Mizuho Macro Themes

Economics & Macro Strategy | Asia ex-Japan

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MIZUHO

The Icarus Problem

- The Icarus Proposition – Fed & Valuations: For a start, **elevated Fed rates catching richly valued markets on the wrong-foot**; triggering *some degree of a meltdown*.
- The Icarus Dynamic – JPY & "Un-carry": Moreover, **JPY squeezed into a sharp flight higher** *could **sink Nikkei** in Icarus-dynamics,* **dragging equities** elsewhere if "carry unwind" is unmitigated.
- Risk Retrenchment: In concert, the **"Icarus problem" entails risk retrenchment** as the first pass effects recession risks and "carry unwind" conspire.
- Dismal US Jobs Culpable: On the surface, the **dismal jobs report** with weakness all around (jobs, unemployment, wages) is **culpable for souring risk sentiments**.
- BoJ Complicit: And the **BoJ is complicit**. Notably, given pre-existing **BoJ-triggered risk retrenchment** (JPY squeeze-"carry unwind" alongside Nikkei plunge).
- Fed Mistake?: On the Fed, ***markets fear that the Icarian wax is melting* on** *"higher for longer"*. *And* inadvertently heading for ***"too high for too long" policy mistake***.
- Soft Landing Supplanted: Which entails the **"Goldilocks" soft-landing scenario being rudely supplanted by a far bumpier descent**, even if not a hard-landing is averted.
- Pessimi-Sahm: A sharp rise in unemployment to 4.3% (from 4.1%) triggering the so-called **Sahm rule**** is **ostensibly a key precipitating factor for "Icarus" risk**.
- Overdone? Yes: But **markets' panic appears overdone** *given that the 'Sahm recession gauge' was already flashing pre-warnings;* which we warned of in the 15th July edition of this report (see Recap 1 below).
- Opportunistic? Yes: What's more, there are hints of **opportunism** in seizing **US jobs stumble** and inadvertent **BoJ-triggered "risks off"** *to re-price richly valued risk assets into the summer lull*.
- But Knife-Catching? No: Nonetheless, ***those mourning Icarus will not relish catching falling knives***. Not yet anyway.
- Equities: **Nikkei** is **down some 18-19%** over the last five sessions, and the risk is that this **makes the 2-3.5% loses on Wall St look ripe for a further shake-down** (as futures suggest).
- UST Yields Slump: Yields have caved in, with the 2Y down ~70bp from a week ago and 10Y slumping close to 50bp.
- UST Yield Curve Bull Steepen: The 20bp bull steepening has decimated yield curve inversion to a mere 2bp.
- Inversion Fades …: compared to **yield curve inversion averaging 35-40bp in H1 this year** and **mid-2023 peak inversion of ~110bp**.
- … But "Inversion Implied" Downturn Risks Don't: The inconvenient fact though is that **recession risks flagged by yield curve inversion** ***involve dissipation/reversal if this inversion as the predicted downturn precipitates***.
- High Bar for Fed Comfort: Which is to say the **bull steepening of the UST yield curve may in fact accentuate downturn worries**. In which context, **Fed cuts** are **not always unequivocal source of relief**.

- Fed Rate Cuts Just Not Cutting It: In fact, **markets are decidedly "risk off" despite aggressive Fed rate cut bets**. The Fed Funds Futures now suggests 6 rate cuts by Jan 2025 FOMC compared to just 2 as at end-June.
- Especially on Fed Motivation: Fact is, Fed rate cuts perceived to be **after-the-fact recourse to desperately try to arrest an economic swoon** from earlier policy mistakes, are **likely to be** *(at least initially)* **"risk off"**.
- Delicate Perceptions Balance: Knowing this, the ***Fed must strike a delicate balance to make that distinction between timely and panicked*** (cuts). And something has to give.
- Change Latency, Not Compulsion: Especially if the Fed is deemed to be compelled to cut to stave off an uncontrolled descent in the financial markets. So even as we highlighted change latency ahead (See Recap 2 below) at the Jackson Hole symposium later this month, how the **Fed will have to target sufficient speed** (of change) ***but avoid self-defeating haste***.
- BoJ's Icarus Bind: **BoJ is arguably in a greater bind**, struggling **to credibly backtrack on hawkish guidance that has flown out of control**, triggering **an unintended Nikkei** tailspin.
- Anti-Goldilocks Icarus: In fact, the **BoJ's problem is with extremes**. Excessive JPY volatility on both sides. The **antithesis of Goldilocks** JPY response, **conspiring with the tyranny of Icarus** (JPY flies and Nikkei crashes).
- No Good Policy Options that Won't cost Credibility: **Both** the **Fed** and **BoJ** are now forced to **weigh off the credibility damage involved in recanting** from the current positions. There are just no good options.
- Neutral Rates to the Rescue?: The **BoJ could possibly allude to being close to neutral rates *given* current exchange rates, external risks** and **relative global policy settings as dog whistle to moderate rate hike expectations**.
- Dulling JPY Volatility: **Dulling JPY volatility remains key** for the **BoJ to stabilize policy**, provide greater clarity for exporters and to arrest unintended adverse asset/equity market sell-off.
- Snapping the JPY "Carry Unwind" Risks: As we pointed out^, **snapping possibly circular transmission between abrupt, unmitigated JPY squeeze and risk asset meltdown is critical** to backstop global markets sentiments.
- Dollar Down on Fed Cut Bets For now, post-NFP jobs data gloom, consequent bets on rate cuts and corresponding collapse in UST yields have *knocked back the USD*.
- But EM FX Gains At Odds with "Risk Off": ***But*** persistent **"risk off"** is **not ordinarily consistent with EM FX gaining on the USD**. More so, amid unwinding "carry trades".
- CNH Gains Relative, Not Resolution": Knowing this, it is **best to remain grounded about CNH gains being a relative artefact of broad-based USD weakness** amid slumping UST yields. And **not a resolution of underlying CNH pressures** imposed by structural geo-economic woes amid chronic confidence deficit.
- Politburo Pain Relief, Not Panacea: Point being, the **Politburo measures** (as welcome as they are!) to boost consumption **offer some pain relief**, ***but*** **far from a panacea** for about employment woes and wealth gaps/erosion are persistent bugbears weighing on confidence.
- AUD Hamstrung …: The **AUD meanwhile may also be hamstrung**, already having broken ranks with more distinct AXJ gains against the USD elsewhere.

  … as RBA is Compromised: **RBA hike prospects have not only diminished post-CPI**, but with wider market risks, ***rate cuts bets will begin to feature sooner rather than later***.

- AXJ Bull Trap?: A potential bull trap for AXJ (EM Asia FX) cannot be ruled out if the knee-jerk gains vs. the USD extend.
- Amid "Risk Off" USD Demand: Especially if risk sentiments deteriorate further. In which case USD weakness on Fed pivot bets are likely to be supplanted by generalized "risk off" and exports dampening effects associated with softer US aggregate demand.

* Reference to the Greek mythology of Icarus, who flew (with winds strapped on by wax) too close to the sun, only to fatally crash when the wax fastening the wings melted.

**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.

^ Please refer to our Note from Friday (see below)

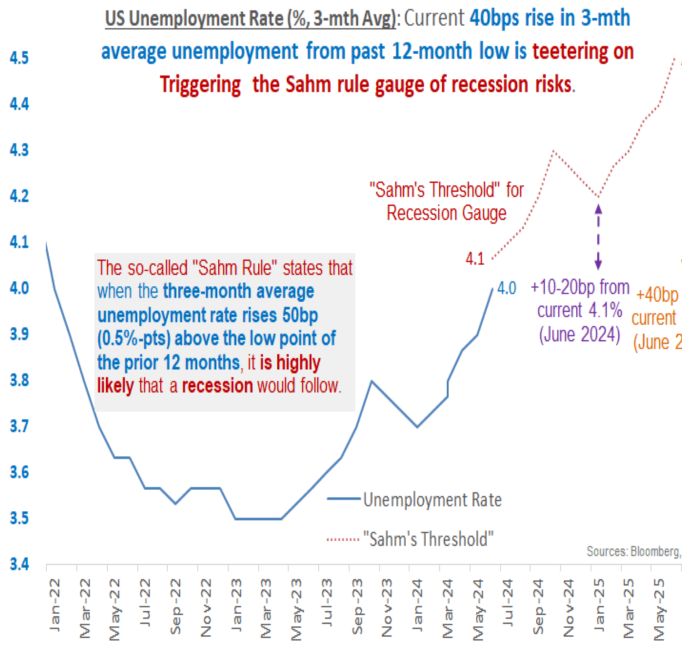
Recap 1 (Excerpts):

Macro Themes – Electing Goldilocks. 15th July 2024

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

- ……
- **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.

Recap 2:

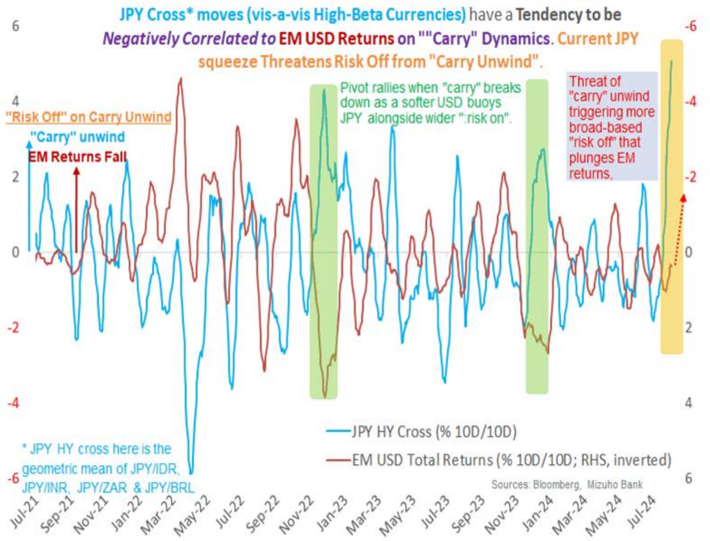
Macro Themes – Changing Minds, 29th July 2024

Fed's Pivot Latency

- On that note, this week's **July FOMC**, *despite being pegged as a non-event,* **could still be a significant driver** of (possibly even dominate) *UST, USD* and *"risk" triggers.*
- Especially as **latency for a change in policy calculus/response grows**; as **obsession over sticky inflation** (from the baggage of being wrong-footed by "transitory") **is confronted by** the ***growing***, and ***non-linear, downside risks*** **to jobs/consumption**.
- Admittedly, **overt concerns about *softening jobs* and *strained consumer resilience***, led by *Fed's Dudley declaring "I have changed my mind* (from higher for longer) … the *Fed should cut now", are not mainstream yet.*
- Nonetheless, there is **scope for Fed rhetoric to temper "higher for longer" more distinctly**.
- To that end, Fed Chair Powell's *press conference is key to watch* as a potential trigger for July.
- The **absence of dovish concessions at the July FOMC** though is **not a denial of change latency**, ***but merely deferment*** to such shift in policy calculus ***to*** a more informed (by data) ***'Jackson Hole"* *** in August.

*Admittedly, the 2024 Jackson Hole Symposium topic (to be held 22-24 Aug), "***Reassessing the Effectiveness and Transmission of Monetary Policy***", appears to be poised for "higher for longer" arguments.

JPY & Risks: Neither "Carry" Nor Calm



"A man that flies from his fear may find that he has only taken a short cut to meet it." – J.R.R Tolkien

- The **JPY squeeze** since 10th July* has been **particularly acute**, with the JPY *surging some 8-9% in just over 3weeks.*
- This has inevitably resulted in **some degree of *unwind in JPY-funded "carry trades*"**.
- Specifically, as the sharp JPY surge imposes **exchange-rate losses that overwhelm "carry" returns** (from JPY-funded investments in high-yielding assets), ultimately forcing liquidation.
- The silver lining is that **a wider contagion that triggers a** *sustained meltdown in EM/risk assets* have been *averted thus far.*
- Partly because the **JPY squeeze**, and ***resultant*** *"carry unwind",* has been *due to a build-up of events**, not an uncontrolled blowout of risk aversion.*
- But the **dark clouds of adverse feedback loop** between **"carry" liquidation and "risk off" contagion cannot be ignored**.
- Point being, the sheer magnitude of JPY squeeze warns of a more emphatic "carry" liquidation with knock-on impact on risk assets.
- Especially **if JPY-equities** and **JPY-EM FX correlations turn** *profoundly and pervasively* **negative**.
- ***Counsel to "keep calm and carry on" will get no love.***
- But **to avoid self-reinforcing panic, is perhaps the more critical thing** for markets to avert a deeper sell-down.
- That said, **caution rules the roost** as sustained JPY/CNY wedge favours keeping away from HY Cross/JPY.

*Corresponding to a plunge in USD/JPY from 162 to sub=150

** From Trump's rant on exchange rate/mercantilism to opportunistic intervention on the "Trump trigger" to BoJ rate hike.