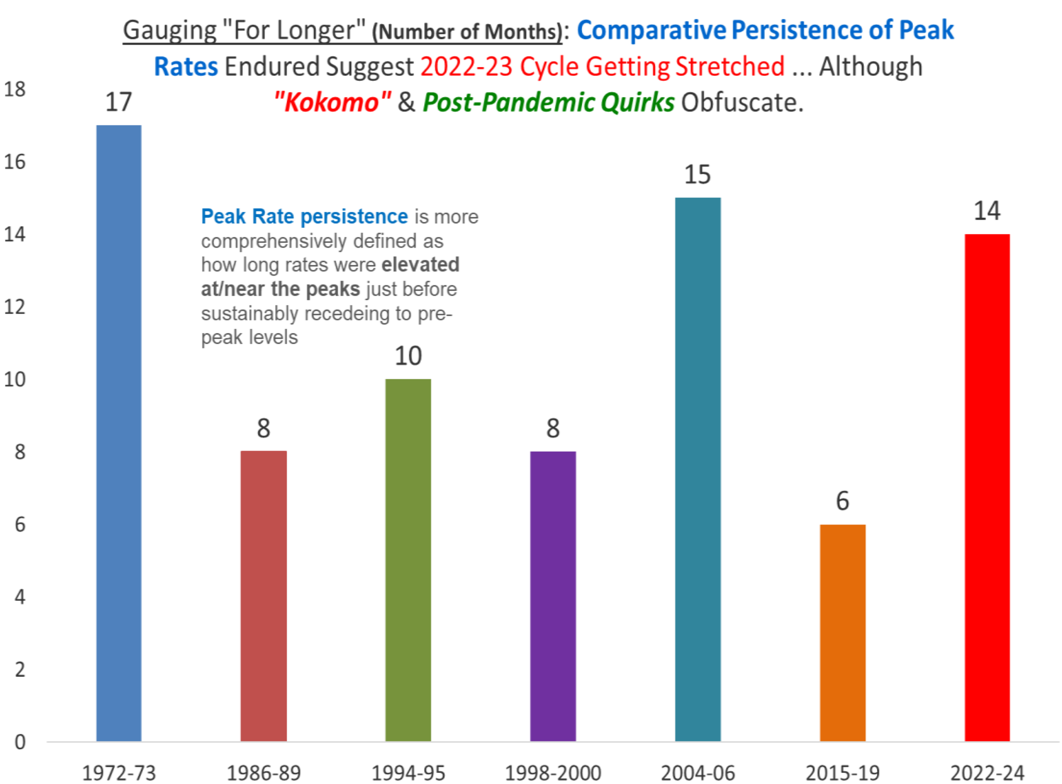
Goldilocks Threatened
Between Pivot Cheer & (Fed) Fumble Fears

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

- J.R.R Tolkien

"I find your lack of faith disturbing"

- Darth Vader, Star Wars



Sources: Bloomberg, Mizuho

August 2024

This Time It is Different? Euphoria

1. Fed's "Type-2" Miscalculation Risk

a. Cooling Inflation Accentuate **Exceptionally Tight Conditions**
b. Especially Risky Given **Stress from Tightening** US **Consumer Cashflows**
c. & Risk of ***Lagging*** Jobs Deterioration that May Soon **Demand Sharper Pivot**
d. Risk View to Stoic Fed: **Deeper Cuts by H1 2025!**
e. Sahm Rule's Recession Gauge Reveals **Fragile "Goldilocks" Assumptions**

2. Spillover Risks … *via Unintended JPY Shocks*

a. Hyper-sensitivity to US Recession Risks & Attendant FOMC Bets
b. Between Goldilocks Pivot & Recession Fears is "Risk Off" & Volatility
c. Box Item: **JPY Carry Unwind Risks**
d. USD/JPY a *Conduit for Risk Retrenchment*

3. Challenging Received Wisdom on Bearish Pivot USD

a. Bearish USD on Peak Fed is Common, But **Not Without Exception**
b. USD Retains Some Relative Policy Advantage …
c. Not to Confuse Peak USD for Bearish USD

4. Why AXJ Reversion is Not Guaranteed?

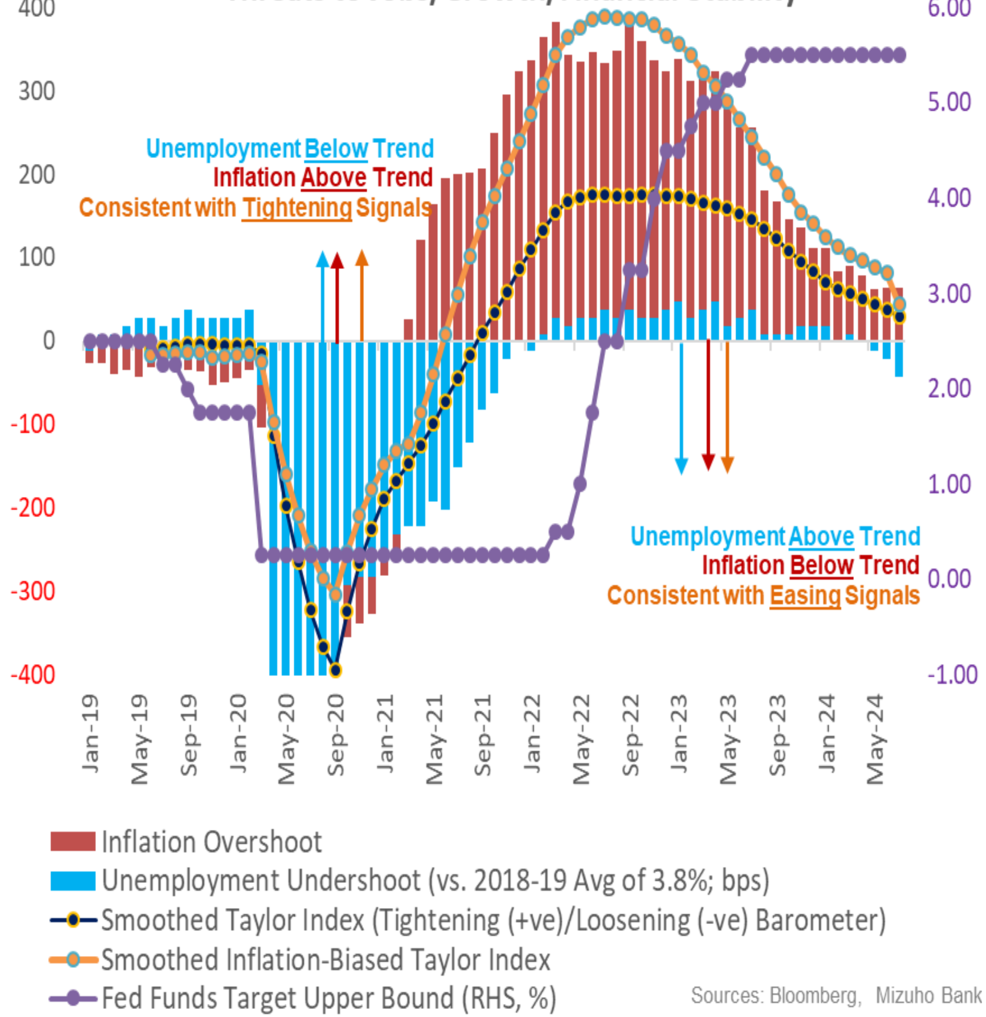
a. AXJ Relative Under-performance On a Conspiracy of Eroding Advantages
b. Specific Structural Factors
c. Carry Unwind Risks on JPY Upside Volatility

5. Especially in the Context of CNH Risks

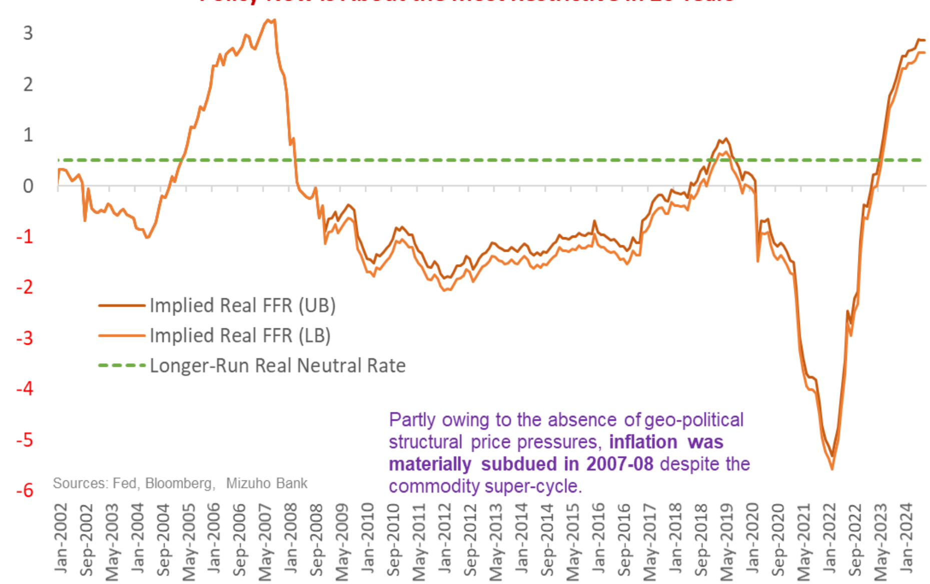
a. China & Attendant CNH Risks Loom Large
b. Exceptional CNY Pressures Amplifies Policy Conundrum ...
c. CNY Carry Unwind is a Distraction …. Sympathetic Drag is the Bigger AXJ Threat

1a. Conditions are Exceptionally Tight – Taylor Rule Does Not Require Such Restriction

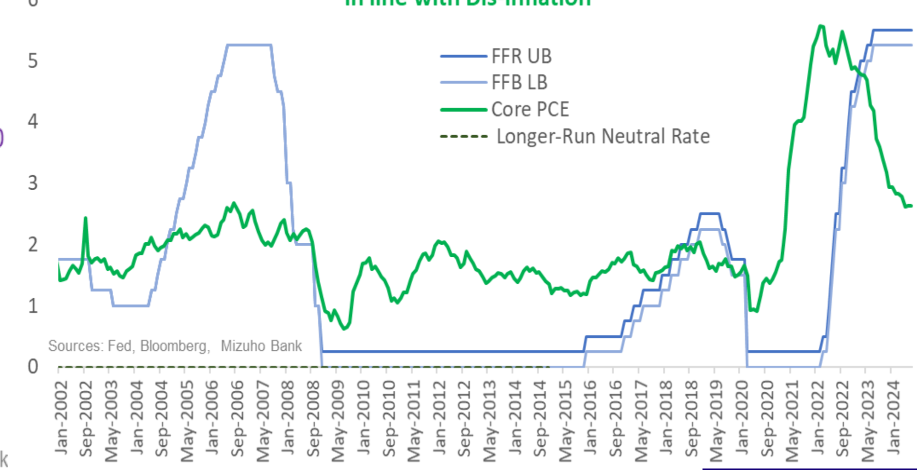
Taylor Rule: Current Setting are Deliberately More Restrictive amid perceptions of inflation risks ... but *Response Function could change Fairly Quickly* on Threats to Jobs/Growth/Financial Stability



Compared to the Longer-term (assumed) Real Neutral Rate of 0.5%, Policy Now is About the Most Restrictive in 20 Years*



2024-25 Rate Cuts Subsumed in the 'Dot Plot' is Overstate Effective Easing ... It is more Calibraton in line with Dis-inflation



1b. Especially as Consumer Cash-flow Constraints Intensify, Threatening Demand Resilience

Chart 1: Aggregate personal savings compared with the pre-pandemic trend

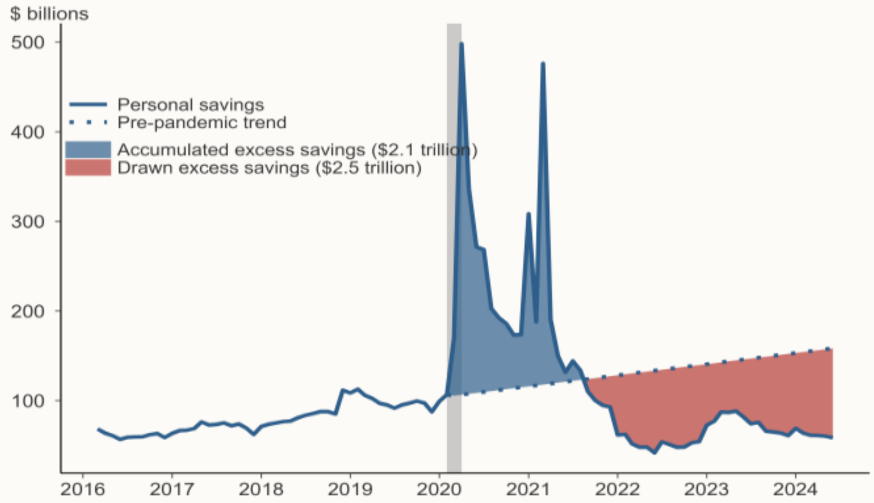
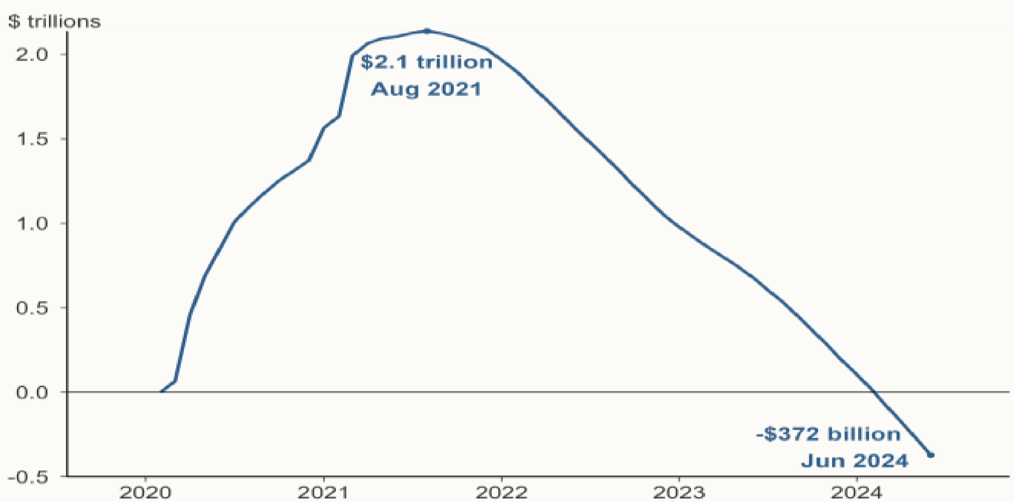
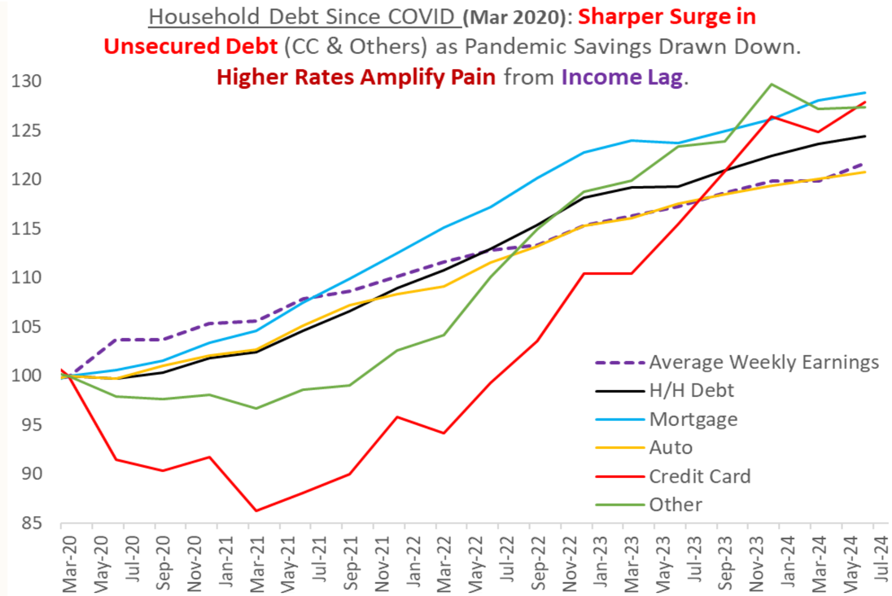


Chart 2: Cumulative aggregate pandemic-era excess savings



Source: Bureau of Economic Analysis and authors' calculations.



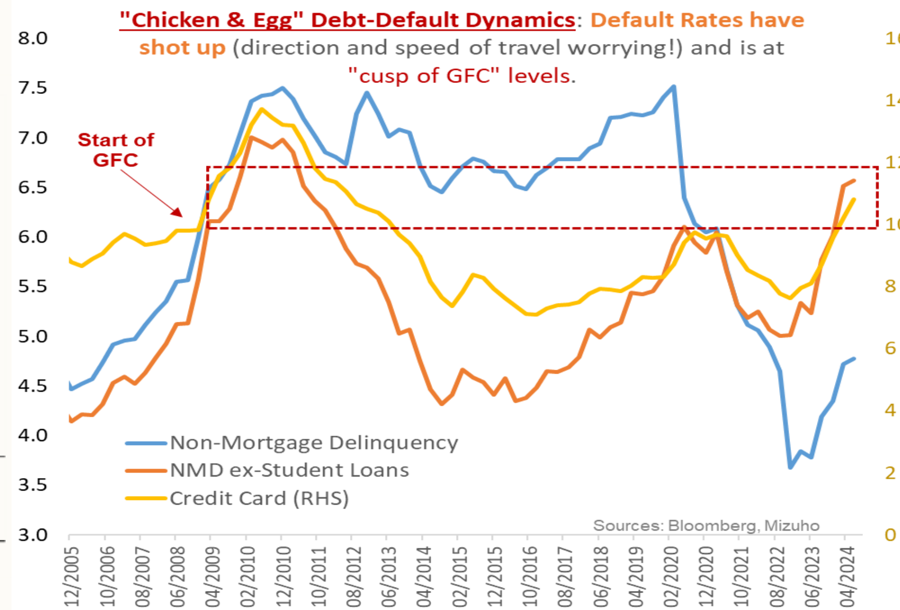


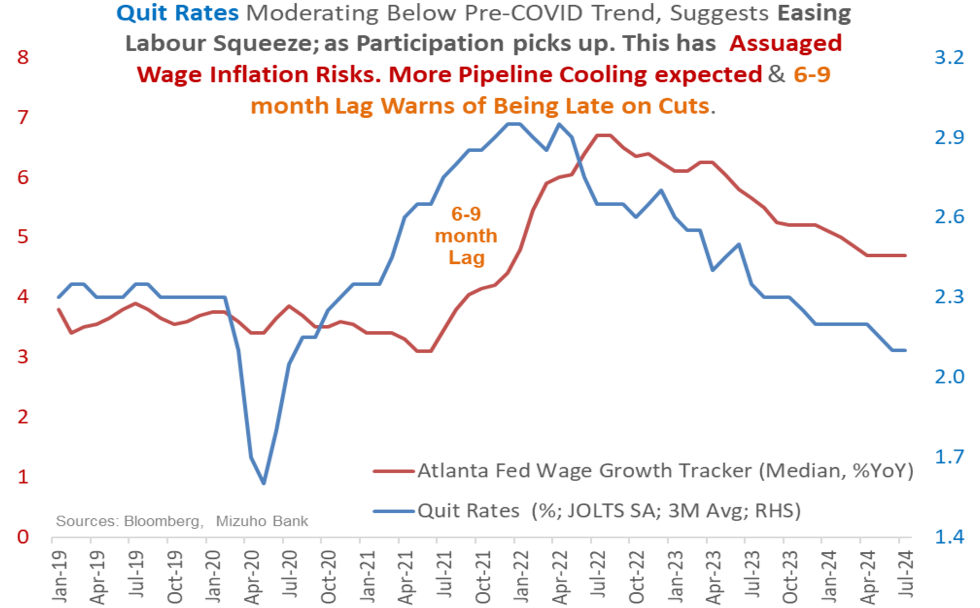
Chart from Bloomberg, San Francisco Fed,

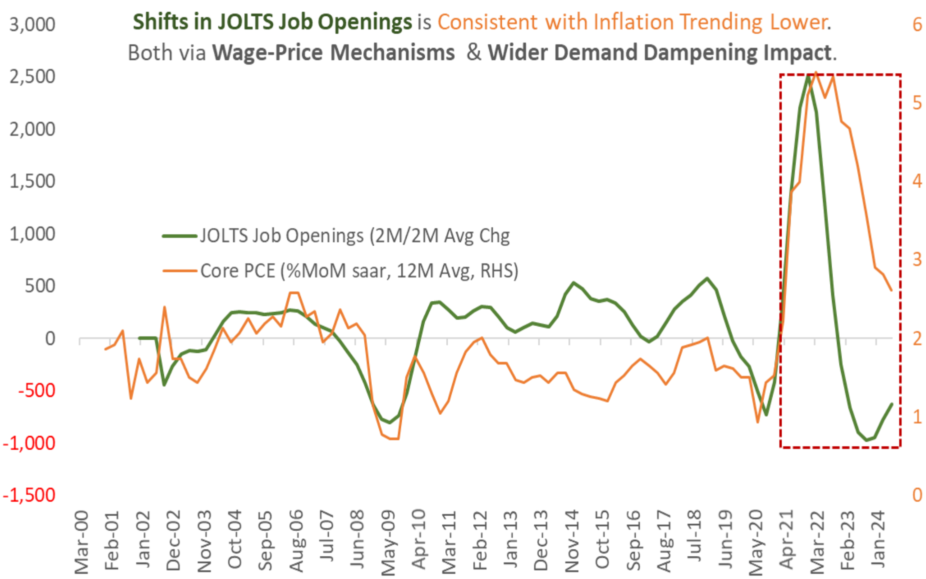
1c. Alongside Cooling Jobs/Wages, *Type 2 Error* May Abruptly Shift Fed Response

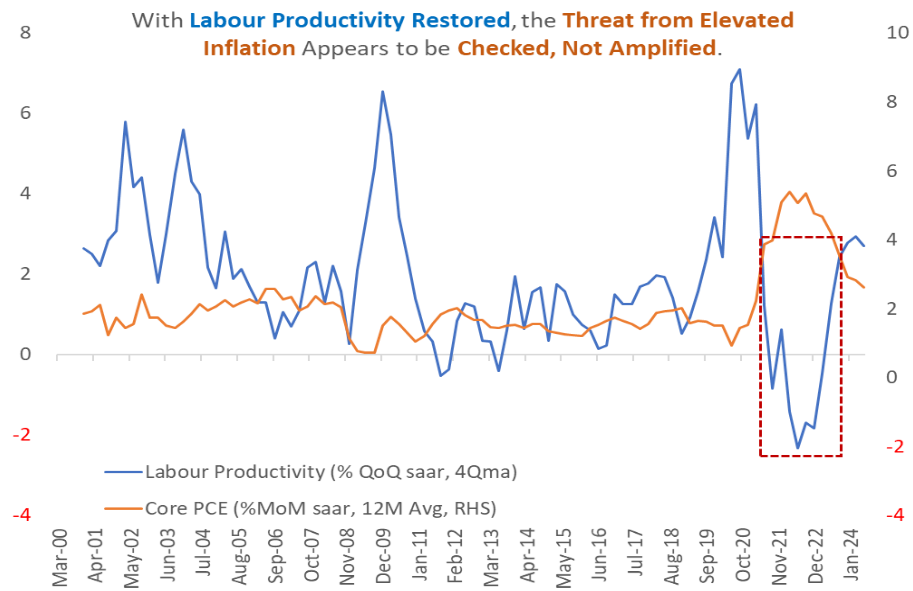
US Consumer - Tightening Cash-flows

- Drawdown of savings, increased credit (and attendant servicing burden) and softening wage gains translate into tighter consumer cash-flows.
- In turn the hit on demand will have negative multiplier effects at the margin, which significantly dampen growth outcomes; even if an outright recession is averted.
- For a Fed that is decidedly not setting out to break something, this will be a jolt out of the Type 2 error resulting from the earlier Type-1 error.

"Type-1" Error: Wrongly rejecting null hypothesis of inflation risks.
"Type-2 Error: Wrongly failing to reject null hypothesis of persistent inflation risks







1d. Fed's "Type-2" Error Risks – *Flipping "Higher for Longer" to "Too High for too Long"*

	End-2021	End-2022	End-2023	2024				2025				2026		2027	
			Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	Q4 25	H1 26	H2 26	H1 27	H2 27
Fed Funds Target Rate Ceiling	0.25	4.50	5.50	5.50	5.50	5.25	5.00	4.25	3.50	3.00	2.75	2.50	2.50	2.50	2.50
Fed Funds Target Rate floor	0.00	4.25	5.25	5.25	5.25	5.00	4.75	4.00	3.25	2.75	2.50	2.25	2.25	2.25	2.25
UST 2Y Yields	0.73	4.43	4.25	4.62	4.75	3.87	3.27	2.70	2.69	2.80	2.53	2.50	2.30	3.33	3.18
UST 10Y Yields	1.51	3.87	3.88	4.25	4.40	3.78	3.65	3.22	3.35	3.42	3.28	3.33	3.18	3.33	3.18

Sources: Bloomberg, Mizuho Forecasts

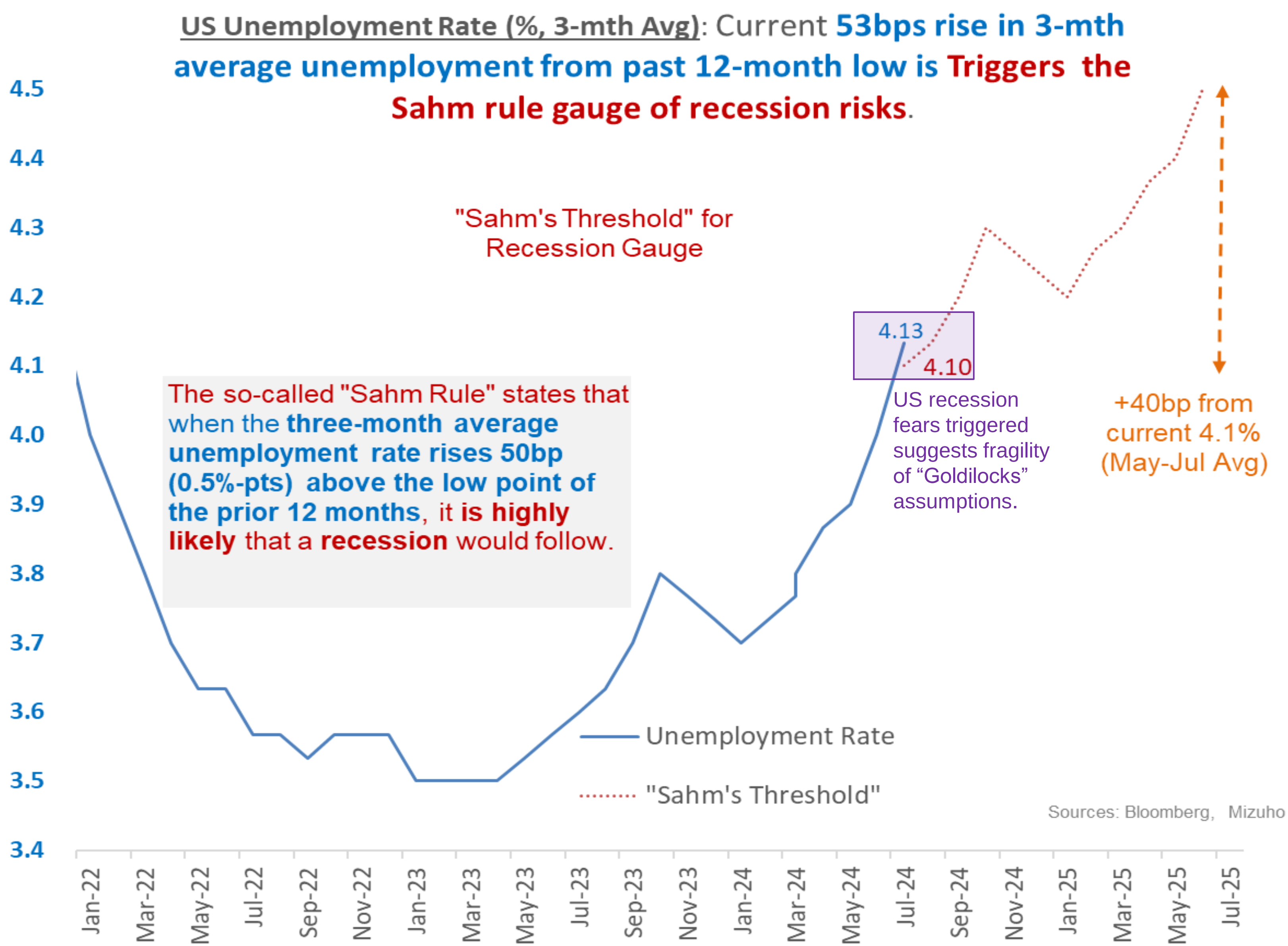
"Too High for Too Long" Risks Defer but Don't Diminish Fed Rate Cuts
- The quirks of post-pandemic durability in demand defer Fed rate cuts vis-à-vis past Fed cycles.
- But 'Type-2' error (from overcompensating for "transitory") of "too high, for too long" are accentuated now
- Which accentuates the risks of having to catch-down more hurriedly with belated rate cuts.

"2024 Runway Curtailed, but 2-3 Cuts Likely …
- Barring a crisis (not our base case), rate cut run-way for 2024 is constrained by data-watching and elections.
- July FOMC virtually ruled out. September, November and December are "live".
- 50-75 bps of rate cuts still on the table, with 50bp being most likely.

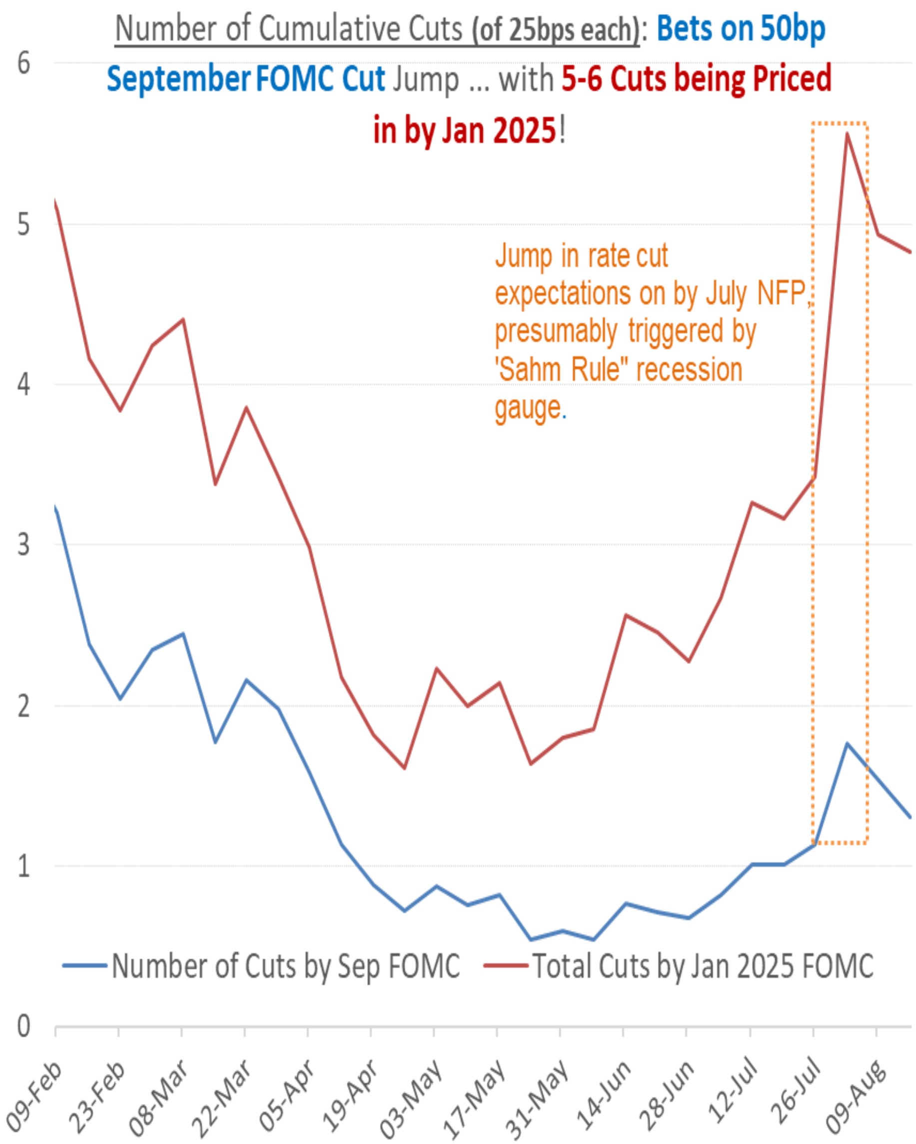
Rate Cuts to Gather Pace in H1 2025
- Sharper demand softening alongside rapid slowdown set to diminish wage-price spiral risks.
- Consequently, Fed rate cuts will gather pace in H1 2025 so as to alleviate acute policy restriction.
- Up to 200bp of rate cuts by mid-2025 is not as outlandish. Fact is, 3.25-3.50% is likely still restrictive.

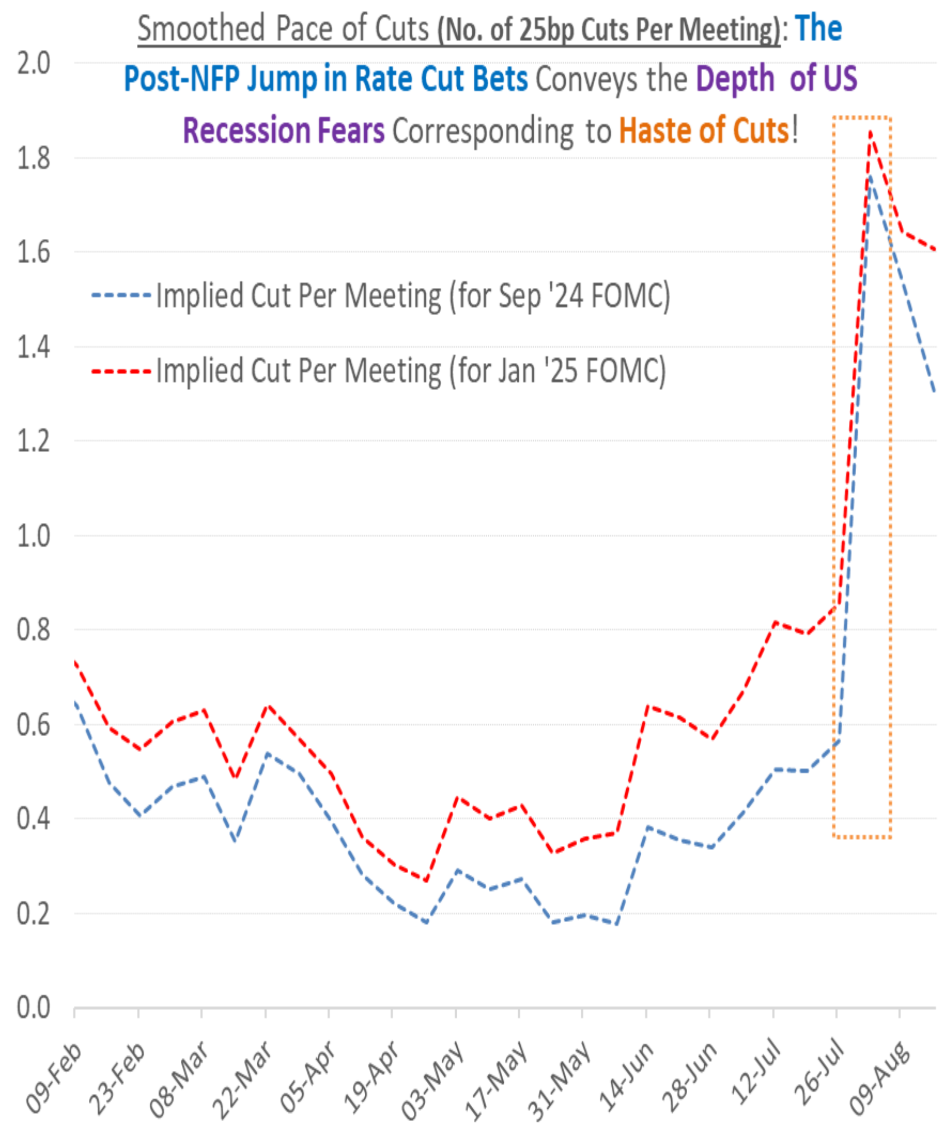
Consumer Slowdown, Not Crisis
- Brisker cuts are premised on sharper consumption slowdown amid tightening cash-flows ➔ Not so soft landing
- And not a crisis from a balance sheet shock – for which far deeper and larger rate slashing will be required.

1e. US Economy: 'Sahm' Fears About Flawed Soft Landing Assumptions?

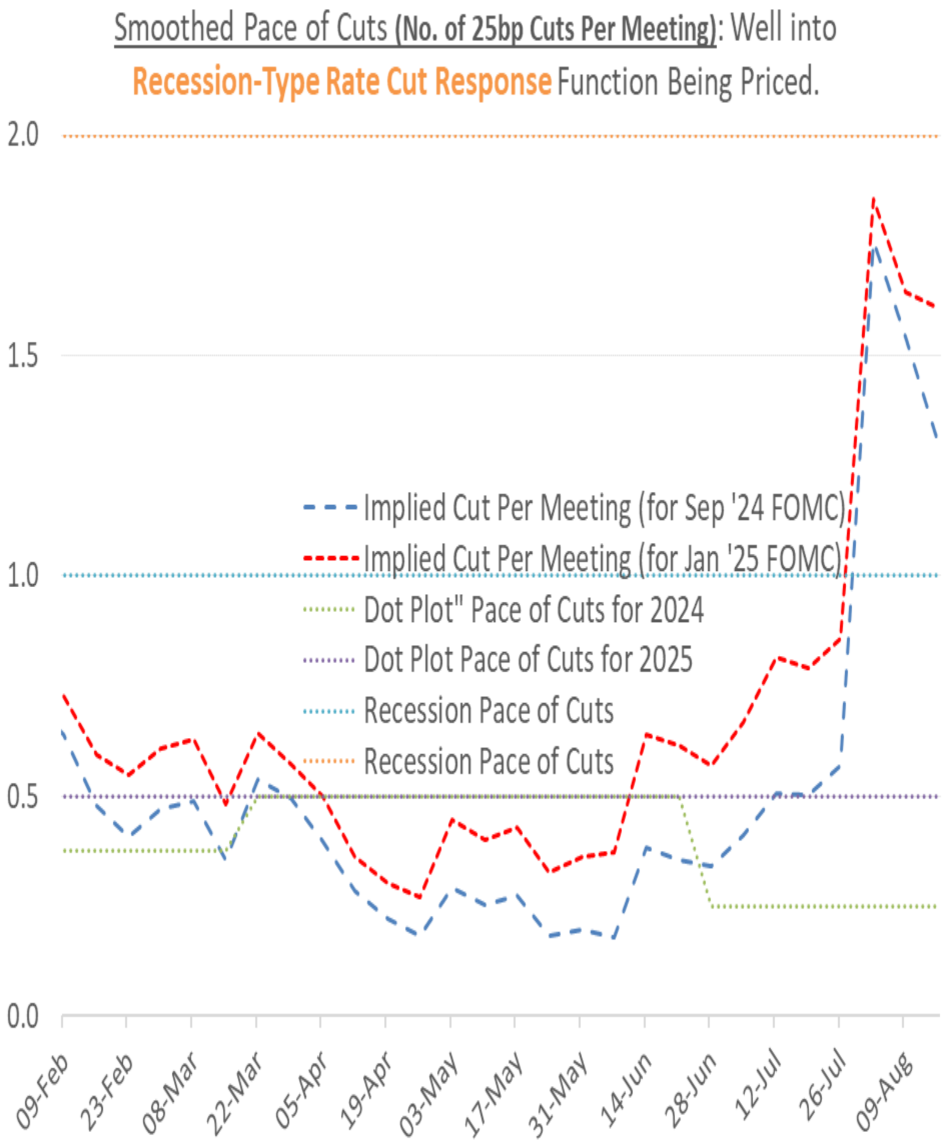


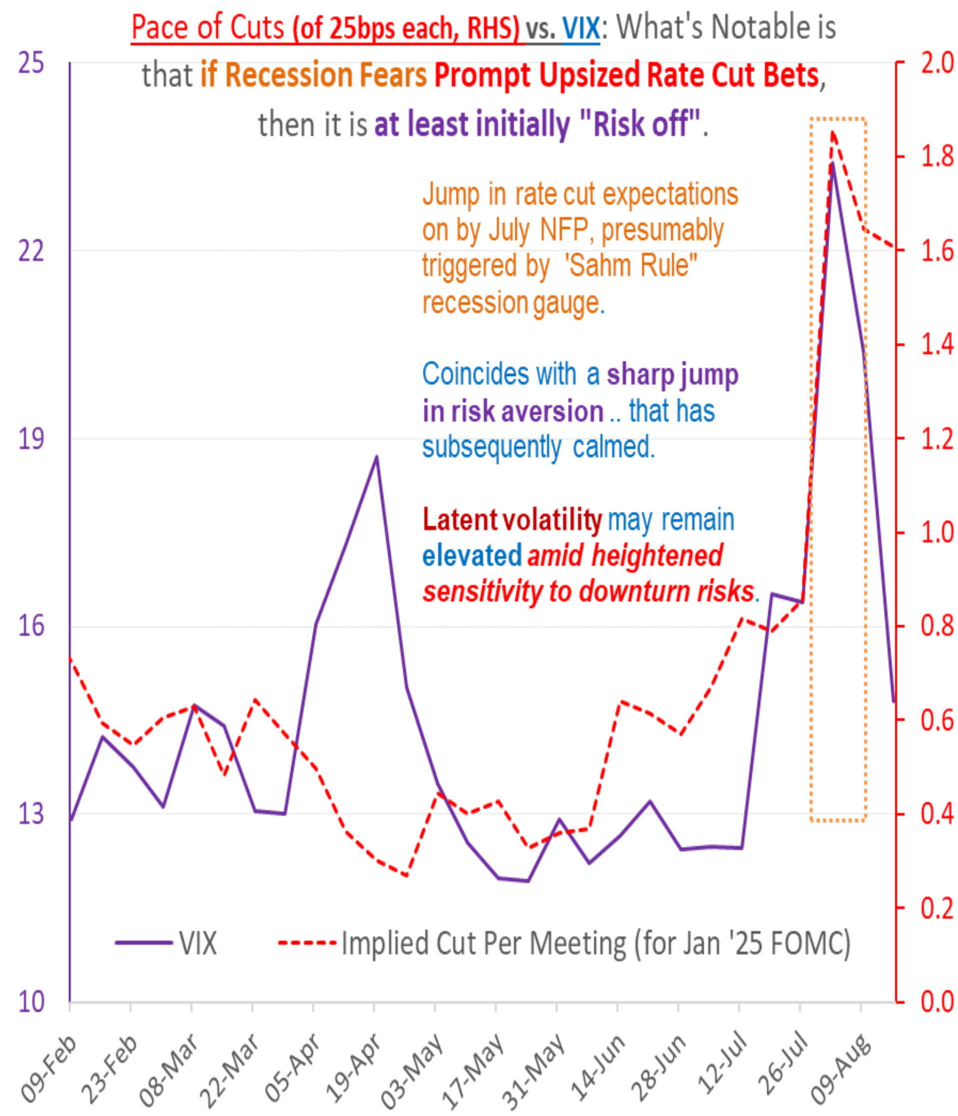
2a. Hyper Sensitivity to US Recession Risks & Fed Response



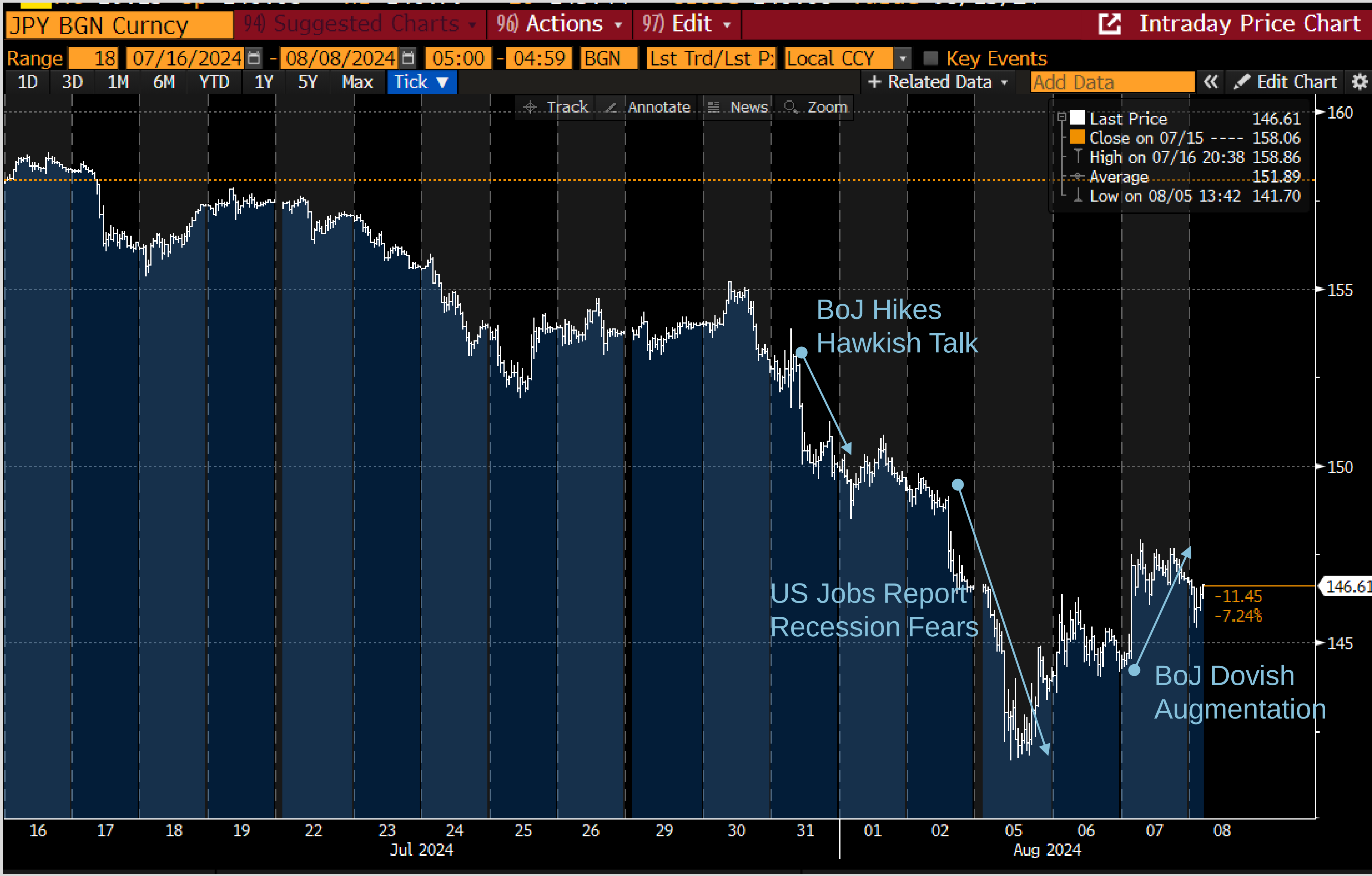


US Jobs – Teetering on US Recession Fears & Attendant Risk Off

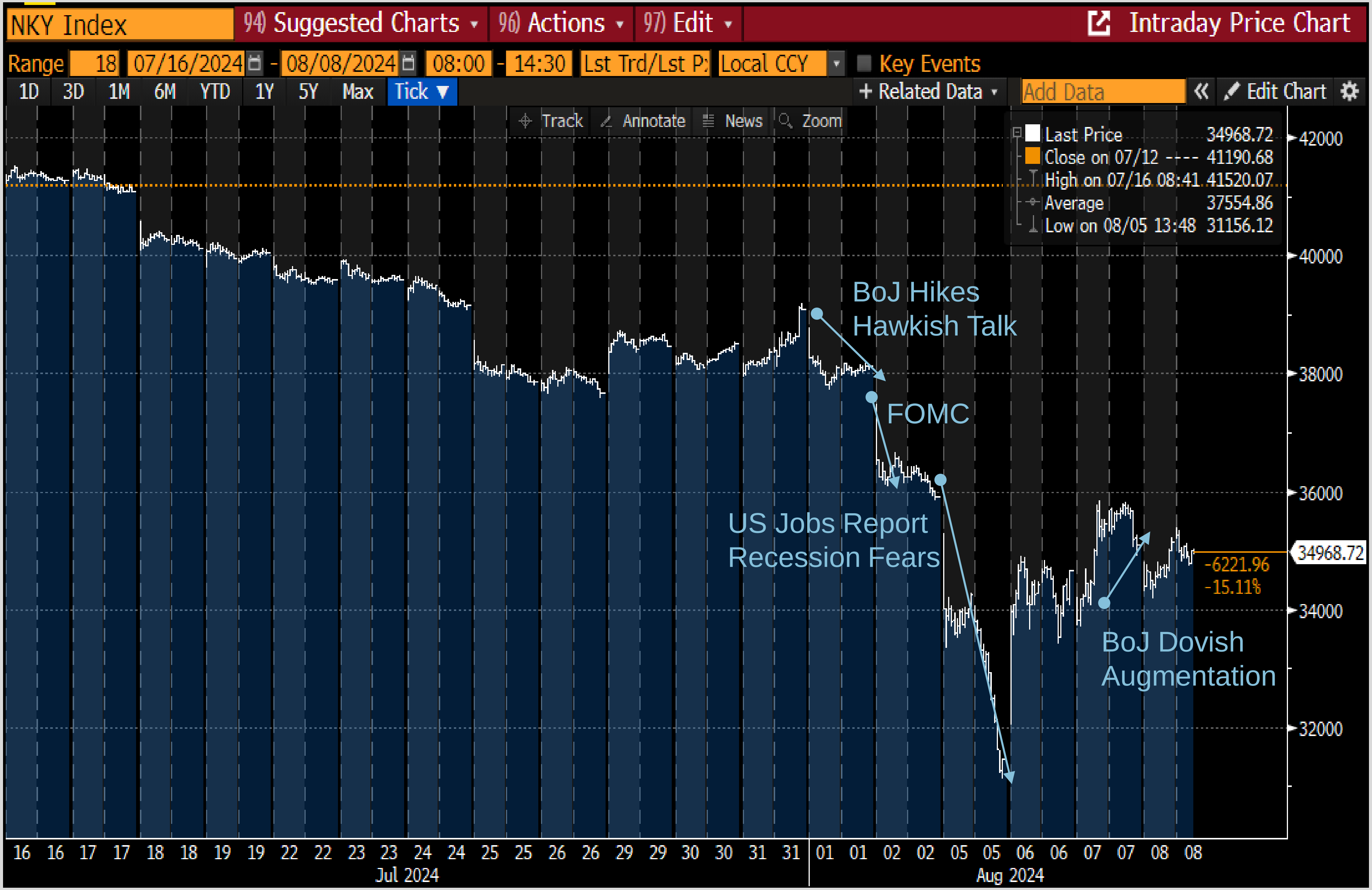




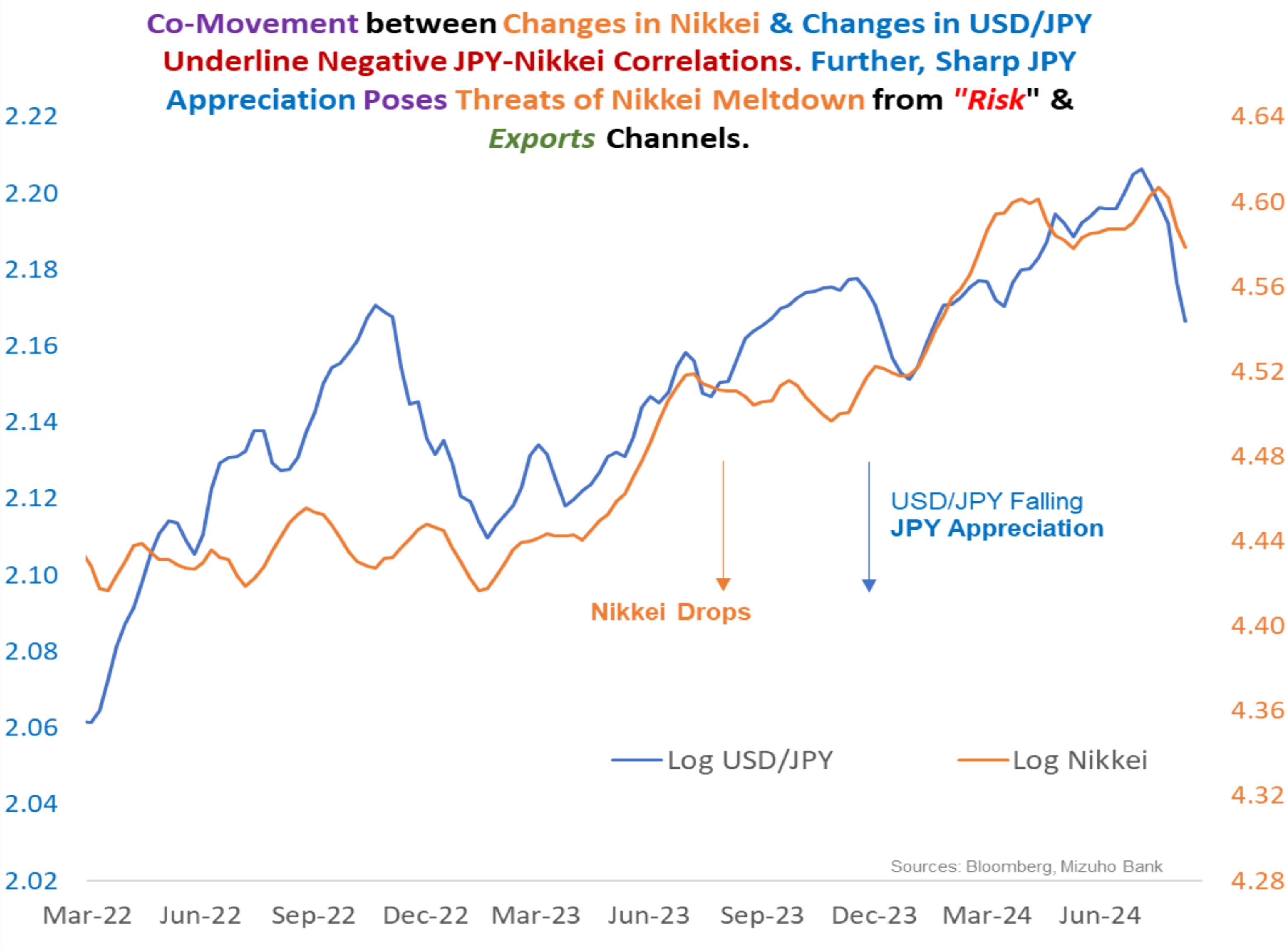
2c. THAT JPY Squeeze – Time-line & Thoughts



2c. & Corresponding Nikkei Plunge



2c. JPY-Nikkei: The BoJ Blame Game



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2c. JPY Carry Unwind Risks – Main Take-Aways

1. **JPY Carry Unwind Risks** are **NOT Exclusively BoJ-Driven**.
2. So, although *BoJ's dovish* caveat (no hikes if markets are unstable) *only partially mitigates JPY carry unwind*.
3. Instead, **Fed pivot expectations** (this time via softer NFP) are a **huge swing factor**.
   - *This is but a manifestation of our long-held view that (earlier) JPY depreciation pressures were a "BoJ problem with a Fed solution", with the Fed solution (rate cuts) now posing the other extreme problem of too sharp a surge/rebound in JPY (and attendant JPY carry unwind).*
4. Corresponding **sharp shifts in Fed rate cut bets** impacts *via Fed-BoJ divergence* expectations.
5. Which consequently *compress UST-JGB spreads* and drag *USD/JPY sharply lower.*
6. In turn, this **sudden and sharp JPY surge "squeezes out" concentrated JPY-funded carry trades**.
7. Inevitably, **JPY-funded** "**carry unwind**" is ***most* detrimental to high-yielding assets**. But not just.
8. **Negative JPY-Nikkei correlation** from acute JPY squeeze may also **adversely impact global equities**.
9. In all, the **threat of global "risk off" involving adverse feedback loop with carry unwind persists**.

Policy Implications:

- **i.** **BoJ**: Dial-back in tightening checks, but doesn't kill adverse (strong) JPY-Nikkei (plunge) spiral.
- ii. **Fed**: Markets become especially sensitized to sharp swings in pivot bets.
- **iii.** **Fed-BoJ**: Any accentuation of Fed-Boj divergence will amplify JPY volatility risks.

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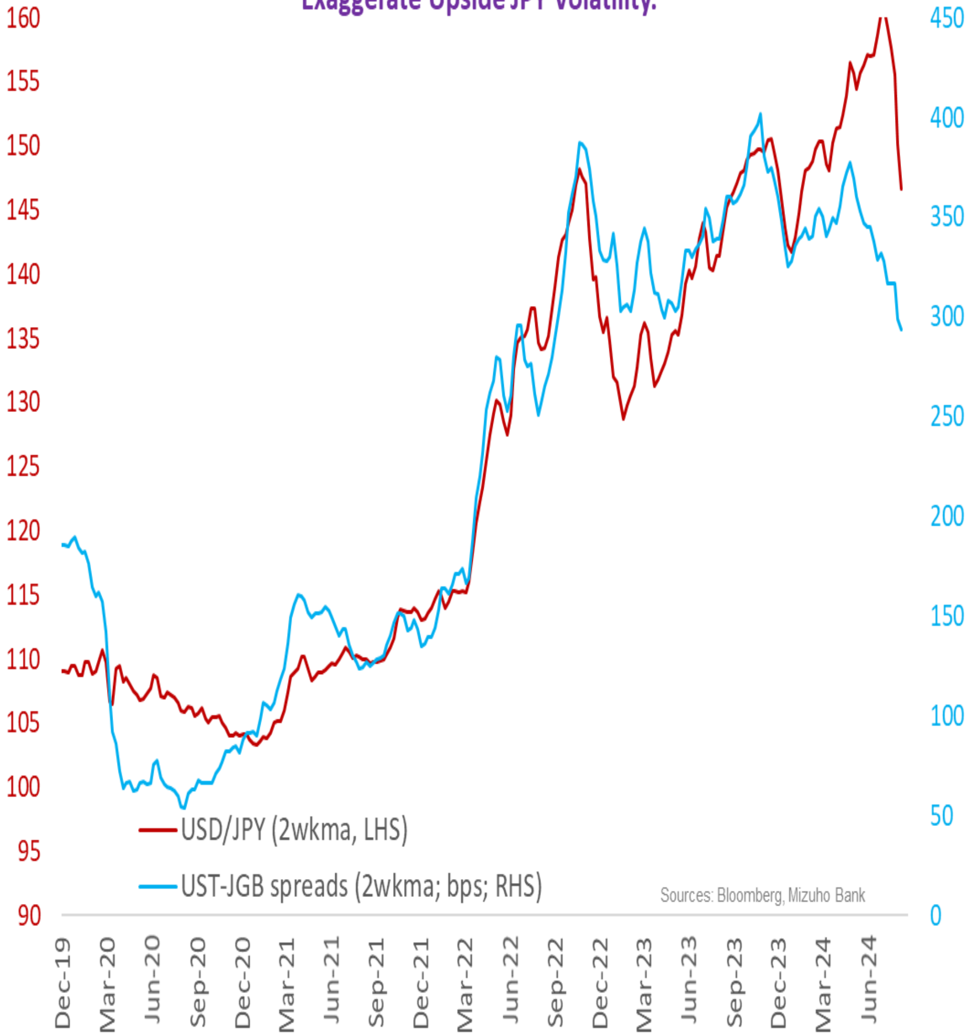
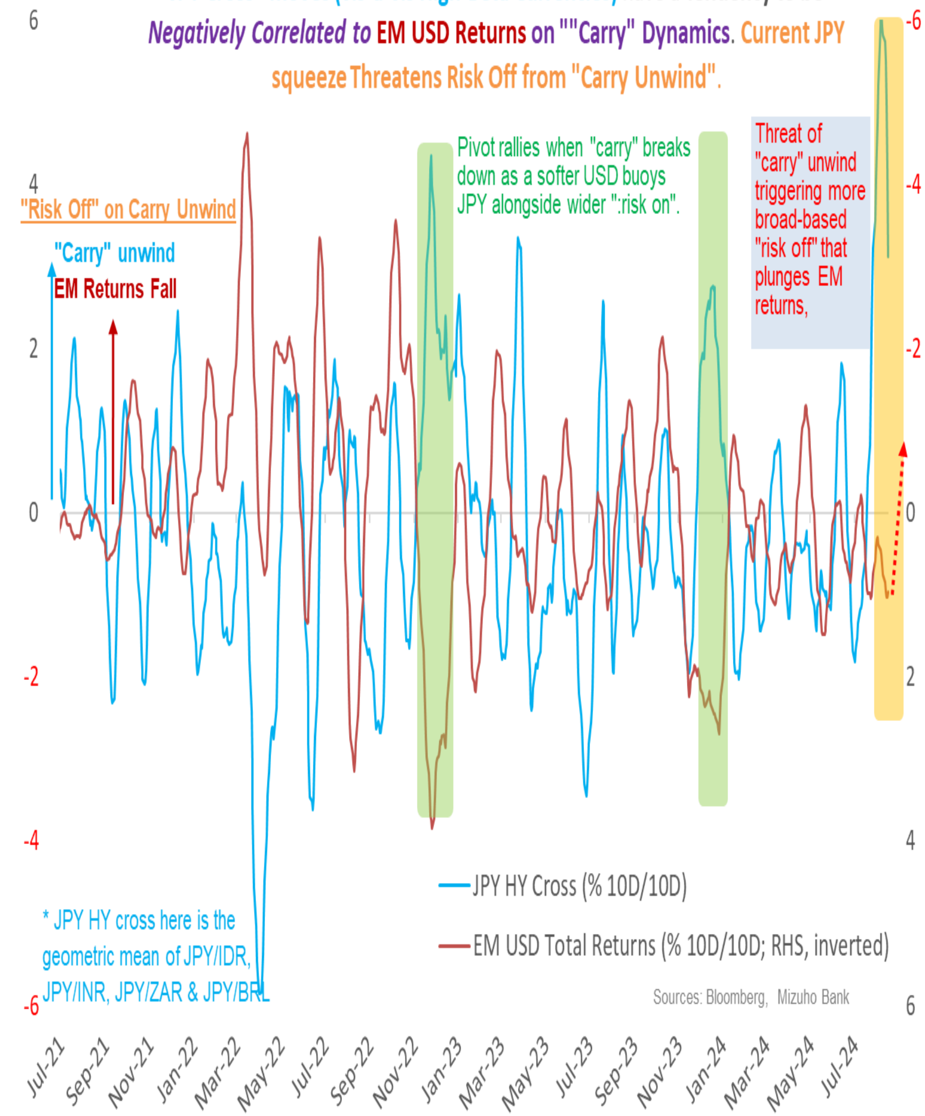
2d. Fed-BoJ & JPY Correlations: Fed's Greater Sway on JPY & "Carry Unwind" Contagion

Fed Pivot Could Accentuate JPY Rebound (USD/JPY Puillback) From BoJ Tightening. Notably, the Optics of Fed-BoJ Divergence May Also Exaggerate Upside JPY Volatility.



JPY Cross* moves (vis-a-vis High-Beta Currencies) have a Tendency to be *Negatively Correlated to* EM USD Returns on ""Carry" Dynamics. Current JPY squeeze Threatens Risk Off from "Carry Unwind".



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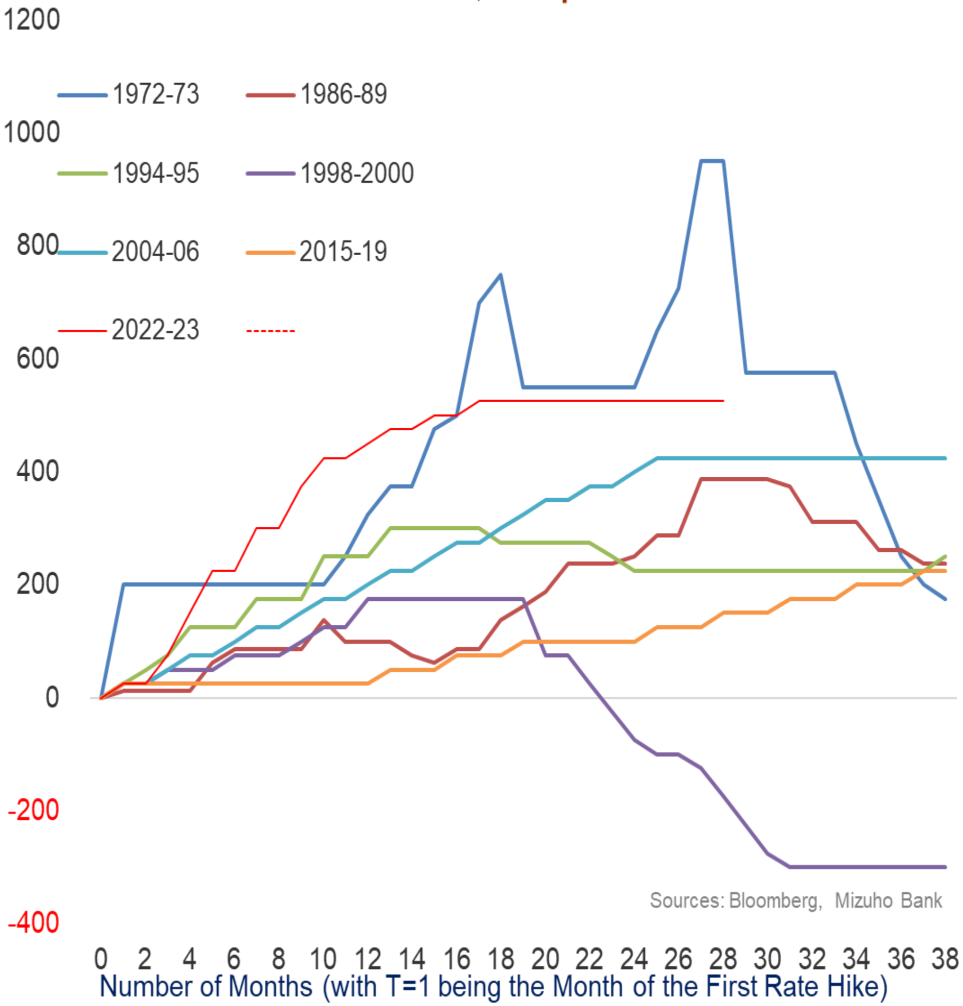
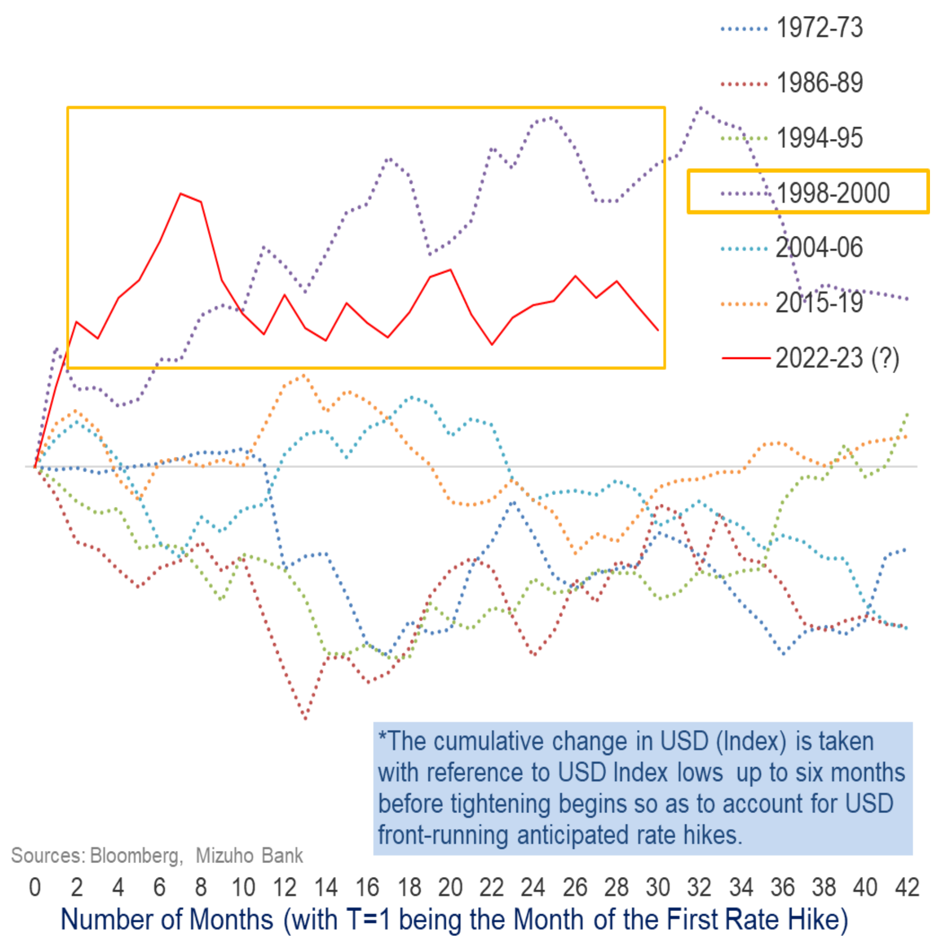
3a. Policy Nuance: Not All Pivots are Created Equal! "Competitive Pivot"/US Exceptionalism

Fed Hiking Cycle (Cumulative Rate Hikes; bp): **Although not the Greatest Amplitude of Rate Hikes** (1970s More Brutal, with >700bp of Hikes), **this Cycle Marks the Fastest Pace of Hikes**; **525bps Over 17 Months**.

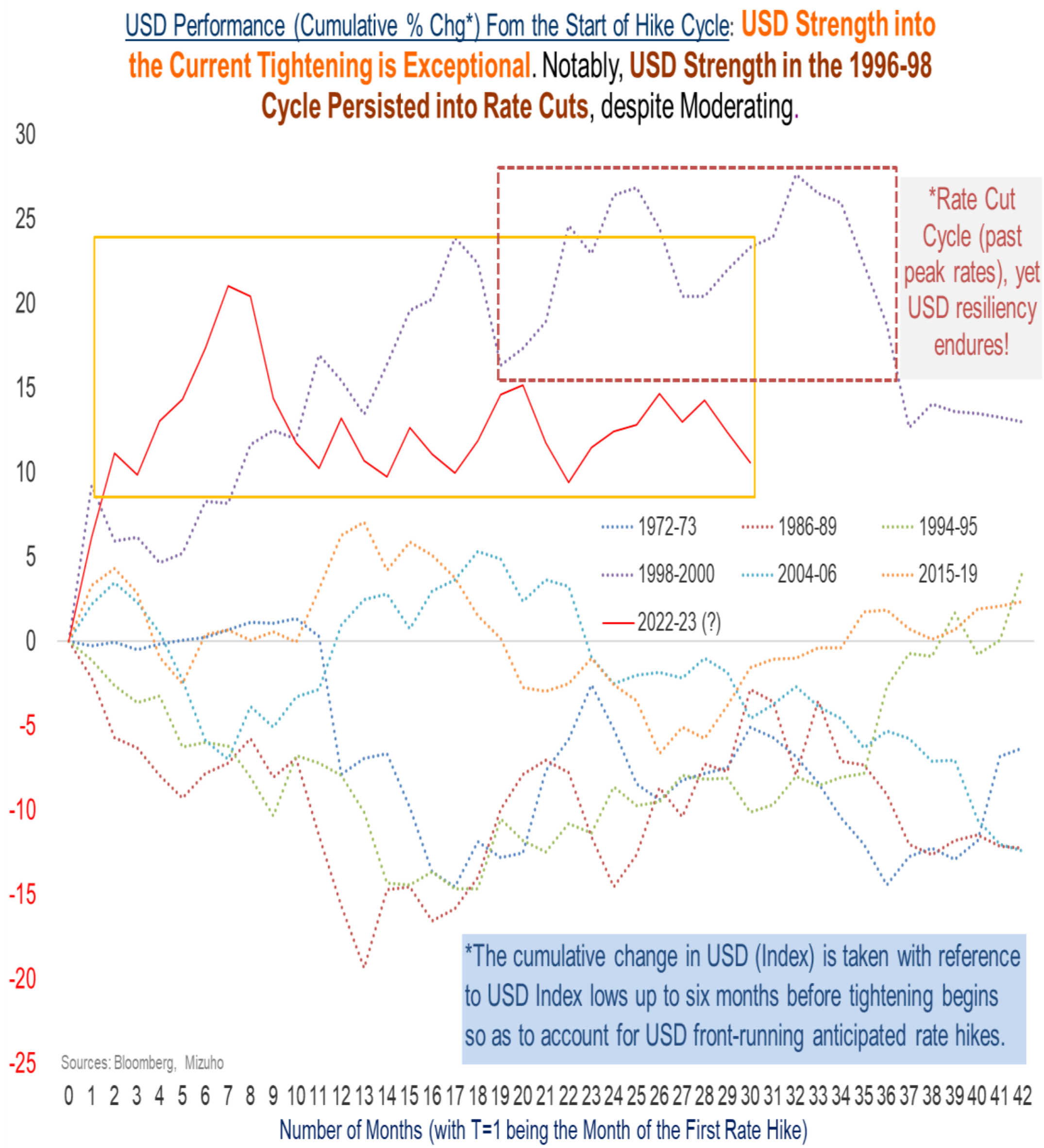


Corresponding USD Performance (Cumulative % Chg*): **Notably, the Current Rate Hike Cycle Has Resulted in the Sharpest Phase of USD Strength in the First 8-9 months**; moderating below corresponidng 1998-2000 Trajectory but **still significantly more buoyed**.



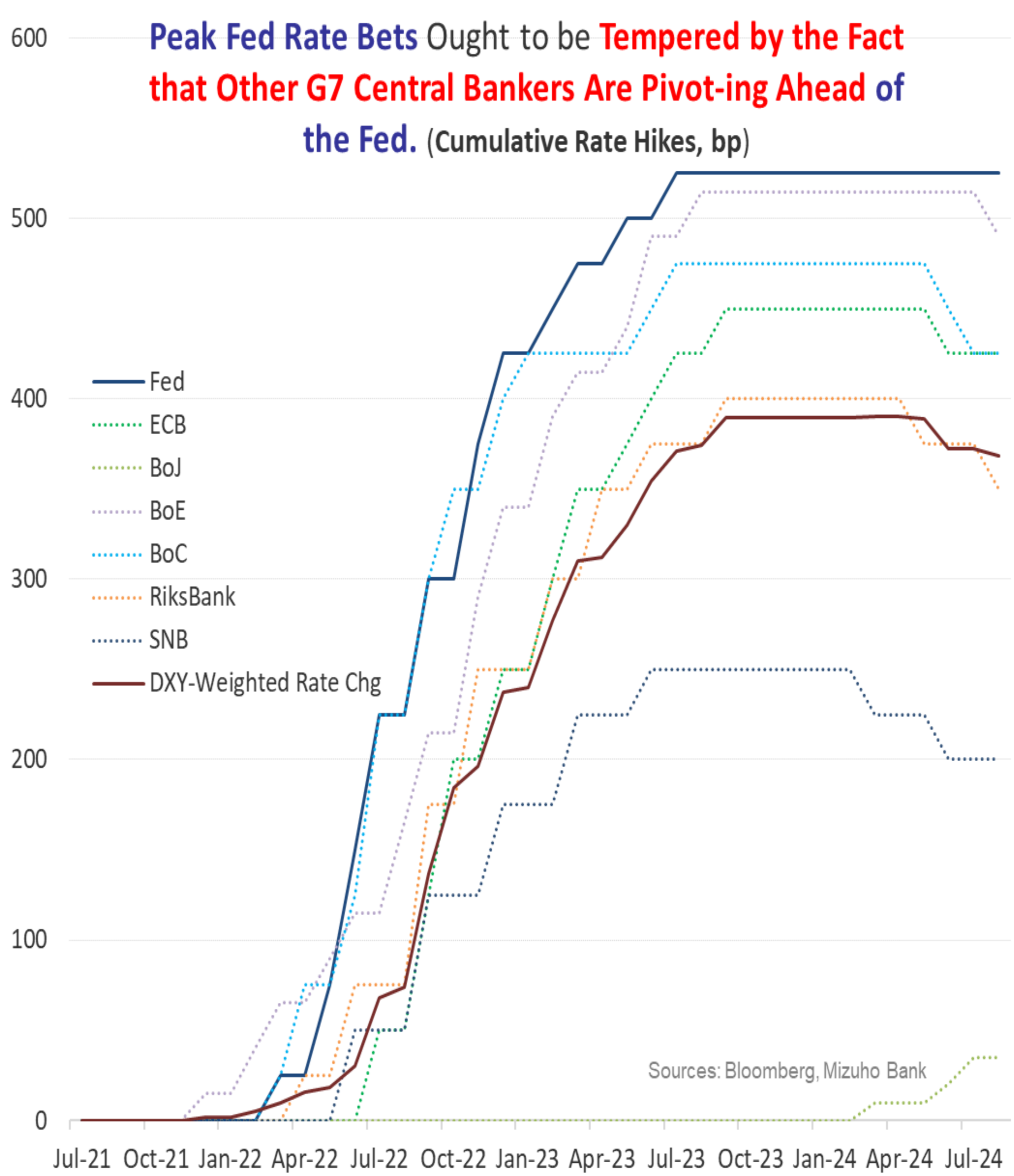
*The cumulative change in USD (Index) is taken with reference to USD Index lows up to six months before tightening begins so as to account for USD front-running anticipated rate hikes.

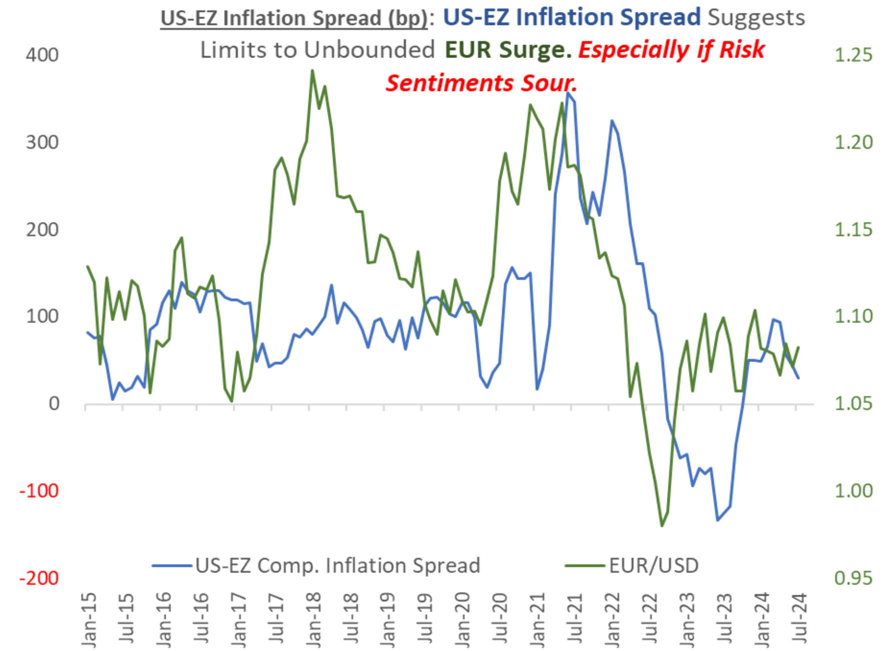
3a: Corresponding USD Response is Not the Usual "Peak USD ahead of Peak Fed"

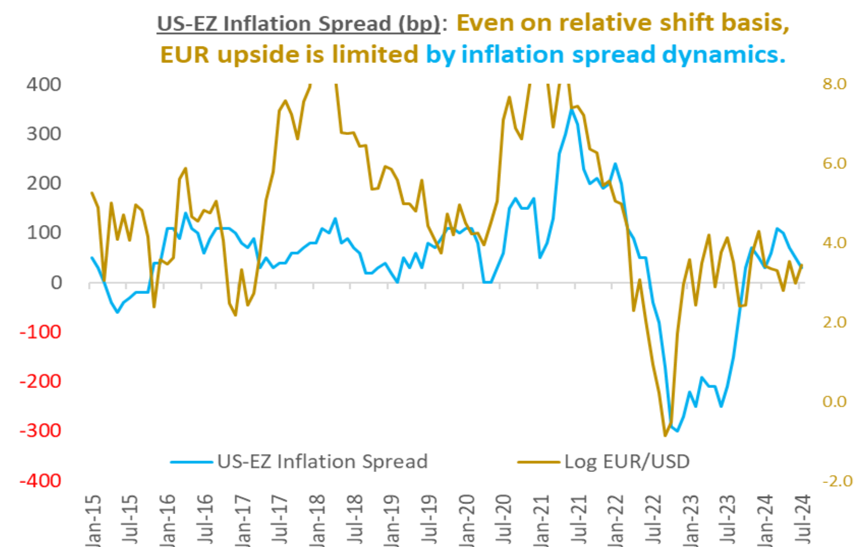


- Arguably, the most **profound challenge to AXJ reversion** (recovering to pre-Fed hike levels) **is persistent, defiant USD strength** *in the context of Fed pivot, which is typically consistent with more pronounced USD pullback.*
- This **anomalous USD strength so late into the Fed tightening cycle is not merely a cyclical blip but a structural feature of** *with uncharacteristic USD resilience into Fed easing ahead*; whereby ***USD may soften*** (from elevated levels), ***but not fully surrender rate hike gains*** as relative US exceptionalism and geo-politics conspire.
- **Admittedly, USD peaked** (in October 2022), **ahead of peak Fed rate** (reached in July 2023), *consistent with the idea of USD front-running the Fed.*
- And to be sure, **a mellower USD as the Fed settles into rate cuts into 2025 is our base case.**
- *Nonetheless,* **further USD declines** *anticipating, or coinciding with Fed cuts,* **may fall significantly short of expectations** pegged to most previous cycles.
- In which case, **commencement of Fed rate cuts alone is not sufficient to fully restore AXJ to pre-2022 levels** given USD dominance be slow to fade.

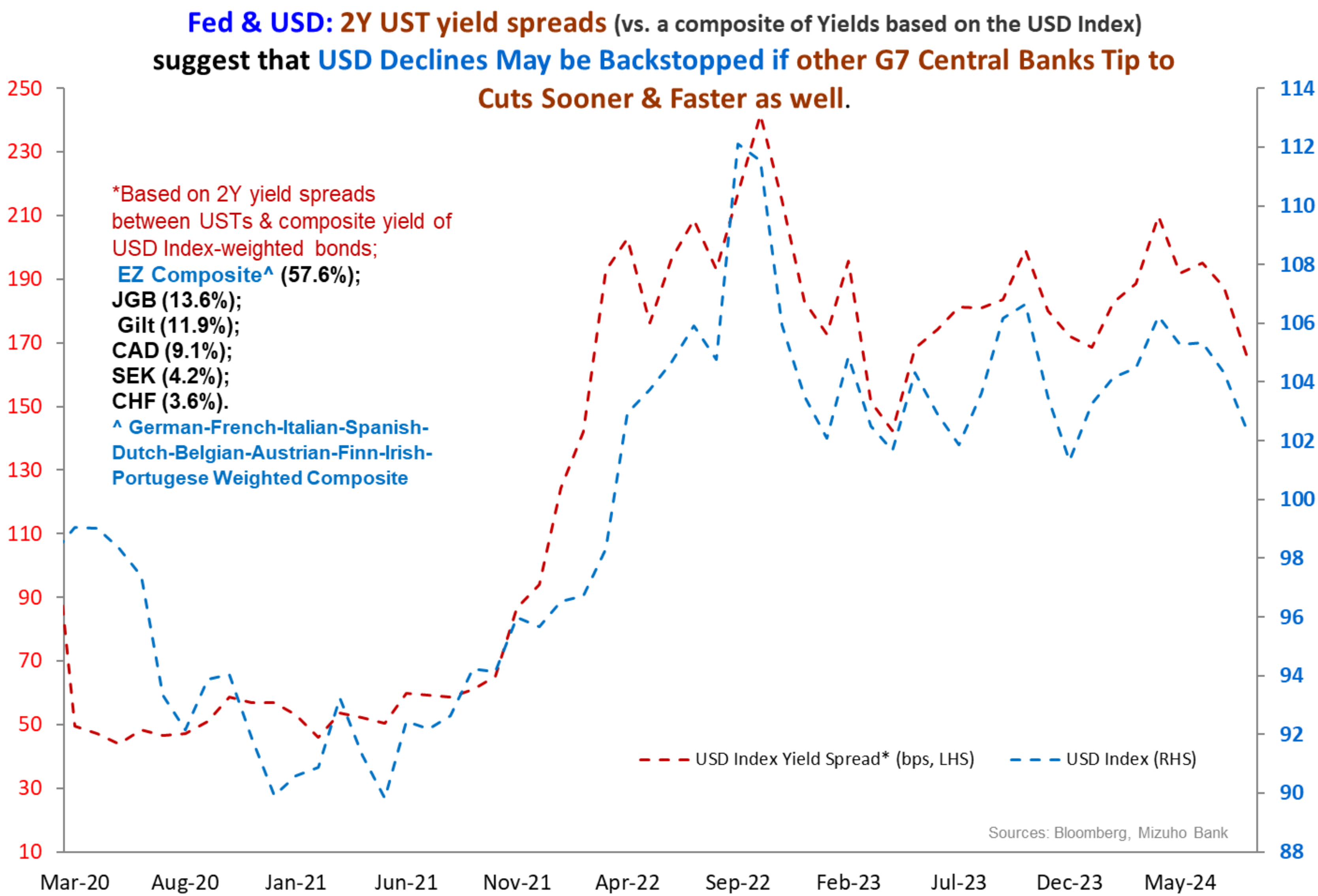
3b: Relative Rate Strength Understate "Competitive Pivot" Inclination Shifts



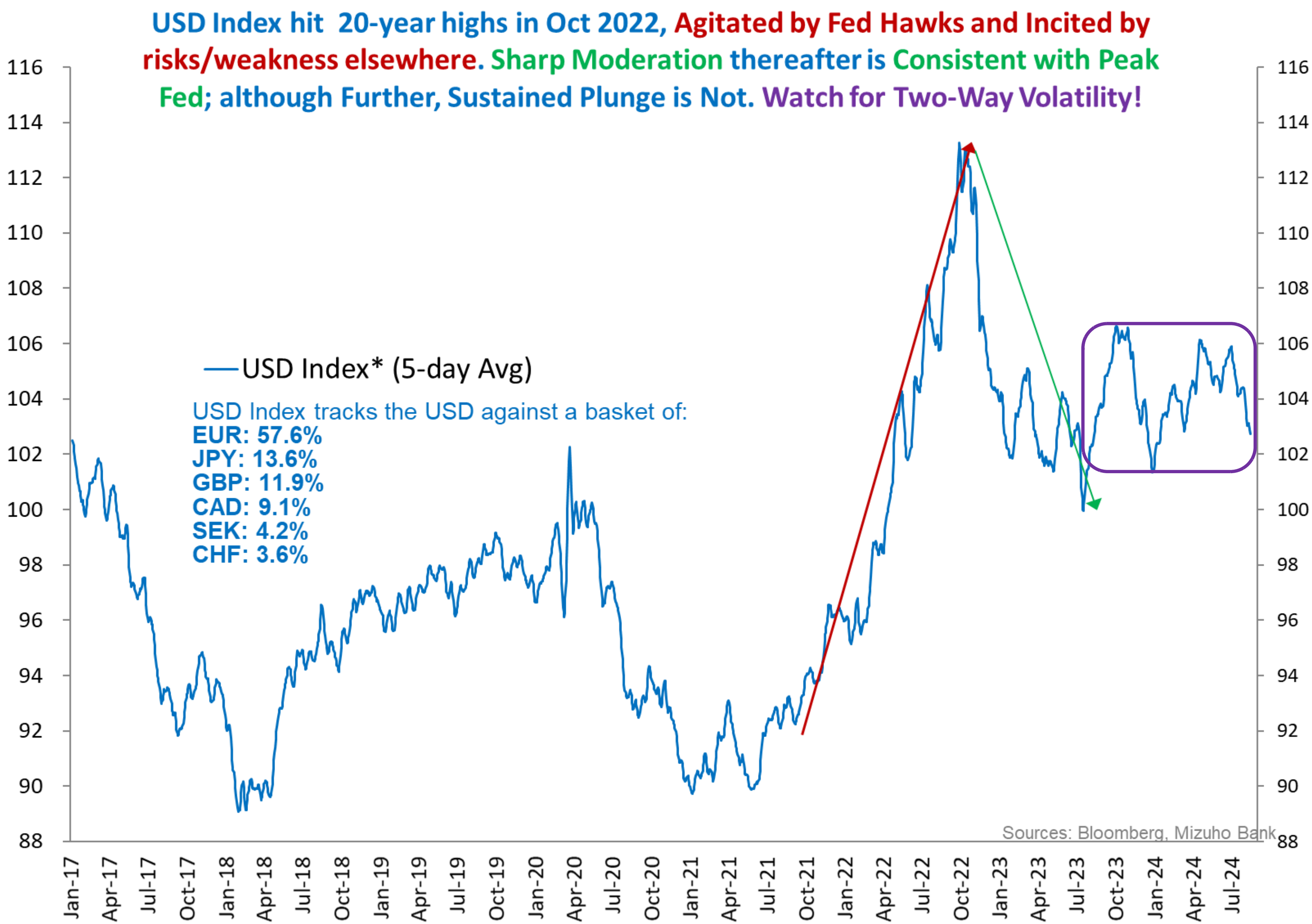




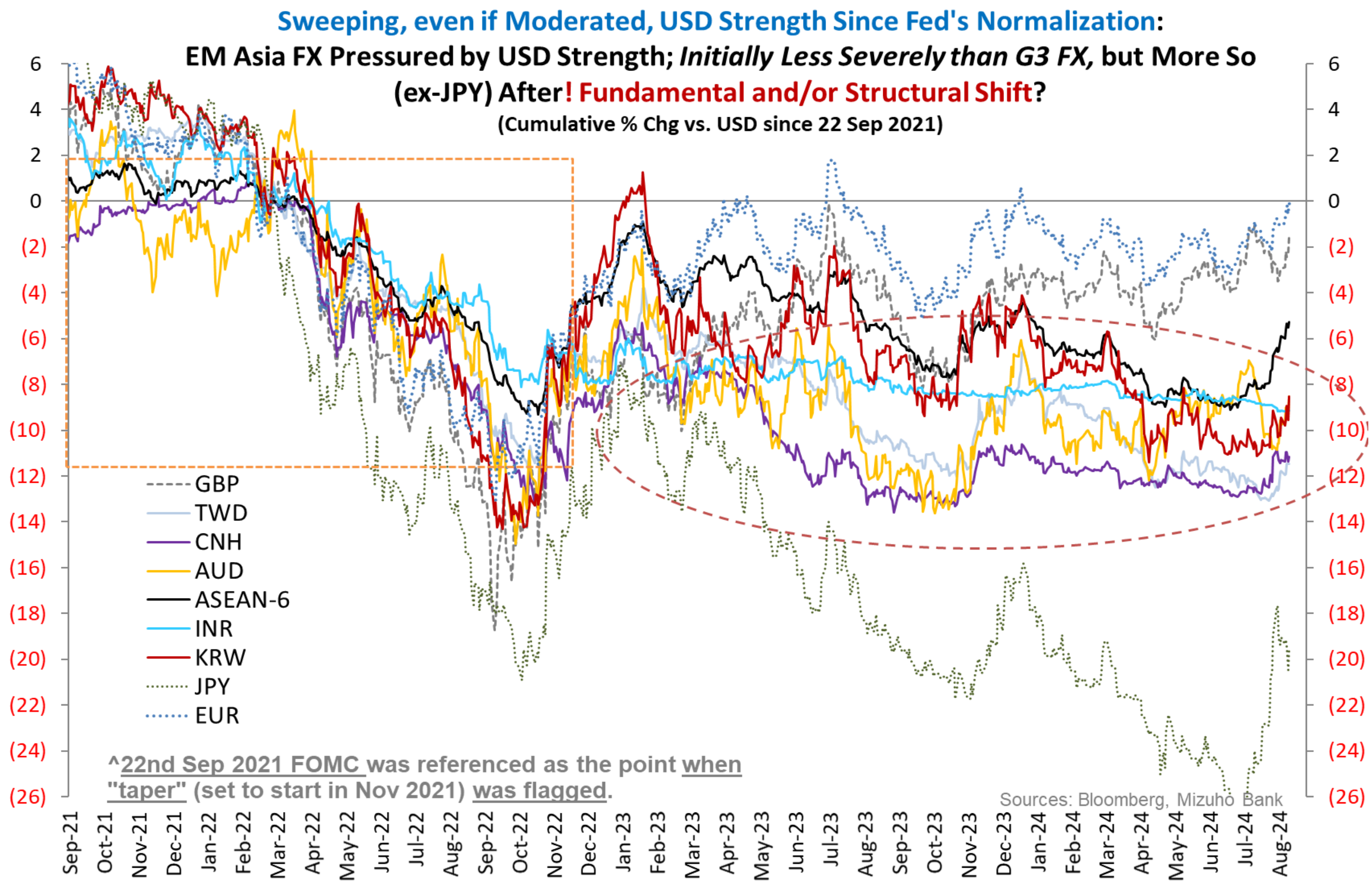
3b: Yield Spreads Better Capture Scope for Backstop .. That Shows Up as USD Resiliency



3c: Peak USD is Not the Same as a Bearish USD



4a. Relative AXJ Under-performance is Worth Analyzing … Notable Hysteresis Risks



- Received wisdom is that a **Fed pivot*** is **associated with** (often anticipatory) **USD decline**.
- The result is a **"pivot USD" primed for a broad-based slide** *as policy sands begin to shift from tightening to easing.*
- And the ***assumption of attendant AXJ reversion (to pre-Fed tightening strength) is arguably embedded* in this "pivot USD" thesis**. In other words, **Asia FX recouping losses over the Fed's tightening cycle (coinciding with reversal of USD gains**.
- ***But this time***, a **Fed pivot is no guarantee that AXJ will revert** to pre-Fed tightening strength.
- Instead, **AXJ reversion is liable to be dampened, delayed and differentiated**. And under certain circumstances possibly even denied for specific Asia FX.
- This owing to a conspiracy of *anomalous USD-Fed cycle dynamics*, accentuated by *unusual policy shifts*, *geo-political disruptions* and *specific CNY risks* compounding *structural cracks*.

*The reference to Fed policy inflection from tightening/rate hikes to loosening/rate cuts.

4b. Relative AXJ Under-performance: Specific Structural Factors

- Finally **structural and (economy-)specific deterioration affecting various AXJ currencies**, to varying degrees, could also **impair pre-Fed hike reversion of AXJ**.
- Some key, but non-exhaustive factors include *property-financial sector stress* (VND) to *political tensions* (VND, THB, KRW) to *accentuated geo-political threats* (TWD, PHP) to as follow.
- And *FX reserves* is notably asymmetric insurance, whereby *inadequacy* imposes a risk premium associated with structurally weaker currencies (e.g. VND) but on other hand, a notable build-up in FX reserves (e.g. INR) is no guarantee of currency boost/recovery
- In fact, *structural reforms* to boost manufacturing under "Make in India" is partly premised on a more competitive rupee, which underpins the case for rupee not reclaiming all of Fed hike losses.
- In any case, with the exception of SGD, which was boosted by an unprecedented magnitude of S$NEER appreciation (allowing it to keep pace with the USD), **reversion to pre-Fed rate hike levels in AXJ would require substantial AXJ appreciation**.
- Which is a **high bar in the current risk climate**; amid heightened geo-political threats, fragile economic recovery and overarching China/CNH risks.

	DXY	CNH	CNY	KRW	TWD	SGD	THB	MYR	IDR	INR	VND	AUD	PHP
Sep '21 FOMC (Taper Flagged)	93.3	6.47	6.47	1,176	27.7	1.35	33.4	4.18	14,241	73.6	22,770	0.726	50.3
Mar '22 FOMC (Since First Hike)	98.7	6.36	6.35	1,220	28.4	1.36	33.3	4.20	14,321	76.2	22,862	0.735	52.3
Average of Taper Flag & First Hike	96.0	6.41	6.41	1,198	28.0	1.36	33.3	4.19	14,281	74.9	22,816	0.731	51.3
Latest (August Avg)	103.1	7.17	7.17	1,366	32.5	1.32	35.2	4.46	15,984	83.9	25,135	0.656	57.2
% Appreciation Required for "Reversion"*	**-6.9%**	**11.8%**	**11.9%**	**14.0%**	**16.0%**	**-2.3%**	**5.7%**	**6.6%**	**11.9%**	**12.0%**	**10.2%**	**11.4%**	**11.6%**

* reversion to average of Sep'21 & Mar'22 Levels

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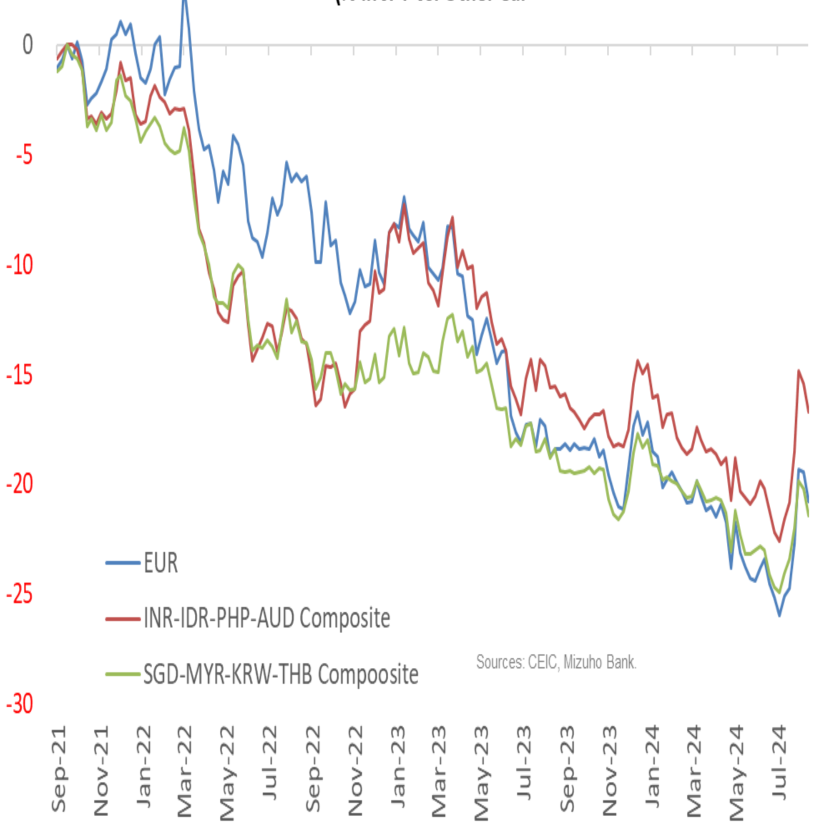
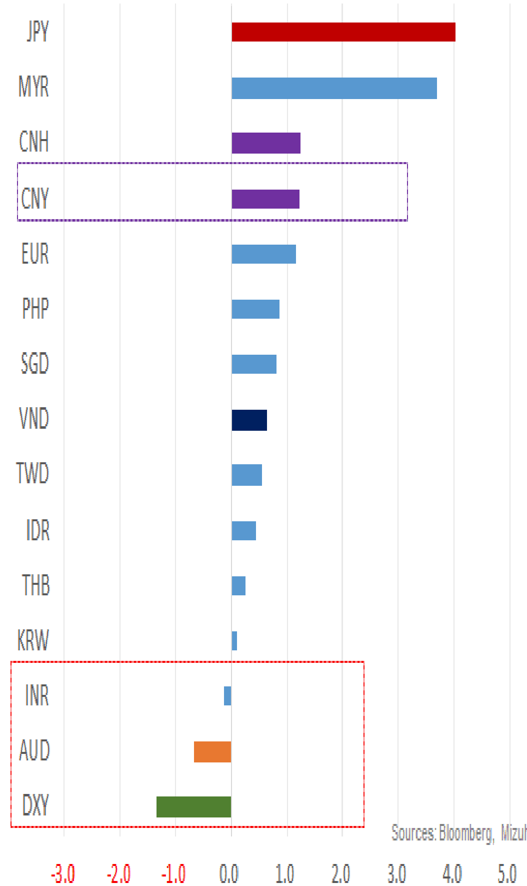
4c. JPY Carry Unwind is a Lingering Risk for AXJ

One-Way JPY Slump, since Fed Tightening Signals (Sep 2021), **to Multi-Decade** (30Y-40Y) **Lows** Sets the Stage for **Acute JPY Squeeze Unravelling Carrry Trades** & Denting AXJ (Hitting High-Yielders Harder) **if Risk Retrenchment Entrenches**.

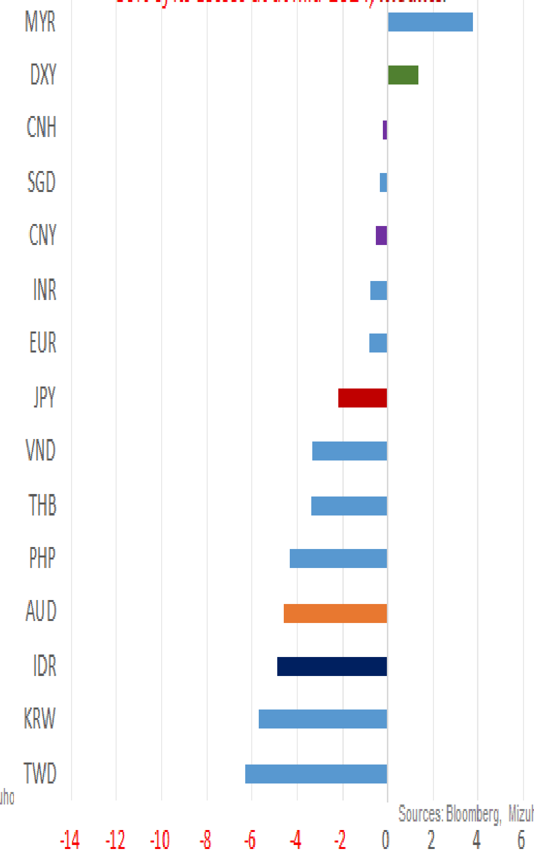
(% in JPY vs. Other Cur



BoJ-US Jobs Trigger (End July to 5th Aug): EM Asia FX moves Mostly **Playing off Weaker USD** and **CNH Buoyancy**. But **JPY Carry Unwind a Latent Risk**.



YTD (End-2023 to 5th Aug): But **EM Asia FX Remain Compromised More Broadly**. And **AXJ Pressures Can Re-emerge** if **JPY Squeeze**, *which has Reclaimed >80% of its Losses at at mid-2024*, **Mounts**.



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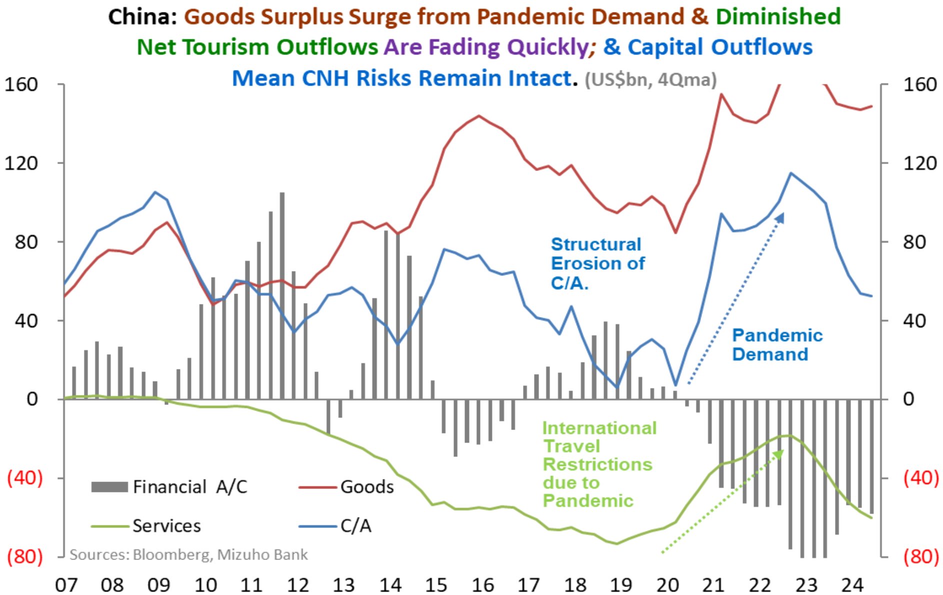
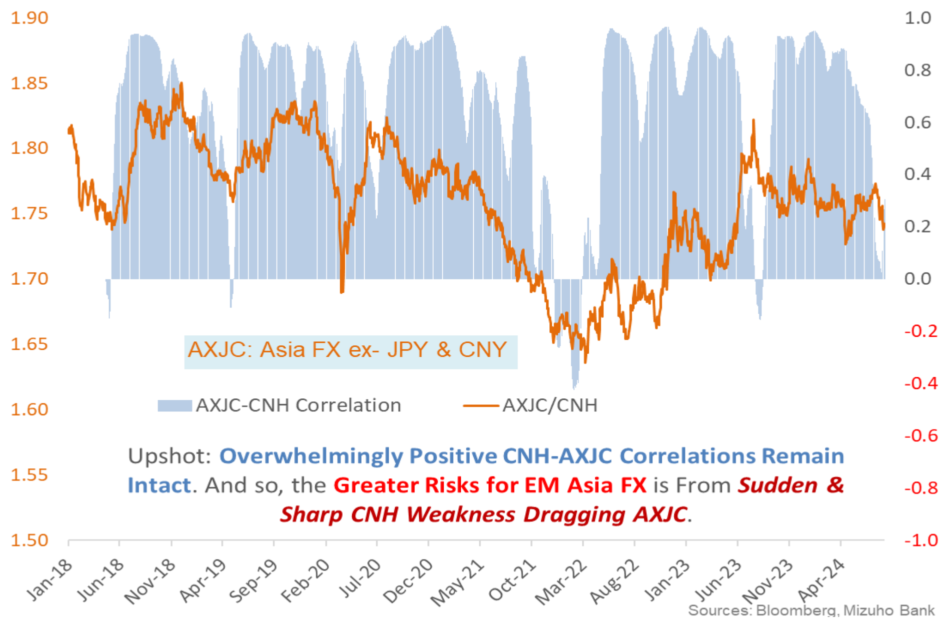
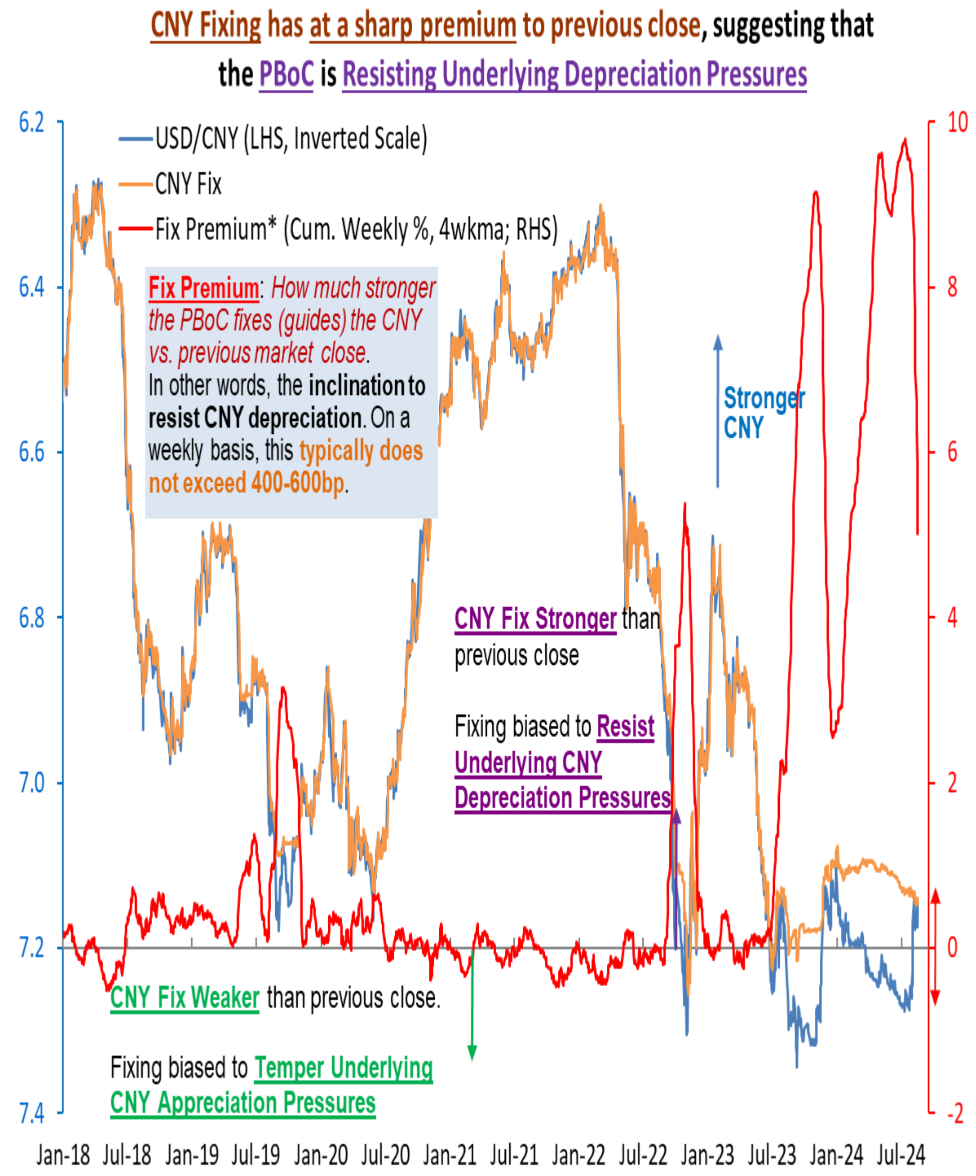
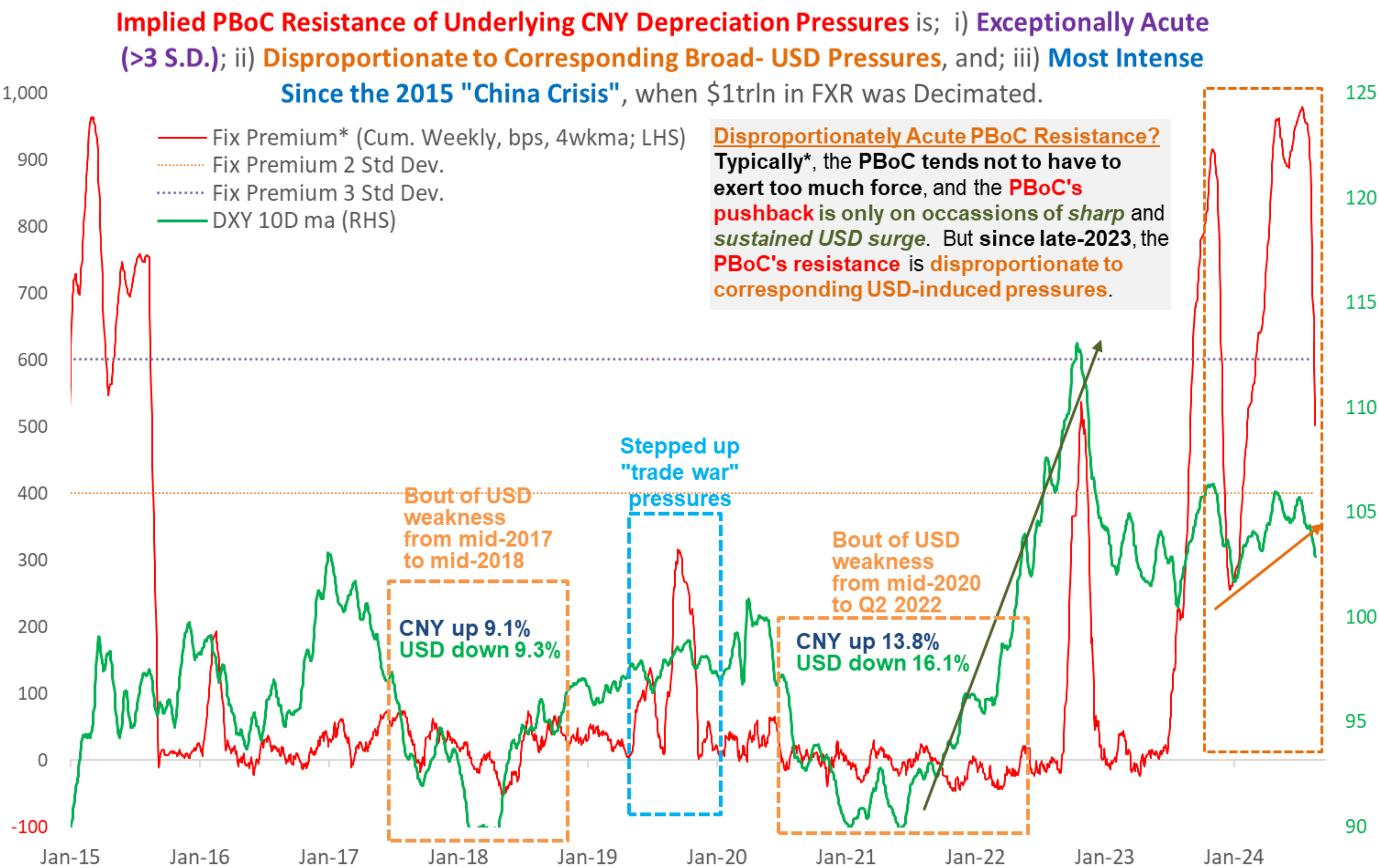
5a. CNH Depreciation Pressures though the Biggest Threat to AXJ



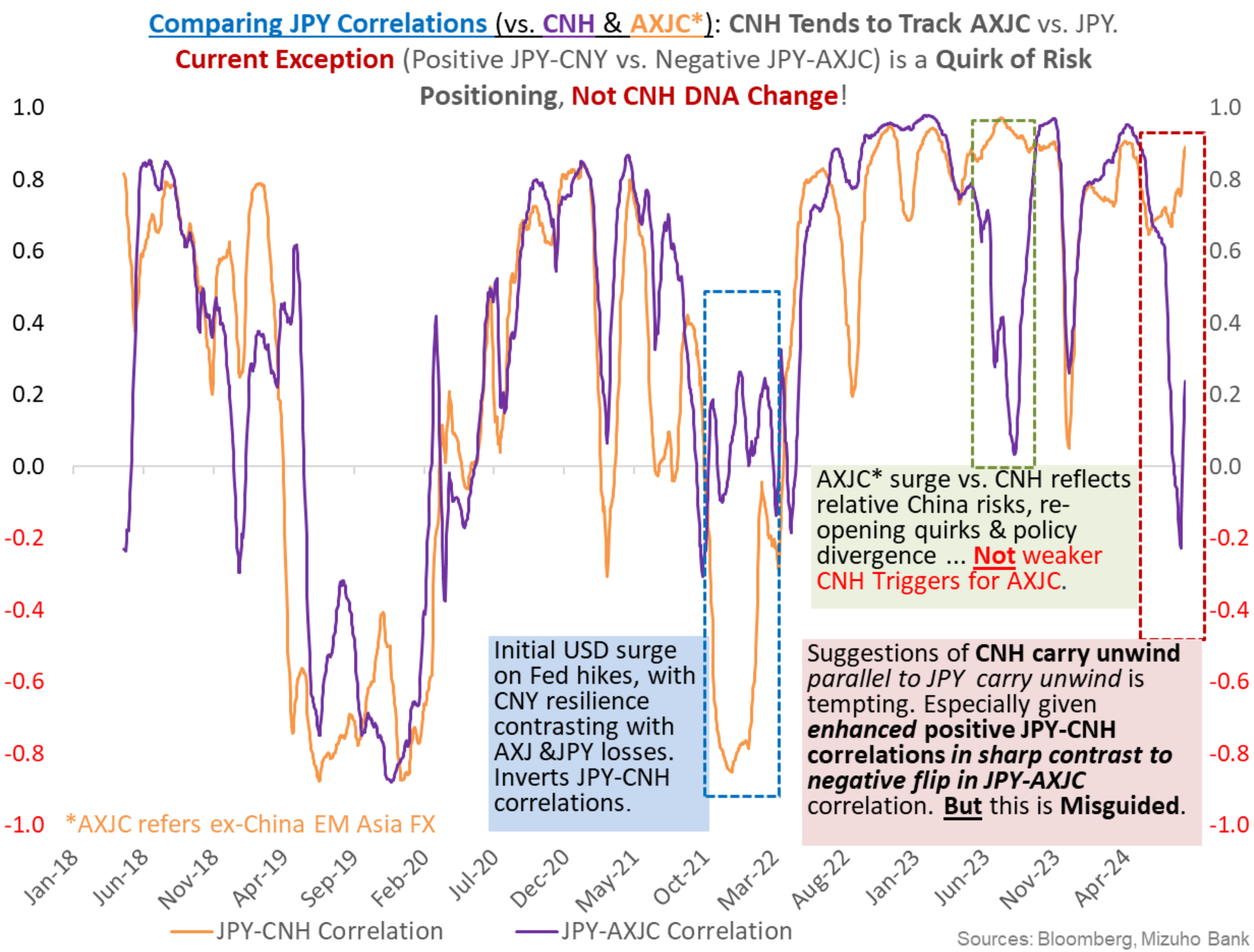




5b. China Factor: Disproportionate Pressures a Reflection of China-specific Risk (Spill-over)

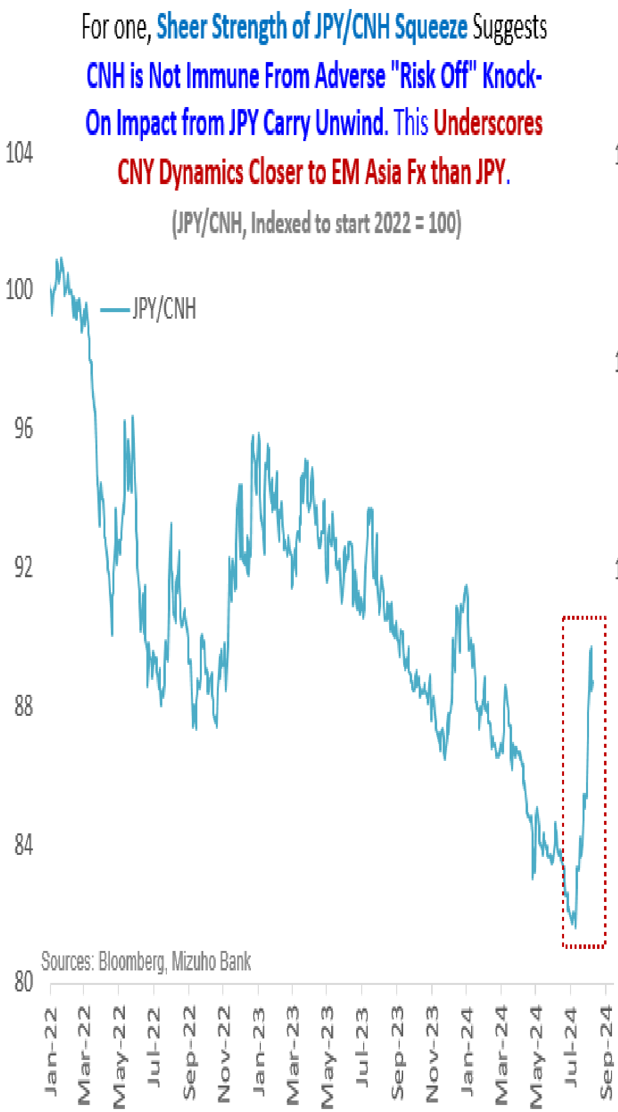


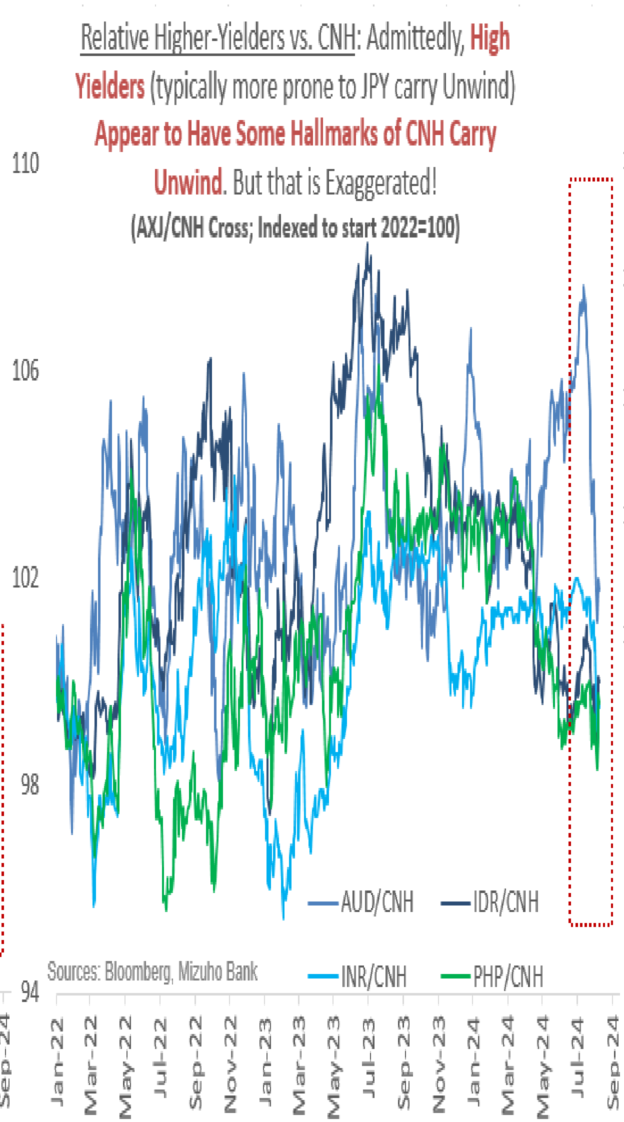
5c. CNY “Carry” Unwind is a Far Cry from JPY “Carry”

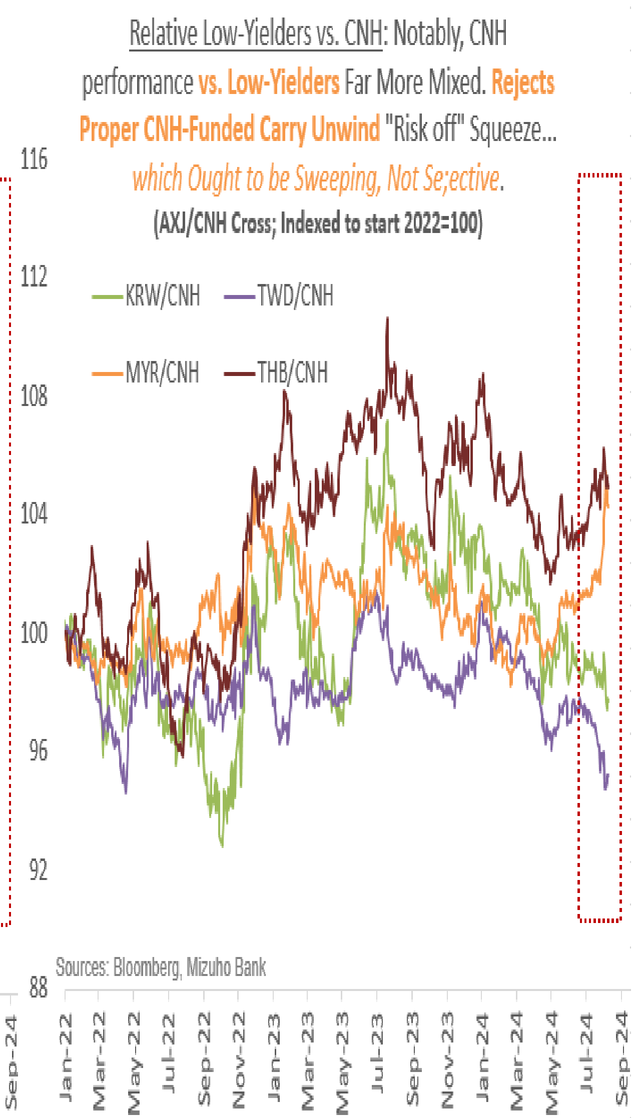


Sources: Bloomberg, Mizuho Bank

5c. Mixed CNH Outcomes Speak to Different DNA … CNH Drag is Still the Bigger Risk







MIZUHO

FX: A Bumpy Path for AXJ amid Policy, Elections, Geo-Political & China Risks

FX Forecasts	Sep 24	Dec 24	Mar 25	Jun 25	Sep 25
USD/CNY	7.00 - 7.43 (7.18)	6.98 - 7.58 (7.26)	6.94 - 7.45 (7.16)	6.91 - 7.30 (7.08)	6.86 - 7.25 (7.07)
USD/INR	81.5 - 86.6 (83.8)	80.2 - 87.5 (84.5)	78.4 - 84.9 (82.2)	78.0 - 83.7 (80.9)	78.1 - 83.3 (80.5)
USD/KRW	1220 - 1440 (1330)	120 - 140 (134)	1220 - 1350 (1280)	1200 - 1350 (1250)	1190 - 1290 (1240)
USD/SGD	1.276 - 1.356 (1.326)	1.315 - 1.400 (1.358)	1.299 - 1.373 (1.335)	1.294 - 1.353 (1.330)	1.302 - 1.368 (1.328)
USD/TWD	31.1 - 33.7 (32.1)	30.6 - 33.5 (32.5)	30.3 - 32.9 (31.3)	29.7 - 31.9 (30.6)	29.3 - 31.5 (30.2)
USD/IDR	15460 - 16420 (16100)	15830 - 17020 (16350)	15840 - 16960 (16200)	15800 - 16640 (16000)	15290 - 16600 (15800)
USD/MYR	4.27 - 4.67 (4.45)	4.34 - 4.65 (4.56)	4.33 - 4.75 (4.52)	4.26 - 4.70 (4.45)	4.20 - 4.55 (4.40)
USD/PHP	55.7 - 60.6 (58.0)	55.8 - 59.3 (58.4)	55.0 - 59.5 (57.8)	55.0 - 59.4 (57.2)	54.1 - 59.0 (56.8)
USD/THB	33.8 - 36.5 (34.8)	34.2 - 37.6 (36.2)	34.3 - 37.5 (35.3)	33.8 - 36.2 (34.8)	33.6 - 36.0 (34.6)
USD/VND	24600 - 25500 (25100)	25200 - 25800 (25300)	24800 - 25300 (24900)	24600 - 25200 (24800)	24500 - 25100 (24700)
AUD/USD	0.628 - 0.693 (0.665)	0.625 - 0.689 (0.652)	0.643 - 0.698 (0.673)	0.639 - 0.720 (0.686)	0.679 - 0.737 (0.705)

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