

Forex Market View

How will US import tariffs affect exchange rates?

- What is the thinking behind US import tariffs?
- Republicans risk losing voter support if import tariffs are broadly implemented
- Even if Japan is exempted from tariffs, there may be a dollar weakening/yen strengthening bias

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

8 Mar – 6 Apr: Y104.0-108.0/\$ (Y105.93/\$ as of 7 Mar)

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What is the thinking behind US import tariffs?

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US president Donald Trump's announcement of plans to apply import tariffs of 25% on steel and 10% on aluminum has moved forex markets. What is the thinking behind the policy, what are the policy details, and how will it impact the market? Addressing the first question, we think the Trump administration's thinking behind applying import tariffs is as (1) a midterm election strategy, (2) a trade negotiation ploy, and (3) a way to reduce the US trade deficit (reduce imports and increase domestic production).

Is it a strategy for the midterm elections in November?

The thinking behind the Trump administration's plan to implement import tariffs in its second year may in part be a midterm election strategy. The midterm elections, which are held midway between the presidential elections held every four years, are congressional elections in which one third of all Senate seats and all seats in the House are up for election. This year's midterm elections will be held on November 6, and including two seats up for special elections, 35 seats in the Senate and all 435 seats in the House will be up for election.

President Trump was elected for his support of bringing manufacturing back to the US

It is not an exaggeration to say that it was the Rust Belt that elected President Trump in the 2016 election. When Mr. Trump argued during his presidential campaign for the repatriation of America's manufacturing base by righting unfair trade, reducing taxes, and investing in infrastructure, he gained the support of the Rust Belt, which has historically supported the Democrat Party. The Republican Party and Mr. Trump defeated the Democrats and Ms. Clinton in the Rust Belt, an area of declining industries such as coal, steel, and autos that covers five US states (Wisconsin, Michigan, Indiana, Ohio, and Pennsylvania) stretching from the Great Lakes region to the East Coast. Of the 306 electoral college votes won by Mr. Trump in the US presidential election, 75, about one fourth of those, came from the five Rust Belt states, and of the six states that were won by the Democrats (and Mr. Obama) in the 2012 presidential election but voted Republican in the 2016 presidential election, four of them (Pennsylvania, Ohio, Michigan, and Wisconsin, all but Iowa and Florida) were Rust Belt states.

Winning the Rust Belt states contributed greatly to Trump's presidential election victory

Of the seven states in the Rust Belt, the Democratic Party and Ms. Clinton only won New York and Illinois, which contain the large cities of New York and Chicago and lean heavily Democratic. Although the Democrats' margin of victory over the Republicans was large at 21% in New York and 17% in Illinois, the Republicans increased their share of the vote in both states. The Republicans and Mr. Trump won Indiana, which has long been a Republican stronghold, with a 19% vote margin over the Democrats. The Republicans/Trump won four states that have traditionally heavily supported the Democrats—Pennsylvania, Ohio, Michigan, and Wisconsin—with a margin of victory over the Democrats of 9% in Ohio but less than 2% in the other three states. The Republicans beating the Democrats in these four states was a huge factor behind the election of President Trump.

Republicans risk losing voter support if import tariffs are broadly implemented

Are the import tariffs aimed at appealing to the Rust Belt states through a revival of the steel and aluminum industries?

With the Trump administration and Republican party suffering from low approval rating, receiving support from the Rust Belt is probably critical to the Republicans winning seats in the midterm elections. It may think it needs to gain support by implementing tariffs to reduce imports and increase production and employment in the US steel and aluminum industries. The midterm primaries (through which each party selects its candidates to run for Senate and House seats in the midterm elections) were kicked off on March 6 in Texas. Several Rust Belt states have their primaries coming up, Illinois on March 20, Ohio and Indiana on May 8, and Pennsylvania on May 15 (Michigan holds its primaries on August 7 and Wisconsin on August 14, later in the primary cycle). There is also a special election to fill a vacant House seat in Pennsylvania on March 13. President Trump may have announced his plans for implementing steel and aluminum tariffs to gain support from Rust Belt voters for the revival of the US steel and aluminum industries.

Chart: News on Trump Administration's Trade/Forex Policies and USD/JPY Level

Date (JST)	News related to US trade and forex policies	USD/JPY*
12-Jan	Treasury Secretary Mnuchin says US government will leave NAFTA unless it is renegotiated US Commerce Dept completes its survey of steel imports, President has 90 days to respond	111.23
23-Jan	US president approves tariffs on washing machines and solar cells, US Trade Rep recommends import restrictions	110.46
24-Jan	US Treasury Secretary Steve Mnuchin says weaker dollar is good for the US Commerce Secretary Ross says US has no intention of starting a trade war, calls China's high-tech products a threat	109.15
25-Jan	US Treasury Secretary says weaker dollar is advantageous for trade over the near term, but believes in longer-term dollar strength	108.70
26-Jan	President Trump says "ultimately I want to see a strong dollar"	108.38
27-Jan	Trump warns against unfair trade, calls for investment in the US	
13-Feb	President Trump considering retaliatory tariffs, even against allies US: President Trump recommends countervailing tariffs on trading partners US President Trump holds bipartisan meeting to discuss steel and aluminum import restrictions	107.59
14-Feb	President Trump considering tariffs and import quotas to deal with steel and aluminum imports Korea files WTO complaint over US anti-dumping duties on steel and other products	107.00
17-Feb	US Commerce Secretary proposes restricting imports of steel and aluminum	
28-Feb	US Commerce Secretary makes final decision on anti-dumping countervailing duties on aluminum foil from China	106.61
1-Mar	US trade policy report: Trump administration warns of using "all available tools" against China Trump administration to announce high tariff rates on steel and aluminum imports	106.88
2-Mar	President Trump to announce next week that US will impose tariffs of 25% on steel and 10% on aluminum	105.66
3-Mar	US Commerce Secretary says steel and aluminum import restrictions likely to be imposed on all countries EU official says a 25% duty on US products is possible if US imposes import restrictions	
4-Mar	US president suggests imposing a tax on imported autos if the EU retaliates	
5-Mar	White House National Trade Commission Director Navarro says some companies may be exempt from US import tariffs Powerful Republican congressmen call for exempting Canada and Mexico from import restrictions US President Trump says exemptions from steel and aluminum tariffs possible if new NAFTA deal is signed	105.96
6-Mar	House Speaker Ryan calls for administration's restraint on steel and aluminum import restrictions US House Budget Committee Chairman calls for exempting fair-trade steel and aluminum from tariffs US Trade Representative says tariff plans are an "incentive" in NAFTA negotiations Leader of the US Republican conservative caucus calls for abandoning plans for steel and aluminum tariffs US President Trump to meet with executives from steel and aluminum-using companies on March 8	106.02
7-Mar	US Treasury Secretary says efforts will be made to avert negative economic impacts from steel and aluminum tariffs Senate Majority Leader McConnell: many Republican Senators concerned over Trump's import restrictions Canada's Finance Minister says NAFTA renegotiation and steel issue should not be linked President Trump sticks with plan to impose steel and aluminum tariffs, warns EU EU provides list of products that would be subject to retaliatory measures if US imposes import restrictions Cohn resigns from heading National Economic Council in opposition to administration's tariff plan US mulling wide-ranging restrictions on imports from China	105.93
8-Mar	White House Press Secretary says exemptions from US steel and aluminum tariffs possible for Canada, Mexico, and others	

Source: Thomson Reuters, Bloomberg; compiled by Daiwa Securities.
*As of 2:00 a.m. JST on following day (noon New York time on the day).

Import tariffs are unlikely to be an incentive for signing trade agreements

Canada accounts for the largest share of US steel imports, but low-priced Chinese products have been the main cause of the increase in imports and declining output and employment in the US steel industry. Despite that, it has not chosen to target Chinese products by applying anti-dumping countervailing tariffs, but has instead indicated plans in principle to slap tariffs on imports from all countries, and this appears to also be a tactic to give the US an upper hand in trade negotiations. President Trump can offer to exempt Canada and Mexico from the import tariffs if they agree to a new and fair North American Free Trade Agreement (NAFTA), as a way to incentivize them to do so. If the US threatens to implement import tariffs, however, other countries would be less likely to compromise in trade agreements than to institute their own retaliatory tariffs, which would only serve to spark a trade war and weaken the global economy. Canada's Minister of Finance has already stated that the renegotiation of NAFTA should not be links to the steel issue. Import tariffs are unlikely to create an incentive to sign trade agreements.

Republicans risk losing voter support if import tariffs are broadly implemented

Additionally, even if steel and aluminum import tariffs have the effect of reducing imports and expanding domestic output in those industries, high tariffs (a tax hike) would raise the cost of manufacturing in the US for, and reduce the earnings of, companies that use steel and aluminum as inputs. If companies pass on those higher costs by raising prices, it will also push consumer prices higher and put downward pressure on personal real incomes and consumption. There is also a risk that retaliatory tariffs implemented by other countries would reduce US exports and increase its trade deficit. Accordingly, if import tariffs are applied broadly, it will amplify the negative impact on the US economy, increase the risk of a decline in production and employment, and possibly trigger a decline in the stock market. If that happens, there is a risk that the Trump administration and Republican Party would suffer a decline in voter approval ratings, and the Rust Belt is probably not an exception.

Even if Japan is exempted from tariffs, there may be a dollar weakening/yen strengthening bias

Implementation of high tariffs is likely

Present Trump is expected to announce and sign an order imposing steel and aluminum tariffs on March 8 or 9 (US time). There is growing opposition within the ruling Republican Party against the administration's plans to restrict steel and aluminum imports. The European Union (EU) announced a list of US products on which it would impose retaliatory tariffs if the US implements import restrictions. Despite this, President Trump stuck with his plan to impose import tariffs and warned the EU that it would be hit with a "big tax." Even though Gary Cohn, Director of the National Economic Council and a proponent of free trade, resigned in opposition to the administration's tariff plans, we think the US is likely to go through with imposing high tariffs.

Tariffs could be more targeted through exemptions for specific countries and companies

Nevertheless, President Trump needs to strike a balance between his midterm election strategy and the risks of harming the economy as he moves forward with import restrictions. If the steel and aluminum tariffs are limited to low-priced products, it should still reduce imports while expanding domestic production in those industries, but may also reduce concerns about harm to the US economy and markets. Peter Navarro, a protectionist who is now Director of the White House National Trade Commission and is expected to be promoted to presidential advisor according to news reports, said that no country would be exempt from the tariffs, but that exemptions for specific companies were a possibility in special cases where such exemptions were needed. On March 7, however, White House Press Secretary Sarah Huckabee Sanders said there is a possibility that exemptions would be granted to Canada and Mexico based on national security considerations, and that exemptions were also possible for other countries, indicating that decisions will be made on a country-by-country basis.

Even if Japan is exempted from tariffs, there may be a dollar weakening/yen strengthening bias

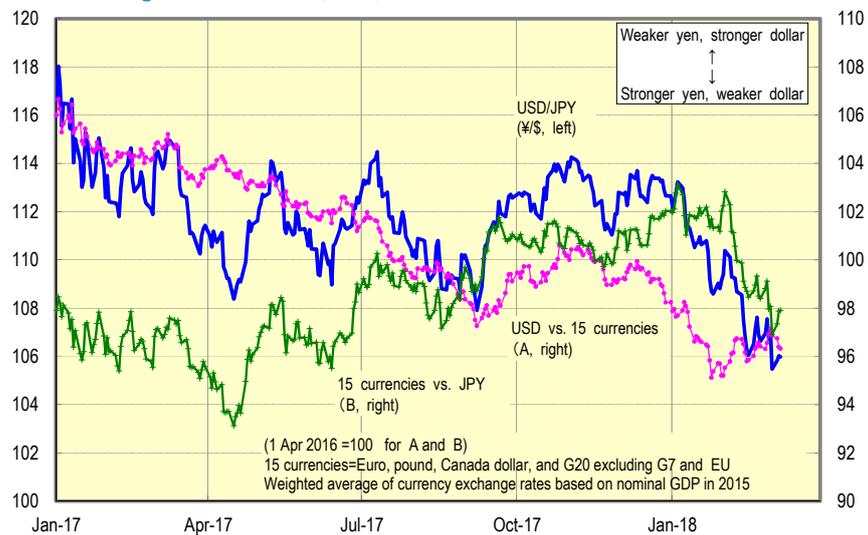
If the US applies steel and aluminum import tariffs on all countries, we think it likely that it would not only weaken the dollar on concerns over damage to the US economy, but also result in a risk-off strengthening of the yen and weakening of commodities and emerging market currencies on the expectation that it would harm the global economy. It is possible that specific countries or corporations would be exempted from the tariffs so as to primarily target imports from China, and this would probably soften the dollar weakening and risk-off

yen strengthening compared with the case of tariffs being implemented across the board. That may still leave a bias toward dollar weakness and yen strength, however. The dollar has weakened and the yen strengthened since President Trump signed an executive order applying import tariffs to washing machines and solar panels on January 23 (the dollar had already started weakening against the yen prior to the US Treasury Secretary's statement on January 24 that a weaker dollar was good for the US). The Trump administration's first implementation of emergency import restrictions (safeguards) under Article 201 of the US Trade Act was primarily targeted at China, but that move also affected currency markets.

Also risks exacerbating US-China trade friction

In addition to the US trade policy report noting that the US would use various measures against China, it has also been reported that the administration is considering a wide range of restrictions on imports from China and on Chinese investment in the US in retaliation for its infringement of intellectual property rights. We think there is a high probability that the US, concerned that China is expanding its national power through its large trade surplus with the US and growing investment in the US, will promote protectionist policies, and there is a significant risk of this exacerbating US-China trade friction. We still see a possibility that protectionist US policies will lead to a weaker dollar and a risk-off strengthening of the yen.

Chart: Exchange Rates of Dollar, Yen, and Other Currencies



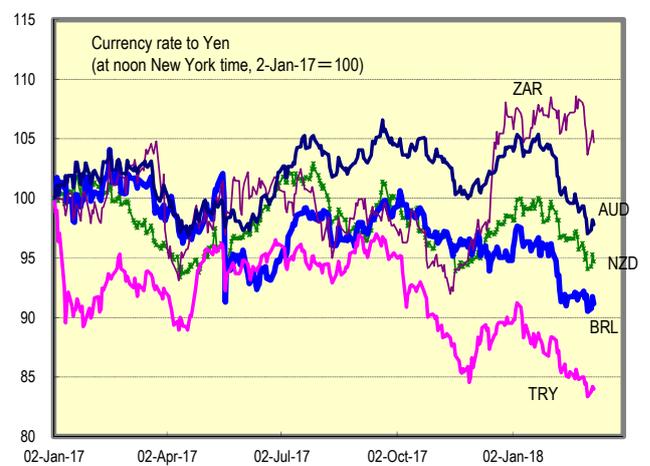
Source: Thomson Reuters; compiled by Daiwa Securities.

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	107.0 104-114	105.0 102-112	106.0 102-112	108.0 103-113	110.0 104-114
EUR-JPY	133.1	135.2	130.5 127-139	126.0 123-135	130.5 123-135	135.0 127-139	135.5 128-140
AUD-JPY	88.3	87.9	82.5 80-90	80.0 78-88	83.0 78-88	86.5 81-91	86.0 81-91
CAD-JPY	90.1	89.6	83.5 82-92	81.0 78-88	83.5 78-88	86.5 81-91	86.5 81-91
NZD-JPY	81.4	79.8	76.0 72-82	72.5 70-80	75.5 70-80	79.0 73-83	78.5 73-83
TRY-JPY	31.7	29.7	27.5 26-31	26.8 25-30	28.0 25-30	29.2 27-32	29.0 27-32
ZAR-JPY	8.3	9.1	8.9 8.5-9.5	8.4 8.2-9.2	8.8 8.2-9.2	9.4 8.6-9.6	9.2 8.6-9.6
BRL-JPY	35.6	34.0	32.4 31-35	31.4 30-35	32.6 30-35	34.3 32-37	33.9 32-37
KRW-JPY (100 KRW)	9.8	10.6	9.7 9.6-10.7	9.4 9.2-10.2	9.7 9.2-10.2	10.1 9.5-10.5	10.1 9.5-10.5
CNY-JPY	16.9	17.3	16.6 16.2-17.5	16.0 15.7-17.0	16.5 15.7-17.0	17.0 16.1-17.4	17.1 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

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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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