Forex Market View

Yen unlikely to weaken vs. dollar on US-China trade agreement

- US economy may slow even if China increases imports from US
- Risk of a further economic slowdown in China from yuan appreciation
- Worsening of US corporate earnings outlook would trigger declines in share prices and interest rates

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

31 Jan- 28 Feb: Y105.5-110.5/$ (Y109.56/$ as of 30 Jan)

Forex Market View DSFE210

FICC Research Dept.

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

Daiwa Securities Co. Ltd.

US economy may slow even if China increases imports from US

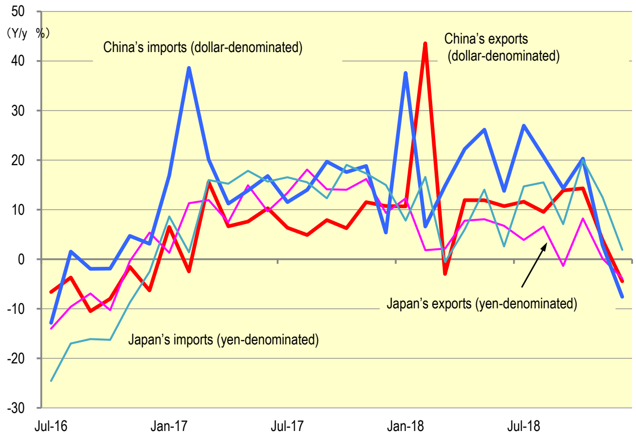
Economic and market impacts from US-China trade talks

The market expects the US and China to reach a trade agreement by the March 1 deadline, thereby avoiding the US imposing additional tariffs on China. The Trump administration likely wants to stabilize the US economy and markets, and may sign a trade agreement to show results from the negotiations. Even if China agrees to expand its imports from the US, however, the US and China are unlikely to reach an agreement on structural problems related to intellectual property rights and technology transfers. If the US lowers the tariffs it has already imposed on Chinese goods it should boost the economy and put markets in risk-on mode, but tariffs are likely to be kept in place in the event of a partial rather than comprehensive agreement. Even if the US signs a trade deal and extends the deadline for imposing additional tariffs on China, the risk remains that it will continue to threaten additional tariffs without relaxing its pressure on China. Even assuming additional tariffs in March are averted, any benefits from an economic boost or risk-on moves are likely to be small if the US and China do not work out their differences.

A slowdown in China's economy would adversely impact other economies

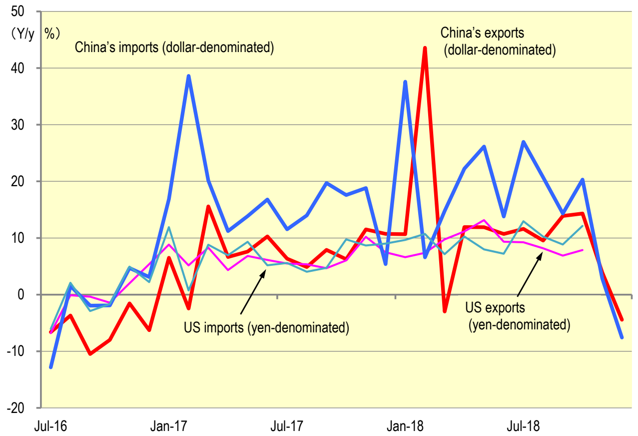
Although an increase in China's imports from the US would have a positive impact on the US economy, it would not necessarily cause the US economy to grow faster. This is because that would have a negative impact on China's economy, and the US is also likely to be adversely affected by a Chinese economic slowdown. China's exports and imports have both slowed dramatically, pushing China's dollar-denominated trade into a y/y decline in December 2018. Japan's trade has also been decelerating, apparently in reaction to this. In December, Japan's exports to China, which account for 20% of its total exports, turned to a 7.0% y/y decline, while y/y growth in its total exports turned to a negative 3.8%. This decline in exports has been slowing the domestic economy, causing a rapid weakening of imports. What is happening in Japan is also likely to happen in the US.

Chart: Imports and Exports in China and Japan



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Imports and Exports in China and US



Source: Thomson Reuters; compiled by Daiwa Securities.

US economy may slow even if China increases imports from US

Looking at the merchandise trade figures, US exports to China only account for 8% of total US exports, but because economic growth is slowing not only in China but worldwide, US exports are likely to slow from November 2018 after having grown at a roughly 10% y/y pace until October 2018. Furthermore, because there was a risk of the US raising tariffs on China and China retaliating in early 2019, at the end of 2018 there was a last-minute surge in demand for imports from China, which account for 21% of all US imports, and in China's demand for imports from the US, making a pullback in US imports and exports likely in 2019. An increase in China's imports from the US would boost US exports, but not by much given the low share of US exports that go to China. Meanwhile, an increase in China's imports from the US would lead to a decline in other countries' exports to China (which would slow their economies) and a decline in Chinese production (which would slow China's economy). This would further slow economic growth in China and many other countries, with the negative impacts from that likely causing the US economy to slow, as well.

Risk of a further economic slowdown in China from yuan appreciation

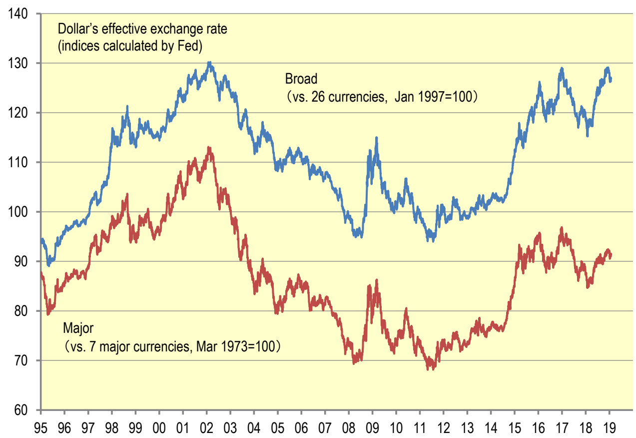
Dollar has appreciated against the currencies of its trading partners, including emerging markets

Exchange rates are another issue for the US in its trade negotiations with China, and the US is likely to demand that China stop the yuan from depreciating. The dollar's effective exchange rate vs. seven developed market currencies is at the same level it was in January 1997 and down about 20% from its peak in early 2002, while its value vs. a basket of 26 currencies, including those for emerging markets, is more than 25% higher than it was in January 1997, and only about 3% below its peak in early 2002. The yuan's decline vs. the dollar since 2014 is a big reason for this, and explains why the dollar's more broadly defined effective exchange rate is so high. It appears that the protectionist Trump administration will demand that China not only increase its imports but also strengthen the yuan in an attempt to eliminate the US disadvantage in trade.

Will China lead the yuan higher in deference to the US?

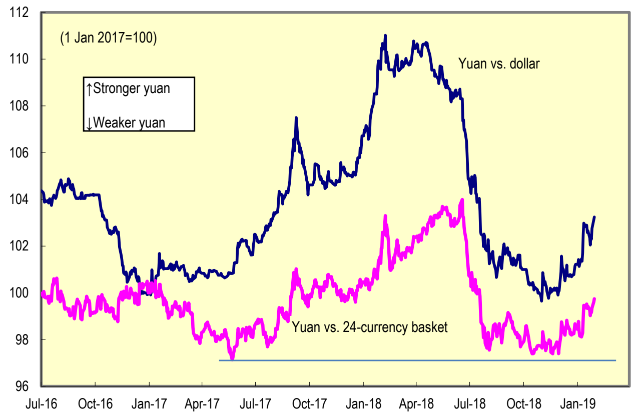
China is likely to accede to US demands to strengthen the yuan. The yuan had been declining against the dollar until November 2018 but turned to a rising trend in December. The yuan has also turned from a declining to a rising trend against the currency basket that China's central bankers use to set the yuan's reference rate. It appears they had been leading the yuan lower since June 2018 to counteract the additional tariffs that the US imposed (by offsetting their negative impact on exports), but may have changed their stance in December to one encouraging yuan appreciation in order to avoid the additional tariffs. This is because the increase in the yuan's value despite it having a tendency to weaken against the dollar and the currency basket during risk-off periods when share prices in the US and other big markets are declining was likely the result of China's monetary authorities selling dollars and buying yuan.

Chart: Dollar's Effective Exchange Rate



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Yuan Exchange Rates



Source: Thomson Reuters; compiled by Daiwa Securities.

Risk of a further economic slowdown in China from yuan appreciation

Nevertheless, although a strengthening of the yuan against the dollar is a positive for US exports, it is a negative for Chinese exports and makes it harder for China to keep its economy from slowing. If a forex market in which a weakening of the yuan and strengthening of the dollar should be the result of a slowdown in the global economy winds up moving in the opposite direction, it will decrease China's price competitiveness and probably lead to a decline in its exports. This becomes even more likely if the yuan continues to strengthen against the currency basket. If China's authorities continue guiding the yuan higher out of deference to the US, it will probably lead to a further slowdown in China's economy and have a dampening impact on the global economy. Even if China avoids the additional tariffs by increasing imports and guiding the yuan higher, the negative impacts on the Chinese and global economies are unlikely to be trivial.

Worsening of US corporate earnings outlook would trigger declines in share prices and interest rates

US is unlikely to avoid an economic slowdown

Economies worldwide appear to be slowing in a mutual feedback loop. The manufacturing PMIs announced by Markit were 49.7 for China in December 2018 (its lowest since May 2017), 50.0 for Japan in January 2019 (its lowest since August 2016), and 50.5 for the euro zone (its lowest since November 2014). The US stood alone with a high PMI in January of 54.9, but other indicators of manufacturing sentiment appear to be signaling an increase in downside risks. The global economic slowdown is making a weakening of exports likely, while the decline in share prices is raising the risk of slower growth in private consumption brought by the reverse wealth effect, and we think the US is unlikely to be the one country that avoids an economic slowdown.

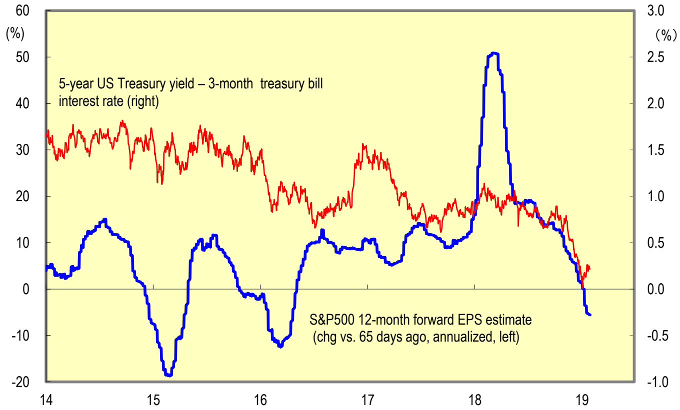
Worsening of economic indicators and corporate earnings would trigger declines in share prices and interest rates

Profit forecasts for the S&P 500 have turned to a declining trend compared with three months earlier, and US companies are clearly being hurt by the global economic slowdown. This increases the likelihood that businesses will curtail business investment and hiring. The rebound in US share prices and long-term rates in early 2019 from their earlier sharp decline can probably be attributed to the expectation that the Fed's decision to halt its rate hikes and balance sheet runoff would soften the economic slowdown. If the upcoming US economic data worsen to below market expectations and US companies cut their profit forecasts, however, it would likely heighten concerns over an economic slowdown and trigger another decline in share prices and long-term interest rates.

Will the dollar weaken further on declines in US real interest rates?

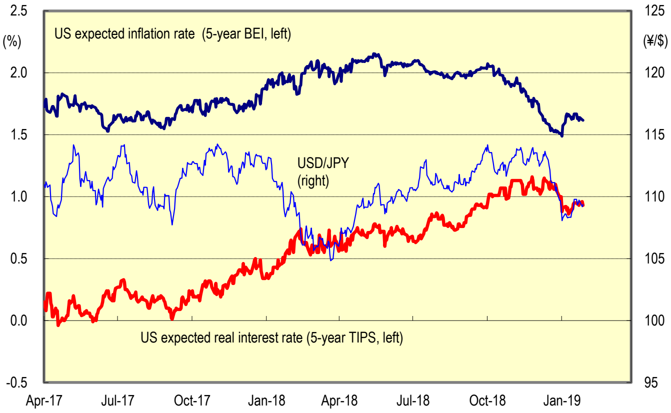
The decline in US long-term rates was initially caused by a decline in inflation expectations brought by weaker oil prices, but is now being driven by a decline in real interest rates. This decline in US real interest rates is weakening the dollar. US real interest rates (the yield on TIPS) are below 1% for both 5-year and 10-year maturities and likely to decline further if concerns over an economic slowdown increase. Even if the US and China reach an agreement on trade issues, if a failure to work out their differences on structural problems means no reduction in tariffs (and a continued risk of additional tariffs being imposed), there is unlikely to be much of an economic boost or increase in the USD/JPY. We think both a risk-off yen strengthening and a weakening of the dollar from declines in US real interest rates are likely.

Chart: Change in US Corporate EPS Estimate and Gap Between Long-term and Short-term Interest Rate



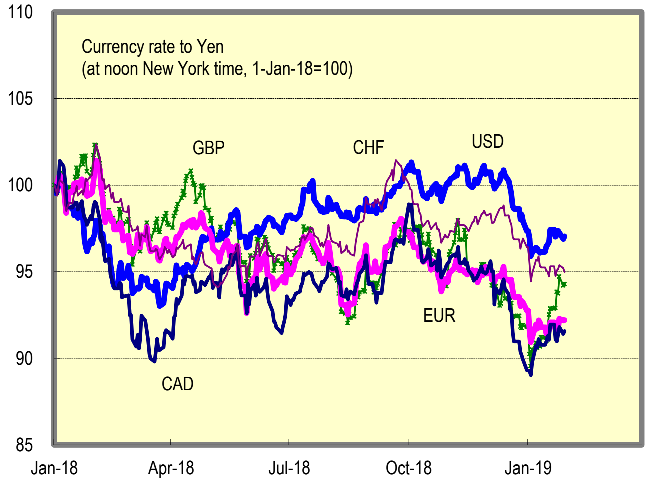
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Expected Inflation Rate, Real Interest Rate, and USD/JPY



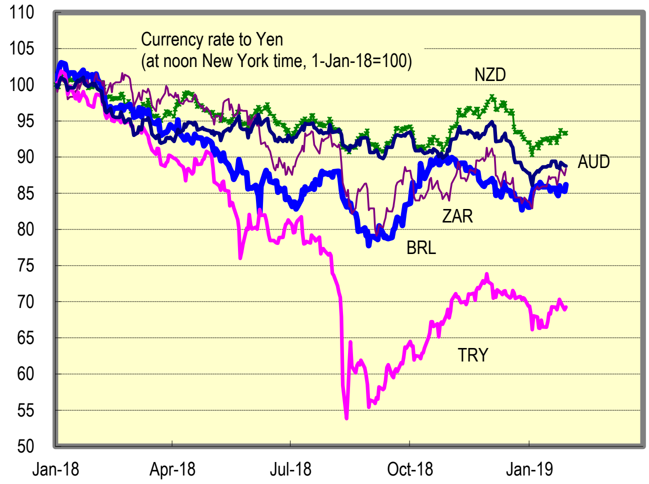
Source: Thomson Reuters; compiled by Daiwa Securities.

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		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	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

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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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[Fitch]

The Name of the Credit Rating Agencies group, etc

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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.

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