Mizuho Macro Themes

Economics & Macro Strategy | Asia ex-Japan

July 8, 2024 | Vishnu Varathan | Head, Macro Research

MIZUHO

Electing Goldilocks

"Your focus determines your reality." – Qui-Gon Jinn, Star Wars, The Phantom Menace

- **Markets appear to have elected for Goldilocks** *interpretations of fraught French politics*, mixed *US jobs* and perhaps even *lingering China headwinds*.
- **Broad-spectrum "risk on"** prognosis has been squares with a **softer USD** (EUR ascendancy) amid **buoyant global equities** (ex-China).
- Arguably, CNY traction (below 7.30), despite softer China/HK equities, support Asia FX.
- But ***focusing on relief*** does **merely *distracts from, but does not defuse, underlying risks***.
- French Election: **Averting the worst of French political risks** of *precipitously swinging far right or left* is the **low bar for relief**. *But wider French spreads* and *consequent EUR dent* is **par for a bumpier course ahead**.
- US jobs: **Unemployment nudged up** to 4.1% amid **softer wage gains** augmented by resilient jobs gains have **fired up bets** (>70% from ~50% end-June) **of "Goldilocks cut"** at the September FOMC.
- Fed Chair Powell Testimony: Powell's **testimony to the Congress** this week, will support **conditions for a September (but not July) cut**, alluding to *encouraging but insufficient evidence of requisite dis-inflation*.
- China Stimulus Hopes: Evidence of bumpy industrial recovery and chronic confidence deficit, **hopes of bigger bang stimulus is growing *but far from guaranteed***.
- RBI's Inflated Flexibility: **Soft, sub-5% inflation** for India **encourages, but does not emancipate**. Not from the tyranny of underlying volatility. This underpins latent rupee risks and inflates the RBI's scope to ease.
- EM Asia's Hold … Not Calm: The **BoK and BNM are set to stay on hold** amid a "higher for longer" Fed. But this is *no guarantee of "Goldilocks" calm*; given stretched USD respite, the likelihood of EZ political bumps ahead and China risks looming large.
- FX: No Room for Complacency: Accordingly, **Asia FX may struggle to extend recent gains** (vs. USD). More likely are prone to profit-taking **as risk is liable to be re-priced**.
- Rates: Watching Risk Premium: **Despite softer UST yields**, **downside in EM Asia rates are far more constrained** as *risk premium* (both term and credit) are **re-priced**. This is **also reflected in underlying FX pressures**.

French Elections: What's Left is Not Right

"Named must be your fear before banish it you can" – Yoda, Star Wars, Revenge of the Sith

- **A Goldilocks must be French**. **Unfazed by (French) elections shocks**, *first from the Right* (first round) and *now the Left* (run-off).
- **Far right related risks** from Marine Le Pen's **National Rally (RN)** have indeed been **mitigated**, as hoped after the first-round shock.
- ***But at the cost of* far-left agenda,** which have **emerged** after **shock win by the New Popular Front (NFP)**.
- Especially as **NFP leader Melenchon promising to implement** "*nothing but its program – all its program*".
- But the **conspicuous shortfall of a clean majority*** of 289 seats for the NFP (projected:

175-205 seats*) **checks the most imminent and devastating French political risks**.

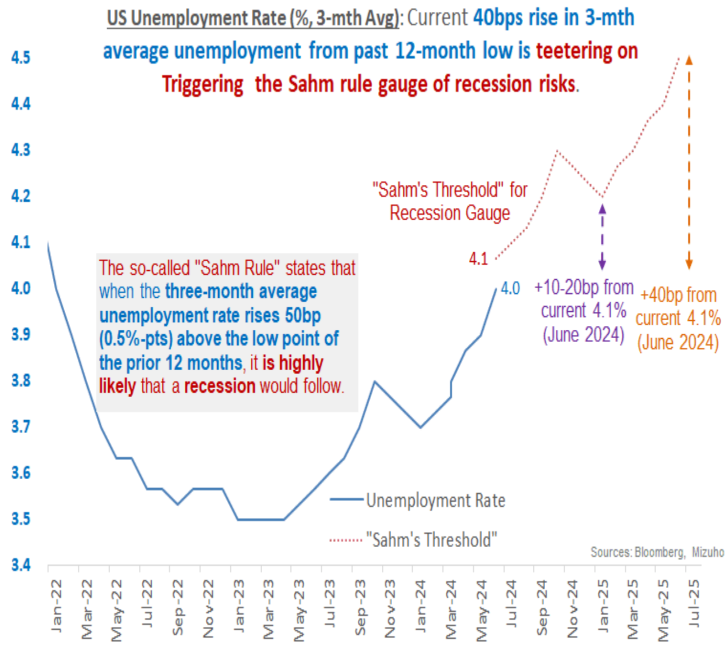
- Specifically, the **overarching relief** of a **precipitous swing to the far-right or far-left** that has been averted.
- Admittedly, a **hung parliament could pose a problem**. More likely though is ***a more muscular Far-Left that arm-twists its way into more public spending,*** thereby accentuating French fiscal/debt vulnerabilities.
- So, what's left (from far-Right risks being mitigated) is not quite right for unfettered risk
- **Widening OAT-Bund spreads** is **par for the course as fiscal slippage risks solidify**.
- So**, there is no excuse for complacency**. A **more extreme iteration of** these fiscal pressures (alongside those of Italy) **may highlight EUR "fragmentation risks"**.
- In which case, ***EUR under-performance vis-a-is real rate spreads against USTs could turn more pronounced***.
- For now, the (**named**) **foremost fear** *of French policies hijacked by extremist* (Right or Left) *agenda* is **assuaged**, *but far from banished*.
- Relief as such only narrowly buoys EUR above 1.08. Whereas optimism falls short of catalysts to extend EUR rallies (to 1.09).

*Far Left NFP is poised for 175-205 seats, Macron's Centrist for 152-180 and Marine Le Pen's far-right (RN) for 130-152 in the 577 seat Lower House.

US Jobs: Sahm Thoughts

"Many of the truths that we cling to depend on our viewpoint." – Obi-Wan Kenobi, Star Wars, Return of the Jedi

- Elsewhere, **a "Goldilocks" read of US jobs lent itself to optimism about markedly higher chances of a September rate cut**, and consequent drop in UST yields.
- This is ***despite the coincidence of less rosy indicators***.
- That is markets now pricing in *~74% chance of rate cut in September, up from ~55% chance at end-June, overlook a not-so-soft landings.*
- Admittedly, headline jobs remained upbeat at 206K (vis-à-vis the 190K consensus) alongside softer but resilient wage gains.
- However, **111K downward revisions tojob gains** *for April and May* alongside the **unemployment rate uptick** (to 4.1% from 4.0%) have induced ***some dovish impulses to be incorporated into policy expectations***.
- Regardless, markets appear to have taken a **"Goldilocks" iteration of controlled jobs landing** that inspires supportive cuts; thereby boosting equities alongside softer yields.
- **Nonetheless, recession risks** are **rising by some measures**, which in turn **could challenge the "risk on" aspects of Fed rate cut bets**.



- Notably, **"Sahm rule" gauge*** that tracks dynamic jobs markets shifts as forewarning is **only fractionally shy of recession warning**.
- For sustained recession risks, it would ***only take a durable*** **(but gradual)** ***0.3-0.4%-pts pick-up in unemployment rate*** to 4.4-4.5% (from 4.1% in June) by mid-2025 as per Sahm rule.

- In turn, this **flags risks of "Type-2" policy mistake** of "***too high for too long***" Fed policy as a matter of inherited policy bias.

*Sahm rule: If the 3-month average unemployment rate rises 50bp (0.5%-pt) above the lows for the preceding 12 months, a recession is likely.

Powell to Play it Cool to Congress

"Never tell me the odds." – Han Solo, Star Wars, The Empire Strikes Back

- But with Fed Chair **Powell primed to signal patience** on commencing rate cuts to the Congress, the (rising) **odds of a recession**, and the *attendant policy inflection*, **implied by Sahm is overshadowed by Goldilocks**.
- Specifically, premising cuts on **further evidence of wider dis-inflation** intact. *Averting a re-acceleration in price pressures* the low bar while *confidence about less "sticky" services inflation* being the higher bar.
- But this may **temper, rather than accentuate**, **prevailing rate cut bets** (3-in-1 odds of a September cut).
- Especially as **Fed Chair Powell's inclination to stress on data dependence** will *dampen implications of backward-looking jobs shortfall over volatility expected in inflation ahead.*
- Whereas the **incentive to maximize policy optionality** may ***overshadow the sensibility of a tactical case for pre-election "insurance" cut***; especially as both inflation and jobs data soften.
- As such, **conditional policy cues** communicated to the Congress are ***biased against growing odds of more cuts sooner****;* especially given the baggage of "transitory inflation".

China Stimulus Hopes

"Difficult to see; always in motion is the future" – Yoda, Star Wars, The Empire Strikes Back

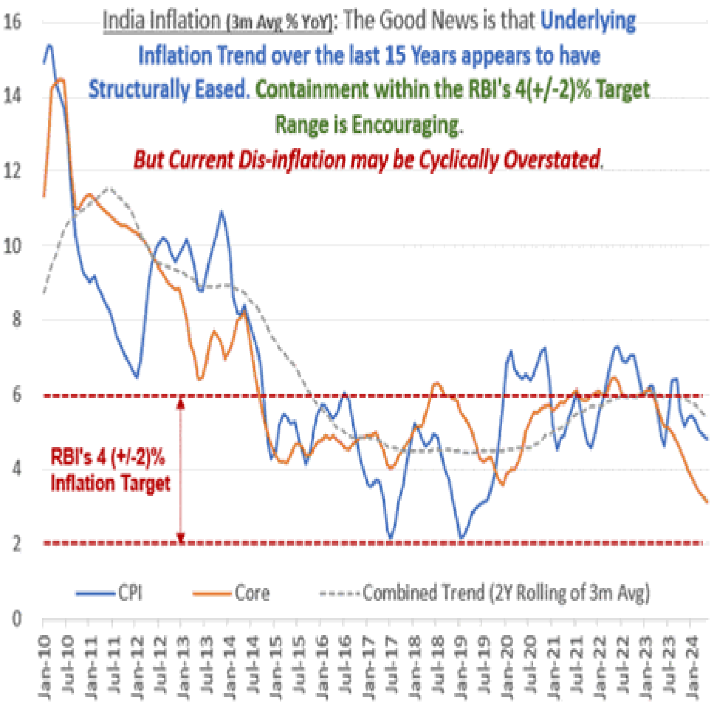
- ***Ahead of the Third Plenum*** (starting 15th July) **hopes of "bigger bang" stimulus** are **elevated**.
- For one, **in-coming evidence of consumption and credit data have been under-whelming**, underpinning chronic confidence deficit hobbling hopes of domestic demand drivers.
- Meanwhile, **prospects of industrial rebound have been hobbled** by elevated geo-political risks; the latest iteration being tariffs targeting China's industrial "over-capacity".
- The **bigger picture** is that *while manufacturing recovery is likely to remain broadly intact,* the **ability to engineer broad-based demand recovery is compromised** by ***binding policy constraints*** and ***attendant trade-offs***.
- On-going **efforts to arrest CNH pressures** are **at the expense of broader policy stimulus**.
- Preventing a bond market bubble is admittedly at odds to stimulus. But nevertheless, reflects financial stability as overarching policy priority.
- This leaves **hopes grasping at fiscal boost** rather than a monetary silver bullet that risks shooting itself in the foot by exacerbating self-reinforcing CNH pressures.
- But the **risk** is that policy stimulus revelations will turn out to be a **damp squib**. Point being, the **Plenum's economic policy initiatives may be tilted to structural plans**, ***not cyclical fillip***.

India' s Inflated Policy Flexibility

"There's always a bigger fish." – Qui-Gon Jinn, Star Wars, The Phantom Menace

- Elsewhere, India's **sub-5% inflation continues to be a gift for the RBI**.
- But this is ***in terms of not overly pressuring the rupee,*** to the detriment of policy independence,
- And **not in the sense of bona fide policy flexibility that allows the RBI to comfortably front-run the Fed's rate cuts**.
- For one, **underlying inflation remains uncomfortably subject to volatility**.
- Which is to say**, exaggerated (but unsustainable) dis-inflation may be**

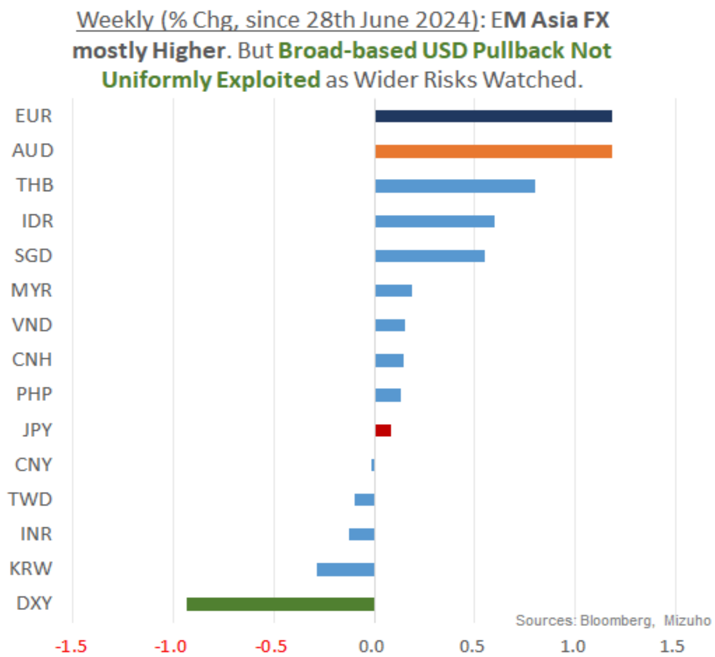
misleading flattering in terms of the implied real rate support **for the rupee**.



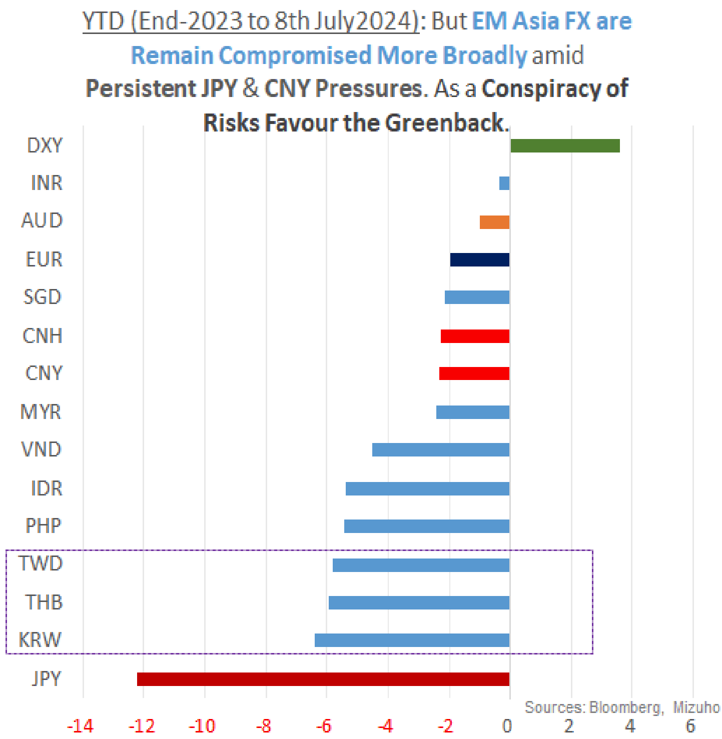
- More importantly, the **cost-free reduction in India's yield pullback** (led by narrowing risk spreads) may also be exhausted as near-term ratings upgrade prospects are on hold.
- And that means rupee support for the same yield spreads may be diminished as risk is re-priced.

FX: Don't Get Carried Away

"Great kid! Don't get cocky." – Han Solo, Star Wars, A New Hope

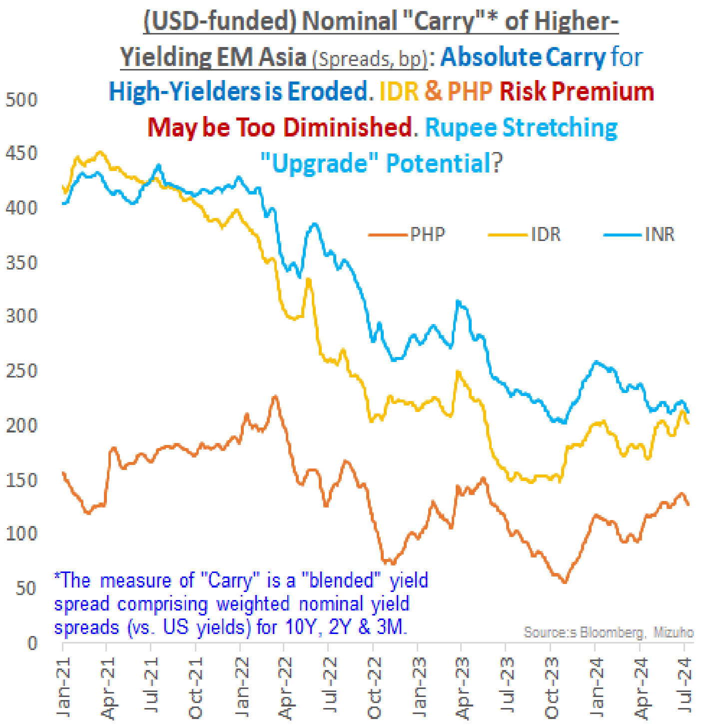


- Admittedly, **USD has slipping** appreciably last week has resulted in Asia FX gains.
- But this is against a backdrop of **relief of worst-case scenarios averted**, and *not on exuberance built on sustained and scalable "risk on"*.
- Instead, conditions for persistent USD strength, both from relative US exceptionalism as well as bouts of haven refuge, remain firmly intact.
- And so, it would be **cavalier over-confidence to get carried away about sustained AXJ rallies derived from unremitting USD weakness**.



- In particular, if **relief from the French elections fade**. Worse yet, uncertainties associated with an untested French coalition government and the pitfalls of fiscal profligacy and debt burden **could undermine EUR**.
- Inevitably, a softer EUR giving up relief gains as the realities of political uncertainties and associated "fragmentation risks" re-emerge will **reversing broad-based USD declines**.
- And this will be **to the detriment of currency gains elsewhere. Asia FX included**.
- And **more so if China risks resurface** in soggy data, led by underwhelming credit and uninspiring domestic demand.

- Finally, **longer-term erosion in Asia FX "carry"** means that the underlying "carry" support for Asia FX is stretched, if not increasingly compromised.
- Especially as **rising term premium** alongside the *risks of* **wider credit/risk premium** from **risk re-pricing undermine Asia FX currency valuations corresponding** to prevailing levels of "carry" (on risk-adjusted basis).



BoK & BNM On Hold

- Elsewhere, the **BoK and BNM** are expected to be **on hold** this week ahead of US CPI.
- ***Even if*** the expected **policy hold has hawkish accents**, this is likely to be a **pre-condition for KRW and MYR backstop** and not a catalyst for rallies in the respective currencies.

Guatemala: This document does not constitute an offering under the rules of the Ley del Mercado de Valores y Mercancías (Stock Exchange Act, Decree 34-96 of the Congress of the Republic of Guatemala), and any of its amendments, including without limitation, Decree 49-2008 of the Congress of the Republic of Guatemala, and its applicable regulation (Governmental Accord 557-97). The document will not be registered for public offering with the Securities Market Registry of Guatemala (Registro del Mercado de Valores y Mercancías), because the products will not be offered or sold: (1) to any person in an open market, directly or indirectly, by means of mass communication; (2) through a third party or intermediary to any individual person or entity that is considered an institutional investor, including entities that are under the supervision of the Guatemalan Superintendency of Banks (Superintendencia de Bancos), the Guatemalan banking regulator, the Guatemalan Social Security Institute (Instituto Guatemalteco de Seguridad Social) and its affiliates; (3) through a third party or intermediary to any entity or vehicle used for purposes of collective investment; or (4) to more than 35 individual persons or entities.

Hong Kong: This document, when distributed in Hong Kong (“**HK**”), is distributed by MHSA or MBHK, depending of the Mizuho entity which you are a client of.

Japan: This document is intended only for certain categories of persons to whom a foreign securities broker is allowed to carry out regulated activities under the relevant articles of the Financial Instruments and Exchange Act (the “**Act**”) and the subordinate legislative instruments (as amended), including but not limited to Financial Services Providers who are engaged in an Investment Management and certain Financial Institutions subject to conditions and limitations in Article 17-3(i) of the Order for Enforcement of the Act. It is solely for the use of such investors and shall not be distributed, forwarded, passed on or disseminated to any other person. This document is solely for the purpose of supplying general information and shall not constitute any investment or financial advice in relation to any products or services.

Malaysia: These documents shall be distributed solely to existing subscribers or clients of Mizuho Securities, and do not constitute an invitation, offer, or recommendation to subscribe for or purchase any securities mentioned therein. These materials also do not, whether directly or indirectly, refer to a prospectus in respect of securities of a corporation; in the case of a unit trust scheme or prescribed investment scheme, a prospectus in respect of any unit of the unit trust scheme or prescribed investment scheme, as the case may be; an issue, intended issue, offer, intended offer, invitation or intended invitation in respect of securities; or another notice that refers to a prospectus in relation to an issue, intended issue, offer, intended offer, invitation or intended invitation in respect of securities. Whilst there may be statements concerning securities and/or derivatives of a certain corporation or entity in these materials, we wish to highlight that these do not constitute, whether directly or indirectly, any form of advice, recommendation, encouragement, promotion, analysis, report or inducement to take any action , i.e., to buy, sell, or hold any securities and/or derivatives, nor is it a form of inducement for the reader to take any position regarding a particular class, sector, or instrument in relation to the securities and/or derivatives so mentioned.

New Zealand: This document is intended only for persons who are “wholesale investors” and “wholesale clients” under the Financial Markets Conduct Act 2013 (“**FMCA**”), as persons who are an “investment business”, meet relevant investment activity criteria, are “large” or are a “government agency”, in each case within the meaning of clauses 37 to 40 of Schedule 1 of the FMCA. It is not intended for, and should not be reproduced or distributed in any form to any other person in New Zealand. This document is distributed in New Zealand by MHSA or MHSS, which are licensed in their respective jurisdictions but are not registered as overseas companies or financial service providers in New Zealand or licensed under the FMCA. Nothing in this document constitutes or is supplied in connection with a regulated offer nor an offer to the public within the meaning of the FMCA.

Singapore: This document is distributed in Singapore by MBSG or MHSS, a holder of a capital markets services licence and an exempt financial adviser regulated by the MAS. Nothing in this document shall be construed as a recommendation, advertisement or advice to transact in any investment product mentioned herein.

Where the materials may contain a recommendation or opinion concerning an investment product, MHSS is exempted from complying with sections 34, 36 and 45 of the Financial Advisers Act 2001 of Singapore. This document is only intended for distribution to “institutional investors”, “accredited investors” or “expert investors”, as defined under the Financial Advisers Regulations, and is solely for the use of such investors. It shall not be distributed, forwarded, passed or disseminated to any other person.

South Korea: This document is distributed in South Korea by Mizuho Securities Asia Limited, Seoul branch solely acting as a broker of debt securities under the Korea Financial Investment Services and Capital Markets Act.

Switzerland: This document is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any financial instrument or to adopt any investment strategy mentioned in this document. The information contained on this document shall not be construed to be an advertisement for any of the financial instruments or services mentioned herein.

Taiwan: This document distributed via MHSA or MHSS from outside Taiwan shall not be re-distributed within Taiwan and does not constitute recommendation of, and may not be used as a basis for recommendation of, securities within Taiwan. This document may not be distributed to the public media or used by the public media without prior written consent of MHSA or MHSS (as the case may be).

Thailand: This document does not constitute any investment or financial advice or any general advice in relation to any products or services and, when distributed in Thailand, is intended only for “institutional investors”, as defined in the Notification of the Office of the Securities and Exchange Commission No. Gor Thor. 1/2560 Re: Provision of Advice to the Public which is not classified as the undertaking of Investment Advisory Business dated 12 January 2017 (as amended). It is solely for the use of such investors and shall not be distributed, forwarded, passed on or disseminated to any other person. The distribution of this document to such institutional investors in Thailand, is solely for the purpose of supplying general information, without charge. It neither constitutes any intention to conduct, or any engagement in any securities business, service business, investment or financial advisory business, or any other business in Thailand, for which Thai licensing is required, nor marketing, offering, solicitation or sale of any products, securities, or services to customers, potential customers or any person in Thailand.

United Arab Emirates (excluding the Dubai International Financial Centre and the Abu Dhabi Global Market): This document is intended only for persons who qualify as professional investors as defined in the Securities and Commodities Authority (“**SCA**”) Rulebook. It is not intended for or should not be passed on, directly or indirectly, to other classes of persons/investors in the United Arab Emirates. The contents of this document have not been reviewed or approved by, or deposited with, the Central Bank of the United Arab Emirates, SCA or any other regulatory authority in the United Arab Emirates. If you do not understand the contents of this document you should consult an authorised financial adviser.

United Kingdom / Germany / European Economic Area: This document is being distributed in the United Kingdom by Mizuho International plc (“**MHI**”), 30 Old Bailey, London EC4M 7AU. MHI is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority and is a member of the London Stock Exchange. This document may be distributed in the European Economic Area by MHI or Mizuho Securities Europe GmbH (“**MHEU**”), Taunustor 1, 60310 Frankfurt, Germany. MHEU is authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (“**BaFin**”). For the avoidance of doubt this report is not intended for persons who are Retail Clients within the meaning of the FCA’s or the BaFin’s rules. Details of organizational and administrative controls for the prevention and avoidance of conflicts of interest can be found at https://www.mizuhoemea.com.

United States: This document is being distributed in the United States by Mizuho Securities USA LLC (“**MSUSA**”) and is the responsibility of MSUSA. The content of publications distributed directly to US customers by non-US members of Mizuho Securities is the responsibility of such member of Mizuho Securities which distributed it. US investors must affect any order for a security that is the subject of this document through MSUSA. For more information, or to place an order for a security, please contact your MSUSA representative by telephone at 1-212-209-9300 or by mail at 1271 Avenue of the Americas, New York, NY 10020, USA. MSUSA acts as agent for non-US members of Mizuho Securities for transactions by US investors in foreign sovereign and corporate debt securities and related instruments. MSUSA does not guarantee such transactions or participate in the settlement process.