Thematic Dragon Risks

In the year of the Dragon, **(Geo-)Politics Could Supplant Global Monetary Policy** as the Dominant Force in Markets.

Making sense of **US exceptionalism & China gloom**

Why "immaculate dis-inflation" may be a fairy tale or illusion.

1. **Trump 2.0**
2. **Competitive Pivot**
3. **No Immaculate "Soft-Landing":**
4. **Debt Reckoning, Risk Re-pricing**
5. **Bumpy Dis-inflation**
6. **Geo-political Threats Unmitigated**
7. **Oil's Non-OPEC Levers**
8. **"Crowding Out"**
9. **China's Prolonged Pain**
10. **India: Silver Lining, Not Bullet**

"It does not do to leave a live dragon out of your calculations, if you live near him"

- Gandalf, Lord of the Rings

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Private and confidential

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March 2024

Ten Themes To Think About

1. 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*.

2. Competitive Pivot

The **Fed may not dominate rate cuts**; *challenging received wisdom on unmitigated USD weakness*, and/or "risk on" bet. Instead, sharp JPY rebound may be the more defined outcome.

3.No Immaculate "Soft-Landing"

Uninterrupted "risk on" glide-path down in rates from "costless" dis-inflation is *stretched*. Instead, *lagged policy pain* may prompt sharper cuts with initial *window of "risk off"*.

4. Debt Reckoning, Risk Re-pricing

Elevated post-pandemic debt and rates warn of pain masked by *unfamiliar lag* from *unprecedented pandemic distortion*. Resultant, *sharply differentiated credit risk premium jump amid* contagion threat.

5. Bumpy Dis-inflation

Inflation has *peaked*, *but* is *prone to bumpier "last mile"*. Resultant "higher for longer" instincts ironically amplifies risks of sharper cuts amid vulnerabilities to of not-so-soft landing.

6. Geo-political Threats Unmitigated

Propensity for *Ukraine* mis-calculations, *Middle-East* spillover and rising *Russo-NATO tension* suggest *elevated, geo-political threats accentuated by* US election as brinksmanship and misjudgment collide.

7. Oil's Non-OPEC Levers

Dominant US output, and (downside) *demand risks* further out diminish OPEC's sway in buoying crude prices; with any significant bullish moves likely to be from *geo-political flares, not OPEC* supply curb flair.

8. "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.

9. China's Prolonged Pain

Absent a sufficiently forceful reversal of real estate clamp-down, *unresolved confidence deficit* is *a binding drag*. More so as structural policy constraints conspire with conflicting political-economic objectives.

10. India: Silver Lining, Not Bullet

Compelling *structural, medium-term allure*, accentuated by "China+1", is a *silver lining contingent on* requisite *reforms*. *Not an unconditional silver bullet* that negates overarching *global uncertainty/headwinds, K-shaped outcomes, and financial stability threats*.

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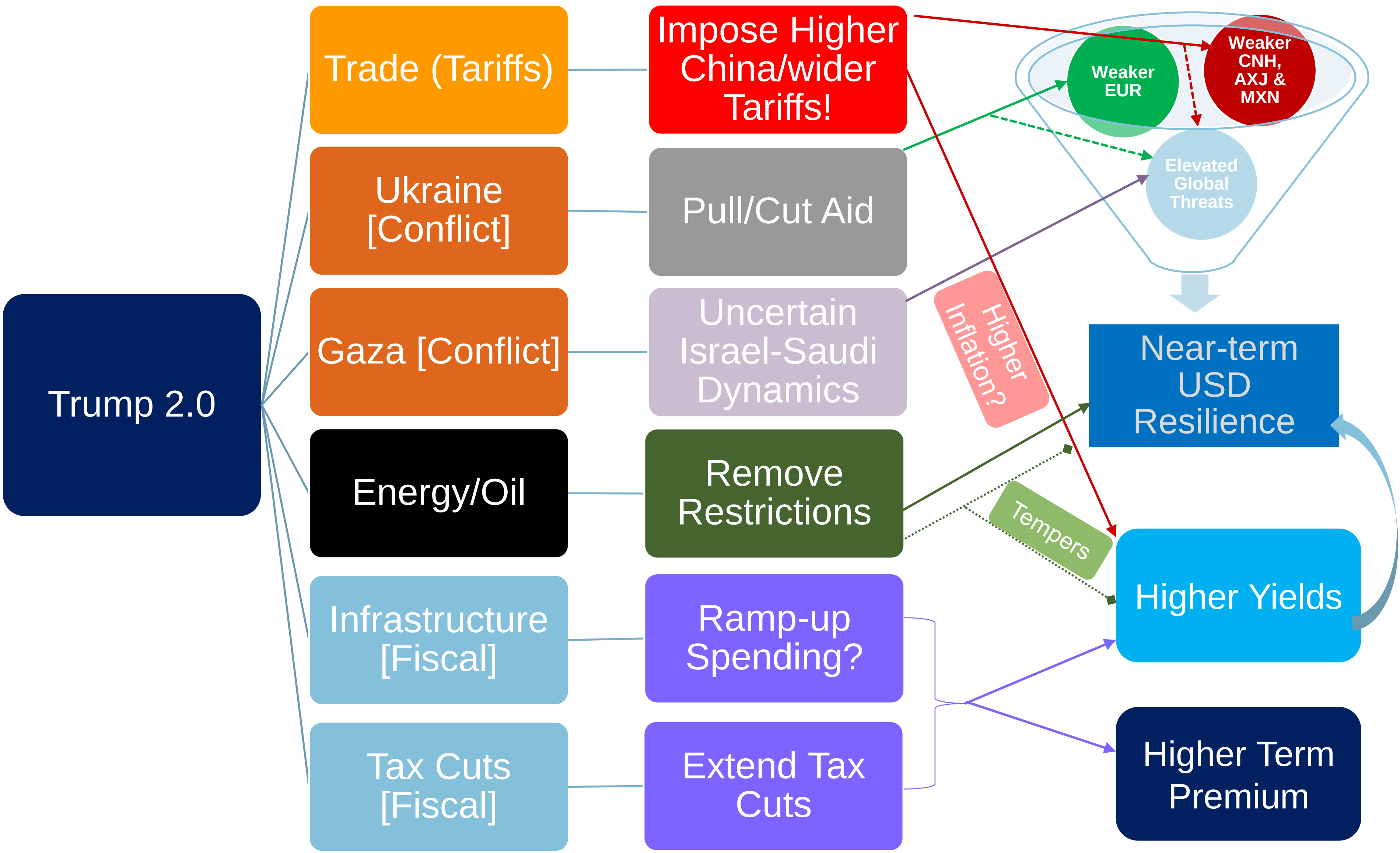
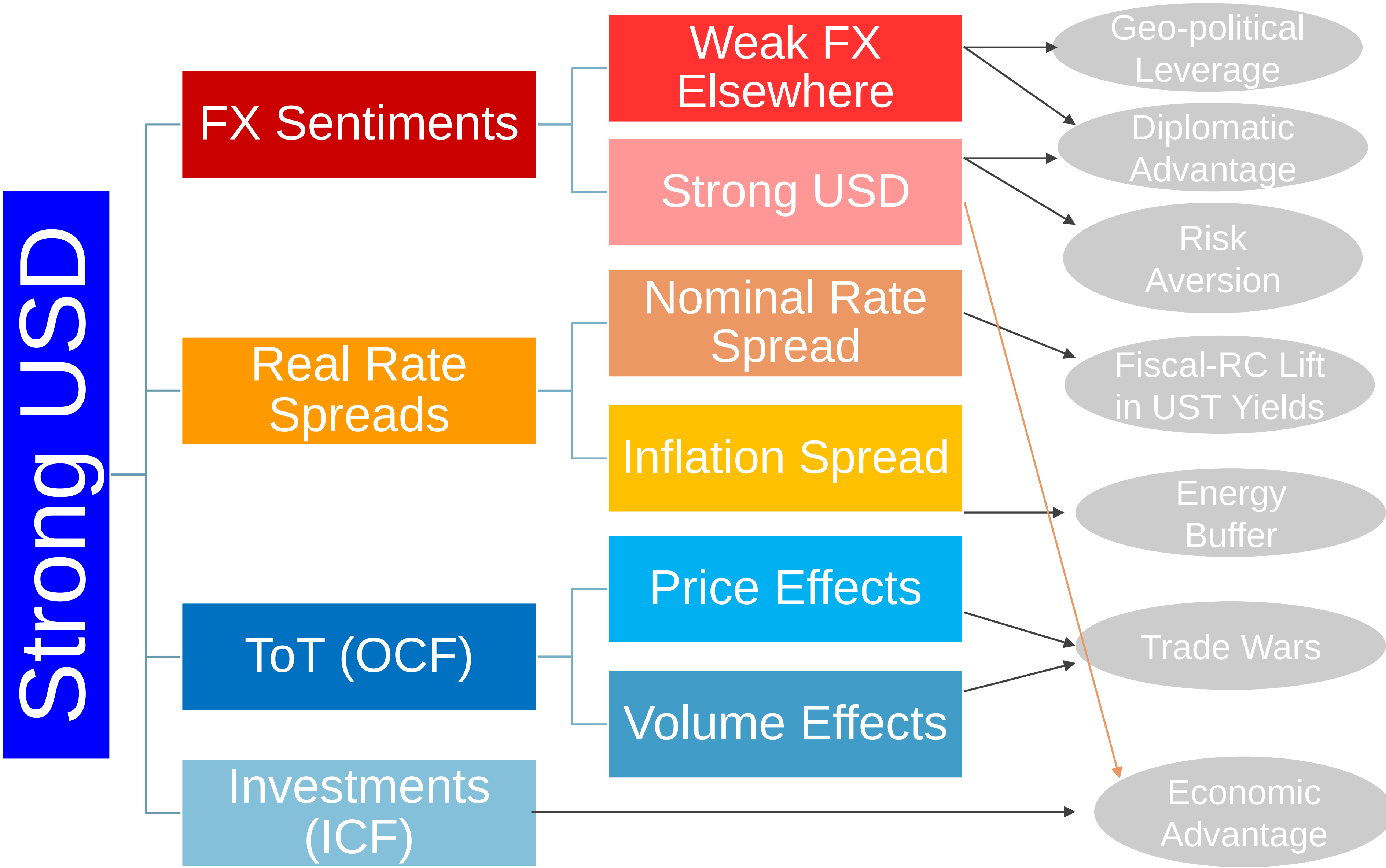
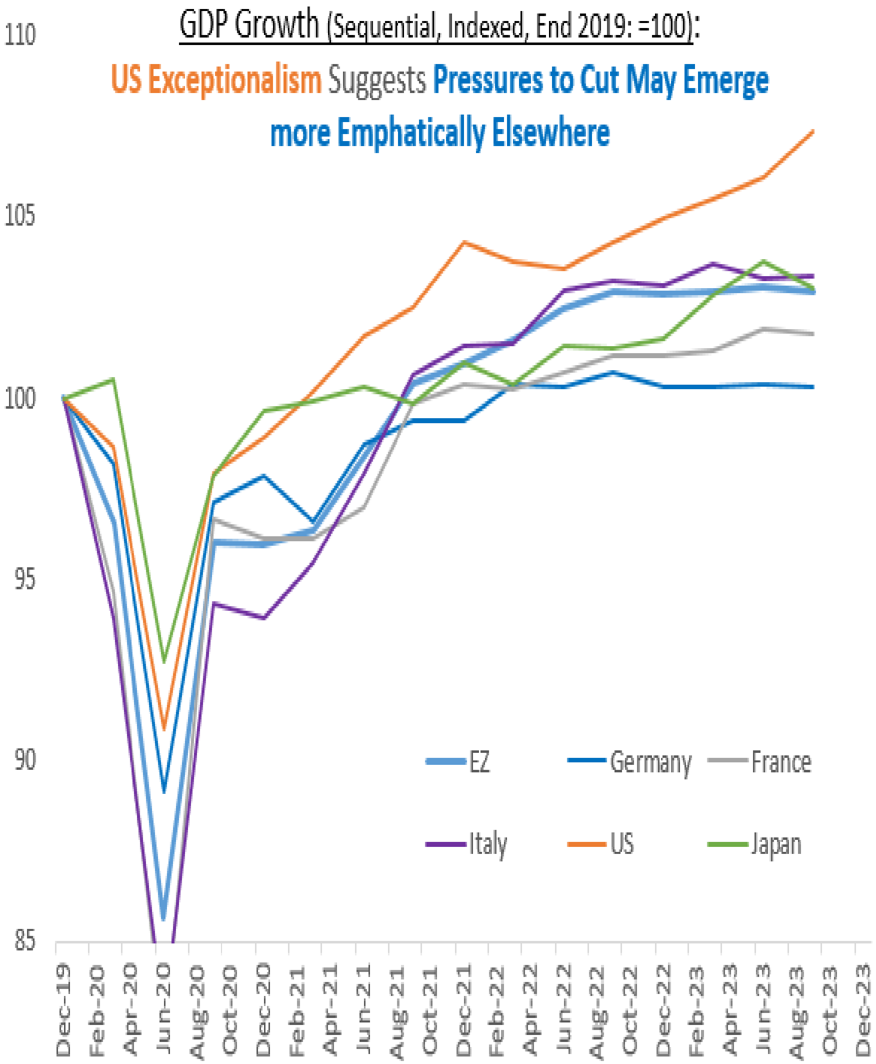
1a. Trump 2.0 (US Elections): Bracing for Geo-economic Blows

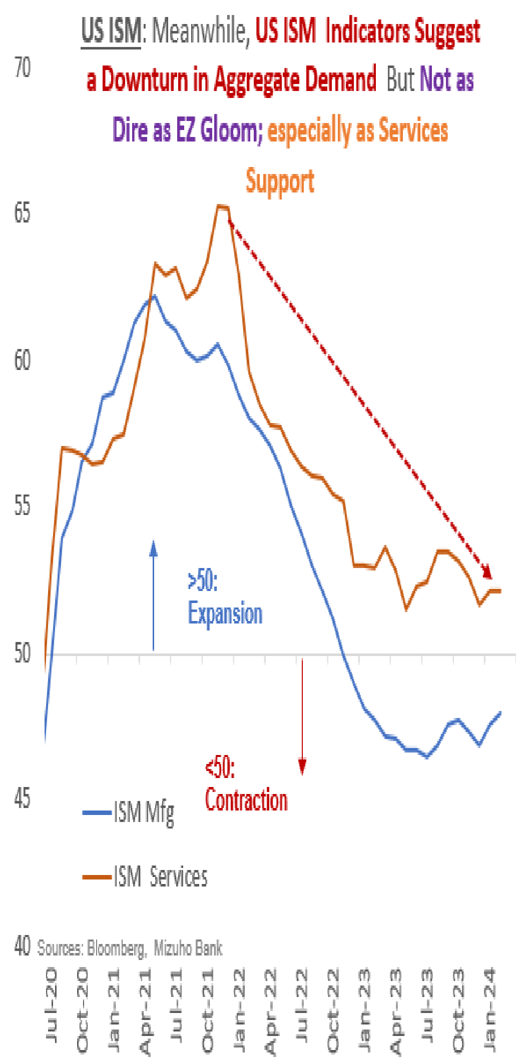


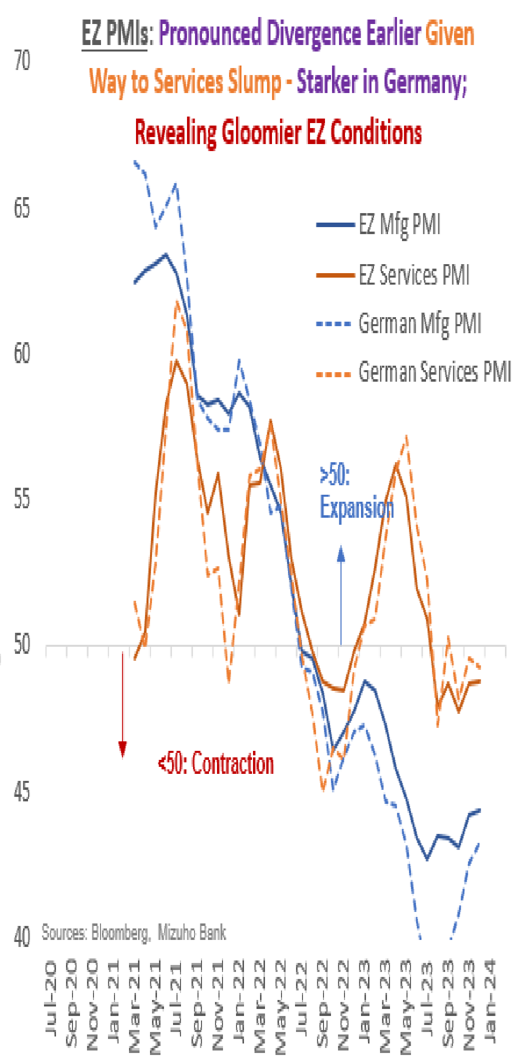
1b. Trump 2.0: Channels of "Dollar Trump"



2a. Competitive Pivot: US Exceptionalisms' Policy Spills Over?







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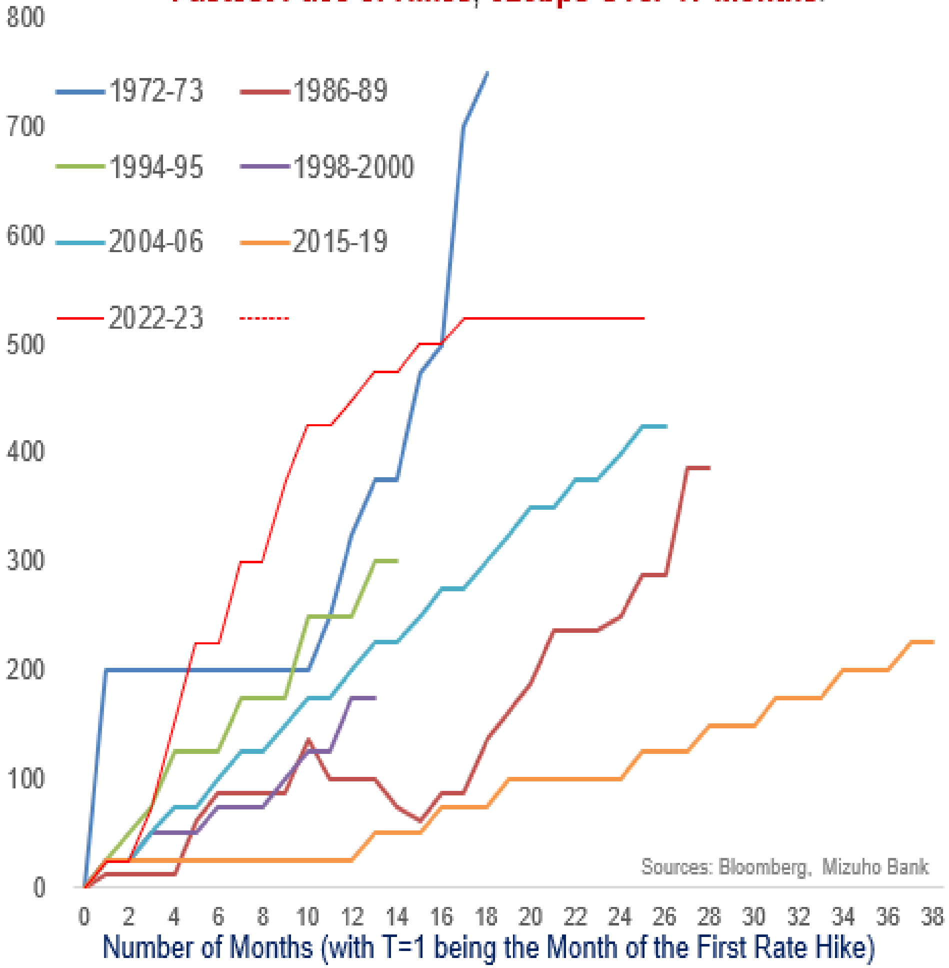
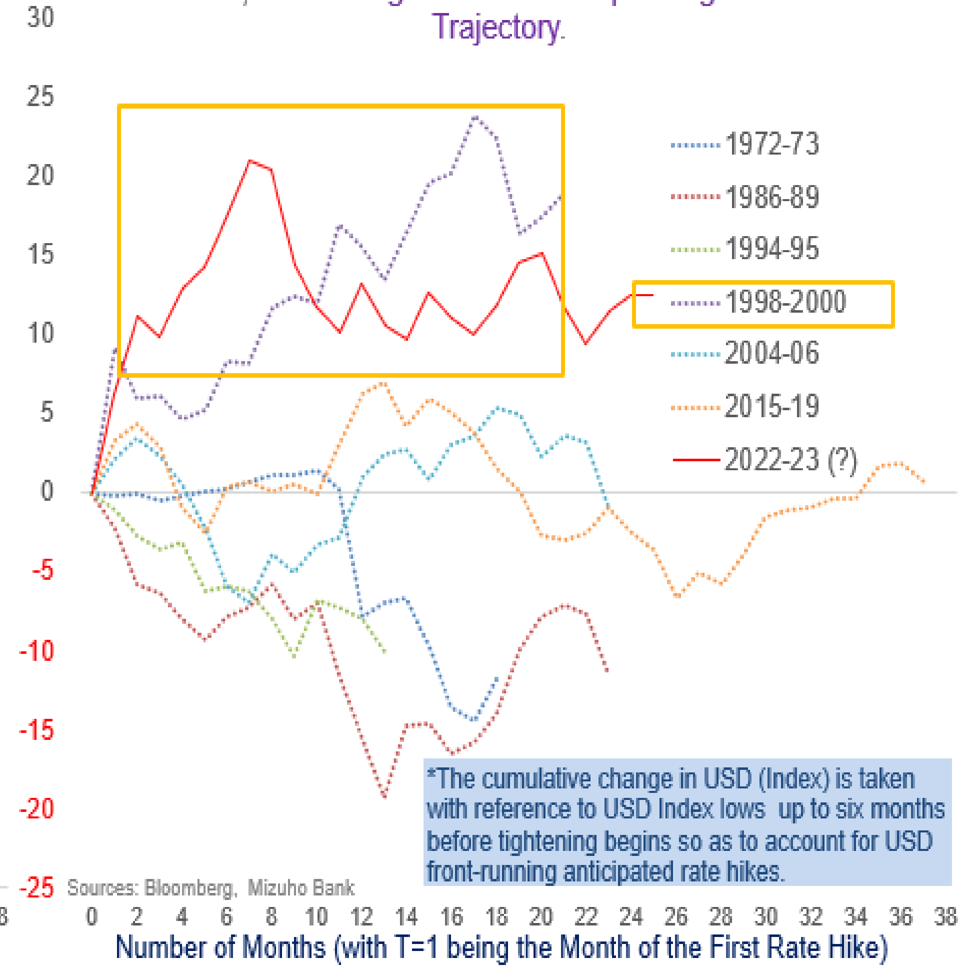
2b. Not All Fed Pivots are Created Equal! "Competitive Pivot"/US Exceptionalism Matter

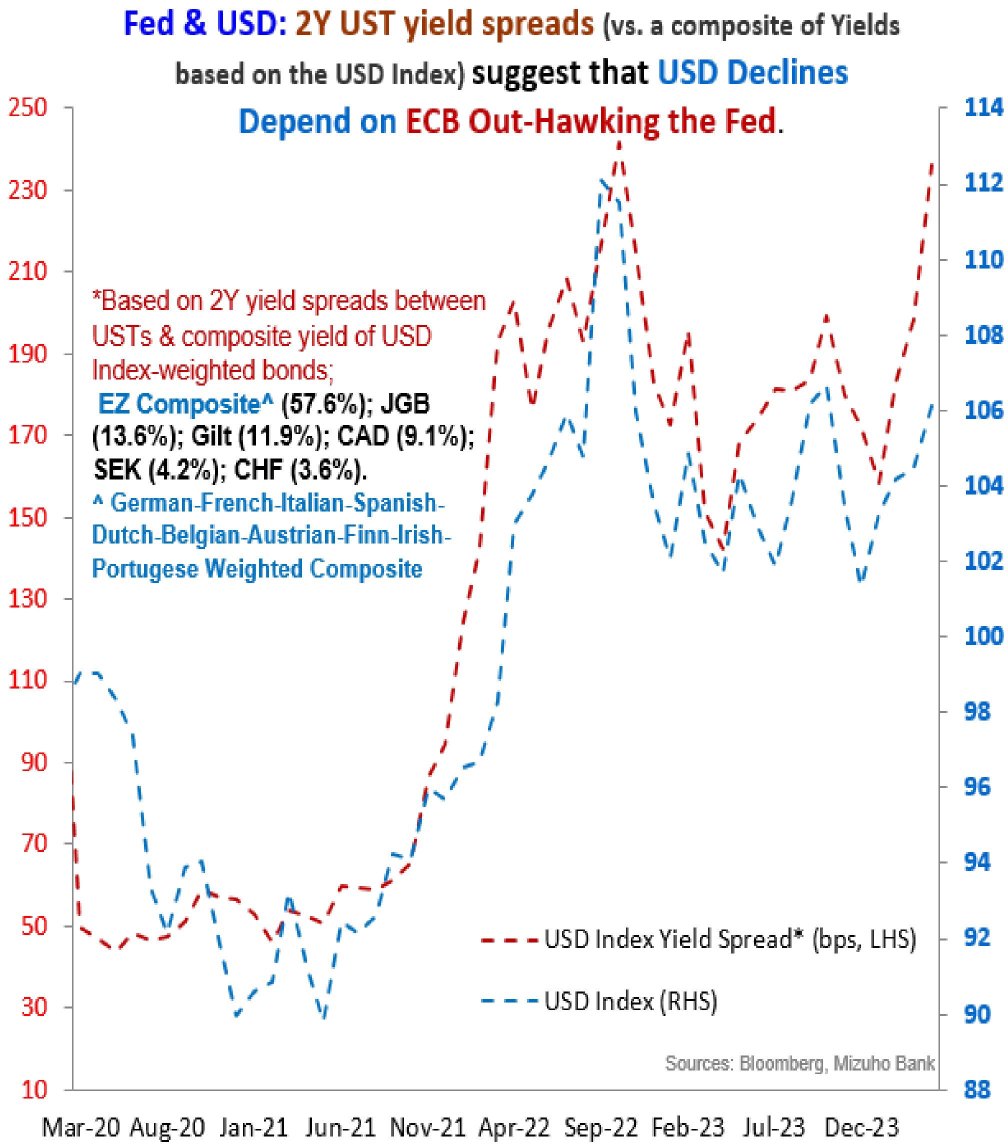
Fed Hiking Cycle (Cumulative Rate Hikes; bp): **Although not the Greatest Amplitude of Rate Hikes** (1970s More Brutal, with >700bp of Hikes), **this Cycle Marks the Fastest Pace of Hikes**; **525bps Over 17 Months**.

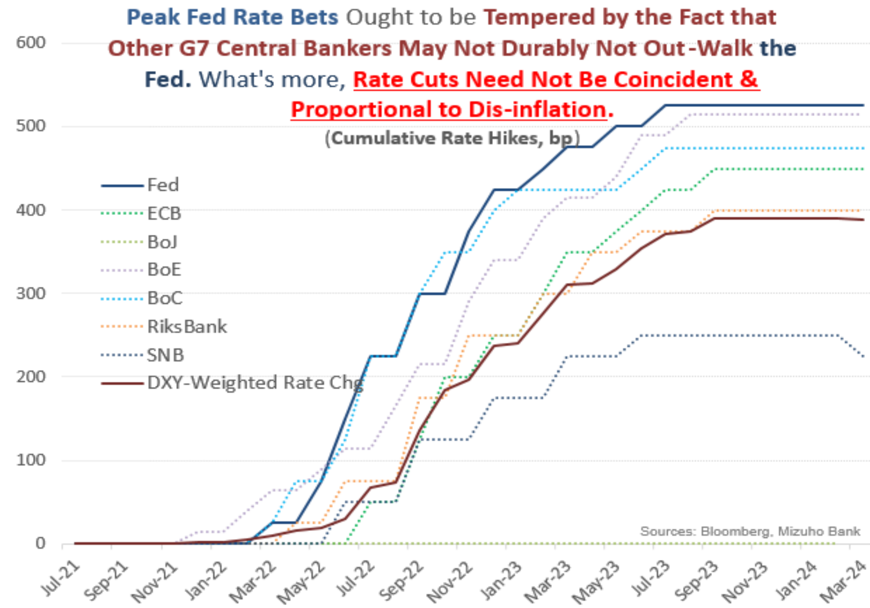


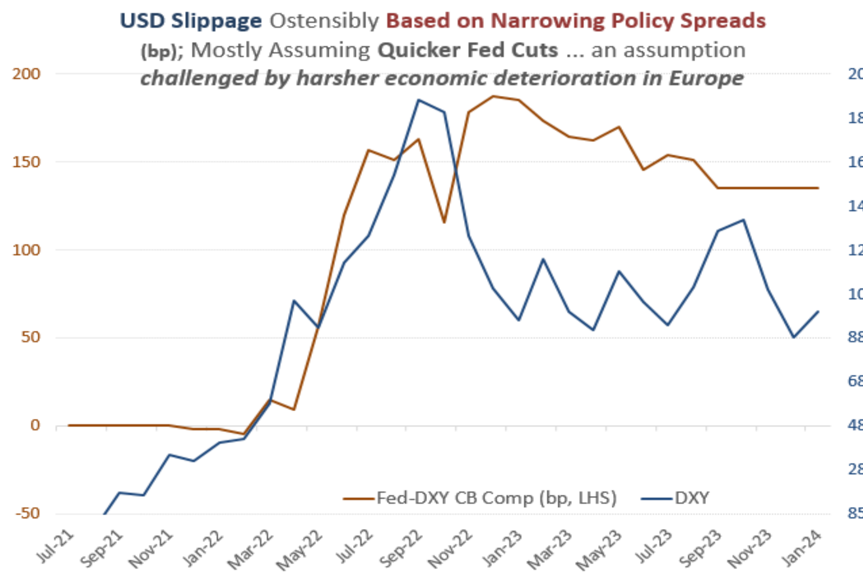
Corresponding USD Performance (Cumulative % Chg*): **Notably, the Current Rate Hike Cycle Has Resulted in the Sharpest Phase of USD Strength in the First 8-9 months**; moderating to below corresponidng 1998-2000 Trajectory.



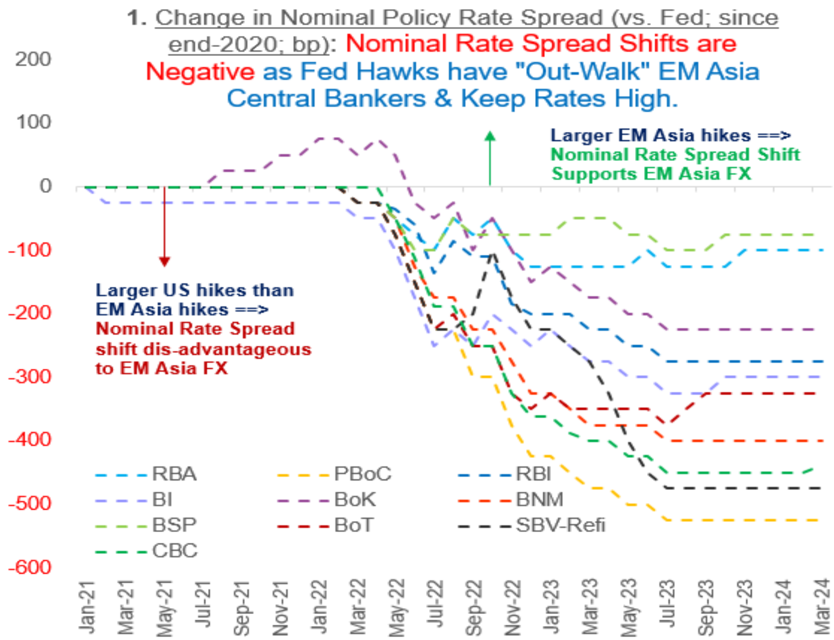
2c. Competitive Pivot: USD Bears Banking on Spread Erosion … A Gambit, Not a Guarantee!

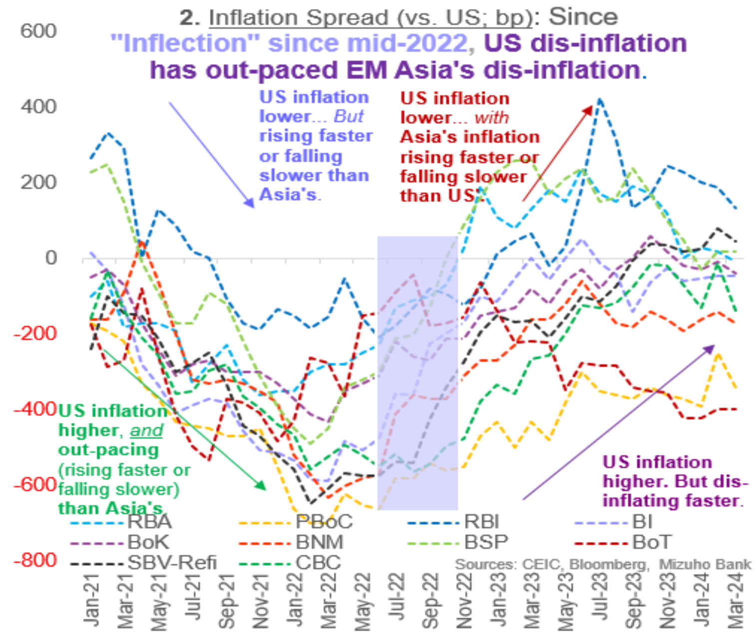


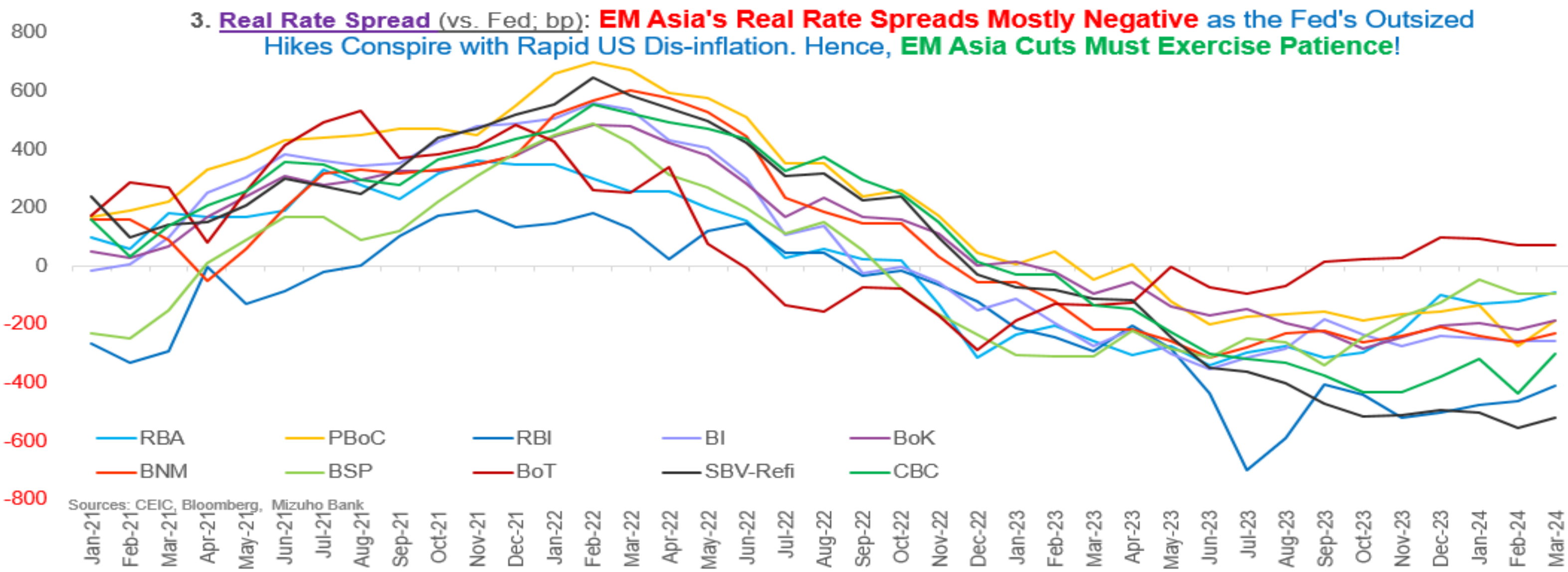




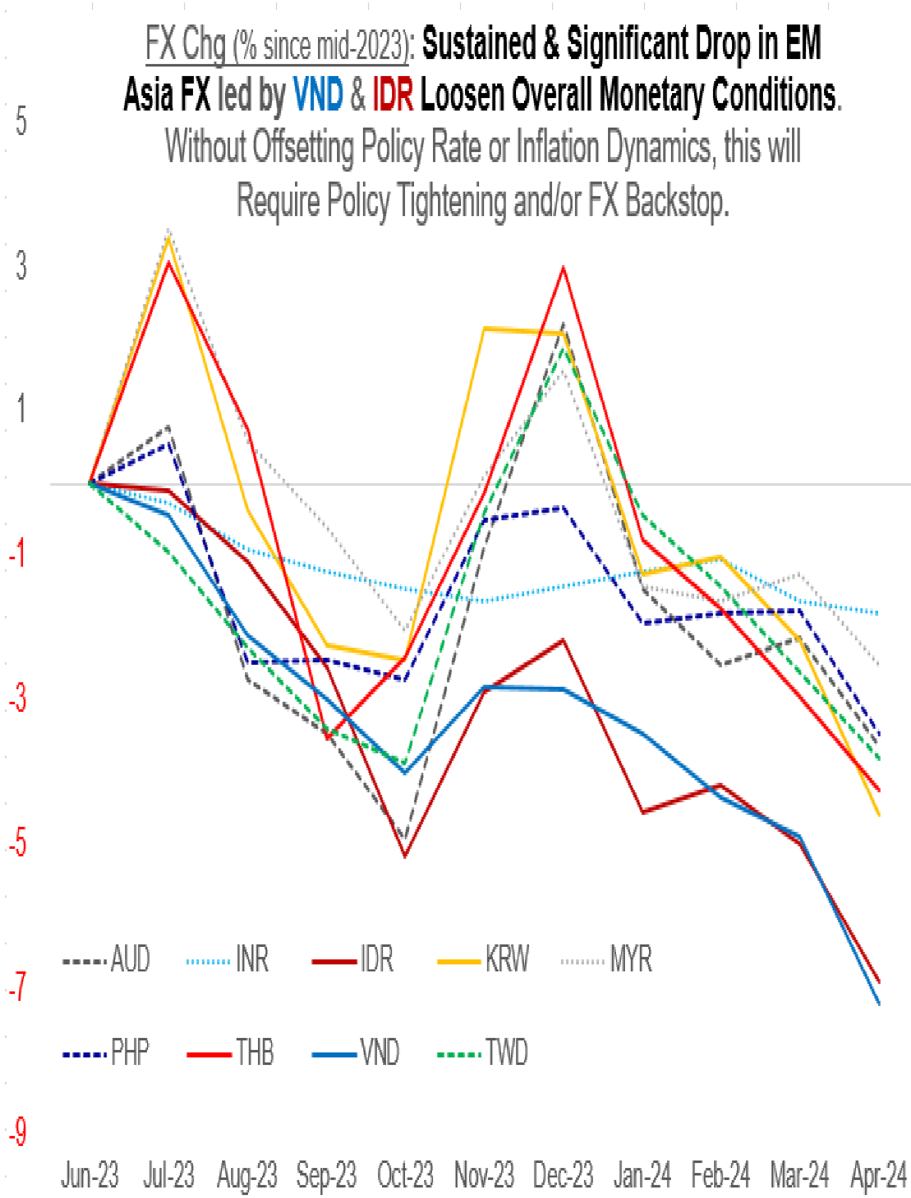
2d. EM Asia: Evolving Inflation Augments Fed “Higher for Longer” Risks

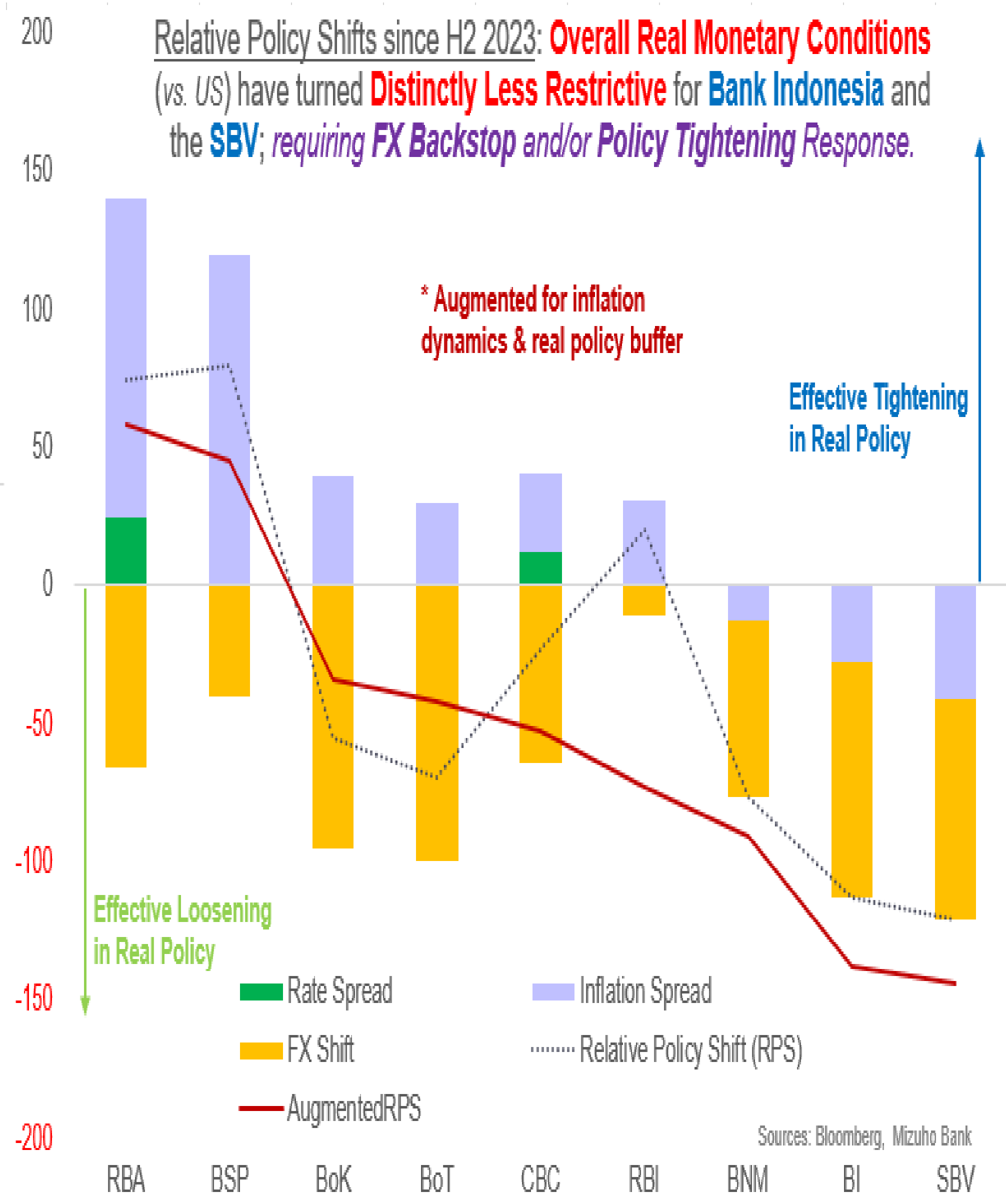






2e. EM Asia: … With FX Amplifying Circular/Reflexive Policy-FX Risks





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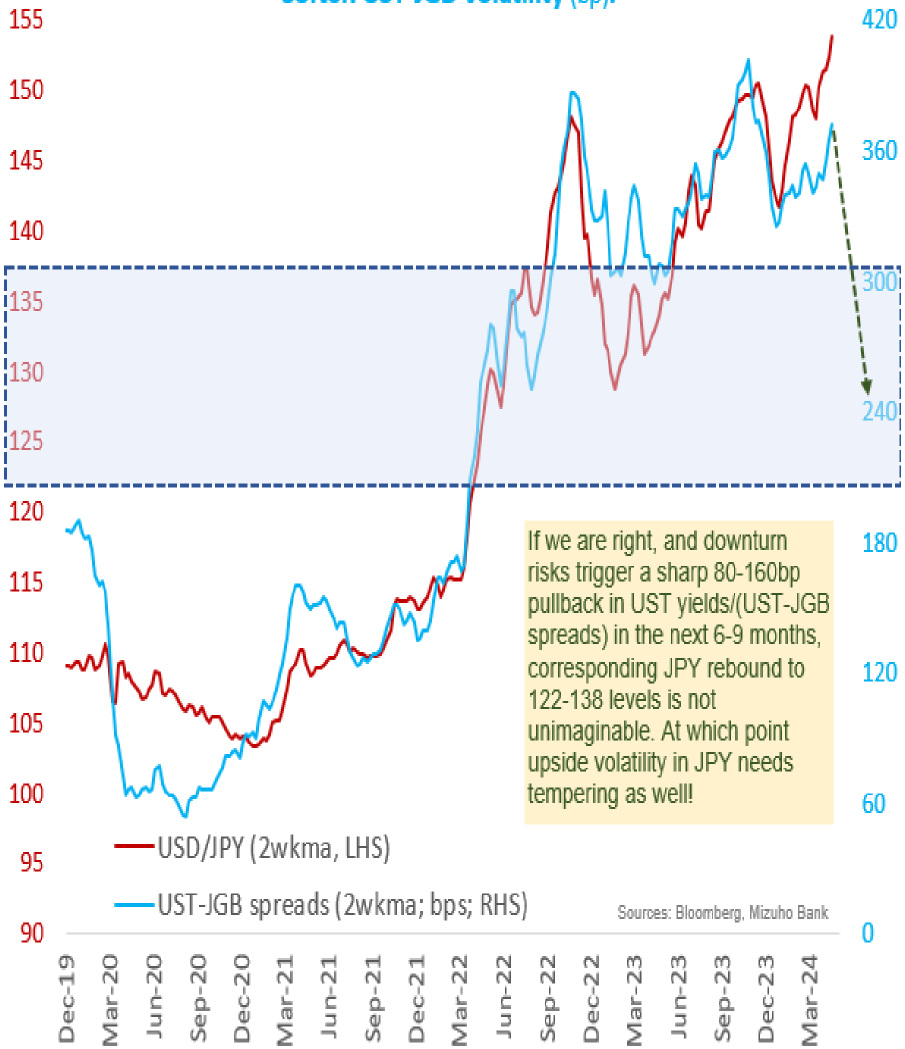
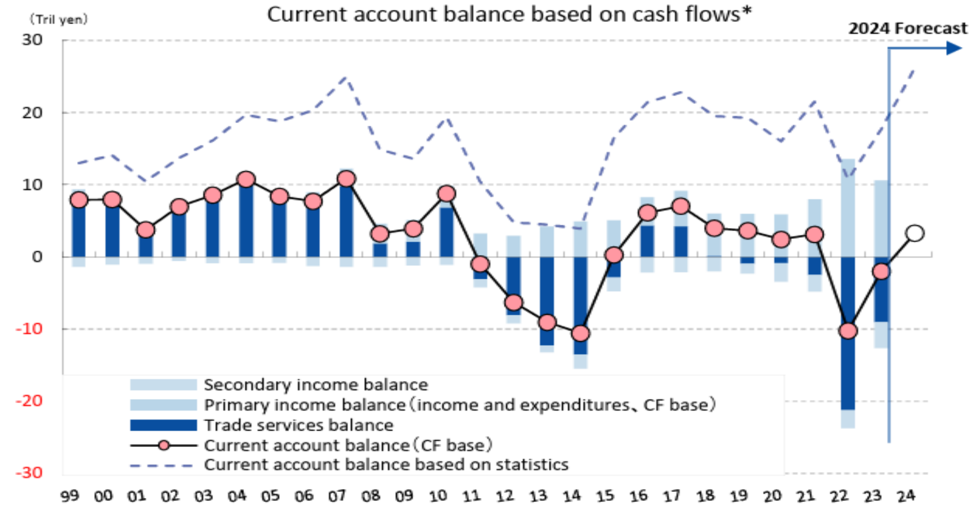
2f. JPY Surge Risks Underpins "*BoJ Problem* with a *Fed Solution*"

Peak Fed May be the Durable Panacea to take some Edge off USD/JPY Upside Pressures; with Calibrated BoJ Shifts to Soften UST-JGB Volatility (bp).

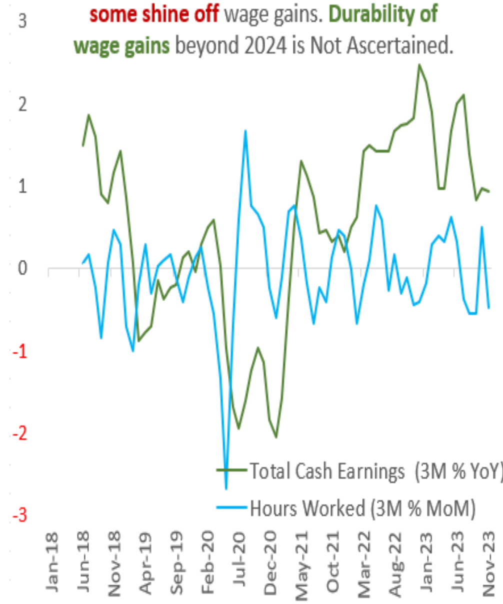




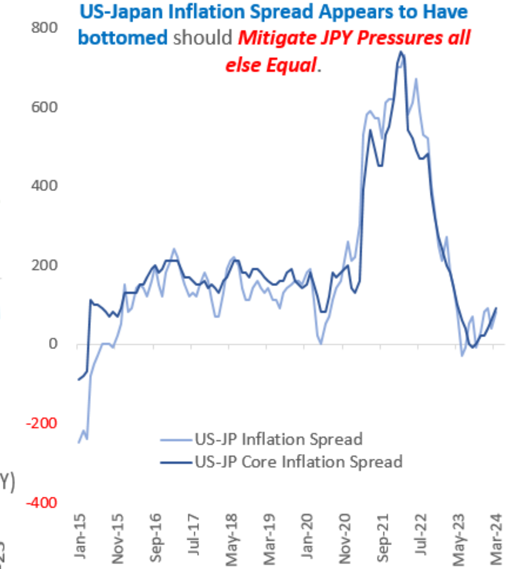
(Source) Bank of Japan (Notes) 2023: Sum from Jan to Oct

*With regard to the receipt and payment of primary income and expenditure, "reinvestment income" of direct investment income, "dividends" of securities investment income and expenditure, and "bond interest, etc." are deducted

Japan Jobs: **Reduced Hours** worked **takes some shine off** wage gains. **Durability of wage gains** beyond 2024 is Not Ascertained.



US-Japan Inflation Spread (bp): **Sharp Drop in US-Japan Inflation Spread Appears to Have bottomed** should ***Mitigate JPY Pressures all else Equal***.



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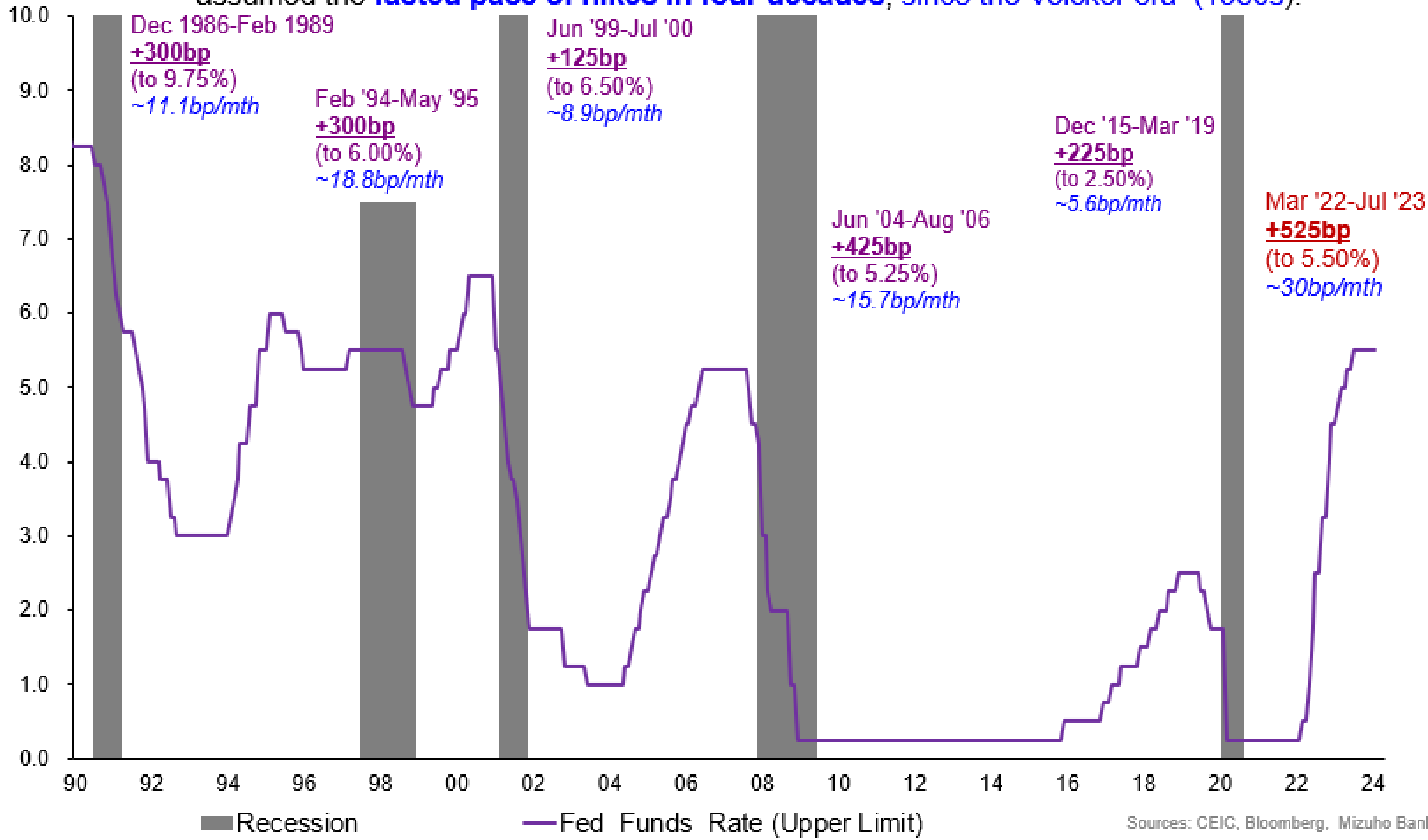
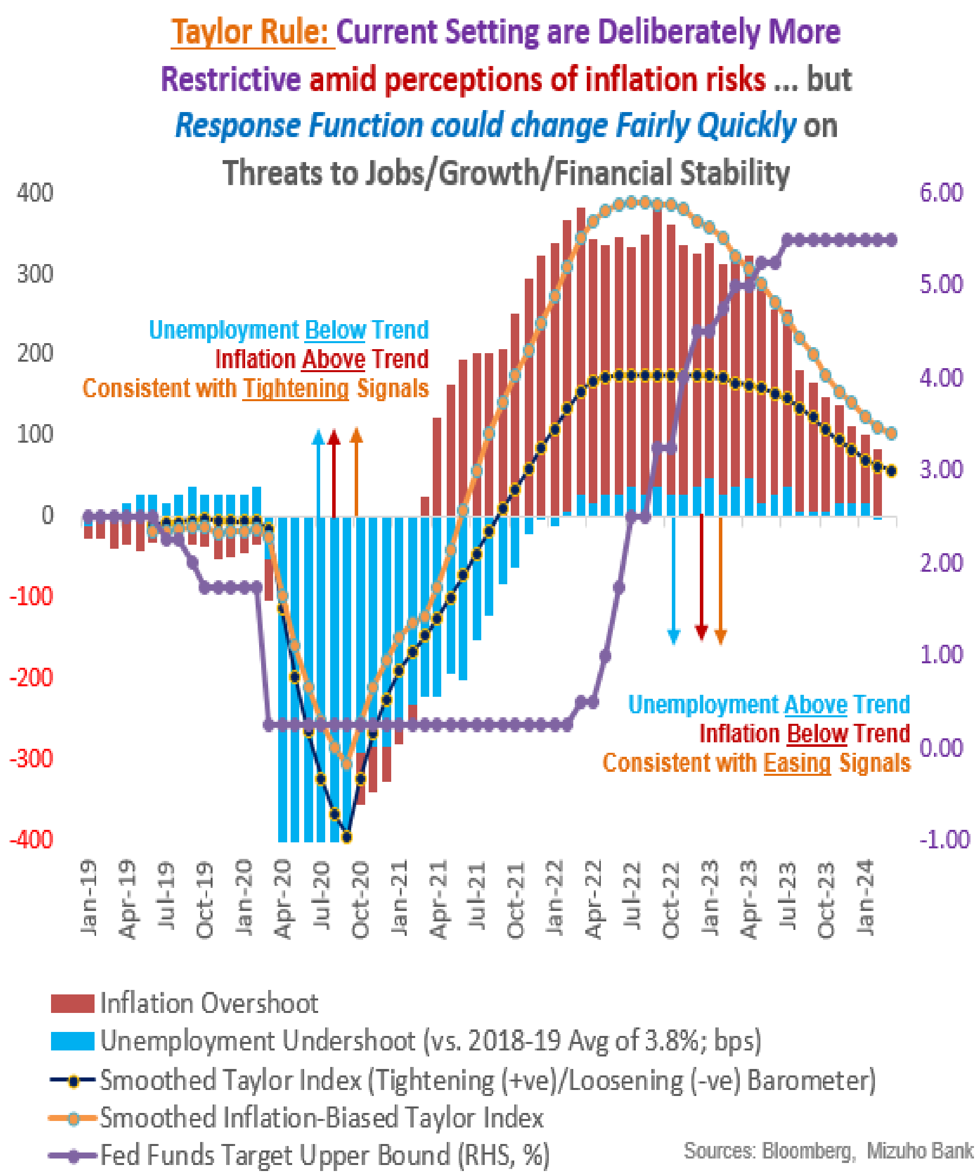
3a. History is Not on the Side of "Immaculate" Soft-Landing; regardless of US Exceptionalism

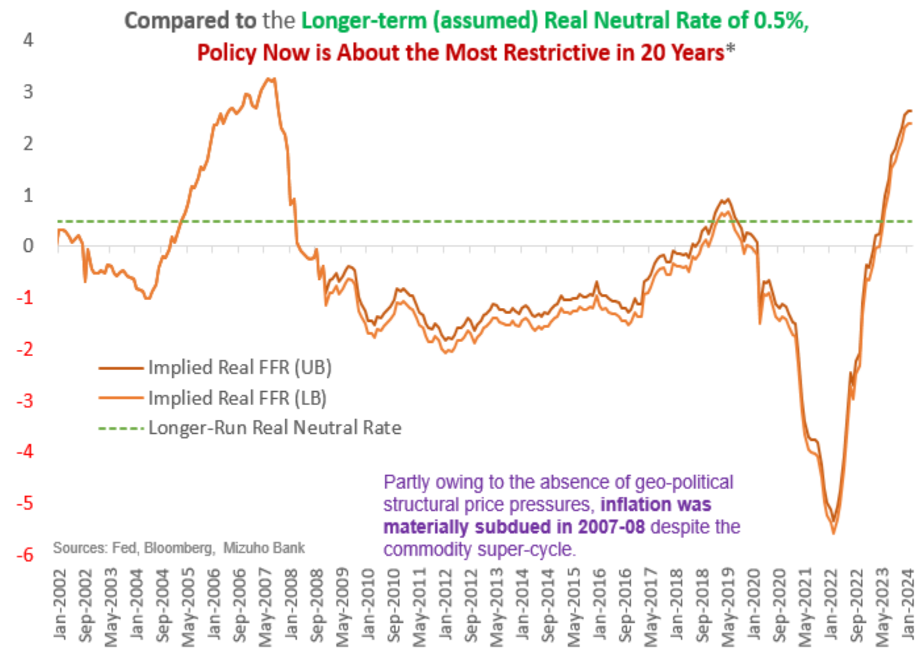
Fed Tightening Cycles & Global Recessions: **Few Tightening Cycles** by the Fed Have Resulted in "Goldilocks" Outcomes that **Avert a Recession**. And this time, the Fed has assumed the **fasted pace of hikes in four decades**; since the Volcker era (1980s).

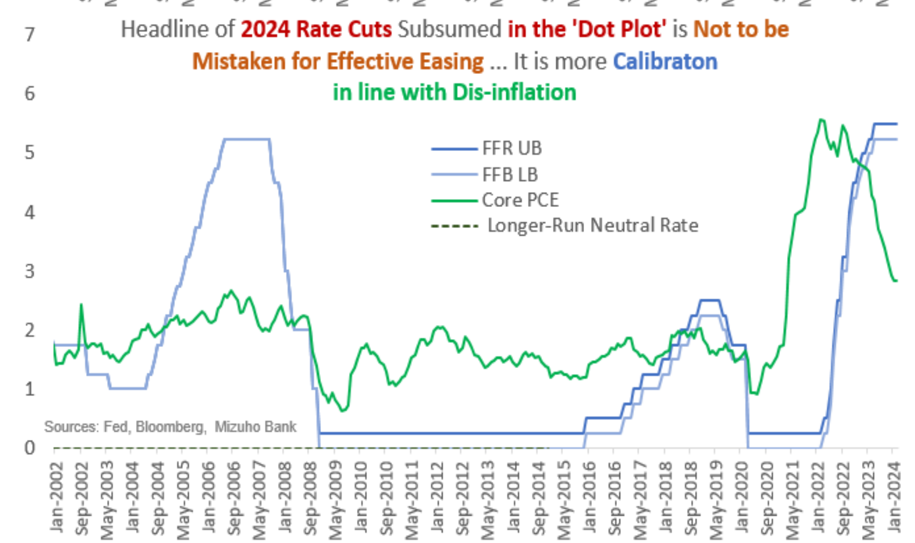


Sources: CEIC, Bloomberg, Mizuho Bank

3b. And to be Sure, Taylor Rule Does Not Require This Much Restriction

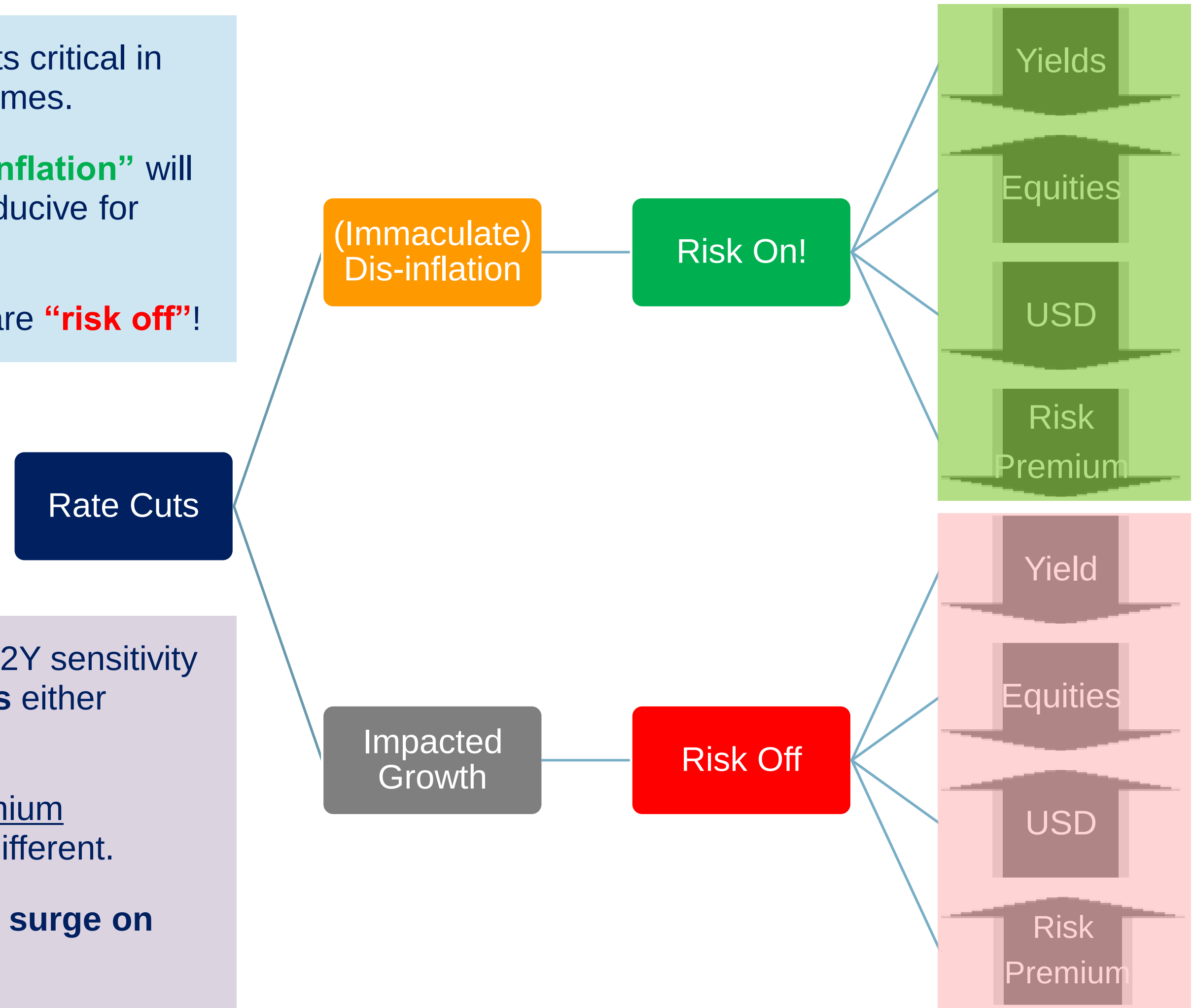






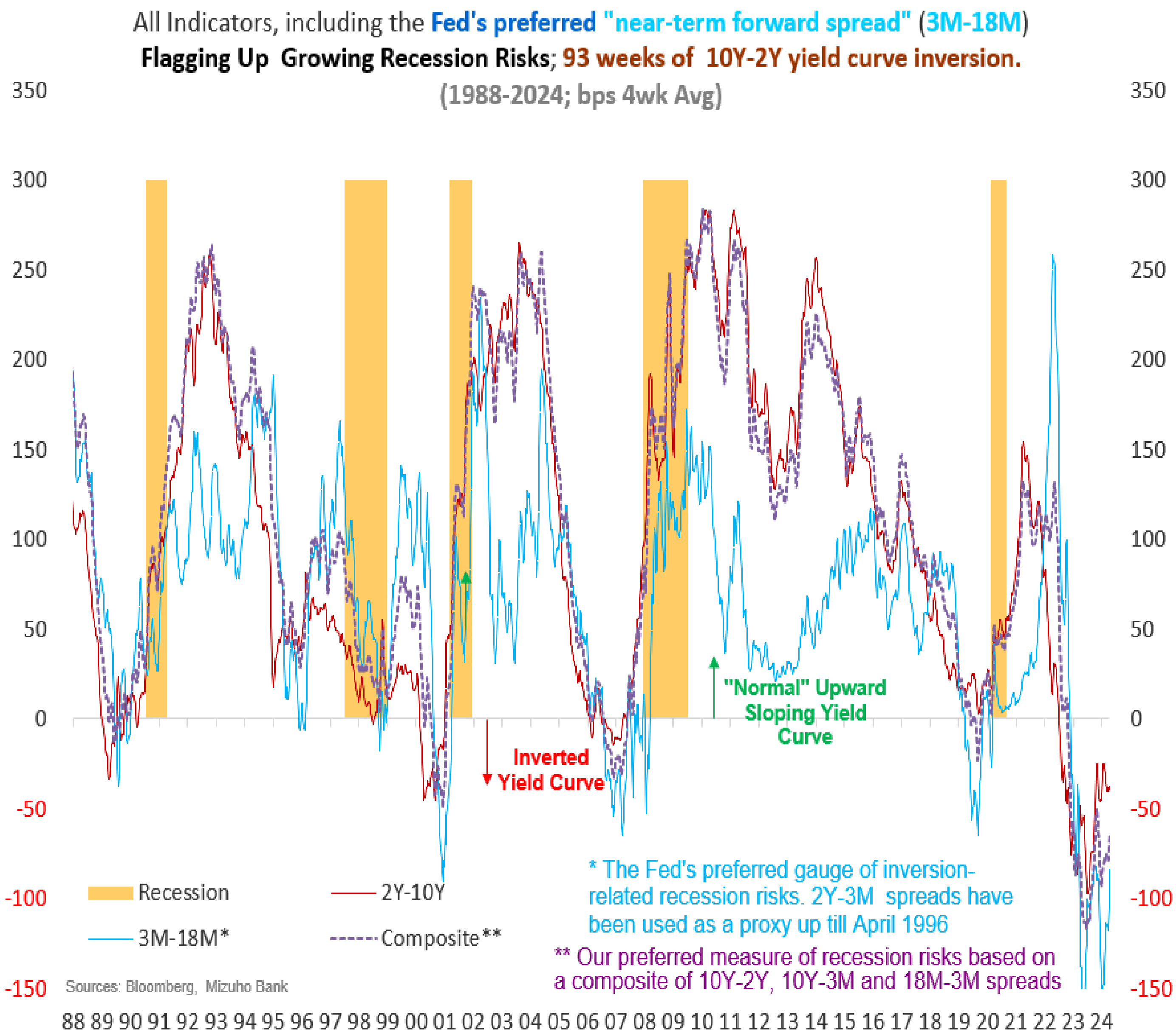
3c. Why Being Wrong About "Immaculate Dis-inflation" Matters

- Arguably, motivation for rate cuts critical in determining asset market outcomes.
- Specifically, **"immaculate dis-inflation"** will trigger **"risk on"** response conducive for asset prices.
- But rate cuts on **growth risks** are **"risk off"**!



- **Drop in yields** – initially led by 2Y sensitivity to policy – is **consistent across** either iteration of rate cuts.
- But USD, equities and risk premium consequences may be starkly different.
- **USD**: To **ease on "risk on"** but **surge on "risk off"** amid haven demand.
- **Equities**: "Immaculate dis-inflation" rallies liable to sharp corrections on hard landing.
- **Risk Premium**: To surge (denting EM/risk assets) if economic outcomes sour.

3d. Inversion Gauge is Also Warns of Long & Variable Lags



Yield Curve Inversion & Recession		
	Average Depth (bp)	Average Lag (Wks)
1981-82	75.6	40
1990-91	10.4	78
2000-02	27.4	54
2007-08	7.2	76
2022-24?	**54**	**93**

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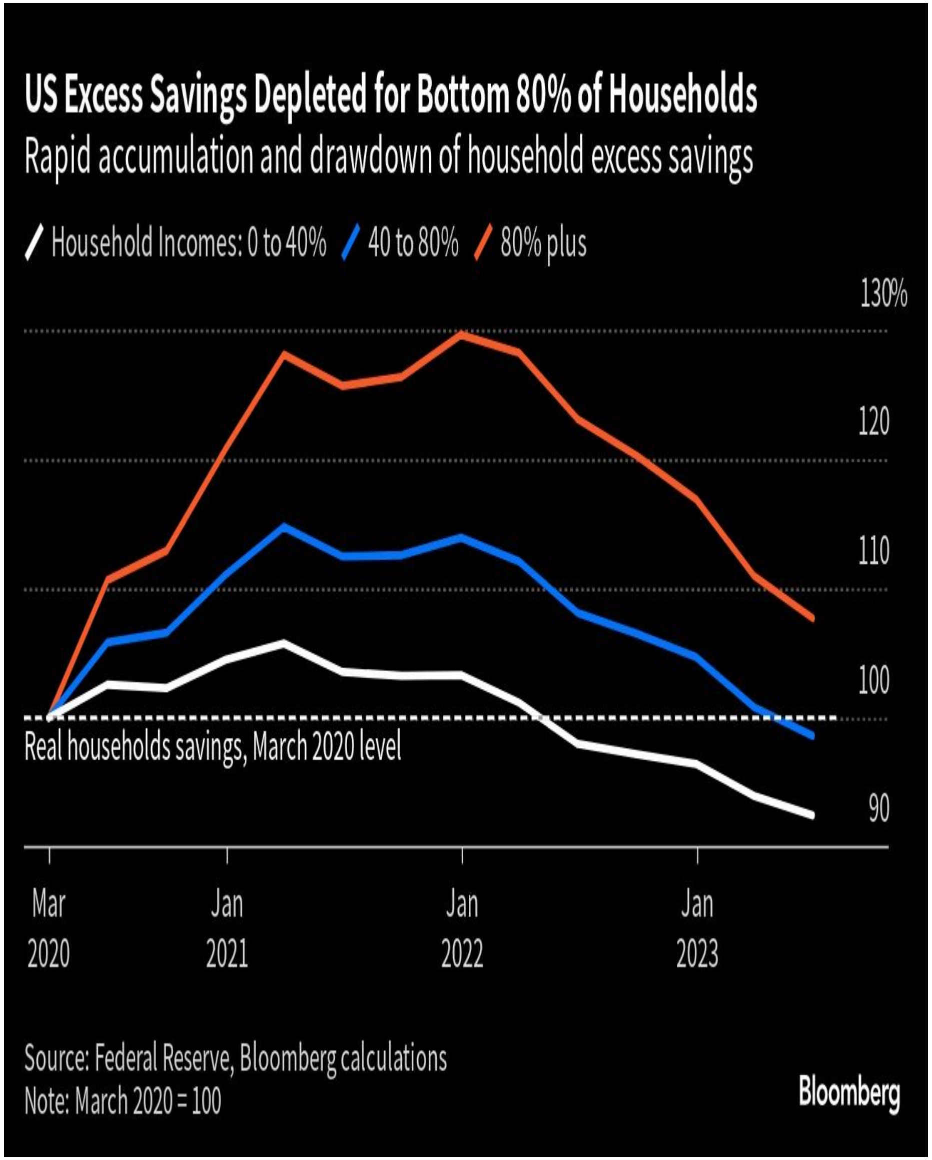
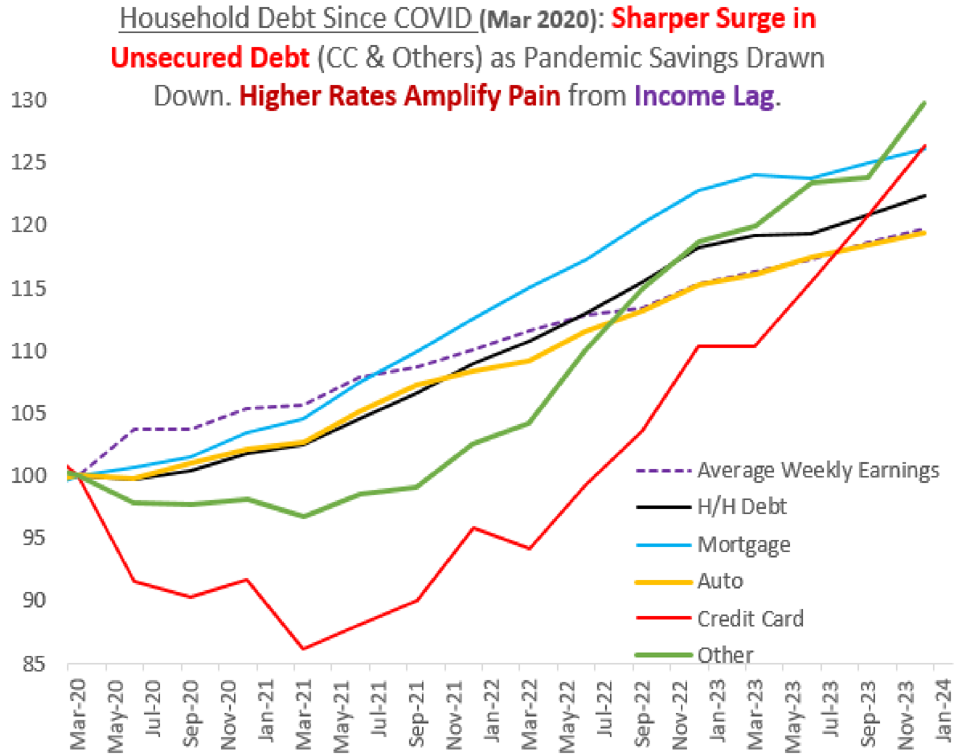
(3→4)a: Unprecedented Distortions & Lags: Illusion of US Consumer Exceptionalism?





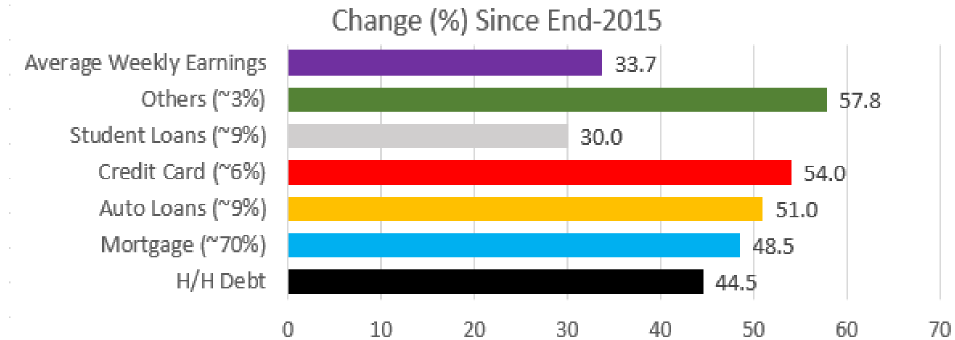
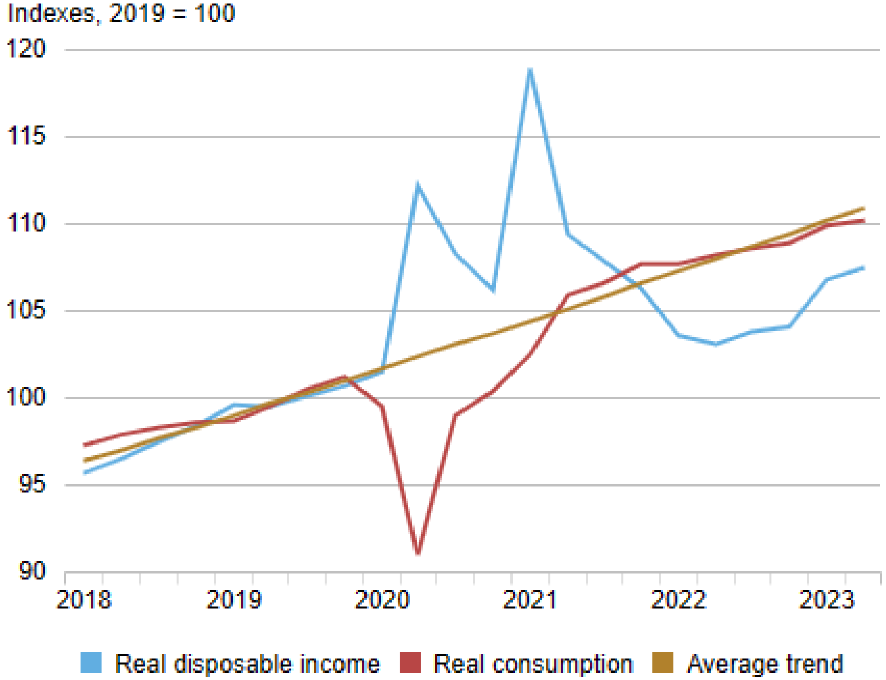


Chart from Bloomberg

(3→4)b. Especially if the Income Constraints Bind Amid Higher Rates

U.S. Consumption Back to Trend but Income Lags

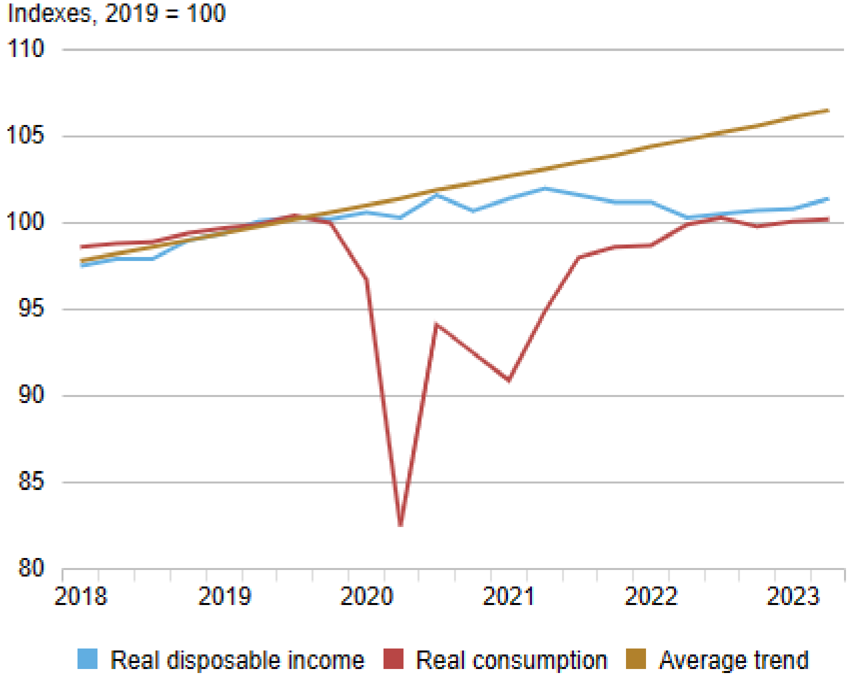
United States: Real Income and Consumption Indexes



Sources: Bureau of Economic Analysis, Integrated Macroeconomic Accounts; authors' calculations.
Note: The average trend for consumption and income is based on growth from the fourth quarter of 2014 to the fourth quarter of 2019.

Foreign Income and Consumption Tracking Below Trend

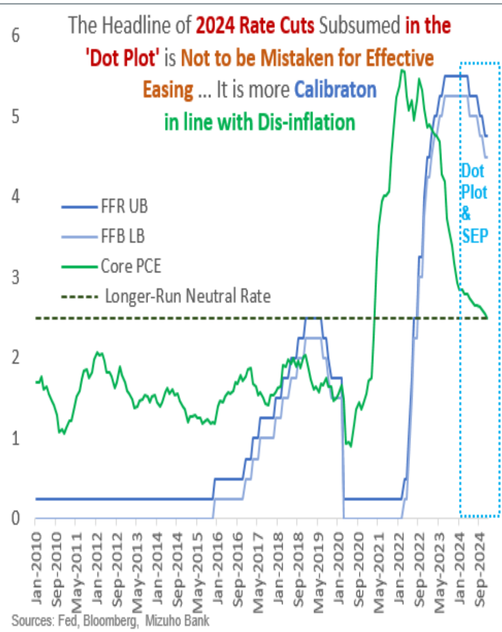
Foreign Economies: Real Income and Consumption Indexes

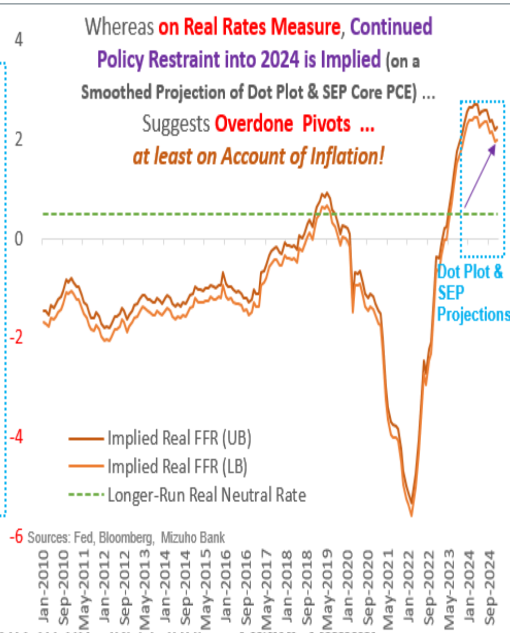


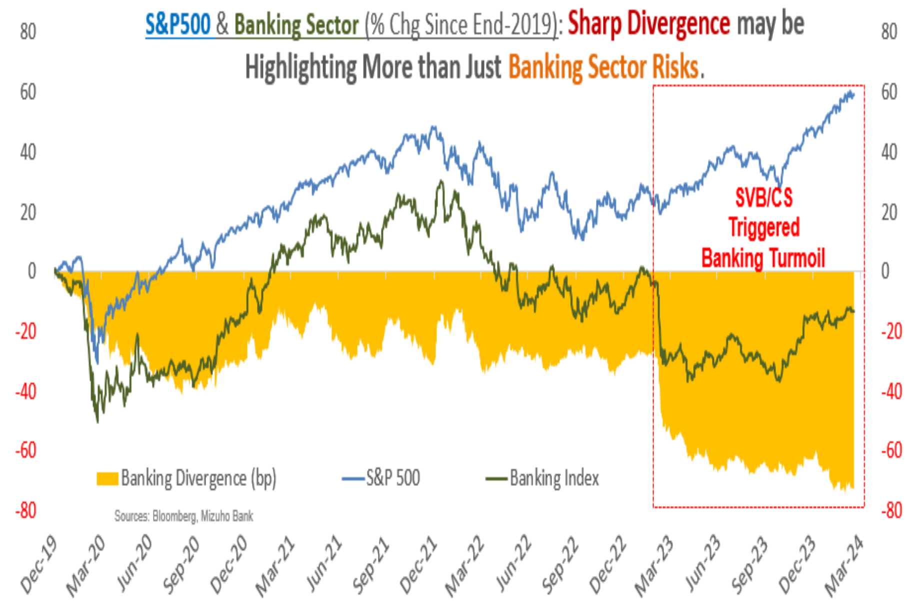
Sources: Eurostat; UK National Statistical Office; Japanese Cabinet Office; Statistics Canada; authors' calculations.
Notes: The foreign high-income series is a GDP-weighted average of the euro area, Japan, the United Kingdom, and Canada. Disposable income data for the second quarter of 2023 in Japan have not yet been released. Income for that quarter is extrapolated from the first quarter of 2023 at the average growth since the first quarter of 2022. Japan represents about 15 percent of the foreign index.

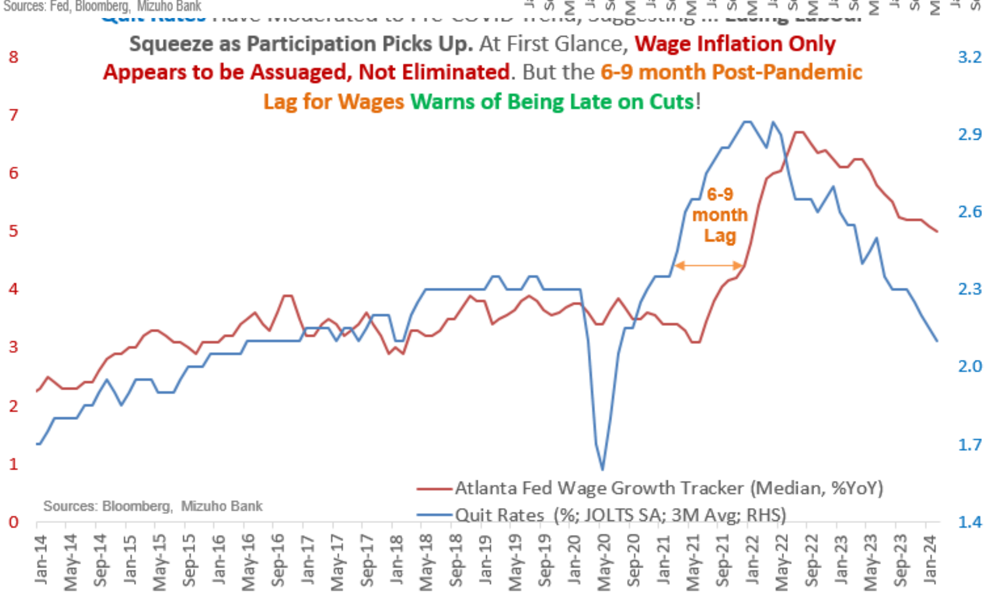
Source: Federal Reserve Bank of New York

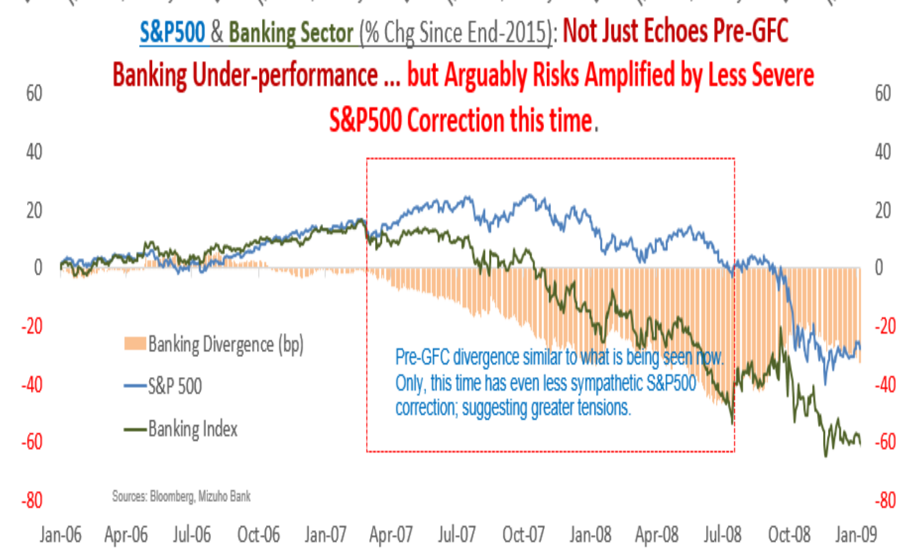
(3→4)c. Especially if Policy Proves Too Tight for Lagged Labour Impact or Financial Risks



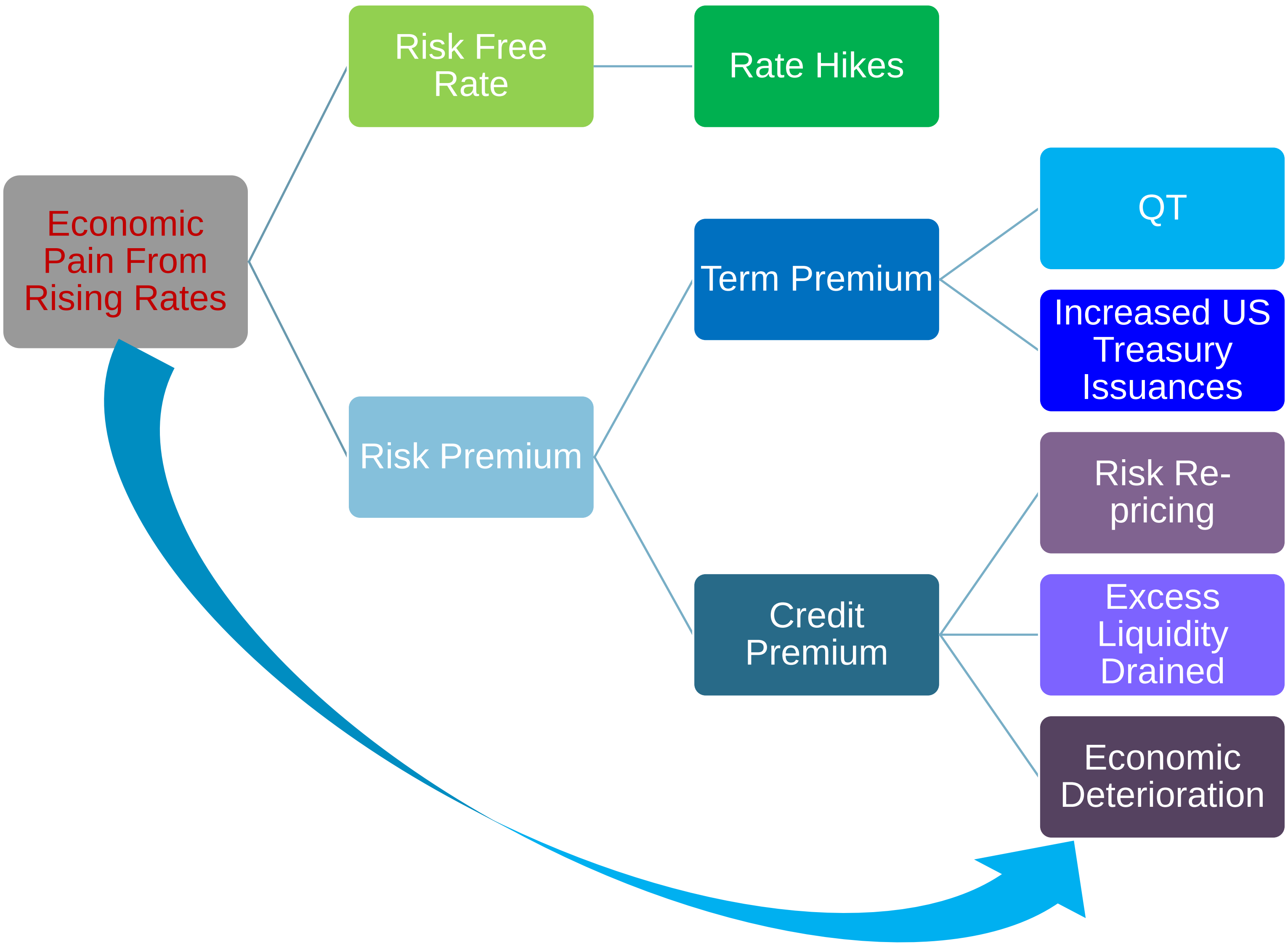






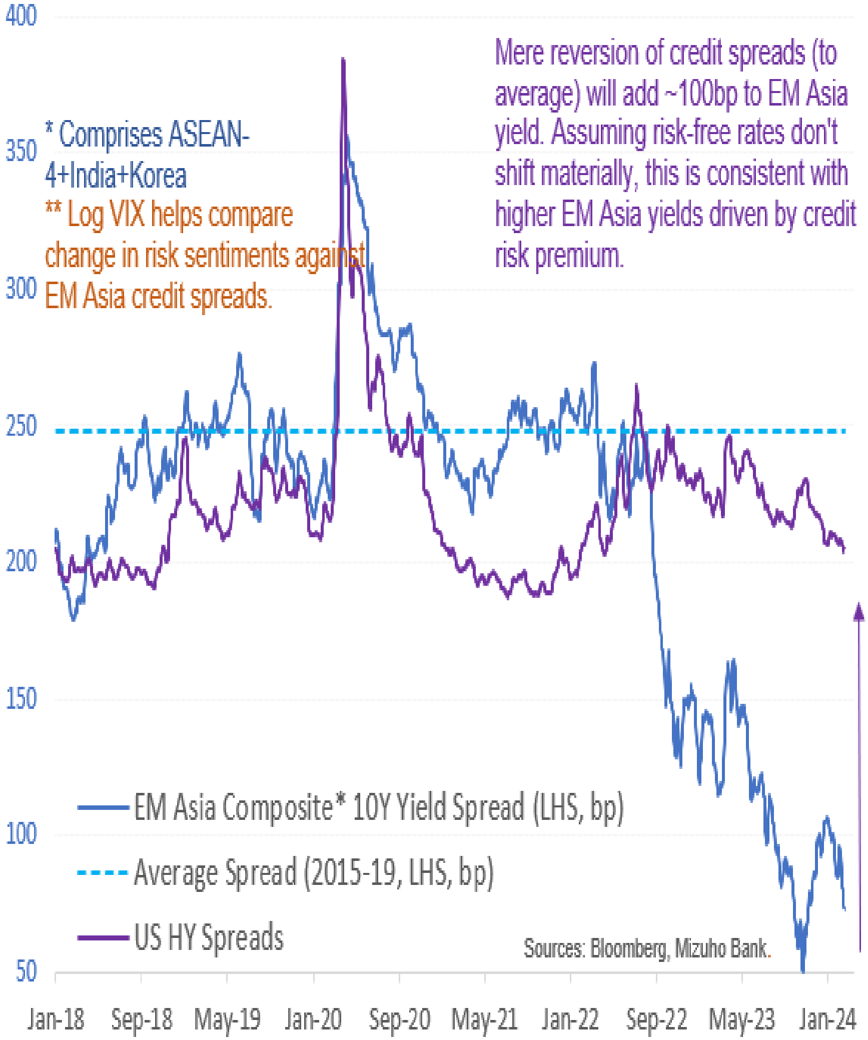


4a. Risk Re-Pricing: Pain from Higher Rates ➔ Asynchronous Risk Premium Threat!

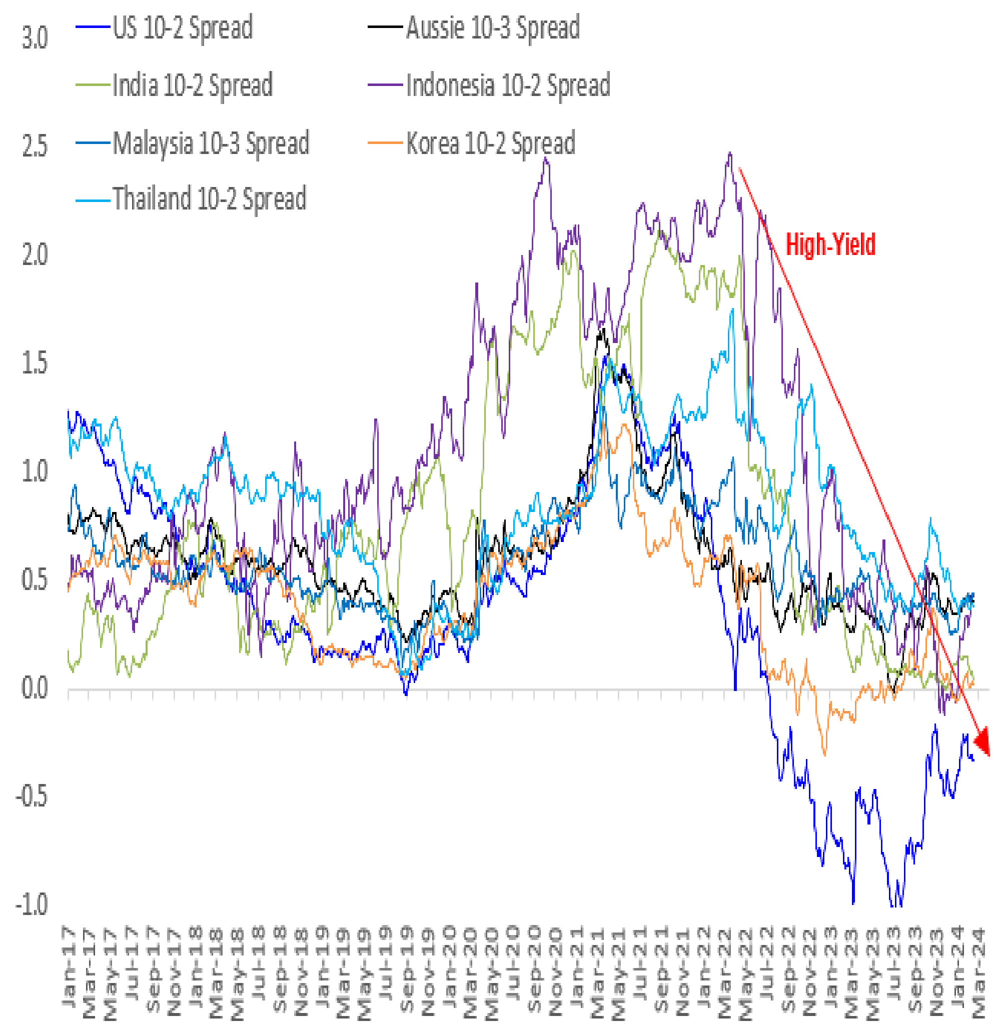


4b. Risk Re-Pricing: Conditions for Risk & Term Premia Restoration?

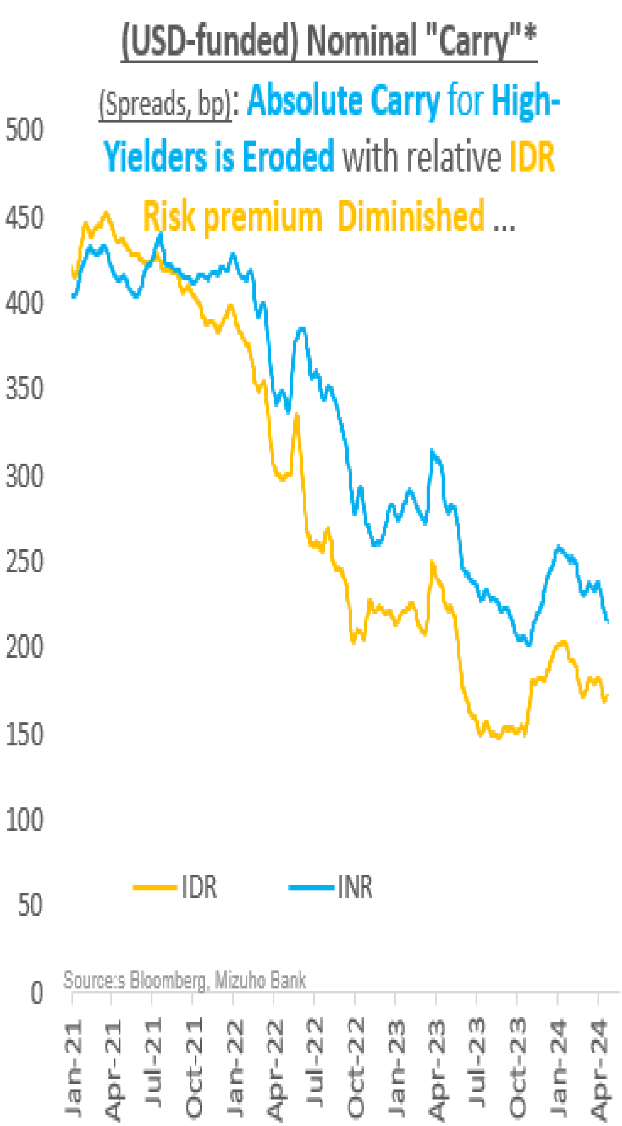
Plunge in 10Y EM Asia Yield Spreads (vis-a-vis UST Yields) Remains **Excessive with Respect to Shifts in Risk Sentiments**.

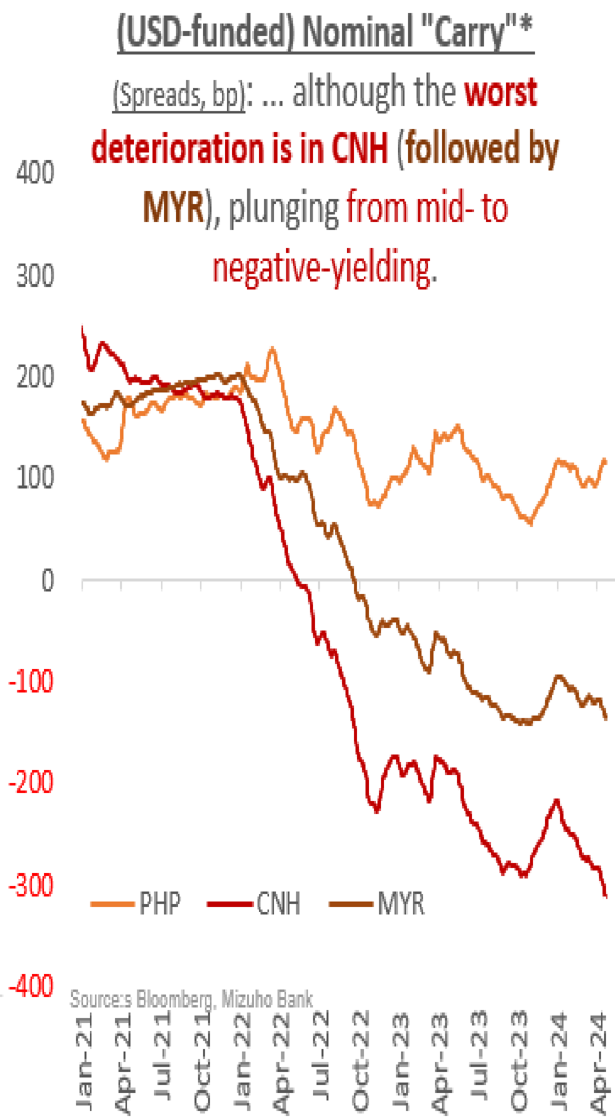


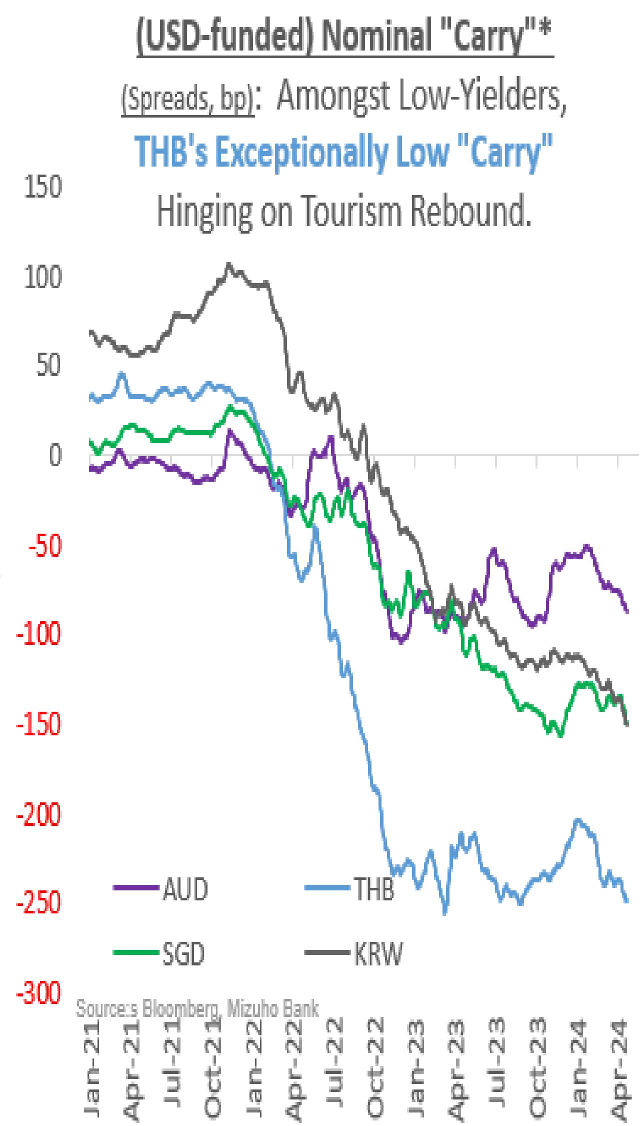
Term Premium (2Y-10Y Spread): **Term Premium is Exceptionally Narrow. This may be Exposed to Risk Re-pricing amid Sustained UST Yield Volatility.**



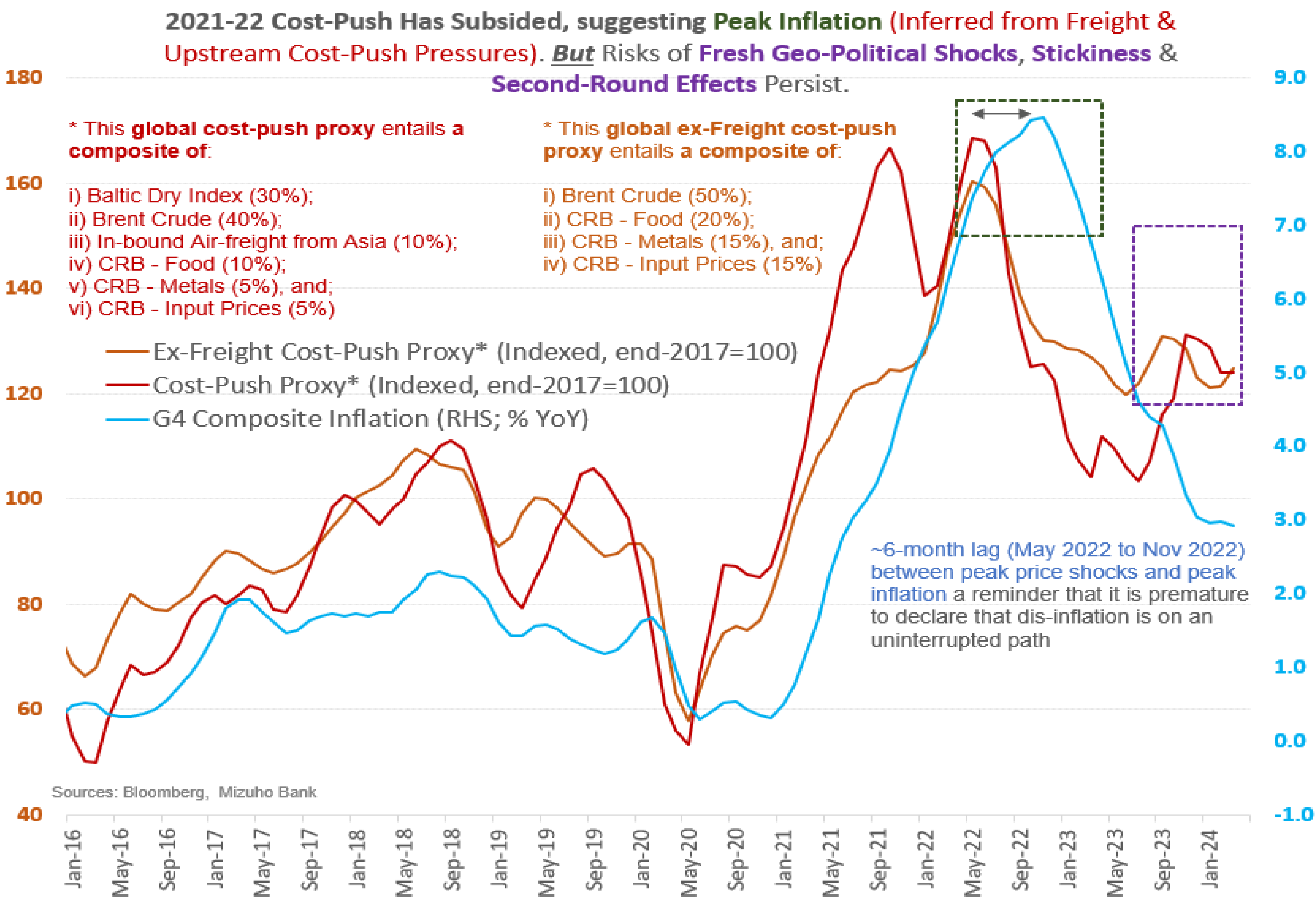
4c. Build-up of Volatility as "Carry" Buffer Declines ➔ Harder to *Keep Calm & "Carry" On*







5a. Bumpy Inflation: Irascible on Shocks (with a Lag) Underpinning "Last Mile" Worries …



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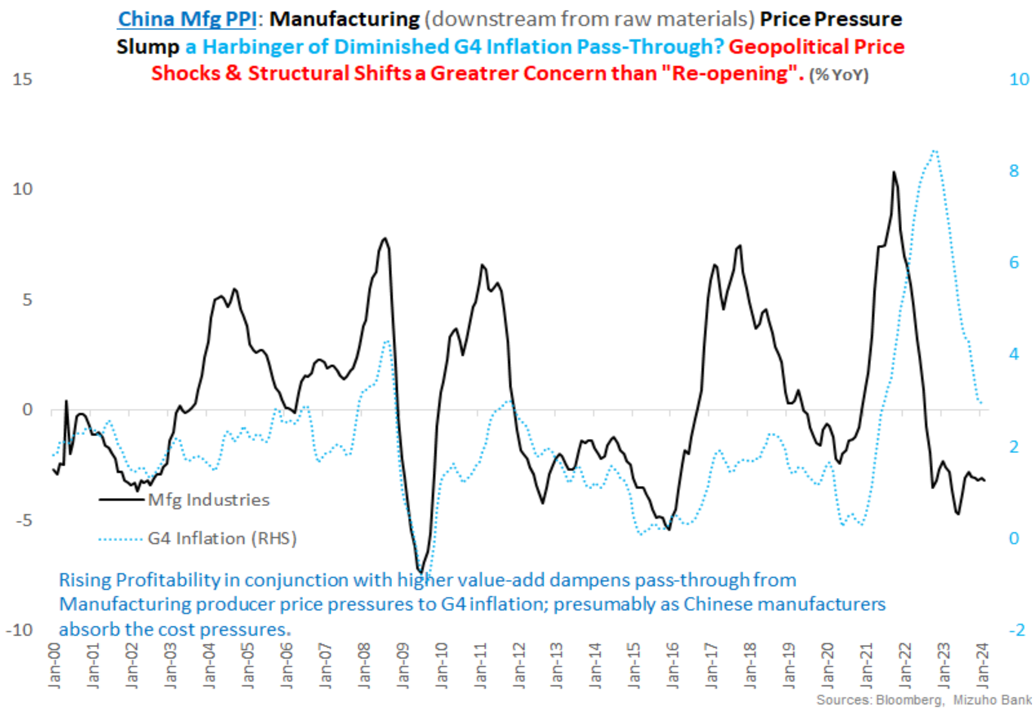
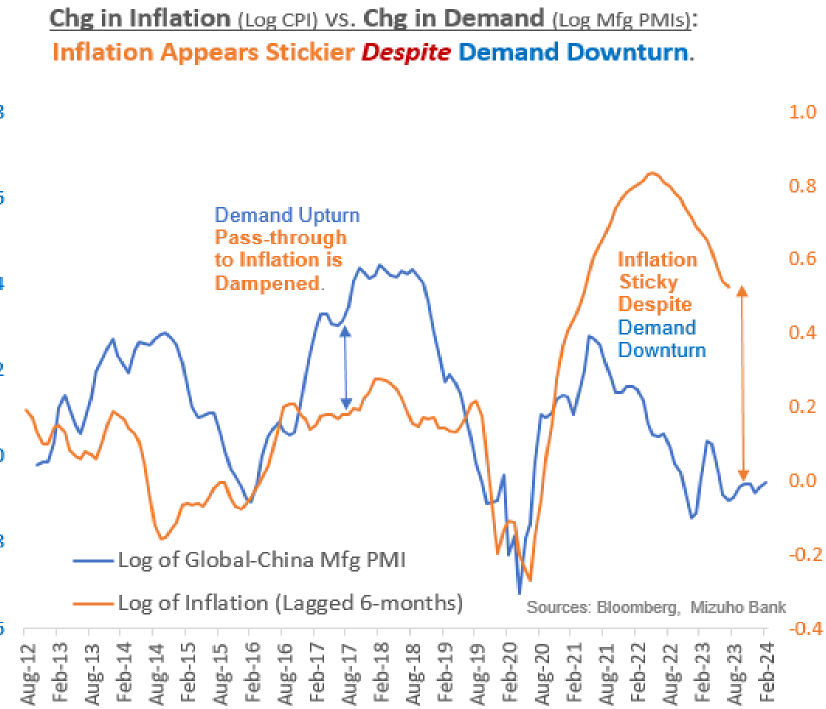
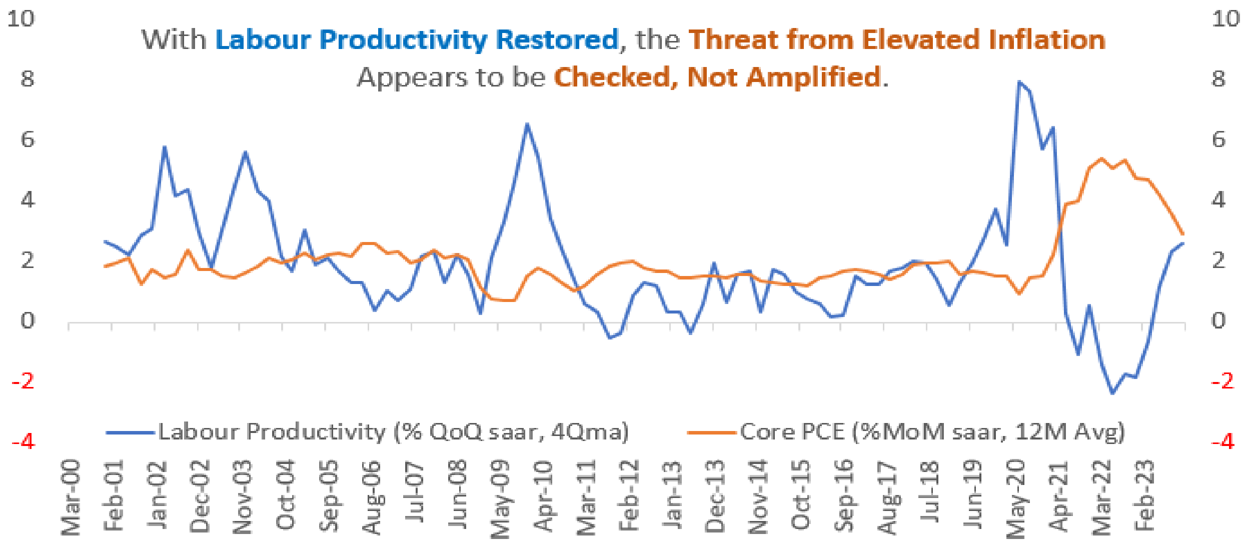
5b. Inflation: Geo-political Structural Lift … But Diminished as Cyclical Policy Lever

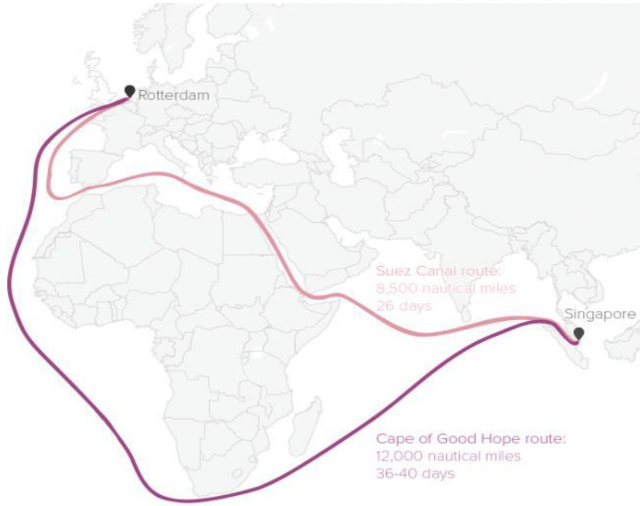






6. Geo-Politics: Conflict, Production & Passage

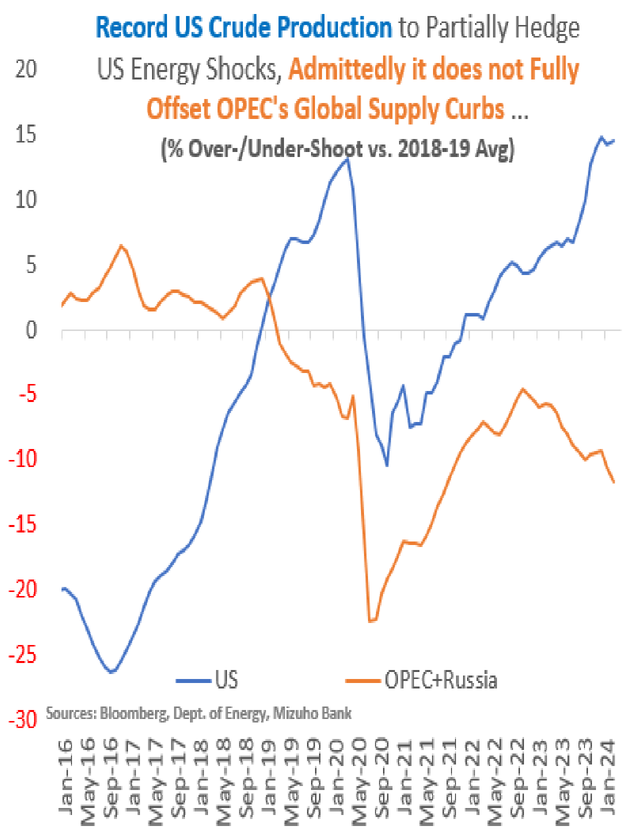
Straits of Hormuz:
Conflict risks
Most critical Oil choke point – Iran risk
20-22MBpD of Oil (~$1.2b worth)
Most of Saudi's Oil passage
~20-25% od seaborne Oil Passage
➔ as Large as a Doubling in Prices!

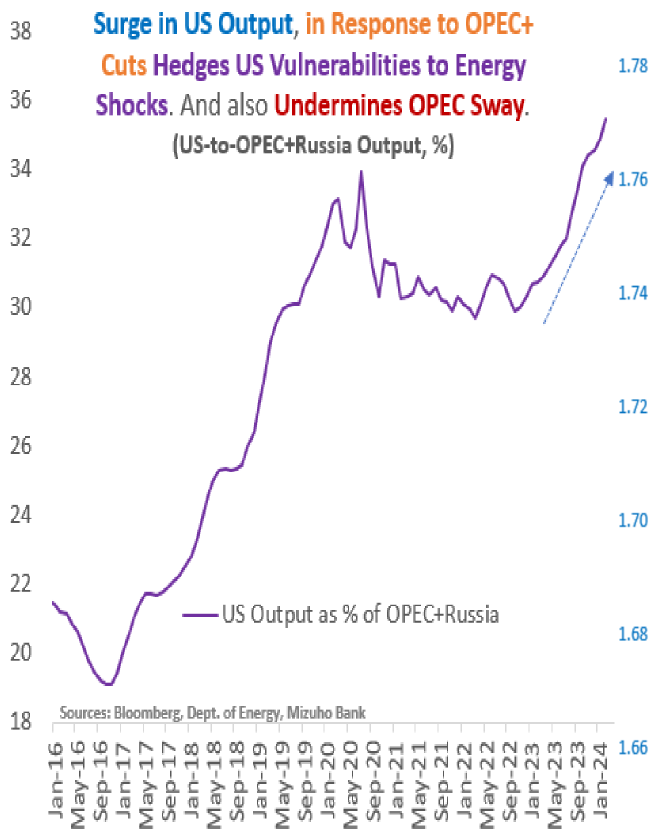


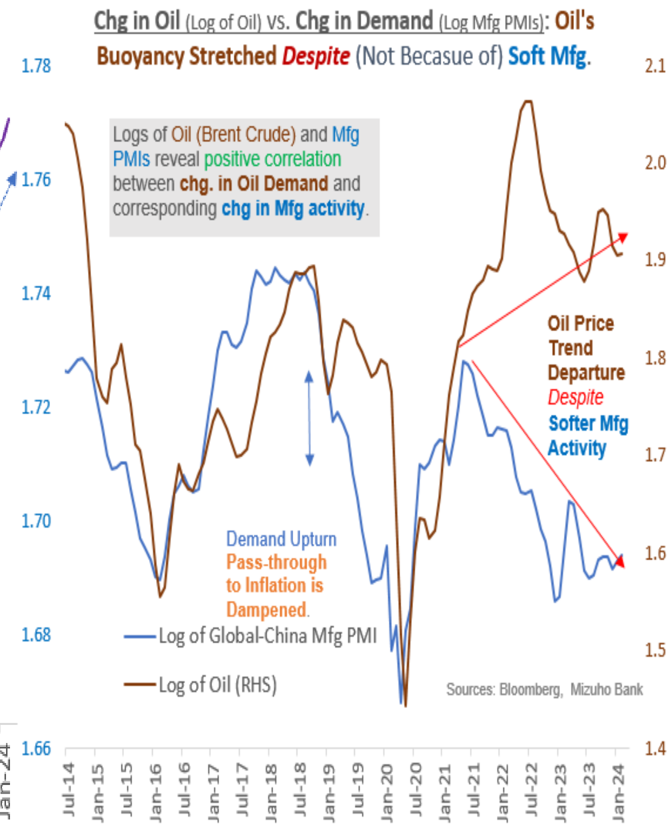
Red Sea:
Conflict risks - Houthi Rebels
Could disrupt passage of Oil
~12% of global shipping (~$1trln)
CoGH detour adds 3-4 weeks to Asia routes
➔ approximated to be 20% of shipping capacity impact

Panama Canal:
Water Crisis
(Non Conflict Risk)

7. Oil: Geo-Political Cues Hijack Near-Term, Demand to Dampen Later Further Out







- **OPEC's ability to exploit**/accentuate geo-political premium to boost prices is **diminished**; deferring to:
  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**.
- *Even* with risk of geo-political flares, **likely to trend/settle lower ~ $60-80**, not durably surmount $100.
- Siege of the Straits of Hormuz can send crude spiking to $130-160. But a temporary "tail risk".

8. “Crowding Out”: Geo-Politics Heightens Uncertainty & Accentuates “Crowding Out” Risks

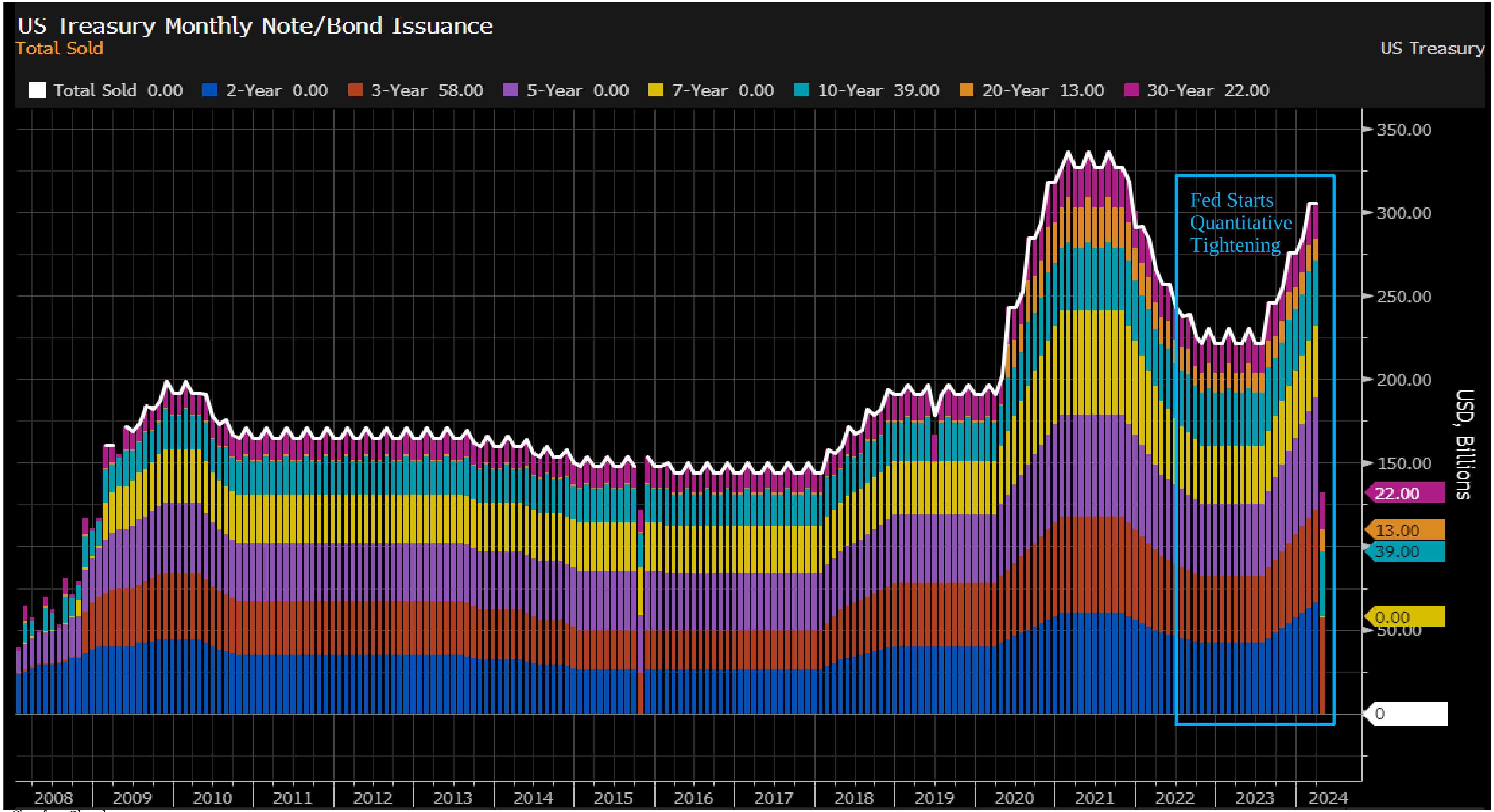
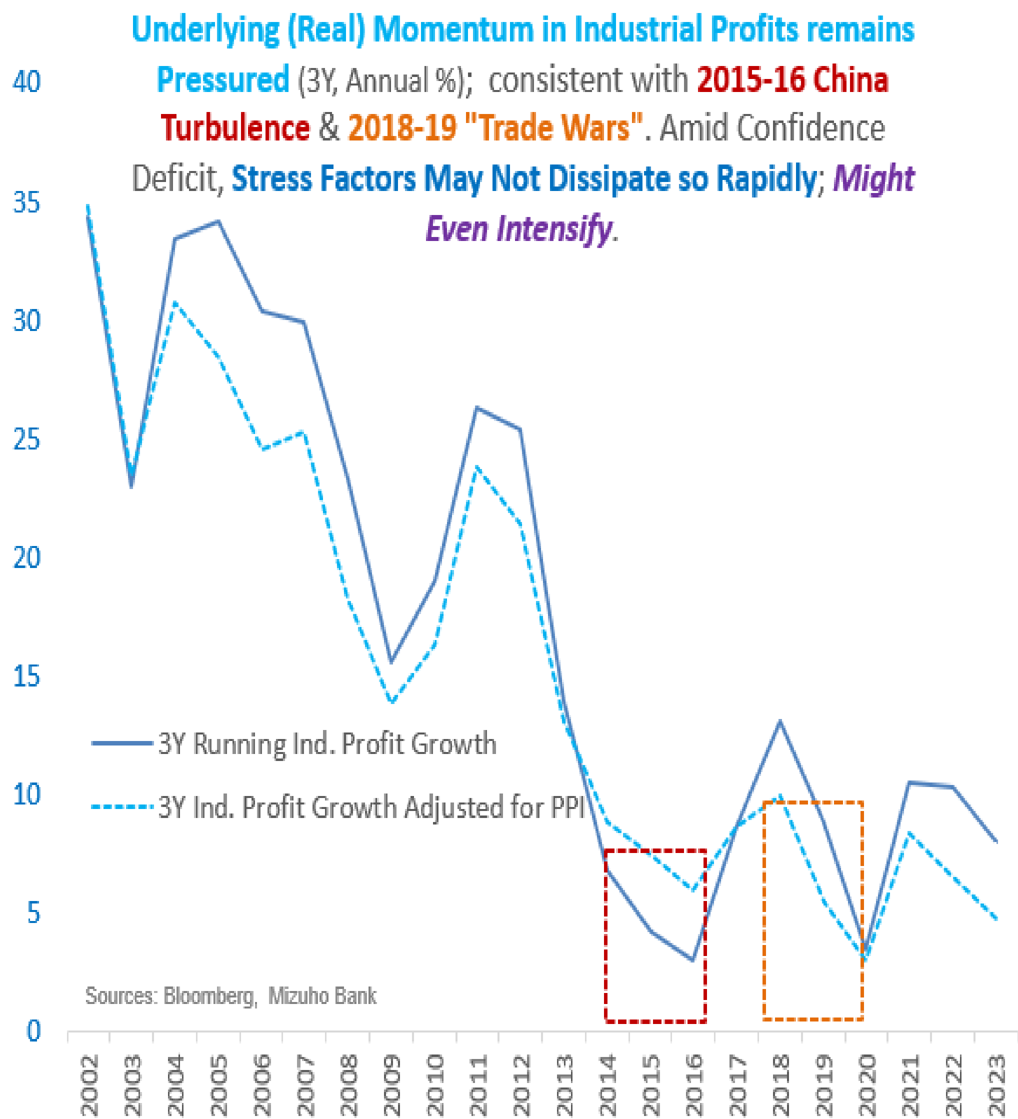
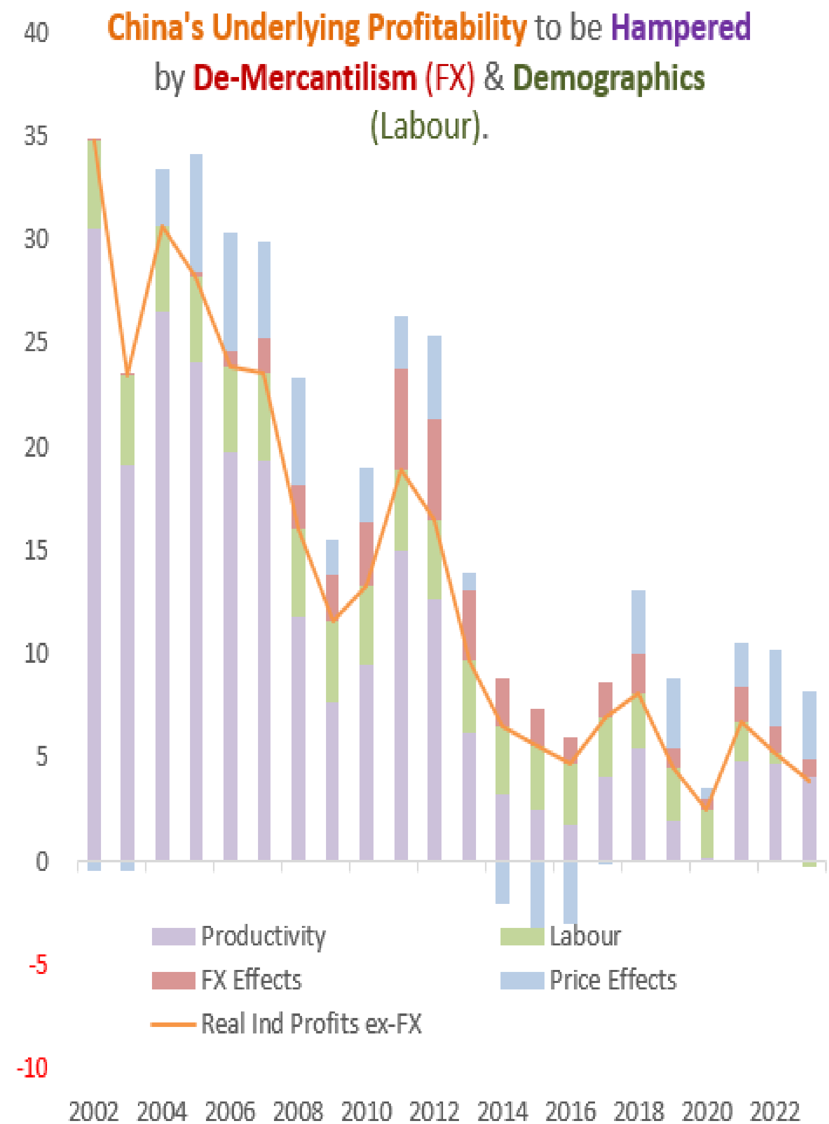


Chart from Bloomberg

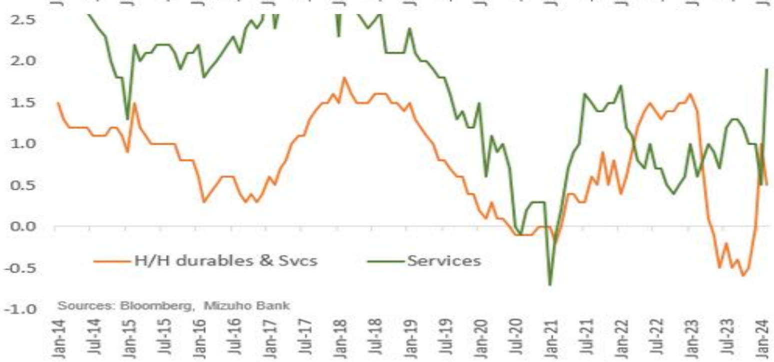
- **Insofar that fears of US debt/unsustainble fiscal trajectory dominate, yields may ironically go higher;**
- **as heightened (but not acute) geo-political risks is associated with increased debt issuance on defense (Ukraine/Gaza) to a greater degree than (yield suppressing) haven demand.**
- **Conspires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

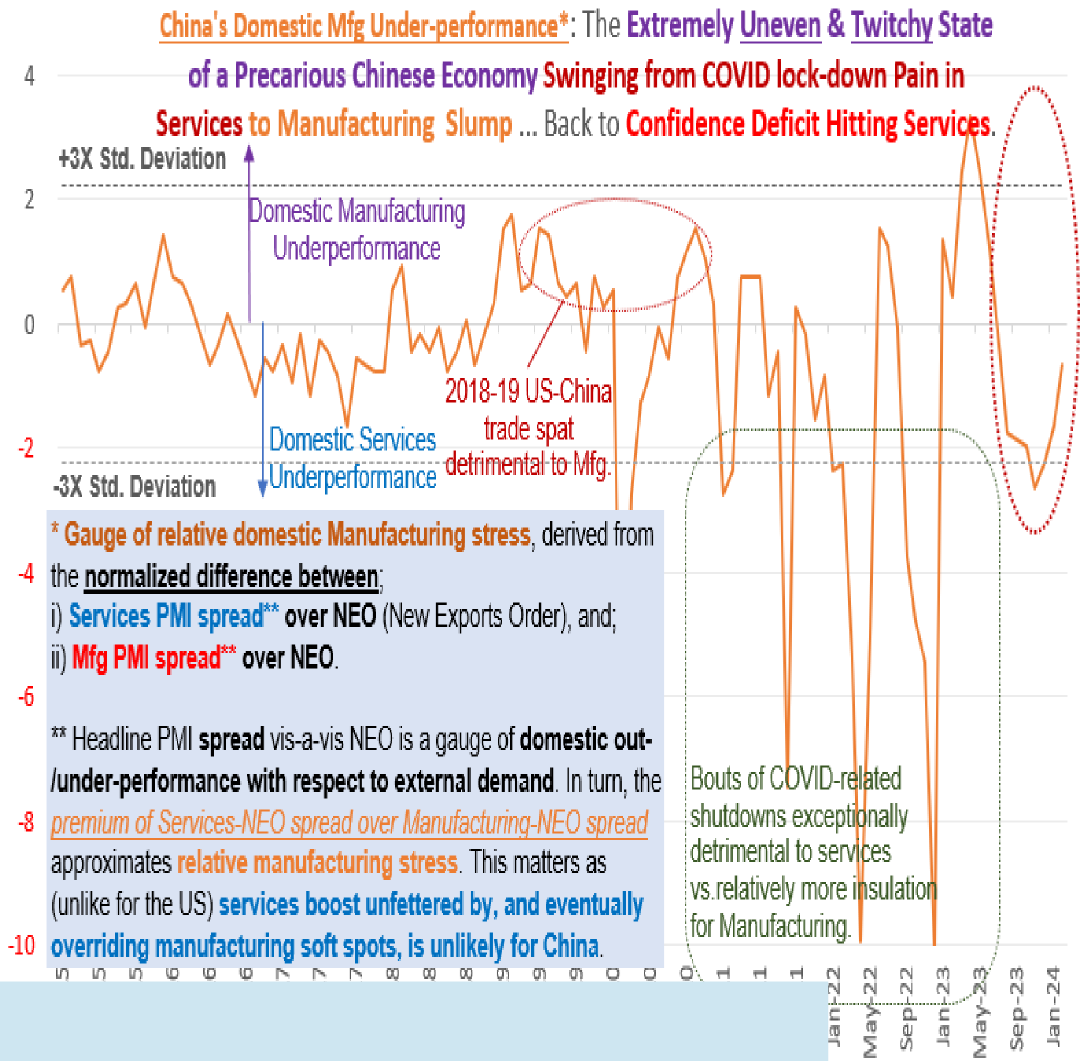
9a. China: Structural Impediments & Constraints





9b. China: Chronic Confidence Deficit





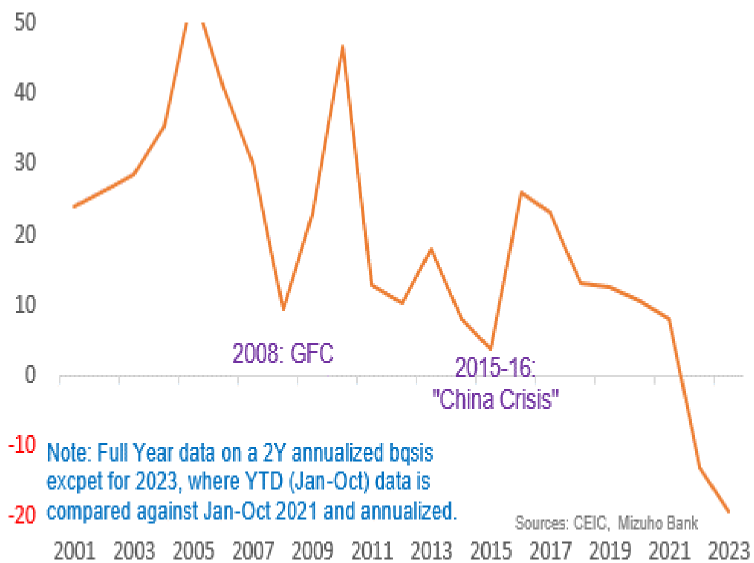
Binding Structural Impediments

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

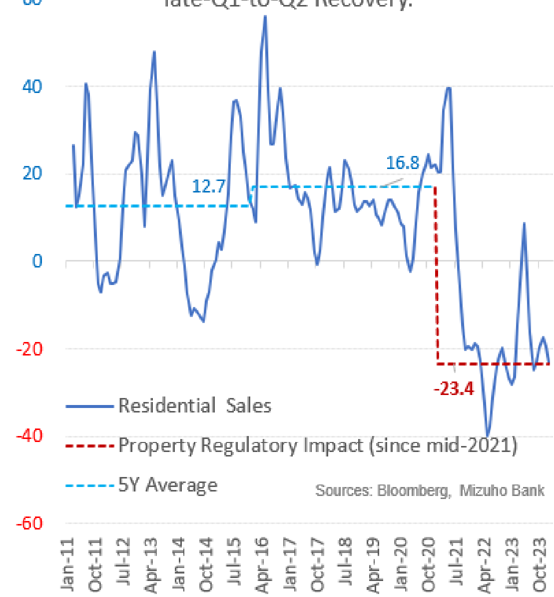
➔ Confidence overhang hampers big-ticket spend and investments, *compromising growth multipliers.*

9c. China: Property Overhang Will Take a Lot to Reverse

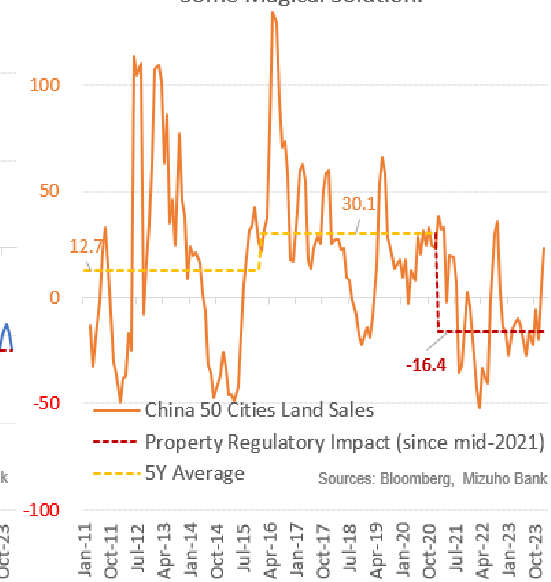
2Y Annualized Home Sales: **Demand, Unshakeable Through Financial Crises**, **Battered by "Common Prosperity"**.



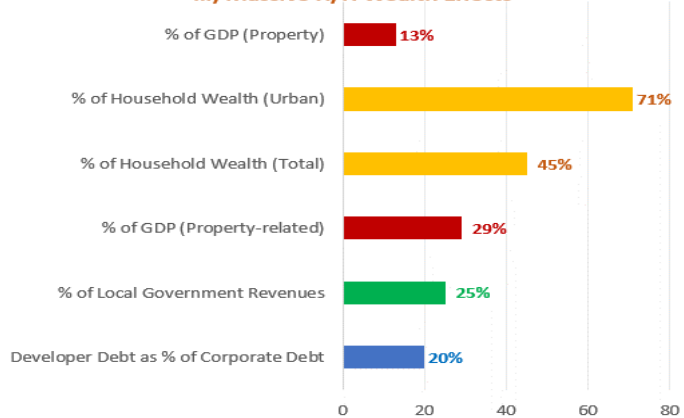
China Property Sales: **Hounded by Confidence Issues**. Base effects flatter late-Q1-to-Q2 Recovery.



China Land Sales: **Local Government Hobbled as Part of the Problem**; Not Some Magical Solution.



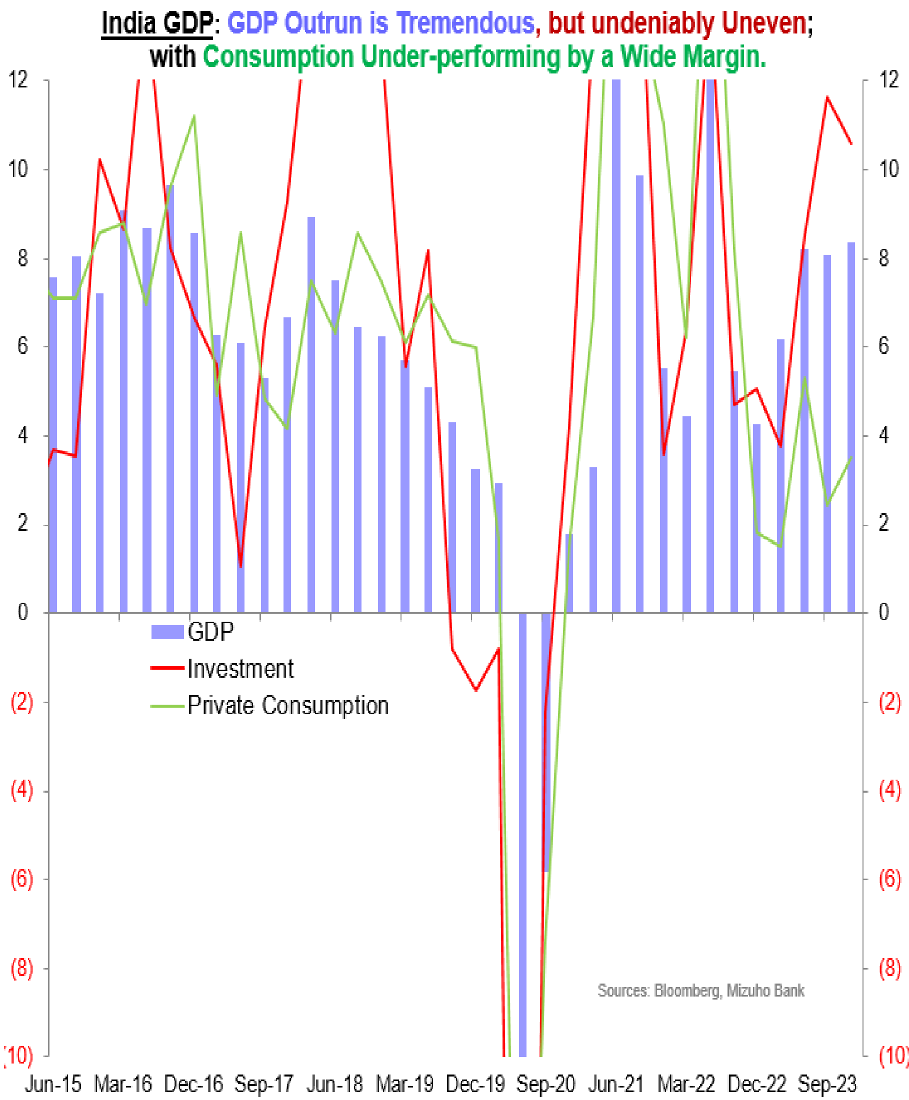
Property Sector Liabilities Will Ripple Far Given **High-Multipliers** via; i) **related Industries/Services**; ii) **Significant Local Government Financing Reliance**, &; **iii) Massive H/H Wealth Effects**

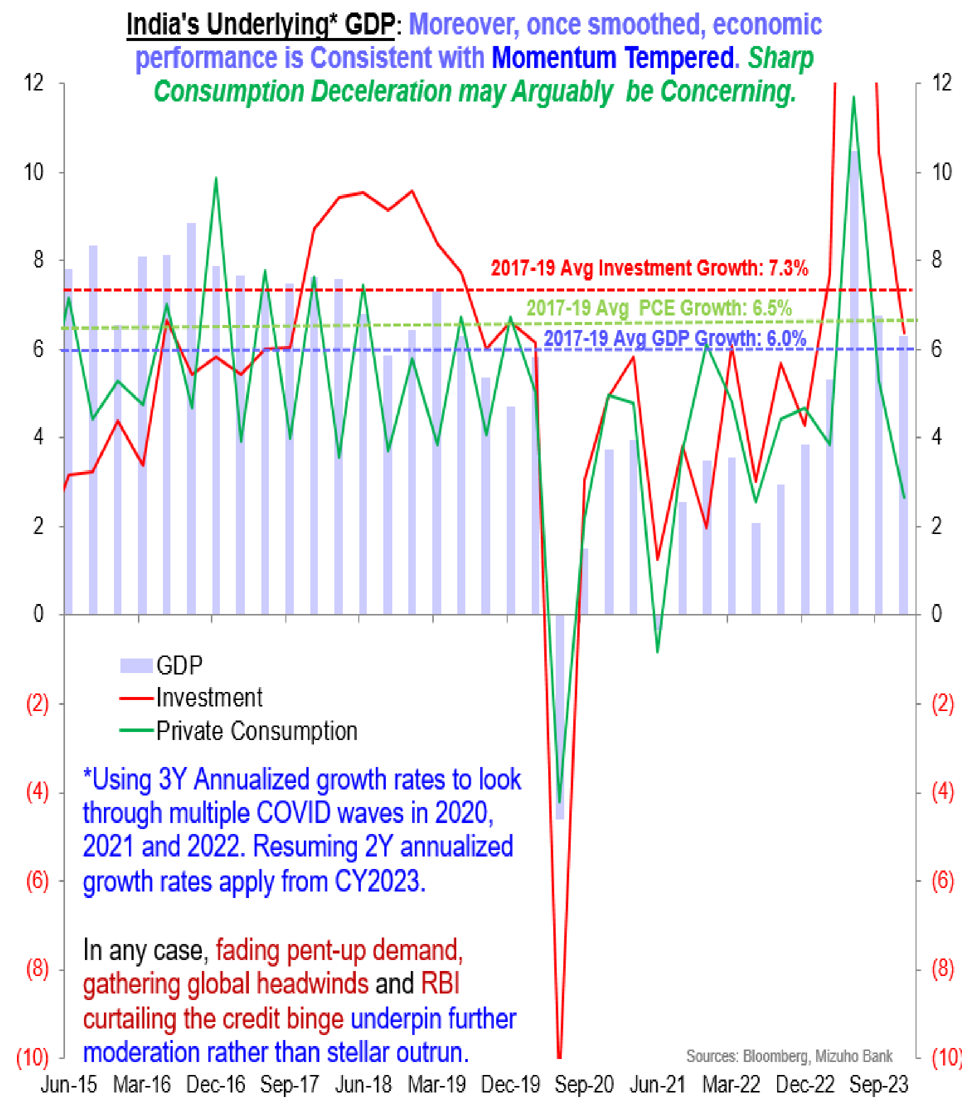


Property Overhang

- Backstop critical but Falls Short!
- Financing cashflow is welcome
- 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.

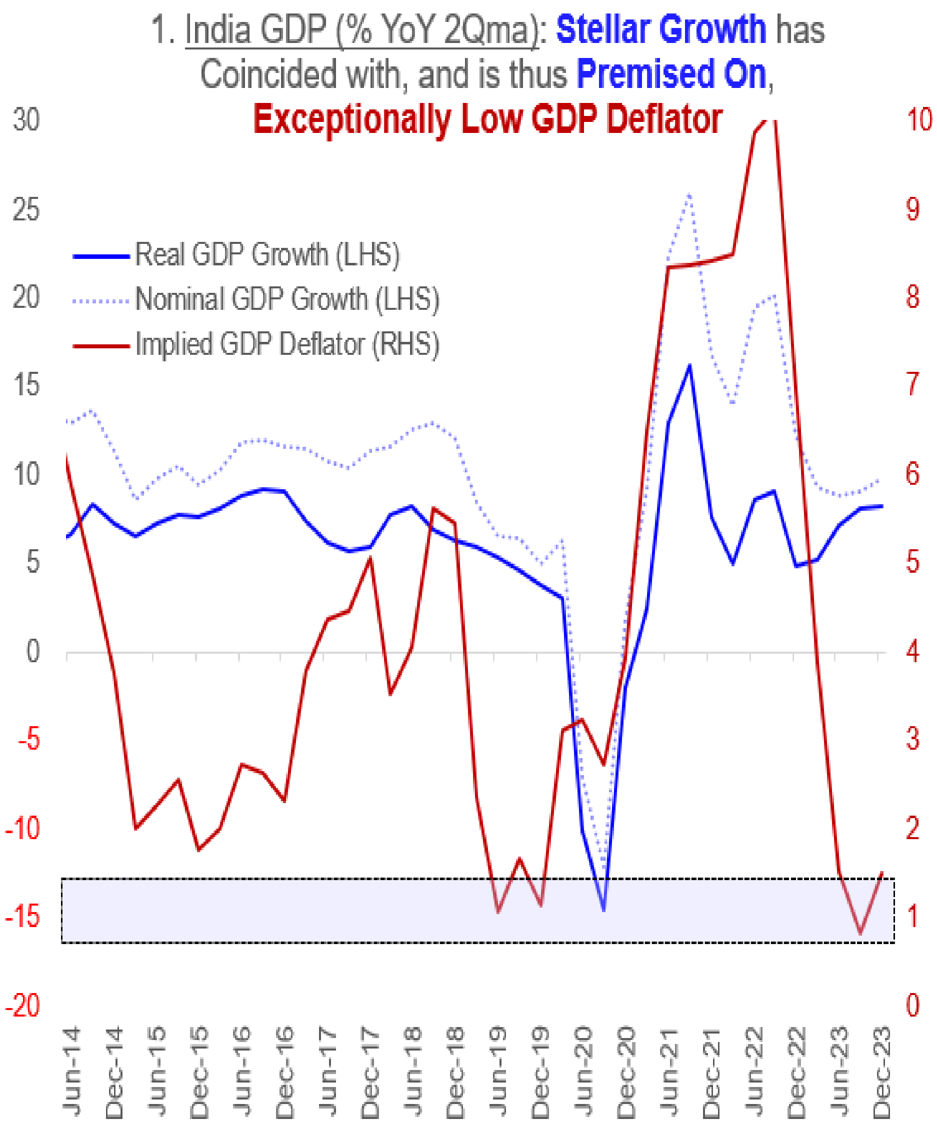
10a. India: Tempering Economic Optimism ➔ "Borrowed" & Uneven Growth…

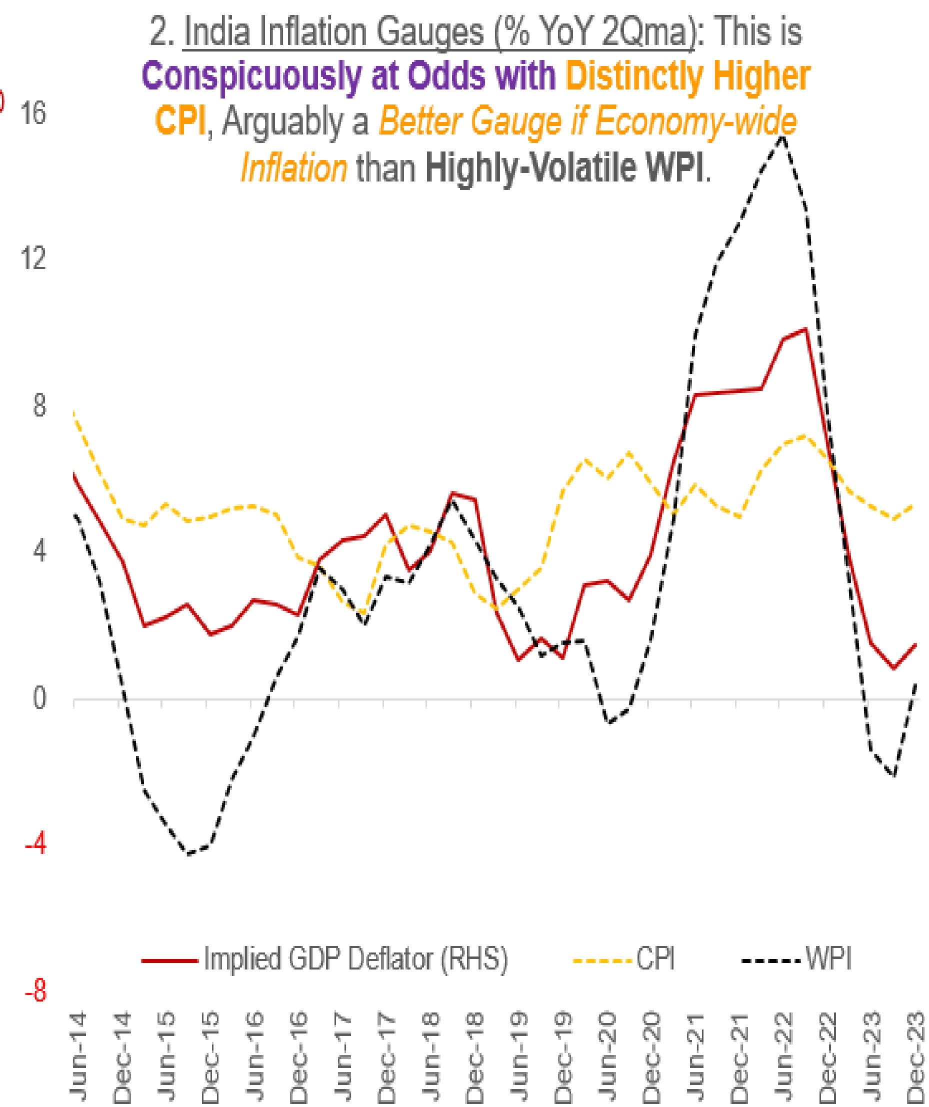




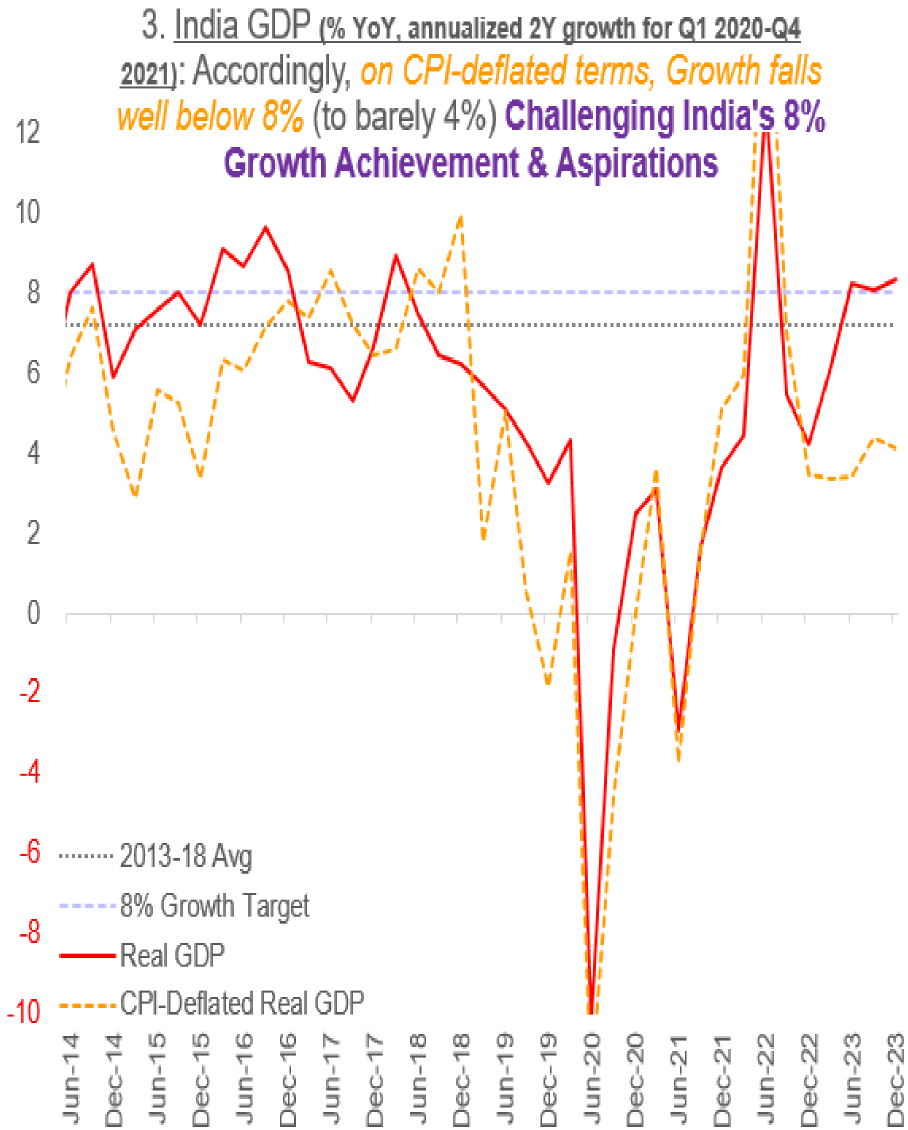
1. **Buffer from External Headwinds** is welcome but far from Sufficient to deflect Global Risks

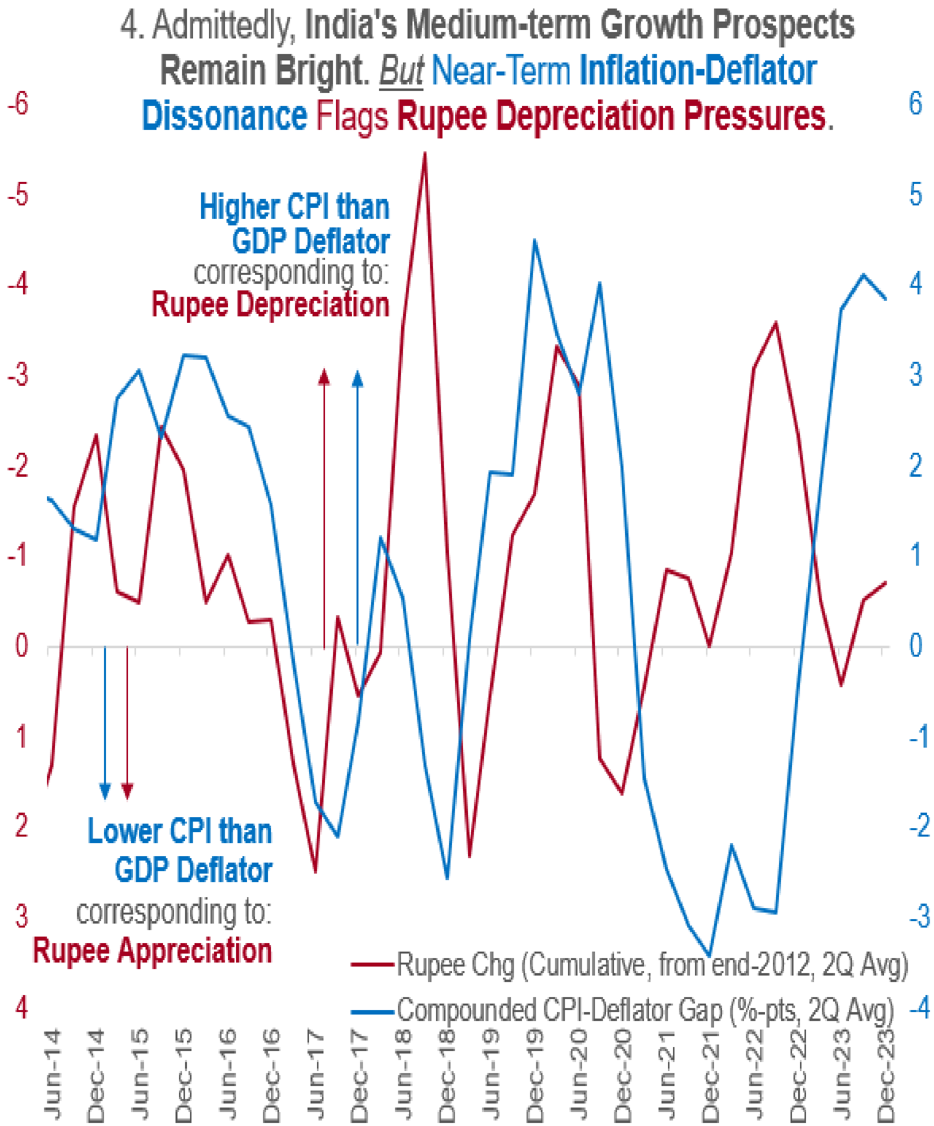
10b. India: Tempering Economic Optimism ➔ Growth Inflated by Extraordinarily Low Deflator?



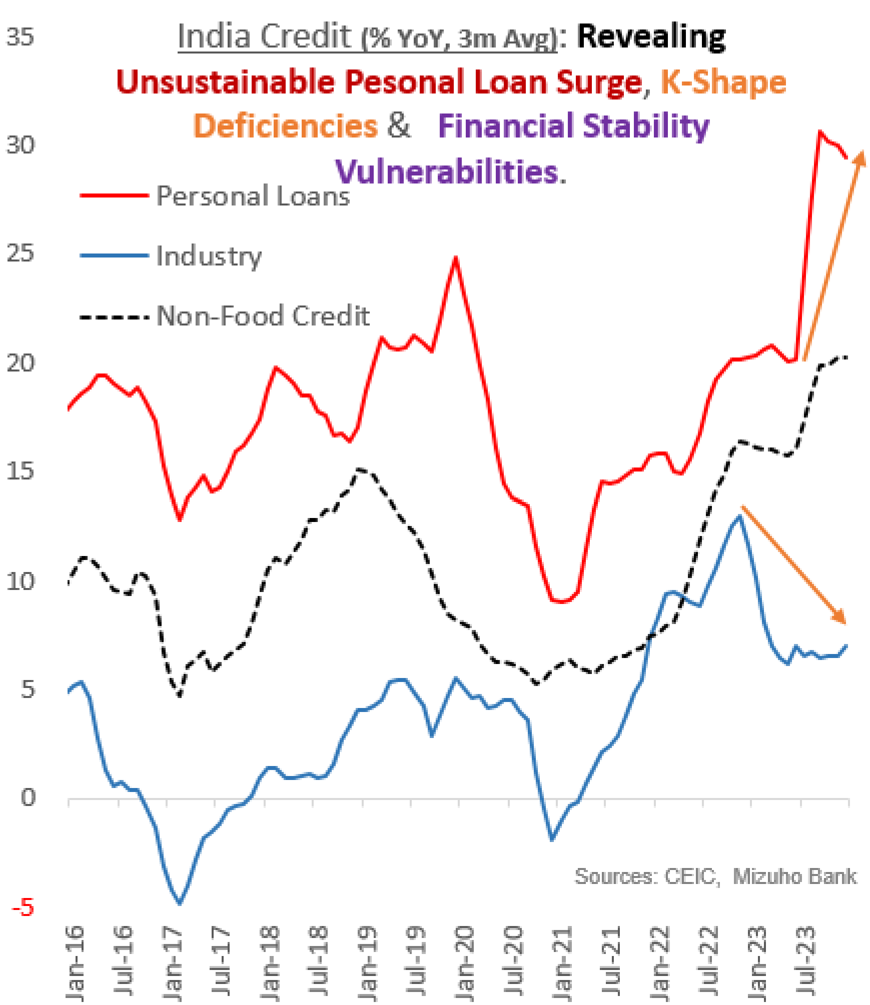


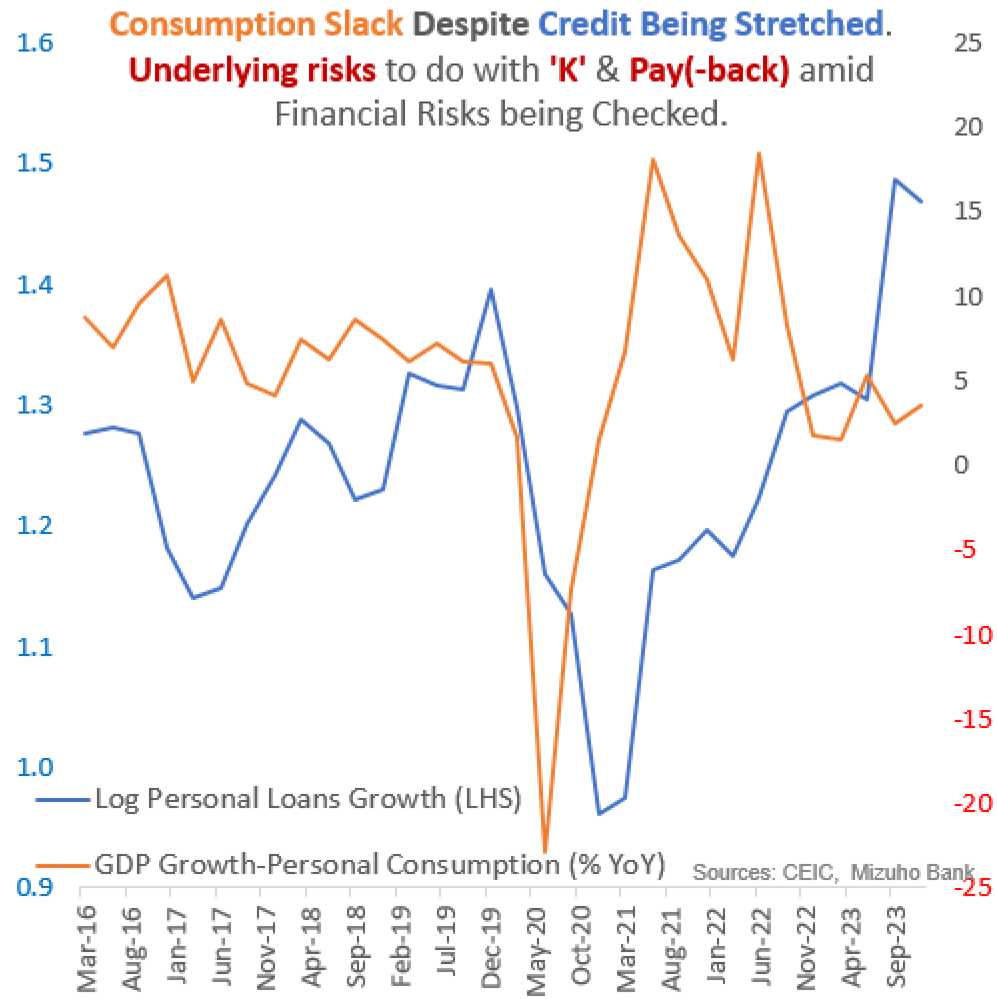
10c. India: Tempering Economic Optimism ➔ In Fact, CPI-based Growth is Barely 4%!





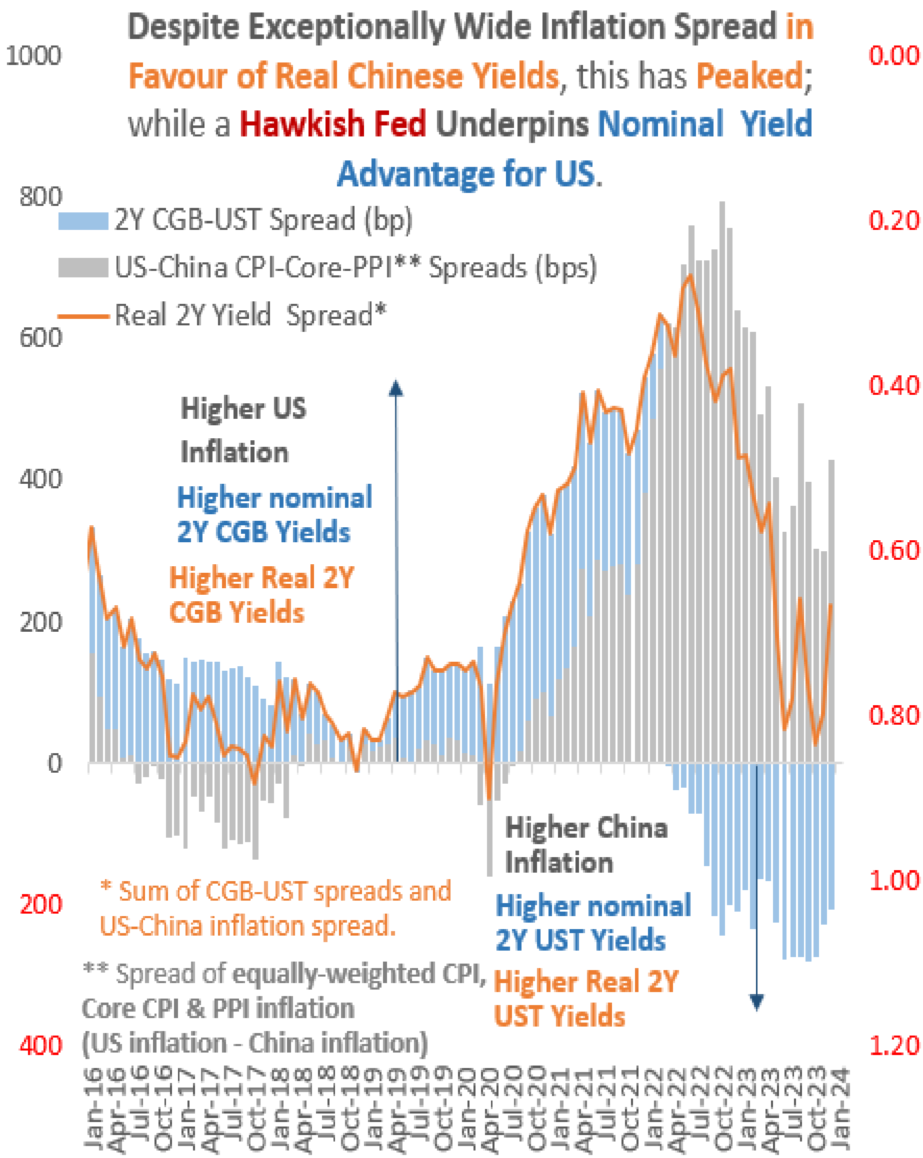
10d. India: The Consumer & the "K"

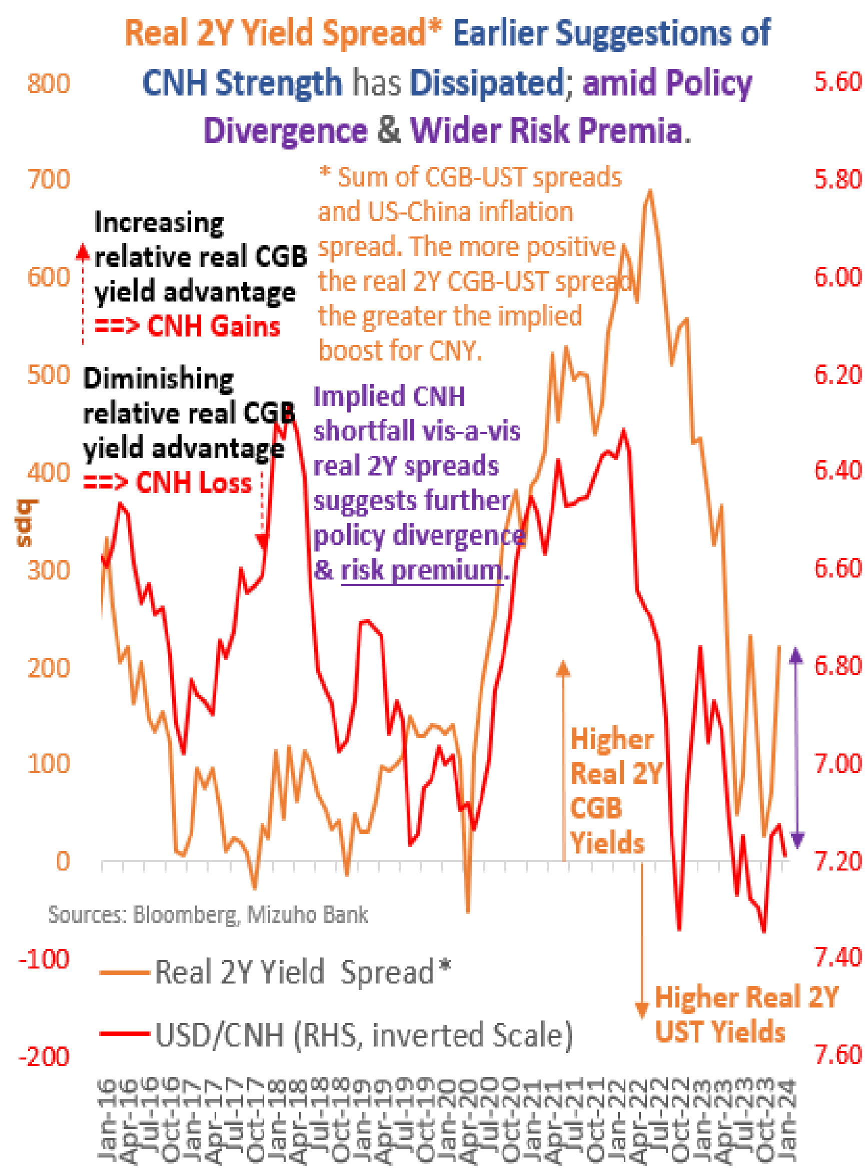




2. **<u>Unsustainable Credit Binge</u>** by "Middle Class" neither sustainable, nor pervasive enough to lift.
3. **<u>Uneven growth/drivers</u>** apparent in equities boom, showing concentrated allure and not reflected across all India firms/businesses.

FX: CNH - Impacted by "Fundamental" Yield Support Eroded …





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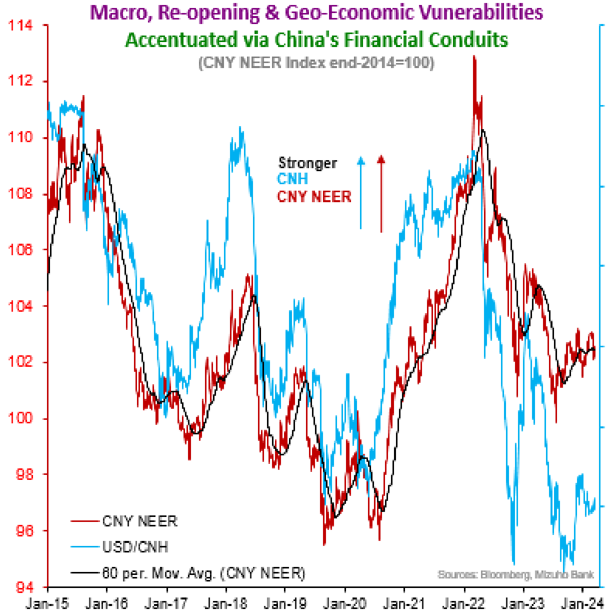
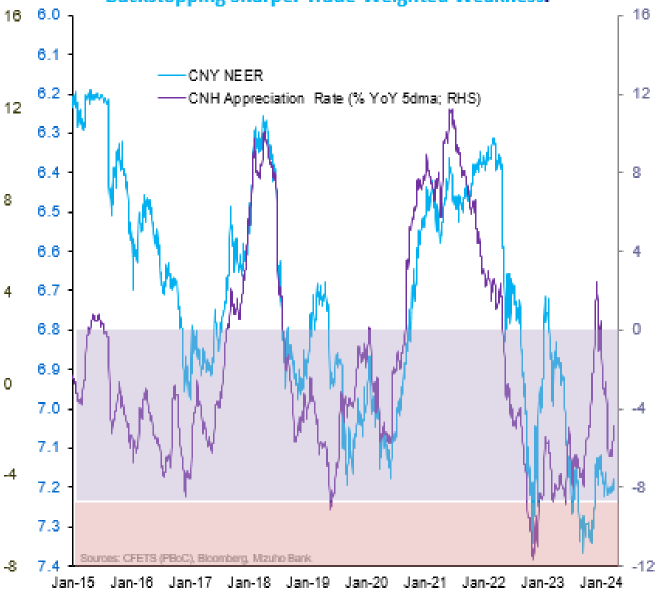
FX: CNH - … & is Still Not Out of the Woods

Drop in CNY NEER (& Sharper collapse in CNH) reflects Macro, Re-opening & Geo-Economic Vunerabilities Accentuated via China's Financial Conduits



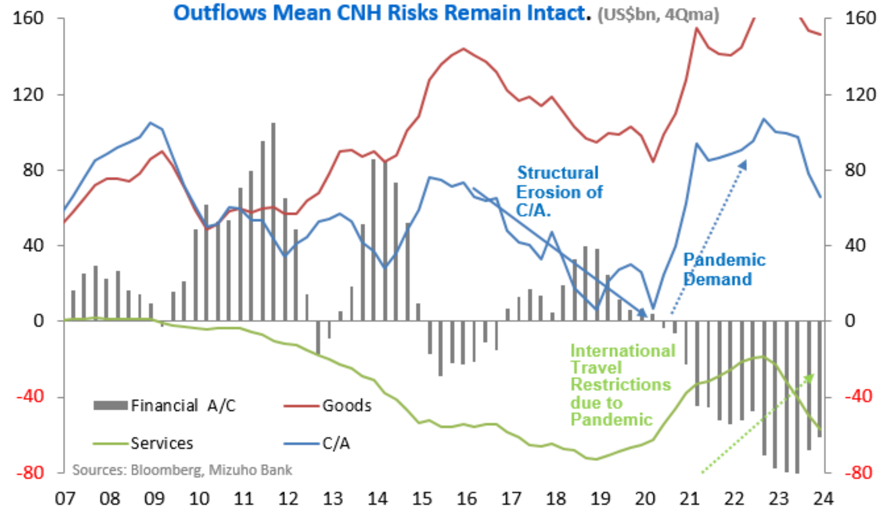
Sharp CNY NEER Depreciation Reflects Economic Disappointment, *Accentuating* Pre-existing Re-opening & Geo-Economic Drag Forces.

CNH Depreciation Validates PBoC Intervention; Backstopping Sharper Trade-Weighted Weakness.



CNY NEER Traction is Undermined by Lingering US-China Risks amid "Unforced" Policy Stumbles. USD trend is instead dictating relative CNY shifts! (Index end-2014=100)

China: Goods Surplus Surge from Pandemic Demand & Diminished Net Tourism Outflows, *provided a Temporary Boost;* but Capital Outflows Mean CNH Risks Remain Intact. (US$bn, 4Qma)



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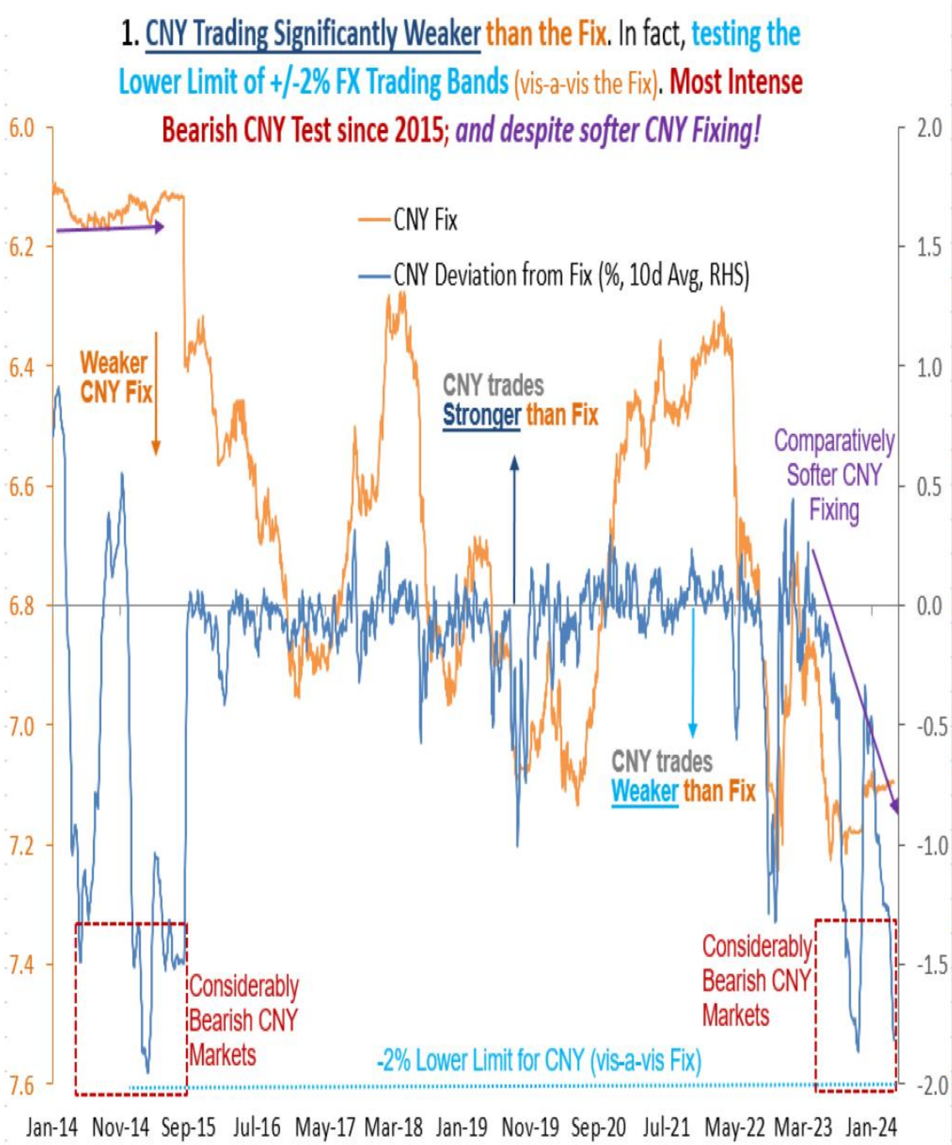
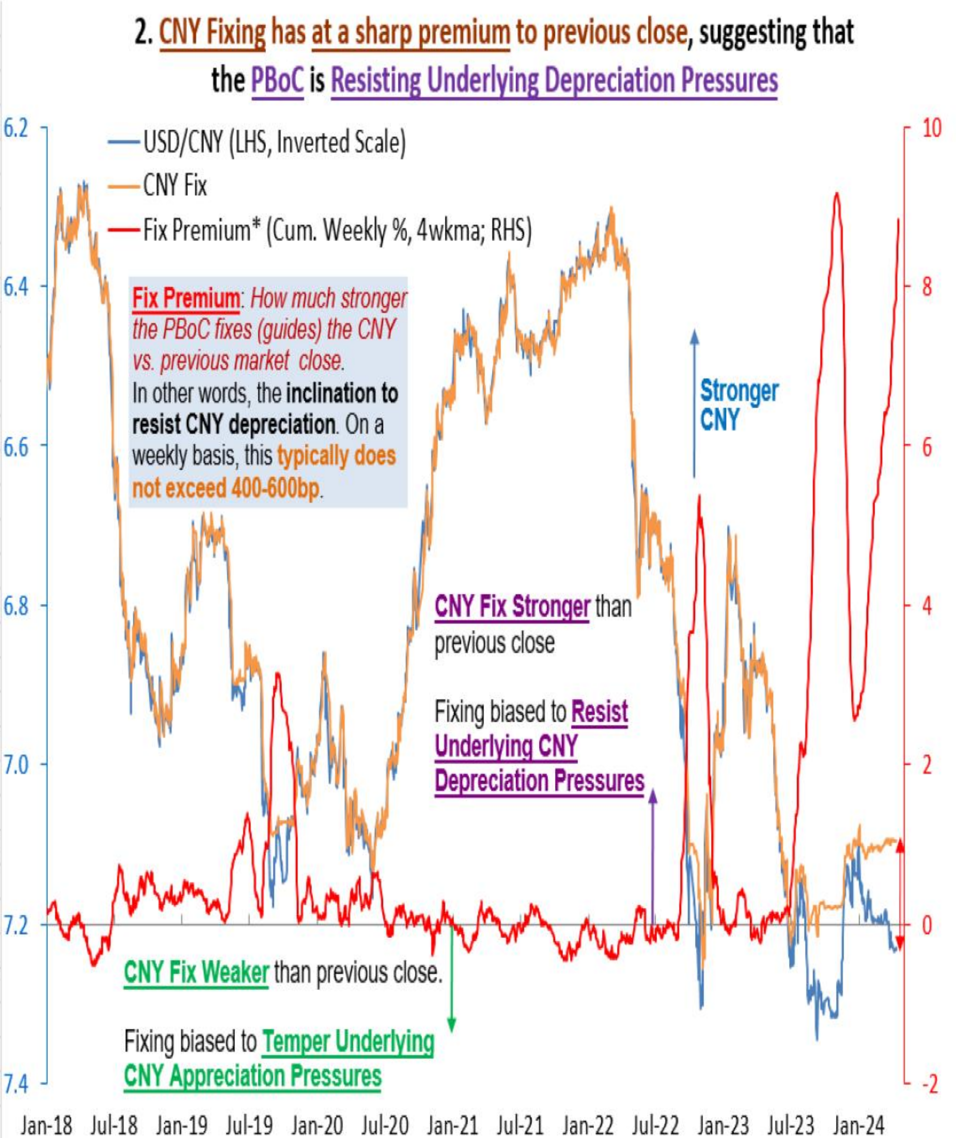
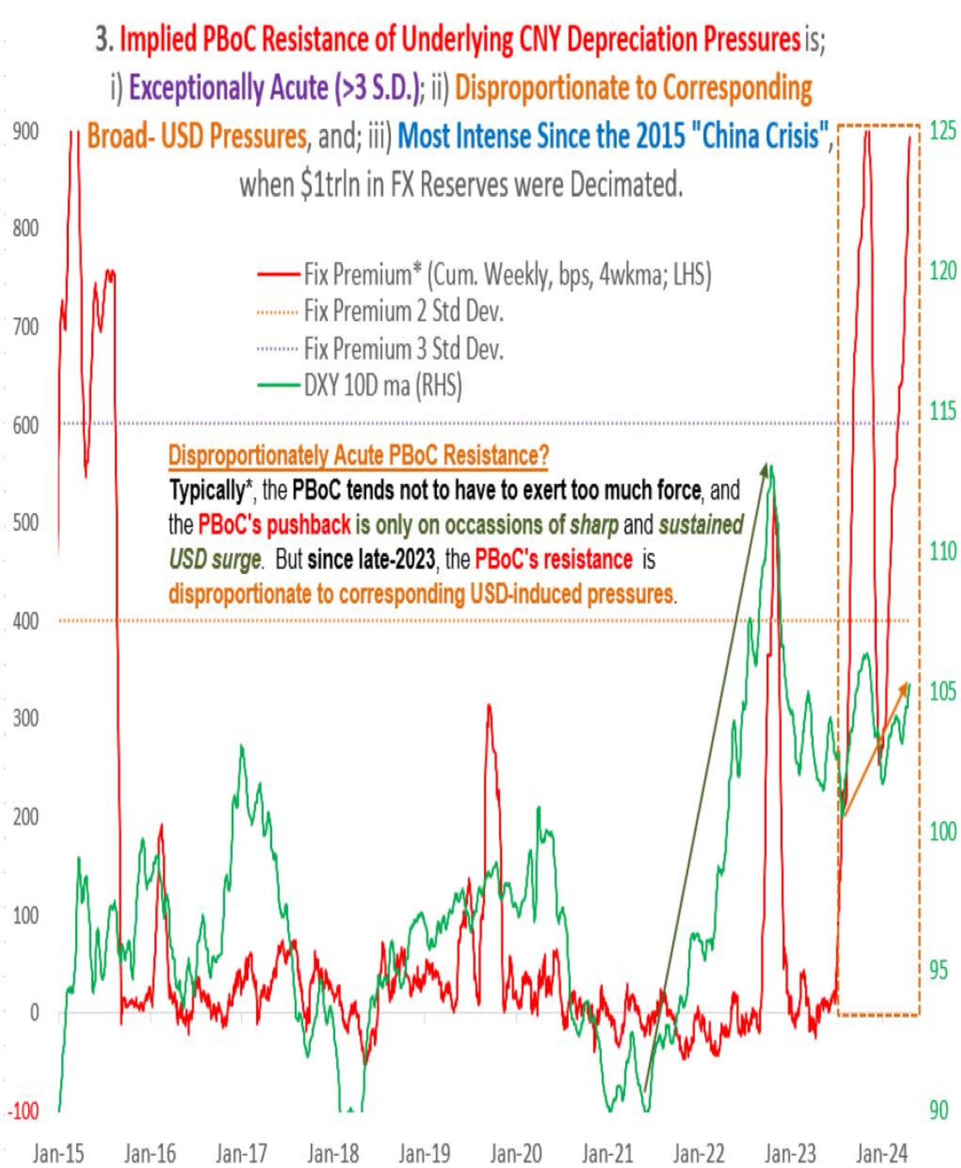
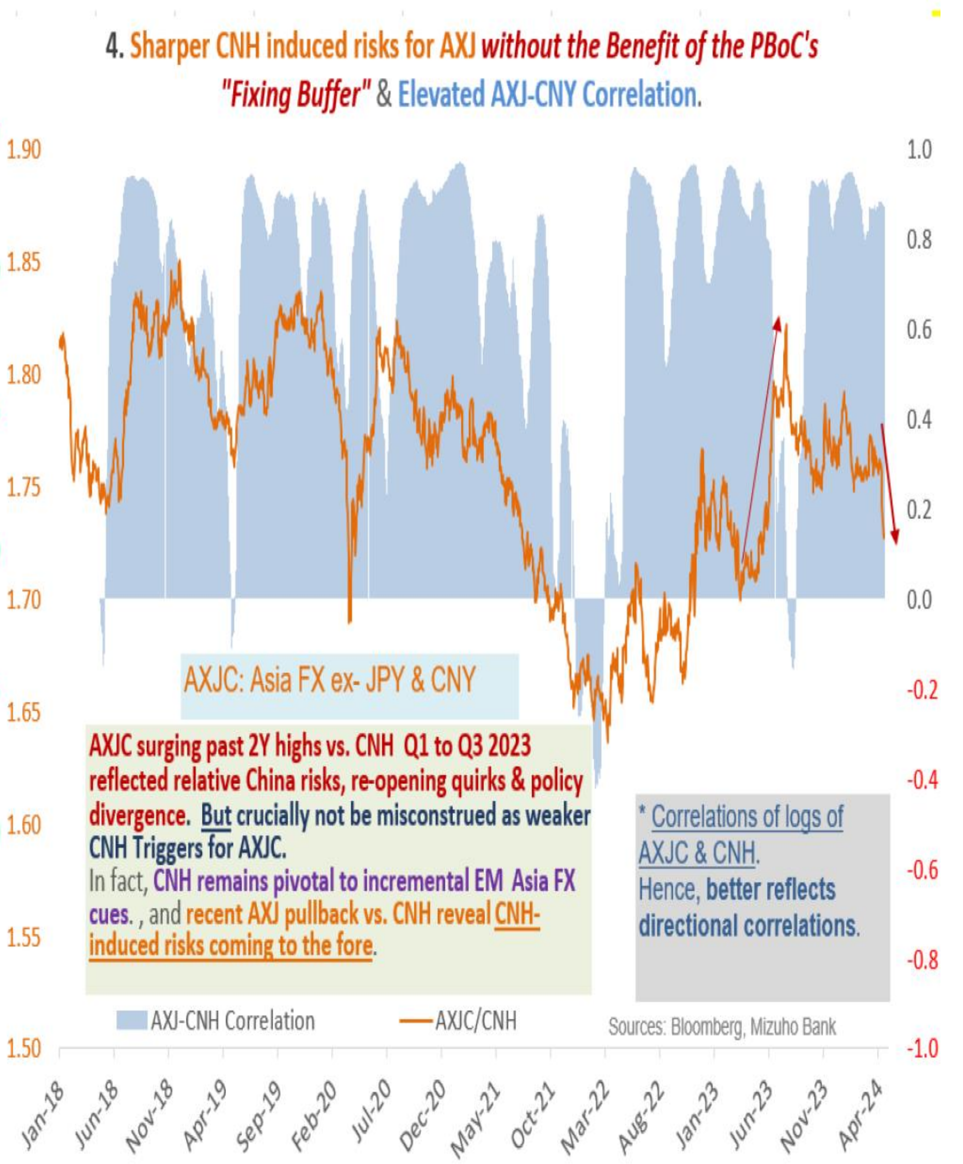
FX: CNH – Pressures & Policy Dilemma Abound





FX: CNH – Pressures & Policy Dilemma Abound





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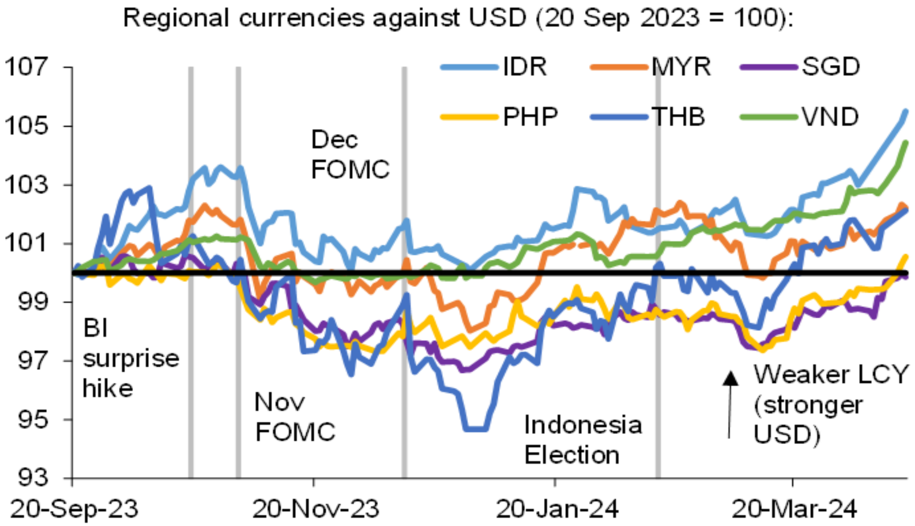
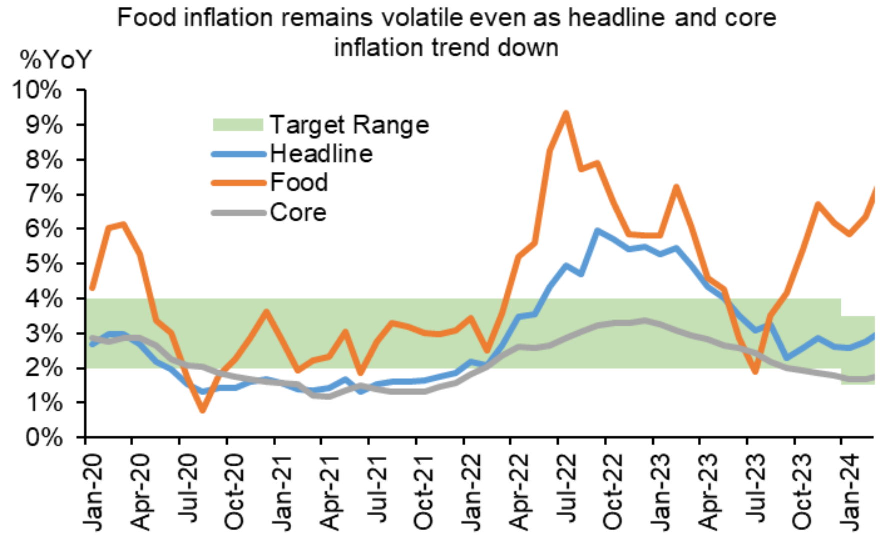
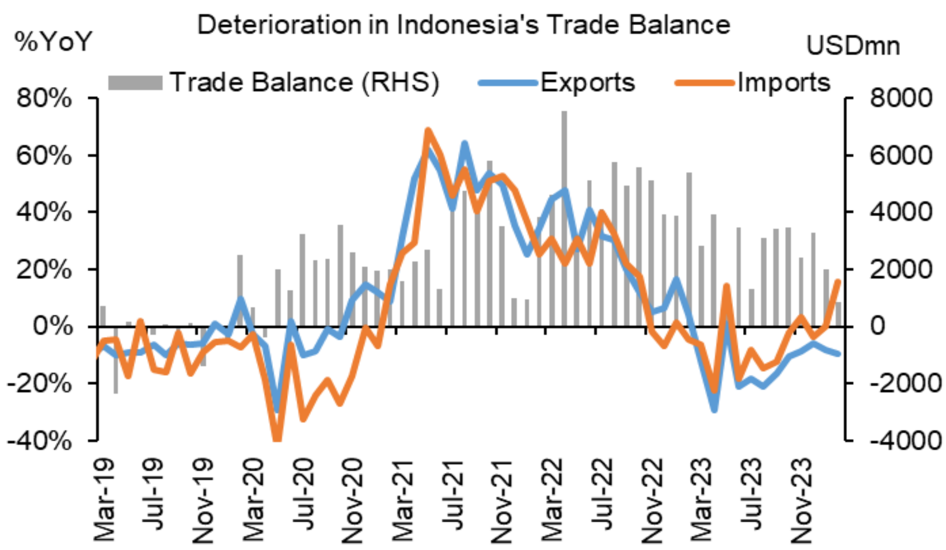
FX: IDR – Pressure from "Twin Deficit" Brink & China/Policy Risks



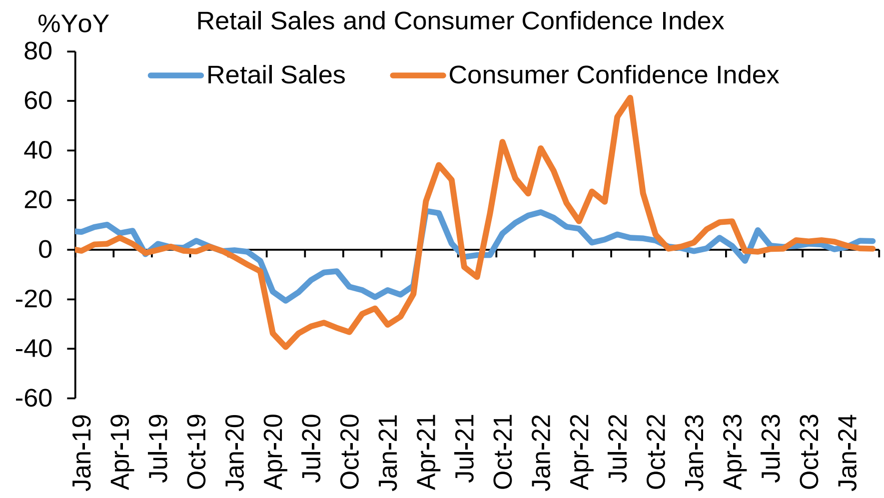
Source: Bloomberg; Mizuho Bank



Source: CEIC; Mizuho Bank

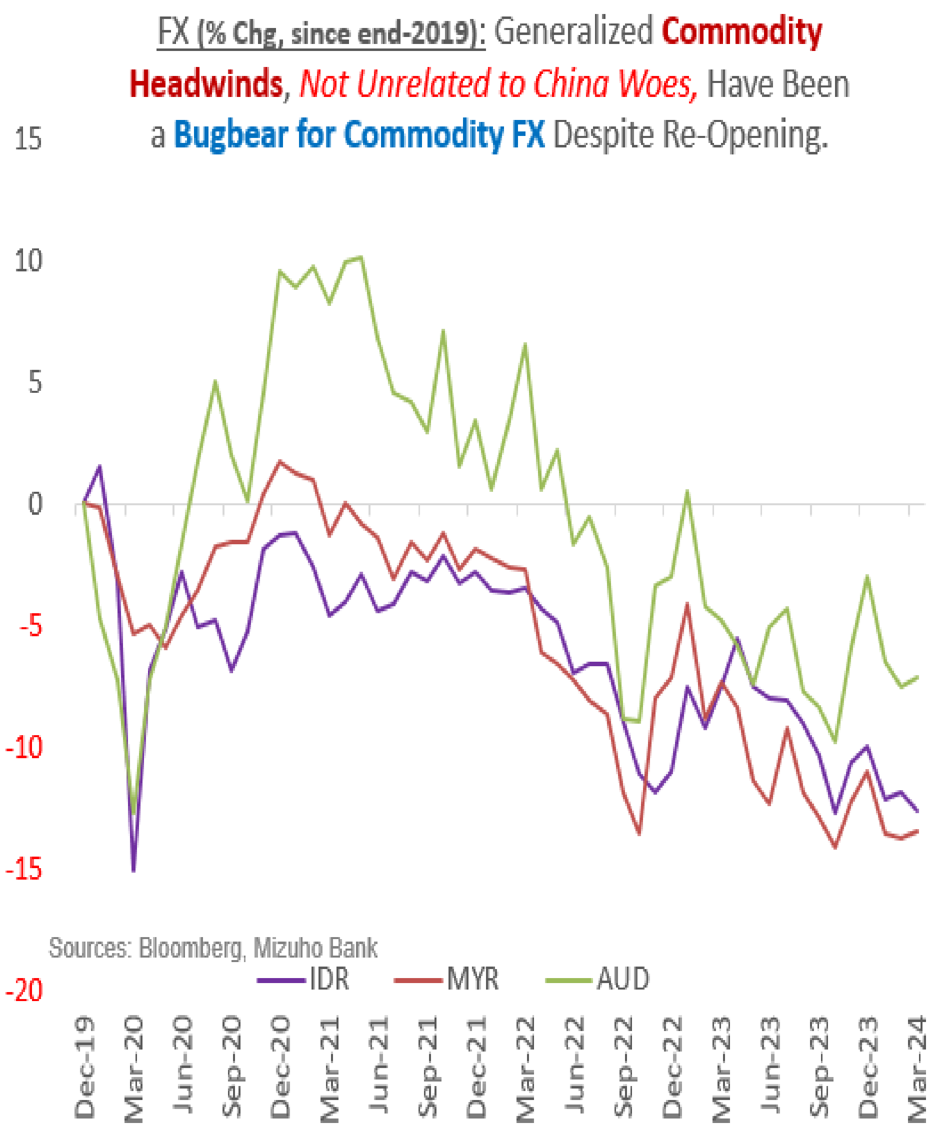


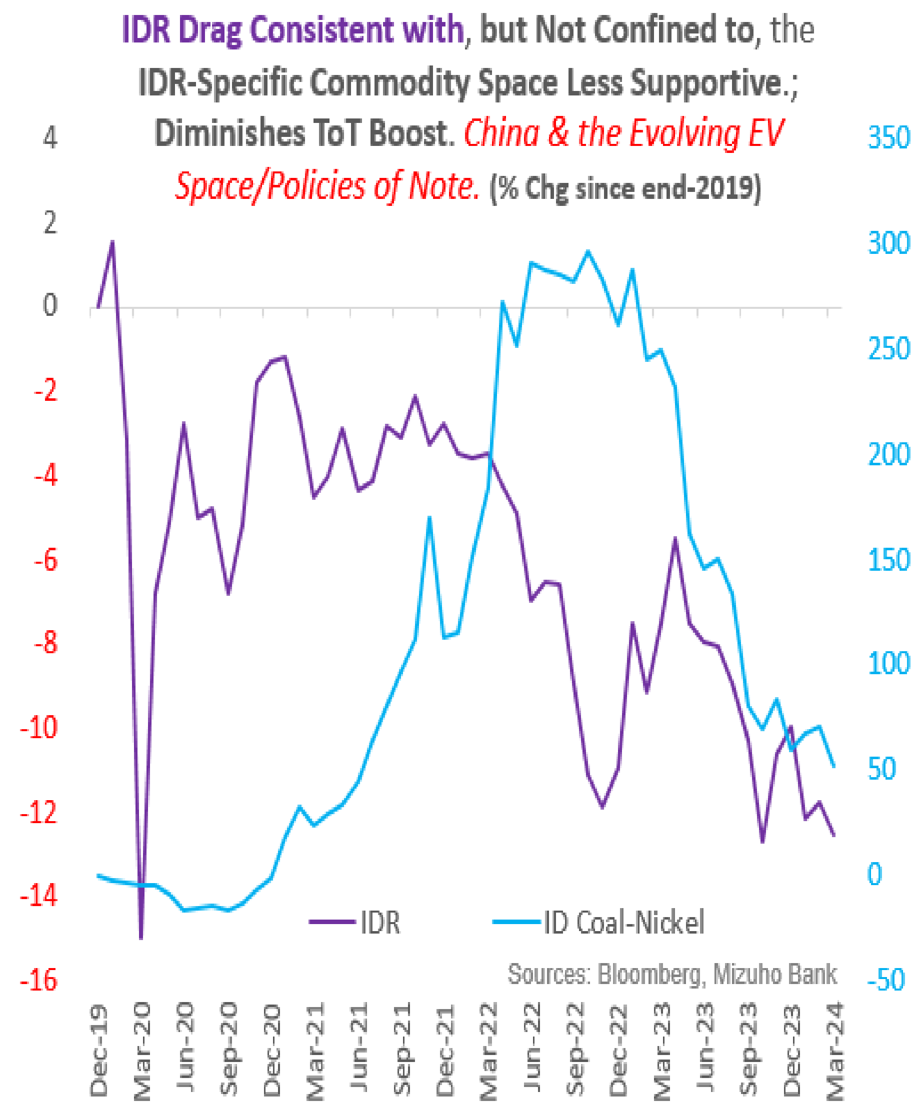
Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

FX: IDR – Commodities & Global Trade Blowback Risks

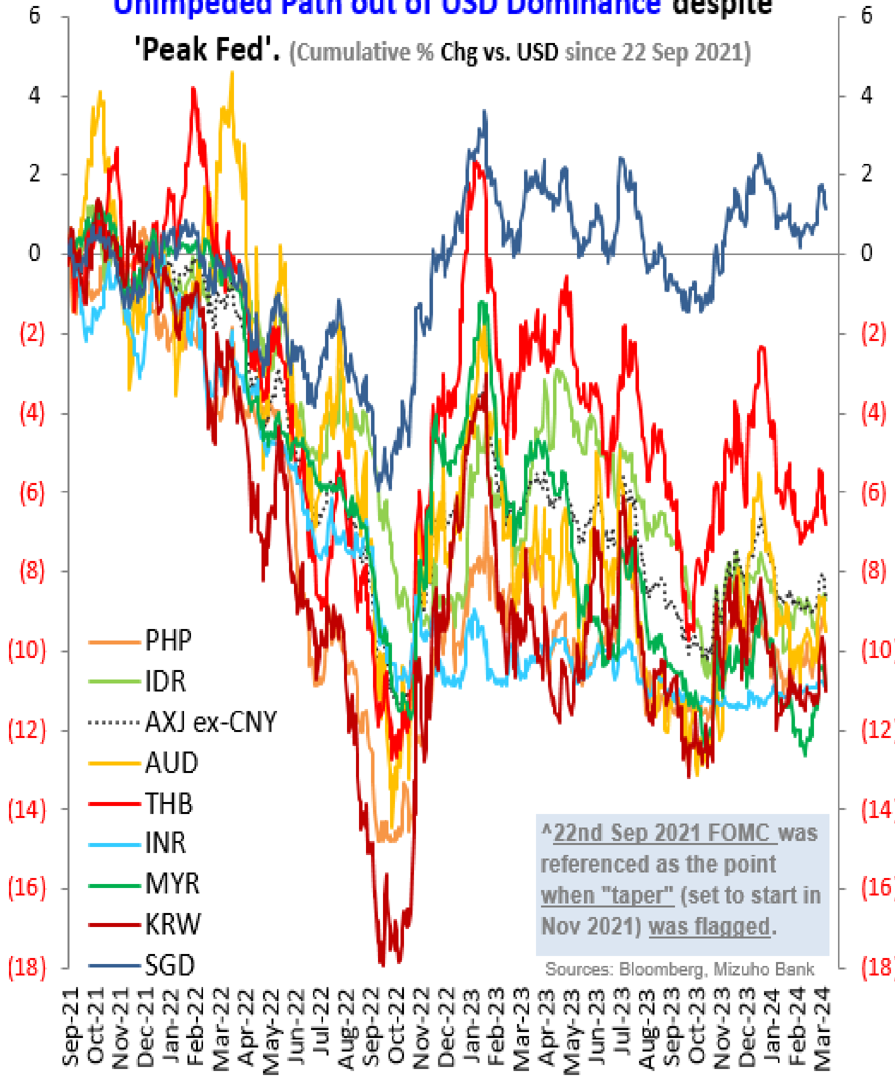




AXJ Outlook: A Bumpy Path Out of USD Dominance

FX Forecasts	Jun 24	Sep 24	Dec 24	Mar 25	Jun 25
USD/CNY	7.17 - 7.58 (7.38)	7.00 - 7.43 (7.18)	6.98 - 7.58 (7.26)	6.94 - 7.45 (7.16)	6.91 - 7.30 (7.08)
USD/INR	82.8 - 86.1 (84.5)	80.5 - 85.5 (82.8)	79.7 - 86.9 (84.0)	78.4 - 84.9 (82.2)	78.0 - 83.7 (80.9)
USD/KRW	1260 - 1410 (1343)	1180 - 1360 (1280)	1230 - 1400 (1330)	1180 - 1310 (1240)	1130 - 1270 (1180)
USD/SGD	1.349 - 1.393 (1.365)	1.295 - 1.377 (1.346)	1.322 - 1.407 (1.365)	1.299 - 1.373 (1.335)	1.294 - 1.353 (1.330)
USD/TWD	30.8 - 32.9 (32.2)	30.6 - 33.1 (31.5)	29.9 - 32.8 (31.8)	30.3 - 32.9 (31.3)	29.7 - 31.9 (30.6)
USD/IDR	15630 - 16770 (16000)	15420 - 16360 (15780)	15390 - 16550 (15900)	15060 - 16120 (15400)	15010 - 15810 (15200)
USD/MYR	4.73 - 4.93 (4.79)	4.50 - 4.85 (4.62)	4.53 - 4.86 (4.76)	4.39 - 4.81 (4.58)	4.25 - 4.68 (4.43)
USD/PHP	55.0 - 57.7 (56.5)	53.4 - 56.4 (55.6)	54.3 - 57.7 (56.8)	52.6 - 56.9 (55.2)	52.5 - 56.7 (54.6)
USD/THB	34.8 - 37.4 (36.3)	34.1 - 36.9 (35.2)	34.2 - 37.6 (36.2)	34.0 - 37.2 (35.0)	33.5 - 35.9 (34.5)
USD/VND	24400 - 25600 (25200)	24300 - 25200 (24800)	25100 - 25700 (25200)	24800 - 25300 (24900)	24500 - 25100 (24700)
AUD/USD	0.610 - 0.687 (0.645)	0.625 - 0.690 (0.662)	0.625 - 0.689 (0.652)	0.643 - 0.698 (0.673)	0.639 - 0.720 (0.686)

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

Appendix: Fed & Yield Outlook – *Growth Risks Rather than Dis-inflation to Drive Deeper Cuts*

	End-2021	End-2022	2023				2024				2025			
			Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	Q4 25
Fed Funds Target Rate Ceiling	0.25	4.50	5.00	5.25	5.50	5.50	5.50	5.50	5.00	4.25	3.50	3.25	3.00	2.75
Fed Funds Target Rate floor	0.00	4.25	4.75	5.00	5.25	5.25	5.25	5.25	4.75	4.00	3.25	3.00	2.75	2.50
UST 2Y Yields	0.73	4.43	4.03	4.90	5.04	4.25	4.62	4.09	3.37	3.13	2.70	2.69	2.80	2.53
UST 10Y Yields	1.51	3.87	3.47	3.84	4.57	3.88	4.25	3.98	3.72	3.55	3.22	3.35	3.42	3.28

Sources: Bloomberg, Mizuho Forecasts

Growth Impact, Not "Immaculate Dis-inflation":

- Fed cuts more aggressively as growth shocks overtake dis-inflation
- Most of the cuts are likely to be concentrated late-2024; with ~200bp of cuts by H1 2025
- Admittedly Presidential elections risks obscure
- But in any case, the drop in 2Y rates will speed up sharply H2-2024
- This will reverse the "inversion" more durably.
- In fact, in 2025 heading into 2026, there could be a more emphatic pick-up in (10Y-2Y) term premium.
- This is likely to be based on structurally higher inflation, once growth risks are checked
- Compounded further by worries of more bloated UST issuances at the longer end from widening fiscal deficit.

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Appendix: BoJ YCC (First published on 12th March): Why YCC Abandonment is Not a Sharp Turn

- *The starting point is the BoJ has a full suite of tools to calibrate, an **aversion to cavalier boat-rocking**.*
- *To that end*, **neither NIRP nor YCC abandonment are tightening**.
- Instead they are **tweaks that don't preclude policy accommodation**.
- To be clear, **a controlled (+10bp) exit from NIRP (to ZIRP)** is **well-telegraphed**; and par for the course.
- Crucially, it is **not a tightening cycle**.
- Fact is, a one-off NIRP-to ZIRP* transition is not inconsistent with policy accommodation.
- *Admittedly*, **YCC abandonment** on paper **has the potential for much more pronounced tightening impact**.
- In particular, **if JGB yields are lifted significantly;** given over 300bp of (UST-JGB) spread.
- ***But*** in practice it is significantly dulled. Fact is, **the BoJ will not allow JGB yields** (and policy) **to become unhinged**.
- For one, it is **hasty to assume** that the **BoJ will abandon YCC** *unconditionally.*
- In particular, **relinquishing YCC, a price-driven policy, will be mitigated by resuming more active QQE**** (a quantity-driven policy).

  Despite the different mechanisms, *both* have the same aim. To *anchor yields along the curve*.
  In fact, *QQE could afford a greater degree of flexibility in targeting yield anchor across the curve more flexibly;* even if quantum of buying is announced before-hand.
- The upshot being, **YCC abandoned**, ***does not equate to yield anchor forsaken.*** Far from.
- And **insofar that the BoJ is highly unlikely to flirt with self-harm from an abrupt policy turn**, *USD/JPY is more likely to be on a glide-path lower, not a free-fall* on assumptions of sharp drops in UST-JGB spreads.
- At least not on account of the BoJ. Whereas unexpected dovish turn by the Fed is a different proposition altogether.
- Point being, the **JPY is a "*BoJ problem with a Fed solution*"**.

^ The BoJ has;

i) dismantled the three-tier rate system and negative interest rates to restore policy rate at 0.0-0.10%;
ii) abolished YCC 0% target with an upper bound of 1%;
iii) but will continue to buy JGBs broadly in line with pre-existing purchases

*A one-off 10bp adjustment to zero policy rate will have less of an impact than earlier YCC range tweaks that have added some 50-80bp of upside.
** qualitative and quantitative easing. In this case quantitative JGB purchases substitute for purchases enacted under YCC

Appendix: BoJ ETF

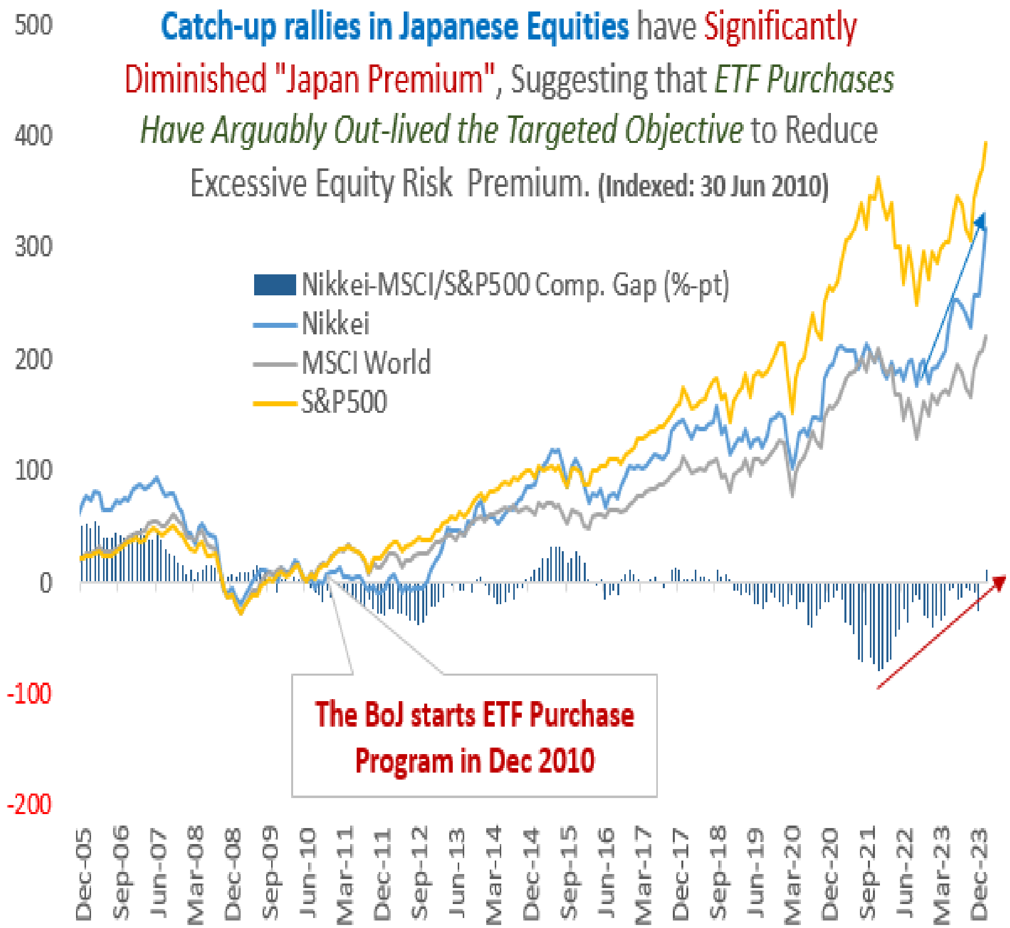
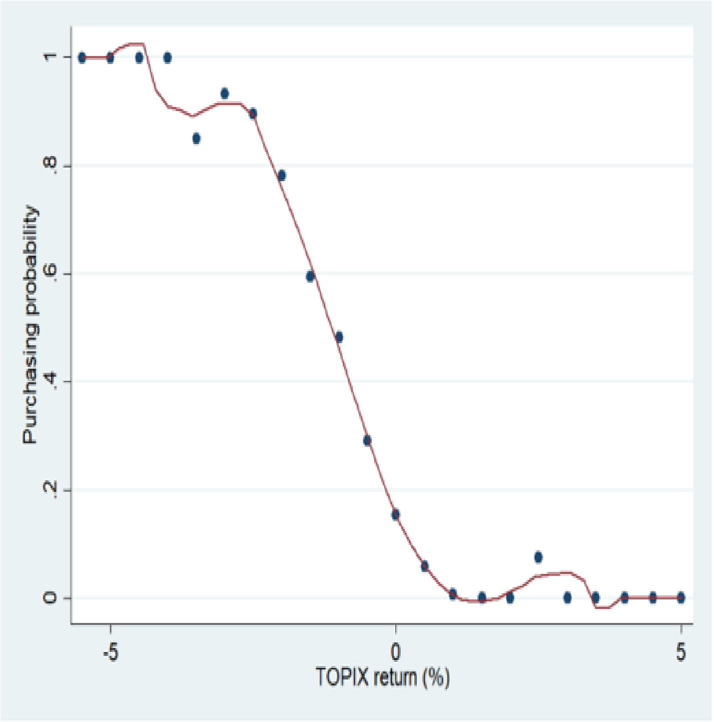


Figure 1: Probability of ETF Purchases under the Program



Source: BIS

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