

Forex Medium-Term Outlook

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Overview of Outlook

In June, USD/JPY fell to the 106 level for the first time since January but recovered right away and still lacks a sense of direction. With regard to the “next move” by the Fed, attention has already shifted away from whether or not there will be a rate cut, to how many rate cuts there will be, and in mid-June, there were times when the U.S. 10-year interest rate slipped below 2% for the first time since November 2016. Finally in June, this report’s main scenario of “a correction of the USD strength of the past five years as U.S. interest rates decline” may have begun to come true. While many argue that rate cuts have already been factored in by the market (and that, therefore, JPY appreciation will be limited), I believe that a significant weakening of USD is inevitable once the policy interest rate begins to fall. However, there are strong predictions that the Fed’s rate cuts this time will be similar to its rate cuts in 1998 – in other words, it seems unlikely that they will continue long enough to merit the term “phase.” Further, it is hard to believe that the Trump administration, facing another presidential election in November 2020, will stand by idly as the economy cools, so I too am currently inclined to believe that the upcoming phase of rate cuts will be “short and shallow” in response to an economic “soft patch,” rather than “long and deep” in response to a “recession.” However, taking into account the level to which U.S. unemployment rates have fallen, it is natural to predict a cyclical economic slowdown, and it would not be surprising to see market trends dominated by the weakening of both U.S. interest rates and USD at least for the current forecasting period (the next year or so).

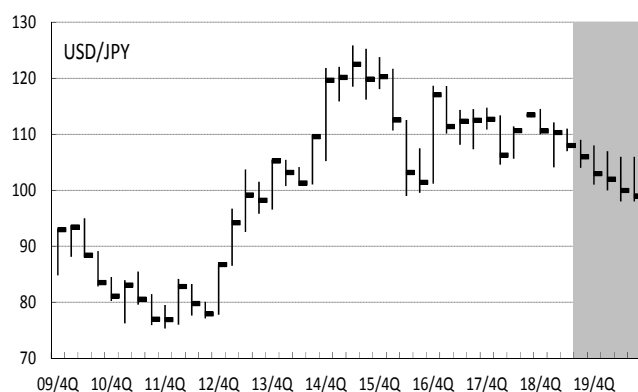
Meanwhile, EUR remains strong, contrary to the weakness of euro area fundamentals. Following the June Governing Council meeting, the ECB watch focus has shifted dramatically from “a phase of rate hikes” to “a phase of rate cuts.” There is strong speculation that the ECB “wants to cut rates in an attempt to weaken its currency,” and in June, statements by relevant officials backing this idea were reported and widely discussed. In his speech at the ECB’s annual meeting, which has been drawing a lot of attention in recent years, ECB President Mario Draghi suggested a resumption of rate cuts and quantitative easing (QE), drawing a sharp reaction from U.S. President Donald Trump. However, even the ECB’s strong easing bias and blatant stance in favor of weakening its domestic currency has not been enough to stem the tide of U.S. interest rate and USD decline in the face of Fed rate cuts. The ironclad rule in the forex market is that U.S. currency and monetary policies determine forex rate trends, and this was reaffirmed by EUR rate trends in June. This report’s main scenario continues to be that EUR strength will intensify during the current forecasting period mainly due to USD weakness.

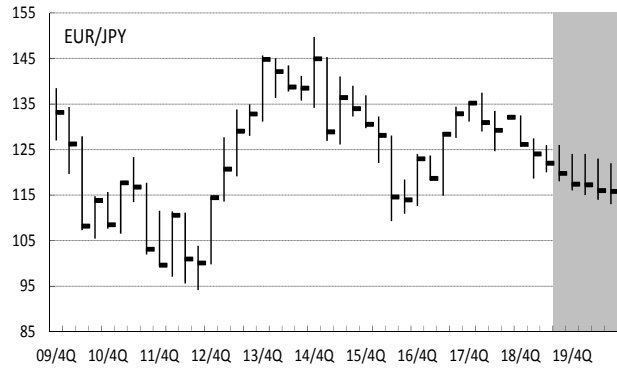
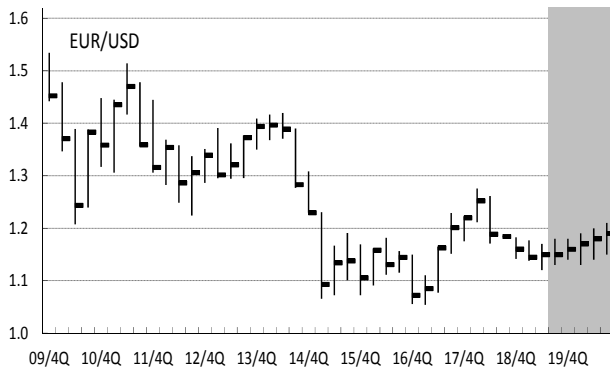
Summary Table of Forecasts

	2019			2020		
	Jan -Jun (actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.10 ~ 112.40 (107.68)	104 ~ 109 (106)	101 ~ 108 (103)	100 ~ 107 (102)	98 ~ 106 (100)	98 ~ 106 (100)
EUR/USD	1.1106 ~ 1.1570 (1.1370)	1.11 ~ 1.16 (1.13)	1.12 ~ 1.16 (1.14)	1.11 ~ 1.17 (1.15)	1.12 ~ 1.18 (1.16)	1.13 ~ 1.19 (1.17)
EUR/JPY	117.85 ~ 127.50 (122.46)	118 ~ 126 (120)	116 ~ 124 (117)	115 ~ 124 (117)	114 ~ 123 (116)	113 ~ 122 (117)

(Notes) 1. Actual results released around 10 am TKY time on 28 June 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts





USD/JPY Outlook – The Conceit of Assuming that “Rate Cuts Have Already Been Factored in”

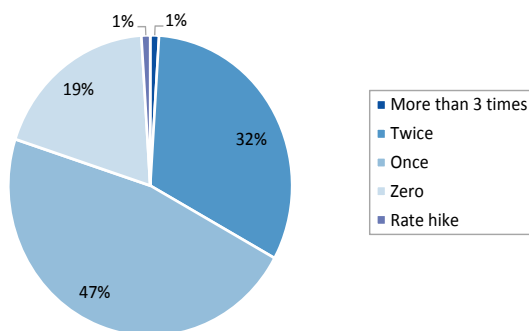
Expectation Gap Between Forex & Interest Rate Markets – Best not to be Too Sure that “Rate Cuts Have Already Been Factored in”

Expectation Gap Between Forex & Interest Rate Markets

The recent monthly survey (survey period June 10-12, released June 15) of forex market participants jointly conducted by QUICK Corp. and Nikkei Veritas discovered something interesting. The results are pregnant with hints for understanding forex rates, especially USD/JPY, now as well as in the future, so I would like to introduce them. Amid a decline in U.S. interest rates, USD has weakened across the board, but when it comes to the USD/JPY outlook, some say that “most interest rate market participants have already factored in 1-2 rate cuts for this year (95% have factored in one rate cut while 70% have factored in a second), so even if rate cuts are suggested or implemented in the coming months, JPY will not strengthen as a result.” I believe, however, that such a theory is dangerous. There is no guarantee that the expectations factored in by interest rate market participants have been fully factored in by spot forex market participants in the same way. For instance, in May, there was an uptick in remarks by senior Fed officials hinting at rate cuts, and these resulted in a stronger push to sell off USD in the forex market. However, looking back at the interest rate market early this year, “no rate hikes this year (status quo for the time being)” had been factored in by almost 100% of participants, and if the time frame was expanded to include 2020, 30% of participants had even factored in rate cuts. The marked decline in the U.S.-Japan interest rate gap during January-April this year was probably influenced by predictions of future rate cuts. Despite this, USD/JPY remained strong during that period, which may have been mainly due to the fact that the absolute level of U.S. interest rates still remained high, but it may partly also have reflected the fact that the forex market was not yet feeling the end of the normalization process as keenly as the interest rate market.

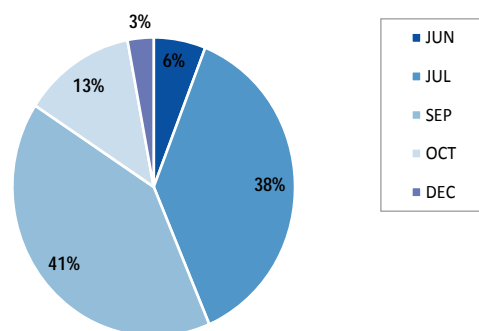
The results of the recent QUICK monthly survey appeared to reflect this expectation gap between forex and interest rate markets. According to the survey, in response to the question “How many times do you predict the Fed will cut its policy interest rate in 2019,” the largest percentage of respondents (47%) answered “Once,” followed by 32% answering “Twice,” and 1% answering “Three times” (see figure to the left below). Adding these numbers up gives the percentage of respondents who expect that the Fed will cut rates within the year, but this comes up to barely 80%. In other words, the survey shows that 20% of respondents assume that there will be no rate cuts this year, which indicates the gap between the forex and interest rate markets, with almost 100% of the latter factoring in rate cuts.

How many times do you predict the Fed to cut policy interest rate in 2019?



(Source) QUICK monthly survey FX

When do you predict the Fed's first rate cut?



(Source) QUICK monthly survey FX

Expectation Gap Also in Terms of Timing of Rate Cut

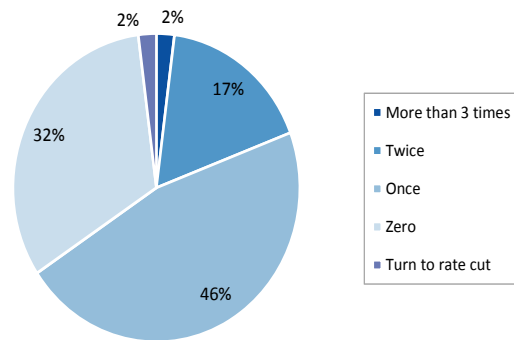
The difference in expectations between the interest rate and forex markets is not limited to whether or not there will be a rate cut, but also in terms of when. In the above survey, those who responded that they expect the Fed to cut rates were additionally asked, “When do you predict the first rate cut will take place?” (see figure on the previous page, right). “September” was the response of the largest percentage of respondents (41%), followed by “July” (38%), “October” (13%), and “December” (3%). Meanwhile, in the interest rate market, 80% of participants had factored in a July rate cut as of the time of the start of this survey (June 10), indicating a significant gap between the expectations of the forex and financial market participants. What is more, 50% of interest rate market participants had factored in a second rate hike by September, indicating that there is likely to be a major difference in the understanding between the two markets.

Expectation Gap Between Forex and Bond Markets

Incidentally, the QUICK and Nikkei Veritas joint monthly survey of forex market participants conducted in February 2019 included the question “How many times do you predict the Fed will raise its policy interest rate in 2019?” (see figure), revealing the mood at that time, when a rate hike was thought inevitable. In response to that question at that time, 32% answered “None,” and 2% answered “The Fed will start cutting rates.” In other words, in February this year, no more than 34% of forex market participants had anticipated a suspension of rate hikes or subsequent rate cuts.

However, as mentioned at the start of this report, nearly 100% of interest rate market participants had factored in “no rate hikes this year” around the same time. It is quite obvious, therefore, that there is a certain gap in expectations between the interest rate and forex markets. Of course, this survey does not speak for the whole of the forex market. Still, taking into account the points mentioned above, it seems rather dangerous to assume that the reaction of forex market participants will be weak in the event of an actual rate cut simply because interest rate market participants have already factored it in. I believe there is considerable scope for the spot USD/JPY market to move in tandem with a revision of the Fed’s policies.

How many times do you predict the Fed to raise policy interest rate in 2019? (February 2019 survey)



(Source) QUICK monthly survey FX

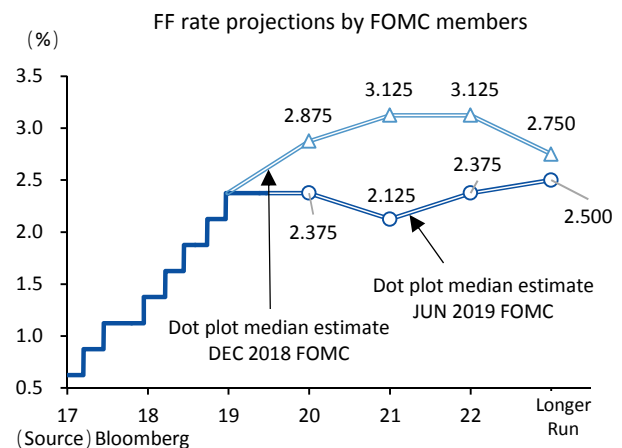
U.S. Monetary Policies Now and Going Forward – Confusion Resulting from the Push to Create Policy Space

Rate Cuts – From “Whether or Not” to “How Much”

At the closely watched June 18-19 FOMC meeting, the target range for the Federal Funds (FF) rate was kept unchanged at 2.25-2.50%. There were two changes made to the statement, (1) with regard to rate cuts, the phrase “the Committee will be patient” was removed, and (2) this was replaced by “the Committee will act as appropriate.” Further, the understanding that “uncertainties about this outlook have increased” was added to the statement, indicating that the recent meeting may have been the opening act for rate cuts to come. At this meeting, St. Louis Fed President James Bullard voted against keeping the FF target range unchanged, seeking instead to lower it by 25 bps, but was rejected. The dot plot of interest rate projections by FOMC members, however, indicates that nearly half (8 out of 17) of the members expect a rate cut by 25 bps or 50 bps by the end of 2019. The focus of attention for the year, therefore, seems to have shifted from “whether or not” there will be rate cuts, to “by how much” (25 bps or 50 bps) rates will be cut.

A Farce Resulting from the Push to Create Policy Space

Taking a look at the dot plot, last time (as of March), 11 out of 17 FOMC members had forecast no change, four had forecast one rate hike, and two had forecast two rate hikes. In other words, none of the members had anticipated a rate cut. This time, however, there has been a dramatic change – of the 17 members, one forecast one rate hike, eight forecast no change, one member forecast one rate cut, while seven members forecast two rate cuts. “Two rate cuts” includes both members who predict a 25-bp cut twice, and those who predict a 50-bp cut once, and could, therefore, include members who expect a 50-bp cut in one stroke in July. The figure to the right compares the latest dot plot with the one from December 2018 (soon after the Fed implemented its fourth rate hike). As is obvious at a glance, the orbit of forecast policy interest rates has changed completely, with as much as



(Source) Bloomberg

a 100 bp difference in the projected FF rate for the end of 2020. As for the end of 2019, both the median and mode of forecasts was 2.375%, which seems to be a downward revision of only 50 bps compared with the December 2018 projection, but this is due to the eight members who predicted no change. Since the remaining more than half of the members predict a rate cut, it would not be wrong to assume that the dot plot has been downwardly revised even more than the figure indicates. Compared with half a year ago, the Fed has gone from a macro-economic tightening mode, with a policy interest rate surpassing the neutral interest rate (2.75% at that time), to a macro-economic stimulating mode, with a policy interest rate lower than the neutral interest rate (2.50% at the moment). It seems, rather, that the dot plot could invite confusion if such a dramatic policy revision is permitted.

To be sure, in the past six months, there have been events such as the intensification of the U.S.-China trade war and the confusion surrounding Brexit, which have increased uncertainties. Having said that, there have been no dramatic changes in the economic or financial climates to warrant such a sharp turn, going from projecting “four rate hikes” in a year to “two rate cuts” in a year. For instance, looking at the Fed staff economic projections (SEP, median of forecasts), the real GDP growth rate forecast has been slightly upgraded and the forecast unemployment rate is even lower. With regard to unemployment rate, the long-term forecast (which is considered to be the same as the natural unemployment

rate) has also been lowered, so the recent lowering of the unemployment rate does not entail a shrinking of the supply-demand gap (in other words, it is not expected to inflate prices). Even so, the fact is that the growth rate for the current forecasting period has been raised. It has to be said, therefore, that a sharply dovish turn in monetary policy operation at this time does not seem justifiable. The Trump administration’s protectionist policies are definitely causing uncertainties to increase, but that has been viewed as a risk since last year, not to mention that President Trump’s erratic words and actions have become more or less normalized in a manner of speaking. The inflation trend was also not very strong to begin with. Ultimately, therefore, it seems that the Fed’s previous stance of prioritizing the creation of “policy space for future rate cuts” over the fundamentals has resulted in this policy operation farce.

FRB economic outlook (multiple forecast, %) as of JUN 2019

	2019	2020	2021	Long-term
Real GDP Growth rate as of MAR	2.0 ~ 2.2 (1.9 ~ 2.2)	1.8 ~ 2.2 (1.8 ~ 2.0)	1.8 ~ 2.0 (1.7 ~ 2.0)	1.8 ~ 2.0 (1.8 ~ 2.0)
Unemployment rate as of MAR	3.6 ~ 3.7 (3.6 ~ 3.8)	3.5 ~ 3.9 (3.6 ~ 3.9)	3.6 ~ 4.0 (3.7 ~ 4.1)	4.0 ~ 4.4 (4.1 ~ 4.5)
PCE inflation rate as of MAR	1.5 ~ 1.6 (1.8 ~ 1.9)	1.9 ~ 2.0 (2.0 ~ 2.1)	2.0 ~ 2.1 (2.0 ~ 2.1)	2.0 (2.0)
Core PCE inflation rate as of MAR	1.7 ~ 1.8 (1.9 ~ 2.0)	1.9 ~ 2.0 (2.0 ~ 2.1)	2.0 ~ 2.1 (2.0 ~ 2.1)	

(Source) FRB

President Trump’s Anger at His Own Reflection in the Mirror

In June, President Trump made the headlines for his verbal attack on Mr. Draghi following the latter’s suggestion that the ECB may implement additional monetary easing. It has to be said that this seems rather hypocritical considering the extent to which the Fed has turned dovish, and given that this may have been at his own instigation. On June 19, amid concerns that the BOJ could also be affected by this series of rows, Japan’s Vice Finance Minister for International Affairs Masatsugu Asakawa, quite appropriately, issued a message stating, “Members of the G7 and G20 group of nations have agreed to tolerate monetary accommodation measures taken by member nations so long as they are not intended to help weaken the domestic currency.” There is something quite difficult to forgive in President Trump’s behavior, whereby he scraps these kinds of international gentlemen’s agreements with a single tweet.

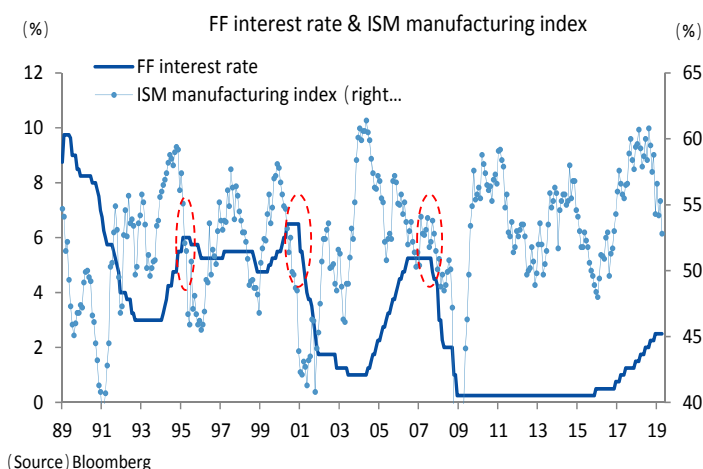
So far, President Trump has meddled, without exception, in domestic monetary policy operation as well as overseas trade relations, but it is abnormal to interfere in the policies of other countries’ central banks, which even their own governments are hesitant to meddle with, and could increasingly isolate him. The fact is that, in a world mostly following the floating exchange rate system, the Fed is unique among central banks in having the power to arbitrarily set currency trends as well as to give continuity to those trends, so of all the central banks in the world, freedom from political intervention is most important in the case of the Fed. Mr. Draghi’s remarks did, to be honest, intend to invite EUR depreciation, but the fact is that EUR ended up appreciating against USD following the recent FOMC meeting. It is very clear that the Fed’s actions, U.S. interest rates, and USD are what create forex market trends.

The June FOMC meeting was the start of a phase of rate cuts by the Fed. As the Fed becomes more dovish, upward pressure will increase on JPY and EUR, placing the BOJ and the ECB in a position of having to consider what their next move should be. In a way, President Trump being angry with foreign central banks attempting to deal with the appreciation of their domestic currencies seems as futile as being angry with his own reflection in the mirror. In this report, I have persistently claimed that EUR and JPY will appreciate as USD weakens across the board, and now finally, there is an increased likelihood of my forecast scenario coming true.

U.S. Economic and Financial Situation Now and Going Forward - Is it Right to Declare Trump's Remarks "Inappropriate"?

FF Rates and Leading Economic Indicators

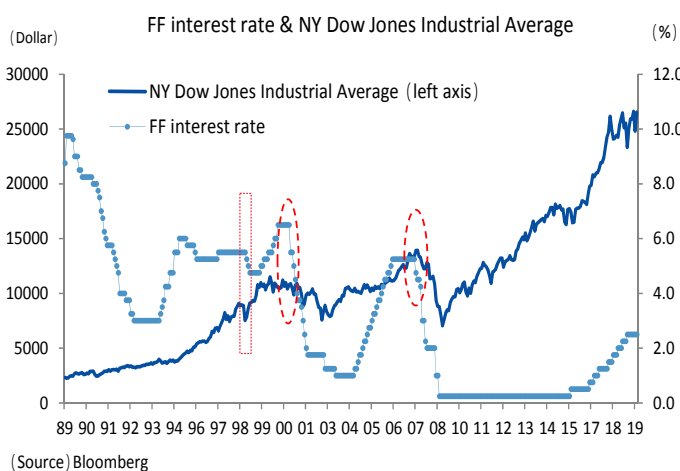
Following the June FOMC meeting, the focus with regard to U.S. monetary policy, has shifted from "whether or not" the Fed will cut rates, to "how many times" it will cut rates. Note, however, that the Fed is likely to adopt the stance that its rate cuts are "preventative" in nature, rather than a too-late response to a cyclical economic slowdown. However, as I have argued several times in this report, by the time a slowdown in employment and wage growth can be confirmed, the phase of economic expansion has usually ended and a phase of economic contraction has likely begun. This is true also of general price-related indicators such as the personal consumption expenditure (PCE) deflator. It is recognized that the response of price-related indicators to economic cycles is rather slow. On the



other hand, soft data including ISM manufacturing indices (hereafter: "ISM") are leading indicators of the economic cycle in addition to stock prices. In other words, had there been a stable correlation between the ISM and FF rates, "preventative rate cuts" would be implemented before the economy really entered a phase of contraction. In this context, looking at the correlation between FF rate and ISM trends over the past 30 years, it seems that the Fed has embarked on rate cuts only after the ISM has deteriorated significantly (see figure on previous page, portion within dotted circle). At least during the past two phases, rate cuts only began halfway through a steep decline in the ISM. There is nothing to indicate that the Fed has sensitively perceived a deterioration in business sentiment to implement "preventative rate cuts." However, the fact is that rate cuts have, indeed, been implemented after business sentiment has begun to worsen markedly, so given that the ISM has recently been showing a steep decline, it would not be easy for the Fed to get away with maintaining the *status quo*.

Betting on the Wealth Effect

Meanwhile, one gets the impression that FF interest rates reflect the movement of stock prices, another leading indicator, more vividly than they reflect the ISM. While maintaining that "monetary policy does not exist for the benefit of stock market investors," it seems the Fed finds it rather difficult to ignore changes in the stock market. However, partly due to the effects of the unprecedented financial crisis, it is not entirely clear whether stock prices are a reliable leading indicator of the economy. Rather, it seems in some senses to be simply a "reflection of monetary policies." Stock prices have rallied since early June, but as is widely known, this is in response to the confidence that the Fed will cut rates. In this climate, there seems no way the Fed can return to talk of normalization, suggesting an abortion of rate cut plans or an eventual resumption of rate hikes.



The question is – is this "obliging relationship" that exists between the central bank and the stock market sustainable? In the case of economies like Japan or the euro area, where the ratio of stock ownership in the household sector is not very high, raising stock prices through accommodative monetary policies is unlikely to curb the slowdown of the actual economy. However, given that shares account for over 30% of the financial assets of U.S. households, it is likely that an "obliging relationship" between the central bank and the stock market could have the practical effect of boosting the real economy via the wealth effect. The ratio of U.S. households' net assets to the nominal GDP has continued to post all-time record highs, and it seems likely that this has made up for the lackluster wage growth. If so, it is not impossible that, if the Fed continues to indulge the stock market, the resultant wealth effect may help it avoid a predicament.

Fed Likely to Use Up Its Few Remaining Options

However, the fact that the unemployment rate appears to have declined to the level of the natural unemployment rate is a problem. Even if the Fed devoted itself to an unabashedly dovish monetary policy, is it really possible to post strong job data as in May as well as keep the financial market stable? Going forward, it is quite possible to envisage a scenario of Nonfarm Payrolls (NFP) consistently falling below +100 K mom, unemployment rates consistently rising, and the slowdown in wage growth becoming more conspicuous. Looking back, there was a phase early this year when the stock markets

rallied at signs that the Fed's stance may become more dovish. At that time, stock prices were boosted by speculation of a postponement or suspension of rate hikes, but this time, it is the switch to rate cuts that is responsible for pushing up stock prices. Ultimately, the Fed may be able to avoid dramatic volatility by continuing to placate the stock market, but this will come at the price of losing the few options left to it. It is worrisome to think that the Fed may rush to find ways of appeasement every time the financial market throws a tantrum as a result of job data or other hard data related to the U.S. economy deteriorating. Under such circumstances, it is easy to imagine that more and more rate cuts may be expected no matter how many times the Fed cuts rates, inevitably leading to another expansion of the balance sheet. Most market participants do seem to believe that the Fed will only implement one or two "preventative rate cuts" before calling a halt to it, but whether or not this is the case will depend on the extent to which the employment situation deteriorates.

Japan's Monetary Policies Now and Going Forward – Unable to Withstand Correction of USD Strength

No Point Revising a Guidance that Nobody Believes to Begin With

As the Fed's rate-cut stance becomes obvious, across-the-board USD depreciation accelerates in the forex market. In response to this, both the ECB and the BOJ have made it clear that they will have to take additional monetary easing measures to counter the upward pressure on their domestic currencies. In fact, both Japanese and euro area interest rates have fallen, but the currencies have not been able to withstand the larger trend of a "correction of USD strength." As I persistently point out in this report, given that USD strengthened consistently over the past five years, it would not be surprising to see the process of correction continue for a while. The economic and financial conditions are not remarkable either in the euro area or in Japan, but it may be best to assume that the two currencies are entering a phase when they will continue to be affected by upward pressures in the forex market, where the value of a currency is always determined in relation to another.

As expected, monetary policy remained unchanged following the BOJ Monetary Policy Meeting held on June 20, and the extension of the forward guidance, which was being rumored in some quarters, was also postponed. The monetary policy statement newly included language that strongly pointed out the risks, saying, "Downside risks concerning overseas economies are likely to be significant, and it also is necessary to pay close attention to their impact on firms' and households' sentiment in Japan," but the basic economic assessment was kept unchanged at "moderate expanding trend." Since this has to be changed before additional monetary easing can be implemented, there is no sense that a decision on this count is going to be made right away. At the most, it can be said that there is an increasing suspicion that the forward guidance will be revised at the July meeting, when the Outlook for Economic Activity and Prices report is released. Specifically, the current language "the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020" is likely to be revised to "the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through the end of 2020 (or until 2H of 2020)." Needless to say, this revision outwardly indicates a response to the downside economic risks, but is, in reality, a response to JPY appreciation.

Having said that, faced with the Fed, which has the policy space to implement 9 rate cuts (although the rate cuts themselves will be the first in 10 years), there is very little the BOJ can do. Perhaps its opening move will be a revision of the forward guidance, but revising a statement that no one places much trust in to begin with is like sprinkling drops of water on parched soil. For instance, in June, Mr. Draghi made waves by taking the lead in stoking monetary easing expectations, but far from depreciating against USD, EUR actually appreciated. It is feared that the BOJ and JPY will also meet the same fate. Rather, having declared that "correction of USD strength" will be the trend for some time to come, I think it would be best for the BOJ to stop at revising its forward guidance, to avoid needlessly using up its cards, thereby making an already difficult exit strategy even more hopeless.

First Rate Cut in 10 Years Could be Powerful Enough to Launch Strong-JPY Trend

After the press conference following the June meeting, BOJ Governor Haruhiko Kuroda presented his understanding of the market by stating that "(since the markets have factored in a July rate cut by the Fed,) nothing will change (i.e., JPY will not strengthen) even if something happens in July." In theory, this may be true, but as I have already explained, expectations factored in by the interest rate and forex markets do not necessarily coincide. With regard to the June FOMC meeting, most market participants had been expecting that, even if the monetary policy itself was kept unchanged, at the very least, the statement would be revised to suggest a shift in policy stance in the direction of a rate cut, and that was, indeed, what happened. Even so, JPY clearly appreciated against USD as a result. It is probably best not to assume that the expectations factored in by the interest rate market are the same as those factored in by the forex market. Further, the July rate cut would be the first in 10 years, and is likely to have significant impact as something that signals the start of a new phase. The first thing to do, therefore, is to set aside the belief that JPY will not appreciate simply because certain expectations have been factored in by the interest rate market. Under such circumstances, I think it is reasonable to believe, as per the forecast scenario of this report, that JPY and EUR appreciation will be the basic trends over the next year as USD weakens across the board.

China's Foreign Currency Reserve as a Catalyst – Could this be the Agent of Change?

Where to Look for the Next Catalyst?

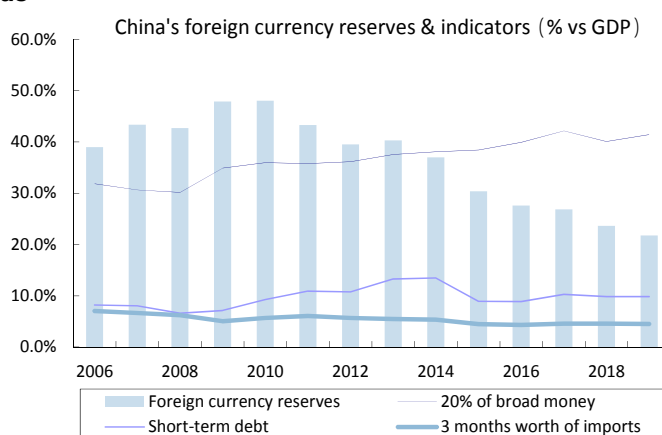
Currently, one of the questions I am most frequently asked by clients who visit on a daily basis or during Q&A sessions following lectures is, "What could be the catalyst for a dramatic change going forward?" In the financial markets, transaction-related factors that could invite dramatic change are called "catalysts," and what with the persistently deadlocked rates of recent years, market participants seem keen on searching for potential catalysts. The U.S.-China trade war and the UK's exit from the EU (Brexit) ought to have been catalysts, but one cannot help feeling that they have now fizzled out as catalysts despite the issues not being fully resolved.

Taking present circumstances into account, the lead candidate among potential catalysts is thought to be "a rate cut by the Fed." Not just FF rate futures market trends but even hints at a rate cut in an FOMC statement could act as the trigger. Over the past two years, this report's basic understanding has been that "a clear decline in U.S. interest rates is an essential requirement for USD strength, accumulated over the years, to begin being corrected." Specifically, I believe that U.S. 10-year interest rates consistently remaining below 2% is one of the conditions that could cause USD/JPY to fall below a 105-yen rate. Now that both the chair and vice chair of the Fed are indicating the possibility of a rate cut, such a development is no longer unrealistic.

Apart from rate cuts by the Fed coming into sight, a potential catalyst I am focusing my attention on is CNY rate volatility (something I have talked about several times in this report). I have discussed the battles surrounding a rate of 7.0 CNY to a dollar before, and this is because, in the tangle between "a weakening CNY" and "Chinese authorities who want to check its descent," there is the danger that CNY could crash unless policy efforts are made to control it. If the authorities had the ability to contain a situation through a feat of strength in a pinch, there would be no reason to focus on the fate of the battle. In August 2015, the Chinese government experienced out-of-control flight of capital, the accompanying depreciation of CNY (and CNY-denominated assets), and international financial turmoil resulting from this (the so-called "China shock"). Most believe that the Chinese government's intent is to prevent such a thing from happening again. Naturally, some of this is bound to be due to the feeling of "shame" that their country should be the epicenter of an international financial turmoil, but another part of it is thought to be due to the awareness that there are no guarantees of being able to contain the devaluation next time round. This is because of insecurities surrounding the Chinese foreign currency reserve, which serves as the ammunition for checking the depreciation of CNY in the event of a panic.

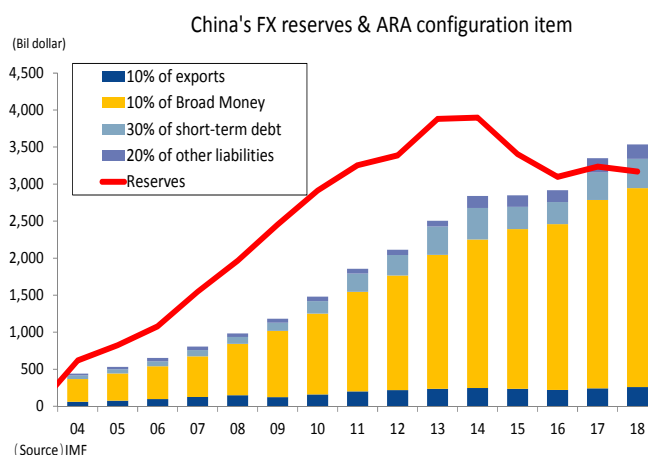
China's Forex Reserves "Insufficient" by IMF Standards

As of the end of April 2019, China had around USD 3 trillion worth of forex reserves. Traditionally, as a rule of thumb, an amount higher than three months' worth of imports, short-term debt, or 20% of money supply, etc., has been considered an appropriate level of forex reserves for a country to have. Going by these criterion, USD 3 trillion seems like a safe amount in some ways but not so safe in other ways. The figure to the right compares the trends of China's forex reserves, short-term debt, three-months' worth of imports, 20% of broad liquidity, all measured in the same unit, as ratios of nominal GDP. As is obvious at a glance, despite its significantly declined current level, the foreign currency reserve easily surpasses three months' worth of imports and short-term debt. However, concerns arise when looking at it in relation with the money supply (broad liquidity in this case).



(Source) Bloomberg

In recent years, the IMF has incorporated these traditional standards into a comprehensive new measure for evaluating the forex reserves of emerging markets under the head of Assessing Reserve Adequacy (ARA). Specifically, the new measure includes four items – (1) exports, (2) short-term debt, (3) money supply (broad money), and (4) other liabilities. The figure to the right plots the trend of China's forex reserves against this measure. The weight of each item from (1) to (4) is different depending on whether a country follows the fixed or floating exchange-rate system, and with regard to China, the IMF employs fixed exchange-rate system indicators¹. Items (1) to (4) are proxy variables for (1)



(Source) IMF

¹ As the figure shows, in the case of the fixed exchange-rate system, the ARA is calculated as a sum of 10% of exports + 10% of money supply + 30% of

the risk of a sharp decline in external demand, (2) risk related to the ability to repay short-term debt, (3) risk of capital flight, and (4) risk related to the loss of inward securities investment, and the composite of these risks is used as a measure of risk adequacy (i.e., ARA). Further, the reason why (1) is exports rather than imports is, as per the IMF's explanation, because "Export revenues are a good approximation of potential losses arising from a negative external demand or terms of trade shock" and many emerging markets, in particular, face this risk. Further, in addition to the fact that imports do not capture negative external demand risks, they are also problematic in that they could decline in times of recession and result in an improvement in a country's balance of payments, giving the wrong signal.

Meanwhile, it is (3) that is key when evaluating the relationship between China's forex reserves and its ARA. Following the 2015 "China Shock," the country's forex reserves declined by about USD 1 trillion. The reserves have remained stable since 2016, but the domestic money supply has continued to increase (in other words, the "risk of capital flight" associated with this has also increased), thanks to which the country's forex reserves have not been able to meet ARA standards since 2017. According to the IMF, the reason money supply is a proxy variable for the risk of capital flight is because it indicates the domestically available liquid resources that could potentially be sold in exchange for foreign-currency-denominated assets during times of crisis. In other words, as the domestic money supply increases, the risk of such money being invested overseas also increases, and the ARA measures whether a country has adequate reserves to apply the brakes on the trend in order to prevent chaos in the forex markets. As of the present time, China's forex reserves are pointed out to be insufficient in this context. The IMF recommends an ARA in the range of 100-150% of GDP (although there is also an upper limit because hoarding forex reserves could result in missed opportunities), but China's forex reserves have slumped to the 80% level as of the present (see figure).

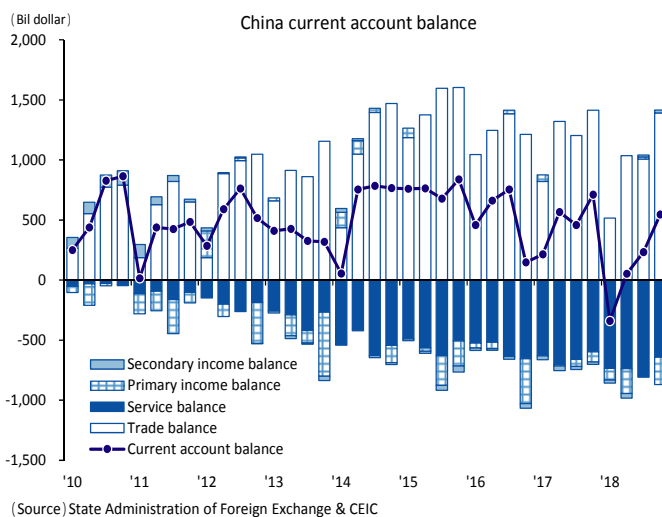


Under such circumstances, there seems to be some concern over the sufficiency of forex reserves, which could serve as ammunition to arrest the devaluation of CNY. However, in the case of China, the authorities are likely to harshly suppress the risk of capital flight at all cost, should it become necessary, so it may be inappropriate to spread anxiety based just on ARA levels. On the other hand, should such a situation arise, it could have the side effect of a decline in appetite to invest in CNY-denominated assets among foreign investors.

Dark Clouds Hanging Over U.S. Interest Rates

As I have discussed in past issues of this report too, maintaining a rate of 7 CNY to a dollar is no more than an act of face-saving by the Chinese government. The more this rate involves a price formation that goes against the will of the markets, the larger the scale of USD selling required to maintain it. Given that China's current account balance is not as enormous as it once was² (see figure), it is natural for CNY to weaken in line with a slackening of demand, and a certain level of free fall should be tolerated. "Certain level of" could also be read as "gentle," but of course, USD selling (a decline in forex reserves) would become necessary at such a time. However, the resultant damage would be less than that caused by fixating on the 7 CNY to the dollar rate.

The problem is that the U.S. Department of Commerce has recently indicated its stance of countering any efforts to devalue CNY with a view to offsetting the effects of additional tariffs by even more tariffs³. Specifically, in applying countervailing duty (CD) on Chinese goods that are exported to the U.S. cheaply with the help of subsidies from the Chinese government, the approach to calculating the level of government subsidy offered will include taking into account the impact of CNY devaluation. Since May 5, when President Trump indicated intent to raise tariffs on USD 200 billion worth of imports from China from 10% to 25%, CNY has been on a decline, and the recent statement issued by the Department of Commerce is widely thought to be a response to this. One can understand the sentiment of the U.S. authorities, of course, but on the other hand, some opine that the Chinese government by no means desires a weaker CNY. What is more, this may potentially be quite a



short-term debt + 30% of other liabilities. Meanwhile, in the case of the floating exchange-rate system, it is calculated as a sum of 5% of exports + 5% of money supply + 30% of short-term debt + 15% of other liabilities, which somewhat lowers the total amount of reserve adequacy required.

² Please see the April 18, 2019 Market Topic titled "USD Strength Unacceptable for China's Current Account Balance."

³ "The Department of Commerce Amends Countervailing Duty Process"

pressing problem if we take into account the current status of China's forex reserves.

The more additional tariffs the U.S. applies on Chinese imports, the weaker CNY will become in order to offset the tariffs, so the battle to maintain CNY at 7.0 to the dollar could become heated and draw market attention. Naturally, the greater the focus on this issue, the greater the volatility in the markets when USD/CNY does surpass 7.0. So long as the confrontation between the U.S. and China continues, a pattern of "tariff imposition by the U.S. → CNY weakening → CNY buying intervention → decline in China's forex reserves → market attention" is expected to continue, and combined with the memory of the August 2015 China Shock experience, the situation entails the risk of causing a major change in the markets.

Risks to My Main Scenario – Trump Administration Policies Affected by Upcoming Presidential Election?

Large Risk that Trump Administration Policies may be Affected by Upcoming Presidential Election

At this point, I would like to review the risk factors related to my main forecast scenario. As has been discussed numerous times, this article's main scenario anticipates "a correction of the USD appreciation that has occurred over past five years", and this correction is expected to cause appreciation of JPY and EUR. Since the most important risk scenarios are those related to JPY depreciation, I will focus here mainly on JPY depreciation risks. The main risk factors are listed in the table, and these have not changed much since last month. The most important of the risk factors is risk factor , which merits close monitoring as it appears

JPY depreciation risk factors

Risk	Detail	Possibility
U.S. economy is surprisingly robust	Unemployment rate not rising, ISM index hitting bottom & economic policy by the Trump administration	medium /high
Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war	low
BREXIT related	2nd referendum	low /medium
Additional monetary easing by BOJ	Funds supply with negative interest rates	low
Reacceleration in China & Europe	GDP acceleration	medium

(Source) Daisuke Karakama by Mizuho Bank

to be both the most important risk factor as well as the risk factor most likely to eventuate. Looking at one aspect of the situation – the U.S. unemployment rate – one finds that the argument is beginning to be made that the current unemployment rate (the lowest level in 49 years) is not excessively low and can be further lowered by restricting the influx of immigrants, although a further lowering of the rate may well increase the upward pressure on wages going forward. Also, a trend already taking place at the time this article was written is that the Fed has responded to economic deceleration by becoming more dovish, thereby intensifying the upsurge in stock prices. This may well have a persistent tailwind effect on the U.S. household sector, which is easily influenced by asset or wealth effects. (I have been assuming that the U.S. labor market trends were peaking out, and my main forecast scenario is based on the assumption that the increasingly apparent decline in employment would impede the rise of stock prices.)

A particularly important factor in all this is the upcoming U.S. presidential election in 2020. Is it realistic to expect President Trump to take no action to counter economic deceleration as the election approaches? While the hurdles on the path toward implementing expansionary fiscal policies seem quite high in light of the recent behavior of the U.S. Congress, there is a possibility that the various supplementary tariffs that have already been imposed might be successively eliminated or lowered. This suggests the possibility of a simultaneous eventuation of risk factors and . In the case that existing tariffs were eliminated or lowered, the U.S. economy may perceive that as a tax cut and respond accordingly. There is certainly a possibility of a positive response to such tariff cuts – particularly from financial markets, which are inclined to straightforwardly respond to such measures – although President Trump might be justifiably criticized for stirring up trouble to get credit for the solution. Both forex markets and financial markets are ineluctably influenced by the ups and downs of the U.S. economy, and trends in those markets can sometimes change dramatically in response to positive and negative U.S. economic trends. Naturally, if the U.S. economy becomes stronger than expected, any moves by the Fed to cut interest rates would probably end up being short-lived. As always, I feel that the difficulty of predicting the FRB's moves is the core element of the biggest risk factor.

Concerns about Clear-Cut Recovery Trends in China and Europe

Risk factor is also attracting considerable attention owing to the significant effect it may have on the Fed's policies. As the economic deceleration trend in China and Europe seems to be showing signs of bottoming out, the risk is essentially that the Fed will be so reassured by those signs that it will renew its policy normalization efforts. The Fed's widely anticipated July rate cut is seen as a precautionary measure, and many observers expect it to be similar to the temporary rate cut of 1998. Such a theory would be even more convincing if a trend of recovery in China and Europe were to become more clear-cut. I currently believe that the upcoming period may be a "short and shallow interest rate reduction phase" associated with a soft patch rather than a "long and deep interest rate reduction phase" associated with a recession but, even so, I anticipate that rate cuts may well continue throughout the forecast period (roughly one year). If the economic recovery trends in China and Europe become more clear-cut than expected, however, the interest rate reduction phase may end by the end of the year after only one or two rate cuts and be followed by renewed interest rate hikes in 2020. For the JPY appreciation scenario, this possibility is a big risk factor. Especially regarding Europe, economic trends during the past year have been so bad that it currently seems that there is no alternative to some kind of a trend of improvement. If the Fed were to conclude that the markets (along with the ECB) appeared to have become overly optimistic about the nascent improvement trend in a manner that might negatively impact the Fed's rate cut policy, it could possibly lead to an unexpected degree of JPY depreciation.

Decreased Likelihood of a Second Brexit Vote

Until last month, this article noted such worrisome political JPY depreciation risk factors as the potential for "a discontinuance of the Trump administration's protectionist politics" (≈ "a complete resolution of the U.S.-China trade war") and the possibility that "the Brexit initiative might be withdrawn following a second referendum". Of these risk factors, it now appears that the likelihood of the latter has become quite low. Former-foreign secretary Boris Johnson is considered by himself and others to be the farthest-right-leaning candidate to replace U.K. Prime Minister May, and he is also the farthest of the candidates from supporting a second Brexit referendum, of which the approval would represent a milestone on the path to the United Kingdom's potential retention within the EU. In a televised interview on June 22, Mr. Johnson pledged to implement Brexit on Oct. 31, with or without a deal. Mr. Johnson's chief rival, Foreign Secretary Jeremy Hunt, has made such statements as – "If we got to the 31st of October, and the EU have not shown the willingness to negotiate a better deal the political risk of no Brexit is far worse than the economic risk of no deal. I would take us out of the European Union in that situation." Neither of the two leading candidates seems likely to adamantly oppose a no-deal Brexit. Since it is still widely assumed that the parliament will not allow a no-deal Brexit, the possibilities of a further Brexit re-postponement or a second referendum cannot be completely ruled out, but it does appear that the United Kingdom's next leader will be promoting a harder-line negotiating posture that that of Prime Minister Theresa May.

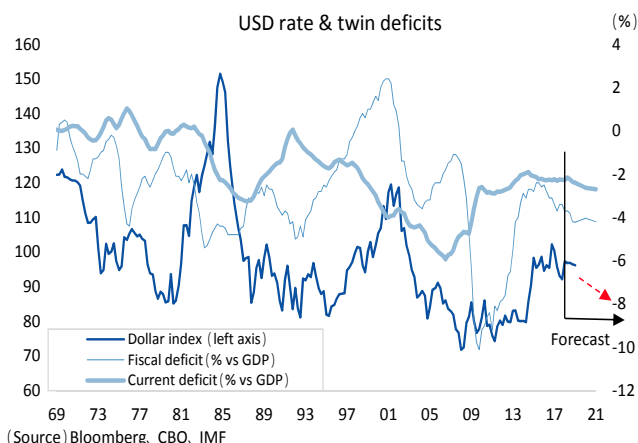
What about the potential for "a discontinuance of the Trump administration's protectionist politics" (≈ "a complete resolution of the U.S.-China trade war")? The results of the June 29 summit meeting between President Trump and Chinese President Xi Jinping were not yet known at the time this article was written but, as this article has repeatedly argued, if the US-China trade war reflects posturing related to the upcoming U.S. presidential election, then it is probably reasonable to conclude that there is zero likelihood of a complete end to the US-China trade war soon, at least during this year. With an eye to his reelection campaign, it appears that President Trump desires to continue playing the role of "the president who confronted China on behalf of fair trade", and it seems that he intends to sustain his basic strategy aimed at keeping relations with China moderately strained while avoiding sharp trends of deterioration or improvement. I believe the June summit meeting will merely serve to confirm this situation. A year from now, however, the nearer-term outlook for the presidential election might lead to some adjustments. By the end of next summer, for example, President Trump might consider it advantageous to conclude some kind of deal before launching his re-election campaign. As argued above, this is a plausible possibility owing to the fact that removing supplementary tariffs would inspire expectations of economic benefits associated with tax cuts.

JPY Depreciation Risks Originating in Japan – Concern about a "Next Move" Outside the Scope of Market Expectations

It continues to be thought very unlikely that Japanese factors will strongly affect USD/JPY trends but, in light of how dovish the Fed has already become, it seems inevitable that expectations that the BOJ will launch some sort of policy initiative will increase going forward. The March BOJ Monetary Policy Meeting expanded its general appraisal of current conditions with downward adjustments to its assessments of export and production operations, and the BOJ's forward guidance was adjusted in April to read – "the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020." Although the June meeting (held immediately after sharp drops in U.S. interest rates and USD) decided to maintain the policy status quo, it did add a strong description of risks – "Downside risks concerning overseas economies are likely to be significant, and it also is necessary to pay close attention to their impact on firms' and households' sentiment in Japan." It is widely believed that the BOJ has no strong policy cards left to play and making do with forward guidance adjustments is the limit of its capabilities, but it is precisely because the overwhelming majority of market players believe this that an unexpected and brilliant policy initiative would have the potential to bring about major market fluctuations.

War Risk with “Twin Deficit” Association a USD Depreciation Risk Factor

While this article has focused primarily on worrisome JPY depreciation risk factors, the risk factor range naturally encompasses JPY appreciation risk factors also. In fact, it seems to me that the number of JPY appreciation risk factors is relatively large. For example, the markets are now cognizant of the risk of war between the United States and Iran, and the trend of increase in oil prices is intensifying. Although the possibility of an actual war seems to be very low, it is a historical rule of thumb that U.S.-related wars tend to promote USD depreciation in connection with the United States’ “twin deficits” (see graph), making such wars a JPY appreciation risk factor. In addition, as described above, a “no-deal” Brexit is progressively becoming the default route, and this is another event



probably more likely to elicit JPY appreciation than JPY depreciation. Furthermore, if the U.S.-China trade talks go awry again, one can expect increased attention will be given to the frictions associated with the pegging of RMB at roughly USD1=RMB7.00. If the United States continues expanding the scope of its supplemental tariffs on Chinese goods, it will not be surprising to see the Chinese authorities consider the option of promoting RMB depreciation as a means of offsetting the effects of the tariffs. As discussed in detail in a previous edition of Mizuho Market Topic⁴, however, China is already incapable of maintaining its previous levels of current account surpluses, and a trend of RMB depreciation, while heartily welcomed by China, could easily spur a unwelcome replay of the China Shock situation that occurred on August 11, 2015, when China adjusted its USD/RMB pegging system and promoted sharp RMB depreciation along with a plunge in Chinese stock prices. In the case that China were to fail to successfully sustain the subtle adjustments entailed by its “optimized RMB depreciation guidance” program and thereby become unable to sustain the roughly USD1=RMB7.00 level, the situation might have the potential to stir up considerable market turbulence. Many observers consider it prudent to keep in mind the lessons of the China Shock.

In addition, the markets often tend to view a wide range of “negative” situations as being factors that promote JPY appreciation, but it would not be worthwhile to examine each such potential situation individually. During the forecasting period, there is a possibility that ‘distortions’ stemming from the record-long period of economic expansion could manifest themselves in innumerable problematic forms and locations. In light of current and prospective political and economic situations, most people would probably not be inclined to disagree with the view that the eventuation of JPY appreciation risk factors is more likely than that of JPY depreciation risk factors. Although I do not think that the U.S. interest rate reduction phase and the accompanying period of JPY appreciation will be a long-term situation extending over years, I believe there is no problem with maintaining this article’s main forecast scenario anticipating a decrease in U.S. interest rates along with across-the-board USD depreciation during the next 12 months.

⁴ Please see the May 20, 2019 edition of Mizuho Market Topic, entitled “Renewed Battle over USD1=RMB7.00.”

EUR Outlook – Intensifying Temptation of Currency Depreciation

Euro Area Monetary Policies Now and Going Forward – A Merely Formal Type of Forward Guidance

Back to the Starting Point Just Two Years After Sintra

At the June ECB Governing Council meeting, 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. Most attention regarding this meeting was focused on the precise terms of the new series of targeted longer-term refinancing operations (TLTRO3), but the meeting also modified the forward guidance (which observers had thought very unlikely) and made mention of additional easing measures, so the content was somewhat surprising. Although the attractiveness of TLTRO3 was somewhat diminished by the fact that the related interest rate will be 10 basis points above the average MRO rate, the benefits for financial institutions remain significant. On the other hand, given the effects of the prolonged period of negative interest rates and interest rate reductions along with such factors as hints about the resumption of quantitative easing (QE), financial institutions' operating environment is likely to be severe for the foreseeable future, so the need for such benefits has probably increased.

Regarding the discussions at the Governing Council meeting, ECB President Mario Draghi reported that there were three main topics – (1) the recognition that uncertainty has increased and become prolonged (2) the need for a more detailed analysis of risks, and (3) the readiness to act in cases of adverse contingencies. Overall, the topics reflect a generally pessimistic mood, but the impact of point (3) is large. The use of the phrase “stands ready to adjust all of its instruments” in the post-meeting statement hints that the “next move” will be one of additional easing, and it appears that the discussions on this point at the latest meeting were more in-depth than ordinarily. It has been exactly two years since President Draghi announced a path to future normalization at the annual ECB Forum in Sintra, Portugal, causing a surge of EUR appreciation, but it seems that the ECB has retreated back to the pre-Sintra-statement starting point.

“A Drop in the Ocean”-Type Forward Guidance Revision

Just recently, at the March Governing Council meeting, ECB revised its forward guidance text from “at least through the summer of 2019” to “at least through the end of 2019”, thereby pushing ahead the expected timing of the first interest rate hike from September to December. The June Governing Council meeting further revised the forward guidance to read “at least through the first half of 2020”, implying that interest rate levels will be kept as they are in the first half of 2020. As ‘the first half of 2020’ probably means a period up to as late as the end of June, the possibility of a rate hike during the next 12 months has been dismissed. It is not impossible that the forward guidance might be revised in an optimistic way in line with changes in economic and financial conditions from the second half of this year, however, and the possibility of such a revision is not low given that a new ECB president will take office this November. Looking at the content of the latest post-Governing Council-meeting statement and interview, however, it is probably reasonable to conclude that the main points are “terminating the normalization scenario” and “preparing for the next round of easing measures”. It literally seems that the Governing Council is merely preparing a “parting gift” for its successor as its president prepares for retirement.

I myself thought that it would be best to thoroughly revise the forward guidance immediately. Reflecting the impact of President Draghi’s speech at the ECB’s annual meeting on June 18 and other factors, at the time this article was written, interest rate expectations factored into EONIA futures suggested that there would be one interest rate reduction within a year and a second within a year and a half. Despite the most recent forward guidance revision, the forward guidance still suggests a certain degree of “motivation to raise interest rates in the first half of 2020”, and one cannot help noting the quite large gap between that posture and the nature of market expectations. Although the forward guidance has been revised, frankly speaking, the revision is akin to “a drop in the ocean”. Regarding this point, a reporter at the press conference posed the frank question – “[the Fed is hinting about interest rate cuts] whereas the ECB’s forward guidance still seems to be tilted towards a hiking bias. Is that correct that the next move in interest rates is more likely to be an increase than a cut?” It is natural that this question be posed, but President Draghi mustered only a monosyllabic response – “No ...” In light of the flow of events from June 2017, it would not have been surprising if President Draghi were to have confidently answered ‘yes’, but it is generally understood that saying “yes” is difficult given the mood since the start of 2019. President Draghi’s negative response gives the impression that the last breath of life has been choked out of the ECB’s normalization process.

EONIA & deposit facility rates of 26 JUN

	EONIA	Assumed deposit facility rate	Timing
Current	-0.37	-0.40	
6month forward 6months	-0.52	-0.55	APR 2020
12month forward 3months	-0.53	-0.57	JUL 2020
15month forward 3months	-0.55	-0.58	OCT 2020
18month forward 3months	-0.51	-0.55	JAN 2021
21month forward 3months	-0.52	-0.56	APR 2021
24month forward 3months	-0.49	-0.52	JUL 2021
24month forward 6months	-0.49	-0.52	OCT 2021

(Source) Bloomberg

(Notes) Assumptions associated with spread of deposit facility rate & EONIA is 3bps

Although the explanation is somewhat superfluous, the main reason cited by President Draghi for the latest forward guidance revision is “the prolongation of uncertainty”, which he described as stemming from such risks as those associated with protectionism, Brexit negotiations, and the vulnerabilities of certain emerging countries. It has already been proven statistically that the euro area economy is particularly vulnerable to the potential impact of such risks, as it is quite susceptible to the impact of external demand fluctuations, and the weakening of euro area manufacturing exports has made the region’s economic deceleration more noticeable.

President Draghi Embroiled in Financial Policy rather than Monetary Policy

Regarding point (3) mentioned early in this section of this article (the readiness to act in cases of adverse contingencies), President Draghi explained that related initiatives might involve further rate cuts, the possibility of restarting the asset purchase programme, or further extensions in the forward guidance. The ECB just terminated the expanded asset purchase programme (APP) half a year ago and, when one notes that the normalization process was already barely viable at the time of the March forward guidance extension, it is not surprising that the forward guidance extension was undertaken. President Draghi pointed out that – “in case these adverse contingencies were to happen, certainly fiscal policy will have to also come into consideration and play a fundamental role.” There is a worldwide trend toward recognizing that the emphasis should be placed on fiscal policy rather than monetary policy, and it is clear that the ECB is also giving recognition to this point.

There is naturally great interest in the question of what kind of situation would lead to a rate cut or QE, but President Draghi did not explain the relevant kinds of situation or required measures at the latest press conference. Regarding the circumstances in which the ECB might restart the expansion of QE, President Draghi emphasized that such measures could be taken at any time by responding that – “the European Court of Justice gave explicitly broad discretion to pursue in a proportionate manner our objectives and comply with our mandate” – but he did not address the issue of what specific conditions might lead to the restarting of QE expansion. Regarding negative interest rates and interest rate reductions, there is naturally concern about the potential impact of interest rate reductions, and President Draghi commented on this, saying – “there was a quite long discussion about whether the period of negative interest rates and whether especially the extension in the forward guidance is affecting banks’ profitability in a way that could hamper lending.” He went on to say that the Governing Council’s overall opinion is – “so far we see no effect” – but that the Governing Council recognizes that there might be such an effect if it were to further extend the forward guidance or decrease interest rates. He further explained that it is for this reason that the introductory statement makes reference to “mitigating measures.” Going forward, there is a possibility that new ECB moves to cut interest rates or extend forward guidance may be packaged as a set including such mitigating measures as those for the tiering of banks’ excess reserves balances subject to negative interest rates.

ECB’s Perception of Sluggish Inflation Expectations

Several questions at the press conference noted the lack of an increase in market-based inflation expectations. For example, the first questioner asked – “You’ve said in the past that [the slide in market-based inflation expectations] was because of negative risk premium predominantly [no deflation risk], but how long can you continue to see market-based inflation expectations so low below your aim?” – thereby directly tapping on one of the ECB’s sore points. The last questioner asked – “despite all your efforts in the past, inflation expectations are close to record lows. Are you concerned about the potential shock, which then would lead to a dis-anchoring of those inflation expectations? Is that the reason why you now mention all these instruments available?” As the graph shows,



the level of five-year, five-year forward inflation swaps (5-year, 5-year forward BEIs; an indicator traditionally emphasized by the ECB) has been approaching 1.20%, a historically unprecedented low level. It is natural that ECB watchers are keenly interested in this situation, because decreases in the 5-year, 5-year forward BEI level have historically been seen to trigger the ECB’s introduction and expansion of QE measures.

Regarding the low level of inflation expectations, President Draghi said – “of course we are concerned but we don’t see signs of de-anchoring, frankly. We see no probability of deflation as well. Because as I said survey-based expectations continue to be anchored at a level of 1.6%/1.7% in the long term.” He went on to say – “clearly, there is some disconnect here between what markets are seeing in the future and what people expect. [and the reason for emphasizing the stable expectations shown by surveys over the relatively instable market-based expectations is that] Markets seem to appear to see something bigger than simply trade disputes.” Although President Draghi refrained from opining about “whether [the market-based expectations are] correct or not,” one gets the overall impression that he believes the pessimism of the markets has become excessive. Financial markets certainly seek to factor in the most extreme scenarios, and it is reasonable for President Draghi to point that out. Although there was probably a real danger of de-anchoring when the 5-year, 5-year forward BEI level fell sharply in 2016, the perspective being emphasized regarding the current situation is that people are diminishing their inflation expectations in response to the deterioration of the economic outlook.

However, because it would be dangerous for a central bank to base its actions on tenuous assumptions, President Draghi said that – “from our side, what we have to do is to take this reading [such as the market-based expectations] seriously and be prepared.” That was his final sentence in the press conference. Although President Draghi’s recapitulation and summary at the end of the press conference was characteristically brilliant, it would be prudent to keep in mind the example of Japan, where survey-based inflation expectations are stable but there has been a slide toward deflation continuing to this day.

Euro Area Currency Policies Now and Going Forward – Desire for Monetary Easing Based on Desire for Currency Depreciation

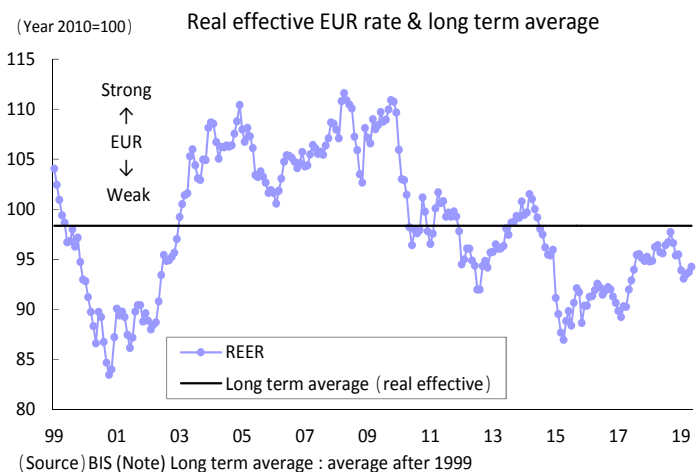
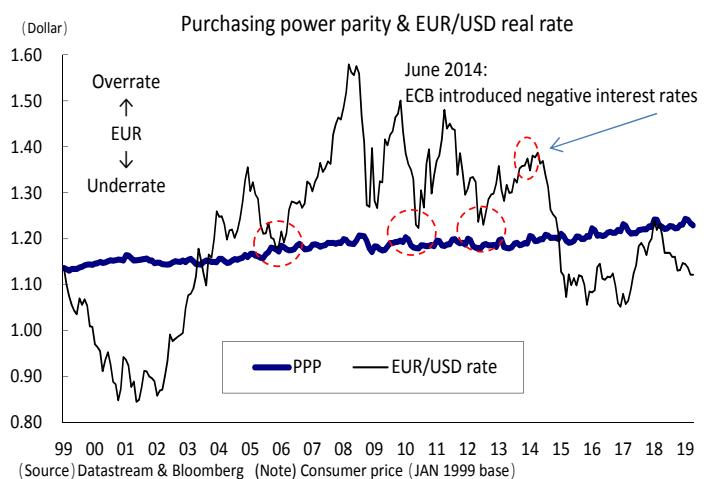
ECB Official Repeats ‘Exchange Rates’ Five Times as the Rationale for Interest Rate Reduction

An interesting news report emerged following the June ECB Governing Council meeting. On June 9, Reuters reported that ECB-related sources has said the ECB is considering the further reduction of interest rates with the objective of promoting EUR depreciation. The source is reported to have said “I’ll give you five reasons for a rate cut,” before repeating “exchange rate” five times. The same source is also reported to have said that EUR/USD1.15 would still be tolerable for some but EUR/USD1.20 would be a critical level to watch. Although it is not clear what position this source is in (he or she might be in a top ECB leadership position or a low-level staffer), many ECB officials from southern European countries are particularly nervous about the possibility of EUR appreciation. Although there are only very tenuous grounds for suspecting that it might be an Italian, one does get the impression that Italian officials are particularly likely to want EUR depreciation owing to the weak growth rate of Italy’s economy, which is on the brink of a recessionary trend. By coincidence, on the same day as the abovementioned Reuters report, Bank of Italy Governor Ignazio Visco stated in an interview with Bloomberg Television that the ECB will take further steps if risks threaten the economic outlook, saying – “If things somehow do not go as predicted, we will certainly act, there is no question.” But one wonders if it was really just a coincidence.

Significance of EUR/USD1.20

Why does the news source have the idea that EUR/USD1.20 would be a critical level to watch? It seems quite possible that the idea stems from the fact that that EUR/USD1.20 is considered to be roughly the level of the EUR/USD purchasing power parity (PPP) exchange rate. EUR/USD has generally weakened since the ECB introduced negative interest rates in June 2014, very rarely exceeding EUR/USD1.20 (see graph, above right). In the wake of ECB President Draghi’s June 2017 Sintra statement, EUR/USD rose above EUR/USD1.25 at one point (February 2018), but that level turned out to be unsustainable. While EUR/USD1.20 is the PPP level, there is not necessarily any basis for complaining that EUR is overvalued simply because EUR/USD exceeds that level – since the EUR PPP level is calculated for diverse countries including Germany, Italy and Greece, it will inevitably be higher than the actual PPP levels of southern European countries. On a real effective basis EUR was about 5% lower than its long-term average as of April this year (see graph, below right), and it does not seem so reasonable to make a fuss if EUR were to appreciate somewhat. People from southern European countries have a different perspective, however, which probably explains why they might make the kind of remarks reported in the abovementioned article.

It is worth noting that, at the post-Governing Council-meeting press conference in September 2017, President Draghi commented on the fact that EUR/USD1.20 had been exceeded for the first time in a long time, saying that two or three Governing Council members expressed concern about EUR/USD at the previous meeting in July and most members expressed such concern at the September meeting. While some euro area countries might not be concerned about the EUR/USD1.20 level, it is probably true that most euro area countries consider that level to be an important watershed level. As seen in the

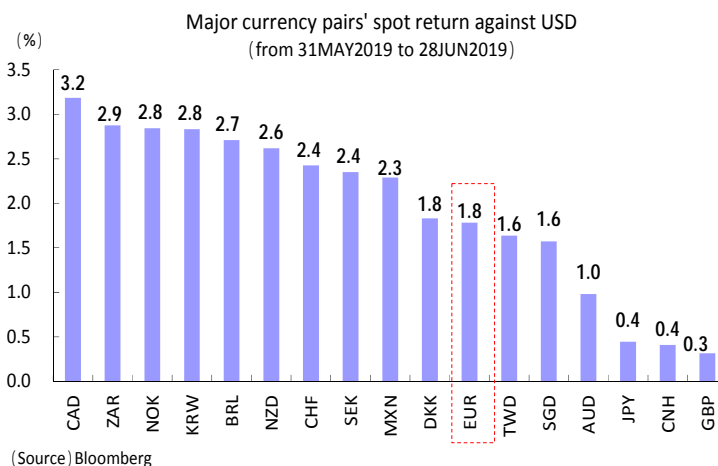


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case of the Reuters report, however, the ECB sometimes expresses its exchange rate-related concerns in an almost embarrassingly straightforward manner, and it would not be surprising to see such expressions create an international issue at some point.

Difficulty of Countering USD Depreciation

As this article has repeatedly pointed out, however, the direction of exchange rate trends is basically determined in line with the convenience of the United States, and the ECB or BOJ will find it difficult to greatly affect those trends regardless of how much they might try. Over the past five years the financial markets have operated based on the major premise that 'the Fed's next move is to raise interest rates', and it was normal to see U.S. interest rates and USD tending upward. As is well known, the full-scale roll-back of this pattern commenced from the beginning of June. In such a situation, it is necessary to consider individual currencies' forex movements against the overall background of adjustments made in line with U.S. interest rates and USD. Compared to Japan and



the United States, Europe continues to have relatively severe political and economic conditions. This and the ECB's hints about renewed easing measures might ordinarily be enough to cause EUR depreciation, but EUR has actually been appreciating against the backdrop of the full-scale adjustments being made regarding U.S. interest rates and USD. This is the case not only for EUR but for all other major currencies (see graph). The difficult-to-forecast forex world recognizes only one iron-clad rule – "The direction of U.S. currency and monetary policies has an absolute effect in the forex market." – and if the ECB seeks to countervail that rule, it is almost sure to merely demonstrate its powerlessness. This is the fate that the BOJ (and JPY) have accepted for many years now, and I think this fate must be accepted with respect to the currency of any country or currency union with large current account surpluses and stubbornly low inflation rates.

However, the euro area does have a "weapon" for promoting currency depreciation that Japan lacks. It is the internal strife among EU authorities centered on the European Commission and individual euro area countries, which has a high potential for generating disruptive and destructive effects. These structural inclination to worrisome disruptions does in fact have the potential power to effectively promote EUR depreciation despite the pressures stemming from USD depreciation, and it is Germany that has been enjoying the benefits of this power more than any other euro area country. Although this weapon has been effective, however, it is still questionable whether EU policy makers including the ECB are actually pleased to see the various developments associated with the weapon's utilization.

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