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Global economic expansion continues as we move into midyear, albeit at a slower pace. Nevertheless, major central banks continue to strike a hawkish tone, leaving the door wide open to further tightening as they remain determined to ease surprisingly tight labor markets and tackle sticky core inflation. Admittedly, their hawkish stance keeps upside risks to the terminal rates. However, how much higher interest rates will eventually rise remains data dependent, as policymakers are mindful of lags in the monetary policy transmission and tightening credit conditions.

Macro Picture

USA: activity data show continued resilience, implying another quarter of solid growth in Q2

EA: incoming data leave no hopes for a strong or swift recovery after the winter technical recession

UK: increasingly tightening BoE monetary stance poses downside growth risks

CESEE: subdued external demand, high inflation and interest rates weigh on the growth outlook

Markets

FX: USD resilient, buoyed by strong economic data from the US

Rates: EU and US rates to trade in a narrow range with risks tilted to the upside

EM: sovereign fixed income spreads tighter on lower volatility and range-bound US rates

Credit: markets to trade within a tight range with investors having priced-in a 25bps hike by both the Fed and ECB in July

Policy Outlook

USA: Fed skips June rate hike, but keeps its tightening bias in place

EA: ECB "very likely" to raise rates again in July, amid persistently high underlying price pressures

UK: inflation persistence keeps pressure on the BoE to raise rates further, likely beyond August

CESEE: central banks reluctant to cut rates amid high inflation and major CBs pledge for more hikes

Key Downside Risks

DM: high inflation persists for longer, requiring additional monetary tightening to tame; tighter than expected global financial conditions

EM: China's growth stutters further and policy stimulus dosed sparingly; adverse climate conditions ante portas curtail growth

Special Topic in this issue:

→ Mid-year global economic outlook

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Special thanks to the Global Markets team (Global_Markets_Trading@eurobank.gr)

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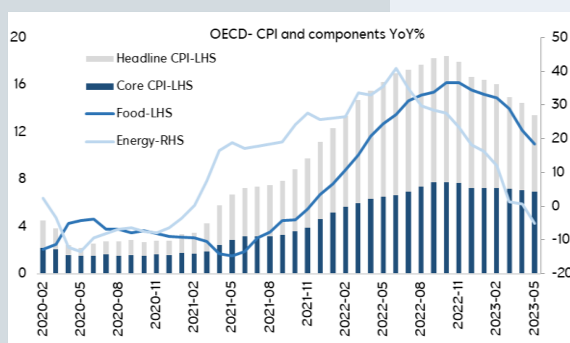
Macro Views

Latest world economic & market developments

Major CBs continue to strike a hawkish tone, leaving the door open to further tightening to ease tight labor markets and tackle sticky core inflation

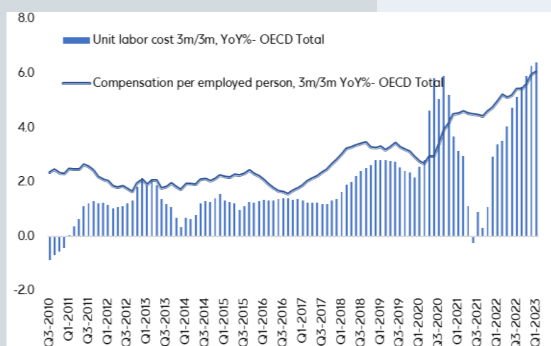
As evident in the latest global PMI surveys for the month of June, economic activity is losing momentum as we move into midyear —though at different speeds across the globe —indicating less underlying resilience to the multiple headwinds it continues to face. In spite of easing supply chain constraints and lower energy prices, the manufacturing PMI slipped further into contractionary territory, coming in at 48.8, a six-month low and down from 49.6 in May, largely due to the sustained weakness of the demand environment. More worryingly, several forward-looking subcomponents eased further, leaving no scope for a re-acceleration in global factory output any time soon. Moreover, while tightening monetary policy is progressively transmitted to the real economy, activity in the services sector — the main growth engine of the global economy this year —also moderated, but still remained at solid levels in expansionary territory, pointing to continued economic growth, albeit at a slower pace. In spite of slower growth momentum, major central banks (with the exception of the BoJ) continue to strike a hawkish tone, also encouraged by fading downside risks from banking sector stress, leaving the door wide open to further tightening at their upcoming meetings to ease surprisingly tight labor markets and tackle sticky core inflation. That said, global headline inflation continued to decelerate in May on energy base effects and a sharp drop in the pace of food prices gains. Core inflation also moderated, though only slowly, continuing to run well above central banks' comfort zones, as persisting labor market tightness across a large number of economies – in spite of signs of moderation in recent months — contributes to strong wage growth that exerts upside pressure on core services inflation, highlighting the risk of price pressures to stay elevated for longer. Admittedly, central banks' hawkish stance keeps upside risks to their terminal rates. However,

Figure 1: Inflation pressures have eased, but still above CBs' comfort zone



Source: OECD, Eurobank Research

Figure 2: Stubbornly high core inflation largely due to rising unit labor costs



Source: OECD, Eurobank Research

how much higher interest rates will actually rise remains data dependent, as policymakers are mindful of lags in the monetary policy transmission and tightening credit conditions.

Developed Economies

US: Incoming activity data for Apri/May continued to show a resilient tone, implying another quarter of solid growth in Q2. Meanwhile, the disinflationary process is progressing, though slowly, with core CPI falling by just 0.2ppts to 5.3%YoY, well above the Fed's 2.0% target. Presumably taking comfort from the sharp drop in May's headline CPI, the FOMC kept the policy rate unchanged at the 13-14 June policy meeting, as expected, to allow the economy to take more time to adapt to higher rates amid uncertainties about how banking turmoil will unfold. However, amid persistently elevated price pressures and relative resilient economic growth, the Fed kept its tightening bias in place. As of early July, futures are pricing in an 85% chance of a hike at the upcoming 26 July meeting, and they even assign a 20% probability that by November the Fed will deliver the second additional hike it signaled at the updated dot plot for 2023. However, there is increasing uncertainty over whether the Fed will extend its tightening cycle beyond July, as the significant tightening in lending conditions observed as of late, will have percolated more forcefully through the economy by the time of the November meeting, eliminating the need for additional tightening at that time.

Euro area: Eurozone Q1 GDP growth was revised lower from 0.1%QoQ to -0.1%QoQ after an equivalent contraction in the prior quarter, implying a mild winter technical recession. Looking ahead, incoming data point to a modest rebound in Q2, highlighting though risks of renewed weakness in H2 as monetary tightening is progressively transmitted to the real economy, particularly in Q4, after the expected boost from the upcoming tourist season should progressively fade away. Indicatively, the compositive PMI averaged 52.3 in Q2, slightly higher from 52.0 in Q1, but sharp decline in the latter at 49.9 in June, below the threshold of 50 for the first time in six months driven by a sharp drop in the services index and a fall in manufacturing output even deeper into contractionary territory, signals that the economy is entering Q3 on a soft tone, especially taking into account that several forward-looking components eased further. All in, after some growth recovery in Q2, we expect the economy to enter a period of broad stagnation, printing a growth rate for the whole 2023 at 0.6%. However, amid stubbornly high core inflation largely on rising unit labor costs, weak growth is not expected to deter the ECB from rising rates by an additional 25bps in July, though the prospect of further tightening in September remains "data dependent" at this stage.

Emerging Economies

Evidently, the extensive monetary tightening adopted by local central banks for at least the past 18 months, has taken a toll on the CESEE region; all CEE3 economies posted, either on quarterly, annually or both terms, negative growth rates in Q1-2023, as outlined in this section in our previous issue. Nevertheless, the tightening cycle has started to bear fruits regarding its imprint on inflation. With all May's and some for June CPI prints having been released, the decreasing path of inflation is evident across all peers, but this continues to proceed broadly at a rather slow pace. In Czechia, CPI inflation eased to 11.1%YoY in May from 12.7%YoY in April, marking the lowest print in the last 16 months and decreasing quicker than the 11.6%YoY market consensus. However, on monthly terms, consumer prices rose by 0.3%, stronger than market expectations of 0.1% after April's 0.2% decrease. In Romania, inflation moderated to 10.64%YoY/0.64%MoM from 11.23%YoY/0.75%MoM in April. In Serbia, inflation decelerated to 14.8%YoY from 15.1%YoY in the previous month while consumer prices increased by 0.9%MoM, higher than 0.7%MoM in April. Poland's flash print for June came in at 11.5%YoY from 13.0% in May and below the 11.8%YoY markets expected. Finally, in Hungary, where the need for compression is more immediate given the abidance on inflation on deep double-digit grounds for almost a year, CPI moderated to 21.5%YoY in May from 24.0%YoY in the previous month and January's peak of 25.7%YoY. Given the above, the MPC held by the central banks in June and early July yielded no surprises as all policy outcomes came in line with market expectations with Serbia being the only exception and raising rates, unexpectedly, by 25bps to 6.25%, after May's pause at 6.00%. In Hungary, the overnight deposit rate was cut by 100bps to 16.0%, following the tantamount easing in May's session, with the key policy rate, however, kept unchanged at 13.0%. Identical were the stances of the central banks of Czechia and Romania with both keeping the key policy rate at 7%. Along these lines, June held sovereign ratings affirmations for two of the CEE3 countries. Fitch Ratings affirmed Hungary's rating at BBB and kept the outlook negative, having downgraded it from stable 6 months ago in the previous scheduled credit review. The key highlights of the review sum up to the solid structural economic indicators and the investment-led growth but also to worsening governance and continuing unorthodox policies. The agency also affirmed Poland's rating at A- with a stable outlook, underlining the diversification of the economy and the slightly lower public debt levels than that of other rated peers. The S&P agency, after conducting a semi-annual review of the EMEA region, which also entails Poland, announced its decision not to update Poland's sovereign credit rating, keeping it, thus, at A- and the outlook stable, with the latest credit review going back to mid-February.

Markets View

Foreign Exchange

EUR/USD: the performance is mixed as the support from the ECB's hawkish stance fades. It continues to trade within a familiar range, with an overall upward trend, reaching a peak at 1.0977 before reversing course, influenced by the ECB Sintra Forum and the strength of the US dollar. With the pair hitting a low of 1.0835 at the end of June and opening levels below 1.09 at current month, we expect a continuing trading range behavior with a resistance on 1.10 and support on 1.08 in the mid-term.

EUR/GBP: the pair remains at lower levels around 0.8590, lacking clear direction but with a persisting bearish momentum, presumably driven by the recent positive headlines from the UK; at the same time, concerns regarding the ECB's ability to maintain its hawkish stance also weigh. We eye for a support line around 0.8560 keeping an upward bias even above the 0.8620 territory in the mid-term.

Rates

EU: in the past month, swap rates have traded within a narrow range but have shown significant flattening. Currently, the 10-year swap rate stands at approximately 3.05%, reaching a peak of 3.12% intramonth. Notably, the yield curve has flattened considerably, with the 5s30s spread trading at -0.77, a significant decrease from -40 basis points at the end of June. Moreover, the implied volatility in the short-term has risen compared to the end of June. Looking ahead, short-term rates at the front end of the curve are expected to continue rising as the ECB maintains its hawkish stance.

US: June concluded with a significant rise in swap rates, accompanied by considerable volatility, particularly in the front-end of the curve. The increase was triggered by a more hawkish tone from the Fed, pushing the market to revise its expectations for an additional 25bps hike. Currently, the 10-year SOFR swap rate stands at 3.58%, having reached a peak of 3.61% intramonth. While the yield curve experienced further inversion, resulting in the widening of the 5s30s spread to -38bps from -20bps at the beginning of June. Looking ahead, short-term rates are projected to remain volatile, and the front-end of the curve is anticipated to continue rising as the Fed maintains its hawkish stance.

Emerging Markets Sovereign credit

Sovereign fixed income was well supported in June by a weaker USD, range-bound UST yields and lower market volatility. The EMBI Global Index closed at 363bps at the end of June, 37 bps tighter on the month. In CEEMEA, Romanian bonds traded strongly, while there was also good buying interest for Hungarian sovereign bonds. Concerning the latter, Hungary's central bank (NBH) eased the one-day deposit rate by another 100bps to 16%, marking a second 100bps cut in a row with the base rate unchanged at 13%. In

Latam, spreads also ended tighter. Both the Brazilian and the Chilean central banks held their policy rates unchanged, but with the latter being more dovish as two members voted for a 50bps cut. In China, sovereign bond yields ended little changed on the month, while markets are ex-pecting additional policy support to support the waning recovery. All in, we expect the environment to remain supportive for EM fixed income during the summer.

Corporate credit

After an eventful May, June was characterised by reduced volatility and mixed performance among risk assets (VIX down to its lowest levels since the wake of the pandemic). Central banks remained at the forefront on inflation persistence and growing recession fears as elevated inflation calls for further mon-etary tightening by central banks. The Fed paused in June for the first time in over a year but signalled two further rate hikes for the remainder of the year (vs investor expectations for one more hike). Mean-while, the ECB hiked by a further 25bps in June and remained committed to another hike in July and a data dependent approach beyond that. In this environment, equities advanced for a third consecutive quarter, with Stoxx 600 +2.4% and the S&P 500 +6.5% in June, on strong performance of tech stocks thanks to excitement around AI. Synthetics ended on tighter ground on a monthly basis, with HY continuing to outperform vs IG and most commodities advancing (Brent crude and WTI +4.5%).

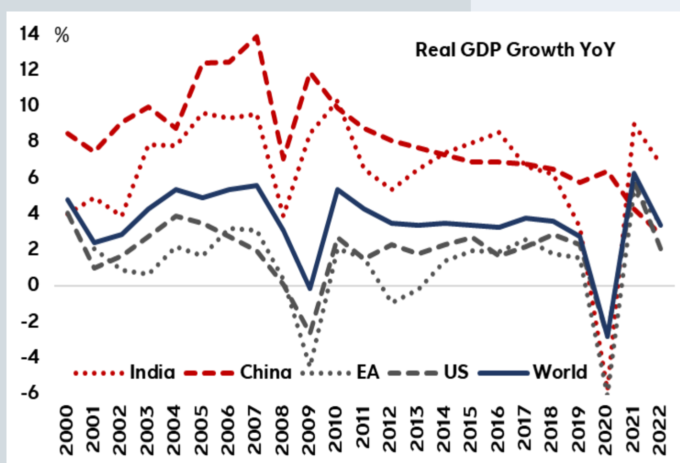
In credit, both EU and US credit spreads tightened in the last month. CDX IG stands -9ps tighter since the beginning of June, with CDX HY -45bps tighter. In Europe, the itraxx Main is -9bps and Xover is -38bps tighter June-to-date, at its year-to-date tights. In corporate cash, performance was mixed, with IEAC ending flattish and IHYG -27bps tighter since the beginning of June. Snr Financials outperformed among EU IG cash (Snr Financials -11bps) while Energy, Utilities and Materials lagged (+3-5bps each). In High Yield, Technology and Consumer Staples outperformed (-138bps and -117bps respectively) while Energy and Materials lagged behind (-2-4bps each). The EU Primary market remained quite active throughout the month, seeing 23 consecutive days of deal flow, with June issuance at €141bn, of which almost a quarter consisted of ESG-related issues.

Attention remains on inflation, recession fears and rates expectations, with markets continuing to weigh the probability of a soft vs hard landing scenario. The credit market is expected to remain range-bound, with investors having already priced-in a 25bps hike by the Fed and ECB at their next meetings in late July. Prior to the central banks' meetings, the Q2-2023 earnings season will kick-off with US banks in mid-July. In the EU primary market, following a fairly strong June in terms of new issuance, activity is expected to calm down in July as the seasonal summer ease starts to set in.

Special Topic: Mid-year global economic outlook

The global economy grew by 3.3% in 2022, cooling down after the v-shaped recovery of 2021 (+6.1%), in the aftermath of the pandemic. In 2023, the world output is expected to expand even slower, by 2.6% before edging up to a still subdued pace of 2.7% in 2024. Prospects in the middle of the year are improved compared to those considered in late 2022 as essential downside risks have not materialised, such as energy shortages (especially in Europe) on the back of a severe winter that could keep prices elevated for longer and the war between Russian and Ukraine escalating further. Furthermore, some positive news emerged, such as the reopening of China's economy, the gradual easing of global supply chain disruptions, and the resilience of labour markets in several major economies, which all support global economic activity. However, headwinds, such as the stickiness of core inflation, transmission of aggressive monetary policy tightening with a lag and tighter credit conditions remain. Additionally, fears over elevated prices pressures for longer than earlier expected and a less buoyant, than initially conceived, China rebound in FY2023 are lately gaining ground. Along these lines, we attempt below to draw a brief x-ray of the two largest developed and the two biggest developing economies, which will, all together, sketch, at large, the big picture for the global economy in the near-term.

Figure 3: Growth cooling down in 2022 after 2021's V-shaped recovery



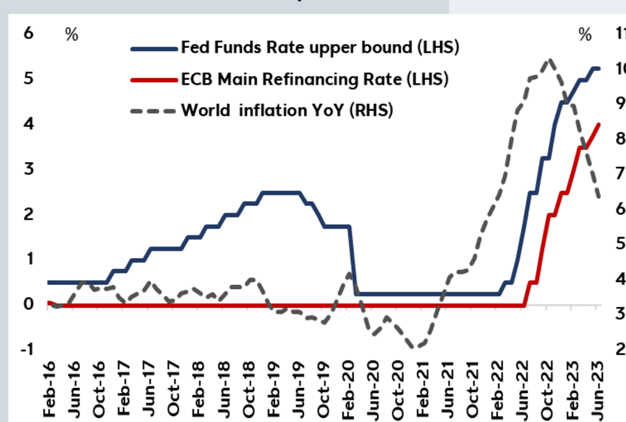
Source: IMF, Bloomberg Eurobank Research

US: after growing by 2.1% in 2022, the economy is expected to slowdown in 2023, expanding its output by 1.3%. GDP landed in Q1-2023 to an annualised 2.0% growth rate from 2.6% in Q4-2022 and further slowdown is anticipated in the following quarters. Voices over a recession sometime between late 2023 and early 2024 are getting louder as monetary tightening may have not fully fed through to the economy yet. Tight labour market conditions and persistent inflationary pressures have urged the Fed into 10 straight interest rate increases since March 2022. This aggressive rate tightening, with the target range for the federal funds rate currently at 5.00% - 5.25%, a level unreached since the summer of 2007, has started to take its toll on the economy, with the labour market, though, remaining surprisingly strong. Indeed, the unemployment rate has been hovering around the historically low rate of 3.4% since 2022 with May's uptick to 3.7% from 3.4% in April, presumably providing to the Fed some breather in the June FOMC meeting, as it decided to skip rate hikes for the first time since March 2022. However, as inflation remains well above its 2.0% target and labour market continues to look steamy (non-farm payrolls continued to spike in May despite the increase in the unemployment rate in the same month), the Fed keeps in its arsenal two additional 25bps rate increases in 2023, as evident in the dot plot included in the Summary of Economic Projections released at the June policy meeting. The median terminal rate expectation has been

pushed to 5.6% by the end of 2023 amid a stubborn core personal consumption expenditure index (core PCE), fueled by the labour market tightness; it has retreated only to 4.6%YoY as of May 2023, from a peak of 5.3% in early FY2022. The Fed projection in June for a 3.9% increase in core PCE in 2023, higher from the previous respective forecast for 3.6% three months earlier, is indicative of its stickiness. All in all, we consider the ongoing interplay between the labour tightness and inflation pivotal for the remainder of the year as it will affect to a big extent decisions over additional monetary tightening, with what is already deployed not fully felt in the economy yet.

EA: the economy expanded by 3.5% in 2022 but has entered a soft patch in 2023 as evident in the anemic final -0.1%QoQ growth reading of Q1-2023, revised from the previous +0.1%QoQ flash estimate and identical to the Q4-2022 growth print. Q1 growth readings from the two largest economies of the group set the stage for the slowdown, with Germany sliding into technical recession (-0.3%QoQ in Q1-2023 vs -0.5%QoQ in Q4-2022) and France's weak uptick (+0.2%QoQ in Q1-2023 vs 0.00%QoQ in Q4-2022) not sufficient to reverse the broader softening dynamics. The EA economy is expected to grow by 0.6% in 2023, characterised by a firm labour market from both unemployment and wage growth perspectives; EA unemployment stood at a record low of 6.5% in May for the second consecutive month, from 6.6% in March-2023 and 6.7% in May-2022, while negotiated wages rose by an all-time high of 4.3%YoY in Q1-2023 from 3.1%YoY in Q4-2022. This fuels disposable incomes and supports, in turn, private consumption but at the same time swells core inflation which proves hard to tame; EA core inflation was at 5.4%YoY in June-2023, from 5.3%YoY in May-2023, and a 3.9%YoY average in 2022; HICP was at 5.5%YoY, from 6.1%YoY and 8.3%YoY in the respective periods. Along these lines, the ECB raised interest rates for the eighth time in a row in June's meeting, having so far increased the key policy interest rates cumulatively by 400bps during the past twelve months, the fastest pace on record, placing rates at 22-year highs. Signals are that one or even two tantamount hikes of 25bps are on the line-up, pointing thus to a terminal ECB deposit rate at 3.75% or 4.00% from 3.50% currently. With the monetary policy remaining data dependent and with the latest core CPI data calling for further interest rate increases, the so far proven resilience of the economy will be put under further stress. On top of the above, world trade growth is anticipated to weaken in 2023 (IMF forecast at 2.4% in 2023, from 5.1% in 2022) on the back of, inter alia, less trade-intensive but more services-driven global demand.

Figure 4: Unprecedented monetary tightening by the Fed and the ECB amid persistent inflation



Source: Fed, ECB, Bloomberg, Eurobank Research

China: GDP expanded by 3.0% in 2022, marking the second lowest growth rate in the last fifty years. However, the long-waited abandonment of the zero-Covid policy in late 2022 spurred hopes over a quick rebound in 2023. Indeed, growth in Q1-2023 came in at 4.5%YoY, boding well with the growth target of 5.0% in 2023 and standing above the 4.0%YoY market consensus and the 2.9%YoY growth rate of Q4-2022. The key contribution on the Q1-2023 annual growth figure came from the services sector, which rose by a hefty 5.4%YoY, mirroring the unleash of the pent-up demand for in-person services after three years of suppression and social distancing measures. However, worries over the longevity of the economic recovery were corroborated based on a plethora of hard data referring to the last couple of months and coming from both the supply and demand sides of the economy. Retail sales and industrial production volumes kept coming below market expectations in both April and May, fueling concerns among market participants over the prospects ahead. The same was true about soft data, i.e., the manufacturing PMI index, which kept sliding below the boom-or-bust level of 50, which separates contraction from expansion. Along these lines, we continue to expect the growth rate in 2023 to stand above the 5.0% target and specifically lie somewhere above 5.5%, but targeted and presumably extensive policy stimulus will most probably be routed ahead for this to happen. Indeed, counter-clockwise with almost all other major central banks in the world, the People's Bank of China stepped into monetary easing and key policy interest cuts in June in its efforts to stimulate the economy and ditch the looming scenario of disinflation.

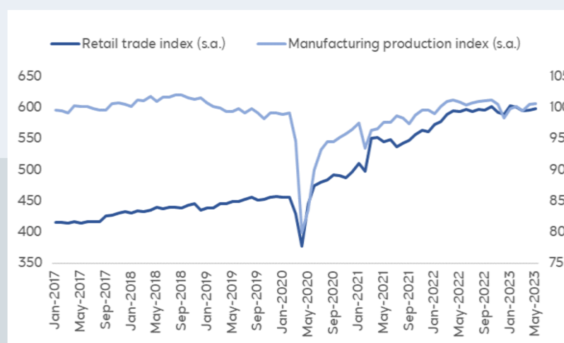
India: the economy lost some of its momentum in 2022 as inflation remained elevated due to rising global energy and food prices and global financial and economic conditions deteriorated. This was translated into a decreasing, still mighty, growth rate of 7.0%, from close to 9.0% in 2021. Having achieved a 5.5% average GDP growth rate over the past decade, 2023 is expected to remain an above trend year, despite the further slowdown, as growth rate is anticipated close to 6.0%. We attribute this year's projected deceleration to the monetary tightening (as inflation is still high, albeit decreasing), whose impact on the economy has not unfolded yet at whole, and to the subdued global growth. Specifically, for India's economy, we flag as an additional key downside risk to growth the resurgence of El Nino which, if realised, will have adverse impact on the primary sector of the economy through large scale catastrophes in crops. The repercussions of the said weather phenomenon will extend beyond the Indian economy, with negative spillover effects in soft and especially agricultural commodities.

US

The Fed skips June rate hike, but keeps its tightening bias in place

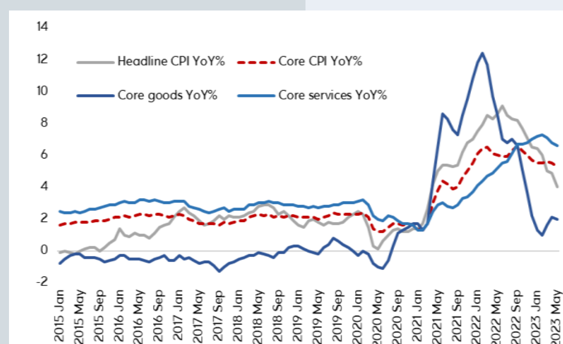
According to the third estimate, US Q1 GDP grew by an annualized rate of 2.0% QoQ saar, slower from a 2.6%QoQ saar increase in the prior quarter, but 0.7ppts faster than the previous estimate. The upward revision was driven by the higher re-assessment in net exports (+0.6ppts) and private consumption (+0.4ppts), that were partly offset by downward revisions in nonresidential fixed investment (-0.8ppts), federal government spending (-0.2ppts) and private inventory investment. Looking into Q2, incoming activity data for April/May continued to show a resilient tone (e.g., retail sales, manufacturing production, certain housing indicators), implying another quarter of solid growth, with the Atlanta Fed's GDPNow model projecting (as of July 3) an annualized growth rate of 1.9%. Meanwhile, the disinflationary process is progressing, though slowly. The May headline CPI dropped sharply to 4.0%YoY from April's 4.9%YoY mainly due to energy base effects, but underlying price pressures remained elevated, with core CPI falling by just 0.2ppts to 5.3%YoY, still well above the Fed's 2.0% target. Presumably taking comfort from the sharp drop in May's headline CPI, the FOMC kept the policy rate unchanged at the 13-14 June policy meeting, as expected, marking the first pause after a string of ten consecutive hikes, to allow the economy to take more time to adapt to higher rates amid uncertainties about how banking turmoil will unfold. However, amid persistent strength in core prices and resilient economic growth, the Fed kept its tightening bias in place, suggesting that it may not have reached the peak in rates yet, as reflected in the forward guidance which shifted to further rate hikes after turning more neutral in May, the median end-2023 dot which rose by 50bps compared to the March projections, and the updated hawkish economic projections which revealed a median forecast for 2023 core PCE inflation to 3.9%, up by 0.3ppts compared to March. As of early July, futures are pricing in an 85% chance of a 25bps hike at the upcoming 26 July meeting, and they even assign a 20% probability that by November the Fed will deliver the second additional hike it signalled at the updated dot plot for 2023. However, there is increasing uncertainty over whether the Fed will extend its tightening cycle beyond July, as the significant tightening in lending conditions observed as of late, is expected to have percolated more forcefully through the economy by the time of the November meeting, eliminating the need for additional tightening at that time.

Figure 5: Several activity data continued to show resilience in May



Source: Fed St. Louis, Census Bureau, Eurobank Research

Figure 6: Sticky core inflation



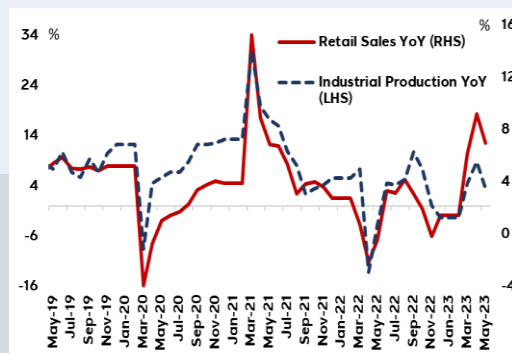
Source: BLS, Eurobank Research

China

Faltering data reflects on the yuan and calls for policy aid

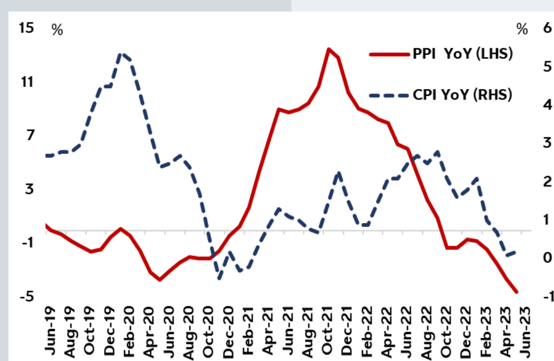
The loss of growth momentum since April has added pressure on policy makers to halt the slide. Amid weakening growth of industrial production (+3.5%YoY in May vs +5.6%YoY in April, in line with market consensus) and retail sales (a lower than expected +12.7%YoY in May vs 18.4%YoY in April), the PBoC proceeded with tantamount cuts in the key policy rates such as the 7-day reverse repo rate (at 1.90% from 2.00%), the 1-year medium term lending facility rate (at 2.65% from 2.75%) and the 1- and 5-year loan prime rates (at 3.55% and 4.20% from 3.65% and 4.30% respectively) in June, setting the stage for stronger policy support ahead, as imposed from the course of economic data. Indeed, industrial profits continued to evaporate in May, albeit at a slower pace (-12.6%YoY vs -18.6%YoY in April) intensifying worries that private investment or new hirings will be deferred, undermining the already gloomy labour prospects for the youth. While the total unemployment rate has been on a downward trend since the start of 2023 (5.2% in Jun-2023 from 5.7% in Dec-2022), well-routed to pre-pandemic levels, the unemployment rate for people between 16 and 24 rose to a new record high of 20.8% in May from 20.4% in April. The soft patch of the economy is also mirrored on consumer prices which continued to slide since Jan-2023 (2.1%YoY), standing marginally above zero in early Q2 (at+0.2%YoY in May, in line with market consensus, from +0.1%YoY in April). Even further, producer prices faltered at the fastest pace in the last 7 years and quicker than market expectations in May (-4.6%YoY vs -3.6%YoY in April, market consensus at -4.3%YoY) with the behavior of both retail and wholesale price indices conceived as stuttering demand and anemic post Covid recovery, following the brisky momentum in Q1-2023. Along these lines and with the pivotal real estate sector not having balanced yet (indicatively, new home prices almost idle at +0.10%MoM in May from +0.32%MoM in April), the economy is also confronted with the depreciation of the yuan more than 6% against the US dollar since April, when the loss of steam was starting to get tangible, constituting it one of the worst performing Asian currencies so far in 2023. The strengthening of the USDCNY close to its 2022 high of 7.3 after moving above the critical level of 7.0 in mid-May, designates a new challenge for the freshly appointed as Party chief at the PBoC, Pan Gongsheng, who could be lining up as next Central Bank Chief.

Figure 7: Loss of momentum in May in...



Source: Bloomberg, Eurobank Research

Figure 8: ..which continues in June as evident in the course of retail and wholesale prices



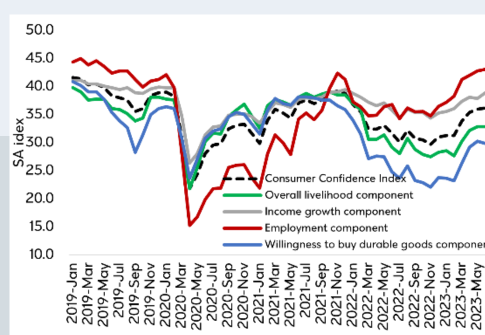
Source: Bloomberg, Eurobank Research

Japan

The economy is expected to grow moderately in H2 2023

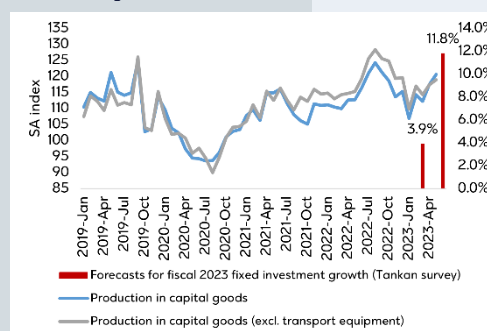
According to the second estimate, Q1 GDP growth was revised to 0.7%QoQ from 0.4%QoQ previously, mainly due to sizable upward revisions in the contribution of change in private inventories (from 0.1ppts to 0.4ppts) and the growth of private non-residential investment (from 0.9%QoQ to 1.4%QoQ). The annual increase came in at 1.9%YoY, 0.6pts higher than the first estimate. Looking ahead, short-term indicators for May and June suggested that the economy retained a positive momentum in Q2 though less pronounced than in Q1. Industrial production in May fell more than in April (-1.6%MoM from 0.7%MoM). However, production in capital goods (excl. transport equipment) further rose by 1.7%MoM in May from 2.7%MoM in April, suggesting that the strong momentum in private investment carries on in Q2. The consumer confidence index released by the Cabinet Office rose by 0.2 points to 36.2 in June compared to May, marking a fourth consecutive monthly increase, but the pace of increase has slowed since March. The increase was driven by the components of income growth and employment, reflecting positive expectations after the wage hikes in shunto annual wage negotiations (final results for this year suggest a +3.58% headline wage growth, the highest since 1993) and indications for a persistently tight labour market, (new jobs-to-applicants ratio rose to 2.36 in May from the previous month's 2.23). The economy is expected to grow moderately in H2 2023, amid an expected global growth slowdown. Private consumption will likely be solid, as rising wages and a peak in inflationary pressures may improve households' purchasing power. Private investment is expected to support economic growth, as according to the BoJ Tankan survey's forecast for fiscal 2023 in June, fixed investment growth (incl. land purchasing expenses) was revised to 11.8% from 3.9% in March 2023, indicating that firms may increase capital expenditure to tackle labour shortages. Inbound tourism will likely support services exports, especially from an expected recovery in arrivals from China, given the economic reopening and the fact that the recovery in foreign visitors is too small (number of foreign visitors -89.4% in Jan-May 2023 from the same period in 2019, while visitors from other major countries is between -31.6% and -18.6%). In view of all the above, we raise our GDP growth forecast for 2023 to 1.3% from 1.0% previously.

Figure 9: Consumer sentiment rose further in June



Source: Cabinet Office Japan, Eurobank Research

Figure 10: Capital expenditure to support growth for the rest of 2023



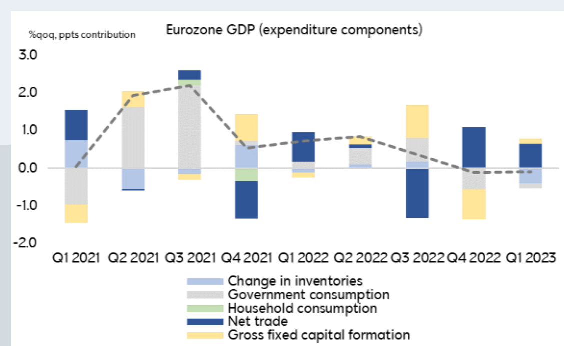
Source: Ministry of Economy, Trade and Industry, Bank of Japan, Eurobank Research

Euro area

After some modest recovery in Q2, risks seem skewed for renewed weakness in H2

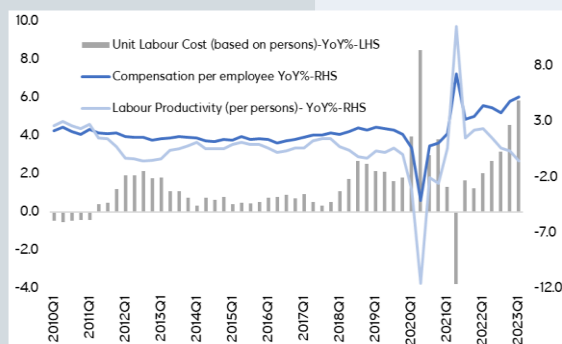
According to the final estimate, Eurozone Q1 GDP growth was revised lower from 0.1%QoQ to -0.1%QoQ after an equivalent contraction in the prior quarter, implying a mild technical recession. In expenditure terms, the drop was driven by an inventory drag (-0.4ppts), a sharp decline in government consumption (-1.6%QoQ) largely due to the phasing out of various pandemic-related measures and a second consecutive fall in private consumption (-0.3%QoQ) as high inflation continued to erode household purchasing power. On the flip side, fixed investment contributed 0.1ppts to GDP growth, while net trade added 0.7ppts, reflecting weaker imports (-1.3%QoQ) rather than a strong export performance (-0.1%QoQ). Looking ahead, incoming data point to a shallow rebound in Q2, highlighting though risks of renewed weakness in H2 as monetary tightening is progressively transmitted to the real economy, particularly in Q4, after the expected boost from the upcoming tourist season should progressively fade away. Industrial production rebounded in April after March's 3.8%MoM decline, rising by a higher than expected 1.0%MoM, retail sales came in flat in April after falling in the prior two months, albeit still 0.4% lower vs. the Q1 average, while the unemployment rate dropped further to a fresh record low of 6.5% in April. Meanwhile, consumer sentiment, though still at low levels by historical standards, continued to increase in June, up by 1.3pts to -16.1, and the composite PMI averaged 52.3 in Q2, slightly higher from 52.0 in Q1. However, a sharp decline in the latter at 49.9 in June, below the threshold of 50 for the first time in six months, driven by a hefty drop in the services index (-3.1pts to 52.0) and a fall in manufacturing output even deeper into contractionary territory (-1.4pts to 43.4), signals that the economy is entering Q3 on a soft tone, especially taking into account that several forward-looking components, including new orders and output expectations, eased further. All in, after some growth recovery in Q2, we expect the economy to enter a period of broad stagnation, printing a growth rate for the whole 2023 at 0.6%. However, amid stubbornly high core inflation (up by 0.1ppts to 5.4%YoY in June) largely on rising unit labor costs, weak growth is not expected to deter the ECB from rising rates by an additional 25bps in July — the message emerging out of the recent ECB's Forum on Central Banking — though the prospect of further tightening in September remains "data dependent" at this stage.

Figure 11: Eurozone experienced a mild winter technical recession



Source: Eurostat, Eurobank Research

Figure 12: Strong rise in unit labor cost on the back of accelerating wage growth and poor productivity



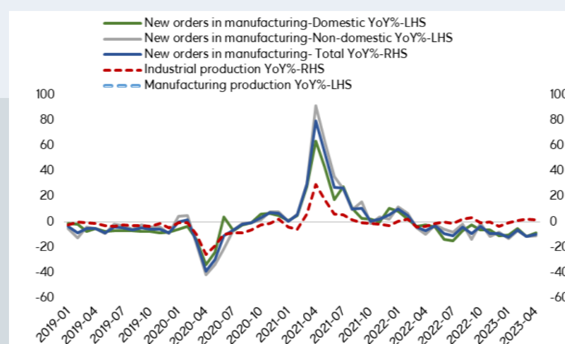
Source: ECB, Eurobank Research

Germany

Likely to avoid another GDP drop in Q2, but a rapid recovery not yet in sight

Germany experienced a technical recession in winter after GDP contracted by 0.3%QoQ in Q1 2023 following a 0.5%QoQ drop in the prior quarter. The largest negative contributor to growth was government consumption (-1.1ppts), while private consumption also exerted a drag (-0.6ppts). Looking ahead, the economy may return to positive growth in Q2, as falling inflation combined with recent strong wage settlements could support real disposable income, especially since employment remains strong. But even if Germany avoids another quarterly drop of GDP in Q2, any recovery would be, at best, anemic, as all prominent leading indicators in the manufacturing sector point clearly to the downside despite the significant drop in energy prices in recent months. The manufacturing PMI, which has been in contraction territory for a full year now, dropped further in June to the lowest level in three years (-2.6ppts to 40.6). In a similar negative tone, the IFO business climate index, after a six-month expansion, fell in June for the second consecutive month, coming in at the lowest level since November 2022 (-3.0pts to 88.5), driven by the manufacturing sector, with business expectations falling particularly strongly amid concerns about the prospect of higher ECB interest rates, while hopes that China's re-opening would boost demand have proved elusive so far.

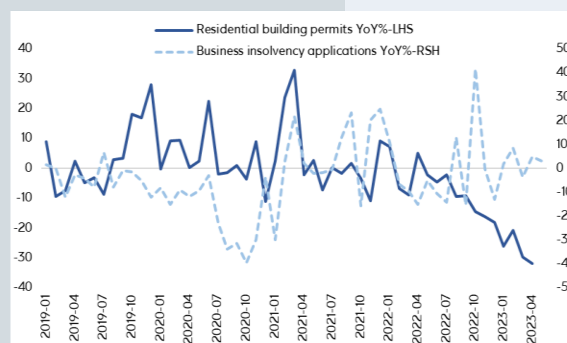
Figure 13: Risk of a significant decline in industrial production, if demand does not pick up



Source: German Federal Statistical Office, Eurobank Research

Industrial output grew by 0.3%MoM in April after a 2.1%MoM decline in March, though still -0.5% below the Q1 average, with manufacturing remaining virtually unchanged (+0.1%MoM) and many companies rating their order backlogs as "too low", according to the latest IFO survey, suggesting risks of a significant decline later this year, if demand does not pick up soon. Worryingly, factory orders unexpectedly declined by 0.4%MoM in April following March's 10.9%MoM plunge. Meanwhile, ECB policy tightening continues to feed through to the real economy, with residential building permits falling by a new post-GFC record rate of 31.9%YoY in April and business insolvency applications rising by a further 3.1%YoY in May after a 4.8%YoY increase in April. Against this backdrop and taking also into account the relatively weak global trade environment, we revise lower our 2023 GDP forecast from flat to -0.3%YoY.

Figure 14: ECB policy tightening continues to feed through to the real economy



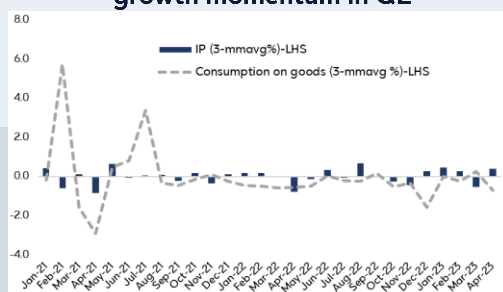
Source: German Federal Statistical Office, Eurobank Research

France

Growth expected to remain subdued for the rest of 2023

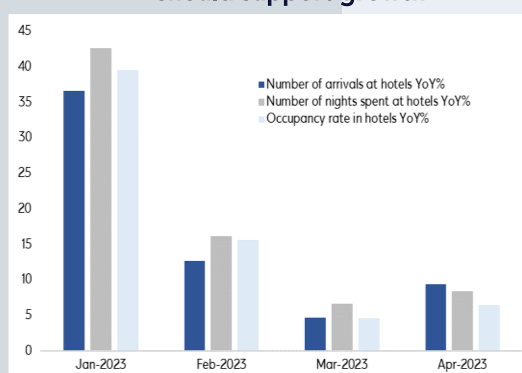
After flattening in Q4 2022, France's GDP rebounded in Q1 2023, expanding by a mild 0.2%QoQ solely supported by net trade, as final domestic demand was sluggish, with private consumption remaining subdued amid persistently elevated price pressures (0.1%QoQ) and gross fixed investment dropping for the first time since Q4 2021 (-0.2%QoQ) amid tighter financial conditions. Turning into Q2, economic activity is expected to retain its positive, though subdued, growth momentum, with France's statistical office INSEE projecting GDP to settle at 0.2%QoQ, the same as in Q1. Led by a particularly sharp drop in June's services print (from 52.5 to 48.0, the lowest since February 2021) mainly due to strikes and protest activity linked to the pension reform, the flash composite PMI dropped back below the boom-or-bust level of 50 for the first time since January, to 47.2 from May's 51.2. On a more encouraging note, though, INSEE composite business confidence stabilized in June at its long-term average of 100, as a further deterioration in the construction sector was offset by a slight improvement in the retail sector (that is not captured in the PMI survey) and increased manufacturing confidence driven by the automotive industry amid easing supply chain bottlenecks. In terms of real activity data, consumer spending on goods dropped by 1.0%MoM in April, the third straight monthly decline and the biggest monthly drop so far this year, as high inflation continued to erode household purchasing power, suggesting that consumption is unlikely to provide much support to growth in Q2. However, industrial production rose by a modestly higher than expected 0.8%MoM in April, 0.6% above the Q1 average. Meanwhile, the labor market remains strong contributing to a pickup in nominal wage growth, with the unemployment rate standing at a 40-yr low of 7.0% in April for the third straight month and the Bank of France estimating negotiated wages – based on wage deals signed at the end of 2022 or at the start of 2023- to grow by 4.4% in 2023 from 2.8% in 2022 and 1.4% in 2021. Looking into Q3, the good health of the tourism sector that continues to benefit from the post-pandemic recovery should support growth, but in Q4, economic activity should weaken amid slower global growth and higher interest rates. All in all, we stick to our view for sluggish GDP growth this year, at 0.5%YoY compared to 2.6%YoY in 2022.

Figure 15: Activity data point to subdued growth momentum in Q2



Source: INSEE, Eurobank Research

Figure 16: The good health of the tourism sector should support growth



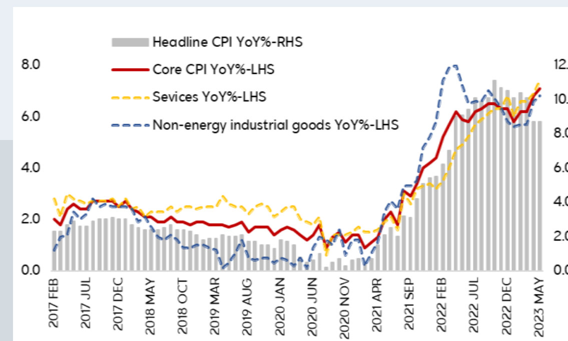
Source: INSEE, Eurobank Research

UK

Inflation persistence keeps pressure on the BoE to hike rates further

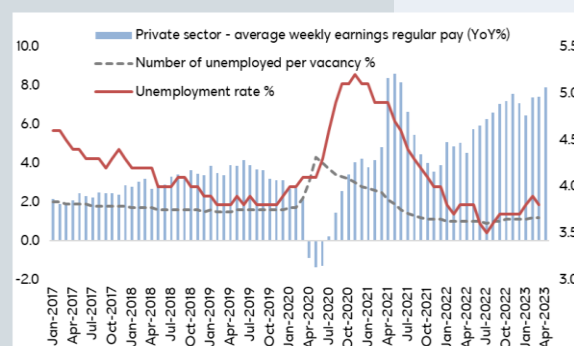
After a mild expansion of 0.1%QoQ in Q1 2023 — though higher compared to earlier expectations for a contraction — UK GDP rose by 0.2%MoM in April, reversing only part of the 0.3%MoM drop in March, pointing, thus, to a not particularly strong start for Q2. Worryingly, the extra bank holiday for the King's coronation in May will likely weigh on growth and the risk of a quarterly fall in Q2 cannot be ruled out if the effect is comparable to the one in June 2022 (Platinum Jubilee bank holiday) when GDP fell by 0.7%MoM. More importantly, GDP is likely to remain sluggish throughout the year as higher BoE rates and a likely global growth slowdown are expected to offset any pickup in real disposable income from lower household energy bills in H2, while the aggressive monetary tightening delivered so far (490bps since late 2021) will be more fully felt in the real economy in the period ahead. All in all, we expect almost flatline growth for the whole year 2023, with risks skewed to the downside, as surprisingly strong inflation and pay growth data keep pressure on the BoE to hike rates further. Confounding expectations for a further decline, headline CPI inflation was held steady at 8.7%YoY in May, but the main upside surprise was in the core CPI which unexpectedly rose from 6.8%YoY% to a new multi-decade high of 7.1%YoY. Despite weakening PPI pressures, stronger GBP and easing global supply chain bottlenecks, core goods inflation rose for the second consecutive month (+0.2ppts to 6.8%YoY), while core services hit a fresh all-time high (+0.5ppts to 7.4%YoY) on rising wage growth and ample business pricing power. That said, the unemployment rate unexpectedly dropped in March from 3.9% to 3.8%, approaching the July 2022 low of 3.5%, and regular average weekly earnings accelerated further in April from 6.8%YoY to 7.2%YoY (3mmavg), the highest ever outside the pandemic, partially due to the 9.7% rise in the minimum wage in April. With both wages and price pressures surprising significantly to the upside, the BoE unexpectedly picked up the pace of rate hikes to 50bps at the June policy meeting, leaving the door open for an extension of the tightening cycle, likely beyond August, if inflation does not show signs of sustained deceleration by then. Markets are now pricing near 100bps of cumulative further tightening by the March 2024 meeting.

Figure 17: Inflation remains stubbornly elevated



Source: ONS, Eurobank Research

Figure 18: Across headline measures, the labor market remains tighter than expected



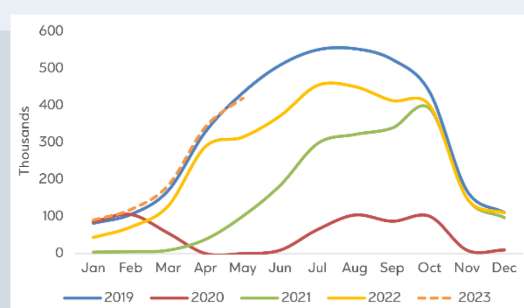
Source: ONS Eurobank Research

Cyprus

Solid growth momentum in tourism, no signs yet of a strong rebound in investment

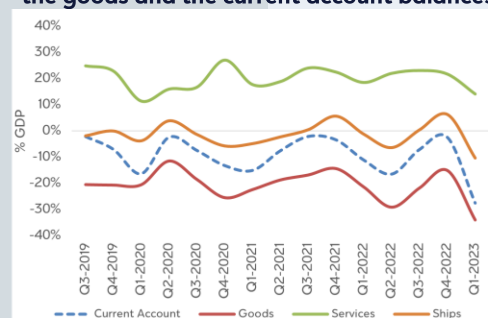
After a further weakening in the growth of services exports in Q1-2023 according to GDP provisional data, recent high frequency data indicate an escalation in the activity of the tourism sector during Q2-2023. The increase in tourist arrivals accelerated from 18.5%YoY in April to 33.3%YoY in May. As spending per capita remained stable in April at last year's levels for the second consecutive month, the widening on an annual basis in tourism receipts in May is expected to be similar to the rise in tourists. The solid rise in arrivals in the first five months of 2023 from certain countries (UK: +25.7%YoY, Israel: +95.5%YoY, Poland: +25.7%YoY) could sustain some stronger support from exports of services to GDP from Q2 onwards. The balance of goods performance remained weak in early Q2, with the deficit narrowing in April by a modest 1.9%YoY, a trend which could be the opposite in volume terms. Despite the ease in HICP inflation in May, to 3.6%YoY against 3.9%YoY a month ago, on the back of the imposition of a zero VAT rate on a list of basic goods since the beginning of that month, the rise in retail trade volume decelerated, albeit moderately, to 6.1%YoY from 7.3%YoY, the slowest pace in 2023. Nonetheless, the extension of the zero VAT rate in June to more food products and more importantly the agreement in mid-May for a higher partial wage indexation for the 2023-2025 period compared to previous years, 66.7% instead of 50% of previous year's inflation, coming into force from June onwards, will boost household spending in the remainder of 2023 and in the next years. It is estimated that wage indexation beneficiaries currently stand at ca 41% of persons employed, decomposed to 28% working in the private sector and 13% in the public sector. In the aftermath of the termination of the real estate protection scheme, there are no indications yet of a robust growth momentum in investment, as credit contraction towards non-financial businesses continued in May for the sixth consecutive month, by 3.2%YoY, same pace as in April and the strongest fall in the last six years. Perhaps these dynamics were in part related to temporary factors, such as concerns about the implications of US and UK sanctions to Russia also affecting Cypriot citizens. In view of the above developments our growth forecast for 2023 remains unchanged, to 2.5%.

Figure 19: The pattern of tourist arrivals in January-May 2023 remains similar to the pre-pandemic one in 2019



Source: CYSTAT, Eurobank Research

Figure 20: The ships balance was for another quarter in Q1-2023 the main determinant of both the goods and the current account balances



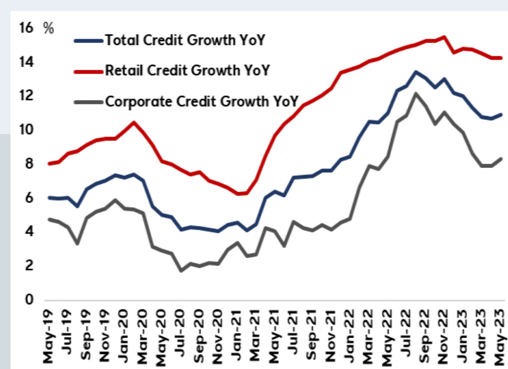
Source: Central Bank of Cyprus, CYSTAT, Eurobank Research

Bulgaria

Prospects improve given the resolution of the political deadlock

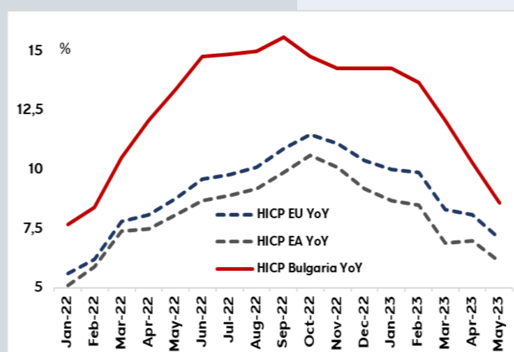
The key development of the previous month comes from the political stage as after five elections in two years and caretaker governance during most of the said period, the country has succeeded in coming up with an 18-month rotational government. The first two winning groups of parties (GERB-UDF and WCC-DB) have agreed to form a government with Nikolay Denkov, the PM designated by the second winning parties' coalition of WCC-DB acting for the first nine months as PM and Mariya Gabriel, the former European Commissioner for innovation under the proposal of GERB-UDF coalition, taking the torch for the rest nine. The outcome was positively embraced with Fitch Ratings agency underlining, on an ad-hoc comment, the improvement it provides for the eurozone entry prospects and the implementation of reforms under the national recovery plan. Apart from the acclaims, the transition to a more stable political reality has already borne fruits; from the worryingly widened fiscal target of a 6.4% deficit as a percentage of GDP for 2023, set at this level by the caretaker government, the Ministry of Finance published at the end of June a draft budget bill for 2023 which aims at a fiscal deficit of 2.5% of GDP from 2.8% in 2022. Furthermore, the government has been reportedly engaged in talks with the EC over the introduction of the euro as a parallel currency in the country as of 2024, before becoming a full eurozone member in 2025. Regarding the growth outlook, based on the final Q1-2023 GDP estimate released in early June, the economic output expanded by 2.1%YoY, below the 2.6%YoY growth reading in Q4-2022 and beating to the downside only by a tad the earlier flash estimate of a 2.2%YoY growth rate. In quarterly terms, seasonally adjusted GDP increased by 0.5%, slightly higher than the flash estimate of 0.4% and feebly lower than the 0.6% quarterly growth rate of Q4-2022. Data from both the supply and demand side of the economy point to further cooling in April as industrial output shrunk by 12.6%YoY, continuing to report negative growth rates for a fourth consecutive month and retail sales contracted by 2.7%YoY, marking the first annual decrease since July 2022. However, the continuing downward path of inflation (+10.1%YoY/-0.1%MoM in May from +11.6%YoY/+0.3%MoM in April) along with the sound credit expansion (10.9%YoY in May vs 10.7%YoY in April after a descending trend during Q1-2023) are expected to act as tailwinds on growth from Q2-2023 onwards. That said, we slightly revise higher our forecast for 2023 to 1.5% from 1.3% with growth risks rendering broadly balanced.

Figure 21: Sound credit growth...



Source: National Bank of Bulgaria, Eurobank Research

Figure 22: ...and abating inflationary pressures to support growth from Q2 onwards



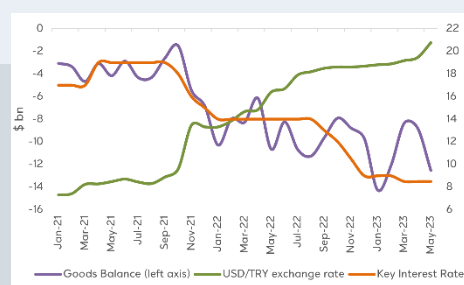
Source: Eurostat, Eurobank Research

Turkey

Shift to conventional monetary policy, but implications of the previous policy stance will persist

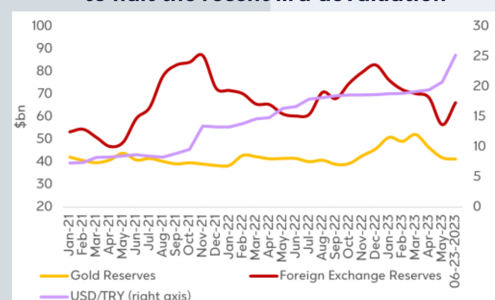
As much anticipated by financial markets after the appointment of a new Minister of Finance and Central Bank (CBRT) Governor in the aftermath of the recent elections, the Monetary Policy Committee (MPC) raised in June 22 the policy rate, to 15% from 8.5%, abandoning the loose monetary policy applied since September 2021. However, the rate hike was smaller compared to market expectations for an increase to 20%, which is considered the main reason behind the strong lira (TRY) devaluation after the MPC policy announcement, by 9.9% during June 22–26, sliding to 0.0383 against the USD, whereas the fall on an annual basis stood at 35.3%. The MPC also declared its intention for as much further monetary tightening as needed until a significant progress relative to the new 5% inflation target is achieved. The shift to conventional monetary policy is also reflected at the loosening in June 25 of some of the macro-prudential measures concerning the banking sector, as well as the increase in the CBRT's foreign exchange reserves by $4.3bn (+4.4%) in the first three weeks past the elections, implying that it no longer supports the TRY in the FX markets. The halt in the lira devaluation after the loosening of the macro-prudential measures is probably a first indication of market appreciation of the changes brought so far to monetary policy. The deterioration of the goods balance, linked to the lira devaluation, persisted in May, with its deficit widening by 17.6%YoY. The goods deficit increased in the first two months of Q2-2023 by 26.7%YoY, somewhat less than in Q1-2023 (+30.9%YoY), implying that net exports could remain a drag on GDP growth in the April-June period. The implications of the unconventional monetary policy are also reflected at inflation, as its deceleration relative to the previous quarter weakened in Q2-2023, to 14.0ppts (40.5%YoY vs. 54.5%YoY in Q1-2023), after a 23.6ppts downfall between Q1-2023 – Q4-2022. The milder ease in Q2 is mainly due to persisting inflation in transport, which is heavily affected by imported energy products prices. The recent lira devaluation could sustain a "higher for longer" inflation, but its pressures on household consumption will be mitigated by the second minimum wage raise in 2023 put in effect from July, by 34%, which affects salaries not only of minimum wage earners, bringing the nominal increase relative to end-2022 to 107.3%. In USD terms the increase is considerably smaller ($437 against $294, +48.6%), identical to average inflation in H1-2023 (47.5%YoY).

Figure 23: The key interest cut in February led to further lira devaluation and eventually did not improve the goods balance



Source: Central Bank of Turkey, Turkstat, Eurobank Research

Figure 24: Contrary to the past, the Central Bank has not used foreign exchange reserves to halt the recent lira devaluation



Source: Central Bank of Turkey, Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2022	2023f	2024f	2022	2023f	2024f	2022	2023f	2024f	2022	2023f	2024f	2022	2023f	2024f
World	3.4	2.6	2.7	8.7	5.7	3.9									
Advanced Economies															
USA	2.1	1.3	0.7	8.0	4.1	2.6	3.6	3.8	4.5	-3.8	-3.3	-3.2	-5.4	-5.7	-5.7
Eurozone	3.5	0.6	1.0	8.4	5.4	2.5	6.7	6.7	6.8	-0.7	1.5	1.6	-3.6	-3.5	-3.0
Germany	1.8	-0.3	1.1	8.6	6.0	2.7	5.3	5.6	5.4	4.6	5.0	5.2	-2.6	-2.4	-1.8
France	2.5	0.5	1.0	5.9	5.5	2.6	7.3	7.3	7.4	-2.7	-1.3	-0.8	-4.7	-4.8	-4.6
Periphery															
Cyprus	5.6	2.5	2.9	8.1	3.4	2.0	6.8	6.3	6.0	-9.1	-8.0	-6.0	2.3	1.5	2.0
Italy	3.7	1.2	1.1	8.7	6.3	2.4	8.1	7.8	7.7	-1.2	0.7	1.0	-8.0	-4.5	-3.7
Portugal	6.8	2.1	1.5	8.1	5.5	2.5	6.0	6.7	6.3	-1.4	-0.8	-0.5	-0.4	-0.4	-0.2
Spain	5.5	2	1.5	8.3	3.8	2.6	12.9	12.8	12.6	0.6	1.0	1.3	-4.8	-4.3	-3.6
UK	4.3	0.2	0.9	9.1	7.2	2.9	3.7	4.1	4.4	-4.9	-3.5	-3.4	-4.5	-5.3	-3.6
Japan	1.0	1.3	1.1	2.5	2.9	1.7	2.6	2.5	2.4	2.1	2.0	2.3	-6.7	-5.5	-4.0
Emerging Economies															
BRICs															
Brazil	2.9	2.1	1.5	9.3	5.0	4.2	9.5	8.6	9.0	-3.0	-2.4	-2.4	-4.6	-7.7	-7.4
China	3.0	5.5	4.8	2.0	1.2	2.2	4.9	5.2	5.0	2.2	1.5	1.2	-4.7	-5.0	-4.6
India	7.0	6.0	6.3	6.7	5.3	5.1		NA		-2.1	-1.5	-1.6	-6.4	-5.9	-5.3
Russia	-2.1	0.5	1.2	13.8	5.3	5.0	3.9	3.5	3.5	10.2	4.2	4.0	-2.2	-3.3	-1.9
CESEE															
Bulgaria	3.4	1.5	2.5	15.3	9.6	4.1	4.3	4.4	4.5	-0.7	-0.6	-0.3	-2.8	-3.0	-3.0
Turkey	5.4	2.2	3.5	72.0	41.4	23.6	10.5	12.0	11.5	-5.5	-6.8	-5.5	-0.9	-2.5	-1.3

Sources: European Commission, World Bank, IMF, OECD, Bureaus of National Statistics, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	September-23	December-23	March-24	June-24
USA					
Fed Funds Rate	5.00-5.25%	5.18-5.45%	5.12-5.35%	4.82-5.10%	4.42-4.70%
3m SOFR	5.27%	5.22%	5.16%	4.84%	4.46%
2yr Notes	5.25%	5.45%	5.35%	5.10%	4.70%
10yr Bonds	5.00%	5.18%	5.12%	4.82%	4.42%
Eurozone					
Refi Rate	4.00%	4.30%	4.25%	4.15%	3.95%
3m Euribor	3.60%	3.79%	3.76%	3.63%	3.42%
2yr Bunds	3.25%	2.73%	2.54%	2.36%	2.20%
10yr Bunds	2.43%	2.41%	2.31%	2.26%	2.20%
UK					
Repo Rate	5.00%	5.40%	5.35%	5.25%	4.90%
3m Sonia	5.30%	4.91%	4.84%	4.73%	4.55%
10-yr Gilt	4.43%	3.98%	3.73%	3.63%	3.54%
Switzerland					
3m Saron	1.74%	1.80%	1.87%	1.93%	1.95%
10-yr Bond	0.87%	1.35%	1.38%	1.34%	1.30%

Source: Bloomberg (market implied forecasts)

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