Forex Market View

Will US administration shift emphasis to a weak dollar policy?

- Tariff dispute weakens US trade but does not shrink the trade deficit
- Will US ramp up trade pressure on Japan, which is unlikely to retaliate?
- Risk of USD/JPY declining on US administration's weak dollar policy

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

21 Jun – 20 Jul: Y107.0-111.0/$ (Y110.13/$ as of 20 Jun)

Forex Market View DSFE155

FICC Research Dept.

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

Daiwa Securities Co. Ltd.

Tariff dispute weakens US trade but does not shrink the trade deficit

Concern that US-China trade war will result in tit-for-tat retaliation

There are growing concerns that the US-China trade war will result in tit-for-tat retaliation. In response to the US announcing it would impose a 25% import tariff on Chinese products totaling $50 billion (with the first wave of that being import tariffs assessed against $34 billion worth of goods effective July 6), China announced it would retaliate by imposing a 25% tariff on $50 billion worth of US products. US president Donald Trump warned that if China raises tariffs again, the US would impose additional tariffs on Chinese goods worth $200 billion, and that if China retaliates with measures of its own, the US would impose additional tariffs on another $200 billion worth of products. Irrespective of how serious the US president is, if the US and China do not try to find a compromise in trade talks, they may wind up locked in an escalating battle of tariffs, even if incremental. Trade friction involving the US has already begun having adverse economic impacts in Germany, a major exporter, and just the existence of concerns about US-China trade friction worsening is likely to amplify negative impacts on the global economy, including by suppressing business investment.

Raising import tariffs has significant negative impacts on the US economy

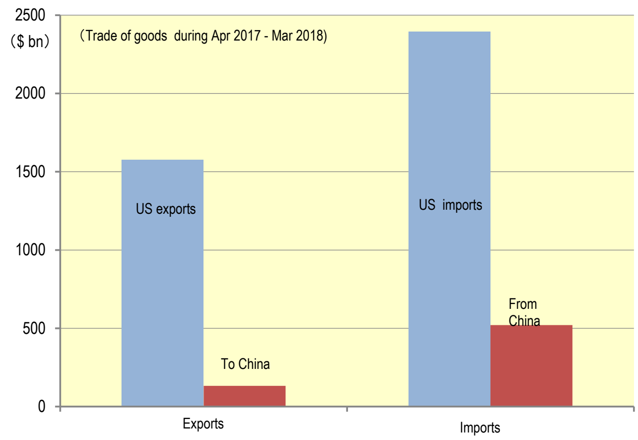
The US administration is curtailing investment in the US by Chinese companies and raising tariffs on the import of Chinese products while demanding that China open its market's, increase exports, improve its trade practices and protect intellectual property, probably because it wants to gain the support of voters, prevent China from gaining a technological edge, and shrink the US trade deficit while increasing domestic production. Nevertheless, if the US deems China's response to its demands on trade as insufficient and raises import tariffs, then even if it does succeed in slowing improvement in China's technological capabilities, it will amplify the negative impacts on the US economy and increase the risk of losing the support of voters.

Chart: US Trade Balance of Goods by Partner Nation ($ bn)

	2015	2016	2017
China	-367.6	-347.3	-375.9
Mexico	-66.6	-69.9	-76.1
Japan	-71.3	-70.4	-70.0
Germany	-75.4	-65.2	-64.1
Italy	-28.2	-28.7	-31.7
India	-23.4	-24.4	-23.0
Canada	-21.2	-16.4	-22.7
South Korea	-28.0	-27.4	-22.6
Taiwan	-14.6	-12.7	-16.2
France	-18.2	-15.7	-15.5
(Reference)			
EU	-157.4	-148.1	-152.6
Total trade balance of goods	-745.5	-736.6	-795.7

Source: US Department of Commerce; compiled by Daiwa Securities.

Chart: Size of US Imports and Exports



Source: Thomson Reuters; compiled by Daiwa Securities.

Tariff dispute weakens US trade but does not shrink the trade deficit

Furthermore, it is likely that try as it may, the US may be unable to reduce its trade deficit with China, the main reason for growth in the US trade deficit overall. This is because if the US slaps tariffs on imports from China and China slaps tariffs on imports from the US, the US will see a weakening of both its exports and imports. From April 2017 until March 2018, the US imported $520 billion worth of goods from China, but its exports to China were about one fourth of that at $130 billion. If China retaliates for the US tariffs on China by imposing tariffs on US products on a similar scale, the impact from tariffs on US exports will be about four times as large as the impact from import tariffs. Because the US would suffer considerable negative impacts on its exports if they became subject to retaliatory tariffs, we do not think the Trump administration would be able to significantly expand the scope of its tariffs. (For example, tariffs on $50 billion worth of goods would affect 38% of US exports totaling $130 billion, but 10% of US imports (from China) totaling $520 billion. (For example, tariffs on $100 billion worth of goods would affect 76% of US exports totaling $130 billion, but 19% of US imports (from China) totaling $5,200 billion. If tariffs were expanded to encompass $200 billion goods, it would be more than the amount of US exports, and thus it is possible that China can achieve the same tariff impact by applying a higher tariff rate on US products than the US applies on Chinese products.)

Will US ramp up trade pressure on Japan, which is unlikely to retaliate?

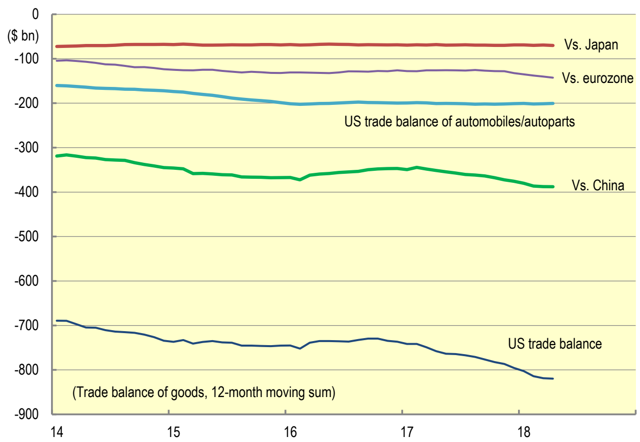
It should be difficult for the US to raise tariffs on automobiles

We think the expansion of tariffs on auto imports being considered by the US is probably unrealistic, as are the tariffs on Chinese imports. The US annual trade deficit in autos and auto components is about $200 billion (exports of $160 billion vs. imports of $360 billion), more than half of the size of the $390 billion US trade deficit with China and a likely US target for reduction. If the US raises its auto tariffs, however, it is very likely that the EU would retaliate with tariffs of similar scope. Because there is a significant risk of the economy worsening from both US exports and US imports weakening but the US trade deficit not getting any smaller, we think an increase in auto tariffs is unlikely.

Will US ramp up trade pressure on Japan, which is unlikely to retaliate?

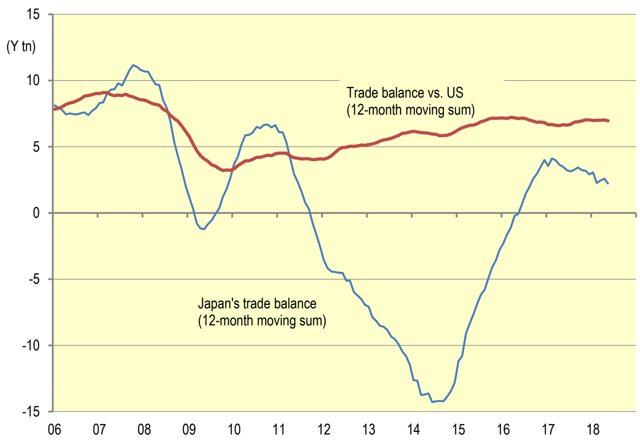
What will the US administration do if it determines that it needs to reduce the trade deficit but that it will be difficult to apply tariffs on Chinese products and on automobiles? One option would be to ramp up trade pressure on trading partners that look unlikely to implement retaliatory measures. Japan's trade surplus with the US has been stable, and in recent years has been larger than Japan's overall trade surplus. Furthermore, the US probably thinks that its ally Japan would be unlikely to impose retaliatory measures in response to US trade policy. In bilateral trade negotiations with Japan, the US has demanded that Japan increase imports and constrain exports to help narrow its trade deficit with the US. Automobiles account for the largest share of Japan's exports to the US (30.6% in FY17), followed by auto parts (6.3%), and it is possible that the US will have to shift its focus away from exports to the US, primarily of autos and auto parts, and toward US production. Nevertheless, Japan's response to US trade demands may not be adequate.

Chart: US Trade Balance



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Japan's Trade Balance and Balance vs. US



Source: Thomson Reuters; compiled by Daiwa Securities.

Risk of USD/JPY declining on US administration's weak dollar policy

US may demand that Japan correct the weak yen

There is a possibility that the US will demand that Japan correct the weak yen. Comparing the 20-year average real effective exchange rates of the major currencies, the dollar is slightly above its average and the euro slightly below, while the yen's is more than 20% below average. In other words, the yen is notably cheaper than the dollar and the euro. The US Department of the Treasury pointed out the yen's weakness in its Semiannual Report on International Economic and Exchange Rate Policies. Furthermore, possibly because the yen's real effective exchange rate has not risen much since bottoming in 2015, Japan's real trade balance, which excludes price changes, is trending upward. Even if the US demands that Japan correct the yen's weakness based on the yen being too weak, with its real trade balance in an improving trend, it would probably difficult for Japan to argue against US demands.

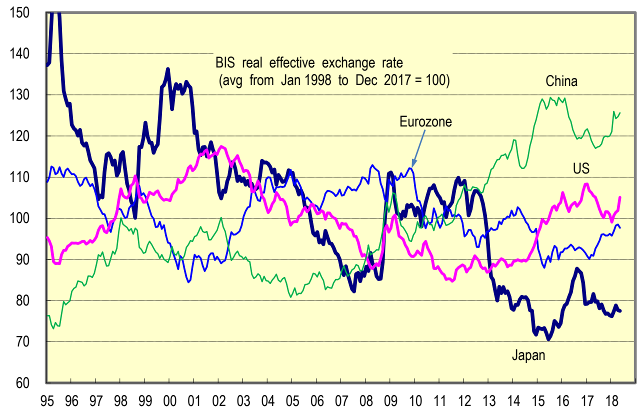
A correction of yen weakness alone may be insufficient to shrink the US trade deficit

When the US and Korea agreed on the broad outlines of its renegotiated free-trade agreement, a supplementary document was added to prevent Korea from engaging in the competitive devaluation of its currency. Although it used a supplementary document that is nonbinding and not subject to sanctions, it appears that the US was able to get Korea to agree to refrain from devaluing its currency. It is conceivable that in its trade negotiations with Japan, the US will likewise demand that Japan prevent the yen from weakening or that it corrects the yen's weakness. Although Japan may comply with US demands to expand its imports and invest more in the US, it will probably be harder for it to reduce exports or correct yen weakness. Furthermore, it is doubtful that the US thinks correcting the yen's weakness would by itself be sufficient to reduce the US trade deficit.

Risk of USD/JPY declining on US administration's weak dollar policy

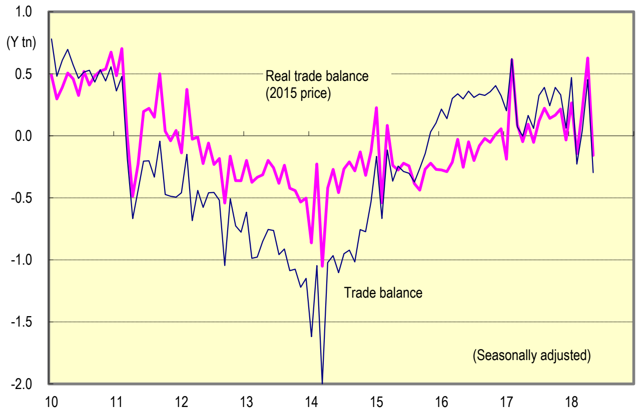
If trade negotiations get bogged down because of the imposition of tariffs and if emerging concerns over a US economic slowdown cause share prices to weaken, the Trump administration may shift its focus away from protectionist trade policies aimed at shrinking the US trade deficit and toward an FX policy. At any rate, the administration is more likely to opt for a weak dollar policy, which has little negative economic impacts and is unlikely to be criticized by voters, than for import tariffs, which are likely to be criticized by voters concerned over the negative economic impacts. The dollar's effective exchange rate is currently rising as a result of risk-off dollar appreciation, but there's a risk of the dollar weakening on statements from the US president or Treasury Secretary that welcome a weak dollar (or express concern over a strong dollar). Together with a risk-off strengthening of the yen, this bears close watching as a factor that could push the USD/JPY lower.

Chart: Real Effective Exchange Rate of Major Currencies



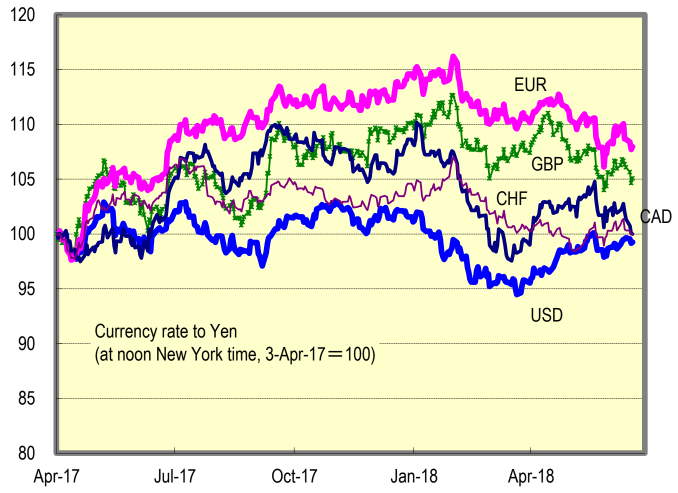
Source: BIS; compiled by Daiwa Securities.

Chart: Japan's Trade Balance and Real Trade Balance



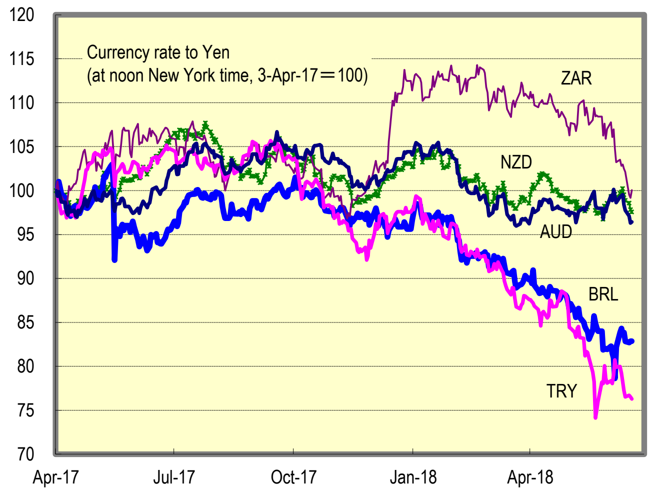
Source: Thomson Reuters; compiled by Daiwa Securities.

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	23.5	23.0	25.0	24.5	25.5
			22-28	21-26	21-26	22-27	23-28
ZAR-JPY	9.1	9.0	8.3	8.1	8.7	8.6	8.8
			8.1-9.1	7.8-8.8	7.8-8.8	8.1-9.1	8.3-9.3
BRL-JPY	34.0	32.1	29.0	28.0	30.5	30.5	31.0
			27-33	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.

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.

■ The Significance of Registration

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)

Assumptions, Significance and Limitations of Credit Ratings

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.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("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

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

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.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moodys.com/pages/default_ja.aspx)

[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)

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 "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.co.jp/web/)

May 2018

Daiwa Securities

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.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association