Forex Market Weekly

Rising long-term rates sparks weaker share prices, yen strengthens

- USD/JPY rose on improving US economic data, but retreated on drop in US share prices
- Global share price weakening sparked by rising long-term rates, yen strengthens
- Rising US interest rates brings downside vulnerability to share prices

This week's USD/JPY forecast range

8 - 12 Oct: Y112.0 – 114.0/$ (Y113.7 at end-previous week)

Forex Market View DSFE184
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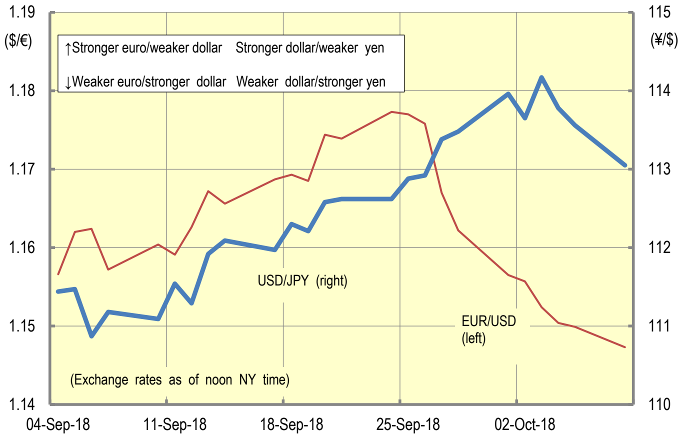
USD/JPY rose on improving US economic data, but retreated on drop in US share prices

Overview of last week's forex market

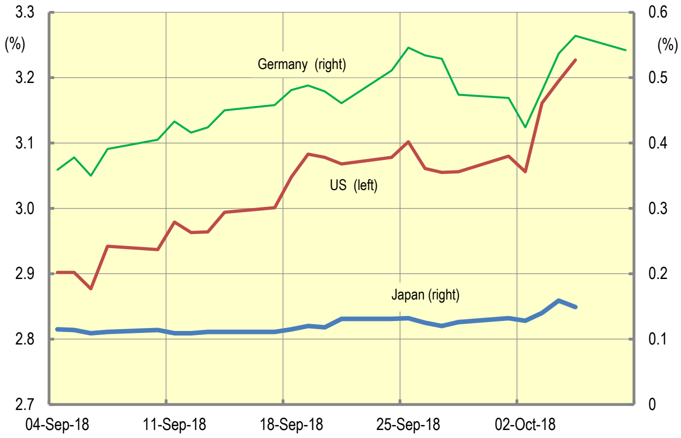
US and Canada reach agreement in their NAFTA renegotiations on the US-imposed September 30 deadline, and the US, Mexico, and Canada will sign the new trade agreement, USMCA, at end-November. The Canadian dollar strengthened, but a risk-on yen weakening pushed USD/JPY up to 114. Markets turned risk off on news that a Chinese warship approached unusually close during a freedom of navigation operation conducted by a US Aegis destroyer aimed at pushing back at China's excessive claims to maritime rights in the South China Sea. A powerful legislator in Italy's League party commented that Italy could solve most of its problems by adopting its own currency, sparking concerns about Italy leaving the euro zone and a sell-off of Italian government bonds, weakening the euro and strengthening the yen. Italy's Prime Minister squashed concerns that it would leave the euro, and a government official released plans to reduce the government deficit in 2020 and 2021, stopping the sell-off of Italian government bonds. When the September ISM nonmanufacturing index rose more than expected, US interest rates rose and the dollar strengthened. The Fed chairman commented that rates could be raised above the neutral rate, sending the USD/JPY to as high as 114.55, but then the yen strengthened on reports of China hacking US IT companies and on the decline in share prices in response to rising US interest rates. Although interest rates rose on the US jobs data, declining share prices pushed the USD/JPY lower.

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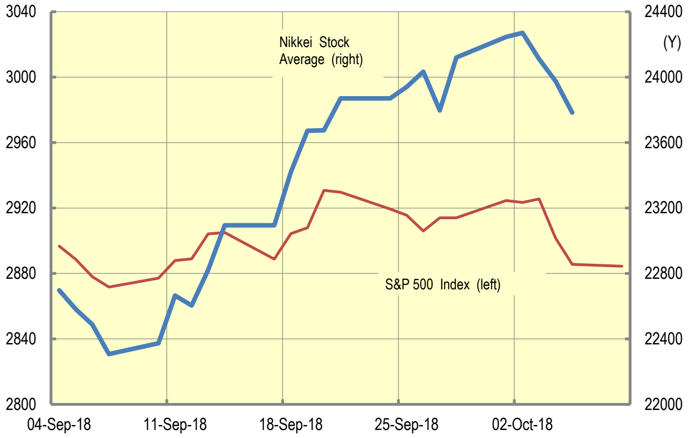
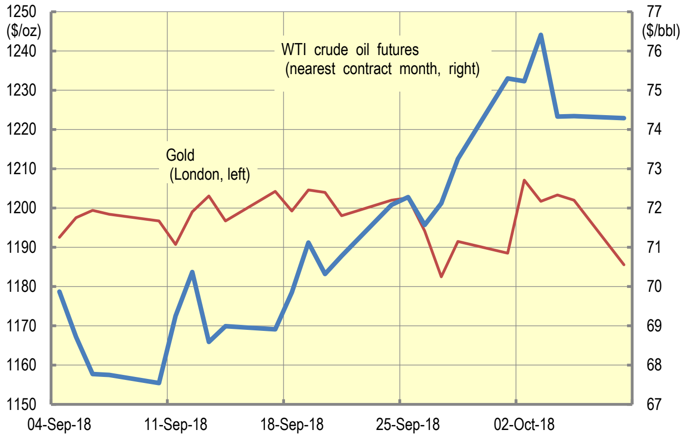
Chart: Stock Market: US S&P 500, Nikkei Stock Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



Source: Thomson Reuters; compiled by Daiwa Securities.

Global share price weakening sparked by rising long-term rates, yen strengthens

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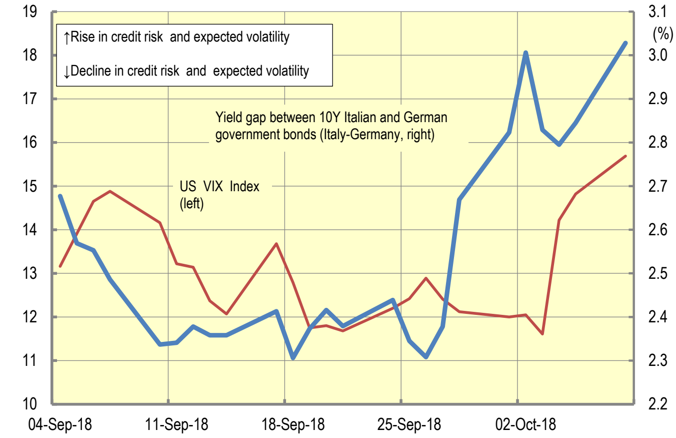
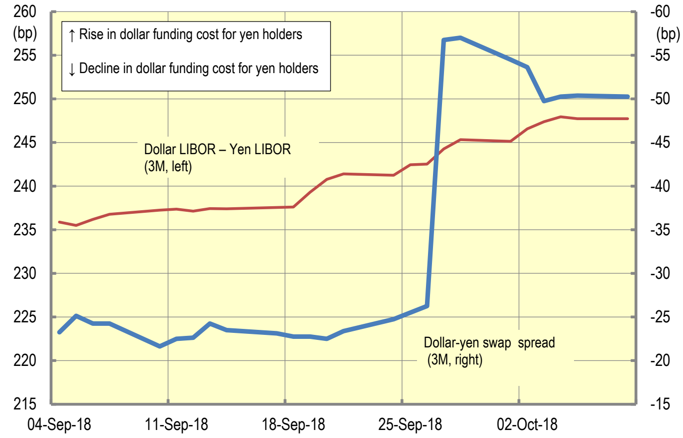
The rise in long-term rates in the US is spreading worldwide. It is not a problem when interest rates rise at a time of improving sentiment, but if they rise when sentiment is peaking as it is now, it tends to spark a weakening of share prices. In Europe, expectations of a Brexit agreement are supporting the pound, while concerns over Italy's government finances are causing credit spreads to widen and share prices to weaken. Stocks have also weakened on rising concerns in China over an economic slowdown caused by its trade friction with the US. If the Chinese authorities respond by not only raising tax rebates (cutting taxes) to support exports but also weakening the yuan, it would probably exacerbate its conflict with the US and also spark a weakening of emerging market currencies, putting markets into risk-off mode. A weakening of share prices globally would probably increase pressures for a risk-off strengthening of the yen.

Chart: US VIX Index and Gap Between Italian and German Long-term Yields



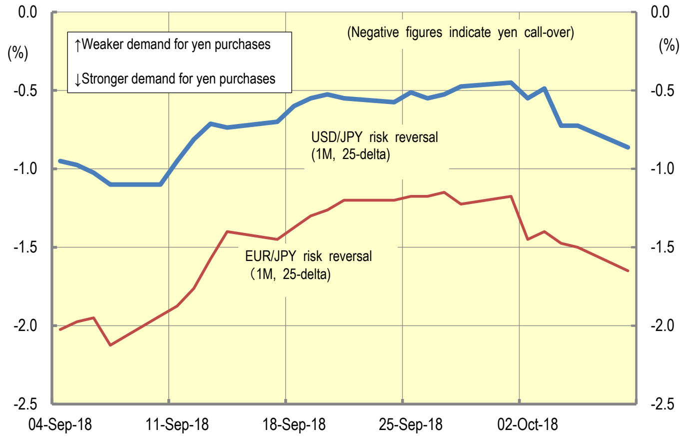
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



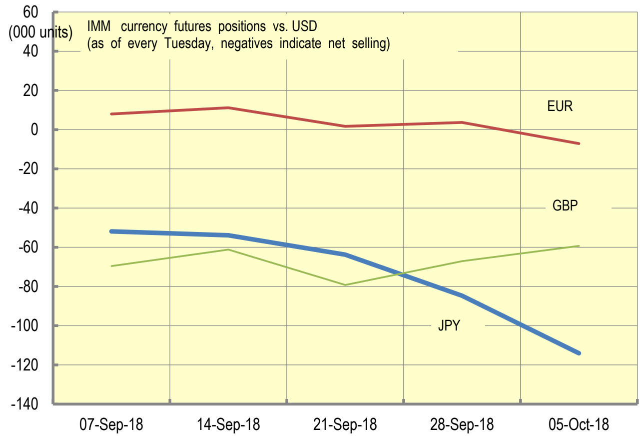
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Rising US interest rates brings downside vulnerability to share prices

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The rise in US long-term rates has widened the yield spread, setting the stage for weaker share prices. The yield spread, the 10-year Treasury yield minus the S&P 500 earnings yield, rose to -2.648% on October 3, the highest it has been since it reached -2.633% on January 31. The day after it peaked at -2.583% on January 26, US share prices turned to a declining trend, then fell sharply in February. Although price-earnings (P/E) ratios are low now compared with then, long-term rates are high, and higher interest rates are making stocks look overvalued. Comparing January with September, the ISM manufacturing PMI was 59.1 vs. 59.8 and the nonmanufacturing NMI was 59.9 vs. 61.6, slightly higher in September for both, but the new orders index, a leading indicator, was 65.4 vs. 61.8 for the PMI and 62.7 vs. 61.6 for the NMI, and thus lower in September. If share prices reflect future growth expectations, they would likely have hit a ceiling before the yield spread reached its peak in January, and that is what the share price decline that began on October 4 suggests. If share prices decline despite rising US long-term rates, the USD/JPY is less likely to increase.

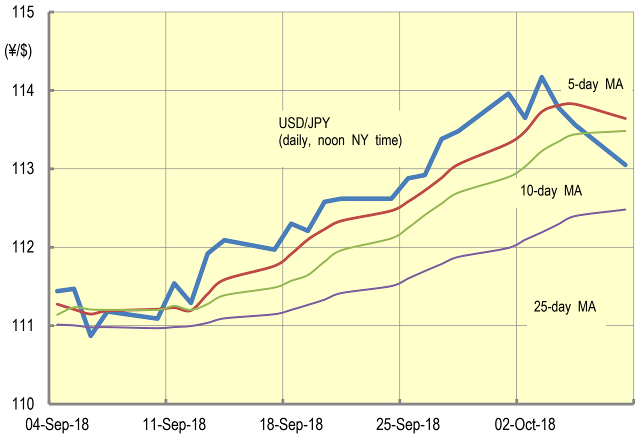
The suspension of US crude oil shipments to China may be one reason for the rise in crude oil inventories

Executives at a leading Chinese shipping company said that all US crude oil shipments to China have been suspended. With the US and China trading sanctions and retaliatory tariffs, those shipments ended abruptly in September. US crude oil inventories increased significantly the last week of September, probably because of declining operating rates at oil refineries and declines in crude oil exports. This was probably because the US reduced its exports to China and India, increasing its crude oil imports from Iran ahead of the sanctions going into effect, reduced its imports from the US. There is a possibility that growing US crude oil inventories, the suspension of US crude oil exports to China (a negative impact on China's economy), and talk of the US providing exemptions from the sanctions on Iranian-produced crude oil will strengthen the yen by causing crude oil prices to fall.

Noteworthy currency: BRL

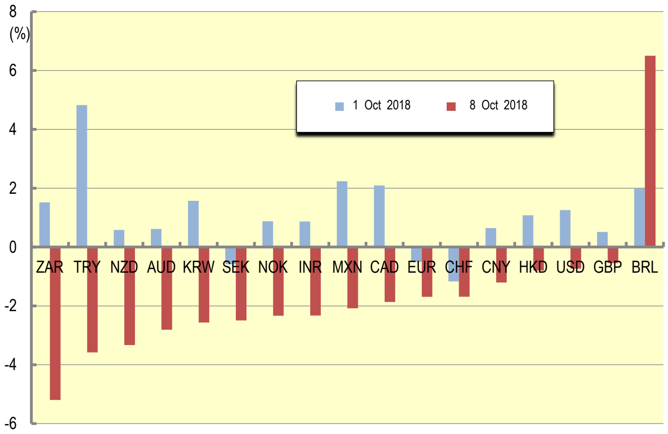
On October 7, the far right candidate Jair Bolsonero won about 46% of the vote in the first round of Brazil's presidential election, well more than the 29% share captured by Fernando Haddad, the left-wing candidate who came in second. The Brazilian real has already appreciated considerably amid growing expectations that Mr. Bolsonero, who appears to support pension reform legislation, will prevail in the runoff election on October 28, but even if he is elected, there is probably not much room for further BRL appreciation in the context of a strengthening USD. The outcome is difficult to predict, given the possibility of voters turning out to vote against Bolsonero, who has made some notably antidemocratic and racist comments. This week, there may be a fading of optimism and steady weakening of the real.

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

8-Oct	●	Annual meetings of World Bank and IMF (until 14th)
9-Oct	●	IMF's press conference on WEO
		Aug German trade statistics
10-Oct	●	IMF's press conference on GFSR
		Sep US PPI
11-Oct		Sep US CPI
	●	G20 Finance Ministers and Central Bank Governors meeting (until 12th)
12-Oct		Sep China trade statistics
		Aug eurozone industrial production
		Oct US University of Michigan's Consumer Sentiment Index (preliminary)
		Trial hearing for American pastor in custody in Turkey
13-Oct	●	IMFC
14-Oct	●	Bavarian congressional election in Germany

Source; Compiled by Daiwa Securities.
Notes: Dates based on JST. ● indicates political events.

Chart: Weekly Forex Forecasts, Noteworthy Currencies/factors

	1 - 5 Oct 2018 (actual)		8 - 12 Oct 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	113.5-114.6	113.7	112.0-114.0	112.8
EUR/JPY	130.6-132.5	131.0	128.7-131.2	129.3
EUR/USD	1.146-1.163	1.152	1.140-1.160	1.147

Noteworthy currencies and factors

BRL	Optimism after first round of presidential election played out; real would weaken gradually
CNY	Chinese authorities likely to induce yuan depreciation to support exports
GBP	Key is whether expectations for Brexit agreement will change ahead of European summit meeting
Currencies in oil-producing nations	Crude oil prices would decline if US lifts sanctions on Iran-produced oil

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.

■ 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)

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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.

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.

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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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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.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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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