Mizuho Bank

One MIZUHO

Forex Medium-Term Outlook

30 November 2018

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

USD/JPY couldn't find a clear sense of direction in November either. The pattern of stock prices undergoing correction in response to an increase in U.S. interest rates also continued from October. Apart from that, significant ripple effects were seen on other asset markets including on high-yield bonds and crude oil prices, but things did not go quite so far as to trigger an increase in risk-off JPY buying. Ultimately, despite the various concerns, the fact remains that U.S. interest rates are high, and there exist investors seeking out USD-denominated assets. Having said that, it is also a fact that Fed Chair Jerome Powell, who has been advancing the "rate hikes beyond the neutral interest rate" scenario, seems not as aggressive about it as he previously was. Going by experience, however, the domination of such a cautious view within FOMC ranks may be a momentary thing. This year, my predicted scenario did not come to pass thanks to the U.S. economy, especially the employment market, being more tenacious than I had assumed, but I do believe that domestic and international economic conditions will gradually make it more difficult to justify Fed rate hikes, causing the FOMC to revise its stance in a more neutral direction, and weakening both U.S. interest rates and USD in 2019. In 2018, the markets began to use a rise in U.S. interest rates as a reason to sell stocks, and this pattern is likely to become more popular and more deeply established in 2019. Under such circumstances, it does seem rather likely that JPY will increasingly appreciate against USD and USD/JPY will be corrected down to the JPY100 level. It is important to bear in mind that the global economy may have peaked.

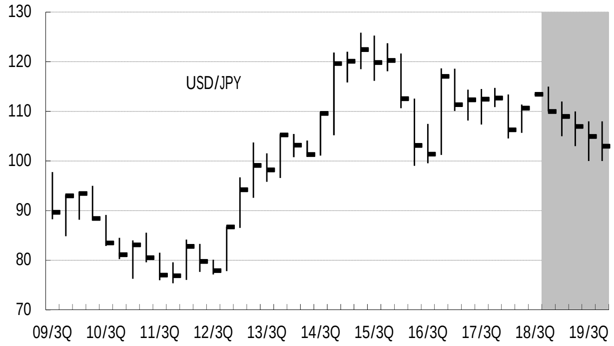
EUR remained in a deadlock in November. There is no sight of a compromise between the Italian government and the European Commission (EC), and although the EC moved to recommend an excessive deficit procedure (EDP) in November, there is no telling until Spring next year whether this will ultimately result in sanctions, which is what the markets are mainly concerned about. In Germany, the Christian Democratic Union (CDU) party will hold an election for the post of party chair in December. This is a key event in terms of gauging the survivability of the Angela Merkel administration going forward. In addition to the above, it is also important to pay attention to developments related to Brexit. All in all, it appears that EUR may continue to be weighed down by political factors. Meanwhile, even though the ECB seems set to maintain its hawkish stance for some time to come, the real economy is slowly but surely deteriorating. Even taking into account that the Fed is beginning to relax its hawkish approach to policy operations, it seems ambitious for the ECB to expect to begin rate hikes as early as September 2019. Having said all this, despite EUR not appearing to have any political or economic factors working in its favor, this report predicts that it will maintain its strength during the period under review thanks to the fact that its rival, USD, is expected to fall from an even higher place.

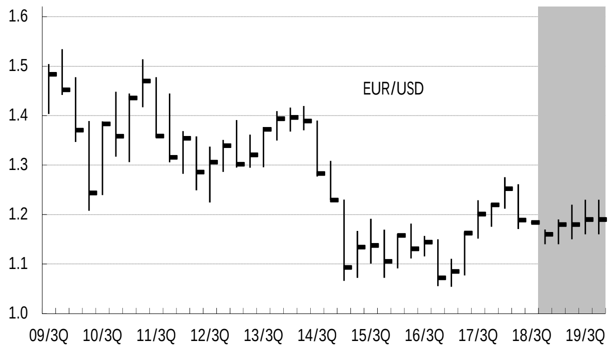
Summary Table of Forecasts

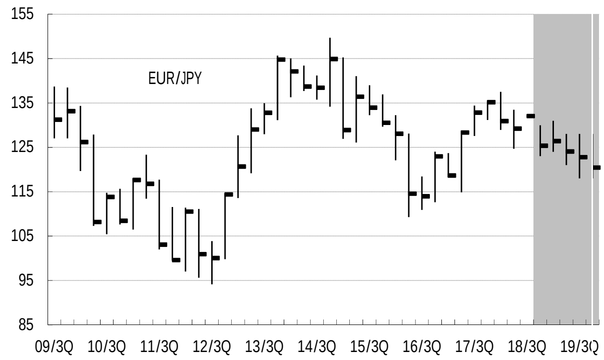
	2018 Jan-Nov (actual)	Dec	2019 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	104.64 ～ 114.55 (113.42)	110 ～ 115 (110)	105 ～ 112 (109)	103 ～ 110 (107)	100 ～ 108 (105)	100 ～ 108 (103)
EUR/USD	1.1216 ～ 1.2556 (1.1391)	1.12 ～ 1.15 (1.14)	1.12 ～ 1.17 (1.16)	1.13 ～ 1.20 (1.16)	1.14 ～ 1.21 (1.17)	1.14 ～ 1.21 (1.17)
EUR/JPY	124.62 ～ 137.51 (129.19)	123 ～ 130 (125)	124 ～ 131 (126)	121 ～ 128 (124)	118 ～ 128 (123)	118 ～ 128 (121)

(Notes) 1. Actual results released around 10am TKY time on 30 Nov 2018. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





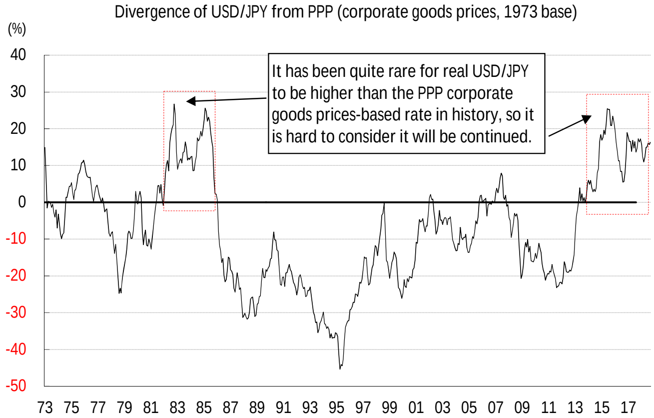


USD/JPY Outlook – Recognizing the Excessive Weakness of JPY

USD/JPY – How to Interpret the Current Level? – Intuitively, JPY is Too Weak

The Longest Ever Phase of JPY Weakness in Terms of CGPI-based PPP

Divergence of USD/JPY from PPP (corporate goods prices, 1973 base)



(Source) Datastream

USD/JPY couldn't find a clear sense of direction in November either. As of the time of writing this report, the year-to-date range is JPY9.99 (a high of 114.55 - a low of 104.56), the lowest range ever recorded. As I have mentioned several times in past issues of this report, historically, USD/JPY has tended to remain below the (1973) corporate goods price index (CGPI)-based purchasing power parity (PPP), and even when it surpasses it, does not go over 20% higher (see exhibit). For a period or three and a half or so years from March 1982 to September 1985, USD/JPY remained more than 10% stronger than the CGPI-based PPP, but this was a phase of extraordinary USD strength which ultimately resulted in the Plaza Accord. The only other phase of USD/JPY remaining over 10% higher than the PPP is the current phase, which began with Abenomics in November 2014 and has lasted four years to the present (although the five-month period following the Brexit referendum, from June to October 2016, was an exception, which makes the current phase only about 3.5 years long too). <u>In other words, the current phase has become the longest ever weak-JPY phase in history if JPY weakness is measured in terms of the CGPI-based PPP</u>.

Some may interpret such developments as a structural change. Japan is currently experiencing an unprecedented labor shortage, which makes it inevitable that wages, and eventually prices in general, will increase going forward. Therefore, some believe that the PPP itself will eventually be revised in the direction of a weaker JPY or stronger USD. In other words, their thinking is that the real USD/JPY rates are simply anticipating this future weakening of JPY against USD, and that eventually the gap between USD/JPY and the PPP will be closed by a revision of the PPP (to reflect a weaker JPY). Such a view seems logical at a glance, but in fact, there are insufficient grounds for such a bold theory because the consumer price index (CPI) and domestic corporate goods price indices (CGPI as well as the producer price index, PPI) have not changed much since five years ago, when the "new dimension of monetary easing" was introduced. Rather, my position is that one should be concerned about how excessively weak JPY has recently been. Incidentally, as of September 2018, the CGPI-based PPP was around JPY96. If USD/JPY were to settle at within 10% of this level, that brings a rate of 105 into sight. Even if the rate falls to that level, it would not be considered such an unreasonable level of JPY weakness against USD in historical terms.

Historical Weakness of JPY Against USD Continues

The table on the next page lists the various USD/JPY milestones that I use as a reference from time to time. As I have explained many times, several types of PPP exist, but there is a strong impression that the PPP of JPY as calculated by international organizations and quoted relatively often tends to be in the 95-110 range (at the current time, it is also possible to see this range as being in the 95-105 range). I call this range the "PPP core zone," and have formulated my forex outlooks based on the rough impression that JPY is excessively weak when USD/JPY surpasses the zone, and excessively strong when USD/JPY falls below the zone. The current rate level, in the 113-114 range, is difficult to find parallels for in terms of any kind of PPP, and intuitively, it seems to be an excessively weak rate for JPY. As it is only for the briefest of moments that the actual forex rate coincides with the PPP, it becomes necessary when investing in currencies, to understand excessive weakness or strength of a currency from a relatively longer perspective and using a broader range. In such a context, when it comes to predicting the exchange rate direction a year from now it does not seem irrelevant to evaluate the current exchange rate as reflecting an excessive weakness of JPY based on the fact that (1) the current phase of "USD/JPY being over 10% higher than the CGPI-based PPP" has surpassed in length the previous such phase, which culminated in the signing of the Plaza Accord, and (2) USD/JPY has clearly deviated from the PPP core zone. The PPP is by no means a precise indicator, but there are phases when it can predict excessive currency weakness/strength. In my opinion, now is one such phase.

Reference points of USD/JPY rate

	JPY rate	Evaluation Standard
	57.2	Purchasing Power Parity（export prices,1973 base, Sep2018）
	72.0	Big Mac Parity(Economist magazine, Nov 2018)
	73.7	Purchasing Power Parity（export prices,1980 base, Sep 2018）
	76.7	Purchasing Power Parity（Mid point between export prices and corporate goods prices,1973 base, Sep 2018） Note 1
	90.3	*Purchasing Power Parity（corporate goods prices,1980 base, Sep 2018）*
Core PPP zone	96.3	*Purchasing Power Parity （corporate goods prices,1973 base, Sep 2018）*
	96.7	Purchasing Power Parity of materials within manufactured products,etc.（METI,FY2016 survey）
	99.6	*Purchasing Power Parity （OECD, 2017, GDP base) Note 2*
	99.6	*Purchasing Power Parity （World Bank, 2017)*
	100.6	Break-even rate for exporters as of Mar 2018 (Cabinet survey, FY2017)
	100.9	*Purchasing Power Parity（consumer price,1980 base, Sep 2018）*
	106.2	*Purchasing Power Parity （OECD, 2017, private consumption）*
	107.4	Corporate planning rate (BOJ Tankan, Sep 2018 survey, fiscal year)
	113.5	***29NOV2018***
	114.3	Next year ahead forecast rate as of Mar 2018 (Cabinet survey, FY2017)
	123.7	Purchasing Power Parity（consumer price,1973 base, Sep 2018）
	132.7	Purchasing Power Parity of processing/assembly within manufactured products,etc（METI FY2016 survey）
	159.0	Overall Purchasing Power Parity of manufactured products,etc.(METI,FY2016 survey)
	260.9	Purchasing Power Parity of energy within manufactured products,etc.(METI,FY2016 survey)

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

Part II of The Reason Why the "Buying of JPY as a Safe Asset" Lacks Vigor – Granted that High U.S. Interest Rates are a Reason

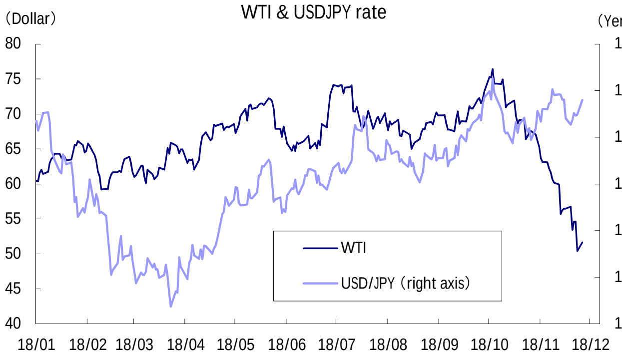
USD/JPY Withstanding Risk-Off Mood

In the previous month's issue of this report, I explained rather simplistically that the "buying of JPY as a safe asset" is not gathering steam because the markets are not yet in "risk off" mode. However, looking at the markets in November, it becomes rather difficult to insist that this is still the case. I would, therefore, like to reconsider the matter. To begin with, the phrase "risk off" is mainly heard around the time when stock prices fall, but in fact, the falling of stock prices is not an isolated event; it usually induces corrections in other asset prices as well, causing crude oil, copper, and other commodity prices to fall, high-yield bond interest rates to rise, and so on. As part of such position adjustments, JPY short positions tend to be liquidated, and this process is what is often labeled the "buying of JPY (as a safe asset) during a risk-off phase." In this context, if we review the markets since October, it becomes clear that USD/JPY has held strong amid significant corrections in the prices of other assets, such as crude oil and high-yield bonds. For instance, crude oil prices have fallen by about 30%, the NY Dow Jones Industrial Average has fallen by about 5%, and U.S. 10-year interest rates have fallen by about 20bps compared with their respective highs in October, but as of the time of writing this report, USD/JPY (which is in the vicinity of 113.30) has undergone almost no change compared with the 114.55 high it hit on October 4 (see figure). Given such significant corrections in crude oil and stock prices, it seems like an insubstantial explanation to say that the buying of JPY has not yet gathered momentum because the markets are not yet in risk-off mode. Incidentally, during the above period, the Nikkei Stock Price Average also fell by around 8%, maintaining the wide gap between stock prices and exchange rates, which has been the focus of attention since last year.

Financial markets after October

	High in Oct	Closing as of 29 Nov	Change ratio
NY dow	26,828.39	25,366.43	-5.4
UST 10yr	3.23	3.02	-21.4
Nikkei index	24,270.62	22,262.60	-8.3
JGB 10yr	0.16	0.08	-7.9
WTI	76.41	50.52	-33.9
USD/JPY	114.53	113.28	-1.1

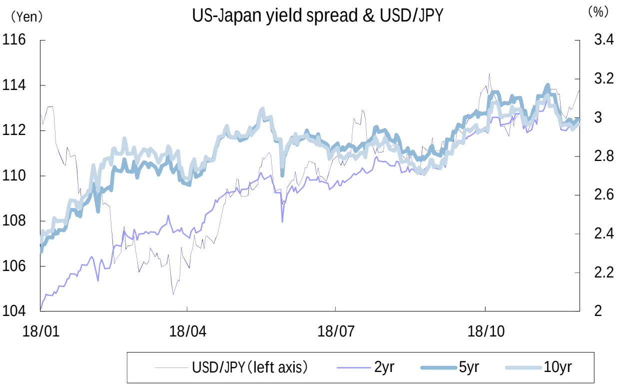
(Source) Bloomberg (Note 1) In change ratio: Interest rates: spread (bps) & others: %
(Note 2) WTI crude futures: NYMEX(Generic 1st future)



(Source) Bloomberg (Note) WTI crude futures: NYMEX (Generic 1st future)

Could the Fundamental Reason be that U.S. Interest Rates are High?

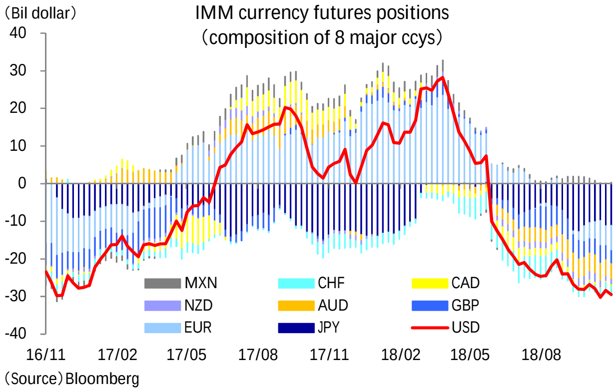
There is probably no single reason why USD/JPY has rebounded, but the fundamental factor may be high U.S. interest rates. Although U.S. 10-year interest rates have receded slightly from their peak in recent weeks, the fact remains that at their peak, they were up as much as 80bps (2.40% → 3.20%) year-to-date, and as of the current time, they are still up about 60bps (2.40% → 3.00%) year-to-date. During the same time, the Japanese 10-year interest rates have risen by 11bps year-to-date at their highest (0.05% → 0.16%) and by only 3bps year-to-date as of the current time. Given how wide the domestic to foreign interest rate gap is tending to be, it comes as no surprise that many investors consider it difficult to continue selling USD in exchange for JPY. In fact, foreign securities investment by Japanese investors continues to post a net acquisition. <u>However, it is also a fact that USD/JPY has not changed all that much since early this year despite the U.S.-Japan interest rate gap expanding to this extent</u>. From what the graph shows, the U.S.-Japan interest rate gap could have been part of the reason why USD/JPY did not break through the previous low early this spring. At the same time, neither has the currency pair surpassed the 115 rate despite a further expansion in the interest-rate gap. <u>USD/JPY not following suit as stock and crude oil prices fall may be contrary to what one might expect from experience, but so is USD/JPY not accelerating to keep up with the remarkable expansion in the U.S.-Japan interest rate gap. Nobody seems to be paying much attention as the rates have been more-or-less stable around the JPY110 level, but it is quite an unnatural situation all the same</u>.



(Source) Bloomberg

One way to explain the situation could be that conflicting pressures on JPY – upward pressure from negative factors such as asset price corrections, trade wars, Brexit, and the political instability in Italy vs. downward pressure from the significant expansion of the U.S.-Japan interest rate gap – are cancelling each other out, keeping USD/JPY stuck at its current level.

No JPY Buying Because Fed Refuses to Acknowledge Risk-Off Situation?



The absolute value of U.S. interest rates is high is a fact. My clients have occasionally told me, based on their understanding of the Fed's operations, that, while they appreciate the logic behind JPY eventually appreciating against USD, it is still rather difficult to sell a currency for which rate hikes have been announced. High U.S. interest rates appear to be canceling out the effect of numerous negative factors, with the result that investors are willing to make some sacrifices for the greater benefit derived from them. Taking into account this situation and reassessing why investors are not buying JPY as a safe asset, perhaps one reason is because the Fed does not acknowledge a "risk off" situation. To be more specific, so long as the Fed explains the fall in stock and crude oil prices as an "appropriate correction," neither rate hikes nor efforts to shrink the balance sheet will be suspended, and both U.S. interest rates and USD will remain strong. It all, therefore, boils down to when and in what form the Fed will change its understanding of the situation and adopt a more dovish stance, and that will be when the current monetary tightening path, which has continued unabated since the "Bernanke Shock" in May 2013, will change. As of the current time, amid strong job data and wages, the Fed is turning a blind eye to asset price fluctuations and turmoil in overseas markets. However, it is because the markets have bought into this scenario of the Fed continuing with its rate hikes that domestic wages and inflation have failed to accelerate, and overseas economic conditions also remain unstable, with USD strength being a by-product of this. Meanwhile, the Fed is happy to go on with its rate hikes because it sees that the markets have already factored them in. It is like a dog chasing its own tail, to borrow the expression of former Vice Chair of the Federal Reserve System Alan Blinder, and one must keep in mind that the current increase in U.S. interest rates and USD are not in response to real economic performance.

Having said that, USD cannot go on appreciating forever with no cost. Stock prices underwent major corrections in February and October this year, when the U.S. 10-year interest rate hit major milestones of 3% and 3.2%, respectively. One of the biggest changes in 2018 has been the using of an increase in U.S. interest rates as a reason for selling off stocks, so stock prices may act as a deterrent to future increases in interest rates. The forex markets have also responded to the rise in interest rates by selling USD. However, going by IMM currency futures transactions, there has clearly been an excessive speculative buying of USD, to the extent that it would not be surprising to see some selling off of the currency to correct the bias (see graph; figures are as of November 20). As in the case of the previously discussed U.S.-Japan interest rate gap, the fact that USD/JPY has failed to reach 115 despite such a large JPY short position may be cause for concern.

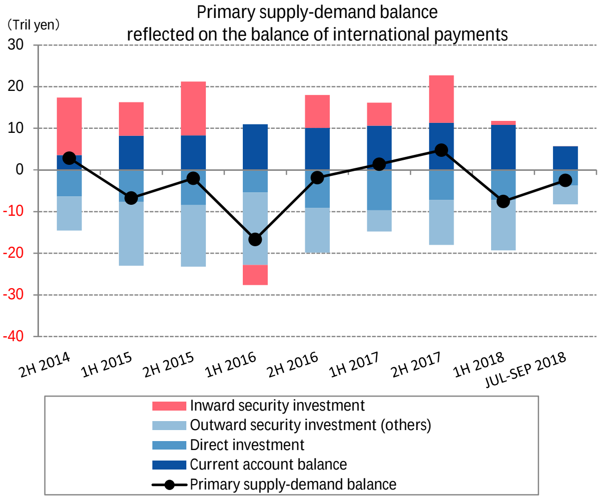
FOMC Statement may Change Only in the New Year

Unlike a policy interest rate (neutral interest rate or equilibrium real interest rate) dictated by the real economy (specifically housing investment, fixed investment, etc.), it is much more difficult to predict a policy interest rate that is dictated by stock prices (which essentially amounts to a neutral interest rate as seen from the perspective of stock prices). This is because, while fixed investment and the associated bank lending show signs of a slowdown as interest rates rise, stock and other asset prices can undergo correction without warning. To me, signs of such corrections were obvious in February and October-November this year, but one wonders when the FOMC will acknowledge them. Will it wait until they end up hurting the real economy through a reverse wealth effect? Or will it adopt a more dovish stance taking into account the recent turbulence in asset prices and emerging markets? My basic understanding is that signs of JPY buying during a risk-off phase will only emerge after the Fed becomes aware of the risks and acknowledges them. It may, however, take at least until the beginning of next year for such an awareness to be reflected in the FOMC statement.

JPY Supply and Demand – Net Selling of JPY Continues

As Before, More People Want to Sell JPY

Japan's September Balance of Payments was released on November 8. With this, the JPY supply-demand balance (see graph on the next page), which I use as a guide when formulating my outlook for this report, has become available for up to the July-September quarter, and I would like to take stock of the situation. The JPY supply-demand balance for the July-September quarter, as provisionally calculated using the Balance of Payments, amounts to a net selling of JPY to the tune of JPY 2.5213 trillion. Meanwhile, a net selling to the tune of JPY 10 trillion has been posted for the January-September 2018 period. Although foreign securities investment by Japanese investors continues to stably post a net acquisition, it appears to have lost some momentum starting 2H. Looking at Portfolio Investment Assets in the International Transactions in Securities (based on reports from designated major investors) for October (when the U.S. 10-year interest rate began to intermittently top 3.2%), while a net acquisition has been maintained, its level is so low as to be almost neutral. One would do well to watch out for a continuation of this trend. In terms of yoy performance, this year's net selling of JPY is higher than last year's by about JPY 12 trillion. The main contributing factors are (1) a decline in domestic securities investment and (2) an increase in foreign securities investment, in that order. The reason direct investment has contributed in the direction of JPY buying is because of the combined effect of a decline in foreign direct investment and an increase in domestic securities investment. The magnitude of JPY selling seems to have decreased compared with 1H, but there is no change in the fundamental fact that more people want to sell JPY than buy JPY. This JPY supply-demand situation is quite consistent with the stability of USD/JPY since the start of the year.



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

Foreign Securities Investment may be Impacted by Increasing Speculation About BOJ Policy Normalization

It is evident that the outlook for the JPY supply-demand balance will continue to depend to a large extent on the trend of foreign securities investment, but looking at the BOJ's prospective policies through next year, an acceleration in Japanese investors' appetite for overseas risk-taking seems unlikely. As is widely known, communications from the BOJ have recently taken an unexpected turn, hinting at the possibility of policy normalization, and there are also signs of a slight improvement in the miserable JPY interest rate and investment climate. Under such circumstances, there could easily be a shift in stance favoring domestic over foreign investments.

Starting with the October 2018 issue of the Financial System Report, published on October 22, there have been several cases of pointing out the ill effects of the BOJ's current policies. The Outlook for Economic Activity and Prices (Outlook Report), which was published following the October Monetary Policy Meeting on October 31, clearly stated that "prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system," while the Summary of Opinions at the Monetary Policy Meeting, which was published on November 8, went further to make a concrete policy proposal, "Attention should be paid to whether the positive effects on inflation expectations will diminish instead if the target level of the long-term yields is maintained at around zero percent for a long time. It is important to consider in a flexible manner such factors as the range of yield movement and the target maturity of JGBs in conducting yield curve control, while maintaining the framework of monetary easing." Incidentally, in a November 5 speech in Nagoya, BOJ Governor Haruhiko Kuroda said, "Japan's economic activity and prices are no longer in a situation where decisively implementing a large-scale policy to overcome deflation was judged as the most appropriate policy conduct, as was the case before," going so far as to acknowledge that the "next move" may not be a monetary easing. Sadly, the BOJ's actions in the coming months will be determined not by the BOJ itself but largely by U.S. economic and inflation conditions and the accompanying policies of the Fed. However, as seen above, the risk of the BOJ's current policies hurting domestic financial institutions is slowly but surely becoming a moot point – in other words, the BOJ is beginning to acknowledge the reversal rate problem, which has been drawing attention time and again since last year. If the idea that a negative interest rate amounts to a reversal rate is, indeed, becoming commonly accepted among Policy Board members, the "next move" could be, as indicated in the Summary of Opinions above, a further expansion of the range of yield movement or a shortening of the target maturity of JGBs (say from 10-year bonds to 5-year bonds).

Meanwhile in the U.S., the current phase of economic expansion has become one of the longest ever, and Fed Chair Jerome Powell himself has suggested the possibility of the policy interest rate (the Federal Funds or FF rate) surpassing the neutral interest rate. Under such circumstances, market participants are getting ready for a scenario where the U.S. economy slows down in response to the rate hikes, causing the Fed to suspend its rate hikes. Even if market participants see the next few rate hikes as a given, many are bound to be concerned about the downside risks to USD/JPY from it. The main outlook scenario of this report also assumes that things will progress in this direction.

It seems quite likely that the JPY supply-demand balance will be tilted in favor of JPY selling for the whole of 2018, and yet, the fact remains that JPY has not weakened as much as it could have. Of course, one could also interpret the situation in another way – that the JPY supply-demand balance propped up USD/JPY and prevented JPY from appreciating too much despite a year filled with risk-off factors. However, in 2019, as a change in Fed's policy stance becomes a realistic possibility and it becomes more difficult to hope for an acceleration in foreign securities investment, the supply-demand balance could be tilted in favor of JPY buying. If that happens, USD/JPY would have less support to that extent. But will it still hold strong? I doubt it.

Risks to My Main Scenario – Outlook for Fed Policy Change in 2019

Not Much Change since October

As I do each month, I would like to review the risk factors related to my main forecast scenario. Just as in October, there were major bouts of stock price adjustments in November, but – because the financial markets' major premise that 'the Fed's normalization process will continue gradually' has not yet collapsed – there has not been much change to the risk factors listed in the table. <u>Bearish remarks made by the Fed's chairman and vice chairman (Jerome Powell and Richard Clarida) during November spurred major drops in interest rates, but – because at this point there is no clear prospect of an adjustment of the Fed's objective of raising interest rates to the neutral interest rate level (assumed to be 3%) – there is still a perceptible risk of policy overkill (risk factor ②).</u>

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US	①	Economic policy by President Trump	・Political intervention in monetary policy and sharpening of protectionism, especially complication of TAG negotiation between US & Japan	Strong JPY Weak USD
	②	Continual excessive monetary tightening by FRB	・Impact by tightening to inside & outside US, in short, fear of stock prices plunge	Strong JPY Weak USD
	③	Stronger-than-expected US economy	・Accelerate beyond the longest past record	Weak JPY Strong USD
Japan	④	FX risk-taking by Japanese investors	・From hedged to unhedged position expansion? ・Increasing cross border M&A continuously	Weak JPY Strong USD
	⑤−1	Risk of BOJ monetary policy change	・Consideration of side effects, withdraw easing monetary policy clearly e.g. stop negative interest rates	Strong JPY Weak USD
	⑤−2	Risk of BOJ monetary policy change	・Radical easing monetary policy such as purchase foreign bonds, helicopter money & etc	Weak JPY Strong USD
Europe	⑥	Political risks in EU	・Conflict intensified between Italy and European Commission ・Conflict intensified about Brexit negotiation ・Fluidization of political situation due to Chancellor Merkel's resignation	Strong JPY Weak USD

(Source) Daisuke Karakama, Mizuho Bank

Looking at factors that have changed since October, there were clear adjustments during November in crude oil prices and the high-yield bond prices, and one gets the impression that the risk-off mood has considerably strengthened, but seems that inducing a change in the Fed's policy perspective may require a bigger shock (such as signs of overkill).

Just as during last month, risks related to Europe (risk factor ⑥) have further intensified. While the U.K. government and the EU have finally drafted a withdrawal agreement proposal, the U.K. government still faces an 'internal battle' to see if Prime Minister May can persuade the Parliament to accept that agreement. The scenario in which the U.K. leaves the EU without an agreement (a 'no deal' scenario associated with 'cliff-edge risk') has become too realistic to be considered a 'tail risk,' and I have received numerous inquiries about what will happen if that 'no deal' scenario were to eventuate. As there is still considerable time remaining before the December EU Summit and the U.K. Parliament's approval deadline (January 21), it appears that a kind of 'chicken game' (designed to generate increasing pressure until one side eventually backs down for fear of the consequences) led by hardline Brexit proponents will continue for the time being. This chicken game is likely to promote USD appreciation against EUR and GBP, generating a temporary noise factor regarding this column's JPY appreciation (USD depreciation) scenario. If the cliff edge scenario does actually occur, GBP can probably be expected to depreciate to below the low levels recorded following the Brexit referendum.

In addition, the confusion regarding Italy's expansionary budget for the upcoming fiscal year is continuing. As Italy's populist government has refused demands that it revise its budget, the European Commission has finally recommended that the Council of the EU initiate an excessive budget deficit procedure (EDP)[1]. While no EU countries have ever suffered actual punishment owing to an EDP procedure, if Italy's populist government maintains its stubborn attitude, it there could be developments related to such punishment as early as next spring. Such development would probably be likely to promote EUR depreciation. In light of the fact that the European Commission's pressure tactics played a role in encouraging Italians to support their populist government, however, there is concern about how the potential for EDP punishment measures might affect the European Parliament elections to be held in late May (as well as Greek and Portuguese general elections scheduled for October). If anti-EU factions were to augment their strength following the European Parliament elections, it could possibly have the effect of intensifying turbulence associated with Italy's reaction to being subjected to the EDP process and European Commission supervision. It is worth noting that the results of the European Parliament elections will also affect the selection of the next European Commissioner in November. As this article has been expressing concern about in the past, there is also a possibility that Italy might decide to accept the EU sanctions while ignoring the EU recommendations and continuing its expansionary fiscal policies, which might significantly undermine the European Commission's authority as the EU's executive branch. If such a situation were to foster a risk-off mood in international financial markets it could conceivably promote JPY appreciation. However, the situations in October and November suggest that it is also possible that excessive EUR selling might promote USD appreciation but unexpectedly be a factor promoting JPY depreciation.

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[1] Please see the November 19, 2018 edition of Mizuho Market Topic, entitled "The Italian Situation Now and Going Forward – Potential for Sanctions."

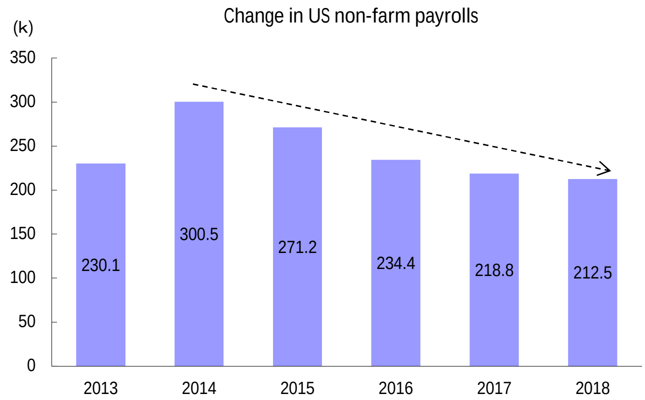
TAG Negotiations as a JPY Appreciation Risk Factor

President Trump's economic policies continue to have the potential for promoting JPY appreciation (risk factor ①). The nature of prospective discussions at the upcoming US-China summit meeting was still unclear at the time this article was written, but in light of the possibility of President Trump running for re-election in 2020, it can be assumed that his administration will not completely abandon protectionist policies. Moreover, even if some sort of accommodation were to be reached with China, it would not be cause for diminishing the pressure placed on Japan and Europe (especially Germany). While the possibility that President Trump might adjust his trade policy stance in response to stock price fluctuations cannot be completely discounted, he can probably be expected to continue expressing his strong dissatisfaction with the Fed's interest rate hikes, and he might cite those hikes as an 'excuse' in the case that he were to eventually adjust his stance. It is generally believed that President Trump has seasoned his criticism with remarks recognizing the Fed's independence as a means of emphasizing the fact that the Fed is responsible for choosing at its own discretion to implement the interest rate hikes (as well as being responsible for associated drops in stock prices). He can be probably be expected to continue criticizing the Fed, as focusing on Fed's policies will facilitate the avoidance of pressures to moderate his trade policies in light of any prospective trends of deterioration in the United States' economic and financial situations.

With respect to President Trump's currency and commerce policies, the direction of the U.S.-Japan Trade Agreement on Goods (TAG) negotiations will be a particularly important factor affecting USD/JPY. Regardless of the outlook for U.S.-China trade frictions, given the U.S. approach to negotiations with South Korea and NAFTA partners (Canada and Mexico), it can be expected that the United States will not alter its basic policy of demanding exchange rate clauses. So far as can be discerned based on leaked information, the Japanese side does not appear at all inclined to discuss exchange rate clauses, so it seems that there is a quite large gap between the U.S. and Japanese perspectives on such clauses. On November 27, news media reported that the Japanese government has begun considering the acquisition of up to 100 F35 stealth fighters from the United States (with a total import value of JPY1 trillion) and, given the timing, it seems reasonable to surmise that the information was strategically disseminated with an eye to promoting harmonious TAG negotiations. On the same day, however, the media reported that the U.S. Department of Commerce is recommending the imposition of a 25% tariff on vehicles imported from all countries except Canada and Mexico, and if the reports are true, Japan will probably have to come up with additional negotiating cards to prevent that recommendation from being implemented. In addition, in the case that there are difficulties in reaching agreement on tariff or non-tariff trade restriction measures, there remains some concern that the trump administration may eventually insist on currency exchange measures (that promote USD depreciation against JPY).

What Would Take for USD/JPY to Approach JPY120

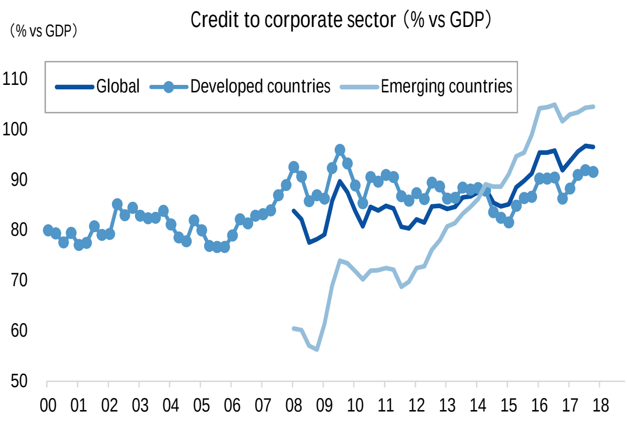
Of course, there is also a need to consider the risk factors that could promote JPY depreciation. In line with the chart of risk factors shown above, this means examining risk factor ③, just as last month's edition of this article did. Various U.S. economic statistics – including extremely strong October employment statistics and an over 3% yoy rise in average hourly wages – are providing additional evidence that justifies the Fed's strategy of monetary policy tightening. While there has been a clear trend of decrease in the marginal increase in employment volume (see graph), the employment situation is in fact quite strong, and it is likely that the marginal increase in employment volume in 2018 will exceed that seen in 2017. While this improvement may be only a temporary trend facilitated by the Trump administration expansionary fiscal policies, it still represents a forecast scenario miscalculation. Employment and wage statistics are basically lagging indicators, and one must strive to avoid overemphasizing the significance of the employment market trends but, just as last year, the biggest reason why this article's JPY appreciation scenario has not yet been realized this year is the robustness of the U.S. economy. In particular, I did not anticipate the accelerating trend of strengthening in the employment market. Since it is difficult to accurately estimate the potential growth rate and the associated neutral interest rate, it is impossible to completely preclude the possibility that such a situation will continue going forward. <u>For example, if the unemployment rate stabilizes in the 3.0-3.5% range while the average hourly wage increase continues to accelerate, the long-term interest rate may well rise into the 3.5-4.0% range. In such a case, it would not be surprising to see USD/JPY approaching the JPY120 level. At this point, this represents the most realistic risk that a JPY depreciation trend will impede the realization of this article's forecast scenario.</u>



(Source) Datastream (Note) Yearly but Year 2018 is Jan-Oct

If such a belief in the U.S. economy's sustained resilience takes shape, it will become necessary to give additional attention to such a belief's potential for promoting Japanese institutional investors' risk-taking along with JPY depreciation (risk factor ④). As previously discussed in this article, the JPY supply-demand environment continues to be characterized by net JPY selling and is therefore not supportive of JPY appreciation. It may well be this supply-demand environment that has played the key role in preventing a decrease in USD/JPY this year despite a succession of factors promoting such a decrease. Nonetheless, the fund management plans of major Japanese life insurance companies for the latter half of this year seem to indicate a decreasing desire to invest in foreign bonds, and the current situation does not appear likely to promote an acceleration of foreign securities investment going forward. While the overall outcome will still be largely determined by trends in the U.S. economy, the risk that such "JPY selling by Japanese" might spur an unexpected trend of JPY depreciation does not appear to be very large. In fact, looking at the current market environment, the height of hedging costs relative to current interest-rate differentials may encourage some Japanese institutions to be open to the possibility of undertaking open (unhedged) foreign bond investments, but it appears that most such institutions are averse to such risk taking and, as somewhat of a gradient is beginning to return to the JPY yield curve (and many forecasts anticipate a gradient restoration going forward), it seems rational to expect most Japanese investors to be increasingly focused on JPY interest rates.

Momentary Glimpse of a Cautious Perspective



(Source) BIS

I have a general expectation that the assumed scenario of 2018 will finally take place during 2019. I had expected that during 2018 the Fed's excessive policy tightening along with incipient economic and financial turbulence within and outside the United States would cause FOMC statements to become more dovish, U.S. interest rates to decline, and USD selling/JPY buying to strengthen. In fact, there was a widespread increase in emerging market turbulence and a worldwide stock price adjustment with the United States as the epicenter. The key miscalculation, however, stems from the fact that the Fed did not begin reconsidering its strategy until this November, so there has been neither a decline in U.S. interest rates nor depreciation of USD. As discussed above, risk factor ③ also turned out to be quite realistic and persistent. One should not blithely discount the possibility that risk factor ③ will continue to be realized next year. However, given that the current economic expansion period is the longest period of its type in history, and taking into account the fact that the employment and wage situation has been said to be a full employment situation for some time already, I believe that, <u>this time, expectations of a Fed shift to more-dovish policies are quite realistic</u>.

Numerous situations during November reconfirmed the very basic fact that "rising interest rates have a negative impact on stock prices". <u>The Fed's vice chairman also began expressing a cautious view on upcoming interest rate hikes in November, although his statements were not very specific. It was probably a momentary glimpse of a cautious perspective that will eventually become predominant within the FOMC.</u> Given that the turmoil in emerging country markets that began in earnest midway through the year is evidence that the world economy is not coping well with the rise in U.S. interest rates, it would not be so surprising to see the Fed's tightening policy revised in the near future. I am anticipating that 2019 will be the year in which the Fed will begin moderating the tightening stance it has maintained over the past five years.

Going forward, the Fed's cumulative rate hikes and the Trump administration's worrisome currency and commerce policies are likely to dampen the world economy's expansion while European political risk factors associated with such countries as Italy, the U.K, and Germany are likely to sporadically prompt financial market turbulence. <u>My basic understanding is that this is not an environment supportive of a worldwide uptrend in stock prices and interest rates. I strongly concur with the view, expressed by the OECD in November, that global economic growth has "passed its recent peak".</u> Given that the FF interest rate reflects the cost of capital both in United States and the rest of the world and that private-sector debt is expanding to an unprecedented level (see graph), my basic understanding is that we are experiencing a dangerous period of market environment transition. Based on recognition of this, I continue to believe that the scenario with the highest degree of likeliness during the upcoming year is that factors within and outside the United States will gradually make it increasingly difficult to justify further interest rate hikes, the FOMC will adjust its stance to become more neutral, and trends in U.S. interest rates and USD will become reversed. Consequently, I am continuing to forecast an adjustment of USD/JPY downward to around the JPY100 level.

EUR Outlook – Recognizing the Euro Area Economy’s Deceleration

ECB Monetary Policies Now and Going Forward – Potential for TLTRO3

Fundamental Scenario Unchanged, but Apparently Far from Discontinuing Reinvestments

In November, the ECB released the Account of its Governing Council meeting held on October 24-25. Market players are intent on learning about the ECB’s “next move” regarding its reinvestment policy, but to the extent discernable from the Account, the October meeting made no preparations for making a decision on this issue at the December meeting. Looking at the “Monetary policy stance and policy considerations” section, which often includes hints about future policy management decisions, one finds that the section describes the ECB’s fundamental evaluation of the situation as unchanged – “The incoming data, while somewhat weaker than expected, remained overall consistent with an ongoing broad-based expansion of the euro area economy and gradually rising inflation pressures” – and there are no indications that the ECB is inclined to intervene to counter the trend of deceleration in the real economy. In fact, the meeting participants widely agreed that a firm domestic demand scenario is exerting upward pressure on wages that will contribute to the attainment of the ECB’s inflation target. Recognizing the threats posed by “uncertainties relating to rising protectionism, vulnerabilities in emerging markets and financial market volatility”, the meeting recognized that it is necessary to maintain significant monetary policy stimulus, which from next year would continue to be provided “by the sizeable stock of acquired assets and the associated reinvestments, and by the enhanced forward guidance on the key ECB interest rates.” In short, the meeting concluded that the ECB’s existing policies are sufficiently stimulative and accommodative, and there is no need to strengthen or supplement those policies.

The Account repeatedly states that “the overall monetary policy stance remained highly expansionary and would remain so even after the net asset purchases had ended” and that after the net asset purchases had ended, stimulus would continue to be provided “by the sizeable stock of acquired assets and the associated reinvestments, and by the enhanced forward guidance on the key ECB interest rates.” The Account also notes that the high degree of monetary stimulus is reflected in the low levels of real interest rates. Regardless of whether it chooses to recognize the current economic deceleration, the ECB appears disinclined to modify its current stance.

Given the Account’s emphasis on stock effects, it can be surmised there are reasonably high hurdles on the path to discontinuing reinvestments, which would attenuate those effects. Besides concluding that the current policy route should be continued, the Account recognized that the present situation is “still subject to a number of uncertainties and fragilities,” so it is understandable that the ECB will maintain a cautious approach to such explicit tightening measures as discontinuing reinvestments and hiking interest rates. Since last year, the ECB has both at press conferences and in its Accounts repeatedly emphasized the importance of the “Three Ps” (patience, persistence, and prudence), and this emphasis was maintained in the latest Account. In light of all these factors, it appears that the likelihood that discontinuing reinvestments will be discussed at the December Governing Council meeting is quite low.

Appraisal of October Stock Market Turmoil

It is noteworthy that the October Governing Council meeting was held shortly after a bout of stock market turmoil. It has been pointed out that the rise in interest rates and accompanying adjustment of U.S. stock prices gave European stock prices a heavy upside and that U.S. stock prices were relatively high from the perspective of viewpoint of the cyclically adjusted price earnings ratio (CAPE). Many observers concluded that the stock price fluctuations in October were merely adjustments within the stock market, and the ECB expressed the view that “Contagion to other financial market segments and other sovereign bond markets had so far remained limited”. Regarding stock market trends characterized by volatility at higher levels during October, the ECB has clearly concluded that the turbulent trends were no more than benign adjustments.

TLTRO Wind-Down Warrants More Attention

Regarding the ECB’s “next move”, attention has been focused mainly on the direction of reinvestment-related policy, but the subsequent key issue will probably relate to whether or not another particular policy can be extended. This is the second round of targeted long-term refinancing operations (commonly called TLTRO2[2]), which was launched in June 2016 and is scheduled to gradually be wound down from June 2020 upon the maturation of assets held (see table). Near the end of the “Economic and monetary analyses” section of the latest Account appears a related statement that – “the remark was made that the maturity of some of the targeted longer-term

TLTRO2（total 4 times）

	Start (y/m/d)	Redemption (y/m/d)	Supply	Interest rate (%)	Supply amount (Bio euro)	User (Numbers of banks)
1	2016/6/29	2020/6/24	1456	0	399.3	514
2	2016/9/28	2020/9/30	1463	0	45.3	249
3	2016/12/12	2020/12/16	1456	0	62.2	200
4	2017/3/29	2021/3/24	1456	0	233.5	474
Total amount at present					**740.3**	

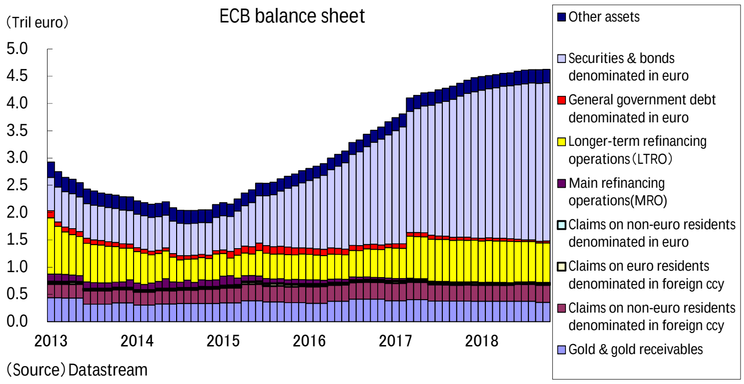
（Source）ECB

* The final borrowing interest rates will depend on interest exemption measures based on loan performance.
* However, for the first round of bidding, refinancing will be allowed for the entire outstanding loans from TLTRO1 (≈ EUR 430 billion).

[2] The policy was also touted for supplying liquidity with a negative interest rate. For more-detailed information, please refer to my book, “ECB European Central Bank: From Organization and Strategies to Bank Supervision,” (Toyo Keizai Shinposha, 2016)

refinancing operations would fall below one year in the course of the next year, which could impact the evolution of excess liquidity and might affect banks' liquidity position." By means of four rounds of asset purchases, TLTRO2 supplied approximately EUR740 billion of liquidity, but voluntary early liquidity repayments are permitted from two years after the initial supply, and such early repayments have already been made with respect to TLTRO2 assets purchased in June and September of 2016. However, such repayments have not been made on a large scale – they amount to EUR11.33 billion and EUR3.36 billion, respectively, for assets purchased in June and September of 2016. In other words, the current balance of TLTRO2 net of early repayments remains about EUR720 billion, most of which is scheduled to be absorbed from the market in June 2020, the redemption date for assets purchased in June 2016.
As reflected in the small volume of early repayments, many regional financial institutions are still dependent on TLTRO funds, but the ECB's executive board member and chief economist Peter Praet said in a November 22 interview with a German newspaper that – "It is premature to decide on a new TLTRO now" – and that is in line with other media reports that appeared previously. Currently, the ECB does not appear inclined to disseminate information regarding the possibility of a successor program (TLTRO3?).

Will ECB President Draghi Leave a "Parting Gift"?

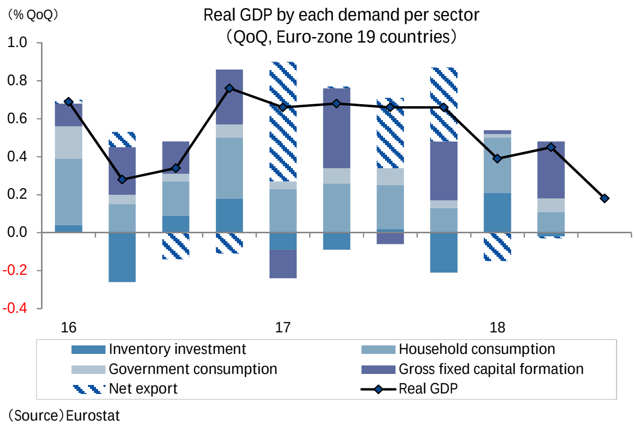


(Source) Datastream

Despite the reporting of statements by ECB-related sources denying plans for a TLTRO3 program before and after the latest Governing Council meeting, it is a fact that some Governing Council members are beginning to express concern about the maturity of TLTRO2, and it will be important going forward to keep abreast of how many members may come to consider TLTRO2 maturity problematic. The approximately EUR720 billion of liquidity scheduled to be gradually redeemed corresponds to approximately 15% of the ECB's balance sheet (approximately EUR4.6 trillion as of November 16), and this is a fairly large sum, albeit considerably less than the value of the ECB's holdings of securities purchased through its quantitative easing policy (approximately EUR2.6 trillion; see graph). Moreover, there are reports claiming that Italy is responsible for more than 30% of the TLTRO2 balance. Italian government bond yields are currently surging, and the latest Account notes that household finance and corporate loan yields are being pushed upward, promoting a tightening the overall financial environment. Under such circumstances, there is due cause for concern about the liquidity situation within the region next year (especially in Italy), and the current trend of increasingly substantial discussions of the possibility of introducing TLTRO3 can be considered appropriate from the viewpoint of forward-looking policy responses.
In fact, rather than purchasing Italian government bonds and continuing to hold and reinvest those bonds, it would be more meaningful for the ECB to directly provide liquidity to Italian private-sector banks, and there is a rationale for giving a higher priority to discussing this liquidity provision than to discussing the prospective reinvestment policy. Of course, since the fundamental problem is the decline in Italian government bond prices, the real solution should entail the Italian government undertaking sustainable fiscal and structural reforms. It may be that facilitating such reforms will require a policy mix combined with monetary easing measures, so it would not be surprising to conclude that indirect support from the ECB is necessary. In any case, it is probably correct to anticipate that discussions about a TLTRO3 program will begin in the first half of 2019. Following the 36-month LTRO program (launched in November 2011) that made ECB President Draghi's name renowned worldwide, TLTRO, and TLTRO2, a TLTRO3 program would be the ECB's fourth liquidity supply program. Will a new liquidity supply program be inaugurated as a parting gift from ECB President Draghi, who is scheduled to retire from the ECB next October? It will be one of the main focal points of ECB watching next year.

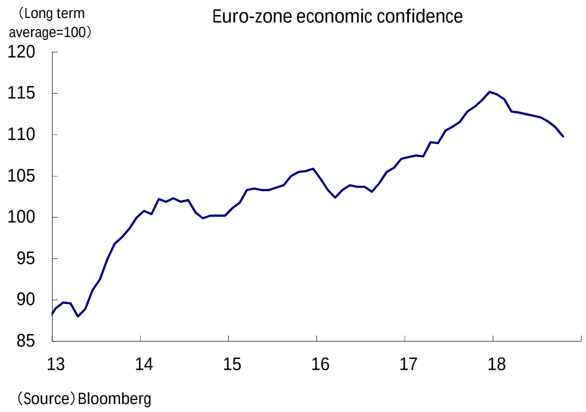
The Euro Area Economy Now and Going Forward – Recognizing the Euro Area Economy's Deceleration

Recognizing the Euro Area Economy's Deceleration



(Source) Eurostat

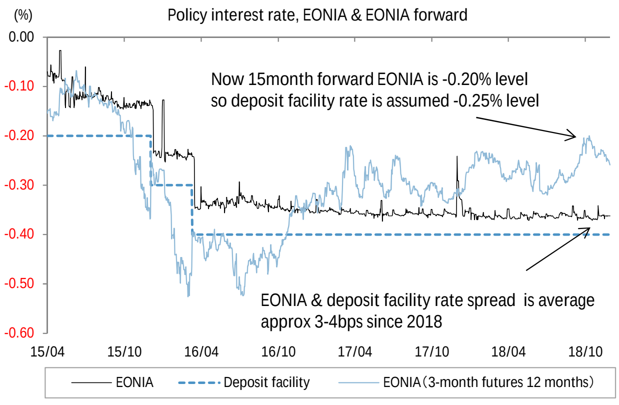
While the euro area July-September GDP figures released in November have been overshadowed by the turbulence related to Italy's fiscal budget, they indicate 0.2% qoq growth, a deceleration from the 0.4% qoq growth in the April-June period. The 0.2% qoq growth rate is the lowest growth rate recorded in about four years, since the April-June 2014 period. Looking at the figures for individual countries, there is considerable concern about Italy, which recorded 0% growth, while Germany's growth rate fell to -0.2%, the first negative growth rate to be recorded by Germany since the January-March 2015 period. Although Germany's negative growth is said to reflect a temporary decline in automobile production owing to the introduction of a new exhaust gas test, that negative growth cast a significant shadow on the euro area as a while. France recorded a robust increase of 0.4% qoq, and that is a considerable acceleration from the previous period's 0.2% qoq growth, which was depressed by a national rail strike. As I have repeatedly pointed out in this article, the euro area's GDP growth in 2017 was supported by unusually strong growth in net exports. Given the sharp appreciation of EUR in the previous year, there was even a possibility that the area's GDP growth could have been nullified by export deceleration this year, but the actual result turned out to be somewhat less dire (see graph). As noted by the ECB, this year's GDP growth was also depressed by such temporary factors as a major wave of unusually cold weather, labor strikes, an influenza epidemic, and the accelerated schedule of the Easter break. Those temporary factors did in fact depress growth as claimed, but they also encouraged a general belief that the euro area economic slowdown in the first half of the year was temporary. In fact, given that the current 22 consecutive quarters the sustained GDP growth is the euro area's longest-ever expansion period, it would not be surprising at this point to confirm the start of a cyclical deceleration phase, particularly in light of the area's internal frictions involving Italy and Germany and external frictions with the United Kingdom and the United States. Objectively speaking, it is probably reasonable to consider the current environment as not being conducive to euro area economy acceleration.



(Source) Bloomberg

It is only since midway through the year that the euro area economy's weakening has begun to be recognized. This June, Germany-based Ifo Institute for Economic Research drastically revised its forecasts of German GDP growth for this and next year while warning that the Italy situation and trade war concerns had the potential for creating "euro crisis 2.0." The following month, the IMF issued a regular report on the euro area economy based on Article IV of the IMF's Articles of Agreement (a so-called Article IV report) in which it suggests that the euro area economy is now peaking out. The report states that "medium-term growth prospects remain lackluster, and risks are particularly serious at this time." While it is hard to imagine a situation in which the euro area falls straight into a recession, the optimistic perception promoted by the ECB and other institutions that "the deceleration is temporary" is doubtlessly incorrect. Furthermore, a recent clear-cut downtrend in the European Commission's Economic Sentiment Indicator (ESI) suggests a situation in which such economic agents as companies and households are increasingly disinclined to undertake proactive consumption and investment activities.

ECB Should Reconsider Normalization Process



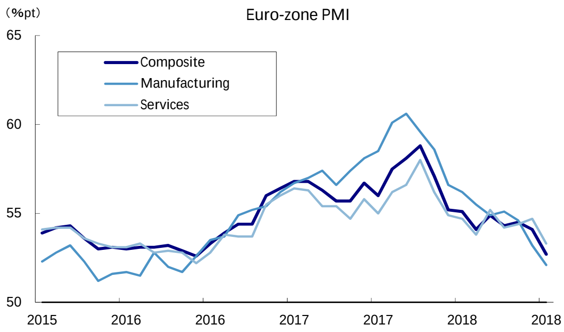
(Source) Bloomberg

Under these circumstances, attention is being focused on the impact of the "next move" of the ECB, which has been displaying willingness to undertake a normalization process. The political turbulence associated with Italy and Germany may turn out to be transient, and it is also difficult to anticipate exactly what kind of impact they may have on the euro area economy. However, the aforementioned deterioration of basic economic indicators has a direct influence on monetary policy management. Given that the deceleration in GDP is so clearly evident, is not it inevitable that it will have an impact on economic and inflation-rate forecasts? Currently, it appears that the October Governing Council meeting has confirmed the fact that the ECB does not intend to correct the financial markets' expectations of the end of quantitative easing within the year, the start of discussions about prospective reinvestment policies in December, and the start of interest rate hikes from as early as next September. Consequently, Euro OverNight Index Average (EONIA) forward contracts and other indicators are continuing to reflect the markets' factoring in of a prospective interest rate hike. Considering the possibility of a hike to be announced at the Governing Council meeting next December, for example, one finds that 12-month-maturity three-month EONIA future contracts indicate that EONIA is expected to rise from -0.36% to -0.25%, and this suggests that the market has factored in its expectations of a single interest rate hike (see graph). The lack of a sharp trend of EUR depreciation despite the deterioration of the economic indicators may well be attributable to the markets' expectations about ECB policies.

How long can the ECB maintain this stance? At the July Governing Council meeting, ECB President Draghi said that the deceleration of growth at that time merely reflected "pullback from the unusually strong growth rates" in the latter three quarters of last year, and particularly reflected a pullback from the "unusually strong export performance" during those quarters. The notion that the recent deceleration is merely a reflection of special, temporary factors implies that it is not necessary to adjust normalization plans, and as explained above, this interpretation had not greatly changed even at the October Governing Council meeting. Although the interpretation makes sense to a certain extent, it would also seem important to give attention to the associated question of what caused the slow-down in exports. The slow-down in exports is partly attributable to the surge of EUR appreciation in 2017, which, in turn, is generally considered to have been spurred by the statements of Draghi himself (the Sintra lecture in June 2017). Another factor believed to have promoted the export slow-down is the deterioration of business sentiment in response to trade war-related situations. At least regarding the first half of this year, it is becoming increasingly difficult to discount the euro area's economic deceleration as being merely a 'temporary' trend. When it is recognized to be something other than a temporary trend, the ECB would seem to be in a situation where it is necessary to reexamine the normalization process. If what we are witnessing is a fundamental slowdown in GDP growth – a very clear trend requiring a monetary policy response – it is questionable whether the December Governing Council meeting will actually begin discussing the possibility of suspending reinvestment. While ECB President Draghi is scheduled to retire less than a year from now, I am hoping that ECB policy will not be affected by efforts to choreograph a glorious ending to his career.

EUR now and going forward – EUR Beset by Five Problems

Five Problems Besetting EUR



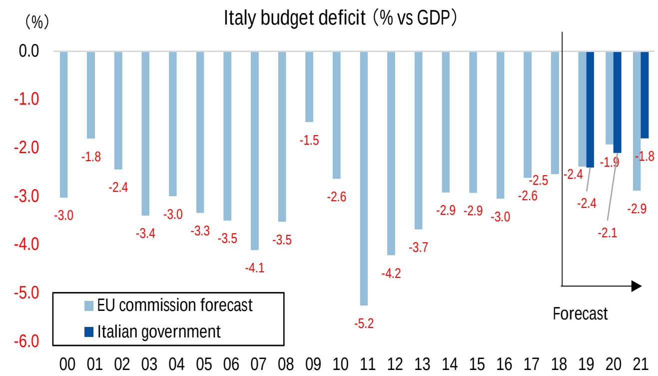
(Source) Bloomberg

Looking at the current situation objectively, it can be said that euro area and the euro exchange rate are beset on all sides by political and economic problems. These includes such problems as anxiety about (1) regional economic deceleration, (2) political unrest associated with Italy's new fiscal budget, (3) Brexit negotiations, (4) post-Merkel era German political instability, and (5) trade frictions, and all five problems seem to be undermining market sentiment, including market sentiment regarding EUR. Regarding problem (1), as explained above, there has recently been a noteworthy cooling down of the euro area economy. For example, the manufacturing Purchasing Managers' Index (PMI) dropped from 59.6 in January to 52.1 in October and the European Commission's Economic Sentiment Indicator (ESI) has fallen sharply from 114.9 to 109.8 over the same period. These are highly significant reflections of current trends in the euro area economy (see graph). Italy's manufacturing PMI has attracted considerable attention as it descended below 50 in October, the first time it has been below 50 since December 2014. The statistics suggest the euro area economy is decelerating. Signs of this deceleration are seen not only in such soft indicators as PMI but also in hard statistics such as GDP. In the four quarters through the third quarter this year, the area's real GDP growth rate has descended "+0.7% → +0.4% → +0.5% → +0.2%," a clear trend of deceleration. (Incidentally, Italy's real GDP

growth in the third quarter this year was 0%). It seems that increasingly widespread awareness of the weakening of the euro area's real economy is discouraging EUR buying, and this is contributing to EUR's heavy upside.
Compared to the number of inquiries about this simple and objectively evident economic deceleration situation, I receive relatively more inquiries about the impact on EUR from such complex political risk factors as problems (2), (3), and (4), which are more conspicuously eye-catching situations. Unfortunately, I have to respond to the latter group of inquiries by noting that investments in EUR-denominated assets are always associated with unique political risks and that such situations as conflicts between the Italian government and the European Commission and between Britain and the European Commission are outside the range of subjects that can be forecast based on simple rational methods.

Risk that Italy May Ignore EU Recommendations

In the autumn economic outlook announced on November 8, the European Commission projects that Italy's fiscal budget deficit as a share of GDP will be 2.9% in 2019 and 3.1% in 2020 – the deficit is expected to exceed the less-than-3% limit stipulated by the EU's Stability and Growth Pact (SGP). However, these figures differ considerably from the deficit projections in the Italian government's fiscal 2019 budget proposal (2.4% in 2019, 2.1% in 2020, and 1.8% in 2021). The Italian projections differ from the European Commission in their magnitudes as well as in their trend direction – since the Italian projections anticipate a trend of deficit shrinking while the European Commission projections anticipate a trend of deficit expansion – so one cannot avoid getting the impression that the two sides are very far apart in their perceptions. The European Commission is seeking to reduce Italy's structural fiscal balance (the basic fiscal balance excluding such temporary factors as those associated with economic cycles), which the Italian government is assuming will be flat at 1.7% over the next three years. However, the European Commission expects Italy's structural fiscal balance to reach 3.0% in 2019 and 3.5% in 2020.



(Source) European Commission
(Note) Forecast is according to EU economy forecast in Autumn edition

Given the EU's chronically problematic tendency to promote a "splitting the difference" type of compromise, it seems most likely that the two sides' budget deficit targets will be brought into alignment somewhere in between the two sides' current projections. In fact, it seems that the financial markets are already assuming that there will be this kind of compromise. In November, the European Commission recommended that the Council of the EU initiate an excessive budget deficit procedure (EDP) with respect to Italy, and there is a possibility that the first associated sanctions will be implemented as soon as next spring. Various penalties may be imposed if Italy does not take the requisite corrective measures, including a penalty equivalent to 0.2% of nominal GDP and the temporary freezing of funding from European Structural and Investment (ESI) Funds (aimed at rectifying disparities within euro area). The main forecast scenario is that a compromise will be arranged to avoid the imposition of such penalties, but it is technically possible for the Italian government to accept the penalties and ignore the European Commission's recommendations while planning its budget however it chooses to. (This is possible because the euro area is fundamentally defective in its lack of effective fiscal policy-related enforcement mechanisms). There is concern that a flouting of the European Commission's recommendations by Italy could strongly promote EUR depreciation, since such a situation would cast doubt on the European Commission's ability to function as the EU's executive branch. Currently, the most worrisome risk associated with the Italian problem is the possibility that Italy may resolutely ignore the European Commission's recommendations, but there are few signs that financial market players betting on such a scenario at this time.

Numerous Factors Promoting EUR Depreciation Other than USD Appreciation

It is difficult to determine the most likely scenarios regarding the remaining two problems ((4) post-Merkel era German political instability, and (5) trade frictions), but there are many market participants who are vaguely uneasy about those problems. Regarding (4), one may recall that the markets responded with increased EUR selling to reports of German Chancellor Merkel's resignation from her position as chairman of the Christian Democratic Union (CDU), but there has actually been little progress in developing medium-to-long-term forecasts of the positive and negative developments one can anticipate regarding a "Post-Merkel EU." In fact, one can anticipate various positive trends regarding the revision of certain policies promoted by the Merkel government in recent years, such as the policy of unrestricted acceptance of refugees and migrants and the policy of fiscal austerity. Nonetheless, as the departure of Chancellor Merkel is inextricably associated with the rising popularity of the far-right AfD (Alternative for Germany) party, her departure has clearly been perceived as reflecting an increase in right-wing populism that may promote destructively centrifugal forces in the EU, and it was this perception that appears to have spurred EUR selling. The CDU's election of a new leader in December will be an important factor, and if CDU Secretary General Annegret Kramp-Karrenbauer (popularly known as 'mini-Merkel') becomes the party's chairperson, then it appears that Chancellor Merkel may not have to retire immediately from the chancellorship. On the other hand, if the anti-Merkel Health Minister Jens Spahn or former-Merkel-rival Friedrich Merz (a Bundestag member for 15 years until 2009) becomes the CDU chairperson, then it seems the Merkel chancellorship may not last much longer. If the Merkel administration ends in 2019, it will have lasted for more than 13 years. As explained in a recent

Mizuho Market Topic article[3], the end of the Merkel administration will be a major transition not only for Germany but for the EU as a whole. In any case, the sudden fluidization of the German political situation is expected to be another factor exerting downward pressure on EUR.

I also have serious worries about the EU-United States relationship. The fact that President Trump's party has lost control of the House of Representatives following the recent midterm elections is not likely to restrain the ramification of President Trump's protectionist policies (problem (5)). It should be kept in mind that the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies released in October contained some harsh criticism of Germany[4]. Ultimately, the euro area will be constrained by the shakiness of its real economy as it seeks to deal with its many internal and external risk factors. As I mentioned earlier, it is obvious that a considerable portion of EUR weakness is attributable to USD's strength, but one must keep in mind that there are many other factors promoting EUR weakness.

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[3] Please see the October 30, 2018 edition of Mizuho Market Topic, entitled "Outlook for the EU without Merkel – Dealing with the Aftermath of Idealism." In addition, please refer to the article entitled – "Angela Merkel Stands Down from CDU Chairmanship to Inaugurate the "Post-Merkel EU" Period –Idealism Not Accepted Despite Economic Robustness" – that was posted on October 31, 2018, on the Toyo Keizai Online website.

[4] Please see the October 18, 2018 edition of Mizuho Market Topic, entitled "Response to U.S. Semiannual Report on International Economic and Exchange Rate Policies – Exceptional Treatment of China."