

August 31, 2021

Overview of Outlook

USD/JPY once again lacked movement in August. JPY remains the weakest currency in the forex market, and I attribute this mainly to investors' unfavorable assessment of the Japanese economy. The same situation can be confirmed in the share markets, where Japanese shares are conspicuously lagging behind their foreign counterparts. Funds are being channeled away from Japan as the country continues to let growth opportunities slip by aimlessly imposing barely warranted movement restrictions. There are no signs of Japan being able to close the economic gap with its competitors anytime soon, making upside risks for either JPY or Japanese shares extremely unlikely. It is true that the spread of Delta and other COVID variants poses a major risk to the global economy, but Western nations appear to be living skillfully with this threat and actually achieving high growth rates. Vaccination rates are steadily increasing in Japan too, which is good news. However, high vaccination rates are viewed favorably as a set with economic normalization, so investors have no reason to invest in a country like Japan that remains in a state of emergency even as vaccinations progress. It is true that the U.S. monetary policy normalization process seems increasingly likely to be pushed back by a meeting or two, but this will not help investors view Japan more favorably – the gap between Japan and the U.S. (or Europe) is simply too large. Taking such circumstances into account, I believe that there is a strong likelihood of USD/JPY remaining quite strong during the current forecasting period.

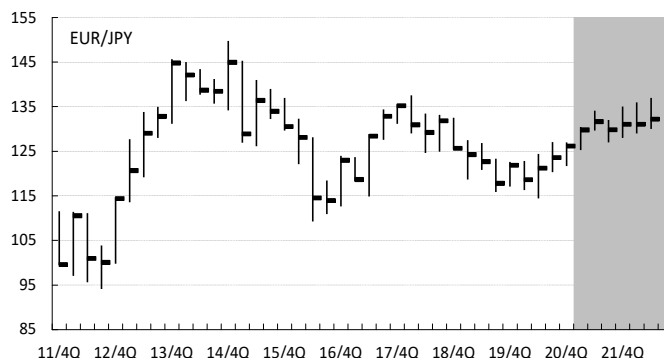
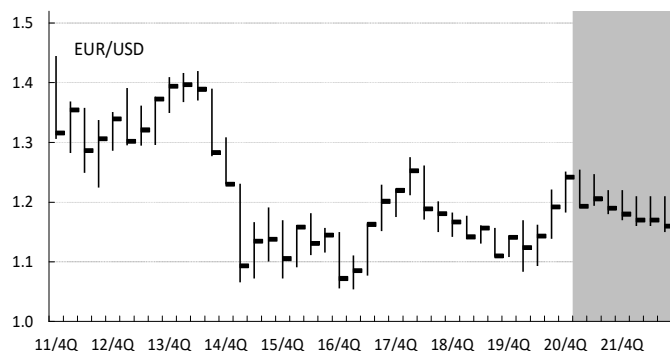
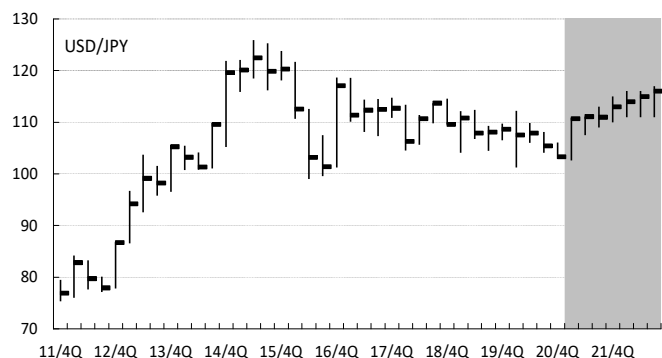
Meanwhile, EUR weakened in August, but not because of any specific negative factor pertaining to the region. The fact is that there are few signs that the ECB will begin to normalize its monetary policy any time soon, and given the contrast with the Fed's monetary policies, the situation is conducive to selling EUR in exchange for USD. The ECB is unlikely to consider ending its main monetary easing measure, the pandemic emergency purchasing programme (PEPP), in the near term, because the PEPP's provisions state that the program will be continued until the end of the pandemic. On the other hand, the program is unlikely to be expanded either, because the euro area's economy remains sound, with the IMF upwardly revising its outlook for it as recently as July. Given that there seems no justification for either expanding or shrinking the PEPP, I believe the ECB will simply wait and watch for the time being. This would make it difficult to close the gap with the Fed, which continues to move steadily toward tapering and rate hikes, thereby inevitably weakening EUR/USD. Having said that, one must remember that EUR is strongly protected by Europe having the world's largest current account and trade surpluses, so it is unlikely to crash. When compared with Japan, the euro area not just has an enormous trade surplus, it is also making considerable progress in its strategy to live with COVID, and these strengths are likely to keep EUR strong against JPY.

Summary Table of Forecasts

	2021			2022		
	Jan -Aug (actual)	Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	102.60 ~ 111.63 (109.89)	109 ~ 113 (111)	110 ~ 115 (113)	111 ~ 116 (114)	111 ~ 116 (115)	111 ~ 117 (116)
EUR/USD	1.1664 ~ 1.2349 (1.1801)	1.16 ~ 1.20 (1.17)	1.15 ~ 1.20 (1.16)	1.14 ~ 1.19 (1.15)	1.14 ~ 1.19 (1.15)	1.13 ~ 1.19 (1.14)
EUR/JPY	125.10 ~ 134.12 (129.67)	127 ~ 132 (130)	128 ~ 135 (131)	129 ~ 136 (131)	130 ~ 137 (132)	130 ~ 138 (132)

(Notes) 1. Actual results released around 10 am TKY time on 31 August 2021. 2. Source by Bloomberg 3. Forecasts in parentheses are quarter-end levels
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Exchange Rate Trends & Forecasts



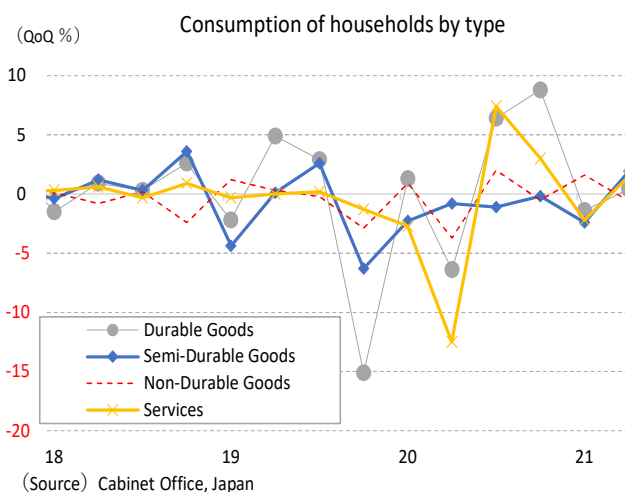
USD/JPY Outlook – JPY the Only Leading Currency Unable to Return to Pre-COVID Strength

The Japanese Economy Now and Going Forward – JPY Behaving Like a Semi-Developed Currency

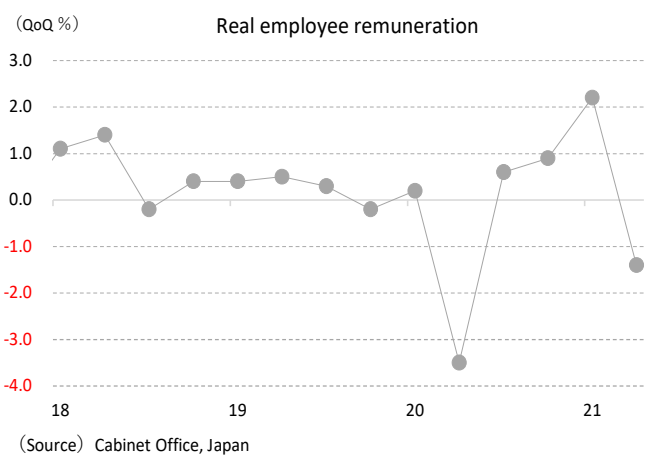
“State of Emergency” a Mere Formality Going by April-June GDP

Japan’s April-June quarter GDP (first preliminary report) released by the Cabinet Office in August posted +0.3% qoq, and an annualized rate of +1.3% on a real basis (after seasonal adjustment and excluding the impact of price fluctuations). The results indicate stronger growth than the +0.66% annualized rate predicted by the Japan Center for Economic Research (JCER) in its ESP Forecast (median of forecasts), so the overall strength of result must be appreciated. In the paragraphs below, all figures indicate real GDP qoq growth rates unless otherwise specified.

As already reported, the biggest contributing factor was Private Consumption (+0.9%), driven by the strong growth of its main component, Consumption of Households (+0.8%). The ESP Forecast had predicted a decline in Private Consumption (at just over -0.1%). In Consumption of Households by type (Durable Goods, Semi-Durable Goods, Non-Durable Goods, and Services), of special note is the strong growth of Services, at +1.5%. Services, including travel, restaurants, and other entertainment, ought to be the most affected by emergency and semi-emergency pandemic-related measures, but they show strong growth for the April-June quarter, which was mostly spent in a state of emergency. Although it is inappropriate to assume the same level of damage as previous periods of emergency given the limited regions affected this time, the accelerated growth of Services seems to indicate that the “state of emergency” has become a mere formality. Minister of State for Economic and Fiscal Policy and Minister in charge Economic Revitalization Yasutoshi Nishimura put it aptly when he said, “I have very mixed feelings about this GDP result.”



Semi-Durable Goods, such as clothing, footwear, and accessories, which have a shorter useful life but are also relatively inexpensive compared with Durable Goods (such as cars), were also strong at +1.9%, posting their first positive qoq growth in seven quarters (since July-September 2019). This seems to reflect consumer behavior of emerging from self-imposed restrictions and seeking out semi-durable goods more than they previously did. Having said that, the recent consumption spurt is mainly the result of pent-up demand and does not reflect any fundamental strength of the Japanese economy. Employee remuneration posted -1.4%, its largest fall in a year, since April-June 2020. There are no signs of movement restrictions being lifted in the foreseeable future, and even if they are, the employment and wage situations are not strong enough to kick-start consumption (see figure).

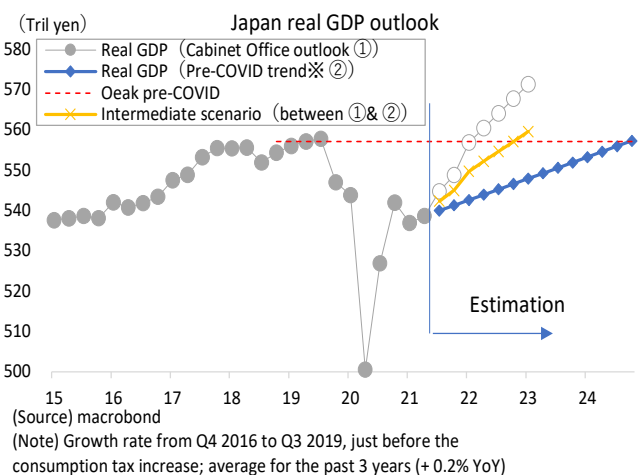


Negative Contribution to GDP Growth From Semiconductor Shortages Expected to Fade Gradually

Another component of Domestic Demand, Private Non-Residential Investment, posted +1.7% growth, which was more or less as expected. Change in Private Inventories is another category that must be monitored closely for predicting movements in the corporate sector going forward. This time, Change in Private Inventories contributed -0.2 pp to Real GDP Growth Rate overall (+0.3% qoq). As reported frequently, semiconductor supply constraints are also impacting the production activities of automakers, so one can conjecture that the liquidation of inventories is a leading indicator of this trend. Going by current media reports, it appears likely that the semiconductor supply constraints will continue until early next year, so it might take some time for production capacity utilization to return to normal. However, assuming that the supply constraints will gradually improve, the negative contribution to GDP growth rate from semiconductor shortages is also likely to gradually fade.

Cabinet Office Estimations No Longer Useful

The fact that Japan was able to avoid negative growth is good news, but it must also be mentioned that the U.S. and the euro area posted +1.6% qoq and +2.1% qoq growth rates, respectively. It is a serious matter that the Japanese economy is still being held back to the extent that it cannot post even half the growth rate of its Western counterparts, and it is bound to take Japan quite some time to recover pre-pandemic growth levels because of this late start. The Cabinet Office forecast in its economic outlook (Mid-Year Economic Projection) for 2021-22 that, thanks to recovery in domestic consumption alongside an increase in vaccination rates, and to recovery in fixed investment and exports alongside overseas economic recovery, real GDP growth rate would be +3.7% for FY2021 and +2.6% for FY2022. If growth does proceed in line with this projection during the July-September and



October-December quarters, real GDP will have recovered sufficiently to post an absolute value of JPY 548.7 trillion or so by the end of the year. As this is higher than the JPY 547 trillion for FY2019, it would amount to a recovery to “pre-pandemic” levels. However, as the figure shows, the October-December quarter of 2019 saw the lowest growth (-1.9% qoq) in five and a half years thanks to the consumption tax hike and Typhoon Hagibis. When we say “recover pre-pandemic growth levels,” therefore, the expectation in real terms is a recovery to the growth level of July-September 2019 (JPY 557 trillion). If the Cabinet Office projection is to be believed, Japan would surpass this level in April-June 2022, but this no longer seems likely, given the spread of COVID variants and the accompanying expansion/extension of emergency measures.

Japanese Economy Expected to Recover Pre-COVID Levels only in or After 2023

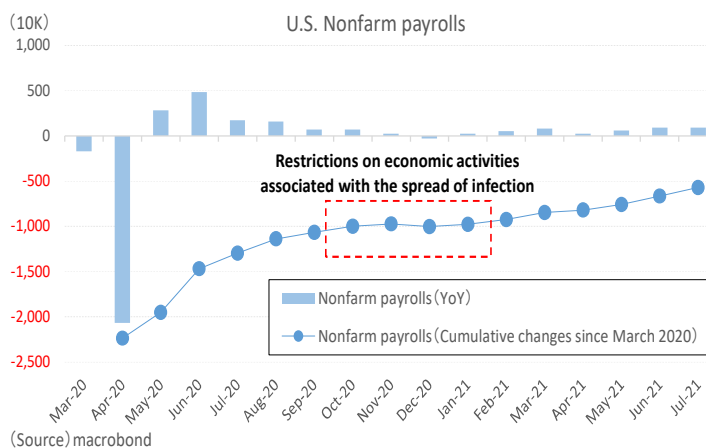
The average growth rate over the three years (12 quarters) leading up to July-September 2019 was +0.2%. Assuming the same pace of growth from next term (July-September 2021) onward, GDP can surpass JPY 557 trillion only in October-December 2024. Having said that, this growth trajectory is probably too conservative, as one can expect some pent-up demand to spur growth as the pandemic ends. Finding middle ground between (1) the optimistic Cabinet Office projection and (2) the above conservative projection, we can come up with (3) a growth trajectory between the two, based on which it might be possible to surpass JPY 557 trillion by October-December 2022. Having said that, scenario (1) is excessively optimistic, so the moderate scenario (3) must also be taken with a degree of caution. If so, we arrive at the conclusion that the Japanese economy may recover pre-pandemic growth levels in realistic terms sometime in 2023. This creates quite a gap between Japan and countries such as China and the U.S., which have already recovered pre-pandemic growth levels, and the euro area, which is certain to achieve full recovery within the year. My basic understanding is that this gap in real economic performance will be reflected as is in the

outlook for asset prices including share prices and forex rates.

U.S. Economy Now and Going Forward – U.S. Job Data Showing Signs of Complete Recovery

Waller's Assumption Close to Realization

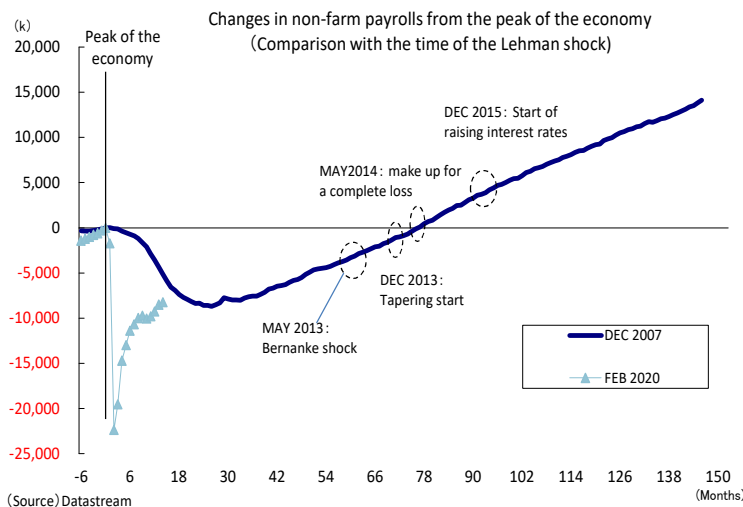
According to the U.S. July jobs report, Nonfarm Payrolls had added +943K jobs mom, exceeding the median of market forecasts (+850 K mom) and further accelerating from the June figure of +938K (upwardly revised after an already strong preliminary figure). On August 2, just before the release of the July job report, Federal Reserve Board member Christopher Waller said, "If the jobs reports come in as I think they are going to in the next two reports (July and August), then in my view, with tapering (phased reduction of quantitative easing), we should go early and we should go fast," adding that he thought it would be reasonable to make the decision in September and start tapering by October. Waller explained that, if jobs increased by 1.6 to 2.0 million over the next couple of months (July and August), the U.S. would have recovered 85% of lost jobs by September, and there would be no reason to extend tapering beyond that. As of April last year, 22.36 million jobs had been lost, but this loss has shrunk to 5.7 million with the release of the July jobs report, which marks the recovery of 75% of lost jobs. It is natural, under such circumstances, for the Fed to consider tapering. Looking back at developments in 2021, jobs have recovered by an average of 617K a month during the January-July period, and an average of +832K a month over the past three months. Immediately following Waller's statement, it was thought that adding 1.6 to 2 million jobs over two months would be difficult, but his assumptions now no longer seem fanciful, and the policy normalization process may proceed smoothly. Thanks to the +943K growth posted in July, Waller's assumption can be realized with just under +700K jobs added in August, which is quite an achievable figure. (Below, payroll change figures are all mom unless otherwise specified.)



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Full Recovery in 10 Months

Industry-sector wise, 380K jobs (40% of the total) were added in entertainment and hospitality sectors, which were the most disadvantaged due to movement restrictions. The net jobs lost in these industry sectors since March last year now stand at -1.737 million, indicating a recovery of 78.9% compared with what had originally been lost (-8.224 million). Restricting ourselves further to just food and accommodation industries within the entertainment and hospitality sector, the recovery is 80.6%. The above recovery rates are both higher than the 74.5% recovery rate for NFP as a whole, and these favorable developments in industry sectors that were hardest hit by movement restrictions indicate that the U.S. is making good progress toward normalization. Incidentally, transportation and warehousing (92.9%) and retail (88.6%) sectors have made even more remarkable recoveries, and these industries can be understood to be making progress toward normalization in combination with robust personal spending and the lifting of movement restrictions. Many other sectors apart from these have also recovered 70-80% of lost jobs by and large, so at least in terms of the number of jobs, recovery to pre-pandemic levels is well in sight. Compared with the previous recessionary phase in the wake of the global financial crisis, when it took over seven years to fully recover the lost jobs, the pace of job recovery this time is dramatic, and this is bound to be heartening for the Fed too. Moreover, the unemployment rate fell by 0.5 pp from 5.9% in June to 5.4% in July, posting a low not seen in a year and four months, since March 2020. There is still some distance to cover before the natural unemployment rate (4.0%) currently assumed by the Fed's Summary of Economic Projections can be reached, but things are steadily moving in the right direction.



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USD/JPY Stronger than Usual

NFP growing by more than 900K and the unemployment falling 0.5 pp in the space of a month are unprecedented developments. Given this change in the trajectory of real economic recovery, it is natural that the monetary policy normalization trajectory should also change, and there is no need to follow in the footsteps of the previous time, when phased tapering of QE took a year to achieve. A scenario where the Fed decides to taper in September, begins tapering in October (or December at the latest), and finishes the process by June 2022 (or July at the latest) is not that far-fetched. For instance, on July 30, St. Louis Fed President James Bullard said that the Fed should start tapering this fall and cut rates fairly rapidly so that its QE program could end early next year and pave the way for rate hikes to begin within 2022 if necessary. Perhaps proposing the start of rate hikes in 2022 is among the more extreme positions held by FOMC members, but going by the recent pace of economic recovery, it is not untenable.

Even forecasting a conservative one-year period for tapering starting this fall, it would end by September or October 2022, in which case, the start of rate hikes in February 2023 (as suggested by the current dot plot) is not that unthinkable a notion. Based on such a monetary policy forecast, it seems reasonable to assume an extremely low possibility of USD weakening against JPY, which is weighed down by an economy severely lagging behind other developed economies. My forecast that USD/JPY will remain stronger than usual this year, therefore, holds.

U.S. Monetary Policy Now and Going Forward – No Change in Outlook for Normalization Process*All Clear Ahead for Policy Normalization*

There was no FOMC meeting in August, but the minutes of the July 27-28 FOMC meeting were released. Since that meeting, and as of the time of writing this report, the pace of spread of the Delta variant has been increasing, so one cannot afford to lower one's guard until the final decision is made, but the situation is not grave enough to change the path of policy operations, and I would like to believe that things will go as I have been predicting in this report. The following section of the minutes clearly reveals the problem awareness and projections of FOMC members:

- Most participants judged that the Committee's standard of "substantial further progress" toward the maximum-employment goal had not yet been met. At the same time, most participants remarked that this standard had been achieved with respect to the price-stability goal.

In other words, the reason the Fed could not embark on tapering in July is because, of its dual mandates, the employment maximization mandate has not yet been met. However, the price stability mandate is no longer an obstacle.

The minutes go on to say that "most participants noted that, provided that the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year," but that "several others indicated, however, that a reduction in the pace of asset purchases was more likely to become appropriate early next year" because of uncertainty in the labor market as well as about the degree of progress toward the price-stability goal. Ultimately, therefore, it comes to either before the end of the year or early next year, and there is no doubt that a consensus is building up toward starting the normalization process. Fed Chair Jerome Powell also casually dismissed questions about the potential impact of the Delta variant on the economy both after his August 17 talk and at the Jackson Hole Symposium, so there are no signs of a major potential change in the Fed's monetary policy operation path as of the moment. I think it would be safe to say, therefore, that all seems clear ahead for policy normalization.

Could Tapering End in 1H of 2022?

The big question has shifted from whether tapering is an option to what the pace of tapering will be. The recently released minutes provided many hints in this regard, noting, "Many participants saw potential benefits in a pace of tapering that would end net asset purchases before the conditions currently specified in the Committee's forward guidance on the federal funds rate were likely to be met. At the same time, participants indicated that the standards for raising the target range for the federal funds rate were distinct from those associated with tapering asset purchases." The emphasize on viewing tapering and rate hikes as two distinct dimensions of monetary policy seems to indicate a sense of caution lest speculation of rate hikes strengthen as soon as tapering is decided. Incidentally, "Several participants noted that an earlier start to tapering could be accompanied by more gradual reductions in the purchase pace and that such a combination could mitigate the risk of an excessive tightening in financial conditions in response to a tapering announcement." Such opinions also support an earlier timeframe for deciding to taper.

The timing at which tapering ends would depend on what is meant by "more gradual reductions." Last time (December 2013 to October 2014), for instance, the process took ten months to bring down the pace of asset purchases from USD 85 billion a month to USD 10 billion a month. However, as I have repeatedly said in past issues of this report, the trajectory of economic recovery is very different this time. Compared with the more gradual deterioration and recovery of the previous time (even though it seemed quite rapid at that time), the economy this time deteriorated and recovered very rapidly, within the space of a year. Concerns of any delay in the normalization process resulting in a rapid rise in inflation are also significantly stronger this time round. All this makes a tapering pace of around USD 10 billion a month seem too slow. The Fed is currently purchasing Treasury securities worth USD 80 billion a month in addition to agency mortgage-backed securities (MBS) worth USD 40 billion, adding up to total purchases worth USD 120 billion a month. If, therefore, we take October this year to be the starting point and assume a tapering pace of

USD 15 billion a month, tapering should end in eight months (June 2022), and if we assume a pace of USD 20 billion a month, the process should end in six months (April 2022). Roughly speaking, tapering can be expected to end sometime in 1H of 2022. Further, rumors are that the current asset purchase program does not deliberately allocate funds to any particular type of asset, so “Most participants remarked that they saw benefits in reducing the pace of net purchases of Treasury securities and agency MBS proportionally in order to end both sets of purchases at the same time.”

Of course, “several participants indicated that they would adjust their views on the appropriate path of asset purchases” depending on the spread of the virus going forward. Of course, this is a risk that is common to the world as a whole, not just the U.S., and needs no mention. At any rate, the minutes confirm what this report has been predicting, that tapering will be decided in September and begun in October at the earliest but within the year at any rate.

Going forward, the timing at which the decision to start tapering is taken could be delayed by a month or two depending on jobs reports and other U.S. economic indicators as well as the status of infections from the Delta or other strains of COVID. However, a simple delay is hardly a factor that needs to be taken special note of in discussing general forex market trends. My basic understanding, therefore, remains that U.S. interest rates and USD will continue to spur each other on and strengthen over the next one year.

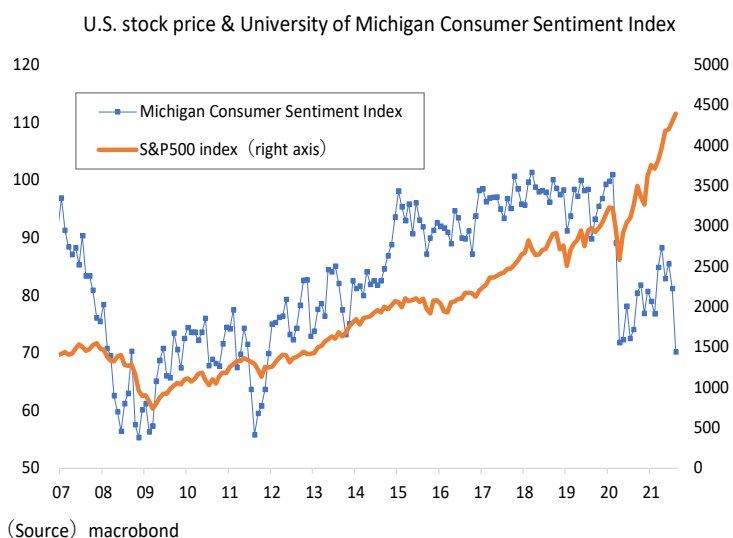
Risks to My Main Scenario – Soft Data Deterioration Trend a Yellow Traffic Light for the Global Economy?

Start of Worldwide Soft Data Deterioration Trend

Since the start of August, there has been an across-the-board trend of deterioration in various economic sentiment indicators. For example, as one can see from the graph, the July University of Michigan Consumer Sentiment Index (preliminary) figures released on August 13 have plummeted to the lowest level seen in about 10 years (since 2011; confirmed figures are mostly unchanged). In Europe also, the Purchasing Managers' Index (PMI) figures announced on August 23 indicated a trend of deteriorating sentiment in the general, manufacturing, and services categories for the first time in a long time. Outside Europe and the United States as well, the spread of covid-19 Delta variant infections is promoting demand restraint and supply chain damage in various places around the world, and it is becoming imperative to assess the likelihood that these trends may be heralding the incipient arrival of a new risk-off period. As such soft economic data as sentiment indexes have tended to show considerable upward and downward fluctuations during the covid-19 pandemic period, one should avoid being too quick to jump to pessimistic conclusions, but it must be recognized that the soft economic data trends will continue to represent a real risk factor going forward.

Specifically, the University of Michigan Consumer Sentiment Index (final) figure for August fell to 70.3, the lowest level since December 2011. This drop has negated all the progressive improvement in that index recorded since last spring. While the University of Michigan Consumer Sentiment Index seems to show large fluctuations due to the small number of survey respondents (300 for preliminary figures and 500 for confirmed figures), I think such evidence that the U.S. household sector's confidence level has been depressed to its lowest level in 10 years merits being taken seriously. The depressed confidence level appears to reflect the stubbornly high inflation rate along with the spread of covid-19 Delta variant infections – if the spread of Delta variant infections persists, there may be a basis for concern about its potential effect on the Fed's normalization process.

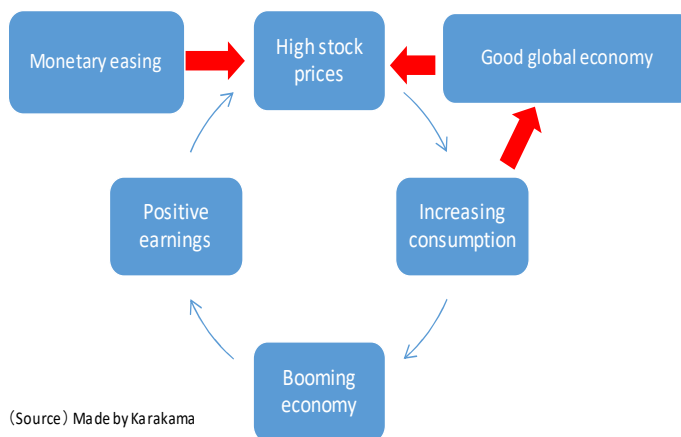
At this point, the deterioration of consumer sentiment does not seem to have exerted downward pressure on stock prices, which are still in a record-high range. If consumer sentiment deterioration were to have a significant negative impact on such economic growth driving factors as personal consumption and capital investment, however, it undeniably would have a potential to necessitate the revision of this article's main forecast scenario.



Normalization Process's Potential to Bring "Bad Interest Rate Increases"

The abovementioned large disparity between the consumer sentiment trend and the stock price level trend is cause for concern. Past issues of this article have discussed the fact that, given the worldwide annihilation of interest rates, stocks have widely come to be preferred as one of the few remaining financial assets capable of providing a steady stream of income (dividends). In light of that, it is still possible that stock prices will continue rising despite the increasing pessimism of consumers and private-sector businesses. However, it is also clear that the continuation of stock price increases is premised on continued monetary easing and the associated low levels of interest rates. If the Fed raises the FF rate, which corresponds to the global cost of fund procurement, one can expect that various interest rates will rise accordingly. When interest rates rise, stocks' steady stream of income will become somewhat less attractive. Basically, monetary easing has boosted stock prices (perhaps to above their fair value) in a manner that has served to provide a stimulus to the U.S. economy. This is because – as stocks account for more than 30% of U.S. household financial assets – one can expect rising stock prices to generate considerable asset or wealth effects that promote consumption. It is undeniable that demand promoted in this way within the U.S. economy has also been a positive driver of the global economy (see flow chart). However, if consumer sentiment remains pessimistic and prevents improvement in real economic conditions, there is cause for concern that the stock market will interpret the interest rate hikes as a purely negative factor ("bad interest rate increases" not reflecting conditions in the real economy) and the Fed will sharply reverse its normalization process in response. We may currently be at a critical moment at which the likelihood of such a chain of events is determined.

Image of a virtuous cycle of the U.S. and global economies



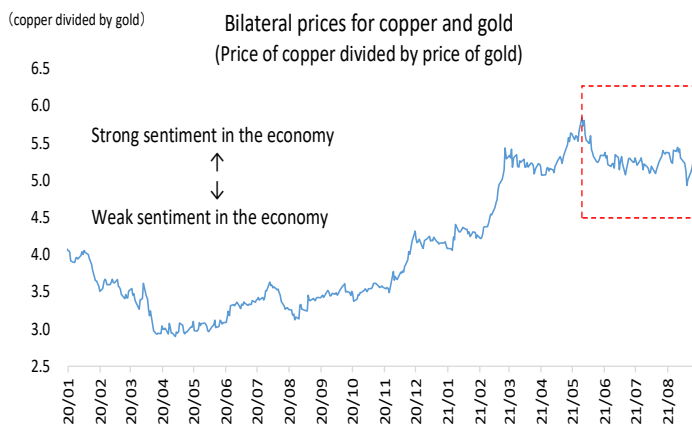
(Source) Made by Karakama

Impact of "Covid-19 Variant Spread" Compounded by "Geopolitical Risk Increase"

To make matters still worse, it became apparent in mid-August that the Taliban rebels would soon take control of Afghanistan's capital Kabul, and the U.S. military was officially withdrawn from Afghanistan as of August 30, although U.S. President Biden indicated that he would allow some U.S. troops to be dispatched to Afghanistan to ensure an "safe and orderly" withdrawal. As the Biden administration has been claiming that it would place greater emphasis on human rights than the previous administration, the Taliban's seizure of the entirety of Afghanistan and the associated surge of human rights violations are a clearly a setback. The situation in Afghanistan has continued to be extremely confused, and it is being covered by a steady stream of media reports. While the impact of the Afghanistan situation on economic and financial scenarios is still unclear, the latest FOMC statement mentioned "increased geopolitical risk" as a risk factor, so it appears that the Afghanistan situation should be considered a potential impediment to the Fed's normalization process. Many observers believe the Afghanistan situation will continue having the direct effect of depressing the Biden administration's public approval ratings, and there is concern that it may also have an indirect negative impact on the U.S. economy's household and corporate sectors. There is undeniably a risk that the decision to undertake a gradual reduction (tapering) of the Fed's quantitative easing, which was previously considered to be a possibility during September, may be delayed due to the combination of "covid-19 variant spread" and "increased geopolitical risk". However, Japan is expected to remain considerably behind the United States for the time being regarding progress made in economic, financial, and societal conditions. Accordingly, although the Fed's schedule for tapering and other normalization measures may be slightly delayed, I do not think there is currently a need to significantly change this article's projection of USD/JPY trends.

Copper-Gold Price Ratio Trend

Amid the deterioration of soft data indicators, it is worth considering some additional indicators that can facilitate interpretation of the soft data trends' significance. During the past three months, copper prices have been declining while gold prices have been rising, causing a downward trend in the copper-gold price ratio (copper price ÷ gold price), which is a leading economic indicator. The persistence of this trend will depend almost entirely on whether the pandemic worsens or improves, but it seems that the global economy must have benefited from a "tailwind" of pent-up demand during the first half of this year. If so, it may also true that some degree of economic deceleration will be unavoidable regardless how

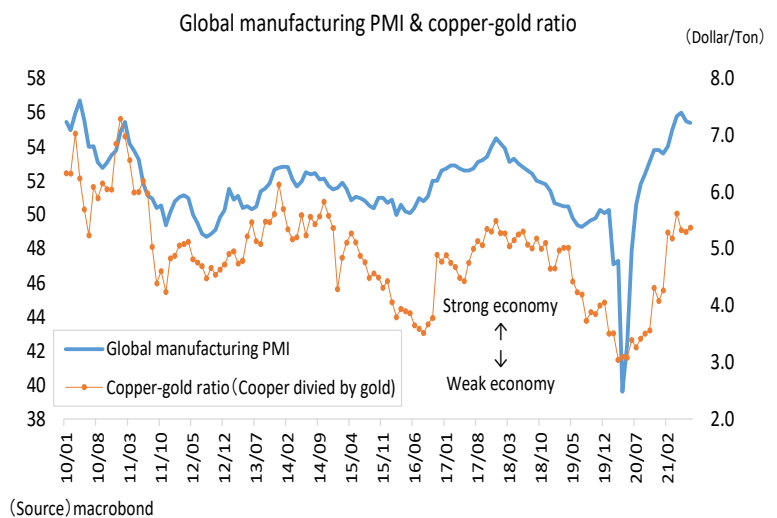


(Source) macrobond

much the covid-19 Delta variant infections spread.

In any case, unlike the soft data trends discussed above, metals-related trends (particularly trends related to copper, the production of which is not increased or decreased with the goal of maintaining prices, as crude oil production is) are considered fairly accurate reflections of actual demand trends. It is a well-known fact that half the world's annual copper consumption reflects demand from China, which, in turn, is directly linked to global economic trends.

For example, there is a stable co-relationship between the copper-gold ratio and the global manufacturing PMI, and it is undeniable that the kind of PMI softening that is beginning to be evident is not mere deterioration of confidence levels – it may be accompanied by a contraction of the real economy. Given this, one would be well advised to consider the copper-gold ratio in conjunction with the various PMIs, as a set of indicators. If there is an actual decline in the global manufacturing industry's utilization rate, it could be considered grounds for concern that that supply constraints may increase further inflationary pressures. Essentially, this is referring to a risk scenario that would arise if the pace of “demand decline due to economic slowdown” is exceeded by the pace of “supply decline due to pandemic growth”. This may be intuitively obvious, but as vaccination programs progress, countries can be expected to have a tendency to discontinue the imposition of lockdowns and other strict behavioral restrictions. If so, then the “demand decline due to the economic slowdown” will be limited, and there will certainly be a risk that the “supply decline due to pandemic growth” will lead to a general increase in prices.



Yellow Traffic Light for the Global Economy

In recent months, concerns about a slowdown in the Chinese economy have contributed to the undermining of economic confidence. All China's basic economic indicators – such as mining and industrial production, retail sales, fixed asset investment, and total social financing (TSF) – are currently weak. In addition to this, the Chinese government has been rapidly announcing a series of new regulations on specified industries and, given the associated uncertainties, it would not be surprising if this situation were promoting a progressively intensifying tendency to refrain from investing in the Chinese market. This is a deep-rooted problem that is unlikely to be resolved in the near future. At this point, it seems wise to anticipate that China will continue experiencing an economic slowdown for the time being.

In light of the abovementioned situation, it may be accurate to say that a yellow traffic light began shining at the global economic outlook roughly midway through this year – perhaps since some time around July. Although it remains difficult to predict an actual shift to a red traffic light, if the Chinese economy's slowdown is recognized, it seems obvious that one should not expect the global economy's momentum in the first half of the year to persist through the second half. I do not yet see a need to revise the main forecast scenario of “Fed normalization moves promoting increases in US interest rates along with USD appreciation”, but does appear that events during the July-August period have slightly increased the likelihood of encountering unforeseen circumstances going forward.

EUR Outlook – Focusing on PEPP Management

EUR Area Monetary Policies Now and Going Forward – New Forward Guidance Might be Troublesome in the Future

Forward Guidance Disagreement Indicates Possibility of Future Disagreements?

There was no ECB Governing Council meeting in August, but the Account of the July 22 Governing Council meeting was released on August 26. That meeting revised the forward guidance regarding how long the key ECB interest rates would remain at their present or lower levels, replacing the previous “until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 per cent within our projection horizon” text with the new “until we see inflation reaching two per cent well ahead of the end of our projection horizon and durably for the rest of the projection horizon” text. Although financial market players did not consider this change to be a market-moving factor, it was a historic meeting from the perspective of ECB watchers. ECB President Christine Lagarde confirmed on the day of the meeting that the forward guidance revision was not approved unanimously but by “an overwhelming majority” of Governing Council members.

On the other hand, President Lagarde said the revision was opposed by “a very, very small number of Governing Council members.” The Account of the meeting notes that “a large majority of members indicated that they could support the revised forward guidance proposal” while “a few members upheld their reservations”. (According to subsequent media reports, these members are likely to be Deutsche Bundesbank President Jens Weidmann and National Bank of Belgium Governor Pierre Wunsch.) Ideally, there should not be disagreement from the very start regarding the guidance language that is a part of the new monetary policy strategy’s foundation, and the existence of such disagreement seems to be a basis for concern regarding the possibility of additional problematic disagreements going forward.

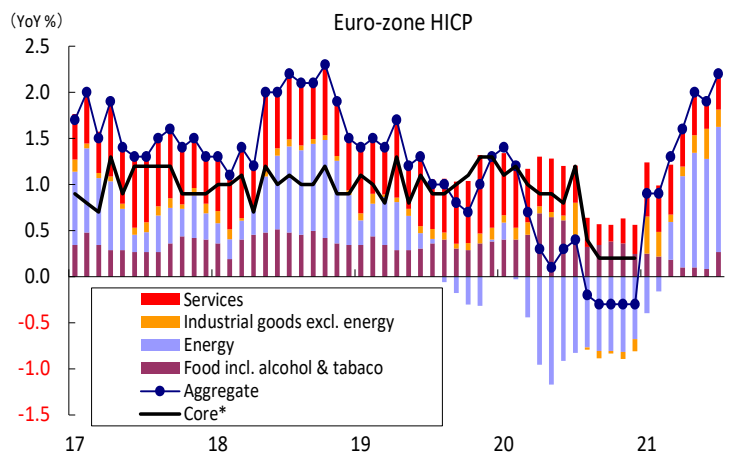
“Interest Rate Guidance” vs. “Asset Purchasing Guidance”

The reason “a few members” had reservations stems from concerns that the new guidance would amount to “intentionally overshooting the inflation target”. Basically, the situation is that “an overwhelming majority” of Governing Council members believe “the strategy itself provided a safeguard by stipulating that only temporary and moderate overshoots of inflation would be consistent with price stability over the medium term”, but some members disagree. As the ECB’s current policy management promises a “end of quantitative easing → rate hike” sequence, there is concern that the new guidance may be misunderstood to suggest a prolongation of the period of ultra-low interest rates and a consequential delay to the termination of quantitative easing. In connection with this, the Account notes that – “There was general agreement to defer the discussion on the [asset purchase programme] APP forward guidance to a future meeting” – and this suggests a possibility that interest rate hike postponements may not necessarily continue to be linked to the state of quantitative easing programs.

Ultimately the opposition from the German and Belgian Governing Council members is based on their concern that the new guidance will be – “seen as promising to keep interest rates at their present or lower levels for a very long time period without an explicit escape clause.” – and that that itself will lead to a delay to the end of quantitative easing. This in of itself can be said to be a legitimate concern. However, the ECB is committed to continuing the Pandemic Emergency Purchase Program (PEPP) until the end of the pandemic, so it should be remembered that the PEPP is outside the scope of such detailed discussions. Moreover, the PEPP is currently the central focus of the ECB’s monetary policies.

Inflation Trend Still Far from Supporting Policy Normalization

While the concerns of the hawkish Governing Council members led by those from Germany are understandable, the harsh reality remains that the new monetary policy strategy and forward guidance allows the ECB to overshoot the 2% inflation target. As can be seen from the graph on the next page, in July, the comprehensive-basis euro area consumer price index (HICP) increased significantly by 2.2% yoy, but core-basis HICP (excluding energy, food, alcoholic beverages, and tobacco) was quite weak at +0.7% yoy. It is quite evident that the upward momentum in HICP seen since the beginning of the year has been supported by the base effect of energy prices and other factors, so it itself cannot be expected to promote monetary policy normalization. As discussed below, explicit increases or decreases in PEPP purchasing rates at this point are perceived as simply promoting unintended speculation on the



(Source) Datastream

(Note) Core excl. energy, food, alcohol & tobacco

parts of financial market players, and the September 9 Governing Council meeting is likely to maintain the status quo along with an equivocal stance regarding normalization – disavowing a desire to quickly move toward normalization while acknowledging a need to continuing planning for eventual normalization moves. Compared to the June

Eurosystem staff projections, the September projections may either generally maintain the HICP outlook unchanged or revise it upward, and it seems unlikely that it will be possible to construe the updated projections as being a rationale for strengthening monetary easing measures.

September 9 Governing Council Meeting likely to Maintain the Status Quo

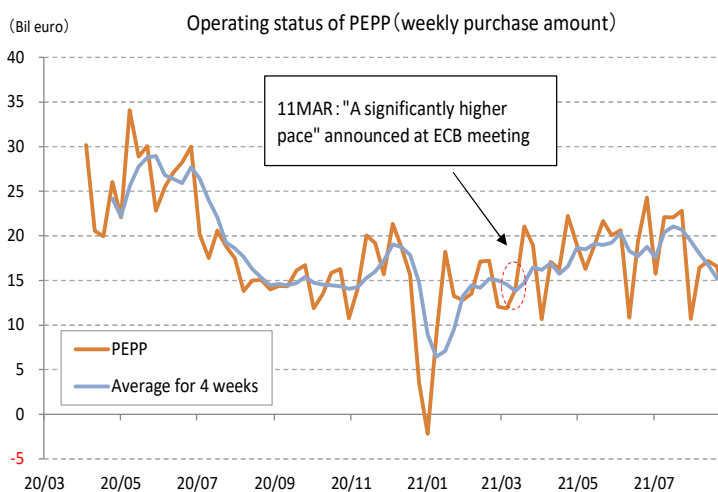
Soon after the start of September (September 9), there will be a Governing Council meeting along with the announcement of the revised staff projection. The ECB has decided to review the pace of its PEPP asset purchases at its Governing Council meetings in March, June, September, and December, which correspond to the timing of staff projection revisions. Given that the PEPP will expire at the end of March 2022, the only remaining opportunities to adjust the PEPP asset purchasing pace will be in September and December. On August 4, Governing Council member and Latvia's central bank governor Mārtiņš Kazāks denied that a related decision would be made in the near future, saying – “Given the uncertainty, given how much time is left, there is no need to decide on that. It's quite unlikely that we will come out in late March 2022 and say this is it, we've done our job and we terminate it. We would like to warn the markets in advance -- but only as much as it's reasonably possible.” This suggests that a September adjustment would not be considered “reasonably possible”. There is only scarce related information from other high-ranking ECB officials owing to the prevalence of August vacations in Europe, but Governing Council member and Deutsche Bundesbank President Jens Weidmann said in an interview with a German newspaper published on August 8 that – “The first P [of PEPP] stands for pandemic and not for permanent. It's a question of credibility.” – emphasizing the need to terminate the PEPP at the end of the pandemic. However, it is quite apparent that the pandemic has not yet ended, and the President Weidmann will probably be in favor of a September Governing Council decision to maintain the PEPP status quo. Frankly, it is highly probable that the PEPP status quo will be maintained in September.

Current PEPP Purchase Pace Already Close to the Limit

However, the above-cited remarks of Governing Council members relate only to the timing of a decision about the possible extension of the PEPP, they did not make mention of the PEPP purchasing pace. Therefore, there is a possibility that the September Governing Council meeting may make some adjustment to the PEPP purchasing pace, and the Account of the July 22 Governing Council meeting also suggests that possibility. At present, however, both upward and downward adjustments might lead to unintended interpretations, so the Governing Council is likely to simply maintain its statement that PEPP purchases will be undertaken at “a significantly higher pace”. If the Governing Council were to increase the pace, it would be tantamount to admitting a perception of a clear deterioration in economic conditions, but the euro area economy is doing well so far and is expected to recover to pre-pandemic levels by the end of the year. The July revision of the IMF World Economic Outlook includes upward adjustments to growth rates for the euro area and other advanced economies. On the other hand, if the Governing Council were to decrease the pace, it would have to base its decision on a perception of a clear trend of improvement in economic conditions. Current economic conditions may well provide a sufficient basis for a decision to decrease the pace, but there remains a difficult problem in that it is impossible to rationally project the economic impact of the spread of covid-19 Delta variant infections going forward. If Governing Council were to decrease the pace in September, inscrutable pandemic-related factors might force it to increase the pace again even prior to December. Given that, it seems wiser and safer for the Governing Council to wait and see while maintaining the status quo.

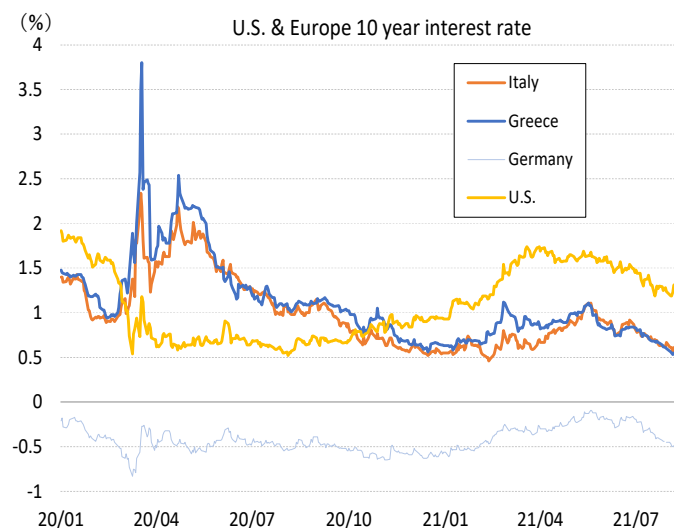
Perhaps reflecting the slowdown of many activities in Europe during the summer vacation season, the PEPP weekly purchase pace has been decelerating. The average weekly purchase pace was EUR1.71 billion in April, EUR1.92 billion in May, EUR1.88 billion in June, EUR1.87 billion in July and EUR1.54 billion in August. The greatest degree of Europe's summer vacation slowdown is believed to begin in the fourth week of July, so the purchase pace slowdown from July through August can be considered to be a technical fluctuation rather than a fundamental trend. Since the phrase “a significantly higher pace” was introduced in March, the PEPP weekly purchase pace has increased from EUR15 billion to around EUR18-19 billion, and it seems likely to return to that level from September.

This pace is sustainable for the ECB. Roughly speaking, EUR19 billion a week is EUR76 billion a month, and if that pace is continued for the seven months from September through next March, total purchases will amount to EUR532 billion. As of August 27, about EUR1.3 trillion of the PEPP's EUR1.85 trillion envelope had been used, and the remaining balance of the envelope amounted to about EUR550 billion, which is very close to the abovementioned EUR532 billion figure. In fact, the figures are so close that some suspicious people might wonder if the ECB might have determined the current “EUR18-19 billion per week” pace by calculating the pace required to finish spending the entire envelope at the end of next March.



Best to Maintain Watchful Waiting Posture

Given the above, if the spread of covid-19 Delta variant infections were to begin seriously impacting the euro area economy, it would not be easy for the ECB to respond by accelerating the PEPP weekly purchase pace. If weekly purchases were boosted to EUR20-25 billion, the PEPP envelope would be exhausted before the end of next March. There are not yet enough problematic economic situations to justify increasing the PEPP purchase pace (undertaking additional relaxation), so it seems best to maintain a posture of watchful waiting. Moreover, the PEPP's purpose is to curb euro area interest rates and thereby maintain a favorable financing environment, not to facilitate quantitative expansion and increase the ECB's balance sheet. In this regard, one can see from the graph that regional interest rates are clearly trending downward, quite unlike this past March, when the "a significantly higher pace" phrase was inserted in the Governing Council meeting statement. Theoretically, the ECB should consider it ideal if it can maintain an accommodative financing environment while using a relatively small portion of the PEPP envelope. If the current interest rate environment is sustained into September, the summer holiday period's weekly purchase pace (around EUR15 billion) should be adequate. As the European and U.S. economies are subjected to downward pressure owing to the spread of covid-19 Delta variant infections, interest rates are likely to decline. It appears that the ECB's true intention is to mark time and continue maintaining a wait-and-see posture regarding the disposition of the remainder of the PEPP's EUR1.85 trillion envelope. The ECB Governing Council is probably hoping that the upcoming months pass as uneventfully as possible



(Source) macrobond

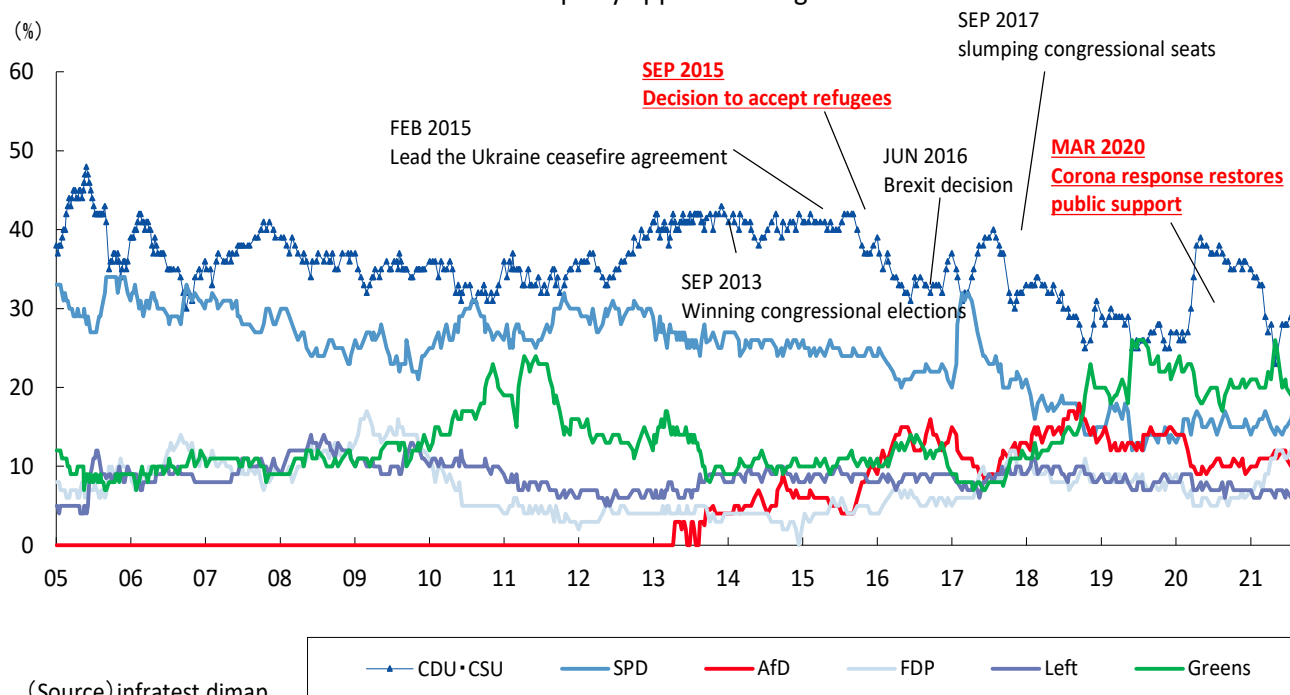
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Appendix: Outlook for German General Elections – Undeniable Likelihood of a CDU/CSU Loss**Environmental Party Lost Momentum in Early Spring**

The September 26 date of Germany's federal parliamentary election (general election) is approaching. Regardless of the election's outcome, Germany's Angela Merkel-led government administrations – which began November 2005 and have continued for 16 years – are approaching their end-point. Looking back at the pandemic-related challenges of the past year and a half, one finds that the Merkel administration (said to be strongly resilient in the face of crises) experienced ups and downs. When the entire world became alarmed about the covid-19 pandemic last spring, the ruling Christian Democratic Union (CDU) and its Bavarian sister party the Christian Social Union in Bavaria (CSU) received high praise for the efforts of Chancellor Merkel, who showed a glimpse of her background as a competent scientist as she worked to control the first wave of infection. Both the CDU and the CSU earned high approval ratings. During the second and third pandemic waves that hit during the period from last fall through early this year, however, the ruling CDU/CSU coalition was criticized for its involvement in an illegal mask procurement scandal and for the sluggishness of Germany's vaccination program, which lagged behind those of the United Kingdom and the United States, and the behavioral restrictions the coalition imposed also alienated some voters. The CDU/CSU's voter approval level has thus been showing considerable fluctuation recently. While the level plunged following the European refugee crisis beginning from September 2015, the coalition was able to regain much of that popular approval during the early stages of the pandemic, only to see that renewed support progressively eroded over the past year. While the past year has been disappointing for the CDU/CSU, the fact that after the rise and fall during the pandemic the coalition's approval rating is roughly at the same level as it was before the pandemic can be considered a positive aspect of the situation.

While CDU/CSU missteps are responsible for some of its approval rating decline, emphasis on environmental protection issues has been increasing both inside and outside Germany, and the coalition led by the Alliance 90/The Greens ("the Greens") party has been able – by focusing on environmental protection issues – to proactively erode CDU/CSU support. As the graph shows, there was a period from early to mid-May this year when the Green's approval rating surmounted that of the CDU/CSU, and the possibility that the next German Chancellor might be from the Greens was mooted at that time. However, the Greens' co-leader Annalena Baerbock has recently been facing accusations of plagiarism in her writings and of misrepresenting her academic background, causing the Greens' approval rating to slump considerably, so at the time this article was written, the party with the second highest level of support was the center-left/socialist Social Democratic Party (SPD). It is also generally believed that the Greens are much less competent than the CDU/CSU with respect to dealing with the kind of emergencies Germany is currently facing. While the sluggishness of Germany's vaccination program has been a concern, the country's vaccination rate surpassed that of the United States (60.51%) and reached 63.89% (both as of August 24). While the pandemic situation seems to be calming down, it is believed that many voters will still insist on voting for the CDU/CSU in light of the coalition's perception of emergency response competence. Although environmental issues will continue being positioned as a highly important issue for the EU, public health emergencies are persisting, and it seems that voters actually consider environmental issues to be secondary to those public health emergencies. This is a natural way to think and easy to understand.

German party approval rating

*SPD Resurgence Leads to Three-Cornered Battle*

As of the end of August, it is quite unclear what will happen in the upcoming general election. Based on Infratest dimap poll results (as of August 17-18), the CDU/CSU party approval rating (as of August 20) was 23% — six percentage points above the Green's 17% party approval rating. Given that the Greens had greater support (26%) than the CDU/CSU (23%) in the May 6 version of this survey, it seems clear that the momentum has been shifting toward the CDU/CSU. However, it would be dangerous to draw premature conclusions in this regard. Amid a large-scale flooding in western Germany in mid-July, CDU party leader and Prime Minister of North Rhine-Westphalia Armin Laschet visited the disaster area on July 17 and was caught on video during a somber press conference chatting cheerfully with the people around him and laughing. This incident attracted considerable attention and has caused many voters to conclude that Mr. Laschet lacks sufficient dedication and gravitas. The incident is also considered to be a primary reason for the recent decline in the CDU/CSU approval rating, which had reached 30% in late July.

However, that does not mean that support for the Greens has resurged. At the time of this article was written, the strongest German party was neither the CDU/CSU nor the Greens but the SPD, which has been sharing in power via a grand coalition (Große Koalition) with the CDU/CSU but has seemed quite lackluster in recent years. The SPD's approval rating has surged from 14% at the beginning of the year to 21%, surpassing the Greens' approval rating. This is the first time in three years (since September 2018) that the SPD has earned a higher approval rating than the Greens. In summary, the current situation is that levels of support for the CDU/CSU, the Greens, and the SPD are all fluctuating in the 17-23% range, and it seems that it will be difficult for any single party to gain a majority in the general election.

According to a poll conducted by another research company (Forsa) during the August 20-23 period and published on August 24, the SPD's approval rating have finally surpassed that of the CDU/CSU. Specifically, the Forsa poll reports approval ratings of 23% for the SPD, 22% for the CDU/CSU, and 18% for the Greens. The Forsa poll is more recent and has a larger sample size, so it can be surmised that the CDU/CSU are quite shocked by its results. Throughout the 16-year Merkel-led government period, the CDU/CSU has very rarely had a lower approval rating than the SPD. There were two periods – the 2009-2012 period immediately after the European debt crisis and the January-March 2017 period immediately after Martin Schulz became the SPD's chairperson – in which the parties' approval ratings were quite close (with that of the SPD only rarely surpassing that of the CDU/CSU), but those were basically transient periods. The current moment of SPD earning a higher approval rating than the CDU/CSU may turn out to be similarly transient, but this particular moment is only a month before the general election. The SPD is undoubtedly hoping it can maintain its momentum for another month and surge into a commanding position in German's next government, which would be the first SPD-led government since the 1998-2005 government headed by Gerhard Schröder. SPD leader (and finance minister) Olaf Scholz has emerged as a the party's candidate for the chancellorship. The SPD's current strength and momentum is particularly apparent when one considers that the Forsa survey at the start of the year indicated that the CDU/CSU's approval rating was 35%, more than double the SPD's 14% approval rating at that time.

Difficulty of Harmonizing Leftist Party Policies

However, it bears noting that the SPD's resurgence has largely occurred because of mistakes on the parts of its rivals. Support for SPD leader Scholz (and the SPD) does perhaps reflect his record actively serving in a key position as finance minister, but it is also reasonable to attribute much of his popularity to the simple fact that he (in contrast to his rivals) has made no conspicuous blunders. While the available information is not currently sufficient to predict what kind of coalition government might be formed after the elections, there is an undeniable possibility that the CDU/CSU may be not be a partner in the next government, which was considered extremely unlikely until a month ago. If the current momentum continues, it is widely assumed that the SPD will be senior partner in a left-wing coalition government formed in cooperation with the Greens and the Free Democratic Party (FDP). Such a government would be considerably to the left of the Merkel government, and it will be worth paying close attention to how it might revise Germany's fiscal policies as they relate to the German economy. Regarding Germany's external policies, it is not expected that there would be a significant change to country's stance toward the EU, but it would seem inevitable that Germany's power to dominate the euro area would be somewhat weaker than during the Merkel era. After the departure of Chancellor Merkel, seeking to provide the EU's disparate members with coordinated economic leadership will be a big challenge for whoever her successor might be, and in that regard, Mr. Scholz, being the current finance minister, may be considered a fairly safe choice for that task.

However, there are some potential concerns about the diplomatic stance of Germany's next government. While the SPD has traditionally promoted pro-Russia and pro-Chinese policies, the Greens have publicly made it known that they will adopt a strict posture toward China and Russia. Although both the SPD and the Greens can be characterized as left wing parties, the differences between them are not inconsiderable. And it will not be easy for either of those parties to coordinate their policy stances with that of the FDP. The not-unlikely possibility of a protracted "political vacuum" situation akin to that following the 2017 general election is quite worrisome. Chancellor Merkel's current (fourth) government was born only after a "political vacuum" situation that lasted for about half a year after the September 2017 general election. Reflecting the weakened state of the CDU/CSU – traditionally Germany's leading parties – it is becoming customary to require a certain amount of post-election time before German coalition governments can be formed, and it is very likely that this will happen again.

An Election that Helps Shape Europe's Future

From the perspective of the euro area economy, a CDU/CSU election loss might have some positive aspects. If such leftist parties as the SPD and the Greens take power, they might promote a major turning point in Germany's economic policies away from the country's traditional emphasis on fiscal austerity. During its later stages, the Merkel government was forced to muster up greater efforts on behalf of the EU (such as helping build a consensus to create the reconstruction fund), but it was during most of its stages somewhat disliked by many of its fellow EU members for being out of step with them. It is hoped that Germany's next government, which will be laying the foundation for the post-Merkel era, will be able to progressively dispel that out-of-step image and reposition Germany to play a strong leadership role in the EU's further integration and strengthening. In this sense, I think one should be paying close attention to Germany's upcoming general election as it may be a key event that determines the nature of Europe's future.

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