Daiwa Securities

Forex Market View

US economic slowdown and USD/JPY decline may have farther to go

- Dollar weakens on US rate declines, yen strengthens on risk off
- US economic slowdown triggers US interest rate inversion
- If US economy continues slowing, further dollar weakening/yen strengthening

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

5 Jun- 4 Jul: Y106.5 - 110.5/$ (Y108.27/$ as of 4 Jun)

Forex Market View DSFE239

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Dollar weakens on US rate declines, yen strengthens on risk off

Interest rates decline more in US than in Japan and Europe

US interest rate declines are gaining momentum. The 10-year Treasury yield stood at 2.530% on May 3, before President Trump's tweet about imposing additional tariffs on China, and one month later on June 3 they had declined to 2.081% (after falling as low as 2.061%). This amounted to a 0.449ppt decline during that period. During the same time frame, 10-year Bund yields declined 0.219ppt, from 0.020% to -0.199%, and from April 26 (prior to the long holiday) until June 3, 10-year JGB yields declined 0.047ppt, from -0.044% to -0.091%. The rate decline was thus relatively greater in the US.

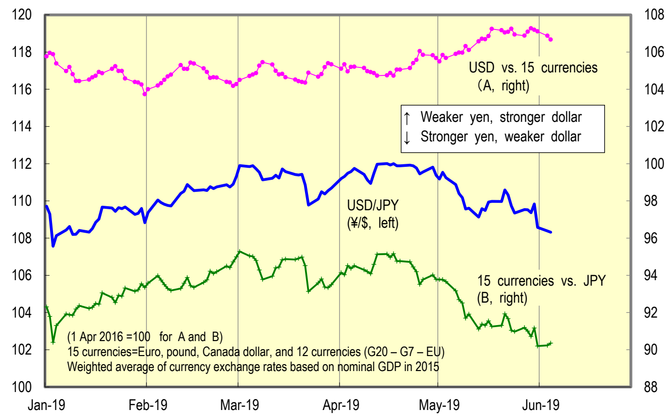
Dollar being sold even during risk-off moves

Declining US interest rates are putting downward pressure on the dollar. Interest rates as well as share prices and commodity prices have been declining globally, and markets are clearly in risk-off mode. Normally both the yen and the dollar tend to be bought when markets turn risk-off, but the relatively greater decline in US interest rates has created a selling bias in the market for dollars. With a US rate decline-driven dollar weakening (a decline in the dollar's exchange rate against a basket of 15 currencies) coexisting with a risk-off yen strengthening (decline in cross-yen rates, i.e., decline in the value of a basket of 15 currencies against the yen), the USD/JPY has been declining even faster than cross-yen rates.

US interest rates are declining because economic indicators are worsening

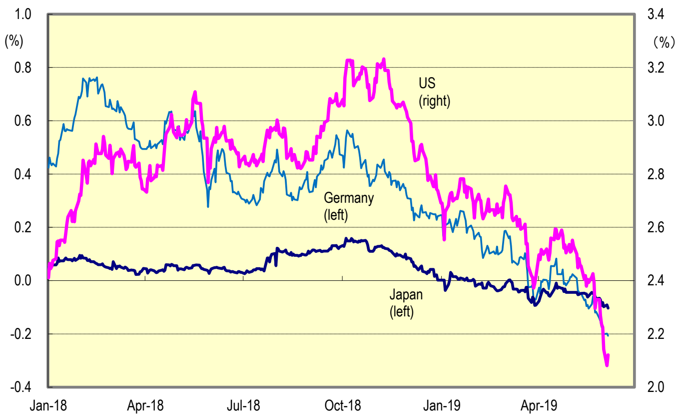
Possible reasons for the relatively greater rate decline in the US are 1) concern that US trade friction with China and Mexico will have greater adverse impacts on the US economy than on the economies of Japan and Europe, and 2) as US rates are higher than rates in Japan and Europe, an increase in Fed rate cut expectations tends to push US interest rates down easily. Even still, US interest rate declines are unlikely to be very large when the US economy is strong. The large decline in US interest rates can be attributed to the recent increase in the number of US economic indicators pointing to an economic slowdown, we think.

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.

US economic slowdown triggers US interest rate inversion

Inversion of US yield curve may be early sign of recession

The decline in US long-term rates has caused the yield curve to invert. Currently, the 10-year Treasury yield is 2.08% v. the FF target rate of 2.25-2.50%, the effective fed funds rate of 2.38%, and the 3-month T-bill yield of 2.30%. Since 1989, whenever the 10-year Treasury yield minus the 3-month T-bill yield turned negative, the US economy entered a recession in 8 to 17 months. Because the yield curve inverted in May 2019, a simple calculation suggests the economy will enter a recession sometime between January and October 2020. Will the US economy enter a recession prior to the US presidential election scheduled for November 3, 2020? Or will the US-China trade conflict be resolved and a recession avoided?

US economic slowdown triggers US interest rate inversion

At the very least, the US economy can be in a slowing trend when the yield curve inverts, as it has in the past. Following are the 3-month average (up to the previous month) of the Chicago Fed National Activity Index (CFNAI) and the 3-month average (up to that month) of the ISM manufacturing PMI for those months when the maturity spread (10-year Treasury yields minus the 3-month T-bill yield) was inverted on the last day of the month: in May 1989 (the economy entered a recession 15 months later), those averages were at -0.19 and 51.0; in August 2000 (a recession followed 8 months later) they were at -0.31 and 51.3; and in August 2006 (a recession followed 17 months later) they were at -0.18 and 52.9. This contrasts with the May 2019 readings of -0.32 and 53.4, which represent the lowest CFNAI but the highest ISM manufacturing PMI of the above readings. The PMI readings for those months with an inverted yield curve were below 50 in May 1989 (49.3) and in August 2000 (49.9), but above 50 in August 2006 (53.7) and May 2019 (52.1). The PMI has been in a stronger downward trend in 2019 than it was in 2006, however.

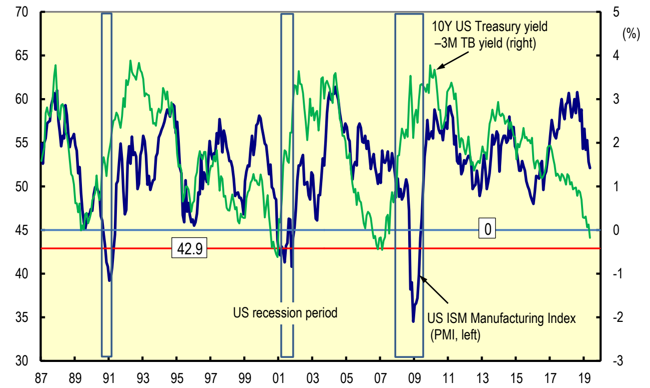
ISM manufacturing PMI may drop below 50

The May 2019 ISM manufacturing PMI recorded a 0.7ppt m/m decline. The sub-indices that showed an increase were new orders at +1.0, employment at +1.3, new export orders at +1.5, customer inventories at +1.1, and prices at +3.2, while those that showed a decline where production at -1.0, supplier deliveries at -2.6, inventories at -2.0, outstanding orders at -6.7, and imports at -0.4. The large decline in orders outstanding and increase in customer inventories indicates weak demand and suggests that manufacturers have been curtailing production and cutting inventories. The rise in new orders and export orders may be attributable to last-minute exports to China (goods that China will in turn export to the US) ahead of the increase in US tariffs on Chinese goods effective June 1. There is a possibility that the PMI will decline below 50 in June in a pullback from that last-minute demand. The latest PMI is far from the threshold PMI reading between US economic expansion and contraction, which is 42.9, but a recession probably becomes more likely once it drops below 50.

Current US economic expansion is tied with the longest ever

The US economic expansion will hit the 120 month-Mark in June 2019, tying it with the longest expansion ever, which was recorded during the IT bubble. Based on the economic cycle, it would not be unusual for the economy to enter a recession fairly soon. The US economy is likely to at least continue slowing if there is no easing of US-China trade friction.

Chart: Difference in Between Long-term and Short-term Interest Rates, Manufacturing PMI



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Post-war Economic Cycle in US (months)

Trough	Peak	Contraction	Expansion	Cycle	
		(From peak to trough)	From trough to peak)	(From trough to trough)	(From peak to peak)
Oct 1945	Nov 1948		37		
Oct 1949	Jul 1953	11	45	48	56
May 1954	Aug 1957	10	39	55	49
Apr 1958	Apr 1960	8	24	47	32
Feb 1961	Dec 1969	10	106	34	116
Nov 1970	Nov 1973	11	36	117	47
Mar 1975	Jan 1980	16	58	52	74
Jul 1980	Jul 1981	6	12	64	18
Nov 1982	Jul 1990	16	92	28	108
Mar 1991	Mar 2001	8	120	100	128
Nov 2001	Dec 2007	8	73	128	81
Jun 2009	(Jun 2019)	18	(120)	91	(138)
	Average	11	58	69	71

Source: National Bureau of Economic Research; compiled by Daiwa Securities.
Notes: (1) Figures in parentheses indicate that stage is ongoing. Average excludes figures in parentheses.
(2) Underlined numbers indicate that period include wartime (Korean War and Vietnam War)

If US economy continues slowing, further dollar weakening/yen strengthening

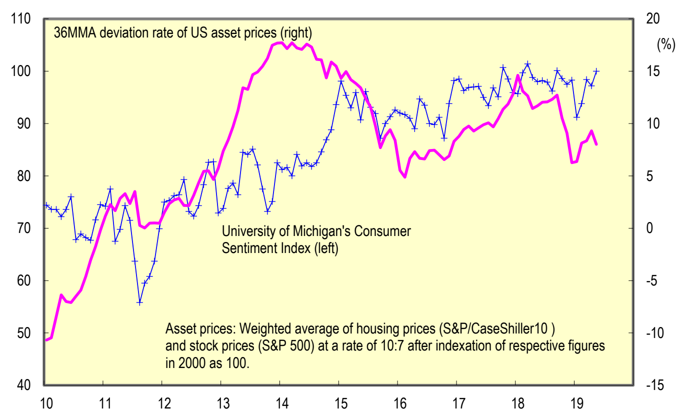
US-China discord and falling share prices have a negative impact on consumer sentiment

The trend in private consumption is closely watched as a factor affecting the US economic trend. While US stock indices rose until end-April then retreated in May, the preliminary University of Michigan Consumer Sentiment Index for May rose sharply to 102.4 (from 97.2 in April), its highest reading since 2004. Strong employment seems to be one reason for this. Nevertheless, although the survey was taken from April 24 until May 15, most of the survey responses were submitted before the increase in concern over US-China trade friction, so the numbers do not reflect much of the impact from declining stocks. The final number, which includes responses accepted until May 28, was revised downward to 100.0, apparently a reflection of US-China trade friction and the decline in share prices.

If US economy continues slowing, further dollar weakening/yen strengthening

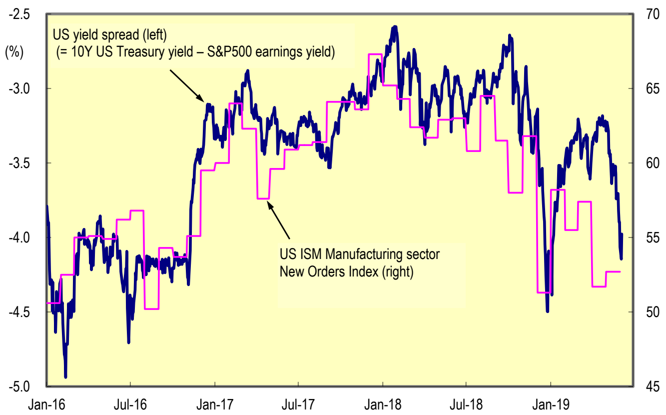
The recent decline in interest rates may support share prices. With both US long-term rates and share prices having declined, the yield spread, calculated by subtracting the S&P 500 equity earnings yield from the 10-year Treasury yield, had declined to 4.14% as of June 3, the lowest it has been since January 3. The yield spread's decline means that share prices now look less overvalued based on their arbitrage relationship with interest rates, and this should constrain the decline in share prices. If dovish statements from Fed officials raise expectations of a rate cut and lead to further declines in interest rates, it is conceivable that share prices will rebound, leaving open the possibility that the dollar weakening brought by declining US interest rates will be offset by risk-on yen depreciation and stop the USD/JPY's decline. If the economic data continue worsening, interest rates will likely decline further, but share prices are likely to fall in step with declines in the expected growth rate of corporate profits. The consequent negative wealth effect would worsen consumer sentiment and exacerbate the economic slowdown. The combination of dollar weakness driven by US rate declines and risk-off yen appreciation probably still has room to run.

Chart: US Consumer Sentiment Index and Asset Prices



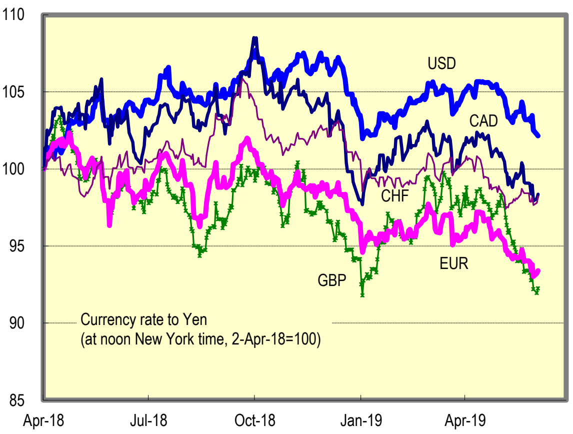
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Yield Spread and Economic Indicators



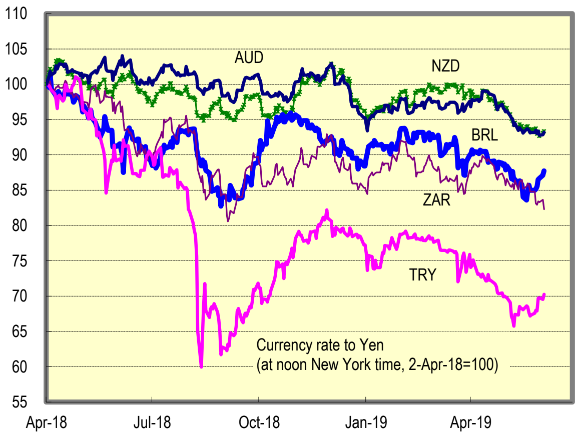
Source: Thomson Reuters; compiled by Daiwa Securities.

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 31 Dec 2018	29 Mar 2019	Forecast Apr-Jun 2019	Jul-Sep 2019	Oct-Dec 2019	Jan-Mar 2020	Apr-Jun 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.

Explanatory Document of Unregistered Credit Ratings

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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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[Standard & Poor's]

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[Moody's]

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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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[Fitch]

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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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