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Macro View

What is the medium- to long-term outlook for the 10-year government bond yield? Approaching around 3% in FY2031

- We have forecasted Japan's long-term interest rate (10-year government bond yield). We expect this rate to rise gradually, mainly due to the diminishing stock effect in the medium to long term, reaching 2.80% by the end of fiscal 2031. The stock effect refers to the downward pressure on interest rates caused by the Bank of Japan's (BOJ) holdings of government bonds. With quantitative tightening (QT), this diminishing effect is expected to continue.
- If interest payments surge along with the rise in long-term interest rates and fiscal sustainability is threatened, there is a risk that this will spur further increases in the rates. However, considering the composition of outstanding government bonds by remaining maturity, interest payments are highly likely to reflect the rise in long-term interest rates only gradually, making it unlikely that such risks will heighten immediately.

Medium- to Long-Term Outlook for Long-Term Interest Rates

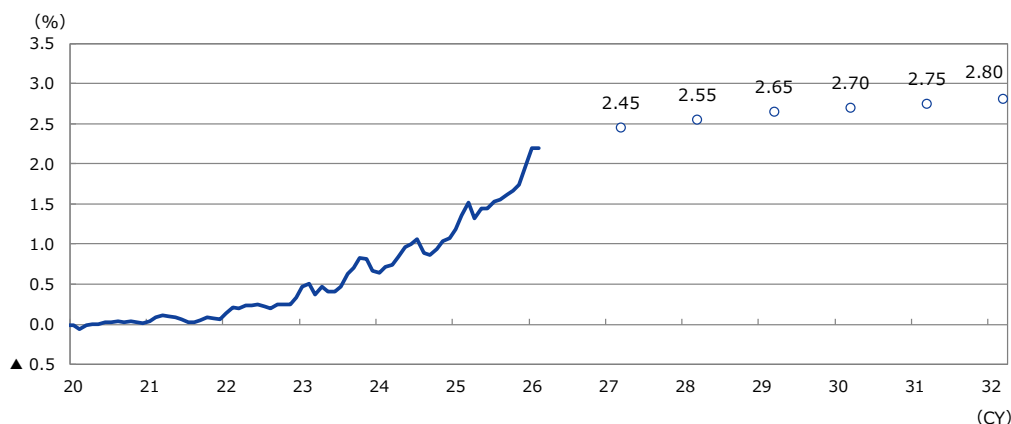
Japan's long-term interest rate (10-year government bond yield) rose to the 2.3% range in January 2026, before temporarily dropping below 2.1%. Recently, it has risen again due to factors such as concerns over the Middle East conflict, hitting 2.38% on March 27, the highest level in about 27 years. Although we do not expect the conflict to be prolonged, our short-term outlook projects the long-term interest rate to rise to 2.45% by the end of fiscal 2026 (Figure 1).

Prime Minister Takaichi, who secured a historic victory in the House of Representatives election, announced a policy to break the long-standing trend of excessive austerity and underinvestment in the future under a "responsible active fiscal policy." Furthermore, she has shown eagerness to reduce the consumption tax on food products and is prepared to submit related bills to the extraordinary Diet session in the autumn if discussions are concluded at the National Council on Social Security. Since she has indicated the intention to secure market confidence by steadily reducing the government's debt-to-GDP ratio, the possibility of shifting to reckless fiscal management is low. However, we believe that the fiscal risk premium is somewhat likely to rise in fiscal 2026.



The theme of this report is the subsequent medium- to long-term outlook for long-term interest rates. To state the conclusion first, we expect the long-term interest rate to rise gradually, primarily due to the diminishing stock effect, reaching 2.80% by the end of fiscal 2031 (Figure 1, 2). The stock effect refers to the downward pressure on interest rates caused by the BOJ's holdings of government bonds. With QT (quantitative tightening), this effect is expected to continue diminishing.

Figure1: 10-year government bond yield



(Note) Data covers the period from January 2020 to March 2032. The figures from March 2026 onwards are forecasts, showing the values at the end of each fiscal year (indicated by unfilled markers).

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on Bloomberg data.

Figure 2: Forecasts and Assumptions for the 10-Year Government Bond Yield

	(%)					
	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
10-Year Government Bond Yield	2.45	2.55	2.65	2.70	2.75	2.80
Policy interest rate	1.25	1.75	1.75	1.75	1.75	1.75
2y1y OIS forward rate	1.75	1.75	1.75	1.75	1.75	1.75
BOJ's holding ratio of long-term government bonds	41	36	31	27	24	21
U.S. 10-year government bond yield	4.10	4.10	4.10	4.10	4.10	4.10

(Note) End-of-period values.

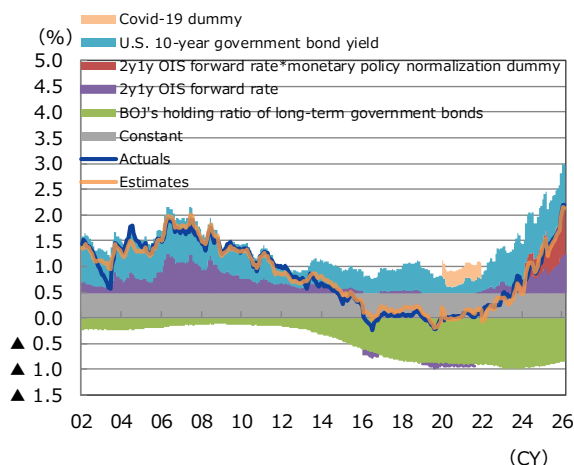
(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from Bloomberg, the Bank of Japan, and the Ministry of Finance.

Factors Fluctuating Long-Term Interest Rates

To understand the factors fluctuating long-term interest rates, we estimated the rate (Figure 3). The estimated values capture the movements of the long-term interest rate over approximately a quarter of a century. For the most recent period, the estimated value as of February 2026 is 2.12%, and the deviation from the actual figure is only -0.07 percentage points.

Fluctuations in the long-term interest rate can be largely explained by: (1) the BOJ's holding ratio of long-term government bonds, (2) 2y1y OIS forward rate (rate hike expectations), (3) the U.S. long-term interest rate, and (4) the COVID-19 dummy. Among these, (4) is a special factor. For the medium- to long-term outlook of the long-term interest rate, we focused on the future prospects of (1) to (3) and their impacts.

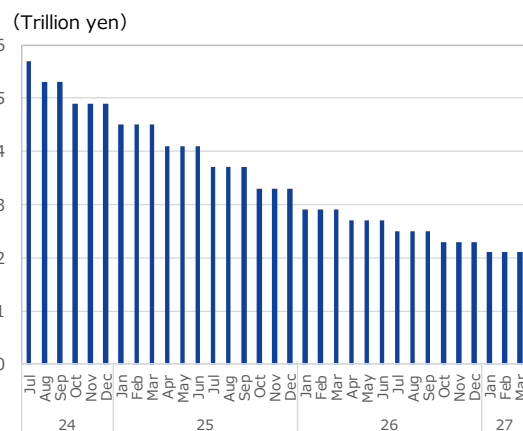
Figure 3: Estimation of the 10-Year Government Bond Yield



(Note) Data covers the period from January 2002 to February 2026. The estimation formula is as follows. 10-year government bond yield = $0.48 - 0.02 \times \text{BOJ's holding ratio of government bonds} + 0.42 \times 2y1y \text{ OIS forward rate} + 0.57 \times 2y1y \text{ OIS forward rate} \times \text{monetary policy normalization dummy} + 0.18 \times \text{U.S. 10-year government bond yield} + 0.30 \times \text{COVID-19 dummy}$, $R^2=0.97$ estimation period: January 2002 to February 2026. The monetary policy normalization dummy is set to 1 for March 2024 onwards, and 0 otherwise. This dummy takes into account the possibility that the impact of the 1-year interest rate two years ahead on the long-term interest rate has strengthened since the lifting of the negative interest rate policy. The COVID-19 dummy is set to 1 from January 2020 to December 2021, and 0 otherwise.

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from Bloomberg, the Bank of Japan, and the Ministry of Finance.

Figure 4: Scheduled Monthly Purchase Amount of Long-Term Government Bonds



(Note) Data covers the period from July 2024 to March 2027.

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Bank of Japan.

Diminishing Stock Effect is a Factor for Rising Long-Term Interest Rates

First, we focus on (1). In July 2024, the BOJ decided on a plan to reduce its purchases of long-term government bonds. Subsequently, in June 2025, it conducted an interim assessment of the plan. The current plan is to reduce the monthly purchase amount of long-term government bonds by about 400 billion yen every quarter until the January-March quarter of 2026, and by about 200 billion yen every quarter from the April-June quarter of 2026 onwards, bringing it to about 2 trillion yen in the January-March quarter of 2027 (Figure 4).

Under such a plan, the BOJ's holding ratio of long-term government bonds is on a declining trend (Figure 5).

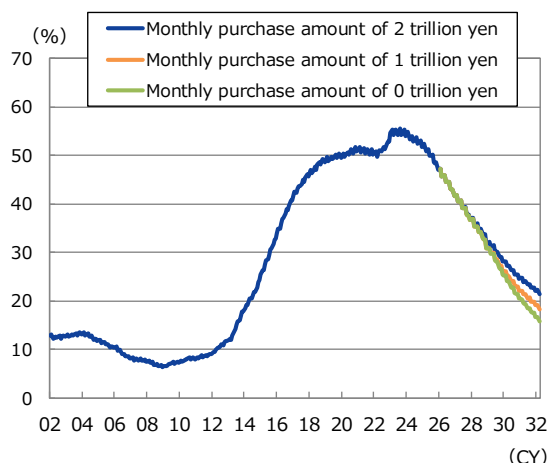
In this report's long-term interest rate outlook, we assume that purchases will continue at about 2 trillion yen, which is the endpoint of the current plan. In this case, the BOJ's holding ratio of long-term government bonds is expected to decline to 21% by the end of fiscal 2031. The annual pace of decline will be about 5 percentage points until fiscal 2028, and then decelerate to about 3 percentage points toward fiscal 2031.

According to the estimation in Figure 3, a 1 percentage point decline in the BOJ's holding ratio of long-term government bonds raises the long-term interest rate by 0.02 percentage points. Due to the diminishing stock effect, the long-term interest rate is calculated to be pushed up by about 0.1 percentage points each year until fiscal 2028. After that, the impact of the diminishing stock effect will become smaller, but it will continue to push up the long-term interest rate. Considering these effects, we expect the long-term interest rate to rise gradually.

Furthermore, the BOJ will conduct another interim assessment of the reduction plan for long-term government bond purchases in June 2026. In the minutes of the Monetary Policy Meeting in June 2025, there were opinions that it is desirable to gradually reduce the monthly purchase amount to zero, and that if reduced to about 1 trillion yen, the BOJ's purchases would no longer be a topic of discussion in the market.

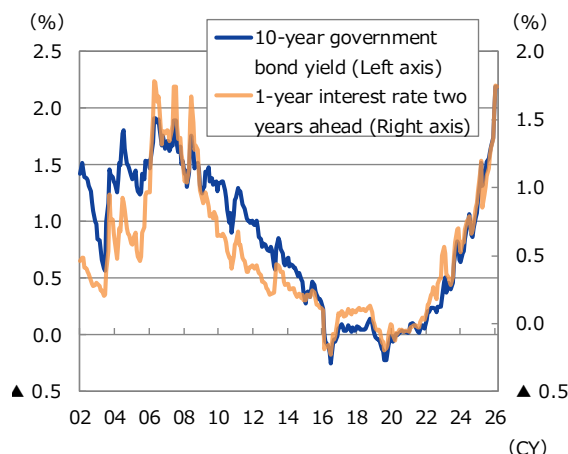
Figure 5 also includes cases where the final purchase amount is about 1 trillion yen or zero. However, the BOJ's holding ratios of long-term government bonds by the end of fiscal 2031 in these cases would be 18% and 16%, respectively, which are not significantly different from the 2 trillion yen case. This is because the BOJ's holding ratio of long-term government bonds is heavily influenced by the redemption of bonds it already holds. The amount of final purchases will likely not have a very large impact on the long-term interest rate through the diminishing stock effect.

Figure 5: BOJ's Holding Ratio of Long-Term Government Bonds



(Note) Data covers the period from January 2002 to March 2032. The figures from March 2026 onwards are forecasts.
(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Bank of Japan and the Ministry of Finance.

Figure 6: 10-Year Government Bond Yield and 1-Year Interest Rate Two Years Ahead



(Note) Data covers the period from January 2002 to February 2026.
(Source) Compiled by Sumitomo Mitsui DS Asset Management based on Bloomberg data.

Impact of Rate Hike Expectations on Long-Term Interest Rates is Limited

Next, we shift our perspective to (2). With the normalization of monetary policy, rate hike expectations have risen rapidly (Figure 6). 2y1y OIS forward rate, which is considered the terminal rate priced in by the market, had been hovering around 0.60% before the lifting of the negative interest rate policy, but has recently risen to about 1.75%. Looking at Figure 3, it can be seen that heightened rate hike expectations have led the recent rise in long-term interest rates.

However, the market has already priced in the normalization of the policy interest rate to a considerable extent. Our company expects that if a prolonged escalation of the Middle East situation can be avoided, the policy interest rate will be gradually raised to 1.75% toward fiscal 2027 in the current rate hike phase. The BOJ has indicated its policy to continue raising interest rates in line with improvements in economic and price conditions, assuming its economic and price outlooks materialize. Furthermore, according to the aggregate responses to the spring wage offensive published by Rengo, the wage increase rate in 2026 is at a high level similar to last year. Considering this, it is highly likely that the BOJ's "price stability target" of 2% will also be achieved. Under these circumstances, the BOJ is highly likely to continue raising interest rates at a gradual pace. However, the market has already largely priced in such rate hikes. It can be said that the impact of rate hike expectations on long-term interest rates is limited.

Additionally, it was reported that Prime Minister Takaichi expressed reluctance toward additional rate hikes during the Takaichi-Ueda meeting in February. In addition, regarding the succession of BOJ board members, a reflationist was presented to and approved by the Diet. However, if the BOJ's stance on rate hikes recedes, the risk of further yen depreciation will increase, so there will likely be limits to political control over monetary policy.

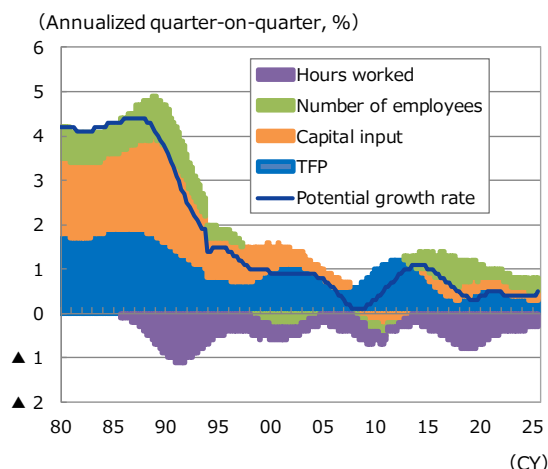
Will the Target Level of the Policy Interest Rate Change?

Looking a little further ahead, is there a possibility that the target level of the policy interest rate will change? According to the estimation in Figure 3, since the lifting of the negative interest rate policy, a 1 percentage point change in 2y1y OIS forward rate changes the long-term interest rate by the same degree. What draws attention is the potential growth rate. According to the Cabinet Office, the potential growth rate for the most recent October-December 2025 quarter is 0.5%, but if this changes significantly, it could affect rate hike expectations (Figure 7). However, our main scenario is that this possibility is low.

Regarding factors that could drive up the potential growth rate, some expect much from the government's growth strategy to be formulated this summer. However, based on past policy track records, it is difficult to place an optimistic outlook of an upward shift in the potential growth rate as the main scenario. On the other hand, regarding factors that could drive down the potential growth rate, there are deep-rooted concerns about a decline in the number of employed persons. However, the number of employed persons continues to increase. The number of employed persons in recent years has slightly exceeded even the most optimistic "growth realization and labor participation progress scenario" presented in the "Estimates of Labor Supply and Demand for Fiscal 2023" (The Japan Institute for Labour Policy and Training) (Figure 8). In that scenario, the participation of women and the elderly in the labor market was expected due to the development of childcare facilities and the extension of healthy life expectancy. In reality, labor participation is progressing at a pace slightly exceeding these expectations. Of course, considering demographics, the time will eventually come when the number of employed persons turns to a decline, but during the period up to fiscal 2031 focused on this time, the number of employed persons is highly likely to remain solid.

If the potential growth rate does not change significantly, it would be reasonable to assume that the policy interest rate will be raised to 1.75% in the current rate hike phase and then remain flat. If so, the future impact of rate hike expectations on long-term interest rates will be limited.

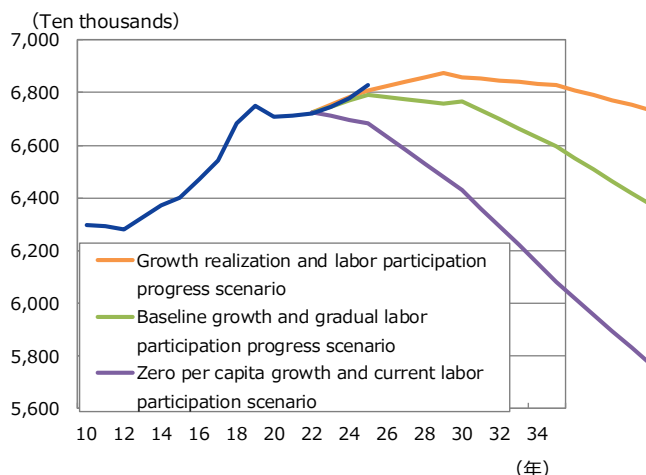
Figure 7: Potential Growth Rate



(Note) Data covers the period from the April-June quarter of 1980 to the October-December quarter of 2025.

(Source) Compiled by Sumitomo Mitsui DS Asset Management

Figure 8: Number of Employees



(Note) Data covers the period from 2010 to 2035. The data for each scenario is based on the "Estimates of Labor Supply and Demand for Fiscal 2023" (The Japan Institute for Labour Policy and Training).

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Ministry of Internal Affairs and Communications and The Japan Institute for Labour Policy and Training.

Impact of U.S. Long-Term Interest Rates is Generally Neutral

Regarding (3) U.S. long-term interest rates, we assume they will level off at just over 4% over the medium to long term, and we expect the impact on Japan's long-term interest rates to be generally neutral. Furthermore, if inflation remains high, there is a risk that the FRB will take a hawkish stance. Additionally, factors such as a shift away from the dollar due to an expanding fiscal deficit are closely watched as upside risks to U.S. long-term interest rates. According to the estimates in Figure 3, if U.S. long-term interest rates rise by 1 percentage point, Japan's long-term interest rates will rise by 0.18 percentage points. If U.S. long-term interest rates were to rise to 5% over the medium to long term, Japan's long-term interest rates would shift upward to close to 3% by the end of FY2031.

Rising Long-Term Interest Rates and Public Finance

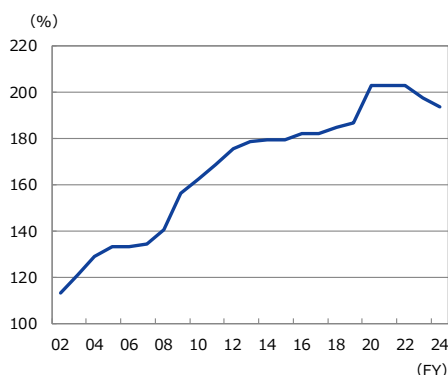
Our company forecasts that Japan's long-term interest rate will rise to 2.80% by the end of fiscal 2031, but what about its impact on public finance? If interest payments surge and fiscal sustainability is threatened, there is a risk that this will spur further increases in long-term interest rates. To evaluate fiscal health, the government's debt-to-GDP ratio is often focused on (Figure 9). As mentioned earlier, Prime Minister Takaichi is also paying attention to this indicator and maintains the idea of securing market confidence by steadily reducing it.

Looking back at the movements of the debt-to-GDP ratio, after rising to 203% in fiscal 2022, it declined for two consecutive years to 197% in fiscal 2023 and 194% in fiscal 2024. The change in this ratio can be approximated by the following formula.

Year-on-year change in debt-to-GDP ratio = (effective interest rate on debt - nominal GDP growth rate) * debt-to-GDP ratio + primary balance-to-GDP deficit

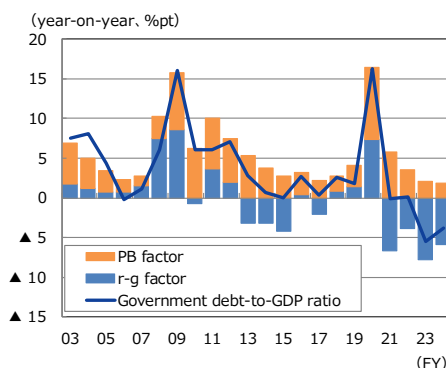
Letting the first term on the right side be the "r-g factor" (r = effective interest rate on debt = interest payments / outstanding debt, g = nominal GDP growth rate) and the second term be the "PB factor" (PB stands for primary balance), the recent decline in the debt-to-GDP ratio was led by the "r-g factor" (Figure 10). The fact that the nominal GDP growth rate significantly exceeded the effective interest rate on debt contributed to pushing down the debt-to-GDP ratio (Figure 11).

Figure 9: Government Debt-to-GDP Ratio



(Note) Data covers the period from fiscal 2002 to fiscal 2024.
(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Cabinet Office.

Figure 10: Breakdown of Factors for the Government Debt-to-GDP Ratio



(Note) Data covers the period from fiscal 2003 to fiscal 2024.
Since the breakdown of factors for the debt-to-GDP ratio is based on an approximation formula, the change in the debt-to-GDP ratio does not necessarily match the sum of each factor.
(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Cabinet Office.

Unlikely that Rising Long-Term Interest Rates Will Immediately Cause Rapid Fiscal Deterioration

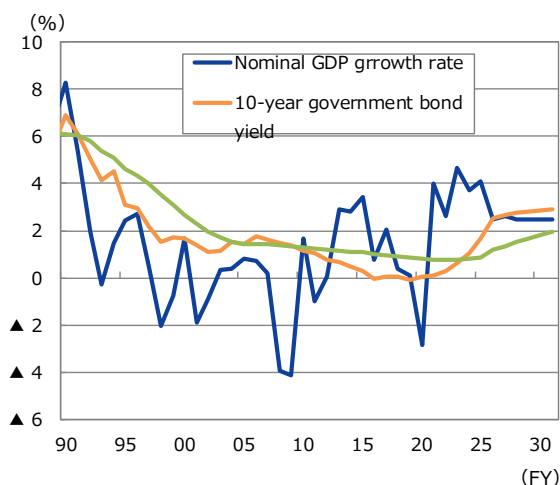
The future concern is that the effective interest rate on debt will rise due to the increase in interest payments accompanying the rise in long-term interest rates, and the effect of pushing down the debt-to-GDP ratio by the "r-g factor" will be lost. However, it is unlikely that such a situation will arrive immediately. The effective interest rate on debt is, so to speak, the average interest rate of the entire outstanding debt. Therefore, the effective interest rate on debt gradually reflects market interest rates, mainly through the maturity and refinancing of existing bonds.

The average remaining maturity of Japan's outstanding ordinary government bonds is as long as 9 years and 6 months. Furthermore, looking at the composition by remaining maturity, those of 7 years or less account for only about half (Figure 12). Roughly speaking, this means that it will take as long as 7 years for the effective interest rate on debt to reflect even half of the market interest rates.

Figure 11 also shows the outlook up to fiscal 2031. Regarding the nominal GDP growth rate, the figures from fiscal 2025 to fiscal 2027 are our company's economic forecasts. From fiscal 2028 onwards, it is simply set at 2.5% (assuming the potential growth rate remains flat from the most recent 0.5% and the GDP deflator reflects a 2% inflation rate). On the other hand, although the effective interest rate on debt is expected to follow a rising trend, its pace is expected to be gradual. The rate in fiscal 2031 will be around 1.9%, and the relationship of $r < g$ will be maintained. Even if the long-term interest rate rises to 2.80% by the end of fiscal 2031, the effect of pushing down the debt-to-GDP ratio by the "r-g factor" is highly likely to persist for the time being, albeit shrinking.

Of course, from a longer-term perspective, the effective interest rate on debt is highly likely to approach the level of long-term interest rates over a long period. In this regard, the importance of the government showing a path to sound fiscal management may increase in the future, but there is a grace period.

Figure 11: Nominal GDP Growth Rate and Interest Rates



(Note) Data covers the period from fiscal 1990 to fiscal 2031. The figures from fiscal 2025 onwards are forecasts.

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Cabinet Office, the Ministry of Finance, and Bloomberg.

Figure 12: Composition of Outstanding Ordinary Government Bonds by Remaining Maturity

Remaining maturity	Composition (%)
Over 20 years	13.8
Over 10 to 20 years	19.3
Over 9 to 10 years	4.0
Over 8 to 9 years	5.4
Over 7 to 8 years	4.8
Over 6 to 7 years	4.7
Over 5 to 6 years	4.2
Over 4 to 5 years	6.2
Over 3 to 4 years	7.2
Over 2 to 3 years	6.8
Over 1 to 2 years	9.6
1 year or less	13.8

(Note) Data is for fiscal 2024.

(Source) Compiled by Sumitomo Mitsui DS Asset Management based on data from the Ministry of Finance.

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