Daiwa Securities

Forex Market View

Will reactionary moves occur against yen depreciation on expectations for economic recovery?

- Expectations for economic recovery on US-China trade agreement would be disappointed
- Expectations for economic recovery on China's tax cuts would also be disappointed
- Economic recovery and rise in stock prices unlikely to proceed despite decline in US interest rates

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

4 Apr-3 May: Y108.5-112.5/$ (Y110.91/$ as of 10 Apr)

Forex Market View DSFE227

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Expectations for economic recovery on US-China trade agreement would be disappointed

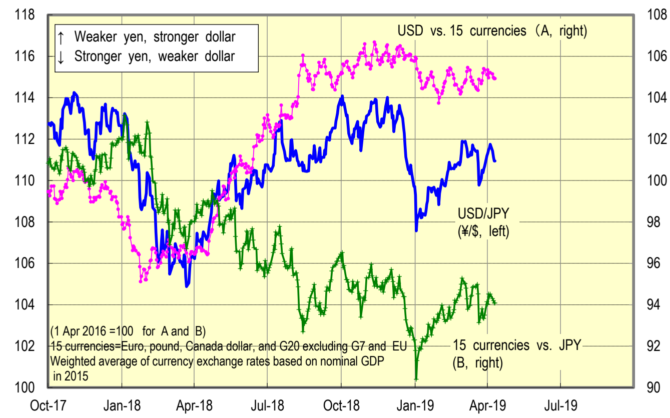
Low possibility that yen will remain weak

Toward this April, the USD/JPY rate rose alongside the rise in cross-yen rates, largely due to risk-on yen depreciation on the back of higher global stock prices. However, it is unlikely that the yen will remain weak. The reasons behind the higher stock prices and weaker yen following the market being inclined toward risk-on mode would include (1) expectations for an economic recovery due to the US-China trade agreement and Chinese economic measures, (2) expectations for higher share prices and economic recovery owing to lower US interest rates, and (3) improvement in some economic indicators in the US and China. However, it is difficult to think that they will be sustained. The reasons are as follows.

Expectations for economic recovery on US-China trade agreement would be disappointed

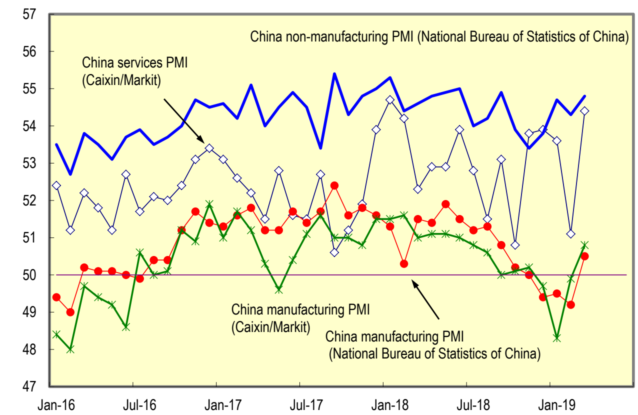
US and China top officials (incl. President Donald Trump) are sending out messages that US-China trade talks have been proceeding steadily. In addition, one media report said that the US and China are drawing closer to a final trade agreement and that most of the issues standing in the way of a deal have been resolved. Reflecting this, the market has raised expectations for a US-China trade agreement. However, according to some media reports, China will pledge until 2025 to increase its imports of US primary products and allow American companies doing business in China to set up wholly owned companies there, but the US can take retaliatory steps if China does not honor its commitments. Other promises that China has offered to implement by 2029 will not be subject to US retaliation if left unfulfilled. If under a new trade deal only a small portion of the trade agreements are binding, and if China is not required to fulfill its commitments until well into the future, it would be difficult for the US to immediately remove or lower existing tariffs on Chinese products. The US would likely first lower tariffs on only a very small portion of goods and agree to a long-term phased tariff reduction subject to the condition of China fulfilling its commitments. If so, the market would be disappointed as it had expected the US tariff cuts on Chinese products to activate global trade. Moves in reaction to expectations for an economic recovery on the US-China trade agreement are likely to cause risk-off mode.

Chart: Exchange Rates of USD, JPY, and Other 15 Currencies



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: China Corporate PMI



Source: Thomson Reuters; compiled by Daiwa Securities.

Expectations for economic recovery on China's tax cuts would also be disappointed

Expectations for economic recovery on China's tax cuts would also be disappointed

Although the Chinese government cut the value-added tax rate in the manufacturing and construction sectors from April, the market expects the tax cuts to lead to an economic recovery there (less of a slowdown). In fact, the tax cut is positive for the private sector in China. However, unless markdowns via tax cuts are spread among Chinese firms, the ripple effect of expansion of final demand (e.g., personal consumption) is likely to be limited, although the tax cut is positive for corporate profits. In March, China's manufacturing PMI, new orders, and production indices improved, likely reflecting expectations for stronger demand due to tax cuts. From April, however, if inventories accumulate alongside weaker-than-expected growth in demand, continuous improvement in those indices would be less likely. Although the tax cut is positive for corporate profits, the positives would be short-lived if the effects of demand expansion are limited. Unless Chinese economic indicators continue to improve, the market is likely to lean to risk-on mode due to reactionary moves against expectations.

Economic recovery and rise in stock prices unlikely to proceed despite decline in US interest rates

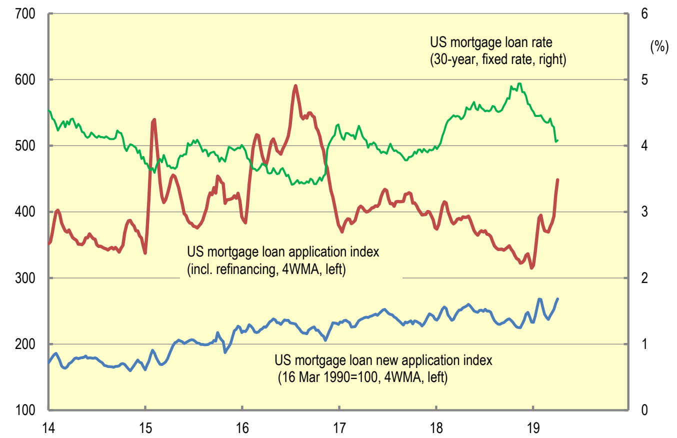
Increasing no. of applications for mortgage loans, reflecting lower US long-term interest rate

It is expected that lower US interest rates will benefit stock prices and economic conditions. At its March FOMC meeting, the Fed decided to suspend rate hikes by leaving rates unchanged and to end its asset drawdown within 2019. It is safe to say that the Fed's shift pushed down US long-term interest rates and the lower rate helped share prices rise. Reflecting a decline in the long-term mortgage rate, the number of applications for mortgage loans has also been increasing, centering on refinancing (weak growth for new loan applications)

Decline in US long-term interest rates unlikely to lead to substantial rise in share prices

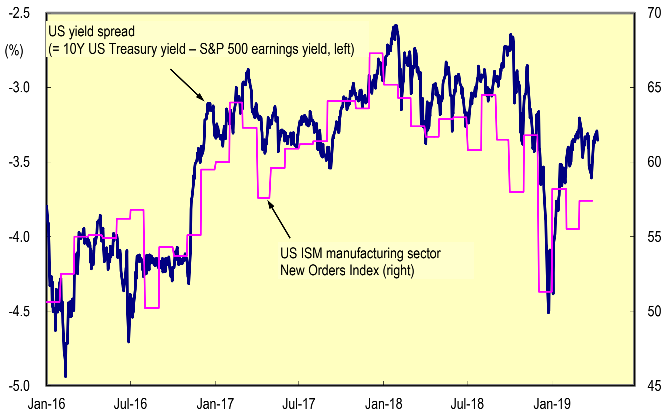
The problem is the sustainability of the effects of lower long-term interest rates on the uptrend in share prices. In the US, share prices have risen in line with the decline in long-term interest rates. However, the equity earnings yield (= EPS estimate / stock price) declined more than the US Treasury yield, leading to a rise in the yield spread (= Treasury yield minus equity earnings yield). The March US ISM manufacturing PMI and New Orders Index improved from the plunge in December 2018. However, the March level is lower than the October 2018 level, which is the second-lowest in 2018 after the December level. Amid weak improvement in business sentiment (as witnessed by ISM data), the upside of the US yield spread would be limited. If it is difficult for the yield spread to rise, share prices are unlikely to rise substantially, although we may see a rise in stock prices (decline in equity earnings yield) in line with a fall in long-term interest rates (Treasury yields).

Chart: US Mortgage Loan Indices and Mortgage Loan Rate



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Yield Spread and ISM Manufacturing Sector New Orders Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Diminishing US tax-cut effects alongside decline in consumer propensity

In the US, consumer sentiment worsened in December 2018 due to lower stock prices. At the same time, consumer propensity, the ratio of disposable income to consumption expenditures, also declined substantially. Consumer propensity hardly rose also in January 2019. In addition, growth in disposable income in 2019 will be lower than that in 2018 when the nation enjoyed the tax-cut effects. This is the background of the slow recovery of retail sales, which plunged in December 2018. Retail sales are expected to increase in Mar-Apr due to higher consumer propensity on the uptrend of share prices. However, if the uptrend slows, growth in personal consumption would be sluggish.

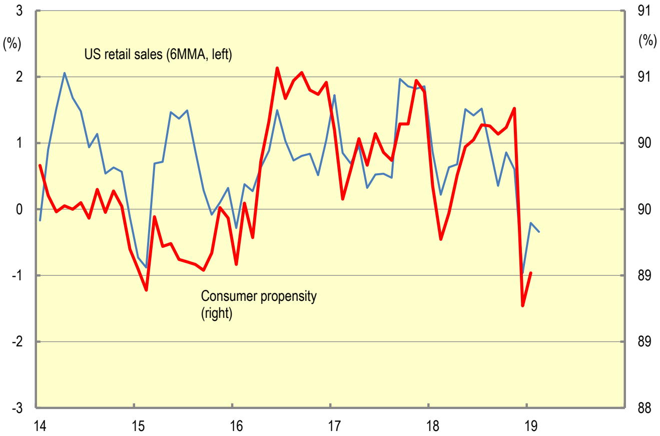
If US economic recovery weaker than market expectations, market would lean to risk-off mode

With the recent decline in the number of US initial jobless claims, the m/m gain in March nonfarm payrolls recovered close to 200,000 people. Although recession risk is apparently diminishing, a decline in the number of workers in the staffing services sector and slowing growth in weekly earnings suggest that the employment environment is not necessarily improving. If a US economic recovery is weaker than market expectations, expected growth rates would decline. If the long-term interest rate declines, the market would easily lean to lower share prices due to risk-off mode. This would serve as a new factor leading to an economic recession.

We should assume shift to yen appreciation, rather than continuation of yen depreciation

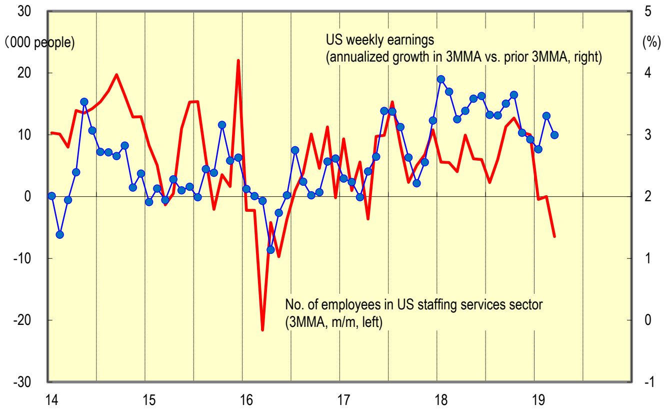
As mentioned, expectations for the US-China trade agreement, those for Chinese economic recovery on tax cuts, those for higher stock prices/economic recovery due to lower US interest rates, and improvement in economic indicators in the US and China are unlikely to continue for long. The possibility appears to be increasing that the market will shift to risk-off yen appreciation due to disappointment in the economic recovery, rather than the continuation of risk-on yen depreciation.

Chart: US Retail Sales and Consumer Propensity



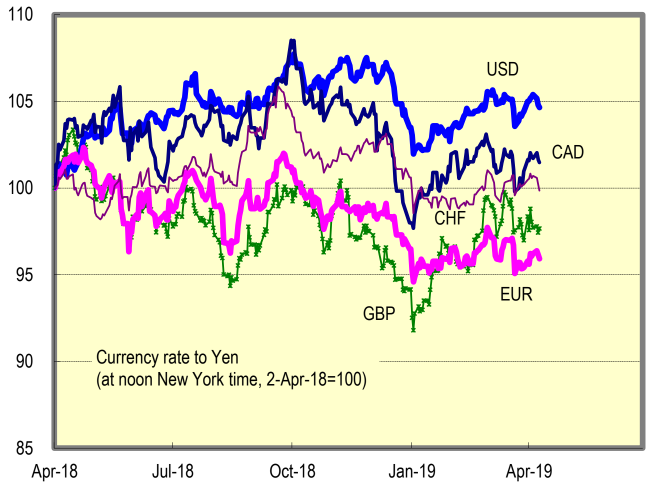
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Weekly Earnings and No. of Employees in Staffing Services Sector



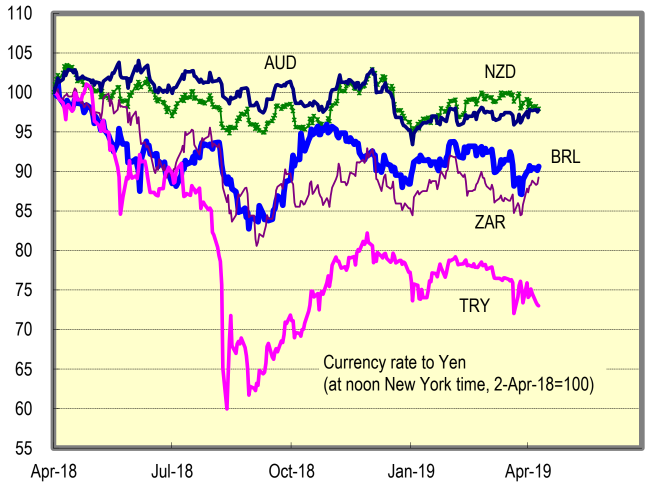
Source: Thomson Reuters; compiled by Daiwa Securities.

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				
	31 Dec 2018	29 Mar 2019	Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 2019	Jan-Mar 2020	Apr-Jun 2020
USD-JPY	110.3	110.7	110.0	107.0	105.0	105.0	107.0
			104-113	104-112	101-110	101-110	101-110
EUR-JPY	126.3	124.3	125.5	121.0	118.0	118.0	122.0
			118-130	117-129	115-127	115-127	115-127
AUD-JPY	77.7	78.6	78.0	75.0	72.5	72.5	76.0
			81-91	72-81	70-79	70-79	70-79
CAD-JPY	81.0	82.8	82.0	79.5	77.5	77.5	80.0
			83-93	76-85	74-83	74-83	74-83
NZD-JPY	74.0	75.5	75.0	72.0	69.5	69.5	72.5
			69-78	69-78	66-75	66-75	66-75
TRY-JPY	20.9	20.0	21.0	19.5	18.5	18.5	19.8
			17-22	17-22	16-21	16-21	16-21
ZAR-JPY	7.7	7.7	7.9	7.4	7.0	7.0	7.6
			7.0-8.3	7.0-8.3	6.7-8.0	6.7-8.0	6.7-8.0
BRL-JPY	28.5	28.5	30.0	27.5	26.5	26.5	28.0
			26-31	26-31	25-30	25-30	25-30
KRW-JPY	9.9	9.7	9.8	9.4	9.2	9.2	9.4
(100 KRW)			9.1-10.1	9.1-10.1	8.8-9.8	8.8-9.8	8.8-9.8
CNY-JPY	16.1	16.5	16.5	15.8	15.3	15.3	16.0
			15.5-17.0	15.5-17.0	15.0-16.5	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.

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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).

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)

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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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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.

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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)

Assumptions, Significance and Limitations of Credit Ratings

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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.

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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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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.

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