

Forex Market View

Euro strength/dollar weakness likely to continue

- Purchasing power parity suggests scope for stronger euro/weaker dollar
- Relative to absolute purchasing power parity, euro is still cheap and dollar is expensive
- Euro has upside potential from viewpoint of real effective exchange rate as well

USD/JPY forecast range (latest: noon New York time)

17 Jan – 16 Feb: Y109.0-113.0/\$ (Y110.73/\$ as of 16 Jan)

Forex Market View DSFE117

FICC Research Dept.

Chief FX Analyst
Yuji Kameoka
 (81) 3 5555-8764
 yuji.kameoka@daiwa.co.jp



Daiwa Securities Co. Ltd.

Surge in the euro against the dollar

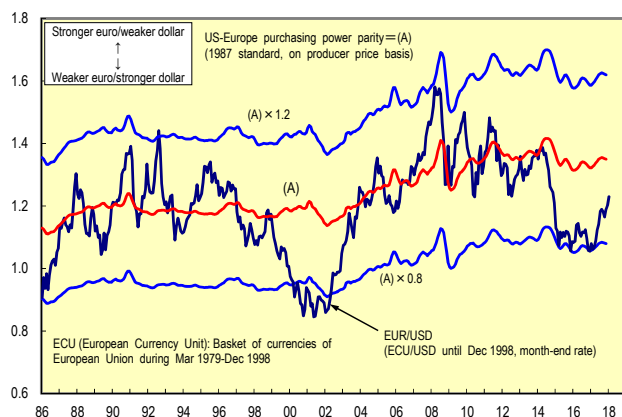
Purchasing power parity suggests scope for stronger euro/weaker dollar

Purchasing power parity suggests scope for stronger euro/weaker dollar

The EUR/USD has surged to above 1.23, topping its highest level seen last September, as expansion of the eurozone economy and the ECB's monetary policy meeting account/board members' remarks led to speculation that the ECB would end asset purchases in September 2018 and raise rates by December. In addition, negotiations between Germany's two largest political parties to form a grand coalition have been proceeding, which is also strengthening the euro. Over the one-month period from 15 December 2017 to 16 January 2018, the 10Y US Treasury yield rose by 0.19 points, from 2.35% to 2.54%, while the 10Y German Bund yield rose by 0.26 points, from 0.30% to 0.56%. We wonder whether the EUR/USD will continue to rise further backed by (1) expectations for an end to the ECB's asset purchases and (2) European long-term interest rates rising more than US rates. In this report, we consider the sustainability of the euro's strength.

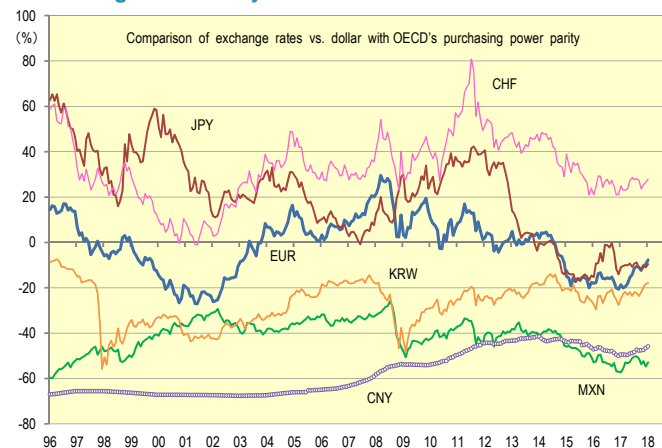
A comparison with purchasing power parity implies that the euro still has upside potential. Using relative purchasing power parity, in which producer prices in the US and Europe are standardized to correspond to exchange rates in 1987, we find that the EUR/USD (or the ECU/USD before the birth of the euro in January 1999) has been "within the $\pm 20\%$ range" relative to purchasing power parity, excluding some exceptional periods. (However, the EUR/USD was around 30% lower than purchasing power parity in October 2000 [before the January 2002 start of circulation of the euro] when the euro declined to its lowest level at 0.8225 against the dollar partly due to appreciation of the dollar stemming from the technology bubble in the US.) Even during the Greek crisis in 2015-16, the euro bottomed out at around 20% lower than purchasing power parity, and turned around in 2017. Although the EUR/USD has recently reached 1.23, it is far below current purchasing power parity of 1.35. Despite progress in appreciation of the euro, the eurozone trade balance has not yet worsened. This is probably because the euro has not strengthened that much relative to purchasing power parity, in addition to favorable conditions in the global economy.

Chart: EUR/USD and US-Europe Purchasing Power Parity



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Comparison of Exchange Rates vs. Dollar with Absolute Purchasing Power Parity



Source: OECD, Thomson Reuters; compiled by Daiwa Securities.

Relative to absolute purchasing power parity, the euro is still cheap and the dollar is expensive

Relative to absolute purchasing power parity, the euro is still cheap and the dollar is expensive

A comparison of the euro with absolute purchasing power parity, which the OECD calculates based on each nation's CPI, also shows that the euro's level is not that high. Although the EUR/USD was 27% lower than absolute purchasing power parity in the US and Europe in 2001, 29% higher in 2008, and 22% lower in 2017, it is 8% lower at the moment. For the time being, the eurozone's price competitiveness in terms of trade is unlikely to be eroded by the euro's strength. The euro should have upside potential as long as the eurozone economy is favorable and there are factors to support euro buying.

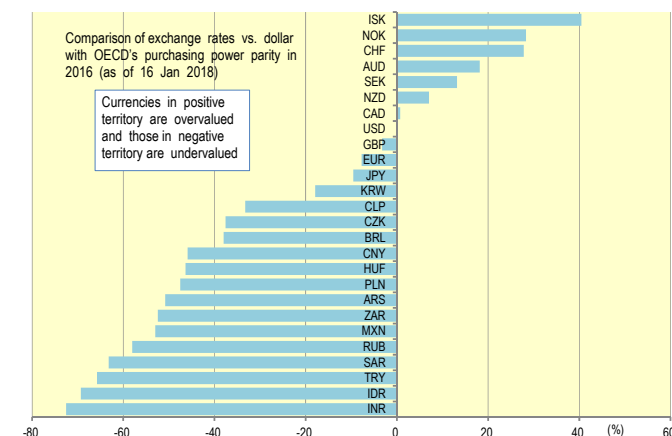
Exchange rate levels relative to absolute purchasing power parity need to be compared to past levels

Exchange rate levels relative to absolute purchasing power parity differ substantially between advanced and emerging nations. Exchange rate levels relative to absolute purchasing power parity in advanced nations are high, while those in emerging nations are low. In nations where income levels and product quality are inferior, exchange rate levels are lower than purchasing power parity, providing advantageous export conditions and leading to conditions conducive to balanced trade competition. In short, as exchange rate levels relative to absolute purchasing power parity vary by nation, it is difficult to assess the strength/weakness of currencies. However, comparing exchange rate levels relative to absolute purchasing power parity with past levels enables us to assess the strength/weakness of currencies in both advanced and emerging nations.

We do not think the current euro level is overly strong or unacceptable for policymakers

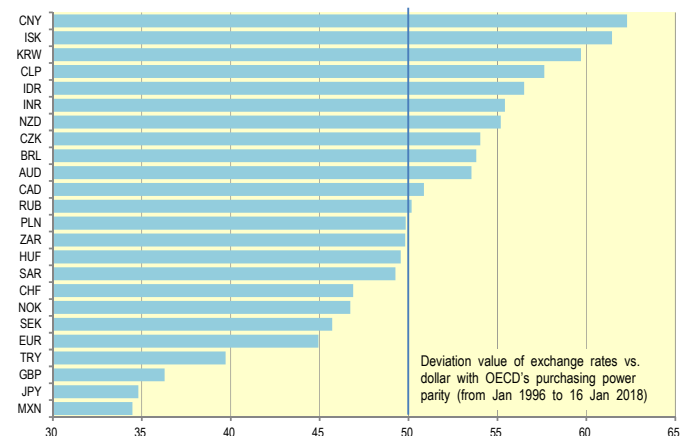
While the deviation value of exchange rates relative to absolute purchasing power parity is high for CNY, KRW, and IDR, the value is low for MXN, JPY, GBP, TRY, and EUR. We therefore understand the recent interventions by central banks, such as (1) won selling/dollar buying by the Bank of Korea due to concerns about won appreciation and (2) peso buying/dollar selling by Banco de México reflecting concerns about peso depreciation-driven accelerated inflation. Regarding the euro, the deviation value of the rate relative to absolute purchasing power parity is lower than 50. We thus think that policymakers do not have to be seriously concerned about the euro's strength for now. Of course, policymakers are likely to attempt to constrain the upward pace by warning against excessive expectations for rate hikes.

Chart: Comparison of Exchange Rates vs. Dollar with Absolute Purchasing Power Parity



Source: OECD, Thomson Reuters; compiled by Daiwa Securities.

Chart: Deviation Value of Exchange Rates vs. Dollar with Absolute Purchasing Power Parity



Source: OECD, Thomson Reuters; compiled by Daiwa Securities.

The euro has upside potential from the viewpoint of the real effective exchange rate as well

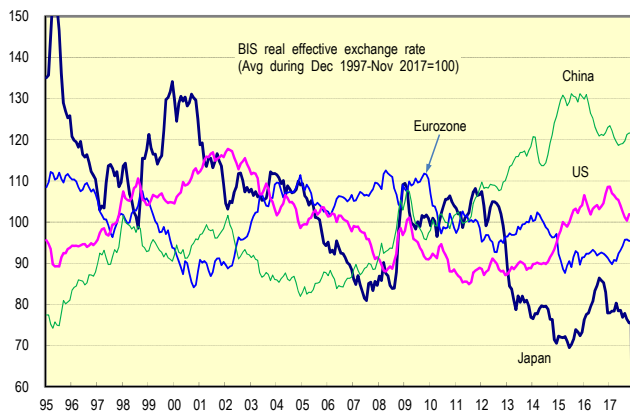
The euro has upside potential from the viewpoint of the real effective exchange rate

The euro is still inexpensive from the viewpoint of the real effective exchange rate as well. As of November 2017, the euro's real effective exchange rate was around 4% below the average over the past 20 years. Although the real effective exchange rate has risen since then, it appears to still be lower than the average. We think the euro has upside potential, given that it has been around the $\pm 10\%$ range relative to the past 20-year average. The dollar's real effective exchange rate was around 9% above the past 20-year average at the beginning of 2017, but it has now declined to the average level. On the other hand, the yen's real effective exchange rate is around 25% lower than the average. In our view, the euro has greater upside potential than the dollar, and the yen has greater upside potential than the euro.

EUR/USD likely to trend upward, despite falling temporarily

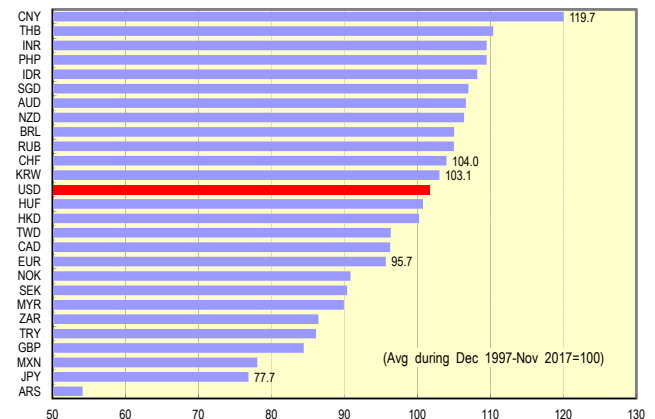
Judging from the exchange rate level, we think there is limited risk of the euro strength causing a setback in the eurozone economy. Euro appreciation is thus likely to continue. Compared to the US, where the Fed has already begun to raise rates, long-term interest rates and currencies are likely to rise in the eurozone going forward, as the ECB is starting its exit from QE. If the market turns to risk-off mode, accumulated positions of euro buying/dollar selling (yen selling) would see a correction, and a shift to a weaker euro/stronger dollar (stronger yen) would be more likely. However, in the case of risk-on mode, a shift to a stronger euro/weaker dollar (weaker yen) would be more likely. Although the EUR/USD may decline below 1.20 at some point in the case of risk-off moves, it would likely rise to around 1.27 toward the end of the year.

Chart: Real Effective Exchange Rate (time series variation)



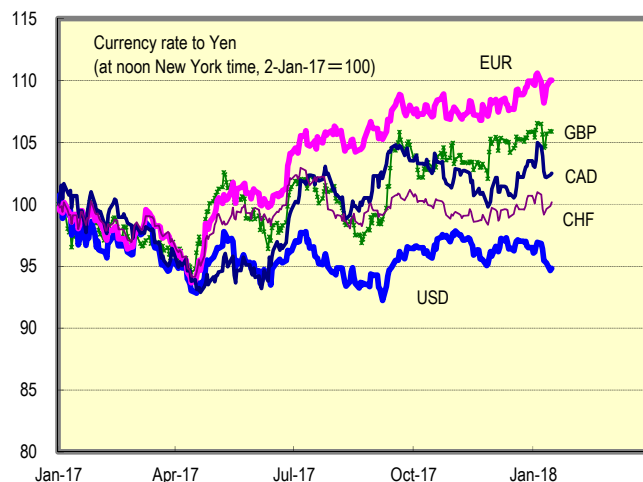
Source: BIS; compiled by Daiwa Securities.

Chart: Real Effective Exchange Rate (as of Nov 2017)



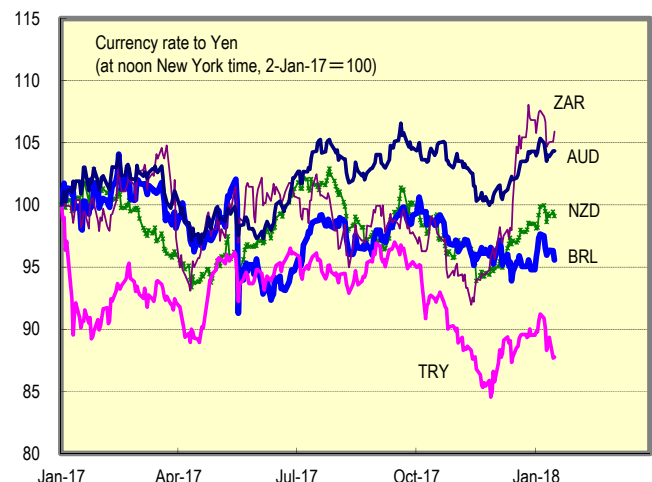
Source: BIS; compiled by Daiwa Securities.

Chart: Major Currencies/JPY FX Index



Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

Chart: EM Currencies/JPY FX Index



Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

Chart: Currency Exchange Rate Forecasts

	Actual		Forecast				
	30 Sep 2017	29 Dec 2017	Jan-Mar 2018	Apr-Jun 2018	Jul-Sep 2018	Oct-Dec 2018	Jan-Mar 2019
USD-JPY	112.6	112.7	109.0	105.0	106.0	108.0	110.0
			105-115	102-112	102-112	103-113	104-114
EUR-JPY	133.1	135.2	131.0	125.0	129.5	134.0	134.5
			127-139	123-135	123-135	127-139	128-140
AUD-JPY	88.3	87.9	84.0	80.0	83.0	86.5	86.0
			81-91	78-88	78-88	81-91	81-91
CAD-JPY	90.1	89.6	86.0	82.0	85.0	88.0	88.0
			83-93	80-90	80-90	83-93	83-93
NZD-JPY	81.4	79.8	76.5	72.5	75.5	79.0	78.5
			72-82	70-80	70-80	73-83	73-83
TRY-JPY	31.7	29.7	28.0	27.0	28.0	29.2	29.0
			26-31	25-30	25-30	27-32	27-32
ZAR-JPY	8.3	9.1	8.4	8.0	8.5	9.0	8.8
			8.1-9.3	7.8-8.8	7.8-8.8	8.3-9.3	8.3-9.3
BRL-JPY	35.6	34.0	33.5	32.0	33.0	35.0	34.5
			31-35	30-35	30-35	32-37	32-37
KRW-JPY (100 KRW)	9.8	10.6	9.9	9.4	9.7	10.1	10.1
			9.6-10.7	9.2-10.2	9.2-10.2	9.5-10.5	9.5-10.5
CNY-JPY	16.9	17.3	16.6	16.0	16.3	16.9	16.9
			16.2-17.5	15.7-17.0	15.7-17.0	16.1-17.4	16.1-17.4

Source: BIS, Fed, Thomson Reuters; compiled by Daiwa Securities.

Notes: 1) Actual shows market rates at noon NY time.

2) Forecast upper row; as of quarter end, lower row; range during quarter.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
 Registered: Financial Instruments Business Operator
 Chief of Kanto Local Finance Bureau (Kin-sho) No.108
 Memberships: Japan Securities Dealers Association
 The Financial Futures Association of Japan
 Japan Investment Advisers Association
 Type II Financial Instruments Firms Association