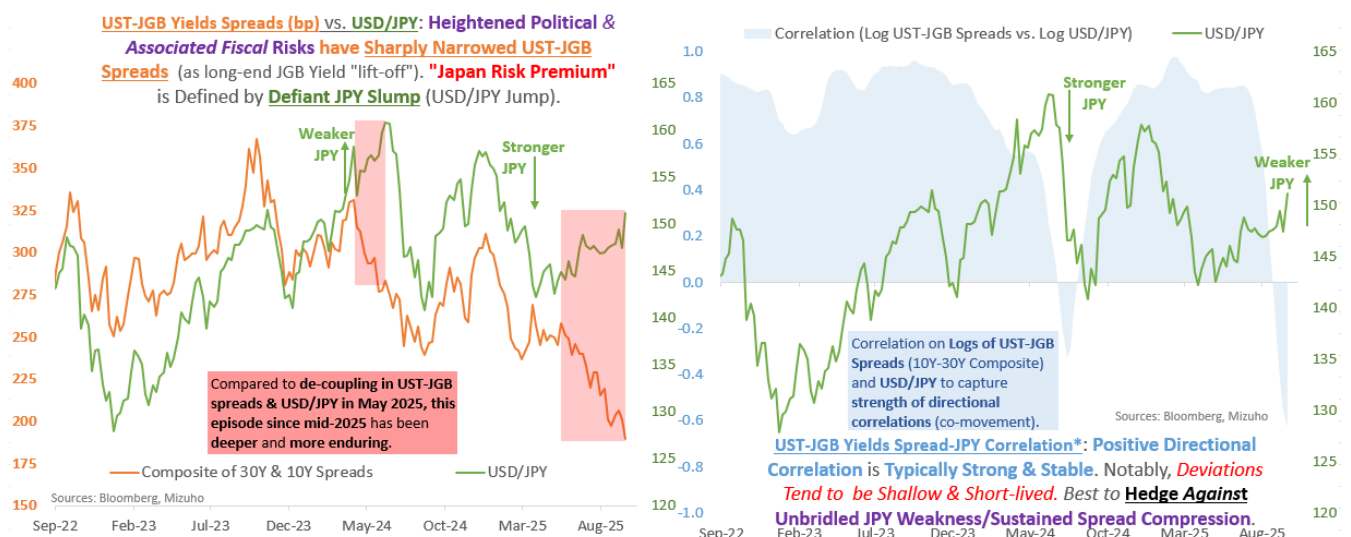


JPY Bear Trap in Plain Sight?

"I am afraid, my dear Watson, that most of your conclusions were erroneous ... to be frank, that in noting your fallacies I was occasionally guided towards the truth." – Sherlock Holmes

In a Nutshell:

- Heightened **political risks** have justifiably invoked JPY and JGB bears. **But** revolving door politics is **not** an unambiguous "Exit Japan" trigger.
- Notably, a **JPY bear trap** lurks on *Fed-BoJ convergence*.
- To be sure, **LDP** has been **dealt a serious political blow from the Komeito breaking up** the long-standing coalition.
- Inadvertent **political horse-trading will obfuscate policy strategy** and *desperate political survival may sacrifice fiscal accountability*.
- As **worries mount** in the direction of **debt being "inflated away"** there is ostensibly a case for bearish JGBs and JPY:
- **JGB yield/Curve**: *Worries of debt value being eroded* are bound to pressure **JGB yields higher led by the long end** (resulting in a **steeper JGB curve**)..
- **JPY**: Coincidentally, **JPY is pressured by currency debasement risks**, which are often associated with unsustainable fiscal-debt spirals.
- **But** this **uncharacteristic**, ostensibly **excessive**, **departure in established USD/JPY and UST-JGB spread dynamics** (positive correlation) is **fair warning of potential for sharp correction**.
- **Especially if Fed inflects abruptly more dovish** (as we think may be the case). All said, the **long shadow of Japanese political risks may conceal a bear trap for JPY**.



Revolving Door, Not Necessarily “Exit Japan”

- The **notoriety of “revolving door” politics**, with all the associated risk of policy/fiscal setback risks, is ostensibly *seeping through to pressure JPY and send JGBs (yields higher)*.
- To be sure, worries are understandable. Political risks are inconveniently **exacerbated by prevailing external geoeconomic challenges** and the **BoJ’s stagflation-type dilemma**.
- **But to declare unbridled “Exit Japan” trades** are **myopic, possibly reckless**. If nothing else, **stretched JPY shorts may be a “bear trap” on impending Fed-BoJ convergence**.

The LDP’s Coalition Setback

- Admittedly, with the **LDP’s junior coalition member pulling out**, the **LDP’s already fraught minority government is now even more precarious**.
- The **LDP’s pre-existing shortfall of seats to secure a Majority in both chambers** is **exacerbated** – *requiring 37 more Lower House seats and 25 in the Upper House* to cross the line.
- The upshot is that **the LDP’s position as the minority government without the Komeito** is **undermined further**. And this *casts a pall on Japan’s political scene* and *undermines economic confidence*.

Sanae Risks a Pyrrhic Premiership: To Win, But Not Govern

- To be sure, **Takaichi Sanae** is arguably **in the leading position to win Premiership race**, *despite the Komeito setback*.
- Simply because the *LDP’s single largest voting block amid a fragmented opposition* provides *sufficient advantages in a run-off* (between the top candidates for) **if an outright Majority cannot be secured**.
- **But the risk is** that **Sanae ability to govern will inevitably be hobbled** as **policy/fiscal plans** will be **at the mercy of Opposition** that **hold the deciding vote**.

Prohibitive Fiscal Costs?

- Notably, to be able *to secure the passage of bills and supplementary budgets*, the **LDP will now have to court both the DPP and Ishin** (if Komeito opposes*).
- And **rolling political turmoil/upheaval tends to pervert incentives**, requiring **sharp trade-offs** between *prohibitively high fiscal cost* or *political failure*. Especially as and
- Simply put, political survival could **reduce political strategy to suboptimal horse-trading**. **short-term political objectives at the expense of longer-term fiscal accountability**.

* Admittedly, Komeito has said that it could support some policies. But we expect a 26-year coalition breakdown will likely see a greater degree of disruption in policy-making support.

Attendant Political-Fiscal Pain (Long-end JGB & JPY)

- This **conspiracy of political-policy-fiscal risks** are ostensibly rich pickings for **long-end JGB re-pricing** (for *higher risk premium/yields*) and **JPY bears**.
- Point being, mounting **worries about fiscal accountability** *amid* **adverse feedback loops** heighten the **notion of debt being “inflated away”** *rather than “grown out of”*.
- **JGB yield/Curve**: In so doing, long-end yields are likely to be lifted emphatically alongside distinct *JGB curve steepening amid concerns that the value of longer-term debt will be disproportionately eroded*.
- **JPY**: Moreover, *JPY is also compromised* as the notion of **“inflating away” debt entails inescapable currency devaluations**.

But JPY Depreciation Overblown Given USD/JPY UST-JGB Dynamics?

- **But** this propensity for **bearish JPY bets** based *on Japan's political risks* in Japan is nevertheless **overblown**. Even if some degree of **persistent Japanese political risks** is **priced in**.
- For one, *unrelenting JPY weakness* (USD/JPY ascendancy) has **defied significant narrowing in UST-JGB spreads** that otherwise ought to buoy JPY.
- And by some measures of *directional correlation between UST-JGB spreads and USD/JPY*, **JPY's excessive weakness has gone too far for too long** (given rising JGB yields alongside narrower UST-JGB spreads).

JPY Bear Trap in Plain Sight

- Crucially, **risks of emphatic Fed-BoJ convergence** from abrupt dovish Fed inflection into 2026 flag **sharp JPY rebound into 2026** *(not an unmitigated collapse)* **is the greater bigger risk**.
- So, as markets drag the JPY, obsessing over BoJ restraint (on hikes), the forest is missed for the trees.
- Crucially, the long shadow of Japanese political risks is concealing a **JPY bear trap in plain sight**.

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