

Forex Medium-Term Outlook

November 27, 2025

Overview of Outlook

USD/JPY continued to rise in November. Reflationary expectations are strengthening under the Takaichi administration, thanks also to the unrestrained rhetoric of those around the prime minister. Unless there is a clear shift in the government and ruling party's fiscal and monetary policies, market participants have little reason to stop selling JPY and JPY-denominated bonds. JPY depreciation against an already weak USD is difficult to understand based on the U.S.-Japan interest-rate differential; the firm establishment of the JPY-selling trend is better explained through Japan-specific factors such as supply and demand, prices, and fiscal conditions. I have frequently discussed supply and demand factors in recent years but, in fact, the JPY supply and demand environment has recently been improving. With the uncertainty surrounding "Trump tariffs" also fading, conditions were in place for a correction of JPY weakness. However, just as things were improving, the Takaichi administration came to power, triggering rampant reflationary trade. The deterioration of relations with China could further lead to an expansion of the trade and services deficit, which is beginning to raise concerns about the supply and demand outlook for 2026. Given these circumstances, it may become more difficult for the BOJ to raise interest rates, which could further exacerbate JPY depreciation. If things continue as they are, rising inflation levels could lower the current administration's approval ratings. However, strongly rightwing governments that take strict stances against other countries have tended to last longer despite high inflation. It will be interesting to see whether the Takaichi administration falls into this category. The JPY depreciation trend will enter its fifth year in 2026 and can no longer be described as temporary. It is a market phenomenon that requires a multifaceted analysis to understand.

EUR/USD remained directionless in November. Against JPY, however, EUR repeatedly renewed all-time highs before finally settling in the 180 level. Inquiries about the reason for this are increasing, but I do not have anything particularly noteworthy to say about this in relation to Europe. It is simply that USD/JPY has soared while EUR/USD has lost momentum, resulting in a purely arithmetical reason for EUR/JPY increase. JPY has weakened against an already weak USD in 2025. This is a historically rare phenomenon that has resulted in a simultaneous increase in both EUR/USD and USD/JPY. However, as discussed in last month's issue of this report, given the near-term interest rate and price outlook, EUR/USD is also likely to rise. If it does, and USD/JPY also shows strong increase, EUR/JPY could realistically rise to the 190 or even 200 level. However, this increase is not limited to EUR/JPY. While the markets are focused on JPY weakening against a weak USD, other cross-JPY pair levels have also been rising. In this report, I have recommended looking at the effective exchange rate to gain a broader perspective, and this has become even more important now.

Summary Table of Forecasts

	2025 Jan-Nov (Actual)	Dec	2026 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	139.89 ~ 158.88 (156.03)	153 ~ 159 (156)	152 ~ 158 (154)	149 ~ 156 (152)	151 ~ 158 (154)	153 ~ 162 (157)
EUR/USD	1.0125 ~ 1.1918 (1.1603)	1.14 ~ 1.19 (1.17)	1.15 ~ 1.20 (1.18)	1.16 ~ 1.21 (1.19)	1.14 ~ 1.19 (1.18)	1.13 ~ 1.18 (1.17)
EUR/JPY	155.63 ~ 182.00 (181.03)	177 ~ 185 (183)	177 ~ 185 (182)	175 ~ 184 (181)	175 ~ 183 (182)	176 ~ 186 (184)

(Notes) 1. Actual results released around 10 am TKY time on 27 November 2025. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



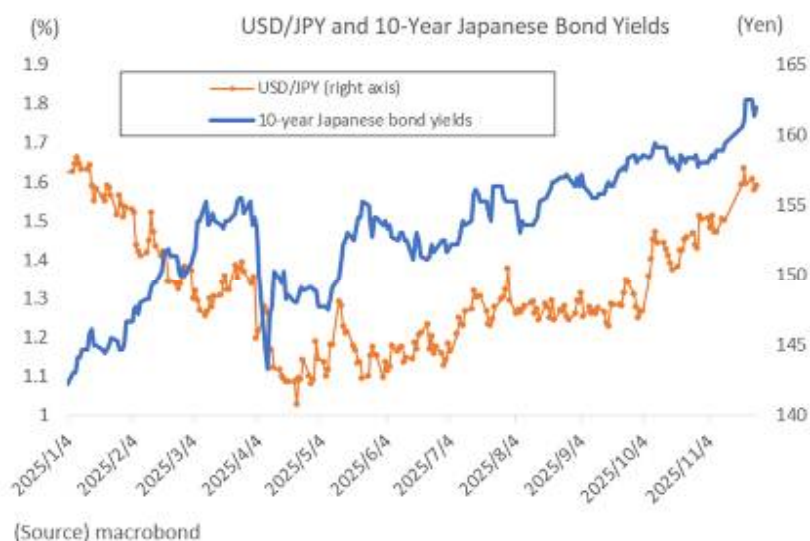
USD/JPY Outlook - Takaichi Fan Culture and the Future of JPY Depreciation

Japan's Fiscal and Monetary Policy Now and Going Forward: Pretense vs. True Intentions

Takaichi Administration's Rate Hike Pretense

Japan's financial markets were very turbulent in November. The stock market has been fluctuating wildly as JPY continues to weaken even as interest rates rise. The October 4th LDP presidential election undoubtedly marked a shift in JPY interest rate and JPY dynamics, and reflationary expectations under the Takaichi Administration remain deeply rooted. As the simultaneous JPY depreciation and rise in interest rates becomes obvious, experts advocating for reflationary policies are suggesting that the financial markets have misunderstood the trend, but this explanation sounds too hollow. In a similar situation, an emerging economy would have been taking measures to defend its currency, but Japan still awaits effective communication from its government and ruling party. As expected, the BOJ kept its monetary policy unchanged following its October 30 Monetary Policy Meeting (MPM), that too with no increase in dissenting votes, which may have contributed to the strengthening of reflationary expectations. While the statement referenced uncertainty surrounding overseas economic activity and prices as the reason for putting off a rate hike, the real uncertainty seems to be in the gap between the BOJ's stance and that of the newly inaugurated Takaichi administration. It may, therefore, be more natural to assume that the rate hike was postponed due to political and economic reasons. As discussed below, the uncertainty surrounding relations with China has emerged to replace the uncertainty surrounding Trump tariffs, and there is a growing sense that the BOJ could use this as its reason for not raising interest rates.

Of course, some are still expecting a rate hike in December or January (priced in at just under 60% and just under 90%, respectively, as of this writing), but just because a rate hike is likely in December or January does not mean rate hikes can be stably continued during the rest of 2026 and beyond. As a rate hike to 0.75% was on track (in the absence of Trump tariffs) before the Takaichi administration took office, that could be publicly presented as being as within the acceptable range even by the current administration, which leans toward a reflationary approach. Judging by the lineup of private-sector members of the newly established Headquarters for Japan's Growth Strategy and the Council on



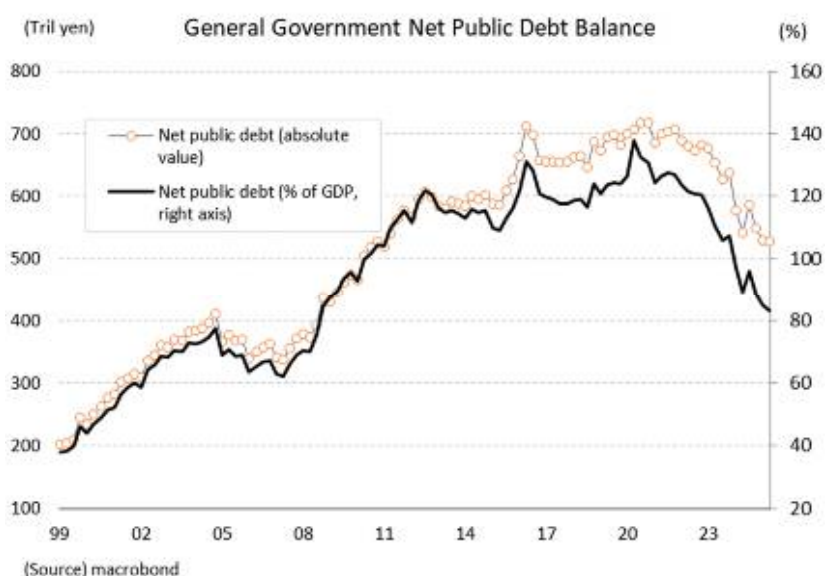
Economic and Fiscal Policy, the administration's ideological bias, at least in the areas of economics and finance, is clear (and indeed, its statements since taking office have been quite biased). If we assume that these councils will play a meaningful role in actual policy management, consecutive rate hikes may be difficult to expect. In fact, the markets are currently factoring in no more than two rate hikes through October 2026, including the upcoming one.

Meanwhile, U.S. Treasury Secretary Scott Bessent drew attention when he said during his visit to Japan in late October "Abenomics has moved from a purely reflationary policy to a program that must balance growth and inflationary concerns for the citizens of Japan." It would appear that this was Bessent's currency and monetary policy advice to Japan based on the country's worsening real income environment resulting from the weak-JPY-led inflation and suggests that the Japanese government could find it difficult to continue unchecked with its expansionary fiscal policy and monetary easing. While it would be awkward for the BOJ to raise interest rates "because the U.S. told us to," the other side of the coin is that a rate hike at the present time will not invite a backlash, given that JPY weakness is not just worsening living standards for Japanese people, but also causing concern in the U.S. Even if the Takaichi administration's true intentions are steeped in reflationary thinking, a rate hike or two may be doable as a pretense. Assuming one by January and a second by July, a policy interest rate of 1.0% is within reach.

Market Participants Only See True Intentions

At the same time, financial markets also understand that the administration's true intention may be to avoid consecutive rate hikes. This is evidenced by the fact that USD/JPY remains high even when a +25bp rate hike by January is nearly 90% priced in. The "Summary of Opinions at the Monetary Policy Meeting" on October 29-30 included the phrase "the timing at which the Bank should raise the policy interest rate is getting closer," which could be seen as a quasi declaration of an interest rate hike, but JPY actually weakened against USD following its publication. Financial markets are not focused so much on the timing of the next interest rate hike as on the probability of Takaichi and her entourage's reflationary stance. As widely discussed, Takaichi has repeatedly stated her basic stance of "responsible, proactive fiscal policy," which calls for strategic fiscal spending to prevent inflation from further accelerating. It seems clear that the only reason she uses the word "responsible" is out of fear of being criticized of "irresponsibility" if she does not. In other words, it is a preface intended to prevent financial market expectations from spiraling out of control. Because market participants already understand this, the preface is largely meaningless. After all, the more one insists something is "not suspicious," the more suspicious it becomes.

Takaichi has also explained that she prioritizes reducing the debt-to-GDP ratio as a measure of fiscal soundness. This is a point I have repeatedly raised in this report as well as in my own books, but when nominal GDP expands due to inflation, the "debt-to-GDP ratio" automatically improves. While debate about the inflation tax is rife, declaring that fiscal soundness will be pursued using the debt-to-GDP ratio as a yardstick is essentially saying that inflation is essential. On top of that, the government has indicated a revision of the target to achieve a surplus in the primary balance within a single fiscal year, making it undeniable that fiscal spending is likely to tilt toward a more unrestrained and expansionary direction. At the very least, market participants who suspect reflation policies to be the government's true intention are likely have become more convinced that the simultaneous



rise in JPY interest rates and depreciation of JPY will continue. Ultimately, even if the government permits one or two interest rate hikes as part of its pretense, or slightly refines the language surrounding expansionary fiscal policy, expectations that Takaichi's true intention is to promote reflationary policies are unlikely to change. Another cause for concern is the fact that experts who have relentlessly advocated the usefulness of monetary easing and expansionary fiscal policy are being invited as a body to participate in policy discussions. Under these circumstances, market participants can hardly be expected to stop trading based on reflation expectations.

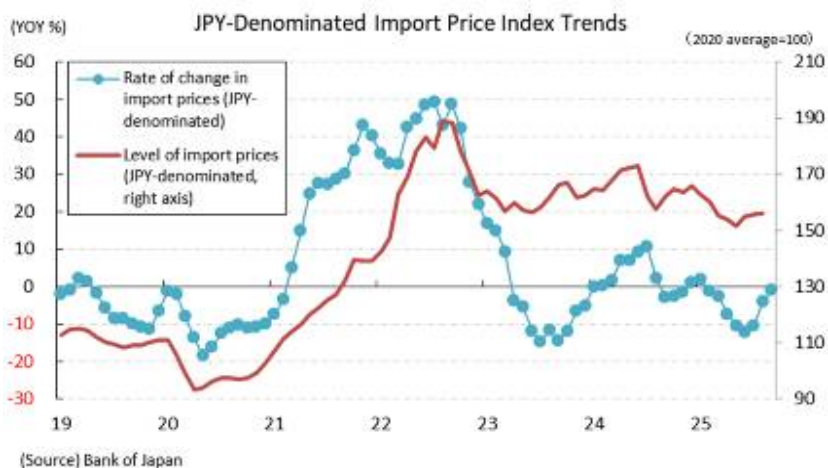
When Rate Hikes Become the True Intention, Will It Be Too Late?

Of course, the government's true intentions may change in the future. Both the Kishida and Ishiba administrations were forced to resign amid the deterioration of real income conditions due to inflation fueled by JPY weakness. It is a universally accepted rule that inflation is disadvantageous to existing governments, and the Takaichi administration should be aware of this. Unless the government can confront and contain JPY weakness, a reasonable expectation is that approval ratings will fall (although the risk of this not happening will also be discussed later). If I were to make a concrete prediction of the pace of rate hikes acceptable to the Takaichi administration, I would predict one hike between December and January, followed by one in April and another in October (i.e., roughly +25 basis points every six months). Assuming this is the case, the policy interest rate would rise to 1.25%. If one assumes a quarterly hike, the rate would rise to 1.50%. Based on the natural interest rate range estimated by the BOJ (-1.0% to +0.5%), the neutral interest rate is between +1.0% and +2.5%, so a quarterly interest rate hike would lead to a rate higher than the lower bound of the estimated neutral interest rate range, creating a somewhat less accommodative financial environment.

The question is whether raising interest rates at this pace will halt JPY depreciation. I do not think so. As I have consistently emphasized in the past, I am skeptical of analyses that attribute JPY depreciation to domestic or foreign interest rates. If the underlying cause of JPY depreciation is the supply and demand structure reflecting changes in the balance of payments structure, then raising the policy interest rate to the neutral interest rate seems unlikely to reverse JPY depreciation. Of course, if the Takaichi administration's true intention becomes to raise interest rates significantly above the neutral interest rate, i.e., to essentially tighten monetary policy, the forex market may also react strongly. However, given the numerous indications of this administration's reflationary preferences, the desire for a large interest rate hike seems unlikely to materialize. Even if it does, it is possible JPY will have further weakened, and public demand for a rate hike will have intensified. In other words, it may be too late by the time this administration changes its true intentions.

The Dangers of Reflationary Policies Could be Recognized

There is, however, a chance that the Takaichi administration will recognize the dangers of reflationary policies. The rate of change in JPY-denominated import price index has remained flat yoy, due in part to the stabilization of resource prices. However, if JPY depreciation since April is reflected with a lag of about three to six months, it is likely that the rate will soon begin to rise. However, price "levels" affect public experience even more than the "rate of change." After nearly doubling from late 2020 to the end of 2022 (from the low 90s to the high 180s in terms of index value), the level fell to around 160 by mid-2023, but has remained stable without further decline. Of course, the low 90s in early 2020 was unusually low due to the impact of the pandemic, but given that the average for 2019 (just before the pandemic) was 111.5, the 157.4 average for 2025 to date represents an increase of more than 40%.



If the JPY depreciation since April pushes the index higher, it is entirely possible that public opinion will try to shift the blame to the strongly pro-reflationary Takaichi administration. If the administration can detect such a shift early through opinion polls and other sources, it could survive. Even Prime Minister Takaichi is unlikely to intend committing suicide by reflationary policies (and one can only hope that such fanatical experts are few and far between). Given that no stakeholders are inconvenienced by rising stock prices, approval ratings tend to rise in proportion to rising stock prices at the beginning of an administration's term. However, rising stock prices is the only positive effect of inflation. Eventually, the worsening real income environment will have an impact on elections.

Discerning Sentiment Through Forex Rates Would be too Late

The forex markets, which operate on impulse, are currently of the belief that the true intentions of the Takaichi administration lean toward reflationary policies, and that it would, therefore, be wise to sell JPY as its first move. The question now is – will the administration's favored inflation-inducing policies create public resentment, which will then lead to a change in true intentions from reflationary to non-reflationary; and, if so, when? In the case of USD/JPY, this could happen when the rate approaches 160, which many market participants consider to be the red line inviting an intervention.

However, changing policy direction based on exchange rate movements is often too late. If USD/JPY hits the 160 level, import-price-led inflation will have to be accepted to that extent. When the forex markets enter a self-fulfilling spiral, they have historically tended to trade against government responses such as currency intervention and interest rate hikes (JPY is sold aggressively to accelerate the move, and bought back when intervention or interest rate hikes are implemented, which creates a profit opportunity). One hopes the Takaichi administration will truly shift to a non-reflationary stance before this becomes a serious issue in the forex market. Realistically, by carefully monitoring the JPY-denominated import price index and the associated upward fluctuations in the consumer price index, they should be able to seize the opportunity to shift.

Series of Bold Statements from Economic Advisors

In November, comments from economic advisors close to the Takaichi administration were frequently brought up for discussion. For example, in an interview with Reuters (published on November 17) Senior Officer and Chief Economist at PwC Consulting Goushi Kataoka, who has also been appointed a member of the Council for Japan's Growth Strategy, mentioned regarding the fiscal 2025 supplementary budget that about JPY 20 trillion, or even up to JPY 28 trillion depending on scale of projects, would be required, exceeding market expectations. He also justified the postponement of BOJ rate hikes until next spring, saying there would be no rate hike in December given the negative growth for the July-September quarter, and that there was no incentive to raise rates in January if there was no rate hike in December. He further went so far as to touch upon the effectiveness of forex intervention to counter JPY weakness, giving an indication of the direction of fiscal, monetary, and currency policies. It was inevitable that many market participants would interpret this interview as reflationary, and indeed, the bond and forex markets clearly reacted in that direction.

On November 23, Chief Japan Economist at Credit Agricole Takuji Aida, another member of the Council for Japan's Growth Strategy, received widespread coverage for his view (expressed in an interview with Bloomberg) that the government would respond to rapid JPY depreciation in the international forex markets through proactive currency intervention. Frankly speaking, questions remain as to whether it is appropriate for an economist, who is merely a private citizen, even if he is an advisor to the government, to make such a definitive statement about currency intervention, which requires high-level political judgment. This is a time when even senior government officials such as the finance minister and vice minister of finance need to exercise a certain amount of caution when speaking.

A Unified Message is Required on Interest and Forex Rates

Of course, when experts hand-picked by the administration speak or release information, it is only natural that they be given considerable freedom to speak. However, it concerns me that this is resulting in what seems like inconsistent information coming from the government and ruling party. Given expressions of concern regarding the simultaneous JPY depreciation and increase in JPY interest rates from the prime minister and finance minister, even tentatively government-affiliated private-sector experts should refrain from making comments that cancel out this sentiment. While forex markets are always impulse-driven, the bond markets are also quite jittery at the current time. The government must disseminate information on interest and forex rates in one voice if it wants to keep the markets under control. A situation in which Finance Minister Satsuki Katayama's comments expressing concern over JPY weakness are followed by comments ruling out an interest rate hike in the near future and demands for a supplementary budget significantly exceeding market expectations is clearly not conducive to controlling market trends.

The Ministry of Finance has complete authority over Japan's currency policy, and the monetary policy direction should be determined in accordance with this. Ideally, Katayama's statements would cover everything that needs to be said on the subject, and it would suffice for BOJ Governor Kazuo Ueda simply add his comments. While this is true even in ordinary times, it is especially true in times of crisis such as the present, given the growing speculative nature of interest rate and forex market trends (the present time should be declared as a crisis as there is nothing to lose by doing so even if it proves not to be true). Given this situation, I believe the first step should be for Katayama to unify information dissemination on interest and forex rates and attempt to calm things down.

What is the Policy Mix?

As I have explained several times before, there are eight possible combinations of fiscal, currency, and monetary policy, but only four are feasible. In the figure to the right, these are combinations (1), (3), (6), and (8). Because currency and monetary policy must always be aligned (for example, it is not possible to pursue a strong currency while lowering interest rates), mutually contradictory combinations are fundamentally impossible. Since 2022, Japan has sought to contain currency weakness (JPY weakness) while holding off on interest rate hikes in monetary policy. This is combination (4), which was fundamentally unsustainable. This is why the current market environment demands interest rate hikes through JPY weakness.

Policy Mix Combinations

	Monetary Policy	Fiscal Policy	Currency Policy	Policy Intent	Example
(1)	Easing	Easing	Weak currency	Escape recession, avoid deflationary spiral	Japan under a Takaichi administration?
(2)	Easing	Easing	Strong currency	Unsustainable	
(3)	Easing	Tightening	Weak currency	Economic support	US, Euro area
(4)	Easing	Tightening	Strong currency	Unsustainable	
(5)	Tightening	Easing	Weak currency	Unsustainable	
(6)	Tightening	Easing	Strong currency	Reduce current account surplus, prevent economic overheating (though less aggressively than (8))	The Japan as it should be?
(7)	Tightening	Tightening	Weak currency	Unsustainable	
(8)	Tightening	Tightening	Strong currency	Prevent economic overheating	The Japan as it should be?

(Source) Prepared by the author

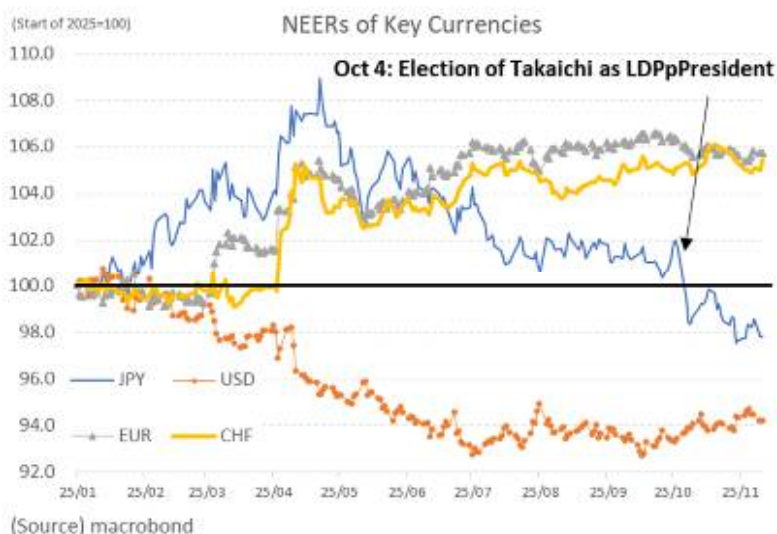
If the Takaichi administration genuinely wants reflationary policies, combination (1) is the frontrunner. However, now that Japan's deflationary gap has been largely eliminated, this policy mix would only induce inflation, and indeed this is happening. Japan, struggling with a chronically weak currency, would be better off with (6) or (8), but market participants seem to understand that Takaichi's real inclinations are inevitably toward (1) rather than (6) or (8). However, keeping aside Takaichi's genuine intention, her shelving of the single-year primary balance surplus target and her move to use the government debt-to-nominal GDP ratio as a measure of fiscal soundness reveal her unwillingness to end expansionary fiscal policy. In this scenario, (8) is unlikely, but (6) may be acceptable. While (6) is better than (1) as an option, in terms of monetary policy, it requires clearly calling for a rate hike.

On this point, Ueda said after meeting Takaichi that she, "understood that that was the case," and that she "did not make any particular requests or demands regarding policy." It would appear that Takaichi refrained from explicitly opposing rate hikes. That said, market participants are bound to be confused by intermittent comments from her economic advisors seeking a postponement of rate hikes. The first step to calming the markets is to identify and publicize the desired policy mix, and then have the appropriate cabinet ministers (including the prime minister) communicate this to ensure a unified voice for interest and forex rate information.

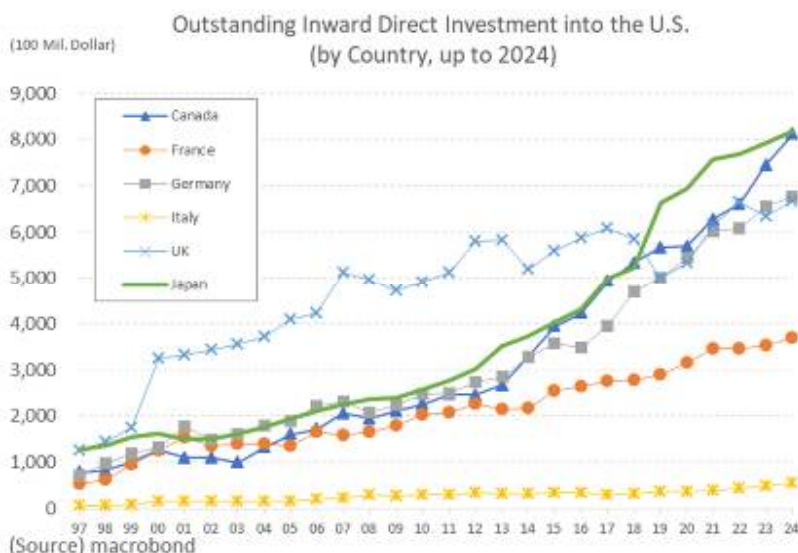
Forex Markets Now and Going Forward – 2025: A Year of JPY Weakness Regardless of USD Strength or Weakness

Regardless of USD Strength or Weakness...

In November, rather than bottoming out, JPY declined even more sharply. As discussed earlier, this largely reflects market expectations for aggressive reflationary policies under the Takaichi administration. At one point during the month, USD/JPY hit the 157.90 level, up roughly 7% since early October. Dollar detachment has been a hot topic since April this year, as the second Trump administration continues to deepen its isolationist stance, and USD has indeed depreciated across the board to a historic low. USD's nominal effective exchange rate (NEER) decline widened, falling to around -7% year-to-date in July. After remaining low through the summer, the currency clearly bottomed out around mid-September and has since begun to recover. During this period, European currencies, led by EUR and CHF, were bought in line with USD's broad-based decline through July (see graph, top), but JPY weakened alongside USD. I believe this may be the result of a growing awareness of the risk of Japan being tied to the U.S. in terms of high economic and security dependency.



EUR buying during the same period was driven by the belief that ReArm Europe plan would achieve strategic independence in terms of security, and that the adoption of joint bonds as a funding source would improve EUR's status as a safe asset and reserve currency. For the roughly six months starting April, the main focus in the forex markets was clearly on whether USD's status as a reserve currency was being undermined. In that context, it was only logical that EUR was preferred while JPY, often perceived as being tied to the U.S., was avoided. Japan and the U.S. share a deep and inseparable security and economic interdependence. More than a quarter of Japan's foreign direct investment income (FDI) comes from the U.S., and Japan is both the world's largest holder of U.S. Treasury bonds and the world's largest investor in the U.S. (see graph, bottom). To some extent, it is true that buying JPY-denominated assets does not provide a hedge against USD-denominated assets.



Starting mid-September, however, USD clearly bottomed out and began to recover. However, JPY was not chosen as a key partner currency and has continued to fall steadily. It is fair to say that JPY has plummeted since October. This clearly coincides with Takaichi's election as LDP President on October 4, and prospective currency devaluation due to continued expansionary fiscal and monetary policies appears to be a key issue for markets. JPY depreciation during 1H of fiscal 2025 stemmed from concerns about the currency being tied to USD, and now appear to be stemming from the "Takaichi risk" during 2H. In any case, JPY's performance during 2025 can be summed up by saying it was bought neither during USD weakness nor strength. Meanwhile, JPY supply-demand vulnerabilities, which I have focused on in recent years, had been showing signs of improvement starting early 2025. It is unfortunate that, despite the supply-demand climate being conducive to a correction of JPY weakness, a change in government has led to a greater sense of JPY depreciation risks than before.

Key Points for the 2026 Outlook

I would like to highlight some key points for 2026. In terms of interest rates, the BOJ is expected to raise interest rates at least twice, and the Federal Reserve is expected to cut interest rates at least twice. However, when considering the JPY rate trend, it is better to focus on JPY's relationship with JPY interest rates alone, rather than with the U.S.-Japan interest-rate differential. The simultaneous depreciation of JPY and rise in JPY interest rates since April constitutes a "Japan selloff," and one should evaluate this from the perspective of whether there will be an end to this trend. The key to this lies in whether the BOJ can raise interest rates quickly and at a good pace in a forward-looking manner, but this seems too much to expect of the Takaichi administration. Meanwhile, once the new FOMC administration is inaugurated in June 2026, and interest rates are not significantly lowered despite a pro-Trump chair, the markets may become aware of a widening discrepancy between Fed operations and the market's dovish expectations. As the current situation shows,

U.S. inflation has not fallen significantly, and rate cut expectations are fading. With rate cuts halted, U.S. interest rates and USD could well begin to rise again. Even if the BOJ decides to raise interest rates, JPY weakness is unlikely to change much if the Fed remains reluctant to cut rates. In the present situation, with the BOJ hesitant to raise interest rates and the Fed unlikely to cut rates, the interest-rate risk appears to be leaning toward further JPY depreciation. On the supply and demand side, the abnormal conditions caused by the pandemic and war have largely been resolved, and a current account surplus on a cash flow (CF) basis comparable to that seen before 2019 is likely to be achieved for 2025 (see graph below). Further, barring a sudden rise in crude oil prices, a CF-based current account surplus of +JPY 3-4 trillion is possible for 2026. The one visible supply-demand risk at this point is the reduction in travel surplus due to a deterioration in relations with China. The travel surplus had been offsetting the digital deficit, which is growing by the year, preventing the overall services deficit from expanding. It is worrying that the recent turmoil is coinciding with the peaking of inbound tourism demand, as many point out. If the services deficit expands as though to make up for the narrowing trade deficit, the supply-demand environment may remain largely unchanged from 2025, or even worsen.

Multifaceted Analysis Is Essential

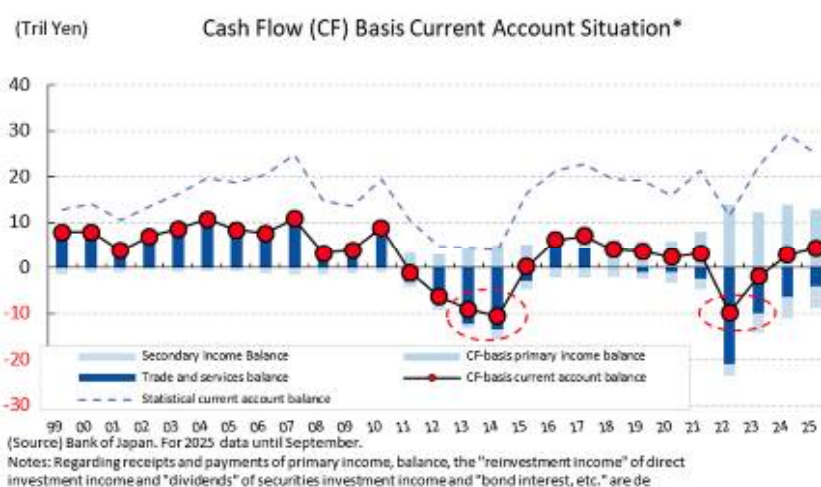
JPY depreciation, which began in 2022, will enter its fifth year in 2026. This market phenomenon, which can no longer be described as temporary, requires a multifaceted analysis to understand. This means not limiting one's analysis of JPY to its movements against USD, but focusing on the currency's effective exchange rate. It also means sufficiently taking into account factors such as supply and demand and fiscal policy, rather than simply focusing on the domestic-international interest-rate differential. Some analysts still resort to the shallow device of plotting the U.S.-Japan interest-rate differential and USD/JPY on the same chart and correlating them. This approach was only successful in the days when JPY interest rates remained static, simply because a correlation existed between rising U.S. interest rates and rising USD.

Now that Japan has returned to an "era of interest rates," it is necessary to examine the implications of the changes in the economic and financial conditions behind these rising interest rates. It is also necessary to begin our analysis with the recognition that the current combination of rising JPY interest rates and JPY depreciation may, to some extent, be the result of the demand for a fiscal risk premium. First, we must pay close attention to whether the government and ruling party will make a major shift in economic policy management. Absent this, the current trend is unlikely to reverse.

JPY Supply-Demand Climate – New Risks Due to Deteriorating Relations with China

How to Interpret the Largest Surplus for 1H of Fiscal Year

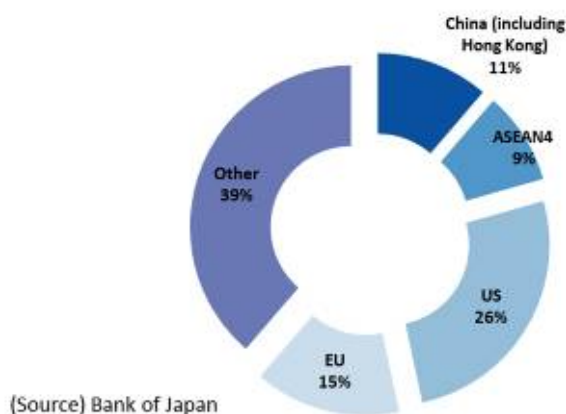
In November, the September balance of payments statistics was released, revealing the current account balance for the first half of FY 2025. At a surplus of +JPY 17.5128 trillion, it marked a new record for 1H of a fiscal year. Since I do not see much point in calculating the figures on a fiscal year basis, I will focus on a calendar-year basis. However, even when viewed in total for the first nine months of the year, the +JPY 24.8458 trillion surplus is a historic one. Having said that, though we may celebrate the statistical surplus on a fiscal year basis, it remains difficult to reconcile it with the current weakness of JPY. The breakdown of the current account surplus shows a



deficit of -JPY 6.4367 trillion for trade and services, a surplus of +JPY 33.4731 trillion for primary income, and a deficit of -JPY 4.4863 trillion for secondary income. The primary income balance continues to generate the entire surplus. The CF-based income surplus, which deducts reinvested earnings and portfolio investment income that will not be converted into JPY, amounts to approximately +JPY 13.0 trillion, roughly a third of the statistical surplus. As a result, the CF-based current account balance is also a surplus of +JPY 4.3 trillion. Given that this is the largest CF-based surplus seen during the ongoing phase of JPY depreciation, one can say that the supply and demand climate is improving.

How should we interpret JPY's continued depreciation despite this? It is possible that (1) the excess JPY selling over the past three years has been accompanied by leads and lags that have not yet become apparent. However, in addition to this basic fact, is it also possible that (2) market participants are aware of the risks to JPY from Japan sharing its fate with the U.S. Japan is the world's largest direct investor in the U.S., and as a result, the U.S. accounts for one-quarter of Japan's investment income (receipts). Whether for the statistical surplus or the CF-based one, Japan's revenue reliance on the U.S. is significant (see graph). Given these conditions, it is logical for market participants to discount JPY from an asset preservation perspective as the U.S. becomes more isolationist. This argument may become even more persuasive going forward under the second Trump administration.

Direct investment income of Japan (receipts, 2024)



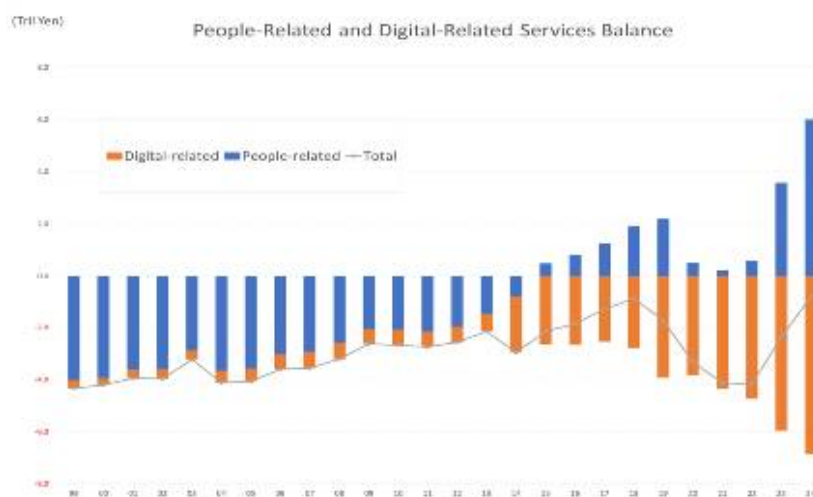
Increasingly Troubling "People vs. Digital" Gap

The travel balance, a valuable source of foreign currency for Japan, has hit a record high of JPY 5.479 trillion year-to-date, but the July-September quarter total, at JPY 1.3296 trillion, was down by JPY 525.9 billion from the previous quarter's JPY 1.9185 trillion. This is the largest qoq decline on record (current statistics). The figure is consistent with the fall in number of foreign visitors to Japan, from 10.98 million in the April-June quarter to 10.13 million in the July-September quarter, a qoq decline of 849,000 people. This was also the largest decline on record. There are several possible reasons for this, and it is unclear which was the decisive factor – JPY depreciation bottoming out when seen over a three-year period; rumors about the prediction of a major natural disaster in Japan, which circulated widely on social media in July; supply constraints in the tourism industry; or stagnant overseas demand. However, this significant decline during the peak season (July-September) is cause for concern. This report has consistently emphasized the changing circumstances surrounding Japan's travel surplus, which had been posting sharp yoy rises for a while as a numerical reaction to the country's isolationist policy until March 2023. Now it appears that those changes have become apparent.



Annualizing current figures, the people-related balance, which primarily consists of the travel balance, is projected to expand its surplus to approximately JPY 6.6 trillion for 2025 (up from JPY 6.0 trillion last year), while the digital-related balance is expected to shrink its deficit to JPY 6.7 trillion (down from JPY 6.8 trillion last year). The people-related surplus has never completely offset the digital-related deficit before, but this may happen for the first time in 2025. However, it may simply be that the three years from 2020 through 2022 were an anomaly, and that the normal state of affairs involves the people-related surplus canceling out the digital-related deficit, or even posting a slight net surplus.

But here is the problem: a future in which the surplus from inbound tourism surpasses the deficit from digital services and continues to accumulate is difficult to envision. As I have repeatedly pointed out in past editions of this report, it is clear which side this power relationship will lean toward. While the deficit in the digital-related balance is expected to expand as the use of AI and other technologies in the real economy gains momentum, demand for inbound tourism will eventually reach its limit (or may already have reached that limit) given Japan's supply constraints. Given these circumstances, the plateauing of the people-related balance is only a matter of time. It is still unclear whether the current peak-out indicates that that time is already here, but it is worth noting that, as of the end of 1H of FY 2025, the signs of the peak-out are beginning to be



confirmed. Further, if Japan can no longer expect Chinese tourists (details below), who make up the largest portion of spending among foreign visitors to Japan, we can no longer expect the travel surplus to expand. Over the past three years, Japan should have learned that gloating over its huge statistical surplus is hollow. A more in-depth analysis of balance of payments statistics is required.

Chinese Inbound Tourism Spending has Impact of Nearly JPY 2 Trillion

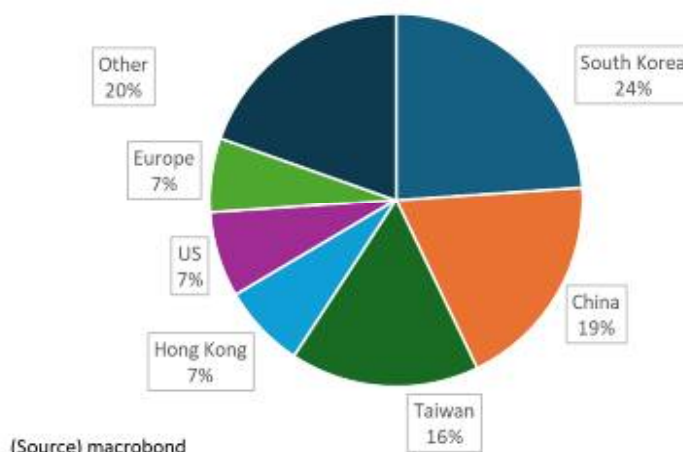
When considering the supply and demand environment, we must also take into account the rapidly deteriorating Japan-China relations. On November 14, the Chinese Ministry of Foreign Affairs urged its citizens to refrain from traveling to Japan for the time being. On November 16, the Chinese Ministry of Education issued a notice urging its citizens to carefully consider plans to study in Japan. It has also been reported that several major Chinese travel agencies have already suspended sales of tours to Japan. This was in retaliation to Takaichi's Diet comment that a Taiwan emergency could easily constitute an "existential threat" for Japan that would justify its exercising its right to collective self-defense.

According to figures for the number of foreign visitors to Japan published by the Japan National Tourism Organization (JNTO), South Korea accounted for the largest share in 2024, at 23.9%, followed by China at 18.9%, Taiwan (16.4%), and Hong Kong (7.3%) (see graph). Specifically, there were 8.82 million visitors from South Korea, 6.98 million from China, 6.04 million from Taiwan, and 2.68 million from Hong Kong. Meanwhile, the per capita spending figures published by the Japan Tourism Agency (JTA) Inbound Consumption Trends Survey rank China first at JPY 277,000, followed by Hong Kong at JPY 249,000, Taiwan at JPY 188,000, and South Korea at JPY 109,000. In terms of impact on the Japanese economy, the key metric is "number of visitors multiplied by per capita spending." Simply multiplying these figures reveals that China's spending impact amounts to approximately JPY 1.9 trillion, significantly higher than the next-highest ranking, Taiwan (approximately JPY 1.1 trillion). The Inbound

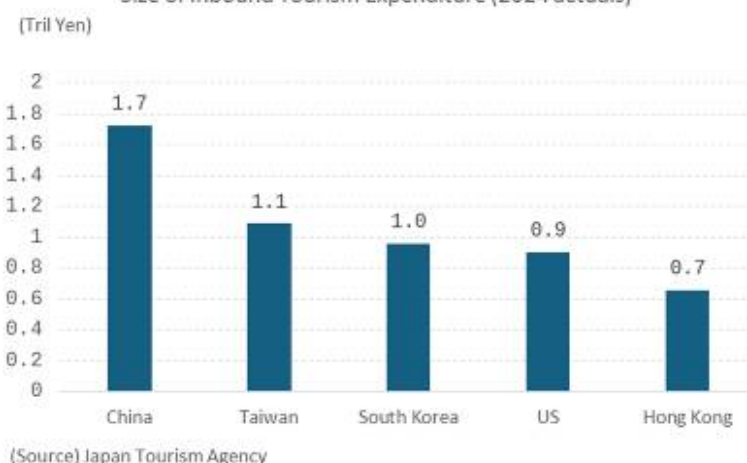
Consumption Trends Survey figure for total spending by Chinese visitors in 2024 had a slight discrepancy at around JPY 1.7 trillion. This was due to the fact that the statistics on inbound spending are compiled by the JTA, while the statistics on the number of foreign visitors to Japan (entries and departures) are compiled by the JNTO, resulting in different samples. While the difference is not significant enough to affect the overall discussion, it is important to note.

The graph to the right lists the top five countries in terms of inbound spending as released by the JTA. The combined spending of South Korea and Hong Kong barely catches up to that of China. Of course, the recent measures are unlikely to result in a complete loss of Chinese tourists, but even if the number is halved, the loss would amount to around JPY 850 billion. Of course, this is still equivalent to the total spending of U.S. visitors, which is a significant figure. It is important to note that, in the most extreme scenario, if the Chinese government were to issue a travel ban, a significant decline in spending could be expected. It is important to formulate the premise for forecasts keeping an eye on future developments.

Share of Foreign Visitors to Japan (2024)



Size of Inbound Tourism Expenditure (2024 actuals)



Supply-Demand Leans Toward JPY Selling

Based on Japan's July-September GDP figures released on November 18, nominal GDP (seasonally adjusted) was approximately JPY 636 trillion. JPY 1.7 trillion corresponds to approximately 0.26% of this. Japan's July-September GDP was up by +0.5% yoy (annualized) on a nominal basis and down by -1.8% yoy (annualized) on a real basis, both very low figures. Under these circumstances, a JPY 1.7 trillion (0.26 pp) loss is not a small figure. Even if the damage were less severe, it would likely be a major blow to inbound tourism demand. It is important to note that the recent self-imposed travel restrictions by China come on top of signs that Japan's travel surplus and inbound tourist numbers are already slowing. In a climate where the disadvantages of JPY weakness get highlighted, stimulation of inbound tourism is one of its few benefits. If this weakens, Japan's ability to earn foreign currency will naturally decline, and the JPY supply-demand balance will skew even more toward JPY selling.

Could This Emerge as a Reason not to Raise Interest Rates?

I am not qualified to pass judgment on Takaichi's remarks and will leave that to experts in that field. However, her remarks and their implications should be taken into consideration when examining Japan's economic and financial situation. At least from the perspective of JPY supply and demand, the travel surplus played the role of offsetting the accumulated trade and digital deficits, so any shakeup of this premise could be interpreted as a factor promoting JPY weakness. It also represents a new risk factor for the BOJ, which is currently considering a rate hike as its next move. At the very least, the uncertainty surrounding Japan-China relations is becoming a more realistic concern than the uncertainty surrounding Trump tariffs, which have been repeatedly mentioned in the past. Of course, as of the time of writing, the situation remains fluid, and it is unclear whether this will become a decisive factor to be considered at the December meeting. However, it is important to note that new reasons for not raising interest rates have emerged, replacing the Trump tariffs. From this perspective, it seems likely that the deterioration of relations with China will be treated by the markets as a reason to sell JPY for now.

Risks to My Main Scenario - When Public Opinion Outweighs Inflation Concerns

Takaichi Fan Culture and Blind Adherence to Reflationary Ideology

LDP President Sanae Takaichi, Japan's first female prime minister in its constitutional history, has notably shown approval ratings exceeding 80% in various opinion polls (as of the time of writing, the most recent nationwide poll conducted by the Yomiuri Shimbun from November 21 to 23 indicated an approval rating of 72%). From the start, her reflationary economic policies and her tough stance toward China have been highlighted. Both of these pose risks, but they seem to enjoy strong public support. In this midst, the phrase "Sana-katsu" (Sanae Takaichi fan culture) is gaining popularity. The word is a derivative of "oshikatsu," which refers to the act of enthusiastically endorsing (supporting) celebrities, athletes, or even manga and anime characters. Sana-katsu seems to be a similar trend of emulating Takaichi's fashions and favorite items. Sana-katsu is now a movement. There are both positive and negative aspects to this level of closeness between the public and a government official, and I would like to discuss both here. In summary, at the outset – blind adherence to Takaichi's behavior carries with it the risk of blind adherence to her reflationary ideology.

First, on a positive note, this simply boils down to an increased interest in politics, and that too among young people. As can be imagined from the popularity of phrases such as "Sana-katsu," the Takaichi administration has strong support among young people. According to the October 21-22 Yomiuri Shimbun nationwide emergency opinion poll, support for the Takaichi Cabinet by age group was 80% in the 18-39 age group, which is a dramatic increase from the 15% support rate for the previous Ishiba administration in the September survey among this age group. This is not an outlier, as the approval rating for this administration is higher overall compared with the previous one, with significant increases in the 40-59 age group (75% vs. 29% in the previous survey) and the 60+ age group (63% vs. 50% in the previous survey) also. However, the stark contrast between the Ishiba and Takaichi administrations is that, while the former primarily relied on older voters for support, the latter is receiving support from younger voters. This offers hope for a breakthrough that will finally address the issue of political apathy among young people.

The low voter turnout rate, a frequent issue in every election, is inextricably linked to political apathy among young people, and has been cited as the reason behind the tendency of Japanese governments to implement policies that benefit the elderly, who have relatively higher voter turnout rates. While most politicians are unlikely to have a policy of not working for those who do not vote, the fact remains that politicians will work for those who do vote, since no politician can hope to exert real influence unless they get elected through votes. If Sana-katsu continues to grow, it may finally lead to young people participating in politics, which would eventually result in the development of policies that benefit the working generation, such as social security reform and measures to combat the declining birthrate.

Once interest is piqued, a certain number of people are likely to remain interested in politics even after the Takaichi administration, i.e., in the next administration, and the one after that. Furthermore, while lively pre- and post-election discussions on platforms such as YouTube and X can sometimes be risky, I think they are a positive development in the sense that they draw attention to previously marginalized demographics.

From Reflation to Xenophobia?

However, it is the negative side that is worrying. If the Sana-katsu fan trend takes hold, it is likely to lead to the widespread establishment of the sentiment that "Takaichi is not bad." Given the oft-cited Japanese social trait of going along with the prevailing mood, it is quite conceivable that ordinary political ups and downs will not dent the cabinet's approval rating. It would not be surprising if, just as fans are tolerant of the mistakes of their favorite celebrities and athletes, fans (citizens) are tolerant of the mistakes of their favorite politicians. Under such circumstances, the usual pattern of high inflation dampening approval ratings may not hold.

Under the Takaichi administration, which favors expansionary macroeconomic policies, inflation risks are undoubtedly on the upside. If a future characterized by difficult inflation were to arrive, it would naturally be suspected that this was related to Takaichi's administration (although, of course, this may not be universally true). However, if the current mood prevails, even if inflation leads to a significant discrepancy between the actual and nominal growth rates, it may be argued that Takaichi is not at fault. To begin with, the causal relationship between practical fiscal or monetary policies and inflation figures is vague, and even the central bank cannot understand it accurately. The general public may judge causality based on their like or dislike of the relevant politician. For instance, would the Takaichi administration's policy mix have received an approval exceeding 80% if the Kishida or Ishiba administrations had advocated it? While it may not apply to all times and situations, it is well-known even in business circles that "who" said something is more important than "what" was said. Especially when it comes to fiscal and monetary policy, even non-experts want to have their say, and "who" said a certain thing can easily impact the impression it has. This is especially true in the case of a sitting prime minister. The key here is Takaichi's stance on international diplomacy. In the case of Takaichi, some of the reasons behind her strong public support include her being the first female prime minister of Japan, her strong support for reflationary policies, and also her strong right-wing leanings. In the July House of Councillors election, along with measures to combat rising prices, restrictions on foreign visitors were a major factor influencing voting behavior, as they were in the LDP presidential election. Given this social climate, even if inflation accelerates as a result of expansionary macroeconomic policies, her strong right-wing leanings could potentially sustain public support for the Takaichi administration. Given that the Takaichi administration receives support for both reflationary and xenophobic ideologies, even if it loses support for the former at some point, it will still be supported for the latter. Indeed, history teaches us that the more difficult inflation makes life, the greater the hostility toward foreigners and the wealthy, so, whatever points the Takaichi government loses to reflationary policies, it will actually gain thanks to its xenophobic policies. In other words, public opinion (the Sana-katsu factor) will outweigh inflation concerns.

The History of High Inflation and Xenophobia

A look back at history reveals a strong affinity between inflation and xenophobia (see table below). Under Argentina's Juan Perón dictatorship, in the 1940s, there was a surge in anti-foreign-capital xenophobic nationalism, rooted in the protection of domestic industry and anti-American sentiment against the backdrop of post-World War II inflation and the resulting social unrest. The Perón regime, which arose from labor unions that had strengthened their solidarity amid inflation, sided with the unions in leaning toward higher wages, improved social security, and the normalization of an expansionary fiscal policy. The Perón regime lasted roughly 10 years by controlling the media and disseminating pro-government information like most long-term dictatorships.

Regimes that Have Lasted Through High Inflation and Currency Devaluation

Country/Government	Period	Inflation conditions	Xenophobia/discrimination	Political outcome	Characteristics of form of government/system
Nazi Germany	1933–1945	Hyperinflation after World War I and sharp rise in unemployment due to the Great Depression	Intense anti-Semitism, nationalism, and exclusion of minorities	Establishment of a dictatorial system that took control of parliament and judiciary	Presidential appointment system; abuse of emergency decrees facilitating centralization of power
Argentina (Perón regime)	1946–1955	Post-war inflation and soaring prices of daily necessities	Anti-foreign capital, anti-foreign forces, emphasis on nationalism	Strongly populist government that continued for approximately 10 years	Presidential system gave it strong powers; wage increases and social security benefits as per labor union demands accelerated inflation
Turkey (Erdoğan government)	2003–present	Persistently high inflation and weak currency	Anti-refugee (Syrian refugees), anti-Kurdish, anti-Western	Transition to presidential system led to lax checks on executive and judiciary; media control and judicial reforms led to the concentration of power	In 2017, a national referendum shifted the government from a parliamentary system to a presidential system
Hungary (Orbán government)	2010–present	Recession and price uncertainty following the debt crisis	Anti-immigration, anti-EU, and anti-capitalist sentiment	Concentration of power through media control, judicial reform, etc	Majority gained in parliament, making it easy to change the system; System changed after gaining majority

(Source) Compiled by author from various sources

Turkey, another prime example of a country suffering from high inflation and currency devaluation, has experienced something similar. The Recep Tayyip Erdoğan government, established in 2003, is still going strong, having shifted the blame for social unrest on to the Kurdish issue and the Syrian immigration and refugee crisis.

In Hungary, the Viktor Orbán government has stayed in power since its inauguration in 2010 by stressing that the European debt crisis and the EU's (i.e., Germany's) immigration policies are causing economic hardship for the people. Incidentally, Prime Minister Orbán, despite sensible restraints by the central bank governor, continued to press the accelerator on expansionary fiscal policy, with the result that Hungary recorded an inflation rate nearly twice the EU average in 2022-23. Even now, Hungary's inflation rate is around 4%, nearly double that of the EU and euro area, which have managed to keep inflation at 2%. The reason the administration has remained in power despite this is that much of

the media is controlled by government-affiliated and pro-ruling party companies that blame the inflation on EU sanctions, the arrogance and greed of multinational corporations, and the Ukraine War.

Another example is Nazi Germany, where the hyperinflation of the 1920s and mass unemployment caused by the Great Depression fueled public discontent, which then developed into extreme xenophobia and nationalism.

While all these regimes have negative images as long-term dictatorships in retrospect, they were initially successful in stabilizing the economy and expanding their support bases. Building on this initial support, they typically embarked on structural reforms under the guise of judicial and electoral reforms, strengthened control over the media and judiciary, and centralized power. (Argentina, Turkey, and Hungary have all revised their political systems along the way.) Looking back at the early stages, Argentina under Perón initially prioritized worker protection through wage increases and expanded social security, while Nazi Germany also saw a significant decline in unemployment. Later, when the domestic economy fell into disarray, this was blamed on foreign forces (immigrants, refugees, the U.S., the EU, etc.), leading to the creation of a “strong government” image to fight them. Inflation, too, is often blamed on foreign forces during such times.

A Balanced Discussion

I do not intend to apply these examples of other countries directly to Japan. In the examples mentioned above, inflation had hit double digits, which is on a completely different level from Japan, even though Japan is struggling with inflation currently. Further, while inequalities are on the rise in Japan, they are still moderate, and ethnic and religious divisions are nonexistent here. While the number of foreign residents is increasing, being an island nation, it is not in an environment similar to Hungary or Turkey, which struggle with a continuous flow of immigrants and refugees. In other words, there is a limit to the extent to which xenophobia can escalate in Japan.

In other words, while Japan is unlikely to descend into extreme scenarios such as the above, it is important to remember, when considering the Takaichi administration, the significance of the fundamental fact that inflation and xenophobia are easily linked. Even if inflation were to occur as the direct result of Takaichi's preferred reflationary policies, it could get linked to foreigners. For instance, “real estate investment by foreigners is driving up apartment prices” or “hotel and food prices are being raised to cater to inbound tourists.” This could lead to the Takaichi administration continuing to receive favorable reviews for its attempt to strictly regulate foreigners despite the poor quality of its macroeconomic policies.

The Council on Economic and Fiscal Policy and the Council for Japan's Growth Strategy are supposed to play the role of advising the government against going down such a risky path, but as previously reported, their role as a check on the government is difficult to expect if their own membership constitutes experts with strong reflationary tendencies. In reality, my main forecast scenario remains that macroeconomic policy excesses may be reined in by public disapproval. However, given the ongoing Sana-katsu movement, high inflation not dampening public sentiment is a risk scenario that cannot be ruled out. A characteristic of long-running governments during periods of high inflation is that, even if they are judged to have been wrong in retrospect, they have considerable public support in the moment. While it is difficult to honestly determine the probability of this scenario coming true, this is certainly a development that should be taken into consideration when considering investment strategies.

Ideally, policymakers should collect balanced opinions and formulate policies through constructive discussion. For example, a year ago, the Nihon Keizai Shimbun and the Japan Center for Economic Research launched the Economics Panel, a survey of economists, to collect diverse opinions, mainly on fiscal and monetary policy, from approximately 50 scholars. The survey results reveal both the pros and cons of diverse issues without converging to a single conclusion. All the respondents are leading experts in Japan. It may be a good idea to use such research as a reference when conducting economic policy.

No matter which approach is chosen, it has to be said that a discussion system that only accepts one ideology when pursuing the growth and stability of the Japanese economy is likely to lead to risky conclusions. One cannot help worrying that the risks of JPY depreciation and rising interest rates for JPY-denominated bonds have suddenly increased.

EUR Outlook – True EUR Strength Still in the Future

EUR Now and Going Forward – Is a 200-Yen Rate for EUR/JPY Realistic?

Not Real EUR Strength

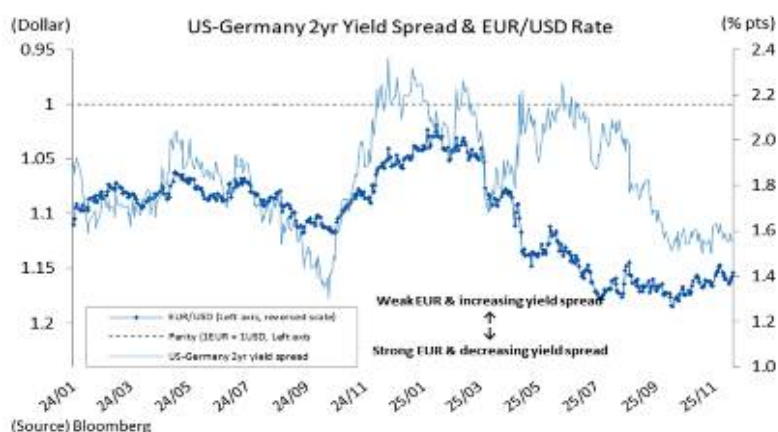
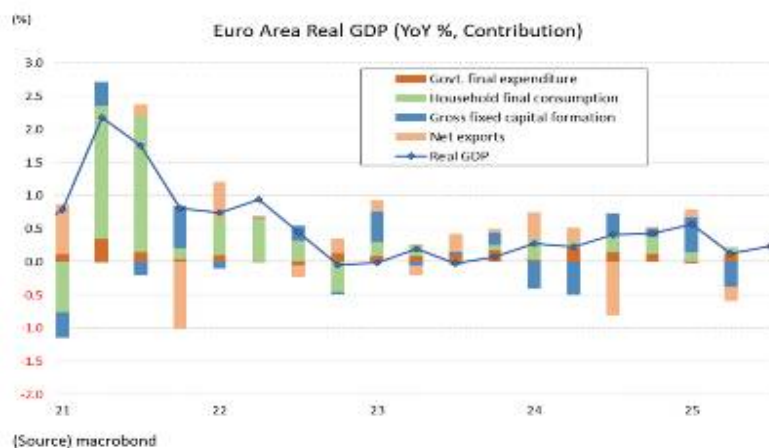
As EUR/JPY stabilizes in the 180 range, the number of inquiries I receive on this topic is on the rise. However, as I said also in last month's issue, I do not have anything particularly noteworthy to say about this in relation to Europe. It is simply that USD/JPY has soared while EUR/USD has lost momentum, resulting in a purely arithmetical reason for EUR/JPY increase. To elaborate, when USD/JPY rose in the past, the overall USD exchange rate was often pushed up accordingly, thereby forcing EUR/USD to decline. The change in EUR/JPY exchange rate computed as a result was unlikely to be large. However, 2025 is a year of JPY depreciation alongside USD depreciation, which results in a historically rare combination of strong EUR/USD alongside rising USD/JPY. While the record high EUR/JPY rate is simply the result of JPY weakness, a more precise explanation is that it is due to JPY weakness alongside USD weakness.

As the graph shows, the present situation is completely different from that in July 2008, when EUR/JPY hit an all-time high (at just under 170). At that time, EUR was truly strong, and EUR/USD reached a record high of just over 1.60. This record has yet to be broken, and there are no signs of it being broken anytime soon. In July 2008, USD/JPY was still trading at around 105. JPY then experienced a period of extreme strength due to the unwinding of JPY carry trades and a large trade surplus. Inevitably, EUR/JPY peaked at just under 170 and then began to decline. Starting 2009, the European debt crisis further accelerated the move away from the euro. This period saw a significant gap emerge between the euro area and the U.S., and between EUR and USD. Following the ECB's introduction of negative interest rates in June 2014, EUR further weakened, and continues to do so to this day. Compared with mid-2008, therefore, EUR is no longer truly strong. The new EUR/JPY record highs are the result of JPY depreciation.

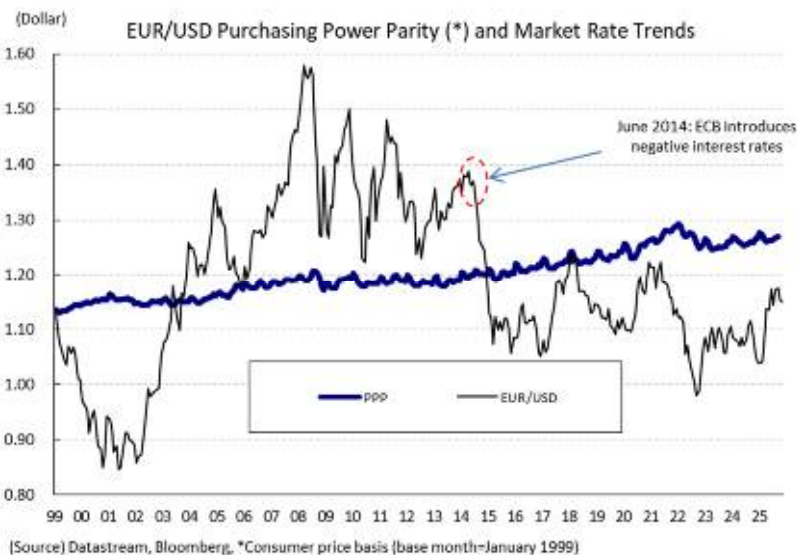


EUR/JPY Hitting 200 Is Not Unrealistic

Although this is not the house view, EUR/JPY hitting 200 is not an unrealistic scenario. While the euro area economy does not show particularly strong growth, it maintains a cruising pace, growing at an annualized rate of +0.9% qoq for the 2025 July-September quarter (see graph). After a surge in production and exports for the January-March quarter (+2.3%) in anticipation of U.S. tariff hikes, followed by a slowdown for the April-June quarter (+0.5%), euro area growth appears to have recovered this quarter (see graph). As explained below, prices are also expected to be stable, so there may be no calls for a rate cut in the foreseeable future. This is a major difference between the ECB and the Fed, which may cut rates as its next move, and this may bolster EUR/USD, which tends to correlate well with interest-rate differentials (see graph, bottom). The euro area's price stability is striking compared with that of Japan and the U.S. The most recent October Harmonized Index of Consumer Prices (HICP; aggregate) for the euro area was up 2.1% yoy, while Japan and U.S. consumer price indices were up 3.0%.



Between the U.S. and the euro area, in particular, U.S. inflation rates have long been above those in the euro area, and this has put upward pressure on EUR/USD from a purchasing power parity (PPP) perspective (see figure), making a theoretical rate of around 1.27-1.30 for EUR/USD likely. Despite the gradual narrowing of the Europe-U.S. interest-rate differential, it seems reasonable to expect the exchange rate to rise to around 1.20. If EUR/USD is set at 1.20, EUR/JPY would be 186 at a rate of 155 for USD/JPY, 188 at a rate of 157 for USD/JPY, and 192 at a rate of 160 for USD/JPY. The 190 level for EUR/JPY is, therefore, not particularly difficult. Unless the Takaichi administration changes its stance on economic policy, a reversal in the rising trend of USD/JPY is unlikely. If EUR/USD is set at 1.20, and USD/JPY approaches 165, then a rate of 200 for EUR/JPY is well within reach. Of course, these are all simply a series of assumptions piled up, but it is true that while the markets are focused on JPY weakening against a weak USD, other cross-JPY pair levels have also been rising. In this report, I have recommended looking at the effective exchange rate to gain a broader perspective, and this has become even more important now.



Daisuke Karakama
 Chief Market Economist
 Global Markets Sales & Trading Department
 Mizuho Bank, Ltd.
 Tel: +81-3-3242-7065
daisuke.karakama@mizuho-bk.co.jp

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