Mizuho Global Perspectives

London **5 July 2021**
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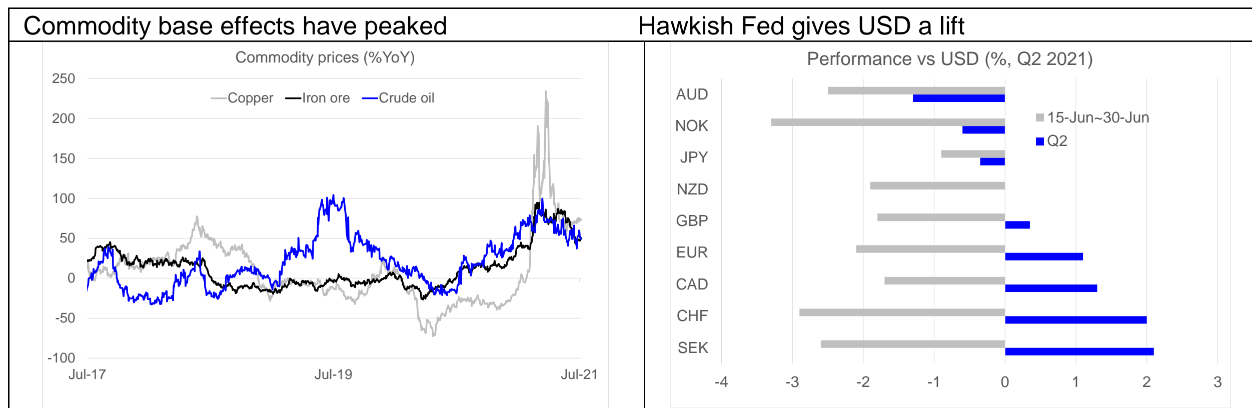
Forecast update – July 2021

Peak growth is here. Slower activity in autumn. Peak inflation near in the US, later elsewhere

The UK and the US are booming and the Eurozone is catching up fast. Japan is alas in the slow lane, with the recovery delayed until H2. PMI survey data suggest that delivery times, input and output price pressures are at or near record levels across a wide range of economies amid the unprecedented surge in activity. The supply side has struggled to keep up in the short term with even labour markets suffering difficulties, despite unemployment rates remaining elevated. The key question for central banks is to what extent these pressures will feed through to consumer prices. We assume some modest pass through to the CPI in the short term in the UK and the Eurozone. In the US, where the economy is already operating at higher capacity rates, the pick-up has been greater and we have pushed our annual CPI forecast for 2021 higher again to 3.5%. Note the 2022 CPI forecast for the US is still only at 2.2%. We continue to expect that the higher consumer prices will be mainly transitory, with soft labour markets and subdued wage growth providing a counterbalance to price pressures from other sources over the medium term.

The June Fed meeting showed a number of FOMC members looking to hike interest rates earlier than at the March FOMC meeting reflecting the strong recovery. This has raised questions about the Fed's commitment to allowing the economy to run hot and its willingness to target average inflation. The Fed's 4.5% unemployment projection for Q4 2021 looks aggressive given the current rate sits at 5.9% in June. Slower progress on the unemployment front may retard the start of tapering, especially if inflation eases off recent highs as seems likely. The BoE sees supply and demand as roughly in balance and this makes it the prime candidate for the first tightening move. It will cease asset purchases at the end of 2021 and we expect a first hike in late 2022 or early 2023. The ECB is unlikely to be anywhere near achieving its inflation goal when the PEPP ends in spring 2022. It seems likely that the Asset Purchase Programme will be re-jigged to plug the gap left by the PEPP. ECB rate hikes do not look likely anytime soon. The prospect of a BoJ policy tightening looks even more distant. Indeed, if the BoJ had any good options for easing policy further it would likely have taken them by now.



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US economy – Initial surge over. Strong and steady from here

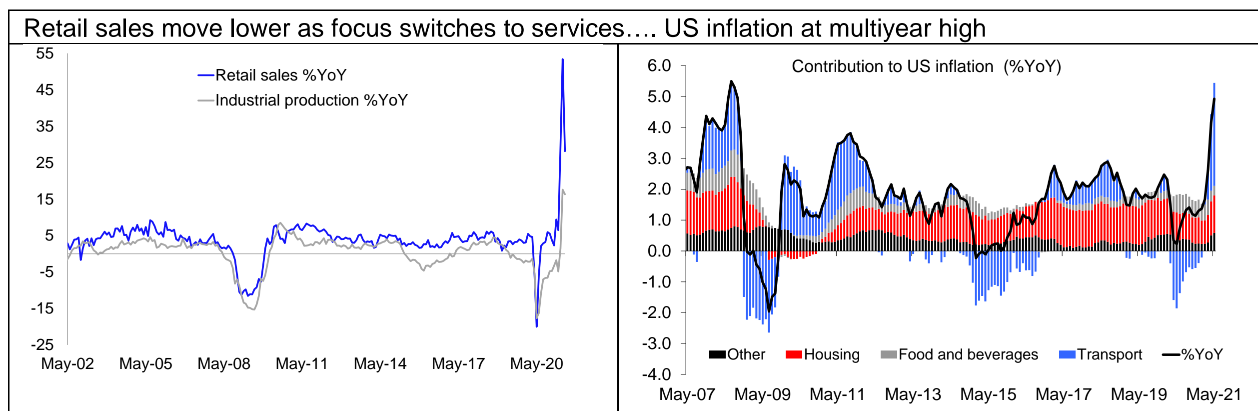
Q2 survey data have been very strong through the quarter. We currently see GDP rising ~2.0%QoQ in Q2. That said more recent data caution against growth going parabolic. Recent housing data have been mixed, April and May retail sales combined are down slightly compared to the level in March and auto sales have slowed steadily since the April peak, as services come back onto consumers' radars. The US vaccination pace has slowed too. The premature winding back of jobless benefits in some states will hit growth in Q3. Labour supply has picked up recently but the increase was mainly accounted for by male workers, suggesting that school closures, and their resulting impact on female labour supply, remains a major issue for the labour market. Labour market supply may be constrained until September, when most schools go back, extended unemployment benefits end and vaccination rates will be higher, reducing fear of Covid. We see the headline unemployment rate pushing down towards 5% by end 2021, leaving the annual average around 5.5%. With the unemployment rate around 5% at year end, we suspect the Fed still will want to see further "substantial progress" towards its goals and we see tapering as unlikely to start until mid-2022. Base effects and bottlenecks are likely to keep headline inflation above 3.0% for most of the rest of the year. However, inflation in 2022 remains on track to be significantly lower than in 2021 at around 2.2% on an annual basis.

Policy – both fiscal and monetary policy highly stimulative. Fed's June meeting starts the discussion on tapering

Infrastructure spending will mainly be funded by tax increases, in sharp contrast to the $1.9trn stimulus package. The infrastructure bill (American Jobs Plan) has already been pared back sharply. We expect the multiplier associated with the stimulus package to be low, while the bulk of the spending associated with the infrastructure packages will fall beyond 2021. The June FOMC meeting marked a renewed concern about inflation, with a number of FOMC members bringing their timeframe for rate hikes into 2023 and some looking at 2022. The FOMC hawks have been much more vocal and the tapering discussion is now underway, with many investors expecting an announcement on tapering at Jackson Hole in August. We see the Fed failing to hit its end 2021 unemployment forecast and expect this will slow the unwinding of stimulus.

Rates – UST yields to push higher in H2

The short end of the yield curve should be well anchored while expectations of elevated fiscal spending/rapid recovery should push longer-dated yields modestly higher. We see 10yr UST yields ~2.0% by mid-2022.



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Eurozone economy – Moving into the sweet spot

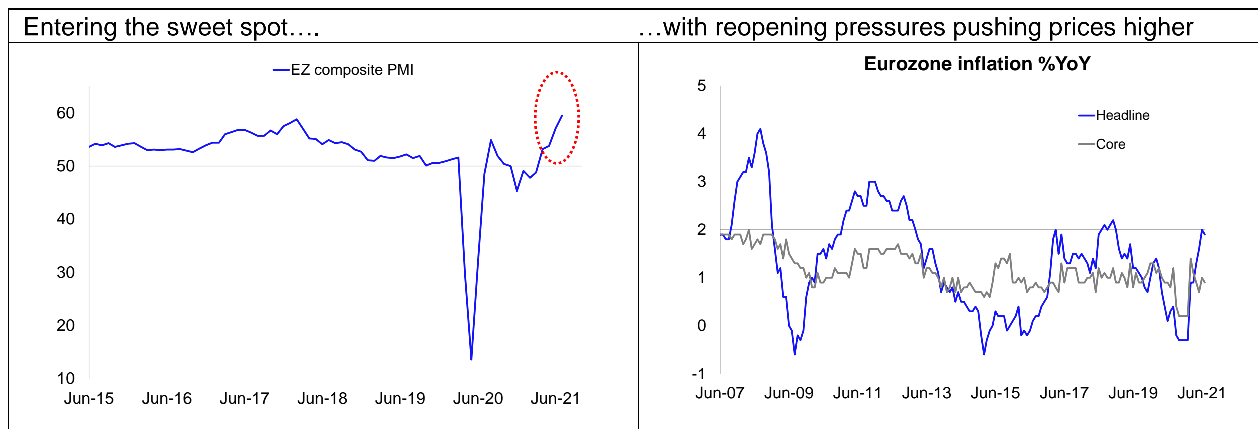
Recent survey data have been very good and we expect to see further improvements in coming months as the Covid case count drops, the vaccination rate rises and restrictions on activity are fully lifted. We see Q2 GDP rising 1.5%QoQ and even faster growth in Q3. Our 2021 and 2022 GDP forecasts remain at 4.3% and 4.1% respectively, with upside risks to 2021. The PMI surveys points to record (at least over the past 23 years) pressures on supply chains and producer prices. That said, our CPI forecasts are unchanged. Energy/commodity price gains will push headline CPI over 2.5%YoY in H2 but with elevated levels of slack in the labour markets a wage/price spiral is highly unlikely. The Eurozone CPI will average around 1.3% in 2022. Around 51% of the EU population have been vaccinated with at least 1 dose. At the current pace 75% of the population should be vaccinated by the end of Q3. We assume governments will keep labour market support programmes running for much of 2021 and any pick up in unemployment is limited.

Policy – National fiscal policy taking up any slack. ECB to maintain PEPP pace

As expected, at its June meeting the ECB maintained the current pace of PEPP purchases. The ECB has recently focussed on financial conditions, and these are little changed since the meeting. The ECB revised up its growth forecasts sharply without any impact on its longer-term inflation forecast, which remained at 1.4% for 2023. We expect the bulk of the PEPP envelope to be used and the programme to end in March as scheduled. That said, the APP looks likely to be pressed into service as a PEPP substitute next year to keep any rise in EGB yields limited. The EU fiscal pact is likely to remain suspended at least until 2022 giving individual countries scope to support the recovery, as they are doing with Spain recently extending its furlough programme. In addition, the Next Generation EU (NGEU) fund will kick into gear in H2. Italy is the major focus. Draghi has pushed his proposals through parliament. The focus now switches to implementation. The EU policy review is due over the summer but seems unlikely to result in as radical change as the FOMC review last year. A symmetrical inflation target at 2.0% seems likely but formal Average Inflation Targeting does not.

Rates – Short end pegged. PEPP purchases to limit any upswing in Bund yields

Policy rates are unlikely to move much any time soon and short-term bond yields are pegged. Elevated PEPP buying should limit any upswing in Bund yields as should the sharp drop in the Eurozone CPI in early H1 2022.



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Japanese economy – Still in the slow lane

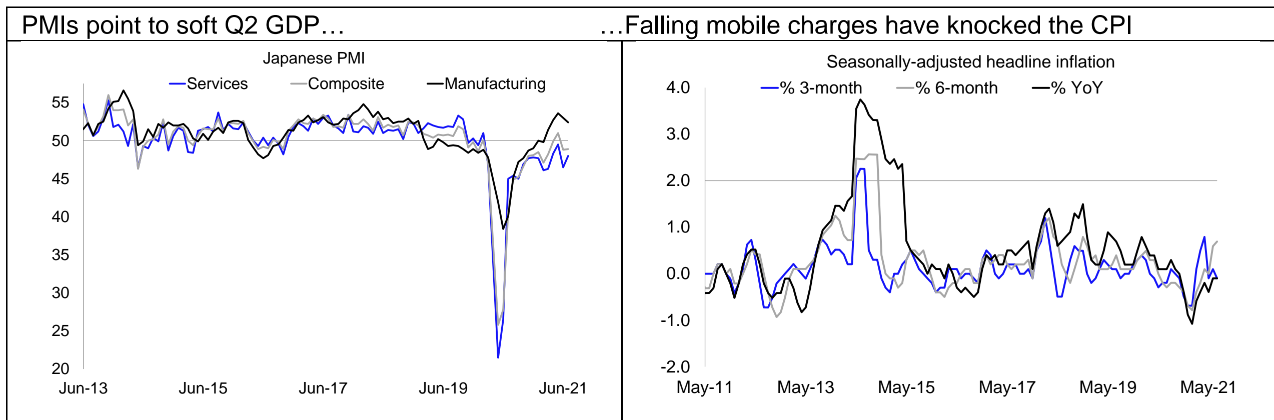
Q1 GDP was a little weaker than we forecast. Furthermore, additional restrictions were imposed over a wider range of prefectures for most of Q2, ending on 20 June. For now we still expect that Q2 GDP will be positive but only marginally so at around 0.3%QoQ. Whilst most data point to strong exports supporting demand, the sharp drop in industrial production in May, due to a lack of chips for auto manufacture, is a reminder of how fragile the domestic recovery is until the vaccination rate rises. The recovery is now clearly an H2 affair. The vaccination programme remains sluggish. To date only ~25% of the population have had one jab – among the lowest in the OECD. The Olympics will go ahead but whether domestic spectators will be allowed is in the balance. The Games should help boost consumer sentiment even if the boost from inbound tourism is missing. Our 2021 GDP forecast is 2.3% with 2022 at 2.8%. The rising virus count has hit government popularity and the Lower House election is now likely to be held as late as possible. Changes to mobile phone charges have pushed headline CPI lower by around 0.5pp. Thus headline CPI will be slow to rise despite the impact of higher energy prices. We look for the CPI to average 0.1% in 2021 and 0.5% in 2022.

Policy – Monetary policy struggling to add stimulus, leaving the onus on fiscal policy.

Fiscal policy will be determined by the Covid crisis. Additional spending will be forthcoming, most likely announced before the election to limit the fiscal cliff. The pandemic remains the driving force and we expect that the labour market and company support measures will remain in place deep into 2021, thus limiting the degree of fiscal retrenchment this year. We see no change in monetary policy over the forecast horizon but the bias is clearly dovish, as the central bank continues to undershoot its 2% inflation target by some margin. A lack of effective easing options is what keeps the BoJ on hold. The March policy review resulted in minimal substantive change - lower ETF purchases and a slightly wider range for 10yr JGB yields. The BoJ also laid the groundwork for lower interest rates if required, although the softer yen in recent months likely means the Bank has no plans to deliver on lower interest rates for the time being.

Rates – BoJ still in control of the curve, despite a slightly wider trading band.

The JGB market will have few problems absorbing any additional issuance. Any long end sell-off is likely to be limited given solid demand from lifers and pension funds. We expect that the BoJ will continue to be successful in its efforts to keep the sub-10yr JGB yield curve within the new 0.0% +/-25bp range.



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UK economy – Rapid recovery

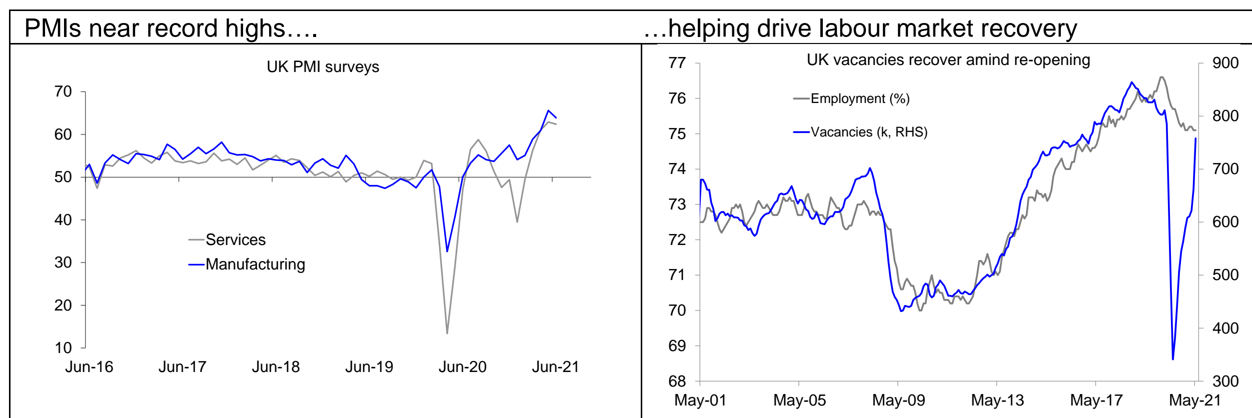
The UK is rapidly emerging from lockdown amid significant progress on the vaccination front. The recent surge in Covid-19 cases due to the Delta variant has not had much impact on hospital admissions. Almost 70% of the population has had at least one dose, with ~50% fully vaccinated. The route out of lockdown remains on track and the economy is responding well. The composite PMI averages above 60 for Q2 and we expect GDP to rise 5%QoQ in Q2. Our 2021 GDP forecast remains at 6.7% with 2022 at 4.3%. The CPI jumped to 2.1%YoY in May and should pick up further as the contribution from energy prices increases. There will be another jump in autumn as VAT cuts drop out of the annual comparison and additional base effects in energy bills hit. The government furlough scheme is still in operation. It has been very successful in limiting unemployment and it will clearly peak at a much lower level than expected at this time last year. How the labour market responds to the end of the programme in autumn will be a key driver of unemployment trends over the next year, with a small jump expected. That said we have pushed our unemployment forecast down again to 5.0% this year and 4.6% next, near levels that start to have the BoE wondering about inflation pressures from the labour market.

Policy – BoE is towards the hawkish end of the spectrum of central banks amid supply side focus

The Bank sharply upgraded its growth forecast in May and sees the bulk of the 2020 Covid drop made up in 2021. It also sees supply and demand as being close to balance for much of the remainder of the forecast horizon, suggesting that it would not take much in the way of stronger demand or weaker supply to see a hawkish bias emerge. The supply focus is unusual among major central banks, which for the most part seem more interested in demand at present. This is possibly because the MPC is dealing with the Brexit impact as well as the Covid impact on the labour market. In recent speeches the Governor has been clear that he sees current price pressures as mainly temporary. The BoE is currently reviewing the sequencing of policy tightening with Governor Bailey potentially favouring some run off in the balance sheet before hiking rates in contrast to the previously stated policy of hiking rates first.

Rates – Gilts set to come under modest pressure as economy recovers

With the data strong and uncertainty about upcoming appointments to the MPC there is a little more risk at the front end in the UK than elsewhere, especially towards the back end of the forecast horizon. Longer-term UK yields will likely move higher as the recovery progresses, with 10 Gilt yields moving above 1.0% by year end and moving higher in H1 2022.



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Forex view – FOMC boost for USD to prove temporary. BoE to boost GBP in 2022

For much of Q2 the US dollar underperformed only to be rescued at the end of the quarter by a hawkish FOMC meeting that saw 2yr UST yields jump amid expectations of earlier Fed removal of policy accommodation, which in turn dragged USD higher. We now see more 2-way risk in short UST yields, as the Fed's labour market forecasts for 2021 look aggressive and there is considerably uncertainty over the Fed's reaction function as the new Average Inflation Targeting regime beds in. Market expectations of tapering could easily be pushed back should the Fed's doves reassert the dominance of the labour market data amid an easing of headline inflation pressures. On a relative basis US real rates are likely to be less supportive for USD going forward. US equity markets remain expensive on a relative basis and are susceptible to adjustment, especially as the reflation trade will undermine inflows into the tech sector, against a backdrop of modestly higher longer-term yields. Capital inflows to the US are likely to slow. The US fiscal metrics look poor and the twin deficits are rising fast. These conditions suggest to us the US dollar will remain under modest pressure in the coming 12 months.

The BoJ's crisis response underscores its relative lack of policy space. The March policy review resulted in minimal change. The BoJ's forecasts from the late April meeting underscored that the 2% inflation target is unlikely to be reached during Kuroda's term. Corporate outbound FDI and M&A activity look to be recovering much quicker than we had anticipated and are not far from pre-Covid levels. However, at the same time portfolio outflows in the fiscal year to date are minimal, with sales of overseas equities equal to purchases of foreign bonds. Lifer hedging could cap any JPY weakness in the near term. JPY should also benefit from Japan's vaccination programme catching up in H2, which should boost sentiment. Looking into 2022, the boost from vaccination catch up should fade and corporate outbound M&A and FDI may continue to build. Policy divergence should also come increasingly back into view - all suggesting a weaker yen in H1 2022.

The pace of vaccinations in the EU has picked up sharply and is now showing up in the activity data as the health crisis eases and restrictions are lifted. Relative real interest rate differentials vs the US suggest a firmer EUR over the longer-term. The €750bn NGEU fund is a major prop, encouraging investors to believe that the eurozone is finally getting its fiscal act together, while former ECB president Draghi becoming PM in Italy helps reinforce the eurozone's weakest link. The "feeble fiscal policy" discount, which has weighed on EUR for the best part of a decade, is being been pared and the current account surplus and relatively positive fiscal position vs the US also appeal. We see EUR/USD pushing towards the 1.30 level by mid-2022.

In the short run we see GBP as due a breather after a positive run. The successful vaccine rollout has likely been fully priced in and the exit from lockdown has been very smooth. Very strong growth in Q2 and Q3 is the baseline. However, in the medium term, it looks as if the BoE will be one of the first central banks to hike its policy rate. It will end asset purchases at the end of 2021, which will tighten policy on a relative basis vs the US and the Eurozone. We suspect that once the first hike becomes more visible as 2022 progress, UK short-term rates will rise dragging GBP higher too. There is a reasonable chance that the first UK interest rate hike comes in late 2022. It remains highly likely that the BoE tightens (sells assets or at least stops re-investment or hikes rates) before the Fed.

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FX forecasts (as of 2 Jul)	Current	End-Q3 21	End-Q4 21	End-Q1 22	End-Q2 22
USD/JPY	112	108	106	107	111
EUR/USD	1.19	1.22	1.24	1.26	1.28
GBP/USD	1.38	1.42	1.45	1.47	1.50
EUR/GBP	0.86	0.86	0.86	0.86	0.85
EUR/JPY	133	132	131	135	142
GBP/JPY	155	153	154	157	167
Bond forecasts (%)	**Current**	**End-Q3 21**	**End-Q4 21**	**End-Q1 22**	**End-Q2 22**
United States					
Policy rate	0.125	0.00~0.25	0.00~0.25	0.00~0.25	0.00~0.25
2yr	0.25	0.25	0.25	0.30	0.35
10yr	1.48	1.60	1.75	1.85	2.00
30yr	2.10	2.20	2.40	2.60	2.80
Eurozone/Bund					
Policy rate/Deposit rate	0/-0.5	0/-0.5	0/-0.5	0/-0.5	0/-0.5
2yr	-0.66	-0.65	-0.65	-0.65	-0.65
10yr	-0.18	-0.20	-0.20	-0.25	-0.25
30yr	0.31	0.35	0.40	0.40	0.40
Japan					
Policy rate	-0.1~0.1	-0.1~0.1	-0.1~0.1	-0.1~0.1	-0.1~0.1
2yr	-0.12	-0.10	-0.10	-0.10	-0.10
10yr	0.04	0.10	0.10	0.10	0.10
30yr	0.68	0.75	0.75	0.75	0.75
United Kingdom					
Policy rate	0.10	0.10	0.10	0.10	0.10
2yr	0.06	0.10	0.20	0.30	0.40
10yr	0.74	0.90	1.10	1.20	1.25
30yr	1.26	1.40	1.60	1.80	2.00
Macro forecasts (%)	**2020**		**2021**		**2022**
United states					
Real GDP	-3.5		6.0		3.3
CPI	1.2		3.5		2.2
Unemployment rate	8.1		5.6		4.6
Eurozone					
Real GDP	-6.8		4.3		4.1
CPI	0.3		1.9		1.4
Unemployment rate	8.0		8.2		7.9
Japan					
Real GDP	-4.8		2.3		2.8
CPI	0.0		0.1		0.5
Unemployment rate	2.8		2.9		2.6
United Kingdom					
Real GDP	-10.2		6.7		4.3
CPI	0.9		1.7		2.0
Unemployment rate	4.4		5.0		4.6

Source: Bloomberg, Mizuho. Note: GDP, unemployment and inflation figures are annual averages.

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