

Forex Market Weekly

Volatility in the cross-yen market

- Share prices fall sharply on rise in US long-term rates, and yen strengthens, primarily in cross-yen market
- Weakening commodity prices likely to change yen from weakening to strengthening
- Yen rises while dollar rises on concerns over increased Treasury issuance

This week's USD/JPY forecast range

12-16 Feb: Y107.0-109.0/\$ (Y108.7 at end-previous week)

Forex Market View DSFE124

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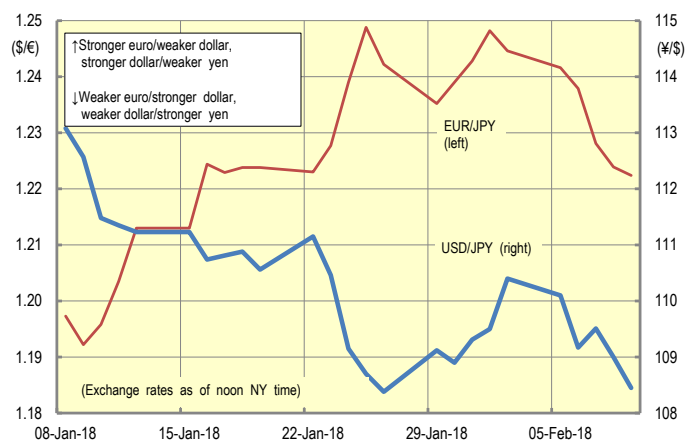


Overview of last week's forex market

Share prices fall sharply on rise in US long-term rates, and yen strengthens, primarily in cross-yen market

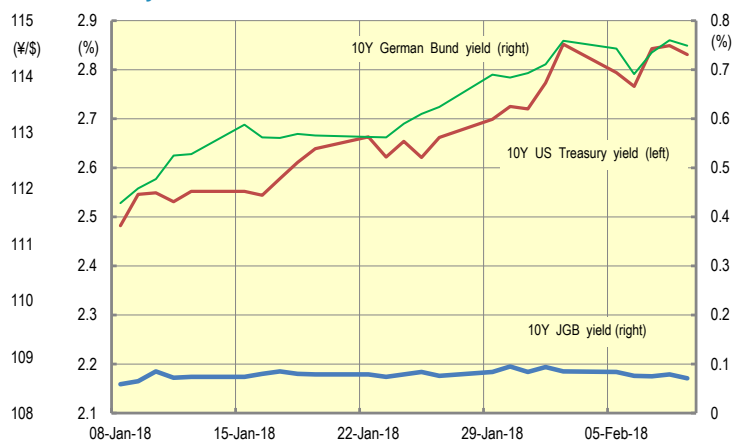
The rise in long-term rates following release of the US jobs report lasted for five days (with the 10Y Treasury yield climbing to 2.88%), but the US share price decline on February 2 pushed Japanese stocks and the USD/JPY lower. The US stock market fell sharply, with the DJIA declining by nearly 1,600 points at one point, the largest intraday decline ever. Long-term rates retreated sharply in step with the declining stock market (the 10Y Treasury yield fell to 2.65%), and the USD/JPY declined to 108.44. On February 8 (February 7 US time), leaders of both the Republican and Democratic parties in the US Senate agreed to raise the spending limit through the 2019 fiscal year and to suspend application of the debt ceiling until March 2019; US long-term rates rose. A rise in interest rates sparked by the Bank of England's hinting at an early rate hike spread beyond the UK, pushing the 10Y Treasury yield back up to 2.88%. US share prices fell sharply, and the yen strengthened. There was agreement on forming a grand coalition in Germany, but cross-yen rates fell across the board, with the EUR/JPY also falling. The yen did not weaken much despite news on February 9 that BOJ Governor Kuroda would serve another term, and a decline in US share prices following passage of US budget legislation pushed the USD/JPY down to 108.04. US stocks later rebounded, and the yen weakened slightly.

Chart: Forex Market: USD/JPY, EUR/USD



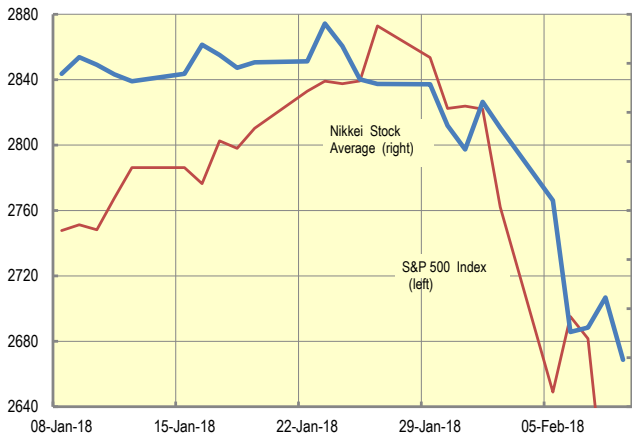
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Bond Market: 10Y Sovereign Bond Yields in Japan, US, and Germany



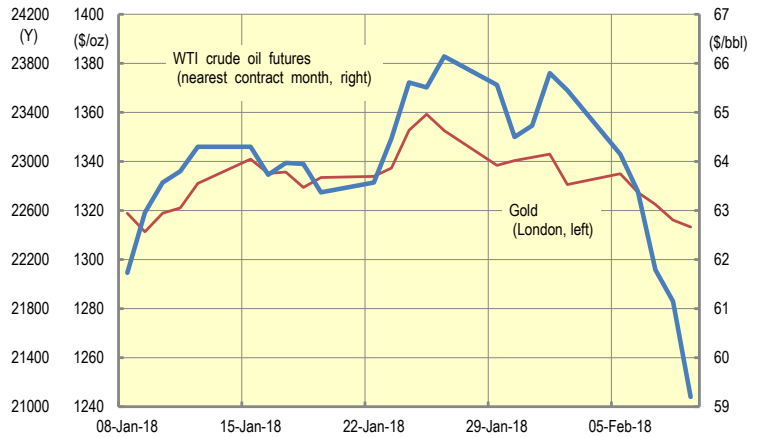
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Stock Market: US S&P 500, Nikkei Stock Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



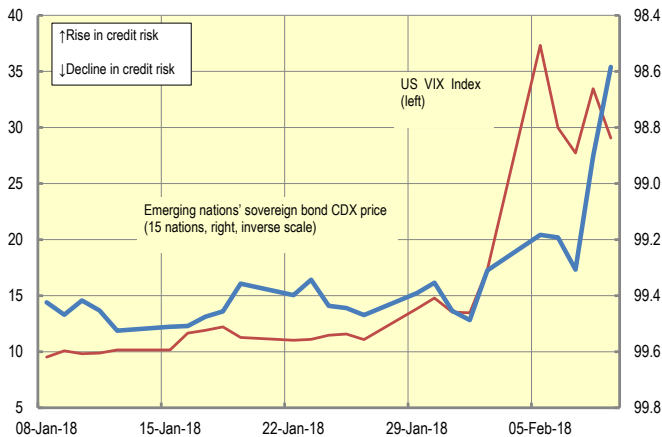
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Weakening commodity prices likely to change yen from weakening to strengthening

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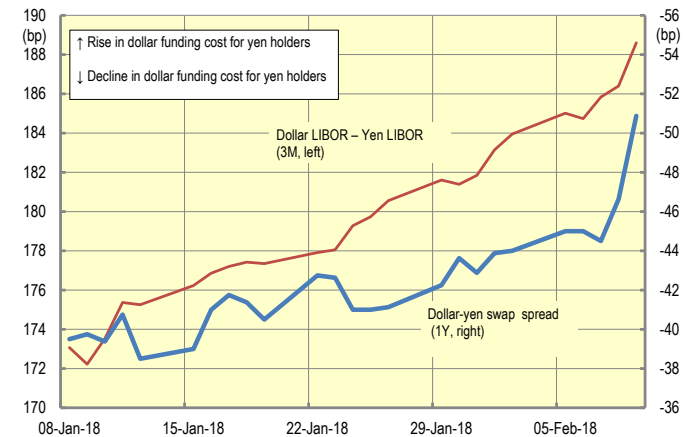
Accelerated growth in US oil production, upward revisions to the oil production outlook, an increase in crude oil inventories, and a larger-than-expected increase in oil product inventories all fueled a significant decline in crude oil prices last week, causing the dollar to strengthen and other currencies to weaken. Declining commodity prices dampen increases in long-term rates via inflation and inflation expectations (more so in the US when accompanied by dollar appreciation), and thus reduce the risk of rising long-term rates causing share prices to decline and the yen to strengthen. On the other hand, weaker commodity prices raise the risks of yen appreciation from declining long-term rates overseas and of declining cross-yen rates (yen appreciation), particularly against the currencies of commodity-exporting economies. If oil and other commodity prices continue to decline, the yen will probably become more likely to strengthen than to weaken.

Chart: Gap in European Sovereign Bond Yields, VIX index



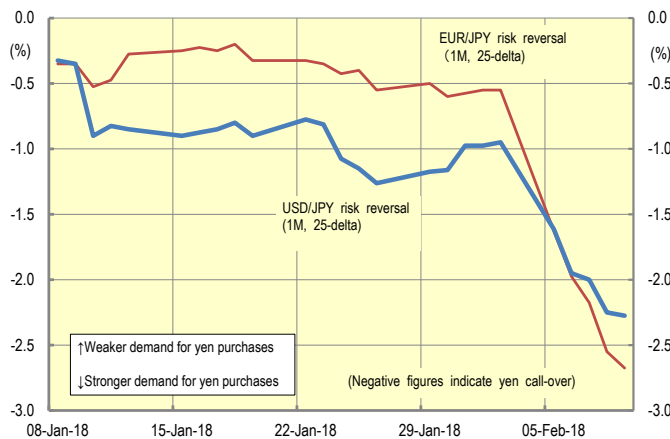
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



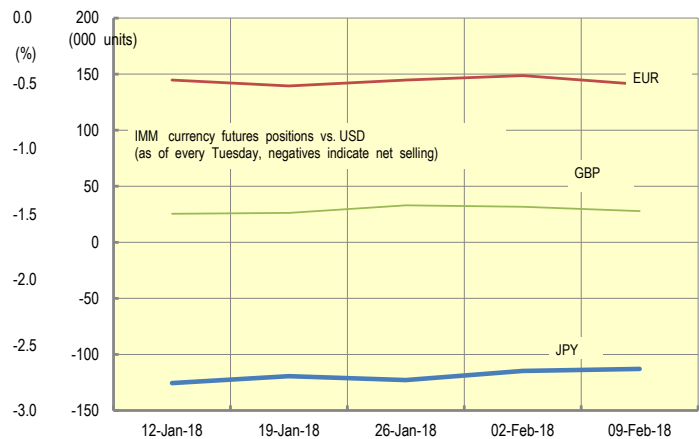
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Risk Reversal on Currency Options



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Net Position of Currency Futures



Source: Thomson Reuters; compiled by Daiwa Securities.

Yen rises while dollar rises on concerns over increased Treasury issuance

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Leaders in the US Senate forged a bipartisan agreement on a budget for the next two years on February 7. They passed budget legislation that raises the spending cap (by nearly \$300 billion over two years), suspends application of the federal debt ceiling (until March 2019), and provides a stopgap budget (until March 23). Increased spending by the federal government expands the fiscal deficit, and because this is likely to further increase Treasury issuance, US long-term rates rose and the dollar's effective exchange rate increased. The increase in long-term rates on concerns over worsening supply-demand caused stocks to weaken, however, leading to a risk-off strengthening of the yen and decline in the USD/JPY. Subsequently, both the Senate and the House passed budget legislation that included stopgap spending authorization, and the president signed it into law. Although US share prices rebounded from the end of last week until early this week, they look likely to remain volatile because of high US long-term rates. There is probably still a risk of the USD/JPY declining from a risk-off decline in stock prices and strengthening of the yen occurring while rising US long-term rates are strengthening the dollar (raising its effective exchange rate).

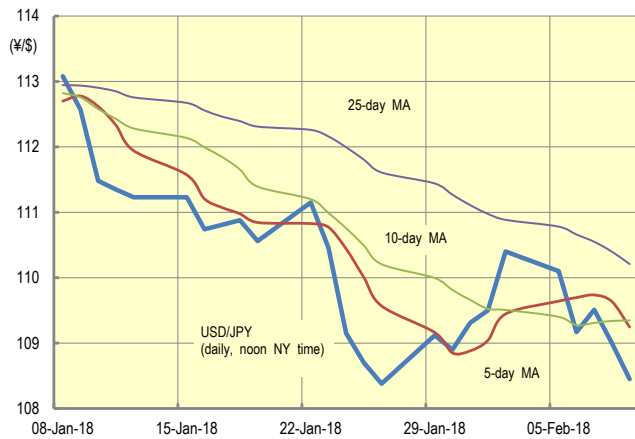
Will the US CPI raise expectations of inflation and a rate hike?

The US consumer price index (CPI) for January 2018 will be announced on February 14. The market is forecasting a CPI change of +0.3% m/m (vs. +0.1% in December) and +2.1% y/y (vs. 2.1%) and a core CPI change of +0.2% m/m (+0.3%) and +1.8% y/y (+1.8%). The dollar's average effective exchange rate in January declined considerably from December, while the average gasoline price during the month increased slightly m/m. Although the CPI may come in as expected, if it exceeds the market forecast it will raise expectations of inflation and rate hikes, and probably push US long-term rates and the dollar's effective exchange rate higher. When a rise in long-term rates is not driven by expectations of faster growth, however, it tends to weaken share prices and strengthen the yen, and this probably makes a decline in the USD/JPY likely.

Noteworthy currency: SEK

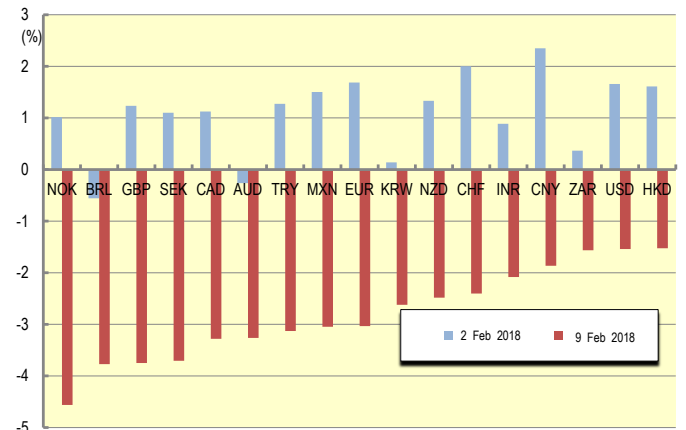
Sweden's central bank (Riksbank) will announce the results of its policy meeting on February 14. We expect it to leave its forward guidance on rate hikes unchanged at this meeting. It had suggested at its December policy meeting that it may begin hiking rates in mid-2018, but because wage growth and inflation have been weak, and possibly also because of ECB President Mario Draghi's comment in January that there was almost no chance of the ECB, which the Riksbank watches closely, hiking rates in 2018, the market has not been pricing in a rate hike. If the Riksbank were to discuss delaying the timing of its rate hike, the Swedish krona (SEK) would probably weaken, but a lack of catalyst makes such a discussion unlikely at the current policy meeting, and we expect only a limited impact on the SEK.

Chart: USD/JPY and Moving Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Weekly Currency Performance (vs. yen)



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Weekly Schedule for Major Economic Indicators/events

- 12-Feb ● US Budget Message for FY19
- 13-Feb Jan UK CPI
- 14-Feb Oct- Dec Japan GDP (first preliminary)
Jan US retail sales, US CPI
- 15-Feb Jan Australian jobs report
Jan European new auto sales
Dec eurozone trade balance
Jan US producer price index
Feb NY Fed's Empire State Manufacturing Index
Feb Philadelphia Fed's Business Outlook Survey Index
Jan US industrial production, capacity utilization rate
- 16-Feb Jan UK retail sales
Jan US housing starts, export-import price indexes
- 17-Feb Feb US University of Michigan's Consumer Sentiment Index

Source: Compiled by Daiwa Securities.

Notes: Dates based on JST. ● denotes political events.

Chart: Weekly Forex Forecasts

	5-9 Feb 2018 (actual)		12-16 Feb 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	108.0-110.3	108.8	107.0-109.0	108.2
EUR/JPY	131.9-137.3	133.3	131.5-135.0	133.3
EUR/USD	1.220-1.248	1.224	1.222-1.242	1.232

Noteworthy currencies and factors

SEK	Discussions of delay in rate-hike timing would weaken SEK, but the possibility is slim
ZAR	Ruling party gave President Zuma to resign; if so, ZAR is likely to strengthen

Source: Compiled by Daiwa Securities.

IMPORTANT

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- 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.

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