**Topic of the month: US-China trade talks: president Trump announces implementation of a fourth round of trade tariffs**

- Even though the US-China summit meeting held at the end of June produced an agreement to resume discussions and the US subsequently decided to delay initiating a fourth round of punitive tariffs upon imports from China, tensions have intensified since then.
  - On August 1, President Trump announced his intention to activate a fourth round of tariffs against China (tariff rate: 10%) effective September 1.
  - On August 5, the US declared China a "currency manipulator."
  - On August 6, China announced it would stop buying US agricultural products.
  - On August 13, the US announced its decision to partially delay the fourth round of punitive tariffs upon imports from China (mainly consumer goods) until December 15.

- Despite a temporary ceasefire regarding trade problems, tensions are settling in as a long-term prospect.
  - The US is in the process of strengthening regulations on China with respect to technology and security. Congress is taking a more hardline stance, opposed to compromising with China.
    - Under the National Defense Authorization Act (NDAA, passed on August 13, 2018), the US is preparing the legal basis for strengthening the management of exports and investment using such laws as the Foreign Investment Risk Review Modernization Act (FIRRMA) and the Export Control Reform Act (ECRA), which will be moving to the implementation phase in sequence.
  - Likewise, China cannot make compromises with respect to matters concerning national sovereignty such as responses to structural issues.

<table>
<thead>
<tr>
<th>Issues</th>
<th>Current state of affairs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trade imbalance</strong></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>
</tbody>
</table>
| **Structural issues**         | **Technology transfer** 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 pressures to transfer technologies in a new foreign investment law enacted in March.  
|                               | **Intellectual property rights** 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.  
|                               | **Subsidies** 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.  
|                               | **Enforcement monitoring procedures** 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. |

Source: Made by MHRI based on US, Chinese government materials and various media reports
Potential downward economic pressure from prolonged US-China tensions

- Trade between the US and China has contracted significantly due to the impact of additional tariffs imposed by the two countries. Taking into account the spillover effects on capital investment and consumption, it is estimated that the global economy’s real GDP growth rate could face downward pressure of as much as 0.3%pt in 2019.

- Given the impact of financial market turmoil (reverse asset effect due to falling stock prices, decline in demand due to lower consumption/investment confidence etc.), the downward effect will be larger.

- In the event of a tariff rate hike to 25%, global economic growth may fall below 3%, leading to risks of a fall into recession.

[ Impact of US-China trade tensions (1) ]
- In the event a fourth round of US tariffs against China is implemented as scheduled

[ Impact of US-China trade tensions (2) ]
- In the event the fourth round of additional tariffs are raised to 25% in 2020

Note: The impact of additional tariffs imposed on US-China trade on real GDP growth in each country/region. Estimates include impact on investment, consumption and ripple effects on third countries.

Source: Made by MHRI based on World Bank, IMF
1. Global economy and market trends: adjustment pressures persist in the global manufacturing sector

- The global manufacturing PMI (July) fell for the 15th consecutive month, breaking below 50. In July the PMI fell in the US and the Eurozone. Among the developed market (DM) economies, the PMI fell below 50.

- The Composite Leading Indicator suggests that the DM economies will continue to slow down. While indicators suggest China will hit bottom in the second half of 2019, this will largely depend on the course of US-China trade tensions.

**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 an expansion-contraction threshold.

**Source:** Made by MHRI based on data from each country

**Source:** Made by MHRI based on OECD
Overview of financial markets: global concerns about a recession increase

- Concerns regarding a global recession are rising, given US President Trump’s announcement of a fourth round of tariffs against China and the reversal of US yields. US-Japan stock prices are unstable. The 10yr UST yield dropped to the 1.5% level, and the yield on 10yr German government bonds fell temporarily to the -0.7% level. The 10yr JGB yield is moving around the mid -0.2% range. Yen-strengthening pressures are rising in the foreign exchange market.

[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 on Bloomberg
2. (1) The US economy: the fourth round of punitive tariffs will serve as downward pressure on consumer spending

- July employment data indicated the firm expansion of employment, with nonfarm payrolls rising +164 thousand m-o-m and the unemployment rate at 3.7%.
  - The number of employees concentrated in domestic demand-dependent industries, such as professional & business services and education & medical services, continued to expand at a steady rate.
- Although strong job growth is expected to underpin consumption, the fall of consumer sentiment may serve as negative factor.
  - Personal consumption-related indicators are continue to follow solid footing. In July, core retail sales grew a strong + 1.0% m-o-m.
  - The August consumer sentiment index (University of Michigan, preliminary readings) fell sharply. Consumers have strong concerns regarding the rise of inflation due to the fourth round of punitive tariffs.
Business conditions have declined, especially in the manufacturing sector. Capital goods orders remain firm, but lack a sense of acceleration.

- The ISM manufacturing and non-manufacturing indexes continued to decline in July (manufacturing: 51.2, non-manufacturing: 53.7).
  - In contrast to a conspicuous pace of decline in the manufacturing sector, the non-manufacturing sector has been relatively firm.
  - The July industrial production index (manufacturing sector) shows manufacturing down 0.3 m-o-m, and production activities in the manufacturing sector continued to be downbeat.
- Even though core capital goods orders, which are a leading indicator of machinery-related capital investment, have remained steady, there is no sense of acceleration.
  - A key point is whether developments in US-China trade talks will play a role in dispelling uncertainty in corporate outlooks.
70% of the fourth round of tariffs upon imports from China is aimed at consumer goods. The tariff burden will fall on retailers and consumers.

- US President Trump announced the implementation of the fourth round of punitive tariffs upon imports from China (List A: Sept. 1 onward, List B: Dec 15 onward)
  - In consideration of the Christmas shopping season, tariffs on items worth some USD150 billion, including notebook PCs and mobile phones, have been postponed to after Dec 15.
- In contrast to the focus on capital goods in the third round of punitive tariffs, nearly 70% of the fourth round of punitive tariffs target consumer goods.
- Tariffs on consumer goods impose a burden on consumers or retailers, who are unable to pass along price hikes.
  - The burden of the fourth round of tariffs (about USD25 billion) is equivalent to 15% of pre-tax profits of retailers.

[ Import items from China subjected to punitive tariffs (Rounds 1-3, 2017 actual) ]
[ Import items from China subjected to tariffs (Round 4, 2017 actual) ]

Note: Imports in 2017 were recounted based on different end uses using standards for the relevant year.
Source: Made by MHRI based on the US Department of Commerce
Despite the fall of imports from China, import substitution is not progressing much

- The year-on-year increase of imports of goods targeted by the tariffs from third countries other than China is only marginal and does not compensate for the fall of imports from China.
  - Despite developments for import substitution in some items, it is negligible in terms of overall imports by the US.
- If the fourth round is implemented, imports from China subject to tariffs are projected to decrease by nearly 30% in 2020 compared to 2018.
  - The foregoing projection is based upon the following assumptions: imports remain flat in Rounds 1 to 3, the tariff elasticity in Round 4 is more or less the same as in previous rounds.

[Import items from China subjected to tariffs (Rounds 1-3)]

[Changes in imports from China and outlook]

<table>
<thead>
<tr>
<th>(USD bn.)</th>
<th>Subject to tariffs</th>
<th>Non-tariff items</th>
<th>Imports from China</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rounds 1-3</td>
<td>Round 4</td>
<td></td>
</tr>
<tr>
<td>2018 Jan-Jun</td>
<td>126.4</td>
<td>114.6</td>
<td>9.0</td>
</tr>
<tr>
<td>2019 Jan-Jun</td>
<td>92.2</td>
<td>116.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Change (%)</td>
<td>−27.1</td>
<td>2.0</td>
<td>11.3</td>
</tr>
</tbody>
</table>

| Avg. tariff rate | 13 | 10 |
| Tariff elasticity | 2.1 | 2.1 |

Assumes that the 4th round of items will have the same tariff elasticity (the elasticity of the import amount with respect to the average tariff rate) manifested in rounds 1-3

Assumes that items from Rounds 1-3 are flat

Assumes growth at the same level as 2019

Note: In the chart “Non-target items” refers to items that do not fall under Rounds 1-3 nor Round 4.

Source: Made by MHRI based on the US Department of Commerce
(2) US monetary policy: In July the FOMC cut interest rates for the first time since the financial crisis. Door open to additional cuts.

- In July the FOMC cut the FF target rate by 0.25%. The cut was in preparation for a downturn due to weakness in the global economy and uncertainty in trade policy.
  - The process of cutting the central bank's holdings of bonds was completed two months ahead of schedule to maintain consistency in the FOMC's accommodative stance.
  - Esther George, president of the Federal Reserve Bank of Kansas City, and Eric Rosengren, president of the Federal Reserve Bank of Boston, voted against the rate cut.

- In the minutes of its meeting the FOMC stated that uncertainties remain even after interest rate cuts and appropriate policies for economic expansion would be maintained, and left open the door to further rate cuts.
  - It also noted that a possible no-deal Brexit at the end of October, China's slow recovery and its growing financial problems and US trade policy represent continued risk factors.

[US policy interest rates]

Note: FF interest rate target level or the upper limit of the target range. Shaded areas are periods of recession.
Source: Made by MHRI based on FRB and NBER

[July 2019 FOMC Statement and FRB Chair Jerome H. Powell’s Press Conference]

- The rate cut takes place against the outlook of global economic trends and the calming of inflation.
- Uncertainty will remain after the rate cut.
- The Committee will act as appropriate to sustain economic expansion.
- The Committee will conclude the reduction of its aggregate securities holdings two months earlier than previously indicated.

[Press conference]

- There are three objectives for the rate cut - preparing for downside risks from weak global growth, particularly in European Union and China, and trade policy uncertainty, to offset the effects these factors are currently having on the economy, and to promote a faster return to our 2% objective.
- This rate cut is a midcycle adjustment to policy. It is not intended to start a long cutting cycle, such as a recession or a very severe downturn.
- We are not hearing from businesses that they are not investing because the federal funds rate is too high.
- Rate cuts serve to increase household and business confidence.
- We do see notable valuation pressures in some markets. However, overall financial stability vulnerabilities are moderate.

Source: Made by MHRI based on FRB
The trimmed mean remained at 2%, but there were continued warning signs of lower inflation expectations

- The trimmed mean inflation rate remained steady at 2%, but the core inflation rate continued to decline, moving down to +1.6% y-o-y.
  - Note that the steady trimmed mean provides grounds for the FOMC to shift from its current rate-cut stance to a neutral/rate-hike stance. Thus, this represents an interest rate upside risk factor that requires close attention.

Note: BEI (forward) = the break-even inflation rate over the five-year period that begins five years from today.
Source: Made by MHRI based on the US Department of Commerce, Federal Reserve of Dallas and Haver
(3) US bond market: US long-term interest rates fall below 1.6%

- With the 10yr UST yield dropping below 1.6%, the fall in interest rates remains unabated.
  - Against the background of a flight from risk in view of worries over US-China trade tensions, investors’ buying into bonds advanced.
  - In addition to 3-month and 10yr USTs, 2yr and 10yr USTs saw a yield curve inversion, leading to a significant deterioration of bond investor sentiment.

- In the absence of concerns regarding the acceleration of inflation, US long-term interest rates are expected to stay in the upper 1% range.
  - The market is factoring in an additional 2.6 rate cuts by the end of the year and about 1.7 rate cuts next year.

[ 2yr and 10yr UST yields ]

[ 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: taking risk-off due to aversion to the announced implementation of a fourth round of tariffs and the bond yield inversion.

- The market has shifted to risk-off mode, given the Trump administration's statement on implementation of a fourth round of punitive tariffs on imports from China and the inversion of yield curves with respect to 2yr and 10yr USTs.

- The Dow Jones industrial average fell about 3% following the July FOMC, staying at around USD 26,000. Valuations are now looking less overpriced.

- From September, the scheduled commencement of the fourth round of tariffs, Brexit, and slowdown of the European economy are all factors weighing down the upside. On the other hand, given signs of the strength of the US economy, as indicated for example by better-than-expected retail sales, stock prices should return to an uptrend subsequent to a temporary decline.

- Watch out for further adjustment risks in the event of sustained high volatility or the fading of excessive factoring of interest rate cuts.

[ S&P 500 Index and forward P/E ratio ]

[ Dow Average stock price forecast and P/E ratio band ]

Source: Made by MHRI based on Bloomberg, Refinitiv

Note: Estimated EPS for the next 12 months is estimated by MHRI. The DS ratio (NY Dow ÷ S&P500) is 9x
Source: Made by MHRI based on Refinitiv, Bloomberg
3. The European economy: economic growth remains low due to ongoing weakness of the manufacturing sector

- In the Apr-June quarter of 2019, the rate of eurozone real GDP growth remained at a low level of +0.2% q-o-q (preliminary flash estimate).
  - Real GDP growth by country: Germany (-0.1% q-o-q) due to a drop in exports, France (+0.2% q-o-q) as automobile purchases slowed, Italy (+ 0.0% q-o-q) where the fall of imports in the previous quarter contributed to economic growth, Spain (+0.5 % q-o-q) turned out to be 0.2%pt lower due to a decline in machinery and equipment investment.

- Corporate sentiment has remained weak even after the turn of the year in 2019, with deterioration of business conditions particularly noticeable in the manufacturing sector.
  - Since February 2019, among 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 actual GDP growth (demand breakdown) ]

[ Eurozone PMI ]

Note: The reading of 50 in the Purchasing Managers' Index (PMI) is the "expansion-contraction" threshold.
Source: Made by MHRI based on Markit, Bloomberg
In May 2019, exports recorded an increase of +4.2% y-o-y.

- In May, exports to Turkey and exports to Denmark served as drags.
  - There was a reactionary drop accompanying the temporary rise of ship exports toward Denmark in the previous year.

The number of export destinations recording negative y-o-y growth of goods exports in the eurozone area is gradually increasing since the beginning of 2018.

- Even though the contributions to overall eurozone exports by each of the export destinations are not large (with the exception of some countries), downward pressures are gradually mounting along with the increase in number of such countries.

**Corporate sector: downward pressure on exports gradually increases**

- Exports of goods to areas outside the eurozone area (by region)
- Number of export destinations for which eurozone goods exports recorded negative y-o-y growth

Source: Made by MHRI based on Eurostat
Corporate sector: Manufacturing sector production continues to be sluggish

- June eurozone industrial production fell sharply (-2.4% y-o-y).
  - The growth rate for automobile production remained negative for the 12th consecutive month.
- The orders level DI also continued to decline, and inventory levels remain high.
  - Since January 2019, the level of orders has remained below the expansion-contraction threshold of zero.

Note: “Zero” is the expansion-contraction threshold. The figures are based on queries on the current level of orders.

Source: Made by MHRI based on Eurostat
Household sector: the labor market remains strong, but there are concerns about the future of employment

- In June, the eurozone unemployment rate was 7.5%, a 1%pt improvement from the previous month (7.6%).
  - In the Jan-Mar quarter of 2019, compensation per employee in the eurozone continued to follow firm footing (+2.2% y-o-y).
  - The volume of retail sales also remained at a high level, indicating the strength of household consumption.

- Meanwhile, employment expectations continued to decline in the manufacturing sector.
  - The employment expectations DI for the next-three-months in the manufacturing sector continued to decline, dragged down mainly by Germany.

Source: Made by MHRI based on Eurostat, ECB

Note: “Zero” is the expansion-contraction threshold. The figures are based on queries on employment expectations over the next three months.

Source: Made by MHRI based on the European Commission
Prices: eurozone core inflation remains close to 1%

- In July, the eurozone inflation rate (preliminary flash estimate) stood at +1.1% y-o-y, down 0.2%pt from the previous month.
  - Core inflation, excluding volatile items such as energy and food, stood at +0.9% y-o-y, down 0.2%pt from the previous month.
    - The impact of higher travel-related charges associated with consecutive holidays in Germany in June faded.
- The inflation swap forward rate (five-year, five year), which shows the inflation expectations of market participants, continued to hover low.

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

[ Market participants’ expected inflation in the eurozone ]

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

Source: Made by MHRI based on Eurostat
Monetary policy: the ECB Governing Council is expected to announce pursuing negative interest rates and the resumption of QE at its September meeting

- At its July 25 meeting, the ECB Governing Council strongly indicated its intention to implement monetary easing at its next meeting (Sep 12).
  - The Council (1) changed forward guidance on interest rates (inserted the phrase "lower levels"), (2) changed expressions concerning price targets (used the expression "symmetry in the inflation aim"), (3) imparted a sense of crisis about stagnating prices and indicated strong intentions to go after additional easing and (4) instructed related committees to pursue negative interest rates and consider options for resuming QE.

- At its September meeting the Governing Council is expected to reduce the deposit facility interest rate (-0.4% ⇒ -0.5%) + tiered measure and announce the resumption of QE (30 billion euros/month, revision of the government bond purchase limit rule).
  - The economic situation in the eurozone, especially in Germany, has deteriorated since the last Governing Council meeting.

<table>
<thead>
<tr>
<th>Economic conditions</th>
<th>The labor market and wage environment remain favorable, and the service and construction industries are solid. However, this outlook is getting worse, especially in the manufacturing industry.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic outlook</td>
<td>The risks surrounding the euro area growth outlook remain tilted to the downside, on account of the prolonged presence of uncertainties, related to geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets.</td>
</tr>
<tr>
<td>Prices</td>
<td>Inflation pressures are yet to appear and inflation expectations have declined. Therefore, a considerable degree of monetary easing is necessary to maintain a favorable financial environment.</td>
</tr>
<tr>
<td>Accommodative stance</td>
<td>While inflation rates, both realised and projected, have been persistently below levels that are in line with the ECB's aim, there is the need for a highly accommodative stance on monetary policy. If the medium-term inflation outlook is below target, the ECB is determined to act in line with its commitment to symmetry in price targets.</td>
</tr>
<tr>
<td>Forward guidance on the key ECB interest rates</td>
<td>Policy rates will remain at or below current levels, at least until the first half of 2020, and as necessary to keep the inflation rate consistent with ECB assumptions.</td>
</tr>
<tr>
<td>Additional easing measures</td>
<td>Relevant committees have been asked to consider measures to mitigate the effects of prolonged negative interest rates, such as stratification of policy interest rates, and options for the size and composition of new asset purchases.</td>
</tr>
<tr>
<td>Why was easing not decided today?</td>
<td>There was no discussion at all (to act at this ECB Governing Council meeting). The current situation has signs of strength and it is difficult to have a pessimistic outlook right now. However, the outlook has deteriorated simultaneously in certain countries and in certain sectors.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on the ECB
Italy: the collapse of the coalition increases the possibility of an early dissolution and general election

- The League, led by Matteo Salvini, submitted a motion of no confidence. If it passes based on the effective collapse of the coalition, Italy will go to general elections.
  - Note that due to the authority to dissolve parliament resting with the president in Italy and in order to avoid confusion over budget deliberations, it is speculated that the Democratic party and the Five Star Movement might first try to form a caretaker government. However, Democratic party leader Nicola Zingaretti has refused a caretaker administration with Five Star (Aug 12).
- If parliament is dissolved and a general election held, a right-wing coalition centered on the League is likely to win.
  - If a populist expansionary fiscal policy is pursued, Italy's financial risk will expand. If the yield on government bonds rises and leads to capital losses among Italian financial institutions and increase of bad loans due to an economic downturn, this will in turn raise concerns about the impact on French banks due to their large share of credit exposure to Italy.

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[ Approval ratings for Italy's political parties ]

[Cross-border credit to Italy (2019 Q1) ]

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Note: Average of public opinion polls conducted monthly. Source: Made by MHRI based on various opinion polls

Note: Credit from various countries to different sectors in Italy. The public sector includes government bond investments. Final risk value base. Source: Made by MHRI based on BIS
German long-term interest rates continue to record all-time lows due to speculation on additional easing measures

- German 10yr government bond yields fell below the deposit facility interest rate of -0.4%.
  - German 30-year bond rate for the first time dipped into a negative territory.
  - In Italy, as conflict within the ruling coalition continues, government bonds are temporarily being sold on a large sale.
- Based on the continuation of weak fundamentals, there's room for Germany's 10yr government bond yields to go even lower.
  - The market is now factoring in about three rate cuts through the end of next year.

Source: Made by MHRI based on Bloomberg

Source: Made by MHRI based on Bloomberg
In July, China’s major economic indicators declined across the board. China's economy continues to slow down.

- Production grew +4.8% y-o-y, the lowest level since Jan-Feb 2009. Retail sales declined to +7.6% y-o-y. Even though retail sales expanded in June due to the pick-up of automobile sales promotions under the old standards prior to the strengthening of environmental standards, the impact of this factor faded in July. Despite a slight acceleration of investment in the manufacturing sector, investment slowed to +5.2% y-o-y due to the moderation of infrastructure investment and real estate development investment.

Looking forward, China's economy is expected to slow down moderately while avoiding a major decline due to economic support measures. However, it should be noted that downward pressures on the entire economy will intensify in the event of the escalation of US-China tensions.
The yuan tumbled past 7 yuan per US dollar to 11-year low, amid concerns regarding US-China tensions

- The People's Bank of China (PBoC) recognized that the yuan’s tumble past 7 yuan per US dollar is due to the impact of the US announcement of tariff hikes.
  - On August 5, the Telegraphic Transfer Middle rate (TTM) was set at a level above 6.9 yuan per US dollar. The yuan continued to weaken, based on the view that the PBoC had accepted a weaker yuan. Subsequently, the US recognized China as a currency manipulator. Even though the PBoC guided the TTM toward a stronger yuan, the yuan is continuing to trade at a level of 7 yuan to the US dollar.
  - Yi Gang, Governor of the PBoC, stated that "China will protect the exchange rate regime determined by the market and will not engage in competitive currency devaluation."
- While the PBoC may suppress panicky volatility, its stance it to accept a certain level of yuan depreciation. The yuan is expected to trade at the current level for the foreseeable future.

[ Highlights of PBoC and Governor Gang statement ]

- The yuan’s exchange rate against the dollar broke past 7 yuan due to the US tariff hikes upon China.
- China will implement a managed floating exchange rate system based on market supply and demand with reference to a currency basket.
- The level of "1 dollar = 7 yuan" is not irreversible. It is normal for the exchange rate to fluctuate.
- In the future, exchange rates will be affected by market supply and demand and US dollar trends in the short term, but in the long term the rates will be determined by the fundamentals of the Chinese economy. China’s fundamentals are stable and financial risk can be controlled.
- China will firmly control short-term speculation and maintain the stable operations of the exchange market.
- China will defend the exchange system determined by the market and will not engage in competitive depreciation.
EM financial markets: both stocks and currencies fall due to global risk aversion

- The US announcement of the fourth round of additional tariffs upon imports from China (Aug 1) led to global risk aversion. In general EM stocks fell in August.
  - Despite the postponement of the imposition of additional tariffs on some import items until December, the future course of trade tensions remains uncertain.
  - In Argentina, stock prices fell sharply as the results of the presidential primary election (Aug 11) rekindled concerns regarding fiscal discipline.

- Many of the EM currencies also fell in August, reflecting the intensification of risk aversion.
- Due to the growing global economic uncertainties such as trade tensions, the odds are high that downward pressure in EM markets will remain.

[ EM, US, Chinese and Argentinian stocks ]

[ Rise/fall of EM currencies against USD ]
5. (1) The Japanese economy: in the Apr-Jun quarter, external demand served as downward pressure but domestic demand pushed up the rate of economic growth

- In the Apr-Jun quarter, Japan’s real GDP grew +0.4% y-o-y (+1.8% p.a.). Although exports served as downward pressure, domestic demand such as personal consumption, capital investment and public demand remained firm and boosted the growth rate.
  - Looking closer at personal consumption, consumption of services picked up due to the 10-day holiday related to the turn of the new era in Japan. In addition, durable goods consumption also increased due to a last-minute rush of demand for cars and white goods prior to the consumption tax hike.
  - In the Apr-Jun quarter, production remained at a modest level of +0.5% q-o-q, falling short of offsetting the dip in the Jan-Mar quarter (-2.5% q-o-q).

\[ \text{Real GDP (quarterly)} \]

\[ \text{Industrial production index} \]

Source: Made by MHRI based on Cabinet Office, System of National Accounts

Source: Made by MHRI based on Japan Ministry of Economy, Trade and Industry, Indices of Industrial Production
An export recovery is unlikely due to the rise of uncertainties reflecting the fourth round of tariffs

- Exports are showing signs of bottoming out, but uncertainties stemming from the fourth round of tariff hikes upon imports from China are serving as a drag. Looking forward, the prospects of a recovery are slim.
  - There are signs of bottoming out in information-related goods. However, the highly-correlated semiconductor market is forecast to weaken again due to US tariff hikes etc.
  - Capital goods are weak. Among the contributing factors are the fall in exports of semiconductor manufacturing equipment and industrial robots. A rebound is unlikely.
  - The slowdown of industrial robots stems mainly from the slowdown of exports toward the US and China. The slowdown of investment in the manufacturing sectors of both countries is having an impact.

[ Real exports (overall, information-related goods/capital goods) ]  

[ Industrial robots (exports) contribution by country ]
In the Apr-Jun quarter, the last-minute rush of demand for durable consumer goods was limited compared to the previous consumption tax hike in 2014.

- As of the Apr-Jun quarter, the last-minute rush of demand for durable consumer goods prior to the consumption tax hike was limited compared with the previous consumption tax hike in 2014.
  - Compared with the previous consumption tax hike, the number of comments on "last-minute buying" decreased. The breakdown also shows that the ratio of “unchanged” is large and that the “better” and “slightly better” ratios are small.

- Even though a certain level of last-minute buying and reactionary fall is expected in the Jul-Sep and Oct-Dec quarters, the impact is likely to be smaller than at the time of the previous consumption tax hike.

[ Number of "last-minute buying" comments ]

[ Breakdown of comments that include "last-minute buying" ]
The reduction of long working hours did not lead to the rise of employment growth due to stagnant production activity

- The reduction of long working hours are progressing due to overtime regulations. Even so, the rate of employment expansion moderated due to the stagnation of production activity.
  - The proportion of regular workers working more than 60 hours/month of overtime has declined sharply since the beginning of 2019.
  - Current production activities are stagnant reflecting sluggish external demand. Growth in new job openings has come to pause.
    - Given the weakness of production activity, employment growth will slow down from the demand side.

[Percentage of regular workers who work overtime of more than 60 hours/month]

[Number of new job offers]

Note: Based on the data excluding part-time work
Source: Made by MHRI based on Ministry of Health, Labour and Welfare, Employment Referrals for General Workers
Note: Seasonally adjusted values by MHRI
Source: Made by MHRI based on Ministry of Internal Affairs and Communications, Labour Force Survey
The amount of public construction completed in May increased for the second consecutive month by +0.6% m-o-m. Disaster recovery projects appear to have progressed.

- The value of public works contracted in July increased significantly by +12.4% m-o-m. Public demand is expected to increase for the foreseeable future as public works related to the plan for building national resilience progress.

The Basic Policy on Economic and Fiscal Management and Reform suggests the possibility of additional economic stimulus measures.

- The policy states that "flexible macroeconomic policies will be implemented without hesitation for downward risks originating overseas," implying future fiscal stimulus.

For the time being, public demand is expanding due to the progress in the initiatives for building national resilience

- The Basic Policy on Economic and Fiscal Management and Reform suggests the possibility of additional economic stimulus measures.
  - The policy states that "flexible macroeconomic policies will be implemented without hesitation for downward risks originating overseas," implying future fiscal stimulus.

[ Value of public works and value of public works contracted ]

<table>
<thead>
<tr>
<th>(JPY trillion)</th>
<th>Completed value of public works</th>
<th>Value of public works contracted (rhs)</th>
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<tr>
<td>May</td>
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<tr>
<td>15/1 15/7 16/1 16/7 17/1 17/7 18/1 18/7 19/1 19/7 (yy/m)</td>
<td>0.9 1.0 1.1 1.2 1.3 1.4 1.5 1.6 1.7 1.8 1.9</td>
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</table>
Companies are cautious about price increases, and growth in prices excluding the consumption tax has slowed

- The household price outlook is on an upward trend while the corporate price outlook remains stagnant.
  - As the household spending mindset has weakened, corporations continue to be reluctant to raise selling prices.
  - There are also system factors such as free preschool education. Growth in prices excluding the consumption tax is expected to slow for the time being.
  - However, from the second half of FY2020, the rise in energy prices will be a plus factor.

[Household and corporate expected inflation rate]

- Expected inflation rate (household)
- Expected inflation rate (corporate: retail)

[Core CPI outlook (quarterly, by contribution)]

- Core CPI outlook
- Series excluding impact of higher consumption tax

Note: Household expected inflation rate after 1 year (weighted average) is calculated based upon the following assumptions:
  - For a decrease, "+5% or more" is -5%, "+5% to -2%" is -3.5%, "less than -2%" is -1%
  - For an increase, "less than 2%" is +1%, "2% to 5%" is +3.5% and "more than 5%" is +5%.

Source: Made by MHRI based on Bank of Japan, Short-Term Economic Survey of Enterprises in Japan (Tankan), Cabinet Office, Consumer Confidence Survey, and Ministry of Internal Affairs and Communications, Consumer Price Index
(2) Domestic monetary policy: BOJ kept policy intact at July MPM. Governor Kuroda raises the possibility of preventive easing

- The Bank of Japan (BOJ) kept monetary policy unchanged at the Monetary Policy Meeting (MPM) on July 29th and 30th. In its release statement, the BOJ added that “the Bank should not hesitate to take monetary easing measures if it is expected that the momentum toward achieving the price stability target will be lost.” BOJ Governor Haruhiko Kuroda mentioned the possibility of moving toward preventive easing in response to growing downside risks in overseas economies.

- The BOJ is closely monitoring the impact global economic uncertainties on corporate and household sentiment. If in future it determines that momentum will be impaired due to yen appreciation or other factors, it may consider policy measures including pursuing negative interest rates.

<table>
<thead>
<tr>
<th>[Outlook Report (July 2019)]</th>
<th>[Summary of opinions (July MPM)]</th>
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<tbody>
<tr>
<td><strong>(Y-o-y % change)</strong></td>
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<td></td>
<td>Real GDP</td>
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<tr>
<td>FY 2019</td>
<td>+0.6 to +0.9 (+0.7)</td>
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<tr>
<td>Outlook as of April 2019</td>
<td>+0.7 to +0.9 (+0.8)</td>
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<tr>
<td>FY 2020</td>
<td>+0.8 to +1.0 (+0.9)</td>
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<tr>
<td>Outlook as of April 2019</td>
<td>+0.8 to +1.1 (+0.9)</td>
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<tr>
<td>FY 2021</td>
<td>+0.9 to +1.2 (+1.1)</td>
</tr>
<tr>
<td>Outlook as of April 2019</td>
<td>+0.7 to +1.0 (+1.0)</td>
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</table>

* At this point, it is important to make a preventive and preemptive policy response to downside risks to prices. It is necessary to further strengthen monetary easing through both yield curve control and forward guidance.

* Since Japan's economy is susceptible to the U.S.-China trade friction and the inflation rate is far from 2 percent, it would be necessary for the Bank to consider the claims for conducting so-called preventive monetary easing against downside risks to economic activity and prices. The effects of the scheduled consumption tax hike and sudden market changes warrant careful vigilance so that the Bank's monetary policy will not fall behind the curve.

* When considering policy responses, it is necessary to examine both their effects and side effects. In doing so, it is important to carry out careful examination and design while taking into account the risk that the effects may be impaired by the side effects.

Source: Made by MHRI based on Bank of Japan
(3) Japanese long-term interest rates: 10yr JGB yield falls below -0.2% level

- The 10yr JGB yield fell below what was viewed as the lower limit of -0.2% in response to the drop in global long-term interest rates caused by interest rate cuts under US and eurozone monetary policy. It is believed that foreign investors’ net buying of JGBs contributed to the decline in interest rates.

- Amid lingering speculation that the BOJ will continue to pursue negative interest rates, yields are forecast to remain under downward pressures.

[ Trend of JGB yields ]

[ Trends in purchases of JGBs by overseas investors (medium and long-term bonds) ]

Source: Made by MHRI based on Bloomberg
Japanese stock market: the upside remains heavy, weighed down by the strength of the yen and the consumption tax hike

- Stock prices fell against the backdrop of the global stock market slide. The Nikkei Stock Average is currently moving around 20,500 yen.
- Against the backdrop of the appreciation of the yen in reflection of future uncertainties, the Nikkei Stock Average has dropped around -5% since the beginning of the month, leading to the expansion of the gap in performance versus US stocks.
- Second quarter earnings turned out to underwhelm. The forward EPS is unable to break out of a downtrend.
- In addition to ongoing expectations toward the appreciation of the yen, the upside should remain heavy due to a fall of personal consumption reflecting a backlash to the last-minute rush of consumption around the time of the consumption tax hike.

[ TOPIX forward P/E ratio and forward EPS ]

[ Nikkei Stock Average and yen-based Dow Jones Average ]

Note: Forward EPS and forward P/E ratio are 12 months ahead
Source: Made by MHRI based on Refinitiv

Source: Made by MHRI based on Bloomberg
6. Forex market: slight appreciation of yen due to intensification of US-China trade tensions and concerns regarding the global economic slowdown

- The yen strengthened against the US dollar to around JPY106/USD due to rising concerns regarding the escalation of US-China trade tensions and global economic slowdown. As concerns regarding US-China trade tensions and global economic slowdown are expected to persist for some time, yen will most likely stay on course of continuing appreciation.

- Turning to the EUR/USD exchange rate, the euro weakened in mid-August due to concerns regarding the slowdown of the European economy, as shown by indicators such as Germany’s negative real GDP growth in the Apr-Jun quarter (Aug 14). The euro should remain weak due to the weakness of the European economy and political uncertainties.

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**USD/JPY exchange rate and risk reversal**

- **Risk reversal** is the implied volatility of call options minus the implied volatility of put options and is known as an indicator that reflects the risk perception of option market participants. Delta: 25%, 1 month.

**EUR/USD exchange rate and risk reversal**

- **Risk reversal** is the implied volatility of call options minus the implied volatility of put options and is known as an indicator that reflects the risk perception of option market participants. Delta: 25%, 3 months.

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Source: Made by MHRI based on Bloomberg
7. Crude oil market trends: the crude oil market is reflecting future concerns

- WTI crude oil prices fell to the lower half of the USD50-level, reflecting concerns regarding the slowdown of the global economy. The upside should remain heavy even in the second half of 2019 and beyond.
  - Amid weak demand for crude oil, the crude oil market continued to soften even in the first half of 2019 when US interest rate cut expectations supported the stock market.
  - While the OPEC Plus is likely to normalize the framework for the control of crude oil supply-demand even from March 2020, which is the deadline of the output cut, upward pressures will not rise in the crude oil market due to the impact of US-China trade tensions. WTI crude is expected to remain in the USD50 range for the time being.

- Even so, it will be necessary to monitor the worsening situation in the Middle East. In the event conditions spiral into military conflict, there is a risk of a surge in crude oil prices.
  - The rise of oil prices under an economic slowdown may serve as a factor increasing downside risks in the global economy.

[Crude oil prices and US stocks]

[Crude oil prices outlook]
8. Outlook on the financial markets

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<tr>
<td>FF rate (qtr-end value, %)</td>
<td>2.25~ 2.50</td>
<td>1.75~ 2.00</td>
<td>1.50~ 1.75</td>
<td>1.25~ 1.50</td>
<td>1.25~ 1.50</td>
<td>1.75~ 2.00</td>
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<td>2.00~ 2.20</td>
<td>2.00~ 2.20</td>
<td>2.00~ 2.20</td>
<td>2.00~ 2.20</td>
<td>2.00~ 2.20</td>
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<td>10yr UST yield (%)</td>
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<td>1.75</td>
<td>1.70</td>
<td>1.75</td>
<td>1.85</td>
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<td>1.90</td>
<td>2.00</td>
<td>1.75</td>
<td>1.60</td>
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<td>Euroyen TIBOR (three months, %)</td>
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<tr>
<td>10yr JGB yield (%)</td>
<td>-0.08</td>
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<td>-0.15</td>
<td>-0.15</td>
<td>-0.15</td>
<td>-0.10</td>
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<td>-0.15</td>
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<td>Nikkei 225 Average (JPY)</td>
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<td>21,000</td>
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<td>22,500</td>
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<td><strong>Europe</strong></td>
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<td>ECB repo rate (qtr-end value, %)</td>
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<td>-0.10</td>
<td>-0.20</td>
<td>-0.20</td>
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<tr>
<td>10yr government bond yield (German bonds, %)</td>
<td>-0.11</td>
<td>-0.45</td>
<td>-0.50</td>
<td>-0.55</td>
<td>-0.50</td>
<td>-0.40</td>
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<td>-0.80</td>
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<td><strong>Forex</strong></td>
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<tr>
<td>USD/JPY rate (USD/JPY)</td>
<td>110</td>
<td>107</td>
<td>105</td>
<td>105</td>
<td>106</td>
<td>108</td>
<td>108</td>
<td>108</td>
<td>109</td>
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<td>95</td>
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<td>EUR/USD rate (EUR/USD)</td>
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<td>1.08</td>
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- **Sub-scenario 1 (upside scenario)**
  - Long-term interest rates and stock prices rise on heightened interest rate hike expectations driven by the acceleration of a US economic recovery. The dollar strengthens against the yen.

- **Sub-scenario 2 (downside scenario)**
  - Tariff hikes and other actions accompanying US protectionist policies lead to global economic slowdown, including the US and European economies. Long-term interest rates fall, stock prices decline. The dollar weakens against the yen.
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