Mizuho EMEA G4 Forecast Update

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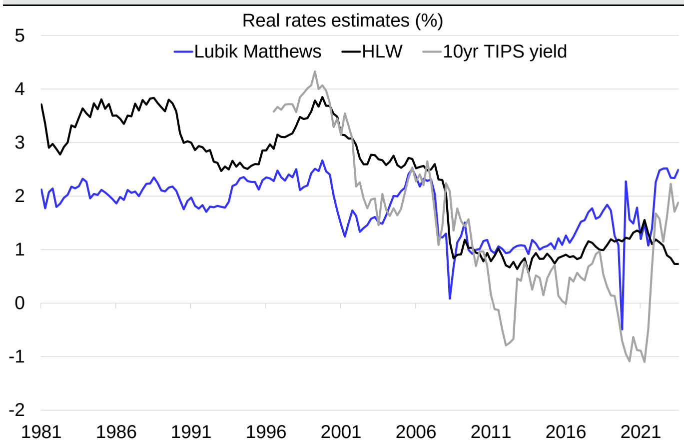
Policy easing – How low, How slow?

For most of the year we have been in the "Lower, slower" camp regarding central bank policy rates. A lot of rate cuts have been priced out since the start of the year and now **we are broadly in agreement with current market pricing through year end**, give or take 10~15bp or so. However, now that the easing cycle looks set to get underway in coming months, the question of "How low, how slow?" is becoming increasingly pertinent.

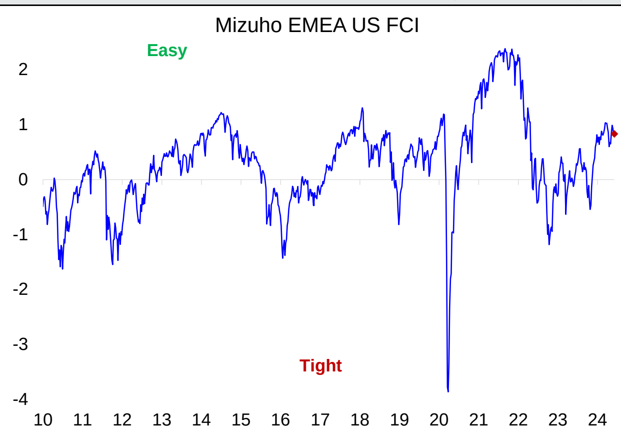
As thoughts turn to easing policy, the notion of the neutral rate is on the minds of both central bankers and investors. **How much easing is required depends to some extent on how tight policy currently is.** Economists use the notion of the neutral rate to judge the stance of policy. The neutral rate is the rate of interest which neither stimulates nor restrains activity, which sees the economy operate at potential. Alas, the neutral rate, like potential growth and the output gap, is highly contentious. It's a useful concept in theory, but much less so in practice. It is not directly observable. There are different methods of calculating what it might be, but these all throw out different results. Indeed, it was only recently that the ECB said that it was not especially useful for day-to-day policy making**. Whilst uncertainty is always with us, it does seem as if for central bankers it is elevated with many of the developments since the start of the Covid crisis potentially impacting neutral rates.** The volatility of the supply side over the past four years has been especially challenging for central banks. In addition, they must estimate how the demand for investment spending to fund the energy transition, the need for additional defence spending and the re-working of supply chains as the world splits into trading blocs impacts the supply of and demand for funds. A recent report OMFIF noted that ~80% of central banks felt that real equilibrium interest rates would be higher than pre-pandemic levels.

We think that central banks will ease slowly and not especially aggressively. This easing cycle will be very different from recent easing cycles. The rapid easing in policy was driven by financial stress in 1999/2000, again in 2008/9 and by a collapse in activity during the pandemic. The coming cycle will more likely resemble that of the early 1980s. Recall that, under Volcker, the Fed eased too early and had to push rates higher again before finally bring inflation under control. **The fact that labour markets are still solid implies no rush to ease and hints at upside inflation risks given the usual linkages between labour markets and service prices, which remain elevated almost everywhere.** With limited clarity on where neutral is, central bankers will likely use the rear-view mirror a little more to steer policy. This involves acting, observing the impact for a while, and then moving again. **How low, how slow? We expect limited cuts to unfold only gradually.**

Elevated uncertainty on neutral rates …



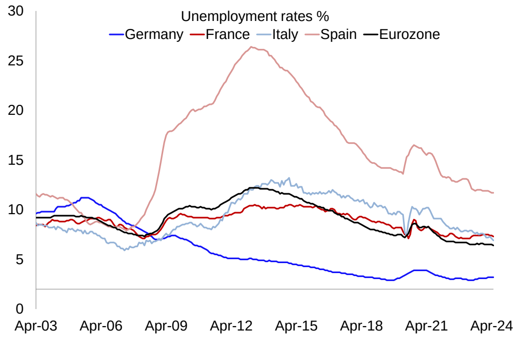
… with conditions loose despite "tight" policy



Source of all charts: Bloomberg

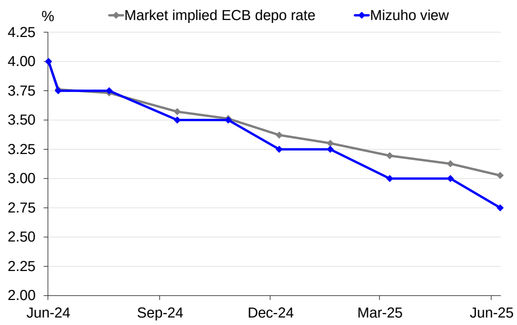
EUR markets

Macro – On the mend. Inflation to resume dip in H2-24



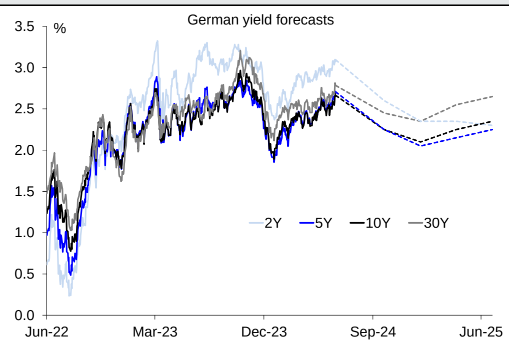
- **Eurozone Q1 GDP rose 0.3%QoQ. The PMI data imply a mild improvement in private sector activity**. Our annual GDP forecasts for 2024 and 2025 are unchanged at 0.5% and 1.0%, respectively.
- **Despite the prolonged period of below-trend growth,** the labour market remains tight, with the unemployment rate dipping further in April to a new low of 6.4%. We again revise down our 2024 unemployment forecast to 6.5% (-0.1pp). Labour hoarding is hitting productivity, which will keep unemployment lower and inflation higher.
- Headline inflation is little changed since November. It sits at 2.6%YoY in April. 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 to start a gentle easing cycle in June



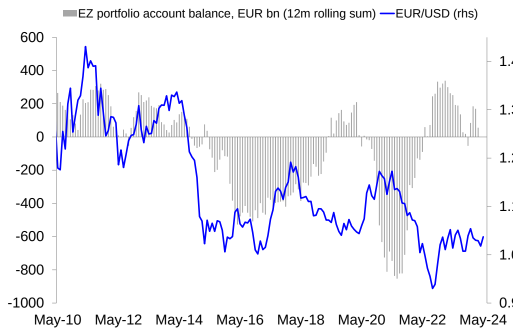
- The ECB is almost certain to cut 25bp at the 6 June meeting but there is little consensus about the timing of any subsequent moves. President Lagarde is not likely to commit to future action in the press conference. We see limited changes in the ECB's forecasts in June.
- We expect that the ECB will proceed to ease slowly, as inflation proves somewhat sticky, cutting rates at roughly 25bp/quarter. The ECB will begin easing well after the economy has 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



- EUR government bond yields continued to move higher in May, on the back of improving European macro data. The lack of progress on the inflation front and the data-dependent approach from the ECB are probably discouraging investors from buying the dips in EUR rates. We think the selloff is now overdone and look for European government bond yields to move lower into the summer.
- **While we think that the direction for EUR rates is south in the summer, we expect YoY changes in 10yr Bund yields to be modest**. The lack of a recession means 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



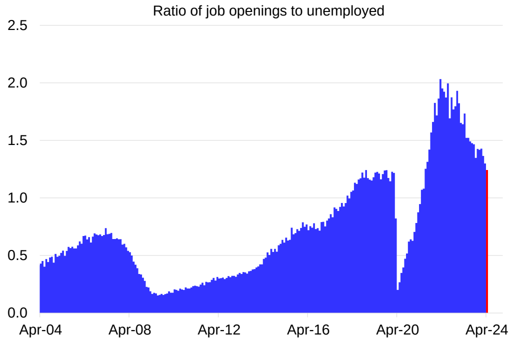
- The eurozone Q1 GDP data possibly mark the start of the recovery in the expectations gap vs the US. Granted, some of the narrowing in growth going forward will be driven by policy easing faster in the eurozone vs the US, which in turn limits interest rate support for EUR. **We see EUR/USD as choppy in coming months**. In the run-up to the FOMC cut in autumn, we see scope for mild USD softness vs EUR. We see EUR trending lower vs GBP on a 12-month horizon.
- 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 as the ECB continues to ease.
- **We see EUR/USD around 1.08 by Q2-25**.

Basis – Tightening drivers still at play but likely put to the test in H2-24

- Abundant USD liquidity and cheaper USD funding themes have driven the EURUSD XCCY basis towards new cycle highs, especially in the front end. Reverse Yankees haven't impacted the basis much. **Some tightening drivers are still at play** (like healthy dollar liquidity), **but the lack of a future liquidity squeeze from the ECB, how much the basis has tightened YTD and a more dovish ECB vs Fed makes receiving positions more attractive**.

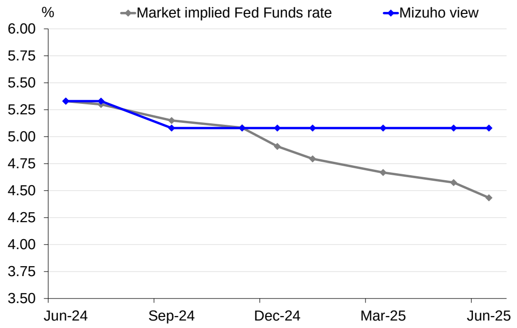
USD markets

Macro – Prospects of loose fiscal policy buoy outlook



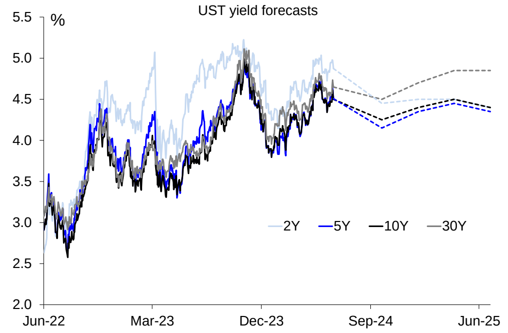
- Q1 GDP was a little soft in real terms, but private domestic sales were solid and nominal GDP growth was elevated, suggesting inflationary pressures remain high. Our 2025 GDP forecast is now 1.8% (+0.2pp)
- Labour market data do not suggest much softening. The direction of travel is weaker, but there 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 ~4.0% 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 2024 CPI forecast is now at 3.0% (+0.5pp) and our 2025 CPI forecast is 2.7% (+0.2pp).** Firmer growth/wider positive output gap, loose financial conditions, expansionary fiscal policy and the solid labour market mean the risks for the CPI are elevated.

Policy – Fed happy to run upside inflation risks



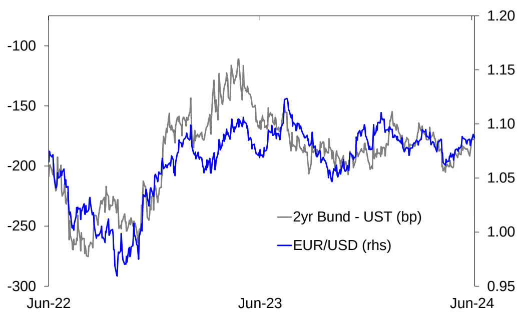
- The recent core PCE print for April showed a marginal improvement vs the prints for Q1. Nonetheless, inflation pressures in the US remain elevated, yet the Fed remains in dovish mode and is clearly most sensitive to downside labour market risks. That said, there seems to be plenty of patience, as well as an acknowledgment that the neutral rate is likely higher. **We can see the Fed squeezing in one cut in coming months, but in the wake of the election and potential loosening of fiscal policy, we expect the Fed to remain on hold for a prolonged period whilst it assesses the inflationary implications**.
- The pace at which the Fed's balance sheet is shrinking is now slowing. The monthly cap on USTs rolling off was reduced from $60bn to $25bn at the start of June. The cap on MBS remained in place. This suggests less pressure for long-end UST yields.

Rates – Capped downside in UST yields



- Signs of a softer US economy are starting to appear, which is helping USTs find a bid and likely behind the flattening seen in 2x5s. The Fed is still keen to cut, although less than initially expected. **We expect USTs to rally into Q3-24, which is when we expect the first cut, especially in the belly of the curve**. Until then, we see USTs consolidating in current ranges on the back of slow progress on the inflation and labour market fronts.
- That said, we think that **the resilience of the US economy will cap how much USTs can rally in the next 12 months.** We expect the steepening theme to gain traction in the coming quarters, especially 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. 2025 should see higher long-term UST yields.**

FX – Mixed prospects



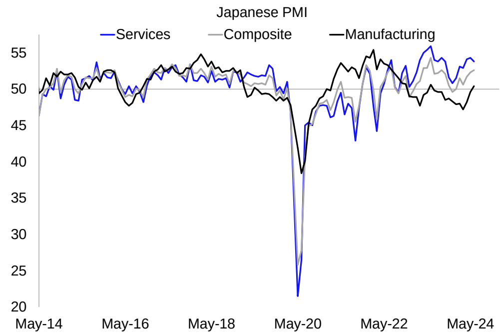
- Both asset managers and speculative investors have taken profits on long USD positions this month. This, combined with some softer data, has weighed on the greenback. **We see mild upside for USD in the near term given our relative near-term policy forecasts, but any upside should be limited**.
- As a potential US rate cut comes into view in the autumn, the greenback may soften a little.
- In the wake of the US election, we see looser fiscal policy boosting US growth, but with limited spare capacity, this will soon show up as higher inflation. Initially, we see this as limiting Fed cuts and lifting the US dollar. However, eventually this fiscal largesse will boost the US twin deficits and should be less USD supportive.

Basis – Cheap dollar funding driving XCCY markets

- Despite a strong US macro backdrop, borrowing dollars has not become more expensive. We expect **the lower dollar premium theme to remain in the near term**, which would continue to 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, ongoing interest to own USD credit, continued US macro resilience, fewer cuts from the Fed and US election risks.

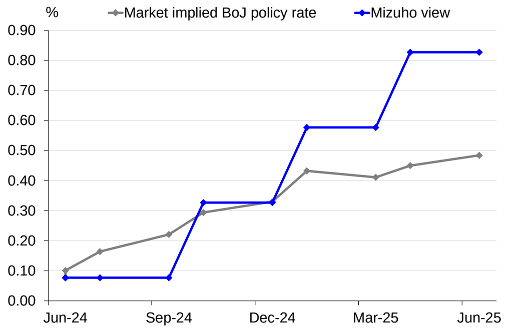
JPY markets

Macro – One-off factors drive weak start to 2024



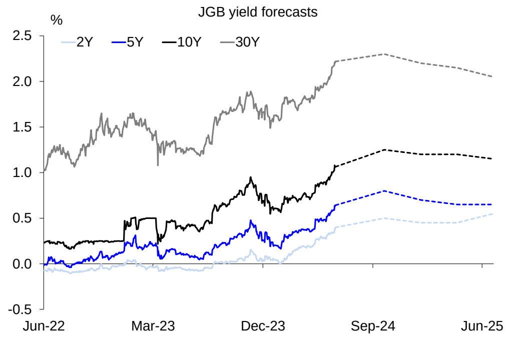
- Q1 GDP was weak, falling 0.6%QoQ, dragged lower by the auto sector, the early January quake and by a reversal of Q4's gain in services exports. Even though we see a decent rebound in Q2, we revise down our annual 2024 GDP forecast to 0.0% from 0.3% previously. **The 2025 pick up in activity will be 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.
- 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 sharp pick up in growth in 2025, driven by consumer spending.

Policy – Rinban decline signalling tighter policy



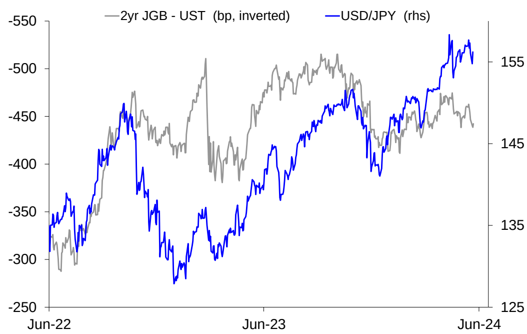
- **BoJ dismantled its YCC with QQE framework and exited negative rates in March**. The overnight call rate has been designated as the short-term policy rate and sits in a 0.0~0.1% range. Governor Ueda remains cautious and the focus is on Rinban, which we believe the BoJ is using to signal tighter policy in the hope of stemming JPY depreciation. More declines in Rinban ops are likely this year. We see the next rate hike in October, but the risks are earlier rather than later.
- In the wake of the April forecasts, the BoJ's ex fresh food and energy CPI forecast for FY26 now sits at 2.1%. **That said, BoJ rhetoric still suggests some residual ongoing caution with regard to hitting the inflation target**. The weak yen is weighing on consumer confidence and there is a widespread feeling that the currency is too weak. Would a hike under these circumstances boost economic sentiment? **We look for the policy rate to hit 0.50% by end Q1-25 and move modestly higher later in 2025, topping out around 0.75%~1.00%.**

Rates – Upside pressure in JGB yields to continue



- JPY rates continue to move relentlessly higher despite slightly softer economic data. With the BoJ having signalled the start of a new era of monetary policy, we expect upside pressure in JGB yields will remain for now. **We still like to tactically sell rallies**.
- The next reduction in Rinban purchases is likely around the corner. We expect to see reductions in the 3-5yr and 5-10yr buckets, which should drive the steepening into the 10yr sector.
- Japanese domestic investors still remain on the sidelines with regards to buying long-term JGBs despite the more attractive yields. We think they may wait for 30yr yields to test 2.30% before buying or buy 20yr JGBs instead. **The 10x30s flattening theme will need to wait until there's more clarity on the BoJ's reaction function.**

FX – JPY hovering below the intervention zone. JPY prospects better further out.



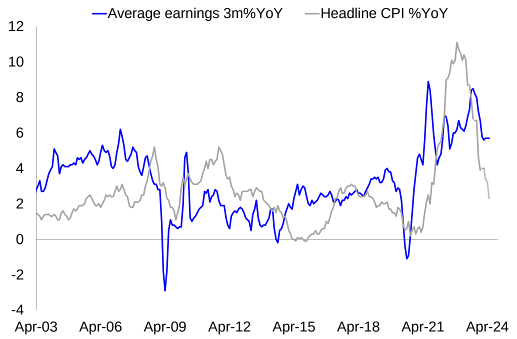
- Over the past month, USD/JPY has hovered below the 160 level that MoF first intervened at, but not far below. USD/JPY remains close to the intervention zone, although **we believe the pair would likely need to make fresh highs to force MoF back into the market**.
- The BoJ's hiking cycle is now underway, 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 75bp in the coming 12 months, 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 142 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 USDJPY XCCY basis has already tightened a significant amount YTD. We still see several drivers that should support a tighter USDJPY XCCY basis 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. BoJ action later in the year should be another support.

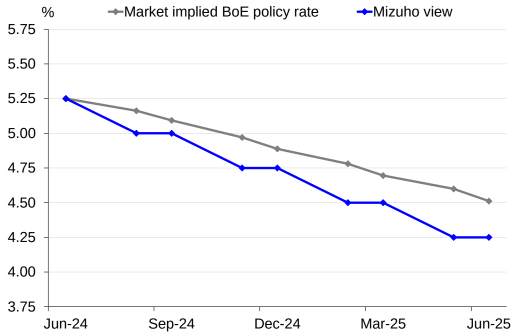
GBP markets

Macro – Activity looking better



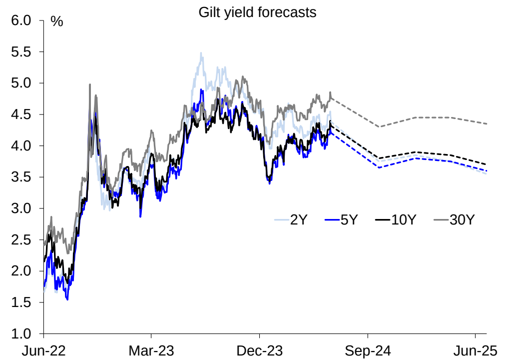
- Q1 GDP showed the UK economy expanding a better-than-expected 0.6%QoQ. We revise up our 2024 GDP forecast from 0.6% to 0.8%.
- Inflation declined in April to just 2.3%YoY but services CPI remained elevated at 5.9%YoY. **A drop below 2.0% now seems less likely, despite a further decline in the retail energy price cap in July.** 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.
- We expect a clear **Labour majority at the upcoming election**, but do not see any significant loosening of fiscal policy in the wake of the poll. We see a mild pick up in spending at worst, as the new government mainly sticks to the current government's spending 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



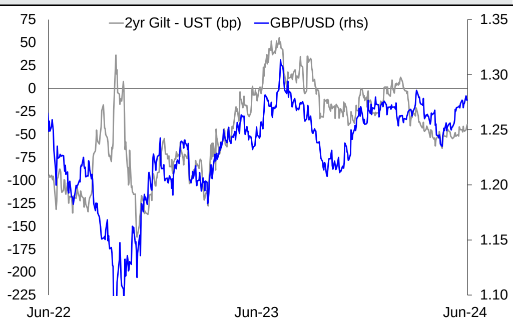
- The BoE left policy unchanged in May. Ramsden shifted into the dovish camp, leaving the vote skew dovish at 2-7. The May meeting saw the CPI revised lower to 1.6% on a 3yr horizon, revealing an easing bias. It's a question of "How low, how slow?"
- **With the June BoE meeting coming in the middle of the election campaign and the recent CPI data disappointing, we continue to see the first cut coming in August with another in November.**
- The £100bn pace of QT has not delivered any upward pressure on yields. The APF currently sits at ~£701bn. 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



- Financial conditions remain tight in the UK. The BoE is also draining a lot of liquidity out of the system. With headline CPI now close to target, **we expect investors to continue to buy the dip**, **especially given that Gilts are usually higher beta compared to USTs and our view that the BoE may out-cut the market.** 4.40% remains the resistance for 10Y Gilt yields.
- 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 front end should outperform as rate cuts become a higher probability scenario, which is why **we like to add steepening exposure on any strong flattening**.

FX – Downside risks dissipating



- 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). GBP positioning has recovered sharply in recent weeks, especially for asset managers. Positioning now looks neutral in our view. **Relative market pricing is a slight negative for cable, but sterling's valuation continues to look somewhat cheap**.
- The Labour Party will win the election; we do not see this as especially GBP negative. If anything, the Labour Party may be more willing to push harder to mend the relationship with the EU. Given its lack of baggage, it will likely be more successful than the current government.
- **We see GBP/USD at 1.34 and EUR/GBP at 0.81 by end Q2-25**.

Basis – Normalisation of the curve overdue

- **The front end of the GBPUSD XCCY basis curve has been able to tighten notably, with 3M-1Y spreads turning positive on the back of the ongoing BoE's liquidity squeeze. 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**.

Mizuho EMEA Forecasts (as of 4 June)

FX forecasts	Current	End-Q3 24	End-Q4 24	End-Q1 25	End-Q2 25
USD/JPY	155	150	145	142	140
EUR/USD	1.09	1.11	1.10	1.09	1.08
GBP/USD	1.28	1.29	1.32	1.33	1.34
EUR/GBP	0.85	0.86	0.83	0.82	0.81
EUR/JPY	169	167	160	155	151
GBP/JPY	198	194	191	189	188

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	4.77	4.45	4.50	4.50	4.40
5yr	4.35	4.15	4.35	4.45	4.35
10yr	4.33	4.25	4.40	4.50	4.40
30yr	4.47	4.50	4.70	4.85	4.85
Eurozone/Bund					
Deposit rate	4.00	3.50	3.25	3.00	2.75
2yr	2.99	2.60	2.35	2.35	2.30
5yr	2.57	2.25	2.05	2.15	2.25
10yr	2.53	2.25	2.10	2.25	2.35
30yr	2.68	2.45	2.35	2.55	2.65
Japan					
Policy rate	0.00~0.10	0.25~0.35	0.25~0.35	0.50~0.60	0.75~0.85
2yr	0.38	0.50	0.45	0.45	0.55
5yr	0.60	0.80	0.70	0.65	0.65
10yr	1.03	1.25	1.20	1.20	1.15
30yr	2.20	2.30	2.20	2.15	2.05
United Kingdom					
Policy rate	5.25	5.00	4.75	4.50	4.25
2yr	4.34	3.75	3.85	3.75	3.55
5yr	4.08	3.65	3.80	3.75	3.60
10yr	4.18	3.80	3.90	3.85	3.70
30yr	4.61	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	4.0
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	0.0	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.