Mizuho Macro Themes

Economics & Macro Strategy | Asia ex-Japan

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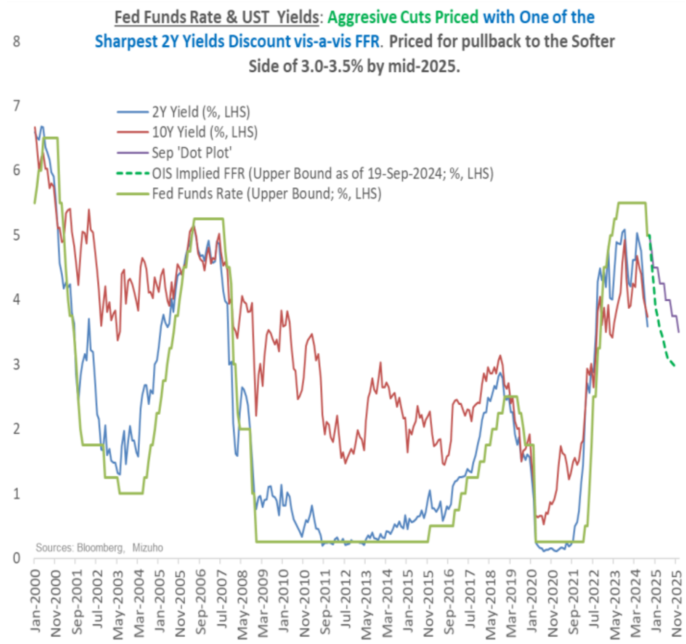
Cold-ilocks?

- A particular risk is that "**risk on", certainly outright euphoria,** is **premised on Goldilocks outcomes**.

- The **obvious problem** with such rosy assumptions and richly-priced cuts is that *"Goldilocks gets cold feet"*. And the blonde bolts *leaving markets to face bears*.

Figure 1. Market Pricing Deeper & Faster Cuts



- No surprises that markets face this **"Cold-ilocks" conundrum** (albeit different iterations of) **with the Fed and the BoJ**.

- For the Fed, distinguished by its last outsized 50bp cut last week (and more in the bag, including 50bp more for 2024 and another 100bp in 2025), *markets appear to be sold on a "Goldilocks" soft-landing*.

- One that entails a **juxtaposition of unfettered dis-inflation** and **unfazed economic resilience**.

- ***Missing either could cool*** optimism quickly, and ***losing both will chill*** abruptly.

- Meanwhile, the BoJ defined by its conspicuous absence of action (tightening) speaks to the *desire for a Goldilocks JPY.*

- The BoJ has on convincingly established that it will avoid sharp JPY appreciation (by mitigating policy mis-step risks).

- But trouble is, *JPY dynamics* are not solely determined by the BoJ. Instead, the *Fed has far larger sway.*

- Consequently, ***even with "Goldilocks" cuts for the US***, **USD/JPY bears could lurk beneath**.

- Under certain circumstances, this could turn out to be a case of **"Cold-ilocks" for some corners of risk** (spooked by JPY carry unwind).

Fed & Fairy Tales

- With the Fed, **"fairy-tale" endings for rate hike cycles are the exception**, ***not the rule***.

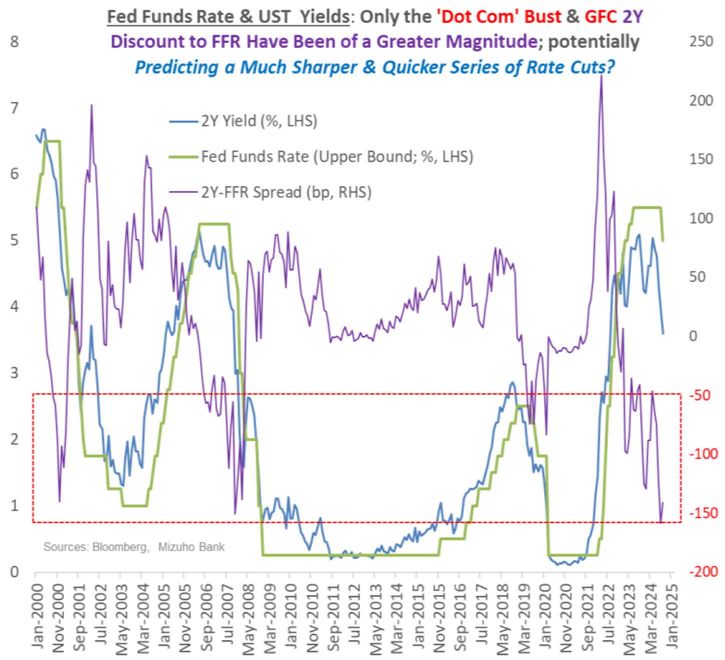
- And in this edition, the two-pronged risk is;

  a) the ***Fed doves, prone to cold feet* on cutting too fast, and delivers less** (rate cuts/easing) than markets have convinced themselves of or;

  b) ***markets get cold feet on the "Goldilocks"***

soft-landing assumptions that dress outsized rate cut, confronted by **recession-type risks that supplant rate cut relief**.

Figure 2. Market Pricing Deeper & Faster Cuts



- Either way, the **post-Fed "risk on" bonanza could be setback**.
- And the **two versions of "cold feet" are not mutually exclusive**.
- The former (a), smaller disappointment, could in certain circumstances be accompanied by the latter (b).
- And subsequent, belated, hastening of cuts, may not short-circuit the initial "risk off" that responds to recession risks/downturn re-pricing over the Fed cut relief.
- The upshot is that this *Fed pivot rally is not without tensions,* perhaps even tenuous.
- And there could be quite a bit of potential to re-price risks between;
  - i) Fed cold feet bout "re-balancing" inflation-jobs risks;
  - ii) market cold feet about "Goldilocks soft-landing" and;
  - iii) building pressures in Fed-market expectations gap (getting harder to find Goldilocks!)
- Some bumpiness in UST yields, a short squeeze in the USD and wobbles in equities may as such be par for the course.
- Especially as the ***dispersion of view and caveats around upsized, front-loaded*** cuts could come through in the rhetoric.

BoJ: Suspended Tightening

- To be sure, the BoJ was **steadfast about higher terminal rates** and the commitment to get there.
- So, on the surface there are no signs of bailing on further hikes.
- ***But*** the **BoJ adeptly suspended its foreseeable tightening plans**.
- Not only by alluding to ***assessment of its two hikes so far,*** suggesting an interim pause.
- But critically by inserting the ***pre-condition of stable markets for further hikes***.
- This is unmistakable central bank speak for **sitting on its hands for now**.
- Specifically, *to avert any inadvertent outbursts of upside JPY volatility.*
- Which is to the detriment of the economy from a double-whammy of adverse income and wealth effects.

- To that end, **BoJ recanting on imported inflation** risks from the JPY is the ***most distinctive code for diminished urgency to tighten*** *and that is on account of JPY.*

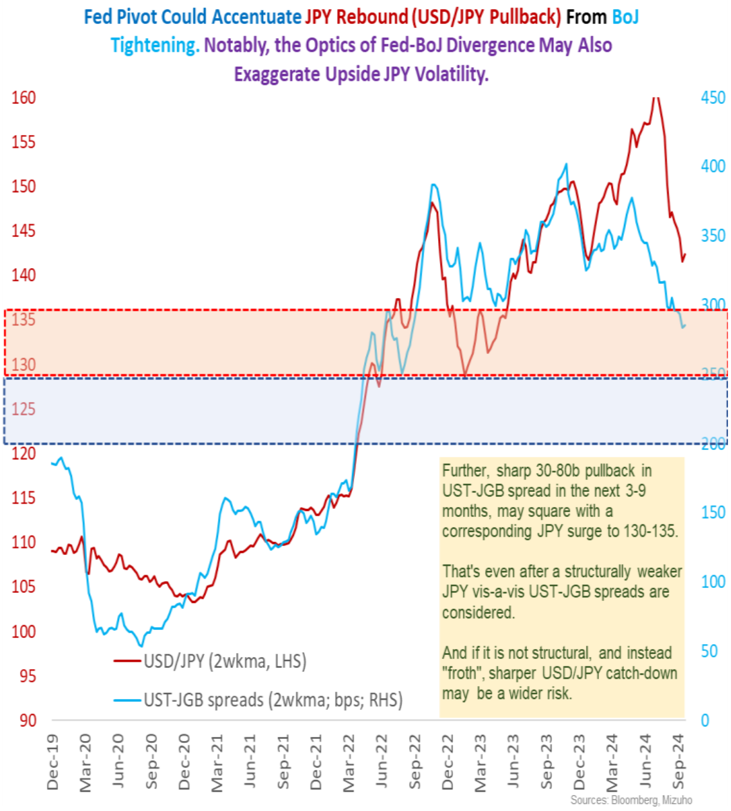
- In fact, it arguably **flips the nature of JPY risks to policy**.

- *From a tightening bias to dampen JPY depreciation* pressures to a case for ***delaying hikes on sharp JPY appreciation risks***.

- But all said, the **BoJ is simply ensuring that it avoids no unforced errors** on its part.

- Whereas ***Fed risks associated with sharp JPY appreciation risks*** loom large, mostly ***unmitigated by the BoJ's "patience"***.

Figure 3. JPY Driven Mostly by Fed via UST-JGB Gap



EM Asia: Flattered Policy Flexibility …

- The **Fed's unequivocal pivot ostensibly delivers flexibility for of EM Asia monetary policy.**

- That is, essentially allowing **EM Asia central banks** *to embark on a corresponding easing cycle.*

- Bank Indonesia cut rates by 25bp ahead of (just hours before) the widely expected (but larger actual) Fed cut.

- The BSP has signalled a 50bp cut on the table in October.

- ***But*** the *degree of "low cost" flexibility is exaggerated.*

- Fact is, most central banks in the region **cannot cut as much as Fed cuts may otherwise suggest**.

- For one, most *EM Asia central banks lagged Fed hikes on the way up* (for rates).

- And so, it follows that they will **struggle with matching Fed rate cuts on the way down.**

- What's more, *US dis-inflation has by and large been relatively more pronounced,* suggesting relatively ***even more diminished real rate cushion*** (vis-a-vis the Fed).

- And so, the combined **real rate limitations warn of currency stability risks that emerge from overzealous Fed (cut) shadowing**.

- Finally, **financial stability concerns** (elevated debt) and **frothy asset markets** (especially overheating housing) also **constrain cuts**.

* BoT and BoK have referenced the constrained from this. The PBoC too has highlighted such financial stability constraints.

** The BoK, the CBC and the RBA in particular have expressly sounded out bubbly housing constraints on policy easing.

… & Understated Latent FX Risks

- In fact, **understated latent FX risks** for EM Asia could be a **reason to be more measured** with the pace rate cuts.

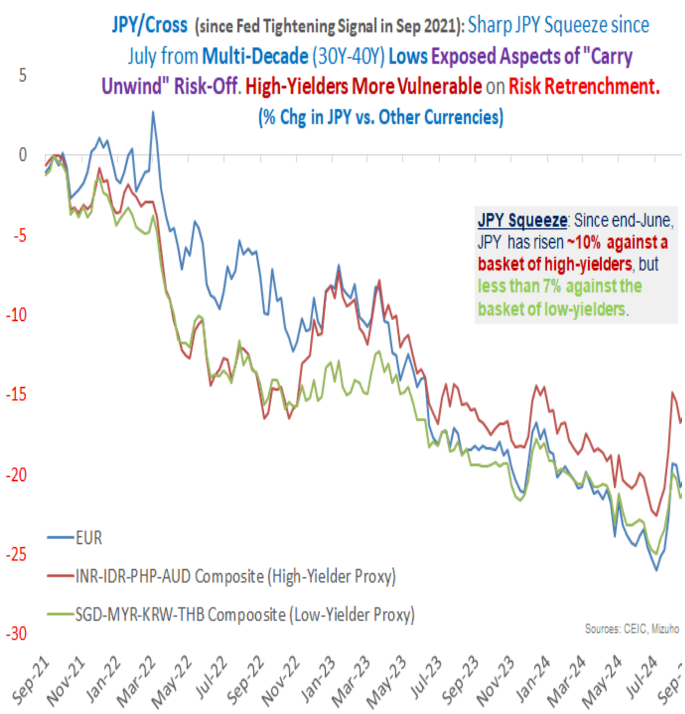
- **More so**, as the **recent wave of Fed-driven, sharp USD pullback from catch-down Fed cut expectations** is **exaggerated**.

- Crucially, it is *neither linear nor immune to sharp reversals* on dynamic relative global policy shifts and US elections.

- And so, EM Asia central banks cannot afford succumb to complacency around lingering (albeit latent) FX risks.

- Even more so as the (spent/overdone USD catch-down from) **Fed is not the only source of potential AXJ headwinds**.

Figure 4. JPY has Scope to Appreciate Against AXJ



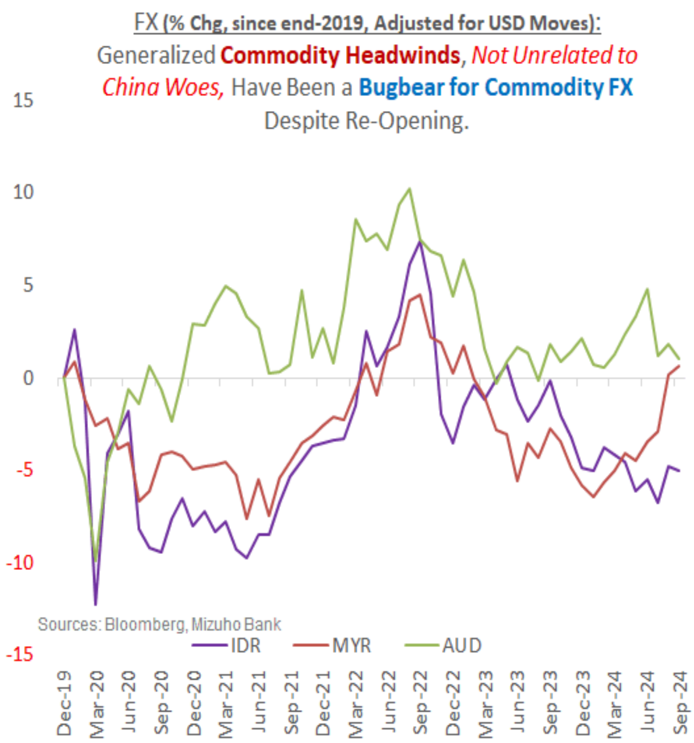
- Instead, another bout of **sharp JPY appreciation can trigger sudden AXJ pullback** amid "risk off".

- Notably, **as (positive) JPY-AXJ correlations reverse sharply** on JPY funding squeeze off", **to the detriment of AXJ**; ***especially higher yielding AXJ***.

- And ***even if a disruptive, potentially destabilizing JPY surge path is averted,*** bracing for **further strength ion JPY against AXJ is par for the course**.

- Moreover, more, **China-related demand gloom can also weigh**. *Especially via commodity channels*.

Figure 5. Commodity-linked AXJ Feel China Strains



- Except for *out-sized catch-up gains in the MYR, subject to a unique conspiracy of tailwinds^*, stark **AUD** and **IDR under-performance** (once broad-based USD moves are backed out) **reveal the magnitude and gravity of lingering China risks**.

^ i) political risk premium dissipating; ii) enlarged semiconductor cycle boost, and; iii) relative fiscal traction.

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