

Forex Medium-Term Outlook

October 29, 2025

Overview of Outlook

USD/JPY continued to rise in October, driven solely by the inauguration of the Sanae Takaichi administration and the resulting rise in reflation expectations. At the time of writing this report, no definite information regarding the Takaichi administration's economic policies has been released, making it possible that market movements are expectations-driven. However, it is undeniable that downward pressure on JPY remains strong. Of course, JPY's nominal effective exchange rate (NEER) has been on a decline since peaking in late April, so the decline cannot be explained solely by the "Takaichi trade." Given that rising JPY interest rates have also been a hot topic over the past six months, it seems clear that JPY is also being sold due to concerns about fiscal risks to the Japanese economy, regardless of whether such risks actually exist. Further, given the rise in EUR and other European currencies against the theme of a rotation from the U.S. to Europe, it is possible that a country's approach to reliance on the U.S. is also being viewed as a factor. Europe's efforts to achieve strategic independence from the U.S. contrast sharply with Japan's near-complete acceptance of its shared fate with the U.S. If the U.S. and Japan are viewed as inseparable, JPY will not just fail to be bought during times of USD selling, it may, in fact, be sold in conjunction with USD. It seems important to carefully consider the reasons behind the strikingly similar movements of USD and JPY in terms of NEER since the beginning of the year. With Japanese households having only just begun to shift their financial assets toward inflation optimization, there also remains ample domestic capacity for JPY selling.

EUR struggled to strengthen in October. Despite the emergence of region-specific negative factors, such as political turmoil in France, this did not destabilize EUR itself, and the currency generally remained strong against the backdrop of USD weakness. EUR has been hitting record highs against JPY on a daily basis, but this does not necessarily indicate a positive assessment of EUR itself; it is merely a reflection of the rotation from the U.S. to Europe combined with across-the-board JPY depreciation, which makes it different from the "europhoria" frenzy seen in the 2000s. EUR/USD purchasing power parity (PPP) is around 1.27, indicating that EUR remains undervalued in terms of price measures. If EUR's status as a reserve currency is really improving and one can assume significant continued rotation from the U.S. to Europe, especially to the euro area, then it would not be surprising for EUR/USD to rise up to the PPP level. With EUR/USD at around 1.30, as suggested by the PPP, and USD/JPY at its current level of 150-155, EUR/JPY could hit 200. One may be forced to view the market from a different perspective, recognizing that nominal levels themselves have no intrinsic meaning. However, it is important to watch out during the current forecast period for developments that lead to markets equating political risks in France and elsewhere with EUR risk.

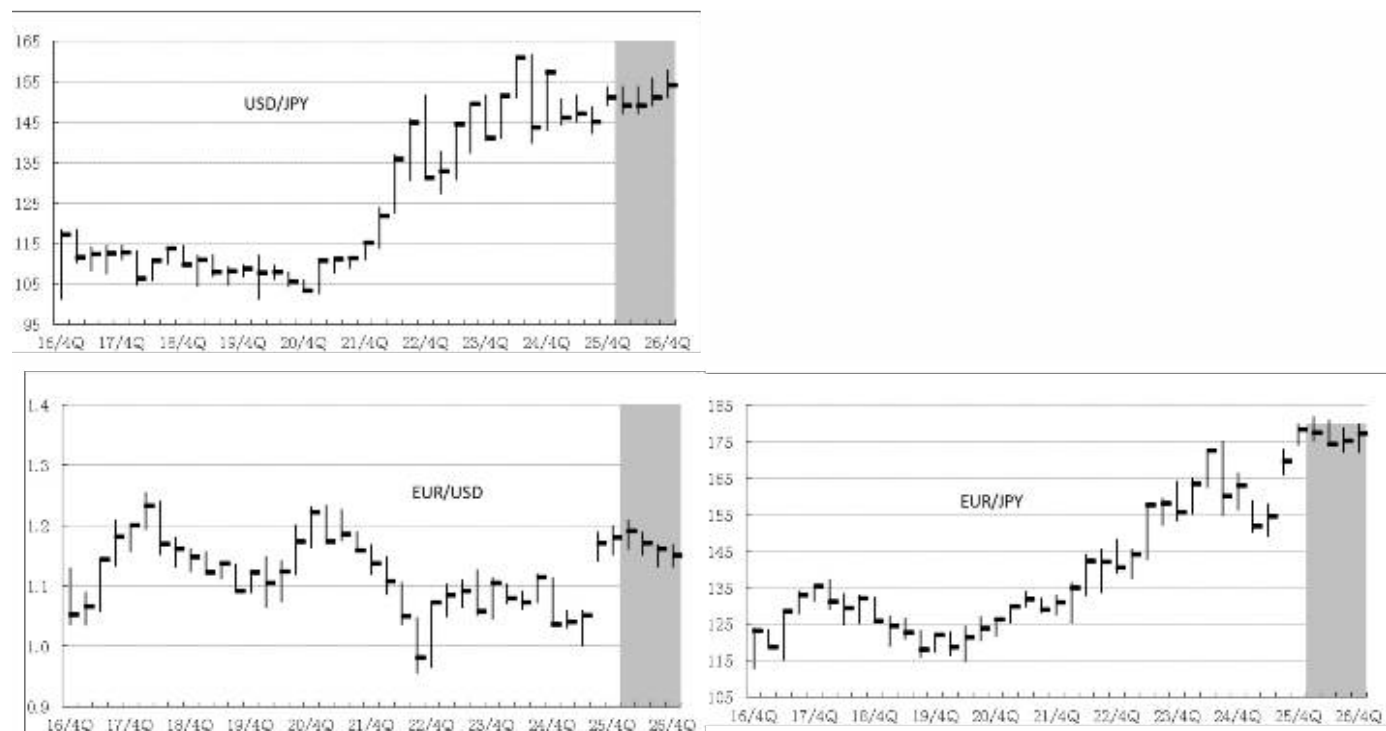
Summary Table of Forecasts

	2025		2026			
	Jan-Oct (Actual)	Nov-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	139.89 ~ 158.88 (151.60)	149 ~ 154 (151)	147 ~ 154 (149)	147 ~ 154 (149)	149 ~ 156 (151)	151 ~ 158 (154)
EUR/USD	1.0125 ~ 1.1918 (1.1655)	1.15 ~ 1.20 (1.18)	1.16 ~ 1.21 (1.19)	1.15 ~ 1.19 (1.17)	1.13 ~ 1.17 (1.16)	1.13 ~ 1.17 (1.15)
EUR/JPY	155.63 ~ 178.23 (176.70)	174 ~ 180 (178)	175 ~ 182 (177)	174 ~ 181 (174)	172 ~ 179 (175)	172 ~ 180 (177)

(Notes) 1. Actual results released around 10 am TKY time on 29 December 2025. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Reflation Expectations and Weak JPY

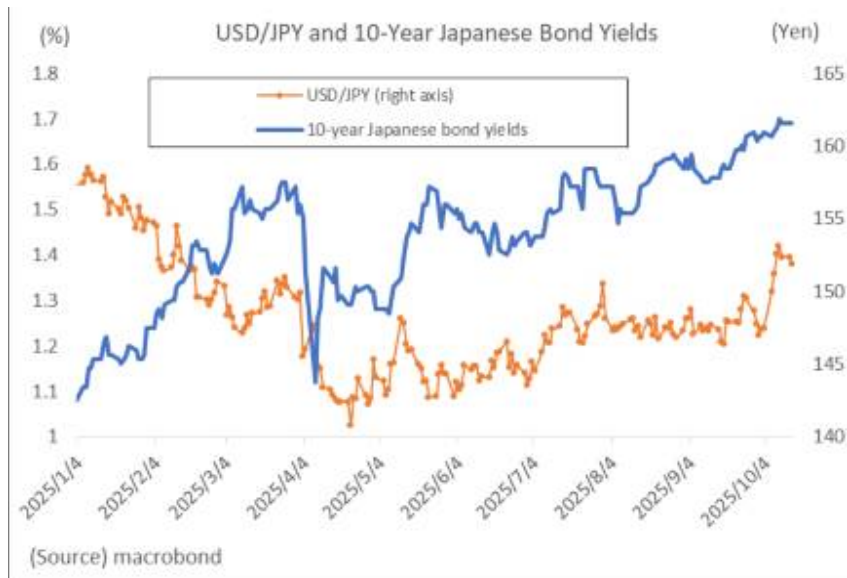
Japan's Fiscal and Monetary Policy Now and Going Forward: Persistent Reflation Expectations

Limited Impact in Reining in Reflationary Policies?

On October 21, LDP President Sanae Takaichi was nominated as the 104th Prime Minister of Japan at a plenary session of both the House of Representatives and the House of Councillors. She is the first woman to assume the position. As previously reported, the LDP-Japan Innovation Party (Ishin Party) coalition will now govern. Following Takaichi's inauguration, as political uncertainty recedes, the Nikkei Stock Average has recovered all the losses it suffered following the Komeito Party's departure from the coalition (and concerns about U.S. regional banks). However, there is no indication of an acceleration in JPY depreciation or JPY interest rate rise. With Taro Aso exerting his influence as LDP Vice-President and former Finance Minister Shun'ichi Suzuki taking on the role of Secretary-General, the "sensible brakes" applied by the Aso faction do seem to be functioning as previously anticipated.

However, the JPY depreciation and rise in interest rates following Takaichi's election as LDP president on October 4 have not yet been reversed (see graph). At the time of writing, market expectations that "a Takaichi administration = reflationary policies = a JPY depreciation and rising interest rates" remain strong. The view that the Aso faction and the Ishin Party will act as a brake on reflationary policies seems correct to some extent, but only "to some extent" as per the prevailing interpretation. While macroeconomic policy revisions as drastic as those seen during the transition from the Democratic Party to the second Abe administration are unlikely, expectations that a coalition with the Ishin Party will curb Takaichi's policy inclinations also do not appear to be very strong. My first impression of the Takaichi administration is that expectations of reflationary policies have become sticky.

This can also be seen in the agreement between the two parties. The agreement clearly states the coalition's basic stance toward fiscal policy: "We aim to resolve social issues by promoting effective expansion of public and private



investment based on responsible and active fiscal policy, while thoroughly implementing expenditure reforms through a review of the bloated and inefficient structure of government.” This gives the impression of a hastily crafted document that combines the LDP’s “responsible active fiscal policy” (under President Takaichi) with the Ishin Party’s “thorough expenditure reform through a review of inefficient government structures.” If the administration finds itself in a tight spot, there is a good chance it will lean toward short-term fiscal expansion, such as through handouts and tax cuts, in order to appease public opinion. It is difficult to say whether the Ishin Party is sufficiently committed to fiscal consolidation to reject such an approach. While this can only be confirmed post-facto, the possibility of the Ishin Party justifying expansionary fiscal policy as “effective investment” cannot be ruled out.

As a minority government, the ruling coalition’s freedom of policy choice is limited. The LDP-Ishin coalition holds only 231 of the 465 seats in the House of Representatives and 120 of the 248 seats in the House of Councillors, two and five seats short of a majority, respectively. As with the Prime Minister nomination, the battle remains tough, with last-minute decision-making only possible if independent lawmakers can be won over. Ultimately, it is highly likely that the government will accommodate the opposition’s demands in the process of passing bills, leading to a situation where it finds itself forced into fiscal recklessness. Perhaps this is why JPY depreciation and rising interest rates have not been significantly corrected since October 4.

Expectations of Finance Minister Katayama

Some see Satsuki Katayama’s appointment as Finance Minister as a factor in JPY appreciation. Indeed, given Katayama’s past comments, such an interpretation is understandable. For example, in a March interview with Reuters in her capacity as the LDP Financial Investigation Committee chair, Katayama made the following comments about the forex market:

- **Because JPY has a long history of being in the 120 level, many believe it should be in the 120-130 range and that the 120 level represents its true value.**
- **JPY appreciation is desirable to bring rising prices under control.**
- **Currency intervention could serve as a trigger (for guiding JPY in the stronger direction), but it is not very effective in the long term, so fundamental measures are necessary.**

It is quite reckless to say that “because JPY has a long history of being in the 120 level, the 120 level represents its true value,” and I suspect that this is at odds with Katayama’s actual views (perhaps the interview was unable to capture her views in their totality). However, her comments acknowledging the usefulness of JPY appreciation in countering rising prices and the limitations of JPY-buying intervention as a measure to prevent JPY depreciation seem to confirm that Katayama is by no means a proponent of reflationary thinking.

So, what are these “fundamental measures” Katayama emphasizes in the same breath as noting the limited effectiveness of currency intervention? In the interview, she mentions a proposal to expand the tax benefits of NISA (tax-free small investment account system) to include a partial exemption from inheritance tax for elderly people who have held Japanese stocks over the long term, stating that she wants to make it advantageous to hold Japanese stocks over the long term. This brings to mind a proposal to curb the sale of JPY to purchase overseas assets by setting a priority quota for domestic assets in NISA, but it is unclear whether she mentioned this proposal in the context of curbing JPY depreciation. This is an issue worth awaiting further information.

Based on these past comments, it will be interesting to see whether Katayama can act as a “wall” against JPY depreciation in the Takaichi administration, where expectations of potential reflationary policies remain strong. However, the matter may not be that simple. As discussed in a gathering hosted by former Vice Minister of Finance for International Affairs Masato Kanda that drew attention last year, the transformation of Japan’s balance of payments structure is a critical issue facing the Japanese economy, one of the side effects of which has surely been a decline in foreign currency earning capacity. If such facts are the underlying cause of JPY weakness, then merely adjusting the direction of monetary and currency policy – in other words, a change in the finance minister – is not enough to reverse the deep-rooted nature of the situation. In this report, I do not consider a finance minister’s appointment to be a reason to revise the level or direction of my USD/JPY outlook. In fact, USD/JPY did move in the direction of JPY strength after a meeting with U.S. Treasury Secretary Scott Bessent at the end of October, but it has not been sufficient to reverse the trend. Ultimately, forex rates are a matter of supply and demand, and a change in leadership alone is unlikely to play a deciding role.

Forex Markets Now and Going Forward: JPY Weakening Alongside USD

NEER Lowest Since the Start of the Year

While the trend of stock price appreciation, JPY depreciation, and interest rate rise has been continuing unabated since Takaichi’s election as LDP president, JPY remains stronger against USD than it was at its nadir in July last year (162 yen to the dollar) as well as the low point at the start of the year (159 yen to the dollar). Some may have the impression that there is currently a lull in the JPY depreciation phase that began in March 2022 even though there has been no significant JPY appreciation. However, this is not true. Indeed, as of the time of writing, USD/JPY is around 153, which reflects JPY appreciation against USD on a year-to-date basis.

However, when viewed in terms of NEER, JPY's NEER turned negative on a year-to-date basis after the LDP presidential election on October 4. Of course, it had already been on a downward trend since peaking in April. As the figure shows, in the immediate wake of the across-the-board USD depreciation following "Liberation Day," JPY's NEER also rose sharply through late April. I recall the sudden rise in expectations at that time that the ongoing three-year JPY depreciation phase was finally beginning to unwind. Around this time, I received many inquiries regarding my traditional assessment of a structurally weak JPY, including some that expressed skepticism. However, as frictions surrounding Trump's tariffs eased (i.e., as the so-called TACO trade strengthened), JPY's NEER began

to decline and remained roughly flat at the year-to-date level throughout the summer. It is worth noting that, while the TACO trade may have contributed to a reversal of USD weakness (shift toward a stronger USD), rising JPY interest rates in Japan since April have also attracted attention.

However, U.S.-side factors (the TACO trade) alone do not sufficiently explain the reasons for the resumption of the JPY depreciation trend. It is also important to consider Japan-side factors, such as the growing concern over increased fiscal risks for Japan. The veracity or urgency of such concerns aside, the possibility that such speculation, particularly among overseas market participants, drove JPY selling cannot be ruled out completely.

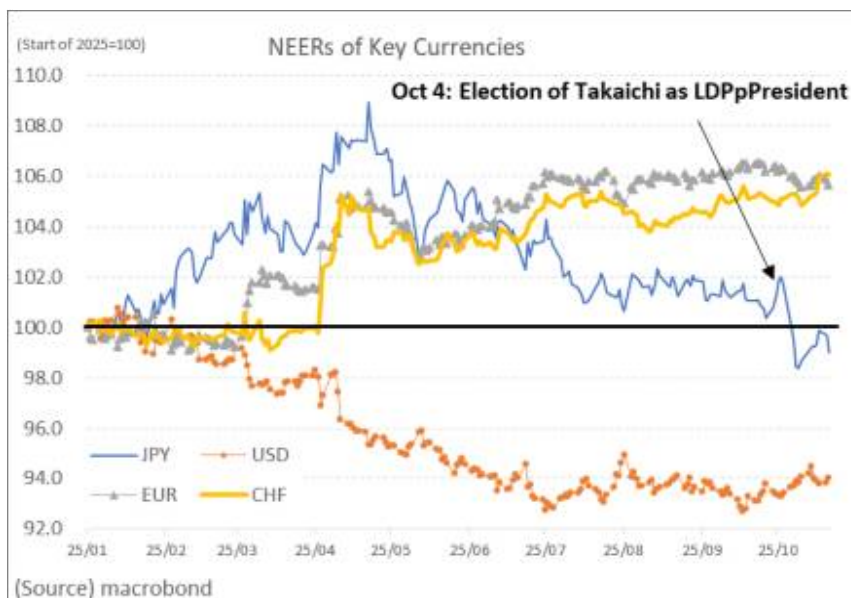
Near-Complete Acceptance of Shared Fate with the U.S.

As the figure above shows, USD's NEER has fallen sharply, down nearly 6% year-to-date. This report has repeatedly argued that these movements are the result of USD's status as a reserve currency being shaken. On the flip side, thanks to capital rotation from the U.S. to Europe, EUR and CHF have been boosted – again something I have discussed in this report in the past. The contrast between European currencies and JPY is that the former have been able to rise against USD weakness, while the latter has been unable to. What accounts for this difference?

There is likely more than one reason, but perhaps the difference in how each country/region approaches its reliance on the U.S. is one factor. As I have mentioned several times in past editions of this report, Europe has begun to move toward military independence from the U.S. and is increasingly willing to issue EU bonds, a new safe asset, to fund this. If a global shift away from USD is truly occurring, the fact that Europe is seeking a gradual withdrawal from the U.S. could be seen as a reason for buying EUR as a counter to USD selling.

Meanwhile, Japan's near-complete acceptance of its shared fate with the U.S. may not just discourage buying JPY as a counter to USD selling, it may even lead to JPY being sold as a set with USD. Given that Japan has agreed to make massive investments in the U.S. largely in line with the U.S. government wishes and is also inseparably tied to the U.S. through its security treaty, it is not surprising that JPY has become a currency to be avoided alongside USD.

In recent years, amid rising geopolitical instability in East Asia, Japan's position that it shares its lot with the U.S. has become increasingly clear. The NEER-related data in the figure on the previous page could be interpreted as indicating an appreciation of European currencies amid a U.S.-Europe capital rotation even as it indicates JPY depreciation due to the view that Japan has accepted its shared fate with the U.S. As shown in the graph, USD is the only currency against which JPY shows significant year-to-date appreciation, while it is essentially weaker against all other currencies. Needless to say, since the NEER is the weighted average of a currency against the currencies of its key trading partners, a decline in JPY's NEER will inevitably push up the JPY-denominated import price index. Forex-related discussions in Japan tend to begin and end with USD/JPY, but it may be important to also keep in mind that the avoidance of JPY as a set with USD is a truly important phenomenon.



Japanese Politics Now and going Forward: Europeanization of Japanese Politics

Europeanization of Japanese Politics

Although the Takaichi administration has managed to get off the ground, it remains a minority ruling party lacking a majority in both the Lower and Upper houses. Europeanization of Japanese politics is once again keenly felt. In July of this year, following the big defeat for the LDP-Komeito coalition in the House of Councillors election, I pointed out that similar scenes have been seen frequently in the euro area since the start of European debt crisis in 2009, reflecting on the fact that political turmoil characterized by minority ruling parties and multi-party coalitions becomes the norm when economies struggle. As is well known, voter support in major European countries has increasingly shifted away from traditional major parties and toward multiple parties, including emerging ones, in recent years. In Japan, the LDP's

dominance is faltering as a multitude of parties, including the Constitutional Democratic Party of Japan, Ishin Party, Democratic Party for the People, and the Party of Do It Yourself, hold a significant number of seats. A similar situation has been occurring for the past 15 years or so in Europe, where this state of affairs has become chronic (see graph). Minority government parties and multi-party coalitions are now commonplace in European politics. While the timing of this trend's emergence varies slightly from country to country, it is safe to assume that this is essentially a side effect of the European debt crisis. Since 2011, when the crisis was at its peak, political instability has become increasingly apparent with each major national election. In political science, there is an indicator known as the "effective number of parties" (ENP), calculated as the inverse of the sum of the squares of each party's seat share. A higher number indicates greater parliamentary fragmentation, and previous research has suggested that ENP greater than four increases the burden of coordination in parliament and shortens government duration.

Looking at data starting 2000, there has been a sharp increase in the ENP of major European countries following the European debt crisis (around 2009-2013), and now all five major European nations (Germany, France, Italy, Spain, and the Netherlands) has an ENP greater than four (see figure). Meanwhile, Japan's ENP in the Upper House (leaving aside the Lower House) also surpassed 4.5 following the July Upper House elections, reaching a fragmentation level on par with Europe. With the LDP no longer expected to maintain a numerical advantage, it was inevitable that Komeito would conclude that there was no incentive to compromise on its principles and form a coalition. (The fact that the Ishin Party's name was mentioned as a possible coalition partner is also likely to have hardened Komeito's stance, given its friction with the Ishin Party.)

Changes in European Politics Pst Financial Crisis

Period	Characteristics	Key phenomena
~2008	Two-party systems are the norm (stable coalitions or single-party governments)	CDU & SPD (Germany), PDL-PD (Italy), PSOE & PP (Spain), etc.
2009~2012	Debt crisis, austerity, and unemployment → voter defection	Populist parties (SYRIZA and M5S in Italy, Podemos in Spain, etc.)
2013~2019	Multi-party coalitions become the norm; left-right alliances, grand coalitions, and short-lived governments become more common	Germany's traffic light coalition (SPD + FDP + the Greens), Italy's M5S + Lega, Spain's PSOE + Podemos
2020s	Polarization of political parties & decline of the center make multi-party coalitions inevitable	Rise of far right and far left leading to a shrinking center

(Source) Compiled by author

Effective Number of Parties (ENP)

Year	Germany	Italy	France	Spain	Netherlands	Japan
2000	2.9	2.3	3.1	2.1	4.2	2.6
2005	3.1	2.5	3.4	2.2	4.6	2.8
2010	3.3	2.8	4.2	2.5	5.4	3.1
2015	3.6	3.7	5	4	5.9	3.4
2020	3.9	4.3	5.2	4.5	6.2	3.6
2023	4	4.4	4.9	4.5	6.3	3.6

(Source) Comparative Political Data Set (CPDS) *Studies show ENP greater than 4 markedly increase policy coordination burden

Fragmentation Triggered by Austerity Measures Due to Debt Crisis in Europe, and by Inflation Tax Due to JPY Weakness in Japan

Italy, for example, is known for its long history of short-lived governments. Since the collapse of the Silvio Berlusconi administration in 2011, Italian politics has become even more fluid, with seven prime ministers and eight cabinets since 2011. The Mario Monti Cabinet, formed immediately after the Berlusconi administration, was a technocratic cabinet with no members of parliament, including the prime minister himself. Since then, the merging and splitting of major political parties has become commonplace. It is not uncommon for the prime minister to change even outside of national election cycles, and critics frequently point to Italy's lack of a stable government and the resulting difficulty in implementing consistent policies as a factor behind its sluggish growth rate. This is not too far away from Japan's reality in recent years.

Italy's political instability reached a peak in June 2018, when a coalition government was formed between the far-left Five Star Movement (M5S) and the far-right League (Lega). The two parties, despite their opposing views, were united by their anti-EU and Italy-first values. While this government collapsed after only 14 months, it is important to understand why such an unorthodox government was formed in the first place. Following the debt crisis, Italy and other southern European countries were forced to implement austerity measures by the European Commission (EC), the ECB, and the IMF (commonly known as the Troika) in exchange for international financial assistance.

Specifically, as the domestic economy was suppressed through spending cuts and tax increases, anti-establishment sentiment steadily grew. Throughout history, national elections held during periods of financial hardship have often led to hostility toward the existing establishment (government and ruling party), foreigners, and upper-income earners. However, in post-crisis Europe, hostility toward the elite ruling class in Brussels and Washington led to the downfall of one government after another. Incoming administrations tend to promote extreme political positions, especially in economic policy, favoring loose fiscal and monetary policies as a backlash against austerity measures. While Japan has not adopted austerity measures (details later), the "inflation tax" triggered by JPY weakness is thought to have had a similar effect.

Incidentally, the political situation in Italy has been stabilizing since 2020. It has evolved from a period when people hoped the government would last at least a year, to a period of stability, with a stable right-wing coalition government that is well regarded. This is attributed to an electoral law enacted in 2017, which requires parties to form pre-electoral coalitions to win in single-member districts. On the right, the Brothers of Italy (Fratelli d'Italia), led by Prime Minister Giorgia Meloni, the League (Lega), and Forza Italia formed a coalition, while on the left, the Democratic Party (Partito Democratico; PD) and smaller parties sought to form alliances. This made potential conflicts predictable, unlike in the past, when conflicts would not be clear until after the results were revealed.

The right-wing coalition won the September 2022 general election, and Meloni took office. Lega's confrontational stance toward the EU and NATO were restrained by achieving a stable division of power within the ruling coalition. Meloni has now built a good relationship with President Trump and is increasingly being called Europe's "kingmaker." While institutional reforms and the emergence of a leader who can curb extreme right-wing views have finally brought stability, the Italian economy remains sluggish, and there remains a fear that the government and ruling party will eventually be targeted.

Europe Embodies the Idea that Financial Hardship Results in Multi-Party Politics

To return to the topic of European political instability, besides Italy, other southern European countries such as Spain, Greece, and Portugal have also been enduring chronic instability. Perhaps the most painful memory for market participants is that of Greece holding a national referendum in July 2015 on whether or not to accept austerity measures as a condition for a bailout. In her autobiography, *Freedom: Memoirs 1954–2021*, former German Chancellor Angela Merkel describes her phone call with Greek Prime Minister Alexis Tsipras immediately before the referendum as "the most astonishing moment of any phone call in my entire political career." Greece had repeatedly been asked to adopt austerity measures in exchange for financial aid over the previous few years, and resentment toward the Troika had been building among the Greek people. The referendum, which was a culmination of that anger, was seen as Greece's gamble on whether to leave EUR.

While Italy and Greece are more often mentioned in the context of the European debt crisis, Spain's longstanding two-party system – the center-left Spanish Socialist Workers' Party (PSOE) and the center-right People's Party (PP) – completely collapsed following the European debt crisis. The current left-wing coalition (SUMAR, including Podemos) and the far-right party (Vox) have begun to break into the territory of the traditional political forces. Neither party was able to form a majority in the 2015 general election, after the impact of the crisis had subsided, leading to a re-election in 2016 with no government having been formed. The current Pedro Sánchez administration (PSOE + SUMAR) is a fragile minority coalition that relies on the cooperation of some opposition parties outside the cabinet. There is a strong sense that under Takaichi, the LDP may be forced to follow this path.

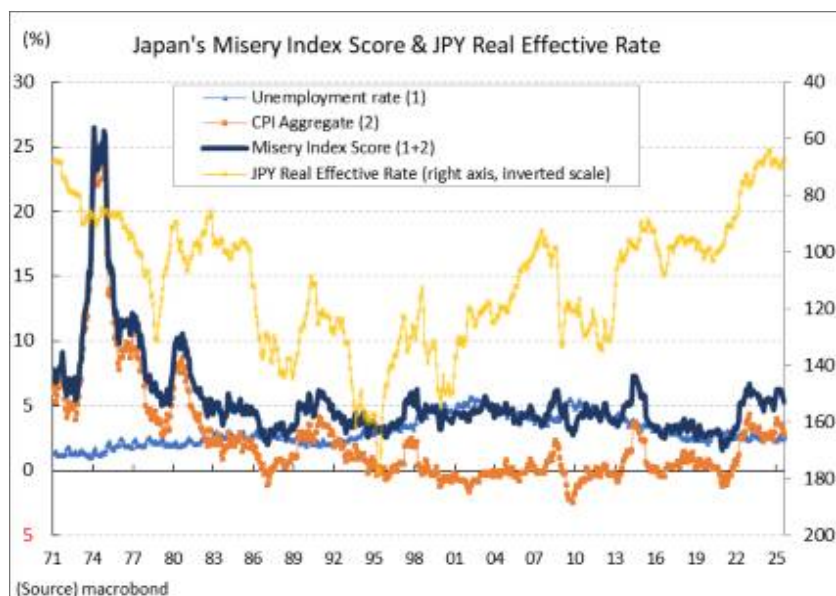
Incidentally, even member states that were considered fiscally strong, such as Austria and Finland, are no exception to the political turmoil, with right-wing forces growing stronger and coalitions requiring ingenuity. But that is not all. As is well known, even in Germany and France, it is becoming increasingly difficult for either of their two largest political parties (the Christian Democratic Union and Social Democratic Party in Germany; and the Republicans and the Socialist Party in France) to form a government on their own. Both countries are losing public support to far-right parties (Alternative for Germany (AfD) in Germany and National Rally (RN) in France). This is partly due to anti-EU sentiment following the European debt crisis, but it is also due to rising xenophobia following the Merkel administration's unlimited refugee acceptance in September 2015. Austria's rightward shift is a prime example of this. The ideological beliefs of the EU and the German government at its center appear to have sparked resentment.

While there are countless examples, the European debt crisis was not merely an economic/financial crisis, but one that marked a turning point that led to a structural shift in the European political system from a two-party system to a fragmented multi-party system. It is also important to understand that the Merkel administration's unrestrained acceptance of refugees before the wounds of the debt crisis had healed further destabilized public opinion. Whatever the reason, European politics over the past 15 years or so has embodied the idea that financial hardship results in multi-party politics.

Political Fragmentation Caused by Debt Crisis in Europe, Weak JPY in Japan

The idea that financial hardship results in multi-party politics applies to Japan as well. If the European debt crisis was the trigger for political instability in Europe, then JPY weakness seems to be the trigger in Japan. Specifically, the trigger is the “inflation tax” resulting from JPY weakness. The European debt crisis caused discontent within the region due to austerity measures, resulting in spending cuts and tax increases. While Japan is not implementing austerity measures, its continued avoidance of them has resulted in an “inflation tax” via JPY depreciation, ultimately forcing the public to endure an experience similar to austerity measures (tax increases).

The recent rise in Japan’s misery index score, driven by historical JPY weakness, could not be unrelated to its recent political instability (see graph). Of course, the increased acceptance of right-wing views and growing political instability may also be due to frictions between foreigners and Japanese people stemming from the growth in inbound tourism. However, ultimately, this is also the result of JPY weakness. JPY weakness and the accompanying inflation reinforce the survival of the fittest phenomenon in the economy. If asset prices experience a corresponding rise in inflation-driven nominal growth, the gap between the “haves” and the “have-nots” will inevitably widen. Politically, this will lead directly to the “buried middle class” phenomenon, which will create an incentive for extreme political positions.



After JPY Supply-Demand Structure, Political Instability is Second Biggest Factor Promoting JPY Selling

A crucial difference between Europe and Japan is the fragility of Japan’s currency. Even with political instability, the euro area currently enjoys the world’s largest trade surplus. Since the inauguration of the second Donald Trump administration in the U.S., speculation of capital rotation from the U.S. to Europe has fueled expectations of robust capital inflows into the euro area. From 2009 to 2012, EUR’s value fluctuated sharply due to intermittent concerns about southern European countries’ withdrawal from EUR. However, the current trend is toward unity, with strategic independence from the U.S. in mind. From the economic and financial perspectives, the trend of EUR buying fueled by expectations of progress in fiscal integration has been noted. Indeed, EUR remains strong despite reports of political instability in core countries like Germany and France. Not to mention that the ECB had, until recently, been in a rate-cut phase, being more concerned about disinflation than inflation. Concerns about political instability notwithstanding, Europe is fortunate to be spared concern due to currency depreciation and the resulting inflation and rising interest rates. In contrast, Japan’s political instability comes on top of concerns about currency depreciation, inflation, and rising interest rates, creating conditions that make financial markets susceptible to volatility.

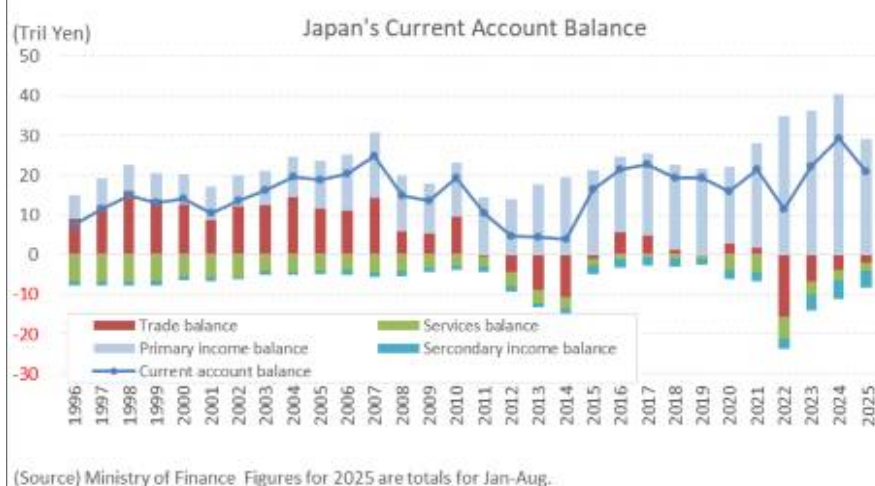
In summary, the euro area economy in the 2010s was vulnerable to currency depreciation and rising interest rates due to political instability triggered by the debt crisis. By contrast, Japan is concerned about a future in which political instability triggered by JPY weakness could lead to a further weakening of JPY and higher interest rates. Japan’s inflation rate already consistently exceeds that of Europe and the U.S., and for the foreseeable future, it is expected to be on par with the U.S. and Europe at best. Having experienced no inflation for 30 years, many Japanese households still have financial asset portfolios that are vulnerable to inflation. For the time being, the situation seems conducive to short-sighted pursuit of expansionary fiscal and monetary policies, especially among this demographic.

However, macroeconomic policy expansion amid inflation will further fuel inflation, creating a vicious cycle. When it comes to prices, deflationary currencies rise and inflationary currencies fall. It seems that political instability in Japan is turning into the second biggest factor promoting JPY depreciation after changes in the JPY supply-demand structure. If a political crisis were to develop and fuel anxiety about Japanese bonds and JPY, the situation would be reminiscent of the former euro area.

JPY Supply and Demand: The Coming Collapse of the Services Deficit

2025 Current Account Surplus on Track to Record High

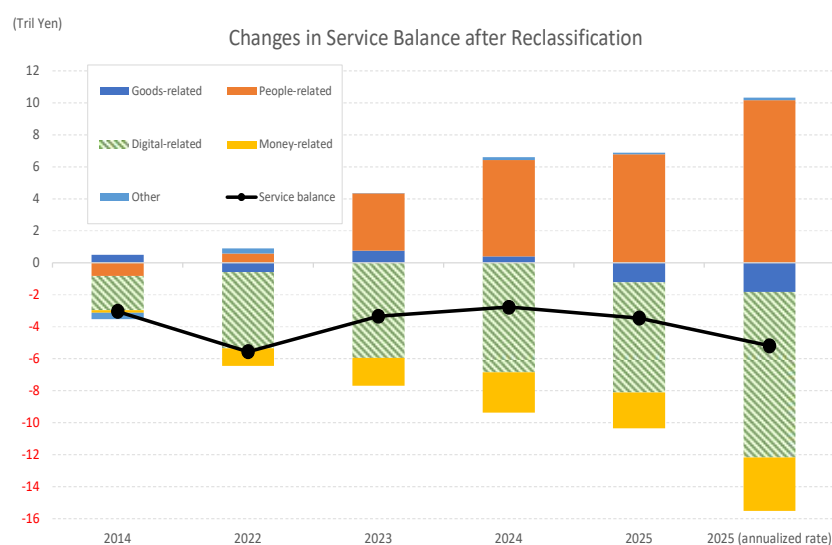
USD/JPY remained stable at the 150 level in October. As I have previously discussed, concerns about political instability in Japan have encouraged speculation of expansionary macroeconomic policies, fueling JPY selling. However, I continue to view the structural change in JPY supply and demand, symbolized by structural changes in the balance of payments, as a major factor in JPY depreciation due to supply and demand being inclined toward net JPY selling. Objectively speaking, JPY has become a difficult currency to buy from both political and economic perspectives. As of the time of writing, balance of payments statistics for August



have been released, so I would like to summarize the supply and demand balance as of the present. Japan's cumulative current account balance for the first eight months of the year posted a surplus of JPY20.9581 trillion, surpassing the previous year's record of JPY20.6720 trillion for the same period. In other words, the current account balance this year is on track to surpass the 2024 record of JPY29.3718 trillion. Despite this, JPY depreciation persists. This is the reason why it is important to consider JPY rates not in response to the widening or narrowing of the domestic-foreign interest rate differential, but rather in response to the supply and demand structure.

Services Balance Will Eventually Collapse

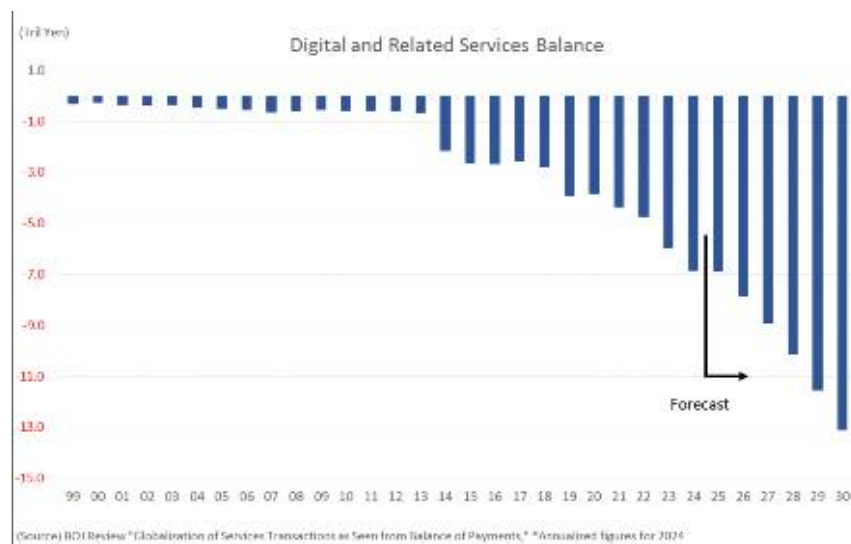
In this report, I have focused on the services balance as an item that will likely determine the overall shape of the current account balance over the long term. In the medium to long term, given Japan's shrinking population, a time will inevitably come when the expanding digital deficit will no longer be offset by an expanding travel surplus within the services balance. In October, the Japan Tourism Agency released the number of visitors to Japan for September, and it was widely reported that the cumulative number of tourists since January this year had already surpassed 30 million, the fastest on record. The report pointed out that sales of high-end items appeared to be running out of steam, and that there were concerns of inbound consumption shifting toward quantity over quality, but there is no guarantee that even the pursuit of quantity will continue.



(Source) Created by the author based on the Bank of Japan paper entitled "Globalization of Service Transactions from the Perspective of Balance of Payments Statistics."

The travel balance, which relies primarily on the labor-intensive tourism industry to generate a surplus (foreign currency), is bound to hit a plateau in the Japanese economy, where labor shortages are a given. Of course, to some extent, it is possible to switch to a strategy of increasing quality (i.e., per capita consumption) if labor shortages cause a plateau in quantity (i.e., the number of visitors to Japan), which offers some hope for maintaining/expanding the travel surplus. However, the digital deficit paid to large platforms is still a capital-intensive industry, where "quality" (i.e., unit price) has been gradually increasing in line with the nominal wages of workers employed, and this trend is unlikely to change going forward.

Despite gradual annual increases in their unit price, people are in no position to refuse services that serve a quasi-infrastructure role in economic activity, such as subscription-based video and music streaming services, cloud storage, and software such as Office 365. The cumulative services balance for January through August this year posted a deficit of JPY2.3024 trillion, which, when annualized, gives JPY3.4536 trillion, which is an increase compared to last year. As the figure above shows, the digital-related deficit (approximately JPY6.9 trillion annualized) is largely offset by the people-related surplus (approximately JPY6.8 trillion annualized) at present. (Incidentally, both the digital-related and people-related surpluses are at their highest levels ever.) This leaves a deficit (approximately JPY2.2 trillion annualized) corresponding to monetary-related balances, such as reinsurance payments. However, as I have repeatedly stated, this structure will eventually collapse. Once Japan reaches the “X-Day” point, when the digital-related deficit can no longer be offset by the people-related surplus, the services deficit floodgates will be opened.



Toward an Era of JPY10-Trillion Trade and Services Deficit

As I have argued in previous issues of this report, I believe the digital deficit will drive the services deficit to a chronic JPY10-trillion level by the 2030s. Based on the latest figures, there are three scenarios—optimistic, standard, and pessimistic—for the services deficit in 2030, which would be approximately -JPY3 trillion, -JPY6 trillion, and -JPY8 trillion, respectively. If we extend the time frame to 2035, the deficit could reach approximately -JPY5 trillion, -JPY15 trillion, and -JPY20 trillion, respectively. Even in the standard scenario, the deficit is expected to stabilize at the -JPY10-trillion level by the early 2030s. This implies that unless the trade balance returns to a surplus, the goods and services balance will inevitably record a deficit greater than -JPY10 trillion. So far, there have only been three years during which the trade and services deficit has exceeded -JPY10 trillion – 2013, 2014, and 2022 – all

of which were years of significant JPY depreciation. There is no doubt that the deficit was due to JPY depreciation in these years. Looking beyond the present, into the future, the nascent changes occurring in the services balance are impossible to overlook. Thanks to the travel surplus, the services balance is unlikely to fall below -JPY10 trillion over the next five years or so. However, given the services balance, which is predicted to collapse into a deficit, the direction for my medium- to long-term JPY outlook forecasts becomes clear, at least from a supply and demand perspective.

USD/JPY and Japan's Worst 10 Trade and Services Deficits

	Trade	Services	Trade and Services	Rate of Change of JPY Against USD (Yoy)
2022	-15.5	-5.6	-21.1	-13.9
2014	-10.5	-3.0	-13.5	-13.7
2013	-8.8	-3.5	-12.3	-21.4
2023	-6.5	-2.9	-9.4	-7.6
2012	-4.3	-3.8	-8.1	-12.8
2024	-3.7	-2.8	-6.4	-11.5
2011	-0.3	-2.8	-3.1	5.2
2015	-0.9	-1.9	-2.8	-0.4
2021	1.8	-4.2	-2.5	-11.5
2019	0.2	-1.1	-0.9	1.0

(Source) Bank of Japan, Bloomberg, *Earliest available data is for 1985

Risks to My Main Scenario: Ample Funds for JPY Selling?

JPY Cash and Deposits Almost Dipping Below 50%

USD/JPY returned to the JPY150 range in October following the inauguration of the Takaichi administration, and there are signs that it may enter a phase of stabilization. With the inauguration, speculation of reflationary policies going forward remain strong, and prices are likely to continue rising, especially for risky assets. In this regard, the preliminary Flow of Funds Accounts (FFA) as of the end of June 2025 provide some interesting insights. This time, I would like to take a look at the composition of household financial assets for the first time since “Liberation Day.” As previously reported, household financial assets have reached a record high of JPY2,239 trillion (see graph). Compared to a quarter-century ago (as of the end of June 2000), financial assets themselves have increased by approximately JPY838 trillion. Dividing this into JPY-denominated assets and foreign-currency assets reveals that JPY-denominated

assets have increased by approximately JPY740.1 trillion and foreign-currency assets by approximately JPY96.9 trillion, with the former overwhelmingly driving the increase.

Composition of Japanese Household Financial Assets
(as of the end of JUN 2025)

	Amount (¥trillion)	Share (%)
Total assets	2,238.7	100.0
Foreign currency nature	111.6	5.0
Foreign currency deposit	7.3	0.3
Foreign investment in securities	40.5	1.8
Investment trust	63.8	2.8
Yen character	2,127.2	95.017
Cash and deposits (excluding foreign currency deposits)	1,119.0	50.0
Government bonds, etc.	33.1	1.5
Stocks and investments	294.3	13.1
Investment trusts (excluding foreign currency portion)	81.6	3.6
Insurance and pension reserves	566.1	25.3
Deposits, etc.	33.2	1.5

Composition of Japanese Household Financial Assets
(as of the end of JUN 2000)

	Amount (¥trillion)	Share (%)
Total assets	1,401.1	100.0
Foreign currency nature	14.7	1.0
Foreign currency deposit	3.5	0.2
Foreign investment in securities	5.0	0.4
Investment trust	6.2	0.4
Yen character	1,387.1	98.997
Cash and deposits (excluding foreign currency deposits)	747.6	53.4
Government bonds, etc.	49.1	3.5
Stocks and investments	131.8	9.4
Investment trusts (excluding foreign currency portion)	50.6	3.6
Insurance and pension reserves	371.9	26.5
Deposits, etc.	36.1	2.6

Changes from the end of JUN 2000 to the end of JUN 2025

	Amount (¥trillion)	Share (%)
Total assets	837.6	
Foreign currency nature	96.9	3.9
Foreign currency deposit	3.8	0.1
Foreign investment in securities	35.5	1.5
Investment trust	57.6	2.4
Yen character	740.1	▲ 3.98
Cash and deposits (excluding foreign currency deposits)	371.4	▲ 3.4
Government bonds, etc.	▲ 16.0	▲ 2.0
Stocks and investments	162.4	3.7
Investment trusts (excluding foreign currency portion)	31.0	0.0
Insurance and pension reserves	194.2	▲ 1.3
Deposits, etc.	▲ 2.9	▲ 1.1

Source: Estimated from the Bank of Japan's "Flow of Funds Statistics"

However, it must also be noted that, when viewed as a percentage of total assets, foreign-currency assets (my calculation) have increased more than five-fold, from 1.0% to 5.0%, while JPY-denominated assets have fallen by 4.0 pp, from 99.0% to 95.0%. This is the first time that foreign-currency assets have reached the 5% level. Further, for statistical purposes, insurance, pension and standardized guarantees, which include foreign-currency-denominated life insurance, account for approximately JPY566.1 trillion, or 25% of the total. If we assume even 5% of this is in foreign currency, the foreign-currency asset ratio would exceed 6%, and if we assume 10%, the foreign-currency asset ratio would rise to 7.5%. As I have repeatedly argued in the past, it is important to remember that roughly 10% of Japanese household financial assets are held in foreign currencies. The growth in foreign currency assets has been driven primarily by investment trusts, which have expanded tenfold over the past quarter century, from approximately JPY6.2 trillion to JPY63.8 trillion, while their share of total assets has quadrupled, from 0.4% to 2.8%. Coupled with the launch of the New NISA scheme, entry-level products such as the eMAXIS Slim All Country Global Equity Index Fund, which offers low-cost investment in global stocks, have undoubtedly attracted cash and deposits from households. Decreasing transaction costs have also boosted foreign securities investments, with foreign currency-denominated foreign securities investments expanding eight-fold over the past quarter century, from JPY5.0 trillion to JPY40.5 trillion, and their share of total assets quadrupling, from 0.4% to 2.8%.

Incidentally, the largest increase in the share of JPY-denominated assets over the past quarter century was in stocks and capital investments (+3.7 pp). As of the end of June 2025, the ratio reached 13.1%, marking the first time it has hit the 13% level – a new record high (see graph). As previously reported, the Nikkei Stock Average has continued to hit new record highs since then, so it is highly likely that the ratio will show continued rise at the next datapoint (end of September, data scheduled for release in December). As previously discussed, portfolios are being shifted from deflation-optimal to inflation-optimal, revealing how foreign currency-denominated assets, stocks, and investments, previously considered risk assets, are now being viewed as tools for asset protection. Meanwhile, the largest decline in JPY-denominated assets was for cash and deposits, which fell 3.4 pp from 53.4% to 50.0%. The symbolic image of half of Japanese households' financial assets being in JPY cash and deposits, which has been a subject of discussion, is finally about to change. Of course, government bonds, which are vulnerable to inflation, also fell by 2.0 pp from 3.5% to 1.5%, and are now at a level roughly equivalent to that of foreign currency-denominated foreign securities investments. As seen in previous issues of this report, going by the change in share of NISA accounts, these trends appear to be driven by the working generation in their 30s to 50s, so they may be trends with a certain degree of sustainability.

Proportion of Stocks and Investment Funds
in Japanese Household Financial Assets



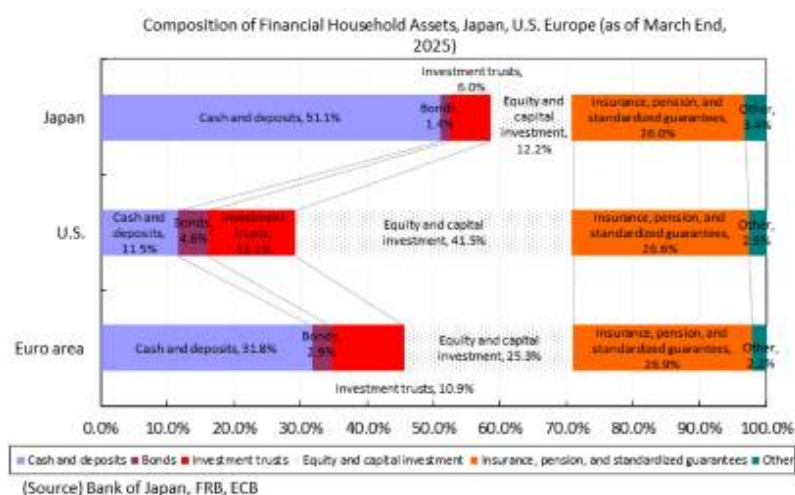
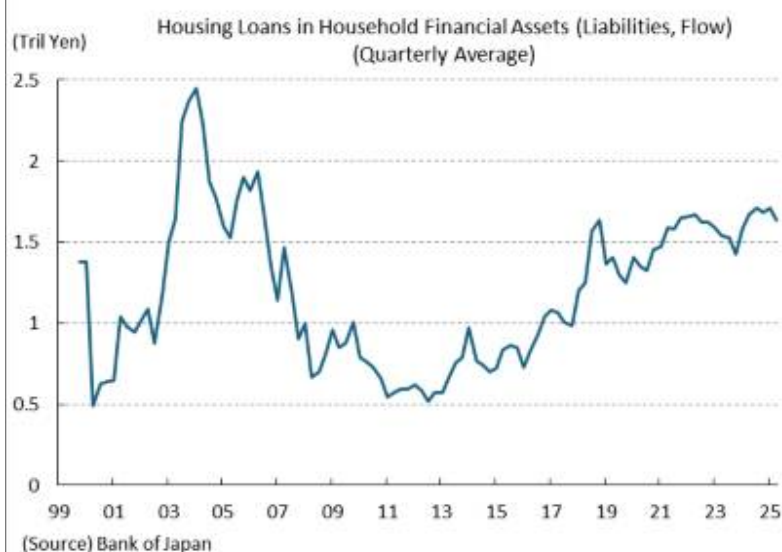
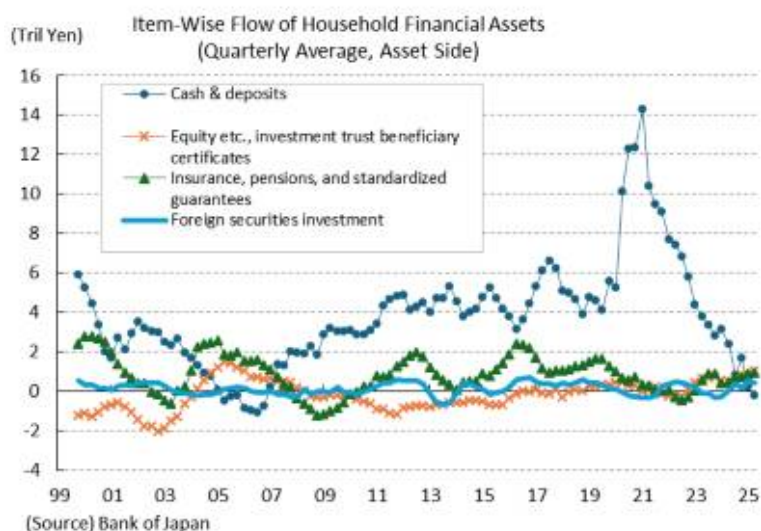
(Source) Bank of Japan

Flow Reveals Change in Values

The figure above shows trends in household financial assets on a stock basis. The figure below shows trends on a flow basis. In this report, I regularly review changes over the past quarter century on a stock basis, but these changes become even more apparent when examining the same period on a flow basis. As explained in the stock-based analysis, the image of half of Japanese households' assets being in JPY cash and deposits is on the verge of changing, but the picture becomes even clearer when viewed on a flow basis. On a flow basis (average of the previous four quarters), JPY cash and deposits have faced an unprecedented decline since the end of March 2021, eventually turning into an outflow by the end of June 2025, down -JPY24.6 billion compared with the previous period. This is the first outflow in 18.5 years (74 quarters) since the end of December 2006. At that time, there had been a continuous outflow of cash and deposits for a year and a half (six quarters) from the end of June 2005 to the end of December 2006. This was the result of a special circumstance, namely the full lifting of the payoff freeze in April 2005. With the lifting of the payoff freeze, current and time deposits other than settlement deposits were no longer fully protected – protection in the event of bankruptcy was limited to JPY10 million (plus interest) per depositor per financial institution. This decline in the relative safety of cash and deposits made it inevitable that people would diversify into other asset classes (such as stocks and insurance). Note that 2005-07 was dubbed the “era of the weak-JPY bubble,” and it was also the last time that Japanese export manufacturing, led by flat-screen TVs, dominated the world. The resultant rise in stock prices, from which investors hoped to benefit, may also have contributed to the outflow of funds from deposits during this time.

Is There Still Ample Investment Capital?

The current outflow of cash and deposits is clearly different from the combined effects of institutional changes and asset management environment seen during 2005-06. As inflation becomes a normalized trend and people are increasingly aware of the need for “defense investment” rather than “investment for asset management purposes,” they are choosing foreign currencies, stocks, and investment trusts. In the same context, the desire to acquire real estate is also rising (see graph to the right, top). Note that the sharp increase in real estate investment during 2002-03 was due to statistical revisions that clarified and reclassified mortgage categories, as well as the introduction of the Flat 35 loan program, and is therefore incomparable to the current increase. When considering the sustainability of this trend, JPY-denominated cash and deposits, which still account for 50% of total assets despite their decline, are noteworthy as an investment source. The fact that JPY-denominated cash and deposits still account for the majority of total assets is a unique feature of Japan, when seen against trends in Europe and the U.S. (see graph to the right, bottom). The ratio of cash and deposits to household financial assets as of the end of March 2025 is particularly low in the U.S., at 11.5%, but even in the euro area, it is significantly lower than in Japan, at 31.8%. Given that Japan's inflation rate remains consistently higher than that of the U.S. and the euro area, it would not be surprising if the shift toward riskier assets continued for some time to come. The shift from savings to investment must be watched as a downside risk for JPY.



EUR Outlook – The Future of EUR/JPY After Hitting a New Record High

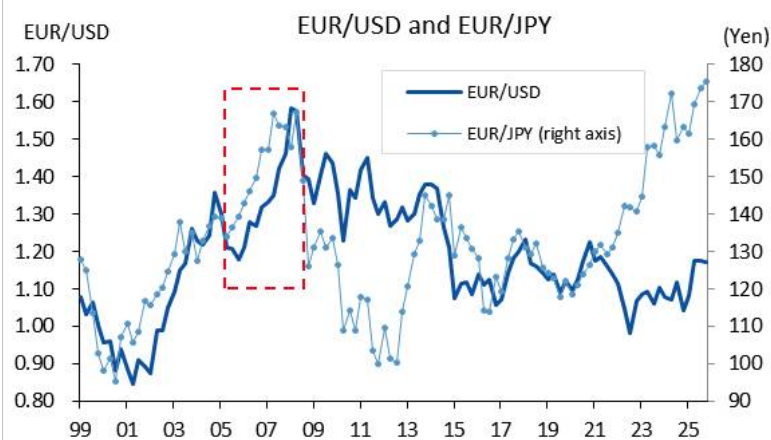
EUR Now and Going Forward: How to Interpret the Record High Against JPY

EUR/JPY Renewing Record Highs Merely a By-product of JPY Weakness

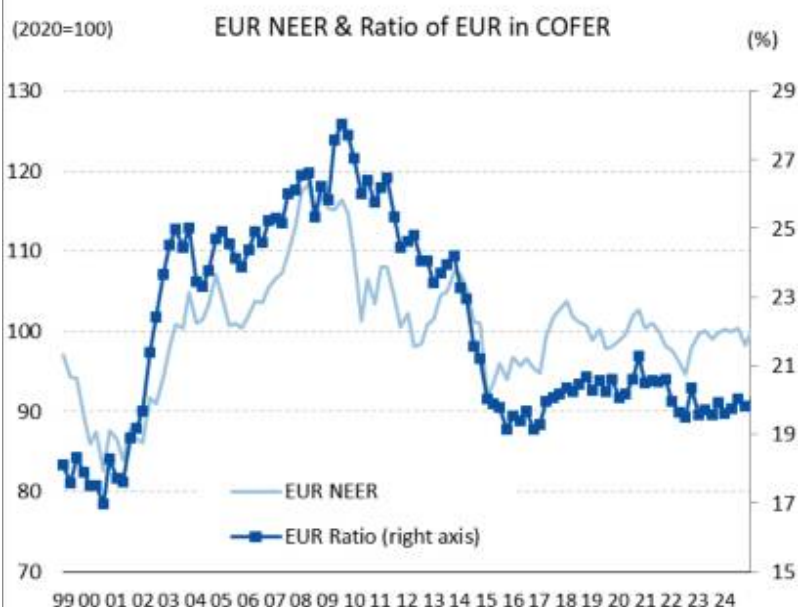
In October, EUR/JPY hit an all-time record high of 178.23. As I explored in last month's edition of this report, expectations have been rife in the forex markets since early spring that USD's status as a reserve currency will be undermined while EUR's status is strengthened. With EUR/JPY hitting a new record high, some may suspect the start of a new era of "europhoria" similar to 2000-09. However, the situation now is different from what it was then. At the time, EUR had surged against both USD and JPY, but this time, the surge is limited to its rate against JPY. The new highs in EUR/JPY this time are a by-product of JPY depreciation; nothing more, nothing less. In other words, the new highs are not a result of EUR appreciation.

In the decade immediately following EUR's introduction, member states' interest rates narrowed significantly against Germany, ushering in a period of low interest rates and strong currencies, particularly in southern Europe. This period stimulated excessive consumption and investment, eventually leading to the European debt crisis (see graph). However, until that happened, EUR's overall appreciation, fueled by its role as a USD substitute, led to its appreciation and a record high of 1.604 against USD and 169.97 against JPY (both on September 30, 2008). EUR's record high against JPY was already renewed in September 2024 and again in October this year, but EUR/USD is still far from its peak. Incidentally, by the end of September 2009, EUR's share of global forex reserves had risen to 28.03%. This, too, is significantly higher than the current share (21.13% as of the end of June 2025).

To reiterate, the EUR/JPY record high is a byproduct of JPY depreciation and does not reflect any notable strengthening of EUR.



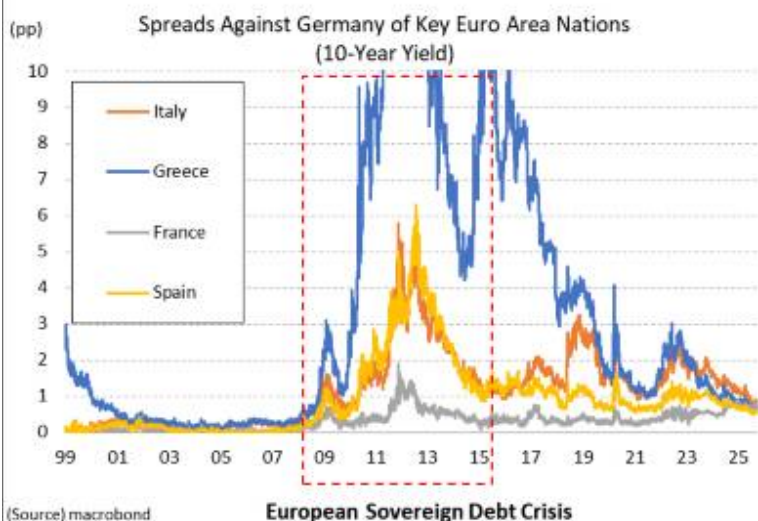
(Source) macrobond



(Source) macrobond

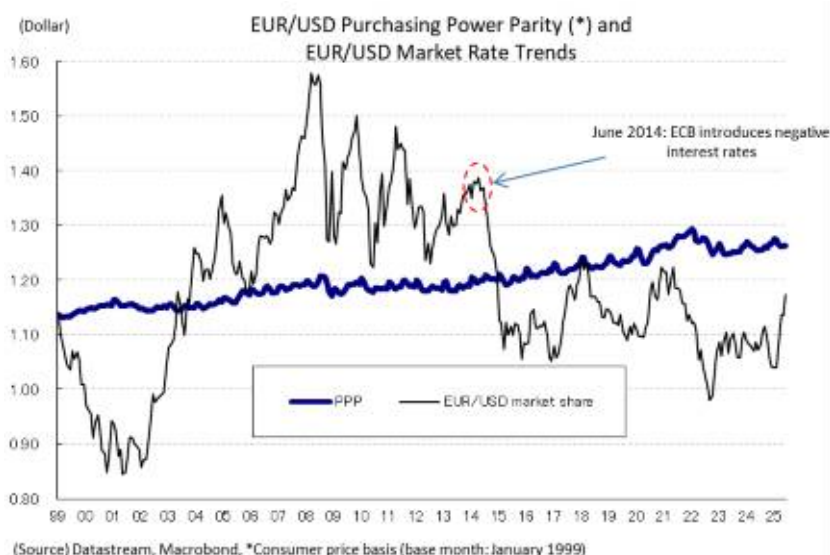
If EUR/USD Rises to PPP Levels, EUR/JPY Will be in 190 Range

However, as discussed in this report last month, EUR's status as a reserve currency is a subject of growing interest in the very long term. For example, regional bond yield spreads against Germany, which had narrowed during the europhoria era, widened significantly after the European debt crisis erupted, but are now narrowing again (see graph). As I have repeatedly discussed in this report, it is intriguing to interpret these movements in regional bond markets as reflecting expectations for joint bond issuance in connection with the ReArm Europe Plan. With expectations of EUR's status as a reserve currency strengthening, if EUR's share of the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) increases, we can expect it to appreciate against USD. EUR/USD in terms of purchasing power parity (PPP) has been gradually rising due to the euro area's consistently



(Source) macrobond

lower inflation rate compared with the U.S. Incidentally, EUR/USD in terms of PPP is around 1.27 as of August 2025. As the figure shows, EUR/USD has consistently remained below 1.20 since the ECB's introduction of its negative interest rate policy in June 2014 (ahead of the BOJ). This is partly due to the euro area's growth rate being slower than that of the U.S., which has led to U.S. policy interest rates structurally remaining higher than those of the euro area and resulted in USD buying vs. EUR selling. However, as is generally known, the Europe-U.S. interest-rate differential is now rapidly narrowing. Given the current divergence in policy stances between the ECB and the Fed, it would not be surprising to see an intensification of EUR buying, driven by the interest-rate differential between the two currencies, for the time being. If the ReArm Europe Plan enhances Europe's security independence and is financed through joint bonds, the region will see an increase in safe assets and could become a receptacle for international capital flows. Military independence and safe assets have been two major things EUR has lacked historically.

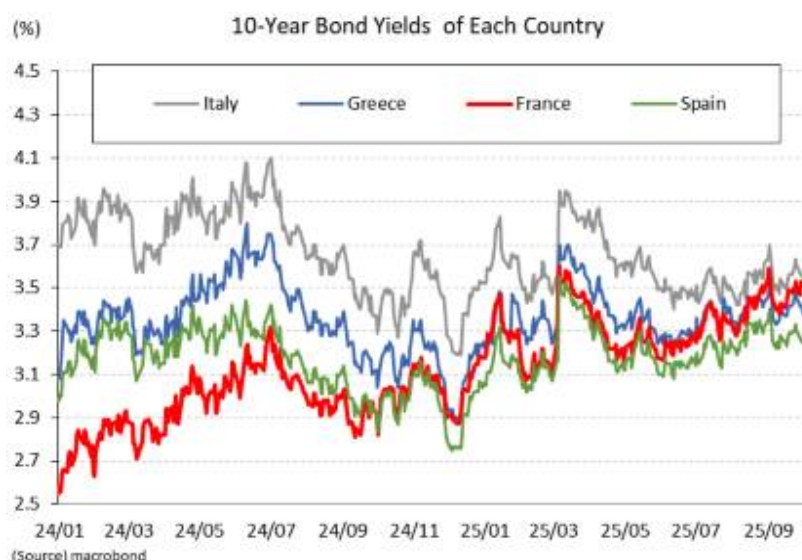


Assuming a significant capital rotation from the U.S. to Europe, particularly the euro area, it would not be surprising to see EUR/USD rise to just under 1.30, as suggested by the PPP. At the time of writing, USD/JPY is around 153, so if EUR/USD hits 1.30, EUR/JPY would climb to around 198. The current 175-180 level for EUR/JPY is merely a result of the weak JPY. However, if EUR's status as a reserve currency is reassessed in comparison with USD, discussions with a view to a further appreciation of EUR against JPY will be necessary.

Euro Area Politics Now and Going Forward: Will “France Risk” Become “EUR Risk”?

New Government Resigns 14 Hours After Formation

On October 7, French Prime Minister Sébastien Lecornu, who had only been in office since early September, resigned, having been unable to reach a consensus in parliament on cabinet appointments and the budget for the coming year due to the ineffectiveness of his minority government. In a speech following his resignation, Lecornu stated, “Every party continues to act as if it has a majority in parliament,” seemingly despairing of any hope to control a divided parliament. Incidentally, Lecornu was the seventh prime minister since President Emmanuel Macron took office in 2017, and the fifth in the past two years (although, as discussed below, the Lecornu administration is still in office following many twists and turns). French politics are literally in flux, and the country's government bonds are facing increasing pressure day by day.



France's 10-year bond yield is now consistently higher than those of Spain and Greece, and on track to surpass that of Italy (see graph). With political uncertainty showing no sign of abating and France's fiscal situation continuing to deteriorate, the outlook for the country's national debt is grim.

On October 5, Lecornu announced his long-awaited cabinet appointments. However, he was unable to secure support from both ruling and opposition parties, forcing the cabinet into the unprecedented situation of resigning *en masse* barely 14 hours after it was formed. In particular, the appointment of former Finance Minister Bruno Le Maire, who has been accused of causing the current fiscal crisis, as Minister of Defense sparked dissatisfaction among the opposition parties, who indicated their intention to submit a motion of no confidence in the cabinet after his policy speech. Other cabinet appointments, due to their strong left-leaning political stances, also drew criticism from his own center-right party and the Republicans, who are allies. There was also a lack of consensus on specific policy issues. Lecornu has withdrawn former Prime Minister François Bayrou's proposal to stimulate the economy by abolishing two public holidays, and has also made concessions to left-wing policies, such as by creating a financial asset tax aimed at the wealthy as well as a temporary tax on high-income earners. However, he has refused to introduce an asset tax on the super-rich or to shelve pension reform, as strongly demanded by the Socialist Party.

In a parliament where the ruling party, the far-right, and the left are split wide apart, it is not easy for any party or prime minister to find common ground on policy, and as discussed below, there are currently no good ideas for how to break the deadlock.

Ever-Present Possibility of General Election

At the above stage, Macron had four options: (1) appointing candidates close to him; (2) controlling parliament by appointing candidates from the opposition (e.g., the Socialist Party); (3) forming a technocratic (expert, non-political) cabinet; or, if all of these options proved difficult, (4) dissolving parliament and calling a general election for the second year in a row. After announcing his resignation, Lecornu stated on a French television program that "(Macron) is in a position to nominate a prime minister within 48 hours," driving speculation that option (1) was likely. However, Macron instead reappointed Lecornu, as though to affirm his control over domestic affairs. This is simply a repetition of the past. Amid repeated appointments and resignations, Macron's influence is clearly waning; repeated appointments with no chance of success only serve to stall for time.

In reality, French public opinion favors option (4), so I will continue to monitor the situation with this outcome in mind. In this scenario, the centrist forces supporting the Macron administration could lose seats, while the far-right, a concern, gains seats. Macron's failed gamble on snap elections a year ago is still fresh in the memory. Mindful of the far-right RN's impressive performance in the June 2024 European Parliament elections, he dissolved the National Assembly (lower house) and called general elections in an attempt to strengthen his administration's base. However, the centrist ruling coalition suffered a crushing defeat and further strengthened the RN. In fact, following the RN's impressive performance in the first round of voting, the centrist and leftist forces narrowly converged on a single candidate in the second round and barely managed to prevent the rise of the far right.

However, there is no guarantee that this outcome can be repeated. As the current political situation shows, centrist and leftist forces are no longer united. Even if the far-right's rise were prevented in the same way as a year ago, the three-way battle would still remain as is, and the situation would not be much different from today. Ultimately, no matter which option is chosen, it is unlikely that a stable government will emerge in France.

Could Political Instability Affect the Fate of the President and of EUR?

Though the four options above are more likely in the near future, there remains a fifth option: Macron himself being forced to resign before the end of his term in 2027. While the French system makes it difficult for parliament to force the president to resign mid-term, it is possible for the president to step down on his own initiative. Will the political turmoil in France end up impacting Macron's chair? It is, indeed, possible that the advancement of the presidential election could suddenly become a major issue during the forecast period. The departure of Macron, who is committed to involvement in the Ukraine war, would have important implications for the European security strategy. A successor who pursues an inward-looking policy would complicate the situation.

If that happens, the impact on EUR will draw attention. At present, political turmoil in France is not viewed as a problem for the euro area as a whole, which is why EUR remains strong. On October 17, S&P downgraded France's sovereign rating, causing France to lose its AA rating from two of the three major rating agencies and triggering a mechanical sell off of the fund. Even this has not had a significant impact on EUR. However, there are concerns that the current political situation could lead to the election of a far-right president or the formation of a far-right government centering on the RN. If France were to clash head-on with the EC, this could very well lead to a EUR sell-off. Further, EU member states are required to submit their budget proposals for the coming fiscal year to the EC by October 15 each year, but France did not manage to meet the deadline and has still not submitted its budget proposal as of the time of writing. In addition to sanctions for non-submission or delay that are in place, documents are also examined after submission or receipt, and if deemed to be in violation of the Stability and Growth Pact (SGP), are ultimately forced to be severely revised. The Lecornu administration is caught between the EC and the Parliament for now, and if delays continue, they will start dominating the headlines.

Could the "France risk" develop into a "EUR risk" at that point? EUR is reaching a situation where political risks, even more than economic and financial risks, can no longer be ignored.

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