Daiwa Securities

Forex Market Weekly

Will there be no US economic slowdown even with trade friction?

- Stronger dollar on weakening pound and declining oil prices; weaker yen on risk-on moves
- China's pushing back on the US could lead to risk-off yen strengthening
- Is US business sentiment peaking out?

This week's USD/JPY forecast range

16 - 20 Jul: Y111.0 – 113.0/$ (Y112.4 at end-previous week)

Forex Market View DSFE162
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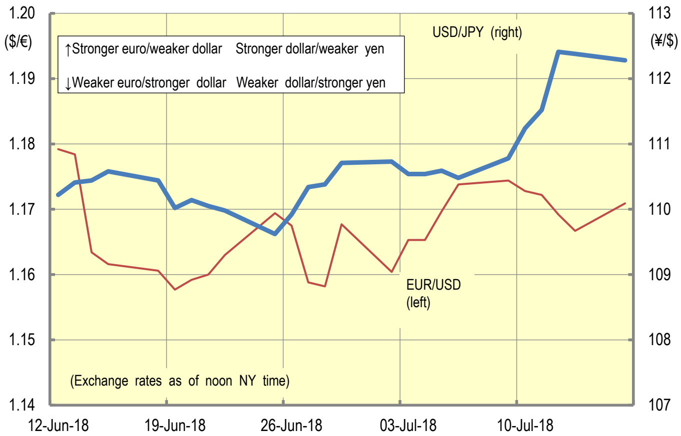
Stronger dollar on weakening pound and declining oil prices; weaker yen on risk-on moves

Overview of last week's forex market

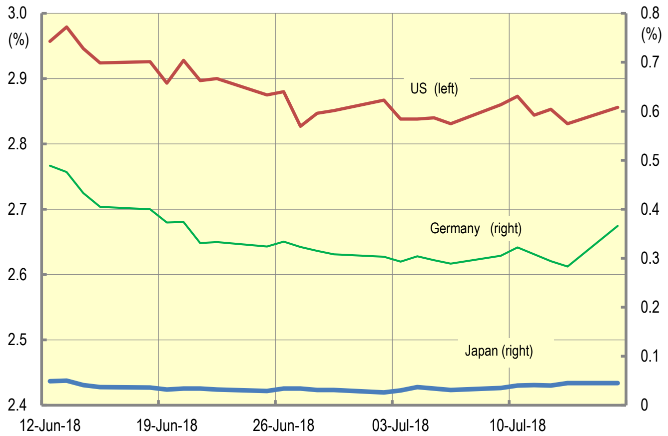
The USD/JPY declined a bit last Friday after the US imposed tariffs on $34 billion worth of Chinese goods, but the USD/JPY remained firm amid a rising trend in the major stock markets. The UK's Brexit Secretary David Davis resigned to protest Prime Minister Theresa May's proposed "soft" Brexit (creating a free trade area in goods with the EU and maintaining common rules), arguing it would weaken the UK's position, while Foreign Minister Boris Johnson (who like Davis is for a "hard" Brexit) resigned for the same reason, and concerns over the direction of Brexit sent the pound sharply lower. The euro was also sold, the dollar was bought, and the USD/JPY rose. Market moves included a risk-on strengthening of share prices and weakening of the yen. On July 10 (July 11 Japan time), the US government announced a new list of $200 billion worth of Chinese products subject to additional tariffs, and this led to a risk-off weakening of share prices and strengthening of the yen, but both markets reversed direction soon afterward. News that oil production and exports would recover on the reopening of a major port in Libya caused oil prices to decline sharply and sent the dollar higher, above a USD/JPY of 112. The major stock markets remained strong, possible because concerns over US-China trade friction are minor, and the USD/JPY rose to 112.80.

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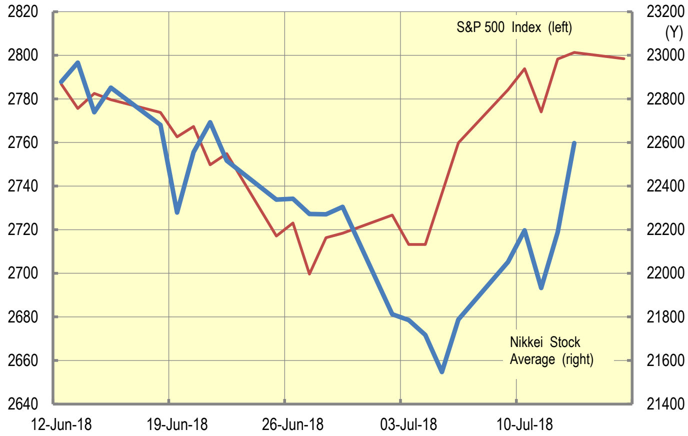
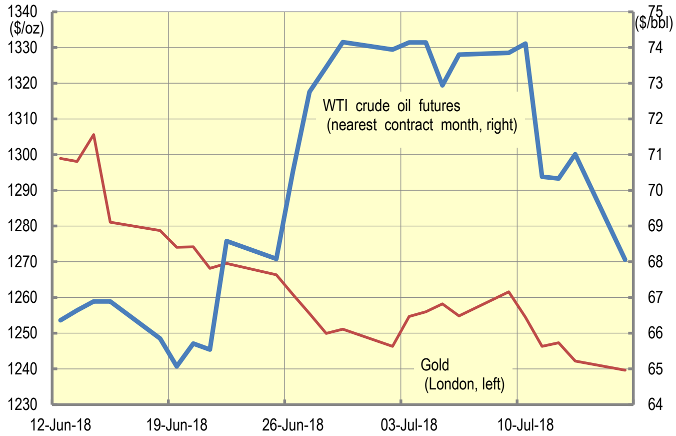
Chart: Stock Market: US S&P 500, Nikkei Stock Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



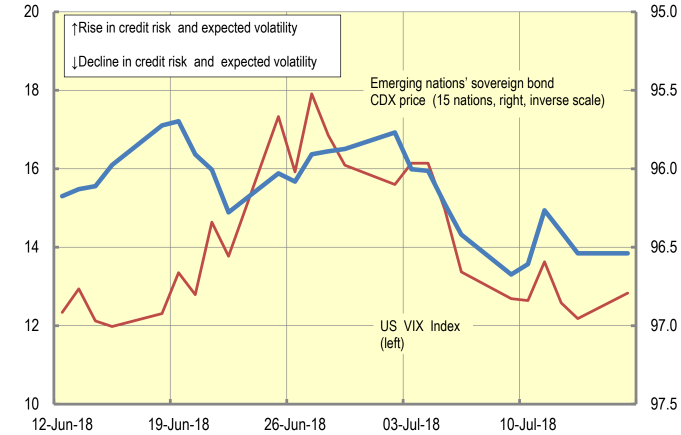
Source: Thomson Reuters; compiled by Daiwa Securities.

China's pushing back on the US could lead to risk-off yen strengthening

China's pushing back on the US could lead to risk-off yen strengthening

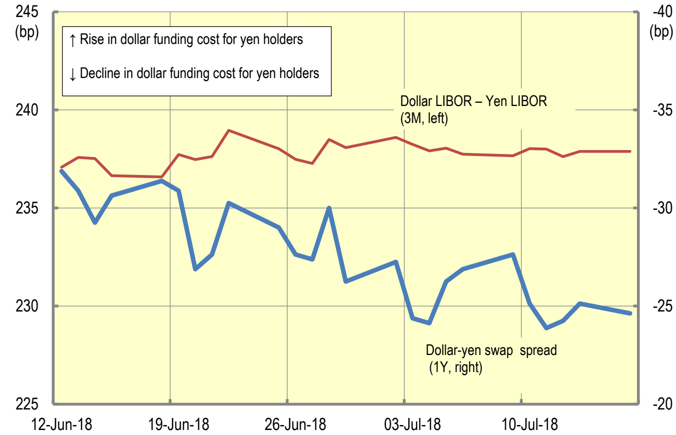
The US Trade Representative (USTR) announced a list of Chinese goods, valued at around $200 billion, that it would impose an additional 10% tariff on. According to US trade statistics, China imported about $130 billion of US product (and exported about $500 billion to the US), which means China cannot retaliate by imposing additional tariffs on $200 billion worth of US goods, so if it pushes back from both the quantitative and qualitative angles, it is conceivable that it could impose retaliatory tariffs higher than 10%. While China characterized US tariffs as bullying and said guns must be laid down in order to talk, the US responded that it was prepared to reopen trade negotiations if China instituted major reforms. The key is how China responds to the US. If it opens its markets and institutes policies for the protection of intellectual property to avoid the additional US tariffs, the market will probably lean toward a risk-on weakening of the yen.

Chart: US VIX Index and Emerging Market CDS



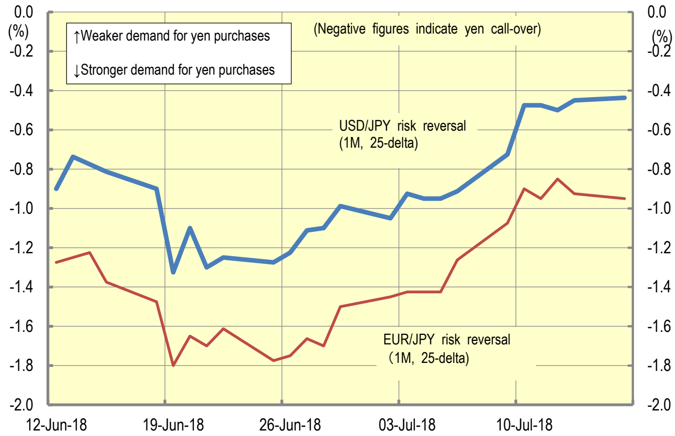
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



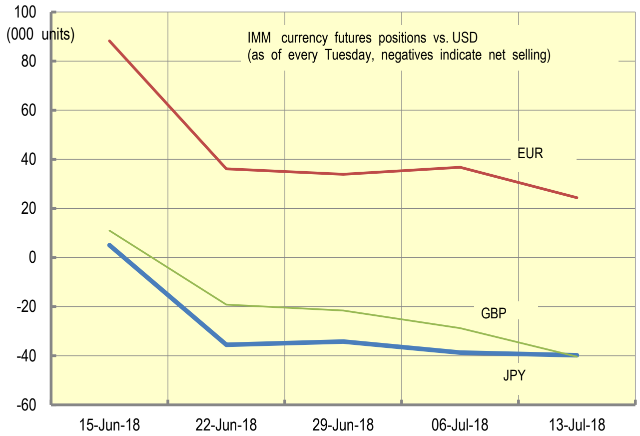
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

In contrast, if it hardens its stance against the US by replacing it with other countries as a destination for its exports, boycotting US products, providing support to Chinese companies damaged by the US tariffs, and weakening the yuan, the risk of the US imposing tariffs will increase and cause the market to lean toward risk-off yen appreciation. China imposed a retaliatory tariffs of 25% on soybeans from the US, but it is already greatly reducing its imports of US-made soybeans and increasing its imports of soybeans from Brazil and other countries in South America. Additionally, China's foreign currency reserves increased in June relative to May, an indication that its monetary authorities have been making less effort to intervene to keep the yuan from depreciating by buying yuan and selling dollars. China's State Administration of Foreign Exchange (SAFE) has noted the need to hedge against the risk of major swings in the yuan's value, and this may be notice of its setting the stage for devaluing the yuan. China is probably hesitant to rapidly implement major reforms, and it makes sense that it has become less trustful of the US, which is reneging on their trade negotiations. China's priority is to retaliate against the US tariffs while mitigating their adverse impact. This has gradually strengthened (concerns over) US-China trade friction and may push the market toward risk-off yen appreciation.

Is US business sentiment peaking out?

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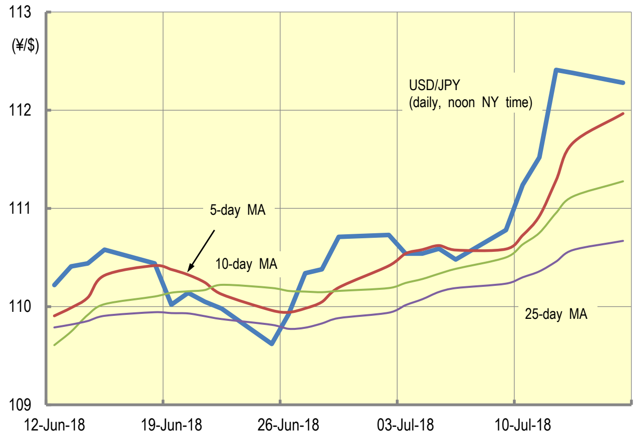
We think the USD/JPY is rising despite this US-China trade friction because the prevailing view (based on rising US share prices) is that the negative impacts will not be large enough to cause the US economy to slow. Because global markets have not gone risk-off to the point of declining share prices, cross-yen rates are also firm. Whether the USD/JPY continues rising will depend on US economic indicators. US retail sales for May were revised upward, but core sales have been weak, rising 0.8% in May and staying flat in June. The US consumer sentiment index and the New York Fed's manufacturing sentiment, new orders, shipments, and outstanding orders indices were all lower in July than they were in June. The data will be watched closely to determine whether US business sentiment is peaking out.

Noteworthy currency: GBP

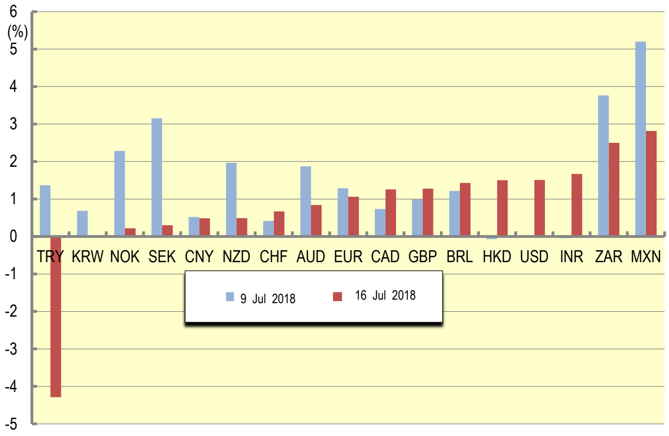
In the UK, amid squabbles within the government over Brexit, the March-May unemployment rate will be announced on July 17, the June CPI on the 18th, and June retail sales on the 19th. If the unemployment rate comes in below expectations, it will point to the possibility of wages increasing faster than the Bank of England expects. Although the CPI is expected to gain momentum in a reflection of rising energy prices, the core CPI is forecast to be flat. If either unemployment declines or the CPI rises, it should raise rate-hike expectations at the BoE's policy meeting on August 2, and would probably strengthen the pound. In addition, although retail sales growth is expected to slow in m/m terms, it is still expected to be strong following a strong month in May. This could possibly be reason for a rate hike.

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

17-Jul		Jun China 70 cities housing prices
		Jun new car sales in Europe
		Jun US industrial production, capacity utilization rate
18-Jul		Jun US housing starts
19-Jul		Jun Japan trade statistics (MOF)
		Jun UK retail sales
		Jul Philadelphia Fed's Business Outlook Survey Index
	○	MPM at South African central bank
20-Jul		May eurozone balance of payment
21-Jul	●	G20 Finance Ministers and Central Bank Governors meeting (until 22th)

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

Chart: Weekly Forex Forecasts, Noteworthy Currencies/factors

	9 - 13 Jul 2018 (actual)		16 - 20 Jul 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	110.3-112.8	112.4	111.0-113.0	112.0
EUR/JPY	129.5-131.6	131.3	129.8-132.3	131.0
EUR/USD	1.161-1.179	1.169	1.160-1.180	1.170

Noteworthy currencies and factors

GBP	Results of UK important indicators may raise expectations for Aug rate hike
AUD	Lower commodity prices and concerns about slowdown of Chinese economy would weaken the currency

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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■ 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")
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)

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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

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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
Type II Financial Instruments Firms Association