MIZUHO

Mizuho EMEA G4 Forecast Update

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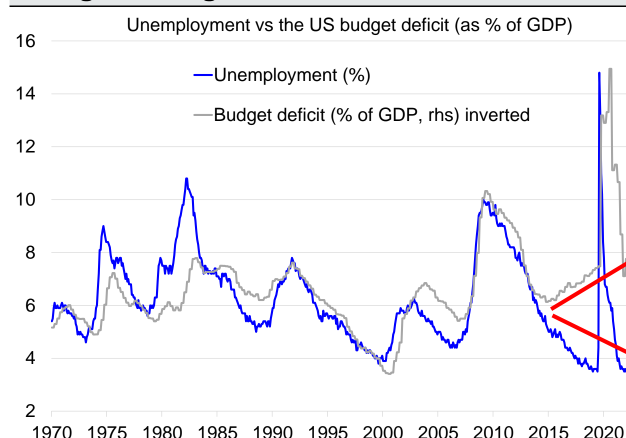
Initial thoughts on a potential Trump presidency

This month we roll our forecasts by one quarter to include Q1-25. By the end of the first quarter next year, the next US presidency will already be 2 months old – well into the 100-day period that many administrations target for getting things done. We acknowledge that 1) it is early to be thinking about an election that doesn't take place until November; 2) it is rare for one of the candidates to be facing so many legal problems (which makes the outcome more uncertain than usual); and 3) aside from his initial presidential election victory in 2016, the Republicans have tended to underperform with Trump at the helm.

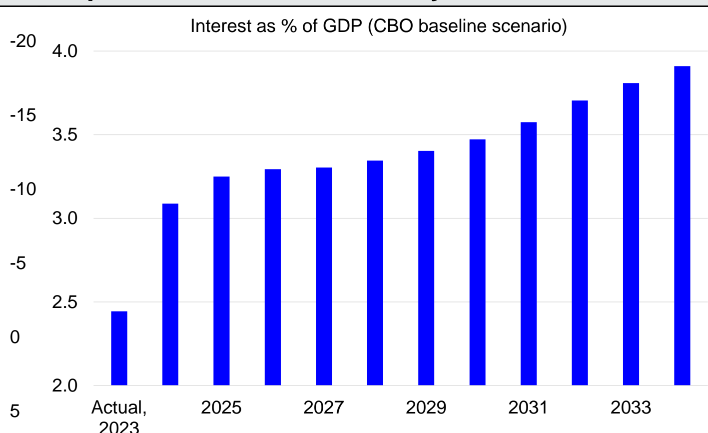
The polls point to a Trump victory in the presidential contest, and in that event, we see a decent chance of a Republican sweep of Congress too. This is our base case for now, although it's not one we hold an especially strong view on. **Plenty can change in coming months.** Nonetheless, our forecasts should reflect our base case and thus we make some preliminary assumptions about what a Trump victory/Republican clean sweep would mean for financial markets. **Fiscal policy will likely be looser under such circumstances. Indeed, this seems likely if either party gets its hands fully on the levers of power. In contrast, a split Congress would make significant additional spending less likely.** Our US colleagues estimate that the FY25 deficit would be up to 10% wider vs the current CBO baseline under a Trump/Republican Congress combination. Many of the tax cuts in the 2017 Tax Cuts and Jobs Act, which mostly expire in 2025, will likely be extended, while significant revenue-raising measures seem unlikely.

With our 2024 US GDP forecast implying growth already around trend, it seems likely that this boost to activity will be mainly inflationary. We have pushed up our end-2025 GDP and CPI forecasts marginally and lowered our unemployment forecast a little too. The labour market remains robust throughout the forecast period. **We suspect that higher inflation will mean that Fed policy has limited scope to ease in 2025.** Tariffs will likely mimic a modest supply-side shock nudging prices a little higher too. **Higher yields and a steeper curve seem more likely given the above developments but how about the US dollar? We suspect that US equity and credit markets will remain solid in the wake of the election. In turn, we think that, at least initially, this is positive for the US dollar as the market focuses on nominal policy rates, but in time the inflationary backdrop may start to weigh on the greenback.** Elsewhere, we are now less upbeat JPY in the wake of soft Q4 GDP data and continue to see GBP performing well, despite the technical recession in Q4, which we see as already in the rear-view mirror.

Rising US budget deficit…



… puts US debt sustainability to the test



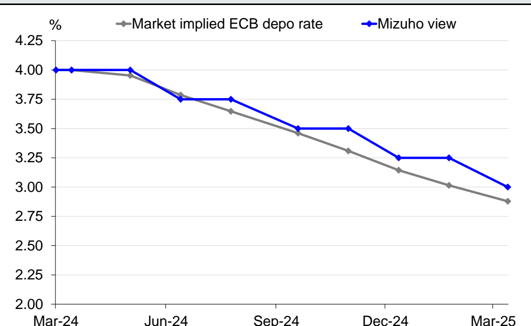
Source of all charts: Bloomberg, CBO

EUR markets

Macro – Looking forward to a firmer H2

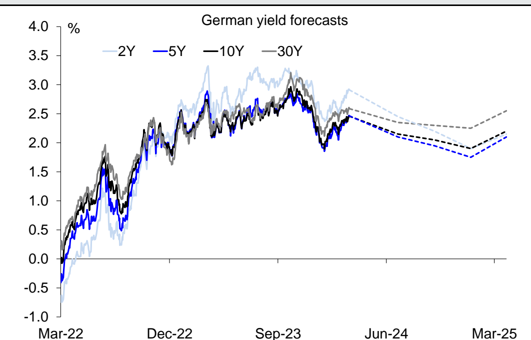
- **The eurozone avoided recession with Q4 GDP coming in flat.** However, activity remains weak, and we expect mildly negative growth in Q1 before a pick-up in Q2. The PMI has bottomed out, albeit at levels that imply contraction. Financial conditions remain tight, while money and credit metrics still 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 January. Labour hoarding is hitting productivity, which in turn will keep unemployment lower and inflation higher than it otherwise would have been. Our eurozone forecasts are unchanged this month.
- 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 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.



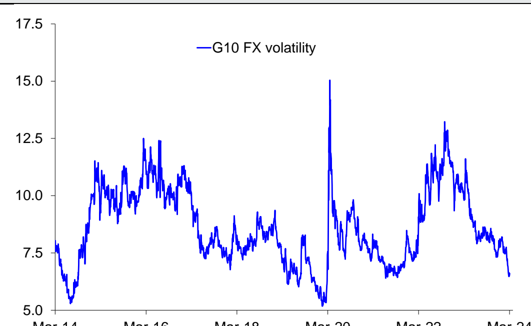
- The ECB left policy rates unchanged in January. Subsequent to that meeting, a number of ECB speakers have noted that June is the likely timing for a first rate cut. Current core CPI remains elevated, the ECB is upbeat on the labour market and there is a desire to see Q1 wage data that will not be available at the time of the April ECB meeting. To us, this means that either the activity data or the price data need to be very weak to push the ECB to ease earlier. Sluggish activity implies some risk of an April move, even if it is not our base case.
- The ECB is expected to announce their **new operational framework** in spring. We expect them to opt for a “demand-driven floor system”, where banks tap the ECB’s liquidity lines whenever they need to. The rate at which banks borrow is also expected to decrease, making the corridor for overnight rates narrower or even zero. This will likely offset part of the ongoing liquidity squeeze from the QT front, provide abundant liquidity to the Eurosystem and have a widening impact on the EE basis, with ESTR likely continuing to remain leaky in periods of stress.

Rates – Buy the dip into the first ECB cut



- The market has done a significant reassessment of the cuts priced for 2024. Current pricing of ECB cuts now looks more in line with our view. We think **the room for more upside in front-end EUR yields is limited** and think this is a good moment to position for a move lower.
- **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, driven by a decrease in the real term premium (not inflation term premium). **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



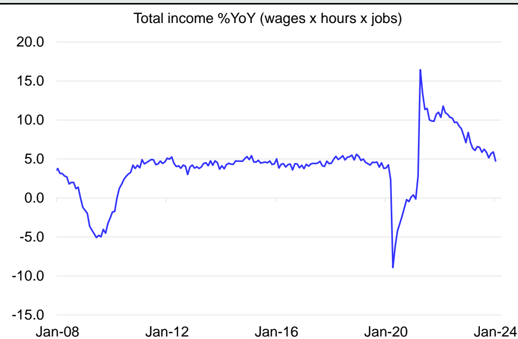
- With the market reassessment of the easing cycle having come a long way since the start of the year, we see scope for a few months of stability in FX markets. In the back half of 2024, the growth gap should start to narrow and EUR should recover a little vs USD.
- It remains the case that official 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 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.

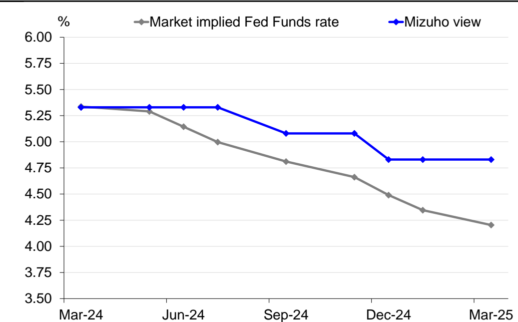
USD markets

Macro – Too Resilient?



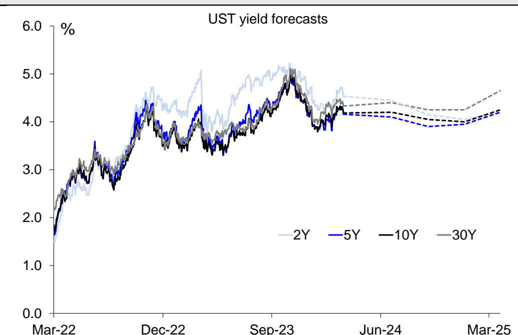
- In the wake of stronger-than-expected Q4-23 GDP, early Q1 momentum looks slightly above trend. We now expect looser fiscal policy in 2025 and nudge our 2025 GDP forecast 0.1pp higher.
- Labour market data do not suggest much softening. The direction of travel is weaker, but there are question marks about the pace of the slowdown. **We see a mild drift higher for unemployment in coming quarters, but from a low starting point.** We now see unemployment averaging 3.9% in 2024 (-0.1pp vs Feb), and 4.2% in 2025 (-0.2pp vs Feb) as fiscal policy loosens.
- Inflation risks in the US remain higher than elsewhere as growth remains 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 nudge our 2024 CPI forecast up to 2.5% (+0.1pp vs Feb), reflecting stickier price developments. Our 2025 CPI forecast is now further above target, at 2.5% (+0.1pp vs Feb).** Firmer growth/wider positive output gap, loose financial conditions, loose fiscal policy and the solid labour market mean the risks for the CPI are elevated.

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



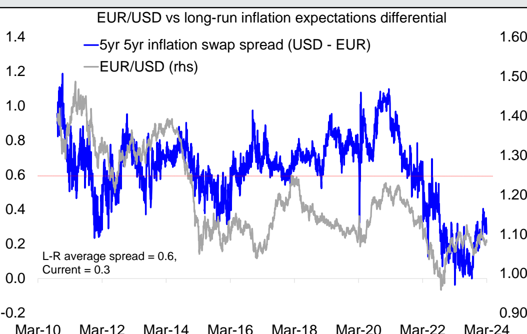
- In recent weeks, FOMC members have stressed that there is no rush to loosen policy. They would like to be more confident that the inflation target is in reach before easing policy. Recent data are undermining any confidence that the Fed might have had on the inflation front. We continue to **see the first cut from the FOMC arriving in H2. If fiscal policy loosens as we expect in 2025, then the terminal rate for the coming easing cycle will likely end with a 4 handle.**
- 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. The Fed is expected to discuss QT in more detail at the March meeting.

Rates – Capped downside in UST yields



- Looking at YTD moves, USTs have been outperforming Gilts and Bunds despite a relatively stronger macro picture. We expect this trend to reverse in the near term. **Cuts priced for the coming 12 months in the SOFR strip can be pushed back a bit further, while a stronger economy and expectations of looser fiscal policy should see term premia being priced into the UST curve.**
- Having said that, we expect the **selloff to show more signs of exhaustion and encounter dip-buying flows** as the macro backdrop softens and inflation eases further in H2-24. The rally will likely be led by the front end, driven by rate cut expectations and increasing term premia. We think that **the resilience of the US economy will cap how much USTs can rally in the next 12 months**. The Fed seems to be in no rush to taper QT, which coupled with loose fiscal policy, suggests higher long-term UST yields into 2025.

FX – Near-term drift. Weaker longer term.



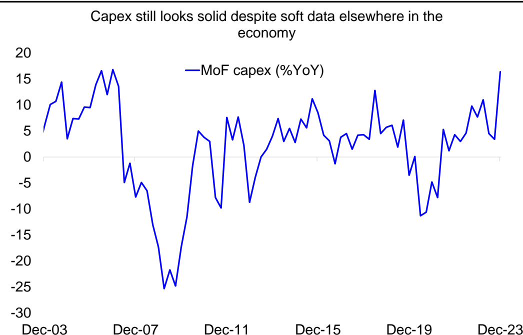
- Higher UST yields dragged the DXY index higher early in the year. We suspect that this dynamic is close to running its course. To date, the rise in UST yields has not been damaging for equity markets, which sit near record highs, but ongoing increases in UST yields will likely undermine equity markets 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 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.

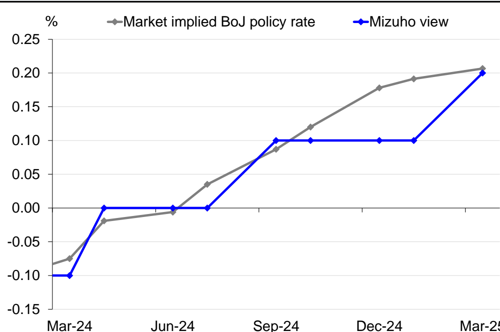
JPY markets

Macro – GDP downgrade



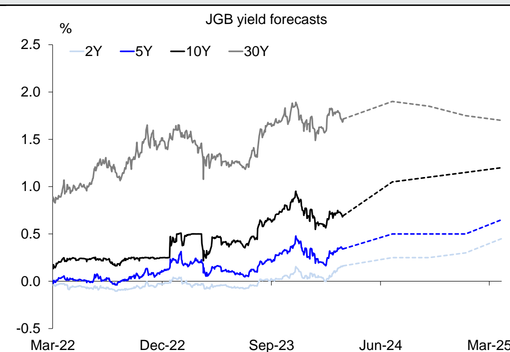
- Weak Q4 GDP and soft January data, most notably industrial production, mean lower 2024 GDP. **It's possible that Q1 GDP comes in flat or even negative, which would mark a third consecutive quarter of decline. We now see 2024 GDP at just 0.3% (vs 0.8% previously).** 2025 GDP is unchanged at 1.0%.
- Government energy subsidies run through spring. Should the subsidies end as expected, headline CPI will jump. Ex fresh food and energy CPI, a better measure of underlying price pressures, sits at 3.5%. **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%.
- 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 still in the cross hairs, despite weak macro data



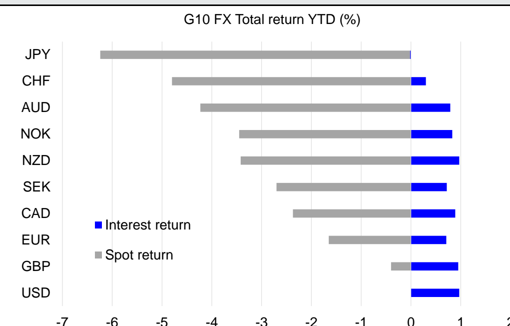
- **BoJ continues to edge towards an exit from NIRP, even as the macro data are softening.** Luckily for the BoJ, the soft activity data are not having much impact on prices, which remain elevated.
- The BoJ's YCC tweak in late October, which **turned the hard 1.0% upper limit for 10yr JGB yields into a "reference rate", spells the end for YCC.** We do not expect formal QT. Rather we expect that the BoJ will simply use the flexibility in the Rinban ops to slow purchases.
- Headline 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, especially as the macro data are coming in soft. This will make a cautious BoJ even more cautious. **We look for the policy rate to hit 0.2% by Q1 2025.**

Rates – Upside pressure in JGB yields to continue



- 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. After being relatively quiet in FY23, we expect Japanese domestic investors will become more active on adding long-term JGBs in FY24. **We like flatteners in 10x30s**, a theme we expect to accelerate in H2-24.

FX – Better times ahead for JPY



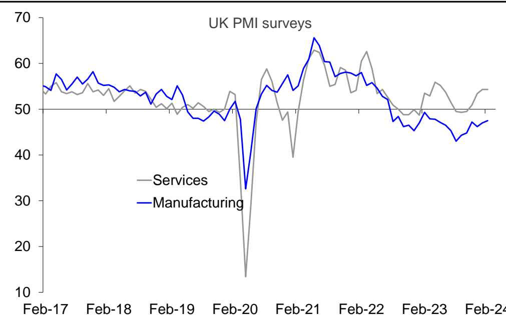
- We see UST yields as much closer to a near-term peak now market pricing is in line with Fed pricing. We expect a BoJ hike by the end of April. Both imply that the firmer yen backdrop that we expect is coming into view. MoF remains concerned about a weaker yen. Thus, investors will be wary of any moves higher in USD/JPY in the near term. Moves higher will be a grind, while elevated short JPY positioning implies sharper moves lower when the backdrop proves supportive.
- 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: **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.

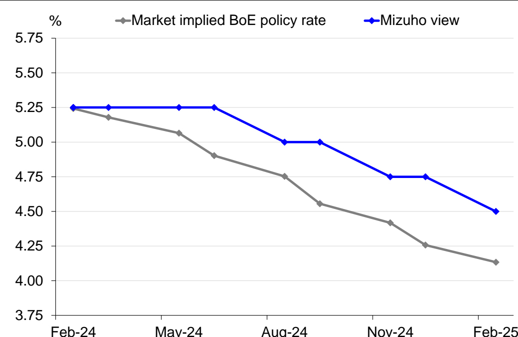
GBP markets

Macro – Slowdown already in the rear-view mirror



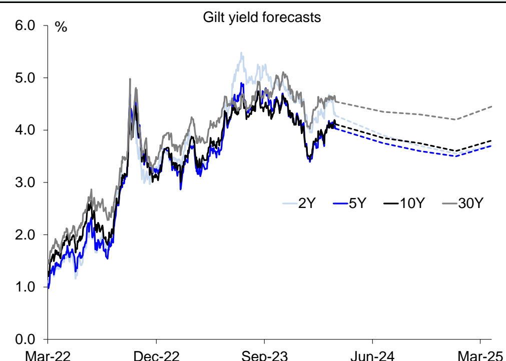
- UK GDP slid 0.3%QoQ in Q4, putting the UK in a recession. We suspect that the slowdown is already in the rear-view mirror. A wide range of data suggest a pick-up in early 2024, most notably the PMI data. Housing markets also look a lot more upbeat too.
- January showed limited progress on inflation at both headline and core levels. **We expect much lower headline CPI in spring and summer, driven by the plunge in wholesale gas prices.** We now see the CPI averaging 2.5% in 2024. A drop below 2.0% mid-year now looks likely. It will only be temporary. Sustained 2.0% inflation is likely only in 2025.
- 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



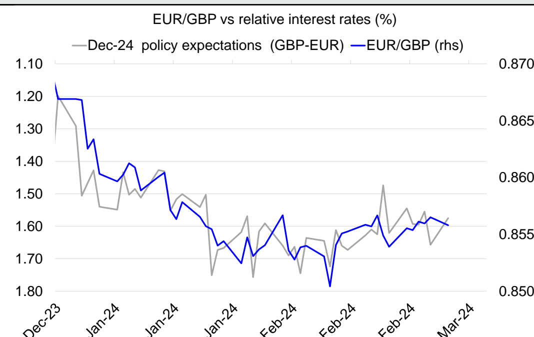
- The BoE left policy unchanged in February in a 1-6-2 vote. The vote skew remains hawkish, but most members believe rates have peaked. The BoE's new forecasts were downbeat on activity but, after a brief drop to target, they see CPI as mostly above over the forecast horizon.
- Recent rhetoric suggests no rush to lower rates even if the hawkish bias is no longer in the statement. Most members have noted the need for more certainty on the inflation outlook before easing policy. Labour markets remain tight by historical standards.
- **Last month we pushed back our first cut from Q2 to Q3 and we remain comfortable with that call, despite the slide into recession.** The new £100bn pace of has not delivered any upward pressure on yields as yet. The APF currently sits at ~£733bn, down from a peak of £895bn. Ramsden raised the possibility of selling the whole Gilt portfolio and substituting other assets.

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



- Ongoing macro softness and inflation heading down in spring will encourage investors to **buy the dip in Gilts**. The retracement of the Q4-23 rally has already gone a decent way. We expect to see lower Gilt yields in the near term and outperformance vs USTs.
- 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.** The pricing of cuts for the BoE looks subdued when compared with the Fed, especially if we consider the relative underperformance of the UK economy in 2024 and 2025. 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 nudge our GBP forecast higher vs EUR on a 12-month horizon as we see UK policy rates remaining higher for longer vs the eurozone, where the scope for cutting seems larger. 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

- 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 EMEA Forecasts (as of 1 March)

FX forecasts	Current	End-Q2 24	End-Q3 24	End-Q4 24	End-Q1 25
USD/JPY	150	144	140	135	135
EUR/USD	1.08	1.09	1.10	1.11	1.10
GBP/USD	1.27	1.32	1.34	1.36	1.35
EUR/GBP	0.86	0.83	0.82	0.82	0.81
EUR/JPY	163	157	154	150	149
GBP/JPY	189	190	188	184	182
Bond forecasts (%)	**Current**	**End-Q2 24**	**End-Q3 24**	**End-Q4 24**	**End-Q1 25**
United States					
Policy rate	5.375	5.25~5.50	5.00~5.25	4.75~5.00	4.75~5.00
2yr	4.53	4.45	4.15	4.05	4.20
5yr	4.16	4.10	3.90	3.95	4.20
10yr	4.18	4.20	4.05	4.00	4.25
30yr	4.33	4.40	4.25	4.25	4.65
Eurozone/Bund					
Policy rate/Deposit rate	4.50/4.00	4.25/3.75	4.00/3.50	3.75/3.25	3.50/3.00
2yr	2.89	2.45	2.20	1.90	2.15
5yr	2.43	2.10	1.95	1.75	2.10
10yr	2.41	2.15	2.05	1.90	2.20
30yr	2.55	2.35	2.30	2.25	2.55
Japan					
Policy rate	-0.1	0.0	0.1	0.1	0.2
2yr	0.18	0.25	0.25	0.30	0.45
5yr	0.37	0.50	0.50	0.50	0.65
10yr	0.71	1.05	1.10	1.15	1.20
30yr	1.74	1.90	1.85	1.75	1.70
United Kingdom					
Policy rate	5.25	5.25	5.00	4.75	4.50
2yr	4.28	3.90	3.70	3.55	3.70
5yr	4.03	3.75	3.60	3.50	3.70
10yr	4.11	3.85	3.75	3.60	3.80
30yr	4.54	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		4.2
Eurozone					
Real GDP	0.5		0.1		1.0
CPI	5.5		2.2		2.0
Unemployment rate	6.5		6.7		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	0.3		0.6		1.4
CPI	7.4		2.5		2.0
Unemployment rate	4.0		4.4		4.6

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

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