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Forex Medium-Term Outlook

26 December 2018

Mizuho Bank, Ltd.
Forex Department

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Overview of Outlook

USD/JPY clearly fell in December. In line with the concerns I have consistently expressed in this report, the prices of risky assets have been forced to undergo a correction in response to the increase in U.S. interest rates. The Fed had until recently remained indifferent to this asset price volatility, but it may finally no longer be able to ignore the fluctuations. This is evidenced by the fact that Committee members were forced in December to downgrade their dot plot projections for the entire forecasting period. Market predictions, however, are even more pessimistic than those suggested by the revised dot plot, with some even predicting the end of rate hikes altogether. More often than not with markets, optimism is built gradually while pessimism strikes all at once, and it has to be said that the climate surrounding the Fed's policies changed suddenly sometime toward the end of November. Over the past five years, financial markets have operated on the premise that the Fed is in the process of policy normalization. However, that premise is set to change starting 2019. My basic understanding is that we have now entered a phase where the Fed's next move is not necessarily a rate hike, a phase in which both U.S. interest rates and USD will inevitably face downward pressures. In 2018, despite the U.S.-Japan interest rate gap expanding, USD/JPY did not even reach 115. This is also a cause for concern regarding the future level of JPY strength. As USD weakens across the board along with a decline in U.S. interest rates, I predict that JPY appreciation will gain the momentum.

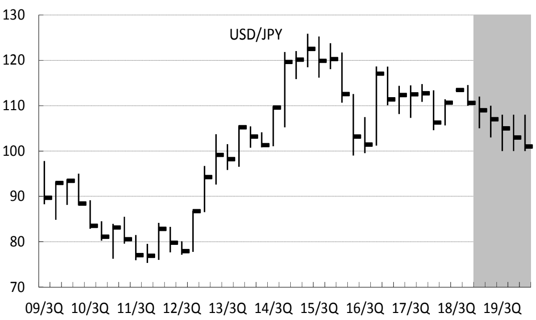
EUR remained stagnant in December too. The Italian government and the European Commission (EC) may gradually be arriving at a compromise in their standoff, but meanwhile, a new problem has arisen – the administration of French President Emmanuel Macron may be in trouble with the intensification of the violence in Paris. However, the biggest problem for EUR is a more fundamental one, namely that the economy is weak, so unless there is a marked improvement on this front, the currency will be difficult to buy. The ECB managed to finalize the end of its expanded Asset Purchase Programme (APP) by the end of the year, but the main challenge is yet to come. Going by the ECB's own experience, ending reinvestments may not be possible anytime soon, possibly taking another two or three years. In fact, ECB President Mario Draghi's assessment of the ECB's outlook as "continued confidence with increasing caution" following the December Governing Council meeting seems to be spot on. It is quite possible that the ECB's stance will become more dovish along with a downward revision of the balance of risks starting early next year. Having said that, EUR will probably retain its strength against USD, given that USD is likely to face significant correction from its current level.

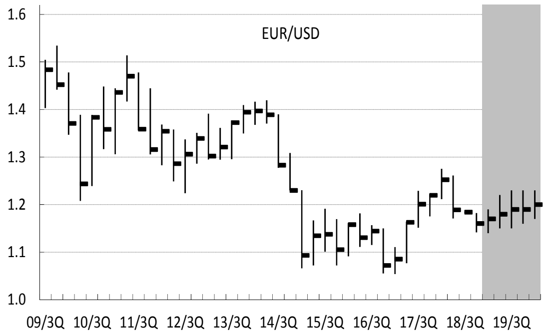
Summary Table of Forecasts

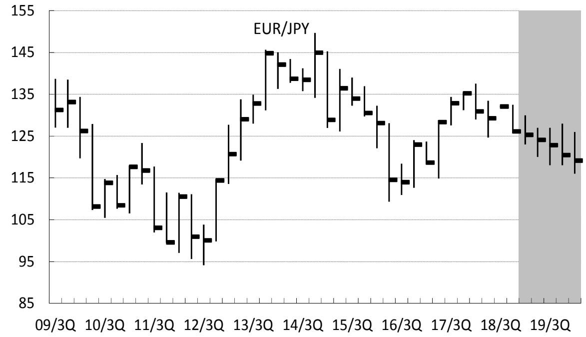
	2018 Jan-Dec (actual)	2019 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2020 Jan-Mar
USD/JPY	104.64 ～ 114.55 (110.62)	105 ～ 112 (109)	103 ～ 110 (107)	100 ～ 108 (105)	100 ～ 108 (103)	100 ～ 108 (101)
EUR/USD	1.1216 ～ 1.2556 (1.1405)	1.12 ～ 1.17 (1.15)	1.13 ～ 1.20 (1.16)	1.13 ～ 1.21 (1.17)	1.14 ～ 1.21 (1.17)	1.15 ～ 1.21 (1.18)
EUR/JPY	124.62 ～ 137.51 (126.17)	123 ～ 130 (125)	120 ～ 127 (124)	118 ～ 127 (123)	118 ～ 128 (121)	116 ～ 126 (119)

(Notes) 1. Actual results released around 10am TKY time on 26 DEC 2018. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





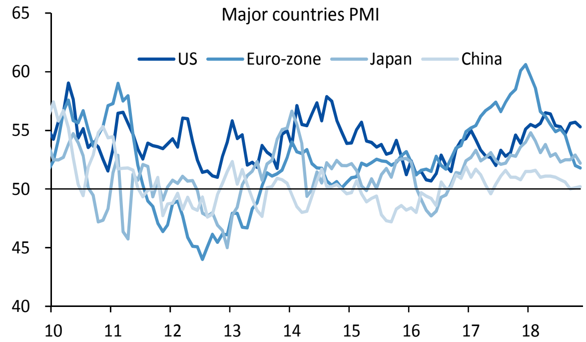


USD/JPY Outlook – Time for a Change in the Premise

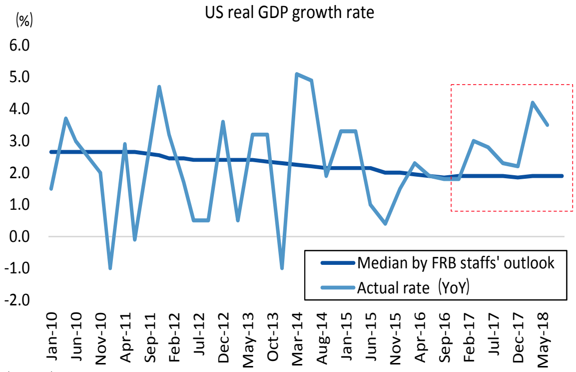
2019 – Vital Points for Global Economy; The Year in Which the True Price of Rate Hikes Emerges

The U.S. Economy in 2018, When it Withstood the Rise in Interest Rates

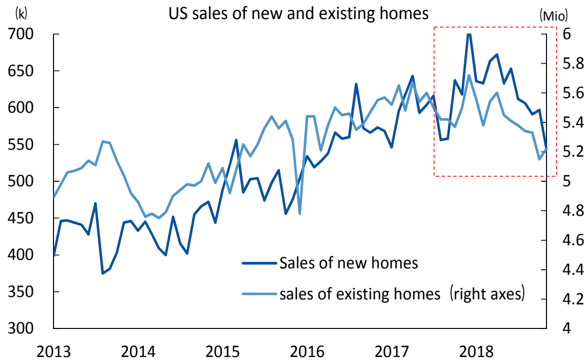
What are the vital points to be considered when forecasting the outlook for the global economy in 2019? I would like to summarize them at the start of this, the final issue of this report for 2018. The Organisation for Economic Cooperation and Development (OECD) Economic Outlook published in November 2018 declared that "Growth has peaked amidst escalating risks." I also believe that the key phrase when it comes to the outlook for the global economy in 2019 is "peaking out." The representative economic indicators have been suggesting this since the beginning of the year even without the OECD's having to point it out. For instance, going by worldwide national and regional manufacturing PMIs, which are important early indicators of the "temperature" of the economy, the "peaking" process began about a year ago. Only the U.S. economy has been holding out, probably because of the effects of fiscal expansion, but even that cannot hold out forever (see graph). At the very least, it will be extremely difficult for the global economy to strengthen in the coming phase. When putting forward a global economic outlook at the beginning of the year, one tends to present a comprehensive list of themes, such as the U.S.-China trade war or Britain's exit from the EU (Brexit), but I do not believe these are the most vital points. What we should really focus on is the fact that successive rate hikes by the Fed will finally begin to undermine economic and financial conditions within and outside the U.S. To put it more loosely, the true price of rate hikes will emerge by and by.



(Source) Bloomberg, Markit



(Source) BEA



(Source) Bloomberg

The U.S. economy truly seemed at its peak in 2018. The Real GDP growth rate (annualized qoq) remained over 3% on an average through the July-September quarter, which is considerably higher than the base level (the long-term economic growth rate as predicted by FOMC staff members is about 1.8%), which can be seen as the potential growth rate (see top graph to the right). The unemployment rate remained around 3.7%, the lowest in 48 years, while the ISM Manufacturing PMI stably remained at an extremely high level in the vicinity of 60. As a result, the U.S. economy is set to renew the record for longest ever phase of economic expansion (120 months) in July 2019. Of course, given that the current phase of economic expansion is a part of the recovery from an unprecedented financial crisis, it would be absurd to consider it dangerous simply on the basis of its length. On the other hand, many by now suspect that the U.S. economy has already reached the very highest extent of recovery possible.

Rate hikes by the Fed most certainly have the effect of applying the brakes on the real economy. The signs of this will be seen, in particular, in consumption and investment activities, which tend to be sensitive to interest rates. For instance, looking at housing-related indicators, which are representative of such activities, both new and existing home sales clearly peaked out early this year (see bottom graph to the right); and conventionally, a decline in housing investment leads to a decline in consumption and investment as a whole, starting with consumer durables.

Trade Wars and Brexit are No More than Secondary Plots

Of course, the U.S.-China trade war and Brexit continue to be important themes for 2019. Another important theme could be the slowing down of the euro area economy and the resulting derailment of the ECB's policy normalization process, and U.S.-Japan trade talks could be in the spotlight during certain phases. However, these are all factors that could only play the role of further damaging an economy that is weakening at its core – in other words, they are merely secondary plot lines, where the main plot line is the peaking out of the global economy. Of fundamental concern is the fact that U.S. interest rates, which function as the cost of capital for the whole world, are continuing to increase at a time when global economic growth is peaking. This has been going on for the past year or two. I think it is important to understand that, given the Fed's policy stance over the past five years, economic and financial slowdown is a natural outcome even without the help of factors such as trade wars and Brexit. The main role of rate hikes is to slow down the economy. That is why it was abnormal in recent years that the real economy continued to expand and stock prices continued to rise despite rate hikes (giving birth to the phrase "Goldilocks economy"). Normally speaking, to the extent that interest rates increase, lucrative projects (investment opportunities) become fewer. This inevitably dampens fixed investment, and thereby employment, wages, and so on. This is the key point when it comes to forecasting the main storyline for economies around the world in 2019.

Having said that, let us also take a look at the impact of a trade war between the U.S. and China. In this connection, some argue that no "real damage" has been done, but that is an irresponsible assessment. It may be an opinion based on the fact that stock prices are still quite strong, but some in the manufacturing sector are beginning to worry that fixed investment plans will have to be approached with caution so long as the risk of a trade war exists. In the business world, it is always too late to address something after the fact. Therefore, at the very least, the prospect of a trade war is causing businesses to hold back on their upcoming plans. This is a major form of "real damage."

Note that a further increase in tariffs (10%→25%) was postponed following the U.S.-China summit held in December, but I do not believe this was a step toward resolving the problem. U.S. President Donald Trump, who would like to be reelected in 2020, has no real motive for stepping back from his protectionist stance, but if he ever did, it would probably be at a time when stock prices or the real economy had weakened to the extent of forcing his hand. Even in such a scenario, he is likely to want to maintain his protectionism to the extent possible while laying the blame on the Fed's rate hikes instead. Having said that, downward pressures from such trade wars are at best "additional factors" weighing down an already weakened global economy. I do not consider them central to my forecasts.

Ironically, the More Robust the U.S. Economy, the Harder it is for EMEs

Incidentally, the OECD Economic Outlook warned that "A combination of risks could amplify each other and seriously erode growth," listing "higher EME interest rates" as one of these risks. This risk again can be traced back to the Fed's rate hike path. The draining away of funds from emerging markets was a big theme in 2018, and there is no question that the rise in U.S. interest rates was behind this. As investors abruptly dumped emerging market currencies, which had become less attractive, central banks in these countries were forced into simultaneously taking measures to protect their respective currencies. As the table shows, a significant overall increase in EME interest rates was observed through 2018. Interest rates in these countries were not raised because their economies were performing well but because of the need to protect their domestic currencies. It is ironic, but so long as the U.S. economy is robust, EMEs will continue to suffer (due to the Fed's rate hikes).

Of course, it is a different question altogether whether the capital drain from emerging economies will result in anything that could be called a "crisis." However, it is somewhat unreasonable that the benefits were advertised so widely during the phase of rate cuts and quantitative easing, and now, when it comes to withdrawing those measures, it is being insisted that the impact will be "limited." At the very least, market conditions are no longer the same as in 2017, when there was so much surplus capital that the 100-year bonds issued by the Argentine government were snapped up.

		Current (%)	Latest policy trends		2018 Cumulative change width
			Date	Decision	
Emerging Asia					
China	1-year benchmark lending rates	4.35	2015/10/23	-25bp	0bp
India	Repurchase rate	6.50	2018/12/5	Unchange	+50bp
Indonesia	7day reverse repo rate	6.00	2018/12/20	Unchange	+175bp
S.Korea	7day repo rate	1.75	2018/11/30	+25bp	+25bp
Malaysia	Overnight policy rate	3.25	2018/11/8	Unchange	+25bp
Philippines	Overnight reverse repurchase agree	4.75	2018/12/13	Unchange	+175bp
Thailand	1 day official rates	1.75	2018/12/19	+25bp	+25bp
Vietnam	Refinance rate	6.25	2017/7/7	-25bp	0bp
Central and Eastern Europe・Africa					
Russia	1week repo rate	7.75	2018/12/14	+25bp	+25bp
South Africa	Repo rate	6.75	2018/11/22	+25bp	+25bp
Turkey	1 week repo	24.00	2018/12/13	Unchange	+1600bp
Latin America					
Brazil	Selic target rate	6.50	2018/12/12	Unchange	-50bp
Mexico	Official overnight rate	8.25	2018/12/20	+25bp	+100bp

(Note) Indonesia has changed policy rate 7 day reverse repo rate instead of BI rate on 19AUG2016
(Source) Bloomberg & Mizuho Bank

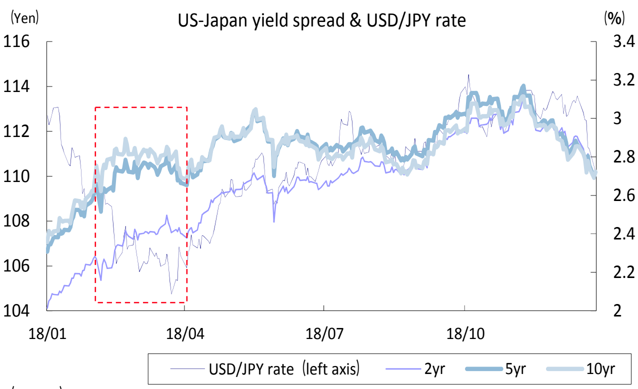
Going Forward, it Will Become Clearer that Higher Interest Rates are an Encumbrance

As I mentioned at the start, the real U.S. economy remained much stronger than expected in 2018. However, as we enter 2019, we must ask ourselves whether it is really possible for the unemployment rate, currently at 3.7%, to improve further, or for the U.S. housing market to maintain its strength despite the rise in interest rates. Of course, it is not altogether impossible for the economy to maintain its current level of strength for another year. However, there are not many grounds for predicting that this will be the case. A year ago, I was concerned whether the U.S. and global economies and financial markets could withstand the rise in U.S. interest rates. In the event, my fears were not realized during the year, but that does not mean the concerns themselves disappeared. Rather, the latent threat posed by those concerns continued to increase and now, in December, the fears are beginning to come true. Going by developments in 2018, 2019 is likely to be a year in which the fact that higher interest rates are an encumbrance become more widely known and deeply felt. My basic understanding is that the Fed, which has managed to dispassionately proceed with its normalization process for five years through 2018, will finally no longer be able to ignore the turbulent domestic and international economic conditions that are due to its policies.

2019 – Vital Points for Forex Rates; Time for a Change in the Premise

May no Longer be Possible to Forecast JPY Weakness

Based on the above understanding of the global economy, what should one's understanding of forex rates be? Logically, it seems obvious that U.S. interest rates and USD, which have remained stubbornly high, will be forced to undergo a correction as the Fed reconsiders its policy normalization process. With regard to USD/JPY, in particular, 2019 seems likely to be a year in which it will be extremely difficult to forecast a weak-JPY scenario. In 2018, JPY neither weakened nor strengthened, but the one thing that no longer seems possible is for JPY to weaken from here. This is because, in most cases, there is only one logical reason for predicting JPY weakness: rate hikes by the Fed → rise in U.S. interest rates → expansion of the U.S.-Japan interest rate gap → JPY selling in exchange for USD. The logic is simple and easy-to-follow, which makes it quite popular. Note that when we talk about the "U.S.-Japan interest rate gap," we are mostly talking about U.S. interest rates. In this context, U.S. 10-year interest rates, for instance, have gone up by up to +80 bps since the beginning of the year. This resulted in the U.S.-Japan interest rate gap widening, but USD/JPY did not



(Source) Bloomberg

show any clear trend during the same period. Of course, carry trade profiting from gap in U.S.-Japan interest rates is likely to have been behind the letup in the upward pressure on JPY when USD/JPY rebounded from its plunge to the 104 level early this spring (see graph). However, we are unlikely, any time soon, to see another year in which the interest rate gap widens as much as it did in 2018. As widely known, 2018 was the year in which U.S. stock prices began to respond dramatically to U.S. interest rate increases. U.S. interest rate levels, therefore, may not be able to increase so easily going forward.

Thinking of it this way, the fact that USD/JPY could not even reach 115 despite the widening interest-rate gap even seems to portend some great calamity in the time to come. For instance, as can be seen from the IMM currency futures transactions, short-term speculators have accumulated significant JPY short and USD long positions (see graph on P.8). The fact that USD/JPY did not even climb to 115 despite this risk bias appears to be due to concerns regarding trade wars, Brexit, and a U.S. economic slowdown. These concerns are also evidenced by the yield curve's failure to steepen despite the Fed's shrill warnings about inflation going forward.

On the other hand, there are many paths to JPY strength. It is still true, from time to time, that events or factors that intensify a risk-evasion mood tend to culminate in JPY appreciation in the forex markets – events ranging from trade frictions, U.S. economic slowdown, Brexit, terrorist attacks, earthquakes, typhoons and so on. In 2019, with the global economy poised to peak out, negative effects are likely to emerge even without help from other factors.

Time for a Change in the Premise

The financial markets have gone through a variety of troubles since 2013, but until recently, there was one major premise that could be depended on not to change. This was the fact that the next move by the Fed would be a rate hike. It was precisely because of this that the "investment refugees" of the world rushed to put their funds into USD-denominated assets, keeping USD consistently strong. I assumed that the above major premise would change in 2018, but it did not. The same assumption is likely to have been made by analysts who predicted a decline in U.S. interest rates and a reversal of U.S. stock prices (and thereby of Japanese stock prices). However, it was in 2018 that the rise in U.S. interest rates finally began to be used as a reason for selling U.S. stocks, a trend not seen until 2017. Going by discussions in investment circles, it seems a matter of waiting for the right opportunity for investors to embark on selling USD (and/buying U.S. Treasuries).

When I explain my reasoning to clients, they sometimes tell me that, while they understand my logic, they cannot sell a currency that is awaiting rate hikes. However, since November, remarks by both Fed Chair Jerome Powell and Vice Chair Richard Clarida have become less upbeat, and rate hike projections (the median of forecasts) were downgraded at the December FOMC meeting. It seems that 2019 will, finally, be the year in which the major premise changes and USD, which has remained plateaued, begins to undergo correction. I would like to predict a correction in USD/JPY down to the 100-level or so.

U.S. Monetary Policies Now and Going Forward – The First Step into a New Phase

First Step into a New Phase – Monetary Policy Cannot be Changed Abruptly

At the FOMC meeting held on December 18-19, the Committee decided to raise the target range for the federal funds (FF) rate from 2.0-2.25% to 2.25-2.5%. The raise was as expected, but prices of stocks and other risky assets fell, probably due to the significant discrepancy between Committee members' policy rate projections (the dot plot) and market expectations. The number of rate hikes projected for 2019 in the dot plot fell from the original three times to twice (see table), but half of the financial market participants had already been expecting no rate hikes in 2019, and some, albeit a small minority, had even been expecting the December rate hike to be postponed. As of the moment, therefore, the considerable turmoil in the markets is unable to remain hidden in the face of the Fed's hawkish tone in not just continuing with rate hikes but also the reduction of its balance sheet in 2019. Treasury yields in the U.S. bond market, shrouded in insecurity over the future, have been intermittently dipping below 2.8% and USD/JPY has also been gradually sliding in response to this. The developments I have expressed concerned about in this report since early this year seem poised to come true as the year draws to a close.

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

FOMC Date	2018	2019	2020	2021	Longer run
Sep-15	3.313%	n.a.	n.a.	n.a.	3.500%
Dec-15	3.250%	n.a.	n.a.	n.a.	3.500%
Mar-16	3.000%	n.a.	n.a.	n.a.	3.250%
Jun-16	2.375%	n.a.	n.a.	n.a.	3.000%
Sep-16	1.875%	2.625%	n.a.	n.a.	2.875%
Dec-16	2.125%	2.875%	n.a.	n.a.	3.000%
Mar-17	2.125%	3.000%	n.a.	n.a.	3.000%
Jun-17	2.125%	2.938%	n.a.	n.a.	3.000%
Sep-17	2.125%	2.688%	2.875%	n.a.	2.750%
Dec-17	2.125%	2.688%	3.063%	n.a.	2.750%
Mar-18	2.125%	2.875%	3.375%	n.a.	2.875%
Jun-18	2.375%	3.125%	3.375%	n.a.	2.875%
Sep-18	2.375%	3.125%	3.375%	3.38%	3.000%
Dec-18	2.375%	2.875%	3.125%	3.125%	2.750%

(Source) FRB

The Fed's basic stance has clearly changed in the two months since early October, when yields began to hover at a level above the neutral interest rate and USD/JPY renewed its year-to-date high. But the fact is that monetary policy cannot be changed abruptly. Even though the Fed's current position seems hawkish compared with what the markets were expecting, the very fact that a fewer number of rate hikes are now projected for next year in the dot plot can be taken as the first step into a new phase.

Change in Balance of Risks – Developments Similar to the ECB

Following the December ECB Monetary Policy Meeting, the phrase "the balance of risks is moving to the downside" made its appearance in the Introductory Statement. ECB President Mario Draghi also assessed the situation as "continuing confidence with increasing caution," giving the sense that things are fine for the moment but the future is uncertain. Almost exactly the same development has taken place with regard to the FOMC statement recently released. The assessment that "risks to the economic outlook are roughly balanced" was retained but came with the caveat "but (the Committee) will continue to monitor global economic and financial developments and assess their implications for the economic outlook." There is no question that the Committee is beginning to prepare for the storm brewing. Further, a slightly change was made in the nuance of the forward guidance, to suggest "some further gradual increases" in the target range for the FF rate. This can be interpreted in different ways, but when taken together with the statements of Fed Chair Jerome Powell, who has moved to rapidly close the gap with the neutral interest rate since late November, it seems to suggest that the scope for further rate hikes has shrunk. We are approaching a new phase when the next move may not necessarily be a rate hike.

When Pessimism Dominates, It is Only Transient

Further, the neutral interest rate level indicated in the dot plot has been lowered from 3.00% to 2.75%. The rate, which was gradually raised over the course of a year, appears to have snapped back to its original level instantaneously, showing how it only takes an instant for things to change when pessimism dominates. In addition to this, the FF rate projections (median of forecasts) for the period from 2019 through 2021 were lowered from "3.125%→3.375%→3.380%" to "2.875%→3.125%→3.125%" (see table on previous page). In other words, the projections indicate that the FF rate will surpass the neutral interest rate at the end of 2019, with monetary policy subsequently entering a phase of tightening. This may be the reason why inflation refuses to accelerate despite the actual unemployment rate being below the long-term unemployment rate (see table). This raising of the FF rate to a level above the neutral interest rate was supposed to prevent share and other asset prices overheating, but it has to be said that that is no longer a convincing explanation given the recent correction in share prices. In his press conference, Mr. Powell stressed that the dot plot projections were merely the views of Committee members, not a plan of action for the FOMC nor an indication of any consensus among Committee members. The prospect of rate hikes over and above the neutral interest rate seems to have gone up in smoke.

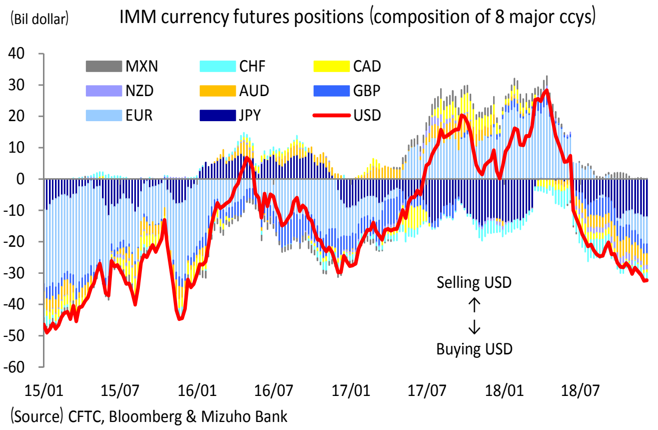
FRB economic outlook (multiple forecast, %, as of DEC 2018)

	2018	2019	2020	2021	Long term
Real GDP Growth rate as of SEP	3.0～3.1 (3.0～3.2)	2.3～2.5 (2.4～2.7)	1.8～2.0 (1.8～2.1)	1.5～2.0 (1.6～2.0)	1.8～2.0 (1.8～2.0)
Unemployment rate as of SEP	3.7 (3.7)	3.5～3.7 (3.4～3.6)	3.5～3.8 (3.4～3.8)	3.6～3.9 (3.5～4.0)	4.2～4.5 (4.3～4.6)
PCE inflation rate as of SEP	1.8～1.9 (2.0～2.1)	1.8～2.1 (2.0～2.1)	2.0～2.1 (2.1～2.2)	2.0～2.1 (2.0～2.2)	2.0 (2.0)
Core PCE inflation rate as of SEP	1.8～1.9 (1.9～2.0)	2.0～2.1 (2.0～2.1)	2.0～2.1 (2.1～2.2)	2.0～2.1 (2.0～2.2)	

(Source) FRB

On the other hand, one cannot help feeling that the emphasis on continuing to proceed as planned with the balance sheet reduction program may have contributed greatly to dampening market sentiment. Mr. Powell pointed out, "We don't see the balance sheet runoffs as creating significant problems," and said he saw no reason to change the current strategy, emphasizing that the Committee did not intend to revise the current rate of reducing its holdings (ending reinvestments) by USD 50 billion a month. So long as USD 600 billion a year (USD 50 billion x 12) worth of Treasuries are released into the market through the issuance of refunding bonds, there will continue to be upward pressure on U.S. interest rates even if the brakes are applied on rate hikes. Of course, the Fed is unlikely to make a sudden leap to the resumption of reinvestments, but given the slowdown in the pace of rate hikes, it is not altogether impossible that it may consider reducing the pace at which it reduces its holdings over the next year.

Impact on Forex Markets – JPY Appreciation is the Only Possible Direction



(Source) CFTC, Bloomberg & Mizuho Bank

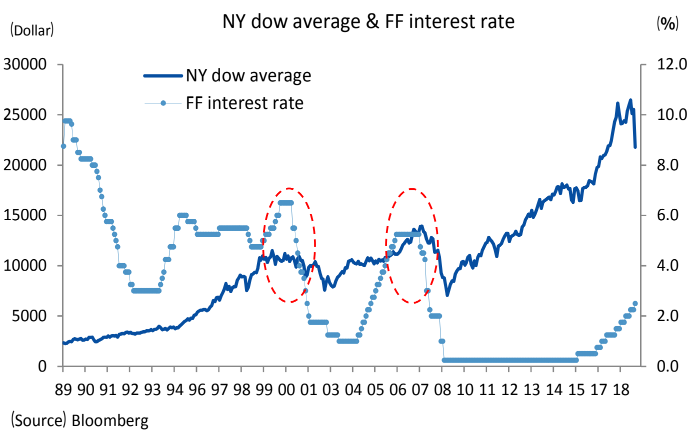
With a clear increase in the risk of U.S. interest rates falling, the impact on forex rates can only be in the direction of JPY appreciation. Considering current economic and financial conditions, the only developments that could cause the 10-year Treasury yield to return to the 3.2% level are a complete resolution of the U.S.-China trade war or another major fiscal expansion – developments too bold to include in my main forecast scenario. The forecast direction for U.S. interest rates going forward seems very likely to be "maintaining current levels at best, but essentially on the decline," and the focus is on the extent to which USD/JPY can withstand the resultant shrinking of the U.S.-Japan interest rate gap. As mentioned above, the U.S.-Japan interest rate gap clearly widened in 2018, but despite this, USD/JPY failed to accelerate. However, forex market reactions are not always diametrical, so one must be prepared for USD/JPY to fall in response to the narrowing of the U.S.-Japan interest rate gap going forward. For instance, with a decline in interest rates, the cost of buying JPY or selling USD will decline for speculators. At the beginning of December, the USD short position held by speculators, as seen from IMM currency futures transactions, had risen to levels last seen three years ago (see figure on previous page). Some correction is likely to have taken place in response to the intensifying "risk off" mood since early this week, but there is probably still a way to go for a full correction. Upward pressure on JPY from short-term traders' actions is still possible and must be watched closely.

Yield Curve Finally Becomes Inverted

In the U.S. bond market in December, the yield curve for some maturities finally became inverted. Some interpret the frequent volatility in stock prices as a response to this warning signal from the bond market. Essentially, short-term interest rates can be thought of as reflecting policy interest rate trends, while long-term bond yields reflect the fundamentals of the real economy. Therefore, the flattening or inversion of the yield curve is taken to mean that the central bank is raising interest rates faster than the fundamentals are recovering. This is the reason why flat or inverted yield curves are feared.

Further, the spread between 2-year and 10-year interest rates, which is the most closely watched, has shrunk to 15 bps as of the writing of this report. Historically, the inversion of the yield curve has been a leading indicator of an economic downturn. Going by the current economic and financial climate, the signal seems to be working correctly this time. Some say that the stock price crash in December in response to the inversion of 3-year and 5-year interest rates was algorithmic, but it would not be surprising if it was also due to fundamentals-oriented market players who took the inversion of the yield curve as the cue to revise their main scenario – from "strengthening inflation/continued rate hikes" to "peaking out of inflation/end of rate hikes." This is likely to be the thinking behind the Fed's policy operations during 2019.

Stock Prices Converge Around Interest Rates



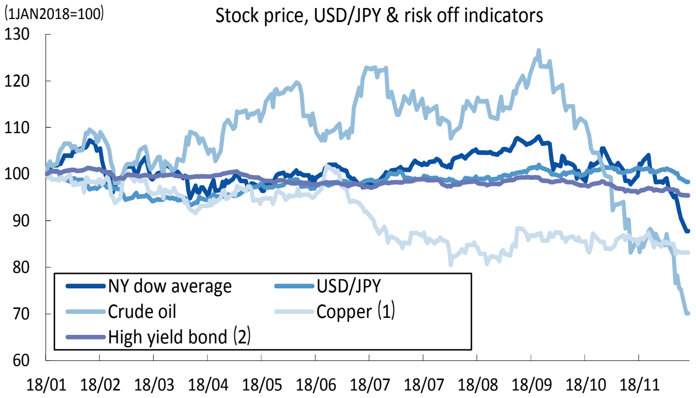
(Source) Bloomberg

Remarks from senior Fed officials like Mr. Powell and Mr. Clarida toward the end of November more or less ended the speculation that had arisen in early October that the Fed would raise interest rates far beyond the neutral interest rate level of 3%. This report has consistently forecast that U.S. and international economic and financial conditions will be shaken by the Fed's excessively zealous pursuit of rate hikes, forcing the Fed to revise its hawkish stance and bringing U.S. interest rates and USD down, thereby resulting in a strengthening of JPY. It seems that that prediction may finally be coming true. As explained later, the intensification of the risk-off mood since early December is clearly causing JPY to soar, and one has to focus on the sustainability of this mood.

In this context, some say that a strong JPY trend (≈ risk-off mode) is also unlikely given that stock prices will rally once the Fed adopts a more dovish stance. There is some truth to this, but those who hold this view seem to be confusing two different time-frames. The Fed needs a significant reason to switch to a more dovish stance – this could be anything from an economic slowdown to turmoil in the financial markets to an escalation of geopolitical risks. However, it is due to some major development of this kind that the Fed would change its position, so in the short term at such times, "bullish stock markets" are likely to copy "cautious bond markets." This is well reflected in the graph on the previous page, which shows how the Fed's rate hikes more or less coincide with highs posted by the NY Dow Jones Industrial Average. In other words, in the ordinary scheme of things, the Fed only acts after the event, and its accommodative monetary stance takes effect subsequently with a time lag, resulting in a recovery in stock prices. In the process of this recovery, both U.S. interest rates and USD decline, exerting upward pressure on JPY. This has conventionally been the pattern seen with regard to JPY trends, and I believe this time will be no exception.

The Genuine Risk-Off Phase that Began in December

In December, Secretary of Defense James Mattis announced his resignation following discord with President Trump, some government agencies have closed down due to budget standoffs resulting from a divided government, there was commotion over reports of President Trump discussing the possibility of firing Mr. Powell, and an awkward attempt by Treasury Secretary Steven Mnuchin to dismiss the reports. All this caused liquidity concerns to emerge for U.S. financial institutions and the Dow lost over USD 1600 over just one week. This is the largest fall the Dow has seen since the collapse of Lehman Brothers. Amid all this, USD/JPY has also been forced to decline. The turbulence in the markets since early December has been more severe than during other similar phases this year (February, October), causing not just stock prices but also crude oil, copper, high-yield bond, and other asset prices to tumble (see graph). This is a genuine risk-off phase, one in which currencies like JPY and CHF should be bought (and they are, in fact, being bought).



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

Motivated Just by a "Hatred" of the Fed?

There are many things worth discussing at this point, but the one thing market participants should really be worried about is developments related to reports of the firing of the Fed Chair. On December 21, Bloomberg reported that "President Donald Trump has discussed firing Federal Reserve Chairman Jerome Powell," based on information from Trump administration sources. Since July this year, the President has verbally intervened in the Fed's actions now and again. The markets have paid scant attention to these interventions, seeing them as merely yet another of the President's theories. However, after witnessing the stock market volatility that began in October, it appears that Mr. Trump may be at the end of his patience. At this rate, the Dow is likely, for the first time in three years, to end the year lower than it did last year. This would be a first-time experience for Mr. Trump.

Given Mr. Trump's penchant for treating high stock prices as a performance report on his administration, perhaps the recent brouhaha is not all that strange, but it is somewhat unexpected. So far, despite his criticism of the Fed's rate hikes, the President has been restrained in his language, showing respect for the Fed's independent status. Perhaps his real intent was to preserve the logic that rate hikes by the Fed, "which acts independently," are to blame for the economic slowdown, so as to insure his own protectionist stance against criticism. In other words, the President's wording appears to have been intended to scapegoat the Fed for the economic slowdown that is bound to take place in the not distant future. However, if he really wants to fire the Mr. Powell, then it seems as though he may simply have been acting out of hatred for the Fed, rather than anything very far-sighted. No one knows the real truth but the President himself, but the fact is that the government and the central bank have become more deeply embroiled with each other in recent years than they ever have been before.

It May be Possible for the President to Fire the Fed Chair

As per the latest reports, advisors have warned that "markets would erupt" if the President removed Powell, but is not clear whether the President has taken their advice seriously. For the time being, all we have is a tweet by Treasury Secretary Mnuchin on December 22, the day after the first report was published, quoting the President as saying, "I never suggested firing Chairman Jay Powell, nor do I believe I have the right to do so."

Having said that, Mr. Trump had tweeted on December 18, the day before the rate hike, that "It is incredible that (…) the Fed is even considering yet another interest rate hike," to which Mr. Powell had retorted at a press conference, "Political considerations play no role whatsoever in our discussions or decisions about monetary policy." Looking back at the history of the Trump administration, anyone who has disagreed has been buried. So, the President's desire to fire Mr. Powell may be only par for the course. The problem is whether such a thing is possible, given how much importance is placed on the independent status of the central bank governor. The "Federal Reserve Act: Section 10. Board of Governors of the Federal Reserve System" says "each member shall hold office for a term of fourteen years from the expiration of the term of his predecessor, unless sooner removed for cause by the President." Going by this, it seems that the President can, indeed, remove the chairman of the Fed. What is more, there are no provisions as to what constitute a "cause" (any valid cause seems all that is required).

Financial Markets Ratify President Trump's Claims

However, whether or not the President has the authority to fire the Fed Chief is not the key point at stake in this confrontation between President Trump and the Fed. What needs to be pointed out in all this confusion is a trend in the financial markets to silently approve the President's criticism of the Fed. More often than not, when President Trump criticizes the Fed's rate hike path, the bond market's response tends to be "end to rate hike path → decline in interest rates," while the buyback of JPY receives a boost in the forex markets. However, let us say this level of aggressive political intervention in the policies of the central bank is seen in an emerging country, that country's government bonds and currency would likely be sold off. Not just is this not happening in the case of the U.S., rather the exact opposite is taking place. This seems to suggest that many market participants think that inflation will not spiral out of control even if accommodative monetary policies in line with President Trump's political intent are continued.

In other words, people no longer believe the Fed's justification of rate hikes as a tool to prevent inflation. It is not as though the financial markets had until now believed the Fed's claim that the rise in U.S. interest rates following rate hikes were in order to prevent inflation. It would be closer to the fact to say that the markets had simply been going along with what the Fed was saying, and the Fed was able to pursue rate hikes with a light heart, knowing that the markets had already factored them in to a sufficient degree – in other words, the Fed was simply going by a mirror-reflection of its own policies in the market; it had fallen into a dog-chasing-its-tail situation, as former Fed Chair Alan Blinder would have described it. Returning to the problem of President Trump's criticism of the Fed, it now appears that he has proved his claims right through action (although it is a different question whether those actions behoove him as the President of the United States).

Market's Reaction to Firing: The Impact of the Rate Hikes Cannot be Erased in Retrospect

Assuming for a moment that the President does indeed fire Mr. Powell, what would the markets' reaction to this be? Ideologically speaking, the big question here is to find out the response to the loss of the central bank's independence, but practically speaking, the move can only result in the birth of a dovish Fed chief with a strong preference for lower interest rates, so the markets are likely to treat it simply as an event leading to lower interest rates, a weaker USD and stronger JPY. To begin with, the question of whether a central bank really needs to be independent under disinflationary conditions is one that is being asked not just of the Fed, but also of the BOJ in Japan and the ECB in the euro area. Therefore, some are bound to treat the loss of the central bank's independence as a minor issue, even though the rules and provisions will need to be clearly revised following such a change. Returning to the question of market response, it is certainly possible that a stock price recovery following a more dovish stance adopted by the Fed could prevent USD/JPY falling through the floor. However, it is too late to erase the impact of the series of rate hikes that have already been conducted, so my basic understanding is that the downside risk to USD/JPY remains high irrespective of the outcome of the issue under discussion. Again, "stock price recovery following a more dovish stance adopted by the Fed" is a development that counts on the "Trump put." It would be very amoral to expect this to continue in perpetuity. This recent event is a major source of "noise," but ultimately, this report's basic understanding that the true price of rate hikes is yet to emerge and will contribute to a U.S. and global economic slowdown in 2019 remains unchanged.

Overview of Tail Risks – Potentials for the Unexpected in Japan, the United States, and Europe

Tail Risks Associated with Japan, the United States, and Europe in 2019

Each month, this article examines and discusses the risks that have a relatively high likelihood of affecting the main forecast scenario, but this year-end edition of the article will take a slightly different approach in presenting an overview of tail risks that could possibly affect the scenario but are rather unlikely to eventuate. Since there has been no significant change to the overall risk scenario as described in this article since November, this edition will dispense with the usual 'Risks to My Main Scenario' section.

At the end of every year, financial institutions and think tanks release a variety of forecasts explaining their perspectives on the possibility of low-likelihood risk factors (so-called 'black swans'), and such forecasts attract considerable attention. One could discuss just about anything if one were to define the scope of discussion as including literally all kinds of low-likelihood risks, so such forecasts tend to focus on relatively 'interesting' risk factors. This article will take the approach of narrowing the geographic scope down to Japan, the United States, and Europe, and discussing the one risk factor for each region (a total of three risk factors) that I think merits the most consideration. People have diverse assumptions about the likelihood of such risk factors, and their opinions about whether a given factor merits being characterized as an 'interesting' potential black swan factor will probably be equally diverse. It might even be appropriate to use the intermediate term 'grey swan' to refer to low-likelihood black swan risk factors that seem somewhat more plausible than the rest of the bevy (flock) and therefore merit examination as a sub-scenario apart from the main scenario. Given the subtle complexity of such distinctions, however, it seems that comprehensively referring to low-likelihood risk factors as 'tail risks' is less likely to foster misunderstandings. In any case, the intention here is to consider the kind of prospective unexpected events that would subsequently be called an "x shock" (such as the 'Lehman shock'), and this seems to be something particularly worth doing at year-end, as people generally have a longer-term perspective when looking ahead to a new year.

The tail risks addressed by this article include, for the United States, "a complete cease-fire in the U.S.-China trade war as well as the opposite scenario of a decisive breakdown of U.S.-China trade relations"; for Europe, "a resumption of the ECB's quantitative easing"; and for Japan, "a BOJ interest rate hike".

U.S.-China Trade Relations – Cease-Fire or Complete Breakdown

For the United States, we will focus on the tail risks of "a complete cease-fire in the U.S.-China trade war as well as the opposite scenario of a decisive breakdown of U.S.-China relations." In 2019, the directions of many situations in the world economy are likely to be determined by the nature of developments associated with the U.S.-China trade war. Regarding the U.S.-China trade war, it seems that most people are anticipating "a continuation of moderate tension", and given that President Trump seems to be merely seeking to arrange a 'deal' (agreement) that benefits the United States, it seems quite likely that the U.S.-China tensions will in fact continue to be at moderate levels. It can be surmised that both sides would like to maintain a situation in which they challenge each other without trying to overplay their hands in ways that might devastate their trade relations. That can be considered the main scenario, while the cease-fire or complete breakdown scenarios are extreme scenarios outside the scope of market expectations. At the time this article was written – amid the 90-day U.S.-China tariff truce period arranged at the December 1 U.S.-China summit meeting – it may superficially appear that the situation is heading for some kind of lengthier armistice, but only a minority of those closely following this situation are anticipating that the two sides will truly resolve their disputes during the truce period. As President Trump was elected to his post partly based on his proposals to increase protectionism, there does not seem to be a compelling reason for him to abandon his emphasis on protectionism before seeking reelection in 2020. Moreover, since the United States' hardline posture regarding China is a conspicuous symbol of the overall U.S. protectionist agenda, it will probably not be easy to soften that posture.

Given the above points, an agreement for a complete cease fire in the U.S.-China trade war seems highly unlikely, and that is why the arrangement of a complete cease fire agreement (for example, the complete withdrawal of proposals for additional tariffs etc.), were it actually to happen, would be expected to have a major impact. Such a complete cease fire would have the potential for reversing the current trend of RMB depreciation that has been intensifying in step with the rise in trade-related strife, and such a reversal might position the forex market to play a decisive role in changing the direction of major trends in international financial markets. Since many international institutions and central banks have been revising their economic growth rate forecasts downwards based on consideration of the U.S.-China trade war's adverse effects, a complete trade war cease-fire could dramatically change fundamental assumptions about the world economy in 2019. In such a case, there is a high possibility that both U.S. interest rates and USD will remain firm. If President Trump were to reach an accommodation with China regarding the trade war, some bouts of turbulence in stock prices and the real economy might be unavoidable, and the possibility of such turbulence has been increased by the market turmoil seen toward the end of 2018. Even the case of such turbulence, however, President Trump may do his utmost to preserve his protectionist policies by attributing that turbulence to the Fed's monetary policies (interest rate hikes). It is thought that this situation may be associated with the sudden emergence of rumors regarding the dismissal of Fed Chairman Powell.

Breakdown of U.S.-China Relations as Reflected in 'Currency Manipulator' Designation

On the other hand, there is naturally a possibility that the U.S.- China trade war will escalate and lead to a sharp deterioration of trade relations between the countries. Such deterioration could manifest itself in a wide range of ways. Standard manifestations include the broadening of the scope of items subject to import tariffs and the raising of tariff rates, and trade could also be restricted by means of various import permit and approval processes. One possible example of such non-tariff measures is the December detention by Canadian authorities of a top executive of a major Chinese telecom equipment company at the request of the United States, followed by the detention of several Canadians by Chinese authorities in what appears to be a retaliation measure. There is a possibility that such measures may come to be used much more than is generally assumed.

From financial markets' perspective, however, the most conspicuous symbol of an intensification of the U.S.-China trade war would probably be the labelling of China as a 'currency manipulator' in the U.S. Treasury Department's

Semiannual Report on International Economic and Exchange Rate Policies (IEERP). A country designated a currency manipulator will have to engage in bilateral consultations through the IMF and thereafter may be subject to punitive tariffs and other measures. The consultation period and the content of sanctions are not stipulated in detail, and some observers do not think the consultations and sanctions will make much difference if the upshot were to be the imposition of additional tariffs similar to those already being proposed. Nonetheless, the currency manipulator designation is actually quite significant in that it officially positions the designator country to criticize the currency policies of the designatee country. If China is designated as a currency manipulator, people will generally become more inclined to anticipate the U.S.-China trade war's prolongation and intensification, and the impact of headlines about that situation may well undermine private-sector enterprises' and households' consumption and investment proclivities. By the way, the IMF's forecast of the U.S.-China trade war's potential impact describes a worst case 'confidence shock' scenario in which U.S. tariffs on all imports from China along with supplementary U.S. tariffs on Chinese automobiles and automobile components cause a deterioration of corporate psychology and a decrease in investment as well as exert secondary negative impacts on financial markets, and this indicates that there are considerable grounds for concern about such a scenario. Such a clear-cut initiative as a currency manipulator determination within the IEERP could easily trigger that kind of scenario.

In any case, it is undeniable that the U.S.-China trade war could potentially exert an overwhelming effect on trends in the world economy and international financial markets during 2019, so it is worth giving top priority to being wary of the eventuation of scenarios in which the trade war situation swings to one or the other extreme.

Resumption of the ECB's Quantitative Easing

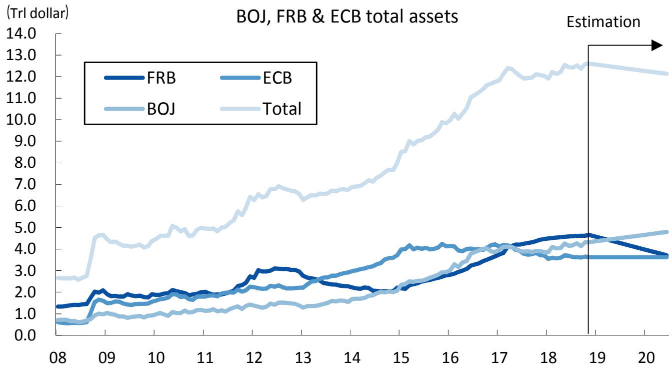
What kind of Europe-related tail risk is worth giving the most attention to? As always, there are numerous potentially perilous situations that are essentially political rather than being directly related to economic policies – such as those associated with the U.K.'s struggles to finalize the draft EU withdrawal (Brexit) agreement, the possibility of the U.K. leaving the EU without an agreement (a 'no deal' scenario), the implementation of a referendum on Italy's departure from the EU (Italeave), and the potential for a simultaneous departure of German Chancellor Merkel and French President Macron – and there are many rumors about such situations being bandied about in the financial markets. However, this article will refrain from discussing those situations at this time. Apart from those situations, other tail risk scenarios that are undeniably worth considering involve ECB policy moves that deviate from market expectations. In particular, although there is only a low likelihood of the ECB resuming quantitative easing, I believe it is worth considering that possibility.

As well known, at the December Governing Council meeting, the ECB decided to terminate the expanded Asset Purchase Programme (APP, generally referred to as QE), which it has been implementing since March 2015. As ECB President Draghi himself has said, however, while the utilization of the APP is slated to be discontinued, the APP itself will be retained in the ECB tool box to prepare for the possibility that it might be needed for responding to emergencies. Most observers are probably inclined to discount the possibility that the use of the APP might be resumed within a year, when the ink on the APP termination announcement has barely had a chance to dry. In light of the historical record, however, it cannot be said that there is zero possibility of such an APP revival. Looking back at the APP's history, for example, one finds that it was inaugurated in March 2015 with EUR60 billion of monthly asset purchases. About a year later, in April 2016, the monthly purchases were increased to EUR80 billion. After roughly another year, in April 2017, however, the monthly purchases were decreased to EUR60 billion. Nine months later, in January 2018, the monthly purchases were further decreased to EUR30 billion, and they were additionally reduced to EUR15 billion from October 2018. In light of the pattern of increases and decreases, one gets the impression that the ECB has a formidably strong desire to respond to economic trends by flexibly adjusting asset purchase levels. Moreover, the euro area is facing what should frankly be acknowledged to be extremely unfavorable political and economic circumstances, and it is quite difficult to avoid getting the impression that the ECB's current bullish policy posture has only a precariously optimistic basis. Many observers are inclined to doubt the veracity of the ECB's recent evaluation that "The risks surrounding the euro area growth outlook can still be assessed as broadly balanced."

Although the ECB has dispassionately maintained a hawkish attitude from 2017 through 2018, the statement presented following the last Governing Council meeting of 2018 qualifies the risk assessment with the additional sentence – "However, the balance of risks is moving to the downside owing to the persistence of uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility." One cannot help wondering if this addition might not be a preparatory move toward responding to the harsh conditions the ECB is expecting in 2019. If, as is now beginning to be anticipated, the Fed will pause its normalization process during 2019, the ECB can probably be expected to shift its emphasis from "the timing of interest rate hike resumption and QE reinvestment termination" to "the timing of APP resumption". It is likely that, at least the Italian government, which has been suffering from a long-term interest rate surge, is currently hoping to see such a shift. Given the challenging nature of the fundamental conditions related to politics and economics that the euro area is facing, it is worth keeping in mind the risk that the ECB's highly fragile normalization process will conclude with a move to revive the APP.

BOJ Reading the Significance of International Trends?

Last but not least, I would like to overview the tail-risks related to Japan. While many people may be inclined to give priority to such possibilities as consumption tax hike postponements and the Abe administration's retirement (along with the BOJ Governor Kuroda's retirement), I think it best to focus on potential changes to the BOJ's policy management, as that is probably the most important issue from the perspective of the financial markets. Specifically, while many observers believe that that the bullishness of U.S. and European monetary policy is now peaking out, I think it worth examining the risk that the BOJ might follow its own piper just a beat behind the Fed and the ECB in shifting toward explicit normalization (essentially, moving toward interest rate hikes). Looking at the situation at the time this article was written, one finds that (with the ECB's decision to terminate its asset purchases) the aggregate balance sheet value of the three leading central banks (the Fed, the ECB, and the BOJ) is projected to begin showing month-on-month declines beginning from January 2019 (see graph). From the start of 2019, it will probably be safe to say that the leading Western central banks' monetary policies are more hawkish than at any other time since the Lehman shock. That is precisely why – with U.S. interest rates rising and euro area interest rates also likely to trend upward – the BOJ may possibly face a market environment that could facilitate its own policy normalization initiatives.



(Source) Macrobond

(Notes) on the assumption that since 2019, FRB: minus 50 bio dollar per month, BOJ: plus 25 bio dollar per month, ECB: flat, exchange rate: as of end of NOV 2018

Of course, since yoy growth in Japan's consumer price index (CPI, core) is still restrained to roughly 1.0% year-on-year, it might be difficult for the BOJ to explain its rationale for explicit tightening. Moreover, there is a general consensus that the BOJ will be able to undertake only highly conservative and cautious policy management initiatives until after the consumption tax increase scheduled for October 2019 (and the BOJ has already presented forward guidance in line with that consensus). However, given the fact that market participants are now generally aware that negative interest rates are eventually accompanied by reversal rate side effects (that impair financial institutions' intermediation function), the BOJ might reasonably argue that the discontinuation of negative interest rates alone could actually have a positive effect on economic conditions. One increasingly gets the impression that the atmosphere within the BOJ is becoming one in which this argument has some positive resonation.

However, it is most likely that a lesson painfully learned during the BOJ's Shirakawa regime – "Even those policy measures that are correct in theory will be counterproductive when their articulation and timing are non-optimal." – remains a key element of the BOJ's way of thinking. If the timing of the FRB's discontinuation of interest rate hikes were to correspond (even roughly) to the timing of a BOJ plan to begin hiking interest rates, it would require considerable courage for the BOJ to implement such a plan – particularly in light of the stubborn insistence on the primacy of forex rates among players in the Japanese economy and society at large, who tend to attach even greater importance to forex rates than their counterparts in other developed countries – so it can be assumed that the likelihood that the BOJ would implement such a plan with that timing is extremely low. All the same, central banks do in fact sometimes demonstrate a determination exceeding the financial markets' expectations to realize their policy normalization objectives. It probably cannot be denied that there is a possibility that such a determination might be reflected in such easy-to-understand ways as the discontinuation of negative interest rates and the shortening (10 years → 5 years) of the interest rates targeted for control by means of yield curve control operations. Will the BOJ rigorously restrict itself to only highly conservative and cautious policy management measures despite its perception of the significance of international trends at a time when it appears that the global economy is peaking out while the Fed and ECB are turning the corner regarding policy normalization? The risk the BOJ might not restrict itself in that way is probably very small but yet not nonexistent.

EUR Outlook – "Increasing Caution" and "Continuing Confidence"

ECB Monetary Policies Now and Going Forward – APP Termination and Outlook Regarding Reinvestment

Combined Balance Sheets of the Three Key Banks Headed for a Decrease in Size

At this year's last ECB Governing Council meeting, in December, it was decided to keep the interest rates on the main refinancing operations (MROs), the marginal lending facility (which is the ceiling of market interest rates), and the deposit facility (which is the floor of market interest rates) unchanged at 0.00%, 0.25%, and -0.40%, respectively, thereby also maintaining the interest rate corridor (the difference between the ceiling and the floor) unchanged at 0.65pp. It was also reconfirmed that the expanded Asset Purchase Programme (APP), currently held at a pace of EUR 15 billion/month, would be discontinued within the year, marking the end of a nearly four-year old program, which had begun in January 2015. Having said that, ECB President Mario Draghi has said that the use of the word "termination" could be the result of some sort of "confusion," given that reinvestments will continue. This will shine the spotlight on the fate of the reinvestment policy, the forward guidance for which was revised from the original "for an extended period of time after the end of our net asset purchases" to "for an extended period of time past the date when we start raising the key ECB interest rates." As of the current time, the first ECB rate hike is expected to take place sometime between October and December next year, so it is hard to believe that reinvestments will stop and the ECB's balance sheet will begin to shrink in 2019 (I will describe this later).

On the other hand, with the end of the APP, the BOJ will be the only one of the three key central banks (the Fed, the ECB, and the BOJ) to have a balance sheet that expands every month. To give you a very rough image, in recent months, the ECB's balance sheet has been expanding by about JPY 2.0 trillion (EUR 15 billion converted at the rate of JPY120 per EUR) a month, and the BOJ's balance sheet has been expanding by about JPY 2.5 to 3.0 trillion a month, while the Fed's balance sheet has been shrinking by about JPY 5.7 trillion (USD 50 billion, converted at a rate of JPY113 to USD) a month. Once the ECB's balance sheet levels off starting January 2019, the combined balance sheets of the three key banks will enter a clearly shrinking phase. This can be seen as yet another sign that the global financial climate is no longer in "post crisis" mode.

End of Reinvestments At Least 2-3 Years Away?

The duration assumed by the phrase "for an extended period of time" remains unclear, but there are some hints. Originally, the ECB had made a commitment to the markets that rate hikes would take place only after the end of the APP. This time, as Part II of this commitment, the ECB has said that reinvestments will be ending only after rate hikes have begun. Specifically, the ECB had originally been using the forward guidance "for an extended period of time, and well past the horizon of our net asset purchases" for its low-interest rate policy. This was changed to "at least through the summer of 2019" following the Bank's declaration in June that it would end the APP within the year. In other words, if rate hikes begin in September 2019, the definition of "for an extended period of time" would turn out to have been "about nine months." However, as the process of "ending APP → beginning rate hikes" has not yet been completed, the fact remains that we still do not know the exact length implied by the phrase "an extended period of time."

Naturally, there was a question probing the real meaning of the phrase. One reporter sought clarification, stating that "the general understanding" of the wording "extended period" was "six-to-12 months," but that "generally it is understood by investors that reinvestments will continue in full for two-to-three years." In responding to this question, Mr. Draghi, in a rare gesture, interrupted the reporter mid-question after he mentioned "the general understanding," asking "Sorry, who says that?" Following this exchange, he answered to the effect that he would not speculate on this "general understanding" of what the phrase meant. This being the case, it could even seem as though he may be supporting the "two-to-three years" theory, but in reality, the intent of his remarks is difficult to grasp. At any rate, it feels somewhat problematic that there seems to be such a great divergence in the meaning of the phrase "for an extended period of time" as it relates to interest rates and reinvestments in the ECB's communications.

The Assessment "Continuing Confidence with Increasing Caution"

Again, as I mentioned in the issue of this report released following last month's meeting, one wonders whether the ECB truly accepts that the economy is currently on the decline. One reporter asked, "Did you discuss changing the balance of risk to "tilted to the downside"? Did anyone call for that?" In response, Mr. Draghi

ECB staff outlook（Dec 2018） (%)

	2017	2018	2019	2020
HICP	**1.8～1.8**	**1.1～2.1**	**0.9～2.5**	**0.9～2.7**
(Previous：Sep 2018)	(1.6～1.8)	(1.1～2.3)	(0.9～2.5)	
Real GDP	1.8～2.0	1.1～2.3	0.8～2.6	0.5～2.5
(Previous：Sep 2018)	(1.8～2.2)	(1.0～2.6)	(0.6～2.8)	

(Source)ECB (Note) EURUSD is assumed to be 1.18 year 2018 and 1.14 year 2019-2020 emphasized that the decision had been unanimous, but even so, some clear changes are visible compared with the previous time. For instance, the caveat "However the balance of risks is moving to the downside owing to the persistence of uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility" was added after the line "The risks surrounding the euro area growth outlook can still be assessed as broadly balanced" in the Introductory Statement. The first question at the recent press conference was "Which are the risks you are primarily focusing on, which could be big-event risks also for your outlook?" Mr. Draghi's answer was that it was exactly the assessment of such risks that was the "focal point" of the discussion, and that the assessment could be summarized in a few words as "continuing confidence with increasing caution."

However, as per the ECB staff's economic and inflation projections, the real GDP growth rate outlook for 2018-21 follow a path of +1.9%→ +1.7%→+1.7%→+1.5% (see chart), with the figures for each year being downgraded by only 0.1 pp. Given the political turmoil in euro area and the weakening of its fundamental economic indicators, it seems fair to say that the ECB's outlook remains quite bullish. However, even if the ECB maintains that the risks are balanced, it seems rather difficult to begin rate hikes in a situation of "increasing caution." My prediction is that economic conditions in the euro area will remain largely unchanged during 2019, inevitably making the start of rate hikes by the ECB a difficult prospect.

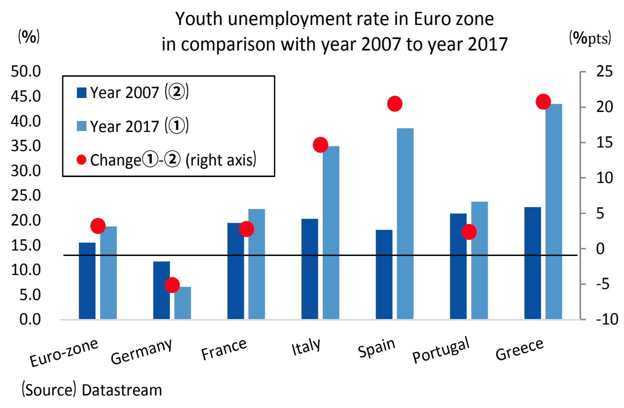
Uncertain future Reflected in French "Yellow Vests" Riots – Issues the EU Should Worry About

Ebbing of Popularity based on Hostility to the Far Right

The "yellow vests" demonstrations and rioting that broke out in Paris midway through November subsequently intensified and spread, eventually forcing the French government of President Emmanuel Macron to adjust its economic policies in December. Originally a movement to protest against a fuel tax increase scheduled for January 2019, the yellow vests movement (named after the high-visibility vests participants wear) has developed into a general protest against the Macron government and its various austerity policies. Since 2017, France has boldly introduced and escalated fuel and carbon taxes as part of its global warming countermeasures. While the taxes were intended to promote a shift to electric vehicles and other environmentally-friendly vehicles, they have placed a growing burden on France's already-stressed people and private sector companies. President Macron's popularity had already been diminishing owing to various of his initiatives – such as those to raise pension payment eligibility ages, ease employment regulations, privatize public facilities, and restore a conscription system – but it appears that the direct burden the populace feels from surging fuel prices triggered an explosion of national sentiment. Macron had an approval rating of over 60% when he won the presidential election in May 2017, but recent surveys indicate his approval ratings have fallen to below 20%. Much of President Macron's initial popularity was attributed to mistakes by far-right parties, the candidates of which Macron shunned, but that source of popularity has ebbed much more quickly than expected[1].

Seemingly Irreversible Divergence of German and French Economies since the Financial Crisis

In response to the yellow vests' demonstrations, the French government considered declaring a state of emergency but ended up shelving the fuel tax hike and making a sharp policy turn-about in promising to raise the minimum wage. While the fuel tax postponement and minimum wage hike may be last-resort desperation measures, they represent victories for the protesters and are likely to encourage resistance to other government policies going forward. There are also grounds for concern about how all this might affect the future behavior of the Italian government, which has been observing the French situation from the sidelines. However, there is a need to understand the original reason why the Macron government had been intent on introducing austerity and structural reform policies prior to its recent placatory appeasement concessions.



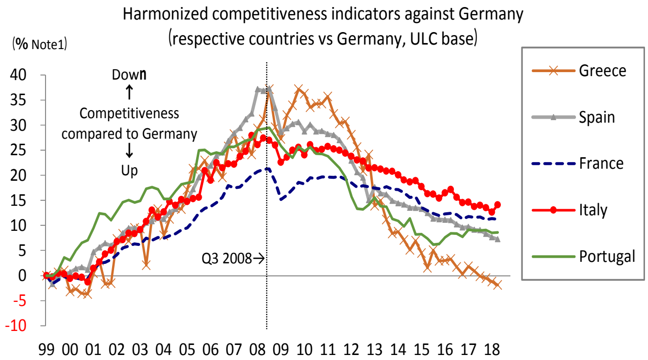
While this article must dispense with a detailed analysis for space reasons, the key issue is that the French economy has been in decline over the past ten years since the financial crisis, particularly in comparison to the German economy, and the implementation of various structural reforms was designed to reverse that decline. France has

[1] The May 8, 2017 edition of Mizuho Market Topic, entitled "Following the French Presidential Election – The Current Situation in France," pointed out the concern that mistakes by President Macron could promote a re-emergence of "Le Pen risk," and this is in fact what appears to have happened.

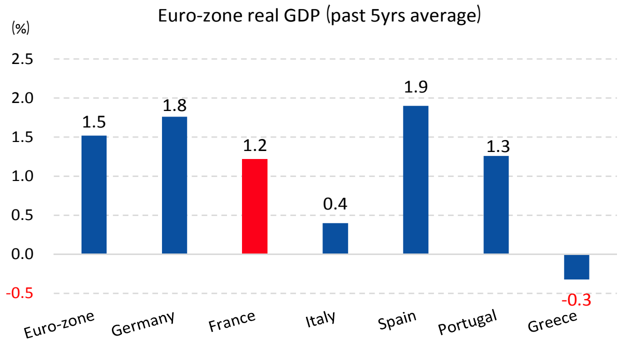
fallen so far behind Germany, at least economically, that it has become questionable whether one should continue referring to Germany and France as the euro area's "two major countries." The graph clearly shows that, since the financial crisis, the youth unemployment rate (for those aged 15 to 24) has improved in Germany but worsened in all the other euro area countries. It is also clear from the graph that France's youth unemployment rate was comparable to those of southern European countries as of 2007 and has edged up a bit more during the past 10 years. Although the French youth unemployment rate may not seem so bad when compared to the rapidly rising rates of other southern European countries, it can be still be said to be roughly in the range of the rates of the PIGS (Portugal, Italy, Greece, Spain). There had long been somewhat of a gap between the economies of France and Germany, but one gets the impression that growth the gap has been considerable and perhaps irreversible during the past 10 years.

High-Cost Structure Preserved in France and Italy

Unit labor cost (ULC) figures are frequently cited as measures of disparities between the economies of Germany and other euro area countries. In short, ULC represents "the cost of creating one unit of added value (real GDP)". Overviewing the disparity ULC in Germany and other euro area countries, one finds that the other countries, particularly southern European countries, bore a relatively heavy cost burden prior to the financial crisis. Following the crisis, however, the disparities have been rapidly shrinking. It goes without saying that this shrinkage has been achieved as a result of painful economic reform measures, and the rise in youth unemployment rates is considered to be one of the side-effects of those reforms. Looking at changes in individual countries' progress in shrinking the gap between their ULC figures and those of Germany during the period from June 2008 to September 2018 (see exhibit on previous page), one finds that Greece and Spain have achieved considerable shrinkage – 30% and 25%, respectively. The gap shrinkage achieved by Italy was only 17%, however, which was somewhat more than the 14% shrinkage realized by France. It appears that this pattern of gap shrinkage progress is related to the fact that, as of 2018, we are seeing more turmoil in Italy and France than in Spain or Greece. Roughly speaking, it seems that structural reforms in Italy and France have not advanced as smoothly as expected, and that these two countries have retained high-cost structures in various areas of their economies (in contrast to Germany). On the other hand, Spain is said to be a good example of a country that has made steady progress in improving its economic fundamentals by implementing basic reforms, such as a 2012 labor market reform measure that has relaxed employee dismissal-related regulations and increased the flexibility of wage negotiation processes. It has been reported that the Macron administration's reform measures, particularly efforts to promote labor market liquidity, were key factors spurring the recent yellow vest protests. However, the gap between French and German economic performance cannot be shrunk unless such reform measures are implemented. The graph shows euro area countries' average real GDP growth rates during the five years from 2013 to 2017, and it is noteworthy that Spain realized a higher growth rate (1.9%) than the euro area average rate (1.5%) and the rate of Germany (1.8%). On the other hand, France's growth rate (1.2%) is below the euro area average level as well as that of Portugal (1.3%).



(Source) ECB
(Note 1) (each country /Germany) x 100-100
(Note 2) Unit labor cost (ULC) =Nominal employees compensation / real GDP



(Source) Datastream

Two Concerns about the Weakening of the Macron Government

The problem is how France's economic situation will be affected by political trends going forward. In light of the current political situation, it appears that it will not be easy to reestablish the Macron government's popularity and authority. This gives rise to two kinds of concerns. One concern is related to the French presidential election scheduled to be held in 2022. The other concern relates to the direction of EU reforms.

The next French presidential election will be held in about three years. During the April-May 2017 election, Macron won an overwhelming victory over Marine Le Pen of the right-wing National Front (FN) party. However, it has been generally believed that one important factor promoting Macron's victory was a decision by many French citizens – in light of turbulence associated with the U.K.'s Brexit vote and the United States' election of President Trump during 2016 – to avoid creating yet a third politically destabilizing factor. Amid the growing momentum of the current worldwide trend of rising antipathy toward globalism and political elitism, it has been generally believed that the voter support for Macron – a pro-EU elitist figure – was not very solidly based. Given that Macron's voter support ratio has fallen to a third of its original level, it appears that those general beliefs were correct. However, France's current situation stems from its voters' decision to choose a pro-EU candidate and shirk the right-wing party. Of course, as noted above, fundamentally strengthening the French economy will require a relaxation of regulations related to corporate activities and the implementation of administrative and fiscal reforms of government activities in line with the Macron government's "small government" orientation, but those initiatives will not be forthcoming if public opinion does not support them. Looking back, it seems that Spain's successful implementation of reforms was largely due to a perception of urgency associated with the country's being forced to seek financial support, but it seems unrealistic to expect that France might develop such a sense of urgency. Given this situation, there is an undeniable possibility that such right-wing parties as the National Rally (RN) party (known as the National Front (FN) party until June 2018) may obtain increased voter support in the next election. Of course, it is impossible for Ms. Le Pen to forgo this opportunity, and she recently began calling for snap elections, saying – "Given the gravity of the political crisis, I cannot see any good way out of this except to return to the polling stations." A defeat of the Macron government could well provide a boost to populist forces in other EU member countries.

Another concern is related to the fact that the decline of the Macron regime is coinciding with the collapse of the Merkel regime. As explained below, German Chancellor Angela Merkel retired in December from her position as chairperson of the Christian Democratic Union of Germany (CDU), which she had occupied for about 18 years. President Macron and Chancellor Merkel are a politically compatible couple who have become widely referred to as "M&M" and "Merkron", and it is believed that the EU political stability they represented was a key factor underlying EUR appreciation during the May-June 2017 period. In fact, the EU did seem to have greater political stability than the United States and the UK at that time, but the situation has dramatically changed since then. In June 2018, the two leaders agreed on the creation of a common regional budget framework, which has been a long-standing objective for the euro area, and a proposal was recently made to start utilizing that framework by 2021. However, it seems most likely that the possibility that the two leaders' authority and energy will be greatly diminished before the details of the framework can be finalized and the approval of the member states can be obtained. If the common budget framework is shelved and a right-wing candidate were to take power in France (there does not appear to be any chance of that in Germany), it is likely that the common budget framework will be semi-permanently deleted from the political agenda along with such proposals as that for a common finance ministry. It is unfortunate for the EU's future that the Macron and Merkel regimes are likely to come to an end at nearly the same time. While the yellow-vest demonstrations are noteworthy in that they are an ongoing current event, it should also be kept in mind they have the potential to be a risk event with respect to the future of France, the EU, and international financial markets. In particular, it will be very interesting to see what kind of candidate French citizens will choose as their next leader in the wake of the yellow-vest demonstrations. There is considerable cause for worry.

Ongoing Shift to a "Post-Merkel" Germany and EU – The EUR 3.0 Era

Questionable Mandate for New CDU Chairperson

On December 7, the Christian Democratic Union of Germany (CDU) elected CDU Secretary General Annegret Kramp-Karrenbauer (the candidate supported by Angela Merkel) to succeed Merkel as the party's chairperson. While Merkel had served as CDU chairperson for about 18 years, since April 2000, the CDU's leadership is finally changing. Given that the new CDU chairperson is a confidant of Chancellor Merkel, however, the mainstream of German politics is not expected to diverge rapidly from Merkel's centrist policies. It is widely believed that the CDU had been gradually shifting leftward under Chairperson Merkel's leadership. That shift has successfully undermined support for the rival Christian Social Union (CSU) party on the left, but it has also been criticized for boosting support for the Alternative for Germany (AfD) party and other right-wing parties in recent years. The recent CDU chairperson election ended up pitting the centrist CDU Secretary General Annegret Kramp-Karrenbauer against the conservative (right-leaning) Friedrich Merz (a Bundestag member for 15 years until 2009), and it might appear that the CDU has had no difficulties in opting for status quo maintenance. In fact, however, no single candidate was able to win a majority in the first round of voting, necessitating a second-round run-off between Kramp-Karrenbauer and Merz. In the second round, Kramp-Karrenbauer won 517 votes to Merz's 482, and it is undeniable that CDU insiders are questioning whether such a narrow margin of victory could be considered a sufficiently clear-cut mandate for Kramp-Karrenbauer. In any case, the result obviated any shock that the financial markets might have otherwise been subjected to.

"CDU not addressing its problems"

Although Chancellor Merkel's policies have greatly weakened the CDU's voter support, the CDU has chosen to replace her with Kramp-Karrenbauer, who is widely caricaturized as being a carbon copy of Merkel or "Merkel 2.0," and there are certainly some people saying that the CDU is not addressing its problems. (The appellation 'Merkel 2.0' was coined by AfD leader Alice Weidel.) Objectively considered, it is hard to understand how the CDU can regain its former level of voter support while maintaining its current support for welcoming refugees, sustaining austerity measures, and distancing Germany from the United States and Russia while seeking closer ties with China. CDU Chairperson Kramp-Karrenbauer has sought to strike an intraparty power balance by appointing Paul Ziemiak – a strict conservative regarding refugee policies who is still quite young at only 33 years old – to the position of CDU secretary general, but it is unclear how effective a balancing measure this will be given that the party's conspicuous 'face' will be an avatar of Chancellor Merkel. (On the other hand, since the CDU party secretary general post is often a springboard for becoming the next prime minister, the significance of giving this post to a conservative is not small.)

Germany major political schedule

Schedule		Election type
2019	23-26 May	European parliament elections (to 26th)
	26th	Bremen
	1 SEP	Freistaat Saxony, Brandenburg
	27 OCT	Thuringia
2020	FEB	Hamburg
2021	MAR	Baden-Württemberg, Rhineland-Palatinate, Saxony-Anhalt
	SEP	Mecklenburg-Vorpommern, Berlin
		Federal Elections

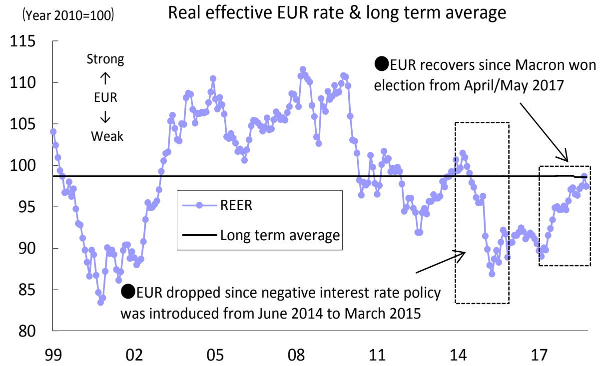
(Source) Made by Karakama with several sources

The first major test of CDU Chairperson Kramp-Karrenbauer will be the CDU's showing in the European Parliament elections to be held this May. Thereafter, there will be state elections in Hamburg[2] in May, Saxony and Brandenburg in September, and Thuringia in October. A large amount of attention will be focused on whether Kramp-Karrenbauer can put an end to the sharp downtrend in the CDU's popularity seen during 2018 (see table). If the CDU does not muster strong performances in those elections, it will be questionable whether Chancellor Merkel will be able to retain her post until 2021.

"Euro 3.0" and the "Last Bastion" of Traditional Centrism

As already noted, France's liberal Macron regime is facing severe challenges. While this article has repeatedly pointed this out as being problematic, when President Macron resoundingly won his position in May 2017, U.S. and U.K. politics were in turmoil owing to the election of President Trump and the result of the Brexit referendum, encouraging some people to think it was realistic to expect Germany's Chancellor Merkel and France's President Macron to not only wield effective leadership in Europe but also restore a certain amount of stability to the global political situation. That has been a factor promoting EUR's recovery since early spring of 2017 on a real effective basis (see graph). Only a year and a half later, we are witnessing a completely unexpected turn of events in that both Merkel and Macron are on the verge of becoming political has-beens. In light of pre-European Parliament election poll results and France's political, economic, and financial situations, President Macron's base of support seems quite tenuous. If Germany offers its extreme right-wing parties an opportunity to gain power at this point, the overall European situation will be one in which the mainstream political parties of all core and semicore EU countries are in decline. Although it may be somewhat of a mere coincidence regarding historically inevitable trends, it can still be considered noteworthy that the period of Angela Merkel's CDU leadership corresponds to that of the EU's common currency and the period of Angela Merkel's chancellorship corresponds to that of the European financial bubble's creation and collapse. Indisputably Europe's top political figure, Chancellor Merkel was in danger of being forced from power owing to the results of Germany's federal elections last September, and at that time it seemed that the EU and EUR may have entered a third phase. The EU/EUR phases include phase ①, from the "dawn of EUR" through the heydays (1999-2007); phase ②, from the financial crisis through the emergence of a departing country (2008-2016); and phase ③, 2017 and beyond. In line with computer jargon, this last phase might be called "euro 3.0". Phases ② and ③ are similar in that they both include crises but are quite different regarding the presence or absence of crisis-moderating "breakwaters." During phase ②, for example, the development of populist groups threatening the previously existing political parties was not seen in such EU "honor student" countries as Germany, Austria, and the Netherlands. Given that anti-EU populism is now growing

Real effective EUR rate & long term average



(Source) BIS (Note) Long term average : average after 1999

2 Berlin and Hamburg are special cities that operate as municipalities as well as being individual states within the Federal Republic of Germany.

throughout the EU, it can be said that euro 3.0 is a phase in which the general acceptance of the EU/euro systems can no longer be taken for granted.

As reflected in the CDU's latest party leadership transition, the CDU can be considered a kind of "last bastion" of strength among the traditional political parties. Campaigning for the CDU chairpersonship position, Kramp-Karrenbauer indicated that she was aware of the "last bastion" situation when she described the CDU as – "the last unicorn in Europe — the last large remaining 'people's party.'" (The term "people's party" is used in Germany to describe broad-based centrist parties.) With the CDU having elected a conventional leadership, it appears that efforts will continue to be made to protect the "last bastion" and may somehow succeed, and yet it can also be said that the CDU election of a conventional leadership is a development that the AfD welcomes, as it may facilitate the AfD's attacks on the CDU. Early in 2018, eight relatively small northern European countries established the New Hanseatic League as a means of counterbalancing and countervailing the leadership of such larger countries as France and Germany, and it will be important for CDU Chairperson Kramp-Karrenbauer (considered to have a strong chance to become Germany's next chancellor) to give due consideration to the New Hanseatic League's agenda. Euro 3.0 is an era in which various initiatives will have to be orchestrated to see if the EU can survive by countering the progressive erosion of a stable, centrist community spirit, and at least one of the major candidates to steer the EU through this era has now been determined.

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