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Forex Medium-Term Outlook

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Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

USD/JPY continued to rise in May. Although the market is welcoming the higher correlation between USD/JPY and the US Treasury yield, it is difficult to deem the current rise of the yield as positively. Rather, there is a lingering suspicion that the rise in the yield is contributing to a "crowding out" effect, and it would be prudent to realize that the U.S. economy may not be able to withstand an increase in nominal interest rates.

Again, it is not just the U.S. economy but also newly emerging economies that are being put to the test for their ability to withstand the rise in the yield. In May, the currencies of Argentina, Turkey, and other emerging economies with current account deficits experienced major fluctuations. Even as the increase in U.S. interest rates makes USD-denominated assets more attractive to investors, given that funds were channeled into many emerging and resource-rich markets in 2017, the reversal of this trend is a concern. Other similar turbulent situations could well arise as the Fed proceeds with its policy normalization. In May, several factors that were negatively affecting market sentiment suddenly receded, including the trade wars and the situation with North Korea, but it is hard to believe that concerns related to the above have been completely rooted out. Therefore, I feel no need to change my main scenario on these developments. My basic understanding is that the slowing down of the U.S. economy will cause the derailment of the Fed's normalization process, resulting in a decline of the yield on US Treasury and a depreciation of USD (together with an appreciation of JPY).

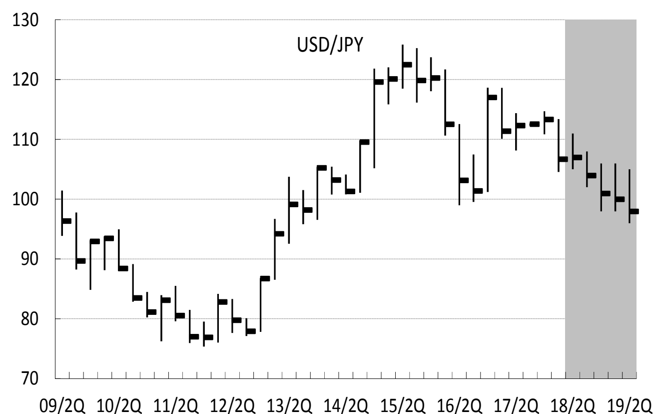
Meanwhile, EUR has been weakening. This is partially the result of USD appreciation due to the rise in the yield of US Treasury, but the political situation in Italy may also have been spurring on EUR selling. Since speculators had originally been strongly inclined to buy EUR, the situation was conducive to reversing trade. However, the future of Italy's political situation seems quite dire. At the very least, it seems clear that the economic and diplomatic ideas of the new government in Italy are in direct contrast to those of the EU. Italian government bond yields have been soaring in the markets due to expansionary fiscal policies and reelection concerns. It has to be said that this has become a big headache for the ECB, which will soon have to think about ending its Asset Purchase Programme (APP). In addition to such political instabilities, the fundamental economic indicators of the Euro area have been progressively worsening, causing a sudden deterioration in the policy environment surrounding the ECB. EUR has continued to weaken against market perception that it will be difficult for the ECB even to begin discussing the possibility of a rate hike any time this year, but I would like to predict that the currency will recover its strength in the second half of the forecasting period as USD weakens.

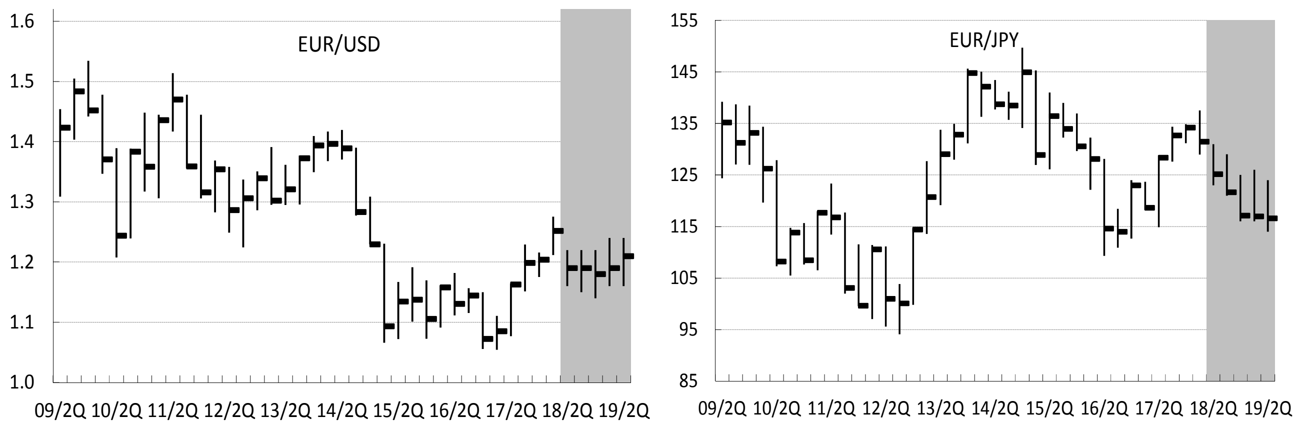
Summary Table of Forecasts

	2018 Jan - May (actual)	Jun	Jul-Sep	Oct-Dec	2019 Jan-Mar	Apr-Jun
USD/JPY	104.64 ～ 113.40 (108.71)	105 ～ 111 (107)	102 ～ 108 (104)	98 ～ 106 (101)	98 ～ 106 (100)	96 ～ 105 (98)
EUR/USD	1.1510 ～ 1.2556 (1.1663)	1.14 ～ 1.20 (1.17)	1.13 ～ 1.20 (1.17)	1.12 ～ 1.20 (1.16)	1.14 ～ 1.22 (1.17)	1.14 ～ 1.22 (1.19)
EUR/JPY	124.62 ～ 137.51 (126.79)	123 ～ 131 (125)	121 ～ 129 (122)	116 ～ 125 (117)	116 ～ 126 (117)	114 ～ 124 (117)

(Notes) 1. Actual results released around 10am TKY time on31 May 2018. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – Is the Recent Rise in Yields Desirable or Undesirable?

Side-Effects of the Increase in U.S. Yields – Emerging Markets Put to the Test

Policy Interest Rate at 40% - A Difficult Decision

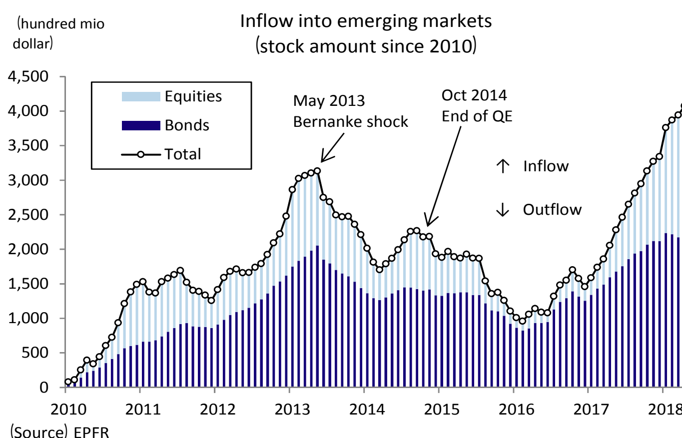
In May, USD/JPY moved in tandem with U.S. 10-year Treasury yields, which surpassed the 3% milestone before stabilizing. Until recently, the assumed path of “rate hikes by the Fed → increase in U.S. yields → USD appreciation” did not seem to be functioning, but it seems that this view is gaining a momentum as of writing this report. However, things are not as simple as this. Tight conditions in the USD market is causing the weakening of other key currencies such as JPY and EUR, but much more significant is weakening of the currencies of emerging and resource-based economies. Specifically, it is causing a turmoil in the asset markets of such countries through the depreciation of their currencies. This is a scenario that has repeatedly been played out during phases of increase in U.S. interest rates, and ominous developments can be seen this time too.

The first country to grab the world’s attention in this regard was Argentina in May. The Central Bank of Argentina raised its policy interest rate, the 7-day repo rate, by 6.75 pp, to an annual rate of 40%. This was the country’s third interest rate hike in eight days, resulting in a cumulative increase in interest rates of 12.75 pp during this period. On the one side, an increase in U.S. yields causes capital to flow into the U.S. (USD appreciation), but on the other side, it causes capital to flow out of other countries (depreciation of those countries’ currencies). As I will explain later, what happens in such phases is that, the weaker a country’s international economic sector, the earlier its currency begins to weaken. Argentina seems like a textbook case, but it should not be taken lightly. The Central Bank of Argentina had been using currency intervention to protect its currency, but that proved insufficient, forcing the bank to also implement policy-rate-related measures. Raising interest rates to protect against currency devaluation is bound to damage the real economy, but the central bank may have been forced into this difficult decision because money will endlessly flow out of the country and flow into USD-denominated assets unless inflation is first controlled.

Obviously Impatient

Right from April, the actions of the Argentinian Central Bank had clearly revealed its impatience. First, on April 24, the bank decided to keep its policy interest rate unchanged at 27.25%. The monetary policy report published at this time pointed out that, though the core inflation rate for April remained quite high, indicators showed that the forecasted inflation is to be lower than the preivous month; the view that prices would begin to fall starting May was indicated. The bank’s view with regards to the value of the Argentine peso (ARS) was that it would stabilize over the next few months as a result of interventions. Obviously, at this time, the bank still thought that it could control the devaluation of ARS. Three days later, on April 27, however, the bank decided on a 3-pp emergency rate hike, bringing the policy interest rate to 30.25%. Subsequently, on May 3, it again implemented a 3-pp rate hike, and then on the next day (May 4), it implemented a bold rate hike by 6.75 pp. This is quite simply a desperate bid to protect its currency against devaluation, and it seems clear that the selling pressure on ARS is much greater than the authorities had originally assumed. This is an example of the ripple effect of the Fed’s matter-of-fact rate hikes and balance-sheet normalization efforts in response to the domestic economy and inflation situation within the U.S., but as I will explain in detail later, for some emerging economies, this is not “somebody else’s problem.”

Excess Capital Promoting the Hunt for Yields

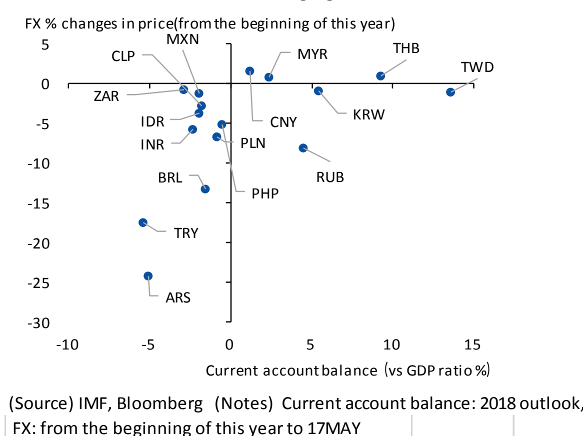


What do we need to understand and learn from this turmoil in Argentina? What we must understand is that (1) the "Goldilocks" economy, much of which was made last year, was a rather abnormal thing; and what we must learn is that (2) there is a risk that markets will begin to look for other similar cases. From the point of forecasts, naturally, (2) is more important.

First, with regards to (1), you may remember that Argentine government issued 100-year bonds on June 19, 2017 and this drew a lot of attention because of the country's lack of an investment grade rating. This was able to happen because excess capital was available then. However, we should have notice this as an omen of the current turmoil in the country. One can see from the figure that excessive monetary easing resulted in an environment where easy money was available for even to an emeriging market. As the graph above shows, even in 2017, when the Fed hiked three times, funds continued to see inflow into emerging economies, and in October, the cumulative net inflow since 2010 had recovered to a level seen before the May 2013 "Bernanke Shock," and funds have continued to flow in vigorously even since. One of the factors contributing to this may have been due to the strong fundamentals of emerging economies and also due to resource-based economies, but on the other hand, the excess capital resulting from excessive levels of monetary accommodation despite strong global economic performance also seems to have promoted the "hunt for yields" by investors. The definition of "excess capital" is often ambiguous, but in general, it seems to be based largely on the amount of base money (BM). In this context, the absolute value of the USD BM will decline now that the Fed has begun shrinking its balance sheet, so the amount of excess capital will also inevitably shrink. With just rate hikes, the level of excess capital in terms of BM would not have changed much, so one can say that there has been a major change since the autumn of last year in this sense.

If the vigorous inflow of capital into emerging economies as described above had been supported by excess BM, aka excess capital, the possibility of an Argentina-like situation arising in other parts of the world going forward, and its impact cannot be underestimated. This is something that warrants close monitoring so long as the Fed continues with its policy normalization process, although it is a different question what the magnitude of the problem will be. As safe USD-denominated assets become more attractive to investors, there will no longer be much motivation for deliberately investing in risky assets denominated in emerging currencies. There are fears that the trend will switch to an outflow of capital from emerging economies as investors, beginning with those who react more swiftly, reverse their hitherto moves.

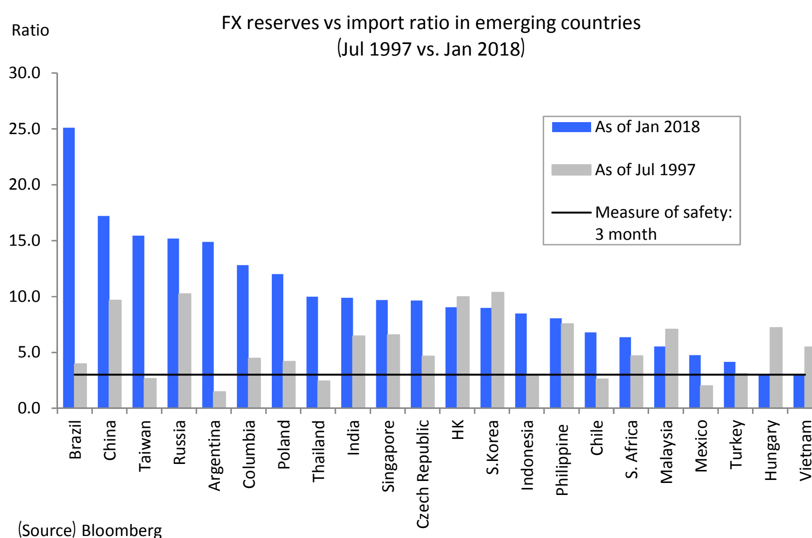
What Could Stand in the Way of the Fed's Policy Path?



(Source) IMF, Bloomberg (Notes) Current account balance: 2018 outlook, FX: from the beginning of this year to 17MAY

Assuming that the markets were to begin to look for other cases similar to Argentina, where will they look? As per theory, the focus will be on countries with weak international economic sectors. In fact, looking at the emerging currency markets this year, the currencies of current account deficit countries have weakened significantly, while the currencies of current account surplus countries have been able to withstand the recent phase (see graph). Based on the weakness of their international economic sectors, the currencies that will draw attention as most likely to weaken are (in descending order) ARS, TRY, INR, ZAR, INR, and IDR, and indeed, these currencies have been weak since early this year. Incidentally, currencies like BRL and MXN have been strong this year despite their current account deficits, but this is either due to the fact that they had already been weakened more than enough over several previous phases, or that they happened to be propped up by political factors as a matter of chance, so it is not that their underlying risk has been completely eliminated.

Narrowing down the targets more rigorously, of the currencies listed on the previous page (current account deficit currencies), the currencies most likely to be targeted are those of countries with low foreign currency reserves. That means MXN and TRY; so the weakness of these two currencies warrant close monitoring going forward (graph to the right). Having said that, just because a country has significant foreign currency reserves does not mean it will not be targeted. ARS has depreciated drastically despite the country's luxurious foreign currency reserves, and one is also reminded of an extreme case from August 2015, when China, the country with the world's largest foreign currency reserves, had to move to protect its currency against devaluation. Foreign currency reserves are, at most, a provision for times of crisis, but they do not prevent a crisis from happening in the first place. Naturally, to take the logic to its extreme, a country cannot use its foreign currency reserves to protect its currency (through forex interventions including the purchase of its own currency) indefinitely, as it will run out of forex reserves at some point. The reason Argentina implemented a major rate hike recently is because the country was unable to protect its currency simply by using its foreign currency reserves.

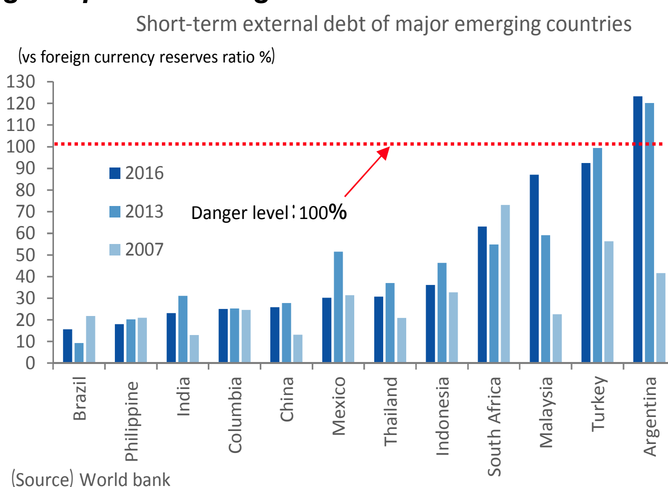


(Source) Bloomberg

My main scenario in this report assumes that the Fed's normalization process will invite a slowdown of the U.S. economy, but it is also important to consider the possibility of the Fed's policy operations being affected by turmoil in emerging and resource-based economies, which had been propped up by asset prices based on excess capital (the 100-year Argentine government bonds being a good example of this). In other words, the question is – will the Fed's policy operation path be affected by the domestic situation or the international one? I feel that the recent turmoil in Argentina has served to highlight the fact that one cannot afford to ignore risks emerging outside the U.S. going forward. The rise in U.S. interest rates, which regulate the cost of capital around the world, should not be interpreted merely from the perspective of JPY selling amid an expansion of the foreign-to-domestic interest-rate gap. Its ripple effects elsewhere should also be carefully considered and understood.

Professor Reinhart Says Emerging Markets in Tougher Spot than during 2008 Crisis

Regarding the crisis in emerging economies as a result of the rise in U.S. interest rates, Bloomberg has also focused on this issue in an article published on May 17 – "Harvard's Reinhart Says Emerging Markets Are in Tougher Spot Than During 2008 Crisis" – which reported on an interview with Harvard University Professor Carmen Reinhart. In the interview, Prof. Reinhart said – "The bigger the tightening, the more the anticipation that rates will go higher and higher and that has multiplier consequences for emerging markets" – and she went on to express concern about the future ramifications of the fact that more than two-thirds of emerging-market debt is now USD-denominated. While the article discussed diverse issues, one of the most eye-catching-albeit-orthodox of the views expressed by Professor Reinhart is – "EM rebounded super-quick after the great financial crisis and an important element of that had to with they had very little external debt." In this regard, the situation certainly seems to have worsened since the financial crisis. Looking at the graph showing the short-term external debt of major emerging countries (as a percentage of foreign currency reserves), one finds that, although few countries have reached the danger level (100%), there has been an increase in the number of countries whose external debt has risen since 2007. The external debt growth of Argentina and Turkey has been very large, and their debt is approaching or surpassing the level considered dangerous, and it is natural that those trends have been causing market turbulence.



(Source) World bank

Currencies of Country with Current Account Deficits – Devastating Situation

Incidentally, as the graph on P.4 shows, while current account deficits of Turkey and Argentina have exceeded 5% of their GDP, there are several other emerging countries whose currencies have depreciated sharply since the start of this year, and there is a clear pattern of such depreciation being promoted by current account deficits. Since the FF interest rate is a measure of the cost of capital within the U.S. economy and also within the global economy, the impact of FF interest rate trends spreads both within and outside the United States. The greatest impact is on countries with high levels of external debt (particularly USD-denominated debt), and these tend to be countries with current account deficits. Indeed, not one of the currencies that have kept appreciating since the start of this year are those of countries with current account deficits (estimated for the period until May 28). Looking exclusively at interest rates, while the investment appeal to the USD-denominated assets, there is relatively little incentive to invest in currencies of emerging countries with weak international economic sectors and unstable political situations. Is it not natural to expect that the trend during 2017 of capital inflows into emerging countries focused mainly in shares will inevitably be reversed? Last year's financial environment – in which Argentina was able to issue 100-year bonds despite having defaulted five times in the past 100 years – was abnormal, and I think that the necessary adjustments to that environment will be accompanied by significant repercussions. In this regard, there are bases for concern about the likelihood of something akin to the taper tantrum of 2013, but Professor Reinhart hinted that the outlook may be even worse, pointing out that – "there are a lot of internal and external vulnerabilities now that were not there during the taper tantrum."

"Endurance test" of Capabilities for Coping with U.S. Interest Rate Rise

The rise of U.S. interest rates has caused the forex market to focus on the expansion of Japan-U.S. interest rate gap and the associated JPY depreciation/USD appreciation trend, but that is only one part of what is happening. As noted above, the rise of U.S. interest rates also means the end of the "disproportionately-low-interest-rate environment" that has been a driver of emerging country markets. Given the generally acknowledged fact that the expansion of quantitative easing (QE) promoted rises of asset prices both within and outside the United States, it would seem overly optimistic to expect that the process of shrinking QE might not have major repercussions. If the scale of financial markets' tantrum were to be considerably greater than that of 2013, one can anticipate that it will become quite difficult for the Fed to maintain its current hawkish policy path. It appears that the world economy has begun an "endurance test" of capabilities for coping with the U.S. interest rate rise, and this is cause for considerable concern at this point in light of Prof. Reinhart's description of the weakened endurance capabilities of emerging country markets.

JPY Supply-Demand Balance – Major Acquisition to Change the Structure of Foreign Credit

Acquisition of a Foreign Company vs. JPY Rates

In the context of JPY supply and demand, one of the big stories in May was a major Japanese pharmaceutical company's acquisition of a large Irish pharmaceutical company. This will be the biggest ever acquisition of a foreign company by a Japanese company in terms of transaction value, at GBP 46 billion (≈ JPY 7 trillion). The largest acquisition before this was that of a large British semiconductor development company by a Japanese telecom giant for ≈ JPY 3.3 trillion, which was announced in July 2016. The transaction value this time, however, will be twice that. When such large-scale foreign direct investments by Japanese companies come to light, JPY selling in the forex markets equivalent to the transaction value always make the headlines. The flow of JPY selling and foreign currency buying that takes place in the forex markets whenever a foreign company is bought results from an outright selling of JPY in the short term, so it is natural that its impact should draw attention. The reason I added "in the short term" is because, in the medium term, one has to take into account dividends from the acquired company, which could expand the primary income surplus. In other words, at the acquisition stage, JPY selling takes place, but the profits, at the later stage, accompany JPY buying, so the two trends cancel each other out overall.

Large M&A by Japanese corpotations after financial crisis

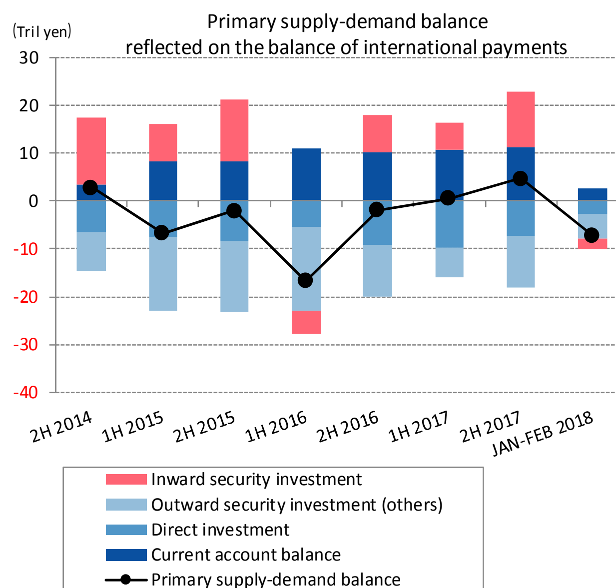
Year	Month	Japan	Overseas	Amount	3 month ago	3 month later	Direction
2018	May	Large pharmaceutical co	Ireland: Large pharmaceutical co	Approx 7 tril yen	109.32	-	-
2016	Jul	Large telecommunications co	UK: Large Semiconductor Research co	Approx 3.3 tril yen	112.58	101.45	Strong JPY
2014	Jan	Large beverage co	US: Large whisky co	Approx 1.7 tril yen	98.26	105.35	Weak JPY
2012	Oct	Large telecommunications co	US: Large telecommunications co	Approx 1.5 tril yen	79.75	86.72	Weak JPY
2011	May	Large pharmaceutical co	Switzerland:Large pharmaceutical co	Approx 1 tril yen	82.1	76.9	Strong JPY

(Source) Karakama according to media (Notes) Year/Month: Timing as announcement of M&A, FX: in comparison with the first day in the month

Having said that, there is no way to tell at this point what percentage of the transaction value will give rise to a forex transaction, and how much of that will be made using JPY funds. Again, even if we knew the amount of the transaction and the currencies involved, it would only be possible to guess at when and to what extent that amount would come into the market. The table on the previous page analyzes how USD/JPY has changed before and after major acquisitions (worth at least JPY 1 trillion) since the financial crisis, by comparing USD/JPY three months before and three months after each transaction. As one can tell, it is difficult to judge merely with this information whether or not an acquisition caused JPY to depreciate. For instance, the October 2012 (communications industry) and January 2014 (beverage industry) Japanese acquisitions of foreign companies appear, going by the results, to have caused JPY depreciation, but the former had coincided with the start of Abenomics (in November 2012) and the after effects of Abenomics were still in effect during the latter, so it is impossible to tell whether the acquisitions themselves contributed to JPY depreciation. On the other hand, JPY actually appreciated following the May 2011 acquisition of a foreign company by a major Japanese pharmaceutical company (the same one as in the recent announcement), but it must be mentioned that this took place at a time when there were exceptional special factors at play, namely the intensification of a risk-off mood following the 2011 Tohoku earthquake and nuclear disaster. The headlines following the acquisition of a foreign company tend to be quite flashy, but forex trends are not determined solely by them.

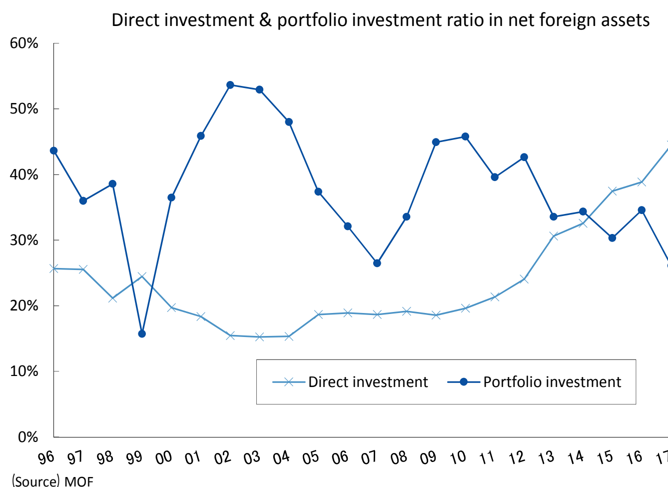
As a Factor that Could Check JPY Appreciation

Having said that, the transaction value of the recently announced acquisition (JPY 7 trillion) amounts to as much as a third of the current account surplus for the calendar year 2017, which itself was the second-largest current account surplus ever. Its impact on JPY supply and demand is bound to be on a different level than any previous transaction. As it is, the JPY supply-demand balance has been tilted toward a net supply of JPY since the beginning of 2018 (see graph to the right), and major life insurers' investment plans for the new fiscal year, released one after the other starting April, had also revealed a vigorous risk appetite in terms of investing in foreign securities without hedging against currency risks (of course, it is a different question whether the plans will actually be implemented). Of course, as I have been repeatedly arguing in this report, foreign securities investment trends ultimately depend on the real U.S. economy and the associated monetary policy trends, so based on my prediction that the Fed's normalization process will fail, I do not think that JPY selling through this path will continue for very long. However, the fundamental trend in foreign securities investment since the 2000s has been upward, and during this time, it is easy to see that the trend has not been dependent on JPY rates or domestic/international economic trends. This probably indicates that foreign securities investment is a management strategy adopted by Japanese companies, which face shrinking domestic markets thanks to the aging of society and lower birth rates, to protect themselves from the vagaries of domestic market conditions.



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

Again, in terms of ratio within the net balance of external assets, thanks to the increments over the past ten or more years, direct investment is closed to securities investment, which was the main category until recently. Looking at the latest data for 2017, the percentage of direct investment within the net balance of assets is 44.5% as opposed to 26.1% for securities investment, making this the third year in a row that direct investment has been the largest component of the net balance of external assets (see graph). However, this was the first time that the gap between the two has been so wide. While Japan has nominally retained its status as the world's largest creditor nation for 27 years in a row, its breakdown has definitively been shifting from securities investment to corporate acquisitions.



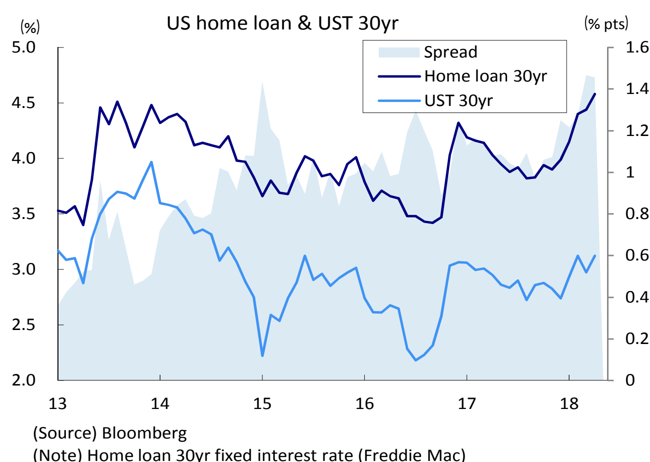
(Source) MOF

Part of this may be due to the fact that securities investment is not as profitable as direct investment amid a global trend of low interest rates, but it is also true that a large number of Japanese companies feel that the potential of the domestic market is limited. From the perspective of impact on the forex market, compared with the flow of investment in securities, which tend not to be hedged against currency risk, direct investment usually takes place through an outright selling of JPY (outright buying of foreign currency). Therefore, it cannot be denied that the JPY supply-demand situation at present is structurally conducive to JPY depreciation. Of course, this alone is unlikely to determine the trend of USD/JPY, but in analyzing JPY rates, it is undoubtedly beginning to take on as important aspect as foreign direct investment or foreign securities investment.

U.S. Economic and Monetary Policies Now and Going Forward – A "Desirable" or "Undesirable" Interest Rate Rise?

Negative Aspects of the Interest Rate rise: Household Sector

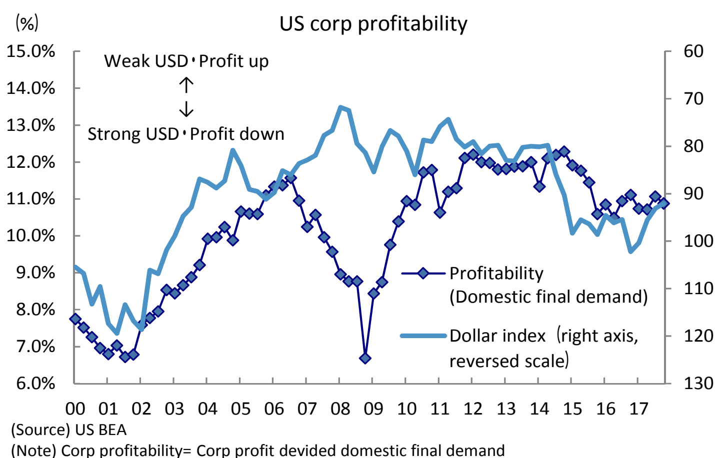
USD appreciation has gained momentum since mid-April, with the USD index rising significantly by almost 5% within the period of a month or so. The forex markets are abuzz with the fact that a direct correlation between USD and U.S. interest rates has returned since 10-year Treasury yield hit 3%. Amid such circumstances, it seems that there are, as usual, few opportunities for discussing the negative aspects of this rise in U.S. interest rates. Naturally, one concern is that a rise in interest rates could dampen consumption/investment activities that are sensitive to interest rates, which could lead to a U.S. economic slowdown. A representative example of "consumption/investment activities that are sensitive to interest rates" is housing investment, and (as the graph shows) the rate of increase in housing loan interest rates has been higher than that of U.S. government bond interest rates since the beginning of the year. The spread between 30-year Treasury yields and the interest rate on 30-year mortgages has expanded to levels not seen since January 2009, and the effects of monetary tightening are expected to surface going forward, with a time lag. Specifically, it may be worth monitoring Existing Home Sales for some time to come. Housing investment is not a very large demand-side component of GDP, but if the impact of durable goods consumption (cars, refrigerators, televisions, etc.) associated with housing investment is also taken into account, trends in this area will always play an important role.



(Source) Bloomberg
(Note) Home loan 30yr fixed interest rate (Freddie Mac)

Negative Aspects of the Interest Rate Rise: Corporate Sector

As with the household sector as described above, there are negative aspects for the corporate sector too. A rise in interest rates can be expected to dampen economic activities, led by fixed investment, but the appreciation of USD accompanying the rise in interest rates could also affect the corporate sector negatively. The graph to the right plots the ratio of corporate earnings within domestic final demand in the U.S. (nominal GDP – inventory investment – net exports). This could be seen as the profitability of U.S. corporations from a macroeconomic perspective. As the graph shows, corporate profitability appears to be in an inverse relationship with USD strength, so, if USD appreciates alongside U.S. interest rates, corporate profitability could be weighed down by higher USD and U.S. interest rates. Of course, the correlation path of " increase in U.S. interest rates → USD appreciation → decline in profitability " could be a mere façade. To look at an example, USD rose sharply and corporate profits declined from mid-2014 through early-2016, but U.S. interest rates did not rise much at all during this period. It would seem as though the rise in USD itself had a negative impact on the corporate sector.



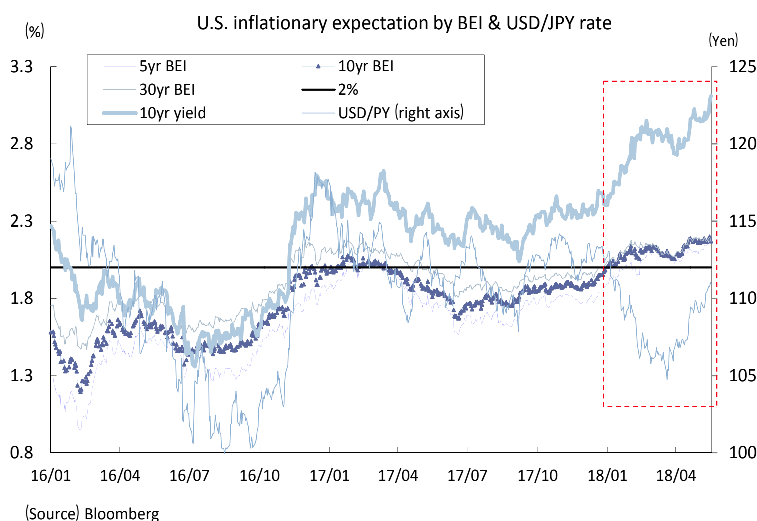
(Source) US BEA
(Note) Corp profitability= Corp profit devided domestic final demand

Negative Aspects of the Interest Rate Rise: International Sector

Again, as already discussed, even if the U.S. economy were to be able to withstand an increase in interest rates (or USD), there is always the question of whether the global economy can withstand it, and this question cannot be ignored. Capital inflows into emerging economy funds (especially equity) accelerated through 2017. Excess capital is the only reason one can think of for why relatively riskier emerging economy markets were preferred despite U.S. interest rates rising. However, the Fed's efforts to shrink its balance sheet will bring down the amount of excess capital, making USD-denominated assets more attractive to investors, so naturally, capital will increasingly flow out of emerging economies. What is already happening in Argentina and Turkey are the first part of this trend, and it appears that the countries with the weakest international economic sectors were targeted first (both Argentina and Turkey have large current account deficits as ratios of their GDPs). That a rise in U.S. interest rates makes USD-denominated assets more attractive to investors is no more than one of the facts to be considered in economic/financial analyses, but it tends to be focused on in the forex markets (especially in the USD/JPY market). While realizing this, I do believe that the most important thing to consider when formulating forex outlooks going forward is how seriously to analyze the rise in capital costs for the global economy from the rise in FF rates.

U.S. Inflation Expectations Peak

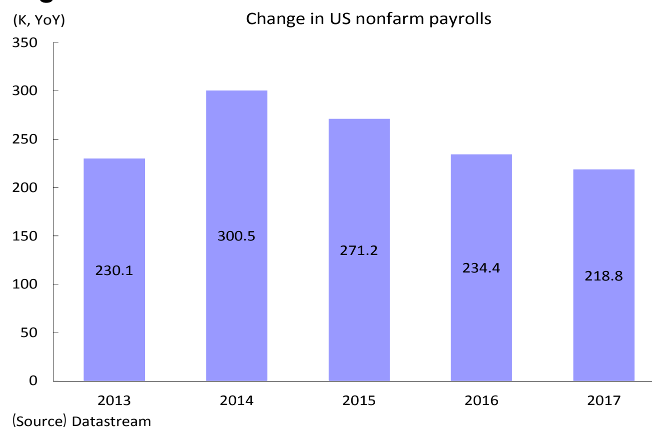
Moreover, while nominal interest rates are expected to become the central theme for financial markets, one cannot ignore the fact that inflation expectations have peaked (see graph). This seems to suggest that there is strong speculation in the markets about future rates of inflation and the end of rate hikes consistent with such rates. At the very least, it is difficult to imagine that the yield curve will steepen under such modest inflation expectations. In other words, there is unlikely to be much change in the flattened yield curve, which suggests future instability in the bond markets. Going by the current inflation expectations and yield-curve shape, it seems that the financial markets may be seeking temporary and undesirable causes behind the recent rise in U.S. interest rates, such as the rise in crude oil prices or concerns over an increase in U.S. government bond issuance. The markets do not seem to be seeing this as a stable and benign story of wage inflations arising in response to tightening conditions in the employment market, causing corporations to be optimistic in their price-setting behavior, thereby leading to a general rise in prices.



(Source) Bloomberg

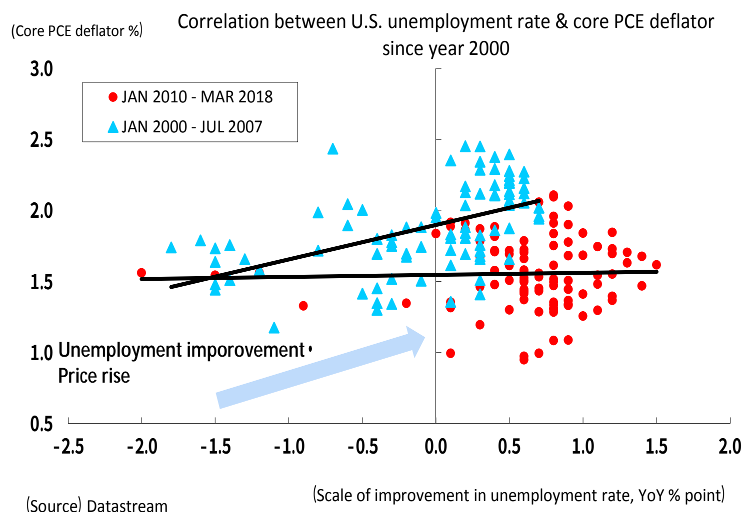
May not Be Realistic to Think of Fed Policies as Being "Behind the Curve"

As I have discussed in past issues of this report, the main theme in the markets currently seems to be to bet on the Fed's policy operation as being either "behind the curve" or "overkill." As mentioned above, if one were to assume a non-linear wage inflation and see the Fed's rate-hike path as being too late to be of use, 10-year Treasury yields surpassing 3% would be a transient phenomenon and one could expect to see a 3.5% or even 4.0% yield going forward. However, although growth in Average Hourly Earnings is quite strong, there are no signs yet of its accelerating. Nonfarm Employment Change, a quantitative indicator of employment, has been maintaining a trend of significant increases, and the sustained rise seems to be surprising for both hawks and doves, but the margin of increase in quantity, which is naturally limited, is bound to peak at some point. In fact, Nonfarm Employment Change has already peaked in terms of annual growth, at +3.01 mio (yoy; same below) in 2014, and has been steadily declining since (see graph), posting +2.71 mio for 2015, +2.34 mio for 2016, and +2.19 mio for 2017.



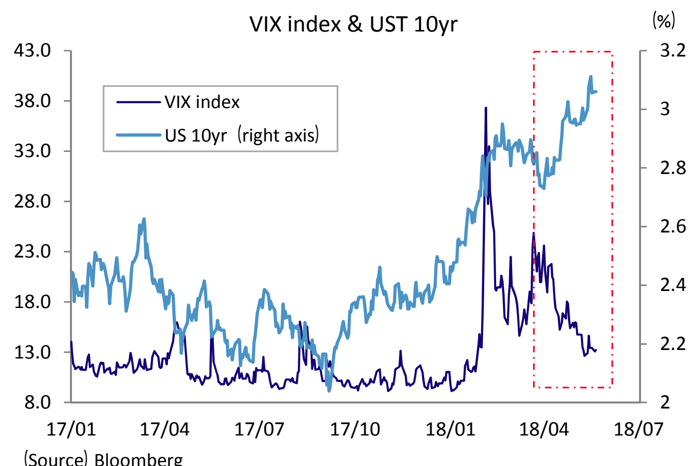
(Source) Datastream

The important question here is whether this quantity can ignite an improvement in quality (i.e., wages) before it peters, but as of the present time, there are no signs of this. Despite this lackluster wage scenario, the nominal interest rates have been running high, and there are concerns that this could cause the real economy to slow down. The Fed's outlook seems to suggest that the flattened Phillips curve will suddenly recover and become steeper going forward, but as the graph on the previous page shows, the situation remains more or less as it has been. Note that during the previous rate-hike phase (June 2004 – June 2006), the core personal consumption expenditure (PCE) deflator remained stably over +2% yoy and Average Hourly Earnings remained in the +3.5% to +4.0% yoy range. This time round, Average Hourly Earnings have remained in the +2.5% to +3.0% yoy range. Under these circumstances, I do not consider it realistic to see the Fed's policy operation as possibly being "behind the curve."



A "Desirable" or "Undesirable" Increase in Interest Rates?

To decide whether the Fed's policy operation is "behind the curve" or "overkill" is also to decide whether the recent increase in interest rates is desirable or undesirable. I find it hard to consider the recent rate hikes and increase in nominal interest rates, which are unaccompanied by an increase in inflation expectations and which are beginning to negatively affect the markets of emerging economies, as desirable. So, to me the Fed's policies seem like overkill, and the increase in interest rates seem undesirable. The U.S. stock price crash in February this year and the soaring of the CBOE Volatility Index (VIX), which are still fresh in the memory, were triggered by the increase in U.S. interest rates (see graph). However, since April, U.S. interest rates have continued to rise even as VIX has fallen, and taken in isolation, this actually makes the interest rate rise seem desirable. In other words, the markets went into risk-off mode following the rise in interest rates in February, but since April, they have been in risk-on mode due to the rise in interest rates. How must this change be interpreted?



My views are as follows. Fundamental inflation-related indicators including Average Hourly Earnings, PCE, the Consumer Price Index (CPI), and inflation expectations have not shown any marked improvement in recent months, and it is not as though the projections of the March dot plot were so much more hawkish than those of the December 2017 dot plot. On the other hand, there has been a clear rise in crude oil prices (≈ USD 64 as of February 1 → ≈ USD 72 as of May 18) and the LIBOR rate (≈ 1.79% as of February 1 → ≈ 2.32% as of May 25, for the 3-month LIBOR) during this period. To my mind, it seems strongly likely that these negative factors contributed to pushing up long-term yields. Perhaps the reason that the markets have not been pessimistic despite all this, and VIX has stabilized at a low level, is because of a series of positive news recently, including North Korea announcing the suspension of its nuclear tests, the summit meeting between the North and the South, and dates being set for a U.S.-North Korea summit. The relaxation of tensions surrounding North Korea seems to have brought about a decline in VIX, glossing over concerns of an undesirable increase in interest rates. As far as I can see, this explanation comes closest to describing the state of affairs over the past two months.

Under such circumstances, I retain my forecast that the rise in interest rates will chip away at U.S. economic and financial performance, causing the Fed's normalization process to fail, and leading to JPY appreciation.

Risks to the Main Scenario – Currency and Commerce Policy Risks

Continued Presence of Geopolitical and Commerce-Related Risks
As I do each month, I would like to review the risk factors related to my main forecast scenario. Regarding the listed risk factors (see table), there have been no major changes since last month. Geopolitical risks greatly receded during April owing to North Korea-related developments, but the situation regarding the possibility of implementing U.S.-North Korea summit talks has subsequently become more fluid, so there are remaining unresolved factors that are due cause for concern. While there still seemed to be a possibility of holding the talks on June 12 at the time this article was written, at least in the forex market, the kind of atmosphere that was promoting a buildup of JPY short positions has mostly dissipated. In addition, I have long felt uneasy about risk factor ① and continue to be concerned about it. The U.S.-China trade talks held in Washington on May 19-20 had the effect of relaxing the tense mood, as reflected in the widely quoted statement of U.S. Treasury Secretary Steven Mnuchin – "We're putting the trade war on hold." However, the differences between U.S. and Chinese views about currency and trade policies are not small.

It is generally understood although not usually recognized explicitly that the United States needs China's cooperation to realize the U.S.-North Korean summit meeting, and most observers believe the 'on hold' declaration was made based on consideration of that situation. After the letter sent by President Trump to Chairman Kim Jong Un saying it would be inappropriate to have the meeting at this time was made public, a portion of observers concluded that there would not be a second chance to have the meeting, and, given this, it would not be wise to exclude the risk that the U.S.-China trade talks might suddenly become more heated. It is true that the two countries have agreed on a policy objective of greatly reducing China's annual surplus in trade with the United States, but the U.S.-promoted target of reducing the surplus by USD200 billion was not included in the joint statement issued at the end of the talks. It is more than likely that we will see renewed strife regarding U.S.-China trade relations going forward.

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US	①	Economic policy by President Trump	・US currency ・trade policy and tough negotiations about economy between U.S. & Japan.	Strong JPY Weak USD
	②	Political risk in U.S.	・Domestic turmoil causing unstable international affairs	Strong JPY Weak USD
	③	FRB monetary policy normalization	・Significant upward revision of neutral interest rate	Weak JPY Strong USD
Japan	④	Political risk in Japan	・Retrogression of reflation policy by Abe resignation	Strong JPY Weak USD
	⑤	Risk-taking by Japanese investors	・From hedged to unhedged position expansion?	Weak JPY Strong USD
	⑥-1	Risk of BOJ monetary policy change	・BOJ might use a reversal rate discussion to begin considering means of reducing its easing measures	Strong JPY Weak USD
	⑥-2	Risk of BOJ monetary policy change	・Radical easing monetary policy such as purchase foreign bonds, helicopter money & etc	Weak JPY Strong USD
Europe	⑦	Political risks in EU	・Political instability in Italy ・Conflict intensified about Brexit negotiation	Strong JPY Weak USD
Others	⑧	Geopolitical risk	・Tension in the Korean Peninsula. War between US & North Korea?	Strong JPY Weak USD?

(Source) Daisuke Karakama, Mizuho Bank

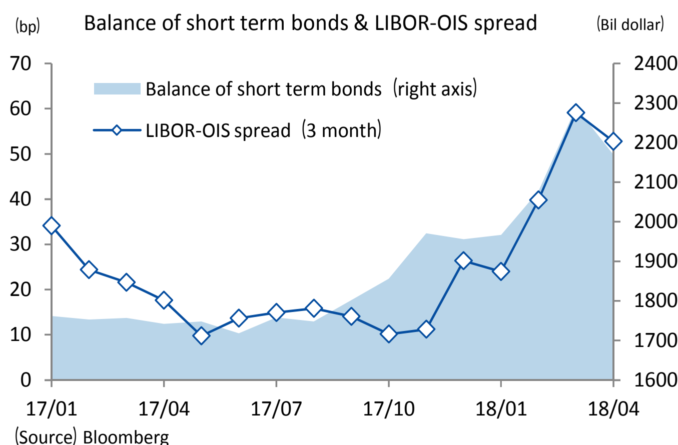
As mentioned in last month's edition of this article, quite a few people believe that President Trump considers trade war issues to be amenable to the 'art of the deal,' and therefore tend to discount his policy positions as being mere bluffs. While there are certainly aspects of his policies that include bluffs, the fact that additional tariffs have already been imposed on steel and aluminum products makes it clear that the policy positions cannot be totally discounted as being empty bluffs. Also, it was reported on May 23 that the Trump Administration is considering imposing tariffs of up to 25% on motor vehicle imports on national security grounds. Unlike steel imports, which represent only about 1% of total U.S. imports, cars are truly the largest import item category, accounting for roughly 25% of total U.S. imports. As the Commerce Department has up to 270 days to investigate the situation and present a report to the president on whether or not to apply tariffs, this is not an issue that will cause problems immediately. Moreover, as

such taxation practices are considered unlikely to be accepted as complying with WTO rules, there is a noteworthy contingent of observers that believes it unlikely that the tariff could actually be imposed. However, given the prospect of interim elections this autumn and another presidential election two years from now, it is unthinkable that President Trump would choose to lower the banner of protectionism at this point. President Trump was able to win election in 2016 on the strength of his promotion of a full array of populist policies focused on improving the welfare of the "left-behind middle class." Going forward, not only China but all countries with large trade surpluses with the United States are likely to be targeted. Because Japan is recording a large surplus centered on automobile exports, has a currency that is considered undervalued, and has recently established a new platform for bilateral negotiations with the United States, I think the risk that Japan will be targeted is a great risk that must not be overlooked.

During May, the perception of a decrease in the geopolitical risks and trade risks that have been exerting a cooling effect on market psychology caused a temporary trend of increase in USD/JPY. However, my basic understanding is that a detailed examination of the fundamental situation makes it clear there has been no significant change to that situation and that it is crucial to keep a close eye on the risk scenario situation at this point.

Interest Rate Rise Accompanying Expansionary Fiscal Policies Definitely a Risk

Regarding the Trump administration's economic policies, aside from trade policies, the administration's fiscal policies continue to be a disruptive factor. As I said in last month's edition of this article, I cannot agree with the idea that "the U.S. economy should be able to overcome the challenges of rising nominal interest rates because expansionary fiscal policies will promote economic overheating." At the moment, one does not at all get the impression of a prospective nonlinear general rise in prices and wages (inflation expectations are peaking out), and it is difficult to consider the current rise in interest rates as a positive factor. Against the backdrop of rising interest rates, there is currently concern about the sustainability of the uptrend in U.S. bond issuance, and the graph on the previous page shows that there is indeed a basis for such concern. In short, there is already reason to be concerned about a crowding out effect, and if the Trump administration proceeds to augment its expansionary fiscal policies in such a situation, there is likely to be a continued trend of "bad interest rate increases" that do not reflect conditions in the real economy. Because this trend has an indirect effect of promoting U.S. economic deceleration, I consider it to be a JPY appreciation risk.



The fact that the U.S. 10-year yield has surpassed and been sustained for a considerable time above the 3% milestone level has almost certainly played a role in making stock and forex markets become increasingly insensitive to this view. However, this should definitely not be construed to suggest that the 3% interest rate level is appropriate for the U.S. economy. The time frames of financial markets and the real economy are completely different, as the effects of monetary policies will emerge only after a lag of about one year. Fundamentally, it should prove eventually impossible for the real economy to continue accelerating amid a sustained rise in interest rates, and it is probably also impossible in practical terms. In the case that the current rise in interest rates is already showing signs of causing a crowding out effect, then overlaying expansionary fiscal policies atop that situation should theoretically further increase the risk of monetary policy overkill. The likelihood that that situation will become a JPY appreciation risk factor appears quite high.

JPY Appreciation Risks – Political Situations in Japan and Europe

In addition, the political situation in Japan continues to have the potential to be a JPY appreciation risk factor. Specifically, the current cabinet's public support rate is descending, and some observers believe that it is becoming increasingly difficult for Prime Minister Abe to win reelection for his third term as the LDP leader in the party's election this September (risk factor ⑤). Because the term "Abenomics" has become considered virtually synonymous with vigorous reflationary policies, particularly among foreign investors, there is probably a significant risk that the replacement of Prime Minister Abe could be construed as indicating a change regarding the policies themselves. As discussed in previous editions of this article, potential successors to Abe have repeatedly made statements suggesting a consciousness of a need for monetary policy normalization[1], so it is not certain whether the support of

[1] Japan's national public broadcasting organization (NHK) inspired considerable controversy by broadcasting a show on March 21 entitled – "LDP's Kishida considering "exit strategy" for normalizing monetary policy". Minister for Internal Affairs and Communications Seiko Noda has expressed interest in running

overseas investors to whom the simple “Abe ≈ reflation ≈ JPY weakness/stock price increases” has appeal will be sustained and transferred to post-Abe governments. The troublesome is that, regardless of who is prime minister, there are very few remaining policy options available to the BOJ at this point and, although normalization should be under consideration given the burden of BOJ policies on Japan’s financial system, if the accession to office of a new prime minister were to correspond with any kind of change to the yield curve control (YCC) framework, it would inevitably lead to widespread talk about the end of “Abenomics.” (Such a prospective event has come to be referred to by such names as “Abexit.”)

Since it is generally believed that the Kuroda-led BOJ has undertaken its policy management under the auspices of the Abe government, a transition to a new prime minister could potentially lead to a replacement of BOJ Governor Kuroda, who may not be positioned to complete his second five-year term owing to his age. While it is not obvious exactly how foreign investors would respond to such destabilizing changes, it is highly likely that they would not respond by increasing their JPY selling and their Japanese stock buying. For the time being, it will be worth keeping a close eye on the Japanese political situation, which should be considered a significant JPY appreciation risk factor. There also remains the possibility that the BOJ might shift toward policy normalization, provoking JPY appreciation (risk factor ⑥-1). As the April Outlook Report revised downward the level of the fiscal 2019 economy-related risk balance, the possibility of such a shift is believed to have become lower.

Other JPY appreciation risks include the European political situation (risk factor ⑦), and risks associated with this situation have clearly increased. The situation in Italy is discussed in detail in the last section of this article, and I hope readers will take a look at that, but it is worth noting in general that an increase in the power of the Northern League (Lega Nord) and its allies is likely to spur increasingly noisy discussions about proposals to withdraw from the EU and the euro area. Aside from such extreme scenarios, there is a high possibility that the coalition will seek to realize its positions regarding such issues as the introduction of a minimum income security system, reconsideration of a VAT increase, and reconsideration of EU financial agreements and, aside from economic policy measures, the coalition is proposing such measures as those to reconsider immigration and refugee policies, crack down on illegal immigrants and refugees, and lift sanctions against Russia. Many of these positions are tantamount to repudiations of existing EU policies, and it is clearly not possible to exclude the Italian situation from the list of serious risk factors when one considers what happened three years ago, when Greece’s far-left government (SYRIA) undertook a fierce confrontation with the EU regarding austerity programs, thereby bringing the operations of Greece’s domestic banking system to a halt and bringing the country to the brink of withdrawal from the euro area. Of course, it seems inevitable that the U.K. withdrawal from the EU (Brexit) process will be accompanied by some turmoil from midway through this year.

“JPY selling by Japanese” Clearly a JPY Depreciation Risk Factor

On the other hand, are there no JPY depreciation risks? It can be said that the JPY supply-demand environment is not supportive of JPY appreciation. For example, Japanese institutional investors’ proactive investment in foreign bonds (risk factor ⑤) can clearly not be excluded from the list of JPY depreciation risk factors. When USD/JPY fell below JPY105 in March, some observers ascribed the firmness of USD/JPY to an increase in Japanese investment in foreign securities. In fact, this interpretation has some basis, given that net buying has been sustained in Japanese investment in foreign securities since the start of 2018. The increasing number of new-fiscal-year fund management plans announced by major Japanese life insurance companies since the start of April also demonstrate the strength of Japanese desire to undertake foreign bond investment accompanied by JPY selling and USD buying (open foreign bond investment).

In addition, although this has already been discussed in the supply-demand section, it seems that JPY selling associated with cross-border M&A activities may have contributed to the trend of increase in USD/JPY seen during May. These flows are not from institutional investors but are similar to institutional investor flows in that they are “JPY selling by Japanese”, and some observers believe these kinds of flows are gradually inclining the JPY supply-demand balance environment toward JPY selling. Japan’s foreign direct investment has continued to surge over the past 20 years or so, and as already mentioned, foreign direct investments have come to replace securities investments as the biggest component of the country’s net external assets. Given that such an amount of “vigorous JPY selling” is stemming from Japanese companies, that the associated direct investments are accumulating overseas, and that direct investments are relatively irreversible compared to securities investments, there is a possibility that the supply-demand balance is gradually becoming structurally averse to JPY appreciation.

against Prime Minister Abe for the LDP leadership and, in April, she said – “We must seriously consider the side effects of the unprincipled continuation of unprecedented policies” – and made other remarks calling for eliminating the 2% inflation target.

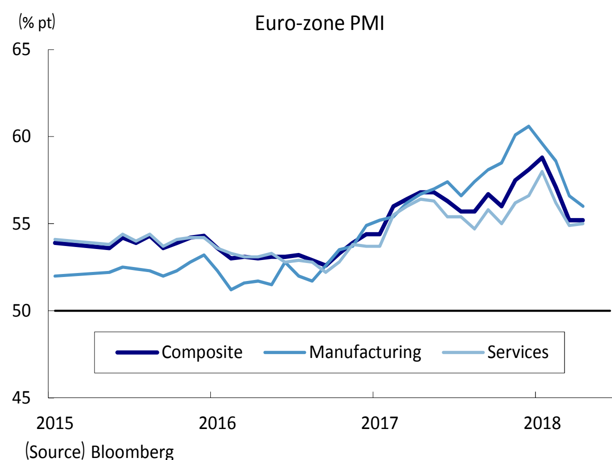
Regardless of the actual characteristics of the flows, however, it is worth remembering that the rational for the “risk aversion promotes JPY buying” theory is based on the fact that Japan has the world’s highest level of net external assets. Given this, I fundamentally think that global confidence in JPY will continue to be strong for the time being. Rather than constituting JPY depreciation risks capable of pushing USD/JPY up to new record high levels, the abovementioned situations are largely risks that this article assumes may have the potential to restrain JPY appreciation, but they can still be roughly classified as JPY depreciation risk factors. It is probably also worth mentioning the potential for the BOJ to introduce radical new easing methods, such as those involving foreign bond purchasing and helicopter money (risk factor ⑦), but there appears to be very little likelihood that such risks will eventuate.

In May, a strengthening of the sequential correlation between U.S. interest rates and USD/JPY created a headwind-period for the JPY appreciation scenario. There is no positive factor in the background of the U.S. interest rate rise, however, and, even after May, there seems almost no need to modify this article’s fundamental view that there is cause for concern about the possibility that the interest rate rise will have detrimental effects within and outside the United States. Rather, to the extent discernable from the turmoil experienced by emerging countries in May, it appears that the Fed’s normalization process (soon to transition into a tightening process) is approaching a rather challenging phase. As I mentioned in the last month’s edition of this article, my fundamental understanding regarding this is based on the simple question – “Is it possible for the economy to avoid deceleration etc. despite its central bank’s sustained tightening of monetary policies?” I think it reasonable to assume an impending economic slowdown, and my forex forecast is based on this assumption. While the U.S. 10-year interest rate continues to rise, yield curve flattening in the U.S. Treasury market is progressing, and it appears that more than a few market participants are wagering that the Fed’s policy management will be characterized by overkill rather than being behind the curve. If a U.S. economic deceleration is accompanied by a diminishing of the Fed’s hawkishness, causing U.S. interest rates fall back downward, I believe one will have to anticipate a trend of across-the-board USD depreciation that facilitates an intensification of JPY appreciation.

EUR Outlook – EUR Continuing to Face Weakening Factors

Euro Area Economy Now and Going Forward – Temporary or Not?

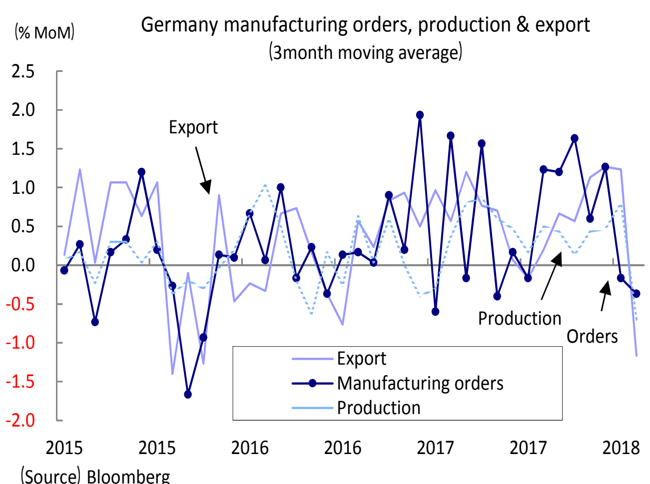
Deceleration of the Euro Area Economy Temporary?



Since the start of this year, there has been increasing discussion about the euro area economy's deceleration. Trends in the Purchasing Managers' Index (PMI) are considered a reflection of economic trends, and the PMI declined to 55.1 in April, its lowest level since January 2017. ECB President Draghi referred to this decline as "unexpected", and one gets the impression that it was a considerable surprise to the ECB. This soft data trend is also seen in hard data. For example, the first quarter euro area real GDP growth rate announced on May 2 was +0.4% QOQ, a deceleration from the +0.7% QOQ growth recorded in the four preceding quarters. Many observers are pointing out the effects of such temporary factors as cold waves, strikes, problems due to the timing of Easter holidays, and influenza epidemics, and much analysis is concluding that what is happening is not fundamental trend of deceleration. At a lecture held in Geneva on May 7, the ECB's chief economist, Peter Praet, mentioned these factors and expressed his confidence that there will be no change to the fundamental growth trend going forward, saying – "There is so far no evidence that the moderation in the pace of economic expansion reflects a durable weakening in demand."
Mr. Praet also said – "A deceleration from the exceptionally high growth rates observed in the second half of 2017 had been expected." – expressing his view that the current signs of deceleration are no more than a reaction to the previous trend. Certainly, if once considers the previous level of strength, a deceleration can to some extent be considered unavoidable, and although the growth rate has slowed down, since the QOQ rate of +0.4% (+1.7% on an annual basis) exceeds the euro area's potential growth rate, the lower figures themselves are not cause for much worry.

However, Mr. Praet showed signs of some concern about the current trends, noting that – "the slowdown has come sooner than anticipated. The downward surprise in incoming information has been broad-based, as it can be observed in both hard data and survey indicators across most sectors and countries." There is a certain tension between the two elements of the gist of his statement – roughly speaking, "probably OK," but "somewhat uneasy" – and since this same tension is seen in the statements of President Draghi after the April 26 ECB Governing Council (GC) meeting, it can be surmised that this is the ECB's official view. At the press conference, President Draghi explained his basic posture by saying – "the reading of the current developments since the beginning of the year is actually very important in deciding the next steps" – and then went on to emphasize the importance of reading and understanding the developments, saying – "The very first thing we have to do is understand exactly whether [the current downturn is] temporary or permanent, whether it's more supply or more demand." He then said he could not exclude the possibility that it was "the beginning of a more significant decline."

EUR Appreciation Irrelevant?

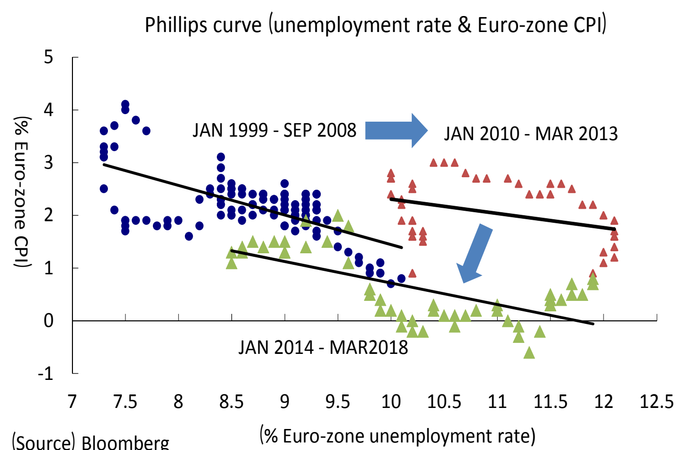


Under such circumstances, the ECB is reaching a juncture at which sober and scrupulous economic analysis is a crucial prerequisite to moving forward with a normalization process. As the ECB Governing Council pointed out, it is possible that the deceleration will prove to be a transient phenomenon. Certainly, the declines of various statistics seen early this year are unnaturally large, and one does indeed get the impression that they reflect an external shock. However, one important point that must be considered in this connection is whether the considerable amount of EUR appreciation seen in the past year can be considered irrelevant or not. From a glance at the graph, which shows trends in Germany's exports, production, and manufacturing orders, it is clear that all those indicators

have greatly slumped since the start of 2018. Even if temporary factors have also contributed to such trends, it is questionable whether it can be said that trends in EUR – which for the full year of 2017 appreciated by about 15% against USD nominally, and by about + 6% on a real effective exchange rate basis – did not affect the export related figures. Incidentally, Chief Economist Praet's abovementioned speech included the statement that – "[...] signs that the past euro appreciation is dampening export growth remain limited. Extra-euro area export growth slowed down in the first two months of the year, albeit from very high levels." – and this can be interpreted as meaning that he does recognize that there has been some impact but does not consider that impact to be severe.

However, so long as the normalization process proceeds, the trend of EUR appreciation can be expected to continue. Although there can be said to remain room for discussions about the 'termination method' of the asset purchase programme (APP), the termination itself is the default route and does not seem likely to exert a shock on the forex market. The problem is the prospect of interest rate hikes, and if substantive discussions about such hikes begin, it is conceivable that EUR may surge again as it did in 2017. The EUR appreciation lull seen since early this year and the recent EUR weakening trend reflect the current weakening of economic indicators against the backdrop of a lack of signs that an interest rate hike is on the horizon. Given the basic attitude of the ECB, which considers EUR appreciation to be a "a source of uncertainty," it appears that the most that can be expected from the ECB's normalization process is the ending of APP within this year, and I do not think it useful at this point to speculate about future interest rate hikes.

Euro Area Phillips Curve Remains Depressed



(Source) Bloomberg

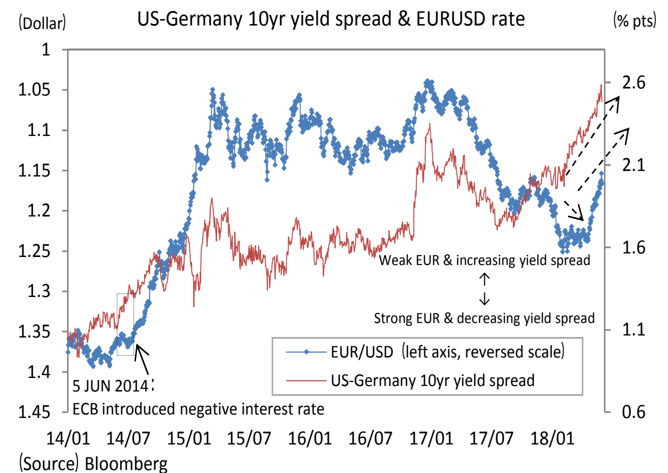
When considering the outlook for the euro area's monetary policy normalization process, it is naturally important to consider the inflation situation. Unlike U.S. inflation rates, which are clearly beginning to rise, the euro area Harmonized Index of Consumer Prices (HICP) is continuing to be weak both on a comprehensive and a core basis. Looking back at the past half year, HICP has been roughly flat – at about +1.4% on a comprehensive basis and about +1.0% on a core basis – and if one considers inflation alone, the current situation cannot be considered ripe for boldly launching a normalization process. Of course, the unemployment rate has fallen sharply in response to the real economy's strength, but the inflation rate has not reacted to this. As the graph shows, the euro area's Phillips curve shifted to the right after the European debt crisis and then shifted downward, and it appears that a structural change has been progressing over the past 20 years. Although the euro area's Phillips curve is not flattening like that of Japan, the sensitivity to the labor market has become weaker than in the past, and it seems to be a fact that the absolute level of prices is also being depressed. Given that the ECB has shown a particularly dogged fixation on the 2% inflation target compared with the Fed and the BOJ, it is questionable whether it could implement a normalization process despite the current inflation situation. As numerous economic indicators are already deteriorating, the outlook for an ECB interest rate hike in 2019 is receding, and this is promoting EUR weakening.

In light of the ECB's hesitancy to promote EUR appreciation at a time when the real economy is seen to be weakening along with the ECB's fear that EUR appreciation alone will depress already feeble inflation rates, even if the ECB manages to terminate APP, I do not anticipate that that the ECB is capable of going beyond "considering discussions" of an interest rate hike.

EUR Now and Going Forward – EUR Continuing to Face Weakening Factors

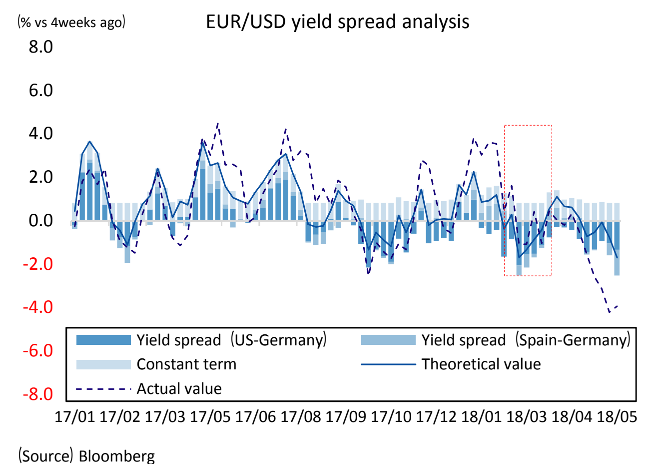
EUR Faces Particularly Powerful Weakening Factors

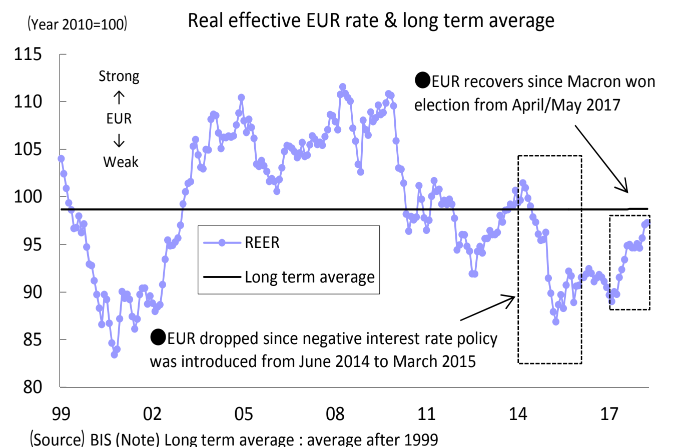
EUR continued showing a trend of depreciation during May, reflecting a weakening of basic economic indicators along with turmoil stemming from Italy's political situation. As of April, the speculative EUR long position had grown to an unprecedented size, and there is no doubt that an environment facilitating EUR selling is exerting an influence. Also, as has been discussed several times in previous editions of this article, one gets the impression that the EUR had been overbought in light of trends in the Europe-U.S. interest rate gap and EUR/USD. The graph shows the relationship between the U.S.-Germany 10-year interest rate differential and EUR/USD, to which the ECB has occasionally made reference, and it is noteworthy that the two have diverged considerably since the middle of last year (indicated by dotted arrows). The EUR/USD decline seen since about a month ago can be considered a movement correcting that divergence, and the logic of this is easy to accept. There is no doubt that the remarkable rise in U.S. interest rates is promoting this trend and, given the across-the-board deterioration of the euro area's basic economic indicators seen since the start of the year along with the abovementioned political turmoil and bias of speculators' positions, it seems reasonable to conclude that EUR faced a particularly powerful combination of weakening factors in May.



Forex Theme of EU Political Stability

The weakening of EUR is reflected in capital flows. The graph shows movements in the euro area's inward and outward securities investments along with EUR/USD, and basically, capital outflows from the area have prevailed since negative interest rates were introduced in 2014. Last year, when EUR/USD surged about 15%, inward securities investment was indeed stronger than in the previous year and the year before that, but outward securities investment remained predominant, causing a net capital outflow. It is hard to imagine that this capital flow situation will greatly change while the above-mentioned expansion of the U.S.-Germany interest rate differential continues. The investment appeal of EUR-denominated assets is clearly inferior. By the way, the rise in the euro area's inward securities investment in the first half of last year was attributable, not only to expectations of ECB normalization moves, but also largely to the elimination of 'Le Pen risk' following the French presidential election in April. (At the time, many people considered 'Le Pen risk' to be a potential third 'unlikely surprise risk,' following the election victories of Brexit and Trump.) Indeed, as the graph shows, the EUR forex trend began reversing from last April, prior to ECB President Draghi's Sintra speech (last June). Given that such expectations of 'EU political stability' were the factor spurring the return of funds back to the euro area, it can be anticipated that the domestic struggles of French President Macron and German Chancellor Merkel along with Italy's political vacuum will prompt an inward securities investment ebb tide. Given the continued existence of U.S.-German interest rate differential growth and EU political instability along with unresolved EUR long positions, it would appear that a clear-cut rise in EUR/USD will continue to be difficult for the time being.





ECB Monetary Policy Akin to Currency Policy

If there is to be a reversal of the EUR forex trend going forward, the ECB's "next move" is certainly likely to be an important factor, but it is important to keep in mind that there are grounds for believing that the ECB and some euro area countries simply do not want EUR appreciation. While the default route is to terminate the APP this year, the market's attention has shifted ahead to the timing of prospective interest rate hikes, and mere hints that such hikes are under consideration have the potential to once again intensify EUR appreciation. There is no doubt that the very large margin of the ECB's negative interest rate (-0.40%) is a background factor restraining investment in the euro area. It is said that not only investors but also managers of national foreign exchange reserves are obliged to take special measures to avoid the adverse effects of the negative interest rates. A termination of the negative interest rate during 2019 would fundamentally improve the investment appeal of EUR-denominated assets, which has been undermined for the past five years, and when the feasibility of such a future termination is recognized, the impact can be expected to be incomparably greater than that of the Sintra speech. But will it be possible for the ECB to implement such a future initiative when it remains unable to boost HICP to the 2% yoy level? I do not think so. If it is judged that the deceleration of various economic indicators seen early this year is not merely attributable to temporary factors but also stems from EUR appreciation, it may be deemed necessary to halt the entire normalization process. EUR appreciation is highly inconvenient for the ECB, and it can be surmised that the ECB's real hope may well be that an expansion of the U.S.-Germany interest rate differential large enough to keep EUR appreciation reined in will create an environment conducive to calmly proceeding with the normalization process (≈interest rate hikes).

Thinking along these lines, it seems apparent that it is at precisely this time – when it has been confirmed that the FRB's normalization process and U.S. interest rate hikes are smoothly advancing – that it should be feasible for the ECB to consider interest rate hikes. This kind of forex-oriented monetary policy management approach aimed at avoiding EUR appreciation is more characteristic of a currency policy than a monetary policy, but it happens to be the route that the BOJ previously has followed and, as it would not be surprising to see the euro area – the region that currently has the world's largest current account surplus – also follow that path.

Italian Policies Now and Going Forward – Potential for a Major ECB Miscalculation

Election Rerun? – Bad Aftertaste from Nomination Refusal

EUR continued to weaken during May as the turbulence of Italy's political situation intensified. The far-left Five Star Movement (Movimento 5 Stelle, M5S) and far-right Northern League (Lega Nord, the League) were forced to try to form a coalition government and were unsuccessful for a prolonged period, during which the likelihood of an election re-run seemed quite high. As described below, this situation is extremely annoying for the ECB and seems likely to lead the ECB to make a major miscalculation.

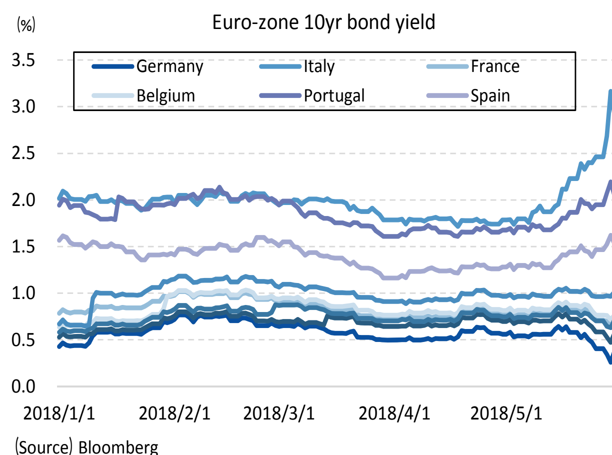
Overviewing the situation, Luigi Di Maio (the leader of M5S, which won the largest share of votes) and Matteo Salvini (leader of the League) reached agreement that neither would become prime minister. On May 21, the two parties agreed to nominate a law professor, Giuseppe Conte, for the position of prime minister, and the nomination was accepted by President Sergio Mattarella. (The Italian president has the power to approve or reject cabinet nominees.) However, President Mattarella rejected the nomination of Paolo Savona, an economist and corporate executive, for the position of finance minister and, because the coalition parties had not agreed on an alternate nominee, the new government could not be formed. President Mattarella cited the "national interest" as the reason for refusing to approve Mr. Savona's nomination, and it was apparent that the key factor behind the refusal was Mr. Savona's advocacy of Italy's withdrawal from the euro area. In view of the failure to form a cabinet, President Mattarella asked Carlo Cottarelli, formerly director of the IMF's Fiscal Affairs Department, to serve as an interim prime minister and form his own cabinet. Mr. Cottarelli is considered supportive of the EU and, as his background suggests, is a person who clearly supports austerity policies, which are diametrically opposed to the policies supported by the two coalition parties. Since it would be virtually impossible for Mr. Cottarelli to win confidence votes in both chambers of parliament, where two coalition parties have a majority, and then undertake such business as budget deliberations, his government would be positioned as an interim technocratic government to serve only until fresh elections can be held. In view of the circumstances, Italian newspapers have been reporting that the fresh elections might be held on September 9. (At the time this article was written, this timing had not yet been confirmed, but I will continue this discussion based on the assumption that the re-election will be scheduled for September 9.)

However, when a president apparently declines to cooperate in forming a cabinet owing to his disapproval of the policy proposals of a candidate minister nominated by the duly elected politicians, there remains a bad aftertaste. Even if there may be concerns about the establishment of an anti-EU/anti-EUR coalition government likely to adopt

economic and diplomatic policies in conflict with the EC's basic policies, it would seem wiser to allow that government to undertake negotiations with the EC and seek adjustments that eventually enable the reconciliation of the two sides' policies. Both parties are seeking to have the president impeached, saying his refusal to approve a nomination is not in accordance with Italy's constitution.

Emphasis on Nominal Democracy or on Actual Market Stability?

Of course, since the financial markets are unlikely to welcome a scenario in which a populist coalition government proposing both left- and right-wing policies, featuring a EUR-skeptic finance minister, and inevitably heading for a wide range of confrontations with the EC, President Mattarella's decision can also be considered an appropriate means of preventing market turbulence. The Italian 10-year bond yield rose about 90 bps in May (see graph), and one could probably make a reasonable argument that allowing the cabinet formation without due consideration of the financial markets' 'voice' might present the new government with obstacles that could possibly prevent its effective governance. However, it is precisely because of the 'voice' of the markets that the coalition government would have had to find its own way to reach compromises with the EC, as proved possible even in the case of Greece. Objectively assessing the recent developments, one gets the impression that the EU may have used the president as a sort of pawn to intervene in Italy's domestic politics in a manner that could lead to serious problems in the future. In short, it can be said that the situation raised the question of whether to place emphasis on nominal democracy or actual market stability, but my view is that even if the question were left up to the coalition government, it is highly probable that the government would eventually have obtained the actual market stability.



(Source) Bloomberg

Potential for a Major ECB Miscalculation

However, the most important thing is that there is little chance the Italian parliament's power structure would become pro-EU even if there were to be a fresh election. Almost all observers agree that it is unrealistic to expect fresh elections would result in anything other than a renewed M5S-League coalition, so it is highly likely that the situation would end up right where it started out. If the interim situation were simply to be prolonged until a similarly disruptive election on September 9, one can anticipate that it would at that time become quite apparent that it would have been wiser to immediately accept the coalition so as to begin seeking compromises with the EC as expeditiously as possible. Since the president is undoubtedly aware of current public opinion poll trends, it is likely that he himself may harbor some doubts about the sagacity of refusing the cabinet nomination (and paving the way to fresh elections). Recent public opinion polls indicate that support for the far-right League has been rising since the March elections, so there are grounds for concern that a coalition government formed after fresh elections in September would be characterized by a still-higher level of anti-EU positions.

In connection with the projection of EUR forex trends, it should be kept in mind that the recent turbulence in Italy could potentially cause the ECB to make a major miscalculation. As is well known, the ECB Governing Council (GC) is currently focusing on the key issue of "when and how to terminate the APP". In light of the deterioration of fundamental economic indicators from the beginning of the year, the ECB's plan appears to be to keep monitoring the situation until the July 26 GC meeting, at which time it will decide whether to terminate the APP at the end of September or the end of December, then the September GC meeting will simply have the task of confirming the schedule proposed at the July meeting. In any case, the plan's objectives appear to be to prepare to terminate the APP within this year and to announce the termination decision in September, at which point the focus can be shifted to issues related to potential interest rate hikes.

However, the September GC meeting is scheduled to be held on the 13th. Is it feasible to have fresh Italian elections on September 9 and then have the GC announce the termination of the APP just four days later? Currently, nearly 19% of the ECB's monthly purchases of government bonds are Italian government bonds, and ECB holdings of Italian government bonds are roughly 1% above Italy's capital investment ratio on the basis of the ECB's capital key. It is unlikely that the ECB can dispose of those holdings without difficulty at a time when Italian government bond prices are depressed by selling spurred by political turmoil. It is natural to anticipate that a September GC announcement of APP termination would become difficult if fresh Italian elections were to be held on September 9, therefore, it cannot be considered impossible that the July 26 GC might decide to delay the APP termination announcement to December at the earliest or even to next March. In such a case, the timing of the prospective

interest rate hike, which had been expected to be implemented by next June at the earliest, will also be shifted backwards until September at the earliest, and it will become questionable whether a rate hike can be realized at all during 2019. Given that the surge of EUR buying since last year has been predicated on expectations of a start to interest rate hikes in 2019 and of the possibility of restoring positive interest rates in 2020, there is a possibility that such a schedule delay might promote greater EUR selling.

In addition, Spain's Prime Minister Mariano Rajoy has become embroiled in a corruption scandal and is facing increasingly intense pressure to resign. It is still unclear whether this situation will lead to fresh elections or a change of government, but in the potential worst-case scenario, general elections might be held this autumn in both Italy and Spain. While the ECB's normalization process has been benefitting from the tail wind of the euro area's longest ever economic expansion period, it is hard to avoid concern about the process's future path amid what seem to be storm clouds gathering ahead.

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