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Eurobank Research

GLOBAL & REGIONAL MONTHLY

Recent high-frequency indicators suggest that the global economic recovery is broadening out, bolstering investors' sentiment about the return to normalcy. Manufacturing conditions have improved significantly, while services activity still lags behind. Lack of seasonal tourism demand, coupled with the reintroduction of travel restrictions amid accelerating Covid-19 infections, suggest that the recovery in services may prove rather difficult. Our global GDP forecast remains at -3.2% for 2020, before rebounding to 5.0% in 2021. Nevertheless, a broad-based and synchronous recovery across sectors and countries is not expected before Q2 2021, as widespread vaccinations against the virus are not expected before mid-2021.

Macro Picture

USA: Incoming economic data provide further evidence of a continuing recovery

EA: Evidence that the initial post-lockdown rebound has started to fade somewhat

UK: In the deepest recession among major economies; Brexit uncertainty adds to potential risks

EM: While improved risk sentiment has tamed the capital outflows, hard data point to a challenging economic outlook

CESEE: Regional economies registered historic output contractions in Q2, though most of them outperformed both expectations and Euro area peers

Markets

FX: USD weakness dominates. Crunch time for GBP

Rates: Steepening of curves is the name of the game post Fed's flexible average inflation target

EM: EM fairly stable with LatAm and lower quality outperforming on commodity price rise

Credit: Further improvement on lower volumes, in line with the strong equity rally

Policy Outlook

USA: Details on Fed's framework review and forward guidance changes remain forthcoming

EA: Explicit dovish bias; further easing could follow amid inflation weakness & EUR appreciation

UK: BoE on a wait-and-see stance; ready to step up QE, if downside risks materialize

CESEE: NGEU & MFF2021-2027 funds pivotal for the recovery prospects of the region

Key Downside Risks

A second wave of Covid-19 infections proves to be more severe than expected, forcing governments to implement stricter restrictions

Escalation of US/China trade tensions: Cancellation of the Phase 1-trade agreement

Additional waves of Covid-19 weigh on already stressed EMs: Global supply chain disruptions undermine the recovery of highly indebted EMs

Special Topics in this issue

- Revised Fed's framework: Flexible average inflation targeting

- EU Recovery Fund: An important step on the road to post-pandemic recovery

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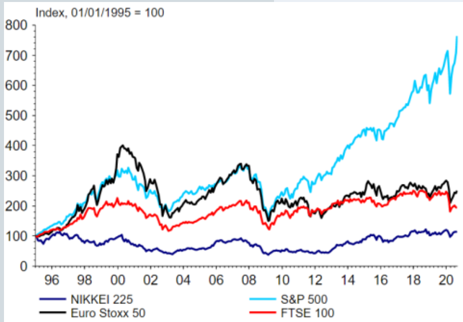
Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook

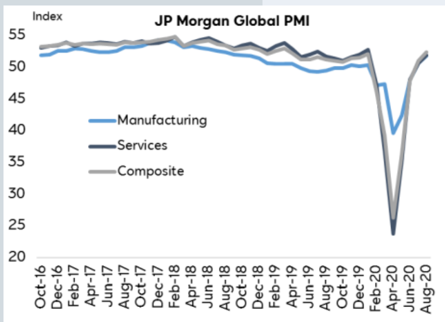
Recent high-frequency indicators suggest that the global economic recovery is broadening out, with retail sales and industrial production data coming in better-than-expected after April's trough and, therefore, bolstering the positive investors' sentiment about the return to normalcy (Figure 1). Global PMI surveys suggest that the share of economies in the world that is in expansionary territory has increased significantly, with the ratio of new orders to inventories exceeding the previous 2017 highs, boding well for future manufacturing activity and international trade. The J.P. Morgan Global Composite Output Index rose to a 17-month high of 52.4 in August, with the steeper pace of expansion recorded in the manufacturing sector as a continued downturn in consumer services weighs on overall services activity (Figure 2). Lack of seasonal tourism demand, coupled with the reintroduction of travel restrictions amid resurging Covid-19 infections, take their toll suggesting that recovery in services could prove rather difficult. Indeed, new coronavirus reported cases have started to increase globally surpassing 27 million, while fatalities exceeded 891k. The virus has continued to spread across Europe with the initial post-lockdown rebound losing some steam; the UK, France and Spain have been reporting a high number of new cases, compared to Italy, which shows relatively modest new infection numbers, and Germany, which has started to experience a downtrend. Meanwhile, in the US, daily new cases and fatalities have been on a downward trajectory in recent weeks, while hard and soft activity data signal continued strength despite the delay of additional fiscal policy stimulus. Overall, we keep our global GDP forecast unchanged at -3.2% for 2020, before rebounding to ca. 5.0% in 2021. Nevertheless, a broad-based and synchronous recovery across sectors and countries is not expected before Q2 2021, as a key driver of the recovery is an effective Covid vaccine and the WHO has made clear that widespread vaccinations are not

Figure 1: Equity markets continue to outperform
Equities in local currency



Source: Refinitiv Datastream, Fathom Consulting

Figure 2: Global PMI at 17-month highs signalling strengthening recovery



Source: Refinitiv Datastream, Eurobank Research expected before the middle of next year. Risks to our outlook include a reintroduction of sweeping lockdown measures, fiscal policy uncertainty, a potential political gridlock in the US presidential elections and/or renewed US/China trade tensions.

Developed Economies

US: The economic recovery remains on track, with data on durable goods orders, consumer spending and housing surprising to the upside. The August ISM manufacturing came in stronger than expected at a two-year high of 56.0, with new orders surging to the highest reading since 2004 and production rising sharply. The August employment report points to further improvement in labor market conditions, with strong hirings and a decline in the U-3 unemployment rate to a lower-than-expected 8.4%. Overall, we expect Q3 QoQ real GDP growth of about 30.0%, with the 2020 GDP growth forecast revised upwards at -5.5% from -6.0%, previously. Lack of a new fiscal package, given that fiscal negotiations remain frozen, represents a downside risk to our forecast, but excess savings of ca. $1 trillion should limit the impact of the sharp drop in incomes due to the expiration of unemployment benefits ($600/week) at the end of July.

Euro area: Following the largest GDP decline since WWII in Q2, the economy is set to rebound in Q3 but the pace of the recovery is likely to be highly dependent on how Covid-19 infections evolve in a number of European countries. That said, the initial post-lockdown technical rebound in economic activity has already lost some steam as we move through Q3, with the ongoing resurgence of coronavirus cases in Europe posing a significant risk to consumer demand recovery and strengthening disinflationary forces in the near term. Meanwhile, the effective euro appreciation since the start of the year and its negative effect on core inflation has been recently highlighted by ECB Chief Economist Philip Lane, who commented that the EUR's value "does matter" for monetary policy. We expect the ECB to communicate an explicit dovish bias at its September meeting, but further monetary policy easing could come later in the year, given that the PEPP still has enough resources for many more months and the recent euro appreciation and core inflation weakness have not affected so far inflation expectations.

EMU periphery: The two largest Southern European economies, Italy and Spain, are the most affected EA countries by the COVID-19 pandemic. Having both put in place very strict and long lasting lockdowns compared to the other big EA economies, their Q2 GDP contracted by a record pace of 12.8%QoQ and 18.5%QoQ respectively, following a decline of 5.5%QoQ and 5.2%QoQ in Q1, above the EA average over the respective periods. The quarterly data suggest that, whereas the two economies performed roughly similarly during the lockdowns back in April, Italy outperformed Spain in Q2, with post-lockdown recovery being faster and steeper in both May and June. That is probably because the gradual reopening process in Italy, starting in early May, took place in a relatively smooth way, whereas the said process was delayed to mid-late May in Spain and was overall more gradual due to significant regional differences. In addition, tourism, which accounts for a relatively higher share of Spain's GDP, was hit particularly hard by the Covid-19 outbreak. Following the unprecedented Q2 GDP decline, economic activity in both economies is expected to bounce back in Q3, while the improvement is likely to continue in Q4, albeit to a lesser extent.

Nevertheless, for the year as a whole, real GDP of both Italy and Spain is expected to contract by around 10.0%, slightly deeper than the projected EA average. Though the growth economic outlook for both countries is surrounded by high uncertainty, as it depends heavily on the evolution of Covid-19, downside risks for Spain appear more pronounced given the resurgence of new Covid-19 cases over the summer and the negative impact on the already compromised tourism season. On an encouraging note, generous ECB monetary policy support and the EU Recovery Fund are clear upside growth risks, as both countries are among the largest potential net recipients.

Emerging Economies

BRIC: Q2 GDP prints reveal the clear differentiation between China and the other three members of the group. China appears to be the only economy, not only among the BRICs, but possibly at global level, that will achieve a modest, still positive GDP growth rate close or even above 2% in 2020. Russia, Brazil and India are heading for GDP contractions at a range of -5% to -6.5% with Russia's standing close to -5% and the other two approaching the lower bound of the range. China's Q2 GDP growth figure climbed to +3.2% YoY from -6.8% YoY in Q1. With respect to the other members of the group, Brazil, ranking second in the world after the US in terms of Covid-19 cases, posted -11.4% YoY GDP growth in Q2 compared to 0.3% in Q1, which is the worst reading since 1997, when the statistical service began to record economic performance data on a quarterly basis. On the same pattern, India's economy crashed by -23.9% YoY in Q1-2021 (April-June), reaching unprecedented lows in more than 15 years. Concluding, Russia's economy seems to be in a better shape, compared to Brazil and India, as GDP in Q2 and solely in July shrunk by -8.5% YoY and -4.7% YoY respectively, compared to +1.6% YoY in Q1 and -6.4% YoY in June. The good agricultural crop of the season along with the slowdown in the manufacturing production fall partially mitigated the Covid-19 repercussions and the negative impact of the agreed at OPEC+ level oil production cut.

CESEE: As of late August, three months after the initial re-opening of their economies, the epidemiological situation in many countries of the Central Eastern and South-eastern Europe (CESEE) region has worsened, prompting governments to reinstate tighter sanitary measures and restrictions on public and economic activities. The latter pose a source of uncertainty over the economic outlook in the second half of 2020. On the data front, the economies across the region recorded historic output contractions in Q2, though the vast majority of them once again outperformed both consensus expectations and Euroarea peers. On the negative side, the Q2 prints confirmed our deepest and earlier stipulated fears that the CESEE economies are poised to go through a very deep recession in 2020, deeper than the Great Recession of 2008-2009

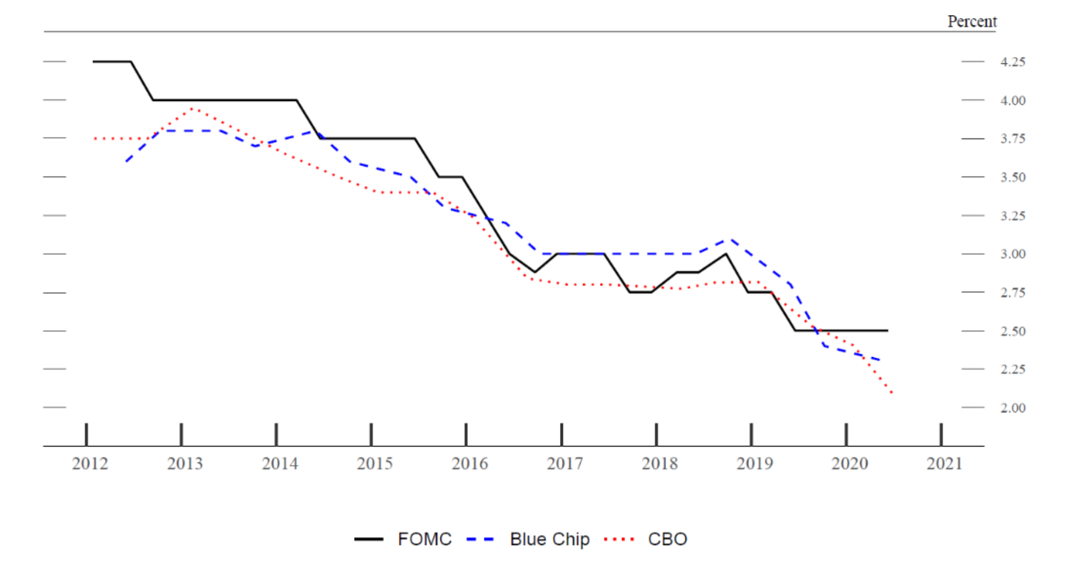
Special Topic
Revised Fed's framework: Flexible average inflation targeting

At the annual virtual Economic Policy Symposium at Jackson Hole on Aug. 27, Fed Chair Jerome Powell announced the much-anticipated results of the Fed's monetary policy framework review with a revised Statement on Longer-Run Goals and Monetary Policy Strategy. The first time the FOMC had published such a statement was in 2012 when it introduced its commitment to an inflation target of 2.0%. The target is being reaffirmed every year since. The monetary policy framework was then reviewed in 2019 as estimates of the neutral level of interest rates continued to downtrend, inflation and inflation expectations consolidated at levels below 2.0% and the unemployment rate plunged to a 50-year low. The revised statement, published at the end of August 2020, helps to inform market participants about the Fed's policy deliberations and the framework it will use to make decisions about the future path of short-term interest rates and other monetary policy tools, while the FOMC plans to conduct an analogous review about every five years.

Although financial market participants were taken aback by the fact that the announcement was made ahead of the 15-16 September FOMC meeting, the conclusions and the changes to the Fed's inflation framework were broadly in line with expectations. In a unanimous vote, the Fed actually agreed to use a different strategy that sought "to achieve inflation that averages 2% over time". The so-called "flexible average inflation targeting" includes targeting temporary and moderate overshoots of the 2% target in recoveries following periods of persistent inflation undershoot during downturns, as is currently the case, a move that signals lower-for-longer US interest rates. Although the previous statement noted that the 2% inflation objective was consistent with the Fed's statutory mandate and that the central bank would be concerned if inflation was running persistently above or below this target, the current change is that monetary policy will attempt to achieve inflation moderately above 2% on a temporary basis following periods when inflation has been running persistently below 2% in order to achieve 2% inflation over time. Fed Chair Jerome Powell made it clear that the Fed would not restrict itself to a specific mathematical formula to define the average, but the approach would rather be a flexible form of average inflation targeting.

The motivation for the review has been detailed throughout the released statement, and was reiterated in Jerome Powell's speech. The Committee remains highly concerned that a low equilibrium real interest rate ("r-star") – driven by fundamental factors that determine potential economic growth including demographics and productivity growth – will lead to persistent inflation and inflation expectations shortfalls below the 2% target and, therefore, further limit the Fed's scope to cut interest rates to boost employment during an economic downturn ("adverse dynamics"). As is evident in Figure 3, the median estimate from FOMC participants of the neutral fed funds rate – the rate consistent with the economy operating at full strength and with stable inflation – has fallen significantly from 4.25% in early 2012 to 2.50% currently, partly reflecting a lower equilibrium real interest rate. With the Fed at near-zero policy rates even in good times, there is less scope for the central bank to boost the economy during a downturn by lowering the fed funds rate.

Figure 3: Real-Time Projections of Longer-Run Federal Funds Rate



Source: Federal Reserve
*Note: The FOMC date are median projections of longer-term normal (rounded to the nearest 1/8 percentage point). The Blue Chip data are consensus estimates for 6 to 10 years in the future. The CBO date are baseline projections of the three-month Treasury bill rate for the calendar year 10 years ahead.

As far as the employment side is concerned, the Committee still targets the maximum of employment, which is "a broad-based and inclusive goal", but a flat Philips curve now means that reversing "shortfalls" – not just "deviations", as was previously the case – from maximum employment actually matter for the Fed's monetary policy. In particular, although the Committee still believes that "it would not be appropriate to specify a fixed goal for employment, policy decisions must be informed by assessments of the shortfalls of employment from its maximum level, recognizing that such assessments are necessarily uncertain and subject to revision." In his remarks, Jerome Powell highlighted that the latter change reflected the Committee's view that "a robust job market can be sustained without causing an outbreak of inflation" and that "employment can run at or above real-time estimates of its maximum level without causing concern". In the past, when the Phillips curve was steeper, monetary policy decisions to tighten policy were taken in advance of employment reaching maximum levels, in order to prevent an unwelcome surge in inflation. Given that several forces have contributed to a flat Phillips curve at the moment, Jerome Powell emphasized that employment can run at or above real-time estimates of its maximum level without raising worries over inflation. Hence, the Committee aim will be to reduce shortfalls in employment and diminish labor market slack, at least until inflationary pressures start to build up.

The fact that the Committee released the outcome of the policy framework review at the Jackson Hole meeting, ahead of the 15-16 September FOMC –as market participants had expected – allows for important decisions in the near future. Apart from the flexible average inflation targeting and the reasoning behind it included in the revised Statement on Longer-Run Goals and Monetary Policy strategy, Fed's conclusions on monetary policy tools and their efficacy to achieve the 2% inflation target over time, as well as the respective communication framework, are expected in the near future. Meanwhile, a change in forward guidance is likely as early as September, implementing an outcome-based guidance that is linked to inflation and/or inflation expectations, although the Committee could alternatively await further clarity on the economic outlook and progress on fiscal negotiations before adjusting its forward guidance. Furthermore, the Fed could potentially increase slightly the weighted average maturity in Treasury purchases that is presently 5-6 years, so as to match the average maturity of current issuance, which is 6-7 years. According to several FOMC members, yield curve control and negative interest rates are not appropriate policies at the moment, as their potential costs more than offset their expected benefits.

Global Macro Themes & Implications

Political agreement on the Recovery Fund: An important step on the road to post-pandemic recovery

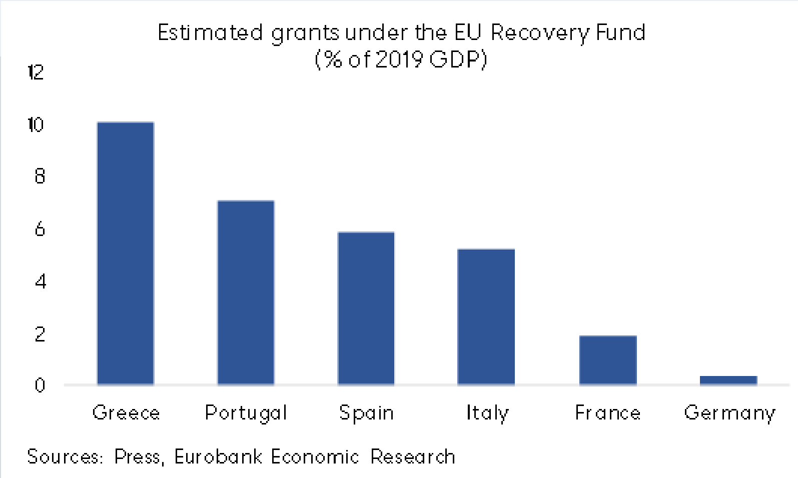
After intense negotiations, EU leaders reached a political agreement in mid-July on a deal for a Recovery Fund and the next Multiannual Financial Framework (EU budget) for 2021-2027 to assist Member States in addressing the Covid-19 outbreak, marking an important step on the road to post-pandemic recovery. The Recovery Fund, officially named “Next Generation EU” with an overall size of €750bn (5.4% of the EU’s 2019 GDP), comprises of: (i) €390bn in the form of grants that would be disbursed through seven programmes of the Multiannual Financial Framework (MFF), and especially the Recovery and Resilience Facility and the React-EU programmes, that cumulatively account for more than 90% of the MFF; and (ii) €360bn in loans. Loans will add to the public debt of the borrowing country. They have to be repaid in full by the borrowing country, which will benefit from cheaper borrowing conditions thanks to the EU’s high credit rating. On the flip side, the coupons and principals of grants disbursed to Member States will be repaid jointly, based on a contribution key (e.g. each country’s share in the EU-27 GDP). As a result, the Recovery Fund would provide some amount of burden-sharing for the very first time, and would ultimately reduce the pressure on the domestic budgets, opening the way for a deepening of the EU integration, and, thus, providing an important boost to medium-term economic growth. However, inevitably, common issuance will add to public finances of net contributors and will benefit net recipients (official data for contribution keys for grants have yet to be published).

The Recovery Fund will be financed through: (i) new debt issued by the European Commission in financial markets with 3-30 year maturity paper on behalf of the EU. The Budget (€1.074,3bn) will be used as guarantee for the issuance of joint debt. Borrowing activity will terminate no later than end-2026, and borrowed funds must be reimbursed from 2028 until 2058, at the latest. The allocation of grants will be front-loaded; 70% will be committed for 2021-22 and the remaining 30% for 2023; (ii) the EU’s Own Resources that represent the amount each Member State is called to contribute to the EU budget annually to finance EU expenditures. The Own Resource’s ceiling will be raised to 2.0% of the GNI, from 1.4% currently. To ease that burden, EU leaders agreed on the introduction of new resources to fund the EU budget, including a new levy on plastic from January 2021, while the introduction of a digital levy, a carbon border adjustment mechanism and, possibly, a financial transaction tax could follow by 2023, at the latest, if needed, to cover all liabilities of the EU resulting from its borrowing. Bear in mind that a decision to increase Own Resources requires unanimous approval by Member States according to their respective constitutional requirements. The funds will be distributed among Member States based on certain criteria: for 2021 and 2022 the allocation keys include the average unemployment rate for the period 2015-2019 compared to the EU average, the population size in 2019 as a share of the EU's total population and the inverse of 2019 GDP per capita relative to the EU average. For 2023, the unemployment criteria will be replaced by the cumulative loss in real GDP over the period 2020-2021 so as to take into account the negative effect of the pandemic, suggesting that the disbursement of grants under the EU Recovery Fund will likely be skewed towards peripheral economies.

To request funds, countries will have to present a national reform plan, outlining their post-pandemic recovery strategies consistent with country-specific recommendations embedded in the European semester. Within two months of the submission, the proposed plan has to be approved by both the European Commission and the European Council by qualified majority voting (i.e. 55% of votes representing at least 65% of the EU population). According to the EU Commission, funds under the Recovery Fund should contribute to "growth potential, job creation and economic and social resilience", while "effective contribution to the green and digital transition shall also be a prerequisite for a positive assessment". Whereas individual countries do not have veto power over the disbursements under the Fund (as was requested by the Netherlands), disbursements may actually delay under a so-called "super emergency break". This means that, if the submitted reform plans are considered to deviate from the specific recommendations, countries will be requested to make the necessary adjustments within three months. The final decision will be made by the European Commission.

For the Recovery Fund to become operational, two steps have to be completed: Ii) approval by national parliaments. Whereas the risk of having a parliament rejecting the Recovery Fund seems low, on the view that the governments are confident of the necessary parliamentary support, there may be an issue for the government of the Netherlands. Dutch PM Mark Rutte, the unofficial leader of the so-called "frugal 4+1" EU countries (the Netherlands, Austria, Sweden, Finland and Denmark), which have long opposed to the idea of any form of financial solidarity, is the head of a coalition government short of an absolute majority in parliament, while the far-right Eurosceptic opposition has criticized the Recovery Fund deal as a waste of Dutch taxpayers' money; (ii) approval by the EU Parliament. The EU Parliament is expected to vote on the Recovery Fund (and the MFF) when it reconvenes in September. According to press reports, European Parliament President David Sassoli has expressed his discontent with regard to the reduced EU budget, while MEPs voted in July in favor of a resolution requesting certain changes to the MFF. Given how difficult it has proved for EU leaders to reach an agreement, the risk of the European Parliament eventually rejecting the Recovery Fund (and the MFF) seems unlikely. However, intense discussions are expected to take place, raising concerns with regard to the timely adoption of the Recovery Fund on 1 January 2021.

Figure 4: Disbursement of grants under the EU Recovery Fund likely skewed towards peripheral economies



Source: EU Commission, Press, Eurobank Research

Macro Themes & Implications in CESEE

Economies across the broader CESEE region recorded historic output contractions in Q2, although the vast majority of them once again outperformed both consensus expectations and Euroarea peers.

As of late August, three months after the initial re-opening of their economies, the epidemiological situation in many countries of the Central Eastern and South-eastern Europe (CESEE) region has worsened. During the past weeks, many of them have been confronted with a sharp rise in infections, hospitalizations and fatalities related to the Covid-19 pandemic, raising fears that the "second wave" has started materializing. However, the picture is not homogeneous across countries. The number of cases in Central Europe (Poland, Czech, Slovakia) are on the rise whereas in the SEE (Bulgaria, Romania, Serbia) the pandemic is gradually retreating after the initial spike in cases.

Overall, the worsening of the epidemiological situation has prompted governments to reinstate tighter sanitary measures and restrictions on public and economic activities. The latter pose a source of uncertainty over the economic outlook in the second half of 2020. But even after taking into account the latest developments, compared to other regions or countries across the world after six months in the covid-19 pandemic, the broader CESEE region seems to be in better shape, while their response to the pandemic may have largely been more successful than that of Western Europe and USA.

On the data front, the national accounts data releases of the second quarter of 2020 took center stage in mid-August to early September. Evidence from those releases are illustrative of the damage to the economies from the implementation of tough social distancing measures to tackle the Covid19 pandemic. The economies across the region recorded historic output contractions in Q2, though the vast majority of them once again outperformed both consensus expectations and Euroarea peers. On the negative side, the Q2 prints confirmed our deepest and earlier stipulated fears that the CESEE economies are poised to go through a very deep recession in 2020, deeper than the Great Recession of 2008-2009.

Looking at the data on a country-by-country basis we conclude that with the exception of Croatia (-14.9% QoQ/-15.1% YoY), an economy which is highly dependent on tourism and services, the CESEE economies were clear outperformers compared to the Euroarea average (and their Euroarea peers). However, even within the large group of CESEE, regional economies had very diverse performances in Q2. Among them, there was a group which posted double digit contraction rates including Hungary (-14.5% QoQ/-13.5% YoY), the Czech Republic (-8.4% QoQ/-10.7% YoY), Slovakia (-8.3% QoQ/-12.1%YoY) and Romania (-12.3% QoQ/-10.5% YoY). In contrast, a handful of other economies posted single digit contraction rates, including Poland (-8.9% QoQ/-7.9%) and the Baltics: Lithuania (-5.1% QoQ/-3.7% YoY), Latvia (-7.5 QoQ/-9.6% YoY) and Estonia.

The economies of our focus (Bulgaria, Cyprus and Serbia) fared much better even by regional standards. In fact, both Bulgaria (-9.8% QoQ/-8.2% YoY) and Serbia (-9.2% QoQ/-6.4% YoY) were among those few economies that posted single digit contractions on both a quarterly and an annual basis in Q2-2020 allowing for optimism that output losses could be contained further in FY2020. The quarterly reading of Cyprus (-11.6% QoQ/-11.9% YoY), a small open economy which also relies on tourism and services, stood somewhere in the middle: it was neither impressive, nor catastrophic, yet still stronger than the regional and EU-28 averages. Finally, Turkey, contracted by -11.0% QoQ/-9.9% YoY in Q2 down from +0.6% QoQ/+4.5% YoY in Q1, coming in above expectations. The provision of large monetary and fiscal stimulus measures, which helped the economy emerge from its previous recession in 2019, helped to partially cushion the impact of the pandemic but inflates domestic imbalances heavily.

In the analysis of the GDP prints across the region, it looks like the contraction was broad-based across all expenditure components. Nevertheless, investments and to a lesser extent net exports, were the components that suffered the biggest declines. Investments, if the replenishment of inventories is also factored in, took the biggest blow given the rise of uncertainty compelled individuals and companies to hold back their investment plans. On the other side, that leaves room for public investment to come in.

Total consumption dynamics, albeit contractionary, received strong support from public consumption mirroring the government support schemes in place. As a result, total consumption's negative contribution was contained. Net exports' contribution was mixed, depending on whether exports contracted more than imports. In a few cases, especially in those economies which are more dependent on services, the collapse of imports outpaced that of exports pushing net exports' contribution in positive territory and partially offsetting some of the output contraction.

High frequency indicators point to continued improvement in July-August despite lingering uncertainty. The re-opening of the economies, even at the expense of a new rise in infections, has strengthened optimism in sentiment and surveys. Having plummeted to multi-year lows in April, those indicators continued their rebound in the last two summer months. However, the rebound is neither strong enough nor uniform across individual sub-categories. The biggest gains were recorded in industry with services and consumer sentiment lagging behind in the rebound. In our view, this may reflect market concerns for a second wave of the pandemic. From that point of view, uncertainties are still very high and it is still highly doubtful when they will able to reach their pre-crisis levels.

The picture of the Markit PMI manufacturing releases in August was also encouraging. After having dropped steeply across the board in April – in some cases the plunge was even steeper than that seen in the Great Recession – PMI indices bounced back in the next months. On the positive side, most of those PMI indices not only hold to their earlier months' gain but in some countries (Poland, Russia, Hungary, Turkey to name a few) have climbed above 50 switching from contractionary to expansionary territory. Although the correlation with manufacturing activity is not necessarily so strong in every case, it still signals that the upward momentum continues creating upside risks to the growth outlook in the H2.

Finally, the agreement reached in the EU Council in late July for the new instrument NGEU and the MFF suggests that the South-Eastern European countries remain well-supported in terms of funds allocation relative to size of their economy. Recall that the European Commission (EC) outlined in May its proposal for a recovery package that encompasses the Multiannual Financial Framework (MFF) for 2021-27 and a recovery instrument named "Next Generation EU". This instrument, will boost the MFF in 2021-24 with €750bn (5.4% of EU27 GDP). Two-thirds of Next Generation EU funds, approximately €500bn will be distributed to member countries as grants, while the remaining one-third €250bn will be given as loans. The vast majority of the CESEE economies, which are also EU members, are going to be net recipients/beneficiaries of this recovery package. So far, from announcements by the countries of our focus we highlight the following:

- Bulgaria is expected to receive a total of €29bn or 47.5% of 2019 GDP, which places the country among those benefitting the most from EU support (€16.7bn non-reimbursable funds from the MFF for the period 2021-2027 & €12.3bn from the NGEU).
- Cyprus could have access to more than €2.7bn or 12.4% of 2019 GDP in funds. The latter refers to the maximum amount (loans & grants) from NGEU given that the net impact from the MFF is more or less zero.
- Romania is entitled to a total of €79.8bn or 35.8% of 2019 GDP (€46.3bn non-reimbursable funds from the MFF for the period 2021-2027 & €33.5bn from the NGEU).

CESEE Markets Developments & Outlook

Bulgaria

Eurobond government bond yields slid across the board, ranging between 6-10 bps. The sharpest slide was observed in the short-term papers, namely the 2022 and 2023 with 7 and 10 bps respectively, while the longer tenors saw their yields sliding by 7 bps for the 2028 and only by 2 bps for the 2035. Local currency government bond yields registered modest losses of 1-3 bps across the short end of the curve, while the longer tenors, namely the 10 and 20 years, saw their yields dropping by 8 bps each. The political turmoil that has surged the last two months keeps escalating as the ruling party resists to step down. Over the last month, the government has announced an increase in expenditures by EUR0.5bn that basically aim to raise salaries in the public sector and grant "one-off" pension increases. Despite the aforementioned increased expenditures, the fiscal budget posted a EUR0.75bn surplus in August.

Serbia

The second wave of the pandemic has started to recede as the country is currently dealing with less than 80 infections per day, compared to 400 per day in June. Regarding the performance of the dinar in the last two months, there has been no change in the monetary policy of the National Bank of Serbia (NBS), amid lack of extraordinary economic developments and the overall volatility of the EUR/RSD pair has been limited. Since the beginning of the year, fluctuations in the dinar are considered negligible as the NBS hastens to bridge any gap between supply and demand through FX intervention. Turning to the real economy, GDP growth declined by -6.4 YoY in Q2. The GDP contraction is broadly rooted in the emergency measures taken to curb the pandemic spread. Finally, in the government bonds front, a stabilizing trend has come up following the initial surge in yields in March. Compared to the previous month, yields are between 2 to 4 bps lower on both ends of the curve.

Markets View

Foreign Exchange

EURUSD: The pair reached the 1.20 psychological level and has consolidated in a range ever since. Whilst certain factors have turned more USD-supportive (relative data and Covid-19 news, debatable Trump's election chances) the overall picture remains constructive as long as the 1.1750 level is not breached. We are now buyers at dips close to the support zone of 1.1750, targeting the 1.20 high (current 1.1800).

GBPUSD: Summertime has ended rather abruptly for GBP. Over the summer the currency has defied gravity and bad news, squeezing out shorts in the process but now it does feel like the market is starting to recalibrate the odds of a no-deal Brexit outcome and similarly recognize that crunch time is close. Brexit talks resume and the vibe seems less than cordial. The pair is now on correction mode, having overshoot to 1.35 in the beginning of September. We are now sellers on rallies targeting a break of 1.30. Support comes at 1.3000 and major resistance is at 1.3500 (current 1.3140).

USDJPY: The pair continued to trade inside a range during August (107.00 – 104.00). The Abe resignation did not have an impact on the currency and overall the pair is drifting trendless. We have a slightly bearish bias as equity valuations are very high ahead of the US election (current 106.30).

Rates

EU: The steepening of the yield curve came to a stall in the first week of September as the strong equity performance took a breather with 2-30s swaps widening to 0.5% as the short end remained anchored. Most markets now face the risk that the second wave of coronavirus could derail the recovery of many EU economies. We believe that the yield curve should continue to steepen, which is a typical yield curve reaction when coming out of a recession. However, the rest of the year will depend on Covid-19 developments and the outcome of the US elections, which at this point are a close race. The drivers are to a large extend offsetting one another (higher supply of debt vs lower core inflation) but the tail risks weigh on the optimistic side (e.g. a vaccine or a much greater step towards a fiscal union) and suggest a slight steepening for EUR curves.

US: The US yield curve posted an impressive steepening rally during August amidst a risk on sentiment with 2-30s swaps widening to 0.9% as the short end remained anchored. The move has corrected in early September as risk on sentiment deteriorated and many economies face elevated or even accelerating infection rates. Although the Covid-19 resurgence restrains a repricing higher of yields, we believe that this is temporary and given the strengthening data, which confirm a rapid recovery, we expect that the curve will steepen amidst a move higher in long-term yields

Emerging Markets credit

Spreads in EM were fairly stable to slightly tighter in EMEA and Asia, while LATAM had a strong rally tighter and outperformed other EM regions. Lower grade and HY names outperformed higher quality ones helped also by the recovery in commodities and oil. Still, macro data and new infection rates are not positive across all regions, and despite the recovery in laggard spreads, the magnitude of any further tightening potential will be affected. The JP EMBI sovereign spread index tightened around 25bps since late July. USD denominated debt outperformed local currency across most regions. Argentina managed to swap the 98.8% of its local law debt. New bonds, issued as part of its restructuring deal, start trading on the first business day after their Sept. 4 settlement date. USD-denominated bonds due in 2030 (known locally as AL30), have an implied price of 49.8 cents on the dollar. We believe that there is still room for improvement and better valuations, if global macro bottoms out and the commodity picture improves further.

Corporate credit

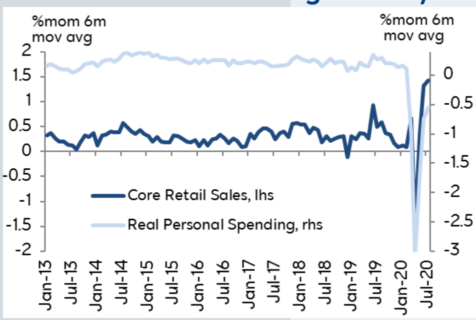
Corporate spreads continued their tightening trend in August, albeit at a less aggressive pace compared to previous months. Light supply was easily absorbed despite the low volumes and activity associated with full summer mode. FED dovish stance continuation, coupled with the strong rally in equity index prices helped to sustain a positive sentiment as news of vaccines hitting the market in late 2020 also provided support to sentiment. Macro data and new infection rates on the other hand remain a negative factor that can affect pricing over the last quarter of the year. EUR Investment Grade spreads outperformed US reaching almost zero basis vs CDS spreads, while HY EUR also continued their rally tighter, compared to US ones that remained at same levels during the whole month. Lower-rated corporates outperformed higher quality ones as the hunt for yield and potentially more ECB support weighted on valuations. Shorter duration was also better bought bringing moderate steepening of the rating curves across mostly lower quality names. The compression trade in cap structure mostly stalled, though some T2 new issues were very well received. EUR IG Corporates tightened by 10bps on average. We believe that further ECB support and vaccine related news will support spreads going forward and any equity related catch up to macro deterioration will have EUR IG spreads outperform the possible downturn.

USA

Incoming economic data provide further evidence of a continuing recovery

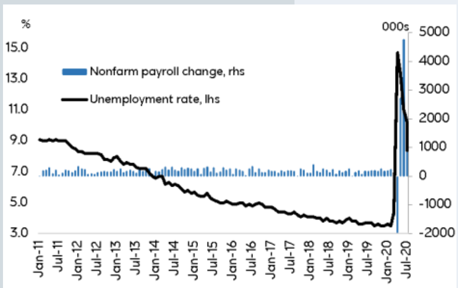
The US economic recovery remains on track, with data on durable goods orders, consumer spending and housing surprising to the upside. Meanwhile, the August ISM manufacturing came in stronger-than-expected at a two-year high of 56.0 from 54.8 in the prior month, with new orders surging to the highest reading since 2004 (67.6) and production rising sharply at 63.6. Furthermore, the August ISM services was close to expectations at 56.9 vs. 57.0 in July, supported by a significant improvement in the employment index and longer supplier delivery times, which rose to the highest reading since May (+5.3pts to 60.5). Turning to the US labor market, decreasing jobless claims point to further improvement in labor market conditions in late August amid strong hirings, while the August payrolls survey revealed a 1.37mn increase in nonfarm payrolls that was in line with market expectations, and the U-3 unemployment rate - derived from employment as measured in the household survey - came in at a lower-than-expected 8.4%, down by 1.8pp from July. Overall, we expect Q3 QoQ real GDP growth of about 30.0%, with the 2020 GDP growth revised upwards at -5.5% from -6.0%, previously. Lack of a new fiscal package, given that fiscal negotiations remain frozen, constitutes a downside risk to our forecast, but excess savings of ca. $1 trillion should limit the impact of the sharp drop in incomes due to the expiration of unemployment benefits ($600/week) at the end of July. On the monetary front, at the annual Jackson Hole meeting in late August, Fed Chair Jerome Powell announced the long-awaited conclusions of the Fed's monetary policy framework review with a revised Statement on Longer-Run Goals and Monetary Policy Strategy, formalized in two main changes (i) a shift of the Fed's monetary policy strategy from the current inflation-targeting to a flexible average inflation-targeting framework, with the statement clarifying that the Committee "seeks to achieve inflation that averages 2% over time"; and (ii) a Fed shift to responding to shortfalls - rather than "deviations"- "from maximum" employment . The fact that the Committee released the outcome of the policy framework review at Jackson Hole ahead of at the 15-16 September FOMC meeting –as market participants had expected – suggests that important decisions are expected in the near future, likely before the end of September.

Figure 5: Domestic demand on track for a continuing recovery



Source: Bloomberg, Eurobank Research

Figure 6: US labor market conditions continue to improve



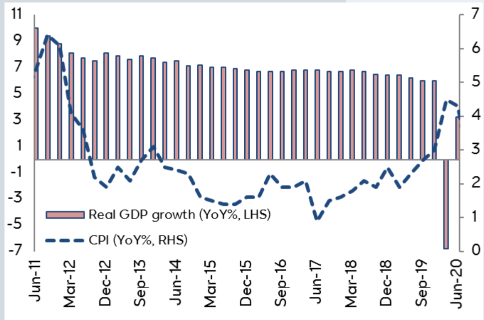
Source: Fed of St. Louis, Eurobank Research

China

Positive Q2 GDP growth print confirmed the economic growth momentum which is at play since May

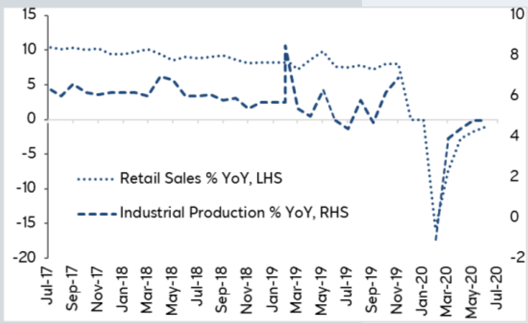
The Q2-GDP growth print, released in mid-July, verified the economic growth momentum which is at play since May. Following the GDP contraction by -6.8% YoY in Q1, GDP rebounded by +3.2% YoY and +11.5% QoQ in Q2, resulting in a -1.6% YoY GDP growth in H1. Breaking down the headline figure into sectors, the primary sector (production) was up by 3.3% YoY from -3.2%YoY, the secondary industry (manufacturing) surged to 4.7%YoY from -9.6%YoY and the tertiary sector (services) spiked to 1.9%YoY from 5.2%YoY, all compared to Q12020. While the recovery has been temporarily paused due to the floods in July and August, hard and soft data point to sustained growth momentum, albeit at an uneven pace with domestic private consumption lagging behind. In brief, Industrial production continued to expand by 4.8% YoY in July, same rate as in June and exports data in August (+9.5% YoY vs +7.2% YoY in July) point to firm external demand stemming mainly from demand for hygiene material related with the pandemic. However, retail sales continued to shrink, albeit at a slower pace (-1.1% YoY in July vs -1.8% YoY in June) at a moment when market consensus anticipated a marginal increase (+0.1%). With respect to the domestic private consumption, since it contributes ca 40% of GDP, the noticed lag worries and calls for an immediate response at an economic policy level. In the aforementioned context, next month top officials will meet to discuss the 5 year economic plan which will be broadly based on the newly introduced "dual circulation" concept. The fresh national priority implies that domestic demand takes centre stage, allowing the internal and external markets to boost each other. That way, China will be able to build up resilience against the currently hostile external environment and reduce its dependency on global export demand. Concluding on the Covid-19 front, new daily cases have stabilised at ca ten per day in the second quarter, not taking into account the spike in Beijing in mid-June which was immediately tamed. Specifically, on September 7, daily confirmed cases reached 23 and were all reported as imported, marking the 23rd consecutive day without new infections. However, at the same day 13 asymptomatic cases were observed which are not officially counted in the official statistics.

Figure 7: GDP growth recovered in Q2-2020...



Source: Bloomberg, Eurobank Research

Figure 8: ...but signs of uneven recovery worry



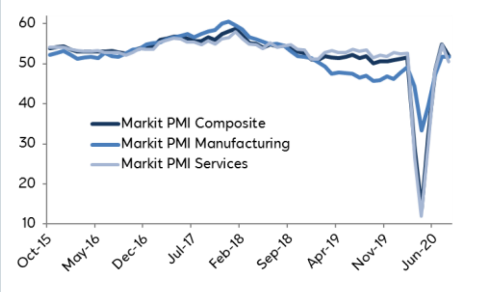
Source: Bloomberg, Eurobank Research

Euro area

Evidence that the initial post-lockdown rebound has started to fade somewhat

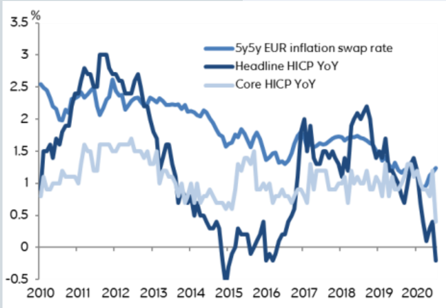
Following the largest GDP decline ever recorded since WWII in Q2, the Euro area economy is set to rebound in Q3 but the pace of the recovery is likely to be highly dependent on how Covid-19 infections evolve in a number of European countries. That said, the initial post-lockdown technical rebound in economic activity has already lost some steam as we move through Q3, with countries like France and Spain having started to battle with a second wave of the pandemic, which dents consumer and business confidence to some degree. Retail sales contracted by 1.3%MoM in July - vs. consensus expectations for a 1.0%MoM increase - reflecting a payback from resilient demand during the initial re-opening in May and June. Meanwhile, the composite PMI for activity lost some momentum in August, declining by 0.3pts to 51.9 (Figure 9), principally driven by a weak services sector (the respective index declined to 50.5 from 54.7 in July), where France experienced a noticeable growth deceleration and the tourism-reliant periphery (Italy and Spain) returned to contractionary territories. Although the Euro Area Economic Sentiment Indicator increased to 87.7 pts in August from 82.4 in July, it remains well below its long-term average of 100. On the inflation front, headline inflation dipped into negative territory for the first time since May 2016 (-0.6pp to -0.2%YoY) driven mainly by technical and seasonal factors amid a deflationary effect of the German VAT rate cut and delays of summer sales in France, Italy and Belgium, while core inflation dropped by 0.8pp to a record low of 0.4%YoY, mainly on the back of weak non-energy industrial goods prices. The effective euro appreciation since the start of the year and its negative effect on core inflation have been recently highlighted by ECB Chief Economist Philip Lane, who commented that the EUR's value "does matter" for monetary policy. We expect the ECB to communicate an explicit dovish bias at its September meeting, but further monetary policy easing could come later in the year, or even in 2021 (depending on the economic and the inflation outlook, the value of the EUR as well as financial market conditions), given that the PEPP still has enough resources for many more months and the recent euro appreciation and core inflation weakness have not affected so far inflation expectations (Figure 10).

Figure 9: The initial post-lockdown technical rebound has lost some steam



Source: Markit, Bloomberg, Eurobank Research

Figure 10: Disinflationary forces but inflation expectations have been so far unaffected



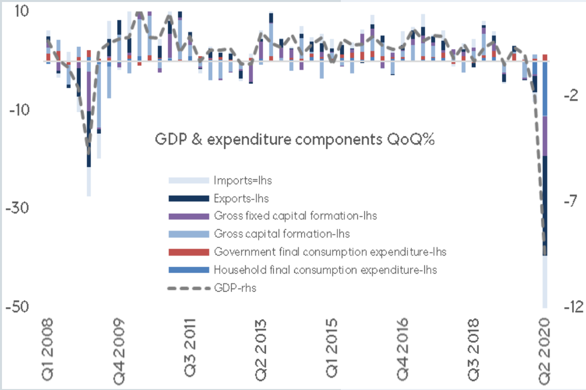
Source: Source: Bloomberg, Eurobank Research

Germany

Fading hopes of a V-shaped post-pandemic recovery

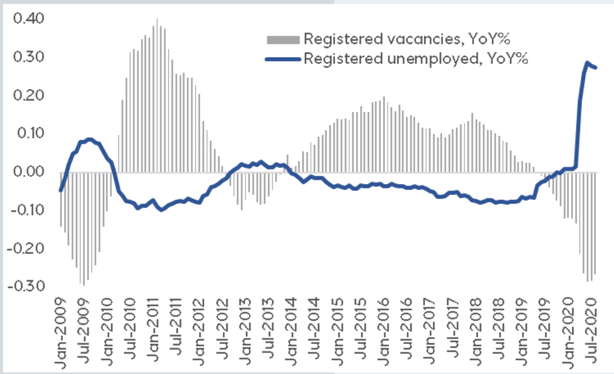
Germany's GDP fell by 9.7%QoQ in Q2, upwards revised from -10.1%QoQ initially reported, remaining though the sharpest decline ever, reflecting the full impact of the Covid-19 pandemic and associated containment measures. All expenditure components fell sharply, with the exception of public consumption which rose (+1.5%QoQ), reflecting emergency support measures (Figure 11). Compared to its EA peers, Germany has been a clear outperformer, as the lockdown measures to contain the Covid-19 outbreak came relatively later and were less strict, the economy started reopening earlier and the government mounted record fiscal support (23% in the form of cash grants and c. 30% in loan guarantees) to soften the hit from the pandemic and pave the way for a strong rebound. In combination with a 2.0%QoQ fall in Q1, GDP stood in Q2 11.7% below the Q4 2019 level. That means that it would take an astonishing 13.0%QoQ increase in Q3 GDP to close the gap with pre-pandemic levels. Several high frequency and sentiment indicators recorded a strong rebound in May and June after the lockdown ended in April, raising hopes of a V-shaped recovery. However, after the initial bounce, the pace of economic recovery has apparently weakened thereafter, purportedly driven by, among others, the resurgence of Covid-19 cases over the summer, fears of another round of lockdown measures, the higher indebtedness of companies and deteriorating labor market conditions (Figure 12). In support of the above, retail sales dropped by 0.9%MoM in July, the second consecutive monthly fall from their May peak, despite the 3pp temporary VAT cut that came into force on 1 July. In addition, the recovery of the industrial production slowed in July, rising by 1.2%MoM following increases of 7.4%MoM and 9.3%MoM in May and June, respectively, while the Composite PMI recorded its first drop in August (to 54.4) after a 37.9 cumulative rise in the three months following the April trough of 17.4. On the assumption that a second Covid-19 wave would not lead the government to reinstate lockdown measures, we expect a 6.5% contraction for the full year, followed by a 5.0% expansion in 2021, suggesting that the economy is unlikely to return to pre-pandemic levels before 2022.

Figure 11: GDP stood in Q2 c. 12% below pre-pandemic Q4 2019 level



Source: Federal Statistical Office (Destatis), Eurobank Research

Figure 12: The Covid-induced recession left a deep mark on the German labour market



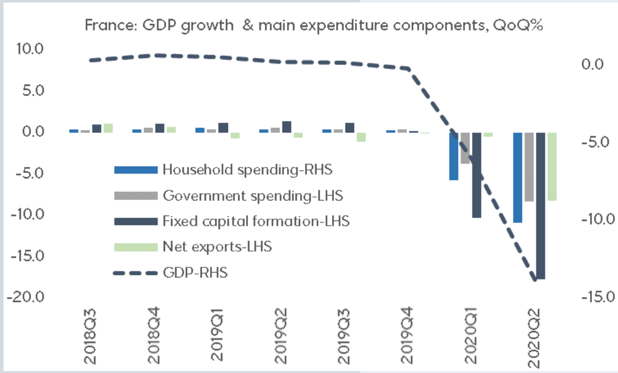
Source: Federal Statistical Office (Destatis), Eurobank Research

France

Post-lockdown recovery slows down following a resurgence of Covid-19 cases

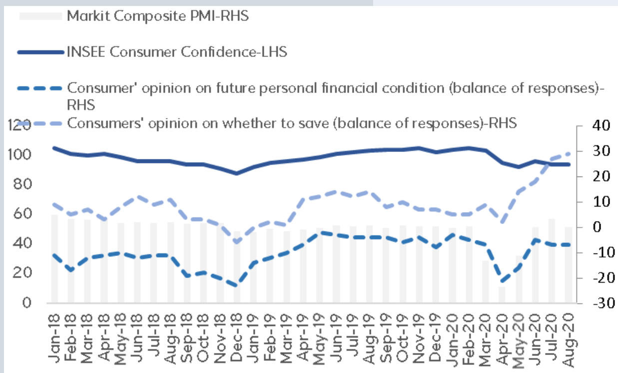
The lockdown in France, which was imposed on 11 March and remained in place for around two months to mitigate the spread of the Covid-19 outbreak, led to a sharp GDP decline in H1 2020. Economic activity contracted by a pronounced 12.5% compared to H2 2019 after a 5.9%QoQ decline in Q1 that was followed by an unprecedented 13.8%QoQ fall in Q2 (Figure 13). Domestic demand accounted for 18.5pp of the H1 GDP decline: investment fell by 16.7% compared to H2 2019, while private consumption dropped by a relatively lower pace of 11.1%, reflecting the positive effect from the government's measures to support the income of furloughed workers. Public consumption also fell by 8.2%, while external demand subtracted 2.5pp from H1 GDP growth (imports -13.7% vs. exports -18.1%). Provided that the second wave of infections would not be worse than the first one, the gradual lifting of containment measures as of mid-May and the government's forceful fiscal response to mitigate the economic effect of the pandemic (measures worth 5.6% of GDP) are anticipated to translate into a noticeable bounce in H2 given the extent of the plunge in economic activity in H1. That said, various activity indicators, including retail trade, continued to improve in July from April's trough, suggesting that economic recovery has probably gained some further momentum in early Q3, especially following the re-opening of the internal EU borders. However, sentiment indicators suggest that the pace of post-lockdown recovery has probably slowed in August, following the resurgence of Covid-19 infections. That said, the flash Composite PMI dropped by 5.7pp to 51.6 over that month, effectively cancelling out the July bounce, while consumers appear inclined to increase further precautionary savings as they get more worried about their future personal financial condition (Figure 14). For the full year, we expect a 10.0% GDP contraction, with the economic outlook being surrounded by high uncertainty as it depends heavily on the epidemiology of Covid-19.

Figure 13: The lockdown led to a pronounced GDP contraction in H1 2020



Source: INSEE, Eurobank Research

Figure 14: Various sentiment indicators suggest that post-lockdown recovery has slowed down



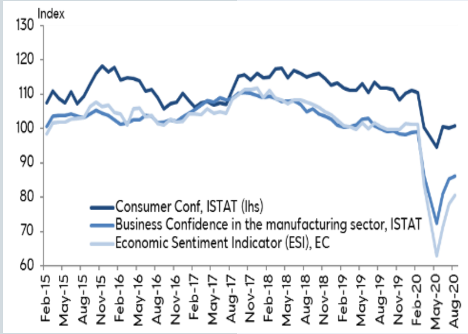
Source: INSEE, Eurobank Research

Italy

The reopening of the economy continues to revive domestic demand

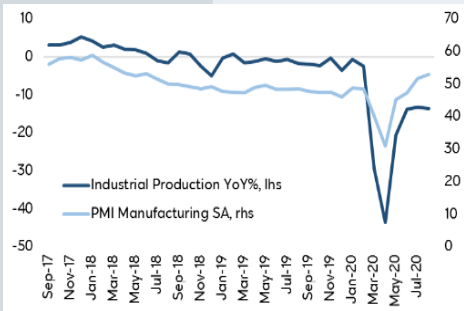
According to ISTAT national accounts data released on 31 August, the Italian economy contracted by a downwards revised 12.8%QoQ (-17.7%YoY) in Q2, recording the steepest drop since the respective series started in 1996. As expected, both domestic and external demand were a drag on overall growth, with consumer spending and fixed investment losing 8.7%QoQ and 14.9%QoQ, respectively, while exports declined (-26.4%QoQ) more than imports (-20.5%QoQ) resulting in a negative contribution from net trade. Nevertheless, the Italian economy is expected to return to positive growth in Q3, with overall 2020 GDP growth envisaged at -10.0%, close to the Bank of Italy's forecast of -9.5%. High frequency indicators suggest that manufacturing conditions improved in August at their fastest pace in more than two years amid looser lockdown restrictions, with the Italian Markit PMI Manufacturing increasing for a second consecutive month in August from 51.9 in July to a 26-month high of 53.1. Factory production and total new orders growth was the sharpest since February 2018, as the reopening of the economy has resulted in increased domestic demand (Figure 16). Nevertheless, the services sector fell back into contractionary territory due to a further decline in total new business and a noticeable drop in foreign demand, with the Markit PMI Services falling to 47.1 in August from 51.6 in the prior month. Moreover, the Economic Sentiment Indicator, a composite indicator produced by the European Commission that covers the manufacturing, services, consumers, retail and construction sectors, rose in August for the third month in a row to a four-month high of 80.6 from 77.9 in July, mirroring broad-based strength across all sectors. Looking ahead, the recently approved Recovery Fund with about $240bn available by the EU in the next few years should diminish the likelihood of financial turmoil, although rising political noise between the ruling parties could lead to increased political instability and market volatility. Regional elections in several regions on 20-21 September (Tuscany, Marche, Liguria, Veneto, Apulia, Campania, Valle d'Aosta), a constitutional referendum on 20 September regarding a reform to reduce the number of MPs from 945 to 600 effective from the next election, and the 2021 budgetary process that starts in September could lead to political uncertainty and further delay the government's reform agenda.

Figure 15: Hopes of an economic recovery fuel consumer and business confidence



Source: Bloomberg, Eurobank Research

Figure 16: Manufacturing conditions improve; sharp rise in factory production and new orders



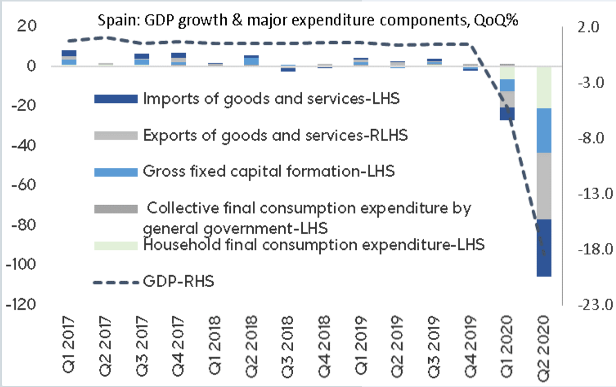
Source: Markit, Bloomberg, Eurobank Research

Spain

The hardest hit by Covid-19 among major EA economies

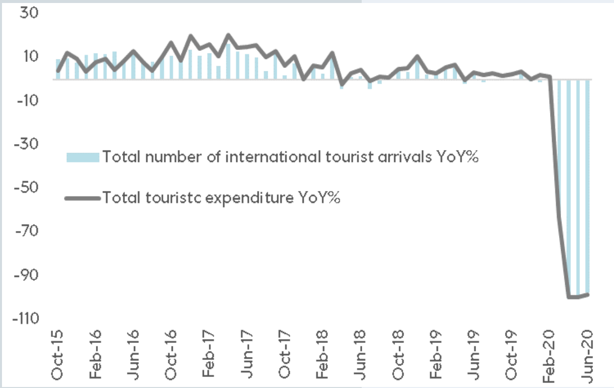
The nationwide lockdown that was put in place for around 2-½ months starting in mid-March to slow the pace of Covid-19 infections, led to an unprecedented decline in H1 GDP (Figure 17). Economic growth plunged by 13.8% compared to H2 2019 (Q1 GDP -5.9%QoQ, Q2 GDP -18.5%QoQ) driven by a pronounced drop in both private consumption and investment (c. -16.5% each vs. H2 2019), with Spain performing the worst in terms of GDP growth than the other major EA economies for a number of reasons. Faced with the deadliest coronavirus outbreak in Europe, the Spanish government was forced to adopt one of the most stringent and extensive lockdowns. Moreover, sectors more vulnerable to social distancing measures, like tourism, account for a relatively higher share of domestic GDP: 14.6% of Spain's GDP vs. a 10.4% on average for the other three major EA economies. Last but not least, the government's direct fiscal support to mitigate the impact of the pandemic was somewhat less robust than the majority of EA economies (2.8%-of-GDP vs. an estimated EA average of 4.0%) due to budget constraints and the minority government's struggle to secure the necessary parliamentary support to pass measures intended to support the health sector, employees and the hardest hit companies. Following the very slow but steady four-stage lifting of containment measures that started in May and was almost completed by end-June, economic activity is bouncing back (e.g. June's industrial output, July's retail sale & car registrations), but remains well below pre-pandemic Q4 2019 levels. For the whole year, GDP is now anticipated to contract by 11.0% down from -9.6% previously, following the pronounced decline in tourist inflows and the very gradual lifting of the lockdown (Figure 18. Confirming downside risks to our expectations, PM Pedro Sánchez announced that the government is unlikely to re-impose a nation-wide lockdown following the resurgence of confirmed Covid-19 cases in recent weeks, but will grant regional governments the authority to impose local lockdowns if it is deemed necessary.

Figure 17: Spain performs the worst in terms of GDP growth compared to its major peers



Source: INE, Eurobank Research

Figure 18: The increase in reported COVID-19 cases over the summer months has weighed heavily on tourist inflows & expenditure



Source: INE, Eurostat, Eurobank Research

Eurobank

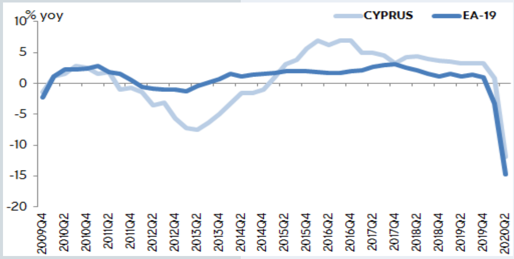
Eurobank Research

Cyprus

The Q2-2020 output performance was the worst since the 2012-2013 crisis

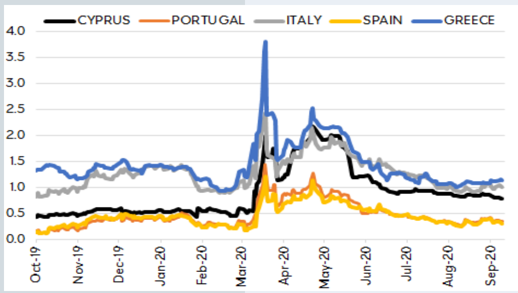
Broadly in line with expectations, the economy registered its worst performance in Q2-2020 since 2012-2013, reflecting the impact of the containment measures against the Covid19 outbreak. According to the flash estimate, real GDP dived by -11.6% QoQ /-11.9% YoY in Q2-2020 down from -1.3% QoQ/+0.8% YoY in Q1-2020 vs. +1.0% QoQ/+3.2% YoY in Q4-2019 and 0.0% QoQ/3.2% YoY in Q3-2019. From the demand side, total consumption declined by -4.8% QoQ/-2.0% YoY in Q2 down from +2.2% QoQ/+4.7% YoY in Q1, receiving however strong support from public consumption (+4.7% QoQ/+16.6% YoY). Investments crashed by -46.1% QoQ/-47.7% YoY in Q2 driven by lower construction activity and transport equipment activity most probably due to ships deregistration. If negative inventories performance is factored in, then the gross capital formation contribution reached -12.1ppts. Finally, net exports' contribution was positive (+1.8ppts in Q2-2020 vs. -4.0ppts in Q2-2019). That was the combined effect from both exports contracting by -17.9% QoQ/-17.1% YoY, and imports dropping by -25.6% QoQ/-19.5% YoY. Meanwhile, the latest high frequency indicators have been recovering since the economy re-opened. Retail sales in volume terms decreased by -2.6% YoY in June compared to -4.7% YoY in May up from -28.9% YoY in April and -0.3% YoY in March, bringing the year-to-June performance at -3.6% YoY. The monthly improvement (6.8% MoM in June vs 33.7% MoM in May) reflects the further easing of the containment measures against Covid-19 pandemic. Having plunged in May, at levels comparable to those seen in H1-2013, at the peak of the previous banking crisis and bail-in events, the economic sentiment indicator (ESI-CypERC) has been on a recovering trend ever since. The ESI-CypERC improved further by 1.9 points to 81.6 in August, up from 79.7 in July, 75.2 in June and 72.9 in May. The rise in the ESI-CypERC index was driven by confidence improvements among firms' assessments in all sectors surveyed, while consumer confidence weakened substantially. Unless there is a second wave of the pandemic, sentiment improvement is expected to accelerate further in the coming months. But even then, the economy is poised to undergo a painful recession in FY2020 given that it is small, open and services-oriented with tourism making an important direct and indirect contribution. Tourist arrivals declined by 88.2% YoY, down to 64,914 in July compared to 550,971 a year ago, bringing the year-to-July decline down to 85.3% YoY In H1-2020, tourism revenues came in at €122.0mn compared to €1.003.2mn in the corresponding period of 2019, down by 87.8%.

Figure 19: Real GDP contraction in Q2 was the worst since 2012-2013



Source: Eurostat, Eurobank Research

Figure 20: Long-term Cypriot government bond yields declined on ECB intervention



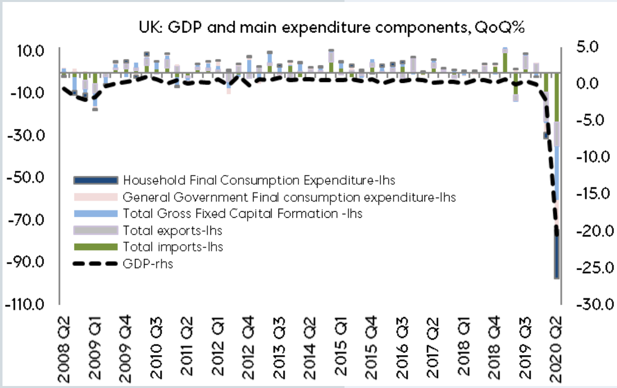
Source: Bloomberg, Eurobank Research

UK

In the deepest recession among major advanced economies

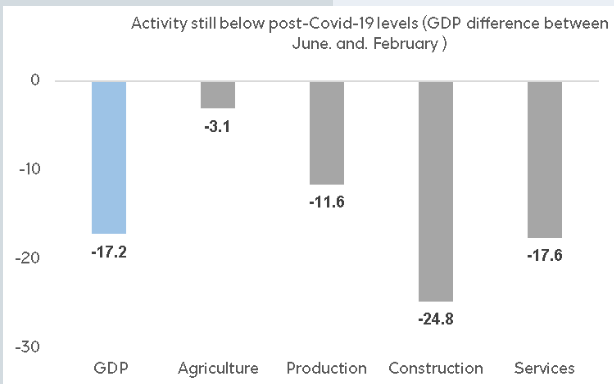
Following a 2.2%QoQ decline in Q1, UK GDP contracted by a record 20.4%QoQ in Q2, the deepest drop of any major advanced economy over the same period. That is probably because: (i) the UK was one of the last major economies to go into lockdown, but also the last to exit; (ii) the UK relies relatively more heavily on the services sector, which has been hit particularly hard by the pandemic (c. 80% of its total output); and (iii) besides the Covid-19 outbreak, Brexit uncertainty is another asymmetric risk the UK faces, adding to supply-side pressures as businesses await more clarity on the future relationship with the EU (Figure 20). However, as the lockdown has been gradually easing since mid-May, economic activity is recovering promptly thereafter, with monthly GDP data suggesting that April marked the trough. GDP bounced in both May and June (+2.4%MoM and +8.7%MoM, respectively), erasing cumulatively a good part of the 27% drop between February and April, with the economy standing at the end of Q2 some 17% below February levels, i.e., prior to the Covid-19 outbreak (Figure 21). The latest hard data and sentiment indicators suggest that the economy will advance further in Q3 on eased lockdown measures and the subsequent improvement in business and consumer sentiment. However, a resurgence in Covid-19 cases over the summer months, the lingering Brexit uncertainty and the expected withdrawal of the Jobs Retention Scheme in October, pose risks for a subdued recovery that could likely prompt further monetary and fiscal policy support before the end of the year. For the full year, we now expect a GDP contraction of around 10.0%, downwards revised from -8.5%r previously, amid looming downside risks. With respect to Brexit, owing to a lack of progress in talks, another formal round of talks began on 7 September, with level playing field requirements and fishing access to UK waters, reportedly continuing to hamper negotiations. On the monetary policy front, the BoE adopted a wait-and-see approach at its latest monetary policy meeting in early August, emphasizing, however, its readiness to step up QE, if needed.

Figure 20: UK in the deepest recession of any major advanced economy



Source: ONS, Eurobank Research

Figure 21: GDP bounced in both May & June, but still some 17% below its pre-virus levels



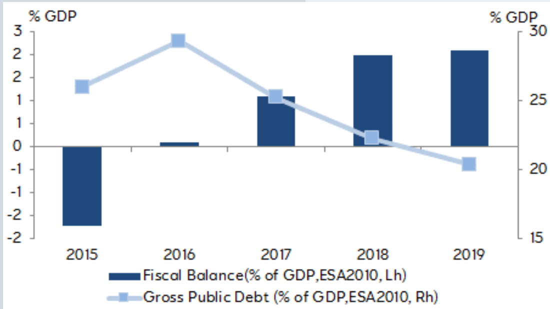
Source: ONS, Eurobank Research

Bulgaria

Despite the meagre Q2 GDP growth print, the economy is facing tailwinds from the ERM-II entry and the Next Generation funds.

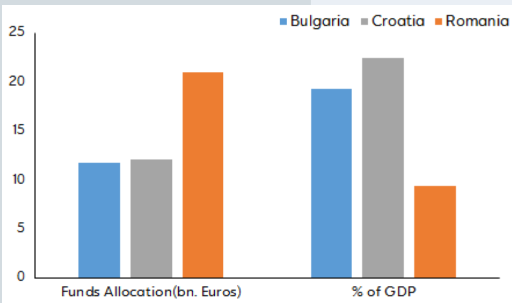
In mid-July, after two years of smooth progress on the requirements of the roadmap agreed between the country, the EU and ECB, Bulgaria was finally accepted in the ERM II, along with Croatia. The Bulgarian lev has been included in the EA preparatory corridor by the mutual agreement of the Finance Ministers of the Euro area, the President of the ECB and the Finance Ministers and Central Bank Governors of Denmark and Bulgaria. In the agreement, the central rate of the lev was set at 1 euro = 1.95583 leva. Moreover, it was accepted that Bulgaria is joining the ERM II with its existing currency board arrangement in place. The key advantage of the integration with the EA pertains to the acceleration of the real convergence of the economy, i.e. the income level and the standards of living, with the EA average level which currently stands at ca 50%. But for this to happen, the country has to work on improving the quality of institutions. According to EC and national top officials, the country could adopt the euro by 2024, if ongoing political instability is overcome, the Maastricht criteria will be fulfilled and institutions act in a decisive way. Equally favorable developments should be realized on the fiscal front as Bulgaria will receive EUR29bn of EU funds from the Next Generation Fund and the EU budget for 2021-2027. The country will receive, inter alia, EUR9bn for the funding of cohesion policies, which is by EUR0.8bn higher than the figure foreseen in the current programming period, and will also be granted EUR7.7bn as non-refundable aid from the Next Generation Fund. Concluding, the Q2 GDP second estimate at -8.5% YoY and -9.8%QoQ released in early September sets the H1 economic growth at -3.1% YoY. It came in a bit lower than market expectations which coincided with the flash estimate published earlier (-8.2% YoY and -9.8% QoQ), in mid-August. Taking into account the above, we revise our GDP growth forecast to -5% from -4.5% in 2020 and upgrade that of 2021 to +4.5% from +4% in 2021.

Figure 23: Bulgaria's fiscal position is sound



Source: Bloomberg, Eurobank Research

Figure 24: Allocated funds proposal from EU Recovery Fund for Bulgaria-Croatia-Romania



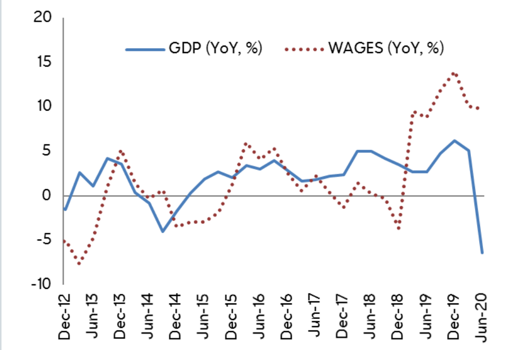
Source: European Commission, Eurobank Research

Serbia

Q2 GDP growth slides to more than 20-year lows due to Covid-19, still it outperforms that of regional peers.

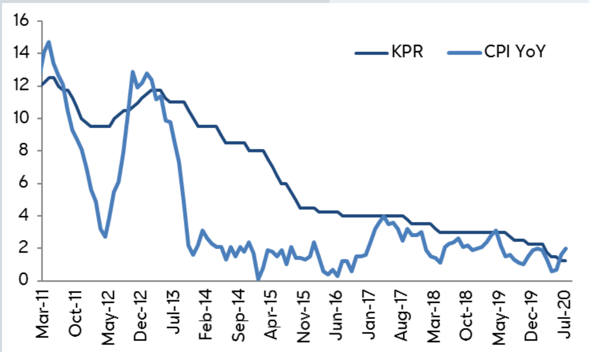
GDP shrunk by -6.4% YoY in Q2, the lowest print in more than 20 years, compared to +5.1% YoY in Q1. The Q2 print was revised slightly upwards from the flash estimate, released in early August, according to which GDP contracted by -6.5% YoY. On the expenditure side, the Q2 GDP contraction was broadly driven by household consumption (-5.5ppts) and gross fixed capital formation (-2.7ppts), both affected by the Covid-19 pandemic, while public consumption and net exports contributed positively (by 1.6ppts and 1.2ppts respectively). In gross value added terms, the steepest contraction was registered in the services sector (-3.5ppts) as it was heavily affected by the containment measures introduced during the state of emergency. Deceleration in the production of industrial goods (-1.6ppts) weighted as well. Despite the sharpest economic contraction in more than 20 years, in terms of H1 GDP performance, Serbia appears to be outperforming its regional peers. This can be attributed to the composition of its industry that produces goods rather inelastic in terms of demand (i.e. food and hygiene products among others) and the good agricultural crop that contributed ca 7% in the total output. Taking the above into account, and despite the prevailing uncertainty over the economic performance in H2, as pressure from Covid-19 next wave is expected to be felt more in the last quarter of the year, we upgrade our forecast to -2% in 2020 from -2.5% previously and keep unchanged our view on 2021 at +4.5%. On a more conservative tone, the IMF, on the completion of the fourth review in late August, projected GDP to contract by -3.5% in 2020 and rebound dynamically to 6.0% in 2021. Regarding the assessment of the PCI implementation so far, the Fund noted that although the immediate national policy priorities have shifted towards the support of the economy during the Covid-19 crisis, the objectives of the PCI, which expires in January 2021, remain ambitious and appropriate. Risks to the outlook are substantial, given the uncertainty about the evolution of the epidemic. Finally, the fiscal deficit target was set at -2% of GDP in 2021, leaving limited room for increases in public sector wages and pensions, but also substantial space for higher public investment.

Figure 25: Meagre Q2 GDP growth print but labor market remains firm



Source: Bloomberg, Eurobank Research

Figure 26: Monetary easing in efforts to contain the recession



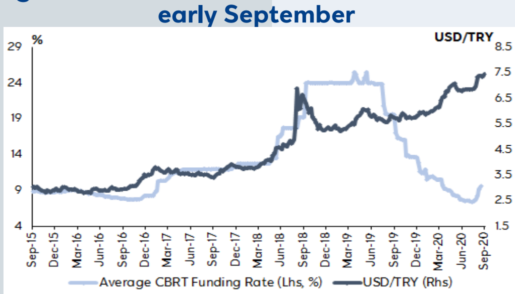
Source: Bloomberg, Eurobank Research

Turkey

Central Bank remained on hold in late August, lira recorded new historic lows

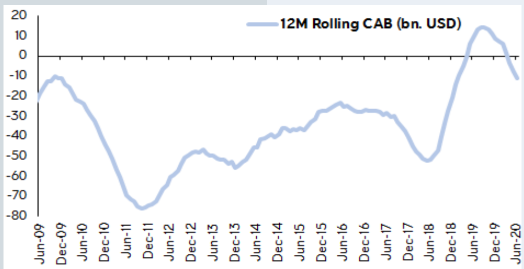
The Central Bank of Turkey (CBRT) left its key policy rate (KPR) unchanged at 8.25% again in late August. Recall that the CBRT had already taken measures to increase the effective funding rate towards 9.75% in the last two weeks in an attempt to support the lira, thus reducing the need to use the formal rate. The decision was in line with the relevant surveys' consensus of Reuters and Bloomberg. We have long argued that so far the policy mix has been overly focused on providing additional support to growth. The CBRT had slashed the KPR by 1575bps in nine consecutive sessions in the current easing cycle. On the other hand, the aggressive monetary policy stance has pushed real interest rates into deep negative territory, stoking concerns for the lira and for a resurgence in inflation at a later stage. The relatively low, by any metric, FX reserves capacity of CBRT despite new or existing swap agreements with other Central Banks constrains authorities' room for maneuver further. Having been on a steady depreciation trend, the lira has continued sliding in the last two months touching new historic lows (at 7.49/$ on September 9, -25.9% Ytd). Having posted multi-year lows in April, all sentiment indicators rebounded further in June-July, some of them nearing their pre-crisis levels, reflecting the easing of lockdown measures and signaling the bottoming out of economic activity contraction. Having dived to an 11-year low at 66.8pts in April, the manufacturing confidence index increased to a six-month high of 106.2 in August, boosted by an improvement in expectations over the next three months regarding export orders (113.5 vs 81.2 in July) and employment (107.3 vs 106.2). Similarly, the PMI index climbed to 56.9 in July 2020 from 53.9 in the previous month, pointing to the second consecutive expansion in factory activity and the sharpest since February 2011. The sentiment in the services and retail trade sectors also improved on a monthly basis, but nevertheless remained below its pre-crisis levels. Services and retail trade confidence rose by 3.8pts to 70.5pts and by 0.3pts to 94.9pts respectively. The improvement was driven on the back of backward-looking indicators. Services and retailers appeared more pessimistic in August regarding the prospects of employment and business activity over the next three months. Moreover, the consumer confidence index remained on a downward trend for a second consecutive month. On a seasonally adjusted basis, the consumer confidence index declined by 1.3pts on a monthly basis to 59.6pts in August vs 60.9 in July, recording the worst performance since May, albeit improved compared to the 54.9pts in April, which was the lowest level ever recorded in the data series since 2004.

Figure 27: Lira recorded new historic lows in early September



Source: Bloomberg, Eurobank Research

Figure 28: Macroeconomic imbalances have been unwinding rapidly in 2018-20



Source: National Authorities, 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)		
	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f
World	3.1	-3.2	5.0	3.5	2.5	2.8									
Advanced Economies															
USA	2.2	-5.5	4.0	1.8	1.0	1.8	3.7	9.0	7.5	-2.2	-2.2	-2.4	-4.7	-17.0	-10.0
Eurozone	1.3	-8.5	5.5	1.2	0.4	1.1	7.6	8.5	9.5	2.7	2.5	2.0	-0.6	-10.0	-5.0
Germany	0.6	-6.5	5.0	1.4	0.6	1.3	3.2	4.5	4.0	7.6	6.1	7.0	1.4	-8.5	-3.5
France	1.3	-10.0	6.5	1.3	0.5	1.0	9.2	9.5	10.2	-0.8	-0.9	-1.2	-2.0	-11.4	-6.0
Periphery															
Cyprus	3.2	-7.5	5.0	0.5	-0.5	0.5	7.1	10.0	9.0	-7.1	-10.0	-9.0	2.8	-4.0	-2.0
Italy	0.3	-10.0	5.5	0.6	-0.1	0.6	9.9	10.5	11.5	2.7	3.0	3.0	-1.6	-11.5	-5.5
Spain	2.0	-11.0	6.6	0.8	-0.2	0.6	14.1	16.8	17.2	2.0	3.2	2.8	-2.8	-11.2	-6.8
Portugal	2.2	-8.8	5.0	0.3	0.0	0.8	6.5	9.5	8.5	0.0	-0.6	-0.4	0.2	-7.8	-3.6
UK	1.4	-10.0	6.0	1.8	0.8	1.5	3.8	5.8	6.7	-4.3	-3.6	-4.0	-2.1	-13.0	-7.0
Japan	0.7	-5.0	2.0	0.6	-0.1	0.0	2.4	3.0	3.2	3.6	2.8	3.0	-3.9	-13.0	-7.5
Emerging Economies															
BRICs															
Brazil	1.1	-6.5	3.4	3.7	2.5	3.1	14.0	13.5	12.5	-2.7	-2.8	-1.5	-1.7	-13.5	-7.0
China	6.1	2.0	7.0	2.9	2.5	2.0	3.6	4.4	4.2	1.2	0.5	0.8	-4.9	-8.1	-5.6
India	6.1	-6.5	7.2	3.7	4.2	4.0		*NA*		-0.9	-0.5	-0.9	-0.2	-7.0	-5.0
Russia	1.3	-5.0	3.0	4.5	3.2	4.0	4.6	5.7	4.9	4.8	0.6	1.5	1.5	-5.0	-2.5
CESEE															
Bulgaria	3.4	-5.0	4.5	2.5	1.5	2.0	4.2	7.0	6.0	4.0	2.0	3.0	-1.0	-4.0	-2.5
Romania	4.1	-6.5	5.0	3.8	2.5	3.5	3.9	9.0	6.5	-4.6	-5.5	-4.0	-4.1	-7.5	-4.0
Serbia	4.8	-2.0	4.5	2.2	1.0	3.0	13.1	14.0	13.0	-5.8	-6.5	-5.0	0.2	-5.0	-0.5
Turkey	0.9	-5.5	4.5	15.2	10.5	10.0	13.8	17.0	15.5	1.1	-1.0	-0.5	-3.0	-7.0	-4.0

Source: EU Commission, IMF, OECD, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	September 2020	December 2020	March 2021	June 2021
USA					
Fed Funds Rate	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%
1 m Libor	0.16%	0.19%	0.20%	0.23%	0.24%
3m Libor	0.24%	0.29%	0.31%	0.35%	0.37%
2yr Notes	0.14%	0.18%	0.22%	0.30%	0.36%
10 yr Bonds	0.68%	0.66%	0.76%	0.89%	0.99%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.49%	-0.44%	-0.43%	-0.42%	-0.42%
2yr Bunds	-0.71%	-0.67%	-0.62%	-0.59%	-0.55%
10yr Bunds	-0.50%	-0.45%	-0.38%	-0.32%	-0.27%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.10%	0.10%
3m	0.07%	0.14%	0.11%	0.13%	0.16%
10-yr Gilt	0.19%	0.18%	0.24%	0.29%	0.35%
Switzerland					
3m Libor Target	-0.73%	-0.73%	-0.73%	-0.73%	-0.72%
10-yr Bond	-0.48%	-0.47%	-0.43%	-0.40%	-0.35%

Source: Bloomberg (market implied forecasts)

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