Forex Medium-Term Outlook

August 31, 2020

MIZUHO

Overview of Outlook

USD continued to weaken in August but showed signs of recovery against JPY. On the other hand, JPY strengthened following the unexpected news of Prime Minister Shinzo Abe's resignation, but this does not seem to be the beginning of a larger trend as of the time of writing this report. It is perhaps only after the full picture of the next administration emerges next month or later that the true impact will become apparent. Looking at the JPY supply-demand situation for 1H of 2020, there is a tendency toward JPY selling led by the trade deficit. My impression regarding past phases of near-hysterical JPY appreciation is that they were often driven by Japanese export companies selling USD in large amounts against the backdrop of trade surpluses. If this is really the case, the current phase of USD weakening against JPY is likely to be gentle compared with that seen in the wake of the 2008 global financial crisis. However, the possibility of a weak-USD trend cannot be ruled out given that USD seems overvalued in light of the enormous U.S. fiscal deficit. U.S. consumer sentiment remaining weak despite the historically high share prices may be another reason to let go of USD, and the impact of the approaching U.S. presidential election is also cause for concern. Market forecasts center around the prediction of USD appreciation if President Trump wins and USD depreciation if Joe Biden wins, but there is no strong consensus regarding this. It seems likely that USD will continue to weaken as a trend during the current forecasting period, but depending on the results of the U.S. presidential and Senate elections, one must also be prepared for a reversal of the trend.

Meanwhile, EUR has remained firm despite the slight respite in USD depreciation. Unlike in the case of Japan, the euro area has one of the world's largest current account surplus mainly due to its enormous trade surplus. This is why EUR is overwhelmingly more likely than JPY to face a strong and direct currency appreciation pressure. In fact, the performance of the two currencies since July has been vastly different. As interest-rate differentials become a thing of the past, it seems natural to assume that a currency backed by the certainty of real demand will be appreciated by investors. Of course, so long as the ECB maintains its deep negative interest rate level of -0.5%, there is a limit to how much EUR can be purchased. Going by past experience, the purchasing power parity (PPP) rate of 1.20 dollar is a key milestone when it comes to EUR/USD and could be a strong ceiling. The EUR speculative long position as seen from IMM futures transactions remains at an all-time record high, so it seems wise to be prepared for a reactionary fall going forward, but in a situation where interest rates have disappeared from the markets, supply-demand analysis becomes quite significant. In the medium term, my prediction is that EUR, as a trend, will remain strong not just against USD but also in general.

Summary Table of Forecasts

	2020 Jan -Aug (actual)	Sep	Oct-Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	101.18 ～ 112.23 (105.36)	102 ～ 107 (104)	100 ～ 106 (103)	98 ～ 105 (100)	98 ～ 105 (101)	99 ～ 107 (102)
EUR/USD	1.0636 ～ 1.1966 (1.1910)	1.17 ～ 1.20 (1.18)	1.15 ～ 1.20 (1.18)	1.16 ～ 1.21 (1.19)	1.17 ～ 1.22 (1.18)	1.17 ～ 1.22 (1.18)
EUR/JPY	114.43 ～ 125.58 (125.48)	121 ～ 127 (123)	119 ～ 126 (122)	117 ～ 125 (119)	117 ～ 126 (119)	118 ～ 128 (120)

(Notes) 1. Actual results released around 10 am TKY time on 31 August 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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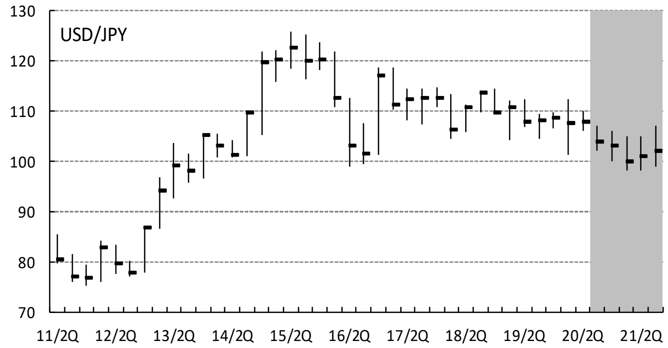
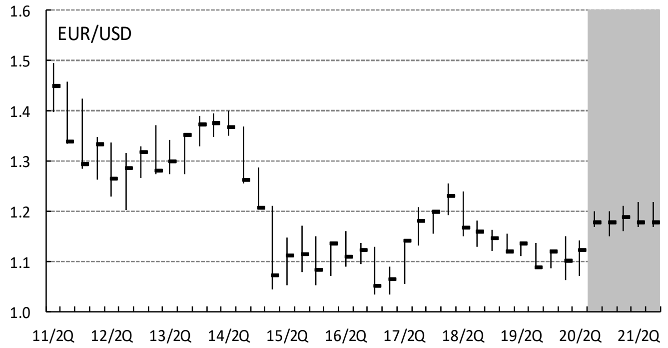
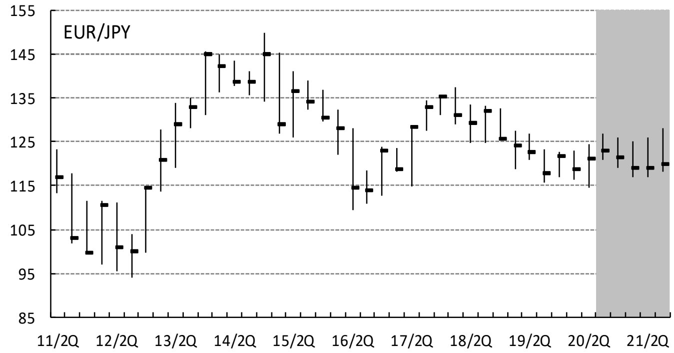
Exchange Rate Trends & Forecasts





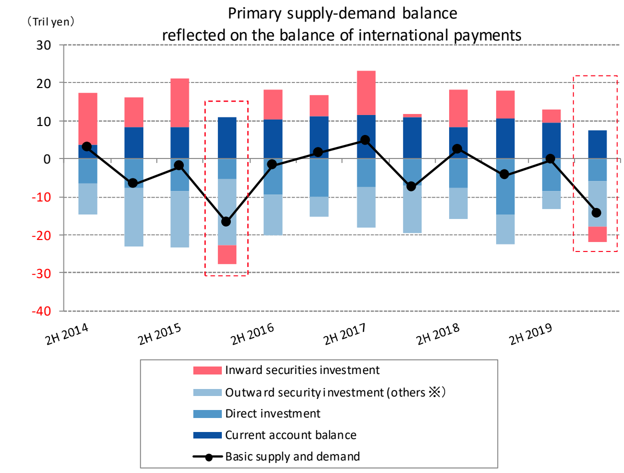


USD/JPY Outlook – Decline in JPY Demand; Effect of Effectively Negative Interest Rates

JPY Supply and Demand – Taking Stock of Basic JPY Supply-Demand During 1H of 2020

Decline in Current Account Surplus Could Impact Forex Market Significantly

USD remained level in the forex markets in August. Although there was a break in the trend of its overall depreciation, the currency did not recover lost ground either. At one point it recovered to the 107 level against JPY, but this did not last long and the currency has been sinking below the 106 level intermittently. The markets continued to be swayed by expectations regarding the additional stimulus package (officially, Phase 4 of the Coronavirus Aid, Relief, and Economic Security Act or the CARES Act), which is being discussed in Congress. However, my basic understanding is that the emergency spending, which has already reached 15% of GDP, is a strong factor indicating USD depreciation. Going forward, when an agreement regarding the details of Phase 4 of the CARES Act is reached, the resulting optimism is likely to boost the purchase of shares and USD, but it should be understood that this is no more than a short-term market response to the situation. <u>In theory and from a longer-term perspective, it is reasonable to forecast USD selling</u>.



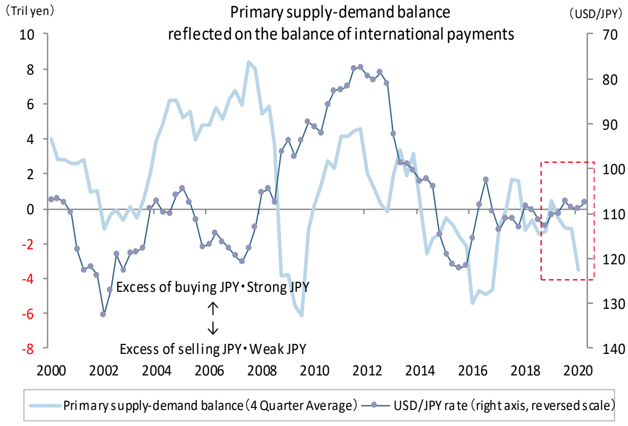
(Source) INDB (Note) ※Subject: including insurers, pension funds & individuals, excluding deposit taking finance instructions & government

In this context, Japan's June international balance of payments were released in August. This enabled the calculation of JPY supply and demand for 1H of 2020, so I would like to summarize the situation here. There was a net JPY sale of around -JPY 14.5 trillion during 1H of 2020 (see figure). <u>This is the largest net sale of JPY in the past four years, since the -JPY 16.7 trillion net sale during 1H of 2016</u>. As the figure shows, the 2016 net sale was led mainly by an increase in foreign securities investment. <u>This time, the net sale comes amid dwindling foreign securities investment, and is the result of a conspicuous decline in the current account surplus</u>.

It is important to understand the breakdown of the decline in current account surplus, which has fallen by around -JPY 3.3 trillion yoy (compared with 1H of 2019). This decline can be explained primarily by the expansion of the trade and service deficits. In the balance of payments, the trade balance fell from +JPY 173.4 billion for 1H of 2019 to -JPY 1.976 trillion for the same period this year, posting the first 1H deficit in five years. Meanwhile, the balance of services fell from +JPY 172.6 billion for 1H of 2019 to around -JPY 1.2 trillion this year. Needless to say, this decline in balance of services is due to the dramatic decline in the travel surplus – the main earner in the services category – as a result of the sharp drop in foreign visitors to Japan. The travel surplus posted a nearly JPY 1 trillion decline from around +JPY 1.4 trillion for 1H of 2019 to +JPY 421.3 billion for the same period this year. As a result, the sum of the balance of trade and services has fallen from a surplus of +JPY 346 billion for 1H of 2019 to a deficit of around -JPY 2.6 trillion for the same period this year. Clearly, this has contributed to dampening the current account surplus. When considering supply and demand from the perspective of the forex markets, trade and travel balances have a more direct impact because the foreign currency earned as a result of the trade and travel balances involve significant transaction flows of outright JPY buying (foreign currency selling). In this sense, the situation is different from 1H of 2016, when net selling of JPY expanded due to an increase in foreign securities investments, a large percentage of which tend to be hedged. The forex market implications of this year's net selling of JPY caused by large trade and service deficits are, therefore, likely to be more significant.

Market Equilibrium Begins to Collapse

As discussed in past issues of this report, one of the reasons for low USD/JPY volatility over the past 2-3 years is probably the fact that JPY has been more or less in a state of market equilibrium. Starting around 2017, neither JPY supply nor demand were conspicuously in excess of the other, and USD/JPY movements appeared to have become small in response to this. Taking this theory into account, one cannot ignore the fact the JPY selling is now clearly expanding (that too as a result of an expansion in the trade and service deficits). Of course, as mentioned at the start, one of the big themes in the forex markets going forward will be an increasing sense of USD overvaluation accompanying U.S. fiscal deficit expansion, so making forecasts based primarily on JPY supply and demand is bound to result in wrong judgements. In my view, the most appropriate thing would be to assume a larger trend of USD depreciation. Past phases of accelerating JPY appreciation were thought to have been largely driven by Japanese export companies selling USD in large amounts against the backdrop of trade surpluses. Such a thing, however, is quite unlikely in the current JPY supply-demand climate. It is reasonable to predict JPY appreciation as a result of USD depreciation, but going by the JPY supply-demand climate during 1H of this year, a near-hysterical phase of JPY appreciation as that seen following the global financial crisis seems unlikely.



(Source) Bank of Japan & INDB

Effectively Negative Interest Rates Propping up Financial Markets? – Could this be the Root of All Evil?

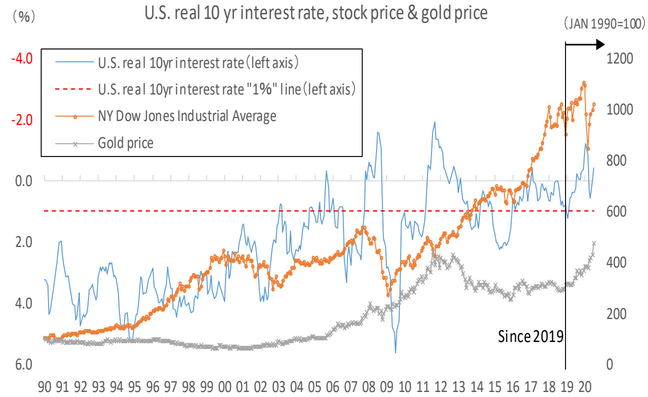
Market Theme Appears Unchanged Since July

Gold prices continued to hit highs on a daily basis in the financial markets in July. Even as of the writing of this report, gold prices are at historically high levels. Given this combination of USD depreciation and gold price appreciation, some are beginning to float the theory of a loss of confidence in USD or using a wider brush stroke to question confidence in fiat currencies in general. Regarding this theory, I argued in a recent issue of Market Topics that it was not wrong, just something proposed in hindsight. Some commonly cited reasons for gold price appreciation include (1) uncertainty over when the COVID-19 crisis will end, (2) loss of confidence in fiat currencies as a result of expansionary fiscal policies implemented in response to the crisis, and (3) gold's zero interest rate, which used to be a disadvantage but is no longer one.

Decline in Effective Interest Rates the Root of All Evil?

All three reasons mentioned above seem relevant, but they only roughly explain the current situation. For instance, they do not explain why leading economic indicators such as copper and share prices are also increasing alongside gold prices. If the vague anxieties indicated in reason (1) were dominant, there would be no reason for copper or shares to be bought. Moreover, bond prices have increased (bond interest rates have decreased) recently. If, indeed, there was a loss of confidence in fiat currency as indicated in reason (2), it would be very difficult to explain a rise in the price of government-issued bonds. Taking these contradictions into account, a more convincing theory may be that the financial markets are simply reflecting a trend of excess liquidity being channeled into (invested in) assets with higher expected returns (put simply, assets that would be easier to explain in retrospect) – my view is that this theory may be closer to the reality.

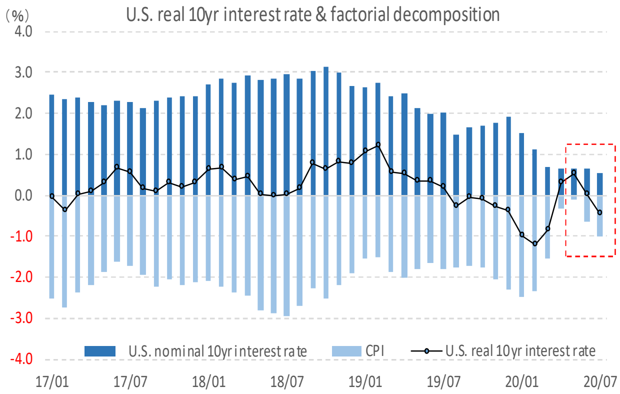
Based on the above general understanding, reason (3) probably comes closest to convincingly explaining why USD would depreciate at the same time that gold and share prices are appreciating. In the first place, the presence of excess liquidity, creating the above financial market conditions, is due to the evaporation of nominal interest rates as a result of full-throttle monetary easing. One cannot overlook the fact that fiat currency interest rates have become scanter than ever before. It is reasonable to assume that the phenomena currently observed in the financial markets are rooted in the fact that U.S. real interest rates (nominal interest rates minus inflation rate) are stable at the lowest levels ever seen. The figure compares the NY Dow Jones Industrial Average and gold price trends against the real U.S. 10-year interest rate trend, which is derived by subtracting the consumer price indicator (CPI, aggregate, yoy) from the nominal 10-year interest rate. The real 10-year interest rate has consistently been below 1% since 2016, and below 0.5% over the past year or so. In 2019, the Fed implemented as many as three rate cuts, which set the 10-year interest rate on a declining trend, both in nominal and real terms. At that time, the vigorous rise in share prices drew most of the attention, but in fact, gold prices also rose. They did not draw as much attention, however, because their rise was not record-breaking.



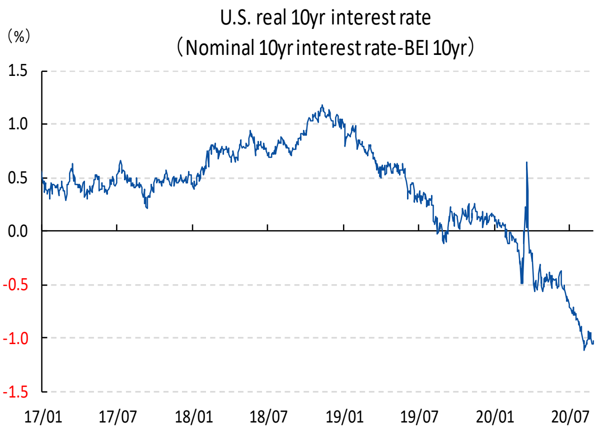
(Source) macrobond

Expectations-Based U.S. Long-Term Interest Rates Settle in Negative Zone

Further, in July, both the U.S. 10-year interest rate and performance-based 10-year interest rate calculated using the CPI fell to -0.4%. However, since April, the CPI has remained at 1% or lower, thanks to the sharp fall in crude oil prices, which is quite an exceptional thing in itself. As the figure to the right (top) shows, real interest rate fluctuations have remained low since April only because both nominal interest rates and CPI have been exceptionally low (the portion within the dotted square). Given that the average CPI for the January-March quarter 2020, before the COVID crisis intensified, was +2.1%, and that the average CPI for the whole of 2019 was +1.8%, and assuming that the economy will, by and large, gradually recover going forward, the real interest rate will probably settle somewhere in the negative zone. The figure to the right (bottom) plots the daily changes in the real 10-year interest rate using the 10-year break-even inflation rate. It is obvious at a glance that the markets had already started factoring in the advent of a phase of negative long-term real interest rates from the end of January. This coincides exactly with when the existence of the novel coronavirus became commonly known. Then, starting April, the U.S. long-term interest rate began to stay below -0.5%, and recently, it has been lower than -1.0%. We are now in a phase when market-expectations-based U.S. long-term interest rates are negative as a rule. Given these expectations regarding U.S. interest rates, which are seen as the world's "cost of capital," investors may have decided that they can afford to buy gold or copper or shares with eyes closed. At the present time, it is extremely difficult to neatly explain all the never-before-seen events, great and small, unfolding in the financial markets, but theories that attempt to find the root cause of such developments in the settling of real U.S. long-term interest rates in the negative zone seem to be fairly convincing.



(Source) macrobond
(Note) Real interest rate = nominal 10yr interest rate - CPI, so CPI is shown as a deduction.



(Source) Bloomberg

U.S. Monetary Policy Now and Going Forward – "Average Inflation Target" Reaffirms Existing Scenario

No U.S.-Style YCC for the Time Being
No FOMC meetings were held in August, but the minutes of the July 28-29 FOMC meeting were published on August 19. There is not much expectation in the markets of any immediate next move by either the Fed or the ECB, even though the possibility of a U.S.-style yield-curve control (YCC) by the Fed has been drawing some interest. As of the writing of this report, the big risk event for the period from September onward (excluding the spread of COVID infections) is the U.S. presidential election, so monetary policy is likely to relegated to the sidelines during this time, but it may be useful to take stock of the various options available to each country's central bank.

The Fed has consistently indicated over the past several FOMC meetings that YCC is not high on its list of priorities, and the policy was once again rejected following the July FOMC meeting. The minutes note that "a majority of participants commented on yield caps and targets as a monetary policy tool" possibly in response to the high expectations in the market. "Most judged that yield caps and targets would likely provide only modest benefits in the current environment, as the Committee's forward guidance regarding the path of the federal funds rate already appeared highly credible and longer-term interest rates were already low," it was noted. Further, "Many of these participants also pointed to potential costs associated with yield caps and targets," including "difficulties in the design and communication of the conditions under which such a policy would be terminated." This is as expected. Market participants would feel greatly incentivized to force the central bank to buy up as many government bonds as possible while their prices are high (interest rates are low). The central bank's balance sheet would expand rapidly as a result. Most FOMC members are likely to be aware of the difficulty of attempting to terminate a YCC policy while preventing the rapid expansion of the Fed's balance sheet.

YCC Could Become Necessary at Some Time?
While it seems quite unlikely that YCC will be introduced in the near term, the possibility cannot be ruled out altogether. The minutes clearly stated that "many participants judged that yield caps and targets were not warranted in the current environment but should remain an option that the Committee could reassess in the future if circumstances changed markedly." As noted above, the FOMC's forward guidance regarding the path of the federal funds rate is currently quite credible as evidenced by low longer-term interest rates. However, there is no guaranteeing that this situation will continue unchanged given the expected increase in the issuance of government bonds. As is generally known, YCC was introduced for the first time by the BOJ as a desperate measure in mad pursuit of quantitative easing (QE) and as a measure to alleviate the side effects of negative interest rates. The BOJ's approach involved controlling the yield curve itself. By contrast, the Fed's official term for the policy is "yield caps and targets," which indicates an approach that caps (sets an upper limit for) or targets interest rates along the yield curve. In other words, if expansionary fiscal policies are further boosted in response to economic stagnation going forward, and concerns emerge of an increase in interest rates, the need for YCC could be taken up for discussion again. However, note that the Fed has worked to quell market anxieties under its policy of "unlimited" bond buying since early spring this year. Given that the "unlimited bond buying" policy was essentially an operation aimed at manipulating real interest rates, one gets the feeling that any future implementation of YCC by the Fed will simply involve openly admitting to doing what it has already been effectively doing under a different guise. If so, it seems very likely that any discussion aimed at introducing YCC will end with the conclusion that it would not be worth its while considering the difficulty of finding an appropriate exit strategy, as pointed out in the recent meeting minutes. Going forward, the rise in U.S. interest rates would have to be quite dramatic and serious before YCC is seriously considered.

Note, however, that while the possibility of YCC was overtly rejected in the recent minutes, "a number of participants (…) commented on outcome-based forward guidance," i.e., urged the continuation of accommodative monetary policies at least until one or more specified economic outcomes (inflation-rate or employment-rate) was achieved, "and also touched on calendar-based forward guidance," i.e., maintaining the current target range at least until a particular calendar date. Further, though not fully refined, the current basic stance of the FOMC seems to be to buoy up expectations in terms of the continuation of current accommodative monetary policies rather than forcing interest rate levels down through YCC.

Under such circumstances, the key to formulating forex market outlooks will be to study and analyze the situation based on the assumption of a "world without interest rate differentials" for some time to come.

Going by the BOJ's Experience, Not Much can be Expected from an "Average Target" Policy
On August 27, the Fed released its "Statement on Longer-Run Goals and Monetary Policy Strategy" coinciding with Fed Chair Jerome Powell's Jackson Hole Economic Symposium speech. It was somewhat surprising to see the release of such a statement before an FOMC meeting had been held. Simply speaking, the statement affirms that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time," indicating that an average of 2 percent inflation over time is ideally desired. Specifically, the statement that says that the Committee "seeks to achieve inflation that averages 2 percent over time," although there is no specific indication of the exact period over which this average inflation target will be calculated. Regarding the statement that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2

percent for some time,” it is very natural for a central bank to strengthen monetary accommodation when inflation is sluggish. The question is, to what extent will the policy’s efficacy be increased by pushing to “achieve inflation moderately above 2 percent?” Going by the BOJ’s experience, any increase in efficacy is doubtful.

Average Target Reaffirms Existing Scenario

At the very least, it appears unlikely that the above statement will impact the Fed’s understanding of the present situation and significantly change its next move. Looking at the personal consumption expenditure (PCE) deflator forecasts for 2022 in the latest summary of economic projections (SEP) released in June, both the aggregate and the core are projected to be below 2% at 1.7%. There is also the fact that, in reality, the PCE deflator has not touched 2% since the end of 2018. It is not clear, therefore, what time period the Fed will use for calculating the “average inflation,” but if one takes the SEP as a guide, returning to monetary tightening any time before the end of 2022 seems unlikely based on the “average inflation” target framework. However, such a policy prediction is consistent with the gist of the June dot plot, which indicated a consensus of opinions around a zero percent interest rate through the end of 2022 (see figure on previous page). Perhaps the “average inflation target,” which has been drawing a great deal of attention, is best understood as no more than a framework for reaffirming the existing policy scenario. However, the “average 2% inflation” target seems quite difficult to achieve even before the end of 2023 unless inflation rises dramatically, in a non-linear manner.

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

FOMC Date	2020	2021	2022	Longer run
Mar-18	3.375%	n.a.	n.a.	2.875%
Jun-18	3.375%	n.a.	n.a.	2.875%
Sep-18	3.375%	3.375%	n.a.	3.000%
Dec-18	3.125%	3.125%	n.a.	2.750%
Mar-19	2.625%	2.625%	n.a.	2.750%
Jun-19	2.125%	2.375%	n.a.	2.500%
Sep-19	1.875%	2.125%	2.375%	2.500%
Dec-19	1.625%	1.875%	2.125%	2.500%
Jun-20	0.125%	0.125%	0.125%	2.500%

(Source) FRB

Many of Mr. Powell’s comments regarding the operation seemed hedged

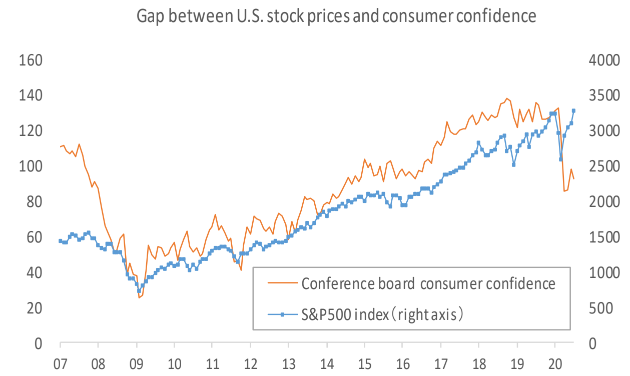
Naturally, Mr. Powell also mentioned the average inflation target in his widely anticipated Jackson Hole speech, but many of his comments regarding its operation seemed hedged. In the section of his speech subtitled “New Statement on Longer-Run Goals and Monetary Policy Strategy,” Mr. Powell declared, “in seeking to achieve inflation that averages 2 percent over time, we are not tying ourselves to a particular mathematical formula that defines the average.” He continued, saying, “our approach could be viewed as a flexible form of average inflation targeting. Our decisions about appropriate monetary policy will continue to reflect a broad array of considerations and will not be dictated by any formula.” On the other hand, he also stated that “if excessive inflationary pressures were to build or inflation expectations were to ratchet above levels consistent with our goal, we would not hesitate to act.”

Ultimately, it boils down to the fact that, having introduced the concept of an “average” in evaluating inflation trends, the Fed will make a qualitative decision regarding the appropriate time period for calculating the average. Further, given the intent to unhesitatingly tighten monetary policy depending on the level of inflationary pressures or expectations, it seems that the average inflation policy itself could be scrapped based on the circumstances. The fact is that accepting an inflation rate of over 2% is not a new development, given that the Fed’s 2% inflation target has always been a “symmetric target.” Of course, in terms of controlling market expectations, it is important for the central bank to communicate that it is willing and able to use whatever means necessary depending on the circumstances, but it seems unlikely that the markets have taken the recent change in monetary policy strategy very seriously.

U.S. economic conditions now and going forward – Emerging Disconnect between Trends in Stock Prices and Consumer Sentiment

Consumer Sentiment Fails to Rise in Parallel with Stock Prices

Although there are some positive developments beginning to alleviate the generally extremely pessimistic appraisals of U.S. economic conditions, the U.S. economy remains in an unstable state, and it is worth giving particular attention to the sluggishness of consumer sentiment. The Conference Board Consumer Confidence Index level dropped sharply to 84.8 in August (from 91.7 in July), the lowest level seen in 75 months, since May 2014. Forecasters had generally been expecting a mom improvement in the index, so the lower level recorded for August was considerably lower than the median level of forecasts (93.0). Substantial deterioration was seen in both the Present Situation Index (95.9 → 84.2) and the Expectations Index (88.9 → 85.2). Given the positive trends seen amid the latest hard data – indicating a robust recovery in personal consumption housing and a clear-cut improvement in housing related figures (home sales and housing investment) – this consumer sentiment deterioration appears to be a conspicuously ‘disparate’ outlier indicator. As discussed in previous editions of this article, U.S. consumer sentiment is fundamentally linked to stock prices (see graph), which is not surprising given the high share of equities in U.S. households’ financial assets. At the end of March 2020, for example, this share was 32.5% for households in the United States, compared



(Source) macrobond

with 17.2% for households in the euro area and 9.6% for households in Japan. When unrealized investment gains increase due to a rise in stock prices, consumer sentiment is expected to improve, and it is also expected that more consumption and investment activities will ensue. This kind of easily understood asset effect has been a special characteristic of the U.S. economy that is lacking in Japan and Europe. As the graph shows, however, although stock prices have re-attained their pre-pandemic level, consumer sentiment remains weak. In fact, it seems that the initial sharp drop in consumer sentiment index has been followed by movements that may well be seeking a still-lower level to bottom out at, and this appears to present due cause for concern.

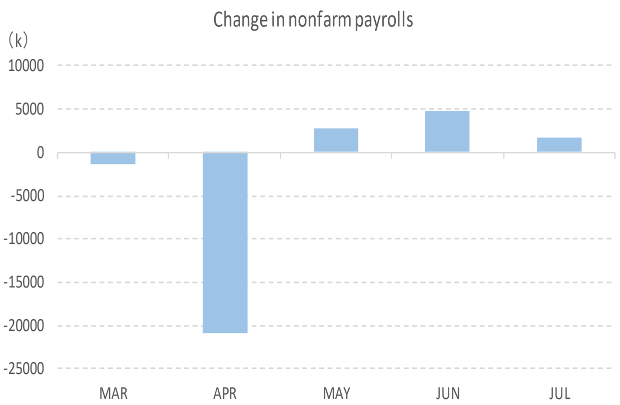
Basis of Consumer Sentiment Trend Disparity

Lynn Franco, Senior Director of Economic Indicators at The Conference Board, said – "Consumer spending has rebounded in recent months but increasing concerns amongst consumers about the economic outlook and their financial well-being will likely cause spending to cool in the months ahead." This trend is clearly shown in the results of the Conference Board's survey of job market conditions – the share of respondents saying jobs are "plentiful" declined (22.3% → 21.5%), while the share of those saying jobs are "hard to get" increased (20.1% → 25.2%). This reflects the fact that the trends of improvement in consumption and investment activities since early spring have not resulted from autonomous trends in the real economy (particularly improvement in the hiring and wage environment) but have been enabled by extremely generous government subsidies, such as supplemental unemployment insurance benefits.

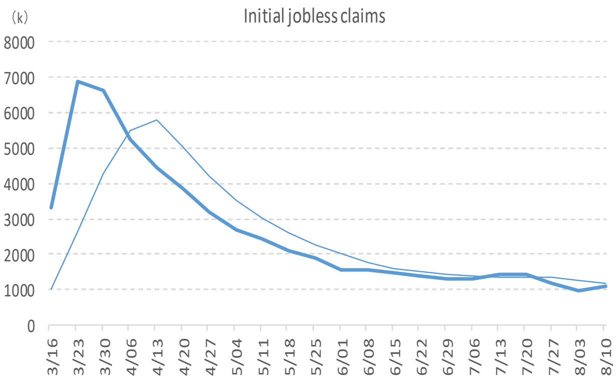
Amid steady improvement in such hard economic data as that related to personal consumption, home sales, and investments, it can be presumed that the "disparate" trend of continued deterioration in consumer sentiment is based on consumers' worry that the current level of government subsidies cannot be sustained forever. Thus, the ending of the pandemic is probably the only factor capable of fundamentally alleviating such consumer anxiety. U.S. consumers are currently dealing with diverse and unclear expectations associated with the impending presidential election, and it seems possible that the confused political outlook is also promoting consumers' doubts about the sustainability of various government subsidy programs. Media reports at the time this article was written continued to indicate that the outlook for a fourth economic stimulus package remained unfavorable, so it does not appear that there will be a major government move to countervail the trend of deteriorating conditions in the real economy in the near future.

Net Loss of Over 12 Million Jobs

Basically, reviving the previous level of consumer confidence entails creating an environment in which consumers can obtain jobs along with the expectation of stable earnings going forward. In this regard, it is worth noting that nonfarm payrolls (NFP) dropped by approximately 22.2 million during the March-April period and then increased by roughly 9.3 million during the May-July period. A superficial examination of stock price trends and other data may encourage an optimistic view that the United States' economic and financial situations have considerably improved from their nadirs, but it bears keeping in mind that the NFP figures suggest that there has been a net loss of more than 12 million jobs over the past half year (see graph, above right). The number of initial jobless claims – an important basis for forecasting future employment trends – has decreased significantly since mid-March (see graph, below right). However, the most recent figure was 1.1 million, which represents the first increase in three weeks, and the margin of increase (135,000 from the previous week) was the largest recorded since mid-March. On the other hand, the continued decline in four-week average number of applications suggests that the deterioration of the employment environment has bottomed out. That said, there has been a clear down-shift from the April-June period's "sharp improvement" trend to a subsequent "modest improvement" trend, and I think it is important to closely monitor the situation and determine whether there may in fact be an ongoing transition from the "modest improvement" trend to a static "flat" trend in the number of applications. Given the net loss of more than 12 million jobs, there remains plenty of room for further improvement. Merely flattening the trend in the number of new unemployment insurance applications is not a sufficient basis for characterizing the situation as "improving".



(Source) macrobond



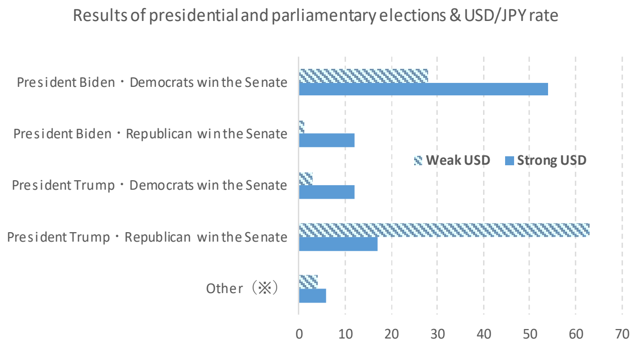
(Source) macrobond
(Note) The thin line is a four-week moving average

In any case, while the recent historically high levels of stock prices tend to obscure the deep wounds suffered by the real economy, it must be remembered that U.S. households continue to face a quite perilous economic environment. A medium-to-long-term forecasts of interest rate and exchange rate trends should take this situation into account, and it is my basic understanding that uptrends in U.S. interest rates and USD are extremely unlikely in the near future.

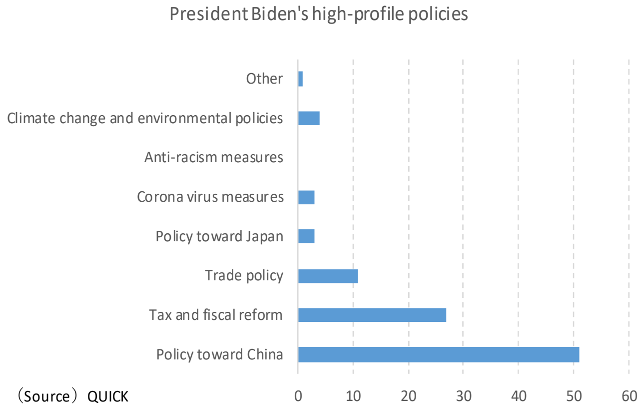
Risks to My Main Scenario – JPY Insulated from U.S. Presidential Election-Related Risks?

The U.S. Presidential Election and the Forex Market

With less than three months remaining before the November 3 U.S. presidential election, I am receiving numerous inquiries about how the election relates to financial market risks, particularly forex market risks. Except for the coronavirus pandemic situation, there is no doubt that the U.S. presidential election is the most important event in the second half of the year with respect to financial market risks. The results of a survey of forex market participants jointly conducted by the financial market information vendor QUICK Corp. and the Nikkei Veritas financial weekly on August 11-12 are a useful basis for evaluating the ways U.S. presidential and senate elections may impact the forex market. The graph (above right) shows that there is a general expectation that a "President Trump/Republican Senate Control" scenario will promote USD appreciation while a "President Biden/Democrat Senate Control" scenario will promote USD depreciation. However, almost 30% of respondents anticipate USD appreciation even in the "President Biden/Democrat Senate Control" scenario, and this suggests that many respondents do not have a very clear idea about what really would ensue if the Democratic Party were to take control of both the presidency and the senate. It is worth noting that, even when the media report that the Democratic Party is making dramatic progress, the financial markets' reaction to such reports has been limited. It seems likely that many financial market players are refraining from speculating on the impact of Democrat control of the presidency and senate because much of Mr. Biden's prospective policy management postures are still unknown or unclear to them. However, it is expected that the Democratic Party's policies will take clearer shape as the elections approach and that the financial markets' price setting processes will begin giving greater weight to expectations regarding the likely impact of election results. Financial market players are particularly interested in whether the current U.S. posture toward China will be softened or maintained (see graph, below right). It thus seems likely that Mr. Biden's statements related to China will be become increasingly important market-moving factors.



（Source）QUICK (Notes)※"No impact", "Weak dollar is a theme until the presidential election, after which the position will be unwinded" etc



（Source）QUICK

It is noteworthy that mixed election results – the "President Biden/Republican Senate Control" and "President Trump/Democrat Senate Control" scenarios – are expected by clear majorities of respondents to be more likely to promote USD depreciation than USD appreciation. Since the financial markets tend to be averse to all kinds of uncertain factors, it does not seem illogical that they would anticipate that USD depreciation would result from mixed election results likely to promote governmental gridlock. Although the relevant number of respondents is not large, it is worth noting that there is some support in the "others" scenario category for the theory that USD selling will be a market theme up until the presidential election and that USD will therefore strengthen following the election regardless of the election result. It does in fact seem likely that the completion of the U.S. presidential election will eliminate uncertainties and thereby generally promote a temporary USD buy-back trend, but even in that case it seems likely that the previous USD selling trend would resume after no more than a few months. In such a case, one must be prepared for the possibility of considerable changes to EUR and JPY exchange rates.

USD/JPY Likely to Be the "Odd One Out"?

The gist of the survey results – that a President Trump second term scenario will promote USD appreciation while a President Biden scenario will promote USD depreciation – seems realistic, but, probably reflecting the decrease in volatility in recent years, respondents seem to strongly favor forecasts that – regardless of the election outcome – the margin of post-election forex rate changes will not be very large (see chart). For both the President Trump scenario and the President Biden scenario, the average USD/JPY levels anticipated by respondents are in the "102 to 110" range. Some respondents predict minimum levels as low as 95 for the President Biden scenario, but some respondents predict minimum levels as low as 98 for the President Trump scenario, and this seems to indicate that neither one of the scenarios' eventuation is likely to cause a significant change to the market's perception of the appropriate USD/JPY level.

USD/JPY end-year forecast
based on President Trump second term scenario

	Low	High
Simple mean	103.24	110.4
Standard deviation	2.14	2.48
Median	103.5	110
Mode	105	110
Lowest	98	105
Highest	108	120

（Source）QUICK

As a matter of fact, amid the accelerating USD depreciation trend seen since July, JPY exchange rates have not moved as much as EUR exchange rates. Even if the U.S. presidential election does promote some sort of forex trend, I consider it a possibility that JPY might be the "odd one out" rather than being in the thick of the trend. There have been hints of such a possibility since last year, and there are those who believe it might reflect the decline in USD-JPY trading volume. In this connection, it has been pointed out that Japan's international trade was close to being balanced in the 2018-2019 period, so the volume of outright trading itself has been declining for macroeconomic reasons. Another related factor is that Japan recorded a trade deficit of more than JPY2 trillion in the first half of this year, and there are those who believe that situation positions JPY to depreciate speedily if USD strengthens. Given that, I think the "President Biden scenario weakening USD" scenario is less likely to give directionality to USD/JPY trends than the "Trump reelection strengthening USD" scenario.

USD/JPY end-year forecast
based on President Biden scenario

	Low	High
Simple mean	102.04	109.32
Standard deviation	2.58	2.61
Median	102	109.75
Mode	100	110
Lowest	95	103
Highest	108	115

（Source）QUICK

In any case, as the polls and news media have been suggesting that Mr. Biden is currently favored to win the election and as market participants do not yet have a clear understanding of the prospective nature of a Biden administration's policies, the current situation seems to be one in which market participants are highly interested in the election but do not yet consider it a factor that should be reflected in determining market price levels. As Biden's policy proposals become more tangible, it can be expected that the forex market will become highly responsive to presidential election-related market-moving factors.

EUR Outlook – EUR/USD to Re-attain the 1.20-1.21 Range?

EUR Area Monetary Policies Now and Going Forward – ECB Views on PEPP and TLTRO3 Elucidated in the July Governing Council Meeting Account

EUR Extremely Robust

Although there was no ECB Governing Council meeting in August, the Account of the July 15-16 Governing Council meeting was released on August 20. That meeting focused on such issues as whether the net purchase envelope of the Pandemic Emergency Purchasing Program (PEPP) should be considered a ceiling rather than a target and how the regional credit environment should be evaluated, and it was not eventful enough to attract a great deal of attention from the financial markets. The meeting's Account does offer substantial information that can facilitate efforts to forecast the ECB's "next move," however, so it is worth overviewing it here.

The beginning of the meeting emphasized that economic and financial situations were generally improving and associated moods were recovering from recent extremely pessimistic nadirs, and Executive Board Member Isabel Schnabel pointed out three main stabilizing factors. These are (1) market participants' expectations that responses to further virus spreading would be less invasive and geographically more targeted than previously, (2) the fact that investors in the euro area were still preferring to keep liquid and cash-like positions (meaning that progressive improvement in such investors' risk tolerance could be expected going forward), and (3) signs that monetary policy seemed likely to continue preventing an increase in risk premia (and that the June Governing Council meeting's moves to expand and extend the PEPP and clarify the reinvestment policy had further strengthened associated expectations). As the ECB is naturally inclined to emphasize factor (3), mentions of the effectiveness of the PEPP and TLTRO3 are scattered throughout the Account.

PEPP Envelope Usage

It is worth taking a closer look at the discussion about the PEPP usage framework, which was a major topic at the time of the meeting. In this regard, the Account says – "The argument was also made that the flexibility of the PEPP suggested that the net purchase envelope should be considered a ceiling rather than a target." The reason for considering the envelope a ceiling is explained in the Account's next sentence – "The point was made that incoming data had surprised on the upside and some of the downside risks surrounding the outlook prevailing at the time of the Governing Council's June monetary policy meeting had receded, increasing the possibility that the [PEPP's EUR1.35 trillion] envelope might not have to be deployed fully."

The counterargument to that is then presented as – "the PEPP had been designed to achieve the dual objective of [1] addressing risks to the smooth transmission of monetary policy across the euro area and [2] risks to medium-term price stability owing to the pandemic crisis. Accordingly, under the baseline scenario in the June Eurosystem staff macroeconomic projections, and in the absence of any significant upside surprises to the medium-term inflation outlook, the current presumption was that the PEPP envelope would have to be used in full." At the post-meeting press conference, President Lagarde frankly stated that – "unless there were significant upside surprises, our baseline remains that we will use the entire envelope of the PEPP." She then further emphasized that the ECB – "will continue to use the envelope of the PEPP and make sure that it helps us to get back to the trajectory of inflation pace pre-COVID-19." Basically, the ECB's current official view is "we will use the entire envelope of the PEPP." In brief, the ECB's position appears to be that the PEPP is designed to suppress systemic risks but also has an economic stimulus objective – it is effectively doing the former but is only partially doing the latter. It can be surmised that the ECB's effort to emphasize that the PEPP is not exclusively designed to counter systemic risks but is also intended to have an economic stimulus effect (≈ boost the inflation rate) reflects the ECB's concern that, if the PEPP objective were limited to countering systemic risks, then there would be growing calls from the Netherlands and Germany to discontinue the PEPP in light of the already ameliorated systemic risk situation.

During the portion of the meeting devoted to the economic and monetary analyses of ECB Executive Board member and chief economist Philip Lane, meeting members pointed out regarding the short-term inflation outlook that – "While oil price developments had led to a rebound in headline inflation, it was still close to zero and almost 30% of the items in the HICP basket had posted negative inflation rates." Although that situation also reflected such special factors as a temporary reduction in the German VAT rate, downward pressure on prices in services and non-energy industrial goods were expected to cause a downward trend in inflation rates. Viewing the inflation situation as problematic, the ECB has naturally concluded it must make full use of the entire PEPP envelope.

Focus on Lending

Discussions about TLTRO3 are another particularly interesting portion of the Account. On June 18, the ECB announced the results of the fourth round of TLTRO3 bidding – 742 banks submitted applications for EUR1,308.4 billion of assets and, after the portion of that used to refinance bridge loans, the net liquidity supply amount was a record-high EUR541.5 billion. TLTRO3's popularity reflects its exceptionally lenient conditions – a -0.50% interest rate that can be reduced to as low as -1.00% for banks that reach a specified lending threshold – but the Account notes that – "the pass-through to lending to the real economy was seen as calling for close monitoring."

That comment about lending pass-through is reminiscent of the "Draghi Bazooka" 36-month longer-term refinancing operation (LTRO), which provided EUR1,118.7 billion of liquidity (EUR489.2 billion from the first bidding round on December 22, 2011, and EUR529.5 billion from the second bidding round on March 1, 2012) but was criticized for promoting very little actual lending. The framework devised in response to that criticism was the TLTRO scheme, which offers varying terms based on individual users' lending records, but the terms have been progressively relaxed over time in the course of successive crisis responses, leading to the current framework offering a negative interest rate regardless of users' lending records. At the time of the July Governing Council meeting, bank lending was being supported by euro area governments' loan guarantee systems, and it was pointed out that further analysis is needed regarding how funds obtained from TLTRO3 will be used. The need to clarify how liquidity from TLTRO3 flows into the real economy is considered to be one of the major issues that the ECB is currently facing.

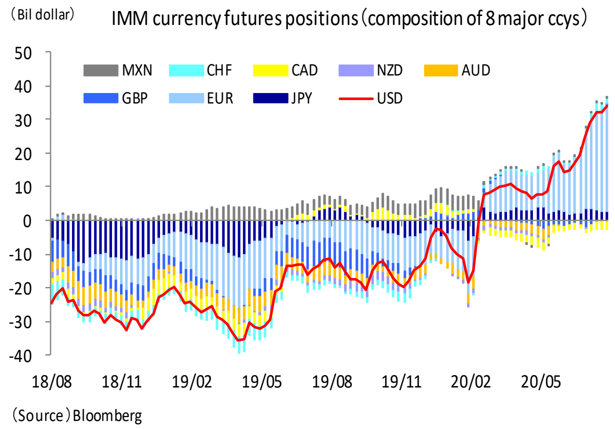
Possibility of APP Temporary Envelope Expansion in September

As discussed in previous issues of this article, it is expected that the additional EUR120 billion temporary envelope for the asset purchase programme (APP) was expected to be exhausted by as early as October. So it would not be surprising if the Governing Council were to consider supplementing that envelope in September when the ECB's staff forecast is to be revised, but the Account makes no direct mention of such consideration. It may be that the July Governing Council meeting did not consider an additional APP envelope because the focus of that meeting was exclusively on the contemporaneous progress being made at that time toward financial and economic recoveries. As mentioned above, however, from early August it has been pointed out that European countries' anti-pandemic measures – initially considered more effective than those of the United States – were beginning to show signs of failure, which was starting to have a negative impact on business sentiment. Depending on the situation at the time of the September 10 Governing Council meeting, one may anticipate the possibility that the Governing Council may move to expand the APP's temporary envelope at that point.

EUR Now and Going Forward – EUR/USD Positioned to Surpass the 1.20 Level

USD Selling Driven Almost Exclusively by EUR Buying

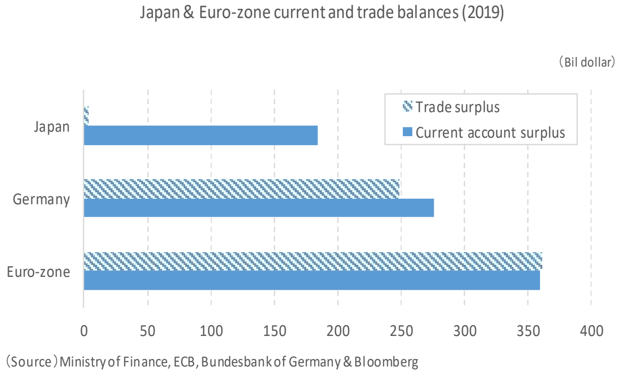
In the foreign exchange market, there has been a pause in trend of USD weakening that began in July, but EUR has continued to strengthen, and the atmosphere strongly suggests it will rise further. While the three principal currencies' relative strength relationship has been changing over time – with alternating periods of "EUR > USD > JPY" and "EUR > JPY > USD" relationships – the USD weakening trend is clearly showing signs of bottoming out, yet the EUR strengthening trend has persisted up through the time this article was written. Looking at the IMM currency futures positions (as of August 25), one finds that the volume of EUR long positions against USD has been increasing week by week. Since these are speculative transactions, one must seek to anticipate the timing of a reverse trading pattern, but there is currently no apparent trigger for determining that timing. During the approximately five months since March USD selling has been driven almost exclusively by EUR buying, and we seem to have clearly reached a stage at which the sustainability of this situation is attracting considerable attention.

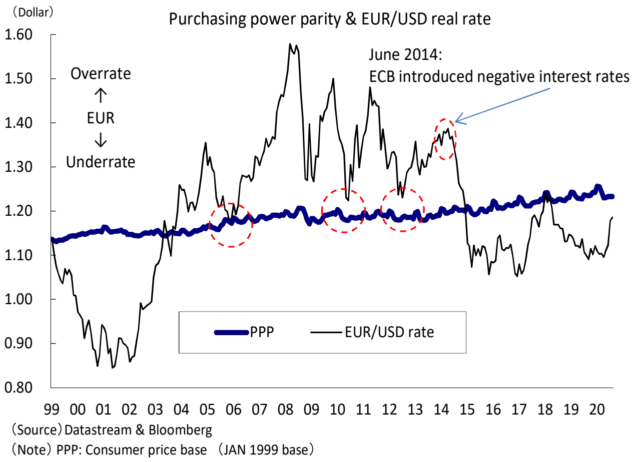


EUR/USD PPP Somewhat Above 1.20

Having repeatedly discussed factors promoting EUR buying in the past, this article will refrain from an additional detailed discussion at this point. But it is worth briefly reemphasizing the point that, since inter-currency interest rate differentials have largely faded away, the supply-demand situation make it natural that there will be considerable EUR buying, since the euro area has been recording the world's largest trade surpluses (backed by current account surpluses). This approach also offers a convincing explanation of why there is such a difference in performance between JPY and EUR, which are both currencies of countries recording current account surpluses. As the graph shows, the Japan's current account surplus's trade surplus portion – which is liable to directly promote USD selling (and JPY buying) – has dwindled to a very low level, while the current account surplus of the euro area (≈ Germany) is roughly the same level as the euro area's trade surplus.

Using price levels to calculate "fair value" of the principal currencies, one also finds that there are considerable differences. This article has argued that a "world without intercurrency interest rate gaps" will promote the creation of a "world without international product price differences", and that this process will eventually make such price-level-based approaches to evaluating currencies as the purchasing power parity (PPP) approach lose their explanatory power. While I still believe in that argument, one should not underestimate the significance of the Europe-U.S. inflation rate gap, as euro area inflation rates have been consistently lower than U.S. inflation rates since the European debt crisis. Consequentially, price differences between the two areas have been accumulating over the past decade or so, and they theoretically should be resolved based on USD and EUR convergence toward a PPP level. The EUR/USD PPP as of this June was calculated to be around 1.23, and even after the EUR recent steady appreciation (bringing EUR/USD to around 1.18), it can currently be said that EUR is undervalued by about -4% on a PPP basis. The graph on the right shows that EUR/USD had long exceeded the PPP level, and it was only the ECB's June 2014 introduction of negative interest rates that caused EUR/USD to descend below the PPP level. In June 2017, former ECB Governor Draghi's statement in a speech given in the Portuguese city of Sintra that – "Deflationary forces have been replaced by reflationary ones." – prompted a temporarily EUR/USD recovery to above the 1.20 level. While former ECB President Draghi made many memorable statements, the fame of his Sintra speech is considered second only to that of his – "The ECB is ready to do whatever it takes to preserve the euro." – statement. It is widely believed that the reason the Sintra speech triggered such a large amount of EUR buying is that it was interpreted by many to indicate a possibility that the euro area's negative interest rate policy might be discontinued.





Given that huge U.S. budget deficits are creating a "USD excessive supply" perception, I anticipate that EUR/USD may surpass the 1.20 level this year but that the continued existence of the ECB's negative interest rate policy – the main factor keeping EUR/USD below the PPP level – will make it difficult for EUR/USD to remain above the 1.20 level. Because of the euro area's huge trade surplus, I think it is reasonable to expect that EUR will tend to appreciate to some extent going forward. In light of all this, my basic understanding is that the recent pattern of EUR/USD moving within the 1.15-1.20 range is likely to continue for the time being.

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