Forex Market View

JPY/USD levels based on Japan/US rate spread

- Intermediate and long-term yields declined as if pricing in US economic slowdown
- Based on Japan/US rate spread, USD/JPY should be at around 105-107
- Depending on US economic data, the USD/JPY may drop below what its correlation with the Japan/US rate spread suggests

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

21 Aug – 20 Sep: Y104.05 – 108.5/$ (Y106.34/$ as of 20 Aug)

Forex Market View DSFE250

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Intermediate and long-term yields declined as if pricing in US economic slowdown

USD/JPY has been firm on rebound in US intermediate and long-term rates

After declining to nearly 105 on August 13, the USD/JPY rebounded sharply to nearly 107 in response to the US postponing until December 15 a portion of its fourth-round of additional tariffs on Chinese goods, initially jumping to above 106 and then rising again. Expectations of fiscal stimulus in Germany led to a rebound in intermediate to long-term bond yields in Europe as well as in the US, while news that the US administration was considering a temporary reduction in payroll taxes also pushed US interest rates higher, and the USD/JPY was firm. We think the direction that the USD/JPY takes will be determined by what happens with intermediate and long-term Treasury yields.

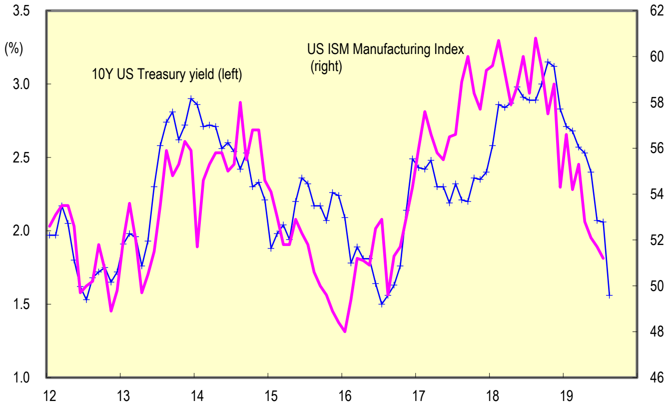
Intermediate and long-term yields declined as if pricing in US economic slowdown

Intermediate and long-term Treasury yields have declined on a deceleration of the economy. US manufacturing sentiment has worsened in step with the slowdown in global trade and economic growth brought in part by US-China trade friction, and this has amplified the market's concerns over an economic slowdown. The ISM manufacturing PMI declined to 51.2 in July 2019, but has yet to drop below 50 and remains higher than its bottoms in 2012 and 2016. In contrast, the 10-year Treasury yield has declined to around its same level as in July 2012 and July 2016. It appears that US long-term rates may have already priced in a further decline in the PMI.

If the US economy continues to worsen, interest rates may decline further

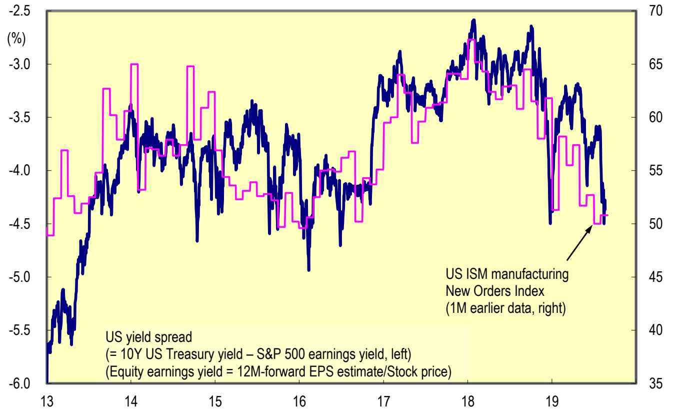
The yield spread, which is the 10-year Treasury yield minus the S&P 500 earnings yield, has also continued declining in step with declines in both interest rates and share prices, to the point of pricing in an economic slowdown. With the US economic slowdown already priced in, intermediate and long-term Treasury yields may have become less likely to continue following the sharp downward trajectory that they have been following. Because the US economic data has not turned to an improving trend, however, interest rates are unlikely to rise either, and there is still a possibility they will decline further if the economic data remains in a worsening trend.

Chart: 10Y US Treasury Yield, Manufacturing Sentiment Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: US Yield Spread, ISM Manufacturing New Orders Index



Source: Thomson Reuters; compiled by Daiwa Securities.

Based on Japan/US rate spread, USD/JPY should be at around 105-107

Intermediate and long-term Treasury yields are unlikely to rise while the yield curve is inverted

With the fed funds rate substantially higher than intermediate and long-term bond yields, the yield curve is currently inverted, and history suggests that intermediate to long-term rates are unlikely to rise during such an inversion. Intermediate to long-term Treasury yields have tended not to turn to a rising trend until rate cuts push the fed funds rate to a level equal to or below their level. In August this year the Fed announced a rate cut and suggested the possibility of additional rate cuts, but intermediate to long-term rates are unlikely to turn to a rising trend, and any increases are likely to be limited, until the Fed cuts rates further.

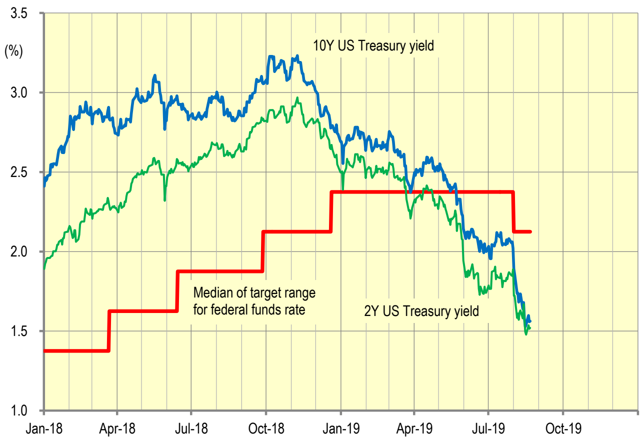
Interest rates are unlikely to rise on expectations of US tax cuts

The media reported that the Trump administration is considering a temporary payroll tax cut, but it also reported that the discussions are in early stages and it is uncertain whether Congress will go along. If the tax cut is financed by a portion of the increased tax revenue brought by the additional tariffs on China, it is unlikely to be a very large tax cut, but the US administration, which blames the strong dollar on Fed monetary policy and wants the Fed to cut rates, is unlikely to implement fiscal stimulus anytime soon, given the risk of that causing interest rates to rise. The Trump White House said that a tax cut was not currently under consideration, and we think it unlikely that tax cut expectations spark a rise in interest rates.

Based on Japan/US rate spread, USD/JPY should be at around 105-107

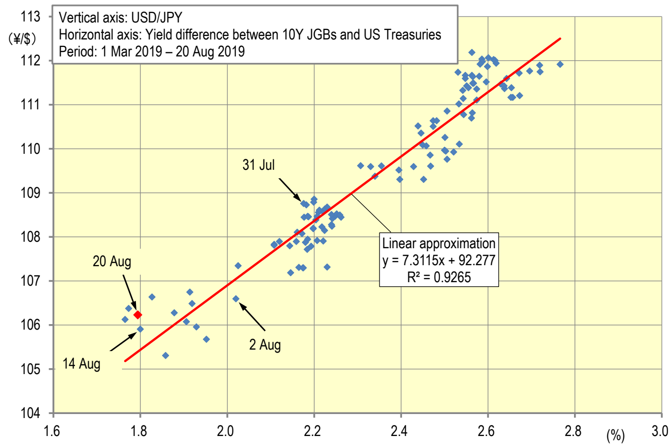
Since March this year, there has been a clear correlation between the Japan/US 10-year government bond spread and the USD/JPY. A USD/JPY in the lower 106 range is consistent with this correlation given the current Japan/US rate spread of 1.8%, albeit somewhat on the high side. The 10-year Treasury yield, currently around 1.55%, is likely to trade in a range of 1.45% to 1.65% for the time being, which would put the Japan/US 10-year government bond spread at around 1.70% to 1.90%. If the USD/JPY stays level with or slightly higher than what its correlation with the Japan/US rate spread suggests, it will likely trade within a range of 105 to 107.

Chart: US FF Rate, 2Y and 10Y US Treasury Yields



Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: Yield Difference Between 10Y JGBs and US Treasuries, USD/JPY



Source: Thomson Reuters; compiled by Daiwa Securities.

Depending on US economic data, the USD/JPY may drop below what its correlation with the Japan/US rate spread suggests

USD/JPY rises on partial postponement of China tariffs and improvement in US economic data

The USD/JPY has been higher than what its correlation with the Japan/US rate spread would suggest since August 13, when the US announced it would postpone a portion of its fourth round of additional tariffs on Chinese goods. Since that day, the dollar has risen against 15 other currencies besides the yen, while those 15 currencies have strengthened slightly against the yen. In other words, there has been both a dollar strengthening and yen weakening (rise in cross-yen rates). The expectation that the postponement of some of the additional tariffs on Chinese goods will have a positive impact on the US and global economies has strengthened the dollar and triggered a risk-on weakening of the yen. Furthermore, the US economic data announced on August 15 (July retail sales and August manufacturing sentiment surveys from the New York Fed and Philadelphia Fed) improved more than expected, pushing the USD/JPY higher by strengthening the dollar and weakening the yen .

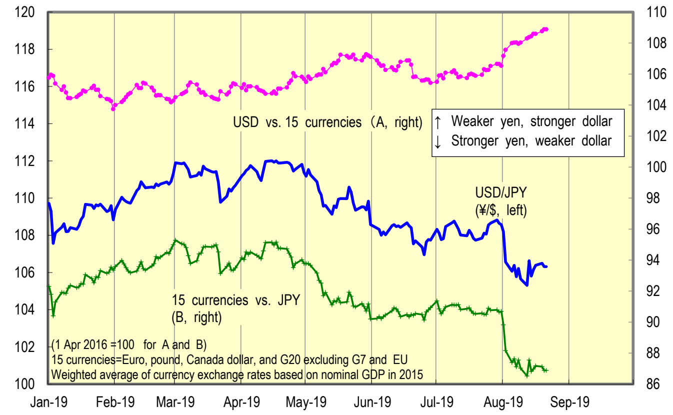
When share prices are rising, the USD/JPY's correlation with the Japan/US rate spread tends to lead to a strengthening of the dollar against the yen

When share prices are weakening the yen comes under risk-off strengthening pressure, as was the case in early August immediately after the Trump administration announced that a fourth round of additional tariffs on Chinese goods would go into effect in September, and therefore the USD/JPY is likely to be lower than what its correlation with the Japan/US rate spread suggests. In contrast, when share prices are rising, the yen is subject to risk-on weakening pressure and therefore the USD/JPY tends to be higher than what its correlation with the Japan/US rate spread suggests. US share prices rose on August 13 when some of the additional tariffs on China were postponed, declined on August 14 in response to weak economic data from China and Germany, then rose again on August 16 and 19 on expectations of fiscal stimulus in Germany and on the US granting a partial 90-day reprieve of its Huawei embargo.

Depending on US economic data, the USD/JPY may drop below what its correlation with the Japan/US rate spread suggests

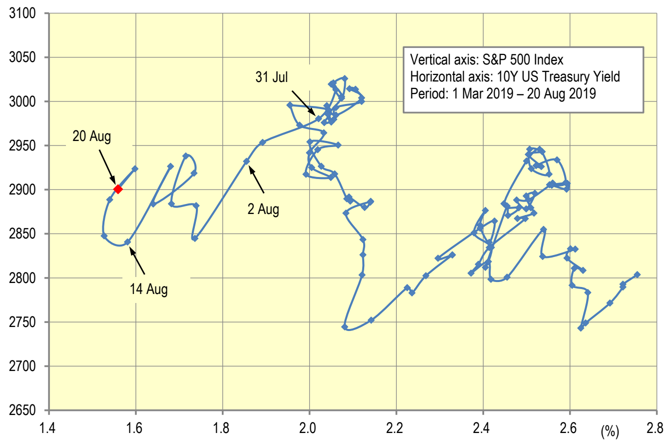
When US economic data surpasses market expectations and/or when US-China trade friction eases, both interest rates and share prices rise in the US, and the USD/JPY tends to rise as well. In contrast, when US economic data falls below market expectations and/or when US-China trade friction heats up, both interest rates and share prices decline in the US, and the USD/JPY tends to decline as well. The strength or weakness of the US economic data makes a big difference as to whether the USD/JPY is higher or lower than what would be suggested by its correlation with the Japan/US rate spread. From July to August, the US economic data surpassed market expectations more often than it did not, but that trend is unlikely to last much longer. There may be a slowdown (worsening) of the US data scheduled to be announced from mid-September, including August retail sales and September manufacturing sentiment, so be aware the risk of the USD/JPY falling below the level suggested by its correlation with the Japan/US rate spread.

Chart: Exchange Rates of USD, JPY, and Other Currencies



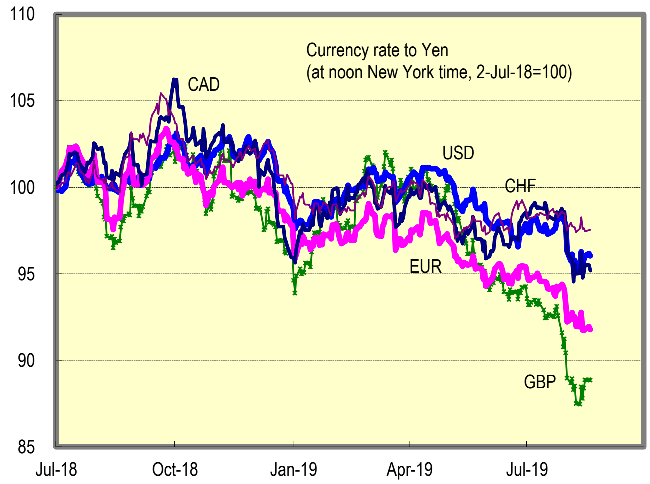
Source: Thomson Reuters; compiled by Daiwa Securities.

Chart: 10Y US Treasury Yield, S&P 500 Index



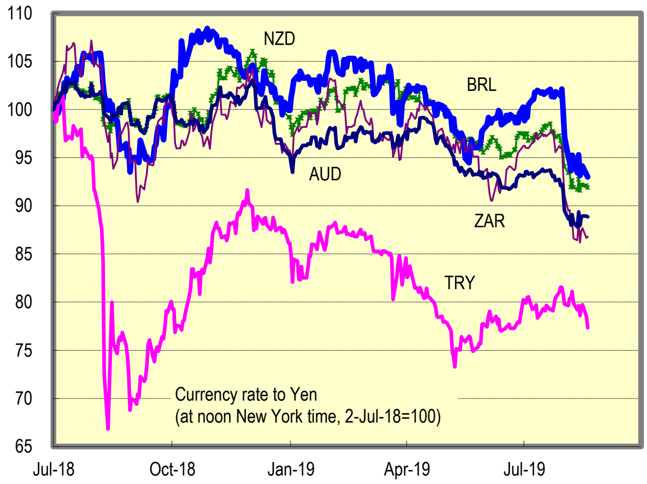
Source: Thomson Reuters; compiled by Daiwa Securities.

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	7.1	6.7	6.7	7.0	7.4
			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.

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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■ 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

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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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