Daiwa Securities

Forex Market View

Yen strengthens on concerns over global economic slowdown

- ➢ Deteriorating sentiment is behind the yen's rise since January
- ➢ There are signs that the economies of each country are slowing in unison
- ➢ US-China trade friction is a new factor contributing to the economic slowdown

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

5 Apr – 4 May: Y104.0-108.0/$ (Y106.55/$ as of 4 Apr)

Forex Market View DSFE136
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Deteriorating sentiment is behind the yen's rise since January

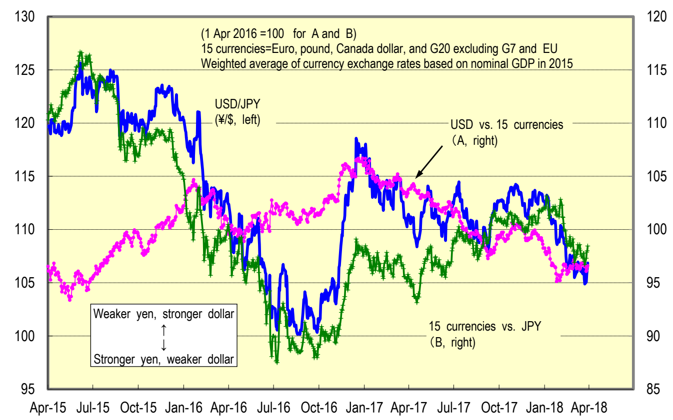
Worsening of global sentiment is a common trait of periods of yen appreciation

Recent periods in which the USD/JPY has declined because of a strengthening yen instead of a weakening dollar were July 2015 to July 2016, December 2016 to April 2017, and January to April 2018. Although this included periods in which speculation of the BOJ cutting back on quantitative easing was the source of yen appreciation (in February 2016, for example), the common trait for all of these periods was a worsening of global sentiment leading to a risk-off appreciation of the yen. It appears that a major determinant of whether the yen is going to weaken or strengthen is whether global sentiment is strong or weak.

Deteriorating sentiment is behind the yen's rise since January

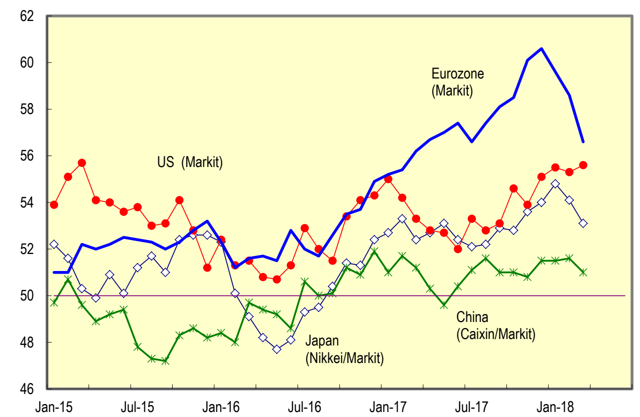
From March 2015 until June 2016, the US manufacturing PMI was worsening while China's manufacturing PMI remained below 50. In 1H 2016, this worsening trend in PMIs spread to the euro zone and Japan, marking a clear deterioration in business sentiment worldwide. The yen strengthened dramatically in 1H 2016, with the USD/JPY declining from above 121 to below 100, and behind that move was this worsening of sentiment, with the 10-year Treasury yield moving sharply lower, from 2.29% to 1.32%. In 1H 2017, manufacturing PMIs were worsening in the US, China, and Japan. US long-term rates declined even with the Fed signaling a continuation of rate hikes, and the USD/JPY fell from above 118 to below 109. Because there was a notable improvement in the euro zone's manufacturing PMIs, however, there is no decline in EU long-term rates and the decline in cross-yen rates (yen strengthening) was limited. Since January 2018, manufacturing PMIs in the euro zone and Japan have worsened, and there have been signs of a worsening in China, as well. In the US, there was no worsening of the manufacturing PMI announced by Markit, but the ISM manufacturing PMI did worsen, as explained below. A worsening of sentiment has also been behind the strengthening of the yen since January, with the USD/JPY declining from above 113 down to as low as below 105.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Manufacturing PMI in Japan, US, Europe, and China



Source: Thomson Reuters; compiled by Daiwa Securities.

There are signs that the economies of each country are slowing in unison

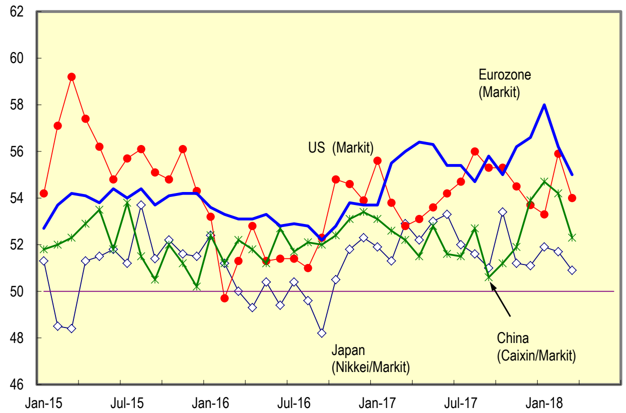
Both manufacturing and services PMIs are worsening worldwide

PMIs for the services sector have followed a similar pattern to those of the manufacturing sector. Services PMIs worsened from 2015 until around summer 2016 and again in 1H 2017, and since January 2018 a worsening trend has taken hold in the euro zone, the US, China, and Japan. PMIs for both the manufacturing and service sectors in every country are above 50, which marks the threshold between growth and contraction, as economies continue to recover, but the recovery pace is getting slower. The direction of the PMI is more important than its level to the market, and if PMIs continue heading downward, the market's concerns over an economic slowdown are likely to lead to a risk-off yen appreciation. That becomes all the more likely if this PMI worsening winds up not being limited to specific countries or regions but becomes common to all of the major economies.

There are signs that the economies of each country are slowing in unison

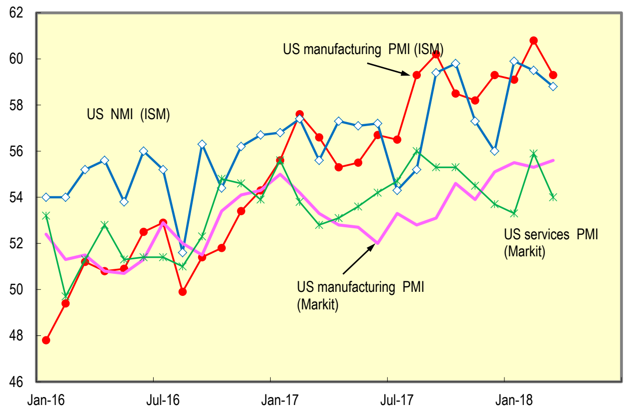
A substantial slowdown in exports has contributed to this recent PMI worsening across countries. For example, the China manufacturing PMI announced by the National Bureau of Statistics of China worsened in February then improved in March, but we attribute this to a decline in production in February brought by domestic environmental measures and the lunar new year. There was a slight improvement in February followed by a clear worsening in March for the China manufacturing PMI announced by Caixin/Markit, however. One reason for this was the slower growth in exports, since few of the companies surveyed are state owned enterprises and many of them are SME exporters. This makes the survey robust to the impact from domestic policies but easily affected by external demand. The US ISM manufacturing index also showed a significant decline in the new export orders index, which led to declines in the new orders, production, and sentiment indices. The economic trends in each country tend to mutually affect each other through imports and exports and thereby follow the same pattern, and there have recently been signs that they are coalescing in the direction of a slowdown.

Chart: Services PMI in Japan, US, Europe, and China



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Corporate Business Sentiment in US



Source: Thomson Reuters; compiled by Daiwa Securities.

US-China trade friction is a new factor contributing to the economic slowdown

Worsening US sentiment could spread to weaker employment numbers

In the US, new orders, production, and sentiment, all affected by final demand, are worsening in both the manufacturing and service sectors. Of the five indices that comprise the US ISM manufacturing index (new orders, production, employment, supplier deliveries, and inventories), the new orders and production indices, which are relatively more leading indicators, have declined for three consecutive months, while both the employment and inventories indices turned to a declining trend in March. The supplier deliveries index (early vs. late deliveries) remains high and supply-demand conditions are fairly tight, but the inventories index is high, an indication that inventories are growing at a fast pace, and this probably makes a slowdown in production more likely. In contrast, of the four indices (sentiment, new orders, employment, and supplier deliveries) that comprise the US ISM nonmanufacturing index (NMI), the new orders and sentiment (production) indices declined, but the supplier deliveries (early vs. late deliveries) and employment indices rose, in March.

Supply-demand appears to be quite tight at this point, but if new orders and sentiment continue to weaken, employment will probably also weaken.

US-China trade friction is a new factor contributing to the economic slowdown

There is now a possibility that US-China trade friction will have a slowing impact on the economy. China implemented measures on April 2 to protect its national interests from being harmed by US restrictions (additional tariffs) on steel and aluminum imports, imposing retaliatory tariffs totaling $610 million on 128 different products imported from the US at a value of $2.75 billion. The negative impacts on the global economy would likely be limited if this had stopped with the US tariffs on steel and aluminum and China's retaliation for that. When the Office of the US Trade Representative (USTR) announced a list of roughly 1,300 items imported from China on which the US would impose punitive tariffs amounting to $50 billion, however, the Chinese government announced that in retaliation, it would impose an additional 25% tariff on 106 items imported from the US valued at about $50 billion. If all of these retaliatory tariffs are implemented they will equate to about $12.5 billion, more than 20 times the retaliatory tariffs aimed at the steel and aluminum tariffs imposed by the US.

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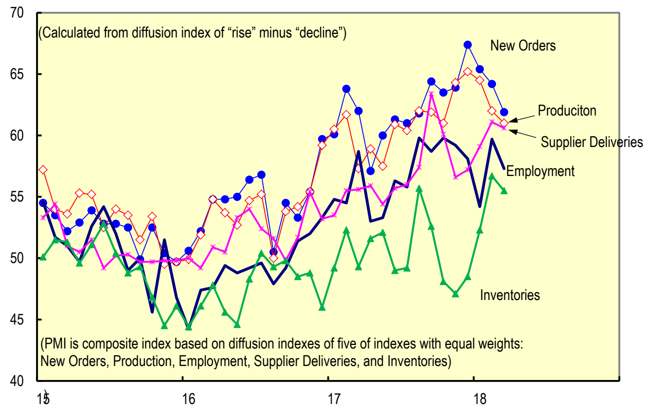
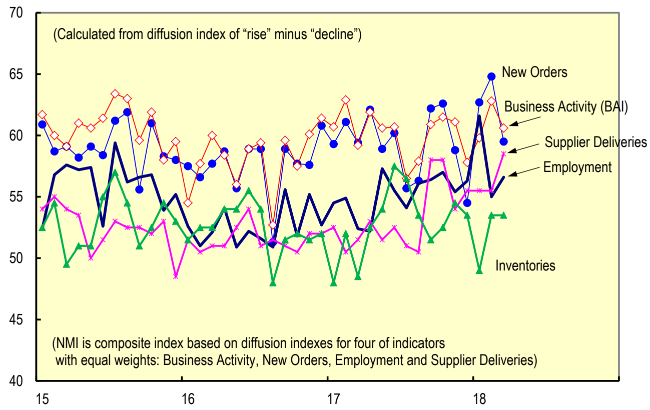
The US and China are of course in talks to avoid imposing tariffs, but there is a risk that the US will impose some punitive tariffs on China if measures taken by China to correct its trade practices are deemed insufficient by the US. If the scope of products subject to punitive tariffs from the US and retaliatory tariffs from China broadens, it will lead to an increase in prices and a weakening of demand across a variety of sectors. Because there is also a possibility of demand weakening on deterioration in business sentiment caused by concerns over trade friction between the US and other countries, the market probably has significant worries about a global economic slowdown. Depending on the direction that each country's economic indicators take, concerns over a global economic slowdown could lead to a risk-off strengthening of the yen.

Chart: US ISM Index



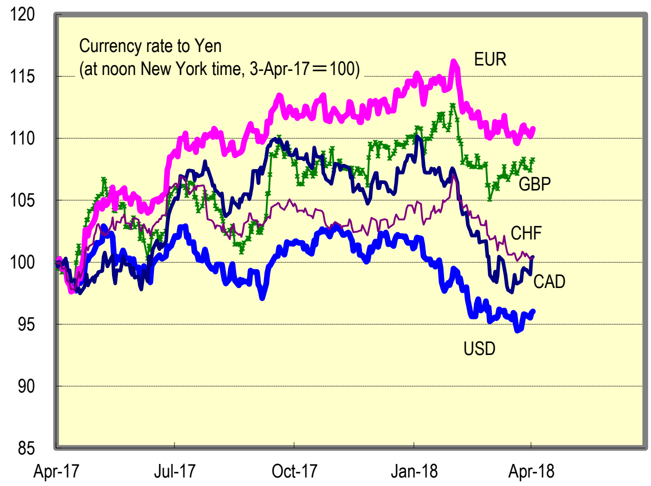
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US NMI



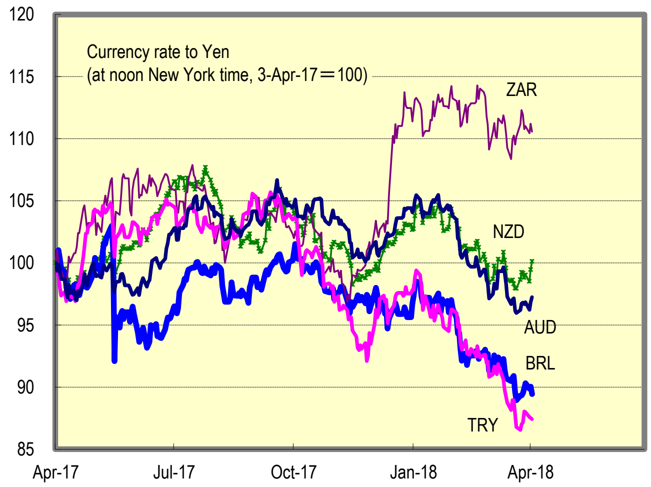
Source: Thomson Reuters; compiled by Daiwa Securities.

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				
	29 Dec 2017	30 Mar 2018	Apr-Jun 2018	Jul-Sep 2018	Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019
USD-JPY	112.7	106.2	105.0	104.0	108.0	109.0	110.0
			102-112	101-111	102-112	104-114	105-115
EUR-JPY	135.2	130.8	127.0	127.0	134.0	134.0	136.5
			124-134	123-133	124-137	128-138	130-140
AUD-JPY	87.9	81.7	79.0	78.0	83.0	83.0	84.5
			76-86	75-85	76-86	78-88	79-89
CAD-JPY	89.6	82.4	80.5	80.0	84.5	84.5	86.0
			77-87	76-86	77-87	79-89	80-90
NZD-JPY	79.8	76.9	73.5	73.0	77.5	77.5	79.0
			71-81	70-80	71-81	73-83	74-84
TRY-JPY	29.7	26.8	26.0	25.5	27.5	27.5	28.5
			24-29	24-29	24-29	25-30	25-30
ZAR-JPY	9.1	9.0	8.6	8.5	9.2	9.1	9.3
			8.3-9.3	8.2-9.2	8.3-9.4	8.6-9.6	8.7-9.7
BRL-JPY	34.0	32.1	31.0	30.5	33.0	33.0	34.0
			29-35	28-34	29-35	30-35	31-36
KRW-JPY	10.6	10.0	9.6	9.6	10.3	10.3	10.5
(100 KRW)			9.4-10.4	9.2-10.2	9.3-10.6	9.7-10.7	9.9-10.9
CNY-JPY	17.3	16.9	16.6	16.4	17.4	17.4	17.7
			16.0-17.3	15.9-17.2	16.1-17.6	16.5-17.8	16.7-18.0

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.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service, Inc. ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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Apr 2017

IMPORTANT

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.

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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association