Mizuho Bank

One MIZUHO

Forex Medium-Term Outlook

31 May 2016

Mizuho Bank, Ltd.
Forex Division

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Overview of Outlook

USD/JPY showed signs of recovering in May. USD began another round of appreciation in view of the FRB's determination to continue with its normalization process, as revealed by the minutes of the April 26-27 FOMC meeting. It appears as though the FRB, lulled into complacency by the temporary weakening of USD, is showing an attitude of "danger past, God forgotten." It is important to remember that when considering the economic policy mix of a country, the monetary and currency policies must not be at odds with each other. From both the April 29 U.S. Semiannual Report on International Economic and Exchange Rate Policies as well as actions and remarks by U.S. Secretary of the Treasury Jack Lew, it is very clear that the U.S. currency policy stance is averse to USD appreciation. If the USD appreciation trend cools off and causes economic indicators to stabilize, it would be natural for the FRB's monetary belt-tightening to gather steam. However, the present weak-USD stance favored by U.S. currency policy (Department of the Treasury) is thought to reflect not just economic trends but also the domestic political situation, so the direction of the currency policy may have internal discrepancies. Such discrepancies will have to be resolved at some point. Even if USD does appreciate in expectation of a June rate hike, it seems highly unlikely that the U.S. political and economic situations will continue to tolerate that trend, so one would like to believe that USD will return to its depreciation trend eventually. People are still concerned about the number of rate hikes the FRB will implement this year, but my understanding is that this is a trivial point when seen against the bigger picture.

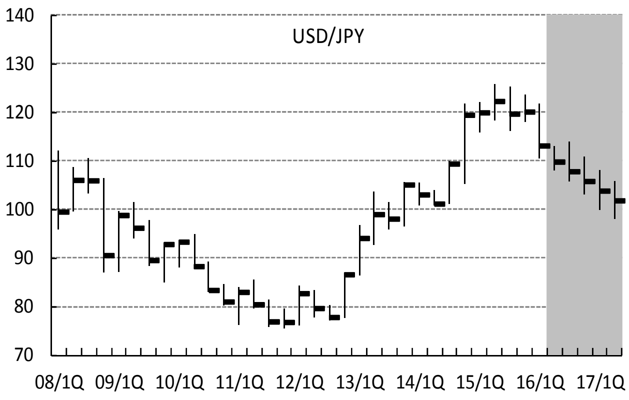
EUR also weakened in May against the recovery of USD. I have been saying right from the beginning in this publication that EUR could weaken around about June, and the recent weakening is within the scope of my assumption. Given that U.S. currency policy makes USD strength difficult to sustain even in the face of aggressive rate hikes by the FRB, both EUR and JPY face the common fate of an inclination to strengthen during phases of USD weakening. My basic understanding remains that EUR, the currency with the largest current account surplus and a relatively high real interest rate, will be able to avoid crashing. Any major changes in EUR will come in July or thereafter. Two of the special measures included in the ECB's comprehensive monetary easing package introduced in March – the second round of Targeted Long-Term Refinancing Measures (TLTRO-II) and the Corporate Sector Purchase Programme (CSPP) – will come into effect in June. In addition, there have recently been signs of a bottoming out of crude oil prices. In other words, from July onward, the ECB will no longer be in a position to make excuses. Supposing neither the Euro area Harmonized Index of Consumer Prices (HICP) nor inflation expectations recover, the forex markets are likely to react with EUR appreciation, thereby pressuring the ECB into implementing an additional monetary easing.

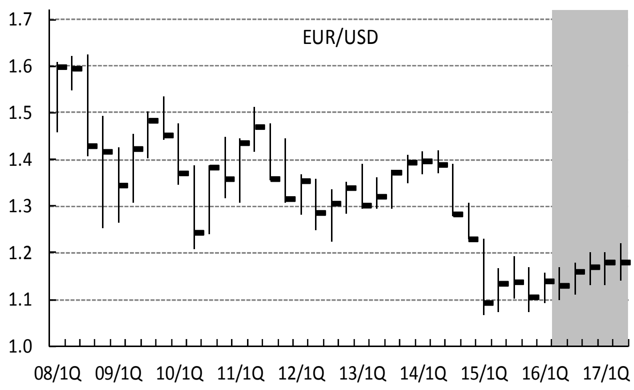
Summary Table of Forecasts

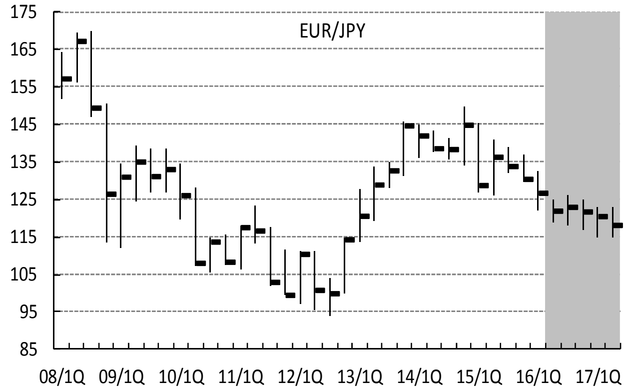
	2016 Jan-May (actual)	Jun	Jul-Sep	Oct-Dec	2017 Jan-Mar	Apr-Jun
USD/JPY	105.55 ～ 121.70 (110.89)	108 ～ 113 (110)	106 ～ 114 (108)	103 ～ 111 (106)	100 ～ 108 (104)	98 ～ 106 (102)
EUR/USD	1.0711 ～ 1.1616 (1.1145)	1.08 ～ 1.15 (1.11)	1.09 ～ 1.16 (1.14)	1.11 ～ 1.18 (1.15)	1.11 ～ 1.18 (1.16)	1.12 ～ 1.20 (1.16)
EUR/JPY	121.48 ～ 132.45 (123.58)	119 ～ 125 (122)	118 ～ 126 (123)	117 ～ 125 (122)	115 ～ 123 (121)	115 ～ 123 (118)

(Notes) 1. Actual results released around 10am TKY time on 31May 2016. 2. Source by Bloomberg 3. Forecast rates are quarter-end levels

Exchange Rate Trends & Forecasts





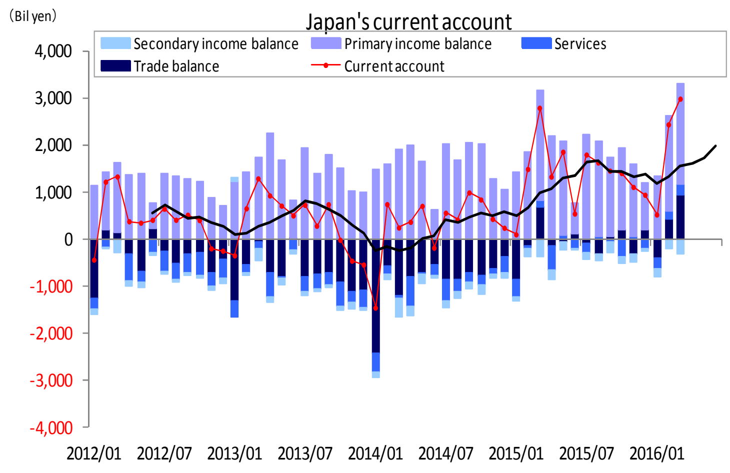


USD/JPY Outlook – The number of rate hikes is a trivial matter

Basic JPY supply-demand situation – Current account surplus extremely reminiscent of the weak-JPY bubble period

Current account surplus extremely reminiscent of erstwhile weak-JPY bubble period

In May, Japan's March Balance of Payments were released. The March Current Account Balance stood at a surplus of JPY 2.9804 trillion, the highest level since March 2007 – during the weak-JPY bubble phase in 2007, Japan's current account surplus had reached a peak. When one remembers the current account deficits posted for some months in 2014, the present seems like a different era altogether. The recent strong current account surplus is the result of a goods and services trade balance of +JPY 1.1701 trillion, and a primary income balance of +JPY 2.1317 trillion, which adds up to a +JPY 17.9752 current account balance for fiscal 2015, the largest annual current account surplus in five years since FY 2010. Looking at it merely in terms of the surplus margin, Japanese trade appears to have recovered from the shock of the 2011 East Japan Great earthquake, following which trade deficits had become a chronic trend.



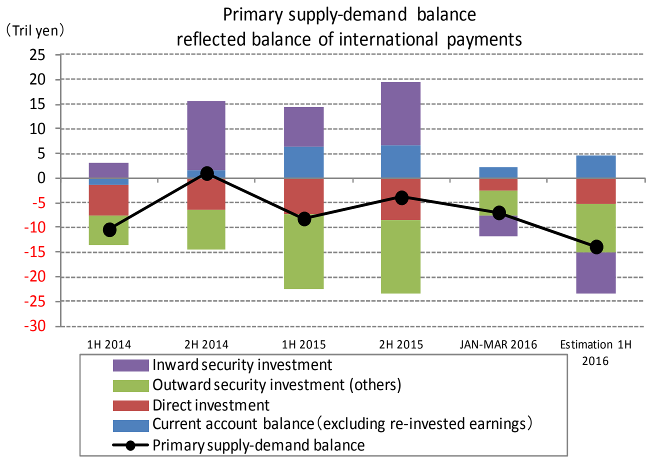
(Source) Ministry of Finance, Japan
(Note) Bold line: Current account 6 months average

However, as a look at the graph will tell, recent improvements in the current account balance have been very discontinuous and abrupt, and seem to lack sustainability. The expansion of the current account surplus since last year has been driven by three big changes: (1) the sharp decline in imports (≈ rapid shrinking of the trade deficit) resulting from the steep fall in crude oil prices, (2) the sharp rise in the primary income balance, and (3) the significant contraction of the service balance deficit. With regard to (1), given that crude oil prices bottomed out in February, the effect of falling crude oil prices will very likely fade away going forward. Meanwhile, trends (2) and (3) were greatly contributed to by JPY weakness and are expected to change in the wake of the steep rise in JPY since February[1]. Looking at it in greater detail, (2) the sharp rise in primary income balance may not change much as it arises from a structural change in the pattern of corporate activity (caused by the foray of Japanese companies into overseas markets). However, (3) the significant contraction of the service balance deficit will inevitably slow down going forward, because it was the result of JPY weakness against CNY, which caused the purchasing power parity of CNY go up, and led Chinese tourists visiting Japan to go on a shopping spree. It is prudent, therefore, to assume that the pace of improvement in the current account surplus will soon peak out.

[1] In computing the JPY-denominated value of the primary income balance, the rate based on the ministerial ordinance ("the average market rate during the month two months before the month in question") is used. In other words, for data pertaining to March, the January forex rate is used for JPY conversions. In other words, the strengthening of JPY since February will begin to affect the Balance of Payments data starting April.

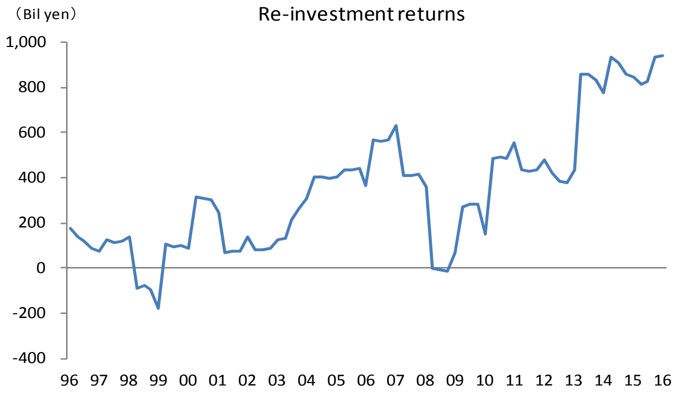
Basic JPY supply-demand during Q1

Taking the above into account, a look at the basic JPY supply-demand balance (see exhibit), which I use in this publication as my guide in formulating my JPY outlook, shows that there has been a net sale of JPY worth ≈ −JPY 7 trillion for the January-March quarter of 2016. There are two reasons for the net sale of JPY despite the expansion of the current account surplus mentioned above – the fact that the expansion of the current account surplus does not account for much in the calculation of the basic supply-demand balance, and the fact that the acceleration of foreign securities investment continues. First, there is the fact that, within the rapidly increasing current account surplus, foreign-currency earnings that are not converted into JPY but reinvested as they are (reinvested earnings; one of the components of the primary income balance) are expanding (see graph). Specifically, the January-March period reinvested earnings were +JPY 941.2 billion, the largest since 1996, when current records began. The primary income balance for the January-March period stood at a surplus of ≈ +JPY 5.5 trillion, but it is certain that just under 20% of this will not be converted to JPY. This is perhaps a consequence of the corporate strategy to channel resources into overseas markets rather than the shrinking domestic market. To that extent, therefore, JPY strength will exert less influence on the calculation of the basic JPY supply-demand balance used in this publication.



(Source) INDB (Note) Subject: including insurers, pension funds & individuals, excluding deposit taking finance institutions & governments

Meanwhile, given the pathetic state of JPY interest rates, Japanese investors' foreign securities investments are accelerating, which is conducive to generating a net sale of JPY. Looking at the FY 2016 investment plans of major Japanese life insurance companies released since April, these companies' appetites for foreign risk is quite strong. Despite the uncertainties accompanying the FRB's normalization process, one can sense their regretful conviction that there is nothing worth investing in domestically. If this pattern (investment in foreign investments exceeding current account surplus earnings) of basic supply-demand seen in the January-March quarter continues, 1H of 2016 may see a higher net sale of JPY than the comparative periods of 2014 and 2015. As I will explain again later, this publication considers JPY depreciation rooted in the acceleration of such foreign securities investment to be the most realistic risk to the strong-JPY scenario, and this seems even more true when the January-March period Balance of Payments is taken into account. However, if, together with the March Balance of Payments, we take a look at the April International Transaction in Securities released on the same day, Portfolio Investment Assets stood at −JPY 600.6 billion, the largest net sale in ten months since June 2015. Looking at historical trends, it has been a regular pattern that whenever the FRB is unable to strengthen its hawkish stance, the foreign risk appetite of Japanese investors tends to weaken. It is not clear whether such past rules of thumb will hold true in these times of negative interest rates, but at present, I believe that even if foreign securities investment accelerates, it will be hedged in various ways and is unlikely to drive JPY depreciation.



(Source) INDB

JPY as seen in the international context – No change in key points following the Sendai G7 meeting

The World vs. Germany – Nothing changes

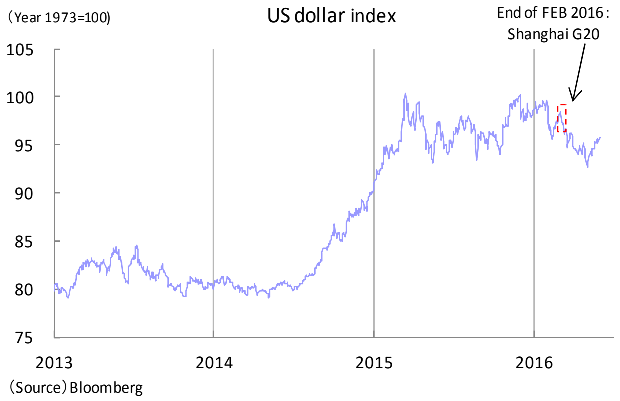
The G7 meeting of finance ministers and central bank governors that took place on 20 and 21 May in Sendai was concluded with the participating countries agreeing to comprehensively use monetary, fiscal, and structural policies to ensure global economic growth (a declaration of similar intent was adopted regarding economic issues at the summit meeting that followed). Despite heightened expectations ahead of the meeting, no agreement on fiscal coordination among the G7 countries was reached, and comments from German Finance Minister Wolfgang Schauble such as "No big decisions were made at the G7 meeting," and his emphasizing, "The most important thing is structural reforms. And the awareness within the G7 has increased" were noticed. U.S. Secretary of the Treasury Jack Lew rejected the need for fiscal coordination, saying that each country had its own stance on fiscal and monetary policies and that some countries have greater room for fiscal policies than the other, but once again expressed his implicit criticism on Germany's austerity path. French Finance Minister Michel Sapin also commented that there was no need for fiscal stimulus up to the scale that implemented in 2008, but where possible, countries ought to take fiscal measures. In other words, with regard to fiscal policies, there seems no change in a structure of "the world vs. Germany." As I will mention again later, this could become a major problem going forward.

The situation that requires philosophical interpretation

As always, the point directly related to forex rates is the disagreement in viewpoints between Japanese Finance Minister Taro Aso and Mr. Jack Lew regarding whether JPY movements seen in the forex markets can be called "orderly," as reported. However, given the "Watch List" recently created for the first time in the history of the Semi-annual Report on International Economic and Exchange Rate Policies (Semi-annual Report), and that two G7 countries (Japan and Germany) were included on that list, Mr. Lew's words and actions were rather subdued. After all, the list was rather unreasonable, having been made mainly with an eye on the domestic political situation, and the fact is that there is nothing to gain from discussing the matter face-to-face. Taking into account that the base of Japan's current account surplus is its income surplus, it would be illogical to criticize it for its currency's weakness in this regard. Japanese companies, having established production facilities in the U.S., produced their goods there, and contributed to U.S. employment and wages, would not find it acceptable to be criticized for repatriating dividends back to Japan. If we take a look at the process that led to the creation of the Watch List, it is understandable why Mr. Lew felt compelled to mention that there was a "pretty high bar" for JPY to be considered disorderly. Given the current political situation in the U.S., it would probably be difficult for Mr. Lew to change his official position that JPY movements are "orderly" even if he does, as a matter of the fact, think they are disorderly. USDJPY moved in the range of 10 yen for the entire year last year, whereas within the first four months this year, JPY has strengthened by as much as 15 yen – this is clearly a "disorderly" manner, and the impact has already started to emerge in the financial statements of major Japanese automakers. Mr. Aso's philosophical interpretation as a politician that "there is election in both the U.S. and Japan, and it is our job to make certain statements of course" is rather appropriate with regard to this situation. However, the fact remains that if the U.S. currency policy continues to favor a weak USD, the downside risk for USD/JPY will continue to expand.

No change in the key point of U.S. aversion to USD appreciation

The recent G7 meeting did not change anything with regard to the two key points – German fiscal austerity and U.S. disfavor of strong USD. With regard to the former, it has to be said (and I will explain this in detail below) that policies that are difficult to comprehend are being continued. As for the latter, I repeatedly mention in this publication that the U.S. position with regard to USD is understandable given the one-sided USD appreciation in the forex markets during the previous two years. Frankly speaking, it is unlikely that USD could sustain its pace of appreciation at +25% in 2 years. USD weakness since the beginning of the year is simply an adjustment to the appreciation before that, and that gives an impression as if adjustment is only just the beginning (see graph). Moreover, since last August, decoupling of USD and CNY has become difficult and inevitably, there will be a gentle weakening of USD and a gentle weakening of CNY in line with this going forward. Taking these points into account, there is no reason, even after the Sendai G7 meeting, to change my JPY outlook in this publication.



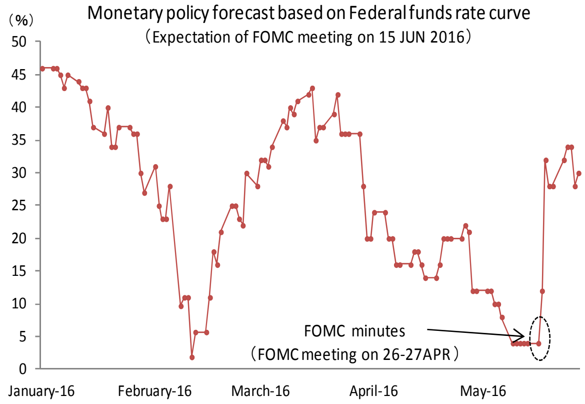
U.S. monetary policies now and going forward – Discrepancy with currency policy is concerning

The number of rate hikes is a trivial matter

In May, apart from the release of the FOMC meeting minutes (described below), there were several hawkish remarks from senior FRB officials, and the strong-USD trend was revived as a result of a return to an FRB normalization process similar to that seen until last year. I would like to believe, however, that this is an unsustainable "boom" based on a temporary optimism caused by USD depreciation. If USD returns to its recent peak (seen around February this year), FOMC members are likely to downwardly revise their FF rate dot-plot projections as during December 2015 - March 2016, causing the currency to fall back again. My main forecast scenario is that there will be no rate hikes this year, but regardless of whether the FRB raises the rates or not, there is no major change in my forecast scenario that USD strength is an unsustainable trend. The number of rate hikes is a rather trivial matter.

Revival of the normalization process

The May resurgence of USD/JPY began with the release of the April 26-27 FOMC meeting minutes on May 18. Specifically, the minutes revealed that there had been discussions as a result of which "most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June." This caused a sudden increase in USD purchases anticipating a June rate hike. Of course, the minutes also revealed a cautionary stance, noting that "Several participants were concerned that the incoming information might not provide sufficiently clear signals to determine by mid-June whether an increase in the target range for the federal funds rate would be warranted." They also said that "Some participants were concerned that market participants may not have properly assessed the likelihood of an increase in the target range at the June meeting." Further, "It was noted that communications could help the public understand how the Committee might respond to incoming data and developments over the upcoming intermeeting period." Summarizing the above very roughly, the FRB's position seems to be that market participants are greatly underrating its rate hike stance. Following this, on May 27, FRB Chair Janet Yellen said at a lecture given at Harvard University said "probably in the coming months such a move (a rate hike) would be appropriate," clearly starting to lay the groundwork for a rate hike at the June meeting. Following the publication of the meeting minutes and such remarks by senior officials, the ratio of factoring in a June rate hike as seen from FF fund futures has increased from under 5% before then to the 30% level (see exhibit). This should probably be read as a sudden increase in the number of market participants anticipating a continuation of the FRB's normalization process and the accompanying strong-USD trend.



(Source) Bloomberg (Note) Expectation : target rate will be changed to 0.50-0.75% at FOMC meeting on 15 JUN 2016

Discrepancy between U.S. monetary and currency policies

Going by the minutes of the meeting and remarks by senior officials, it would not be surprising if a rate hike were to be implemented in June. However, it is important to remember the inviolable rule that when considering the economic policy mix of a country, the monetary and currency policies must not be at odds with each other. From both the April 29 Semiannual Report released by the Treasury Department as well as actions and remarks by Treasury Secretary Jack Lew around the same time, it was very clear that the authorities are averse to USD appreciation. The USD index also gives the impression that the adjustment of the strong-USD trend of the past two years has only just begun, and the recent recovery in business confidence in the U.S. manufacturing sector is clearly the result of the temporary break in the

Combination of policy mix

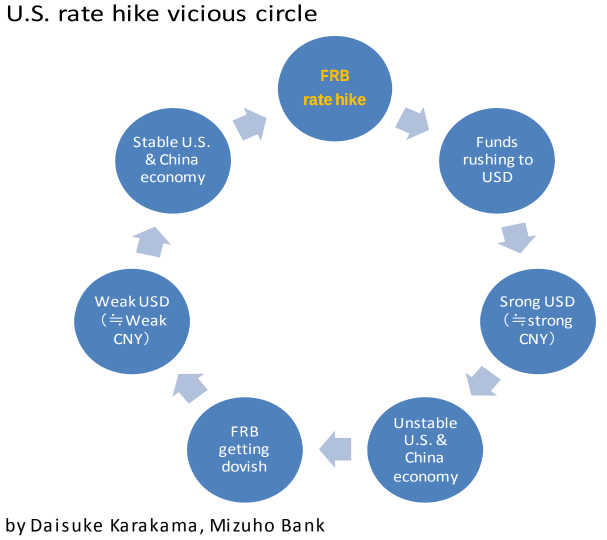
	Monetary policy	Fiscal policy	Currency policy	Policy purpose	Japan, US & Euro zone
①	easing	easing	Weak ccy	overcome the recession, avoid deflationary spiral	Japan
②	easing	easing	Strong ccy	×	
③	easing	tightening	Weak ccy	boost economy	Euro zone
④	easing	tightening	Strong ccy	×	
⑤	tightening	easing	Weak ccy	×	
⑥	tightening	easing	Strong ccy	shrink current account surplus, prevent overheating economy	
⑦	tightening	tightening	Weak ccy	×	US now ?
⑧	tightening	tightening	Strong ccy	prevent overheating economy	

（Source）By Daisuke Karakama, Mizuho Bank
(Notes) ×means unrealizable policy. ＊US is placed in⑥as easing fiscal austerity

USD appreciation trend. If the USD appreciation trend cools off and causes economic indicators to stabilize, it would be natural for the FRB's monetary belt-tightening to gather steam. However, the present weak-USD stance favored by U.S. currency policy (Department of the Treasury) is thought to reflect not just economic trends but also the domestic political situation. It seems, therefore, that the direction of the currency and monetary policies are at odds with each other.

The "strong-USD trap" vicious circle

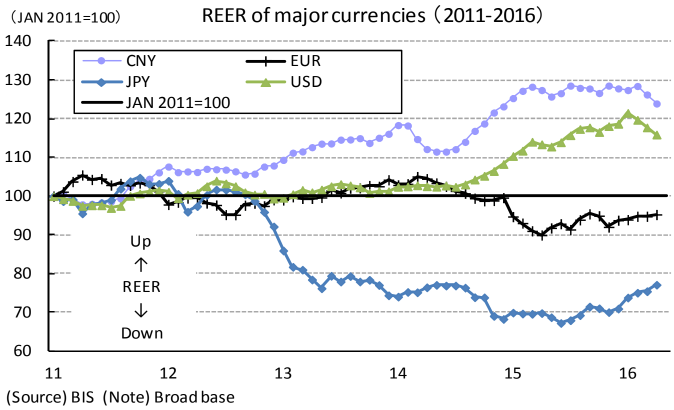
In the second half of this year, there will be a lot of focus on the currency policies of the new U.S. president, but whether the new president is Ms. Hillary Clinton or Mr. Donald Trump, there is unlikely to be any big difference in their currency policy stance of deterring USD appreciation. I would not go so far as to predict aggressive action (raising tariffs and non-tariff barriers) by the authorities following the inauguration of the new administration. It is, however, unlikely that the new administration will tolerate the kind of one-sided USD appreciation seen since June 2014 as a result of the U.S.'s solitary march toward normalization. One has to remember that the FRB is the only central bank in the world that can afford a rate hike right now, so if the FRB returns to its stance favoring rate hikes, it will be difficult to stop the world's investment refugees from closing in on the U.S. again. As a result, another one-sided appreciation of USD will begin to gather steam, once again exerting an unexpected austerity effect on the U.S. economy.



Unless the U.S. economy can extricate itself from this "strong-USD trap" vicious circle, it is unreasonable to expect a continued spate of rate hikes from the FRB. If a continued spate of rate hikes cannot be expected, a strong-USD scenario will be very fragile. I know I repeat myself, but it is because the USD appreciation trend had begun to cool off that there are renewed expectations of a rate hike recently – it seems very much to be a case of "danger past; God forgotten." In order for the "strong-USD trap" not to be activated, an economic climate where a pro-rate hike stance on the part of the FRB would not trigger an across-the-board appreciation of USD is necessary. For instance, during past phases when the FRB implemented rate hikes, newly emerging and resource rich economies had also implemented several rounds of rate hikes. In that climate, carry trade using USD funds gained momentum and USD weakened even when the FRB raised its rates. Coming back to the present, there are very few central banks around the world that can even contemplate a normalization process, so such a move by the FRB would inevitably trigger USD appreciation.

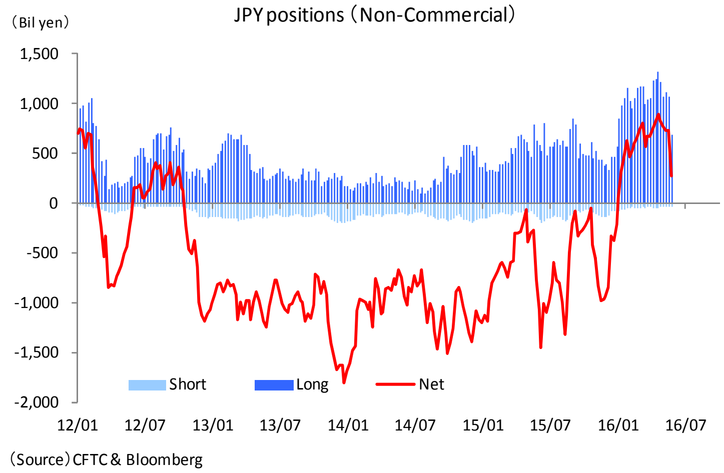
Monetary policy is predicted to converge toward currency policy

Since the major devaluation of CNY on August 11 last year, the global economic scenario has clearly changed. What that event signified was that China could no longer go along with those levels of USD appreciation. Virtually pegged to USD, CNY became the G4 currency (USD, EUR, JPY, CNY) to have been most impacted by currency appreciation over the previous five years (see exhibit). There is no way of knowing for sure whether there was indeed a "secret Shanghai G20 Accord" to bring about a gentle weakening of CNY through a gentle weakening of USD, but regardless of that, it is clear that a weakening of USD is essential for the stability of the U.S. and Chinese economies, and, therefore, the global economy. Paradoxically, it is probably because this is the case that rumors of a secret accord surfaced. Going by the U.S. political climate and the international forex market context, it seems likely that the FRB's austerity-oriented monetary policy will gradually converge toward the Treasury Department's currency policy favoring an adjustment of the strong-USD trend.



Risks to my main scenario – Outward securities investment continues to be the most realistic risk

Adjustment of JPY long positions following considerable growth in those positions



Since mid-May, USD/JPY has been robust, sometimes recovering to above the JPY110 level, there is no need at all to change my forecast's main scenario that I have been maintaining since midway through last year – namely, that "the weak-JPY trend will end with 2015 and the currency will begin to strengthen in 2016." As I frequently argue, the elimination of the excessive accumulation of JPY long currency futures positions during the April-June period, expectations of GPB and EUR selling in connection with the U.K.'s potential exit from the EU (Brexit), and other factors can easily generate a predominant trend of USD buying. In fact, following JPY weakening in May, IMM currency futures transactions and other situations indicate that speculative JPY buying positions are shrinking considerably, and a bit more progress of JPY depreciation in June appears likely to roughly neutralize the speculative positions (see graph). This article has long assumed that, following the liquidation of positions, the JPY appreciation trend will once again commence. On the other hand, it is probably worth noting that, even with the current degree of position liquidation, USD/JPY has merely recovered to the 110-111 range.

In May's forex market, expectations of a June U.S. interest rate hike sharply rose, spurring a predominant tendency to anticipate JPY depreciation and USD appreciation. However, I would recommend keeping one's distance from an overly simplistic expectation of an incipient series of rate hikes. The essential point in forecasting the 2016 forex outlook is "the U.S. and Chinese need for stable USD depreciation." Although the BOJ and ECB are likely to struggle against the appreciation of their respective currencies stemming from this, it is inevitable that this situation will occur at the time of a soft landing on the part of the global economy, and it must be considered a cost that has to be borne in that connection. Moreover, as confirmed by the graph on the previous page, during the past five years RMB and USD have appreciated by roughly 30% and 20%, respectively, while JPY and EUR have depreciated by roughly 30% and 10%, respectively. In light of this, what is currently taking place is merely a roll-back of the unidirectional market trend seen during the past five years, and this kind of movement is not particularly unnatural in a floating exchange rate system. In order to forecast additional forex rate movements in the same direction as seen during the past five years, one would have to have quite strong confidence in the economies of the countries whose currencies have been appreciating, but I do not have such confidence in the real economies of the U.S. and China. Accordingly, it is a basic understanding that I must forecast JPY appreciation

In addition, as already explained, regardless of how intent the U.S. (FRB) is on normalizing its monetary policies, so long as the country's currency policies (Treasury Department) are designed to avert USD appreciation, it appears impossible that the kind of USD appreciation trend seen in the past two years will take place going forward. At a time when both U.S. presidential candidates are proposing the restraint of USD appreciation, projecting an extension of the previous forex rate trend line would be dangerous. Ultimately, a country's monetary and financial policies must always be oriented in the same direction, and my view is that the direction of U.S. policies is likely to be toward USD depreciation. While this may lead to some residual dissatisfaction on the part of the FRB, realizing a series of consecutive interest rate hikes is going to be unfeasible, given the domestic and international economic environment, and I anticipate that at the very least there is likely to be a pause in the interest rate hike schedule. If the U.S. truly desires USD depreciation, then this anticipation is clearly destined to be realized eventually. Rather than being a "forecast," this is simply pointing out a "natural law" of the forex markets.

Rather than giving excessive attention to temporary fluctuations in speculative positions or individual nuances of monetary policies, I continue to recommend maintaining a good grasp of the international context along with a big-picture perspective on the market. Specifically, I will maintain without change my forecast scenario presented last month of JPY appreciation with a lower USD/JPY bound represented by the purchasing power parity (PPP) range of 100-105.

Risks to main scenario: Continued realistic risk regarding Japanese investor trends

Naturally, in addition to the main scenario, I also have risk scenarios. Basically, there is no change in potential risks from the last month. First, what is likely to happen regarding the risk (upside risk) of a continued weak JPY / strong USD trend during 2016? The greatest risk is that the U.S. economy will be unexpectedly robust, and that the FRB's normalization process will proceed with unexpected smoothness (risk factor (1)). In this case, USD would continue appreciating in general, and we would see JPY depreciation against USD for a fifth consecutive year. I was surprised to see the release of FOMC minutes suddenly revive expectations of a June interest rate hike, which had previously almost dissipated. In this regard, it is true that the prospect of risk factor (1) flashed through my brain. As already explained, however, the key issue to focus on is whether the U.S. political and economic situations could tolerate the currency appreciation (USD appreciation) that hawkish monetary policy would bring about. I personally do not think they can, and I am anticipating that, sooner or later, the U.S. desire for USD depreciation will re-emerge. Given that the U.S. employment/wage situation is gradually approaching a full-employment situation, the FRB naturally desires to continue its normalization process, but I think it is advisable to assume that unreasonable normalization will be refrained from.

Potential Risks to the Main Scenario

		Risk Factors	Remarks	Direction
US	①	FRB monetary policy normalization	・Successive interest rates hike after unexpectedly high economic growth, B/S reductions also affected.	Weak JPY Strong USD
US	②	Potential monetary policy adopted by new President	・Regardless of new President, Hilary or Trump, Strong USD will be perceptibly capped. Focusing on new Secretary of the Treasury nominstion.	Strong JPY Weak USD
US	③	Additional FRBs easing	・Interest rate cut in the wake of U.S. sudden recession & QE4 pondering?	Strong JPY Weak USD
Japan	④	Risk-taking by Japanese investors	・Changing main policy from currency hedges to increasing open positions?	Weak JPY Strong USD
Japan	⑤	Japan officials strong JPY curbing	・BOJ's continuous negative interest rates expansion. ・Buying USD/JPY intervention (or rumor)	Weak JPY Strong USD
Europe	⑥	EU officials strong EUR curbing	・Continuous negative interest rates expansion (i.e. targeting -100bp as Sweden)	Weak JPY Strong USD

Second, proactive overseas investments by Japanese investors present another risk for the JPY strength scenario. <u>Frankly speaking, this appears to be the risk factor most likely to eventuate.</u> Given the negative yields on JPY bond issues with maturities up to 10 years, the objective argument that "there are no alternatives to USD as an investment destination" is highly convincing. As already explained, based on the fiscal 2016 asset management plans announced by leading life insurance companies, it is clear that the trend of shifting from domestic to overseas investments is becoming stronger. One gets the impression that such overseas investments are predominantly hedged, but in light of the absolute size of the domestic-overseas interest-rate gap, overseas securities investment accompanied by JPY selling and USD buying (so-called open foreign securities investment) will continue, and it could have the effect of pushing USD/JPY upward. In addition, there is the view that the postponement of the consumption tax rate increase will be accompanied by a reduction of financial institutions' credit ratings, and that if that increases the cost of foreign currency procurement to above the current level, then institutions will find it increasingly difficult to take the option of hedging their overseas investments. Despite that, I believe that the shakiness of the FRB normalization process means that outward securities investment does not present much of a threat, but because JPY interest rates have descended to unprecedented levels, the number of investors willing to assume forex risks is increasing, and there is a clear risk that rules of thumb based on past experience are no longer applicable. The Japan/U.S. 2-year interest rate gap – which has historically shown a strong correlation with USD/JPY – is coming within sight of its level prior to the 2008 financial crisis, and this appears to have become a factor supporting USD/JPY.

Third, there continues to be an alarming risk regarding the policy responses of the Japanese government and the BOJ (risk factor (5)). In particular, regarding monetary policies, the negative interest rate policy introduced in January has generally received a very negative appraisal. Given this, it appears that there is not much likelihood that the BOJ will adopt a "sequential escalation of force" approach to progressively expanding the negative margin of interest rates. In the period prior to national elections, it is probable that the government and ruling party will not be seeking to intensify a negative interest rate policy that has been met with negative appraisals on the part of the general public. As has become clear in light of the considerable JPY strength elicited by the April BOJ GC meeting's decision to maintain the status quo, the financial markets (particularly forex markets) are increasingly behaving as though they are addicted to easing. In light of this trend, it would not be surprising if the BOJ were to respond to the trend by moving ahead with a sequential escalation of easing going forward. In particular, it is impossible to completely rule out the possibility that the BOJ will progressively move ahead with expanding the negative interest rate margin and thereby prevent JPY from appreciating as much as it would otherwise be expected to. As already being demonstrated with increasing clarity, however, negative interest rates are not capable of halting currency appreciation and stock depreciation trends stemming from overseas factors. In addition, it may be that there is a risk that the ECB's all-out easing measures could, by means of a sharp drop in EUR/USD, directly lead to an unexpected rise in USD/JPY (risk factor (6)).

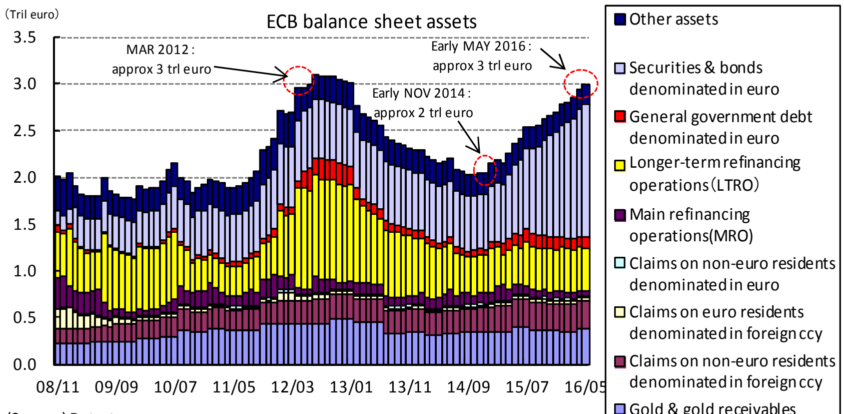
Another risk (downside risk) to the main scenario's anticipated JPY appreciation/USD depreciation trend relates to the direction of currency policies under the newly elected U.S. president (risk factor (2)), and this situation will become clearer in the latter half of the forecast period. Currently both leading candidates – the Democratic Party's Hillary Clinton and the Republican Party's Donald Trump – have been publicly criticizing JPY depreciation. While such criticism must naturally be somewhat discounted as it is being voiced in the context of election campaigns, it is worth remembering that the plan for doubling U.S. exports over five years presented by President Obama in his January 2010 State of the Union speech coincided with the start of a five-period of JPY strength against USD. One must keep in mind the possibility of a similar situation occurring if the new U.S. presidential administration is inaugurated during a period when USD is continuing to be strong at a high level. Another conceivable risk related to the United States is that a sharp deterioration in U.S. economic conditions might not only preclude monetary policy normalization but actually a shift (perhaps in the fourth quarter of 2016) toward monetary easing policies. In this case, regardless of what monetary policies Japan adopts, it appears unquestionable that there will be an acceleration of the JPY appreciation/USD depreciation trend.

EUR Outlook – The ECB's balance sheet and EUR exchange rates

The ECB's balance sheet and EUR exchange rates – Regarding the current and prospective balance-sheet situation, etc.

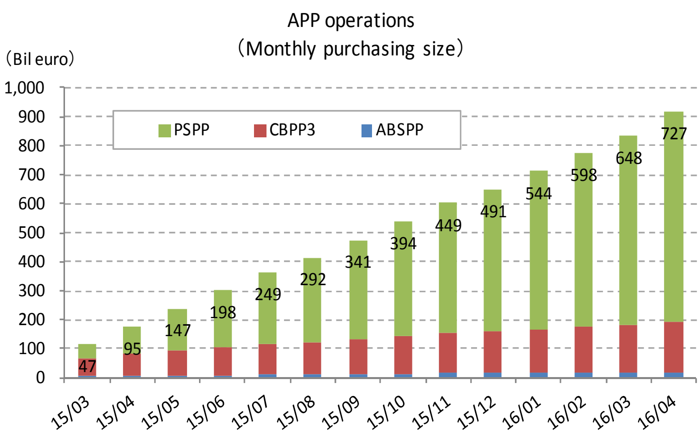
The ECB's balance sheet after target attainment

As U.S. currency and monetary policies have been in the limelight, the ECB's monetary policies did not attract much attention in May. It is, however, highly noteworthy that, following the steady expansion of the ECB's balance sheet, the size of the balance sheet had attained the EUR3 trillion landmark as of the end of April (see graph). This EUR3 trillion figure is significant. After the ECB GC meeting on November 6, 2014, the ECB announced that – "Together with the series of targeted longer-term refinancing operations (TLTRO) to be conducted until June 2016, these asset purchases will have a sizeable impact on our balance sheet, which is expected to move towards the dimensions it had at the beginning of 2012." – and at the press conference on that day, ECB President Draghi further clarified this, saying – "the beginning of 2012 means March 2012, that is to say right after the second LTRO." Essentially, since the November 6 GC meeting, the ECB has had the target of "expanding its balance sheet by June 2016 to the size of the balance sheet as of March 2012." This was not the kind of clearly communicated annual growth target as those in the BOJ's quantitative and qualitative easing (QQE) policy. President Draghi himself has sometimes said that "size" is not important (The expression "move towards the dimensions it had at the beginning of 2012" was omitted from ECB statements from January 2015.), and the market's level of attention to this issue has definitely not been high, but it is true that the ECB has been conscious of the "EUR 3 trillion" balance sheet level.



(Source) Datastream
(Note) ECB accounced they would restore same level to B/S as of MAR 2012

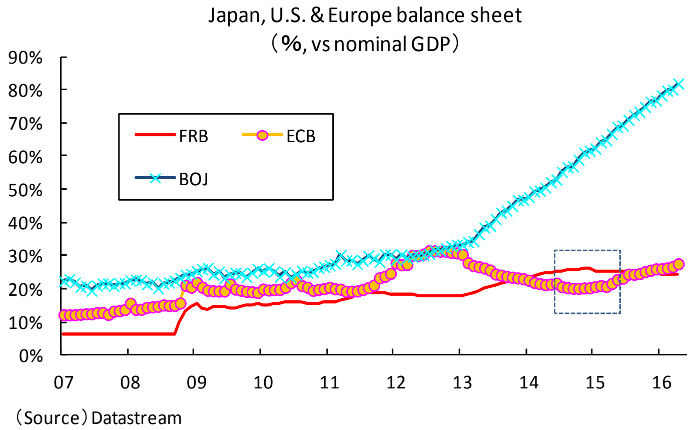
The ECB's targeted "volume" was attained a month before the June 2016 end of the targeting period, but it is worth noting that, at the time of the target's announcement in November 2014, the public sector purchase programme (PSPP), which is the core of the expanded Asset Purchase Programme (APP), did not yet exist. The PSPP was inaugurated in March 2015, and it had a balance of EUR 726.5 billion at the end of April 2016 (see graph). Given this, it is easy to understand how extremely difficult it would have been to attain the EUR3 trillion mark using only the methods available as of November 2014. (The balance sheet size as of November 2014 was roughly EUR2 trillion, so attaining the EUR3 trillion mark entailed realizing an increase of approximately EUR1 trillion.) As of November 2014, it was thought that the target level would be reached using three tools – TLTRO, the asset-backed securities purchasing program (ABSPP), and the covered bond purchase program (CBPP). Based on currently available figures, seven TILTRO bidding rounds have accumulated a total of EUR 425.3 billion in assets, and the balances of ABSPP and CBPP3 as of the end of April were EUR 19.0 billion and EUR 172.3 billion, respectively. Since the total "volume" of these three programs combined is less than EUR 620.0 billion, it is clear that without additional programs (≈PSPP) the current level could not have been attained. Regardless of whether the ECB wanted to or did not want to undertake a quantitative expansion program focused on government bonds, at the time that the "EUR3 trillion" target was announced, the ECB can be said to already have been in a position that made it inevitable that it would have to undertake such a program.



(Source) ECB

Non-correlation of "volume" and forex rates

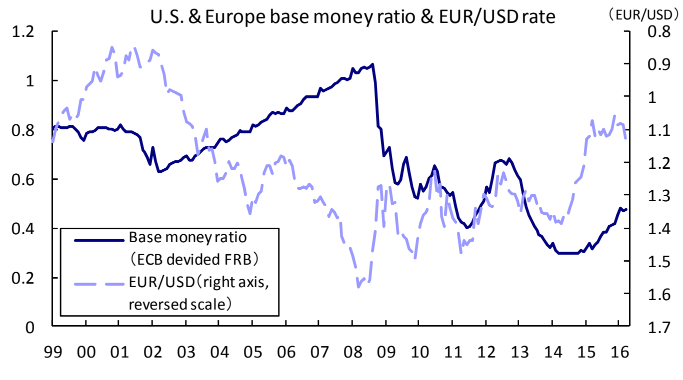
As the ECB had already introduced negative interest rates at the time, it is thought that the ECB's stubborn focus on expanding "quantity" was solely intended to be a means of guiding EUR downward. In fact, the current level of EUR/USD (in the vicinity of USD 1.10) represents an 18% EUR depreciation from June 2014 (when negative interest rates were introduced) and a 10% EUR depreciation from November 2014 (when the "quantity" target was announced), and this appears to show that the original objective may have been attained to a large extent. In fact, however, it is probably true that this accomplishment was only realized with a considerable amount of help from the FRB's monetary policy normalization efforts. While this is an argument that this article has already strongly propounded in the past, I believe that Soros-chart-type theories that seek to find a relationship between central banks' balance sheet scales and forex market trends do not have a logical basis and should be frankly recognized as such. (If you search for "Soros Chart" on the Internet, you will find the material almost exclusively focused on USD/JPY, and one gets the strong impression that the theories are simply arbitrary and irrational attempts to analyze JPY exchange rates.) For example, as can be seen from the graph on the right showing central bank balance sheet sizes as a percentage of their respective economies, the ECB's balance sheet scale is not particularly large compared to that of the FRB. In fact, as noted previously, during the period when EUR/USD rapidly declined (the area encompassed by the black square), it was the FRB's "volume" that showed a relatively great amount of relaxation. Since the start of this year, the ECB's degree of relaxation has gradually begun exceeding the FRB's, and it is true that EUR/USD has shown a strengthening trend of increase since the start of the year. And yet, if we are examining the effect of "volume" expansion as a percentage of economic scale on forex rates, then it is clearly the BOJ that has been overwhelming in the scale of its relaxation struggle. It should be recognized that, fundamentally, the utility of irrational theories about the impact of balance sheet scale itself on forex rates is highly questionable.



(Source) Datastream

EUR/USD Soros chart also useless

The graph on the right shows trends in the base money ratio (ECB ÷ FRB) and in EUR/USD – it is a EUR/USD version of the kind of Soros chart sometimes used to analyze USD/JPY. While it is true that there appears to be a certain amount of correlation between the trends for the period since the financial crisis, it is also clear that there is almost no stable correlation for the preceding years. Moreover, an increase in base money does not necessarily lead directly to money supply growth and, given that the lack of growth in currency volume in the real economy has become a stable situation, even if there is a correlation between the trends, that does not mean that there is a theoretical basis to support that correlation. Essentially, it seems likely that the movements since the financial crisis to a certain degree reflect responses to expansions and contractions of the FRB's quantitative expansion (QE) program. Going forward, the change in the Europe-U.S. base money ratio stemming from programs centered on the expanded APP (monthly asset purchases increased from EUR60 billion to EUR80 billion) and the second series of targeted longer-term refinancing operations (TLTRO-II, launched from June) seem to have a high likelihood of indicating a decrease in EUR/USD. In fact, however, I am forecasting that EUR/USD will increase owing to the FRB's increasing dovishness.



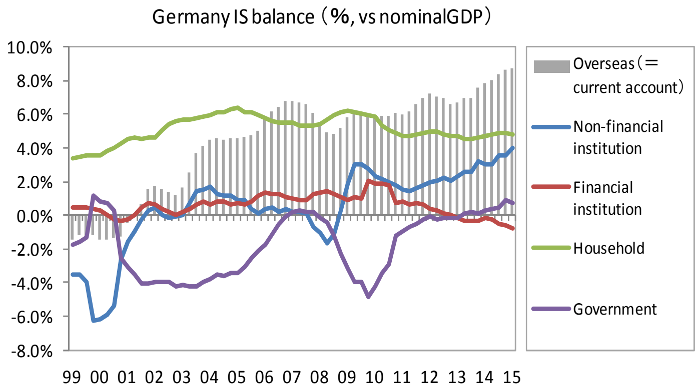
(Source) Datastream

The test awaiting the ECB from July

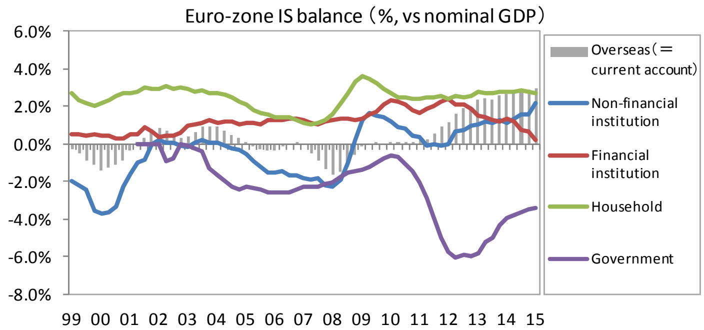
If the ECB is going to be facing a test or ordeal during the forecast period, it would seem likely to start from this July. Of the comprehensive package of easing measures approved on March 10, the measures that has attracted the most attention is the negative-rate funding program, TLTRO-II, which will have its initial bidding round on June 23 (the date of bid submissions), and the corporate sector purchase programme (CSPP), which will enable purchases of corporate bonds when it is launched during June. In other words, it appears that the ECB is anticipating that the effects of these programs will gradually be elicited in from July. In addition, crude oil prices have clearly bottomed out since February, and it can be expected that, going forward, this will support a recovery in the Euro zone's Harmonized Index of Consumer Prices (HICP) as well as in inflation expectations as seen in five-year in five years inflation swap break-even inflation (BEI). In short, from July the ECB will not be in a position to make excuses. In the case that, HICP and inflation expectations were to remain low from July, as the market evaluations of TLTRO-II and CSPP are being made, it seems likely that the ECB will be forced to make some kind of policy response. In that situation, the forex markets are likely to react with EUR appreciation, thereby pressuring the ECB into implementing an additional monetary easing, and the ECB will respond by forcefully working to depress EUR going forward.

The Euro zone economy now and going forward – Enabling Germany to be Germany

An abnormal IS balance



(Source) Eurostat (Note) Household including non profit organizations

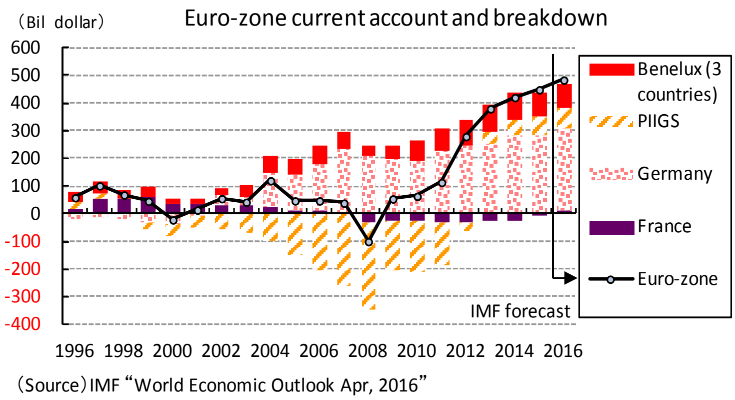


(Source) Eurostat
(Notes) Household including non -profit organizations
Domestic & overseas balance are not always matched due to statistical error

The G7 summit held in Japan's Ise-Shima region on 26 and 27 May (Ise-Shima summit) and prior meetings in Sendai (G7 meeting of finance ministers and central bank governors on 20 and 21 May) failed to come up with the kind of fiscal action coordination accord that had been expected. However, it must frankly be said that Germany's economic situation in abnormal, at least with respect to the country's investment-savings (IS) balance. As can be seen from a glance at the graph, the German economy's domestic sectors are basically recording a net saving surplus, and the foreign sector has an overwhelming saving deficit (≈current account surplus). In other words, Germany's economy is being supported by using foreign demand to compensate for the overwhelming weakness of domestic demand (see graph on upper right). In fact, it is not just Germany but many of the major Euro zone countries in which both corporate and household sectors have fallen into the pattern of recording savings surpluses. In view of the situation for the Euro zone as a whole (see graph on lower right), Germany and other countries are beginning to recognize the need for government consumption and investment to compensate for the private-sector savings surpluses. During Prime Minister Abe's tour of Europe prior to the summit, such countries as France and Italy were receptive to his fiscal stimulus proposals, while Germany remained coolly distant. Germany's habitual pattern of refraining from addressing its own surpluses while relying on external demand alone to support its economy has frequently been considered a problematic situation within the Euro zone in the past, and now this issue is finally beginning to be addressed on the stage of international economic diplomacy, as the problem steadily increases in magnitude. To repeat, since the repeated urgings of such fellow Euro zone countries as France and Italy have fallen on deaf ears in the case of Germany, such outsider countries as the United States and Japan have added their voices to the urgings, but it appears that the suggestions will continue to get the cold shoulder.

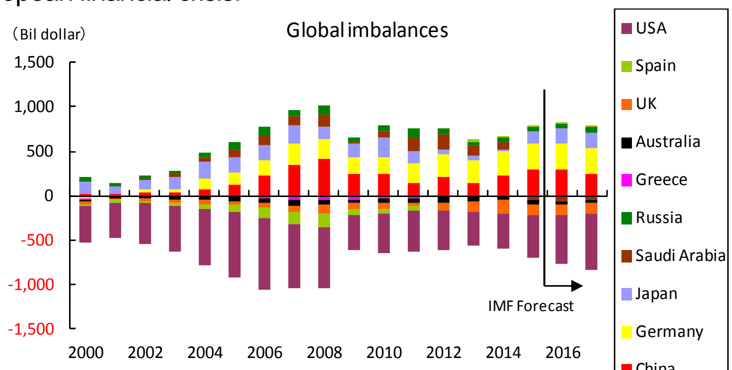
"Germany can be Germany because other countries are not Germany"

One of the factors behind Germany's utilization of foreign demand is the existence of EUR, which has depreciated to reflect the weakness of peripheral Euro zone countries, and this situation does not require much explanation. In my book, entitled "Ready for the Japanization of Eurozone, Euro and ECB," I warned that the problem of Germany's "perpetually undervalued currency" would spur trade frictions between the Euro zone and the United States[2]. Now that Germany has been included in the newly established "Monitoring List" of the U.S. Treasury Department's Semiannual Report on International Economic and Exchange Rate Policies, it is impossible not to conclude that the anticipated frictions are finally being generated. (At the same time, I find it difficult to understand why Japan is included among the five countries on that list.) The key point is that Germany does not consider the "perpetually undervalued currency" issue to be a problem, and there is concern that the country is actually doing its utmost to avoid recognizing the problem. Germany has a strong tendency to demand that other Euro zone countries follow the example of its economic behavior, <u>but it must be recognized that "Germany can be Germany because other countries are not Germany</u>." Germany was often characterized as the "Sick Man of Europe" during the first half of the 2000s, and its subsequent recovery has often been attributed to labor regulation reforms instituted by Prime Minister Gerhard Schröder, but that is not the only factor. The 1999 launch of EUR, as the "perpetually undervalued currency," followed by the advent of a Europhoria mood that provoked bubbles in peripheral Euro zone countries accompanied by abundant domestic demand were key factors enabling Germany to expand its exports to other Euro zone countries. Subsequently, the Euro zone's current account imbalance peaked in the 2007-2008 period (see graph), leading to the European financial crisis.



(Source) IMF "World Economic Outlook Apr, 2016"

In light of this history, it should be recognized that Germany's current attitude has an aspect of irresponsibility. In brief, Germany is being expected to use some of its abundant financial resources to stimulate its domestic demand and contribute to an uptrend in the Euro zone economy, and it would seem that actually doing this would be a step that would for the first time complete the common currency area project in an important sense – namely, the sense of mutual support. In the case that "countries other than Germany" both within and outside the Euro zone were to seek to achieve Germanesque IS balances (≈huge current account surpluses), the upshot would inevitably be a currency war aimed at capturing external demand. The Ise-Shima summit had the potential for being an important venue for gaining Germany's understanding of this point, but it unfortunately appears that the meeting did not lead to a major change in the current situation.



(Source) IMF "World Economic Outlook Apr, 2016"

Until the first half of 2000s, the main cause of imbalance in the global economy was the U.S. current account deficit, but as you may know, this was also a remote cause of the financial crisis that subsequently erupted. <u>However, it is now becoming widely established that the main cause of global imbalance at the present time is the German current account surplus, (see graph on previous page), and this seems likely the root cause of the global currency wars. I am concerned that there will come a time when such topics will have to be discussed urgently at G7 or G20 meetings going forward.</u>

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[2] In addition, please refer to the May 15, 2015, edition of Reuters Forex Forum, entitled "Europe-U.S. Trade Friction Elicited by the Euro Area's Japanification."