

Forex Market Weekly

Forex market is not fully factoring in US midterm elections

- The yen weakened due to expectations for agreements on Brexit and the US-China trade issue
- Euro and yuan weakness caused by deterioration of business sentiment
- If the midterm elections result in a divided Congress, the USD/JPY may decline

This week's USD/JPY forecast range

5 – 9 Nov: Y111.5 – 113.5/\$ (Y113.2 at end-previous week)

Forex Market View DSFE192
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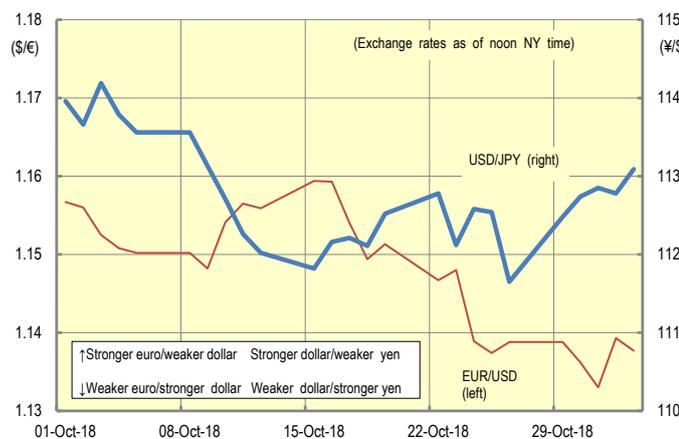


The yen weakened due to expectations for agreements on Brexit and the US-China trade issue

Overview of last week's forex market

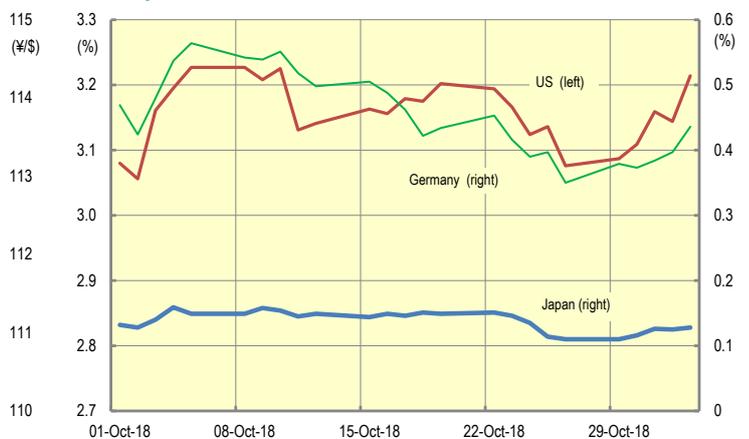
At the beginning of the week, media reports that China was considering a 50% tax cut on car purchases sent overseas interest rates and the USD/JPY rate higher. The US Department of Commerce announced that it had placed restrictions on exports to Chinese semiconductor maker Fujian Jinhua Integrated Circuit Company (JHICC). In addition, the news that the US was planning to impose additional tariffs against China in anticipation of failure to reach an agreement at the upcoming US-China summit meeting led to a decline in the USD/JPY. However, the rate rose once again, reflecting the US president's remark that "I think we'll make a great deal with China." On 31 October, the USD/JPY rose to 113.39 after the ADP nonfarm private sector employment number exceeded the market consensus, but the undershoot of the Chicago Purchasing Manager's Index caused the USD/JPY to retreat. On 1 November, the pound strengthened sharply, reflecting media reports that UK Prime Minister Theresa May reached an agreement with the EU on financial services (the EU's chief negotiator denied the report). Many currencies rose against the dollar and yen on reports that (1) US President Trump had a favorable dialogue with the Chinese president regarding trade and North Korea, and (2) the EU side was considering a concession plan for the Irish border issue. US long-term interest rates and the USD/JPY rate rose as US payrolls increased more than expected, in addition to media reports that President Trump has instructed his staff to start drafting the terms of a trade agreement with China (reportedly, key officials denied that a draft was in process).

Chart: Forex Market: USD/JPY, EUR/USD



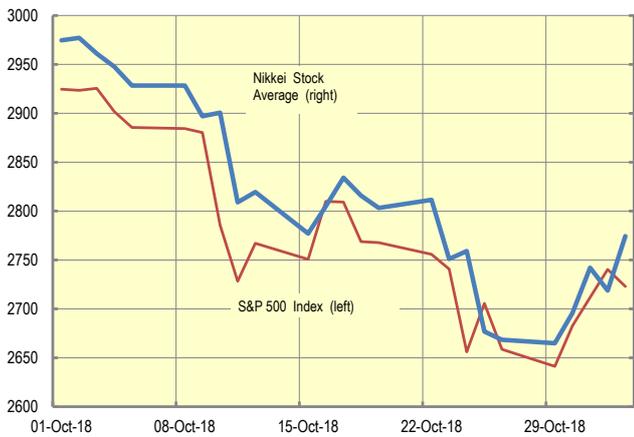
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Bond Market: 10Y Sovereign Bond Yields in Japan, US, and Germany



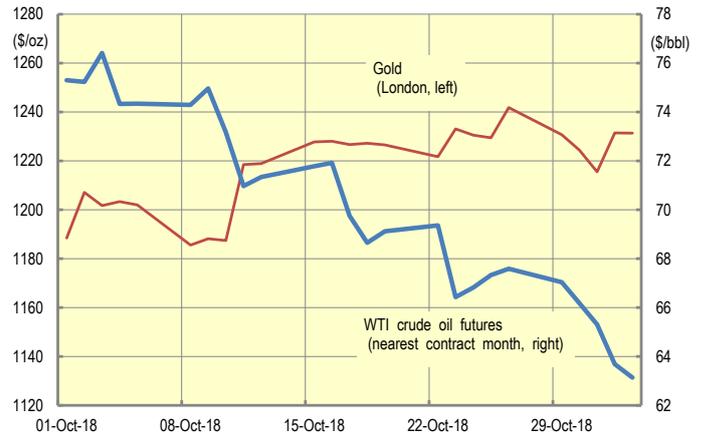
Source: Thomson Reuters; compiled by Daiwa Securities.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



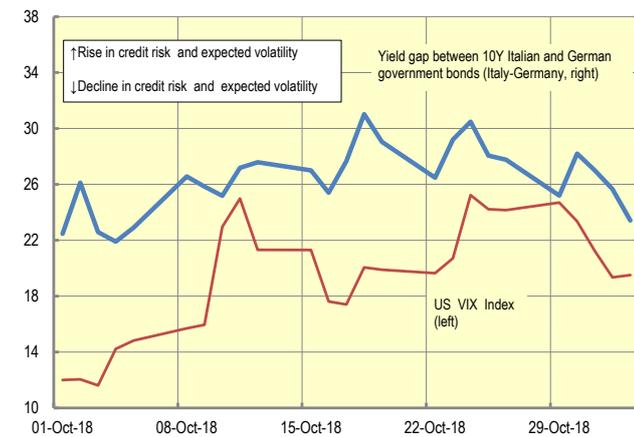
Source: Thomson Reuters; compiled by Daiwa Securities.

Euro and yuan weakness caused by deterioration of business sentiment

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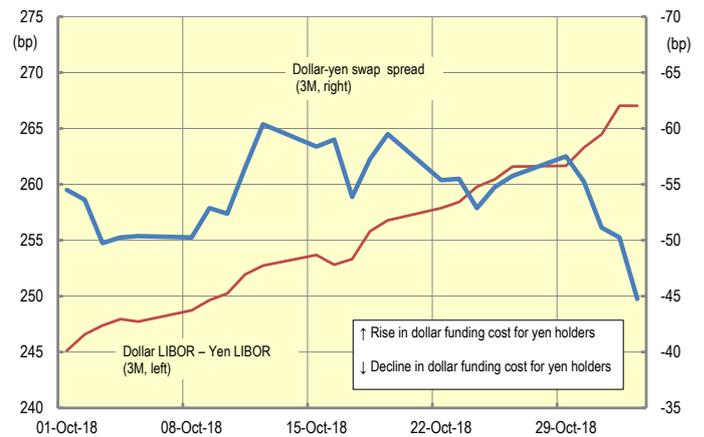
After hitting a high of \$1.255/€ in February, last week the euro declined to \$1.130/€, the lowest level since August. Meanwhile, the yuan traded at 6.976 to the dollar, the lowest level since May 2008. The downtrend for both currencies was caused by the deterioration of business sentiment. The eurozone Economic Sentiment Indicator for October came in at 109.8, its lowest reading since May 2017, posting a decline for the tenth straight month. This was influenced by stricter standards for automobile fuel from September. In addition, the October China manufacturing PMI announced by the National Bureau of Statistics of China declined to 50.2, the lowest level seen since July 2016. Although the Caixin/Markit manufacturing PMI rose by 0.1 m/m to 50.1, new export orders remained sluggish, with lower output and reduced corporate confidence amid rising production costs. We have not seen any signs of clear improvement in the Chinese economy. Due to expectations for the UK-EU Brexit agreement and the US-China trade agreement, the euro and yuan rebounded sharply against the dollar toward the weekend. However, downward pressure is likely to continue in light of economic sentiment.

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



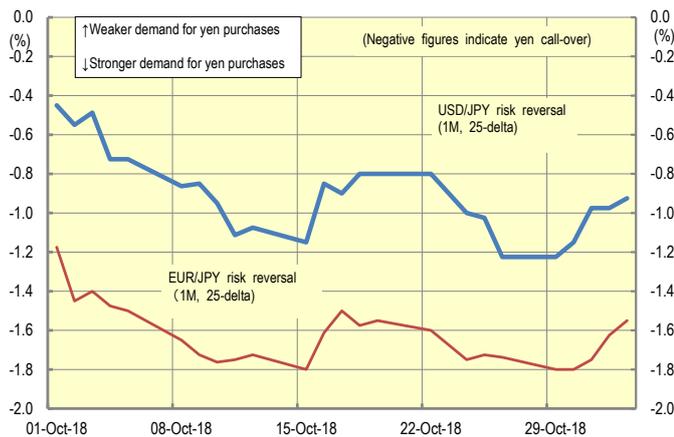
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



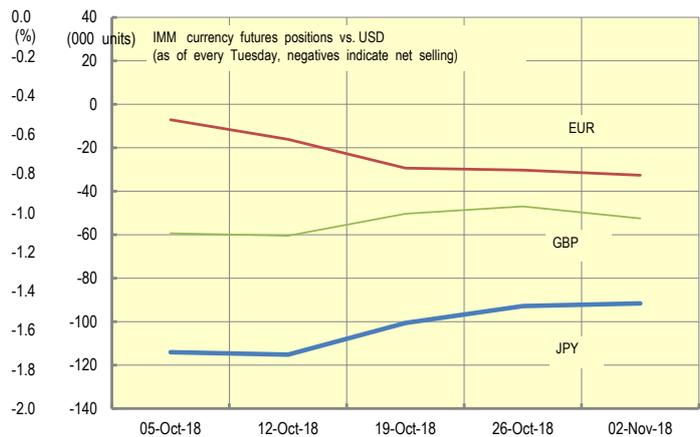
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

If the midterm elections result in a divided Congress, the USD/JPY may decline

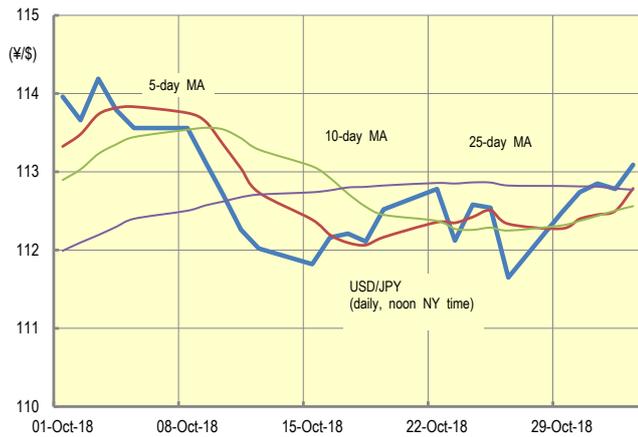
If the midterm elections result in a divided Congress, the USD/JPY may decline

Although opinion polls point to various potential outcomes, according to the Gallup survey, President Trump's job approval rate during the week of 22-28 October declined by 4 points from the previous week to 40%, reminding us of the difficult situation facing the Republican Party. It is highly possible that the Republicans will lose seats and cede control of the House to the Democrats, where every seat is up for reelection. However, we cannot say for sure, given the current situation. In the Senate, of the 51 Republican seats and 49 seats held by Democrats, nine Republicans and 26 Democrats are up for reelection (including two in special elections). Among the seats up for reelection, campaigns for around four Republican seats and six Democratic seats are regarded as close battles, and their results could tip the balance for both parties. According to the Reuters/Ipsos/UVA Center for Politics State Poll, in the battleground state of Florida (where a seat currently held by a Democrat is up for reelection), the incumbent Democratic Senate candidate's approval rate was 49%, higher than the 44% rate for the Republican Senate candidate. On the other hand, in the states of Texas and Nevada (where Republican seats are up for reelection), the approval rates of Republican candidates were higher. There is a high possibility that the Republicans will maintain their majority in the Senate. When the Republican Party holds a majority of seats in both chambers, a Republican party victory in both chambers at midterm elections tends to cause the USD/JPY rate to rise, while a Republican defeat in both chambers tends to cause the rate to decline. In past cases where both chambers were controlled by a Democratic majority and its defeat in the House resulted in a divided Congress, the USD/JPY rose. Looking at it the other way around, if a Republican defeat leads to a divided Congress when both chambers were controlled by a Republican majority, a decline in the USD/JPY would be more likely.

Noteworthy currency: AUD

The Reserve Bank of Australia (RBA) is to hold its monetary policy meeting on 6 November. Although the nation's unemployment rate fell sharply to 5.0% in September, the decline was largely caused by a decrease in the number of job seekers. We thus think the improvement is unlikely to lead to a pickup in wage growth. Regarding CPI readings for the Jul-Sep period, both the headline rate and the core inflation rate slowed from the Apr-Jun figures. In addition, retail sales in Jul-Sep were weak, although Apr-Jun GDP was driven by consumption. The RBA is thus likely to continue to be concerned about consumption. The bank is expected to maintain its stance of avoiding rate hikes for the time being. Again this week, we expect the Australian dollar to be swayed by external factors, such as the US midterm elections and US-China relations.

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

- 5-Nov ● Eurozone finance ministers meeting (until 6th)
- US imposes second round of sanction against Iran (ban on crude oil exports)
- 6-Nov ○ Oct US ISM non-manufacturing index
- RBAMPM
- Sep German manufacturing orders
- US midterm elections
- 7-Nov ○ Sep German industrial production
- Sep eurozone retail sales
- 8-Nov ○ Oct China trade statistics
- ECB economic report
- Sep German trade statistics
- 9-Nov ○ FOMC statement
- Oct China CPI/PPI
- Jul-Sep UK GDP
- 10-Nov ○ Nov US University of Michigan's Consumer Sentiment Index (preliminary)

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

| | 29 Oct - 2 Nov 2018 (actual) | | 5 - 9 Nov 2018 (forecasts) | |
|---------|------------------------------|---------|----------------------------|---------|
| | Range | Weekend | Range | Weekend |
| USD/JPY | 111.7-113.4 | 113.2 | 111.5-113.5 | 112.3 |
| EUR/JPY | 127.2-129.4 | 128.9 | 127.0-129.5 | 127.8 |
| EUR/USD | 1.130-1.146 | 1.139 | 1.130-1.150 | 1.138 |

Noteworthy currencies and factors

| | |
|-----|---------------------------------------------------------------------------------------------|
| AUD | RBA MPM to be uneventful, US midterm elections and US-China relations to serve as catalysts |
| GBP | If optimism grows regarding Brexit negotiations, pound would strengthen |
| EUR | Greater optimism regarding Brexit negotiations would lead to euro appreciation |
| CAD | If crude oil prices decline after imposition of ban on Iran's oil exports, CAD would weaken |
| CNY | Expectations for US-China trade agreement would diminish after US midterm elections |

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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■ Credit Rating Agencies

[Standard & Poor's]

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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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[Moody's]

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[Fitch]

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- 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.

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