Forex Market View

Accelerating US economic growth and rising USD/JPY may not be sustainable

- It may be premature to expect US economic growth to accelerate
- US economic data likely to weaken, with a lag, following dollar appreciation
- Accelerating US economic growth and rising USD/JPY may not be sustainable

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

7 Jun – 6 Jul: Y107.0-111.0/$ (Y110.00/$ as of 6 Jun)

Forex Market View DSFE151

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It may be premature to expect US economic growth to accelerate

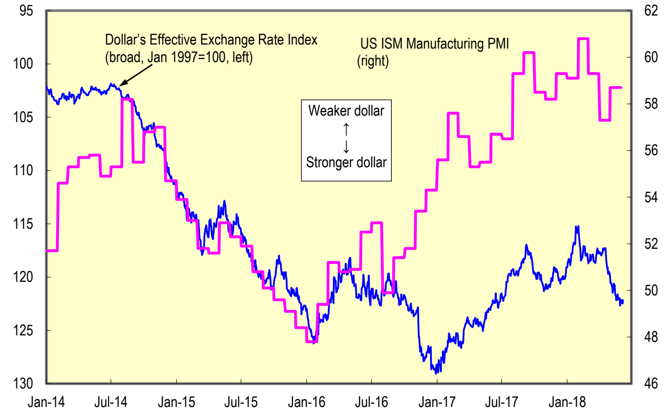
USD/JPY rises on the strength of US economic indicators

Improving US economic data combined with rising US long-term rates (a widening Japan/US rate spread) have pushed the USD/JPY higher. The dollar (i.e., its effective exchange rate) normally tends to strengthen when the market is risk-on and weaken when it is risk-off. Nevertheless, we attribute the dollar's strengthening in April-May this year amid a risk-on global rise in share prices and interest rates to the US economic data having shown more strength than the economic data for other countries. We consider here the sustainability of this rise in the USD/JPY brought by strong US economic data.

Expectations of resumed economic growth on improvement in US retail sales and PMI

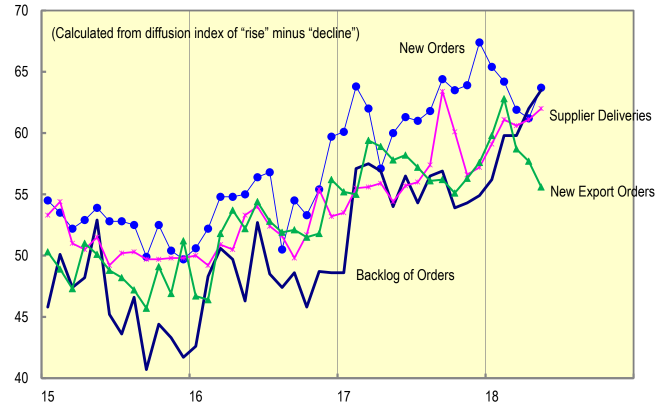
We attribute the rise in US long-term rates and the USD/JPY from mid-April until mid-May to improving US economic indicators. Growth in US retail sales for March announced on April 16 was +0.6% m/m, beating the market expectation of +0.4% and recording its first positive sequential growth in four months. US economic data, which had tended to underperform market expectations up until that announcement, turned to a trend of beating market expectations toward the end of April. Although that trend of beating market expectations weakened in May, m/m growth in US retail sales was +0.3% in April, in line with market expectations, while March retail sales were revised upward to +0.8%, and this pushed both US long-term rates and the USD/JPY higher. In late May, oil prices weakened on speculation that OPEC will relax its production cuts when it meets in June, the US administration announced it was considering imposing new tariffs on automobiles, President Trump canceled the US-North Korean summit, Italy was in political turmoil, and concerns over US-China trade friction were reignited, causing US long-term rates and the USD/JPY to retreat, but both then rebounded on the US employment data and ISM manufacturing PMI in May improving more than the market expected. This may have created market expectations of the US economy regaining upward momentum.

Chart: Dollar's Effective Exchange Rate and ISM Manufacturing PMI



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: ISM Manufacturing PMI



Source: Thomson Reuters; compiled by Daiwa Securities.

US private consumption may start weakening again

It may be premature to expect accelerated growth in the US economy, however. Improvement in the US manufacturing PMI in May could be attributable to the recovery of private consumption in March and April, but benefits from growth in disposable income from tax cuts and tax refunds may start to lose momentum and cause private consumption to weaken again. It may be that US auto sales volume in May was at its weakest in nine months not only because of higher gasoline prices and interest rates but also because benefits from rising incomes are fading. If that is the case, private consumption of products other than automobiles will probably also slow, and that may be followed, with a lag, by a slowing of the new orders indices and PMI.

Signs that US exports are declining on dollar strength

Additionally, last year the dollar had a positive impact on the US manufacturing PMI by weakening, but this year it is strengthening and having a negative impact. After having been rising until February 2018, the export orders index for US manufacturers declined for three consecutive months in March, April, and May, while real exports declined in April. If exports are slowing because of dollar strength and a slowing of overseas economies, that will have a negative impact on domestic production, and could lead to another worsening of US sentiment. In the past, the export orders index has at times been followed, with a lag, by both the new orders index and PMI changing in the same direction.

US economic data likely to weaken, with a lag, following dollar appreciation

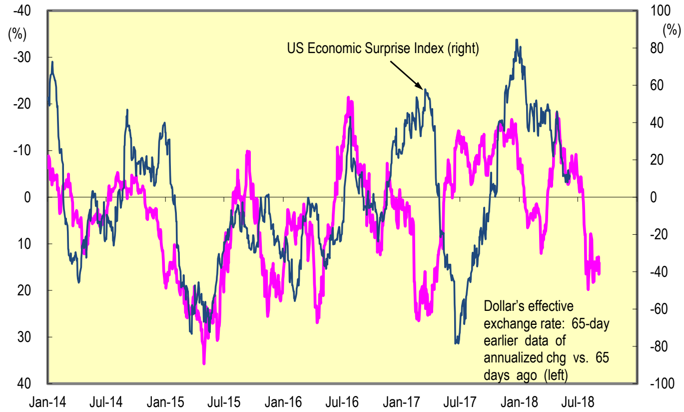
US economic data likely to weaken with a lag following dollar appreciation

The USD market has shown a correlation with the ESI, a measure of changes in US economic indicators relative to market forecasts. For example, the 65-day rate of change in the dollar's effective exchange rate (broadly defined) tends to be followed about 65 days later with a change in the US ESI in the opposite direction. Although there are exceptions (after the US presidential election in November 2016, Trump policy expectations strengthened the dollar and raised the ESI, followed by a pullback until mid-2017 in which the dollar weakened and the ESI declined), in general the two exhibit an inverse correlation, with the dollar rising when the ESI is falling and vice versa. Based on this, we think the US ESI, in a lag with the dollar's strengthening, is likely to enter a declining trend by around August this year. That would not hold if there were sufficient factors contributing to accelerated US economic growth despite dollar appreciation, but there are not enough of those factors now.

Is the market leaning toward a risk-off decline in US stocks and long-term rates?

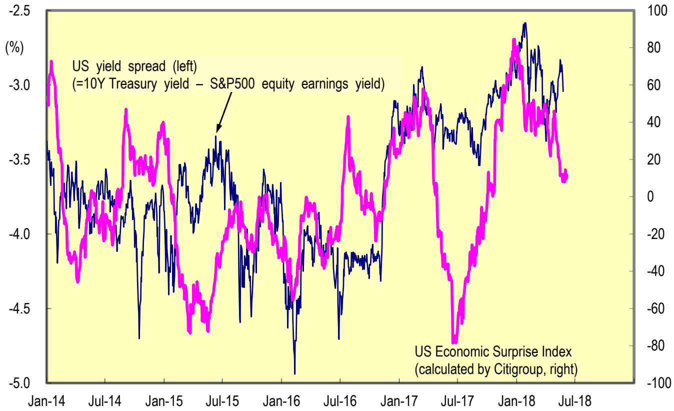
US share prices and long-term rates are likely to rise (as is the yield spread, defined as the US Treasury yield less the equity earnings yield) when US economic data beat market expectations, but likely to decline (as is the yield spread) when the economic data fall short of market expectations. If the US ESI is likely to fall with a lag following dollar appreciation, the second pattern noted above becomes relatively more likely. Private consumption, helped by the effects of tax cuts and tax refunds, recovered and the US economic indicators announced in Apr-Jun improved, but if those indicators turn to a weakening trend as said effects wear off and that is accompanied by dollar appreciation, there is likely to be a risk-off decline in US share prices and long-term rates.

Chart: US ESI and Change in Dollar's Effective Exchange Rate



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US ESI and Yield Spread



Source: Thomson Reuters; compiled by Daiwa Securities.

Accelerating US economic growth and rising USD/JPY may not be sustainable

Dollar strengthening against the euro on relative sentiment may lose momentum

While the euro area's manufacturing PMI (Markit) continued worsening until May this year, the US manufacturing PMI (Markit) followed an improving trend and was higher than the euro zone PMI in both April and May. This relative improvement in US business sentiment (deterioration in EU business sentiment) has fueled the dollar's strength against the euro. There is a possibility that the relative improvement in the US PMI will weaken as the strong dollar exerts a negative impact on the US economy and the weak euro exerts a positive impact on the euro zone economy. Even if there is no immediate relative improvement in the euro PMI that sends it higher than the US PMI, there is a possibility that the relative sentiment-driven pressures strengthening the dollar against the euro will get weaker.

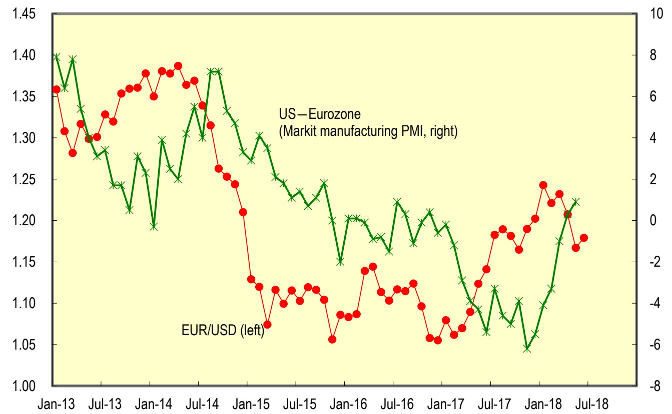
Dollar's effective exchange rate strengthens on risk-off moves

Nevertheless, the market will become more vulnerable to risk-off pressures if US economic data starts deteriorating without the economic data turning to an improving trend in the EU, Japan, and other countries. In addition, the dollar is more likely to strengthen when the market is risk-off. Even if the dollar strength driven by relatively stronger US sentiment starts to fade, we expect the dollar's effective exchange rate to remain firm on the dollar strength brought by risk-off moves. The dollar is likely to strengthen relative to commodity-based and emerging market currencies and also may strengthen relative to the euro.

Accelerating US economic growth and rising USD/JPY may not be sustainable

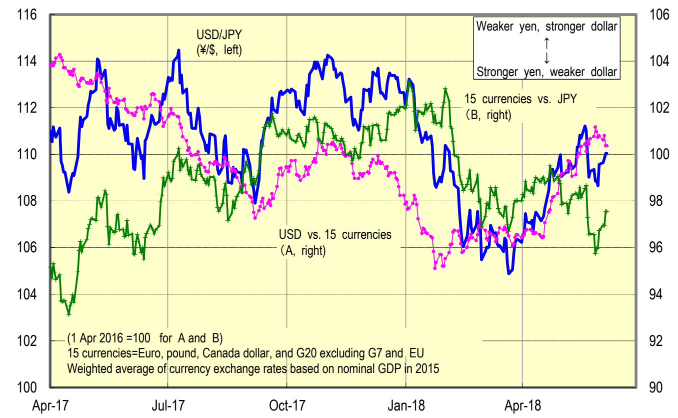
When the market turns risk off, the yen tends to become the strongest currency. Not only do cross-yen rates fall, but the yen tends to strengthen more than the dollar, leading to a decline in the USD/JPY. We think the US economic data is more likely to start deteriorating and pushing the USD/JPY lower than to continue improving and keep the USD/JPY in a rising trend.

Chart: EUR/USD and Gap Between US and European PMI



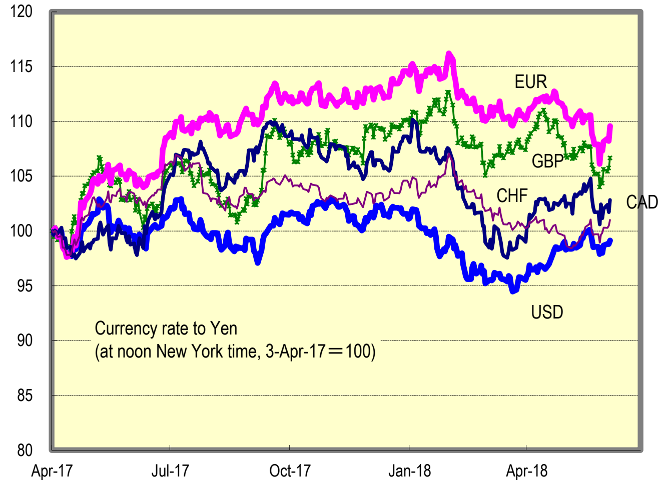
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Breakdown of USD/JPY



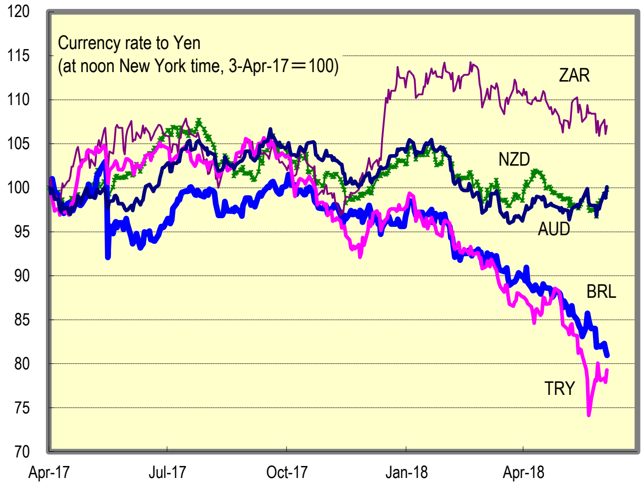
Source: Thomson Reuters; compiled by Daiwa Securities.

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	108.0	105.0	108.0	109.0	110.0
			104-112	102-111	102-111	104-113	105-114
EUR-JPY	135.2	130.8	126.5	123.0	130.0	130.0	132.0
			124-134	120-130	120-133	124-134	126-136
AUD-JPY	87.9	81.7	81.0	79.0	83.5	83.0	85.0
			78-86	76-85	76-86	78-87	79-88
CAD-JPY	89.6	82.4	83.0	81.0	84.5	84.5	86.0
			80-88	78-87	78-88	80-89	81-90
NZD-JPY	79.8	76.9	75.5	73.5	78.0	77.5	79.0
			72-80	71-80	71-81	73-82	74-83
TRY-JPY	29.7	26.8	24.0	23.5	25.5	25.5	26.5
			22-28	21-26	21-26	22-27	23-28
ZAR-JPY	9.1	9.0	8.5	8.2	8.8	8.7	8.9
			8.3-9.3	8.0-9.0	8.0-9.0	8.3-9.3	8.4-9.4
BRL-JPY	34.0	32.1	29.0	28.0	30.5	30.5	31.0
			28-33	26-31	27-32	28-33	29-34
KRW-JPY	10.6	10.0	10.0	9.7	10.3	10.3	10.5
(100 KRW)			9.5-10.5	9.4-10.4	9.4-10.6	9.8-10.8	10.0-11.0
CNY-JPY	17.3	16.9	16.9	16.4	17.3	17.3	17.6
			16.5-17.5	16.1-17.3	16.1-17.6	16.6-17.8	16.8-18.0

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.

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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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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]

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The name of the Credit Rating Agencies group: S&P Global Ratings ("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

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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May 2018

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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