

June 2, 2020

Overview of Outlook

In May, USD/JPY showed almost no movement. Now that the interest-rate gap has almost completely disappeared, the only thing that seems capable of moving USD/JPY is the U.S. budget deficit, which has expanded to unprecedented levels. However, the markets show no sign so far of seeing this as a factor. From the perspective of interest rates, USD selling could gain momentum if the Fed were to introduce negative interest rates. However, it is yield curve control (YCC) that is drawing attention as the likely next move. The BOJ has already verified the sustainability of YCC, and it may be the practical option for the Fed to consider as its next move, given that the Fed is already implementing unlimited government bond purchases. USD/JPY, however, will become even more immobile if both the BOJ and the Fed simultaneously implement YCC. The one factor of uncertainty in this extremely stable state of affairs for USD/JPY is the continued weakness of CNY owing to the Hong Kong problem. With the U.S. presidential election looming, it seems unlikely that President Donald Trump will overlook CNY weakness indefinitely. Excessive political intervention seeking USD depreciation could add to the unprecedented U.S. fiscal deficit and result in a major outflow of funds from USD-denominated assets, causing unexpected JPY strength against USD. This is a risk factor that must be kept in mind.

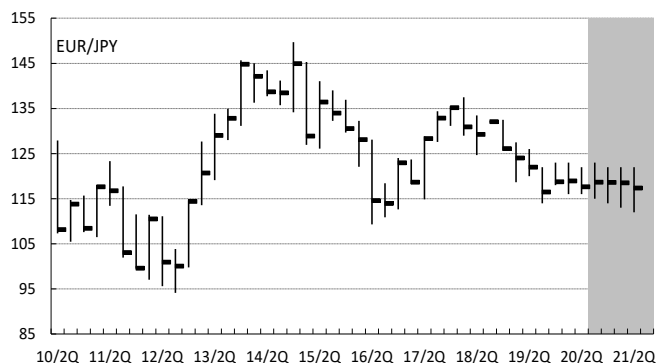
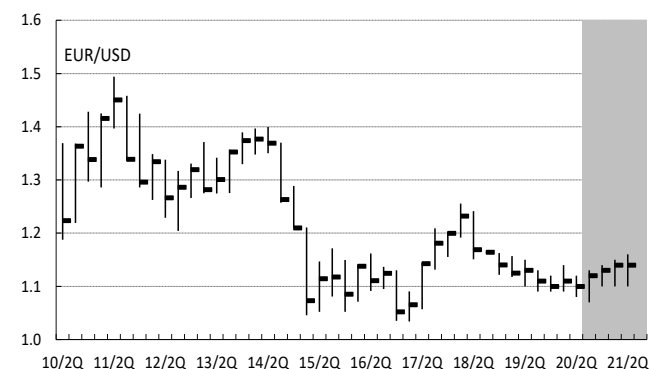
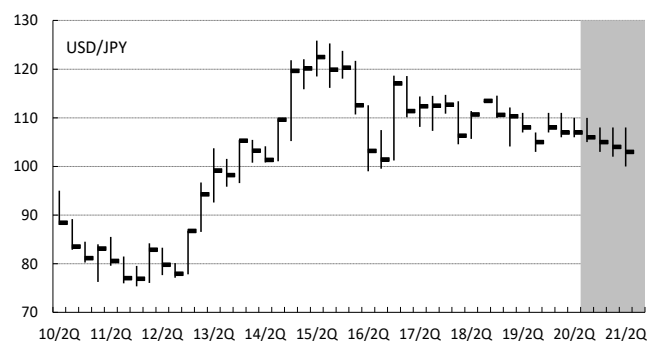
Meanwhile EUR also lacks movement. News reports regarding the proposed EU recovery fund are coming in at a dizzying pace, and the final decision on this subject is scheduled to be made at the EU summit meeting in June, so some fluctuation in EUR is expected as a byproduct. With regard to monetary policy, concerns may be raised at the sustainability of current government bond purchases, which are disproportionately weighted in favor of certain member states. The Pandemic Emergency Purchase Programme (PEPP) has been quite effective, but it also has major side effects. In May, the ECB published an article affirming the effectiveness of deepening negative interest rates, leading to speculation in some quarters that it may be paving the way for its next move. However, the ECB's policies have recently aimed to improve the risk tolerance of financial institutions by lowering the cost of fund procurement (to negative levels) in line with the policy interest rate level. It seems reasonable to assume, therefore, that it would not deliberately invite systemic instability by deepening negative interest rates. In the event that it does, EUR selling will gain momentum. My main forex-related prediction of this report continues to be USD depreciation, and the recent expansion in the U.S. fiscal deficit has only increased my conviction in this regard. As the opposite side of the coin, EUR could gain strength relative to USD.

Summary Table of Forecasts

	2020			2021		
	Jan -May (actual)	Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	101.18 ~ 112.23 (107.56)	106 ~ 110 (107)	105 ~ 110 (106)	103 ~ 108 (105)	102 ~ 108 (104)	100 ~ 108 (103)
EUR/USD	1.0636 ~ 1.1495 (1.1131)	1.08 ~ 1.12 (1.10)	1.07 ~ 1.13 (1.12)	1.10 ~ 1.14 (1.13)	1.10 ~ 1.15 (1.14)	1.10 ~ 1.16 (1.14)
EUR/JPY	114.43 ~ 122.88 (119.74)	116 ~ 122 (118)	115 ~ 123 (119)	114 ~ 122 (119)	113 ~ 122 (119)	112 ~ 122 (117)

(Notes) 1. Actual results released around 10 am TKY time on 2 June 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels

Exchange Rate Trends & Forecasts



USD/JPY Outlook – Methodology for Creating a Post-Pandemic Worldview

Global Post-Pandemic Trend of Progressive “Japanization” – Transitioning to a World Dominated by Savings Surpluses

What Will Change After the Coronavirus Pandemic?

In May, there was a general trend of peaking out in daily numbers of new COVID-19 (coronavirus) infections in developed countries, although there remain considerable differences among trends in individual countries. It seems that this trend has given people a bit more leeway to pause and consider the future, as it has been accompanied by an increase in the number of inquiries I have been receiving about what kinds of changes we should be anticipating in the post-coronavirus era. These inquiries appear to reflect a general awareness that the world may not return to what was previously considered normal when the pandemic is over and that there may well be considerable post-pandemic changes to economic and financial situations. The use of such portentous phrases as “new behavior patterns” by the Japanese government’s expert panel of infectious disease specialists may also have promoted public anxiety about the possibility that the world may not return to its previous state. (I personally think it somewhat inappropriate to use the phrase “new behavior patterns” when simply referring to countermeasures taken in response to a single pandemic.)

Before the emergence of the coronavirus situation, U.S.-China relations were progressively deteriorating owing principally to disputes about trade-related issues. In mid-January, it appeared that the U.S.-China Phase One trade agreement had broken the ice and that U.S.-China relations might be headed toward improvement, but that now seems like it was a long time ago. Immediately before the coronavirus shock, financial markets were generally being buoyed by the perception that U.S.-China trade frictions were deescalating. In light of the intensifying confrontation regarding the new coronavirus’s source along with the magnitude of the pandemic’s global impact, however, it appears that U.S.-China relations are entering another period of deterioration. Dissatisfied with China’s initial responses to the spread of the virus, President Trump has been quick to announce his readiness to levy retaliatory tariffs. I will discuss this situation later in this article in connection with the RMB depreciation trend, which accelerated in May.

Has Internal Reserves Accumulation been Justified?

From an economic analysis standpoint, there is a concern that the private sector's propensities to consume and invest may not easily re-attain previous levels following the pandemic. In brief, there is concern that many private sector entities may become increasingly convinced that it is wiser to refrain from unnecessary spending. Given the invisibility of the virus threat and the persistent fear that there may be a second wave of infections next winter, a full-scale re-acceleration of economic activities may be forestalled until a vaccine becomes available, and it probably should be anticipated that growth-driving rises in consumption and investment proclivities will continue to be somewhat restrained even after the current wave of infections has ended. The eventuation of this negative outlook seems quite likely.

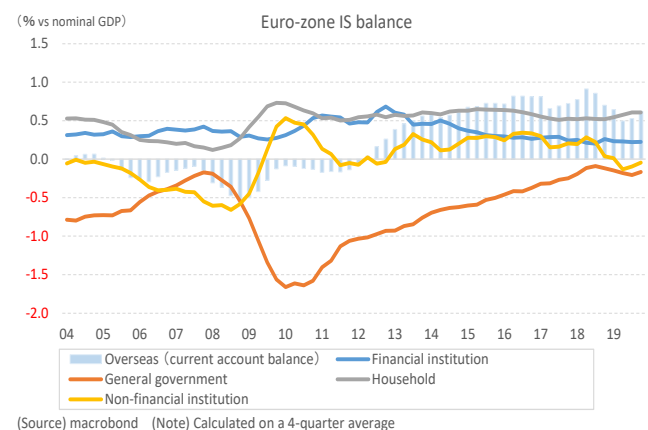
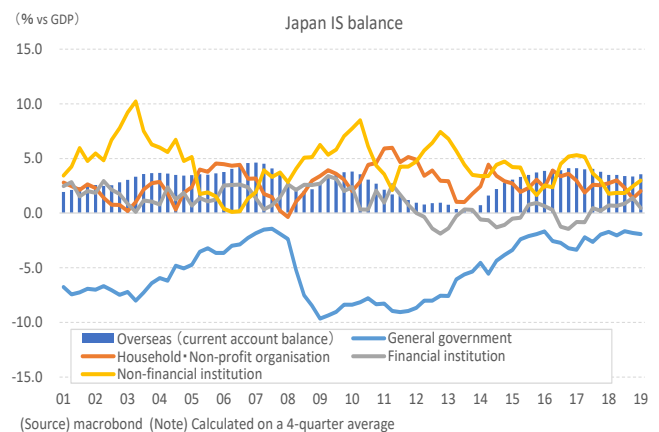
As is well known, Japanese companies have for many years been subject to criticism for accumulating excessive levels of internal reserves. On the other hand, the Japanese government and the BOJ (by means of Abenomics policies) have been struggling unsuccessfully to promote a trend of increase in salaries and wages. It can be said that one of the principal missions of the Kuroda-led BOJ and the Abe administration since 2012 has been implementing policies capable of changing behavior patterns deeply rooted in Japanese companies' fundamental corporate management policies. Since the coronavirus shock, it is likely that Japanese corporate managers are congratulating themselves on having the foresight to accumulate the reserves they need to get through the crisis period, however, and this situation can be expected to make the mission of changing behavior patterns all the more difficult. Of course it is also well known that, besides accumulating cash and deposits, Japanese companies have been allocating a portion of their profits to direct investments aimed at generating future profits. It seems likely that it will be that portion of their profit allocation that may be reduced in response to the pandemic. Regardless of that, the rate of growth in Japanese companies' internal reserves (especially cash and deposits) has been high for many years (see graph below), and it is safe to say that the reserves have proven to have a valuable shock absorber effect recently. In light of that, can also be anticipated that substantially changing this aspect of Japanese companies' fundamental corporate management policies will be difficult going forward, despite the fact that that aspect of the policies is presenting an obstacle to the government's efforts to counter the disinflationary trend. But so long as such behavioral constraints in the real economy persist, companies' dynamic strength can be expected to diminish. Although they may consider themselves sufficiently robust at this point, it is undeniable that there is a potential for non-linear growth in their management challenges sometime in the future.

Global IS balance "Japanization"

In macroeconomic analysis, the savings-investment (IS) balance is the key dynamic resource allocation factor.

During Japan's "lost 20 years" era, the IS balance pattern was that the private sector (the household and corporate sectors) records savings surpluses and the government sector borrows from those savings and records savings deficits (see upper graph). In the euro area, the same pattern became quite pronounced following the financial crisis, and it was accompanied by a weakening of inflationary pressures and the restriction of interest rates and growth rates to rather moderate ranges. One of the most important symptoms of the Japanization process is a decline in the private sector's willingness to consume and invest, which is can be confirmed by IS balance trends. I am expecting the Eurozone IS balance trend (see lower graph) to spread throughout the world and progressively reduce the global economic growth rate, and I think this pattern is highly likely to determine the overall economic scenario in the post-pandemic period. Many countries' governments have already adopted extremely proactive stances regarding fiscal spending increases, and the IMF recently increased its estimate of the value of such fiscal support measures worldwide to USD8 trillion. From an IS balance perspective, the first question is the extent to which the USD8 trillion will be able to offset upcoming decreases in private sector consumption and investment. Another question is the extent to which private sector savings can offset a fiscal spending surge greatly exceeding the post-Lehman-shock fiscal spending surge,

and this question (assuming private sector savings will be incapable of offsetting the spending surge) provokes concerns about the possibility of rising interest rate levels, but central banks' recent and current moves suggest that if interest rates rise, they will simply purchase more bonds – it seems very unlikely that central banks will allow interest rates to rise in a manner that impacts the real economy. Some might consider the central bank's confidence in this approach to verge on hubris, and it may well turn out that the banks are overestimating the sustainability of their capabilities.



The “Central Bank Balance Sheet Soundness” and “Currency Confidence” Themes

Central banks have been undertaking large-scale bond purchases to forestall increases in interest rates, but they have been somewhat self-sacrificing in doing so – shouldering the burden of huge balance-sheet growth to enable the real economy to avoid shouldering the burden of higher interest rates. Similarly, Japan’s previous JPY selling/USD buying forex market intervention measures have caused the country to accumulate a huge amount of foreign currency reserves as an alternative to JPY appreciation – but one wonders if the current trend of central banks shouldering the burden of balance-sheet growth as an alternative to interest rate rises will continue intensifying going forward. (Of course, it would be natural to note that Japan already exemplifies such a chronic intensification phenomenon.)

If so, the “central bank balance sheet soundness” and “currency confidence” themes may become major issues during the post-pandemic era. Personally, my view is that these two themes are not strongly interconnected in a fundamental way. Looking back, one might want to consider the example of the Swiss National Bank (SNB), which shouldered considerable forex losses in its efforts to restrain CHF appreciation and became increasingly suspected of having liabilities exceeding its assets. In the 1970s, Germany’s central bank (Bundesbank) came to have a negative net worth when deutsche mark (DM) appreciation led to a decrease in its foreign currency reserves. Given the existence of cases in which excessively strong currency confidence causes central banks to have a negative net worth, it can be similarly argued that a central bank’s purchase of a large amount of government bonds does not necessarily mean that its balance sheet soundness has been fatally compromised. Similarly, damage to currency confidence does not necessarily mean the currency in question is fatally compromised, and the temporary depreciation of the currency may soon be forgotten. We should keep in mind that the forex markets have an impulsive nature and are prone to straightforwardly responding to the latest theme of the moment. In forex markets, there is a considerable difference between what is “theoretically correct” and what is “practically correct”. Especially in today’s foreign exchange world, which is said to have become largely disassociated from the “fair value” concept, it is important to monitor how market participants’ psychological characteristics cause the market to muster strong or weak sympathetic responses to each new theme. When the market does respond strongly to a negative theme, however, the currency most likely to be targeted is that of a country whose central bank’s balance sheet is expanding relative to the size of its economy. JPY is particularly liable to being the victim of such targeting, given that the BOJ is the only major central bank to boast a balance-sheet value surpassing 100% of its country’s annual GDP, and this is an issue that Japanese forex market participants should keep in mind.

What Will Prices Be Like after the Pandemic? – Transitioning to a World Dominated by Savings Surpluses*Dominance of Deflation*

The abovementioned “currency confidence” theme has ramifications regarding the question of whether it is inflation or deflation that is likely to become predominant in the post-pandemic era. When imagining how Japan might suddenly suffer from inflation following its protracted disinflationary trend, it seems the most likely scenario would be cost-push inflation due to JPY depreciation accompanied by rising import prices. Demand-pull inflation caused by a generally tight supply-demand situation seems quite unlikely. This outlook is not limited to Japan. In the current era the efficiency of providing most goods and services has risen to such a high level that it is hard to imagine the onset of demand-pull inflation unless the economy’s supply capacity is restricted by the destruction of production facilities and social infrastructure. Of course, the “corona shock” scenario is often characterized as being akin to a wartime situation in light of the hampering of production capabilities and the increased difficulty of international trade owing to diminished shipping capabilities and stricter border controls, so there has been some decrease in supply capabilities. Despite a lack of physical damage to production and distribution capabilities, it appears that the pandemic’s impact on the people who operate those capabilities could perhaps cause upward pressures on prices in a manner similar to that of a wartime situation. This is an additional reason for concern about the potential for cost-push-type inflation. Although localized price increases are expected for certain goods – such as medical supplies, masks, and disinfectants as well as telework-related equipment (computers, headsets, webcams, etc.) – it appears unlikely that upward pressures on prices will spread globally amid pandemic-related restrictions that are artificially reducing demand. Looking at coronavirus-related items within Japan’s consumer price index, one finds the weighting of masks and other “healthcare supplies/equipment” is 0.72%, the weighting of cold medicines and other “medicines/health-promoting ingestible products” is 1.21%, and the weighting of medical treatment fees and other “insured medical services” is 2.37%. When the highest-weighted “insured medical services” category is included, the total weighting of items that seem directly related to the pandemic reaches 4.3%. The weighting of such products as personal computers, televisions, video recorders within the “culture & recreation durable goods” is only 0.59%. Regarding electrical appliances, such “household durables” as microwave ovens, electric rice cookers, and air conditioners have a weighting of 1.11%.

In contrast, the “culture & recreation services” category of services – such as hotel charges, package tour charges, monthly lessons fees, movie theater and theme park entrance fees, and game fees – has probably suffered a great deal due to the pandemic, and it has a weighting of 5.92%, roughly 1.5 times that of the “healthcare related” products and services. It is worth noting that the “eating out” category alone has a 5.21% weighting. Moreover, as people restrain their demand for goods and services they do not consider necessary and urgent, demand is sufficiently sluggish to make it illogical to expect a sustained upward pressure on prices from the demand side.

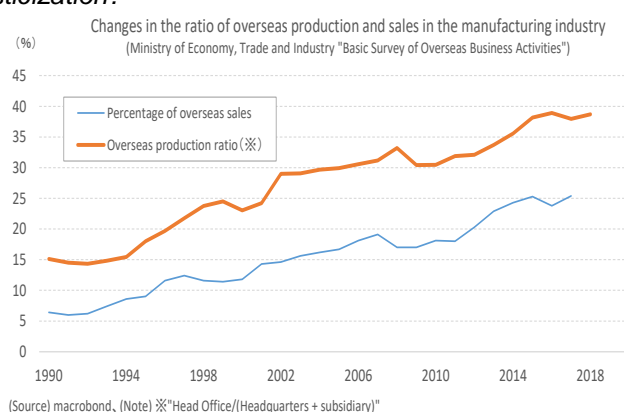
Deflation and inflation trends should not be predicted simply on the basis of CPI weightings, but even when the weightings are considered together with the IS-balance situation discussed above, it seems more reasonable to be concerned about a prospective disinflationary/deflationary trend stemming from a long-term period of weak demand. Looking at the situation from a macroeconomic perspective, it appears that, in a world where the private sector progressively accumulates savings, Japanization is likely to proceed.

General Trends away from Globalization and toward Domesticization?

At this moment, it is very difficult to forecast either inflation or deflation with great confidence. Everything will depend on the speed, magnitude, and length of growth in coronavirus infections and the timing and speed of the resumption of economic activities. But one thing that can be said with confidence is that the longer economic activities are paused, the more likely it is that supplies of some items will be insufficient somewhere in the world.

There are now seeds of inflation that exist because of supply constraints. Regarding Japan, for example, when this article was written there were situations in which such electronics products as smartphones and PCs could not be repaired because components could not be obtained from China. Even in the case of housing construction,

there are many cases in which plans called for Chinese-made toilets that cannot be delivered, and in some cases this kind of problem prevents the completion of new housing units. If the number of such supply problem cases increases with regard to daily necessities, one can expect shortages-induced price increases to become ubiquitous. If the shortages persist long enough, there will be moves toward establishing alternative production bases in Japan. If the relevant products were originally sourced from overseas to realize lower costs and prices, it can be expected that the prices of the domestically-sourced alternative goods will be higher. The question of whether such changes will become widespread following the pandemic is important. If such de-globalization trends take root and a growing number of people decide it is wiser to procure a growing number of products from domestic sources, one can anticipate significant changes with respect to manufacturing cost structures. Given that Japan's overseas sales and production ratios have rising for many years (see graph) and that those rises have to some extent contributed to the controlling of prices, it may be that we are on the brink of a major paradigm shift. For example, if products previously sourced from Southeast Asia are sourced from Germany, the United States, or Japan, the selling prices of those products will naturally be higher.



Shifting Emphasis from Efficiency to Safety?

Despite the associated outlook for price increases, if during the course of a deglobalization trend a country concludes that it is optimal from a national risk management perspective to be able to obtain various goods from domestic sources, that country's government may institute various laws and regulations to promote that optimal situation. Current events may be promoting the creation of a world in which each country chooses to shift its emphasis from efficiency toward safety or national security. In light of the excessive regulation regimes imposed on financial institutions following the Lehman shock, the prospect of a world dominated by individual countries' economic national security concerns seems quite plausible. (The degree to which the post-Lehman shock regulations were paranoid and excessive may be clearly perceived only by those within the financial industry, and readers with other backgrounds may not realize it). Such publications as the IMF's Global Financial Stability Report (GFSR) released in April have pointed out that the existence of such strict regulations has so far generally prevented the need for concern about financial institutions' soundness, but the lack of problems also reflects the excessive nature of the regulations.

If the potential inflation scenario described above becomes a reality, the progressive unwinding of globalization will promote inefficiency throughout the global economy and is likely to usher in a "high cost" world. While this is not a main forecast scenario, its likelihood is not extremely low.

Will Globalization Stop after the Pandemic? – A Third Crisis

Global Trend of Boldly Promoting Inefficiency?

As described above, it seems likely that the post-pandemic world will see a general shift of emphasis from efficiency toward safety or national security, and there is a risk that the impact of this shift on national laws and regulations and corporate management strategies may bring about a dominant global trend toward deglobalization and the re-domestication of many industries. As also described above, the main post-pandemic forecast scenario is that the impact of the private sector's surplus savings will make itself felt in various ways, and the overall upshot of that impact is expected to be an increase in deflationary pressures. In light of the excessive regulations imposed on financial institutions following the Lehman shock, however, it appears possible that the corporate sector will be required to modify its behavior even prior to a crisis. In brief, if the view that it is best to ensure domestic sources of various products for the sake of national risk management (regardless of cost increases) becomes dominant, and

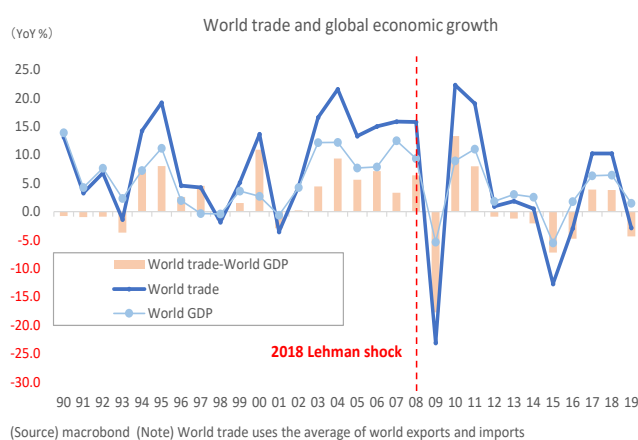
the unwinding of globalization promotes inefficiency throughout the global economy, there is a possibility that the onset of a “high cost” world will be accompanied by rising inflation rates.

Forces Countering Globalization since a Decade Ago

Although our memories may be somewhat overshadowed by current coronavirus pandemic shock, it should be remembered that there were concerns about the potential unwinding of globalization even before the pandemic. Many people began to be aware of that potential in 2016, following such political events such as the UK’s decision to depart from the EU and the election of President Trump. In particular, it might seem reasonable to consider President Trump to be a key symbol of incipient anti-globalization, as he began expressing his protectionist views even before taking office and began creating and expanding tariff and non-tariff barriers to trade with major trading partners soon after his inauguration. The relevant data suggests that a globalization-unwinding trend had already begun progressing before 2016, however, and after reviewing the data it may seem more reasonable to consider the Trump administration policies and coronavirus pandemic shock to be mere coups de grace.

The concept of globalization is difficult to concisely define and explain¹. One reasonable definition might be “the promotion of high economic growth rates by abundant cross-border consumption and investment activities”. Besides movements of goods and money, the key “cross-border” element of that definition also refers to humans’ freedom of movement as a part of globalization. While the EU originally had the role of “protecting” its member states from globalization pressures, it subsequently became considered a symbol of globalization and as such became considered unappealing to those who dislike the globalization concept of “borderless flows of people, things, money, and services” on a global level.

Given the complexity of that, the simplest way to estimate globalization levels is measure trends in international trade transactions. Initially, the lowering of tariffs and non-tariff barriers along with technological advances enabling low-cost, large-volume international product shipments encouraged companies to set up and operate numerous bases outside their home countries. If increasing numbers of international trade transactions promotes greater economic growth, it seems quite likely that trade transaction volumes will grow faster than the world economy when the globalization process is working well. In fact, that was the pattern observable over many years. As can be seen from the graph, the pattern of yoy growth in global trade volume exceeding yoy growth in global GDP persisted up until the Lehman shock in 2008. Shortly after the Lehman shock, the “global trade > global GDP” pattern was reestablished for a couple of years amid post-Lehman-shock reactive adjustments, but the “global trade < global GDP” pattern has become more common since about 2012.



Multiple factors may have promoted the recent pattern, but one particularly important factor is the progressive development of labor-saving technologies (such as robotization technologies) that have diminished the appeal of business models entailing the establishment of geographically distant bases to take advantage of relatively low-cost labor resources. Moreover, the business models focused on low-wage labor resources have sometimes raised concerns about associated intellectual property outflows, including intentional outflows as well as outflows stemming from insufficiently rigorous intellectual property management systems. It is well known that this issue has caused noteworthy frictions between China and the United States. It is also easy to find additional reasons for a gradual transformation of the nature and roles of overseas bases reliant on low-cost labor resources since the initial globalization phase, such as the upward pressure on wages in China as well as Southeast Asian countries that have been sustaining rapid economic growth rates.

Peaking Out of Direct Investments

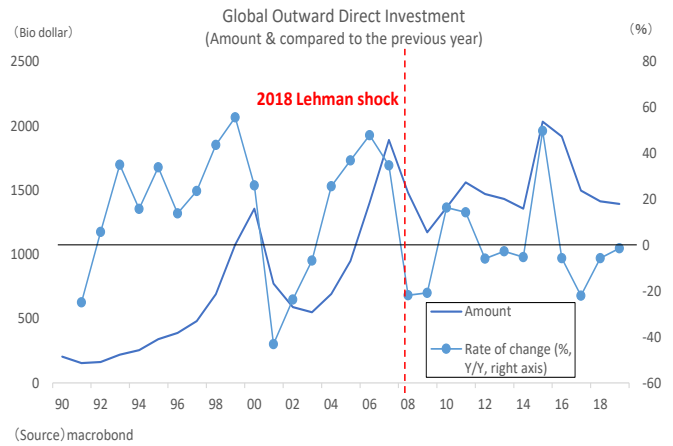
Besides trade transaction volume, there are other kinds of data that suggest a petering out of the globalization trend. If the globalization trend is in its heyday, one should be seeing companies proactively investing in the establishment of overseas bases. It is not difficult to understand that, in periods when trade transactions are burgeoning, multinational corporations will be investing in the establishment of production, logistics, and sales bases around the world. Such activities are statistically reflected in foreign direct investment (FDI) figures. In the 12-year period from 2008 to 2019, the global external FDI balance showed yoy increases only 3 times – in 2010, 2011, and 2015 (see graph). In contrast, during the 12-year period from 1996 to 2007, there were only three years in which the global external FDI balance did not show a yoy increase. Moreover, these exceptional three years were in the period from 2001 to 2003, and it is thought that the trend at that time reflected a reaction to the terrorist attacks in the United States. In light of this along with the trade transaction volume trend changes mentioned above, it seems that the globalization trend has begun decelerating since the financial crisis, although it is not yet apparent whether it has been actually moving toward an unwinding process.

¹ For more detailed information, please refer to Risaburo Nezu’s article entitled “The End of Globalization?” Research Institute of Economy, Trade and Industry, April 27, 2018

This coronavirus pandemic shock can be seen as the “third shock to globalization” — following the financial crisis (the Lehman shock) and the 2016 shock of the voting processes that approved Brexit and elected Donald Trump to the U.S. presidency – and I suspect that the fact that this latest shock is a global life-threatening crisis gives it a potential for changing the management attitudes in the corporate sector and as well as policy attitudes in the government sector. If the changes become so great that “doing things domestically whenever feasible” becomes a generally accepted goal, then there are grounds for concern that inflationary pressures will be generated. Even before such a goal becomes generally accepted, it is likely that lessons will be drawn from the current crisis that lead to the imposition of export

restrictions on items that may become considered strategic medical care-related items. (Initial movements in this direction have already been seen in the EU.) If that happens, there is a possibility that it will be mandated that certain goods be produced domestically regardless of whether the producers want to do that or not. In Japan, given manufacturing industries’ chronic labor shortages, this would be likely to generate upward pressures on wages, but it could also financially weaken some companies.

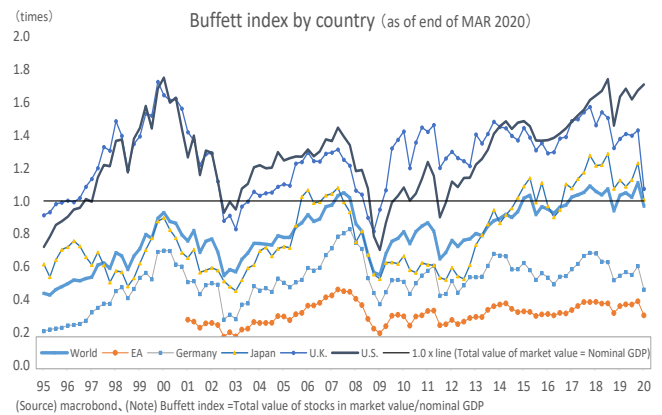
The biggest key to forecasting economic and financial situations in the post-pandemic era is the private-sector surplus savings situation that has already been repeatedly noted in this article. Having mentally digested that situation and considered the nature of various prospective “globalization unwinding” and “domesticization” processes, we can begin envisioning the various ways in which the surplus savings can be optimally utilized. I expect these changes will cause an uptrend in stock prices that deviates from trends in the real economy in ways that are discussed in the next section of this article.



Post-Pandemic Expansion of Disparities between Real Economy and Financial Market Trends – Continued Inexplicable Trend of High Stock Prices

Real Economy vs Financial Market

As noted above regarding the post-pandemic economic and financial situation, there is a possibility of a transition to a world in which, while there are persistent private-sector savings surpluses, the government sector will move to borrow and make use of those savings surpluses. That is the same structural change Japan experienced during its “lost 20 years” period. As described, this kind of situation is liable to generally promote Japanization processes involving the accumulation of government debt and the assumption of that debt by central banks, and it is necessary to consider how central bank balance sheet expansion is accepted as an alternative to economic stagnation. At the time this article was written, only the BOJ had a balance sheet equal to or larger than its country’s annual GDP, but current situations suggest that Europe and the US are pursuing their own paths toward the same sort of “central bank balance sheet > annual GDP” scenarios.



The above-described world will be one in which central banks’ provision of excess liquidity becomes the normal situation, and markets that may be called financial markets but are, roughly speaking, surplus money markets, are likely to emerge. In recent years, people have begun questioning why it is that financial markets have continued to perform better than real economies, but it is noteworthy that this pattern may become the norm in the post-pandemic world. When discussing the relationship between macroeconomic trends and stock prices, people often cite the ratio of market capitalization to nominal GDP, which is sometimes called the Buffett indicator because of its use by the prominent U.S. investor Warren Buffett as a tool for making investment decisions. It is widely believed that Buffett indicator levels higher than 1.0 may indicate stock market overheating. Although there is room for debate about how appropriate it is to compare stock market capitalization stock figures with GDP flow figures, I regularly monitor Buffett indicator trends because they are a simple indicator of the nature of current trends. The graph on the right shows ratios of stock market capitalization to nominal GDP for the world and individual countries, and the right-most data points have been calculated for figures as of the end of March this year. The right-most data points show major drops in reaction to the coronavirus pandemic. Disregarding Europe for the time being, it is noteworthy that Buffett indicators for the world and for Japan are in the vicinity of 1.0, while the United States remains at the height of 1.7. This suggests that financial markets are still much stronger than the associated real economies. The overall impression one gets from this is that the pandemic’s impact on financial markets has been less than its impact on the

real economy. At the time this article was written, stock prices were still strong, and I perceive a clear disparity between those stock prices and conditions in the real economy.

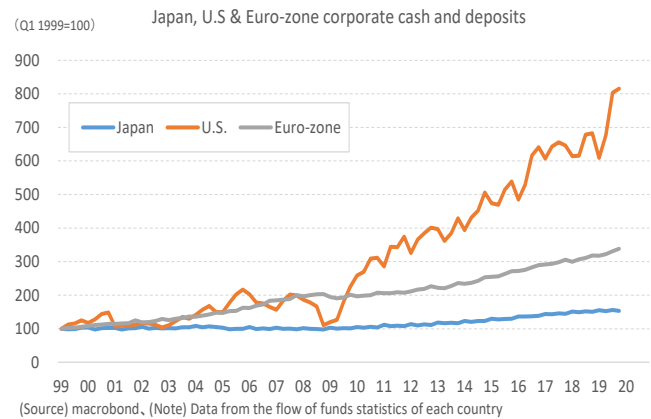
Logical Connection Between Excessive Private Sector Savings and Ironically High Stock Prices

In the post-pandemic world, such a gap between the real economy and financial markets may become normal. The established pattern of chronic private-sector savings surpluses is logically linked with the continued strength of stock prices. Private-sector savings surpluses reflect the corporate sector’s perception that there are not many worthy investment opportunities available. Given that, it is easier for corporate managers to make such moves as those to buy back shares and increase dividends.

Alternatively, the managers can also choose to accumulate funds for corporate acquisitions, and it may be that we will see M&A transactions gaining momentum.

If the number of investment opportunities in the economy as a whole is decreasing, it may be natural to see a parallel decrease in the number of companies.

If the number of companies were to decrease, it would be likely to lower levels of inter-company competition, which could further reduce companies’ propensities to undertake new investments. This sequence of situations could become a vicious cycle that reinforces the private-sector savings surpluses trend. It is worth noting that levels of corporate sector cash and deposits are rising in the world’s three principal economies – of the United States, Europe, and Japan – and the question of how companies should utilize those funds will be an important issue in the post-pandemic era. If levels of inter-company competition become lower along with a decrease in the number of companies, it is probable that corporate profits will eventually stabilize and promote a further strengthening of stock prices. Since such trends are not associated with growth in real economy consumption or investment activities, however, governments and central banks may have to continuously provide support to the real economy. It is ironic that stock prices should be strong amid these circumstances.

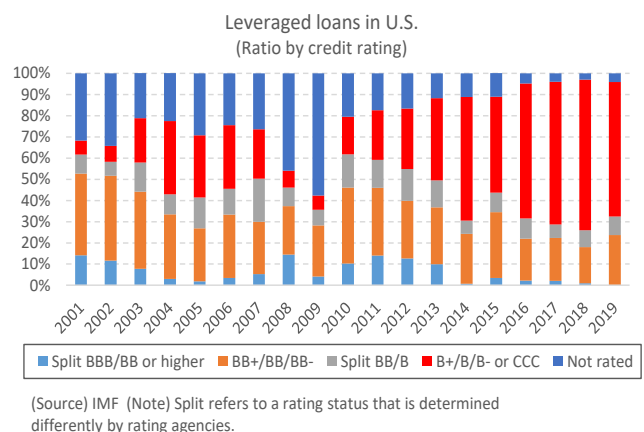


From investors’ perspective, there is an expectation that interest rates will tend to not increase in the chronic-private-sector-savings-surpluses world because of central banks’ bond purchases. So there is a theoretical basis for stock prices to remain strong relative to bond prices. In a world of negligible interest rates, investors have a strong incentive to buy stocks that can be expected to generate dividends on a predictable periodic basis. It has been pointed out that one factor explaining the continued strength of stock prices despite the deterioration of corporate profits in recent years is the fact that the general disappearance of yield-generating financial products has encouraged investment funds to focus on stocks that can be expected to generate steady returns in the form of dividends. (This is sometimes referred to as the “bondification of equities”.) This is also a factor that can help explain recent trends of increase in prices of real estate assets and high-yield bonds. Given speculation about the possibility that negative interest rate policies might be introduced in the United States and United Kingdom, it can be conjectured that investors are choosing to invest in stocks owing to a lack of alternative types of investments. The prospective situation is a world in which stock prices reflect the overall state of the financial environment more than they reflect the performance of individual companies. In this regard, it might be reasonable to conclude that the applicability of traditional corporate performance valuation approaches in modern stock markets is fading away, just as forex markets have been drifting away from the traditional approach of determining currency values with reference to interest rate differentials. It is becoming necessary to forecast market trends based on an understanding of how the dynamic structural shift to chronic private-sector savings surpluses is fundamentally changing the way traditional asset markets function.

U.S. Economic and Financial Situations and the Fed’s Next Move – The Next Five Years May be Critical

Follow-Up Report on the WEO/GFSR

Chapter 2 and beyond of the IMF’s World Economic Outlook (WEO) and Global Financial Stability Report (GFSR), which were marked “incomplete” for some time, were finally published toward the end of May. The GFSR, in particular, provided detailed inside information regarding the corporate debt problem, which has, since before the COVID crisis, been a source of concern as a possible trigger of the next financial crisis. Specifically, the report provided a clear explanation of the problems with loans to companies that have low credit ratings (“leveraged loans”) and indicated what issues will be of concern going forward. As the figure shows, the issuance of B- to CCC-rated leveraged loans in the U.S. has increased dramatically in the U.S. over the past 10 years. These loans have come to comprise 60-70% of all leveraged loans in recent years. Further, as one can easily surmise from such data, over half



of all newly formed investment-grade assets in the credit market are BBB-rated, which has been regarded as dangerous in the markets. Debt markets tend to be vulnerable to shocks, and in the event of a crisis, the rating of such assets could immediately be downgraded to speculative grade or lower, directly causing funding difficulties for the companies in question. The Fed also pointed this out in its Financial Stability Report published earlier this year, in February, and its concerns proved quite accurate in March, when the markets were plunged into gloom. This is likely why the Fed responded so quickly and boldly in its decision to purchase all types of assets (although the pace at which it cut rates may have been too rapid, considering the potential for this to be a long-drawn-out battle).

The fact that B- to CCC-rated bonds have comprised well over 50% of all new bond issuances since 2014 may be explained by the presence of excessive liquidity relative to the real economic performance from around this time. 2014 is also the year that the ECB introduced negative interest rates, eliminating interest rates across the EU. The excessively accommodative monetary climate in the U.S. in light of the strength of its real economy appears to have combined with investment difficulties outside the U.S. to cause the leveraged loan market to flourish, leading to the excessive risk-taking behavior of recent years.

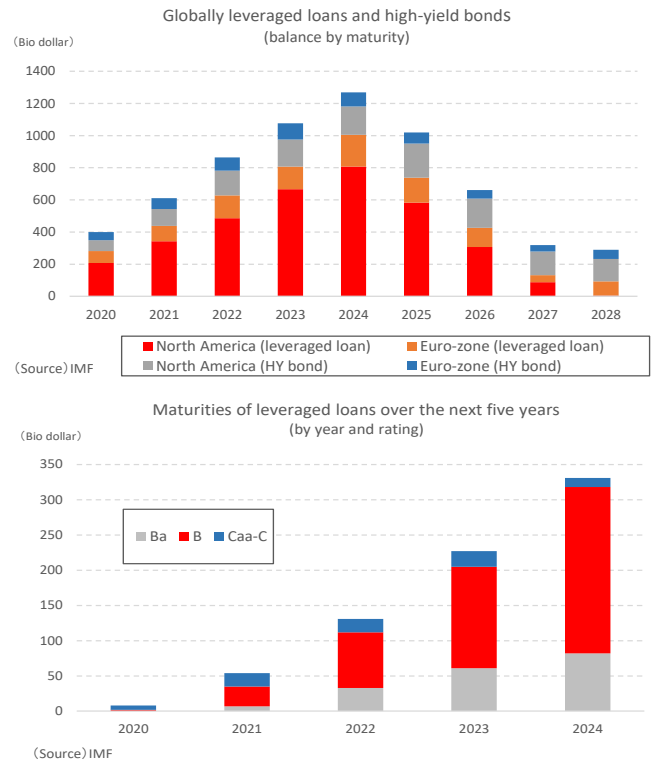
The Next Five Years May be Critical

The previous section explained the background to a potential crisis. The GFSR calls for caution over the next few years as a way to deal with concerns that could emerge going forward. “While refinancing risks for high-yield bonds and leveraged loans seem manageable in the short term, their maturity profile appears more challenging over the medium term, with a record amount of loans maturing in five years,” it points out. As the top-right figure shows, leveraged loans amounting to enormous sums are due to mature in the U.S. in the next four to five years (especially over the next four years through 2024). If there are problems with refinancing at the time of maturity, a large number of these borrowers may default, leading to considerable losses and raising concerns of a systemic risk. Moreover, as the bottom-right figure shows, most of the loans that are due to mature in the above timeframe have low ratings, not to mention that ratings are likely to be further downgraded during phases of economic recession, such as the present. There are, therefore, concerns of the refinancing climate further deteriorating.

Could YCC be the Fed's Next Move?

U.S. monetary policy going forward must be predicted in light of this current state of affairs and future outlook. To get straight to the point, given the aforementioned state of corporate debt, it may be difficult for the Fed to return to monetary tightening over the next five years or so. The first question to address would be whether the Fed can shift from an “accommodative” to “neutral” stance during this period. Let us take a look back at what happened during the previous crisis – the global financial crisis began in September 2008. After the Fed responded promptly with accommodative monetary policies, it took four years and eight months before the start of policy normalization could be announced in May 2013 (at the event that is called the “Bernanke shock”). Based on this, “five years or so following a major crisis” seems like a reasonable measure to go by. Incidentally, it was only in December 2015, a further two years and seven months after announcing policy normalization (seven years and three months from the start of the crisis) that a rate hike was actually able to be implemented. Given that the recent crisis is thought to be of a greater magnitude than the 2008 crisis, it would not be surprising to see four or five years pass by before the next rate hike can begin to be considered.

In light of the current situation, the next move is further monetary accommodation. Going by the minutes of the April FOMC meeting, some options the Fed is considering include (1) making its forward guidance more explicit (and outcome-based, i.e., conditional on macroeconomic indicators, or date-based, i.e., linking it to a specific time-period), (2) making its asset purchase policy more explicit, and (3) purchasing Treasury securities with a view to pegging short- to medium-term yields to specific levels. Option (3), needless to say, is the Fed's version of yield curve control (YCC). Regardless of which of the above frameworks is adopted, it seems clear that the Fed favors maintaining current levels of accommodation over the long term rather than risking the side effects of a negative interest rate policy (NIRP) in an effort to increase the degree of accommodation. As far as sustainability goes, the YCC has already been tried and tested by the BOJ. The debt status of companies with low credit ratings in the U.S. is worrisome to begin with, and they face a critical challenge of refinancing in the coming years. Therefore, instead of betting on NIRP and facing a systemic risk, the more rational option for the Fed would be to ensure stably low interest rates over the longer term and strengthen YCC and the associated forward guidance to enable these companies to make a soft landing. If the Fed does indeed adopt YCC, USD/JPY will become even more immobile, and inflation and supply and demand will become relatively more important factors influencing the rates.



Risks to My Main Scenario – Beware the Risk of Excessive USD Depreciation in an Effort to Correct CNY Weakness

Risks Continue to Depend on COVID Infection Progress

In this section, I would like to discuss the risks to my main scenario. As I have been saying in past issues of this report, there are three scenarios presented by the IMF that could involve JPY appreciation risks. Scenario 1 assumes that measures to contain the spread of the virus in 2020 will last roughly 50% longer than assumed in the baseline. Scenario 2 assumes that there is a second outbreak of the virus in 2021 that is roughly two-thirds as severe as in the baseline. Scenario 3 assumes that it takes longer to contain the outbreak in 2020 and that there is a second outbreak in 2021. In each of these scenarios, it is assumed that the financial environment will become tighter due to rises in each country's government bond yields and that monetary policy authorities will have to implement additional measures in response to that. With regard to USD/JPY, it appears that the likelihood of the Fed being forced to adopt NIRP becomes progressively higher with each scenario, and it can be understood that the risk of JPY appreciation will rise in step with that likelihood. It can also be anticipated that the protraction of a cautionary stance to infections will require stepped-up demand-stimulation measures, further magnifying the already enormous U.S. fiscal deficit. If that happens, diminishing confidence in USD could promote increased USD selling. In the WEO, the IMF worries that "the limits of central banks to backstop the financial system [could be tested], further [raising] the fiscal burden of the shock." – this concern may be based on an awareness of the possibility of USD depreciation as a result of diminishing confidence in USD.

While it is difficult to make specific forecasts for the three scenarios, it seems likely that in the case of scenario 1, USD/JPY will fall below JPY 100 within the year, and in the case of scenarios 2 or 3, that USD/JPY will shift downward to the JPY95-100 range in 2021.

Risks Associated with USD and CNY Weakness

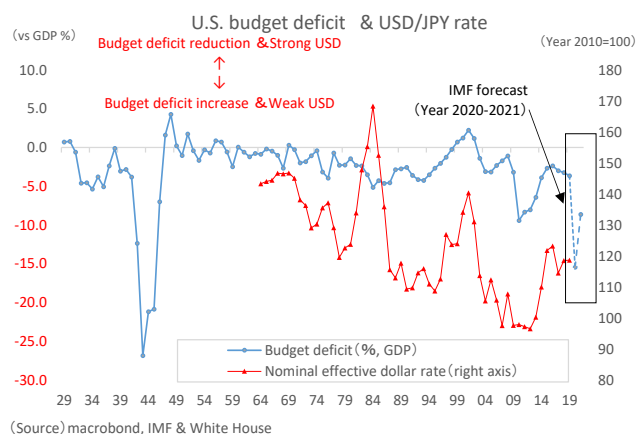
One of the risks to my main scenario not associated with COVID has to do with the relationship between USD and CNY. On May 25, the People's Bank of China (PBOC) pegged CNY at 7.1209 to the dollar, which is the lowest it has been in the twelve years and three months since February 2008. CNY depreciation is not a recent phenomenon, but something that has been happening since the beginning of the year. As the currency of the country of origin of COVID, CNY has tended to be sold off by investors. Although the spread of infections appears to have slowed down for the moment, CNY continues to weaken amid rising concerns over (1) renewed confrontation between the U.S. and China and (2) uncertainties over the future of the Chinese economy, which mutually reinforce each other. Nervousness about the risks to the financial markets from this situation is, therefore, quite natural. In connection with (1), Hong Kong has been plunged into chaos after the National People's Congress of the People's Republic of China (NPC), which was convened on May 22, announced its decision to promulgate a national security law in Hong Kong in an effort to control anti-establishment activities there. As the U.S. takes a critical view of the danger posed to the "one country two systems" principle, the more chaotic the situation in Hong Kong, the more intense the confrontation between the U.S. and China is expected to get. This will naturally promote further CNY selling.

Is CNY Weakness Actually Profitable for China?

What forex market participants are interested in finding out is how the Trump administration will view this CNY depreciation trend. Depending on the situation, there may be political intervention aimed at inducing sharp USD depreciation against CNY. The PBoC, for its part, is likely to maintain that its pegging of CNY at a weak rate merely "follows" the market rate. From the perspective of the U.S., however, it could seem as though the PBoC "approves" the market rate. The PBoC's current system for pegging CNY invites constant debate on whether market rates are being "followed" or "arbitrarily approved." It cannot be denied, however, that this is a subject that can be utilized by the Trump administration in the run up to the presidential election. This situation could well be used for the imposition of additional tariffs or non-tariff barriers on China, which could develop further into a confrontation. However, in the event that additional tariffs are imposed, China is bound to try to offset the impact of those tariffs by further weakening its domestic currency. In this context, one is reminded of the new rule introduced by the U.S. Department of Commerce in April, as per which, countries that attempt to offset the impact of additional tariffs by devaluing their currencies will face further additional tariffs. This new rule has not yet been applied to any actual cases, but it is quite possible that the Trump administration will try to impose it in earnest in the run up to the election (partly as a PR exercise). The relation between CNY weakness and the Trump administration's additional tariffs is a complex issue that is intertwined on many levels, but it seems unlikely that the Trump administration will overlook the continued depreciation of CNY. USD/CNY rates could well be influenced by a strong statement from President Trump indicating his government's intention to bring the value of USD down relative to CNY.

USD Weakness Itself Could Pose a Risk

There is also the concern of whether an intentional attempt to weaken USD can remain controlled. As I have repeatedly said in this report, the U.S. fiscal deficit is expected to expand dramatically through the end of 2021. Keeping in mind the large volume of U.S. Treasury securities that will have to be issued to finance the debt, it is important to question whether politically promoting USD weakness is really an appropriate strategy over the medium to long term. As the figure shows, the U.S. fiscal deficit is forecast to expand to 15% of GDP through 2021. One cannot help feeling, under such circumstances, that USD is liable to weaken on its own even without political intervention. Excessive political intervention could promote a capital outflow from the U.S., inviting a crash in USD-denominated asset prices, and resulting in a dramatic strengthening of JPY. This must be kept in mind as one of the risks to USD/JPY. CNY's depreciation against USD tends to be discussed as a dichotomy between China's attempt to weaken its domestic currency and U.S. displeasure at this behavior, but it must be noted that USD weakness itself could invite undesirable turmoil in the U.S. and global financial markets in the current phase.



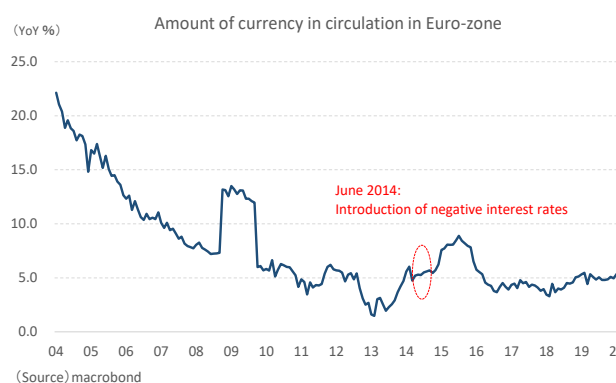
EUR Outlook – Will the Next Move be a Deepening of Negative Interest Rates?

EUR Area Monetary Policies Now and Going Forward – ECB Paper Justifies NIRP

ECB Paper Justifying the Effectiveness of NIRP

There was no ECB Governing Council meeting in May, but the Bank published a paper titled “Negative rates and the transmission of monetary policy” on May 13. The paper highlighted the effectiveness of NIRP. In combination with a recent ruling by the Federal Constitutional Court of Germany questioning the legality of the ECB’s quantitative easing measures, this may result in drawing greater attention to the deepening of negative interest rates as the possible next move by the ECB in the coming days. The paper begins by citing the benefits of NIRP, namely that negative rates allow monetary accommodation to propagate through the entire yield curve, raise asset prices by exerting a downward pressure on the term premium, and incentivize commercial banks to expand lending. Originally, the main concern regarding NIRP was that it could cause a major shift toward cash in favor of deposits, causing bank revenues to go into a decline, given the non-negativity constraint of cash (i.e., that there can be no negative interest rate on cash). There was also originally a concern that the monetary policy effect could be diluted if investors hoarded cash rather than rebalancing their portfolios (channeled more funds into assets with higher expected returns). The article, however, has rejected these potential side effects, saying, “so far there are no signs of large-scale liquidity “leakages” of this type, mainly owing to the costs of forgoing the services provided by central bank reserves or commercial bank deposits as a means of conducting payments and storing value.” It points out that the side effects of NIRP so far have been limited.

It is true that there is no data to suggest an increased pace of growth in the amount of currency in circulation since the introduction of negative interest rates in June 2014. There has, in fact, not been much change in currency in circulation since before the policy was introduced (see figure). This may be due to the fact that negative interest rates have not been applied to retail deposits due to the potential legal problems (depending on the country) as well as due to concerns about an outflow of funds from deposits. As a result, there has been no significant shift toward cash in response to NIRP. Many Euro area member states have legalized negative interest rates on corporate deposits, and this trend is gradually expanding, but retail deposits have been spared. However, even if a negative interest rate is not overtly applied to retail deposits, there could be cases where an effective negative interest rate is being applied through bank fees and commissions. Regardless, the paper concludes regarding the lack of evidence of any marked outflow of funds from deposits, that “a negative nominal rate would only generate a change in behaviour among retail depositors as a result of some form of money illusion or other behavioural bias.” At any rate, the mere existence of a negative interest rate has not so far resulted in a flight of capital from banks, and the paper suggests that, in this sense, the side effects have thus far been limited.



Impact on Bank Revenues “Negligible”

The paper also says that “negative interest rates have both adverse and beneficial effects on bank profitability,” concluding that “the net effect is ultimately an empirical question.” This position could invite some debate. While recognizing that profits resulting from the difference between short-term and long-term interest rates have been negatively affected, the paper emphasizes that there are also positive effects as the increase in asset prices (caused by NIRP) have been supporting the macroeconomy and, therefore, bank profits. It points out, in particular, that “the positive impact of the policy on macroeconomic conditions leads to higher intermediation volumes, supporting net interest income.” Other positive effects, such as an increase in credit demand in a low-interest-rate climate, and capital gains resulting from the increase in the value of securities held by banks, are also mentioned.

This analysis of the beneficial effects of NIRP appears reasonable at first glance, but it is dubious in some ways. In the first place, it is impossible to say for sure that the improvement in the macroeconomic situation is premised on the NIRP. With any policy, it is impossible to simulate what might have happened had that policy not been implemented, so those who defend the policy have an advantage over those who criticize it. However, it seems extremely risky to extoll the benefits of NIRP based on the assumption that that was what promoted economic stability.

On the other hand, there is an unmistakable causal relationship between NIRP and vanishing difference between short-term and long-term interest rates. This is probably why the paper reserves judgment on it, calling it an “empirical question.” However, the paper’s conclusion that “negative interest rates have had a broadly neutral impact

on bank profitability so far (...). Overall, taking all effects into account, NIRP is estimated to have had a negligible impact on bank profitability up to now," is likely to invite significant opposition.

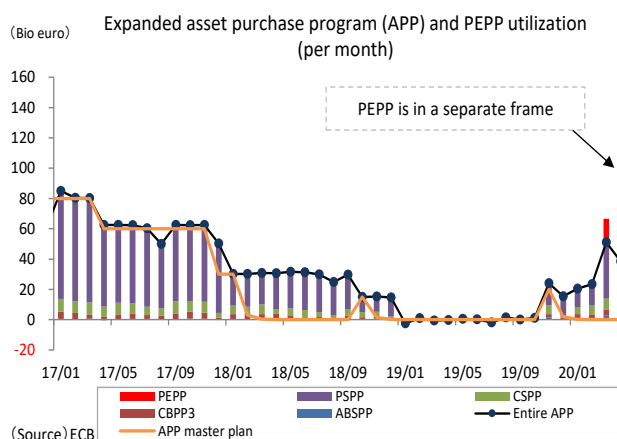
Hinting at the ECB's Next Move?

A paper such as this could lead to conjectures that the next move by the ECB could be a deepening of negative interest rates, but the paper itself says that "potential factors that may hinder the transmission of monetary policy in the event of any further extension of the policy or deeper cuts into negative rate territory must therefore be monitored closely." In a way, it appears to recommend a cautious approach toward deriving the next move from the current state of affairs. Given that the ECB did not resort to deepening negative interest rates at its March meeting, which came right on the heels of the Fed's large rate cut, when expectations of the same from the ECB were at their peak amid widespread gloom in the markets, my prediction is that the deepening of negative interest rates remains relatively weak as an option for the ECB.

Recent Status of ECB's Asset Purchases – German Court Says Furious Pace of ECB Asset Purchases Unconstitutional

April Purchase Amounts: 8 Days' Worth of PEPP Purchases ≙ APP Purchases for Whole of April

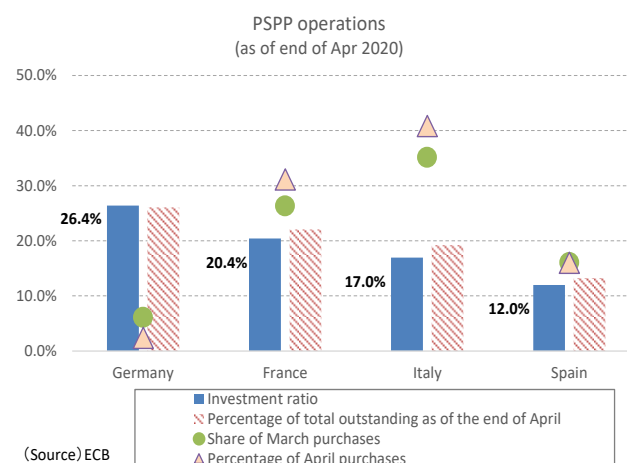
The ECB has recently been purchasing assets at a furious pace as part of its monetary policy. The amount of assets purchased in the first week of May equaled the amount of assets purchased during the entire month of April. The scale of the purchases was so stupendous that it is surprising this was not more widely reported. Let me summarize the situation briefly. The ECB currently operates three asset purchase programs: (1) the EUR 20 billion per month expanded asset purchase programme (APP), which was resumed in November last year, (2) the temporary envelope of additional net purchases amounting to EUR 120 billion until the end of the year that was added to the expanded APP at the March 12 Governing Council meeting, and (3) the pandemic emergency purchase programme (PEPP) that was announced at the March 18 emergency meeting of the Governing Council, which has an overall envelope of EUR 750 billion until the end of the year. Of the above, (2) and (3) are COVID-specific countermeasures, and together amount to a total asset purchase envelope of EUR 870 billion within the year. Of the three, (3) is the main program, with (1) and (2) playing supporting roles.



In April, the ECB purchased EUR 34.89 billion worth of assets under the APP and EUR 103.37 billion worth of assets under the PEPP. As discussed below, on May 5, the German Federal Constitutional Court stirred up controversy when it ruled that the public sector purchase program (PSPP), which forms the core of the APP, is unconstitutional. However, it feels intuitively out of place to rule programs (1) or (2) unconstitutional while completely ignoring the overwhelming scale of purchases under (3). Of course, it is a question of the logic behind the purchases more than the amount itself, but this argument seems feeble in the face of the extent by which the PEPP exceeds the APP. It is unprecedented in the ECB's history to see monthly asset purchases amounting to EUR 100 billion. Incidentally, the purchase amounts under all four programs that constitute the APP (the PSPP for purchasing government bonds, the CSPP for purchasing corporate bonds, the ABSPP for purchasing asset-backed securities, and the CBPP3 for purchasing covered bonds) have posted mom decreases for April, while the PEPP alone posted an mom increase. Of course, it is natural for the PEPP to increase in April compared with March, as the program was implemented only for the last week of March compared with the whole month of April. However, a rough calculation of the pace of purchases indicates a weekly pace of around EUR 24 billion and a daily pace of around EUR 4.8 billion. In other words, the APP purchase amount for the whole of April (EUR 38.49 billion) can be covered by no more than 8 days' worth of purchases under the PEPP. That is the magnitude of difference between the PEPP and the APP (≙ PSPP).

A Considerable Amount of Funds Invested in Southern European Government Bonds

The recently released April PSPP (government bond purchase program) purchase data by country suggests that the ECB's balance sheet may have become even more disproportionately weighted in favor of the southern European member states. Looking at the stock-based figures as of the end of April for the four major euro area countries (see figure), the data shows PSPP purchases in excess of the capital key for three of these countries (all except Germany). Still, in stock terms, the discrepancy is no more than 1-2 pp. However, looking at the monthly purchase amounts (flow-based data), there seems no relation to capital key contributions. Italian bond purchases, which made up for as much as 35% of the ECB's monthly PSPP purchases for March, increased to over 40% in April (see figure). The percentage of Spanish bond purchases was also quite high at 16%. As per the rules, the combined

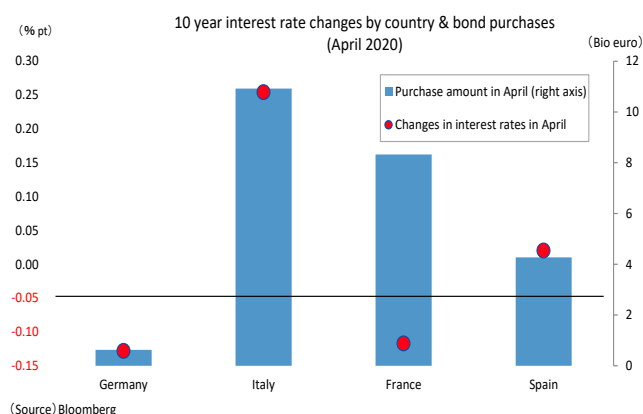


percentage of Italian and Spanish bond purchases in the ECB's balance sheet should be no more than 29%, but in fact, it was 51% in March and 56% in April. According to the current configuration of the PSPP, the ECB can utilize all the flexibilities incorporated into the APP framework, but must ensure that the ultimate allocations at the end of the program are in accordance with the capital key of each national central bank. Keeping this requirement in mind, the current pace of asset purchases seems hardly sustainable.

Moreover, it would not be surprising if more than twice the confirmed amount of southern European government bonds had actually been purchased, because the details of PEPP purchases, which are almost three times the size of APP purchases, have not yet been released. It is not difficult to imagine that a considerable amount of funds may have been invested in Italian and Spanish bonds (the PEPP targets all marketable securities that can be purchased under the APP, including both private and public sector bonds). However one sees it, there is strong suspicion that the ECB's balance sheet is even more disproportionately weighted in favor of the southern European member states than apparent from the already released PSPP data.

If the ECB Does Not Intervene...

As explained above, the PEPP is the main focus of the ECB's current asset purchase programs. In May, however, Germany's Federal Constitutional Court ruled that the ECB had to prove the legality of the PSPP within three months and that, if that was not possible, Germany's central bank (the Bundesbank) would have to discontinue its participation in the PSPP as well as begin selling German government bonds. However, German government bond purchases accounted for only 2% of PSPP purchases in April, so excluding German bonds from the program would not greatly change the overall scale of the program. Given that the ECB's crisis response measures such as the expansion of the APP increase and establishment of the PEPP were principally designed to support a heavily



indebted countries that could cause contagious financial market problems (primarily Italy), the halting of German government bond purchases would not directly promote a genuine crisis. More disturbing than that situation is the fact that 10-year yields on the bonds of both Italy and Spain rose throughout April despite the ECB's purchases of those bonds so far (see graph). Without the ECB's intervention, it appears highly likely that the yield levels may have risen to levels that could potentially have put both countries in dire fiscal straits.

Germany's Federal Constitutional Court Ruling Currently a Strictly Legal Issue

I'm not very concerned about the German Constitutional Court's ruling that a portion of the PSPP is unconstitutional. As mentioned above, (1) the PEPP is currently the main quantitative easing tool, and (2) the proportion of German government bonds purchased through PSPP is very small. Even if the court decision were actually to cause the Bundesbank to suspend its German government bond purchases, it would not in fact be such a serious problem. This is because, even if the ECB cannot prove the PSPP's legality within three months, it will only be the Bundesbank that will become unable to buy German government bonds, while the central banks of other EU countries will still be positioned to gradually step up their German government bonds purchases to compensate for the lack of Bundesbank purchases. My view is that the court case is strictly a legal issue relating to how to resolve conflicts between decisions of EU countries' courts and decisions of the EU Court of Justice and that there is no need for concern about the impact of the case on economic and financial situations. However, PEPP is an emergency response tool that was never expected to become a permanent fixture. Given this, it may be that persistent doubts about the legality of the PSPP will continue to overshadow ECB policy management operations in the post-pandemic era.

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