

Forex Market View

US expresses concern over China's handling of foreign exchange in its FX policies report

- Watchlist of six countries is unchanged, none are pronounced a currency manipulator
- US wants a mechanism in trade agreement to prevent yen from depreciating
- If the yuan weakens further, US may take a harder line in its policies on trade with China

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

18 Oct – 16 Nov: Y109.0-114.0/\$ (Y112.19/\$ as of 17 Oct)

Forex Market View DSFE187

FICC Research Dept.

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



Daiwa Securities Co. Ltd.

Watchlist of six countries is unchanged, none are pronounced a currency manipulator

No change in six countries on watchlist in Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States

The US Treasury Department released its semiannual report, Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States, on October 17. The three criteria it uses to evaluate 13 countries, its 12 largest trading partners plus Switzerland, are listed below, and it still has the same six countries on its watchlist that it did in April 2018.

Chart: Major Foreign Trading Partners Evaluation Criteria in US Currency Report

US Treasury's Currency Report (17 Oct 2018)

Target: 12 largest trading partners of US (accounting for more than 70% of US trade in goods) and Switzerland (used to be one of 12 largest trading partners of US and included in monitoring list)
Monitoring list: China, Japan, Korea, India, Germany, and Switzerland (six nations)

	Bilateral trade		Current account			Foreign exchange intervention		
	Goods surplus with US (\$bn, for 1 year through Jun 2018)	Balance (% of GDP, for 1 year through Jun 2018)	3-year change in balance (% of GDP)	Balance (\$bn, for 1 year through Jun 2018)	Net purchases (% of GDP, for 1 year through Jun 2018)	Net purchases (\$bn, for 1 year through Jun 2018)	Net purchases for 8 of 12 months	
China	390	0.5	-2.3	68	0.0	1	Yes	
Mexico	73	-1.6	0.3	-20	0.0	0	No	
Japan	70	4.0	1.8	198	0.0	0	No	
Germany	67	8.2	0.0	329	na	na	na	
Italy	32	2.8	1.0	57	na	na	na	
India	23	-1.9	-0.6	-50	0.2	4	No	
Korea	21	4.6	-2.3	73	0.3	4	No	
Taiwan	17	14.3	1.4	85	1.2	7	Yes	
Switzerland	17	10.2	0.0	72	2.4	17	No	
France	16	-0.6	-0.2	-16	na	na	na	
Canada	15	-3.1	0.0	-53	na	na	na	
UK	-7	-3.5	1.5	-98	na	na	na	
Brazil	-9	-0.7	3.5	-14	-2.0	-41	No	
(Memo) Euro area	143	3.6	0.7	486	0.0	0	No	

Three criteria ⇒ \uparrow At least \$20bn \uparrow At least 3% \uparrow At least 2% over 12-month period

US Treasury's Currency Report (13 Apr 2018)

Target: 12 largest trading partners of US (accounting for more than 70% of US trade in goods) and Switzerland (used to be one of 12 largest trading partners of US and included in monitoring list)
Monitoring list: China, Japan, Korea, India, Germany, and Switzerland (six nations)

	Bilateral trade		Current account			Foreign exchange intervention		
	Goods surplus with US (\$bn, in 2017)	Balance (% of GDP, in 2017)	3-year change in balance (% of GDP)	Balance (\$bn, in 2017)	Net purchases (% of GDP, in 2017)	Net purchases (\$bn, in 2017)	Net purchases for 8 of 12 months	
China	375	1.4	-0.9	168	-0.6	-68	No	
Mexico	71	-1.6	0.2	-18	-0.2	-2	No	
Japan	69	4.0	3.3	197	0.0	0	No	
Germany	64	8.1	0.6	299	na	na	na	
Italy	32	2.8	0.9	54	na	na	na	
India	23	-1.5	-0.2	-39	2.2	56	Yes	
Korea	23	5.1	-0.9	78	0.6	9	Yes	
Taiwan	18	-3.0	-0.6	-49	0.0	0	No	
Switzerland	17	14.6	3.1	84	1.3	7	Yes	
France	15	-0.6	0.4	-15	na	na	na	
Canada	14	9.8	1.4	67	6.6	45	Yes	
UK	-3	-4.1	1.3	-107	0.0	0	No	
Brazil	-8	-0.5	3.8	-9	0.1	2	No	
(Memo) Euro area	133	3.5	1.0	440	0.0	0	No	

Three criteria ⇒ \uparrow At least \$20bn \uparrow At least 3% \uparrow At least 2% over 12-month period

Source: US Department of Treasury; compiled by Daiwa Securities.

None of the countries exceeded the watchlist threshold for all three criteria, and none were named a currency manipulator. The market was concerned that China could be named a currency manipulator because of the yuan's weakening since April, but it was not, because the only one of the three watchlist criteria that China met was its having a trade surplus with the US of at least \$20 billion, and it was under the thresholds for current account balance (more than 3% of GDP) and FX market intervention (intervening with foreign currency purchases greater than 2% of GDP). The report warned that Korea intervened by selling the won to keep it from appreciating vs. the dollar, while it noted that India changed its pattern of market intervention from rupee selling to rupee buying, and it forecast that if that pattern continues it will remove India from the watchlist in its next semiannual report.

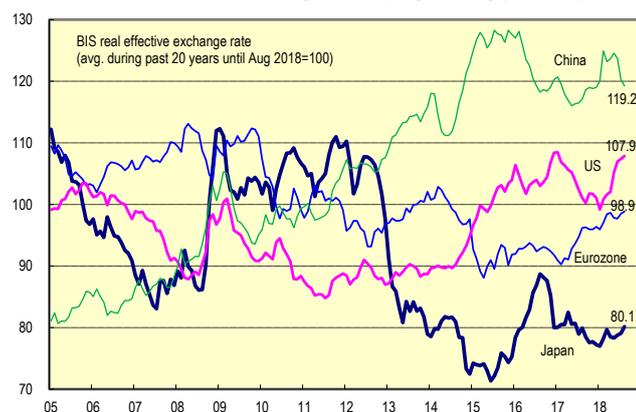
Will any country exceed the watchlist threshold for all three metrics?

Possible scenarios in which a country exceeds the watchlist criteria in all three categories include an expansion of Switzerland's trade surplus with the US (surplus in the goods trade account) and an increase in FX market intervention by Korea (by purchasing foreign currencies). Nevertheless, although growth in the trade surplus caused by an increase in exports or decline in imports is beyond the control of government, the amount of currency market intervention is something that government officials can exert control over. If Switzerland's trade surplus with the US increases above the watchlist threshold, it may reduce the level of its FX market intervention (buying foreign currencies and selling the Swiss franc) to below the watchlist threshold. Unless significant won appreciation prompts Korea to engage in sustained currency market intervention (buying foreign currencies and selling the won), we think its currency intervention is unlikely to exceed the watchlist criteria.

Japan has the weakest real effective exchange rate among the top US trading partners

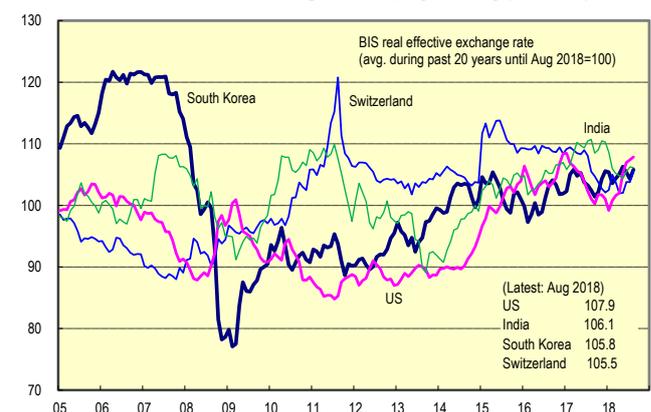
US wants a mechanism in trade agreement to prevent yen from depreciating
Japan exceeds the watchlist thresholds for its trade surplus with the US and current account balance, but its foreign exchange market intervention (buying foreign currencies and selling the yen) remains at zero. Nevertheless, the US noted in its semiannual foreign exchange policy report in April 2018 that the yen's real effective exchange rate is nearly 25% below its 20-year average, and in the October 2018 version of that report it noted that the yen's value has been at record low levels since 2013. This suggests regarding Japan that the US sees the yen's weakness as a problem. Of the countries covered by the report, the 12 largest trading partners of the US plus Switzerland, three had a real effective exchange rate at least 10% lower than its 20-year average in August—Japan (down 19.9%), Mexico (down 17.0%), and the UK (down 13.6%)—and Japan's currency is the weakest.

Chart: Real Effective Exchange Rate (avg. during past 20 years =100)



Source: BIS; compiled by Daiwa Securities.

Chart: Real Effective Exchange Rate (avg. during past 20 years =100)



Source: BIS; compiled by Daiwa Securities.

US seeks a currency clause in its trade agreement with Japan

The US dollar's real effective exchange rate is nearly 10% above its 20-year average. Of the six countries on the watchlist, China, India, Korea, and Switzerland all have real effective exchange rates above their 20-year average, while Germany's (the euro) is near its 20-year average. Given the obvious weakness of Japan's currency, we would expect the US try to prevent competitive currency devaluations by requesting that its trade agreement with Japan contain the same FX clause that it inserted into its new trade agreement with Mexico and Canada (and that it requested in its FTA with Korea). Even if Japan does not

intervene in currency markets (by buying foreign currencies and selling the yen), if the yen weakens at a time when the BOJ is continuing with its accommodative monetary policy, there is a possibility that the US will see that as an effort by Japan to devalue its currency and either implement retaliatory measures or demand that Japan take corrective measures. Adding a currency clause would probably make it easier for the US to pressure Japan into correcting yen weakness (strengthening the yen).

If the yuan weakens further, US may take a harder line in its policies on trade with China

Trump administration is concerned over yuan's weakness against the dollar

Although the US did not name China a currency manipulator in the most recent report on the Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States, it did express concern over the weak yuan, noting the possibility that the yuan's recent decline could exacerbate China's trade surplus with the US. The yuan's dollar exchange rate started declining in April this year, but that could be attributed to risk-off market moves, the rise in US interest rates, and dollar appreciation, and up until June the yuan had not depreciated as much against the dollar as other currencies had. Since the US decided to implement additional tariffs on China in June, however, the yuan has fallen considerably more against the dollar than other currencies have. The yuan's exchange rate vs. the basket of currencies used as a benchmark by the People's Bank of China is near its low reached in May 2017, and if it falls below that it will be at its lowest since July 2014. The yuan's decline against the dollar, which has led its decline against other currencies, is one reason for the increase in the dollar's effective exchange rate, and yuan weakness is probably a source of concern for the Trump administration, which thinks a strong dollar puts the US at a disadvantage.

If the yuan weakens further, US may take a harder line in its policies on trade with China

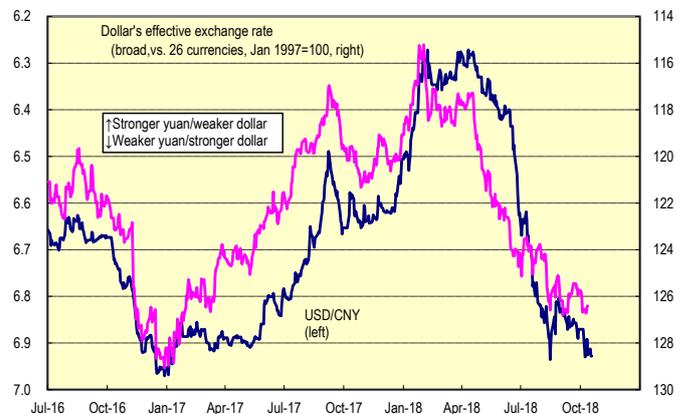
In its Semiannual FX Report, the US noted that while the People's Bank of China's direct intervention in currency markets has been limited this year, it will continue to keep a close eye on China's foreign exchange actions. There is a possibility that the US thinking on this is that even if concerns over negative impacts on the Chinese economy from US tariffs have sparked a market-driven weakening of the yuan, the Chinese authorities are also contributing to yuan devaluation in order to ameliorate the tariffs' negative impacts on exports. Even if the Chinese authorities have supported the yuan's value by selling dollars and purchasing yuan, if it is able to encourage yuan selling and dollar buying by state owned banks, it may also be intentionally devaluing the yuan. Although it is unclear where the truth is, if there is a further weakening of the yuan, it is likely to exacerbate concerns over the Chinese economy and lead to a risk-off strengthening of the yen. It may also heighten the Trump administration's concerns over the yuan's weakening vs. the dollar and lead it to take a harder-line stance in its trade policies with China.

Chart: Index of Yuan vs. Dollar and Currency Basket



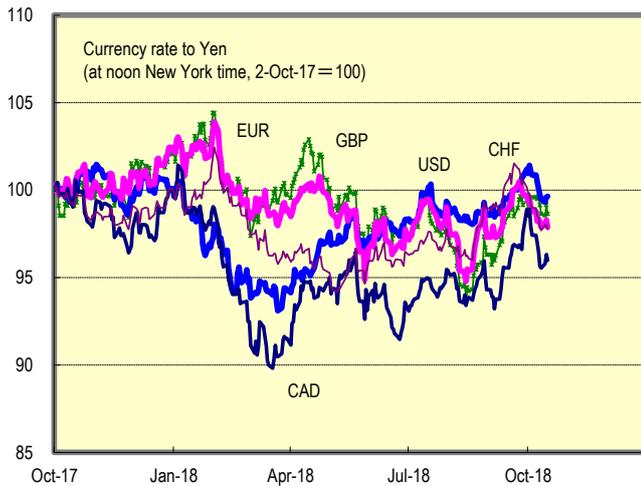
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/CNY and Dollar's Effective Exchange Rate



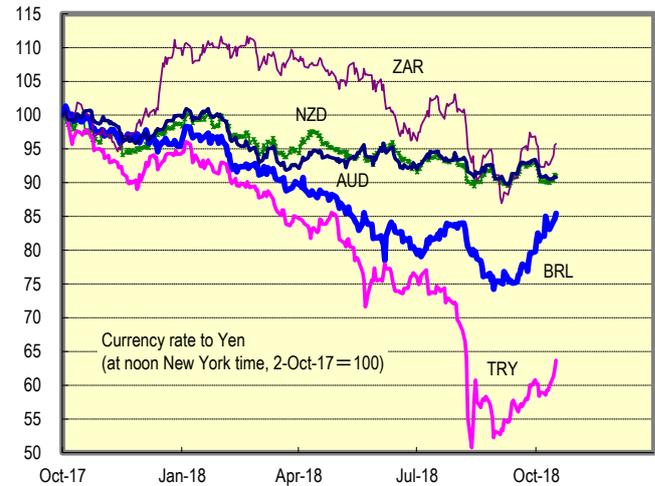
Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

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				
	29 Jun 2018	28 Sep 2018	Oct-Dec 2018	Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 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	129.0	124.5	129.0	125.5	123.0
			124-134	122-133	122-133	122-133	120-131
AUD-JPY	81.9	82.1	79.0	75.5	79.0	76.5	75.0
			77-84	74-83	74-83	74-83	72-81
CAD-JPY	84.3	88.0	85.5	82.5	85.5	83.0	82.0
			83-90	80-89	80-89	80-89	79-88
NZD-JPY	74.9	75.2	72.5	69.0	72.5	70.0	68.5
			70-77	67-76	67-76	67-76	66-75
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	7.5	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	9.8	9.5	9.8	9.6	9.4
(100 KRW)			9.5-10.3	9.2-10.2	9.2-10.2	9.2-10.2	9.1-10.1
CNY-JPY	16.7	16.5	15.9	15.4	16.2	15.6	15.3
			15.5-16.7	15.2-16.7	15.2-16.7	15.2-16.7	14.8-16.3

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.

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>)

Assumptions, Significance and Limitations of Credit Ratings

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.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (<http://www.standardandpoors.co.jp>)

[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)

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 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.moody.com/pages/default_ja.aspx))

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.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moody.com/pages/default_ja.aspx)

[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)

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 "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (<https://www.fitchratings.co.jp/web/>)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (<https://www.fitchratings.co.jp/web/>)

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

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.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association