Sumitomo Mitsui Asset Management

Japan Market Memo

(No.058)

For information only

21 November 2016

Today's Topic **USD/JPY Rate Forecast**

JPY has turned to decline against USD

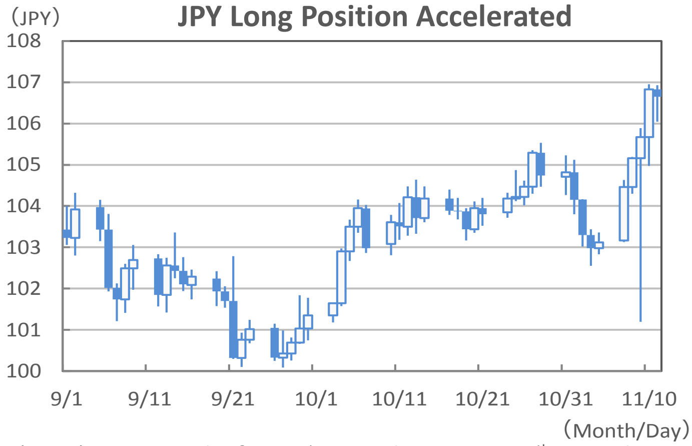
- ✓ Unwinding of JPY long position accelerated further on the back of sharp US long-term interest rate rise and widening of Japan and US long-term interest rate spread after Mr. Donald Trump was elected as US President.
- ✓ Currency market conditions seems to favor weaker JPY against USD as short-term real interest rate (negative interest rate) differentials (US-Japan) is expected to continue narrowing.
- ✓ As market has started to discount US economic recovery expected to be promoted by US President-elect Donald Trump and favorable US long-term interest rate hike, weak JPY is expected to stay for the time being. However, we need to keep our eyes on (i) US President-elect Donald Trump's statements and (ii) materialization of fiscal spending and international trade policy.

Point 1 Accelerating correction of JPY appreciation

Market is trying to find the appropriate level of long-term interest rate

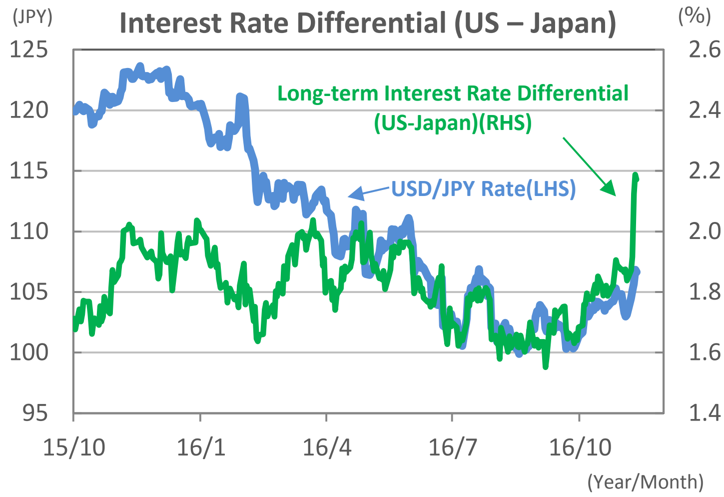
- JPY weakened against USD since Mr. Trump was elected as 45th US President and USD/JPY rate entered into 107 yen level as of 10 a.m. 14th November 2016 (Japan time).
- Background of accelerating correction of JPY appreciation is the widening of interest rate differential between Japan and US long-term interest rates. US long-term interest rates rose in favor of US President-elect Donald Trump's economic measures based on fiscal expansion.
- US 10-year government bond yield was slightly above 1.6% in the beginning of October. It climbed up to 1.8% level by the end of October on rising expectation towards December US interest rate hike supported by economic data indicating US economic expansion. On 9th November after the victory of Mr. Trump on the US Presidential election and the Republicans winning majority of both congresses' seats, US 10-year government bond yield surpassed 2% level for the first time in about 6 months. It seems that adjustment of low interest rate progressed as expectation rose on fiscal expansion and tax cut which US President-elect Donald Trump advocated as his economic policy. Market is likely to try to find appropriate level of long-term interest rate for the time being.
- USD/JPY rate trended towards stronger USD against JPY as interest rate differential between Japan and US long-term interest rate started to head towards widening trend.

USD/JPY Rate: Unwinding of JPY Long Position Accelerated



(Note) Data period is from 1st September 2016 to 11th November 2016.
(Source) SMAM, based on Bloomberg L. P. data.

USD/JPY Rate and Long-term Interest Rate Differential (US – Japan)



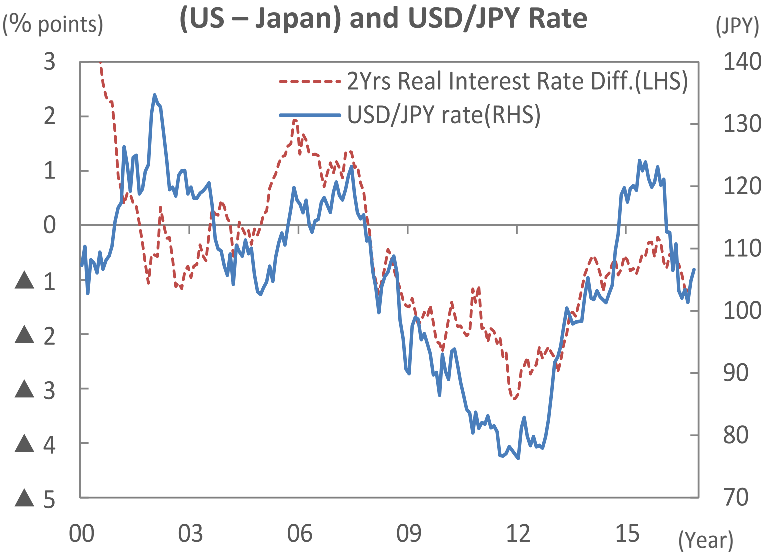
(Note 1) Data period is from 1st October 2015 to 11th November 2016.
(Note 2) Long-term Interest Rate Differential = 10-year US Bond Yield – 10-year JGB Yield.
(Source) SMAM, based on Bloomberg L. P. data.

Point 2 Focus is on December US Monetary Policy

Real interest rate (negative) differential is likely to narrow

- Market is focusing on December US monetary policy for a short while. FRB is likely to raise interest rates at December FOMC. US interest rate hike from next year is expected to be around 2 times based on deliberate decisions. Meanwhile, differential of real interest rate sinking in the negative territory will continue to narrow, as no significant change of BOJ's monetary policy is expected. We can say that such environment will lead USD to strengthen against JPY.

Japan/US Real Interest Rate Differential (US – Japan) and USD/JPY Rate



(Note 1) Data period: Japan/US real interest rate differential is from January 2000 to October 2016. USD/JPY rate is from January 2000 to November 2016. November 2016 is as of 11th November 2016.

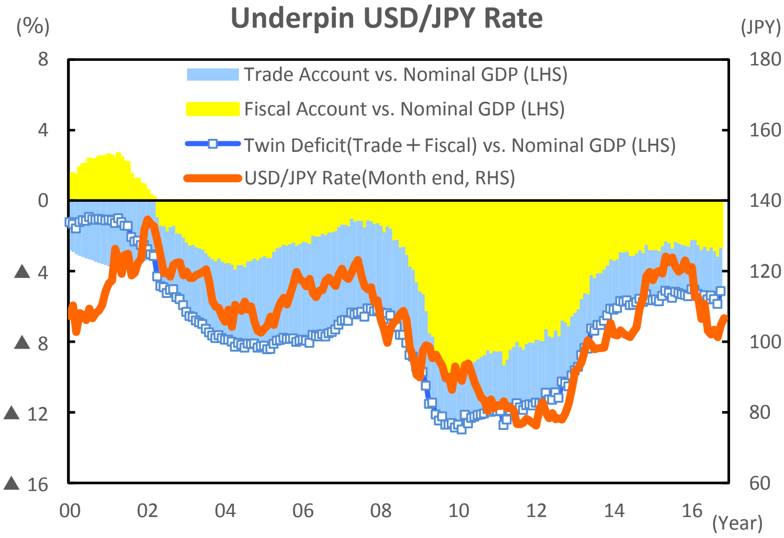
(Note 2) Real interest rate differential is calculated by subtracting Year-on- year growth rate of Consumer Price Index excluding Food and Energy (US Core, Japanese Core Core) from interest rate differential.

(Source) SMAM, based on US Department of Labor, US Statistics Bureau and IMF data.

Future Outlook Expectation over weak JPY

- As the market has started to discount US economic recovery expected to be promoted by US President-elect Donald Trump and favorable US long-term interest rate hike, JPY appreciation is expected to continue for the time being. However, we need to keep our eyes on US President-elect Donald Trump's policies and statements. He already announced "100-day Plan (hereafter Plan)". His actual course of fiscal spending and international trade policy will be key factors to cause fluctuations of USD/JPY rate.
- If fiscal deficit increases significantly, it might possibly lead USD to depreciate against JPY as so called twin deficits (Trade deficit and Fiscal deficit) of US which had been improving, may start to deteriorate. Although the next government is expected to totally change its fiscal policy to expansion from reduction, if the size of fiscal spending becomes realistic after consultation with the congress, we may not need to be overly concerned on JPY appreciation.
- We will also draw our attention to Trump's International trading policy. According to "Plan", it is an extremely protectionist policy such as withdrawal from Trans-Pacific Partnership (TPP). If this protectionist policy is implemented in line with "Plan", it may trigger risk-off and possibly lead JPY to appreciate. We therefore need to carefully watch this policy.

Improvement of Twin Deficits Underpin USD/JPY Rate



(Note) Data period is from January 2000 to November 2016. Trade account is till September 2016, Fiscal account is till October 2016, USD/JPY rate is as of 11th November 2016.

(Source) SMAM, based on Bloomberg L. P. data.

Disclaimer

Please read this disclaimer carefully.

- This material is for non-Japanese institutional investors only.
- The research and analysis included in this report, and those opinions or judgments as outcomes thereof, are intended to introduce or demonstrate capabilities and expertise of Sumitomo Mitsui Asset Management Company, Ltd. (hereinafter "SMAM"), or to provide information on investment strategies and opportunities. Therefore this material is not intended to offer or solicit investments, provide investment advice or service, or to be considered as disclosure documents under the Financial Instruments and Exchange Law of Japan.
- The expected returns or risks in this report are calculated based upon historical data and/or estimated upon the economic outlook at present, and should be construed no warrant of future returns and risks.
- Past performance is not necessarily indicative of future results.
- The simulated data or returns in this report besides the fund historical returns do not include/reflect any investment management fees, transaction costs, or re-balancing costs, etc.
- The investment products or strategies do not guarantee future results nor guarantee the principal of investments. The investments may suffer losses and the results of investments, including such losses, belong to the client.
- The recipient of this report must make its own independent decisions regarding investments.
- The opinions, outlooks and estimates in this report do not guarantee future trends or results. They constitute SMAM's judgment as of the date of this material and are subject to change without notice.
- The awards included in this report are based on past achievements and do not guarantee future results.
- The intellectual property and all rights of the benchmarks/indices belong to the publisher and the authorized entities/individuals.
- This material has been prepared by obtaining data from sources which are believed to be reliable but SMAM can not and does not guarantee its completeness or accuracy.
- All rights, titles and interests in this material and any content contained herein are the exclusive properties of SMAM, except as otherwise stated. It is strictly prohibited from using this material for investments, reproducing/copying this material without SMAM's authorization, or from disclosing this material to a third party.

Registered Number: Kanto Local Finance Bureau (KINSHO) No.399
Member of Japan Investment Advisers Association, The Investment Trusts Association, Japan and
Type Ⅱ Financial Instruments Firms Association