Forex Market View

Yuan market reflects US-China relations

- Is China ready to devalue the yuan?
- The US could possibly designate China a currency manipulator
- If China fails to stem the yuan's decline, markets will turn risk off

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

13 Jun- 12 Jul: Y106.5 - 110.5/$ (Y108.40/$ as of 12 Jun)

Forex Market View DSFE241

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Is China ready to devalue the yuan?

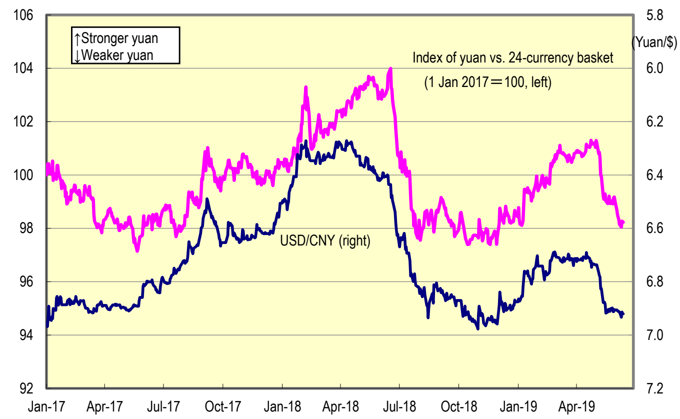
Yuan declines on US-China trade war

The yuan has been weakening against the dollar, with the USD/CNY rising from 6.7 to above 6.9 in April-May. The yuan has been in a sharp decline since May 6, when President Trump announced the US would raise its additional tariffs on $200 billion worth of Chinese imports from 10% to 25%, as concerns over the direction of China's economy have apparently raised selling pressures on the yuan. On June 7, the Governor of the People's Bank of China commented that the trade war may temporarily put downward pressure on the yuan. The USD/CNY had a floor value of 6.92 until June 7, but on June 10 the yuan weakened to above 6.93. The yuan thus weakened at a time when most other currencies strengthened against the dollar on news that the US would indefinitely suspend its additional tariffs on Mexican goods. The yuan rebounded to 6.91 on June 11, but this may just be reflecting market pressures on the yuan.

Does the yuan's weakening against a currency basket reflect the intentions of Chinese officials?

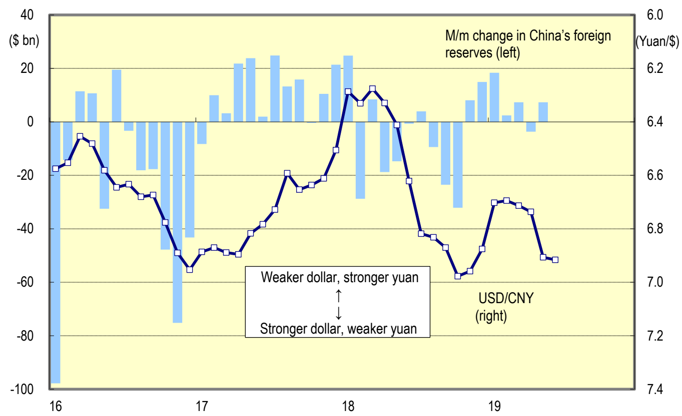
In May, as markets were leaning risk off many currencies declined against the dollar, and so did the yuan, but the yuan also declined against the basket of 24 currencies that Chinese officials use to set the yuan's reference rate. From end-May into June, most currencies strengthened against the dollar in response to the relatively large decline in US long-term rates compared with other major rates markets and to the rise in share prices and other risk-on market moves. Within this weak-dollar environment, the yuan has been either flat or declining against the dollar and thus has weakened further against the currency basket. This may be because Chinese officials are starting to encourage the yuan's decline instead of trying to stem it. China's foreign exchange reserves have often declined during past periods of yuan weakening as result of the Chinese government's FX market intervention buying the yuan and selling foreign currencies, but those reserves increased in May.

Chart: USD/CNY and Index of Yuan vs. Currency Basket



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Change in China's Foreign Reserves and USD/CNY



Source: Thomson Reuters; compiled by Daiwa Securities.

The US could possibly designate China a currency manipulator

Trump administration warns against yuan devaluation

The Trump administration has warned against yuan devaluation. On June 10, President Trump commented, "President Xi can do whatever he wants. They devalue, they loosen...and it nullifies...the tariffs." He followed that with criticism of the Fed: "And we don't have that advantage because we have a Fed that doesn't lower interest rates." It appears that the US president wants the Fed to cut rates, push US interest rates and the dollar lower, and strengthen the yuan against the dollar, but despite the recent decline in US interest rates and weakening of the dollar brought by expectations of a rate cut, the yuan has weakened against the dollar. If the yuan continues to weaken, the US may ramp up its criticism of China's yuan devaluation and apply more pressure with additional tariffs on Chinese goods.

Depending on its FX market intervention, China may be designated a currency manipulator

In its Semiannual Report on International Economic and Exchange Rate Policies released in May, the US Treasury Department encouraged China to take measures needed to keep its currency from weakening. It lowered the threshold of one of the criteria for currency manipulation designation, the current account balance as a percent of GDP, from over 3% to over 2%, and also increased the number of countries covered in the report from 12 to 21, among which China had by far the largest trade surplus with the US. In principle, the nine countries listed as monitored (there were six countries on the list in the previous report issued October 2018, but India and Switzerland were removed and Ireland, Vietnam, Italy, Malaysia, and Singapore were added) meet two of the listing criteria, but China was added to the list based on meeting only one (the size of its trade surplus with the US). China's cumulative FX market interventions over the 12-month period ending December 2018 came out to be a net selling of foreign currencies (buying of yuan), but its foreign exchange reserves have increased in every month except April in 2019 and thus the US has probably determined that China has on net been buying foreign currencies (selling the yuan). In principle, countries are deemed to be currency manipulators when they meet all three of the monitored criteria, but China could be designated a currency manipulator if it meets only two.

Chart: Evaluation Criteria in US Currency Report

US Treasury's Currency Report (28 May 2019)

Target: US trading partners whose bilateral goods trade with US exceeds $40bn annually (21 nations as of 2018)

Monitoring list: China, Japan, Korea, Germany, Italy, Ireland, Singapore, Malaysia, and Vietnam (nine nations)

	Trade balance with US	Current account			Foreign exchange intervention		
	Goods surplus with US ($bn, for 1 year through Dec 2018, figures in parentheses indicate those for 1 year through Jun 2018)	Balance (% of GDP, for 1 year through Dec 2018)	3-year change in balance (% of GDP)	Balance ($bn, for 1 year through Dec 2018)	Net purchases of foreign currency (% of GDP, for 1 year through Dec 2018)	Net purchases of foreign currency ($bn, for 1 year through Dec 2018)	Purchases of foreign currency in 6 out of 12 months
China	419 (390)	0.4	-2.4	49	-0.2	-32	Yes
Mexico	82 (73)	-1.8	0.8	-22	0.0	0	No
Germany	68 (67)	7.4	-1.1	298	–	–	–
Japan	68 (70)	3.5	0.4	176	0.0	0	No
Ireland	47	9.2	4.8	35	–	–	–
Vietnam	40	5.4	3.0	12	1.7	4	-7
Italy	32 (32)	2.5	1.2	52	–	–	–
Malaysia	27	2.1	-0.9	8	-3.1	-11	No
India	21 (23)	-2.4	-1.3	-65	-1.7	-47	No
Canada	20 (15)	-2.7	0.9	-45	0.0	0	No
Thailand	19	7.0	-1.0	35	0.0	0	No
Switzerland	19 (17)	10.2	-1.0	72	0.3	2	No
Korea	18 (21)	4.7	-2.9	76	-0.2	-3	No
France	16 (16)	-0.3	0.1	-9	–	–	–
Taiwan	16 (17)	12.2	-1.7	72	0.4	2	Yes
UK	-5 (-7)	-3.8	1.1	-109	0.0	0	No
Singapore	-6	17.9	0.7	65	4.6	17	Yes
Brazil	-8 (-9)	-0.8	2.2	-15	-2.6	-49	No
Belgium	-14	-1.3	-0.3	-7	–	–	–
Netherlands	-25	10.8	4.3	99	–	–	–
Hong Kong	-31	4.3	1.0	16	-1.4	-5	No
Eurozone	152 (143)	2.9	0.2	398	0.0	0	No
	↑	↑			↑		↑
Monitoring criteria	At least $20bn (Around 0.1% of US GDP)	At least 2%			At least 2%		6 of 12 months
					Persistent, one-sided intervention in FX markets		

Source: US Department of Treasury; compiled by Daiwa Securities.

If China does not stem the yuan's decline, markets will turn risk off

US president sees dollar appreciation as disadvantageous to the US

The dollar's real effective exchange rate has been rising in recent years, and relative to its 20-year average is currently higher vs. both the yen and the euro. One reason for this is that while Japan and Europe have adopted accommodative monetary policies, the US has been raising rates. President Trump tweeted on June 11 that the "euro and other currencies are devalued against the dollar, putting the US at a big disadvantage. The Fed Interest rate way too high." Although he did not clearly say so, Mr. Trump may think that not only the euro but also the yen has been devalued through monetary easing. If the Fed starts cutting rates and market rates in the US decline, it will probably cause the dollar's real effective exchange rate to decline.

Even Fed rate cuts may not unwind dollar strength

Nevertheless, although the dollar tends to be sold when markets turn risk-on, it tends to be bought during risk-off moves, and a rate cut will not necessarily lead to a weaker dollar. The trade weights used by the Fed to calculate the dollar's effective exchange rate are, in order from the highest: 18.6% for the EU, 16.2% for China, 13.6% for Canada, 13.3% for Mexico, and 6.4% for Japan. Because the dollar tends to strengthen against the currencies of China, Mexico, Canada, and other countries when markets turn risk off, the dollar could strengthen overall even if a decline in US interest rates causes it to weaken against the yen and European currencies. If there is no unwinding of dollar strength despite Fed rate cuts, the US is likely to aim its ire at the Chinese yuan.

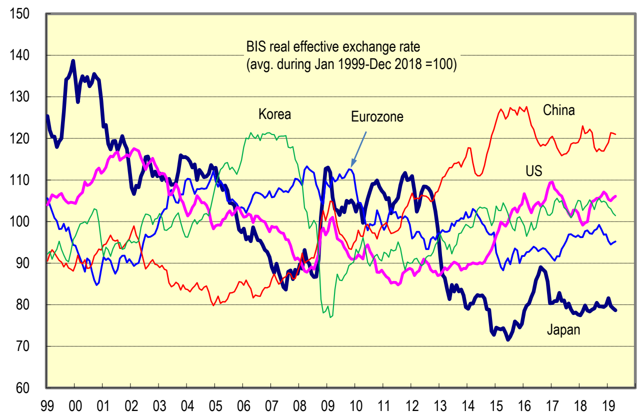
There is a risk of countervailing tariffs from the US if China does not stem the yuan's decline

The currency with the highest real effective exchange rate relative to its 20-year average is the Chinese yuan. Nevertheless, the US thinking is probably that the only moderation of the yuan's cheapness came from further liberalization of China's capital transactions and that it remains undervalued. The US dollar's real effective exchange rate is on the high side among the major currencies, and the Trump administration has warned that dollar appreciation is putting the US at a competitive pricing disadvantage. The US Treasury Department maintains that its proposal for imposing tariffs on countries with a devalued currency does not take into account the central bank's monetary policy, and if that is true there is little risk that Japan and Europe will be subject to countervailing tariffs based on having a devalued currency. On the other hand, if China does not stem the yuan's decline, the risk of the US viewing that as intentional devaluation and imposing countervailing tariffs in response will probably increase.

Yuan market reflects China's stance vs. the US

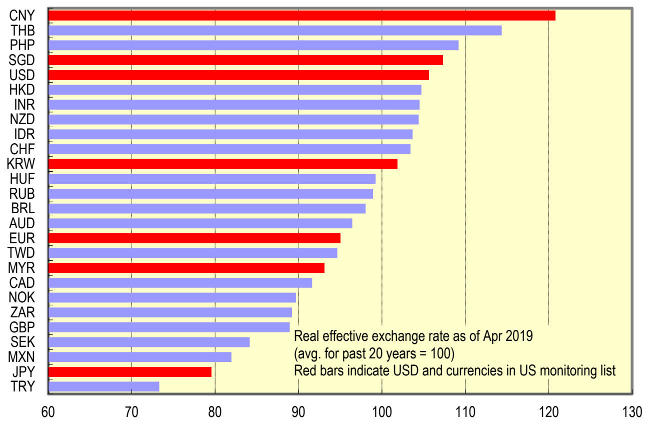
President Trump has said that if China's Xi Jinping does not meet with him at the G20 meeting scheduled for June 28-29, the US may impose a 25% tariff on $300 billion of Chinese imports. The yuan market likely reflects not only market pressures but also China's stance vs. the US. If China goes against US demands and devalues the yuan it would be signaling its unwillingness to compromise in the face of increasing US pressure, and that would probably put markets into risk-off mode and strengthen the yen. The trend in the yuan market, a reflection of the US-China relationship, bears close watching.

Chart: Real Effective Exchange Rate (avg. for past 20 years = 100)



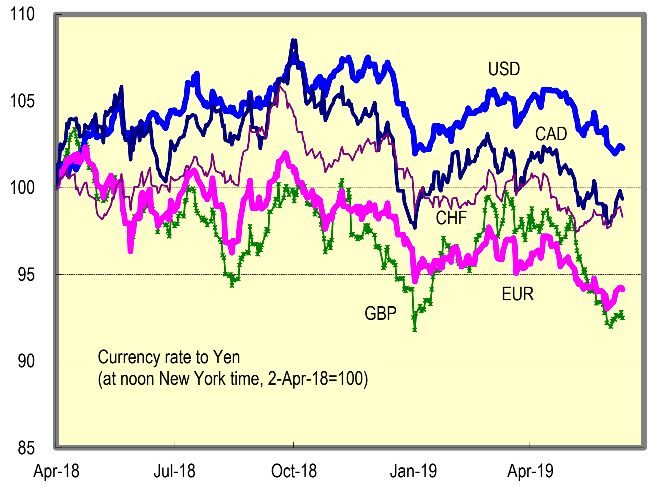
Source: BIS; compiled by Daiwa Securities.

Chart: Real Effective Exchange Rate (avg. for past 20 years = 100)



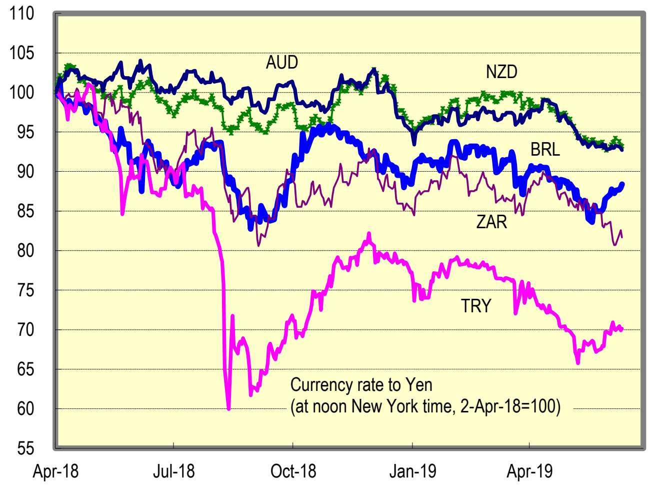
Source: BIS; compiled by Daiwa Securities.

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	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.

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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.
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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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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]

The Name of the Credit Rating Agencies group, etc

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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.

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