Monthly Economic Report

July 22, 2019
Mizuho Research Institute
The US-China Summit held in Osaka on June 29 agreed on the resumption of US-China trade talks.

- The US put off the imposition of the fourth round of additional tariffs on some $300 billion worth of Chinese goods.
  - On transactions with Huawei, US President Trump referred to possible approval of exports of products not involving security problems (See the following page).

There were no signs of progress seen in ministerial talks on the phone held on July 9.

- The remaining sticking points include the size of increase in China’s imports from the US, the handling of punitive tariffs and the necessity of improving legal systems in addressing structural issues.
  - President Trump voiced frustration over China’s failure to make good on its pledge to expand agricultural imports (China disavows such pledge).
  - China held on to its arguments prior to the suspension of trade talks, including the demand for removal of additional tariffs already imposed.

[ Issues in US-China trade tensions ]

<table>
<thead>
<tr>
<th>Issues</th>
<th>Current state of affairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade imbalance</td>
<td>China is seeking to reconcile the trade imbalance problem by raising imports from the US. But the rift remains unbridged as the size of import increases sought by the US does not appear to be commensurate with the reality.</td>
</tr>
<tr>
<td>Technology transfer</td>
<td>The US asserts that US companies operating in China are being pressed by the Chinese government to transfer their technologies to Chinese companies. China has prohibited administrative pressure for the transfer of technologies in a new foreign investment law enacted in March.</td>
</tr>
<tr>
<td>Intellectual property rights</td>
<td>The US asserts that the Chinese government is helping Chinese companies acquire US firms holding cutting-edge technologies. China denies the US allegation and says it is reinforcing efforts to protect intellectual property rights.</td>
</tr>
<tr>
<td>Subsidies</td>
<td>The US asserts that the Chinese government is providing unfair subsidies to promote Chinese companies under its “Made in China 2025” initiative. China asserts that its subsidy policy is consistent with WTO rules.</td>
</tr>
<tr>
<td>Enforcement monitoring procedure</td>
<td>The two countries are making adjustments to hold working-level talks every month, vice-ministerial talks quarterly and ministerial talks twice a year. China appears opposed to the US stance on penalties.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on US, Chinese government materials and various media reports

[ China’s arguments on US-China trade talks ]

- China, while criticizing the US stance, wants to continue talks
  - Strongly opposed to stronger pressure on China with punitive tariffs
  - (Sanctions against each other) must not be escalated unlimitedly

- “Three matters of principle” that cannot be compromised
  - To cancel all the punitive tariffs
    - Negotiations while the punitive tariffs remain in force are unacceptable
  - To make China’s goods purchases from the US (imports) reflect the reality more closely
    - Acceptable levels of imports have limits in view of an impact on the Chinese economy
  - To make the text for any trade deal more balanced
    - China wants a deal premised on “equality and dignity,” does not tolerate interference in domestic affairs

Source: Made by MHRI based on an interview of Vice Premier Liu He (May 10, 2019)
**Topic of the month (2)  impacts of restrictions on exports to South Korea**

- The Japanese government made a review of restrictions on exports of semiconductor materials to South Korea. If semiconductor output in South Korea is suspended or stagnates under the influence of export curbs, it would push down the Japanese economy through slower sales on the IT market due to delays in sales of smartphones and other products mounted with semiconductors.
  - South Korea accounts for 17% of Japan's semiconductor memory imports, which is low compared with Taiwan (50%).
  - The ratios of dependence on semiconductor imports from South Korea are higher in major IT products producers such as China, Taiwan and Vietnam than in Japan.

- Japan’s exports of semiconductor-manufacturing equipment may take a dive if South Korean semiconductor producers postpone their capital investment.
  - Semiconductor-manufacturing equipment occupies the top slot in Japan’s exports to South Korea. Semiconductor-manufacturing equipment is one of Japan’s major export items (2018: ¥1.3 trillion). South Korea has the largest share of 34% in Japan’s exports of semiconductor-manufacturing equipment.

[South Korean share in imports of semiconductor memories (2017)]

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Share (% of imports from S. Korea)</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>80</td>
</tr>
<tr>
<td>China</td>
<td>70</td>
</tr>
<tr>
<td>Taiwan</td>
<td>50</td>
</tr>
<tr>
<td>US</td>
<td>40</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
</tr>
</tbody>
</table>

Note: HS854232
Source: Made by MHRI based on UN Comtrade

[Exports of Japan’s semiconductor-manufacturing equipment and share by country/region in 2018]

- South Korea: 34%
- China: 24%
- Taiwan: 16%
- US: 10%
- Other: 16%

Note: The sum of HS846810 and 849620
Source: Made by MHRI based on Ministry of Finance, Trade Statistics
Exports of consumer goods may be affected by boycotting of Japanese products

- In response to Japan’s restrictions on exports of semiconductor materials to South Korea, some sectors in the country are moving for boycotting of Japanese products and cancelations of Japan travel plans.
  - Some are calling for participation in boycotting of Japanese goods, listing names of Japanese companies targeted for boycotting. Some press reports said sales volumes of Japanese beer are falling.
  - When the boycotting of Japanese products spreads in South Korea, exports of consumer goods to the country may take a dive. Major items of consumer goods exports include automobiles, cosmetics, golf clubs and pharmaceuticals. But sales to South Korea account for just around 7% of Japan’s total exports of consumer goods.

[ News articles on boycotting of Japanese products (excerpts) ]

<table>
<thead>
<tr>
<th>Publication date</th>
<th>Media</th>
<th>Content (excerpts)</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 3</td>
<td>Yonhap news agency</td>
<td>On a community site in South Korea on July 3, the posting with a title, “Let us join a boycott movement against products of Japanese firms,” which also carried a list of firms targeted for boycotting, was chosen as the most excellent posting…The list includes automakers such as Toyota and Honda, electronics manufacturers such as Sony, Panasonic and Canon, clothing makers like Descente and UNIQLO, and brewers like Asahi, Kirin and Sapporo.</td>
</tr>
<tr>
<td>July 4</td>
<td>Yonhap news agency</td>
<td>Since calls are being made for boycotting of Japanese products and cancellations of travels to Japan in South Korea, there is the view that the decline may escalate. However, major travel agencies explained that at the moment, they see no unusual developments in relation to reservations for or cancellations of travels to Japan.</td>
</tr>
<tr>
<td>July 8</td>
<td>Yonhap news agency</td>
<td>Major supermarket chain e-mart disclosed that between July 1, when the Japanese government announced the latest trade measure, and July 7, sales of Japanese beers fell 14.3% from the previous week. During the same period, sales of imported beers increased 2.9% and domestic Korean beers rose 3.6%, an indication that more South Korean consumers chose other beers than Japanese beers.</td>
</tr>
<tr>
<td>July 8</td>
<td>JoongAng Ilbo</td>
<td>Over the past few days, NAVER Café received many postings from consumers that they “canceled plans for trips to Japan.” They included the postings that “I canceled the reserved air ticket to Fukuoka even at the risk of losing money”; “I canceled the trip to Sapporo and will go to Taiwan instead”; and “I plan to go to the Donghae (the Sea of Japan in Japanese) beach by canceling the Japan travel.</td>
</tr>
<tr>
<td>July 9</td>
<td>Korea Economic Daily</td>
<td>There have been successive cancellations for Japan travel products by TV home shopping businesses. Home shopping channel “A” aired a program for domestic travel products instead of a program on Hokkaido travel products set to be aired on July 7. It said the decision was made at an emergency internal meeting given the rising sentiment to avoid trips to Japan. Home shopping company “B”, which originally planned to sell products for trips to Osaka on July 5, aired a program for general travel products.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on Nikkei Telecom
There is concern that South Koreans visiting Japan may fall due to deteriorating ties with Japan

- South Korea is the largest source of visitors to Japan along with China. South Koreans mostly visit Kyushu. The number of South Korean visitors to Japan has been stagnant since the second half of 2018. There is concern that the number may decline further due to the deterioration of Japan-South Korea relations.

- On the other hand, the number of Japanese tourists visiting South Korea has been moderately recovering recently.

**[Prefectures attracting overnight travelers from South Korea (accommodations with 10 or more employees)]**

- **One out of every seven** South Koreans visited Japan, with the ratio of repeaters rising to **71.2%** (2018)
- South Korean accounted for **25%** of all foreign visitors to Japan, almost matching **27%** for Chinese (2018)
- **South Koreans were the largest group of foreign visitors making overnight stays in the geographically close Kyushu region** (2018)

**[Changes in the number of tourists between Japan and South Korea]**

Source: Made by MHRI based on Japan National Tourism Organization (JNTO), Visitor Arrivals to Japan and Japanese Overseas Travelers, Japan Tourism Agency, Consumption Trend Survey for Foreigners Visiting Japan, Overnight Travel Statistics Survey, and CEIC DATA

Note: Seasonally adjusted by MHRI
Source: Made by MHRI based on CEIC Data
1. Global economy and market trends: adjustment pressures on global manufacturing continuing

- The global manufacturing PMI (June) declined for 14 consecutive months to break below 50 (the lowest level since June 2012). In June, the manufacturing PMI declined in the Eurozone and Japan, falling below 50 among both the developed market (DM) economies and emerging market (EM) economies.

- Leading indicators suggest the continuation of an economic slowdown in DM economies. While the leading indicator for China indicates that the Chinese economy may bottom out in the second half of 2019, it will depend largely on the future course of US-China trade tensions.

![Global Manufacturing PMI](image1)

![OECD Composite Leading Indicator](image2)

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**Note:** The Purchasing Managers’ Index (PMI): an index calculated by multiplying new orders, production, order backlogs, prices, employment and purchase amounts, etc. by a certain weight. The reading of 50 is expansion-contraction threshold.

Source: Made by MHRI based on Markit

**Note:** The leading indicator: An index compiled based on economic indicators used to predict which way an economy may go in the future. Generally speaking, the reading below 100 indicates that the economy is weakening.

Source: Made by MHRI based on OECD
Overview of financial markets: resumption of US-China trade talks and expectations of rate cuts in Europe and the US push up stock prices, send long-term interest rates lower

- In response to rising expectations about interest rate cuts in Europe and the US and resumption of US-China trade talks, stock prices followed an uptrend. Germany’s long-term interest rates remain on the downtrend.
  - The yield on 10yr US treasury bonds temporarily fell below 2.0%. The yield on 10yr German government bonds temporarily dropped into the -0.4% range, renewing historical lows by pricing in the rate cut. The 10yr Japanese government bond yield hovered in the range around the middle of the -0.1% range. The US dollar weakened against the Japanese yen and the euro.

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 on Bloomberg
2. (1) The US economy: corporate business sentiment keeps falling, production also sluggish

- The ISM Manufacturing and Non-Manufacturing indexes have been following a downtrend since peaking out at the end of 2018. The decline is particularly noticeable in the manufacturing sector.

- Production in the manufacturing sector turned lower since the end of 2018. More recently, output has been slightly recovering, centering on the automobile and auto parts industries.

- According to comments from companies covered by the ISM survey and the FRB’s Beige Book, US corporations are concerned over punitive tariffs and trade tensions between the US and China.

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Note: ISM index: An economic indicator that shows corporate business sentiments. A reading below 50 suggests an economic recession.

Source: Made by MHRI based on US Institute for Supply Management

Source: Made by MHRI based on FRB
US trade with China shrinking, centering on sectors subject to punitive tariffs

- US exports to China decreased, mainly for agricultural, forestry and fishery products, and oil/natural gas.
  - Almost all of US exports of agricultural, forestry and fishery products, and oil/natural gas are subject to the punitive tariffs.

- US imports from China fell, mainly for computers/electronics equipment and machinery/electric machinery.
  - Around 80% of imports of machinery/electric machinery are subject to the punitive tariffs. On the other hand, only about 40% of imports of computers/electronics equipment are targeted for punitive tariffs.

[ US exports to China (by sector) ]
[ US imports from China (by sector) ]

Note: Tallied on the three-digit level of the North American Industrial Classification System (NAICS). Some sectors with only small contributions are included in other goods.
Source: Made by MHRI based on US Department of Commerce
June jobs data confirms the robust pace of employment expansion, raising hope for underpinning consumption

- Amid softening corporate activities, the key to sustained economic expansion are an expansion of employment and consumption.
- Nonfarm payrolls in June increased by +224 thousand people over the previous month. The unemployment rate remained low at 3.7%.
  - The jobs data showed that employment is sustained at robust levels, despite concerns voiced in May over a slowing pace of employment expansion.
- Against the backdrop of the favorable employment environment, core retail sales in June posted a steady rise of +0.7% m-o-m.

[Nonfarm payrolls]

[Core retail sales]
(2) US monetary policy: FRB tilts toward a rate cut in response to mounting uncertainties

- At its June meeting, the FOMC made a policy shift toward the preparation for easing from a “patient” wait-and-see stance in preparation of both a rate hike or rate cut.
  - In the dot plot forecasts, FOMC participants wishing to keep the target federal funds rate unchanged until the end of the year and those wishing to cut the rate before the year-end are on par at eight vs. eight.

- Mounting uncertainties are behind the shift in policy stance. Given the recognition that the policy targets have yet to be attained in both full employment and price stability, the low interest rate is highly likely to stay for long.
  - While the dot plot forecasts signals an interest rate hike in 2020, a rate hike would be difficult insofar as the FRB sticks to its symmetric inflation objective.

- Participants judged that uncertainties and downside risks surrounding the economic outlook had increased significantly over recent weeks.
- Many participants noted that, since the Committee’s previous meeting, the economy appeared to have lost some momentum. Many participants noted that they viewed the risks to their growth and inflation projections...as shifting notably over recent weeks and that risks were now weighted to the downside.
- Participants judged that it would be important to closely monitor incoming data for any signs of softening in labor market conditions.
- Participants generally agreed that downside risks to the outlook for economic activity had risen materially since their May meeting, particularly those associated with ongoing trade negotiations and slowing economic growth abroad.
- While overall financial conditions remained supportive of growth, those conditions appeared to be premised importantly on expectations that the Federal Reserve would ease policy in the near term.

- (Despite the strong jobs data for June) there is no change in my view that a rate cut may become necessary in the near future, because the conditions from a broader perspective, including overseas developments, have not changed.
- The US has problems with the corporate sector (not the household sector or employment).
- Consumer sentiments remain favorable, but they may be eroded by uncertainties over time.

Source: Made by MHRI based on FRB
(3) US bond market: US long-term interest rates fell momentarily below 2.0%

- The yield on 10yr UST fell momentarily below 2.0% against the backdrop of the FRB’s dovish policy stance.
  - US interest rates were pushed down by apparently slowing economic indicators and the suggestion made at the June FOMC meeting that the federal funds rate may be reduced by the end of the year.
  - In addition to medium- and long-term interest rates, the yield on 30yr UST temporarily dropped below the target range for the FF rate of 2.5%.

- We predict that US long-term interest rates will continue to hover in the lower half of the 2% range, believing that the current speculation on a FF rate cut is overshooting.
  - Market participants are taking into consideration about three rate cuts by the end of the year and about one cut in 2020.

[ US federal funds rate, 3-month, 2yr, 10yr and 30yr UST yields ]

Source: Made by MHRI based on Bloomberg

[ US federal funds rate outlook of market participants ]

Note: The number of FF rate cuts going forward based on FF rate futures (a reduction by 25 basis points is assumed per rate cut).

Source: Made by MHRI based on Bloomberg
(4) US stock market: while expectations toward a rate cut are underpinning stocks, the sense of economic slowdown is weighing down the upside

- Stock prices rose on the resumption of US-China trade talks and mounting expectations about a rate cut by the FRB.
- The market consensus about corporate earnings announcements going into full swing from July is that the earnings will stay almost flat from the previous quarter.
- While corporate earnings are likely to prove sluggish for the Apr-Jun quarter, stock prices are expected to stay at high levels on the back of rate cut expectations for some time to come. However, the price increases should be only moderate as lingering uncertainties over the future and a sense of economic slowdown are expected to weigh down the upside.

[ S&P 500 Index and yield spread ]

Note: Yield spread: Calculated by deducting the earnings yields from long-term interest rates. The smaller the yield spread, the stronger the sense of undervaluation of stock prices. Source: Made by MHRI based on Bloomberg

[ Actual and forward EPS ]

Source: Made by MHRI based on Refinitiv
3. The European economy: the Eurozone economy’s weakening ahead is a cause of concern

- In the Jan-Mar quarter of 2019, eurozone real GDP rose +0.4% q-o-q.
  - Behind the positive growth are transient factors helping to push up the growth rate, such as a rebound in automobile purchases put off in the preceding quarter.

- Corporate sentiment has remained weak even after the turn of the year in 2019, with a deterioration of business conditions particularly noticeable in the manufacturing sector.
  - Since February 2019, of the Purchasing Managers’ indexes (synthetic PMI) having a high correlation to GDP, the Manufacturing PMI has remained below the expansion/contraction threshold of 50.

![Eurozone industrial production chart]

![Eurozone PMI chart]

Note: The Purchasing Managers' Index (PMI): an index calculated by multiplying new orders, production, order backlogs, prices, employment and purchase amounts, etc. by a certain weight. The reading of 50 is the "expansion-contraction" threshold.
Eurozone production remains sluggish

- In April, industrial production in the eurozone in April fell (-0.4% y-o-y).
  - The growth rate of automobile output remains low since August 2018.
  - The auto production expectation DI, which shows auto output expectations over the next three months, fell below the threshold of zero for four consecutive months up to May.

- Eurozone exports in April grew by a moderate +2.6% y-o-y.
  - The increase in UK-bound exports in the run-up to Brexit in March 2019 has faded.

Source: Made by MHRI based on Eurostat
Environment for personal consumption in eurozone steady, but rising concerns ahead

- In May, the eurozone unemployment rate dipped -0.1% pt to 7.5% from the previous month (7.6%).
  - In the Jan-Mar quarter of 2019, eurozone compensation per employee remained steady (+2.2% y-o-y).

- However, the employment expectation DI that shows employment expectations in the next three months continued to decline in Germany and other countries.
  - The employment expectations DI in the eurozone fell below the expansion-contraction threshold of zero for the first time since July 2016.
  - Major German manufacturers are announcing large-scale restructuring plans.

![Eurozone Unemployment Rate and Compensation per Employee](chart1.png)

![Eurozone Employment Expectations DI](chart2.png)

Note: The expansion-contraction threshold is zero. The DI is based on employment expectations over the next three months.
Source: Made by MHRI based on European Commission.

Source: Made by MHRI based on Eurostat, ECB.
Expected inflation in the eurozone slips to an all-time low

- In June, the eurozone CPI (flash estimate) stood at +1.2% y-o-y, remaining flat from the previous month.
  - Core inflation (excluding volatile items such as energy and food) stood at +1.1% y-o-y, up from +0.8% y-o-y in the previous month.
    - As the impact of higher travel-related charges during the Easter holidays faded, the core inflation rate returned to levels thus far around 1.0%.

- The inflation swap forward rate (five-year, five year), which shows the inflation expectation of market participants, remained on the downtrend.
  - In addition to falling crude oil prices, the market may have factored in expectations about a policy rate cut by the European Central Bank (ECB).

[ Eurozone CPI (y-o-y % change) ]

[ Market participants’ expected inflation in the eurozone ]

Source: Made by MHRI based on Eurostat

Note: Estimates made by using the inflation swap forward rate. “T-year, N-year” means market participants’ expectations of the average inflation rate for the period of N years from T years later.

Source: Made by MHRI based on Bloomberg
Monetary policy: likelihood of ECB’s additional easing growing, Christine Lagarde named next ECB President

- In a speech at the ECB Forum on June 19, Mario Draghi suggested the possibility of additional easing.
  - The possibility is increasing that the ECB will go for additional easing while paying attention to exchange rate movements after the G20 Summit or the next FOMC meeting. The most likely option may be a policy rate cut along with measures to mitigate the impact. For the moment, there have been no noticeable market fluctuations, including a sharp rise in the value of the euro.

- At the EU Summit held June 30 through July 2, EU leaders named IMF Managing Director Christine Lagarde of France as the next ECB president.
  - The appointment of Ms. Lagarde is unlikely to have a major impact on the direction of ECB monetary policy.

[ Key points of ECB President Mario Draghi’s comments (June 19) ]

<table>
<thead>
<tr>
<th>Prospects of additional easing</th>
<th>In the absence of improvement (in the price situation), such that the sustained return of inflation to our aim is threatened, additional stimulus will be required.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Response measures</td>
<td>In the coming weeks, the Governing Council will deliberate how our instruments can be adapted commensurate to the severity of the risk to price stability.</td>
</tr>
<tr>
<td>Economic structure</td>
<td>The euro area is a relatively open economy for its size, with total trade (exports of goods and services) making up 51% of GDP, compared with 27% in the United States. This means that the impact of negative rates on inflation and financing conditions via the exchange rate is more powerful.</td>
</tr>
</tbody>
</table>

[ ECB President, Vice President and Executive Board members ]

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<thead>
<tr>
<th>Post</th>
<th>Name</th>
<th>Nationality</th>
<th>Term of office</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>President</td>
<td>Christine Lagarde</td>
<td>France</td>
<td>From Nov 1, 2019 (scheduled)</td>
<td>While her capability as the ECB president is unknown, she is highly rated for her ability to handle a crisis situation.</td>
</tr>
<tr>
<td>Vice President</td>
<td>Luis de Guindos</td>
<td>Spain</td>
<td>Until May 31, 2026</td>
<td>Former finance minister of Spain (Partido Popular)</td>
</tr>
<tr>
<td>Executive Board Member</td>
<td>Benoît Cœuré</td>
<td>France</td>
<td>Until Dec 31, 2019</td>
<td>The next vice president is expected to be a non-French.</td>
</tr>
<tr>
<td>Executive Board Member</td>
<td>Philip R. Lane</td>
<td>Ireland</td>
<td>Until May 31, 2027</td>
<td>Chief economist. As the new president is a politician, his views about the economic conditions may be highly valued.</td>
</tr>
<tr>
<td>Executive Board Member</td>
<td>Sabine Lautenschlager</td>
<td>Germany</td>
<td>Until Jan 26, 2022</td>
<td>As the Executive Board member hailing from Germany, he remains cautious about further monetary easing together with Bundesbank President Jens Weidmann.</td>
</tr>
<tr>
<td>Executive Board Member</td>
<td>Yves Mersch</td>
<td>Luxembourg</td>
<td>Until Dec 14, 2020</td>
<td>Mersch was nominated as the vice-chair of the ECB’s Single Supervisory Mechanism (SSM) and the Supervisory Board.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on ECB
German long-term interest rates sink to all-time lows due to speculation on implementation additional monetary easing measures

- German 10yr government bond yields temporarily fell below the deposit facility interest rate of -0.4%.
  - As investors went on to obtain yields, Greek 10yr government bond yields also fell to a historical low.
  - After the European Commission refrained from issuing recommendations for Italy to address its excessive fiscal deficits, Italy’s long-term interest rates dropped to the lowest level since 2016.
- As the market has already priced in all dovish factors, German 10yr government bond yields are expected to move in a range between -0.2% to -0.4%.
  - The market is now factoring in about 1.5 rate cuts by the end of the year.

**Eurozone 10yr government bond yields**

**Eurozone policy rate outlook of market participants**

Source: Made by MHRI based on Bloomberg

Note: The number of reductions in the deposit facility interest rate by the end of 2019 based on OIS (a cut of 10 basis points per reduction is assumed).
Source: Made by MHRI based on Bloomberg
4. The Chinese economy and EM financial markets trends: the Chinese economy is continuing to slow down

- China’s real GDP in the Apr-Jun quarter grew +6.2% y-o-y, slowing down from the growth of +6.4% y-o-y in the Jan-Mar quarter, showing that the Chinese economy is continuing to slow down.
  - The positive contribution by external demand narrowed due to the decline in growth of fixed asset investment and retail sales in real terms, reflecting the deterioration of corporate earnings and slowdown of income growth, and the slower growth of exports.
  - Manufacturing PMI in June fell below the expansion-contraction threshold of 50 for two consecutive months. Production and new orders indexes declined, while the employment index sank to the lowest level since the collapse of Lehman Brothers.

- The Chinese economy is expected to bottom out toward the end of 2019 as it will take some time for stimulus measures to produce the intended economic support effects. While the resumption of US-China trade talks averted further sanctions by the US for now, a path to a final agreement remains uncertain. Going forward, there remains the risk of the Chinese economy taking another dive, triggered, for instance, by restraints on investment.

Note: The Purchasing Managers’ Index (PMI): an index calculated by multiplying new orders, production, order backlogs, prices, employment and purchase amounts, etc. by a certain weight. The reading of 50 is the “expansion-contraction” threshold.

Source: Made by MHRI based upon National Bureau of Statistics of China, General Administration of Customs of China
After the US-China Summit, the Chinese yuan strengthens. Market interest rates fell to the lowest levels in about 10 years

- Following the US-China Summit on June 29, the Chinese yuan firmed up, rising to the 6.84 yuan level to the US dollar on a closing basis for the first time in about two months.
  - Going forward, the yuan is expected to follow a firming trend amid mounting expectations about a US rate cut and hopes for progress in US-China trade negotiations.

- Subsequent to the public management of Baoshang Bank in the Inner Mongolia Autonomous Region, the People’s Bank of China has been providing more liquidity mainly to small and medium banks through open market operations and the standing lending facility (SLF).
  - As the Chinese central bank succeeded in the stable supply of funds, market interest rates declined, with the overnight Shibor falling to the 0.8% range for the first time in approximately 10 years.
  - The monetary authorities are expected to provide funds by employing such tools as the medium-term lending facility (MLF) in order to secure stable liquidity. In a speech delivered on July 2, Premier Li Keqiang hinted at a targeted reduction in the reserve deposit rate as a step to support small and medium businesses.
**EM financial markets: EM stock advances on US rate cut hopes take a breather**

- EM stocks took a breather from the recovery seen in June. In particular, Chinese and South Korean stocks weakened.
  - Chinese stocks faced downward pressure from a slowing economy. South Korean stocks were hit by export restrictions by Japan, in addition to the deepening sense of economic stagnation.
  - Despite the accord to resume negotiations at the US-China Summit on June 29, the future course of US-China trade tensions still remains uncertain.
- EM currencies overall are picking up due to speculation on an US rate cut serving as downward pressure upon the US dollar. However, the Chinese yuan and the Korean won faced downward pressure as with their stock markets.
  - South Korea, Indonesia and South Africa cut their key interest rates in the face of weakening economic activities. The lower rates might prod their currencies to weaken further.
- Since concerns regarding global economic slowdown have not yet diminished entirely, it will be necessary to monitor the possibility of EM financial markets weakening again in the second half of 2019.

![Graph showing EM stock advances and rate of rise/fall of EM currencies against USD](image_url)

**Note:**
- MSCI Emerging represents EM stocks
- Source: Made by MHRI based on Refinitiv, MSCI

**Source:** Made by MHRI based on Refinitiv
5. (1) The Japanese economy trends: the overall assessment of economic conditions was revised upward, but the economy is expected to lack strength for some time to come

- The Indexes of Economic Conditions in May rose for the second consecutive month, with the overall assessment of economic conditions revised upward from “worsening” to “halting to fall.”
  - Improvements in production and shipments contributed to the increase. However, as it is highly likely that the growth of May production may prove to be only transient, the Japanese economy is expected to continue lacking strength for some time to come.

<table>
<thead>
<tr>
<th>Overall assessment</th>
<th>Definition</th>
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<tbody>
<tr>
<td>(1) Improving</td>
<td>Indicates the likelihood of an economic expansion.</td>
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<tr>
<td>(2) At a standstill</td>
<td>Indicates the likelihood of an economic expansion coming to a standstill.</td>
</tr>
<tr>
<td>(3) Signaling a possible turning point</td>
<td>Indicates the likelihood that the economic trough to be determined ex post facto existed in the prior few months.</td>
</tr>
<tr>
<td>(4) Worsening</td>
<td>Indicates the likelihood of an economic recession</td>
</tr>
<tr>
<td>(5) Halting to fall * As of May</td>
<td>Indicates the likelihood that economic conditions are halting to fall</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on Cabinet Office, *Indexes of Business Conditions*
Production growth helped by transient factor of output of new vehicles. Output is expected to remain flat for some time

- The output rise in May stemmed mainly from higher auto production, but this positive factor is expected to prove only transient. Going forward, production is expected to stay largely flat for some time to come.
  - Higher automobile production reflected a temporary rise in output in association with the model change. It also mirrored the running of some auto plants during the long Golden Week holiday period in May.
  - The June correction value (-1.7% m-o-m) and July production plans (+0.3% m-o-m) indicate that production will remain flat for some time to come.

[ Indices of Industrial Production (contribution by sector) ]

[ Indices of Industrial Production (production plans, corrected value) ]

Note: Seasonally adjusted
Source: Made by MHRI based on Ministry of Economy, Trade and Industry, Indices of Industrial Production
Business sentiment worsens among manufacturers. Profit plans are not so bad, but they faces the downside risk if the yen rises sharply

- In the June BOJ Short-Term Economic Survey of Enterprises in Japan (Tankan) released on July 1, the Business Conditions DI of large enterprises worsened significantly to +7% from the March survey (+12%) for manufacturers, but nonmanufacturers showed a marginal improvement of +23%pt.
  - Among manufacturers, the DI worsened for machinery-related sectors and automakers in the wake of the slowing economies of China and other countries and sluggish IT demand.
  - Among nonmanufacturers, the Business Conditions DI improved for retailers and accommodation and food service sectors thanks in part to special demand during the long Golden Week holiday period in May.

- The FY2019 forecast for current profits was revised downward to -4.3% y-o-y, but the forecast level is not necessarily so bad in comparison with past years.
  - However, Japanese companies are assuming the exchange rate of ¥109.35 to the US dollar, somewhat lower than the currently prevailing exchange rate, spawning the risk of lower-than-expected corporate earnings.

[ Diffusion Index of Business Conditions ]

[ Current profits forecast (all enterprises, all industries) ]

Source: Made by MHRI based on Bank of Japan, Short-Term Economic Survey of Enterprises in Japan (Tankan)
Despite the current strength of fixed (capital) investment, investment sentiment is not necessarily stronger than past years

- The total supply of capital goods in May rose +6.1% y-o-y to post increases for the third straight month. Fixed investment is currently following firm footing.

- Fixed investment plans in the June BOJ Tankan (+2.3% y-o-y), was upwardly revised from the March survey. Considering the large downward revision in actual investment for FY2018 (June), the size of the upward revision for FY2019 cannot be described as stronger than past years.
  * Among the underlying factors are the rising uncertainties surrounding trade tensions and sluggish IT-related demand.

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**Total supply of capital goods**
(excluding transportation equipment)

**Fixed investment forecast**
(all enterprises, all industries)

---

Source: Made by MHRI based on Ministry of Economy, Trade and Industry, Indices of Industrial Domestic Shipments and Imports

Note: Includes land purchasing expenses but excludes software and R&D investment.
Source: Made by MHRI based on Bank of Japan, Short-Term Economic Survey of Enterprises in Japan (Tankan)
While the rise in number of employed persons took a breather, but the employment environment remains favorable. Personal consumption also stays firm

- The unemployment rate in May leveled off at 2.4% from April. The rise in number of employed persons (-80 thousand m-o-m) took a breather.
  - New job openings in May increased (+4.2% m-o-m) for the second consecutive rise, indicating the continuation of a favorable employment environment.

- In May, the Consumption Activity Index (the travel balance adjusted) turned negative (-0.7% m-o-m). However, the index remained firm when averaged out.

Source: Made by MHRI based on Ministry of Internal Affairs and Communications, Labour Force Survey

Source: Made by MHRI based on Bank of Japan, Consumption Activity Index
The rise of prices is slowing down and is expected to follow a moderate slowdown

- The amount of public construction completed in April rose (+1.3% m-o-m), increasing for the first time in two months. Spending under the first supplementary budget for FY2018 has made progress.
  - The value of public works contracted fell in June (-6.2% m-o-m), but increased in the Apr-Jun quarter (+6.7% q-o-q). Public demand is likely to increase for the time being.

- The nationwide core CPI (all items less fresh food) rose in May (+0.8% y-o-y), slowing down from April (+0.9% y-o-y).
  - Rises in energy prices slowed and mobile phones pressed down prices. For some time to come, the increase in the core inflation rate is expected to continue slowing in response to falling energy prices and mobile phone communication charges.

Source: Made by MHRI based on various news reports

Source: Made by MHRI based on Ministry of Internal Affairs and Communications, Consumer Price Index
(2) Domestic monetary policy: BOJ expected to keep policy intact at July MPM

The Bank of Japan (BOJ) is expected to keep its monetary policy unchanged at the Monetary Policy Meeting (MPM) on July 29-30. At the June meeting, no MPM members voiced support for additional easing at an early date.

- The June MPM discussed the provision of funds to financial institutions with negative interest rates, but there are skeptics about the effects of such measure.

The BOJ is closely watching the potential impact of uncertainties over the global economy upon corporate and household sentiment. If the BOJ downgrades its economic judgment in its Outlook for Economic Activity and Prices (the “Outlook Report”), it may revise the forward guidance (by lengthening the time frame).

- Corporate forecasts for prices in the June BOJ Tankan fell to the lowest levels since records began.

[ Summary of opinions (June MPM) ]

- It is necessary to persistently continue with the current powerful monetary easing as the momentum toward 2 percent inflation is maintained.
- It is necessary to closely examine the effects of such factors as deterioration in firms' and households' sentiment on the inflation momentum. If there is concern that such momentum will be lost, the Bank should consider implementing necessary policy measures appropriately.
- Amid changes in the external environment such as growing expectations for monetary easing in the United States and Europe, the Bank also needs to strengthen monetary easing. In addition, it is necessary to further consider in depth the feasibility of a wide range of additional easing measures, as well as their effects and side effects.
- Regarding the provision of funds with negative interest rates by central banks to financial institutions, there is a risk that it will not lead to an increase in the amount of bank loans and concern that it will bring about downward pressure on interest rates, depending on developments in economic activity and financial conditions.

[ BOJ Tankan (firms’ price forecasts) ]

Note: Price outlook in five years
Source: Made by MHRI based on Bank of Japan
3) Japanese long-term interest rates: 10yr JGB yield hovers in negative territory

- The 10yr JGB yield hovered around the middle of the -0.1% range, reflecting declines in interest rates overseas. Declines in super-long JGB yields due to purchases mainly by life insurers took a breather for now.

- Amid falling interest rates in Europe and the US, investment in JGBs by overseas investors remain at high levels. As the BOJ is unlikely to pursue further negative interest rates, we see only limited room for further falls in JGB yields. But the 10yr JGB yield could dip temporarily into the -0.2% range, pulled down by the decline of overseas interest rates.

![Trend of JGB yields](image1)

Source: Made by MHRI based on Bloomberg

![JGB yields from the perspective of overseas investors](image2)

Note: Currency exchange rate hedging costs are assumed values (annualized) calculated with the use of three-month forward rates, etc.
Source: Made by MHRI based on Bloomberg
(4) Japanese stock market: the upside is limited amid lingering uncertainties about the future

- Overseas investors became net buyers of Japanese equities (the sum of cash equities and futures) in the latest reporting week for the first time in nine weeks, encouraged by higher overseas stock markets.
- The forward EPS is continuing to decline, while the forward P/E ratio broke below 13x.
- While Japanese stocks are undervalued in terms of valuation, there are strong uncertainties reflecting factors such as US monetary policy, thus making full-scale buy backs by foreign investors is unlikely. We expect the upside to be limited for some time.

[Foreign investors’ trading in Japanese stocks and Nikkei average]

[Forward EPS, forward P/E ratio]

Note: Forward EPS and forward P/E ratio are for 12 months ahead. Source: Made by MHRI based on Datastream
6. Forex market: caution over the yen’s rapid rise easing for now upon resumption of US-China trade talks

- The yen weakened to the ¥108 range to the dollar at one point, as caution over the yen’s quick rise eased following the resumption of US-China trade talks. If an anticipated US rate cut turns out to be no more than a preventive response, USD/JPY exchange rates are expected to be range-bound.
  - In the BOJ Tankan (June survey), the assumed exchange rate of large enterprises/manufacturing for the first half of FY2019 was ¥109.36 to the dollar, revised from the previous Tankan survey toward a weaker yen.

![Risk reversal graph](image1)

Note: Risk reversal: a method of analyzing foreign exchange rate expectations of participants on the options market
Source: Made by MHRI based on Bloomberg

![Assumed USD/JPY exchange rate by Japanese firms graph](image2)

Note: The assumed USD/JPY exchange rate among large manufacturing enterprises reported in the BOJ Tankan survey. The assumed exchange rates for the first half are based on the June surveys and those for the second half are based on the December surveys.
Source: Made by MHRI based on Bank of Japan, Bloomberg
7. Crude oil market trends: despite a rebound of crude oil prices due to heightened tensions in the Middle East, the upside should be limited in the second half of 2019

- WTI crude oil prices rebounded to $60 temporarily in response to heightened tensions in the Middle East, triggered by Iran’s move toward high-level uranium enrichment, in an apparent violation of the Iranian nuclear framework agreement.
  - Later, the UK seized an Iranian-flagged tanker off Gibraltar. Meanwhile, Iran seized a UK tanker in the Straits of Hormuz.
  - US Vice President Pence mentioned a possible military action against Iran, and the US decided to redeploy its troops in Saudi Arabia, adding fuel to the already tense situation in the Middle East.

- However, the uptrend of crude oil prices took a breather recently, and we expect the upside of crude oil prices to remain weighed down for the second half of 2019.
  - The extension of coordinated output cuts by OPEC Plus is a factor to support crude oil prices. As the global economy is slowing down, however, it will likely take some more time for the crude oil market to find an equilibrium of supply and demand.
8. Outlook on the financial markets

<table>
<thead>
<tr>
<th></th>
<th>O Main scenario</th>
<th>O Sub-scenario 1</th>
<th>O Sub-scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>FF rate</td>
<td>2.25~ 2.50</td>
<td>2.00 ~ 2.25</td>
<td>1.75 ~ 2.00</td>
</tr>
<tr>
<td>(qtr-end value, %)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10yr UST bond yield (%)</td>
<td>2.30</td>
<td>2.10</td>
<td>2.20</td>
</tr>
<tr>
<td>Dow Jones Average (USD)</td>
<td>26,100</td>
<td>27,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Euroyen TIBOR (three months, %)</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
</tr>
<tr>
<td>10yr JGB yield (%)</td>
<td>-0.08</td>
<td>-0.15</td>
<td>-0.15</td>
</tr>
<tr>
<td>Nikkei 225 Average (JPY)</td>
<td>21,400</td>
<td>21,500</td>
<td>21,500</td>
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<tr>
<td>ECB repo rate (qtr-end value, %)</td>
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<td>-0.10</td>
<td>-0.10</td>
</tr>
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<td>10yr government bond yield (German bonds, %)</td>
<td>-0.11</td>
<td>-0.30</td>
<td>-0.25</td>
</tr>
<tr>
<td>USD/JPY rate (JPY/USD)</td>
<td>110</td>
<td>108</td>
<td>108</td>
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<tr>
<td>EUR/USD rate (USD/EUR)</td>
<td>1.12</td>
<td>1.14</td>
<td>1.15</td>
</tr>
</tbody>
</table>

- 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 strengthens 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 weakens against the yen.
Mizuho Research Institute Ltd.

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