MIZUHO

Forex Medium-Term Outlook

January 31, 2023

Overview of Outlook

The direction of USD/JPY movements was unclear at the start of 2023, reflecting continued expectations of dovish moves by the Fed, which intermittently overlapped with expectations of hawkish moves by the BOJ, causing periods of sharp JPY appreciation against USD. Despite this, however, it is unlikely that BOJ moves toward normalization will be realized as easily as the forex market is apparently hoping. While there are growing expectations that the Fed will begin reducing interest rates by the end of the year, the window of opportunity for the BOJ to steer in the opposite direction would be extremely narrow and, considered from a historical perspective, it appears unlikely that the BOJ would attempt it. If the April BOJ Monetary Policy Meeting held immediately after the new BOJ governor is appointed were to make a decision to undertake thorough policy normalization, that normalization process could be expected to be protracted over the next five years. It is anticipated that the global economy will decelerate in 2023, reflecting slowdowns in Europe and the United States, and it can be expected that global trend will impact Japan. Even if the slowdown in Japan is driven principally by such overseas factors, the BOJ may well become evaluated in a very bad light if its normalization coincides with negative economic trends in Japan. If that happens, the BOJ's policy environment under its new leadership will become even more difficult, so it can probably be expected that the BOJ will do its utmost to avoid such a scenario. Looking at the JPY supply-demand environment, it appears certain that speculators are anticipating an unwinding of JPY shorts, which is likely to push USD/JPY downward. On the other hand, Japan's trade deficit is still huge, so even if speculative JPY buying progresses, it appears inevitable that somewhere along the line JPY will become constrained by the fundamental realities of actual JPY supply-demand trends. In fact, net JPY short positions in IMM currency futures trading have shrunk to the level seen around the spring of 2021, but USD/JPY continues to hover around JPY130. When projecting the JPY exchange rates outlook, one must take full account of this "speculation promoting JPY appreciation, actual supply-demand situation promoting JPY depreciation" situation.

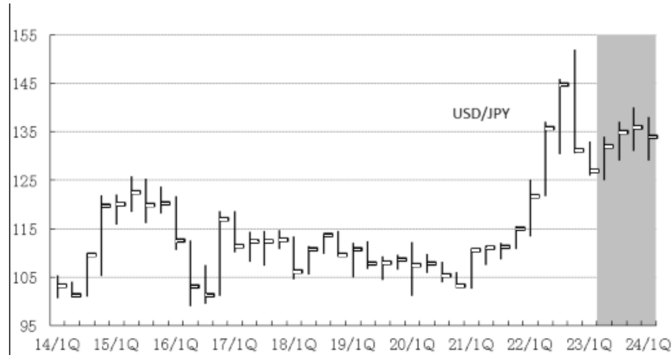
EUR exchange rates continued to be firm in January. Assisted by the tailwind of warm winter weather, the euro area's economic and financial environment has unexpectedly improved, and it is becoming possible that the ECB's interest rate hike phase will last longer than the Fed's. Looking at euro area inflation trends, the headline figures are being restrained by energy price trends, but non-energy items are actually showing accelerating inflation rates. In light of still smoldering concerns about wage inflation, it appears the ECB has little reason to make a sharp transition to increased dovishness. In this regard – considering the FF interest rate situation, where the interest rate futures market is beginning to anticipate a rate cut from mid-year – EUR-related interest rates seem quite attractive. A closer look at the ECB Governing Council's discussions reveals that the majority of members support a 75bp rate hike, a halt to ECB rate hikes in the near future appears very unlikely. Moreover, warm winter weather is not only affecting interest rate trends but is also exerting a broadening effect on supply and demand trends. In particular, falling energy prices are promoting an improvement in Germany's trade balance, which was on the brink of slipping into the red. If the downward trend in energy prices continues during the spring and subsequently, EUR (supported by the world's biggest trade surpluses) may regain its former strength. In terms of both interest rates and the supply-demand situation, it seems that we are seeing sudden decreases in the importance of factors promoting EUR selling.

Summary Table of Forecasts

	2023 Jan (Actual)	2023 Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2024 Jan-Mar
USD/JPY	127.22 ~ 134.78 (130.30)	126 ~ 133 (127)	125 ~ 134 (132)	129 ~ 137 (135)	131 ~ 140 (136)	129 ~ 138 (134)
EUR/USD	1.0482 ~ 1.0929 (1.0853)	1.07 ~ 1.12 (1.10)	1.08 ~ 1.13 (1.11)	1.09 ~ 1.15 (1.12)	1.09 ~ 1.15 (1.12)	1.08 ~ 1.14 (1.11)
EUR/JPY	137.45 ~ 142.84 (141.40)	136 ~ 143 (140)	139 ~ 148 (147)	142 ~ 152 (151)	143 ~ 153 (152)	141 ~ 149 (149)

Notes: 1. The actual results were released at around 10a.m. tokyo time on 31st Jan 2023. 2. Data source from Bloomberg.
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Overview – Speculation Promotes JPY Appreciation; Actual Supply-Demand Promotes Depreciation

Basic Understanding of USD/JPY – Summarizing the Important Assumptions and Paths for the 2023 Outlook

Important Assumptions for 2023

A variety of views are being expressed regarding the outlook for USD/JPY in 2023, but the key assumptions appear to be common. (1) That the Fed's rate hikes will end in spring, (2) that the BOJ is unlikely to exit negative interest rates (i.e., no consecutive rate hikes), and (3) that resource prices will be higher than they were before the pandemic (see chart). This report's basic path that JPY will appreciate during the January-March quarter and depreciate from the April-June quarter onward is also based on assumptions (1) through (3) above. Since early this year, expectations of Assumption (2) failing have driven JPY appreciation, but these have turned out to be hasty expectations by the financial markets.

Major Premises for 2023 Forex Market Outlook

①The Fed rate hikes will stop in the spring.

②BOJ will not end NIRP.

③Resource prices will be higher post-pandemic.

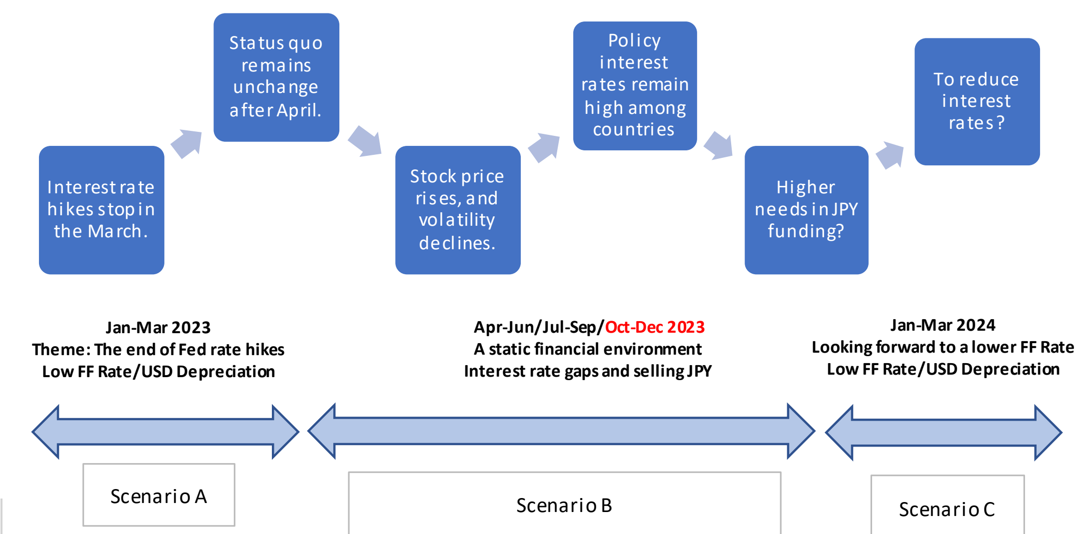
(Author's notes)

Apart from this, if Assumption (1) is wrong, i.e., the Fed continues to hike rates after spring, then perhaps it would be difficult to expect JPY buying opportunities (JPY strength/USD weakness) to continue through the January-March quarter. If, on the other hand, Assumption (2) fails, and the BOJ decides to raise interest rates to coincide with the start of a new regime, JPY appreciation against USD may continue even beyond the January-March quarter, i.e., into and beyond the April-June quarter. If Assumption (3) fails (typically represented by a sharp fall in crude oil prices, etc.), and Japan's import value falls, thanks mainly to mineral fuel prices, the JPY supply-demand situation could tilt markedly toward JPY buying (symbolized by Japan's trade balance turning into a surplus). In such a situation, even if the kind of carry trading presumed by this report takes place, JPY may not weaken as much as expected (i.e., beyond 140). The point to note here is that USD/JPY trends predictions for 2023 share these important assumptions regarding U.S. and Japanese interest rates as well as the JPY supply-demand balance as determined by Japan's external economic sector, and there are probably no major differences in terms of how the various experts are viewing them.

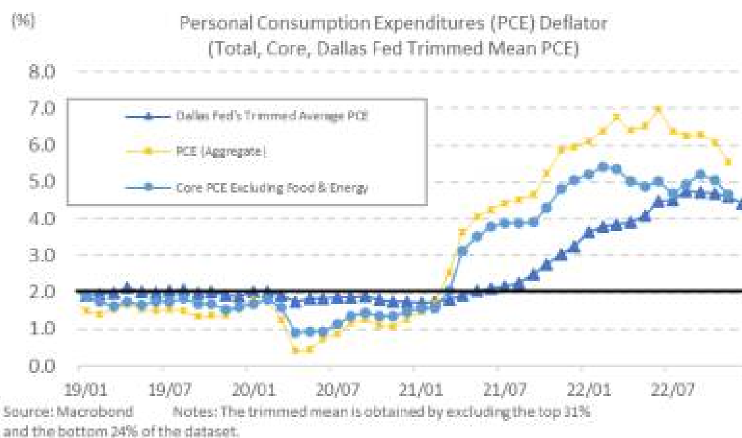
At any rate, one cannot underestimate the importance of the aforementioned three assumptions when it comes to formulating the USD/JPY outlook for 2023, and the main risks involve these assumptions being betrayed. (N.B. My usual Risks to My Main Scenario section is omitted in this month's report as its contents would overlap with this section.)

Summarizing the Paths for 2023

Having summarized the key assumptions, let me present an overview of the basic paths with the help of an illustrative diagram. In the sense that the Fed's rate hikes will be the main focus of attention, the January-March 2023 quarter is likely to have a similar climate as the October-December 2022 quarter. For the time being, the key concern is the timing of the rate hike margin being lowered from +50 bps to +25 bps, but eventually, the focus will shift to the timing of +25bp rate hikes ending. If the financial markets are to be believed, this could happen by March at the earliest, and by May at the latest. Let us call this Phase A.



(Author's notes)



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

Most market participants seem to agree on the interest and forex rate outlooks for Phase A, with few divergent views. But the same cannot be said for the following Phase B. Many in the financial markets currently seem to think that USD will continue to be sold off in Phase B in anticipation of lower U.S. interest rates going forward. However, it seems unlikely that the Fed will begin to discuss rate cuts as soon as it ends rate hikes. Even if the Fed decides to end rate hikes during the March-May period, the headline figures for the consumer price index (CPI) or personal consumption expenditure (PCE) deflator are unlikely to have fallen to the 2% level by then, so the situation would not be conducive to discussing rate cuts. My prediction is that the Fed will maintain a high policy interest rate from spring through fall this year and call for the subsiding of price pressures. This "lull" in the Fed's policy operation could promote lower volatility in the markets and encourage share prices to rise.
Looking back, there have historically been phases when changes in policy interest rates have not made the news. An example is the period of over a year from June 2006 through September 2007, when the federal funds (FF) rate was maintained at 5.25% (needless to say, the Fed reversed its stance and began a new phase of rate cuts amid rumors of the collapse of BNP Paribas and the subprime mortgage crisis). Going back a little further, the phase of rate hikes from June 2004 onward was also quite gentle, at the pace of +25bp per hike, and this period from the second half of the 2000s and until the collapse of Lehman Brothers in 2008 was characterized by low inflation and stable markets, which earned it the title of "(a period of) great moderation" and improved the risk tolerance of market participants. There also remained a considerable gap between domestic and foreign policy interest rates during this time, and the forex markets saw the holding of high-interest-rate currencies ("carry trading") as quite attractive. Specifically, with JPY being the only currency with zero interest rates, 2005-2007 became a golden era for yen carry trading. In those days, the Japanese economy was in a "weak-JPY bubble," and the era was symbolized by Japan's manufacture and export of the renowned "Kameyama model" flat-screen televisions. One wonders whether history could repeat itself this spring under similar conditions, with JPY being the only negative-interest-rate currency. Incidentally, Japan was an export powerhouse in 2005-2007, but it now posts enormous trade deficits. If carry traders use JPY as their funding currency, that could exert a stronger downward pressure on JPY from the supply-demand perspective this time round.

Full Effect of Rate Hikes to Emerge Only in October-December or Beyond?
It is said that the effect of interest rate hikes only begins to emerge half a year or so after they have been implemented, so the real economy is expected to begin feeling the weight of capital costs only in the second half of the October-December 2023 quarter or the January-March 2024 quarter. For instance, if we assume the last rate hike to take place in March at the earliest, its impact on the real economy will emerge only in September or thereafter and can be confirmed by economic indicators only in October or beyond. This situation corresponds to Phase C in the figure above. The timing for this phase should be evaluated with a reasonable range, and I have used red font for it as it is difficult to predict with accuracy. However, at the current time, the U.S. housing market is showing clear signs of a slowdown, thanks partly to the impact of rate hikes (see figure). If housing investment stagnates, it is not just construction-related employment, consumption, and investment, but also durable and semi-durable goods consumption and investment accompanying house moving that will be impacted. Housing investment accounts for only 3-5% of U.S. nominal GDP, which is not very high, but a slowdown in housing investment will dampen the consumption not just of construction materials, but also that of cars, household appliances, furniture, and other items. Given that rate hikes are expected to continue for some time, it seems natural to assume that the housing market will also continue to deteriorate. If this has a ripple effect on employment and wages, and hourly wages decline to the Fed's satisfaction, eventually we may begin to see the need for rate cuts being suggested.

Source: Macrobond

When will these developments become a concern? Perhaps in November at the earliest. If everything proceeds as planned, hints of an upcoming rate cut could be included in the FOMC statement by December. If so, one would do well to pay attention to statements and other communication from senior Fed officials starting October. January-March or October-December 2023 may be a good time for market participants looking to trade when USD/JPY is at its lower bound, while April-June and July-September 2023 may be a good time for those looking to trade when USD/JPY is at its upper bound. Of course, as mentioned above, all this is based on assumptions (1) to (3) above, and further predicated on nothing unforeseen happening. The strengthening of JPY since early this year involves an implicit

expectation of Assumption (2) failing, and whether or not this happens will be one of the key points to watch out for during 1H of the year.

BOJ Monetary Policy Now and Going Forward – Upcoming Regime; Narrow Path for Hawkish Actions

Maintenance of Status Quo; Noise Created by Fringe Elements

At its Monetary Policy Meeting (MPM) held on January 17-18, the BOJ decided to maintain the status quo. The simultaneously released Outlook Report (Outlook for Economic Activity and Prices) maintained its CPI (excluding fresh foods) forecast for FY 2023 at 1.6%, but raised forecasts for FY 2022 and FY 2024 from 2.9% to 3.0% and from 1.6% to 1.8%, respectively. The slowdown in CPI growth for FY 2023 assumes lower electricity and gas prices thanks to government fiscal subsidies. Immediately following the meeting, USD/JPY rose sharply, but fell back right away with news of a deterioration in U.S. economic indicators and the associated decline in U.S. interest rates and USD, resulting in an overall level trend for USD/JPY.

As seen also in the Bloomberg Survey (in which 42 out of the 43 people surveyed predicted that the status quo would be maintained), almost no one had been expecting any revision to the monetary policy this time around. To begin with, it would have been too lacking in constancy and, therefore, unlikely for the BOJ to have attempted another expansion of the permissible range for long-term yield fluctuation following right after December. Expectations had only risen as the result of some media reports immediately preceding the meeting, but these reports, which gave the strong impression of being no more than noise created by fringe elements in the financial markets and primarily in the media, were not taken seriously by most Japanese market participants.

Expansion of Joint Operations – Hawkish or Dovish?

Of course, there were some details that cannot be seen as maintenance of the status quo. As already reported, it was decided following the recent meeting to expand the “funds-supplying operations against pooled collateral (pooled collateral operations)” despite maintaining the main policy framework (YCC). With regard to the interest rate on loans disbursed under pooled collateral operations based on the fixed-rate method, it was explained that “The Bank shall determine the interest rate of each loan in order to encourage the formation of a yield curve that is consistent with the guideline for market operations, taking into account market prices of Japanese government bonds for each maturity.” In accordance with this, it has become possible to supply funds of medium- to long-term maturities (5 to 10 years) to financial institutions, something that was previously avoided (or exercised caution over). Not limited to loans disbursed under the fixed-rate method, the Bank also announced a decision to extend the target duration of variable-rate loans (whereby loan interest rate is determined by competitive bidding) from 1 year to 10 years. <u>This will incentivize financial institutions, which are able to secure long-duration loans at low interest rates, to then go ahead and buy Japanese government bonds (JGBs) that offer high yields</u>. The idea seems to be that this will allow the BOJ more scope to control the yield curve without having to buy JGBs itself. During the European sovereign debt crisis, the ECB supplied low-interest-rate funds to regional financial institutions when it implemented its low-interest-rate targeted longer-term refinancing operations (TLTRO), thereby aiming to increase arbitrage trading of European government bonds with stubbornly high interest rates. <u>Although Japan is not currently facing a debt crisis, it is using the same technique as Europe in terms of making use of the banking sector’s investment activities to keep down interest rates on government bonds</u>.

Most market participants are viewing this approach (expansion of the pooled collateral operations) as a monetary easing aimed at countering expectations of excessive monetary tightening, but some view it as a tightening measure aimed at preparing for policy normalization actions to come. The first variable-rate loan operation under the expanded framework, which offered five-year loans, ended strongly, but given the emphasis on “encouraging the formation of a yield curve that is consistent with the guideline for market operations,” this may be realized through interest rates on five-year pooled collateral operations. This itself has prompted some in the markets to consider this a strategy implemented in preparation for raising interest rates.

Matrix for Policies

	Monetary Policy	Fiscal Policy	Currency	Intent	Examples
①	Easing	Easing	Depreciation	To overcome the recession, and to avoid the deflationary spiral	
②	Easing	Easing	Appreciation	Unsustainable	
③	Easing	Tightening	Depreciation	To support the economy	Japan
④	Easing	Tightening	Appreciation	Unsustainable	
⑤	Tightening	Easing	Depreciation	Unsustainable	
⑥	Tightening	Easing	Appreciation	To decrease the surplus in current account, and to prevent economic overheating (tho it is weaker than ⑧)	UK, Euro Area, US
⑦	Tightening	Tightening	Depreciation	Unsustainable	
⑧	Tightening	Tightening	Appreciation	To prevent economic overheating	

BOJ's next move for tightening?

Author's notes

Impact on Forex Rates and the Next Move

Taking into account the aforementioned decision, one must consider the implications for the forex markets and the BOJ's next move. First, with regard to the former, it must be noted that, irrespective of the BOJ's actual intentions, the forex markets responded to the maintenance of the status quo by selling JPY. Consequently, it seems that there will remain scope for JPY appreciation depending on the BOJ's actions. In formulating a medium-term forex outlook, one must continue to assume that a hawkish stance adopted by the BOJ poses a JPY appreciation risk, as explained earlier. A major reason JPY strengthened after temporarily weakening was because the U.S. December Retail Sales, Producer Price Index (PPI), Industrial Production and other indicators, which were released later in the day (U.S. time), fell short of market forecasts. As already discussed, the Fed's shrinking its pace of rate hikes or suspending them altogether will be the main focus of attention during the January-March quarter (or even up to the middle of the April-June quarter), and could result in a dominant trend of USD depreciation against JPY during this time. This is an unavoidable situation so long as USD remains the dominant reserve currency.

Moving on to the BOJ's next move, an abolition of the YCC or the accompanying elimination of negative interest rates seems unlikely to be decided during the remainder of BOJ Governor Haruhiko Kuroda's term, as that would be evaluated as a failure of the Kuroda regime. Given Japan's economic/financial situation, there are also natural limits to the BOJ's actions on the hawkish side, so the Bank cannot afford any wasteful actions. Perhaps the Bank would like to create some policy space for hawkish policy measures to be undertaken going forward.

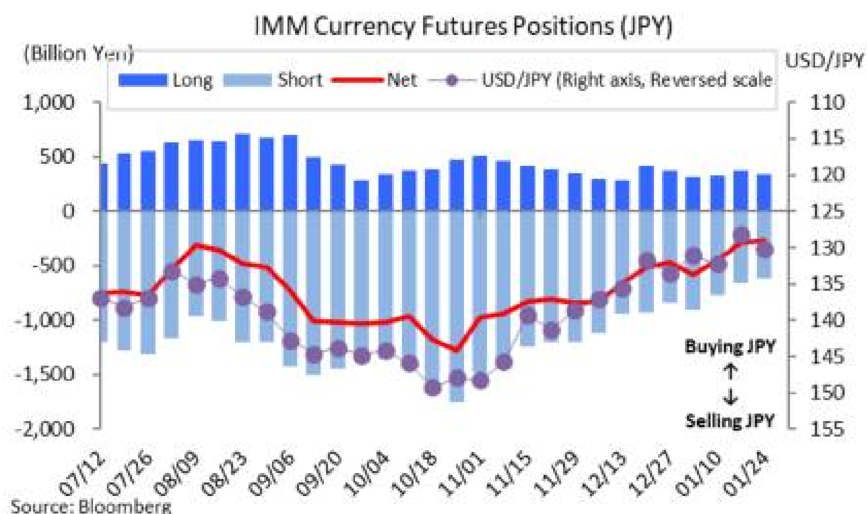
Further, even assuming that the new regime takes hawkish actions, the path for these actions would be extremely narrow. Let me present a rough picture here. The suspension of interest rate hikes by the Fed and economic slowdown in the U.S. are likely to draw attention starting May. Meanwhile, the BOJ's MPMs are scheduled for April, June, and July. Assuming that expectations of rate cuts by the Fed are likely to strengthen during 2H of the year, the BOJ will have no choice but to make use of that timing (April, June, or July) to promote policy normalization. However, openly exhibiting a hawkish stance so soon after inauguration of the new regime is risky. The new regime's first MPM on April 27-28 is likely to draw close attention not just from the markets, but also from the broader society, and the image set at that meeting could end up sticking for the next five years (as in the case of the Kuroda regime). This year, amid clear signs of global economic recession led by Europe and the U.S., Japan's economy is also likely to be forced into a gradual decline. Of course, this should not be attributed to the BOJ's monetary policies, but depending on the stance the new regime exhibits at its first meeting, it could end up being blamed for the economic slump. One would assume, therefore, that the BOJ would like to avoid indiscriminately showing off its hawkish stance. The price target mentioned in the government-BOJ joint statement could be revised to a more abstract one, but it seems unlikely that the new regime would go so far as to hint at abolishing YCC or negative interest rates at its very first meeting.

Of course, things could turn out very different depending on who is chosen to be the new governor, but it is difficult to forecast JPY appreciation based on the assumption of a "BOJ pivot," which is a necessary condition for speculators to accumulate JPY long positions. Further, policy normalization is unlikely to be an easy task for the BOJ given its political ramifications. Given the Kishida administration's obvious intent to increase taxes, there are limits to how much the BOJ can tighten monetary policy. The Kishida administration's political resources are not sufficient for adopting a policy mix of fiscal and monetary tightening simultaneously. Not that such a policy mix would be appropriate for Japanese economic and financial conditions. Given the hardships the Japanese people are facing due to JPY deterioration and higher prices, the government-BOJ joint statement calling for the 2% inflation target to be met as soon as possible needs some revision. However, it is difficult to assume that this alone will lead to rapid and sustained monetary tightening (N.B., as a fundamental rule, I do not think it is advisable to conventionalize the practice of revising the BOJ's joint statement with the government every time there is a change in regime). From the perspective of the forex markets, an unexpected monetary policy tightening by the BOJ remains as a strong-JPY risk, but it does not make it into my main scenario. I maintain my prediction that carry trade spurred on the by domestic-foreign interest rate gap is likely to flourish starting spring (April-June quarter).

JPY Supply and Demand Climate – The Future of JPY Buying by Speculators vs. JPY Selling Due to Supply and Demand

The Future of JPY Buying by Speculators vs. JPY Selling Due to Supply and Demand

In the IMM currency futures transactions, which are used in the forex markets as indicators of trends in speculative trading, as of January 24, 2023, the JPY position was net short at -USD 2.08 billion, the smallest net short since March 9, 2021, when the JPY position turned net short, at -USD 4.51 billion. It was in March 2022 that USD/JPY began to soar, posting the largest JPY depreciation in history since the signing of the Plaza Accord, and the average JPY position for that month was net short at an average of -USD 7.72 billion. Based simply on the amount, the



Source: Bloomberg

net short position has now shrunk to about one-third its size in March 2022. To that extent, perhaps, the JPY selling appetite of speculators has receded. However, despite this significant weakening of the JPY selling appetite, USD/JPY continues to trend at around 125-130. Considering that USD/JPY was at 110 around this time last year, one could say that JPY remains around 20-yen weaker against USD despite speculators' appetite for JPY selling having waned. Ultimately, despite the weakening of JPY selling appetite of speculators, given that real supply and demand factors are overwhelmingly tilted in favor of a net JPY selling, there are solid grounds for JPY to weaken against USD. Rapidly shifting positions such as those seen in IMM currency futures trading are likely to be influenced by interest rates, especially as determined by the Fed's monetary policy trends, which is itself an important thing to note. However, this does not mean that the impact of the trade deficit can be ignored. I believe the current situation reflects a tug of war between JPY buying by speculators and JPY selling due to actual supply and demand.

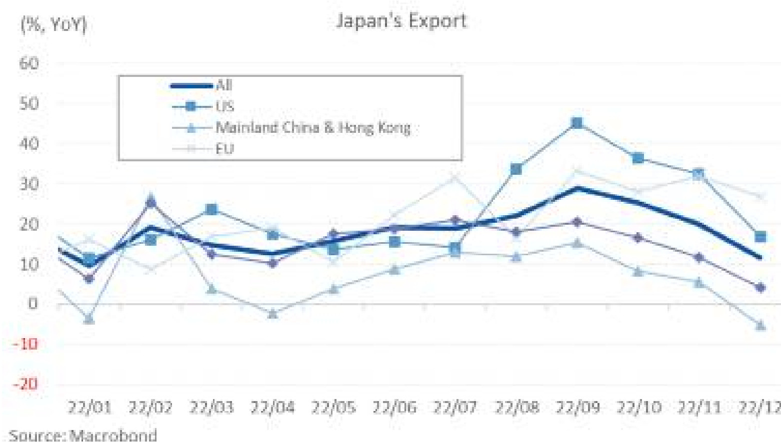
Significant JPY Selling Due to Supply-Demand Factors will Remain
The JPY net short position is shrinking, but this does not mean that JPY long positions are increasing in terms of the gross position before netting out. Let me explain this using figures. For instance, the average monthly JPY long position was USD 2.83 billion during the March-October 2022 period, when JPY depreciated dramatically against USD. This is nearly the same as (or, in fact, higher than) the average monthly JPY long position for the period from November 2022 through January 17, 2023 (USD 2.74 billion), when JPY appreciated markedly against USD. Starting March 2022, the domestic vs. foreign interest rate gap and Japan's trade deficit expanded rapidly at the same time, which created a situation conducive to speculative JPY selling, and this did in fact produce opportunities for significant profits, which were only further promoted by Kuroda's statements favoring JPY weakness at every excuse. In this context, it must be mentioned that the domestic vs. foreign interest rate gap has recently been shrinking thanks to speculations about the Fed's actions, which has contributed to speculators rolling back their JPY short positions. However, the Fed's policy operations have nothing to do with the elimination of Japan's trade deficit. A fourth of Japan's import value is determined by mineral fuel prices. The price of crude oil, the most representative mineral fuel, peaked in mid-2022, but at USD 80 or so per barrel, it still remains about 30% higher than in 2019, when it was USD 60 or so per barrel. At this rate, the import value is unlikely to return to its prior level.
Meanwhile, taking a look at exports, there is a marked slowdown in the growth of exports to various countries/regions, with exports to China actually falling yoy. While import values are expected to go down compared with 2022, this time (for 2023), the growth in export values is expected to be sluggish. As a result, a significant trade deficit will remain, as will JPY selling due to actual supply and demand. If speculators aggressively accumulate JPY long positions under such circumstances, it is probably because they expect the new BOJ regime to aggressively tighten monetary policy from April onward. As discussed above, however, there is an extremely narrow path for the BOJ to implement monetary tightening, and it cannot be included in my main forecast scenario. I believe it would be dangerous to bet on JPY appreciating based on the assumption that the BOJ will pivot.

Could Shrinking JPY Short Positions be Laying the Ground for Further JPY Depreciation?
I would rather like to take the impact of the shrinking JPY short positions (which indicates a greater possibility of their expanding again) more seriously. Following the end of its current phase of rate hikes, the Fed seems likely to maintain the status quo (a lull in policy operations) for some time to come. Such a policy stance is likely to result in high share prices and low volatility in the financial markets. Because of the FF rate remaining high, there will continue to be a significant domestic vs. foreign interest rate gap. This, combined with low volatility, would make forex transactions that target the interest rate differential (selling a currency that offers low interest rates to buy and hold a currency that offers higher interest rates; also known as carry trading) quite profitable. A similar situation was seen in 2006-07, a period characterized by the "weak-JPY bubble." Since Japan also had an enormous trade surplus at that time, JPY depreciated, but not without concern that it would appreciate eventually due to strong actual demand for the currency (in fact, JPY did strengthen dramatically from 2007 onward). Japan today, however, has an enormous trade deficit. Rather than JPY short positions continuing to be rolled back to eventually give way to a net JPY long position, it is easier to imagine JPY short positions beginning to accumulate again. Of course, such assumptions would be overturned if the Fed decides to start cutting interest rates soon, but I do not think that is a very strong possibility.

Import Increase followed by Export Decrease
Besides the speculative movements reviewed above, one must give due consideration to actual JPY demand stemming from Japan's trade balance. According to trade statistics released by the MOF on January 19, Japan's trade balance for all of 2022 was a deficit of JPY19,971.3 trillion – the largest deficit ever recorded since 1979, when the preparation of comparable figures began. Moreover, it is more than 1.5 times the size of the deficit in 2014 (approximately JPY12.8 trillion), which was the largest deficit ever previously recorded (see graph). There are clear grounds for anticipating that the trade deficit should decrease in the future, as resource prices peaked midway through last year and JPY's depreciation peaked from last November, but while oil prices are not as high as they were at

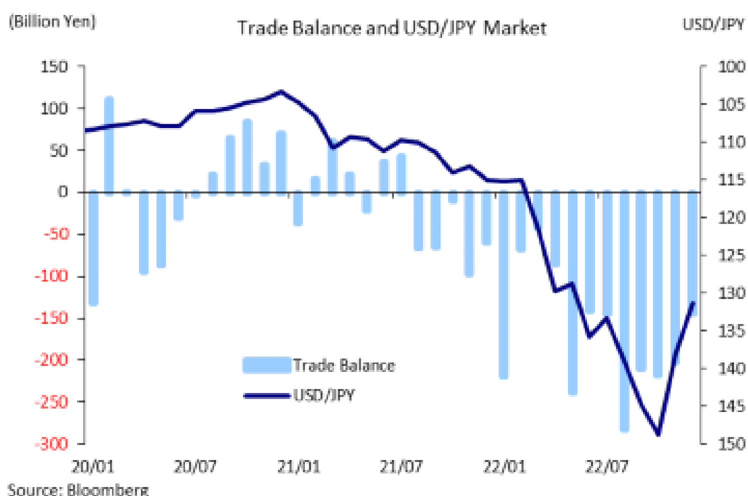
their peak, they are still higher than they were before the pandemic. Going forward, so long as Japan has to obtain resources and operate supply chains in a world that effectively excludes Russia and China, the situation cannot be expected to change significantly with respect to crude oil and various other production factors that Japan imports.

Under these circumstances, Japan (which excels in trade involving the processing of imported products) is likely to continue being forced to import goods relatively expensively and sell goods relatively cheaply, so it is possible that the country's trade-related losses will remain high for a certain period of time. During 2022, a great deal of attention was focused on the increase in Japanese imports owing to rising resource prices and the rapid depreciation of JPY, but during 2023, it can be expected that much of that attention will be shifted to the issue of severe monetary tightening measures along with economic recessions in Europe and the United States. If so, it is possible that Japan will face a deceleration of its imports accompanied by a decrease in its exports. One can already see signs that this scenario is taking shape from an examination of trends in Japanese exports to individual countries/regions (see lower graph). In December, Japan began recording a yoy decrease in its exports to China, where previous concerns about an economic slowdown were compounded by the impact of the spreading covid infections. As there is apparently no country likely to serve as a locomotive of global economic growth in the near future, it can be said that Japanese exports will be facing a quite severe environment.



Linkage between JPY Exchange Rates and Japanese Trade Balance

Even if the increase in Japanese imports becomes moderated, if the decrease in Japanese exports becomes noteworthy, the country's trade deficit can be expected to remain quite large. In light of the fact that the approximately JPY20 trillion trade deficit recorded in 2022 will impact the forex market after a certain lag period, it would be dangerous to blindly believe in the often heard opinion that the Japan-U.S. interest rate differential will shrink and therefore JPY will continue appreciating during 2023. Looking at the timing of the trends, one gets the impression that JPY depreciation/USD appreciation trend in 2022 and the subsequent JPY appreciation/USD depreciation trend paralleled the trends of expansion and contraction in Japan's trade deficit (see graph). One can see a similar correlation of forex trends with trends in the US-Japan interest rate gap, which tends to be more frequently emphasized in financial markets, but it should be kept in mind that the forex/interest rate gap trend correlation is literally a correlation rather than a clear causal relationship involving the actual JPY supply-demand situation, while the forex/trade deficit trend correlation is obviously more of a causal relationship directly related to the actual JPY supply-demand situation. Whatever the size of Japan's trade deficit may be, one can expect that there will be a corresponding amount of JPY selling (outright purchases of foreign currency) in the forex market. While it is not irrational to anticipate that JPY will appreciate to some extent due to the decline in US interest rates, a proper analysis cannot completely ignore the impact of Japan's growing trade deficit. Even if Japan's trade deficit were to fall to half its 2022 level, it would still amount to about JPY10 trillion, which is comparable to the largest Japanese trade deficit ever recorded (the approximately JPY12 trillion deficit seen in 2014).



It is worth noting that JPY fell by more than 10% against USD in 2014. While this was largely attributed at the time to the unconventional monetary easing approach of the Governor Kuroda-led BOJ, I believe that the size of Japan's trade deficit also had a considerable effect. In any case, as exchange rates are ultimately determined by currencies' supply-demand situations, I still doubt that the prospect of US-Japan interest rate gap shrinkage fully justifies widespread expectations that USD/JPY may decrease to near JPY110.

EUR Outlook – Euro Area Benefiting from Warm Winter Weather

EUR Area Monetary Policies Now and Going Forward – Warm Winter Weather Enables Sustained ECB Hawkishness

ECB Governing Council Recognizes Euro Area Strength

Since the beginning of 2023, EUR exchange rates have continued to be firm and, as this article did not anticipate this trend, there is a need to understand the factors causing the situation. In brief, one very important factor is that the euro area economy is recovering owing to the tailwind effects of warm winter weather, which have prevented the economy from suffering more than expected damage from the energy crisis. Natural gas prices and other energy prices have remained moderate, partly owing to the effects of EU-wide price restraint measures, but the weather factor played a key role and cannot be disregarded. Until midway through last year, it seemed highly unlikely that the ECB would be able to sustain a hawkish stance in light of the real economy's current and prospective situations, and there was a general consensus that the situation called for EUR selling. (This article also argued in favor of this consensus view.) Focusing exclusively on current business sentiment trends, however, one finds that the recovery momentum in the euro area is stronger than that in Japan and the United States; moreover, Germany's trade balance (the key factor determining the EUR supply-demand situation) has clearly bottomed out. Owing to the seasonal warming up of the weather and the drop in energy prices, the euro area can be expected to begin recording large surpluses again in the future.

Under such circumstances, the ECB may well have the leeway to regain confidence in its ability to maintain a hawkish policy stance. The Account of the December 14-15 ECB Governing Council Meeting (released on January 19) helps understand the ECB's perspective on the situation. Participants at the December meeting recognized the firm condition of the euro area economy mentioned above, generally concurred with the latest Eurosystem staff projections anticipating a relatively short-lived and shallow recession in the fourth quarter of 2022 and first quarter of 2023, and opined that even with the impact of rising energy prices, internal demand (including demand for employees) was unexpectedly robust. Consequently, the employment and wage situation's momentum was seen as strong, and while signs of a slowdown in the euro area Consumer Price Index (HICP) are still being confirmed, the economy was considered to be entering phase meriting caution about high energy prices' potential spillover effects (price pass-throughs). The reality, however, is that HICP headline rates are starting to decline because of the large drop in energy prices while inflation rates related to other items are accelerating.

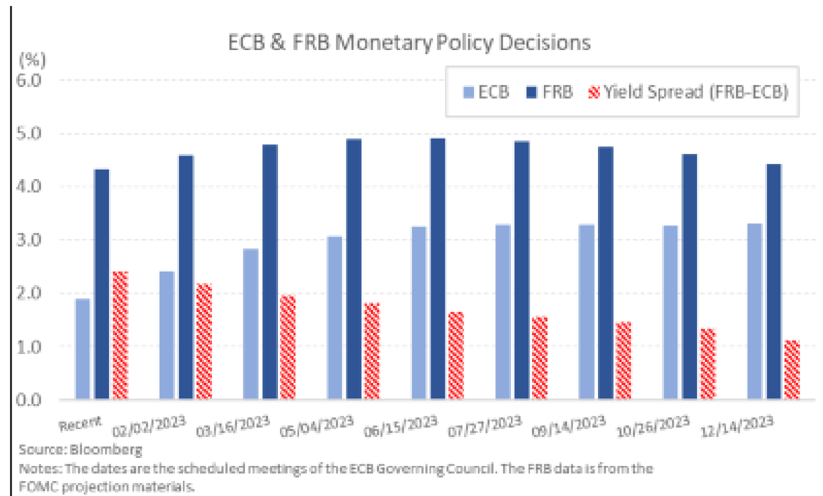
Wage Trends Definitely Merit Attention

Going forward, the most important point will be to determine the magnitude of the spillover effect on wages. According to the Governing Council meeting account, growth in the ECB's internally emphasized negotiated wage indicator is expected to accelerate during the two to three quarters beginning from the fourth quarter of 2022. It is anticipated that that the negotiated wage indicator, which covers seven major euro area countries, will rise by more than 5% from 2022 through 2023. This figure can be said to be within the range of the December staff projections, but in reality, euro area labor cost increases greatly exceeding the negotiated wage increase were becoming normalized during the 2021-2022 period. In light of this, the situation is still one that makes it difficult for the ECB to evaluate or project the magnitude of second-round effects on labor costs. That is why the Governing Council meeting account clearly states that participants were concerned that fundamental inflationary trends are not decelerating. Monthly HICP figures are obviously a key indicator of euro area economic and financial trends that financial market participants should pay close attention to, but figures on negotiated wages and labor costs (announced quarterly) are expected to become of roughly equal importance going forward. Even if the rate of increase in HICP headline rates decelerates, the ECB cannot be expected to significantly modify its policy stance unless wage-related figures move in parallel. Going forward, it will be necessary to monitor changes in comprehensive assessments of the employment and inflation situations.

Background of Decision to Decelerate Interest Rate Hikes

The December Governing Council meeting decided to reduce the margin of interest rate hikes from 75bp to 50bp, and the discussion behind that decision is attracting attention. The account clearly states that "A large number of members initially expressed a preference for increasing the key ECB interest rates by 75 basis points" in light of the height of inflation indicators and expectations. After the decision was made to reduce interest rate hikes margin to 50bp, to countervail potential misinterpretations of that move, a strongly worded sentence was inserted into the meeting's

statement cautioning that – "We decided to raise interest rates today, and expect to raise them significantly further, because inflation remains far too high and is projected to stay above our target for too long." On this point, the account points out that some members continued to support maintaining the 75bp interest rate hike pace rather than the approach (proposed by ECB Executive Board member and chief economist Philip Lane) of decelerating to 50bp hikes while also making it clear that – "interest rates would still have to rise significantly at a steady pace to reach levels that were sufficiently restrictive".
Ultimately, some of the members advocating a 75bp hike decided to go along with the Lane proposal if the majority of members supported it, leading to the final decision to adopt the Lane proposal. In light of this background, it should be understood that, although the Governing Council did ultimately decide to decelerate rate hikes to 50bp, the associated decision was by no means a monolithic one. It thus seems reasonable to assume that it will take a considerable amount of time to begin discussions about decelerating to 25bp hikes or halting the hikes, as there still exists a significant minority of members who believe that the addition of strong language cannot compensate for the reduction in the rate hike margin.
Moreover, given the approval of balance sheet reduction (QT) measures slated to start from this March, it is possible to consider the reduced interest rate hike margins as being appropriate. The EUR15 billion monthly pace of planned QT measures is modest compared to the pace of the ECB's asset purchases during the past two years, but amid discussions about reducing interest rate hike margins and even possibly suspending the hikes, there remains a possibility that the ECB may switch to a course of accelerating its QT measures. Since the pace of QT measures is expected to be reviewed quarterly, it appears possible that there could be a shift to a combination of accelerating QT measures and decelerating interest rate hikes from the third quarter of this year. In any case, it is unlikely that euro area interest rates will fall significantly, and it is conceivable that EUR buying will be supported not only by supply-demand factors but also by interest rate factors. In light of the FF interest rate situation – where the interest rate futures market is beginning to anticipate a rate cut from mid-year – EUR-related interest rates seem quite attractive (see graph).

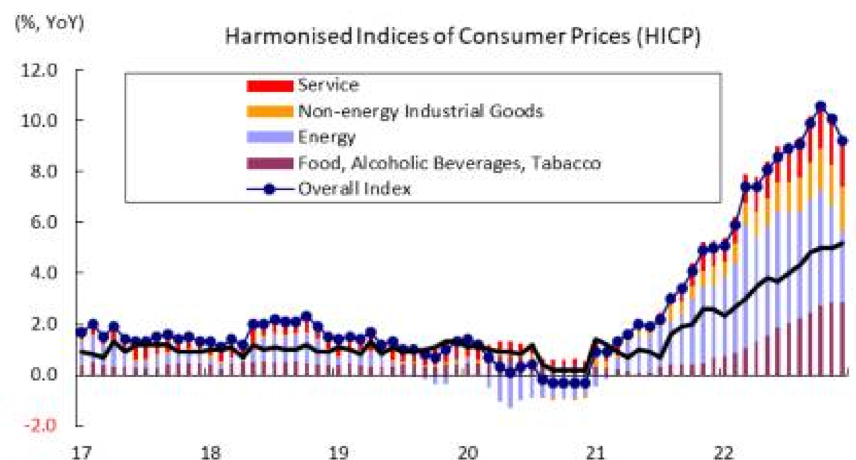


Source: Bloomberg
Notes: The dates are the scheduled meetings of the ECB Governing Council. The FRB data is from the FOMC projection materials.

The Euro Area Economy Now and Going Forward – Hard to Claim Inflation has Peaked Out

ECB's Assessment of "Second-Round Effects"

While attention remains largely focused on BOJ and Fed monetary policies, speculation is beginning to emerge that the ECB may from March decrease the margins of its interest rate hikes from 50bp to 25bp. Citing information from multiple ECB officials, Bloomberg reported on the possibility on January 17. While the February 2 ECB Governing Council meeting is expected to be the second consecutive meeting to raise the policy interest rate by 50bp (from 2.00% to 2.50%), there has been a clear deceleration of the headline inflation rate, so there are grounds for expecting the margin of subsequent hikes to be reduced to 25bp. At the time this article was written, it had been announced that the rate of yoy increase in HICP had finally retreated to single-digits, standing at 9.2% in December. Moreover, the considerable margin of HICP deceleration (0.9 percentage point from the 10.1% yoy November rate) makes it only natural that observers have begun keenly anticipating how the ECB will respond. The decrease in headline inflation rates largely reflect the decrease in energy price inflation rate, which has fallen from 34.9% yoy to 25.5% yoy. As you can see from a glance at the graph, however, the inflation slowdown is limited to energy prices, while the pace of core basis inflation (excluding such products as food, alcoholic beverages, tobacco, and energy that tend to show relatively large degrees of fluctuation) has actually accelerated – from 5.0% to 5.2%. Among core basis items, the rate of inflation for industrial products excluding energy increased from 6.1% to 6.4%, and the rate of inflation for services increased from 4.2% to 4.4%. The ECB should be particularly concerned about the acceleration of service price inflation, which is closely related to the wage situation. What we are now seeing in the

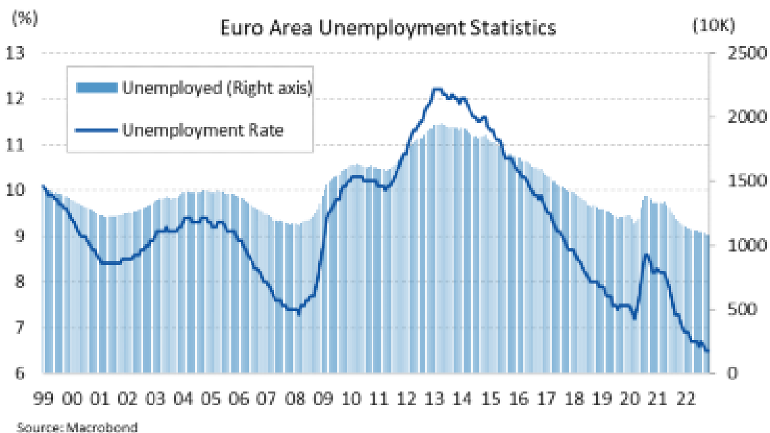


Source: Datastream
*Excluding energy, food, alcoholic beverages, and tabacco.

euro area is the continued impact of price pass-throughs that began after sharp surges in energy prices, and attention is focused on the question of how persistent this price pass-through effect will turn out to be. The ECB frequently refers to such price pass-throughs as "second-round effects", and it is increasingly important to gain a good understanding of current trends regarding such second-round effects.

Likely Emphasis on Preventing Acceleration of Core Basis Inflation

Aiming to restrain the expectations of an ECB shift to dovishness after the December ECB Governing Council meeting reduced the margin of interest rate hikes from 75bp to 50bp, ECB President Christine Lagarde made the noteworthy statement – "Anybody who thinks that this is a pivot for the ECB is wrong." As mentioned above, the December Governing Council meeting's statement also emphasizes that the interest rate hike margin reduction is not a pivot, stating – "We decided to raise interest rates today, and expect to raise them significantly further, because inflation remains far too high and is projected to stay above our target for too long." Moreover, as also pointed out above, the December Governing Council meeting's account shows that a majority of the Governing Council was initially in favor of a 75bp hike. <u>It would also be quite unnatural for the ECB to lower rate hike margins to 25bp soon after announcing – "We [...] expect to raise [interest rates] significantly further"</u>.



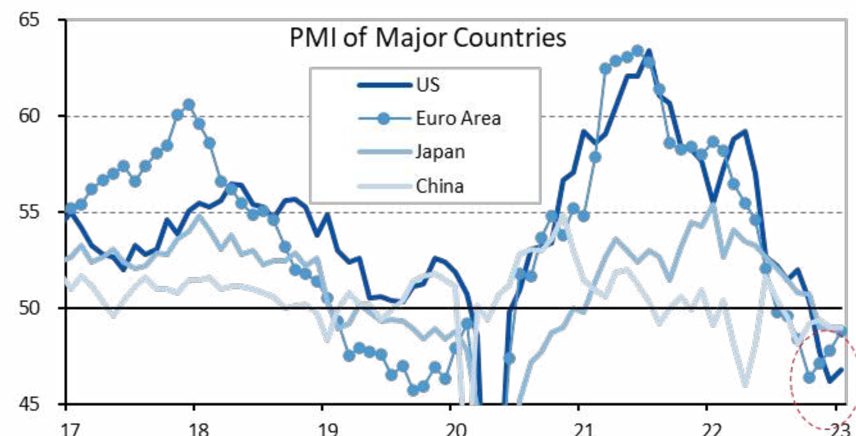
Source: Macrobond

In addition, in light of recent trends in service prices, one would ordinarily anticipate that the ECB will be extremely cautious about casually advocating the reduction of interest rate hike margins. Of course, the ECB has already made numerous changes to its policy management decisions over the past year, and it could perhaps argue that reducing interest rate hike margins was consistent with the December ECB Governing Council meeting's statement by saying that interest rates will continue to be raised even if margin of individual hikes were reduced. Since wage-price spirals are extremely difficult to restrain once they have begun, however, the ECB should be prepared to do whatever it takes to prevent them – <u>it would appear more rational to sustain 50bp hikes with the intention of allowing for overkill rather than underkill with regard to forestalling the momentum of wage-price spirals</u>. Owing to the peaking out of energy prices and the record warm winter weather, rates of growth in headline HICP are expected to continue declining from January, but there are no signs of a prospective easing in the employment and wage situation. Euro area unemployment rates are attaining their lowest levels seen since related statistics have been calculated, and there is no straightforward basis for expecting wage growth to decelerate (see graph on previous page). As explained above, <u>the slowdown in the euro area economy has not been as large as expected (partly due to warm winter weather), so the acceleration of core HICP growth may become a relatively more serious problem for the ECB</u>. While it would be nonsensical to attempt to predict the March Governing Council meeting's decisions before the February Governing Council meeting is held, at the time this article was written, there was no basis for rationally predicting a further reduction of interest rate hike margins in March. Accordingly, it appears likely that the ECB's maintenance of a hawkish stance will continue to promote EUR appreciation for the time being.

The Euro Area Economy Now and Going Forward – A Kamikaze in the Guise of Warm Winter Weather

Euro Area Saved by a Kamikaze

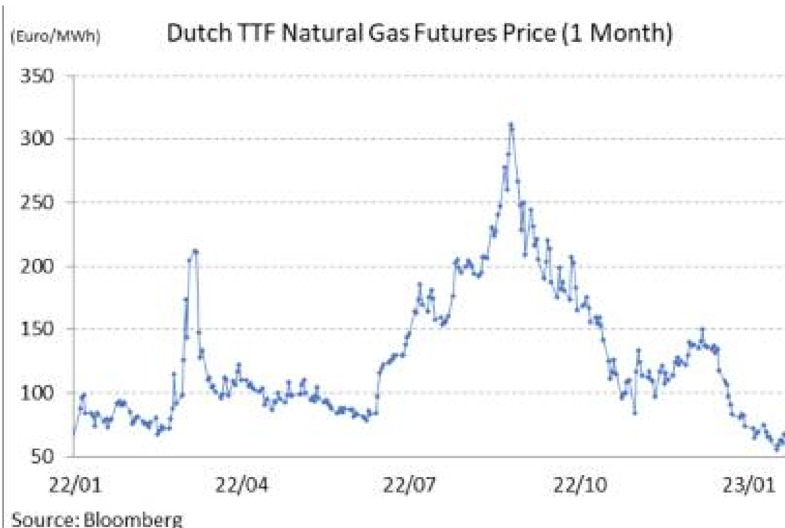
Announced by S&P Global on January 24, the euro area Purchasing Managers' Index (PMI) figure (composite) for January was 50.2, exceeding the average of market expectations (49.8) and rising 0.9 percentage point from 49.3 in the previous month. The composite PMI thus rose above 50 (the dividing line between perceptions of economic expansion and contraction) for the first time since June last year. The January service industry PMI also exceeded market expectations (50.2) at 50.7, improving from 49.8 in the previous month and reaching its highest level in six months. The manufacturing PMI, which has been attracting particular attention, remained below the watershed 50 level, at 48.8, but improved by 1.0 percentage point from the previous month's 47.8 level and exceeded market expectations (48.5). Looking at the behavior of principal global economies' manufacturing PMIs over the past few months (see graph), one finds that the euro area manufacturing PMI has shown the most upward momentum. The euro area's pace of manufacturing PMI deterioration during the January-October



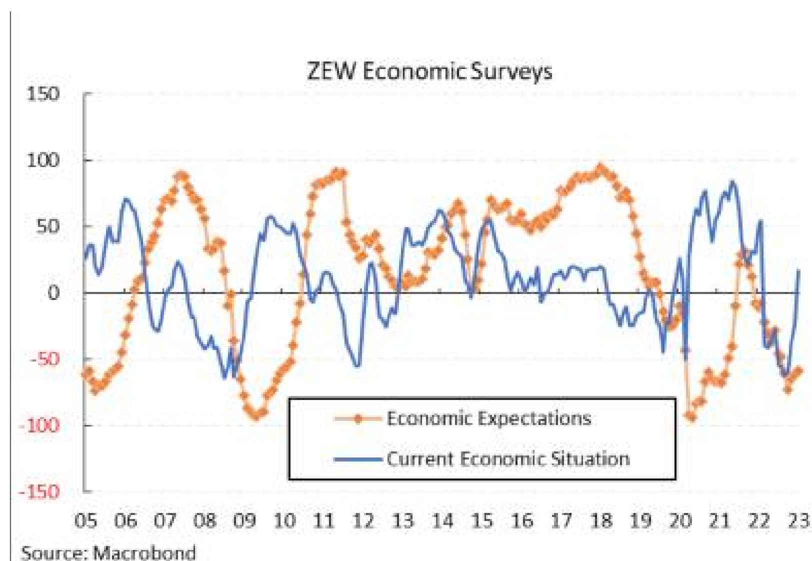
Source: Bloomberg, Markit
Note: The dip in the curve due to Covid was deliberately cut.

period of 2022 was by far the fastest, but it appears that the deterioration in euro area business sentiment from summer through autumn last year principally reflected anticipation (amid a worsening energy crisis) that Europe might be facing extremely dire challenges amid cold winter weather.

As overviewed above, however, Europe has been experiencing record-breaking warm weather during the 2022-2023 winter season – so warm that some observers are attributing the weather to a worrisome global warming trend. Reflecting inevitable adjustments made in the face of a tight energy supply-demand situation along with previous power consumption reduction efforts that entailed sacrificing economic growth potentials, natural gas prices have already fallen 18% since the beginning of the year and have become fairly stable around the EUR58/MW level (see graph). That is close to the level prior to last July, when the gas price surge began. About half a year ago, it was anticipated that rolling blackouts during the winter would cause Germany to suffer an economic growth rate slump comparable to that caused by lockdowns during the initial stages of the covid-19 pandemic, and in light of those dreadful expectations, it can be said that the euro area's actual performance has been outstandingly good. It can be said that this winter's mild weather has saved the euro area economy just as the legendary "kamikaze" (divine wind) typhoon saved Japan by destroying the Mongols' invading navy in 1281.

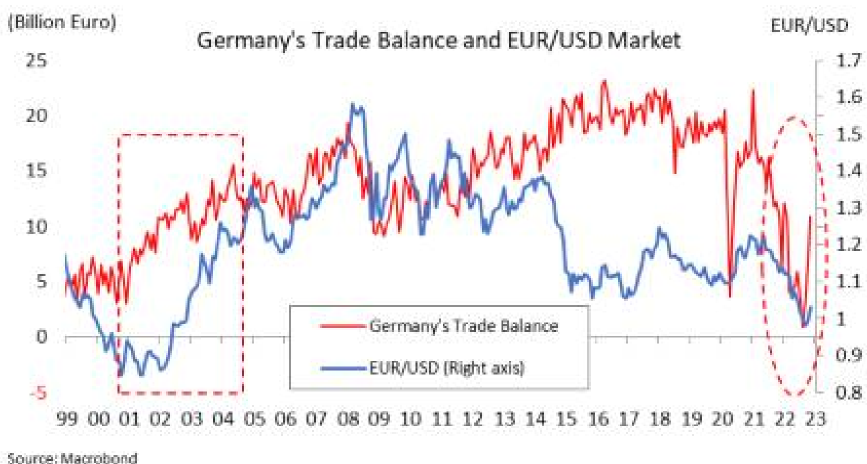


Released on January 17, Germany's ZEW business sentiment index for January improved by 40.2 percentage points from the previous month, the first time in 11 months (since last February) that this index has surmounted the zero level representing the watershed between expectations of economic expansion and contraction (see graph). The ZEW index is said to give financial market participants an understanding of business sentiment with respect to the upcoming six-month period, and the latest movement in this index seems to indicate confidence that a deep recession in the German economy is being avoided. In addition to weather factors, natural gas prices appear to be plummeting owing to the repletion of Chinese gas inventories and the anticipation that gas procured by Chinese gas importers will distributed to Europe. According to some reports, Chinese gas importers will begin shipments to Europe during February and March. While there had been concern that China's cancellation of its zero-coronavirus policy would tighten the global energy supply-demand situation, so far such concerns appear to have been baseless, and the lack of the anticipated tightening of the global energy supply-demand situation is directly benefitting the euro area. Of course, natural gas prices remain high by historical standards – the current price of around EUR58/MW is more than triple the five-year average prior to the pandemic (about EUR17 during the 2015-19 period) – so one can not yet say that the situation has become normalized.



Warm Winter Weather also a Tailwind for EUR

The trend of recovery in the euro area economy will naturally be a factor pushing EUR exchange rates upward. It had been expected that the ECB might be forced to abbreviate its interest rate hike phase due to concerns about damage to euro area economy but, as overviewed above, the likelihood of such a development has considerably diminished, so interest rates are another factor that has a high likelihood of



supporting EUR. Furthermore, as a dire energy crisis has apparently been averted, EUR exchange rates will probably be benefitting from supply-demand-related tailwind effects. Last summer, anticipating the worst winter in Europe's history, this article predicted that Germany would suffer significantly expanding trade deficits and that EUR exchange rates would collapse. However, the unexpectedly warm winter weather stopped the fall of Germany's trade balance just in time to prevent deficits – Germany's trade balance appears to have bottomed out, and it seems that that EUR exchange rates are beginning to rebound in response (see graph). When EUR fell below parity against USD (EUR1 = USD1) during the first half of the 2000s, it was observed that the reversal of the Europe-U.S. interest rate differential promoted the bottoming out of EUR/USD, and it was just at that same time that Germany's trade balance showed marked improvement. As Germany's trade balance once again bottoms out at this time, it is worth noting the potential for a similar trend of recovery in EUR/USD going forward.

Daisuke Karakama
Chief Market Economist
Derivatives & Forex Department
Mizuho Bank, Ltd.
Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp

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