MIZUHO

Mizuho Macro Themes

Economics & Macro Strategy | Asia ex-Japan

September 17, 2024 | Vishnu Varathan | Head, Macro Research

Of Curves & Curveballs

Falling Behind the Curve

- As markets assess it, **falling behind the curve** is the ***overwhelming policy threat*** pervades **across various global economies** – from the US to Japan to UK to China.

- ***But*** this threat is ***expressed differently***. And with **differentiated implications** and **consequences**.

- Fed: For the *Fed,* a "behind the curve" assessment has invoked aggressive, upsized and front-loaded cuts starting with a 50bp move this week (at the Sep FOMC).

- BoJ: **Swimming against the global easing tide**, a hawkish BOJ raises the stakes on *"behind the curve" even more acutely*. Only, in its case, necessitating that any hawkish bias is subdued, if not suspended.

- BoE: There **is every chance that** the **BoE** is *"behind the curve"* on cuts More so, **if it walks the talk to hold back** (on a cut) this week. The BoE's affected restraint on cuts, may accentuate compensatory easing down the road.

- China: Beijing is deemed **woefully** *"behind the curve"* on getting sufficient stimulus for escape velocity. Worryingly soft data casting doubt on China's 5% growth target merely reflects deep-seated confidence crisis.

- (Behind the) Yield Curves: And the consequent yield curve outcomes (and in China's case, policy intent) are dramatically different across markets.

    - **USTs** are in a *bull steepening* phase reflecting accentuated, **front-loaded cuts by the Fed**.
    - The **PBoC** is *vehemently resisting a bull flattening,* as deflation-type outcomes being reflected in the curve are being handled with **long-end short-selling** by the PBoC.
    - And the **BoJ** is *tempering any bear steepening* in the **JGB curve,** *as scope for tightening is qualified by a drawn-out timeline conditioned on stable market.*
    - **Gilt yields** have *fallen the least, with only mild bull steepening* over the last 3 months. Scope for more catch-down in Gilt yields is becoming more compelling.

Bracing for Curveballs

- The warning is that **markets steeped in rich policy expectations** are ***ripe for volatility***.

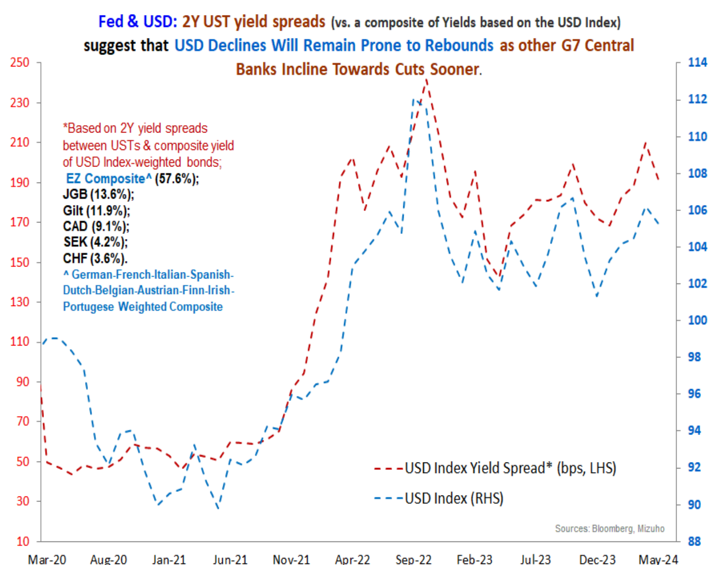
- Accordingly, it may be **best to be braced for (policy) curveballs** that could potentially force market re-pricing.

- Especially as aggressive Fed-led rate cut expectations (at this meeting and beyond!) knocked back can reverberate far and fast.

- The bottom-line is that is that **asset markets may** have inadvertently **overshot**, possibly **under-accounted risks** or *even* **gone the wrong way**.

i. Falling UST Yields: UST yields, while not necessarily misguided could arguably have front-run a little too much too soon.

ii. Bearish USD: Accordingly, USD's downside may be overdone on over-extended rates/yield differentials. What's more, it could also under-account for risk aversion (on recession risks) that may support the Greenback.



iii. Equities: In which case, equities could also stumble rather than surge on bigger cuts. The uncertainty around the response is perhaps more problematic.

Restraint, Relatives & Risk

- **Two things** may be **underpriced** for now.

- First, is some degree of (at least ***initial***) ***Fed restraint*** despite the call for an aggressive cut cycle from the get-go.

- This in turn will require adjustments to rate cut projections, and corresponding backstop in UST yields.

- Second, and perhaps more importantly, the **propensity for other G10 central bankers to join a dovish arms race**.

- In other words, the **Fed's relative** (to other G10 central bank) **dovish shift might be overdone**.

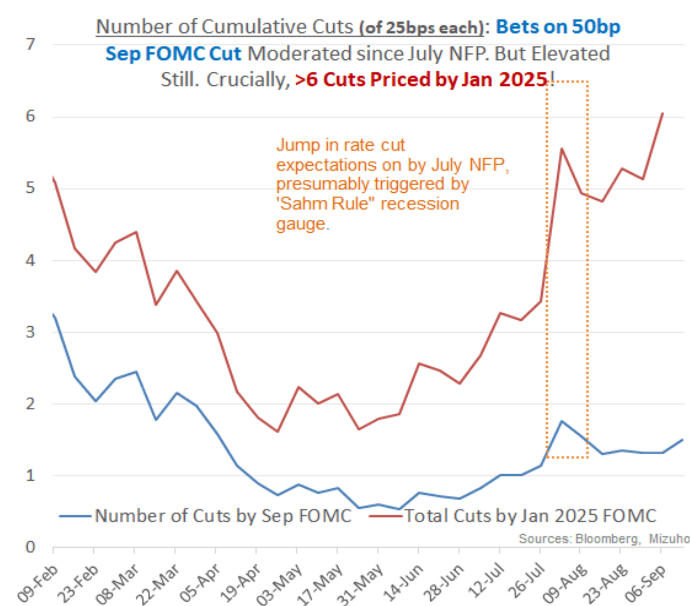
- Especially in the context of relative US exceptionalism, which begs the question of the easing required of other G10 central banks, if the Fed needs to be so aggressive.

- Point being, ***if Fed doves don't "go it alone"***, and they rarely do, then aggressive **USD bears may be hobbled** *as yields elsewhere catch-down* (vis-à-vis UST yields).

- What's more, it remains **unclear if the Fed "going big" is necessarily a "risk on"** trade.

- *Especially if large cuts* are *associated with belated response to unavoidable recession risks*, which could chill (risk appetite), rather than pre-emptive relief that thrills (bulls).

FOMC: "Fifty-Fifty" or Just "Go Big"



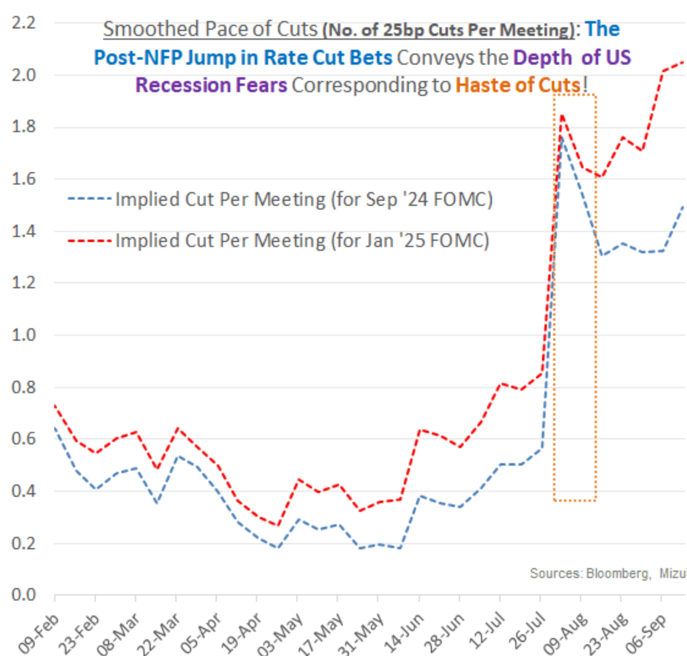
- We concede that the **Fed undertaking a 50bp pre-election "insurance" cut is a close call**. *Nearly "fifty-fifty"* in our books.

- But **markets** are far **more aggressive**(ly dovish). *Perhaps* even *too aggressive.*

- Fed Fund Futures are suggesting *70% odds of a 50bp cut this week* (Sep FOMC).

- What's more, the bet cumulates to *6-7 cuts by January 2025* (over the next 4 meetings) and *9-10 cuts by mid-2025*.

- This front-loaded and fairly furious pace of cuts is presumably premised on the view that the **Fed is scrambling to avoid being behind the curve**.



- Arguably, with justification for being pre-emptive (given policy lags) in the context of **deteriorating jobs** and **softening demand/sentiments**.

- But equally, it may also be ***(unduly?) encouraged by selective (ex-) Fed rhetoric***.

- Notably, **ex-New York Fed Chair Dudley's view** that the **Fed ought to** (and probably will) "**go big**".

Managing the Pivot Transition

- But trouble is, **fervent bets on "going big" runs the risk of inherently stoking volatility** given a propensity for binary frames (i.e. "go big or go home") rather than nuanced views.

- To be sure, *we concur with markets on mounting risks of falling behind the curve.*

- In fact, markets are now aligning with **our long-held** (since May) **call for 8-10 cuts by mid-2025**.

- Nonetheless, ***we "only" expect 25bp at the September FOMC***.

- Primarily because it is no less important for the Fed **to manage the transition from** "*higher for longer*" to "*too high for too long*".

- Not just to **ease into the rate cut cycle** in a manner consistent with controlled descent in economic data.

- Notably, does ***not abruptly*** (and prematurely) ***abandon "last mile" dis-inflation risks*** to the wider detriment of policy credibility.

- Crucially, also to ***reclaim control on the policy course narrative***, which has been seized by excitable markets.

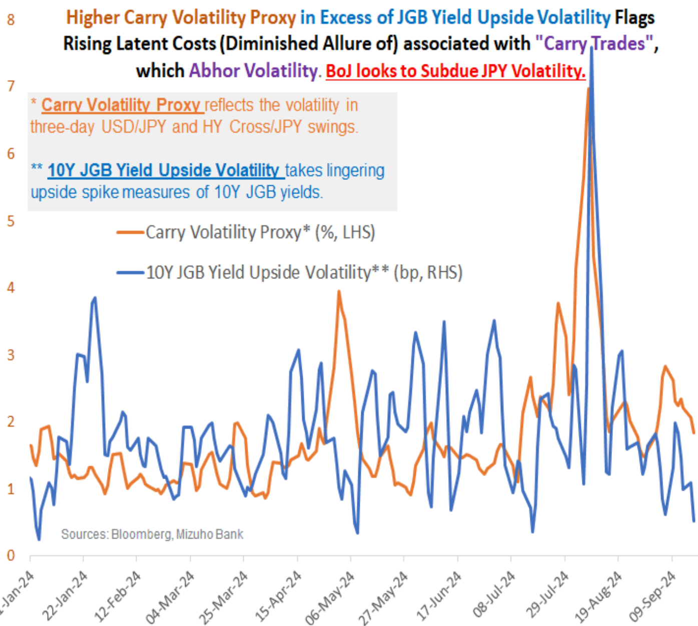
- The upshot is that it is **in the Fed's interest to position (for pivot), not panic**. Afterall, ***on a bad day***, **markets could bleed from big cuts** (if recession "risk off" is triggered).

BoJ: Not Rocking Boats

- It is fair to say that the **JPY is currently the closest things to a poster child for volatility** and *potential meltdowns* (triggered by sharp JPY "carry" unwind).

- Arguably, **Japan/BoJ hurt most from unwelcome, excessive JPY volatility** either way (although we argue sharp JPY appreciation is more damaging than equivalent depreciation*)

- And so, it **follows that** the **BoJ's guiding premise will be to subdue potential JPY volatility** from policy expectations. Which is *consistent with prolonged, mildly hawkish hold.*



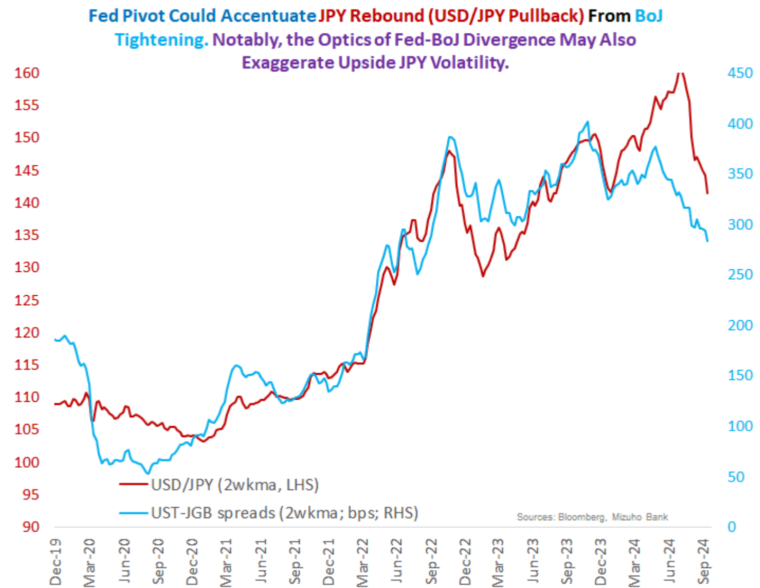
- This is ***even if the Fed manages to contain post-FOMC volatility***.

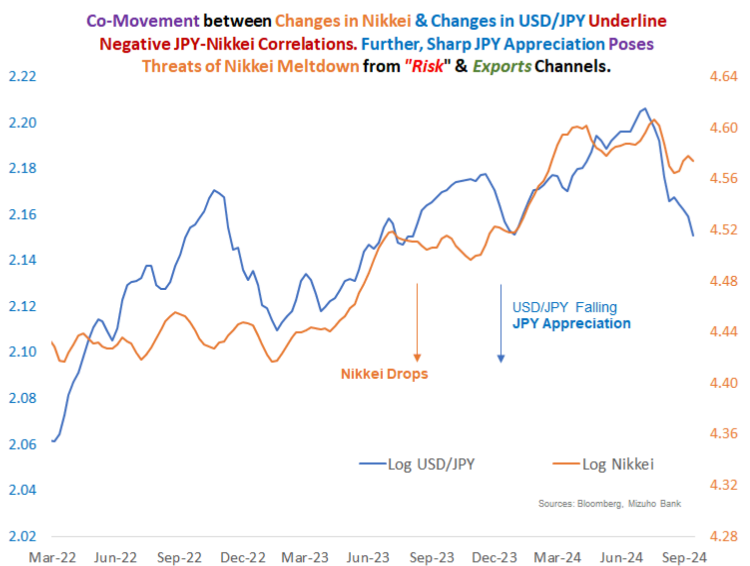
- Point being, the risk of convulsions of dovish Fed expectations is correlated to sharp JPY spike (derived from expectations of sharply narrower UST-JGB spreads ahead).

- And so, the **low bar, path of least harm for the BoJ is to not rock the boat**.

- Hence, scope for further tightening to a higher terminal rate, while not abandoned, will be appropriately watered down over a longer horizon and conditioned on stable markets.

- Even then, a sub-140 USD/JPY cannot be dismissed a priori amid policy noise.





* Not the least due to adverse equities impact given negative JPY-Nikkei correlations

Masked EM Asia Risks Amid China Woes

- **EM Asia sentiments appear to be supported** insofar that upsized Fed rate cut bets have corresponded to stronger AXJ (with broad-based USD declines) and equity gains (especially outside of Greater China).

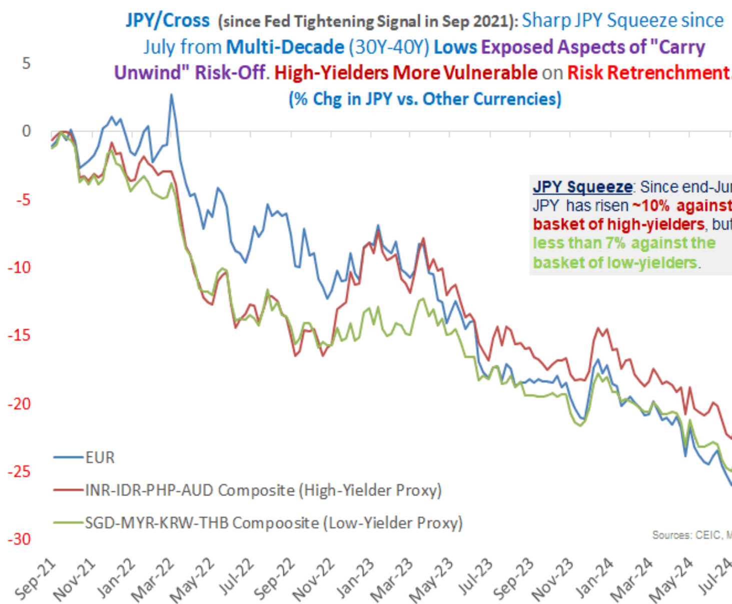
- But the **danger** here **is that underlying vulnerabilities are masked**. Crucially, ***broad-***

based "risk on" assumptions are ***almost surely exaggerated***.

- Point being, "**risk off" curveballs** be it from *recession fears* or *financial jolts* could present **rude shocks**.

- For one, any **demand dampeners from perceptions of US recession risks will tend to hurt EM Asia** sentiments via net exports channels.

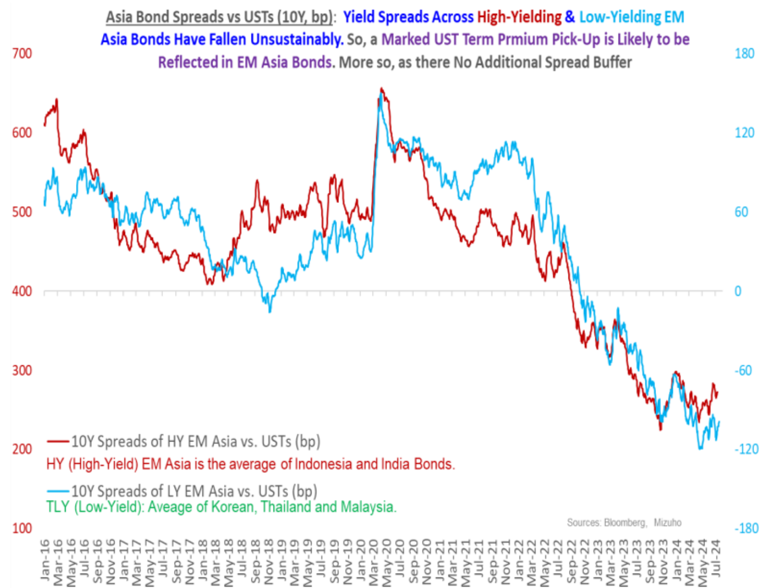
- What's more, a bearish USD (that take pressures off external debt and imported inflation risks) could have mostly exhausted on front-loaded cut expectations.

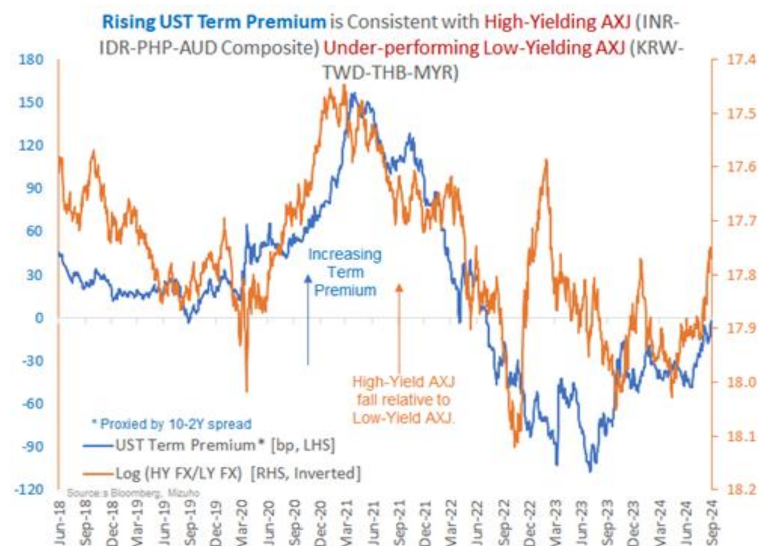


- Whereas *another leg of "JPY carry unwind" poses risks to AXJ,* especially higher-yielding EM Asia FX. the bar for this may be higher, but it is not a negligible risk either.

- Moreover, *a steeper (even if lower) UST yield curve* presents its own relative *pressure on higher-yielding EM Asia assets.*

- Finally, **persistent China demand risks** means that both supply-chain drag and commodities dent threaten to be a **dampener on premature EM Asia's "risk on"**.





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