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"WILL JAPAN BE AT THE HEART OF THE NEXT CRISIS?"

- Among the risks looming over 2026, the case of Japan is one of the most serious
- The authorities are playing with fire, particularly with regard to the debt burden
- Sooner or later, monetisation will have to be accelerated to avoid default
- Using kawaii mascots to attract savings will not be enough

CARTOON OF THE WEEK: "The next black swan could be wearing a kimono"

Source: Gemini, Altitude IS

FINANCIAL MARKETS ANALYSIS

As 2026 approaches, there is one topic that investors should continue to monitor very closely: Japan. In the Land of the Rising Sun, problems are becoming increasingly numerous, complex and systemic. They could end up causing major turmoil on global financial markets, whether in bonds, equities or currencies. **In August 2024, investors got a glimpse of the damage** that a simple rate hike by the Bank of Japan could cause to their wealth. The resulting appreciation of the yen led to losses for all investors who had borrowed yen for free with the aim of investing elsewhere (carry trade), particularly in US equities. They had no choice but to urgently sell their assets to repay their yen loans, causing global markets to plummet. **This episode may have been just a dress rehearsal for a more damaging shock, as Japan faces a growing list of challenges.**

- **On the geopolitical front,** the archipelago is located on the front line in a highly tense region. Its geographical proximity to Taiwan and Chinese ambitions, coupled with North Korea's unpredictability, are forcing Tokyo into a historic remilitarisation. This situation not only increases government spending, but also exposes Japanese markets to a growing risk premium in the event of regional escalation. Recently, by suggesting that her country could intervene militarily in the event of an attack on Taiwan, **the Japanese Prime Minister has reignited tensions with Beijing.** This was all it took for China to step up its retaliatory measures against Japan, notably by suspending tourist travel and purchases of seafood products.

- **On the demographic front,** the accelerated ageing of the population and the shrinking labour force are hampering potential growth and weighing on domestic consumption. To address the labour shortage in critical areas, Japan must succeed in replacing the missing human capital with technological capital. The challenge is to maintain production momentum through massive robotisation, while breaking the historical taboo on immigration. Without this radical transformation, **the country risks seeing its social protection system collapse under the weight of health and pension costs,** which the working population is no longer able to finance.

- **On the economic front, the country has once again entered recession.** Gross Domestic Product contracted by 0.6% in the third quarter (see Fig. 2). Business investment fell sharply, while exports clearly lacked momentum (see Fig. 3). Household consumption and public spending contributed to growth, but this was not enough. This slowdown presents the government with an impossible equation: how to kick-start the economy without further increasing the deficit?

Fig. 2 – Japanese GDP growth

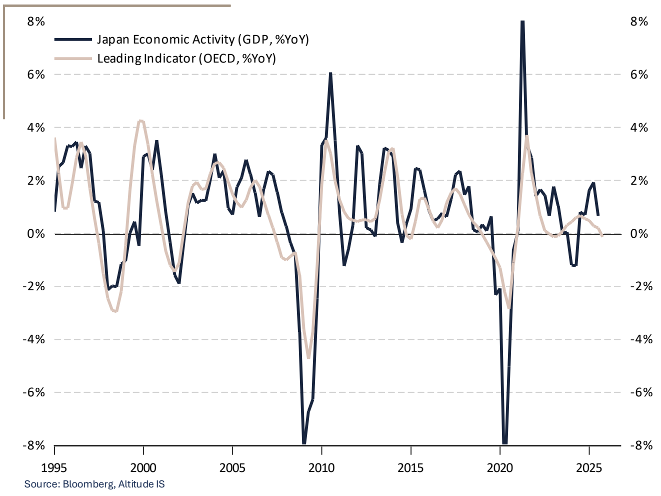
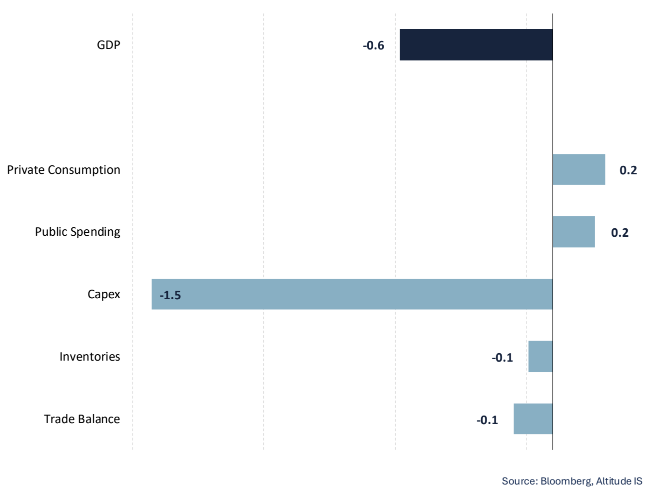


Fig. 3 – Contribution to GDP growth



- **On the fiscal front,** public debt stands at 230% of GDP. This is a real sword of Damocles, given that these loans are increasingly being financed by the BoJ rather than by the Japanese people. In the absence of private subscribers for JGBs, the central bank is forced to act as the buyer of last resort. As long as interest rates were zero, the cost of this debt seemed painless, but in an environment of normalised rates, **debt servicing is skyrocketing.** It has become one of the government's largest items of expenditure.

- **On the monetary front, the Bank of Japan** is caught in a dilemma. On the one hand, it must continue to raise its key interest rates (see Fig. 4) to support the yen and avoid importing inflation. On the other, it must do so extremely slowly to avoid generating too sharp a rise in yields (see Fig. 5), in case it causes a depreciation in the stock of sovereign bonds held by local banks. Finally, and most importantly, it **must manage to avoid a Japanese government default.**

Fig. 4 – Bank of Japan policy rates

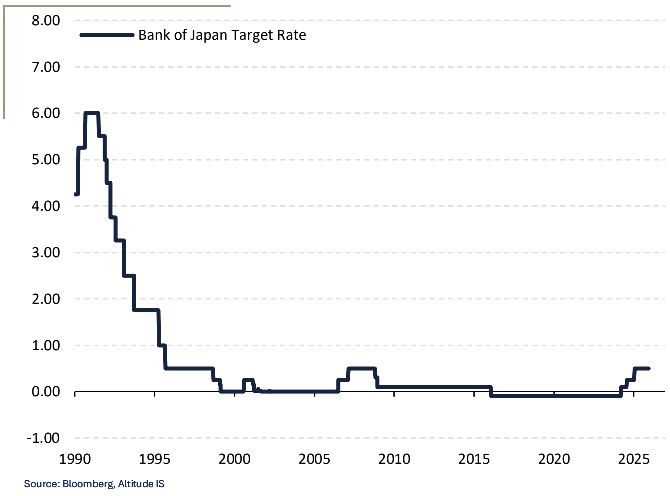
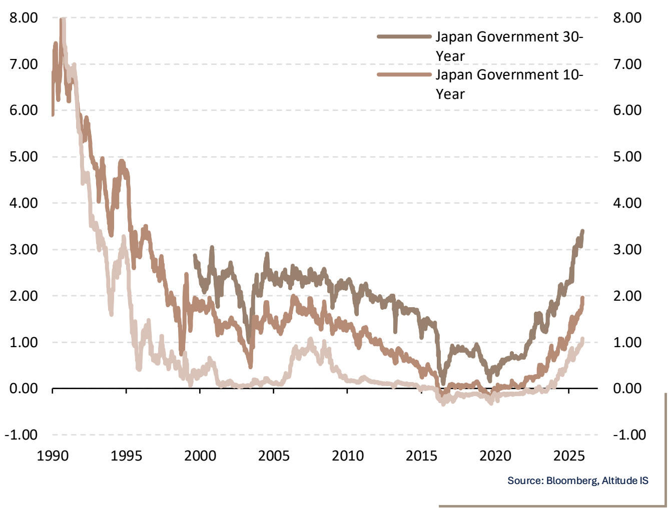


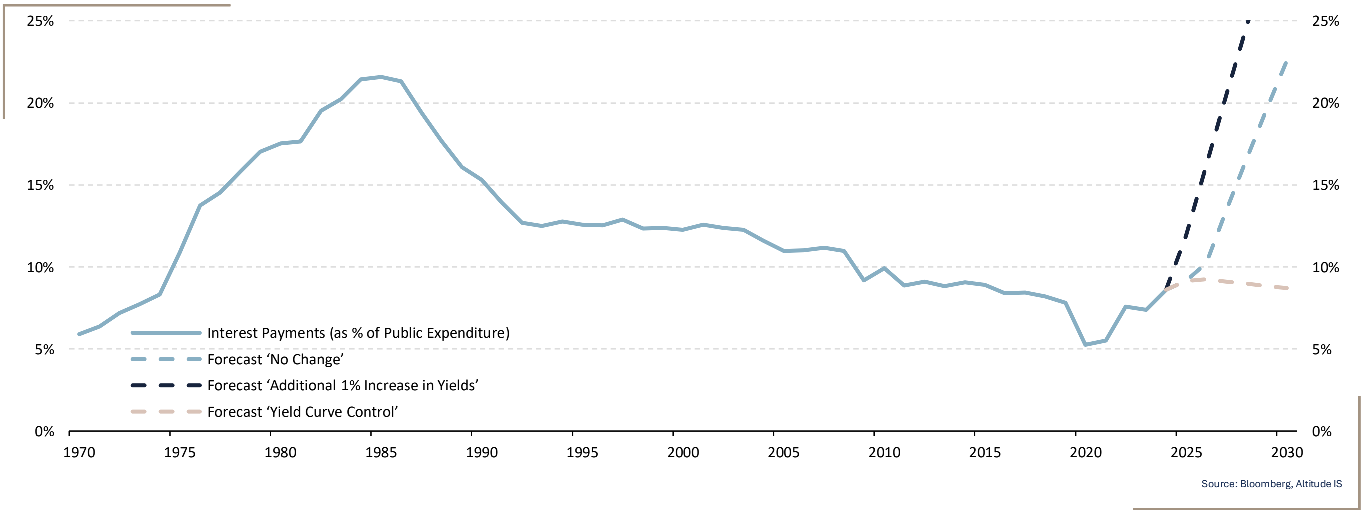
Fig. 5 – Japanese bond yields



The Japanese problem can be summarised as follows. Looking closely at the intricacies of Japanese sovereign debt, it appears that the average maturity is 8.6 years and the average interest rate is 0.9%. **One of three things will happen** (see Fig. 6)**:**

1. **Return to the previous situation (Yield Curve Control).** If the average yield had remained below 1% and the debt had not increased further, the interest burden could remain sustainable. Under this scenario, the Japanese government would have to pay out 11.8 trillion yen each year to service its historical debt. This is only slightly more than today and represents the government's utopian gamble on moderate growth and sustained low interest rates.

Fig. 6 – Interest charges paid by the Japanese government



2. **Nothing changes with regard to the current situation.** With 10-year bond yields at 2%, interest payments would double within four years, reaching ¥35.4 trillion annually. This would represent more than a quarter of expenditure, equivalent to the social security budget. If no action is taken, Japan will either have to double its VAT or make drastic cuts to pensions. In both cases, this would cause a major recession.

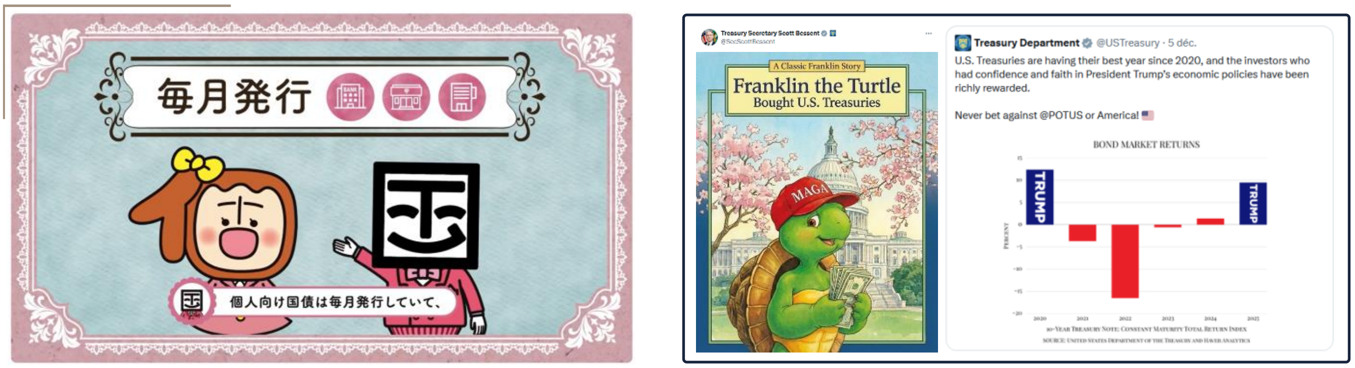
3. **Worsening of the situation (risk of default).** In a scenario where the average rate exceeds 3%, the burden would reach 44.2 trillion yen. Mathematically, bankruptcy would be inevitable. With Japan's

total tax revenue at around 70 trillion yen, more than 60% of Japanese taxes would be used solely to pay interest on past debt. There would not be enough money left to fund the police, the army, roads or schools without borrowing heavily again... which would drive rates even higher, leading to a deadly spiral.

It is clear that doing nothing or allowing the situation to deteriorate are not viable options. Faced with this relentless arithmetic, the Japanese authorities will be forced to navigate between the Scylla of bankruptcy and the Charybdis of debt monetisation. As always in human history, and in order to avoid a collapse of the system, they will opt for a form of insidious financial repression, where real rates will remain deeply negative in order to "liquidate" the debt. **This will involve increased interventionism by the Bank of Japan, which will be forced to manipulate the yield curve to guarantee the solvency of the state, sacrificing its creditworthiness and the external stock of the currency.**

From 2026 onwards, Japan could pose a major risk for international investors. As one of the world's largest creditors, any massive repatriation of capital by the Land of the Rising Sun to finance domestic needs and absorb sovereign debt issues would send shockwaves through Western bond markets, drying up liquidity and pushing up long-term interest rates. Furthermore, the heightened volatility of the yen whenever the BoJ attempts technical adjustments would make global equity markets vulnerable to flash crashes.

Fig. 7 – Propaganda for government bonds in Japan and the United States



Source: Altitude IS

Faced with saturated central bank balance sheets and reduced appetite among foreign investors, the Japanese Treasury is desperately turning to private individuals to attract their savings. For the time being, the government has not yet changed the laws to force them to hold public debt. It is still at the stage of offering incentives, but **this phenomenon of "retailisation" of sovereign debt is taking a surreal turn.** The very serious Ministry of Finance has institutionalised the infantilisation of investors through marketing campaigns (see Fig. 7). These feature "Kokusai-sensei" (Mr Sovereign Bond), an anthropomorphic character in the form of a scroll with glasses, and his sidekick "Koko-chan", a reassuring figure designed to explain to households that financing the country's abysmal deficit is a civic, safe and friendly act. The objective is clear: to mobilise households' dormant savings to curb the Bank of Japan's purchases.

As the same causes produce the same effects, it is interesting to note that Americans are copying Japanese communication tools. The form differs to suit American culture, but the substance remains the same. The Trump administration is relying on social media and the "finfluencer economy" to carry out this propaganda work for US Treasuries. We are seeing a proliferation of viral content on TikTok and

X (Twitter), touting short-term returns as "free money". These platforms are also reporting that Donald Trump is securing his fortune by having accumulated more than $180 million in US bonds since 1st January. For his part, Treasury Secretary Scott Bessent has just used "Franklin the Turtle", a children's cartoon character, to tout the performance of government bonds this year (see Fig. 7). The fact that the solvency of the world's two largest economic powers depends (in part) on kawaii mascots or cartoon turtles highlights the fragility of the balance between supply and demand for sovereign debt.

Conclusion:

It is becoming imperative to systematically hedge currency risk on Japanese assets and to monitor institutional capital flows to and from Tokyo with the utmost vigilance, as the next black swan could be wearing a kimono.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	1 008.9	56.68	-0.2%	-0.1%	22.1%	18.0%	22.8%
USA (S&P 500)	6 827	53.12	-0.6%	-0.2%	17.5%	25.0%	26.3%
USA (Dow Jones)	48 458	61.96	1.1%	0.7%	15.8%	15.0%	16.2%
USA (Nasdaq)	23 195	49.16	-1.6%	-0.8%	20.9%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	602.2	57.20	0.0%	-0.8%	23.1%	10.2%	19.5%
UK (FTSE 100)	9 649	49.48	-0.2%	-2.4%	22.1%	9.6%	7.7%
Switzerland (SMI)	12 887	61.39	-0.4%	0.7%	14.7%	7.5%	7.1%
Japan (Nikkei)	50 168	56.55	0.7%	-0.4%	29.8%	21.3%	31.0%
Emerging (MSCI)	1 390	56.18	0.4%	-1.0%	32.8%	8.0%	10.2%
Brasil (IBOVESPA)	160 766	62.04	2.2%	2.0%	33.7%	-10.4%	22.3%
Mexico (IPC)	64 712	64.13	2.0%	1.4%	35.8%	-11.0%	22.4%
India (SENSEX)	85 225	55.40	-0.5%	1.0%	10.6%	9.6%	20.5%
China (CSI)	4 557	50.80	-0.1%	-1.3%	19.5%	18.2%	-9.1%
Com. Services (MSCI World)	162.9	49.91	-2.6%	1.4%	31.8%	31.9%	38.1%
Cons. Discretionary (MSCI World)	460.1	57.21	0.4%	-0.8%	10.4%	20.7%	29.5%
Cons. Staples (MSCI World)	292.0	55.91	0.6%	0.8%	9.8%	4.7%	3.2%
Energy (MSCI World)	264.6	49.83	-1.0%	-0.5%	14.6%	2.9%	6.0%
Financials (MSCI World)	223.4	73.00	2.0%	2.2%	27.9%	25.1%	16.4%
Health Care (MSCI World)	391.9	55.87	0.1%	0.5%	14.3%	1.5%	4.1%
Industrials (MSCI World)	468.6	62.84	1.4%	0.9%	26.5%	12.8%	22.6%
Info. Tech. (MSCI World)	957.8	45.94	-1.8%	-2.6%	25.4%	31.9%	51.5%
Materials (MSCI World)	387.9	67.25	1.8%	3.4%	30.0%	-7.6%	12.9%
Real Estate (MSCI World)	988	46.25	-0.4%	-1.5%	3.9%	-0.4%	5.3%
Utilities (MSCI World)	192.2	37.67	-0.7%	-3.3%	23.6%	13.0%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.55%	50.66	0.0%	-0.1%	7.7%	-1.7%	5.7%
USA (Sovereign)	3.94%	42.26	-0.2%	-0.4%	5.8%	0.6%	4.1%
Euro Area (Sovereign)	2.97%	35.15	-0.3%	-1.1%	0.2%	1.9%	7.1%
Germany (Sovereign)	2.62%	28.54	-0.4%	-1.4%	-1.8%	0.6%	5.6%
UK (Sovereign)	4.48%	50.59	-0.2%	-0.5%	5.5%	-3.0%	5.6%
Switzerland (Sovereign)	0.55%	20.94	-1.1%	-1.3%	0.2%	5.4%	7.9%
Japan (Sovereign)	1.71%	30.37	0.1%	-1.4%	-3.9%	-2.1%	0.9%
Emerging (Sovereign)	5.95%	58.83	0.1%	0.5%	12.4%	7.0%	11.0%
USA (IG Corp.)	4.87%	43.95	-0.2%	0.3%	7.2%	2.1%	8.5%
Euro Area (IG Corp.)	3.25%	38.52	0.1%	-0.2%	2.8%	4.7%	8.2%
Emerging (IG Corp.)	6.11%	55.10	0.1%	0.2%	7.6%	7.0%	6.7%
USA (HY Corp.)	6.70%	60.65	0.0%	0.8%	8.0%	8.2%	13.4%
Euro Area (HY Corp.)	5.53%	59.89	-0.1%	0.4%	4.9%	8.2%	12.1%
Emerging (HY Corp.)	7.41%	67.83	0.2%	0.7%	12.9%	14.9%	13.1%
World (Convertibles)	539.7	53.68	-0.1%	-0.6%	22.6%	9.4%	12.3%
USA (Convertibles)	706.3	49.89	-0.5%	-1.0%	18.0%	10.1%	14.6%
Euro Area (Convertibles)	288.6	53.13	0.1%	-0.5%	24.0%	14.7%	7.3%
Switzerland (Convertibles)	278.5	53.34	0.2%	-0.1%	15.7%	-10.5%	5.8%
Japan (Convertibles)	257.3	59.27	1.1%	0.4%	13.5%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 791	90.11	n.a.	0.3%	11.2%	11.1%	7.8%
Macro	1 450	80.55	n.a.	0.6%	8.1%	7.4%	1.6%
Equity Long Only	2 442	79.28	n.a.	-0.5%	10.4%	12.0%	15.9%
Equity Long/Short	1 941	90.14	n.a.	0.6%	15.8%	14.0%	7.7%
Event Driven	1 901	88.51	n.a.	1.2%	10.2%	8.7%	7.3%
Fundamental Equity Mkt Neutral	1 851	96.90	n.a.	1.0%	12.1%	12.4%	6.6%
Quantitative Equity Mkt Neutral	1 827	87.93	n.a.	3.3%	9.8%	9.8%	7.8%
Credit	1 708	98.71	n.a.	0.5%	7.0%	8.5%	8.1%
Credit Long/Short	1 722	100.00	n.a.	0.6%	5.8%	10.0%	11.2%
Commodity	1 987	88.71	n.a.	-1.0%	11.1%	14.7%	7.3%
Commodity Trading Advisors	1 399	66.83	n.a.	1.4%	4.2%	7.9%	-3.6%
Volatility							
VIX	15.74	43.28	2.1%	-10.1%	-9.3%	39.4%	-42.5%
VSTOXX	15.67	40.42	-0.7%	-12.2%	-7.8%	25.3%	-35.0%
Commodities							
Commodities (CRB)	543.7	n.a.	1.3%	1.5%	1.3%	5.1%	-8.0%
Gold (Troy Ounce)	4 344	n.a.	3.7%	6.4%	65.5%	27.2%	13.1%
Silver (Troy Ounce)	63.23	n.a.	8.7%	25.9%	118.8%	21.5%	-0.7%
Oil (WTI, Barrel)	57.44	n.a.	-4.4%	-1.8%	-19.9%	0.1%	-10.7%
Oil (Brent, Barrel)	61.95	n.a.	-4.1%	-0.1%	-16.4%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	98.37	34.26	-0.7%	-0.9%	-9.3%	7.1%	-2.1%
EUR	1.1734	67.25	0.8%	1.2%	13.3%	-6.2%	3.1%
JPY	155.10	50.91	0.5%	0.1%	1.4%	-10.3%	-7.0%
GBP	1.3365	61.41	0.3%	1.6%	6.8%	-1.7%	5.4%
AUD	0.6647	63.68	0.3%	2.4%	7.4%	-9.2%	0.0%
CAD	1.3765	71.20	0.7%	2.1%	4.5%	-7.9%	2.3%
CHF	0.7963	59.05	1.3%	0.0%	14.0%	-7.3%	9.9%
CNY	7.0490	72.83	0.3%	0.8%	3.6%	-2.7%	-2.8%
MXN	18.002	70.13	1.5%	2.3%	15.7%	-18.5%	14.9%
EM (Emerging Index)	1 838.9	56.49	0.1%	0.1%	6.4%	-0.7%	4.8%
XBT	89 840	n.a.	-2.8%	-5.6%	-4.1%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions

Total Return by asset class (Negative \ Positive Performance)

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