

Mizuho EMEA G4 Forecast Update

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MIZUHO

Election risks – populism to steepen curves

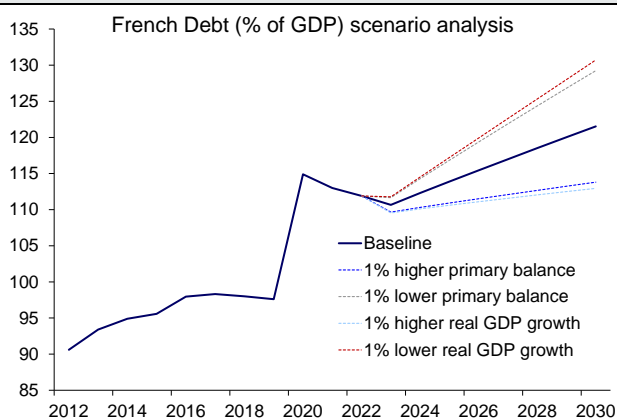
Populism has been on the rise for much of the last 2 decades. With over half the world's population participating in elections this year, the opportunity for further advances is evident. **The rise of populism has recently coincided with the surge in fiscal spending in the wake of Covid and the Cost of Living/Energy Crisis.** Fiscal consolidation has not been a big theme as yet. This is despite urging from institutions like the IMF, OECD and BIS to start consolidation sooner rather than later. **Populists are not likely to address fiscal issues and it's also possible that more fiscally conservative politicians feel unable to address such issues when facing populists across the ballot box, given demands for additional spending.**

Looking at France, which has been the hot topic this last month, it seems counterintuitive to think that **a hung parliament is seen as the most market-friendly option.** Such an outcome will help to avoid sizeable spending that both the far-right and far-left wings are proposing, but it will also likely delay any legislative change, which will prevent any significant debt consolidation. For countries like France, where debt sustainability metrics look worrying, it is not a welcome prospect. **The French debt-to-GDP ratio is among the highest in the EU, at 110.6% of GDP in 2023.** Countries with relatively close ratings, like Belgium (AA by S&P) and Spain (A by S&P), have lower debt burdens (104.5% and 107.5% of GDP, respectively). The budget deficit figures are also discouraging for France. According to the Bloomberg survey consensus, the deficit is expected to remain above the 3.0% EU threshold until 2026, from a 2023 deficit of 5.5% of GDP. **France's expected deficit trajectory is worse than Italy's.**

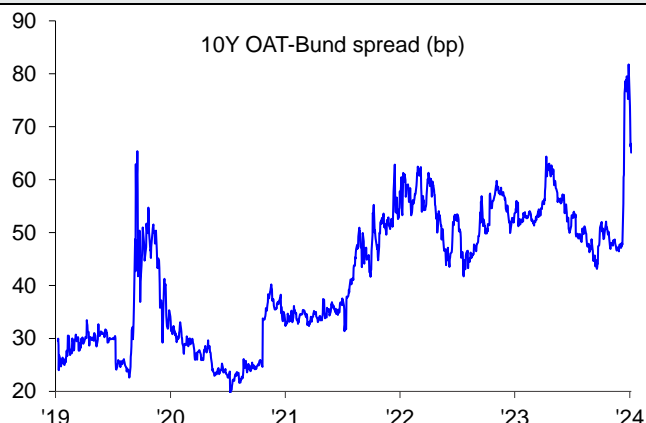
The snap French legislative elections and Trump's win in the recent Presidential debate have brought the focus back to debt sustainability and political risk. **With fiscal policy remaining relatively expansionary, it is potentially inflationary.** Additionally, higher spending usually implies some degree of debt issuance, which tends to weigh more heavily on long-term bonds. Both factors will most likely continue to apply steepening pressure to rates curves and prevent central banks from easing policy aggressively.

Going back to France, we think we are in the midst of a rating repricing of the credit. Our debt sustainability analysis and the high chances of no significant debt consolidation in the coming years make us confident in seeing 10Y OATs trading within the 75-85bp range vs Bunds in the medium-term (assuming a hung parliament), which is close to the median spread-to-Bund value for A-rated European sovereigns. **EU fragmentation fears are off the table for now, which suggests a low spillover to EUR FX in the medium term.**

Rising debt to GDP ratio in all scenarios ...



... to keep the bearish pressure on French bonds

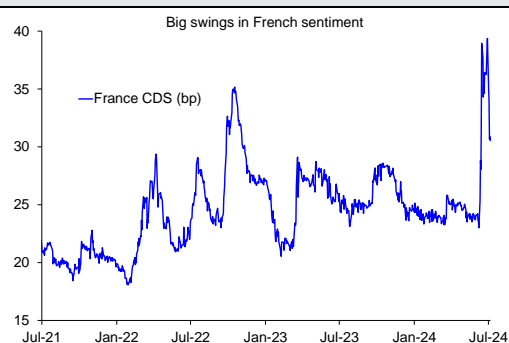


Source of all charts: Bloomberg; Baseline of the debt sustainability analysis: European Commission

EUR markets

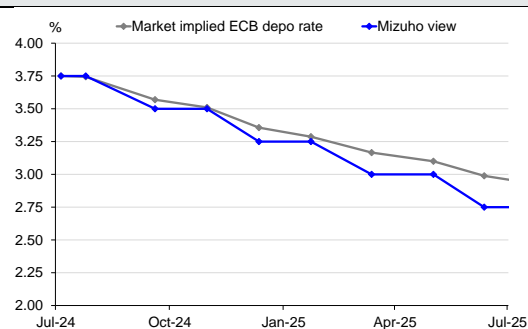
Macro – Downside risks from French developments likely to be small

- **PMI data imply a modest improvement in private sector activity vs Q1 but we expect growth to dip a little in Q2.** Our annual GDP forecasts for 2024 and 2025 are unchanged, but we see small downside risks at the eurozone level driven by higher French financing costs assuming a hung parliament. French GDP is ~20% of EZ GDP.
- The labour market remains tight, with unemployment remaining at the cycle low of 6.4% in May. Labour hoarding is easing, but nonetheless hits productivity, which keeps unemployment low and inflation high.
- Headline inflation is little changed since November. It sits at 2.5%YoY in June. Core inflation's decline has been steadier, and it sits at 2.9%YoY. **The rock-solid labour market remains a source of upside inflation risk for now.** Indeed, 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. We look for headline CPI growth to average 2.2% in 2024, ending the year close to target. By 2025, we see the post-Covid inflation surge as a thing of the past.



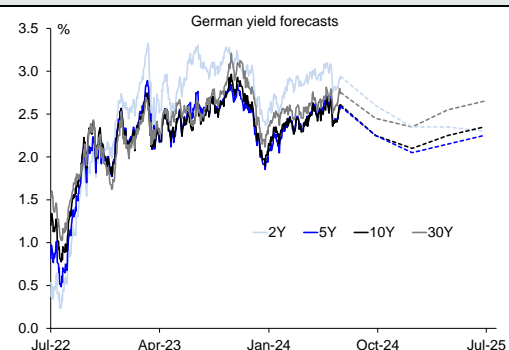
Policy – ECB easing underway but no rush

- The ECB cut the policy rate 25bp at the 6 June meeting. Recent commentary suggests that **the ECB is not yet fully convinced on inflation.** The firm labour market allows a gradual pace of easing.
- We expect that the **ECB will proceed slowly**, as inflation proves somewhat sticky, cutting rates at roughly 25bp/quarter. The ECB has started easing well after the economy bottomed out. The recovery is underway, and the labour market remains solid, which will limit how far the ECB can cut rates. We expect that the **easing cycle will terminate with the deposit rate around the 2.75% 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 changes are scheduled to start in September.** Recall that the partial stop to PEPP reinvestments will start in July.



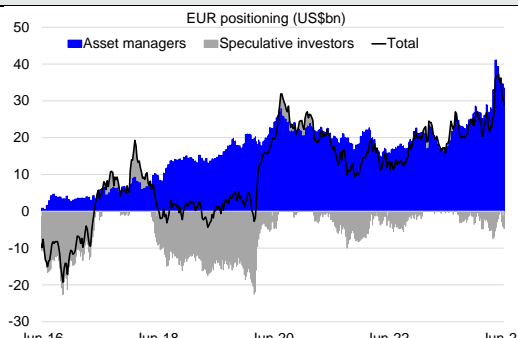
Rates – Summer rally if no upside surprises

- The call for French snap elections triggered a large risk-off move in EUR rates at the beginning of June that was later unwound as absolute majority government scenarios were seen as less likely. With 10Y Bund yields now back at the recent highs, **we expect European government bond yields to move lower into the autumn assuming the coming inflation data don't surprise to the upside.**
- While we think that the near-term direction for EUR rates is south, **we expect YoY changes in 10yr Bund yields to be modest.** 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.** That said, steepeners are very costly to put on in Bunds due to the negative carry, which is why we expect the **bull-steepening** theme to be more prevalent in higher-yielding EGBs (like BTPs) and in the swaps space.



FX – Muddling through

- Fr-exit is not on the agenda in the French elections. As such, its most likely that **French assets bear the brunt of any adjustments rather than the single currency.** Nonetheless, we suspect that the outcome will weigh somewhat on inflows into eurozone assets and push EUR a fraction lower relative to our previous forecasts.
- In the short run, we can see scope for EUR to nudge higher as the first Fed cut approaches. However, in the wake of the US election, we see the greenback enjoying a bounce as expectations of looser fiscal policy build, which in turn limit any further Fed easing even as the ECB continues to lower policy rates. Central banks appear to have retained their appetite for USD. **We see EUR/USD around 1.07 by Q2-25.**



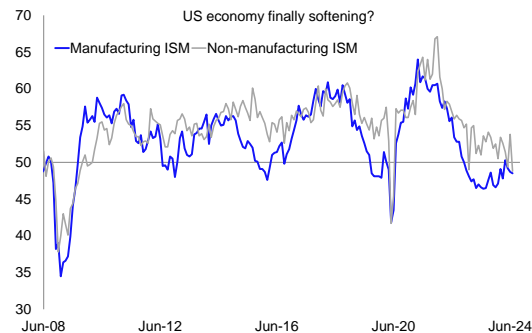
Basis – Tightening drivers still at play but likely put to the test in coming months

- June saw the first strong widening in EURUSD XCCY, driven by the French political backdrop. However, spreads have managed to recover and print new highs in the long end. **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 makes receiving positions more attractive.

USD markets

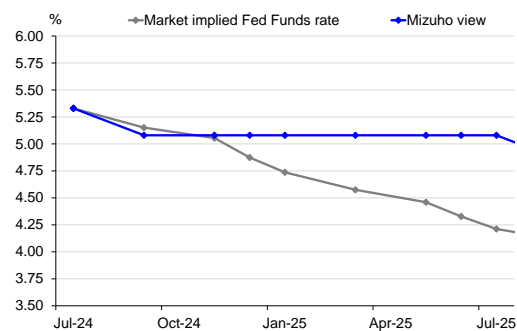
Macro – Prospects of loose fiscal policy buoy outlook

- Q1 GDP was a little soft in real terms, but private domestic sales were solid and nominal GDP growth was elevated, suggesting inflationary pressures remain firm. Our 2025 GDP forecast remains at 1.8%.
- Labour market data do not suggest much softening. The direction of travel is weaker, but there are question marks about the pace of the slowdown. **We see a mild drift higher for unemployment in coming quarters, but from a low starting point.** We see unemployment ~3.9% in 2024 and ~4.1% in 2025 as fiscal easing supports growth.
- Inflation risks in the US remain higher than elsewhere as growth remains above trend and there are bigger question marks about how tight policy really is. The productivity numbers look good but are susceptible to a slowdown in activity. There is a growing risk that Fed policy may not be tight enough to ensure inflation drops back towards 2.0% in a timely manner. **Our CPI forecasts are unchanged at 3.0% for 2024 and 2.7% 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.



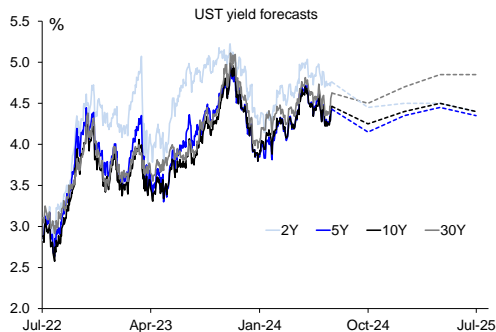
Policy – One bitten, twice shy?

- The Fed's June Dot Plot, which implied only one 25bp cut this year, followed by 4 in 2025, suggests that the Fed has learned its lesson after the premature signalling of rate cuts early in the year. The latest view is that more evidence of inflation's decline is required before easing. This rules out a rate cut in July, but we still see a September cut as likely, despite the proximity of the election – mainly as **the Fed has indicated that it wants to ease** rather than because the data demand action. We assume caution after the election as the Fed waits to see if there is large-scale fiscal easing which alters the outlook.
- 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.**



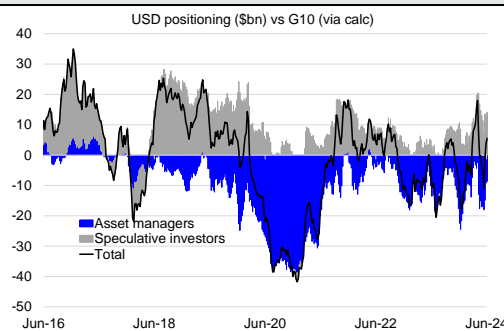
Rates – Steepening is the way to go

- Since the last US Presidential debate, the UST curve has been bear-steepening in anticipation of a Trump victory and the accompanying risks of higher spending and rising inflationary pressures. **While we think that steepening is the way USD rates will move, we think the market may be overreacting given the time until the election.**
- Signs of a softer US economy continue to appear, which is supporting USTs. The Fed is still keen to cut. **We expect USTs to continue to rally in Q3-24, which is when we expect we'll see the first cut. The belly of the curve should be especially supported.**
- **The resilience of the US economy will cap how much USTs can rally.** We expect the steepening theme to gain traction via the inflation risk premium channel. **An economy growing at trend and expectations of looser fiscal policy should see term premia being priced into the UST curve.**



FX – Mixed prospects

- As the US election took centre stage in the wake of the first presidential debate and the recent supreme court ruling, the greenback firmed. Both events seemed to boost Trump's chances of winning. **This seems to confirm our expectation that the initial reaction to a Trump victory in November would be a firmer US dollar, driven by looser fiscal policy.** With limited spare capacity, this will soon show up as higher inflation. This should limit Fed cuts, lifting the US dollar. However, eventually this fiscal largesse will boost the US twin deficits and should be less USD supportive. The greenback is already rich by most metrics limiting significant further upside.
- **However, ahead of election we expect a Fed rate cut in the autumn, which we expect to soften the greenback a little.**



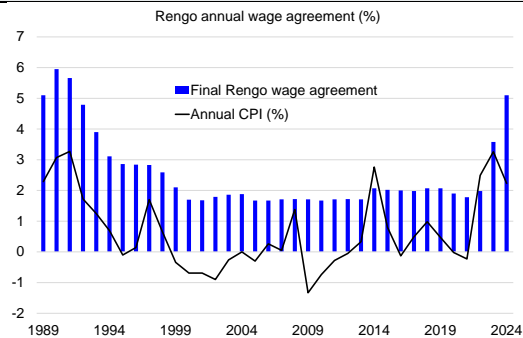
Basis – Risks to the cheaper USD funding view rising

- During June, front-end XCCY basis pairs have been widening off the tights. **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 the latter part of 2024** on the back of a slowdown in Yankee issuance, US and European election risks, and fewer cuts from the Fed vs what the market is expecting.

JPY markets

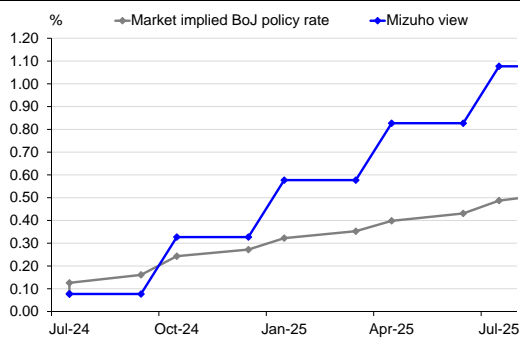
Macro – 2024 GDP to contract but outlook upbeat

- The recent downward revision to Q1 GDP means we now 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 impact of the ongoing yen weakness implies marginally higher CPI, meaning a slightly slower decline towards the 2% target. We see headline CPI remaining above 2.0% through mid-2025, before easing below 2.0%. 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.



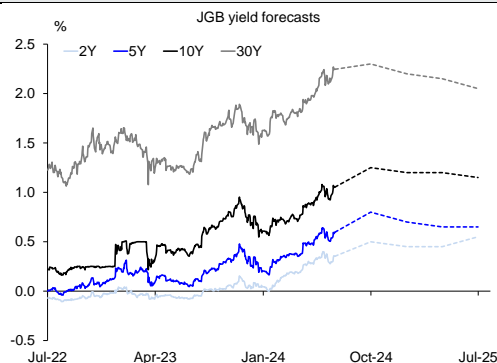
Policy – Rinban cut, then rate hike

- Whilst the large fall in Q1 GDP seems like an inauspicious backdrop for tighter policy, the fact that much of the decline was driven by one-off factors means that **BoJ tightening is likely to go ahead, given expectations that GDP will be positive in coming quarters.** We expect the BoJ will start reducing Rinban operations in July, most likely by ~¥1trn initially and then more gradually as the year progresses. In July, we look for the BoJ's FY24 GDP forecast to be revised lower. The FY24 CPI forecast may be revised higher due to the weak yen.
- By October, the BoJ will have been able to confirm the rebound in activity in the Q2 GDP data and should be looking at firmer real wage growth too. Consequently, it should be in a position to hike rates by 25bp. The risks are that the weak yen forces the BoJ into an earlier hike/more aggressive Rinban reductions. **We look for one additional 25bp hike before end FY24. In FY25, we see the policy rate topping out around 0.75%~1.00%.**



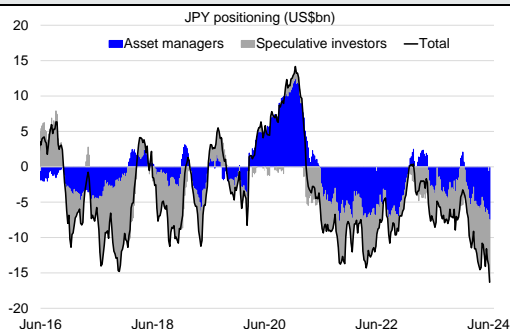
Rates – Upside in the front-end capped for now

- The bearish pressure in JPY rates continued in June despite the disappointing June MPM. 1y1y is currently trading around 60bp. **Given the slowdown in economic growth, we think the upside in 1y1y (and front-end rates more generally) is capped.**
- We expect to see a ¥1tn reduction in the monthly JGB purchase amount in July, focused on the 3-5yr and 5-10yr buckets, which should drive the steepening into the 10yr sector.** Subsequent reductions will likely be in the region of ¥250bn/quarter.
- Japanese domestic investors remain on the sidelines with regards to buying long-term JGBs. We think they may wait for 30yr yields to test 2.30% before buying. **The 10x30s flattening theme will need to wait until there's more clarity on the BoJ's reaction function.**



FX – Back in the intervention zone

- Over the past month, USD/JPY has hovered around the 160 level that MoF first intervened at. USD/JPY remains close to the intervention zone, although **we believe the pair would likely need to push higher still to force MoF back into the market.**
- The BoJ's hiking cycle is now underway, which has helped narrow the 2yr yield spread vs USTs. USD/JPY seems to be ignoring moves in JPY rates, focusing mainly on the UST side. We expect that the BoJ will hike multiple times in the coming year, pushing 2yr JGB yields higher, while mild Fed cuts will lower UST yields. This narrower yield spread should ease some of the upward pressure on USD/JPY, allowing a drift down to the 145 level on a 12m horizon. Short JPY positioning remains elevated, and the yen is cheap on almost all metrics.



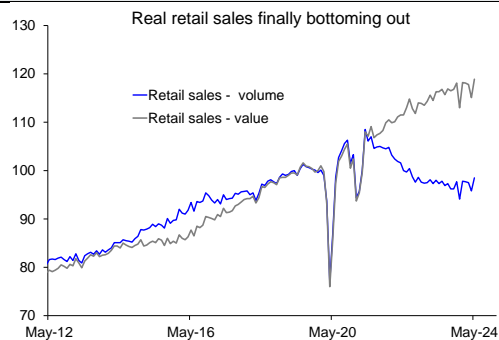
Basis – Tightening is the way to go

- The French related risk-off, the disappointing June BoJ MPM, USDJPY spot grinding higher, and domestic funding needs around quarter end saw USDJPY XCCY spreads widen in June. However, 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.**

GBP markets

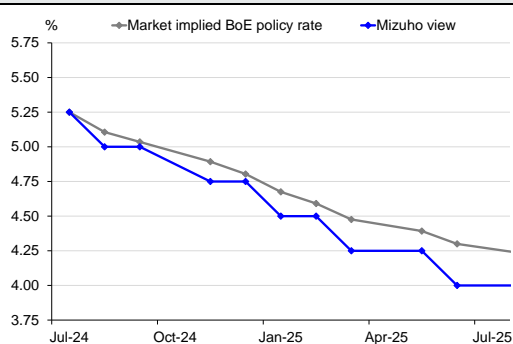
Macro – Activity looking solid, higher CPI in H2

- Our GDP forecasts remain unchanged at 0.8% for 2024 and 1.4% for 2025. Recent data have been a little mixed, but we still see the recovery as on track. Retail sales for May were strong but some of the housing data have looked a little soft. The services PMI dipped in June, but that seems partially related to uncertainty ahead of the election.
- Inflation declined in May to 2.0%YoY but services CPI remained 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.



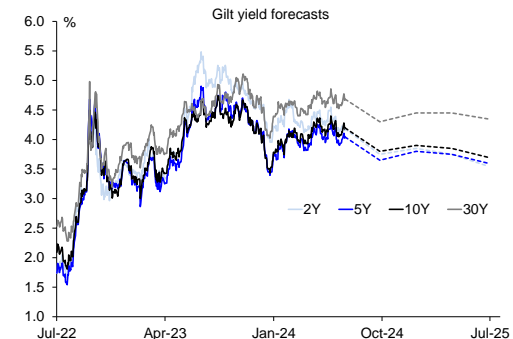
Policy – BoE to kick off easing cycle in August

- In the midst of the election campaign, the June BoE meeting was a wash – policy was left unchanged, as was the 7-2 vote. It was Broadbent’s last meeting. We haven’t heard from the BoE since the election was called. Post-election commentary will be closely watched. Our current reading is that Bailey will vote for a cut in August, alongside Breeden and new member Lombardelli, giving a majority for a 25bp cut. **We see the BoE reducing rates again in November and continuing to cut 25bp/quarter in H1-25 as well.**
- Governor Bailey recently noted he sees reserves in a £345-500bn range (although 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 end active QT in the September review.**



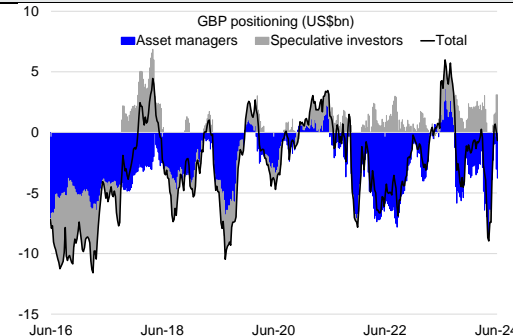
Rates – Buy the dip, but remain cautious about H2-24

- June was a good month for Gilts, with investors coming in to buy as 10Y Gilt yields approached the 4.40% handle. We expect this theme – buying the dip – to continue in UK rates. Financial conditions remain tight in the UK, the BoE is also draining a lot of liquidity out of the system, wages are decelerating, and headline CPI is close to target. Additionally, **Gilts are usually higher beta compared to USTs and we think the market is underestimating future BoE cuts.**
- That said, inflation progress looks less promising in H2-24, which suggests that **the bullish momentum in UK rates may stall around the end of the year.**
- The new government will likely see GDP growth expectations rise, which will help to build term premia in the long end of the curve.



FX – Politically-stable safe haven

- The election results have been priced in ahead of time. We do not see the Labour Party as GBP negative. If anything, it may be more willing to push harder to mend the relationship with the EU. Given its lack of baggage, it has a reasonable chance of success, although gains will be small. Stability will be a plus for GBP in a politically unstable world.
- We continue to see the BoE (-50bp) cutting less and later than the ECB (-75bp) this year, but a little earlier and a little more than the Fed (-25bp). **Relative market pricing is a slight negative for cable, but sterling’s valuation continues to look somewhat cheap, and positioning looks neutral.**
- **We see GBP/USD at 1.34 and EUR/GBP at 0.80 by end Q2-25.**



Basis – Normalisation of the curve pending

- **GBPUSD XCCY also experienced the French-related risk-off widening, which has helped the front end of the curve normalise after reaching 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 4 July)

FX forecasts	Current	End-Q3 24	End-Q4 24	End-Q1 25	End-Q2 25
USD/JPY	161	158	154	150	145
EUR/USD	1.08	1.10	1.09	1.08	1.07
GBP/USD	1.28	1.29	1.32	1.33	1.34
EUR/GBP	0.85	0.85	0.83	0.81	0.80
EUR/JPY	174	174	168	162	155
GBP/JPY	206	204	203	200	194
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	5.00~5.25	5.00~5.25	5.00~5.25
2yr	4.71	4.45	4.50	4.50	4.40
5yr	4.33	4.15	4.35	4.45	4.35
10yr	4.36	4.25	4.40	4.50	4.40
30yr	4.53	4.50	4.70	4.85	4.85
Eurozone/Bund					
Deposit rate	3.75	3.50	3.25	3.00	2.75
2yr	2.94	2.60	2.35	2.35	2.30
5yr	2.59	2.25	2.05	2.15	2.25
10yr	2.61	2.25	2.10	2.25	2.35
30yr	2.75	2.45	2.35	2.55	2.65
Japan					
Policy rate	0.00~0.10	0.00~0.10	0.25~0.35	0.50~0.60	0.75~0.85
2yr	0.34	0.50	0.45	0.45	0.55
5yr	0.58	0.80	0.70	0.65	0.65
10yr	1.08	1.25	1.20	1.20	1.15
30yr	2.27	2.30	2.20	2.15	2.05
United Kingdom					
Policy rate	5.25	5.00	4.75	4.50	4.25
2yr	4.18	3.75	3.85	3.75	3.55
5yr	4.04	3.65	3.80	3.75	3.60
10yr	4.20	3.80	3.90	3.85	3.70
30yr	4.68	4.30	4.45	4.45	4.35
Macro forecasts (%)	2023		2024		2025
United states					
Real GDP	2.5		2.2		1.8
CPI	4.1		3.0		2.7
Unemployment rate	3.6		3.9		4.1
Eurozone					
Real GDP	0.4		0.5		1.0
CPI	5.5		2.2		2.0
Unemployment rate	6.6		6.5		6.6
Japan					
Real GDP	1.9		-0.1		1.0
CPI	3.3		2.5		1.9
Unemployment rate	2.6		2.5		2.4
United Kingdom					
Real GDP	0.1		0.8		1.4
CPI	7.4		2.5		2.0
Unemployment rate	4.0		4.2		4.5

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

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