and Household Net Worth**



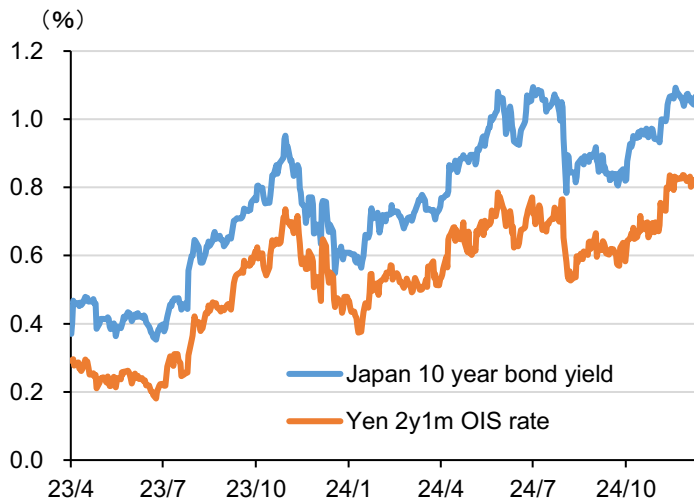
Source: U.S. Bureau of Economic Analysis, FRB, MUFG: Trust Bank

**Exhibit 2: Term Premium on U.S. Long-Term Interest Rates**



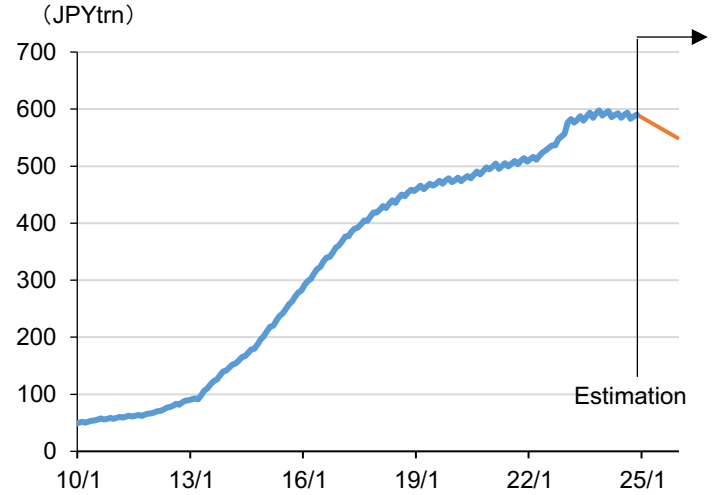
Source: Federal Reserve Bank of New York, MUFG: Trust Bank

**Exhibit 3: Rates in Japan**



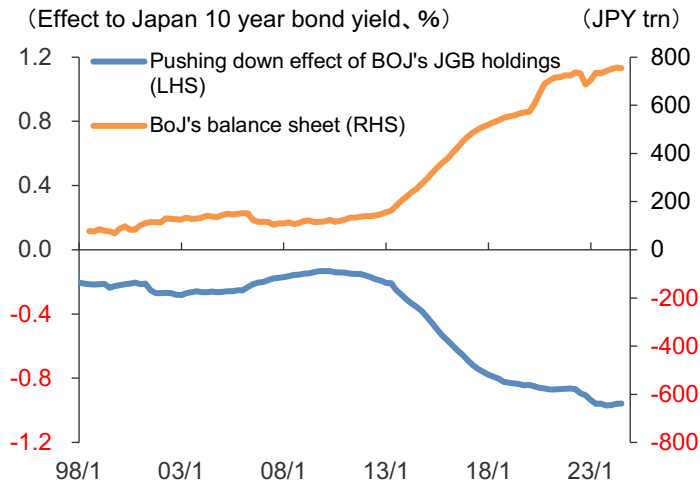
Source: Bloomberg, MUFG: Trust Bank

**Exhibit 4: JGB holdings by the Bank of Japan**



Source: BOJ, MUFG: Trust Bank

**Exhibit 5: Effect of BOJ's JGB holdings**



Source: BOJ, MUFG: Trust Bank

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