Mizuho Brief: Macro Risks

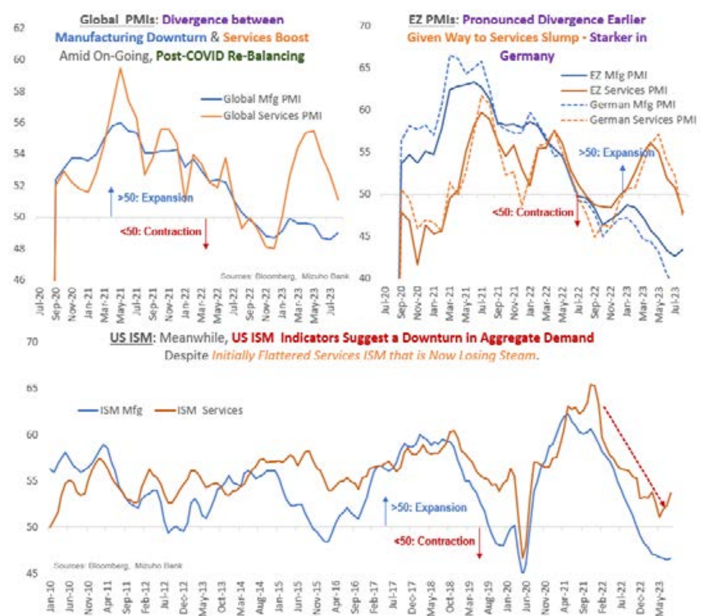
MIZUHO

Economics & Strategy | Asia ex-Japan

September 12, 2023 | Vishnu Varathan | Head, Economics & Strategy

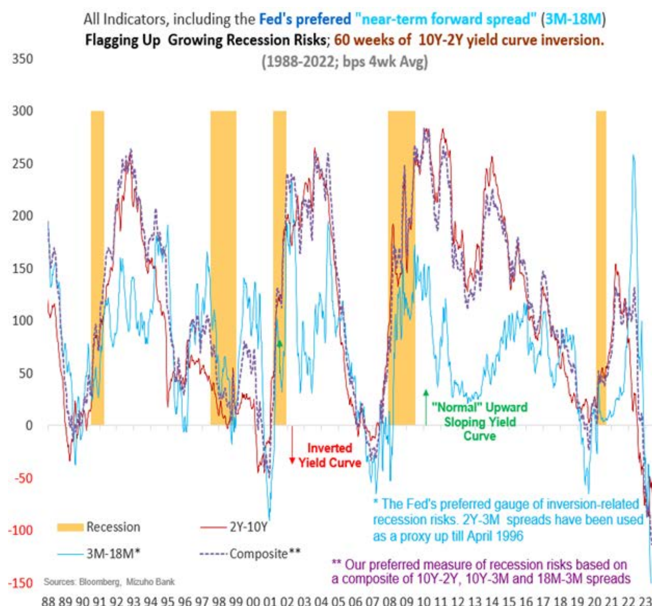
Why Peak Fed is Not Peak Pain

- *As the Fed approaches the end of rate hikes,* not only is **anticipatory relief palpable**, but **"pivot" exuberance is building**.
- *But* our warning is that **cheer is premature**.
- For one, historically downturns coincide with **acute credit tightening** *after* **"peak Fed"**.
- What's more, **risk premium** (in EM Asia) has been **unusually depressed**; **under the cover of** *exceptional inflation spread inversion* and *indulgent post-pandemic liquidity.*
- But both are **on borrowed time**. And ***reversion*** underway set ***to prompt risk re-pricing****;*
- with *China chills threatening to exacerbate economic headwinds, capital outflow/currency depreciation risks.*
- More so **as a strong USD imposes demand pressures** and **financing risks**.



1. Downturn Risks

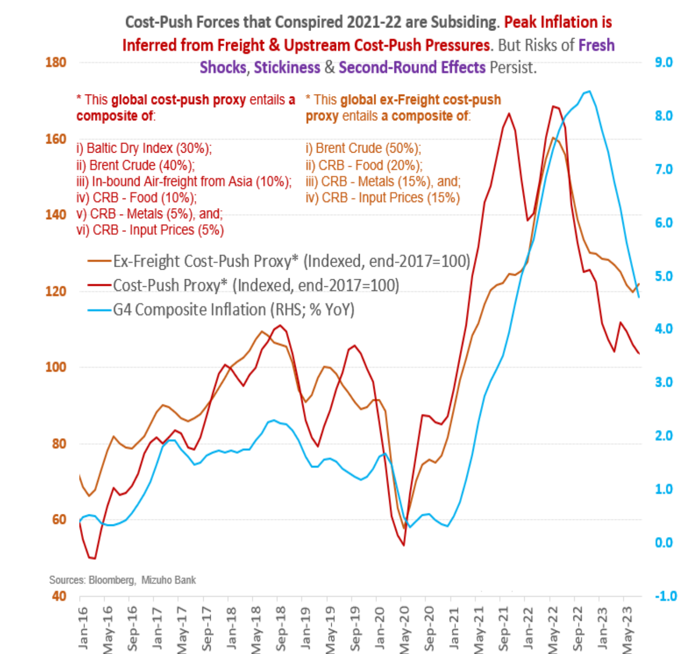
Global downturn risks flagged by a **profoundly inverted yield curve**, which has a *remarkable track record for predicting recessions.*



Add to that signs of **fading post-pandemic pent-up demand/buffers** and exceptionally brutal policy tightening and the dangers of a downturn ahead become harder dismiss.

2. Inconvenient Inflation & Geopolitics

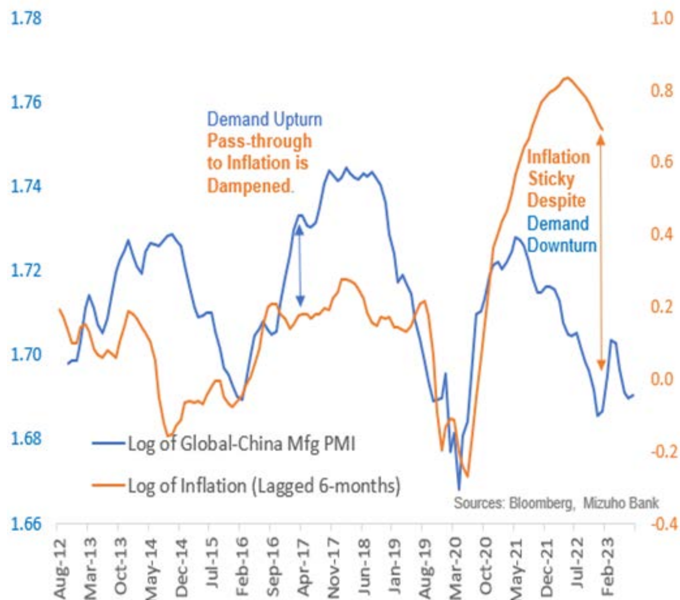
While **global inflation** has probably peaked, it remains *uncomfortably elevated, inconveniently sticky;*



and perhaps most worryingly, **exposed to further outburst of cost-shocks** from weather and persistent geo-political risks; be it first-order Russia-Ukraine or derivative via OPEC+.

3. Dangers of Policy Mis-steps from Dissociation

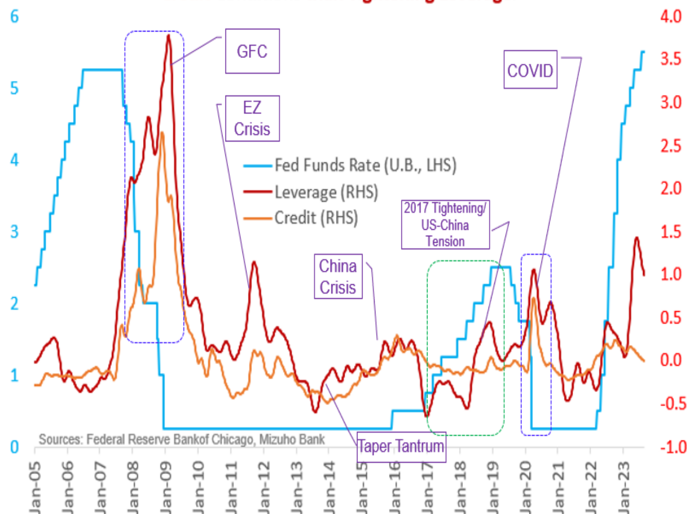
The **dangers of over-tightening are accentuated** by the *dissociation between (dis-)inflation, jobs and demand,* whereby **slowing demand has not materially** weakened the labour market and **not sufficiently induced dis-inflation**.



Amid elevated (~$90) oil in a climate of global manufacturing slump. The odds of, and costs associated with, policy mistakes (*too much tightening for too long*) are high and rising.

4. Tyranny of Long & *Variable* Lags

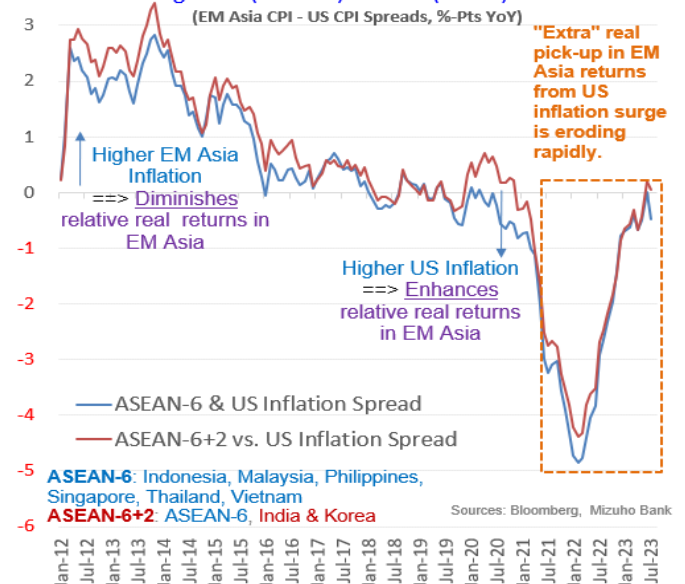
Long and ***variable*** **policy lags amplify policy mis-step risks**. Specifically, as the *Fed deems credit tightening sanguine* and policy lags shortened by large, rapid hikes alongside forward guidance.



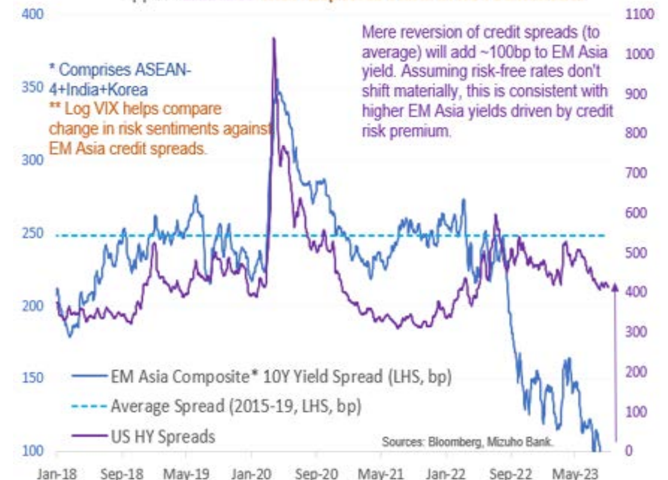
The **resultant false sense of comfort** to hold rates high(er) **may perversely precipitate a recession** if far sharper leverage tightening belatedly (amid unfamiliar post-pandemic dynamic) invokes credit shocks.

> ***Policy*** ➔ *Expect the* ***Fed to cut rates sooner and more sharply*** *from H1 2024.*
>
> ***UST Yields*** ➔ *Consequently,* ***near-term upside volatility*** *in UST yields may* ***flip to sharp downside volatility*** *(accentuated initially at the front-end) from late-2023/early-2024.*

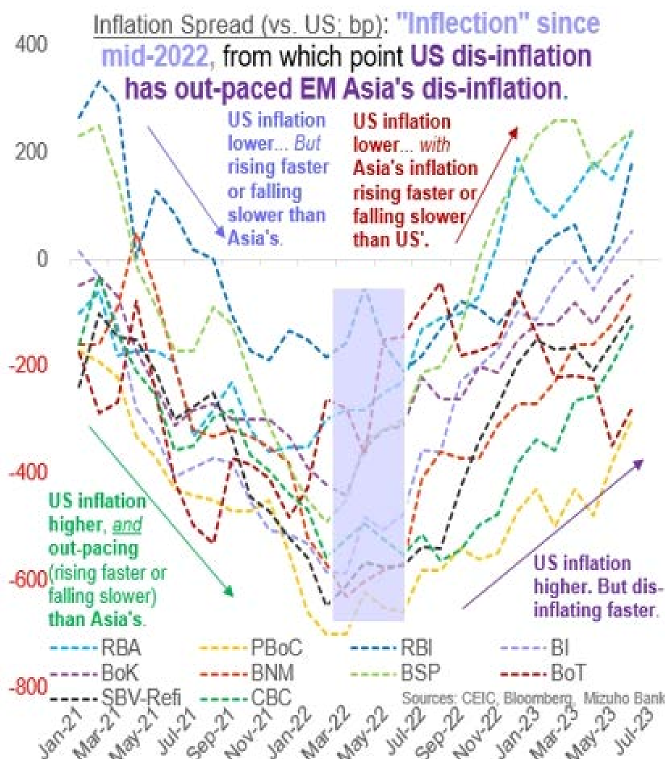
5. Exceptionalism Exhausted



An exceptional state of **significantly higher US/DM inflation vis-à-vis EM** (Asia included) in the context of unprecedented global liquidity has imaginably driven an *unusual reduction in risk premium.*



But this **exceptionalism is on borrowed time**; *as liquidity drains* and EM Asia's *excess inflation vis-à-vis US is restored* amid a conspiracy of food/energy risks, tourism resumption and stretched subsidies.



6. The Missing Risk Premium Puzzle

This will restore "missing" risk premium (pressuring EM Asia FX/assets) as; i) Fed policy lags catch-up and; ii) unusual (US-Asia) inflation dynamics revert

> ***Risk Premium*** ➔ *Even as "risk-free" rates (Fed Funds rate, UST yields) may be set to fall, risk premium could rise sharply.* ***This will obfuscate the outlook of rates in EM Asia****.*

7. Amplified by China

China risks comprising deep-seated economic distress (including far-reaching property impact) and geo-political threats could very well **catalyse risk premium restoration**; *potentially comprising a less orderly sell-off in EM Asia assets/currencies.*

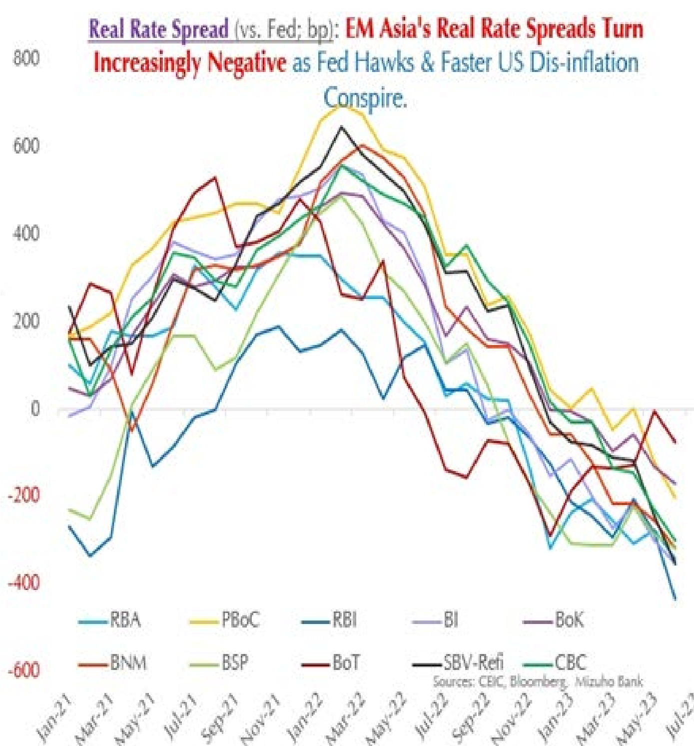
Not just via supply-chain and investment drag. But also, **capital outflow risks** deriving from ***chronic CNY depreciation spill-over*** and/or potential China credit risk blowout.

8. Don't Dismiss (Strong) USD Risks

Despite **received wisdom about "peak USD"**, it would be **unwise to dismiss** the occurrence and impact of **a strong USD too soon**. Atypically, despite late-stage Fed tightening/peak cycle, USD;

i) retains *real yield advantage* amid relative economic out-run and dis-inflation edge, and;
ii) the boost from *haven allure* amid uncertainty

> ***USD Impact*** ➔ *Exceptional real rate advantages of the USD and lack of allure in the alternatives (G10 FX) may prolong USD strength until very aggressive Fed rate cuts and bottoming of economic gloom.*



This will **dampen and defer sustained gains against the Greenback** (into H2 2024).

Meanwhile, it could **accentuate capital outflow risks** corelated, and often proportional, to "twin deficit" and inflation vulnerabilities.

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