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Morning Briefing

On Bonds In Japan & Tariffs On South Korea

Check out the accompanying [chart collection](#).

Executive Summary: Japan's Bond Vigilantes are riling the historically placid Japanese government bond market. Demand for JGBs has tanked, and now the risk of a destabilizing yield curve is likely to stay the Bank of Japan's hand at its meeting this week, delaying its tightening push. Political uncertainty has the Bond Vigilantes fearing budget-busting fiscal loosening. William explores how Japan got to this point and what may come next. ... Also: South Korea's economy has rebounded impressively despite strong headwinds, and it's not the only export-dependent Asian nation displaying remarkable resilience in the face of Trump's Tariff Turmoil.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay [here](#).

Japan's Bond Turmoil I: BOJ on Hold. This week's Bank of Japan (BOJ) meeting on Thursday won't be a high-drama affair after all. A few weeks ago, many thought the BOJ might tighten by 25bps given that inflation, at a [3.3% y/y](#) rate, is running well above the bank's 2.0% target ([Fig. 1](#)). Now the widespread expectation is that the BOJ will keep its benchmark interest rate at 0.5% ([Fig. 2](#)).

What's changed is the intensifying drama in the Japanese government bond (JGB) market. Japan's typically docile Bond Vigilantes have been roused.

Last week, a routine auction of 40-year bonds attracted the least demand [since 2011](#) amid concerns that Tokyo's already crushing debt load is about to get worse ([Fig. 3](#)). The risk of a destabilizing yield surge ensures that the BOJ won't be hiking rates again anytime soon—certainly not at this week's July 30-31 board meeting.

Analysts are blaming political uncertainty. On July 20, the Liberal Democratic Party (LDP)—which has [led Japan since 1955](#) with only two brief interruptions—[lost its majority](#) in upper-house elections. That means the LDP no longer has direct control over the upper or lower

chambers of parliament.

Maintaining power requires Prime Minister Shigeru Ishiba's party to cobble together a governing coalition of pro-tax-cut opposition lawmakers. The fast-rising odds of a budget-busting fiscal loosening are spooking Japan's normally placid debt market. Not helping are the high odds that Ishiba will resign in short order. Since [*taking office on October 1*](#), Ishiba has been something of a fiscal hawk.

Let's look at the local and global headwinds challenging JGBs:

(1) *Fiscal worries*. For JGB traders used to some of the most predictable politics anywhere, all this is a lot.

The worry for the Bond Vigilantes is that Japan's [*260% debt-to-GDP ratio*](#) is about to get worse. That's already the biggest debt burden among developed nations, and its manageability is already in doubt given Japan's aging and shrinking population ([*Fig. 4*](#)). Add in the global trade war and confusion about what exactly Ishiba agreed on—and didn't—to secure a [*15% tariff*](#) rate from Donald Trump's White House, and it's no wonder that 10-year JGB yields are trading at 1.56%, not too far from the 1.59% level reached in mid-July, [*the highest since 2008*](#) ([*Fig. 5*](#)).

(2) *US-Japan deal*. The specifics of the US-Japan pact are [*in dispute*](#). This includes the mechanics of the \$550 billion of investments that Japan is expected to make in the US. Trump claims it will be all new cash that his White House gets to direct—and keep [*90% of the profits*](#).

Japanese officials came away with a very different impression. The fund, as Tokyo describes it, will involve a mixture of investment, loans, and financial guarantees over an unspecified multi-year time horizon.

US car companies are [*crying "Foul!"*](#) After all, Japan appears to be getting away with a 15% auto tax when American companies face 25% on imports from suppliers and plants in Canada and Mexico.

(3) *The China question*. The other question is how tariff negotiations with China will progress. US and Chinese negotiators are meeting in Sweden this week. A deal with Japan's [*\\$4.2 trillion economy*](#) is nice, but the real prize is Xi Jinping's \$18 trillion market. The Chinese leader has so far held his game plan very close to the chest.

Moreover, tariff uncertainty is muddying the economic picture.

Japan's Bond Turmoil II: Tail Risks Abound. The JGB market's first burst of volatility this year came in mid-May as concerns about Trump's tariffs were slamming US Treasuries. On May 20, a sale of [20-year JGBs](#) saw the weakest demand since 2012. The "tail"—i.e., the gap between the average and lowest-accepted price—was the widest since 1987.

The resulting shockwaves, meanwhile, have BOJ Governor Kazuo Ueda turning tail. The background music surrounding weak auctions is the BOJ's withdrawing from the bond market ([Fig. 6](#)). In July 2024, around the time Team Ueda started hiking rates, the bank began [reducing its quarterly JGB purchases](#) by 400 billion yen (\$2.7 billion). It was all part of "normalizing" a rate environment that's been [trapped near zero](#) since 1999 and ending quantitative easing (QE).

(1) *Throttling back.* Trump's Tariff Turmoil (TTT) already had the BOJ scaling back its quantitative tightening (QT) moves. Now also driving that scale-back are concerns that Japanese tax cuts will trigger the worst volatility that JGBs have seen in decades.

At this week's meeting, Team Ueda will put on its monetary kabuki makeup to keep alive the rate-hike narrative. Ueda is determined not to suffer the same fate the BOJ did [back in 2007](#), the last time the central bank got rates as high as the current 0.5%. By the time the 2008 global financial crisis hit, zero rates were back. So was QE.

Whether the Ueda BOJ can avoid the same fate is unclear. Yet fresh troubles in the bond market thicken the plot considerably.

(2) *Tax cut fever.* The momentum toward tax cuts is intensifying, post-election. The immediate target is repealing the [10% consumption tax](#). That, many economists say, would unleash considerable pent-up consumption.

Another concern is how the nation's dismal productivity collides with politicians' obsession with quick wage increases above those driven by Japan's long-term structural reforms. For [12-plus years now](#), the LDP has been pledging to improve worker efficiency. It promised to do so by reducing bureaucracy, catalyzing innovation, making labor markets more meritocratic, and empowering women.

Yet the LDP's answer has been a linear focus on higher wages to match rising living costs. [Japan ranks 29th](#) out of 38 members of the Organization for Economic Co-operation and

Development in productivity. Rising wages might exacerbate the problem, leaving Japan even more inflationary and less competitive.

(3) *Too much stability?* Hence, the problem with continuity. Stability has its place, but too much can perpetuate unproductive policies. Case in point: Spending jolts to paper over the reality that the vast majority of Japan's [123 million people](#) lack confidence in the nation's economic prospects going forward.

Inflation that the BOJ is hard-pressed to control hardly helps.

As a sign of the public's lack of economic confidence, the "Japanese first" anti-immigration Sanseito Party performed surprisingly well in last week's election. It won 14 upper-house seats versus the one it had previously.

Japan's Bond Turmoil III: Political Strains. While the election was hardly a landslide, it's a reminder that Western political dynamics are drifting Japan's way, too. Locals worry that Tokyo [property prices](#) are rapidly rising due to wealthy foreign buyers. And the influx of [20 million-plus](#) tourists in the first six months of 2025 is raising tensions, fueling speculation about rising crime.

Here's more about the political and economic winds picking up velocity in Japan:

(1) *IMF warning.* One wildcard is whether the governing coalition, to be named later, favors tax cuts beyond consumption levies. Or will it promote fiscal loosening to finance a new wave of social spending to address Japan's fast-aging population and declining birthrate? As Mizuho Securities analysts [write](#), "potential risks remain."

On July 24, International Monetary Fund's (IMF) Julie Kozack [said that](#) "generalized subsidies and tax cuts, in our view, should be avoided," noting that "Japan has limited fiscal space ... because of high public debt." Broad tax cuts and benefits, she added, are "not an efficient use of Japan's limited fiscal space." Rather, the IMF advises putting together a "clear fiscal consolidation plan."

(2) *Volatility surge.* It was the BOJ's withdrawing from the JGB market that began its recent descent into volatility, after long being considered one of the least volatile debt markets anywhere.

Over the last 20 years but especially since 2013, the central bank has been Japan's largest

investor, purchasing more than half of all outstanding JGB issues. The BOJ became a stock market whale, too, hoarding exchange-traded funds. By 2018, in fact, the BOJ's supersized balance sheet topped Japan's GDP.

In April 2023, Ueda took the helm determined to normalize rates once and for all. With deflation pivoting firmly toward inflation and Tokyo prodding Japan Inc. to raise wages, the BOJ had valid reasons to tap the brakes. Now, though, Ueda's team is throttling back on QT. Instead of reducing purchases by 400 billion yen per quarter, the BOJ will taper by just 200 billion yen every three months.

(3) *Yellen's playbook*. Also, last month, Japan's Ministry of Finance (MOF) took a page from former US Treasury Secretary Janet Yellen's playbook, cutting back on longer-maturity debt issuance. The MOF reduced its sale of 20-year debt by tens of billions of dollars in favor of shorter maturities.

It's not clear whether that measure will be enough to calm the market, especially as tax cut debates heat up. Ishiba hasn't helped in that regard: On May 19, he called Tokyo's debt challenge worse than Greece's.

(4) *Restoring calm*. Such risks complicate the BOJ's way forward, a conundrum that will be on display this week. Ueda is caught between the need to continue hiking rates to battle inflation and keeping rates low to support growth and maintain financial calm.

Of course, Japan doesn't face the same capital flight risks as most other major economies. Roughly 90% of JGBs are held domestically. Yet if the "yen-carry trade"—the practice of borrowing cheaply in yen to bet on higher-yielding assets elsewhere—blows up, Japan's bond market volatility could quickly become the world's problem.

(5) *Nikkei flying*. Despite all the above, the Nikkei stock price index soared when Japan's trade deal was announced and is now back in record-high territory (Fig. 7). The Japan FTSE stock price index is up 5.5% ytd (Fig. 8). Leading the way have been the Telecommunications (12.4%), Financials (11.1%), Real Estate (10.2%), and Technology (9.6%) sectors.

South Korea: Tariff Resilience. As South Korea jockeys for a tariff deal with US President Donald Trump that's at least as good as Japan's, it's doing so from a position of surprising strength.

No one would call Korea's 0.6% y/y [Q2 growth](#) rate “stellar.” Its rebound, though, from 0.0% in Q1 is noteworthy considering the strong headwinds bearing down on Asia's fourth-biggest economy ([Fig. 9](#)).

Korea's performance could augur well for the trajectory of the global economy. Korea often serves as an early-warning system for global inflection points. Its sizable, open economy is on the front lines of high-tech export sectors susceptible to zigs and zags in demand patterns. Korea is signaling that the tariffs aren't decimating global commerce.

Notably, Korea isn't the only highly export dependent Asian nation showing surprising economic resilience in the face of Trump's tariffs. China's [30% US tariffs](#) are far lower than Trump's earlier 145% threat but still a Smoot-Hawley Tariff Act level US import tax. Yet China's [Q2 GDP](#) grew a stronger-than-expected 5.2% y/y thanks largely to strong exports ([Fig. 10](#)).

And take Singapore: Like Korea, it's also a global bellwether. Its trade-to-GDP ratio of [just over 300%](#) is roughly [five times](#) the global average. Yet it grew a better-than-projected [4.3% y/y](#) during Q2, up from Q1's 4.1%. And thanks to imports, its manufacturing sector [grew 5.5% y/y](#) in Q2, faster than 4.4% in Q1. Singapore faces a US tariff of 10%, Trump's baseline level.

Let's look at the lay of the land in Korea:

(1) *Political setbacks.* Korea is managing a recovery despite the tariffs, market volatility, and a political crisis that saw a president impeached and removed from power. On June 3, voters [elected Lee Jae-myung](#) to end the six months of turmoil caused by former President [Yoon Suk Yeol](#)'s reckless martial law declaration in December.

Yet Korea is bouncing back impressively despite a near-complete political vacuum. The several months before Lee took office on June 4 were a policy dead zone.

(2) *Korean challenges.* President Lee isn't enjoying even the briefest of political honeymoons. His to-do list is as daunting as that of any leader of a [top-12 economy](#). In Korea's case, it means creating greater space for startups and midsize companies to thrive in an economy dominated by a handful of legacy family-owned conglomerates.

Lee's team also must tame runaway housing inflation that far outpaces average wage increases, which has caused a sky-high [household debt](#) problem. Add increased attention

from Trump's trade negotiation team to the list.

(3) *Trump talks ongoing.* As Lee officials make clear, they are scrutinizing Japan's agreed-upon [15% tariff deal](#) as a model for what Seoul will accept. Korea will surely demand the Japanese treatment.

The silver lining: For all the headwinds hitting the new Lee government, Korea is more than just standing its ground in a topsy-turvy global environment. Its outlook is looking bullish, as reflected in the recent performance of its stock market ([Fig. 11](#)).

Calendars

US: Tues: Consumer Confidence 95.8; JOLTS 7.55m; Goods Trade Balance -\$98.3b; Wholesale Inventories -0.1%; Atlanta GDPNow 2.4%; S&P/CS Composite House Price Index 2.9%/y. **Wed:** Fed Interest Rate Decision 4.5%; Real GDP & Price Index 2.4% & 2.4%; ADP Employment Change 78,000; MBA Mortgage Applications; Pending Home Sales 0.0%. (Source: FX Street)

Global: Tues: Spain GDP 0.6%q/q; Spain Retail Sales; Australia CPI 2.1%/y. **Wed:** Eurozone GDP Flash Estimate 0.1%q/q, 1.2%/y/y; Eurozone Economic Sentiment 94.5; Germany GDP Flash Estimate -0.1%q/q, 0.2%/y/y Germany Retail Sales 0.5%; France GDP Flash Estimate 0.1% q/q; Italy GDP Flash Estimate 0.2%q/q, 0.6%/y/y; Spain CPI 2.7%; Japan Retail Sales; China NBS M-PMI & NM-PMI 49.7 & 50.3; BoC Interest Rate Decision 2.75%. (Source: FX Street)

Strategy Indicators

S&P 500/400/600 Forward Earnings ([link](#)): During the July 25 week, forward earnings rose simultaneously for all three of these indexes for the eighth time in the nine weeks since May 30. LargeCap's forward earnings rose for a tenth straight week in its longest winning streak since it did so for 12 weeks through late December, and has posted gains in 12 of the 13 weeks since it bottomed during the April 25 week. MidCap's rose for the ninth time in the 10 weeks since it bottomed during the May 16 week. SmallCap's has risen for nine straight weeks since it bottomed during the May 23 week, and is now on the longest winning streak since June 2022. LargeCap's forward earnings rose 0.5% w/w to its eighth straight record

high. MidCap's rose 0.3% w/w to a 13-week high and is 1.4% below its record high during the April 4 week. SmallCap's rose 1.1% w/w to a 23-week high and is 12.1% below its June 2022 record. LargeCap's forward earnings has soared 26.5% from its 54-week low during the week of February 1, 2023; MidCap's is just 7.7% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and is up just 3.0% from a very recent 42-month low during the May 23 week. These three indexes' forward earnings downtrends from mid-2022 to early 2023 and again during Trump's Tarriff Turmoil were relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (9.7%, 9.0%, 13.9%), MidCap (0.4, 1.7, 18.0), and SmallCap (-10.2, 2.7, 18.9).

S&P 500/400/600 Valuation ([link](#)): Valuations were mostly unchanged w/w for these three indexes during the July 25 week. LargeCap's forward P/E rose 0.3pt w/w to a four-year high of 22.4. It's now at the highest level since the April 23, 2021 week and 5.4pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt w/w to a four-week high of 16.3. It's now 0.8pt below its 40-month high of 17.1 during the November 29 week and 4.1pts above the 12-month low of 12.2 in October 2023. That compares to a record high of 22.9 in June 2020 when forward earnings was depressed and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was steady w/w at 15.3, and is 0.3pt below its 20-week high of 15.6 during the July 4 week. It's 2.4pts above its 17-month low of 12.9 during the April 4 week and 4.7pts above its 14-year low of 10.6 in September 2022, but remains 1.8pts below its 41-month high of 17.1 during the November 29 week. That compares to a record high of 26.7 in early June 2020 when forward earnings was depressed, and a record low of 10.2 in November 2009 during the Great Financial Crisis. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E is at a 28% discount to LargeCap's P/E, not much above its 25-year-low 29% discount during the July 5, 2024 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is at a 13-month low 32% discount to LargeCap's P/E. That compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now just 2ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is now at a 13-month low 6% discount to MidCap's, up from a 20-year low 10% discount in late 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

US Economic Indicators

Regional M-PMIs ([link](#)): Earlier this month, the New York, Philadelphia, and Richmond Fed banks reported on activity for July, and showed manufacturing activity picked up in both the New York and Philadelphia regions, but deteriorated in the Richmond region. The Dallas and Kansas City Fed banks have now reported on manufacturing activity for July, and Dallas showed a pickup in manufacturing, while Kansas City growth was subdued. The Dallas Fed's production index, a key measure of the state's conditions, shot up 20.0 points (to 21.3 from 1.3) to its highest level in more than three years, while the new orders (-3.6 from -7.3) gauge moved closer to positive territory. Measures for both capacity utilization (17.3 from -1.0) and shipments (2.7 from -7.3) swung from contraction to expansion during the month. The general business activity shot up 13.6 points to a near-zero reading, indicating no change in activity—after five months of deterioration. The labor market improved, with both the employment (8.4 to 5.7) and hours worked (7.7 from -8.4) measures improving—the latter to its highest reading in almost three years. Prices paid for raw materials (41.7 from 43.0) held relatively stable, while prices paid finished goods (11.1 from 26.1) eased 15 points. Turning to Kansas City, July's composite index barely budged, edging up to 1.0 from -2.0 in June and -3.0 in July, with July's increase driven by nondurable manufacturing, while durable manufacturing continued to contract. The volume of shipments (to 3 from 8) slowed during the month, while the new orders (2 from -2) measure moved back above the breakeven point of zero. Meanwhile, production (-3 from 5) moved from expansion to contraction during the month, while the backlog of new orders (-30 to -11) fell substantially. Prices paid for raw materials (47 from 51) and prices received for finished product (18 from 21) both eased this month.

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