Mizuho Brief: Macro Tail Risks

Economics & Strategy | Asia ex-Japan

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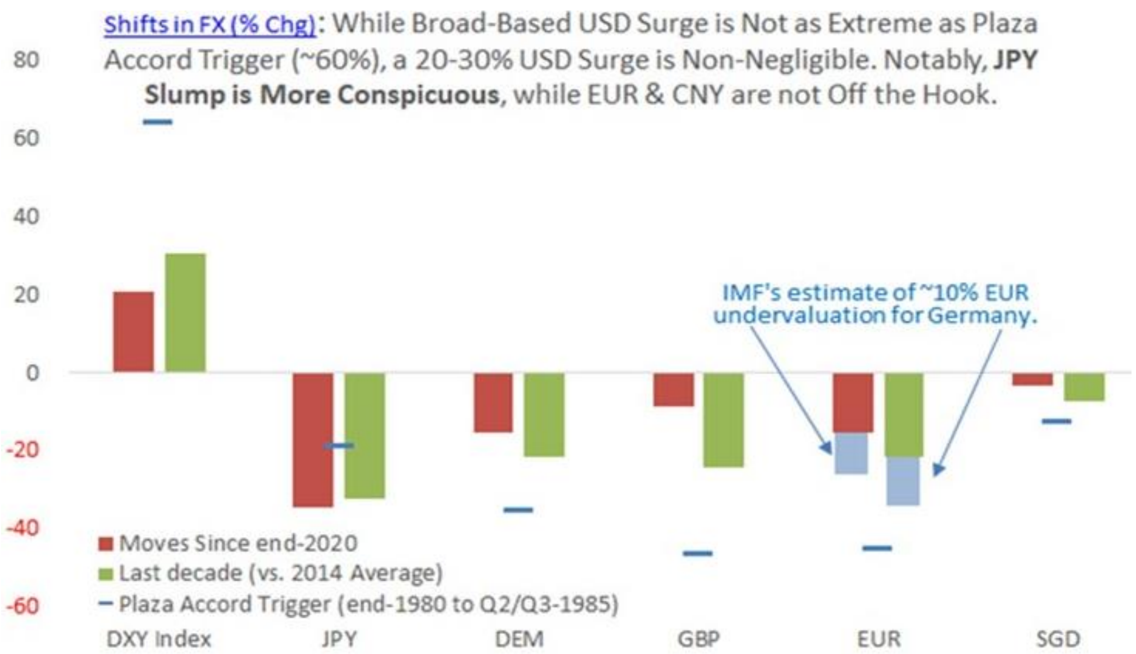
Macro Tail Risks: The "Trump Plaza

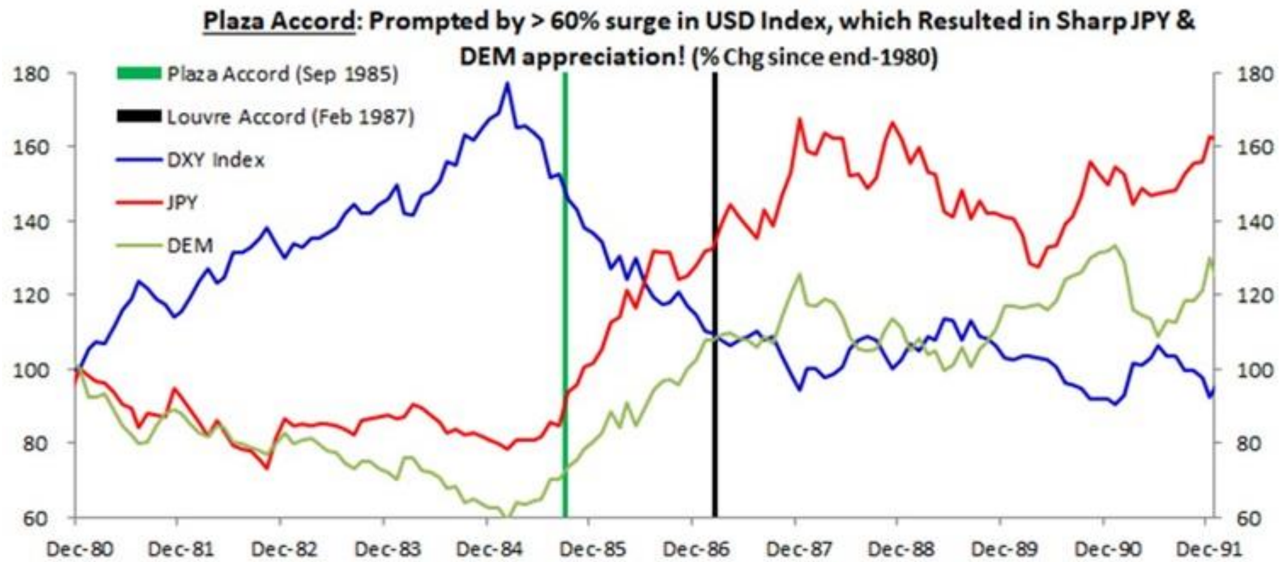
"Never tell me the odds" – Han Solo, Star Wars (The Empire Strikes Back)

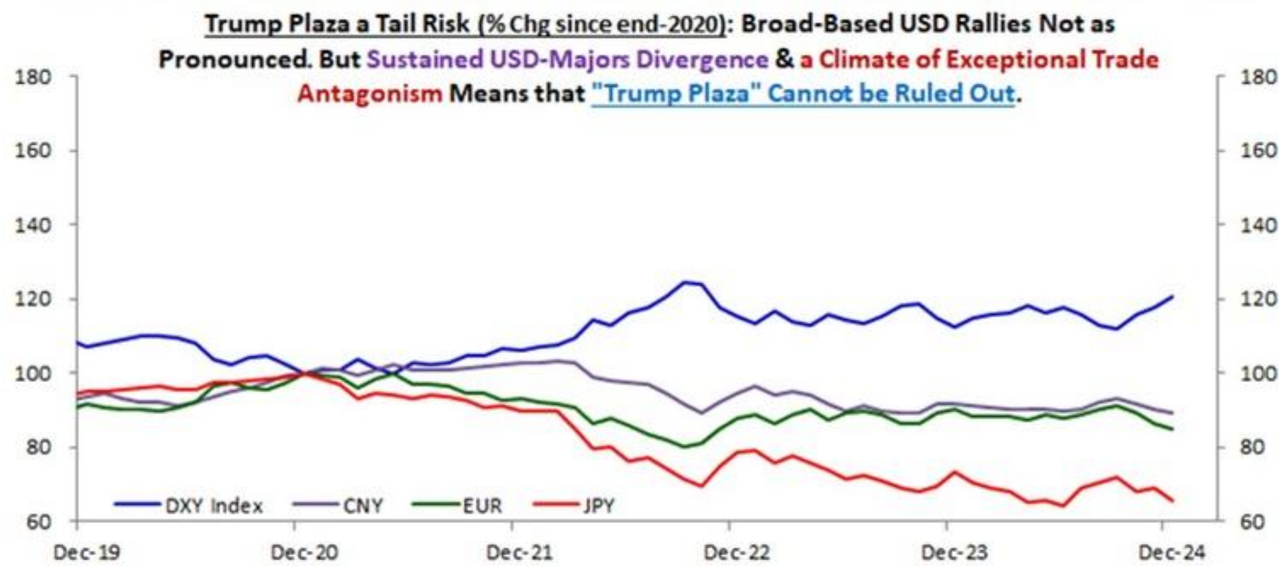
In a Nutshell:

- A **Plaza Accord-type reflex** from the Trump Administration is *admittedly* **a "tail risk"** (*of extreme consequence but very low probability*).
- Especially given **broad-based currency valuations** (vis-à-vis the USD) ***have not diverged as violently as compared to the 1980-1985 Plaza Accord run-up***. **Nonetheless**, coordinated policy action to revalue major currencies (JPY, EUR) higher (and soften the USD) **cannot be dismissed summarily**.
- Not *when global trade antagonism is exceptionally elevated* amid US tariff threats. **Perversely**, *currency pressures* on US partners *from* **tariffs threats** may **increase the odds of a "Trump Plaza" outcome**.
- Upshot: With **JPY exceptionally undervalued**, *USD significantly stronger* (on broader measures) and the *US intent on forcefully correcting trade imbalances*, **nothing is off limits**.
- Especially **insofar as a carefully managed calibration of currencies** (vs. USD) **helps to achieve the USD's dual objective** of an *uncontested reserve currency* yet *sufficiently competitive.*
- ***While certainly not the first resort***, there is **an identifiable path to Trump Plaza** (Plaza Accord 2) **amid heightened geo-economic tensions**.
- If this comes to bear, the ***sharpest appreciation shocks may come through the JPY*** with **significant collateral damage** *to Nikkei* and *risk sentiments amid "carry unwind".*
- ***AXJ assets could inevitably be swept up in volatility*** *and* ***pressured****. Although opposing FX (appreciation) forces via JPY and CNY cues will obfuscate the "end game".*



- The Trump Plaza (Accord 2.0) Tail Risk: The **"Trump Plaza"** reference is less to real estate and ***tail risks*** (*of extreme consequence but very low probability*) ***of the 1985 Plaza Accord-types of event trigger**** from this Trump (2.0) Administration.
- Exceptional USD Strength - Subduing Excessive & Unabating: Specifically, flagging the risk of **exceptional USD strength, if unabated, triggering** the possibility of **a coordinated G10/Major central banks/Finance Ministries plan** *to guide check extended, excessive and unabating USD strength.*
- Orderly Markets & by Order of US Manufacturing Ambitions: The stated aim of this Plaza Accord-type course will be **to restore orderly FX markets t remove trade distortions**. Notably, **US ambitions to revive strategic manufacturing advantage** also features.
- Critics of Scale & "Success" Not Wrong: Critics of the idea have good reasons to reject the idea of a Plaza Accord reboot 40-years on. For one, the experience of *materially higher FX imbalance thresholds* and *lessons of mixed success*





- JPY is the Sore Thumb: Notably, JPY is more than 33% weaker (vs. the USD) since end-2020, ***reminiscent of Plaza Accord-type perceived currency imbalance***.
- EUR Masks Trade Imbalance: Sure, EUR is "only" 15% softer (vs. USD) from end-2020. *But IMF estimates of EUR being ~10% undervalued for Germany* is smoking gun for a US Treasury inclined to re-balance currency shifts based on effective German-led trade imbalances with the Euro-zone.
- CNY a Chronic Undervaluation: And while CNY slippage is deemed even less extreme, it is less the recent depreciation than it is notions of chronic undervaluation.

* The Balanced USD "Bessent Agenda": Crucially, **Treasury Secretary Bessent's desire for** a **USD uncontested** in its position **as the global reserve currency *but not untenable*** (from excessive strength) ***as a globally competitive manufacturer***, arguably **can square with coordinated calibration of USD strength.**
* Albeit Requiring Steady Hands: The caveat is that this attempt at surgical precision in recalibrating a "Goldilocks USD" requires exceptionally steady hands, given two-way risks associated with reflexivity.
* Mitigating Uncontrolled USD Tailspin: **Bessent's time in stress-testing FX markets** and **structurally far less desirable fiat alternatives** (in other Majors) may **mitigate risks of setting off a disorderly plunge in the USD**.
* The "Louvre" Fear Lingers: Nonetheless, the **memories of** the ***"Louvre Accord"*** *that was subsequently required to arrest excessive USD weakness* **s warns of inadvertent oversteer** if "reflexivity" risks take hold.
* Underpins "Tail" & Tool: Accordingly, this, **puts the "tail" in Plaza Accord reboot risks**. *But while* a **"Trump Plaza"**, so to speak, is clearly **not the first port of call**, it would be a *mistake not to recognize it as **a potential tool in the box for strident trade hawks**.*
* JPY the Most Pronounced Risk?: ***If "Trump Plaza"/Plaza Accord 2.0* tail *risk materialize*,** **sharp revaluation shocks may be most pronounced in the JPY**. Not only *given the depth of JPY fall,* but perhaps from *memories of* the *original Plaza Accord.*
* Adverse Nikkei & "Risk Off" Spill-over: In which case, the collateral damage from a **coincidence of *adverse Nikkei spill-over*** and "***carry unwind" accentuating "risk off"*** may be considerable.
* CNY Cues & AXJ Stress: Consequently, **AXJ assets could also come under pressure**, although the *opposing FX (appreciation) forces from JPY* and (imaginably) *CNY cues* will **create tensions** and **set off attendant volatility**.

** To realign Major currencies higher (vis-à-vis the USD) to address entrenched trade imbalances*

*** Extrapolated from the 7.5% from the IMF Article IV, (conservatively) adjusted for a drop in EUR since.*

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