Monthly Economic Report

January 20, 2020

Mizuho Research Institute
US-China trade talks reached “Phase One” of the trade agreement on December 13, 2019, and an eight-chapter trade agreement was signed on January 15, 2020.

- In addition to a $200 billion increase in China’s purchases of US goods over 2017 over two years, the two countries reached certain accord on how to deal with structural problems, including intellectual property and technology transfers. The US separately expressed its intent to halve the additional tariff rate imposed in September 2019 on some $110 billion of imports from China from 15% to 7.5% in mid-February.

- While the two countries will move on to talks on the second phase (“Phase Two”), no major breakthrough or confrontation is expected before the US presidential election.
  - President Trump hinted at a post-election accord, and expressed to remove the additional tariffs imposed already after reaching “Phase Two” of the trade agreement.

Outline of “Phase One” of the US-China trade agreement

<table>
<thead>
<tr>
<th>Topic</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intellectual property</td>
<td>The Parties shall ensure fair, adequate, and effective protection and enforcement of intellectual property rights. The agreement provides for trade secrets, pharmaceutical-related intellectual property, patents, geographical indications, trademark protection, and pirated and counterfeit goods.</td>
</tr>
<tr>
<td>Technology transfer</td>
<td>Neither Party shall require or pressure natural or legal persons of the other Party to transfer technology to its natural or legal persons. A Party shall not support or direct the outbound foreign direct investment activities of its persons aimed at acquiring foreign technology.</td>
</tr>
<tr>
<td>Trade in food and agricultural products</td>
<td>The Parties shall cooperate on nontariff barriers (quarantine, tariff quotas) to trade in food and agricultural products. China shall adhere to US, international standards. The agreement provides for dairy products, beef, pork, poultry, aquatic products, rice, feed, pet food, and agricultural biotechnology.</td>
</tr>
<tr>
<td>Financial services</td>
<td>China commits itself to the further opening of its financial services markets (banking, insurance, securities, credit rating, electronic payment, and fund management). The US pledges non-discriminatory treatment of Chinese financial institutions.</td>
</tr>
<tr>
<td>Macroeconomic policies and exchange rate matters and transparency</td>
<td>The Parties shall refrain from competitive devaluations and setting the target of exchange rates for competitive purposes. The Parties shall ensure transparency in their foreign exchange policies (monthly foreign exchange reserves data, etc.). If there is failure to arrive at a mutually satisfactory resolution in their consultations over foreign exchange policies, either party may ask the IMF to undertake rigorous surveillance of exchange rate policies of the other party.</td>
</tr>
<tr>
<td>Expanding trade</td>
<td>Over the two years from January 2020 to the end of 2021, China will increase its imports from the US by $200 billion (some $130 billion of goods and some $56 billion of services) over the 2017 baseline. The imports are categorized into manufactured goods, agricultural products, energy, and services, with the numerical targets set for each category. The Parties project that the trajectory of increases in China’s imports from the US will continue in calendar years 2022 through 2025.</td>
</tr>
<tr>
<td>Bilateral evaluation and dispute resolution</td>
<td>The Parties shall hold meetings of the Trade Framework Group, made up of the US Trade Representative and the Chinese Vice Premier, every six months. The Parties shall create the Bilateral Evaluation and Dispute Resolution Secretariat, with the heads of each Party’s Bilateral Evaluation and Dispute Resolution Office meeting on a quarterly basis and subcabinet-level meetings to be held at least once a month. The Parties shall resume regular macroeconomic meetings between the US Treasury Secretary and the Chinese Vice Premier. If the disputes of the Complaining Party are not resolved through bilateral consultations, the Complaining Party may resort to taking action, such as suspension of an obligation under this Agreement or adoption of a remedial measure. If the Party Complained Against considers that the action of the Complaining Party was taken in bad faith, the remedy is to withdraw from this Agreement by providing written notice of withdrawal to the Complaining Party.</td>
</tr>
<tr>
<td>Final provisions</td>
<td>This Agreement shall enter into force within 30 days of signature by both Parties or as of the date on which the Parties have notified each other of the completion of their respective applicable domestic procedures, whichever is sooner.</td>
</tr>
</tbody>
</table>

Source: Made by MHRI based upon USTR materials
The US Treasury Department released the semiannual Report on Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States. The Treasury has determined that China should no longer be designated as a currency manipulator at this time.

- While the report no longer designated China as a “currency manipulator” against the backdrop of Phase One of the trade agreement between US and China, the report requests China to take policy initiatives to expand domestic demand and warned against market intervention by the People’s Bank of China or other state-owned banks.
- In addition to nine countries in the Monitoring List, including China, Japan, Germany, South Korea and Singapore, it has added Switzerland again to the list.

Even though Japan remains in the Monitoring List, there are no material changes in the contents of the report.

Criteria for assessing foreign exchange policies and the conditions of countries on the Monitoring List

<table>
<thead>
<tr>
<th>Assessment points</th>
<th>Significant bilateral trade surplus with US</th>
<th>Significant current account surplus</th>
<th>Persistent, one-side FX market intervention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key criteria</td>
<td>Massive and disproportionate</td>
<td>Trade surplus with US in excess of $20bn</td>
<td>Current account surplus in excess of 2% of GDP</td>
</tr>
<tr>
<td>Unit</td>
<td>(Unit)</td>
<td>($1bn)</td>
<td>(%)</td>
</tr>
<tr>
<td>China</td>
<td>✔</td>
<td>401</td>
<td>1.2%</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>69</td>
<td>3.4%</td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td>67</td>
<td>7.3%</td>
</tr>
<tr>
<td>Ireland</td>
<td></td>
<td>50</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Vietnam</td>
<td></td>
<td>47</td>
<td>1.7%</td>
</tr>
<tr>
<td>Italy</td>
<td></td>
<td>33</td>
<td>2.8%</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td>26</td>
<td>3.0%</td>
</tr>
<tr>
<td>Switzerland</td>
<td></td>
<td>22</td>
<td>10.7%</td>
</tr>
<tr>
<td>South Korea</td>
<td></td>
<td>20</td>
<td>4.0%</td>
</tr>
<tr>
<td>Singapore</td>
<td></td>
<td>-4</td>
<td>17.9%</td>
</tr>
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1. Global economy: A sense of bottoming out seen in business sentiment in the manufacturing sector; leading indicator showing signs of recovery

- The global manufacturing PMI, an indicator of business sentiment, exceeded the threshold of 50 in December 2019, as it did in November.
  - Even so, the recovery is led by emerging economies, and the manufacturing PMI remains below 50 in Japan and Europe.
  - The OECD Composite Leading Indicator has been showing signs of recovery since last autumn, an indication that the OECD economies is headed toward a recovery from the second half of 2020.

### Global PMI

![Global PMI graph](image)

**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.

**Source:** Made by MHRI based upon Markit

### OECD Composite Leading Indicator

![OECD Composite Leading Indicator graph](image)

**Source:** Made by MHRI based upon OECD
Overview of financial markets: US stocks scales a new high following the US-China trade agreement

- US stock prices renewed historical highs reflecting Phase One of the US-China trade agreement. The Nikkei Average advanced to the JPY24,000 level. Even though WTI crude oil prices temporarily rose to the mid-USD60 level given the destabilization of the Middle East, they are currently declining due to views that the Middle East situation is unlikely to lead to a military conflict. The yen weakened against the US dollar to the JPY110 level.

**Major market trends**

![Graphs showing market trends]

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

Source: Made by MHRI based upon Bloomberg
2. (1) US economy: The manufacturing sector remains sluggish. Even though the nonmanufacturing has bottomed out, its recovery is tepid

- In December 2019, the ISM Manufacturing PMI remained stagnant at 47.2.
  - The production index fell sharply. The new orders and new export orders indexes failed to put a halt to the downtrend.
- The ISM Nonmanufacturing PMI in December 2019 edged up to 55.0, indicating a halt to the downtrend.
  - The employment index recovered in the latest two months, indicating that the robust pace of employment expansion in the service-providing sector is being maintained.
Amid the slow recovery of business sentiment, capital investment remains sluggish

- Shipments and new orders of core capital goods remained flat, with no signs of recovery.
- The corporate capital investment outlook is continuing to follow a downtrend, led primarily by manufacturers.
  - While the US and China reached Phase One of the trade agreement in December 2019, the poor outlook for capital investment reflects lingering uncertainties among corporations.

**Core capital goods shipments and new orders**

**Corporate capital investment outlook (6 months ahead)**

Source: Made by MHRI based on US Department of Commerce

Source: Made by MHRI based upon US Federal Reserve Banks in the Federal Reserve districts
December employment data shows the continuing structure of the service-providing sector making up for sluggishness in the goods-producing sector

- In December 2019, nonfarm payrolls rose by +145 thousand m-o-m. In terms of the three-month average, the rise was a solid +184 thousand m-o-m.
  - While the growth of employment in the goods-producing sector remained at rock-bottom levels, the service-providing sector continued to provide support, mainly in such areas as education, medical services, leisure and entertainment.
- The average hourly wage rose +2.9% y-o-y, with the rate of increase staying near 3% even after peaking out.

**Nonfarm payrolls**

(M-o-m difference, 10 thousand people)

In December, +145 thousand people m-o-m change

**Average hourly wages**

(Y-o-y % change)

Source: Made by MHRI based upon the Bureau of Labor Statistics, US Department of Labor
Consumption remains robust, propped up by firm consumer sentiment

- Consumer sentiment-related indicators remained robust.
  - The Index of Consumer Expectations of the University of Michigan recovered to the pre-plunge level. The Conference Board Consumer Confidence Index stayed at high levels, though void of upward momentum.

- Personal consumption remained robust. The year-end shopping season appears to have been favorable, paced by online shopping. Consumer sentiment-related indicators remained robust.
  - Real personal consumption in November rose +0.3% m-o-m. Though consumption of goods was led down by motor vehicles in October, it has picked up recently.

**Consumer sentiment-related indicators**

[Graph showing consumer sentiment indicators with data points for the Conference Board and the University of Michigan, indicating December 2022 values of 126.5 and 99.1 respectively.]

**Real personal consumption**

[Graph showing m-o-m % change in real personal consumption with data points for goods and services, indicating recent fluctuations and recovery.]
(2) US monetary policy: hurdles to changing monetary policy remains high, indicating a high possibility of the FF rate remaining unchanged

- The key policy rate is expected to be kept unchanged for the time being. FOMC participants are likely to remain concerned that “the level of longer-term inflation expectations was too low” (the December FOMC minutes).
- The Fed dot plot forecasts flattened in December. Most FOMC participants supported the stance of holding the key policy rate steady during 2020.
- The core inflation rate in November rose +1.61% y-o-y, failing to halt the downward deviation from the 2% inflation target.
- The risk is a possible military conflict with Iran (as of January 9, that possibility was seen likely to be avoided).

Summary of the Dec 2019 FOMC meeting

<table>
<thead>
<tr>
<th>Review of the monetary policy framework</th>
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<tbody>
<tr>
<td>● Participants generally saw the feedback from Fed Listens events as reinforcing the importance of sustaining the economic expansion so that the effects of a persistently strong job market reach more of workers.</td>
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<tr>
<td>● In relation to the definition of “maximum employment,” some participants referred to the impacts of the heterogeneity in labor market, the continued absence of significant wage pressure even as the unemployment rate had moved below its longer-run level, and the rise in the labor force participation rate.</td>
</tr>
<tr>
<td>● Participants recognized that segments of the public generally do not regard the fact that aggregate inflation is running modestly below the FOMC’s 2% goal as a problem. Participants generally agreed that they need to communicate more clearly to the public their rationale for achieving 2% inflation.</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Monetary policy</th>
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<tbody>
<tr>
<td>● The labor force participation rate could rise further still. Further strengthening in overall labor market conditions is possible without pushing up inflation.</td>
</tr>
<tr>
<td>● As reflected in their SEP projections, participants regarded the current stance of monetary policy as likely to remain appropriate for a time as long as incoming information about the economy remained broadly consistent with the economic outlook.</td>
</tr>
<tr>
<td>● Various participants were concerned that the level of longer-term inflation expectations was too low.</td>
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<tr>
<th>Policy rate outlook of FOMC participants</th>
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Currently, the key policy rate is expected to remain unchanged for the time being. FOMC participants are likely to remain concerned that “the level of longer-term inflation expectations was too low” (the December FOMC minutes). The Fed dot plot forecasts flattened in December. Most FOMC participants supported the stance of holding the key policy rate steady during 2020. The core inflation rate in November rose +1.61% y-o-y, failing to halt the downward deviation from the 2% inflation target. The risk is a possible military conflict with Iran (as of January 9, that possibility was seen likely to be avoided).
(3) US bond market: long-term US interest rates expected to move at levels slightly below 2% for the time being

- On the back of progress in US-China trade talks, the yield on 10yr UST rose temporarily to the 1.9% level.
  - The rise in long-term interest rates since early autumn can be largely explained by rising term premiums.
  - Market participants are expecting about 0.9 rate cut by the end of 2020 and about zero rate cut in 2021.
- We expect US long-term interest rates to stay at levels slightly below 2% for the time being in view of uncertainties reflecting President Trump’s hardline foreign policy.

**Long-term US interest rates and term premiums (10yr)**

**Market participants’ forecast on the US policy rate**

*Note: Calculated based upon FF rate futures.*

Source: Made by MHRI based upon Bloomberg
The optimistic view of the US economy emerged on the back of solid economic indicators and strong corporate earnings. The Dow Jones Industrial Average broke through USD29,000.

Even though the SKEW Index remains at high levels, it fell sharply after peaking in late December 2019.
- This points the receding of investors' need for hedging (=bearish sentiment) against the risk of stock market slides.
- The market adjustment risk stemming from a sense of overvaluation is seen diminishing in the short run. However, the forward P/E ratio is high at 18x, calling upon market participants to stay alert.

Looking forward, watch out for corporate earnings announcements and developments in the US economy. Even though corporate earnings in the fourth quarter of 2019 are estimated to have declined y-o-y, stock prices are expected to stay firm on sustained expectations of a recovery in 2020.
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, revealing low growth comparable to the preceding quarter
  - Household consumption expenditures were firm with an increase of +0.5% q-o-q on the back of fiscal spending to support households.
- The Purchasing Managers’ index (synthetic PMI), having a high correlation with GDP, is continuing to hover barely above the expansion/contraction threshold of 50.
  - While the business sentiment in the manufacturing sector is beginning to show signs of bottoming out, weak conditions are persisting. The Eurozone economy is expected to take some time before climbing out of low growth.

**Eurozone real GDP growth rate (by demand component)**

**Eurozone PMI**

Note: PMI at 50 is the expansion/contraction threshold
Source: Made by MHRI based upon Markit, Bloomberg

Source: Made by MHRI based upon Eurostat
Despite signs that the export slowdown is bottoming out, the tendency toward production cuts is persisting

- In October 2019, exports to areas outside the eurozone increased (+3.6% y-o-y), accelerating for the second consecutive month.
  - Exports to the UK contributed +0.7% pt y-o-y to the overall growth. Exports to Turkey recovered moderately, contributing +0.5% pt y-o-y.
  - Intra-eurozone exports fell (-1.7% y-o-y). The growth of exports to areas outside the eurozone fell short of propping up intra-eurozone exports and production.

- In October 2019, industrial production in the eurozone stood at -2.4% y-o-y, revealing that output cuts are continuing.
  - In particular, output cuts in motor vehicle production is persisting (-16.4% y-o-y).

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

![Graph of Exports of goods to areas outside the eurozone](image1)

Source: Made by MHRI based upon Eurostat

### Industrial production in the eurozone

![Graph of Industrial production in the eurozone](image2)

Source: Made by MHRI based upon Eurostat
Despite the ongoing strength of the labor market, the improvement is peaking out

- In October 2019, the eurozone unemployment rate stood at 7.5%, roughly leveling off from 7.6% in the preceding month.
  - In the Jul-Sep quarter of 2019, compensation per employee in the eurozone continued to follow firm footing at +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.

![Eurozone unemployment rate and compensation per employee](chart1)

![Eurozone employment expectations DI by sector](chart2)

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
Eurozone core inflation rate likely to stay close to 1%

- In December 2019, the eurozone inflation rate (preliminary flash estimate) stood at +1.3% y-o-y, up +0.3% pt over the previous month (+1.0% y-o-y) reflecting higher energy prices.
  - The core inflation rate, which excludes volatile items such as energy and food, stood at +1.3% y-o-y, flat from the preceding month. The y-o-y rise of +1.8% in service prices is just -0.1% point lower than the previous month (+1.9% y-o-y).
  - 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.

Eurozone CPI (y-o-y % change)

Eurozone selling price expectations DI over the next 3 months

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 ECB is expected to keep its monetary policy unchanged at the Governing Council meeting on January 23.

- The ECB is expected to emphasize its stance of ascertaining the impact of higher crude oil prices on the Eurozone economy and taking action as necessary.

- The ECB is expected to keep key policy rates unchanged, as rising oil prices are unlikely to prod the Eurozone economy into negative growth.

- A rise of +10% in crude oil prices is expected to push up the CPI by approximately +0.13%pt, putting the ECB in a bind where it has to worry about stagflation. In light of the risk of economic slowdown due to the secondary ripple effects of higher oil prices, the ECB’s policy stance should tilt toward a rate cut. However, rises in oil prices are seen limited, higher oil prices are not expected lead to a recession and a reduction of the key policy rate.

Key points of the December ECB Governing Council meeting

| Business conditions | The ongoing weakness of international trade in an environment of persistent global uncertainties continues to weigh on the euro area manufacturing sector. But incoming economic data and survey information point to some stabilization. |
| Economic outlook | The risks surrounding the euro area growth outlook remain on the downside. In particular, these risks pertain to the prolonged presence of uncertainties, related to geopolitical factors, rising protectionism and vulnerabilities in emerging markets. |
| Prices | Measures of underlying inflation remained generally muted and indicators of inflation expectations stand at low levels. The weaker growth momentum is delaying the pass-through of higher wage to inflation. |
| Forward guidance on policy interest rates | The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen (1) the inflation outlook converge to a level sufficiently close, but below, 2% within its projection horizon, (2) the probability of reaching this outlook are done “robustly,” and (3) such convergence has been consistently reflected in underlying inflation dynamics. |
| Change in the monetary policy strategy | The review started in January 2020 and our goal is to complete it before the end of 2020. As for details of the review, we have no fixed landing point as of now, but we will cover challenges that our society is facing, including climate change. |

Impact of 10% oil price rises on inflation rate

Note: The macro model-based estimates on the assumption that crude oil prices in the first quarter of 2020 rose +10% over the baseline and continue to maintain that level.

Source: Made by MHRI based upon ECB
German 10yr government bond yields are expected to hover around -0.2%

- German long-term interest rates rose to the -0.1% range for the first time in seven months on the back of US interest rate rises and the receding of concerns over Brexit.
  - The Economic Surprise Index rose to the highest level in approximately two years. Stronger economic indicators than earlier forecast were partly responsible for the difference in the pace of long-term interest rate rises between the US and Germany.
  - Given statements by ECB officials criticizing negative interest rates and other factors, market expectations toward additional rate cuts have more or less faded.

- Amid muted inflation concerns, we expect German 10yr government bond yields are hover around -0.2%.

**US and German 10yr government bond yields**

**Economic Surprise Index**

Note: Using the Citi Economic Surprise Index.
Source: Made by MHRI based upon Bloomberg
China’s real GDP growth in the Oct-Dec quarter of 2019 levelled off at +6.0% y-o-y (Jul-Sep quarter: +6.0% y-o-y).
- The growth of retail sales slackened and the increase in imports exceeded that of exports, resulting in the smaller contribution of external demand. On the other hand, the larger rise of investment in the manufacturing sector helped to keep the economic growth rate unchanged.
- Of monthly economic indicators, industrial production in December 2019 recorded the second consecutive increase (+6.9% y-o-y). Going forward, however, output is expected to remain tepid.
  - By industry, the growth of output expanded for motor vehicles and communications/electronic equipment, but output rose at a slower pace for machinery-related industries.
  - Motor vehicle output expanded following progress in inventory adjustment. However, the rise of output should come to a pause going forward, due to the slow recovery of motor vehicle sales amid the ongoing deterioration of labor market conditions.

Looking forward, the Chinese economy is expected to moderate but should be able to avoid a sharp decline due to the government’s economic stimulus measures.

**China’s real GDP growth rate**

![Chart showing real GDP growth rate](chart.png)

**Production trends of major industries**

![Chart showing production trends](chart.png)
The Chinese yuan keeps edging up. The PBoC cuts the reserve requirement ratio

- The yuan edged up steadily as the US dollar was increasingly sold in overseas markets.
  - The yuan rose steadily against the US dollar on the back of dollar selling in overseas markets and progress of US-China trade talks. After the US lifted the designation of China as a “currency manipulator,” the yuan advanced to the level of 6.88 to the dollar for the first time in about five and a half months.
  - Even though the signing of Phase One the US-China trade agreement took place as scheduled on January 15, talks to seek a “Phase Two” agreement are expected to face a rocky road. Thus, the yuan is likely to remain swayed by the direction of US-China trade talks.

- On January 1, the People’s Bank of China (PBoC) announced a reduction in the reserve requirement ratio. The reserve rate was lowered by 0.5% pt for all commercial banks on January 6.
  - The reserve requirement ratio cut is expected to release some 800 billion yuan of liquidity into the money markets. The measure is designed to cope with the demand for funds ahead of Chinese New Year festivities and funding support for small enterprises.
  - If concerns arise over an economic slowdown going forward, the PBoC is expected to move to ease credit further through another cut in the reserve requirement ratio and a reduction in the MLF rate.

**USD/RMB rate**

![Graph showing USD/RMB rate]

Source: Made by MHRI based upon Bloomberg

**Reserve requirement ratio and LPR/MLF interest rates**

![Graph showing reserve requirement ratio and LPR/MLF interest rates]

Note: LPR is the average of the prime rates of 18 major banks. MLF is a medium term lending facility of the People’s Bank of China.

Source: Made by MHRI based upon the People’s Bank of China, CEIC data
EM financial markets: EM stock markets firm following progress in US-China trade talks

- EM stocks that rose before and after Phase One of the US-China trade agreement on December 13, 2019, remained firm after the turn of the year.
  - Despite instabilities, fund inflows into EM countries (securities investment) tended to pick up since the progress of US-China trade talks in October 2019.
  - The military confrontation between the US and Iran early in 2020 had only a limited impact on EM stocks as they averted an all-out clash.
- Despite tailwinds from the US-China trade agreement, the upside of EM currencies proved heavy, as some currencies weakened such as the Chilean peso, which was hurt by the country’s political instability.
- Given the formal signing of Phase One of the US-China trade agreement, EM stocks are expected to retain their firmness for the time being and recovery of EM currencies is expected.

**EM stocks and currencies**

![Graph showing EM stocks and currencies](image)

**Fund flows to EM countries**

![Graph showing fund flows to EM countries](image)

Note: EM stocks based upon MSCI Emerging; EM currencies based upon JP Morgan Emerging
Source: Made by MHRI based upon Refinitiv, MSCI, JP Morgan

Note: Securities investment represents the sum of stock investment in Indonesia, India, Thailand, South Africa, South Korea, Brazil, the Philippines, Vietnam, Taiwan, China, Qatar, Sri Lanka and Pakistan and bond investments in Indonesia, India, Thailand, South Africa, Hungary and Ukraine.
Source: Made by MHRI based on IIF
5. (1) The Japanese economy: production shows underlying weakness, with a pickup in the Jan-Mar quarter expected to be limited

- In November 2019, industrial production fell -0.9% m-o-m for the second consecutive decrease (October: -4.5% m-o-m).

- The forecast index (planned production) points to an increase of +2.8% m-o-m for December 2019 and an increase of +2.5% m-o-m for January 2020. Even so, the forecast index is prone to downswings. When we extend the forecast index by the revision (+0.4% m-o-m) provided by the Ministry of Economy, Trade and Industry that takes this tendency into account, industrial production in the Oct-Dec quarter is set to incur a large drop of -4.2% q-o-q.
  - The anticipated quarterly drop is huge when compared with the fall of -2.9% q-o-q in the Apr-Jun quarter of 2014, right after the previous consumption tax hike, leading to our assessment that the underlying trend of production is weak.
  - Since both external and domestic demand are lacking strength and inventory adjustments are only halfway through, we expect a pickup in production in the Jan-Mar quarter to be limited.

Indices of Industrial Production

<table>
<thead>
<tr>
<th>Year</th>
<th>Shipments-inventories balance (Y-o-y % change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>15/4</td>
</tr>
<tr>
<td>2014</td>
<td>15/4</td>
</tr>
<tr>
<td>2015</td>
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<td>2018</td>
<td>15/4</td>
</tr>
<tr>
<td>2019</td>
<td>15/4</td>
</tr>
</tbody>
</table>

Note: The figure for 4Q 2019 is the average for Oct-Nov 2019.
Source: Made by MHRI based upon Ministry of Economy, Trade and Industry, Indices of Industrial Production
Transportation equipment and capital goods push down production in the Oct-Dec quarter

- By sector, production in November fell for production machinery (-8.9% m-o-m) and electric and information & communication equipment (-2.9% m-o-m), affected by sluggish exports of capital goods and typhoons. Motor vehicles rose (+4.5% m-o-m), subsequent to a large drop in October due to typhoons.

- In the Oct-Dec quarter (the forecast index for December), output fell steeply for transportation equipment (-7.5% q-o-q) and capital goods (-7.1% q-o-q). On the other hand, output of electronic parts and devices rose (+3.7% q-o-q) for the second quarter in a row, indicating the improvement of the IT cycle.

Industrial production index (contribution by sector) Industrial production and forecast indexes for major industries

![Graph showing industrial production index (contribution by sector) and forecast indexes for major industries]

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

Note: The figures for 4Q 2019 were calculated based on the forecast index for December.
Source: Made by MHRI based upon Ministry of Economy, Trade and Industry, Indices of Industrial Production, Indices of Industrial Production Forecast
Exports remain weak, but are expected to stop falling ahead

- In November 2019, the export volume index stood at -1.0% m-o-m, falling for the second month in a row. The index for the Oct-Nov period also stood at -2.2%, weakening in comparison to the Jul-Sep quarter.
  - While exports to China are beginning to pick up, centering on semiconductor-related products, exports to Europe and the US dipped further, with motor vehicles and capital goods leading the way down.
    - Exports of motor vehicles remained weak, due mainly to the shift to overseas production but turned positive in November (on a single-month basis) for the first time in four months, showing signs of bottoming out.
    - As for capital goods, construction machinery was sharply lower, due largely to the fall of output due to typhoon damage. Export orders are indicating a possible bottoming-out of exports ahead.
    - In IT-related areas, while semiconductors are turning up, exports of panels and other electronic parts have yet to see a recovery.

Export volume index by region

Machinery orders (external demand)

Note: Adjusted for seasonal factors by MHRI.
Source: Made by MHRI based upon Ministry of Finance, Trade Statistics

Note: Machinery orders excluding rail cars, aircraft and ships are estimates by MHRI.
The dotted line indicates anticipated releases.
Source: Made by MHRI based upon Cabinet Office, Machinery Orders
Employment and income environment are leveling off; New job openings growing only sluggishly, particularly in the manufacturing sector

- Real wage income is leveling off subsequent to an uptrend thus far.
  - Real wage income in November 2019 was more or less unchanged at +0.1% m-o-m. In addition to the slower growth in number of employees, wages also lacked strength due largely to weaker production and corporate earnings.

- Even though the number of new job offers (a leading indicator of the number of employees) remains at high levels, it is following a downtrend, particularly in the manufacturing sector.
  - The unemployment rate stood at 2.2% in November 2019, indicating an ongoing labor shortage. However, given the increasingly cautious stance among manufacturers regarding hiring, the number of employees is expected to flatten out.

### Real wage income (seasonally adjusted)

![Real wage income graph]

**Note:** Seasonally adjusted by MHRI, and adjusted for the impact of the permutation of samples for the Monthly Labour Survey.

### New job offers (seasonally adjusted)

![New job offers graph]

**Note:** Seasonally adjusted by MHRI. The nonmanufacturing sector excludes agriculture, forestry and fisheries industries.
**Source:** Made by MHRI based upon Ministry of Health, Labour and Welfare, Report on Employment Service
Consumption of durable goods slack even after allowing for the pre-consumption tax hike front-loading of demand and reactionary falls

- Even though retail sales (in real terms) rose into positive territory in November 2019 (+4.4% m-o-m), the rebound is weak in view of the fall in October (-14.2% m-o-m).
  - Retail sales of motor vehicles and machinery & equipment accounted for around half of the declines in October and November. Trends of consumption of goods remain weak, mainly with respect to durable goods.
- New car registrations in December fell from the previous month after posting a month-on-month (m-o-m) increase in November on the back of a rebound in demand following typhoons and the consumption tax hike in October. In terms of cumulative contributions, registrations were below the pre-consumption tax hike level.
  - While the decline may be attributed to the delay in introduction of new models (Honda postponed the release of the FIT and Suzuki that of the Hustler), it may be due to the fall in consumers' consumption propensity in the face of rising prices and the lackluster employment and income environment.
  - In particular, sales of light vehicles lost momentum in the absence of a cut in the light motor vehicle tax.

Retail sales in real terms (contributions by sector)

New car registrations (cumulative contribution ratio)

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

Source: Made by MHRI based upon Japan Automobile Dealers Association, Shinsha hanbaidaisu jokyo (New auto sales), Japan Light Motor Vehicle and Motorcycle Association, Sales data of mini vehicles
The breadth of the y-o-y rise of the Tokyo CPI (Ku-area) widened. Even so, the underlying trend is still flat

- The breadth of the rise of the core CPI for the Ku-area of Tokyo widened, reaching +0.8 y-o-y in December (November: +0.6% y-o-y). The rise of the Bank of Japan (BOJ) version of the core CPI for Tokyo also widened to +0.9% y-o-y in December (November: +0.7% y-o-y).

- The bigger year-on-year rise in culture and recreation (golf clubs, etc.) and clothes and footwear (winter clothing, etc.) contributed to pushing up the overall core CPI.

- Price hikes after the consumption tax hike are viewed to remain limited. Going forward, the BOJ version of the core CPI is expected to level off amid sluggish consumption growth. The growth of the core CPI is likely to widen moderately, reflecting falls in crude oil prices in late 2018.

Trends of CPI for Ku-area of Tokyo (y-o-y), ex institutional factors

Comparison of CPI for Ku-area of Tokyo (y-o-y, ex institutional factors) before and after the consumption tax hike

Note: Figures in and after October 2019 are the estimates that exclude institutional factors (consumption tax hike and free education)
Source: Made by MHRI based upon Ministry of Internal Affairs and Communications, Consumer Price Index, published materials
(2) Domestic monetary policy: BOJ expected to keep policy unchanged at January MPM and continue to take an accommodative stance

- The Bank of Japan (BOJ) is expected to keep monetary policy unchanged at the January Monetary Policy Meeting (MPM) (January 20-21), and maintain its accommodative policy stance.
  - The output gap in the third quarter of 2019 stood at roughly the same level as in the previous quarter.

- The BOJ is expected to keep its monetary policy unchanged while ascertaining the effects of the consumption tax hike. Given the high hurdles to pushing interest rates further into negative territory, there are high expectations toward the government’s policy measures to deal with the potential downswing of the economy under the effects of the consumption tax hike.
  - In the Outlook for Economic Activity and Prices (the “Outlook Report”), the BOJ is expected to set forth its outlook factoring in the effects of the government’s economic stimulus measures.

Summary of Opinions
(December Monetary Policy Meeting)

- Japan’s economy has maintained its moderate expansion owing to steady domestic demand such as private business fixed investment and public investment, and the effects of a decline in external demand and the consumption tax hike have been limited. For the time being, the focus should be on examining uncertainties over the outlook.
- There has been no further increase in the possibility that the momentum toward achieving the price stability target will be lost. It is appropriate to maintain the current guidelines for market operations and asset purchases.
- In the current situation where risks are skewed to the downside, the Bank should continue to examine whether additional monetary easing will be necessary and prepare for a possible economic downturn as one of the risk scenarios. In doing so, it will become more important not only to conduct monetary policy but also to enhance cooperation with the government in terms of fiscal and growth policies.
- If account maintenance fees are charged on their (households and firms) savings, the negative impact of a decline in returns on their assets could be greater than the positive effects of a decrease in the costs on liabilities resulting from borrowing.

Note: A portion of opinions of MPM members is summarized.
Source: Made by MHRI based upon Bank of Japan
(3) Japanese bond market: 10yr JGB yield hovers near 0%

- The 10yr JGB yield temporarily declined to around -0.03%, reflecting falls in overseas interest rates due to the escalation of the situation in the Middle East. However, the yield rose to near 0% along with the ebb of concerns regarding military tensions in the region.

- The outstanding balance of the monetary base stood at approximately JPY518 trillion as the end of 2019, an increase of only JPY14 trillion over the end of 2018. This is the smallest rise in terms of the year-end balance since 2013, when the BOJ started the unconventional quantitative and qualitative monetary easing policy. Even though the BOJ has been reducing its JGB purchases in market operations in order to induce a steepening of the yield curve in the super-long zone, there is only limited room for further reductions from the perspective of maintaining an increase in the monetary base.

### Trend of JGB yields

![Graph showing the trend of JGB yields from 2017 to 2020.](image1)

### Trend of the outstanding balance of the BOJ’s monetary base

![Graph showing the trend of the outstanding balance of the BOJ’s monetary base from 2012 to 2019.](image2)

Source: Made by MHRI based upon Bloomberg
The Japanese stock market largely leveled off amid profit-taking selling by individual investors.

- In recent trading days, stock prices stayed firm on the back of the yen’s weakening following the partial agreement in US-China trade talks and the emergence of bullish views regarding the US economy.

- On a US dollar basis, the Nikkei Stock Average now stands at levels lower than the most recent high in December 2019.
  - Looking forward, even when Japanese stocks follow US stocks higher, Japanese stocks still have some room to pursue higher ground. However, profit-taking selling is likely to dominate the market when the Nikkei Stock Average approaches the 2018 high of JPY 24,270.

- While higher overseas stock markets are expected to help prop up Japanese stocks, the upside is likely to gradually become heavy in the face of lingering uncertainties over the direction of US-China talks for “Phase Two” of the trade agreement.

**USD-denominated Nikkei Stock Average and Dow Jones Average**

**TOPIX forward P/E ratio and forward EPS**

Note: Forward EPS and forward P/E ratio are for 12 months ahead.
Source: Made by MHRI based upon Refinitiv
6. Forex market: USD rises to the JPY110-level along with the ebb of concerns

- The yen temporarily strengthened against the US dollar to JPY107.65/USD reflecting the escalation of Middle East tensions, but returned to the JPY110-level on press reports that both the US and Iran intend to avoid a further military confrontation and the US-China trade agreement.

- Looking forward, we expect the US dollar to weaken against the yen as the US manufacturing sector has yet to show any signs of picking up and the lingering uncertainties over developments following Phase One of the trade agreement between the US and China.

- As for EUR/USD exchange rate, the market environment is likely to remain unfavorable for the euro as the eurozone economy stays weak.

**USD/JPY exchange rate and risk reversal (one month)**

**Nominal effective exchange rates of USD, JPY and EUR**

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 latest exchange rate is for December 31, 2019, for USD, and for January 17, 2020, for JPY and EUR.

Source: Made by MHRI based upon Bloomberg
7. Crude oil market: market focus shifting from the Middle East risk to speculation on supply-demand easing

- WTI crude oil prices temporarily rose to USD65, reflecting the killing of a senior commander of Iran’s Islamic Revolutionary Guard Corps (IRGC) by the US forces and the ensuing retaliatory missile attacks on US bases in Iraq.
  - Iran’s retaliatory attacks failed to cause massive damage to the US forces. As both the US and Iran refrained from mounting additional attacks, concerns regarding a military clash have receded.
- Crude oil prices bounced back subsequently, now standing below levels of early January before their sharp rise.
  - The surge of crude oil prices has cooled down, reflecting the avoidance of an all-out military confrontation between the US and Iran. High levels of crude oil inventories in many countries helped contain sharp price rises.
- In 2020, we expect the upside of crude oil prices to remain reined in by speculation of an easing of supply and demand.

**Trend of crude oil prices (WTI crude oil futures)**

**OECD private-sector crude oil inventories**

Source: Made by MHRI based upon Refinitiv

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

- **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.

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