Forex Medium-Term Outlook

June 30, 2020

MIZUHO

Overview of Outlook

Once again in June, USD/JPY saw little movement. Having lost its interest-rate gap, it may be natural for this currency pair to remain more or less unvarying. Following the June FOMC meeting, it became clear that a consensus was forming on maintaining the zero percent interest rate through 2022. If, in addition to this, the Fed were to introduce yield curve control (YCC), USD/JPY will further lose volatility. Under such circumstances, if one were to still attempt to gauge USD/JPY's direction of movement, this report's position is to bet on JPY strength. JPY, which has maintained its status as the currency of the world's largest net external creditor for 29 years in a row as of the end of 2019, is still liable to be bought during phases of risk aversion. Of course, it is difficult to be sure how the forex markets will respond if Japan's position in this context is usurped by Germany in the near future, but it is still too early to worry about that. Risks for the current forecasting period continue to depend mainly on the spread of COVID-19, but apart from that, one must also pay attention to the possibility of the Trump administration's desire to weaken USD as the U.S. presidential election approaches. Overall, my prediction is that USD/JPY will remain strongly range-bound during this forecasting period, with reasons for predicting JPY depreciation against USD being especially scarce.

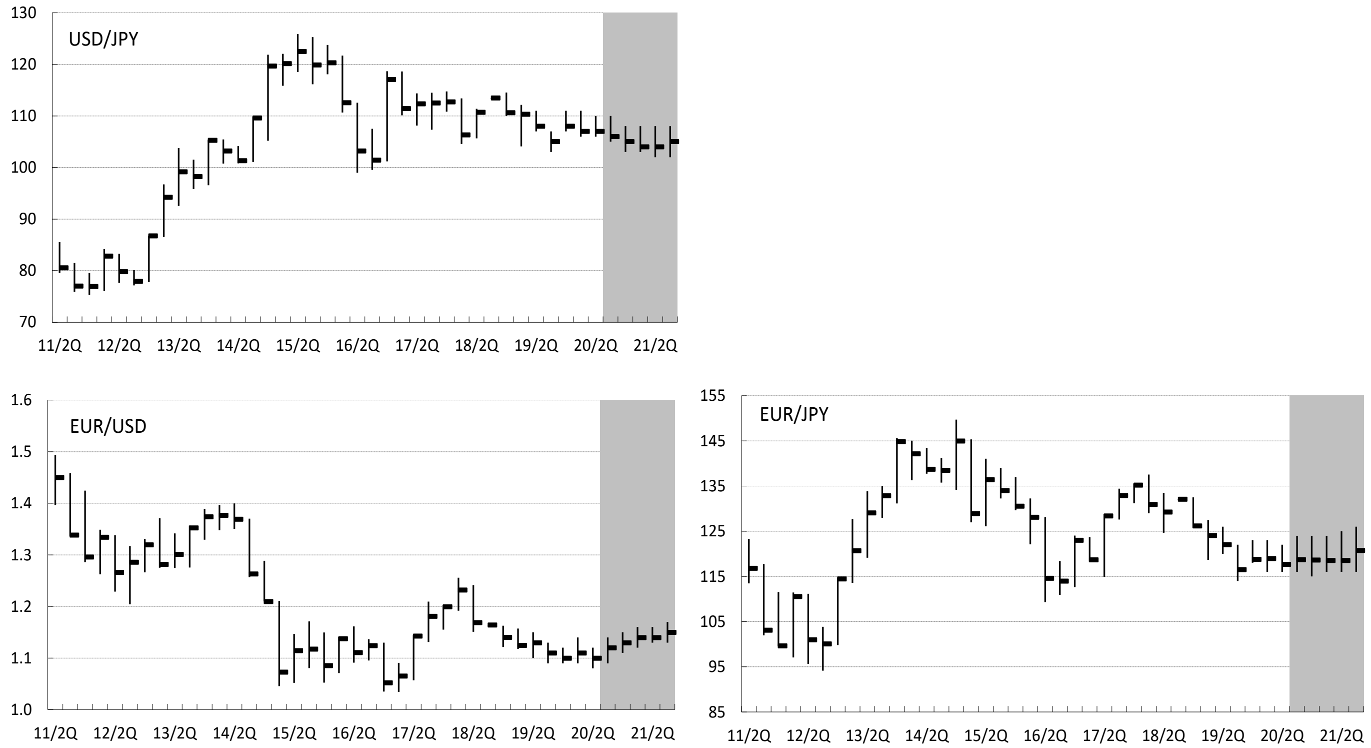
Meanwhile, EUR has remained strong despite the investment climate in the euro area being unfavorable in every way, be it politically, economically, or financially. Several reasons for this are conceivable. For instance, going by the interest rate gap between the U.S. and Europe (Germany), one gets the impression that EUR was originally undervalued, and that it is now merely adjusting to its correct level. Another theory that has been gaining strength is that one can no longer expect the U.S.-Europe interest rate gap to expand, and this may also have something to do with the situation. The latter theory, in particular, is equivalent to assuming that the COVID crisis has extinguished USD's chances of further appreciation. The consensus building within the FOMC to keep the federal funds (FF) rate at zero percent until 2022 has certainly made it more difficult for speculators to short EUR against USD in the expectation that USD will strengthen going forward. However, this implies that the recent rise in EUR is not due to positive factors related to the EU, but simply a result of its rival currency (USD) weakening. Inevitably, there will come a phase of reversal of this accumulated long position, during which EUR is bound to weaken. However, as stably low U.S. interest rates become the established trend, EUR is unlikely to continue being sold off against USD unilaterally, so the odds of EUR remaining unnaturally strong are quite high.

Summary Table of Forecasts

	2020 Jan -Jun (actual)	Jul-Sep	Oct-Dec	2021 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	101.18 ～ 112.23 (107.69)	105 ～ 110 (106)	103 ～ 108 (105)	103 ～ 108 (104)	102 ～ 108 (104)	102 ～ 108 (105)
EUR/USD	1.0636 ～ 1.1495 (1.1237)	1.09 ～ 1.14 (1.12)	1.11 ～ 1.15 (1.13)	1.12 ～ 1.16 (1.14)	1.13 ～ 1.16 (1.14)	1.13 ～ 1.17 (1.15)
EUR/JPY	114.43 ～ 124.43 (121.02)	116 ～ 124 (119)	115 ～ 124 (119)	116 ～ 124 (119)	116 ～ 125 (119)	116 ～ 126 (121)

(Notes) 1. Actual results released around 10 am TKY time on 30 June 2020. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
3. Forecasts in parentheses are quarter-end levels

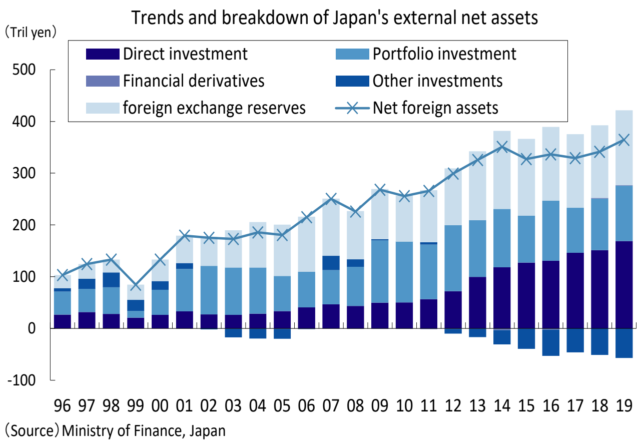
Exchange Rate Trends & Forecasts



USD/JPY Outlook – Deprived of Volatility

JPY's Strength as a Safe Asset – 29 Consecutive Years as World's Largest Net Creditor

29 Consecutive Years as World's Largest Net Creditor Led by Strong Share Prices and Low Interest Rates



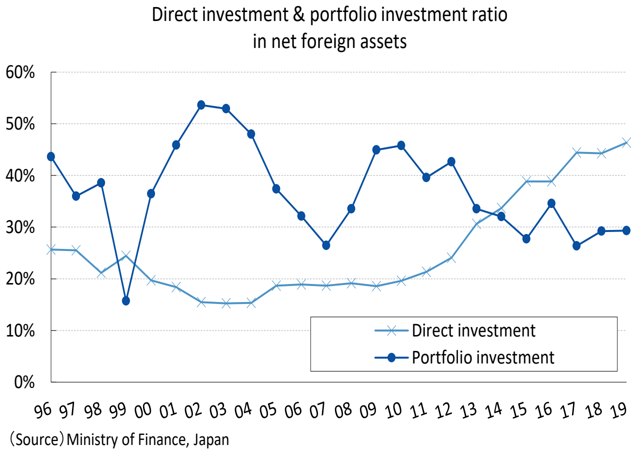
USD/JPY has entered a world without interest rate gaps. In this report, I have presented my basic understanding that in a world without interest rate gaps (which is also a world without price disparities in the medium- to long-term), supply and demand become relatively more important based on the process of elimination. In this connection, the "International Investment Position of Japan (End of 2019)," published by the Japanese Ministry of Finance on May 26 is important. According to it, Japan's net international investment position (derived by subtracting the external liabilities of Japanese corporations, the government, and individuals from their external assets) had increased by JPY 23 trillion yoy to post JPY 364.525 trillion in 2019, growing for the second year in a row. With this, Japan maintained its status as the world's largest net external creditor for the 29th consecutive year, and it also posted its highest ever net international investment position, renewing the record for the first time in five years. (All figures below are yoy unless otherwise stated.)

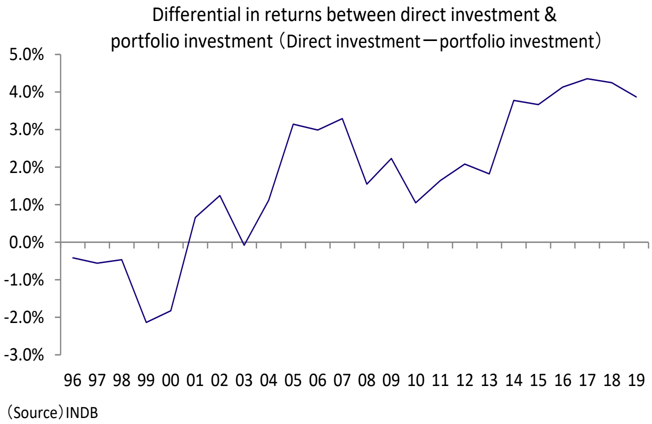
The increase in net international investment position is the result of external assets exceeding external liabilities. Specifically, liabilities had increased by +JPY 56.6 trillion, but assets had increased even more by +JPY 79.7 trillion, boosting the net international investment position. Of the increase in external assets, +JPY 52.2 trillion was owing to portfolio investment. Further, if the increase is classified under the three factors (1) transaction flow, (2) forex, and (3) other adjustments (i.e., price fluctuations), (1) accounted for +JPY 20.1 trillion, (2) accounted for -JPY 5.3 trillion, and (3) accounted for +JPY 37.4 trillion. The slight JPY appreciation appears to have resulted in appraisal losses, but these losses were cancelled out by the increase in the prices of marketable securities (appraisal gains). Looking at the appraisal gain portion of (3) by product, equity and investment fund shares accounted for +JPY 25.6 trillion, while debt securities accounted for +JPY 11.8 trillion.

In other words, while the forex markets lacked movement, strong share prices and low interest rates (strong bond prices) played a big role in boosting Japan's net international investment position. Incidentally, of the +JPY 20.1 trillion of (1), debt securities accounted for +JPY 17.2 trillion. This shows that debt securities increased not just due to the price factor of appraisal gains, but also due to transactions, i.e., volume.

Clear Progress in Structural Change

Analyzing the change in net external assets by category, of the +JPY 23 trillion yoy increase, +JPY 17.8 trillion was owing to direct investment, making this the leading category. Apart from this, portfolio investment accounted for +JPY 7.1 trillion, financial derivatives and other investment accounted for -JPY 6.0 trillion, and reserve assets accounted for +JPY 4.2 trillion. As for the weight of each category within net external assets, direct investment posted its highest ever at 46.4% (+2.1 pp yoy), while portfolio investment remained more or less level at 29.3% (+0.1 pp yoy). Looking at the average for the above two categories for the period from 2000 through 2010, portfolio investment was decidedly the larger category, accounting for 41.6%, while direct investment accounted for 18.0%. However, the average of the same two categories for the period from 2011 through 2019 was 32.8% for portfolio investment and 35.8% for direct investment, indicating a gradual change in the size of the two categories, eventually resulting in a flip in their relative importance (see figure on previous page). This overtaking of portfolio investment by direct investment may partly be the result of a decline in portfolio investment profitability due to a worldwide decline in interest rates in the wake of the global financial crisis (see figure), but another contributing factor is likely to be Japanese corporations' decision not to confine themselves to the shrinking domestic market in Japan. Whatever the case, it is true that Japan's external economy has undergone a dramatic structural change over the past 10 years, and it is quite likely that this factor cannot be overlooked when analyzing JPY trends.





World's Largest Net External Creditor" a Product of the "Two Lost Decades""

Japan's status as the world's largest net external creditor is not as good as it sounds. The stock variable "net external credit" is a product of the yearly accumulation of the flow variable "current account surplus," which is theoretically the result of surplus domestic savings (savings > investment). Robust foreign portfolio investment and direct investment (cross-border M&A) by Japanese investors implies a scarcity of domestic investment opportunities. The years from 1990-2010 have long been called the "two lost decades" of the Japanese economy, and in view of this, it could be said that Japan's status as the world's largest net external creditor is a byproduct of its two lost decades.

Incidentally, direct investment has been growing rapidly only in the past ten years or so, which falls after the period typically described as the two lost decades. This level of robustness in foreign direct investment is likely the result of many Japanese companies deciding that there are no investment opportunities with high expected returns in the domestic market. To put it more harshly, it is the result of companies deciding that buying time and markets through the acquisition/financing of foreign companies is more likely to contribute to medium- to long-term growth than investing in the shrinking domestic market. If a time comes when we look back and call the period from 1990-2020 the "three lost decades," the ten years since 2010 could be interpreted as the period when Japanese corporations began to desert their country.

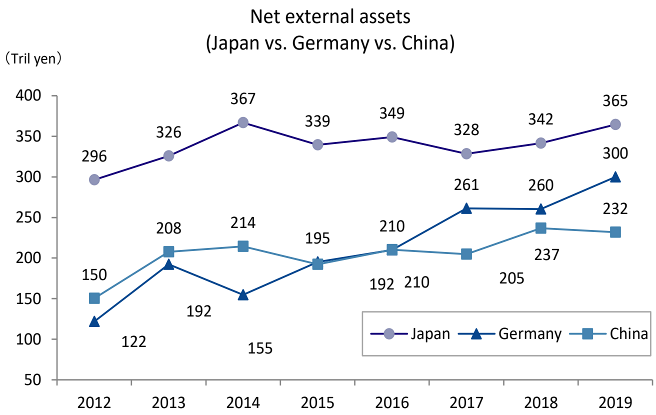
Implications for JPY

From the perspective of formulating a JPY outlook, my understanding is that the nature of these changes is making it increasingly difficult for a strong-JPY trend to take hold. A country's status as the world's largest net external creditor is undoubtedly a factor favoring the appreciation of its currency. In fact, during periods of high volatility and stronger risk aversion in the financial markets, JPY still tends to be bought, even if not to the extent it used to be. Indeed, when considered simply from the point of view of supply and demand, JPY strength seems the only way to explain the enormous gap between Japan's external assets and liabilities. Japan's status as the world's largest external creditor is one of the most important factors when discussing the value of JPY, and this should be positioned as a causal factor of JPY strength.

However, as we have seen, the structure of Japan's net external credit is clearly undergoing a major change. For several years after the turn of the century, Japan's net external assets comprised mostly portfolio investment, especially investment in U.S. and other foreign government bonds. During those years, whenever market volatility increased and brought in a phase of risk aversion, it was not surprising to see investors let go of these foreign government bonds (foreign currency-denominated assets) and return to JPY-denominated assets. This formed the basis of the trend of JPY buying during risk-off phases. However, as we have already seen, close to half of Japan's net external assets at the current time are owing to direct investment. It is difficult to imagine that companies would let go of foreign enterprises they have acquired and return their funds to JPY-denominated assets every time a risk-off mood intensifies in the markets. This change in the structure of Japan's net external assets over the past 10 years is the reason why JPY buying during risk-off phases has dwindled. In the forex markets, "buying JPY during risk-off phases" is seen as synonymous with "buying JPY as a safe-haven currency," but this is a mistake. As mentioned above, the former trend has weakened as a result of a structural change in Japan's net external assets, but this does not indicate a weakening in the latter trend.

Noting that Germany is Closing in on Japan

There is no doubt JPY will continue to be a safe-haven currency so long as Japan remains the world's largest net external creditor. Just because JPY buying during risk-off phases has dwindled as a flow variable does not mean JPY's status as a safe-haven currency has weakened. However, one concern is whether JPY will continue to be seen as a safe-haven currency if Japan loses its status as the world's largest net external creditor. In this context, it is important to see Japan's position against that of other countries. A cause for concern in recent years is the rapid rise of Germany, the world's second largest net creditor. Like Japan, Germany has a strong position as an external creditor, having been accumulating a current account surplus as a result of shrinking domestic demand amid lower birth rates and an ageing society, and as the figure shows, Germany has been closing in on Japan.



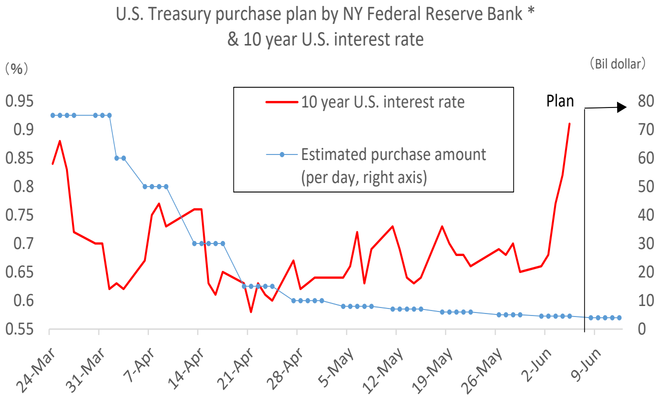
(Source) Ministry of Finance, Japan

With EUR, which many call the permanently undervalued currency, as its currency, Germany has been posting trade surpluses stronger than most other countries every year. This has helped it accumulate considerable net external credit. Meanwhile, Japan has been through cycles of severe JPY strength and natural disasters, leading to a gradual overseas shift in production. Consequently, there are few export bases remaining in Japan, and the country's trade balance has become more or less neutral. In the case of Germany, irrespective of the level of its trade surplus, its currency (EUR) will not strengthen enough to reflect the strength of the German economy. Inevitably, then, Germany's net external credit is likely to continue growing in the coming years, and it will not be surprising to see it overtake Japan at some point.

Of course, regardless of whether a country is ranked first or second, so long as it has a significant amount of external credit, there will be more demand for its currency than for other currencies. Therefore, even if Japan falls to second place, JPY is likely to remain a safe asset. However, the forex markets sometimes respond in emotional ways, and one cannot rule out the possibility of JPY being sold off when Japan is dethroned from its position as the world's largest net external creditor. This may not happen in the next few years, but I think it is an important factor to take into consideration when formulating the medium- to long-term JPY outlook.

U.S. Monetary Policies Now and Going Forward – Declining Volatility

Shift from Unlimited to Specific Scale of Asset Purchases Comes as a Relief
At the June 9-10 FOMC meeting, the target range for the federal funds (FF) rate was kept unchanged, but the scale of asset purchases was changed from unlimited to a more specific level. However, even in the case of interest rates, the dot plot showed a consensus within the FOMC to keep the FF rate at zero percent at least through the end of 2022. The two main takeaways from the June FOMC, therefore, are that (1) a forward guidance was indicated for the scale of asset purchases, and (2) a policy of maintaining FF rates close to zero through 2022 was confirmed.



(Source) NY Federal Reserve Bank
(Note) * Due to the estimated amount, it is different from the actual amount

First, with regard to (1) the scale of asset purchases, the statement was revised from the previous "in the amounts needed to support smooth market functioning," which effectively indicates unlimited purchases, to "at least at the current pace to sustain smooth market functioning." This was accompanied by more specific figures published by the NY Federal Reserve Bank, which mentioned that USD 80 billion a month worth of U.S. Treasury securities, USD 40 billion a month worth of mortgage-backed securities, and USD 250-500 million a week worth of commercial mortgage-backed securities would be purchased. Intuitively, this shift in stance from unlimited to a specific scale of purchases seems like a toning down of the accommodative monetary stance, but that is not really the case. As the figure shows, the pace of purchase of Treasury securities has shrunk markedly since March, including in early June, following the release of the unexpectedly strong job data for May and the resultant soaring of interest rates, which caused market participants to wonder whether the Fed planned to allow asset purchases to continue decreasing (≒ interest rates to rise) further. It is in this context that the recent FOMC statement issued a clear message that asset purchases will not further decrease, which was well appreciated by the markets. The USD 80 billion/month of Treasury securities purchases is the monthly equivalent of the USD 4 billion/day announced right before the meeting. Meanwhile, the time frame is mentioned as "over (the) coming months," which leads to some questions as to specifically how many months are being considered. At any rate, the shift from unlimited to a specific level of purchases appears to indicate a turning point in the recent series of emergency measures.

Declining Volatility of USD/JPY
Moving on to (2) FF rates, the dot plot provides a clear indication of the Fed's stance. All 17 FOMC members projected an FF rate of 0.00-0.25% for 2020 and through the end of 2021, and all but two (i.e., 15) members projected the same for the period through end of 2022 as well. Two members predicted a rate hike in 2022. Of course, the dot plot does not indicate the Fed's established policy path, but given such a strong consensus in projections, the markets are likely to factor in stably low FF rates at least for the next year and a half. As for yield curve control (YCC), which has been drawing attention lately, Fed Chair Jerome Powell mentioned that it had been discussed even before being asked. The meeting minutes will provide confirmation regarding the details of the discussions, but given the dearth of options remaining, YCC will inevitably draw attention as a possible next move by the Fed every time there is an FOMC meeting.

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

FOMC Date	2020	2021	2022	Longer run
Mar-18	3.375%	n.a.	n.a.	2.875%
Jun-18	3.375%	n.a.	n.a.	2.875%
Sep-18	3.375%	3.375%	n.a.	3.000%
Dec-18	3.125%	3.125%	n.a.	2.750%
Mar-19	2.625%	2.625%	n.a.	2.750%
Jun-19	2.125%	2.375%	n.a.	2.500%
Sep-19	1.875%	2.125%	2.375%	2.500%
Dec-19	1.625%	1.875%	2.125%	2.500%
Jun-20	0.125%	0.125%	0.125%	2.500%

(Source) FRB

Having said that, the very clear policy indications provided in the dot plot may already be serving as a strong forward guidance that comes with some of the benefits that can be expected from YCC. It is natural to assume that even if YCC is not implemented, the dot plot's prediction of policy interest rates is sufficient to rob USD/JPY of its volatility. Ultimately, therefore, in terms of its forex market implications, the Fed's policies may not serve as strong drivers of forex rates unless negative interest rates are introduced.

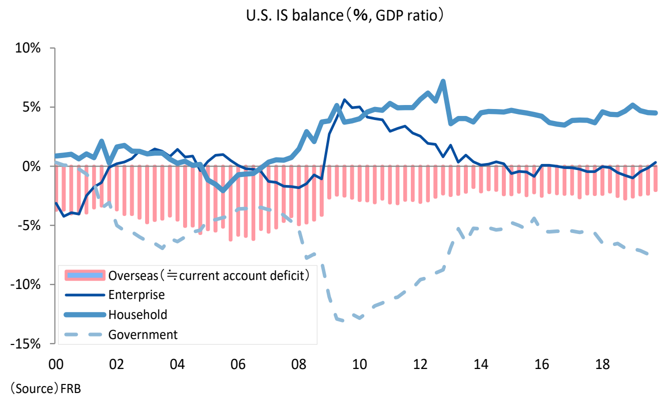
No Figures Expected to Fully Recover by End of 2022

Lastly, the (median value of) real GDP growth rate for 2020, 2021, and 2022 in the FOMC staff Summary of Economic Projections (SEP) predict a v-shaped recovery at -6.5%→+5.0%→+3.5%, but the margin of growth seems to indicate that the growth lost this year will not be fully recovered fully next year. The SEP projections are slightly more optimistic than the recent OECD projections, which indicate a -73% real GDP growth for the U.S. assuming there is no second wave of infections. In a “double-hit scenario” (i.e., if there is a second wave), the outlook for growth is -8.5%. The SEP’s unemployment rate projections are 9.3%→6.5%→5.5%, indicating that unemployment is not expected to return to the pre-crisis 3.5% level even by the end of 2022. Finally, core personal consumption expenditure (PCE) deflator projections are +1.0%→+1.5%→+1.7%, falling short of the +2% target during the forecasting period. In conclusion, it appears from the recent projections that none of the figures (growth rate, unemployment rate, inflation rate, and the resultant FF rate) are set to recover by the end of 2022. Having said that, Mr. Powell also displayed some hesitation at making predictions at the current time, and it must be mentioned that attempting to predict asset prices based on the SEP or other leading institutions’ projections is in itself an unreliable effort. Note that toward the end of June, U.S. Secretary of the Treasury Steven Mnuchin expressed optimism at the possibility of the U.S. economic recession ending by the end of the year, but the end of a recession is not the same thing as the recovery of pre-crisis growth rates. The growth curve is expected to be either L-shaped or checkmark-shaped. Consequently, U.S. interest rates are not expected to rise, and the situation remains unconducive to predicting USD appreciation.

U.S. Currency Policies Now and Going Forward – Will the U.S. Exercise Its Special Privilege?

Will Consumption/Investment Appetites of U.S. Corporate Sector Recover?

Since last month, in connection with the macroeconomic outlook for the U.S. and the euro area, this report has warned of the possibility that saving may come to be seen as the right thing to do. If this happens, it would result in a radical change in the American private sector’s behavioral principles, which have led U.S. economic growth by encouraging consumption exceeding income. If such a change were to take place, both the potential growth rate and the natural interest rate in the U.S. would stabilize at low levels in the long run, and going by Japan’s experience, monetary policy could eventually fall into a painful liquidity trap. Let us take another look at the history of the U.S. saving-investment (IS) balance trend. The subprime mortgage crisis and the global financial crisis caused a clear change in U.S. household sector, turning it into an economic entity with excessive savings (see figure). The year 2007 marked the clear shift away from the behavior pattern of borrowing money to consume or invest, and the coronavirus crisis could cause the conservative stance to intensify.



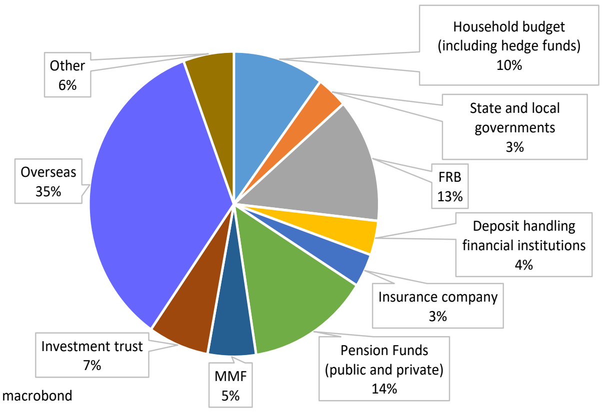
Going forward, the main concern with regard to the U.S. economy is whether the U.S. corporate sector, which had finally managed to return to a savings deficit state after many years of posting surplus savings following the global financial crisis, can recover its robust consumption/investment appetite again this time. If restrained behavior aimed at preventing the spread of infections becomes the norm, corporate revenues will be affected alongside demand, so there may be no excessive savings, but if consumption and investment remain weak even after economic activity has returned more or less to normal, the corporate sector may also become a “surplus savings” entity alongside the household sector. If more than a few companies suffer irreversible damage as a result of the suppression of economic activity at an unprecedented scale for longer durations than previously seen, the idea that it is important to save for an emergency may become firmly established, and surplus savings in the corporate sector may become the norm even in the U.S.

Special Privilege as Administrator of World’s Key Currency

As mentioned above, in a world where the household sector has excessive savings, interest rates (the natural interest rate) stabilize at low levels in order to balance savings and consumption/investment activity. There is a good reason why the euro area, where both the household and corporate sectors have surplus savings, has a negative policy interest rate. Negative interest rates, which violate the non-negativity constraint of nominal interest rates, have become the norm in the euro area, which pioneered the idea, but even here, the authorities are increasingly beginning to think twice before further deepening negative interest rates. To summarize a complex concept, there is not all that much disparity from one country to another in terms of what kind of policies the central bank can implement. The fact is that central banks in the U.S. and Europe have consistently been following in the footsteps of the BOJ. As already mentioned, there is speculation that the Fed may implement YCC, and this possibility is becoming increasingly more realistic.

However, there are some things that the Fed can do that other central banks cannot. These are special privileges available to the Fed as the administrator of the world's key currency. In a world without fair value, based on a floating exchange rate system that makes forex predictions extremely difficult, the one certainty is that forex rates are ultimately dictated by the expectations of the U.S. The trump administration has been one of the most vocal administrations in the history of the U.S. when it comes to expressing a desire for a weaker USD, but even this administration is not yet blatant about it – for example, a desire for "strong USD" is mentioned in the same breath as a desire to introduce negative interest rates. If the president of the U.S. were to truly seek USD depreciation, there could be several ways of achieving it. Stronger pressure could be exerted on the Fed with hints at replacing the Fed Chair, forex-related clauses could be included more comprehensively in trade negotiations, and ultimately, a currency intervention could be implemented if it came to that. All this would most certainly cause USD to weaken.

Share of U.S. Treasury Bonds by Holder (as of end of 2019)



(Source) macrobond

In fact, when fiscal and monetary policies options are exhausted, currency policy options could still remain as important tools. Be it in terms of the ballooning of government debt, the decline in interest and inflation rates, or the slowdown in growth, there is no doubt that the U.S. economy (and the Fed) are following in the footsteps of Japan (and the BOJ). However, unlike in the case of Japan, where 90% of government debt is held domestically (domestic loans), close to 40% of U.S. government debt is held by foreign investors. As unprecedented fiscal expansion continues, it may at some point become difficult for the Fed to unilaterally suppress U.S. Treasury yields (see figure). In this context, the U.S. household sector is also of interest in addition to foreign investors. As the figure shows, the household sector owned around 10% of U.S. Treasury securities as of the end of December 2019, compared with 0.1% as of the end of December 2007, soon after the subprime mortgage crisis broke out. The ratio of ownership has increased 100-fold in this duration, but this is said to be partly due to a technical factor, namely that the household sector includes hedge fund managers. These speculators have been added to the household sector simply for the reason that they cannot be added to any other category in the U.S. funds-flow statistics. During the same period, the holdings of the external sector have declined from 39.4% to 24.7%. There remains the possibility that fleet-footed hedge fund managers will soon be bored of low-interest-rate Treasury securities and expand their overseas asset portfolio instead. In this sense, compared with JPY interest rates, which are held securely low by the BOJ and the private banking sector in Japan, U.S. interest rates are more liable to increase, creating a structure that could cause USD rates to become unstable.

This relative instability of USD compared with JPY from the funds-flow perspective combined with U.S. authorities' ability, as administrators of the world's key currency, to weaken USD rates if they so desire makes it very easy for USD to be guided, at least in the weaker direction. Of course, any acceleration in USD depreciation could have side effects such as the soaring of U.S. Treasury yields and crashing of U.S. share prices, so a weak-USD policy is very much a double-edged sword. Still, considering that the USD index is at a historical high, it must be noted that there is significant scope for the currency to be downwardly revised. In formulating a forex outlook, therefore, one must be wary of the possibility of the U.S. misusing its special privilege as the administrator of the world's key currency if, at some time going forward, all discretionary macroeconomic policy options are exhausted.

Risks to My Main Scenario – Stock Price Drops Closely Linked to JPY Appreciation Risk

Stock Price Drops and JPY Appreciation Risk

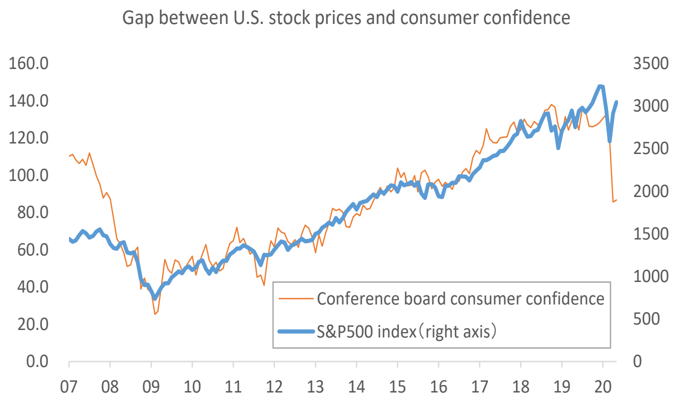
It continues to be difficult to clearly present coherent risk scenarios given that interpretations of all types of factors – including political, economic, societal, diplomatic factors – are subject to the proviso that the situations may become quite different depending on the nature of prospective coronavirus pandemic trends. Released on June 10, the OECD's economic outlook focuses on "two equally probable scenarios" – (1) a scenario in which the pandemic ends after the first wave (single-hit scenario) and (2) a scenario in which a second pandemic wave arrives before year-end (double-hit scenario). In brief, the OECD is positioning a scenario with a second pandemic wave accompanied by a second economic slump and bottoming out as one of its main forecast scenarios. If awareness of a realistic likelihood of a second pandemic wave were to become widespread and provoke ruthless risk asset selling, as seen in June, the assumption of a trend of falling stock prices going forward will become a main forecast scenario, but the financial markets have not yet become quite so negative in their assumptions. Regarding the forex market, one should, in theory, expect that plunging stock prices would be a factor promoting a risk-off mood accompanied by JPY appreciation.

On June 25, the IMF released an updated version of its Global Financial Stability Report (GFSR) that notes the emergence of a ‘disconnect’ between financial markets and real economies. The report’s analysis notes that intermittent stock price plunges have already stemmed from that disconnect and warns of the risk of more such stock price plunges going forward. The updated GFSR suggests that the “disconnect between markets and the real economy” should be considered to be among the most important economic problems we are currently facing. The report spotlights the stock price recovery, saying – “Looking at economies with systemically important financial sectors, equity markets have bounced back from their March troughs, on balance, recovering to about 85 percent of their mid-January levels, on average, though there is some dispersion.” – and confirms the more-optimistic mood in credit markets, saying – “In credit markets, spreads have narrowed significantly from their earlier peaks. On average, about 70 percent of the initial widening has been retraced.” – but it does not consider there to be solid bases for those trends.

Regarding the stock price outlook during the forecast period, I believe it highly likely that we will see a basic trend of rising prices despite alternating periods of “chronic increases” and “acute drops”. Amid a situation in which U.S. interest rates are stable at low levels, however, it can be expected that the level of USD/JPY will not raised by significant margins during “chronic increases” periods but will be lowered by more-considerable margins during “acute drops” periods, so a gradual decrease in USD/JPY seems to be the most likely trend. Based on this expectation, one can envisage a risk scenario in which the full-scale onset of a second pandemic wave diminishes the periods of “chronic increases” and increases the frequency of “acute drops”, and I think such a pattern has the potential to depress USD/JPY to below JPY100.

Disparity between Stock Prices and Consumer Sentiment

Even without reference to the IMF GFSR, many financial market participants are probably somewhat skeptical about the basis for the strengthening of stock prices since March. This relates to a situation that the GFSR describes as – “A disconnect between financial market optimism and the evolution of the global economy has emerged.” For example, the GFSR states that the strong recovery in the S&P 500 consensus forecasts of company earnings suggests that markets are expecting “a quick “v-shaped” rebound”, and it points out the disparity between that and recent real economic indicators, which suggest “a deeper-than-expected downturn”. Published at the same time as the updated GFSR, the updated version of the IMF’s World Economic Outlook (WEO) also clearly describes the seriousness of the slump in the real economy. The updated WEO global economic outlook for 2020 is for -4.9% negative growth, a figure revised downward by 1.9 percentage points from the WEO released in April. (The updated WEO global economic outlook for 2021 is for +5.4% growth.) One can at least say there are no apparent factors on which one would base a “buy” recommendation for this year’s global economy. (As explained below, however, stock prices are a leading indicator and need not correspond to this year’s situation.)

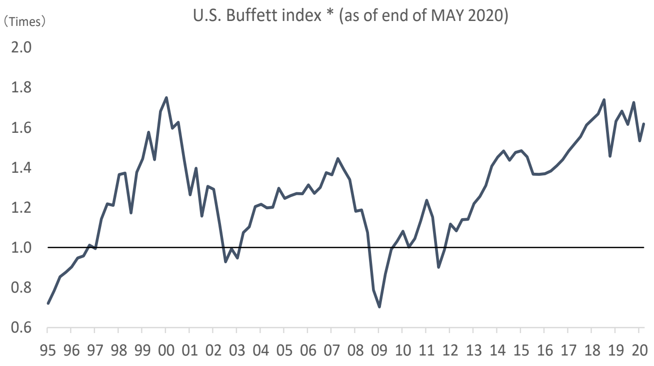


（Source）macrobond

The GFSR also cites the contrasting movements in the S&P 500 Index and the Conference Board consumer confidence index as a good example of the “disconnect between markets and the real economy”, and there certainly is a clear contrast in those movements (see graph). Looking back over many years, one finds that such clear divergences between the indices are quite rare. If one assumes that this consumer sentiment situation will determine prospective trends in personal consumption, which accounts for 60% of demand in the US economy, then there are indeed grounds for serious concerns. With respect to the current pandemic situation, at least, it seems more rational to expect that stock price trends would parallel consumer sentiment trends.

The GFSR is naturally worried about the sustainability of current asset prices, and it points out that there are many triggers that could lead to downward price adjustments in the future. In particular, in the case that a second pandemic wave were to further prolong the current recession (already considered a recession of unprecedented severity), it could lead to a resurgence of trade frictions along with a broadening of social unrest around the globe in response to rising economic inequality that could lead to a reversal of investor sentiment. It is probably reasonable to consider such potential scenarios as cases in which stock price drops are likely to promote JPY appreciation and USD depreciation.

Unrealistically High Stock Prices a Necessary Evil



(Source) macrobond (Note) * Total value of stocks in market value/nominal GDP

However the "disconnect between markets and the real economy" theme predates the corona shock. In recent years, stock prices in developed countries (especially the United States) have continued to grow despite a general decline in GDP growth rates and, even more pertinently, despite a general decline in corporate earnings. In the United States, the market capitalization of equities has outstripped the country's annual nominal GDP, and the gap between the two has been widening (see graph). Previous editions of this article have described factors contributing to this trend as including ① the fact that monetary policies in recent years have tended to be managed with reference to stock prices (and stock price levels have consequently become predicated on excessive monetary easing) ② the fact that such monetary policies have led to low interest rate levels that, in turn, have made equities the only financial assets capable of providing a steady stream of income (dividends) and therefore have caused fund managers to tend to concentrate greater shares of their funds in equities.

Despite that, it seems a bit dangerous for the IMF to assert that stock prices are excessively high. As stock prices are a leading indicator of the real economy, they not necessarily have to be in line with the real economy's current state. For example, although the updated WEO has revised the global growth rate downward to -4.9% in 2020 and +5.4% in 2021, the expected growth trajectory is a V-shaped recovery. It is reasonable to consider stock prices to be reflecting anticipation of that V-shaped recovery. Given that nobody can rationally forecast prospective pandemic trends, there is no real rational basis for determining that current stock prices are excessively high.

Moreover, although financial bubbles have many negative aspects over the long term, there are no economic agents currently facing difficulties stemming from rising stock prices. Regarding the U.S. household sector, for example, since equities comprise more than 30% of household financial assets, high stock prices can be expected to have an asset effect that causes consumption to increase. Regarding the corporate sector, the sustained high level stock prices is promoting the stability of corporate management. Given that we are currently facing an emergency situation, it seems reasonable to consider unrealistically high stock prices to be "a necessary evil" that can play a positive role in helping promote the real economy's recovery.

As a publication that makes policy proposals designed to ensure the international financial system's robustness, the GFSR is structurally obligated to warn of dangers associated with rising stock prices and debt accumulation, and so it is understandable that it would be sounding the alarm regarding the current height of stock prices. Realistically speaking, however, the GFSR should be prepared to recognize that the current situation is one in which overstretched asset prices (particularly stock prices) can be considered a "necessary evil". Such tradeoff nuances are addressed at the end of the GFSR, which notes that current responses have helped mitigate immediate dangers but have "intertemporal risk implications" and that associated financial fragilities should be quickly addressed when an economic recovery trend is firmly underway.

Difficulty of Assessing JPY Depreciation Risk

The adjustment range of JPY associated with the unrealistically high stock prices situation is quite large, and it is likely that the situation will exert a correspondingly large downward pressure on USD/JPY, which has become less volatile in recent years. If the various possible developments mentioned above (such as the onset of a second pandemic wave, the intensification of U.S.-China trade frictions, and growth in social unrest along with frequent protest demonstrations) were to cause frequent stock price plunges, they would be liable to depress USD/JPY more than anticipated in the main forecast scenario.

While it is difficult to assess JPY depreciation risk factors, the main such factor might be rapid progress in vaccine development that might bring the pandemic to an early end. In the case that the development of an effective vaccine in the near future becomes generally anticipated, it can be expected that stock prices will become extremely strong and that monetary policies will shift from easing to neutral stances, and it will be likely that an increase in U.S. interest rates will be accompanied by a clear-cut rise in USD/JPY. Of course, that would be the optimal situation. At this point, however, I think it would be overly optimistic to position such a situation as the main forecast scenario and, given the great number of uncertainties we are currently facing, I think it better to dispense with a detailed analysis of that scenario.

EUR Outlook–The ECB Wields a Real Bazooka

EUR Area Monetary Policies Now and Going Forward – ECB Success in Dialog with Markets

Explicit Articulation of Reinvestment Policy Highly Significant
The June 4 ECB Governing Council meeting decided to strengthen the pandemic emergency purchase programme (PEPP) in line with market expectations. Previously EUR750 billion, the PEPP's total size was increased by EUR600 billion, to EUR1.35 trillion, and the program's term was extended to the end of June 2021. The Governing Council also announced that it continue reinvesting maturing PEPP principal payments at least through the end of 2022. While media headlines tend focus on the size of asset purchasing programs, it is the protracted reinvestment policy that is likely to prove more important in the future. All the ECB policy interest rates were left unchanged from their levels set at the previous Governing Council meeting, and the bank's various liquidity supply programs were also unchanged.

Prior to the meeting, I had thought it would be premature to expand the PEPP in June. Since the PEPP still had 70% of its capacity remaining and investors were showing increasing interest in purchasing Italian government bonds, it seemed that it would have been better to just monitor the development of the coronavirus pandemic. In this regard, ECB President Lagarde said that two main factors led to the PEPP expansion decision; (1) a significant deterioration of the inflation outlook owing to the pandemic, and (2) a significant tightening of financial conditions in euro area that needed to be alleviated. As the financial markets as of March were still generally expecting a V-shaped recovery from the July-September quarter, it is not difficult to understand President Lagarde's reasoning, but the margin of PEPP expansion was still surprising.

It seems likely that the perception that the pandemic may last significantly longer than originally expected is also an important factor. Originally, the Governing Council planned to purchase assets under the PEPP "until it judges that the coronavirus crisis phase is over, but in any case until the end of this year". The period of purchases has now been extended until the end of June 2021 and, while the principal reinvestment policy had not previously been explained (it was assumed that there would be a natural decrease in the asset purchases balance due to redemptions), it has now been clearly stated that maturing principal payments will be reinvested "until at least the end of 2022". These decisions seem to clearly indicate that the ECB has decided that it will be dealing with the pandemic for a protracted period of time. Consequently, the ECB's balance sheet will inevitably remain at high levels for the next two and a half years. While the increases to the PEPP's size and time period are significant, I expect the protracted reinvestment policy will prove even more important in terms of its future effects. EUR appreciated in the wake of these policy decisions, and it is worth noting that the pattern of EUR appreciation following ECB measures that were positively evaluated by the markets was seen during the European debt crisis. It is safe to say that President Lagarde has succeeded this time in her "dialog with the markets".

Discrepancy Between PEPP and PSPP Reinvestment Policies
Regarding the PEPP reinvestment policy, it was noted that – "the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance." – and this proviso makes it clear that the ECB is intent on not allowing its policy stance to be affected by the timing of future PEPP asset maturities. While it is difficult to understand the exact intention of the proviso, it may have been added based on consciousness of the possibility of a discrepancy with the reinvestment policy of the public sector purchase program (PSPP), the ECB's regular government bond purchasing program. In fact, a reporter at the press conference posed a question about this discrepancy. Currently, the reinvestment policy of the asset purchase programme (APP, which includes the PSPP) is to continue fully reinvesting principal payments from maturing securities "for an extended period of time past the date when we start raising the key ECB interest rates". If PEPP reinvestments continue until the end of 2022, it means that from January 2023, the balance of bonds purchased via the PEPP will begin to decline (the balance sheet will begin to shrink). If the key ECB interest rates have not been raised by that time (they probably will not be), there will be a discrepancy in that reinvestment for the PEPP will be discontinued while reinvestment for the PSPP will be continued. While the PEPP and the PSPP are similar in that they are both used to purchase assets and thereby provide funds to the banking sector, they will be different, or inconsistent, with respect to their repurchasing policies. The reporter sought to clarify this point, asking – "Does that imply that the roll-off of PEPP could actually start before the first rate hike?" – and President Lagarde avoided responding directly to that question but pointed out that the PEPP's separately defined repurchasing period – "reflects the nature of PEPP, which is different from the PSPP." So the ECB's view is that the programs are different in nature, although the effects of the programs should be the same in terms of their provision of liquidity in the financial markets.

Rationale for EUR600 billion PEPP Expansion and Avoiding Increase to Negative Interest Rate Depth

Another reporter wondered about the ECB's reason for expanding the PEPP by EUR600 billion and asked – "why have you agreed on raising it by EUR600 billion and not more, because if you keep the current pace, that would mean that it is used up by February 2021." It appears that the ECB's reasoning regarding this is very simple. Currently, the ECB's main forecast scenario is for the economy's growth rate and inflation trends to begin recovering from the pandemic shock beginning in this year's July-September quarter and gradually re-attain the "pre-COVID inflation path". <u>The "current pace" of PEPP bond purchases represents the pace of the past two months, which includes the worst period of the pandemic crisis, so the ECB's fundamental view is that that the "current pace" is not expected to continue until February 2021, so the PEPP is of sufficient size and will probably not be used up during the period through February 2021.</u> President Lagarde's answer to the reporter's question did in fact mention the ECB's anticipation of an economic rebound in the third quarter and a return to pre-COVID inflation path (although of course there remains a great deal of uncertainty about the main forecast scenario).

The same reporter also asked about whether the ECB might further increase the depth of negative interest rates and whether President Lagarde could confirm that "the lower bound has been reached." President Lagarde gave a long answer, of which the key portions are – "we have decided to use PEPP but it's not as if it was PEPP and nothing else. We have a whole package of tools" – and – "In terms of PEPP as the best possible instrument at the moment, one item in the package of tools that we use and the size of which we believe as a Governing Council in broad agreement is perfectly appropriate and adequate in order to respond to the needs[.]" Her answer emphasized that the ECB has abundant tools for supporting corporate finance. As the PEPP is directly intervening in the CP and corporate bond issuance market, the overall nature of the ECB's corporate finance support measures has become clear, and it would be illogical to expect the ECB to stubbornly take additional measures to further increase the depth of negative interest rates. It must also be remembered, as discussed below, that the ECB's third-phase long-term liquidity supply (TLTRO3) operations is providing the banking sector with an extremely large amount of liquidity and is providing banks and companies with additional support through such measures as interest rate exemption provisions.

Junk Bond Purchases and German Constitutional Court Judgment

In addition to the PEPP, the news conference focused on such issues as the potential purchase of junk bonds and the recent Federal Constitutional Court of Germany ruling questioning the legality of the ECB's quantitative easing measures. In fact, the first reporter to ask questions asked about both of those situations. The Fed's recent decision to purchase junk bonds (bonds of "fallen angels") has attracted increased attention to the issue of whether the ECB might follow suit, but President Lagarde critiqued that approach, saying – "We want to insulate the way we conduct policy from the effect of the pandemic and avoid self-fulfilling pro-cyclicality." – and then reinforced her dismissal of that possibility, saying – "the Governing Council has not discussed this matter." <u>It appears that the ECB is not considering junk bond purchases even as a future option</u>. Regarding the German Constitutional Court judgment, President Lagarde reaffirmed that the Court of Justice of the European Union recognizes the PSPP as constitutional and in line with the ECB's mandate. She also confirmed that the ECB is paying attention to the judgement, noted that it is – "directed at the German government and at the German parliament" – and said the ECB was – "confident that a good solution will be found. A good solution that will not compromise the ECB's independence." Naturally, President Lagarde expressed a view that the legality of PEPP should be taken for granted. She noted that the Governing Council regularly conducts policy efficiency and cost-benefit analyses of its monetary policy measures and implicitly suggested that the analyses will also demonstrate the measures' legality. This situation is likely to be one of the major issues closely monitored by ECB watchers this summer.

By the way, it has become clear that German government bonds are being purchased through the PEPP as if to make up for what was not purchased through the PSPP. A reporter posed a question about this, saying – "We could see, with a bit of a surprise, that the German Government bond purchases [through the PEPP] were slightly higher than the capital key benchmark." – and then asking about the reason for that. It is being speculated that the PEPP is being used as a "loophole" in response to the German Constitutional Court's decision, as the decision relates to the PSPP but not the PEPP. Governor Lagarde avoided giving a clear answer to this question by simply providing an explanation of the PEPP's policy objectives, but it can be surmised that the ECB is seeking to ensure that the sum of purchases through the PSPP and PEPP do not diverge excessively from the capital key.

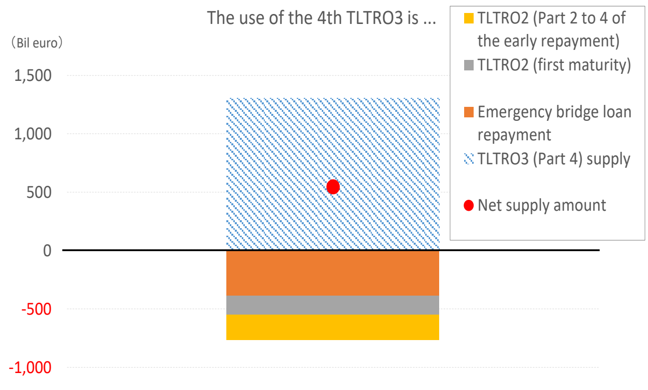
Renewed Concerns about Deflation

It was also noteworthy that several questions were posed at the press conference about the return of deflationary pressures. About six years has past since the publication of my book, “Ready for the Japanization of Eurozone, Euro and ECB” (Toyo Keizai Shinposha, July 2014), at a time when concerns about Eurozone Japanization were beginning to emerge. At that time, there were concerns about the weakening of euro-zone inflation expectations as well as about the lack of increase in the euro-zone Harmonized Index of Consumer Prices (HICP). The ECB’s latest staff forecast for 2020/2021/2022 anticipates HICP growth rates of +0.3%/+0.8%/+1.3% on a comprehensive

basis and of +0.8%/+0.7%/+0.9% on a core basis excluding food and energy, and the prospect of HICP growth rates not attaining +1.0% over the next two years is considered somewhat shocking. It appears that outlook may have promoted the decision to reinvest maturing PEPP principal payments through the end of 2022. In fact, President Lagarde stated at the press conference that – “when we see an inflation outlook at the end of our projection period, in 2022 at 1.3%, we make the determination that measures are needed, action is necessary.” – and <u>this statement appears to be an acknowledgement that the softening inflation outlook was a factor contributing to the decision to undertake additional easing</u>. In recent years, there has been a tendency to deemphasize the basic approach of predicting the ECB’s “next move” based on trends in HICP and inflation expectations but, currently, it appears that it may be useful to return to giving more attention to this basic approach of projecting policy trends based on inflation trends.

TLTRO3’s “Genuine Bazooka” Status

On June 18, the ECB announced the results of the fourth round of TLTRO3 bidding – 742 banks submitted applications for EUR1,308.4 billion of assets. Known as the “European debt crisis game changer” and for boosting the reputation of former ECB President Draghi immediately after he took office, the 36-month longer-term refinancing operation (LTRO) provided EUR1,118.7 billion of liquidity during bidding rounds on December 22, 2011, and March 1, 2012. (The liquidity amounts for individual bidding rounds were EUR489.2 billion and EUR529.5 billion, respectively). Feelings of admiration for former ECB President Draghi’s quick decisiveness and for the unprecedented scale of the LTRO caused market players to begin using the phrase “Draghi Bazooka” as a way of dramatically describing the LTRO’s power. This time, the scale of liquidity supply through TLTRO3 is so great that the magnitude of a single bidding round will exceed the combined magnitude of both 36-month LTRO bidding rounds. To gain a better perspective on the unprecedented scale of TLTRO3, it is worth noting that TLTRO1 had 8 bidding rounds with a total value of EUR432 billion and TLTRO2 had 4 bidding rounds with a total value of EUR740 billion.



(Source) ECB

Roughly half of the “Draghi Bazooka” 36-month LTRO is said to have been used for the redemption of financial bonds issued during the three years immediately after the Lehman shock, and it is also said that the European financial system would have been in a state of great confusion in the absence of this funding. Regarding the TLTRO3, the refinancing portion also accounts for roughly half the total value, but this, strictly speaking, represents the “refinancing of funds borrowed from the ECB.” Specifically, funds used for early repayment of TLTRO2 assets (from the second to fourth bidding rounds) will amount to EUR241 billion, and funds used for repayment of first bidding round TLTRO2 assets on their maturity will amount to EUR164 billion on June 24. It seems that the reason for the surge in early repayment of TLTRO2 assets is that it is advantageous to refinance by means of TLTRO3.

It will also be necessary to repay EUR388.8 billion of bridge loans extended in 13 weekly rounds from March 18 to June 10 as part of the crisis response (all maturing on June 24). Even after deducting these items, however, the net liquidity supply amount will be EUR541.5 billion. As explained below, this amount exceeds total amount of asset purchases undertaken by the ECB since March. <u>Focusing on the contribution to the ECB balance sheet alone, it seems apparent why TLTRO3 is considered a “genuine bazooka.”</u>

Guaranteed Profit Schemes

The TLTRO3 usage conditions are also exceptional. The TLTRO3 itself is based on a framework introduced when the ECB was led by former President Draghi, but the terms of use have been gradually relaxed. The April 30, 2020, Governing Council meeting set the base interest rate at “main refinancing operation rate (0%) + -50bps”, and banks that reach the lending threshold became eligible to receive a preferential interest rate of “deposit facility interest rate (then -0.50%) + -50bps”. In other words, even banks that do not reach the lending threshold will benefit from a ▲50bps margin on the liquidity supply amount. The real significance of such guaranteed profit schemes now seems to be just as great as that of policy interest rates.

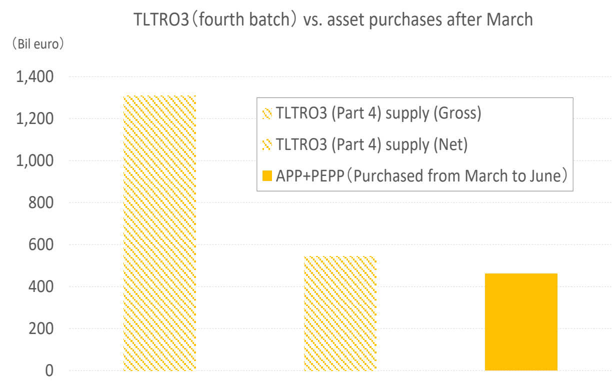
The decision to launch TLTRO3 was made in March 2019, at which time TLTRO3 was positioned as a technical measure to facilitate compliance with Basel III bank capital standards. Discussions at that time were conscious of the fact that after June 24, 2019, TLTRO2 assets (from the first bidding round) due to mature on June 24, 2020, would constitute “funds with less than one year to maturity”. When calculating the Basel regulations’ net stable funding ratio (NSFR), long-term funds with maturities of one year or more can be included as stable funds with a 100% weighting but funds with maturities of less than one year are included with only a 50% weighting. It is said that the reason the TLTRO3 successor scheme was needed immediately was to enable financial institutions to maintain their NSFRs.

However, there was some debate about whether it would be appropriate for central bank to design a funding scheme with such a regulatory compliance facilitation feature. Reflecting that debate, TLTRO3’s standard interest rate at the time of its introduction was “main refinancing operation interest rate (then 0%) +10bps”, and if the lending threshold was reached, the maximum interest rate was “deposit facility interest rate (then -0.40%) +10bps”. The “+10 bps” portion of the interest rate was made higher than that of the corresponding TLTRO2 rate as a concession to TLTRO3 opponents. However, the September 2019 Governing Council meeting withdrew the “+10bps” from the formula and extended the loan period from two years to three years. (TLTRO2 loan periods were then as long as four years). The same Governing Council meeting also reduced the deposit facility interest rate from -0.40% to -0.50%, thereby expanding the preferential interest rate to a maximum of -0.50%. Since the preferential interest rate of TLTRO2 was a maximum of -0.40%, the stance that “TLTRO3 is stricter than TLTRO2” had been completely abandoned at that point.

At the post-corona-virus-shock Governing Council meeting led by President Lagarde on March 12, 2020, TLTRO3 was assigned a base interest rate of “main refinancing operation interest rate (0%) +-25bps” and a preferential interest rate of “deposit facility interest rate (-0.50%) +30bps”. Then, as mentioned above, the April 30 Governing Council meeting further relaxed the rates, defining the base interest rate as “main refinancing operation interest rate (0%) + -50bps” and the preferential interest rate as “deposit facility interest rate (-0.50%) + -50bps”. At the time, the lending threshold required for preferential interest rate eligibility was lending growth of “0% or more between 1 April 2020 and 31 March 2021”, but on March 18 the lending threshold was redefined to become lending growth of “0% or more between 1 March 2020 and 31 March 2021”. In other words, the lending threshold was redefined to give preferential treatment to banks that increased their lending during March despite the pessimistic mood prevailing at that time. The fourth round of TLTRO3 bidding was the first bidding round following these relaxations of conditions, and the results of that round appear to indicate that the ECB has successfully attained its objectives.

Policy Interest Rates and “Shadow Policy Interest Rates”

As mentioned above, the net supply of liquidity via TLTRO3 is in excess of EUR540 billion. Market participants and media headlines tend to focus on the magnitude and content of ECB asset purchases, and this time the magnitude of liquidity supply is greater than of the ECB’s total asset purchases since March. The ECB’s most conspicuous asset purchase operation, the PEPP, was launched on March 18 and had purchased assets worth about EUR315.5 billion as of June 19. In addition, the original expanded asset purchase programme (APP) accounted for about EUR146 billion of purchases over the same period. Thus, while the PEPP and APP programs are currently considered to be the two main pillars of the ECB’s monetary easing operations, the total amount of purchases made via those programs since March amounted to about EUR 461.5 billion, and the magnitude of net liquidity supply via the latest round of TLTRO3 bidding is considerably higher. In light of this, it is clear that it is the TLTRO3 rather than the PEPP or APP that merits the appellation of “bazooka” regarding the ECB’s balance sheet expansion.



（Source）ECB、（Note）Asset purchases through June 19

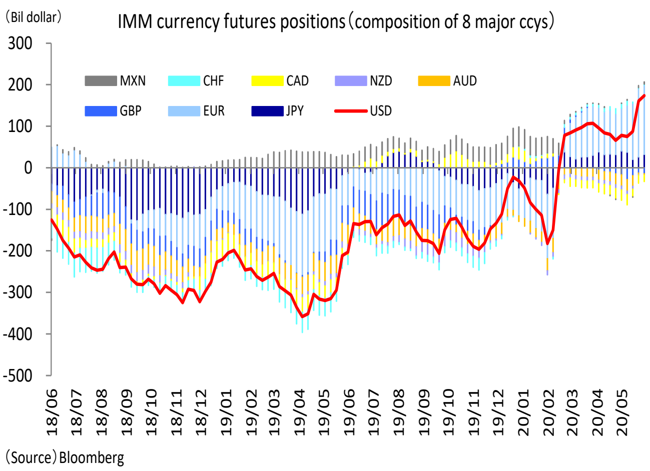
These results make one reconsider the question – “what are policy interest rates?” In essence, such policy interest rates as the main refinancing operation interest rate (0%) and the deposit facility interest rate (-0.50%) have become merely standards used when setting applicable interest rates for various types of funding operations. While these standards are important in of themselves, I feel that the task of optimally adjusting policy interest rates in line with funding operation objectives is beginning to become a non-trivial part of monetary policy management. As already noted, the maximum preferential interest rate for TLTRO3 is “deposit facility interest rate (-0.50%) + -50 bps”. The nominal sizes of the policy rate and the preferential treatment rate are already equivalent, and any further increase to preferential treatment rate will make it greater than the policy rate. It cannot actually be said that this is an inappropriate situation, but given that the policy interest rate is the relevant currency region’s “standard” interest rate, it undeniably seems peculiar that the standard interest rate would superficially appear to no more significant than the preferential treatment rate.

The April 30 Governing Council meeting expanded the ECB’s liquidity supply operations lineup with the launch of pandemic emergency longer-term refinancing operations (PELTROs), which are designed to foster a sense of security in the money market. With tenors of from eight to 16 months, PELTROs provide funds on shorter-term bases than TLTRO3 and their applicable interest rate is “major refinancing operation interest rate (0%) + -25 bps”, which is higher than the applicable interest rate for TLTRO3, but they are still a “guaranteed profit scheme”. (PELTRO can be used without being concerned about lending performance.)

It is expected that these “guaranteed profit schemes” will improve European banks’ risk tolerance and enhance the smoothness of their financial intermediary functions. It is anticipated that these benefits will promote improved support for the cash flow needs of euro area companies and, of course, interest rate exemptions should alleviate the impact of negative interest rate side effects on banks. Going forward, it seems likely that there will continue to be intermittent concerns about the possibility of the ECB further depressing negative interest rate levels. In light of the difference between “nominal policy interest rates” and “more-complex interest rate systems used for funding operations”, however, it appears that ECB watchers may have to devote increasing attention to analyzing differences between policy interest rates and “shadow policy interest rates”.

EUR now and going forward – Continued EUR Appreciation Owing to USD Weakness

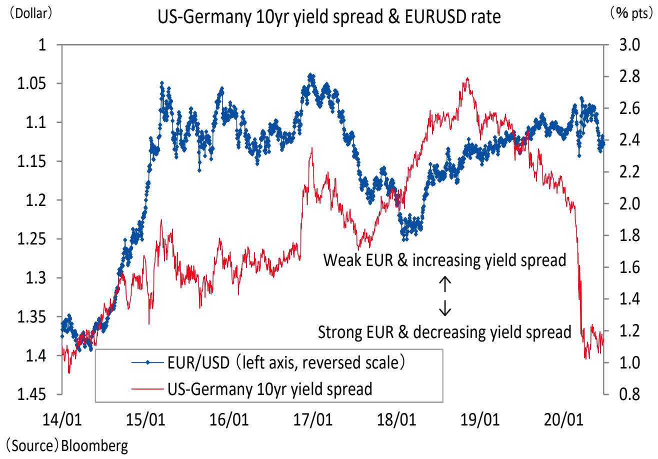
USD Depreciation Driving EUR Appreciation



Europe’s investment environment continues to appear rather unfavorable, reflecting the continued weakness of economic and financial situations along with internal political strife associated with the EC’s recovery or reconstruction fund proposal, which does not seem likely to be resolved expeditiously. However, EUR has maintained robust performance in the forex market. Looking at the IMM currency futures trading figures released by the U.S. Commodity Futures Trading Commission (CFTC), as of June 23, non-commercial short USD positions against eight major currencies had rapidly expanded by about USD10 billion in the previous four weeks (see graph). As one can see from a glance at the graph, the USD selling is basically being driven by EUR buying. EUR buying has accumulated discontinuously since the full-scale coronavirus shock began in March, and there has been almost no fluctuation in this trend, which is said to reflect such factors as the ECB’s additional easing measures, the EU’s internal political strife, and concerns about a second wave of infection in Germany. How should this be interpreted?

Continued Discrepancies Regarding the U.S.-Europe Interest Rate Gap

I believe there are two main reasons for the EUR’s strength during the coronavirus shock period. First, in light of the interest rate gap between the U.S. and Europe (Germany), one gets the impression that EUR was originally undervalued, and that it is now merely adjusting to its correct level. The second reason is that one can no longer expect the U.S.-Europe interest rate gap to expand, and this is equivalent to assuming that the pandemic crisis has undercut expectations of future USD appreciation.



Regarding the first point, as the graph shows, the U.S.-Germany interest rate gap has narrowed sharply since mid-2019 (owing to a relatively large drop in U.S. interest rates), while the trend of USD strength and EUR weakness have continued. In June 2019, the U.S.-Germany 10-year interest rate gap averaged 2.3 percentage points. By June 2020 it had decreased to 1.1 percentage points, a shrinkage of more than 1.0 percentage point in a year. During that period, however, EUR/USD descended to around 1.07 and then returned to around 1.13, which is close to the level of a year ago. Looking at the past year, despite an increasingly noteworthy relative decline in U.S. interest rates, EUR's exchange rate against USD has continued to seem rather weak. In light of this, it would not be surprising to see EUR continuing to appreciate against USD going forward.

The main reason aversion to EUR and preference for USD has persisted despite the above-described concerns about U.S-European interest rate trends is general concern about the fundamentals of the euro area economy along with expectations that the euro area economy will be the slowest of the world's principal developed economies (of the United States, Europe, and Japan) to begin recovering. It has been felt that continuously smoldering anticipation of additional ECB easing measures have made conditions for EUR purchasing difficult. There has also been a fundamental argument that the ECB policy interest rate cannot be maintained at -0.50%. These are reasonable explanations, but they do not seem to tell the whole story. As the entire global economy has fallen into a recession due to the pandemic, it appears that concerns about economic fundamentals have become a less obvious reason to avoid EUR, and it seems possible that it is that situation combined with the narrowing of the U.S.-Europe interest rate gap that has emboldened market players to shift to a more-positive perspective on EUR buying.

Disappearance of USD Appreciation Expectations

The point made above – regarding general concern about the fundamentals of the euro area economy along with expectations that the euro area economy will be the slowest of the world's principal developed economies (of the United States, Europe, and Japan) to begin recovering – seems to be associated with some expectations that the U.S. economy will recover in the near future and the Fed will eventually resume its interest rate hikes. In other words, it seemed wise to bet on expectations of future USD appreciation. As already noted, however, the Fed is assuming low economic growth rates for the time being and is forming a consensus view that its policy interest rate should remain at 0% through the end of 2022. In light of that and the increasing attention given to the possibility of creating a yield curve control (YCC) system, it is becoming generally believed that the U.S.-Europe interest rate gap will not widen as a result of increases in U.S. interest rates. Under these circumstances, many people seem have concluded that shorting EUR against USD while betting on expectations of future USD appreciation has become considerably less likely to be a winning strategy.

For whatever reason, it does appear that the euro area itself is not generating EUR buying incentives but that EUR is simply strengthening owing to USD weakness. If one were to seek alternative explanations other than USD weakness, one might consider the possibility that EUR buying is being promoted by positive expectations regarding the EU reconstruction fund and the ECB's bold policy responses. Going forward, there are concerns that process of unwinding accumulated EUR long positions may exert downward pressure on EUR, but the main factors influencing EUR appear likely to be the stable low levels of U.S. interest rates along with the disappearance of USD appreciation expectations. Although the large negative margin of the ECB policy interest rate make significant EUR appreciation unlikely and the range of EUR appreciation against USD is expected to be limited, it seems likely that EUR will sustain its unexpected strength for the time being, with EUR/USD moving in the 1.10-to-1.15 range.

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