
Mizuho Economic Outlook & Analysis

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2016 Economic Outlook *A restart of Japan's virtuous cycle*

<Slow global economic recovery and downside risks of emerging market (EM) economies>

- ◆ The US economy will continue to expand at a mild pace
- ◆ In Europe, slow economic growth and low inflation will continue
- ◆ China's economy will continue to slow down gradually
- ◆ Keep a close eye upon EM debt adjustment and low crude oil prices

<Despite uncertainties, look forward to a gradual recovery of the Japanese economy>

- ◆ Look forward to the restart of a virtuous cycle due to the improvement of corporate earnings and labor market conditions
- ◆ Wage hike rates should surpass that of 2015
- ◆ The impact of low crude oil prices will bottom out, lifting the core inflation rate to the lower half of the 1%-level

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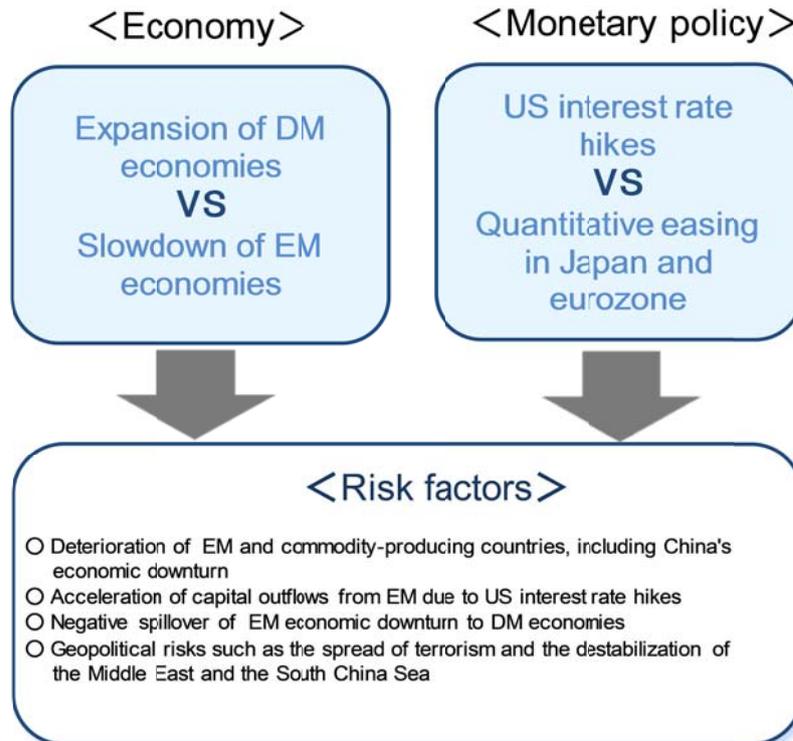
1. Chief economist's perspective ~ What will 2016 bring?

(1) The keys to understanding 2016 are the “transition period” of the shift in economic growth drivers and “divergence”

The year 2015 proved disappointing as the economic recovery expected at the beginning of the year did not materialize. Mizuho Research Institute (MHRI) forecasted at the beginning of last year that the “triple merits” of (1) a weaker yen and stock rally fueled by monetary easing, (2) fiscal expansion supported by the consumption tax hike postponement and the supplementary budget, and (3) lower crude oil prices, would contribute to economic expansion. However, looking back at developments in 2015, a sense of caution pervaded in the market, probably because the global economy had entered a “transition period” of a shift in economic growth drivers. Alongside clearer signs of EM slowdown following their high economic growth, the developed market (DM) economies finally started to recover from the financial crisis and began to move in the direction toward normalization. This led to a sense of uncertainty toward a shift in policy. The significant balance sheet adjustment in the world from the 2000s started in the form of (1) a crisis in the DM private sector (subprime loan crisis and the collapse of Lehman Brothers in 2007–2008), which then developed into (2) a DM sovereign debt crisis from 2009, finally culminating in (3) an EM debt crisis from 2015 (the “third phase”). With the world entering the third phase, this sense of caution is expected to continue throughout 2016.

The chart on the next page indicates two “divergences” in the world in 2016. In the economy there will be a divergence between the DM and EM countries, and in terms of finance there will be a divergence between interest rate hikes in the US and monetary easing in Japan and the eurozone. In addition, the year 2016 will witness several important political events such as the US presidential election, which will lead to the rise of geopolitical risks, which in turn will tend to spread uncertainties around the world.

[The “two divergences” in the world in 2016]



Source: Made by MHRI

(2) For Japan, 2016 will be the year of “Abenomics 2.0,” or the restart of a virtuous cycle

In 2015, even though Japan’s GDP growth underwhelmed, there were a number of positive surprises occurring for the first time in years. The Nikkei average exceeded 20,000 yen for the first time in 19 years. Ordinary profits of Japanese firms renewed past records. The number of foreign tourists visiting Japan also hit a record high, reaching nearly 20 million. These events reflect Japan’s growing reputation overseas. The job-to-applicant ratio increased to the level last seen in the first half of the 1990s, and the wage hike rate of leading companies rose to the highest level since 1998. As a result, tax revenue grew to a level last recorded in the early 1990s during Japan’s bubble economy. Looking back at Abenomics over the past three years, the first half game of Abenomics may be commended for accomplishing certain achievements.

Having said so, why is there a “sense of uncertainty” that the accomplishments of Abenomics are not for real? Last year, the spread of economic recovery widened the gap between the haves and the have-nots, resulting in a cautious mindset both among the household and corporate sectors. It is a virtually impossible task to melt the frozen mindset after the collapse of the bubble economy and persisting throughout the quarter

century referred to as the “age of snow.” Japan, transformed into an “herbivore nation” to survive under asset deflation and the strong yen, and has plunged into a state of diminishing equilibrium in which corporate management tries to hold as few assets as possible and conducts aggressive restructuring. Such a negative mindset will not be eliminated without the initiation and continuation of strong pressures. The government has added “three new arrows” to the existing “three arrows” to mobilize all of the nation’s policies and restart the virtuous cycle of the economy.

There are signs that the mindset is starting to improve. While firms are reluctant to increase capital investment reflected in the GDP growth rate statistics, they are raising the investment value in overseas companies in such forms as M&As. With Japan having become a “normal country” with a stable government, rising stock prices, and increasing numbers of foreign tourists, overseas market participants have started to appreciate the true value of Japan. Even so, it appears that the Japanese have not yet climbed out of a vicious cycle of pessimism.

As mentioned earlier, uncertainties will tend to rise with respect to the EM economies in 2016. Geopolitical risks are also high. Furthermore, since the fall of crude oil prices will add uncertainty to future developments, it will be necessary to be prepared for the realization of various risks. Nevertheless, despite such uncertain circumstances, we should note that the Japanese economy is continuing to improve, as if ascending a spiral staircase. The year 2016 will be the start of “Abenomics 2.0,” in other words, the second half of the Abenomics game, and the virtuous economic cycle is expected to be restarted. This year is the Year of the Monkey in the Chinese zodiac, which carries the meaning of “growth” or “extension”. As such, we look forward to new positive movements in the Japanese economy.

(Hajime Takata, Chief Economist)

2. Messages from MHRI’s overseas offices ~ Focal points in 2016

(1) From New York: “The 2016 presidential election will see a counterbalancing struggle between the Democrats and Republicans”

The successor to Democratic President Barack Obama, who has served two terms, or eight years, will be decided in 2016. The prominent Democratic candidate is former Secretary of State Hillary Clinton, but the final battle against the Republican candidate is expected to be a harsh one. The Republican Party is undergoing an extraordinary situation with real estate tycoon Donald Trump leading the run-up. Who will become the Republican candidate remains unpredictable. Contested ground in the economy includes the tax system, trade, energy, social security and financial regulation. In general, the

Democratic candidate during a US presidential election tends to focus on the working class, whereas the Republican candidate places emphasis on the wealthy and large corporations. Nevertheless, when it comes to the area of financial regulation, the Republican Party also maintains a hardline stance on strengthening such regulations, and therefore the trend of tightening financial regulations will likely continue.

(Atsushi Niigata, Chief Representative, New York Office)

(2) From London: “Will BREXIT (the UK exit from the EU) be averted?”

The British Conservative Party, which gained a working majority in the general election last year, has pledged to decide after a national referendum whether the UK should remain in the EU by the end of 2017. Once certain concessions in the negotiations over EU reform are gained, Prime Minister David Cameron intends to hold the referendum in 2016. But it remains uncertain whether the UK government will be able to reach agreement with the EU on such short notice over various issues including partial restrictions on social security for immigrants. Recent polls suggest that “remaining in the EU” is preferred under the condition that the UK ensures its own interests through negotiations, and the outcome may lead in both directions depending on how the negotiations evolve. Attention is gathering around the British public’s decision, including when to hold the national referendum and the possible outcome.

(Yasuo Yamamoto, Chief Representative, London Office)

(3) From Singapore: The Philippine’s upcoming presidential election in May will be closely contested

The Philippines will hold a presidential election in 2016. The focal point is whether the structural reforms carried out by the current Aquino administration will be sustained. Senator Grace Poe, who decided in September 2015 to run in the election and advance the Aquino administration’s policies, now stands at the top in terms of public support. However, since the Second Division of the Philippine Commission on Elections disqualified Senator Poe as a presidential candidate in December, citing a failure to meet citizenship and residency requirements, she may not run in the presidential election. Furthermore in November, Davao City Mayor Rodrigo Duterte, known for cracking down on criminal groups using extrajudicial measures, suddenly declared his candidacy in the upcoming presidential election. With the running of a nationally popular figure in the election, the situation has become even more difficult to predict.

(Hiroshi Inagaki, Senior Economist)

3. Outlook on the global economy in 2016 ~ The pace of recovery will be sluggish, and the EM economies will carry downside risks

- ◆ In 2016, the global economy is expected to recover mainly among the DM economies. However, given the ongoing EM slowdown, the pace of recovery should remain sluggish. Global economic growth in 2015 (countries and areas covered in MHRI forecasts, weighted average of each region) declined to +3.1% y-o-y (from 3.5% y-o-y in 2014) and is projected to rise to +3.4% y-o-y in 2016. This is primarily because the contraction of the growth rate in commodity-producing countries will significantly narrow in 2016 compared with 2015, affecting the calculation of the growth rate in a positive way. Excluding this impact, the improvement of the global economy will remain tepid.
- ◆ Our main scenario holds that the global economy will recover modestly, but that there are downturn risks of a negative spillover from the Chinese economy to the commodity-producing economies. Should such risks intensify, interest rate hikes may be postponed in the US, leading to the slowdown of the global economy, including the DM economies.

[Outlook on the global economy]

Calendar year	(Y-o-y % ch)			
	2013 (Actual)	2014 (Actual)	2015 (Forecast)	2016 (Forecast)
Total of forecast areas	3.3	3.5	3.1	3.4
Japan, US, Eurozone	0.8	1.5	1.8	1.9
US	1.5	2.4	2.4	2.5
Eurozone	-0.2	0.9	1.5	1.4
Japan	1.4	-0.0	0.6	1.0
Asia	6.4	6.3	6.2	6.1
China	7.7	7.3	7.0	6.7
NIEs	2.9	3.4	2.0	2.4
ASEAN5	5.1	4.6	4.6	4.4
India	6.4	7.1	7.4	7.7
Australia	2.0	2.6	2.3	2.6
Brazil	3.0	0.1	-3.7	-2.5
Russia	1.3	0.6	-4.1	-0.4
Japan (FY)	2.0	-1.0	1.0	1.5
Crude oil price (WTI, USD/bbl)	98	93	49	52

Note: The total of the forecast areas is calculated based on the 2012 GDP share (PPP) by the IMF.

Source: Made by MHRI based on the International Monetary Fund (IMF).

4. Outlook on the 2016 Japanese economy ~ Despite strong uncertainties, a gradual recovery is expected

- ◆ In 2016, the Japanese economy is expected to return to a recovery track driven by the improvement of corporate earnings and labor market conditions. Even so, the pace of recovery will most likely be gradual.
- ◆ Turning to each of the major components, exports are expected to continue improving given the ongoing recovery of the DM economies. Nevertheless, the Chinese economy is forecast to slow down, albeit temporarily supported by infrastructure investment. The slowdown of China's economy is expected to weigh on the recovery of Japan's exports. Capital investment will likely see an increase in renewal investment backed by solid corporate earnings. However, given the ongoing low level of operation ratios, it is difficult to foresee a full-fledged expansion of investment aimed at increasing production. As for personal consumption, while the improvement of labor market conditions will support consumer spending, strong growth is unlikely since the stock adjustment of consumer durables will continue for some time.
- ◆ Core inflation is projected to rise gradually, supported by a moderate improvement in the GDP gap, easing of downward pressures of low crude oil prices, and a rise in food prices due to the weaker yen. MHRI forecasts that the core inflation rate will rise to the lower half of the 1%-level in the latter half of 2016.

[Outlook on the Japanese economy]

		2013	2014	2015	2016	2014		2015				2016				2017
		FY				Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
GDP (real)	Q-o-q % ch	2.0	-1.0	1.0	1.5	-0.7	0.5	1.1	-0.1	0.3	0.0	0.1	0.4	0.5	0.5	0.8
	Q-o-q % ch p.a.	--	--	--	--	-2.8	1.8	4.4	-0.5	1.0	0.2	0.5	1.6	2.0	2.0	3.2
Domestic demand	Q-o-q % ch	2.4	-1.5	0.9	1.4	-0.7	0.1	1.1	0.1	0.1	-0.1	0.1	0.4	0.5	0.6	1.1
Private sector demand	Q-o-q % ch	2.2	-1.9	0.9	1.8	-1.2	0.1	1.5	-0.1	0.2	-0.0	0.3	0.4	0.6	0.7	1.3
Personal consumption	Q-o-q % ch	2.3	-2.9	0.4	1.8	0.0	0.4	0.3	-0.5	0.4	0.3	0.2	0.2	0.3	0.6	1.8
Housing investment	Q-o-q % ch	8.8	-11.7	2.0	3.8	-6.9	-0.7	2.0	2.5	2.0	-2.1	-1.2	0.9	5.1	0.5	1.3
Capital investment	Q-o-q % ch	3.0	0.1	1.8	3.0	-0.4	0.2	2.7	-1.3	0.6	0.8	1.0	0.6	0.7	0.7	0.9
Inventory investment	Q-o-q contribution, % pt	-0.3	0.6	0.2	-0.2	-0.6	-0.1	0.5	0.3	-0.2	-0.3	-0.1	0.1	-0.0	0.0	-0.3
Public sector demand	Q-o-q % ch	3.2	-0.3	0.6	0.4	0.6	0.1	-0.2	0.9	-0.1	-0.2	-0.3	0.2	0.3	0.3	0.3
Government consumption	Q-o-q % ch	1.6	0.1	1.2	1.0	0.2	0.4	0.2	0.4	0.3	0.2	0.2	0.3	0.3	0.3	0.3
Public investment	Q-o-q % ch	10.3	-2.6	-1.1	-2.7	1.6	-0.5	-2.0	3.3	-1.5	-1.7	-2.5	-0.4	0.3	0.3	0.3
External demand	Q-o-q contribution, % pt	-0.5	0.6	0.1	-0.0	0.1	0.3	-0.0	-0.2	0.1	0.1	0.0	0.0	0.0	-0.1	-0.3
Exports	Q-o-q % ch	4.4	7.8	1.6	4.3	1.6	2.9	1.9	-4.3	2.7	1.2	0.9	0.9	1.0	0.9	0.6
Imports	Q-o-q % ch	6.7	3.3	1.0	4.1	1.1	0.8	1.7	-2.6	1.7	0.5	0.8	0.8	0.9	1.5	2.0
GDP (nominal)	Q-o-q % ch	1.7	1.5	2.5	2.1	-0.9	0.8	2.0	0.2	0.4	1.0	-0.6	1.0	0.7	0.9	0.0
GDP deflator	Y-o-y % ch	-0.3	2.5	1.5	0.6	2.0	2.3	3.3	1.5	1.8	2.2	0.6	0.8	0.9	0.4	0.3
Domestic demand deflator	Y-o-y % ch	0.4	2.1	0.2	0.9	2.3	2.1	1.4	0.0	0.0	0.3	0.5	0.7	0.8	1.0	1.0

Note: Figures in the shaded areas are forecasts.

Source: Made by MHRI based on the Cabinet Office, *National Accounts*.

5. Outlook on the financial markets in 2016 ~ Despite US interest rate hikes, the rise of long-term interest rates will be gradual

- ◆ Turning to the financial markets in 2016, we forecast the rise of stock prices, the rise of interest rates, and the appreciation of the US dollar reflecting the gradual growth mainly of DM economies. Despite lingering risks of EM slowdown such as China, stock prices in DM countries should follow a gradual upward path, reflecting accommodative monetary policies adopted in Japan and Europe as well as the uptrend in corporate profits.
- ◆ In the US, the Federal Reserve Board (FRB) commenced its interest rate hike from December 2015, and is expected to continue to do so at a gradual pace in 2016. On the other hand, the Bank of Japan (BOJ) may implement additional monetary easing measures due to the slower-than-expected increase in the inflation rate. With regard to the JPY/USD exchange rate, the yen should continue to weaken due to differences in the monetary policy stances of the two nations. Even so, the pace of yen depreciation should remain subdued due to the market's wariness toward a stronger US dollar.
- ◆ In Japan, the rise of long-term interest rates should remain limited from both the supply side and the demand side, on the back of the decline in amount of JGB issues due to JGB purchases by the BOJ and tax revenue growth. However, Japanese interest rates should gradually be subject to upward pressures amid the rise of stock prices and US interest rates. Keep a close eye upon market conditions in times of the rise of market volatility triggered by events such as sudden swings in overseas interest rates and speculation on the BOJ's exit strategy.

[Outlook on the financial markets]

	2014	2015	2016	2015		2016				2017
	FY			Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Japan										
Uncollateralized O/N call rate (End-of-period rate, %)	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1	0~0.1
Euroyen TIBOR (3-mo, %)	0.20	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17
Interest rate swaps (5-yr, %)	0.26	0.22	0.25	0.23	0.19	0.20	0.25	0.25	0.25	0.30
Newly issued JGBs (10-yr, %)	0.48	0.40	0.55	0.39	0.32	0.35	0.45	0.55	0.55	0.60
Nikkei average (JPY)	16,273	19,800	21,500	19,412	19,300	20,500	21,100	21,400	21,700	21,800
US										
Federal funds rate (End-of-period rate, %)	0~0.25	0.50~0.75	1.50~1.75	0~0.25	0.25~0.50	0.50~0.75	0.75~1.00	1.00~1.25	1.25~1.50	1.50~1.75
Newly issued government bonds (10-yr, %)	2.33	2.22	2.65	2.21	2.20	2.40	2.50	2.60	2.70	2.80
Dow Jones average (USD)	17,183	17,600	18,400	17,066	17,500	17,800	18,000	18,200	18,500	18,800
NASDAQ Composite Index (Index (pt))	4,527	5,030	5,280	4,922	5,020	5,150	5,200	5,250	5,300	5,350
Eurozone										
ECB key policy interest rate (End-of-period rate, %)	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
German government bonds (10-yr, %)	0.90	0.60	0.60	0.70	0.60	0.50	0.50	0.50	0.60	0.70
Forex										
JPY/USD exchange rate (JPY/USD)	110	123	127	122	123	126	126	126	127	127
USD/EUR exchange rate (USD/EUR)	1.27	1.09	1.03	1.11	1.07	1.05	1.04	1.03	1.03	1.03

Note: The shaded areas are forecasts. The forecasts are averages of the relevant periods. However, the uncollateralized overnight call rate, federal funds rate, and ECB policy interest rates are end-of-period rates.
Source: Made by MHRI based on Bloomberg.