Daiwa Securities

Forex Market View

USD/JPY may continue downward even if dollar weakening loses momentum

- Relative decline in US interest rates sparked dollar weakness
- Context includes concern over US economy, declining inflation expectations, and fading rate hike expectations
- USD/JPY continues declining even with risk-off softening of dollar depreciation

<u>**USD/JPY forecast range (latest: noon New York time)**</u>

21 Nov– 20 Dec: Y109.0-114.0/$ (Y112.65/$ as of 20 Nov)

Forex Market View DSFE194

FICC Research Dept.

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

Daiwa Securities Co. Ltd.

Relative decline in US interest rates sparked dollar weakness

Decline in USD/JPY sparked by dollar weakness

The recent decline in USD/JPY is owing more to dollar weakness than to yen strength. Following the US midterm elections, the USD/JPY rose to 114.2 until November 12, then declined to 112.3 until the 20th. Meanwhile, the EUR/USD declined from 1.150 on November 7 to 1.122 on the 13th, then rose to 1.147 by the 20th. Risk-off euro selling and dollar buying until November 13, which was Italy's deadline for resubmitting a budget, pushed the dollar's effective exchange rate against major currencies to its highest in 16 months, after which the market turned to dollar selling. The EUR/JPY, which had declined to 127.5 by the 13th, rose to around 129 by the 20th, so the yen was not appreciating.

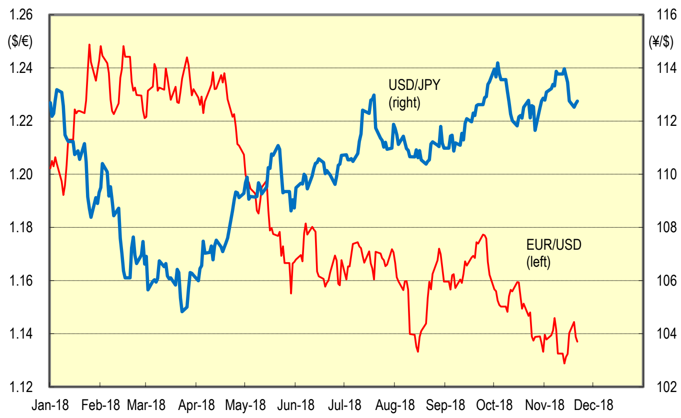
Relative decline in US interest rates sparked dollar weakness

It was the relative decline of US interest rates that sparked the dollar's weakening. US long-term rates began declining on November 9 in response to the downturn in share prices brought by concerns over corporate earnings. Nevertheless, while risk-off moves also sparked a decline in long-term rates in the EU, the dollar was bought until the US Treasury market holiday on November 12 (13th Japan time). Because US long-term rates started declining relative to rates in Germany and other countries on the 13th, however, a strengthening of the euro and weakening of the dollar changed the trend in the dollar's effective exchange rate from rising to falling.

Risk tolerance may have increased some since late October

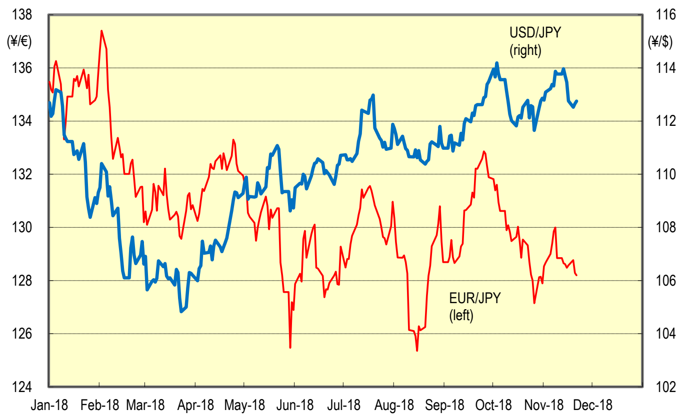
The 10-year Treasury yield declined to around its low in late October of 3.06%, but the USD/JPY is about Y1 higher than its low recorded then of 111.37. We think one reason for this is that the rate of m/m decline in US share prices, a reflection of risk tolerance, is slightly smaller now than it was in late October.

Chart: USD/JPY and EUR/USD



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY and EUR/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Context includes concern over US economy, declining inflation expectations, and fading rate hike expectations

Risk-off preference brought by concerns over the US economy

We attribute the decline in US interest rates to concerns over the US economy (a risk-off mood), a decline in inflation expectations, and a fading of rate hike expectations. Because US economic indicators have begun worsening at a time when economic indicators for the EU and China are already in a worsening trend, the expectation that only the US economy would be exempt from a slowdown has begun to lose ground, and concerns over the economy may be starting to cause a risk-off weakening of US share prices and decline in long-term rates (rise in bond prices). Although US economic indicators have not begun to weaken overall, there are signs of a peaking out of manufacturing sentiment, home sales volume, home builder indices, and consumer sentiment. Additionally, there are signs of a slowdown not only in the macro economic data but in such micro data as the orders booked by the leading US IT companies, and the rate of growth in forecast EPS for US companies overall has continued to weaken. There is still hope that the US-China summit will produce a trade agreement that stops the additional US tariffs on Chinese goods (the tariff hike schedule for January 2019), but it is unclear how that will go. Even if the additional tariffs can be avoided, we expect a weakening of trade volumes to put downward pressure on production from 2019, because last-minute demand ahead of the tariff hikes is already boosting exports and imports. We think there is still a possibility that concerns over the economy will weaken the dollar through a risk-off decline in US long-term rates.

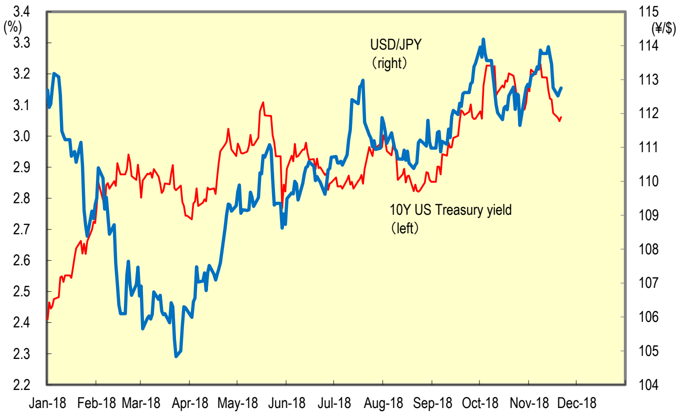
The decline in oil prices is one reason for the decline in US inflation expectations

Additionally, the decline in inflation expectations is having a downward impact on US long-term rates. The US 5-year BEI, which had risen to 2.16% in May, declined to 1.81%, while the US 10-year BEI, which was at 2.18% in May and 2.17% in early October, declined to 1.96%. We think one reason for this is the significant decline in oil prices following their peak in early October. With other commodity prices having already been in a declining trend because of the weak demand outlook, increased oil production and inventories in the US and the grace period allowed for the trade embargo on Iranian-produced oil started feeding concerns about an oversupply of oil, pushing oil prices lower. Although Saudi Arabia and other OPEC members have started indicating a willingness to cut production, Russia and other non-OPEC producers have remained hesitant to do so, making it unlikely that production cuts will be large enough to trigger a sharp rebound in oil prices. Employee wage growth in the US has been accelerating, but the peaking of the core CPI, a measure of inflation that excludes food and energy prices, is making it difficult for inflation expectations to strengthen. We think it likely that declining inflation expectations will continue exerting downward pressure on US long-term rates.

Fed rate hike expectations are receding in response to dovish comments from Fed officials

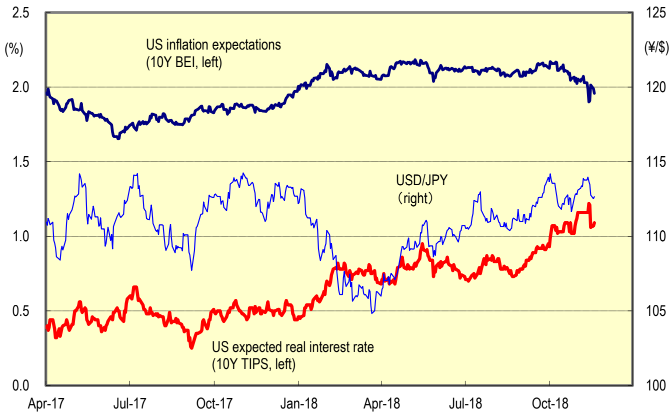
One factor that has recently begun having a downward impact on US long-term rates is the fading of rate hike expectations. Rate hike expectations were already fading amid signs of a worsening of US economic indicators, and that fading accelerated when Fed officials started making dovish statements in November. San Francisco Fed President Mary Daly said on November 12 (13th Japan time) that it was "too soon to know" whether a rate hike is needed in December. On November 14 (15th Japan time), Fed Chair Jerome Powell cited as reasons to be concerned: tariff hikes, signs of an global economic slowdown, signs of the US housing market slowing, rising corporate debt, and a fading of effects from fiscal stimulus.

Chart: 10Y US Treasury Yield and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: 10Y US BEI, TIPS Yield, and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

On November 16, Fed Vice Chair Richard Clarida said that US interest rates are close to what the Fed considers to be neutral and that there is evidence suggesting the global economy is slowing. The statements, seen as evidence of a dovish turn at the Fed, were followed by a significant decline in the expectation of interest rate increases shown by fed funds futures (the January 2020 contract declined from 2.945% on November 8 to 2.735% on the 20th) and by a downturn in the yield on TIPS, an indicator of real yields. Additionally, the decline in inflation expectations has weakened rate hike expectations, and the decline in real yields may also be a factor. The fading of Fed rate hike expectations is weakening the rise in US real interest rates and in US interest rates relative to rates in other countries, both of which had been supporting dollar appreciation.

USD/JPY continues declining even with risk-off softening of dollar depreciation

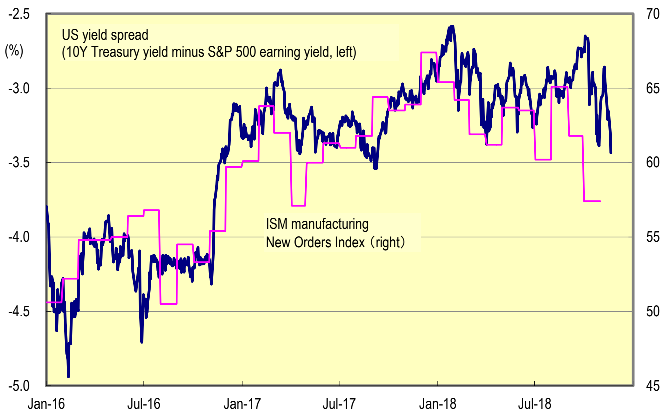
Conditions make it unlikely that decline in long-term rates will lead to higher share prices

A decline in long-term rates can pave the way for share prices to rise, but this is unlikely to happen when growth expectations are declining. The yield spread, defined as the 10-year Treasury yield minus the equity earnings yield, has been declining because of the decline in share prices and interest rates, but it is still within its trading range since 2017. If the new orders index for US manufacturers, which is related to the corporate earnings outlook, were to worsen below the bottom of its range since 2017, it would probably cause the yield spread to decline further. That would push markets into risk-off mode and make a concurrent decline in US long-term rates and share prices more likely.

USD/JPY continues declining even with risk-off softening of dollar depreciation

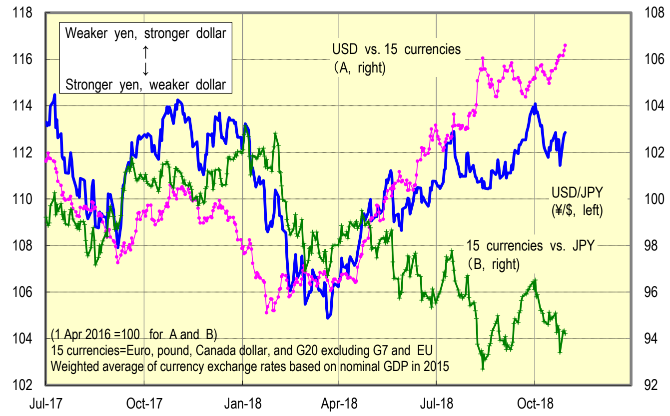
A relative decline in US interest rates has a weakening impact on the dollar, while risk-off moves strengthen both the yen and the dollar. A turn to risk off would eliminate the one-way decline in the dollar relative to the euro and many other currencies and make it more likely that the dollar's effective exchange rate becomes range-bound. Risk-off moves also make it more likely that the yen will strengthen, however. In other words, even though a risk-off dollar strengthening dampens the dollar weakening impacts from falling US interest rates and makes the dollar's effective exchange rate less likely to decline, the combination of dollar weakness from falling US interest rates and risk-off yen appreciation is likely to keep the USD/JPY in a declining trend. Instead of an across-the-board weakening of the dollar, we expect an across-the-board strengthening of the yen to cause both the USD/JPY and cross-yen rates to decline.

Chart: US Yield Spread and ISM Manufacturing New Orders Index



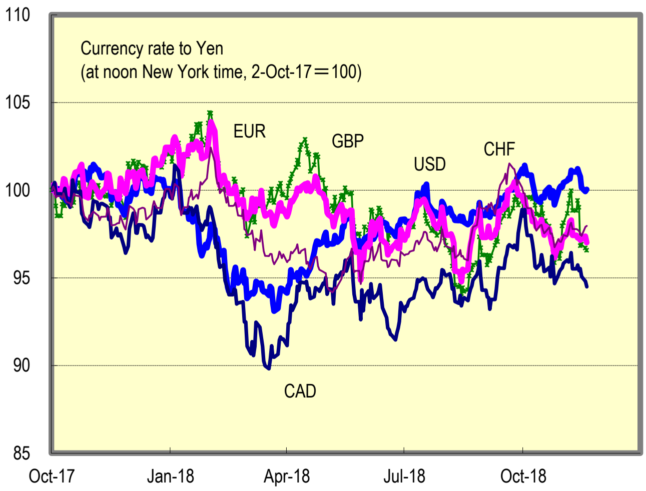
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Exchange Rates of USD, JPY, and Other Currencies



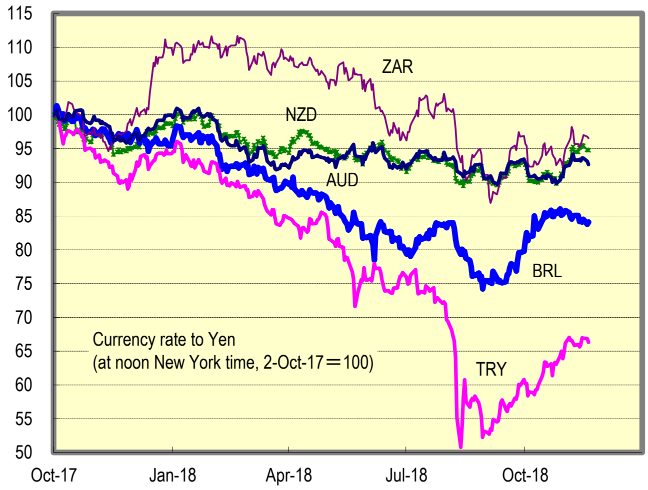
Source: Thomson Reuters; compiled by Daiwa Securities.

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		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	125.5	122.0	126.5	123.5	121.0
			124-133	120-131	120-131	120-131	118-129
AUD-JPY	81.9	82.1	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	72.5	69.0	72.5	70.0	68.5
			71-78	67-76	67-76	67-76	66-75
TRY-JPY	24.1	18.8	19.0	17.5	19.0	18.0	17.3
			17-22	16-22	16-22	16-22	15-21
ZAR-JPY	8.1	8.0	7.6	7.1	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	28.2	26.4	28.2	27.0	26.1
			26-31	25-31	25-31	25-31	24-30
KRW-JPY	9.9	10.2	9.6	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.

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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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.
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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

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May 2018

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.

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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association