Forex Market View

With Fed rate hikes nearing an end, yen more likely than the dollar to strengthen

- Rebound in USD/JPY may be temporary because Fed officials' dovish turn was expected
- Rate hike amid heightening concerns over a US economic slowdown should cause risk-off yen appreciation
- Although US interest rate levels are relatively higher, if they decline in relative terms the dollar will weaken

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

20 Dec-18 Jan: Y109.0-114.0/$ (Y112.14/$ as of 19 Dec)

Forex Market View DSFE201

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Rebound in USD/JPY may be temporary because Fed officials' dovish turn was expected

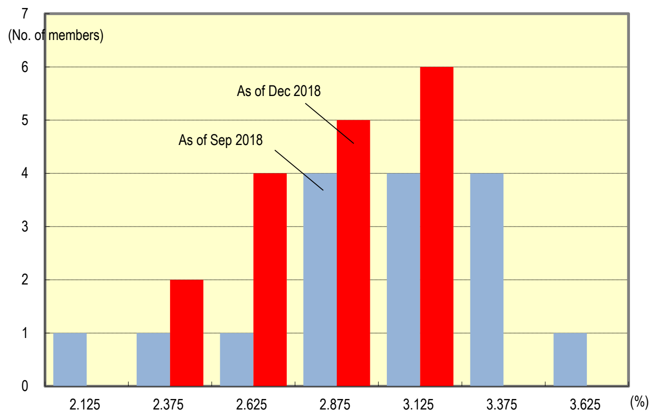
FOMC members lower their rate hike outlook

The Fed decided to hike rates by a quarter point at its FOMC meeting, but Fed officials have clearly become more dovish. The median forecast from FOMC members median forecast was lowered from 2.5% to 2.3% for 2019 real GDP growth, from 3.125% to 2.875% for the end-2019 fed funds rate, and from 3.375% to 3.125% for the end-2020 and end-2021 fed funds rate. With a 2019 growth forecast that now exceeds the potential growth rate (slightly raised from 1.8% to 1.9%), the FOMC statement noted that "some further gradual increases" in the federal funds rate would be appropriate, language that indicates less of a need for further rate hikes than previously. It wrote that risks to the economic outlook are roughly balanced but that it would continue to monitor global economic and financial developments. Additionally, Fed Chairman Jerome Powell said at his press conference that there have been developments that may signal some softening relative to what was expected a few months ago, including slower growth in overseas economies, an increase in market volatility, and a tightening of financial conditions.

Rebound in USD/JPY may be temporary because Fed officials' dovish turn was expected

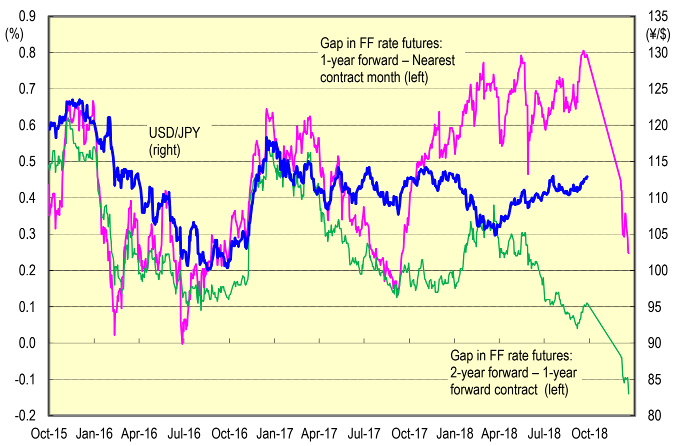
With Fed officials expressing concern over the economy slowing, both US stock prices and long-term rates declined further, and the 2020 rate hike expectations indicated by fed funds futures also declined. Forex markets experienced a risk-off strengthening of both the dollar and the yen. Nevertheless, possibly because the Fed's dovish turn was within what the market expected, 2019 rate hike expectations rose slightly, short-term Treasury yields remained firm, and the USD/JPY rebounded slightly from previous dollar selling. Nevertheless, there is probably little expectation of the global economy recovering on the US moderating its pressure on China, US economic growth is weaker than officials have projected, and it is likely that forecasts for both growth and rate hikes will be revised further downward.

Chart: Projections for End-2019 FF Rate Among FOMC Members



Source: Fed; compiled by Daiwa Securities.

Chart: USD/JPY and Outlook for FF Rate Futures



Source: Thomson Reuters; compiled by Daiwa Securities.

The more likely scenario is probably a decline in the USD/JPY as risk-off moves trigger more strengthening in the yen than in the dollar amid a continued decline in US stocks and US interest rates, particularly long-term ones.

Rate hike amid heightening concerns over a US economic slowdown should cause risk-off yen appreciation

Rate hikes made amid heightening concerns over a US economic slowdown are likely to push both stocks and interest rates lower

The Fed hiked rates seven times between December 2016 and September 2018, and US stocks showed a greater tendency to decline after those seven FOMC meetings. Looking at the 20-day periods before and after each FOMC meeting, share prices rose before six of the seven meetings and declined after four of them, with the DJIA on average rising 560 points prior to the meeting and declining 213 points afterward. There was a 501pt decline after the June 2018 FOMC meeting and a 1,802pt decline after the September meeting, suggesting that as an economic slowdown becomes more of a concern, rate hikes have a more of a downward impact on stocks. In contrast, there was not much of a difference in the direction of 10-year Treasury yields before and after the FOMC meetings, although the tendency was for an increase prior to the meeting and a decline afterward. Because long-term rates tend to decline when share prices are declining, rate hikes made amid heightening concerns over an economic slowdown are probably likely to not only weaken stocks but also cause long-term rates to decline. The USD/JPY tended to rise prior to the FOMC meeting and weaken afterward and tended to decline when there was a pronounced decline in US stocks and US interest rates. (We note that following the June 13, 2018 FOMC meeting the US imposed tariffs on China on July 6, and the USD/JPY rebounded on a winding down of negative catalysts.)

We expect a risk-off strengthening of the yen following the latest Fed rate hike

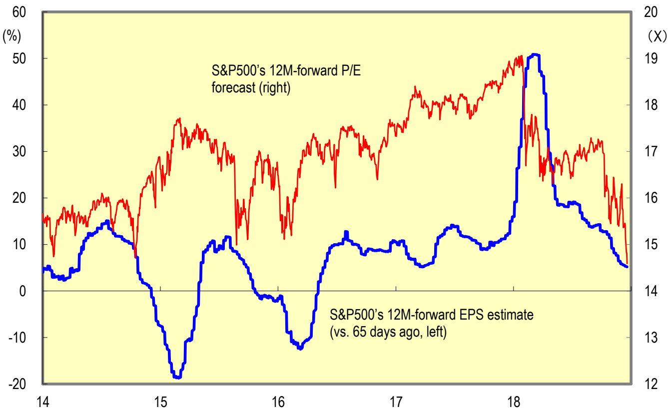
What is likely to happen after the latest rate hike? US corporate earnings growth forecasts (12-month forward EPS, 65-day change) have continued to weaken, not only because of concern over US-China trade friction, but also because of a weakening of final demand, including US exports, housing investment, and business investment. The US has postponed imposing additional tariffs on China (raising tariff rates) until at least March 2, 2019, but US business sentiment is deteriorating irrespective of whether there is another postponement, making it likely that profit forecasts will continue to weaken. If the market deems the weakening of corporate earnings forecasts to be temporary, share prices and P/E forecasts would likely stop declining soon and start rising, but if it deems this weakening of profit forecasts to be sustained, both share prices and P/E forecast are likely to continue falling. This time there are growing concerns that the US economy may be peaking after a long period of expansion, and conditions seem to be getting closer to the latter pattern. Rate hikes made amid concerns over a US economic slowdown are likely to weaken stocks, and the consequent risk-off yen appreciation is likely to pull the USD/JPY lower.

Chart: Change in Market Around FOMC Meeting

20-day change		10-year US Treasury yield (%)	DJIA ($)	Nikkei Stock Average (Yen)	USD/JPY (Y/$)
Dec-16	Before FOMC*	0.28	924	1391	5.90
	After FOMC**	-0.15	162	111	1.20
Mar-17	Before FOMC*	-0.02	338	139	0.49
	After FOMC**	-0.21	-358	-1025	-5.12
Jun-17	Before FOMC*	-0.09	768	69	-2.30
	After FOMC**	0.19	158	215	4.03
Sep-17	Before FOMC*	0.11	601	876	2.36
	After FOMC**	0.06	745	1053	1.44
Mar-18	Before FOMC*	-0.03	-115	-590	-1.34
	After FOMC**	-0.04	66	777	0.96
Jun-18	Before FOMC*	-0.14	432	249	0.19
	After FOMC**	-0.14	-501	-1034	1.11
Sep-18	Before FOMC*	0.17	261	1186	1.12
	After FOMC**	0.06	-1802	-1943	-0.34
Average for seven pre-FOMC meetings		0.02	560	453	0.59
Average for seven post-FOMC meetings		-0.01	-213	-267	0.02

Source: Thomson Reuters; compiled by Daiwa Securities.
Note: Shaded columns indicate drop
**For 20 days until first day of FOMC meeting.*
***For 20 days from second day of FOMC meeting.*

Chart: Expected Profit Growth Rate and P/E Forecast at US Corporations



Source: Thomson Reuters; compiled by Daiwa Securities.

Although US interest rate levels are relatively higher, if they decline in relative terms the dollar will weaken

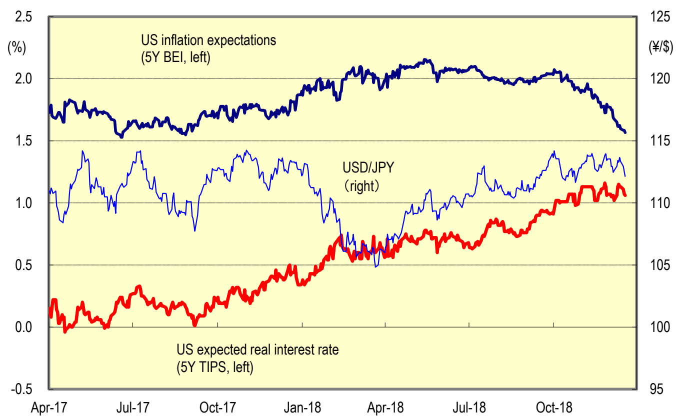
US real interest rates, which have supported the dollar, look likely to decline

US long-term rates have already declined, but rate hikes made amid concerns over an economic slowdown have given risk-off moves momentum, and this is likely to cause interest rates to decline further. The decline in US long-term rates so far can be mostly attributed to declines in inflation expectations. The 5-year BEI decline from 2.07% on October 3 to 1.57% on December 19, while the yield on TIPS, an indicator of real interest rates, was at 1.06% on December 19, higher than the 0.95% on October 3. The USD/JPY declined from 114.19 to 112.14 during that same period on the decline in US long-term rates, and we think one factor that limited the USD/JPY decline is that real yields, which affect the currency's value, remained high. Nevertheless, although the decline in inflation expectations has probably boosted real interest rates to some extent thus far, it should be a factor with a downward impact on real interest rates over the long term. With Fed officials having started to soften their stance of continued rate hikes, the market sees less of a risk of interest rates rising, and this probably makes a decline in real interest rates more likely. A decline in not only nominal interest rates but also real interest rates in the US would facilitate a decline in the USD/JPY.

Although US interest rate levels are relatively higher, if they decline in relative terms the dollar will weaken

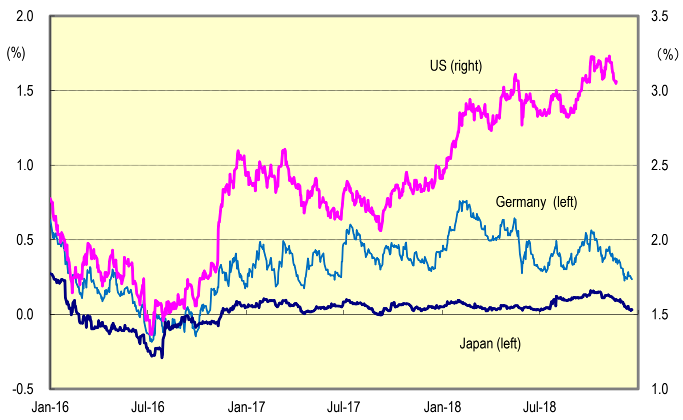
Even if the Fed pauses or stops its rate hikes in 2019, both short-term rates and long-term rates in the US will probably remain high relative to rates in the other major advanced economies. This probably does not mean, however, that it would spark dollar buying. If higher-yielding currencies were always, you would expect to see a sharper increase in expected return from both interest and exchange rates from high-yielding currencies than that from low yielding currencies, but that is not what actually happens. The relative change in interest rates has a stronger impact on a currency's value than the level of interest rates. However much higher the interest rate level is in relative terms, a currency's value tends to weaken when its interest rate declines in relative terms. If there is a relative decline in the expected return from interest, a decline in the currency's value will increase the expected return from the exchange rate, thereby keeping that currency in balance with other currencies. The 10-year government bond yield is much higher in the US than it is in Japan or Germany, but when that interest rate differential narrows, the dollar tends to weaken against the yen and the euro. Because risk-off moves tend to result in a strengthening of the yen against the dollar and a weakening of the euro against the dollar, a relative decline in US interest rates does not always cause the euro to strengthen against the dollar but it is likely to cause the yen to strengthen against the dollar.

Chart: US Inflation Expectations, Real Interest Rate, and USD/JPY



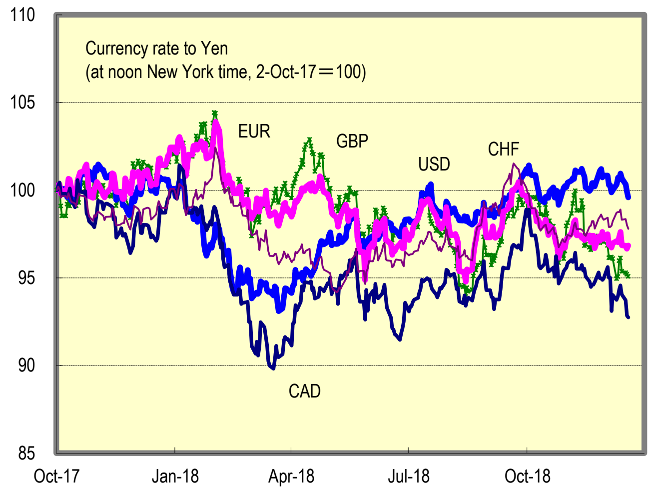
Source: Thomson Reuters; compiled by Daiwa Securities.

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



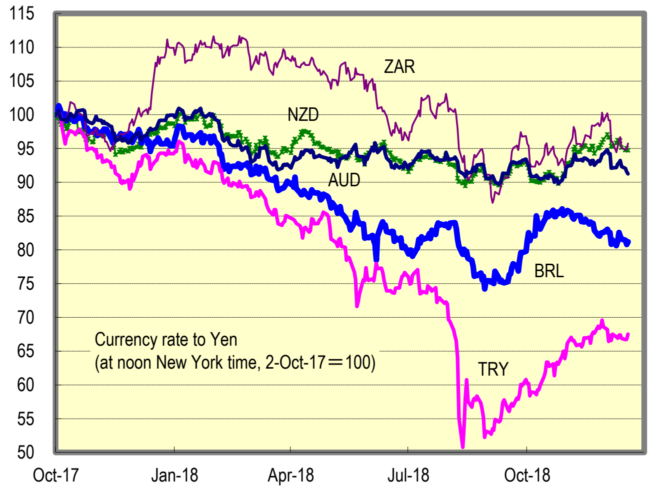
Source: Thomson Reuters; compiled by Daiwa Securities.

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	111.0	108.0	110.0	108.0	107.0
			109-115	105-113	105-113	105-113	104-112
EUR-JPY	129.3	131.9	126.5	122.0	126.5	123.5	121.0
			124-133	120-131	120-131	120-131	118-129
AUD-JPY	81.9	82.1	79.0	74.5	78.0	75.5	74.0
			76-83	73-82	73-82	73-82	71-80
CAD-JPY	84.3	88.0	82.5	79.0	81.5	79.5	78.5
			81-90	77-86	77-86	77-86	76-85
NZD-JPY	74.9	75.2	73.5	69.0	72.5	70.0	68.5
			71-78	67-76	67-76	67-76	66-75
TRY-JPY	24.1	18.8	20.0	18.0	19.7	18.6	17.8
			17-22	16-22	16-22	16-22	15-21
ZAR-JPY	8.1	8.0	7.7	7.2	7.6	7.3	7.1
			7.4-8.4	6.8-8.3	6.8-8.3	6.8-8.3	6.6-8.1
BRL-JPY	28.6	28.1	28.5	26.4	28.2	27.0	26.1
			26-31	25-31	25-31	25-31	24-30
KRW-JPY	9.9	10.2	9.8	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	15.9	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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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

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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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Japan Investment Advisers Association
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