26 October 2018
Japanese report: 25 Oct 2018 (DSFX317)

Forex Market View

Yen appreciation may be a bigger risk than depreciation

- Risks that would cause the yen to weaken or strengthen
- Easing of US-China conflict and a sharp rise in oil prices are both unlikely
- US economic slowdown and a split Congress are likely

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

25 Oct – 23 Nov: Y109.0-114.0/$ (Y112.58/$ as of 24 Oct)

Forex Market View DSFE189

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Risks that would cause the yen to weaken or strengthen

Risks that would cause the yen to weaken or strengthen

In the forex market over the near-term, risk factors for yen depreciation include the Fed turning hawkish, an easing of the US-China conflict, and sharply rising oil prices, while risk factors for yen appreciation include a US economic slowdown, a weakening of the yuan & additional China-US tariffs, a Japan-US agreement with a currency clause, a split Congress in the US, and a hard Brexit. Based on the likelihood of each risk factor, overall we think the risks of yen appreciation outweigh those of yen depreciation, and think the yen is likely to strengthen.

Easing of US-China conflict and a sharp rise in oil prices are both unlikely

Fed turning hawkish

We look first at yen depreciation risks. If the Fed turns hawkish, it will probably lead to a rise in US long-term rates and stronger dollar. US long-term rates have risen, possibly pricing in the expectation of the fed funds rate being raised above the neutral rate (that level FOMC members consider appropriate over the long term, the median among members is 3.00% and central range is 2.75-3.00%) by 2020. Nevertheless, although tariffs pose the risk of inflation, they also raise the risk of an economic slowdown, and we think FOMC members are unlikely to raise their policy rate forecasts unless the US economy accelerates. The weakening of share prices sparked by the rise in US long-term rates has become another factor making the Fed cautious about turning hawkish. We do not see a very high probability of the Fed turning hawkish and pushing US long-term rates and the dollar higher.

Chart: FOMC Members' Projections for Appropriate FF Rate Level

	End-2018		End-2019		End-2020		End-2021	Longer run	
	Jun 2018	Sep 2018	Jun 2018	Sep 2018	Jun 2018	Sep 2018	Sep 2018	Jun 2018	Sep 2018
(%)	(No. of members)								
4.125					2		1		
3.875			1			1	1		
3.625				1	3	6	2		
3.5					1		1	1	1
3.375			3	4	4	2	4		
3.25					1			1	1
3.125			4	4	1	4	1		
3							1	5	6
2.875			4	4		1	3		
2.75								4	4
2.625	1		1	1	2	1	1	1	
2.5								1	3
2.375	7	12		1					
2.25								1	
2.125	5	4	1	1		1	1		
1.875	2		1		1				
Median	2.375	2.375	3.125	3.125	3.375	3.375	3.375	2.875	3.000
Weighted average	2.242	2.313	2.975	3.016	3.308	3.281	3.234	2.866	2.883

Source: Fed; compiled by Daiwa Securities.

Easing of US-China conflict

If the conflict between the US and China eases, it should lead to a global risk-on rise in share prices and weakening of the yen. Thus far, however, the US has rebuffed the concessions offered by China to increase imports from the US, open its markets, ease capital restrictions, and protect intellectual property, instead opting to impose additional tariffs on Chinese goods and restrictions on China's investment in the US. We attribute this not only to the US deeming China's systemic reform as insufficient but also to its having a longer-term objective of preventing China from gaining technological and military supremacy. The Trump administration is likely to continue pursuing a protectionist trade policy with China in anticipation of the next presidential election in 2020. With the US and China having suspended trade talks, we think it unlikely that a meeting between their leaders on the sidelines of the G20 meeting in November will lead to mutual concessions that ease commercial tensions.

Sharp rise in oil prices from supply reductions

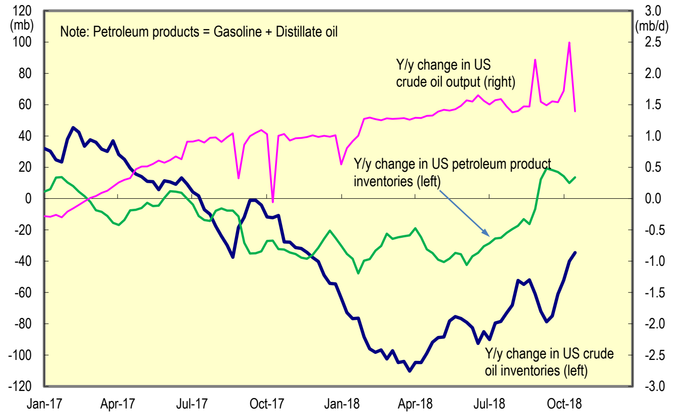
If a reduction in supplies causes oil prices to rise sharply higher, it should cause the yen to weaken through a rise in overseas interest rates and worsening of Japan's trade balance. Nevertheless, although the supply of oil from Iran will decline as a result of the US imposing an embargo on Iran-produced oil in November, China, Turkey, India, and other major recipients of Iranian oil exports will continue to import Iranian oil, and the US has offered exemptions from the sanctions to countries that reduce those imports by at least 20%. This makes a sharp reduction in supply unlikely. Additionally, US crude oil inventories are in a rising trend, and growth in the amount of crude oil supplied by the US, Saudi Arabia, and Russia should be enough to cover demand. We also think it unlikely that the US will deem Saudi Arabia's Crown Prince complicit in the Saudi journalist's murder and impose significant economic sanctions on the oil kingdom. Saudi Arabia has indicated it has no intention of reliving the oil embargo. We think a tightening of global oil supply-demand and sharp rise in prices brought by a reduction in supply from Iran and Saudi Arabia is unlikely.

US economic slowdown and a split Congress are likely

US economic slowdown

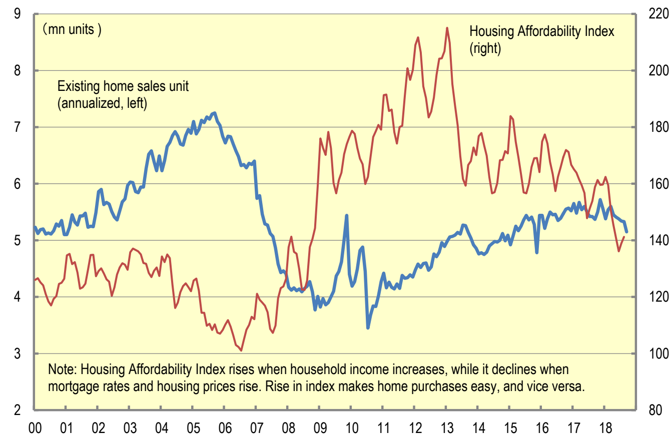
We look next at the risks of yen appreciation. If the US economy slows, it would likely push the USD/JPY lower through risk-off moves and a decline in US long-term rates. On top of the European and Chinese economies having already begun to slow, dollar depreciation is also having an impact, and US exports have slowed. Although both exports and imports apparently increased in September on last-minute demand prior to the imposition of additional tariffs on China, a pullback is likely from October. The rise in US interest rates sparked a decline in home sales, and home loan applications have dropped to their lowest in four years. Additionally, US retail sales are showing signs of a slowdown in private consumption, possibly owing to the diminishment of impacts from tax cuts and the wealth effect. President Trump has proposed making the income tax permanent and providing additional tax cuts for the middle class. Some Senate Republicans oppose making the tax cuts permanent, however, and even if legislation offering additional middle-class tax cuts can be drafted over the next several weeks, it would be difficult to pass if the Republicans lose the midterm elections. We see more than a small probability that the US economy will slow in response to additional US-China tariffs and falling share prices, and that the correction in overvalued US share prices will continue, leading to a fading of rate hike expectations and decline in US long-term rates.

Chart: US Crude Oil Output, Inventories of Petroleum Products and Crude Oil



Source: US Energy Information Administration, Thomson Reuters; compiled by Daiwa Securities.

Chart: US Housing Affordability Index and Existing Home Sales Unit



Source: National Association of Realtors, Thomson Reuters; compiled by Daiwa Securities.

Yuan depreciation and additional China-US tariffs

A further weakening of the yuan would likely cause a risk-off strengthening of the yen on concerns that the US would take a tougher stance in its trade policies with China, lead to additional US-China tariffs, and cause an economic slowdown. Although the US refrained from naming China a currency manipulator in its October report, Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States, it did express concern over the weak yuan and the possibility that it could exacerbate China's trade surplus with the US. It also said that it would keep a close eye on China's currency practices moving forward. In the US view, although the Chinese authorities may intervene to buy yuan, they tolerate (or encourage) yuan weakening to support exports. Both Chinese stocks and the yuan strengthened recently on expectations that the government would cut income taxes and allow bank wealth management funds to invest in stocks, but there is a possibility that a tax cut amounting to about 1% of GDP would not be enough to offset the negative impacts from the US imposing additional tariffs on Chinese goods. If the yuan weakens further on concerns over a Chinese economic slowdown and the authorities allow it to continue, it will increase the risk of the Trump administration following through with its plans to raise tariffs on $200 billion of Chinese goods from 10% to 25% in 2019.

A currency clause in the Japan-US trade agreement

In its trade negotiations with Japan, the US wants to add a currency clause to prevent currency devaluation. The inclusion of such a clause would probably draw attention to US pressures to correct the yen's weakness and pave the way for yen appreciation. This is because if the yen continues weakening while the BOJ maintains its accommodative stance, there is a risk that the US will characterize that accommodation as a tool to devalue the yen and seek measures to reverse the yen's weakening. Japan will of course resist such a currency clause, and we think inclusion is unlikely. Nevertheless, while the risk of yen appreciation from the inclusion of a currency clause is low, there is a risk that the yen will be strengthened as a result of the BOJ continuing to taper QE to buttress Japan's contention, in arguing against inclusion, that it is not devaluing the yen.

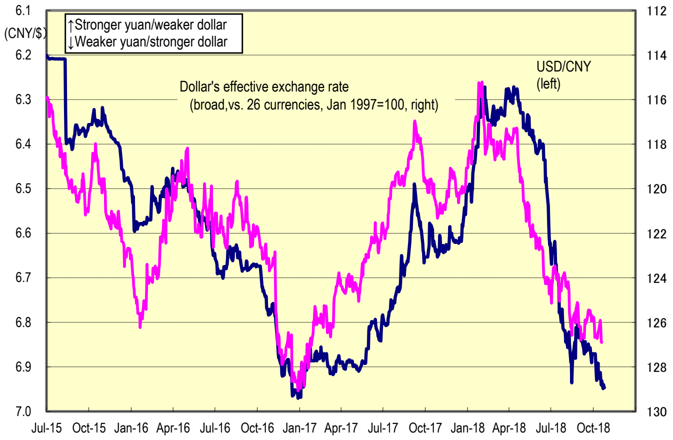
The US midterm elections resulting in a split Congress

If the US midterm elections result in a split Congress, concerns over a reduction in the administration's power to implement policy and a strengthening of its protectionist stance would likely push the USD/JPY lower. In previous midterm elections, the USD/JPY has tended to rise when the party in the White House maintained control of both legislative chambers, regardless of whether it was the Republicans or the Democrats. When majority control of both chambers switches from the ruling party to the opposition party, however, the USD/JPY tends to rise when the Republicans are in the White House and decline when the Democrats are. This is probably based on the view that associates the Republican Party with a rising dollar on tax cuts, rising interest rates, and foreign capital inflows, and the Democratic Party with a weaker dollar on protectionist trade policy. If the Republicans, now in the White House, maintain control of both chambers after the midterm elections this November, the USD/JPY is likely to rise, but if the opposition Democratic Party gains a majority in the House and splits control of Congress, there is probably a greater risk of the USD/JPY declining.

Hard Brexit

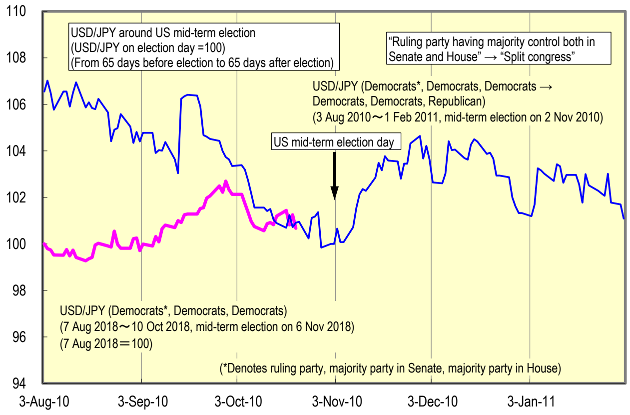
If there is a hard Brexit, i.e., if the UK leaves the EU without an agreement, both the pound and euro would weaken and markets would turn risk off. The EU has proposed a backstop for the UK to avoid a post-Brexit hard border in Northern Ireland, under which Northern Ireland would continue to follow the EU's customs regulations after Brexit. It is likely that one of the conditions that the EU would require under this backstop is an extension of the transition period, now until end-2020, under which the UK remains bound to the EU's customs rules after Brexit. If the UK accepts the EU proposal, opposition from political parties in Northern Ireland and the UK conservatives and hard Brexiteers would increase the risk of the Brexit agreement not being approved by the British Parliament. The border issue makes it difficult for the UK to compromise with the EU, and ultimately it will probably come down to whether the EU is willing to compromise. A Brexit without an agreement would probably have a negative impact on both the UK and EU economies, and we see more than a trivial risk of that happening.

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



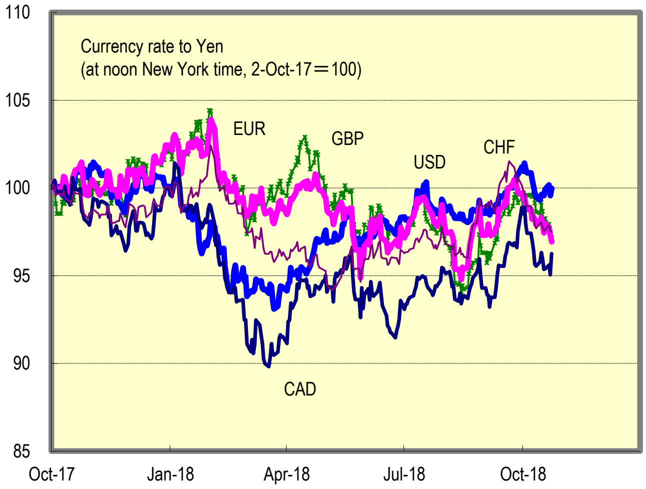
Source: Fed, Thomson Reuters; compiled by Daiwa Securities.

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



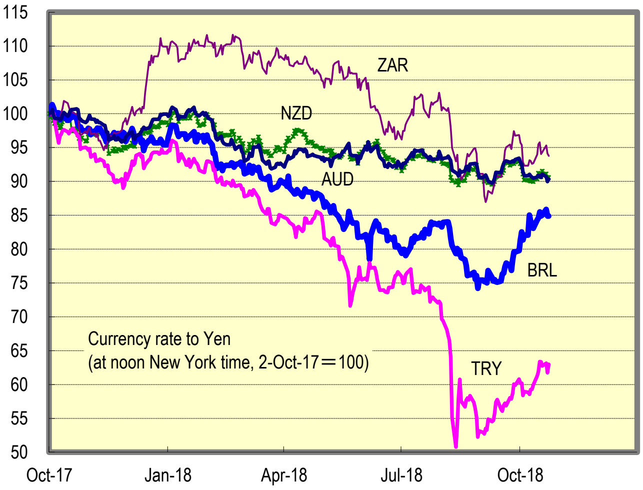
Source: Thomson Reuters; compiled by Daiwa Securities.

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	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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1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

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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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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
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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
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