Monthly Economic Report

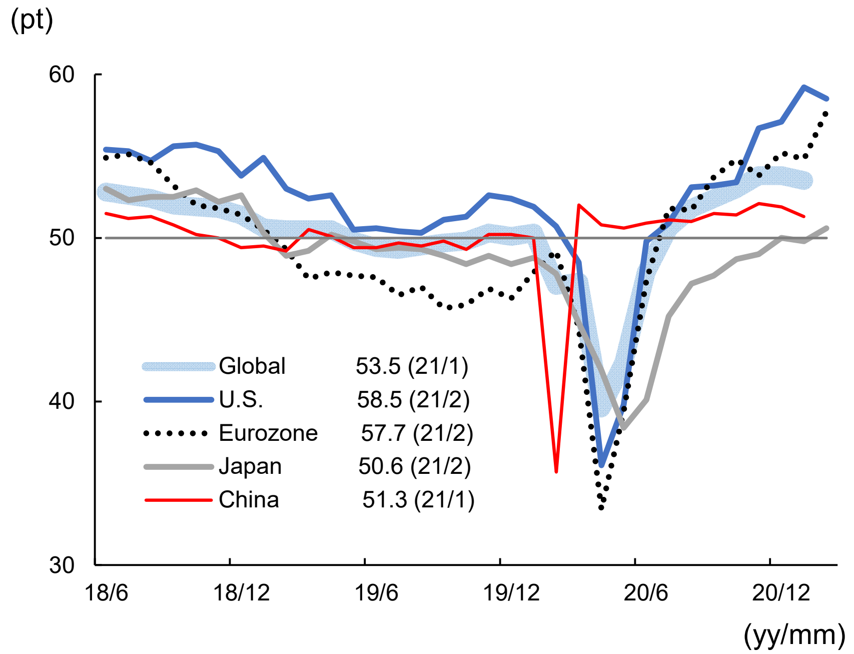
February 25, 2021

Mizuho Research Institute

1. Current state of the global economy: the manufacturing sector led the recovery, with particularly noteworthy improvement in US business conditions

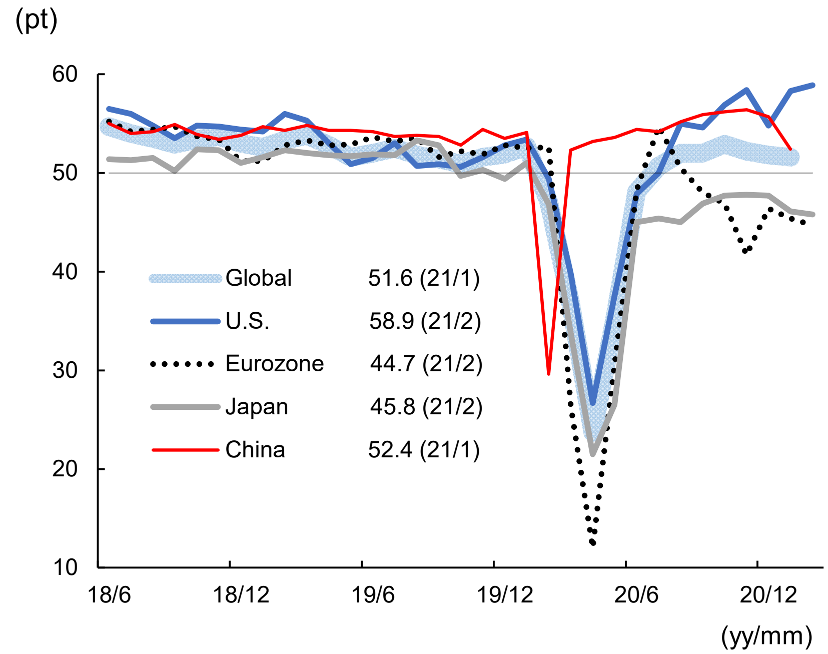
- The global economy is recovering, mainly in the manufacturing sector.
  - In the US, production is increasing in a broad range of industries, apart from the motor vehicle industry, which appears to be affected by the shortage of semiconductors. Even in the Eurozone, where motor vehicle output also appears to be peaking out, the manufacturing PMI is rising, and business conditions of the overall manufacturing sector is solid.
- The non-manufacturing PMI also rose in the US. This stems from the strength of consumption due to the economic stimulus measures passed at the end of 2020.
  - On the other hand, the non-manufacturing sectors in Japan and the Eurozone are still affected by mobility constraints, and the Chinese economy is feeling the effects of Covid-19 infections and mobility restraints around the Chinese New Year.

Manufacturing PMI



Note: The Purchasing Managers' Index (PMI) is an index calculated by weighting indexes such as new orders, output, order backlogs, prices, employment, and quantity of purchases. The reading of 50 in the PMI is the "expansion-contraction" threshold.
Source: Made by MHRI based upon the National Bureau of Statistics of China, Markit Economics.

Non-manufacturing PMI



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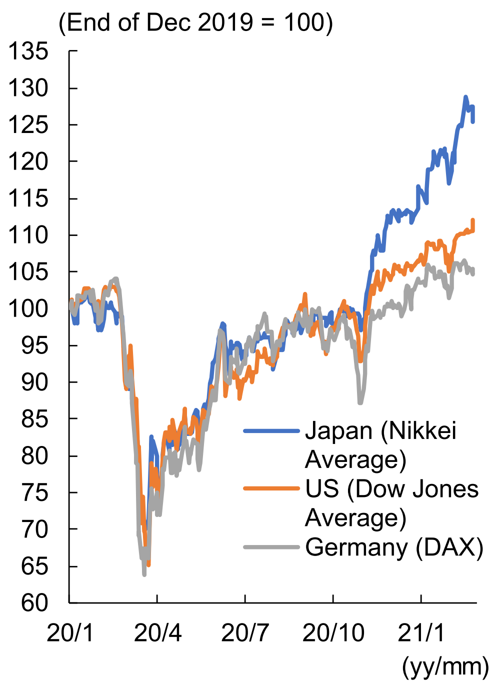
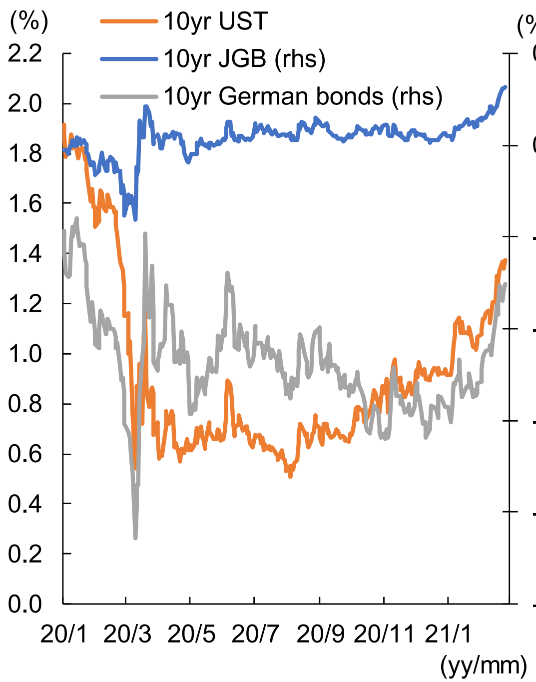
Source: Made by MHRI based upon the National Bureau of Statistics of China, Markit Economics.

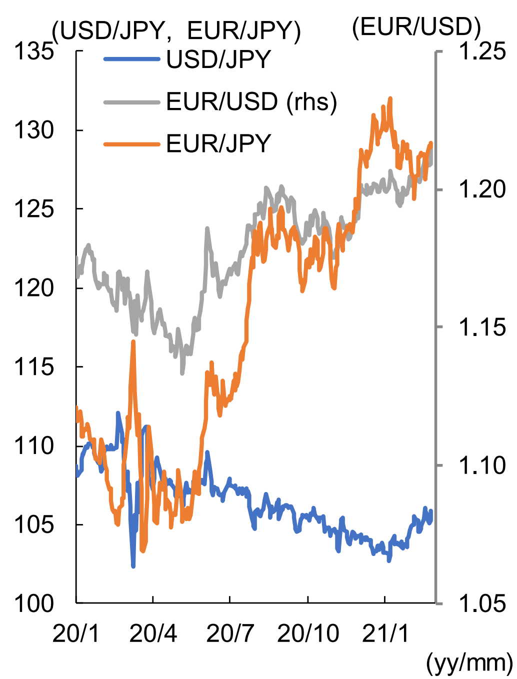
Overview of financial markets: stock prices and interest rates rise on the back of expectations towards additional US stimulus measures and improved earnings

- Stock prices and interest rates rose against a backdrop of growing expectations towards additional US economic stimulus measures and improvement of corporate earnings.
  - Despite a temporary stock market correction over the end of January along with the rise of volatility, a strong rebound ensued on expectations toward further US economic stimulus measures and improvement of corporate earnings. The Nikkei Average recovered to the JPY30,000 range for the first time in about 30.5 years.
  - Interest rates rose on growing expectations towards additional US economic stimulus measures and rise of inflation expectations. The 10yr UST yield temporarily rose to the 1.4%-level.
  - The yen weakened amid the rise of the stock market and US interest rates. The USD/JPY exchange rate rose temporarily to the JPY106-level.

Major market trends







Note: All indexes show actual results up to February 24.
Source: Made by MHRI based upon Bloomberg.

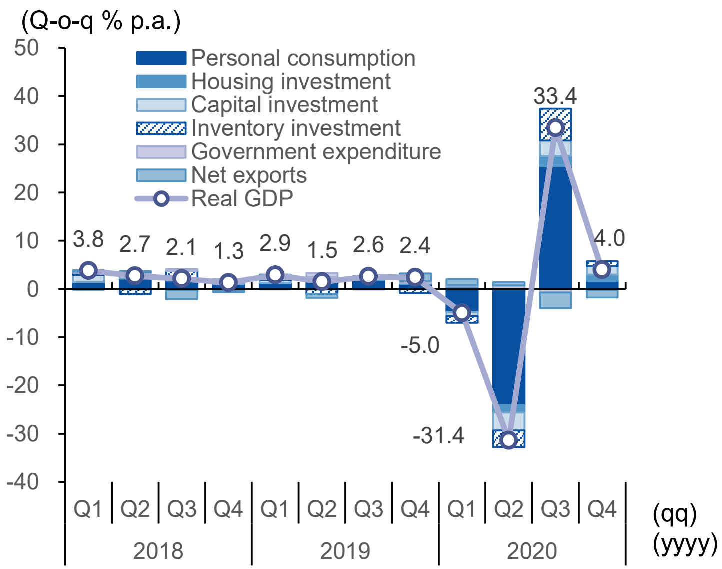
2. (1) US economy: strong recovery of real GDP growth in the Oct-Dec quarter. A moderate recovery is also expected going forward

- In the Oct-Dec quarter of 2020, US real GDP growth grew strongly (+4.0% q-o-q p.a.), recovering to 97.5% of the level before the Covid-19 pandemic.*
  - The strong housing market and machinery investment continued to drive the recovery.
  - While the services sector continued to pick up, vulnerable sectors affected by the soft lockdown took a downturn again.

  * "Before theCovid-19 pandemic" refers to the Oct-Dec quarter of 2019.

- Looking forward, we expect the continuation of a moderate recovery.
  - Corporate investment incentive is currently strong. The recovery in machinery investment is spreading beyond sectors related to Covid-19, raising the prospect of an economic recovery centering on the manufacturing sector.

Real GDP growth



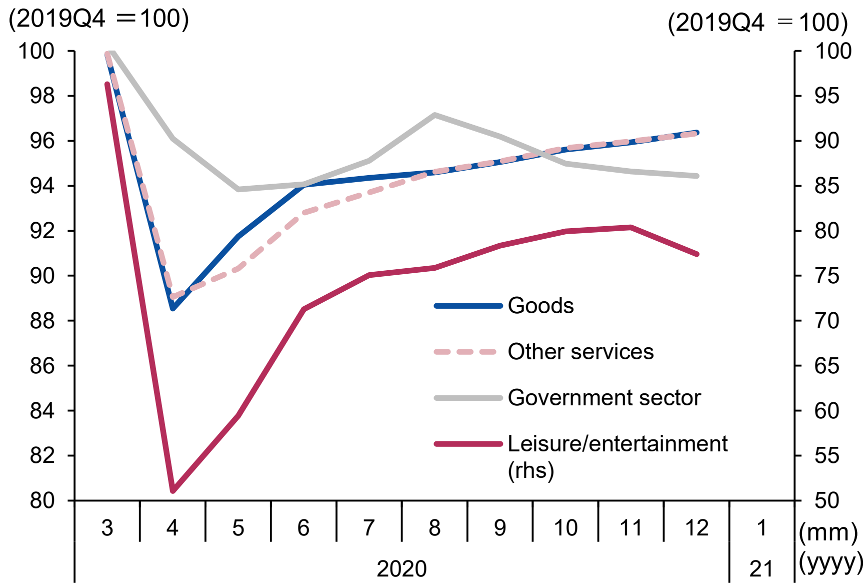
(Q-o-q % p.a.) The "*" indicates the degree of contribution	2020 Q3	2020 Q4	Key points in the Oct-Dec quarter
Real GDP	33.4	4.0	
Personal consumption	41.0	2.5	・Goods fell slightly due to the fading of pent-up demand ・Although services remained on an uptrend, vulnerable services took a downturn
Housing investment	63.0	33.5	・A strong uptrend continued. In addition to extremely low interest rates, the change in lifestyles amid the Covid-19 pandemic underpinned real demand mainly for single-family homes
Capital investment	22.9	13.8	・The recovery of machinery investment spread beyond sectors related to Covid-19. ・Construction was still sluggish in many sectors, other than drilling-related sectors
Inventory investment	6.6	1.0	・While demand was restrained amid restrictions on activity, production recovered steadily. Inventory build-up continued
Government expenditure	- 4.8	- 1.2	・The effects of stimulus measures faded ・State and local governments in tight fiscal positions continued to reduce spending
Net exports*	- 3.2	- 1.5	・Both domestic and external demand continued to grow strongly. Given the strong growth of imports, the degree of contribution by external demand remained negative
Exports	59.6	22.0	・The goods-led recovery continued (reaching 96.4% of the pre-Covid-19 level) ・Exports of services remained at rock-bottom levels
Imports	93.1	29.5	・The recovery of the manufacturing sector led to high growth of industrial materials and capital goods ・The recovery of imports of services was slow, dragged down by mobility restrictions

Source: Made by MHRI based upon the US Department of Commerce.

Since the turn of the year, the recovery of employment remains an unfinished challenge; the labor participation rate is not rising

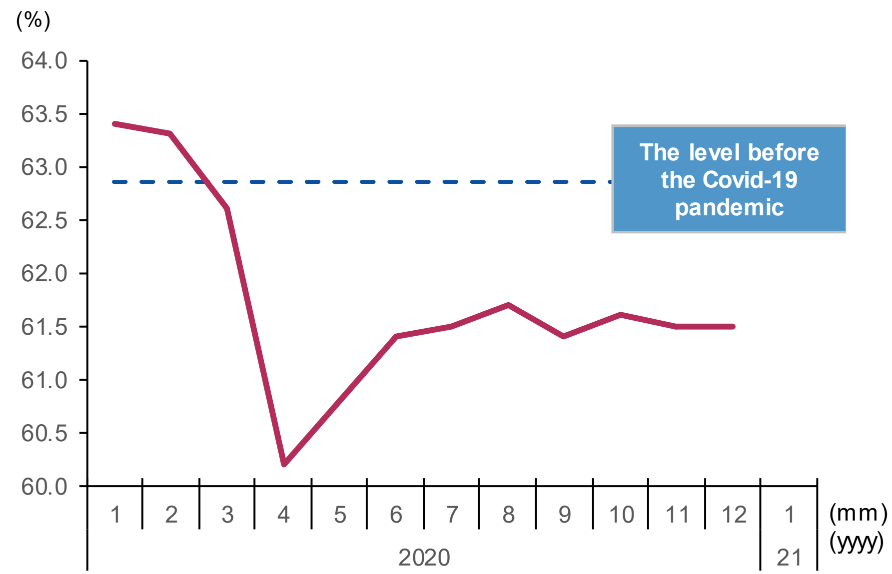
- Despite a slight upturn of nonfarm payrolls in January (+49 thousand m-o-m), employment deteriorated compared to December 2020 in many industries, revealing that employment is actually weak.
  - Employment continued to worsen in leisure and entertainment, albeit not as badly as in December 2020. Employment in goods, retail sales and healthcare also took a downturn, given the ongoing impact of the spread of Covid-19 infections and mobility constraints.
    - Employment in the government sector (education) rose, but the rise may only be superficial. Employment in January is actually weaker than the headlines figures.
- Although the unemployment rate improved to 6.3% (-0.4pt m-o-m) in January, the labor participation rate fell slightly, revealing that the incentive to join the labor market is not rising.
  - The increase of employed persons was smaller than the pace of decline of unemployed persons, indicating that more people are opting out of the labor market.

Number of employees by sector



Source: Made by MHRI based upon the US Department of Labor.

Labor force participation rate

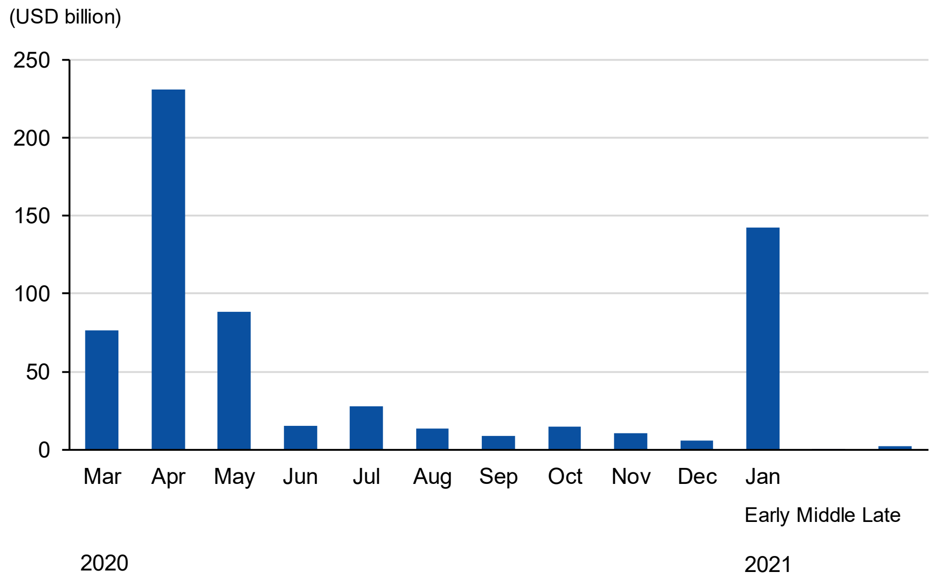


Source: Made by MHRI based upon the US Department of Labor.

Income and consumption rose sharply in January, given the impact of the economic stimulus measures

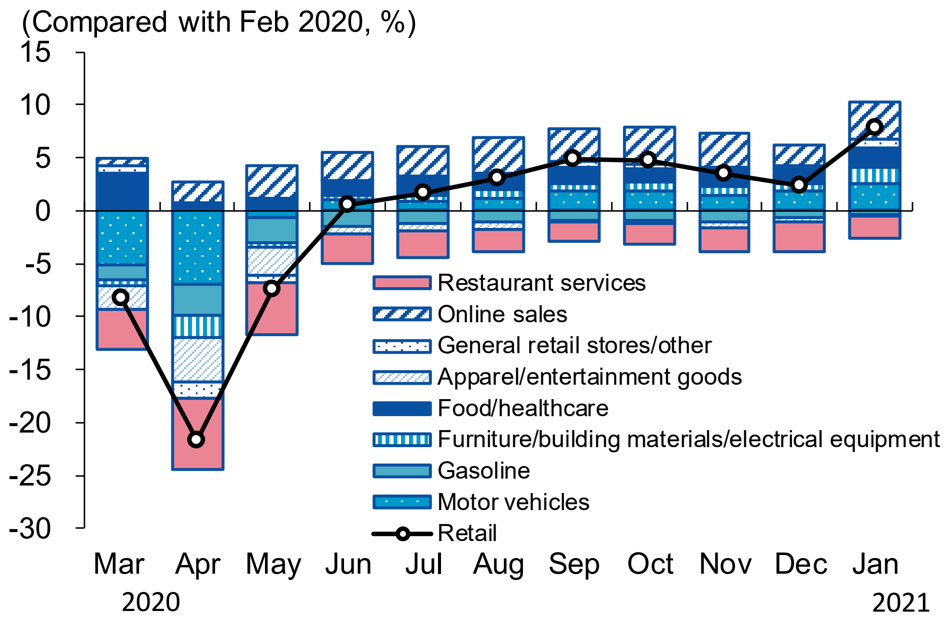
- Despite the weakness of jobs, household income appears to have increased dramatically in January due to the impact of the economic stimulus measures passed at the end of 2020.
  - The delivery of checks for cash benefits (USD 600 per person) was completed by early January for about 90% of the budgeted amount, pushing up income by approximately 8%. The restoration of additional unemployment benefits (USD 300 per week) also helped lift income.
- In January, retail sales rose +5.3% m-o-m, rising far above the market forecast (+1.1% m-o-m). Core retail sales also grew sharply (+6.0% m-o-m).
  - Retail sales confirmed the positive impact of the economic stimulus measures. There was a further rise in furniture, leisure/entertainment goods, and online sales, which had already recovered to levels prior to the Covid-19 pandemic. As for apparel, restaurant services and department store sales, which lagged in recovery, the breadth of the rate of decline narrowed.
  - In January, core retail sales rose strongly, reaching +4.0% of the Oct-Dec average.

Cash benefits



Source: Made by MHRI based upon the US Department of the Treasury.

Retail sales



Source: Made by MHRI based upon the US Department of Commerce.

(2) US monetary policy: FOMC judges that it is “likely to take some time” before conditions for tapering are satisfied

- According to the January FOMC minutes, the FOMC judged that it is “likely to take some time” before the conditions for tapering are satisfied.
  - Employment: FOMC observed that achieving the “broad-based and inclusive goal of maximum employment” would take some time even with a brisk pace of improvement in the labor market.
  - Inflation: FOMC confirmed the importance of distinguishing between one-time increases in relative prices and changes in the underlying trend for inflation.
  - Financial stability: It would be important for the appropriate regulatory bodies to address structural vulnerabilities. Raised equity valuations might have been affected by trading by retail investors.

Key points of the minutes of the January FOMC meeting

【Economy, labor market】
- Most participants expected that the stimulus provided by the passage of the CAA in December, the likelihood of additional fiscal support, and anticipated continued progress in vaccinations would lead to a sizable boost in economic activity (upward revision to the medium-term outlook).
- At present, however, the economy is far from achieving the FOMC's “broad-based and inclusive goal of maximum employment.” Even with a brisk pace of improvement in the labor market, achieving this goal would take some time.

【Inflation】
- Many participants stressed the importance of distinguishing between one-time changes in relative prices and changes in the underlying trend for inflation (whether inflation is on track to moderately exceed 2 percent for some time), noting that the rise in measured inflation would be unlikely to have a lasting effect.
- With regard to upside risks, some participants pointed to the possibility that fiscal policy could turn out to be more expansionary than anticipated, that households could display greater willingness to spend out of accumulated savings than expected, or widespread vaccinations and easing of social distancing. The potential for supply constraints to affect price inflation somewhat more than anticipated or for price increases among industries most adversely affected by the pandemic was also noted.
- The risks to the outlook for inflation have become more balanced, but most participants still viewed the risks as weighted to the downside.

【Financial stability】
- Several participants noted areas of strength in the financial sector (for example, the banking system, etc.). That said, 2-3 participants stated that it would be important to stay vigilant.
- Several participants noted structural vulnerabilities in such areas as investment funds, credit markets and the Treasury market. A couple of participants commented that it would be important for these to be addressed by the appropriate regulatory bodies (rather than monetary policy).
- Some participants commented that equity valuations had risen further, that initial public offering activity was elevated, or that valuations might have been affected by retail investors trading through electronic platforms.

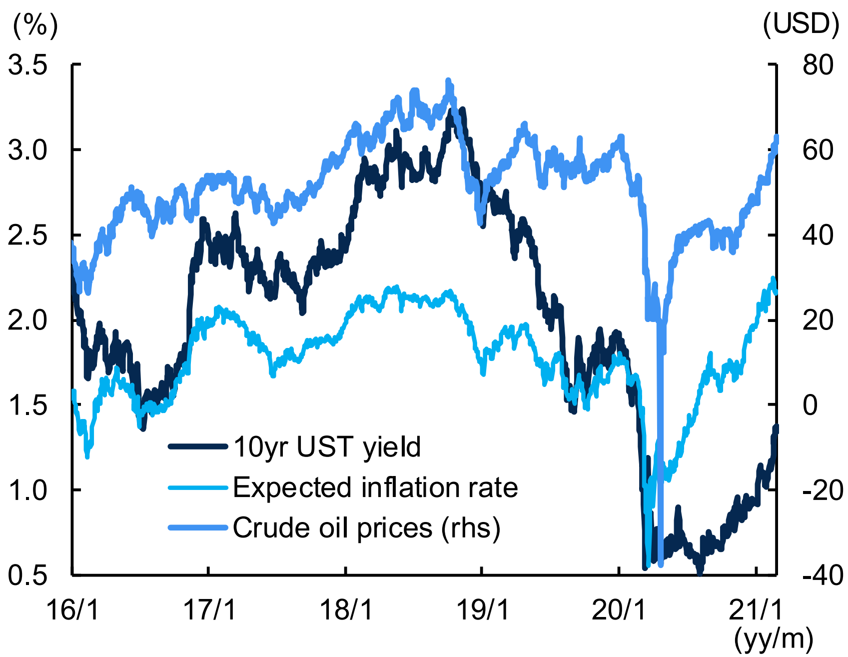
【Monetary policy】
- FOMC participants judged that it was likely to take some time for “substantial further progress (i.e. the guidance for asset purchases) to be achieved.”

Source: Made by MHRI based upon FRB and CQ.com.

(3) US bond market: the 10yr UST yield is expected to move around 1.0% to1.5%

- The 10yr UST yield temporarily breached1.4% on the back of the progress in of Covid-19 vaccine rollouts, expectations toward additional economic stimulus measures and strong economic indicators.
  - The expected inflation rate rose to the highest level since May 2018, and crude oil prices rose above USD 60 per barrel.
- Despite indications that the FRB would maintain the policy rate target at the present level until the end of 2023, the market is factoring in more than one rate hike in early 2023.
  - As the FRB is indicating a cautious stance toward a rate hike amid expectations that the rise of inflation will be moderate, there is likely to be limited room for the market to factor in further rate hikes. The10yr UST yield is expected to move around 1.0% to1.5%.

Trends in expected inflation rate



Note: The expected inflation rate is the breakeven inflation rate (10yr).
Source: Made by MHRI based upon Bloomberg.

Discounting of rate hikes by forward rates

Note: The graph shows rates obtained by subtracting the one-month forward rates of the month ahead from the one-month forward rates for a particular number of years ahead. The rise in rates per one rate hike is assumed to be 0.25 percentage points.
Source: Made by MHRI based upon Bloomberg.

(4) US stock market: stock prices trended at record-high levels due to expectations toward economic recovery. Looking forward, keep an eye on adjustment risks

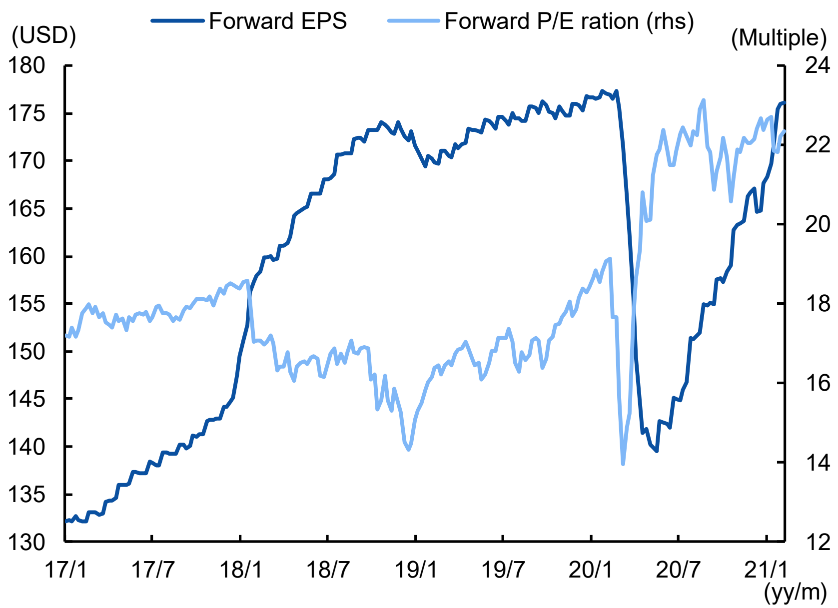
- Even though the Dow Jones Industrial Average temporarily fell below USD 30,000 at the end of January due to concerns over retail investors' speculative transactions, it subsequently breached USD 31,000 on the back of expectations toward economic recovery driven by the US economic stimulus measures and progress of Covid-19 vaccinations. The main US stock price indexes traded near historical highs.
- Around 90% of corporate earnings results have been announced, of which 80% of companies reported earnings higher than analyst forecasts.
  - The forward EPS has recovered more or less to the level prior to the Covid-19 pandemic.
- Even though the stock market should follow firm footing for the time being due to expectations toward the improvement of corporate earnings, market adjustment risks should be monitored closely since the forward P/E ratio (22x) indicates a strong sense of overvaluation even when considering the low interest rate environment and the boost provided by hi-tech stocks.

S&P 500 corporate earnings announcements

	Higher-than-expected	No surprise	Lower-than-expected	Progress rate (%)	No. of companies which have reported earnings
Energy	57%	0%	43%	91.3	21 / 23
Materials	82%	0%	18%	100.0	28 / 28
Capital goods	80%	3%	17%	97.3	71 / 73
General consumer goods	75%	0%	25%	78.7	48 / 61
Consumer staples	74%	4%	22%	84.4	27 / 32
Healthcare	81%	2%	18%	90.5	57 / 63
Finance	87%	3%	10%	98.4	63 / 64
Information technologies	93%	0%	7%	88.2	67 / 76
Communication services	96%	0%	4%	92.3	24 / 26
Utilities	63%	16%	21%	67.9	19 / 28
Real estate	61%	18%	21%	93.3	28 / 30
S&P500	80%	3%	17%	89.9	453

Source: Made by MHRI based upon Refinitiv.

S&P 500 Index forward P/E ratio and forward EPS

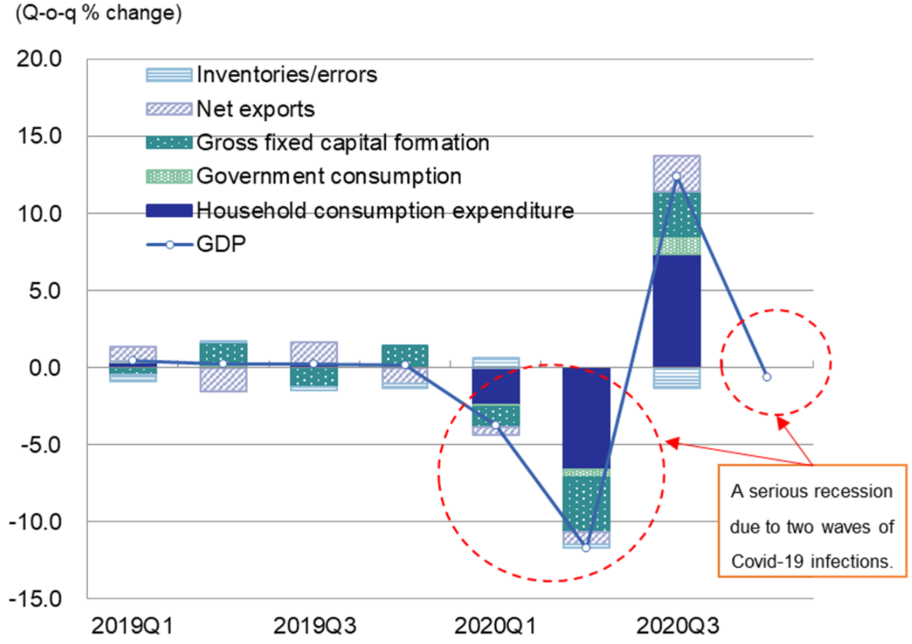


Note: Forward EPS and forward P/E ratios are based on 12-month forecasts.
Source: Made by MHRI based upon Refinitiv.

3. (1) The Eurozone economy: negative growth in the Oct-Dec quarter. Economic stagnation due to stringent Covid-19 prevention measures

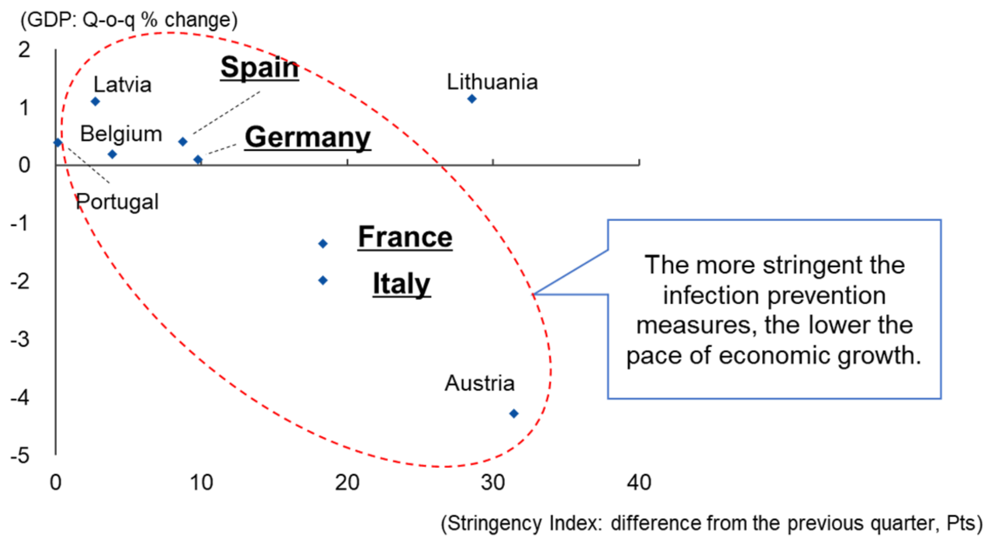
- In the Oct-Dec quarter of 2020, Eurozone real GDP growth fell once again into negative territory (flash estimate: -0.6% q-o-q), due to more stringent measures to contain the resurgence of Covid-19 infections.
  - The differences in the growth rates of each country were due to the stringency of their respective Covid-19 prevention measures. France (-1.3% q-o-q) and Italy (-2.0% q-o-q), both of which imposed nationwide stay-at-home restrictions, recorded negative growth. In contrast, growth remained more or less flat in Germany (+0.1% q-o-q) and Spain (+0.4% q-o-q), which implemented relatively mild restrictions.
- Looking forward, the manufacturing sector should continue to follow a moderate recovery, while the further stringency/extension of Covid-19 prevention measures should serve as a drag on personal consumption and keep economic activity stagnant.

Eurozone: real GDP growth rate



Note: Real GDP q-o-q growth and the degree of contribution by demand component
Source: Made by MHRI based upon Eurostat.

Eurozone: GDP growth rate in the Oct-Dec quarter and the Stringency Index



Source: Made by MHRI based upon Oxford, Eurostat.

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(2) Eurozone monetary policy: weak prices are a concern. ECB maintains monetary easing measures for the maintenance of favorable financing conditions

- According to the minutes of the January 21 Governing Council meeting, the ECB confirmed the view that price pressures remain subdued. The ECB also indicated a cautious stance regarding the economic outlook, the need to distinguish between a temporary boost to inflation and sustained increase, and the need to stay alert to the euro's appreciation.
- The ECB emphasized the importance of assessing "favorable financing conditions" based on a holistic approach. It plans to continue to flexibly wield the Pandemic Emergency Purchase Programme (PEPP) and other tools to preserve "favorable financing conditions."

Key points of the ECB Policy Board meeting (January 21)

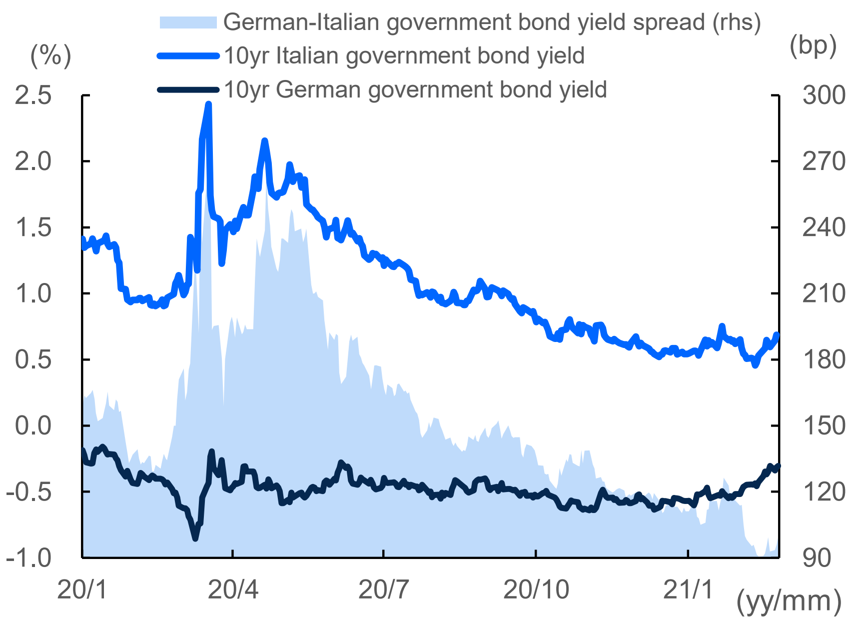
	Post-meeting press conference (1/21)	Meeting discussions (from the account published on 2/18)
Economic situation	Broadly in line with the December 2020 macroeconomic projections. The risks surrounding the Euro growth outlook remain tilted to the downside but less pronounced. The agreement on future EU-UK relations and the start of vaccination campaigns are encouraging, but lockdown containments and their length, retail sales, and declining mobility continue to be sources of downside risk.	It was argued that the December staff projections might be too optimistic, with risk from extended lockdowns, slow vaccination roll-outs and the spread of new, more virulent, mutations of the virus. At the same time, it was noted that the economic costs of containment measures were now lower than in spring 2020, as the measures were more targeted and firms had learned to better adjust to the restrictions.
Outlook for prices	Headline inflation is likely to increase but underlying price pressures are expected to remain subdued as the support of energy price dynamics and the end of the temporary VAT reduction in Germany are constrained by weak demand, notably in the tourism and travel-related sectors.	There was broad agreement that underlying price pressures were expected to remain subdued owing to weak demand, notably in the tourism and travel-related sectors, as well as to low wage pressures, though headline inflation was likely to increase in the coming months, in part supported by the end of the temporary VAT reduction in Germany. The point was made that a temporary boost to inflation should not be mistaken for a sustained increase.
Outlook for exchange rates	On the strength of the euro, we are monitoring very carefully exchange rates, because they have an impact on prices.	Noting that the recent persistent trend appreciation of the euro had reversed since the start of 2021, possible adverse implications of a further appreciation of the euro for the inflation outlook were reiterated.
Pandemic Emergency Purchase Programme (PEPP)	We will continue our purchases under the PEPP with a total envelope of EUR 1,850 billion until at least the end of March 2022. The envelope needs not be used in full, and the envelope can be recalibrated depending on financing conditions.	It was confirmed that the purchases under the PEPP (despite occurring at a slower pace) contributed to preserving favourable financing conditions for all sectors. The dual role of the PEPP, namely countering the downward impact of the pandemic on the projected path of inflation and supporting the smooth transmission of monetary policy (maintenance of the market function), was stressed.
Outlook for future policies	Identify whether or not we are in the presence of favorable financing conditions for all sectors (households, corporations, sovereigns, etc.) based on a holistic and multiple-indicator approach.	It was also emphasized that a holistic approach was needed when defining favourable financing conditions in a broad and flexible manner, for all sectors. In view of developments with regard to risk-free rates, credit spreads, bank lending rates, stock prices and exchange rates, Governing Council members agreed that "favorable financing conditions" have been preserved since December 2020.

Source: Made by MHRI based upon ECB

(3) Eurozone bond market: German 10yr government bond yield expected to move around -0.5% to -0.2%

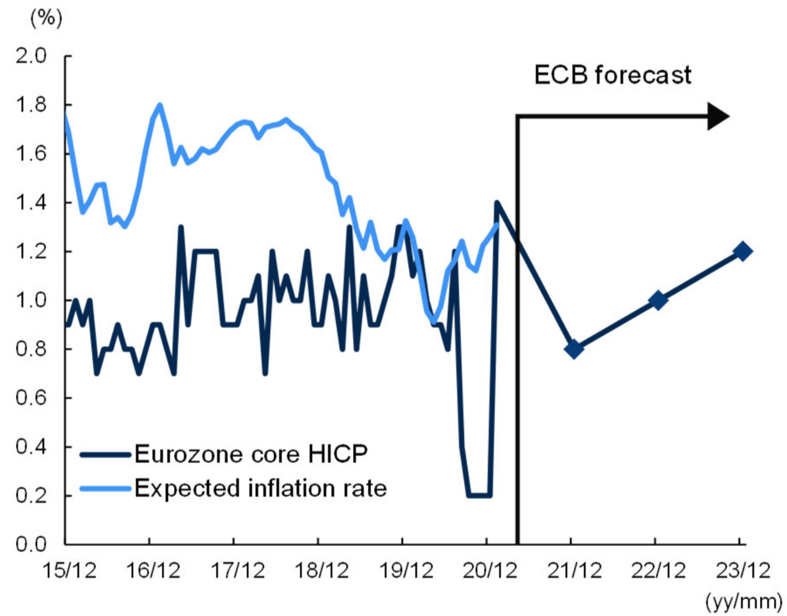
- German-Italian government bond spreads fell below 100 bps to the narrowest level in about five years.
  - In Italy, expectations mounted on the back of the new cabinet formed by former ECB President Mario Draghi, sending 10yr Italian government bond yields down to a record low.
  - The 10yr German government bond yield rose to the -0.3% level along with the rise of US long-term interest rates and stock prices.
- The Eurozone core HICP in January rose sharply amid background factors such as the end to the temporary reduction of the German VAT and cancellations of winter sales.
  - ECB President Christine Lagarde said on February 10 that the ECB's Eurozone inflation target of just below 2% is "very far away." Given prospects of the prolongation of monetary easing, 10yr German government bond yields are expected to move around -0.5% to -0.2%.

German-Italian government bond yield spreads (10yr)



Source: Made by MHRI based upon Bloomberg

Eurozone core HICP

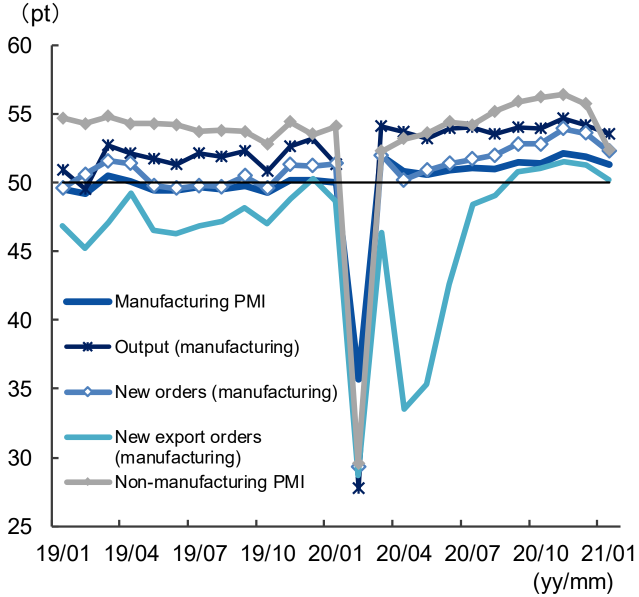


Note: The expected inflation rate is the month-end rate of five-year inflation swaps starting five years ahead.
Source: Made by MHRI based upon Bloomberg

4. (1) The Chinese economy: the PMI fell from the previous month for both manufacturing and non-manufacturing sectors, reflecting the resurgence of infections

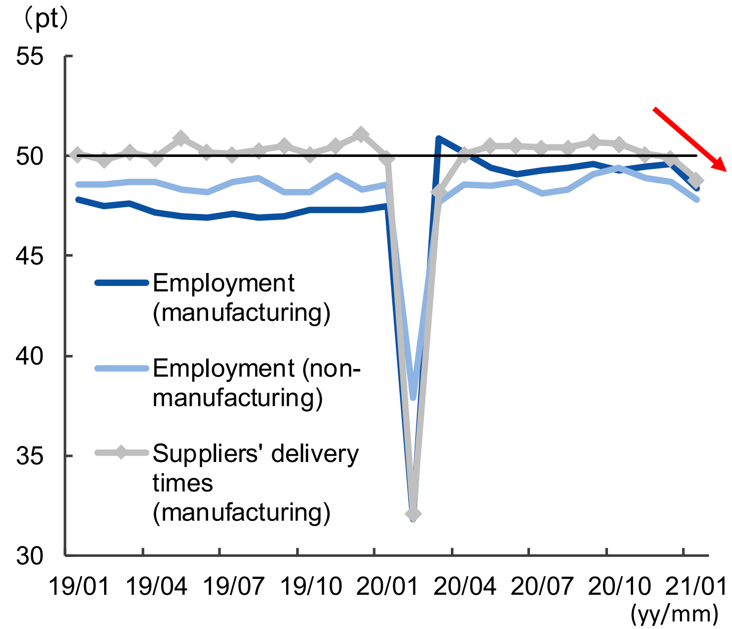
- Reflecting the resurgence in Covid-19 infections, the January manufacturing PMI fell for the second consecutive month to 51.3 (December: 51.9).
  - Output and new orders fell mainly in Northeast China where Covid-19 infections are spreading. The effects were also noted in a deterioration of the employment environment and delays in suppliers' delivery times.
  - New export orders also declined, due to the impacts of the global resurgence of Covid-19 infections.
- The non-manufacturing PMI also sharply dropped to 52.4 from the previous month (55.7), the lowest level since March 2020.
  - The National Bureau of Statistics of China commented that business conditions worsened in sectors vulnerable to Covid-19 infections, including accommodations/food and beverage, entertainment and transportation.
- The authorities called for the public to refrain from traveling around Chinese New Year to contain the spread of Covid-19 infections, which could push down the economic growth in the Jan-Mar quarter.

Manufacturing & non-manufacturing PMI by the National Bureau of Statistics of China



Source: Made by MHRI based upon the National Bureau of Statistics of China and CEIC data.

PMI (employment & suppliers' delivery times)

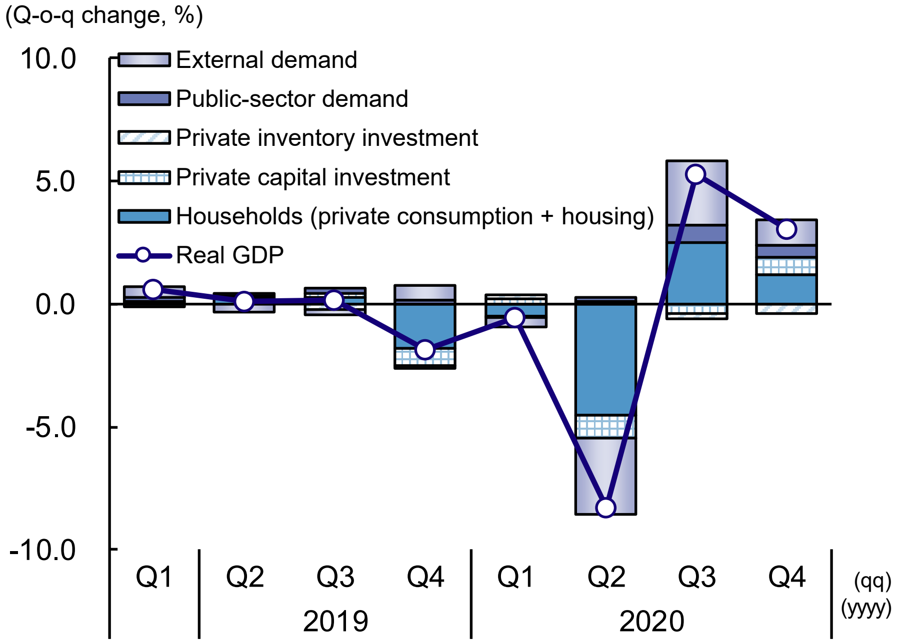


Source: Made by MHRI based upon the National Bureau of Statistics of China and CEIC data.

5. (1) The Japanese economy: despite the double-digit p.a. growth in the Oct-Dec quarter 2020, negative growth is inevitable in the Jan-Mar quarter

- Japan's real GDP growth in the Oct-Dec quarter 2020 (the first preliminary QE) rose +3.0% q-o-q (+12.7% p.a.), recording strong growth for two quarters in a row.
  - Personal consumption (+2.2% q-o-q), capital investment (+4.5% q-o-q) and exports (+11.1% q-o-q) served as the drivers of growth. The Go To Travel Program, which continued until mid-December, helped lift personal consumption. The rise in capital investment was due mainly to a counter-reaction to the decline up to the previous quarter. In addition to motor vehicles, exports of capital goods bound for US and China increased.
  - Reflecting the re-issuance of a declaration of state of emergency, a sharp decline of personal consumption appears inevitable in the Jan-Mar quarter. Given the slowdown of capital investment and exports due to the fading of pent-up demand, real GDP is projected to fall into negative territory (-9.3% p.a.)

2020 Oct-Dec quarter GDP (the first preliminary QE)



	2020 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2021 Jan-Mar
Real GDP	-0.6	-8.3	5.3	3.0	-2.4
(Q-o-q % change, %)	-2.2	-29.3	22.7	12.7	-9.3
(Y-o-y % change)	-2.0	-10.3	-5.8	-1.2	-2.9
Domestic demand	-0.2	-5.2	2.5	2.0	-2.6
	(-0.2)	(-5.2)	(2.6)	(2.0)	(-2.5)
Private-sector demand	-0.2	-7.2	2.6	2.0	-2.9
	(-0.1)	(-5.4)	(1.9)	(1.5)	(-2.1)
Personal consumption	-0.6	-8.4	5.1	2.2	-3.9
Housing investment	-3.7	0.5	-5.7	0.1	-2.2
Capital investment	1.4	-5.9	-2.4	4.5	0.1
Inventory investment	(0.1)	(0.1)	(-0.2)	(-0.4)	(0.1)
Public-sector demand	-0.2	0.6	2.4	1.8	-1.7
	(-0.0)	(0.2)	(0.7)	(0.5)	(-0.5)
Government consumption	-0.3	0.2	2.8	2.0	-1.9
Public investment	0.1	2.2	0.9	1.3	-0.8
External demand	(-0.4)	(-3.1)	(2.6)	(1.0)	(0.1)
Exports	-5.3	-17.2	7.4	11.1	2.4
Imports	-3.1	1.3	-8.2	4.1	1.7
Nominal GDP	-0.5	-8.0	5.5	2.5	-3.0
GDP deflator (y-o-y)	0.9	1.4	1.2	0.2	-0.7

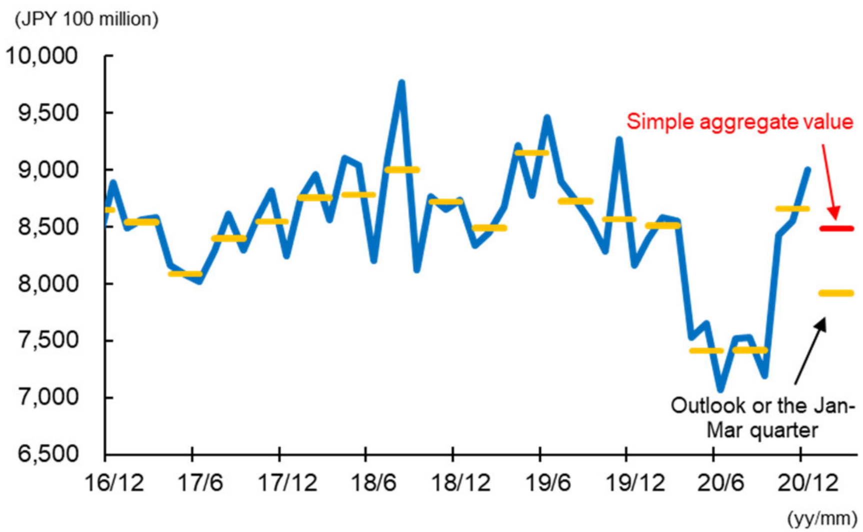
Note: Figures in the right-hand chart indicate changes from the previous quarter (in real terms) unless otherwise noted. The figures in parentheses represent the contribution to growth. Figures for the Jan-Mar quarter 2021 are forecasts.
Source: Made by MHRI based upon Cabinet Office, *Quarterly Estimates of GDP*

Capital investment rebound sharply in the Oct-Dec quarter, but is expected to stay flat in the first half of 2021

- Private-sector machinery orders (excluding orders for ships and those from electric power companies) staged a temporary rebound, bolstered by pent-up demand.
  - In the Oct-Dec quarter, machinery orders rose a dramatic +16.8% q-o-q (the Jul-Sep quarter: -0.1% q-o-q), recovering nearly to the level prior to the spread of Covid-19 infections (2019).
- Although capital investment on a GDP basis rebound to +4.5% q-o-q in the Oct-Dec quarter, capital investment is forecast to stay flat in the first half of 2021.
  - According to the Cabinet Office's outlook (*), capital investment would fall deep into negative territory (-8.5% q-o-q) in the Jan-Mar quarter. It should be noted that the outlook may be weaker-than-reality due to the low achievement rate in the Apr-Jun quarter 2020. In terms of the simple aggregate value, not affected by the achievement rate, the result would be a smaller drop of -2.0% q-o-q.

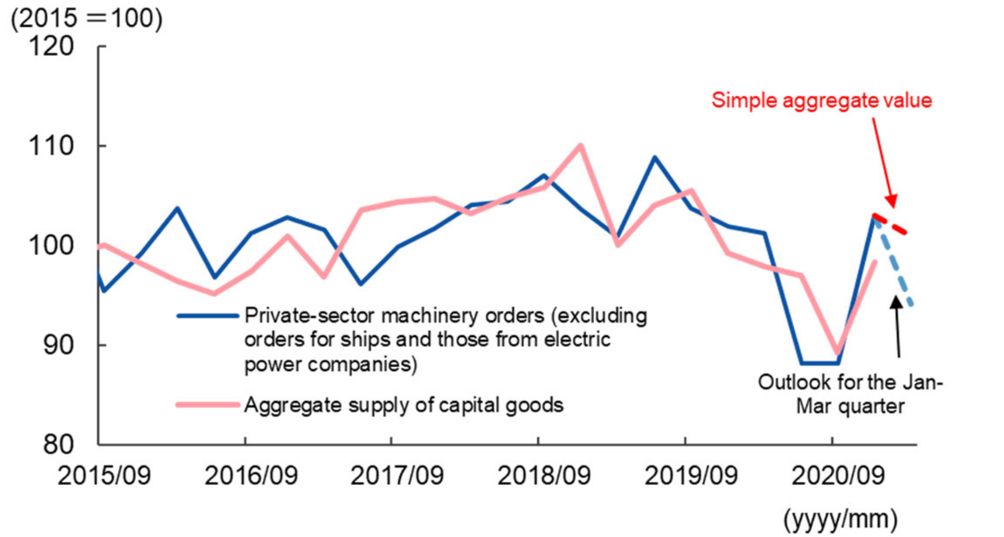
    *The Cabinet Office's outlook is based on the formula of "the simple aggregate value × the average achievement rate in the three previous quarters," and the achievement rate is calculated by the formula of "actual value/the simple aggregate value."
  - While capital investment has weathered its worst times, it is expected to stay almost flat in the first half of 2021 in a backlash to the pent-up demand.

Private-sector machinery orders (excl. orders for ships and those from electric power companies)



Source: Made by MHRI based upon Cabinet Office, *Machinery Orders*

Relationship with aggregate supply of capital goods

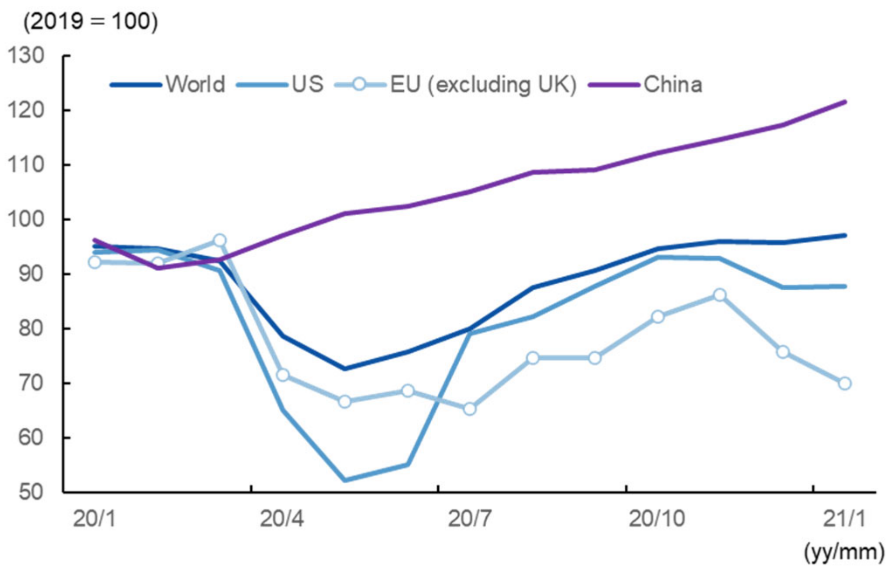


Source: Made by MHRI based upon Cabinet Office, *Machinery Orders*, Ministry of Economy, Trade and Industry

Exports in January stay on upward trend, bolstered by shipments bound for the US and China

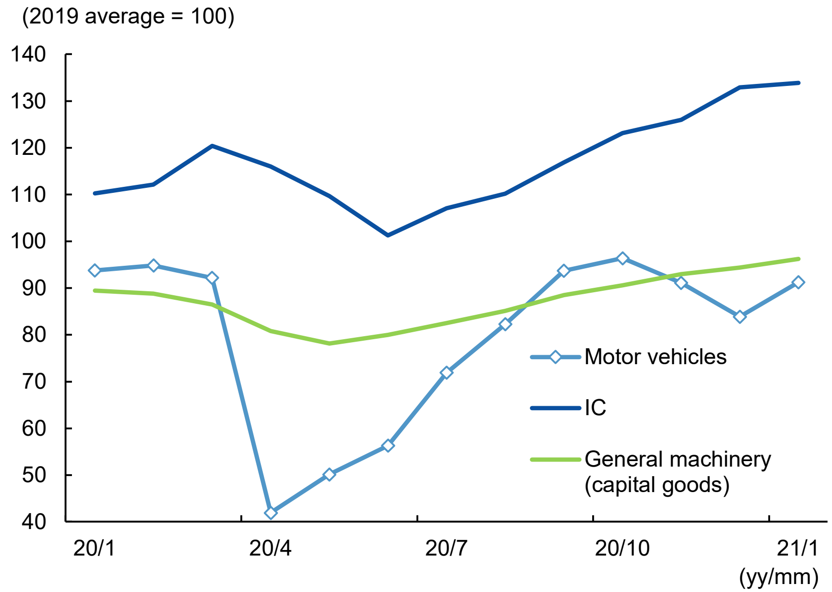
- Exports continued to follow an uptrend, bolstered by exports to the US and China.
  - In January, the export volume index stood at +1.4% m-o-m (seasonally-adjusted for the time lag caused by the Chinese New Year), rising for eight consecutive months.
    *The Chinese New Year starts on February 12th in 2021 (January 25th in the case of 2020).
  - While exports to the US and China increased, driven by capital goods and IT-related goods, exports to Europe decreased, dragged down by computers and capital goods.
- Exports should continue to follow an uptrend.
  - Even though production and exports of motor vehicles are expected to be weaker than expected due to the impact of the earthquake and a shortage of semiconductors, overall exports should remain on an expansionary path, driven by exports of capital goods and IT-related goods to the US and China.

Export volume index by major destination



Note: Seasonally adjusted by MHRI after adjustment for the Chinese New Year
Source: Made by MHRI based upon Ministry of Finance, Trade Statistics

Major export items

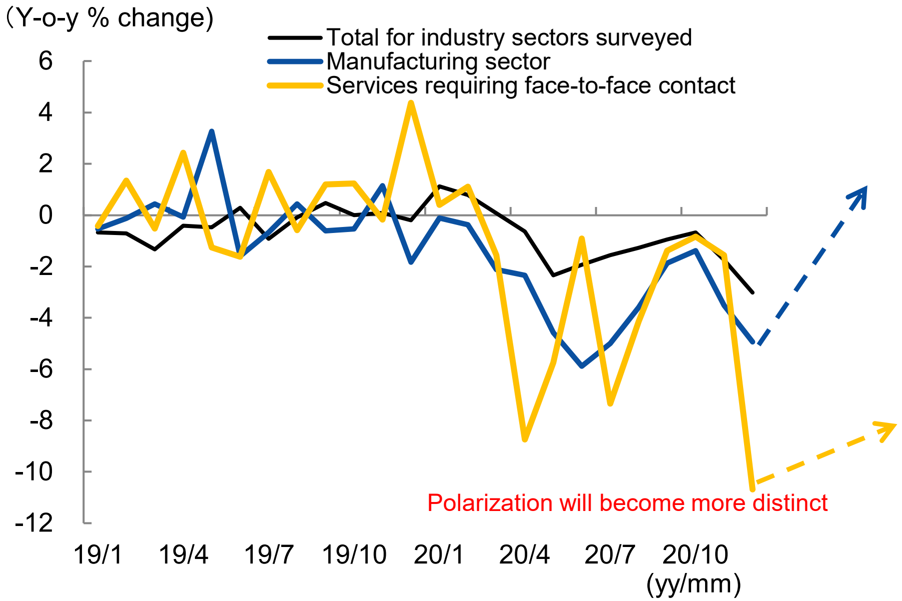


Note: General machinery is based on nominal amount. Seasonally adjusted by MHRI after adjustment for the Chinese New Year
Source: Made by MHRI based upon Ministry of Finance, Trade Statistics

Nominal wages fell sharply due to bonus cuts. Despite expectations that they will bottom out this winter, the pace of recovery will be slow.

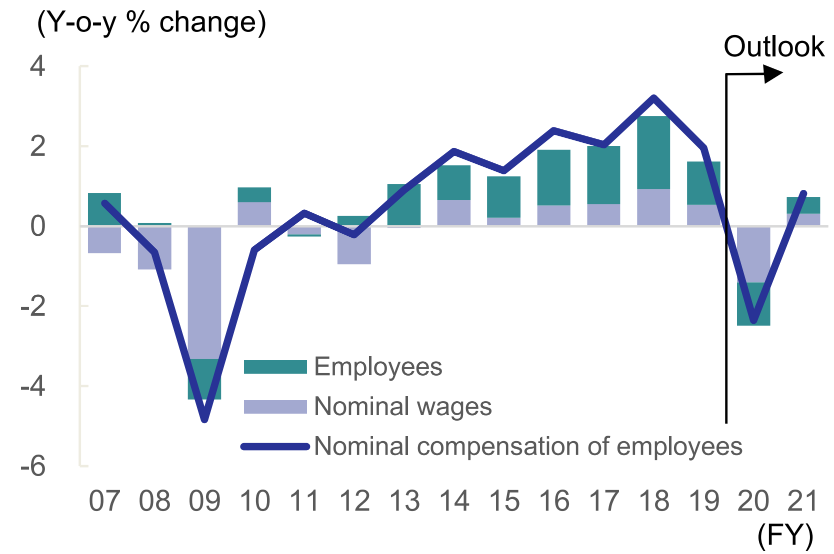
- Nominal wages (the main series) in December 2020 fell a sharp -3.0% y-o-y (November 2020: -1.8% y-o-y). The breadth of the decline was the widest since December 2009 (-6.0% y-o-y).
  - The decline stems primarily from the decline of special cash earnings (-5.1% y-o-y). By industry, the wage gap widened between the manufacturing sector and services requiring face-to-face interactions.
  - The rate of decline in nominal wages is expected to narrow after bottoming out this winter, along with the recovery of production in the manufacturing sector. However, the polarization of wages between the manufacturing and service sectors is projected to intensify over the summer. The pace of recovery is expected to be extremely sluggish (FY2020: -1.4% y-o-y, FY2021: +0.3% y-o-y).
- Nominal compensation for employees in FY2020 is expected to drop -2.4% y-o-y (due chiefly to wage adjustments). Even though nominal compensation of employees is forecast to pick up in FY2021 (+0.8% y-o-y), the pace of recovery will likely be sluggish (a return to the level before the Covid-19 pandemic is only expected sometime after FY2023) due to the continued slump in certain service sectors.

Trends in nominal wages by sector



Note: In terms of the main series covering all business establishments surveyed.
Service sectors requiring face-to-face interactions include accommodations/food and beverage sectors, living-related services/amusement services sector.
Source: Made by MHRI based upon Ministry of Health, Labor and Welfare, *Monthly Labour Survey*

Outlook on nominal compensation of employees



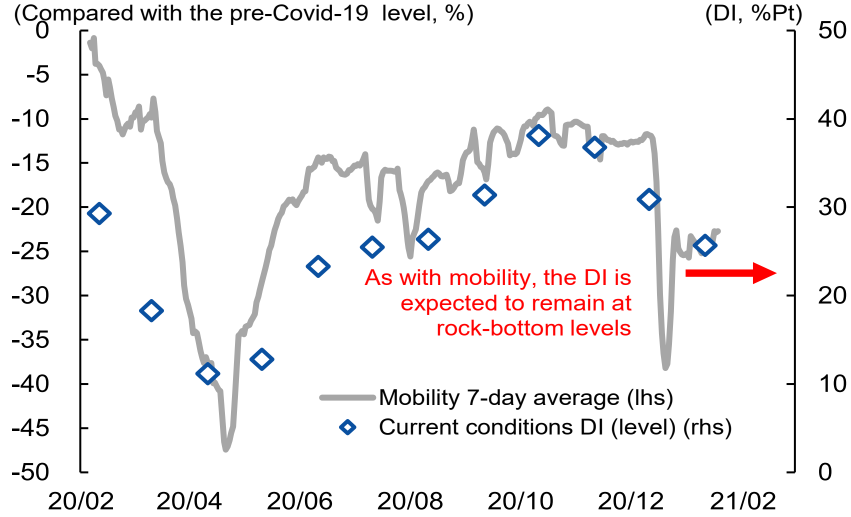
Note: Nominal wages are prevailing wages calculated by MHRI.
Source: Made by MHRI based upon Cabinet Office, *Quarterly Estimates of GDP*, Ministry of Health, Labor and Welfare, *Monthly Labour Survey*, and Ministry of Internal Affairs and Communications, *Labour Force Survey*

Despite the deterioration of business sentiment in January following the re-declaration of a state of emergency, the deterioration is limited compared with the previous declaration

- Following the reissuance of a declaration of a state of emergency, business sentiment deteriorated mainly in service sectors requiring face-to-face interactions. However, the level of the DI for current conditions remained higher than that at the time of the previous declaration in 2020.
  - The Economy Watchers Survey in January revealed a deterioration of the DI for current conditions (direction) (December: 34.3 → January: 31.2) for the third month in a row.
  - The DI for current conditions (level) deteriorated for the third consecutive month (December: 28.7 → January: 27.0). Food and beverage sectors, and sectors related to tourism and transportation fell deep into negative territory, almost on par with the deterioration at the time of the previous declaration of a state of emergency in 2020. On the other hand, the degree of deterioration was limited for retail and manufacturing sectors. Among the background factors were stay-at-home consumption, the impact of cold waves and solid investment demand by the US and China.

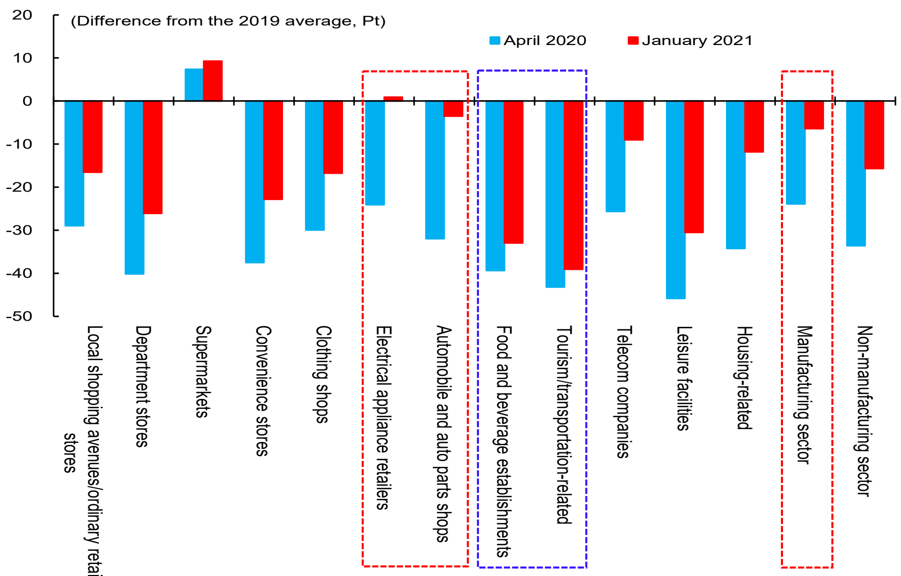
- While the DI for future conditions was lifted by expectations towards the commencement of Covid-19 vaccinations, business sentiment in February-March is expected remain at rock-bottom levels due to the extension of the state of emergency and delay in supply of vaccines.
  - The DI for future conditions was positive for the second month in a row (December: 36.1 → January: 39.9). Comments citing vaccines rose sharply (December: 113 → January: 226).

Economy Watchers Survey: DI for current conditions (level) and mobility



Source: Made by MHRI based upon Cabinet Office, *Economy Watchers Survey* and Google LCC, *Google Mobility*

Economy Watchers Survey: DI for current conditions (level) (by sector; original data and change from the 2019 average)



Source: Made by MHRI based upon Cabinet Office, *Economy Watchers Survey*

(2) BOJ monetary policy: January BOJ Monetary Policy Meeting kept policy unchanged

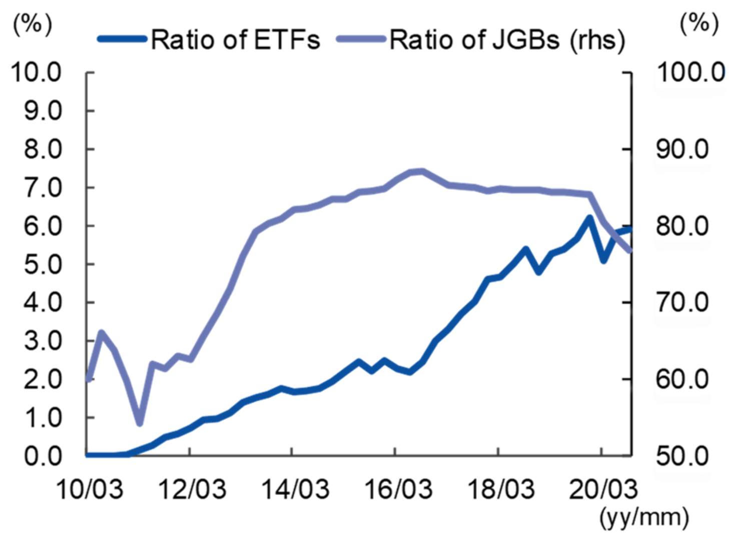
- At the Monetary Policy Meeting (MPM) on January 20 and 21, the Bank of Japan (BOJ) decided to maintain its current monetary policy stance.
  - The MPM decided to extend by one year the deadlines for loan disbursements under the Fund-Provisioning Measure to Stimulate Bank Lending and the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth.
- While attention will focus upon the results of the "assessment" at the next MPM meeting in March, there is the possibility that it may lead to (1) the abolishment of allocated exchange-traded fund (ETF) purchase amount, and the securing of flexible purchase measures, and (2) a wider allowable range of upward and downward movements for Japanese government bond (JGB) yields, and changes in the "maturity classification" and purchase amount for JGBs.
- Other options include (3) changes to the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, (4) revival of forward guidance related to the policy interest rate, and (5) review of the three-tier structure of current accounts held by financial institutions at the BOJ.

Opinions on the "assessment" at the January MPM

- The Bank should also reassess the side effects on the functioning of financial intermediation and of financial markets while taking into account that such effects have the tendency to accumulate.
- One consideration behind the assessment, among others, is whether the Bank can conduct monetary policy more flexibly in a prioritized manner so that it can enhance the sustainability of such conduct during normal times and be nimble in responding to changes in circumstances.
- The main focus of the assessment is not on countermeasures to side effects of monetary easing but on how the Bank can be nimble in making effective responses.
- In terms of yield curve control and purchases of assets such as ETFs, it is crucial for the Bank to conduct them more flexibly in a prioritized manner while maintaining the current policy framework.
- While monetary easing is expected to be prolonged, allowing 10-year JGB yields to move upward and downward to some extent will meet the investment-management needs of financial institutions through market functioning, and thereby will contribute to financial system stability.
- Even in a situation where 10-year JGB yields are allowed to move to some extent, the effects on economic activity are likely to be limited, since the proportion of funds that are affected by long-term interest rates is not high among those raised by firms and households.

Source: Made by MHRI based upon the Bank of Japan

Ratios of ETFs and JGBs in BOJ assets



Source: Made by MHRI based upon the Bank of Japan

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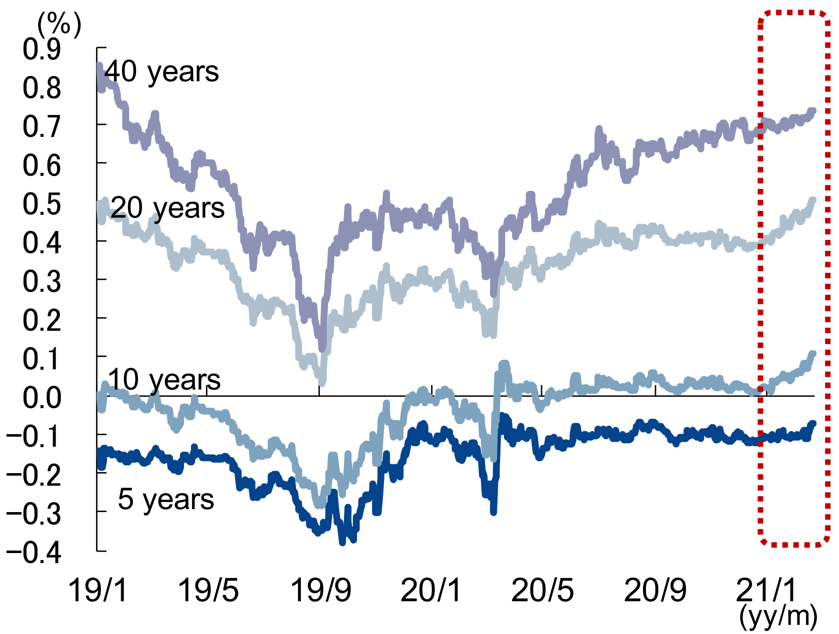
(3) Japanese bond market: 10yr JGB yield projected to trend around 0%

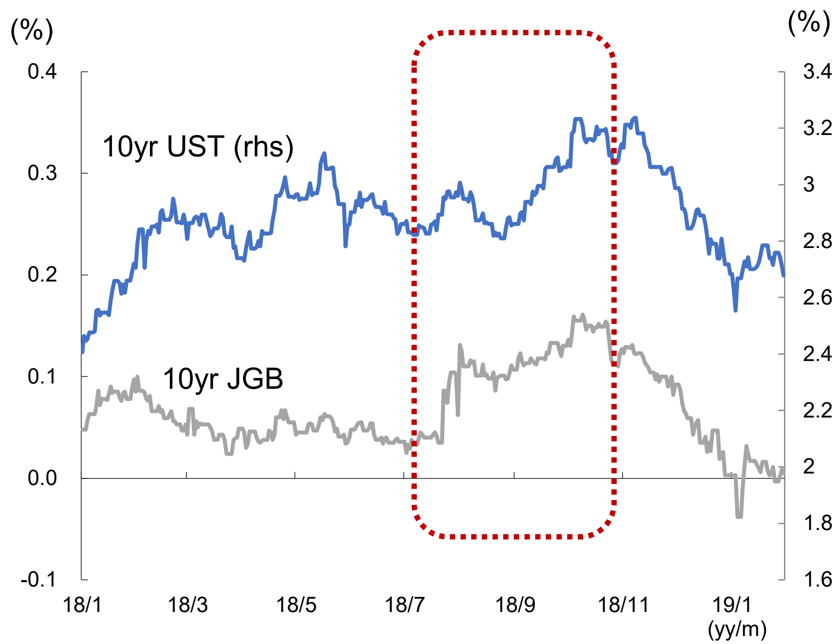
- The yield on 10yr JGBs rose to 0.126% on February 24, reflecting media reports that the BOJ is considering an expansion of the allowable range of movements of JGB yields as part of the monetary policy “assessment” and rise of US interest rates.
  - When the allowable range of upward and downward movements in JGB yields was expanded to ±0.2% in July 2018, the 10yr JGB yield surged to 0.161%. Subsequently, however, JGB yields declined in tandem with the 10yr UST yield.
- Until the next MPM meeting in March, the long-term interest rate may rise temporarily, and a wider range of fluctuation may occur due to speculation on the monetary policy “assessment.”
  - However, given prospects of the prolongation of monetary easing, the 10yr JGB yield is projected to remain around 0%.

Trends in JGB yields



Source: Made by MHRI based upon Bloomberg.

Trends in 10yr UST and JGB yields in 2018

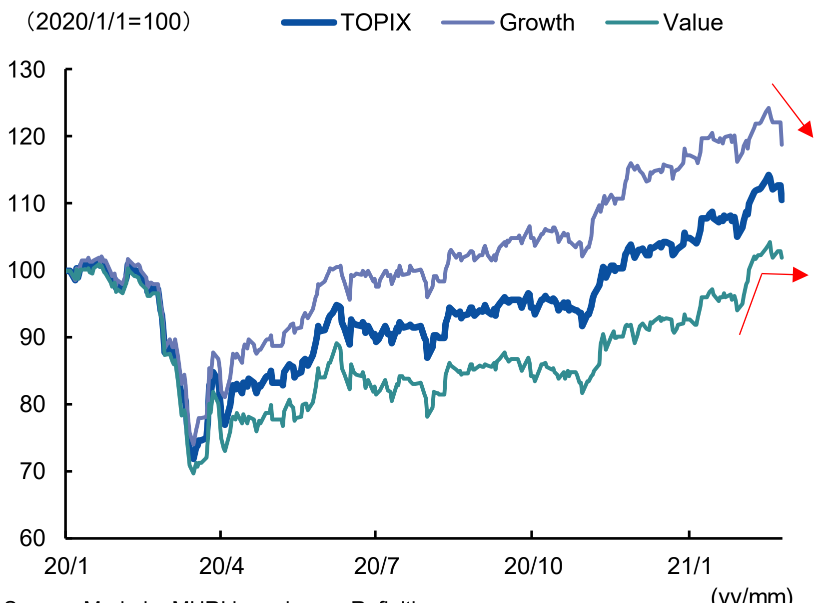


Source: Made by MHRI based upon Bloomberg.

(4) Japanese stock market: Nikkei Average breached the 30,000 mark on expectations of economic recovery

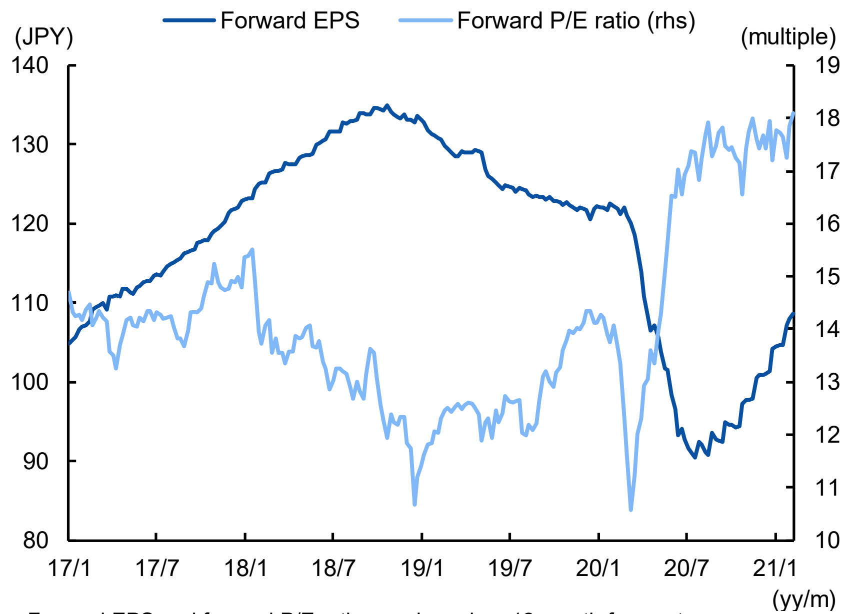
- The Nikkei Average breached the 30,000 mark for the first time in approximately 30 years on expectations toward economic recovery (February 15) .
  - In addition to the rollout of Covid-19 vaccines in Japan and expectations of an economic recovery reflecting the US economic stimulus measures, the latest corporate earnings turned out to be stronger than earlier forecasts, sending the price of value stocks, whose recovery had been delayed, higher. However, growth stocks are declining at the moment due to the rise of US interest rates.
- While the forward EPS is lower than the level prior to the Covid-19 pandemic, it is continuing to follow a recovery path. Valuation remains high with the forward P/E ratio standing at 18x.
- Given that the rise of Japanese stocks most likely stems from moves to factor in the further rise of corporate earnings, it would be necessary to monitor the risks of stock price adjustment due to the stagnation of economic recovery because of delays in vaccine rollout and sharp rise of US interest rates.

TOPIX Growth/Value Index



Source: Made by MHRI based upon Refinitiv.

TOPIX forward EPS and forward P/E ratio

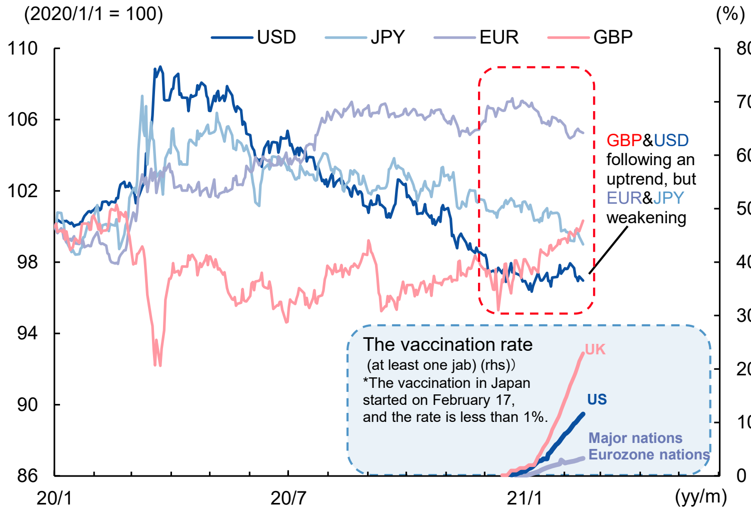


Note: Forward EPS and forward P/E ratios are based on 12-month forecasts.
Source: Made by MHRI based upon Refinitiv.

6. Forex market: upward pressure on USD from the rise of US interest rates should be limited. USD/JPY rates will likely move in a narrow range

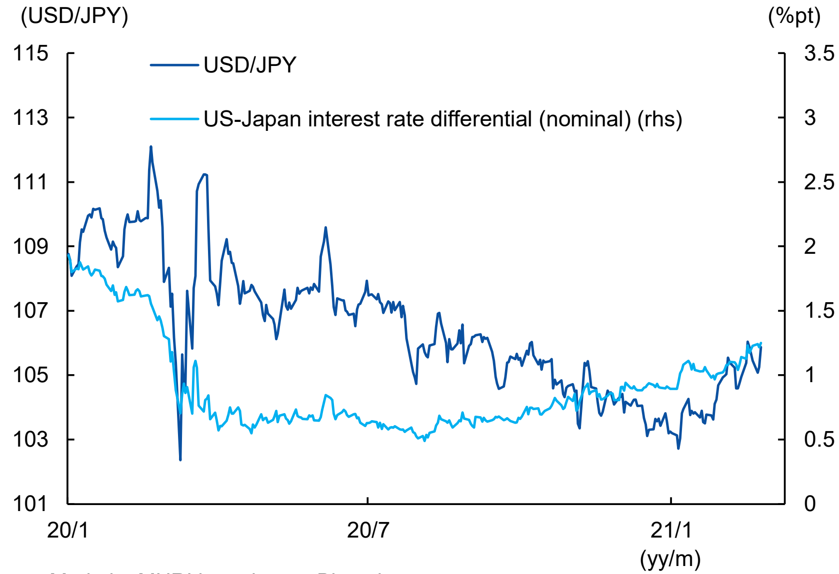
- The US dollar has strengthened against the yen since the turn of the year on the back of the rise of US interest rates. Despite a temporary rise of the US dollar to the mid-JPY106 yen level, this is taking a breather.
  - In addition to the widening differential between Japanese and US interest rates, the odds are high that the slow Covid-19 vaccine rollout in Japan compared to the US served as USD-buying and JPY-selling incentives.
  - However, comments by a high-ranking Fed official underscoring the Fed's maintenance of an accommodative monetary policy stance served to limit the upside of the US dollar, resulting in the US dollar to trade with the Japanese yen around the upper end of the JPY105-range.
- Looking forward, US interest rates have limited room to rise much further. The USD/JPY currency pair is expected to continue trading in a narrow range around the JPY105.
  - Even though the FRB will most likely tolerate a rise of long-term interest rates accompanying the recovery of the economy to a certain extent, the odds are high that it will maintain a cautious stance towards tapering.
  - We expect that the expansion of the Japan-US interest rate differential will come to a pause, and that US dollar-strengthening pressures from the perspective of interest rates will be limited.

Nominal effective exchange rates of major industrial nations and the vaccination rate (first jab)



Note: The vaccination rate for major Eurozone nations is based on the four nations of Germany, France, Italy and Spain. The nominal effective exchange rate and the vaccination rate (first shot) represent the figures available as of the morning of February 25.
Source: Made by MHRI based upon Bloomberg, *Our World in Data*.

USD/JPY exchange rates and Japan-US interest rate differential



Source: Made by MHRI based upon Bloomberg.

7. Outlook on the financial markets

		○ Main scenario					○ Sub-scenario 1				○ Sub-scenario 2			
		2020/ Oct-Dec	2021/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2021/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2021/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
US	Federal funds rate (End-of-quarter, %)	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25
	10-yr UST bond yield (%)	0.86	1.15	1.15	1.05	1.10	1.25	1.30	1.30	1.35	1.15	0.80	0.85	0.85
	Dow Jones Average (USD)	29,093	31,000	30,800	31,000	31,200	31,900	32,200	32,700	32,800	31,000	26,900	27,300	27,400
Japan	Euroyen TIBOR (3-month, %)	-0.06	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07	-0.07
	10yr JGB yield (%)	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Nikkei Stock Average (JPY)	25,203	29,200	29,000	28,600	28,700	29,500	29,700	30,000	30,200	29,200	23,500	23,600	23,600
Europe	ECB deposit facility rate (End-of-quarter, %)	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	10-yr government bond yield（German government bonds, %)	-0.57	-0.45	-0.45	-0.45	-0.40	-0.40	-0.35	-0.35	-0.30	-0.45	-0.70	-0.65	-0.65
Forex	USD/JPY rate (USD/JPY)	104	105	105	106	107	106	107	108	108	105	105	105	105
	EUR/USD rate (EUR/USD)	1.19	1.20	1.19	1.18	1.17	1.19	1.17	1.17	1.16	1.20	1.19	1.19	1.19

- Sub-scenario 1 (upside scenario)
  - The vaccine rollout is completed at an early stage and restrictions on economic activities are lifted along with the achievement of herd immunity as early as mid-2021. Long-term interest rates and stock prices rise. The dollar strengthens against the yen.
- Sub-scenario 2 (downside scenario)
  - Vaccine rollouts do not progress due to concerns regarding efficacy and side effects, and restrictions to ensure social distance are prolonged. The pace of global economic recovery remains extremely sluggish, long-term interest rates decline, and stock prices fall. The dollar continues to weaken against the yen.

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