Daiwa Securities

Forex Market View

Are US economy and USD/JPY risks biased to the downside?

- Is risk-on yen depreciation from fading of US economic concerns only temporary?
- Will the yen rise against the dollar on strengthening of concerns about US economic slowdown?
- The dollar should decline without improvement in the US economic outlook, even with expectations of a Fed monetary policy response

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

10 Jan- 8 Feb: Y105.5-110.5/$ (Y108.38/$ as of 9 Jan)

Forex Market View DSFE205

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Is risk-on yen depreciation from fading of US economic concerns only temporary?

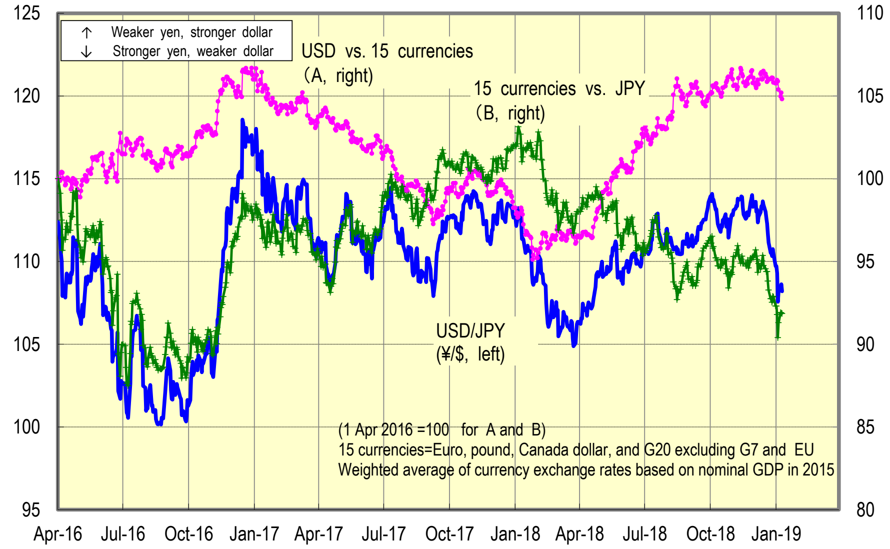
Yen weakens after appreciating sharply

The USD/JPY, which fell as low as under 105 on a sharp yen strengthening to start the year, momentarily rose back to as high as 109. Judging from the trend in other currencies, this was caused more by a yen sell-off (yen depreciation) than by a rise in the dollar. The decline in US stocks that started before Christmas has stopped, and risk-off yen appreciation has turned into risk-on yen depreciation.

Four factors causing risk-on yen weakening

We think one reason for this is that the fading of rate hike expectations triggered by concerns over a US economic slowdown was accompanied by a large decline in long-term rates, making share prices look less overvalued. Many of the comments coming from Fed officials have shifted from hawkish views about the need for continued rate hikes to more dovish ones supporting putting off rate hikes depending on economic and market trends, and this also appears to have pushed interest rates lower while easing concerns over an economic slowdown. Additionally, the December 2018 US nonfarm payrolls growth greatly exceeded market expectations and the US-China trade talks have gotten closer to an agreement on trade, raising expectations that additional tariffs on China can be avoided, both of which probably eased concerns over the economy slowing. We thus attribute the yen's risk-on weakening to four factors: (1) US stocks looking less overvalued, (2) Fed officials becoming more dovish, (3) the strength of US employment data, and (4) expectations of a US-China trade deal.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

The US jobs data may have had the strongest risk-on effects

We do not think any single one of these factors alone created risk-on conditions, but rather think it was the combination of all four. The strength of the US employment numbers probably contributed the most to the rebound in US share prices, long-term rates, and the USD/JPY. However much declines in US share prices and interest rates strengthen expectations of delays in rate hikes and trade agreements, as long as the US economic data is worsening more than expected, concerns over an economic slowdown should heighten and make a risk-on market less likely. It appears that jobs growth and wage growth significantly beating expectations at a time when the number of US indicators coming in below market expectations is increasing is probably what dampened concerns over the economy and triggered the risk-on mood.

There is a rising risk of a slowdown in US private consumption and employment

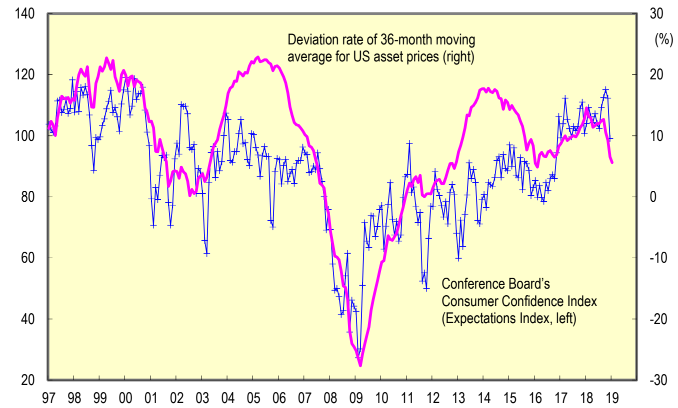
We think it is unlikely that concerns over a US economic slowdown will just continue to weaken, however. This is because consumer sentiment, particularly forward-looking indicators, have begun to worsen in response to the decline in share prices that began in October last year, and this is likely to dampen consumption expenditures. Combined with the fading of tax cut impacts, this negative wealth effect from declines in asset prices is likely to cause private consumption to slow. It may have been signs of slower private consumption that triggered the worsening of sentiment among nonmanufacturers, which had been relatively firm relative to that of manufacturers, the latter having worsened first in response to the slowdown in exports and overseas economies. Employment has thus far been growing at a strong pace because of strong private consumption, but a slowdown in consumption would likely make companies more hesitant to increase hiring, and a slowdown in hiring would likely amplify the deceleration in consumption. Although December employment was stronger than expected, there is no guarantee that private consumption and hiring will remain strong. The number of job openings peaked in August and then entered a decline. There is a risk that a slowdown in private consumption, which had remained firm even while US exports, housing investment, and business investment were slowing, could trigger a negative chain reaction in the economy.

Will the yen rise against the dollar on strengthening of concerns about US economic slowdown?

The market's risk tolerance depends on the economic trend

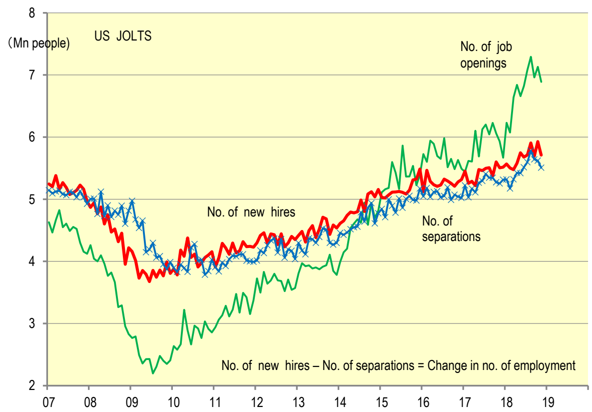
US share prices declined as if pricing in an economic slowdown, but these risk-off moves have stopped, and whether markets continue in risk-on mode will ultimately depend on the direction of the economy. The yield spread, defined as the 10-year UST yield minus the S&P 500 earnings yield, fell to -4.55% in December on the decline in share prices and interest rates, its lowest since June 2016. The ISM manufacturing new orders index declined from 62.1 in November 2018 to 51.1 in December 2018, and the stock and bond markets apparently anticipated this worsening of the economic data. That index had fallen to 49.7 in December 2015 then entered a recovery, while the yield spread turned to a rising trend after dropping to nearly -5% in January 2016. If the economic indicators stopped declining, share prices and long-term rates will have sufficiently priced in the economic slowdown and should turn to a rising trend, but if the economic indicators do not stop declining it will be difficult argue that share prices and interest rates have fallen sufficiently, making them less likely to rise.

Chart: Consumer Sentiment and Change in Asset Prices in US



Source: Thomson Reuters; compiled by Daiwa Securities.
Note: Asset prices are calculated via weighted average of housing prices (S&P/CaseShiller10) and stock prices (S&P 500) at rate of 10 to 7 after indexation of respective data in 2000 as 100.

Chart: No. of Job Openings, New Hires, and Separations in US



Source: Thomson Reuters; compiled by Daiwa Securities.

Will the yen rise against the dollar on strengthening of concerns about US economic slowdown?

The USD/JPY's level should also change depending on US economic indicators. The USD/JPY had tracked close to its estimated value based on the percentage changes in the 10-year UST yield and the S&P 500 index up until 2017, but in 2018 the dollar weakened in response to US protectionism, and it often traded about 6-12 lower than its estimated value. Since December 2018, however, the large decline in US rates and share prices caused its estimated value to drop sharply, and the USD/JPY is now trading about 2-8 below that estimated value. If the 10-year UST yield drops to 2.4% and the (25-day) percentage change in share prices is at -10%, for example, the USD/JPY's estimated value would be about 109, and if it were to trade 2-8 below that, it would be at 101-107. Although this is nothing more than a yardstick for the exchange rate, a decline in US economic indicators below market expectations and strengthening of concerns over an economic slowdown would likely lead to a risk-off yen strengthening and weakening of the dollar on declining US interest rates.

The dollar should decline without improvement in the US economic outlook, even with expectations of a Fed monetary policy response

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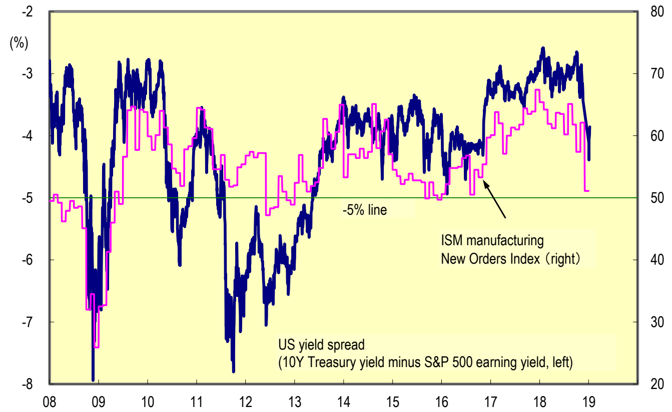
Fed Chair Jerome Powell said he is sensitive to the downside risks to the economy priced in by the market, is prepared to make major changes to the policy stance if necessary and will respond flexibly. If the Fed indicates it is willing to delay rate hikes and stop tapering its bond reinvestments (balance sheet reduction), it would suppress the market's concerns over the US economy and risk-off moves. Nevertheless, there is no guarantee that a shift by the Fed to a dovish monetary policy will create a risk-on mood and lead to an increase in US share prices, long-term rates, and the USD/JPY. If the US economic data continues to worsen, the market's economic outlook is unlikely to improve even if a change in Fed policy is expected, risk-off moves will become more likely, and rate-cut expectations are likely to push US interest rates lower and weaken the dollar.

Even if the US and China reach an agreement on trade, the yen is unlikely to weaken if the structural issues remain

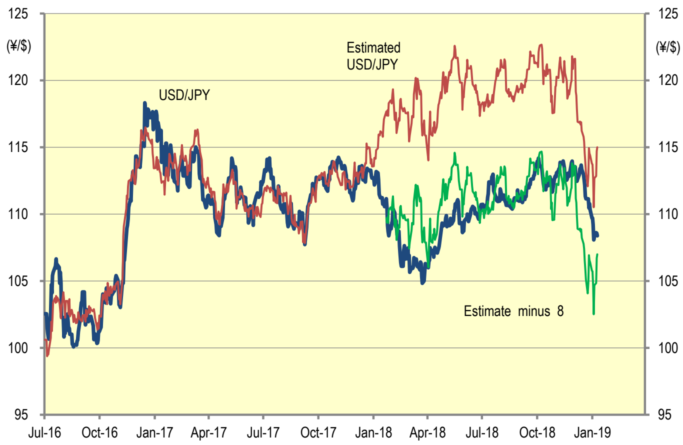
If the US and China reach an agreement on trade, there is a possibility of the dollar strengthening against the yen. It will take time to solve the intellectual property infringement, forced technology transfers, and other structural problems, however, and until these problems are solved the US may postpone but will not abandon its additional tariffs on China (i.e., the risk of it imposing additional tariffs will remain) and it will be difficult to erase the uncertainty of trade friction. Even if China expands its imports of agricultural products and energy from the US, the US economy is unlikely to recover based just on that. Furthermore, if US companies are restricted from using Chinese-made telecom equipment, the negative impacts on China's economy will become a risk-off factor. If a recovery in the global economy brought by a US-China trade agreement becomes unlikely, so would a risk-on weakening of the yen.

Chart: US Yield Spread and ISM Manufacturing New Orders Index



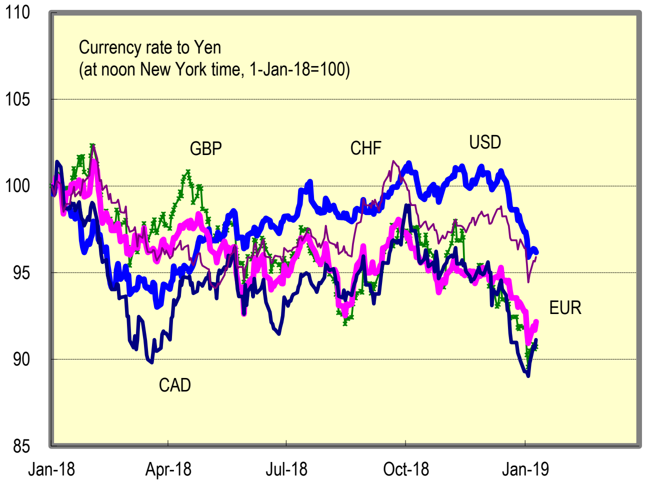
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Actual and Estimated USD/JPY



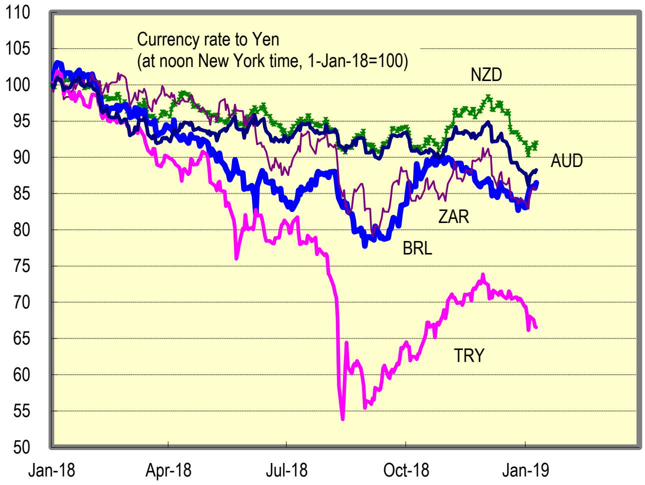
Source: Thomson Reuters; compiled by Daiwa Securities.

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 28 Sep 2018	31 Dec 2018	Forecast Jan-Mar 2019	Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 2019	Jan-Mar 2020
USD-JPY	113.7	110.3	108.0	110.0	107.0	105.0	105.0
			104-112	104-112	104-112	101-110	101-110
EUR-JPY	131.9	126.3	122.0	126.5	122.0	119.0	119.0
			118-128	118-130	118-130	115-127	115-127
AUD-JPY	82.1	77.7	75.5	79.5	76.0	73.5	73.5
			81-91	73-82	73-82	70-79	70-79
CAD-JPY	88.0	81.0	79.5	82.0	79.5	77.5	77.5
			83-93	76-85	76-85	74-83	74-83
NZD-JPY	75.2	74.0	71.5	75.0	72.0	69.5	69.5
			69-77	69-78	69-78	66-75	66-75
TRY-JPY	18.8	20.9	19.0	20.8	19.5	18.5	18.5
			17-22	17-22	17-22	16-21	16-21
ZAR-JPY	8.0	7.7	7.4	7.9	7.5	7.2	7.2
			7.0-8.1	7.0-8.3	7.0-8.3	6.7-8.0	6.7-8.0
BRL-JPY	28.1	28.5	27.7	29.8	28.2	27.0	27.0
			26-31	26-31	26-31	25-30	25-30
KRW-JPY	10.2	9.9	9.4	9.8	9.4	9.1	9.1
(100 KRW)			9.1-10.0	9.1-10.1	9.1-10.1	8.8-9.8	8.8-9.8
CNY-JPY	16.5	16.1	15.4	16.2	15.5	15.0	15.0
			15.0-16.3	15.0-16.5	15.0-16.5	14.5-16.0	14.5-16.0

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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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).

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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

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

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[Fitch]

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: 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 materials presented along with this cover letter, 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.

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