Mizuho Macro Themes

Economics & Macro Strategy | Asia ex-Japan

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Of Chaos & Control

In a Nutshell

- In these times of political uncertainty and geopolitical strife, it is tempting to declare that the **line between chaos and control is uncomfortably fine**.

- Fact is, for all appearances, the ability to exercise control is tenuous. And the *potential to descend into chaos looms large*.

- Especially as **headlines** (at a glance) **have a tendency to feed into this fear of eroding control amid emerging chaos**.

- But that said, **fears of unmitigated disasters** appear to be overblown. Instead, **controlled chaos** may be the state of play **as markets muddle through the line-up of risk events**.

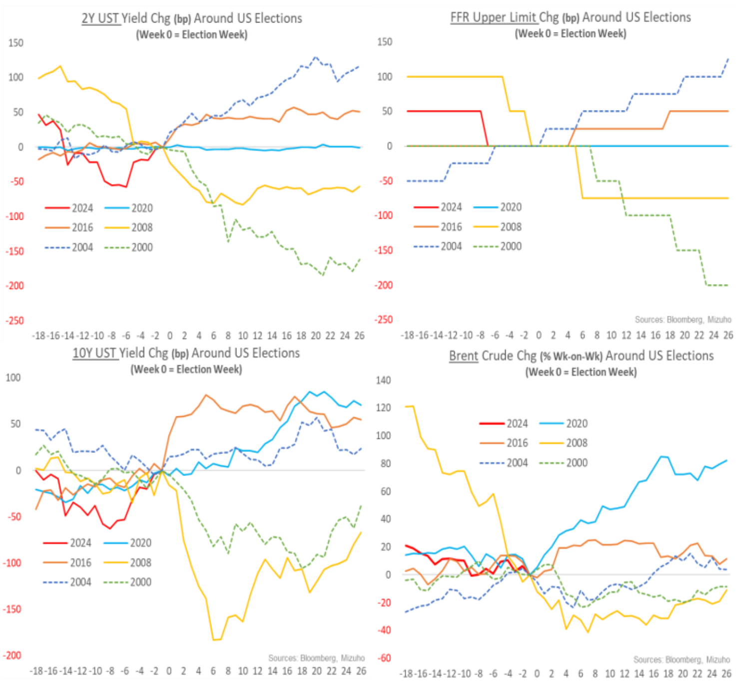
- Geo-politics/Oil/Gold: **Averting geo-political chaos** in the Middle East is the **low bar for keeping a lid on Oil**. But *Gold is nevertheless buoyed on wider factors*.

- Japan Politics/JPY/JGBs: Political uncertainty after **loss of LDP's Parliamentary** control/Majority and consequent fiscal doubts compromise JPY and (long-end) JGBs. But **JPY and JGB sell-off** on **fiscal blowout fears are overdone**.

- US Elections & Bear Steepening: With **more prominent fiscal deterioration risks ascribed to Trump 2.0**, **UST bear steepening** appears to be the **favoured US elections trade** ***to*** *track rising odds of a Trump win*.

- Geo-Economic "USD Trump": Alongside long-end led yield ascendancy is the **case for relative geo-economic USD strength** (on trade and geo-political shifts) that *defies fiscal woes* and *dulls Fed pivot*.

- Don't Forget the Fed: Trump-induced relative USD resilience may have merit, but **unbridled UST sell-off** (yield surge) **risks being overblown** in the face of sustained Fed cut cycle, which inevitably imposes a drag on yields. **Especially at the front-end**.



- The "Musk Fiscal Blindside": **Assumptions of more dire Trump 2.0 fiscal outcomes** may be **wrong-footed by** the **"Musk fiscal blindside"** (brutal cost cuts under Musk lifting fiscal assessment). The *resultant short squeeze on long-end USTs, plunging yields*.

US Election & Markets: Trump Crowd & Fed Clout

- With just a week to go, **US elections uncertainty** is **acute**. *But polarized as the politics maybe,* **outcomes aren't so starkly bifurcated**.

- *Certainly,* **not chaotic**. In fact, **moves may** eventually be **more controlled** than not.

- Crowded "Trump Trades" & Higher Bars: For one*,* **Trump (2.0) trades** are not just **somewhat crowded**, but *arguably a tad too hyped.* This may raise the bar for pushing the envelope further.

- The Harris Win: A **Harris win** is the **obvious election variable** that **could dampen extended "Trump positioning"**; although admittedly, Harris market outcomes are not necessarily are diametrically opposed).

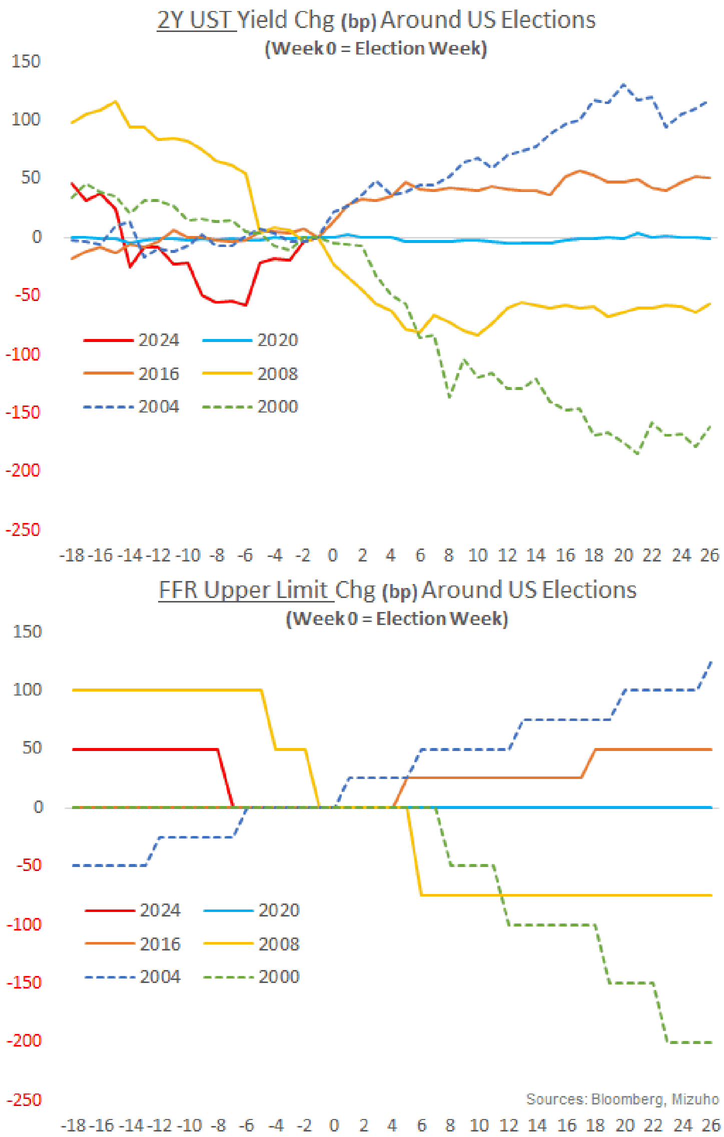
- Fiscal Deterioration: Notably, **fiscal deterioration** is **exaggerated by**, *but not exclusive to,* **Trump 2.0**. So, **UST curve steepening either way** is likely. Question being a matter of degree and nature.

- Trump Bear Steepening: Whereas, with Trump 2.0 the bet is on more acute fiscal deterioration resulting in to more prominent **(long-end led) upside volatility in UST yields**, which is exacerbated by tariff impact (via inflation expectations in the term structure).

- Exaggerated in Exclusion (of Fed): But this appears to be **exaggerated**. Especially **as** *the Fed easing cycle is under- accounted for.*

- Fed Cycle to Override: Point being, the *Fed has far more pronounced and persistent effect on (especially front-end) yields.*

Figure 1: 2Y Yields Tightly tied to the Fed Cycle …



- Conducive for Softer Front-End Yields: As has been the case over past easing cycles that have coincided with elections, a **Fed easing cycle** that stays in play **squares with softer front-end yields** (as FFR-sensitive front-end yields get dragged lower) *past the elections volatility* (Figure 1).

- Looser Long-End Control **Admittedly, 10Y UST yields** over the past election cycles have been comparatively (vis-à-vis 2Y yields) **less tethered to the Fed cycle**.

- Partly on Fed Cut Steepening: This **relatively weaker 10Y yield association with Fed Fund**

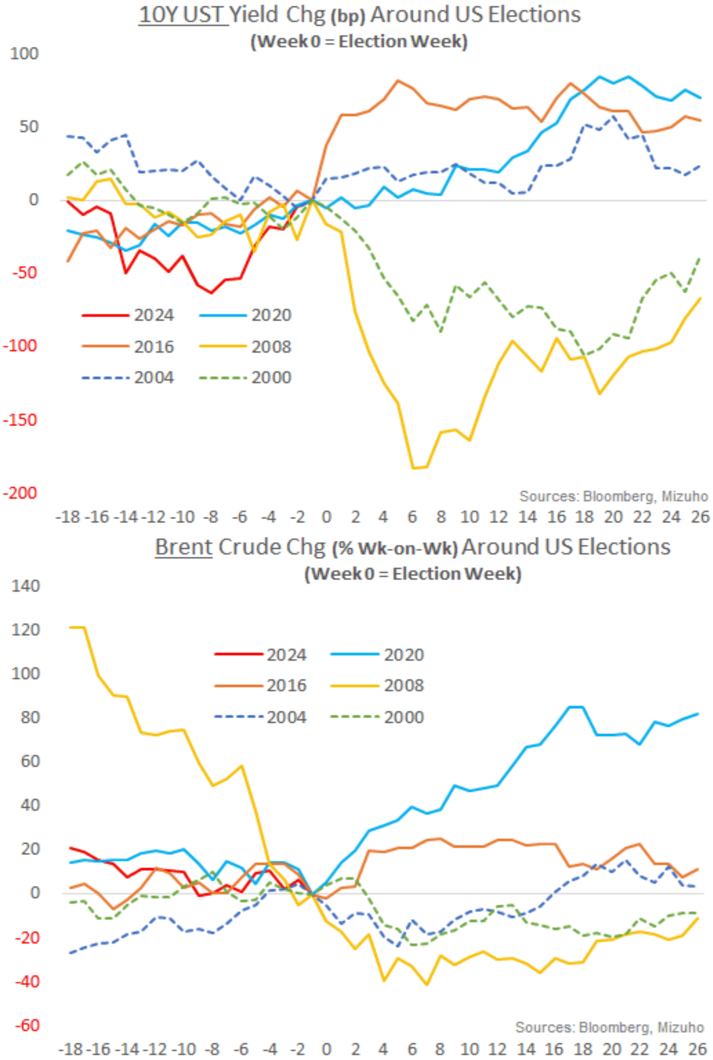
rate (cuts) may be **partly attributable to the usual steepening typical in a Fed cut cycle**.

- Oil's Impact: But beyond that *Oil price fluctuations* have often (and to a significant extent) *explain deviations in long-end yields*.

- Mitigates Sharp Long-End Yield Upside: And to that end, **subdued oil prices** may **buffer unmitigated upside in long-end yields**.

- Some, Not Overriding, "Trump Premium": That said, it is noted that *even adjusting for oil prices* there is a certain **Trump (bear steepening) effect**. But this "Trump premium" is expected **to augment**, ***not override***, the **Fed cycle impact**.

Figure 2: 10Y Taking cues off Oil. Some "Trump Effect" on Higher 10Y Yields than Otherwise.



- Controlled but Emphatic Steepener: Accordingly, a **more emphatic, albeit controlled, steepening of the UST yield curve**, is consistent with a **Fed easing cycle** accentuated by **structural term premium restoration**.

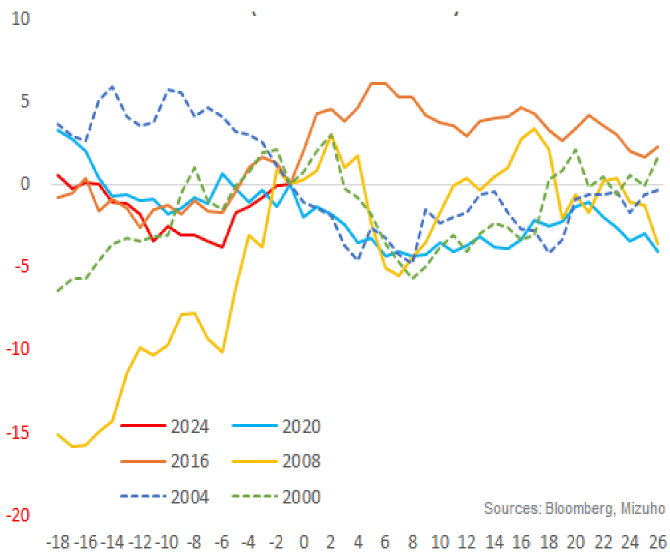
- **The "Musk Fiscal Blindside"**: In almost ubiquitous assumptions that Trump 2.0 will materially hasten US fiscal deterioration, a **Musk appointment** (to cut costs) is **potentially the biggest fiscal blind-side**.

- **Attendant "Fat Tail" Long-End Squeeze**: The 180-degree spin on fiscal outcomes *could inflict a painful squeeze on crowded short long-end UST bets*.

The Geo-Economic "USD Trump"

- Compelling "USD Trump Resilience": To be sure, our sense is **that Trump 2.0** will **bias** *trade, industrial* and *geo-political* dynamics for a **greater degree of USD resilience**.

Figure 3: USD Resilience on Trump?



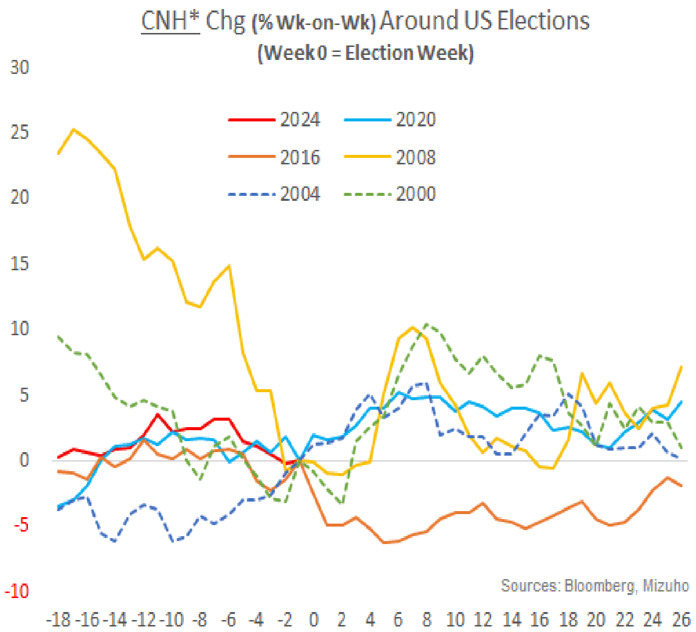
- The Geo-political Case: Point being, more **naked and unencumbered self-interest on energy security** (*less restrictive extractive energy policies for the US*) alongside **geo-**

political posturing will **strengthen** the **USD relative to other Major currencies**.

- Defying Fiscal Woes & Dulling Pivot: These industrial and geo-political factors are well-positioned to **at least temporarily defy US fiscal woes** (especially as fiscal deterioration elsewhere in the West provides relative cover) and **dull the drag expected from Fed pivot**.

- Trading USD Strength: More so, as **Trump's antagonistic trade tendencies**, **inadvertently bias the USD for strength**, *at the expense of (far more exports-reliant) MXN, CNH and EUR*, which are particularly vulnerable to be hit by tariffs/non-tariff barrier risks.

Figure 4: CNH at Risk from Trump Trade Antagonism

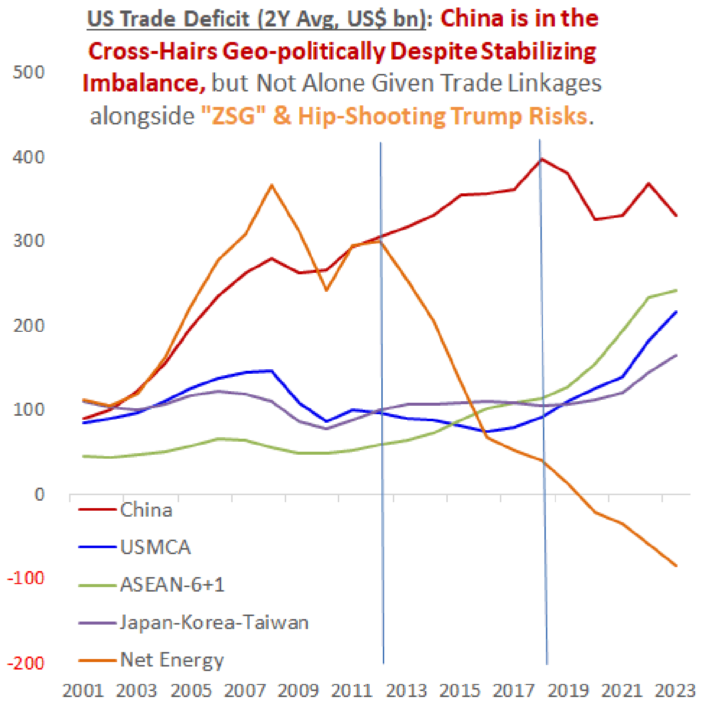


Trump 2.0 & Wider Risks to Global Trade

- The Unremitting China Risk: To be sure, **China's trade imbalance** with the US has **stabilized, if not diminished**. US' bi-lateral trade deficit with China, which peaked at nearly $420bn in 2018 fell below $300bn in 2023. ***But*** that **does not fundamentally change US-China trade antagonism** that is set to only grow.

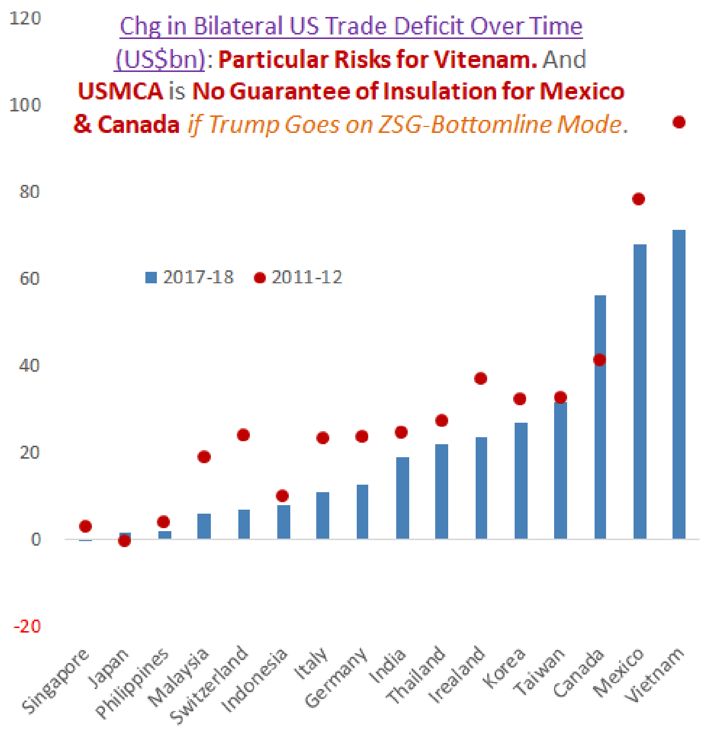
- Collateral Damage Beyond China: Crucially, **Trump's inclination for "zero-sum game" type of attack on bi-lateral US trade deficits** may **flag acute risks beyond just China**.

Figure 5: China Gets No Reprieve



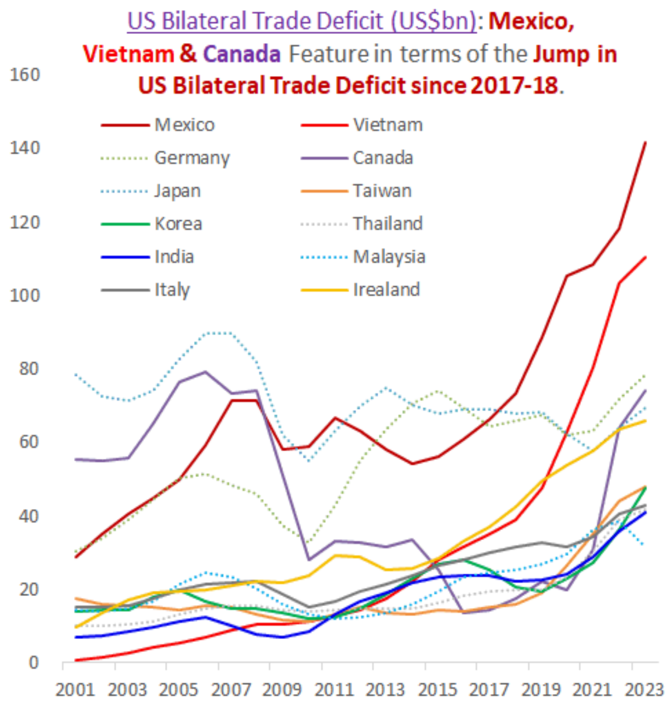
- "Bottom-line" Risks: Given sharp shifts in trade imbalances, *Vietnam* is **most at risk**, **if Trump fixates on "bottom-line" trade "losses"**.

Figure 6a: Bi-lateral Zero-Sum Game Risks



- Even *Taiwan* and *Korea,* don't get a free pass on strategic China diversification arguments. Point being, Trump's **preference for squeezing out bilateral "deals" diminish the importance of strategic policy trade-offs**.

Figure 6b: Vietnam, Mexico & Canada Vulnerable



- In the same vein the USMCA does not guarantee immunity for *Mexico* and Canada. Although the USMCA could offer a relatively higher degree of buffer from heightened global trade uncertainty.

Middle East Conflict Under Control

- A **direct Israeli strike directly into Iran** over the weekend is **precisely the type of event** that **potentially boils over as geo-political chaos**.

- *But it hasn't.* And perhaps by design. Specifically, **Israel's strike** appears to have been **carefully calibrated to facilitate a controlled de-escalation of aggression**.

- By ***avoiding oil assets*** and ***civilian casualties*** (instead targeting facilities), a **mutually face-saving off-ramp** has been engineered.

- That said, **averting an imminent, unbridled war** is one thing, but ***assured, lasting triumph of diplomacy over conflict is quite another***.

- Nonetheless, the **consolation** is that for now (and into the US elections), **Middle East conflict threats** appear to be **controlled**.

- So, **while Gold may be elevated** on multi-dimensional, structural factors, **Oil prices are comfortingly subdued**.

- Yields: In turn, this means that **long-end (10Y) UST yields** are **spared additional upside pressures on from geo-political "Oil premium"**.

Japan Elections: No Uncontrolled Fiscal Blowout

- The loss of a Majority for the LDP (and its partner Komeito) at the weekend is admittedly ***not*** the definition of **political chaos**.

- *Nonetheless,* **loss of control of Lower House** in the **worst loss for the ruling LDP since the 1990s, heightens political and policy uncertainty**.

- Especially given the disproportionate sway of "Kingmakers" that will require policy compromises and fiscal trade-offs.

- But that said, it appears that **fears of fiscal deterioration are overblown**.

- Which in turn suggests that *JPY weakness* and *sell-off in long-end JGBs* are likely stretched.

- But scope for stretched positions to reverse out is crimped by the market volatility amid heightened uncertainty into US elections.

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