Forex Market View

Direction of USD/JPY to change depending on US economic data

- Risk-on weakens both yen and dollar; declining US interest rates weaken dollar
- USD/JPY likely to fall if rise in US share prices slows
- US economic data may weaken and push USD/JPY lower

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

28 Feb- 27 Mar: Y107.0-112.0/$ (Y110.92/$ as of 27 Feb)

Forex Market View DSFE217

FICC Research Dept.

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

Daiwa Securities Co. Ltd.

Risk-on weakens both yen and dollar; declining US interest rates weaken dollar

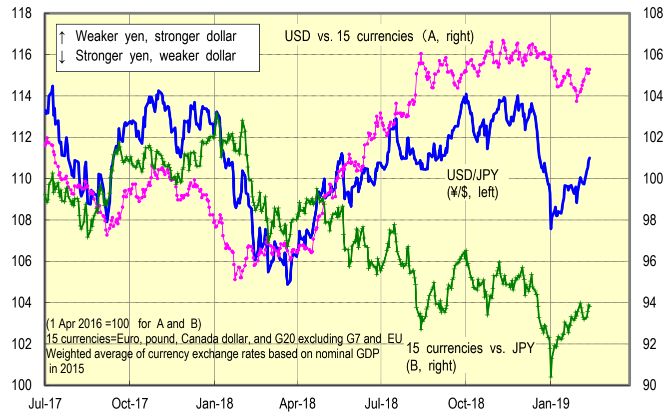
Risk-on weakens yen and dollar, Chinese yuan rises

The dollar rose after announcement of the January US jobs data showing strong growth in nonfarm payrolls, but it has turned to a declining trend against 15 major currencies excluding the yen. Cross-yen rates have remained in a rising trend since January, but with dollar weakness offsetting yen weakness, the USD/JPY has been stagnant. The yen's weakness in the cross-yen market reflects the prevailing risk-on mood, and the latter is one reason why the dollar's effective exchange rate has switched from dollar strengthening to dollar weakening. We think this risk-on mood is being driven by expectations of US monetary policy becoming neutral (i.e., the end of Fed tightening), a US-China trade agreement, and the UK being able to avoid a no-deal Brexit. The recent sharp rise in the value of the yuan, driven by US demands for China to strengthen the yuan amid US-China trade talks, has also been a factor weakening both the dollar and the yen since mid-February.

Declining US interest rates are putting downward pressure on the dollar

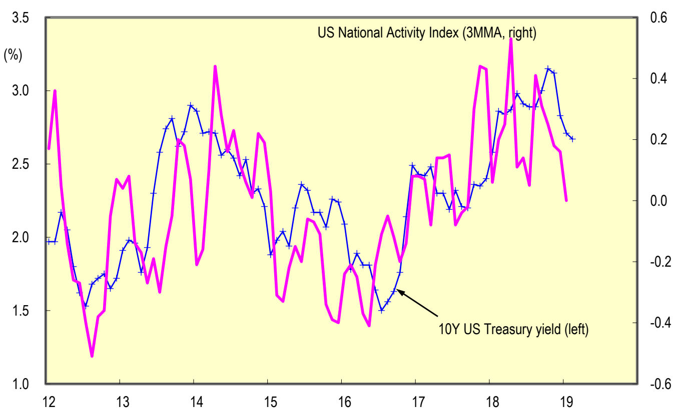
If the only factors involved were risk-on moves and yuan appreciation, downward pressures would be greater on the yen than on the dollar and the USD/JPY would continue rising. The fact that the USD/JPY had stalled probably suggests that the declining trend in US interest rates, brought by the weakness shown in December retail sales and some other US economic data as well as by Fed officials dialing back their hawkish stance, is putting downward pressure on the dollar. If risk-on moves gain momentum and US interest rates do not decline further, yen depreciation will probably outpace dollar depreciation and push the USD/JPY higher, whereas if risk-on moves do not strengthen and US interest rates continue declining, dollar depreciation will probably dominate and push the USD/JPY lower. It is the trend in the two elephants in the room, risk tolerance and US interest rates, that should drive the USD/JPY.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US National Activity Index and 10Y Treasury Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

USD/JPY likely to fall if rise in US share prices slows

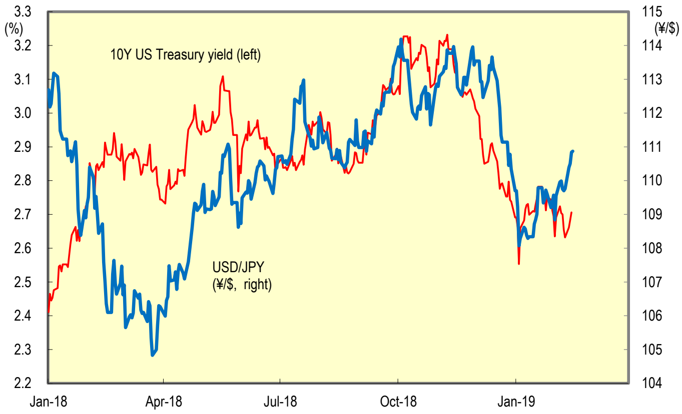
Long-term rates decline on slowdown in US economic growth

US economic data are probably key to the trend in US interest rates. For example, the 10-year Treasury yield correlates with the Chicago Fed National Activity Index (CFNAI), a measure calculated using 85 monthly economic indicators, and both have been in a declining trend the past few months. Although US nonfarm payrolls and other January 2018 data were strong, the CFNAI has been declining (from +0.36 in November 18 to +0.05 in December and to -0.43 in January), with its 3-month moving average down to 0.0. This means that US economic growth has slowed to its long-term trend. Although far from the "-0.7 or lower" threshold that indicates an increase likelihood of a recession, its drop into negative territory signifies growth has dropped below average, making it more likely that unemployment will increase and factory utilization will decrease. This makes the Fed more likely to lean dovish. Based on the trend in the US economic data thus far, we think it likely that US interest rates will continue declining and putting downward pressure on the dollar.

USD/JPY likely to fall if rise in US share prices slows

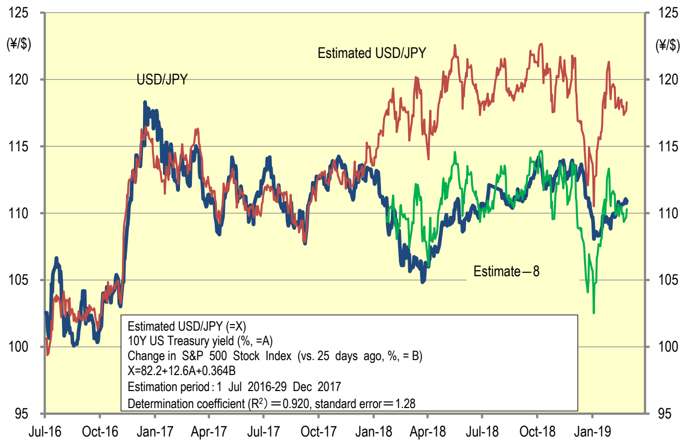
The USD/JPY rose in February, diverging from the declining trend in US interest rates. We attribute this to a risk-on weakening of the yen. A regression of the USD/JPY against the 10-year Treasury yield and the 25-day change in the S&P 500 has high explanatory power. The USD/JPY clearly had an upward bias in Jan-Feb because of rising US share prices. The current USD/JPY level of 110 can also largely be explained by moves in US interest rates and share prices. Nevertheless, if there is no decline in US interest rates and share price growth slows, it will lower the estimated value of the USD/JPY.

Chart: 10Y US Treasury Yield and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Regression of USD/JPY via US Long-term Interest Rate and Change in Stock Price



Source: Thomson Reuters; compiled by Daiwa Securities.

US economic data may weaken and push USD/JPY lower

Share prices have become less attractive based on their arbitrage relationship with US interest rates

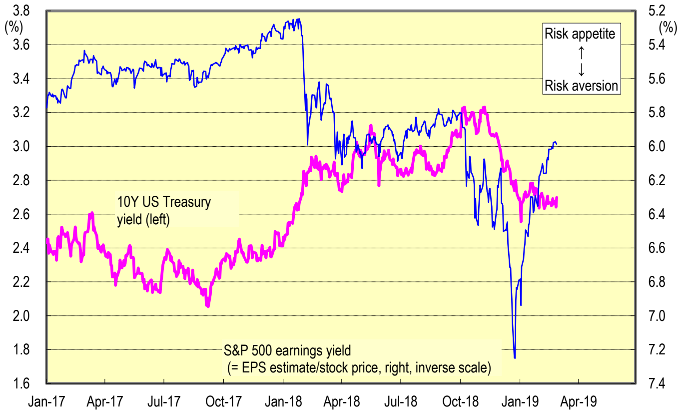
The forecast P/E of the S&P 500, which had declined to 13.8X in December 2018, is up to 16.7X in February 2019 and is approaching its peak of 17.3X in Aug-Sep 2018. The equity earnings yield (the inverse of P/E: EPS forecast/share price) had risen to 7.25% in December 2018 but has since dropped to 5.98%. Since the 10-year Treasury yield declined about 0.17ppt while the equity earnings yield declined about 1.27ppt, it is probably more accurate to say that share prices have been rising amid stagnant interest rates than it is to say that interest rate declines have been supporting share price appreciation. The yield spread (10-year Treasury yield - S&P 500 earnings yield) rose to -3.29% after bottoming at -4.51% in December 2018, and it has remained high since early February 2018. Share prices have thus become significantly less attractive as measured by their arbitrage relationship with US interest rates.

US economic data may weaken and push USD/JPY lower

Share prices are easily affected by the economic outlook. Improvement in the economic outlook creates more upside for share prices, and likewise when the economic outlook worsens it increases downside risks in the stock market. There is therefore a reasonable probability that risk-on downward pressures on the yen will be alleviated by slower increase in the ISM manufacturing index and US nonfarm payrolls, both of which were strong in

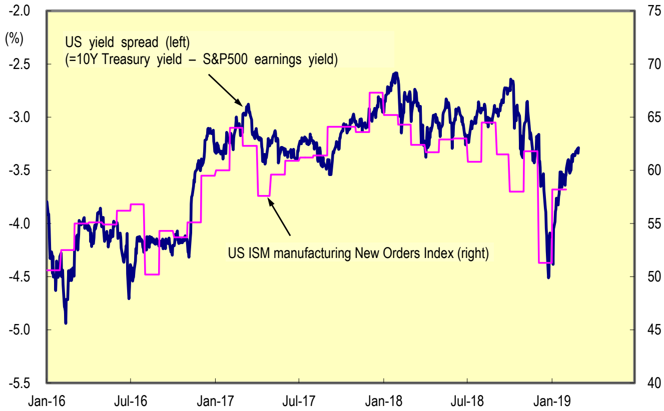
January 2019. Meanwhile, President Trump extended the deadline for raising tariffs on China, and the risk-on moves driven by expectations of a US-China trade agreement appear to be wearing off. Furthermore, risk-on moves driven by expectations the UK can avoid a no-deal Brexit should also start to fade if the Brexit deadline is extended and are likely to continue to fade until the majority votes remain in a second UK referendum on leaving the EU, which would strengthen expectations of Brexit being called off. Although it will depend on the US economic data, we think the USD/JPY is likely to decline on a combination of risk-off yen appreciation and continued downward pressure on the dollar from declining US interest rates.

Chart: US Long-term Interest Rate and Equity Earnings Yield



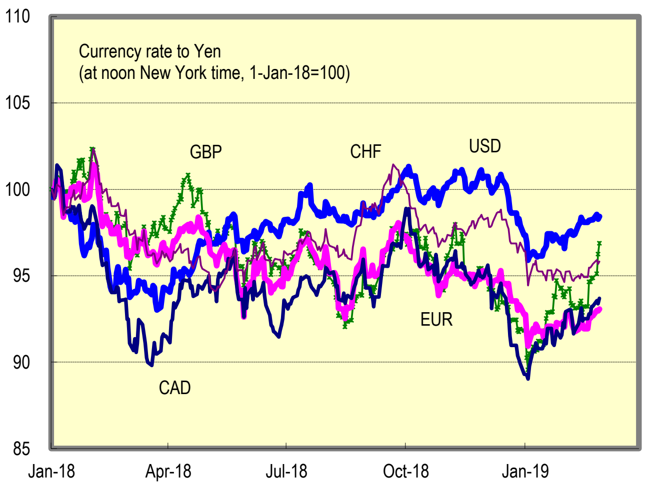
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US New Orders Index and Yield Spread



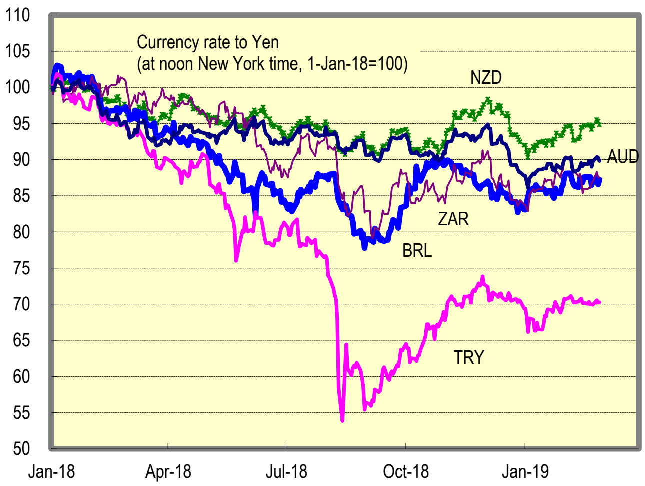
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

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	109.0	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	125.5	122.0	119.0	119.0
			118-128	118-130	118-130	115-127	115-127
AUD-JPY	82.1	77.7	76.5	79.5	76.0	73.5	73.5
			73-81	73-82	73-82	70-79	70-79
CAD-JPY	88.0	81.0	80.5	82.0	79.5	77.5	77.5
			77-85	76-85	76-85	74-83	74-83
NZD-JPY	75.2	74.0	73.0	75.0	72.0	69.5	69.5
			70-78	69-78	69-78	66-75	66-75
TRY-JPY	18.8	20.9	19.5	20.8	19.5	18.5	18.5
			17-22	17-22	17-22	16-21	16-21
ZAR-JPY	8.0	7.7	7.6	7.9	7.5	7.2	7.2
			7.2-8.3	7.0-8.3	7.0-8.3	6.7-8.0	6.7-8.0
BRL-JPY	28.1	28.5	28.0	29.8	28.2	27.0	27.0
			26-31	26-31	26-31	25-30	25-30
KRW-JPY	10.2	9.9	9.5	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	16.0	16.7	16.0	15.5	15.5
			15.2-17.0	15.5-17.0	15.5-17.0	15.0-16.5	15.0-16.5

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.

■ 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.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

[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

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

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.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moodys.com/pages/default_ja.aspx)

[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)

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 "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.co.jp/web/)

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.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association