Forex Market View

Dollar under weakening pressure from worsening US economic data

- Risk-off yen appreciation and lessening dollar appreciation on declining US interest rates
- Weaker US economic indicators behind decline in US interest rates
- ISM manufacturing PMI may fall short of market expectations

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

29 May-28 Jun: Y107.0-111.0/$ (Y109.50/$ as of 28 May)

Forex Market View DSFE237

FICC Research Dept.

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

Daiwa Securities Co. Ltd.

Risk-off yen appreciation and lessening dollar appreciation on declining US interest rates

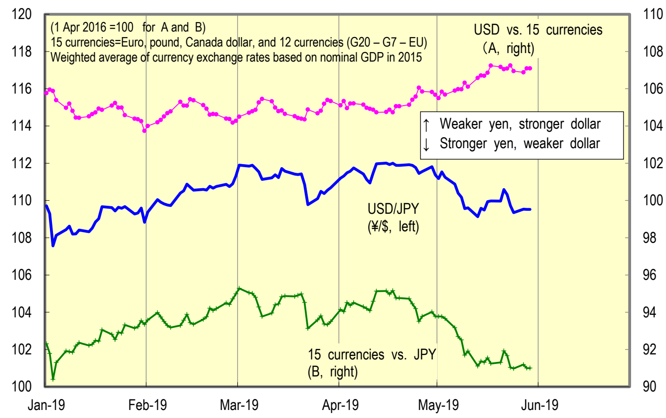
Yen appreciation exceeds dollar appreciation on risk-off moves

The decline in the USD/JPY in April-May was more from yen appreciation than from dollar depreciation. The USD/JPY had fallen by 2.2% over slightly more than a month until May 28, with a basket of 15 major currencies excluding the yen and dollar falling 4.4% against the yen and 2.3% against the dollar. Thus, the dollar has been appreciating, but the yen has been appreciating more, causing the USD/JPY to decline. Yen appreciation outstripping dollar appreciation is the typical pattern seen in a risk-off market. In fact, during that same period the world's major stock indices declined and so did long-term interest rates. Some US economic data coming in weaker than the market expected, comments from the US administration arguing that the Fed should consider cutting rates, and a decision by President Trump to raise additional tariffs on Chinese goods to 25% all combined to trigger a stronger yen via risk-off moves and interest rate declines.

Lessening dollar appreciation on declining US interest rates

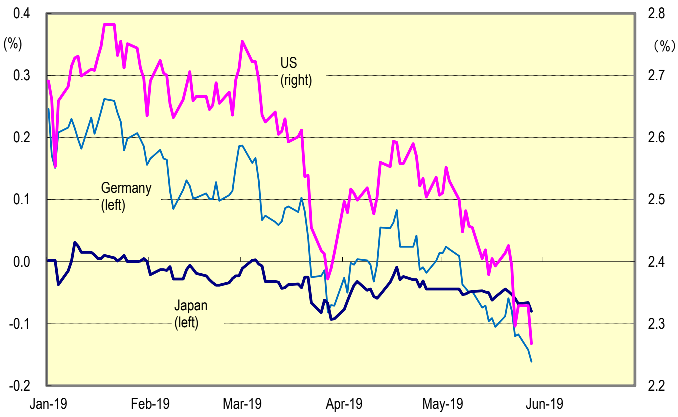
Risk-off dollar appreciation has lost momentum recently, however. Until May 22, there was not much of a difference in the amount of decline between 10-year Treasury yields and 10-year Bund yields, but since then rate declines have been relatively greater in the US, and the euro switched from weakening against the dollar to strengthening against it. Measured against a basket of 15 currencies, the dollar went from strengthening to weakening. Risk-off moves create dollar strengthening pressure but relatively greater declines in US long-term rates create dollar weakening pressures, and the latter (dollar weakening pressures) have been slightly greater than the former (dollar strengthening pressures). When declines in US interest rates amplify dollar weakening pressures, a rise in the dollar's effective exchange rate (dollar appreciation) becomes less likely and the USD/JPY becomes likely to decline as much as or more than cross-yen rates.

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



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: 10Y Sovereign Bond Yields in Japan, US, and Germany



Source: Thomson Reuters; compiled by Daiwa Securities.

Weaker US economic indicators behind decline in US interest rates

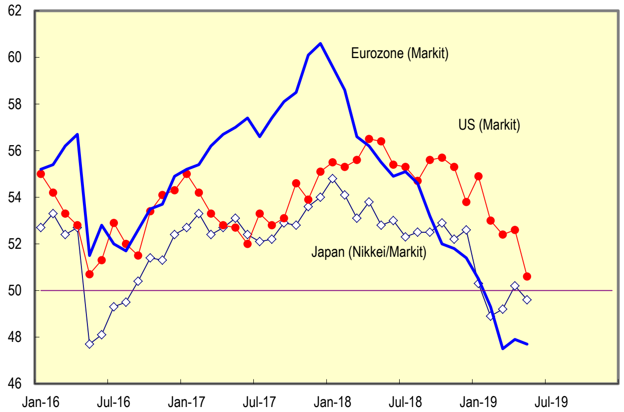
Weaker US economic indicators behind decline in US interest rates

Long-term rates have declined by more in the US than they have in Europe because of the view that the US is relatively more vulnerable to adverse impacts from US-China trade friction. US sentiment, which had worsened less than sentiment in Europe, has worsened significantly recently, and this has probably further supported that view. The manufacturing PMIs announced by Markit showed the euro zone PMI declined first and remained below 50 from February to May. Markit's US PMI was at 52 or higher up until April, but the May PMIs announced on May 23 showed it dropping sharply to 50.6, its lowest in 116 months, going back to September 2009. The survey was taken May 13-22 and we think responses reflected impacts from the US raising tariffs on Chinese goods. It appears that the market seeing the possibility of the US economy, which had been relatively stronger, having started to slow more is what pulled US long-term rates lower. Although this may be attributable to long-term rates in Japan and Germany already being in negative territory and thus being less likely to decline than long-term rates in the US, if there is a clear weakening of US sentiment, we think the relatively greater decline in US long-term rates is likely to put downward pressure on the dollar.

The direction of US economic data will be a source of volatility for interest rates and exchange rates

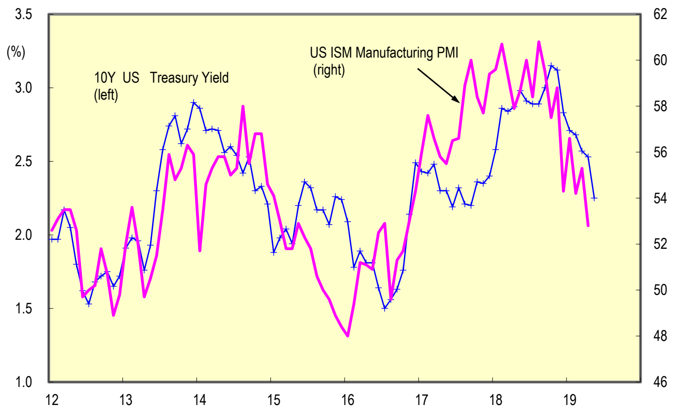
In the US, the manufacturing PMI tends to lead the nonmanufacturing PMI slightly, is closely watched by the market, and can easily affect market trends. The ISM manufacturing PMI and 10-year Treasury yields are highly correlated, and manufacturing sentiment can easily affect exchange rates by causing interest rates to change. The May US manufacturing PMI announced by Markit deteriorated more than expected, causing a significant decline in US long-term rates, and depending on the May ISM manufacturing index scheduled to be released on June 3, there is likely to be movement in both US long-term rates and the USD/JPY. Currently, the average market forecast for the May ISM manufacturing PMI is for it to increase to 53.3, from 52.8 in April. The question is whether manufacturing sentiment will improve like the market expects.

Chart: Manufacturing PMI in Japan, US, and Eurozone (Markit)



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US ISM Manufacturing PMI and 10Y Treasury Yield



Source: Thomson Reuters; compiled by Daiwa Securities.

ISM manufacturing PMI may fall short of market expectations

Reasons why the market expects the ISM manufacturing PMI to improve

It may be that the market expects the May ISM manufacturing PMI to improve based on the improvement in the regional Fed bank manufacturing indices that have already been announced. The Empire State Manufacturing Survey for May, announced by the New York Fed on May 15, rose to 17.8 from 10.1 in April, a second consecutive month of increases and the highest it has been in six months. The sub indices showed an increase in demand, with new orders, shipments, and unfilled orders all rising and inventories declining. The 6-months ahead forward-looking indicators for general business conditions, new orders, and shipments also showed a sharp rise, and this was a strong survey. The Manufacturing Business Outlook Survey announced by the Philadelphia Fed on May 16 rose from 8.5 in April to 16.6, its highest in seven months. Of the sub indices, shipments and employment rose but new orders and inventories declined. The 6-months ahead forward-looking indicators were nearly unchanged from April, but overall this was a strong survey.

Most of the data that showed improvement was based on survey responses given prior to the additional tariffs

It is important to note when the two surveys were taken, however. The Empire State Manufacturing Survey was sent out at the beginning of the month and responses were allowed as late as May 15, but most of the responses were turned in by May 10. The Philadelphia Fed's Manufacturing Business Outlook Survey for May 2019 reflects responses turned in by May 13. President Trump announced on May 5 that he would raise tariffs on $200 billion of Chinese imports from 10% to 25% on May 10 and he did exactly that, but we do not think either survey reflected much of an impact from the additional tariffs on China. Looking at the correlation coefficient that the ISM manufacturing PMI has had over the last five years (2014-18) with seven different indices (manufacturing sentiment indices from the New York, Philadelphia, Kansas City, Dallas, and Richmond Fed banks, the Chicago PMI, and the Markit manufacturing PMI), the New York Fed's survey ranks No. 3 and the Philadelphia Fed's ranks No. 4, with neither correlating that highly. Improvement in the May 2019 manufacturing indices from the New York Fed and the Philadelphia Fed probably does not mean there is a high probability of the ISM manufacturing PMI also improving.

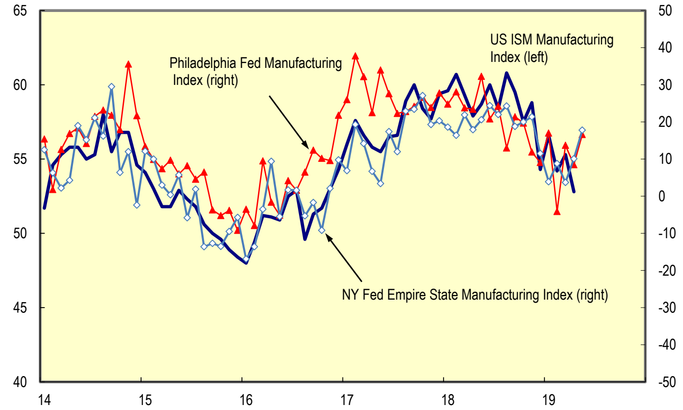
The economic data that worsened was based on survey responses given after the additional tariffs

The Kansas City Fed's May Manufacturing Survey announced on May 23 showed a slight decline to 4, from 5 in April. Of the sub indices, production, shipments and new orders declined and inventories rose, a breakdown showing weakness. That survey was taken on May 15-20. Additionally, the Texas Manufacturing Outlook Survey announced by the Dallas Fed on May 28 declined from 2.0 in April to -5.3, the lowest it has been in six months, while the 6-months ahead outlook declined from 18.4 to 19.1. Of the sub indices, production, new orders, and unfilled orders declined, and although employment and delivery times increased, this was a weak survey. It was taken on May 14-22.

ISM manufacturing PMI may fall short of market expectations

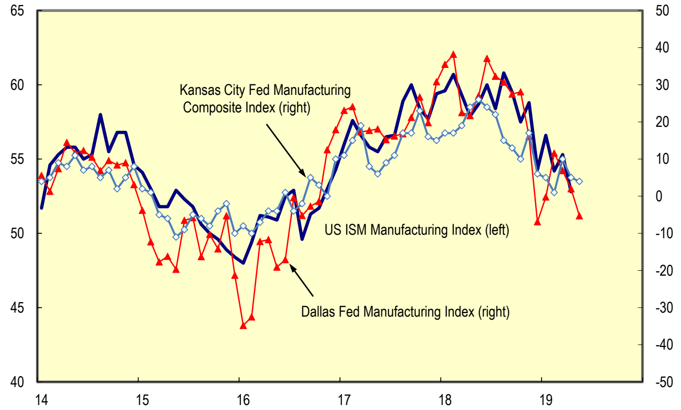
These last two surveys were taken after the additional tariffs on China were announced and were probably weak because they reflected the expected impact from those tariffs. Of the seven surveys listed above, the Dallas Fed's survey showed the highest correlation coefficient with the ISM manufacturing PMI over the past five years and the Kansas City Fed's showed the second highest (the Chicago PMI was No. 5, the Richmond Fed's survey No. 6, and the Markit PMI No. 7). Because the May ISM manufacturing PMI will likely also show considerable impacts from the increase in tariffs on Chinese goods, we think it is unlikely to show m/m improvement as the market expects, but rather is more likely to worsen. Be aware of the possibility of a decline in US interest rates and weakening of the dollar (decline in the USD/JPY) caused by a negative surprise from US economic data.

Chart: Manufacturing Sentiment Indices from NY Fed, Philadelphia Fed, and ISM



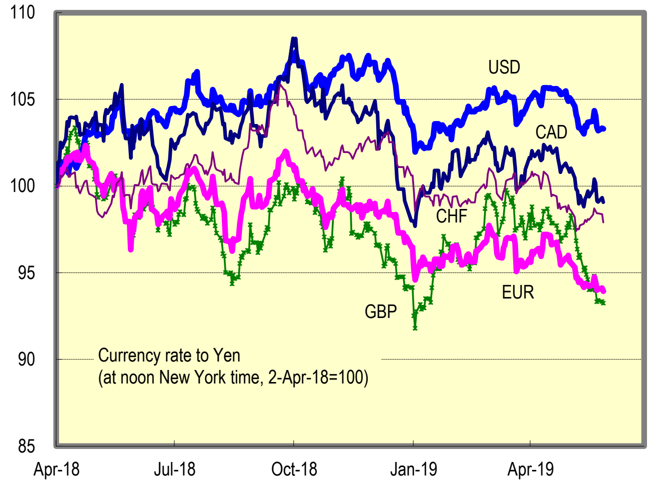
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Manufacturing Sentiment Indices from Dallas Fed, Kansas City, Fed, and ISM



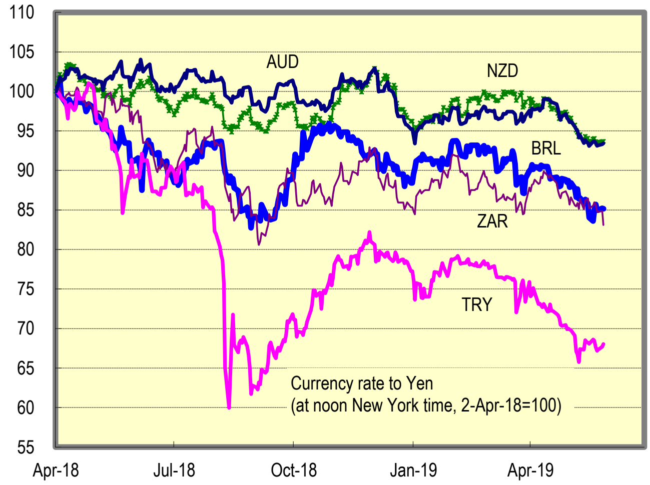
Source: Thomson Reuters; compiled by Daiwa Securities.

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	29 Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
	2018	2019	2019	2019	2019	2020	2020
USD-JPY	110.3	110.7	109.0	107.0	105.0	105.0	107.0
			104-113	104-112	101-110	101-110	101-110
EUR-JPY	126.3	124.3	122.0	119.0	116.0	116.0	120.0
			116-128	115-127	113-125	113-125	113-125
AUD-JPY	77.7	78.6	75.5	73.0	70.5	70.5	71.0
			72-81	71-80	68-77	68-77	68-77
CAD-JPY	81.0	82.8	81.5	79.5	77.5	77.5	80.0
			77-86	76-85	74-83	74-83	74-83
NZD-JPY	74.0	75.5	72.0	69.5	67.5	67.5	71.0
			68-77	68-77	65-74	65-74	65-74
TRY-JPY	20.9	20.0	18.5	17.5	16.5	16.5	18.0
			16-21	16-21	15-20	15-20	15-20
ZAR-JPY	7.7	7.7	7.7	7.4	7.0	7.0	7.7
			7.2-8.2	7.2-8.2	6.9-7.9	6.9-7.9	6.9-7.9
BRL-JPY	28.5	28.5	27.5	26.5	25.0	25.0	27.0
			26-31	25-30	24-29	24-29	24-29
KRW-JPY	9.9	9.7	9.2	9.0	8.7	8.7	9.0
(100 KRW)			9.0-10.0	8.8-9.8	8.5-9.5	8.5-9.5	8.5-9.5
CNY-JPY	16.1	16.5	15.8	15.3	14.8	14.8	15.5
			15.5-17.0	15.0-16.5	14.5-16.0	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.

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.

■ 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

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