# Mizuho EMEA G4 Forecast Update

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MIZUHO

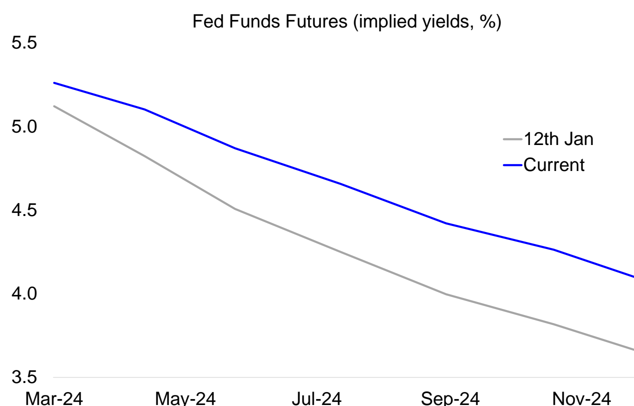
## *Aggressive rate-cut reassessment ongoing*

Financial markets have dialled back their policy expectations somewhat in January. We think this dynamic has further to run in coming months, especially for the Federal Reserve and the ECB. Falling inflation was a key driver of the market excitement about rate cuts at the back end of 2023, but we continue to see lower spot inflation as a necessary but not sufficient condition for lower policy rates. **Central banks need to be convinced that, not only will inflation come down, but that it will stay down**. The historical record shows that central banks have a tendency to declare victory prematurely. Most central bankers are aware of the fact. Fed Chair Powell recently noted that the prudent thing to do would be to "*give it some time*". Confidence that inflation will stay down is in part driven by the labour market and core/services inflation. Much of the disinflation to date has been driven by lower energy and food prices, while services inflation remains elevated. A normalisation of goods price inflation combined with service price inflation remaining elevated would see CPI push higher again. As the OECD notes in its latest forecast update: "*With core inflation still above target in most countries and unit labour cost growth generally remaining above levels compatible with medium-term inflation objectives, it is too soon to be sure that the inflationary episode that began in 2021 will end in 2025*".

**In the short run, we think that central bank view drives policy decisions, with the data being more of a driver over the medium term.** Our central bank forecasts remain broadly unchanged with the mild cuts we do see coming mainly in H2. **In the UK, we revised up our 2024 GDP forecast a further 0.3pp to 0.7% and have taken out one BoE cut, to leave the policy rate at 4.75% at year end.** Base effects from the surge in GDP in H2-23 see us revise up 2024 GDP in the US by 0.6pp, of which 2/3 is simply a mechanical boost from the 2023 carryover and 1/3 reflects the judgement that H1 will have more momentum. We now see **US 2024 GDP at 2.0%. Labour markets remain firm and we trim our unemployment forecasts a little, with Japan an exception. Inflation fell faster than expected and thus our 2024 CPI forecasts are a little lower.** The firmer GDP growth in the US and the UK leaves the Eurozone falling behind. We see EUR suffering as a result, falling more against GBP and rising less against the US dollar than previously. We still see lower global policy rates merely curtailing rather than derailing the BoJ's hiking cycle.

**Improving US macro outlook …**

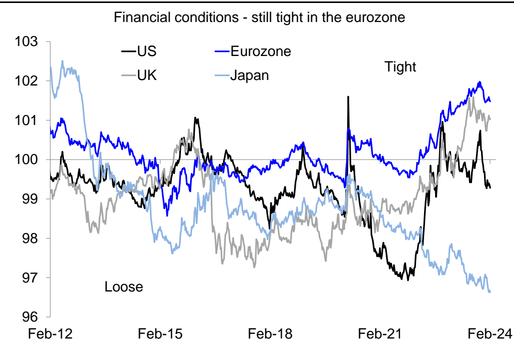
**… calls heavy cuts into question**




*Source: Bloomberg*

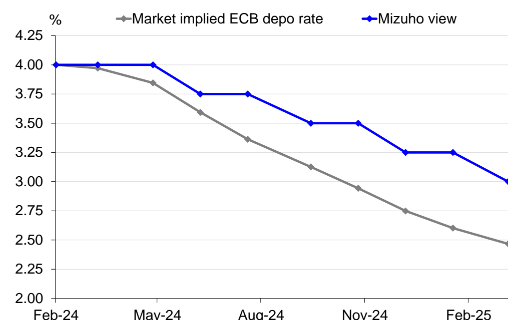
# EUR markets

## Macro – Flat



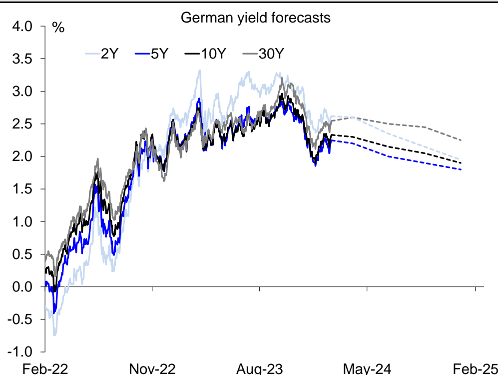

- **The eurozone avoided recession with Q4 GDP coming in flat.** However, activity remains weak and we expect mildly negative growth in Q1 before a pickup in Q2. The PMI has bottomed out, albeit at levels that imply contraction. Financial conditions remain tight, while money and credit metrics still point to subdued activity. The EU fiscal agreement in December will limit the scale of any fiscal contraction.
- **Despite the prolonged period of below-trend growth,** the labour market remains tight, with the unemployment rate at the cycle low in December. Labour hoarding will hit productivity, which in turn will keep unemployment lower and inflation higher than it otherwise would have been. We have lowered our unemployment forecast a little.
- Headline inflation has been volatile and sits at 2.8%YoY in January. Core inflation is coming down more slowly and sits at 3.3%YoY. **The labour market remains a source of upside inflation risk for now.** Indeed, the ECB expects almost no change in unemployment and elevated wage growth through late 2024. We look for headline CPI growth to average 2.2% in 2024 and to be close to target in 2025.

## Policy – ECB aiming for summer. Weak data a risk.



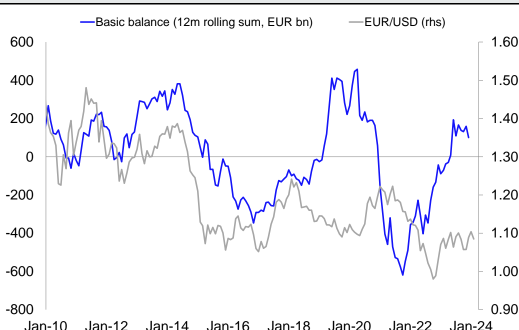

- The ECB left policy rates unchanged in January. We felt that President Lagarde did not push back as hard as she might have against market pricing of aggressive cuts. Furthermore, she played down the risks of upward pressures on inflation from events in the Middle East. **Nonetheless, she reiterated that summer remains the most likely timing for the first cut.** A recent speech from Chief Economist Lane underscored the desire to see Q1 wage data that will not be available by the time of the April ECB meeting. That said, weak activity implies some risk of an April move, even if it is not our base case.
- In December, the ECB announced a partial reduction of **PEPP reinvestments by ~€7.5bn/month**, to start in H2-24. Future rating revisions, weakening growth, upside pressure in yields in the near term, lack of significant fiscal consolidation and subdued risk appetite make further BTP-Bund tightening unlikely in early 2024. However, looking at H2-24, more flexible EU fiscal rules and lower yields should encourage investors to add high-carry BTP positions.

## Rates – Patience needed before buying the dip




- Following the dovish shift from the ECB, markets are now pricing more cuts from the ECB than for the Fed. However, we think that **markets are still too excited about early and aggressive cuts from the ECB** – easing will be more gradual. We expect progress on the disinflation front to remain choppy. This should continue to apply **bearish pressure to front-end rates early in the year**. That said, we expect market participants to be quick to buy any dip in EGBs.
- **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%). Ongoing QT from the ECB and a higher term premia in USTs will most likely cap how much long-term EUR rates rally. **We see 10yr Bund yields moving below 2.00% in 2024 and 2x10s becoming flat.**

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



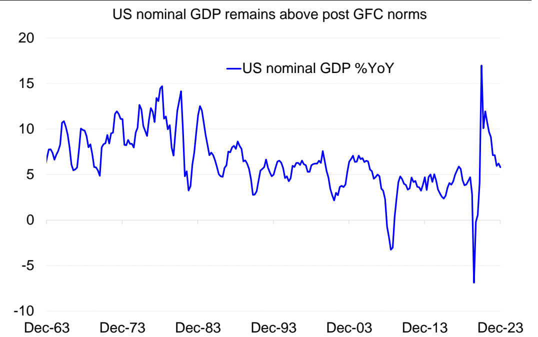

- We see global yields maintaining their upward momentum in coming weeks and expect that this will weigh on EUR, especially with the US economy outperforming near term. In the back half of 2024, the growth gap should narrow and EUR should recover.
- It remains the case that official investors, such as 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 1.12 by end 2024.**

## Basis – Tightening momentum fading

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

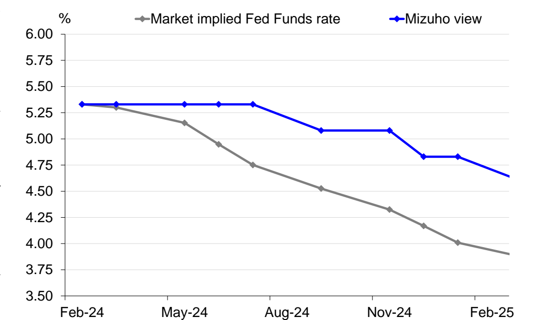
# USD markets

## Macro – Resilient



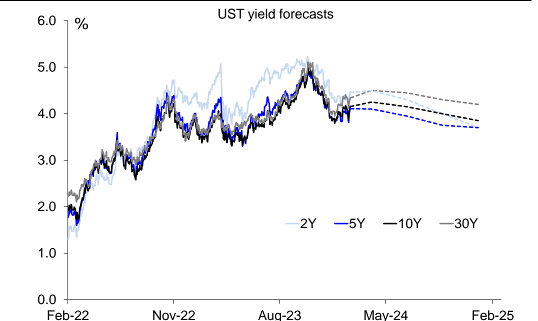

- The stronger-than-expected Q4-23 GDP growth drives the bulk of the upward revisions via a larger carry-over effect, but we also see a little more momentum in H1-24. We now see 2024 GDP at 2.0%.
- Labour market data do not suggest much softening. The direction of travel is weaker, but there are question marks about the pace of the slowdown given signs of labour hoarding. **We see a mild drift higher for unemployment in coming quarters but from a lower starting point.** We now see unemployment averaging 4.0% in 2024, which implies a slower decline in wages too.
- Inflation risks in the US remain higher than elsewhere as growth in H2 was well above trend. There is a growing risk that Fed policy may not be tight enough to ensure inflation drops back towards 2.0% in a timely manner. **We again nudge our 2024 CPI forecast down to 2.4%, reflecting recent better-than-expected progress. Nonetheless, we still see 2025 CPI above target, at 2.4%.** Firmer growth/wider positive output gap, loose financial conditions and the solid labour market mean the risks for the CPI are on the upside.

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



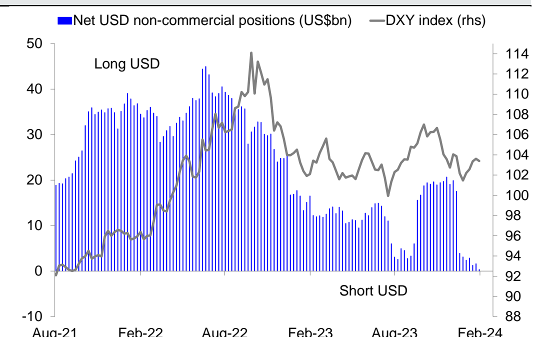

- The late January FOMC meeting was less dovish than the December meeting. Chair Powell noted that cuts in March were not the base case, which he repeated in a TV interview recorded just ahead of the payrolls report. The rock solid payrolls report put paid to market speculation of a March cut. We continue to see current market pricing as incompatible with a firm economy and inflation risks on the upside, **and still see the first cut not arriving until H2.** Evidence that policy is not especially tight seems to be building**.**
- Discussion on QT pace has already started. We expect **the Fed will stick to the current $95bn/month pace until the RRP facility approaches $400bn**. Once there, and in order to make QT more sustainable in the long run, we expect the Fed will slow the QT pace. We expect the change to happen around the end of H1-24, unless reserves at the Fed tumble towards $2.5tn and put too much pressure on US funding markets.

## Rates – Towards new YTD highs in UST yields




- Ongoing upside surprises in US macro data have pressured UST yields back to YTD highs. While the March meeting is fully priced out, we still think that the **cuts priced for 2024 in the SOFR strip look excessive**.
- **We expect USTs to continue reversing the December rally with yields remaining elevated into spring**, unless the data show material weakness. **We expect the curve to build a term premium once again** given the upside inflation risks, a still-too-resilient economy and a central bank already hinting at future cuts.
- Q2-24 onwards should see UST yields falling again as the macro backdrop softens and inflation eases further. The rally will likely be led by the front end, driven by rate cut expectations. **We expect the bear-steepening of Q1-24 to shift to bull-steepening.** We see 2x10s disinverting in H2-24 amid a likely taper of the Fed's QT. The resilience of the US economy will cap how much USTs can rally in 2024, especially front-end rates.

## FX – Near-term bounce on-going. Weaker longer term.



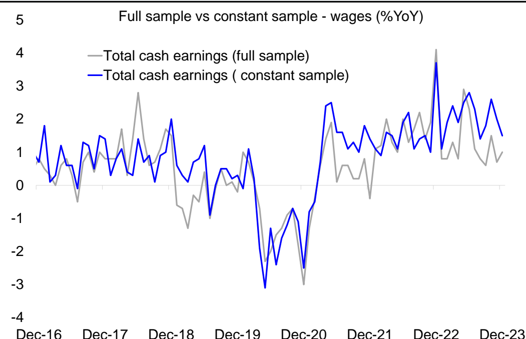

- Higher UST yields dragged the DXY index higher in January and we expect this dynamic has further to run in coming weeks as markets continue to price out Fed cuts. To date, the rise in UST yields has not been too damaging for equity markets, which sit at record highs, but on-going increases in UST yields 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 back half 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?

- 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 further US macro outperformance.

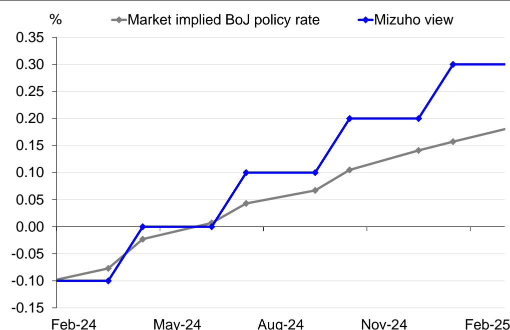
# *JPY markets*

## Macro – Mild downside risks



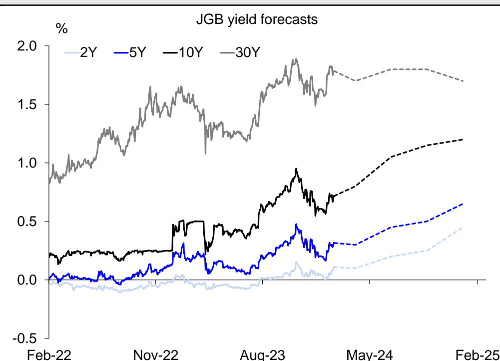

- We leave our **GDP forecasts for 2024 (0.8%) and 2025 (1.0%) unchanged, but see the near-term risks as being on the downside, as pent-up demand and inbound tourism gains lose steam. Note that in both years, growth should remain above trend against a backdrop of limited policy tightening.**
- Government energy subsidies run through April 2024. Should the subsidies end as expected in spring, headline CPI will jump higher. Ex fresh food and energy CPI, a better measure of underlying price pressures, sits at 3.7%. **We look for the headline CPI to average ~2.5% in 2024**, helped by an increasingly positive output gap and rising wages.
- Wage data were a little disappointing in 2023. The 2023 Shunto wage negotiations delivered the biggest wage increase in 30 years. However, small and medium-sized businesses saw much lower rates of pay growth. The 2024 spring wage round looks set to be at least as large as that in 2023 and probably a little higher. **We expect wage growth in 2024 to push higher** and expect that whole economy pay rates are likely to be nudging levels that the BoJ would like to see to be confident on tighter policy in coming quarters.

## Policy – NIRP in the cross hairs.



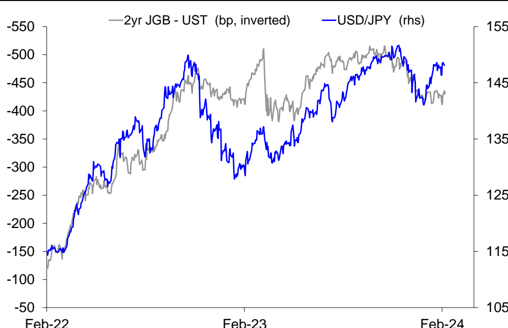

- **BoJ is inching towards an exit from NIRP**. The January BoJ meeting showed the discussion is underway, but a little more certainly on the price and wage outlook is required.
- The BoJ's YCC tweak in late October, which **turned the hard 1.0% upper limit for 10yr JGB yields into a "reference rate", spells the end for YCC**. We expect Rinban ops will continue to vary with 10yr yields, thus dampening volatility.
- Headline and core CPI will be heavily impacted by energy subsidies. The BoJ's ex fresh food and energy CPI forecast for FY25 is 1.9% – a whisker away from the BoJ's 2.0% inflation target. **We expect that price pressures will remain elevated and the BoJ will up its forecast to 2.0% by April, which in turn should allow the end of NIRP**. We still see any hiking cycle in Japan as limited in scale. **We look for the policy rate to hit 0.2% by end 2024**. The yen remains a wild card. We suspect the BoJ doesn't want to see much additional weakness from current levels.

## Rates – Selloff to continue as NIRP end comes into view




- The BoJ is laying the groundwork for the end to NIRP amid sluggish macro data. Expectations for tighter monetary policy are unlikely to ease, which means that **front-end JGBs will remain under pressure throughout our forecast horizon**. We like to tactically sell rallies.
- Bearish pressure in short-term JGB yields should play out in the 10yr sector to a greater extent; but the steepening momentum should fade once the policy shift materialises later in the year.
- The long end of the JGB curve remains steep; Japanese domestic investors are still on the sidelines despite more attractive yields. We expect they will be cautious on adding long-term JGBs in FY23, but they should become more active in FY24. **We like flatteners in 10x30s**, a theme we expect to accelerate in H2-24.

## FX – In thrall to UST yields



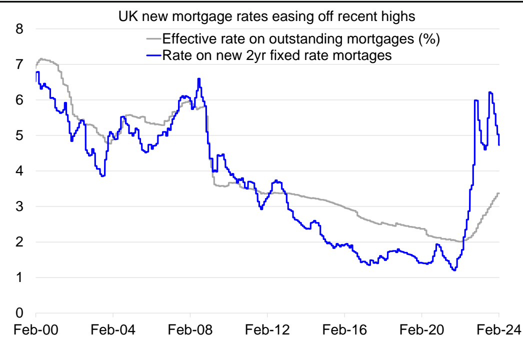

- Given that we see UST yields higher in the near term, we see USD/JPY remaining elevated. Any decline will likely need to wait until closer to the March BoJ meeting. **We see April as the more likely timing for a BoJ move** and thus a better time to look for USD/JPY to move lower.
- Improvements in the trade balance should slow in coming months, although any dip in oil prices will be a boon for Japan. The services balance should improve a little in 2024 driven by the rebound in tourism.
- To date, the yen has failed to draw much support from the BoJ's YCC tweaks, but combination of a rising policy rate at home and falling yields overseas should be supportive. Valuations and positioning both suggest scope for solid gains in 2024. The yen remains cheap and **we see USD/JPY at 128 by year end**.

## Basis – Pay the USDJPY XCCY basis

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

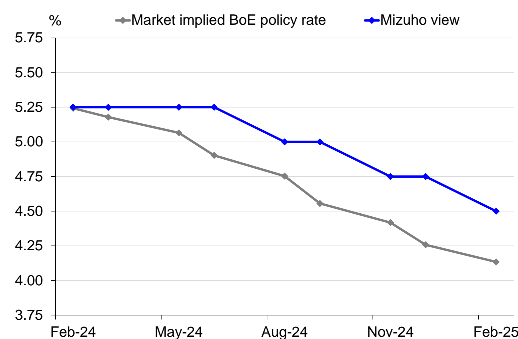
# *GBP markets*

## Macro – A little less downbeat



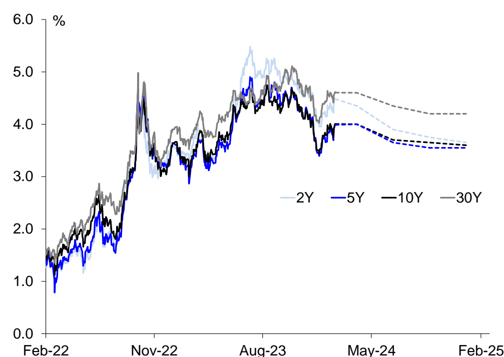

- We see **mildly negative growth in Q4**. That said, we revise up our 2024 GDP forecast again, to 0.7% (vs 0.4% prev.), thanks to mildly looser fiscal policy, housing holding up better than expected, a faster-than-expected drop in inflation and the jump in the PMI.
- December showed limited progress on inflation at both headline and core levels. We expect lower CPI in spring, driven by energy. **Risks are now more balanced than previously and the UK looks less of an outlier on the inflation front compared to international peers.** We see the CPI averaging 2.6% in 2024 as gas prices fall rapidly.
- 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 – Atop Table Mountain for a little longer



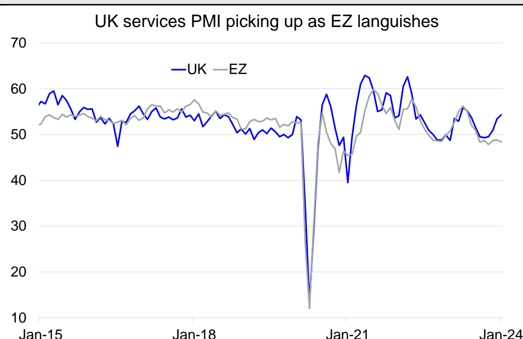

- The BoE left policy unchanged in February in a 1-6-2 vote. The vote skew remains hawkish but most members believe rates have peaked. The BoE's new forecasts were downbeat on activity but after a brief drop to target, they see CPI as mostly above over the forecast horizon.
- Recent rhetoric suggests no rush to lower rates even if the hawkish bias is no longer in the statement. Both Governor Bailey and Chief Economist Pill have noted the need for more certainty on the inflation outlook. Labour markets remain tight by historical standards.
- **Firmer economic activity and questions over labour market indicators suggest a later BoE move and we now see only 2 cuts this year, in August and November**. The new £100bn pace of has not delivered any upward pressure on yields as yet. The APF currently sits at ~£738bn, down from a peak of £895bn in 2021.

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




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

## FX – Downside risks dissipating




- The pricing of UK short-term interest rate expectations for H1-24 looks reasonable to us. However, expectations for EUR and USD policy cuts look a little overcooked, which may weigh on GBP in the near term. GBP positioning looks fairly neutral and will not push cable one way or another. We now see the growth outlook a little firmer and UK policy rates remaining a little higher in 2024. This should support GBP.
- 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 1.36 by end 2024.**

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

- There are **several drivers that 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. Additionally, GBPUSD XCCY basis has still room to move tighter, towards the 2021 highs – risk-reward to pay the dips remains.

## Mizuho Forecasts (as of 6 February)

| FX forecasts | Current | End-Q1 24 | End-Q2 24 | End-Q3 24 | End-Q4 24 |
|---|---|---|---|---|---|
| USD/JPY | 149 | 148 | 140 | 134 | 128 |
| EUR/USD | 1.07 | 1.09 | 1.10 | 1.11 | 1.12 |
| GBP/USD | 1.26 | 1.28 | 1.32 | 1.34 | 1.36 |
| EUR/GBP | 0.85 | 0.84 | 0.83 | 0.83 | 0.82 |
| EUR/JPY | 159 | 160 | 153 | 149 | 143 |
| GBP/JPY | 188 | 189 | 185 | 180 | 174 |
| **Bond forecasts (%)** | **Current** | **End-Q1 24** | **End-Q2 24** | **End-Q3 24** | **End-Q4 24** |
| United States | | | | | |
| Policy rate | 5.375 | 5.25~5.50 | 5.25~5.50 | 5.00~5.25 | 4.75~5.00 |
| 2yr | 4.45 | 4.50 | 4.30 | 4.00 | 3.70 |
| 5yr | 4.10 | 4.10 | 3.95 | 3.75 | 3.70 |
| 10yr | 4.15 | 4.25 | 4.15 | 4.00 | 3.85 |
| 30yr | 4.34 | 4.50 | 4.45 | 4.30 | 4.20 |
| Eurozone/Bund | | | | | |
| Policy rate/Deposit rate | 4.50/4.00 | 4.50/4.00 | 4.25/3.75 | 4.00/3.50 | 3.75/3.25 |
| 2yr | 2.60 | 2.60 | 2.35 | 2.15 | 1.95 |
| 5yr | 2.22 | 2.20 | 2.00 | 1.90 | 1.80 |
| 10yr | 2.31 | 2.30 | 2.15 | 2.05 | 1.90 |
| 30yr | 2.51 | 2.60 | 2.50 | 2.45 | 2.25 |
| Japan | | | | | |
| Policy rate | -0.1 | -0.1 | 0.0 | 0.1 | 0.2 |
| 2yr | 0.11 | 0.10 | 0.20 | 0.25 | 0.45 |
| 5yr | 0.32 | 0.30 | 0.45 | 0.50 | 0.65 |
| 10yr | 0.72 | 0.80 | 1.05 | 1.15 | 1.20 |
| 30yr | 1.79 | 1.70 | 1.80 | 1.80 | 1.70 |
| United Kingdom | | | | | |
| Policy rate | 5.25 | 5.25 | 5.25 | 5.00 | 4.75 |
| 2yr | 4.45 | 4.40 | 3.90 | 3.75 | 3.65 |
| 5yr | 3.94 | 4.05 | 3.65 | 3.55 | 3.55 |
| 10yr | 3.95 | 4.00 | 3.70 | 3.65 | 3.60 |
| 30yr | 4.56 | 4.60 | 4.35 | 4.20 | 4.20 |

| Macro forecasts (%) | 2023 | 2024 | 2025 |
|---|---|---|---|
| United states | | | |
| Real GDP | 2.5 | 2.0 | 1.4 |
| CPI | 4.1 | 2.4 | 2.4 |
| Unemployment rate | 3.6 | 4.0 | 4.4 |
| Eurozone | | | |
| Real GDP | 0.5 | 0.1 | 1.0 |
| CPI | 5.4 | 2.2 | 2.0 |
| Unemployment rate | 6.5 | 6.7 | 6.9 |
| Japan | | | |
| Real GDP | 1.7 | 0.8 | 1.0 |
| CPI | 3.2 | 2.5 | 1.9 |
| Unemployment rate | 2.6 | 2.5 | 2.4 |
| United Kingdom | | | |
| Real GDP | 0.5 | 0.6 | 1.2 |
| CPI | 7.5 | 2.6 | 2.0 |
| Unemployment rate | 4.1 | 4.5 | 4.8 |

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

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