

ECONOMIC RESEARCH – MARCH 2026

INVESTMENT INSIGHT

JAPAN



- ✓ **The specter of stagflation threatens the yield curve**
- ✓ **Yen under energy shock and monetary deadlock**
- ✓ **Stagflation risks threaten the Nikkei**

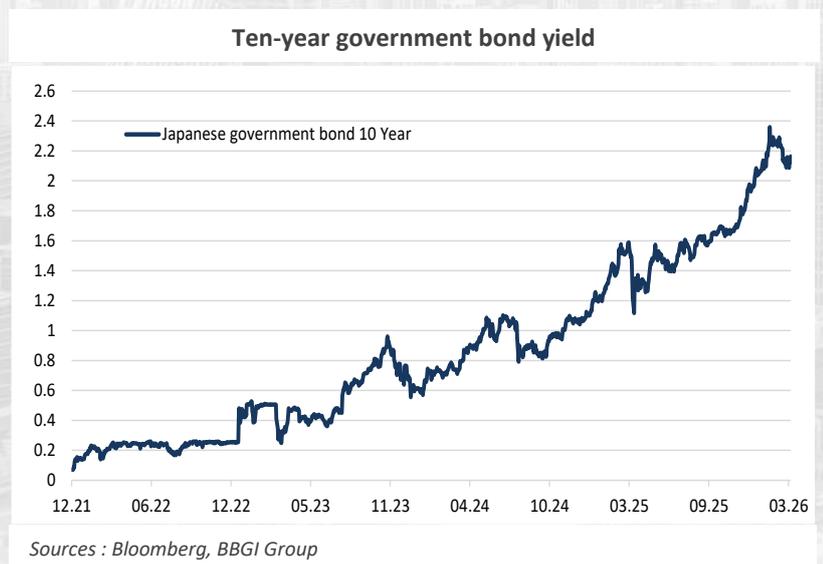
STAGFLATION RESHUFFLES THE DECKS FOR JAPANESE ASSETS

Bond market volatility and the specter of stagflation

The Japanese fixed-income market is under intense pressure, with 10-year JGB yields stabilizing near 2.1% after significant volatility. This calm is fragile, as yields are now deeply correlated with inflationary fears triggered by the Middle East conflict. We anticipate yields will resume an upward trend toward 2% and beyond, as current coupons fail to offset capital erosion in an environment of rising prices and recessionary risks.

JGB performance and the yield curve shift

Japanese Government Bond (JGB) performance is expected to remain negative in the coming months as yield normalization coincides with an energy-driven inflation spike. Historically, yields fluctuated between 1.1% and 1.3%, but the current paradigm shift toward 2% reflects a permanent adjustment to the BoJ's exiting of yield curve control. While the bond market is technically becoming less risky due to higher absolute yields, a meaningful entry point for foreign capital will likely require a decisive reversal in the yen's trend and even higher yield levels to provide a sufficient safety margin against duration risk.



The Yen caught in a geopolitical and monetary vice

The Japanese yen remains under intense pressure, exacerbated by the global oil shock and a widening monetary deadlock. With crude oil surpassing \$80 per barrel, Japanese importers are forced into heavy yen selling to secure dollars, pinning the exchange rate in a weak range between 155 and 160 JPY/USD. Japan faces a paradox where currency weakness directly fuels imported inflation, yet the BoJ remains reluctant to pivot aggressively beyond 0.75% for fear of crushing domestic consumption. Until the Bank of Japan crosses the psychological 1% threshold to anchor expectations, structural selling pressure on the yen will persist.

Negative real yields and carry trade dynamics

The interest rate differential between Japan and the United States continues to be the primary engine for the carry trade, with investors shunning the yen as its yield fails to cover rising inflation. Real yields remain firmly negative, further isolating the archipelago. While a cooling US economy might offer some respite through future Fed cuts, current geopolitical tensions favor the dollar as a safe-haven asset. Consequently, we believe the yen is vulnerable to further weakening and do not recommend active long positions until a significant shift in either BoJ policy or energy costs materializes.

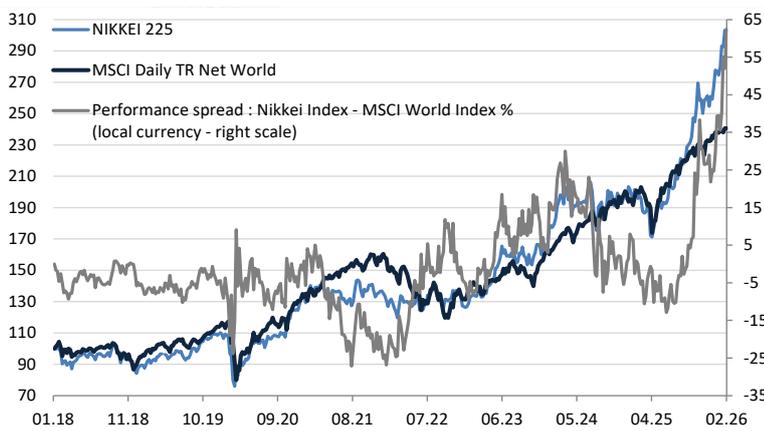
Nikkei valuations and rising equity risk premium

The Nikkei is undergoing a rigorous reassessment of its risk premium as the energy crisis threatens corporate margins. Although earnings growth was initially projected at +10% for 2026, these estimates are being revised downward. While structural trends—such as the unwinding of cross-shareholdings and the push for higher price-to-book (P/B) ratios—provide a valuation floor, they cannot prevent a tactical adjustment. We anticipate a significant risk of consolidation, with the index potentially retreating 10% to 12% below the 50,000-point mark as international investors recalibrate their exposure to Japanese macro risks.

Sectoral allocation and supply chain vulnerabilities

Technology and semiconductor stocks, previously the darlings of foreign investors, now face headwinds from potential supply chain disruptions linked to the energy crisis. While these sectors benefit from structural tailwinds, the threat of stagflation—zero growth combined with soaring input costs—is cooling investor appetite. We suggest a more cautious allocation to the Japanese equity market, prioritizing companies with strong pricing power and low energy sensitivity. The primary focus for the remainder of 2026 will be capital preservation as the market navigates this unstable equilibrium of high costs and fragile demand.

Nikkei and MSCI World indices



Sources : Bloomberg, BBGI Group

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