

Forex Market Weekly

Forex market suggests sustained yen appreciation trend

- Steep USD/JPY drop on risk aversion, lower US rates
- USD/JPY likely down in 2018 for third straight year
- Risk of deterioration for US/China Dec manufacturing PMIs

USD/JPY forecast range

25 Dec - 4 Jan: Y109.5 – 111.5/\$ (Y110.3 at end-previous week)

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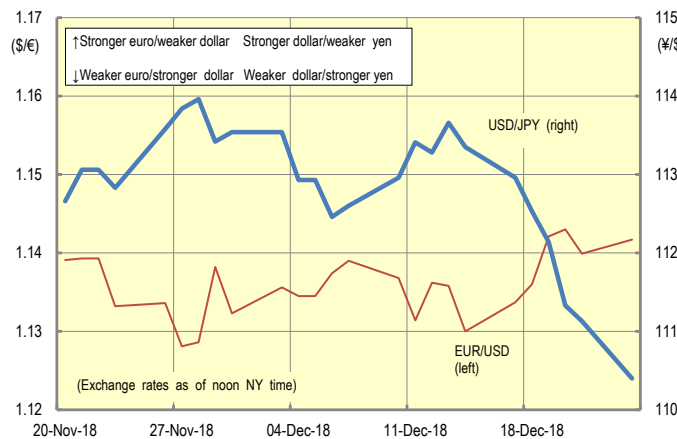
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Overview of last week's forex market

Steep USD/JPY drop on risk aversion, lower US rates

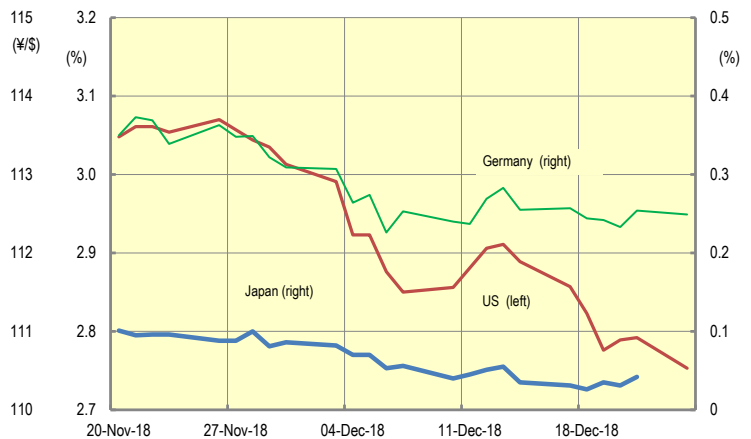
UK Prime Minister Theresa May indicated that she is opposed to a second national referendum on Brexit. The British pound fell after she warned the leaders of France and Germany that a disorderly no-deal Brexit was likely without further concessions from the EU. The dollar and US interest rates began declining ahead of the FOMC meeting. US equities dropped after the Federal Reserve Bank of New York's Empire State Manufacturing Survey for December came in below the market consensus. Chinese equities fell and the yen appreciated after China announced tighter restrictions on investment in its automobile industry. Italy and the EU reached an agreement on Italy's 2019 budget, which provided a lift for the euro. The USD/JPY slipped to around 112.25 ahead of the FOMC statement. The FRB raised its benchmark interest rate a quarter-point, but also said it now forecast only two rate hikes in 2019, down from three hikes previously projected. Short-term Treasury yields remained solid as these results were in line with market expectations, but US equities and long-term interest rates fell. The dollar rebounded slightly just after the FOMC statement, but then turned lower and moved below JPY112. US stocks fell, the oil price declined, and the yen appreciated after the Federal Reserve Bank of Philadelphia's Manufacturing Business Outlook Survey for December missed the market consensus. Yen appreciation was further supported by stronger risk aversion amid the US federal government shutdown and reports US President Trump mulled firing Fed Chairman Jerome Powell. On 24 December the USD/JPY fell to 110.26.

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



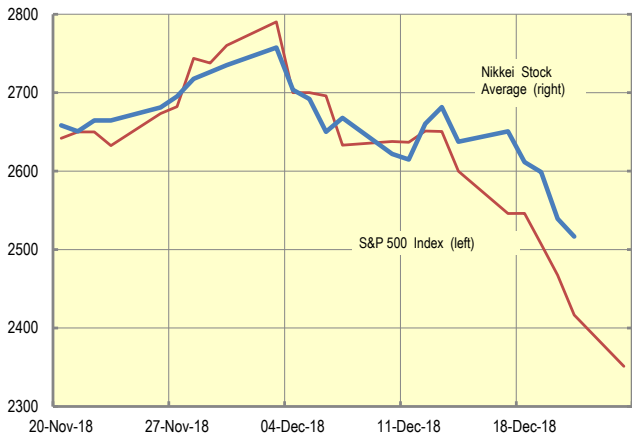
Source: Thomson Reuters; compiled by Daiwa Securities.

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



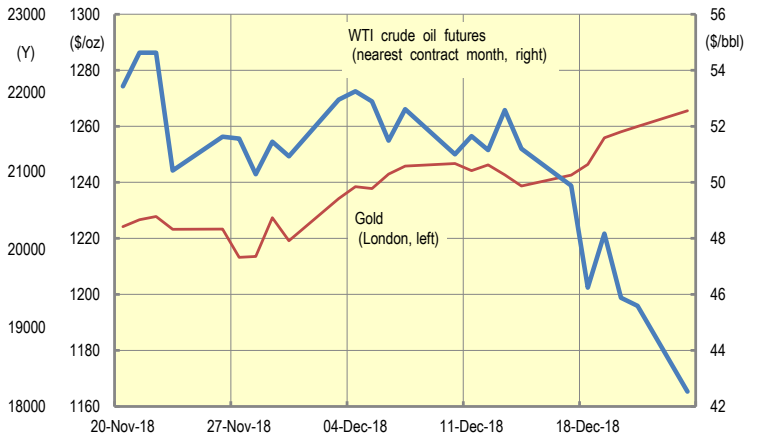
Source: Thomson Reuters; compiled by Daiwa Securities.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



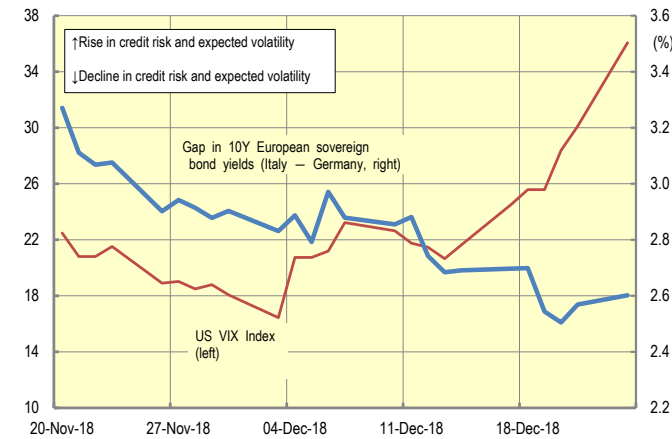
Source: Thomson Reuters; compiled by Daiwa Securities.

Declining trend likely to continue

USD/JPY likely down in 2018 for third straight year

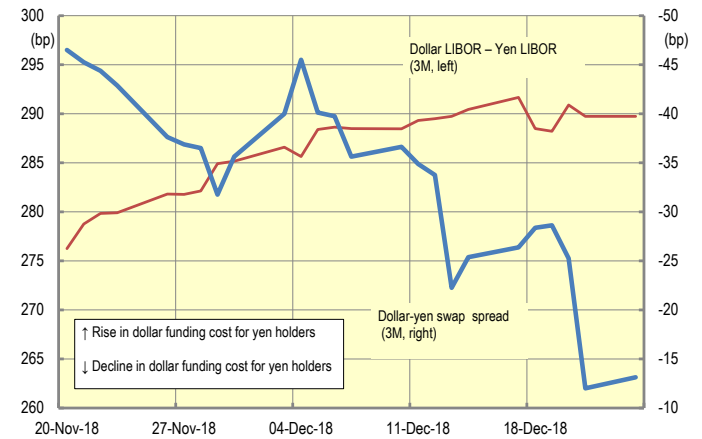
The USD/JPY started 2018 at 112.66 and appears likely to end 2018 below that level. In that case, the pair will have ended lower for three straight years. There is a real possibility that the strong yen / weak dollar trend that started from around mid-2015 is continuing. The USD/JPY tends to follow an eight-year cycle and 2011 marked the bottom (peak for yen appreciation) of the current cycle. Regardless of whether the pair drops below the USD/JPY low of 99.09 set in 2016, the yen appreciation trend could easily continue in 2018-20. Based on the global economy and market conditions, yen appreciation and dollar depreciation will likely continue until around end-2019.

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



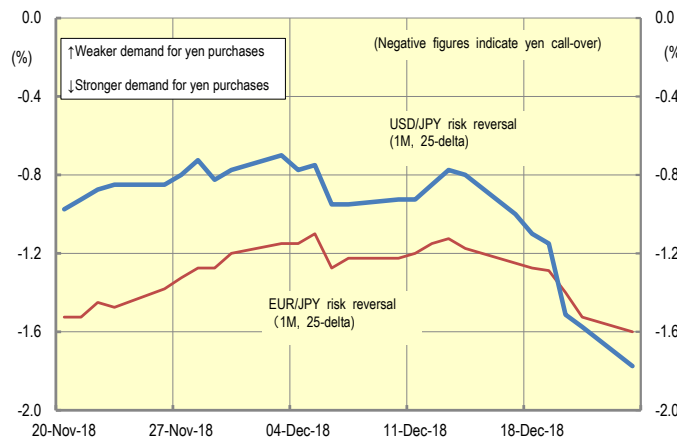
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



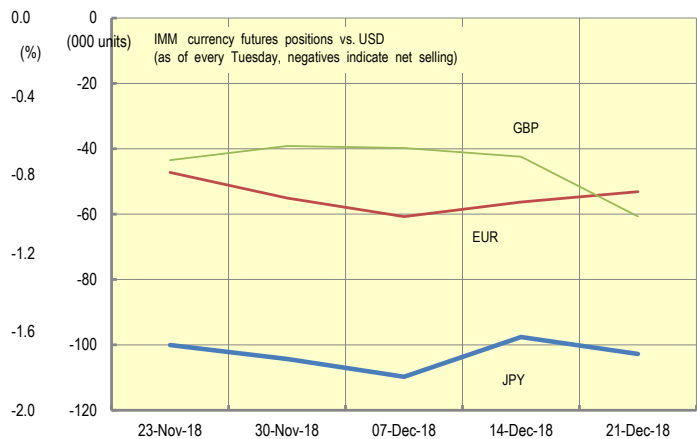
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Currency performances over past year

We looked at the performances of 18 major currencies (vs USD) over the past year. The top six currencies were the Japanese yen (+2.6%), the Swiss franc (+0.1%), the US dollar (0%), the Hong Kong dollar (-0.3%), the Mexican peso (-1.3%), and the euro (-3.6%). The middle six currencies consisted of the South Korean won (-4.1%), the New Zealand dollar (-4.2%), the Chinese yuan (-4.7%), the Norwegian krone (-4.8%), the British pound (-4.8%), and the Canadian dollar (-6.1%). The bottom six currencies were made up of the Swedish krona (-7.5%), the Indian rupee (-8.6%), the Australian dollar (-8.7%), the South African rand (-13.6%), the Brazilian real (-14.7%), and the Turkish lira (-27.9%). Safe-haven currencies made up the top group, while emerging market currencies made up the bottom group, which is the pattern associated with a risk-off market. The US dollar will probably struggle to remain in the top group in 2019 amid falling US long-term interest rates.

Worsening US/China business sentiment could push yen higher

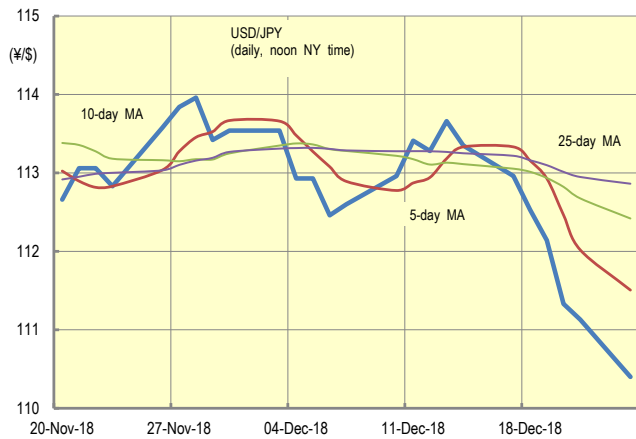
Risk of deterioration for US/China Dec manufacturing PMIs

The US and China will announce their December manufacturing PMIs during the year-end / New Year period. The manufacturing PMI from China's National Bureau of Statistics in November fell to 50 (mark separating growth from contraction), while the Caixin/Markit manufacturing PMI remained just above 50 in Sep-Nov. December business sentiment will likely weaken due to movements to shun Chinese communications devices and with Chinese equities performing poorly. A decline in the PMI below 50 would heighten concerns about a slowdown for the Chinese economy. Meanwhile, the US ISM manufacturing PMI for November was better than expected. However, there is a very good chance that the reading for December will deteriorate with manufacturing surveys from the federal reserve banks of New York and Philadelphia falling to their lowest levels since May 2017 and August 2016, respectively. If business sentiment in the US and China worsen, further yen appreciation due to risk aversion and declining interest rates overseas seems likely.

Noteworthy currency: EUR

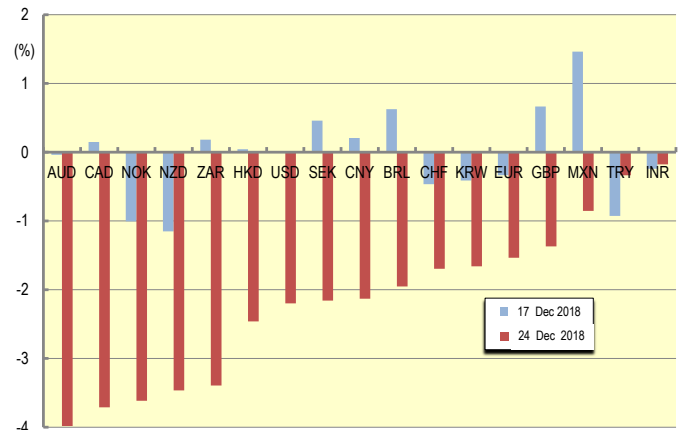
The euro has maintained a solid tone versus the dollar on lulls for Britain's Brexit negotiations (discussion to continue after January adjournment) and for the Italian debt problem. Risk aversion due to slumping US equities has had a euro-weakening effect, but German interest rates declining at a slower pace than US rates has provided a euro-boosting effect. The gradual increase in the likelihood of the ECB normalizing its policy is also underpinning the euro. That said, the euro will probably trade in a narrow range (not rise in a straight line) ahead of the 28 December release of Germany's December CPI (smaller y/y gain than in Nov expected).

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

- 26-Dec Oct US S&P Case-Shiller Home Price Indices
- 27-Dec ○ ECB economic report
- 28-Dec Nov US new home sales
Dec Consumer Confidence Index (Conference Board)
 Nov Japan's industrial production, shipments, inventories
 ○ Summary of Opinions at BOJ MPM on 19-20 Dec
 Final session of the year at Tokyo Stock Exchange
Dec German CPI
- 31-Dec Dec China manufacturing PMI (National Bureau of Statistics of China)
 Dec US Chicago Purchasing Manager's Index
- 2-Jan Dec China manufacturing PMI (Caixin)
- 3-Jan Nov eurozone M3
Dec US ADP national employment report
- 4-Jan Jan US ISM manufacturing index
 First session of the year at Tokyo Stock Exchange
 Dec German jobs report
 Dec eurozone CPI
Dec US jobs report

Source: Compiled by Daiwa Securities.
 Notes: Dates based on JST. ○ indicates monetary policy-related events.

Chart: Weekly Forex Forecasts, Noteworthy Currencies/factors

	17 - 21 Dec 2018 (actual)		25 Dec 2018 - 4 Jan 2019 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	110.2-113.6	110.3	109.5-111.5	110.5
EUR/JPY	125.8-128.6	126.1	124.7-127.2	126.0
EUR/USD	1.129-1.149	1.143	1.130-1.150	1.140

Noteworthy currencies and factors

EUR	Euro would steady due to pause in UK and Italian issues, but also face upside resistance
USD	Dollar to be swayed by interest rate differentials, rather than risk tolerance
JPY	Deterioration in US and Chinese indicators would lead to strong yen due to risk-off sentiment and yield declines
AUD	If Chinese indicators worsen, AUD would weaken due to concerns about negative impact on Australia

Source: Compiled by Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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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.
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- 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.

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