

Forex Medium-Term Outlook

1 February 2019

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Forex Department

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Overview of Outlook

Over the past year, my main forecast scenario in this report has been that, with the end of the Fed's policy normalization process, both U.S. interest rates and USD will fall, and against this, a strong appreciation of JPY cannot be avoided. JPY did strongly appreciate early this year, which appeared to suggest that my forecast was close to coming true. In fact, it would not be too much of a stretch to say that the January FOMC meeting statement did, indeed, declare an end to the normalization process, and I would like to predict a further adjustment in U.S. interest rates and USD around the time that the dot plot is revised in March. Already some FF interest rate futures market participants are factoring in a rate cut within the year, so the trend has clearly switched to "the next move after normalization." In the event that the financial markets become even more pessimistic than they are currently, it is not impossible that the Fed will begin to hint at a rate cut or suspension of its balance-sheet size reduction (or an expansion) as its "next move." If that happens, U.S. interest rates and USD will inevitably undergo further corrections. The biggest risk to this forecast scenario would be a repeat performance of 2018, i.e., the U.S. economy surprisingly retaining its strength, allowing the Fed to proceed with its policy normalization efforts. If that happens, JPY's potential to appreciate will be curtailed yet again. However, even if that does happen, it will not change the fact that the U.S. economy has reached the limits of its growth potential. If we assume that the possibility of the U.S. economy accelerating during the forecasting period is miniscule, it is rather difficult to predict JPY depreciation against USD.

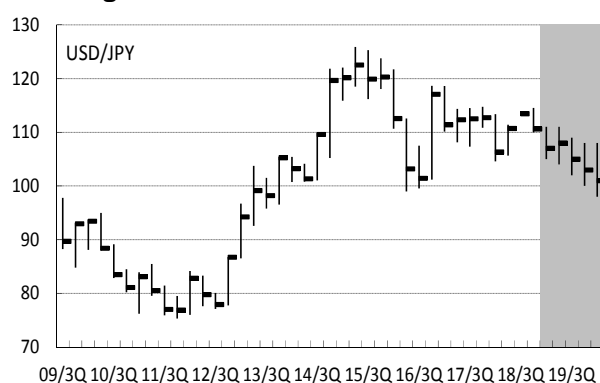
Meanwhile, EUR remained strong in January. Frankly speaking, the climate surrounding EUR is quite unfavorable, with uncertainties related to Brexit negotiations intensifying, euro area fundamental economic indicators deteriorating one after another, and various international organizations all increasingly forecasting an uncertain fate for the euro area going forward. Despite all this, EUR is not just stable, but even appears to have an underlying strength. This is not because of a positive evaluation of the economic, financial, or political conditions in the euro area, but largely due to the fact that USD has been predominantly sold off in the markets since autumn last year. However, one cannot say that this is the only reason behind EUR's strength. Precisely because the political and economic conditions within the region lack vigor, risk appetites have taken a hit, and investment activity involving overseas risks are lackluster, and this must also be noted as one of the reasons. EUR does not crash is because, even though there are no significant funds coming into the region from outside based on a positive assessment of the region's economy, the funds flowing out of the region into other economies is also limited. My original forecast that EUR will retain its strength for passive reasons including the depreciation of USD and a predominantly repatriation-oriented flow of capital, therefore, remains unchanged.

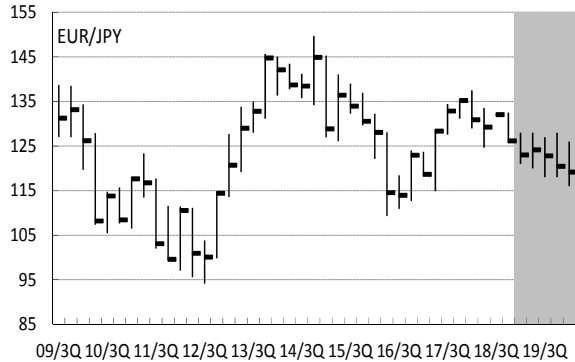
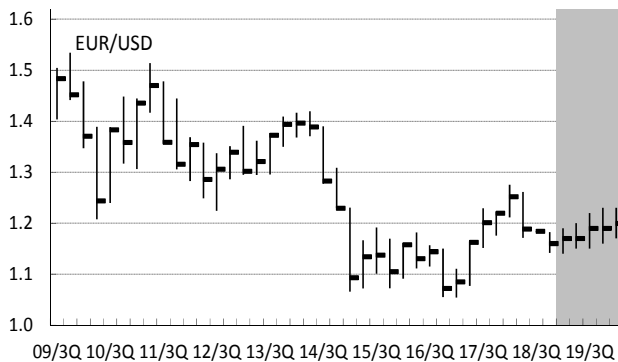
Summary Table of Forecasts

	2019					2020
	Jan (actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	104.10 ~ 110.00 (108.85)	105 ~ 111 (107)	104 ~ 111 (108)	102 ~ 109 (105)	100 ~ 108 (103)	98 ~ 108 (101)
EUR/USD	1.1289 ~ 1.1570 (1.1446)	1.11 ~ 1.17 (1.15)	1.10 ~ 1.18 (1.15)	1.12 ~ 1.20 (1.17)	1.14 ~ 1.21 (1.17)	1.15 ~ 1.21 (1.18)
EUR/JPY	117.85 ~ 125.22 (124.59)	121 ~ 128 (123)	120 ~ 128 (124)	118 ~ 127 (123)	118 ~ 128 (121)	116 ~ 126 (119)

(Notes) 1. Actual results released around 8:30 am TKY time on 1 February 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



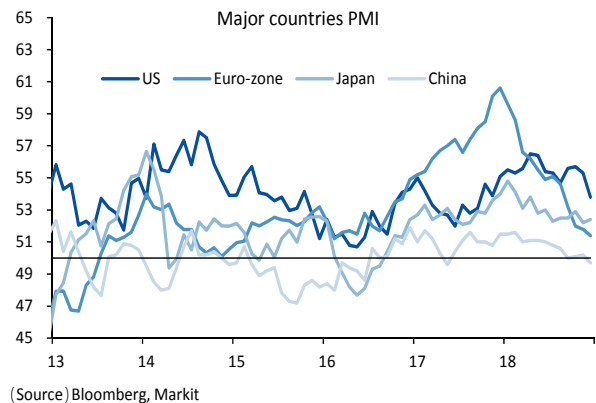


USD/JPY Outlook – Finally a Declaration of the End to the Normalization Process

USD/JPY Now and Going Forward – 2019 Began with JPY Appreciation

Finally, a Clear Report of the Signal Gun

Early in the morning of January 3, Japan time, USD/JPY plunged to 104.10, a low not seen since March 2018. Amid heightened insecurities over a decline in U.S. interest rates and drop in U.S. stock prices against the backdrop of a U.S.-China trade war and the shutdown of federal government agencies, a major U.S. IT company Apple announced a downward revision of its revenue forecast, causing the creeping suspicion of a global economic slowdown to approach the proportions of a certainty. What is more, the reason for the downgrade was weakened sales in China, which appears to have further fanned the insecurities (although, the decline in sales is thought to be due to the maturing of the smartphone market rather than the U.S.-China trade war). Subsequently, USD/JPY was bought back and recovered to the 110 level, but there is no denying that the level of the currency pair has fallen a notch. There often needs to be a clear signal before a bubble collapses. Last time, this came in the form of what is called the “Paribas shock” or the “Lehman shock.” This time, could this be the “Apple shock” under which stock-price corrections spread? Further, on January 2, China’s December Manufacturing PMI was released, posting 49.7, lower than the neutral level of 50 (the dividing line between economic expansion and contraction) for the first time in a year and seven months (see graph). The manufacturing PMIs of other major countries have also been deteriorating across the board, so there is no longer any doubt that the global economy is peaking out. 2019 is likely to be the year that plumbs the depths of the global economy.



Meanwhile, to digress a bit, one gets the impression that developments of this kind tend to take place over the New Year or Golden Week breaks, which are periods when only Japanese investors, as opposed to investors elsewhere, take long breaks. By now it seems like a seasonal event to hear that these events are devised to induce individual Japanese investors to cut their losses and take advantage of this. From the perspective of avoiding too much of a shock, going along with global standards may not be all that much of a pipe dream.

Don’t Forget the Major Precondition for the “Plan” to Work

Should the recent market movements be seen as a “plan” devised to take advantage of the long break during which trading in Japan tends to be limited? In a way, they probably are. However, on a fundamental level, that is probably not their most important aspect. To begin with, for the success of any plan that aims to lower U.S. interest rates or USD/JPY, a major precondition is global economic slowdown and the accompanying revision of the Fed’s policy stance. Without that, the plan has no chance of success. It is logical to assume that the underlying somber mood is what caused short-term speculative traders to embark on such actions. Although USD/JPY’s drop to the 104-level was very temporary this time, the fact is that during strong-JPY phases, USD/JPY declines to lower levels amid great volatility, going three steps forward and two steps back.

The interpretation that these movements are “planned” is correct in the short term, but one must also have the medium-term perspective that the global economy is poised at the summit of its recovery. Again, the Fed’s official forecast (median) is that the policy interest rate will be raised twice in 2019. It would be wise to prepare for a market correction as this forecast goes up in smoke.

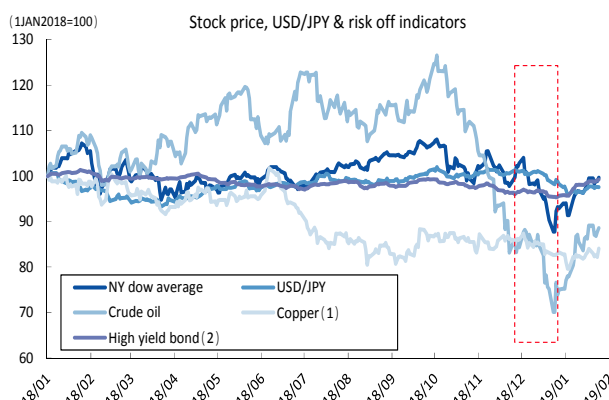
“JPY Buying During Risk-Off Phases” Still Alive

The recent developments have also proved that the trends of “buying JPY during risk-off phases” and “buying JPY as a safe haven currency” are still alive¹. The reason why USD/JPY showed almost no movement despite the violent corrections in stock prices starting October last year was not because JPY stopped being seen as a safe haven currency, as some bullish analysts said. It was merely because a “risk-off” phase had not yet begun. During a risk-off phase, a flight of capital can be seen not just from stocks, but also other relatively high-risk assets such as commodities (oil, metals, etc.) and high-yield bonds. This did not happen during October-November last year, probably because that was merely a correction of overheated U.S. stock prices.

However, since December, we have clearly entered a risk-off phase, with the main theme shifting from “overheated U.S. stocks” to “a change in the Fed’s path” and “global economic slowdown” (see graph).

Behind this are several things including real damage from the U.S.-China trade war, the flight of capital from emerging economies following U.S. rate hikes, political instability in the EU, and the resulting global economic slowdown (deteriorating corporate revenues) – all of these, despite being pointed out so frequently as risk factors, were being ignored throughout 2018.

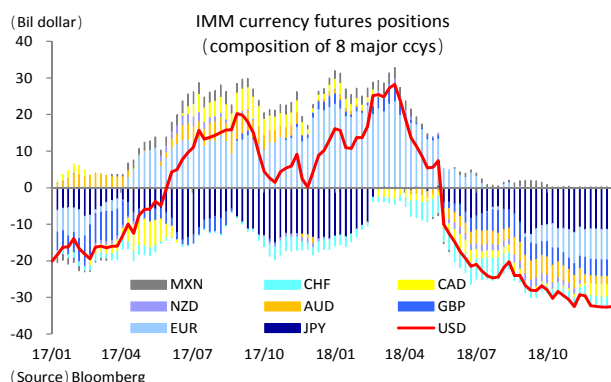
Ultimately, the root cause of the problem still remains the same as it was a year ago. It is simply that it has become easier to visualize following the downgrading of a major U.S. IT company’s revenue forecast, and the phenomenon will probably continue to manifest itself in a variety of ways going forward. Again, employment-related indicators tend to have a major impact on financial markets, but employment and wage-related indicators are some of the most lagging economic indicators, and it must be kept in mind that by the time they change for the better, the economy is likely to be close to peaking.



(Source) Bloomberg
(Notes) 1: LME copper 3mth forward. 2: Bloomberg/Barclays Global HY Total Return Index

“Sudden” but not “Abnormal”

Through 2018, IMM currency futures transactions showed that speculators were accumulating short positions not just in JPY but in many other currencies against USD (see figure; N.B. Due to the government shutdown, the latest releases available are from January 1, 2019). This was only natural, given that the Fed was proceeding with its normalization process. However, if the markets assume a change in the Fed’s policy operation path, as mentioned above, the cost of selling USD will go down, and this will act as an incentive for investors to close their previous positions. However, from October through December last year, despite the U.S. 10-year interest rate dropping from 3.2% to 2.7%, USD/JPY remained range-bound. The fact that the



(Source) Bloomberg

correction in response to the decline in U.S. interest rates has abruptly begun now may be “sudden,” but I do not believe it is “abnormal.” The U.S. 10-year interest rate has now fallen to 2.55%, but when USD/JPY fell to the 104-level in February-March last year, it had been corrected down to the level of 2.80%, which was said to have prevented USD/JPY from falling through the floor. This time, it does not seem likely that U.S. interest rates will be able to act as a breakwater. Unlike last year, the Fed’s next move is at best “maintaining the *status quo*” but possibly a shift to a more dovish position. From an orthodox perspective, a gradual decline in the U.S. 10-year interest rates and an accompanying depreciation of USD itself is a reasonable basic scenario. The chaotic developments at the start of the year are in line with the storyline presented in previous issues of this report and the Forex Medium-Term Outlook report, raising the accuracy of my forecast.

Rate Outlooks of Big Three Economic Organization Chiefs

On January 7, the big three Japanese economic organizations (the Japan Business Federation (KEIDANREN), the Japan Chamber of Commerce and Industry (JCCI), and the Japan Association of Corporate Executives (Keizai Doyukai)) held a new year meeting in Tokyo, and their leaders each presented their respective outlooks for stock prices and forex rates. Their views have not been influencing the markets in particular, but given that these are the outlooks of some of the leaders of the financial world, I would like to summarize them here. With regard to USD/JPY, KEIDANREN Chairman Hiroaki Nakanishi, JCCI Chairman Akio Mimura, and Keizai Doyukai Chairman Yoshimitsu Kobayashi all predicted more or less similar ranges of 100-110, 100-115, and 104-115, respectively. Collectively, their predictions appear to be suggesting a quiet

¹ Please see the October 24, 2018 issue of Market Topic titled “Why the trend of buying JPY as a safe asset does is failing to gather momentum,” for instance. Also see the article titled “Answering the questions ‘Is the trend of buying JPY during risk-off phases dead?’ and ‘When will the trend of weak USD/strong JPY begin?’”, published by Toyo Keizai Online on October 27, 2018.

market resembling last year's. My own outlook assumes a 100-110 range with the possibility also of falling below 100, which is closest to Mr. Nakanishi's outlook.

However, even within this range, one's diagnosis of the Japanese and global economies could be quite different depending on whether one predicts a longer duration for the 100-105 range or the 105-110 range. I am concerned about the continued fall in stock prices, but Mr. Nakanishi's outlook in this regard was "stock prices will probably remain at JPY20,000 level," which gives the impression that he assumes that USD/JPY will remain in the 105-110 range for longer. The Annual Survey of Corporate Behavior is released by the Cabinet Office every year in February or March, and if we look at the FY2017 survey (which was conducted during early 2018 and released on March 2, 2018), the forecast USD/JPY rate one year from the time of the survey (January 2018) was 114.3, while the break-even USD/JPY rate was 100.6 (see chart). As of the moment, JPY has strengthened to the level of 108 to the dollar, but going by the break-even rate, there may be room for further strengthening. Again, the prediction of the top three chiefs that USD/JPY will not fall below 100 may be not just a "forecast" but also "wishful thinking" based on the implications for business profits.

Forecast USDJPY rate after 1 year & break-even USDJPY rate by "Annual Survey of Corporate Behavior"

Survey year	Forecast USDJPY rate after 1 year	Break-even USDJPY rate	USDJPY rate 1 month before survey ()	-	-	-1 year before (Deviation of the forecast)
2000	114.2	107.0	112.2	7.2	5.2	4.6
2001	132.8	115.3	127.4	17.5	12.1	13.2
2002	124.5	114.9	122.3	9.6	7.4	-10.5
2003	109.3	105.9	107.9	3.4	2.0	-16.6
2004	106.4	102.6	103.8	3.8	1.2	-5.5
2005	113.2	104.5	118.6	8.7	14.1	12.2
2006	115.5	106.6	117.3	8.9	10.7	4.1
2007	111.0	104.7	112.3	6.3	7.6	-3.2
2008	97.0	97.3	90.4	-0.3	-6.9	-20.6
2009	95.9	92.9	89.6	3.0	-3.3	-7.4
2010	88.4	86.3	83.4	2.1	-2.9	-12.5
2011	80.3	82.0	77.9	-1.7	-4.1	-10.5
2012	88.4	83.9	83.6	4.5	-0.3	3.3
2013	105.7	92.2	103.5	13.5	11.3	15.1
2014	119.5	99.0	119.4	20.5	20.4	13.7
2015	120.9	103.2	121.8	17.7	18.6	2.3
2016	113.1	100.5	116.0	12.6	15.5	-4.9
2017	114.3	100.6	113.0	13.7	12.4	-0.1

Note 1) Forecast : Class values average Break even rate: real value average Note 2) Break-even rate: exporters only

Note 3) USDJPY rate 1 month before survey: December excluding FY1994 & FY2008 (FY1994 & FY2008: January)

(Source) Cabinet of office, Government of Japan & Bloomberg

Excessive JPY Strength vs. Excessive JPY Weakness

In some ways, a USD/JPY rate below 100 may not be abnormal. As I have repeatedly explained in this report, the 95-110 range seems to a balanced range for USD/JPY based on the various types of purchasing power parity (the "PPP core zone"), so it seems reasonable to see a rate below 95 as signifying excessive JPY strength and a rate above 110 as signifying excessive JPY weakness (see chart to right). Looking back at the past five years, the most that USD/JPY swung in the direction of JPY strength within this core zone was right after the UK referendum approving Brexit (on June 23, 2016), when it temporarily hit 99.0. The weak JPY trend, however, has dominated, with USD/JPY remaining over 110 most of the time since October 2014 – normalizing deviation from the core zone. Although the currency pair remained below 110 for an extended period from April to November 2016, the only difference was that it was within the core zone during this period. The prediction of the leaders of the financial world that USD/JPY will not fall below 100 is close to the median of market forecasts, but in preparing my forecasts going forward, I would like to take into account that JPY has long remained at a level that can be evaluated based on PPPs as excessively weak.

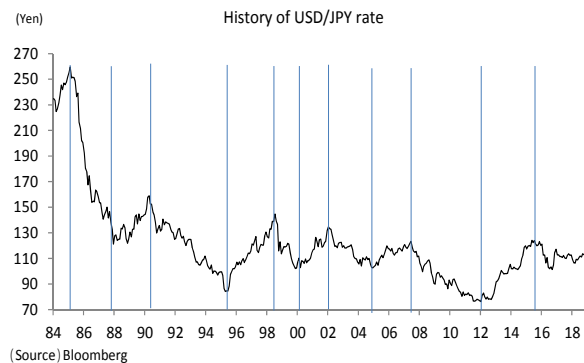
Reference points of USD/JPY rate

JPY rate	Evaluation Standard
57.6	Purchasing Power Parity (export prices, 1973 base, Nov 2018)
72.0	Big Mac Parity (Economist magazine, Nov 2018)
74.3	Purchasing Power Parity (export prices, 1980 base, Nov 2018)
77.0	Purchasing Power Parity (Mid point between export prices and corporate goods prices, 1973 base, Sep 2018) Note 1
90.5	Purchasing Power Parity (corporate goods prices, 1980 base, Nov 2018)
96.5	Purchasing Power Parity (corporate goods prices, 1973 base, Nov 2018)
96.7	Purchasing Power Parity of materials within manufactured products, etc. (METI, FY2016 survey)
99.6	Purchasing Power Parity (OECD, 2017, GDP base) Note 2
99.6	Purchasing Power Parity (World Bank, 2017)
100.6	Break-even rate for exporters as of Mar 2018 (Cabinet survey, FY2017)
101.2	Purchasing Power Parity (consumer price, 1980 base, Nov 2018)
106.2	Purchasing Power Parity (OECD, 2017, private consumption) Note 2
108.7	31 January 2019
109.4	Corporate planning rate (BOJ Tankan, Sep 2018 survey, fiscal year)
114.3	Next year ahead forecast rate as of Mar 2018 (Cabinet survey, FY2017)
124.0	Purchasing Power Parity (consumer price, 1973 base, Nov 2018)
132.7	Purchasing Power Parity of processing/assembly within manufactured products, etc (METI, FY2016 survey)
159.0	Overall Purchasing Power Parity of manufactured products, etc. (METI, FY2016 survey)
260.9	Purchasing Power Parity of energy within manufactured products, etc. (METI, FY2016 survey)

(Source) Made by Daisuke Karakama, Mizuho Bank (Note 1) support level more than 10 years (Note 2) Purchasing power parity (OECD) as of July 2017 (revised every Jun & Dec)

The History of USD/JPY The History of JPY Appreciation The History of Deflation

Given the forex rate climate in recent years, however, it is not difficult to see why the leaders of the financial world would all predict another year of little movement in forex rates. Over the past five years, except in 2014 and 2016, which were characterized by a series of major developments including sensational monetary easing by the BOJ under Governor Haruhiko Kuroda, the referendum approving Brexit, or the election victory of U.S. President Donald Trump, the USD/JPY movement range has been extremely narrow – the narrowest ever in 2018 (last year), the second narrowest in 2015, and the sixth most narrow in 2017. 2017 and 2018 also combined to form the two-year period with the narrowest range of all time.



This year will mark the 33rd anniversary of the signing of the Plaza Accord, and in all these years, there has never before been a phase when the rates were this stable. If we divide up the years since the Plaza Accord into major USD/JPY movement phases, my understanding is that we are currently in the 11th such phase (see figure on the next page), a phase that seems to be characterized by a lack of direction (although, we could perhaps say that the direction has been vaguely toward JPY appreciation since July 2015).

Having said that, as one can tell at a glance from the graph, the history of USD/JPY is also the history of JPY appreciation. This is probably why the history of JPY appreciation has coincided with the history of deflation. To the extent that inflation in Japan is lower than that in the U.S., Japan's international competitiveness was cancelled out through the strengthening of its domestic currency – theoretically, such a strengthening was bound to happen. December 2012 saw the birth of the second Shinzo Abe administration, and the following April, the BOJ implemented unprecedented monetary easing under the leadership of Mr. Kuroda, but this has not ultimately resulted in any fundamental change in Japan's inflation situation. Naturally, there has been no change in the relative gap between Japanese and U.S. inflation rates either. If so, it may not be too difficult to imagine the direction of structural pressures likely to be exerted going forward. I think it is important not to get so lulled by the quietness of the recent years as to forget the theoretically expected direction of rate movements.

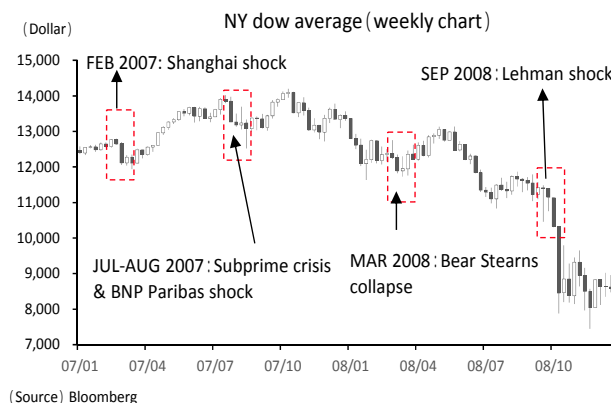
Stock Markets Now and Going Forward – The Real Bubble Begins After the Bubble has Collapsed

Fed Finally Begins to Relax Its Fighting Pose

As I argued in last month's issue of this report too, in my view, the key phrase for the global economy this year is "peak out," and I think that stock and other asset prices will begin to weaken as a reflection of the global economy, which has already reached its recovery limits, and that the central banks of various countries (especially the U.S.) will have to revise their current monetary policies in accordance. Under such circumstances, my basic forecast scenario for the bond markets is a decline in U.S. interest rates, and that for the forex markets is USD depreciation. In this context, Fed Chair Jerome Powell acknowledged in a speech on January 4 that the markets were jittery about the global economy and said that the Fed was prepared to soften its monetary policy stance if necessary. Finally, it seems the Fed has begun to relax its fighting pose, which it had been justifying based on concerns of inflation. I think it would be appropriate to see this as a development in line with my basic forecast scenario. In addition to such remarks by the Chairman, U.S. December job data, released on January 4, was also surprisingly strong, so stocks have been on the mend since early this year. Having said that, one cannot overlook the fact that both the NY Dow Jones Industrial Average and the S&P 500 recently posted their largest decline since 2008. It would be difficult not to characterize such a movement as a "peaking out," and it is precisely because of it that some in the FF interest rate futures market have even begun to factor in a rate cut within the year. Given that the financial markets have not experienced a downward phase over the past 10 years, one must expect to see various kinds of crises going forward.

The Real Bubble Begins After the Bubble has Collapsed

Having said all that, it is not ordinary for the stock markets to fall/climb several hundred dollars day-on-day. As I repeatedly mention in this report, this kind of volatility at high levels is a sign of the last stages of a bubble. To begin with, the turbulence in the U.S. stock markets seen before and up to Christmas last year were said to have been owing to concerns over the reckless actions of the Trump administration – the federal government shutdown, the resignation of U.S. Defense Secretary James Mattis, and suspicion that Fed Chair Jerome Powell was about to be fired. Of course, concerns about the U.S.-China trade war were also thrown into the mix. However, it is not as though

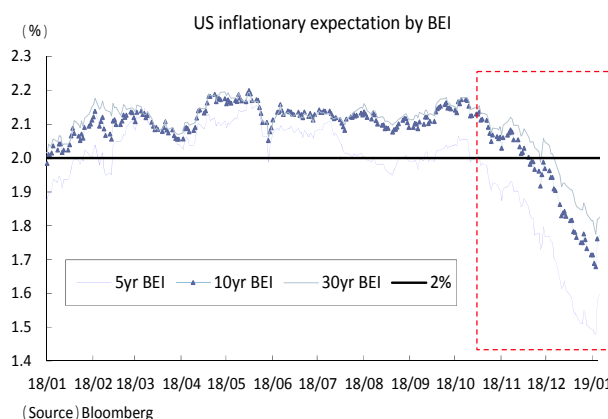


the above concerns no longer exist since December 26, nor can the effect of several successive rate hikes be canceled out simply by the Fed changing course on its policy normalization efforts at this late hour. All this strengthens my suspicion that the repeated stock-price volatility is because of the withdrawal of market participants who are not convinced of a continued increase in stock prices, leaving prices to be determined mainly by short-term speculators. Looking back at 2007, stock prices managed to continue rising and posting new record highs through most of the year despite crashing in February (the Shanghai Shock) and July (the BNP Paribas Shock). However, the markets began to weaken early in 2008 and continued to weaken, leading ultimately to the collapse of Lehman Brothers (see figure).

Keio University Professor Seki Obata (former member of the Government Pension Investment Fund investment committee) provides a convincing explanation of this in his book², describing the phenomenon as “the real bubble begins after the bubble has collapsed.” According to Mr. Obata, once stock prices take a big tumble from a high point, which is a state where all investors are worried about the bubble, investors who are no longer confident of the sustainability of stock price growth sell their stocks and withdraw from the market. Those who enter the market at this stage are predominantly ultra-bullish investors, who still believe in the sustainability of stock price growth. Since all the investors in the market at this stage are bullish, the markets can easily run out of sellers, which results in sporadic soaring of stock prices. However, these ultra-bullish investors, despite being confident of sustained stock-price increases, are not confident about when such increases will come to an end (when they should sell). They know that their investment behavior is based on a desire to win by betting on the bubble and they are intensely aware that they need to get out before the next big crash. Consequently, the big escape at the time of the second crash can easily get reflected in stock prices. This is why bubbles tend to go through the first collapse soaring second collapse stages, giving rise to the idea that “the real bubble begins after the bubble has collapsed.” Professor Obata says, “A soaring of stock prices could become the cause of their crashing, and consequently, when prices begin to collapse even a bit, they come crashing all the way down” – a point that should definitely be considered in conjunction with the movement of the markets since November last year. The above book was authored over 10 years ago, but it has many lessons that are relevant to the current situation.

Important not to Forget the Big Picture

In addition to the aforementioned considerations, there is the fact that the “Powell Put” came right on the heels of a period of sweeping pessimism, so it is not surprising that the Dow would recover in January, and the financial markets overall would be filled with a sense of optimism. However, looking at the real U.S. economy, the fact is that there is almost no scope remaining for further improvement. It is very unlikely for there to be a significant decrease in the unemployment rate from its current level, or for there to be another sharp rise in home sales. Perhaps this understanding of the economy combined with the bond market’s sense that U.S. 10-year interest rates will not return to the 3.20% level again is what makes it easy to formulate a forecast of USD depreciation against JPY going forward. Incidentally, if there really were widespread inflation concerns, inflation expectations are likely to have suddenly ballooned in response to the abrupt shift in the central bank’s stance from strongly hawkish to dovish. However, market inflation expectations, as reflected in the break-even inflation rate (BEI), are actually declining rather sharply (see figure on the previous page). This is because most market participants never believed that the Fed was implementing rate hikes in order to contain inflation. The financial markets are fully prepared for a decision by the Fed to stop rate hikes and also apply the brakes on its balance-sheet reduction efforts going forward. In order not to severely misread market trends in 2019, it will be important not to be swayed by stock-price movements and other short-term factors, but rather to keep one’s eye on the big picture – the fact that the economy, and therefore monetary policy too, move in cycles.



² Seki Obata, *All Economic Activity Leads to Bubbles*, Kobunsha Publishing Co., Ltd., August 2008

U.S. fiscal policies now and going forward – Normalization Process Completion Announcement

Normalization Process Completion Announcement – Nipping in the Bud of Rises in U.S. Interest Rates and USD

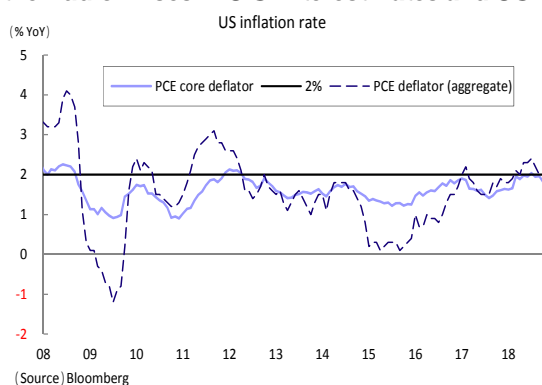
Although the January 29-30 FOMC meeting decided to maintain the monetary policy status quo, the bold adjustment of the post-meeting statement was a surprise. Regarding the key portions hinting at the Fed's "next move", the previous statement's text – "The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with..." – has been deleted, and the text – "the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." – has been inserted.

The word "patient" suggests that the Fed's "next move" may no longer be an additional interest rate hike, a development that this article has long been anticipating. The real intention of the statement's hints about policy interest rate adjustments going forward is generally considered to relate to either "an additional hike" or "maintaining the status quo" but, depending on circumstances, one can probably not completely exclude the possibility that the hints' meaning could encompass the possibility of an "interest rate cut". In any case, it seems that the hurdles on the path to additional rate hikes have become considerably higher, and it appears that the prospects for renewed trends of increase in U.S. interest rates and USD can be considered to have been nipped in the bud. The context of the insertion of the word "patient" in the statement is – "In light of global economic and financial developments and muted inflation pressures". The markets will not resume their factoring in of a prospective interest rate hike unless there is an upsurge in such inflation indicators as the personal consumption expenditure (PCE) deflator, but the PCE deflator has been quite stable since midway through last year (see graph). At this point, there are no factors that seem likely to cause a non-linear rise in inflation pressures going forward. The latest statement does not include the previous statement's – "The Committee judges that risks to the economic outlook are roughly balanced" – text. Consequently, at the time of the January FOMC, the central banks of the United States, the EU, and Japan all had shifted their risk balance assessments toward the downside.

Also issued on January 30, the "Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization" states that – "the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate." It is thus likely that there will be a focus on prospective changes to the pace of balance sheet shrinkage or even a halt to the shrinkage. Already, at the post FOMC meeting press conference, reporters were posing questions about the Fed's objectives regarding the size and asset composition of the post-shrinkage balance sheet. (The chairman's answers were essentially limited to saying that a decision will be made regarding those issues sometime in the future.) There seems to be no reason not to conclude that the latest statement should be considered a declaration of the termination of the normalization process that had been continued since May 2013.

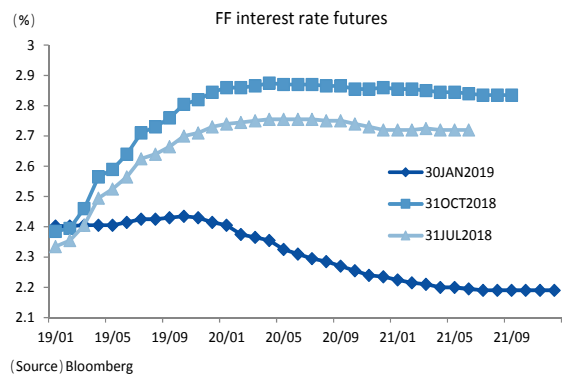
All FOMC Meetings are "Live Meetings"

By the way, not many observers had been inclined to expect the latest FOMC meeting to modify its statement to the extent that it did. Market participants will need to prepare for the possibility that policy adjustments may be undertaken regardless of the timing of changes in FOMC members' interest rate projections (the dot plot). It is said that the move to arrange news conferences after each FOMC meeting beginning from this year is designed to promote a more-detailed dialog with the markets, and this greater dialog effect had already appeared at the time of this year's first meeting. Fed Chairman Powell has pointed out that all meetings are now "live" for possible rate increases, and there is a need to take this into account when making projections going forward. Prior to the latest FOMC meeting, there were numerous speculative media reports attempting to forecast developments regarding the statement and press conference. For example, a January 25 Wall Street Journal article reported on prospective changes to the Fed's balance sheet reduction strategy. It seems conceivable that the Fed might be planning to take the approach of more-actively shaping market expectations based on an increased number of press conferences as well as information-leak-based media reports. At the same time, the relative importance of the dot plot has declined. It is possible that the median forecast level in the dot plot released in March will decrease to an extent that suggests no interest rate hike this year. While the current point in time appears to represent an important milestone of economic conditions, however, conditions in the economic and financial environment may dramatically change during 3-month periods, and the danger of stubbornly sticking to a system that limits important decision making processes to the months of March, June, September, and December is now becoming increasingly apparent.



Danger of Precipitously Concluding that Things are already “Factored In”

Given that the FF interest rate futures market has begun to factor in the possibility of interest rate cuts within one year (see graph), while the downtrends in U.S. interest rates and USD started last autumn, numerous observers are concluding that the recent announcement was merely confirming an already existing situation. Regardless of how much the chair and other high-ranking officials of the Fed may disseminate information in advance via lectures and other informal communications methods, however, it should be remembered that the influence of messages disseminated via regular FOMC meeting statements and dot plots still have a critically strong effect on the financial product price formation process. This is attested to by the fact that U.S. interest rates and USD showed clear-cut drops immediately following the release of the latest FOMC meeting statement. Although the phrase “already factored in” is frequently used in financial markets, one should assume that price formation processes for taking new factors into account have not been completed until the authorities officially recognize the new factors.



Given that, if the dot plot released in March suggests “no interest rate hike within this year”, it can be expected to be a factor depressing U.S. interest rates and USD. This article has been forecasting these developments since a year ago. The issue regarding the direction of developments going forward is almost settled, and the key issues now concern the extent to which the requisite adjustments to U.S. interest rates and USD will be realized.

Japanese Financial Policies Now and Going Forward – No Longer Able to Display “Aspirations”?

Dissipating Expectations of Normalization

The January 22-23 BOJ Monetary Policy Meeting decided to maintain its “QQE with Yield Curve Control (YCC)” framework by a majority vote of 7 to 2 (with Policy Board members Goushi Kataoka and Yutaka Harada opposed). The Outlook for Economic Activity and Prices (“Outlook Report”, see chart) projections for the consumer price index (excluding fresh foods and the effect of consumption tax increases and policies concerning the provision of free education, hereinafter “core CPI”) have been revised downward for the entirety of the forecast period, with the projection for fiscal 2019 falling below the 1% level. The Outlook Report states – “With regard to the risk balance, risks to both economic activity and prices are skewed to the downside.” – clearly emphasizing a downward shift of the risk balance. In this regard, the BOJ’s view can be considered quite different from that of the Fed and the ECB, which are still claiming the risk balance is balanced. At the post-meeting press conference BOJ Governor Kuroda said the level of risks has been rising and requires close attention, and it is probably reasonable to interpret that as an official dismissal of expectations of BOJ normalization, which had been surging since last year.

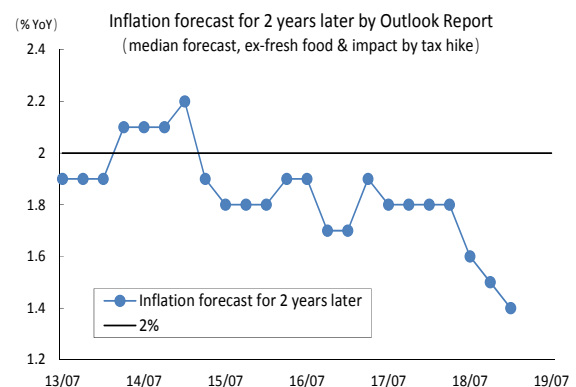
Major outlook by BOJ policy board members (YoY%)

	Real GDP	Core CPI (ex fresh food)	Excluding impact by consumption tax hike & free education policy
FY 2018	+0.9 ~ +1.0 <<+0.9>	+0.8 ~ +0.9 <<+0.8>	
Outlook as of OCT	+1.3 ~ +1.5 <<+1.4>	+0.9 ~ +1.0 <<+0.9>	
FY 2019	+0.7 ~ +1.0 <<+0.9>	+1.0 ~ +1.3 <<+1.1>	+0.8 ~ +1.1 <<+0.9>
Outlook as of OCT	+0.8 ~ +0.9 <<+0.8>	+1.5 ~ +1.7 <<+1.6>	+1.3 ~ +1.5 <<+1.4>
FY 2020	+0.7 ~ +1.0 <<+1.0>	+1.3 ~ +1.5 <<+1.5>	+1.2 ~ +1.4 <<+1.4>
Outlook as of OCT	+0.6 ~ +0.9 <<+0.8>	+1.5 ~ +1.7 <<+1.6>	+1.4 ~ +1.6 <<+1.5>

(Source) Bank of Japan (Note) <> indicate the median estimate by policy board members

An Environment Impacting even “Aspirations”

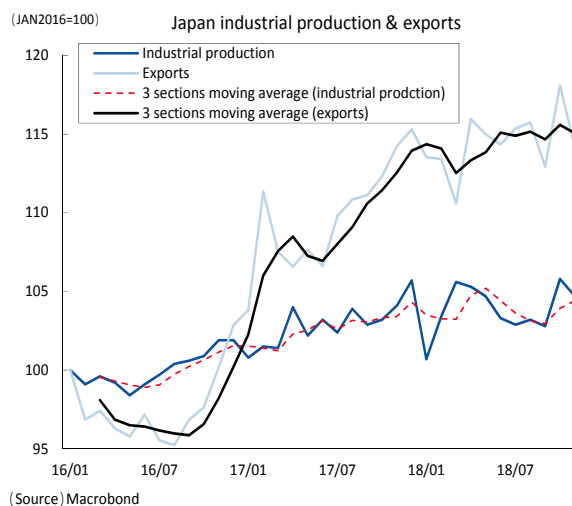
While the latest Meeting was almost completely uneventful, I think it worthwhile to focus on the weakness of the updated inflation forecasts that have emerged. The core CPI outlook for FY2018/2019/2020 period was broadly downgraded to “+0.8%/+0.9%/+1.4%”, from “+0.9%/+1.4%/+1.5%” at the time of the previous Outlook Report last October. The latest Outlook Report explains that the significant -0.5% point downward revision to the core CPI forecast for FY2019 is “due primarily to the decline in crude oil prices.” Even more noteworthy, however, is the fact that the core CPI forecasts were lowered for the period through FY2020. It has become generally understood that the longest-range forecasts in the Kuroda-led BOJ’s Outlook Reports – for the fiscal year two years after the forecast time (currently FY2020) – are more likely to reflect the BOJ’s hopes, aspirations,



(Source) Bank of Japan

and enthusiasm than they reflect objective expectations. For that reason, the “Outlook Report” has often been scornfully referred to as a “Aspiration Report.” As is also partially reflected in the chart, if one overviews the “core CPI forecast for two years later” during the period since Governor Kuroda was appointed, one finds that it mostly has remained in the “+1.8-2.0%” range. These anticipated core CPI levels never actually eventuated, but this has never been considered to be such a big problem given the difficulty of making precise forecasts for a period two years from a given point in time, and this difficulty is generally recognized even now. However, the “core CPI forecast for two years later” has been revised downward in three consecutive reports, since the July 2018 Outlook Report, and has now fallen below the +1.5% level for the first time. Should this be understood to indicate that the BOJ’s pessimism about its operating environment has come to impact even its “aspirations”? It seems unquestionable, on the other hand, that it will be a steep uphill battle to realize the latest forecast of a sharp core CPI upsurge (+0.9% +1.4%) during the FY2019-2020 period.

Regarding the real economy, the BOJ has maintained its appraisal that both exports and industrial production “have been on an increasing trend”. As the graph shows, neither exports nor mining and manufacturing production showed a clear upward trend during the latter half of 2018, and it would seem more accurate to characterize the trends as “flat” (see graph). Given the downward revisions seen throughout much of the Outlook Report, one might well think that the time was ripe for a downward revision to the evaluation of the exports and industrial production situations, and it is natural to suspect that the BOJ is showing a bit of stubborn bravado in its insistence that the fundamental scenario has not changed. Nevertheless, exports and production have been “increasing” compared to their levels at the beginning of 2018, so the BOJ characterization cannot really be said to be mistaken. However, when the uptrend has reversed clearly in terms of YOY change figures, the evaluation of the exports and industrial production situations will probably have to be revised, and it can be expected that at that time there will be whispers in the financial markets about the leeway for monetary policy adjustments.



“Next Move” Indisputably toward Easing

Going forward, the BOJ Outlook Report’s downward revisions along with a clear shift to the downside in the overseas economy’s environment make it likely that the financial markets will be increasingly inclined to call for additional monetary policy easing. It is practically impossible for the BOJ to pursue normalization at a time when the Fed and the ECB are discontinuing their normalization processes. Although it does not really require reconfirmation at this time, it is worth noting that the most heavily weighted variable in the BOJ’s policy reaction equation is forex rates rather than inflation rates. It is also safe to say that this heavy weighting of the forex variable is not restricted to the Kuroda-led BOJ but has been the case throughout the BOJ’s history. The fundamental nature of Japan has given it an obsession with forex rates that is particularly strong compared to other developed countries. In the future, if the BOJ’s operating environment becomes increasingly affected by the discontinuation of normalization processes by the central banks of the United States and Europe, there will naturally be downward pressure on U.S. and European interest rates, shrinking the difference between those interest rates and Japanese interest rates, which are already quite negligible. If Japan’s domestic-overseas interest rate differential shrinks, JPY buying and foreign currency selling by speculators will become lower in cost and feature greater executional ease. Given that it appears to have largely given up on its 2% inflation target (aspiration), the BOJ is likely to focus principally on forex rates. It thus seems indisputable that the BOJ’s “next move” will be in the direction of easing.

If things remain unchanged, there is a possibility that the FY2021 inflation rate forecast added to the Outlook Report this April will be below +2%. In that case, Policy Board members Kataoka and Harada (who voted against the status quo maintenance at the last Meeting) are likely to be increasingly insistent on pursuing the 2% inflation target and increasingly uninclined to be satisfied with status quo maintenance. At that juncture, the focus will be whether Deputy Governor Masazumi Wakatabe is also inclined to vote against status quo maintenance, even at the cost of promoting divisiveness among the senior Policy Board members. Although I anticipate the current majority support for maintaining the status quo would still be preserved in such a case, I think it is worth pointing out the possibility of such a case and the potential for such a situation to become a concern from the perspective of financial markets in the future.

Risks to My Main Scenario – Nature of JPY Depreciation Risks

Still Leeway for Adjustments

As I do each month, I would like to review the risk factors related to my main forecast scenario. Through last month, this risk review examined both JPY depreciation- and JPY appreciation-related risk factors. As explained below, however, since this article's main scenario anticipates USD depreciation along with JPY appreciation stemming from the USD depreciation, it should be understood that the most important risk scenarios are those related to JPY depreciation. In view of this, I will focus here mainly on JPY depreciation risks.

For the past year, the basic story line of this article's main scenario is – “The end of the Fed's normalization process is accompanied by U.S. interest rate decreases and USD depreciation, and that situation forces JPY to appreciate.” Since last October, the Fed has become increasingly dovish as it has been unable to ignore stock price volatility associated with the rise in U.S. interest rates. As mentioned above, the January FOMC meeting statement is essentially an announcement of the end of the Fed's normalization process. As already mentioned regarding the FF interest rate futures market's factoring in of interest rate trends expected during the upcoming year, there are already signs that the factoring in of interest rate decreases has begun, and it is hard to envisage how a trend of recovery in U.S. interest rates and USD could happen going forward from this point. I think it safe to say that the processes associated with my main scenario are steadily progressing.

In fact, rather than “steadily progressing” it may be more accurate to say that “associated adjustments have already been made”. Given the extent to which the FOMC meeting statement shifted to dovishness, it might not be entirely unreasonable to argue that there is already no leeway for additional adjustments. However, I do not believe that the financial markets have yet completely factored in the implications of the monetary policy adjustment. As noted above, while it is assumed that many market participants anticipate that the dot chart released in March may be tantamount to a confirmation of the “no interest rate hike in 2019” scenario, I personally think there is a widespread underestimation of the size of the shock that will reverberate at the time the dot chart is actually released. Roughly speaking, however, it should be recognized that the Fed still has some playable policy cards. For example, if the market were to become more pessimistic than it currently is, it would probably be possible to hint that the “next move” might be an interest rate cut or a halt to the balance sheet shrinking process (or even an expansion of the balance sheet). In such a case, there will be a need for further adjustments to interest rates and forex rates.

The Most Important and Realistic Risk Factor

To repeat, however, there are several kinds of realistic risk factors that could promote JPY depreciation and that must be considered with respect to their potential effect on the main forecast scenario (see chart). The biggest such risk factor is probably that of a situation in which the U.S. economy is surprisingly robust and the Fed therefore finds itself positioned to continue its normalization process. In May 2013, for example, when then-FRB Chair Ben Bernanke

began suggesting the possibility of a tapering of quantitative easing, there were probably no FOMC members inclined to forecast that the U.S. unemployment rate might decline to 3.7%. Previously known as a leading dove within the FOMC, Minneapolis Federal Reserve Bank President Neel Kashkari wrote in an essay (regarding the 2012 FOMC midpoint long-term unemployment rate estimate of 5.6%) that – “many more Americans wanted to work than we had expected” – and this reflects the fact that it is very difficult to accurately define a country's full-employment situation (or estimate a country's potential growth rate). One can not deny the fact that there is a risk that the U.S. economy will maintain robustness to an unexpected degree over the next year or so.

The key reason why this article's main scenario has not been realized over the past year is that I underestimated the fundamental strength of the U.S. labor market. It was the unexpectedly strong growth of non-agricultural employment that enabled the Fed to continue its interest rate hikes, causing a trend of increase in U.S. interest rates and USD until sometime around last autumn. “Unexpected U.S. economic robustness” is the most important risk factor for this article's main scenario – if the unexpected robustness continues, the main scenario's forecasts of JPY appreciation and USD weakening (to roughly USD1 = JPY100) will not be realized. Given that the latitude for further improvement in the U.S. economy is almost indisputably small, the possibility of movement toward JPY depreciation remains low, but it is unquestionable that movement toward JPY appreciation will be restrained. Barring a clear-cut and sharp deterioration of U.S. economic conditions, it is reasonable to anticipate that the forex market may continue to lack a clear sense of direction, just as during 2018.

JPY depreciation risk factors

	Concrete examples	Symbolic	Possibility
	U.S. economy is surprisingly robust	Unemployment rate not rising, Recovering stock price and ISM index	medium /high
	Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war	low
	Discontinuation of BREXIT	Re-national referendum implementation	medium /high
	Additional monetary easing by BOJ	Supply negative-interest funds	low

(Source) Daisuke Karakama by Mizuho Bank

Political JPY Depreciation Risks

While “unexpected U.S. economic robustness” is a economics-related JPY depreciation risk, there are also political JPY depreciation risk factors. Perhaps the biggest of such risk factors relates to the possibility of the discontinuation of the Trump administration’s protectionist policies. Many forecasting institutions have suggested that the biggest issue of concern for the world economy at this time is the impossibility of predicting the future course of the Trump administration’s trade war strategy. This is causing a trend of weakness in such soft data as purchasing managers’ indexes, and it is also beginning to undermine the hard economic statistics of most countries. There are probably more than a few companies that are restraining their capital investment plans in light of uncertainties stemming from the Trump administration’s trade policies. Rather than being a risk factor, the threat of trade war is gradually becoming a reality that can be said to be presenting the world economy with significant political obstacles. Thus, the elimination of the trade war threat could be expected to have a quite large psychological effect that would inevitably exert a positive effect on real economic indicators. A complete resolution of the U.S.-China trade war, for example, would be a potent symbol of trade war threat elimination, and it would be wise to be prepared for the potential ramifications of such an event. What I am referring to here is literally a complete ending of the U.S.-China trade war involving a complete discontinuation of the cycle of additional tariffs met with additional counter tariffs along with other initiatives symbolically conveying the message that the two parties were moving to normalize their relations, and I imagine that the markets would respond in a highly positive manner to such a scenario. However, the reforms the United States is demanding from China – such as intellectual property rights protection and the ending of forcible technology transfers – are not amenable to rapid resolutions, and I do not expect the related conflicts will be settled quickly. Moreover, with an eye to his reelection campaign, it appears that President Trump desires to continue playing the role of “the president who confronted China on behalf of fair trade”, and it seems most likely that he may seek to keep relations with China moderately strained while avoiding sharp trends of deterioration or improvement.

I also think it important to keep a close eye on the progress of Brexit negotiations and their potential to become another political JPY depreciation risk factor. Although predictions are difficult to make at this stage, if speculation about the possible postponement of the March 29 deadline for reaching an agreement were to prove accurate, it can probably be expected that a general feeling of relief may promote JPY depreciation. However, there is an even greater JPY depreciation risk associated with the potential for a decision to re-implement the Brexit referendum, which would revive expectations of an annulment of Brexit and generally foster optimistic moods. Given that JPY depreciation is currently being promoted by mere rumors that the negotiation deadline might be postponed, it is reasonable to expect that the impact of a decision to re-implement the Brexit referendum might be as large as that stemming from the previous referendum’s results. Regarding political risk factors, this seems to be the most fearsome JPY depreciation risk factor.

JPY Depreciation Risks Originating in Japan

Compared with overseas factors, it is basically much less likely that Japanese factors will strongly affect forex trends, but it is still worth paying close attention to the BOJ’s actions. The “Outlook Report” release on January 23 clearly shifted the BOJ’s risk balance assessment toward the downside, and it would not at all be surprising to find the BOJ is considering additional easing measures as its “next move”. In the general speculation about the BOJ’s “next move”, however, there is still no consensus view about what specifically kind of measure is most likely to be under consideration. Given the already weakened state of domestic financial institutions, further depressing negative interest rates no longer seems to be a realistic option, and it is also difficult to imagine that the Bank would proceed deeper into the world of QE, which it is currently trying to exit through a complicated series of moves. The proposal of introducing a negative lending rate made by a former BOJ executive director, Hideo Hayakawa, in a recent Bloomberg interview has attracted attention, but given that such a measure could be considered a direct subsidy to financial institutions and that it almost surely would not augment lending volume, it is not considered a viable option at this time. In the case of considerable JPY appreciation, however, it may well be the BOJ’s only available option, and such a measure’s powerful headline impact could probably promote JPY depreciation to a certain extent. As a policy to supply negative-interest funds has already been implemented overseas in the form of the ECB’s second round of targeted long-term refinancing operations (TLTRO2), it can be argued that the hurdles on the path to a Japanese negative lending rate policy are not as high as those faced at the time the BOJ introduced negative interest rates. In any case, the apparently low likelihood of a negative lending rate policy heightens the risk that such a policy might bring about considerable JPY depreciation if were to be implemented.

Various JPY Appreciation Risk Factors

While this article has focused primarily on JPY depreciation risk factors, of course JPY appreciation risk factors also exist. Although a certain amount of JPY appreciation is consistent with the main forecast scenario, JPY appreciation risk factors are those factors with the potential to promote a considerably greater degree of JPY appreciation than that anticipated in the main forecast scenario. The financial markets often tend to view a wide range of “negative” situations as being factors that promote JPY appreciation, and it would not be worthwhile to examine each such situation individually. One way to focus on relatively significant JPY appreciation risk factors is to take another look at the JPY depreciation risk factors just discussed and consider what would happen if the situation in question were to be exactly opposite to that associated with the JPY depreciation risk factor in question. For example, it is worth considering a case in which the U.S. economy unexpectedly stalls, pressuring the Fed into cutting interest rates and resuming quantitative easing measures, or a case in which the U.S.-China trade war suddenly intensifies. Other JPY appreciation risk scenarios worth thinking about include a case in which there is a complete breakdown of Brexit negotiations, making a “no-deal” Brexit inevitable, and a case in

which the BOJ resolutely perseveres with its normalization process and boldly hikes interest rates. Looking at Europe, one can see a potential for a sharp rise of political instability in such core and semi-core countries as Germany, France, Italy, and such instability in each country could, depending on the situation, be considered to be JPY appreciation risk factors. The potential for a recurrence of the kind of turbulence related to fund flows involving emerging countries that caused financial markets to suffer several bouts of jitters last year is also worthy of being considered a JPY appreciation risk factor.

Many observers are already whispering about the incipient peaking out of the global economy, and there is probably a high likelihood that numerous and diverse “negative” situations will occur here and there in the world during the forecast period. As mentioned earlier, the U.S. economy may well maintain its current robustness going forward but seems extremely unlikely to accelerating from this point. My basic view is that it is reasonable to anticipate that U.S. interest rates and USD will move in accordance with the trend in the U.S. economy.

EUR Outlook Likelihood of Continued EUR Appreciation Owing to USD Weakness

ECB Monetary Policies Now and Going Forward – Baseline Scenario of “No Interest Rate Hike This Year”

Change in Balance of Risks Could Delay Normalization Process

At the January-ECB Governing Council meeting, it was decided to keep the interest rates on the main refinancing operations (MROs), the marginal lending facility (which is the ceiling of market interest rates), and the deposit facility (which is the floor of market interest rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, thereby also maintaining the interest rate corridor (the difference between the ceiling and the floor) unchanged at 0.65pp. As I mentioned in last week’s issue of this report, the recent meeting held two points of interest – (1) a change in the balance of risks (balanced downside), and (2) the fate of Round 3 of the Targeted Long-Term Refinancing Operations (TLTRO3). To cut to the chase, information commensurate to the level of interest was provided on both counts, so the meeting was not altogether uneventful for ECB watchers.

With regard to point (1), at the December Governing Council meeting, the language was changed from the previous “broadly balanced” to “the balance of risks is moving to the downside,” suggesting that the risks were balanced at the moment but rather precariously so. This time, the present continuous tense of the verb was changed to present perfect tense to make: “The risks surrounding the euro area growth outlook have moved to the downside.” This is the first time since April 2017 that the risk balance assessment has been downgraded. Incidentally, the assessment in April 2017 was “The risks surrounding the euro area growth outlook, while moving towards a more balanced configuration, are still tilted to the downside.” So, contrary to the present, the direction of change in the balance of risks was positive. Subsequently, as one still clearly remembers, EUR began to soar after the infamous speech by ECB President Mario Draghi in Sintra in June the same year. In any case, with the balance of risks having shifted to the downside, it seems inevitable that the policy normalization process will be postponed. The ECB cannot move forward with normalization efforts until it changes its assessment, but given that the recent change in the risk assessment is reported to have been unanimous, it will not be changed again in a hurry.

A Basic Stance of Not Being in “Policy Mode”

Now that the risk balance assessment has been downgraded, the markets will naturally begin to speculate about its impact. In this connection, the first question at the press conference was “What sort of implication will (it) have?” Mr. Draghi’s response was “Today we didn’t discuss the (policy) implications (of the change in the risk balance). Today’s meeting was essentially devoted to an assessment. Where are we? Why are we here? How long will this slowdown last? Is the slowdown going to worsen or stay as a shallow lower path? These were the questions that were asked.” As one can see, he did not commit himself to any connection between the risk assessment and a change in policy. Of course, it is impossible that the two things will remain unrelated, with Mr. Draghi himself acknowledging that “Quite clearly, the assessment will have implications about policy but we didn’t discuss them,” so the situation can probably best be summed up as “as of the current stage, we are not ready to consider any concrete policy actions.” Another reporter asked point blank, “The Fed has also been clear that it’s going to react to that by doing probably less rate hikes this year whereas even though the balance of risks has changed today, there’s not so much of a sense about how exactly you’re going to react to that.” Mr. Draghi responded to this by saying that the ECB was only taking stock of the situation at the current time, underscoring that it was in “the assessment mode” rather than “the policy mode.” He additionally asserted, “if you look at the number of instruments we have in place now, we can conclude that it’s not true that the ECB has run out of fuel or has run out of instruments.” If the present mood persists, it seems reasonable to assume that the ECB will have to shift to “policy mode” sooner or later.

President Draghi Tacitly Acknowledges No Rate Hikes This Year

The fact that the recent meeting was spent mostly in reassessing the balance of risks was clear also from how Mr. Draghi, in response to the third reporter who asked “How long will (the current phase) last in your view,” talked at such length about his own perception of the macroeconomic situation that he forgot to answer the second question by the same questioner. Incidentally, the second question was “(Is) the market pricing (the ECB’s) interest hike correctly?” In response to this, Mr. Draghi said, “When markets place the first rate hike in 2020, they are using the state contingent part of our forward guidance. They assess the economic prospects that way and it shows that they have understood our reaction function.” Possibly because of the convoluted nature of the sentence, it

EONIA & deposit facility rate

	EONIA	Assumed deposit facility rate	Timing
Current	-0.37	-0.40	
6month forward 6months	-0.34	-0.37	JAN 2020
12month forward 3months	-0.30	-0.33	APR 2020
15month forward 3months	-0.28	-0.31	JUL 2020
18month forward 3months	-0.22	-0.25	OCT 2020
21month forward 3months	-0.19	-0.22	JAN 2021
24month forward 3months	-0.11	-0.14	APR 2021
24month forward 6months	-0.09	-0.12	JUL 2021

(Source) Bloomberg

(Notes) Colored part is to expect the timing of 10bps rate hike completely
Assumptions associated with spread of deposit facility rate & EONIA is 3bps

seems not to be drawing much attention, but it seems to indicate a tacit acknowledgement on the part of Mr. Draghi that there will be no rate hikes this year. Currently, the six-month-maturity six-month EONIA forward contracts are -0.34%, which is not that different from the present rate of -0.37%. In other words, very few market participants seem to think that there will be a rate hike this year. Further expanding the forecasting timeframe, the 12-month-maturity three-month EONIA forward contracts are -0.30%, the 15-month-maturity three-month EONIA forward contracts -0.28%, and the 18-month-maturity three-month EONIA forward contracts -0.22% (see chart on previous page), indicating that the markets are fully factoring in a rate hike only in September 2020 or beyond. If we assume that a rate hike decision is likely to coincide with a revision of the staff macroeconomic projection (March, June, September, or December), a rate hike seems likely around June 2020 at the earliest. Of course, based on the forward guidance (which indicates that reinvestments will be continued up to the time rate hikes begin) the termination of reinvestments will also be further postponed. If we take into account that even the Fed, which was in a stronger position economically and financially, took three years from the end of quantitative easing to the end of reinvestments, perhaps 2021 could be a milestone to watch out for.

TLTRO3 May be More Urgent than Rate Hikes

With regard to the handling of TLTRO3, which was the other point of interest alongside the risk-balance assessment, Mr. Draghi said, “Several speakers actually raised this issue but no decision was taken because we didn’t discuss policies this time. We only were focused on the assessment.” In other words, while acknowledging that the matter was brought up, Mr. Draghi emphasized that the main topic of discussion was changing (i.e., assessing) the balance of risks rather than considering any new policies to be introduced. In last week’s issue of this report, I mentioned that the situation in which the ECB was placed was not at all conducive to policy normalization. Going by yesterday’s Introductory Statement and Mr. Draghi’s press conference, it would seem that the ECB is also aware of this fact. As is obvious from the IMF’s revised World Economic Outlook, which was released on January 21, of the world’s three key economies – Japan, the U.S. and the euro area, it is the underlying strength of the euro area’s economy that is of the most concern.

In just three months, the main scenario of the financial markets appears to have been downgraded significantly from “two rate hikes in 2019” to “no rate hikes in 2019,” and now some are pessimistically predicting a “resumption of the asset purchase programme (APP).” It seems very likely, therefore, that in March this year, coinciding with the next revision of staff projections, instructions for the implementation of TLTRO3 will be given to internal expert committees, and that a framework for its implementation could be released as early as April, or at the latest by June this year, which will be exactly a year to the maturity of the first round of TLTRO2. Some reports speculate that, in view of the impact on bank profits, rate hikes may be considered, and there were some questions from this point of view at the press conference. However, the more urgent issue is that of the successor scheme to TLTRO2, which has a big impact on financial institution cash flows.

TLTRO2 implementation Status (total 4 rounds)

	Implementation date (yy/mm/dd)	Maturity date (yy/mm/dd)	TLTRO period (days)	Borrowing rate (%) Note 2	Amount in EUR	Number of Banks
No.1 Note 1	2016/6/29	2020/6/24	1456	0	3,993	514
No.2	2016/9/28	2020/9/30	1463	0	453	249
No.3	2016/12/12	2020/12/16	1456	0	622	200
No.4	2017/3/29	2021/3/24	1456	0	2,335	474
Total amount at present					7,403	

(Source) ECB

(Note 1) The ultimate borrowing rate depends on the interest rate reduction and exemption measures according to the loan performance.

(Note 2) However, the first bid was made possible to refinance the total borrowing balance (approx EUR 430 billion) by TLTRO 1.

To provide a recap of the situation, the Account of the monetary policy meeting of 24-25 October, 2018, stated in this connection that “the remark was made that the maturity of some of the targeted longer-term refinancing operations would fall below one year in the course of the next year (2019), which could impact the evolution of excess liquidity and might affect banks’ liquidity position.” The issue has frequently been talked about since then. A total of around EUR 740 billion was provided over a total of four rounds of TLTRO2 (see chart). Two years after the provision of these funds, voluntary early repayments are possible, and some such repayments have already taken place for operations conducted in June, September, and December 2016. However, these repayments were rather insignificant, at EUR 11.03 billion, EUR 3.63 billion, and EUR 3.13 billion, respectively. In other words, as of the current time, the outstanding amount of funds provisioned via TLTRO2 remains around EUR 720 billion, after subtracting the repaid portions from the original amount. The large part of this will be absorbed from the markets in June 2020, which is the date of maturity for the round of operations conducted in June 2016 (i.e., Round 1 of TLTRO2, which was worth EUR 399.3 billion).

Under such circumstances, it seems highly likely that TLTRO3 could be considered not so much in the context of additional easing, but rather in response to financial system instability, and it is predicted that the ECB will take up this issue as one that is clearly more pressing than rate hikes. In addition to this, the ECB will need to consider what kind of measures can be presented as countermeasures to the slowing real economy. At any rate, it seems that the situation now is very different from as late as autumn last year, when around two rate hikes in 2019 were being predicted. As one

can see from the FF interest rate futures market, it seems there may rather even be a slight possibility of factoring in a rate cut.

The Euro Area Economy Now and Going Forward – Negative Political/Economic Factors Supporting EUR

Europe Leading the Global Economy's Slowdown

The IMF has announced its revision of the October 2018 edition of the IMF World Economic Outlook, reducing its global economic growth rate forecasts from 3.7% to 3.5% for 2019 and from 3.7% to 3.6% for 2020 (see chart). While this is an issue that has been repeatedly discussed in previous issues of this article, it is worth making special note of Europe's economic slowdown, which contrasts with the situations in other developed countries. Particularly conspicuous is the trend in Germany, which for the third quarter of 2018 recorded negative QOQ growth for the first time since the first quarter of 2015, and for which the 2019 growth rate forecast has been lowered by 0.6 percentage point, from 1.9% to 1.3%. Many observers attribute the third quarter drop exclusively to a temporary motor vehicle production slump owing to German automobile manufacturers' late response to the introduction of a new emission gas standard (Worldwide Harmonised Light Vehicle Test Procedure (WLTP)) in September, but given the global trend of economic deceleration, it is hard not to be pessimistic about the prospects for Germany's exports, which are a key locomotive of the country's economic growth. Looking at the outlook for 2019, one finds that the forecast for France (which has been facing widespread anti-government demonstrations) has been lowered from 1.6% to 1.5%, while the forecast for Italy (which has been suffering from a tumultuous political situation that complicated its formation of a government budget for the upcoming fiscal year) has been reduced from 1.0% to 0.6%. As a result, the 2019 growth rate forecast for the euro area as a whole has been cut from 1.9% to 1.6%. Europe's weakening is particularly conspicuous when compared to the trends seen in the world's other leading developed economies, as Japan's growth rate forecast was adjusted upwards and the forecast for the United States remained unchanged.

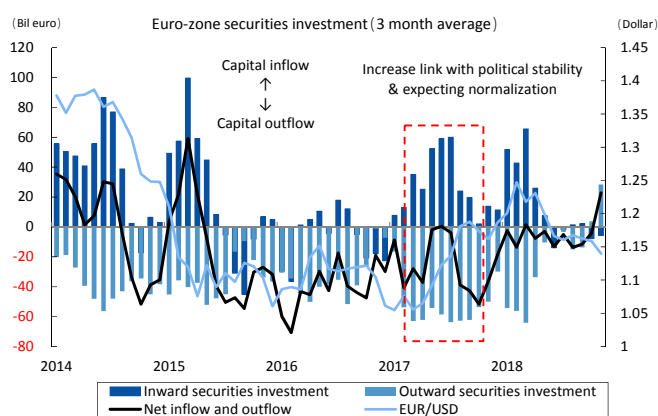
IMF world economic outlook (Revision of Autumn, January 2019)

	2019			2020		
	(outlook)	(As of OCT)	Modified with	(outlook)	(As of OCT)	Modified with
World	3.5	3.7	▲ 0.2	3.6	3.7	▲ 0.1
Developed countries	2.0	2.1	▲ 0.1	1.7	1.7	0.0
US	2.5	2.5	0.0	1.8	1.8	0.0
Euro-zone	1.6	1.9	▲ 0.3	1.7	1.7	0.0
Germany	1.3	1.9	▲ 0.6	1.6	1.6	0.0
France	1.5	1.6	▲ 0.1	1.6	1.6	0.0
Italy	0.6	1.0	▲ 0.4	0.9	0.9	0.0
Spain	2.2	2.2	0.0	1.9	1.9	0.0
Japan	1.1	0.9	0.2	0.5	0.3	0.2
Emerging countries	4.5	4.7	▲ 0.2	4.9	4.9	0.0
China	6.2	6.2	0.0	6.2	6.2	0.0
Russia	1.6	1.8	▲ 0.2	1.7	1.8	▲ 0.1
India	7.5	7.4	0.1	7.7	7.7	0.0
Brazil	2.5	2.4	0.1	2.2	2.3	▲ 0.1

(Source) IMF "World Economic Outlook" JAN 2019

Capital Flows Supporting EUR

Despite the obvious weakness of the euro area's political and economic situations, however EUR has remained firm. This largely reflects the plunge of USD from high levels recorded last autumn, and it by no means reflects an appraisal of the economic, financial, and political situations within the region. But these factors may not be the only factors affecting EUR. It is probable that the deterioration of the euro area's political and economic conditions has itself been promoting EUR strength by reducing investors' risk tolerance levels and thereby restraining euro area investors' risk-taking initiatives focused outside the area. This, in turn, has restrained EUR selling (other currency buying) activity in forex markets. To the extent discernable from various kinds of statistics, it appears that, while evaluations of the euro area economy have naturally not promoted much capital inflows from outside the region, it is also true that the level of capital flows departing the euro area for other regions of the global economy has not been high.



(Source) Datastream

These situations are confirmed by inward and outward securities investment figures within the euro area's balance of payments statistics. Looking at inward securities investment during the past three years, one finds that the only periods of net purchasing (net capital inflows) were the first half of 2017 and the first third (January through April) of 2018. Regarding the first half of 2017, this article has several times discussed the rising expectations of EU political stability that emerged in the April-May 2017 period when Emmanuel Macron was elected and inaugurated as France's president. The first third of 2018 was a period in which investments in EUR-denominated assets gained momentum owing to expectations spurred by such ECB policy normalization measures as those to adjust the forward guidance text, terminate the asset purchase programme (APP) as well as indications that the ECB might later undertake interest rate hikes and terminate

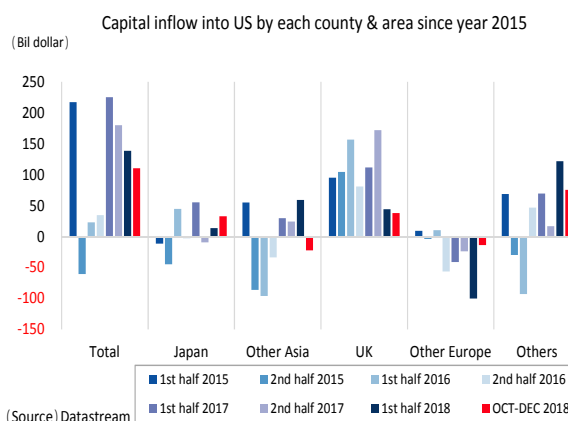
reinvestments (shrink its balance sheet). However, inward securities investment into the euro area almost disappeared during the latter half of 2018 (see graph).

Net outward securities investment (net capital outflows) to outside the euro area were sustained during the part of the latter half of 2018 albeit at considerably lower levels. From September 2018, however, a trend of net selling (capital inflows; fund repatriation) accelerated, causing a considerable net influx of capital. It is important to note that this pattern of euro area-related capital flows is preventing EUR from dramatically weakening despite the extremely negative trends in the euro area's political and economic situations.

Narrowing "Europe USA" Flows

When examining the relationship between EUR/USD and capital flows, one finds a worrisome aspect of trends in U.S. inward securities investment. This situation is reflected in U.S. statistics (Department of the Treasury, Treasury International Capital (TIC) reports) shown in the graph on the right. (As there is no separate category for the euro area, we will refer to figures for the "other Europe (excluding the United Kingdom)" category as a proxy.) Basically, the direction of Europe-U.S. capital flows is not "other Europe USA" but "USA Other Europe". Because it is assumed that a not-inconsiderable portion of investment from other European countries is statistically accounted for as investment from the United Kingdom, it can also be assumed that there still does in fact exist a considerable "other Europe USA" flow; however,

there was a sharp drop in the flow of capital from the United Kingdom into the United States during 2018 (see graph). In any case, the U.S. data confirms the European data in suggesting that the level of European investors' risk tolerance has fallen against the backdrop of chaotic political and economic developments in Europe and in indicating that this has restrained the flow of capital (foreign securities investment) from Europe to the United States. This situation constitutes a "tailwind" promoting a rise in EUR against USD. The euro area has the world's largest current account surplus, and if it refrains from outward investment, it is likely that EUR trading will be dominated by real-demand-based buying. The pattern of growing risk avoidance moods in a given economy suppressing external risk taking and thereby promoting the strengthening of that economy's currency is a pattern that has been frequently seen with respect to JPY. I argued several years ago in my book, "Ready for the Japanization of Eurozone, Euro and ECB,"³ that EUR would become subject to this pattern, and this now seems to be happening. When considering the background of EUR's surprising strength at this time, it is wise to keep in mind that the simple factor "EUR strengthening resulting from USD weakening" is being compounded by a growing imbalance in international capital flows.



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³ Daisuke Karakama, *Ready for the Japanification of Eurozone, Euro and ECB*, Toyo Keizai, Inc., November 2014