

Forex Medium-Term Outlook

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Forex Department

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Overview of Outlook

In June, USD/JPY saw only slight movements. Amid steady inflation in the U.S., the Fed has also been continuing with its rate hikes, but long-term interest rates have peaked at 3% and inflation expectations are sluggish. Inevitably, USD/JPY also has not much room for movement. As the Federal Funds (FF) rate approaches the long-term neutral interest rate level, there may, after all, be increasing realization that the Fed's monetary policy operations are now going beyond normalization and entering a phase of tightening. In fact, the FOMC statement has also begun to include hints to that effect. Most market participants predict two more rate hikes for this year, but there are fears that the yield curve may have become inverted before then, so I would like to believe that we are moving into a phase where it is risky to consider a rate hike" the obvious next move by the Fed. The global economy is also showing strong signs of approaching a cyclical peak, and it is important not to forget that even if the U.S. is able to withstand the Fed's rate hikes, the rest of the world will not be able to. In particular, capital outflow from emerging economies will remain a potential cause for concern. Under such circumstances, my rate outlook will be based on the assumption that the Fed's policy operation is likely to be constrained by the situation outside the U.S. Regarding the forex markets in particular, my basic understanding that the slowing down of the U.S. economy will cause the Fed's normalization process to collapse, resulting in a decline U.S. interest rates and a depreciation of USD (together with an appreciation of JPY) has not changed.

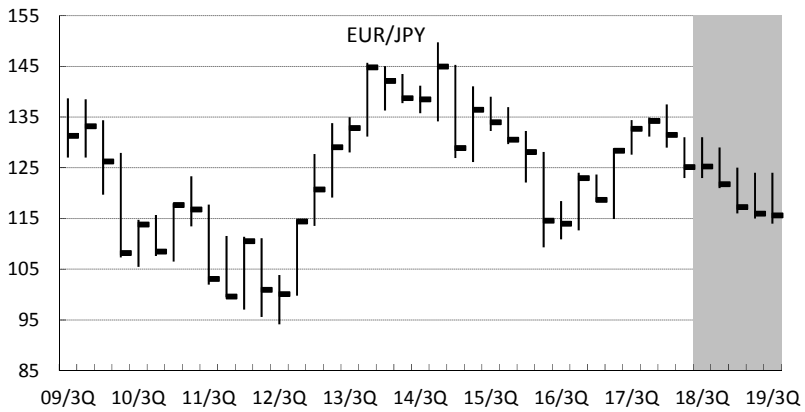
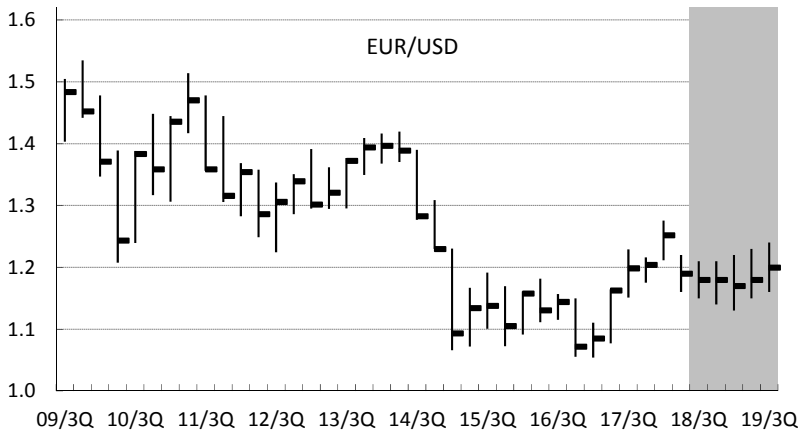
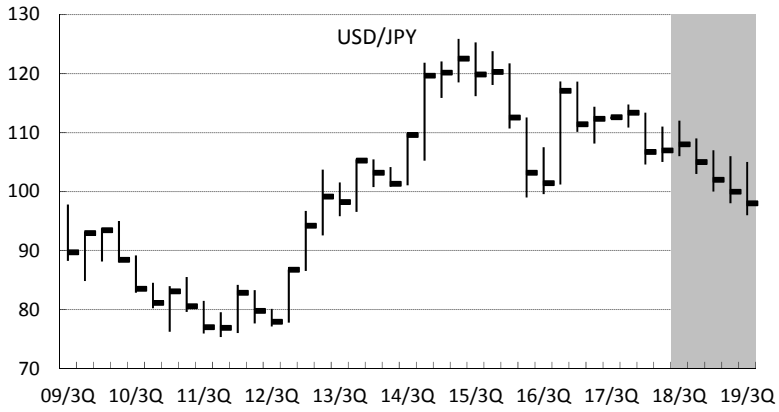
Meanwhile, EUR movements have also continued to lack a sense of direction. The crisis in Italy, which drew a lot of attention from late May through June, appears to have blown over for the moment, but one must beware that it could rear its head again this autumn, when budget deliberations take place. As for monetary policy, while an end to the Asset Purchase Programme (APP) has been declared, the ECB included the guidance that it would keep key ECB interest rates unchanged "at least through the summer of 2019 and in any case for as long as necessary," which triggered EUR selling at an increased pace. As of the present time, most market participants predict the start of rate hikes in September next year at the earliest, but the problem is that the Fed is highly likely to be approaching the end of its own rate hikes around that time. Is it really possible that the ECB would begin rate hikes even as the Fed is ending them? I find it hard to believe that the ECB, which has expressed discomfort at EUR strength so far, will confidently embark on closing the gap between its monetary policy and that of the U.S. Considering the economic and financial situations, it is very possible that there will be no rate hikes in 2019. While EUR may be able to avoid a major crash amid across-the-board USD depreciation, my basic understanding is that it will find it more difficult to pursue its upper bound.

Summary Table of Forecasts

	2018		2019			
	Jan - Jun (actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.64 ~ 113.40 (110.45)	106 ~ 112 (108)	103 ~ 109 (105)	100 ~ 107 (102)	98 ~ 106 (100)	96 ~ 105 (98)
EUR/USD	1.1508 ~ 1.2556 (1.1570)	1.13 ~ 1.19 (1.16)	1.12 ~ 1.19 (1.16)	1.11 ~ 1.20 (1.15)	1.13 ~ 1.21 (1.16)	1.14 ~ 1.22 (1.18)
EUR/JPY	124.62 ~ 137.51 (127.77)	123 ~ 131 (125)	121 ~ 129 (122)	116 ~ 125 (117)	115 ~ 124 (116)	114 ~ 124 (116)

(Notes) 1. Actual results released around 10am TKY time on 29 June 2018. 2. Source by Bloomberg

Exchange Rate Trends & Forecasts

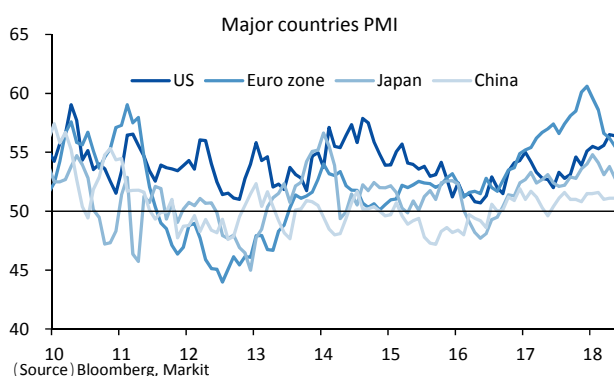
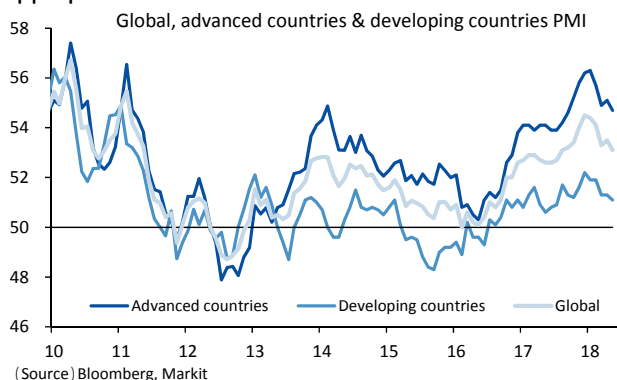


USD/JPY Outlook – The Turning Point at Which “Normalization” Becomes “Tightening”

The Global Economy Now and Going Forward – Slowdown Increasingly Obvious

Global Economic Slowdown Increasingly Obvious

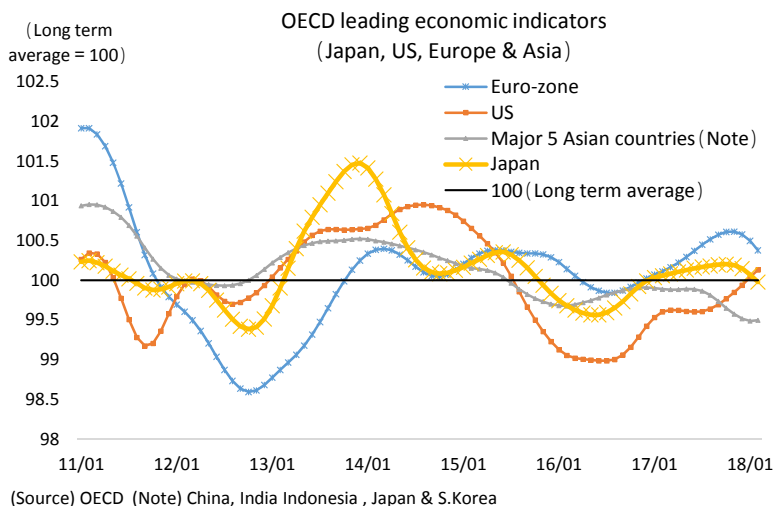
While on the one hand, there is talk of the forward-looking policy operation of the U.S. and European central banks, on the other hand, the rather long recovery phase of the global economy is steadily approaching maturity. The Global Manufacturing PMI (purchasing managers' index) released by Markit Economics fell from 53.5 for April to 53.1 for May, a low last seen in July last year (see graph). The index does remain higher than 50, which is the turning point between economic contraction and expansion, but it has clearly begun to head toward a slowdown in terms of its direction. This is true for both developed economies and emerging ones. Roughly speaking, I think it would be reasonable to say that the global economy, which bottomed out in early 2016, is now approaching its peak again, thanks partly to a gradual permeation of the impact of U.S. rate hikes. To be more precise, in addition to the tightening effect of rate hikes, other risk factors have also emerged, such as the capital outflow from emerging economies in the wake of U.S. rate hikes, the intensification of protectionist trends in the U.S., and the potential instability of the Italian political situation, and none of these have been eradicated so far. Country-wise, with the exception of the U.S., there is a strong sense of economic slowdown in the euro area and Japan as well as in China. If FOMC members' FF rate projections (dot plot) come true, the FF rate will reach the neutral interest rate toward the end of 2019, but it seems highly likely that the U.S. yield curve will become inverted before then. The global economy is already peaking, and more and more market participants will become aware of this fact gradually – that seems an appropriate assessment of the current situation.



OECD Leading Indicators Also Hint of the Same

The same assessment of the current situation can be reached based on the OECD Composite Leading Indicators (CLI)¹, which offer a short cut to understanding leading economic indicators. While PMIs tend to comprise soft data collected through questionnaire surveys, the CLI is a composite index calculated on the basis of GDP and other hard data. Because of this, it is less promptly available than the PMI but can reflect the economic situation more accurately. The index is designed to lead the actual economy by about six months (four to eight months on an average, to be more specific). As one can tell from the graph, developed economies including Japan, Europe, and the U.S. bottomed out in early 2016 and began to expand at a rising pace following that, but a slowdown in the Japanese and European economies has been suggested starting late 2017 or early 2018. The Asian economies also bottomed out in early 2016 but continued to lack vigor even after that and appear to be approaching a slowdown without ever surpassing 100. The only economy putting up a good show is the U.S. Since it is not reasonable to go ahead with monetary tightening as a matter of fact amid a retardation of leading economic indicators, one has to conclude that the U.S. economy is, in fact, doing well. One conceivable basic interpretation of the situation is that the Fed's rate hikes and balance sheet size reduction efforts aligned with the strength of the U.S. economy are sapping the vigor of other economies (especially emerging economies) around the world. Of course, in addition to this interpretation, it must be noted that the present situation simultaneously involves a number of other risk factors including capital outflow from emerging economies, the intensification of protectionist trends in the U.S., and the potential instability of the Italian political situation.

¹ A composite index of key indices computed by the Organization for Economic Co-operation and Development (OECD) for early prediction of turning points in economic cycles. The index is said to lead turning points by about 4 to 8 months on average.

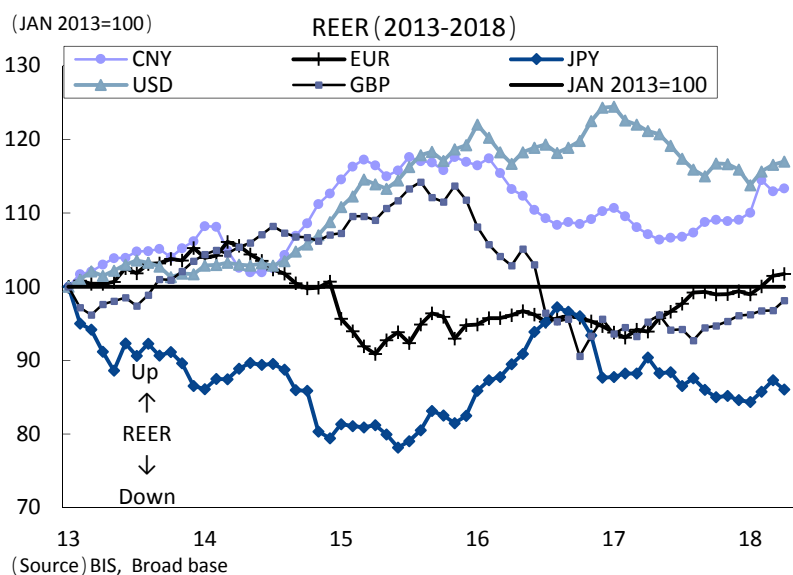


At any rate, it is not a good idea to ignore the alarm signals emanating simultaneously from two representative leading economic indicators, the PMI and the CLI. The economic slowdown in the near future (approximately six months to a year from now) suggested by these indicators is consistent with the underlying concern that this report has consistently been voicing, namely that the Fed's policy operations amount to an economic overkill, and I believe that the appreciation of JPY against USD is the forex outlook consistent with it.

USD/JPY Now – Three Years Since the Peak

Three Years Since USD/JPY Peaked at 125.86

Perhaps it is still a fresh memory for some, but it was three years ago, on June 10, 2015, that USD/JPY peaked at 125.86 under Abenomics. The same day, BOJ Governor Haruhiko Kuroda told the House of Representatives Committee on Financial Affairs that JPY was “significantly weak in light of its real effective exchange rate (REER)” and that “it does not seem possible, under normal circumstances, that it (the REER) will depreciate further.” It is not certain whether Mr. Kuroda had any intention of deterring the further depreciation of JPY (probably he did not have any specific intent), but his remark resulted in a rapid selloff of JPY, and USD/JPY fell from 125.86 before his



comment to 122.46 following it. Ultimately, USD/JPY has not returned to rise beyond the high posted on this day so far. My forex outlook switched to predicting JPY appreciation in June 2015, and this was because I too found it abnormal that JPY had, when seen in terms of its REER, weakened to levels last seen in the early 1980s. In the event, my calling it the “peak” rate for USD/JPY at that time has turned out to be correct, but as of the present time, JPY has only appreciated by 10% compared with that peak, leaving the sense of the historical weakness of JPY unchanged (see graph on previous page). As far as

one can tell from the graph, this seems to be attributable to the fact that the across-the-board surge in USD strength starting June 2014 has still not undergone sufficient adjustment. Even after the significant weakening of USD last year, the distortions in the forex markets remain. EUR may be the only key currency to have undergone the appropriate level of adjustment.

Three Years is a Turning Point

This is a point I have brought up in past issues of this report too, but three years has tended to be a turning point in the USD/JPY rate cycle. If June 2015, when the currency pair hit its last high, is taken to be one of its peaks, the current phase of JPY strength can be said to have begun in July 2015. Given that the USD/JPY wave seems to have a 36-month wavelength for phases of both JPY strength and JPY weakness, as the chart shows, a number of market participants may be expecting the current phase of JPY strength to come to a close about now. And to be sure, despite whispers of the outlook for JPY strength, the trend has been rather sluggish.

On the other hand, history also shows that phases of JPY strength have at times continued for as long as 42 months, so it may not be advisable to let down our guard before early 2019. Further, it is also clear that the rate of change

during each phase (calculated based on the rates at the start and end points of each phase) has been around 30%. A 30% rate of change from JPY125 in the strong-JPY direction would involve a significant drop to below 90 for USD/JPY, but there are no signs of any such JPY appreciation taking place so far. Forex movements over the past three years have been rather gentle overall, except during periods of major developments (such as Brexit or the U.S. presidential election).

JPY strengthening & weakening trend since Plaza accord

Start	End	Direction	Numbers of days	Numbers of months	Rate of variability	Key phrases (some representative examples)
MAR 1985	DEC 1987	Strong JPY	1005	33.5	-51.7	Plaza Accord
JAN 1988	MAR 1990	Weak JPY	790	26.3	23.5	Japanese Economic Bubble
APR 1990	APR 1995	Strong JPY	1826	60.9	-46.9	Collapse of Japanese Economic Bubble
MAY 1995	JUL 1998	Weak JPY	1157	38.6	71.0	Asian Currency Crisis, Japanese Banking Crisis, "Strong dollar a national advantage" (for the U.S.)
AUG 1998	DEC 1999	Strong JPY	487	16.2	-26.4	Russian financial crisis, Fall of long-term capital management (LTCM)
JAN 2000	JAN 2002	Weak JPY	731	24.4	24.5	Dot-com bubble and its collapse, U.S. September 11, 2001 terrorist attacks
FEB 2002	DEC 2004	Strong JPY	1034	34.5	-23.0	End of Japanese banking crisis, Japanese economic boom surpasses erstwhile Izanagi boom, Phase of U.S. rate cuts
JAN 2005	JUL 2007	Weak JPY	911	30.4	14.4	Financial bubble
AUG 2007	Oct 2012	Strong JPY	1888	62.9	-34.1	Collapse of Lehman Brothers, European debt crisis, U.S. monetary easing
Nov 2012	JUN 2015	Weak JPY	942	31.4	51.0	FRB's normalization process, End of European debt crisis, Abenomics
JUL 2015	?	Strong JPY	?	?	-12.2	Collapse of Chinese economic bubble, Brexit, US President Donald Trump (to act on conservative)
Average (overall)			1,077.1	35.9	34.4	
Average (strong JPY)			1,248.0	41.6	-32.4	
Average (weak JPY)			906.2	30.2	36.9	

(Source) Bloomberg (Notes) month=30 days, Classified as either trends exceeds one year.

The "Average (Overall)" for the "Rate of Change" is the average of the absolute values. Strong JPY stage since JUL 2017: preliminary calculation as of end of MAY 2018

Kuroda's Statement that JPY Would not Weaken Further Still Holds True

Of course, the later point based on the wavelength of each USD/JPY phase is merely a game of numbers and is simply intended for reference. The former point, that JPY continues weak compared with its REER, is an argument that I like to take into consideration in formulating my outlook. The situation that led Mr. Kuroda to say three years ago that JPY would not weaken any further has not changed much, making one reluctant to bet on the future weakness of JPY. To make a long story short, it is possible that the length of USD/JPY phases is largely determined by the length of U.S. economic cycles and, therefore, the length of Fed policy operation phases. As the current U.S. economic phase is on its way to becoming the longest ever, it is interesting to wonder how long USD/JPY will follow along with it. This is something that merits thinking about calmly.

U.S. Economic and Monetary Policies Now and Going Forward – Policies Increasingly Accompanying a Sense of Guilt

Policies Increasingly Accompanying a Sense of Guilt

At the FOMC meeting held on June 12 and 13, the target range for the FF rate was raised by 25 bp to 1.75-2.00% by a unanimous decision, finally hitting the benchmark 2% FF rate. Again, the median of FOMC members' rate hike projections (dot plot) hinted at two more rate hikes this year, up from previous projections of one (although, as I will explain later, this is not a big deal). The statement itself was rather brief, indicating a sense of confidence regarding current policy operations. There was some speculation that the word "accommodative" as applied to the monetary policy stance would be removed, but it was retained. However, the guidance that "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run" was deleted as a whole. This amounts to an official recognition that the current FF rate is approaching the long-term interest rate level (i.e., the neutral interest rate), thereby indicating that monetary policy has entered "tightening" mode.

The essence of the Fed's policy operation is increasingly becoming focused on one point of "distance from the neutral interest rate." Going forward, as the Fed's policies move beyond the realm of "normalization," policy operation may be accompanied by a sense of guilt that "perhaps we have gone overboard with tightening." One wonders how the Fed interpreted the drop in share prices following its decision this time. Fed Chair Jerome Powell, who has adopted the policy path of the previous chair, Janet Yellen, has made it clear that he will continue the normalization process even if share prices fall. Still, it is important to note that the robust appetite for consumption and investment in the U.S. household sector is largely due to the wealth effect, which is based on strong share prices. It is natural to assume that the increase in unearned income is a major part of the reason why savings rates have fallen significantly despite a moderate increase in wages. Low interest rates, strong share prices, and household

consumption (real economy) all share each other's fate, and if rate hikes work to significantly neutralize the wealth effect, it seems inevitable that the current policy path will collapse at some point. I would like to caution that this is likely to take place within the year.

The Upswing in the Median of Projections Is not a Big Deal

Let us take a more detailed look at the dot-plot projections. The median of members' FF rate projections for the end of 2018 rose from 2.125% last time, to 2.375% this time. This caused the projection for the number of remaining rate hikes this year to rise from one to two. Similarly, the median of members' FF rate projections for the end of 2019 rose from 2.875% last time, to 3.125% this time. This caused the projection for the number of rate hikes in 2019 to rise from one to two (see chart to the right). However, as I pointed out also in the preview to this report, the projection for the number of rate hikes remaining for this year was in a position to increase with just a single FOMC member's projection increasing from "three" to "four" rate hikes in 2018. So, one hesitates to especially emphasize an increase in the hawkishness of the Fed based on the upward revision of the median projection. Incidentally, the FF rate projection for the end of 2020 remains unchanged at 3.375% (one rate hike in 2020), and the "longer run" interest rate (thought to be the neutral interest rate) also remains unchanged at 2.875%. In other words, the assumption based on the recent dot plot is that the FF rate will overtake the neutral interest rate by the end of 2019, which is consistent with the deletion of the guidance mentioned in the previous section. The fact that the Fed intends to continue with rate hikes in 2020 despite the FF rate overtaking the neutral interest rate in 2019 seems to indicate that it is concerned about an overshooting of inflation and asset price.

No Need for Concern that the Fed has Fallen Behind the Curve

There is no change in this report's stance just because the rate hike projections in the dot plot have increased. Projections suggesting an increase in the actual number of rate hikes despite no increase in the assumed neutral interest rate simply indicate a stronger awareness of the end-point of rate hikes. Given that wage increases are not currently strengthening, and that inflation expectation is clearly peaking (see graph), there is no reason to assume that U.S. inflation rates will rise to uncontrollable levels. In other words, there is no need to worry that the Fed has fallen behind the curve. Rather, these things contribute to my basic understanding of the need for concern of an overkill due to too many rate hikes.

It is precisely because the markets also think this way that the yield curve in the U.S. bond

Policy interest rate outlook as of each year end (median estimate)

FOMC Date	2018	2019	2020	Longer run
Mar-15	n.a.	n.a.	n.a.	3.750%
Jun-15	n.a.	n.a.	n.a.	3.750%
Sep-15	3.313%	n.a.	n.a.	3.500%
Dec-15	3.250%	n.a.	n.a.	3.500%
Mar-16	3.000%	n.a.	n.a.	3.250%
Jun-16	2.375%	n.a.	n.a.	3.000%
Sep-16	1.875%	2.625%	n.a.	2.875%
Dec-16	2.125%	2.875%	n.a.	3.000%
Mar-17	2.125%	3.000%	n.a.	3.000%
Jun-17	2.125%	2.938%	n.a.	3.000%
Sep-17	2.125%	2.688%	2.875%	2.750%
Dec-17	2.125%	2.688%	3.063%	2.750%
Mar-18	2.125%	2.875%	3.375%	2.875%
Jun-18	2.375%	3.125%	3.375%	2.875%

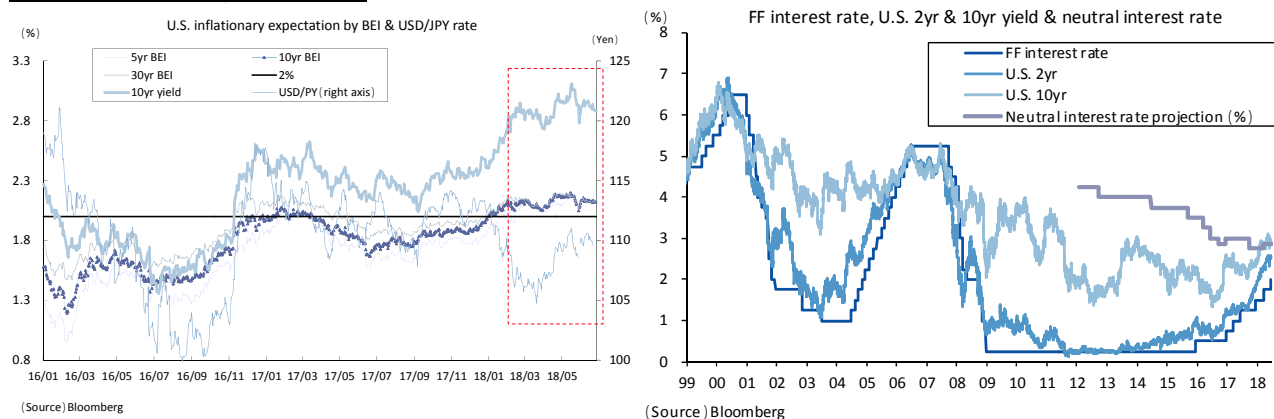
(Source) FRB

market has continued to flatten and an inversion of the curve is beginning to seem possible. If, as the Fed fears, the U.S. economy is truly overheating, the benefits of this are likely to be spilling over to emerging economies. And if that had been true, the kind of turmoil witnessed in early May would not have taken place. Even if we assume that the benefits of the overheated economy have not spilled over to other economies but remain within the U.S., it is a problem that the Fed would continue to implement rate hikes as a matter of course despite the major and rapid shift of capital taking place in the global asset markets. USD being the key global currency, the impact of a rise in its procurement cost is not contained domestically, but rather urges capital outflow from emerging countries. Also, the U.S. economy seems to be rushing forward at a rate of just under +3%, which is significantly higher than the potential growth rate of close to +2% (+2.6% yoy for the entire year 2017, and an annualized rate of +2.8% qoq for January-March 2018), but one has to contemplate this from the fundamental standpoint of how sustainable such a high rate of growth is. Going by the trends so far, now that the 10-year interest rate has peaked out after hitting the neutral interest rate, it seems to be simply a matter of time before the 2-year interest rate catches up to and overtakes it (i.e., before the yield curve becomes inverted.) Under such circumstances, my understanding regarding the forex outlook remains unchanged that USD will depreciate alongside U.S. interest rates, and JPY, which is already undervalued, will appreciate in line with this.

Entering a Phase of Contemplating the End of Rate Hikes

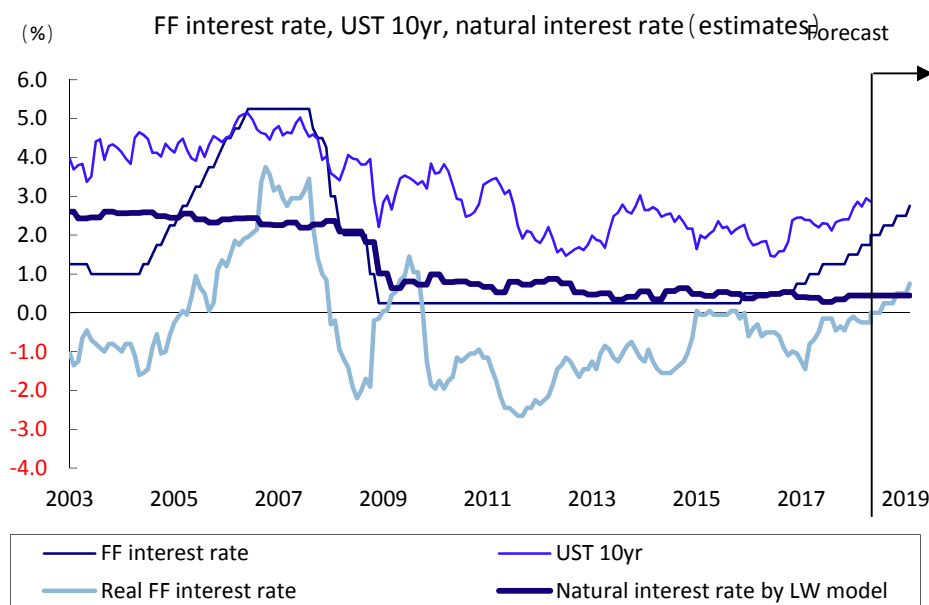
Ultimately, the big question at the current time boils down to "when will the rate hikes be done?" I know I repeat myself, but as of the current time, the median of FOMC members' projections for the Federal Funds rate at which the Fed's stance would be considered neither "tight" nor "accommodative," i.e., the neutral interest rate, is 2.875%. Subtracting the expected inflation rate from this gives the equilibrium real interest rate or the natural interest rate,

which is thought to approximate the potential growth rate in the medium to long term. To clarify, so long as the time-frame is “medium to long term,” the potential growth rate \approx natural interest rate \approx equilibrium real interest rate, and this can be obtained by subtracting the expected interest rate from the nominal neutral interest rate. There are several theories regarding the medium/long-term potential growth rate of the U.S. economy, but taking the estimate put out by the Congressional Budget Office (CBO) as an example, it was 1.5-2.0% or so for the past three years, from 2014 through 2017 (i.e., an average of 1.7% or so). The neutral interest rate derived from this is 3.5-4.0% if we assume that the expected interest rate is the target 2%. This value is about 0.5-1.0 pp higher than the median of current forecasts (2.9%), but it must be emphasized again that the 3.5-4.0% rate signifies the underlying strength of the U.S. economy (its potential growth rate) in the medium to long term. Current values do not always coincide with the medium- to long-term value.



Entering a Tightening Phase in December This Year – The LW Model

The level of underlying strength of the U.S. economy in the short term is likely to be lower than the 1.5-2.0% level assumed by the Fed. For instance, in a May 15 lecture, John Williams, who was appointed the new president of the New York Fed in June (but was the president of the San Francisco Fed at the time of the lecture), said that he considered the neutral interest rate to be 0.5% or so, and that if the inflation rate continued around 2% (which is the target interest rate),



(Source) Bloomberg

the typical nominal short-term interest rate would be 2.5%. As the graph shows, the natural interest rate as estimated using the model developed by Mr. Williams and Mr. Laubach, an economist at the Fed (the Laubach-Williams model or the LW model), declined dramatically following the financial crisis and is currently moving at around the 0.4% level. Intuitively speaking, when the real FF rate is lower than this, monetary policy can be thought to have an accommodative effect, and such a situation has indeed become normalized since 2009 (further, it can also be seen that the accommodative effect has been shrinking since 2012). However, if rate hikes proceed as per the current dot plot projections, and the inflation rate (the PCE deflator here) remains stable at around 2%, the FF rate will surpass the natural interest rate as suggested by the LW model when it is raised to 2.25-2.50% in December this year, i.e., the real FF rate will enter positive territory. In other words, monetary policy will clearly enter the tightening phase at that time.

The Turning Point for the Shift to Tightening

Of course, it is difficult to accurately predict the natural interest rate level. However, it is a fact that Williams and Laubach are both big names in the field of empirical research into the natural interest rate, and their estimate is one of the most credible indicators available to us in this regard. As far as one can tell from recent FOMC statements, minutes of meetings, and remarks by senior officials, there is definitely strong suspicion that this phase of rate hikes is approaching to an end. It is only because of this that the flattening of the U.S. yield curve as well as its significance as a harbinger of economic recession can become topics for discussion of considerable importance. My basic understanding, therefore, is that it would be prudent to closely watch the financial markets while bracing oneself that this very moment may be the turning point that marks the shift to monetary tightening.

Risks to the Main Scenario – Further Intensification of Protectionism

Further Intensification of Protectionism in June

As I do each month, I would like to review the risk factors related to my main forecast scenario. Regarding the listed risk factors (see table), there have been no major changes since last month. Although the number of risk factors was decreased by one owing to the consolidation of ‘U.S. political risks’ (previously listed as risk factor) within risk factor , this is not meant to suggest that JPY appreciation risks are receding. In fact, while the apparent easing of U.S. China trade frictions during May was considered to represent a kind of ‘trade war truce’², protectionism has re-intensified from the period immediately preceding and following the U.S.-Korea summit conference in June, and this is once again having a negative effect on financial markets’ mood. Owing to the increasing clarity of U.S. confrontations with China as well as the EU, it is apparent that, rather than remaining unchanged, the negative effect of the Trump administration’s protectionist posture on market psychology may actually be increasing. In light of the general trend, expecting that Japan alone might receive some kind of dispensation from the aggressive U.S. stance on trade would probably be unrealistically optimistic. Thus, we cannot disregard the potential of risk factor to promote JPY appreciation in the course of U.S.-Japan bilateral negotiations.

Potential Risks to the Main Scenario

	Risk Factors	Remarks	Direction
US	Economic policy by President Trump	· Protectionism to be sharpened, trade friction between U.S. & Japan.	Strong JPY Weak USD
	Continual excessive monetary tightening by FRB	Plunge into complete “tightening” stage	Strong JPY Weak USD
Japan	Political risk in Japan	· Retrogression of reflation policy by Abe resignation	Strong JPY Weak USD
	FX risk-taking by Japanese investors	· From hedged to unhedged position expansion? · Increasing cross border M&A continuously	Weak JPY Strong USD
	-1 Risk of BOJ monetary policy change	· BOJ might use a reversal rate discussion to begin considering means of reducing its easing	Strong JPY Weak USD
	-2 Risk of BOJ monetary policy change	· Radical easing monetary policy such as purchase foreign bonds, helicopter money & etc	Weak JPY Strong USD
Europe	Political risks in EU	· Conflict intensified between Italy and European Commission · Conflict intensified about Brexit negotiation	Strong JPY Weak USD

(Source) Daisuke Karakama, Mizuho Bank

The fact that a major U.S. motorcycle manufacturer has plans to shift a portion of its production activities overseas in response to the EU’s retaliatory tariffs became a major topic of discussion on June 25, and this is an indication that players in the real U.S. economy have already begun taking concrete measures to respond to the potential for a trade war. Although the idea that “trade wars are essentially a matter of making a deal (negotiation)” is probably correct, I think one still must keep in mind the fact that players in the real economy and the financial markets will begin making precautionary adjustments before trade war situations become serious. Players in financial markets, particularly the forex market, are especially intent on responding to the ramifications of potential situations well in advance of the eventuation of those situations.

Regarding risk factor , there are grounds for concern about policy normalization overkill, as discussed above. It is

² During the US-China trade talks held in Washington on May 19 to 20, the widely quoted statement of Treasury Secretary Steven Mnuchin – “We’re putting the trade war on hold.” – was considered to suggest the possibility of a trade war armistice.

generally considered to be confirmed that the Fed will implement an additional two interest rate hikes this year, raising the FF interest rate to the 2.25%-to-2.50% range. According to the empirical research of a team led by John C. Williams, president and CEO of the Federal Reserve Bank of New York, the neutral interest rate is estimated to be about 2.50%, so there is now increasingly realistic concern about the possibility that further interest rate hikes will bring the Fed's policies beyond 'normalization' and into the scope of what can be called 'tightening'. From 2019, the Fed's policy rate seen on a real basis will enter the positive zone and there are grounds for concern about the impact of that on the real economy, and it is somewhat questionable whether the Fed will dispassionately continue its rate hikes despite that impact. Given that there is a lag between the implementation of a monetary policy and the emergence of the effects of that policy, this article's fundamental understanding is that there is due cause for concern about the risk of policy overkill. If the Fed's interest rate hikes in 2019 are implemented at the 4-hike-per-year rate seen in 2018, I anticipate the eventuation of risk factor

Diminishing Abexit Risk but Continued Concerns About European Politics

In addition, the political situation in Japan has been considered to be a JPY appreciation risk factor. Following a temporary slump, the current cabinet's public support rate appears to be recovering, and some observers have begun agreeing with the assessment of LDP Secretary General Toshihiro Nikai, who said on June 26 that Prime Minister Abe is sure to win reelection for his third term as the LDP leader in the party's election this September. Thus, the likelihood of risk factor has been declining from this spring, and the "Abexit" theme embraced primarily among overseas investors – along with the surges of JPY appreciation and Japanese stock price declines anticipated based on that theme – now seem likely to prove illusory. The theme can be expected to be a hot topic of discussion in financial markets after Prime Minister Abe announces his candidacy and other candidates subsequently begin announcing their candidacies. Asked about the timing of his candidacy announcement on a June 17 Yomiuri Telecasting Corporation broadcast, Prime Minister Abe said it would be – "around the time that the noise of cicada songs becomes noisy in the Tokyo region" – and there are increasing expectations that the announcement will be sometime after the current Diet session ends in mid-July.

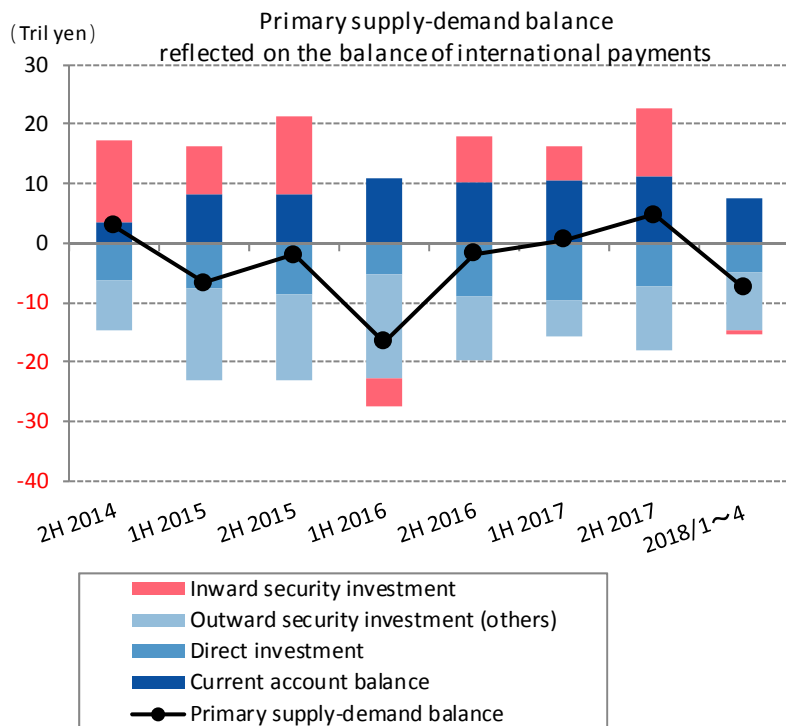
There remains a deep-rooted possibility that the BOJ might shift toward policy normalization (risk factor -1). In light of the continued gradual downscaling of government bond purchasing operations and whispered rumors about the limits of financial institutions' capabilities for coping with the current interest rate environment, there are persistent expectations that the BOJ will increase the long-term interest rate target of its yield curve control (YCC) framework. In fact, since boosting the interest rate target may only be feasible at a time when the central banks of the United States and Europe are striving to normalize their policies, such expectations can be considered reasonable. On the other hand, the Fed's interest rate hikes are said to be approaching the neutral interest rate (≈ 'the interest rate hike end point'), and it would require some degree of boldness on the part of the Fed to move its policies into the realm of actual tightening. It is questionable whether it would be possible for the BOJ to shift in the direction of monetary policy tightening at a time when forex markets are definitely not inclined to promote JPY depreciation. In any case, if such a decision is to be made, it would be best to make it as early as possible, so it is possible that such a decision might be made at the July Monetary Policy Meeting or other policy meetings in the near future, and one should take care to closely monitor the related situations, just in case. Although it is not considered a part of this article's main forecast scenario, the realization of this possibility would clearly be considered a JPY appreciation risk. It goes without saying realizing the possibility would require some kind of persuasive argument with respect to the sluggishness of the consumer price index (CPI).

Other JPY appreciation risks include those associated with the European political situation (risk factor), and these have not been dispelled. Although Italy's political turmoil has died down for the time being, the new populist government is likely to pursue the expansionary fiscal policy route during its October discussions of the fiscal budget for next year, and that is highly likely to provoke a confrontation with the European Commission. There are large gaps between the views of the new Italian government and the European Commission regarding economic policies as well as other policies, and there remains concern that a worst-case development of strife between the two might lead the Italian government to call for a referendum. It is well-known that governmental moves to externalize difficult decisions by entrusting them to referendums can spur great market turmoil, as already seen in the cases of Greece and the United Kingdom. In addition, negotiations over the United Kingdom's withdrawal from the EU (Brexit) are finally entering the phase of negotiating the terms of post-Brexit U.K.-EU trade relationships. There is concern about whether a U.K. withdrawal from the EU without a negotiated agreement – referred to as jumping off the 'cliff edge' – can be avoided, and the outlook is still unclear at this point. This issue is discussed in detail in the last section of this article, so please refer to that section.

JPY Supply-Demand Environment as a JPY Depreciation Risk

On the other hand, are there no JPY depreciation risks? As I mentioned in the last month's edition of this article, it can be argued that the JPY supply-demand environment (see graph) has not up to now been very supportive of JPY appreciation. For example, the proactive external risk taking (essentially JPY selling) of Japanese institutional

investors and companies (risk factor) cannot be excluded from the list of JPY depreciation risk factors. When USD/JPY fell below JPY105 in March, some observers noted that USD/JPY did not drop as much as it was expected to owing to an increase in Japanese investment in foreign securities. In fact, this interpretation may have some basis, given that net buying has been sustained in Japanese investment in foreign securities since the start of 2018. The fund management plans announced by major Japanese life insurance companies in April also demonstrate the strength of Japanese entities' desire to undertake foreign bond investment accompanied by JPY selling and USD buying (open foreign bond investment).



(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

In addition, as discussed in detail in a previous edition of this article, it should be noted that JPY selling associated with Japanese companies' cross-border M&A activities contributed to the trend of increase in USD/JPY seen during May. These flows are unquestionably "JPY selling by Japanese" in the broad sense of the phrase, and they have become a factor inclining the JPY supply-demand balance environment toward JPY selling. Japan's foreign direct investment has showed a basic trend of increase for almost 20 years, and foreign direct investments have now come to replace securities investments as the biggest component of the country's net external assets³. Given that such an amount of "vigorous JPY selling" is stemming from Japanese companies, that the associated direct investments are accumulating overseas, and that direct investments are relatively irreversible compared to securities investments, there is a

possibility that the supply-demand balance is gradually becoming structurally averse to JPY appreciation. I believe risk factor cannot be ignored, as it is a risk factor potentially capable of preventing USD/JPY from descending below JPY100 in line with this article's main forecast scenario. It is probably also worth mentioning the potential for the BOJ to introduce radical new easing methods, such as those involving foreign bond purchasing and helicopter money (risk factor -2), but decisions to utilize such methods would not be likely to be taken until after considerable progression of a JPY appreciation trend, so they are not cause for much concern at this time.

As I have mentioned in each month's edition of this article recently, my fundamental understanding regarding this is based on the simple question – "Is it possible for the economy to avoid deceleration etc. despite its central bank's sustained tightening of monetary policies?" I think it is reasonable to assume an impending economic slowdown, and my forex forecast is based on this assumption. Given that the U.S. FF interest rate is expected to reach the neutral rate level this year and attain a positive level in real terms next year, I anticipate that my basic understanding in this regard is likely to become increasingly significant. The current progressive flattening of the U.S. yield curve can probably be considered to be a situation that is supportive of my view. This article's main scenario continues to anticipate U.S. economic deceleration accompanied by a diminishing of the Fed's hawkishness, causing U.S. interest rates to fall back downward and spurring a trend of across-the-board USD depreciation that facilitates an intensification of JPY appreciation.

³ Please see the May 30, 2018 edition of Mizuho Market Topic, entitled "Japan's external asset/debt situation at the end of 2017 – The basis of JPY's 'safe currency' characteristics."

EUR Outlook –Start of ECB Interest Rate Hikes a Distant Prospect

ECB Monetary Policies Now and Going Forward – Balancing Concessions to Hawks (APP) and Doves (Interest Rates)

No Surprises Except the Early Date of the Announcement

At the June ECB Governing Council meeting, it was decided to keep the interest rate on the main refinancing operations (MRO), the rate on the marginal lending facility (the ceiling of market rates), and the rate on the deposit facility (the floor of market rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, with the interest rate corridor (difference between the ceiling and the floor) also remaining unchanged at 0.65 pp. However, the meeting was somewhat surprising in that it determined the termination schedule for the asset purchase programme (APP), since it had been generally anticipated that this schedule decision would not be made at such an early date. The schedule calls for making net purchases under the APP at the current monthly pace of EUR30 billion until the end of September 2018, reducing monthly net purchases to EUR15 billion from October through December, and ending the program within this year. Having decided to introduce quantitative easing (QE) in January 2016, the ECB is now planning to discontinue QE after about three years of associated asset purchases. Even after net purchases are ended, however, the ECB will continue reinvesting the principal payments from maturing securities purchased under the APP, so the scale of its balance sheet will be maintained. In addition, the Governing Council also indicated that it expects the key ECB interest rates to remain at their present levels “at least through the summer of 2019 and in any case for as long as necessary.” Accompanying these decisions, the ECB deleted the portion of its forward guidance statement indicating that interest rates will remain at their present levels “well past the horizon of our net asset purchases.” That phrase may have been intended to indicate that the interval or lead-time period from the APP termination date to the interest rate adjustment date was seen as being at least seven to eight months long. Thus, the latest Governing Council meeting’s key decisions related to three points – the termination of APP, the continuation of reinvestment, and the maintenance of interest-rate levels. While the Governing Council meeting attracted high-profile reporting and provoked sharp forex rate movements, the only really surprising aspect of the meeting is the timing of the APP termination announcement being in June rather than July, as had previously been expected. The plans to halve monthly net purchases during the last quarter of this year and maintain interest rate levels through next summer do not significantly differ from mainstream market expectations. Many commentators are saying the sharp EUR depreciation following the meeting reflects “the disappointment of market players who had factored in an interest rate hike in June next year,” but in the outlook for a rate hike next June has always been tenuous, and the market players who had factored in a June rate hike were not in the majority. The situation can be interpreted as one in which speculative EUR long positions were accumulated in response to the resolution of Italy’s political crisis and previous statements by the ECB’s chief economist, Peter Praet, and then the positions were disposed of based on the “buy on rumors, sell on facts” principle.

Concessions to Hawks on APP as Well as to Doves on Interest Rates

To repeat, terminating the APP within this year had been generally considered to be the predetermined route. Although there had been some differences of expectations regarding such issues as whether the termination would be in September or December and whether there would be tapering (EUR30 billion → EUR 15 billion) or not in the case of a December termination, most observers were in agreement regarding the high likelihood of “termination within this year,” and that was the mainstream market expectation. While I do not know the background factors causing the policy announcement to be made in June rather than in July, there is a possibility that the Governing Council expedited the announcement as a concession to its relatively hawkish members. There are some reports that certain Governing Council members had wanted to explicitly suggest the possibility of an interest rate hike in mid-2019. The latest Governing Council’s announcement that it expects to maintain current interest rate levels “at least through the summer of 2019 and in any case for as long as necessary” is dovish to an extent incompatible with the mid-2019 hike suggestion, so it may well be that the Governing Council decided to expedite the APP termination announcement as a compensatory concession to the hawkish members. Given the current fragile economic indicators and the prospect of additional political turbulence in Italy this autumn, there does not appear to be an obvious rational basis for expediting the APP termination announcement. Since the issues of extending the APP to October and beyond and tapering the APP were not discussed at the time of the April Governing Council meeting, one gets the impression that the APP termination announcement was very sudden. As reflected in one of the questions posed at the post-Governing Council-meeting press conference, which characterized the meeting’s statement as “a balance or a compromise between doves and hawks,” it appears that the Governing Council meeting’s decisions were made based on an internal politics calculation that balanced “a concession to hawks regarding APP” with “a concession to doves regarding interest rates.”

According to reports, some Governing Council members had proposed that the announcement to contain a proviso recognizing the possibility of an APP extension, but this proposal was rejected in order to give priority to the relatively

hawkish members. Examining the statement closely, one may note that the decision to taper after September is “subject to incoming data confirming our medium-term inflation outlook,” and this phrase appears to reflect the views of those members who desire to insert a proviso recognizing the possibility of an APP extension. But the avoidance of an explicit extension possibility proviso can probably be considered to be a concession to the hawkish members.

September 2019 a Key Date for Realizing an “Honorable” Finale Career

Although it can be said that concessions were made to both sides, it seems that the doves actually got the short end of the stick. It is true that – “we expect [key ECB interest rates] to remain at their present levels at least through the summer of 2019 and in any case for as long as necessary” – statement appears designed to cater to a maximum extent to the dovish Governing Council members but, as already noted, there were really not so many market players expecting an interest rate hike as early as June, so the prospect of a hike in September or later should not be considered to be much of a surprise. It may be that EUR selling was provoked by the “in any case, for as long as necessary” portion of that statement, but that portion can also be construed as having an opposite meaning, suggesting that – “If the economic and financial situation is good, it will be possible to raise rates in the summer of 2019.” The Governing Council meetings scheduled for next “summer” include those in July and September, and if a rate hike announcement were to be made at one of those meetings, it would be a decision completely at odds with dovish policy management.

Although it may seem cynical to suggest this, there is a possibility that the current Governing Council is concerned about whether it will be able to implement a rate hike by September 2019. That corresponds with the final ECB staff forecast revision prior to President Draghi’s retirement, and would be the last opportunity for President Draghi to choreograph an honorable ending to his career. Both in the orient and the occident, central banking analysts frequently come up with theories focused on individual central bankers’ career choreography motivations, and these theories are sometimes quite pertinent. Looking ahead, if German Bundesbank Governor Jens Weidmann (who is on the farthest-right wing among the hawks) were to be President Draghi’s successor, taking steps to make the associated policy transitions gradual rather than sudden and drastic would be the most considerate approach from the perspective of the financial markets. There are probably good reasons to expect the ECB to seek to realize an interest rate hike prior to the advent of its next president.

The Fed Required Three Years to Discontinue Reinvestment

As relevant information is still too scarce, it is probably still too early to begin seriously analyzing the outlook regarding the ECB’s reinvestment policy and the maintenance of the ECB’s balance sheet scale. A reporter at the press conference posed a question about – “how long those reinvestments will continue, and also whether they are tied to the interest rate hike” – and President Draghi responded – “we didn’t discuss the reinvestment policies you have noted; we will discuss it in the future meetings.” At this stage, it is probably not an issue that can be discussed realistically. In this regard, it is worth noting the Fed required three years after its October 2014 termination of QE to discontinue its reinvestment policy, even though it was blessed with positive domestic economic trends and was not concerned about currency appreciation. Since there is a high possibility that euro area’s economic cycle will continue to be facing challenges going forward, and given the ECB’s tendency to express its abhorrence of EUR appreciation, it would not be surprising if the ECB were to require somewhat more time to discontinue its reinvestment policy. Even if one were to assume that the ECB might be capable of discontinuing its reinvestment policy in the same three-year period the FRB required, the ECB decision to begin balance-sheet shrinkage would still be no sooner than some time around June 2021.

The upshot of these arguments may be the possibility of a – “September 2019 interest rate hike start, mid-2020 return to positive interest rates, and start of balance-sheet shrinkage from some time in the latter half of 2020 or in 2021” – outlook. As we move ahead within this prospective time-frame, however, there will be numerous momentous elections in euro area countries. By the autumn of 2019, in particular, such relatively problematic countries as Greece and Portugal will face challenges associated with general elections. Looking further ahead, Germany will be holding its federal election likely to determine its post-Merkel political trends no later than October of 2021, and France will be holding a presidential election in 2022.

ECB exit strategy fastest case (2018-2020)

	Period	Details	Political events
Decision	OCT 2017	Decision of APP extension & reduction	
	JAN -SEP2018	APP reduction (60bil 30bil)	
	OCT-DEC 2018	APP reduction (30bil 15bil)	Italy budget deliberation
	DEC 2018	APP abolition?	
Forecast	SEP 2019	Deposit facility interest rate hike(0.40% 0.30%)	Greece, Portugal & EU general election
	DEC 2019	Deposit facility interest rate hike(0.30% 0.20%)	
	MAR 2020	Deposit facility interest rate hike(0.10% 0%)	Spain general election & US President election
	JUN 2020	Deposit facility interest rate hike(0% +0.10%)	
	After SEP 2020	Balance sheet reduction	

(Source) Karakama, Mizuho Bank

Bad Timing for Interest Rate Hikes – Possibility of Zero Hikes in 2019

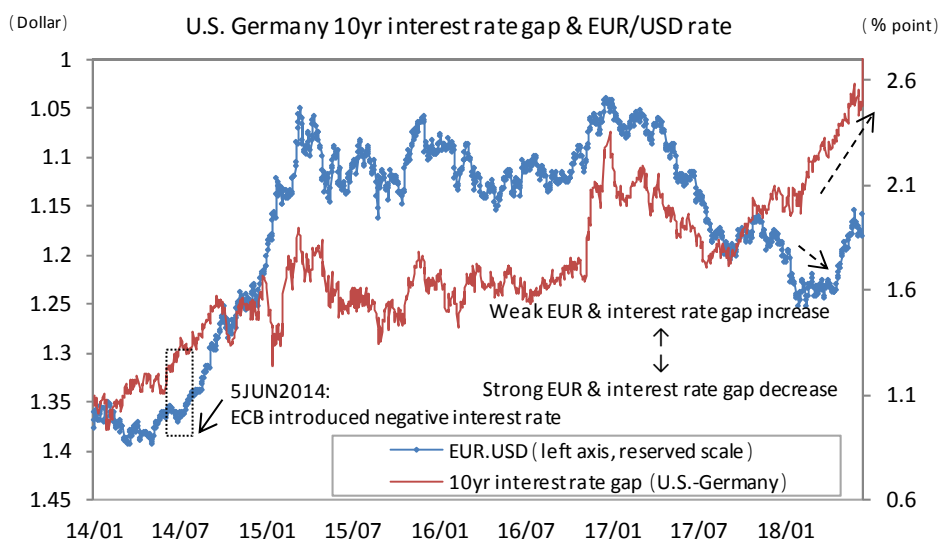
As this article has repeatedly argued, the ECB's biggest worry is about how to deal with interest rate hikes after the termination of the APP. While hiking interest rates itself is not necessarily a problem, the ECB's real concern is about how higher interest rates will promote EUR appreciation. According to the ECB's revised staff forecast (see right chart), the euro area Harmonized Index of Consumer Prices (HICP) is expected to be +1.7% during the 2018-2020 period, an upward revision from the previous forecast of +1.4% in the 2018-2019 period and +1.7% in 2020. However, the main reason for the upward revision is rising crude oil prices rather than wage inflation and, most importantly, the outlook of continuing to be unable to attain +2.0 inflation by 2020 is unchanged. Given such circumstances, one really wonders if it is going to be possible for the ECB to undertake policies that promote further EUR appreciation.

ECB staff outlook (June 2018)

	2017	2018	2019	2020
HICP	1.5	1.6 ~ 1.8	1.0 ~ 2.4	0.9 ~ 2.5
(Previous : MAR 2018)	1.5	(1.1 ~ 1.7)	(0.6 ~ 2.2)	(0.8 ~ 2.6)
Real GDP	2.5	1.8 ~ 2.4	0.9 ~ 2.9	0.6 ~ 2.8
(Previous : MAR 2018)	2.5	(2.1 ~ 2.7)	(0.9 ~ 2.9)	(0.7 ~ 2.7)

(Source) ECB

(Note) EURUSD is assumed to be 1.20 year 2018 and 1.18 year 2019-2020



(Source) Bloomberg

The ECB has enjoyed a EUR weakening trend for the past four years, since the introduction of negative interest rates in 2014. During that period, the ECB frequently rationalized the trend as reflecting the gap between U.S. and euro area monetary policies. It is true that there is a clear gap between the policies of the FRB – which has hiked interest rates seven times since December 2015 – and those of the ECB – which only hinted at its intention to normalize its policies a year ago, in June 2017 (the Sintra speech). It has therefore been reasonable to attribute the

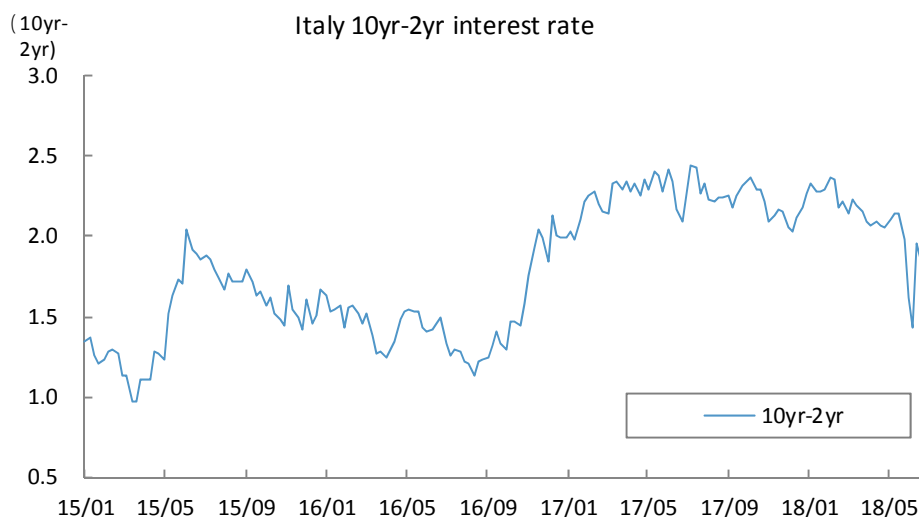
continued weak EUR trend to the U.S.-Europe interest rate gap. However, if things go smoothly, it is possible that the FF interest rate may reach the neutral interest rate level in the autumn of 2019. This may represent the “interest rate hike end point,” and there is also concern about the potential for yield curve inversion at that time. To the extent discernable from the most recent Governing Council meeting statement, it seems that the earliest date at which the ECB might hike interest rates is right about that time, and one might assume that such timing would be extremely poor in light of developments in the United States.

If the gap between U.S. and euro area monetary policies, which had previously been clearly broadening, were to suddenly begin a period of narrowing from autumn 2019, it is not difficult to imagine how EUR forex rates would be affected. Since negative interest rates are generally considered to be the main factor behind EUR weakness, there is a possibility of a surge of EUR appreciation in response to mere news about prospective interest rate hikes. EUR appreciated by up to 15% against USD following the Sintra lecture, and the ECB did not hide its displeasure about that trend. Given the ECB’s aversion to EUR appreciation, it is highly questionable whether the ECB will be capable of boldly advancing with interest rate hikes at a time when the Fed is marking time. Personally, I do not think the ECB will be able to do it. In addition, some observers believe the deterioration seen in the euro area’s fundamental economic indicators since the start of the year is attributable to EUR appreciation. Could the ECB really undertake interest rate hikes at a time when the euro area economy may be headed toward a cyclical downtrend? In light of all these factors, it appears that ECB may implement no more than one interest rate hike in 2019 (possibly one rate hike between September to December) and, given the possibility of adverse economic and financial situations, it is fully possible that there may even be zero hike in 2019.

Italian Policies Now and Going Forward – A Major ECB Miscalculation

Deep Claw Marks from Bear Flattening

Following the apparent resolution of Italy’s recent political crisis, there is a strong general tendency to consider the situation to be settled and over with. As EUR/USD has recovered from its recent nadir (USD1.1510) and the stability of Italian government bond yields has been restored, the Italian political situation has clearly been removed from the list of top forex market themes. However, there has been a major political transition among EU countries during the course of the European debt crisis since 2009 and the refugee crisis since 2015 (the advance of populist parties from being leading opposition parties to actually taking power) and, in the context of that transition, the historical significance of recent Italian political events is likely to turn out to be very large. That is my personal view at least. It seems that it should be seen as a sign of fear that bond markets’ yields remain undiminished undermined, “it can not be done as it is”. The continued disinclination of yields to decline in bond markets should probably be considered a reflection of market players’ fear that the crisis situation cannot be ended quite so easily. While there are signs of a peaking out of Italian government bond yields of all maturities, a series of turbulent situations has left deep claw marks from bear flattening, and this suggests fears of a sharp economic cooling trend in the near future. The experts are inclined to view the yield rise for relatively short-term maturities as reflecting the risk of Italy’s exit from the EU and the inevitable expansion of the forex risk premium associated with that risk, but one cannot always be sure of the extent to which financial markets have rationally taken into account all the relevant concerns. However, it is clear that Italy’s new government does seem to suggest a level of likelihood of the assumed “worst case scenario” (withdrawal from the euro area) in a manner that only a populist government could.

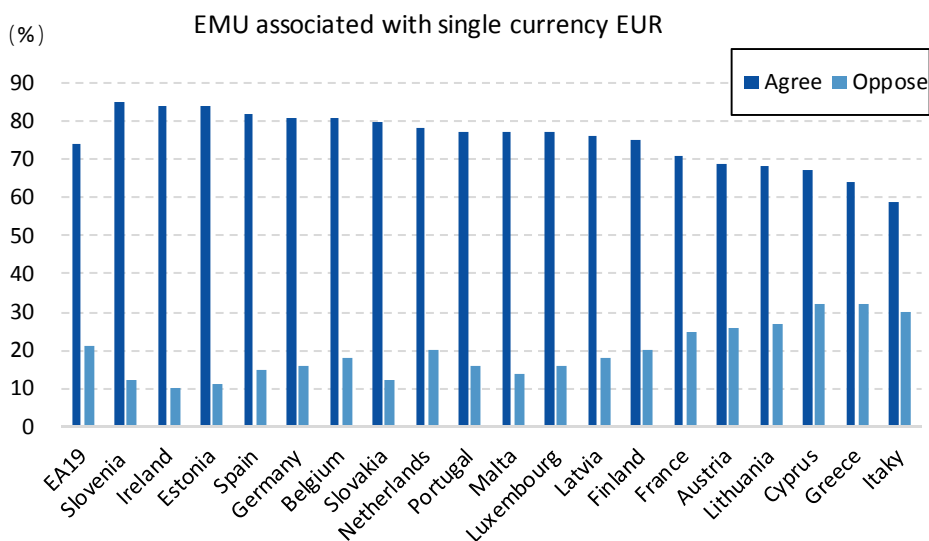


(Source) Bloomberg

Italy's Particularly High Level of Antipathy for EUR

Expansionary fiscal policies are the issue regarding which the far-left Five Star Movement (Movimento 5 Stelle, M5S) and far-right Northern League (Lega Nord, the League) are the most in agreement, and those same policies are the issue regarding which both parties are the most in disagreement with the basic policies of the European Commission (EU) and the ECB. Unless the coalition partners somehow able to agree on modifying certain key items of their platform – such as a minimum income security policy, the deferment of value added tax rate increases, and income tax reductions – they are likely to face severe conflicts with the EU akin to those experience by Greece in the first half of 2015. When a populist government faces insurmountable obstacles to implementing its agenda, its last resort measure will tend to be to organize a referendum. Even in the absence of a populist regime, when the United Kingdom's ruling party faced insuperable intraparty conflicts, it eventually consigned the decision-making power to a referendum, thereby paving the way to withdrawal from the EU. In light of that event in very recent history, it cannot be said that the worst-case scenario is inconceivable.

According to an IPSOS opinion poll of 1002 Italians questioned on May 30-31, 29% of respondents would vote to leave the euro area if a referendum on that subject were to be held on June 4, and only 40% of respondents had trust or confidence in the EU. Leaving the issue of confidence in the EU aside, it seems that the roughly 30% support for withdrawal from the euro area is a quite high level. As pointed out regarding the U.K. referendum and U.S. presidential election of 2016, it is a fact that major election and referendum upsets can easily result when there exists a 'silent majority' of people who are discouraged from declaring their true opinions in opinion polls by the vehemence of their ideological opponents. This situation was also seen in the German general election of September 2017, when AfD (Alternative for Germany) party won more additional seats than expected. Thus, it is shocking that about 30% of Italians openly support withdrawal from the euro area even at the present stage, when there is no real realistic prospect of a vote on that issue. According to the Eurobarometer poll conducted by the EC, Italy is the EU member country with the lowest level of confidence in EUR as a common currency (see graph on previous page). If a referendum were to be held, one cannot but fear the extent to which the share of negative votes might exceed the share of negative opinions expressed to the pollsters.

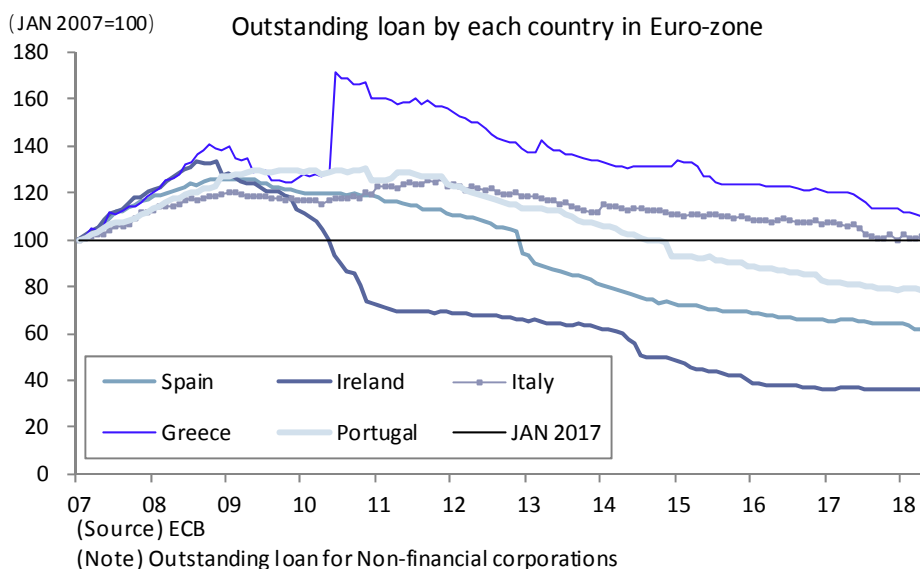


(Source) European Commission "Eurobarometer"

Lack of Progress in Dealing with Nonperforming Loans

The Italian parliament will begin full-scale budget deliberations this autumn, and it is expected that there will be some related skirmishes with the EU during the October-December quarter. Of course, the EU will seek to enforce compliance with EU limits on budget deficits by attempting to intervene in the new Italian government's budget drafting process but, depending on the nature of related developments, there is a possibility that the Italian government might respond by introducing mini-BOTs (small-denomination, non-interest-bearing, tradeable securities akin to a parallel currency that can be used to pay taxes and buy any services or goods provided by the state) and undertaking brinkmanship negotiations while brandishing the threat of holding an anti-EU referendum. At that time, there will be another upward bounce in Italian government bond yields. Viewed from this point in time, I think the ECB's decision to being shrinking APP asset purchases from October will be accompanied by a considerable amount of risk. It seems likely that the direction of the Italian political situation and the ECB's monetary policy management may be influenced by consciousness of the question of whether Italy's domestic banking sector, which holds a large quantity of Italy's government bonds, will be able to cope with a rise in the yield of those bonds. As is

well known, the share of nonperforming loans within Italian domestic banks' assets is a remarkably high at 11.1%, compared with 4.9% share of nonperforming loans for banks within the euro area as a whole. Of course, one might expect that Italy's disposal of bad loans is progressing amid positive economic conditions, but Italy's overall balance of loans has not changed much (see graph). Normally, one would expect to see the overall loan balance decline significantly during the nonperforming loan disposal process, so the lack of much of a drop in Italy's overall balance is probably due cause for concern. During the European debt crisis era, there has been a uniform trend of decrease in the balance of loans in Italy and the other southern European countries that were key market-destabilizing factors, so Italy's outlier situation is conspicuous. It is likely that individual countries' levels of vulnerability to rising interest rates will be an important issue in the course of future developments.



Current Account Surplus Cause for Concern?

It is precisely because of this problematic state of Italy's domestic financial system that Italy's new government might be expected to do its utmost to avoid a full-scale confrontation with the EU, so the main forecast scenario is one in which the government shifts to a more-realistic policy course. While Italy's international competitiveness would undoubtedly improve with a withdrawal from the euro area, the country's banking and corporate sectors would be highly likely to suffer great damage during the process leading up to such a withdrawal, and this suggests that the most likely outlook is one in which the ruling parties will have to adjust their policies when confronted with harsh realities. Although it may seem paradoxical, the seriousness of the prospective situation may well be exacerbated by the fact that Italy has a current account surplus. Greece's 2015 decision to yield to EU demands stemmed largely from its recognition that it could not receive Emergency Liquidity Assistance (ELA) without making a political compromise. Italy's current account surplus reached a new record high level of USD56.1 billion (2.9% of its GDP) in 2017, and this surplus may be considered a sufficient basis for resisting EU demands for a certain period of time, but if the confrontation is prolonged, the ultimate damage to Italy's domestic economy is likely to be increased.

In any case, it must be recognized that the fluidity of political situations makes it difficult to rationally forecast the related outlook at this point in time. But one thing that can be said with a fair amount of confidence is that it is still too early to consider Italy's political crisis finished.

Brexit Now and Going Forward – Biggest Event in the Latter Half of the Year?

Prime Minister May Survives Once Again

The U.K. withdrawal from the EU (Brexit) is likely to be the biggest news event during the latter half of this year, and I would like to present a short follow-up feature on Brexit in light of the considerable progress of related situations during June. The House of Lords' 'meaningful vote' amendment of the EU withdrawal bill attracted considerable attention but was rejected by the House of Commons by 319 to 303 vote on June 20. The amendment called for the government to seek parliamentary approval of its withdrawal policy in the case that the negotiations with the EU fail and would have given Parliament the right to make a 'meaningful vote' on any withdrawal agreement negotiated by the prime minister. In short, it was an amendment designed to strengthen the Parliament's authority regarding the Brexit negotiations. The EU withdrawal bill itself was narrowly saved by 324-to-298 House of Commons vote on June 12, after Prime Minister Theresa May reached a compromise with 'moderate' rebels (pro-EU MPs) within the ruling Conservative Party. However, discrepancies emerged between the positions of the rebel faction and the

government regarding the law's wording and interpretation, leading to the additional June 20 vote on the withdrawal bill. After the vote, a Department for Exiting the European Union (DExEU) spokesperson said: "We have not, and will not, agree to the House of Commons binding the government's hands in the negotiation." In addition, Secretary of State for International Trade Liam Fox told the BBC that – "There is no change to the fundamental issue here which is the government cannot be forced by Parliament to negotiate something which it does not want to do [and the government had] to be able to hold out in our negotiations the prospect of no deal [otherwise the EU would get the upper hand]."

The basic policy of Prime Minister May's government is to exclude Parliamentary influences as a means of enabling itself to flexibly negotiate the withdrawal, and it has repeatedly made strong statements both domestically and overseas of its intention not to compromise on that point. Prime Minister May has faced crises with the potential for bringing down her government numerous times, but she has each time managed to escape from the brink of disaster.

Prime Minister May's Perilously Narrow Path

This time, Prime Minister May had to tread a perilously narrow path to salvation. If the amendment had been passed and the final decision-making authority on the withdrawal policy had been transferred to Parliament, the risk of U.K. withdrawal from the EU without a negotiated agreement – referred to as 'hard Brexit' or jumping off the 'cliff edge' – would have receded, and the potential for effectively retaining preferential tariff arrangements and access to the single EU market (so-called 'soft Brexit') would have increased. In such a case, the risk of Brexit becoming a "nominal departure" would increase, and Prime Minister May would have lost face and might have been forced to resign. That situation could potentially lead to political turmoil including the possibility of dissolving Parliament and holding new elections. As simply rejecting the 'moderate' faction's meaningful vote amendment could have led to the government's downfall, Prime Minister May recognized a need to show a reasonable spirit of compromise. The threat to the government was very realistic, because cooperation between the Conservative Party's 'moderate' faction and the opposition party might have orchestrated a parliamentary majority positioned to pass a no confidence motion. If such a scenario had actually taken shape, it would have had the disastrous outcome of a general election being held only a half year before the effective Brexit negotiation deadline. In other words, Prime Minister May faced the difficult task of "maintaining the face of 'hard-liners' including herself while also respecting the views of the 'moderates'," and she was just barely able to succeed in carrying out that task by obtaining the support of some members of the 'moderate' faction.

European Union (Withdrawal) Bill Passed Based on a Subtle Balance of Power

The May government had to utilize considerable persuasion and concessions to surmount the challenges. Previously, the government ('hard-line' faction) and the moderate faction agreed that if a deal negotiated by the government with the EU is rejected by parliament, or if a deal has not been reached by Jan. 21, 2019 (or if Prime Minister May announces the likelihood that a deal will not be reached by that date), the government will have to come up with a new plan of action and present it to Parliament. However, the May government's basic stance is that its policy will not be bound by the Parliament's deliberations at that time, and that Parliament's vote should be "on neutral terms", simply noting what has been presented by the government. The government ('hard-line' faction) strongly believes that – "Parliament cannot tie the hands of government in negotiations." – as expressed by Prime Minister May. In response, the 'moderate' faction demanded that Parliament have the right to deliberate on the proposal and propose amendments to the action plan if it deems necessary. In short, if Parliament were to instruct the government to continue negotiations, the government would have to continue negotiations, and an "exit without an agreement (cliff edge scenario)" would not be possible. The 'moderate' faction's objective is to prevent such a cliff edge scenario. From the perspective of the government ('hard-line' faction), the potential for a cliff edge scenario must be maintained as a necessary bargaining card for use in negotiations with the EU, so precisely defining and limiting the nature of Parliament's deliberations and votes on the action plan is a very important point.

Ultimately, the government conceded that, in the case that negotiations break down, increasing the possibility of a cliff edge scenario, the government will present a new action plan to Parliament for its consideration, but the question of whether there is a need for revisions to the plan or not will be left up to Commons Speaker John Bercow to decide at that time. This made it possible to preserve the face of the government ('hard-line' faction), which was intent on precluding Parliament's influence on the plan, while also ensuring that the 'moderate' faction will retain the right to speak out about the plan. In any case, after the amendment was rejected by the House of Commons, the European Union (Withdrawal) Bill in its original form was finally approved by Parliament, received royal assent from the Queen, and thereby officially became law. The bill enables EU law to be transferred into UK law as a means of promoting a smooth Brexit process.

However, while the bill was passed based on a subtle balance of power between the government ('hard-line' faction) and 'moderate' faction, it is not completely clear whether it will be possible to implement the bill in a stable manner, and it seems that this issue will probably not become clear until the possibility of a cliff edge scenario increases to a certain extent. It to be hoped that the worries and concerns about this situation will turn out to be baseless.

Evidence that Parliament's Right to Have a Voice Is Strengthening?

During the course of a series of Brexit-related developments, financial markets have maintained a positive perspective on the situation, and GBP has been appreciating, but interpreting this scenario is not easy. It can be said that there is a general good feeling about the fact that the 'moderate' faction was somehow appeased and the worst-case scenario of new elections was avoided but, ultimately, it remains true that the optimal scenario from financial markets' perspective will be a 'soft Brexit'. It is also true that maintaining the May government's basic policy strengthens the U.K.'s negotiating position, and this may be a positive factor with respect to 'short-term stability'. On the other hand, there remains some uncertainty about how the government and Parliament will interact in the case that the possibility of a cliff edge scenario increases, so maintaining the May government's basic policy may not necessarily be a positive factor with respect to 'future stability'. The 'hard-line' faction led by Prime Minister May appears to believe that it is now in a stronger position to negotiate with the EU, but it remains to be seen whether the EU agrees with this assessment. Given the perspectives of the 27 countries slated to remain in the EU, there appears to be a strong disinclination to allow the U.K. to exit while 'cherry picking' only those EU arrangements that it finds appealing. It therefore seems reasonable to anticipate that, regardless of the political situation in the U.K., the EU will not be inclined to go easy on the U.K. Thus, the continued risk of a cliff edge scenario is evident. In any case, the recent struggle regarding the amendment of the European Union (Withdrawal) Bill was evidence of a sudden increase in the right to have a voice of the portion of the British parliament desiring to promote a 'soft Brexit'. Positioned between the conflicting demands of Parliament and the EU, Prime Minister May has been showing an unexpected amount of tenacity, but it remains unclear how long she can maintain her position. In the case that, as just seen, Parliament progressively increases its involvement with the negotiating process, it is likely that GBP forex rates will become unstable over the short term, but there is also a possibility of a general reevaluation of the situation and a resurgence in GBP in the case that the May government chooses to compromise somewhat with the Parliament in that regard. In light of GBP forex rate movements during the recent political crisis, it is impossible to rule out the possibility of sharp fluctuations going forward. The next step will entail negotiations about the trade and tariff arrangements that will be key determinants of the 'future relationship' between the EU and the U.K. This can be said to be the crux of the Brexit negotiations, and it is highly likely that it will be characterized by complex twists and turns.

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