Daiwa Securities

Forex Market View

Is a period of yen appreciation coming soon?

- US stocks are the most overvalued they have been in recent years
- Worsening US sentiment could spark a risk-off yen strengthening
- Yen may strengthen to a USD/JPY of 105

<u>**USD/JPY forecast range (latest: noon New York time)**</u>

9 Aug – 7 Sep: Y107.5-112.5/$ (Y110.94/$ as of 8 Aug)

Forex Market View DSFE169

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Daiwa Securities Co. Ltd.

US stocks are the most overvalued they have been in recent years

Conditions affecting exchange rates are unstable

Although the USD/JPY has been trading in a narrow range around 111, conditions affecting exchange rates could hardly be viewed as stable, and we think there is a growing risk of yen appreciation, including in yen cross rates. This is because US stocks, which have been in a rising trend, are vulnerable to a decline, and risk-off pressures on the market are likely to strengthen.

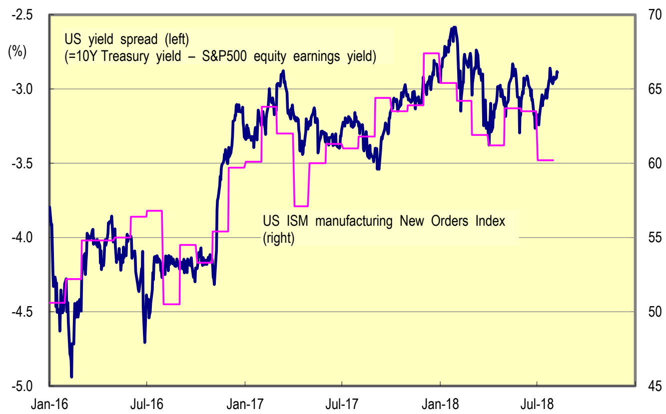
US stocks are the most overvalued they have been in recent years

One indicator of whether share prices are over- or undervalued based on their arbitrage relationship with interest rates is the yield spread (= long-term rate - equity earnings yield), and the rise in the US yield spread (10-year Treasury yield - S&P 500 earnings yield) indicates that share prices are becoming more overvalued. The yield spread based on the 12-month forward EPS forecast for S&P 500 companies (a weighted-average of current and next fiscal-year EPS estimates) was -2.8% as of August 8. That spread had hit similar levels in Jan-Mar and May this year and is not at its highest in recent years. US business sentiment weakened going into July, however, and the US ISM manufacturing new orders index came in at 60.2 in July, below April's 61.2 and its lowest this year. A rise in the yield spread despite weakening business sentiment indicates stocks are becoming more overvalued, and in that sense US stocks are more overvalued now than they have been. The yield spread also rose amid worsening US business sentiment in January and March, but in both of those episodes share prices declined significantly soon thereafter.

Risk of US share prices falling and the yen strengthening is high

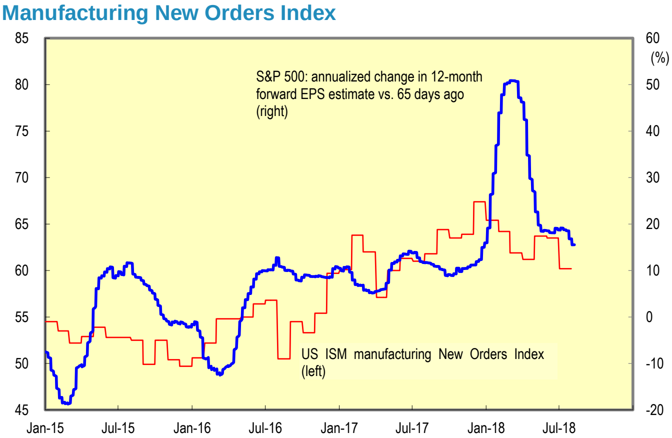
Furthermore, the forecast for US corporate earnings growth (the 65-day change in the 12-month forward EPS forecast) rose significantly in Jan-Mar as the market priced in benefits from the tax cut, but they later retreated, and then declined further, following the worsening of sentiment in July. Based on this, we think there is a growing risk of US stocks turning downward amid a risk-off strengthening of the yen.

Chart: US Yield Spread and Manufacturing New Orders Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Estimated US Corporate Profit Growth Rate and Manufacturing New Orders Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Worsening US sentiment could spark a risk-off yen strengthening

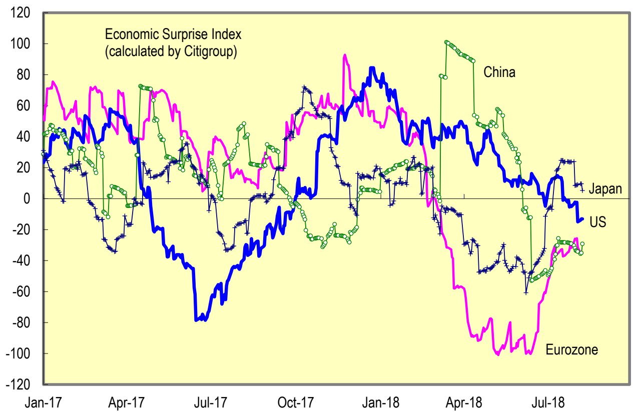
US economic data likely to weaken further on impacts from dollar appreciation

In what direction is US business sentiment likely to head moving forward? The Economic Surprise Index (ESI), a measure of results vs. market forecasts for US economic data, has been in negative territory recently. On top of the large gap between market forecasts and the actual data, the economic indicators coming in below market forecasts are now the majority. The US ESI tends to move in the opposite direction of the dollar's effective exchange rate with a lag of about three months, and that trend has largely held recently, as well. Judging from this, the US ESI is prone to a declining trend because of negative impacts from dollar appreciation, and we think likely to stay in negative territory for at least the next three months.

Worsening US sentiment could lead to yen appreciation from risk-off moves and a narrowing of the Japan/overseas interest rate differential

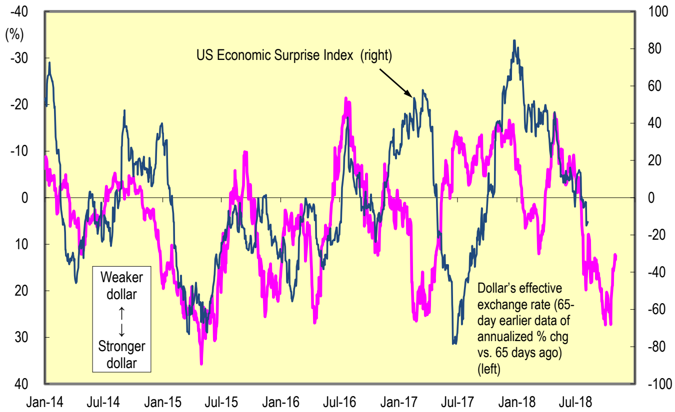
Considering the economy's slowing trend, share price levels are already quite overvalued from the perspective of their arbitrage relationship with US long-term rates, and if US economic data falls below market expectations and causes sentiment to worsen further, both share prices and long-term yields are likely to decline. Furthermore, the ESIs of both the euro zone and China are also in negative territory, while Japan's is just barely positive. This sets the stage for a worsening of sentiment and decline in share prices and long-term rates worldwide. In other words, a risk-off preference is emerging in the market while the long-term interest rate differential that Japan has with overseas is narrowing, and this is increasing the probability of yen appreciation, against the dollar and other currencies.

Chart: Economic Surprise Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Dollar's Effective Exchange Rate and US Economic Surprise Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Yen may strengthen to a USD/JPY of 105

Yen could strengthen to a USD/JPY of nearly 105

When US share prices were falling in Jan-Feb and Mar-Apr this year, the S&P 500 stock index declined about 5-7%, and when US long-term rates were declining in Mar-Apr, the 10-year JGB yield declined as much as 0.2ppt. Next, we use regression analysis to consider the extent to which the USD/JPY could decline in the event that there is an equivalent decline in US share prices and yields. The USD/JPY tends to move in reaction to the Japan-US interest rate differential and the level of risk tolerance, and a regression using the 10-year Treasury yield (or the Japan-US 10-year government bond yield spread) and the percentage change in the S&P 500 index has very strong explanatory power. In 2018, however, the USD/JPY was often about Y6-12 (about Y9 on average) below its estimated value. This could be attributed to protectionist US trade and exchange rate policies causing exchange rates to deviate in the direction of a weaker dollar. If that is true, we think about the same degree of deviation is likely to hold unless the US changes its policies. If the 25-day change in the S&P 500 index is -6% and the 10-year Treasury yield declines about 0.2ppt to 2.8%, the USD/JPY's estimated value would be 115.3, and a Y9 downside deviation from that would be 106.3. If the market suddenly turns risk off and interest rates start declining, there is a good chance of the USD/JPY declining to nearly 105.

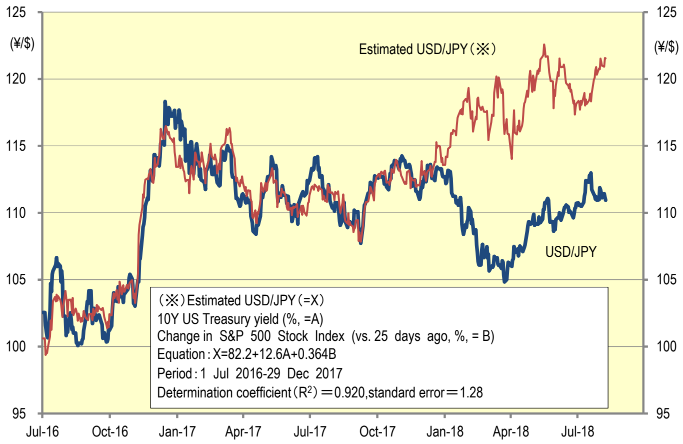
Depending on US sentiment, there is a risk of USD/JPY dropping below 105

If the S&P 500 index declines 6% and the 10-year Treasury yield drops to 2.8%, the yield spread would be about 0.5-0.6ppt lower than it is now. If US business sentiment, which affects the market's growth expectations, stays where it was in July or even gradually worsens, the yield spread would probably be unlikely to decline to a sufficiently low level for share prices to no longer look overvalued. If the yield spread declines about 1ppt amid a gradual worsening of US business sentiment, it would be down to its level of 2016, but this may not be sufficient for share prices to no longer look overvalued. For example, if the S&P 500 index declines 10% and the 10-year Treasury yield drops to 2.6%, the yield spread would be about 1ppt lower than it is now. The estimated value of the USD/JPY in that case is 111.3, and a Y9 downward deviation from that is 102.3. When also taking estimation errors into account, there is a possibility that the risk-off mood will lose momentum and the yen will stop appreciating before the USD/JPY declines to that level, but there is a risk of it falling below 105.

Is a period of yen appreciation coming soon?

The Trump administration announced that (in round 2) it would impose an additional 25% tariff on $16 billion worth of Chinese products on August 23, and China announced it would impose retaliatory tariffs of similar size on the same day. There is still a risk of the US imposing (in round 3) additional tariffs on $200 billion worth of Chinese products from September, and amid rising concerns over a US-China trade war, there is a rising probability that the emergence of concerns over a US economic slowdown will spread unease over the global economy. This would make it more likely that the market's risk-off preference would lead to a strengthening of the yen, led by yen cross rates, and we think the USD/JPY may be getting closer to a period of yen appreciation in which it declines to around 105 over a period of several months.

Chart: USD/JPY (estimate and actual)



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY Matrix with Variables of US Long-term Rate and Change in Stock Price

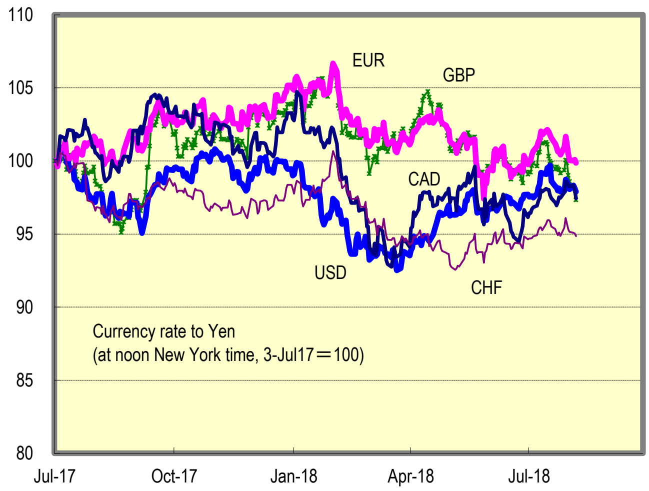
	10-year US Treasury yield (%)								
	2.4	2.5	2.6	2.7	2.8	2.9	3.0	3.1	3.2
10	116.1	117.3	118.6	119.8	121.1	122.4	123.6	124.9	126.1
8	115.3	116.6	117.9	119.1	120.4	121.6	122.9	124.1	125.4
6	114.6	115.9	117.1	118.4	119.6	120.9	122.2	123.4	124.7
4	113.9	115.1	116.4	117.7	118.9	120.2	121.4	122.7	123.9
2	113.2	114.4	115.7	116.9	118.2	119.4	120.7	122.0	123.2
0	112.4	113.7	114.9	116.2	117.5	118.7	120.0	121.2	122.5
-2	111.7	113.0	114.2	115.5	116.7	118.0	119.2	120.5	121.8
-4	111.0	112.2	113.5	114.7	116.0	117.3	118.5	119.8	121.0
-6	110.2	111.5	112.8	114.0	115.3	116.5	117.8	119.0	120.3
-8	109.5	110.8	112.0	113.3	114.5	115.8	117.1	118.3	119.6
-10	108.8	110.0	111.3	112.6	113.8	115.1	116.3	117.6	118.9
-12	108.1	109.3	110.6	111.8	113.1	114.3	115.6	116.9	118.1
-14	107.3	108.6	109.8	111.1	112.4	113.6	114.9	116.1	117.4

Source: Daiwa Securities

Notes: (1) Calculated by assigning 10Y US Treasury yield and change in US stock price to regression formula for USD/JPY.

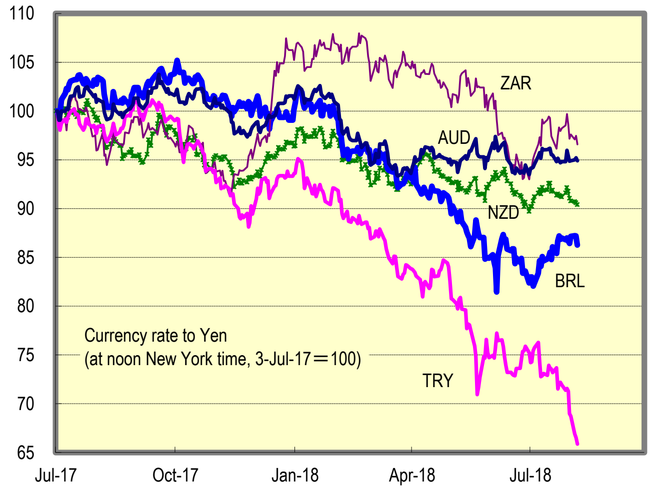
(2) Vertical axis shows change in S&P 500 Stock Index (vs. 25 days ago, %).

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 30 Mar 2018	29 Jun 2018	Forecast Jul-Sep 2018	Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019
USD-JPY	106.2	110.7	107.0	108.0	109.0	110.0	109.0
			104-113	103-112	104-113	105-114	105-114
EUR-JPY	130.8	129.3	123.0	127.5	130.0	132.0	131.0
			121-132	121-132	124-135	126-137	126-137
AUD-JPY	81.7	81.9	77.0	80.0	82.0	84.0	83.0
			75-84	75-84	77-86	79-88	79-88
CAD-JPY	82.4	84.3	80.0	82.0	83.5	85.0	84.0
			78-87	78-87	79-88	80-89	80-89
NZD-JPY	76.9	74.9	71.0	73.5	75.5	77.0	76.5
			69-78	69-78	71-80	72-81	72-81
TRY-JPY	26.8	24.1	20.5	21.5	22.5	23.0	23.0
			19-25	19-24	20-25	21-26	21-26
ZAR-JPY	9.0	8.1	7.7	8.1	8.4	8.7	8.6
			7.5-8.7	7.5-8.7	7.8-9.0	8.0-9.2	8.0-9.2
BRL-JPY	32.1	28.6	27.5	30.0	31.5	32.5	32.0
			26-31	26-32	28-33	29-34	29-34
KRW-JPY	10.0	9.9	9.3	9.6	9.7	9.9	9.8
(100 KRW)			9.1-10.2	9.1-10.2	9.3-10.4	9.4-10.5	9.4-10.5
CNY-JPY	16.9	16.7	15.5	16.1	16.5	16.9	16.8
			15.0-17.0	15.0-16.5	15.5-17.0	15.8-17.3	15.8-17.3

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).

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■ 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")
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[Moody's]

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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