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Forex Medium-Term Outlook

30 August 2019

Mizuho Bank, Ltd.
Derivatives & Forex Department

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Overview of Outlook

USD/JPY steadily continues to weaken. The current phase of interest rate cuts by the Fed, the first in 10 and a half years and begun citing "insurance" as the reason, may become surprisingly protracted amid the intensifying trade war between the U.S. and China. Going by the minutes of the July FOMC meeting, opinion within the FOMC was divided, but it seems safe to assume that the rate cuts will continue at least during the current forecasting period. There also remains, as usual, an impression that, despite the deterioration in U.S. as well as global economic and financial situations, JPY appreciation against USD will be limited. This is because USD is appreciating overall in the forex markets. This may be partly because EUR, harmed by the dire political and economic situations in Europe, is unable to replace USD as an investment option as well as because of China's intention to devalue CNY in retaliation for the additional tariffs. As is generally understood, U.S. President Donald Trump is not happy with the persistent strength of USD. Although only as a risk scenario, the possibility of U.S. authorities intervening in the forex markets to weaken USD, which has existed since July, may be worth keeping in mind so long as USD strength in real-effective terms remains uncorrected. Meanwhile, one cannot afford to ignore developments related to phase two of the Trump tax cuts, which were hinted at in August – if it takes place, it could directly result in an unexpected weakening of JPY. Despite all the noise, it may be safe to assume that U.S. interest rates are unlikely to rise during the current forecasting period. Inevitably, USD/JPY seems likely to become top-heavy and continue to gradually weaken.

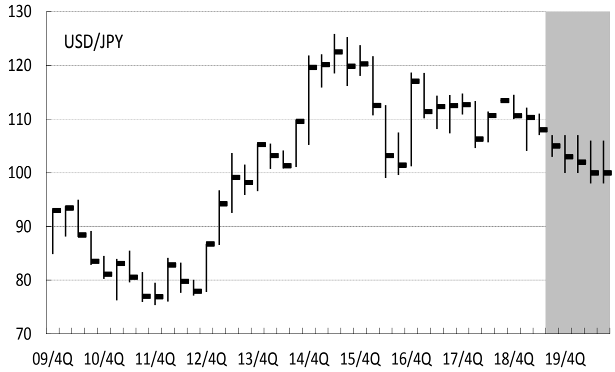
EUR also continues weak. Despite U.S. interest rates declining as a result of the Fed's switch to a more dovish stance, there is no relative increase in EUR buying; rather there seems to be a decline. The markets have factored in a further three rate cuts by the ECB by the end of 2020 despite the policy interest rate already having sunk to -0.40%, and German 10-year interest rates fell to the -0.70% level at one point. The Account of the July ECB Governing Council meeting did not just hint at a rate cut as the Bank's next move, but an entire monetary easing package including quantitative easing and a revision of the forward guidance, so EUR certainly seems difficult to buy at the moment. What is more, the euro area remains in a state of confusion, with fears of recession in Germany and Italy and continuing uncertainty over the fate of Brexit, so investors may be keeping EUR at arm's length based on the region's fundamentals in addition to its monetary policies. Having said that, with U.S. 10-year interest rates looking likely to fall below 1.5%, it is hard to imagine that USD will remain perennially strong just because it is in a "relatively better" position. I would like to keep my prediction that investors may reconsider purchasing EUR at some point, spurred on by the fact that the ECB has very little remaining scope for monetary easing and that there is strong underlying demand for EUR.

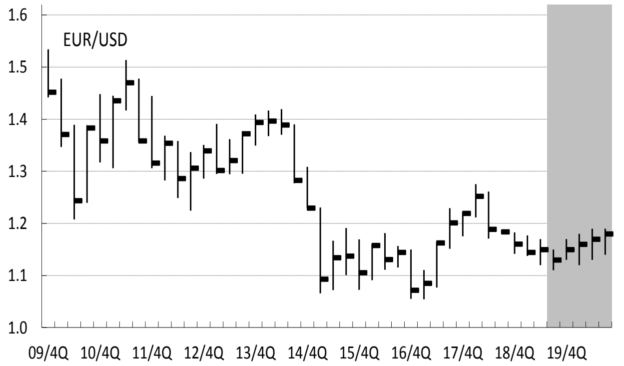
Summary Table of Forecasts

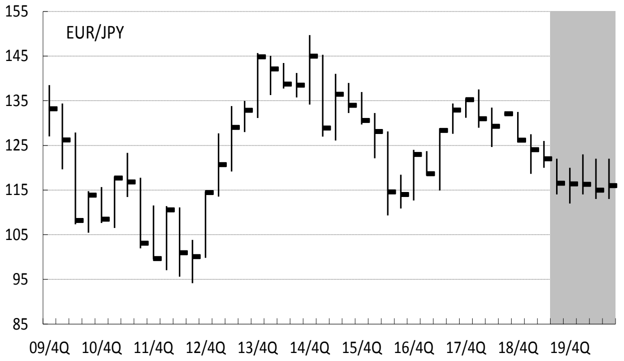
	2019 Jan -Aug (actual)	Sep	Oct-Dec	2020 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	104.10 ～ 112.40 (106.43)	103 ～ 107 (105)	100 ～ 107 (103)	100 ～ 107 (102)	98 ～ 106 (100)	98 ～ 106 (100)
EUR/USD	1.1027 ～ 1.1570 (1.1052)	1.09 ～ 1.13 (1.11)	1.11 ～ 1.15 (1.13)	1.10 ～ 1.16 (1.14)	1.11 ～ 1.17 (1.15)	1.12 ～ 1.17 (1.16)
EUR/JPY	116.58 ～ 127.50 (117.64)	114 ～ 122 (117)	112 ～ 120 (116)	114 ～ 123 (116)	113 ～ 122 (115)	113 ～ 122 (116)

(Notes) 1. Actual results released around 10 am TKY time on 30 August 2019. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts







USD/JPY Outlook – – The Challenge of a Simultaneously Strong JPY and USD

U.S.-China Trade War & Forex Rates Now and Going Forward – The Challenge of a Simultaneously Strong JPY and USD

Round 4 Tariffs Also Eventually 30%?

On August 23, President Trump declared that the existing 25% tariffs (from the first three rounds) on USD 250 billion worth of imports from China will be raised to 30% starting October 1. The fourth round of tariffs, which went into effect on September 1, was initially planned to be 10%, but this has also been raised to 15%. For some of the products in this round of tariffs that will significantly impact the household sector, such as smartphones, notebook computers, and toys, the imposition of tariffs has been postponed to December 15. However, these products are also expected to receive the new 15% tariff rate. To summarize, tariffs have been raised from 25% to 30% for the first three rounds of products worth about USD 250 billion; as part of round 4, a 15% tariff has been applied to an additional USD 110 billion worth of goods starting September 1, and the same 15% will be applied to a further USD 160 billion worth of products that have a bigger impact on the household sector starting December 15.

In the coming months, the tariff rate for Round 4 products may also be intermittently raised, first to 25% and then to 30% in the worst case scenario (resulting in an across-the-board 30% tariff rate on all imports from China). The new round of harsh tariffs announced by the Trump administration were in reaction to China's announcement on August 23 of a round of retaliatory 5-10% tariffs on USD 75 billion worth of imports from the U.S. including crude oil and agricultural produce, but the U.S. response was so swift as to almost seem premeditated.

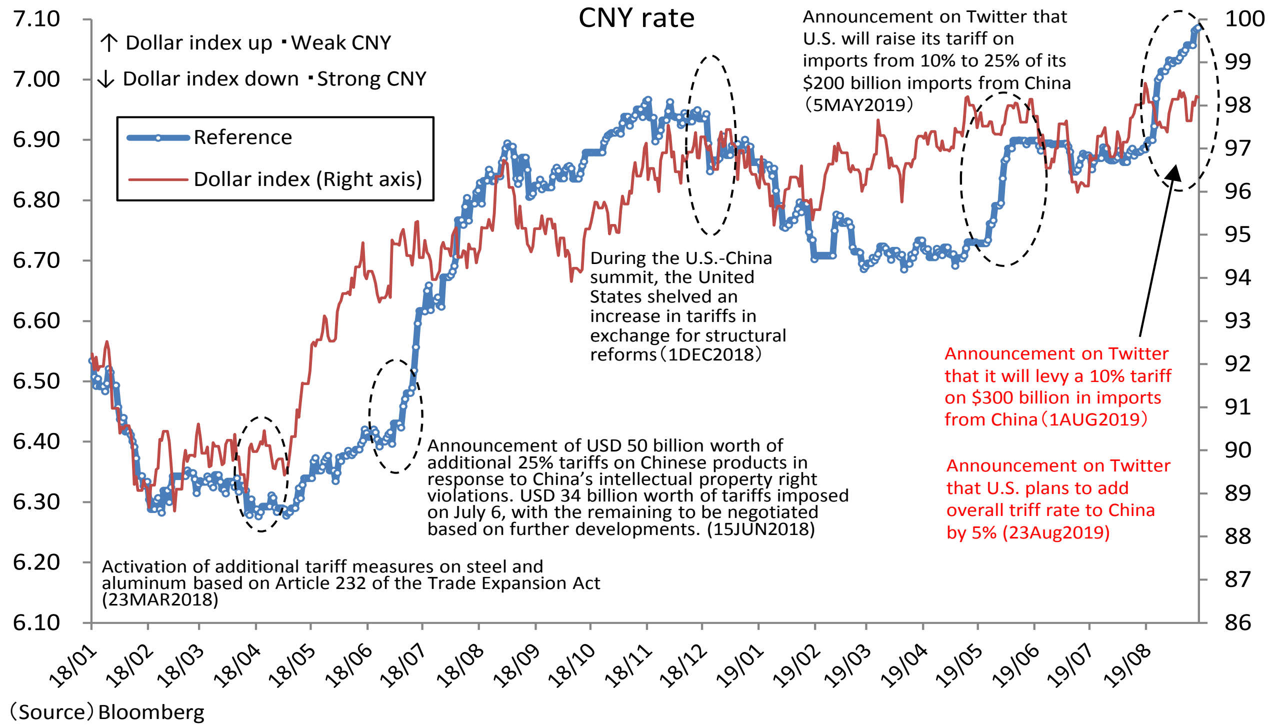
Powell's Tragedy

Fed Chair Jerome Powell's talk at the Jackson Hole Economic Symposium was expected to affect trading in the Asian markets starting the last week of August (August 26 onward). Even before the speech, financial market participants were expecting Mr. Powell to project a more dovish stance (specifically, hint at additional rate cuts), having learned his lesson after his hawkish posture at the press conference following the July FOMC meeting stirred up a storm of criticism. In fact, Mr. Powell did live up to those expectations, but it appears that his efforts were in vain, lost in the hullabaloo over retaliatory tariffs on Chinese imports. Forget about "insuring" against risks; in the current situation, palliative rate cuts have become necessary, and the number of rate cuts required seems to be gradually increasing. Going by global economic and financial developments since the July meeting, it has to be said that Mr. Powell failed in his communication with the markets. There is an air of tragedy about the man – pushed around by politics and struggling with communication problems to boot.

There was never any guarantee that the current phase of rate cuts, which began in July citing "insurance against downside risks from trade policy uncertainty," would end on the same note. It would have been one thing if Mr. Powell and President Trump were of the same mind and could communicate with each other perfectly, but as of the current time, it cannot be said even for the sake of flattery that the two have a smooth relationship. The biggest reason for the failure of the July press conference was Mr. Powell's claim that the Fed had cut rates to "insure against" risks, when in fact it had done so for dubious political reasons. If Round 4 tariffs are, indeed, raised to 30%, the so-called "downside risks from trade policy uncertainty" could surpass their stature as "risks" and cause real damage to the real economy. By the time that happens, the Fed will probably be in the middle of a full-fledged "rate-cut phase" rather than simply "insuring against risks," and it seems highly likely that U.S. interest rates and USD will have fallen another notch.

CNY Trends Worth Paying Attention To

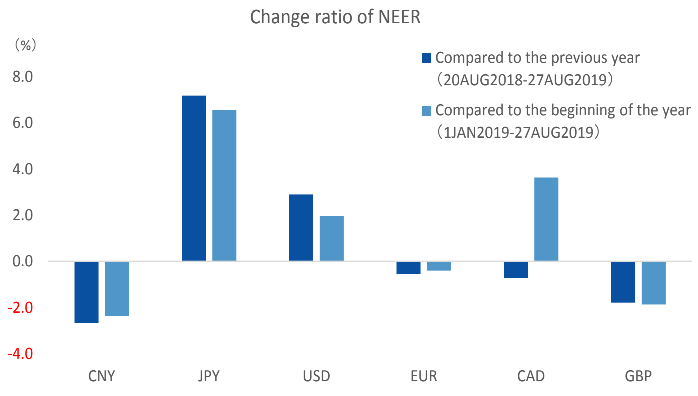
Meanwhile, one cannot afford to take one's eyes off China either. Specifically, CNY trends must be closely monitored. Given the limited volume of its imports from the U.S., imposing additional tariffs on them is hardly sufficient as a battle strategy for China. A significant currency devaluation in order to cancel out the effects of the additional tariffs will also be necessary. Theoretically, a 5-pp increase in tariffs can be cancelled out by a 5-pp devaluation of the currency. When it comes to the financial markets, there is a strong impression that U.S. interest rate, stock, and USD trends determine sentiment in other asset markets as well, but recently, the CNY rate level has also been affecting transactions. As I have mentioned in past reports, CNY depreciation tends to gain momentum every time there is an event that raises tensions in the U.S.-China trade war (see figure). If the current mood continues, USD/CNY is bound to continue rising as CNY progressively weakens to hit 7.5 yuan to the dollar, 8.0 yuan to the dollar, and so on. On August 18, the *Nihon Keizai Shimbun* ran an article that asserted, based on provisional calculations, that CNY could be weaker than 10 yuan to the dollar if the rate was based purely on supply and demand. It would be unsurprising to see more similar assertions going forward, given that China can no longer afford to maintain its past current account surplus levels. CNY rate trends in response to future tariff hikes will have considerable significance for other asset markets too. Nor can one afford to forget the troublesome fact of the Trump administration's temper tantrums in response to a weakening CNY.



(Source) Bloomberg

Simultaneously Strong JPY and USD

As U.S. economic and financial growth become more sluggish, JPY has steadily appreciated against USD, but considering the margin of decline in U.S. interest rates, JPY appreciation has been rather limited. Several reasons for this can be thought of. As I have repeatedly argued in this report, the outright sale of JPY through foreign direct investment has been helping prop up USD/JPY, and this continues to be the case. However, there may be an even more easy-to-understand factor working at the present time. In the forex world, where the value of a currency can only be expressed in terms of another currency, a currency that is in a "relatively better" position tends to be bought. In this context, a look at the daily nominal effective exchange rates (NEER) published by the Bank for International Settlements (BIS) (see figure) shows that USD has strengthened by +2.4% year-on-year and by +1.5% year-to-date. In other words, both JPY and USD are strong overall in the forex markets at the current time. So long as the U.S. economic and financial situations are relatively strong, USD will not depreciate despite the decline in U.S. interest rates (in fact, though on the decline, U.S. interest rates are still quite high). For the same periods, the decline in NEER has been -1.2%/ -0.9% for CNY, -0.9%/-0.7% for EUR, and -3.0%/-3.1% for GBP, indicating quite



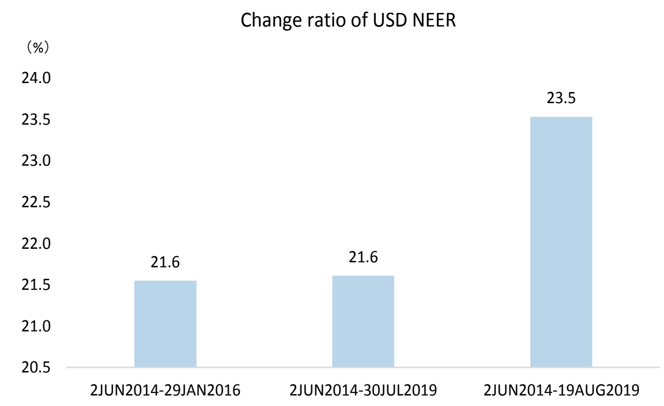
(Source) BIS

obviously that these currencies have been sold. Where would investors looking to desert the U.S. for better investment options head? CNY is a non-starter to begin with, but even EUR is unsuitable given Europe's miserable political and economic situations. Under ordinary circumstances, EUR should have been a good alternative to USD because the euro area has the world's largest current account surplus and very limited scope for monetary easing. However, there are fears of recession hanging over Germany, the main pillar supporting the region's economy, a political vacuum in the region's third-largest economy, Italy, and uncertainties over the fate of Brexit – all combining to make it extremely difficult to buy EUR. It may still be worthwhile to bet on such a dire situation had there been some rewards in terms of interest rates, but long-term interest rates are negative in all except the southern European states, making it a pretty hopeless situation.
Under such circumstances, the distribution of global currency strength is bound to fall to disproportionately to JPY's share, given that it is the currency of the world's largest creditor with very little scope for pushing back with monetary easing. As per the aforementioned NEER statistics, JPY's NEER has soared by +5.8% yoy and +5.2% year-to-date. Though the transition is gradual, JPY seems to be steadily progressing in line with this report's predicted scenario of a below-100 rate for USD/JPY.

USD Strength Importing a Recession

The damage from USD strength has begun to be apparent in some quarters. In the latest (August 9) release of the U.S. Producer Price Index (PPI), the Core PPI (excluding food products and energy) posted a -0.1% mom decline, betraying market predictions of an increase (the median of market forecasts was +0.1% mom). This was the first time in two years that the Core PPI posted an mom decline. Further, yoy growth was also the lowest it has been in two years at +2.1%. As aggregate demand contracts amid a global economic slowdown, it stands to reason that PPI growth would become sluggish, given that PPI is an upstream indicator of inflation. However, there is also the fact that USD remains stubbornly strong despite verbal interventions by the president and the Fed's switch to rate cuts, and some point out that this could be one of the factors behind sluggish inflation. Currencies like JPY, CHF, and recently even EUR, are liable to be bought during phases of global economic slowdown, but overall in the forex markets, USD itself is also a safe-haven currency. For instance, there is no doubt that USD/JPY has fallen since the beginning of August, but the USD index has hovered around 98 with no clear sense of direction. USD strengthened significantly as a result of "investment refugees" around the world rushing to it starting 2015, when the Fed became the only central bank in the world to be implementing rate hikes. During that time, it was pointed out that the U.S. would merely be importing a recession via its strong domestic currency if the Fed remained the only central bank to hike rates even as the rest of the global economy faltered, but to be honest, USD attracts investors during a global economic slowdown irrespective of the Fed's monetary policies. Even so, it seems logical that USD should weaken a bit more than it has as a result of such a clear change in the Fed's policy stance, but it seems investors are still drawn to the currency because of its relatively high interest rates compared with the currencies of other developed economies, not to mention the relatively high level of confidence in USD.

Effectively 17 Rate Hikes When Combined with USD Appreciation



(Source) BIS

There is a famous phrase from a speech by Federal Reserve Board Member Lael Brainard regarding the tightening impact on the U.S. economy as a result of USD strength. In a talk titled "The "New Normal" and What It Means for Monetary Policy," given on September 12, 2016, Ms. Brainard said, "estimates from the FRB/US model suggest that the nearly 20 percent appreciation of the dollar from June 2014 to January of this year could be having an effect on U.S. economic activity roughly equivalent to a 200 basis point increase in the federal funds rate.[1]" For the period in question (June 2, 2014 to January 29, 2016), the increase in USD's NEER as published by the BIS was about +21.6%, so the calculation seems to be that a +1% appreciation in USD has about the same effect as a +9bps increase in the FF rate. Now, if we take the same date (June 2, 2014) as the start date and calculate the increase in USD's NEER for the period until July 30, 2019, the day before the recent rate cut, the increase is still exactly the same at around +21.6%. Taking into account that there have been nine rate hikes in the interim, one could conclude that there has been the equivalent of a +425 bps increase in the FF rate (9 x 25 bps through actual rate hikes, plus an appreciation in USD worth the equivalent of 200 bps increase in the FF rate), which equates to raising the FF rate by 25 bps a total of 17 times.

This is the same as the number of rate hikes implemented between June 2004 and June 2006 under former Fed Chair Alan Greenspan and his successor Ben Bernanke (who supervised the final three rate hikes of that phase). As is widely known, it was around a year after the last of these rate hikes (in June 2006) that the financial bubble collapsed with the BNP-Paribas shock. This time, a rate cut was implemented (in June 2019) six months after a series of nine rate hikes (the last of which was in December 2018), and one gets the impression that the change in monetary policy direction is more sudden than it was when the financial bubble collapsed. What is more, if we look at the aforementioned BIS data for a more

[1] Please see my September 13, 2016 Market Topic titled "Talk by Lael Brainard – The Dignity of the Doves," where I discussed this speech in detail.

extended period through August 19, 2019, it is obvious that the margin of USD appreciation has become even wider at around +23.5%, so it appears that the U.S. economy is experiencing an even greater oppression from currency appreciation (see figure on previous page).

Of course, factors such as commodity prices, stock prices, and external demand trends are also constantly changing and impacting the U.S. economy, so there can be a variety of arguments as to how to suitably calculate the rate hike effect. However, it cannot be denied that circumstances effectively amounting to 17 rate hikes caused a sudden cooling of the stock markets (given that the economy was not as overheated as it had been during the financial bubble period), which is what probably gave rise to greater pressure on the Fed from political quarters and drove it to cut the rate. As no severe recession is expected, my main scenario does not predict the Fed using up all of the policy space it created by implementing nine rate hikes, but I do believe that the Fed's monetary policy operation can be expected to significantly correct the USD appreciation equivalent to as many as 8 rate hikes.

U.S. Monetary Policies Now and Going Forward – The Lure of an "Adjustment" & the BOJ's Experience

FOMC Divided; Diverse Reasons for Cutting Rate

The minutes of the July 30-31 FOMC meeting reveal that it is becoming increasingly difficult to reach a consensus within the Fed. As is widely known, the Fed decided to embark on a phase of rate cuts for the first time in 10 years at its recent meeting. Following the meeting, Chair Powell quashed expectations of additional rate cuts, causing widespread disappointment in the financial markets. Despite using up one of only nine available rate cuts, the July FOMC meeting was, by and large, a failure, not just for the Fed but also for the financial markets and for President Trump, all thanks to Mr. Powell sporting a needlessly passive attitude. The minutes of the meeting offer the reasons for the recent rate cut in itemized format (even though the items are rather long and explanatory), probably with the intention of re-clarifying the details of a meeting that ended so badly.

Going by the minutes, the decision to implement a 25-bp rate cut seems not to have been a simple one, and this may have been one of the reasons the press conference was also difficult. The minutes note, for instance, that "a couple of participants" preferred a 50-bp rather than a 25-bp rate cut to better address the stubbornly low inflation rates of the past several years, "several participants" favored maintaining the same target range because they viewed risks and uncertainties about the global economy and international trade as having diminished, and "a few participants" expressed concerns that further monetary accommodation presented a risk to financial stability. With more than two participants each favoring disparate actions including a 25-bp rate cut, a 50-bp rate cut, and no rate cut, it could not have been easy to reach a consensus and communicate a unified message. Having said all that, there does appear to have been majority support for a rate cut, and taking into consideration that only a limited number of rate cuts are available, it would have been quite useful to make good use of market "expectations" of future rate cuts (leaving aside the question of whether or not those expectations are met).

Three reasons for the recent 25-bp rate cut were explained lengthily in itemized format (a format rarely seen). Simply speaking, they were as follows:

1. there are signs of deceleration in economic activity in fixed investment and manufacturing due to the slowing of overseas economies, leading most participants to revise down their estimates of the policy rate path
2. a number of participants observed that policy authorities in many foreign countries had limited policy space to deal with contingencies and considered a policy easing at this meeting to be a prudent step from a risk-management perspective
3. a number of participants were concerned about the inflation outlook and concluded that the improvement in market-based inflation expectations reflected market participants' expectation of more accommodative monetary policy in the near future

It is obvious from the above that a variety of reasons comingled to result in the decision to cut rates, but the mainstream view within the FOMC seems to favor an "approach in which policy would be guided by incoming information and avoid any appearance of following a preset course." Additionally, the minutes also emphasized that "most participants viewed a proposed quarter-point policy easing at this meeting as part of a recalibration of the stance of policy, or mid-cycle adjustment, in response to the evolution of the economic outlook over recent months." Perhaps Mr. Powell's now infamous explanation at the press conference was intended to give a glimpse into these diverse opinions exchanged at the FOMC in the process of making the decision.

The Lure of an "Adjustment" & the BOJ's Experience

Given how the tone of reluctance in the communication following the July meeting stirred up a storm of criticism from political and economic circles, it seems likely that the continuation of rate cuts will be hinted at more strongly at the September meeting. Authorities customarily describe their actions as "preventative" or "as insurance against risks" during phases when it is difficult to accurately read the economic cycle, but such adjectives are totally unconvincing when the central bank suddenly changes track and implements a rate cut right after a year of four rate hikes. At the present time, no one can tell for sure whether the current phase of rate cuts will end as a mere mid-cycle "adjustment," but 100% of market participants currently expect a rate cut in September, and close to 80% expect three or more rate cuts by June next year. One gets the impression that the rate cuts will continue for a year, which makes this a full-fledged "phase" of rate cuts, rather than an "adjustment."

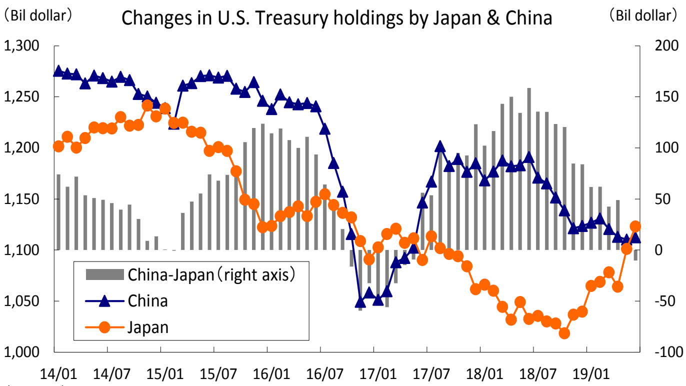
From the perspective of the Fed, given that the rate cut was a debatable decision, perhaps the main intention was to emphasize the temporary "adjustment" aspect of it in order to ensure the option of changing track again when required. However, labeling a rate cut an "adjustment" has the effect of immediately putting an end to market expectations and risks causing asset price volatility. A similar famous failure on the part of a central bank was the BOJ's decision to terminate its zero interest-rate policy (ZIRP) on August 11, 2000. At that time, the BOJ ventured to end ZIRP and raise interest rates noting that the "adjustments to the degree of monetary easing in accordance with the improvement of the economy would contribute to sound economic development in the long term." The phrase "adjustments to the degree of monetary easing" is similar to the Fed's recent communication. Subsequently, in the wake of the collapse of the IT bubble, the BOJ was compelled, for the first time in history, to implement quantitative easing the following March.

Minor adjustments are only possible when one is able to fully grasp the nuances of the situation and has a clear understanding of what policies need to be implemented, but as is well known, central banks' economic forecasts are not that much more precise than those of market participants. A central bank may use the word "adjustment" to give the impression that the decision in question is not that significant, but the fact is that rate cuts and rate hikes are big events for the markets. It seems likely that Mr. Powell, having learned from his mistake in July, will work to issue a strongly dovish message after the September FOMC meeting so as not to crush market expectations.

Appendix: Regarding China's Selling of U.S. Bonds – Difficulty of "A Drop in the Ocean"-Type Measures

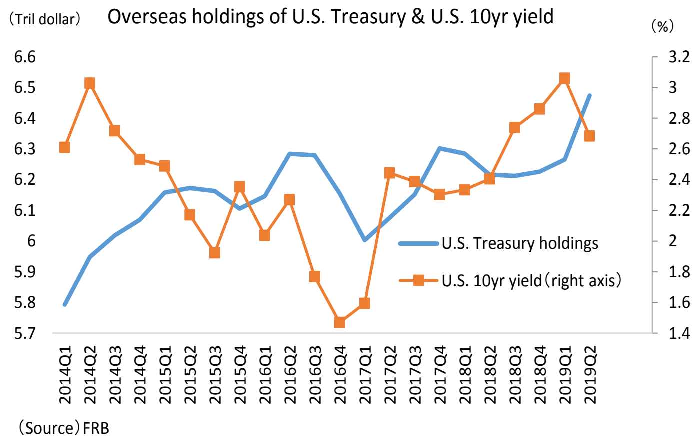
Selling of U.S. Government Bonds as "the Next Move"

The generally held view is that the RMB depreciation seen since August is a Chinese measure designed to counter the Trump administration's imposition of additional tariffs, but some observers are concerned about what kinds of countermeasures China might implement other than currency-weakening policies and policies to adjust the usage of various government permits and approvals. Regarding the sale of U.S. government bonds by China, there have been reports that a January 2018 periodic review of China's foreign currency reserve management policy concluded that U.S. bonds were becoming less attractive than other assets and that, owing to tensions in trade relations with the United States, the purchase of U.S. bonds should be slowed or stopped. These reports have attracted considerable attention and spurred much discussion. In addition, since the beginning of this year, the gradual decline of China's U.S. government bond holdings has been attracting attention in connection with trade-war-related countermeasures. The level of China's U.S. bond holdings has shown yoy declines for 11 consecutive months – from last August to this June (see graph above) – and quite a few people are seeking to interpret this trend as indicating retaliatory intentions and measures. Of course, the "USD1 = RMB7.0 battle" has become a hot topic during the past year, and it seems that the amount of reserves consumed in connection with RMB selling/USD buying intervention may be large, but market players are continuing to seek new market-moving factors and themes as U.S.-China tensions become protracted. Headlines about the "Chinese selling of U.S. government bonds" theme have proven to attract considerable attention, and there is a possibility that more such headlines – even those based on unclear sources of information – will promoting market turbulence going forward.



(Source) Bloomberg

Four Reasons Why U.S. Government Bond Selling is Unlikely



In light of the current level of U.S.-Chinese tensions, it is not surprising to see headlines about China selling U.S. government bonds, but the more one calmly considers the situation, the less likely such selling seems. The main reasons for considering China's selling of U.S. government bonds unlikely are: (1) such selling could not be expected to have much effect, (2) China wants to avoid a decrease in its foreign currency reserves, (3) the "splashback" from the bloodletting associated with the sale of U.S. bonds would be considerable, and (4) there are no assets suitable as alternatives to U.S. bonds. There are other reasons, but these are probably the main ones. The most fundamental problem is reason (1). China has certainly reduced its U.S. bond holdings since last year, but U.S. interest rates have been declining during this time period. This is probably because periods of RMB depreciation during which China engages in USD selling and RMB buying are often a risk-off periods, as it is likely that countries other than China will tend to seek U.S. bonds during such risk-off periods. For example, looking at the first graph in this appendix section comparing trends in the balance of U.S. bonds held by Japan and China, one finds that China has reduced its U.S. government bond holdings by USD73 billion over the past year, but Japan has increased its U.S. government bond holdings by USD52 billion over the same time period. This counterbalancing of Chinese selling is not limited to Japan. The second graph in this appendix section shows that movements in the balance of U.S. government bonds held by non-residents (overseas sector) roughly reflect trends in U.S. 10-year interest rates. Overall, non-residents' U.S. bond holdings have increased since the first quarter of last year, and the rise has accelerated since the start of this year. There is sufficient demand for U.S. government bonds to compensate for independent Chinese selling. If the aim of selling U.S. bonds were to be to hurt the U.S. economy by spurring an "unwanted rise in U.S. interest rates," it should be understood that the effectiveness of this strategy would be weak.

China Disinclined to Decrease its Foreign Currency Reserves

Reason (2) is also important. As this situation has been discussed in past editions of this article, I will refrain from presenting detailed explanations at this time. Essentially, however, because China's current account surpluses are not as large as they were in the past, fundamental supply-demand factors are more likely to cause RMB selling, so the country probably does not want to reduce its foreign currency reserves unnecessarily. The reason the Chinese government has been defending RMB in the "USD1 = RMB7.0 battle" is that USD/RMB exceeding the 7.0 level is likely to promote such capital outflows as those seen in August 2015, at which time it will be necessary to restrain RMB weakness through the use of a large amount of foreign currency reserves. It may be difficult for speculators to confidently sell RMB when China has USD3-to-4 trillion of foreign currency reserves at its disposal, but the speculators may become more confident if China's foreign currency reserves were to fall below the USD2 trillion level. Even with the current level of roughly USD3 trillion of foreign currency reserves[2], given that the level is said to be insufficient based on the IMF methodology for assessing reserve adequacy (ARA), it is hard to imagine China being inclined to reduce that level. Of course, China could sell U.S. bonds and invest the proceeds in other foreign-currency-denominated assets. As mentioned in reason (4) above, however, there are no alternatives to U.S. government bonds (suitable for inclusion in foreign currency reserves) that offer comparable levels of liquidity, safety, and profitability.

Reason (3) is probably the most frequently pointed out issue discouraging China's sale of U.S. government bonds. Although down from its peak, the balance of China U.S. bonds was about USD1.1 trillion as of this June. If these bonds were to be sold in large quantities, the valuation loss ("splashback") on U.S. bonds incurred by China in exchange for a rise in U.S. interest rates would be too large to overlook. Regarding valuation gains and losses, given that the Fed has begun undertaking interest rate cuts, the risk that the U.S. interest rate trend going forward will be descending is greater than the risk that it might increase. Since China is disinclined to reduce its foreign currency reserves anyway, it would seem that this is a time when it will be particularly motivated to retain its U.S. government bond holdings given the expectation of enjoying valuation gains. Moreover, China's selling of U.S. government bonds could be expected to have a negative impact on China's real economy. If the selling of a large amount of U.S. bonds were to cause RMB to appreciate against USD, it would have the effect of increasing the impact of the existing supplementary tariffs on Chinese exports. It seems clear that China would prefer to avoid that kind of scenario.

[2] Please see the June 6, 2019 edition of Mizuho Market Topic, entitled "China's Foreign Currency Reserves as the Next Catalyst".

Measures Offering "A Drop in the Ocean"-Type Benefits and Major Downsides

In light of the above discussion, although news reports about the possibility of China strategically selling U.S. government bonds are likely to persist going forward, it seems that China would face such small upsides and large downsides from such selling that the selling is unlikely to happen. As pointed out in reason (1), achieving the biggest objective of damaging the U.S. economy by causing an unwanted rise in interest rates is likely to be hindered by the purchase of U.S. government bonds by countries other than China. As the U.S. bond market is the world's deepest and broadest financial market, it will be impossible for China to dictate the direction of trends in that market – no matter how much bonds China were to sell, the effects could be expected to be akin to "a drop in the ocean". Moreover, the insignificant "a drop in the ocean"-type benefits would be accompanied by the major downside of a decrease in China's foreign exchange reserves.

Furthermore, even if the objective of objective of damaging the U.S. economy by causing an unwanted rise in interest rates were to be attained, it would questionable whether that would actually redound to China's benefit. If damage were to be inflicted on the U.S. market, which accounts for about 20% of China's global exports, it would inevitably have a negative impact on the Chinese economy. Of course, some observers may believe that the current China-U.S. struggle is ascending to a level that transcends rational calculations of balances of economic gains and losses, but <u>when one considers the magnitude of the relevant gains and losses, the major scale of the downsides for China makes it difficult to imagine that China would consider the strategic selling U.S. government bonds to be a realistic option.</u>

Risks to My Main Scenario – Second Trump Tax Cut to Promote JPY Depreciation?

Second Trump Tax Cut to Promote JPY Depreciation?

JPY depreciation risk factors

	Risk	Detail	Possibility
①	U.S. economy is surprisingly robust	Economic policy by the Trump administration such as elimination of tariffs, tax reduction	medium/high
②	Discontinuation of the Trump administration's protectionist policies	Complete resolution of US-China trade war (Complete elimination of additional tariffs)	low
③	BREXIT related	General election and 2nd referendum	low/medium
④	Additional monetary easing by BOJ	Funds supply with negative interest rates	low
⑤	Reacceleration in China & Europe	GDP acceleration	medium

(Source) Daisuke Karakama by Mizuho Bank

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 scenaros are those related to JPY depreciation, I think it important to focus here mainly on JPY depreciation risks.The main risk factors are listed in the table, and these have fundamentally not changed since last month. The most important of the risk factors is risk factor ①. <u>In this regard, on August 20, President Trump revealed that he is considering additional tax cuts to support the economy</u>. Specifically, he said he was considering reductions to payroll taxes and capital gains taxes but, given that a large tax cut was just recently implemented, it is unclear whether the U.S. Congress will readily accept a second Trump tax cut. Regarding this article's main forecast scenario, which anticipates JPY appreciation, it bears remembering that expansionary fiscal policies were in the background of the unexpectedly sustained robustness of the U.S. economy in 2018. That robustness enabled the Fed to raise interest rates four times during the year, promoting U.S. interest rate increases and USD appreciation. <u>The possibility that the same sort of events might recur before the November 2020 presidential election represents a big risk factor for this article's main scenario</u>. There is also good cause for paying close attention to the related issue of risk factor ②. Unlike such fiscal stimulus measures as tax cuts, which require negotiations with Congress, the president has the authority to impose additional tariffs at his discretion. On the other hand, there is also a possibility that president might exercise his authority to progressively eliminate or decrease tariffs, and such a decrease could be considered an economic stimulus measure. In the case that existing tariffs were eliminated or lowered, the financial markets (particularly forex markets), which are inclined to straightforwardly respond to such measures, may perceive that as a tax cut and respond positively. Although President Trump might be justifiably criticized for stirring up trouble to get credit for the solution, tariff reductions have the potential to effectively improve market sentiment. In any case, financial markets are ineluctably influenced by the ups and downs of the U.S. economy, and forex market trends are likely to take shape in response to positive and negative U.S. economic trends. Naturally, if the U.S. economy shows more resilience than expected, there is a possibility that the Fed's interest rate cuts might end up being short-lived. At that time, U.S. interest rates are likely to rise, and USD/JPY should move in accordance. I consider this JPY depreciation risk to be the most realistic as well as the largest risk factor.

Concurrent Recovery Trends in Europe and China

Economic and financial situations in China and Europe are important in that they have a significant influence on the Fed's policies, so there is also a need to give due consideration to risk factor ⑤. 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 likelihood of this is considered to be extremely low in light of the current relationship between the Fed and political factors (≈ President Trump), but it probably is undeniable that – in the case that benefits from China's tax cuts become apparent going forward and synergistically combine with the effects of RMB depreciation – global economic sentiment could be greatly improved by a re-strengthening of Chinese economic conditions. (However, this scenario would require a softening of the Trump administration's position along the lines of risk factor ②.) On the other hand, with such would-be economic locomotives as Germany and Italy on the brink of recessionary conditions, it seems quite unreasonable to expect the euro area economy to bottom out within a year. At the time this article was written, expectations were increasing that, in light of the delayed recovery of German manufacturing industries, the ECB may be forced to simultaneously undertake interest rate cuts and quantitative expansion measures, so rather than unexpected economic recovery in Europe, it seems more realistic to be concerned about unexpected economic deceleration there. However, it is very important to note that when China's economy resurges, the benefits to Germany exports may well promote a general recovery in the euro area economy. If this scenario were to eventuate, it might cause a dramatic change in global economic sentiment.

In Europe, there has been little change regarding the chaos associated with Brexit. While the administration of U.K. Prime Minister Boris Johnson is seeking to expedite the implementation of a no deal Brexit, there remains an undeniable possibility that Parliament might try to prevent that by tabling a no confidence motion and that such a motion might be passed. In such a case, we must assume that there would be a U.K. general election in the autumn. In the case that the pro-second-referendum Labour Party were to attain a majority in Parliament, it would immediately revive the "second referendum→JPY depreciation" scenario. Based on public opinion polls, it currently appears that neither the Conservative Party nor the Labour Party would be likely to realize a Parliamentary majority on their own, but it is generally believed that the Conservative Party will be weakened by losing voters to the Brexit Party and that the Labor Party may benefit from that situation. In the case of new elections, it seems likely that JPY will weaken as the financial markets take into account various post-election possibilities, such as a discontinuation of the Brexit policy or a clear transition to a soft Brexit policy. This is risk factor ③, which at this time cannot be said to have zero likelihood of eventuation.

Difficulty of BOJ Measures to Prevent JPY Appreciation

As global economic deceleration increases JPY appreciation pressures, it seems inevitable that expectations that the BOJ will launch some sort of policy initiative will increase going forward, although it continues to be thought that such initiatives are fundamentally not likely to exert powerful effects. The BOJ will probably have to pursue measures in line with the easing-oriented policies of the Fed and the ECB, although its leeway for additional easing is continuing to diminish, and a major BOJ initiative capable of reversing the strong USD appreciation trend seen over the past five years is so unlikely that it barely merits inclusion in the risk scenario category. Some observers do not want to completely discount that possibility, however, based on a view that it is precisely because many market players believe in this possibility that an unexpected and brilliant BOJ policy initiative would have the potential to bring about major market fluctuations. It is thought that such measures as those to further depress negative interest rates and introduce a negative lending rate will only be considered if USD/JPY descends below JPY100, but if the BOJ were to take initiatives in advance of expectations, it might help elevate USD/JPY. Basically, however, it seems most appropriate to categorize this possibility as a risk scenario that is considerably less likely to eventuate than other risk scenarios, because the BOJ simply is not believed to have sufficient power to reverse the USD appreciation trend.

Many JPY Appreciation Risk Factors, but Easier to Anticipate

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, this article will continue to argue that the number of JPY appreciation risk factors seems much larger. For example, predictions of USD-selling forex market interventions have disappeared since July. It basically seems (I hope it is) extremely unlikely that the Trump administration will become impatient and take measures to promote USD depreciation, but one cannot completely discount that possibility so long as progressive JPY appreciation is insufficient to eliminate the appreciation of USD on an effective basis. Of course, as described above, under Prime Minister Johnson, a no-deal Brexit is progressively becoming the default route, and this is another situation likely to elicit JPY appreciation.

Last month's edition of this article pointed out that RMB depreciation associated with U.S.-China trade frictions could cause turbulence, saying – "[I]f 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. [...] In the case that China were to [...] become unable to sustain the roughly USD1=RMB7.00 level, the situation might have the potential to stir up considerable market turbulence." As is well known, the basis for this concern has been real since the beginning of August. Going forward, there is probably cause for concern about the possibility that USD/RMB might reach such landmark levels as USD1=RMB7.5 or USD1=RMB8.0. Last month's article also included the text – "[Can the Germany-driven] euro area [...] avoid recession? [...] If there is serious talk of a German recession, it may become impossible to ignore the JPY appreciation pressures stemming from Europe." This is still a point of concern now in August, as Germany's central bank (the Bundesbank) pointed out in its August monthly report that the country may fall into a technical recession. JPY appreciation risk factors appear to be more numerous than JPY depreciation risk factors, and many of them seem relatively easy to anticipate.

There are numerous other JPY appreciation risk factors, although it would not be worthwhile to examine each such potential situation individually. Situations with the potential to promote JPY appreciation include the poor state of Japan-Korea relations, which is said to be the worst in the post-WWII era, along with North Korea's provocative actions. Given that the United States has enjoyed a record-long period of economic expansion, there is a possibility that "distortions" stemming from that protracted 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. Of course, if the Fed's current round of interest rate reductions ends up limited about two to three "insurance" cuts, as in 1998, it does not seem likely to promote a JPY appreciation trend over several years. However, one gets the impression that citing 'insurance' as a reason for interest rate cuts may be tabooed after Fed Chairman Powell was forced to repeatedly explain its meaning at the press conference following the July FOMC meeting. The Trump administration's intensifying protectionism is steadily increasing the focus on the "economic deterioration → interest rate cuts" concept, and so long as this situation continues, it is hard to imagine a major USD/JPY trend reversal. I continue to believe there is no need to adjust this article's main forecast scenario anticipating the possibility of USD/JPY descending to below USD1/JPY100 during the next 12 months.

EUR Outlook – ECB-Style YCC and the German Economy's Undermining Effects

Euro Area Monetary Policies Now and Going Forward – YCC Discarded by BOJ and Picked Up by ECB

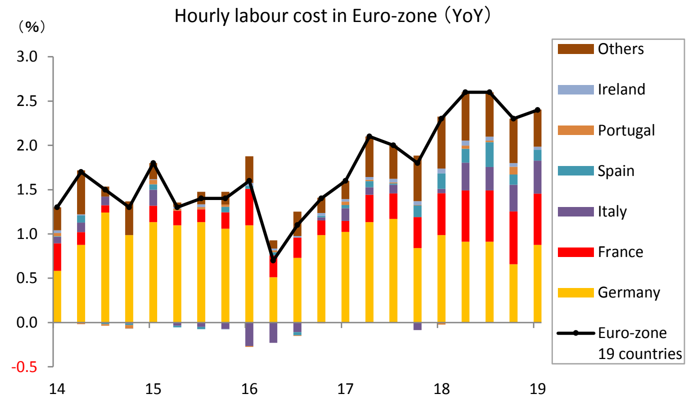
Increased Possibility of Package Easing

Released on August 22, the Account of the ECB's July 24-25 monetary policy meeting includes the text – "the view was expressed that the various options should be seen as a package, i.e. a combination of instruments with significant complementarities and synergies" – and this caught my attention. The Account notes that – "experience had shown that a policy package – such as the combination of rate cuts and asset purchases – was more effective than a sequence of selective actions." Accordingly, there appears to be a possibility that the already consensus-supported "10 basis point cut in the ECB deposit facility rate" may be presented at the September 12 meeting as part of a package that includes such other components as a reinauguration of the expanded asset purchase programme (APP). Looking back at previous years, it is apparent that the Mario Draghi-led ECB consistently showed a disposition to take decisive action without hesitation. The June 5, 2014, monetary policy meeting, for example, responded to rising concern about deflation and, just as today, smoldering worries about the "Japanization of the euro area" trend with five measures – (1) the surprise initial introduction of a negative interest rate along with the announcement of (2) the start of targeted longer-term refinancing operations (TLTRO), (3) preparations for outright purchases in the asset-backed securities (ABS) market, (4) the continuation of main refinancing operations (MROs) as fixed rate tender procedures with full allotment, and (5) the transition to non-sterilization of bond purchases under the Securities Market Program (SMP).

The Account also notes that, besides considering an interest rate cut, the meeting decided to begin preparatory work on a tiered system to mitigate the side-effects of negative interest rates and considered concerns about possible unintended consequences of a tiered system and its ability to fully mitigate potential side-effects. Given the impediment of summer holidays and the fact that it is said to be quite difficult to effectively introduce a tiered system in a common currency area, it may not be guaranteed that an acceptable plan for introducing a tiered system will be completed by time of the September meeting.

Rise in Wages Not Reflected in Inflation

The overview presented at the start of the July meeting by Executive Board Member Benoît Cœuré noted that the EONIA forward curve indicated that a 10 basis point cut in the ECB deposit facility rate was then priced in for September 2019 and that, at its trough, the curve had priced in a cumulative cut of almost 30 basis points by the end of 2020. (At this point, additional pricing in is progressing.) He also noted that the ECB's Survey of Professional Forecasters (SPF) indicated "a considerable downward shift" in interest rate expectations. *or* It was also noted that the ECB's Survey of Professional Forecasters (SPF) indicated a considerable downward shift in inflation rate expectations. Looking at the real economy, concern was expressed about the fact that increases in unit labor costs (ULC) and capacity utilization rates were not prompting a rise in inflation or that such a prompting was being delayed, and this was attributed to a dampening of the contribution of unit profits to the GDP deflator. As the graph illustrates, ULC has shown strong growth over the past five years. In this regard, there are doubts about how long it will be possible for the corporate sector to absorb its rising costs, but given the ongoing shift to economic deceleration, it may be that the deceleration of ULC will be accompanied by the loss of an opportunity for ULC to promote greater inflation.



（Source）Eurostat

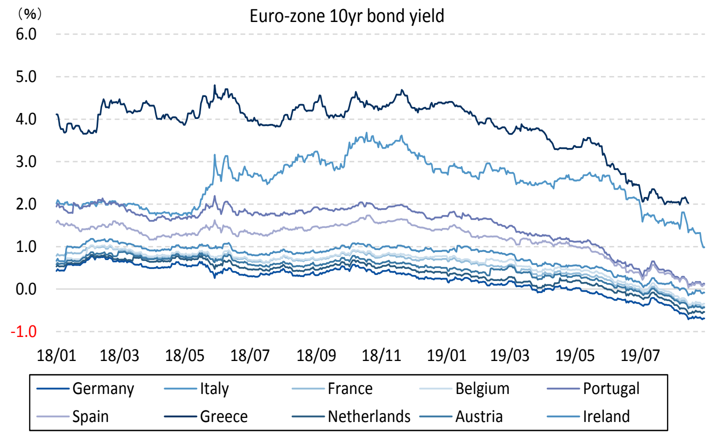
Too Early to Revise Monetary Policy Strategy Definitions

The Account also hints at the existence since July of some debate regarding the modification of the ECB's medium-term inflation target, which has traditionally been described as "below, but close to, 2% over the medium term". As discussed in previous editions of this article, however, the phrase is a fundamental part of ECB's policy strategy and not easily revised. It was in fact noteworthy that the statement for the July monetary policy meeting included the sentence – "[...] if the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim." – but the meeting did not go so far as to change the traditional "below, but close to, 2% over the medium term" phrase.

The latest Account notes that – "the point was made that any future change in the inflation aim should not be employed as an isolated policy measure but should be linked to a broader review of the ECB's monetary policy strategy to ensure consistency of the strategy" – and this indicates a view that emphasizing symmetry in the short term should not be done in a way that is inconsistent with the medium-term target or strategy. It is likely that this reflects a judgment that the policy stance should not be adjusted piecemeal in the course of responding to market expectations at regular meetings. The "below, but close to, 2% over the medium term" phrase was drafted after "a thorough evaluation" of monetary policy strategy at the May 8, 2003, monetary policy meeting, so it would be natural to think that modifying the phrase will entail a considerable amount of work. Since the exact meaning of the phrase is an important issue that is directly related to the nature of the ECB organization's mission, associated decisions should ideally be made only after thoroughgoing discussions within the new Lagarde-led ECB.

What moves will the ECB take?

What moves will the ECB take in light of the weakness of the euro area's political and economic situations? As mentioned above, besides the interest rate reduction regarding which there is already a consensus, the resumption of quantitative easing – by means of a renewed asset purchase programme (APP), or APP2 – has emerged as a realistic option. Because the ECB already has a negative interest rate of -0.40% – deeper into negative territory than the rates on the BOJ's current accounts (and deposit facility) – it seems apparent that the ECB has no choice but to shift its emphasis from "interest rates" toward "quantity" in the near future. APP2 is an option that the ECB is likely to be considering sooner or later.



(Source) Bloomberg

However, introducing APP2 will not be easy owing to the excessively low level of interest rates on government bonds in the euro area. At this point, interest rates on government bonds of the four major countries of Germany, France, Italy and Spain as well as on the government bonds of such semi-core countries as Belgium, the Netherlands, and Austria are in the negative range. At the time this article was written, positive interest rate levels were only narrowly being maintained on the government bonds of the four southern European countries (Portugal, Italy, Greece, and Spain) collectively referred to as the PIGS. Regarding Spanish bonds, the interest rate is approaching zero, standing at 0.1%, and its shift into negative territory is just a matter of time. At the time this article was written, the interest rate on 10-year U.S. government bonds was 1.5%, while that on 10-year Italian government bonds was 1.0%, and that on 10-year Greek government bonds was 1.6% – the highest level of government bond interest rates in the euro area (see graph). In light of the disastrous state of the euro area's political and economic situations along with Italy's worrisomely low interest rates, there is due cause for concern about fiscal discipline in the area going forward.

Will APP2 Require an ECB version of YCC?

Given the extremely low level of government bond interest rates, an ECB turn to the "quantity" route would be tantamount to a decision to actively purchase government bonds selling at historically high price levels. If purchases are made in line with the ECB's capital key, the largest share of purchases will be of German government bonds featuring the deepest negative interest rates seen among developed countries' bonds. It may seem that there is still leeway for the ECB to resort to the "quantity" route because the APP has been suspended since the end of last year; however, as noted above, it will be difficult for a central bank to make the decision to hold a large amount of government bonds with negative yields. Even if the decision is made to launch APP2, the program will inevitably entail dealing with considerable challenges.
Taking the BOJ as an example, in January 2016, the BOJ recognized the limits of the "quantity" route and returned to the "interest rate" route. Consequently, negative interest rates were introduced, but in September of the same year it was judged that implementing negative interest rates was difficult owing to the impact of the negative rates on the financial system, and a yield curve control (YCC) framework was introduced to keep the 10-year interest rate at around zero percent. In short, when the potential efficacy of the "quantity" and "interest rate" routes were approaching their limits, policy makers conceived the idea of "fixing interest rates at intended levels", resulting in YCC. When something can no longer be moved in any direction, it is clear that the only option is to have it "not move". Regarding the ECB, since there is no longer much leeway for the implementation of either "quantity" or "interest rate" policies, it seems likely that policy makers will consider an "immobilization" policy.

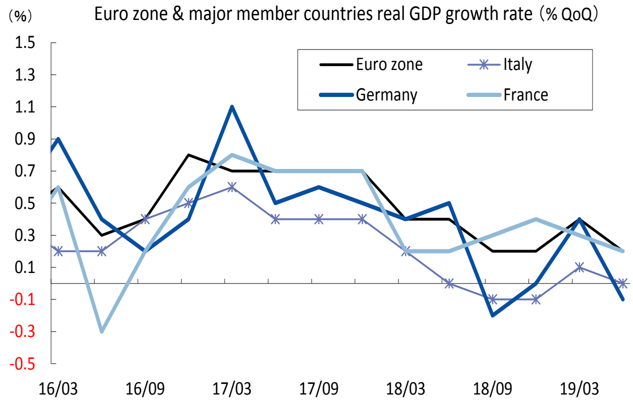
When considering the nature of an ECB version of YCC, however, one encounters the "which country's interest rate is the target" problem. As the central bank for all countries in the euro region, the ECB is not allowed to target interest rate levels in specific countries. If controlling the "level" of interest rates is not acceptable, it seems natural to consider whether the "direction" of interest rates can be controlled. The BOJ's YCC has already set an allowable deviation range of ± 20 bps from the target level (roughly a zero percent interest rate), so it follows that it might be possible for the ECB to set an allowable deviation range of ± 20 bps from specified levels. (These levels could be, for example, the 10-year interest rate levels of individual member countries on the day of the monetary policy meeting that introduces APP2.) Since the starting point "levels" are disparate, one could only seek to govern the range of deviation from the levels measured at a specified reference date.

While this kind of program seems to be one of the ECB's few remaining policy options, it might be criticized insofar as controlling the quality of the program's YCC system would depend on market adjustments undertaken by individual member countries' central banks. In other words, introducing such a program might be difficult for the ECB because it would entail the re-delegation of the ECB's own discretionary authority. In any case, it is clear that designing an "APP2 with ECB-style YCC" framework will require technical ingenuity, and a decision about such a program will only be made after instructions to develop such a framework are given to the ECB's internal technical committees and those committees are given sufficient time to carry out their challenging task. This is likely to be one of the highlights of the new Lagarde-led ECB.

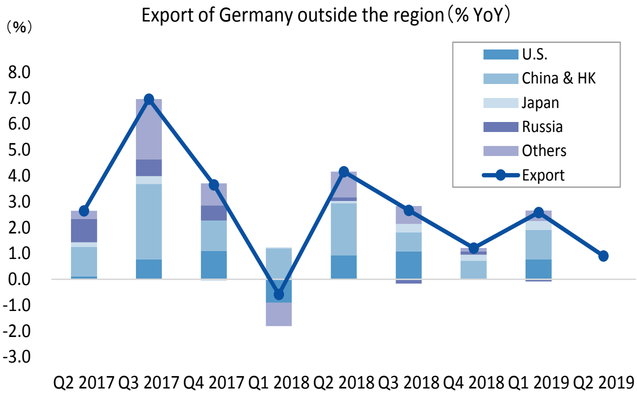
Euro Area Economic Policies Now and Going Forward – Germany Undermining Euro Area Growth

Europe-Rooted Risk-Off Mood and Germany's Situation

To a considerable extent, the risk-off mood that has been strengthening since the beginning of August seems to stem from Europe. The euro area April-June real GDP growth rate (revised value) announced by Eurostat on August 14 was unchanged from the preliminary report at +0.2% qoq, but Germany's simultaneously announced growth rate was -0.1% qoq, and that figure's negative value promoted a pessimistic mood (see graph). Germany's qoq growth rate also fell to -0.1% in the July-September period of last year – the first such negative growth seen in 14 quarters – and was followed by zero growth in the October-December period. For the past four quarters, Germany's average growth rate has been zero, and this situation has undercut the euro area's economic momentum over the past year. However, the situation is not good in many other euro area countries either. Looking at their qoq GDP growth rates for the April-June period, one finds that Italy showed zero growth and France recorded its lowest growth rate in 4 quarters (+ 0.2%), so all the area's major countries were lacking in vitality. In light of this, it seems reasonable to expect the ECB to further reduce interest rates. (Although it is hard to deny that the ECB has stubbornly clung to its normalization dream during the past year despite emerging signs that the regional economy was decelerating.)



(Source) Bloomberg

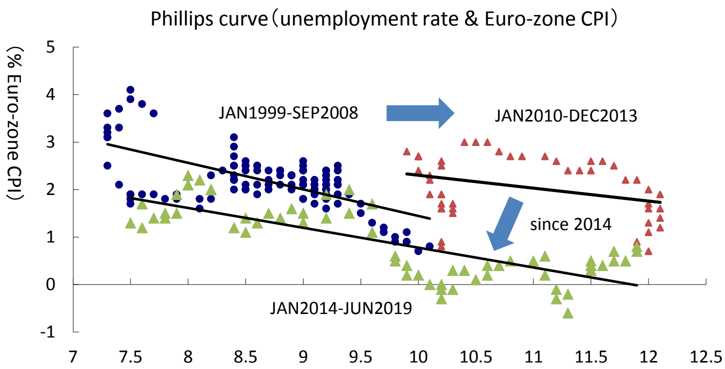


(Source) Datastream

In light of such economic and financial conditions, it is not surprising that the euro area manufacturing industry's sentiment is very poor, and the decline of the manufacturing industry PMI in Germany has been particularly severe. Many observers consider this to stem from a drop in exports that is largely attributable to the economic slowdown in China. However, looking at the adjacent graph showing yoy changes in Germany's exports to countries outside the euro area by region, one finds that, even though the momentum of growth in exports to China and Hong Kong has been decreasing, it appears impossible to attribute the overall decline of German exports to that factor. It seems that a slowdown in exports to Russia and countries in the "other" category (including countries in the Middle East and Africa) may be a key factor undermining Germany's exports and economy.

Subsidence of the Euro Area's Phillips Curve

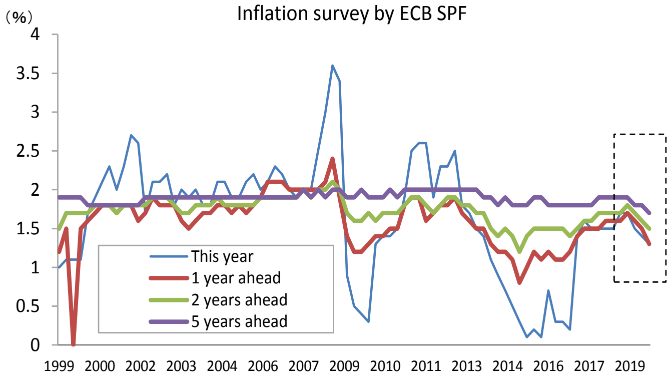
The current state of the euro area economy appears to be corroborating the worrisome situations I pointed out five years ago in my book – "Ready for the Japanization of Eurozone, Euro and ECB" (published in July 2014). When I wrote that book, it was considered to be sensational that the ECB had introduced a negative interest rate (-0.10% deposit facility interest rate), but now the negative interest rate's depth has grown to -0.40% and seems likely to descend further next month. In addition, a quantitative easing program



(Source) Bloomberg

that had not yet been launched when I wrote the book (but seemed to be unavoidable eventually) was introduced by the ECB's Governing Council in January 2015 as the expanded asset purchase programme (APP). The ECB managed to discontinue the APP last December, but in light of the practical limits to the deepening of negative interest rates, it appears that the APP will inevitably be resumed in the near future.

This kind of monetary policy Japanization (BOJ-ization) phenomenon is well known, but there are now clear signs that the euro area's real economy itself is beginning to change. The first graph in this section shows how the euro area's Phillips curve has moved during three time periods – the period from establishment of the euro area until immediately before the financial crisis (January 1999 through September 2008), the peak period of the European debt crisis (January 2010 through December 2013), and the past five years (January 2014 through June 2019). It shows that the Phillips curve has shifted downward during the past five years after being forced to shift to the right in response to the financial crisis and European debt crisis. Although the unemployment rate has generally recovered to pre-crisis levels (For example, France has reached its lowest level of unemployment since 2008.), the yoy inflation rate has fallen chronically below +2%. Unlike that of Japan, the slope of the euro area's Phillips curve has not yet disappeared to make the curve flat. As ECB Governor Draghi expressed concern about at the latest press conference, however, because survey-based inflation expectations are now deviating downwards (see the second graph in this section), it is fully possible that the euro area is now proceeding along the same path that Japan has been following. While observing the recent tragedy of the euro area economy, this kind of perception has become progressively stronger.



(Source) ECB "Survey of professional forecasters" (Note Looking ahead 5 years, Q2 – Q4 1999 is horizontal in Q1 1999, and Q2 – Q4 2000 is horizontal in Q1 2000.

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