KGI

CIO Insights

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The Path to a Strong Yen Era

Bracing for the Unwinding of Near-Zero-Cost Trades

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The Path to a Strong Yen Era

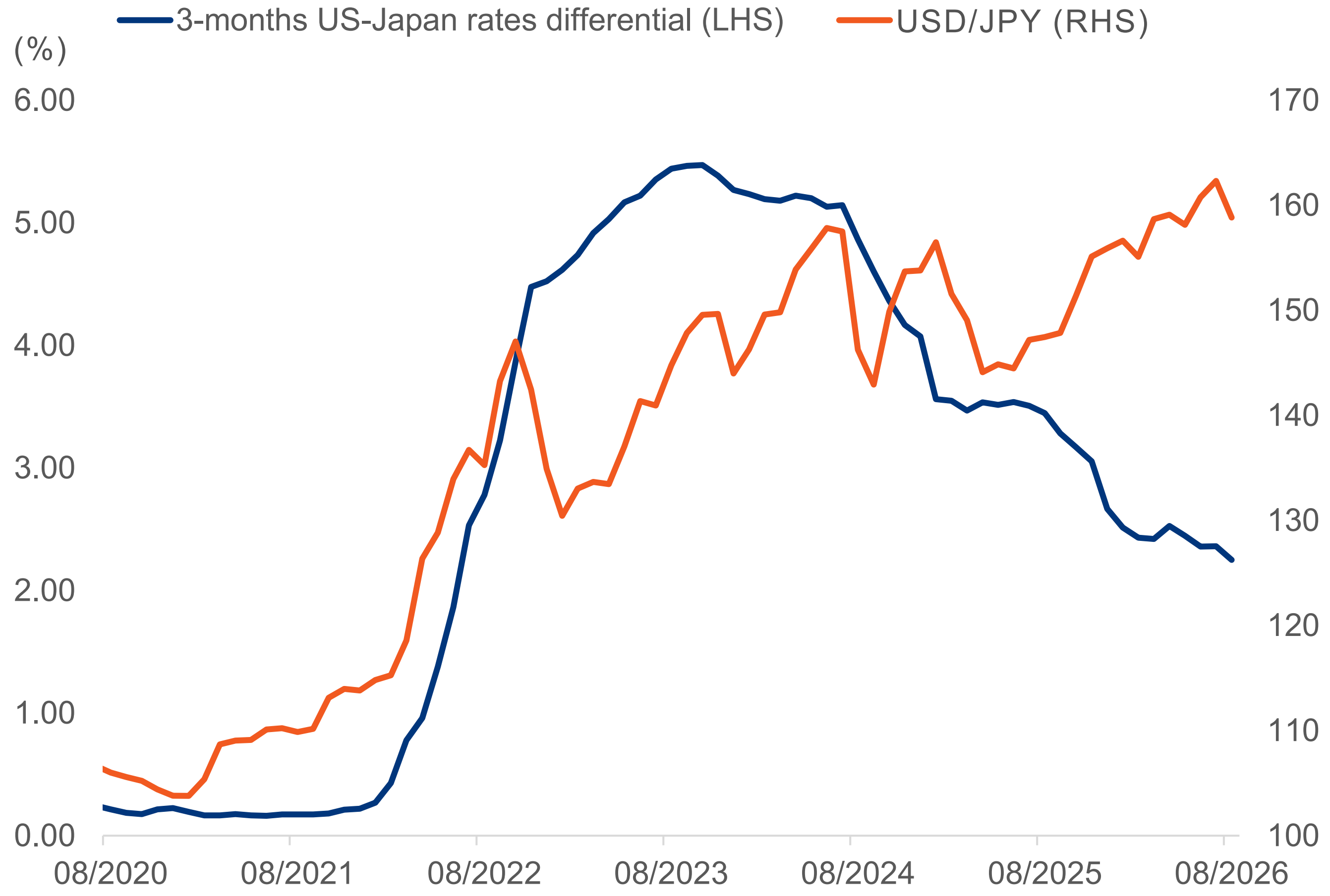
Investment Summary

- **The narrowing interest-rate differential between the US and Japan points to a stronger yen**. The BoJ's interest-rate normalization, aimed at curbing inflation and the yen's decline, is expected to be more effective than direct government intervention in the FX market.
- **The era of near-zero-cost yen funding for foreign-asset purchases is drawing to a close.** Recent data show that 97% of Japan's US Treasury sales were concentrated at the short end. Weak US economic data may raise expectations of divergent policy-rate paths in Japan and the US. Further narrowing of the interest-rate differential could unsettle US markets.
- Any global sell-off stemming from yen strengthening would initially shock Japan's markets through tighter global liquidity and negative sentiment-driven de-rating. However, **we see opportunities to buy sectors that benefit from a stronger yen and higher rates after the initial market shock**: banks and financials, utilities, import-led retail/staples, domestic telecommunications, and services.

Source: KGI

What if the Yen Becomes Much Stronger?

FX-Hedged US-Japan Interest Rate Spread Is at a Bare Minimum



Source: Bloomberg, KGI

A Stronger Yen Would Change The Market Regime

The Possible End of Near-Zero-Cost Yen-Funded Trades

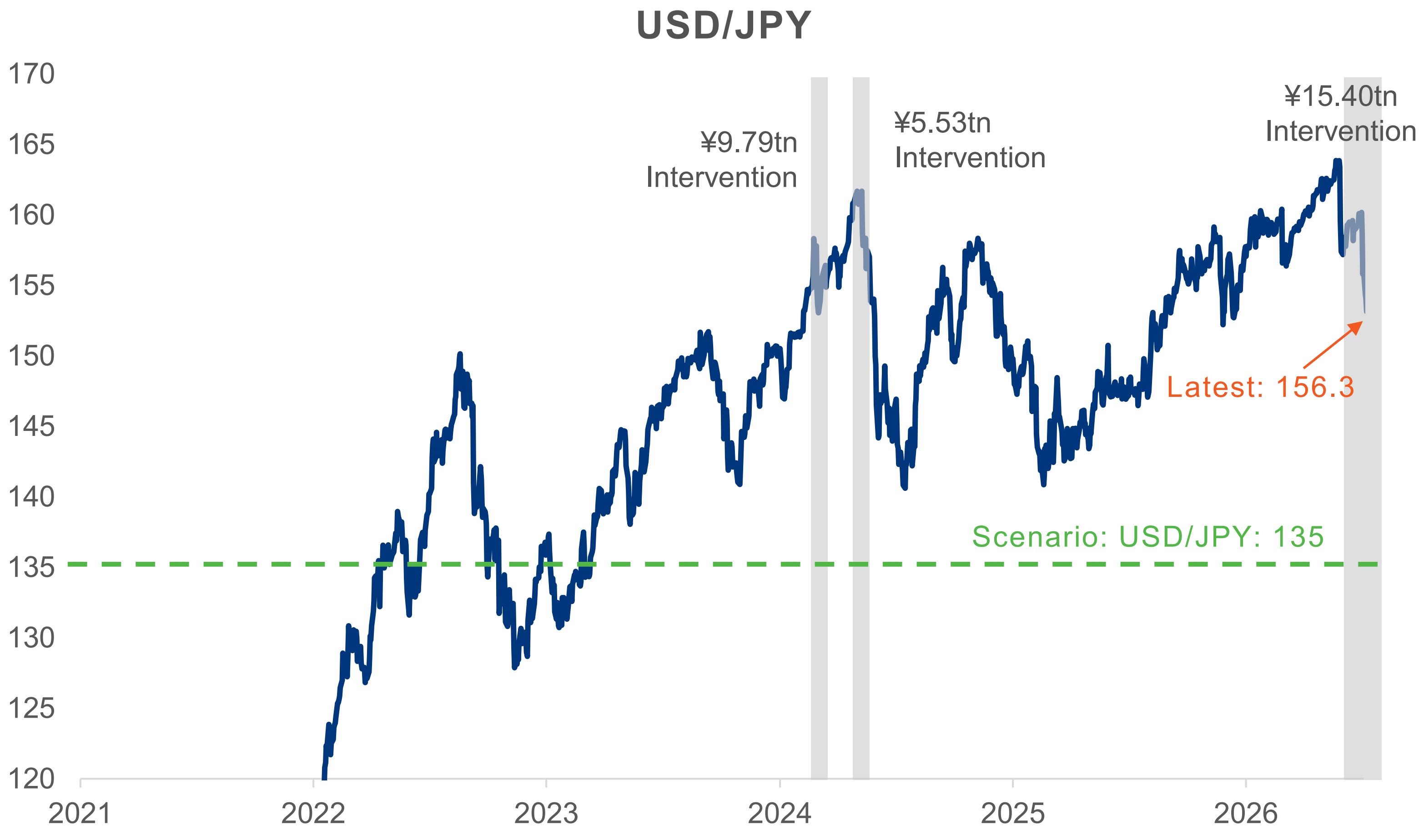
- **Scenario:** USD/JPY appreciates from 156.3 to 135, representing a 15.8% gain in the yen's value against the dollar.
- **Catalyst:** sustained BoJ normalization, with a narrower US-Japan policy-rate differential; a less supportive dollar backdrop could reinforce the move.
- **First phase:** carry deleveraging and higher volatility pressure global liquid risk assets, including Japanese exporters.
- **Second phase:** Japanese capital allocation and equity leadership rotate toward JGBs, banks, import-sensitive businesses, and domestic-value stocks.

Yen Carry Trade Explained

Source: KGI

The US Would Prefer an Intervention Approach

Otherwise, US Rates/Yields Would Have to Rise to Maintain Stability in Capital Flows



Intervention Scale

¥9.79tn in 2024 Q2; **¥5.53tn** in 2024 Q3; and **¥15.40tn** from 30 Jul-26 Aug 2026.

Coordination Signal

Japan and the US confirmed a coordinated yen-buying operation on **31 Jul 2026**, producing an immediate sharp rebound in the yen.

Policy Alignment

The BoJ policy rate reached **1.00%** on 31 Jul 2026; a stronger yen requires rate expectations and capital flows to reinforce the signal.

Source: Bloomberg, KGI

Why Not a Weak Yen?

A Weak Yen Transfers Purchasing Power from Households to Foreign Income Earners

- Japan's reliance on imported fuel makes the yen a material terms-of-trade variable: the country met 97% of its oil demand through imports in 2022.
- The BoJ identifies the recent weak yen and higher crude-oil prices as factors driving up import and consumer-goods prices, placing pressure on households' real income.
- Exporters benefit from a translation tailwind on foreign earnings. However, Japan has been a net importer (exports minus imports) over the past five years. A stronger yen would help narrow its trade deficit.
- The policy dilemma has sharpened because consumption, wage dynamics, and inflation expectations now matter more than the historic "weak yen helps exporters" narrative.

TRANSMISSION MECHANISM

Weaker yen	**Higher import costs**
Lower real income	**Weaker consumption / higher inflation risk**

Source: KGI

Takaichi Calls for Debt Issuance to Fund Spending if Needed

Higher Rates and Yields Support the Repatriation of Capital to Japan

- **Replacing the Primary Balance Surplus Target:** Takaichi has significantly deprioritized Japan's previous "primary balance surplus" target, shifting the fiscal focus toward boosting GDP growth to reduce the overall debt-to-GDP ratio instead.
- **The 2040 Vision:** Her long-term economic blueprint aims to mobilize more than ¥370 trillion ($2.28 trillion) in combined public and private investment across 17 strategic sectors by 2040. The ultimate goal is to more than double Japan's long-term economic growth rate.
- **Focus on High-Tech and Semiconductors:** The government is channeling substantial capital into artificial intelligence (AI), semiconductors, green energy, space development, and robotics to secure national supply chains and technological leadership.
- **Accelerated Defense Spending:** Takaichi has accelerated Japan's defense buildup, fast-tracking plans to raise annual military spending to 2% of GDP by March 2026 – years ahead of the previous administration's timeline.
- **Inflation Relief and Tax Cuts:** To alleviate the rising cost of living, she has implemented substantial supplementary budgets to fund household energy subsidies and has actively campaigned for tax-threshold changes and provisional fuel-tax cuts.

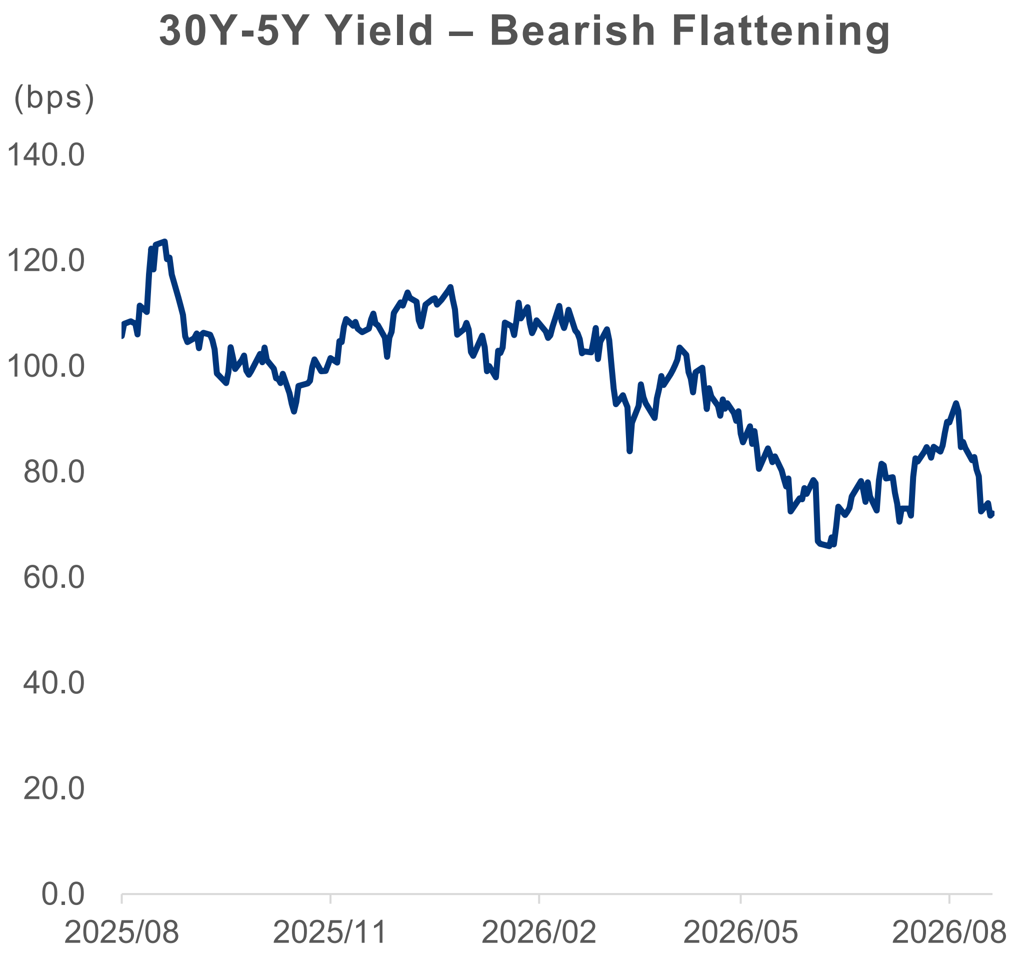
All These Policies Require Funding Support.

Source: KGI

Is There Imminent Selling of Long-Duration US Treasuries?

The Data Do Not Yet Show a Long-Duration Treasury Liquidation

- Japan-based investors sold a net $71 billion of US government debt through June 2026.
- Nearly all of that – about $69 billion – was in short-term Treasury bills (maturing within one year).
- Net sales of longer-term notes and bonds were only $3 billion.
- This matters because the market generally believes that Japan's selling drove the rise in long-duration US Treasury yields. In fact, 97% of the sales were concentrated in short-term Treasury bills.
- This is consistent with our previous view that short- to medium-term US Treasuries may face greater downside risk than long-duration bonds.



Source: Bloomberg, KGI

A US Asset Sell-Off Can Initially Send Stress to Japan

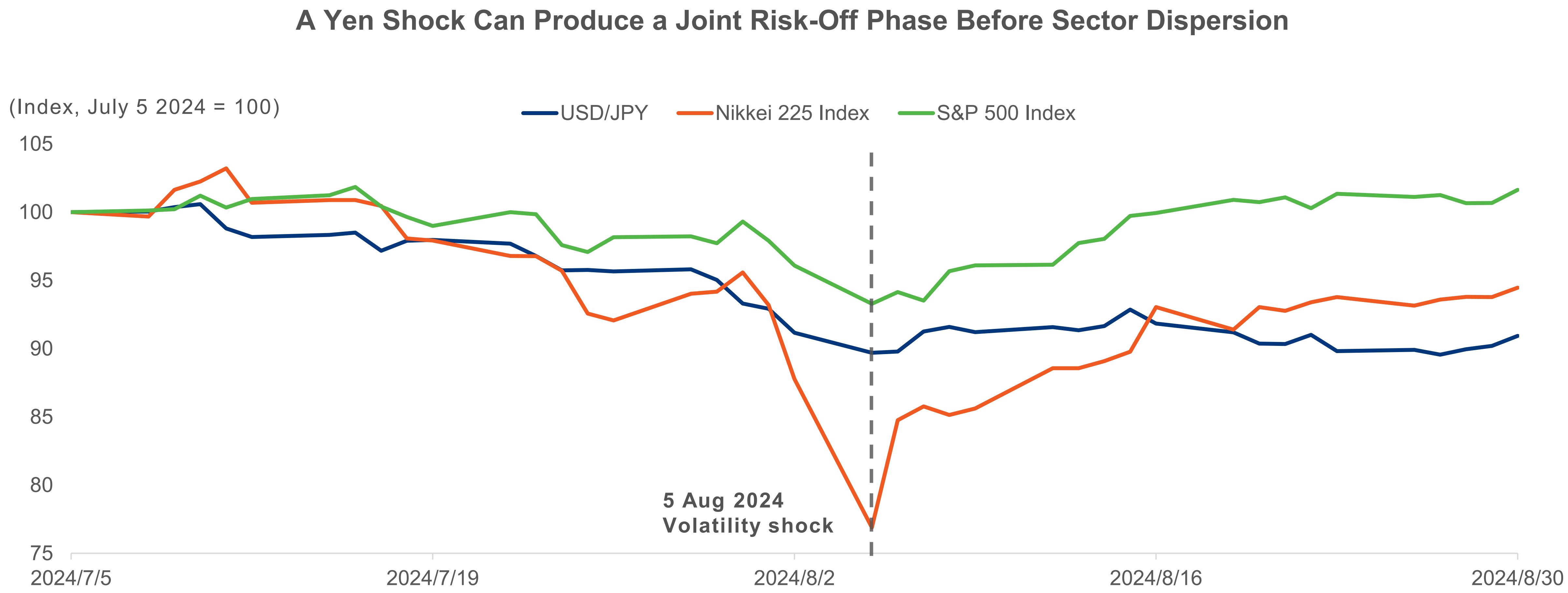
Phase	US Capital-Market Effect	Japan Capital-Market Effect
1. Initial Shock	Yen-funded leverage unwinds; high-beta assets face liquidity-driven selling	Nikkei exporters are sold alongside global risk assets; JGB/FX volatility rises
2. Repricing	Treasury term premiums and credit spreads may widen if Japanese demand softens	Export earnings reset lower; domestic rate-sensitive stocks diverge
3. Reallocation	Dollar diversification and defensive positioning increase	JGBs, banks, insurers, and import-sensitive domestic names outperform

Feedback loop:
US risk-asset losses tighten global conditions → leveraged portfolios reduce exposure → Japan shares the initial liquidity shock; later, relative value favors domestic assets if policy credibility holds.

Source: KGI

Déjà Vu – The August 2024 Episode

Initial Shock to the Domestic Market Before Identifying the Winners and Losers



Source: Bloomberg, KGI

Changes Give Rise to Alpha: Japan’s Likely Winners

Financials and Businesses That Rely on Imports

Sector	Why It Can Benefit in a Stronger-Yen/Higher-Rate Regime	Illustrative listed companies
Banks and selected insurers	Wider lending NIMs/reinvestment yields and a steeper domestic rate structure	MUFG, SMFG, Mizuho, Tokio Marine
Utilities and city gas	Lower dollar-denominated fuel-procurement costs; tariff pass-through may improve the margin outlook	Kansai Electric, Tokyo Gas, Osaka Gas
Import-led retail / staples	Cheaper foreign merchandise, food inputs, and energy can relieve cost pressures	Nitori, Aeon, Seven & i
Domestic telecom and services	Stable yen revenues and an improved household real-income outlook	NTT, KDDI, SoftBank Corp.

Source: KGI

Changes Give Rise to Negative Alpha: Japan’s Likely Losers

Foreign Earnings (Exporters), Inbound Spending, and Yen-Funded Valuation Support

Sector	Why It Faces a Headwind in a Stronger-Yen Regime	Illustrative listed companies
Automakers and exporters	Lower translated overseas earnings; potential pressure on price competitiveness	Toyota, Honda, Nissan, Mazda
Semiconductor equipment / precision machinery	Large foreign-revenue exposure, translation headwinds, and potential risk-off de-rating	Tokyo Electron, Advantest, Fanuc, Keyence
Trading houses / global resource owners	Dollar-linked profits and dividends translate into fewer yen	Mitsubishi Corp., Mitsui & Co., Itochu
Inbound tourism, department stores and leisure	Japan becomes more expensive for overseas visitors; discretionary-spending sensitivity increases	Takashimaya, Isetan Mitsukoshi, JR Central, Oriental Land

Source: KGI

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