Mizuho EMEA G4 Forecast Update

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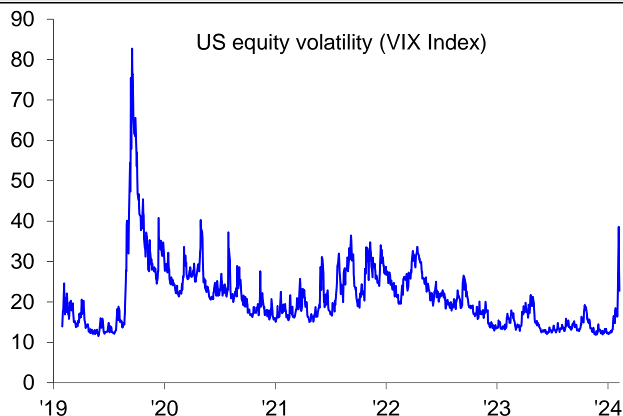
MIZUHO

Slowing not slumping

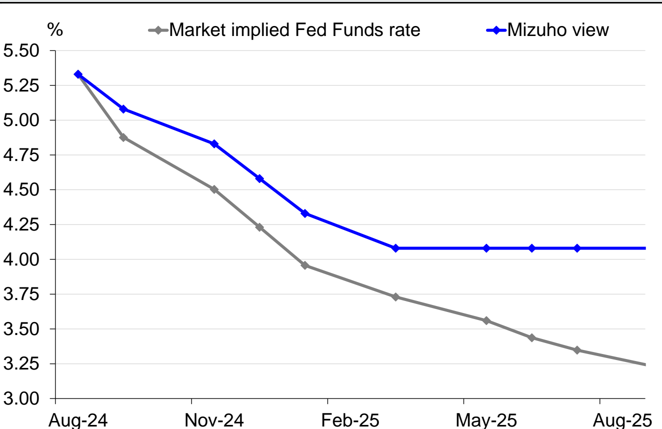
The dramatic turn in financial markets over the past few weeks has a number of causes, one of which is US political developments. In the wake of the presidential debate in late June, Trump was riding high in the polls and even more so following the 13 July assassination attempt. Markets priced in a Trump win, leading to a firmer US dollar. However, the Democrats have subsequently ditched Biden and swung behind Vice President Harris with unexpected enthusiasm. Her fund-raising has been prodigious and large swathes of the electorate appear energised by her candidacy. **Early polls suggest a much more competitive race**, especially across the key swing states. Trump's pick of Vance as VP has gone down badly with much of the electorate. He only appeals to a small core of Trump supporters. The Democratic ticket is much more balanced. The Democrats have momentum. **We no longer expect that Trump will be the next US President**. That said, **a Democratic sweep looks hard** given the likely loss of Manchin's West Virginia seat in the Senate and the fact that the Democrats are defending a lot more Senate seats than the Republicans. Very few of the Republican seats in the Senate are in play. **Potential gridlock likely means less fiscal spending, which in turn suggests that fiscal policy will be much less of a headwind to Fed easing in 2025.**

It is not just the political backdrop where the prospects look different. With the increase in financial market volatility, the risks of a hard landing appear greater. US fixed income markets are pricing in recession and an aggressive Fed response. However, we do not expect an intermeeting cut. The current situation does not resemble either Covid (2020) or the GFC (2008). The Fed did undertake an intermeeting cut in 2001, albeit well after the tech bubble had peaked. In the July meeting, Chair Powell warned that the FOMC was now much more attentive to downside labour market risks as inflation risks had declined. Subsequently, the early August labour market report has fanned recession fears, triggering the Sahm rule, as the unemployment rate ticked up to 4.3%. We see the current market turmoil as having a modest dampening impact on sentiment and activity against an essentially solid backdrop. The economy is slowing, not slumping. **We expect that Fed to start cutting in September, as previously, but we now expect that the Fed will also cut in November and December as well, as growth slows a little more than previously expected.** However, market expectations of aggressive back-to-back 50bp cuts look extreme given that the **economy seems to be slowing rather than slumping**. Recent FOMC commentary also seems to be pushing back against overly hasty action. We see H2 activity as soft but still positive. More Fed cuts relative to elsewhere means a weaker US dollar, especially when combined with less aggressive fiscal policy in 2025, which also weighs on the outlook for the US dollar in 2025.

Despite rising volatility …



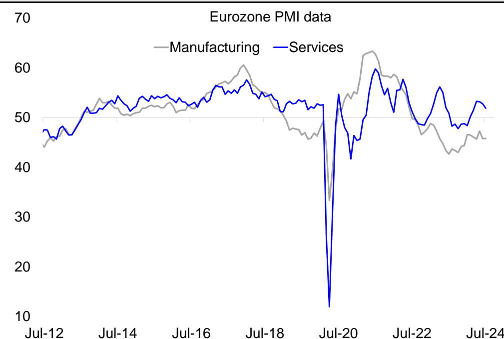
… Fed unlikely to validate market expectations



Source of all charts: Bloomberg

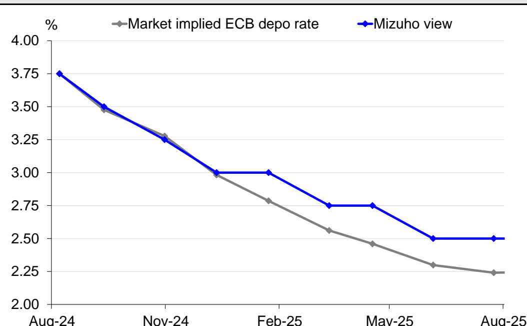
EUR markets

Macro – A little underwhelming



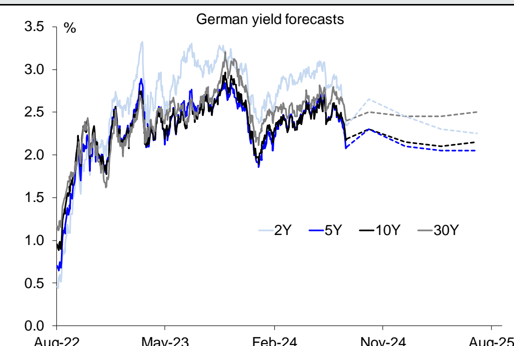
- Q2 GDP was a little firmer than expected but leading indicators for Q3 look less upbeat. France is struggling for policy direction and activity in Germany remains downbeat, with fiscal policy remaining tight. **The 2024 upward GDP revision is already in the rear-view mirror. Activity in late 2024/early 2025 will be somewhat weaker than we anticipated, which sees 2025 GDP revised lower**. A slightly firmer EUR will be broadly offset by slightly faster ECB easing.
- The labour market remains tight, but it looks as if the cycle low is now behind us. **Labour hoarding has eased a lot as demand slows**.
- Headline inflation is little changed since November. It sits at 2.6%YoY in July. Core inflation's decline has been steadier, and it sits at 2.9%YoY. **The solid labour market remains a source of upside inflation risk for now, albeit an easing one.** The ECB expects almost no change in unemployment and sees elevated unit wage growth through late 2024, which it expects will be paid for by lower unit profits. The risks here are on the downside. We look for headline CPI growth to average 2.2% in 2024, ending the year close to target.

Policy – ECB easing underway



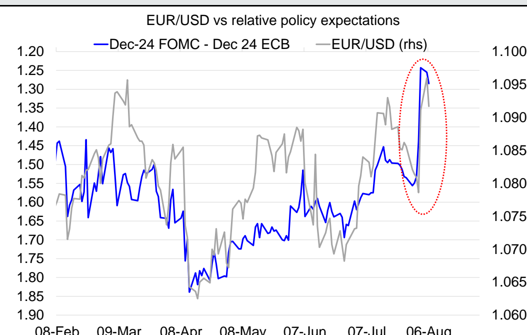
- The ECB left policy unchanged in July. Recent ECB commentary has hinted that the September meeting is not a done deal, as they seek to stress a meeting-by-meeting approach. **Recent market volatility ensures a 25bp reduction in September.**
- The weaker growth outlook means there is now a good chance that the ECB also cuts in both November and December. The recovery is looking a little shaky and monetary easing is warranted. Nonetheless, inflation risks remain. We expect that the **easing cycle will terminate with the deposit rate around the 2.50% level next summer**.
- The ECB announced their **new operational framework** in late March. They opted for a "demand-driven floor system", where banks tap the ECB's liquidity lines whenever they need to. The spread between the rate on the MROs and the DF is expected to decrease from the current 50bp to 15bp. The **changes are scheduled to start 18 September**.

Rates – EGBs in need for some retracement before the rally can continue



- The post US payrolls rally in EUR rates has driven technical indicators to overbought territory. **We think this latest rally has gone too far too fast**. Market pricing of the terminal rate (around 150bp cuts by September 2025) looks excessive. We think the EZ economy argues for gradual cuts and a terminal of 2.50%.
- After some retracement and as the ECB keeps delivering cuts, we expect **European government bond yields to move lower into Q4 assuming the coming inflation data don't surprise to the upside**.
- While we think that the medium-term direction for EUR rates is south, **we expect the downside in 10yr Bund will be capped**. The lack of a recession and the slow progress on the inflation and labour market fronts mean rates are not likely to fall to the Covid lows. **We continue to expect an ongoing build-up in term premia, driven by a recovering economy and inflation expectations.**
- **EGB spreads will likely remain under pressure** as funding for 2025 becomes the focus in September.

FX – Less downbeat outlook



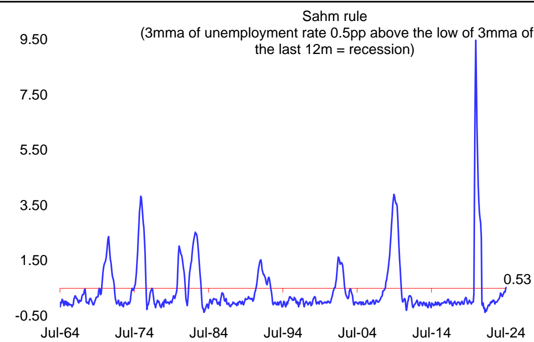
- EUR has not been hit by the carry trade unwind in recent sessions. In the short-term, we see **UST yields rising more than EGB yields which will help the US dollar**. However, the medium-term picture is more supportive as we now expect that the US will ease more relative to the ECB than we previously expected.
- With Trump no longer expected to win the US election **we no longer have a "Trump bump" for the US dollar ahead of the vote**.
- EUR speculative positioning is close to flat, and valuations are not stretched. The economy is not dynamic, but it seems stable. The risks here are on the downside if French or Italian assets come under pressure.

Basis – Tightening drivers still at play but likely put to the test in coming months

- XCCY spreads continue to be choppy around cycle highs. The latest global risk-off momentum has driven a bit of widening but moves have been contained. **Abundant USD liquidity and reverse EUR issuance keep supporting paid positions. While some tightening drivers are still at play, the lack of a future liquidity squeeze from the ECB and how much the basis has tightened YTD still makes receiving positions look more attractive.**

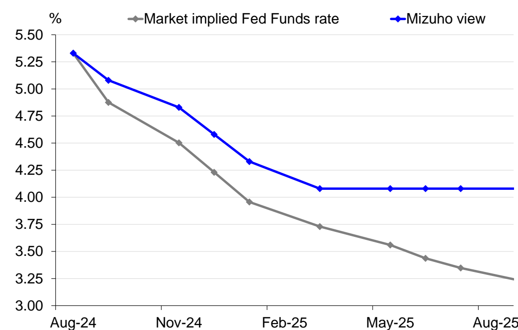
USD markets

Macro – Cooling not collapsing



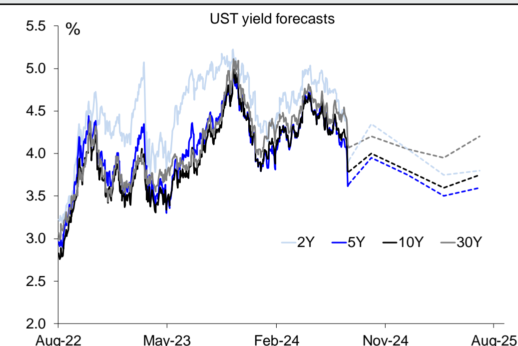
- Q2 GDP was upbeat, rising 0.7%QoQ, leaving H1 activity slightly above trend. This leads to a small upward revision to our 2024 GDP forecast despite that fact that **we now see a slightly weaker H2**. We look for 2024 GDP to rise 2.4% (prev 2.2%). We now look for a weaker 2025 with GDP at 1.5% (1.8% prev), with **fiscal policy in 2025 likely to be less expansionary under a divided government**.
- The labour market looks softer in the wake of the July payrolls report but **we are not convinced that recession is in the offing**. We see a higher unemployment rate this year (4.1% vs 3.9% prev) and next (4.4% vs 4.1% prev) but meltdown seems unlikely.
- Inflation risks in the US remain higher than elsewhere although they are lower now that the activity risks have shifted to the downside. **Our CPI forecasts are a little lower at 2.9% for 2024 and 2.5% for 2025.** Firm growth/positive output gap, loose financial conditions, expansionary fiscal policy and the solid labour market mean the risks for the CPI are on the high side.

Policy – Measured front loading. No panic.



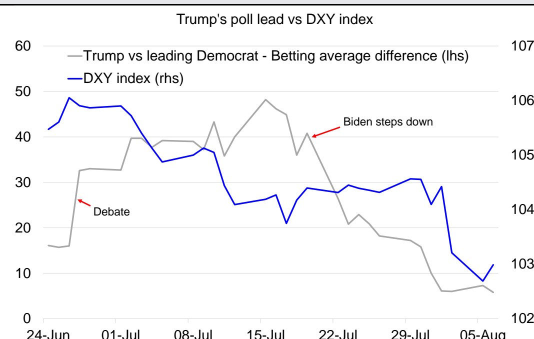
- The Fed's July meeting teed up the markets for a September cut. We expect the subsequent market volatility in the wake of the payrolls report will have a modest negative real-world impact. We expect that the Fed will respond, albeit by much less than the market currently expects and at scheduled meetings. Inter-meeting action is not likely. **We now see the Fed easing 25bp in each of the 3 meetings left this year.** Next year, the Fed will continue to ease gradually as it seeks out the neutral rate that keeps the economy on an even keel.
- The pace at which the Fed's balance sheet is shrinking has slowed. The monthly cap on USTs rolling off was reduced from $60bn to $25bn at the start of June. The cap on MBS remains in place. This suggests **less upward pressure for long-end UST yields from the QT front.** We do not expect that rate cuts will interfere with planned QT, in the absence of a sharp selloff at the long end.

Rates – Steepening is the way to go



- The weakness in the last payrolls report triggered a sharp bull-steepening move in USTs. 10yr UST yields fell below 3.80% for the first time in the current cycle and 2x10s tested dis-inversion levels. **We think this was an overreaction**. USTs look expensive. We expect USTs to fade the aggressive Fed pricing and recent strength as Fed members argue against reading too much into one report and data elsewhere remain relatively resilient.
- Recent moves have indicated the direction of travel in the medium term. After a period of correction, broader signs of a softer US economy will likely see USD rates bull-steepening again. **The front-end and belly of the curve should be especially supported**, while the long end underperforms. **An economy growing at trend, Fed cuts and relatively loose fiscal policy should support term premia being priced into the UST curve.**

FX – Extra Fed cuts, less fiscal support to weigh



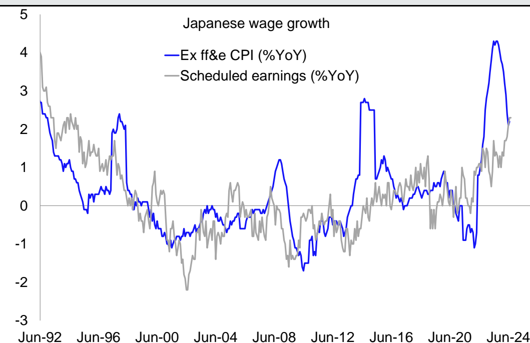
- In the short run, the US is where front-end pricing looks most overextended, and **we expect a near-term reversal that should lift UST yields and support the US dollar** vs most other G10 currencies. We see the DXY index with scope to push back up to 104.50.
- **Our new forecasts see a split government in the wake of the November election, less fiscal stimulus, and more monetary easing vs last month. This means a weaker US dollar vs our previous forecasts. The US dollar remains expensive vs most metrics and speculative positioning is mildly positive.**
- **We now look for EUR/USD to push up to 1.14 and for GBP/USD to rise towards the 1.40 level on a 12m horizon.**

Basis – Dollar liquidity remains healthy but risks on our cheaper USD funding view are rising

- XCCY markets have been relatively isolated from the global risk-off sentiment that was triggered after the last US payrolls report. **Dollar liquidity remains healthy and plentiful, which will prevent a much higher dollar premium in the near term and support paid positions in most pairs**. However, we see **risks to our cheaper USD funding view in coming months** on the back of a slowdown in Yankee issuance, risk-off insurance, and US election risks.

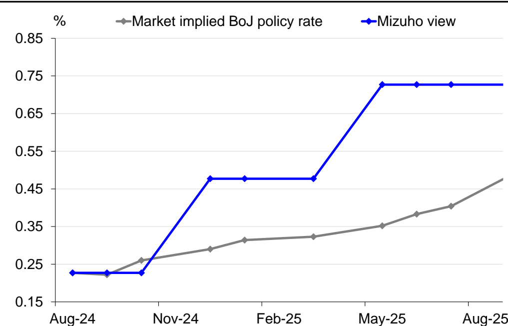
JPY markets

Macro – 2024 GDP to contract but outlook upbeat



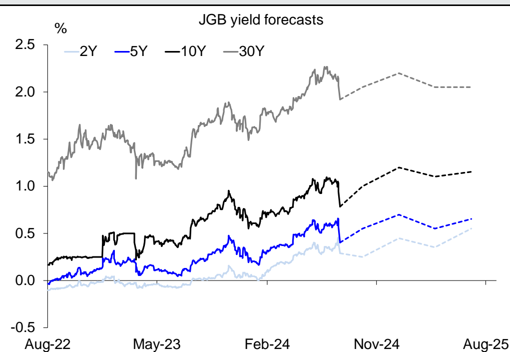
- The further downward revision to Q1 GDP means we see CY24 GDP contracting 0.1%, despite our expectation of a solid bounce in activity in Q2. Cash handouts in H2 will help keep the recovery on track. **In 2025, activity will be driven by gains in real income as inflation drops back towards and probably below target, even as wage growth remains solid.** The unemployment rate is seen remaining low and stable over the forecast period. **We doubt changes at the top of the LDP will mean much change in terms of policy**.
- The firmer yen in the wake of the BoJ move means a mildly lower CPI forecast and we trim our CPI forecasts by 0.1pp for both 2024 and 2025. We do not see much in the way of upside risks on the CPI front. The underlying CPI seems to be in the 1~2% range.
- The 2024 Shunto wage negotiations delivered a larger-than-expected gain, boosting expectations that this year the gains should feed through to the national wage data, as they conspicuously failed to do last year. Evidence should be visible over the summer. **Inflation should remain elevated into H1-25, so real wages will not pick up significantly until next year**. In turn, this lays the foundation for a pickup in growth in 2025, driven by consumer spending.

Policy – Market reaction to delay further tightening for now



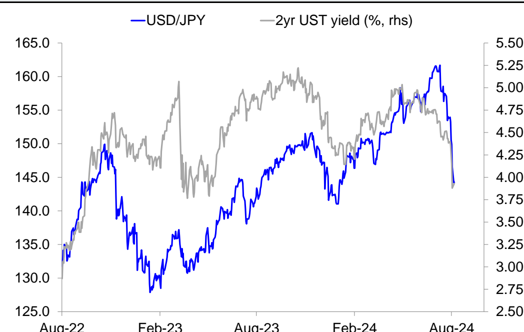
- At its late July meeting, the BoJ announced both an interest rate hike to 0.25% and a reduction in Rinban purchases by ¥400bn/quarter until purchases reach ~¥3trn/month in around Q1 26 from the current ~¥6trn. However, **the BoJ took an upbeat view on the prospects of further rate hikes in coming quarters in its outlook report alongside an upbeat view on wages**. Governor Ueda underscored the upbeat view in his press conference, noting that 0.5% was not a limit. The more upbeat BoJ view on the outlook seems, in part, to have been driven by government pressure to stem yen weakness.
- The market reaction to the rate hike has been significant – enough to make the BoJ cautious about hiking again in the near-term. An October hike now seems unlikely. **We now expect that the BoJ will hike a further 25bp around year end and again in late spring**. The firmer yen will weigh on sentiment. The currency move has been sufficient to put some downward pressure on the inflation rate necessitating fewer hikes.

Rates – Upside in front-end yields to resume



- In line with the moves in global rates, JPY rates also became better bid at the beginning of the month. JGB yields are lower on the month. We think the BoJ will continue to hike policy rates in coming quarters, which will likely keep the **upside pressure in JGB yields**. 1y1y has fallen below 0.46%, but we think that once market volatility settles, this too will move higher, towards 60-75bp.
- Ongoing QT should continue to pressure the 10yr point, where we expect to see the most steepening.
- Japanese domestic investors are still very quiet with regards to buying long-term JGBs. We think they may wait for 30yr yields to cheapen again before buying. **The 10x30s flattening theme will need to wait until there's more clarity on the BoJ's reaction function.**

FX – Too far, too fast



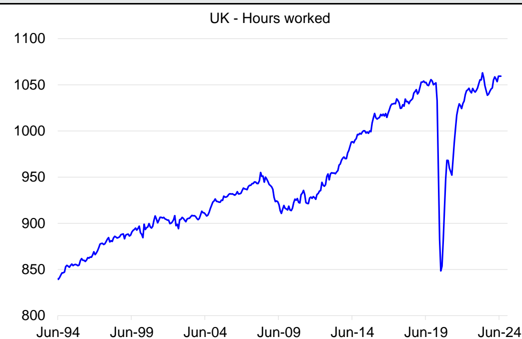
- The plunge in UST yields and a heavy clearing out of short JPY positioning have pushed USD/JPY below our 12m forecast. **The speed of the move is a function of how extended JPY shorts were**. We now see speculative positioning on the CFTC basis as close to neutral.
- Given our view that the front end of the UST curve looks over-extended and the fact that the huge jump in JPY is sufficient to alter the inflation picture vs when USD/JPY was up at 160, in the short run, **we expect some reversion and see scope for USD/JPY to trade back up to the 145~150 level.** However, in time the BoJ will deliver more hikes than currently priced and the pair will again start to trade lower as the short-term yield spread again starts to narrow. At current levels, JPY is still cheap on most metrics, just not as cheap as it was last month.

Basis – Tightening is the way to go

- The BoJ has made it clear: there is more tightening to come. July has seen USDJPY XCCY basis spreads print new highs. We still see paying drivers at play: **subdued interest from Japanese investors** to buy hedged overseas assets, **Yankee issuance** remaining attractive for Japanese issuers, and the **ongoing attractiveness of JGBs and JPY SSAs swapped** into USD. The latest fall in USDJPY FX look to be position-driven, which limits the potential widening in XCCY.

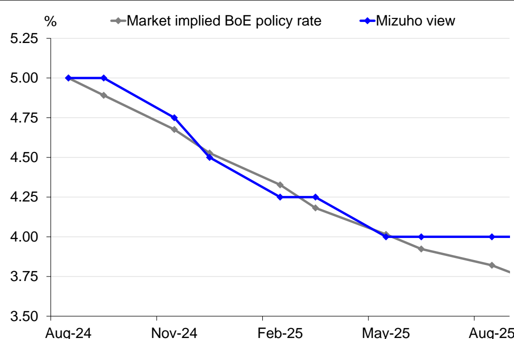
GBP markets

Macro – Activity looking solid, higher CPI in H2



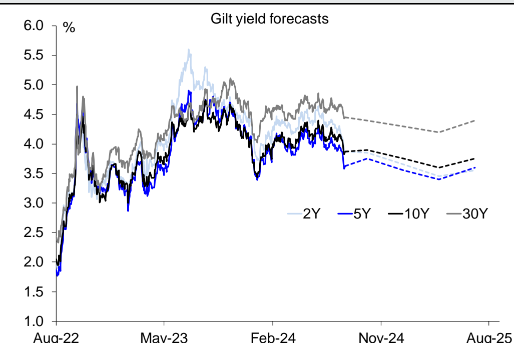
- The solid Q2 GDP data see us revise up our 2024 estimate to 1.0% (vs 0.8% prev) but we revise 2025 down by a similar amount to 1.2%. UK activity looks a little mixed, but the improvement in real wages should help keep consumption ticking over in coming quarters.
- Inflation remained at 2.0%YoY in June, but services CPI remains elevated at 5.7%YoY. The CPI will likely edge higher into year end. We see the CPI averaging 2.5% in 2024 and close to 2.0% in 2025.
- **The Labour Party won a clear majority in the recent election**, but do not see any significant loosening of fiscal policy in the wake of the vote. We see a mild pick up in spending and borrowing, as the new government broadly sticks to announced spending and tax plans.
- **The labour market, especially wages, remains a key source of inflation risk**. This month, the data on wages have been mainly on the firm side. Both the official wage data and the Indeed wage survey remain elevated, while the REC Report on Jobs showed weakness easing. The new ONS labour market survey will debut in autumn, but until then, questions over the official labour market data will see more weight placed on alternative sources.

Policy – BoE easing on track



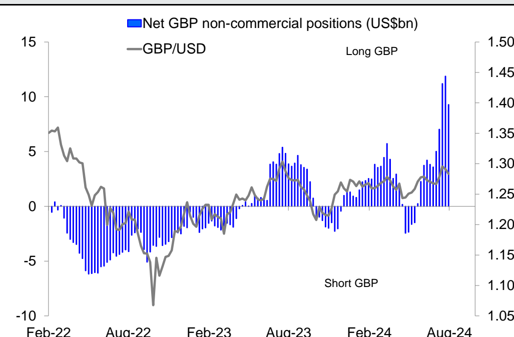
- The BoE cut rates 25bp in August in a tight 5-4 decision. The BoE headlines suggested that additional easing will be slow to appear, despite the CPI forecast remaining below target between year 2~3 of the forecast horizon. More cuts are coming. While in general we see the cuts coming at around 25bp/quarter, **we see the BoE easing slightly more in Q4**, given cover by the additional cuts we expect from the Fed. We have added one additional 25bp cut to our outlook over the coming 12 months.
- Governor Bailey recently noted he sees reserves in a £345-500bn range. He seemed happy to replace long-dated Gilts with short-dated repos. In 2025, there are ~£90bn of redemptions, suggesting active QT next year will not make much difference. This raises the prospect that **the BoE may taper active QT in the September review, especially given government pressure.**

Rates – Bearish repricing not as needed



- The risk-off sentiment in global markets also helped Gilts find a strong bid. However, front-end pricing doesn't look as overdone in GBP rates. When compared to the US, **the UK economy is much more sensitive to tight financial conditions**. We expect **investors to continue to buy Gilts given coming cuts, which will put a cap to how much Gilt yields can rise in the near term.**
- Inflation progress looks less promising towards the end of the year. Additionally, the UK economy is expected to strengthen into 2025. **The bullish momentum may find some resistance in H1-25.**
- The new government is looking to deliver supply-side reforms, which together with the BoE's easing will likely see GDP growth expectations rise, helping to build term premia in the long end of the curve.

FX – Politically-stable safe haven



- Long GBP positions rose sharply in the wake of the election and have been unwound in the wake of recent market volatility, despite the fact that UK policy rate pricing has moved much less than in the US. GBP's correlation with risk appetite has been its undoing. **In the short-run, we expect cable will hold its ground as UST yields rise.**
- We now see the Fed cutting 5 times on a 12 month horizon vs 4 times for the BoE, leaving the spread flat vs 75bp previously. We also think that the macro backdrop in the UK is more upbeat than it is in the Eurozone and is less prone to a sharp downswing in the US. **It looks as if the UK is reverting to having higher policy rates than the US, as was the case before Brexit.**

Basis – Normalisation of the curve pending

- **GBPUSD XCCY has largely shrugged off the global risk-off momentum, with the front end of the XCCY curve remaining above parity.** The long end remains too wide. More certainty on the BoE's reaction function, lower GBP rates vol that keeps attracting demand to add GBP fixed income, still-cheap USD funding and ongoing popularity of reverse GBP issuance should be **supportive of ongoing steepening.** However, this positioning has been struggling recently. We suspect it may be due to some new type of BPA (Bond Purchase Agreement) flow.

Mizuho EMEA Forecasts (as of 6 August)

FX forecasts	Current	End-Q3 24	End-Q4 24	End-Q1 25	End-Q2 25
USD/JPY	144	150	145	140	138
EUR/USD	1.09	1.10	1.11	1.12	1.14
GBP/USD	1.27	1.30	1.33	1.36	1.40
EUR/GBP	0.86	0.85	0.83	0.82	0.81
EUR/JPY	158	165	161	157	157
GBP/JPY	184	195	193	190	193
Bond forecasts (%)	**Current**	**End-Q3 24**	**End-Q4 24**	**End-Q1 25**	**End-Q2 25**
United States					
Policy rate	5.25~5.50	5.00~5.25	4.50~4.75	4.00~4.25	4.00~4.25
2yr	3.98	4.35	4.05	3.75	3.80
5yr	3.73	3.95	3.75	3.50	3.60
10yr	3.89	4.00	3.80	3.60	3.75
30yr	4.18	4.20	4.05	3.95	4.20
Eurozone/Bund					
Deposit rate	3.75	3.50	3.00	2.75	2.50
2yr	2.38	2.65	2.45	2.30	2.25
5yr	2.12	2.30	2.10	2.05	2.05
10yr	2.20	2.30	2.15	2.10	2.15
30yr	2.40	2.50	2.45	2.45	2.50
Japan					
Policy rate	0.25	0.25	0.50	0.50	0.75
2yr	0.29	0.25	0.45	0.35	0.55
5yr	0.44	0.55	0.70	0.55	0.65
10yr	0.89	1.00	1.20	1.10	1.15
30yr	2.10	2.05	2.20	2.05	2.05
United Kingdom					
Policy rate	5.00	5.00	4.50	4.25	4.00
2yr	3.90	3.85	3.65	3.45	3.55
5yr	3.69	3.75	3.55	3.40	3.60
10yr	3.92	3.90	3.75	3.60	3.75
30yr	4.49	4.40	4.30	4.20	4.40

Macro forecasts (%)	2023	2024	2025
United states			
Real GDP	2.5	2.4	1.5
CPI	4.1	2.9	2.5
Unemployment rate	3.6	4.1	4.4
Eurozone			
Real GDP	0.4	0.7	0.8
CPI	5.5	2.2	2.0
Unemployment rate	6.6	6.5	6.7
Japan			
Real GDP	1.8	-0.1	1.0
CPI	3.3	2.4	1.8
Unemployment rate	2.6	2.5	2.5
United Kingdom			
Real GDP	0.1	1.0	1.2
CPI	7.4	2.5	2.0
Unemployment rate	4.0	4.3	4.5

Note: Real GDP, CPI and unemployment rates are on an annual average basis.

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