

November 30, 2022

Overview of Outlook

In November, USD/JPY retreated somewhat to trend around the 140 level for the most part. Expectations of a change in the Fed's monetary policy caused U.S. interest rates to fall, which prompted USD selling and resulted in a correction of the USD/JPY level. The shift in the Fed's policy stance prompted a reversal in across-the-board USD strength, and this could help USD/JPY also to recover roughly half of the ground lost this year and return to around 130. On the other hand, the JPY supply-demand structure has been distorted by Japan's historically high trade deficit, the impact of which may linger. If senior Fed officials were to declare an end to the current phase of rate hikes through statements or lectures, U.S. interest rate decline and USD selling would most likely gain momentum – a situation one can expect to see sometime from the end of this year through 1Q of next year. However, once the end of rate hikes loses its freshness as a factor influencing trades, trading based on interest rate differentials could regain momentum. Also, by this time, market volatility is also likely to have subsided, thanks to the Fed's switch to a more dovish stance. It must be noted that a sufficient interest rate differential and low volatility are the two key conditions for carry trade to flourish. I cannot get on board with the theory that, in 2023, USD/JPY will return to its 2022 starting point of 112-113 simply based on a decline in U.S. interest rates and an over-optimistic interpretation of a temporary deceleration in interest rate growth. Moreover, as an upside risk, one must also consider the possibility of the Fed not ending its current rate-hike phase next spring. Taking into account the existence of an average inflation target, one would do well to watch out for a possible sustained phase of 25-bp rate hikes.

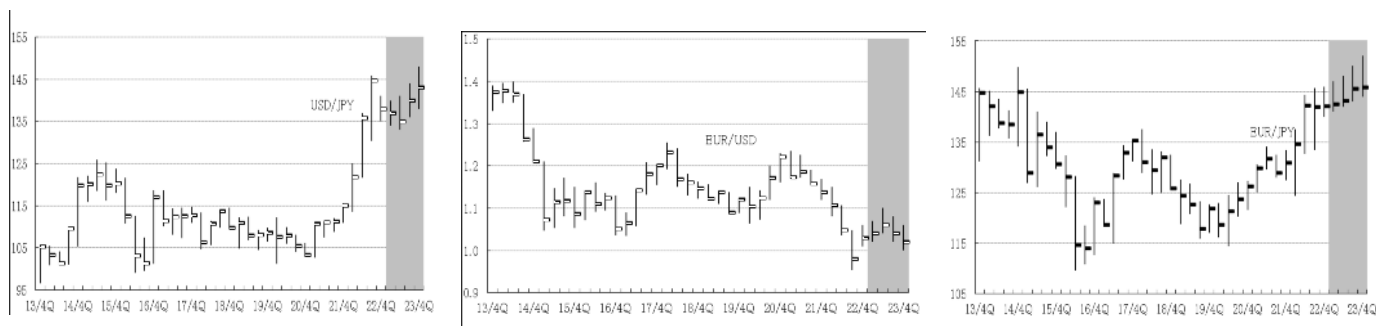
EUR remained strong in November. Contrary to the U.S., where inflation growth seems to be slowing down, the euro area is experiencing inflation acceleration. By itself, this is not desirable, but it has resulted in speculation that the ECB's rate hike phase could continue past that of the Fed, and this has shrunk the Europe-U.S. interest rate differential and boosted EUR. As opposed to the Fed, for which the markets have already factored in a shrinking pace of rate hikes, most ECB members are seen as supporting +75bp rate hikes, gradually widening the difference between the stances of the ECB and the Fed. However, the euro area, where a technical recession is a certainty, is also facing stagflation, and there are limits to how much EUR can be bought simply based on high interest rates. Perhaps supply and demand, rather than interest rates, should be the focus of attention. Steep natural gas prices, which were Europe's vulnerability, have now fallen and stabilized thanks to power-saving efforts and a mild winter. Germany, which, unlike Japan, has retained its power as an export hub, can recover its large current account surplus so long as resource prices can be kept down. If the euro area as a whole, led by Germany, recovers its current account (and trade) surplus, investors could reevaluate EUR from a supply-demand perspective. In this context, Russia's EU-related energy policies going forward will be a key factor.

Summary Table of Forecasts

	2022		2023			
	Jan-Nov (Actual)	Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	113.47 ~ 151.93 (138.63)	135 ~ 141 (138)	134 ~ 140 (137)	133 ~ 141 (135)	136 ~ 144 (140)	138 ~ 148 (143)
EUR/USD	0.9528 ~ 1.1495 (1.0343)	1.01 ~ 1.06 (1.03)	1.02 ~ 1.07 (1.04)	1.04 ~ 1.10 (1.06)	1.02 ~ 1.08 (1.04)	1.00 ~ 1.06 (1.02)
EUR/JPY	124.41 ~ 148.35 (143.38)	140 ~ 146 (142)	141 ~ 147 (142)	142 ~ 148 (143)	143 ~ 150 (146)	144 ~ 152 (146)

Notes: 1. The actual results were released at around 10am TKY time on 30 Nov 2022. 2. Data source from Bloomberg.
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts

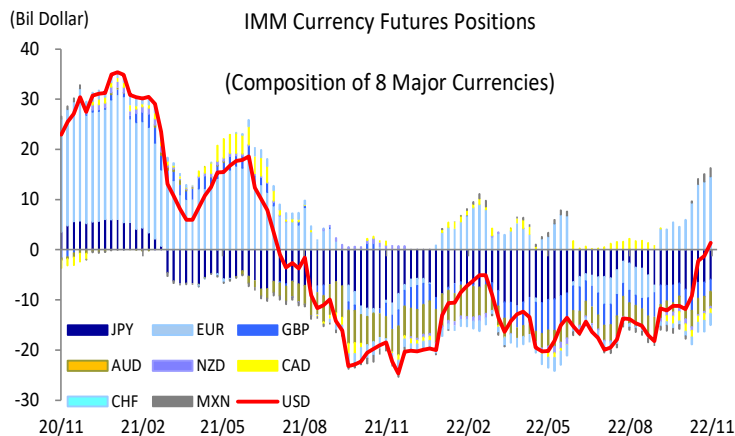


USD/JPY Outlook – The End of USD Strength is not the End of JPY Weakness

Forex Markets Now and Going Forward – Has the USD Buying Phase Ended?

Speculative USD Position is Short for First Time in 1 Year and 4 Months

In November, the forex markets were abuzz with the news that the speculative USD position, as reflected in IMM currency trades, had turned short. As of November 15, the synthetic position of eight key currencies against USD had expanded to a long position worth +USD 1.35 billion, which amounts to a short position from the perspective of USD. This is the first time since July 2021, i.e., in a year and four months, that this USD position has turned short (see figure). As a result of this development, I have been getting an extremely large number of inquiries as to whether this symbolizes a reversal of the weak-JPY/strong-USD trend, and I would like to present my basic understanding in this report. To cut to the chase, I think there is a good possibility that this indicates a reversal of the strong USD phase, but it seems more unlikely that it indicates a reversal of the weak JPY phase. With regard to the recent developments in IMM currency futures transactions, it is important to take note of two things – (1) that it is the result of rapid EUR buying, and (2) that the JPY short position remains large.



Source: Bloomberg

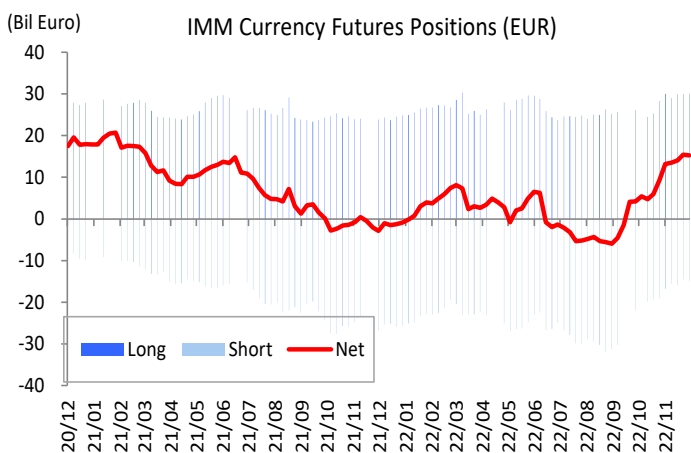
USD Selling \doteq EUR Buying

First, with regard to (1), as obvious at a glance, EUR buying is what has been driving the recent USD weakness. In terms of market rates, EUR/USD, which had consistently been trending below parity, recovered in November and stabilized at around 1.00~1.03 dollars. Conditions for EUR buying are undoubtedly favorable from both the interest rate and demand perspectives (details later). From the interest-rate perspective, inflation expectations are stronger in Europe than in the U.S., resulting in the U.S.-Europe interest rate gap shrinking. On the demand side, the stabilization of resource prices and other factors appear to be boosting EUR. This has been the most unexpected development from the perspective of this report. Going by resource price trends in June-July, it seemed obvious to assume that the European economy's external sector would become weaker as things became more difficult during winter. This was the reason I predicted a weakening of EUR over the year-end period.

However, in addition to the energy saving efforts of the various member states, the surprisingly warm winter has caused natural gas prices to fall back almost to their summer level, i.e., before their steep increase. Unlike Japan, Germany is still a powerful exporting nation, so its trade surplus is expected to recover strongly as long as mineral fuel import prices can be kept down. Once that happens, demand-driven EUR buying can be expected to recover. Further, looking at the EUR position as reflected in IMM currency futures trades, while the EUR long position has not changed much, its short position has been rapidly shrinking, causing an expansion of the net EUR long position. Of course, some of this is due to market participants factoring in the Fed's transition to a more dovish stance, but part of it may also be due to speculators, who had been betting on EUR weakness, beginning to sense a shift in wind direction in connection with interest rates and supply & demand.

USD Selling \neq JPY Buying

Moving on to point (2), the current JPY short position is roughly JPY 1.2 trillion, but the average JPY short position between early March (when JPY began to depreciate) and end of October was JPY 1.3 trillion (see figure, right). Going by these figures, speculators' sentiment related to JPY selling does not seem to have changed significantly. Incidentally, the current JPY long position is around JPY 420 billion, while the average for March through end of October was JPY 370 billion. While it looks like there is a slight tilt toward JPY buying, the fact is that the JPY long



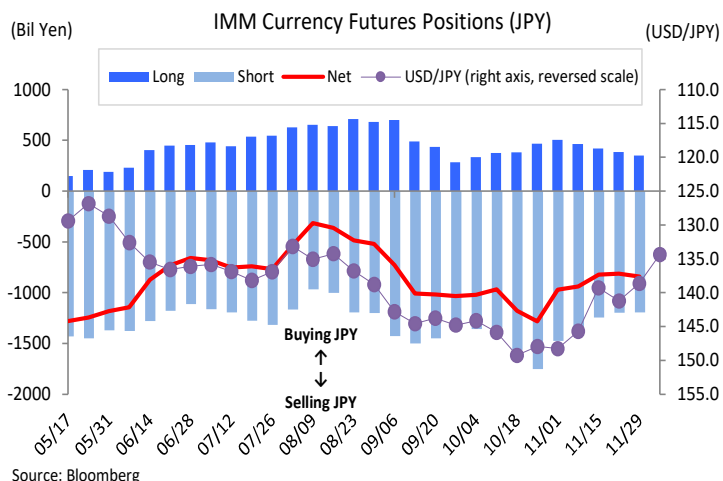
Source: CFTC, Bloomberg

position in summer this year was roughly JPY 700 billion, i.e., close to twice the current level. Even after netting the short and long positions, there was a net short position of only JPY 300 billion or so in mid-August compared with three times that, i.e., a net short position of JPY 900 billion, as of mid-November. Going just by the position level, speculators appear to have been more optimistic about JPY appreciation in summer than they are now.

Of course, currency positions in IMM currency futures trades do not necessarily provide a true overall picture of the forex market. However, in contrast to EUR, for which the long position has remained more or less unchanged while the short position has shrunk dramatically, there is still too little data to assume any significant change in speculators' perception of JPY. Moreover, there is no change in the fact that investors are preferring to sell JPY even though the synthetic position of eight key currencies against USD has turned long, so interpreting the latter to mean a reversal of the JPY weakness trend is somewhat premature.

As seen above, taking into account the increase in reasons to buy EUR, as the Fed strengthens its dovish stance, there definitely seems a high likelihood of USD depreciation going forward.

However, the start of USD depreciation is not the same as the end of JPY depreciation. My basic understanding is that the recent phase of JPY weakness/USD strength resulted in a dramatic rate movement range because it was the combined result of overall USD strength and overall JPY weakness. As the portion pertaining to overall USD strength fades, it would not be surprising to see USD/JPY undergo a correction and settle somewhere around 130. However, it seems natural to assume that the portion of JPY depreciation attributable to market perceptions around Japan's historically large trade deficit, its indefinitely continuing zero interest rate policy, etc., will linger. It seems unreasonable to claim based on IMM currency futures transactions that a phase of JPY appreciation toward the 110-115 level against USD has begun.



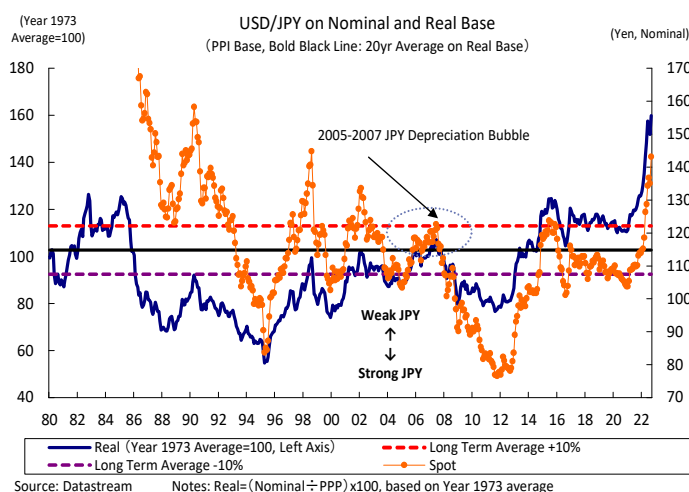
USD/JPY Now and Going Forward – The Challenges in Reviving Real-Effective JPY Appreciation

In Real Terms, JPY Interest Rates > U.S. Interest Rates

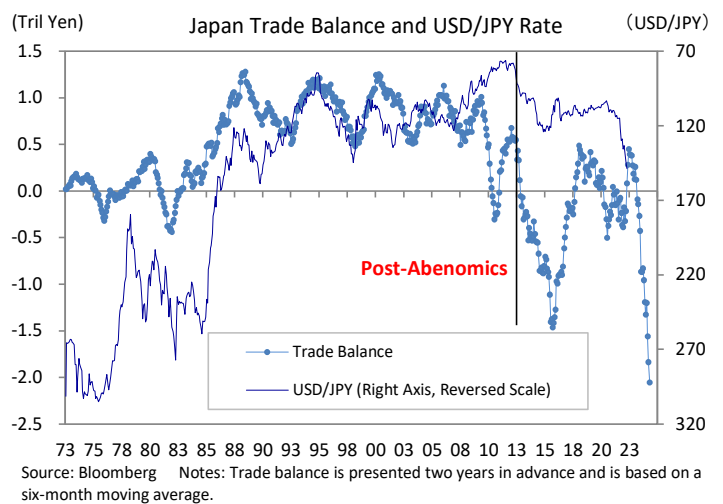
In November, USD/JPY seemed to stall at around the 140 level. The financial markets have begun to sell USD taking their cue from the weakening of the Fed's hawkish stance. However, news of a slowdown in the Fed's rate hike pace starting from the December FOMC meeting is itself nothing surprising. The key is to see how long, having fallen from +50bps to +25bps, the Fed will continue to increase interest rates at the pace of +25bps. Further, as I have continued to stress in this report, rather than swing between joy and sorrow at each new market development, what is important is to seriously think about why JPY depreciated to the extent it did in 2022. The more deeply one considers this question, the harder it becomes to explain it all away as a factor of interest rate differentials. For instance, in the stock markets, arguments focusing on the level of real interest rates are common. The argument that share prices increased because of a decline in real interest rates or that share prices decreased because of an increase in real interest rates have been heard a number of times in just the past year. Looking at these real interest rates, it is easy to see that they have remained higher in Japan than in the U.S. Despite this, 2022 became a year in which JPY selling was propelled by an increase in nominal U.S. interest rates. I do not intend to declare that the argument based on one or the other (real or nominal interest rates) is more appropriate in the absolute sense. Theoretically, arguments based on real interest rates are more appropriate, but so long as market participants focus on nominal interest rates, the latter become the main drivers. However, it does seem quite unreasonable that JPY depreciated by as much as 40 yen against USD solely on the strength of nominal interest rates while the theoretically important fact of higher real interest rates in Japan was completely overlooked.

Overshooting of Real USD/JPY

The figure shows the trend of real effective USD/JPY based on the producer price index (PPI) and using 1973 as the base year. Even historically, rarely has real effective USD/JPY remained more than +10% above its long-term average. For instance, during the 2005-2007 "weak-JPY bubble," the JPY depreciation trend reversed after hitting the ceiling at roughly +10%. Before that, during 2000-2005, USD/JPY fluctuated from the long-term average in the +10% to -10% range. From 2013 onward, under the qualitative and quantitative easing (QQE)-led reflationary policies of Abenomics, USD/JPY surged above the +10% divergence ceiling, and after that, until early 2021, the +10% level remained one of its stable resting points.

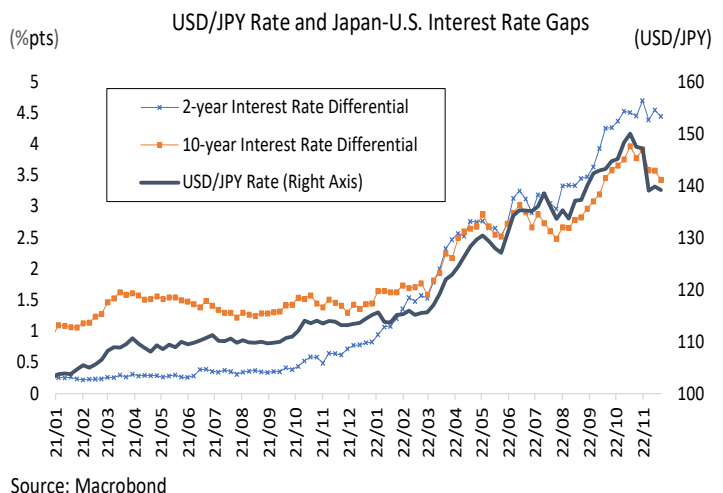


This resting point shifted to the +15% level around mid-2021, climbed to +20% or so toward the end of 2021, moved higher to +30% in the spring of 2022, and shot up to nearly +60% in September 2022. It seems unlikely that the Japanese economy underwent such a sudden structural change as to warrant this dramatic increase, so suspecting an overshoot in USD/JPY post September seems warranted. However, given that the +10% (above the long-term average) level, which had previously functioned as a ceiling, became a stable resting point for real effective USD/JPY from 2013 onward, and that this resting point became even higher from 2021 onward, it seems within reason as part of an ordinary analysis to assume that the Japanese economy has undergone some sort of structural change in the 10 years since 2013. I believe that this may simply be the result of the loss of Japan's trade surplus and the rapid expansion of its foreign direct investment. In fact, Japan has not been able to earn a trade surplus since 2012-13 (see figure). Going forward, for the real effective USD/JPY rate to be revised in the direction of JPY strength, it will take either (1) JPY appreciation in nominal terms, (2) higher inflation in Japan relative to the U.S., or (3) both. If path (2) is thought unrealistic, path (1) will have to be contemplated. Assuming that the overshooting of the real effective USD/JPY is to be corrected simply by nominal JPY appreciation against USD, a rate of 115 would still amount to a +25% divergence from the long-term average, with 110% amounting to +20%. It is only at the 100-yen rate that a +10% divergence can be achieved. However, few market participants at this time anticipate a 100-yen or even 110-yen rate. The more one calmly ponders the question from the perspective of real effective rates, the more obvious the difficulty of returning to the 100-110 range seen a year or two ago becomes.



Interest Rate Gap is Important but...the Only Change is That Its Pace of Expansion has Slowed

Taking the above into consideration, I believe that the key factor in the ongoing phase of JPY weakness, characterized by the largest fall in JPY's value since the Plaza Accord, is not interest rate differentials but rather the change in JPY's supply-demand structure. However, as the figure shows, there does exist a stable correlation between the U.S.-Japan interest rate gap and USD/JPY, so given the forex market's strong tendency toward auto-correlation, one feels the need to take fresh stock of the interest rate situation in predicting near-term developments. However, assuming that JPY interest rates will remain unchanged under yield curve control (YCC), it is present and prospective U.S. interest rates that must be considered.



In this context, it is important to take stock of developments in the foreseeable future based on the November 1-2 FOMC meeting and its minutes. The markets interpreted the November FOMC meeting results as less dovish than expected (details later), but that was simply because the markets had expected too much, while the Fed's communication itself showed almost no change. There is no reason to believe that a +75bp rate hike (which is three times larger than a normal rate hike) would have been normalized, and the projection of a nearly 5% terminal FF rate by mid-2023 remains unchanged. As of the time of writing this report, the key points with regard to the Fed's basic policy stance do not indicate (1) an imminent slowing of the rate-hike pace, or (2) a reversal of the monetary tightening posture (i.e., the end of rate hikes) even if the pace slows. In October, the financial markets interpreted (1) as signaling the end of rate hikes, causing U.S. interest rates and USD to fall, while share prices climbed in reaction. However, with the inflation rate remaining over 7%, one cannot afford to overlook point (2).

From the perspective of USD/JPY, the expansion of the interest rate gap has so far been considered a reason for USD buying and JPY selling, but as per the Fed's basic stance ((1) and (2)), the only change so far is that the interest rate gap, while still expanding, will expand more slowly, which is not a real change. Incidentally, the minutes of the FOMC meeting held on September 20-21 indicated that "once the policy rate had reached a sufficiently restrictive level, it likely would be appropriate to maintain that level for some time until there was compelling evidence that inflation was on course to return to the 2 percent objective." Further, the minutes of the November 1-2 FOMC meeting noted that "the level to which the Committee ultimately raised the target range for the federal funds rate [...] had become more important [...] than the pace of further increases in the target range." A slower pace of rate hikes is the predetermined policy path and does not constitute important information. At any rate, it seems highly likely that the FF rate, having attained a level close to 5%, will be kept at that level at least through 2023. As discussed in past issues of this report, it is important to be prepared for such a market environment, combined with the decline in volatility accompanying a more dovish stance by the Fed, to encourage JPY carry trade.

JPY Appreciation Risk Depends on the BOJ, But...

If there were a risk to the aforementioned scenario, it would involve the collapse of the assumption that JPY interest rates are unlikely to change. The next BOJ governor will soon be revealed. Given the predictions of someone further removed from monetary easing than the present governor being chosen, it will be interesting to see what policy revisions take place. Of course, from the perspective of absolute interest rate levels and the resultant U.S.-Japan interest rate gap, it would still be reasonable to sell JPY and buy USD, but any monetary tightening on the part of the BOJ would have novelty factor for forex market participants and could generate a large short-term response. If the new BOJ administration were to begin monetary tightening from next spring, coinciding with the Fed ending its own rate hike phase, there could be a short-term JPY buyback as the interest rate gap shrinks. Suppose the BOJ's monetary tightening results in something more dramatic, such as exiting negative interest rates, the impact would be significant and would especially encourage speculators looking to reverse trade contracts. Of course, even if there does exist a JPY appreciation risk, my basic understanding is that it is extremely small.

While I repeat myself, given the drastic change in JPY's supply-demand structure, there are limits to how much JPY can continue to appreciate simply based on the interest rate differential. Even if JPY appreciates to some extent amid a rollback in the recent JPY short position, the level of appreciation is likely to be smaller than expected. A rate of 130 for USD/JPY would amount to recovering roughly half the ground lost this year, and I predict that to be the lower bound for USD/JPY during the current forecasting period.

The Japanese Economy Now and Going Forward – Implications of Highest Increase in Prices in 40 Years

Largest CPI Increase in 40 Years – Impact Greater Than Consumption Tax Hike

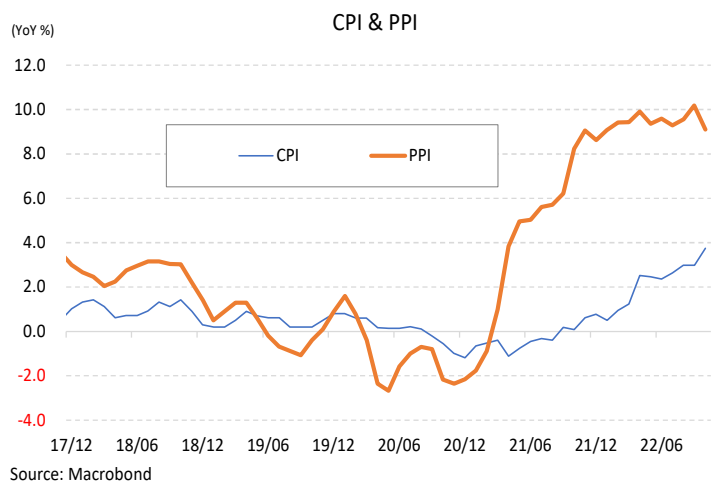
While the JPY depreciation trend seems to be stalled, the impact of the dramatic JPY depreciation since early this year on the Japanese economy may only just have begun. The most typical impact, i.e., price rises, have only recently begun to be manifested in domestic prices. On November 18, Japan's October consumer price index (CPI) was released and CPI was reported to have increased sharply, by +3.7% yoy, with Core CPI excluding fresh foods rising by +3.6% yoy – each higher by +0.7pp compared with September. This is the largest growth in Core CPI since February 1982, i.e., in 40 years and 8 months. Incidentally, a recent peak was +3.4% yoy for May 2014 following the 3% increase in consumption tax rate in April 2014. In other words, the increase in prices as a result of higher resource prices and JPY depreciation has eroded the household sector's purchasing power more than the consumption tax hike did.

Traditionally, the increase in costs has been absorbed by the corporate sector in Japan, while the household sector did not tend to feel the ripple effects of price rises. This time round, though, there are definitely signs of a spillover from the corporate to household sector beginning to take place (see figure on previous page). Over the past nine years, the BOJ under Governor Haruhiko Kuroda has been trying to encourage sustainable inflation through "suitable expectation management." Suitable expectation management means creating an environment where the household sector will come to expect price increases as part of the natural course of things. Earlier this year, in June, Kuroda stated, "households' tolerance for higher prices has increased." This was misreported in some media channels as "households are becoming more accepting of price hikes" and resulted in great uproar. However, going by the trend of price rises in the past few months, "suitable expectation management" certainly seems to have progressed to some degree. With the price-rise trend becoming more obvious, companies that had been hesitating to increase prices for fear of a slump in sales could feel emboldened to increase their prices as well.

Food Prices Continue to Rise

Even without going into all the media reports, there is a strong sense that this has been an autumn of price rises, with prices continuing to increase from September to October to November, and the trend has been especially conspicuous with regard to food products. Looking at specific figures, food prices excluding fresh food prices have increased by +5.9% yoy, contributing 1.38pp, or 40%, to overall CPI growth. A closer look reveals the top contributing categories to be eating out (+5.1% yoy, contributing +0.24pp), prepared foods (+6.5% yoy, contributing +0.23pp), and cereals and grains (+8.2% yoy, contributing +0.17pp). In October, there were widespread media reports of a major conveyor-belt sushi chain finally ending its 100-yen per plate price, and other categories of restaurants are also likely to have increased their prices significantly. Apart from this, the increase in prices of snack foods, bread, etc., have also been making the news, indicating that the recent CPI growth is a tangible development.

Further, while not something that began in October, utility prices also continued their increase, growing dramatically by +14.6% yoy (contributing +1.06pp). When essentials such as food and utilities become more expensive, relatively low-income households are the first to suffer. The comprehensive economic package aimed at countering soaring

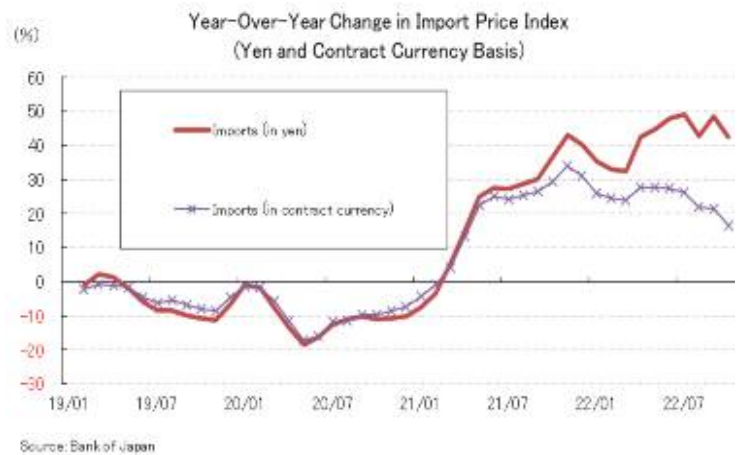


Source: Macrobond

prices, which will go into effect in January next year, is expected to include measures to soften the increase in electricity and gas prices. This is expected to alleviate the damage to some extent, but (as explained later) that can only happen so long as the impact of JPY depreciation continues no further.

Will Resentment of Inflation Due to Weak JPY Continue to Strengthen?

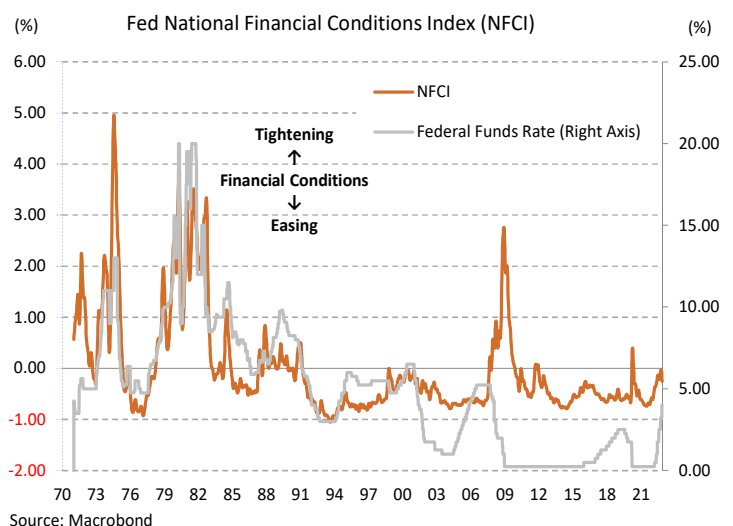
In April this year, the JPY-based and contracting-currency-based import price indices began to diverge, and by July, while the growth rate in terms of contracting currency had slowed markedly, that in terms of JPY had remained persistently high (see figure). Needless to say, this is the result of JPY depreciation. Some say that the main driving force behind the recent increase in prices is high resource prices, with the impact of JPY depreciation being limited, but that is a misleading statement. In the October import price index, while import price growth in terms of contracting currency was +16.6% yoy, JPY-based import price growth was +42.6% yoy, indicating that JPY depreciation had contributed to an additional 30pp increase in import prices. This also reflects the excess funds draining out of Japan and directly resulting in the real income environment (statistically, the real GDI) deteriorating. Many have debated the merits and demerits of JPY deterioration since early spring, but the truth is that an economy with a deteriorating real income situation cannot achieve strong growth. While it is true that USD/JPY has undergone some correction from its highest point, it still remains at around 20% higher than it was at this time last year. When it comes to the import price index, one has to also take into account leads and lags relating to exchange contracts, so inflationary pressures via the JPY-based import price index are likely to linger for some time to come and push up the CPI from November onward. While there have been these two factors – high resource prices and weak JPY – behind the recent increase in prices, as the impact of the former begins to fade, the impact of the latter will come into closer focus. I believe there is a need to discuss the merits and demerits of JPY weakness from two separate viewpoints – (1) from a macro perspective in terms of its impact on the GDP (≡ large, export-oriented, manufacturing industry enterprises) and (2) from a micro perspective in terms of its impact on households. In practical terms, however, the latter surpass the former in terms of the sheer number of economic entities, so the resentment of higher prices resulting from JPY depreciation is likely to be the bigger topic of social concern for some time to come.



U.S. Monetary Policy Now and Going Forward – Switch to +25bp is Key

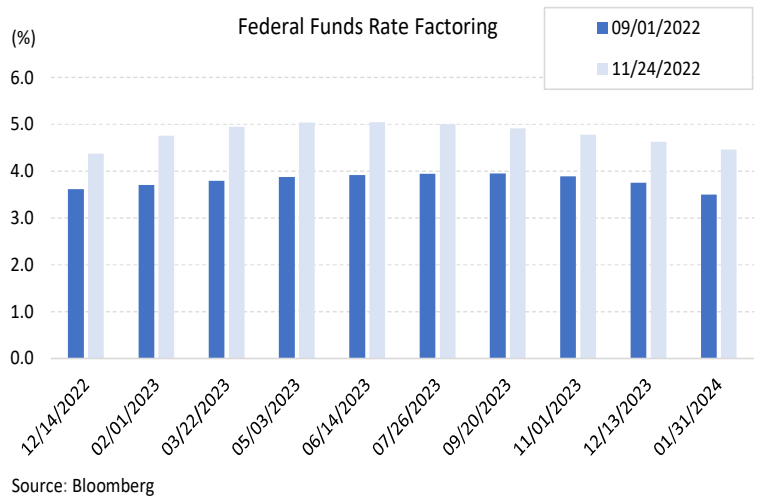
Will There Really Be a +25bp Rate Hike in February?

The minutes of the November 1-2 FOMC meeting confirmed unanimous agreement on the future rate hike path continuing to be determined by the data, but “a number of participants observed that, as monetary policy approached a stance that was sufficiently restrictive to achieve the Committee’s goals, it would become appropriate to slow the pace of increase in the target range for the federal funds rate.” Additionally, “a substantial majority of participants judged that a slowing in the pace of increase would likely soon be appropriate.” Further, it was mentioned that considerations including “the cumulative tightening of monetary policy to date” were likely to influence the “pace of future increases in the target range for the federal funds rate.” Judging by all this, it seems almost certain that the rate hike margin will be shrunk from +75bps to +50bps at the December FOMC meeting.



This is the also originally expected path. In terms of rate hike margin, the timing of its reduction from +50bps to +25bps is of interest, and when that happens, the terminal FF rate level will finally come into view. As of the current time, the rate-hike margin for 2023 is projected to be a total of +50bps, with many assuming +25bps each in February and March. However, is +25bps in February a realistic prediction given that the CPI remains over +7% yoy despite slowing down? The market forecast of +50bps in February and +25bps in March portrays the quickest path, but I believe it is quite likely there will be a +50bp rate hike in both February and March, and a continuation of rate hikes at the pace of +25bps from May onward.

Further, as Fed Chair Jerome Powell mentioned in his press conference in November, a tightening program addresses three questions – (1) “how fast to go,” (2) “how high to raise (the) policy rate, (3) “how long to remain at a restrictive level.” Going by the current state of affairs, it seems likely the Fed is aiming for (1) a cruising speed (+25pb rate hikes), and will enter a phase of contemplating question (2) going forward. Further down the line, question (3) will have to be addressed as well. Leave alone (3), there seems to be no firm consensus even regarding (2) at the current time. In theory, the impact of a rate hike only becomes clear 6 months to a year after the event, so given that the first +75bp rate hike was implemented this June, its impact is bound to become obvious shortly. Meanwhile, as I have discussed previously, the National Financial Conditions Index (NFCI), published by the Federal Reserve Bank of Chicago, shows financial conditions to be historically “accommodative.” This is in contrast to the early 1980s, under the chairmanship of former Fed Chair Paul Volcker, when this index clearly indicated tighter financial conditions – a fact Powell never fails to point out. Given Powell’s inclination to emulate the policy operation of that period, he could be aiming for a higher level for (2) and a longer duration for (3).



The Key Driver of USD/JPY is not the U.S.-Japan Interest Rate Gap...

At any rate, the FF rate, which is the world’s cost of capital, seems poised to continue gradually increasing for some time to come. As discussed above, the media tends to focus just on the slowing pace of rate hikes, but the next point of focus for the Fed is (2) how high to raise the policy rate. According to the November meeting minutes, “various participants noted that, with inflation showing little sign thus far of abating, and with supply and demand imbalances in the economy persisting, their assessment of the ultimate level of the federal funds rate that would be necessary to achieve the Committee’s goals was somewhat higher than they had previously expected.” If we focus solely on the rate levels over the past two months, there has been a mutually-inspired decline in both U.S. interest rates and USD, triggered by a slowdown in various inflation-related indicators. However, compared with early September, the FF rate level in the foreseeable future as factored in by financial markets has jumped by +100bp (see figure). While it is true that the Fed has become more dovish in November compared with September, the fact is that the projected terminal FF rate has gone up a notch.

In this context, if the U.S.-Japan interest rate gap had been the real driver of JPY selling and USD buying, it seems unlikely the above market outlook for the FF rate would go unnoticed. However, USD/JPY has plummeted after hitting a year-to-date high in the past two months. Analysts who claim that the U.S.-Japan interest rate gap is the main driver of JPY selling refuse to acknowledge this fact. Ultimately, the main factor influencing trades is not the level of the interest rate gap, but rather its direction – or in other words, “the Fed’s mood.” The simple fact of the matter is that USD is sold when the Fed’s mood is gauged as “dovish” and bought when the Fed’s mood is gauged as “hawkish.” The U.S.-Japan interest rate gap simply happens to be the indicator that most directly reflects the Fed’s mood. However, it is not all that meaningful to study USD/JPY levels based on the interest rate gap. The gap between the U.S. and Japanese policy interest rates is still quite high and expected to become higher in the coming months.

The Concerning Problem of Carry Trade and its Possibility

If the Fed’s policy operation proceeds in accordance with what the markets have factored in, the FF rate will hit 5% or so by March next year. Subsequently, it will remain more or less level during the next phase. The end of rate hikes is highly likely to directly result in higher share prices and lower volatility in the financial markets. If senior Fed officials were to declare an end to the current phase of rate hikes through statements or lectures, U.S. interest rate decline and USD selling would most likely gain momentum – a situation one can expect to see sometime from the end of this year through 1Q of next year. However, once the end of rate hikes loses its freshness as a factor influencing trades, trading based on interest rate differentials could regain momentum; and a sufficient interest rate differential and low volatility are the two key conditions for carry trade to flourish.

Is it not a major leap to interpret a temporary slowing of the Fed’s interest rate growth to imply a major turning point for the forex markets and, especially, for JPY – the currency of the only country with negative interest rates and a large importer to boot? At the very least, I do not believe USD/JPY will return to its 2022 starting point of 112-113 in 2023 simply based on a decline in U.S. interest rates. My prediction is that the 130 level will function as a lower bound for USD/JPY in 2023.

Risks to My Main Scenario – Renewed Emphasis on FAIT as an Upside Risk

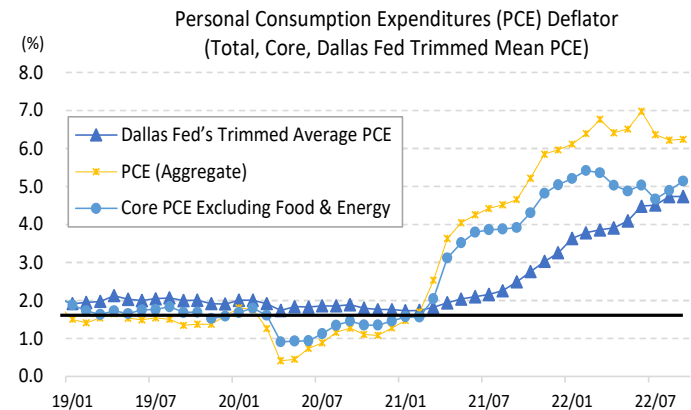
Fed to Countervail Stock Price Uptrend?

As discussed above, the Fed’s shift toward dovishness was a major trading theme in November’s financial markets. As senior Fed officials have intermittently pointed out, however, a rate hike pace slowdown is not synonymous with a rate hike halt, and the emphasis going forward will be on rate hike sustainability. This point is attested to by a portion

of the minutes of the FOMC meeting held on November 1 and 2 – “participants emphasized that the level to which the Committee ultimately raised the target range for the federal funds rate, and the evolution of the policy stance thereafter, had become more important considerations for achieving the Committee’s goals than the pace of further increases in the target range.” In addition to the decline of U.S. interest rates and the weakening of USD, the stock market’s rash optimism is not good news for the Fed. As already mentioned, although the Chicago Fed’s National Financial Conditions Index (NFCI) suggests that rate hikes are promoting monetary tightening, the fact that the NFCI remains in negative territory suggests that monetary policies remain accommodative overall. As a rise in stock prices helps depress the NFCI, it is considered a trend that the Fed should forestall. In the case of the United States, stocks comprise more than 30% of household financial assets, so a rise in stock prices can be expected to boost consumption and investment proclivities through the wealth effect. The argument that “rising stock prices push up inflation expectations” is particularly persuasive with respect to the United States, and as the FRB seeks to curb inflation it cannot afford to ignore that. Going forward, there will continue to be grounds for concern that stock price uptrends in response to the fading of interest rate hike expectations may themselves cause the Fed to shift toward greater hawkishness.

Increased Emphasis on Average Inflation Target?

Moreover, although the U.S. economy is slowing down, CPI levels above +7% yoy and PPI levels above +8% yoy do not suggest the economy has reached a stage at which the direction of monetary policy should be changed. The personal consumption expenditure (PCE) deflator is particularly relevant to monetary policy management decisions, and it has also remained high at levels above +6% yoy. Furthermore, the Dallas Fed’s trimmed average PCE deflator, which indicates the underlying trend, has remained around +4.7% yoy, more than double the +2% yoy target (see graph). While the U.S. inflation situation in the United States is generally acknowledged to have peaked out, the key issue of how and when inflation might descend to the 2% level remains quite opaque. It seems appropriate to quote here a portion of Fed Chairman Jerome Powell’s speech at the Jackson Hole Economic Symposium this past August 22:



Source: Macrobond Notes: The trimmed mean is obtained by excluding the top 31% and the bottom 24% of the dataset.

appropriate to quote here a portion of Fed Chairman Jerome Powell’s speech at the Jackson Hole Economic Symposium this past August 22:

- The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels that were the norm until the spring of last year. Our aim is to avoid that outcome by acting with resolve now.

Chairman Powell emphasized that multiple failed attempts to lower inflation were made over a period of 15 years and that the Powell-led Fed’s goal is to avoid such failed attempts. In light of the fact that senior Fed officials are intermittently making similar statements, although the Fed may reduce interest rate hike margins in light of current inflation trends, it appears quite unlikely that the Fed will discontinue its monetary tightening policy soon.

First of all, while many financial market participants may have forgotten this, the Fed announced a switch to flexible average inflation targeting (FAIT) in August 2020. (FAIT seeks to achieve the 2% inflation target on average over time, so if inflation has been persistently below the target, the FOMC may aim to achieve inflation moderately above the target for a limited time.) Accordingly, there is a possibility that the Fed will continue its monetary tightening process while focusing on “price levels” rather than on the “rate of change in prices.” FAIT was made much of when it was first introduced but after the U.S. economy was hit by an unexpected rise in inflation rates it has fallen into oblivion. The price trends that financial markets pay attention to are always the yoy rates of change in prices, but the prices of goods and services in the United States (as well as in Japan) have already risen significantly above their pre-pandemic levels. Thus, a policy management approach focusing on restraining the “level” of prices over time periods rather than on restraining the “rate of change in prices” at various individual points in time can be expected to be beneficial. Given how much prices have already been rising, it seems difficult to argue that the real economy will be fine if the rate of change in prices eventually settles down to a +2% yoy rate, as the price rises so far have already considerably damaged the real income environment.

In light of this, it seems possible that, based on the FAIT concept, the Fed may continue to tighten monetary policy until the average inflation rate converges to +2% over a certain time period. Regarding the FOMC’s prospective interest rate hikes, while it is assumed that hikes by +50bp in December and by +25bp each in February and March is the default course, if the FOMC is seeking to make the average yoy inflation rate converge to +2% in April and subsequently, there would appear to be a possibility that it may wish to implement additional 25bp interest rate hikes. It is best to keep in mind the possibility that the peak interest rate level will be higher than the 4.75% level that is widely anticipated – it may be 5.50% or approach 6.00%. This article’s basic assumption is that the rate will be hiked to 5.00%, and my forecast values are based on that premise, but if the rate comes to exceed that level, the trajectory of USD/JPY will naturally shift upward. It seems worth noting the possibility of renewed emphasis on the FAIT concept as an upside risk factor.

EUR Outlook – Potential Supply-Demand Situation Improvement in Forecast Period's Latter Half

EUR Area Monetary Policies Now and Going Forward – ECB Fights Specter of Persistent Wage Inflation

Euro Area Economy Approaching Downside Scenario

EUR exchange rates continued to be firm in November. Since there was no ECB Governing Council meeting in November, I would like to overview the current situation based on the Account of the October 26-27 Governing Council meeting, which was released on November 24. In his review of the economic and financial situation, ECB Executive Board member and chief economist Philip Lane said the current assessment pointed to negative euro area GDP growth in the last two quarters of 2022, suggesting the possibility of a technical recession. However, he emphasized that this outlook – “was very different from a scenario in which the euro area entered a prolonged period of negative growth. It was also very different from the downside scenario described in the September 2022 ECB staff macroeconomic projections” – and he said the moderation of the resource price surges was preventing the situation from worsening. An extreme scenario in which energy supplies from Russia are completely discontinued has not yet taken shape, and although it is not possible to confidently predict the future course of the situation, it is still possible to insist that the situation is not yet as bad as portrayed in the staff projections' downside scenario. So far as can be discerned from the Account, the revised staff projections presented at the December Governing Council meeting are likely to include a downside scenario not greatly differing from the downside scenario presented in September. The Account notes that – “The concern was expressed that, with the changes in the economic outlook, the economy was now closer to the downside scenario than to the baseline scenario depicted in the September ECB staff projections.” – and this reflects the fact that some Governing Council members are accepting the harsh reality of the euro area's economic deterioration.

Stubborn Wage Inflation

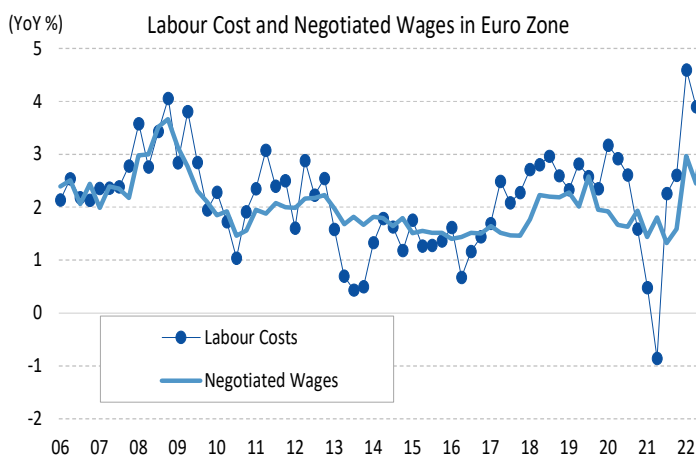
Regarding the key inflation situation, the Account noted that – “the rise in both headline and core inflation had come with an increase in demand-driven factors,” suggesting a concerning possibility that the main source of inflationary pressures may shifting from supply factors to demand factors. Another section of the Account reads – “There was a risk that future wage growth was being underestimated, as also suggested by more timely information on wages from job postings on private digital platforms, which were increasing faster than data on negotiated wages” – and it is noteworthy that data from sources including private-sector websites were employed to confirm fears about wage inflation. While specific data sources are not specified, the Account probably refers to monthly data compiled by Ireland's central bank and a private job search company (Indeed Hiring Lab). This point is discussed in detail below. In any case, as the pace of increase in resource prices is beginning to decelerate, it is worth paying attention to such wage-related data.

With respect to the recent decline in natural gas prices – one of the few recent news items that are beneficial for the euro area – the Governing Council members' arguments were divided between those emphasizing that the price trend remains unpredictable and those asserting that the previous projections were too pessimistic, but it is noteworthy that Governing Council members repeatedly expressed concerns about the possibility of another uptrend in natural gas prices. Regarding supply factors, Governing Council members shared an awareness of the problem that although resource prices have peaked, there is a lag in the spread of the positive impact, so it was recognized that the inflationary pressures stemming from resource prices along with previous EUR depreciation will persist. As a result of this comprehensive evaluation, Governing Council members concluded that – “risks to the inflation outlook were primarily on the upside.” Considering future trends in resource prices and nominal wages to be opaque and noting – “an increasing risk that inflation might become entrenched and that second-round effects and a wage-price spiral could emerge” – Governing Council members are likely to maintain a cautious stance with respect to inflation-related upside risks. According to the ECB survey, the pace of nominal wage growth reached 2.9% qoq in the July-September quarter, accelerating from 2.5% qoq in the previous quarter, so it is understandable that the Governing Council feels it is not in a position to relax its monetary tightening stance.

ECB Staff Outlook (Sep 2022)

	Outlook Sep 2022			Adverse Scenario		
	2022	2023	2024	2022	2023	2024
Real GDP	3.1	0.9	1.9	2.8	-0.9	1.9
HICP	8.1	5.5	2.3	8.4	6.9	2.7

Source: ECB, Sep 2022



Source: Macrobond

Notes: It differs from the actual labour cost growth due to unsettled wages.

Future rate hikes...

In light of the Governing Council's understanding of the current situation overviewed above, it appears that the ECB's future interest rate hike trajectory will not be easily revised. For example, as of late October, a "vast majority" of Governing Council members were in favor of a +75bp rate hike. It seems that "a few" members felt it possible to reduce the rate hike margin to +50bp by tightening the terms and conditions of the third series of targeted longer-term refinancing operations (TLTRO3), but they were a minority. The doves being in the minority is a rare situation at the ECB, and this situation probably indicates that the ECB's concerns over rising inflation rates have risen to unprecedentedly high levels. The ECB will naturally determine the course of future interest rate hikes in light of changing conditions, but as the Fed has already announced a "step down" to 50bp rate hikes, there appears to be a widening gap between the interest rate hike trajectories of the Fed and the ECB, and it seems safe to assume that this is a main reason why EUR/USD has risen since the beginning of November.

Balance sheet reduction measures are attracting attention as the ECB's "next move". In particular, the Account notes that it was seen as necessary to discuss the reinvestment strategy for the Asset Purchase Programme (APP) together with an assessment of the impact of early repayments made due to the stricter terms and conditions of TLTRO3. While the reinvestment of assets purchased under the Pandemic Emergency Purchase Programme (PEPP) is being used to support Italy and other financially fragile countries, the contrast between that situation and the suspension of APP asset reinvestment along with ongoing interest rate hikes was seen as potentially complicating the ECB's communication with financial markets. The ECB is entering a period in which its Lagarde-style information dissemination capabilities will be facing major challenges.

Euro Area Real Wage Deterioration

With respect to the euro area's worrisome wage situation, the UK-based Financial Times newspaper on November 9 published an interesting article entitled "Eurozone wage growth accelerating, job ads show". The above-mentioned negotiated wage statistics are the standard index for monitoring wage trends in the euro area, but the index's benefits are reduced by the fact that it is published at infrequent intervals and is not very up-to-date. In light of this, real-time online job information from private companies (mentioned in the above-mentioned Governing Council meeting Account) is attracting attention as a means of following monthly wage trends in a more-timely manner. Although the data's scope is limited to six euro area countries, such real-time data is a useful tool for closely monitoring inflation trends and thereby gaining a better understanding of the euro area's economic and financial situation as well as of the ECB's policy management.

Excerpted from that article, the graphs on the previous page

show nominal wage and consumer price index (CPI) trends in six euro area countries and the United Kingdom. The graphs clearly show that Germany and France are the only euro area countries where nominal wage growth has paralleled CPI growth. In Germany, while yoy CPI growth has reached a 10% rate, nominal wages were up by only 7.1% yoy in October. Nominal wages were losing the race against inflation rates, causing Germany's real income environment to deteriorate.

Ireland, Italy, and the Netherlands have been recording CPI growth at rates close to 10% yoy (roughly the same level as Germany) but are lagging behind Germany regarding their nominal wage growth rates (in the 4.0-5.0% range). It can be assumed that inflation is similarly outpacing wages in many other euro area countries, causing the euro area economy to show symptoms of incipient stagflation. For the euro area as a whole in October, nominal wages were up 5.2% yoy (rising about three times faster than before the pandemic) but the CPI was up 10.7% yoy (the 16th consecutive month in which the CPI rise has gained momentum).

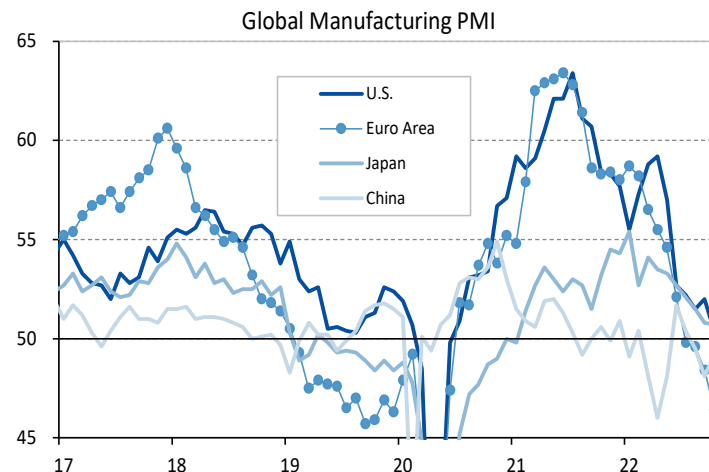
ECB Faces a Very Challenging Mission

As nominal wage growth is not currently keeping up with inflation in euro area countries other than Germany and France, the risk of the kind of wage-price spiral greatly feared by the ECB (and other central banks) appears small. Instead, there is a high level of expectation that as the real income environment deteriorates the economy will decelerate, and that inflation will be suppressed by means of a balanced economic contraction toward a lower equilibrium point. ECB President Christine Lagarde has repeatedly denied the onset of a wage-price spiral, and the Account of the latest Governing Council meeting notes that – "it was underlined that [...] there were no indications of



a wage-price spiral at present.” Of course, if conditions become such that both businesses and workers anticipate persistent double-digit inflation, then there is a risk that (even in such euro area countries as Ireland and Italy, where nominal wage growth is currently restrained) social norms dictating that nominal wages must immediately be adjusted to compensate for inflation may take root. Because such social norms could greatly prolong inflation and persistently impede the ECB’s policy goals, it appears that the ECB currently has no choice but to continue to tightening its monetary policy stance while optimistically asserting that wage-price spirals have not yet emerged.

As the euro area as a whole tends to eventually reflect the influence of trends in Germany and France, it remains difficult for the ECB to dismiss concerns that there is a rising risk of a wage-price spiral. Consequently, there arises the possibility that the ECB will implement monetary policies that are tailored to larger euro area countries but have overkill effects in the area’s smaller countries. The euro area’s manufacturing PMI has descended by a greater margin and to a lower level than that of other economies, reflecting the relative unfavorability of conditions in the euro area economy at a time when yoy growth in the euro area Consumer Price Index (HICP) is threatening to surpass the 10% level, and this situation suggests there is a high likelihood that the ECB may implement policies unsuitable for many small euro area countries. Fundamentally, the ECB determines its monetary policies based on average



Source: Bloomberg, Markit

Notes: The dip in the curve due to covid was intentionally cut.

figures for the entire euro area and is unable to tailor those policies to the needs of specific countries. As the ECB Governing Council moves ahead with monetary tightening measures despite associated overkill risks, one wonders whether its members will be able to continue working concertedly based on consensus decisions. Fighting high inflation rates during a recession is one of the most difficult tasks for a central bank to address, but in 2023 the ECB will face the extremely difficult mission of countering inflation during a recession in 19 disparate countries while perhaps also dealing with internal disagreements. While the ECB seeks to suppress persistent inflationary trends with large-margin interest rate hikes, it will continue to be somewhat accommodative in some areas (such as the introduction of a flexible reinvestment policy to control Italian government bond yields). It appears highly likely that the ECB will be forced to sustain a complex mixture of forceful inflation-restraining polities while retaining certain kinds of accommodative policies going forward. Both the Fed and the ECB currently share a common awareness of the difficulty of fighting inflation during a recession, but from the spring of 2023 the difficulty of the ECB’s task appears likely to be considerably magnified by unique challenges presented by a single currency area comprising countries with disparate economic conditions.

EUR Now and Going Forward – Interest-Rate-Differential and Supply-Demand Tailwinds

Inadvisability of Buying EUR Based on Interest Rate Factors

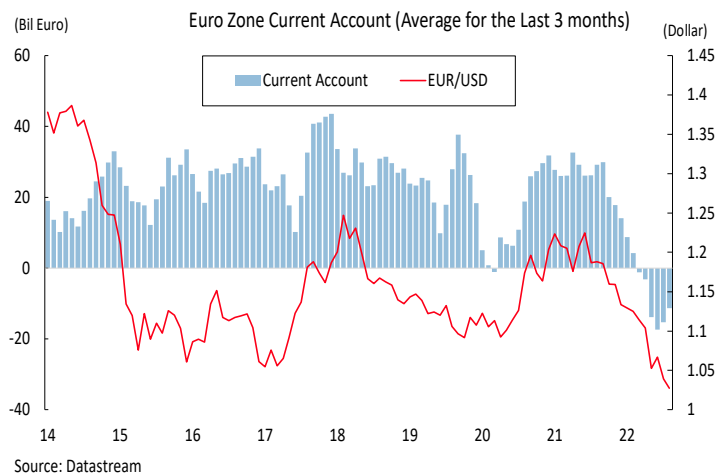
EUR exchange rates have remained firm since the beginning of November in line with the relationship of those rates to trends in Europe-U.S. interest rate differentials (see graph). While U.S. interest rates have declined following the announcement of the deceleration of the U.S. consumer price index (CPI) in October, there has been no such good news about inflation deceleration in the euro area. The Europe-U.S. disparity can be considered to be fundamentally a monetary policy disparity or simply an interest rate disparity. However, given that unalloyed worries about inflation in the euro area are developing into serious concerns about a prospective stagflation trend there, it is questionable whether high interest rates should be considered sufficient incentives for EUR buying. If one focuses exclusively on interest rate levels, however, one has to wonder how long USD’s strength against EUR will continue. The ECB’s policy management has changed even more than the Fed’s over the past year, and there is an undeniable possibility that, as the Fed reduces the margin of its interest rate hikes, the ECB may attain a comparable level of such hikes. Frankly, however, my basic understanding is that buying EUR based on interest rate factors is a short-sighted approach.



Source: Bloomberg

Supply-Demand Environment Tailwind Becomes a Headwind

While the interest rate situation may be considered a tailwind for EUR, the supply-demand situation is now a headwind. Although resource prices may have peaked out, they are still at high levels, and the deceleration of the global economy is expected to exert a growing negative impact on the euro area economy, which is highly dependent on external demand. Moreover, although forex market players may not generally focus on this issue, the progressive deterioration of the euro area's current account balance is consistent with a softening of EUR exchange rates. It is generally understood that the euro area's annual current account surplus averaged USD360 billion (approximately JPY50 trillion at 1USD = JPY140) over the five-year period from 2017 to 2021, corresponding to 2.5-3.0% of the euro area's GDP.

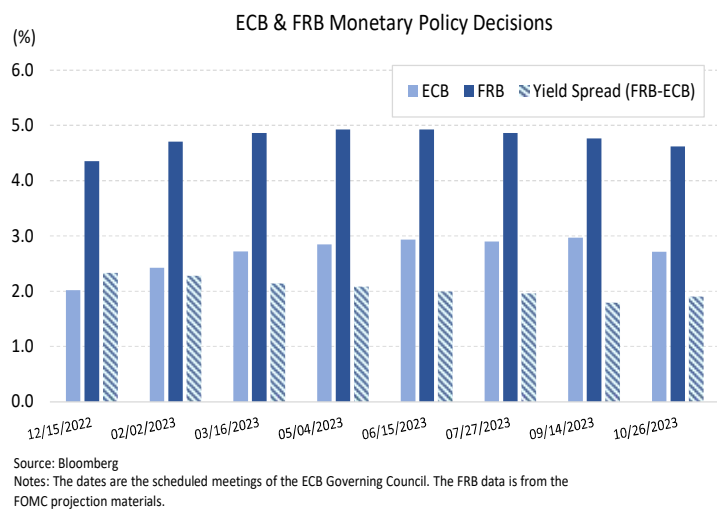


Leaving aside the surplus to GDP ratio, the euro area's current account surpluses were nominally the world's largest and unrivaled by other economies, and the EUR supply-demand environment those surpluses promoted is a legitimate reason for why EUR exchange rates did not plunge.

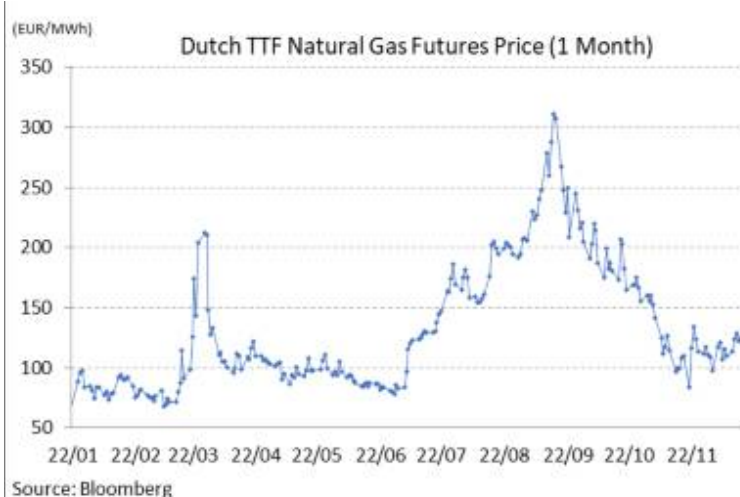
Prior to 2009, when the European debt crisis emerged, the euro area's current account balance was almost in balance, and intermittent deficits were not uncommon. There were times during that period when EUR exchange rates soared, but that was largely owing to expectations that EUR would become the world's second key currency. At the time, EUR accounted for just under 30% of the world's foreign exchange reserves, nearly 10 percentage points higher than its current share. It can be said that market expectations fostered an environment supportive of EUR, even though the supply-demand environment was not very supportive at that time. In the current situation where such market expectations no longer exist, however, it is thought that such persuasive factors as those associated with interest rate differentials and supply-demand situations are necessary to support EUR. In that sense, as the euro area's current account deficits become chronic (and huge), it can be said that EUR exchange rates are exposed to strong downward pressures.

Interest Rate Differential Not Significantly Narrowing, but Potential EUR Supply-Demand Improvement from Spring

Moving ahead with analyses of interest rate trends, it is worth noting that the financial markets are anticipating that by June 2023 the FRB and ECB will increase their policy interest rates to roughly 5% and 3%, respectively. As the graph on the right shows, it certainly appears that the gap between the ECB rate and the FRB rate may be expected to shrink, albeit very slowly, although I do not consider the margin of prospective shrinkage to be a very large one. In light of current inflation trends, there remains a possibility that the ECB will continue hiking interest rates after the Fed stops, so it is possible that the EUR-USD interest rate differential will narrow more than the markets are now anticipating. However, an opposite scenario is also quite possible. The peaking out of U.S. inflation is now a fresh topical factor that focusing greater attention on the euro area's high levels of inflation and interest rates, but it appears that the deceleration of the euro area's real economy is perceived as being clearly more serious than that in the United States' real economy. Again, the question remains whether it is sustainable to keep buying EUR simply because associated interest rates are high.



If one really anticipates the possibility of buying EUR going forward, it may a good idea to first review the EUR supply-demand situation. It has been pointed out that Europe is projected to have an unusually warm winter this year (people in some German regions are still wearing short-sleeves), and that the turmoil associated with European fuel prices may diminish. As the graph shows, European natural gas prices have returned to levels roughly comparable to their pre-summer levels and are not so far above their levels prior to the Ukraine conflict. If the current



situation can be sustained until next spring, natural gas prices (which have already begun softening owing to electric power conservation efforts) may stabilize at a lower level (see graph). In that event, it is reasonable to anticipate that improvement in Germany's trade balance may enable the euro area's current account surplus to be restored, which could spur a trend toward more-positive evaluations of EUR. This article is anticipating that EUR buying will resume after spring 2023 based on a reassessment of the EUR supply-demand situation rather than based on interest rate-related factors. On the political front, German Chancellor Olaf Scholz's sudden visit to China (and the sale of a controlling stake in a Hamburg port terminal to China) is causing ripples in Germany and has spurred considerable speculation about the possibility of prospective changes in Russia's energy policies with regard to Germany (and, by extension, the EU). While the damaged Nord Stream pipelines cannot be used immediately, over the next three to six months it will be worth watching for additional signs that the severity of Europe's energy crisis might possibly diminish.

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