

Japan's volatility reflects Bank of Japan's (BOJ) policy normalisation, not fiscal stress. Fundamentals remain solid, with strong external assets, contained deficits, and continued fiscal discipline. Market moves are being driven by technical flows as Japan exits yield suppression. In this environment, we believe the yen is positioned for appreciation as stretched shorts unwind, and long-dated Japan Government Bonds (JGBs) offer attractive entry points for income and duration exposure.

A story of policy normalisation, not a fiscal crisis. Japan is rarely a market driven by political noise. For decades, it has been associated with stability – steady institutions, predictable policymaking, and muted political volatility. That's why recent market reactions to remarks by Prime Minister Sanae Takaichi have felt so unusual. Her campaign styled comments on fiscal policy have repeatedly moved the yen and triggered swings in long dated Japanese government bonds (JGBs), prompting headlines that question Japan's fiscal health.

These concerns, often centered on Japan's high debt to Gross Domestic Products (GDP) ratio, tell only part of the story. When placed in the broader context of Japan's macro fundamentals and structural strengths, the picture looks far more balanced. In our view, Japan's underlying position remains sound.

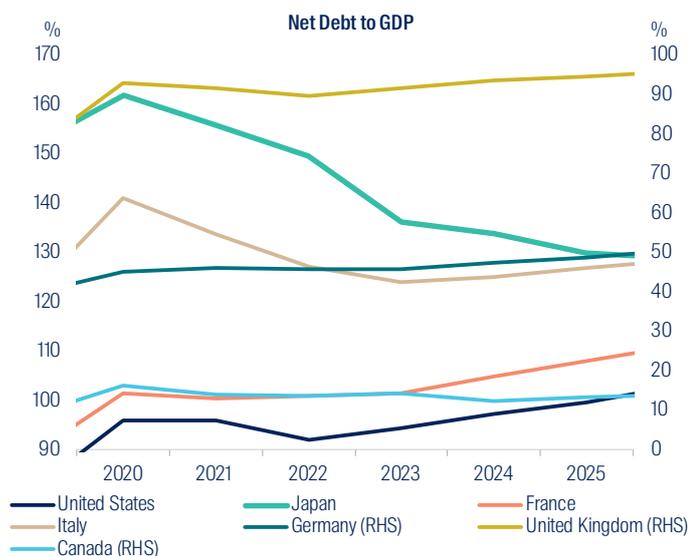


Figure 1
Source: IMF, Bloomberg, as of Dec 2025.

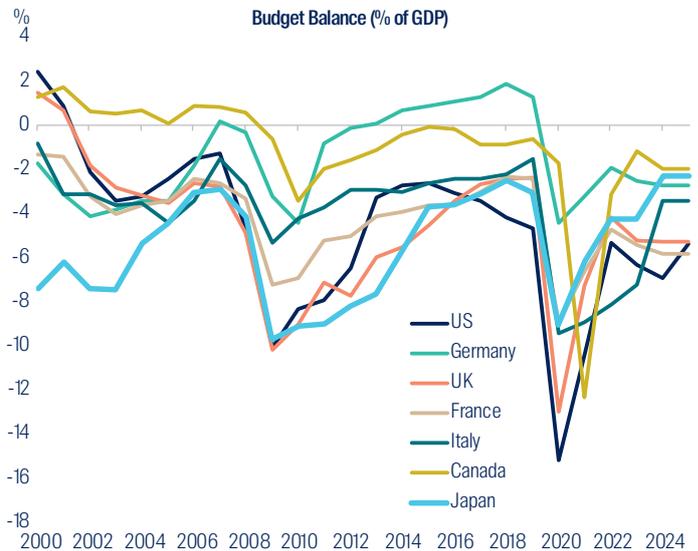


Figure 2
Notes: Based on latest yearly data, only 2025 data was available for the US.
Source: Bloomberg Dec 2025.

Japan is one of the world's largest net international investors.

The income it earns from overseas assets has grown into a powerful buffer for its economy. A key point often overlooked is how Japan's net debt position has improved in recent years, particularly when compared with other major developed economies (Figure 1). While gross debt numbers appear large, Japan has accumulated substantial foreign assets whose returns have outpaced what the government pays on its long standing, low interest domestic debt.

Fiscal deficits are manageable and improving. Japan does run a primary deficit, but the numbers remain contained. Current projections put Japan's primary deficit at 2-3% of GDP from FY2026 to FY2028, with a gradual improvement thereafter. Viewed against the G7 nations¹, these figures are not alarming – in fact, they compare relatively well (Figure 2). Japan's fiscal path is challenging but far from unstable, and the government has continued to signal that fiscal discipline remains a priority.

New leadership doesn't mean fiscal irresponsibility.

Regardless who won Japan's snap election, new fiscal measures were expected. Discussions around consumption tax cuts and targeted stimulus have been ongoing across parties. We see

¹ The G7 (Group of 7) is an intergovernmental forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States, along with The European Union as a non-enumerated member.

Japan's Liberal Democratic Party's (LDP) supermajority as a sign that these measures can be implemented more smoothly. Much of Takaichi's remarks relate to targeted and temporary stimulus, and come with explicit commitments to maintain fiscal discipline.

Technical factors, not fiscal fears, are driving JGB volatility.

Overseas investors represent a relatively small share of super long JGB holdings, yet account for a large share of trading volume. This asymmetry amplifies price moves during a time when the BOJ is tapering off its purchases of long-tenured JGBs. Markets have been long accustomed to the BOJ being the largest buyer of Japanese government bonds, but it is important to remember that this should not be and will not be the market norm going forward. The Bank of Japan has been tapering its purchases, stepping back from nearly two decades of yield curve control. This marks the end of an era where the BOJ effectively suppressed long-term yields. As such, volatility is inevitable as the market adjusts to a more dynamic equilibrium through price discovery.

JGB yields and the yen have deviated from long term averages. 10 Year JGBs are now trading above 2%, while the JPY is cheap compared to its 5- or 10-year averages of 138 and 124 respectively. We believe there resides attractive opportunities to hold the JPY and JGBs for various reasons:

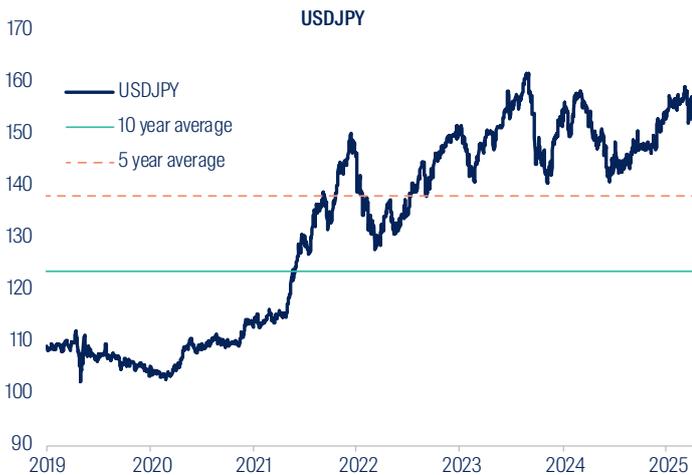


Figure 3
Source: Bloomberg, as of 20 January 2026.

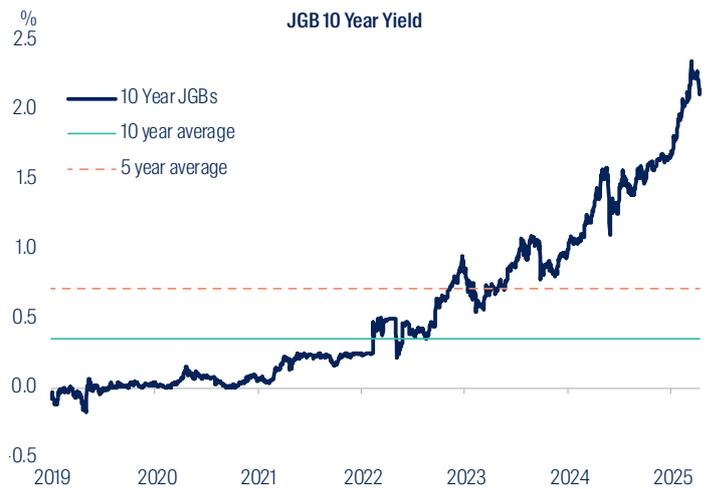


Figure 4
Bloomberg, as of 20 January 2026.

JPY:

- Policymakers monitor yen weakness closely due to its impact on domestic inflation. Previous episodes have shown that authorities are willing to intervene to support the yen to avoid excessive depreciation.
- Carry trade positioning looks stretched: hedge funds remain short yen, while real money flows have turned neutral to long over the past year – suggesting potential for a reversal.
- In any global risk off environment (eg: Middle east geopolitics), the yen is likely to benefit from safe haven demand.

JGBs:

- Higher yields offer compelling income opportunities for income oriented strategies.
- Long dated JGBs are becoming a useful instrument for expressing duration views as price discovery improves.
- With fiscal expectations stabilising and deficit projections contained, we believe the long end of the curve appears more balanced and attractive for income-oriented investors.

Japan's recent market turbulence says less about fiscal fragility and more about a market adjusting to life without guaranteed BOJ liquidity. After decades of ultra cheap yen funding and suppressed yields, global investors need to recalibrate to a new reality: Japan is no longer the world's anchor of zero cost capital.

Source: First Sentier Investors as at 20 February 2026.

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