Forex Market View

USD/JPY market after the FOMC meeting

- Trend in US long-term rates is key to USD/JPY market
- US long-term rates unlikely to rise with small rate cut
- It may be too early for US long-term rates and the USD/JPY to rise in response to Fed rate cuts

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

1 – 30 Aug: Y106.0 – 110.0/$ (Y108.58/$ as of 31 Jul)

Forex Market View DSFE248

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Trend in US long-term rates is key to USD/JPY market

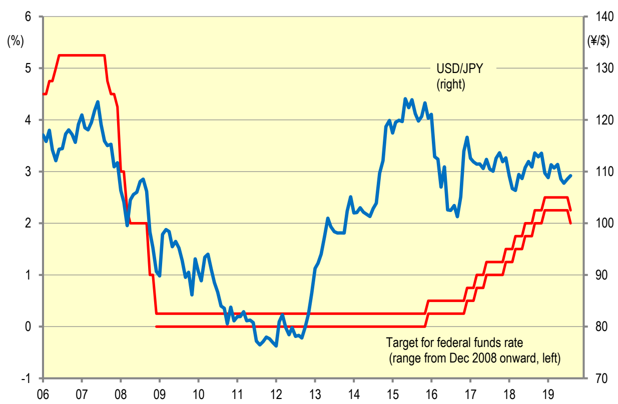
USD/JPY rises on fading of Fed rate cut expectations

The Fed decided on July 31 to lower its target range for the fed funds rate by a quarter point to 2.00-2.25%. This was the first rate cut of the current US economic expansion, which has lasted more than 10 years and dates back to June 2009. This was a preemptive rate cut aimed at keeping the economy from falling into recession, and some think a rate cut will have a positive impact on the US economic outlook, share prices, long-term rates, and the USD/JPY. The latest FOMC statement said the Fed would continue to monitor the upcoming data and act as appropriate, but Fed Chairman Jerome Powell denied that this was the start of a longer-term cycle of easing, and this somewhat reduced rate cut expectations. Although it moved up its timetable for stopping the shrinkage of its balance sheet by two months, from end-September to August 1, our impression is that the Fed is not easing monetary policy as aggressively as the market expected. A decline in rate cut expectations has led to a risk-off weakening of stocks and flattening of yield curve, but a rise in US yields mostly for short-term to intermediate bonds pushed the USD/JPY up above 109. We look at previous rate-cutting cycles to consider where the USD/JPY may be headed.

Intermediate to long-term bond yields in the US tend to influence the USD/JPY

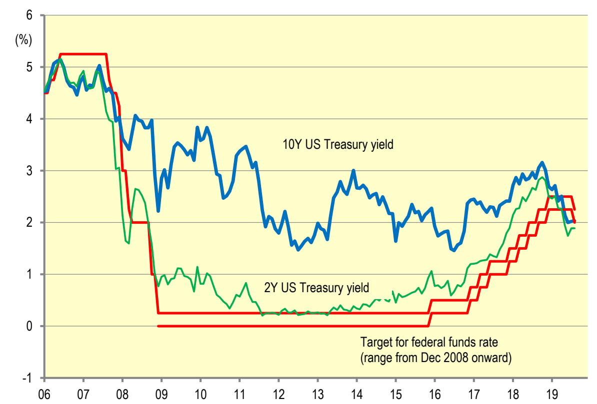
During the Fed's last rate-cut cycle, a 15-month period from September 2007 until December 2008, the Fed lowered its fed funds rate target 10 times by a total of more than 5ppt. US share prices declined for 17months, from October 2007 until March 2009, and the US economy was in recession for a total of 18 months, from December 2007 until June 2009. The USD/JPY began declining in July 2007, prior to the first rate cut, and continued to decline until October 2011, when the Fed had finished cutting rates and was implementing quantitative easing. Although the Fed rate cuts and US recession had ended, the USD/JPY continued to decline until intermediate and long-term Treasury yields bottomed (the 2-year Treasury yield bottomed in September 2011 and the 10-year yield in July 2012). The USD/JPY rebounds when there is a rebound in intermediate to long-term Treasury yields, even when the Fed is cutting rates, and it is the trend in intermediate and long-term yields that has a significant impact on the USD/JPY.

Chart: FF Rate and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: FF Rate, 2-year and 10-year US Treasury Yields



Source: Thomson Reuters; compiled by Daiwa Securities.

Trend in US long-term rates is key to USD/JPY market

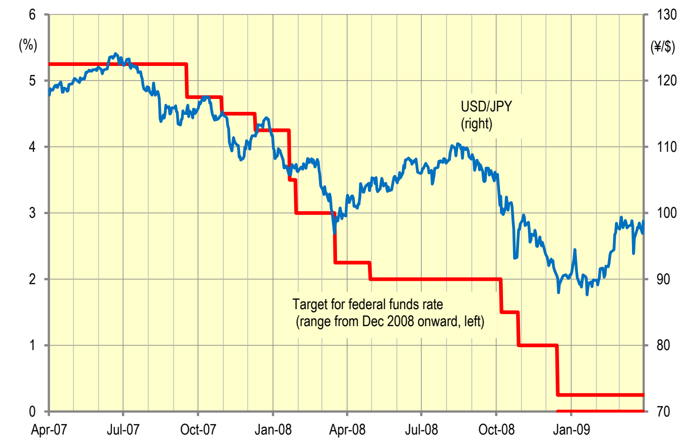
Because there is a possibility that the US economy, although decelerating, will bottom before it enters a recession this time around, both the period of time the Fed cuts rates and the extent to which it cuts them look likely to be considerably less than they were the last rate-cut cycle. The question of when US long-term rates turn to a rising trend is probably key to the USD/JPY market.

US long-term rates unlikely to rise with small rate cut

Even amid concerns over a US recession, long-term rates and the USD/JPY rebound on large rate cuts

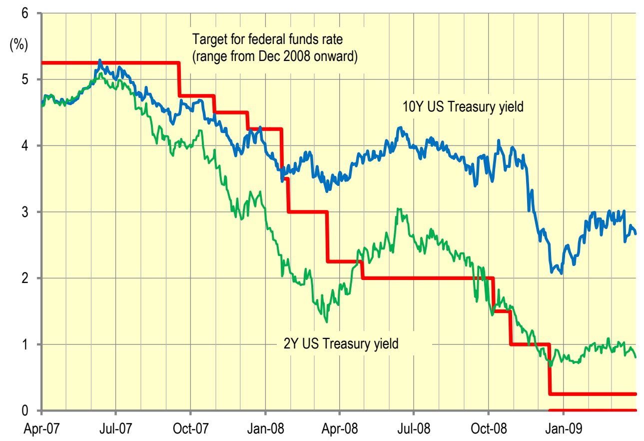
Of reference here is the period when US long-term rates and the USD/JPY rebounded in March 2008, when the Fed was still cutting rates and the US economy was in recession. When the Fed began cutting rates in September 2007 (with a reduction from 5.25% to 4.75%), the fed funds rate was higher than the 10-year Treasury yield of 4.48%. Long-term rates were declining during the rate cuts and the fed funds rate stayed above the 10-year Treasury yield, but in January 2008 the fed funds rate was reduced to 3.00%, well below the 10-year Treasury yield then of 3.70%. Because of increasing concerns over a recession, evidenced by a drop in the ISM manufacturing index below 50 and a large decline in the 3-month moving average of the Chicago Fed National Activity Index (CFNAI) down to -0.80 in February 2008, the 10-year Treasury yield declined to 3.30% in March 2008. When the Fed funds rate was lowered to 2.25% in March, however, US long-term rates rebounded and the USD/JPY also turned to a rising trend. Thus, even amid strong concerns over a US recession, cutting the fed funds rate to a level well below the long-term rate led to a rebound in both US long-term rates and the USD/JPY.

Chart: FF Rate and USD/JPY



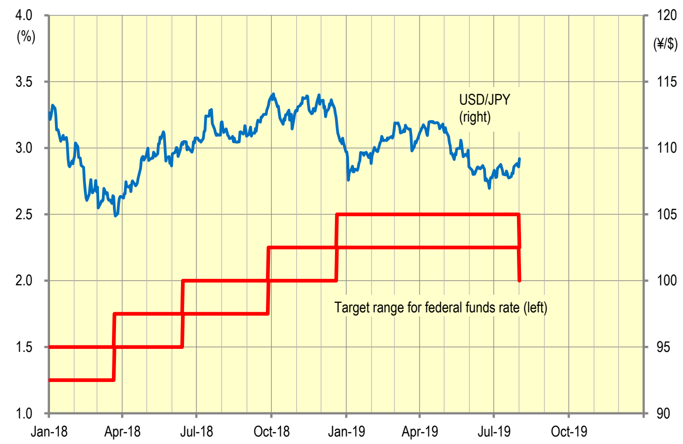
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: FF Rate, 2-year and 10-year US Treasury Yields



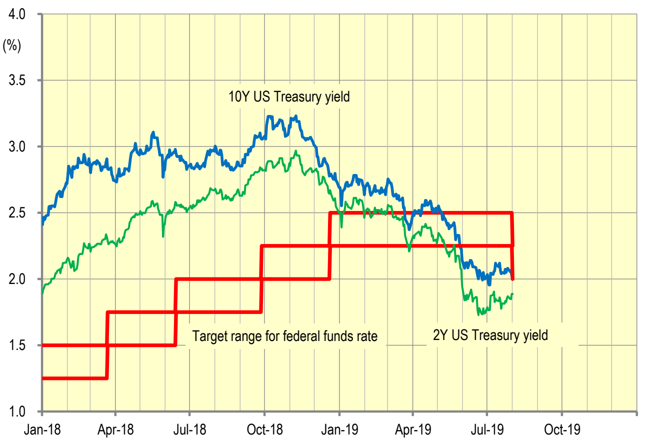
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: FF Rate and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: FF Rate, 2-year and 10-year US Treasury Yields



Source: Thomson Reuters; compiled by Daiwa Securities.

A strong global economy also has an upward impact on US long-term rates and the USD/JPY

As evidenced by the ISM manufacturing new export orders index having remained above 50 until September 2008, however, the rise of the BRICs and other emerging markets supported global economic growth. The substantial rate cuts in the US within this context weakened the dollar and pushed commodity prices higher, and that combined with rising inflation expectations turned US long-term rates to a rising trend. Although there were rising concerns about a recession in the US, we think it was the large Fed rate cuts and strength of the global economy that fueled the rebound in US long-term rates and the USD/JPY.

US long-term rates unlikely to rise with small rate cut

Compared with that of 2008, the recent US economic slowdown has been moderate. The ISM manufacturing index was above 50, at 51.7, as of June 2019, while the CFNAI's 3-month moving average was -0.17 as of May, above the threshold for recession of at or below -0.7. Nevertheless, because global economies, including in China, the EU, and Japan, are slowing and interest rates are in a declining trend, Fed rate cuts are less likely to spark a weakening of the dollar and rise in commodity prices, and in fact the dollar is appreciating. Although there are recession concerns in the US, it is probably not the case that small Fed rate cuts can easily raise inflation expectations and turn long-term rates to a rising trend. The fed funds futures market is currently forecasting a reduction in the fed funds rate to 1.50-1.75% by June 2020, the 2-year Treasury yield is around 1.90%, and the 10-year Treasury yield is around 2.05%. Unless the fed funds rate target is lowered to 1.75-2.00%, which is below the 10-year Treasury yield and level with the 2-year Treasury yield, or to an even lower level, there will be no easing of concerns about an economic slowdown and both US long-term rates and the USD/JPY are unlikely to rebound. If US economic indicators worsen, the extent of rate cuts needed to spark a rebound in US long-term rates and the USD/JPY will probably increase.

It may be too early for US long-term rates and the USD/JPY to rise in response to Fed rate cuts

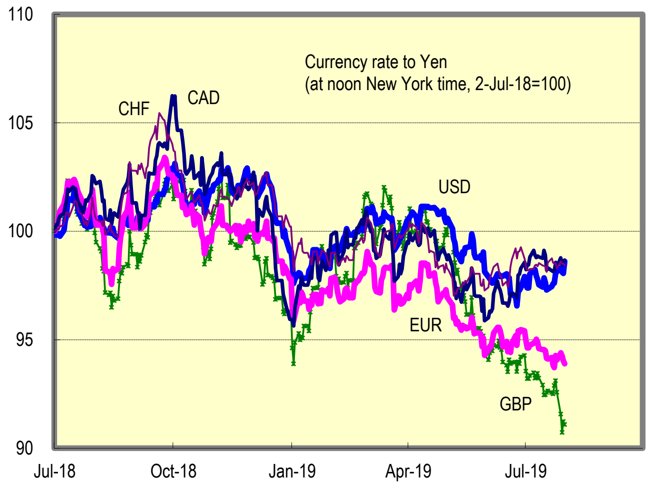
It is difficult to argue that improvement in US economic data will continue

There has been improvement in some US economic indicators, but it is difficult to say what lies ahead. The improvement in the manufacturing indices of the regional Fed banks in July can be attributed to a reduction of the concerns over the US imposing additional tariffs on goods from Mexico that had caused them to worsen in June. A relatively large number of the new orders and unfilled orders indices were negative (more respondents expected worsening than expected improvement) in July, and the likelihood of continued improvement in sentiment is not that high. Some sentiment indicators have worsened, with the MNI Chicago business barometer for July dropping sharply to its lowest level since December 2015, making it hard to expect clear improvement in the ISM manufacturing index. Additionally, if growth in nonfarm payrolls, which beat market expectations in June, slows down clearly in July, concerns over an economic slowdown may begin to spread again. For expectations that Fed rate cuts will halt the economic slowdown to strengthen and US long-term rates and the USD/JPY to rise would probably require more signs of improvement in the economic data.

It may be too early for US long-term rates and the USD/JPY to rise in response to Fed rate cuts

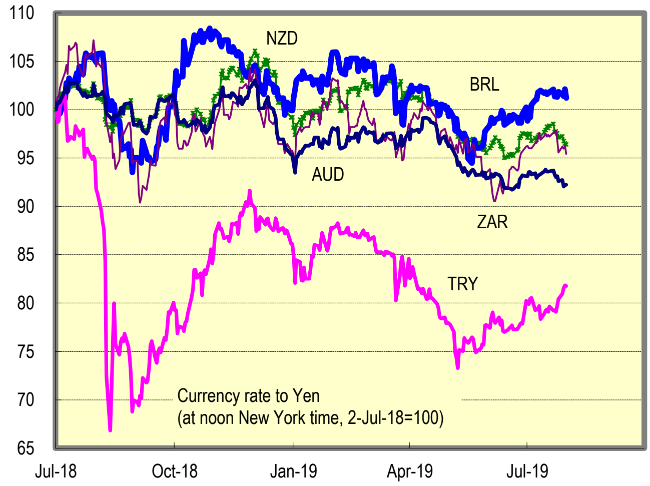
A few observers expected a 50bp rate cut at the end-July FOMC meeting, but the Fed wound up cutting rates 25bp as most expected. Rate cut expectations weakened somewhat in response to Fed Chair Jerome Powell's comment that the rate cut did not signal the start of a longer-term easing cycle, but the Fed did suggest the possibility of additional rate cuts. Although it will ultimately depend on the upcoming economic data, expectations of a global economic slowdown and a weak inflation outlook are well entrenched in the market, and we do not think this is conducive to the emergence of expectations that rate cuts will stop. Within this context, if the Fed's monetary easing as is perceived as lukewarm relative to market expectations it will likely spark risk-off moves, which in turn would have negative impacts on the economy and make it more likely that rate cuts will continue. We think the more likely near-term scenario is that rate-cut expectations remain well entrenched and make increases in US interest rates less likely, while risk-off moves and declines in US long-term rates push the USD/JPY lower. It may be too early for US long-term rates and the USD/JPY to rise in response to Fed rate cuts.

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	105.0	105.0	106.0	108.0
			104-112	101-110	101-110	101-110	103-112
EUR-JPY	124.3	122.7	119.0	116.0	116.0	119.0	123.0
			115-127	113-125	113-125	113-125	115-127
GBP-JPY	144.2	137.0	129.5	126.0	126.0	129.5	134.0
			125-138	123-136	123-136	123-136	126-139
AUD-JPY	78.6	75.6	73.0	70.5	70.5	73.5	76.5
			70-79	68-77	68-77	68-77	70-79
CAD-JPY	82.8	82.4	80.0	78.0	78.0	80.0	82.5
			77-86	75-84	75-84	75-84	77-86
NZD-JPY	75.5	72.4	69.5	67.5	67.5	70.0	73.5
			67-76	65-74	65-74	65-74	67-76
TRY-JPY	20.0	18.7	18.2	17.0	17.0	18.0	19.0
			16-20	15-19	15-19	15-19	16-20
ZAR-JPY	7.7	7.6	7.4	7.0	7.0	7.3	7.7
			7.0-8.0	6.6-7.8	6.6-7.8	6.6-7.8	6.9-8.1
BRL-JPY	28.5	28.2	26.8	25.0	25.0	26.5	28.5
			25-30	24-29	24-29	24-29	25-30
KRW-JPY	9.7	9.3	8.9	8.5	8.5	8.8	9.1
(100 KRW)			8.6-9.6	8.2-9.2	8.2-9.2	8.2-9.2	8.5-9.5
CNY-JPY	16.5	15.7	15.3	14.8	14.8	15.2	15.7
			14.9-16.4	14.4-15.9	14.4-15.9	14.4-15.9	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.

Explanatory Document of Unregistered Credit Ratings

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1) Duty of good faith.
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]

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[Moody's]

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[Fitch]

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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.

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