Monthly Economic Report

September 24, 2019
Mizuho Research Institute
Topic of the month: The global economy will slow down by 2020 reflecting the escalation of US-China trade tensions

- We have revised downward our forecast on economic growth for all regions from our forecast in August, as a result of the addition of the following preconditions to our analysis, namely the postponement to December of part of a 4th round of US punitive tariffs upon China discussed in the August outlook, China’s countermeasures, and further US countermeasures (adding 5% to the total tariff for China).
  - In addition to the escalation of US-China trade tensions, the growth rates for Japan and the NIEs (as well as the US and China) have been lowered. India’s growth rate has been revised downward based upon our view that its weakness will continue for the near term.


### [Outlook on the global economy]

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<th>Japan (FY)</th>
<th>Crude oil price (WTI, USD/bbl)</th>
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Note: The total of the forecast area is calculated upon the GDP share (PPP) by the IMF. Sources: Made by MHRI based upon releases by the International Monetary Fund (IMF) and statistics of relevant countries and regions.
US-China trade issue: focus is on a "deal (mini deal)" at a summit meeting in November

- It is difficult for both the US and China to compromise due to domestic political factors.
  - In the US, when considering such matters as Congressional approval of the US-Mexico-Canada trade agreement (USMCA) and political maneuvers by the Democratic Party leading up to the presidential elections, a softening of attitudes toward China is difficult to imagine as long as there is no room for concessions with China.
  - Also, it's difficult for China (President Xi Jinping), about to mark the 70th year of Communist rule, to compromise with the US for fear of being criticized as "weak-kneed."
  - Attention will gather around the outcome of US-China ministerial talks scheduled for October.
    - A US-China summit on the sidelines of the APEC meeting in November could lead to a "mini deal."

[ Schedule of major political events ]

Note: Dates related to the US are blue and red for China
Source: Made by MHRI
Brexit: The possibility of a no-deal Brexit by October 31 has declined, parliamentary elections may soon happen

- In the UK, a bill was passed requiring a postponement of the October 31 deadline for exit if negotiations with the EU are not finalized by October 19 (as of September 9).
  - Under passage of the bill, it is probable that an October 31 no-deal Brexit will be avoided and the deadline for withdrawal will be extended until January 31. Attention is focused on EU opposition to the UK government's resubmitted proposal on the Irish backstop.
- Parliament is likely to be dissolved and general elections held sometime in or after November. With the Conservative Party in the lead, the possibility of leaving the EU without an agreement remains strong.
  - The opposition parties, mainly the Labour Party, are expected to submit to parliament a no-confidence motion in the cabinet with the aim of triggering general elections after November.
  - The future direction of Brexit will depend greatly on the outcome of the elections, but the Conservative Party is currently leading according to current polls.

Note: As of September 23. The Sinn Fein Party (7 members) does not take its seats owing to its policy of abstention. Also, since the deputies usually do not vote, the majority of seats is 320 against the fixed membership of 650. Tellers are included in the votes.

Source: Made by MHRI based on BBC (UK)
Crude oil market trends: Attacks on Saudi oil facilities underscore geopolitical risks

- The September 14 attack on Saudi Arabian oil facilities halted 60% of domestic crude oil production. WTI crude oil futures rose 15% in one day, but a September 17 statement by Saudi Arabia's energy minister, Abdulaziz bin Salman, that production would recover by the end of September brought prices back down by 6%.

- A background factor is the escalation of the prolonged conflict between US/Saudi Arabia and Iran has grown worse which is unlikely to be resolved any time soon.

- While it is unknown whether attacks on oil facilities will continue, the event served to underscore the geopolitical risks in the Middle East.

[Crude oil prices]

[The US/Saudi and Iran conflict]
Although the situation can be addressed by running down inventories, the base price of crude oil may rise

- Even if it takes several months for production in Saudi Arabia to recover, inventories can cover for now
  - It has been reported that already 2 million barrels of suspended production of 5.7 million barrels/day had been restored.
  - The remaining 3.7 million barrels/day can be covered by stocks in developed market (DM) economies (3.7 million barrels/day $\times$ 3 months = approximately 330 million barrels)
- While Saudi Arabia has concluded that Iran was involved in the attack, it appears that military conflict is undesirable. Thus the main scenario would be the avoidance of collision.
- However, the armed Houthi Islamic rebel movement has stated that it would continue to attack oil facilities.
- A heightened sense of geopolitical risks is likely to contribute to higher crude oil prices

### [ Future scenarios ]

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Description</th>
<th>Probability</th>
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<tbody>
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<td>Stable scenario</td>
<td>Over the near term, respond by drawing down inventories. After crude oil production in Saudi Arabia recovers, the market settles around the USD 50 range again.</td>
<td>medium</td>
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<tr>
<td>Base price rises scenario</td>
<td>Saudi Arabia's production recovery can help avoid a tightening of the supply-demand balance. However, the crude oil baseline price (average price) rises due to warnings about geopolitical risks.</td>
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<tr>
<td>Soaring price scenario</td>
<td>Sporadic attacks on oil facilities lead to the rise of concerns about a tightening of the supply-demand balance and, thereby, a surge of crude oil prices.</td>
<td>low</td>
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</table>

### [ OECD commercial inventory ]

- Source: Made by MHRI based on EIA
- OECD inventory 29.0 (Aug 2019)
- 300 million barrels

Source: Made by MHRI
1. Global economy and market trends: adjustment pressures persist in the global manufacturing sector

- The global manufacturing PMI (August) has fallen below 50 for the 4th consecutive month. In August the PMI fell in the US and Japan. Among the developed market (DM) economies, the PMI remained below 50.

- The Composite Leading Indicator (CLI) suggests that the DM economies will continue to slow down. While the CLI indicates that China will bottom out 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 fixed weight. 50 is the expansion-contraction threshold.

Source: Made by MHRI based on Markit
Overview of financial markets: long-term interest rates have turned around due to expectations of progress in US-China talks

- In August, the stock market adjusted due the escalation of US-China trade tensions and long-term interest rates declined sharply worldwide. Entering into September, the market shifted into risk-on mode in expectation that talks between the US-China talks would make progress. The 10yr UST yield temporarily rose to the 1.9% level and the 10yr JGB yield temporarily rose to the -0.1% level. The Nikkei Stock Average recovered to 22,000 yen. The appreciation of the yen receded 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: Business conditions in the manufacturing sector are worsening but nonmanufacturing is solid

- In August, the ISM manufacturing PMI fell to 49.1. It is below 50 for the first time in three years, and most of the items are below the standard.
  - Export orders, a leading indicator of exports, was 43.3, the lowest level since April 2009. This suggests exports will continue to be sluggish.
- In August, the ISM nonmanufacturing PMI rose to 56.4, and remains strong compared to the manufacturing sector.
- July core capital goods shipments remained unchanged at -0.6 % m-o-m. New orders saw a modest rally of + 0.2 %.

![Chart: ISM manufacturing and nonmanufacturing PMI](Baseline = 50)

![Chart: Core capital goods shipments & new orders](Baseline = 50)

**Note:** ISM PMI: An index showing business sentiment in the manufacturing sector. 50 is the expansion-contraction threshold.
Source: Made by MHRI based on the US Institute for Supply Management

Source: Made by MHRI based on the US Department of Commerce
While US exports to China have recently picked up, the 4th round of retaliatory tariffs will serve as a drag from the end of the year

- China has announced imposition of a 4th round of retaliatory tariffs on US goods. It will cover USD75.2 billion worth of goods.
  - Goods affected under Rounds 1-4 total USD106.5 billion (2017 actual), and levies tariffs averaging around 14% on nearly 80% of China-bound exports.

- While US exports to China have recently picked up, the 4th round of retaliatory tariffs will serve as a drag from the end of the year.
  - If exports of the additional goods decrease to the same extent as the goods targeted up to Round 3, US China-bound exports in 2020 will decline by 20% relative to 2018.

### Goods subject to the retaliatory tariffs on US goods (Rounds 1-4 total, 2017)

- Food, etc.: 17.2%
- Industrial materials: 37.7%
- Capital goods: 28.4%
- Autos & auto-related parts: 13%
- Consumer goods: 3.7%

**Total (2017): USD106.5 billion**

**Note:** Aggregations of tariff items are based on the HS6 digit levels.

**Source:** Made by MHRI based on the US Department of Commerce

### Changes in US exports to China

**Note:** Aggregations of tariff items are based on the HS6 digit levels.

**Source:** Made by MHRI based on the US Department of Commerce
The pace of job growth remains strong, especially in the service sector

- August employment data indicate that nonfarm payrolls rose +130 thousand m-o-m and the unemployment rate was unchanged at 3.7%.
  - Although the pace of job growth in the financial sector is continuing to slow down, job growth remained firm in the service sector.
- The degree of job satisfaction among consumers reached a historical high.

![Nonfarm payrolls graph](image1)

![Consumer outlook on employment (job satisfaction level) graph](image2)

Source: Made by MHRI based on the US Bureau of Labor statistics

Source: Made by MHRI based on the Conference Board
Last-minute rush of demand in view of punitive tariffs on Chinese goods will serve as tailwinds for year-end sales

- Consumers’ expectations toward the future fell sharply according to the University of Michigan Consumer Sentiment Index. Even though the Conference Board Consumer Confidence Index worsened slightly, it still remains relatively high.
  - According to the Conference Board, buying intentions for consumer durable goods (6 months from now) are improving.
  - Toward the end of the year, a last-minute rush of demand in view of punitive tariffs on Chinese goods will serve to boost consumption.

- August core retail sales maintained steady growth, up +0.3% m-o-m.

Source: Made by MHRI based on the Conference Board and the University of Michigan

Source: Made by MHRI based on the US Department of Commerce
US monetary policy: at its September meeting, the FOMC again cut rates and maintained easing

- As in the previous meeting, the FOMC decided to cut interest rates based upon the weakness in the global economy and uncertainty in trade policy. It also maintained its stance to continue monetary easing.
  - The FOMC again noted that uncertainties remain even after interest rate cuts and that appropriate policies for economic expansion would be maintained.

- The surprise in the September dot plot forecast compared to June is the downward shift of the distribution for the long-term neutral rate of interest.
  - The decline of overseas interest rates and yield inversions appear to have had an impact.

- The sharp rise in the repo market interest rate has reignited arguments over the creation of a standing repo facility (SRF)* and buying government debt in proportion to the dollar bill balance (= BS re-expansion). *A scheme that lends short-term funds as necessary to financial institutions.

[ FOMC dot plot forecast ]

[ Standing repo facility discussed at June FOMC ]

- Staff report
  - Preparing for abnormal interest rate increases in the FF market
  - Incentives (for banks) to encourage a shift from reserves to securities
  - Key parameters: interest rate levels (spread), qualified financial institutions, qualified securities
  - Matters for consideration: Ripple effects on collateral and unsecured markets; in cases where qualified financial institutions are financially vulnerable; stigma concern; ensuring of competitive fairness

- Necessity of Standing Repo Facility (SRF) (disagreement among participants)
  - Not required under the “abundant reserves” regime
  - Useful as a means to increase interest rate control, even in current regimes or when reserves are significantly reduced

- SRF design
  - Depending on the purpose of establishing the SRF, the appropriate SRF design changes
  - Various parameters should be carefully considered to prevent unintended consequences, such as potential moral hazards and increased volatility in the FRB balance sheet

- Consideration on other means and initiatives

Note: Numbers are the number of dots
Source: Made by MHRI based on FRB
Even though the trimmed mean remained at 2%, the FOMC remains wary of lower inflation expectations

- Although the trimmed mean inflation rate remained steady at 2%, the core inflation rate and market inflation expectations continued to decline.
  - 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.

[ Inflation indexes ]

Note: BEI (forward) = 5-Year forward, 5-Year breakeven inflation rate
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 rate rose temporarily to 1.9%

- The US 10yr UST yield, which had fallen below 1.5%, rose temporarily to the 1.9% level.
  - Amid the global low-interest rate environment, the tight supply & demand for US bonds has pushed the term premium further into negative territory.
  - Profit-taking sell-offs, reflecting expectations toward the alleviation of US-China trade tensions, and the sharp fall of interest rates are serving as factors pushing up interest rates.
- As uncertainties toward the future course of US-China trade tensions are anticipated to linger, US long-term interest rates are forecast to move around the mid 1% range.
  - The market has factored in around one additional interest rate cut this year and about 1.7 rate cuts next year.
(4) US stock market: despite current market strength, an implementation of the 4th round of tariffs will weigh heavily on the upside

- Stocks have been range-bound since mid-August. Currently, however, prices are rising due to expectations of monetary easing by US and European central banks and progress in US-China talks.

- Solid earnings results in the retail industry, retail sales and the ISM nonmanufacturing PMI have confirmed the firmness of domestic demand, providing corporate earnings with a dose of reassurance.
  - The stock market has priced in future firmness in the US economy, serving to underpin share prices.

- Attention is gathering upon the October FOMC and US-China talks scheduled for late October. While there seems to be a floor on prices until the US-China talks, if the 4th round of tariffs is implemented after a breakdown of negotiations, this will weigh heavily on the upside.
3. The European economy: the slowdown in the manufacturing sector remains unchanged low economic growth expected to persist

- The Eurozone real GDP growth rate during the Apr-Jun quarter of 2019 stood at +0.2% q-o-q, comparable to the low level in the Jul-Aug quarter of 2018.
  - Given the lack of export growth, external demand pushed down real GDP growth by -0.1%pt q-o-q.
  - Household consumption expenditure, government consumption expenditure and gross fixed capital formation each made positive contributions of +0.1%pt q-o-q.

- Business conditions in the manufacturing sector are conspicuously worse and corporate sentiment has remained weak even after entering 2019.
  - Since February 2019, the manufacturing PMI has remained below the expansion-contraction threshold of 50.
Corporate sector: the slowdown of exports to areas outside the eurozone is rippling through to intra-eurozone exports and production

- In June 2019, exports to areas outside the eurozone only stood at +1.5% y-o-y, despite positive contributions by exports bound for the US and China.
  - Intra-eurozone exports fell (-2.1% y-o-y), recording a decline for the first time since July 2016. The weakness of exports to areas outside the eurozone may have spread to intra-eurozone exports.

- In June, industrial production in the eurozone decreased sharply (-2.4% y-o-y).
  - The rate of year-on-year growth of automobile production remained in negative territory for 12 consecutive months.

[ Exports of goods to areas outside the eurozone (by region) ]

[ Industrial production in the eurozone ]

Source: Made by MHRI based on Eurostat

Motor vehicle production

Industrial production
Household sector: despite the strength of the labor market, there are concerns about the future of employment

- In July, the eurozone unemployment rate stood at 7.5%, unchanged from the previous month (7.5%).
  - 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.

[ Eurozone unemployment rate and compensation per employee ]

[ Eurozone employment expectations DI by sector ]

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 August, the eurozone inflation rate (flash estimate) stood at +1.0% y-o-y, unchanged from the previous month (+ 1.0% y-o-y).
  - Higher food prices were offset by lower energy prices.
  - Core inflation, excluding volatile items such as energy and food, stood unchanged from the previous month at +0.9% y-o-y.
- The inflation swap forward rate (five-year, five year), a measure of the market's inflation expectations, has continued to hover low around 1.2% since June 2019.

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: at its September meeting, the ECB Governing Council announced its pursuing of negative interest rates and resumption of QE

- The ECB announced a comprehensive relief package at the Governing Council meeting on September 12th.
  - (1) Lowering the deposit facility rate further into negative territory (-0.4% → -0.5%), (2) revision of interest rate guidance (linking the duration of low interest rates to the inflation rate), (3) introduction of a two-tier system for reserve remuneration of banks to mitigate the adverse effect of negative interest rates, (4) restart of net purchases under the asset purchase program (20 billion euros/month), changing the terms of the third series of targeted longer-term refinancing operations (TLTRO III) (the maturity of the operations extended from 2 to 3 years, etc.)
  - The ECB noted that the background to starting the comprehensive relief measures was the economic slowdown, rising geopolitical risk and a worsening inflation outlook. At the same time, it emphasized the need for fiscal stimulus.

- For the time being, the ECB is prepared to maintain an accommodative policy stance and confirm the effects of policy.

[ ECB policy rate and core inflation rate ]

[ Overview of ECB relief package ]

- **Policy interest rate**
  - Main refinancing operations rate: 0% (unchanged)
  - Marginal lending facility rate: 0.25% (unchanged)
  - Deposit facility rate: -0.5% (-0.1% point)

- **Forward guidance on policy interest rate**
  - ECB now expects key interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within the Banks's projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.

- **Measure to mitigate the adverse effect of negative interest rates**
  - The negative interest rate for excess reserves is divided into two tiers. Of the reserve deposits that are held in the current account, a certain multiplier (initially 6) will be applied to statutory reserves, which will be exempt from the deposit facility rate (-0.5%) and the main refinancing operations rate (0%) will be applied.

- **Asset purchases**
  - The Governing Council decided to restart net purchases under its asset purchase programme at a monthly pace of €20 billion as from 1 November. ECB expects them to run for as long as necessary to reinforce the accommodative impact of the Bank’s policy rates, and to end shortly before the Bank starts raising the key ECB interest rates.

- **Changing the terms of TLTRO III**
  - Reduce the applicable interest rate by 0.1% point from the previous plan to the same level as the main refinancing interest rate (0%). A prime interest rate of up to -0.5% may be applied to financial institutions that have increased lending. The loan period will be extended from 2 years to 3 years.

Source: Made by MHRI based on ECB
German long-term interest rates remain low, chasing after peripheral country government bond yields is expected to continue

- The German long-term interest rate, which had set a record low, temporarily rose to the -0.4% level, putting rate declines on pause.
  - The German 30yr bond rate, which was sinking deeper into negative territory, rose to 0% on fiscal stimulus expectations and the retreat of Brexit concerns.
  - In Italy, given the launch of a new coalition government expressing willingness to coordinate with the EU, the country's long-term interest rate fell below 1% to record a historical low.
- Amid the persistence of soft fundamentals, the German 10yr government bond yield is expected to hover around -0.5%.
  - Against a backdrop of low German interest rates, investment in government bonds of neighboring countries is expected to continue in search of yields.
4. The Chinese economy and EM financial markets: China's economy continues to slow down

- In August, China’s major economic indicators declined across the board, indicating that the Chinese economy is continuing to slow down.
  - Production slumped at +4.4% y-o-y. Retail sales growth slowed slightly to +7.5% y-o-y, given the ongoing reactionary fall to the rapid expansion of auto sales in June. Despite a pick-up of investment in infrastructure, investment in the manufacturing sector fell below the previous-year level, bringing overall investment down to +4.2% y-o-y.
  - The Manufacturing PMI fell short of 50 (expansion-contraction threshold) for the fourth month in a row. For the 15th consecutive month, new export orders remained sluggish at below 50.

- China's economy is expected to slow down gradually, i.e. avoiding a major decline due to government economic stimulus measures. However, as further punitive tariffs are planned by the US, a further slowdown of exports and investment is a cause for concern.

![China's major economic indicators](image1)

![Manufacturing PMI](image2)

Note: 1. January and February figures for industrial production, retail and investment in fixed assets are cumulative Jan-Feb y-o-y figures.
2. Fixed asset investment is converted from the year-to-date cumulative to a single month.
3. Industrial production is actual value. Total retail sales of consumer goods, fixed asset investment and exports are nominal values.
4. Exports are on an RMB basis.

Source: Made by MHRI based upon National Bureau of Statistics of China, General Administration of Customs, CEIC data
The yuan is continuing to weaken. The People's Bank of China cut its reserve requirement ratio.

- The yuan is continuing to weaken even after the yuan broke through 7 yuan-per-dollar level on August 5. The People's Bank of China (PBoC) intends to stabilize the market amid further yuan-weakening pressures.
  - The PBoC will most likely subdue panic-fed volatility, and is currently maintaining market stability by setting the yuan-to-dollar midpoint reference rate to a stronger yuan. However, it is prepared to tolerate a certain degree of yuan depreciation from the perspective of supporting the economy. For the time being, we expect that the yuan will trade around the current level.

- On September 16th, the PBoC cut the reserve requirement ratio for all commercial banks by 0.5%pt. Furthermore, on September 20th, it cut the LPR by 5BP.
  - Also, the reserve requirement ratio will be cut for qualified city commercial banks (banks with regional operations) in two phases by 0.5%pt each on October 15th and November 15th.

- Looking forward, the PBoC will most likely engage in targeted monetary easing in order to stabilize the supply of funds to private enterprises and small and micro enterprises.

[ Divergence of the USD/RMB rate from the closing rate of the midpoint rate on the previous day]

[ Reserve requirement ratio, LPR and MLF interest rates ]
EM financial markets: stocks and currencies remain soft, given ongoing global risk aversion

- EM stocks, which fell amid the escalation of US-China trade issues in August, showed signs of bottoming out from around the middle of August. Even so, the upside is heavy.
  - The US launched the 4th round of additional tariffs (September 1). Despite expectations toward progress at the ministerial level talks in October, the future is uncertain.
  - Even though the Hong Kong stock market, weakened by prolonged public demonstrations, rebound subsequent to the withdrawal of the extradition bill (September 4), it lacks momentum.
- EM currencies were also generally weak in August. The sell-off of Argentine’s peso, triggered by concerns regarding fiscal reconstruction, spread across Latin America.
- The odds are high that the EM markets will remain soft, given ongoing global economic uncertainties such as trade tensions.

**[ EM, US, Chinese and Hong Kong stocks ]**

**[ Rise/fall of EM currencies against USD ]**

Note: Positive bars show EM currencies’ rate of rise against USD, while negative bars show EM currencies’ rate of decline against USD.

Source: Made by MHRI based on Refinitiv, MSCI
5. (1) The Japanese economy: Apr-Jun quarter real GDP growth (2nd QE) was revised downward

- According to the Second Preliminary Quarterly Estimates of GDP (“2nd QE”) for the Apr-Jun quarter of 2019, Japan’s real GDP grew +0.3% q-o-q (+1.3% p.a.), revealing a downward revision from the First Preliminary Quarterly Estimates of GDP (“1st QE”) (+1.8% p.a.).
  - Despite the uptick of public demand, the slower-than-expected growth of capital investment served as a drag.
  - Even though external demand served as negative pressure upon Japan’s economic growth in the Apr-Jun quarter, our view remains unchanged that domestic demand remained firm.
  - Looking forward, Japan’s economic growth is forecast to remain tepid. In addition to sluggish exports due to US-China trade tensions, capital investment growth will likely slow down reflecting the rise of uncertainties. Consumption is also expected to lack strength due to slow wage growth.

### [ 2019 Apr-Jun quarter GDP (2nd QE) ]

<table>
<thead>
<tr>
<th>Source: Made by MHRI based upon Cabinet Office, Quarterly Estimates of GDP</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>2018 Apr-Jun</th>
<th>Jul-Sep</th>
<th>Oct-Dec</th>
<th>2019 Jan-Mar</th>
<th>Apr-Jun</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>0.5</td>
<td>-0.5</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>(Q-o-q change, p.a.)</td>
<td>1.9</td>
<td>-1.9</td>
<td>1.8</td>
<td>2.2</td>
</tr>
<tr>
<td>(Y-o-y change)</td>
<td>1.5</td>
<td>0.1</td>
<td>0.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Domestic demand</td>
<td>0.5</td>
<td>-0.3</td>
<td>0.8</td>
<td>0.1</td>
</tr>
<tr>
<td>Private demand</td>
<td>0.7</td>
<td>-0.4</td>
<td>1.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Private inventory investment</td>
<td>(0.5)</td>
<td>(-0.3)</td>
<td>(0.8)</td>
<td>(0.0)</td>
</tr>
<tr>
<td>Personal consumption</td>
<td>0.3</td>
<td>-0.1</td>
<td>0.4</td>
<td>-0.0</td>
</tr>
<tr>
<td>Housing investment</td>
<td>-1.8</td>
<td>0.8</td>
<td>1.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Capital investment</td>
<td>3.0</td>
<td>-2.8</td>
<td>3.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>Inventory investment</td>
<td>(-0.1)</td>
<td>(0.2)</td>
<td>(0.0)</td>
<td>(0.1)</td>
</tr>
<tr>
<td>Public demand</td>
<td>-0.2</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Government consumption</td>
<td>(-0.1)</td>
<td>(-0.0)</td>
<td>(0.1)</td>
<td>(0.1)</td>
</tr>
<tr>
<td>Public investment</td>
<td>-1.4</td>
<td>-1.8</td>
<td>-1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>External demand</td>
<td>(0.0)</td>
<td>(-0.2)</td>
<td>(-0.4)</td>
<td>(0.4)</td>
</tr>
<tr>
<td>Exports</td>
<td>0.8</td>
<td>-2.1</td>
<td>1.2</td>
<td>-2.0</td>
</tr>
<tr>
<td>Imports</td>
<td>0.8</td>
<td>-1.2</td>
<td>3.6</td>
<td>-4.3</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>0.2</td>
<td>-0.5</td>
<td>0.4</td>
<td>1.0</td>
</tr>
<tr>
<td>GDP deflator (y-o-y change)</td>
<td>-0.1</td>
<td>-0.4</td>
<td>-0.3</td>
<td>0.1</td>
</tr>
</tbody>
</table>
The July Indexes of Economic Conditions rose but the overall assessment of economic conditions remains unchanged

In July, the Indexes of Business Conditions rose by +0.3pt, rising for the first time in two months. However, the overall assessment of economic conditions remained unchanged at "bottoming out" for the third month in a row.

- The industrial production index, the durable consumer goods shipment index, the producer goods shipments index, the investment goods shipment index and others related to production provided upward boost.
- Our view is that the rebound is weak compared with the decline in June (-2.9pt) and lacks strength.
- Based on the August industrial production adjustment (-0.7% m-o-m), there are concerns that the August overall assessment of economic conditions might be revised downward.

[ Indexes of Business Conditions (Composite Index (CI) of coincident indicator) ]

[ Overall assessment of economic conditions ]

<table>
<thead>
<tr>
<th>Overall assessment</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Improving</td>
<td>Indicates the likelihood of economic expansion.</td>
</tr>
<tr>
<td>(2) At a standstill</td>
<td>Indicates the likelihood of economic expansion coming to a standstill.</td>
</tr>
<tr>
<td>(3) Signalling 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) Weakening</td>
<td>Indicates the likelihood of an economic recession.</td>
</tr>
<tr>
<td>(5) Bottoming out</td>
<td>Indicates the likelihood of an economic recession bottoming out.</td>
</tr>
</tbody>
</table>

Note: Indexes of Business Conditions: An index created to consolidate the movements of indicators that react to economic trends such as production and employment, and to contribute to understanding the current state of the economy and make forecasts. The CI of coincident index is calculated using indices that move in line with economic trends.

Source: Made by MHRI based upon Cabinet Office, Indexes of Business Conditions
The BOJ Tankan (September survey) business conditions DI forecast a deterioration due to the escalation of trade tensions and the overseas economic slowdown

- The Business Conditions DI of large enterprises/manufacturing sector deteriorated by 6pt (+7%pt → +1%pt) and the nonmanufacturing sector worsened by 2pt (+23%pt → +21%pt).
  - The escalation of trade tensions pushed down the DI among manufacturers. Among nonmanufacturers, the fading impact of the demand boosted by the long Golden Week holidays this year and the decline of inbound Korean tourists pushed down the DI.
  - Looking forward, the manufacturing sector outlook is unchanged given the ongoing severe overseas environment. Meanwhile, nonmanufacturers expect a deterioration due to a backlash from the last-minute rush of demand in the run-up to the consumption tax hike.

- The FY 2019 forecast for fixed investment (all enterprises, all industries) expects upward revision to +2.7% y-o-y from the June survey (+2.3% y-o-y). However, the breadth of the revision is expected to be small compared to past years, because fixed investment plans have become more cautious, especially in the manufacturing sector, reflecting growing uncertainties.
The volume of exports turned negative for the first time in three months. Production turned positive for the first time in two months, but lacks strength

- The export volume index stood at -4.9% m-o-m in August (July: +2.4% m-o-m), falling into negative territory for the first time in three months.
  - By geographic destinations, the US, China and Europe were also all negative. By goods, transportation equipment and general machinery contributed to the downturn.

- The industrial production index stood at +1.3% m-o-m in July (June: -3.3% m-o-m), rising for the first time in two months. A wide range of industries, such as automotive, turned positive.
  - Compared to the Apr-Jun quarter, the industrial production index turned slightly negative in July (-0.3%). Although it rose in reaction to the fall last month, the rebound is weak.
  - Production plans for August/September area also flat when averaged out. Looking forward, production is forecast to lack strength due to the slowdown in overseas economies and sluggish IT demand.

Note: Seasonally adjusted figures produced by MHRI.
Source: Made by MHRI based on Ministry of Finance, Trade Statistics of Japan.

Source: Made by MHRI based on Japan Ministry of Economy, Trade and Industry, Indices of Industrial Production.
Corporate profits (y-o-y) declined significantly in the manufacturing sector. Capital investment remains firm in nonmanufacturing

- In the Apr-Jun quarter, ordinary profits fell for the first time in two quarters (-12.0% y-o-y).
  - In the manufacturing sector, the breadth of the fall of ordinary profits widened to -27.9% y-o-y (previous quarter: -6.3% y-o-y). Non-manufacturing sector ordinary profits turned negative (-1.5% y-o-y).
  - Reflecting the semiconductor market slump and escalation of US-China trade tensions, ordinary profits fell sharply in sectors such as information communication machinery, general-purpose machine, and production machinery.

- In the Apr-Jun quarter, capital investment (adjusted for seasonal factors, including investment in software) rose +1.5% q-o-q, recording an increase for the third month in a row.
  - While capital investment fell in the manufacturing sector (-4.3% q-o-q) for the second consecutive quarter, capital investment in the nonmanufacturing sector increased (+ 4.7% q-o-q) for the second quarter in a row due partly to software investment.

![Corporate profits](image)

![Capital investment](image)

Source: Made by MHRI based on Ministry of Finance, Financial Statements Statistics of Corporations

Note: Seasonally adjusted
Source: Made by MHRI based on Ministry of Finance, Financial Statements Statistics of Corporations
The labor market remains firm, but there are signs that employment is turning cautious. Personal consumption decreased due to weather factors

- The unemployment rate improved from June to 2.2% in July. The number of employed persons increased (+150 thousand m-o-m).
  - New job openings in July fell (-1.6% m-o-m). The stance toward employment may have become cautious due to concerns about the global economic slowdown.

- In July, the consumption activity index (travel balance adjusted) declined (-2.4% m-o-m).
  - Durable goods, non-durable goods and services all declined. Clothing, food & drink, and machinery equipment were negative due to weather factors.

Source: Made by MHRI based on Bank of Japan, Consumption Activity Index

Source: Made by MHRI based on Ministry of Internal Affairs and Communications, Labour Force Survey
Public investment increased. The rise of prices is slowing down and should continue to moderate

- The amount of public construction completed increased for the third consecutive month in June (+2.2% m-o-m). Disaster recovery projects appear to have made progress.
  - The average value of public works contracted during the period from July to August increased by +3.2% compared with the Apr-Jun quarter. Public demand should increase for some time due to the progress of the government’s program to reinforce infrastructure in view of natural disasters (the “national resilience program”).
- The nationwide core CPI (all items less fresh food) remained flat in July at +0.6% y-o-y.
  - Despite the upturn of mobile phones into positive territory, the slowdown of energy and recreational services served to depress the index.
  - Given the slowdown of energy prices, the breadth of the CPI in positive territory should gradually narrow for some time.

[ The amount of public construction completed and the value of public works contracted ]

[ Consumer price index ]

Source: Made by MHRI based on Ministry of Internal Affairs and Communications, Consumer Price Index
(2) Domestic monetary policy: BOJ underscores its stance to pursue additional monetary easing

- The BOJ issued an addendum to its September policy meeting statement that said, "it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost."

- The BOJ ties “momentum” to 1) the output gap and 2) the expected inflation rate. Both have worsened recently.
  - The BOJ's output gap is calculated based on the Tankan Employment Conditions DI and Production Capacity DI. It should be noted that in the June Tankan survey, the breadth of both DIs in the “insufficient” zone have narrowed.
  - In the October Outlook for Economic Activity and Prices (the “Outlook Report”), we expect that the outlook for prices for FY 2019 and FY 2020 will be revised downward.

- While the BOJ is presumed to be cautious toward easing, given uncertainties regarding the effect of additional monetary easing, it may move to ease further in the event of the appreciation of the yen.
  - Options would be to push interest rates deeper into negative territory and revise the hierarchical structure of current account deposits at the BOJ.

[ "Momentum" of price rise (BOJ) ]

[ Outlook for prices (BOJ Outlook Report, MHRI) ]

<table>
<thead>
<tr>
<th></th>
<th>Bank of Japan (July Outlook Report)</th>
<th>MHRI September outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FY 2019</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI (excluding fresh foods)</td>
<td>+1.0</td>
<td>+0.7</td>
</tr>
<tr>
<td>CPI (excluding fresh foods, consumption tax, impact of free education)</td>
<td>+0.8</td>
<td>+0.5</td>
</tr>
<tr>
<td><strong>FY 2020</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI (excluding fresh foods)</td>
<td>+1.3</td>
<td>+0.8</td>
</tr>
<tr>
<td>CPI (excluding fresh foods, consumption tax, impact of free education)</td>
<td>+1.2</td>
<td>+0.6</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based on Bank of Japan's Outlook Report
(3) Japanese long-term interest rates: 10yr JGB yield temporarily fell to around -0.3%

- The 10yr JGB yield temporarily fell to around -0.3%, reflecting the fall of global long-term interest rates stemming from US and eurozone interest rate cuts. Currently, the fall of the yield is pausing, reflecting the rise of US and eurozone long-term interest rates.

- BOJ Governor Haruhiko Kuroda and a member of the Policy Board indicated a tolerance stance, while keeping a close eye upon the fall of interest rates accompanying the decline of overseas interest rate. For the time being, yields are forecast to remain under downward pressure.

Source: Made by MHRI based on Bloomberg

Source: Made by MHRI based on media reports, Bank of Japan
Japanese stock market: solid for the near future, but expect softening after the consumption tax hike

- Stock markets surged since mid-August along with the global shift to risk-on mode. The Nikkei Stock Average is currently moving around JPY22,000.
- With stocks looking undervalued given a forward P/E ratio of around 12 times as of end-August, the market started to see buybacks and net buying by foreign investors.
  - However, given deep-rooted concerns regarding the future course of economic slowdown and yen appreciation, the forward EPS is continuing to fall.
- Stock prices look firm for the near future, reflecting expectations toward the progress of US-China negotiations. However, we forecast that the stock market will soften toward the end of the year, due to ongoing concerns regarding yen appreciation amid uncertainties in the global outlook and speculation on interest rate cuts, and prospects of a post-consumption tax hike economic slowdown.

Note: Forward EPS and forward P/E ratio are for 12 months ahead.
Source: Made by MHRI based on Refinitiv
6. Forex market: volatility in light of US-China trade tensions

- The USD/JPY exchange rate volatility intensified in light of media reports about US-China trade tensions.
  - At one point the yen strengthened against the US dollar to around JPY 104/USD due to tit-for-tat US-China tariffs but later settled back to around JPY 108/USD.
- We expect that the yen will tend to strengthen against the US dollar, due to concerns regarding US-China trade tensions and global economic slowdown.
- As for the EUR/USD exchange rate, the euro has continued to weaken since mid-August. Looking forward, the euro should continue to weaken.

[ USD/JPY exchange rate and non-commercial net positions ]

[ EUR/USD exchange rate and net positions of speculators ]

Note: Net positions among speculators refer to Chicago IMM euro futures non-commercial positions. Source: Made by MHRI based on Bloomberg
7. Outlook on the financial markets

- **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.
Mizuho Research Institute Ltd.

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