Daiwa Securities

Forex Market Weekly

What are the sources of volatility in the FX market?

- Expectations of ECB ending QE are strengthening the euro, and concerns about trade friction with US are constraining yen depreciation
- USD/JPY unlikely to continue climbing following the FOMC meeting; keep an eye on US trade policy
- May US retail sales are a source of volatility in the USD/JPY

This week's USD/JPY forecast range

11 -15 Jun: Y108.2-110.5/$ (Y109.5 at end-previous week)

Forex Market View DSFE152
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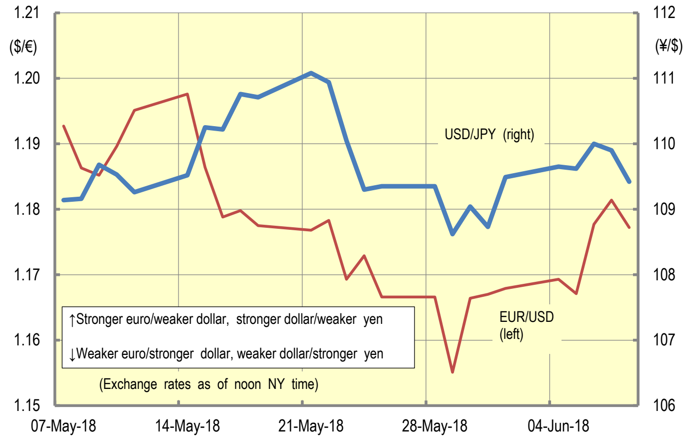
Expectations of the ECB ending QE are strengthening the euro, and concerns about trade friction with the US are constraining yen depreciation

Overview of last week's forex market

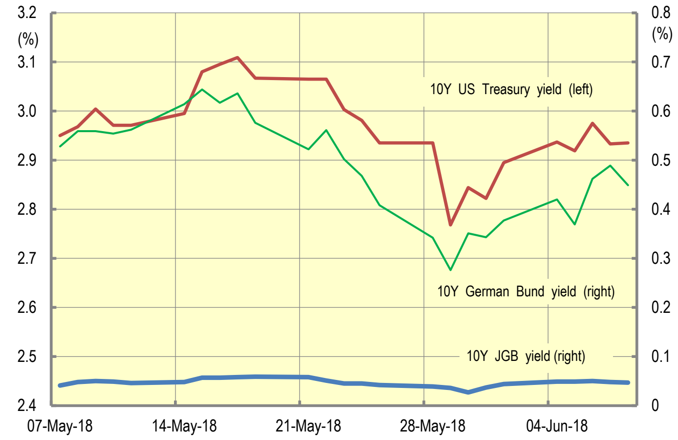
Early in the week, China warned that trade agreements would be rendered invalid if the US imposes tariffs, and this constrained the USD/JPY's rise. Spain's new prime minister indicated that he does not plan on forming a coalition with Podemos, a far-left political party, while fading concerns over growth in government spending led to euro buying and dollar selling. The EU announced that it would impose restrictions on steel imports as early as July, but Canada announced that it would not immediately oppose US tariffs, and there was a risk-on weakening of the yen. China proposed increasing imports from the US, but it was reported the US may not take them up on it if the offer is conditional on the US delaying its punitive tariffs; the USD/JPY declined in response. The euro strengthened on comments from Italy's new prime minister, Giuseppe Conte, that he was not considering abandoning the euro, and continued to strengthen on a comment from ECB executive board member Peter Praet that when the ECB meets next week, it will debate whether to end its bond purchases by end-2018. Although the USD/JPY rose to 110.27 in reaction to rising interest rates in Europe and the US, concerns that the US would take a hardline stance on trade at the G7 meeting caused both US interest rates and the USD/JPY to retreat. The G7 had adopted a communiqué committed to fighting trade protectionism, but the US president reversed his position and refused to sign it.

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.

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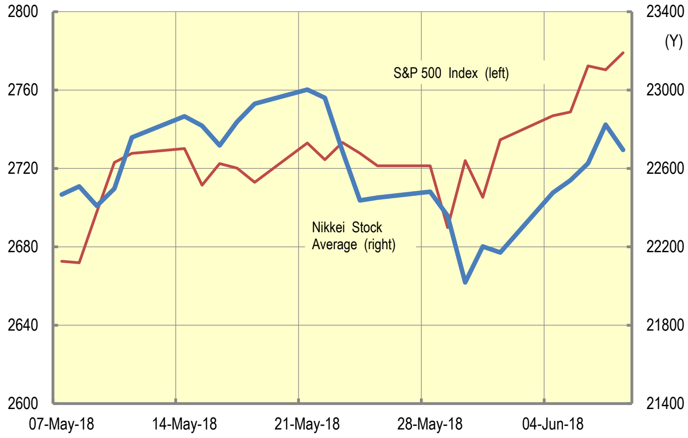
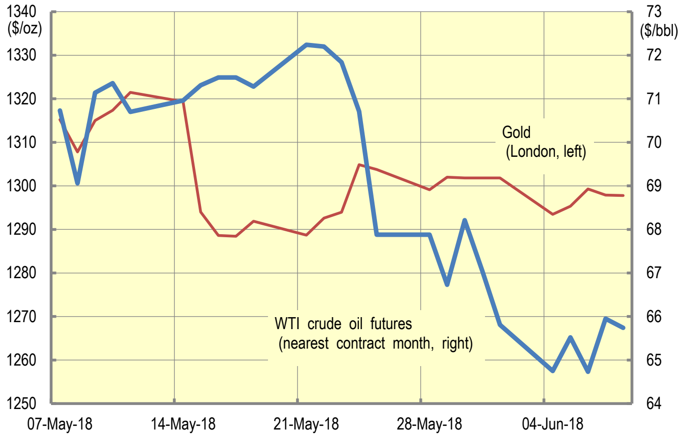
Chart: Stock Market: US S&P 500, Nikkei Stock Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



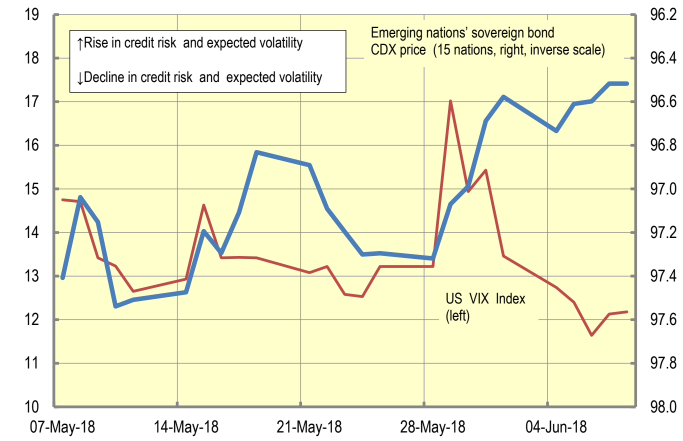
Source: Thomson Reuters; compiled by Daiwa Securities.

USD/JPY unlikely to continue climbing following the FOMC meeting; keep an eye on US trade policy

USD/JPY unlikely to continue climbing following the FOMC meeting

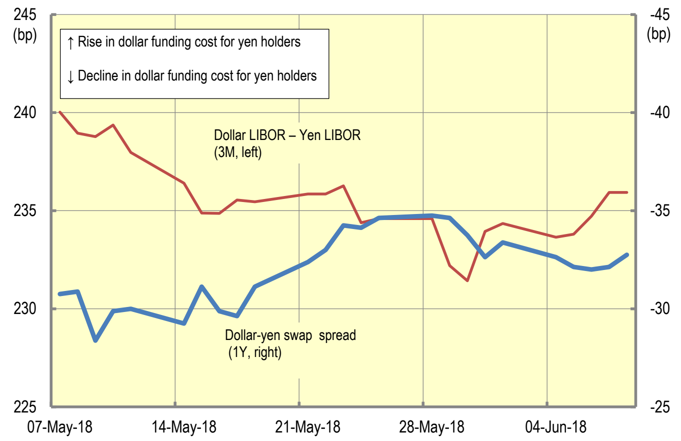
Although there is a possibility of the US-North Korean summit on June 12 resulting in a formal agreement to end the Korean War, if the US and North Korea cannot immediately agree to a verifiable and irreversible denuclearization (and instead leave that for discussion at the next summit), the market is unlikely to respond with risk-on moves. The dot chart will be watched closely as an indication of the probability of a Fed rate hike. At the March meeting, the same number of members supported three rates hikes this year as supported four rate hikes, and it will be interesting what the numbers look like after this meeting. The US economic data that has been announced thus far since April has been strong, but with the risk of trade friction adversely affecting the US economy having risen somewhat, we doubt the Fed will expect much of a change in inflation expectations, and do not expect it to change its policy rate outlook by much. We assign a low probability to US long-term rates and the USD/JPY continuing to rise following the FOMC meeting. Even if US interest rates rise because a majority of board members support four rate hikes in 2018, the market may turn risk off and constrain increases in the USD/JPY.

Chart: US VIX Index and Emerging Market CDS



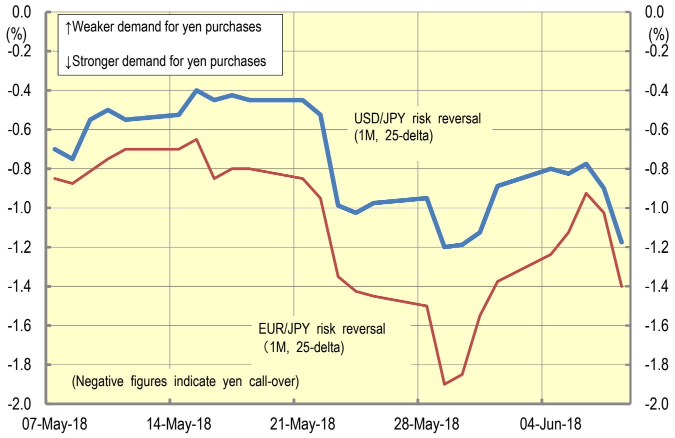
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



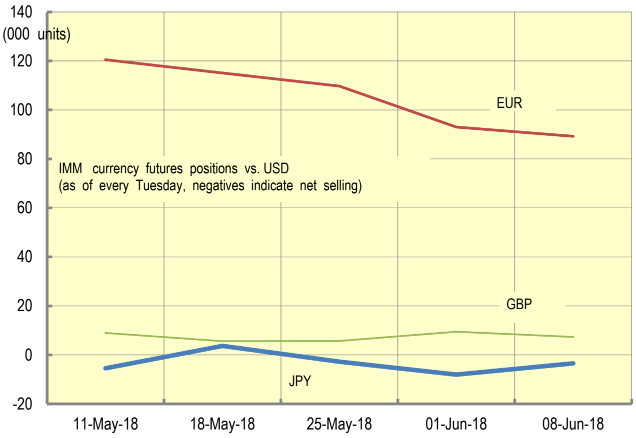
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

The USD/JPY will probably decline if the US announces a list of Chinese imports subject to punitive tariffs

US share prices, interest rates, and the USD/JPY declined after the FOMC released its statement on March 21, primarily because concern over a US-China trade war loomed larger than the FOMC statement and outlook of Fed officials. The US government had initially announced that it would impose (by May 22) punitive tariffs on as much as $60 billion worth of goods from China, and it did so on the 22nd (the USD/JPY later rebounded when the US and China indicated a willingness to discuss). The US government has said it will announce a list of Chinese products subject to punitive tariffs by June 15, and such an announcement is possible after the FOMC statement is issued on June 13. China has proposed increasing its imports of agricultural products and energy from the US as long as the US does not impose said tariffs on China, but it is unclear how the US will respond. If the US does announce a list of Chinese products subject to punitive tariffs, the USD/JPY will probably decline.

May US retail sales are a source of volatility in the USD/JPY

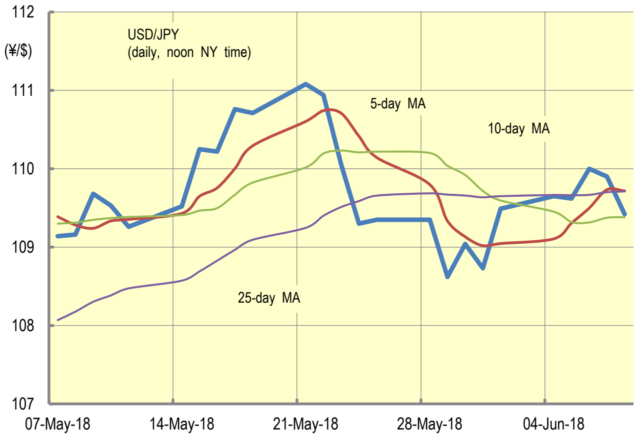
May US retail sales are a source of volatility in the USD/JPY

The May retail sales data for the US is set to be released on June 14. Retail sales grew faster than expected in March, at +0.7% m/m, and in April, at +0.2%, leading to increases in US long-term rates and the USD/JPY. As the boost from rising disposable incomes brought by tax cuts and tax refunds gradually wear off, however, it is questionable whether retail sales can reach the market's forecast of +0.4% growth. New auto sales in the US increased to a seasonally adjusted annual rate of 17.48 million in March, then declined to 17.17 million in April and 16.91 million in May. We doubt this decline in the demand to purchase automobiles is only because of high gasoline prices. Given that the trend in durable goods consumption often reflects individuals' propensity to consume, a weakening of US retail sales is also possible. US retail sales data are probably one source of volatility in the USD/JPY.

Noteworthy currency: EUR

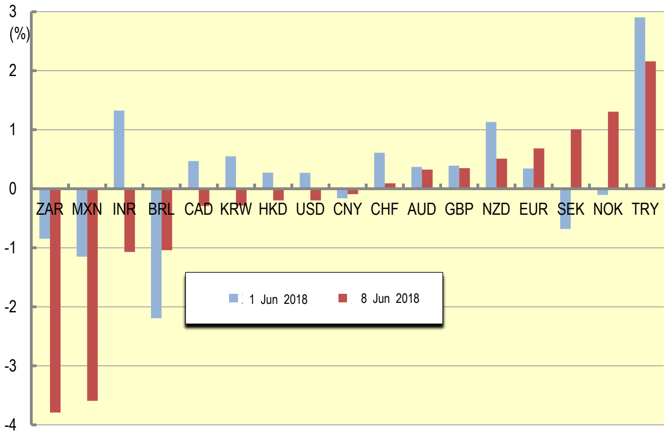
The ECB will discuss its asset purchase program on June 14, at its Governing Council meeting. Although another extension of the program until December and then ending of it is basically a done deal, most market participants had expected it to delay that decision until July because of the economic slowdown and political turmoil in Italy. However, ECB executive board member Peter Praet, who exerts powerful influence on the Governing Council, thinks there is strong evidence that the economic slowdown is temporary and wage growth is accelerating. This means there is an increased likelihood of the ECB's Governing Council becoming bullish on the economy. We think the ECB, wanting to avoid a replay of the Fed's taper tantrum and with an eye on the low German yields and weak euro of late, has become more likely to make its decision to extend and end QE in June. A June decision would mean a stronger euro, but because the decision, if delayed, has become more likely to be made in July, the resulting decline in the euro may be only temporary.

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-Jun		June German ZEW Indicator of Economic Sentiment
		May US CPI
13-Jun		May US PPI
14-Jun	○	FOMC statement (Fed chair Powell's press conference)
		May China industrial production, retail sales
	○	ECB president (President Draghi's press conference)
		May US retail sales,US import and export price indexes
15-Jun		May China 70 cities housing prices
		May European new car sales
	○	BOJ MPM (Governor Kuroda's press conference)
		Jun NY Fed's Empire State Manufacturing Index
		Jun US University of Michigan's Consumer Sentiment Index

Source; Compiled by Daiwa Securities.
Notes: Dates based on JST. ○ indicates monetary policy-related events.

Chart: Weekly Forex Forecasts, Noteworthy Currencies/factors

	4 - 8 Jun 2018 (actual)		11 - 15 Jun 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	109.1-110.3	109.5	108.2-110.5	108.8
EUR/JPY	127.5-130.3	128.9	127.3-129.8	128.0
EUR/USD	1.165-1.184	1.177	1.167-1.187	1.177

Noteworthy Currencies and factors

EUR	If ECB decides to end QE, EUR would strengthen; even if decision is delayed, depreciation would be temporary
CAD	US-Canada trade friction may cause currency depreciation
BRL	Brazilian central bank's stance of currency intervention would slow pace of currency depreciation

Source; Compiled by Daiwa Securities.

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).

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[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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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

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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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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)

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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

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May 2018

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.

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