27 December 2018
Japanese report: 26 Dec 2018 (DSFX333)

Forex Market View

USD/JPY may decline for fourth consecutive year in 2019

- Dollar tops out, yen continues appreciating
- USD/JPY may bottom around 2019
- We expect USD/JPY to decline in 2019

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

26 Dec-25 Jan: Y108.0-113.0/$ (Y110.23/$ as of 25 Dec)

Forex Market View DSFE203

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Dollar tops out, yen continues appreciating

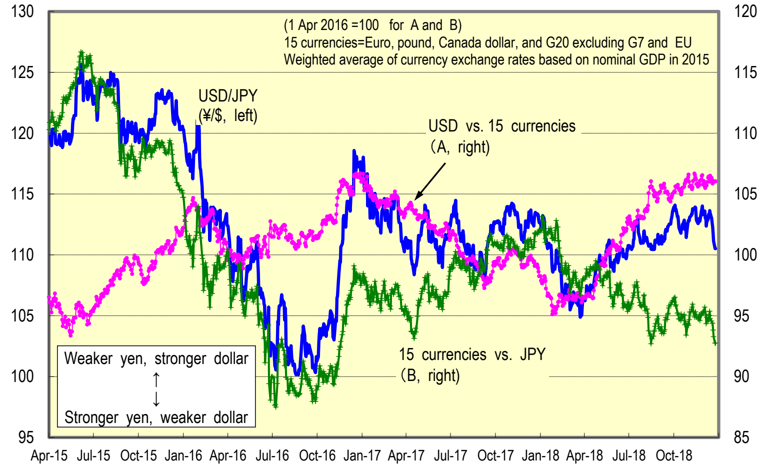
Dollar is topping out

During 2018, the USD/JPY declined in Jan-Mar, rose in Apr-Sep, and declined in Oct-Dec. Early in the year, the dollar was weakened by news that Chinese authorities had become negative on investing in US Treasurys and recommended cutting or suspending purchases (January 10) and by US Treasury Secretary Steven Mnuchin's comment that a weak dollar was good for the US (January 24). Then the dollar strengthened when the US president extended the grace period for imposing additional tariffs on steel and aluminum imports from Canada, the EU, and Mexico (May 1), China agreed to expand imports from the US in a joint statement from their trade talks (May 19), and US Treasury Secretary Steven Mnuchin commented that the US-China trade war was on hold (May 21). The US having a stronger economy and higher interest rates than other countries and risk-off moves also strengthened the dollar. Since October, however, US stocks have weakened on concerns over corporate earnings, followed by long-term rates turned to a declining trend, and the dollar's appreciation topped out.

The yen is still appreciating

The yen has been in a rising trend against currencies other than the dollar (cross-yen rates have been declining). There was a risk-off strengthening of the yen during a period of heightening concerns over US-China trade friction and the US raising its auto tariffs, and amid a decline in the value of the Turkish lira caused by disagreements between the US and Turkey. Nevertheless, although the USD/JPY declined on a risk-off yen appreciation in Feb-Mar, it rose in Apr-Sep despite the yen strengthening against currencies other than the dollar because US long-term rates rose in response to strong US economic growth. The US economy started showing signs of weakness in October and caused US long-term rates to peak, however, clearing the way for the yen to follow a strengthening trend against the dollar, as well.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

USD/JPY may bottom around 2019

Yen has an inverse correlation with share prices

Global share prices and the yen's value vs. the dollar generally show an inverse correlation, with rising share prices accompanied by a weakening yen and vice versa. In contrast, global share prices and the euro's value vs. the dollar generally show a positive correlation, with rising share prices accompanied by a rising euro and vice versa. Nevertheless, in January not only the euro but also the yen showed a positive correlation with share prices (share prices rose and the yen strengthened) because the dollar weakened in response to protectionism. Because the dollar has been weakening amid declining US interest rates in the context of declining share prices, not only the yen but also the euro has correlated inversely with share prices (declining stocks and a strengthening euro). Looking first at the yen, concerns over a global economic slowdown have fueled the tendency toward a risk-off weakening of stocks and strengthening of the yen, while interest rates have also had an upward impact on the yen because the decline in long-term rates has been much greater in the US than in Japan. Looking next at the euro, while the tendency has been for a risk-off weakening of both stocks and the euro, interest rates have had an upward impact on the euro because the decline in long-term rates has been much greater in the US than in the euro zone. Thus, while the yen is more likely to rise against the dollar, the euro does not have a strong bias relative to the dollar in either direction.

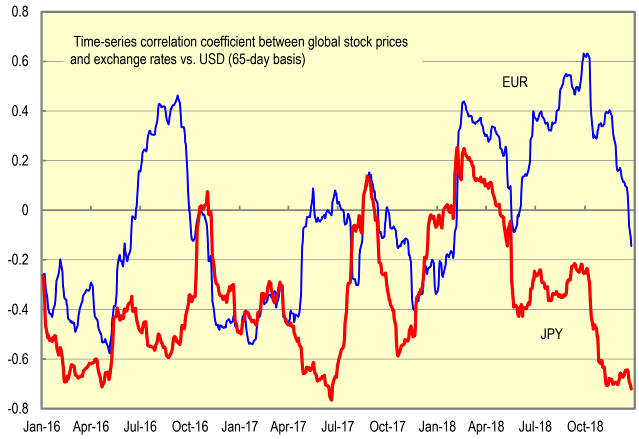
The USD/JPY has dropped below its 200-day moving average

The USD/JPY had been trading above its 200-day moving average in 2H 2018, but it dipped slightly below that level, trading at 110.93 as of December 25. Because the USD/JPY is above where it was 200 days ago (106.42), the 200-day moving average is still rising, but empirical data indicates that once the USD/JPY drops clearly below its 200-day moving average, instead of rebounding it tends to continue declining. Even if it stops at around 110-111 for now, be aware of the possibility of the USD/JPY declining further.

USD/JPY may bottom around 2019

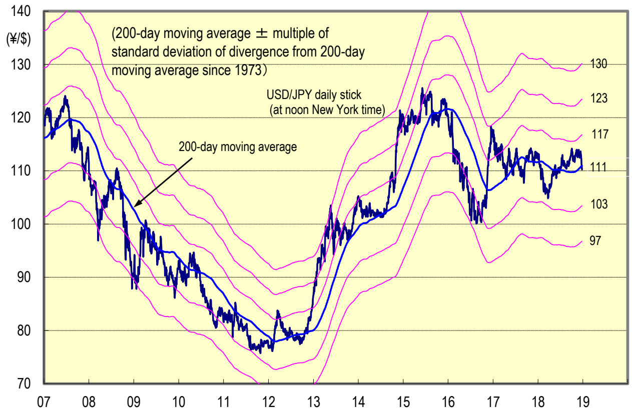
The USD/JPY bottomed at above 75 in October 2011 and peaked above 125 in June 2015. The USD/JPY looks set to close the calendar year lower than it began for a third consecutive year in 2018, after doing so in 2016 and 2017. In the past, the USD/JPY has followed a cycle of around 8 years (7 to 9 years). Because the USD/JPY last bottomed in 2011, its next bottom is likely to be around 2019 (2018-20). Whether the USD/JPY in 2019 drops below its 2016 low of 99.09 or its 2018 low of 104.56 will probably depend on the global economy and market conditions.

Chart: Time-series Correlation Coefficient Between Global Stock Prices and Exchange Rates vs. USD



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY and 200-day Moving Average ± Standard Deviation



Source: Thomson Reuters; compiled by Daiwa Securities.

We expect USD/JPY to decline in 2019

We expect USD/JPY to decline in 2019

Even if such sources of concern as the US government shutdown and talk of the Fed chairman or the Treasury Secretary being dismissed are resolved, we think the market trend is unlikely to return to a risk-on mood. Dismissal of the Fed chairman would require approval from Congress, and it is doubtful that the market thinks Mr. Jerome Powell's firing is likely. The primary reasons that the market is in a risk-off mode are probably concerns over (1) a global economic slowdown, (2) adverse impacts from US protectionism, and (3) the reduction in degrees of freedom for US fiscal policy. This risk-off trend looks likely to continue as a result of a US economic slowdown brought by the large decline in share prices (negative wealth effect), a Chinese economic slowdown brought by US trade pressure, and the start of a split Congress in the US. We think the USD/JPY is likely to remain in a declining trend until around end-2019. More specifically, in Jan-Mar 2019 we look for both US share prices and long-term rates to decline (a postponement of Fed rate hikes) on concerns over an economic slowdown and expect that to be accompanied by a decline in the USD/JPY to around 108, within a range of 105-113. In Apr-Jun, we expect it to rebound to around 110 as a result of declines in US long-term rates making share prices look less overvalued. Nevertheless, we expect US share prices to top out in Jul-Sep in response to the continued slowdown of the US economy and expect the return of declining share prices and long-term rates to push the USD/JPY back down to around 108, while in Oct-Dec we expect it to decline to around 107, within a range of 104-112.

Risk 1: US-China trade negotiations

The FX market is generally affected by the economic trend, inflation, and monetary policy outlook in the US and other major economies, but other major risks to exchange rates include the US-China trade negotiations, Japan-US trade negotiations, and Brexit. There are three possible outcomes of the US-China trade negotiations, (1) both the US and China agree in their trade negotiations to remove their additional tariffs (weaker yen and stronger dollar), (2) the US-China trade negotiations break down and the US imposes additional tariffs on China (stronger yen and weaker dollar), and (3) the US postpones its additional tariffs on China while asking China to provide more concessions to the US and pursue further reform (neutral to the USD/JPY), and we think the third one is the most likely. This third scenario is unlikely to have any positive impact on the global economy or markets, and if the negative impacts on China's economy appear to be stronger than the positive impacts on the US economy, it could result in a risk-off strengthening of the yen.

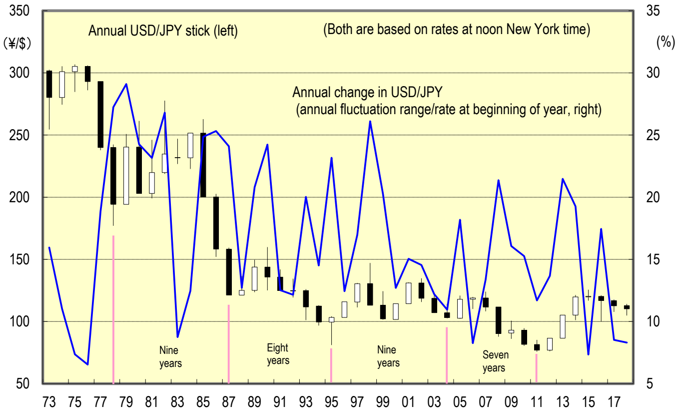
Risk 2: Japan-US trade negotiations

We see two possible scenarios for the Japan-US trade negotiations: (1) in response to US demands, Japan opens its market, expands production in the US, increases imports from the US, and reduces exports to the US (Japan-US trade and capital flows cause the yen to weaken and dollar to strengthen) and (2) the US demands a currency clause to prevent yen depreciation (even if not formally incorporated into a Japan-US trade agreement, this would put pressure on the government and the BOJ to strengthen the yen, i.e., correct yen weakness). We think the most likely scenario is that impacts from (1) and (2) offset each other, resulting in minimal FX impacts, but there is a possibility of the yen weakening or strengthening, depending on the negotiations.

Risk 3: Brexit

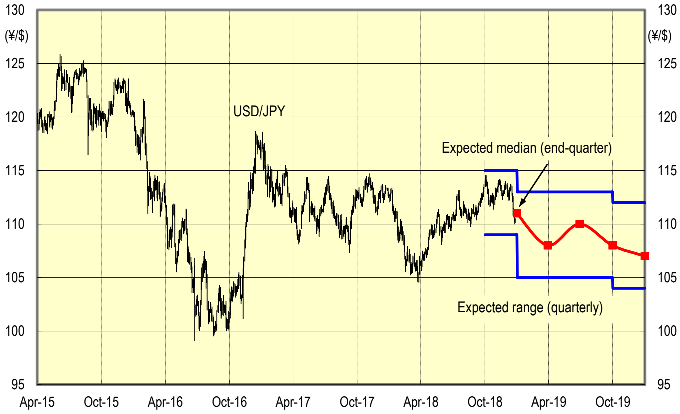
Possible scenarios for Brexit are (1) the British Parliament approves the Brexit plan in January (positive surprise resulting in a pound strengthening and risk-on yen weakening), (2) the British Parliament rejects the Brexit plan in January, resulting in a no-deal Brexit (economic and market turmoil resulting in a pound weakening and risk-off yen strengthening), and (3) the Brexit deadline is postponed to allow for another referendum (a majority vote to remain, resulting in pound strengthening and yen weakening). Which of these scenarios happens is unknown, but if parliament's rejection of Brexit leads to scenario (3), it would probably cause a temporary weakening of the pound and strengthening of the yen, followed by pound strengthening and yen weakening.

Chart: USD/JPY's Annual Stick and Change



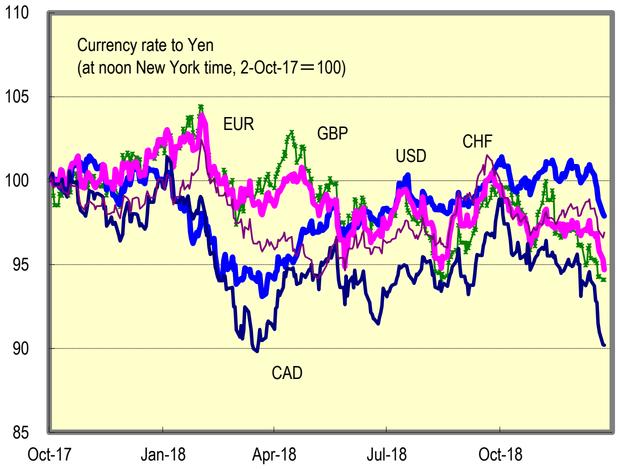
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Forecast for USD/JPY



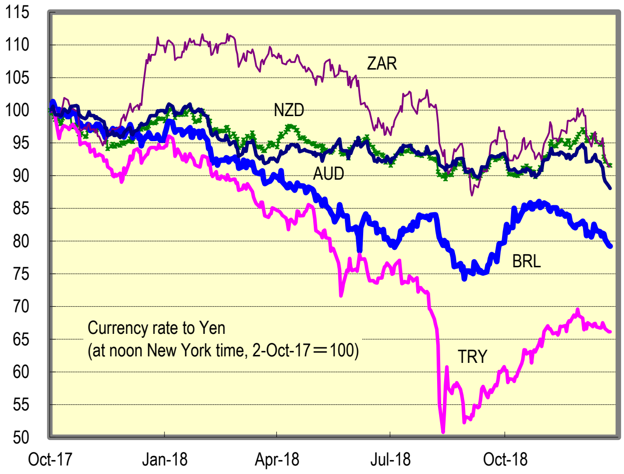
Source: Thomson Reuters; compiled by Daiwa Securities.

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	74.5	70.0	74.0	71.5	69.5
			71-78	67-76	67-76	67-76	66-75
TRY-JPY	24.1	18.8	20.5	18.3	20.0	19.0	18.2
			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	16.1	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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Registered Credit Rating Agencies are subject to the following regulations:
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.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ 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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The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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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")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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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
Type II Financial Instruments Firms Association