

Forex Market View

What will happen? Brexit and the pound sterling

- Why did the pound rebound on the failure to pass the proposed Brexit plan?
- Risks from passage of the alternative Brexit plan expected by the market
- A delay in the UK's exit from the EU may strengthen the pound

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

17 Jan- 15 Feb: Y105.5-110.5/\$ (Y108.83/\$ as of 16 Jan)

Forex Market View DSFE207

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Daiwa Securities Co. Ltd.

The pound rebounded after British Parliament rejected the proposed Brexit deal

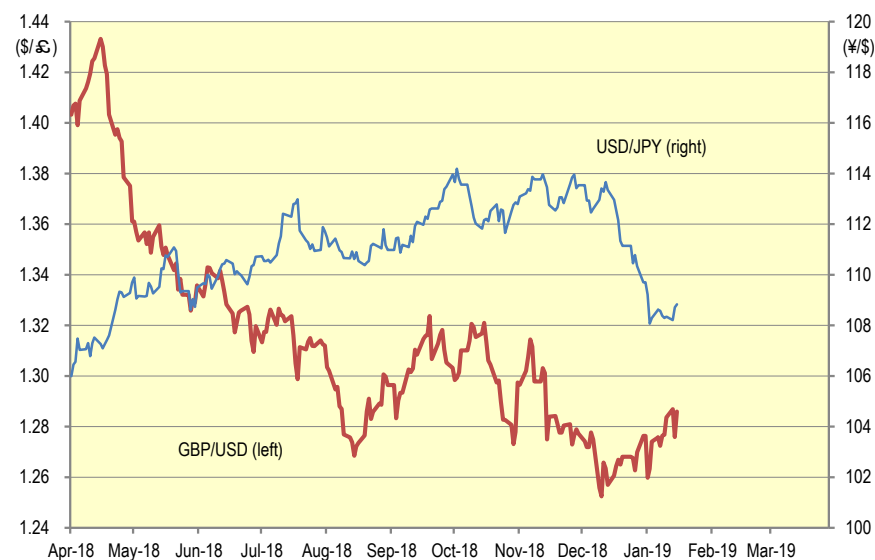
Why did the pound rebound on the failure to pass the proposed Brexit plan?

On 15 January, British Parliament rejected by a large 230-vote margin the Brexit plan agreed to by the UK and the EU. The pound declined immediately after the vote, but quickly rebounded after that. Although Parliament's rejection of the deal was probably already priced in, news that Prime Minister Theresa May wants bipartisan meetings as early as January 17 may have raised expectations that an alternate Brexit plan could be put together and passed. Some observers expect the March 29 date for the UK to leave the EU to be extended, and this probably lowered concerns about a no-deal Brexit.

EU stands ready to renegotiate under conditions

Michel Barnier, the EU's head negotiator for Brexit, said on January 16 that the risk of a no-deal Brexit is higher than it has ever been, but also said that if the UK lets its red lines change, the EU is prepared to start new Brexit negotiations. The EU had been maintaining there is no room for renegotiation, and its conditional willingness to renegotiate with the UK reduced fears of a disorderly withdrawal.

Chart: GBP/USD and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

The EU is also considering extending the UK's exit date

In addition, UK parliamentarians are apparently preparing a motion to extend the UK's exit date. A spokesperson for the European commission said on January 16 that the EU could decide to delay the UK's exit date if the UK provided justification. There are reports that the EU is considering delaying the exit date until 2020. The UK Parliament rejected a no-confidence motion submitted by the opposition party on January 16, and the risk of Prime Minister May resigning or holding a general election has subsided for now. This lessening of concerns over a no-deal Brexit strengthened the pound and led to a slight risk-on weakening of the yen

The UK government is sticking with its plan to leave the EU customs union

Risks from passage of the alternative Brexit plan expected by the market

We think the UK's "red line" refers to exiting the EU customs union. The EU's precondition for resuming negotiations appears to be that the UK accept further harmonization with EU regulations and abandon its idea of leaving the EU customs union and single market. At this point, however, the UK government is sticking with its basic plan of leaving the EU customs union. The opposition Labour Party, which wants to stay in the customs union, says Prime Minister May must first give up the option of choosing a no-deal Brexit, and party leader Jeremy Corbyn is not participating in talks with Ms. May.

Risk of an alternative Brexit plan in which the UK remains in the customs union

If the UK government changes its position, agrees to remain in the customs union, holds a bipartisan conference, drafts an alternative Brexit plan, and resumes negotiations with the EU, it is questionable whether it could reach an agreement with the EU on the new plan. If Parliament were to approve an alternative plan, it would probably cause a significant risk-on appreciation of the pound and weakening of the yen. There would be opposition from Brexit supporters, however, and it is uncertain whether the new deal would pass Parliament. The market expects the UK to pass an alternative Brexit plan that keeps the UK in the EU customs union, but there is a risk that either the UK government does not change its red line or it does but Parliament rejects the alternative plan.

Possibility that the EU does not commit to imposing an expiration date on the backstop

EU negotiator Michel Barnier has said there is a need for a backstop plan to avoid a hard border dividing Ireland from Northern Ireland. Even if, to get support from Brexiteers, the UK requests from the EU a legal commitment to an expiration date on a backstop plan based on the Brexit deal agreed with the EU in November 2018, the EU would probably not agree. In other words, there is a significant risk that it will be unable to get the EU's agreement on an alternative plan that modifies the existing Brexit deal

Would a delay in the UK's exit from the EU strengthen the pound?

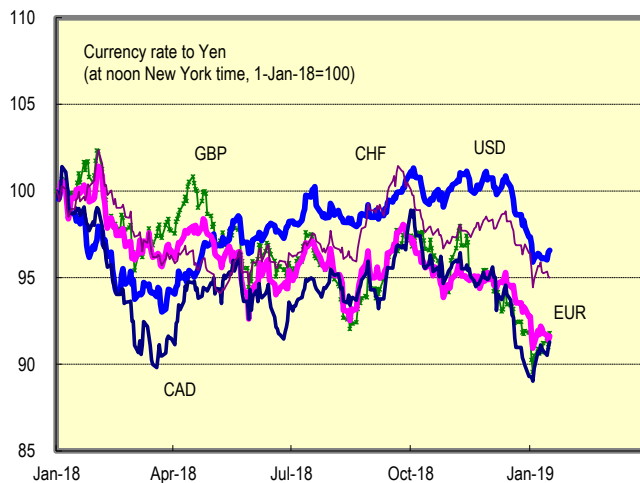
A delay in the UK's exit from the EU may strengthen the pound

Prime Minister May will announce the future direction of Brexit by January 21, and if she proposes an alternative plan but is unable to get it passed by Parliament, she would likely request the EU to extend the exit date. Germany's economics minister Peter Altmaier said it is important to avoid a disorderly withdrawal and that an extension of the UK's exit date should be granted. If the UK requests an extension, the EU would probably agree to it based on a unanimous vote by all 27 member countries not counting the UK. In that case, the risk of a no-deal Brexit would be avoided until the new exit date, and this is likely to create a risk-on mood in the market and cause the pound to strengthen above \$1.30.

Avoiding Brexit would probably cause a significant risk-on appreciation of the pound

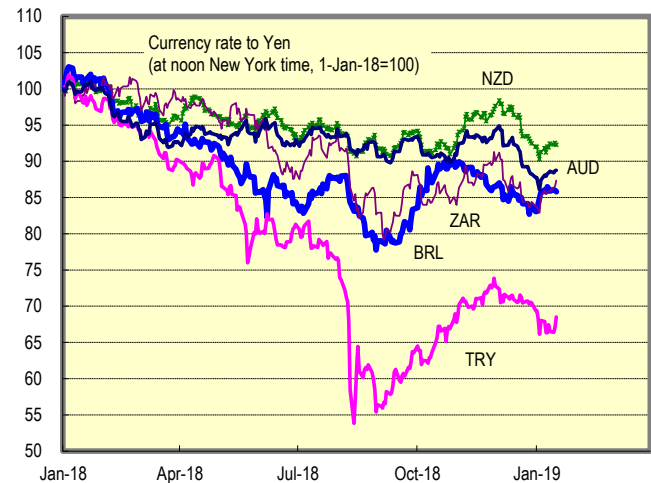
Because merely extending the exit date would not eliminate the uncertainty over Brexit, however, the pound's risk-on appreciation is unlikely to be significant. If the UK holds another Brexit referendum in the future, the majority vote remain, and the UK government abandons the Brexit project, it would likely eliminate concerns and result in a significant risk-on appreciation of the pound, and that would probably lead to a weaker yen.

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

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>)

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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)

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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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Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

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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.
- 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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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association