Acrophobia - Fear of Heights

Of Rates, Geo-politics, Restraints & Risks




~Fear of heights is often not about how high the climb is, but how far down the drop will be

MIZUHO

Private and confidential

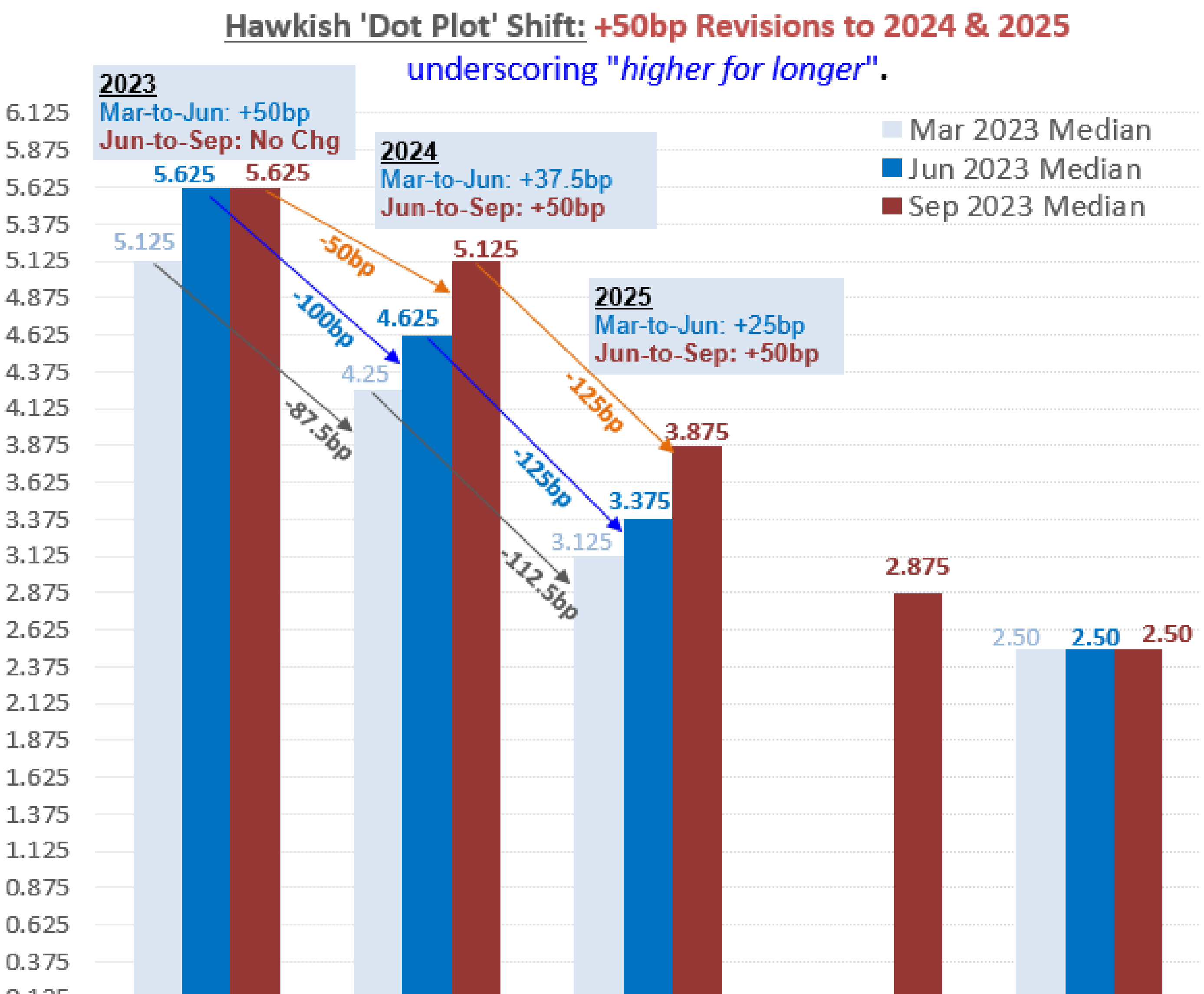
Photo Credits: Financial Times

November 2023

Fears of Policy Mis-steps & Geo-Political Miscalculations

1. **High Rates: Why 'Peak Fed" Flags Incoming Pain, Not Imminent Panacea**
    a. “Higher for Longer” in Real Terms
    b. Exacerbated by Lagged, & Variable Transmissions
2. **Highs of Re-opening: Global Demand Twists, Turns & Tumbles?**
    a. Fading Goods-to-Services Transition with Limited Manufacturing Inflection?
    b. Inconveniently High Cost Shocks both a Policy Risk & Demand Drag
3. **Heightened Geo-political Risk: Conflict & Casualties**
    a. Oil Compounds Pain & Cost Shocks
    b. Uncertainty & “Crowding Out” Risk
4. **High Bar for China: Landing, Not Launching**
    a. Stimulus is Pain Relief, Not Structural Panacea
    b. Property Dent & Confidence Deficit
    c. CNY Risks
5. **High USD & Asia FX: Bracing for Outflows & Volatility**
    a. “Real Risks” Favour USD
    b. Cost shocks & Fiscal strains

1a. Hawkish (Dot) Plot Doubling Down on “*Higher for Longer*”?



Sources: Bloomberg, Mizuho Bank

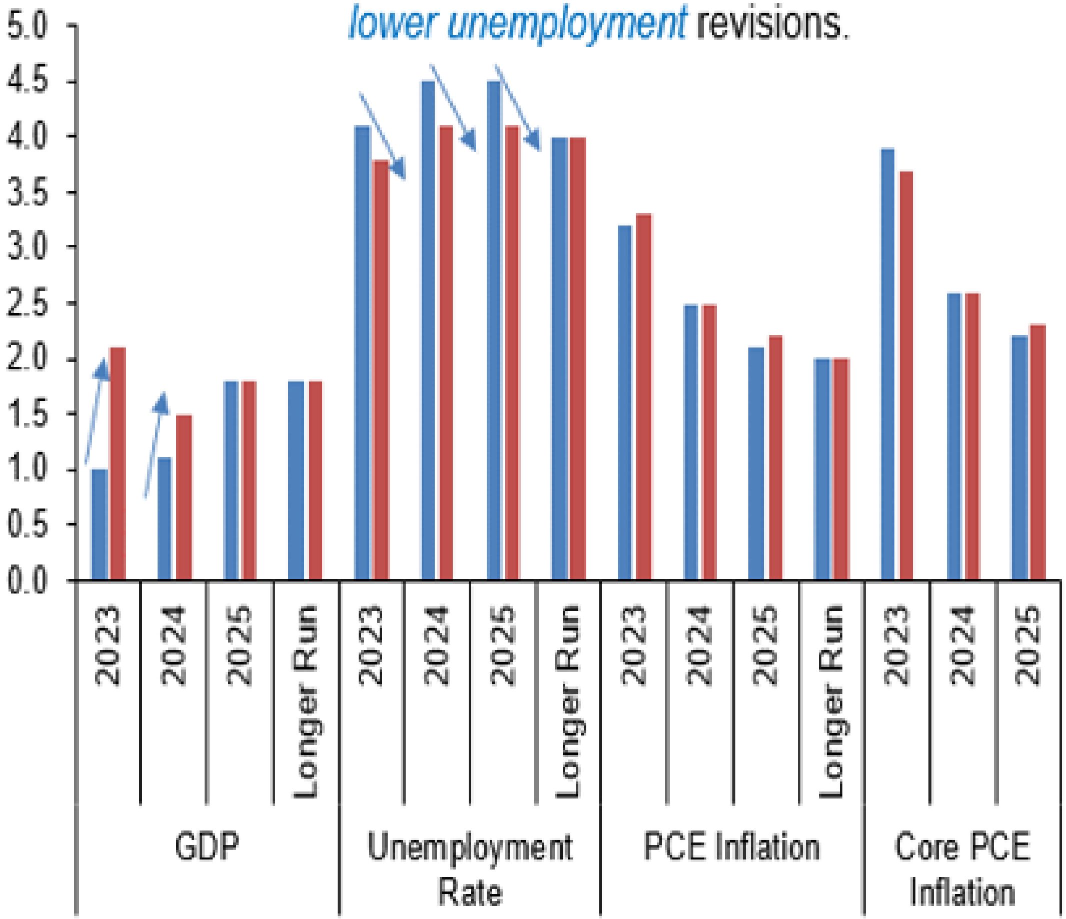
Q: What is it saying … of the inflation dynamic … (that to) achieve the same inflation forecast … but need another half-a-point of (higher) Funds rate?

Powell:

Wouldn’t say that’s (inflation persistence) something that has appeared in recent data … **more about stronger economic activity** … if I had to attribute one thing …

1a. “Soft Landing” Type of Economic Revisions Validating Hawkish Skew?

SEP Projections (Jun vs Sep 2023): **"Soft-er landing" projections** associated with *Higher growth* and *lower unemployment* revisions.



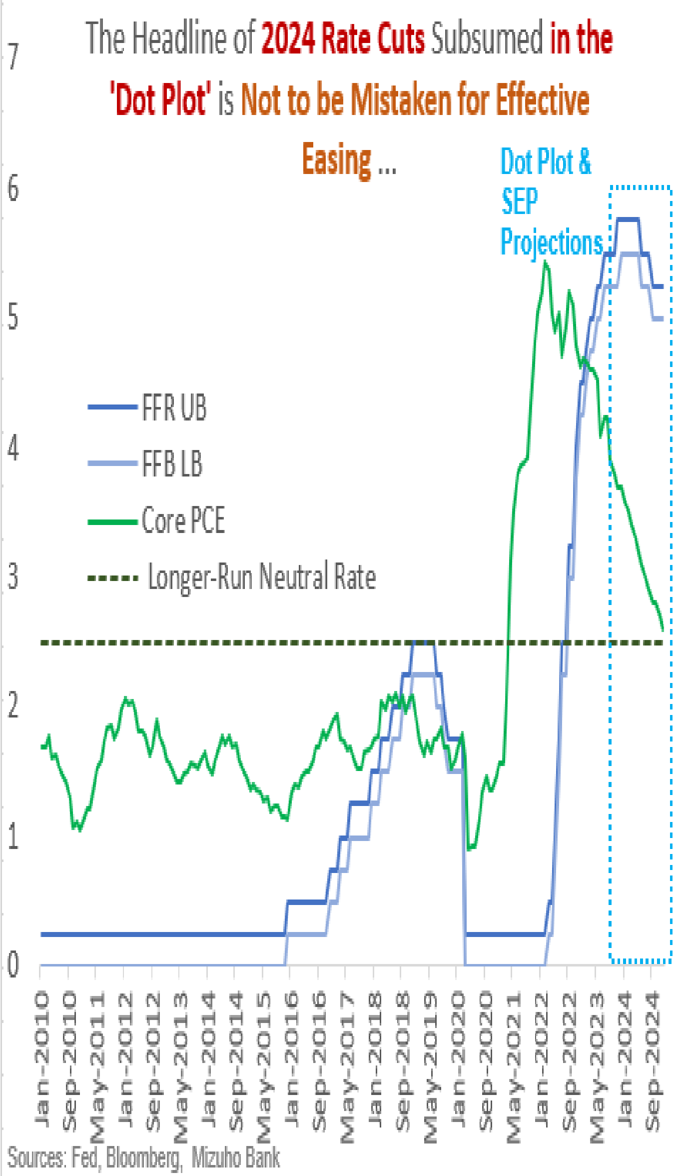
Jun Median Sep Median

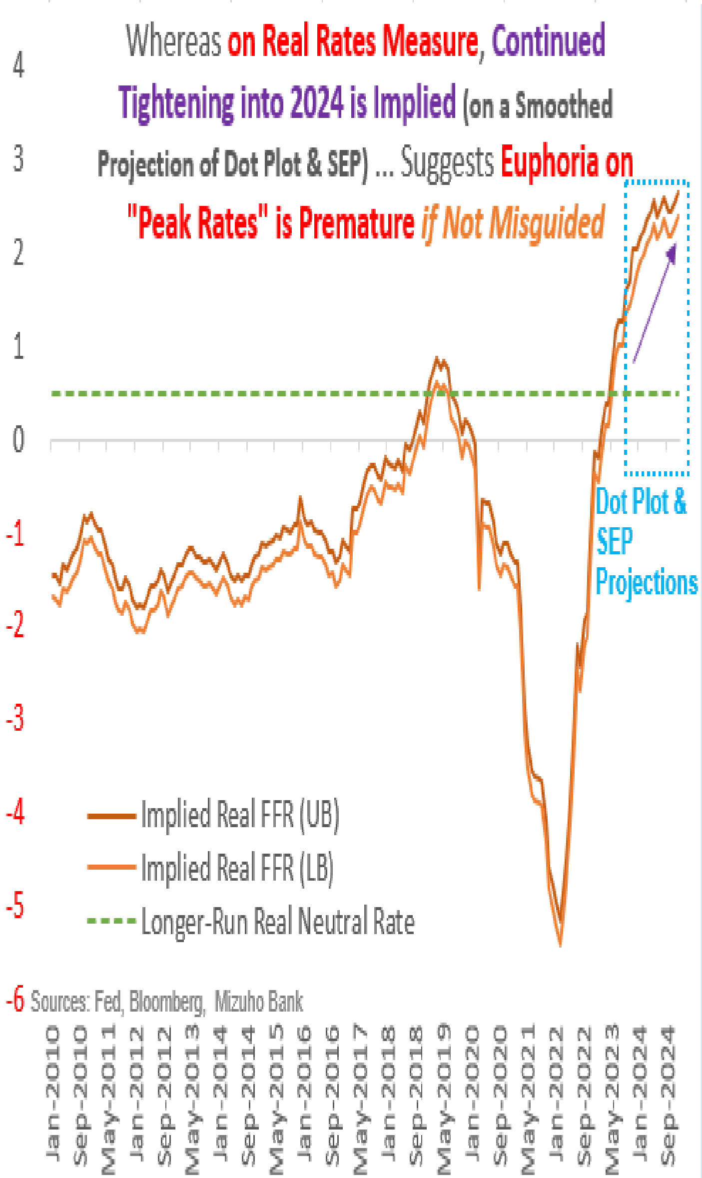
Source: Fed, Mizuho

Percent

Variable	Median[1] 2023	2024	2025	2026	Longer run
Change in real GDP	2.1	1.5	1.8	1.8	1.8
June projection	1.0	1.1	1.8		1.8
Unemployment rate	3.8	4.1	4.1	4.0	4.0
June projection	4.1	4.5	4.5		4.0
PCE inflation	3.3	2.5	2.2	2.0	2.0
June projection	3.2	2.5	2.1		2.0
Core PCE inflation[4]	3.7	2.6	2.3	2.0	
June projection	3.9	2.6	2.2		
Memo: Projected appropriate policy path					
Federal funds rate	5.6	5.1	3.9	2.9	2.5
June projection	5.6	4.6	3.4		2.5

1a. Real(-ity of) Restrictive Rates …





Q: You have indicated *sufficiently restrictive* will be **judged on a real** rather than nominal basis … implying some scope for nominal cuts next year (on softer inflation) … is the FOMC targeting a real …policy restriction?

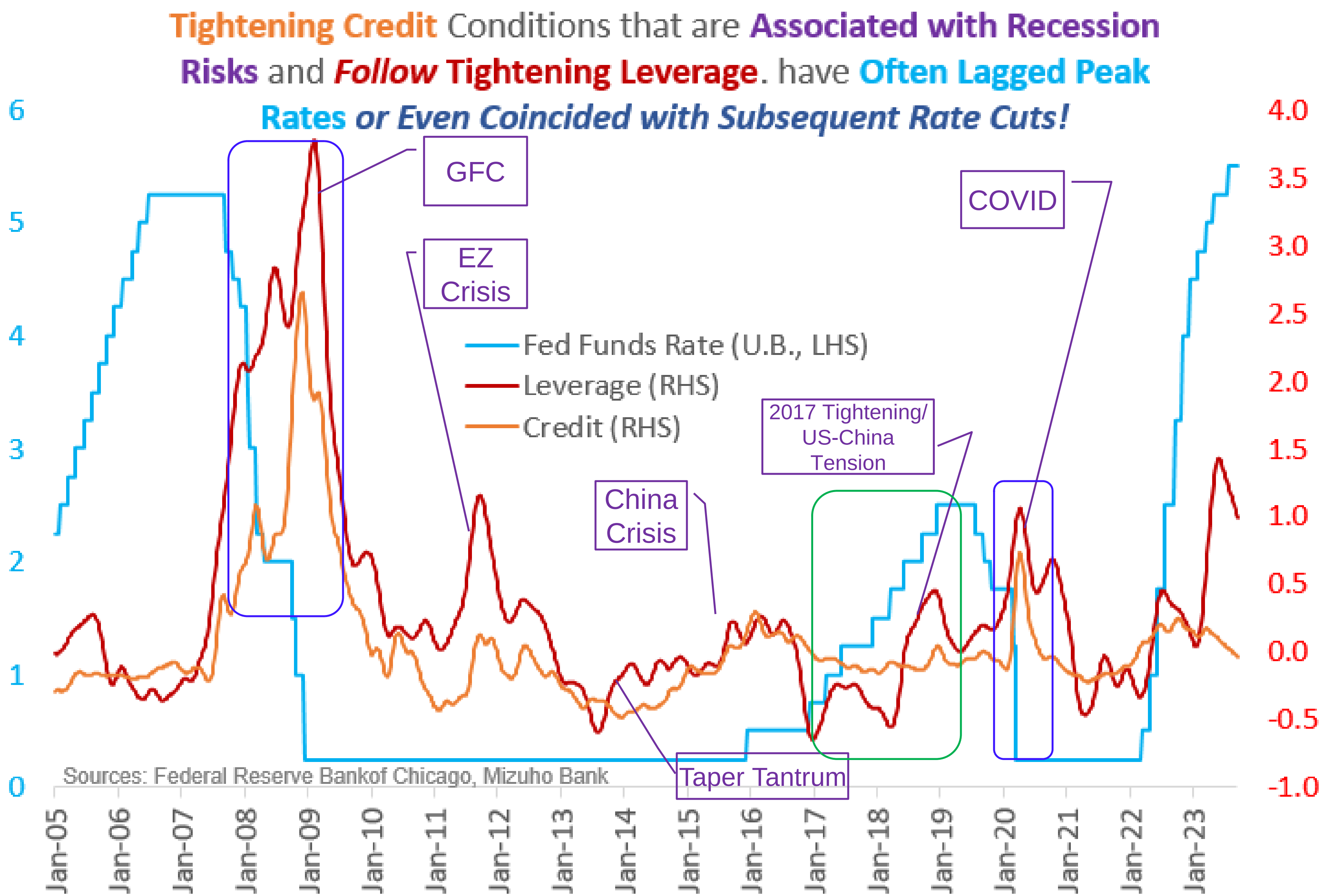
Powell:

(will) **know sufficiently restrictive only when you see it**

… combination of an unwinding of pandemic-related demand-supply distortions and **monetary policy's work in suppressing demand** … is actually working …

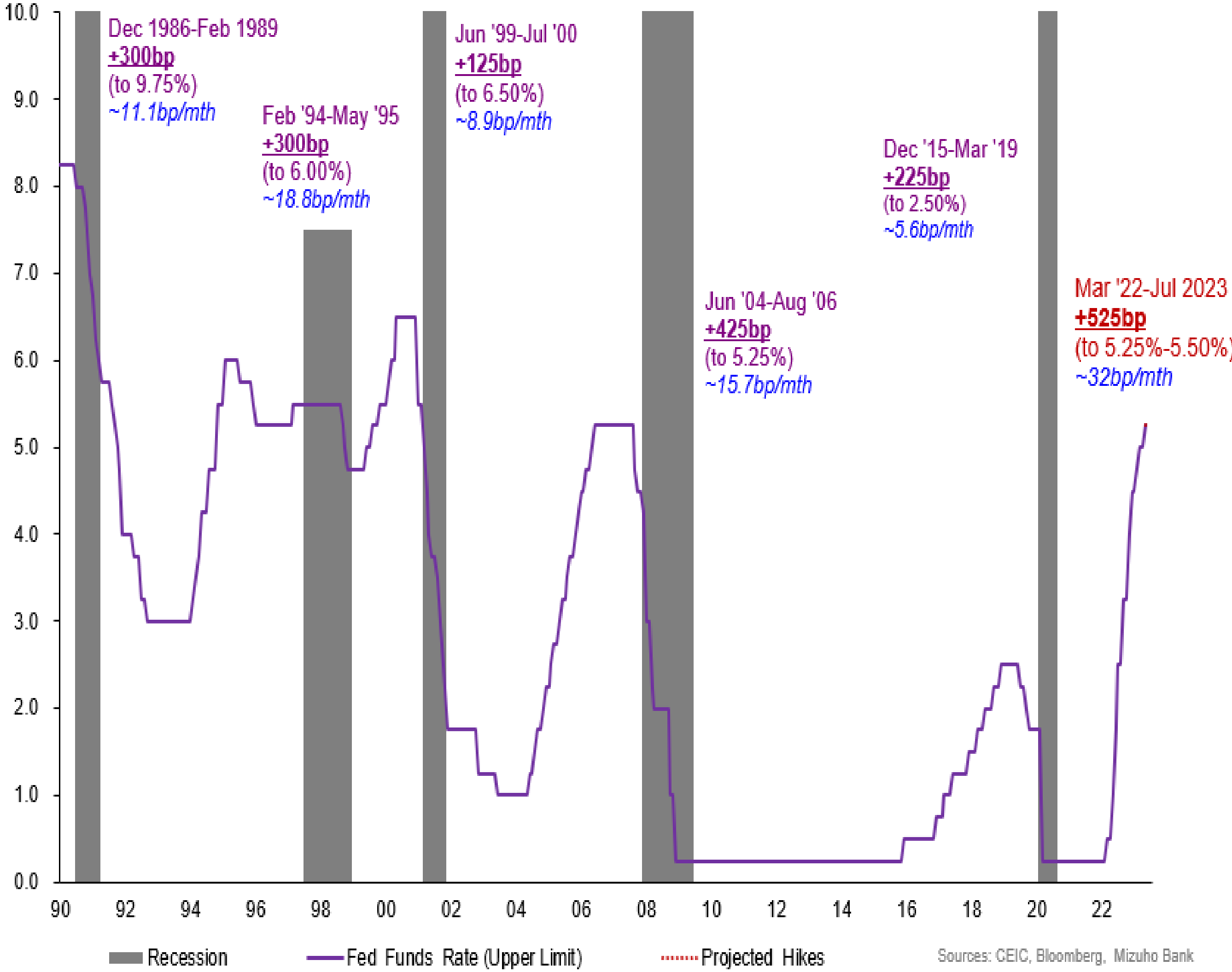
want (to be) confident … this is the right level and ***for now stay here*** … **haven't got … confidence about that** (high enough rate) **yet**.

1b. The Long & *Variable* Lags of Policy



1b. In any Case, Recessions Have Followed Sharp Rate Hikes, *With Considerable Lag*

Fed Tightening Cycles & Global Recessions: **Few Tightening Cycles** by the Fed Have Resulted in "Goldilocks" Outcomes that **Avert a Recession**. And the Fed has assumed the **fasted pace of hikes in four decades**; since the Volcker era (1980s).



Sources: CEIC, Bloomberg, Mizuho Bank

Q: Would you call a **soft landing** now **a base line expectation**?

Powell:

No, I would not say that … always thought **soft landing** was a **plausible outcome** … there was a path to a soft-landing … *path narrowed and widened … ultimately decided by factors outside of our control*

Soft landing is *a* primary objective … *trying to achieve* …

[**but subordinated to price stability**] though … **worst thing** … is to **fail to restore price stability** … best thing … for everyone … restore price stability

ability to … **move carefully** … planning to …

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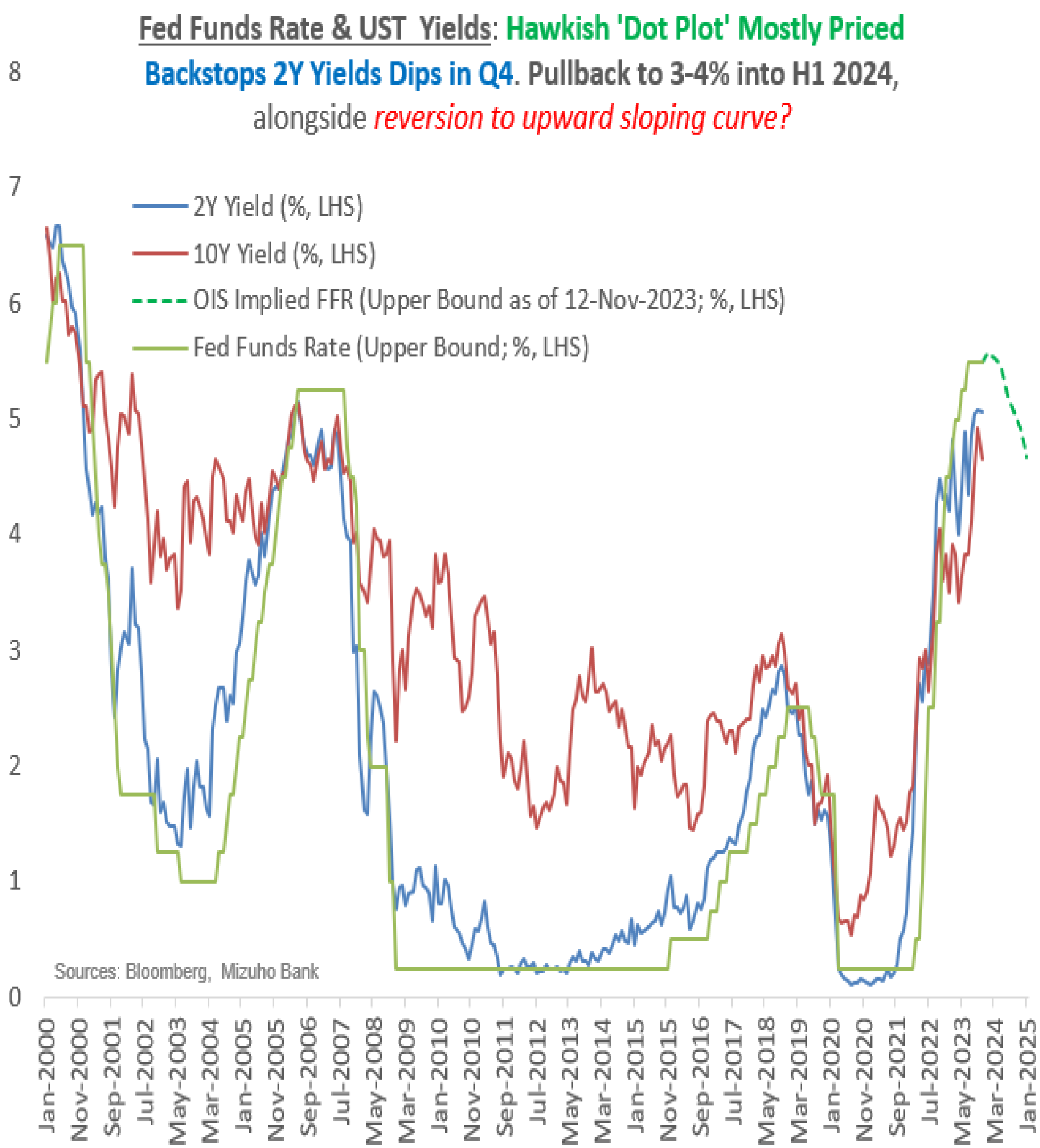
What this May Mean for Yields: *Higher … but Not for THAT Much Longer*



1) **2Y Volatile; Path Down in Late-2023**
   - "Higher for longer" ➔ Amplifies two-way volatility in 2Y yields, with 5.0-5.4% altitude likely tested.
   - Pivot expectations mount Q1-Q2 2024.
   - **Sub-4%** into mid-/Q3-2024 not outlandish on "cold feet"!

2) **10Y Downside to Follow 2Y**
   - **Testing above 5% through 5.3% as US exceptionalism conspires with debt issuances** longer.
   - Ironically, **heightened geo-political risks may be supplanted by related debt bloat** unless conflict risks flare.
   - *Hastening reversal of 10--2Y inversion (**"reversion"** to upward sloping curve)*

3) **Twitchy "Reversion"**
   - **Less pronounced downside** on Fed policy shifts (vis-à-vis 2Y) into mid-H2-2024 to *durably reverse "inversion"*.
   - But instances of **sudden geo-political flare-ups** resulting in *sharp 10Y yield drop* could *fleetingly re-impose inversion pressures*.

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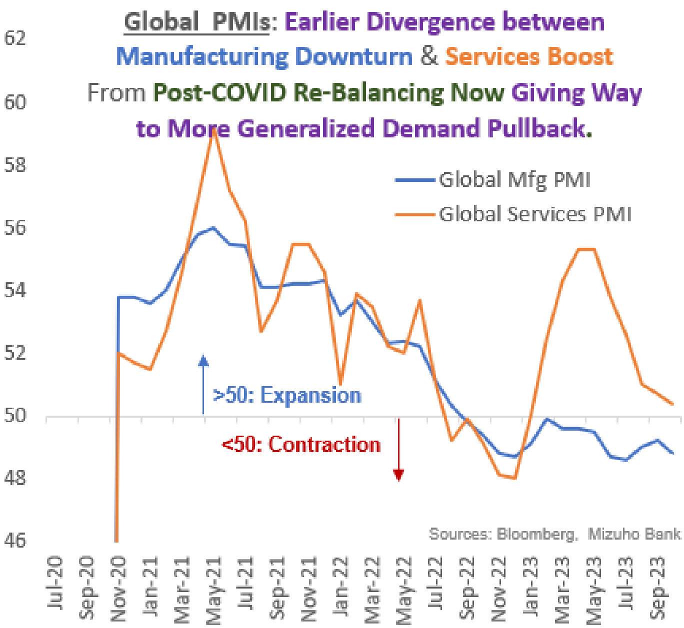
Our Fed & Yield Outlook: *Cold Feet May Over-take Careful Tightening Bias in H1 2024*

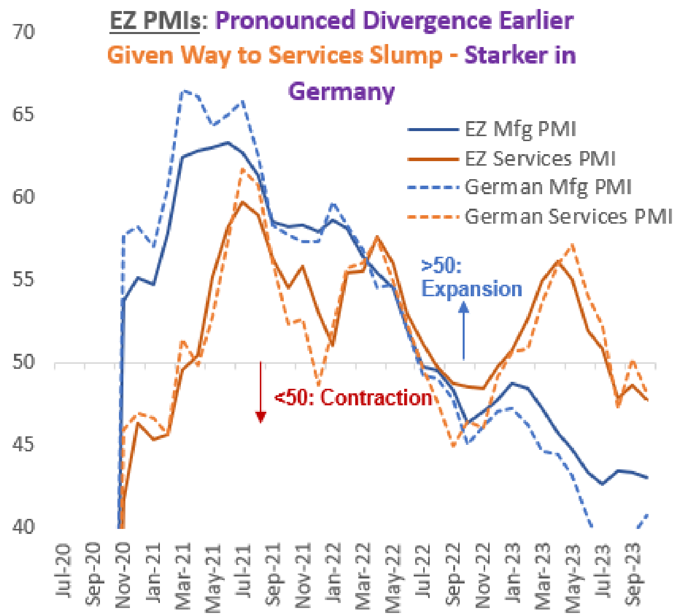
	End-2021	2022				2023				2024			
	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24
Fed Funds Target Rate Ceilin	0.25	0.50	1.75	3.25	4.50	5.00	5.25	5.50	5.50	5.25	4.50	3.75	3.75
Fed Funds Target Rate floor	0.00	0.25	1.50	3.00	4.25	4.75	5.00	5.25	5.25	5.00	4.25	3.50	3.50
UST 2Y Yields	0.73	2.32	2.95	4.28	4.43	4.03	4.90	5.04	4.91	4.00	3.23	2.93	2.80
UST 10Y Yields	1.51	2.36	3.01	3.83	3.87	3.47	3.84	4.57	4.72	4.12	3.56	3.28	3.22

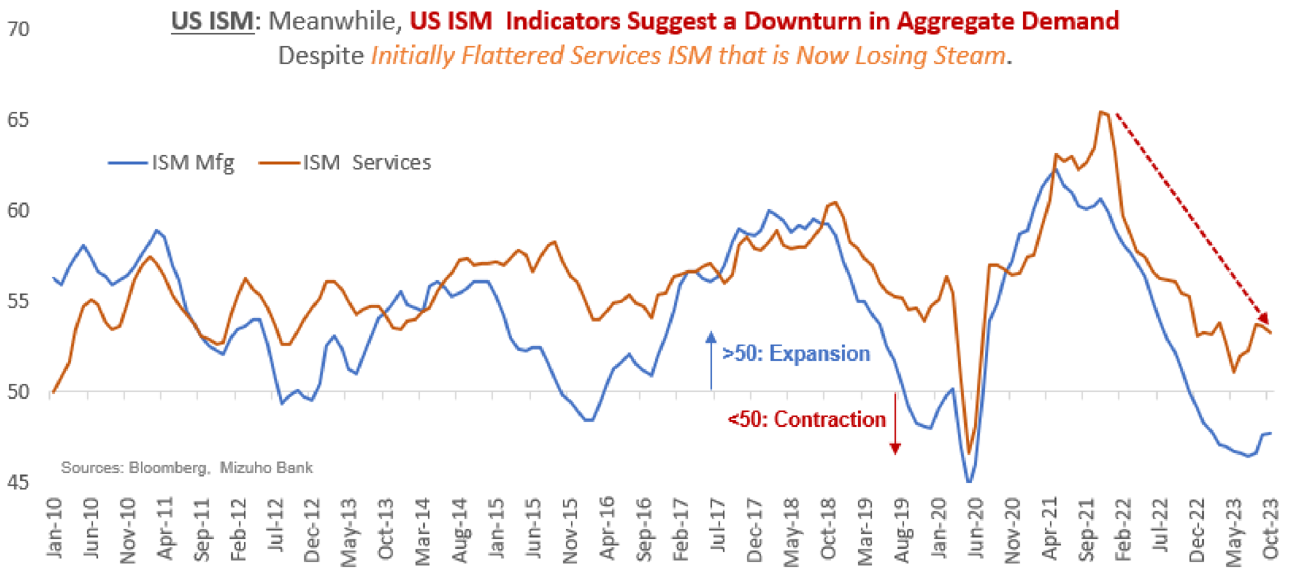
Sources: Bloomberg, Mizuho Forecasts

- **"Live" Dec FOMC, but Hawks Not Living it Up**: ***Realized peak rates may be 5.25-5.50%***.
- **But Tightening Bias Not Shed in 2023**: Nonetheless, **latent/dormant tightening bias** may be **hard to fully shed**. Fed's **emphasis on "higher for longer" rates may linger till Q1 2024**.
- **Volatility**: **Upside yield bias from "high for longer"** may be **sensitive to infection on soft data points**; especially on signs of consumer pull-back. ***Oil*** is as such as **two-way risk**.
  - ❖ "Careful" Fed may limit Yield upside: Although measured tightening calibration bias **could limit scope for strong surge in yields**; 2Y amid 5.0-5.4% and 10Y 4.5-5.3%.
  - ❖ ***Counter-intuitive*** **Bear Steepening on Geopolitics** will **hasten reversion to a normal sloping yield curve**; *as US debt woes on military spending drive long-end yields higher eclipsing haven demand (for now) that ought to drags yields lower instead*. But will be non-linear.
- **Giving way to Sharply Softer Yields**: But with **Fed easing likely by H1 2024** **UST yields head sharply, albeit bumpily, lower in early-2024, picking up pace into mid-2024**.

2a. Demand Re-balancing More *Red Herring* than *Silver Lining*?







- **Stark divergence in Mfg & Svcs PMI ➔**
- **Global goods-to-services demand re-balancing "silver lining" that buffer and buys time?**
- ***But* the risk is that stellar services hides recession risks in plain sight.**
- **Especially as *eroding savings*, *high inflation*, *fiscal consolidation*, *higher rates* & *heightened geo-economic uncertainties* warn of fading consumption boost.**
- **Critically, setting off far more pernicious demand shocks from confidence deficit spiral.**
- **Despite partial tourism offset, EM Asia's goods exports reliance hobble unchecked bullishness.**

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2a. To Hit Depleted Savings?

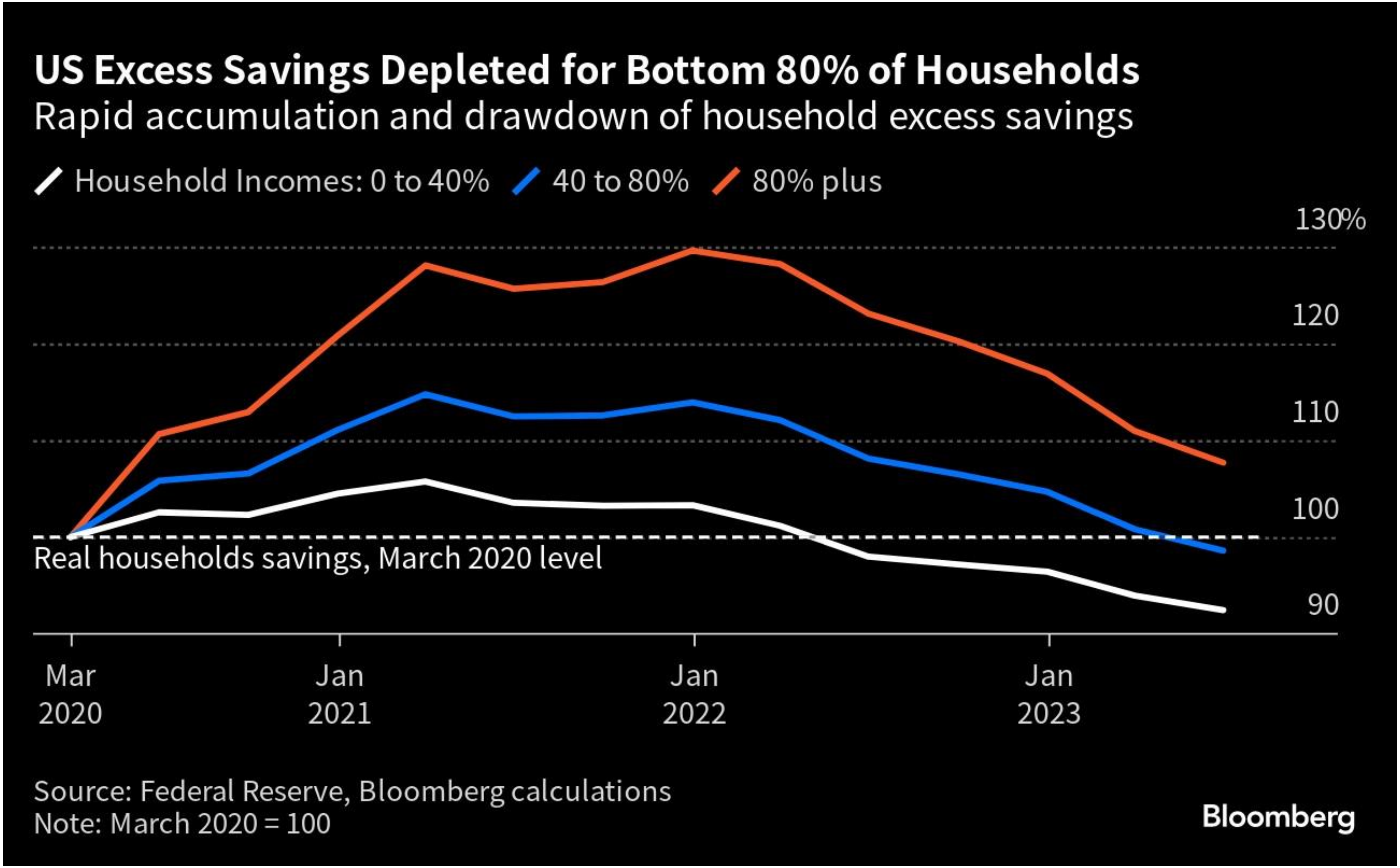
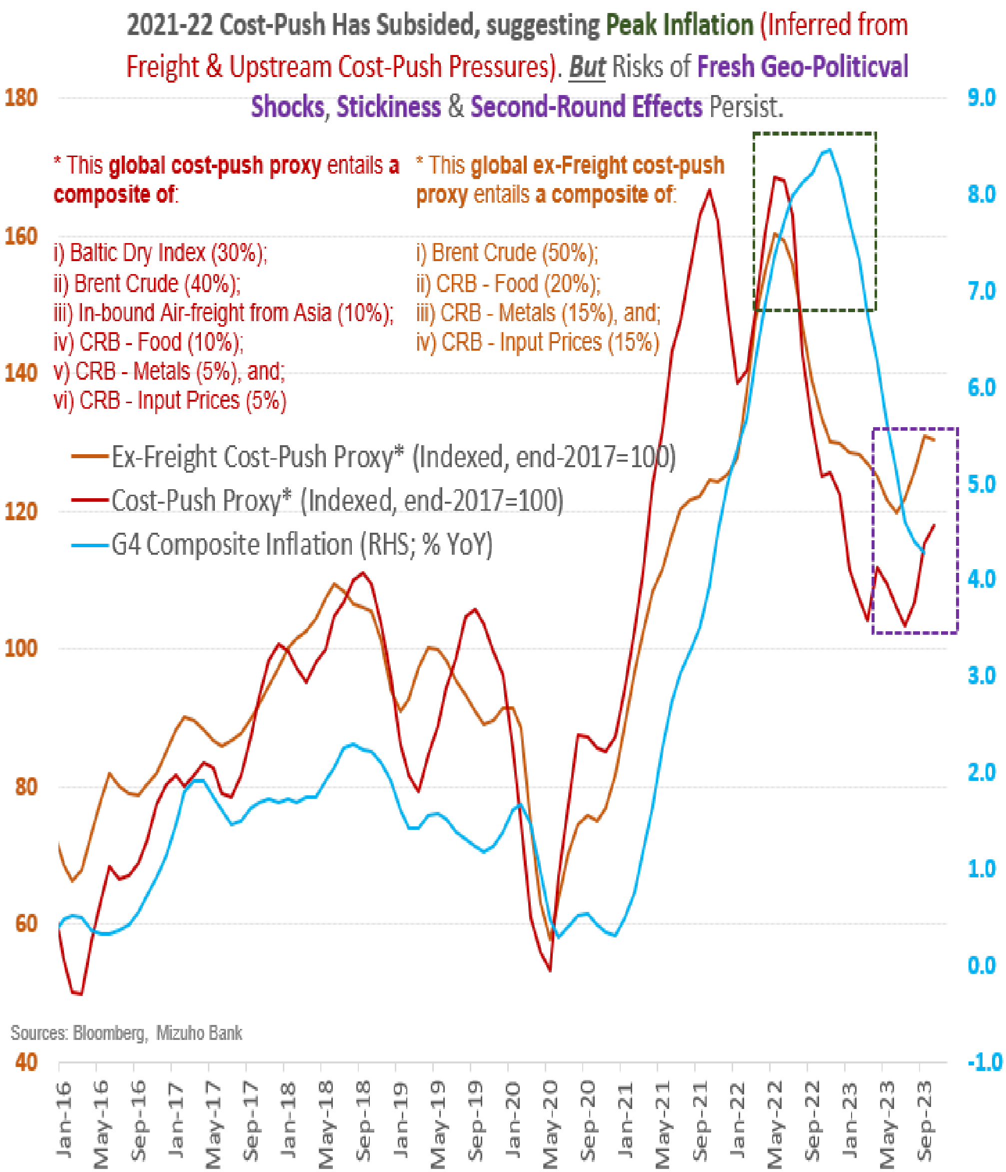
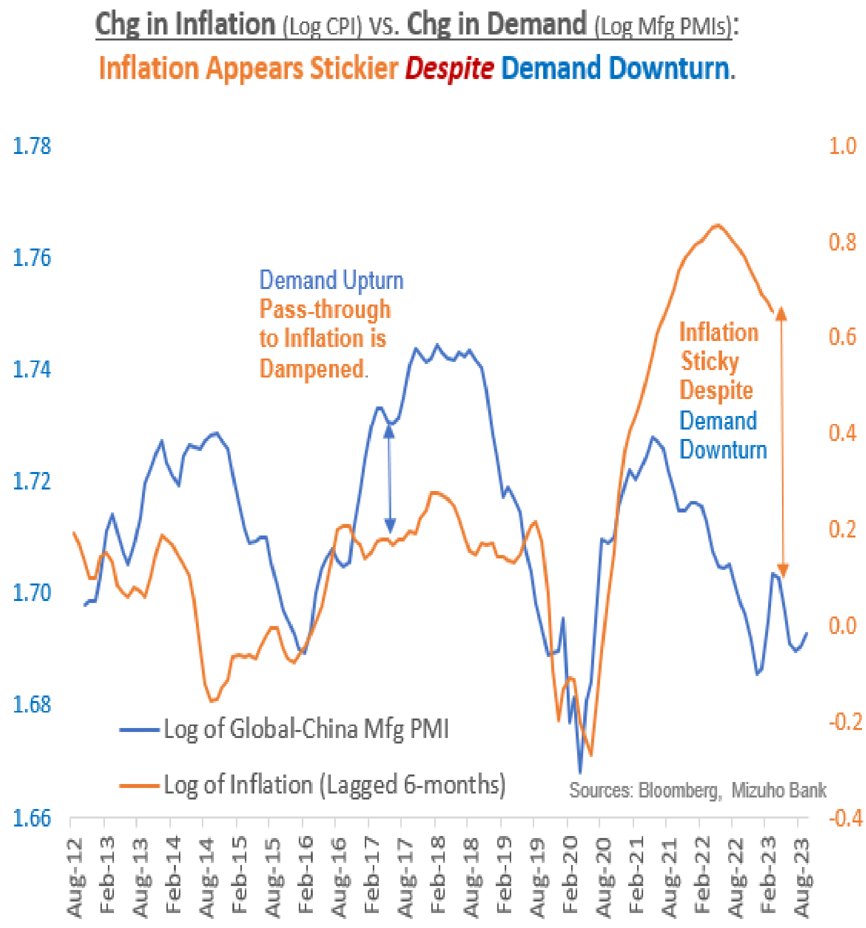


Chart from Bloomberg

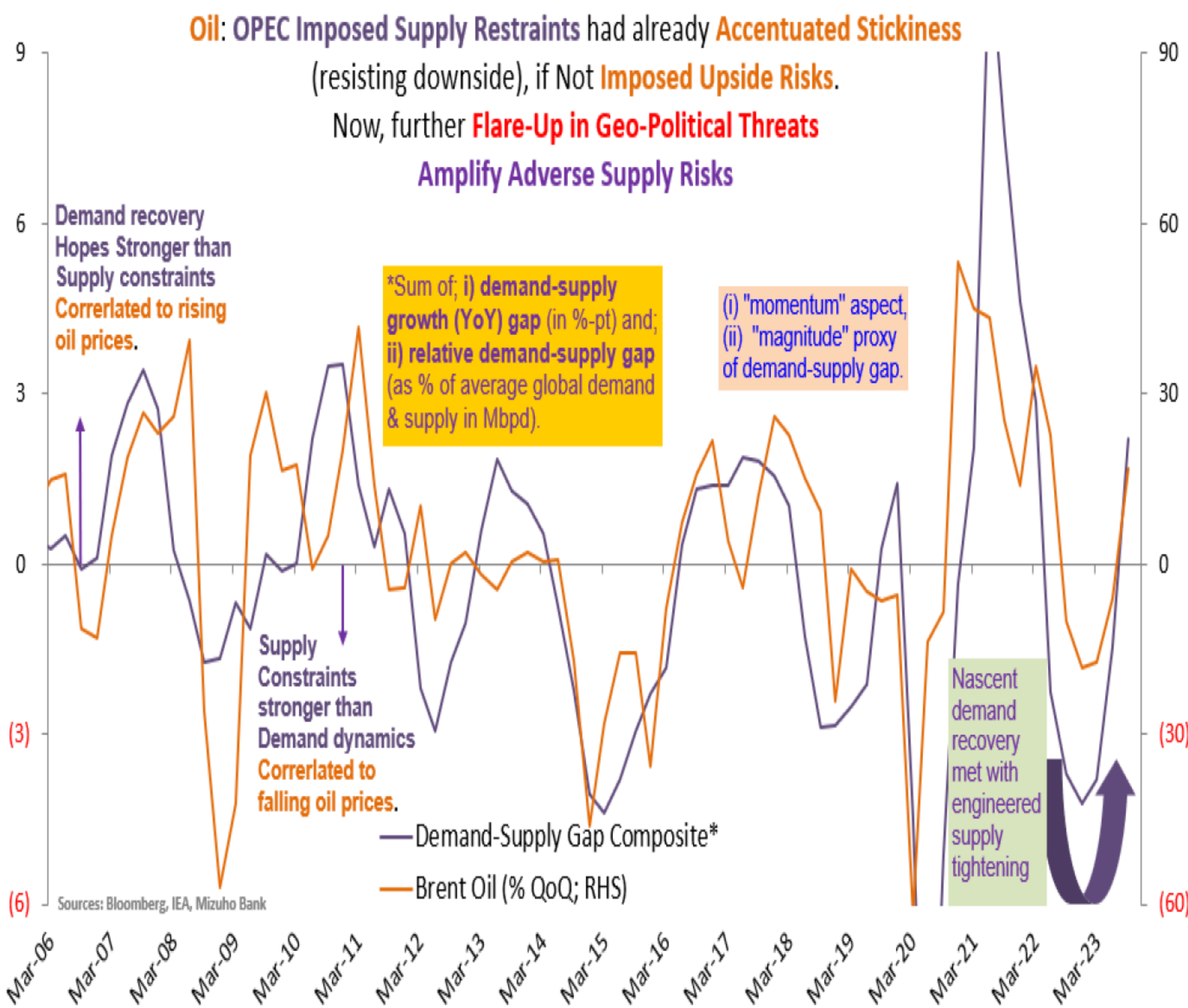
2b. Inflation: Irascible on Shocks … Compound Policy Dilemma & *Hits Demand*





- **Stagflation-type outcomes of** elevated inflation *despite* soft demand ➔ Cost shocks hurting demand rather than softer demand taming inflation?
- **Policy dilemma inherited from pandemic-related series of high inflation amplifies hard-landing risks?**

3a. Oil Price Shocks … Complicated by Geo-politics



Geopolitically-charged $100-120 surge not imminently unavoidable

But equally, ***dangers of a geo-political flare-up in Oil*** *is concealed under the illusion of a controlled war.*

Nuanced point: It would take *identifiable*, *proximate*, *threats of supply disruption* of a significant magnitude **to catalyze** such a large order of Oil price agitation;

Upshot: $100-120 crude is not the prevailing base case. *But* it is *a significant and growing risk;*

More so, **as OPEC-engineered supply tightness** and **Saudi**'s Budget **preference/incentives for $100+** oil;

Amplify Crude price sensitivities to growing adverse **geo-political supply shocks.**

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3a. Oil Price Shocks … Policy Impact if Sustained … but Not Unequivocal

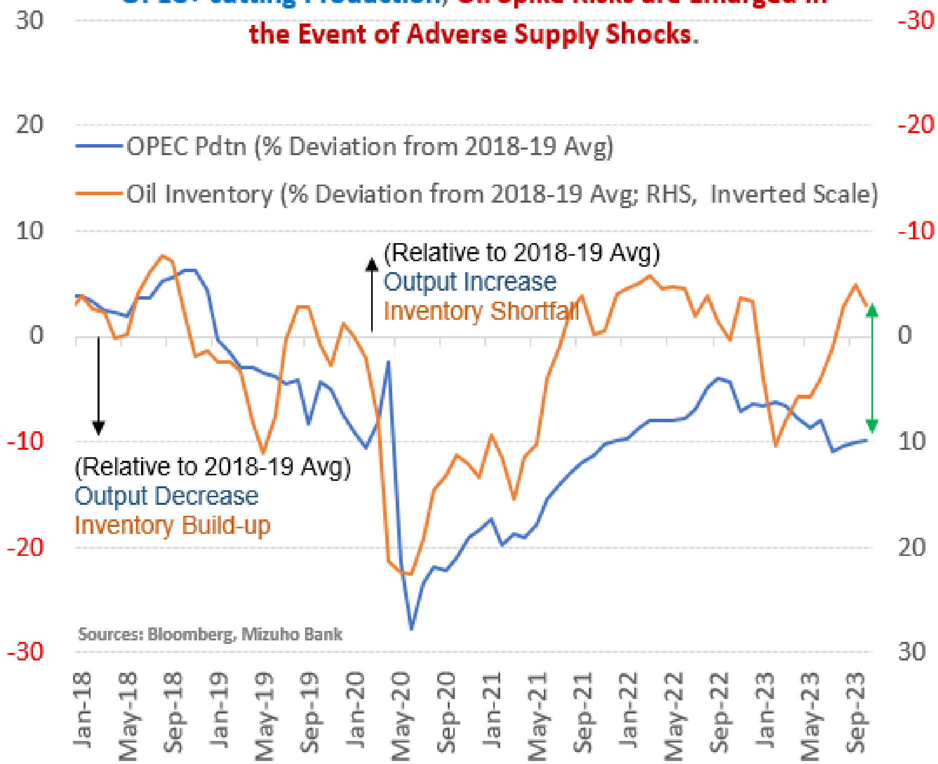
Powell:

Energy prices being higher (and **oil price shock**) … is a **significant thing** ….

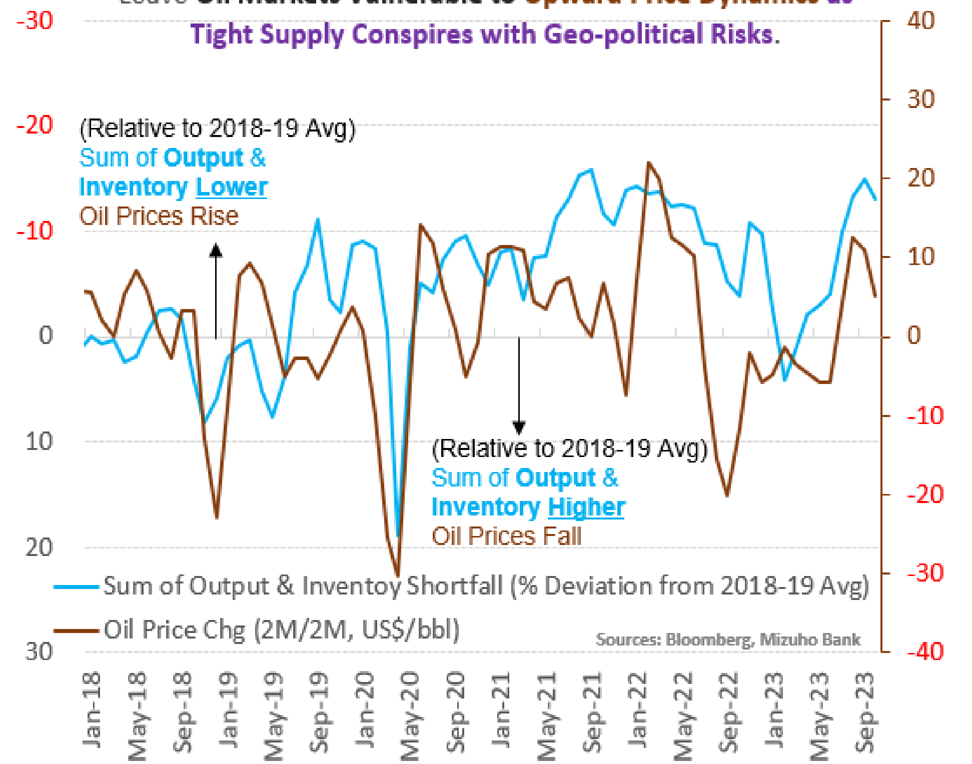
Can **affect spending** … **sentiments** … over time … can affect consumer **expectations of inflation** …

Tend to look through short-term volatility… question is how long higher prices are sustained

Oil Inventories Pullback below 2018-19 average. With **OPEC+ cutting Production**, **Oil Spike Risks are Enlarged in the Event of Adverse Supply Shocks.**



Confluence of OPEC+ Out put Cuts & Inventory Drawdown Leave **Oil Markets Vulnerable to Upward Price Dynamics as Tight Supply Conspires with Geo-political Risks.**



3b. Heightened Uncertainty & “Crowding Out” Risks

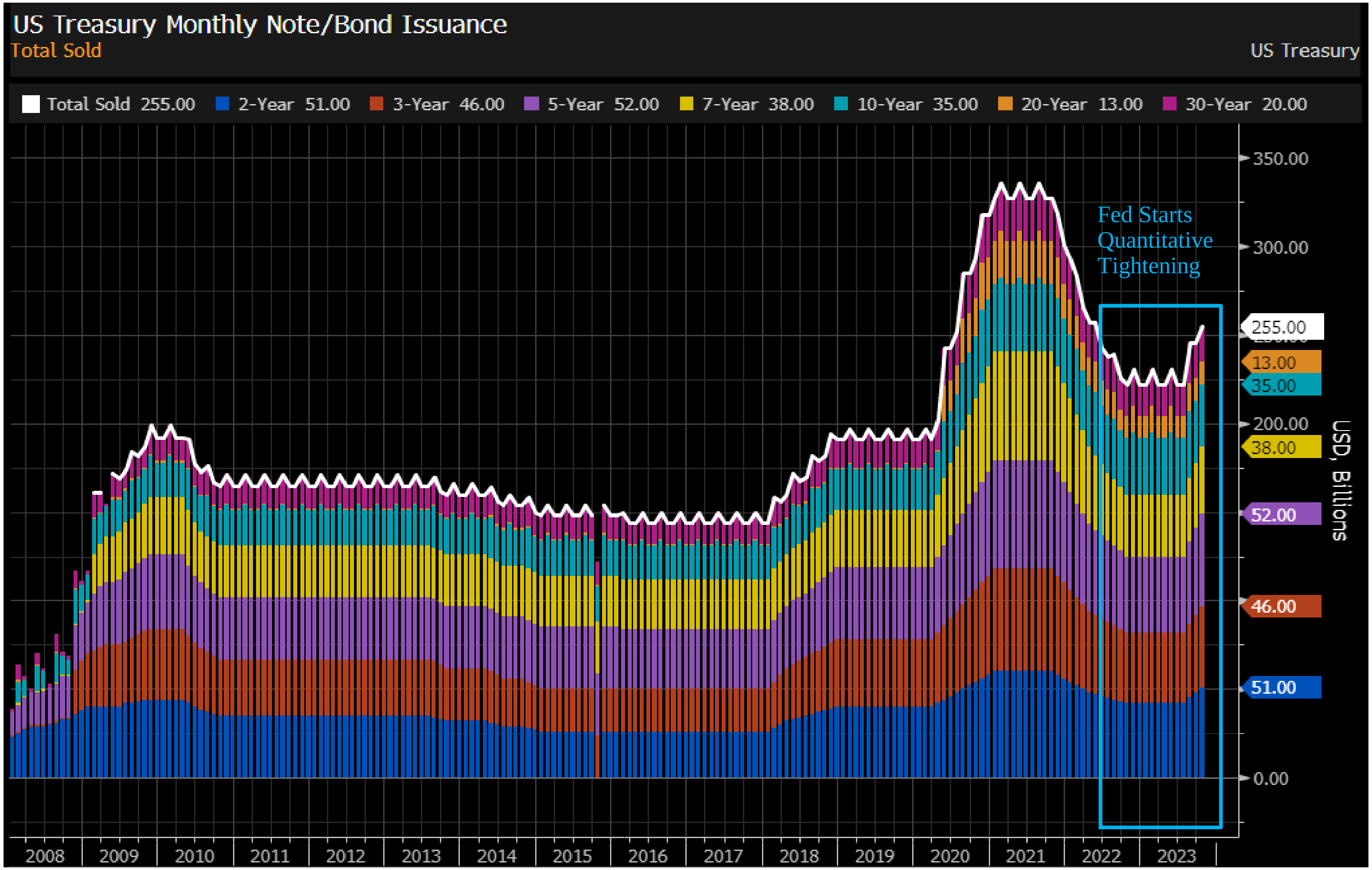
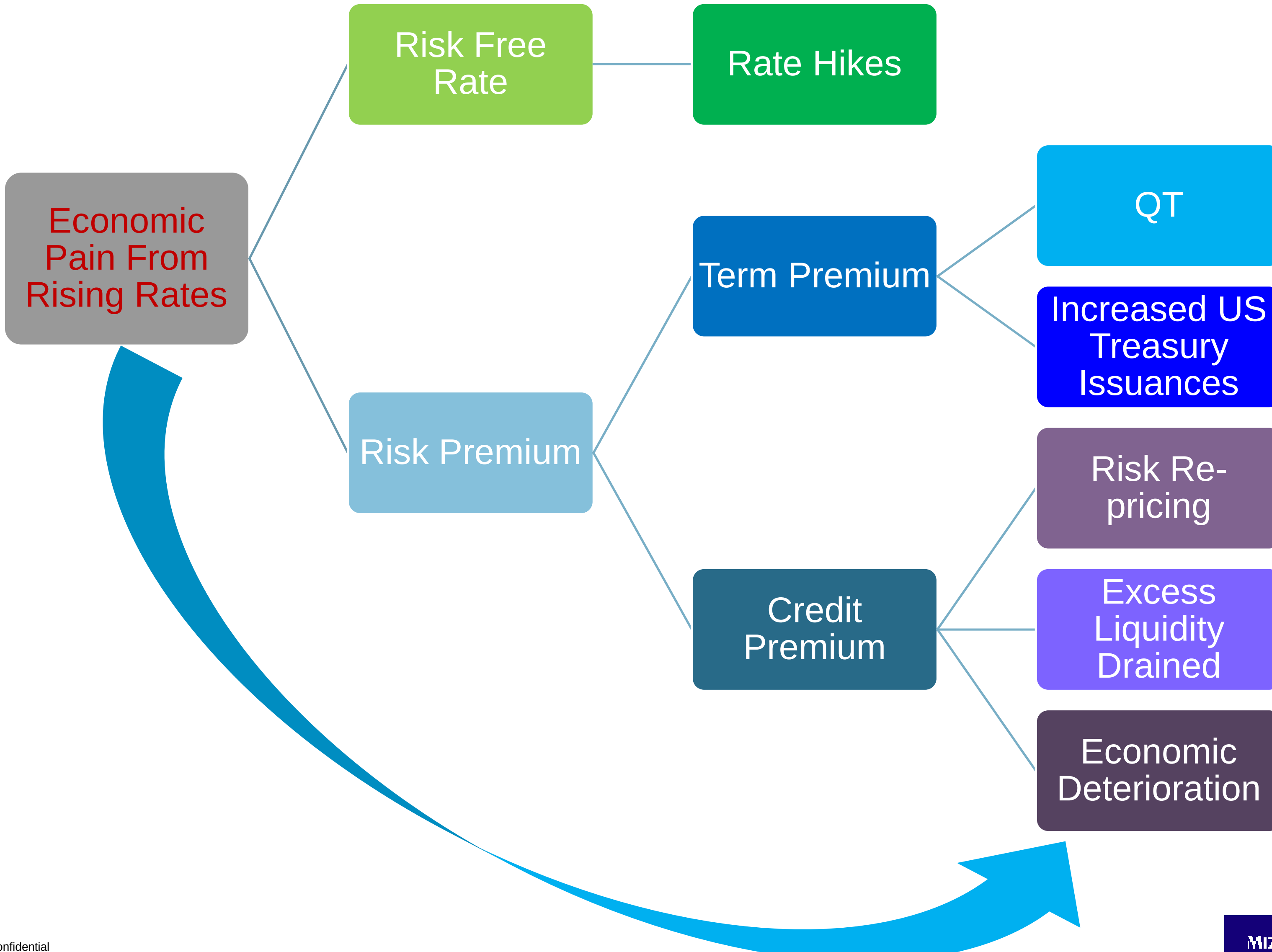


Chart from Bloomberg

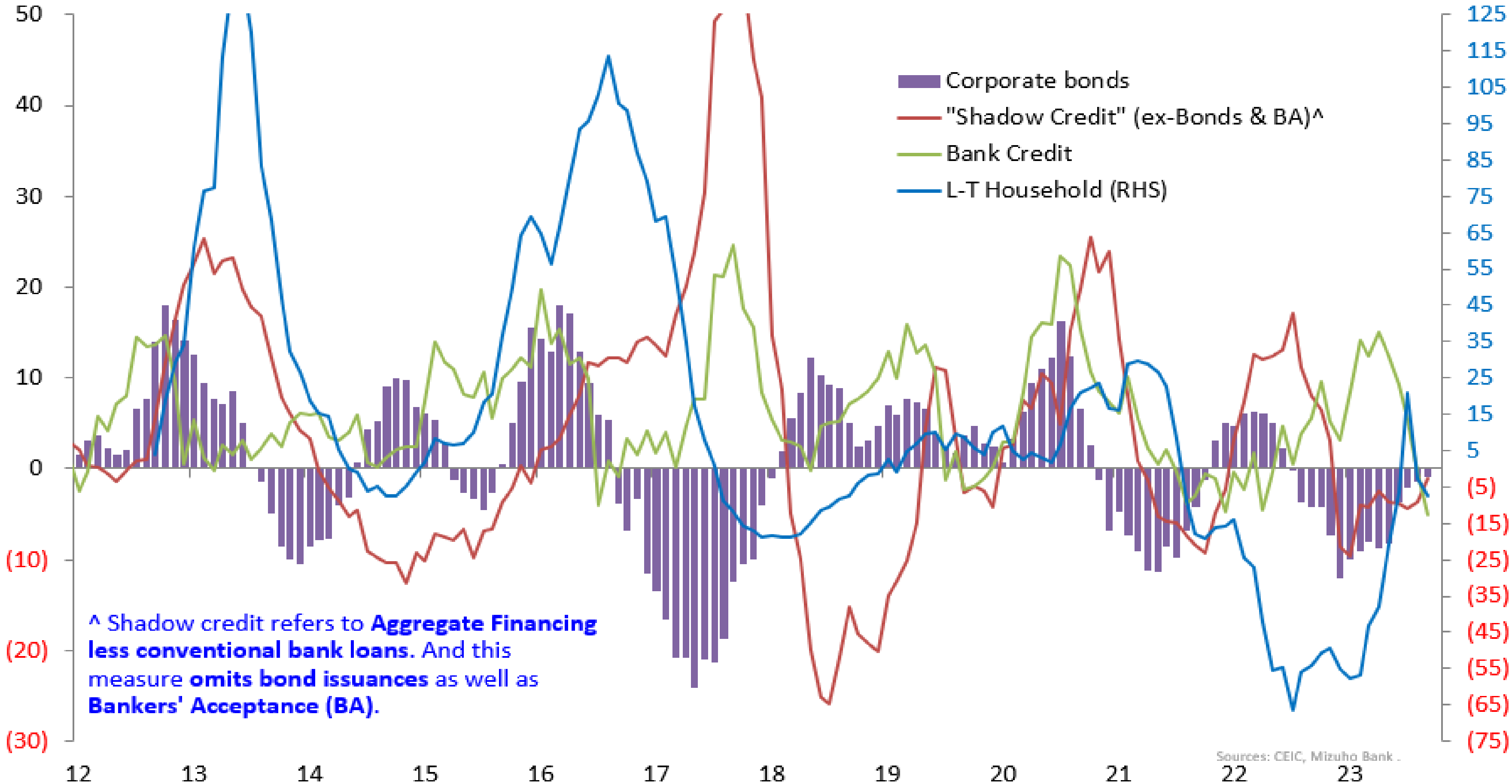
- **Insofar that fears of US debt/unsustainble fiscal trajectory dominate, yields may ironically go higher;**
- **as heightened (but not acute) geo-political risks is associated with increased debt issuance on defense (Ukraine/Gaza) to a greater degree than (yield suppressing) haven demand.**
- **Conspires with QT & “higher for longer rates” inflation to amplify “crowding out” risks.**

3b. Visualizing Pain from Higher Rates



4a. China: Structural Headwinds …

China Credit: Pick-Up in Bank Loans is Not Convincing, and weakness in L-T Household debt Lingers amid Property Travails. Sub-par Shadow Banking Reflects wider Confidence Deficit & Constraints; with long shadows reflected in bonds (% YoY 6M Avg)



Binding Structural Impediments

i) Elevated Leverage: Structurally higher credit intensity conspires with financial stability risks ("Minsky moment"), resulting in subdued, if not sub-par growth outcomes.

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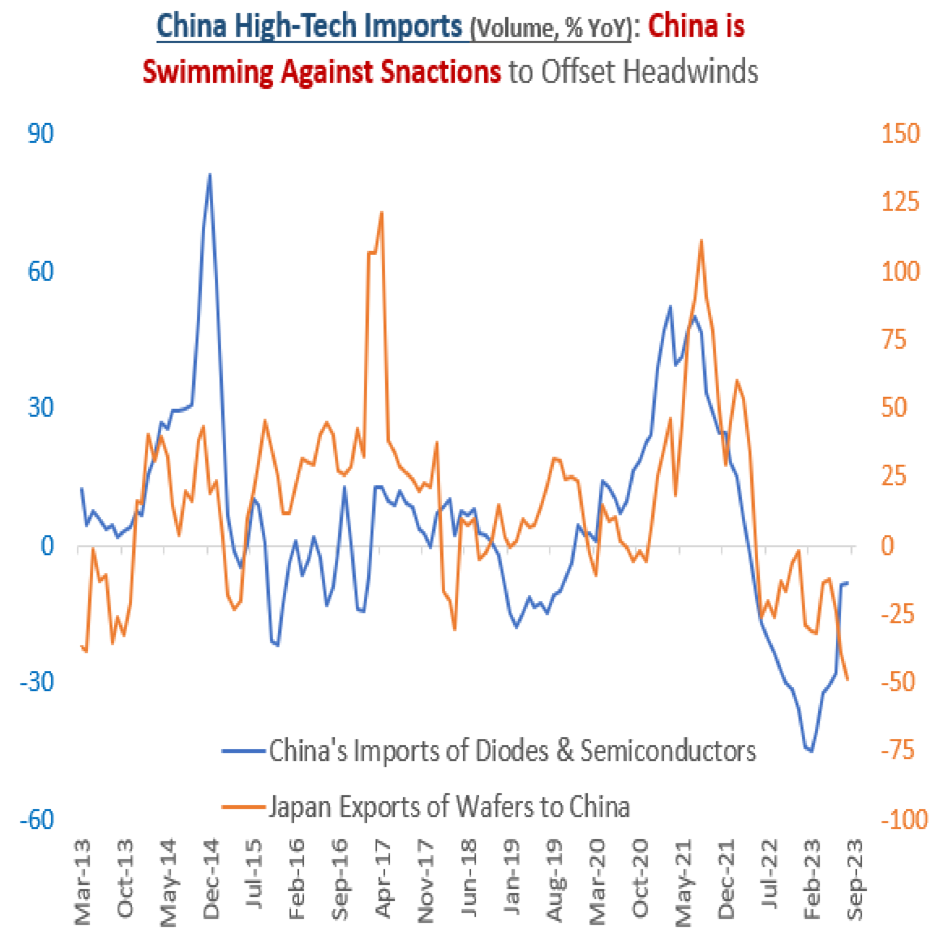
4a. … Not Offset by Cyclical/Re-opening Boost

Sources: Bloomberg, Mizuho Bank

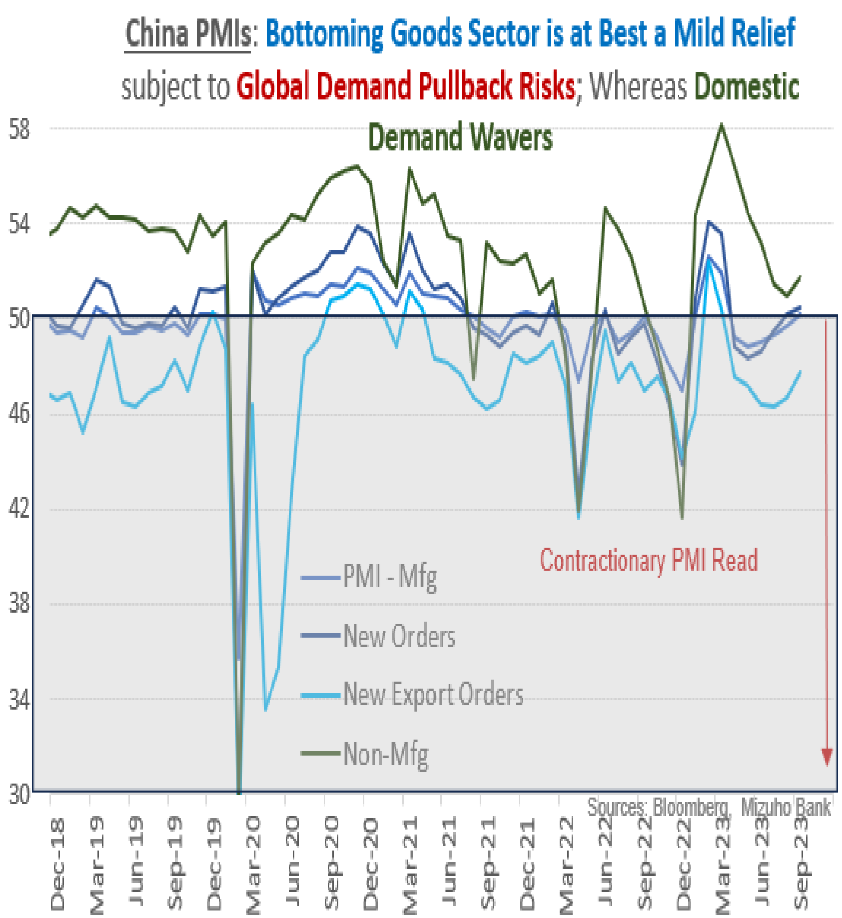


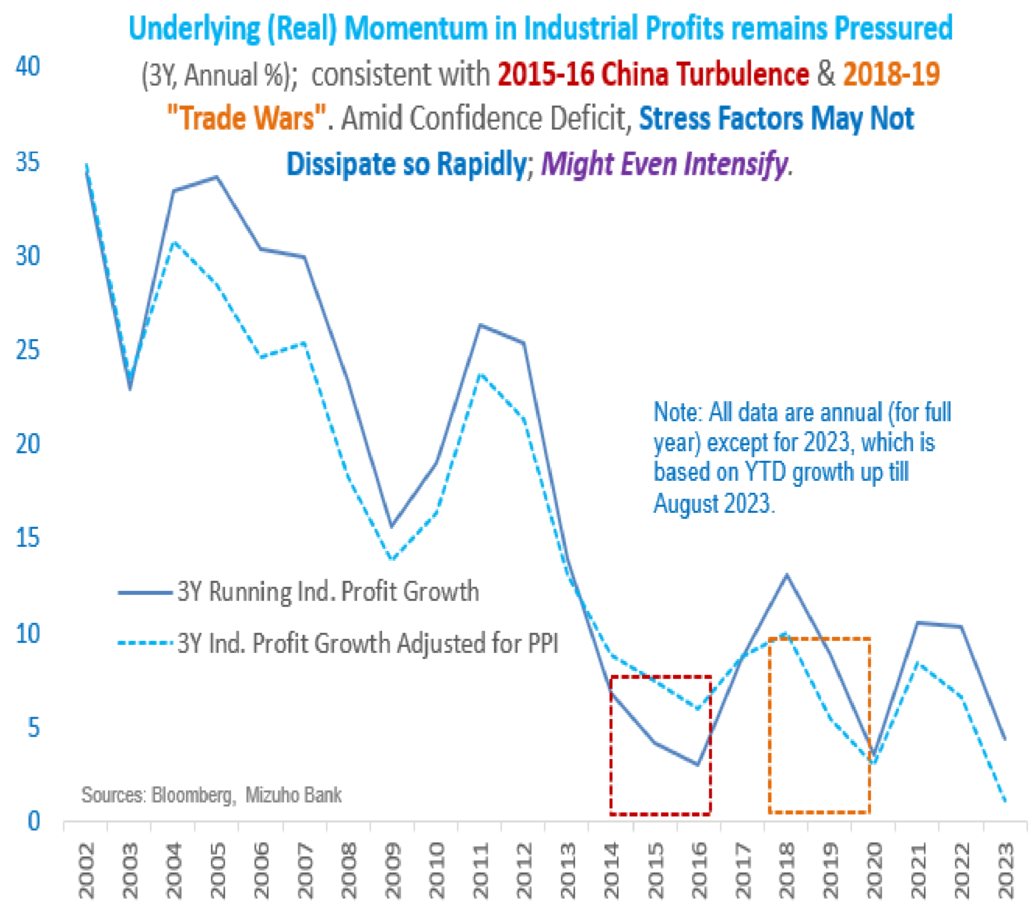
Sources: Bloomberg, Mizuho Bank

Binding Structural Impediments

ii) Geo-politics: Sanctions challenge China's high-tech sector ambitions, posing the most binding threat. Limited policy/diplomatic options mean unforgiving margins for miscalculation; with far-reaching, adverse consequences.

4a. … In Fact, Cyclical Momentum is Not Compromised by Structural Impediments



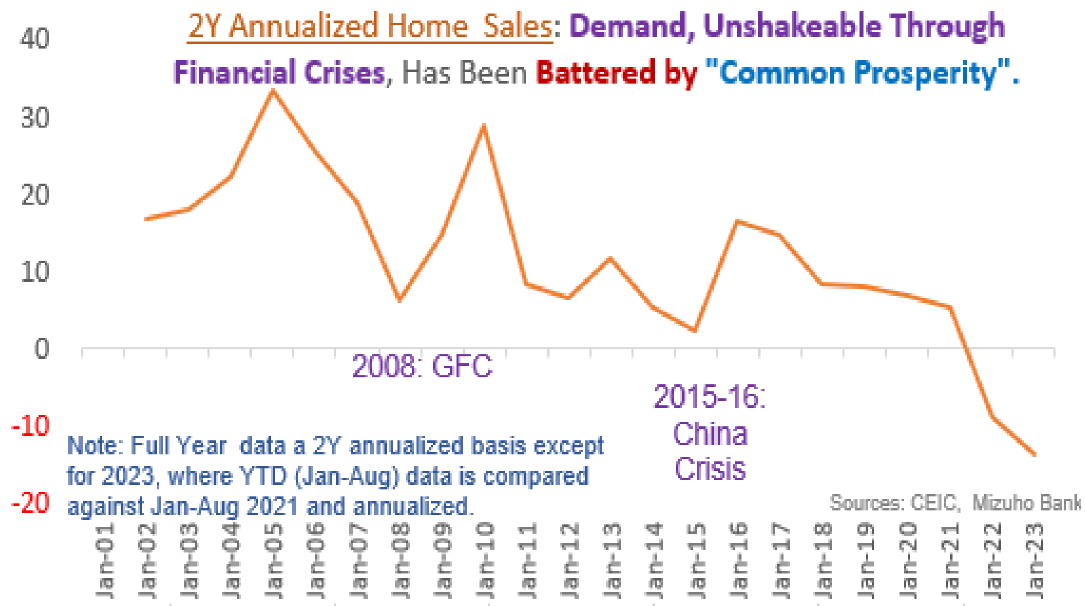


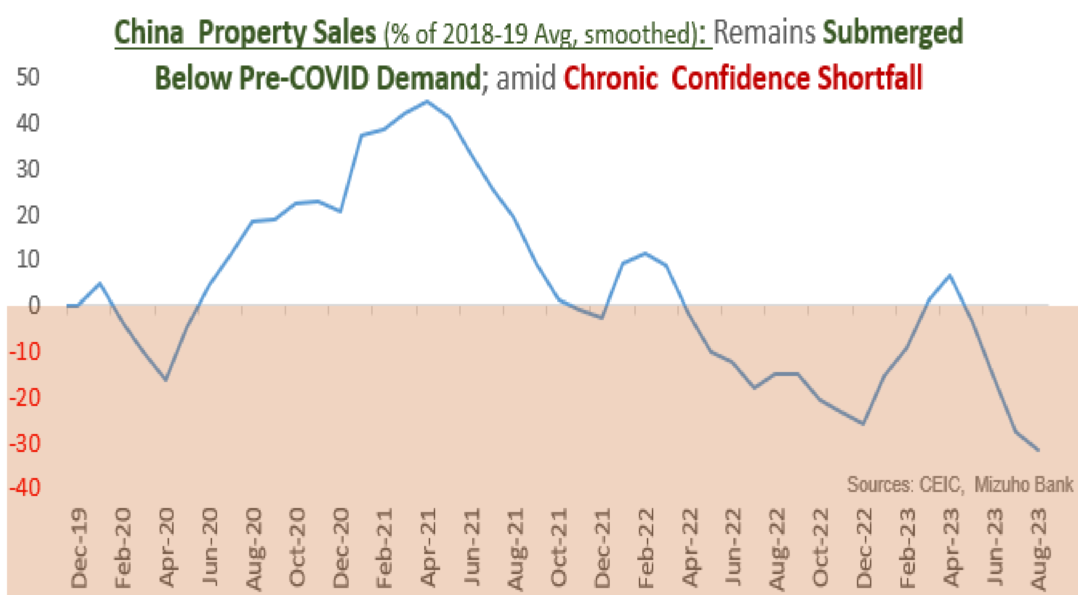
Binding Structural Impediments

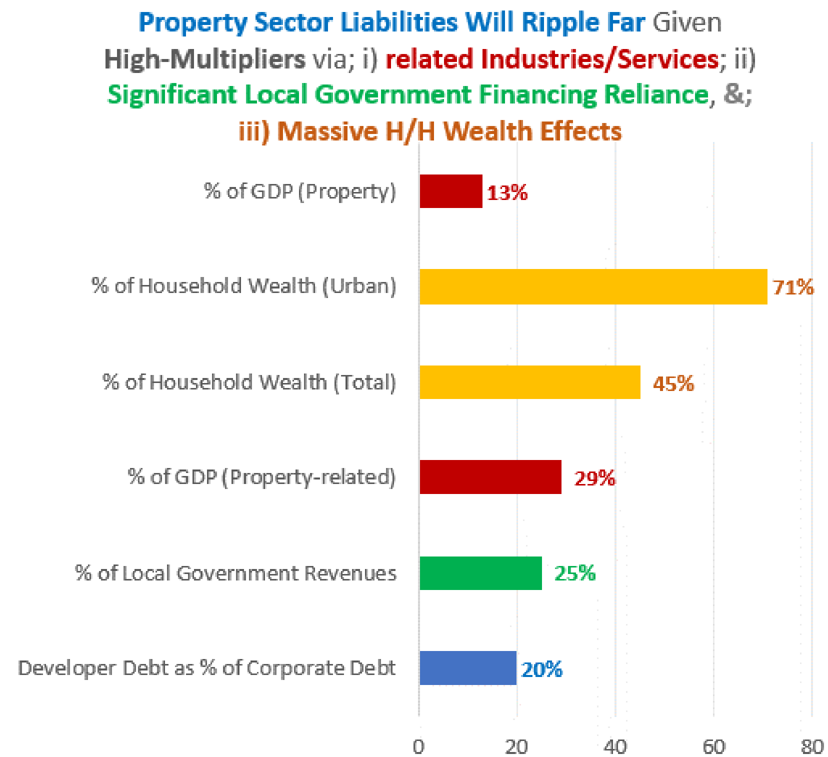
iii) Confidence Deficit: By-product of uncertainty on "Common Prosperity" campaign (motivated by *complex socio-political agenda that sometimes supplant economic aims*).

➔ Confidence overhang hampers big-ticket spend and investments, *compromising growth multipliers.*

4b. Crucially, China's Property Drag May be Hard to Reverse







Property Overhang

- Backstop/Relief critical but Fall Short!
- Financing cashflow is welcome Relief … But
- Not Sustainable Without Sales (Operating Cashflow) Recovery Requiring Confidence.
- Psyche of "sure win" property has changed.
- POEs defaulting amid "Common Prosperity" leaves **Confidence Shaky**.
- Compromises growth multipliers & credit.

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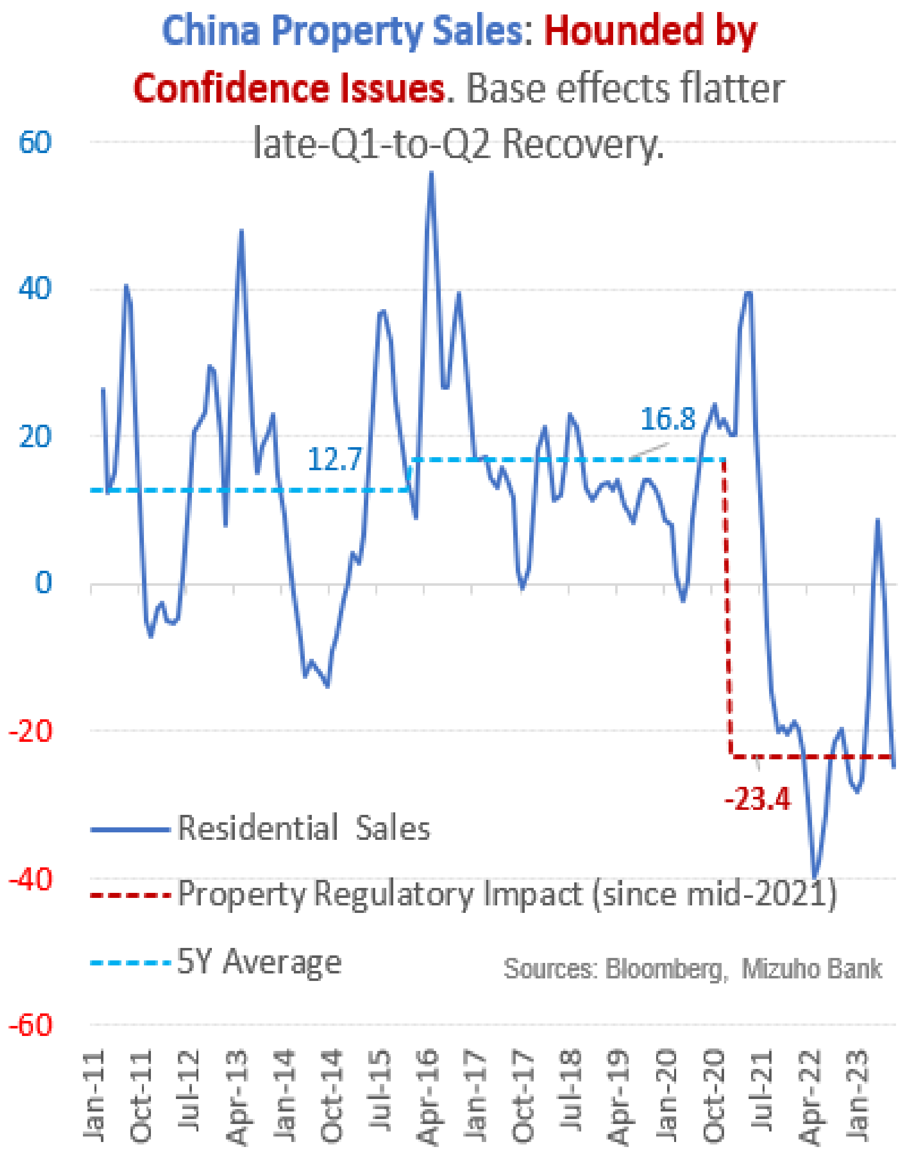
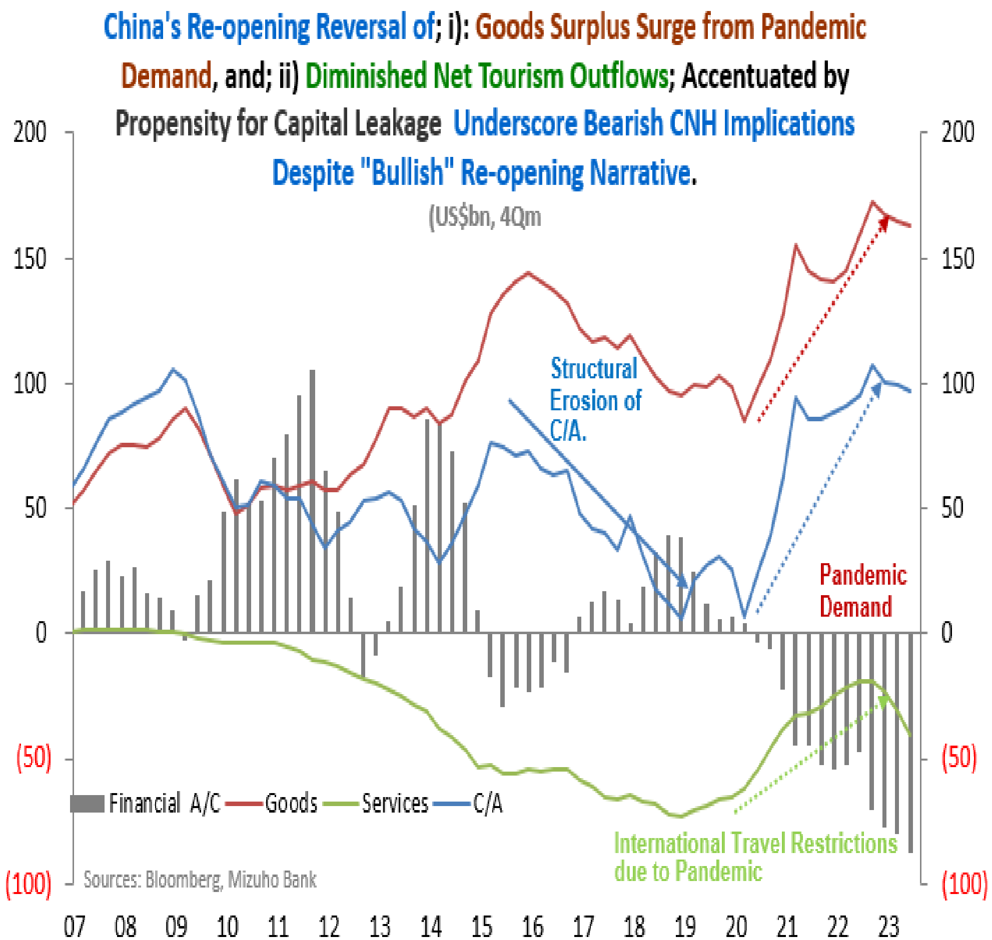
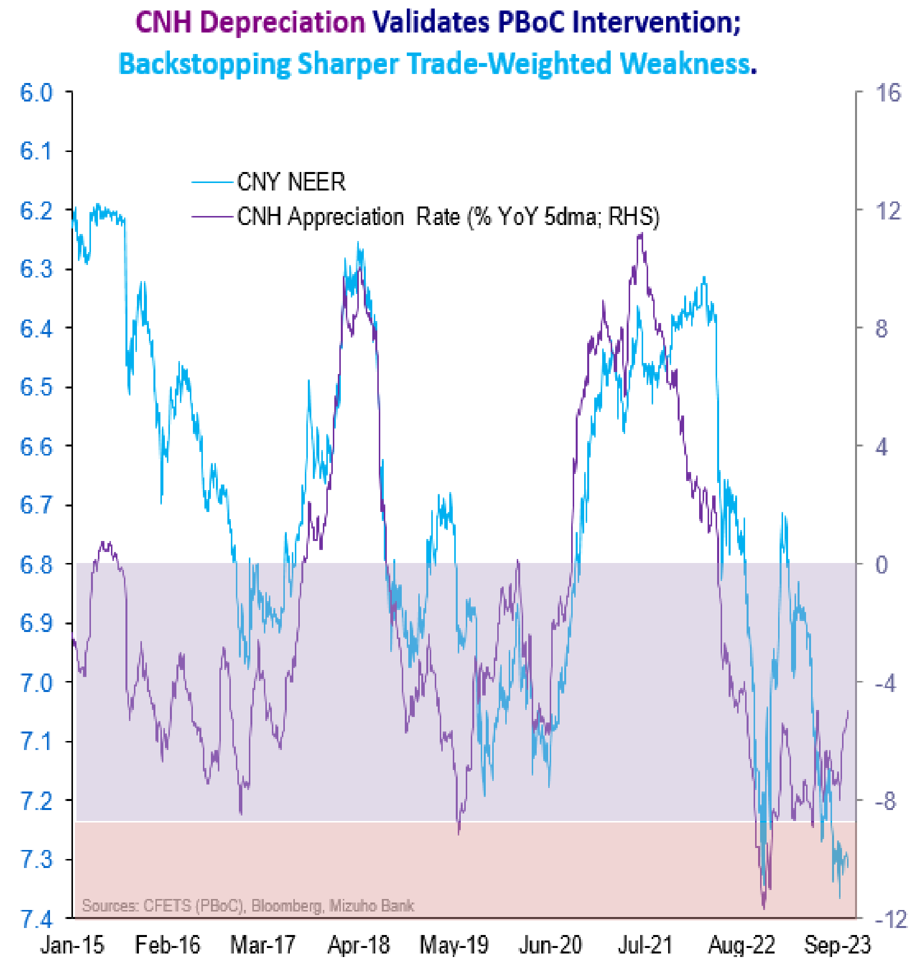
4b. … And Upstream Developer Crisis Risks Adverse Feedback to Local Governments



4c. Re-opening "Cash-Flow" Shifts Undermine CNY



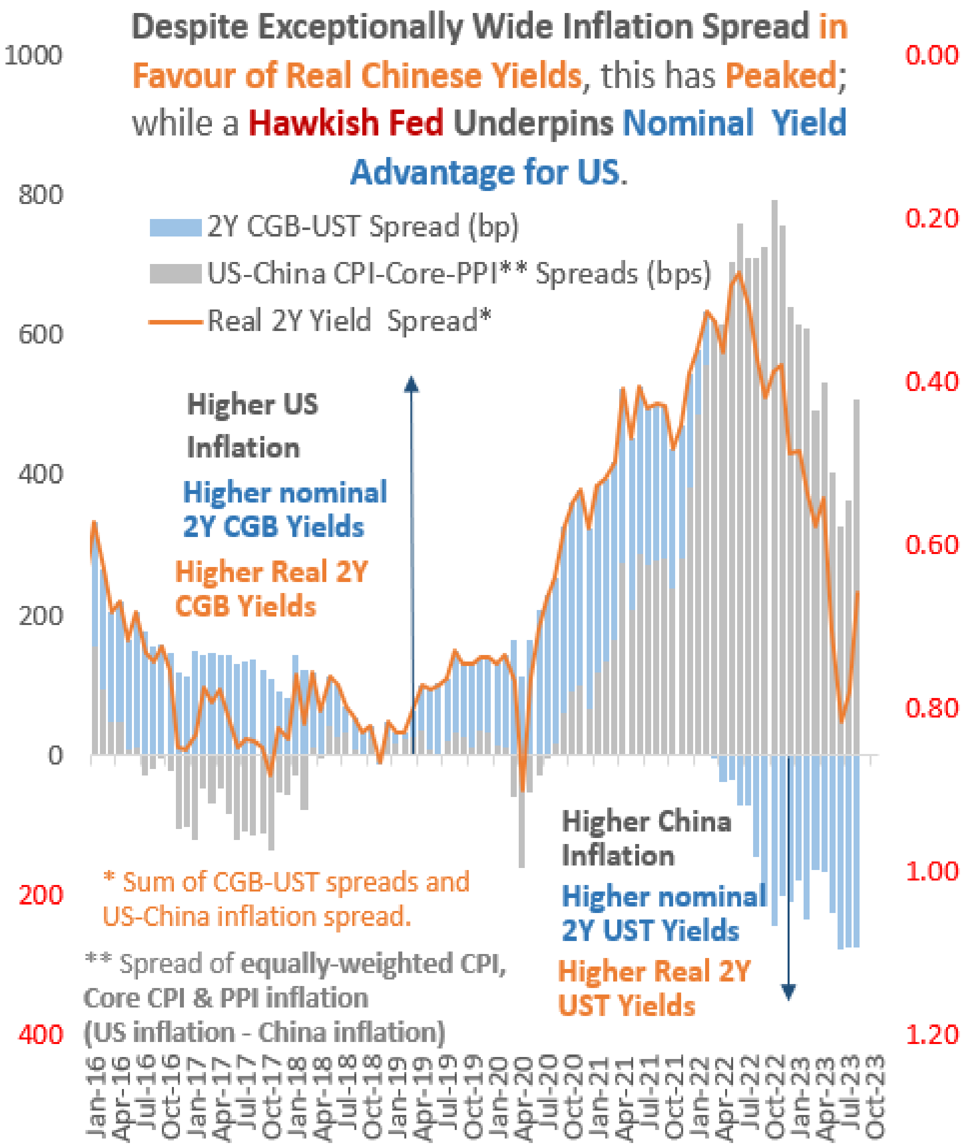


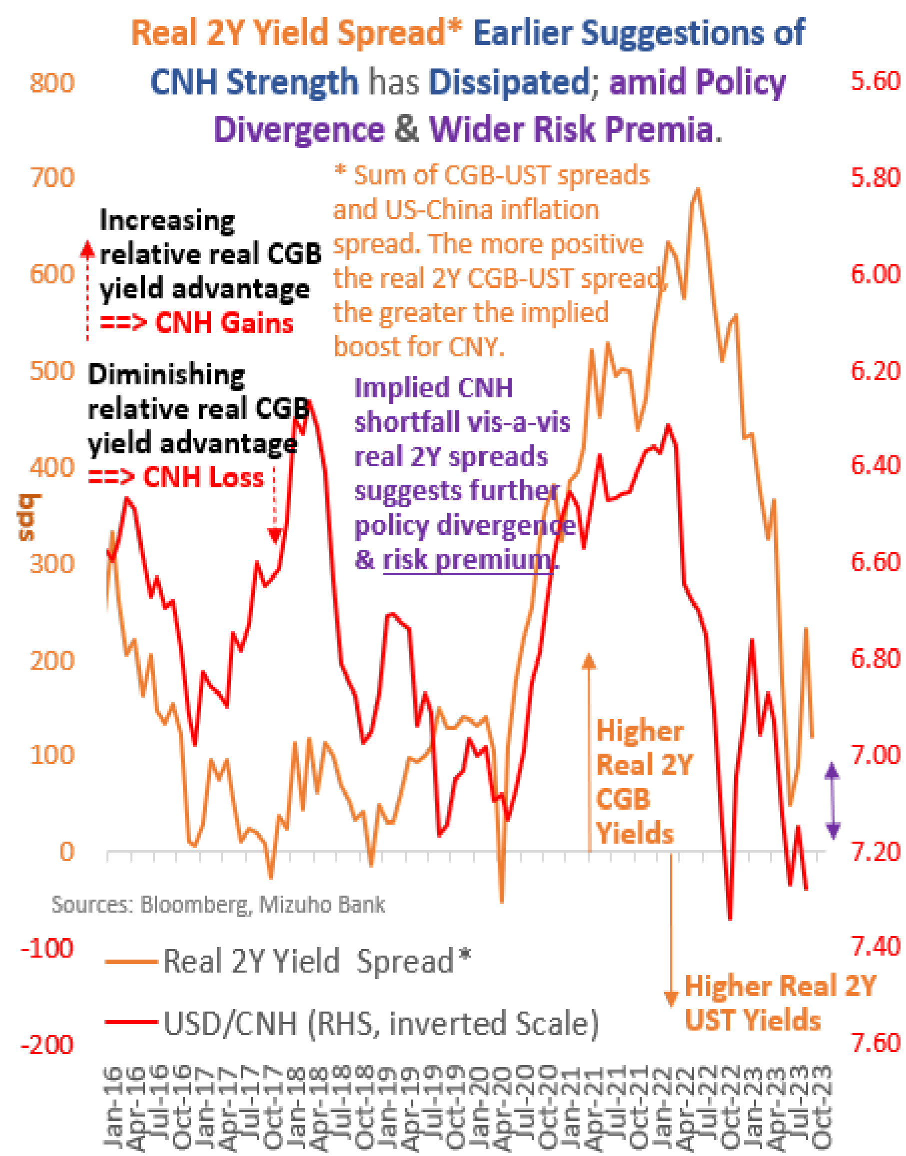
i) Goods Acccount: Global goods-to-services consumption shift diminishes exceptional COVID boost to Good Surplus.

ii) Services (Tourism): Outbound Tourists to re-widen services deficit – much of it being Chinese tourists spending overseas. Chinese tourists spending overseas in 2019 accounted for 1.7% of China's GDP in net terms.

iii) Capital Account: Capital flight becomes an enlarged risks as political uncertainty and policy shifts (including confiscations risks amid 'Common Prosperity' induce shift of funds out.

4c. CNY Re-opening Risks Accentuated by Geo-economics





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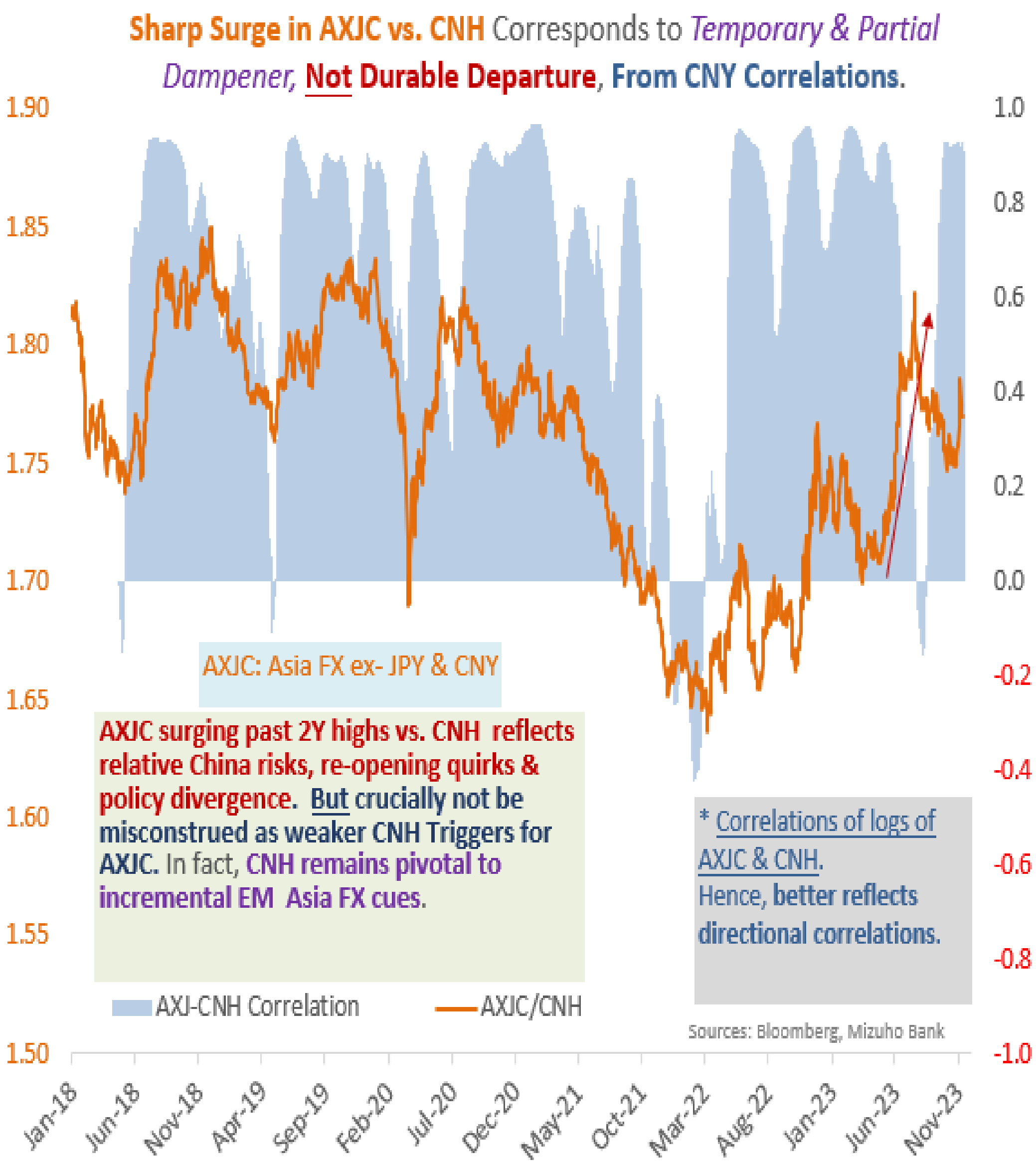
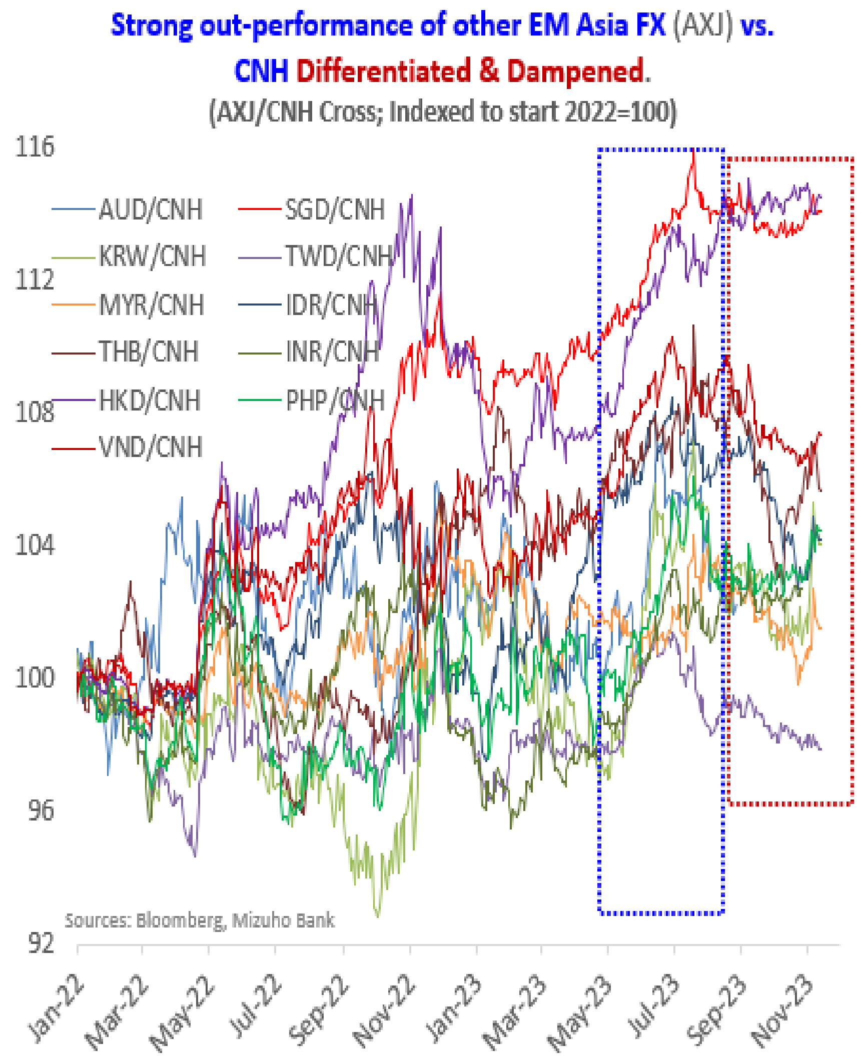
4c. Remembering CNY Correlations

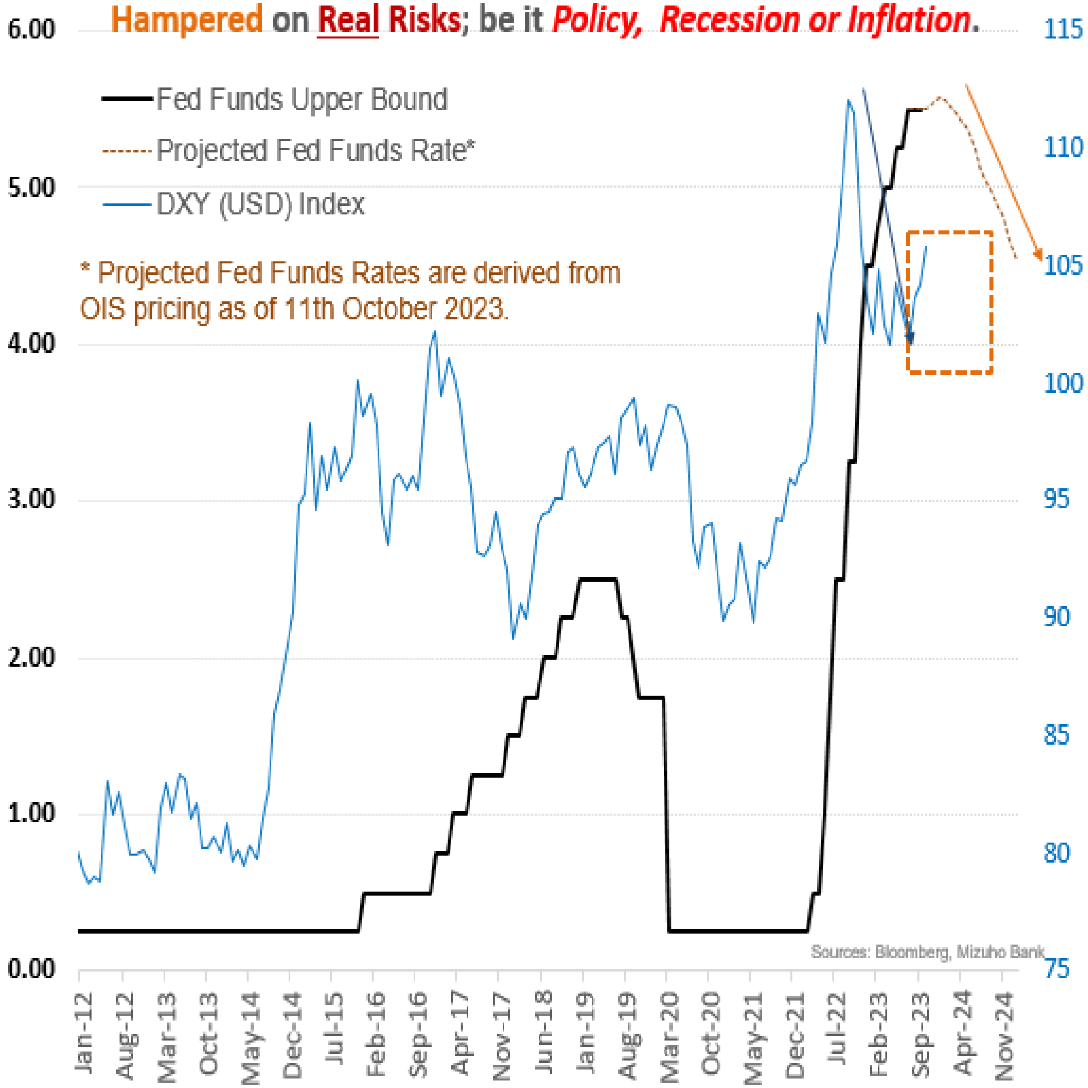
"It is stupidity rather than courage to refuse to recognize danger when it is close upon you"
- Sherlock Holmes





5. Elevated USD: Received Wisdom on "Peak USD" from "Peak Fed" Needs REAL-ity Check

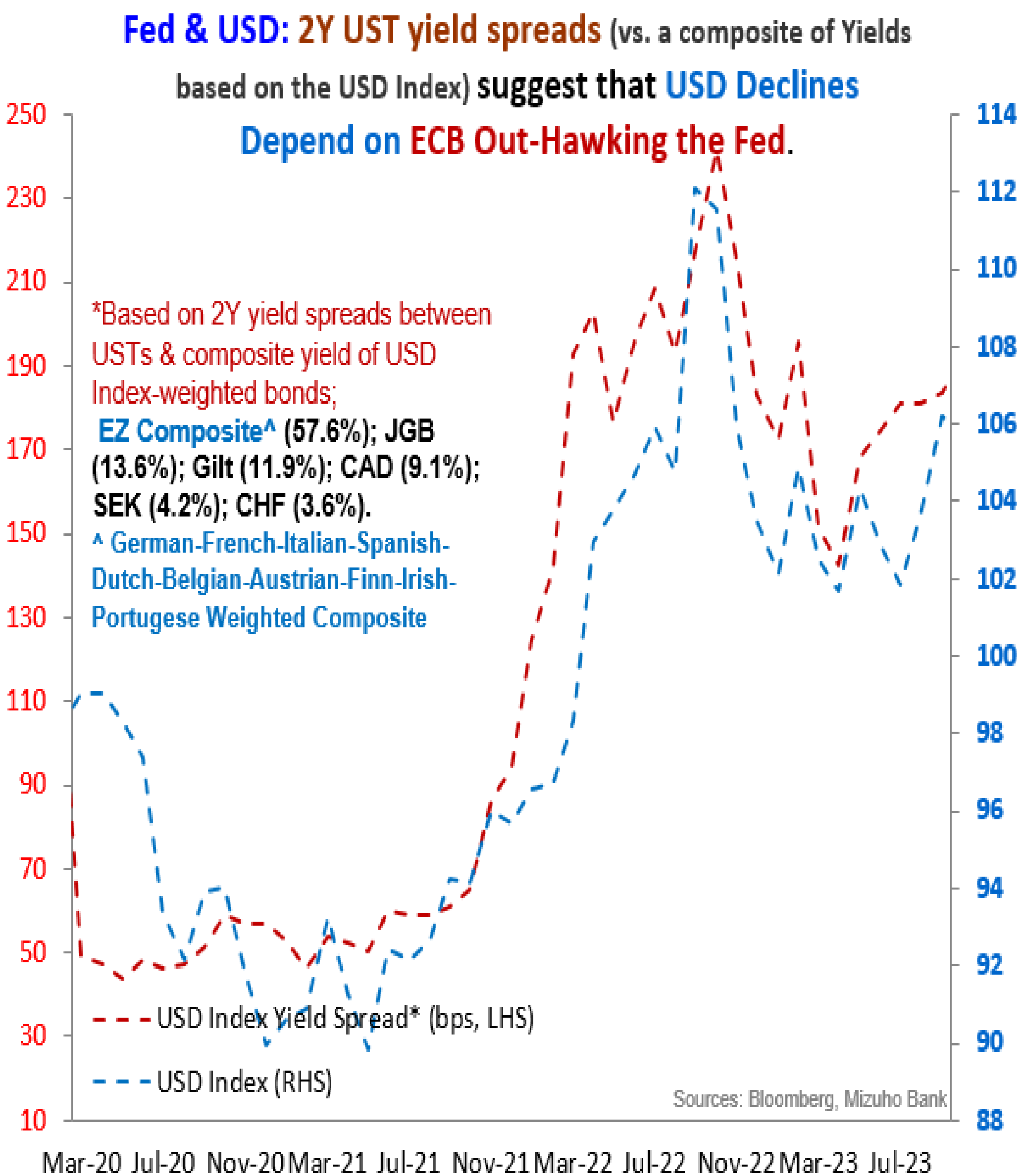
Historical Precedent is for USD Strength to Peak before Rates. *But this time,* **Unfettered USD Slide may be Hampered on Real Risks; be it *Policy, Recession or Inflation*.**

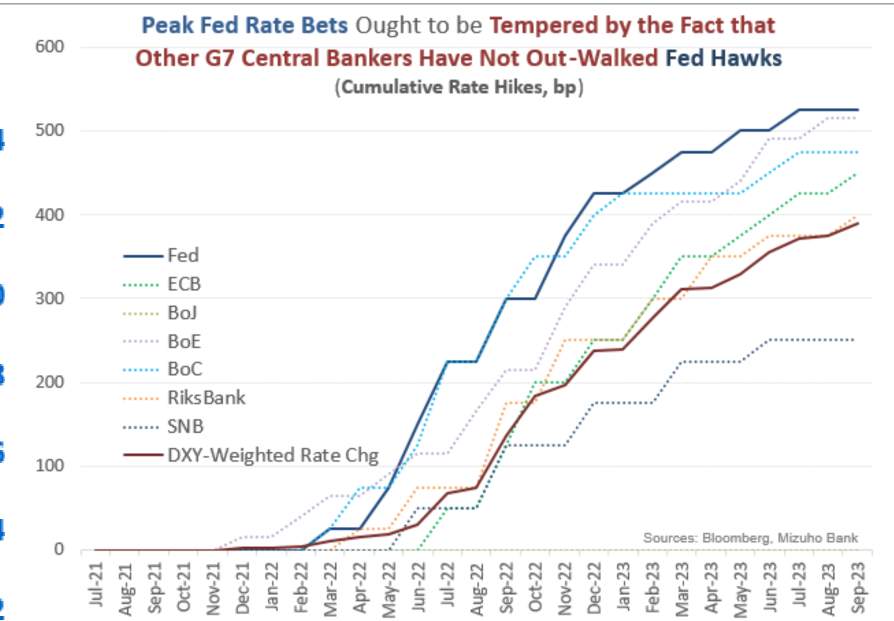


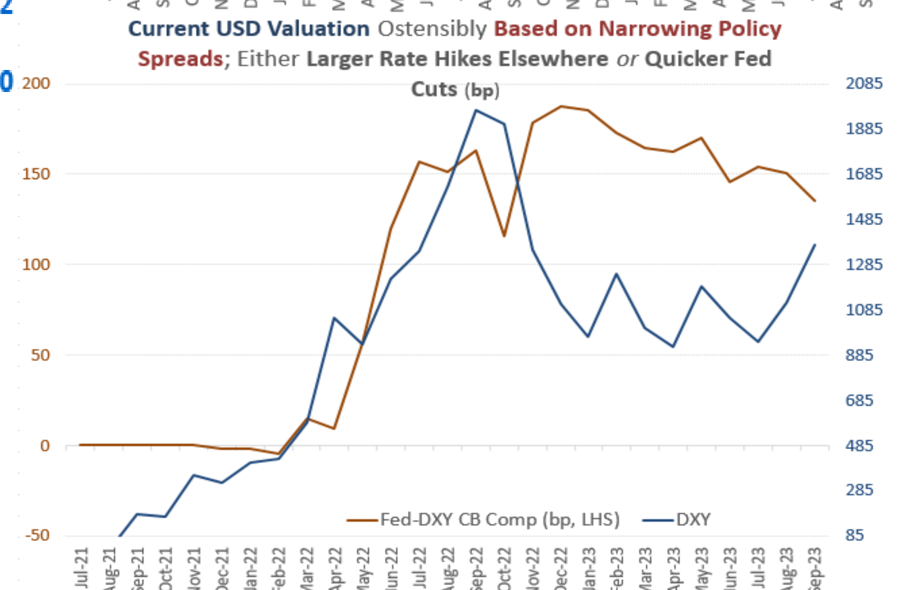
USD: Keeping It Real?

- **USD bears** betting on "peak Fed" risk being **wrong-footed** by *over-estimated "divergence"* and *overdone soft-landing assumptions;* with attendant "risk on" that tends to weaken USD.
- Crucially, **faster US dis-inflation** sharpens **real yield spread advantages** for the USD.
- This **inverts received wisdom** on the higher inflation-currency strength positive correlation for EUR and Majors (DM) FX.
- Apart from **kicking the tyres of rate hike assumptions** associated with higher inflation, this entails a **fundamental shift in viewing DM FX mechanics via real** *rather than nominal* **rate differentials**.
- Arguably, this **"real" shift is compelling** in a world where risks of high and volatile inflation now involve DM; not just an "EM problem".
- And *insofar that EUR tends to have an outsized impact on* determining the wider *USD trend,* **"real" USD advantages compromise scope for fettered EM FX gains on "peak Fed"**.

5. USD Bears Counting on Erosion of Spreads ... A Gambit, Not a Guarantee!

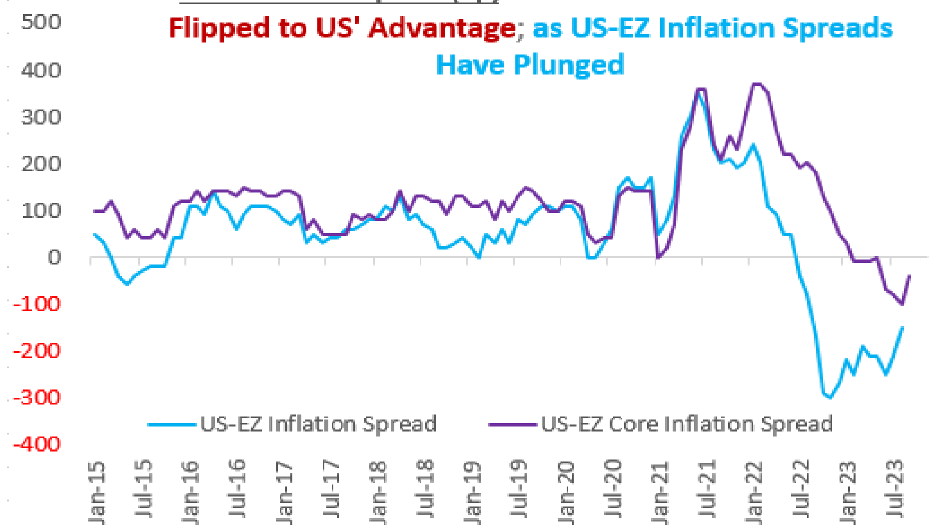






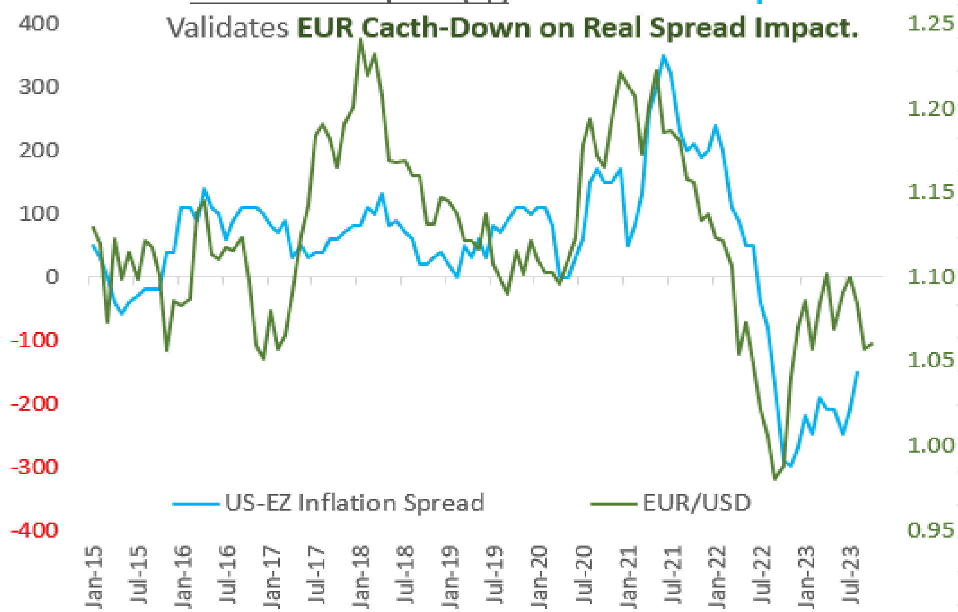
5. EUR: Hawkish ECB Flex May Not Persist & “Real” Challenges Remain!

US-EZ Inflation Spread (bp): Real Rate Differentials Are Flipped to US' Advantage; as US-EZ Inflation Spreads Have Plunged

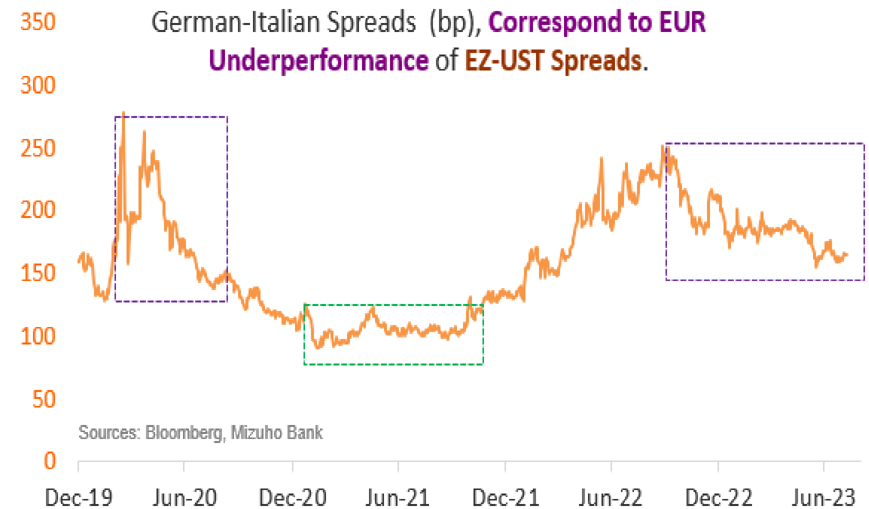


EZ-UST Yield Spread Support (2Y spreads) for EUR Buoyancy; alongside Contained Fragmentation Risks.

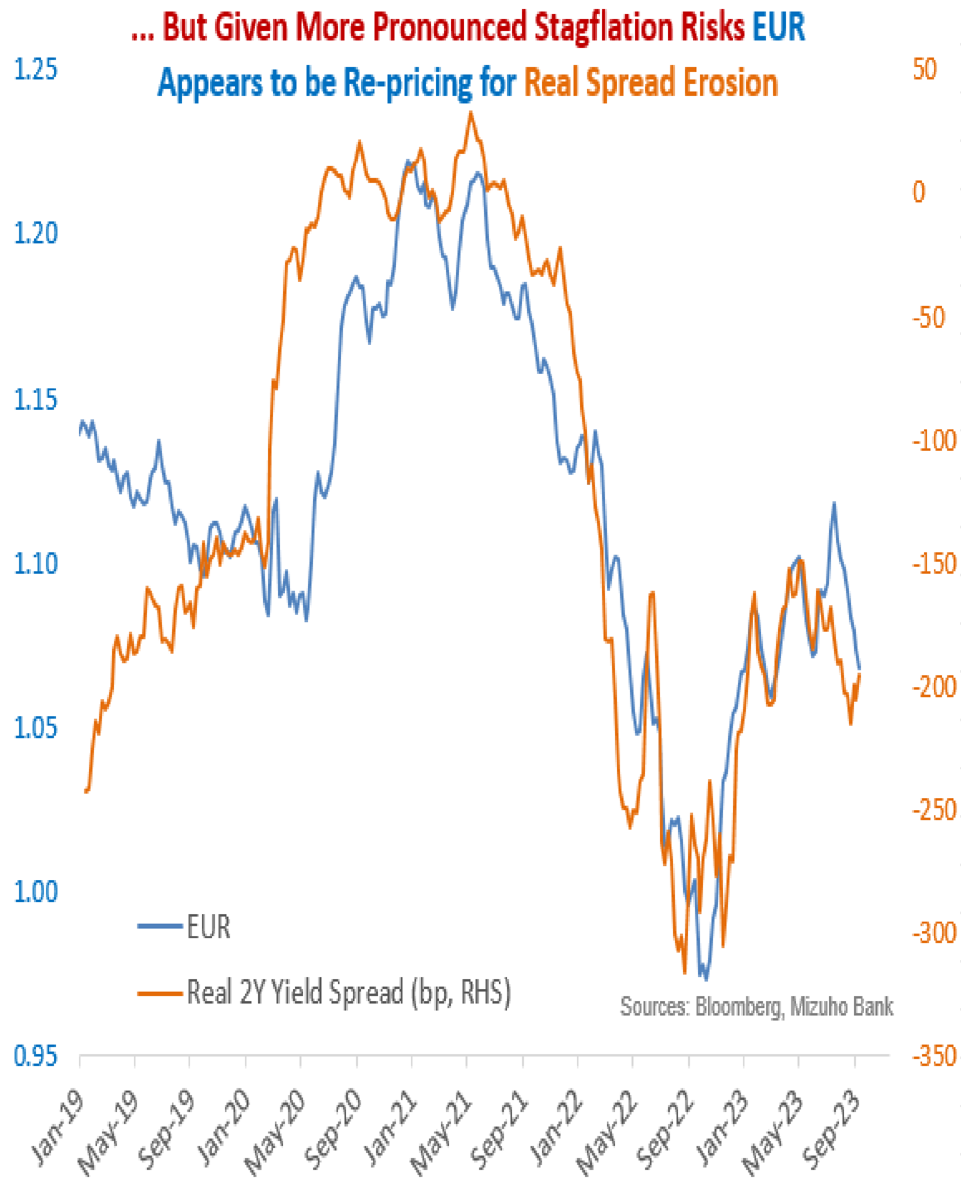
US-EZ Inflation Spread (bp): US-EZ Inflation Spread Validates EUR Cacth-Down on Real Spread Impact.



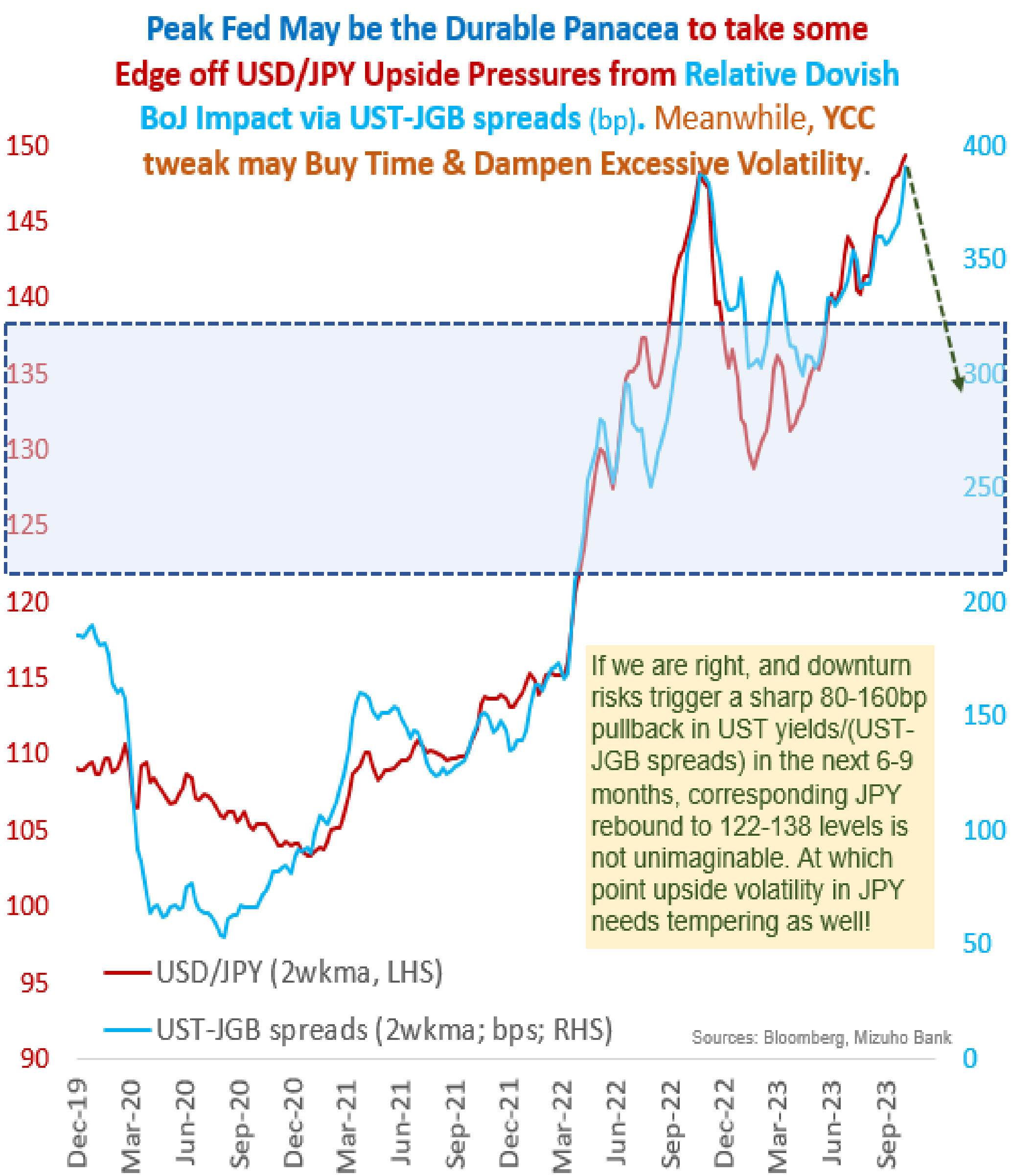
Fragmentation Risks as Highlighted by Sharply Wider German-Italian Spreads (bp), Correspond to EUR Underperformance of EZ-UST Spreads.

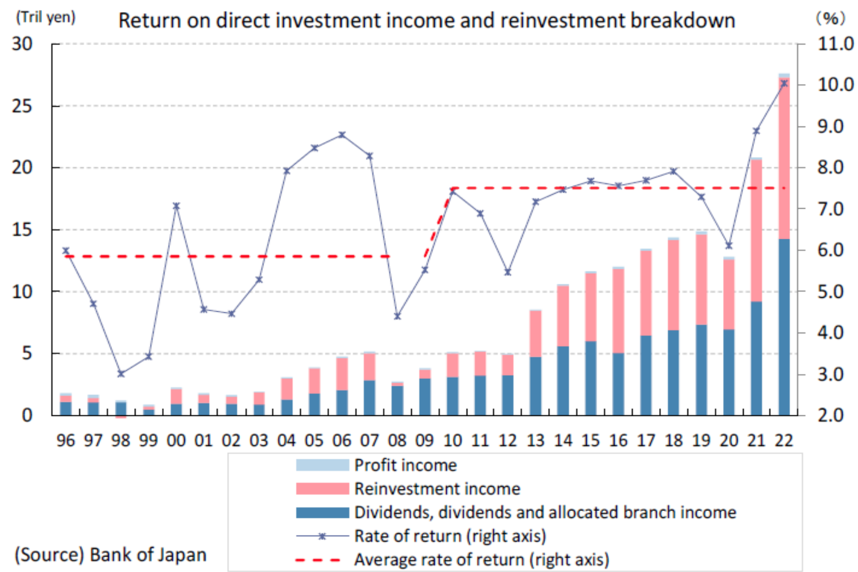


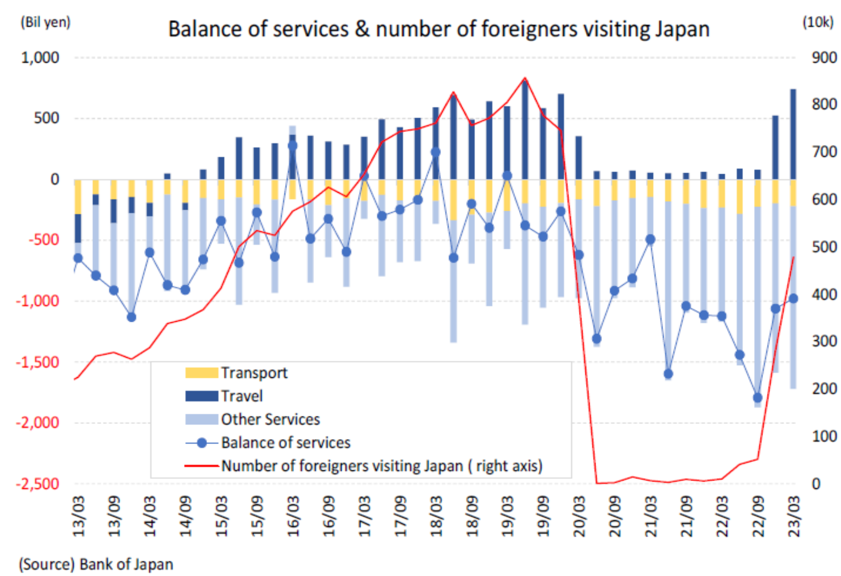
5. EUR: More So if ECB Hawks Can't Out-Walk the Fed



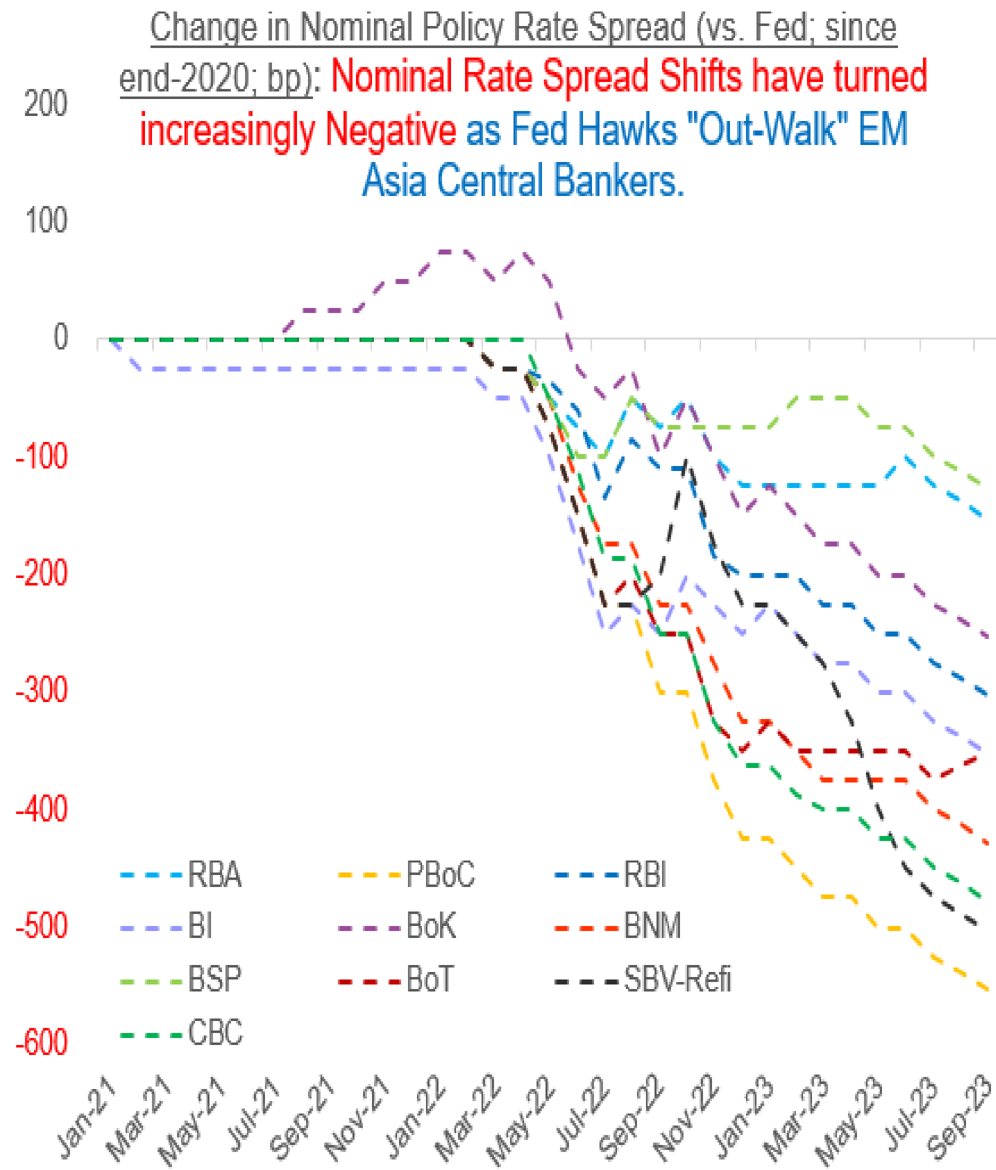
5. JPY: A *BoJ Problem* with a *Fed Solution* … Financial & C/A Shifts Should Support too

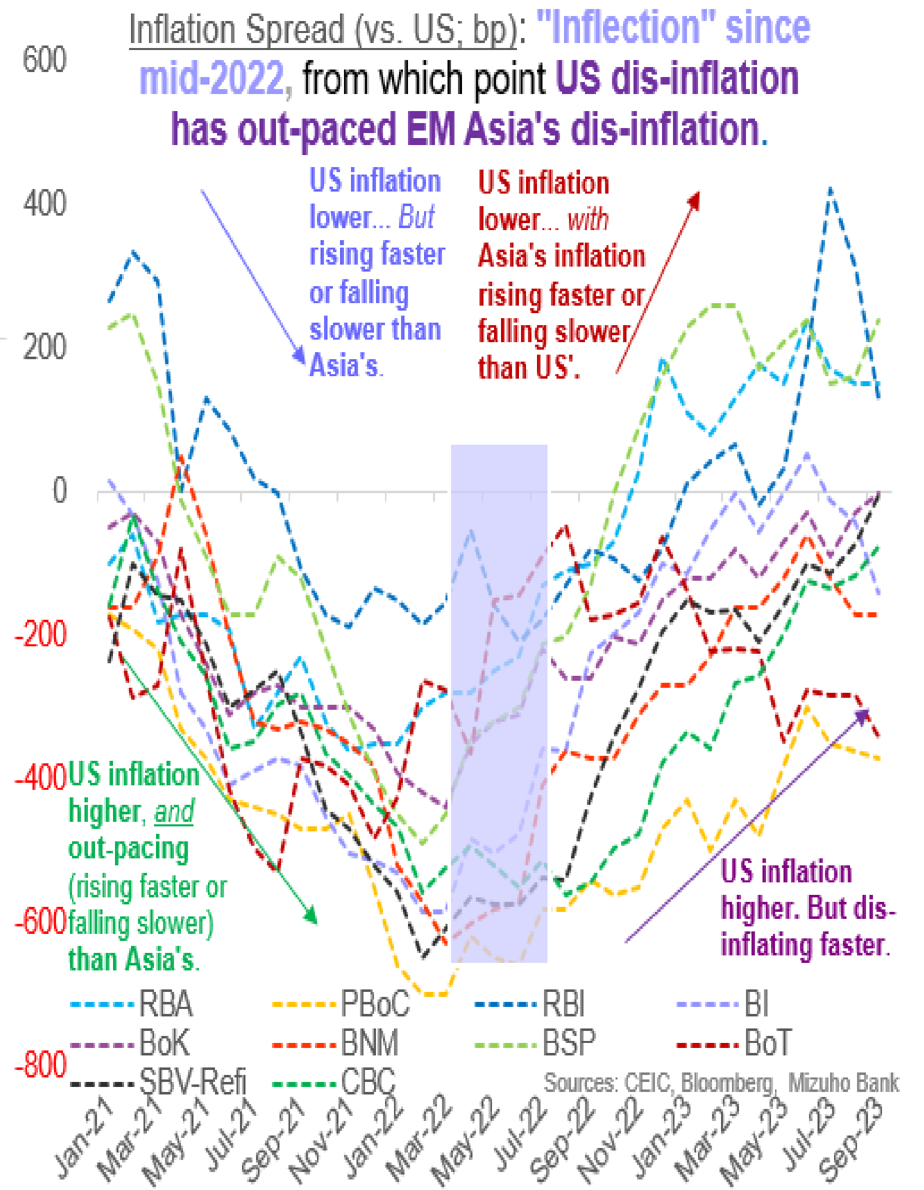






5. AXJ: "Real" Risks to the Downside Linger





Sources: CEIC, Bloomberg, Mizuho Bank

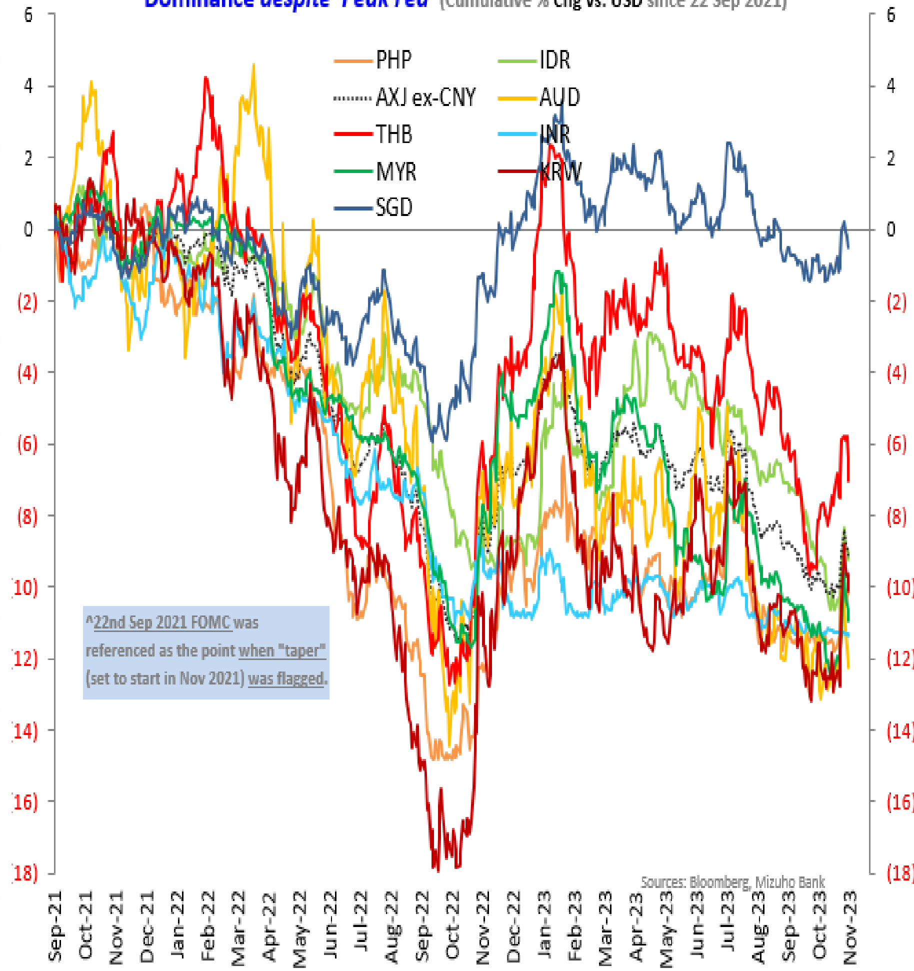
FX: A Bumpy Path Out of USD Dominance

FX Forecasts

FX Forecasts	Dec 23	Mar 24	Jun 24	Sep 24	Dec 24	Mar 25
USD/CNY	7.11 - 7.51 (7.28)	7.08 - 7.50 (7.35)	7.17 - 7.73 (7.42)	6.87 - 7.50 (7.18)	6.83 - 7.34 (7.06)	6.76 - 7.13 (6.95)
USD/INR	80.6 - 85.2 (82.9)	80.6 - 85.5 (83.5)	82.2 - 86.2 (84.5)	79.2 - 86.4 (83.5)	78.2 - 84.7 (82.0)	78.0 - 83.6 (80.8)
USD/KRW	1260 - 1430 (1335)	1280 - 1420 (1325)	1230 - 1420 (1335)	1190 - 1360 (1290)	1190 - 1320 (1250)	1190 - 1340 (1240)
USD/SGD	1.343 - 1.393 (1.367)	1.338 - 1.404 (1.373)	1.346 - 1.417 (1.380)	1.319 - 1.397 (1.362)	1.316 - 1.382 (1.353)	1.312 - 1.372 (1.348)
USD/TWD	30.9 - 32.9 (32.3)	31.3 - 33.4 (32.0)	31.2 - 33.8 (32.2)	29.6 - 32.5 (31.5)	29.3 - 31.8 (30.2)	28.9 - 31.0 (29.8)
USD/IDR	15170 - 16020 (15400)	14900 - 15960 (15250)	14960 - 16160 (15580)	14750 - 16350 (15710)	15320 - 16160 (15670)	15190 - 16000 (15380)
USD/MYR	4.54 - 4.89 (4.75)	4.60 - 4.86 (4.66)	4.48 - 4.88 (4.72)	4.42 - 4.77 (4.68)	4.42 - 4.80 (4.61)	4.39 - 4.77 (4.58)
USD/PHP	55.3 - 57.4 (57.0)	54.4 - 59.4 (55.9)	53.8 - 58.8 (55.5)	54.7 - 59.5 (57.2)	53.3 - 58.3 (56.0)	52.9 - 57.7 (55.0)
USD/THB	34.5 - 37.5 (35.7)	35.0 - 37.5 (36.0)	35.8 - 38.0 (36.5)	34.1 - 36.9 (35.5)	34.0 - 36.8 (35.0)	33.6 - 36.0 (34.6)
USD/VND	23800 - 24800 (24450)	23600 - 24900 (24300)	24000 - 24800 (24500)	24000 - 24600 (24100)	23900 - 24400 (24000)	23700 - 24300 (23900)
AUD/USD	0.628 - 0.655 (0.636)	0.619 - 0.695 (0.655)	0.595 - 0.658 (0.631)	0.626 - 0.701 (0.653)	0.643 - 0.698 (0.673)	0.638 - 0.719 (0.685)

Note: For FX forecasts, level in parentheses pertains to period end forecasts; and the period's range precedes this.

EM Asia FX are Highly Differentiated; with No Unimpeded Path out of USD Dominance *despite 'Peak Fed'* (Cumulative % Chg vs. USD since 22 Sep 2021)



Sources: Bloomberg, Mizuho Bank

FX Views: A Narrative of US Exceptionalism to Fed Cold Feet amid Recession Risks

Q4 2023: US Exceptionalism & USD Bulls ... Triggered & Tempered

A **hawkish skip at the Sep FOMC** set the stage for **"higher for longer" Fed** to leverage on spots data out-run to pushing UST yields higher despite moderating inflation. The resultant **surge in real UST yields** is a reflection of **'US exceptionalism' narrative triggered**; in contrast to concerns of economic slowdown that is accompanying, if not overshadowing, less unimpeded dis-inflation in Europe/UK. Consequently, *"higher for longer Fed backed by US exceptionalism* **buoys the USD**; possibly even triggering bouts of appreciation.

But **'US exceptionalism boost'**, expressed via *real rate differentials favouring USD* (see USD: Keeping it Real, 25 July 2023)* while mostly retained into Q4, **may not endure in a linear fashion**. Especially if the Fed dials back hawkish bias (with or without a hike in Q4). This is a risk if activity slows from *lagged credit tightening* colliding with US *government shutdown risks* as well as the *auto union strikes*. Diminished hawkish inclination could in turn temper any outrun in USD strength in the first half of Q4; leading to some moderation of USD gains.

CNH is a key swing factor hinging on the strength of policy stimulus to prop up the economy (and confidence) and or direct measures taken to stem capital outflows. Unassuaged China fears may dampen the extent to which EM Asia FX may regain traction even as USD gains moderate later in Q4; especially if year-end USD demand is accentuated. Whereas, manufactured China cheer and CNH rebound may lean into 'Santa rallies' to amplify scope for some rebound in AXJ.

Q1 2024: Fed Pivot Bets & Goldilocks

Where earlier we had anticipated pronounced recession risks precipitating from lagged policy tightening to hit in Q1, we have now **pushed out the worst of US recession risks out to Q2-Q3**. *Nonetheless,* measured *softening in US data* coinciding with *conspicuous absence hawkish references to more hikes by Fed speakers* for could prompt **further softening in the Greenback**, insofar as **"pivot" bets** start seeping into the Fed calculus; especially *as the 'US exceptionalism' premium* baked into the USD *erodes further*.

It is worth noting that the notion of a controlled landing, rather than an unavoidable crash, may help with a **"Goldilocks"-like scenario**; in which, relief from bets on/signs of Fed pivot are not overwhelmed by acute demand for precautionary/haven demand for USD. To be clear, two-way FX volatile will remain a feature amid headline driven triggers; some involving fresh buckles in EM Asia FX. But that said, the wider Fed pivot relief could lend some traction for EM Asia FX in early Q1.

Q2-Q3 2024: Recession Risks!

Although, that support could be brutally reversed into (either side of) mid-2024 as recession risks from lagged policy tightening hits more jarringly via credit channels; and potentially via financial shocks. The reflex here will be for the refuge of the Greenback regardless of expectations for the Fed to cut rates aggressively. Simply because safety takes precedence over meagre returns. Especially as recession risks cast a long shadow on exports-dependent, economies hobbled further by stagflation-type headwinds crimping domestic buffer. This could further dim economic outlook, hence support for FX via growth-based returns allure. Depending on the degree of financial shocks involved, the flight to safety can vary across EM Asia FX. Higher inflation, debt exposures and "twin deficit risks may be amplified.

What's more, a sharp appreciation in the JPY, in accordance with "risk off" triggers also means that funding currency squeeze accentuates downside pressures in EM Asia FX. Interrupted FDI inflows, exacerbated by capital flight underscore the risks of disorderly correction in AXJ (may not be adequately offset by higher FX reserves).

And so, we expect AXJ on the whole to slip back further amid recession risks; albeit prone to two-way volatility and differentiated outcomes. Modest recovery off extreme sell-off levels in EM Asia FX as aggressive Fed rates cuts starts to coincide with worst-case recession/markets outcome later into Q3 is reasonable; with Fed pulling stops on QE-type stimulus being a decisive turnaround factor for AXJ (mainly on USD slide).

Q4 2024: Chasing Rainbows

Heading into late 2024 is when the narrative of sustained EM Asia FX gains currency (no pun intended). This will be mostly premised on dovish Fed and bottoming global economy conspiring to lift optimism and a flood back into "growth" bets that favour EM assets. And to be sure, the rain need not be decisively over for forward-looking markets to chase rainbows. Just signs of bottoming may be seized upon.

What's worth mentioning though is that CNH remains a key factor in determining relative levels. Crucially, given lingering economic and geo-political drag, the ability of CNH to regain ground could set the relative marker for various EM Asia FX. This could be an evolving equilibrium with regards to CNH.

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