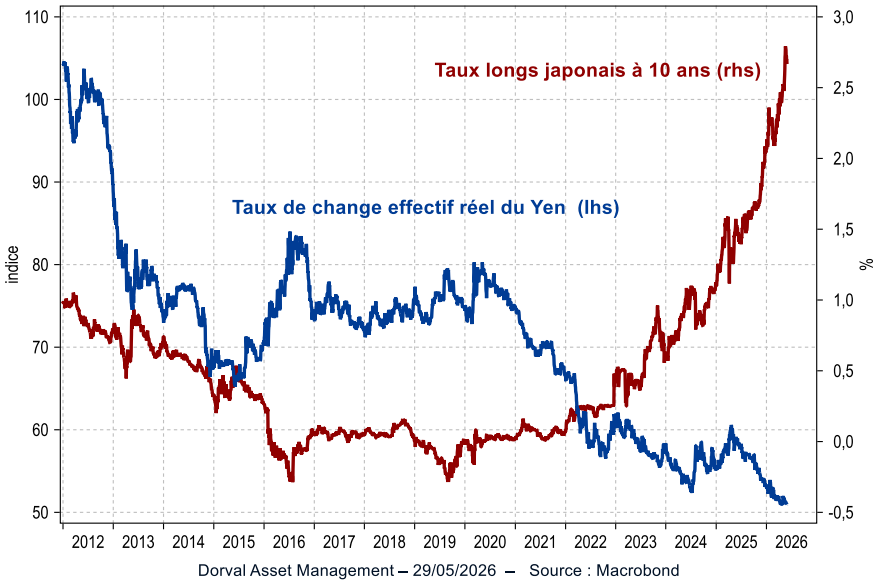
Japan's dual malaise

01 June 2026

With the yen on life support and strong upward pressure on long-term interest rates, Japan is experiencing a dual malaise. The country's reflation strategy is indeed colliding with the uncertainties stemming from the Iranian crisis.

Having appeared stabilised at a very low level since mid-2024, the yen's real effective exchange rate has slipped back again since last autumn. As for long-term rates, they continue their upward adjustment, rising by a full percentage point in seven months to 2.75% on the 10-year maturity (Chart 1). Thirty-year yields even surpassed 4% in early May.

Persistently rising long-term yields and a slumping yen: Japan's dual malaise



10-year Japanese government bond yield (rhs) / Yen real effective exchange rate (lhs)

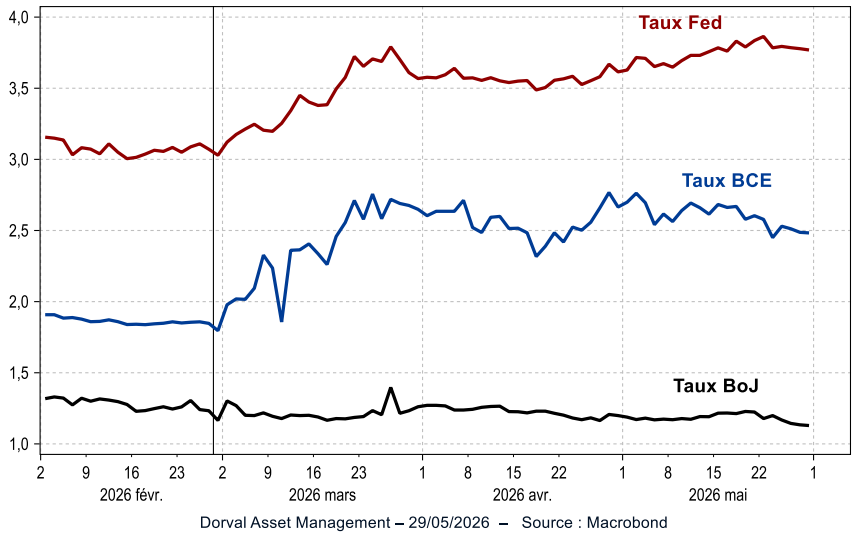
In any other country, the scale of these movements and the extreme undervaluation of the currency would point to a deep crisis. But this is not the case in Japan, where the stock market continues to rise and economic growth is proceeding normally. Rather than a crisis, we should for the time being speak of a malaise – one sufficiently tangible to have led the Bank of Japan (BoJ) to intervene in the foreign-exchange market to the tune of 73 billion dollars since the end of April.

The recent movements appear at first sight to be linked to the fiscal and monetary fallout from the energy crisis originating in Iran. Prime Minister Takaichi has opted for a fiscal shield strategy to offset the impact of higher import prices, raising questions about a budgetary trajectory that had been clearly improving since 2023.

Moreover, the Iranian shock has had a completely asymmetric impact on expectations for global policy rates (Chart 2). While the Fed and ECB rates priced in by markets for the end of the year have been revised upwards by 60 to 75 basis points, nothing has moved on the Japanese money markets. These still assume that the BoJ will raise its policy rate from 0.75% today to just over 1% at the end of the year. This divergence between Japan and the rest of the world explains a sizeable part of the pressure on the exchange rate, but also on long-term yields, which are being squeezed by a sharp rise in inflation expectations.

Iranian shock: no impact on expected Japanese short-term rates, in contrast with US and European dynamics

Policy rates expected by markets for December 2026



Dorval Asset Management – 29/05/2026 – Source : Macrobond

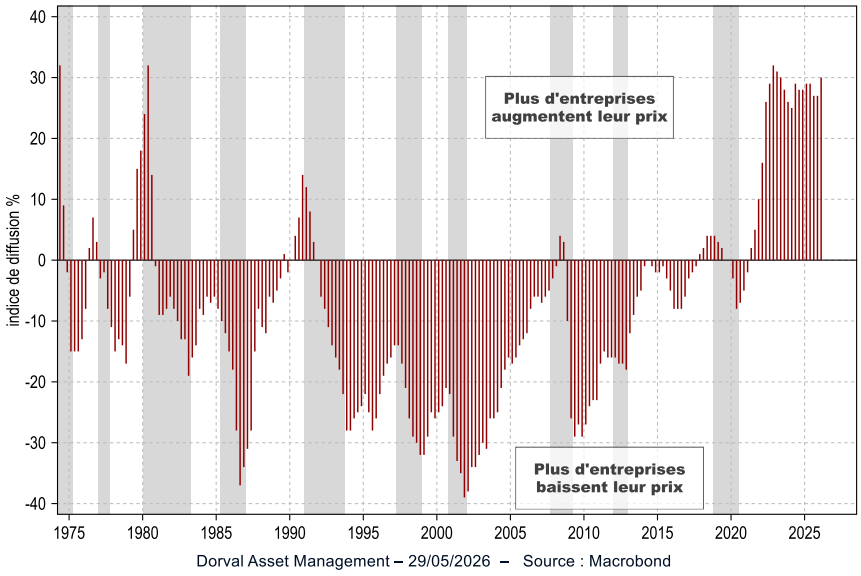
Fed rate / ECB rate / BoJ rate

How can we explain such an under-reaction on Japanese money markets? Essentially because the BoJ has been pursuing a determined reflation strategy for nearly 15 years now: to escape the deflation of the 1990s–2010s and anchor the inflation rate at 2% over the medium term. And while long-term inflation expectations have indeed risen sharply in recent months, they have merely reached a level that satisfies the BoJ, at +2.2% on 29 May 2026. The BoJ is also keen above all to avoid being seen as a threat to economic growth, since even a mild recession could jeopardise years of efforts to restore something close to normal inflation in Japan.

Should the BoJ not at least slightly adjust its stance now that the risks of deflation have clearly receded, as some indicators suggest? The well-known Tankan survey of Japanese firms, for example, shows that since 2022 they finally seem to be getting used to raising their prices on a regular basis (Chart 3). Is this not evidence of a profound shift in mindsets?

Corporate Japan discovers rising selling prices

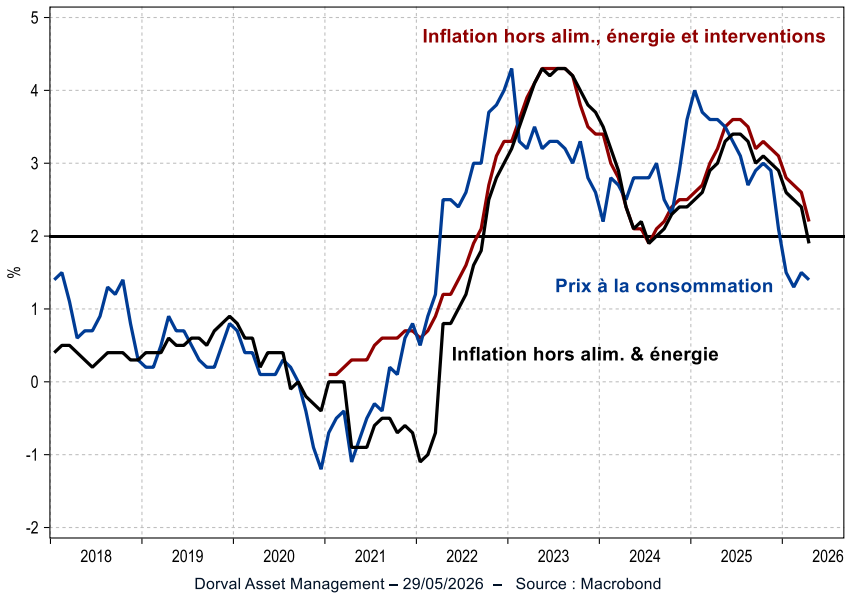
Tankan survey: balance between the % of firms raising vs lowering their selling prices



Diffusion rate % / More forms are raising their prices / More firms are cutting their prices

The BoJ, quite appropriately, keeps a close eye on a broad set of indicators, including, of course, consumer prices. In this regard, it is not always easy to identify a clear trend, because consumer price indices have been affected by specific events, such as the sharp surge in rice prices in 2024–2025, and by government interventions, including the recent fiscal shield. In April, headline inflation stood at 1.4%, and inflation excluding food and energy at 1.9%, both having been declining for several months. The rise in energy prices has been offset, absorbed by the fiscal shield. The BoJ's new measure, adjusted for government interventions, suggests somewhat higher underlying inflation, at 2.2% in April, but this too has been falling for several months (Chart 4).

Inflation has been easing in Japan for several months



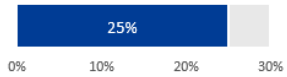
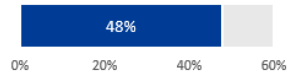
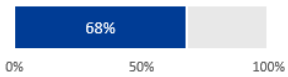
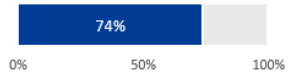
Inflation excluding food, energy and government interventions / Consumer prices / Inflation excluding food and energy

Based on these figures, it is easier to see why the BoJ is hesitating to change its tone. The current dual malaise in Japan's bond and foreign-exchange markets may encourage it to raise its policy rate as early as 16 June, but probably without altering its underlying strategy.

Finally, as with almost all current economic and financial trends – with the notable exception of AI – the future of Japan's dual malaise will, of course, be decided in Iran. A reopening of the Strait of Hormuz would temper expectations of rate hikes in Western countries, which would support the yen. It would also help shore up growth prospects, thereby increasing the likelihood of another BoJ rate hike in the fourth quarter. A reopening would lastly reduce the need for fiscal support and improve the debt trajectory, most likely easing pressure on the long end of the yield curve.

Conversely, a continuation of the blockade would keep the BoJ under strain, prompting further interventions in the foreign-exchange market and possibly in the bond market as well. All in all, buying 10- to 30-year Japanese government bonds on an unhedged basis appears to be a conceivable strategy, with a probably asymmetric payoff profile, but one that is clearly quite risky in the very short term.

Our exposure rates are as follows:

Fonds	Net equity exposure*	Breakdown of main investment themes	Hedging and Safe haven basket
Dorval Global Conservative		- Core basket : 100% long Eurostoxx banks / short Eurostoxx	- 2 - 8y and 30y government bonds : 32% - 10y German and French government bonds futures : 4% - Money-market instruments.
Dorval Global Allocation		- Core basket : 80% - AI value chain : 11% - Value Software : 3% futures Eurostoxx banks: 6%	- 2 - 8y and 30y government bonds : 21% - 10y German and French government bonds futures : 11% - Money-market instruments.
Dorval Global Vision		- Core basket : 74% - AI value chain : 11% - Europe/Japan Financials : 7% - Global Industrial Recovery :7% - Value Software: 4%	
Dorval Convictions		- Core basket : 91% - Climate : 5% - Small and Mid caps : 4%	Eurostoxx 50 futures and options
Dorval Convictions PEA		- Core basket : 89% - Climate : 7% - Small and Mid Caps : 5%	Eurostoxx 50 futures

* including options' delta

*All funds presented are exposed to the following specific risks: discretionary management risk, **capital loss risk**, equity risk, market capitalisation risk, currency risk, interest rate risk, credit risk, derivative risk, sustainability risk. The capital invested is not guaranteed.*

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