Mizuho Brief: Macro Themes

Economics & Strategy | Asia ex-Japan

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MIZUHO

Ten Dragon Themes

- 1. Competitive Pivot: The Fed will not dominate, maybe not even lead, rate cuts; *challenging received wisdom on unmitigated USD weakness,* and/or "risk on" bet. Instead, sharp JPY rebound may be the more defined outcome.
- 2. Immaculate "Soft-Landing" Challenged: An *uninterrupted "risk on" glide-path down in rates* from "costless" dis-inflation is *stretched.* Instead, *lagged policy pain* spread unevenly *may prompt* sharper cuts and initial a *window of "risk off".*
- 3. Bumpy Dis-inflation: Inflation has *peaked, but* is *prone to bumpier "last mile"* from both demand and supply risks. Resultant "higher for longer" instincts ironically amplifies risks of sharper cuts as it unearths vulnerabilities to of not-so-soft landing.
- 4. Debt Reckoning & Risk Re-pricing: *Elevated post-pandemic debt and rates* conspire to inflict pain. Albeit with *unfamiliar lag due* to *unprecedented pandemic distortion.* Resultant risk re-pricing involves *sharply differentiated credit risk premium jump amid* accentuated contagion threat.
- 5. China's Prolonged Pain: Absent a sufficiently forceful reversal of real estate clamp-down, the *unresolved confidence deficit* poses *a binding drag.* More so as structural policy constraints conspire with conflicting political-economic objectives.
- 6: India: Silver Lining, Not Bullet: Compelling *structural, medium-term allure,* accentuated by "China+1", is a *silver lining contingent on* requisite industrial/farm/education *reforms. Not silver bullet* that negates China risks; especially as it grapples with *K-shaped outcomes, financial stability threats,* and overarching *global uncertainty/headwinds.*
- 7. Oil's Non-OPEC Levers: *Dominant US output,* and (downside) *demand risks* further out diminish the OPEC's ability sway in buoying crude prices; with any significant bullish moves likely to be from *geo-political flares, not OPEC* supply curb flair.
- 8. Geo-political Threats Unmitigated: Propensity for *Ukraine* mis-calculations, *Middle-East* spillover and rising *Russo-NATO tension* suggest *elevated, not assuaged, geo-political threats.* US Presidential election only *accentuates risks* as diplomatic brinksmanship and political misjudgment conspire.
- 9. Crowding Out: Conflict and need for gradual cutback on pandemic debt reliance warn of bloated global government debt issuances and resultant "crowding out" pressures. In turn, this is likely to; i) increase term premium, and; ii) differentiate (credit) risk premium along dimensions of cash buffer and credit/capital market access.
- 10. Trump 2.0: Rising likelihood of a second Trump Presidency brings with it heightened uncertainty, "second wind" for USD, possibly interrupted yield declines and likely wider term/risk premiums.

1. Competitive Pivot

Fed pivot is not merely forgone conclusion, but an **aggressive bet**, doubling down on 75bp of cuts indicated in the December 'Dot Plot'. But this under-accounts for more dire economic conditions in Europe, which will probably force ECB (amongst other Major central banks) to quickly catch down with Fed cuts; if not leap-frog in terms of emergency easing.

If so, the appropriately nuanced narrative is one of **"competitive pivot"**, *to the exclusion of Fed-ECB/BoE divergence play that singles out USD for weakness.* Necessarily, this entails **two-way FX volatility involving USD resilience**, perhaps even bullish outburst; in sharp contrast to overly-simplistic expectations of unfettered, linear USD decline.

Crucially, **FX dynamic** associated with "competitive pivot", suggests **stand-out JPY out-performance**, and ***not unambiguous USD slump***. Point being, *violent compression of global yield spreads vis-à-vis JGBs* as global rates/yields fall sharply amid **"competitive pivot"** *squares with unilateral JPY spikes* (Cross/JPY slump); especially accentuated in a world where JPY dominates as the only "funding currency".

What's more, **if a brutal, self-reinforcing contagion of** (JPY-funded) **"carry" unwind** is **set off**, then the **consequent deterioration in risk sentiments** is more **likely to underpin USD**. Typically to the detriment of other Major currencies, apart from JPY and maybe CHF.

2. Immaculate Soft-landing Challenged

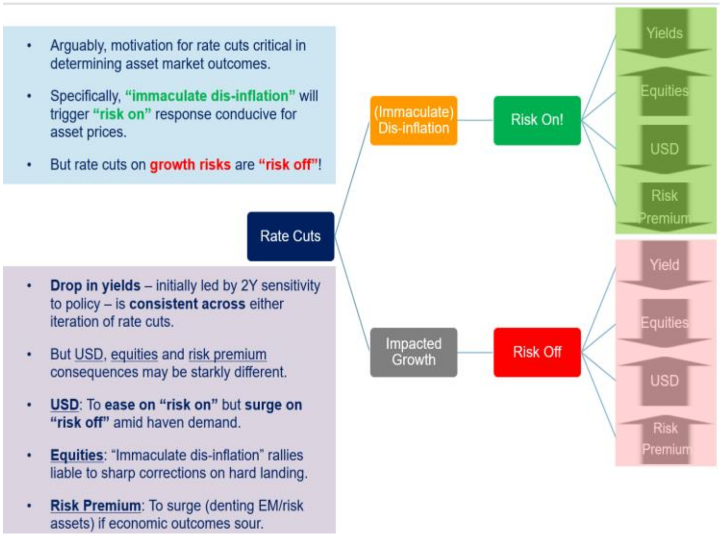
Context for emphatic iteration of "competitive pivot", is that ***sufficiently deep global rate cuts are catalysed by adverse demand shocks*** associated with impacted growth, **not "immaculate dis-inflation"**.

For a start, **"soft landing"** amid sustained dis-inflation appears **inconsistent with sharp rate cuts**. Moreover, ***dis-inflation flattered*** **by exceptionally high base** effects **does not distract from the unabated strain on household cash-flows** from a tyranny of elevated prices – left behind by a run of exceptionally high inflation – conspiring with steep rate hikes.

Finally, adverse demand shocks from a confluence of sweeping, albeit uneven, geo-political risks, attendant cost shocks (also potentially from weather-related disruptions) and the impact of lagged credit tightening set the scene for **unavoidable economic pain to supplant inflation** *as the overarching driver of policy.*

Given sharper *trade-off between growth and inflation risks* in Europe/UK, this notably *sets in motion the case for ECB/BoE to engage in more drastic policy correction.* Crucially, this also means that **rate cuts**, *rather than inspiring "risk on" from fairy tale "immaculate dis-inflation",* **will invoke "risk off"**.

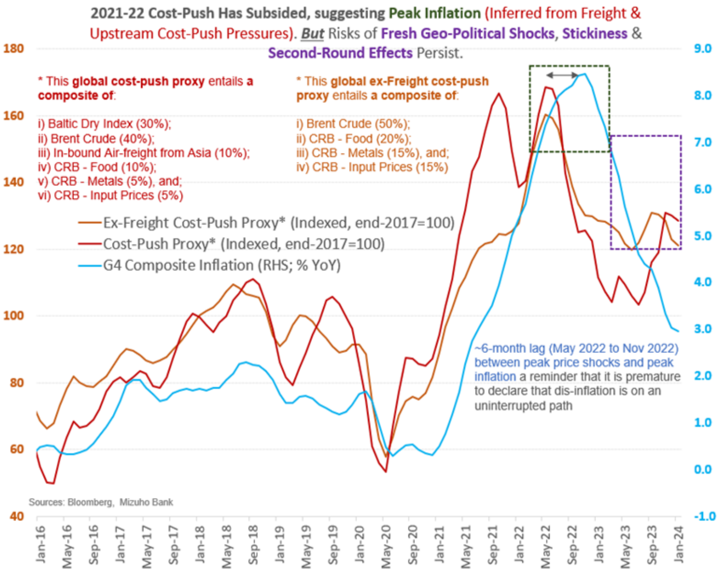
Distinction with a Difference: Why Being Wrong About "Immaculate Dis-inflation" Matters



3. Bumpy Dis-Inflation

In 2024, **inflation may prove more mercurial** than the encouraging trend of dis-inflation might otherwise suggest. Notably, *sequential price pressures may not abate* despite year-on-year dis-inflation, which is exaggerated by exceptionally high base.

Geo-political cost flares pose the most obvious *challenge* to *unfettered dis-inflation;* as threats to both production and passage of key goods/commodities loom large. Moreover, inclement weather exacerbates cost-push risks while services capacity remaining tight, might exert "second round" effects (via higher wages); hampering notions of a quick exit from tight policy.



Yet, the ***a priori*** **risks of sticky inflation** may not only dissipate rapidly on a not-so-soft landing scenario, but may be *supplanted by outright fears of deflationary shocks ex-post.*

4. Debt Reckoning & Risks Re-pricing

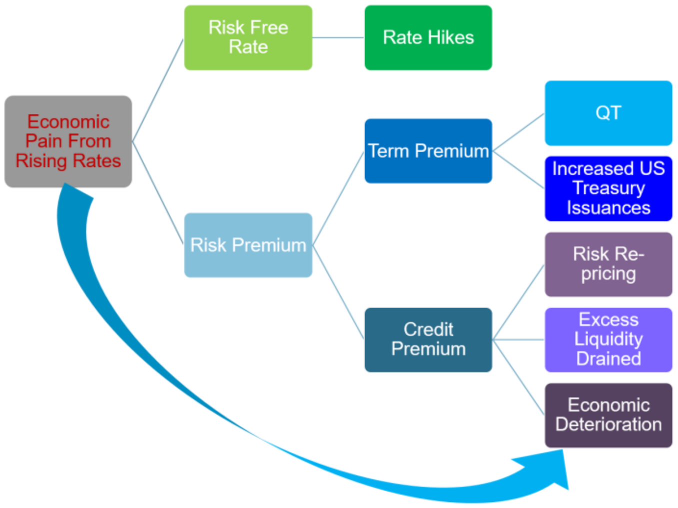
Not-so-soft landing scenarios partly concede that **long and variable monetary policy lags** must come home to roost. Especially **as higher debt** levels across the public and corporates, households **start to bite**; *albeit with an unfamiliar path and delay* given the **obfuscations of pandemic** *savings buffer* further distorted by *post-pandemic deprivation demand.*

Fed Waller's view that 'big shocks travel fast', referring to *greater confidence around averting policy-induced hard-landing* by virtue of having reduced policy lags via "big shocks" (large hikes and aggressive 'forward guidance'), *could be prove painfully wrong.* Especially **as *fading post-pandemic distortions/buffer amplify structural policy lags*** coming home to roost amongst more indebted households and corporates.

The **resultant *false sense of comfort* to hold rates high(er) *may perversely precipitate a recession*** if far sharper leverage tightening belatedly (amid unfamiliar post-pandemic dynamic).

This is expected to invoke credit shocks; in turn induce a **rude reinstatement of credit risk premium**; which has *thus far* been *unnaturally suppressed through the*

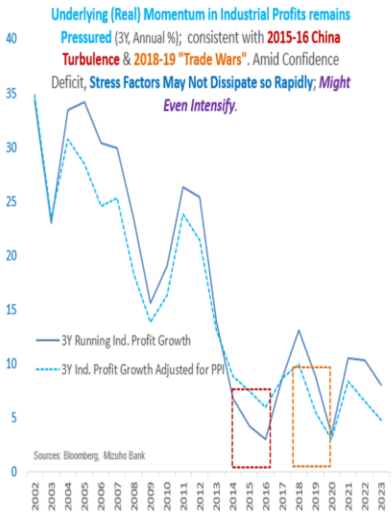
Fed rate hike cycle.

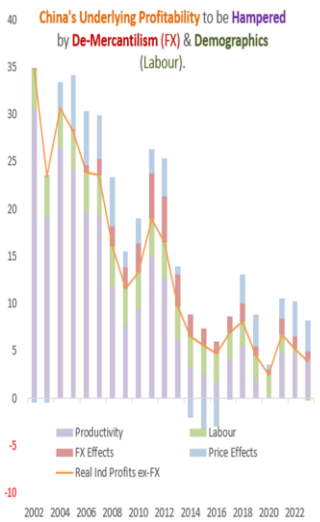


Inevitably, such an episode of risk re-pricing could; i) **sharply differentiate credit quality** within and across industries/geographies, and more worryingly; ii) **accentuate vulnerabilities to** financial **contagion** given inextricable linkages across asset markets.

5. China's Prolonged Pain

China is **likely to continue stumbling along** as potential for unfettered economic rebound is stifled by a conspiracy of *inadequate stimulus to overcome* binding *chronic confidence deficit* and "live" threats of *intensifying geo-political headwinds* that compounds pre-existing *demographic challenges*.





Trouble is, **confidence deficit** is **hard to snap** given **immutable policy constraints** from;

i) *conflicting political-economic objectives* (manifesting in less business-friendly aspects of "Common Prosperity);
ii) *tensions between* threats to *financial stability* and *incentives to pump-prime* and;
iii) the *trade-offs between* retaining or sharpening *exports advantage* on one hand and spurring *domestic consumption* on the other.

Upshot being, with China's **growth multipliers smothered** by confidence deficit that **circle back to mute** already constrained **policy stimulus**, there is simply no sure-fire, ***no quick fix or instant policy gratification***.

The sobering reality is one of ***China is mired in a vicious spiral of weak confidence feeding off, and into, subpar growth***. In particular, amid **rising costs of stimulus** hampering the ability to redress a conspiracy of structural (demographic/productivity) headwinds, geo-political threats and socio-political conflicts.

6. India: Silver Lining, Not Bullet

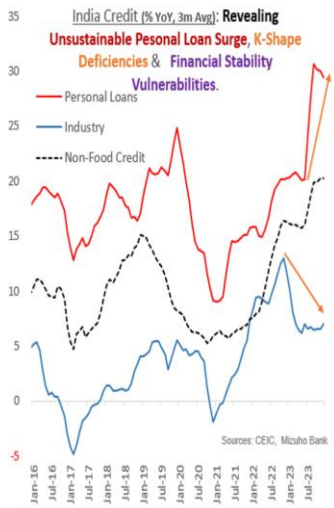
As we have alluded to before, **India's structural allure** *accentuated by "China+1" geo-economics shifts* make a **compelling case for India to be the prominent**, if not unchallenged, **bright spot** in the medium to longer-term (5-15 year horizon).

But that **neither guarantees an imminent and unfettered economic boom** without necessary reforms (to industrial, farm and education) *nor* does it **insulate from global economic/geo-political headwinds** *in the near-term*. Crucially, **India cannot, currently or in the foreseeable future, supplant China**'s **manufacturing capacity** and/or **raw economic heft** – given China's economy is five times the size and with a far greater share of manufacturing.

Admittedly, **stellar economic performance in recent quarters**, running at >8% GDP growth rate since Q2 (Apr-Jun) 2023 could trigger **temptation to upgrade India's growth potential to 8-9%**. But this borders on being **a tad too optimistic**.

For one, *underlying consumption* – which accounts for 56-58% of GDP – *growth has decelerated despite* the *headline GDP pick-up;* and in spite of a surge in personal loans. This reveals **risks of a K-shaped, uneven growth spurt** currently.

Moreover, it warns of a further dip in economic momentum as (not if) the extraordinary credit outburst is exhausted. Both of which suggest that durable **underlying growth** is more **likely** than not to be in the **6.5-7.0% range**.



services boosting demand for oil.

But ***with the Gaza conflict, OPEC's ability to exploit and accentuate geo-political premium to boost prices is diminished***. This, as;

1) **proximate threats** to production and passage of oil **from conflict overtake OPEC production guidance** as the more emphatic price trigger;
2) a **surge in non-OPEC output** from US ramp-up to prospects of relaxation of sanctions elsewhere offset OPEC curbs and;
3) **concerted US pressure** to have lower pump prices heading into the Presidential elections **features in oil market bets**.

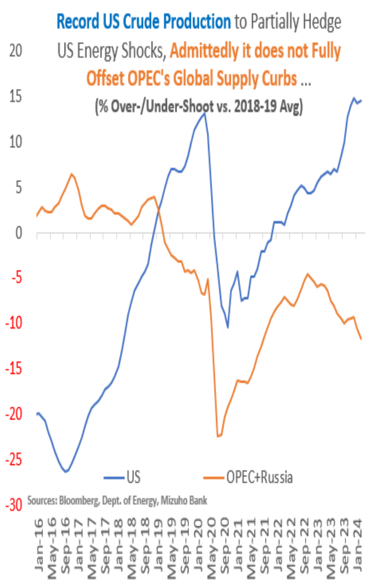
All said, **India promises the silver lining of higher growth opportunities**, looking past near-term interruptions, at a time **when China is wobbling**. *But* it **falls** well **short of a silver bullet that negates headwinds and uncertainty** in a geo-politically charged global economy. In fact, *India itself is neither insulated from interim global headwinds nor a bona fide substitute for China.*

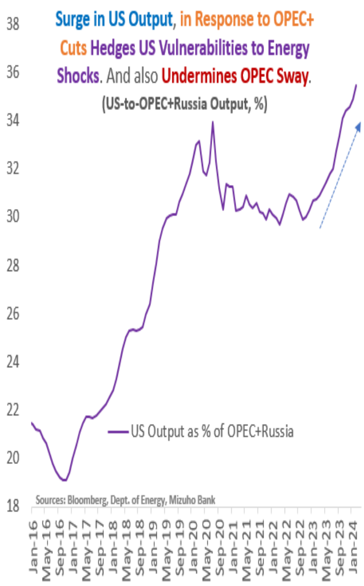
What's more, **implied internal fractures** *from Angola's exit from the cartel* **undermine OPEC's signalling powers**; overshadowing dismissals the departure on account of Angola's relative oil production/market insignificance.

Finally, *even with risk of geo-political flares,* Oil is more **likely to trend and settle lower ~ $60-80**, not durably surmount $100. Admittedly, a siege of the Straits of Hormuz, sending crude spiking to $130-160, cannot be dismissed. But this is a highly unlikely "tail" with fleeting dynamic, not an enduring equilibrium.

7. Oil's Non-OPEC Levers

Oil is set **to be predominantly driven by non-OPEC triggers**. In other words, *geo-politics, demand shocks* and *US production,* rather than increasingly futile attempts by the OPEC to play unilateral price setter.





A **moderation in demand**, as the pace of surge in global travel wanes (late-stage normalisation) amid lagged policy tightening effects and lingering China soft spots, **coinciding with non-OPEC production bump-up** ought to cool prices a little more from here. While The path to a measured softening though could prove highly volatile, possibly violent at times. *First order impact* of **cost shock** to be followed on quickly with *second order* **demand hit**.

8. Geo-political Threats: Throbbing, Not Ebbing

Meanwhile, **geo-political threats** remain **entrenched**. The **Russia-Ukraine conflict** has become **a prolonged war**, where **waning fiscal/weapons support** from elsewhere in the West over time **ostensibly emboldens Russia's calculus**.

Admittedly, **since the Russia-Ukraine war**, and into a good part of 2023, ***OPEC had some degree of leverage to underpin Oil's geo-political premium***.

In particular, as it cut/restrained output, citing economic uncertainty; despite strong recovery in global travel and

More so, as the Israel-Hamas war competes for attention, resources and worst of all, polarize political positions, thereby undermining collective deterrents. In fact, the involvement of Houthi rebels attacking Red Sea merchant ships with Iran fast becoming explicitly implicated, **heighten threats of spill-over conflict**.

In any case, *higher shipping costs* from the **diversion of merchant vessels** from the Red Sea constitutes with *tail risks of energy price spikes* **if Iran blockades the Straits of Hormuz**. These "live" threats means that sequential cost shock risks are more pronounced.

And, US Presidential elections **accentuate military miscalculation risks**. On one hand, there may be generic temptation to *misjudge US preference for non-engagement* tendencies.

But more worryingly, the prospects of *Trump Presidency divide rather than deter.* **Disengagement from Ukraine may embolden Russia** whilst upping the stake for Europe; especially if antagonistic Trump confrontations with NATO play out again. Whereas, **unqualified Israel support** could inadvertently catalyze **wider Middle East conflict**.

9. Crowding Out

The **structural tide of higher post-pandemic government bond issuances heightened by the on-going conflict** – both Ukraine and Gaza – as long-drawn wars rapidly drain resources and trigger increased military spending.

Prolonged wars, with distinct potential to broadens (particularly in the context of the Gaza spill-over to the Middle East), mean **upside risks to longer tenure issuances** from US and Europe **will be a feature of geopolitics**.

And in a world without QE, the risk is two-fold. First, **term premium may be sharply increased** *as higher issuances heighten pre-existing concerns of fiscal sustainability.*

Second, the **deluge of government bond issuances** inevitably will also result in **more pronounced "crowding out"** of the private sector. Moreover, as funding costs are broadly driven higher, any "crowding out" will be **sharply differentiated** along ***dimensions of capital market access*** and ***positive cash flows***.

The resultant *widening dispersion in risk premium* means not just a structural shift away from cheap money will be marked by **unevenly higher effective costs of borrowing**.

10. Trump 2.0

As the US elections comes into view, the possibility of a **second Trump Presidency is an undeniable force**. In fact, **the ground swell warns** that ***only the legal system, not the Democrat challenge***, ***stands in the way of 2.0***. And all the *heightened uncertainty that comes with a Trump Presidency.*

Trump is many things. Arguably different things to different folks, partly explaining why something incredulous appears inevitable.

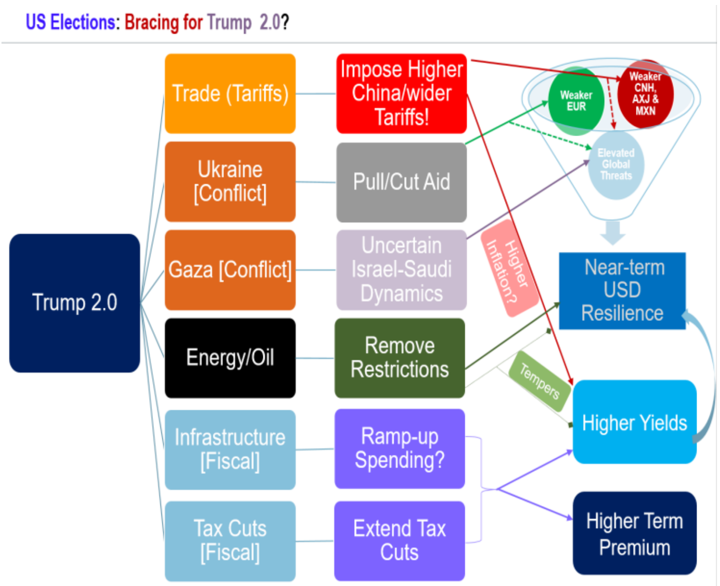
But above all, he is **highly unpredictable** and **inconsistent**. So any exercise in predicting his impact risks being an exercise in futility.

But despite knowing this, we are inclined to conclude that **Trump 2.0** will likely;

i) be *USD positive,* albeit mainly from the **deleterious impact on EUR** (Ukraine pullout, Nato friction, trade conflict spill-over), **CNH** (trade conflict escalation risks) and wider AXJ (mainly from inadvertent supply-chain impact from US-China trade conflict/CNY proxy) alongside the likes of **MXN**;

ii) pose *impediments to bond market rallies* (as yields may be boosted by tax cut extension and/or MAGA-driven infrastructure boost), thereby *subduing policy-induced downside in yields* and;

iii) iii) catalyse *greater term premium sooner,* as longer term fiscal challenges collide with increased geo-political security costs that may become institutionalized whilst.



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