Mizuho EMEA G4 Forecast Update

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MIZUHO

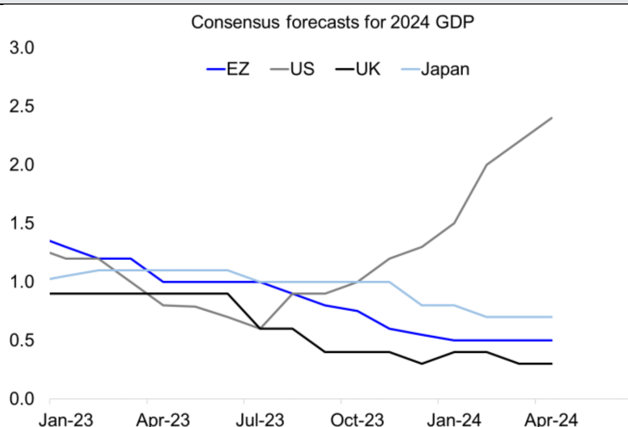
US exceptionalism

The US economy has outperformed expectations significantly over the past few quarters, despite interest rates being at their highest for almost 2 decades. The long-awaited recession is nowhere to be seen. The consensus forecast for 2024 GDP growth is now a slightly-above trend 2.4%. Since end 2019, US GDP has averaged 2.1% – more or less trend – despite the pandemic. This performance is remarkable. We attribute this to multiple factors. The US turned into a net energy exporter just ahead of the energy crisis sparked by the Russian invasion of Ukraine. In addition, the US looks to have established a lead in a few key technologies just as they were on the cusp of widespread adoption. In its recent Economic Outlook, the OECD looked at innovation. The US was generally better than average but didn't really stand out. Perhaps the US is just better at commercialising its innovations. Last, but by no means least, US fiscal policy has been significantly looser than elsewhere and is set to remain so. **For us, fiscal developments are the driving factor behind US economic outperformance over the last decade**.

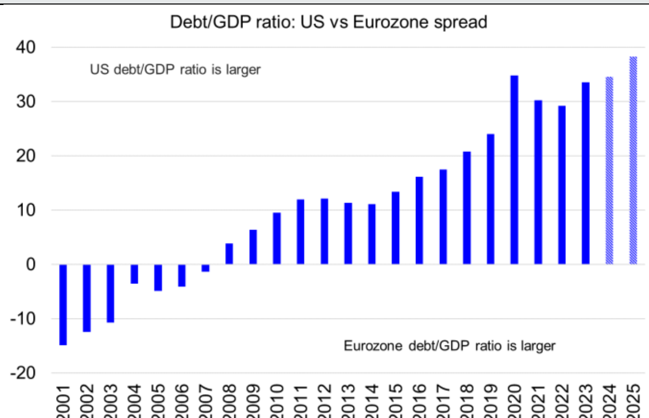
Most developed markets are expecting to see some fiscal consolidation in the next few years after spending heavily to support economies through Covid. This is not the case in the US. Fiscal policy was very loose in the four years up to Covid and is expected to remain loose well beyond Covid too. The OECD (on the basis of existing policy, as official forecasts usually are) forecasts that the US deficit will be 7.6% of GDP in 2024 and roughly the same in 2025. In contrast, the eurozone deficit drops to 2.9% in 2024 and to just 2.3% of GDP in 2025, ~1/3 the size of the US deficit. Indeed, **it is possible that US fiscal policy loosens further in the wake of the election should one party win a clean sweep**. Furthermore, it is almost guaranteed that the Trump tax cuts, due to expire in 2025, will in some way be extended regardless of who is in power. US politics make fiscal policy difficult, as Fitch noted when it downgraded the US credit rating in August 2023. There seems to be a special difficulty in raising taxes, which is arguably necessary. As the chart below right illustrates, outstanding US debt as a percentage of GDP has risen almost 50pp more over the last quarter of a century vs the Eurozone – almost 2 percentage points per year. **If US deficits of 7% are the new normal, then perhaps the new neutral policy rate may be ~5% as tight monetary policy needs to compensate for loose fiscal policy.**

Loose fiscal and tight monetary policy has long been seen as a benign backdrop for currencies. Indeed, the US dollar is among the world's best performing currencies since 2016, when US fiscal policy loosened significantly. This is especially the case in a "lowflation world". **However, in an inflationary world, the policy combination may be less supportive of a firm currency, especially if financial markets become concerned about debt levels**.

US growth outperforming G4 peers …



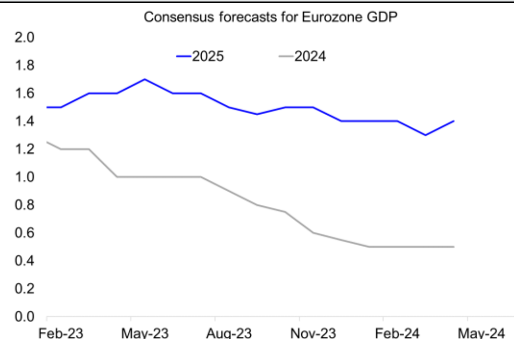
… sustained by ongoing fiscal expansion



Source of all charts: Bloomberg

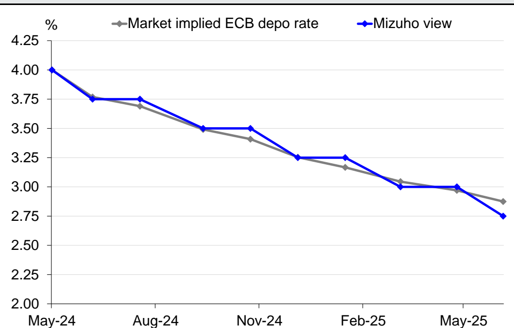
EUR markets

Macro – On the mend



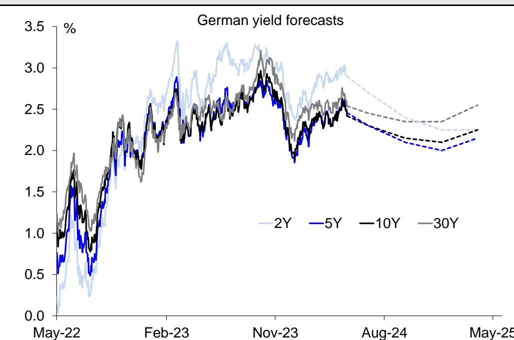
- **Eurozone activity looks much more perky in recent weeks, as the 0.3%QoQ Q1 GDP jump confirmed the exit from the H2-23 recession and the PMI data imply acceleration into Q2.** We suspect we will see some payback in Q2 GDP, but we revise up our 2024 GDP forecast from 0.1% to 0.5% in the wake of the Q1 data.
- **Despite the prolonged period of below-trend growth,** the labour market remains tight, with the unemployment rate still at the cycle low of 6.5% in March. Labour hoarding is hitting productivity, which in turn will keep unemployment lower and inflation higher.
- Headline inflation has been volatile and sits at 2.4%YoY in April. Core inflation is coming down more slowly and sits at 2.7%YoY. **The 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 on track for June to start the easing cycle



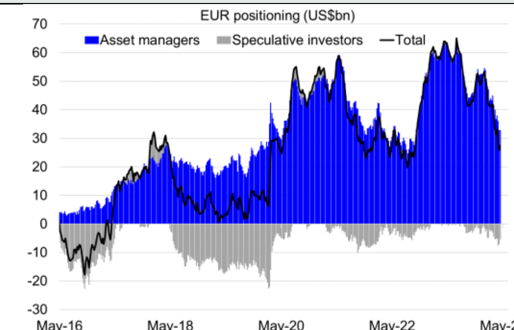
- The ECB left policy rates unchanged in March. It marginally downgraded its GDP outlook for 2024 from 0.8% to 0.6%, alongside lower CPI forecasts (2024: 2.3% vs 2.7% prev, 2025: 2.0% vs 2.1%). There was also less concern over inflation risks such as Red Sea disruptions. These softer forecasts provide the backdrop for a softer tone on the policy outlook. President Lagarde hinted that the first move will come in June. Subsequent to the meeting, some of the doves tried to garner support for cuts in both June and July. Lagarde has pushed back on this view, noting that the ECB is data dependent and does not pre-commit. We see weaker activity than the ECB and expect 3 cuts to be delivered over the balance of the year, in June, September and December. The eurozone outlook is weak and as such the risks for policy remain on the low side vs our forecasts.
- 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.

Rates – Buy the dip into the first ECB cut



- EUR government bond yields moved higher in April, mostly driven by moves in USD rates. Rates vol has seen large swings, likely discouraging investors from buyint the dips in EUR rates in April. We think that European government bond yields will be moving lower in Q2-24 as the ECB delivers their first cut. Inflation progress will likely be bumpy in the coming months, but we don’t think it will stall enough to derail the June cut.
- **While we think that the direction for EUR rates is south in Q2, 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 expect some build-up in term premia, driven by a recovering economy.** 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 happen in higher-yielding EGBs (like BTPs) and in the swaps space.**

FX – Dip near term, better prospects for Q3



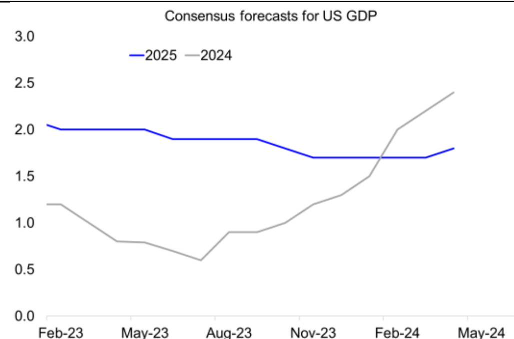
- The US economy and expectations for the US economy have outperformed those in the eurozone a lot since the start of the year. The eurozone Q1 GDP data possibly mark the start of the eurozone recovery as the expectations gap peaks. Granted, some of the narrowing in growth going forward will be driven by policy easing faster in the eurozone vs the US, which in turn limits interest rate support for EUR. In the short run, we think USD has some momentum, with a softer period in Q3 as growth elsewhere catches up and US thinks about rate cuts. In the wake of the US election, we see the greenback enjoying a bounce as expectations of looser fiscal policy build.
- **We see EUR/USD around 1.09 by Q1-25.**

Basis – Tightening momentum fading

- The tightening in the EURUSD XCCY basis is showing signs of exhaustion. Seasonality suggests that there will be plenty of reverse Yankee issuance in coming weeks, which will likely prevent the basis from tightening much further. 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.

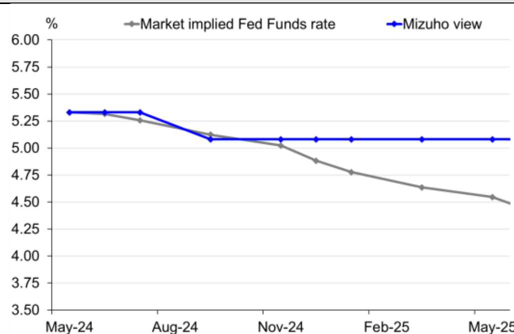
USD markets

Macro – Loose financial conditions drive upside inflation risks



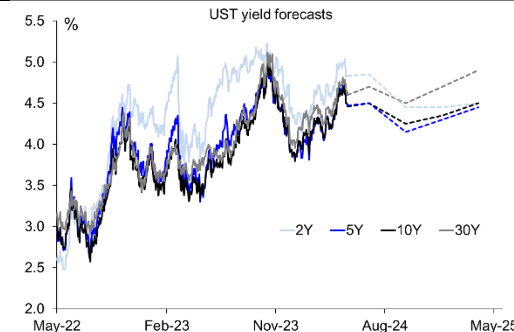
- Q1 GDP was a little soft in real terms, but private domestic sales were solid and nominal GDP growth was elevated, suggesting inflationary pressures remain high. Our 2024 real GDP forecast remains at 2.0%
- Labour market data do not suggest much softening. The direction of travel is weaker, but there 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 spending 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 at 2.5% as is our 2025 CPI forecast.** 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



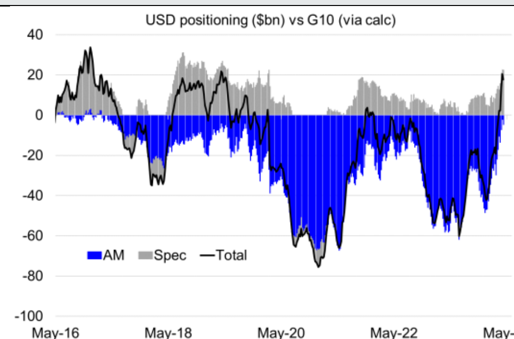
- Despite 3 consecutive elevated CPI prints the Fed retains its dovish bias. In the post-meeting press conference Powell re-affirmed that the base case was for cuts. He also noted that the required confidence that rate cuts were appropriate has not yet arrived. While in no rush to ease policy he seemed keen to underscore that hikes were not the base case. Powell noted that he was sensitive to labour market risks.
- In order to make QT more sustainable in the long run, the Fed announced it will slow the pace at which the balance sheet is shrinking from June. The monthly cap on USTs rolling off was reduced from $60bn to $25bn. The cap on MBS remained in place. The lower-than-expected cap, combined with the US Treasury continuing to fund increases in issuance via T-Bills, while keeping coupon issuance unchanged, helped long-end yields stabilise in the wake of the meeting.

Rates – Capped downside in UST yields



- The lack of progress on the inflation front has seen UST yields print another leg higher, although levels reached were still below the 2023 highs. In the last few weeks, USTs were able to catch a bid thanks to softer-than-expected labour market data.
- The Fed is still keen to cut, although likely less than initially expected. **We expect USTs to rally into Q3-24 when we expect the first cut.** Until then, we see USTs consolidating in current ranges on the back of slow progress on the inflation and labour market front.
- 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. **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



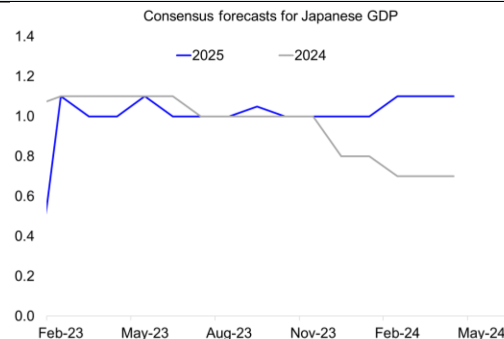
- It has been a month of two halves for the US dollar, rising sharply in the first half of the month and then becalmed in the back half, even as the data remain strong. This suggests near-term exhaustion to us. USD positioning is starting to look elevated. Valuations are a potential hurdle for the US dollar as well.
- We see some scope for mild USD outperformance continuing through Q2 but as a potential US rate cut comes into view in the autumn, the greenback may soften in Q3. 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 inflation. Initially, we see this as limiting Fed cuts and lifting the US dollar. However, eventually this fiscal largess will boost the US twin deficits and should be less USD supportive.

Basis – Reaching the limits of cheap dollar funding? A question for H2-24.

- Despite a stronger US macro backdrop, borrowing dollars has not become more expensive. We expect **the lower dollar premium theme will 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 and fewer cuts from the Fed.

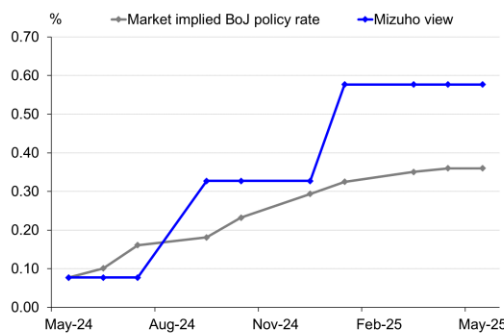
JPY markets

Macro – One-off factors drive weak start to 2024



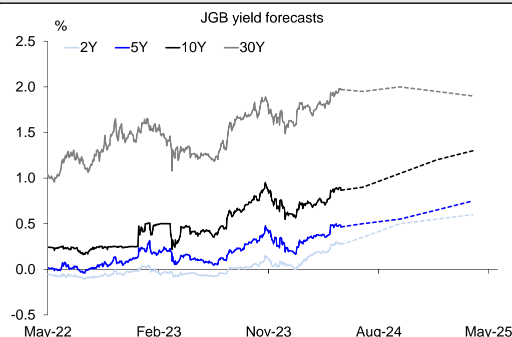
- Industrial production plunged over 5.0%QoQ in Q1, dragged lower by the auto sector and the early January quake. Net exports will also be hit by a reversal of last quarters' gain in services. **These factors will drag Q1 GDP into negative territory**. We expect that there will be a sizable reaction in Q2, when growth will be solid. The risks to our 0.3% annual 2024 GDP forecast are on the low side. The unemployment rate is seen remaining low and stable over the forecast period.
- The impact of the on-going yen weakness implies marginally higher CPI, meaning a slightly slower decline towards the 2% target. The Tokyo CPI drop is largely idiosyncratic and will not feed through much to the national CPI. We see the headline CPI remaining above 2.0% through mid-2025. 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 will feed through to the national wage data as they conspicuously failed to do last year. **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 – All change. More to come.



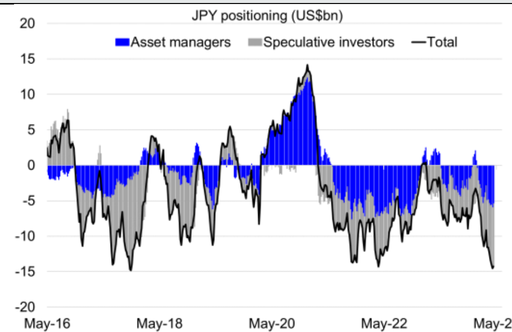
- **BoJ dismantled its YCC with QQE framework and exited negative rates in March**. The overnight call rate has been designated as the short-term policy rate and sits in a 0.0~0.1% range. The IOER is set at 0.1% and will apply to all excess reserves. In April the BoJ simply stated that bond buying would be in line with the March statement. This implies no change for now. Vast redemptions mean only a modest cut in the Rinban from current pace (~¥6trn/month) of purchases is required to shrink the balance sheet. We see this coming in H2 24.
- 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 suggest still suggests some residual on-going caution with regard to hitting the inflation target.** The weaker yen sees us revise up our policy forecasts and we now see two larger moves in the coming 12 months. **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



- 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. However, we think that weak macroeconomic data and political noise will likely cap the upside in JGB yields. **We still like to tactically sell rallies.**
- The bearish pressure should play out in the 10yr sector to a greater extent as **the BoJ will likely slow JGB purchases in coming quarters**. This should drive the steepening into the 10yr sector.
- Japanese domestic investors have remained on the sidelines with regards to buying long-term JGBs despite the more attractive yields. We think that the lack of policy action in coming months will encourage them to buy, capping the upside move in 30yr JGB yields. **We still like flatteners in 10x30s**, a theme we expect to accelerate in H2-24.

FX – MoF forced into intervention. JPY prospects better further out



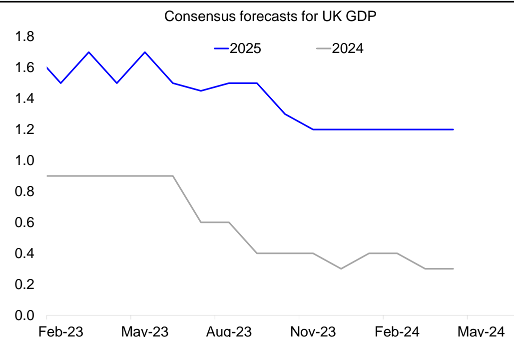
- USD/JPY moving above the 160 finally forced MoF's hand on the intervention front. The ~¥9trn amount seems large and in line with more recent practice which has seen larger, less frequent salvos. In the short run, intervention will limit the upside but unless there is a turn in the fundamentals, MoF will struggle for impact. USD/JPY is likely to remain elevated in the near term, possibly even moving higher.
- The BoJ's hiking cycle is now underway. As noted above, we expect that the BoJ will hike 50bp in the coming 12 months, pushing 2yr JGB yields higher and 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 drivers still at play

- 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.

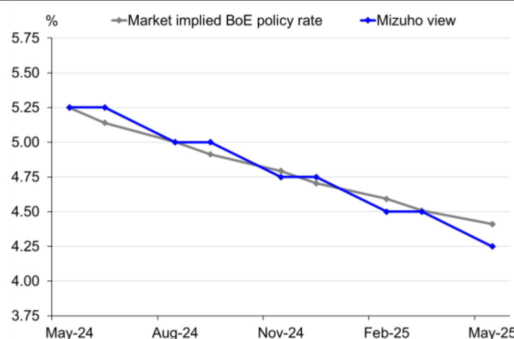
GBP markets

Macro – Slowdown already in the rear-view mirror



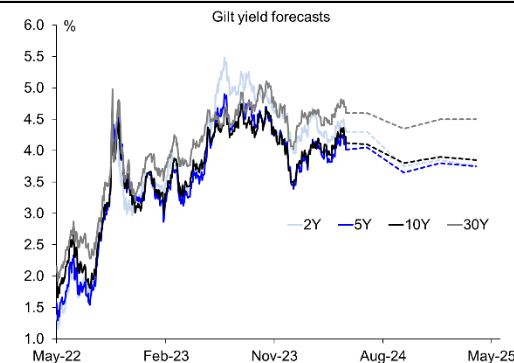
- Recent UK activity data have been solid. The composite flash PMI pushed further above 50 in April and the February GDP data were also upbeat. Our macro forecasts are little changed this month.
- Inflation declined in February to just 3.2%YoY but services CPI remained ~6.0%YoY. **We expect much lower headline CPI in spring/summer, driven by the fall in wholesale gas prices.** We see the CPI averaging 2.5% in 2024. Falling below the 2.0%YoY level in summer looks less likely due to the recent rise in oil and gas prices.
- We expect a **change of government at the upcoming election**, which will likely be in autumn 2024, but do not see any significant loosening of fiscal policy in the wake of the poll. The opposition have reassured voters that they will not simply open the fiscal spigot.
- **The labour market, especially wages, is the key source of inflation risks**. This month the data on wages have been mainly on the firm side. Both the official wage data and the Indeed wage survey ticked higher, while the REC Report on Jobs showed continuing weakness. 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 – Mixed commentary leaves BoE going in August



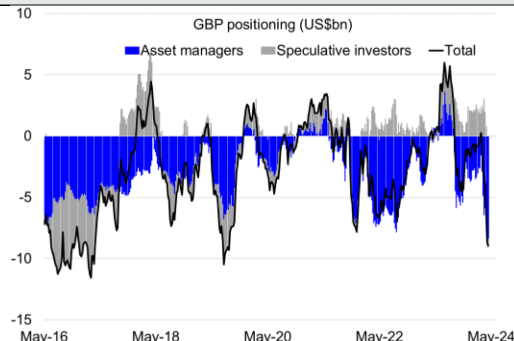
- The BoE left policy unchanged in March, but the two hawks shifted back into the pack, leaving the vote skew slightly dovish at 1-8. The May meeting may see the CPI revised a little lower, on the back of higher yields, but otherwise forecasts will be little changed.
- **We continue to see the first cut coming in August with another in November. The external members are at the extremes (1 dove, 3 hawks). The next move in interest rates will be decided by the BoE core. Recent commentary from this group has been mixed, with former hawk Ramsden sounding dovish but Chief Economist Pill hinting that he still prefers to err on the side of caution. Pill has always voted with Bailey, Ramsden has not.**
- The £100bn pace of QT has not delivered any upward pressure on yields. The APF currently sits at ~£703bn. We expect the BoE to maintain the current pace of QT for the time being.

Rates – Buy the dip into Q2-24, but remain cautious about H2-24



- Gilts haven't been immune to the global rates selloff. The last UK CPI developments were mildly disappointing, not helping any appetite to buy the dip. 4.40% seems to be the new resistance for 10Y Gilt yields. **With CPI expected to fall sharply in the next report, we expect investors to buy the dip in Q2-24.**
- 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. Our YoY changes in yields are relatively modest.
- 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**. Ongoing QT is another support to the steepening momentum.

FX – Downside risks dissipating



- We continue to see the BoE (-50bp) cutting less than the ECB (-75bp) this year. GBP positioning has deteriorated sharply in recent weeks, especially for asset managers. The move looks overly negative in our view, although we now see the BoE moving ahead of and more than the Fed. That said, relative market pricing looks reasonable.
- The Labour Party will likely win the next election, but we do not see such a development as especially GBP negative. If anything, the opposition 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 1.33 and EUR/GBP at 0.82 by end Q1-25.**

Basis – Normalisation of the curve well due

- **The front end of the GBPUSD XCCY basis curve has been able to tighten notably, but 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**. We expect to see long-end GBPUSD XCCY basis spreads tighten in the coming months.

Mizuho EMEA Forecasts (as of 7 May)

FX forecasts	Current	End-Q2 24	End-Q3 24	End-Q4 24	End-Q1 25
USD/JPY	155	155	150	145	142
EUR/USD	1.08	1.08	1.11	1.10	1.09
GBP/USD	1.25	1.26	1.29	1.31	1.33
EUR/GBP	0.86	0.86	0.86	0.84	0.82
EUR/JPY	166	167	167	160	155
GBP/JPY	194	195	194	190	189
Bond forecasts (%)	**Current**	**End-Q2 24**	**End-Q3 24**	**End-Q4 24**	**End-Q1 25**
United States					
Policy rate	5.25~5.50	5.25~5.50	5.00~5.25	5.00~5.25	5.00~5.25
2yr	4.83	4.85	4.45	4.45	4.50
5yr	4.47	4.50	4.15	4.30	4.45
10yr	4.46	4.50	4.25	4.35	4.50
30yr	4.60	4.70	4.50	4.70	4.90
Eurozone/Bund					
Deposit rate	4.00	3.75	3.50	3.25	3.00
2yr	2.90	2.70	2.40	2.25	2.25
5yr	2.46	2.30	2.10	2.00	2.15
10yr	2.42	2.30	2.15	2.10	2.25
30yr	2.54	2.45	2.35	2.35	2.55
Japan					
Policy rate	0.00~0.10	0.00~0.10	0.25~0.35	0.25~0.35	0.50~0.60
2yr	0.27	0.35	0.50	0.55	0.60
5yr	0.47	0.50	0.55	0.65	0.75
10yr	0.87	0.90	1.05	1.20	1.30
30yr	1.97	1.95	2.00	1.95	1.90
United Kingdom					
Policy rate	5.25	5.25	5.00	4.75	4.50
2yr	4.30	4.30	3.75	3.85	3.75
5yr	4.02	4.05	3.65	3.80	3.75
10yr	4.12	4.10	3.80	3.90	3.85
30yr	4.60	4.60	4.35	4.50	4.50
Macro forecasts (%)	**2023**		**2024**		**2025**
United states					
Real GDP	2.5		2.0		1.5
CPI	4.1		2.5		2.5
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		6.6		6.8
Japan					
Real GDP	1.9		0.3		1.0
CPI	3.3		2.5		1.9
Unemployment rate	2.6		2.5		2.4
United Kingdom					
Real GDP	0.3		0.6		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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