Daiwa Securities

Forex Market View

Risk of US-China trade friction/currency friction compounding one another

- US-China currency friction exacerbated by sharp decline in yuan's value
- China is tolerating some yuan weakness but can it avoid a significant yuan devaluation?
- Risk of US-China trade friction/currency friction compounding one another

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

8 Aug – 6 Sep: Y104.05 – 108.5/$ (Y105.61/$ as of 7 Aug)

Forex Market View DSFE249

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Daiwa Securities Co. Ltd.

US-China currency friction exacerbated by sharp decline in yuan's value

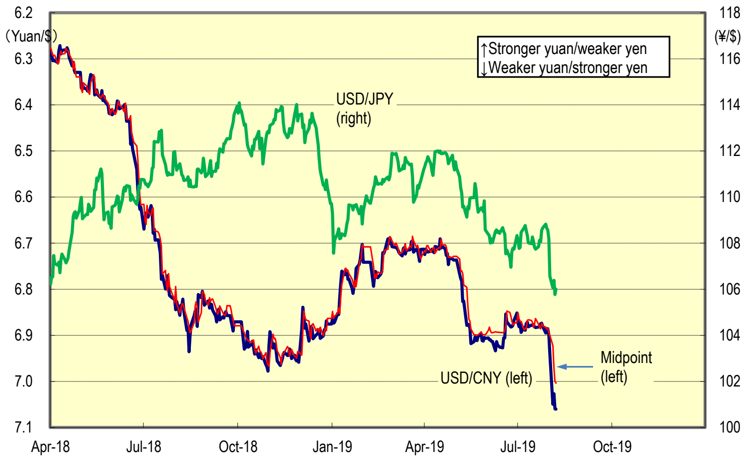
US-China currency friction exacerbated by sharp decline in yuan's value

The yuan began weakening when President Trump announced that a fourth round of additional tariffs on China will go into effect on September 1 (early morning September 2 Japan time), and it opened the week of August 5 by sharply depreciating to a USD/CNY above 7. The US designated China a currency manipulator for the first time since 1994. China's monetary authorities set the yuan's reference rate against the dollar at 6.9683 on August 6, and although that was weaker than the peg of 6.9225 on August 5, it was considerably stronger than the yuan's close the day prior of 7.0498, and thus led to a quick strengthening of the yuan. With China setting the reference rate progressively weaker at 6.9996 on August 7 and then 7.0039 on August 8, however, it reined in the yuan's appreciation in the market. The trend in the yuan's dollar exchange rate is being affected by concerns over US-China currency friction, and that is starting to affect moves in the broader forex market.

Concerns over a US-China confrontation are creating a risk-off mood

When the dollar is the main driver of exchange rate fluctuations, the USD/JPY and USD/CNY tend to move in the same direction. The dollar strengthened from April to November 2018 on rising US interest rates, then weakened from November 2018 to January 2019 on declining US interest rates. When risk tolerance is the main driver of exchange rate fluctuations, however, the USD/JPY and USD/CNY tend to move in opposite directions. From January until April 2019 there was a risk-on weakening of the yen and strengthening of the yuan, and the USD/JPY rose while the USD/CNY fell. Since April 2019 there has been a risk-off yen strengthening and yuan weakening, thus the USD/JPY fell while the USD/CNY rose. The sharp weakening of the yuan after the US announced additional tariffs on China can be attributed to concerns over the US-China conflict creating a risk-off mood.

Chart: USD/CNY and USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

China is tolerating some yuan weakness but can it avoid a significant yuan devaluation?

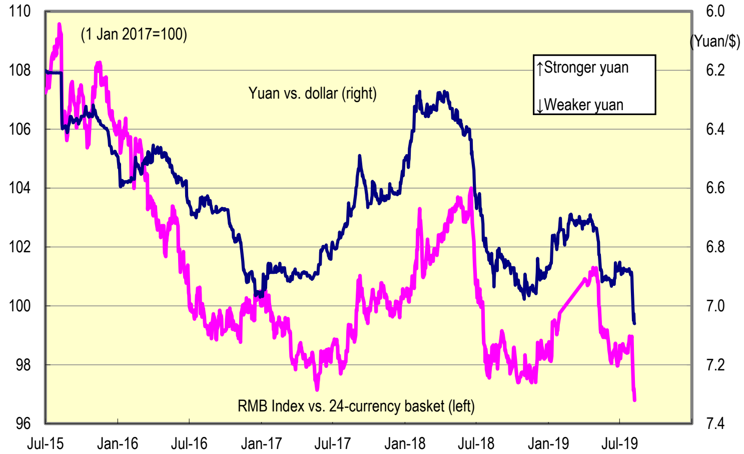
When the US announced additional tariffs on Chinese goods, China allowed the yuan to weaken

President Trump's announcement of additional tariffs on Chinese goods pushed the market into risk-off mode and weakened the yuan, but it was probably China's monetary authorities not acting to stop the yuan's decline that explains why the yuan weakened as much as it did. Since 2018, when the US has announced additional tariffs on China the yuan has turned to a declining trend after having been firm up until then. This suggests that the Chinese government tolerates a weaker yuan as a way to counteract the additional tariffs. That is exactly what happened this time around. The US decided to impose an additional 10% tariff on the roughly $300 billion of imports from China that had been spared additional tariffs until now, but because China had already imposed retaliatory tariffs on most of its imports from the US, there are a few categories of goods left for its to impose new additional tariffs on. This is why it is not surprising that China would use a weaker yuan as a countermeasure to lessen the adverse impacts from additional tariffs on Chinese goods. The argument had been made that China was ceding to US demands for a stronger yuan in order to avoid additional tariffs and thus defended the yuan to ensure it did not weaken to a USD/CNY above 7, but if the US goes through with the additional tariffs China will no longer have a need to keep the yuan from weakening.

China should want to avoid significant yuan depreciation

Nevertheless, although a weaker yuan provides an advantage to Chinese exporters (the value of foreign-currency-denominated exports stated in yuan increases), it also raises the risk of capital flight from China. In addition, there is risk of financial destabilization if the share prices of Chinese companies decline while the amount of their foreign currency-denominated debt stated in yuan increases. This alone makes it likely that the Chinese authorities will try to contain any rapid and major weakening of the yuan. The People's Bank of China held a meeting with numerous overseas exporters on August 6, telling them that China would not use its currency as a weapon in its trade dispute with the US and that the yuan's large decline would not continue. That is probably because the market's rising anxiety over yuan depreciation is also a negative for China. In August, the yuan weakened against the dollar but also against the basket of 24 currencies used as a reference for China's monetary authorities, against which it is already slightly below its weakest level since 2017. If China's government thinks that although it needs to weaken the value of the yuan vs. the dollar to mitigate impacts from the additional tariffs that the US placed on Chinese goods, it does not need the yuan to substantially weaken against the currency basket, it will likely take steps to constrain any further weakening of the yuan against that basket.

Chart: Yuan vs. Dollar and RMB Index vs. Currency Basket



Source: Thomson Reuters; compiled by Daiwa Securities.

Risk of US-China trade friction/currency friction compounding one another

The yuan may continue to weaken against the dollar, depending on market conditions

China may stabilize the yuan against the currency basket, and if it does so the yuan will become more likely to move against the dollar. Because the dollar (and yen) tend to weaken and other currencies tend to strengthen when markets are in risk-on mode, the yuan is likely to strengthen against the dollar when it is stable against the currency basket. Furthermore, even when US interest rates are declining and the dollar is weakening, the yuan, like other currencies, is likely to strengthen against the dollar. When markets are in risk-off mode, however, the dollar (and yen) tend to strengthen and other currencies tend to weaken, and therefore the yuan is likely to weaken against the dollar when it is stable against the currency basket. Furthermore, even when US interest rates are rising and the dollar is appreciating, the yuan, like other currencies, is likely to weaken against the dollar. The Chinese government maintains that the yuan's exchange rate is determined by market supply-demand, and depending on market conditions there is a possibility that the yuan will weaken against the dollar.

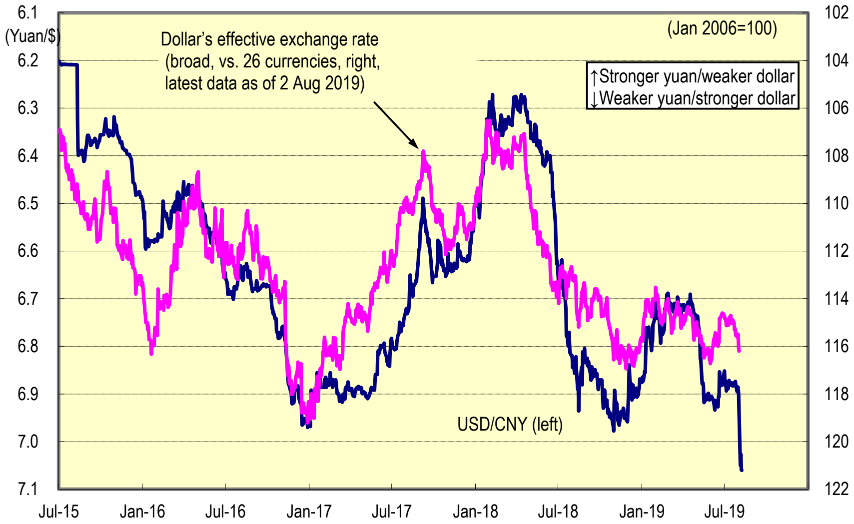
Will the US try to suppress dollar appreciation on concerns that the dollar is getting too strong?

The dollar's effective exchange rate rose in 2018 and has remained high in 2019. Even though US intermediate and long-term rates declined on heightening expectations of a Fed rate cut, the dollar did not weaken because interest rates declined in other countries, as well. The dollar's effective exchange rate based on its broader definition, i.e., when measured against the currencies of its major trading partners, was close to its peak in November 2018. It was within this context that the market turned risk-off and the dollar came under strengthening pressure. The Chinese yuan has the largest weighting within the basket of currencies used to determine the dollar's effective exchange rate, and if the yuan weakens against the dollar as other currencies do, the dollar's effective exchange rate is likely to increase. With it worried about further dollar appreciation at a time when manufacturing sentiment is worsening, the US is likely to try to rein in the dollar's rise.

Risk of US-China trade friction/currency friction compounding one another

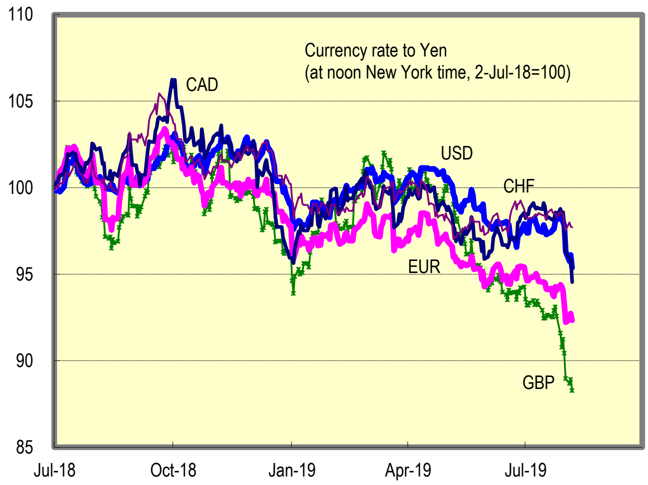
The US named China a currency manipulator to keep the dollar from appreciating, but even if this amplifies pressures to correct the yuan's weakness, China is unlikely to talk the yuan higher. This creates the risk of the US taking an even harder line on its trade policy toward China. If the US ramps up its additional tariffs and sanctions, however, all that is likely to do is make markets more risk-averse and cause the yuan to weaken against the dollar. If the US and China do not both compromise, there is a risk that trade friction and currency friction will exacerbate each other via feedback between the two. To ensure that the trade and currency issues between the US and China do not enter a negative feedback loop and push markets further risk-off, there is probably a need for the Fed to take a more accommodative stance and/or the US to agree to lower tariffs in its trade negotiations with the EU and Japan.

Chart: USD/CNY and Dollar's Effective Exchange Rate



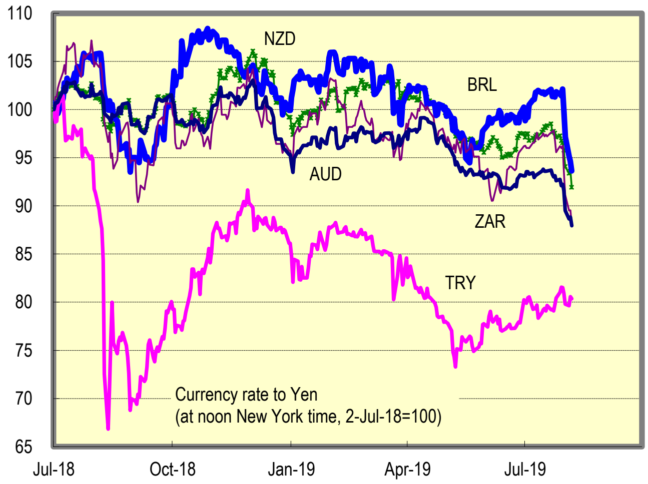
Source: Thomson Reuters; compiled by Daiwa Securities.

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	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	7.2	6.8	6.8	7.1	7.5
			6.7-7.9	6.4-7.6	6.4-7.6	6.4-7.6	6.7-7.9
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	8.8	8.4	8.4	8.7	9.0
(100 KRW)			8.5-9.5	8.1-9.1	8.1-9.1	8.1-9.1	8.4-9.4
CNY-JPY	16.5	15.7	15.1	14.6	14.6	15.0	15.5
			14.5-16.0	14.2-15.7	14.2-15.7	14.2-15.7	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.

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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.
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)

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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.

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[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)

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Assumptions, Significance and Limitations of Credit Ratings

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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.

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[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)

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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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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