

# Daiwa's View

## Things to watch for in 2020: Part 2

- Will we see further dollar depreciation?

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Daiwa Securities Co. Ltd.

### Will we see further dollar depreciation?

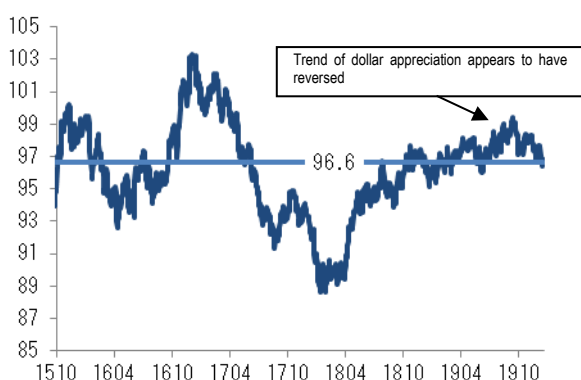
#### Things to watch for in 2020: Part 2

As the panicky tone eased in the overnight market, three US stock indices ended higher across the board. However, the rise in US yields was limited to around 2bp and the VIX Index did not decline much, so it does not appear that caution has been fully eliminated in the market.

In particular, US risk assets are performing solidly, similar to last year. Here, we can point out the benefits from dollar depreciation. As the US Dollar Index has now declined to 96.6 after hitting a peak at 99.4 in late September 2019, the dollar may have entered a depreciation trend. This is a major difference with the trends since October 2016 when the dollar strengthened alongside the surge in yields due to the election of President Donald Trump<sup>1</sup>.

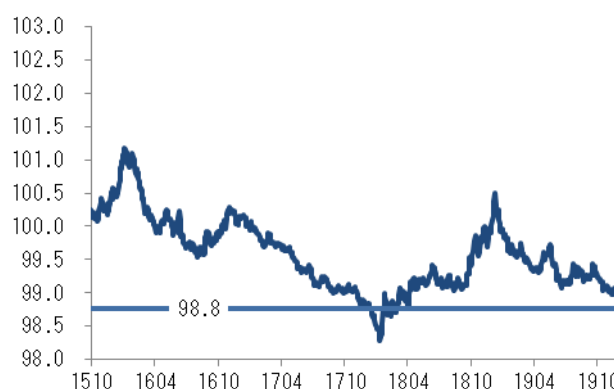
As we know, dollar depreciation makes the US financial condition accommodative and props up valuation of risk assets. Among some US financial condition indices, we look at the Goldman Sachs Financial Condition Index, which is often quoted by the Fed. The index has now improved to 98.8, the lowest level since March 2018. One reason behind this depreciation of the dollar appears to be the dovish stance at the Fed, which has set a high hurdle for rate hikes. In addition, Mr. Trump is expected to prefer a weaker dollar prior to the presidential election. In short, there is a possibility that political conditions have been set for continuous depreciation of the dollar in 2020.

Chart 1: US Dollar Index



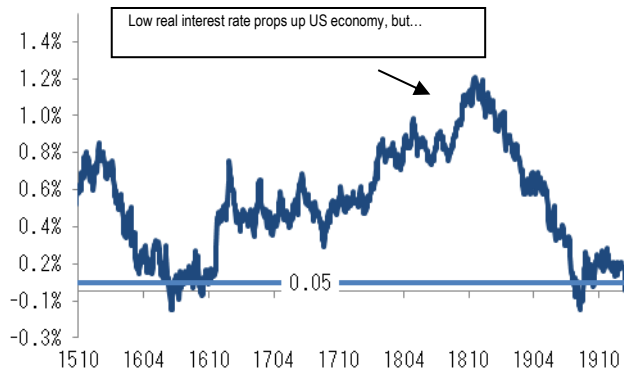
Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Goldman Sachs US Financial Condition Index

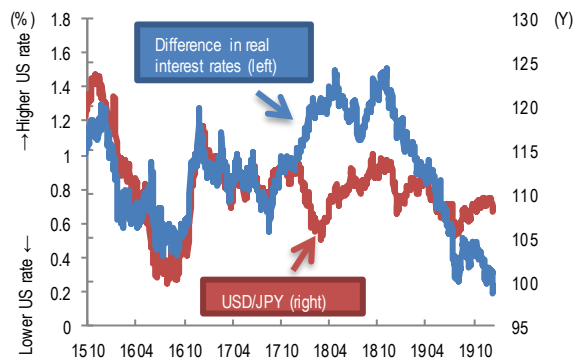


Source: Bloomberg; compiled by Daiwa Securities.

<sup>1</sup> That said, US real interest rate in 2016 was low until right before presidential election. As election dramatically changed situation, we cannot drop our guard in 2020, either.

**Chart 3: 10Y US Real Interest Rate**


Source: Bloomberg; compiled by Daiwa Securities.

**Chart 4: USD/JPY, Differential Between 10Y Japanese and US Real Interest Rates**


Source: Bloomberg; compiled by Daiwa Securities.

A troubling aspect is the impact of dollar depreciation on Japan. The simplest conclusion caused by the weaker dollar would be a rise in Japanese stock prices in tandem with higher US stock prices. Meanwhile, given the fact that the weaker dollar and stronger yen are two sides of the same coin, Japanese stocks are expected to underperform US shares even in the stage of higher US stock prices.

In addition, the fact that dollar depreciation has been driven by low US interest rates also makes the impact on JGB yields complicated. In fact, the 10-year US real interest rate is at the 0.05% level, almost the same as in 1H 2016, and the differential between Japanese and US real interest rates is also at the same level as in 1H 2016 or indicates lower US yields/higher JGB yields. The correlation between the USD/JPY and the differential between Japanese and US real interest rates has weakened compared to before, but if the correlation is maintained over the long term, any one of (1) the weaker dollar/stronger yen, (2) a rise in US yields, or (3) a decline in JGB yields may occur or multiple phenomena of the three may be observed simultaneously (Chart 3).

Given the fact that the hurdle for (2) a rise in US yields is high due to the Fed's stance, market participants are likely to note the possibility of (1) the weaker dollar/stronger yen or (3) a decline in JGB yields. From this viewpoint, an important point for JGB yields in 2020 is whether we will see further depreciation of the dollar, in addition to the point whether US yields will rise.

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### ■ Credit Rating Agencies

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