Concerns about Japanese and US Government Bond Market Trends

President Trump's each and every move is causing confusion in the US markets. The New York Stock Exchange Dow Jones Industrial Average was at around 42,000 points at the end of March, but it plunged following the announcement of reciprocal tariffs on April 2, falling below 37,000 at one time. The Dow subsequently rebounded following the April 9 announcement of a 90-day suspension of adding on reciprocal tariffs, and it was in the 41,000 range as of May 8. The yen-dollar exchange rate was holding in the ¥150–160 yen per dollar range through around the end of March, but the dollar then rapidly depreciated and dropped below ¥140 per dollar at one point. The dollar also fell versus other currencies across the board. The yield on 10-year US government bonds dropped below 4% on April 4 amid a "flight to quality" sparked by the decline in stock prices caused by the Trump tariffs, but suddenly climbed above 4.5% at one point on April 9, and that spike in interest rates is said to be one reason for the 90-day suspension on the reciprocal tariffs. Interest rates did not subsequently decline by all that much, and were at 4.37% as of May 8. In this way, from the beginning through the middle of April, US markets showed a triple decline of lower stock prices, a weaker dollar, and lower bond prices all at once.

While various factors have been noted as causes, it is natural to conclude that the root of this lies in the economic irrationality and the lack of predictability of President Trump's policies. President Trump insists that his series of tariff policies will bring forth a resurgence of the US, but the consensus is that stagnation of trade on a global level may lead not only to an economic downturn but also to a rise in prices. The impact of frequent changes to important policies is also substantial. Trump publicly stating that he would fire Federal Reserve Chair Jerome Powell (which he later withdrew) in particular had a significant impact. This resulted in heightened uncertainties that the propriety of monetary policy might be lost from political interference and controlling inflation could become difficult.

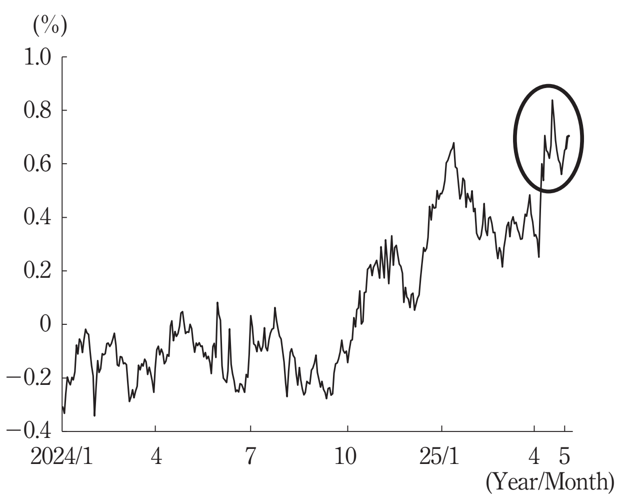
What vividly demonstrates the uncertainty regarding US markets is the trend of the term premium on US government bonds. A term premium is the additional interest rate that investors demand in accordance with the length of the redemption period of long-term bonds, and it tends to increase when concerns regarding fiscal sustainability or inflation heighten. Figure 1 shows the trend of the term premium on US government bonds (10 year) as calculated by the Federal Reserve Bank of New York. While the term premium was moving within a negative range until the beginning of October last year, it turned to an increase from around the time that Trump was elected president in November. What is particularly outstanding is that the term premium expanded from 0.26% to 0.84% in less than 20 days through mid-April when the various Trump tariff policies were being announced in rapid succession. Apparently, uncertainties regarding not knowing what types of policies President Trump with his belief in America First might set forth next have obstructed the flow of funds into the US and pushed up the term premium. However, looking over a time span of around 30 years, while the last decade or so has been a low-level phase, the causes for concern surrounding US markets are too numerous to count. The point of interest is whether the term premium will expand further.

Then, what about Japan? Since term premium estimates are not presented in Japan, as an alternative we can look at the additional market interest rate from the differential between the yields on 40-year government bonds and 10-year government bonds. This gap, which was 1.17 percentage points on April 2, expanded to 1.65 percentage points on April 14, and further to 1.77

percentage points by May 7 (see Figure 2). This occurred because while the yield on the 10-year bond decreased, the yield on the 40-year bond greatly increased. Such trends can reflect heightened concerns about the long-term sustainability of Japanese government finances from the spate of proposals not backed by funding sources put forth with an eye on the House of Councillors election such as cash payments and reductions to the consumption tax. Receding expectations of interest rate hikes by the Bank of Japan under concerns regarding recession with the imposition of the Trump Tariffs are a factor that should pull down long-term interest rates, but these concerns are more than compensating for that factor.

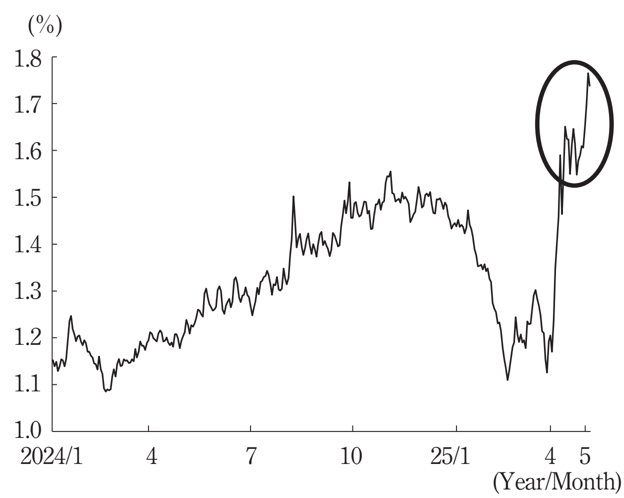
Some analysts say that recently the changes in President Trump's important policies are being influenced by government bond market trends. Will the market be able to fulfill its checking function against policies that lack rationality? The Japanese and US government bond market trends demand close monitoring.

Figure 1: Trend of the Term Premium of US Government Bonds



Note: The Term Premium on 10-year US government bonds
Source: Federal Reserve Bank of New York

Figure 2: Yield Differential between 40-year and 10-year Japanese Government Bonds



Source: Ministry of Finance