Daiwa Securities

Forex Market Weekly

Mixed yen buying/selling on US/China trade talks, US economic indicators

- Yen sold soon after surge on Apple shock
- Yen weakness on hopes for US/China trade talk progress likely limited
- Poorer US non-manufacturing sentiment may invite risk-off yen appreciation

This week's USD/JPY forecast range

7 - 11 Jan: Y107.5 – 109.5/$ (Y108.5 at end-previous week)

Forex Market View DSFE204
FICC Research Dept.

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

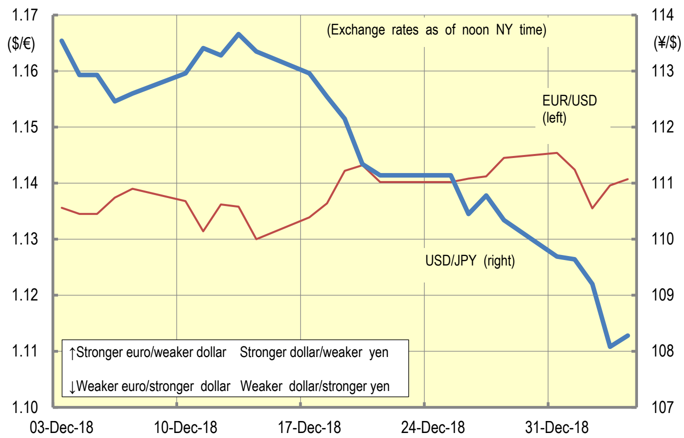
FX Analyst
Mayu Shinooka
(81) 3 5555-8777
mayu.shinooka@daiwa.co.jp
Daiwa Securities Co. Ltd.

Yen sold soon after surge on Apple shock

Overview of last week's forex market

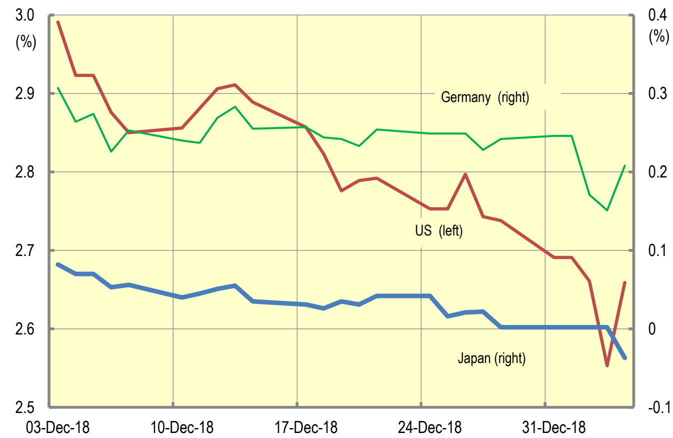
The US dollar weakened following reports that US President Donald Trump was considering firing his Treasury Secretary Steven Mnuchin, but rebounded after Trump expressed his confidence in Mnuchin. The USD/JPY fell after the Federal Reserve Bank of Richmond reported that its manufacturing index dropped by a record amount in December. Still, the USD/JPY rose to 111.41 when US stocks rebounded on news that US year-end sales turned up for the first time in six years. That said, the USD/JPY again weakened on reports that Trump was mulling an executive order preventing US firms from using communication devices produced by Chinese manufacturers Huawei and ZTE. The US government shutdown has continued with talks between Republicans and Democrats breaking down. The USD/JPY, which had fallen back to around 110.50, slipped to 109.65 at the end of last year on deterioration for China's manufacturing PMI in December. The USD/JPY then fell below 109.00 after China's Caixin December manufacturing PMI fell below 50 (indicating contraction). Apple then shocked markets by lowering its Oct-Dec sales forecast on declining sales in China. The resulting risk-off yen appreciation (albeit with many traders away for the holidays) briefly pushed the USD/JPY below 105.00. However, the yen was then again sold, despite steep declines for US stocks and interest rates. The USD/JPY moved back over 108.00.

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



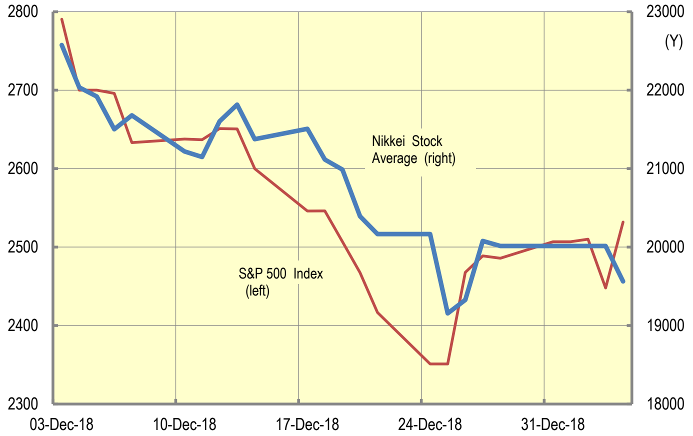
Source: Thomson Reuters; compiled by Daiwa Securities.

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



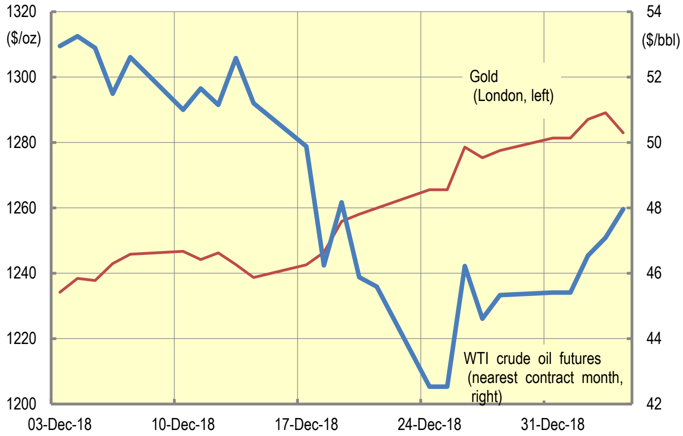
Source: Thomson Reuters; compiled by Daiwa Securities.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



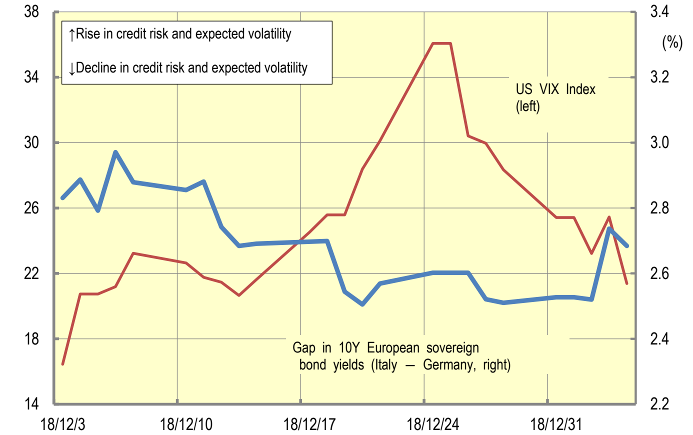
Source: Thomson Reuters; compiled by Daiwa Securities.

Yen weakness on hopes for US/China trade talk progress likely limited

End to US government shutdown could ease risk-off mood

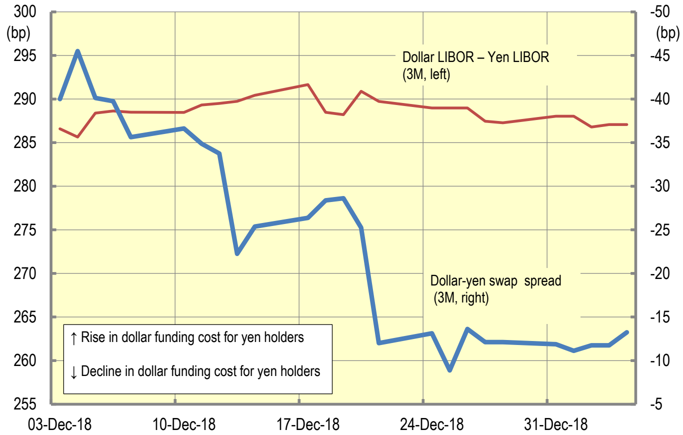
We believe that risk-off yen appreciation has been mainly driven by concerns of a slowing global economy, but continuation of the US government shutdown is probably another contributing factor. The US Congress is now split with Republicans holding a majority of seats in the Senate and Democrats controlling the House of Representatives. The government will likely remain closed without a temporary funding bill as long as the president/Republicans and Democrats cannot iron out their differences. The risk-off mood could ease if Trump, who is demanding funding for a wall along the US border with Mexico, makes concessions and agrees to the offer from Democratic leaders for 1.3 billion dollars for border security.

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



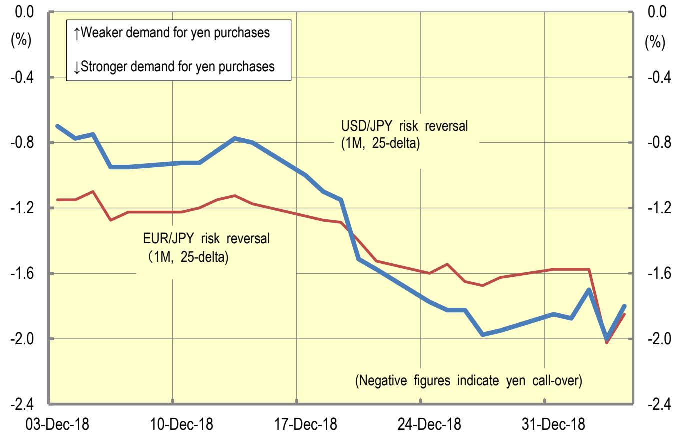
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



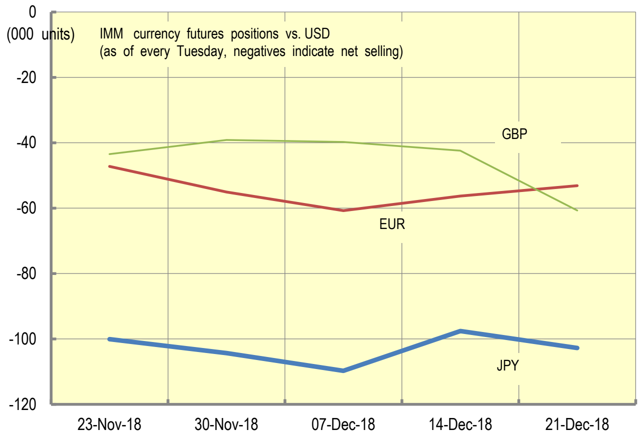
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Yen weakness on hopes for US/China trade talk progress likely limited

Trump has tried to stabilize markets by continuously stressing that good progress has been made negotiating a trade deal with China. US/China vice-ministerial level trade talks are scheduled for 7-8 January and the focus is on the degree of progress toward a trade agreement. The US set a grace period until 2 March, during which it will not impose any additional tariffs on Chinese goods. The risk-off mood would likely ease if there is some indication that the grace period could be extended further until implementation of a trade agreement is confirmed. That said, the degree to which the risk-off mood is mitigated could be modest as long as the risk of US imposing additional tariffs on Chinese goods remains in place. Moreover, a switch to a risk-on mood seems less likely with the US government considering bans on the use of some Chinese communications equipment at US corporations. Even if the yen depreciates on expectations for easing trade tensions between the US and China, we expect such depreciation to be limited

Poorer US non-manufacturing sentiment may invite risk-off yen appreciation

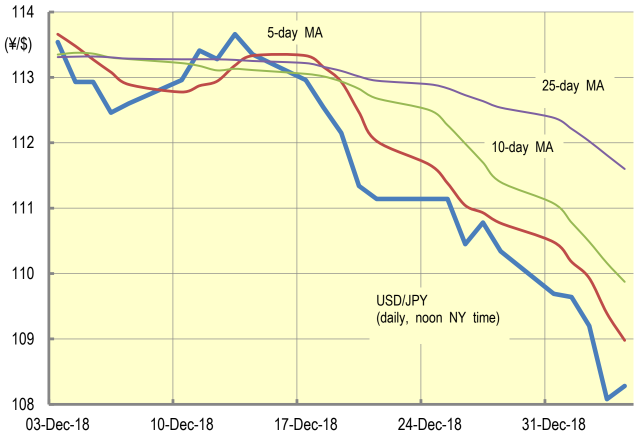
Risk-on yen deprecation seems unlikely

The yen appreciated last week on worsening manufacturing PMIs in both the US and China. The biggest swing factor for forex markets this week is likely to be the December US ISM non-manufacturing data. This reading, which improved modestly to 60.7 in November, is expected to decline slightly to 59.0 in December (market consensus). However, as was the case with the manufacturing index, there is a relatively good probability that the reading will miss the market consensus. We believe such an outcome could easily serve as a factor driving risk-off yen appreciation. Federal Reserve Bank of Dallas President Robert Kaplan on 3 December called for the FRB to exercise greater patience regarding future rate hikes and on 3 January said he favors a rate hike pause. An increase in the number of such dovish US financial authorities and lower US rates could lead to not only dollar depreciation, but risk-on yen depreciation as well. However, it is probably hard to imagine much risk-on yen depreciation at a time when US economic indicators are undershooting market forecasts, even if US interest rates are falling.

Noteworthy currencies: BRL and ZAR

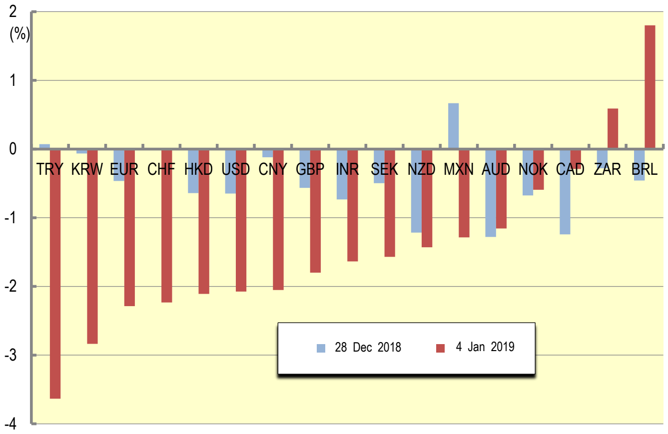
Since the end of 2018, the US dollar has depreciated on (1) concerns about a slowdown for the global economy and (2) meaningful declines for US interest rates on concerns about excessive tightening of US monetary policy. Since the start of 2019, there have been gains for the Brazilian real and South African rand—two currencies that had depreciated due to tightening of US monetary policy. With FRB Chairman Jerome Powell on 4 January indicating a more flexible monetary policy stance, the focus is on whether these emerging market currencies can continue outperforming for now.

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

7-Jan		Nov German manufacturing sector orders
		Nov eurozone retail sales
8-Jan		Dec US ISM non-manufacturing index
		Nov German industrial production
		Nov US trade statistics (to be postponed if gov't agencies shut down)
9-Jan		Nov German trade statistics
		Nov eurozone unemployment rate
	●	UK Parliament to resume deliberations on draft EU withdrawal agreement
10-Jan	○	Minutes of FOMC meeting on 18-19 Dec
		Dec China CPI
	○	Account of ECB Governing Council meeting on 12-13 Dec
11-Jan		Fed chairman Powell to attend discussion
		Speech by Fed vice chairman Clarida
		Speech by member of ECB Executive Board Mersch
		Dec US CPI

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

	25 Dec 2018 - 4 Jan 2019 (actual)		7 - 11 Jan 2019 (forecasts)	
	Range	Weekend	Range	Weekend
USD/JPY	104.9-111.4	108.5	107.5-109.5	108.5
EUR/JPY	118.7-127.1	123.7	122.2-125.2	123.7
EUR/USD	1.130-1.150	1.140	1.130-1.150	1.140

Noteworthy currencies and factors

BRL	If US monetary policy becomes flexible, real may strengthen vs. dollar
ZAR	If US monetary policy becomes flexible, rand may strengthen vs. dollar
USD	Deterioration in US economic indicators may lower interest rates and weaken dollar
JPY	Deterioration in US economic indicators could lead to risk-off yen appreciation
AUD	If US-China trade talks move forward, this may strengthen Australian dollar

Source; Compiled by Daiwa Securities.

Daiwa Securities

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.

■ The Significance of Registration

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]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
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)

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 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)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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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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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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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