Mizuho Insights: 2021 Risk Outlook

MIZUHO

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"Who knows? Have patience. Go where you must go, and hope!" – **Gandalf, Lord of the Rings**

A Glimpse of the "Other Side"

In a nutshell: After **unprecedented pandemic setback** in **2020**, **the road back to normalcy is a relief**. But recovery will be **neither brisk nor unfettered**. Fact is, **demand resumption from vaccines will not be instantaneous *nor* fully restore pre-COVID consumption levels**. Instead, a **bumpy recovery** predicated on vaccine rollout and lingering China risks will result in **uneven, initially tentative, pick-up spread over 2021-22**. While job losses may not surge, **wages will be subdued** amid fragile jobs recovery. And the coincidence of **spots of cost-push** from front-running commodity prices eroding profits/disposable income may **perversely hamper demand restoration**. Hence, not just justifying, but **requiring record policy accommodation**. But despite record stimulus, **access to liquidity/credit will remain uneven**. Whereas frustratingly, **asset bubbles** become a **prominent feature** rather than by-product **of ultra-loose monetary policy persisting**. Resultant **intensification of hunt for yields amid a deluge of cheap money will boost EM assets and FX** (accentuated by a **chronic soft USD trend**); albeit in a **differentiated** manner consistent with COVID recovery. Exacerbated **risk mis-pricing** and **overdone EM FX gains** may emerge as **sources of policy/political discomfort**.

Bumpy Ascend

To be sure, the **global economy is poised to be on a better footing into 2021** as **vaccine rollout broadens** against a backdrop of **abundantly accommodative policy**. Demand recovery back to pre-COVID levels will thus continue to be on track, likely **picking up pace and extending to a sturdier 2022**. That's the good news.

However, the more sobering reality is that the **recovery from unprecedented pullback may not be complete or uninterrupted**; **prone to air pockets** along the way, led by fresh outbreaks of COVID globally. But COVID outbreak in the interim to global vaccination is not by a long shot the only downside risk. Instead, risks of **policy mis-steps** as well as **diplomatic/geo-political minefields** keep means a **narrow path to averting headline shocks**. Alongside a **more leveraged** world, in which households and businesses alike remain afflicted by **confidence shortfall**, the return of pent-up demand is **fragile/tentative.** And that sets course for a **bumpy ascend as the world digs itself out of the COVID hole.** [See Table 1 & Figure 1]

Strains: Virus, Vaccine, Policy … & Recovery?

Vaccine availability, while a **catalyst for recovery**, is **not guarantee of unbridled rebound**. Challenges to **efficacy** and **strains on capacity and logistics** required for global rollout of sufficient scale and speed are compounded by outbreak of ***new and more virulent strains of COVID***. In turn, **renewed strains** on **healthcare capacity** and **re-imposition of social restrictions** – as nuanced as it may be – will **invariably interrupt, and possibly retard, economic recovery**. The degree of disruption will vary between countries (stacked against EM), but **does not distract from the bigger picture of a strained recovery**.

What's more, **unprecedented, monetary stimulus front-loaded alongside strains from record fiscal stimulus hamper scope for more policy fillip**. Mainly as **trade-off between unimpeded stimulus and macro-stability sharpens** in 2021. Especially for "twin deficit" EM economies, overly aggressive central bank balance sheet expansion may evoke debt monetization fears; in which case turn counter-productive.

Upshot: While the **vaccine will catalyze more emphatic demand recovery**, the road to *unencumbered activity and travel resumption associated with ~60-70% global herd immunity is 2-3 quarters away*. More worryingly, it may be **fraught with resurgence of virus mutations** and **subject to more constrained policy options**.

Vaccine: Limited Immunity, Not Sweeping Panacea

Crucially, the **vaccine may only be expected to restore demand potential smothered by the virus** and related activity and border restrictions. But a **sweeping panacea it is not.** Specifically, economies are not absolved of **underlying risks such as US-China conflict**, **political uncertainty** and **payback for policy stimulus**. Instead, these risks may come home to roost post-COVID, dampening recovery beyond initial pent-up demand.

US-China: The most prominent being, **US-China tensions** that have **mounted** on US' **trade and financial sanctions** on China as well as friction from issues related to Taiwan and Hong Kong. How these risks evolves will have **far-reaching** spill-over impact on global (especially Asia) **supply-chain and capital flow volatility**.

Political risks: **Worsening inequalities** in a post-COVID world, **polarization on social issues** and more **dis-enfranchisement** may result in **more acute political risks post-COVID** as social restrictions are relaxed.

Debt: **Higher public debt** from record fiscal stimulus in response to the pandemic, while alleviated by lower interest rates, **will not be simply vaccinated away**. EM economies are particularly disadvantaged insofar they do not enjoy low/negative rates of DM economies.

Jobs: Devil in the Details

Upbeat assumptions of **job losses** mitigated by on-going economic recovery must be tempered by economic realities of **significant rise in unemployment typically lagging the economic cycle**. Especially given exceptional fiscal support for wages during COVID, which may have merely kicked the retrenchment can down the road. So, **less adverse jobs outcomes** are necessarily **dependent on continued fiscal efforts**.

On balance, **exceptional policy support** thus far alongside **"green shoots" of vaccine-driven recovery** will probably **help avert worst case global jobs crisis**. Nevertheless, **lingering weakness in sentiments** and **confidence** will probably show up as prolonged **weak wage growth**.

Inflation: Demand-Pull/Cost-Push Dissonance

Which in turn suggests **demand-pull inflation pick-up will be hampered by weak wage-price dynamics**. However, this should not be mistaken for all-round absence of price pressures.

Instead **cost-push arising from commodity, energy** and **food prices** alongside corresponding rise in freight/logistics costs and **COVID-related cost pass-on** (healthcare/surveillance infrastructure) could lift inflation; **especially amid competition for resources** as economies start-up from a position of diminished stockpiles. [Figure 3.]

A distinction needs to be made between transitory base effects and "stickier" cost step-up. But **some dimension of "reflation" must be conceded**. Crucially, the **dissonance** between **lagging demand-pull and front-running cost-push needs close monitoring**.

The Unwelcome "Squeeze"

This is where the **rubber meets the road on** the **inflation debate**. The upshot, in the context of global central banks bent on averting deflation, restoring target inflation, is that **not all inflation are equally desirable**.

Specifically, **rapid cost-push inflation in the absence of adequate wage-gains** (the not-so-secret sauce for a virtuous demand-pull inflation restoration) inflicts the **tyranny of diminished disposable income**. The corporate equivalent of which is **shrinking profit margin** insofar that weak demand conditions compromise the ability to pass-on higher costs. Weak wages and compromised profits in concert may **dampen durable demand recovery**.

This **unwelcome "squeeze" on households and businesses**, despite showing up as higher inflation in aspects of consumer/producer price indices, is in fact the **perverse manifestation of a deflationary demand spiral**.

Exceptional Accommodation, Not Access

Which is exactly why **central banks will justifiably not react to any initial pick-up in inflationary pressures**; even if this is over are above base effects. The *Fed's* shift to *flexible average inflation targetting* in this regard will be a **global anchor for** not only **"lower for longer" rates**, but also "**larger for longer" balance sheets**.

However, the resultant **deluge of cheap money**, will still **suffer from asymmetry of access – both within and economy and across the globe**. Within an economy, **smaller enterprises and households** that need the financing the most, may unfortunately be **deprived of affordable credit**. Insofar that direct **fiscal intervention may plug some of these gaps**, the ***importance of not yanking fiscal lifelines are emphasized***.

But insofar that **EM economies are subject to far more imposing borrowing constraints**, compromised access to cheap financing will **drive sharper divergences in the capacity for policy support, and thus, inequalities**.

Exuberance & Inequality

Optimists will argue that **aggressive yield-seeking by cheap central bank mone**y let loose in a recovering global economy – and the resultant **diversion of capital into EM economies** – will **help to paper over some of the credit access disadvantages** faced by EM economies. In other words, **almost cavalier bet that exuberance will help alleviate inequalities**. This is not an entirely false premise as EM economies benefit from capital inflows.

But the **trouble is** that **this version of "trickle down" capital market benefit** derived of yield-seeking "hot money" is **vulnerable to two-way "easy come, easy go" volatility**. Crucially, **asset bubbles end up as the prominent feature** of such cheap central bank cash, **whereas stable boost to consumption and investment may be a second-order outcome**.

Upshot being, **with exuberance**, **concerns of market distortions**, **over-valuation** and **risk mis-pricing will persist in 2021 as the catch up in fundamentals and**

revenues/earnings lag the inundation of central bank liquidity in to asset markets. What's more, this also comports with a **bigger picture of widening inequality** exacerbated by **financial repression**, **asymmetric access to credit** and **run-away asset prices**.

Cheaper USD: A Matter of Speed & Depth

A **conspiracy of exuberance**, **exceptional US monetary largesse** (low US rates/yields and Fed QE at a pace of some $120bn/mth) alongside **sharply widening US "twin deficits" make for a weakening USD theme**. What's more, **lower real UST yields** – as nominal yields remain anchored by the *Fed's paradigm shift to "flexible average inflation targetting"*, but inflation expectations run up to a greater degree in anticipation of recovery and cost-push – help **entrench a softer USD bias to persist into 2021**.

But the **speed and depth of the USD's decline may moderate** after an almost 7% drop in the USD Index in 2020 (down ~13% from its March peak). Especially **given record speculative short USD positions** and already **depressed real UST yields**. Moreover, **lingering uncertainties** mean that episodes of latent **volatility in the Greenback should not be discounted** if safe-haven demand is triggered ("left half of USD Smile") or nominal UST yields play catch up to inflation expectations abruptly lifting real yields. [Figure. 4]

EM Asia Assets/FX: Flattered but Not Carried Away

A **cheaper USD** is, on many accounts, **positive for EM Asia**. Fundamentally, a softer **USD deflates external debt**, **flattering credit metrics** and **buoying EM Asia asset valuations**. Moreover, studies have shown that a **softer USD boosts external demand, benefitting of most EM Asia exporters**. What's more, **"carry trades" financed by a cheap USD** also favour EM Asia; especially where the growth story is supported by strong post-COVID revival and/or commodity-driven positives. *That said*, **EM Asia currencies are not set to be carried away in 2021 either**.

Apart from more measured USD wekness, **discomfort with "too much, too soon" EM Asia FX appreciation** getting **too far ahead of realized recovery** in tourism (e.g. THB) and/or exports is one clear concern. Excessive currency appreciation **negating policy stimulus** (e.g. RBA concerns about AUD) is another. What's more, **C/A advantages gained during the pandemic** – from imports compression (led by oil, capital goods, Figure 5.) outpacing exports drop – **set to erode on COVID recovery ought to diminish appreciation bias**. This may be felt most acutely by PHP, INR, IDR whereas usual C/A surplus positions buoy KRW, THB, SGD and MYR tone. Finally **more measured CNY appreciation in 2021** on stability cues and diminished C/A as well as pandemic advantages **may check EM Asia FX**.

Asia Not Immune to FX Policy Risks

But **EM Asian central bankers** (e.g. BoT, BoK) **fretting too much currency appreciation too soon** may be **denied unfettered policy recourse as diplomatic/geo-political risks mount**. The (Dec 2020) **US Treasury Report declaring Vietnam a "Currency Manipulator"** and **adding Thailand, Taiwan, India to the "Monitoring List"**, which also consists **China, Japan, Korea, Singapore and Malaysia** (apart from Germany and Italy), is a case in point about **FX policy tensions between US and Asia**.

A more **promising landscape for Asia in 2021 is not disputed**. **But COVID vaccine alone does not immunize wider risks**; even if Biden's pivot to Asia entails softening of Trump's zero-sum game, bottom-line approach to trade with Asia. **Spill-over risks from China**, which helped with the region's supply-side demand recovery in 2020,**and pre-existing risks within EM Asia** are not to be ignored.

Beware China Risks …

The **elephant in the room is US-China conflict risks**. While Biden may justifiably lower the termperature, headline uncertainty, **polarization of US or China alignment** and attendant **re-wiring of supply chains** will begin to re-jig. **China's selective boycott of Australia may intensify**, though **Indonesia's coal sector may benefit** from this. Meanwhile Vietnam, Malaysia and Thailand benefitting from global manufacturers re-locating away from China come at the cost of walking a diplomatic tight-rope with China.

China's policy/regulatory risks revealed in the crackdown on Alibaba, justifiably spooks. Also, **PBoC reining in credit risks** with well-intentioned curbs **to prevent a "Minsky moment" down the road** ironically **risks setting off unintended financial contagion** if credit rollover risks inadvertently result from Beijing (over-)tightening screws on liquidity. Opacity on policy/regulation may **stifle within China and Asia via supply-chains/financial linkages**

… & ASEAN Politics

Renewed unrest from street protests in Thailand, and the **Malaysian government's susceptibility to "no confidence" challenges** are political risks which could potentially resurface. Meanwhile **India's farm bill protest is unwelcome disruption** in the midst of the pandemic.

Brighter, but Braced

Gandalf's "Who knows?" wisdom is priceless, driving home the point that a glimpse into a brighter 2021 is no reason for complacency; **requiring that we be braced for bumps** along the way.

Table 1: Growth Outlook

Base case	Actual	Forecast					
	2019	**2020**	2021	2022	2023	2024	2025
China	6.1	**2.1**	7.9	6.0	5.6	4.8	4.6
India	4.2	**-7.8**	7.5	9.1	7.8	7.6	6.7
Australia	1.8	**-3.2**	3.7	3.6	3.2	2.9	3.0
Korea	2.0	**-1.0**	3.1	2.9	2.7	2.6	2.5
Indonesia	5.0	**-2.4**	5.6	7.3	6.5	5.8	5.5
Malaysia	4.3	**-5.5**	6.7	6.9	4.9	4.5	3.7
Philippines	5.9	**-8.3**	6.6	13.4	9.6	8.6	4.6
Singapore	0.7	**-6.0**	4.8	3.6	2.5	2.6	2.0
Thailand	2.4	**-6.9**	4.2	5.3	3.6	3.3	3.6
Vietnam	7.0	**2.9**	6.9	8.2	6.7	6.2	5.7
ASEAN-5	4.8	**-4.7**	5.6	7.4	5.8	5.3	4.5

Source: Mizuho Estimates

Figure 2. How Vaccine Impacts on Growth Recovery

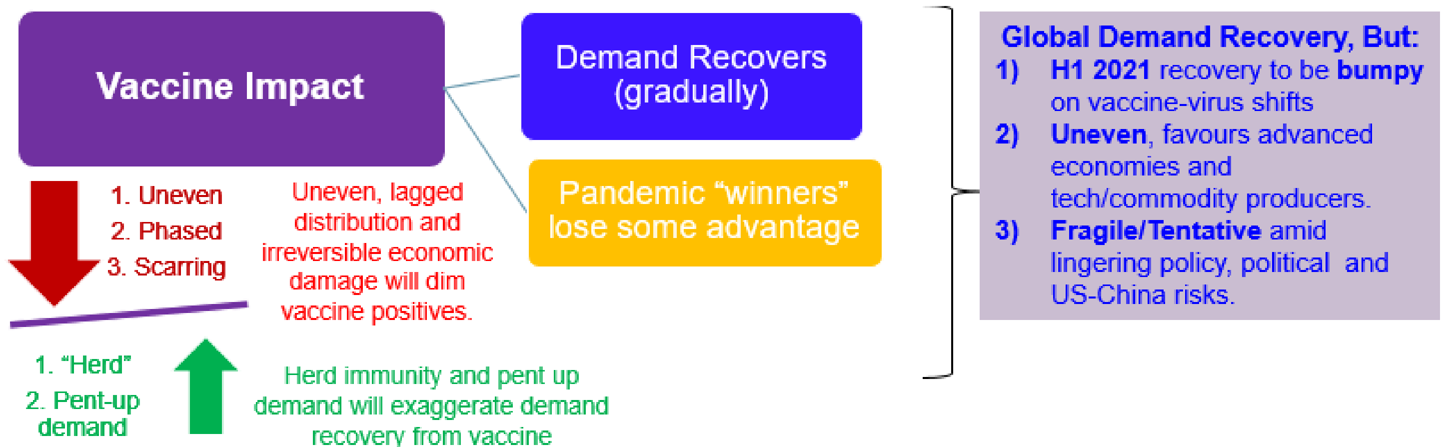


Figure 3. Commodity Prices Surge on Expectations of Vaccine-Driven Demand Recovery

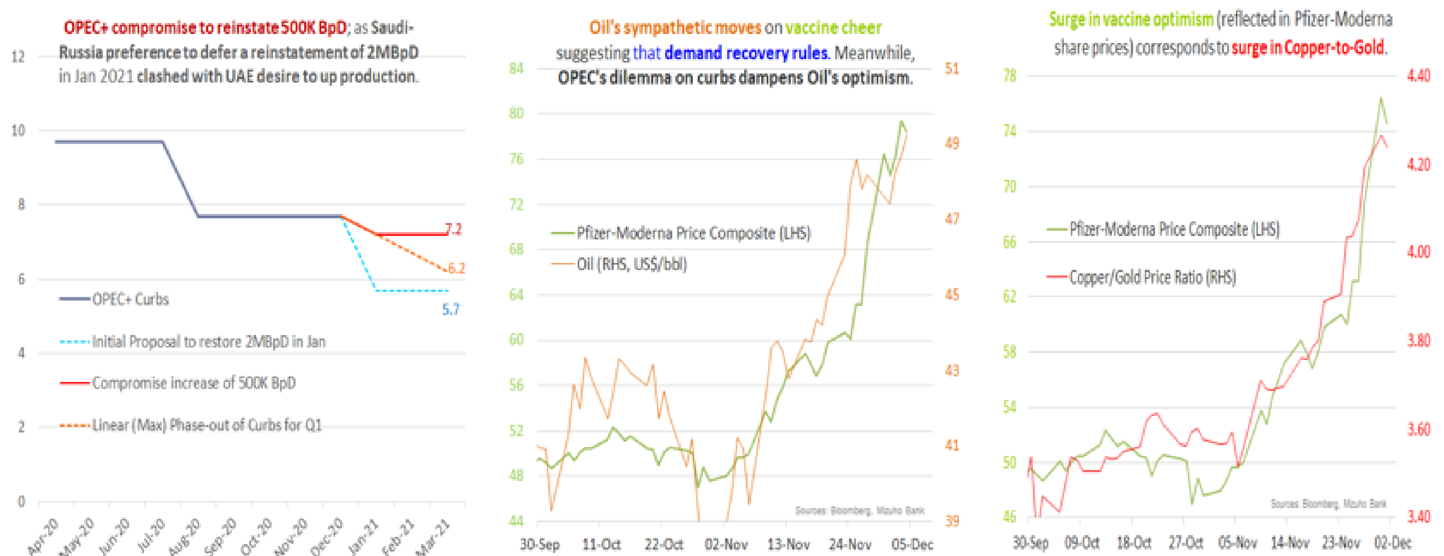
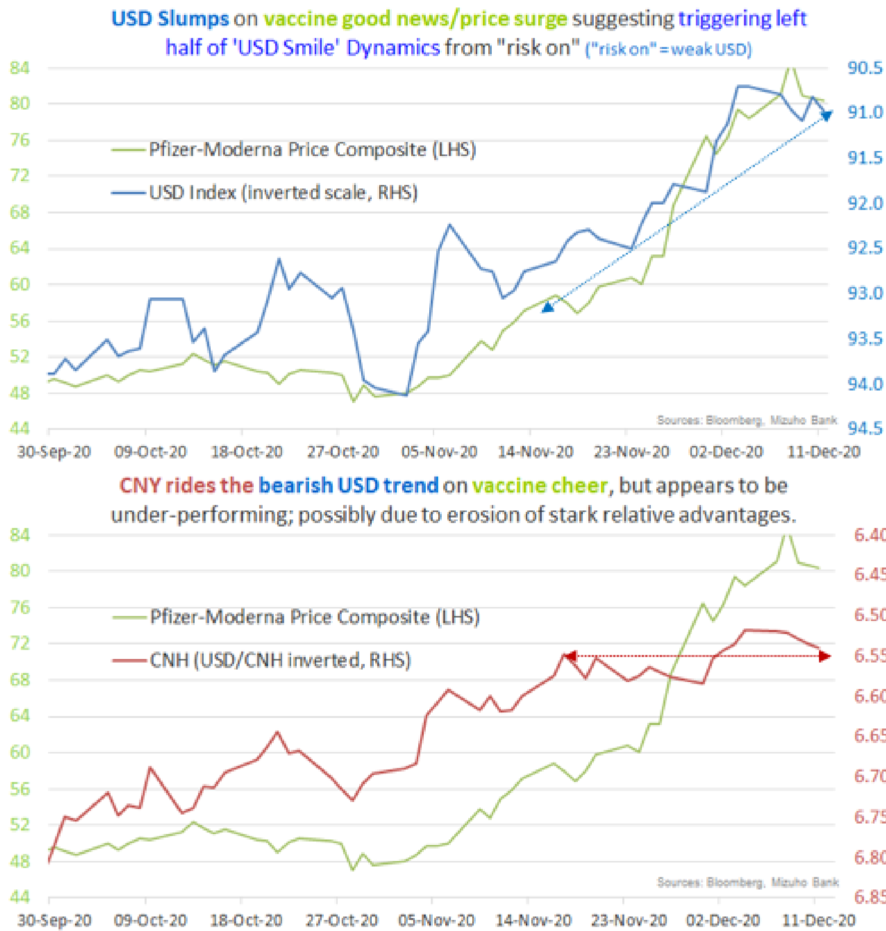


Figure 4. USD & CNY Dynamics



USD Drivers:

USD Bears have not left the building:

i) Comparatively **Dovish Fed driven by the novel FAIT* paradigm**.

ii) Left half of **'USD Smile'**

iii) **Low(er)** ***real*** **UST yields** as rise in BE and inflation swaps overtake.

But **'USD Smile' remains a two-way dynamic**, ➔ any loss of confidence or sudden scares or sustained rise in (real) UST yields could upset USD bears; and unevenly across EM.

CNY Drivers:

To be sure, there is **some degree of positive "income effect" boosting CNY**, accentuated by a **weaker USD** trend.

But this will be tempered by the erosion of relative COVID advantages in:

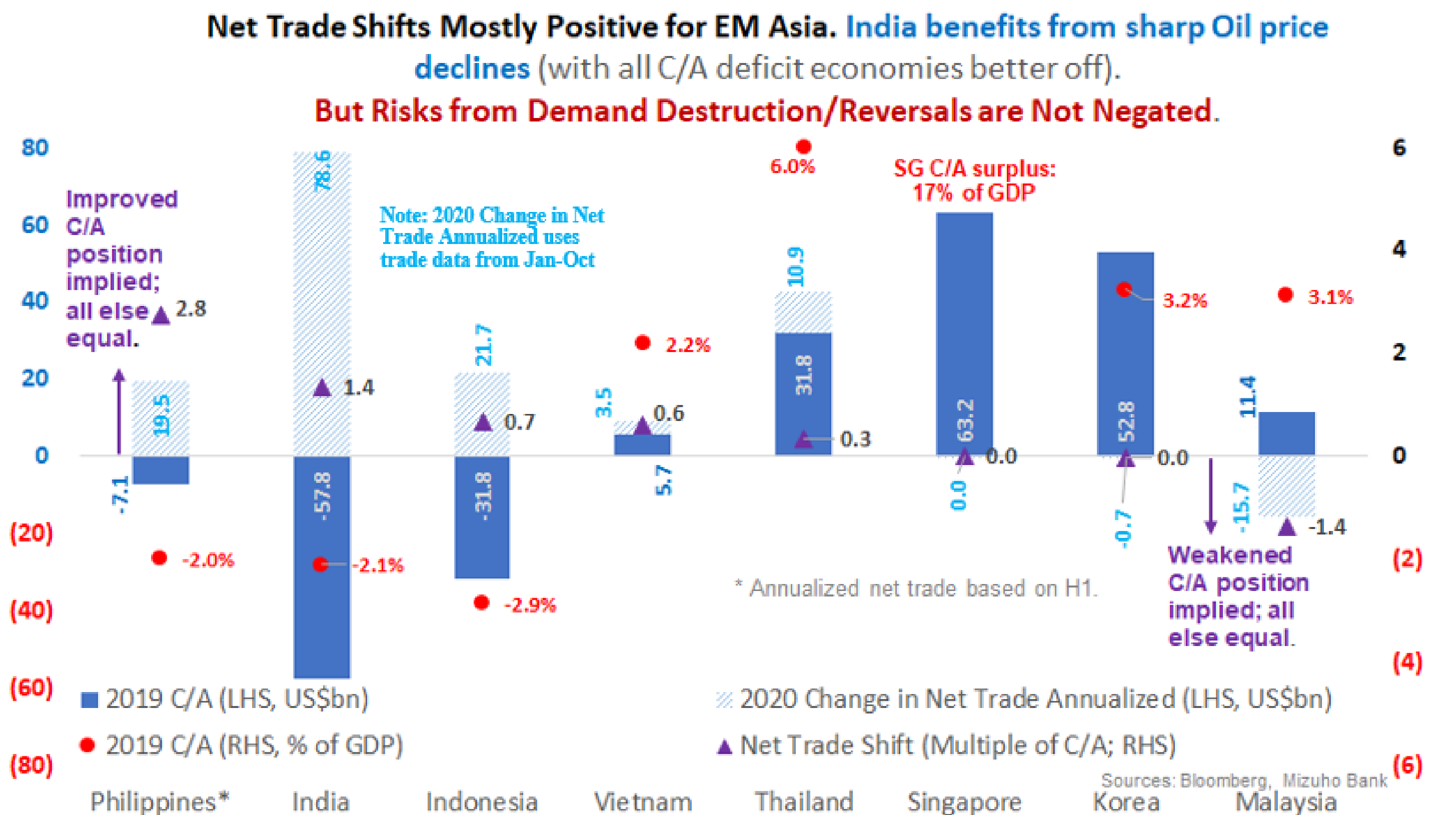
i) **Leading the recovery**

ii) **Exceptional containment**,

iii) **Exports shift** to cater to **pandemic** demand, and;

iv) **Onshore substitution of outbound tourism** forgone.

Figure 5. Current Account Shifts During the Pandemic



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