Mizuho EMEA G4 Forecast Update

3 September 2024

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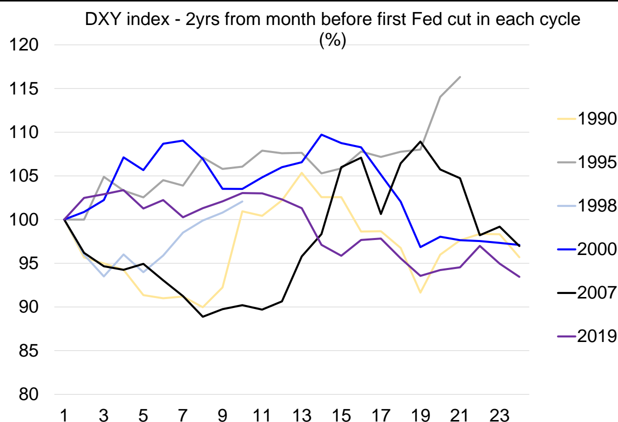
MIZUHO

Gradual decline in prospect for the greenback

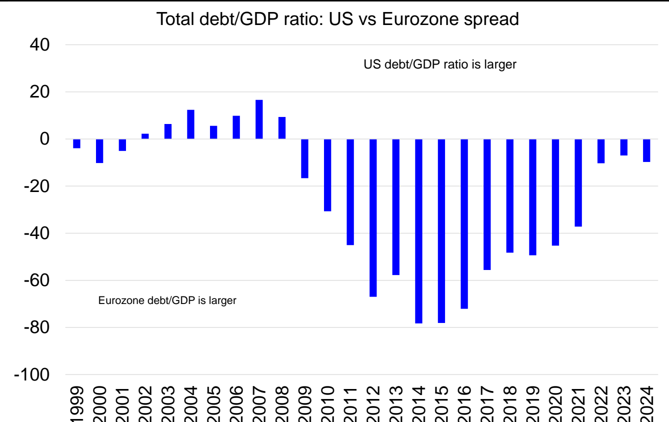
August was a bad month for the greenback with both EUR/USD and GBP/USD making year-to-date highs during the month, as investors await the start of the Fed's easing cycle. USD/JPY also declined sharply with the BoJ undertaking its second hike of the cycle back in late July. **We expect that the Fed will begin easing in September.** Our macro outlook suggests they could afford to wait but the Fed has signalled a move in the near future, most recently Chair Powell at the Jackson Hole symposium. **Thus, we expect a 25bp cut in September, followed by similar-sized cuts in November and December.** The chart below left details the movement of the DXY index in the wake of the first cut of the cycle. The chart suggests there is no consistent pattern for the DXY index as the Fed easing cycle gets underway.

Ultra-loose fiscal policy in the US has been a concern for many currency investors, especially as neither the Republicans nor the Democrats seemed minded to pursue fiscal consolidation, despite the explosion in the deficit in recent years. **Fiscal laxity has been a boon for US growth over the bulk of the past decade and has, as yet, put very little pressure either on long-run UST yields or on the US dollar.** Indeed, by helping the US grow faster, loose fiscal policy has arguably been a boost for the greenback. US government debt as a % of GDP has surged since Trump became president in 2016. In 2007, US and Eurozone government debt as a % of GDP were broadly comparable at around 65%, but currently the US government debt/GDP ratio is higher by ~35 percentage points (122% vs 88%). Despite the surge in government indebtedness, over this period the DXY index has been broadly firm. We looked at debt in the economy as a whole rather than just government debt, as solid balance sheets in the private sector might counterbalance weakness in the public sector – after all it's the private sector that the government will tax to get its house in order. **Solid private sector balance sheets suggest they have the wherewithal to withstand any tax increases required to help get public sector balance sheets back in order.** Here the picture is a little more opaque. The relative total debt/GDP ratio has changed much less since 2007 and if anything has swung marginally in the US dollar's favour, offering one potential explanation as to why the Greenback has held up so well. The fiscal policy impact on the currency is unclear, especially where the US is involved, with the US dollar being the world's reserve currency. We expect a divided government in the US in the wake of the November elections that prevents the fiscal situation worsening dramatically next year. **We see the US dollar as declining gently in coming quarters as the Fed eases policy gradually.** Indeed, market pricing of Fed cuts looks overly aggressive, and we expect that a correction here would be an additional factor than means the US dollar softens slowly rather than plunges dramatically.

DXY performance around first Fed cut is mixed



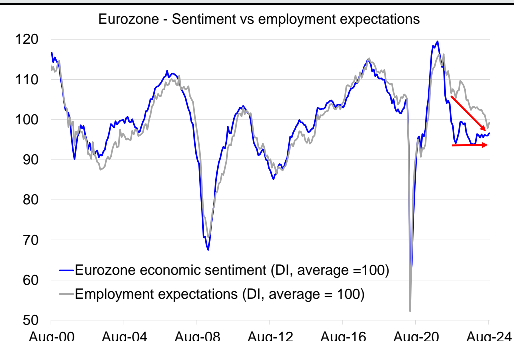
Total debt/GDP paints a less -ve picture for USD



Source of all charts: Bloomberg

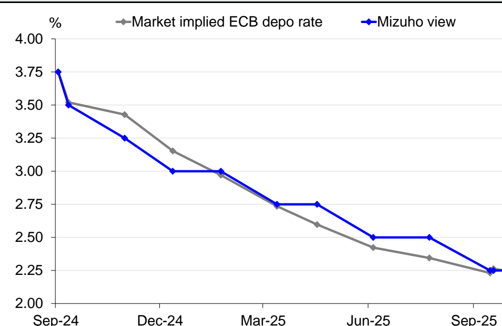
EUR markets

Macro – Macro downside risks amid gridlock in France and Germany



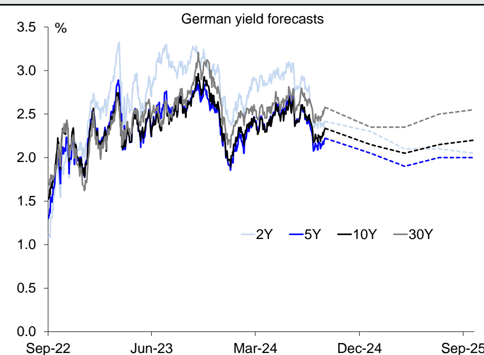
- The jump in the August eurozone composite PMI was in large part due to a boost in French services from the Olympics. The German PMI was dismal and the country appears to be on the brink of recession. Both France and German face a difficult macro backdrop with limited political control to break out of the downturn. **France has limited fiscal space and Germany is unable to use the space it has**.
- Labour hoarding is now broadly in the rear-view mirror. **We expect to see a modest rise in unemployment in coming months as firms become less cautious on securing labour against a soft backdrop**
- Headline inflation is back close to target but core inflation's decline has been much slower, and it sits at 2.8%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 2.4% in 2024, ending the year close to target.

Policy – ECB easing underway



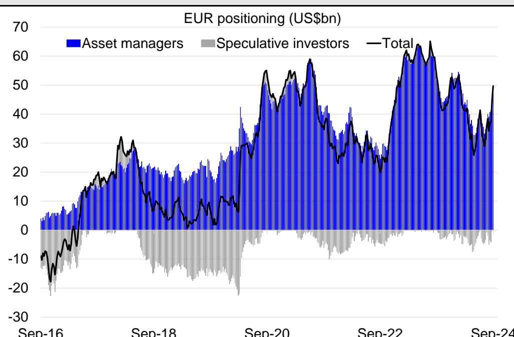
- The ECB left policy unchanged in July. Recent ECB commentary has hinted that the September meeting is not a done deal, as they seek to stress a meeting-by-meeting approach. **Nonetheless, further 25bp reductions in September and December are highly likely.**
- The weaker growth outlook means there is now a good chance that the ECB also cuts in both October 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 2.25% level next autumn**.
- 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 – EUR duration starting to look attractive



- European government bond yields moved higher in August, as markets pushed back against the post US payrolls rally. We are slowly approaching levels where going long duration looks attractive again. Front-end pricing looks fair to us. We see terminal rate around 2.25%.
- The global duration rally that we are expecting should push European government yields lower as well, 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 the difficult fiscal backdrop and rising inflation premia.**
- **EGB spreads will likely remain under pressure** as funding for 2025 becomes the focus in September.

FX – EUR: Mild upside vs USD



- Despite soft eurozone data in recent months, the market focus on the US easing cycle has seen EUR/USD push up to a 12-month high, even as EUR has underperformed vs the rest of the G10.
- We no longer expect Trump to win the US presidency and thus **we no longer have a "Trump bump" for the US dollar ahead of the vote**.
- EUR speculative positioning is modestly positive while valuations are not stretched. The economy is not dynamic, but it seems stable for now. The risks here are on the downside if French or Italian assets come under pressure. Both France and Germany face difficulty in driving policy change, which limits EUR's upside. We see only modest gains for EUR in the coming 12 months.

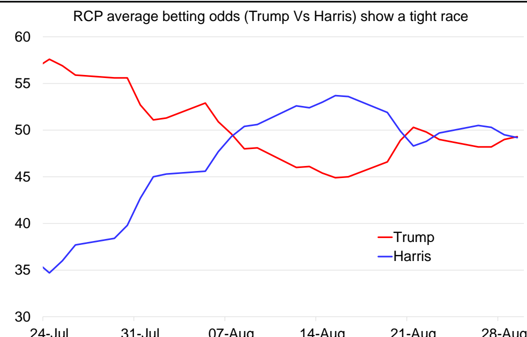
Basis – Tightening put to the test in coming months

- 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. The lack of a future liquidity squeeze from the ECB, a likely slowdown in Yankee issuance after a stellar year and how much the basis has tightened YTD still makes receiving positions look more attractive.**

USD markets

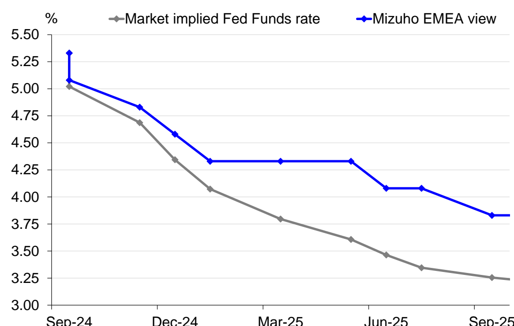
Macro – Cooling not collapsing

- Q2 GDP was upbeat, rising 0.7%QoQ, leaving H1 activity slightly above trend. We look for 2024 GDP to rise 2.5%. We look for a weaker 2025 with GDP at 1.6%, 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 average unemployment rate this year (4.1%) and next (4.4%) but meltdown seems unlikely. The consumer seems to be in reasonable shape, even if excess Covid savings are mostly spent.
- Inflation risks in the US remain higher than elsewhere although they are lower now that the activity risks are more neutral. **Our CPI forecasts see 2024 CPI at 3.0% and 2025 CPI at 2.5%.** Firm growth/positive output gap, loose financial conditions, expansionary fiscal policy, easing monetary policy and the solid labour market mean the risks for the CPI are on the high side.



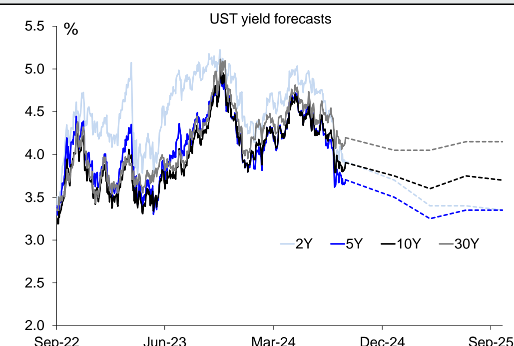
Policy – Measured front loading

- The Fed Chair's Jackson Hole address means easing is coming in September. The only questions is: 25 or 50bp? We expect that the Fed will cut 25bp as 1) we see activity as holding up and 2) think 50bp would make markets think the Fed knows something. **We see the Fed easing 25bp in each of the 3 meetings left this year.** Next year, the Fed will ease more gradually as it seeks out the neutral rate that keeps the economy on an even keel, which we see in the 3.5~4.0% range. For now we see limited need for the Fed to go beyond neutral.
- 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.



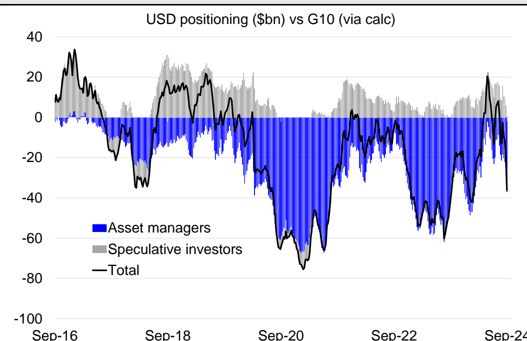
Rates – Steepening is the way to go

- One month after the weak payrolls report and UST yields are generally back around the pre-payrolls levels, except in the front-end, where yields are lower. The curve is also back to the steepest levels in 2x10s since mid-2022. **We still think that the market overreacted in early August, but the weakening of the labour market and the notion that the Fed wants to cut cannot be ignored.**
- The direction for yields is lower. We still see the possibility of markets pushing back against current front-end pricing (in a bear/twist flattening fashion), but only if data come in stronger than expected.
- The "long-duration" theme will gain more traction once broader signs of a softer US economy emerge. Regarding curve moves, steepening is the way to go. **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 above 103.
- **Our latest forecasts see a split government in the wake of the November election, less fiscal stimulus, and more monetary easing. This means a weaker US dollar vs our forecasts at the end of July. The US dollar remains expensive vs most metrics. Speculative positioning has eased sharply during August as the start of the Fed easing cycle becomes more certain.**
- **We look for EUR/USD to push up to 1.15 and for GBP/USD to rise towards the 1.40 level on a 12m horizon.**

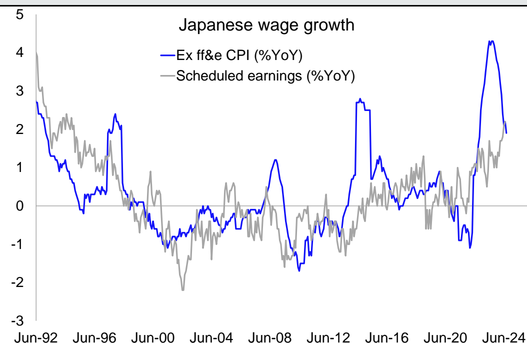


Basis – Risks to our cheaper USD funding view are rising

- USD funding has not cheapened further in August. We think **risks to our cheaper USD funding view are rising** on the back of US election risk, carry-trade unwinding, risk-off insurance and a likely slowdown in Yankee issuance (which has already surpassed last year's YTD amounts). Having said that, **dollar liquidity remains healthy and plentiful, which will prevent an aggressive widening and a much higher dollar premium in the near and medium term.**

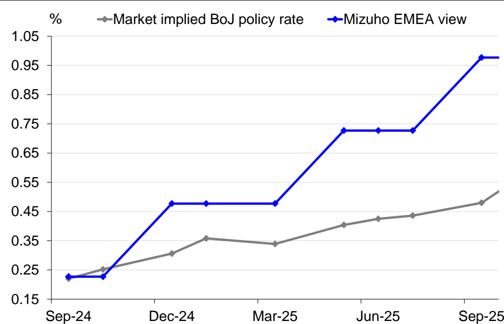
JPY markets

Macro – 2024 GDP to contract but outlook upbeat



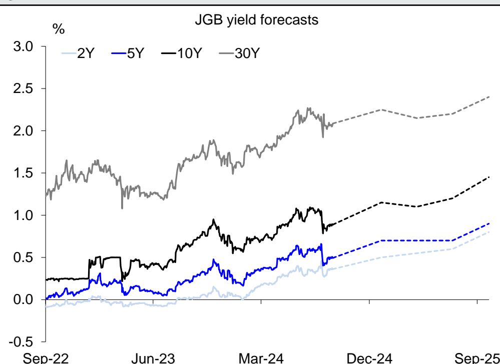
- We expect solid growth in H2, helped by cash handouts from the government and the reversal of most of the one-off drags in H1. **In 2025, activity will be driven by gains in real income as inflation drops back towards and probably below target, even as wage growth remains decent.** The unemployment 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. Last month, we trimmed our 2024 CPI forecasts by 0.1pp. This month, the 2025 forecast is pushed up to 2.1% (vs 1.8% prev) due to the extension of subsidies rather than underlying inflationary pressures. 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 H2 next year**. In turn, this lays the foundation for a pickup in growth in 2025, driven by consumer spending.

Policy – BoJ still on track for modest hiking cycle



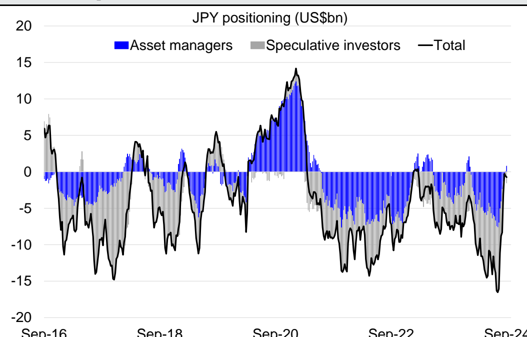
- At its late July meeting, the BoJ announced both an interest rate hike to 0.25% and a reduction in Rinban purchases by ¥400bn/quarter until purchases reach ~¥3trn/month in around Q1-26 from the current ~¥6trn. However, **the BoJ took an upbeat view on the prospects of further rate hikes in coming quarters in its outlook report alongside an upbeat view on wages**. Governor Ueda underscored the upbeat view, noting that 0.5% was not a limit.
- The market reaction to the rate hike was significant – enough to make the BoJ cautious about hiking again in the near-term. A few days after the BoJ meeting, Deputy Governor Uchida said the Bank would not hike while markets were volatile. An October hike now seems unlikely. **We expect that the BoJ will hike a further 25bp around year end**. Given that we see inflation settling below the 2.0% level in H2-25 we see only moderate further hikes, looking for the policy rate to top out around the 1.0% level. The currency move has been sufficient to put some modest downward pressure on the inflation rate.

Rates – Upside in front-end yields to resume once market volatility settles



- JGB yields are still below the pre-payrolls levels. **The "Uchida put"** (i.e., BoJ not delivering any change until market volatility settles) **has proved useful in pushing back rate hike expectations.** The 1y1y JPY rate is currently trading around 0.55% vs 0.65%, which was the level post-July BoJ meeting.
- Our policy-rate view suggests that, **once volatility settles down, upside pressure in JGB yields will resume**. Ongoing QT should continue to pressure the 10yr point, where we expect to see the most steepening. Japanese domestic investors have become more constructive on long-term JGBs, buying larger amounts in July. With QT plans now out, we think they will use any cheapening to buy. **The 10x30s flattening theme will likely continue in coming quarters.**

FX – Near-term JPY outlook is still weaker but medium-term outlook is positive



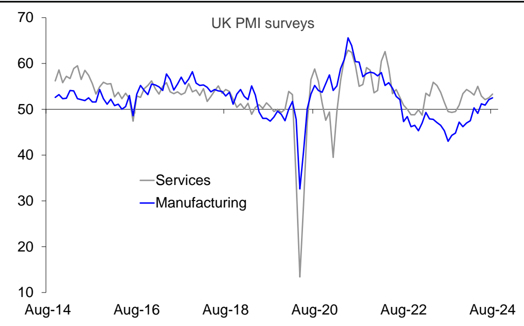
- The "narrow" carry trade appears done. Speculative JPY positioning is now slightly positive. The "broad" carry trade is much more difficult to judge. We do not see large-scale repatriation of overseas assets by Japan's major investor groups as likely.
- Given our view that the front end of the UST 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 in late July.

Basis – Tightening on hold

- USDJPY XCCY basis hasn't been able to print new highs. With **Samurai issuance** expected to come in autumn, **JGB ASW looking unattractive** and the **US elections**, we may see more **sideways price action in coming months**. We still see some paying drivers at play, like future BoJ tightening and subdued interest from Japanese investors to buy hedged overseas assets, which will put a cap to how much the basis can widen.

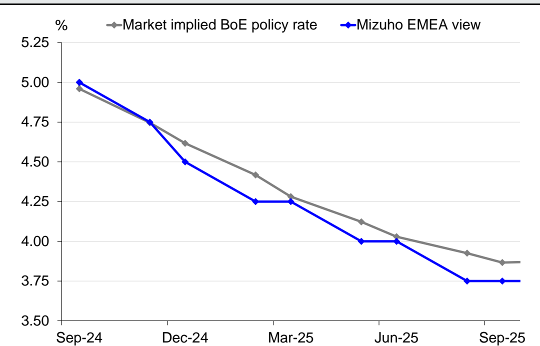
GBP markets

Macro – Activity looking solid, higher CPI in H2



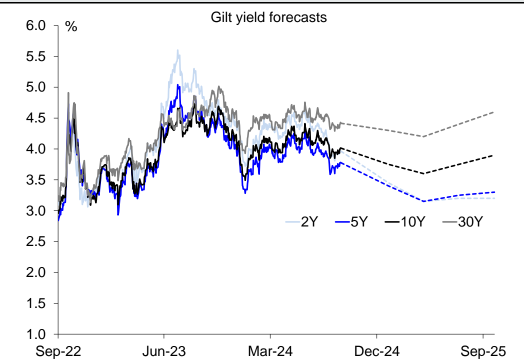
- UK data remain solid and we see GDP at 1.1% in 2024. **For 2025, our forecast is 1.2% but the risks seem to be to the upside.**
- Inflation rose to 2.2%YoY in June. Services CPI remains elevated at 5.2%YoY. We see the CPI averaging close to 2.0% in 2025.
- **The Labour Party won a clear majority in the summer election.** Rather than loosening in the wake of the vote, fiscal policy looks likely to tighten. We see a mild pick up in both taxes and borrowing, as the new government broadly sticks to announced spending and tax plans.
- While headline CPI is close to target, **a renewed rise in energy prices will push the CPI higher for much of the remainder of the year. Underlying CPI and wages remain too high for comfort for policy makers. The labour market, especially wages, remains a key source of inflation risk**. This month, official wage data showed a sharp drop. However, the decline was driven by base effects in NHS bonus payments. Private sector pay rose in YoY terms. The Indeed wage data also remain firm. 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



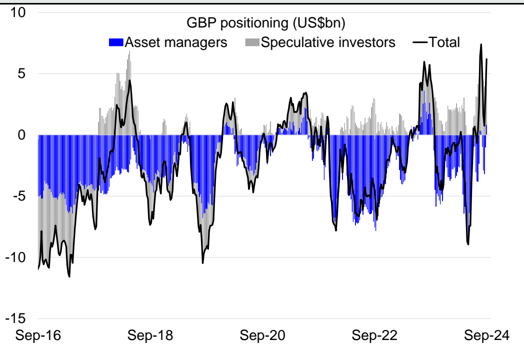
- The BoE cut rates 25bp in August in a tight 5-4 decision. BoE commentary suggested that additional easing will be slow to appear, despite the CPI forecast remaining below target between year 2~3 of the forecast horizon. More cuts are coming. While in general we see the cuts coming at around 25bp/quarter, **we see the BoE easing slightly more in Q4**, given cover by the additional cuts we expect from the Fed. We suspect that fears of tight fiscal policy are overdone. **We doubt fiscal tightening will hit activity levels in 2025 significantly**.
- 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. This raises the prospect that **the BoE may taper active QT while still increasing the amount of QT for 2024/25 in the September review, especially given government pressure**.

Rates – Steepening is the name of the game



- Gilts have been paring the gains seen in early August and 10Y Gilt yields are trading around key technical levels (4.05-4.10%). When compared to the US, **the UK economy is more sensitive to financial conditions and the UK has tighter conditions**. Therefore, we expect **investors to continue to buy Gilts given coming cuts, which will drive Gilt yields lower into the new year, especially in the front end of the curve.**
- Inflation persistence remains a worry. Together with the expected economic rebound in 2025 and the wall of issuance that is expected to be announced in the October budget (we see at least £25bn more issuance over the next four years), steepening will likely continue, and the **bullish momentum may find some resistance in H1-25.**

FX – Politically-stable safe haven



- Speculative long GBP positioning rose sharply in the wake of the election, was aggressively unwound in the wake of market volatility in early August and is now being rebuilt. GBP positioning is close to looking stretched. **In the short-run, we can see some scope for cable to ease back given relative BoE/Fed pricing.**
- Whilst we expect the spread between GBP and US policy rate expectations to narrow in favour of the US dollar, it is still the case that GBP is likely to be among the highest yielding currencies in the G10 basket on a 12m horizon. **We suspect that the UK is reverting to having higher policy rates than the US, as was the case before Brexit**. We look for GBP/USD to hit 1.40 on a 12-month horizon.

Basis – Outperforming other basis pairs thanks to the BoE

- **GBPUSD XCCY has largely shrugged off the global risk-off momentum, with the front end of the XCCY curve remaining above parity.** However, it hasn't been able to print new highs. The widening that we expect in other basis pairs will also likely take over in GBPUSD XCCY. Having said that, we think **GBPUSD will outperform given the ongoing liquidity squeeze from the BoE**. The curve (10x30s) has failed to steepen, which we believe is related to some new type of BPA (Bond Purchase Agreement) flow. Levels are starting to look a bit stretched though.

Mizuho EMEA Forecasts (as of 2 September)

FX forecasts	Current	End-Q4 24	End-Q1 25	End-Q2 25	End-Q3 25
USD/JPY	147	145	140	138	135
EUR/USD	1.11	1.11	1.12	1.14	1.15
GBP/USD	1.31	1.31	1.35	1.38	1.40
EUR/GBP	0.84	0.85	0.83	0.83	0.82
EUR/JPY	163	161	157	157	155
GBP/JPY	193	190	189	190	189

Bond forecasts (%)	Current	End-Q4 24	End-Q1 25	End-Q2 25	End-Q3 25
United States					
Policy rate	5.25~5.50	4.50~4.75	4.25~4.50	4.00~4.25	3.75~4.00
2yr	3.92	3.70	3.40	3.40	3.35
5yr	3.70	3.50	3.25	3.35	3.35
10yr	3.90	3.75	3.60	3.75	3.70
30yr	4.20	4.05	4.05	4.15	4.15
Eurozone/Bund					
Deposit rate	3.75	3.00	2.75	2.50	2.25
2yr	2.42	2.30	2.10	2.10	2.05
5yr	2.22	2.05	1.90	2.00	2.00
10yr	2.34	2.15	2.05	2.15	2.20
30yr	2.58	2.35	2.35	2.50	2.55
Japan					
Policy rate	0.25	0.50	0.50	0.75	1.00
2yr	0.37	0.50	0.55	0.60	0.80
5yr	0.51	0.70	0.70	0.70	0.90
10yr	0.91	1.15	1.10	1.20	1.45
30yr	2.11	2.25	2.15	2.20	2.40
United Kingdom					
Policy rate	5.00	4.50	4.25	4.00	3.75
2yr	3.97	3.45	3.15	3.20	3.20
5yr	3.80	3.40	3.15	3.25	3.30
10yr	4.05	3.75	3.60	3.75	3.90
30yr	4.45	4.30	4.20	4.40	4.60

Macro forecasts (%)	2023	2024	2025
United states			
Real GDP	2.5	2.5	1.6
CPI	4.1	3.0	2.5
Unemployment rate	3.6	4.1	4.4
Eurozone			
Real GDP	0.4	0.7	0.8
CPI	5.5	2.4	2.0
Unemployment rate	6.6	6.5	6.7
Japan			
Real GDP	1.7	-0.1	1.1
CPI	3.3	2.4	2.1
Unemployment rate	2.6	2.5	2.5
United Kingdom			
Real GDP	0.1	1.1	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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