

Japanese assets under pressure amid uncertainty about election, BoJ normalisation

This Sunday's Upper House elections in Japan are weighing on Japan's government bonds and the yen. Fears of political uncertainty, looser fiscal policy and also the effects of earlier BoJ policy normalisation have all contributed to JGB weakness. Here, we look at what's at stake and how markets might react



Japan's Prime Minister Shigeru Ishiba campaigning for the Upper House election

Polls suggest LDP and Komeito will struggle to retain majority

There are two main reasons for the recent surge in Japanese government bond yields: the domestic political uncertainty and the Bank of Japan's policy normalisation process. On the former, there are concerns that the current ruling coalition may not secure a majority in the upcoming election. This outcome could increase uncertainty regarding the domestic political environment, which may affect the country's tariff negotiations with the US and its fiscal policy.

Second, expectations for a BoJ rate hike have resurfaced. A recent surge in inflation, particularly in

food and related items, is likely to prompt the central bank to revise its quarterly inflation outlook, which will be released at the end of this month. As a result, it is possible that a BoJ rate hike could occur sooner than previously anticipated.

The ruling coalition needs a minimum of 50 seats out of 125 contested in order to secure a majority in the Upper House. However, recent polls indicate that there is a significant possibility that the Liberal Democratic Party and Komeito will fall short.

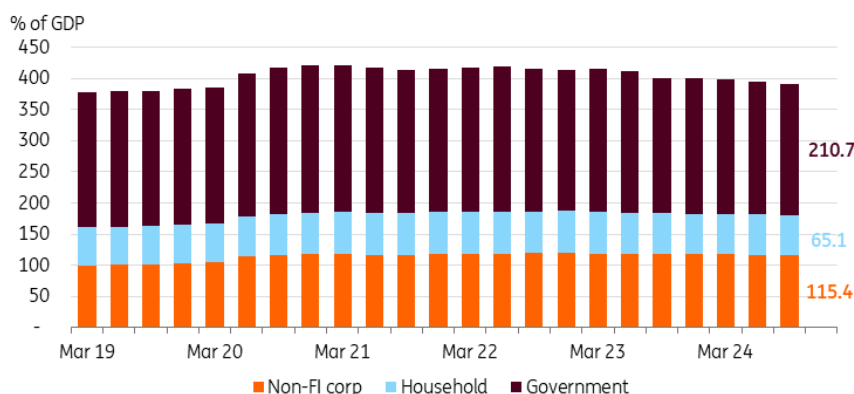
A 13-14 July poll by major newspaper *Asahi Shimbun* projects the ruling coalition will win approximately 43 seats in this election -- 34 for the LDP and 9 for Komeito -- down from earlier estimates of 48-56. When combined with their 75 uncontested seats, the coalition would fall short of the 125-seat majority threshold in the Upper House.

One very interesting dynamic this campaign season is that the far-right party, Sanseito, is gaining popularity among conservative voters. Sanseito promotes a “Japan First” policy similar to Donald Trump’s “America First” campaign. Although Sanseito currently holds just one seat, the recent poll suggests that it could potentially secure 8-17 seats, reflecting a surge in support among conservatives and protest voters. While not a direct threat to the LDP’s seat count, Sanseito’s rise poses a strategic challenge by fragmenting the right-leaning vote and reshaping the political narrative.

Election uncertainty has weighed on both JGBs and the yen. If the LDP loses, possible outcomes include PM Shigeru Ishiba stepping down, a snap election, or a new coalition government. Each outcome could complicate government policy and US trade negotiations.

Additionally, numerous populist policies were prominently featured during the election campaign. These include a 20,000 yen voucher, reductions to the consumption tax, increased childcare support, and cuts to social insurance premiums. Such measures are likely to place additional strain on fiscal policy; Japan is already among the most highly indebted countries in the world.

Japan government debt % of GDP



Source: CEIC, BIS, ING

BoJ: Hotter-than-expected inflation fuels rate hike bets

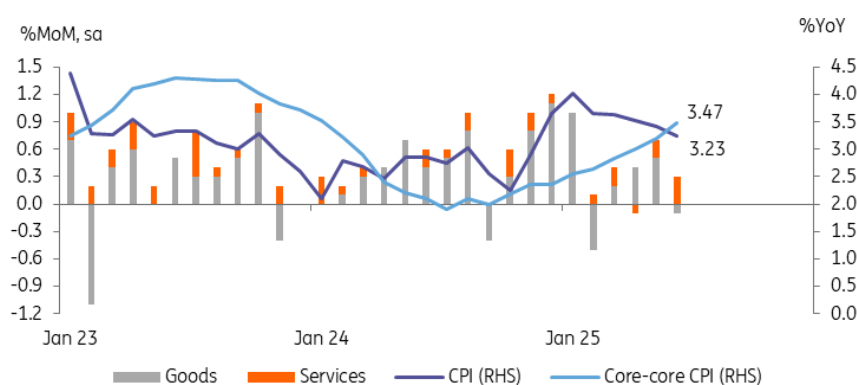
Markets largely anticipate the BoJ will maintain its current stance at the 30-31 July meeting, although the quarterly inflation outlook may be revised up. The BoJ has communicated that despite the recent surge in food costs, underlying inflation has not yet stabilised around the 2%

mark. However, the food price spikes have broadly impacted other service costs. An upward revision in inflation may signal that another rate hike is on the way. The market-implied odds of a rate hike, as reflected in overnight index swaps (OIS), have climbed to 50–60% over the past week.

The July inflation data confirmed that underlying price pressures strengthened with core-core inflation, which excludes fresh food and energy, rising quite rapidly.

Given the tight labour market, evidenced by a roughly 2.5% unemployment rate and wage growth exceeding 5% for a second year, a shift towards expansionary fiscal policy is likely to elevate inflation expectations. This may lead to a further increase in JGB yields.

Core inflation excluding fresh food and energy has accelerated since last summer



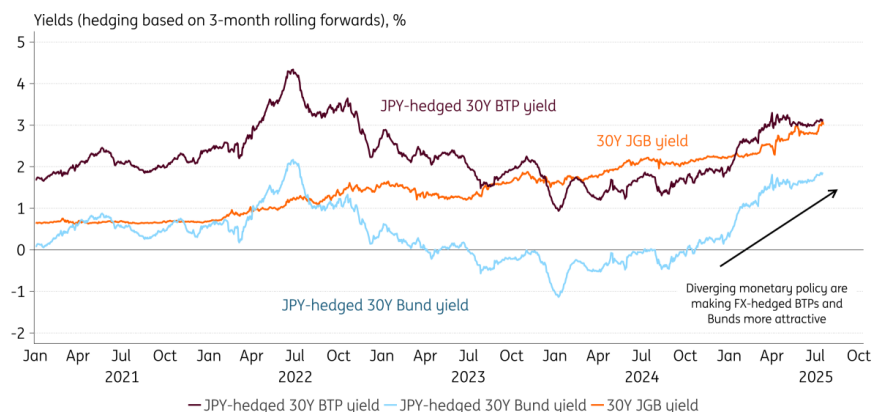
Source: CEIC

Uncertainty over US trade policy is a key factor in the BoJ’s rate hike decisions. We expect action only after tariff issues are resolved. However, the election results will significantly slow trade talks with the US. Although US Treasury Secretary Scott Bessent and PM Ishiba are scheduled to meet pre-election, it is not anticipated that any concrete agreements will be made. Depending on the election results, future trade talks may face more challenges. We still expect the [BoJ to deliver a 25bp hike in October](#).

Eurozone government bonds may offer attractive alternatives to JGBs

Fiscal uncertainty, driven by campaign promises and rising debt, may encourage Japanese investors to look elsewhere for better risk-return opportunities, with FX-hedging costs moving in their favour. Japanese institutional investors, such as pension funds and insurance firms, are known to rely on FX hedges to manage their currency exposure. The hedging costs are often derived from the relatively short-dated interest rates between two countries. Rate hikes by the Bank of Japan and cuts by the European Central Bank thereby reduce the costs to hedge euro exposures. Since the beginning of this year, the 30-year Italian government bond (BTP) has offered a higher yield on an FX-hedged basis. A 25bp hike from the BoJ and a 25bp cut by the ECB later this year would increase FX-hedged yields on euro bonds by another 50bp. If JGBs were to match such moves to balance the relative value, another 50bp rise in 30Y yields is not unthinkable.

FX-hedged eurozone bonds are increasingly appealing as an alternative to JGBs



Source: ING, Macrobond

JPY: Temporary setback

It's fair to say the yen has been underperforming recently. EUR/JPY, for instance, has rallied 6% from the start of June. A variety of factors have been at play here, including the above fiscal worries, US trade winds turning against Japan and a low-volatility environment that has favoured the carry trade. Notably, a survey we conducted during our recent FX webinar [revealed that](#) the yen had dropped dramatically, compared to the euro and the Swiss franc, as a preferred safe haven in the event of a dollar crisis.

Should the weekend election result create more domestic uncertainty for Japan and JGBs, USD/JPY could briefly push through the 149.50/150.00 area towards 151.50/152.00. However, the yen is one of the most undervalued currencies in the G10 space. We suspect that Japanese investors would use the opportunity of a stronger dollar in the third quarter to increase their FX hedges on dollar assets.

If the BoJ resumes hiking in October and the Federal Reserve cuts in December -- and the market is speculating about Fed Chair Jerome Powell's replacement at a time of seasonal dollar weakness -- then USD/JPY should be back at levels near 140 by the end of the year.

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