Monthly Economic Report

December 24, 2019
Mizuho Research Institute
On December 13, the US and China reached “Phase One” of the trade talks.

- Both countries will mutually called off the imposition of the second half of Round 4 of punitive tariffs (List B) which was scheduled for December 15.
  - The US also promised to halve the additional tariff rate imposed in List A of Round 4 (imposed on September 1) from 15% to 7.5%.
  - The trade agreement is scheduled to be signed in January 2020.
- Given the difficulty to realize China’s commitment to increase its purchases of US goods and services by $200 billion over the course of the next two years, there are lingering risks such as US tariff hikes.

[Overview of US-China “first phase” trade agreement (US announcement and China’s position)]

<table>
<thead>
<tr>
<th>US commitments (tariffs) and announcement</th>
<th>China’s commitment (tariffs) and position</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tariffs</strong></td>
<td></td>
</tr>
<tr>
<td>• Called off the imposition of Round 4, List B additional tariffs (worth some USD160bn) set for December 15.</td>
<td>• Called off the imposition of the second half of Round 4 punitive tariffs (on some USD 45bn) set for December 15.</td>
</tr>
<tr>
<td>• Halve Round 4 List A additional tariff rate (imposed on September 1 on some USD 120bn) from 15% to 7.5% 30 days after signing of the trade agreement.</td>
<td>• Continue with the measure to suspend additional tariffs on automobiles and auto parts (worth some USD 11.7bn).</td>
</tr>
<tr>
<td><strong>China’s commitments</strong></td>
<td></td>
</tr>
<tr>
<td>• Protection of intellectual properties (protection of trade secrets and rights of pharmaceuticals, measures against pirated copies and forged products, etc.)</td>
<td>• Expressed the statement that “the US and China reached consensus” on the matter in the left column.</td>
</tr>
<tr>
<td>• Ban on demands for technological transfers, restraints on instructions and support for foreign investment aimed at acquisition of foreign technologies.</td>
<td>• No reference to details.</td>
</tr>
<tr>
<td>• Eliminate import barriers to farm and fishery products. Increase imports of US products and services by more than USD 200bn over the actual imports in 2017 (some USD 130bn of goods and some USD 57.2bn of services) over the next 2 years.</td>
<td>• Emphasizes the expansion of imports based on market principles and WTO rules. The text of the trade agreement is still under examination, and specific amounts of imports are set to be publicized later.</td>
</tr>
<tr>
<td>• Liberalize financial services (eliminate restrictions on foreign capital investment and discriminatory regulations).</td>
<td>• Already accelerated the opening to foreign capital in financial services, including banking, securities, insurance and credit ratings, etc.</td>
</tr>
<tr>
<td>• Enhance transparency in foreign exchange policy and inhibit competitive depreciation and other unfair foreign exchange practices.</td>
<td>• In March 2019, People’s Bank of China President Yi Gang stated that a consensus has been reached.</td>
</tr>
<tr>
<td>• Fair and prompt settlement of disputes. Conduct of regular consultations. Both countries can implement proportionate response measures deemed appropriate.</td>
<td>• No reference to details</td>
</tr>
</tbody>
</table>

Source: Made by MHRi based upon USTR documents, State Council of the People’s Republic of China and various media reports
Uncertainties linger despite a temporary truce in US-China trade tensions

- Despite a temporary truce in US-China trade tensions, uncertainties remain, given lingering possibilities of an escalation of tensions.
  - While the US and China reached “Phase One” of the trade agreement on December 13, there is a high possibility of the re-escalation of tensions over China’s implementation of the accord.
  - The odds are high that trade talks in Phase Two will stall.
  - If the postponed punitive tariffs in Round 4 (List B) are invoked in 2020, there are concerns that the impact could be as large as or even larger than that in 2019.

[ Trends in US-China trade ]

Note: Estimated potential impacts of additional tariffs imposed on US-China trade on real GDP of other countries/regions, including impacts on investment and consumption and ripple effects to third countries. Round 4 (List B) includes China’s resumption of additional tariffs on US automobiles and auto parts.

Source: Made by MHRI based on World Bank, IMF
1. Global economy: business sentiment among manufacturers are showing signs of bottoming out, and leading indicators show signs of recovery

- The global manufacturing PMI, an indicator of business sentiment, recovered to the expansion-contraction threshold of 50 for the first time in seven months.
  - However, the recovery is led by emerging market (EM) economies, and the manufacturing PMI remains below 50 in Japan and Europe.
  - The OECD Composite Leading Indicator rose above the previous month for the first time in 22 months, presaging a recovery of the OECD economies from the second half of 2020.

Note: The Purchasing Managers' Index (PMI) is an index calculated by weighting indexes such as new orders, output, order backlogs, prices, employment, and quantity of purchases. The reading of 50 in the PMI is the "expansion-contraction" threshold.
Overview of financial markets: US stock market hit record high reflecting US-China trade deal

- US stock prices scaled a new record high reflecting the US-China trade deal. The Nikkei Average temporarily rose above the JPY24,000 level. The 10yr UST yield rose above 1.9%. USD/JPY exchange rate moved around the mid-JPY109 level.

Note: Currency exchange rates are based upon the nominal effective exchange rates as released by the authorities of each country. Source: Made by MHRI based upon Bloomberg
2. US economy: GDP in Jul-Sep 2019 unchanged from the second estimate; personal consumption firmness stands out

- The rate of US real GDP growth in the Jul-Sep quarter of 2019 (the third estimate) remained unchanged from the second estimate at +2.1% q-o-q p.a.
  - Personal consumption expenditures were revised upward (from +2.9% q-o-q p.a. to +3.2% q-o-q p.a.), underscoring the strength of consumer spending. Inventory investment turned out to be weaker than the second estimate.
  - Even though the breadth of the decline of capital investment narrowed (from -2.7% q-o-q p.a. to -2.3% q-o-q p.a.), our view remains unchanged that capital investment remains weak.

Source: Made by MHRI based upon US Department of Commerce
Though business sentiment stopped deteriorating, it is still far from a recovery

- In November, the ISM Manufacturing Index edged down from the preceding month to 48.1, remaining at rock-bottom levels. The export orders index, which rose sharply in the previous month, stood at 47.9, falling below 50 again, showing dull movement.

- In November, the ISM Nonmanufacturing Index also edged down to 53.9. The new orders index showed signs of bottoming out. The employment index rebounded in the latest two months, suggesting that the strong growth of employment is continuing in the services sector.

- Shipments and new orders of core capital goods moved sideways, falling short of a recovery.

[ISM Manufacturing/Nonmanufacturing indexes]

[Core capital goods shipments and new orders]
Looking at the pace of employment expansion, the services sector is still supporting the sluggishness in the goods sector

- In November, nonfarm payrolls rose by +266 thousand m-o-m. Nonfarm payrolls in the past two months were also revised upward (total of +41 thousand).
  - Even excluding the fading impact of strikes at General Motors (an increase of +41 thousand m-o-m in the automobile-related segment), nonfarm payrolls grew a solid +225 thousand.
  - While the pace of employment expansion remained slow in the goods sector, services sector employment growth is accelerating again, particularly in areas such as education, medical services and leisure/accommodations.

- Average hourly wages rose at a stable pace of +3.1% y-o-y, indicating that inflationary pressures are stabilizing.

Source: Made by MHRI based upon the Bureau of Labor Statistics, US Department of Labor
Consumer sentiment recovers; the year-end shopping season got off to a smooth start, contributing to firm consumption

- The final reading of the University of Michigan consumer sentiment index for December recovered to 99.3.
  - The index of consumer expectations, which had been recovering more slowly than consumers’ assessment of current conditions, recovered close to the level seen in July.
- Personal consumption expenditures remain robust. The year-end shopping season got off to a smooth start, contributing to firm consumption.
  - In November, real personal consumption expenditures rose +0.3% m-o-m. In October, while consumption of goods fell primarily with respect to automobiles, goods consumption is currently picking up.
  - Media reports indicate that the Black Friday and Cyber Monday (online) sales in the run-up to the year-end shopping season appear to have produced favorable results.

Source: Made by MHRI based on University of Michigan

Source: Made by MHRI based on US Department of Commerce
(2) US monetary policy: given the high hurdles to change the policy rate, the odds are high that the FOMC will keep the federal funds rate unchanged

- The FOMC kept the policy rate unchanged at its meeting in December. While the “uncertainty about the outlook” disappeared from the FOMC statement, the odds are high that the federal funds rate will remain unchanged even after the turn of the year into 2020.
- The dot plot chart flattened compared with September. Most FOMC participants supported the stance of keeping the policy rate unchanged during 2020.
- There was no change in the FOMC’s stance that “the current monetary policy is appropriate” and that “a policy change would require a major change in the outlook.”
- According to the minutes of the October FOMC, “It is judged that negative interest rates currently did not appear to be an attractive monetary policy tool in the US.” On the other hand, the minutes also said, “By contrast, a majority of participants saw greater benefits in using balance sheet tools to cap shorter-term interest rates” (in comparison with the capping of longer-term rates).

[ Summary of December FOMC Press conference ]
- The current monetary policy stance is somewhat accommodative, seen appropriate to push up the inflation rate.
- The relation between the economic slack and inflation has weakened in comparison with some time ago, but there still exists the relationship between the two.
- When compared with the preventive rate cuts in 1995 and 1998, there is the similarity in that the economy has been expanding but there is also a major difference in the economic structure over inflation.
- Before the FOMC moves toward a rate hike going forward, it is necessary for inflation to rise significantly and for the FOMC to determine that higher inflation is being sustained.
- While the Summary of Economic Projections (SEP) did not contain details, many FOMC participants believe that the overshooting of inflation rates is appropriate.
- While the FOMC says that it has a tool to increase the inflation rate to its target, the FOMC is not particularly confident about that but remains rather humble about it, because not only the US but also other countries across the world have been unable to achieve the inflation targets.
- We have to say “NO” to the question of whether the opportunistic inflation targeting is sufficiently credible. For such targeting to become credible, it must be accompanied by an unbending policy (instead of placing expectations on an accidental increase in the inflation rate).
- The labor market is strong but not necessarily tight, as it is not reflected in wage increases.

Source: Made by MHRI based upon FRB

[ Policy rate outlook of FOMC participants ]

Note: indicates the median rate.
Source: Made by MHRI based upon FRB
(3) US bond market: long-term U.S. interest rates are expected to remain at just under 2% for the time being

- Responding favorably to the progress in US-China trade talks, the 10yr UST yield rose to the 1.9% level.
  - While the ISM Manufacturing Index still remains below 50, positive headlines about the US-China trade negotiations served to push up long-term interest rates.
  - As the market continues to factor in the rate cut, the margins of short-term rate rises are limited, while optimistic views of the economy ahead are pushing up long-term rates, sending the yield curve steepening.
- In the near absence of inflation fears, the financial markets have yet to factor in a rate hike. We expect US long-term interest rates to stay at levels just below 2% for the time being.

![ISM Manufacturing Index and long-term interest rates](image1)

![2yr/10yr UST yields](image2)
(4) US stock market: while stock prices stay high on strong expectations toward economic recovery, take note of adjustment risks

- Investors took a risk-on stance following the agreement in principle on Phase One of the US-China trade deal. The three major stock price indexes scaled new highs.
  - By industry sector, growth stocks in information technology and healthcare, etc. pushed up the overall market.

- While the forward EPS stayed flat, the forward P/E ratio rose to about 18x on improved risk appetites, with a sense of overvaluation growing stronger.

- Despite lingering uncertainties regarding China’s conditions for purchasing US farm products, the US stock market should follow firm footing due to the ebb of anxieties.
  - For the time being, keep a close eye on the signing of Phase One of the trade agreement by the US president and developments leading to talks on Phase Two of the trade agreement. Also, stay alert to adjustment risks due to a sense of overvaluation.

[ Sector-based rate of rise/fall of the S&P 500 index and contribution ]

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

Note: Calculated based on the rate of rise/fall in December
Source: Made by MHRI based upon Bloomberg

Note: The forward EPS and forward P/E ratio are for 12 months ahead.
Source: Made by MHRI based upon Refinitiv
3. The European economy: Eurozone growth in the Jul-Sep quarter matched the preceding quarter; the low growth rate is expected to continue

- The eurozone real GDP growth rate stood at +0.2% q-o-q in the Jul-Sep quarter of 2019, maintaining the growth comparable to the preceding quarter.
  - Household consumption expenditure was steady at +0.5% q-o-q against a background of fiscal spending to support households.
- The Purchasing Managers’ index (synthetic PMI), having a high correlation with GDP, remains barely above the expansion-contraction threshold of 50.
  - Although business confidence in the manufacturing sector is beginning to show signs of bottoming out, it remains weak, and it will take time for the eurozone economy to recover from low growth.

Source: Made by MHRI based upon Eurostat
Note: PMI at 50 is the expansion/contraction threshold.
Source: Made by MHRI based upon Markit, Bloomberg
The slowdown of exports to areas outside the eurozone continuing, likely to require some time before a recovery in production

- In September 2019, the pace of export growth to areas outside the eurozone stood at +2.1% y-o-y, remaining at the level recorded two months ago.
  - Exports to the UK grew, contributing +0.5% pt y-o-y to overall growth.
  - Intra-eurozone exports fell (-1.6% y-o-y), revealing the ongoing decline of intra-eurozone demand.
- In September 2019, industrial production in the eurozone stood at -1.9% y-o-y, indicating that the underlying trend remains weak.
  - In particular, production of motor vehicles remained weak (-8.1% y-o-y).

Source: Made by MHRI based upon Eurostat
Despite the ongoing strength of the labor market, there are signs that the improvement may be peaking out

- In October 2019, the eurozone unemployment rate stood at 7.5%, remaining more or less flat from the previous month (7.6%).
  - Compensation per employee in the eurozone remaining on firm footing in the Apr-Jun quarter of 2019 (+2.1% y-o-y).

- Meanwhile, employment expectations continued to deteriorate 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 ]

Source: Made by MHRI based upon 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 upon the European Commission
The rise of the eurozone core inflation rate is temporary; the core CPI rate likely to stay close to 1%

- In November 2019, the eurozone inflation rate (flash estimate) stood at +1.0% y-o-y, rising to the level seen in August.
  - The core inflation rate, which excludes volatile items such as energy and food, stood at +1.3% y-o-y, rising from +1.1% y-o-y in October.
    - Service prices rose +1.9% y-o-y, recording the strongest rise since April, contributing to the rise of the core inflation rate.
    - Entertainment-related services prices may have increased temporarily due to a string of holidays.
  - As the selling price expectations index remains lackluster in the services and manufacturing sectors, the core inflation rate is expected to remain close to 1% for the time being.

Source: Made by MHRI based upon Eurostat, ECB

Note: “Zero” is the “expansion-contraction” threshold. The figures are based on queries on selling price expectations over the next three months.
Source: Made by MHRI based upon the European Commission
ECB kept monetary policy unchanged. ECB reform is expected to move forward under the new administration of President Christine Lagarde

- There were no surprises from the ECB Governing Council meeting on December 12. The ECB kept its monetary policy framework unchanged.
  - ECB President Christine Lagarde managed to steer through her first press conference without any trouble, but emphasized her intention to conduct communication in her own style.

- ECB President Lagarde is expected to commence discussions on a possible change in the monetary policy strategy in January 2020 to reach a conclusion by the end of the year.
  - The focal points in the discussions may include (1) changes in the monetary policy strategy, including the definition of price stability; (2) changes in the communication strategy, including the way of transmitting information by the ECB President; and (3) the ECB’s contribution to solving problems related to climate change.

- On the other hand, given that prices unlikely to rise throughout 2020, the ECB is expected to find it difficult to break away from the accommodative monetary policy environment.

### [Key points in ECB reform sought by President Christine Lagarde]

<table>
<thead>
<tr>
<th>Issues</th>
<th>Key points</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Change in the monetary policy strategy</td>
<td>Will the ECB change the definition of price stability, currently defined as the policy to &quot;maintain inflation rates below, but close to, 2% over the medium term.</td>
<td>In reaction to the definition of current price stability, clarify that the price stability may be moved up or down in vertical symmetry. The objective is to avoid the formation of mistaken expectations under the low inflation environment that the inflation rate should be capped at 2%.</td>
</tr>
<tr>
<td>(2) Change in the communication strategy</td>
<td>Will the ECB Governing Council restrict the President in indicating the direction of policy in advance? Will the Governing Council take the vote on each occasion?</td>
<td>In response to the major division in the Governing Council that occurred in the final days of former ECB President Mario Draghi, the Governing Council may introduce a new system that would not allow the President’s arbitrary decision.</td>
</tr>
<tr>
<td>(3) ECB’s contribution to solutions of climate change problems</td>
<td>Will the ECB deepen the recognition of climate change-related risk and conduct a stress test? Will the ECB introduce a monetary policy framework that can specifically contribute to reducing greenhouse gas emissions, including “Green QE”?</td>
<td>Germany and many other countries oppose the introduction of Green QE. The Bank of England has already announced the introduction of a stress test on climate change in 2021, and the ECB can do the same. But there is the issue of independence from politics.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon ECB
Brexit will become a reality on January 31; the transition period expected to be extended

- In the UK House of Commons election held on December 12, the Conservative Party clinched a victory by winning 365 seats.
  - The Withdrawal Agreement Bill (WAB) was passed through the House of Commons second reading on December 23, with 358 affirmative votes against 234 dissenting votes. The House of Commons went into Christmas recess and will reopen on January 7. As the WAB is expected to be sent to the House of Lords by mid-January, Brexit will become a reality at 23:00 (British Time) on January 31.

- The UK and the EU are likely to officially start negotiations on a free trade agreement (FTA) between them around March. The transition period is expected to be extended until June 30.
  - The WAB does not allow an extension of the transition period (expired on December 31, 2020). The risk is rising that the transition period may expire without conclusion of an FTA. However, as it is still possible that the transition period can be extended by an amendment of UK law, this may be a tactical move to secure an advantage in negotiations. Since there remain many issues in dispute in negotiations, including regulations of products to secure the fairness in competition, the effectuation of the UK-EU FTA at the end of December is deemed difficult.

[ Outcome of UK general elections ]

<table>
<thead>
<tr>
<th>Party</th>
<th>Election outcome</th>
<th>Pre-election</th>
<th>Rise/Fall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative Party</td>
<td>365</td>
<td>299</td>
<td>66</td>
</tr>
<tr>
<td>Labour Party</td>
<td>203</td>
<td>243</td>
<td>-40</td>
</tr>
<tr>
<td>Scottish National Party (SNP)</td>
<td>48</td>
<td>35</td>
<td>13</td>
</tr>
<tr>
<td>Liberal Democrats</td>
<td>11</td>
<td>21</td>
<td>-10</td>
</tr>
<tr>
<td>Democratic Unionist Party (DUP)</td>
<td>8</td>
<td>10</td>
<td>-2</td>
</tr>
<tr>
<td>Sinn Fein Party</td>
<td>7</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Plaid Cymru (The Party of Wales)</td>
<td>4</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Social Democratic and Labour Party (SDLP)</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Union Movement</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Green Party</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Independent Group (TIG)</td>
<td>0</td>
<td>5</td>
<td>-5</td>
</tr>
<tr>
<td>Brexit Party</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
<td>25</td>
<td>-25</td>
</tr>
<tr>
<td>Total</td>
<td>650</td>
<td>650</td>
<td></td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon UK House of Commons, BBC

[ Major scheduled events in 2020 ]

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 7</td>
<td>House of Commons reopens Continuous discussion of the WAB</td>
</tr>
<tr>
<td>During January</td>
<td>Parliament takes vote on related bills The WAB and other related bills are expected to be passed.</td>
</tr>
<tr>
<td>January 29</td>
<td>European Parliament’s plenary session European Parliament is expected to ratify the Brexit treaty.</td>
</tr>
<tr>
<td>January 31</td>
<td>Brexit from the EU Brexit is expected to become a reality at 23:00 (British Time) on January 31.</td>
</tr>
<tr>
<td>March 26-27</td>
<td>EU summit meeting Progress in FTA negotiations between the UK and the EU is expected to be discussed.</td>
</tr>
<tr>
<td>July 1</td>
<td>Deadline for decision on the extension of the transition period An extension of the transition period for one or two years are expected to be decided.</td>
</tr>
<tr>
<td>December 31</td>
<td>Expiration of the transition period under the present Brexit treaty The expiration of the transition period under the present Brexit treaty</td>
</tr>
</tbody>
</table>

Source: MHRI
Germany’s SPD new leaders: intending to seek the point of compromise with CDU/CSU on expansionary fiscal policy after 2021 while maintaining “GroKo”

- Germany’s SPD officially elected a pair of new leaders at its party convention held on December 6.
  - Saskia Esken (a member of Bundestag) and Norbert Walter-Borjans (former finance minister of the state of North Rhine-Westphalia)
    - The duo is skeptical about the grand coalition (“GroKo”) with CDU/CSU.

- Going forward, the SPD will seek a new agreement on an expansion of investment with its coalition partners CDU/CSU.
  - However, the SPD has no clear path toward recovering its sagging popularity after the departure from the coalition. The new leading duo may compromise on the maintenance of the balanced finance policy of CDU/CSU for maintaining the coalition.

[ Major decisions at SPD convention (1) (investment-related) ]

<table>
<thead>
<tr>
<th>Theme</th>
<th>What they stand for</th>
</tr>
</thead>
</table>
| Investment for the future       | • The federal government, state governments and municipalities need to invest a total of EUR 450bn in education, transportation, telecommunications and environmental fields (an amount equivalent to 15% of nominal GDP) over the next 10 years  
  • Germany should not stick to a balanced finance policy. |
| Climate change remedies         | • Raise CO2 prices in and beyond 2021.  
  • Achieve the renewable energy ratio of 65% in 2030 (the current target: 55-60% by 2035), and break with coal-fired thermal power generation by 2035 (the current target: by 2038). Make investment and implement employment measures for the attainment of the new targets. |
| Other                           | • Secure budgets for public housing construction in and beyond 2021 (EUR 1bn per year).                                                                 |

Source: Made by MHRI based upon SPD convention materials, Spiegel

[ Major decisions at SPD convention (2) (consumption related) ]

<table>
<thead>
<tr>
<th>Theme</th>
<th>What they stand for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on assets</td>
<td>• Impose taxes on assets worth EUR 2mn or larger at the rate of 1-2%.</td>
</tr>
</tbody>
</table>
| Labor market reform           | • Increase the minimum wage to EUR 12 a month.  
  • Extend the period of unemployment insurance benefits in light of the number of years of work in the past. |
| Other                         | • Secure budgets for school-age children and childcare in and beyond 2022 (EUR 2bn a year).            |

Source: Made by MHRI based upon SPD convention materials, Spiegel
German 10yr government bond yields are expected to hover around -0.3%

- German long-term interest rates rose to the -0.2% range amid rising expectations toward expansionary fiscal policy following the outcome of Germany’s SPD leadership election.
  - Market speculation about interest rate cuts receded in the wake of a string of critical comments on negative interest rates by ECB officials.
  - Spanish and Italian interest rate spreads with German interest rates widened along with the focus of attention upon political risks in the two countries.
- Given the expected persistence of soft fundamentals, the German 10yr government bond yield is anticipated to hover around -0.3%.

Source: Made by MHRI based upon Bloomberg

[ German long-term interest rates and eurozone short-term interest rates ]

[ Spread with German interest rates (10yr) ]
4. The Chinese economy and EM financial markets: the Chinese economy continues to lack strength

- China’s major economic indicators still appear to lack strength, even though production and consumption accelerated in November, due partially to temporary factors. In investment activities, infrastructure investment shows signs of recovery.
  - While production accelerated (+6.2% y-o-y), the acceleration in many sectors was only due to a rebound from the slower growth in the previous month. Despite the rise in growth of consumption (+8.0% y-o-y), Internet sales on November 11 (Singles’ Day) had a large impact. In real terms, consumption leveled off from the previous month (4.9% y-o-y).
  - Investment growth accelerated by +5.2% y-o-y. While growth of investment slowed down in the manufacturing sector along with the deterioration of corporate earnings, real estate development investment edged up and growth of infrastructure investment accelerated on the back of fiscal policy.

- The odds are high that the Chinese government will support the economy by expanding fiscal spending mainly for infrastructure investment and easing credit through lowering the reserve requirement ratio.

[China’s major economic indicators]

[Manufacturing investment, real estate development investment, infrastructure investment]

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Note: 1. The figures for industrial production, retail sales, and investment in fixed assets in January and February are changes of the cumulative total of January and February over the same period a year ago.
2. For fixed asset investment, the cumulative year-to-date figure is converted into a single month.
3. Industrial production is in real terms. Total retail sales of consumer goods and investment in fixed assets, and exports are in nominal terms.
4. Exports are on a RMB basis.

Source: Made by MHRI based upon the National Bureau of Statistics of China, the General Administration of Customs of China, CEIC data
The yuan advances; the PBoC classifies 587 financial institutions into the high-risk category

- The yuan advanced along with the progress in US-China trade talks.
  - Following media reports on Phase One agreement in US-China trade talks on December 13, the yuan rose sharply against the US dollar and recovered to the 6 yuan level to the dollar for the first time in about a month. Subsequently, the yuan moved narrowly at levels around 7.0 yuan to the dollar. Going forward, the yuan is likely to remain dependent on the direction of US-China trade talks.

- On November 25, the People’s Bank of China (PBoC) announced the 2019 Financial Stability Report, which released the results of the assessment of domestic financial institutions.
  - The assessment of small and medium-sized financial institutions was relatively poor, and the PBoC classified a total of 587 banks and financial institutions into the “high risk” category. The central bank said these institutions have been affected by the slowing economy and the reinforcement of the ascertainment of nonperforming loan claims.

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[Results of the PBoC’s assessment of domestic financial institutions]

<table>
<thead>
<tr>
<th>Rating</th>
<th>Large</th>
<th>Small &amp; Medium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of firms</td>
<td>Share (%)</td>
</tr>
<tr>
<td>1</td>
<td>1</td>
<td>4.2</td>
</tr>
<tr>
<td>2</td>
<td>11</td>
<td>45.8</td>
</tr>
<tr>
<td>3</td>
<td>7</td>
<td>29.2</td>
</tr>
<tr>
<td>4</td>
<td>3</td>
<td>12.5</td>
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</tr>
<tr>
<td>7</td>
<td>1</td>
<td>4.2</td>
</tr>
<tr>
<td>8</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>9</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>10</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>D</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>24</td>
<td>100.0</td>
</tr>
</tbody>
</table>

The high risk “D” represents a financial institution that was taken over or shut down.

Note: The results of assessment conducted in the Oct-Dec quarter of 2018
Source: Made by MHRI based upon the People’s Bank of China
EM financial markets: EM stock markets rebound following the US-China trade agreement

- EM stocks that had lacked any significant price movements advanced in the wake of the Phase One agreement in US-China trade talks on December 13.
  - Hong Kong and Chinese stocks also rebounded after remaining under pressure from protracted protest demonstrations in Hong Kong following the enactment of the Hong Kong Human Rights Act in the US (November 27).
- Most EM currencies also rebounded, except some like the Turkish lira and the Argentine peso.
- Given the market consensus that the US-China Phase One trade agreement will be officially signed as it is, both EM stocks and currencies are expected to follow the uptrends for the time being.

[ EM stocks and Chinese/HK stocks stocks ]

[ Rate of rise/fall of EM currencies against USD ]
5. (1) The Japanese economy: 2019 Jul-Sep GDP (2nd QE) revised upward slightly from the 1st QE

- According to the 2nd QE for the Jul-Sep quarter of 2019, Japan’s real GDP grew +0.4% q-o-q (+1.8% p.a.), revealing upward revision from the 1st QE (+0.2% p.a.). The uptick of capital investment and personal consumption contributed to the upward revision.
  - Even though external demand served as a drag, private and public demand grew firmly. However, the firmness of private demand is due largely to the front-loading of demand in the run-up to the consumption tax hike. Actual private demand is far from strong given the deterioration of the environment surrounding consumer spending and capital investment, such as weak income growth and stagnant corporate earnings.

[ Second Preliminary Quarterly Estimates of GDP (2nd QE) of the Jul-Sep quarter of 2019 ]
Indexes of business conditions fell sharply; overall assessment of business conditions expected to be kept unchanged as “worsening” for the time being

- In October, the indexes of business conditions fell a sharp -5.6pt m-o-m, with the overall assessment of business conditions kept unchanged as “worsening.”
  - Retail and wholesale commercial sales and shipments of consumer durable goods decreased due to a reactionary fall arising from the consumption tax hike. Industrial production and shipments also fell sharply.
  - The three-month moving average also showed a decline of -1.5pt. As a recovery of production cannot be expected any time soon, the overall assessment of business conditions is expected to remain as “worsening” for the time being.

[Indexes of business conditions (Composite Index (CI) of coincident indicators)]

[Overall assessment of business conditions]

<table>
<thead>
<tr>
<th>Overall assessment</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Improving</td>
<td>Indicates the likelihood of an economic expansion.</td>
</tr>
<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>Upward turning point</td>
</tr>
<tr>
<td></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></td>
<td>Downward turning point</td>
</tr>
<tr>
<td></td>
<td>Indicates the likelihood that the economic peak to be determined ex post facto existed in the prior few months.</td>
</tr>
<tr>
<td>(4) Worsening ⊂ As of October</td>
<td>Indicates the likelihood of a 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 making forecasts. The CI of coincident index is calculated using indices that move in line with economic trends.

Source: Made by MHRI based on Cabinet Office, Indexes of Business Conditions
October industrial production fell sharply following Typhoon No. 19 and reactionary drops from the previous month; production likely to remain weak

- In October, industrial production fell (-4.2% m-o-m), with production falling in 12 industrial sectors out of 15 sectors covered.
  - Output fell for general-purpose and commercial machinery in a reactionary fall from large deals in the previous month. Output dropped sharply for transportation equipment due to the reduced number of operating days and constraints on the supply of some parts and components resulting from Typhoon No. 19, contributing to the overall weakness of production.

- If production goes ahead as projected by the production forecasts, industrial production in the Oct-Dec quarter should fall (-4.1% q-o-q). This is weaker when compared with drop at the time of the previous consumption tax hike (Apr-Jun quarter of 2014, -2.9% q-o-q).
  - The typhoon impact proved to be a major drag on production. Production forecasts are weak particularly for the transportation machinery industry.

[ Breakdown of industrial production contributions ]

[ Production forecasts of industrial production ]

Source: Made by MHRI based upon Ministry of Economy, Trade and Industry, *Indices of Industrial Production*
Exports in November fell for the second consecutive month due mainly to falls in exports to US and Europe; exports to China turned positive

- In November, the export volume index fell (-1.0% m-o-m), declining for the second consecutive month.
  - By region, falls in exports to the US and Europe pulled down overall exports. However, China-bound exports turned positive (+2.0% m-o-m).
  - Semiconductor-related exports are beginning to pick up, particularly those to China, but those for motor vehicles remained weak.
  - Exports of motor vehicles continued to decline. However, as the breadth of the fall narrowed, exports of motor vehicles should bottom out.

Note: Adjusted for seasonal factors by MHRI.
Source: Made by MHRI based upon Ministry of Finance, Trade Statistics
Employment data leveled off in October; consumer confidence recovering steadily from the impact of the consumption tax hike

- The unemployment rate stood at 2.4% and the ratio of job offers to job applications came to 1.57 times in October, both leveling off from the previous month. While the number of employed persons is rising moderately, the number of employees is leveling off when averaged out.
  - While the labor market is expected to retain its firmness, the labor market is likely to flatten out in the future, as companies, particularly manufacturers, are becoming increasingly cautious about employment.

- Consumer confidence is steadily recovering from the impact of the consumption tax hike. Confidence about employment and income is also showing signs of ceasing to fall.

Source: Made by MHRI based upon Cabinet Office, Consumer Confidence Survey

Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, Labour Force Survey
Retail sales fall in October; new auto sales in November weak

- In October, retail sales (in real terms) fell into negative territory (-15.0% m-o-m).
  - Poor sales of motor vehicles as well as machinery and equipment pulled down overall retail sales. In addition to the adverse effects of typhoons, reactionary falls after the front-loading of demand ahead of the consumption tax hike were reflected in sales of durable goods.

- In November, new car registrations picked up from the sharp fall in October, but fell short of making up for the previous month fall.
  - The fall after the consumption tax hike is bigger than the upswing brought about by the front-loading of demand ahead of the tax hike.
    - In addition to the adverse impacts of typhoons (supply constraints, the reduced number of visitors to showrooms), the delays in introduction of new models (postponement of the release of new models), and the loss of purchasing power stemming from higher prices of passenger cars (around +1.5% on a CPI basis) were the factors behind the downswing.

[ Retail sales in real terms (contributions by sector) ]

[ New car registrations ]

Note: 1. Seasonally adjusted in real terms by MHRI  
2. As seasonal adjustments are made for each series, the sum total of contributions by each series and the overall growth do not match.  

Note: Seasonally adjusted by MHRI. The dotted line indicates the level of sales in the Jan-Mar quarter of 2019.  
Source: Made by MHRI based upon Japan Automobile Dealers Association, Japan Light Motor Vehicle and Motorcycle Association,
Price hikes following the consumption tax hike are more subdued than after the previous tax hike, perhaps against the backdrop of slow consumption reflecting the fall of disposable income

- The nationwide core CPI in October revealed a larger rise of +0.4% y-o-y. Excluding system-oriented factors (contributions +0.8%pt from the consumption tax hike and -0.6%pt from free education), the October rise of +0.2% y-o-y was smaller than the previous month’s increase, indicating that price hikes following the consumption tax hike are limited.

- Compared with the previous consumption tax hike, the reduced tax rate for food and some other items, larger drops in gasoline prices, and an intensification of price competition associated with the introduction of reward points for consumers making cashless payments apparently helped contain corporate moves to “raise prices.”

- However, the growth of consumption is expected to weaken, reflecting the consumption tax hike and the “softening” of the employment and income environment. Prices are also expected to flatten out going forward.

### Contributions of system-oriented factors to y-o-y changes in CPI

<table>
<thead>
<tr>
<th></th>
<th>Consumption tax hike</th>
<th>Free education</th>
<th>Contribution (total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core CPI</td>
<td>+0.8%Pt</td>
<td>-0.6%Pt</td>
<td>+0.2%Pt</td>
</tr>
<tr>
<td>Core CPI, BOJ version</td>
<td></td>
<td>-0.7%Pt</td>
<td></td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index*, publicized documents

### Comparison of CPI (y-o-y) before and after the tax hike (excluding system-oriented factors)

Note: Values for April 2014 and October 2019 exclude system-oriented factors. Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index*
BOJ *Tankan*: Assessment of business conditions worsened for both manufacturing and nonmanufacturing enterprises, with no improvement expected in the near future

- The Business Conditions DI of large manufacturers stood at +0%pt (September survey: +5%pt), deteriorating for the fourth quarter in a row. The forecast flattened out.
  - The Business Conditions DI for automakers worsened sharply following sluggish sales both at home and overseas. The DI for machinery-related manufacturers and materials-related enterprises also worsened due to the slowdown of overseas economies and deterioration of market conditions.
  - Uncertainties over trade tensions and concerns regarding the continuation of the overseas economic slowdown served to drag down forecasts. The DI flattened out among automakers, revealing their cautious outlook.

- The Business Conditions DI of large nonmanufacturers deteriorated to +20%pt (September survey: +21%pt). The forecast DI stood at +18%pt, indicating a further deterioration.
  - The Business Conditions DI worsened for retailers, construction companies and real estate firms because of reactionary falls after the consumption tax hike and sluggish housing and construction investment. The breadth of the deterioration at 1%pt, was smaller than the 5%pt drop at the time of the previous consumption tax hike.
  - Going forward, retailers are seeing a recovery in their business conditions, but construction and real estate companies expect to see a further deterioration. Information services firms are also expected to see a deterioration due to the fading replacement demand associated with the termination of operating system (OS) support.

<table>
<thead>
<tr>
<th>(N/P)</th>
<th>June 2019 survey</th>
<th>September 2019 survey</th>
<th>December 2019 survey</th>
<th>(Change)</th>
<th>(Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Forecast</td>
<td>Actual</td>
<td>Forecast</td>
<td>(Change)</td>
</tr>
<tr>
<td>Large enterprises</td>
<td>15</td>
<td>12</td>
<td>13</td>
<td>8</td>
<td>-4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7</td>
<td>7</td>
<td>5</td>
<td>2</td>
<td>-5</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>23</td>
<td>21</td>
<td>21</td>
<td>15</td>
<td>-1</td>
</tr>
<tr>
<td>Medium-sized enterprises</td>
<td>13</td>
<td>6</td>
<td>12</td>
<td>5</td>
<td>-3</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>5</td>
<td>0</td>
<td>2</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>18</td>
<td>11</td>
<td>18</td>
<td>9</td>
<td>-4</td>
</tr>
<tr>
<td>Small enterprises</td>
<td>6</td>
<td>-1</td>
<td>5</td>
<td>-3</td>
<td>-4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-1</td>
<td>-5</td>
<td>-4</td>
<td>-9</td>
<td>-5</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>10</td>
<td>3</td>
<td>10</td>
<td>1</td>
<td>-3</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon Bank of Japan, *Short-Term Economic Survey of Enterprises in Japan (Tankan)*
BOJ Tankan: earnings projections for FY2019 revised down due to the revision of the expected exchange rate toward a stronger yen

- Current profit projections for FY2019 (all enterprises, all industries) were revised down to -7.5% y-o-y from the September survey (revision rate: -0.9%).
  - This was due primarily to the revision of the expected exchange rate toward a stronger yen (107.83 JPY/USD and the sharp downward revision in projected current profits of manufacturers reflecting the overseas economic slowdown.
  - Reflecting the impact of the strong yen over the summer, the expected exchange rate for the second half of FY2019 (106.90 JPY/USD) is more cautious than current market exchange rates.

---

[ Current profit projections (all enterprises, all industries) ]

- FY2017 (new base)
- FY2017 (old base)
- FY2018
- FY2016
- FY2019

[ Expected exchange rates and market exchange rates (large, manufacturing enterprises) ]

- FY2018 expected exchange rate (June survey: 110.33 yen/dollar)
- FY2019 expected exchange rate (September survey: 108.87 yen/dollar)
- FY2019 expected exchange rate (December survey: 107.83 yen/dollar)

Source: Made by MHRI based upon Bank of Japan, Short-Term Economic Survey of Enterprises in Japan (Tankan)
BOJ Tankan: momentum of fixed (capital) investment slowing due to deteriorating business sentiment and earnings

- FY2019 fixed investment projections (all enterprises of all industries) was revised upward as usual from the September survey (+2.4% y-o-y) to +3.3% y-o-y.
  - Even though the level of investment on a year-on-year basis remains firm, the revision rate (+0.8% y-o-y) is smaller than usual.
  - Though automation and labor-saving investment is underpinning the overall investment level, the momentum of fixed investment is viewed as slowing down reflecting the weakness of business sentiment and corporate earnings.

[ Fixed investment projections (including land purchasing expenses but excluding software and R&D investment ) ]

<table>
<thead>
<tr>
<th>(Y-o-y % change)</th>
<th>FY2018</th>
<th>FY2019</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Mar survey projections</td>
</tr>
<tr>
<td>All enterprises</td>
<td>6.6</td>
<td>-2.8</td>
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<tr>
<td>Manufacturing</td>
<td>8.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>5.4</td>
<td>-5.6</td>
</tr>
<tr>
<td>Large enterprises</td>
<td>7.3</td>
<td>1.2</td>
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<tr>
<td>Manufacturing</td>
<td>7.0</td>
<td>6.2</td>
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<tr>
<td>Nonmanufacturing</td>
<td>7.4</td>
<td>-1.6</td>
</tr>
<tr>
<td>Medium-sized enterprises</td>
<td>8.3</td>
<td>-6.6</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>6.4</td>
<td>-5.1</td>
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<tr>
<td>Nonmanufacturing</td>
<td>9.5</td>
<td>-7.5</td>
</tr>
<tr>
<td>Small enterprises</td>
<td>2.6</td>
<td>-14.9</td>
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<tr>
<td>Manufacturing</td>
<td>17.2</td>
<td>-6.1</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>-4.4</td>
<td>-20.1</td>
</tr>
</tbody>
</table>

Note: The right-hand chart shows the survey results for all enterprises of all industries.
Source: Made by MHRI based upon Bank of Japan, Short-Term Economic Survey of Enterprises in Japan (Tankan)
Economic stimulus measures: the latest measures envision 26 trillion yen in scale of projects with 13 trillion yen in fiscal spending

On December 5, the government formulated a package of economic stimulus measures, worth 13.2 trillion yen in fiscal spending and 26.0 trillion yen in scale of projects. The scale is around the same level as the economic stimulus measures of 2016.

- In the short run, public investment is expected to push up GDP by around 0.7% to 0.8%. However, there are concerns that progress in projects may be delayed due to a shortage of construction manpower.

<table>
<thead>
<tr>
<th>[Outline of the latest economic stimulus measures]</th>
<th>[Comparison with the economic stimulus measures in the past]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fiscal spending</td>
</tr>
<tr>
<td>1 Restoration and reconstruction after natural disasters and the ensuring of safety and security</td>
<td>5.8</td>
</tr>
<tr>
<td>2 Focused support for people trying to override the downward risk of the economy</td>
<td>3.1</td>
</tr>
<tr>
<td>3 Investment for the future and the maintenance and enhancement of economic vitality, looking beyond the Tokyo Olympics and Paralympics</td>
<td>4.3</td>
</tr>
<tr>
<td>Total</td>
<td>13.2</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon Cabinet Office, Comprehensive Economic Measures to Create a Future with Security and Growth

Source: Made by MHRI based upon the website of the Prime Minister’s Office of Japan, etc.
(2) Japanese monetary policy: the December MPM maintained policy, did not alter its accommodative stance

- The Bank of Japan (BOJ) maintained its current monetary policy at the Monetary Policy Meeting (MPM) in December. The BOJ did not change its accommodative policy stance. BOJ Governor Kuroda stated that “despite some brightness seen in the overseas economies, it is necessary to maintain a policy stance of being tilted toward monetary.” Speculation on further easing factored in by the market receded.

- The BOJ is expected to maintain the current policy while paying close attention to the impact of the consumption tax hike. The hurdles for pursuing negative interest rates further into negative territory are high due to concerns over adverse side effects. The BOJ hopes for the government’s policy responses to a possible economic downswing after the consumption tax hike.
  - In the *Outlook for Economic Activity and Prices* to be released in January 2020, the BOJ is set to examine the effects of the government’s economic stimulus measures.

[ Summary of BOJ Governor Kuroda’s comments ]

(The current state and outlook of the Japanese economy)
- The virtuous cycle from income to spending being maintained in both the household and corporate sectors. While Japan's economy is likely to continue to be affected by the slowdown in overseas economies, its impact on domestic demand is limited.
- It is true that overseas risks to the outlook are showing some signs of moving downward to a somewhat bright direction. But downside risks regarding the overseas economies remain at high levels, and it is necessary to pay close attention. It is appropriate to maintain a policy stance of being tilted toward monetary accommodation.
- The Outlook for Economic Activity and Prices to be released in January 2020 will refer to and incorporate the effects of the government’s economic measures.

(Conduct of monetary policy going forward)
- It is fully conceivable that BOJ may push interest rates further into negative territory if the circumstances require it.
- Although the current yield curve is not seem as a serious trouble, I would not be surprised to see a little bit more steepening in the ultralong zone.

Source: Made by MHRI based upon Bank of Japan
(3) Japanese long-term interest rates: 10yr JGB yield rose into positive territory

- The 10yr JGB yield temporarily rose into positive territory, reflecting rises in US and European interest rates driven by expectations of progress in US-China trade talks. However, the JGB yield was hesitant to rise further due to a psychological threshold of 0% for long-term interest rates.

- In its JGB purchasing operations in December, the BOJ reduced purchases of JGBs with maturities of over 10yr to up to 25yr to 50-150 billion yen, with the ceiling lowered by 50 billion yen from the previous operation. The BOJ apparently intends to prompt the ultralong zone of the yield curve to steepen by reducing purchases of that zone as it has been flattening vis-à-vis the medium to long zones.

- Reflecting discussions at meetings of primary dealers, the JGB Issuance Plan for FY2020 increased issuance of 40yr JGBs in greater demand from life insurers and other institutional investors, and instead, reduced amounts of JGBs offered in liquidity enhancement auctions. Even though the increased issuance of 40yr JGBs extends the average JGB maturities, that extension is held down to around one month on a calendar basis.

Source: Made by MHRI based upon Bloomberg

<table>
<thead>
<tr>
<th>JGB Issuance Plan for FY2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2019</td>
</tr>
<tr>
<td>Annual issuance amount</td>
</tr>
<tr>
<td>40yr JGB</td>
</tr>
<tr>
<td>30yr JGB</td>
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<tr>
<td>20yr JGB</td>
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<tr>
<td>10yr JGB</td>
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<tr>
<td>10yr inflation-indexed JGB</td>
</tr>
<tr>
<td>5yr JGB</td>
</tr>
<tr>
<td>2yr JGB</td>
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<tr>
<td>TB</td>
</tr>
<tr>
<td>Liquidity enhancement JGB</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon Ministry of Finance
(4) Japanese stock market: stocks retained higher prices, rolling back profit-taking pressure

- Investors took a risk-on stance reflecting the Phase One agreement in US-China trade talks. The Nikkei Stock Average recovered to JPY24,000 for the first time in 14 months and stayed high thereafter.

- In terms of valuation, the forward P/E ratio recovered to the 14x mark for the first time in 23 months since January 2018.
  - In addition to the decline of the forward EPS, it reflects the anticipated recovery of corporate earnings in 2020.

- For the time being, stocks are vulnerable to profit-taking selling. The 2019 high of around JPY24,270 is expected to emerge as the resistance level for the Nikkei Stock Average.
  - Since Japanese stocks have been driven higher on the back of expectations, stay alert to the possibility of quick setback in the event of adjustments on the overseas stock markets.

Source: Made by MHRI based upon Refinitiv
Source: Made by MHRI based upon the Japan Exchange Group

[ Trading of foreign investors by investment sector ]

[ TOPIX forward P/E ratio and forward EPS ]

Source: Made by MHRI based upon the Japan Exchange Group

Note: Forward EPS and forward P/E ratio are for 12 months ahead.
Source: Made by MHRI based upon Refinitiv
6. Forex market: the yen expected to strengthen slightly early in 2020

- USD/JPY exchange rates firmed up to the mid-JPY109 level, reflecting the Phase One agreement in US-China trade talks and a major victory of the ruling Conservative Party in the UK general elections.

- USD/JPY exchange rates are expected to hover around the JPY109 level toward the year-end. However, an upturn of the US manufacturing sector may be needed for the dollar to advance further against the yen. As the growth of the US economy is likely to slacken after the turn of the year, the yen is expected to strengthen slightly against the dollar.

- EUR/USD exchange rates grew somewhat stronger following the outcome of US general election. Looking forward, however, the market environment is likely to remain unfavorable for the euro, given the expected difficulties in FTA negotiations between the UK and the EU, and the ongoing weakness of the eurozone economy.

![Graph showing USD/JPY exchange rates and risk reversal (one month)]

![Graph showing one-year ranges of USD/JPY exchange rates]

Note: Risk reversal is obtained by subtracting the implied volatility of put options from the implied volatility of call options. It is known as an indicator that reflects the risk recognition of participants in the options market. The delta is 25%.

Source: Made by MHRI based upon Bloomberg

Note: The solid line shows the monthly average, while the dashed lines indicate the lowest and highest levels of JPY in each month. For 2019, the values are based on the actual USD/JPY exchange rates movements up to December 16.

Source: Made by MHRI based upon Bloomberg
7. Crude oil prices continue to rise on the back of output cuts, but concerns over easing supply and demand remain

- OPEC Plus decided to step up output cuts, increasing output cuts by 900 thousand barrels to 2.08 million barrels per day.
  - The output cuts will be expanded further by 500 thousand barrels from January 2020. Separately, Saudi Arabia unveiled a plan to cut production by an additional 400 thousand barrels.

- Crude oil prices rose on news of the deeper output cuts and the Phase One agreement in US-China trade talks. WTI crude prices rose above USD 60 per barrel.

- However, crude oil supply and demand may ease again. In 2020, we expect WTI crude prices to move in a range from the upper half of the USD50 level to the lower half of the USD60 level.

[ Crude oil prices (WTI crude oil futures) ]

[ Supply-demand simulations (the case where the output cut remains in place in and beyond April) ]

Note: Demand in and after the Oct-Dec quarter of 2019 is the forecast by the IEA. Supply in the Oct-Dec quarter of 2019 is the Oct-Nov average. Supply for 2020 is based on the supply-demand balance simulation made by using the production of non-OPEC producers forecast by the IEA and the total of production targets of OPEC members.

Source: Made by MHRI based upon IEA
8. Outlook on the financial markets

<table>
<thead>
<tr>
<th></th>
<th>● Main scenario</th>
<th>● Sub-scenario 1</th>
<th>● Sub-scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US</strong></td>
<td><strong>FF rate</strong> (qtr-end value, %)</td>
<td>1.75~ 2.00</td>
<td>1.50~ 1.75 1.75~ 2.00 1.50~ 1.75 1.75~ 2.00</td>
</tr>
<tr>
<td></td>
<td>10yr UST bond yield (%)</td>
<td>1.79 1.80 1.80 1.90 1.90</td>
<td>1.75 1.75 1.75 2.00 2.00</td>
</tr>
<tr>
<td></td>
<td>Dow Jones Average (USD)</td>
<td>26,683 27,500 27,500 27,500 27,500</td>
<td>28,000 29,000 29,500 30,000 28,000 24,000 22,500 22,000</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>Euroyen TIBOR (three months, %)</td>
<td>0.03 0.01 0.05 0.05 0.06</td>
<td>0.03 0.07 0.07 0.08 0.00 0.00 0.00 0.00</td>
</tr>
<tr>
<td></td>
<td>10yr JGB yield (%)</td>
<td>-0.20 -0.10 -0.05 -0.05 -0.05</td>
<td>-0.05 0.10 0.15 0.15 -0.05 -0.25 -0.30 -0.30</td>
</tr>
<tr>
<td></td>
<td>Nikkei 225 Average (JPY)</td>
<td>21,270 23,000 23,000 23,000 23,000</td>
<td>23,000 24,500 25,500 26,500 23,000 20,000 18,500 16,500</td>
</tr>
<tr>
<td><strong>Europe</strong></td>
<td>ECB deposit facility rate (qtr-end value, %)</td>
<td>-0.43 -0.50 -0.50 -0.50 -0.50</td>
<td>-0.50 -0.50 -0.50 -0.50 -0.50 -0.50 -0.60 -0.60</td>
</tr>
<tr>
<td></td>
<td>10yr government bond yield (German government bonds, %)</td>
<td>-0.51 -0.35 -0.40 -0.30 -0.30</td>
<td>-0.35 -0.20 -0.10 0.00 -0.35 -0.60 -0.70 -0.90</td>
</tr>
<tr>
<td><strong>Forex</strong></td>
<td>USD/JPY rate (USD/JPY)</td>
<td>107 109 108 108 106</td>
<td>109 110 111 112 109 101 97 93</td>
</tr>
<tr>
<td></td>
<td>EUR/USD rate (EUR/USD)</td>
<td>1.11 1.10 1.10 1.10 1.10</td>
<td>1.10 1.11 1.12 1.12 1.11 1.15 1.20 1.20</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 continues to strengthen against the yen.

- Sub-scenario 2 (downside scenario)
  - Global economic slowdown, including Europe and the US, due to tariff hikes accompanying US protectionist policy. Long-term interest rates fall and stock prices fall. The dollar continues to weaken against the yen.
Mizuho Research Institute Ltd.

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