Mizuho EMEA G4 Forecast Update

27 March 2024

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MIZUHO

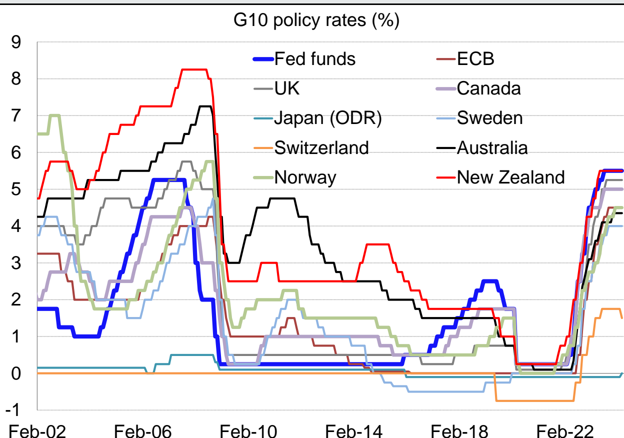
SNB fires the starting pistol on the G10 easing cycle – How low? How slow?

In the wake of the dovish March FOMC press conference, the SNB (that meets only quarterly) unexpectedly dropped its policy rate from 1.75% to 1.50%, kicking off the G10 easing cycle. It will not be long before others join in. With the ECB fixed on a June start and the Fed seemingly also set to move in June, the DM easing cycle should be well underway by the end of H1.

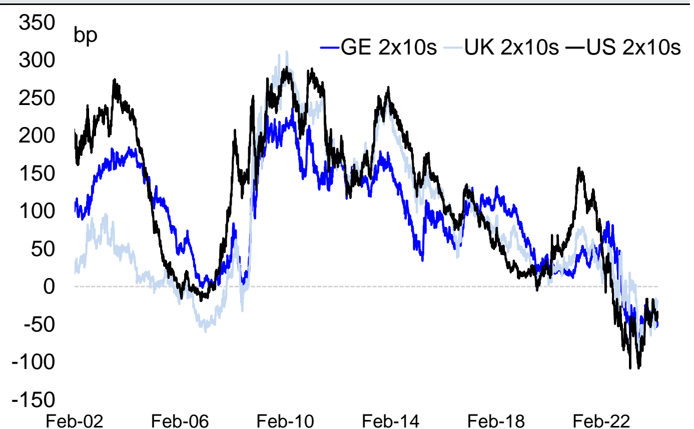
So what can we expect from this easing cycle? Since the 1990s, policy cycles have tended to see rates drop quickly across most of the G10 and subsequently rise more slowly and in less co-ordinated fashion. The rapid declines in policy rates were generally driven by credit events rather than central bank success in squeezing inflation out of the system. This time round, the reverse looks to be true. Rates surged in a co-ordinated fashion between late 2021 and mid-2023 amid a series of global inflation shocks. They now look set to drift lower at different speeds. In theory, the neutral rate should play a key role in determining how low rates need to go. In practice, the neutral rate is hard to observe. As the ECB's Schnabel recently noted, there are good reasons to believe that the neutral rate has risen, not least the fact that elevated policy rates seem to be having only minimal impact on labour markets. One interpretation of this development is that neutral rates are near current policy levels. Few central bankers seem willing to make such a leap, although most policymakers seem to believe that neutral rates are higher than they were pre-Covid. **The uncertainty about how tight policy actually is suggests to us that, as long as labour markets hold up, then central banks will go slow in easing policy – driving using the rear-view mirror if you will.** Cut, see what happens, and if after a period nothing too bad happens, cut again. This process is always slower than decision making when the destination is clear or if inflation is far from the central bank target and the response is obvious. **We remain in the "Lower, Slower" camp with regard to developed world central bank policy rates**. This leaves yield curves slow to dis-invert. Indeed, on a 12-month horizon, our forecasts see DM curves as essentially flat. Here, Japan remains the exception.

The bulk of the drop in inflation has been driven by declines in food and energy prices. Industrial goods prices have also softened. There is good evidence that service prices are much sticker than goods prices, especially when labour markets are firm. If goods prices revert to their usual levels, then service prices need to come lower for central banks to meet their inflation targets. The BIS underscored the sticky service price dynamics in their most recent quarterly review published in March. We view it as suggesting that much of the easy disinflation is now behind us and **the last mile of the disinflation process will prove more stubborn than markets currently expect, leaving policy rates coming lower only slowly**.

G10 easing cycle. "Lower, Slower"…



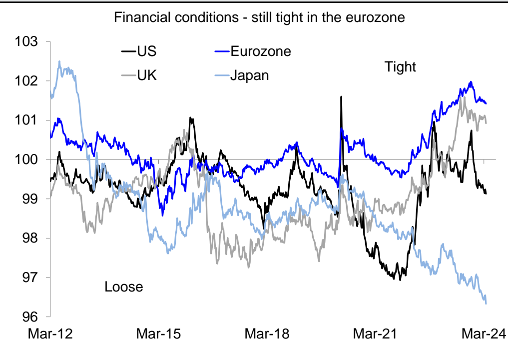
…to make dis-inversion exit a slow one



Source of all charts: Bloomberg

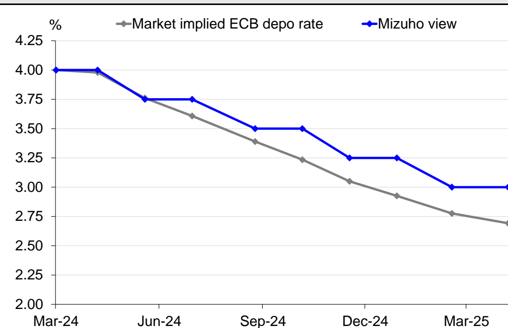
EUR markets

Macro – Looking forward to firmer activity levels in H2



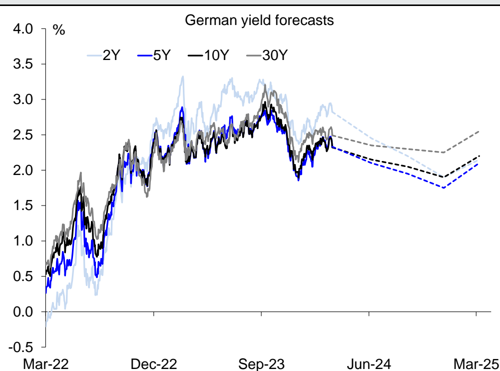
- **Eurozone activity is showing only limited signs of life.** Q1 GDP will be close to flat. The PMI is creeping higher but is still below 50. Industrial production remains depressed. Financial conditions remain tight, while money and credit metrics still point to subdued activity.
- **Despite the prolonged period of below-trend growth,** the labour market remains tight, with the unemployment rate at the cycle low of 6.4% in February. Labour hoarding is hitting productivity, which in turn will keep unemployment lower and inflation higher than it otherwise would have been. We again nudge our 2024 unemployment forecast lower, down 0.1pp to 6.6%, reflecting current labour market strength.
- Headline inflation has been volatile and sits at 2.6%YoY in February. Core inflation is coming down more slowly and sits at 3.1%YoY. **The labour market remains a source of upside inflation risk for now.** Indeed, the ECB expects almost no change in unemployment and sees elevated unit wage growth through late 2024, which it expects will be paid for by lower unit profits. We look for headline CPI growth to average 2.2% in 2024 and to be close to target in 2025.

Policy – ECB aiming for June to start the easing cycle



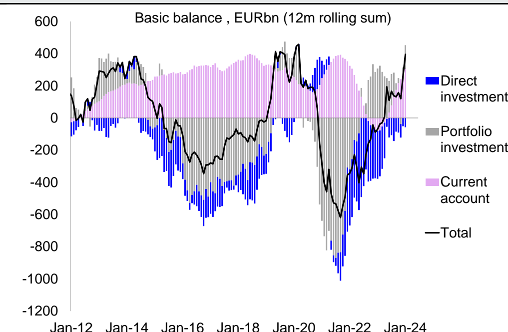
- The ECB left policy rates unchanged in March. It marginally downgraded its GDP outlook for 2024 from 0.8% to 0.6%, alongside lower CPI forecasts (2024: 2.3% vs 2.7% prev, 2025: 2.0% vs 2.1%). There was also less concern over inflation risks such as Red Sea disruptions. These softer forecasts provide the backdrop for a softer tone on the policy outlook. President Lagarde hinted that the first move will come in June. Subsequent to the meeting, some of the doves tried to garner support for cuts in both June and July. Lagarde has pushed back on this view, noting that the ECB is data dependent and does not pre-commit. We see weaker activity than the ECB and expect 3 cuts to be delivered over the balance of the year, in June, September and December. The eurozone outlook is weak and as such the risks for policy remain on the low side vs our forecasts.
- The ECB announced their **new operational framework** in late March. They opted for a "demand-driven floor system", where banks tap the ECB's liquidity lines whenever they need to. The changes are scheduled to start in September.

Rates – Buy the dip into the first ECB cut



- EUR government bond yields have been falling throughout March. We expect yields to continue falling. **Any rise in yields will likely encounter solid demand.**
- **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 recession means rates are not likely 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%).
- Term premia have been easing since Q4-23, mainly driven by a decrease in the real term premium (inflation term premium also eased). **A recovering economy will likely reverse those moves and drive an increase in term premia**. That said, steepeners are very costly to put on in Bunds due to the negative carry, which is why we expect the **bull-steepening theme to happen in higher-yielding EGBs (like BTPs) and in the swaps space**.

FX – Stable near term, better prospects for EUR further out



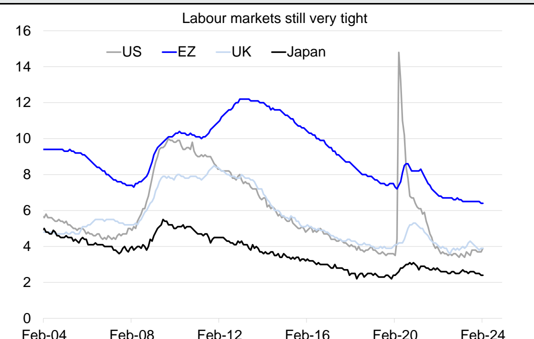
- With the market reassessment of the easing cycle having come a long way since the start of the year, we see scope for a few months of stability in FX markets. In H2-24, the growth gap should start to narrow, as the eurozone recovers and EUR should recover a little vs USD.
- It remains the case that 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 escaped any censure from the ratings agencies, with both Italy and France emerging with current ratings intact. We see EUR/USD around 1.10 by Q1-25.**

Basis – Tightening momentum fading

- The tightening in the EURUSD XCCY basis is showing signs of exhaustion. The front end is struggling to print new highs. While some tightening drivers are still at play (like **Yankee issuance** looking attractive to European issuers and **healthy dollar liquidity**), 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.

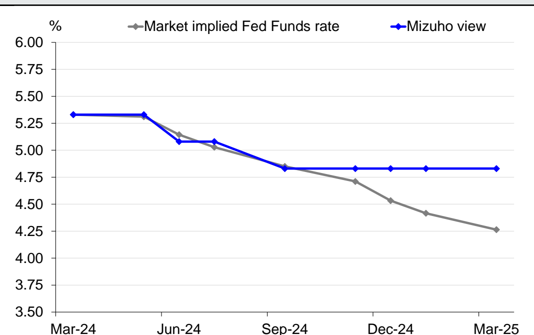
USD markets

Macro – Loose financial conditions drive upside inflation risks



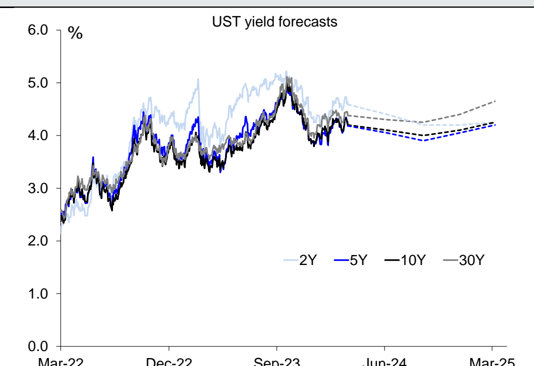
- Q1 GDP looks to be coming in around trend. Our GDP forecasts are unchanged this month. There is a non-negligible risk that the loose financial conditions that the Fed has sparked will see growth and inflation re-accelerate in 2024. We are monitoring this risk closely.
- Labour market data do not suggest much softening. The direction of travel is weaker, but there are question marks about the pace of the slowdown. **We see a mild drift higher for unemployment in coming quarters, but from a low starting point.** We see unemployment averaging 3.9% in 2024 and 4.1% in 2025 as fiscal policy loosens.
- Inflation risks in the US remain higher than elsewhere as growth remains above trend. The productivity numbers look good but are susceptible to a slowdown in activity. 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. **Our 2024 CPI forecast is at 2.5% as is our 2025 CPI forecast.** Firmer growth/wider positive output gap, loose financial conditions, expansionary fiscal policy and the solid labour market mean the risks for the CPI are elevated.

Policy – Fed happy to run upside inflation risks



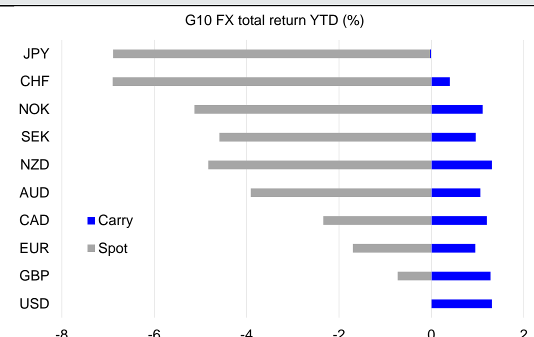
- The Fed sharply upgraded its growth outlook for 2024 and modestly upgraded its outlook for 2025. Growth remains at or above trend throughout the forecast period and yet the disinflation process remains intact, even if core PCE now declines a little slower than previously forecast. The press conference was also dovish with the elevated CPI prints in January and February ascribed to volatility in the data rather than seen as evidence of inflation picking up again.
- Discussions on the pace of QT have 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 pace. We expect the change to happen at the next FOMC meeting, unless reserves at the Fed tumble towards $2.5tn and put too much pressure on US funding markets.

Rates – Capped downside in UST yields



- The 2024 selloff is showing signs of exhaustion. The fact that the Fed is keen to cut is likely the cause. 10Y UST yields have been unable to move above the 4.35% handle. With rate cuts likely to come in the next two quarters, we expect UST yields in the front-end and belly to fall towards the Q4-23 lows, especially if inflation comes in soft.
- That said, we think that **the resilience of the US economy will cap how much USTs can rally in the next 12 months.** The negative carry of holding longs in UST cash is not helping either. We expect the steepening theme to gain traction in the coming quarters despite the very likely QT taper. **An economy growing at trend and expectations of looser fiscal policy should see term premia being priced into the UST curve. 2025 should see higher long-term UST yields.** Markets may also have to reassess the cuts priced for 2025.

FX – Near-term drift. Weaker longer term.



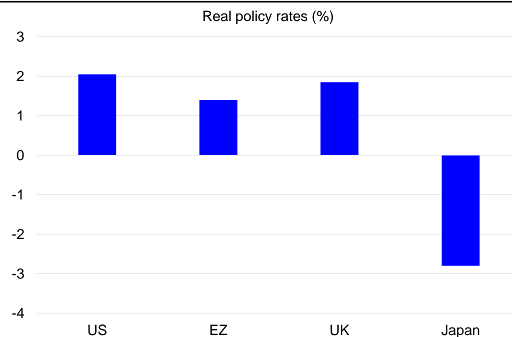
- Higher UST yields dragged the DXY index higher early in the year. This dynamic seems to be close to running its course. To date, the rise in UST yields has not been damaging for equity markets, which sit near record highs, but ongoing increases in UST yields will likely undermine equity markets and boost safe-haven demand for the greenback, which we expect to limit its downside later in the year. USD positioning is close to neutral.
- **The bigger picture remains one of a softer USD, against the backdrop of declining Fed policy rates. This is especially the case in the middle of the year, when we see Fed cuts starting. 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 – Reaching the limits of cheap dollar funding? A question for H2-24.

- Despite a stronger US macro backdrop and a pick-up in geopolitical risk, borrowing dollars has not become more expensive. We expect **the lower dollar premium theme will remain in the near term**, which would continue to support paid positions in most pairs. However, we see risks to our cheaper USD funding view in the latter part of 2024 on the back of a slowdown in Yankee issuance, ongoing interest to own USD credit and continued US macro resilience.

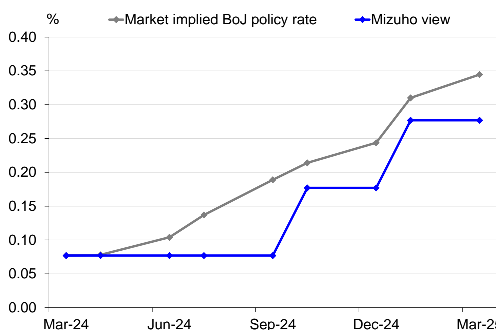
JPY markets

Macro – Rising wages to lift real incomes



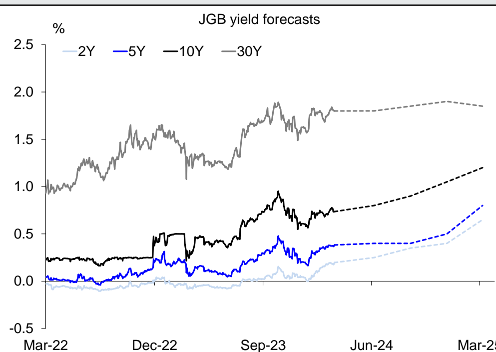
- Q4 GDP was revised into the positive column allowing Japan to avoid recession. Q1 data have been mixed, with the January industrial production report especially weak. Q1 GDP will likely be slightly negative. However, the spring wage round was upbeat, potentially boosting activity in H2**. Our 2024 GDP forecast remains at just 0.3% but the risks seem to be to the upside.** 2025 GDP is also unchanged at 1.0%. Sluggish China activity remains a risk for external demand, but activity elsewhere is holding up for now, especially in the US.
- Government energy subsidies are rolling off and headline CPI is pushing higher, as expected. Ex fresh food and energy CPI, a better measure of underlying price pressures, sits at 3.2%. **We look for the headline CPI to average ~2.5% in 2024**, helped by base effects and rising wages. 2025 CPI should be close to 2.0%.
- The 2024 Shunto wage negotiations delivered a larger-than-expected gain, boosting expectations that the gains will feed through to the national wage data as they conspicuously failed to do last year. **Inflation should remain elevated through most of 2024 so real wages will not pick up significantly this year. That should happen in 2025**.

Policy – All change. More to come.



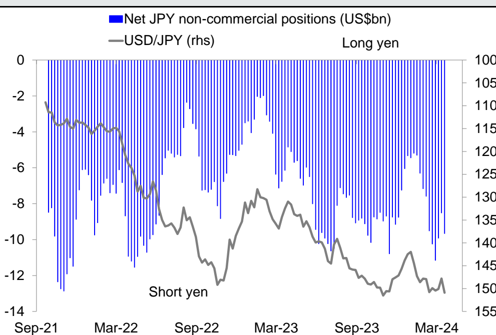
- **BoJ dismantled its YCC with QQE framework and exited negative rates in March**. The overnight call rate has been designated as the short-term policy rate and sits in a 0.0~0.1% range. The IOER is set at 0.1% and will apply to all excess reserves. The BoJ cut the upper end of the Rinban ranges although in the press conference Ueda noted that for now Rinban purchases would be broadly unchanged. Fixed rate ops and fund supply ops both remain and can be used as needed should longer-term rates become volatile. No QT for now.
- 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 price pressures will remain elevated and the BoJ will up its forecast to 2.0% in April**. The BoJ will cautiously push rates higher starting with two small moves in the coming 12 months before graduating onto 25bp moves next fiscal year. **We look for the policy rate to hit 0.25% by Q1-25 and move modestly higher later in 2025, topping out around 0.5%~0.75%.**

Rates – Upside pressure in JGB yields to continue



- With the BoJ having signalled the start of a new era of monetary policy, we expect upside pressure in JGB yields will remain for now. However, we think that weak macroeconomic data and political noise will likely cap the upside in JGB yields. **We still like to tactically sell rallies.**
- The bearish pressure should play out in the 10yr sector to a greater extent as **the BoJ will likely slow down JGB purchases in coming meetings**. This should drive the steepening into the 10yr sector.
- Japanese domestic investors have remained on the sidelines with regards to buying long-term JGBs despite the more attractive yields. We think that the lack of policy action in coming months will encourage them to buy, capping the upside move in 30yr JGB yields. **We still like flatteners in 10x30s**, a theme we expect to accelerate in H2-24.

FX – Better times ahead for JPY



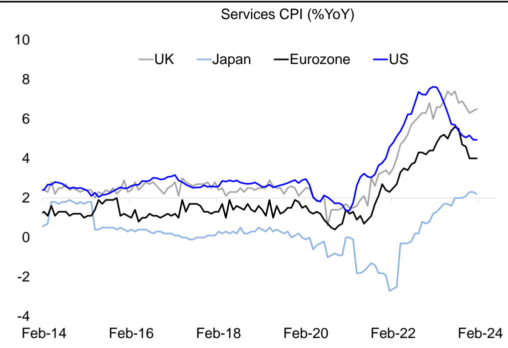
- The BoJ move did not provide much of a lift for JPY, suggesting that we need to wait until we see lower UST yields before USD/JPY shifts lower. We continue to expect that the front-end USD/JGB yield spread will narrow and USD/JPY will follow. Short JPY positioning is quite stretched and, if it starts to unwind, USD/JPY might move quickly.
- The yen is already subject to heavy verbal intervention and physical intervention remains possible not too far above current levels.
- 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.
- Valuations and positioning both suggest scope for solid gains in 2024. The yen remains cheap and **we see USD/JPY at 135 by Q1-25**.

Basis – Pay the USDJPY XCCY basis

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

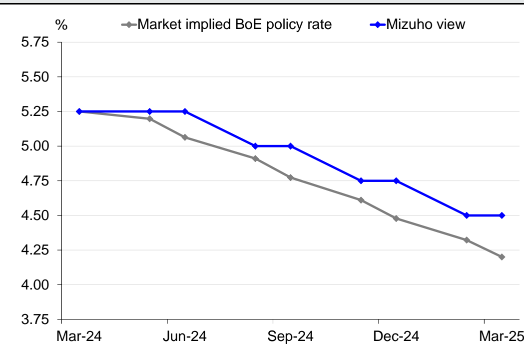
GBP markets

Macro – Slowdown already in the rear-view mirror



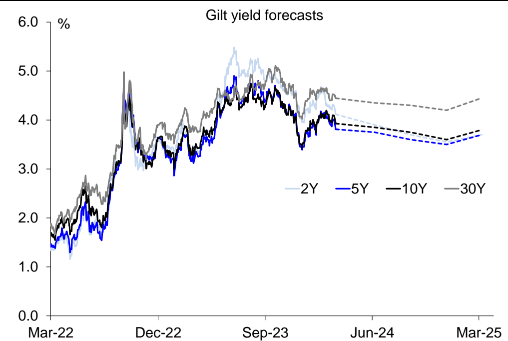
- Recent UK activity data have been good. The composite PMI remains above 50, retail sales held up in February despite poor weather and house prices are recovering. Fiscal policy is also slightly looser now. Our macro forecasts are little changed. Unemployment is a little lower.
- Inflation declined in February to just 3.4% but services CPI remained over 6.0%. **We expect much lower headline CPI in spring/summer, driven by the fall in wholesale gas prices.** We now see the CPI averaging 2.5% in 2024. A drop below 2.0% mid-year now looks likely, but it will likely push above 2.0% again late in the year.
- 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**. In the short run, questions over the official labour market data will see more weight placed on alternative sources.

Policy – Bailey hints at looser policy on the way



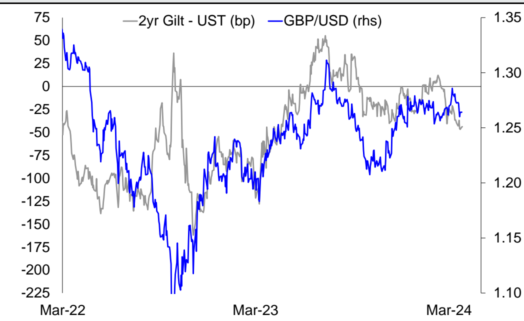
- The BoE left policy unchanged in March but the two hawks shifted back into the pack, leaving the vote skew slightly dovish at 1-8. In the wake of the meeting Governor Bailey said he felt market pricing of cuts "*for the year as a whole*" was reasonable and that he was encouraged by recent data. Our view is that the BoE remains in no rush to ease but as Baily noted there was a range of views on how confident the Committee were that inflation was heading back to target. BoE speak will be closely scrutinised for additional clues in coming weeks.
- **In January, we pushed back our first cut from Q2 to Q3. In the wake of Bailey's comments, the risks to this view are clearly sooner rather than later, but a slow pace of cuts still seems likely.**
- The new £100bn pace of QT has not delivered any upward pressure on yields. The APF currently sits at ~£730bn. We expect the BoE to maintain the current pace of QT for the time being.

Rates – Buy the dip into Q2-24, but remain cautious about H2-24



- March has been a great month for those holding longs in Gilts. We think the **outperformance vs Bunds has gone a bit too far though**.
- The retracement of the Q4-23 rally is showing signs of fatigue and we think we have seen the peak in Gilt yields. **Dip-buying** will likely continue to be the way to play Gilts in Q2-24, due to ongoing falls in inflation rates. We expect to see lower Gilt yields in the near term.
- 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**. Ongoing QT is another support to the steepening momentum. Inflation progress looks less promising in H2-24, which suggests that the bullish momentum in UK rates may stall and the steepening may slow.

FX – Downside risks dissipating



- The UK economy is outperforming the eurozone. We leave our GBP forecasts unchanged. The UK has less scope for rate cuts than elsewhere. We suspect the BoE (-50bp) will cut less than the ECB (-75bp) this year and start cuts later than the Fed. GBP positioning does not look especially stretched, especially for asset managers.
- 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 than the current government.
- **We see GBP/USD at 1.35 and EUR/GBP at 0.81 by Q1-25**.

Basis – Brace for more steepening; paying drivers still at play

- The tightening momentum in GBPUSD XCCY basis is strong and **several drivers will likely continue to support a tighter GBPUSD XCCY basis and a steeper GBPUSD XCCY curve**: more certainty on the BoE's reaction function, lower GBP rates vol that keeps attracting demand to add GBP fixed income assets, cheaper USD funding and ongoing popularity of reverse GBP issuance. GBPUSD XCCY basis has still room to move tighter towards the 2021 highs.

Mizuho EMEA Forecasts (as of 26 March)

FX forecasts	Current	End-Q2 24	End-Q3 24	End-Q4 24	End-Q1 25
USD/JPY	151	144	140	135	135
EUR/USD	1.08	1.09	1.10	1.11	1.10
GBP/USD	1.26	1.32	1.34	1.36	1.35
EUR/GBP	0.86	0.83	0.82	0.82	0.81
EUR/JPY	164	157	154	150	149
GBP/JPY	191	190	188	184	182
Bond forecasts (%)	**Current**	**End-Q2 24**	**End-Q3 24**	**End-Q4 24**	**End-Q1 25**
United States					
Policy rate	5.25~5.50	5.00~5.25	4.75~5.00	4.75~5.00	4.75~5.00
2yr	4.59	4.40	4.20	4.20	4.25
5yr	4.22	4.05	3.90	4.05	4.20
10yr	4.23	4.10	4.00	4.10	4.25
30yr	4.40	4.30	4.25	4.40	4.65
Eurozone/Bund					
Deposit rate	4.00	3.75	3.50	3.25	3.00
2yr	2.87	2.45	2.20	1.90	2.15
5yr	2.37	2.10	1.95	1.75	2.10
10yr	2.35	2.15	2.05	1.90	2.20
30yr	2.51	2.35	2.30	2.25	2.55
Japan					
Policy rate	0.00~0.10	0.00~0.10	0.00~0.10	0.10~0.20	0.20~0.30
2yr	0.19	0.25	0.35	0.40	0.65
5yr	0.38	0.40	0.40	0.50	0.80
10yr	0.73	0.80	0.90	1.05	1.20
30yr	1.81	1.80	1.85	1.90	1.85
United Kingdom					
Policy rate	5.25	5.25	5.00	4.75	4.50
2yr	4.17	3.90	3.70	3.55	3.70
5yr	3.85	3.75	3.60	3.50	3.70
10yr	3.97	3.85	3.75	3.60	3.80
30yr	4.45	4.35	4.30	4.20	4.45
Macro forecasts (%)	**2023**		**2024**		**2025**
United states					
Real GDP	2.5		2.0		1.5
CPI	4.1		2.5		2.5
Unemployment rate	3.6		3.9		4.1
Eurozone					
Real GDP	0.4		0.1		1.0
CPI	5.5		2.2		2.0
Unemployment rate	6.5		6.6		6.8
Japan					
Real GDP	1.9		0.3		1.0
CPI	3.3		2.5		1.9
Unemployment rate	2.6		2.5		2.4
United Kingdom					
Real GDP	0.1		0.6		1.4
CPI	7.4		2.5		2.0
Unemployment rate	4.0		4.2		4.5

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

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