Forex Market View

USD/JPY moves on the direction of US economy and share prices

- If the US economic outlook worsens, it leads to a risk-off decline in the USD/JPY
- The risk of a trade war raises the risk of an economic slowdown
- As a rule of thumb, the USD/JPY tends to decline starting in April

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

11 Apr – 10 May: Y104.0-108.0/$ (Y107.28/$ as of 10 Apr)

Forex Market View DSFE138
FICC Research Dept.

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

Daiwa Securities Co. Ltd.

If the US economic outlook worsens, it leads to a risk-off decline in USD/JPY

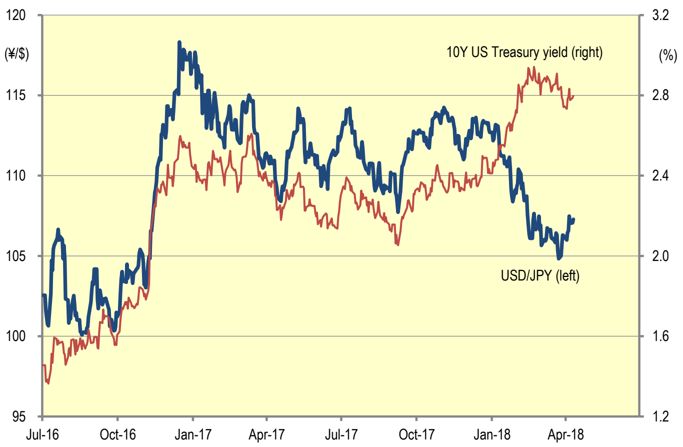
USD/JPY has regained its correlation with US share price volatility

In January this year, US long-term rates and share prices rose while the USD/JPY fell. One reason for this was probably the strengthening of the yen caused by increased speculation that the BOJ would taper QE and pursue an exit strategy, speculation that was caused by the BOJ having unexpectedly reduced its purchases of superlong JGBs despite JGB yields not having declined by much. Another reason was probably the dollar weakening caused by the Trump administration's trade and foreign exchange policies becoming more explicitly protectionist. The dollar's effective exchange rate, which had declined during the risk-on mood, declined further on the US administration's imposition of higher tariffs (trade restrictions) on washing machines and solar cells and by the US Treasury Secretary's comment that a weaker dollar is "good for the US." Since February, US stocks increasingly seen as overvalued have been falling together with the USD/JPY, and this restored the correlation between US stock market volatility and the USD/JPY. With the Trump administration imposing additional tariffs (import restrictions) on steel and aluminum and also proposing punitive tariffs on China for its theft of intellectual property, speculation of a US-China trade war appears to have changed the direction of share prices and the USD/JPY. US long-term rates started declining, thereby aligning their trend with that of the declining USD/JPY, but the USD/JPY has continued to show a relatively stronger correlation with US share prices than with US long-term rates, as evidenced by the USD/JPY rising when US long-term rates were declining and stocks rising.

If the US economic outlook worsens, it leads to a risk-off decline in the USD/JPY

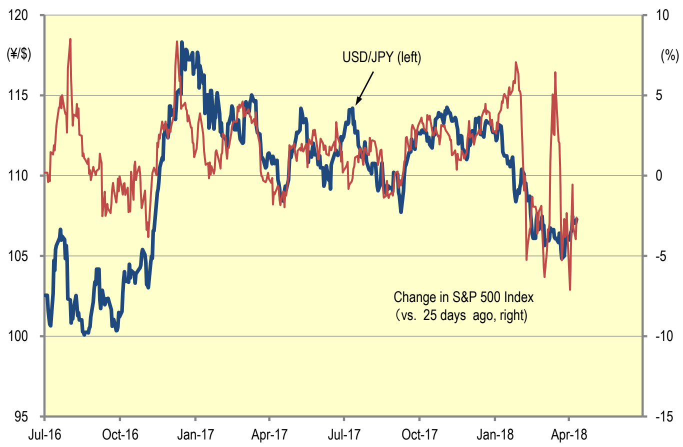
Long-term rates change to reflect the outlook for US inflation, the economy, monetary policy, and the fiscal balance (Treasury issuance), and when the economic outlook worsens, it reduces inflation expectations, weakens rate hike expectations, and paves the way for long-term rate declines. For example, the US jobs data for March showed a much greater worsening of the nonfarm payrolls data than the market expected, but y/y growth in hourly wages accelerated slightly in line with the market forecast.

Chart: USD/JPY and 10Y US Treasury Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY and Change in S&P 500 Index



Source: Thomson Reuters; compiled by Daiwa Securities.

If the employment data continues to weaken, it will limit increases in the market's inflation expectations, possibly owing to a weakening of upward wage pressures, which means a decline in real rates as well as US long-term nominal rates. Although declining long-term rates have an upward impact on share prices, because of the arbitrage relationship between stocks and long-term rates, if share prices are not sufficiently undervalued, a worsening of the economic outlook tends to have a downward impact on share prices, and the USD/JPY also tends to decline on risk-off yen appreciation.

The risk of a trade war raises the risk of an economic slowdown

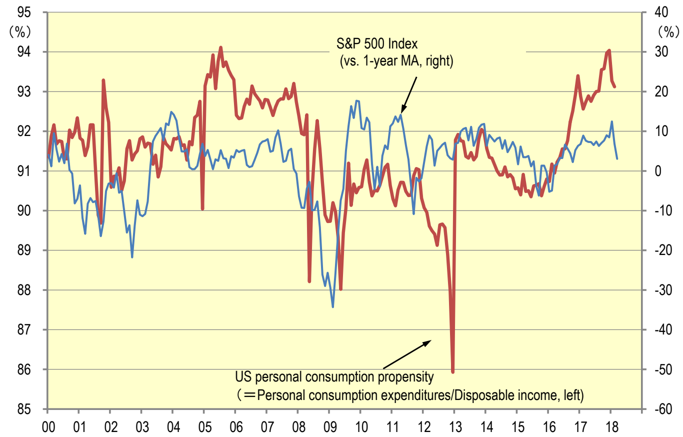
Slowing consumption weakens share prices, and weaker share prices cause consumption to slow

The USD/JPY tends to move together with US share prices, and it is probably the economic outlook that moves both. Private consumption slowed, including consecutive months of declining US retail sales, from December 2017 to February 2018, and the cause was probably the level of expenditures as a fraction of income. The US propensity to consume, given as the ratio of consumption expenditures to personal disposable incomes, rose to as high as 94.0% in November and December 2017, close to its peak of 94.1% reached in July 2005, but then started declining. The rising value of asset portfolios brought by rising share prices (the wealth effect) combined with expectations of tax cuts caused consumption to grow faster than income, leading to a rise in the propensity to consume (decline the savings rate), but it appears that the savings rate fell too low, making consumption growth vulnerable to a slowdown. Share prices and the economy interactively affect each other, with the economy affecting share prices at the same time that share prices are affecting the economy. Recently, slower consumption started to weaken share prices, and those weaker share prices are in turn causing consumption to slow further.

The risk of a trade war raises the risk of an economic slowdown

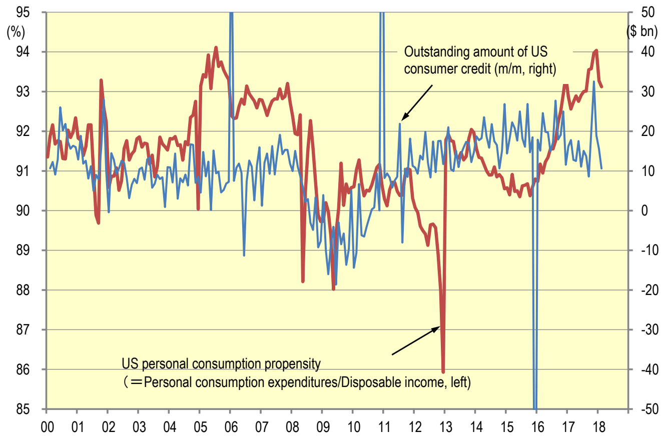
One cause of the decline in the US propensity to consume that began in January was the increase in disposable income brought by the reduction of income taxes. M/m growth in disposable income was +0.3% in November 2017, +0.4% in December, +1.0% in January 2018, and +0.4% in February, accelerating in January in response to the tax cut. The m/m change in consumption, however, was +0.7% in November 2017, +0.5% in December, +0.2% in January 2018, and +0.2% in February. Thus the acceleration in disposable incomes was temporary, but the slowdown in consumption has been a sustained one. In addition, m/m growth in consumer credit outstanding peaked in November 2017 and began to decline rapidly until February 2018. Thus the main reason behind the decline in propensity to consume was not growth in disposable incomes from the tax cut but rather a slowdown in consumption. While growth in disposable incomes is unlikely to increase, there is likely to be a worsening of consumer sentiment in response to the negative wealth effect that makes consumption unlikely to grow. Until US share prices become sufficiently undervalued, the consumption slowdown and weakening of share prices are likely to have synergistic effects. If concerns over a US-China trade war fade, even if US share prices and the USD/JPY increase, as long as China does not sufficiently satisfy US demands, those concerns likely to linger and act as a constraint on such increases. If it takes time to eliminate those concerns, the very presence of trade war risks will increase the risk of an economic slowdown. The USD/JPY and cross-yen rates are probably unlikely to break out of their declining (yen strengthening) trend.

Chart: Change in Stock Price and Personal Consumption Propensity in US



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Personal Consumption Propensity and Change in Outstanding Amount of Consumer Credit



Source: Thomson Reuters; compiled by Daiwa Securities.

As a rule of thumb, the USD/JPY tends to decline starting in April

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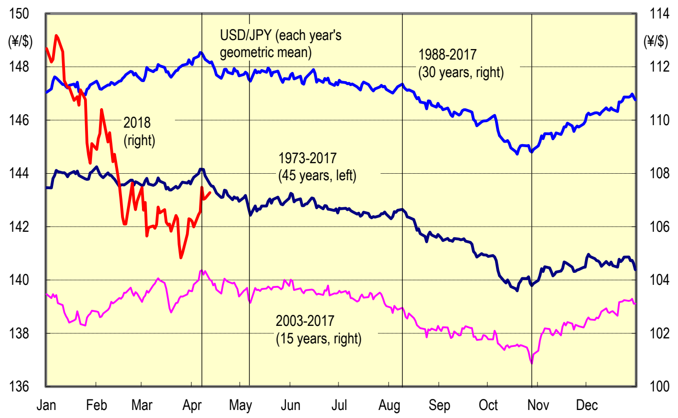
We think the USD/JPY is likely to follow a downward trend, in part owing to seasonality. Over the 45 years from the start of the USD/JPY floating exchange rate regime in 1973 until 2017, the 30 years since the end of the post-Plaza Accord dollar weakening in 1988, and the 15 years since the end of the share price decline in 2003 following the collapse of the US IT bubble, the USD/JPY on average has tended to rise until early April (around April 6-7), then decline until mid-to-late October. The USD/JPY's declining trend has been particularly pronounced from early April until early May, which suggests that is a period when the USD/JPY is likely to decline. After declining considerably more than average in Jan-Mar this year, the USD/JPY rose in line with the average pattern until early April, but it has come up against upside resistance.

USD/JPY tends to decline in years of a US midterm election

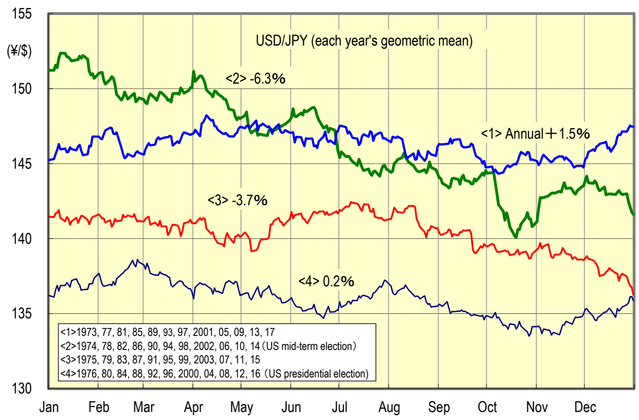
Averaging out the USD/JPY movement every four years from 1973 until 2017, the decline from January to October has tended to be greater in years with a US midterm election like this year than in other years, with a clear downward trend from early April until early May. The dollar's effective exchange rate also tends to follow a declining trend during that time. Although there are times when the USD/JPY rises if risk-on dollar weakening is exceeded by risk-on yen weakening, if it is a "sell the US" dollar weakening, that combined with a risk-off yen strengthening makes a decline in the USD/JPY likely. A remark by China's President reduced concerns over a US-China trade war and led to a yen weakening. Nevertheless, if China does not quickly announce specific policies to implement plans it has long talked about for reducing tariffs, easing inbound foreign investment into its financial and automotive sectors, and protecting intellectual property, the US will not abandon its planned tariffs, making it possible that the USD/JPY will decline in accordance with the average pattern.

Chart: USD/JPY in 2018 and Average over Past 15, 30, 45 Years



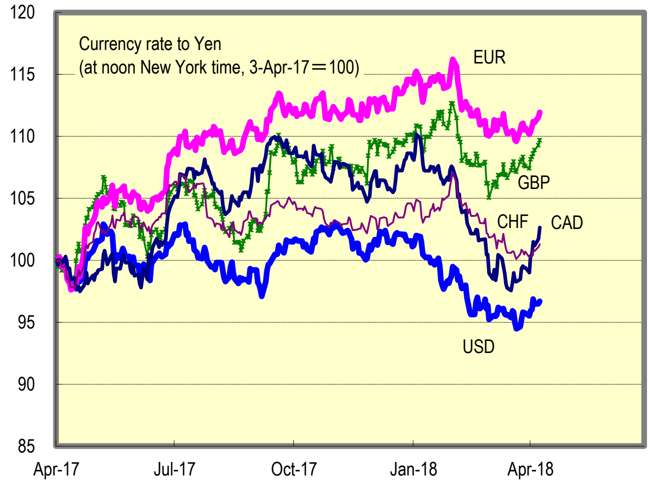
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Average USD/JPY Every Four Years



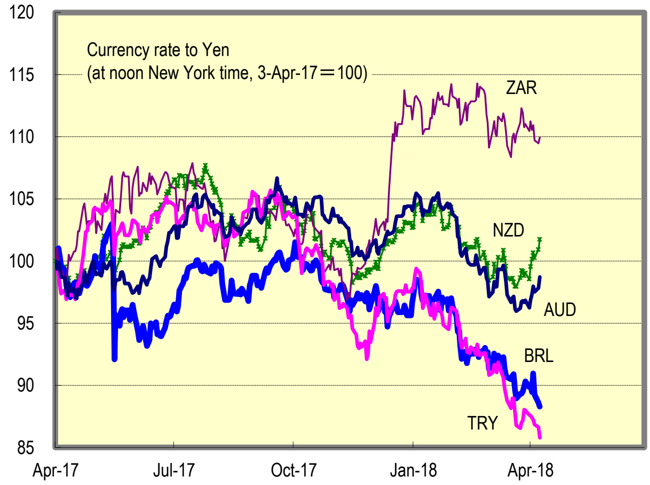
Source: Thomson Reuters; compiled by Daiwa Securities.

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 29 Dec 2017	30 Mar 2018	Forecast 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

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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).

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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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
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