Monthly Economic Report

February 21, 2019

Mizuho Research Institute

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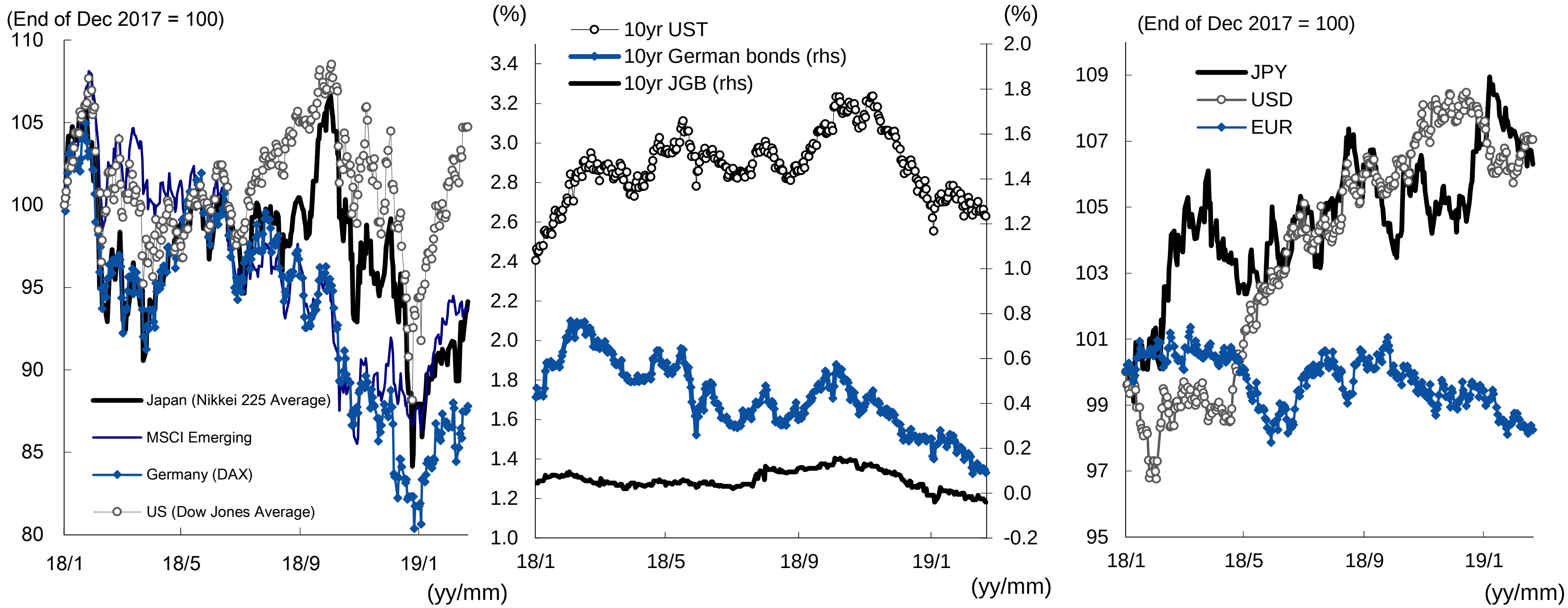
1. Overview of financial markets: market caution easing on expectations for progress in US-China trade talks

- Financial market concerns remain subdued owing to expectations for progress in US-China trade talks and China's economy-boosting measures and the FRB's backpedaling on its gradual rate hike policy. While the impacts of trade tensions and the slowing Chinese economy did become more apparent, such as downward swings of exports by many countries, market reactions have been limited.
- Despite the upturn of stock prices, rises in long-term interest rates were limited. The 10yr JGB yield stayed in the negative range near 0%.

[Major market trends]

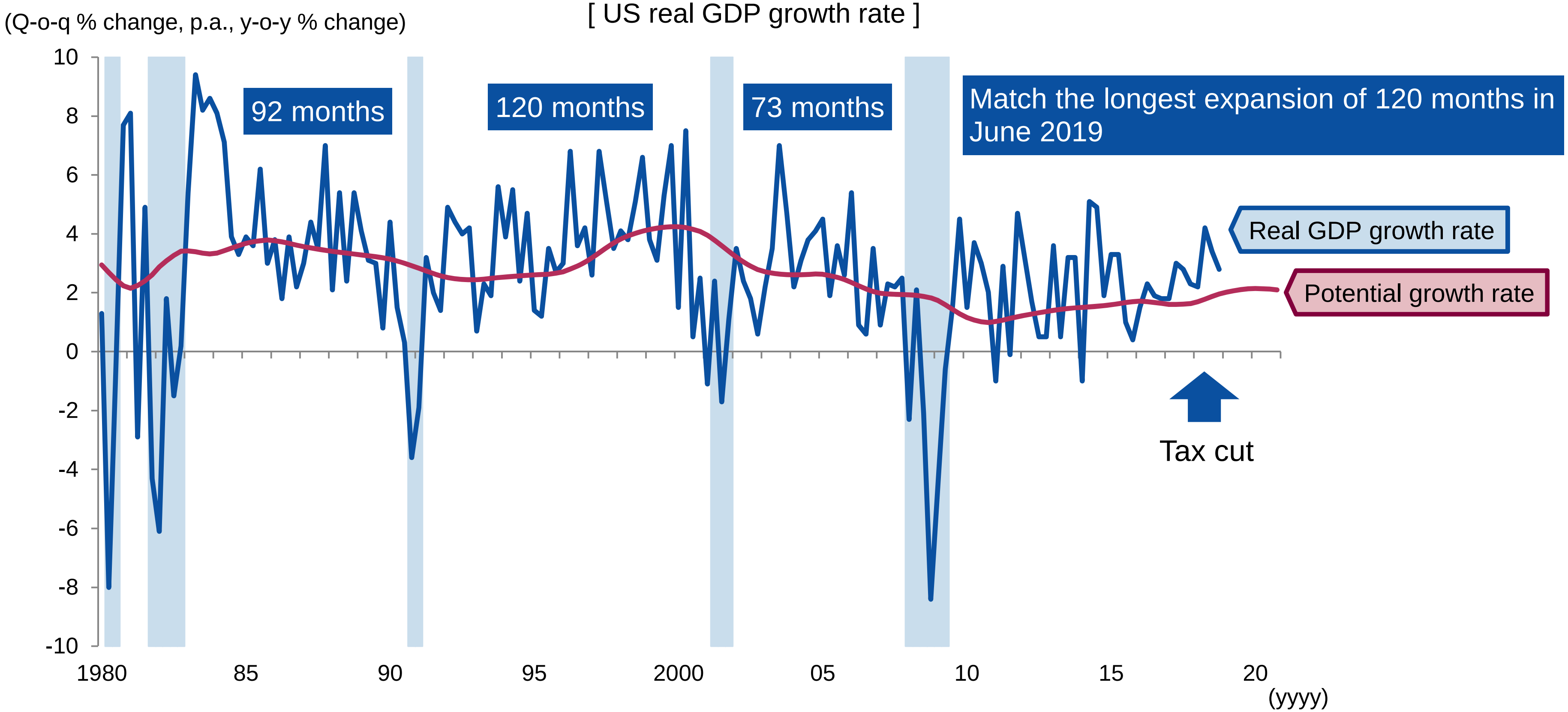


Note: Currency exchange rates are based upon the nominal effective exchange rates as released by the authorities of each country.
Source: Made by MHRI based upon Bloomberg

2. The US economy: economic growth will mark the longest expansion in history in the summer of 2019

- The US economy has been growing faster than its potential rate of growth, given the tailwinds of expansive fiscal policy.
  - Real GDP growth in the Jul-Sep quarter of 2018 was +3.0% y-o-y, far stronger than the potential growth rate of +1.8% (Congressional Budget Office).
  - The economy has already marked the second longest period of economic expansion in US history and is set to match the longest expansion period of 10 years in June 2019.

[US real GDP growth rate]

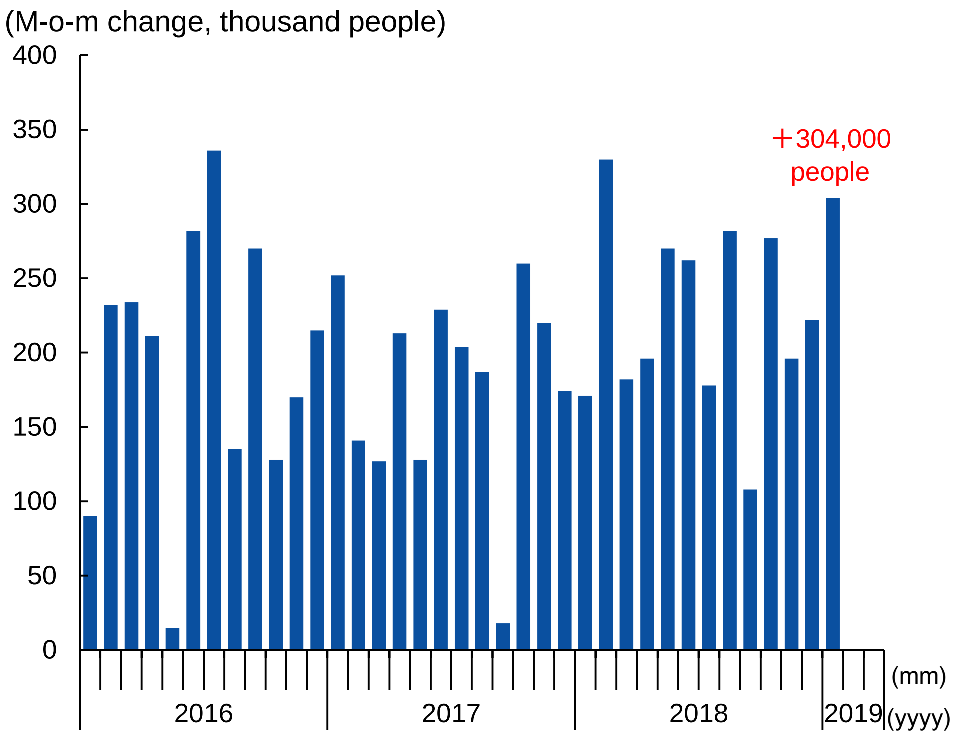


Note: The potential growth rate is shown y-o-y, and the actual growth rate is shown q-o-q. The actual growth in Q4 2018 is based on GDPNow of the Federal Reserve Bank of Atlanta.
Source: Made by MHRI based upon US Department of Commerce, NBER, Federal Reserve Bank of Atlanta

Employment data for January 2019 indicates the strength of the labor market

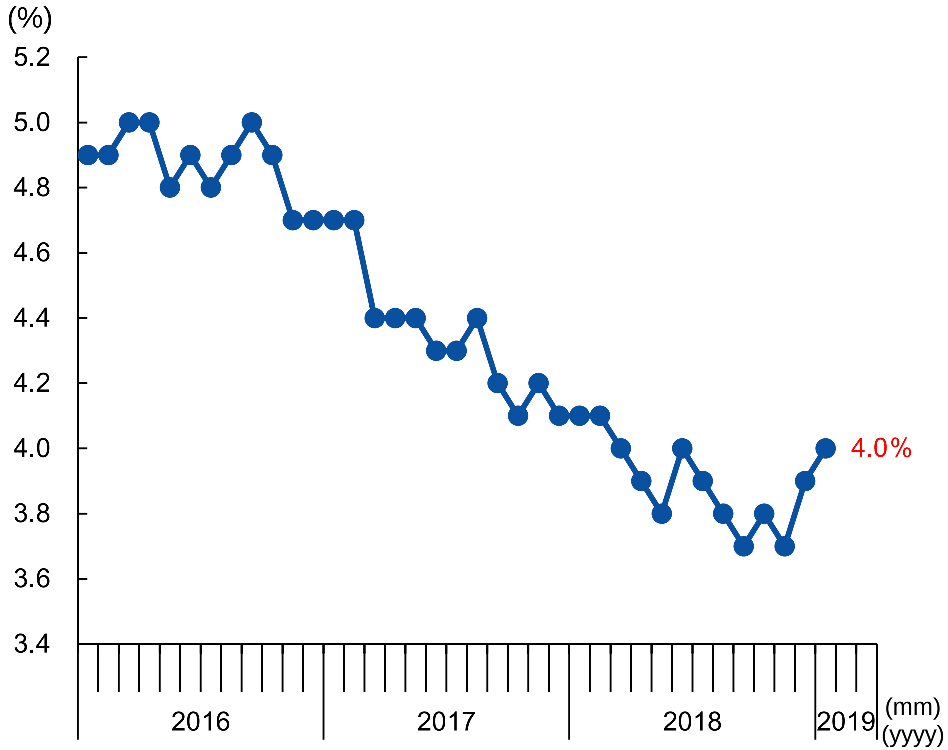
- In January 2019, nonfarm payrolls (NFP) rose +304 thousand m-o-m. The unemployment rate stood at 4.0%, while hourly wages increased +3.2% y-o-y.
  - The three-month average NFP is strong with +241 thousand people per month. The rise in the unemployment rate should be taken as positive as it stems from the rise in the labor force participation rate.
  - It was confirmed that a rising sense of economic slowdown, as shown in the decline in business sentiment, has yet to spread to the labor market.

[Nonfarm payrolls]



Source: Made by MHRI based upon US Department of Labor, Bloomberg

[Unemployment rate]

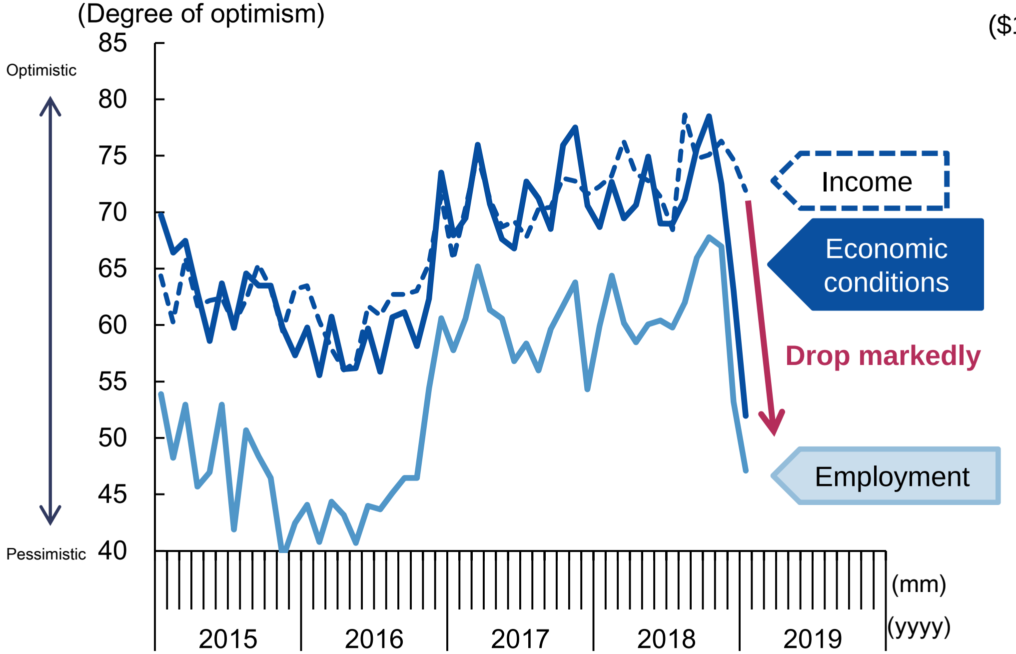


Source: Made by MHRI based upon US Department of Labor, Bloomberg

Strong optimism about the future among consumers receded in late 2018 due to stock market fall and government shutdown

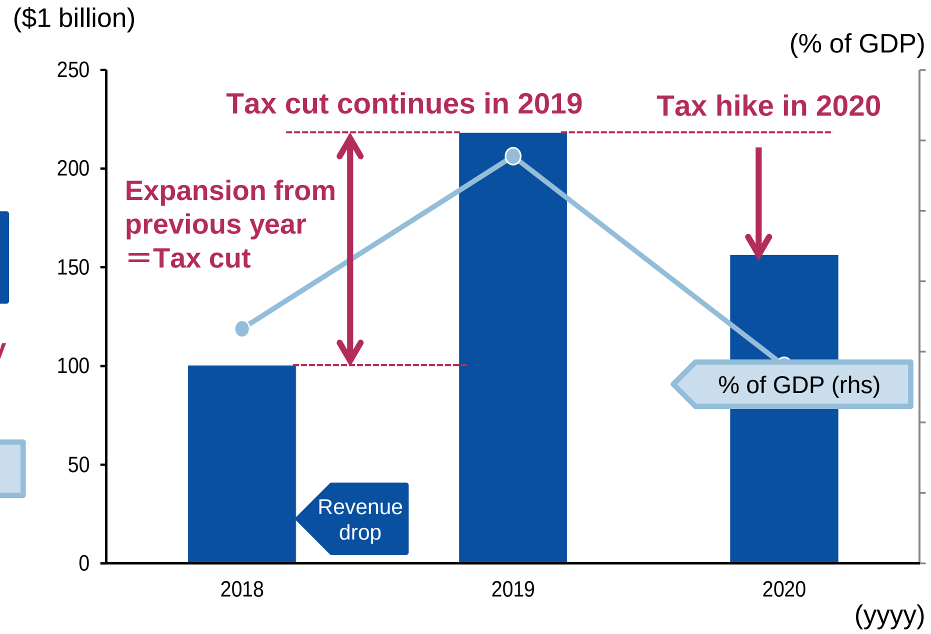
- ❑ If concerns over the economy and employment going forward grow stronger, the effect of the tax cut may not materialize, leading to a slowdown in consumption.
  - The Conference Board's Expectations Index for December showed a sharp drop of 13.2 points m-o-m, the biggest fall since August 2011. Optimism about the future outlook of business and employment conditions receded significantly. Even though the Index of Consumer Expectations of the University of Michigan picked up somewhat in February 2019, it still remains on a moderate downward path. While American households can expect to benefit from the tax cut of the same size as the previous year, the income gains due to the tax cut would most likely go into savings in the event of a deterioration of consumer sentiment.
    - ✓ In 2018, the income gains from the tax cut (0.7% of GDP) appears to have been channeled directly to consumer spending. But the same may not be expected in 2019.

[Degree of consumer optimism about the future]



Note: Degree of optimism = Calculated under the formula of "Percentage of positive replies about the future" / "Sum of positive and negative replies"
Source: Made by MHRI based upon Conference Board

[Size of personal income tax cut]

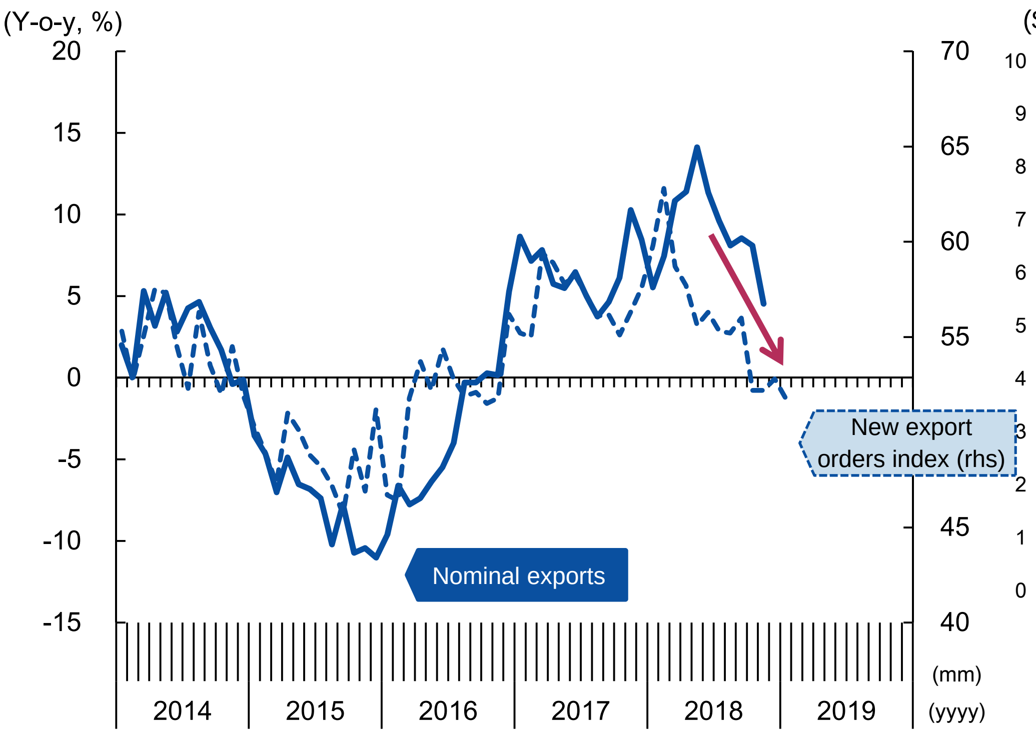


Source: Made by MHRI based upon CBO, JCT

US exports are slowing. China-bound exports worsen, given downward pressures due to US-China trade tensions

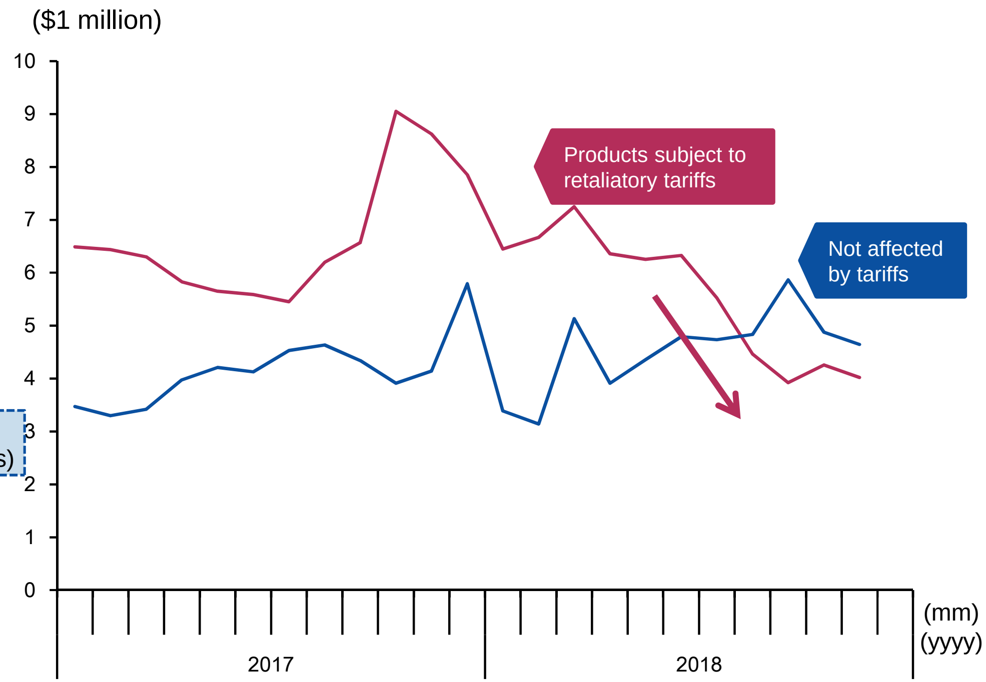
- The new export orders index of the US manufacturing sector declined sharply in the second half of 2018.
  - China-bound exports fell 30% y-o-y as of October 2018. The deterioration concentrated on products subject to China's imposition of retaliatory tariffs against the US.

[US export trends]



Source: Made by MHRI based upon US Department of Commerce, ISM

[China-bound exports and China's retaliatory tariffs]



Note: Retaliatory tariffs are China's countermeasures against the US imposition of Section 232 tariffs on steel and aluminum and Section 301 sanctions tariffs.

Source: Made by MHRI based on US Department of Commerce

US monetary policy: FOMC (January 29-30) backpedals on gradual rate hikes, signaling an end to the rate hike phase

- Background factors include "reversed currents," such as the slowing overseas economies and tightening financial conditions, muted inflation pressures and receding financial imbalance risks.
  - Backpedaling on the gradual rate hike policy while maintaining the favorable economic outlook suggests a long period of no changes in policy rates (an end to the rate hike phase).
    - ✓ If the FOMC adopted a temporary wait-and-see stance, it would suffice to simply add the wording like "we will wait and see patiently" to the statement without backpedaling on the gradual rate hike policy.
  - According to the FOMC minutes, many participants observed that "if uncertainty abated, the Committee would need to reassess the characterization of monetary policy as 'patient' and might then use different statement language."
  - FOMC participants agreed that it is important to be flexible in managing the process of balance sheet normalization in light of economic and financial developments. Almost all participants thought that it would be desirable to announce "before too long" a plan to stop reducing the Federal Reserve's asset holdings later this year.

[Key changes in January FOMC statement
(Comparison with December 2018 Statement; 2nd paragraph)]

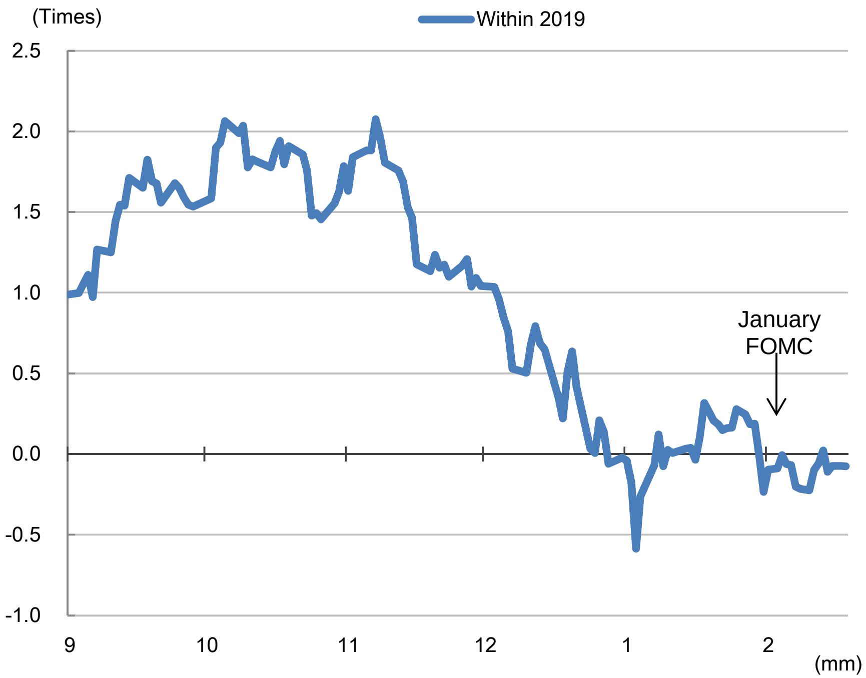
	Statement of January 2019	Statement of December 2018
Main scenario	The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes.	(No particular comment)
Risk judgment	(No particular comment)	The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.
Future policy	In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.	The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.

Source: Made by MHRI based upon FRB

US bond market: US long-term interest rates hover in the higher half of the 2% range following the FRB's dovish stance

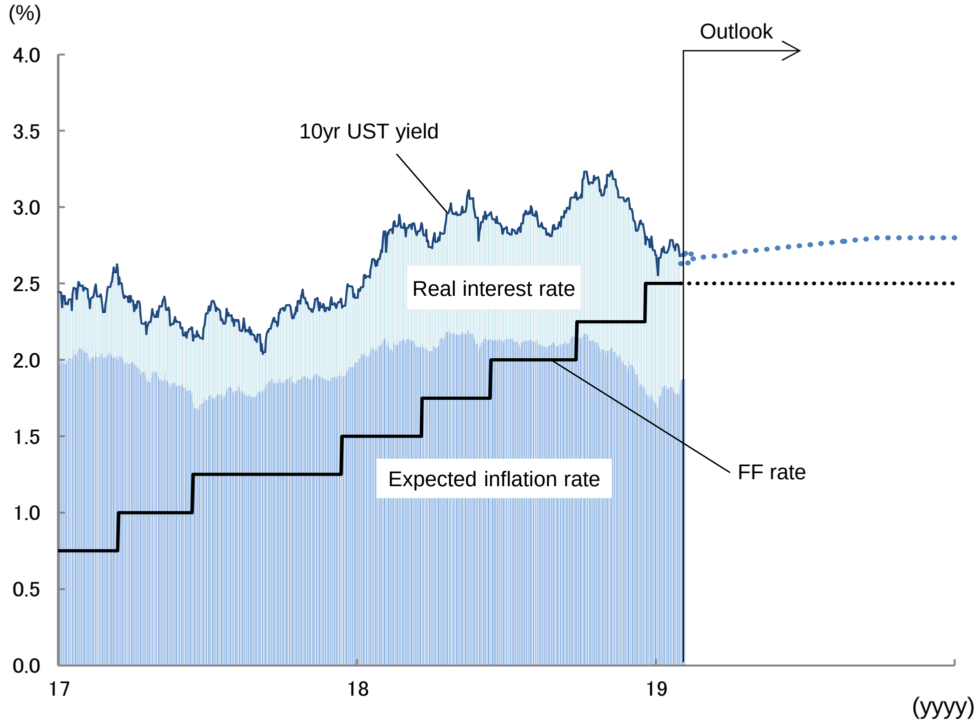
- ❑ The 10yr UST yield rose since the turn of the year, but fell significantly after the January FOMC meeting.
  - Market participants have been discounting the rate hike in 2019 on the back of robust economic fundamentals. But expectations have dipped into negative territory again.
- ❑ Investors remain cautious in their economic outlook, and the 10yr UST yield is expected to hover in the higher half of the 2% range for some time to come.
  - As there is little concern over an acceleration of inflation, market expectations about a hike in the federal funds rate remain subdued.

[US federal funds rate outlook of market participants]



Note: The rate hike path expected from FF rate futures
Source: Made by MHRI based upon Bloomberg

[10yr UST yields and expected inflation rates]

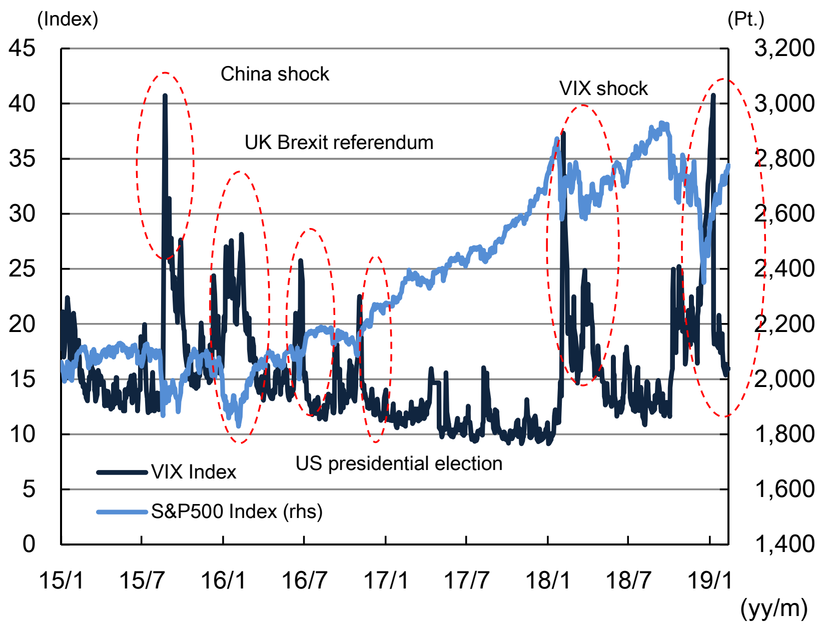


Note: The expected inflation rate is the breakeven inflation rate (10yr).
Source: Made by MHRI based upon Bloomberg

US stock market: likely to react nervously to US-China trade talks, but underpinned by the FRB's slower pace of tightening

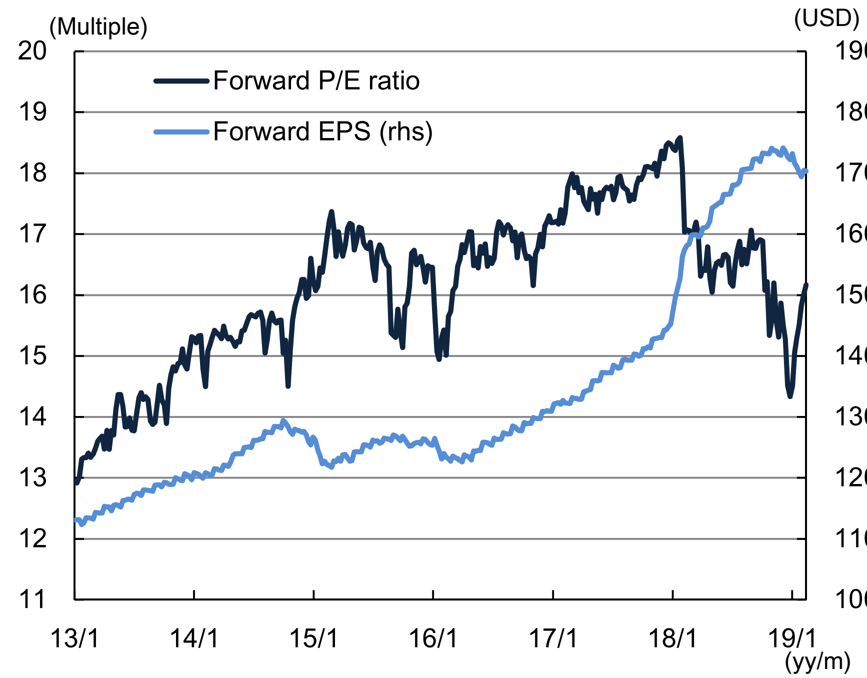
- Pessimism observed at the year-end and the turn of the year was somewhat corrected and stocks went on a stronger uptrend after the FRB indicated a cautious stance regarding monetary policy normalization and overall corporate earnings turned out to be better than expected.
  - The VIX Index also remained below 20.
- Toward the end of the corporate earnings announcement season, stock prices may react nervously to the direction of US-China trade talks. The slower pace of monetary policy tightening is serving to support the stock market.
  - However, as improvements in corporate earnings are taking a breather, rising stock prices are pulling up the forward P/E ratio back to 16x. Watch out for an acceleration of the pace of increases in the forward P/E ratio going forward

[S&P500 Index and VIX Index]



Note: The CBOE Volatility Index (VIX Index) is the index of implied volatility of S&P500 options. VIX is said to indicate the level of investors' anxiety and the level of 20 represents the threshold of rising anxiety.
Source: Made by MHRI based upon Datastream, Bloomberg

[Trends of forward P/E ratio and EPS for S&P500 Index]



Note: Forward P/E ratio and EPS are for 12 months ahead.
Source: Made by MHRI based upon Datastream

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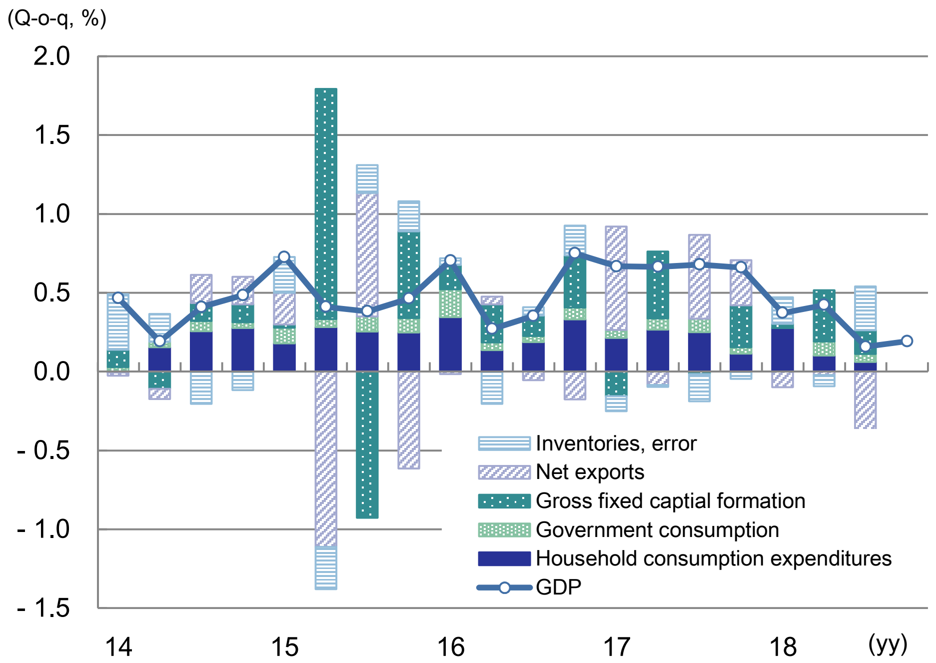
3. The European economy: the Eurozone economy loses momentum in the second half of 2018

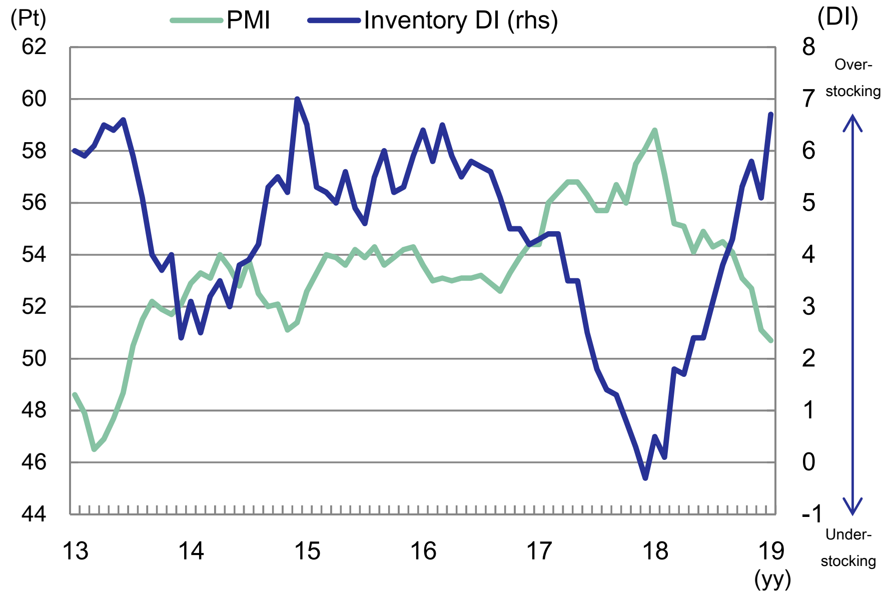
- Eurozone real GDP growth stood at +0.2% q-o-q in the Oct-Dec quarter 2018, remaining low as in the preceding quarter.
  - France (+0.3% q-o-q) saw personal consumption level off from the preceding quarter, while Italy (-0.2% q-o-q) remained in negative territory for the second consecutive quarter. Among major economies, only Spain accelerated economic growth. Even though German economic growth picked up from the preceding quarter, the rebound remains weak.
  - Along with the rise of wide-ranging uncertainties, including the future course of the US and Chinese economies, the slower Eurozone growth stemmed primarily from the fall of new orders and accumulation of inventories.
    - ✓ Slowing automobile output in Germany and anti-government demonstrations in France also adversely affected Eurozone growth. But the slowdown cannot be described as temporary due to special factors.

[Trends of Eurozone real GDP growth rate]



Source: Made by MHRI based upon Eurostat

[Eurozone PMI and Inventory DI]



Note: The inventory DI is obtained by asking whether inventories are excessive or not compared with the normal level of inventories. The figure zero is the threshold of judgment.

Source: Made by MHRI based upon European Commission, Markit

ECB should find a rate hike in 2019 difficult. A rate hike in 2020 may also be a tall order

- The ECB at its Governing Council meeting on January 24 kept the monetary policy framework unchanged.
  - The ECB acknowledged that the risks surrounding the euro area growth outlook had moved to the downside, from neutral previously.
- The first rate hike in 2019 appears difficult. A rate hike in 2020 depends on price trends, but may still be a tall order as inflation remains subdued.
  - Unless underlying prices go up, the forward guidance about the policy rate needs to be changed.
  - Another focal point is whether the ECB will take some measures to deal with a decline in the financial intermediation function associated with the prolongation of negative interest rates.

[Summary of ECB Governing Council (January 2019)]

Economic conditions	Recent data and survey results (on the Eurozone economy)had continued to be weaker than expected, on account of softer external demand due to specific factors in some country and sectors.
Economic outlook	The risks surrounding the euro area growth outlook had moved to the downside, as the persistence of uncertainties related to geopolitical factors and the threat of protectionism, vulnerabilities in emerging markets and financial market volatility was increasingly weighing on economic sentiment (the previous wording of "broadly balanced" deleted).
Prices	Underlying inflation remained generally muted, but was expected to increase over the medium term on the back of the ECB's easier monetary policy, high levels of capacity utilization and rising wage growth.
Forward guidance on the policy rate	In discounting the rate hike in 2020, the financial markets are discounting the state-contingent leg of the policy rate guidance (maintain low interest rates "in any case as long as necessary"). This indicates that in the formation of expectations based on the economic outlook, market participants understand our policy reaction function.
Targeted longer-term refinancing operations	Some members took up targeted longer-term refinancing operations (TLTRO), but we did not discuss TLTRO at the latest meeting…TLTRO is very useful and efficient in order to restore the penetration of monetary policy effects in the Eurozone…It is not the tool directed at individual sectors or individual countries.

Source: Made by MHRI based upon ECB

[ECB forward guidance (January 2019)]

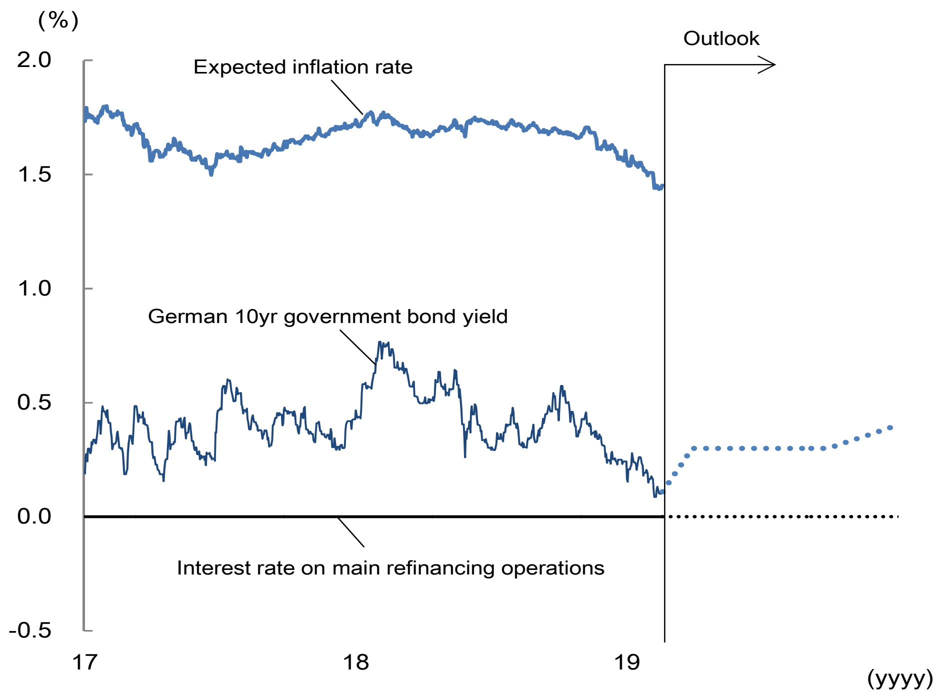
	ECB Governing Council on January 24, 2019	Point
Policy rate	**The ECB expected the key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation with the ECB's expectations.**	If prices fail to go up past the summer (May through September?), how is the ECB going to amend its forward guidance?
Reinvestment	The Governing Council intended to continue reinvesting **for an extended period of time past the date when it started raising the key ECB interest rates**, and in any case for as long as necessary to maintain favorable liquidity conditions and an ample degree of monetary accommodation.	Reinvestment is allocated accordance to the balance of purchases pursuant to the capital key. Any reallocation is to be conducted in a moderate manner.

Source: Made by MHRI based upon ECB

German long-term interest rates hover at low levels given a spate of weak economic indicators

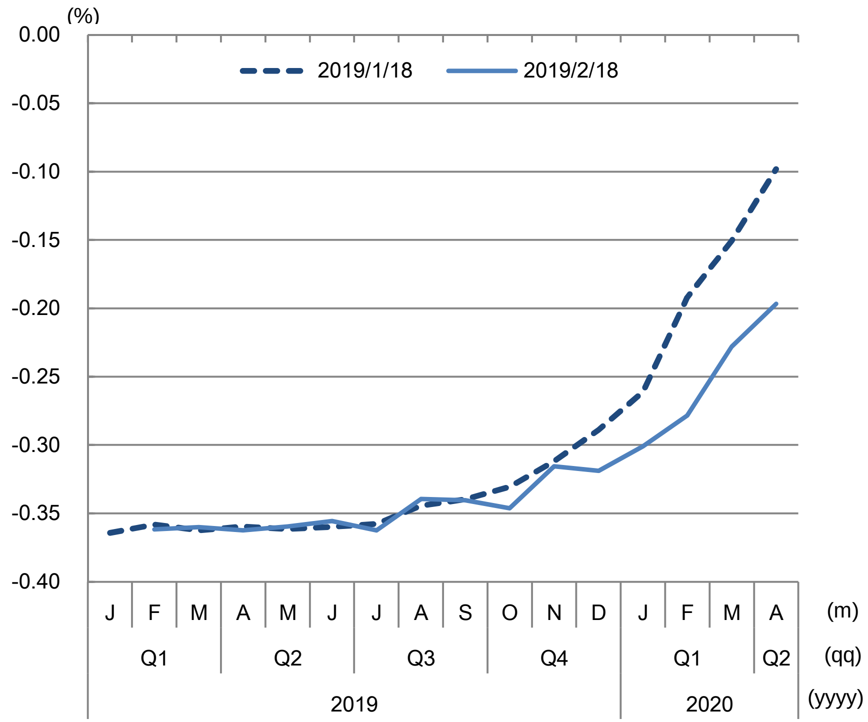
- ❑ As the European Commission revised downward its outlook on Eurozone economic growth, the German 10yr government bond yield temporarily fell to the lowest level in approximately two years.
  - Amid a spate of weak economic indicators, the Brexit quandary continued to smolder, leading to the decline of German interest rates.
- ❑ With the recent risk-off mood on the markets likely to continue for some time to come, German long-term interest rates are expected to hover at low levels.
  - The discounting of interest rate hikes receded further from the preceding month.

[German 10yr government bond yield and expected inflation rate]



Note: The expected inflation rate is the five-year forward five-year inflation swap forward rate.
Source: Made by MHRI based on Bloomberg

[Eurozone policy rate outlook of market participants]

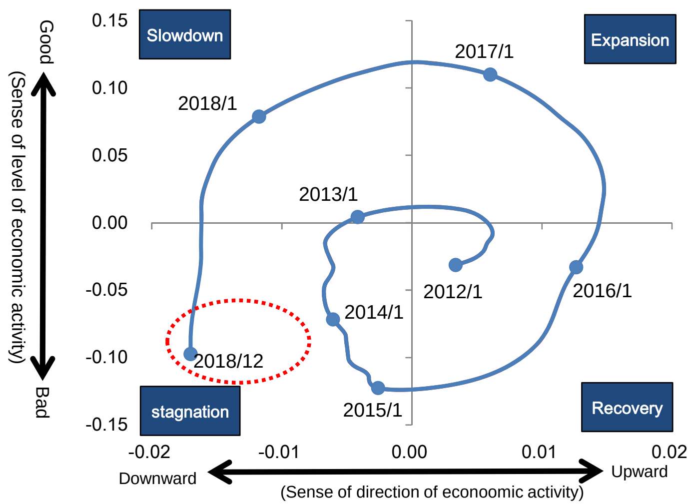


Note: EONIA forward rate curve
Source: Made by MHRI based on Bloomberg

4. The Chinese economy : China remains stagnant

- The Chinese economy remains stagnant. Looking forward, the economy will likely continue to stagnate as the downturn of exports intensifies due to the impact of trade tensions.
  - The business cycle clock of the diffusion index entered a slowdown phase in 2017 and moved down into the phase of stagnancy in the second half of 2018.
  - The production-inventory balance moved into negative territory in the Oct-Dec quarter of 2018 for the first time in three years. Past negative phases lasted for an average of seven quarters. If the balance continues to stay negative for a period similar to the past average, the breadth of the balance in negative territory will likely stop widening around the middle of 2019 and move back into positive territory only in the second half of 2020.
    - ✓ Even though the economy is expected to emerge out of the stagnant phase of the business cycle clock around the middle of 2019, the stagnancy may persist if US-China trade tensions worsen.

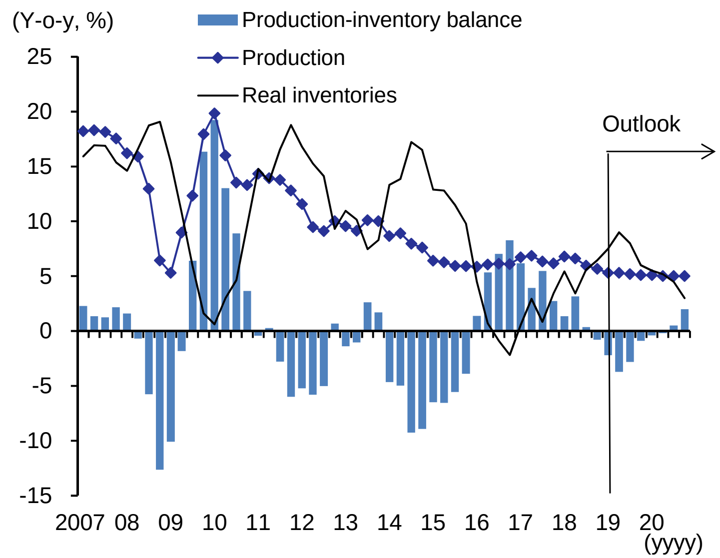
[Business cycle clock of China's diffusion index]



Note: The diffusion index comprises six indices of production, retail sales of consumer goods, investment in fixed assets, exports, ratio of job offers to applicants and corporate earnings, respectively standardised, and adjusted to remove the trend and outliers, weighted equally. The Y-axis plots the upward and downward divergence from the trend, while the X-axis plots the variation (m-o-m change) in the time series for the cycle components.

Source: Made by MHRI based upon National Bureau of Statistics of China and the General Administration of Customs, China

[Outlook for production-inventory balance]



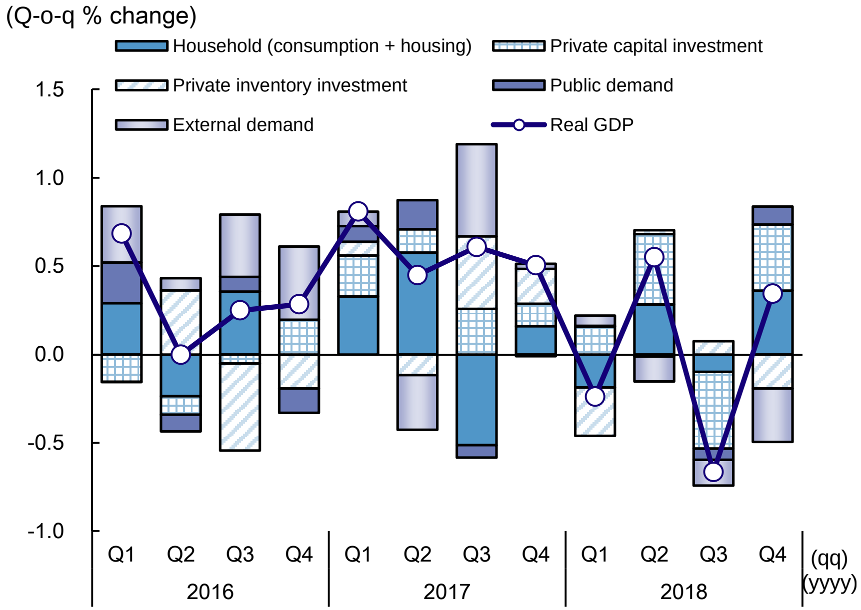
Note: The production-inventory balance = Production q-o-q – inventory q-o-q. Inventory is made real with the use of PPI.

Source: Made by MHRI based upon National Bureau of Statistics of China, General Administration of Customs of China

5. The Japanese economy: real GDP in the Oct-Dec quarter grew at an annual rate of +1.4%, but was still flabby

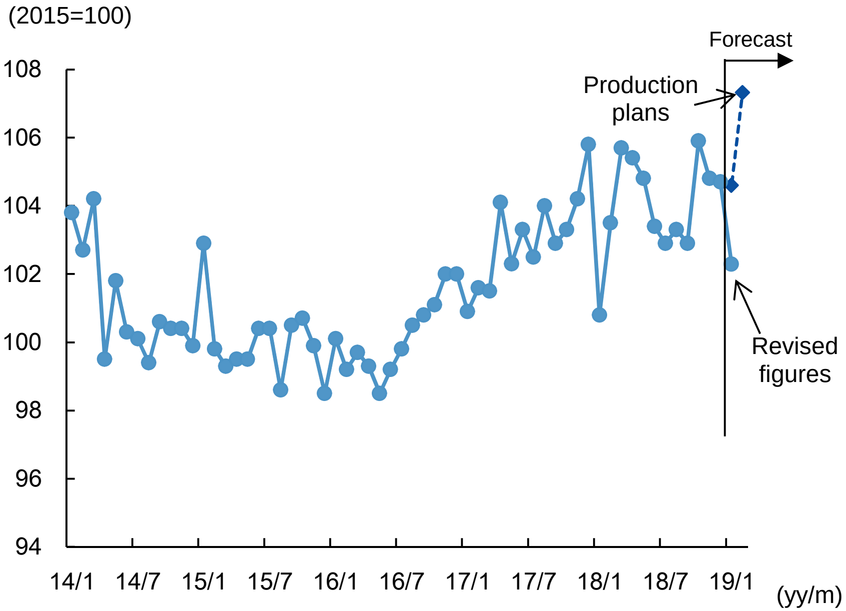
- ❑ Even though Japan's real GDP grew +0.3% q-o-q (+1.4% p.a.) in the Oct-Dec quarter, recording positive growth for the first time in two quarters, it lacked momentum.
  - Despite expectations toward a strong due to the ebb of negative effects of the natural disasters during summer, real GDP fell short of recouping the drop in the Jul-Sep quarter.
  - While domestic demand such as personal consumption and capital investment was firm, external demand and public investment turned out to be a drag on growth.
- ❑ Industrial production growth in the Oct-Dec quarter remained a moderate +1.9% q-o-q.
  - Production plans suggest that industrial production in the Jan-Mar quarter may stay subdued. Production is expected to slow down, reflecting a moderation of shipments bound overseas.

[Trends of quarterly real GDP]



Source: Made by MHRI based on Cabinet Office, *Preliminary Quarterly Estimates of GDP*

[Trends of industrial production index]



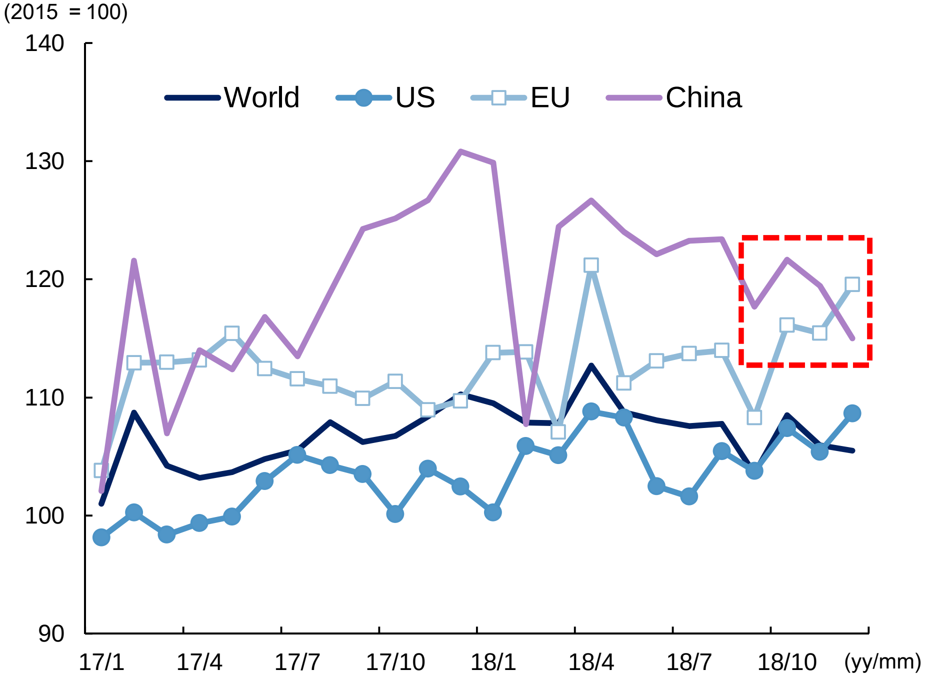
Source: Made by MHRI based upon Ministry of Economy, Trade and Industry, *Indices of Industrial Production*

External demand: China-bound exports falling recently. Export growth should be weak due to overseas economic slowdown

❑ Japan's exports to China are falling. Looking forward, export growth should remain weak, reflecting the slowdown of overseas economies.

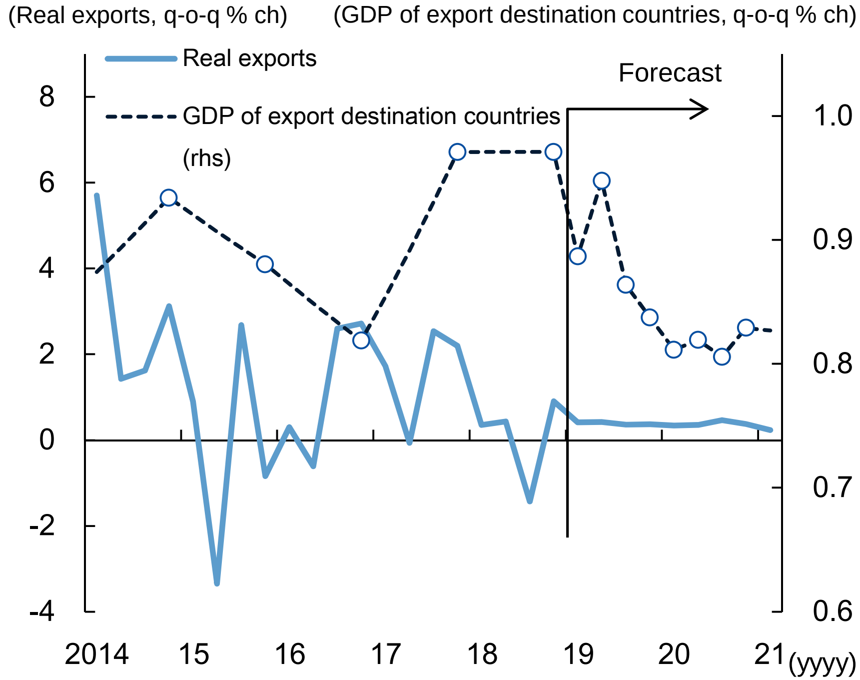
- By commodity, exports of general machinery are falling. This may stem from the postponement of investment due to uncertainties regarding trade tensions, in addition to the slowdown of the Chinese economy.
- Japan's export growth should remain tepid for some time to come, given the ongoing slowdown of the overseas economies (mainly China), and peak-out of IT demand.

[Export volume index (by region)]



Note: Seasonally adjusted figures by MHRI
Source: Made by MHRI based upon Ministry of Finance, *Trade Statistics*

[SNA real exports and GDP of export destination countries]

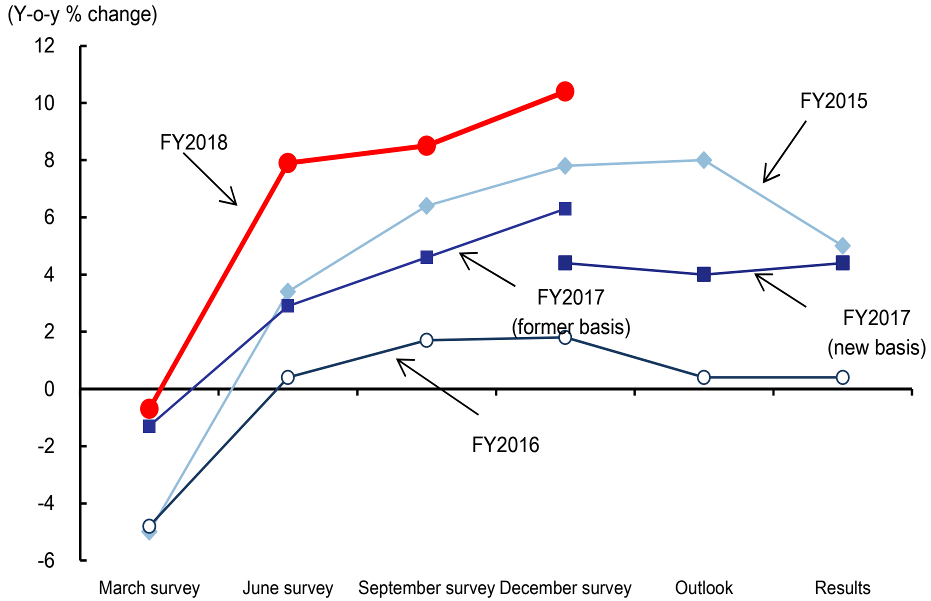


Note: GDP for export destination countries is the average real GDP of Japan's major export destination countries weighted by export value. Quarterly data only for 2019-2020.
Source: Made by MHRI based upon IMF, *World Economic Outlook*, Ministry of Finance, *Trade Statistics*

Fixed investment: even though fixed investment is supported by needs for labor-saving investment, the pace of growth is gradually moderating due to adjustment pressures

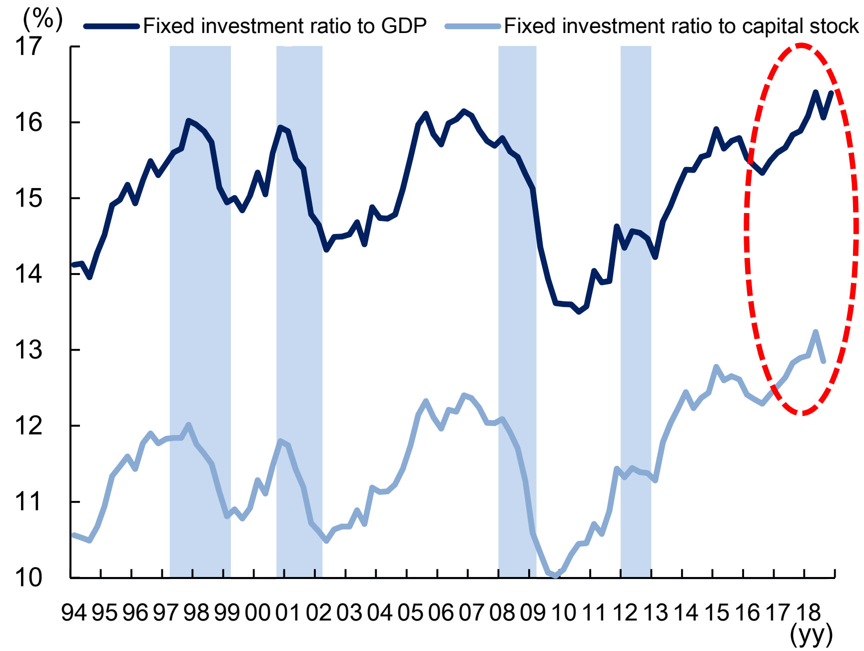
- Corporate investment incentive remains strong. Looking forward, fixed investment will likely continue to be supported by high levels of corporate earnings and needs for rationalization and labor-saving investment.
  - On the other hand, fixed investment has already reached very high levels in terms of the ratio to capital stock. Growth of fixed investment is expected to slow down gradually under adjustment pressure.

[Fixed investment (BOJ *Tankan* December 2018 survey)]



Note: Includes land purchasing expenses, but excludes software and R&D investment.
Source: Made by MHRI based upon Bank of Japan, *Short-term Economic Survey of Enterprises in Japan (TANKAN)*

[Fixed investment ratio to GDP, fixed investment ratio to capital stock]

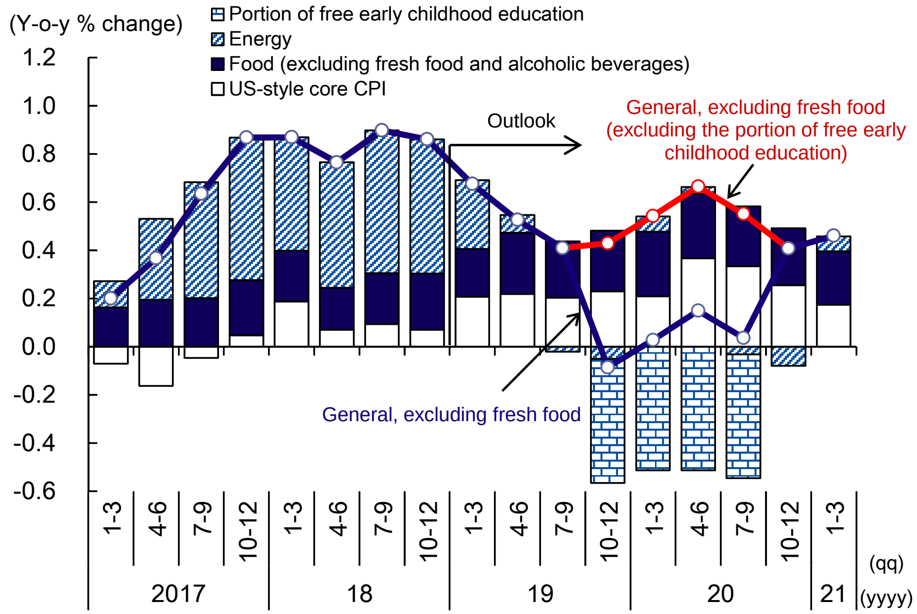


Note: The shaded areas indicate periods of recession.
Source: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP* , *Quarterly Estimates of Net Capital Stocks of Fixed Assets*

Prices: price rise expected to slow due to sluggish crude oil prices. Cuts in cellphone communication charges may push down prices further

- ❑ Given sluggish crude oil prices serving as a drag upon prices, the rise of the core CPI should gradually slow down.
  - The rise in core CPI is expected to slow temporarily to around 0%. Even when the factor of free early childhood education is excluded, the price rise is still likely to be slow.
- ❑ There is the risk that reductions in cellphone communication charges and free higher education may push down prices further.
  - The negative impact of cuts in communications charges by the three mobile phone carriers upon CPI is estimated at to be -0.9% at most (on the assumption of 40% reductions from April 2019).
  - If free higher education is introduced in April 2020, the measure may push down CPI by -0.1% at most.

[Contribution breakdown of core CPI (General, less fresh food)]



Note: Excluding the impact of the consumption tax hike. US-style core CPI excludes the impact of free early childhood education.
Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index*

[CPI downside risk factors]

Factor	Details	Commencing timing	Impact on core CPI
Cut in cellphone communications charges	Assuming that three major cellphone carriers reduce communication charges by 40%	Apr-Jun quarter 2019	-0.9%
Free private high school and higher education	Provision of school entrance fees and part of tuition according to household income	April 2020	-0.1%

Note: 1. Higher education means education at universities, two-year colleges, specialized vocational high schools and vocational technical schools.
2. The margin and timing of reductions in cellphone communication charges are yet to be decided, as are details of the institutional design of free higher education. Since the assumptions may vary, the price estimates need to be interpreted with considerable leeway.
Source: Made by MHRI based on various news reports, Cabinet Office, *New Economic Policy Package*, Ministry of Internal Affairs and Communications, *Consumer Price Index, Family Income and Expenditure Survey*

Japanese monetary policy: BOJ *Outlook Report* lowers the consumer price forecast

- ❑ The Bank of Japan (BOJ) lowered its outlook on prices in the *Outlook for Economic Activity and Prices* (“*Outlook Report*”) released on January 23, 2019. Despite heightened awareness on uncertainties regarding the future course of the global economy, the BOJ raised its outlook on economic growth, reflecting the government’s measures to ease the impact of the scheduled consumption tax hike.
  - Since the BOJ’s price outlook did not factor in the impact of anticipated cuts in cellphone communication charges, the outlook may be subject to downward revisions. The BOJ remains alert to a downswing of inflation expectations.
- ❑ The BOJ will likely keep policy interest rate unchanged by forward guidance until it ascertains impact of the consumption tax rate hike. In the event of a sharp rise of the yen, a policy option may be to push interest rates further down into negative territory. However, the BOJ will most likely be cautious in its judgment in light of potential adverse side effects.

[*Outlook Report* (January 2019)]

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hike
Fiscal 2018	+0.9 ~ +1.0 (+0.9)	+0.8 ~ +0.9 (+0.8)	
Forecasts made in October 2018	+1.3 ~ +1.5 (+1.4)	+0.9 ~ +1.0 (+0.9)	
Fiscal 2019	+0.7 ~ +1.0 (+0.9)	+1.0 ~ +1.3 (+1.1)	+0.8 ~ +1.1 (+0.9)
Forecasts made in October 2018	+0.8 ~ +0.9 (+0.8)	+1.5 ~ +1.7 (+1.6)	+1.3 ~ +1.5 (+1.4)
Fiscal 2020	+0.7 ~ +1.0 (+1.0)	+1.3 ~ +1.5 (+1.5)	+1.2 ~ +1.4 (+1.4)
Forecasts made in October 2018	+0.6 ~ +0.9 (+0.8)	+1.5 ~ +1.7 (+1.6)	+1.4 ~ +1.6 (+1.5)

Note: Forecasts of the majority of Policy Board members. Figures in parentheses indicate the medians of the Policy Board members’ forecasts.
Source: Made by MHRI based upon Bank of Japan

[Options for additional easing]

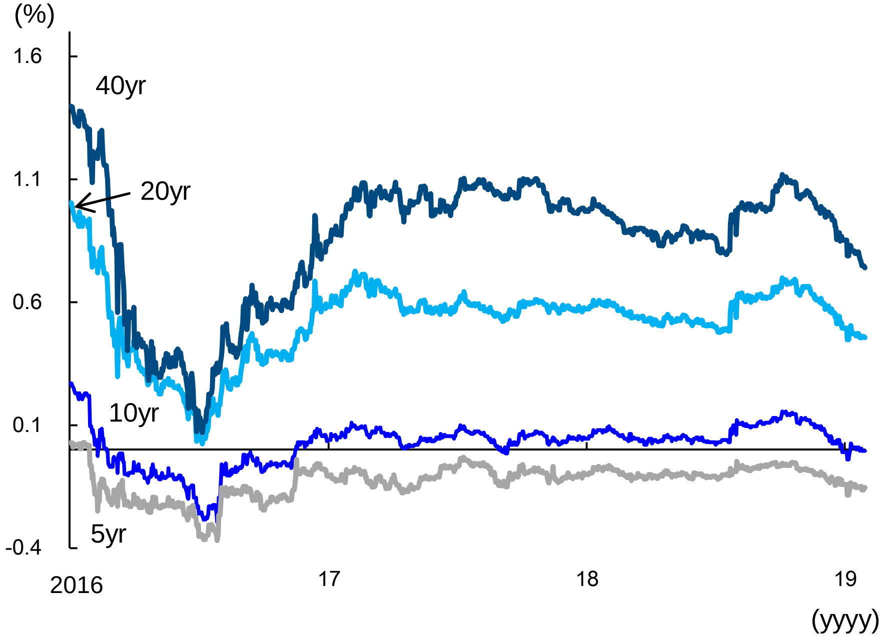
Policy Tool		Probability
Pushing the negative interest rate further down	* Expand the negative margin of the policy interest rate, as an option in the event of the sharp rise in the yen. * There are concerns that further drops in long-term interest rates would result in the worseneing of investment performance of life insurers and pension funds and an adverse impact on profits of financial institutions due to narrowing spreads between deposit and lending rates.	Low
Reducing the lending rate on the Loan Support Program into negative territory	* Deal with concerns over a possible downswing of profits of financial institutions by reducing the lending rate on the Loan Support Program, thereby creating room for pushing down the already negative policy interest rate deeper into negative territory. * This might have the risk of stimulating calls for the reduction in existing lending rates, with adverse side effects possibly more than offsetting the policy effects.	Low
Lengthening of the target maturity of the yield curve control	* Strengthen downward pressure on yields in the entire yield curve by lengthening the target maturity of the yield curve control from the current 10 years to 20 years. * It remains to be seen whether pushing interest rates further down would have the effect of boosting the economy and pushing up prices. Any further drop in yields of ultralong-term bonds would adversely affect investment by pension funds and life insurers. * If lower interest rates dampen demand for the yen, this can be expected to produce a favorable effect on exchange rates.	Possible
Expansion of ETF purchases	* Expand the increase in ETF purchases from the current 6 trillion yen a year. This can be expected to have the effect of underpinning the stock market in the event of sharp falls in stock prices. * But this spawns concerns over the side effects, including the distortion of the market functions or the greater risk of the BOJ incurring losses.	Possible
Expansion of JGB purchases	* The effects of boosting the economy and pushing up prices are uncertain. * This policy is not sustainable if the government issues more JGBs. Thus, it is hard for the BOJ to boost JGB purchases substantially. * There is the risk that this policy may sharpen criticisms against monetization by the central bank.	Possible

Source: Made by MHRI

Japanese long-term interest rates: 10yr JGB yield hovers in negative territory amid speculation that the BOJ will continue to take monetary easing stance

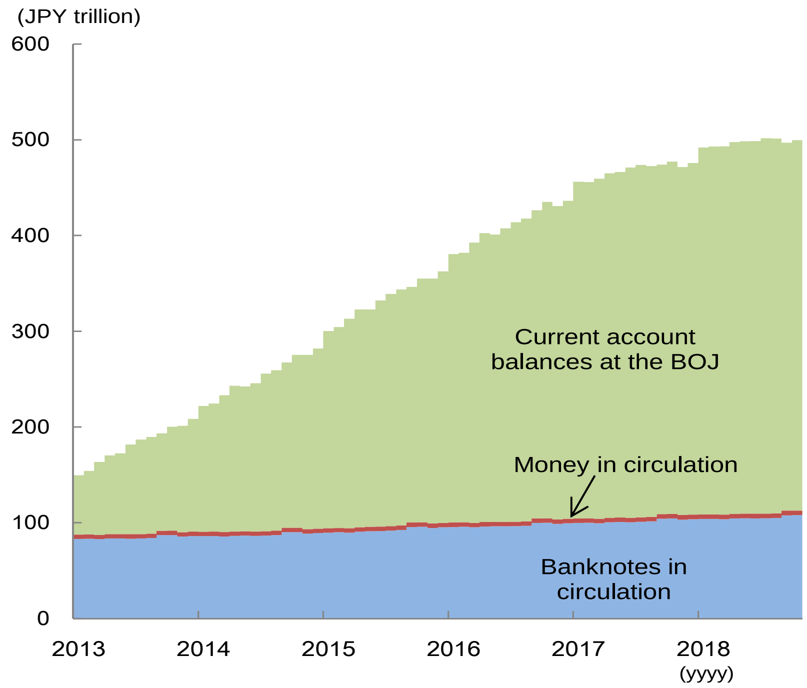
- Amid the ebb of speculation that the BOJ will shift its monetary policy stance, JGB yields declined, mainly in the ultralong-term zone, prompting a flattening of the yield curve. The 10yr JGB yield is expected to hover in the range of -0.1% to +0.1% for some time to come.
- Since the second half of 2018, the growth of monetary base has been slowing due in part to redemptions of JGBs held by the BOJ. Speculation that the pace of reductions in the BOJ's JGB purchases will slow, prompted in part by the BOJ's move to significantly increase its purchases of T-bills (Treasury Discount Bills), may be working to push down interest rates.

[Trends of 10yr JGB yield]



Source: Made by MHRI based upon Bloomberg

[Trends of monetary base]

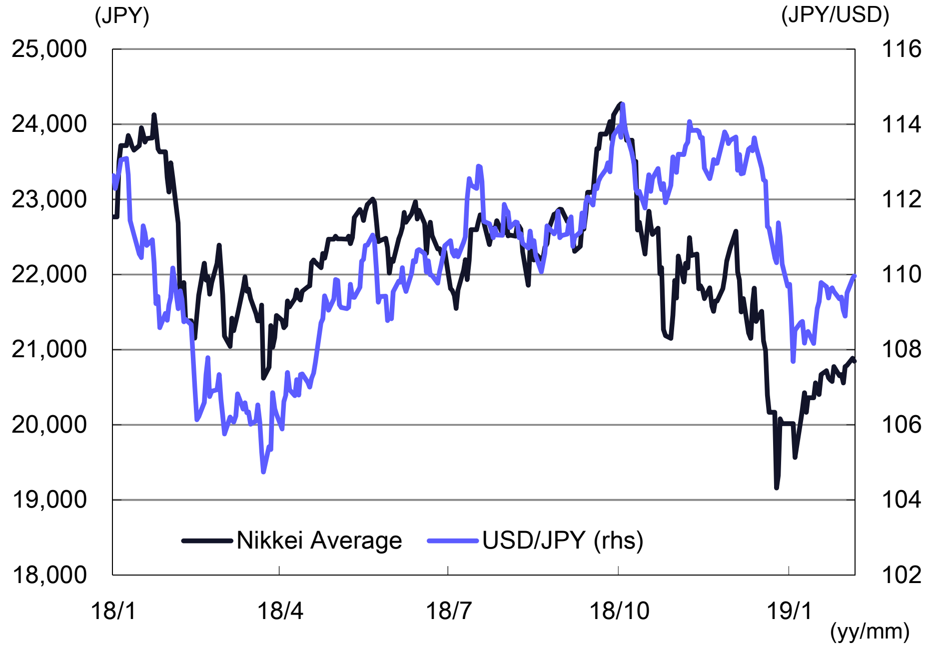


Source: Made by MHRI based upon Bank of Japan

Japanese stock market: concern over a stronger yen suppressing the upside, but room exists for further advance

- ❑ Japanese stocks are rising in tandem with higher stock prices globally. But the margin of rise is limited compared with the US stock market as the upside is being suppressed by concern over a stronger yen due to an apparent slowing of the pace of US monetary policy tightening.
- ❑ Lingering concern over a stronger yen ahead of Japan-US trade negotiations is holding expectations about corporate earnings going forward in check. In terms of valuation, however, the forward P/E ratio is in the range of 12x, leaving some room for further advances of stock prices if the risk of the yen advancing sharply fades away.
  - In terms of the average P/E ratio of 14x since the introduction of Abenomics, the current price levels have discounted a drop of nearly 5% in corporate earnings in FY2019. Which is more pessimistic than the market consensus.

[Nikkei Average and USD/JPY exchange rate]



Source: Made by MHRI based upon Bloomberg

[Nikkei average estimated from forward EPS and P/E ratio]

Current stock price level

Nikkei Average (JPY)	FY2019 forward EPS				
	Market forecast 7.6% profit rise (JPY131)	5% profit rise (JPY128)	±0% (JPY122)	5% profit fall (JPY116)	10% profit fall (JPY110)
P/E ratio 11x	18,800	18,300	17,400	16,600	15,700
P/E ratio 12x	20,500	20,000	19,000	18,100	18,100
P/E rato 13x	22,200	21,600	20,600	19,600	18,600
P/E ratio 14x	23,900	23,300	22,200	21,100	20,000
P/E ratio 15x	25,600	25,000	23,800	22,600	21,400

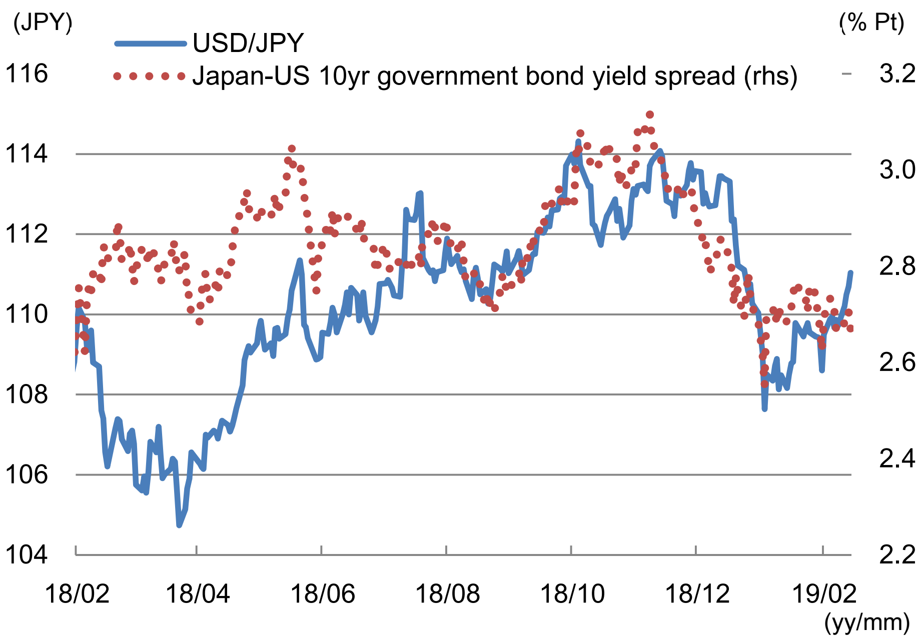
Prospective range

Note: Estimates based on the TOPIX forward EPS as of February 1, 2019, and the Nikkei/TOPIX ratio of 13x.
Source: Made by MHRI based upon Datastream, Bloomberg

6. Forex market trends: USD/JPY exchange rate unlikely to go much higher

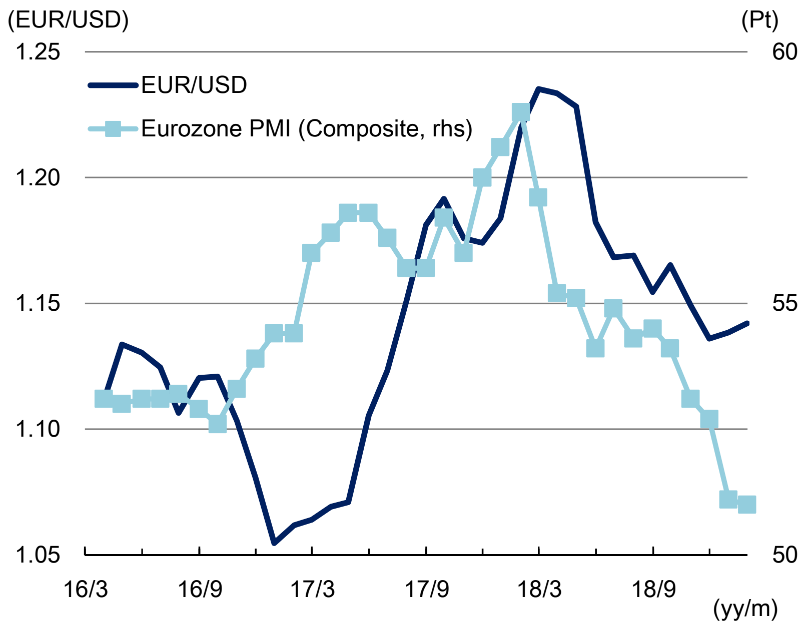
- The USD/JPY exchange rate remains top-heavy on the back of worries over the slowing global economy. Even though the USD/JPY rate rose above ¥111 temporarily on expectations of progress in US-China trade talks, uncertainties are lingering. The FRB indicated its cautious stance on the continuation of monetary tightening at the FOMC meeting in January, putting a damper on the US currency's advance.
- The EUR/USD exchange rate tended to weaken against the backdrop of deteriorating Eurozone economic fundamentals and lingering uncertainties regarding European politics. Market participants are concerned regarding Eurozone business sentiment, as indicated by ECB President Draghi's concerns regarding the Eurozone's economic outlook. The FRB's reinforcement of its dovish stance is underpinning the euro.

[USD/JPY exchange rate and future US policy interest rate]



Source: Made by MHRI based upon Bloomberg

[Euro exchange rate and Eurozone PMI]



Source: Made by MHRI based upon Bloomberg

7. Outlook on the financial markets

		Main scenario					Sub-scenario 1				Sub-scenario 2			
		Oct-Dec	2019 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2019/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2019 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
US	FF rate (qtr-end value, %)	2.25～2.50	2.25～2.50	2.25～2.50	2.25～2.50	2.25～2.50	2.25～2.50	2.50～2.75	2.75～3.00	3.00～3.25	2.00～2.25	1.75～2.00	1.50～1.75	1.25～1.50
	10yr UST bond yield (%)	3.03	2.70	2.75	2.80	2.85	3.00	3.40	3.60	3.60	2.20	2.00	1.60	1.60
	Dow Jones Average (USD)	24,891	24,700	26,000	26,000	26,500	26,000	27,000	28,000	29,000	24,000	23,000	22,000	21,000
Japan	Euroyen TIBOR (three months, %)	0.05	0.05	0.05	0.05	0.05	0.05	0.10	0.10	0.10	0.00	0.00	0.00	0.00
	10yr JGB yield (%)	0.09	0.02	0.10	0.10	0.10	0.05	0.10	0.20	0.20	0.00	-0.10	-0.10	-0.10
	Nikkei 225 Average (JPY)	21,897	21,000	22,500	21,500	21,500	22,000	23,000	24,000	25,000	20,000	19,000	18,000	17,000
Europe	ECB repo rate (qtr-end value, %)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	10yr government bond yield (German bonds, %)	0.37	0.21	0.30	0.30	0.40	0.50	0.70	0.90	0.90	-0.20	-0.20	-0.20	-0.20
Forex	USD/JPY exchange (USD/JPY)	113	109	109	109	109	115	115	120	120	105	105	100	100
	EUR/USD exchange rate (EUR/USD)	1.14	1.14	1.14	1.13	1.13	1.10	1.10	1.05	1.05	1.20	1.20	1.30	1.30

- Sub-scenario 1 (upside scenario)
  - Long-term interest rates and stocks rise on heightened interest rate hike expectations driven by the acceleration of US economic recovery. The dollar continues to strengthen against the yen.
- Sub-scenario 2 (downside scenario)
  - Global economic slowdown, including Europe and the US, due to tariff hikes accompanying US protectionist policy. Long-term interest rates fall and stock prices fall. The dollar continues to weaken against the yen.