Are Japanese long-term interest rates proof of historic success?

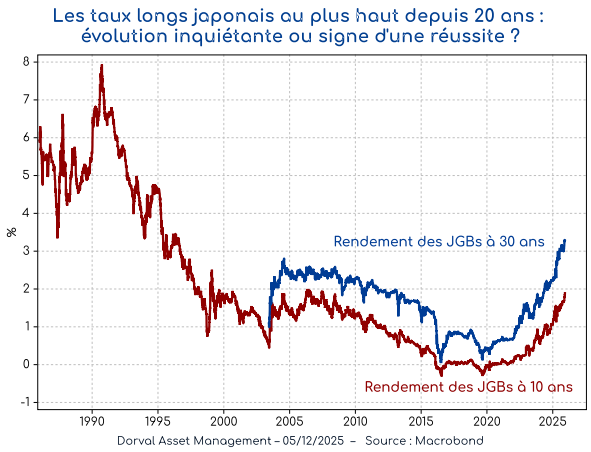
December 8, 2025

Dear clients, dear partners,

After more than a decade of efforts to achieve a lasting exit from deflation, Japan is seeing a sharp rise in long-term interest rates. This trend is evidence of economic normalisation finally getting underway, but it also has mixed implications for global investors.

Initiated by the late Prime Minister Shinzo Abe and Bank of Japan Governor Haruhiko Kuroda in 2012-2013, is Japan's reflationary economic policy on the verge of success? This may be the first way to understand the message behind the rise in Japanese long-term interest rates (Chart 1), which is causing some excitement in global markets.

Japanese long-term rates at their highest in 20 years: cause for concern or a sign of success?



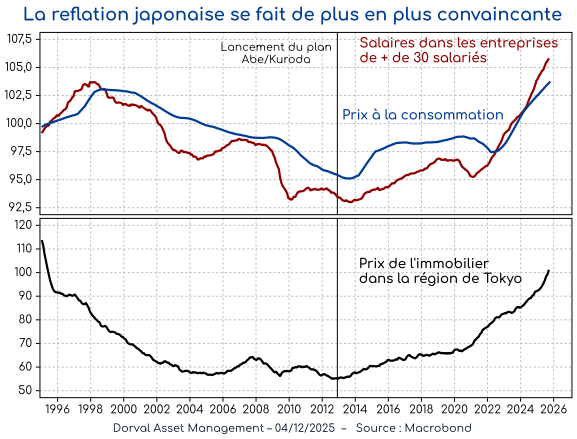
Yield on 30-year JGBs / Yield on 10-year JGBs

This fascinating experiment, following 15 years of deflation from 1998 to 2013, aims to create the conditions for a return to 'normal' inflation of around 2%. A country with a rapidly declining population, and therefore very low growth potential, needs positive inflation to make it easier to lower real interest rates (i.e. after inflation) and reduce the real value of accumulated debt. For such an economy, inflation of 2% and interest rates between 1% and 2% is a much preferable situation to inflation of 0% and negative or zero interest rates.

This is precisely what reflationary policy aims to achieve. Since 2013, consumer prices, wages and property prices have risen moderately at first. But at the end of the Covid period, the movement accelerated significantly (Chart 2). Instead of countering this inflation, as other central banks did in 2022-2023, the BoJ saw it as a

historic opportunity to unanchor the overly low inflation expectations of Japanese economic agents. It therefore maintained its negative rates until February 2024, causing the yen to fall sharply and fuelling inflation.

Japanese reflation becoming increasingly convincing

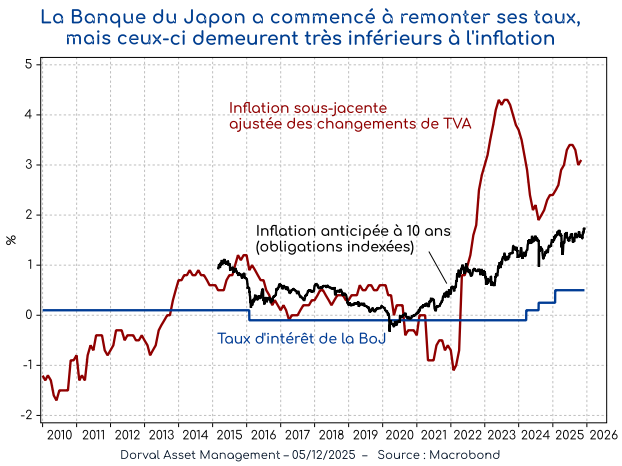


Launch of the Abe/Kuroda plan / Wages in companies with more than 30 employees / Consumer prices / Property prices in the Tokyo region

This seems to be working. Japan's core inflation is now at +3%, slightly above the central bank's 2% target, and Japanese companies are changing their habits in favour of systematic annual wage increases. However, the Bank of Japan is taking its time to normalise rates so as not to dampen the momentum of rising medium- and long-term inflation expectations, which are on track to reach its 2% target.

After only three rate hikes since the beginning of 2024, the Bank of Japan is preparing to raise its interest rate again by 25 basis points to +0.75%, probably on 19 December. The BoJ will pay particular attention to developments in corporate wage policies when deciding on the timing of future hikes. It will also monitor core inflation, which is expected to fall from +3% in 2025 to just under +2% in 2026. In any case, monetary rates will remain well below measured and anticipated inflation (Chart 3).

The Bank of Japan has started to raise interest rates, but they remain well below inflation

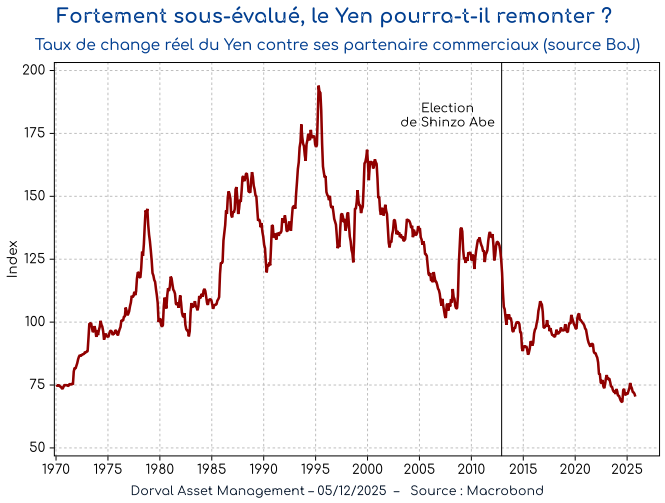


Core inflation adjusted for VAT changes / 10-year forward inflation (index-linked bonds) / BoJ interest rates

These rate hikes have been accompanied by a halt and even the beginning of a reversal of asset purchases by the BoJ (quantitative tightening). During these latest interventions, Governor Ueda reiterated his goal of a 'neutral' monetary policy, which he defines as interest rates of at least 1% and a downward trend in the central bank's balance sheet. At this stage, the Japanese money market anticipates that this 1% interest rate level will be reached next summer. The ultimate goal of the reflationary policy is to achieve sustained inflation of close to 2% with a fully neutralised monetary policy.

Substantial progress has already been made, but a major challenge remains: to bring the yen out of its considerable undervaluation without damaging the Japanese economy and stock market or significantly reducing inflation. Compared to its trading partners, adjusted for inflation differentials, the yen has lost more than 40% since Shinzo Abe's election in December 2012 (Chart 4). Goldman Sachs experts estimate that the yen is the most undervalued currency in the world, by around 30% compared to other competing currencies. With the interest rate differential between Japan and other developed countries narrowing, the yen should be able to appreciate gradually.

Is the yen, which is heavily undervalued, likely to rise?
Real exchange rate of the yen against its trading partners (source: BoJ)



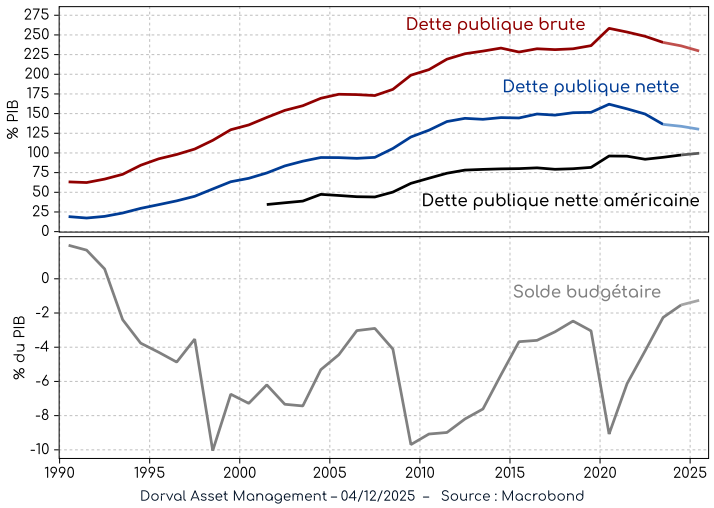
Election of Shinzo Abe

The fiscal policy announced by the new Prime Minister Sanae Takaichi could contribute to this. It provides for a 'temporary' increase of around 1% of GDP in the budget deficit for the 2025 and 2026 fiscal years. In a country known for its record public debt, this announcement may seem irresponsible. However, Japan's budget deficit is currently at its lowest level in 33 years, at 1.5% of GDP.

Furthermore, its enormous gross public debt of 225% of GDP is significantly reduced when converted to 'net' debt, i.e. after taking into account the considerable cash reserves managed by the state, including those of the pension reserve funds. In short, Japan has preferred to borrow at low interest rates rather than repay its debt with its reserves, as the latter are invested in assets (Japanese and global equities, etc.) whose returns exceed sovereign rates. These reserve funds now represent 100% of GDP. Net Japanese debt is therefore 125% of GDP, which is on a par with Italy and not far behind the United States (Chart 5). Finally, it should be noted that nearly half of Japanese bond debt is currently held by the Bank of Japan.

Japan's public finances are improving

Les finances publiques japonaises s'améliorent



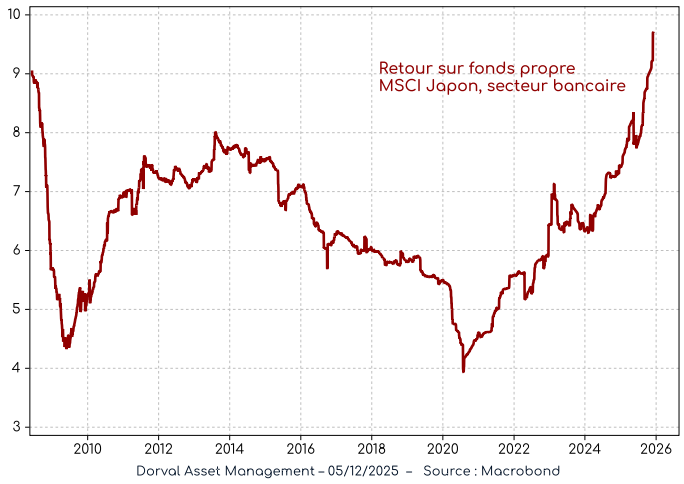
Gross public debt / Net public debt / US net public debt / Budget balance

At this stage, the rise in long-term Japanese interest rates is therefore probably not due to concerns about public debt, but rather to recognition of the success of the reflation plan orchestrated by the Japanese authorities.

For investors, this reflation has its pros and cons. On the positive side, it makes Japan more attractive, with a heavily undervalued currency, decent economic growth and a spectacular recovery in the profitability of the financial sector (Chart 6). Banks and insurance companies are the main beneficiaries of the rise in interest rates.

Strong rebound in Japanese banks' profitability

Forte remontée de la rentabilité des banques japonaises



Return on equity
MSCI Japan, banking sector

On the negative side, the rise in Japanese rates calls into question one of the pillars of the stock market rally since 2024, namely the downward trend in short-term rates in developed countries. It adds to the ECB's status quo and the Fed's hesitations. The rise in long-term Japanese rates, particularly 30-year rates, is also contributing to

growing investor mistrust of long durations and may cause short-term shocks. Finally, it is raising fears of a repatriation of Japanese pension fund assets, even if flows do not indicate this at this stage.

The second derivative of the monetary rates of the major central banks will indeed be one of the risk factors for 2026. However, it is important to reiterate that in Japan, these rate rises are evidence of economic and monetary success that should also be taken advantage of. Japan accounts for 15% of the equity portion of our global funds, with an overweight position in banks. Finally, with real short-term rates still very negative in Japan and, to a lesser extent, in Europe, and an upcoming Fed rate cut, the risk of a sharp tightening of global liquidity remains moderate at this stage.

Our exposure rates are as follows:

Fund	Net equity exposure	Breakdown by theme (as a percentage of total equities)	Other
Dorval Convictions	66%	- Core basket excluding themes: 55% - Financials: 27% - Reflation: 15% - Small caps.: %	Euro Stoxx 50 futures and options hedges

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