Forex Market View

Decline in USD/JPY after US-China summit meeting

- Little progress in yen depreciation, despite postponed additional tariffs
- Yen depreciation appears to be constrained by concerns about slowdown in Chinese economy
- Lower US interest rates also causing decline in USD/JPY

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

5 Dec-4 Jan: Y109.0-114.0/$ (Y112.92/$ as of 4 Dec)

Forex Market View DSFE198

FICC Research Dept.

Chief FX Analyst
Yuji Kameoka
(81) 3 5555-8764
yuji.kameoka@daiwa.co.jp

Daiwa Securities Co. Ltd.

Little progress in yen depreciation, despite postponed additional tariffs

US postponed additional tariffs on Chinese goods for 90 days

At the US-China summit meeting on 1 December, the US decided to hold off on imposing additional tariffs on $200.0bn worth of Chinese goods for 90 days from 1 December, though the hike was scheduled at the beginning of 2019. In addition, both nations agreed to begin negotiations on structural reform regarding issues such as violation of intellectual property rights, forced technology transfer, non-tariff barriers, and cyber attacks. According to explanations from the US government side, China proposed to increase imports from the US by around $1.2tn. Moreover, the two nations appear to be nearing agreement on reduction in the current 40% tariff on imported cars from the US.

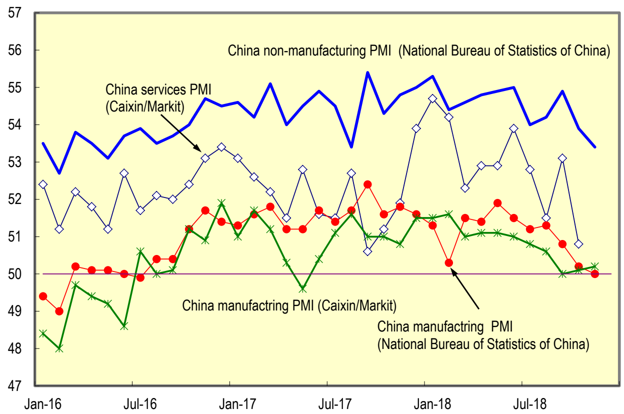
Little progress in risk-on yen depreciation, leading to decline in USD/JPY

Despite these factors, however, risk-on yen depreciation has proceeded little, excluding moves vs. some currencies. On the contrary, the USD/JPY rate is declining. Why? We can point to (1) remaining risk of additional tariffs by the US, (2) risk of a slowdown in the Chinese economy due to its compromise to the US, and (3) the yield downtrend on diminishing expectations for US rate hikes.

Doubts about resumption of US-China trade war

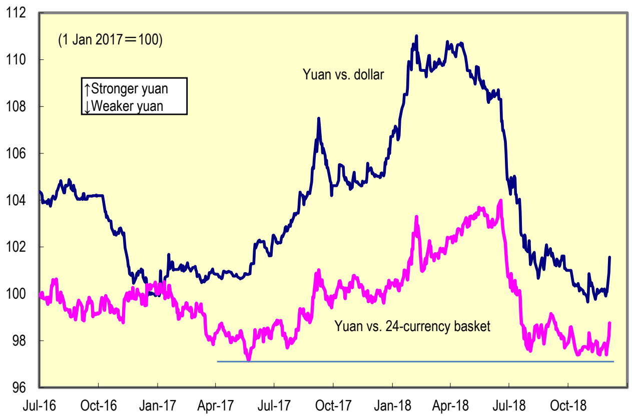
According to explanations from the US government side, China was committed to immediately move to improve trade relations with the US. However, the market appears to have strong doubts about whether China is able to work out effective measures to cope with the aforementioned issues within the 90 days. Going forward, United States Trade Representative Robert Lighthizer, a hard-liner on China, will lead the next rounds of trade talks with China, taking over the position from Treasury Secretary Steven Mnuchin. It appears that concerns are lingering about a resumption of the trade war, despite the ceasefire, as structural reform negotiations between the two nations may break down.

Chart: Business Sentiment at Chinese Companies



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Exchange Rates of Yuan vs. Dollar and Currency Basket



Source: Thomson Reuters; compiled by Daiwa Securities.

Yen depreciation appears to be constrained by concerns about slowdown in Chinese economy

Chinese economy may slow further due to higher imports

If China increases imports of energy and agricultural/industrial products from the US as well as lowers tariffs on imported cars from the US, this would be positive for the US economy. On the other side of the coin, however, this would also have a negative impact. If China decreases imports from third-party nations in line with an increase in imports from the US, this would be negative for third-party nations. In addition, if Chinese production declines in line with substitution of domestic production by imports, this would be negative for the Chinese economy. It is not necessarily that the impact will be negative for the global economy on a net basis as the negatives in China would be partially offset by positives in the US. However, given the scale of additional tariffs to date, China has been more damaged by the US-China trade war than the US. Accordingly, it is possible that the Chinese economy will slow further due to higher imports and the slowdown will have a negative impact on other economies.

Stronger yuan may lead to further slowdown in Chinese economy

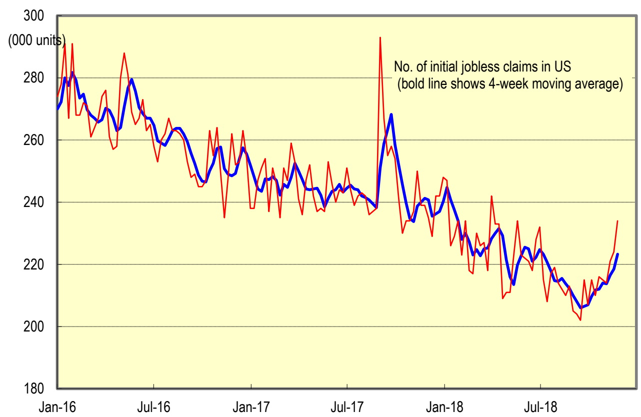
In addition, the yuan substantially rose against the dollar after the US and China reached agreement, posting the highest two-day advance since 2007. This was caused by risk-on sentiment reflecting the agreement between the two nations. A reason that “the yuan rose similar to other currencies” does not appear to be enough to explain the substantial advance. Since previously, as the US government has been expressing concerns about weaker yuan/strong dollar, the Chinese authorities may have agreed with the US government with respect to inducing of the yuan to avoid depreciation. If so, China’s exports would tend to decline, while imports would increase. A decline in net exports would have a further negative impact on the Chinese economy. If the Chinese authorities have to induce the yuan to strengthen amid the difficulty in increasing exports due to the global economic downtrend, a further slowdown in the Chinese economy may have a negative impact on the global economy. The weakness of the dollar vs. the yuan is spreading to other currency pairs, which appears to be one reason of pushing down the USD/JPY. However, we think that concerns about a slowdown in the Chinese economy due to yuan appreciation are the main reason behind the constrained risk-on yen depreciation (pressure on risk-off yen appreciation).

Lower US interest rates also causing decline in USD/JPY

Dollar depreciation due to lower US interest rates

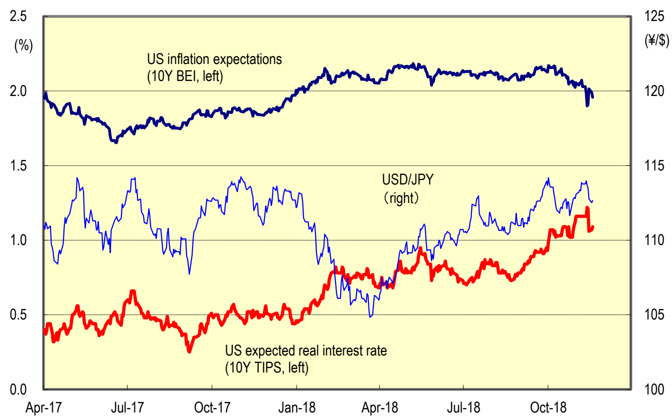
Due to a decline in US long-term interest rates, the current condition does not allow a relative rise in US interest rates, leading to a slight retreat in the dollar’s effective exchange rate. The narrower difference between the US and Japan long-term interest rates has caused the decline in the USD/JPY. The background factors of lower US interest rates include signs of a US economic slowdown, a decline in US inflation expectations, and dovish remarks by US policymakers.

Chart: No. of Weekly Initial Jobless Claims in US



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Inflation Expectations, Real Interest Rate, and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

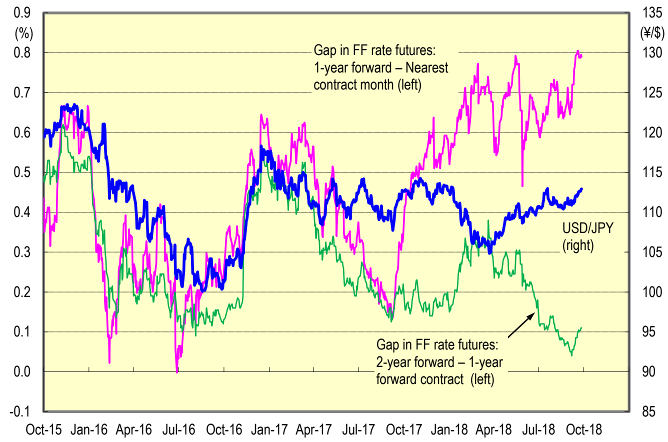
Expectations for US rate hikes diminishing due to concerns about US economic slowdown and lower inflation expectations

In the US, exports, housing investment, and capex have already started to slow. Going forward, the slowdown may spread to employment and personal consumption. As the number of initial jobless claims is continuing to increase, a slowdown in job gains appears to be just a matter of time. This, combined with diminishing asset effects due to the retreat in stock prices, is likely to cause a slowdown in personal consumption. Moreover, at the OPEC meeting on 6 December, member and some non-member nations are expected to decide to cut crude oil production. However, they would probably decide on only modest output cuts, leading to a strong possibility that crude oil prices will remain cheap due to concerns about excessive supply stemming from inventory growth. Lower crude oil prices are likely to remain to serve as a factor to lower inflation expectations. Regarding the inflation rate, Fed Vice Chairman Richard Clarida stated that he remained more concerned about falling short of the central bank's 2% objective than running above it. At least some US policymakers have started to be worried about a decline in the inflation rate partly because of the global economic slowdown. They thus appear to have a prudent view for continued rate hikes. The market now expects rate hikes to end after two hikes (in Dec 2018 and once in 2019) over the next year. Rate hike projections by policymakers are also likely to be revised downward. It is highly possible that a further decline in US long-term interest rates will remain a factor to weaken the dollar. If concerns about a US economic slowdown strengthen, it would be difficult to see higher stock prices despite a decline in long-term interest rates. Thus, a simultaneous risk-off yield decline (higher bond prices) and lower stock prices would be more likely.

"Risk-off yen appreciation" and "dollar depreciation due to lower US interest rates" would also serve as factors

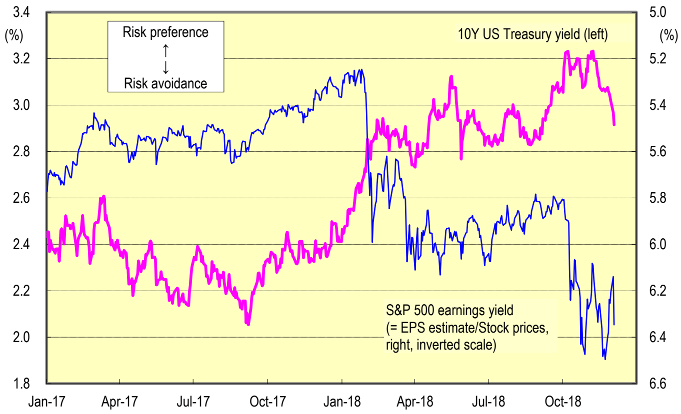
Amid lingering risk that the US government may impose additional tariffs, a decline in the USD/JPY would be more likely due to greater concerns about an economic slowdown in China and the US, coupled with "risk-off yen appreciation" and "dollar depreciation due to lower US interest rates."

Chart: USD/JPY and Outlook for FF Rate Futures



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Long-term Interest Rate and Equity Earnings Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

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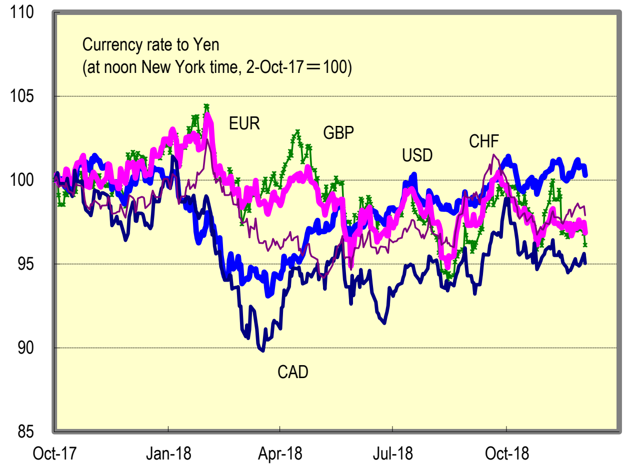
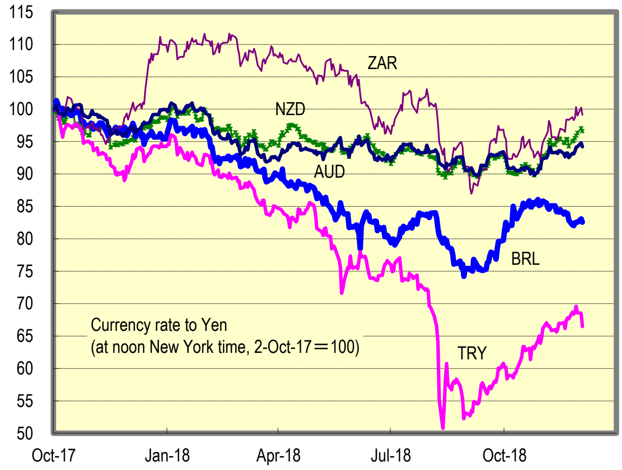
Chart: Major Currencies/JPY FX Index



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 29 Jun 2018	28 Sep 2018	Forecast Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 2019
USD-JPY	110.7	113.7	111.0	108.0	110.0	108.0	107.0
			109-115	105-113	105-113	105-113	104-112
EUR-JPY	129.3	131.9	126.5	122.0	126.5	123.5	121.0
			124-133	120-131	120-131	120-131	118-129
AUD-JPY	81.9	82.1	79.0	74.5	78.0	75.5	74.0
			76-83	73-82	73-82	73-82	71-80
CAD-JPY	84.3	88.0	83.5	80.0	83.0	80.5	79.5
			82-90	78-87	78-87	78-87	77-86
NZD-JPY	74.9	75.2	73.5	69.0	72.5	70.0	68.5
			71-78	67-76	67-76	67-76	66-75
TRY-JPY	24.1	18.8	19.5	17.7	19.3	18.3	17.6
			17-22	16-22	16-22	16-22	15-21
ZAR-JPY	8.1	8.0	7.7	7.2	7.6	7.3	7.1
			7.2-8.2	6.8-8.0	6.8-8.0	6.8-8.0	6.6-7.8
BRL-JPY	28.6	28.1	28.5	26.4	28.2	27.0	26.1
			26-31	25-31	25-31	25-31	24-30
KRW-JPY	9.9	10.2	9.8	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	15.9	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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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).

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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")
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

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
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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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

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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