Daiwa Securities

Forex Market Weekly

Stronger yen on rekindled concerns about slowing US/China economies

- Switch from weak to strong yen; euro drops after ECB postpones hike
- Weaker equities, stronger yen very likely on poor US manufacturing data
- Risk-off mood probably limited even if revised Brexit proposal rejected

This week's USD/JPY forecast range

11 - 15 Mar: Y110.0 – 111.5/$ (Y111.1 at end-previous week)

Forex Market View DSFE220
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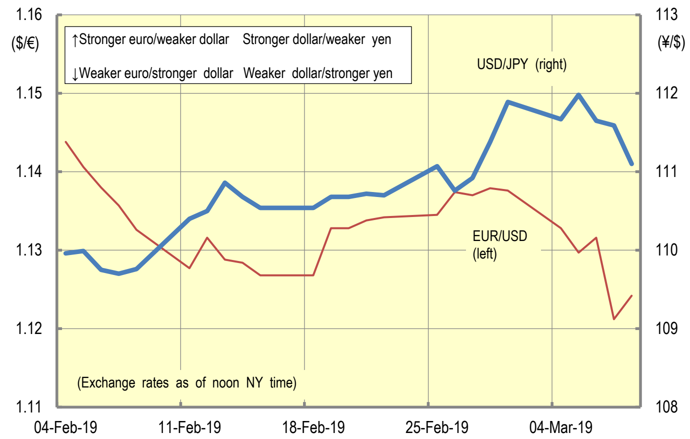
Overview of last week's forex market

Switch from weak to strong yen; euro drops after ECB postpones hike

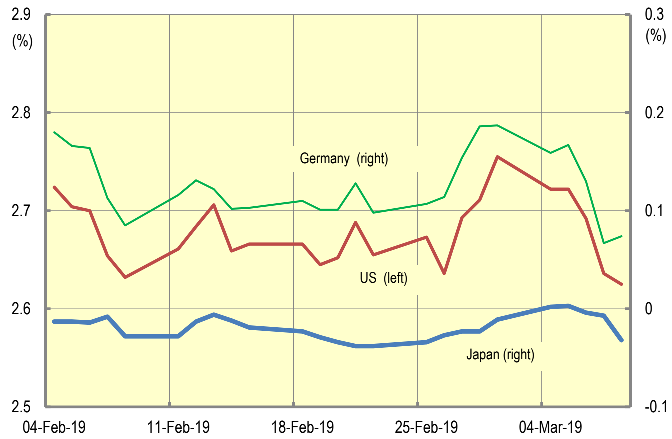
Interest rates in the US/Europe fell and yen depreciation ran its course despite gains for Chinese equities on promising reports about trade talks including "US could remove additional tariffs on Chinese goods if China fulfills its trade commitments" and "signing of trade deal possible when US/China leaders meet around March 27." The USD/JPY fell on a drop in US construction spending and after the US House of Representatives began investigating obstruction of justice allegations against President Donald Trump. The pair then recovered after China's National People's Congress presented new economic stimulus measures, including a cut in the value-added tax rate for manufacturers. The USD/JPY marked a new recent high of 112.13 on a better-than-expected US ISM non-manufacturing index for February. However, the pair fell back after national security adviser John Bolton said the US could ramp up sanctions if North Korea does not denuclearize. Meanwhile, the Canadian dollar lost ground on worsening visibility regarding the timing for additional rate hikes by the Bank of Canada. European interest rates declined and the euro fell after the ECB revised its guidance, postponed its next rate hike until 2020, announced that a third Targeted Longer-term Refinancing Operations (TLTRO) program will start from September, and lowered its eurozone growth and inflation forecasts. This weighed on US interest rates and resulted in a stronger yen against the dollar and other currencies. The USD/JPY briefly dipped below 111 on a bigger-than-expected decline for Chinese exports and sluggish US hiring in February.

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.

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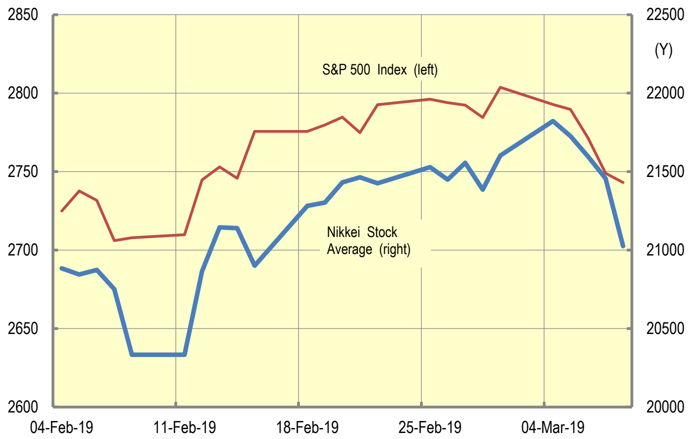
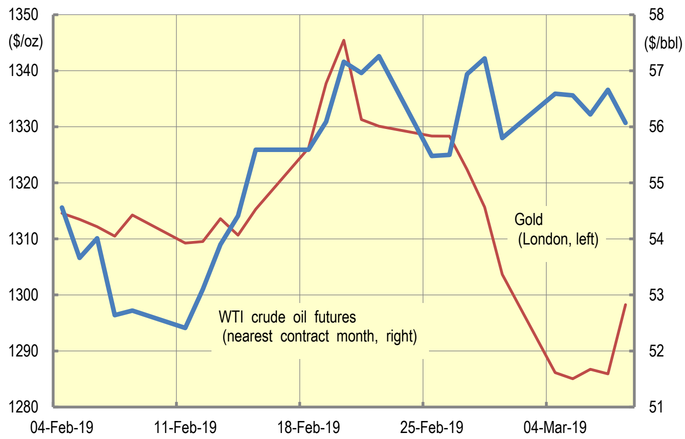
Chart: Stock Market: US S&P 500, Nikkei Stock Average



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Commodity Market: Crude Oil Futures, Gold



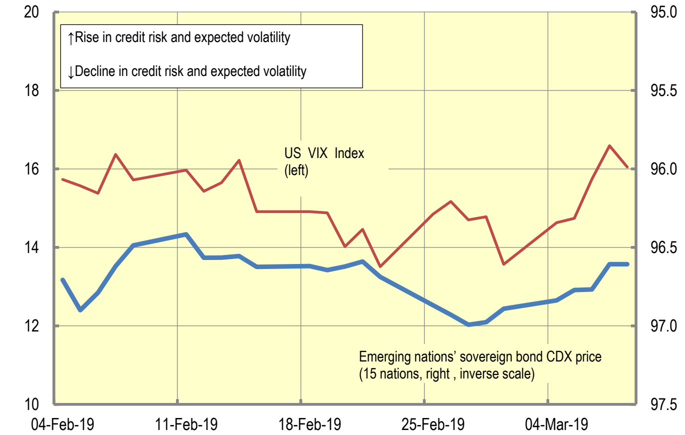
Source: Thomson Reuters; compiled by Daiwa Securities.

Weaker equities, stronger yen very likely on poor US manufacturing data

Market likely focusing more on manufacturing PMI than non-manufacturing index

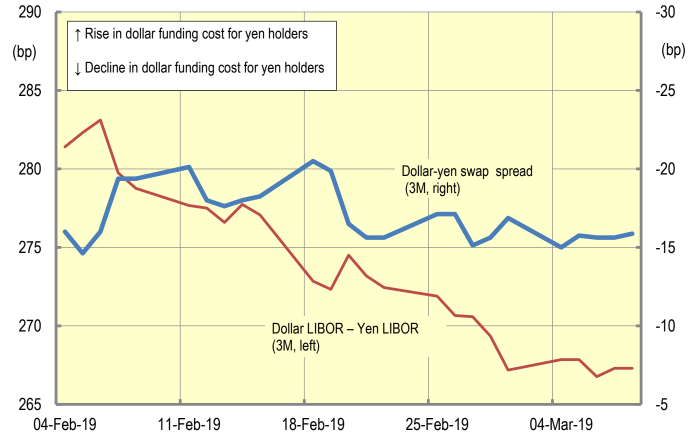
The February US ISM manufacturing PMI came in at 54.2, a 2.4-point decline from the January reading, while the new orders index was 55.5, down 2.7 points. Meanwhile, the February US ISM non-manufacturing index (NMI) was 59.7, up 3.0 points from January and beating the market consensus. The new orders index was up 7.5 points at 65.2. With contrasting results for the manufacturing PMI and non-manufacturing index, we need to determine which index deserves greater importance. The non-manufacturing index is important as the covered industries account for larger percentages of overall added value and employment, while the manufacturing PMI is important due to its leading indicator characteristics. Looking at the time-lag correlation coefficient over the past ten years for the manufacturing PMI and non-manufacturing index, the highest correlation is for when comparing the manufacturing PMI to the non-manufacturing index for the following month (Ex. comparing February manufacturing PMI to March non-manufacturing index). In other words, manufacturing PMI tends to function to some degree as a leading indicator for the non-manufacturing index. Accordingly, manufacturing PMI tends to influence markets more. We note that US equities fell sharply in February and October of 2018. The January manufacturing PMI, released on 1 February 2018, fell 0.6 point m/m and new orders declined 4.0 points, but the non-manufacturing index, released on 5 February, improved 4.0 points with new orders up 8.4 points. Similarly, the September manufacturing PMI, released on 1 October 2018, dropped 1.5 points and new orders fell 3.3 points, but the non-manufacturing index, released on 3 October, improved 3.1 points with new orders up 1.2 points. In other words, equities fell sharply in months that followed months when the manufacturing PMI deteriorated and an improvement for the non-manufacturing index clearly emerged. This suggests that market participants place greater importance on the manufacturing PMI over the non-manufacturing index. If this apparent rule of thumb holds true, we can assume that deterioration for the February 2019 manufacturing PMI could easily lead to a drop for US stocks and increased risk-off yen appreciation pressure. Until now, expectations for a US/China trade deal had brightened investor sentiment and suppressed concerns about a slowing global economy. However, the yen trend could probably easily switch from depreciation to appreciation if expectations for a trade deal peak and economic indicators for China and the US worsen.

Chart: US VIX Index and Emerging Market CDS



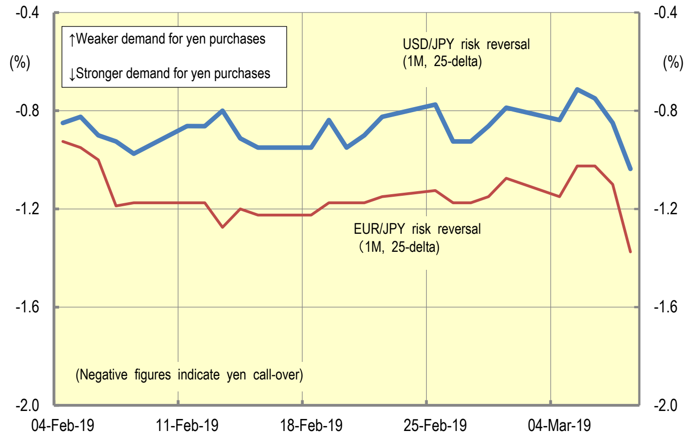
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: LIBOR Gap and Currency Swap Spread



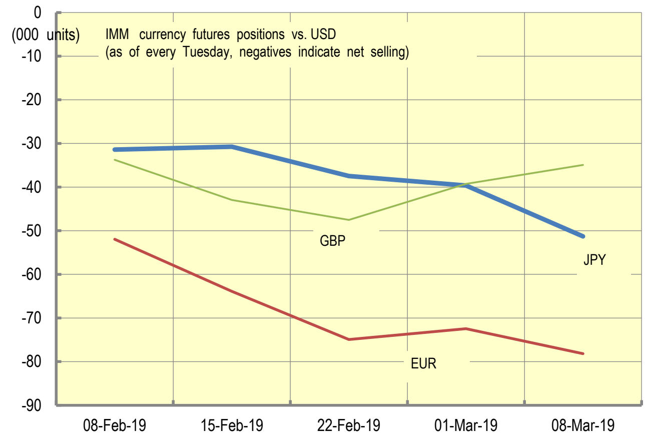
Source: Thomson Reuters; compiled by Daiwa Securities.

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.

Risk-off mood probably limited even if revised Brexit proposal rejected

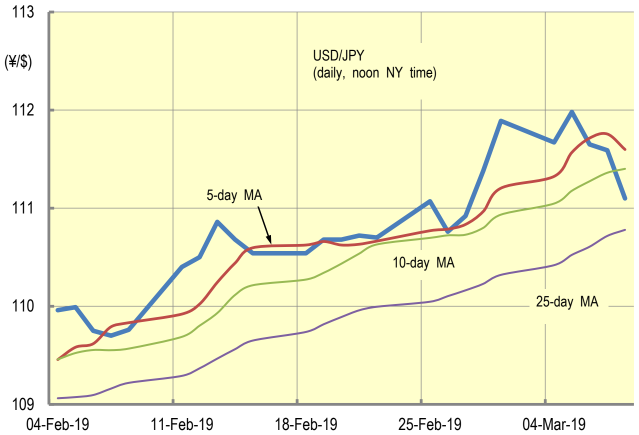
Britain could ask for Brexit delay

While England and the EU have not yet reached an agreement regarding the revised Brexit proposal, the two sides could still announce an agreement by 11 March. Northern Ireland's Democratic Unionist Party (DUP), which has formed a non-Cabinet alliance with the government of Prime Minister Theresa May, plans to support the Brexit proposal provided there are legal guarantees that the backstop (to avoid hard Irish border by creating temporary customs union) would never become a permanent arrangement. Brexit hardliners within May's ruling Conservative Party will probably adopt a similar stance. There is still the risk that the British Parliament will reject the revised Brexit proposal if it does not include such legal guarantees. However, any risk-off mood would probably be short-lived if Parliament then rejects a no-deal Brexit and asks the EU for a Brexit delay.

Noteworthy currency: EUR

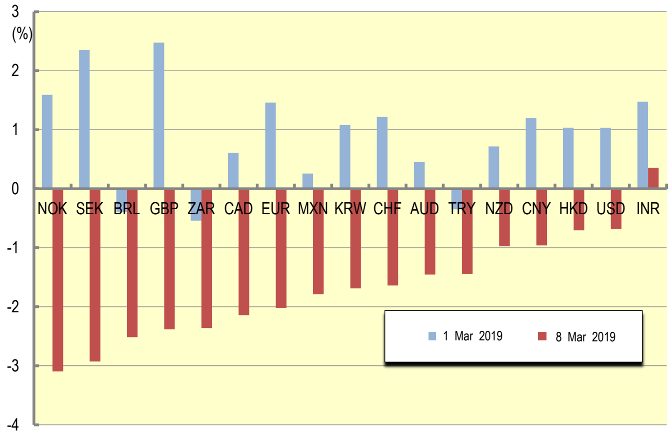
Ever since the ECB turned dovish, pessimism about a slowing eurozone economy has increased. The euro could fall on a further deterioration of market sentiment if data due out on 11 March does not show rebounds for Germany's industrial production and trade balance in January. This week's Brexit talks could also impact the euro. If the Brexit proposal is rejected on 11 March, the pound could fall and pull the euro lower. However, the pound and euro could then rebound modestly if a no-deal Brexit is also rejected and a measure to delay Brexit is passed.

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

11-Mar	Jan German industrial production, trade statistics
	Jan US retail sales
12-Mar	Feb US CPI
13-Mar	Jan eurozone industrial production
	Jan US durable goods orders
14-Mar	Jan-Feb China industrial production, retail sales
	Jan US new home sales
15-Mar	Feb China 70 cities housing prices
○	BOJ MPM (governor Kuroda's press conference)
●	Closing of China's National People's Congress (Beijing)
	Feb Europe new car sales
	Mar NY Fed's Empire State Manufacturing Index
	Feb US industrial production, capacity utilization rate
	Mar US University of Michigan's Consumer Sentiment Index (preliminary)

Source; Compiled by Daiwa Securities.
Notes: Dates based on JST. ○ indicates monetary policy-related and ● indicates political/international events.

Chart: Weekly Forex Forecasts, Noteworthy Currencies/factors

	4 - 8 Mar 2019 (actual)		11 - 15 Mar 2019 (forecasts)	
	Range	End of week	Range	End of week
USD/JPY	110.7-112.2	111.1	110.0-111.5	110.7
EUR/JPY	124.2-127.5	124.9	123.7-125.2	124.1
EUR/USD	1.117-1.140	1.124	1.115-1.130	1.121

Noteworthy currencies and factors

EUR	Euro is softening due to ECB's dovish shift; effect of Brexit discussion should be unavoidable
GBP	Even if Brexit proposal is rejected, risk-off would be temporary until Brexit delay is approved
JPY	Deterioration in US manufacturing indices would cause risk-off yen appreciation

Source; Compiled by 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.

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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).

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■ Credit Rating Agencies

[Standard & Poor's]

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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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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)

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