Forex Market View

Risk of US administration breaking its silence on yen weakness

- US tariffs on Chinese imports to have significantly adverse impact on China
- US may demand a correction of yen weakness to cut its deficit with Japan
- Rising risk of the Trump administration expressing concern over yen weakness

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

21 Sep – 19 Oct Y108.5-113.5/$ (Y112.57/$ as of 20 Sep)

Forex Market View DSFE179

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Risk-on yen appreciation despite outlook for US imposing tariffs on China

Ahead of the September 25-26 FOMC meeting and a near-certain rate hike, US long-term rates are poised to rise. Because this meeting looms in the context of strong economic data, including in the US jobs report and ISM indices, both US long-term rates and the USD/JPY have climbed higher. The Trump administration announced that it would impose an additional 10% tariff on about $200 billion of Chinese goods effective September 24, and despite China taking retaliatory measures, there has been a risk-on strengthening of share prices and weakening of the yen in the cross-yen market.

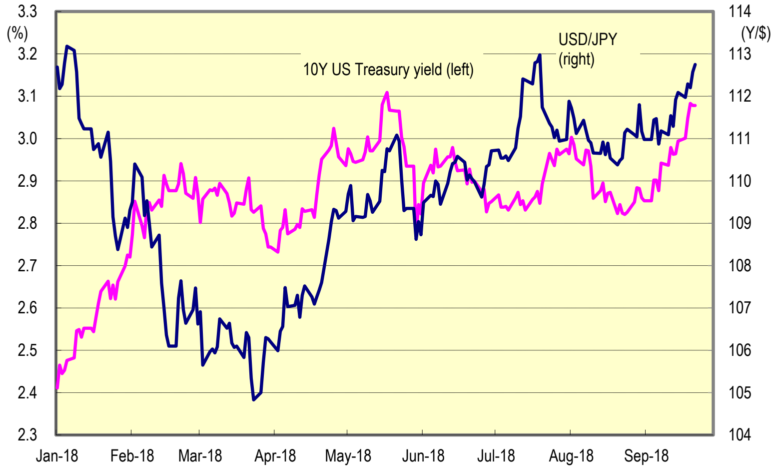
US-China expected to resume trade talks and avoid tariff hikes

President Trump had originally said he would impose an additional 25% tariff on $200 billion of Chinese goods, but later softened that and said he would initially hold the initial increase to 10% and not raise the tariff to 25% until 2019. This may have ameliorated the impacts, although markets did turn slightly risk-off. The US also said it was always ready to engage in dialogue with China over trade, and China, while noting that the additional tariffs imposed by the US have cast fresh uncertainty over their bilateral negotiations, did not reject the offer of talks. Because there is still a possibility that the US and China will resume their trade talks, there may still be expectations of those talks leading to a compromise by end-2018 that makes it possible for the US to not raise those tariffs to 25%.

Negative impacts on US from China's retaliatory tariffs expected to be small

Furthermore, China had announced retaliatory tariffs on $60 billion of US goods based on raising tariffs to 5%, 10%, 20%, and 25%, but has since changed that to raising them for now to only 5% and 10%. The scope of US goods subject to China's retaliatory tariffs is not the same as the additional tariffs that the US is imposing on China but rather less than one third, and the additional tariffs rates are either the same or lower. The view that the negative impacts on US exports to China from China's retaliatory tariffs will be less than initially thought and less than the retaliatory tariffs it has imposed thus far (25% on $50 billion of US goods) may have pushed the market in a risk-on direction.

Chart: US Long-term Interest Rate and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

US tariffs on Chinese imports to have significantly adverse impact on China

Nevertheless, although these developments may have moderated risk-off pressures and temporarily pushed markets toward risk-on, the pressures toward risk-on are unlikely to be sustained. The additional US tariffs on $200 billion of Chinese goods, although only at a 10% rate, are of a greater scale than the additional 25% tariffs on $50 billion worth of Chinese goods that the US had already imposed. The negative impacts from the additional tariffs will be small on the US but significant on China. Although Chinese stocks rebounded, partly on expectations of growth in government investment, the Chinese government has stated that it needs to curtail its debt, and that although it will promote effective investments it will not rely on investments aimed at boosting growth. Risk-on yen depreciation may peak as optimism over the Chinese economy fades in reaction to the slowdown in its economic indicators.

US may demand a correction of yen weakness to cut its deficit with Japan

Correcting the US-China trade imbalance with tariffs may be impossible

The US strategy of using additional tariffs to press China into reforming its systems and practices, including by providing intellectual property protection, halting subsidies to corporations, and opening its markets, may be aimed not only at enabling the US to keep its dominant position in technology but also at correcting the US-China trade imbalance. Nevertheless, although slapping tariffs on Chinese goods will reduce US imports from China, if China imposes retaliatory tariffs, US exports to China will also suffer. Because the US imports much more from China than it exports to China, an equivalent percentage?? decline in both imports and exports would reduce the US trade deficit with China, but if that leads to a weaker yuan and stronger dollar, it is possible that exports will be reduced more than imports and thus the trade deficit will not decline. In fact, the yuan's USD exchange rate declined by about 9% from its peak in March 2018 until September, and there is a reasonable likelihood that US tariffs on Chinese goods will not lead to a correction of the US-China trade imbalance.

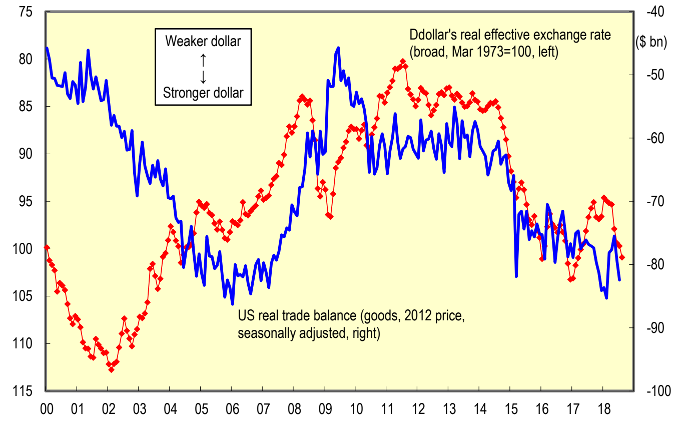
US may pursue dollar devaluation to cut its trade deficit

The US trade deficit is in a rising trend. One reason for this is that US domestic demand is stronger than external demand, making it more likely that imports will grow faster than exports. Another likely cause is the strength of the dollar. There is a correlation between the US real trade balance and the dollar's real effective exchange rate: the US real trade balance has been worsening (the trade deficit has been growing) since the dollar began its pronounced strengthening trend in 2H 2014. Thus far, the Trump administration has been saying that a weak dollar gives the US an advantage in trade and a strong dollar puts it at a disadvantage. If the Trump administration is trying to reduce the US trade deficit, tariff policy will probably prove insufficient and it may pursue a policy of devaluing the dollar.

US may demand a correction of yen weakness to cut its deficit with Japan

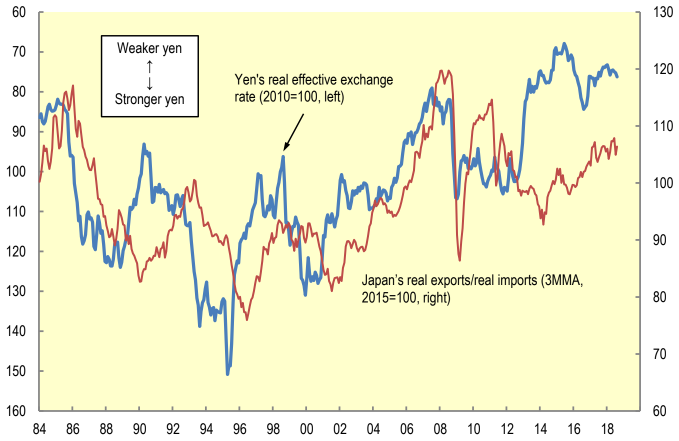
A second round of Japan-US trade talks are set to begin on September 25, and the US is likely to blame the lack of decline in its trade deficit with Japan on Japan's tariff and nontariff barriers but also on the weakness of the yen. The yen's real effective exchange rate has weakened considerably since 2013, and Japan's real exports, a measure that corrects for price fluctuations, have grown more than its real imports. The yen's real effective exchange rate has strengthened since mid-2015, but not by much, while there has been no clear change in the improving trend in Japan's real trade balance.

Chart: Dollar's Real Effective Exchange Rate and US Real Trade Balance



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Yen's Real Effective Exchange Rate and Ratio of Japan's Real Exports to Real Imports



Source: Thomson Reuters; compiled by Daiwa Securities.

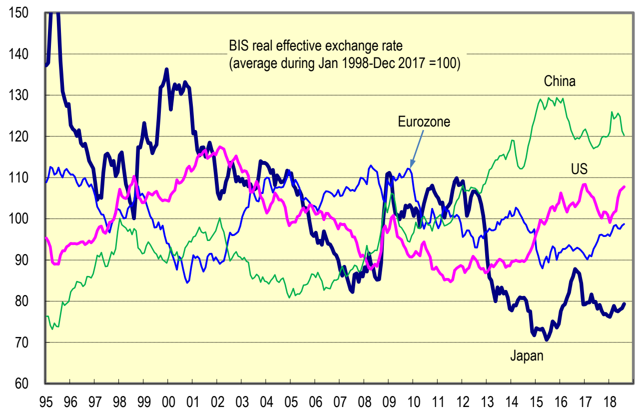
Assuming that Japan does not have much room to accommodate US demands that it expand its imports of agricultural and energy products from the US or that it replace some of its exports of autos, which account for the majority of Japan's roughly Y7 trillion annual trade surplus with the US, with US production, there is a possibility that the US will ask Japan to restrict the volume of its auto exports (by imposing an additional tariff on excess amounts) and reverse the yen's weakening.

Rising risk of the Trump administration expressing concern over yen weakness

Rising risk of the Trump administration expressing concern over yen weakness

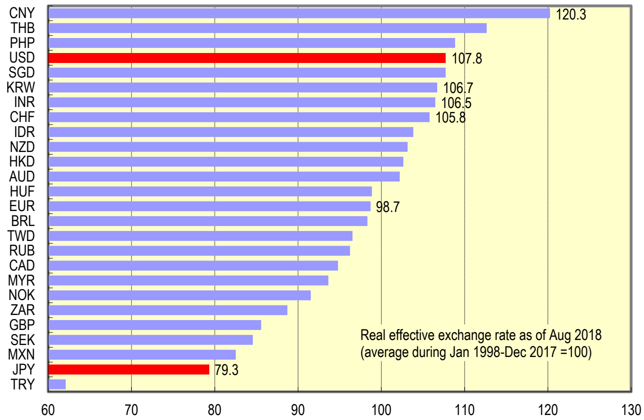
In July this year, the Trump administration criticized China, the EU, and other countries for manipulating their currencies. Based on real effective exchange rates (REER), in 2018 the dollar strengthened, the yuan weakened, and there was not much movement in either the euro or the yen. The dollar's REER is approaching the recent-year peak that it reached in January 2017, and the Trump administration's concerns about the strong dollar may be rising. In its Semiannual Report on International Economic and Exchange Rate Policies dated April 2018, the US Treasury Department noted that the yen's REER is almost 25% weaker than its 20-year average, and the yen's value has not changed much since that report came out. Based on the REER figures announced by the Bank for International Settlements (BIS), in August the yen was 21% below its average over the 20-year period from 1998 until 2017, the euro was 1% below, and the dollar was 8% above. Only three of the 27 major currencies—the Chinese yuan, the Thai baht, and the Philippine peso—have appreciated more relative to their 20-year average REER than the US dollar has, while only two currencies—the Argentine peso and the Turkish lira—have depreciated more than the yen. Based on where exchange rates are now, the brunt of US concerns over the strong dollar are likely to be aimed not only at China and the EU but also Japan. We think there is now a higher risk than before of the Trump administration expressing concern over yen weakness and pushing for a stronger yen.

Chart: Real Effective Exchange Rate in Major Nations



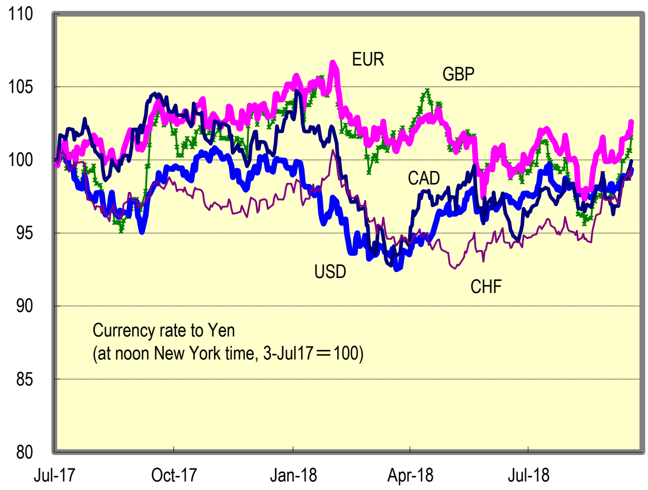
Source: BIS; compiled by Daiwa Securities.

Chart: Comparison of Real Effective Exchange Rate vs. Average over Past 20 Years



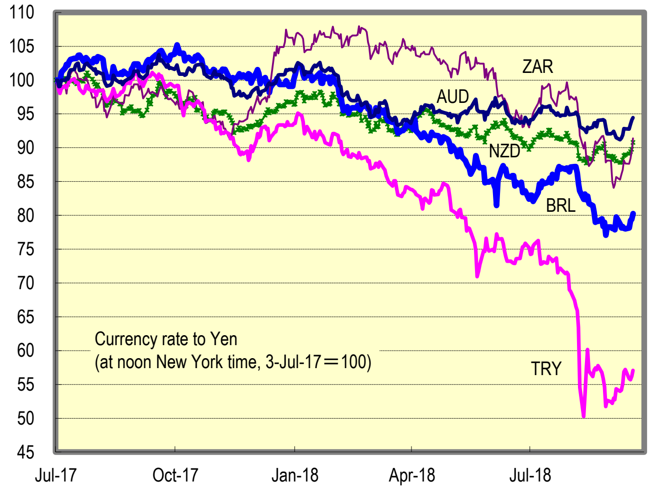
Source: BIS; compiled by Daiwa Securities.

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				
	30 Mar 2018	29 Jun 2018	Jul-Sep 2018	Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019
USD-JPY	106.2	110.7	111.0	110.0	108.0	110.0	109.0
			109-114	107-114	105-113	105-113	105-113
EUR-JPY	130.8	129.3	129.0	130.0	126.5	131.0	129.0
			124-132	124-134	123-134	123-134	123-134
AUD-JPY	81.7	81.9	79.0	80.5	78.0	81.5	79.5
			78-84	77-84	76-85	76-85	76-85
CAD-JPY	82.4	84.3	85.0	85.5	83.0	86.0	84.5
			83-88	82-89	81-90	81-90	81-90
NZD-JPY	76.9	74.9	72.5	74.0	71.5	75.0	73.0
			71-77	70-77	69-77	69-77	69-77
TRY-JPY	26.8	24.1	17.1	18.3	17.4	19.0	18.2
			15-25	15-21	15-21	15-21	15-21
ZAR-JPY	9.0	8.1	7.2	7.5	7.2	7.6	7.4
			7.0-8.6	6.8-7.8	6.8-8.0	6.8-8.0	6.8-8.0
BRL-JPY	32.1	28.6	26.5	27.5	26.5	28.5	27.5
			25-31	24-30	24-30	24-30	24-30
KRW-JPY	10.0	9.9	9.8	9.9	9.7	10.0	9.8
(100 KRW)			9.6-10.2	9.4-10.2	9.3-10.3	9.3-10.3	9.3-10.3
CNY-JPY	16.9	16.7	16.1	16.4	15.9	16.7	16.3
			15.8-17.0	15.3-16.8	15.5-17.0	15.5-17.0	15.5-17.0

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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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.
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■ Credit Rating Agencies

[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.

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