

# Forex Market View

## Forex markets after the US midterm elections

- Will expectations of cooperation between the Republicans and Democrats end in disappointment?
- Risk of policy gridlock for Trump administration and increased protectionism
- Protectionist trade policies are unlikely the reason why the Republican's lost

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

8 Nov – 7 Dec : Y109.0-114.0/\$ (Y113.31/\$ as of 6 Nov)

Forex Market View DSFE193

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Daiwa Securities Co. Ltd.

### Will expectations of cooperation between the Republicans and Democrats end in disappointment?

### Will expectations of cooperation between the Republicans and Democrats end in disappointment?

The results of the US midterm elections produced a split Congress, with the Republicans keeping their majority in the Senate and the Democrats winning a majority in the House, but despite this US share prices, long-term rates, and the dollar all climbed higher. This may have been because President Trump applauded the call for bipartisan cooperation by the leader of the House Democrats, Nancy Pelosi. Expectations that the Republicans and Democrats would cooperate rather than confront each other may have been one factor pushing share prices and the dollar higher. However, the Trump administration does not intend to compromise with Democrats but rather seeks their cooperation. President Trump effectively fired Attorney General Jeff Sessions immediately after the midterm elections, possibly out of concern of a continuation of the Russia-related investigation. He warned that if the Democrats use their power to further investigate his administration, he will halt bipartisan cooperation and retaliate. The problems inherent in implementing policy with a split Congress will probably eventually surface and raise concerns.

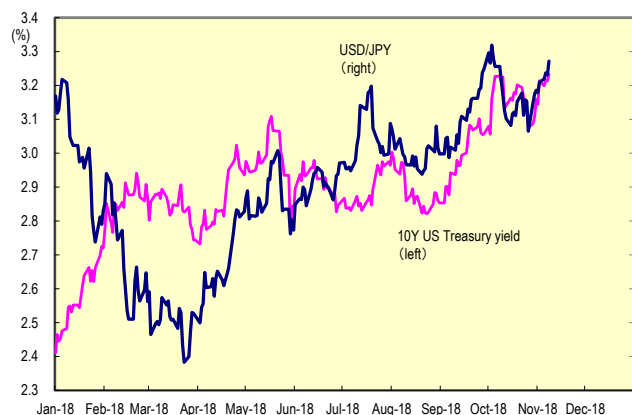
### Reasons why a split Congress will push the USD/JPY lower

### Risk of policy gridlock for Trump administration and increased protectionism

We think a split Congress has increased the risks of a decline in the USD/JPY, for the following reasons.

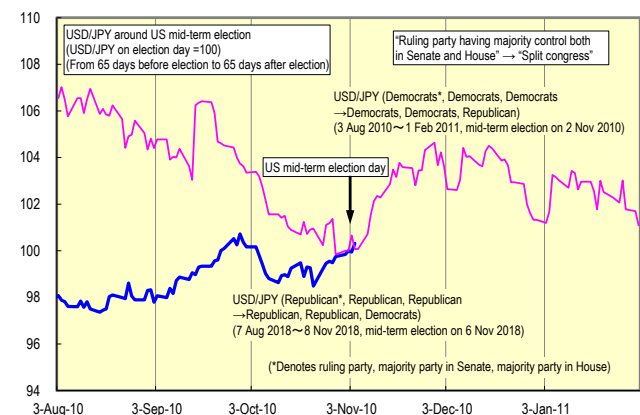
- Because the Democrats have a majority in the House of Representatives, it will become difficult to pass a budget or legislation that the Democratic Party is not on board with, and this will reduce the Trump administration's ability to implement policy.
- The Democrats are more protectionist and keener on a weaker dollar than the Republicans are, and this makes the USD/JPY more likely to decline under a Democratic majority than under a Republican majority.
- It is unlikely that the US administration will adopt a more conciliatory stance with China on the thinking that Republicans lost because of protectionist trade policies, and the risk of additional tariffs on China remain.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY Around US Mid-term Elections (in 2010 and 2018)



Source: Thomson Reuters; compiled by Daiwa Securities.

## Risk of gridlock in US fiscal policy

Because of opposition from the Democrats, it has become more difficult for the administration and Republican Party to pass tax cuts that also benefit the wealthy. Even if there is an agreement on infrastructure investments and middle-class tax cuts, there is a significant risk that no agreement can be reached on how to pay for them, via tax increases or otherwise, thereby leading to policy gridlock and a lame-duck Congress. Eventually, expectations of bipartisan policy cooperation will fade and concerns about policy confrontation will rise. Although there is a possibility that both parties will agree to infrastructure investments and to lower- and middle-class tax cuts without any tax hikes in order to avoid a contraction if concerns over a US economic slowdown become stronger in the future, that would further increase the US government deficit, constrain the Fed's ability to raise interest rates, and create expectations of interest rate declines, making it more difficult for the USD/JPY to rise.

Chart: USD/JPY, Ruling Parties in US Presidential Elections, Majority Parties in Senate and House

Year	USD/JPY				Y/y		President		Senate*	House*	
	Open	Highest	Lowest	Close							
1973	301	303	254	280	-21	Weaker dollar	Richard Nixon	Republican	Democrats	Democrats	
1974	281	305	274	301	21	Stronger dollar	Gerald Ford	Republican	Democrats	Democrats	Midterm elections
1975	301	307	285	305	4	Stronger dollar	Gerald Ford	Republican	Democrats	Democrats	
1976	305	306	286	293	-12	Weaker dollar	Gerald Ford	Republican	Democrats	Democrats	Presidential elections
1977	292	293	238	240	-53	Weaker dollar	James Carter	Democrats	Democrats	Democrats	
1978	238	242	177	194	-46	Weaker dollar	James Carter	Democrats	Democrats	Democrats	Midterm elections
1979	195	251	195	240	46	Stronger dollar	James Carter	Democrats	Democrats	Democrats	
1980	238	261	203	203	-37	Weaker dollar	James Carter	Democrats	Democrats	Democrats	Presidential elections
1981	203	246	199	220	17	Stronger dollar	Ronald Reagan	Republican	Republican	Democrats	
1982	219	278	219	235	15	Stronger dollar	Ronald Reagan	Republican	Republican	Democrats	Midterm elections
1983	232	247	227	232	-3	Weaker dollar	Ronald Reagan	Republican	Republican	Democrats	
1984	232	252	223	252	20	Stronger dollar	Ronald Reagan	Republican	Republican	Democrats	Presidential elections
1985	252	263	200	200	-51	Weaker dollar	Ronald Reagan	Republican	Republican	Democrats	
1986	199	203	152	157	-43	Weaker dollar	Ronald Reagan	Republican	Republican	Democrats	Midterm elections
1987	158	159	121	121	-36	Weaker dollar	Ronald Reagan	Republican	Democrats	Democrats	
1988	123	137	120	125	4	Stronger dollar	Ronald Reagan	Republican	Democrats	Democrats	Presidential elections
1989	125	152	123	144	19	Stronger dollar	George H. W. Bush	Republican	Democrats	Democrats	
1990	147	160	124	135	-8	Weaker dollar	George H. W. Bush	Republican	Democrats	Democrats	Midterm elections
1991	134	142	125	125	-11	Weaker dollar	George H. W. Bush	Republican	Democrats	Democrats	
1992	125	135	119	125	0	Weaker dollar	George H. W. Bush	Republican	Democrats	Democrats	Presidential elections
1993	125	126	100	112	-13	Weaker dollar	William Clinton	Democrats	Democrats	Democrats	
1994	112	114	96	100	-12	Weaker dollar	William Clinton	Democrats	Democrats	Democrats	Midterm elections
1995	100	105	80	103	4	Stronger dollar	William Clinton	Democrats	Republican	Republican	
1996	103	116	103	116	13	Stronger dollar	William Clinton	Democrats	Republican	Republican	Presidential elections
1997	116	132	111	131	15	Stronger dollar	William Clinton	Democrats	Republican	Republican	
1998	131	148	112	113	-17	Weaker dollar	William Clinton	Democrats	Republican	Republican	Midterm elections
1999	113	125	101	102	-11	Weaker dollar	William Clinton	Democrats	Republican	Republican	
2000	102	115	101	114	12	Stronger dollar	William Clinton	Democrats	Republican	Republican	Presidential elections
2001	114	132	114	132	17	Stronger dollar	George W. Bush	Republican	Republican	Republican	
2002	132	135	115	119	-13	Weaker dollar	George W. Bush	Republican	Republican	Republican	Midterm elections
2003	119	122	107	107	-11	Weaker dollar	George W. Bush	Republican	Republican	Republican	
2004	107	115	102	102	-5	Weaker dollar	George W. Bush	Republican	Republican	Republican	Presidential elections
2005	103	121	102	118	15	Stronger dollar	George W. Bush	Republican	Republican	Republican	
2006	118	120	109	119	1	Stronger dollar	George W. Bush	Republican	Republican	Republican	Midterm elections
2007	119	124	107	111	-8	Weaker dollar	George W. Bush	Republican	Democrats	Democrats	
2008	112	112	87	91	-21	Weaker dollar	George W. Bush	Republican	Democrats	Democrats	Presidential elections
2009	91	101	85	93	2	Stronger dollar	Barack Obama	Democrats	Democrats	Democrats	
2010	93	95	80	81	-12	Weaker dollar	Barack Obama	Democrats	Democrats	Democrats	Midterm elections
2011	81	86	76	77	-4	Weaker dollar	Barack Obama	Democrats	Democrats	Republican	
2012	77	87	76	87	10	Stronger dollar	Barack Obama	Democrats	Democrats	Republican	Presidential elections
2013	87	105	87	105	19	Stronger dollar	Barack Obama	Democrats	Democrats	Republican	
2014	105	122	101	120	14	Stronger dollar	Barack Obama	Democrats	Democrats	Republican	Midterm elections
2015	120	126	116	120	0	Stronger dollar	Barack Obama	Democrats	Republican	Republican	
2016	120	122	99	117	-3	Weaker dollar	Barack Obama	Democrats	Republican	Republican	Presidential elections
2017	117	119	108	113	-4	Weaker dollar	Donald Trump	Republican	Republican	Republican	
2018	113	115	104	113	0		Donald Trump	Republican	Republican	Republican	Midterm elections
2019							Donald Trump	Republican	Republican	Democrats	
2020							Donald Trump	Republican	Republican	Democrats	Presidential elections

\*Denotes majority party.

Source: Compiled by Daiwa Securities.

**Risk of US protectionism and preference for a weaker dollar gaining momentum**

The Democrats agree with the Trump administration's hard line on China. The Republican Party tends to be free-trade oriented and prefer a strong dollar, while the Democratic Party is protectionist and prefers a weak dollar. Since 1973, there has not been that much difference in the probability of the USD/JPY rising between Republicans controlling both houses (53%) and a split Congress (60%), provided the split Congress was a result of the Republicans rebounding from the Democrats controlling both houses. The dollar strengthened during three of the six years of split Congress under the Republican Reagan Administration, although the dollar weakened considerably in 1985-86, when the Plaza Accord was signed. The dollar strengthened during three of the four years of a split Congress under the Democratic Obama administration, but the yen weakened in 2013-14 because of the BOJ's QQE policy. The probability of the dollar strengthening when the Democrats control both houses is low at 30%, and the USD/JPY declined in 1987 and 2007, years following the Republicans losing both houses. The USD/JPY is probably more likely to decline when a Republican loss results in a split Congress than when both houses are controlled by the Republicans.

**Protectionist trade policies are unlikely the reason for the Republican Party's losses**

**Protectionist trade policies are unlikely the reason why the Republican's lost**

In the Great Lakes region's Rust Belt (Pennsylvania, Wisconsin, Ohio, Michigan, Indiana, and Illinois) that drove President Trump's election victory in 2016, the Republican Party fared poorly in gubernatorial elections (the Republicans won Ohio and the Democrats won Pennsylvania, Wisconsin, Michigan, and Illinois), but in the House election there was not a significant number of electoral districts that flipped from the Republicans to the Democrats. In addition, the increase in support for the Democrats among women and Hispanics was one factor behind the Republicans' loss of the House, and the issues that most concerned voters were immigration, healthcare, and the economy. There is a good chance that President Trump does not think that his protectionist trade policy caused the Republicans to lose.

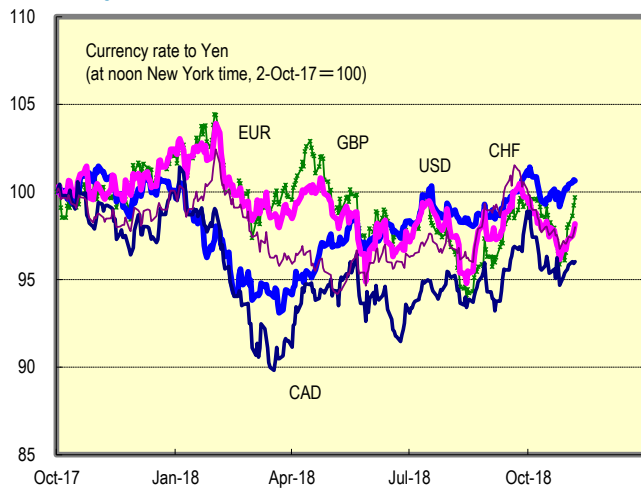
**Is the USD/JPY's rise on expectations of a US-China trade deal limited?**

Rising expectations that a trade deal will be reached at the US-China summit in late November have contributed to the rise in the USD/JPY since October 30 (from the lower 112 to the upper 113 range), but the Trump administration is unlikely to switch from a hard-line to a conciliatory stance in its trade policy with China. What may be possible is the US temporarily postponing the increase in tariffs on Chinese goods (from 10% to 25%) scheduled to go into effect at end-2018, but we cannot see it removing the additional tariffs that it has placed on China thus far. This would make it difficult to stop the US economic slowdown that has been rippling out from the manufacturing sector, and the rise in the USD/JPY would probably be temporary.

**Major risk of the USD/JPY retreating**

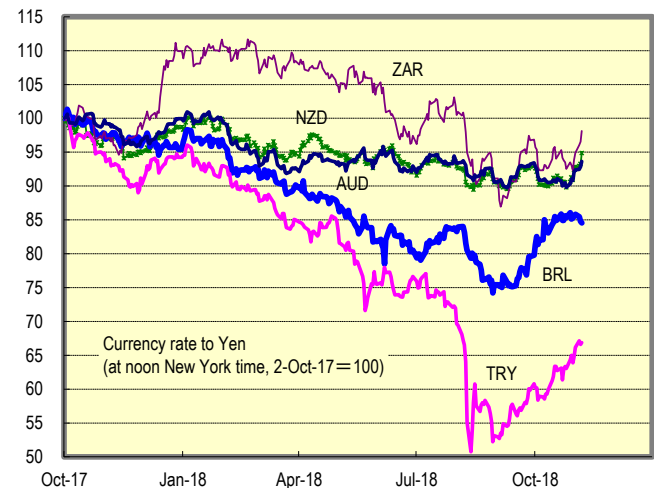
In other words, it will become more difficult for the Trump administration to freely enact fiscal policies, and that combined with the Democratic Party's protectionism and desire for a weaker dollar probably means there is still a risk of additional tariffs on Chinese goods going into effect. There is a significant risk of the USD/JPY declining as a result of risk-off pressures for a stronger yen brought by a US economic slowdown, declining US long-term rates, and pressures for a weaker dollar from protectionism. With the split Congress set to begin in January 2019, the dollar is unlikely to continue strengthening against the yen.

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	Forecast			
	29 Jun 2018	28 Sep 2018		Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019
USD-JPY	110.7	113.7	110.0	108.0	110.0	108.0	107.0
			108-115	105-113	105-113	105-113	104-112
EUR-JPY	129.3	131.9	127.5	123.0	127.5	124.5	122.0
			123-133	121-132	121-132	121-132	119-130
AUD-JPY	81.9	82.1	78.0	74.5	78.0	75.5	74.0
			76-83	73-82	73-82	73-82	71-80
CAD-JPY	84.3	88.0	84.5	82.0	84.5	82.5	81.0
			82-90	79-88	79-88	79-88	78-87
NZD-JPY	74.9	75.2	71.5	68.0	71.5	69.0	67.5
			69-76	66-75	66-75	66-75	65-74
TRY-JPY	24.1	18.8	18.5	17.0	18.5	17.5	16.7
			16-21	15-21	15-21	15-21	14-20
ZAR-JPY	8.1	8.0	7.4	7.0	7.5	7.2	7.0
			7.1-8.1	6.7-7.9	6.7-7.9	6.7-7.9	6.5-7.7
BRL-JPY	28.6	28.1	27.5	25.7	27.5	26.4	25.5
			25-30	24-30	24-30	24-30	23-29
KRW-JPY	9.9	10.2	9.6	9.3	9.6	9.4	9.2
(100 KRW)			9.3-10.3	9.0-10.0	9.0-10.0	9.0-10.0	8.9-9.9
CNY-JPY	16.7	16.5	15.7	15.2	15.9	15.4	15.1
			15.4-16.7	15.0-16.5	15.0-16.5	15.0-16.5	14.6-16.1

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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- 4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

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- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
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\* 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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