

Forex Market Weekly

No deal Brexit moving closer to reality

- US rates, stocks, USD/JPY fell as US/China trade deal hopes peaked
- Oil price jump on production cut agreement likely short-lived
- Risk UK Parliament could reject Brexit deal

This week's USD/JPY forecast range

10 – 14 Dec: Y111.5 – 113.5/\$ (Y112.7 at end-previous week)

Forex Market View DSFE199
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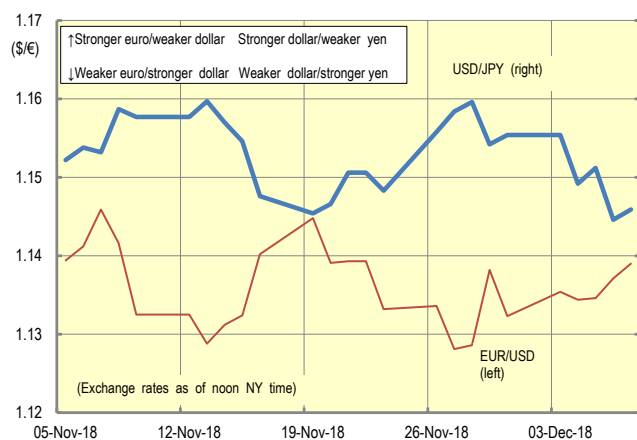


US rates, stocks, USD/JPY fell as US/China trade deal hopes peaked

Overview of last week's forex market

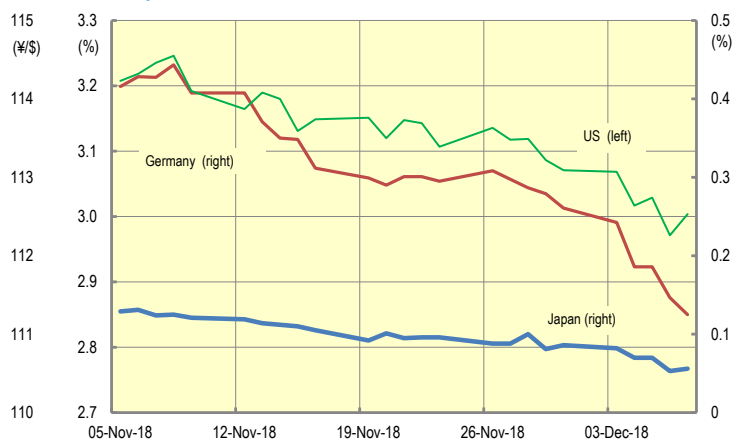
Meeting on the sidelines of the G20 meeting in Buenos Aires, US President Donald Trump and Chinese President Xi Jinping reached a temporary ceasefire in the trade war between the world's two largest economies. The US agreed to a 90-day grace period during which it will not impose additional tariffs on \$200bn in imports from China to allow for negotiations on structural changes to China's trade practices. Meanwhile, China agreed to substantially increase its imports of US farm produce, energy, and other products. The USD/JPY rose to 113.86 at the start of last week on risk-on yen depreciation. However, this yen weakening trend quickly ended. The yuan strengthened and the dollar weakened. As a result of the weaker dollar, the USD/JPY pulled back. Even though the USD/JPY then rallied on higher US stocks, US interest rates fell and the USD/JPY dropped after FRB Vice Chairman Richard Clarida said risk has tilted toward "too-low inflation." US stocks fell sharply with risk-off yen appreciation ensued as concerns about the US/China trade spat flared up. Specifically, Trump warned of additional tariffs on Chinese goods if negotiations during the 90-day grace period (starting December 1) break down and National Economic Council Director Larry Kudlow added that an agreement with China to reduce tariffs on US auto imports was not yet reached. The arrest of Huawei CFO in Canada on suspicion of violating US sanctions against Iran raised fears that US/China relations could further deteriorate. As a result, stocks fell, the yen appreciated, US rates dropped, and the dollar weakened (fell to JPY112.22). Even though the USD/JPY rose on an oil price rally after OPEC agreed to cut production, the pair again retreated on declines for US stocks and interest rates.

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



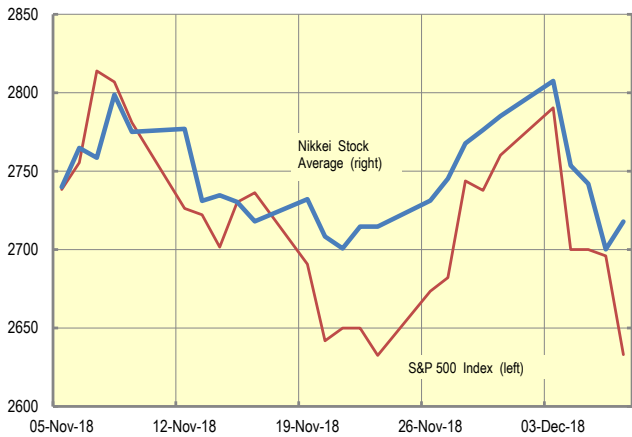
Source: Thomson Reuters; compiled by Daiwa Securities.

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



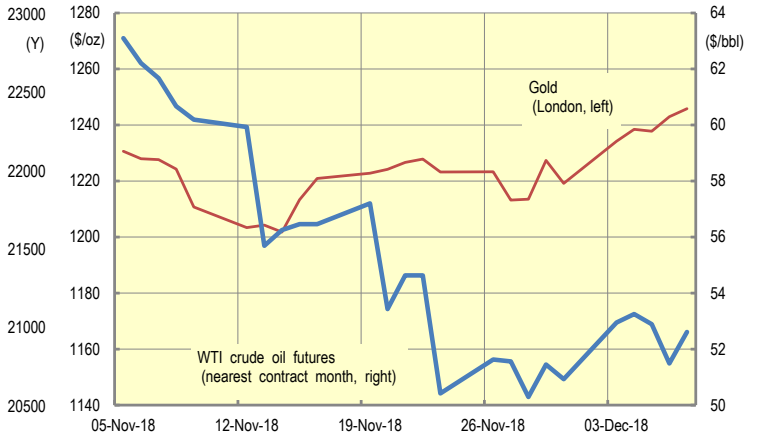
Source: Thomson Reuters; compiled by Daiwa Securities.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



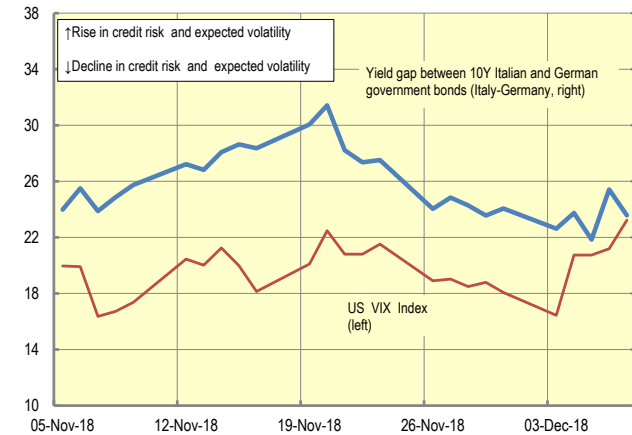
Source: Thomson Reuters; compiled by Daiwa Securities.

OPEC agrees to cut production

Oil price jump on production cut agreement likely short-lived

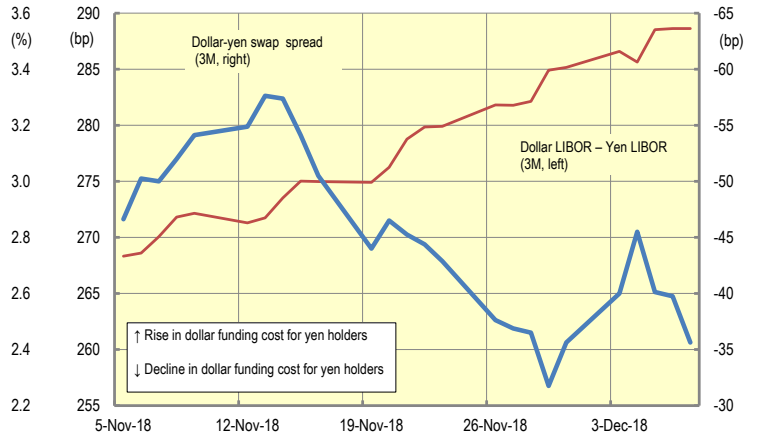
OPEC and its oil-producing allies agreed on 7 December to a 1.2 million barrels per day production cut. The crude oil price rallied as the output cut was bigger than the market had expected. Russia agreed to reduce supply gradually over several months, probably because making such cuts during the winter is more difficult for Russia than other countries. Prices for commodities other than oil are trending lower on expectations for weaker demand due to a slowing global economy. This suggests that the oil price rally could be short lived. Lower commodity prices will probably weigh on global inflation expectations and interest rates, while providing lift to the yen.

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



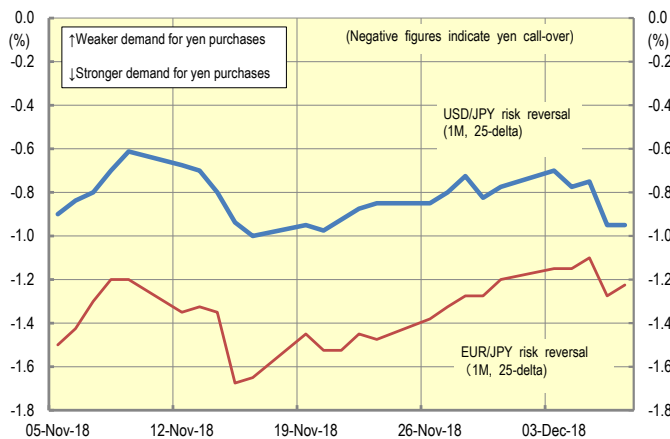
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



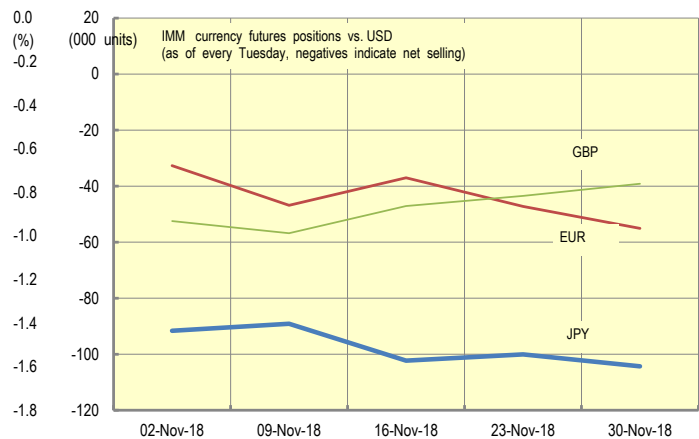
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Risk UK Parliament could reject Brexit deal

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On 11 December, the UK Parliament is set to vote on the draft of a Brexit deal reached with the EU. After first voting on whether to accept the motion to amend the government's draft Brexit agreement, a vote will be held on whether to accept this draft as well as a political declaration including future long-term relations with the EU. Northern Ireland's Democratic Unionist Party, which has supported the administration of Prime Minister Theresa May from outside the Cabinet, is opposed to the draft agreement, as are many in the ruling Conservative Party. As such, there is a high risk that the draft will not pass. The May administration is apparently considering shoring up support in the House of Commons by stressing that Britain will no longer have the option of remaining in the EU customs union as of July 2020 if Parliament fails to approve a Brexit deal. Still, there is probably little chance that Parliament will accept the draft Brexit deal. The likely ramifications of such a scenario in which the draft Brexit deal is rejected could include the resignation of May, the removal of May as prime minister through a no-confidence vote, the opposition Labour Party rising to power after demanding a no-confidence vote against the May administration, general elections, renegotiating terms for leaving the EU, extending negotiations, a second Brexit referendum, and withdrawing plans to leave the EU. Even though many members of Parliament are opposed to leaving the EU without a deal in place, the risk of an unintended "no-deal Brexit" is growing. Markets are likely to turn risk adverse amid concerns about a no-deal Brexit. There is a strong possibility for not only a weaker pound, but a stronger yen. *(The parliamentary vote on Brexit deal has been postponed.)*

Risk of trade concessions hurting Chinese economy

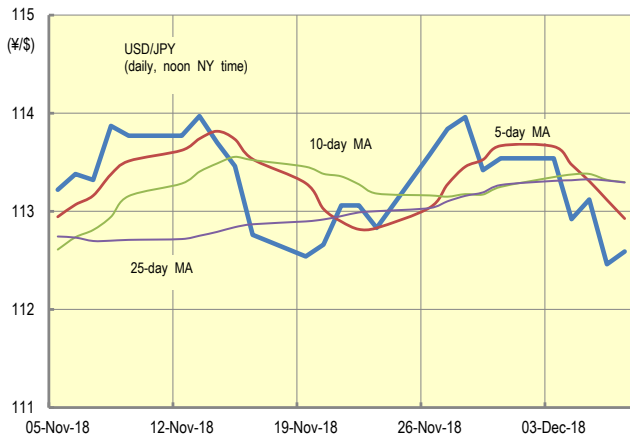
China has agreed to increase its imports of US farm produce, energy, and other products. Indeed, it is now preparing to restart imports of US soy beans and LNG. These concessions will not hurt the Chinese economy provided it can simply switch the source of such imports to the US from other countries. However, the import of US industrial goods beyond what is required could lower Chinese production. Also, allowing the yuan to appreciate, as demanded by the US, would hurt China's exports and production. Such concessions could encourage the US to ease its hardline policies with China. However, these concessions could have negative impacts if they cause the Chinese economy to slow. The emergence of risk aversion factors out of China probably warrants careful attention.

Noteworthy currency: EUR

The Governing Council of the ECB will hold its next monetary policy meeting on 13 December, when it is expected to end new bond purchases under QE. It will apparently discuss the policy of reinvesting maturing asset from next year, but probably will not make announcements in most cases. The ECB will likely maintain an optimistic stance, while still recognizing the growing risks for an economy that is slowing. However, eliminating the market's pessimistic stance seems challenging. Meanwhile, the council is not expected to discuss again extending Targeted Long-Term Refinancing Operations (TLTRO). We need to

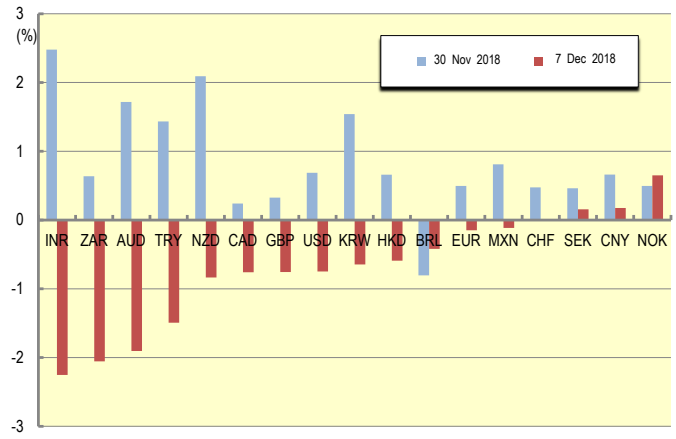
monitor potential euro depreciation if disappointment over no TLTRO discussions results in higher Italian yields and lower German yields.

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

- 10-Dec ○ Oct German trade statistics
- 11-Dec ○ Dec German ZEW Indicator of Economic Sentiment
- **UK Parliament to vote on withdrawal agreement from EU**
- 12-Dec ○ Oct eurozone industrial production
- **Nov US CPI**
- 13-Dec ○ MPM at Brazilian central bank
- **ECB Governing Council meeting (president's press conference)**
- **EU summit meeting (until 14th, Brussel)**
- 14-Dec ○ Dec BOJ Tankan
- Nov China industrial production, retail sales
- Nov European new car sales
- **Nov US retail sales**
- Nov US industrial production, capacity utilization rate
- 15-Dec ○ Nov China 70 cities housing prices

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

	3 - 7 Dec 2018 (actual)		10 - 14 Dec 2018 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	112.2-113.9	112.7	111.5-113.5	112.3
EUR/JPY	127.6-129.4	128.4	125.4-128.9	127.7
EUR/USD	1.131-1.143	1.138	1.125-1.145	1.135

Noteworthy currencies and factors

EUR	Even if ECB remains optimistic, it would be difficult to eliminate market concerns Italy to submit revised budget draft; euro likely to fluctuate depending on content
GBP	If UK Parliament rejects draft EU withdrawal agreement, pound would weaken
SEK	Market may expect Dec rate hike, depending on inflation and unemployment rate levels
Currencies in oil-producing nations	Currency appreciation on rebound of crude oil prices is unlikely to continue

Source: Compiled by Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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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)

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[Moody's]

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[Fitch]

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- 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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