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Social distancing measures remain in place in most countries given the uncertainty that another wave of Covid-19 infections from new variants could emerge. Incoming economic data point to greater resilience in developed economies, while manufacturing production has continued to advance at a faster pace than services. With vaccination campaigns steadily progressing, we expect a global GDP growth acceleration to 5.5% in 2021 from -3.5% in 2020, with the recovery path largely dependent on the governments' exit strategies.

Macro Picture

USA: Substantial Covid-related aid to further support savings and spending

EA: Improving manufacturing sector and depressed services point to a two-speed economy

UK: Beyond Q1, the gradual lift of restrictions should underpin a strong recovery

EM: Limited room for further easing ahead of a new Covid-19 wave across LatAm, Asia & EMEA

CESEE: Third wave of Covid19 infections ante portas undermining growth recovery in H1 2021

Markets

FX: End of month USD strength due to US economic outperformance and rising yields

Rates: EU and US rates pressured higher, with curves steepening and real rates rising quickly

EM: Another month of negative total returns due to rising US rates and spike in volatility

Credit: Spreads were slightly tighter across ratings and sectors, expected to trade range-bound

Policy Outlook

USA: Fed's pledge for continued policy support; tapering announcement not expected before Q4

EA: Very accommodative policy stance by the ECB to maintain favorable financing conditions

UK: The BoE stands ready for further action if recovery disappoints

CESEE: Third wave of infections necessitates additional fiscal & monetary support in 2021

Key Downside Risks

Emergence of new Covid-19 variants pushes economies into extended or stricter containment measures: post-pandemic recovery may be delayed for 2022

Policy support withdrawn before sustained economic recovery is on track

China tightening financial conditions quicker than anticipated could result in weaker demand for EM exports and impede their recovery

Special Topics in this issue:

-Upside risks to inflation

-Preview of our Virtual Trip Notes to Serbia

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March 2021

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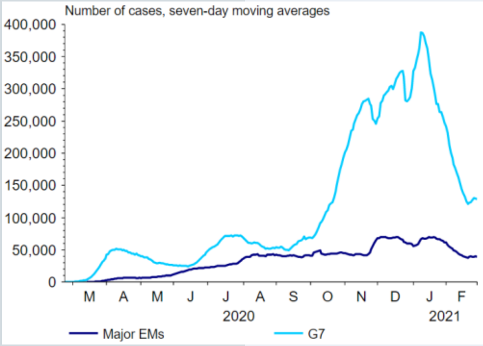
Latest Macroeconomic Developments & Outlook

World Economic Outlook

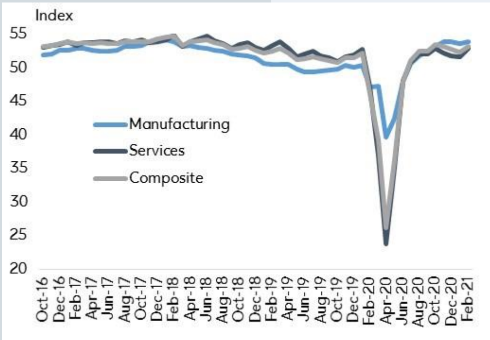
New global Covid-19 cases have decelerated since the beginning of the year (Figure 1), but social distancing measures to contain the pandemic are still in place in most countries around the world given surrounding uncertainty that another wave of infections from new variants could emerge. Recent incoming economic data point to greater resilience in developed economies, with the US leading the way at the start of year. According to the Atlanta Fed's GDPNowcast model, US Q1 real GDP growth is set to more than double to 10.0%QoQ saar from 4.1% in the final quarter of 2020. Latest national accounts updates across countries and regions point to strong fixed investment and exports prints, restocking pressures and high personal savings rates. Meanwhile, global manufacturing production, benefitting from a recovery in trade and exports, has continued to advance at a faster pace than services at the start of the year, as has been the case since the current upsurge started in mid-2020. According to the J.P. Morgan Global Manufacturing PMI, the respective index rose to a three-year high of 53.9 in February from 53.6 in January, keeping the rate of expansion among the best registered over the past decade (Figure 2).

Figure 1: Covid-19 new daily cases



Source: Refinitiv Datastream, Fathom Consulting

Figure 2: JP Morgan Global PMI



Source: Refinitiv Datastream, Eurobank Research

Nevertheless, the global manufacturing sector has remained beset by supply-chain disruptions, delivery delays and rising cost inflationary pressures. Meanwhile, inflation expectations have increased significantly amid vast monetary and fiscal support and an expected sharp global economic rebound, stoked by building pressures in US producer prices, higher input costs and elevated commodity prices. Although the latest soft and data have raised fears of inflationary pressures leading to a sell-off in the government bond space, Fed and ECB officials and economists have generally downplayed longer-term inflationary pressures highlighting the existing labor market slack in the economy. We share the view that the upturn in prices in the spring will prove temporary, and expect inflation prints to soften below the Fed's and ECB's targets towards year-end.

With vaccination campaigns steadily progressing, the US regulators approved the J&J vaccine for emergency use starting next week, while the European Medicines Agency is expected to approve the said vaccine for the EU in early March. Assuming herd immunity for most major developed economies by Q3 2021, we envisage stronger GDP growth prints for most countries in H2 2021. The recovery path will be largely dependent on the governments' exit strategies with restrictions expected to be lifted only gradually so as not to jeopardize a safe exit from the Covid-19 pandemic. Overall, we expect a GDP growth acceleration to 5.5% in 2021 from -3.5 in 2020, supported by expansionary fiscal and monetary policy.

Developed Economies

US: A sharp increase in personal income in January, coupled with a relatively smaller increase in spending, lifted the savings rate further to its highest level since May 2020. Most of the increase in incomes reflected payments introduced by the CRRSA Act in December 2020. Given that many activities remain constrained and households are at the moment unable to resume spending on certain services categories, substantial fiscal support has disproportionately affected savings compared to consumption. Although February data are likely to be softer relative to January due to adverse weather conditions and the fact that most of the rebate checks have already been distributed, we expect Biden's fiscal stimulus package to be passed in March to keep savings at elevated levels. Should our baseline scenario for broad vaccinations towards herd immunity around Q3 be realized, increasing mobility and improved confidence should lead households to boost their spending expenditures by reducing their excess savings. Taking into account upside surprises on Q1 economic data releases, we have lifted our 2021 GDP projection to 5.5% from 5.2%, previously.

Euro area: Leading indicators point to a two-speed economy as the manufacturing sector keeps improving while services remain depressed. The manufacturing PMI performed strongly in February, with broad-based strength across all countries except for the case of Greece. On the flipside, business activity fell for a fourth consecutive month as Covid-related restrictions continued to weigh on businesses. Services and retail output is likely to remain subdued well into March as another uptick in Covid-19 cases impedes any meaningful easing of restrictions in the following weeks. Overall, we expect economic activity to remain weak throughout most of H1 2021, before the reopening of the economy leads to a consumption-driven rebound from Q2 onwards. We share the view that inflation will remain well below target despite some volatility in the near term, given persistent slack in the economy and subdued wage pressures. With very accommodative monetary policy stance by the ECB and supportive fiscal policy throughout the year, we anticipate a GDP recovery of 4.2% in 2021 following a contraction of 6.7% in 2020.

EMU periphery: Among the European periphery economies, Spain was a laggard in 2020. Real GDP fell by 11.0YoY%, the deepest contraction since the civil war in 1936-1939 and among the steepest declines in the euro area for a number of idiosyncratic factors. These include a higher than the euro area average increase in the unemployment rate mainly due to the high proportion of temporary employees to the total employment and the economy's relatively higher dependency on tourism, which is one of the sectors most affected by the pandemic. Moving into Q1 2021, the level of restrictions is set to remain high across most of euro area member states, including periphery economies, amid fears over a renewed surge in Covid-19 infections due to the new more contagious variants, making a strong hit on Q1 GDP highly likely. We do not anticipate a significant rebound in economic recovery before immunization rates and improved weather conditions allow for a widespread lifting of restrictions, which will probably not take place before early H2. The post-pandemic recovery is expected to be strong, dependent on several factors including, the pace of funds absorption from the NextGenEU package (two largest Southern European economies, Spain and Italy, are among the main beneficiaries).

Emerging Economies

BRIC: Q4 GDP prints in Brazil and India pointed to less severe recession rates than those anticipated by the market consensus. In Brazil, GDP shrunk by 0.3%YoY in Q1, -10.9%YoY in Q2, -3.9%YoY in Q3 and -1.1%YoY in Q4 setting the FY2020 print at -4.% from -4.5% broadly expected. However, developments on the pandemic front are not equally favorable as the local government in Sao Paulo, the most populous state in Brazil, has reimposed restrictive measures amid the resurgence of cases. Along these lines, the vaccination roll out struggles to catch up with 3.2% of the country's population having received at least one dose of the vaccine as of early March. In Russia, with the Q4 GDP figure due in early April, the GDP has shrunk so far by -3.2% YoY in 9M2020 (+1.6%YoY in Q1, -8%YoY in Q2 and -3.4%YoY in Q3), which is a tad lower than the flash estimate for the full year released by Rosstat in early February. Assuming that the estimate is confirmed by the Q4 print, Russia will have experienced a recession of -3.1% in 2020, which may have been the sharpest decline since 2009 but is much better than that expected a quarter ago. Daily new cases have declined since late December but do not allow for the gradual easing of the existing restrictions. The vaccination roll our proceeds slowly with 2.9% of the country's population having received at least one dose of the vaccine. Having shrunk by -24.4% YoY in Q2, the economy of India managed to recover in the next quarters, posting a milder GDP drop of -7.8% in 2020, when the market's expectation earlier exceeded the -10.0% plunge. However, Covid-19 cases, after having significantly dropped for months, have seen a sharp uptick in February causing restrictions to remain in place amid the slowest inoculation rollout in the BRIC group (only 0.9% of the country's population has received at least one dose of the vaccine). Concluding, the outlier of the group from an economic perspective is China, which after a +2.3% growth in FY2020, is expected to post a GDP growth rate above 8% in 2021. For this to happen, the quick vaccination roll out in the country of 1.1bn citizens is pivotal. As of mid-February, only 3% of the population had been inoculated, when the respective figure for the US stood at 17%.

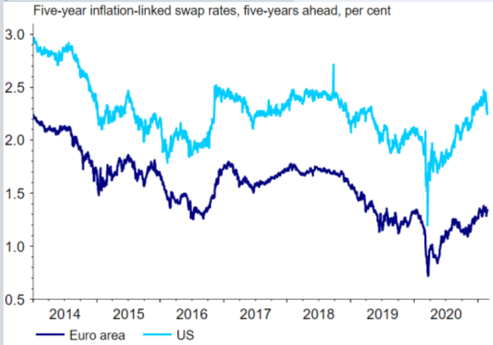
CESEE: As of late February – early March 2021, the improvement pace of the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE), which had started in the past two months stalled, making authorities more cautious in activating their reopening plans. Multiple countries across the region are experiencing a new wave of infections mostly related to the Covid19 virus mutations exacerbating fears of a third wave. The resurgence of infections has raised a lot of uncertainty over the economic outlook of the broader CESEE region. The severity and duration of the new Covid19 wave have increased the downside risks for the growth rebound prospects of 2021-22. Given the pronounced negative base effects on economic activity from the restrictive measures in place, GDP is expected to drop further on an annual basis in Q1, weighing on the FY2021 outcome.

Special Topics

I. Upside risks to inflation

Reflation expectations seem to be driving markets since the beginning of the year, as the exceptional monetary and fiscal policy support to mitigate the impact of the Covid-19 pandemic and a more robust - than - expected economic rebound in H2 2020 have raised investors' worries about rising inflation, with breakeven inflation rates ticking up considerably in recent weeks (Figure 3). Fears of inflationary pressures have resulted in an uptrend in government bond yields, with the 10-yr Treasuries jumping to a one-year high slightly above 1.60% on 25 February and the 2/10-yr yield spread – a broad indicator of economic expectations and outlook – widening the most since late 2016.

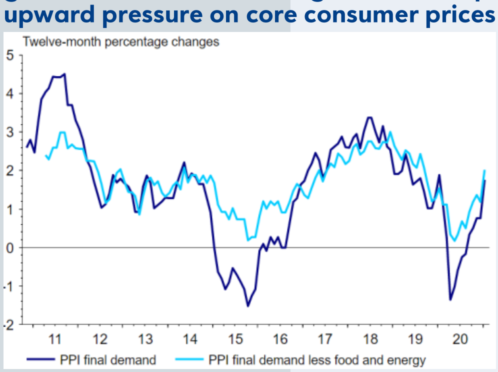
Figure 3: Breakeven inflation rates on the rise



Source: Refinitiv Datastream, Eurobank Research

Such concerns were stoked by stronger-than-expected US macroeconomic data, which pointed to building price pressures. More specifically, headline PPI accelerated by 1.3%MoM (1.7%YoY) in January from 0.3%MoM in December, the fastest pace of growth since 2009. Producer prices strengthened broadly with strong readings across energy, goods and services prices, but prices regarding goods and services exports outperformed. Excluding food, energy and trade services, core PPI also showed widespread strength increasing to a record high of 1.2%MoM (2.0%YoY) from 0.4%MoM in the prior month (Figure 4). It seems that stronger global demand along with idiosyncratic factors (China's abolition of tariffs in certain imported goods, rising consulting and portfolio management fees in US firms amid the recent stock market rally) led the export PPI sub-indices to accelerate faster than the domestic ones. Meanwhile, healthcare costs surged by 0.9%MoM – the second highest jump on record – pushing the annual rate to its highest level since 2007. Although January CPI data were generally softer than anticipated (headline CPI +0.3%MoM/+1.4%YoY and core CPI +0.0%MoM/1.4%YoY), the policy-induced rise in health care inflation (legislative changes and modifications in 2021 Medicare Physician Fee Schedule – MPFS) has important implications for the US inflation outlook in the near-term, given that healthcare costs account for about a fifth of the core personal consumption expenditure index (PCE), the Fed's preferred gauge of inflation.

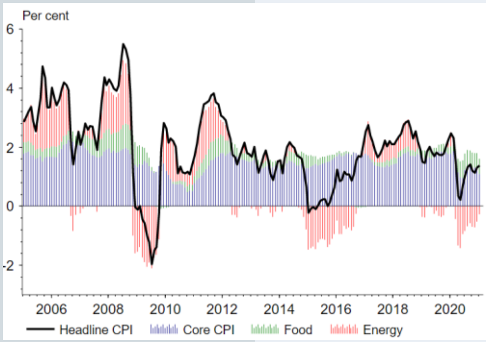
Figure 4: US PPI of finished goods should put upward pressure on core consumer prices



Source: Refinitiv Datastream, Eurobank Research

Furthermore, leading indicators such as the US ISM, PMI and Fed regional surveys point to rising prices-paid indices at decade highs, while the US NFIB small business association cited hiring difficulties that could result in increasing wage pressure. The Bloomberg Commodity Price index skyrocketed to record highs on 24 February, with many industrial metal prices at multi-year highs and Brent crude oil rising to fresh 13-month highs above $65/bbl in the last week of February – partly due to weather related disruptions in US crude production – shrugging off news that Saudi Arabia might abandon its unilateral 1mn barrel a day production cut from April. The strong upswing in key commodity prices has sparked the discussion around the return of the so-called commodity "super-cycle" amid fiscal reflation and an ultra-dovish monetary policy stance.

Figure 5: US Headline CPI & Contributions



Source: Refinitiv Datastream, Eurobank Research

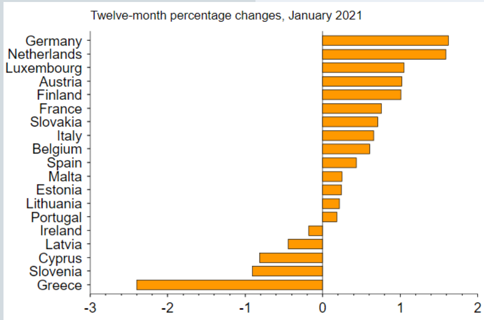
Although the $1.9trn US fiscal package does shift the balance of risks around inflation to the upside, we share the view that any discussion on inflationary pressures is rather premature for the time being. Although recent commodity prices' increases, imported inflation and the USD depreciation could exert upward pressure on input costs over the coming months, elevated inflation prints are not likely to be sustained. Our baseline scenario suggests that a positive output gap of about +2.5% by year-end would not be sufficient to alter our medium-term view on inflation, taking into account the expected disinflationary healthcare forces later in the year, partly due to the reintroduction of across-the-board cuts to Medicare reimbursement rates from Q2 onwards[1]. Although core PCE inflation may average around 2.0%YoY in Q2, we expect inflation to move back below 2.0% by the end of the year, after the most noticeable base effects in the spring and early summer have faded out. Indeed, travel and transportation prices plunged over the same period in 2020, with airline fares and hotel lodging rates experiencing vast declines. Beyond 2021, as the boost from healthcare recedes, core PCE inflation is expected to hover below the Fed's target in 2022, before more sustainably reaching or even overshooting the Fed's target in 2023 when the US will likely have fully recovered amid easy financial conditions and supportive fiscal policy. That said, the No Surprises Act and other legislation included in the Consolidated Appropriations Act 2021 (CAA), designed to provide protection against rising healthcare costs and lack of transparency, is expected to take effect on Jan. 1, 2022.

Referring to a potential near-term rise in inflation, Fed Chair Jerome Powell highlighted at the press conference that followed the January FOMC meeting that inflation would likely increase temporarily by "a few tenths" this spring due to base effects, with the Committee's focus remaining on the broader disinflationary

[1] The federal government's Medicare sequester suspension until March 31 - part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act initially set to expire on Dec. 31, 2020 - has halted a 2% reduction in Medicare reimbursements to give providers financial relief during the Covid-19 pandemic. Should no additional action be taken by US Congress, the 2% payment cut will go into effect on April 1.

pressures that have weighed on US inflation over the past twenty years. Although he mentioned the possibility that the full reopening of the economy could potentially create some upward pressure on prices, Powell stressed that this would likely be a transient phenomenon. Furthermore, at his semi-annual testimony before the House Financial Services Committee on February 24, Fed Chair Jerome Powell pushed back on inflation worries signaling that the Central Bank is in no hurry to start monetary policy normalization as it could take more than three years for the inflation goal to be reached and there is still “a long way” before the US economy returns to maximum employment. According to Powell, employment is currently nearly 10 million below its post-pandemic February 2020 level, a larger shortfall than the worst of the Great Recession's aftermath, with the true unemployment rate at 10.0% (according to the Bureau of Labor Statistics, many unemployed individuals have been misclassified as employed so the actual number of unemployed is wrong).

Figure 6: EA Headline HICP boosted by one-off factors in January



Source: Refinitiv Datastream, Eurobank Research

In the euro area, medium-term market-based inflation expectations have ticked up in early-2021 following a downturn in 2020, moving back to relatively modest pre-pandemic levels (Figure 3). In the meantime, inflation surged in January with headline and core HICP increasing to 0.9%YoY and 1.4%YoY from -0.3%YoY and 0.2%YoY, respectively in December 2020. A combination of rising energy prices and one-off technical factors has pushed euro area inflation back to pre-pandemic levels (Figure 6). The Brent crude oil price strengthened by almost 10.0%MoM in January, exerting upward pressure on energy prices across all major euro area economies that contributed about 30bps to the annual headline euro area inflation in January. On the core inflation front, prices were lifted by the reversal of the VAT tax cut in Germany (+3pp) as businesses passed around 50-60% of the increase through to consumer prices. Adding to the above, the new carbon tax (€25/CO2 ton) introduced in Germany also contributed to an increase in the price of fuels. Meanwhile, delays in winter sales in Italy, France and Germany (by 2-4 weeks) pushed non-energy industrial goods (NEIG) prices higher in January, as the said core prices have not experienced the typically negative seasonality of NEIG prices on the month. Last but not least, the revision of the weights of the HICP sub-indices for 2021 lowered the relative weights of certain poorly consumed categories, reducing the negative seasonality of volatile components such as air fares, package holidays and clothing. According to the flash estimate, headline inflation remained stable at 0.9%YoY in February, while core inflation edged down by 30bp to 1.1%YoY driven lower by both services and non-energy industrial goods.

Looking forward, assuming that the reopening of the euro area economy starts at the beginning of Q2 and accelerates further in Q3 amid widespread vaccinations that could lead to herd immunity towards Q4, euro area inflation could finish 2021 at elevated levels around or even above the 2.0% target supported by supportive base effects from late-2020 disinflation. Nevertheless, any building inflationary pressures should prove only temporary as favorable base effects progressively level off and pent-up consumer demand is exhausted. Meanwhile, labor market slack is expected to increase when governments' job support schemes start to unwind, while wage growth is anticipated to remain subdued over the next couple of years (the indicator of negotiated wages in the euro area weakened noticeably since the pandemic averaging 1.8% in 2020 vs. 2.2% a year earlier), given absent pressure by unions for wage increases (e.g. wage negotiations between the IG Metall workers' union and employers have stalled). That said, although the Governing Council (GC) did mention possible upside risks to inflation this year at the ECB's monetary policy meeting in January, it was highlighted that "such a temporary boost to inflation should not be mistaken for a sustained increase, which was still likely to emerge only slowly" and in any case that the "projected path of inflation continues to be distant from the GC's medium-term inflation aim."

II. Preview of our Virtual Trip Notes to Belgrade

In mid-February, we held virtual discussions with high-level officials from the Fiscal Council, the European Bank for Reconstruction and Development (EBRD), the World Bank (WB) and the International Finance Club (IFC). In the following lines we present a cohesive overview of the reasons behind the over-performance of the Serbian economy in 2020 and its current status.

Serbia entered the Covid-19 crisis with significantly milder imbalances than a decade ago. Since 2013, the economy has been continuously growing, with the exception of 2014 when extreme weather conditions led to a mild recession of -1.6%. In 2018 and 2019 the economy took off posting GDP growth rates above +4.0%, while the consensus for 2020 GDP, before the Covid-19 outbreak in Europe exactly one year ago, stood at 3.5% and was expected to remain at these levels until 2024. In Q1-2020, the economic activity expanded by 5.2% YoY but after the onset of the pandemic shrunk by -6.3% YoY in Q2, -1.4% YoY in Q3 and -1.1% YoY in Q4. The decomposition of the GDP from the expenditure side shows that had it not been for public consumption and gross fixed capital formation, which contributed positively by 0.93pp and 0.81pp respectively to the headline -0.98% figure, the recession would have been deeper as private consumption and net exports declined by -1.61% YoY and -1.03% YoY respectively. The government has set an ambitious target range for economic growth in 2021 between +5% and +6%. Our discussants recognized the economic rebound is close as the pandemic will start to fade away but forecast that this will lie somewhat lower than the official forecast, i.e. around +3.5% to +4.0%. In our view, there is idle potential in the economy, which we anticipate to translate into a GDP growth rate of ca.4.5% in 2021. That said, risks are tilted to the downside and broadly stem from the vaccination roll out in 2021 in the EU, the main trade partner of Serbia.

With respect to the fiscal landscape, following a firm fiscal consolidation effort in the period between 2015 and 2018, Serbia reduced its public debt to GDP ratio, from 70.0% in FY2015, to 52.0% in FY2019. During the course of the year and as the crisis evolved, the administration introduced a set of counter crisis measures worth ca. 12.7% of GDP in 2020. The fiscal supportive measures led to a budget shortfall of 8.0%, which is higher than that in most CEE countries but lower than that expected earlier in the year. The record high budget gap heightened the public debt to 56.8% of GDP at the end of 2020, which calls for a cautious approach in projecting medium term fiscal policies. The budget bill for 2021 projects a shortfall of 3.0%, which, with the moderate estimate of the output rise of 4.0% to 4.5%, leaves the public debt in the neighborhood of 57% to 58% of GDP. On the monetary front, inflationary pressures have declined in recent years creating a more stable and predictable macroeconomic environment. The average annual inflation declined visibly lower from 8.5% YoY in 2008-2013 to 2.0% YoY in 2014-2019 and further down to 1.6% YoY in 2020 converging to the levels of advanced economies. Apparently, the benign inflation trajectory has allowed the NBS to pursue an accommodative policy in 2018-2020, however, room and need for further NBS policy rate cuts appear to be limited. At the same time, real policy rate stands close to zero at the moment but is less negative than regional peers. Looking ahead, it appears that the trough of the monetary policy easing cycle has been reached. Provided that the epidemiological situation improves in H2, the need to provide additional monetary policy stimulus will subside.

Macro Themes & Implications in CESEE

Third wave of Covid19 ante portas: A resurgence in mutations related infections undermine growth recovery prospects for the CESEE region in the first months of 2021

Having been confronted with an exponential rise in new infections, hospitalizations and fatalities since October and November, authorities across the region reinstated stringent health and social distancing measures and restrictions on public and economic activities. The restrictions were initially imposed at the local level but were soon extended at the national level, while some countries even resorted to a national lock-down to avoid further aggravation. As of late February – early March 2021, the improvement pace of the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE), which had started in the past two months stalled, making authorities more cautious in activating their reopening plans. Multiple countries across the region are experiencing a new wave of infections mostly related to the Covid19 virus mutations exacerbating fears of a third wave.

The resurgence of infections has raised a lot of uncertainty over the economic outlook of the broader CESEE region. The severity and duration of the new Covid19 wave have increased the downside risks for the growth rebound prospects of 2021-22. Although the rollout of vaccinations had initially spurred more optimism for the growth prospects of the broader CESEE region in 2021, full return to normal conditions may take more time to materialize. The resurgence of infections will most probably put a break on the pace of recovery – not limited to the services sector – given that restrictive measures will remain in place in the first months of 2021. The latter has become more evident in the recent PMI and sentiment announcements.

In addition, the logistics of the production, distribution and execution of the vaccination program on such a massive scale may require additional investments and effort, leading potentially to further delays. So far, with a few notable exceptions, the vaccination progress across the region has failed to impress. Serbia ranks first in the vaccination race and Turkey second, having provided at least one dose to 14% and 8.7% of their population respectively. In both cases, access to vaccines from China and Russia makes the difference. Bulgaria and Albania are lagging far behind with the share of the population that has received at least one dose of the vaccine standing at 2.9% and 0.2% respectively.

On the macroeconomic data front, the revised Q4-2020 national accounts data announcements took center stage. The data releases surprised to the upside demonstrating that the economies have so far weathered the second wave of infections much better than initially expected. In fact, in some cases particularly in the CEE3 space (Hungary and Czech Republic), there were upward revisions to the flash estimate stemming from a higher estimate for exports, which underlines the resilience of their external sector. Turning to the economies of our focus:

Bulgaria: According to the flash estimate, GDP on a seasonally adjusted basis slowed to +2.1% QoQ in Q4 vs. +4.3% QoQ in Q3. Thus, GDP contraction was further contained to -3.8% YoY in Q4 down from -5.2% YoY in Q3, bringing the FY2020 performance at -3.8%. Ahead of the parliamentary elections scheduled for early April, the government has announced that it will open bars, restaurants and cafés on March 1st, despite the rise of infections.

Cyprus: Despite the country's high sensitivity as a small, open and services-oriented economy with tourism being one of its backbone industries, the economic impact has so far turned out less severe than initially anticipated. According to the revised estimate, GDP on a seasonally adjusted basis expanded by +1.4% QoQ in Q4 despite the reintroduction of restrictive measures. The latter translates into -4.5% YoY in Q4 bringing the FY2020 performance down to -5.1%.

Serbia: The economy registered the second lowest contraction rate behind Belarus in 2020, outperforming CESEE & EU peers. The GDP estimate of Q4 was revised to -1.1% YoY up from -1.3% YoY, so that the FY2020 came at -1%. The economy's low by regional standards exposure to sectors most hit by the pandemic (e.g. tourism) plus the hefty economic support package contained the output losses incurred in the past year.

Overall, the past year has proved to be one of the most challenging for the broader Central, Eastern and South-eastern Europe (CESEE) in the post-communism transition period. The regional economies have suffered a Covid19 pandemic-induced recession in 2020, deeper than the Great Recession of 2008-2009. On the positive side, all economies have on average outperformed the initial pessimistic official and international organizations forecasts.

This outperformance is rooted in two factors. Firstly, the pandemic outbreak found the broader CESEE region in the best shape in the post-Lehman period. Having recovered from the previous world recession of 2008-2009, most countries have had enough time and have put a lot of effort in rebuilding their fiscal and external buffers. As a result, even though the pandemic hit at a time when the regional economies had passed the peak of the cycle, it found them in a relatively strong position from a growth point of view. Secondly, the countries of the CESEE region coped very well during the first phase of the pandemic. The lock-downs that were rapidly imposed and efficiently enforced by the authorities, more so than in Western Europe, took their toll on economic activity but were successful in containing the pandemic and averting a public health system collapse. Thirdly, the policy response both on an individual country level and on the multilateral level has been unprecedented and to a high degree well-orchestrated and coordinated. Most of the economies who are EU member states were able to benefit directly or indirectly from the ECB-EU Commission decisive intervention.

CESEE Markets Developments & Outlook

Bulgaria

Eurobonds were quite active during February with yields rising across the board. As usual, the German Bund activity was the key driver for the sovereign paper activity with the most notable tenors standing on the long end of the curve as the 2030, 2035 and 2050 tenor yields rose by 12, 9 and 13 bps respectively. Local currency denominated government bonds on the other hand, remained largely unchanged with the exception of the 4 and 20 year tenors, which saw a 4-5 bps rise. Meanwhile, Fitch upgraded the outlook for Bulgaria from BBB neutral to BBB positive.

The government has been gradually easing the Covid-19 restrictive measures, beginning in mid-February with the opening of shopping centers and non-essential shops and the opening of restaurants at 50% of their capacity on March 1st. On the political front, the official parliamentary election campaign kicked off on March 3rd. So far all preliminary polls predict a tight race between the Bulgarian socialists' party and the ruling GERB party, with the latter leading by 1-2 points. Overall, the polls predict that 5 political parties will enter the new parliament, of which two would make their debut on the political scene. Despite the ongoing pandemic, the voting turnout is forecast to be unusually high at 60%, though this can change drastically in case of a 3rd Covid-19 wave.

Serbia

After years of prolongation and preparation, JP Morgan finally announced its decision to include three government bonds, those with 5, 7 and 12-year tenors, in the GBI-EM index. According to a recent research by JP Morgan, the respective inclusion will push the foreign ownership of domestic bonds to grow from 26.6% currently to around 30%, which translates into a EUR400mn increase in foreign bond holders. Government bond yields extended their recent decline in February, experiencing an almost parallel downside shift by 15-20bps along the entire curve. In the near term, yields are expected to remain at current levels as any push on demand for bonds coming from the GBI-EM inclusion resulting in suppressing of yields, could be offset by expectations over surging inflationary pressures. With respect to the FX market, the EUR/RSD cross is not anticipated to be affected by the inclusion of Serbian sovereign bonds in the GBI-EM index, as the National Bank of Serbia will most probably soak up all excess liquidity and preserve the FX rate at the current level of 117.55.

Markets View

Foreign Exchange

EUR/USD: The pair remains in a trading range around 1.2050 driven by the rise in US yields on one hand and the expected US stimulus package on the other. Focus is on the Eurozone and US economic data this month as bad news for the economy are starting to become good news for the market with the view that they will keep yields low. Historical and implied volatility remain at low levels and so far have not been affected by the significant increase in rates volatility. We expect 1.1950 support level to hold again before a move higher towards the 1.2350 January highs. A break of support could lead to a much deeper correction towards 1.1650. The catalyst for such a correction would be a risk off period in the financial markets.

GBP/USD: GBP was the outperformer for February in the FX space as vaccinations in the UK progressed very quickly and reversed the negative sentiment on the country post Brexit and its handling of the pandemic. The pair had a strong move higher during most of the past month, from 1.3560 low to 1.4237 high, before reversing towards 1.3900 due the spike in US yields and the general shaky sentiment in the markets. We see support at current levels but a break of 1850 would lead to a deeper correction back to 1.3650. Volatilities in this pair as well are stable as in the case of the EURUSD, and as such the main factor that drive it lower is a further rise in US yields that could potentially cause a risk off event.

Rates

EU: The level of the EU swap curve increased in February between 5 and 25 bps for a second consecutive month. The 10y swap rate is hovering around zero and the slope of the curve also increased with 30s-10s trading at 40 bps vs 34 a month ago. The bear steepening was driven by a catch up of nominal rates to already high inflation expectations as the market is starting to price significant growth pick up post removal of lockdowns. Looking forward we expect the bear steepening move to persist and the long end rates to continue towards 50bps.

US: The level of the US swap curve increased significantly in February with the 10y swap rate trading 153bps, 32bps higher than in the previous month. The steepening of the curve also continued with 30s-5s above 115bps vs 110bps in January. The move again followed the significant rise in inflation expectations from previous months on the back of a higher than expected stimulus package and significant upgrades of US growth predictions for the rest of the year. The 5y5y inflation swap forward, a key gauge of inflation expectations retraced to 230bps from 237bps last month. Overall the swift increase in nominal rates and the retracement lower of inflation expectations helped real rates to move significantly higher and raise some worries in the markets. The moves were swift and large in historical terms and also drove implied volatilities in the swaptions market significantly higher. Looking forward we expect the curve to bear flatten with a slow pace as QE tapering expectations move closer in line with the vaccination progress. Implied volatility should also retreat from its current very high levels.

Emerging Markets credit

Emerging markets credit spreads ended slightly tighter in February with the exception of LatAm where we saw widening towards the end of the month due to the sharp rise in US Treasury yields and rates volatility. In LatAm, Mexico 27s and Chile 29s were the best performers, while Peru 37s underperformed. In CEEMEA, the credit spreads of Russian and Saudi Arabian sovereign bonds declined, while Romanian bonds were weaker and underperformed. South Africa continued tightening as the uptrend in commodity prices continued and budget announcement by the government were perceived as positive by the market. Turkish bond spreads were little changed, while the Central Bank kept its policy rate unchanged at 17% in line with market expectations. In Asia spreads were also little changed with 10y EUR Chinese bonds performing pretty well as demand for Chinese assets, especially local currency ones is heating up. We remain cautious but positive in EM spreads as long as the pace of rise in US yields moderates and reflects investors' optimism regarding growth. Further rise in US yields and volatility should probably be short term negative for EM sovereign bonds, but we believe this should provide buying opportunity.

Corporate credit

EUR IG cash corporate spreads were mostly unchanged to a few basis points tighter in the month of February. CDS spreads were a few basis points tighter also, on admittedly tight valuations, while ECB support and absence of strong supply remain key drivers of tightening bias. Credit underperformed the move in equites, while the rise and steepening in rates curves put some pressure on longer duration. Spreads tightened until mid-month (especially in HY), but the rates related turbulence toward month end retraced most of the tightening move. US IG names absolute spread moves were in-line with EUR IG names, with broad based tightening of -3/-10bps on average, versus -2/-10bps in EUR IG. In EUR IG, Travel & Leisure and Retail, as well as Basic Materials were the tightening outperformers, with -14, -7 and -6 bps respectively, followed by Real Estate, Insurance and Financial Services, around -5/-6bps tighter. Other major sectors were -2/-4bps tighter.

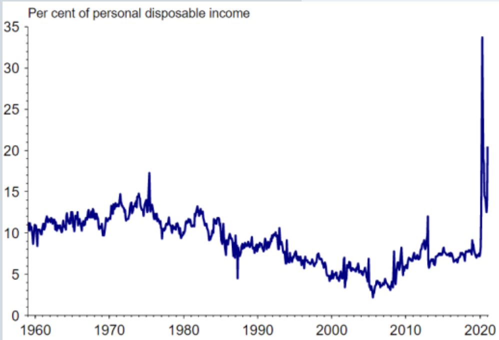
Credit Rating-wise BBB- EUR cash paper was -8bps tighter, making it the outperformer of the IG universe, with other grades slightly tighter (BBB -3bps, BBB+ -3bps, A- -2bps, A -3 bps, A+ -3 bps, AA- -2bps, AA -2bps, AA+ -3bps). In the EUR HY universe CCC- was -140bps tighter, CCC -52bps, CCC+ -53bps, B- -24bps, B -18bps, B+ -24bps,BB- -7, BB - 8, BB+ -13bps. Technical for cash remains strong, with considerably lower supply (pick up is expected in March), Central Bank support and liquidity, being the major tailwinds. Earnings reporting was overall positive and better than expected in many cases. We believe that spreads will trade mostly range-bound in the coming month, especially in EUR, where ECB will likely support lower rates for longer. Any widening should be idiosyncratic, while increased supply is expected to be well absorbed. Potential sources of spread widening, might come from inflation/rates stretch or a reaction to equities market correction in sympathy. Mid-term expected spread direction is moderately wider and steeper, given the eventual economy reopening, higher inflation expectations and rates, and normalization of monetary policies.

USA

Substantial Covid-related stimulus package to keep "excess savings" elevated, boding well for personal consumption

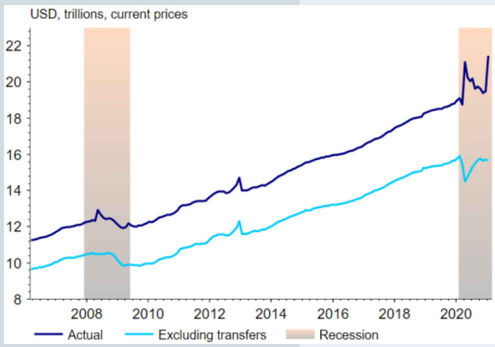
A sharp increase in personal income in January (+10.0%MoM from +0.6%MoM in December), coupled with a relatively smaller increase in spending (+2.4%MoM from -0.4%MoM in December) lifted the savings rate from 13.4% to 20.5%, the highest since May 2020 at 24.7% and compares to the April 2020 peak of 33.7% (Figure 7). Most of the increase in incomes reflected payments of $600 stimulus checks, as well as $300/week in supplemental unemployment insurance benefits introduced by the CRRSA Act in December 2020 (Figure 8), with total government transfers rising on the month by close to $2trn on an annualized rate (+53%MoM) compared to a modest rise in compensation of employees by $87bn (+0.7%MoM). Given that many activities remain constrained and households are at the moment unable to resume spending on certain services categories such as recreation, accommodation, and travel, substantial fiscal support has disproportionately affected savings compared to consumption. Although February data are likely to be softer relative to January due to adverse weather conditions and the fact that most of the rebate checks have already been distributed, we expect Biden's fiscal stimulus package to be passed in March to keep savings at elevated levels. Should our baseline scenario for broad vaccinations towards herd immunity around Q3 be realized, increasing mobility and improved confidence should lead households to boost their spending expenditures by reducing their excess savings. January durable goods orders (+3.4%MoM) also point to a continued uptrend in business investment into the new year, following a strong increase in January retail sales (+5.3%MoM) and auto sales (16.6mn units saar) that point to accelerating consumer demand for durable goods. Taking into account upside surprises on the above mentioned economic data releases, along with robust home sales and higher inventories, we have lifted our estimate for Q1 2021, taking our GDP projection for 2021 to 5.5% from 5.2%, previously. On the monetary front, minutes from the Jan 29th FOMC meeting reflected Chair Jerome Powell's admonition that any discussion about tapering of asset purchases (currently running $120bln/month) or exit strategies are rather "premature" as there is a long way to go before the US economy can achieve its dual mandate objectives.

Figure 7: US savings ratio



Source: Refinitiv Datastream, Fathom Consulting

Figure 8: US personal income (annualized rate)

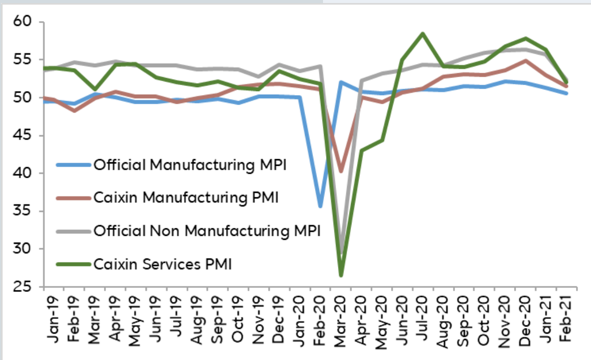


Source: Refinitiv Datastream, Fathom Consulting

China

Bottleneck in vaccinations cast a shadow over the fulfillment over the broadly expected above 8% GDP growth rate estimate

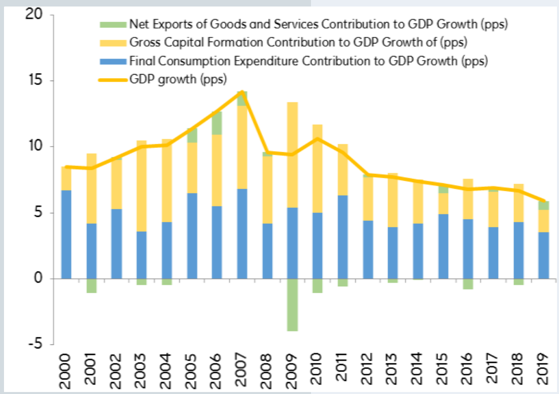
Figure 9: PMIs losing some steam amid Lunar Year Festivities



Source: Bloomberg, Eurobank Research

February, just like January, was a month with no hard data releases due to the Lunar Year festivities that took place around the middle of the month. All PMIs that were timely released came in lower compared to January and below the market consensus, which had already factored in some deceleration amid the festive period. The retreat is not worrying for the time being, as it is interpreted as seasonal abatement and is linked to the mild Covid-19 resurgence in mid-January. On the political front, Two Sessions, i.e. the Chinese People's Political Consultative Conference (CPPCC) and the 13th National People's Congress (NPC) for 2021 are beginning this week. No major surprises are anticipated and the NPC is expected to corroborate the 14th Five Year Plan for the period 2021-2021. The key goals of the plan, which are about to be stipulated in the NPC, pertain to: i. the convergence of the GDP per capita with the level of moderately developed countries, i.e. pursuing a higher quality economic development ii. self-reliance regarding technological development, iii. full release of the growth potential and strengthening of domestic demand and iv. gradual decarbonisation of the economy. For a second year in a row, China is not expected to set a specific GDP growth target for 2021 but inflation, job creation, the budget deficit and local government bond issuance ceiling for 2021 will be targeted. We stick to our forecast for economic growth above 8% for the full year but with risks tilted to the downside. The draconian measures that authorities imposed during Q1-2020 proved capable of putting the economy back on track for the rest of year and led to a 2.3% growth in FY2020. Returning to a pre-Covid-19 growth pattern at the range of +8.0%, which is currently the market consensus, requires the elimination of Covid-19 without social restrictions and at this point the quick vaccination roll out in a country of 1.1bn citizens is pivotal for such an endeavor. Bottlenecks in production and an unconventional strategy of jabbing first the 18-59 aged group of people has resulted in only the 3% of the population having been inoculated by mid-February, when the respective figure for the US stood at 17%.

Figure 10: Gradual substitution of investments by consumption in the GDP growth contribution



Source: National Bureau of Statistics, China, Eurobank Research

Euro area

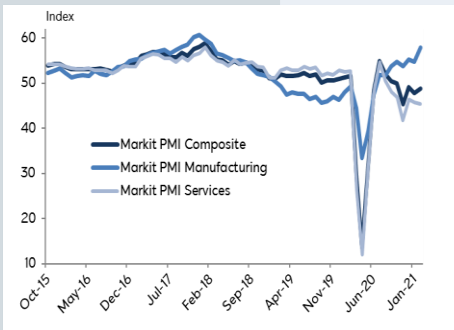
Improving manufacturing sector and depressed services point to a two-speed economy

Figure 11: EA Economic Sentiment vs GDP

Source: Refinitiv Datastream, Fathom Consulting

Leading indicators point to a two-speed economy as the manufacturing sector keeps improving while services remain depressed. According to the EC Economic Sentiment Indicator (ESI), industrial confidence surged to an almost two year high of -3.3 in February (from -6.1 in January) while services (to -17.1 from -17.7) and construction (to -7.5 from -7.7) moved sideways and retail trade continued to deteriorate (to -19.1 from -18.5). Meanwhile, consumer confidence remained stuck at remarkably low levels at the beginning of the year, improving marginally in February (to -14.8 from -15.5 in January) but remaining below December's four month high of -13.8. The manufacturing sector in the euro area economy performed strongly at the Markit PMI survey as well, with the respective index increasing to a three-year high of 57.9 in February from 54.8 in January and marking the eighth month in a row that the index is above the 50.0 threshold that separates expansion from contraction. Apart from Greece, where the respective index slipped back into negative territory, the upsurge in manufacturing was broad-based across all countries with Germany (37-month high of 60.7) and the Netherlands (29-month high of 59.6) leading the way. On the flipside, euro area business activity fell for a fourth consecutive month in February (by -0.7pts to 44.7 from 45.4 in January) as Covid-related restrictions continued to weigh on businesses (Figure 12). Services and retail output is likely to remain subdued well into March as another uptick in Covid-19 cases impedes any meaningful easing of restrictions in the following weeks. Overall, we expect economic activity to remain weak throughout most of H1 2021, before the reopening of the economy leads to a consumption-driven rebound from Q2 onwards. Households have continued to accumulate savings amid government job support schemes and activity restrictions, and these excess savings are expected to boost personal expenditures as soon as the restrictive measures are gradually lifted. We share the view that inflation will remain well below target despite some volatility in the near term, given persistent slack in the economy and subdued wage pressures. With very accommodative monetary policy stance by the ECB and supportive fiscal policy throughout the year, we anticipate a GDP recovery of 4.2% in 2021 following a contraction of 6.7% in 2020.

Figure 12: EA PMI suggest a two-speed economy



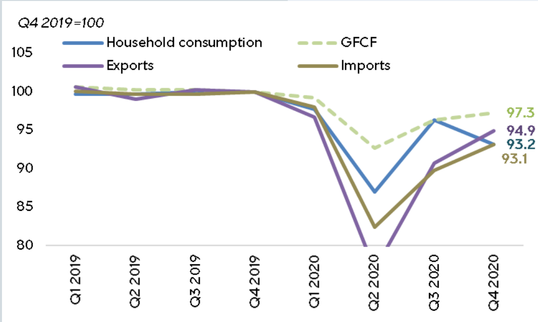
Source: ECB, Refinitiv Datastream, Eurobank Research

Germany

Q1 GDP likely to contract despite strong global manufacturing demand

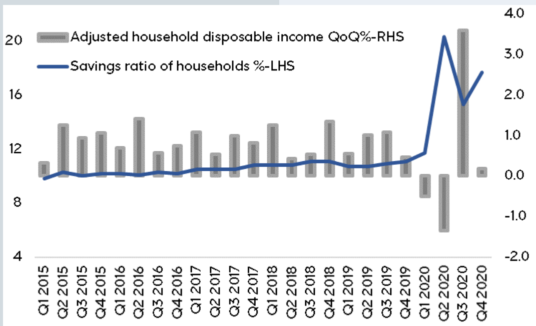
German Q4 GDP was revised upwards to 0.3%QoQ in the final release (+0.2ppt) as weakness in private consumption was more than offset by strong investment and net exports. In contrast to expectations for a positive performance ahead of the scheduled expiration of the temporary VAT cut on 31 December, household consumption dropped by 3.3%QoQ, finishing the year at 93.1% of the pre-pandemic Q4 2019 level (Figure 13). Government consumption dropped by 0.5%QoQ, remaining though however up 2.7%YoY. On the other hand, gross fixed capital formation rose by 1.0%QoQ, contributing 0.2pp to the Q4 GDP growth and recovering 97.3% of its pre-crisis levels, reflecting strong dynamics in the manufacturing sector thanks to robust global demand. Against this background, exports rose by 4.5%QoQ, outpacing imports' growth of 3.7%QoQ, with net exports adding 0.6pp to the Q4 GDP growth. For the full year 2020, the German economy contracted by -4.9% (NSA). However, despite strong export demand and manufacturing growth — as has been also suggested by recent sentiment indicators — domestic activity is set to deteriorate again in Q1 2021 and experience a renewed contraction. Most of the current Covid-19 restrictions, which started on 16 December and were initially intended to be lifted after 10 January, were extended further and are currently scheduled to remain in place until 7 March, that is through most of Q1. Admittedly, the epidemiological picture in Germany has improved materially in recent weeks. New cases per week have dropped close to 65 per 100k people in late February from around 175 in January — but still above the government's new target of 35 — while the weekly number of new hospitalizations has declined significantly. However, the government had to adopt a more cautious stance due to the increasing risk of the new more infectious variants, as their share to the new cases has increased to more than 20% in February. Semiconductor supply shortages that may disrupt car production and the expected weather-related slowdown in construction, could also weigh on domestic activity in Q1. However, an anticipated bounce in construction on the back of improved weather conditions and large-scale vaccinations from Q2 onwards that would allow for the gradual withdrawal of the containment measures and pent-up demand (Figure 14), could pave the way for a strong rebound in the remainder of the year, especially in H2, taking GDP growth at 3.5% for the year as a whole.

Figure 13: GFCF has recoverd more than 97% of pre-pandemic levels



Source: Federal Statistical Office (Destatis), Eurobank Research

Figure 14: Relaxation of the lockdown could release pent-up demand, backed by accumualted savings



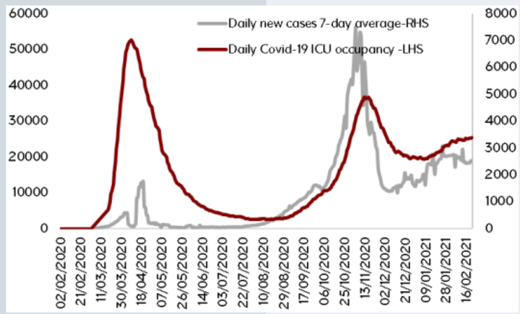
Source: Federal Statistical Office (Destatis), Eurobank Research

France

Tighter restrictions possible in light of growing pressure on the health system

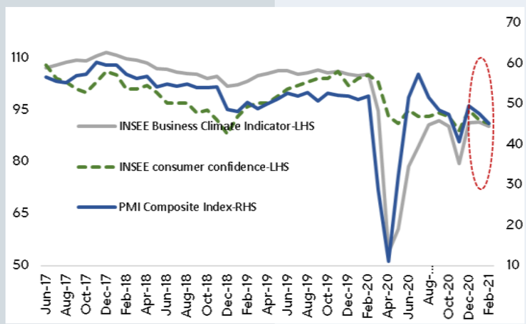
France's Q4 2020 GDP surprised to the upside, translating into a positive carry-over of 3.6% into 2021, after the 8.3% decline for the whole year 2020. However, short-term growth prospects may be negatively affected due to an increasing share of the new, more contagious strains in new infections that has led to a steadily increase in hospitalizations and the number of ICU beds used by Covid-19 patients (Figure 15). So far, France has avoided a third lockdown as the government seems to be prioritizing the economy for as long as there seems to be some capacity left in the health system. The government, instead, decided in late January to tighten restrictions further, through extended curfews, tougher border control, increased policy action against curfew breakers, the closure of large non-food shopping centers and greater adherence to working from home. However, as suggested by the Health Minister, Olivier Veran, these measures have not been adequately effective in containing the spread of the pandemic and called the implementation of the "crisis organization" protocols in order for hospitals to increase the number of ICU beds available. Against this background, and taking also into account the delays in the vaccination program, the level of restrictions is expected to remain high, possibly until the end of March. Furthermore, press reports suggested that the government may even consider tougher measures after the requested activation of the aforementioned protocols (either a tighter curfew, or a partial and time-specific lockdown), if the option of a third nationwide lockdown remains unpalatable for political and/or economic reasons (the associated economic cost of the current activity restrictions is estimated at around €4bn/month, less than half compared to €9-10bn of the second lockdown in November). All this support our expectations for a renewed contraction in Q1 2021, albeit modest, as has been also suggested by recent activity indicators, such as business and consumer surveys (Figure 16). In Q2, GDP growth is expected to turn slightly positive as some relaxation of restrictions may take place once the most vulnerable people have been immunized. It will likely take until Q3 before herd immunity has been achieved as most population should be vaccinated by then, leading to a lifting of restrictions and a boost in confidence (President Emmanuel Macron has been committed to offer a jab by the end of the summer to all French people who are willing to be vaccinated). The national recovery plan will also support the post-pandemic economic rebound, with GDP for the whole year expected to expand by 5.6%, lower compared to the French government's growth forecast of 6.0%.

Figure 15: Steadily increase in ICU utilization



Source: OWID, Eurobank Research

Figure 16: Sentiment indicators point to a modest contraction in Q1 2021



Source: INSEE, Eurobank Research

Italy

Focus centres on the approval process of the Recovery Plan, with EU funds expected to start flowing by June

Following a significant decline in Covid-19 cases and easing pressure on the national healthcare system, restrictive measures loosened in late January. The ongoing lifting of restrictions, along with the gradual increase in vaccinations, has boosted business and household confidence (Figure 17). The EC Economic Sentiment Indicator (ESI) advanced to a one-year high of -94.6 in February, with broad-based strength across sectors (Figure 18). Meanwhile, the February manufacturing PMI accelerated sharply on its strong January performance, rising to a 37-month high of 56.9 from 55.1 in the prior month. Nevertheless, Covid-19 infections remain at relatively high levels, with the daily rate surpassing the 17,000-infection benchmark in the last four days of February, a level previously not seen since mid-January. That said, Draghi's government is expected to extend or even tighten current restrictions until 6 April, the day after Easter Monday. The current system of tiered restrictions based on the contagion risk level of each region is set to remain in place, coupled with a ban on traveling between regions (apart from work or health reasons and emergency situations). Following weak economic momentum in Q1, the expected loosening of containment measures later in spring, when the vulnerable population will have been vaccinated, will set the scene for an economic recovery. Assuming herd immunity at the start of Q4, the economic recovery should accelerate in H2 2021, boosted by rising inflows of EU funds that will likely provide a cushion for private investment and consumption, leaving our 2021 GDP growth projection to 5.0% from -8.7% in 2020. Meanwhile, the newly appointed Draghi government reduces political uncertainty and increases the chances that Italy will submit by 30 April a fully detailed plan that is compliant with the EC requirements, in order to receive the amount of €196bn (c. 11% of GDP) from NGEU's main pillar, the Recovery and Resilience Facility (RRF). The new administration should ensure that the funds are absorbed in a timely and efficient manner, in line with the Country Specific Recommendations (CSR) included in the European Semester, while focusing on the implementation of Italy's long-awaited structural reforms (Public administration, fiscal, Justice, Health etc.).

Figure 17: Italy consumer and business confidence on the rise

Source: Refinitiv Datastream, Fathom Consulting

Figure 18: EC Economic Sentiment Indicator

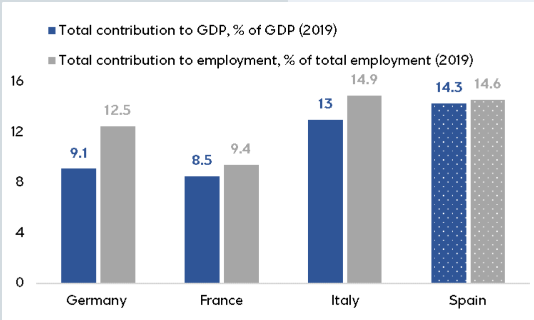
Source: EC, Eurobank Research

Spain

Level of restrictions set to remain high, making a hit on Q1 GDP highly likely

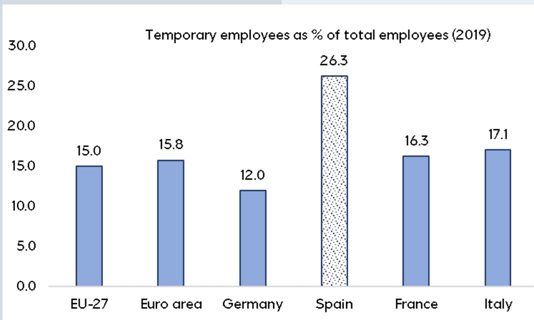
Spain has addressed the third wave of Covid-19 infections that broke out in the country in January, with more localised and milder than in most other EA countries Covid-19 restrictions, particularly as regards capacity constraints and opening hours for hospitality venues. Daily confirmed new cases (7-day average) have dropped under 7,500 as of late February for the first time since December, following a peak of c. 30,000 in mid-January that had triggered tighter containment measures in most Spanish regions, with earlier curfews and shorter business hours in non-essential services and hospitality sectors. However, the increasing risk of the new more infectious variants, whose share to the new cases has jumped to more than 35% as of late February, makes the health authorities cautious. Aiming to prevent a renewed surge in Covid-19 infections, the level of restrictions is set to remain high, in spite of the notable decline in new cases, making a strong hit on Q1 GDP highly likely. Such a scenario is in line with the latest sentiment indicators of economic activity, including February's EC surveys, which revealed a deterioration for the second consecutive month in retail (-29.7, -4.7pts), services (-29.7, -1.9pts), and consumer confidence (-25.2 -15pts), while manufacturing and construction declined (-9.6 and -15.2, respectively) following a short-lived improvement in January. Assuming that more vaccines become available in the coming weeks and restrictions are progressively lifted, we expect a moderate improvement in economic activity in Q2, but a meaningful acceleration only in H2, when a large share of population will have been vaccinated. Tourism and pent-up demand should also support the recovery from summer onwards, taking annual GDP at 5.8% for the whole year. Admittedly, the vaccination program continues to move forward. As of 28 February, 3.61mn jabs have been administered (5.0% of the population), above that of Spain's EA peers, with 1.2mn people (2.7% of the population) having received both shots. However, given the economy's high reliance on tourism (Figure 19), one of the sectors most gravely hit by the pandemic, political fragmentation amid regional tensions and material differences over policy issues between the two ruling parties and the elevated unemployment rate as the high incidence of temporary labour contracts renders redundancies easier (Figure 20), the pandemic will likely leave Spain with more permanent scars, delaying its return to pre-Covid levels.

Figure 19 Spain relies heavily on tourism, a sector that has been gravely hit by the pandemic



Source: Eurostat, Eurobank Research

Figure 20: Spain has the highest proportion of temporary employees compared with its EA peers



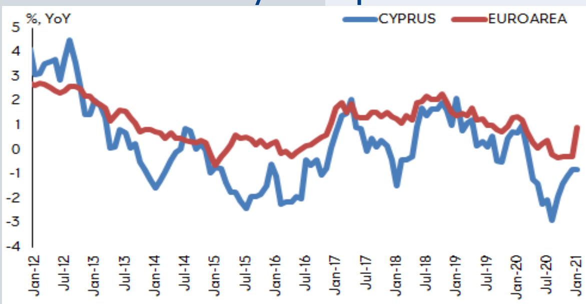
Source: World Travel and Tourism Council, Eurobank Research

Cyprus

Fourth quarter's output performance surprised to the upside

GDP on a seasonally adjusted basis expanded further by +1.4% QoQ in Q4 on top of +8.9% QoQ in Q3 despite the reintroduction of restrictive measures. The latter translates into -4.5% YoY in Q4 compared to -4.7% YoY in Q3, -12.6% YoY in Q2, +1.4% YoY in Q1 and +3.3% YoY in Q4-2019, bringing GDP contraction at -5.1% YoY in 2020. Thus, the Covid19 pandemic ended a period of high growth averaging 4.4% in 2015-2019. Despite its sensitivity as a small, open and services-oriented economy with tourism making an important direct and indirect contribution (13.8% of GDP and 13.2% of total employment according to WTTC), Cyprus outperformed initial market and international organizations' forecasts and Euroarea peers in FY2020. The over performance can be broadly attributed to two factors. First, the quick, sizeable and still ongoing financial support from the government and second the extensive use of bank loans moratoria. However, given the sharp deterioration in the epidemiological situation as of late Q3-early Q4, the downside risks to the outlook of 2021 have increased. Local authorities reintroduced social distancing measures, initially at a local level and subsequently at a national level, which were supposed to be lifted after January but as of early March authorities have been reluctant to proceed with any gradual relaxation.

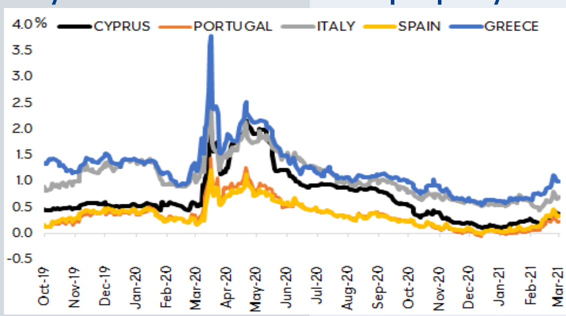
Figure 21: HICP inflation has been in negative territory since April



Source: Eurostat, Eurobank Research

Despite their rise, the number of infections and the death toll remain relatively low so far, compared to other EU countries. According to the latest EC winter economic forecasts (February 2021), the economy is headed to rebound by +3.2% in 2021 (vs. 3.7% in autumn 2020) and +3.1% in 2022 (vs. 3.0% in autumn 2020), below the Euro area average. After a catastrophic year (-84.1% in arrivals, -85.4% in revenues), tourism is expected to post only a partial recovery this year. UK, Russia and Israel, which accounted for 60% of total arrivals in 2019, are speeding up vaccination to reach herd immunity, lifting hopes for a decent performance in 2021 in these tourism markets. Finally, Cyprus was also among the first to tap international markets in early February 2021, raising an amount of €1.5bn with a new 5Y Eurobond at very low yields (0.05%) to address the increased gross borrowing needs of 2021, before the yields' spike worldwide. In addition, Cyprus has already received the first installment of €250mn in loans from the SURE instrument out of a total amount of €479mn earmarked to address increased unemployment risks; this places the country among those few that will receive the maximum allowed support (2% of GDP).

Figure 22: Long-term Cypriot government bond yields on the rise in line with periphery



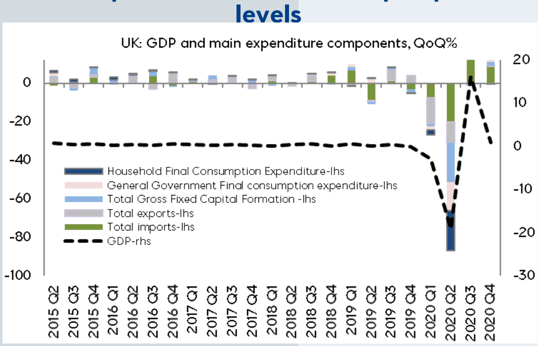
Source: Bloomberg, Eurobank Research

UK

The gradual lift of restrictions should bounce output from Q2 onwards

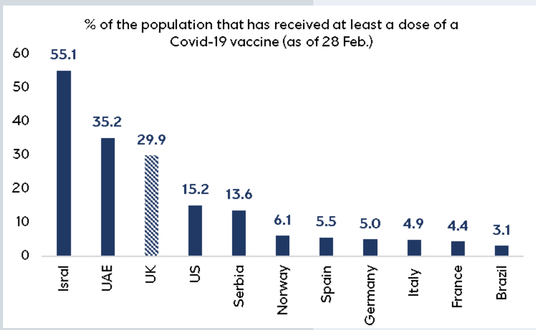
UK Q4 2020 GDP surprised to the upside, growing by 1.0%QoQ, twice the market consensus, despite the introduction of tiered restrictions in October, a national lockdown in November and tighter containment measures in the second half of December. Household consumption contracted modestly (-0.2%QoQ) and net trade was a drag on GDP growth amid stockpiling ahead of the country's exit from the EU on 31 December (exports: 0.1%QoQ, imports: 8.9%QoQ). However, their negative contribution to GDP growth was more than offset by strong government consumption (6.4%QoQ) and investment (2.1%QoQ). For the full year 2020, the UK economy contracted by a record pace of 9.9% and remained depressed at 7.8% below the Q4 2019 pre-pandemic level (Figure 23). However, moving into Q1 2021, we see risks for a strong hit on output, mostly due to the third stricter lockdown imposed from the beginning of January to curb the rapid spread of the more infectious strain of the virus, the continuing unwinding of stockpiling ahead of the Brexit deadline on 31 December and frictions following the UK's exit from the single market and customs union (non-tariff barriers and checks). Supporting the above, retail sales dropped by a hefty 8.2%MoM in January, the biggest monthly drop since last April, and PMI services averaged 44.6 in January-February 2021, lower compared to the October-December 2020 average of 49.6. Encouragingly, the news flows on the vaccine rollout has been impressive. The government confirmed in mid-February that its initial vaccination target has been fulfilled, having offered the 15mn most vulnerable citizens (c. 20% of the population), which include 90% of the over 70s, at least one dose of a Covid-19 vaccine. The vaccination programme continues as planned and as of February 28, more than 20mn citizens, or c. 30% of the UK population, have received at least one dose, well ahead of the US and the big European counties (Figure 24). Having reached the first vaccination milestone, PM Boris Johnson announced a roadmap for gradually lifting current restrictions. Easing will take place in four stages, with a five-week interval between each stage. The first one begins on 8 March when schools will reopen and the government's plan provides, subject to virus data, for all restrictions to be removed by late June. Assuming that all go as planned, we expect a strong bounce from Q2 onwards, with output rising by 4.5% for the full year.

Figure 23: UK GDP surprised to the upside in Q4, but still depressed at 7.8% below pre-pandemic levels



Source: ONS, Eurobank Research

Figure 24: The UK's vaccination rate among the highest globally

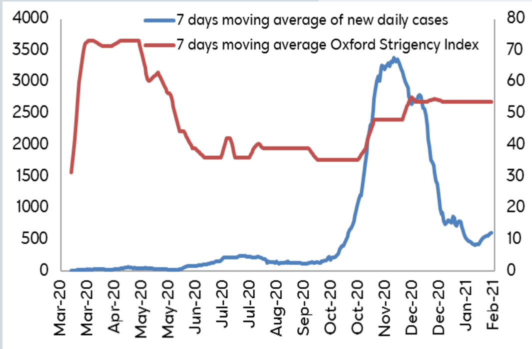


Source: OWID, Eurobank Research

Bulgaria

Heading for parliamentary elections in April, amid a modest economic recession of -3.8% in 2020 and a slow vaccination roll-out

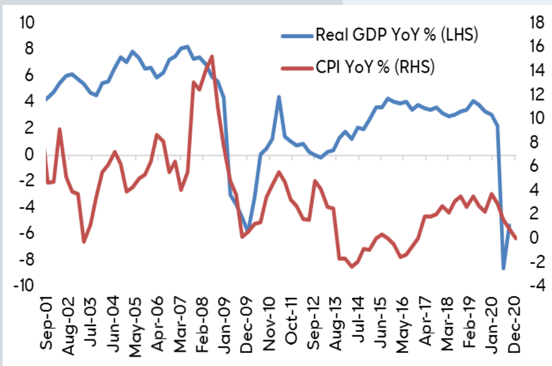
Figure 25: Additional restrictive measures tamed winter's second wave



Source: Our World in Data, Eurobank Research

The Q4 GDP flash estimate released in mid-February came in at -3.8% YoY, setting the FY2020 performance at the same level. In Q1-2020 GDP expanded by +2.4% but kept shrinking in the following quarters by -8.5% YoY and -5.3% YoY in Q2 and Q3 respectively. If the final Q4 detailed data due on March 9 verify the -3.8% YoY flash estimate, the FY2020 final print will be positively surprising against our forecast, which is currently revised to -4.0% from -4.5%. In our upward revision we take into account the apparently contained economic fallback in the last quarter of 2020, which along with the current one are considered the toughest quarters in terms of the severity of the pandemic so far. February was a month with a plethora of published forecasts by international financial institutions over the country's economic performance in 2021. The OECD forecasts pointed to a mild V-shaped recovery from a -4.1% recession in 2020, whereby Bulgaria will rebound by +3.3% in 2021 and +3.7% in 2022. On a more conservative tone, the IMF, in its Article IV consultation conclusions, estimates a -4.6% recession in 2020, with a projected rebound of +3.6% and +4.3% in 2021 and 2022 respectively. Finally, the EC, in its Winter Economic Forecast, anticipates real GDP to expand by +2.7% in 2021 and +4.9% in 2022 after contracting by -4.9% in 2020. In our view, the greatest challenge the country will face in the next two quarters is the timing of the tourism recovery, which is tied to the vaccination rollout. Based on data from the ECDC, as of March 2, Bulgaria holds the lowest position in the national vaccine uptake for the first dose ranking with 3%, after Latvia with 2.8%. Nevertheless, the respective figure, albeit low, has substantially improved in the last 10 days after the government decided to open "green corridors" allowing anyone to be inoculated, regardless of whether they were in a priority group under the country's vaccination plan. Driver for such an opening was the low acceptance and turnout at the vaccination centers by elder groups of people. Meanwhile, there is only a month left until the parliamentary election with polls predicting a tight race between the Bulgarian socialists party and the ruling GERB, with the latter leading by 1-2 points.

Figure 26: ...but came at a cost in terms of GDP growth



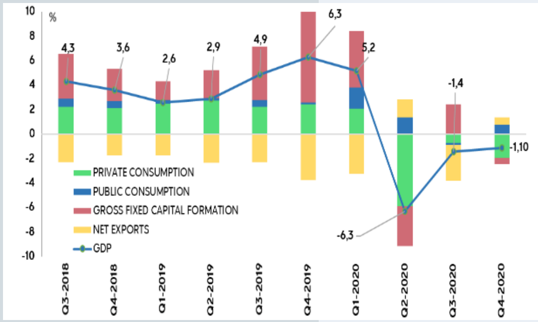
Source: Eurostat, Eurobank Research

Serbia

Public consumption and investments curbed the decline of the GDP in 2020

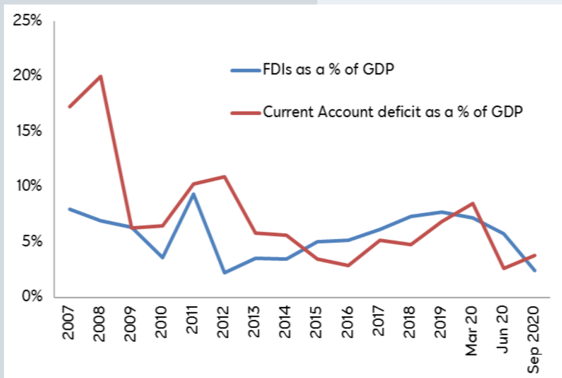
The Q4 GDP growth print released in early March set the economic recession in FY2020 at -0.98% and practically confirmed the flash estimate of late November. The economic activity shrunk by -1.1% YoY in Q4-2020, after -1.4% YoY in Q3, -6.2% YoY in Q2 and +5.2% YoY in Q1. The decomposition of the GDP from the expenditure side for the entire year shows that had it not been for the public consumption and the gross fixed capital formation, which contributed positively 0.93pp and 0.81pp respectively to the headline -0.98% figure, the recession would have been deeper as private consumption and net exports declined by -1.61% YoY and -1.03% YoY respectively. The decline of imports by -2.3% YoY prevented net exports contribution from decreasing further and dragging the GDP recession rate deeper. On the monetary front, January's inflation print surprised to the downside. The most recent data showed that inflation decelerated further to 1.1% YoY in January 2021 down from 2.0% YoY in January 2020 and 1.3% YoY in December 2019, standing below the Bloomberg consensus expectations of 1.5% YoY. Inflation hit its lowest level since last May remaining below the lower end of the NBS target tolerance band for the second consecutive month. Having fallen below 1% YoY (0.9% in July 2018), core inflation (CPI excluding food, energy, alcohol and tobacco) has been trending higher in recent months to reach 2.1% YoY in December 2020 and remaining flat on an annual basis in January 2021. According to the relevant survey of the NBS, the short & medium-term inflation expectations of the financial and corporate sectors moved within the target band (3±1.5%) manifesting that they remain well anchored. The short and medium term inflation expectations of the financial sector stood close to 2.0%, while those of the corporate sector stood a bit lower at 1.5% and 1.9% respectively. Concluding, as regards the pandemic, the government is heading towards tightening of the restrictive measures amid the more than doubling of cases in two weeks (4,157 cases on March 2 vs 1,386 on Feb 14), while at the same time the vaccination roll out proceeds rapidly with Serbia ranking first in Europe (but behind the UK and the US) in terms of the share of the total population that had received at least one vaccine dose by March 1.

Figure 27: Public consumption and investments supported GDP from shrinking further



Source: Statistical Office of the Republic of Serbia, Eurobank Research

Figure 28: The CAD remains covered by FDIs



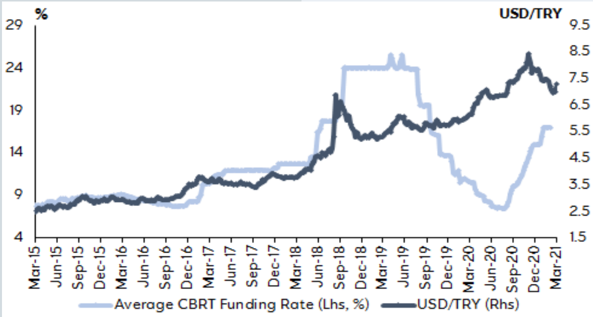
Source: Statistics Office of the Republic of Serbia, Eurobank Research

Turkey

CBRT remained on hold but also vigilant of upside inflation risks

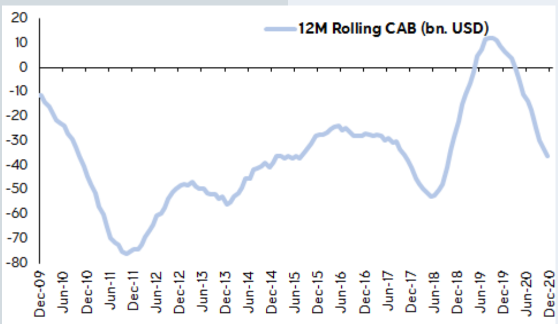
The Central Bank of Turkey (CBRT) left its key policy rate (KPR) – the 1-week repo rate – at 17.0% in late February meeting markets' expectations once again in the second MPC of the year. Recall that under the leadership of the recently appointed governor Naci Agbal, CBRT has already hiked by a cumulative 675bps since early November. More importantly, in the accompanying statement, CBRT reiterated its commitment to sustain the tightness of the monetary policy stance in the period ahead until strong indicators point to a permanent fall in inflation in line with the targets and price stability. In our view, the hawkish CBRT rhetoric shows that the leadership is aware of the risks of any premature rate cuts. High inflation remains a key challenge and necessitates CBRT to remain more cautious and vigilant until it becomes more confident about the inflation trajectory. CBRT has set the year-end target in 2021 at 9.4% and mid-term target at 5%. However, inflation has climbed further to 15.0% YoY in January vs. 14.6% YoY in December compared to 11.9% YoY in October, driven by high food and energy inflation and the continued pass-through from earlier FX depreciation. In the same period, core inflation also rose sharply to 15.5% compared to 14.3% YoY vs. 11.5% YoY. Factoring in the latest hike, the inflation-adjusted rates have climbed to levels similar to the yields offered by emerging-market peers, a move enough to soothe market concerns and offer a decent rate premium reward to satisfy investors' appetite. That said, given that inflation has not peaked, the option of another rate hike is still on the table if upside inflation risks materialize in Q2. On the other hand, tight monetary policy and tightened financial conditions weigh on economic activity which constrain CBRT maneuver. From that point on, CBRT has assessed that GDP may expand by 4-5% YoY in Q1-2021 based on the economic activity indicators released in the first two months, following a 5.9% YoY print in Q4-2020. As a result, full year GDP growth reached +1.9% in 2020, a bit lower than the CBRT projection of 2.5% but significantly higher than the government forecast of 0.3% in last October and the 0.5% projection of the local market participants, making the country one of the few exceptions in the world, which escaped a deep recession. Having plunged to an all-time low of 8.52/$ on November 7, the lira rebounded strongly reaching 6.95/$ in mid-February. Yet, driven by concerns stemming from the rising sovereign bond yields worldwide, lira retreated to 7.48/$ in early March still placed among the highest performing EM currencies so far in 2021.

Figure 29: Lira retreated since mid-February on rising market yields' concerns worldwide



Source: Bloomberg, Eurobank Research

Figure 30: Macroeconomic imbalances have been widening since mid-2019



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)		
	2020e	2021f	2022f	2020e	2021f	2022f	2020e	2021f	2022f	2020e	2021f	2022f	2020e	2021f	2022f
World	-3.5	5.5	4.2	3.2	2.8	2.9									
Advanced Economies															
USA	-3.5	5.5	3.0	1.2	2.2	2.1	8.1	6.0	5.0	-3.0	-3.3	-3.0	-15.8	-10.3	-6.3
Eurozone	-6.7	4.2	4.0	0.3	1.5	1.2	8.0	9.0	8.6	2.0	2.3	2.3	-9.5	-6.2	-3.7
Germany	-4.9	3.5	3.6	0.5	2.3	1.4	4.2	4.0	3.8	6.3	6.4	6.0	-4.8	-5.5	-2.0
France	-8.3	5.6	4.0	0.5	1.1	1.1	8.2	9.8	9.5	-2.2	-1.7	-1.5	-11.0	-7.6	-5.2
Periphery															
Cyprus	-5.1	3.5	3.0	-1.1	0.5	1.0	7.8	7.5	7.0	-10.0	-9.0	-9.0	-4.5	-1.0	-0.5
Italy	-8.7	5.0	4.6	-0.2	0.7	0.6	9.1	10.3	9.8	3.2	3.0	3.1	-11.3	-7.6	-5.0
Spain	-11.0	5.8	5.3	-0.3	0.8	1.1	16.2	17.8	16.1	0.8	1.4	1.7	-12.2	-8.6	-5.8
Portugal	-7.6	4.7	4.3	-0.1	0.9	1.1	6.8	8.2	7.2	-1.3	-0.5	-0.4	-8.0	-5.4	-3.0
UK	-9.9	4.5	5.7	0.9	1.5	1.9	4.6	6.6	5.6	-2.7	-3.8	-3.9	-17.0	-8.6	-5.5
Japan	-5.1	2.8	2.2	-0.2	-0.1	0.4	2.8	3.1	2.9	2.9	3.2	3.3	-10.5	-8.0	-5.3
Emerging Economies															
BRICs															
Brazil	-4.0	3.5	2.5	3.2	3.8	3.5	13.4	14.4	13.4	-0.8	-1.2	-1.4	-14.9	-7.2	-6.5
China	2.3	8.4	5.5	2.5	1.5	2.3	3.8	3.8	3.6	1.5	1.4	1.0	-6.9	-5.8	-4.3
India	-7.7	9.2	N/A	6.4	4.6	N/A		NA		1.1	-0.7	N/A	-7.6	-5.5	N/A
Russia	-3.1	3.0	2.5	3.4	3.9	3.8	5.8	5.7	5.3	1.9	2.4	2.9	-4.3	-2.1	-1.0
CESEE															
Bulgaria	-4.0	3.5	4.2	1.7	2.1	2.5	5.1	4.8	4.5	1.2	2.0	1.5	-3.0	-3.9	-2.5
Romania	-3.9	4.5	5.0	2.3	2.8	2.5	5.0	5.3	5.0	-4.5	-4.0	-5.0	-9.0	-7.0	-5.0
Serbia	-1.0	4.5	4.0	1.3	1.8	2.3	13.4	9.4	8.8	-6.4	-5.6	-5.5	-8.9	-3.2	-1.7
Turkey	1.9	4.8	5.0	12.3	15.0	10.0	13.5	13.3	13.0	-5.5	-3.0	-2.5	-5.5	-4.5	-4.0

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

Eurobank Fixed Income Forecasts

	Current	March 2021	June 2021	September 2021	December 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	0.10%	0.14%	0.15%	0.16%	0.17%
3m Libor	0.19%	0.26%	0.28%	0.31%	0.32%
2yr Notes	0.14%	0.16%	0.20%	0.23%	0.28%
10 yr Bonds	1.45%	1.16%	1.30%	1.35%	1.46%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.55%	-0.50%	-0.49%	-0.50%	-0.49%
2yr Bunds	-0.69%	-0.70%	-0.67%	-0.63%	-0.61%
10yr Bunds	-0.32%	-0.46%	-0.40%	-0.33%	-0.30%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.10%	0.15%
3m	0.07%	0.07%	0.10%	0.12%	0.12%
10-yr Gilt	0.75%	0.40%	0.46%	0.49%	0.57%
Switzerland					
3m Libor Target	-0.75%	-0.74%	-0.74%	-0.74%	-0.74%
10-yr Bond	-0.29%	-0.44%	-0.40%	-0.37%	-0.35%

Source: Bloomberg (market implied forecasts)

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