Forex Market Weekly

Yen swayed by Chinese stocks, yuan

- USD/JPY moved by US stocks / long-term rates, Chinese stocks
- Weaker GBP, risk-off mood possible in event of hard Brexit
- Softer yuan on US/China trade friction concerns, stronger risk aversion

This week's USD/JPY forecast range

22 - 26 Oct: Y111.2 – 113.2/$ (Y112.5 at end-previous week)

Forex Market View DSFE188
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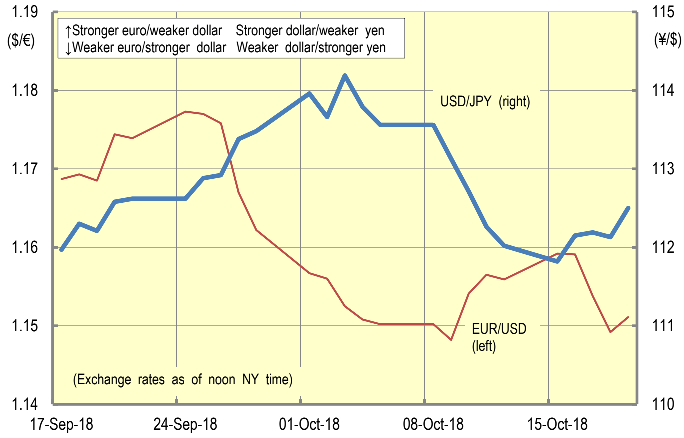
USD/JPY moved by US stocks / long-term rates, Chinese stocks

Overview of last week's forex market

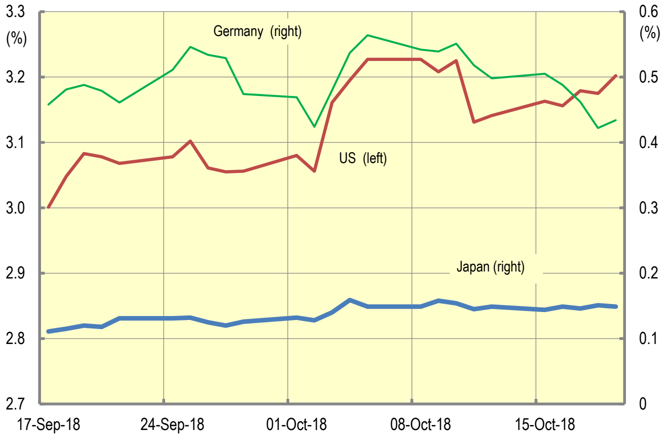
The week started with reports about poor progress for Brexit negotiations, which clouded prospects for a special EU summit slated for November. Also, an aide to US President Donald Trump said that the Trump administration would further strengthen its trade and military policies regarding China. This produced a risk-off mood that sent equities lower and the yen higher, which dropped the USD/JPY to 111.62. The pair then rebounded when Japanese Finance Minister Taro Aso said there had been no specific talks with the US Treasury Secretary about including currency provisions in free trade talks between Japan and the US. Yields on Italian government bonds declined after Italian Minister of Economy and Finances Giovanni Tria expressed confidence in persuading the EU to accept Italy's FY19 budget. Yen depreciation continued as investors regained their appetite for risk, due in part to gains for US stock markets. However, these trends reversed after a high-level Italian government official mentioned the potential for an EU rejection of Italy's budget and a downgrade for Italian government debt. The euro weakened and the yen strengthened on the strong probability the European Commission will conclude that Italy's budget is a breach of EU rules. US long-term rates moved higher and the USD/JPY rose to 112.73 after the release of FOMC meeting minutes reminded investors that more rate hikes are likely. However, the EU postponed its special Brexit summit planned for November and China's equities / currency fell. The USD/JPY briefly fell below the 112.00 line on a plunge for US stocks and a drop for US long-term interest rates, but then recovered along with a rebound for Chinese stocks.

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



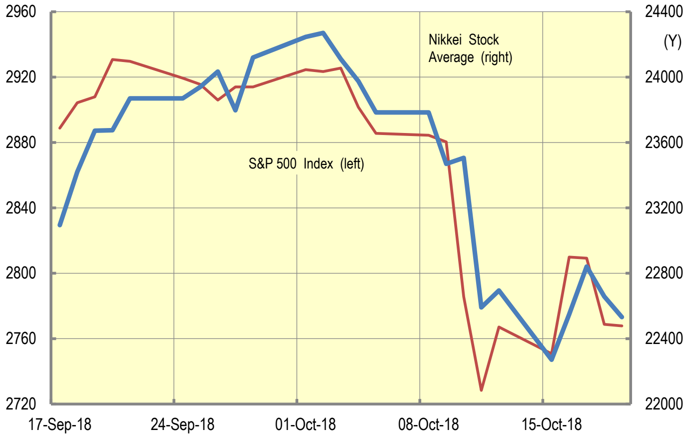
Source: Thomson Reuters; compiled by Daiwa Securities.

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



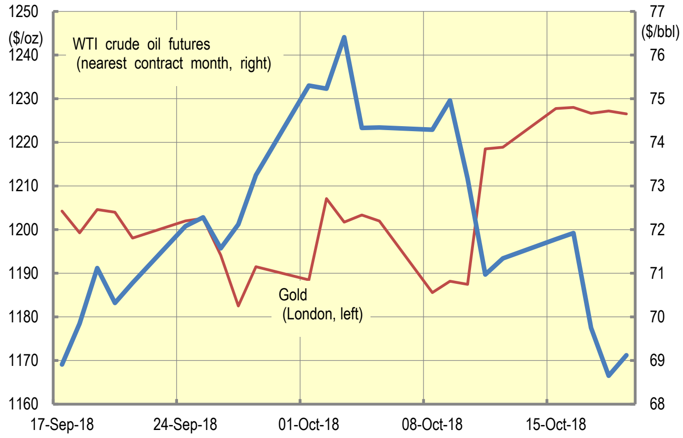
Source: Thomson Reuters; compiled by Daiwa Securities.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



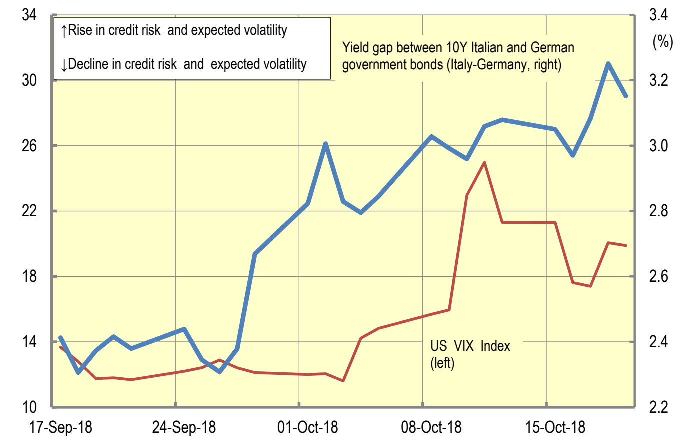
Source: Thomson Reuters; compiled by Daiwa Securities.

Weaker GBP, risk-off mood possible in event of hard Brexit

Focus on efforts to avoid hard Brexit

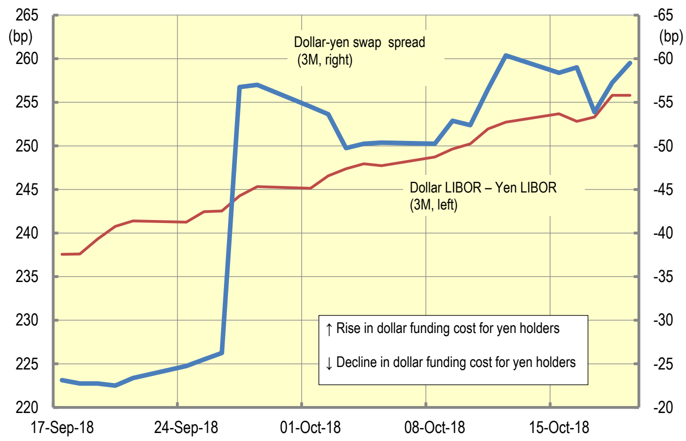
With Brexit negotiations making little progress, EU officials decided to postpone a special summit to hammer out the final Brexit terms scheduled for mid-November. Negotiations have run into difficulties with England rejecting a hard border between Northern Ireland, which is part of the UK, and Ireland, an EU member. In order to avoid a hard border, the EU proposed a “backstop” provision (Northern Ireland would continue adhering to EU customs regulations even after Britain leaves the EU). Even if the Brexit transition period is extended (England remaining in EU customs union and integrated market until end-December 2020), the same conditions would most likely still apply. If England were to concede to the backdrop provision, a customs and regulatory border would essentially need to be drawn down the middle of the Irish Sea (separating Northern Ireland and England). There is increased risk that the UK Parliament will fail to approval any Brexit agreement as Northern Ireland’s Democratic Unionist Party, which supports the current administration from outside of the Cabinet, will inevitably oppose a “one country, two systems” compromise that separates Northern Island from England, while the ruling Conservative Party and Brexit hard-liners will oppose making concession to the EU. The potential for concerns about a no-deal Brexit weakening the pound and making investors more risk adverse probably still exists.

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



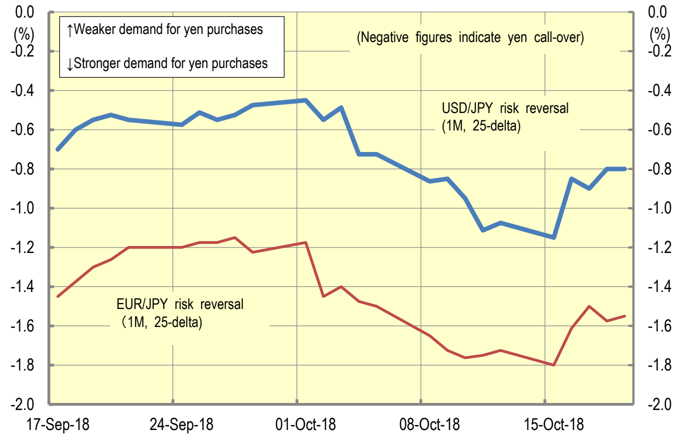
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



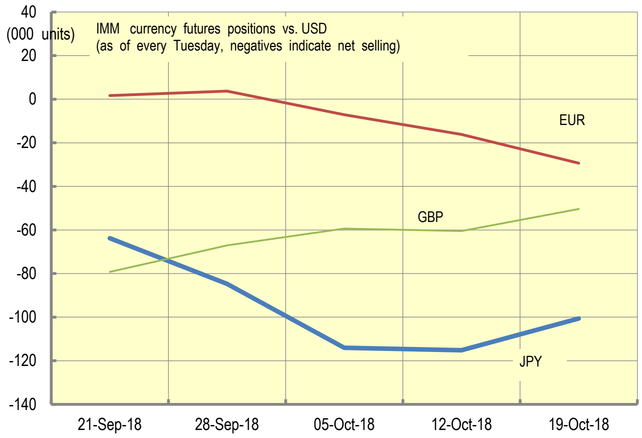
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Softer yuan on US/China trade friction concerns, stronger risk aversion

Focus on yuan depreciation

The US Treasury Department's semiannual report on the forex policies of major trading partners did not designate China a currency manipulator as only one of its three watchlist criteria applied to China (having trade surplus with US of at least $20 billion). The report did however state, "The Treasury is concerned about the depreciation of the yuan and will carefully monitor and review this determination over the following six-month period, including through ongoing discussions with the People's Bank of China." US Treasury Secretary Steven Mnuchin said, "Of particular concern are China's lack of currency transparency and the recent weakness in its currency." This comment seems to suggest that while Chinese authorities are not directly intervening to weaken its currency (= yuan selling), the US suspects they could be indirectly guiding the yuan lower. Following the release of this report, the yuan stopped declining versus the dollar and Chinese equities started declining (we note that Chinese shares rose on 19 October after banking regulators in China decided to allow for the investing of bank wealth-management funds in the stock market). Whether the yuan is falling on (1) market concerns about the Chinese economy or (2) less support from Chinese authorities for the yuan and Chinese shares, remains unclear. However, amid the worsening trend for Chinese economic indicators, there is the potential for further yuan depreciation on market selling and tolerance of a weaker yuan among Chinese authorities. A weaker yuan would probably heighten concerns about trade frictions between the US and China and spur on a risk-adverse mood.

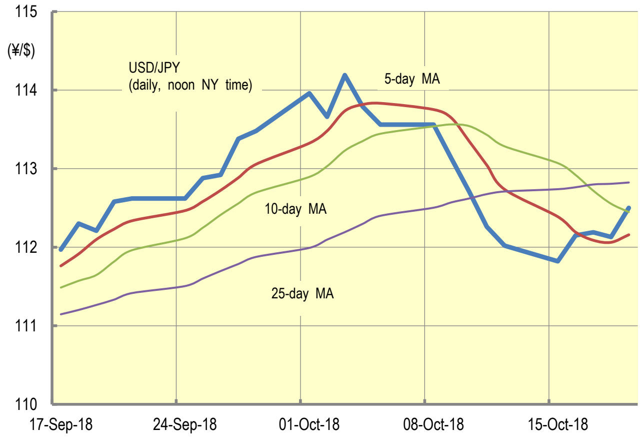
Concerns about punishing Saudi Arabia for journalist's death, Saudi retaliation unlikely to grow

Saudi Arabia has admitted its involvement in the death of a journalist that disappeared in Turkey. US President Trump has commented on the possibility of punishing Saudi Arabia, but US Treasury Secretary Mnuchin said it was premature to comment on possible sanctions against Saudi Arabia until the investigation is completed. For now, the US will probably not take any steps to punish Saudi Arabia. As such, there is probably little likelihood of concerns about a jump in interest rates and weaker stocks globally due to higher crude oil prices on Saudi retaliation (oil supply cuts).

Noteworthy currency: EUR

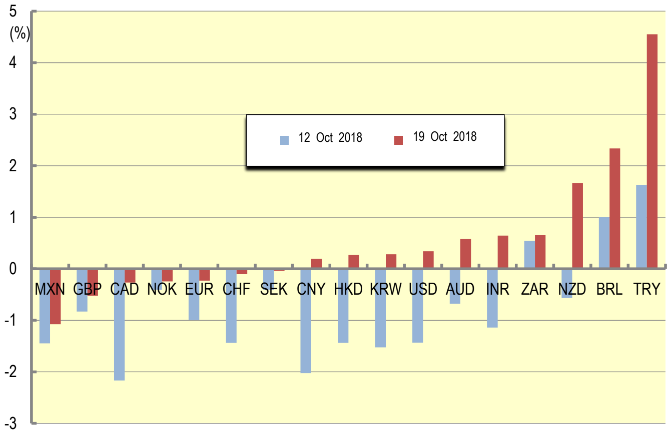
ECB President Mario Draghi has suggested that the reinvestment of maturing bonds acquired through the central bank's quantitative easing could be discussed at the 25 October ECB Governing Council meeting. The ECB is also purchasing German government bonds at below the minimum yield as it runs out of assets to buy. The ECB probably needs to make some adjustments before hiking rates, such as reinvesting principal from maturing short-term bonds into long-term bonds. Whether or not the ECB will clarify such a policy at the upcoming meeting is uncertain. However, if its investment in long-term bonds increases, the euro would likely appreciate on higher German short-term rates. Then the euro could reverse course and depreciate on a decline for long-term rates.

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

23-Oct	○	MPM at Indonesian central bank
24-Oct		Oct eurozone PMI (Markit)
		Sep US new home sales
25-Oct	○	US Beige Book (Fed)
		Oct German IFO business climate index
	○	MPM at Turkish central bank
	○	ECB Governing Council meeting (president Draghi's press conference)
		Sep US durable goods orders
26-Oct		Jul-Sep US GDP (preliminary)
		Oct US University of Michigan's Consumer Sentiment Index (final)
28-Oct		End to Daylight Saving Time in Europe
	●	Runoff vote for Brazilian presidential election

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

	15 - 19 Oct 2018 (actual)		22 - 26 Oct 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	111.6-112.8	112.5	111.2-113.2	112.0
EUR/JPY	128.3-130.3	129.6	127.8-130.3	128.6
EUR/USD	1.143-1.163	1.151	1.140-1.160	1.148

Noteworthy currencies and factors

EUR	If ECB buys more long-term German gov't bonds, euro would retreat after rising
GBP	If Brexit negotiations remain tangled, concerns about hard Brexit would cause euro depreciation
CNY	Key is whether authorities will accept weaker yuan caused by concerns about economic slowdown

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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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.

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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

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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Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association