

Forex Market View

Manufacturing PMIs affect the strength of currencies

- The trend in manufacturing PMIs varies across countries, but no signs of recovery
- Positive correlation between PMI level and currency fluctuation
- Positive correlation between PMI change and currency fluctuation

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

24 Jul – 23 Aug: Y105.5 – 109.5/\$ (Y108.07/\$ as of 23 Jul)

Forex Market View DSFE247

FICC Research Dept.

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



Daiwa Securities Co. Ltd.

The trend in manufacturing PMIs varies across countries, but shows no signs of recovery

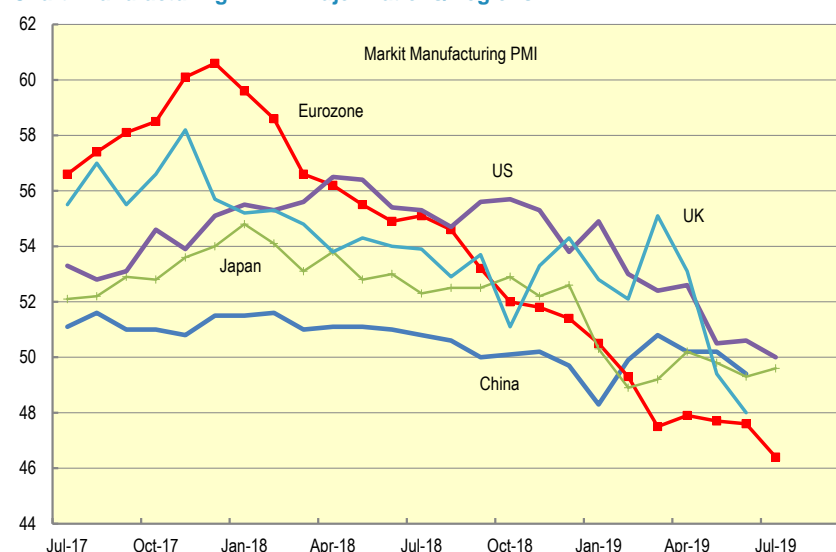
The yen comes under upward pressure when manufacturing PMIs remain in a worsening trend

The trend in manufacturing PMIs varies across countries, but shows no signs of recovery

The trend in the manufacturing PMIs announced by Markit differ by country. The euro zone PMI, which was early to drop below 50, had stopped declining temporarily, but resumed its downward trend in July. The US PMI has continued a steady decline, and hit 50 in July. PMIs in China and Japan have been around 50. The UK's PMI, which had been relatively strong, worsened significantly in May and June and dropped below 50. Overall, we see no indication that PMIs are about to turn to a recovery trend.

Although there has been a temporary truce in the US-China trade war, their mutual tariffs remain elevated and the negative impacts on the economy look likely to persevere longer than the positive impacts. Rising demand ahead of the consumption tax hike in Japan may be constraining deterioration in its PMI, such that declines in demand after the consumption tax hike may push its PMI lower. Confusion over Brexit has begun to adversely impact the UK economy and should affect the EU economy, as well. Even if the US and EU start providing more accommodative monetary conditions and create positive economic impacts, those impacts will probably require time to show up. As long as manufacturing PMIs remain in a worsening trend, the yen is likely to come under strengthening pressure from risk-off moves and interest rate declines.

Chart: Manufacturing PMI in Major Nations/Regions



Source: Thomson Reuters; compiled by Daiwa Securities.

Positive correlation between PMI level and currency fluctuation

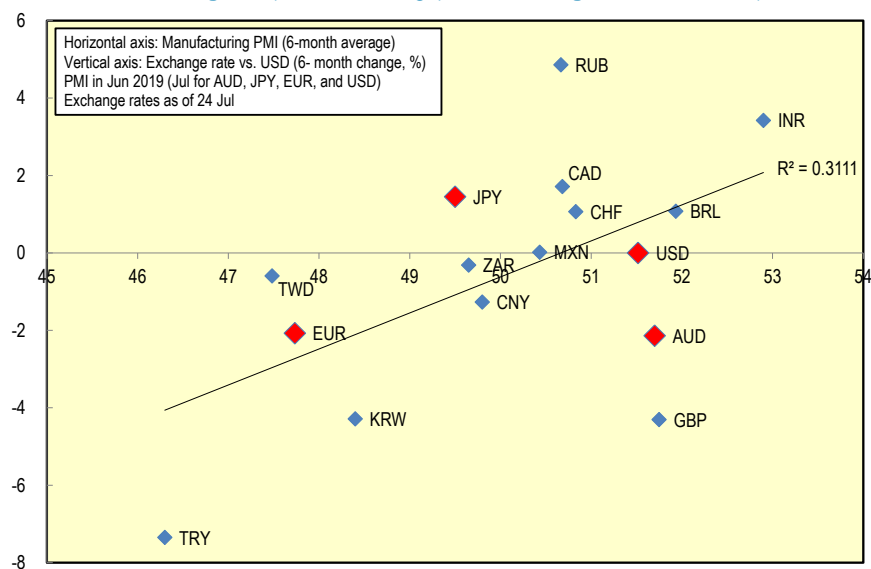
Positive correlation between PMI level and currency fluctuation

If PMIs were worsening to the same degree in all countries differences in currency fluctuation would be unlikely to develop, but that is not the case. There are differences in both the level of and changes in PMIs, and this provides one explanation for differences in currency performance. As the Chart below shows, there is a positive correlation, albeit a weak one, between the level of each country's manufacturing PMI (6-month average) and the 6-month change in the value of its currency vs. the dollar. The currency tends to strengthen when PMI levels are high and weaken when PMI levels are low. For example, India has a relatively high PMI level and its currency, the rupee, is relatively strong, while Turkey has a relatively low PMI level and its currency, the lira, is relatively weak.

The UK's currency is weak relative to the level of its PMI

Based on the correlation between PMI level and currency fluctuation, the Russian ruble is strong relative to its PMI level while the UK pound is weak. It is difficult to explain the strength of the ruble, given that Russia's PMI is not in an improving trend and the price of crude oil has not risen relative to six months ago. In the UK, we think continued confusion over Brexit combined with its manufacturing PMI clearly falling more than that of other countries has helped weaken the pound. A currency's performance is affected not only by the level of that country's PMI but also by the change (increase or decrease) in its PMI.

Chart: Manufacturing PMI (6-month average) and Exchange Rates vs. USD (6-month change)



Source: Thomson Reuters; compiled by Daiwa Securities.

Positive correlation between PMI change and currency fluctuation

Positive correlation between PMI change and currency fluctuation

As the Chart on the next page shows, there is a positive correlation, albeit a weak one, between the change of each country's manufacturing PMI (change in the most recent month relative to the average over the previous three months) and the 3-month change in the value of its currency vs. the dollar. The currency tends to strengthen when PMI levels are high relative to the previous 3-month average and weaken when PMI levels are low relative to that average. For example, Turkey's PMI is above its 3-month average and its lira is stronger against the dollar than it was three months ago, while the UK's PMI is below its 3-month average and its pound is weaker against the dollar than it was three months ago. Thus, the PMI affects currency performance not only through its level but also through its change.

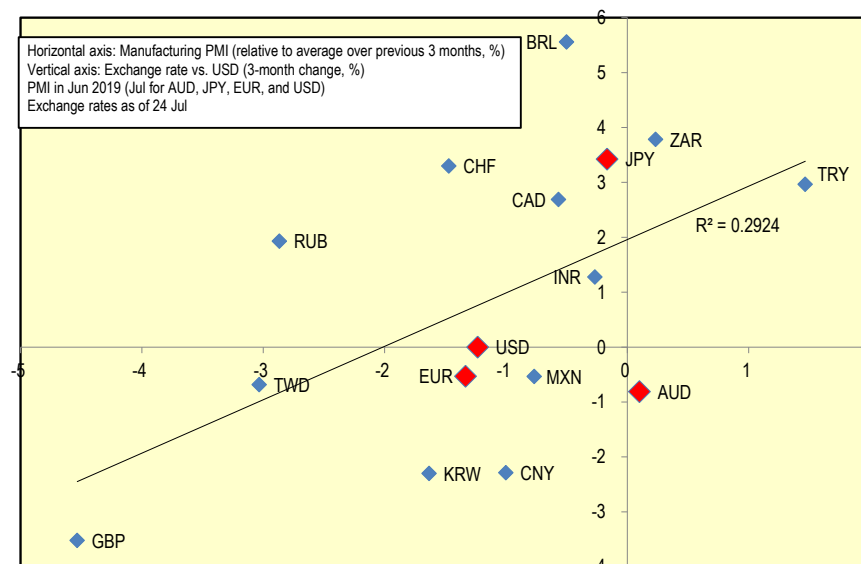
Australia's currency is weak relative to the change in its PMI

Based on the correlation between PMI change and forex rates, Brazil's real and Switzerland's franc are strong relative to the change in their PMI, while China's yuan, Korea's won, and Australia's dollar are weak. In Brazil, expectations of progress toward pension reform have boosted the real, while in Switzerland, the rise in gold prices and the decline in US interest rates and the dollar on expectations of Fed easing have boosted the franc. In Korea, Japan's strengthening of restrictions on its exports to Korea have weakened the KRW, and in Australia expectations of a rate cut have weakened the AUD. Although the AUD temporarily rose in reaction to a lull in Australian rate cut expectations, it resumed declining after Australia's manufacturing PMI declined in July relative to June.

Currencies are affected over the long term by PMI levels and over the short term by PMI changes

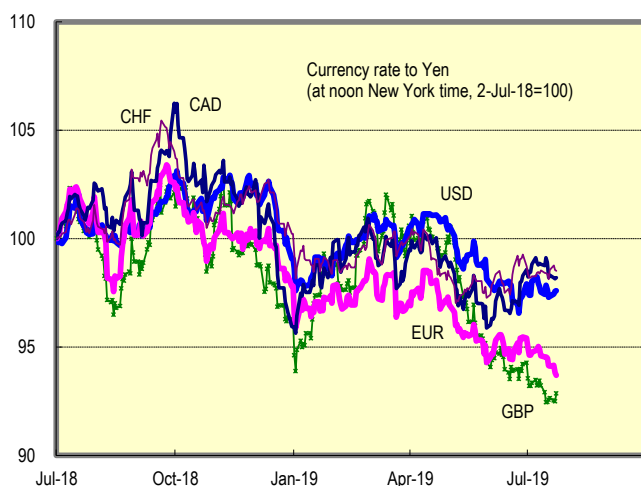
It is probably worth looking at a country's manufacturing PMI as a factor affecting the performance of its currency. Long-term fluctuations in currency rates tend to be affected by PMI levels while short-term fluctuations tend to be affected by PMI changes. When currency fluctuations cannot be explained by PMI level or change there are likely other factors involved, and when those fluctuations cannot be explained with other factors either, we expect the currency's value to correct back to what the correlation with PMI levels and changes suggests.

Chart: Manufacturing PMI (relative to average over previous 3 months) and Exchange Rates vs. USD (3-month change)



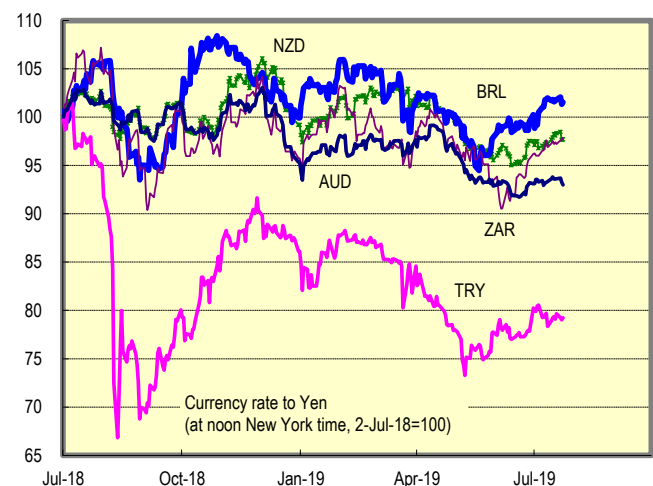
Source: Thomson Reuters; compiled by Daiwa Securities.

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				
	29 Mar 2019	28 Jun 2019	Jul-Sep 2019	Oct-Dec 2019	Jan-Mar 2020	Apr-Jun 2020	Jul-Sep 2020
USD-JPY	110.7	107.8	107.0 104-112	105.0 101-110	105.0 101-110	106.0 101-110	108.0 103-112
EUR-JPY	124.3	122.7	119.0 115-127	116.0 113-125	116.0 113-125	119.0 113-125	123.0 115-127
GBP-JPY	144.2	137.0	131.5 126-139	128.0 124-137	128.0 124-137	131.5 124-137	136.0 127-140
AUD-JPY	78.6	75.6	73.0 81-91	70.5 68-77	70.5 68-77	73.5 68-77	76.5 70-79
CAD-JPY	82.8	82.4	80.0 83-93	78.0 75-84	78.0 75-84	80.0 75-84	82.5 77-86
NZD-JPY	75.5	72.4	69.5 67-76	67.5 65-74	67.5 65-74	70.0 65-74	73.5 67-76
TRY-JPY	20.0	18.7	17.8 16-20	16.8 15-19	16.8 15-19	17.7 15-19	18.7 16-20
ZAR-JPY	7.7	7.6	7.4 7.0-8.0	7.0 6.6-7.8	7.0 6.6-7.8	7.3 6.6-7.8	7.7 6.9-8.1
BRL-JPY	28.5	28.2	26.8 25-30	25.0 24-29	25.0 24-29	26.5 24-29	28.5 25-30
KRW-JPY (100 KRW)	9.7	9.3	8.9 8.6-9.6	8.5 8.2-9.2	8.5 8.2-9.2	8.8 8.2-9.2	9.1 8.5-9.5
CNY-JPY	16.5	15.7	15.3 14.9-16.4	14.8 14.4-15.9	14.8 14.4-15.9	15.2 14.4-15.9	15.7 14.7-16.2

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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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

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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]

The Name of the Credit Rating Agencies group, etc

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- 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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The Financial Futures Association of Japan
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