Mizuho EMEA G4 Forecast Update

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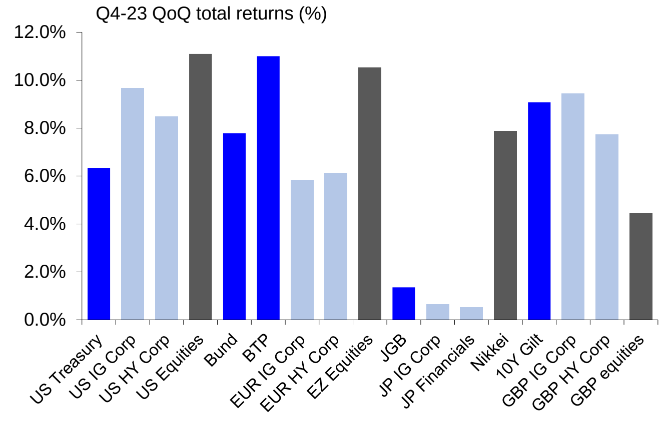
2024: "How low, how slow?" not "How far, how fast?"

The plunge in policy rate expectations in the final months of 2023 looks overdone. **The major central banks are done hiking, but we continue to expect that they will proceed carefully with regards to lowering policy rates.** Firstly, given the recent past, it is imperative than central banks ensure that the job of getting inflation back to 2.0% is done and done well. In the wake of the biggest surge in prices in 40 years, **any doubts about central banks' commitment to achieving the 2% target could see longer-term inflation expectations and long-term interest rates rise**. Secondly, with this in mind, and given the difficulties in forecasting in recent quarters, it behoves central banks proceed carefully, which to us implies **later rather than earlier cuts**. If inflation continues to surprise on the low side, then it is possible that rate cuts will come in spring, but it is more likely that inflation data in coming quarters declines more slowly than in the recent past and rate cuts are pushed out later in the year. **Peak disinflation looks to be in the rear-view mirror**. Furthermore, the bulk of the decline in inflation has been driven by energy price declines, which remain volatile and cannot be taken for granted. **Labour markets remain solid and continue to imply that core inflation risks lie on the upside even if headline CPI drifts below target**.

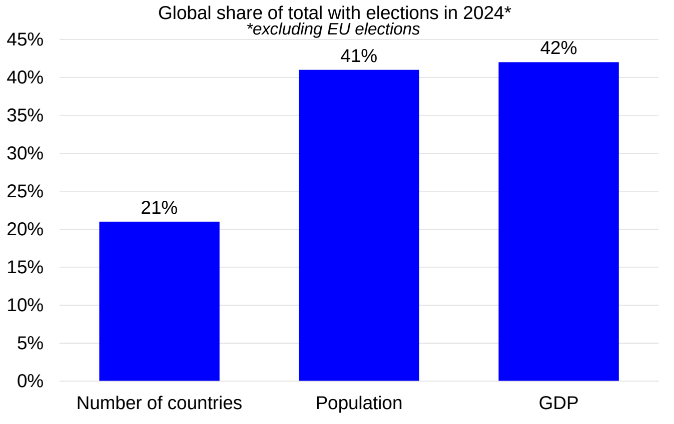
In the short run, we think that central bank view drives policy decisions, with the data being more of a driver over the medium term. We don't see any of the major central banks being in a rush to ease policy. We note that almost all major central banks see inflation as easing only slowly in 2024 and being above target for the year. By H2-24, GDP in the Eurozone and the UK should be past the worst and labour market deterioration may start to ease. **In the wake of the dovish December FOMC meeting, we have added one extra Fed cut in 2024.** We now see one 25bp cut in Q3 and one 25bp cut in Q4. **In the Eurozone and the UK, we continue to see one cut per quarter staring in Q2.** We have revised up our 2024 UK GDP forecast from 0.0% to 0.4%, but growth remains well below trend. **For the BoJ, we push back the first hike to Q2.**

Given relatively muted policy expectations, we see FX developments as also fairly muted in 2024. We expect the US dollar will enjoy a modest rebound in Q1 as markets price out US rate cuts, but then we see the end-2023 dynamic re-exerting itself as markets push UST yields gently lower, which in turn will drag the DXY index lower.

Markets rallied hard in late 2023 …



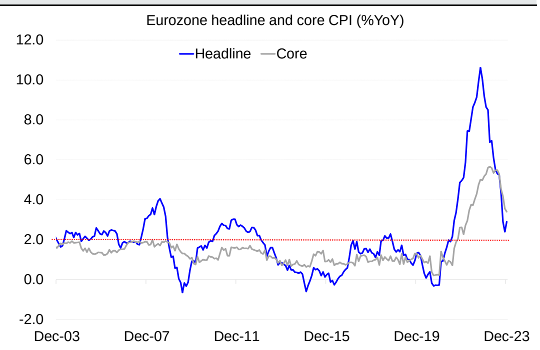
… into a year full of political risks



Source: Bloomberg

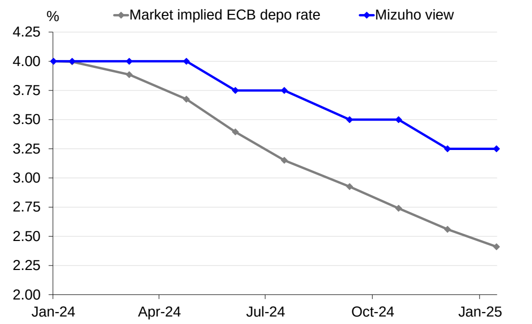
EUR markets

Macro – Winter is here, although downside fiscal risks ease



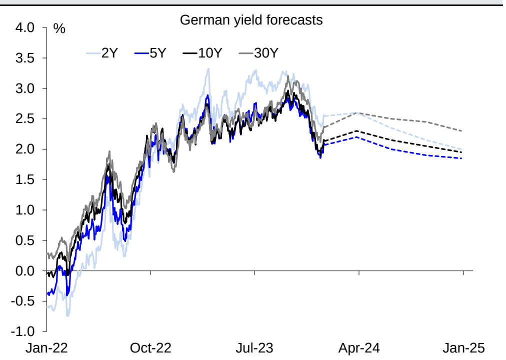
- **GDP likely declined in Q4-23, confirming that the Eurozone is in recession. Activity will remain soft in early 2024**. The PMI data look to be bottoming out, albeit at levels that imply contraction. Financial conditions eased further in December but remain tight, while money and credit metrics still point to subdued activity. The EU fiscal agreement in December will limit the scale of any fiscal contraction, although budget developments in Germany remain a downside risk.
- **The recession we expect is mild by historical standards.** The unemployment rate will ease off the cyclical low and peak around 7.0%, before flattening out as the region exits recession in H2-24, as easier policy starts to lift activity.
- Headline inflation was volatile in Q4 and sits at 2.9%YoY in December. Core inflation is coming down much more slowly and sits at 3.4%YoY. **The labour market remains a source of upside pressure for now.** Indeed, the ECB expects almost no change in unemployment and elevated wage growth through late 2024. We look for headline CPI growth to average 2.4% in 2024 and to be close to target in 2025.

Policy – ECB sees labour market as rock solid, meaning less urgency to act



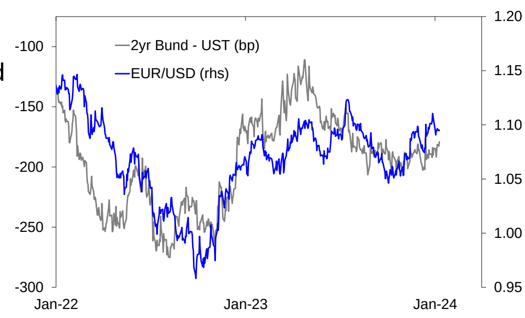
- The ECB left policy rates unchanged in December. The ECB consensus for holding rates at current levels for a prolonged period remains solid. The doves seem to be increasingly concerned about the slowdown in activity and are happy to let the data determine the timing of cuts, while the hawks still warn of the dangers of premature easing. The ECB's official forecast sees GDP remaining positive. **Our activity and labour market forecasts are more downbeat than the ECB's**. Our base case is for a first cut in June, but the risks are tilted earlier rather than later. We expect one cut in each of Q3 and Q4.
- The ECB announced a partial reduction of **PEPP reinvestments by ~€7.5bn/month**, to start in H2-24. Future rating revisions, weakening growth, upside pressure in yields in the near term, lack of significant fiscal consolidation and subdued risk appetite make BTP-Bund tightening unlikely in early 2024. However, looking at H2-24, more flexible EU fiscal rules and lower yields should encourage investors to add high-carry BTP positions.

Rates – Patience needed before buying the dip



- Despite the sell-off in early January, **markets are still too excited about early and aggressive cuts from the ECB**. We think easing will be more gradual. As seen in the last CPI print, progress on the disinflation front will likely remain choppy. This should continue to apply **bearish pressure to front-end rates early in the year**. That said, we expect market participants to be quick to buy any dip in rates.
- **While we think that the direction for EUR rates is south, we expect YoY changes in 10yr Bund yields to be modest**. The lack of a deep recession means rates are not likely going to fall to the Covid lows. The Eurozone neutral rate will remain higher than pre-Covid times and not far away from current estimates (2.25-2.50%). Ongoing QT from the ECB and a higher term premia in USTs will most likely cap how much long-term EUR rates rally. Supply will pressure EUR rates higher early in the year; 2024 will see positive net supply. **We see 10yr Bund yields moving below 2.00% in 2024 and 2x10s becoming flat in 12-months' time.**

FX – EUR short-term pull back vs USD to continue, better prospects further out



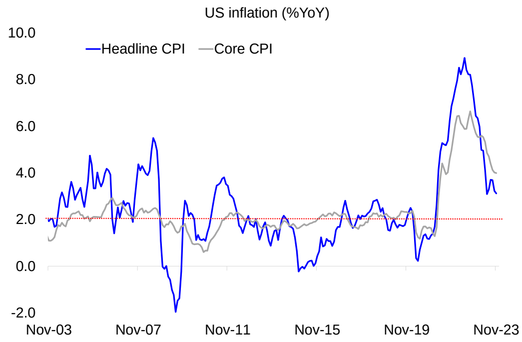
- EUR/USD rallied further in December as the dovish FOMC meeting added momentum to the plunge in global yields. USD position liquidation continued in December. Front-end UST yields have declined too far and any reversal in January will likely drag USD higher too.
- It remains the case that official investors, such as central banks, are looking to diversify out of the US dollar and EUR is a beneficiary of this trend. EUR is also attractive for private sector investors that avoided the single currency through the period where it had negative rates.
- **Eurozone member states also escaped any censure from the ratings agencies, with both Italy and France emerging with current ratings intact**. **We see EUR/USD around 1.14 by end 2024**.

Basis – Good risk-reward to receive the basis

- The EURUSD XCCY basis has finally become less negative. Some tightening drivers are still at play: **Yankee issuance** continues to look attractive to European issuers and **dollar liquidity looks healthy, partially boosted by potentially slower QT in H2-24**. However, the lack of a future liquidity squeeze from the ECB and how much the basis has tightened makes receiving positions more attractive, especially if the ECB cuts more aggressively than the Fed, as we expect.

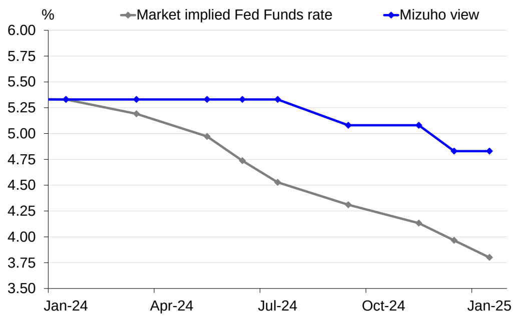
USD markets

Macro – Sluggish in 2024 but no recession



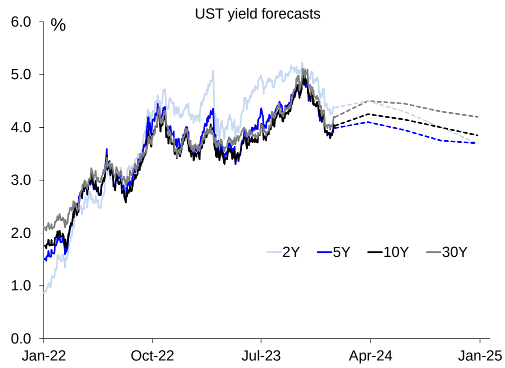
- We again revise up our US GDP forecasts driven by the easing in financial conditions since October, resulting from the plunge in yields. We now see 2024 GDP at 1.4% (+0.2pp), with 2025 GDP at 1.4% (+0.3pp). This also leads to a slightly lower unemployment forecast.
- Labour market data are mixed. The direction of travel is weaker but there are questions marks about the pace of the slowdown given signs of labour hoarding. **We see a mild drift higher for unemployment in coming quarters.** We now see unemployment averaging 4.1% in 2024 vs 4.2% previously, which implies a slower decline in wages too.
- Inflation risks in the US remain higher than elsewhere as growth remains close to trend. There is a growing risk that Fed policy may not be tight enough to ensure inflation drops back towards 2.0% in a timely manner. **We nudge our 2024 CPI forecast down but just by 0.1pp to 2.6 %, despite the recent benign data.** Firmer growth/wider positive output gap, loose financial conditions and the solid labour market mean the risks for the CPI are on the upside.

Policy – Fed "pause" to be almost one year long



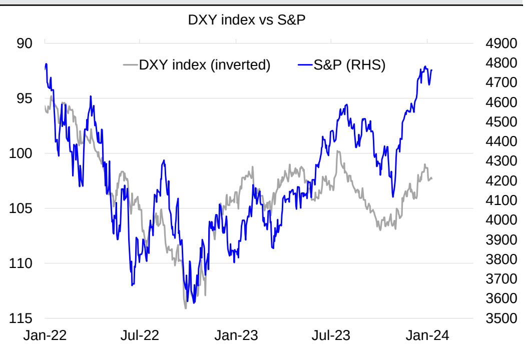
- The December FOMC meeting was unambiguously dovish, confirming that rates have likely peaked, while the 2024 and 2025 Dots were revised lower, even as activity was seen firmer. The press conference revealed a discussion on rate cuts. The Fed seemed surprised at the dovish market reaction, with post-meeting commentary suggesting markets were overly optimistic in pricing in an aggressive easing cycle.
- We see current market pricing as incompatible with a firm economy and inflation risks on the upside, **with the first cut not until H2.**
- Discussion on QT pace has already started. We expect **the Fed will stick to the current $95bn/month pace until the RRP facility approaches $400bn**. Once there and in order to make QT more sustainable in the long run, we expect the Fed will slow the QT pace. We expect the change to happen around the end of H1-24, unless reserves at the Fed tumble towards $2.5tn and put too much pressure on US funding markets.

Rates – Hello again, term premia!



- The December FOMC meeting added fuel to the rally and markets are pricing in almost 140bp of cuts in 2024. **We think this is excessive.**
- **We expect USTs to continue to push back against the December rally and remain high into spring**, unless the data show material weakness. **We expect the curve to build a term premia once again** given the upside inflation risks, a still-too-resilient economy and a central bank that already hints at future cuts.
- Q2-24 onwards should see UST yields falling again as the macro backdrop softens and inflation eases further. The rally will likely be led by the front end, driven by rate cut expectations. **We expect the bear-steepening of Q1-24 to shift to bull-steepening.** We see 2x10s disinverting in H2-24. The resilience of the US economy will cap how much USTs can rally in 2024, especially front end rates.

FX – Near-term bounce in prospect. Weaker longer term.



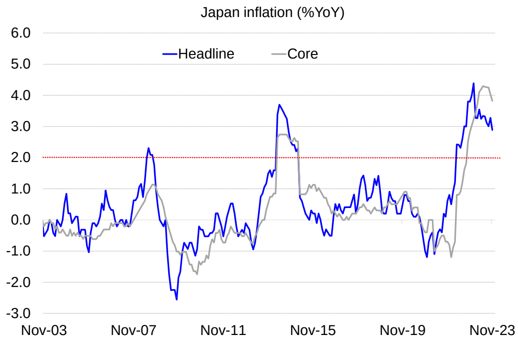
- The DXY index declined further in December to sit near a six-month low. The ongoing plunge in UST yields narrowed the USD yield advantage and the jump in US equities eased safe-haven demand. There was evidence of investors bailing out of long USD positions as year end approached. USD positioning looks more neutral now.
- **We see UST yields as having declined too much. Consequently, a bounce in the US dollar in January looks likely as investors price out some US cuts that were priced in through December.**
- **The bigger picture remains one of a softer USD, against the backdrop of declining Fed policy rates. However, as we do not see large moves in policy rates in 2024, we expect any decline in the US dollar to be similarly modest.**

Basis – Dollar premium to fade only gradually

- Despite a stronger US macro backdrop and a pick-up in geopolitical risk, borrowing dollars has not become more expensive. We think **there is room for the dollar premium to ease further**, which would continue to support paid positions in most pairs. However, the risk of further US macro outperformance or any risk-off sentiment driving the dollar premium higher remains. As such, we continue to prefer to trade the XCCY basis tactically.

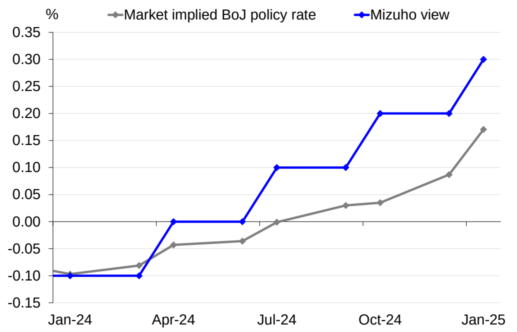
JPY markets

Macro – Mild downside risks



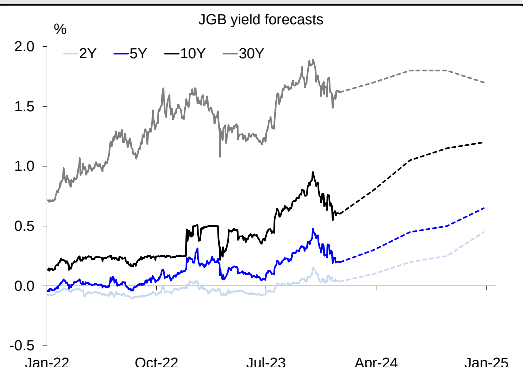
- We leave our **GDP forecasts for 2024 (0.8%) and 2025 (1.0%) unchanged, but see the near-term risks as being on the downside, as pent-up demand and inbound tourism gains lose steam. Note that in both years, growth will remain above trend against a backdrop of limited policy tightening.**
- Government energy subsidies will be extended through April 2024. When the subsidies end, the CPI will jump higher. Ex fresh food and energy CPI, a better measure of underlying price pressures, is just below 4.0%. **We look for the headline CPI to average ~2.5% in 2024**, helped by an increasingly positive output gap and rising wages.
- Wage data were a little disappointing in 2023. The 2023 Shunto wage negotiations delivered the biggest wage increase in 30 years. However, small and medium-sized businesses saw much lower rates of pay growth. The 2024 spring wage round looks set to be at least as large as that in 2023 and probably a little higher. **We expect wage growth in 2024 to push higher** and expect that whole economy pay rates are likely to be nudging levels that the BoJ would like to see to be confident on tighter policy in coming quarters.

Policy – NIRP in the cross hairs.



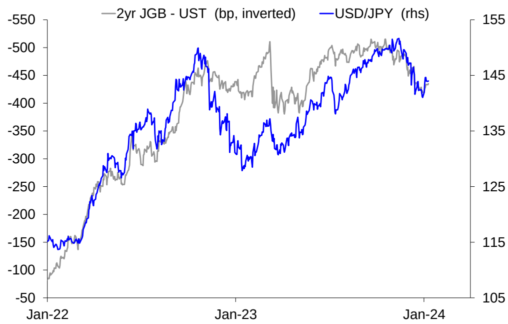
- The BoJ tweaked YCC in its late October meeting. **We see the decision to turn the hard 1.0% upper limit for 10yr JGB yields into a reference rate as spelling the end for YCC**. We expect Rinban ops will continue to vary with 10yr yields, thus dampening volatility.
- **BoJ rhetoric remains cautious. There is a sense that officials are keen for financial markets not to price in too much tightening. The 1 January quake is another reason for caution and we now see the end of NIRP in April rather than March**.
- Headline and core CPI will be heavily impacted by energy subsidies. The BoJ's ex fresh food and energy CPI forecast for FY25 is 1.9% – a whisker away from the BoJ's 2.0% inflation target. **We expect that price pressures will remain elevated and the BoJ will up its forecast to 2.0% by April, which in turn should allow the end of NIRP**. We still see any hiking cycle in Japan as limited in scale. **We look for the policy rate to hit 0.2% by end 2024**. The yen remains a wild card for the BoJ.

Rates – Higher but slower



- The fact that the BoJ remains cautious suggests that policy change expectations will be kept at bay in the very near term. However, expectations for tighter monetary policy are unlikely to ease fully, which means that **front-end JGBs will remain under pressure throughout our forecast horizon**. We prefer a short bias for 2024.
- Bearish pressure in short-term JGB yields should also put the 10yr sector to the test; but the steepening momentum should fade late in the year.
- Long-end JGBs should remain relatively shielded. Higher rates will make long-term JGBs look increasingly attractive to Japanese domestic investors, who are looking to add long-term exposure. **We like flatteners in 10x30s**, a theme we expect to accelerate in H2-24.

FX – In thrall to UST yields



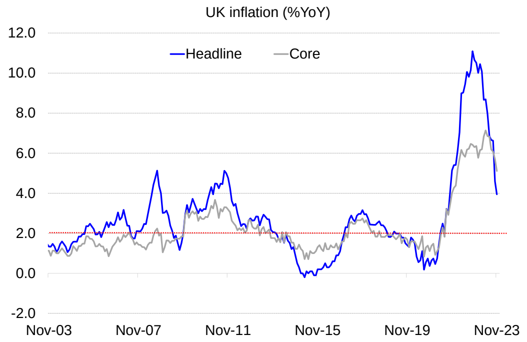
- The drop in USD/JPY in December took the pair well below intervention levels. IMM data show a sharp trimming of JPY shorts in December, as expectations of a BoJ policy change built. In the short run, we expect some reversal as yields overseas rise. However, **the longer-term case for JPY looks positive as overseas central banks cut**.
- Improvements in the trade balance should slow in coming months, although any dip in oil prices will be a boon for Japan. The services balance should improve a little in 2024 driven by the rebound in tourism.
- To date, the yen has failed to draw much support from the BoJ's YCC tweaks but combination of a rising policy rate at home and falling yields overseas should be supportive. Valuations and positioning both suggest scope for solid gains in 2024. The yen remains cheap and **we see USD/JPY at 128 by year end**.

Basis – Pay the USDJPY XCCY basis

- Several drivers should support a tighter USDJPY XCCY basis: **JPY appreciation**, **subdued interest from Japanese investors** to buy hedged overseas assets, **Yankee issuance** remaining attractive for Japanese issuers and the **ongoing attractiveness of JGBs swapped** into USD. We especially like the belly of the curve; the long end will remain driven by x-gamma flows. The key risk for our paying view is any type of strong risk-off sentiment.

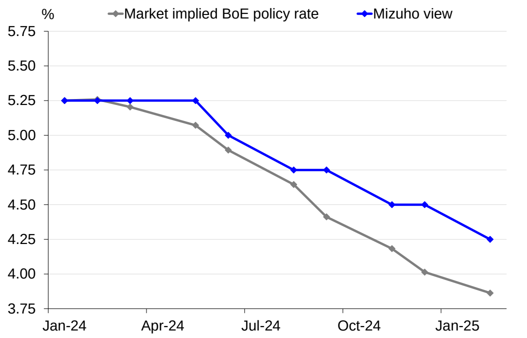
GBP markets

Macro – A little less downbeat



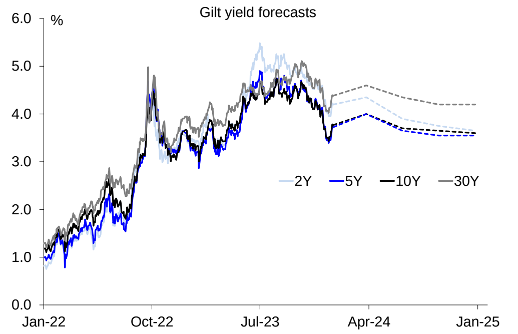
- We see **negative growth in Q4, putting the economy in recession**. That said, we revise up our 2024 GDP forecast to 0.4% (vs 0.0% prev.) thanks to mildly looser fiscal policy, housing holding up better than expected, a faster-than-expected drop in inflation and better PMI data.
- November showed a large drop in headline inflation. Core inflation also declined quite sharply. Food price declines in December add to downside pressures for the upcoming CPI print. **Risks are now more balanced than previously and the UK looks less of an outlier on the inflation front compared to international peers.** We see the CPI averaging 3.0% in 2024 (vs 3.2% previously).
- We expect a **change of government at the upcoming election**, which will likely be in autumn 2024, but do not see any significant loosening of fiscal policy in the short run in the wake of the poll. The opposition have been keen to reassure voters that they will not simply open the fiscal spigot.
- The labour market, especially wages, is the key source of inflation risks and here we see some mild encouragement. **Some of the leading indicators are pointing to softness, which will show up in the official data in due course**.

Policy – Atop Table Mountain



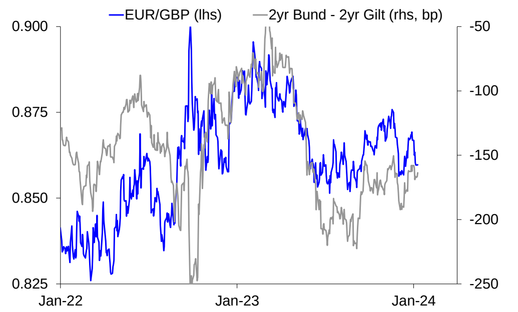
- The BoE left policy unchanged in December in a 6-3 vote. The statement retained its hawkish bias alongside a promise to do more if required. The BoE's November forecasts implied softer activity, with 2024 GDP almost flat but slightly higher inflation due to weak supply.
- Recent rhetoric has had a hawkish bias. Since Pill referenced market expectations (of a potential cut by mid-2024) in a 7 November speech, the BoE has appeared keen to push back against expectations of early rate cuts. Pill himself has been conspicuously less dovish since.
- We see the **first cut in Q2-24 with one further cut in each of Q3 and Q4 taking the policy rate down to 4.5% by end 2024**. Active QT will continue in the background. The new £100bn pace of has not delivered any upward pressure on yields as yet. The APF currently sits at ~£744bn, down from a peak of £895bn in 2021.

Rates – Buy the dip into Q2-24



- In line with our views in USTs and EGBs, we expect the **bearish pressure in Gilts to continue throughout Q1-24**. Elevated Gilt issuance and the limited progress we expect on the inflation front will provide some support to short positions. The long end of the curve should be the most hit by supply, driving the steepening in the curve.
- Ongoing macro softness and inflation heading down again will encourage investors to **buy the dip in Gilts into Q2-24**. The front end should outperform as rate cuts become a higher probability scenario, which is why **we like to add steepening exposure on any strong flattening**. Having said that, inflation progress looks less promising in H2-24, which suggests that the bullish momentum in short-end UK rates may stall and the steepening may slow down.

FX – Downside risks dissipating



- The pricing of UK short-term interest rate expectations for H1-24 looks reasonable to us. However, expectations for EUR and USD policy cuts look a little overcooked, which may weigh on GBP in the near term. GBP positioning looks fairly neutral and will not push cable one way or another. GBP still appears relatively cheap from a long-run perspective, even when Brexit is taken into account.
- The Labour Party will likely win the next election, but we do not see such a development as especially GBP negative. If anything, the opposition may be more willing to push harder to mend the relationship with the EU. Given its lack of baggage, it will likely be more successful that the current government. **We see GBP/USD at 1.35 by end 2024**.

Basis – Brace for more steepening

- Front-end GBPUSD XCCY has been able to tighten notably in 2023. Momentum in that part of the curve looks to be fading and a shift to a more dovish BoE should support any receiving flow. **We turn neutral on front end GBPUSD XCCY, but continue to expect further normalisation in the long end**, which remains too flat and should benefit from lower GBP rates vol and any progress on the inflation front. **Complex x-gamma flow** will continue to be a key driver.

Mizuho Forecasts (as of 8 January)

FX forecasts	Current	End-Q1 24	End-Q2 24	End-Q3 24	End-Q4 24
USD/JPY	144	144	138	132	128
EUR/USD	1.10	1.10	1.10	1.12	1.14
GBP/USD	1.27	1.27	1.30	1.32	1.35
EUR/GBP	0.87	0.87	0.85	0.85	0.84
EUR/JPY	158	158	152	148	146
GBP/JPY	183	183	179	174	173

Bond forecasts (%)	Current	End-Q1 24	End-Q2 24	End-Q3 24	End-Q4 24
United States					
Policy rate	5.375	5.25~5.50	5.25~5.50	5.00~5.25	4.75~5.00
2yr	4.38	4.50	4.30	4.00	3.70
5yr	3.99	4.10	3.95	3.75	3.70
10yr	4.03	4.25	4.15	4.00	3.85
30yr	4.20	4.50	4.45	4.30	4.20
Eurozone/Bund					
Policy rate/Deposit rate	4.50/4.00	4.50/4.00	4.25/3.75	4.00/3.50	3.75/3.25
2yr	2.54	2.60	2.35	2.15	2.00
5yr	2.07	2.20	2.00	1.90	1.85
10yr	2.14	2.30	2.15	2.05	1.95
30yr	2.36	2.60	2.50	2.45	2.30
Japan					
Policy rate	-0.1	-0.1	0.0	0.1	0.2
2yr	0.04	0.10	0.20	0.25	0.45
5yr	0.20	0.30	0.45	0.50	0.65
10yr	0.60	0.80	1.05	1.15	1.20
30yr	1.62	1.70	1.80	1.80	1.70
United Kingdom					
Policy rate	5.25	5.25	5.00	4.75	4.50
2yr	4.20	4.35	3.90	3.75	3.65
5yr	3.72	4.00	3.65	3.55	3.55
10yr	3.77	4.00	3.70	3.65	3.60
30yr	4.38	4.60	4.35	4.20	4.20

Macro forecasts (%)	2023	2024	2025
United states			
Real GDP	2.5	1.4	1.4
CPI	4.1	2.6	2.4
Unemployment rate	3.7	4.1	4.5
Eurozone			
Real GDP	0.5	0.1	1.0
CPI	5.4	2.4	2.0
Unemployment rate	6.5	6.8	7.0
Japan			
Real GDP	1.7	0.8	1.0
CPI	3.2	2.5	1.9
Unemployment rate	2.6	2.5	2.4
United Kingdom			
Real GDP	0.5	0.4	1.2
CPI	7.5	3.0	2.0
Unemployment rate	4.1	4.5	4.8

Note: Real GDP, CPI and unemployment rates are on an annual average basis.