

Forex Market View

How the yen might move if the consumption tax hike is postponed

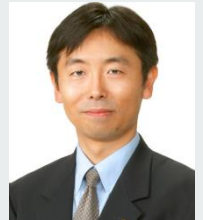
- Two patterns in forex and stock trends following consumption tax hike postponements
- BOJ policies and domestic/overseas growth have affected forex and stock trends
- Possibility of strong yen/weak stocks if 2019 consumption tax hike is postponed

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

23 May-21 Jun: Y107.0-111.0/\$ (Y110.27/\$ as of 22 May)

Forex Market View DSFE235

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Two patterns in forex and stock trends following consumption tax hike postponements

Questions about whether the consumption tax hike will go through

In light of concerns about a slowdown in growth worldwide, it remains to be seen whether Japan's government increases the consumption tax this fall, as scheduled, or postpones it. Opinion is divided, but one key related point is whether the government downgrades its overall assessment of the economy in its May Monthly Economic Report, which comes out on the 24th. In this report, we consider how exchange rates might be affected if the consumption tax increase is postponed.

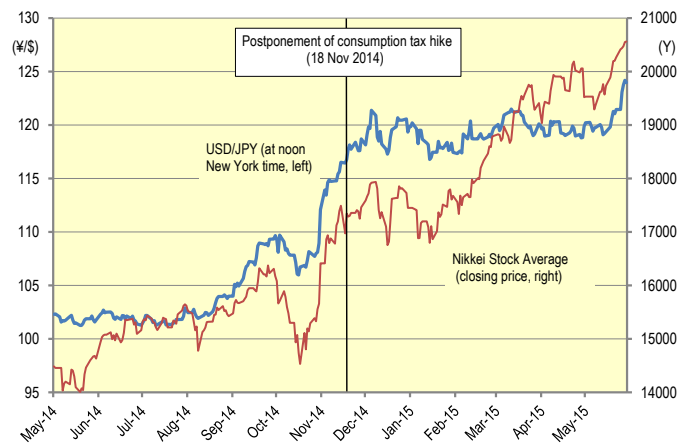
The yen weakened and stocks rose after the first consumption tax hike postponement

Forex and stock trends were very different following the Abe administration's previous two consumption tax hike postponements. The first postponement was on 18 November 2014. The government decided to postpone an increase in the consumption tax from 8% to 10%, originally scheduled for October 2015, to April 2017 because the April 2014 increase (from 5% to 8%) led to a slump in consumer spending. The yen weakened and stocks rose after the decision. USD/JPY went from around Y116/\$ on 17 November to about Y121/\$ on 5 December, and the Nikkei 225 rose from 16,973 to 17,935 on 8 December.

The yen strengthened and stocks fell after the second consumption tax hike postponement

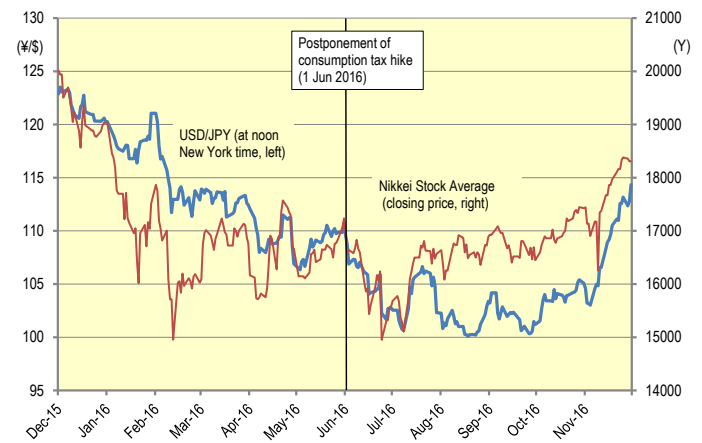
The second postponement was on 1 June 2016. The government decided to postpone the consumption tax hike (to 10%) again, from April 2017 to October 2019, because of weak growth in emerging countries and substantial risks for growth worldwide. The yen strengthened and stocks fell after the decision. USD/JPY went from around Y110/\$ on 31 May to about Y100/\$ on 8 July, and the Nikkei 225 fell from 17,234 to 14,952 on 24 June. Hence, there have been two patterns in forex and stock trends following consumption tax hike postponements: 1) a decline in the yen's value and a rise in stock prices and 2) a rise in the yen's value and a decline in stock prices.

Chart: USD/JPY and Nikkei Stock Average Around Decision to Postpone Consumption Tax Hike (1)



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: USD/JPY and Nikkei Stock Average Around Decision to Postpone Consumption Tax Hike (2)



Source: Thomson Reuters; compiled by Daiwa Securities.

BOJ policies and domestic/overseas growth have affected forex and stock trends

BOJ expanded QQE in 2014

One reason for the clear difference in forex and stock trends following the consumption tax hike postponements is the difference in market reactions to the BOJ's policies. The BOJ decided to expand QQE on 31 October 2014 by increasing the annual pace of growth in the BOJ's long-term JGB holdings by Y30 trillion to Y80 trillion. Following the decision, the yen weakened and stocks rose. Conditions remained favorable for a weak yen and strong stock prices.

The BOJ adopted its negative interest rate policy on 2016

The BOJ decided on 29 January 2016 to assess a rate of -0.1% on current accounts that financial institutions hold at the BOJ. Following the decision, the yen strengthened and stocks declined on the expectation that the BOJ would be less likely to purchase long-term JGBs if financial institutions curtail increases in the current accounts that they hold at the BOJ. Even with the postponement of the consumption tax hike, the yen's appreciation trend hardly changed.

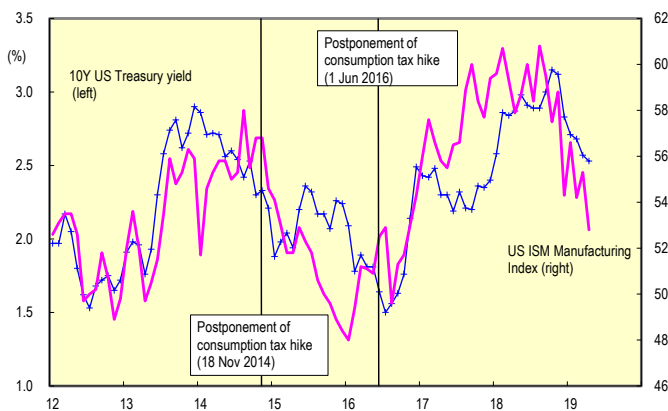
Differences in the strength of US growth

Another reason for the clear difference in forex and stock trends following the consumption tax hike postponements is the difference in the strength of the US economy. For example, the US ISM manufacturing index (PMI) averaged 56.0 in May-October 2014 but only 49.5 (below the key threshold of 50) in November 2015-April 2016. Also, the Chicago Fed National Activity Index (CFNAI) averaged +0.13 in May-October 14 but only -0.33 (below the key threshold of 0, corresponding to trend growth) in November 2015-April 2016. In other words, there were concerns about the slowdown in US economic growth from above trend in 2014 to below trend in 2016. Hence, in 2016, even with the postponement of the consumption tax hike, it was difficult for expectations for an improvement in growth to rise and for risk-off trends (a strong yen and weak stocks) to give way to risk-on trends (a weak yen and strong stocks).

Acceleration and deceleration in Japan's economic growth

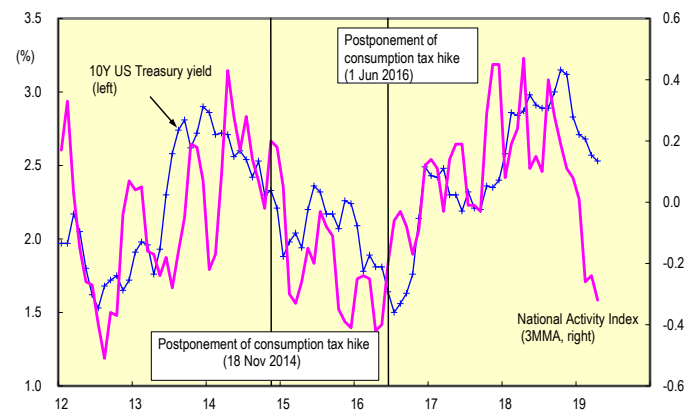
As a result, in 2014, real GDP growth in Japan accelerated from 0.3% in Jul-Sep to 2.0% in Oct-Dec. Growth in domestic private sector final demand slowed somewhat from 2.0% in Jul-Sep to 1.2% in Oct-Dec but stayed in positive territory. By contrast, in 2016, real GDP growth in Japan sharply decelerated from 2.7% in Jan-Mar to 0.4% in Apr-Jun, and growth in domestic private sector final demand slowed drastically from 0.7% in Jan-Mar to -1.7% in Apr-Jun. Even with the 2016 postponement of the consumption tax hike, the yen appreciated and stocks declined because of concerns about the slowdown in Japan's economic growth.

Chart: US ISM Manufacturing Index and 10Y Treasury Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Chicago Fed National Activity Index and 10Y US Treasury Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

Possibility of strong yen/weak stocks if 2019 consumption tax hike is postponed

Neutral impact of BOJ policies on forex and stock trends

We now consider what might happen to the yen and stock prices if the government postpones the consumption tax hike scheduled for October 2019. The BOJ's policies are likely to have a neutral impact on forex and stock trends, given the limited leeway and expectations for additional easing by the BOJ.

US economic growth slowing and below trend

The average US ISM manufacturing index in November 2018-April 2019 was 55.3, which is not low, but the index declined from 58.8 in November 2018 to 52.8 in April 2019. The CFNAI averaged -0.15 in November 2018-April 2019, but the three-month moving average declined from 0.11 in November 2018 to -0.32 in April 2019. In other words, US economic growth is slowing and below trend. With the added negative impact of the deterioration in US-China trade frictions, expectations for a slowdown in US economic growth are likely to dominate expectations for a pickup in growth.

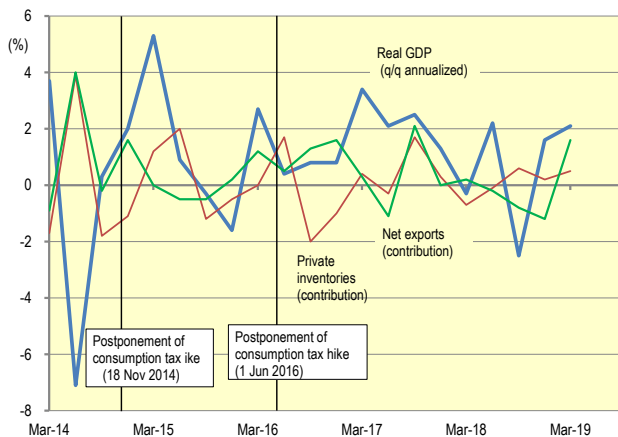
Slowdowns in demand in Japan and other countries

Japan's real GDP growth (annualized) accelerated from 1.6% in Oct-Dec 2018 to 2.1% in Jan-Mar 2019, but demand did not improve. The GDP growth accelerated mainly because of a sharp rise in the contribution of net exports, from -1.2ppts to 1.6ppts, thanks to a decline in imports that exceeded the decline in exports. An increase in the contribution of private sector inventory changes, from 0.2ppt to 0.5ppt, also helped the GDP growth accelerate. The contribution of domestic private sector final demand excluding inventory changes declined sharply from 2.3ppts to -0.3ppt. In other words, total domestic production increased thanks to a decline in imports and a rise in inventories, and domestic final demand and overseas demand (exports) both weakened. Expectations for a slowdown in Japan's economic growth are likely to dominate expectations for a pickup in growth.

Possibility of strong yen/weak stocks if 2019 consumption tax hike is postponed

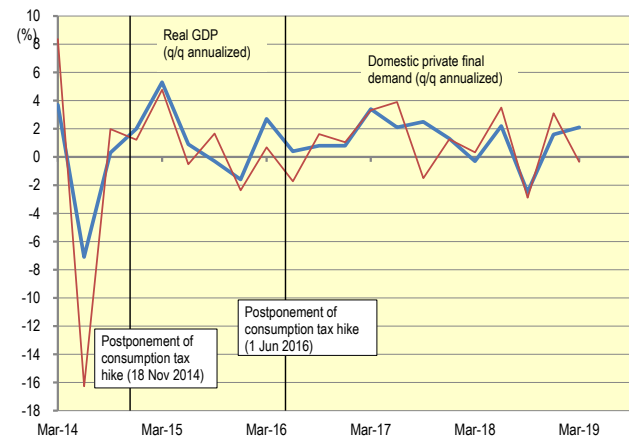
Growth is slowing in many countries around the world, and growth concerns are probably dominating in the market. As such, concerns about growth in Japan and other countries will probably not diminish even if Japan's government postpones the consumption tax hike. Hence, if the October 2019 consumption tax hike is postponed, we think a strong yen/weak stock pattern, like that after the June 2016 postponement, is more likely than a weak yen/strong stock pattern, like that after the November 2014 postponement.

Chart: Real GDP Growth Rate and Contribution from Net Exports and Private Inventories



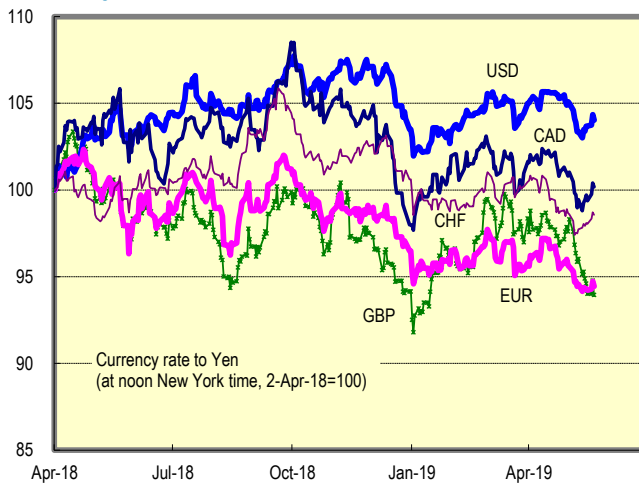
Source: Cabinet Office; compiled by Daiwa Securities.

Chart: Growth Rate of Real GDP and Domestic Private Final Demand



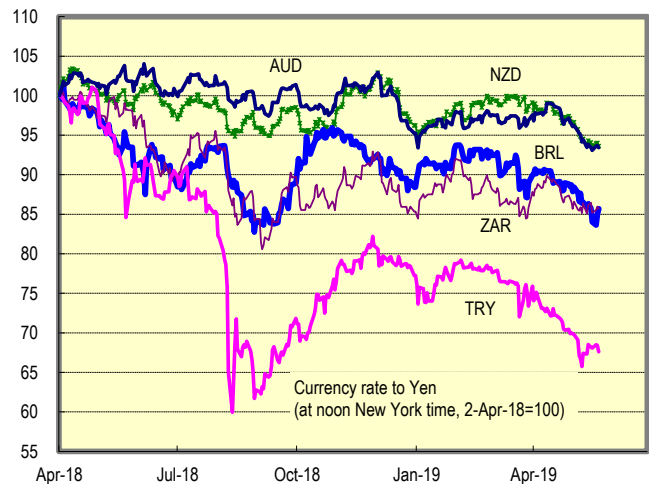
Source: Cabinet Office; compiled by Daiwa Securities.

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	109.0 104-113	107.0 104-112	105.0 101-110	105.0 101-110	107.0 101-110
EUR-JPY	126.3	124.3	122.0 116-128	119.0 115-127	116.0 113-125	116.0 113-125	120.0 113-125
AUD-JPY	77.7	78.6	75.5 72-81	73.0 71-80	70.5 68-77	70.5 68-77	71.0 68-77
CAD-JPY	81.0	82.8	81.5 77-86	79.5 76-85	77.5 74-83	77.5 74-83	80.0 74-83
NZD-JPY	74.0	75.5	72.0 68-77	69.5 68-77	67.5 65-74	67.5 65-74	71.0 65-74
TRY-JPY	20.9	20.0	18.5 16-21	17.5 16-21	16.5 15-20	16.5 15-20	18.0 15-20
ZAR-JPY	7.7	7.7	7.7 7.2-8.2	7.4 7.2-8.2	7.0 6.9-7.9	7.0 6.9-7.9	7.7 6.9-7.9
BRL-JPY	28.5	28.5	27.5 26-31	26.5 25-30	25.0 24-29	25.0 24-29	27.0 24-29
KRW-JPY (100 KRW)	9.9	9.7	9.2 9.0-10.0	9.0 8.8-9.8	8.7 8.5-9.5	8.7 8.5-9.5	9.0 8.5-9.5
CNY-JPY	16.1	16.5	15.8 15.5-17.0	15.3 15.0-16.5	14.8 14.5-16.0	14.8 14.5-16.0	15.5 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.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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- 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.

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