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GLOBAL & REGIONAL MONTHLY

Following the immediate surge of global activity due to the reopening of the economies in H1 2021, global growth momentum seems to have peaked and is speedily losing steam. Despite the slowing pace of economic recovery and worries regarding the contagious Delta variant, major central banks have signaled the end of the ultra-loose monetary policy amid upside risks to the inflation outlook. Overall, we expect 2021 global GDP growth to reach ca. 6.0%, before decelerating to 4.5% in 2022, as the waning effect of the monetary and fiscal policy boost will start taking its toll on global economic activity.

Macro Picture

USA: The underlying momentum remains resilient, but there are tentative signs of softening

EA: Real GDP growth seems to have peaked in Q2, but should continue to advance robustly

UK: The pace of economic recovery is slowing amid supply side constraints

EM: China's deceleration and increasing energy prices cloud the economic outlook

CESEE: Sustained recovery momentum in Q3 strengthens optimism for GDP growth prospects in 2021-2022

Markets

FX: USD strength continued as worries over the global economy surfaced from multiple directions

Rates: EU and US rates moved higher due to an increase in inflation expectations, earlier-than-expected global monetary policy tightening likely

EM: Spreads under modest pressure on rising US rates, weak Chinese growth and the Evergrande case. The hiking cycle of Central Banks continues

Credit: Spreads slightly tighter in September, expected to move moderately wider towards end of Q4, as tapering starts and rates move higher

Policy Outlook

USA: A taper announcement expected in November if economic progress continues as expected

EA: Slower pace of Q4 PEPP purchases by the ECB. Decisions on PEPP and APP due in December

UK: BoE opened the door for higher rates should labor market tightness persist post-furlough

CESEE: Energy and food prices-driven inflation spike compels regional Central Banks to reassess their policy options

Key Downside Risks

More persistent upside inflation risks, premature and rapid withdrawal of policy support, mounting contagion risks from China, spread of new virus mutations, imposition of stricter restrictions

EM sphere: The coal supply "at any cost" by China further inflates already high energy prices, undermining the fragile growth potential

Special Topics in this issue:

- German politics: Tough and lengthy post-election coalition talks lie ahead

- An Evergrande (collapse?) chronicle

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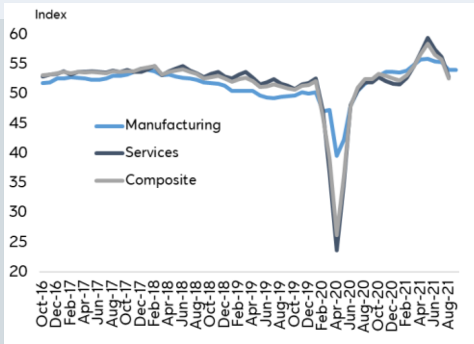
World Economic Outlook

Following the immediate surge of global activity due to the reopening of the economies in the first half of the year, global growth momentum seems to have peaked and is speedily losing steam. Inflation risks are skewed to the upside, as supply shortages are exerting upward pressures on firms' costs and, consequently, on consumer prices. Indeed, the latest September PMI Markit survey suggests that the global manufacturing recovery remains constrained by supply chain bottlenecks and material shortages, leading to rising input costs and selling prices. The respective index did not change in September, remaining at a six-month low of 54.1 and in an expansionary territory over the past 15 months (Figure 1).

Figure 1: JP Morgan Global PMIs

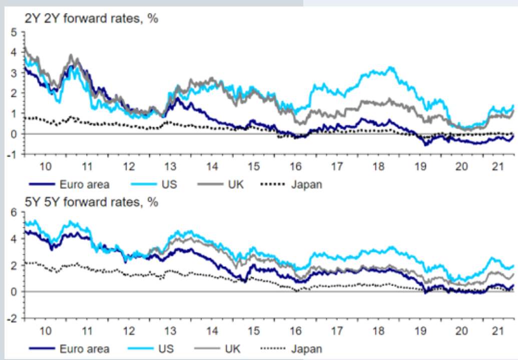


Source: Refinitiv Datastream, Eurobank Research

Despite the slowing pace of the economic recovery and worries regarding the contagious Delta variant, major central banks have signaled the end of the ultra-loose monetary policy amid upside risks to the inflation outlook (Figure 2). Fed Chair Jerome Powell noted that tapering conditions were "all but met", with most participants being in favor of concluding asset purchases around mid-2022 and half the committee looking for a rate hike in 2022. Furthermore, the minutes of the September's BoE policy meeting were relatively hawkish, with markets currently pricing in about two rate hikes in 2022. Adding to the above, the Norges Bank was the first G10 Central Bank to raise its policy rate by 25 bps to 0.25%, while, in the emerging markets' space, the Central Bank of Brazil (BCB) hiked the Selic rate by another 100bps to 6.25% and Mexico's Central Bank increased its benchmark interest rate by 25bps to 4.75%.

Overall, we expect 2021 global GDP growth to reach ca. 6.0%, before decelerating to 4.5% in 2022, as the waning effect of the monetary and fiscal policy boost will start taking its toll on global economic activity. Inflation uncertainty has increased significantly, highlighting the risk that rising prices pressure could prove more persistent than previously expected.

Figure 2: Inflation Expectations



Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

Developed Economies

US: High frequency economic indicators continue to suggest some softening in the underlying momentum, which remains resilient overall given the contagious Delta variant spread. The recent economic deceleration was reflected in the updated Summary of Economic Projections (SEP) of the September FOMC meeting, with the real GDP growth median forecast for 2021 falling by 1.1pps to 5.9%, while inflation forecasts were revised remarkably higher this year partly due to supply constraints. Higher expected inflation led to a hawkish tilt in the Fed's dot plot with half the committee looking for a rate hike in 2022 and the 2023 median projection rising from 0.625% to 1.00%. The Committee signaled that a slowdown in the pace of asset purchases will likely be announced in November provided that economic progress continues as expected. Notwithstanding a negative surprise in the upcoming September labor market report, the Fed could announce a tapering of ca. $15bn/month (~$10 in Treasuries and ~$5 in MBS) at its November meeting, concluding purchases in Q2 2022.

Euro area: As restrictive measures due to the Covid-19 pandemic eased across Europe, private consumption was the major growth driver in Q2, recovering strongly to more than 90% of its pre-crisis level in Q4-2019. Leading indicators suggests that the recovery continues well into Q3, but the pace of the expansion seems to be softer relative to the Q2 bounce. Demand seems to have peaked in Q2, while supply chain constraints and worries over the contagious Delta variant and its economic consequences have started to weigh on production and services in Q3. PMI surveys suggest that shortages have been translated into higher costs, with input prices advancing at their fastest rate in over two decades and selling price inflation accelerating to the third highest rate recorded in about 20 years. Favorable financial conditions and an upgraded inflation outlook prompted the ECB to announce a "moderately" lower pace of PEPP purchases in Q4 at its 9 September meeting, broadly in line with expectations, while key future monetary policy decisions are due at the 16 December meeting.

Emerging Economies

EM: The big picture in the emerging sphere is continuing economic growth recovery but with serious challenges ahead. An optimum point needs to be found where fiscal stimulus, leverage, growth and required capex for vaccination infrastructure could all balance. With the end of the pandemic still not in sight, overleveraged emerging economies with low percentages of vaccination will struggle to return to pre-pandemic levels of GDP growth. China's economic slowdown along with the turmoil in the real estate sector and the energy shortfalls cloud the EM outlook ahead. While the overleverage of real estate companies in China is expected to have, broadly, limited effect, i.e. especially on interconnected Asian emerging economies, its economic slowdown and the push in the global coal prices, driven by the unofficial governmental mandate to supply coal "at any cost", poses downside risks for the global growth and especially for the commodity and energy dependent emerging economies.

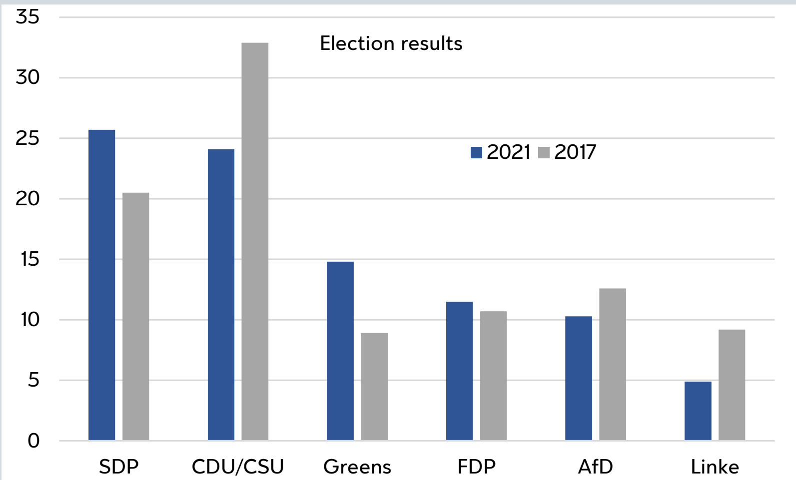
CESEE: During the past month, the pace of the vaccination programs slowed down in many countries of the region. Even though supply bottlenecks are no longer such a binding constraint, progress remains uneven among countries in the region. Further progress in the vaccination programs could turn out to be a game changer for the regional prospects in H2-2021 compared to the previous three waves, thus minimizing the socioeconomic cost of a fourth wave, if it materializes. On the economic data front, releases in Q3 have so far been upbeat. The sustained recovery momentum in Q3-2021 lays the foundations for a stronger regional rebound in H2-2021. Inflation has been staging a dynamic comeback in the past months albeit from a relatively low base. Inflation dynamics are largely driven by higher energy, food prices, unfavorable base effects and the economies reopening. The stronger than anticipated growth rebound both in the region and globally, the tighter labor markets and the inflation come-back compels the regional Central Banks to reassess their policy options for inflation expectations not to be de-anchored.

Special Topics

I. German politics: Tough and lengthy post-election coalition talks lie ahead

The centre-left SPD, headed by acting Finance Minister Olaf Scholz, won Germany's 26 September general election with 25.7% of the vote (+5.2% compared to the 2017 election). This constitutes a big turnaround taking into account that the party was consistently polling in third place over the first half of this year. The SPD beat the centre-right Christian Democratic Union (CDU) and its Bavarian sister party, the Christian Social Union (CSU), for the first time since 2002, albeit by a narrow margin (Figure 3). The CDU/CUS led by Armin Laschet secured 24.1% of the vote (-8.8%), the worst result in the party's 70-year history. The centre-left Green party ranked third with a score of 14.8% (+5.9%), their best ever result that positions the party as a kingmaker in the post-election coalition talks, along with the liberal democratic FDP, which won 11.5% of the vote (+0.8%). The Eurosceptic right-wing populist AfD scored 10.3% (-2.3%), and the Left Party Die Linke took 4.9% (-4.3%), narrowly failing to pass the 5.0% threshold for entering the Bundestag (Germany's parliament) in the second (national) vote. However, the party won three regional mandates in the "first-past-the-post" regional vote, the minimum number of local constituencies a party has to win to send delegates in Bundestag should it fail to meet the 5.0% threshold.

Figure 3: SDP ahead of CDU/CSU for the first time since 2002



Source: Bundeswahlleiter, Eurobank Research

Germany uses a mixed electoral system that combines proportional representation and "first-past-the-post" features, while the threshold for securing parliamentary representation is 5.0% or at least three direct mandates in the local constituencies. Each voter casts two votes on election day. The first vote is given to the preferred candidate in the voter's local constituency. The vote for these candidates resembles a "first-past-the-post" voting system, where the person with the most votes wins outright. In this way, half of the 598 MPs of the Bundestag are elected directly from the country's 299 constituencies. The remaining seats are allocated to the political parties according to the second ballot, which selects political parties instead of individual candidates. These seats are distributed to the political parties proportionally, taking also into account the persons who won the 299 constituencies in the first ballot. In other words, after the second ballot, each party is allocated as many additional MPs, as to ensure that the composition of the Bundestag is proportional to the votes cast in the second ballot.

In the new Bundestag that emerged from the September 26 elections, the SDP has secured the largest parliamentary group with 206 MPs (+53 from the 2017 general election), followed by CDU/CSU with 196 (-50), the Greens 118 (+51), the FDP 92 (+12), the AfD 83 (-11) and the Left 39 (-30). That said, the new parliament will have a total of 735MPs, above the normal size of 598MPs, taking into account the additional awarded seats, proportional to the second votes.

Coalition options

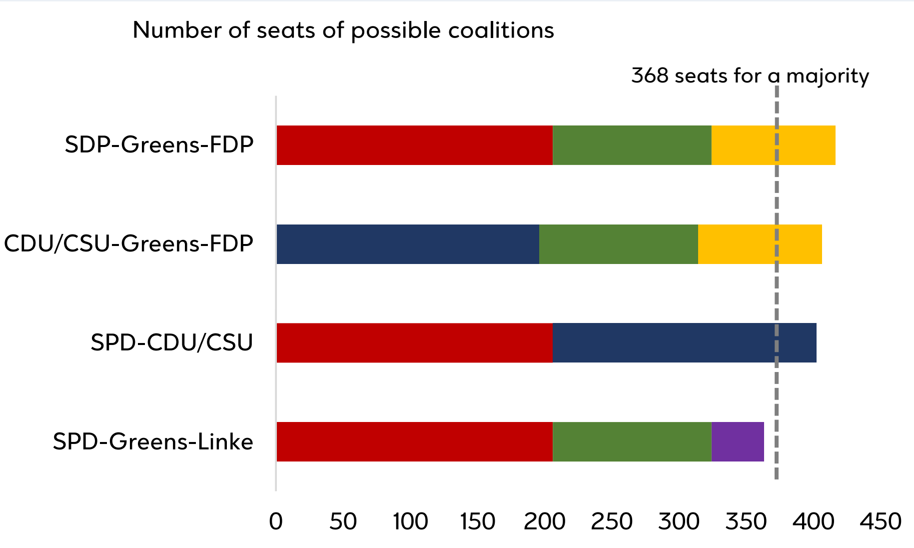
For a new government to be formed, a parliamentary majority of at least 368 MPs (absolute majority) is required. The coalition parties nominate the candidate chancellor, who does not necessarily have to come from the largest party. The coalition talks take place in two phases. First, exploratory talks are held between the parties with an intention to finding common ground and room for compromise on contentious issues. These are followed by formal coalition talks that aim at reaching an agreement on a joint program (mainstream parties have already ruled out co-operation with the right-wing populist AfD). In arithmetical terms, based on Germany's 26 September election results, there are three potential coalitions that could reach the required parliamentary majority (Figure 4):

(i) An SPD-led grand coalition, between the SPD and the CDU/CSU
(ii) An SPD-led "traffic light" coalition, between the SPD, the Greens, and the FDP
(iii) A CDU/CSU-led "Jamaica" coalition, between the CDU/CSU, the Greens and the FDP.

The coalition scenario (i), which essentially constitutes the continuation of the grand coalition, this time led by the SPD and potentially including the FDP or the Greens, currently seems as the least likely scenario, after both the SPD and the CDU/CSU signaled that they do not intend to continue governing together (all grand coalitions since 1949 have been led by the CDU/CSU). As things stand, it seems unlikely that either party would agree to the other becoming the senior coalition partner, with its party leader replacing Angela Merkel as chancellor. Nevertheless, nothing can be ruled out as in 2017 a grand coalition was not considered possible and attempts were made for a "Jamaica" coalition, which however failed, resulting in the formation of a grand coalition again.

Be that as it may, at the time of writing, the most likely coalition options are the aforementioned (ii) and (iii). Should either of them materialise, Germany will have a three-party coalition government for the first time ever at the national level. The critical issue is which of the two larger parties, the SPD or the CDU/CSU, will manage to convince the two junior parties to join either one of them in a three-party governing coalition. The Greens have a stronger policy overlap with the SPD and have governed together in the past under Chancellor Gerhard Schröder from 1998 to 2005. On the other hand, the FDP seems to be more aligned with the Conservatives, and were junior coalition partners in the CDU/CSU-led government from 2009 to 2013.

Figure 4: Possible post-election coalition formations



Source: Bundeswahlleiter, Eurobank Research

Contentious issues

Whichever coalition scenario eventually emerges, post-election talks will likely be difficult and lengthy. The Greens and the FDP have already started bilateral discussions to find some common ground, to maximise their bargaining power, before talks are broadened to include their potential senior coalition partner, the SPD or the CDU/CSU.

As regards the scenario of a "traffic-light" coalition led by the SPD, collaboration between the latter and the Greens would likely be relatively easy given substantial overlap between the two centre-leftist parties' manifestos. However, collaboration with the FDP may not be easily achieved, taking into account its considerable political differences with the other two parties, which would require material concessions. More so, given that the FDP's negotiating position has strengthened significantly after a left-wing, red-red-green coalition between the SPD, the Greens and the Left, that could potentially trigger a substantial shift in German politics towards more expansionary fiscal policy and more supportive EU policy, has narrowly failed short of a parliamentary majority.

The SPD's manifesto, provides for significant tax hikes to fund increased government spending, including higher social benefits and a higher minimum wage. On the other hand, the FDP's agenda is mainly focused on deregulation, business-friendly tax policy and a commitment to respecting the constitutional debt break. The restrictions posed by the latter raise questions over the availability of enough fiscal space to cover the SPD's spending plan and the Green's ambition for investment into renewable energy to accelerate Germany's path to net-zero emissions. In addition to the above, the FDP would strongly oppose any kind of common debt issuance or laxer fiscal rules on the European level, or making the EU Recovery Fund permanent.

As regards the scenario of a "Jamaica" coalition led by the CDU/CSU (according to the German constitution, it does not automatically follow that the biggest party will lead a coalition government and the chancellor does not necessarily have to come from the biggest party), collaboration with the FDP could be more easily achieved. However, convincing the Greens to come on board will likely be much more complicated. The Greens are committed to decarbonisation and additional funds for the green transition, whereas both the CDU/CSU and the FDP are focused on fiscal discipline and a more balanced budget.

In any case, the potential coalition partners will have to compromise and find sufficient common ground on their stumbling blocks. The choice between a "traffic light" coalition and a "Jamaica" coalition, remains a close call. However, whichever coalition scenario emerges, both are centrist in nature and are expected to broadly maintain the status quo, apart from a shift to green transition (Greens' red line).
As required by the German constitution, the new Bundestag will hold its inaugural meeting on 24 October, one month after the general election, while the existing caretaker government (and the chancellor) will remain in place until then. There is no fixed timetable for the election of a new chancellor. According to the German constitution, there can be up to three votes. Until now, the new chancellor was always elected from the first ballot, as she/he had already secured the so-called qualified majority. This implies that a new chancellor is unlikely to be elected before coalition talks conclude, which may take several months, as was the case in 2017 (it took almost six months until a new government was formed).This time, however, things may move faster as leaders of all four potential coalition partners appear eager to conclude negotiations before the end of the year, i.e., before Germany takes over the G7 presidency on 1 January 2022.

II. An Evergrande (collapse?) chronicle

The Global financial markets where shaken in late September on a risk-off mode amid fears over an Evergrande contagion effect. The tone was given by Asian bond and stock markets, which tumbled amid the biggest sell-off in Chinese property stocks in more than a year, implying that trading desks around the world may have discounted the risk of contagion from the debt crisis that the Evergrande Group is facing and the potential profound impact on China's economic growth path. Meanwhile, the Evergrande share halted trading yesterday, following unconfirmed news that Hopson Development Holdings Ltd., an Evergrande's competitor, plans to acquire a 51% stake of the company's property services unit. Before the suspension of trading of the share, its price has slid to HKD2.95 from HDK14.90 at the beginning of the year, having lost more than 80% of its value. Whether there will be a consolidating or a selective bailout across the real estate sector or the Politburo will abide by the crackdown of the overleveraged and subsequently inefficient real estate firms is a tough puzzle for analysts. The uncertainty that adds to the already distressed landscape stems from the lack of transparency and information – at least at the time of writing – with respect to the exact creditors and borrowers of the real estate firms and the magnitude of each one's exposure. The landscape blurs further by the global geopolitical momentum but also the energy shock currently at play. At first glance, the military partnership AUKUS between the US, Australia and the UK sealed only a few weeks ago under, causes inevitable turmoil in China's relations with the developed world. As such, the timing for proceeding with the restructuring of one of China's most pivotal economic sectors may not be appropriate and an intermediate solution that entails state assistance could be pursued.

As regards the focal point of concern, Evergrande Group has recently become one of the biggest sources of financial risk in China with a plethora of analysts asking whether this shock could spill outside China's boundaries. At first glance, the Evergrande case seems to have similarities with the collapse of the Lehman Brothers back in 2008. The USD300bn liabilities in its balance sheet, dispersed in more than 200 banks and financial institutions, are seen as capable of transmitting shock waves into the financial system and disrupting the economic growth trajectory of China. Evergrande, formerly called the Hengda Group, was founded in 1996 in Guangzhou by Xu Jiayin, a real estate developer, and expanded its balance sheet and operations in the last 25 years, largely through leverage. What started as a homebuilding company, has currently expanded into electric vehicles (Evergrande New Energy Auto), an internet and media production unit (HengTen Networks), a theme park (Evergrande Fairyland), a soccer club (Guangzhou F.C.) and a mineral water and food company (Evergrande Spring), among others.

The first signs of stretched liquidity trace back to 2020, when the management of the group addressed a letter to the local government of Guangdong in August 2020, informing about possible difficulties in meeting payments due in January 2021. The company later denied the authenticity of the letter, but a group of investors, following the alleged date of the letter, approved a waiver of their right to force a USD13bn repayment. From that point onwards, Evergrande outlined a plan to reduce USD100bn debt roughly by half by mid-2023, mainly through assets disposal. So far, the debt reduction has not proceeded as planned with the group neither gathering sufficient funds compared to those required for debt repayments, nor successfully raising fresh debt in order to rollover existing and maturing debt liabilities. The inability of the group to restructure its debt promptly has inevitably led to credit downgrades, with Fitch Ratings stating on September 8 that a default seems probable and debt restructuring experts claiming that a haircut on the face value of its maturities at stake at the range of 70%, or even above that, should not come as a surprise. Additionally, the inability to pay promptly two coupons so far, is currently viewed by markets as a matter of ''when'' and not of ''if'' the group will eventually go bankrupt. The latter development gets worse and more complicated, taking into account that the collapse of Evergrande will have a large impact on the job market as it employs 200,000 people and hires 3.8mn more as temporary staff every year for project developments.

Approximately USD700mn coupon payments are maturing by the end of 2021, with an additional USD2bn debt maturing in March 2022. Whether Evergrande's access to capital markets will be maintained is the determining factor affecting its going concern. Apart from the efforts made by the group and the expert restructuring advisors, it remains to be seen whether a bail out scheme will be on the table by the local and central Chinese government. While not officially stated (yet), the government appears to have instructed authorities in Guangdong to come up with a plan to manage the group's debt problems. Towards this direction, regulators in September allowed Evergrande to renegotiate payment deadlines with banks and other creditors, paving the way for another temporary reprieve. Unlike the traditional bailouts the Chinese government has offered in the past to national champions like distressed, but huge, State Owned Enterprises (SOEs) and corporates, the policy lines for distressed firms appear different in the Xi Jinping's regime. The recent crackdown in the sectors of technology and education cast a shadow on whether Beijing will be keen on facilitating the survival of Evergrande. There are signs that raw competition among corporates is a clear mandate in the Xi era and therefore, a brave and clear bailout of Evergrande would blur the explicit signal the government wishes to emit. That said, in 2021 alone, 25 Chinese businesses had defaulted on ca. USD10bn worth of bonds, setting a new record in default bonds and underlining Beijing's intention to eliminate the moral hazard of previous years, when large SOEs and private firms were rescued on the name of their size and not their competence. On the other hand, Evergrande has the characteristics of a "too big to fail" firm. Real estate is one of the major engines of China's growth, accounting approximately for one third of the economic output, and the bankruptcy of any such company would have huge repercussions. China's central bank highlighted in 2018 that companies including Evergrande might pose systemic risks to the nation's financial system. Given the inflection point the group currently stands at, as information and data come gradually into surface and developments evolve, the situation should and will be closely monitored.

Macro Themes & Implications in CESEE

Sustained recovery momentum in Q3 strengthens optimism for GDP growth prospects in 2021-2022. Inflation spikes across the region driven by higher energy, food prices and the economies reopening. Central Banks in the CEE region tighten their monetary policy stance further.

As of early September 2021, the epidemiological situation in many countries of the Central, Eastern and Southeastern Europe (CESEE) has shown signs of deterioration compared to early July. Having weathered the third wave of infections, countries are now becoming increasingly confronted with a new wave – the fourth one since the beginning of the pandemic – with the number of Covid-19 infections, hospitalizations and fatalities trending higher in the last couple of months. The virus's mutations – especially the delta one – has been at the epicenter of global media attention. The rise in infections worldwide has raised the red flag for the CESEE region as well, with the region now confronted with a fourth wave in autumn.

As of early October 2021, the epidemiological situation in many countries of the Central, Eastern and Southeastern Europe (CESEE) has shown signs of deterioration compared to early July. Having weathered the third wave of infections, countries are now becoming increasingly confronted with a new wave – the fourth one since the beginning of the pandemic. The virus's mutations – especially the delta one – has been at the epicenter of global attention. The rise in infections has raised the red flag for the CESEE region as well, with the region now confronted with a fourth wave in autumn. As a result, satisfactory progress in the vaccination programs could turn out to be a game changer as it will most probably give more room for maneuver to authorities to avoid general lockdowns as in the previous three waves, thus minimizing the socioeconomic cost of the fourth wave.

During the past month, the pace of the vaccination programs slowed down in many countries of the region. Even though supply bottlenecks are no longer such a binding constraint, progress remains uneven among countries in the region. As of early October, Lithuania ranked first in the vaccination process having administered at least one dose to 72.7% of its adult population. Hungary, the first EU country to have procured vaccines from China and Russia ranked second, having administered at least one dose to 68.8% of its adult population. The Czech Republic and Slovenia are next in line having administered at least one dose to 67.0% and 62.9% of their adult population respectively. In contrast, Bulgaria and Romania are still lagging behind with the respective figures being 24.1% and 33.1% respectively. Meanwhile, during the previous month, Turkey made impressive progress in its vaccination program doubling the vaccination rate (% of total population) from 19.7% in late May to 40.2% in late June, 58.7% in early September and further to 63.3% in early October.

On the economic data front, releases in Q3 have so far been upbeat. Sentiment indicators rising close to, if not above, their pre-pandemic levels also sent an optimistic signal for the economic outlook, creating strong expectations for the growth readings of Q3. The sustained recovery momentum in Q3-2021 lays the foundations for a stronger regional rebound in H2-2021. The better than anticipated growth performance in H1-2021 and the acceleration of the vaccination programs across the CESEE region, has reignited optimism for the growth prospects of the broader CESEE region in 2021-2022. Yet the pandemic is still far from over and the road to normalization is full of challenges. Provided that the vaccination programs remain on track and the economic impact of a fourth wave remains manageable, the CESEE region is now expected to have covered more quickly the lost ground of 2020 by the end of the year instead of 2022 initially expected. Serbia, Romania, Poland and Hungary are among those regional economies who have already surpassed their pre-pandemic GDP levels by the end of Q2-2021. In contrast, it will most probably take some more time for Bulgaria to surpass its pre-pandemic GDP level, due to the ongoing political instability and the impact of the fourth wave of infections. In any case, the impact of the RRF funds, which applies to EU members is expected to be felt on the medium-term prospects.

Inflation has been staging a dynamic comeback in the past months albeit from a relatively low base. Inflation dynamics are largely driven by higher energy, food prices, unfavorable base effects and the economies reopening. As regards the first two factors, the sensitivity of the broader region is comparatively higher than in the rest of the EU given that these factors' share in the consumption basket is higher than in Western Europe. The data announcements so far showed that, consumer prices across the region climbed further on a monthly basis in September reaching new multi-month highs. In Poland, headline inflation accelerated to 5.8% YoY up from 5.5% YoY in August. In Turkey, inflation reached 19.6% YoY up from 19.25% in August standing now above the key policy rate.

The stronger than anticipated growth rebound both in the region and globally, the tighter labor markets and the inflation come-back compels the regional Central Banks to reassess their policy options for inflation expectations not to be de-anchored. In that direction, the Central Banks of Central Eastern Europe (CEE), who were the first to initiate the tightening cycle in June, have proceeded with further monetary policy tightening. During the past month, the Central Banks of Hungary (MNB) and the Czech Republic (CNB) hiked rates further, demonstrating their willingness to proceed with policy normalization in the aftermath of the pandemic. More specifically, the MNB hiked the policy rate by 15bps to 0.90% below market expectations, bringing the cumulative hikes at 75bps. The MPC stressed that the inflation outlook is subject to upside risks after reviewing the inflation report for Q3 and concluded that tightening is set to continue until risks become balanced over the policy horizon. In contrast, the CNB surprised the markets, tightening by 75bps to 1.50%, which is the biggest rate hike since 1997 and the second largest in the Central Bank's history. The guidance from CNB is even more hawkish with its leadership suggesting that there are more hikes in the pipeline but with their pace being subject to uncertainty and new data.

On the flipside, the Central Banks of Southeastern Europe (SEE region) appeared until very recently more reluctant to discontinue their accommodative monetary policy stance. The Central Banks of Serbia (NBS) and Romania (NBR) have remained put on their respective policy rates putting more emphasis on stimulating growth. Their focus on growth is also reinforced by the uncertainty surrounding the pandemic, especially as the mutations' advance around the globe coincides with dwindling demand for vaccinations in both countries. However, in the case of Romania this could be about to change as the NBR is increasingly confronted with higher core pressures and the pressure from CEE Central Banks.

CESEE Markets Developments & Outlook

Bulgaria

Eurobond yields rose across all maturities, with sharp spikes registered along the mid and long-end of the curve. More specifically, the 2028 papers rose by 21 bps, followed by the 2035 with 18 bps and the 2030 with 16 bps. The short end of the curve was also active, with the 2023 and 2024 tenors having their yields rising by 6 and 10 bps respectively. On the other hand, local papers saw little change within the month. During September, the Ministry of Finance re-opened the 5- and 10-year local currency denominated paper auctions, raising in total EUR 250mm, which was more than double the amount they had forecast for September. On the political front, a new party emerged from the interim government, led by two Ivy League school graduates. Preliminary polls show that ca. 15-16% of the voters are backing the newly formed "Continuing the Change" party, placing them second after GERB.

Serbia

Despite the high inflation readings since the beginning of the year, the National Bank of Serbia (NBS) will most probably try to delay initiating a monetary tightening stance through an interest rate hike for as long as possible and any forward guidance in October's monetary board meeting is not on the table. We ground our view on the NBS's opinion that the recent spike in inflation is transitory, not based on idiosyncratic factors but caused at a global level from the reopening of the economies. While the prices pressure is not regarded as longstanding, its duration cannot be determined yet as there are still bottlenecks in many sectors of the economy and most probably, it will take time for the industrial and manufacturing sectors around the world to satisfy all the pent-up demand that unfolded after the reopening. That said, vague indications of hawkishness are evident in the government bond market as the yields keep surging steadily after their sharp decline in July. Yields rose slightly between 2-7 bps along the entire curve in September compared to July, when they experienced an almost parallel downside shift of 30 bps on the back of the inclusion of three sovereign bonds in the J.P. Morgan EMBI indices. As such, the 4-year, 6-year and 11- year bonds yields are traded currently at 2.30%, 2.52% and 3.45%, respectively.

Markets View

Foreign Exchange

EUR/USD: The pair made a significant move downwards to the 1.1550 level as per the last days of the previous month. The main drivers for the safe haven dollar currency buying, was spanned by concerns over the inflation gap between the Eurozone and the US, the meltdown effects on global markets from China's construction giant Evergrande, the steady tapering rhetoric by the Fed the ECB's view that recent price increases are due to transitory inflation effects. With eyes on the upcoming announcement on official inflation numbers and mainly the US treasuries and Bunds' moves, we believe the pair will revisit the 1.17 territory and consider the magnitude of this downside movement a turbulent overreaction to the previous factors' effects. In case the downward movement continues, we do not see a break down action below the 1.15 support level.

GBP/USD: Additionally to the above factors, the market's concerns over a belated tapering in the UK, as well as the severe recent energy issues in the country, moved the pound lower, even in the 1.3450 territory. Even if a short-term further downside move occurs, we set our support level at max 100 pips lower to 1.34 for at least 1-month's horizon, while our view is for a retracement above the 1.37 level, following the same rationale that the market has already overreacted to recent shocks.

Rates

EU: Rates increased sharply in September, for a second consecutive month, with 10y Swap trading at 15bps up from 1bps in the previous month. The shift of the curve remained anchored, with 5s-30s trading at 68bps. Looking ahead, we expect the rates to increase further and the curve to steepen, as inflation is expected to keep rising for the next 2-3 months according to the ECB. Moreover, the Delta variant hasn't had the expected impact.

US: Rates followed the same trajectory as in Europe, with the 10y swap rate trading at 148bps, up from 132bp at the beginning of the month. The shift of the curve remained anchored, with 5s-30s trading at 78bps. Looking ahead, we expect US rates to move higher and the curve to steepen as a sharper-than-expected rise in inflation, due to high energy prices and continued supply-chain disruptions, will probably lead to an earlier-than-expected global monetary policy tightening cycle.

Emerging Markets credit

EM assets came under moderate pressure due to the sharp rise in US yields, after the latest FED meeting, which implied a slightly more aggressive than consensus expectations regarding the timing of the tapering, along with concerns on the impact of the Evergrande situation. The EMBI Global Index closed at 324 bps at the end of September, 11bps higher on the month. In CEEMEA, Turkish sovereign spreads ended significantly wider on the month. In an unexpected move, the CBT cut its policy rate by 100bp to 18% at the September meeting, while the Czech Republic Central Bank hiked the base rate by 75 bps to 1.5%, which was the largest rate hike since 1997. In LatAm, IG spreads were little changed, while the central banks continued their hiking cycle due to inflationary pressures. In Asia, Chinese sovereign bonds proved to be pretty resilient to concerns on slowing growth and the Evergrande situation, with the latter being contained at the moment. We remain neutral on EM fixed income due to a combination of weak Chinese growth, rising US rates and the sharp move in energy prices that is not helpful in estimating if inflation has peaked.

Corporate credit

EUR IG cash corporate spreads were slightly tighter in September, with spreads on most grades and sectors ending -2/-3bps better, as continuous supply was well-received, while moves in rates and equities did not affect credit too much. CDS indices spreads were mostly unchanged to slightly tighter on a roll adjusted basis, broadly in line with cash. Some small decompression was evident towards the end of the month, with below investment grade underperforming. ECB guidance is still supportive of Credit, and is expected to remain so in Q4/21. Sector-wise, in EUR IG, Financials were -3.5bps tighter, Real Estate -2.5bps tighter, Oil & Gas -2bps tighter, Health Care -2.5bps tighter, Telecoms -2.0bps tighter, Industrials -2bps tighter, Consumer Goods -1.5bps tighter, Utilities -2.0bps tighter, Technology -2.5bps tighter and Basic Materials -2.0bps tighter. US IG names spread were between -2/-8bps tighter in September, with Oil & Gas -8bps tighter making it the month outperformer. Financials were -3.5bps tighter, Real Estate +4bps wider, Health care -4bps tighter, Telecoms -3.5bps tighter, Technology -4bps tighter, Industrials -4.5bps tighter, Consumer Goods -3.5bps tighter, Utilities -5.5bps tighter, and Basic Materials -2.5bps tighter.

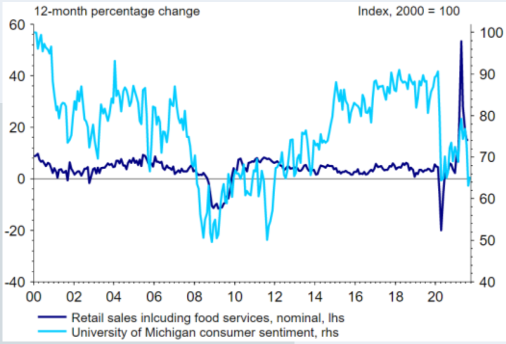
Rating-wise, EUR IG spreads in BBB was -3.0bps tighter, in A -2.0bps, in AA -1.5bps, and in AAA -2.0bps. In the EUR HY universe, CCC was unchanged, B grade was -45 bps tighter and BB was +4.0bps wider. Rating-wise in US IG the BBB rating bucket was -5.5 bps tighter, A was -3.5bps tighter and AA was -4bps tighter. Technical for cash continues to remain strong both in EUR and US, with supply well received, and cash balances ready to buy the dip. Tapering initiation by end of Q4 in US is expected to affect spreads in the medium term, but inflation persistence and potentially higher rates might be more important for US credit spreads in the short term. ECB is still supportive, but medium-term the tapering discussion is expected to gain more focus as well. Therefore, we expect both US and EUR credit spreads to start trading modestly wider in the short term, with a possible continuation of this trend towards Q4 and year end.

USA

The underlying momentum remains resilient, although there are tentative signs of softening

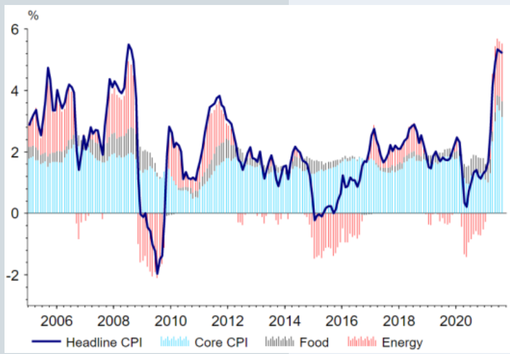
High frequency economic indicators continue to suggest some softening in the underlying momentum, which remains resilient overall given the contagious Delta variant spread. Durable goods orders rose by a hefty 1.8%MoM in August following an upwards revised increase of 0.5% in the prior month, but orders excluding transportation advanced by a mere 0.2%MoM pointing to a moderation in equipment investment in Q3. Meanwhile, industrial production decelerated to 0.4%MoM from 0.9%MoM in July amid supply bottlenecks and disruptions from Gulf hurricanes in August that weighed on manufacturing and mining. On the consumption front, although the Conference Board's index of consumer confidence fell to a six-month low of 113.8 in August from 125.1 in July, retail sales increased more than expected in August (+0.7%MoM), likely capitalizing on back-to-school shopping and the distribution of Child Tax Credit payments. Nevertheless, the surge in August retail sales was to some extent offset by a downward revision of 0.7pps in the July print reporting a 1.8% decline on a monthly basis. The recent economic deceleration was reflected in the updated Summary of Economic Projections (SEP) of the September FOMC meeting, with the real GDP growth median forecast for 2021 falling by 1.1pps to 5.9% and the unemployment rate projection rising by 0.3pp to 4.8%. Inflation forecasts were revised remarkably higher this year partly due to supply constraints, with headline and core measures now expected at 4.2% and 3.7% from 3.4% and 3.0%, respectively, in June. Higher expected inflation led to a hawkish tilt in the Fed's dot plot with half the committee looking for a rate hike in 2022 and the 2023 median projection rising from 0.625% to 1.00%. The Committee signaled that a slowdown in the pace of asset purchases will likely be announced in November provided that economic progress continues as expected. Fed Chair Jerome Powell highlighted that tapering conditions were "all but met", with most participants being in favor of concluding asset purchases around mid-2022. Notwithstanding a negative surprise in the upcoming September labor market report, the Fed could announce a tapering of ca. $15bn/month (~$10 in Treasuries and ~$5 in MBS) at its November meeting, concluding purchases in Q2 2022.

Figure 5: US retail sales and consumer confidence



Source: Refinitiv Datastream, Fathom Consulting

Figure 6: US Headline CPI & contributions



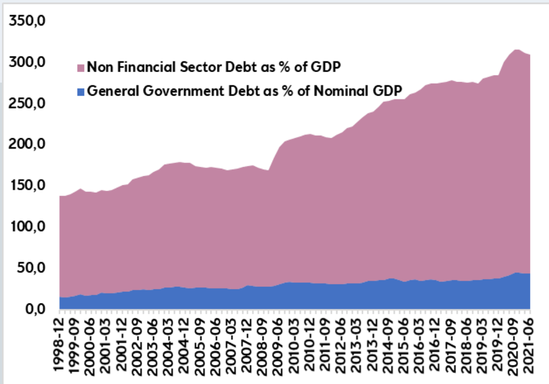
Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

China

Besides Evergrande, the energy crunch and the zero tolerance policy towards Covid-19 will take their toll on the economic growth rate of 2021

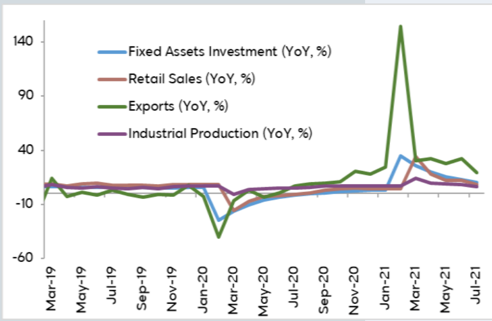
Gradually since July, soft and hard data point to the economy having entered a cooling mode, while at the same time, the continuance of radical economic reforms and the zero tolerance policy towards Covid-19 have also been taking their toll on the economy. Adding to the above, a possible bankruptcy of the national real estate champion Evergrande along with the energy crunch currently at play, make the economic landscape suddenly gloomier, clouding the outlook ahead. The energy crisis has been building up since the summer but it manifested itself more clearly currently, with energy blackouts not only in plants but in residential areas as well. Current power cuts in China are the outcome of the coincidence of a plethora of factors. In our view, the key determinant to the crisis is the overdependence on coal of the energy-intensive and manufacturing-driven Chinese economy in a period when the global demand for Chinese goods is strongly reviving. At the same time, the recently implemented cabinet's decision to shut down inefficient power plants in an effort to rationalize the energy market but also the early chase of the zero emission target by 2060 has led to power shortages with the country not having prepared adequately for substituting coal energy sources with alternative ones. In the above context, the fact that energy firms are importing thermal energy but are obliged to sell it in the domestic energy system at set prices only made things worse, resulting in the pompous power curtailments across the country. Following the havoc of the electricity blackouts, the unofficial governmental mandate to the country's top state-owned energy companies – from coal to electricity and oil – is to secure energy supplies for the winter at all costs. With the adverse impact on the economy from the coal turmoil still under reckoning, the government seems determined to continue with the zero tolerance policy towards Covid-19, a policy which so far has proved to weigh on the headline growth through all the channels of the economy. Taking into account all of the above, we decide to lower our projection to 8.0% from 8.2% with risks tilted to the downside.

Figure 7: Private debt continues to surge in 2021 casting shadows on the financial stability..



Source: National Institution for Finance and Development, Eurobank Research

Figure 8:...with the economy passing to a cooling mode since summer



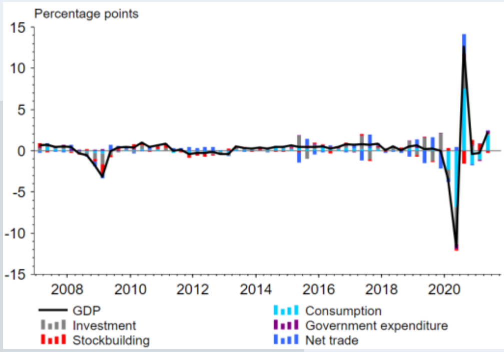
Source: Bloomberg, Eurobank Research

Euro area

Real GDP growth seems to have peaked in Q2, while short-term inflation risks are skewed to the upside

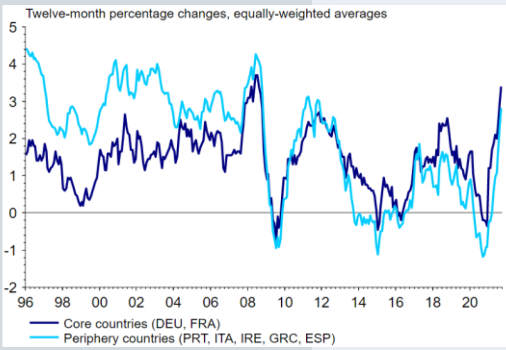
Q2 real GDP growth was revised higher by 20bps to 2.2%QoQ, mirroring a stronger than expected economic rebound in H2-2021. As restrictive measures due to the Covid-19 pandemic eased across Europe, private consumption was the major growth driver (+3.7%QoQ), recovering strongly to more than 90% of its pre-crisis level in Q4-2019. Leading indicators suggests that the recovery continues well into Q3, but the pace of the expansion seems to be softer relative to the Q2 bounce. The September Composite PMI declined by 2.9pts to 56.2, mirroring a broad-based deceleration across manufacturing (-2.8pts to a final estimate of 58.6) and services (-2.7 pts to a 4-month low of 56.4). Demand seems to have peaked in Q2, while supply chain constraints and worries over the contagious Delta variant and its economic consequences weighed on production and services in Q3. Meanwhile, shortages have been translated into higher costs, with input prices advancing at their fastest rate in over two decades and selling price inflation accelerating to the third highest rate recorded in about 20 years. Rising consumer prices were also evident in the September flash HICP releases, with headline and core inflation surging to 13-year highs of 3.4%YoY and 1.9%YoY from 3.0%YoY and 1.6%YoY, respectively, in August. Wholesale gas and electricity price was a major inflation driver and is expected to exert upward pressure to energy prices and, consequently, headline consumer prices in the remainder of the year. Higher expected inflation was reflected in the updated ECB's macroeconomic forecasts published at its September 9 monetary policy meeting, with 2021 HICP inflation projected at 2.2% (+0.3pp) and real GDP growth expected at 5.0% (+0.4pp). Favorable financial conditions and an upgraded inflation outlook prompted the ECB to announce a "moderately" lower pace of PEPP purchases in Q4, broadly in line with expectations. ECB President Christine Lagarde highlighted after the September 9 Governing Council meeting that the decision to reduce the PEPP purchase pace was just a recalibration rather than a tapering signal, noting that key future monetary policy decisions – including the PEPP, the APP and the LTROs – are due at the 16 December meeting.

Figure 9: Euro area contributions to quarterly GDP growth



Source: Markit, Refinitiv Datastream, Fathom Consulting, Eurobank Research

Figure 10: Euro area HICP inflation



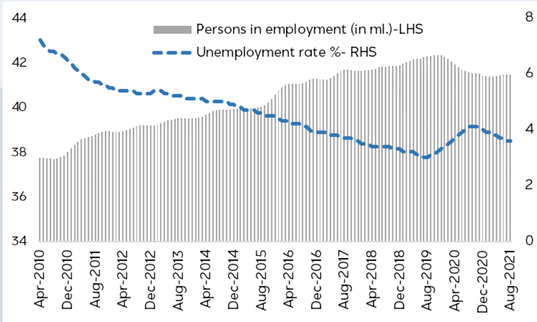
Source: Refinitiv Datastream, Fathom Consulting

Germany

Supply bottlenecks slow economic recovery

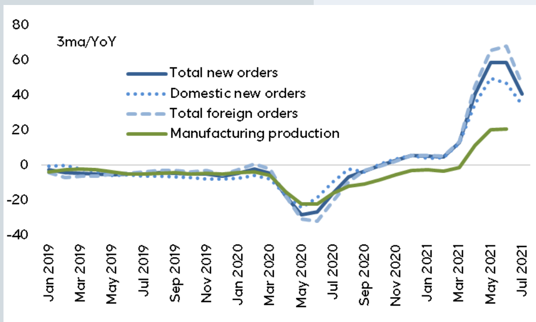
German GDP grew by a healthy 1.6%QoQ in Q2 following a contraction of 2.0%QoQ in the prior quarter, mainly on the back of stronger household consumption amid improved consumer confidence, as the sharp drop in new Covid-19 cases allowed a broad reopening of the economy in May. Another strong growth increase is expected in Q3 on the view that, since the reopening only started in the last few weeks of Q2, the bulk of the economic rebound is expected to materialize over the summer. Meanwhile, new Covid-19 cases have been on a gradual decline in recent weeks. In addition, the labor market continues to recover rapidly (Figure 11), and consumers have turned notably less pessimistic. The unemployment rate dropped by 0.2pts to 5.4% in September, the lowest level since March 2020, employment was little-changed from July's eight-month peak of 41.47mn, and vacancies have already exceeded pre-pandemic levels, assisting Germany's GfK consumption exiting negative territory in September for the first time since the first Covid-19 wave (+0.3 from August's -1.1). However looking further ahead, leading indicators send clear signs for a sharply lower GDP growth in Q4, pointing to some normalization from the reopening-led bounce. Indicatively, the ZEW Indicator of Economic Sentiment that gauges economic activity six months ahead, declined in September for the fourth consecutive month to 1 ½-yr lows (26.5 from August's 40.4), the IFO business climate dropped for the third month in a row (98.8 from 99.6) and the Composite PMI declined notably (-4.8pts to 55.3) amid a deteriorated sentiment in both services (-4.8pts to 56.0) and manufacturing (-4.2pts to 58.5). All the above reflect worries over rising inflation (HICP to a near 30-yr high of 4.1%YoY in September) mainly due to increasing commodity costs and production disruptions, along with noticeable supply bottlenecks in raw materials and input goods in the manufacturing sector. That latter has left manufacturing output 6.5% below pre-pandemic levels in July, in spite of the 1.3%MoM increase over that month, having probably a long way to go to catch up with strong orders growth (Figure 12). We see German economic growth peaking close to 3.0%QoQ in Q3 before easing around 0.5%QoQ in Q4, with the economy growing by 3.1% in the year as a whole.

Figure 11: The labor market continues to recover rapidly



Source: Federal Statistical Office, Eurobank Research

Figure 12: Manufacturing production lagging orders by a wide margin



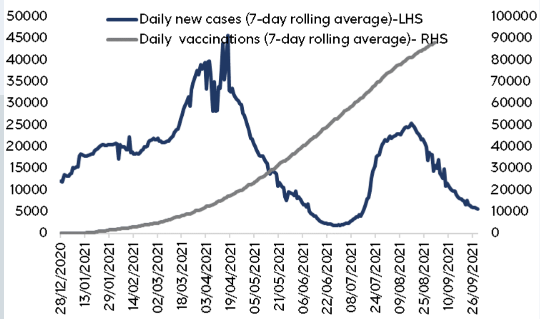
Source: Federal Statistical Office, Eurobank Research

France

Solid recovery to continue in H2-2021

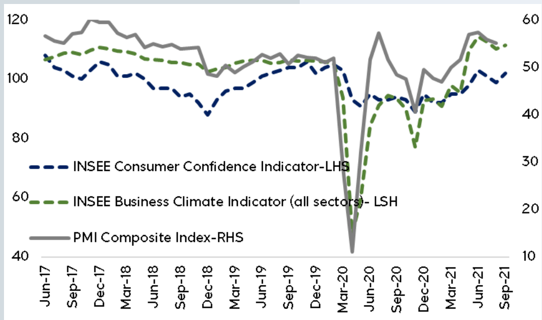
France's GDP bounced back in Q2 growing by 1.1%QoQ, the first positive reading since Q3 2020, mainly driven by stronger domestic activity following the relatively swift withdrawal of lockdown measures that started in early May. The rebound in Q2 took France's output 3.2% below its Q4 2019 pre-pandemic level, narrowing the gap from 4.3% in the first quarter of the year. With tight restrictions now out of the way as the bulk of containment measures were removed in the end of June thanks to good progress on the vaccination campaign — especially after the announcement of the Covid-19 health pass that was effective from early August — momentum in economic activity is expected to gather further pace in Q3. Admittedly, the INSEE consumer confidence rose by 3pp to a three-month high of 102 in September, taking the Q3 average up for the third consecutive quarter, as households appear to pay more attention on improving epidemic conditions rather than higher energy prices that erode their purchasing power (Figure 14). Similarly, the INSEE business climate rose in the same month by 1pp to 111.5, remaining comfortably above its pre-pandemic level for the fifth consecutive month, adding to the view that the expected negative impact of the mandatory use of the health pass to access specific public venues has been limited so far. In addition, even though the PMI composite dropped by 0.8pp to 55.1 in September, with manufacturing leading the decline amid ongoing supply disruptions, it remained still 1.8pts above its long-term average, consistent with solid growth in Q3. The INSEE estimates real GDP growth of 2.7%QoQ in Q3 before decelerating to 0.5%QoQ in Q4 as the economy is seen returning to its pre-crisis level by the end of the year. For the whole year, the INSEE projects real GDP growth of 6.25%YoY, after an 8.0% contraction last year, while for 2022, according to the draft Budget Law presented recently by the government, the economy is seen expanding by 4.0%. Under the said budget, the government forecasts the budget deficit to GDP ratio shrinking from -9.1% in 2020 to -8.4% in 2021 and to -4.8% in 2022, while the debt to GDP ratio is seen rising by 0.6pp to 115.6% by end-2021 before falling to 114% in 2022.

Figure 13: Good progress on the vaccination campaign



Source: Our World In Data, Eurobank Research

Figure 14: Sentiment indicators point to solid GDP growth in Q3



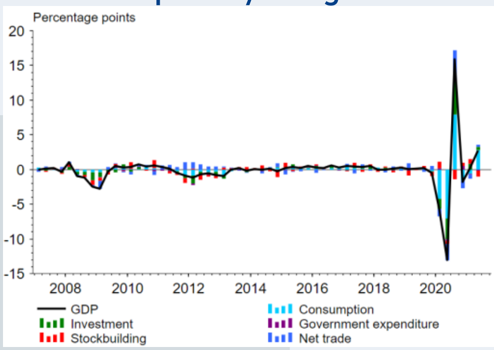
Source: INSEE, European Commission, Eurobank Research

Italy

Higher than expected H1 GDP growth leads to improved economic prospects in 2021

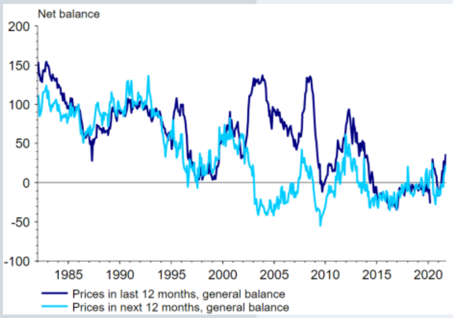
Following an upward revision of the Q1 GDP growth print to 0.2%QoQ, and a stronger than expected Q2 GDP growth rate of 2.7%QoQ, the carry-over effect for this year currently stands at roughly 5.0%YoY. The strong performance of the economy so far in 2021, as Italy recovers steadily from the pandemic shock, suggests that the country is now closing the gap with the rest of the euro area, with GDP expected to have reached 2019 levels by Q2 2022. The manufacturing sector continued to outperform, with industrial output advancing by 0.8%MoM in July following a hefty increase of 1.1%MoM in June, while the September manufacturing PMI signaled the fifteenth consecutive month of improvement. More specifically, the headline index decelerated marginally to 59.7 from 60.9 in August, suggesting that the rapid upturn in manufacturing conditions continued well into Q3. High frequency indicators bode well for economic outlook, with consumer confidence hitting a record high of 119.6 in September from 116.2 in August that mirrored a surge in the economic climate index (+11.2pts to 143.6) and an improvement - to a lesser extent - in the personal, current and future climate indices. Turning to the business confidence climate, the index fell only marginally by 0.2pts to 113.8, still standing close to historical highs. In addition, the EC's Economic Sentiment Indicator (ESI) eased for the second consecutive month to 116.8 in September, 2.8pts below the all-time high of 119.6 in July, remaining though at relatively high historical levels. The ESI was dampened by a plunge of -7.1pts in retail trade confidence, followed by a fall of -1.3pts in services and -0.4pts in both industrial and consumer confidence indicators. Overall, we expect real GDP growth to accelerate to 5.8% in 2021 with the Next Generation EU fund (NGEU) providing a substantial boost, close to the projection included in the updated Economic and Financial Document approved by the Council of Ministers on 29 September. In terms of NGEU implementation, the Italian government received the first €25bn installment (~ 13% of total resources), with the next €25bn disbursement expected by early-2022 depending on structural reforms' progress. In politics, latest polls regarding local elections in 1,192 Italian towns and cities, taking place on 3-4 October, point to the M5S's weakness, while the PD could be the winner in five major cities.

Figure 15: Italy contributions to quarterly GDP growth



Source: Refinitiv Datastream, Fathom Consulting

Figure 16: Italy consumer survey



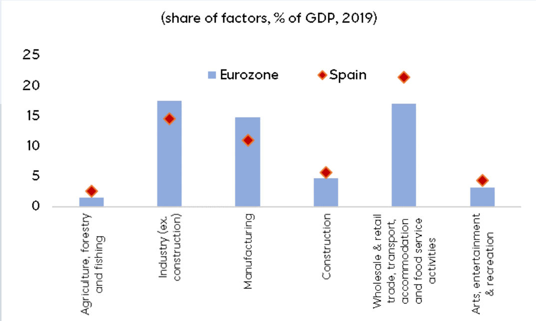
Source: Refinitiv Datastream, Fathom Consulting

Spain

Continues to lag behind all other major EA economies

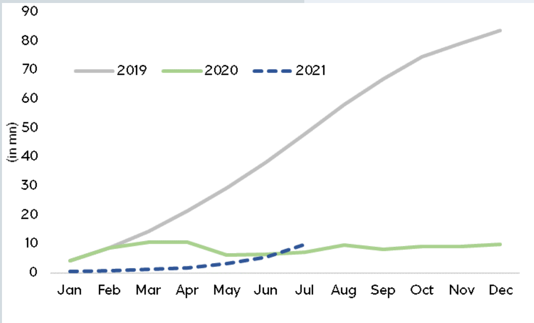
According to the second estimate, Spain's real Q2 GDP was revised sharply lower to 1.1%QoQ, less than half compared to the first print of 2.8%QoQ, suggesting that the rebound in economic activity after the reopening process started in early May, proved to be more sluggish than initially thought. The pronounced revision was mainly concentrated in domestic demand, as household consumption growth was down to +4.6%QoQ from +6.5%QoQ previously, and investment growth shaped at -2.2%QoQ from -1.5%QoQ in the first estimate, leaving the level of activity 8.4% below pre-pandemic levels (vs. 6.8% previously). Real GDP growth was also revised lower for Q1, contracting by -0.6%QoQ vs. -0.4%QoQ initially estimated. Overall, Spain continues to lag behind all other major EA economies after suffering the deepest contraction in 2020 (-10.8%YoY) for a number of idiosyncratic factors, including the relatively more stringent and longer lasting Covid-19 restrictions, as well as the economy's higher dependency on sectors most gravely hit by the pandemic, including contact-sensitive sectors such as tourism (Figure 17). Looking forward, sentiment indicators pertaining to Q3 (PMIs & EC consumer sentiment for August) point to continued economic recovery, also supported by the successful vaccination programme. Spain has currently one of the highest vaccination rates in the world, with near 80% of the population fully vaccinated, well ahead of all other major EA countries as well as the US and the UK. However, the rebound in tourism during the summer high season following the reopening of the economy and of the intra-EU borders, though somewhat stronger than initially expected, has remained well below trend. The number of cumulative overnight stays as of late July exceeded by c. 40% the July 2020 level but was still c. 80% below 2019 (Figure 18), suggesting a weaker and more gradual post-pandemic recovery. Supported, though, by expansionary fiscal and monetary policies, accumulated savings and incoming EU funds (Spain received the first tranche of €9bn from the Resilience and Recovery Facility in mid-August), economic recovery is expected to be carried over into Q4, with GDP growth at 5.8% for the full year, against the Bank of Spain's more optimistic view for a growth rate of 6.2%.

Figure 17: Spain is relatively higher dependent on sectors most gravity hit by the pandemic



Source: Eurobank Research

Figure 18: Tourism activity still well below trend in July



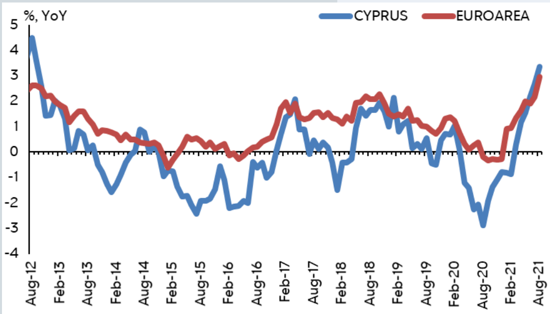
Source: Spanish Statistical Office (INE), Eurobank Research

Cyprus

Solid high frequency indicators' performance in Q3-2021

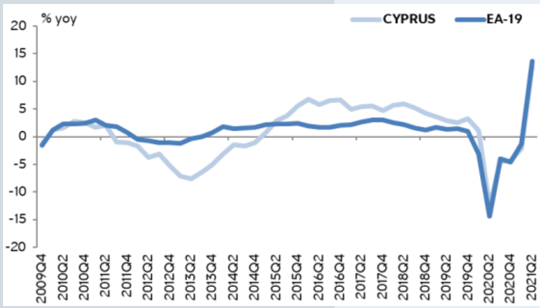
As of late-September, the epidemiological situation in Cyprus has improved compared to late July when the number of new Covid-19 cases in the fourth wave of infections peaked. On top, the latest ECDC data demonstrate that the vaccination program has accelerated so that 80.3% of the adult population vs. 79.2% in EU/EEA has received at least the first vaccine dose and 77.1% vs. 73.4% in EU/EEA has been fully vaccinated. Despite sporadic lockdown measures in H1-2021 and the rise of infections in Q3, economic activity also remained relatively resilient strengthening optimism for the near-term prospects. According to the revised estimate, GDP on a seasonally adjusted basis expanded by +0.2% QoQ in Q2-2021 compared to +1.7% QoQ in Q1-2021 vs. +1.3% QoQ in Q4-2020. The latter translates into +12.9% YoY in Q2-2021, a tad below the Euroarea (+13.6% YoY), up from -1.6% YoY in Q1-2021, and -4.4% YoY in Q4-2020. The high frequency indicators trajectory in Q3 also bodes well. So far, tourist arrivals were higher by 126.4% YoY in the 8M-2021, but 64.9% YoY lower from 8M-2019. In 7M-2021, tourism revenues came in at €504,5mn compared to €164,5mn in the corresponding period of 2020, up by 206.7%, albeit still lower by 64.6% from their respective reading of 7M-2019. The Economic Sentiment Indicator (ESI) remained strong in September standing very close to the level of June, which was the highest since the pandemic started. The ESI edged down by 0.5 points to 104.4 in September down from 104.9 in August and 105.0 in June. Factoring in the very good performance in Q1 and the solid growth performance in Q2, underpinned by favorable base effects from phasing out last year's restrictions and strong sentiment improvement, economic activity is projected to rebound by more than 5% in 2021. Headline inflation has turned positive in 2021 (7M-2021: +1.2% YoY, July: 1.4% MoM/3.3% YoY) on base effects from last year's energy prices slump. HICP is forecasted to remain in relatively high levels in 2022 underpinned by high energy but also non-energy and services prices as the economy recovers. In late September, Fitch affirmed the long-term sovereign rating of the country at BBB- (investment grade) with a stable outlook. The rating reflects the country's institutional strength, underlined in its per capita GDP and governance indicators and its record of robust economic growth and sound fiscal policy prior to the Covid19 pandemic. In the rating agency's view, these strengths are counterpoised by balance-sheet weaknesses, in particular high public debt, and a weak banking sector.

Figure 19: HICP inflation in positive territory since March 2021



Source: Eurostat, Eurobank Research

Figure 20: The economy rebounded strongly on an annual basis in Q2-2021 in line with EA-19



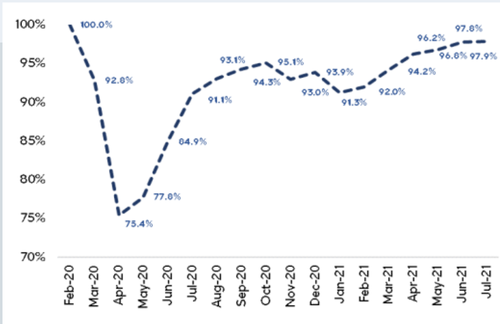
Source: Eurostat, Eurobank Research

UK

The pace of economic recovery is slowing on supply side constraints

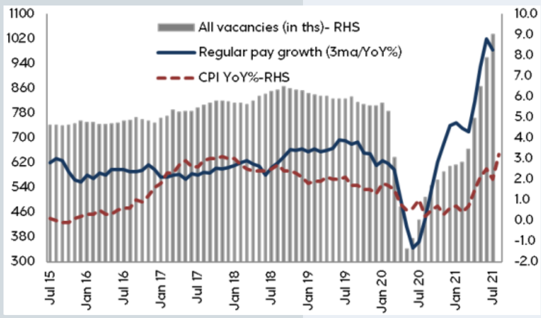
After GDP grew by a hefty 5.5%QoQ in Q2, UK activity appears to run out of steam as the economy edges closer to "normal" (Figure 21). In support of the above, GDP expanded by a lower than expected 0.1%MoM in July. Services saw no growth despite the lifting of the remaining restrictions on 19 July and construction output declined for the fourth consecutive month (-1.6%MoM), offsetting a 1.2%MoM increase in industrial production that was entirely driven by technical factors. Timelier data (August retail sales, consumer confidence and PMIs for September) added to the view for considerably lower GDP growth in Q3, a view also supported by the BoE which revised downwards its Q3 GDP growth forecast by a hefty 0.8pp to 2.1% at the September meeting, arguing that supply side constraints (in both inputs and labor), put a break on economic activity. But the BoE placed little attention on recent disappointing activity data. Amid concerns of more persistent upside inflation risks, mostly related to the rapidly tightening labor market (Figure 22), the BoE adopted a more hawkish than expected tone. Indeed, the most recent UK labor market data revealed a further decline in the unemployment rate in July to a near one-year low of 4.6%, a further increase in vacancies to an all-time high of over 1mn and total pay growth in excess of 8.0% 3m/YoY. Focusing on the rapidly strengthening labor market and ongoing supply chain disruptions, two MPC members called for an early end to the QE programme (up from one member in August) and the Committee argued that recent developments "appear to have strengthened" the case for modest policy tightening over the forecast period, that could be delivered in the form of a rate increase, even before the end of the QE programme, if necessary. The BoE acknowledged, though, that considerable uncertainties remain, having probably in mind the expected impact on the labor market of the closure of the government's furlough scheme at the end of September. Should the impact prove minimal and tightness in the labor market persists, a BoE rate hike could potentially be delivered by the end of this year. The most timely labor market data post the September furlough-end are scheduled for release on 14 December, ahead of the December 16 MPC meeting and shortly before the QE programme is expected to finish.

Figure 21: UK GDP edged up to c. 98% of its pre-pandemic level



Source: Eurostat, ONS, Eurobank Research

Figure 22: Elevated wage growth, while soaring vacancies point to further wage gains

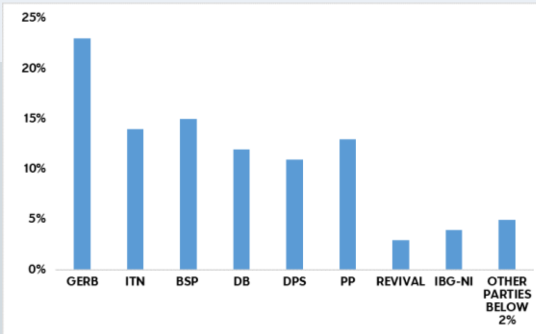


Source: ONS, Eurobank Research

Bulgaria

Q2-2021 GDP print lags behind the EU and the region average, highlighting the need for political stability.

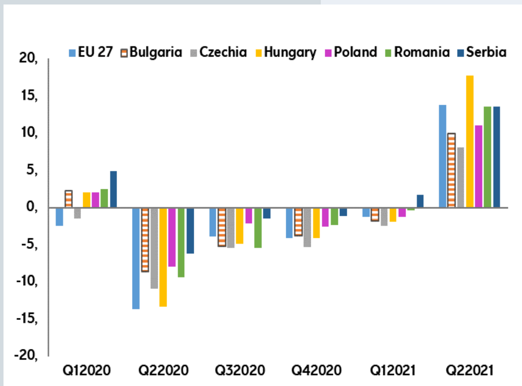
Figure 23: Latest polls continue to point to a fragmented parliament...



Source: Politico, Eurobank Research

According to the Q2-2021 GDP print, the economy grew by 9.6% and 0.6% on an annual and quarterly basis respectively. While the annual print compares favorably with that of the previous quarter (9.6% in Q2 vs -1.8% in Q1), some loss of steam is detected on a QoQ basis (0.4% in Q2 vs 2.5% in Q1). Additionally, the print, on both a quarterly and annual basis, lags compared to those achieved in the EU and the region average. We could, therefore, come to the conclusion that the political uncertainty of the country since April has weighed on the economic performance in a particularly adverse period due to the pandemic. By definition, a caretaker government, no matter how competent, has limited ability to implement the economic policy agenda, especially under extraordinary economic circumstances and with a fragmented parliament that is unable to reach compromises (3 failed attempts to form a coalition government). Adding to this, the low rate of complete vaccinations (15.5% as of end of September, the lowest in Europe) and the limited prospect of its improvement anytime soon, along with the fourth wave of the pandemic, which comes with increased infectiousness (11.1% positivity in testing results as of end of September) cast a shadow over the outlook of Q42021, which will be likely the toughest from the pandemic perspective. The economic growth rate in H1-2021 lies roughly at 4.0% and taking into account the above, we fine tune our estimate for the full year print at 4.2% from 4.5%, given the recently increased downside risks. We consider the chances of the H2-2021 growth to outperform the H1-2021 growth limited and we associate it directly to a stable outcome in the parliamentary and first round presidential elections in mid-November. Concluding with the inflation outlook, CPI inflation in Bulgaria accelerated to 3.7% YoY in August, from 3.0% YoY in July and -0.6% YoY in January, with the main upward pressure coming from food, utilities and fuel prices, in line with the global and regional trend at play since the beginning of the year. We consider the resulting risks manageable, as they do not stem from idiosyncratic factors.

Figure 24: ...with the political instability weighing on the economic performance



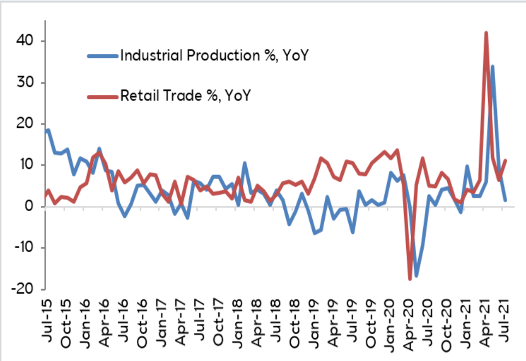
Source: Eurostat Eurobank Research

Serbia

Solid growth momentum but with challenges lying ahead, mostly related to the vaccination rate.

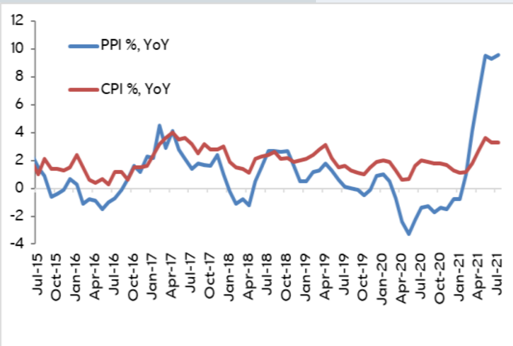
With the H1-2021 GDP growth rate standing at ca. 7.7%, we decide to upgrade our forecast for 2021 to 6.3%, below the official projections of 7% due to some points of concern. Indeed, the macroeconomic momentum in Serbia is currently strong; the ambitious public investments programme will continue to have a positive impact in H2-2021, while private consumption will be supported by increasing wages and pension hikes, in the run up to presidential, parliamentary and local elections next year. The funding of hikes is not expected to have an adverse impact, as the budget execution has so far overshot expectations posting milder deficits in absolute and relative terms, and as such, the fueling of consumption through the wages and pensions channel is seen to remain intact at least for the first half of 2022. On the flipside, hard data on both the supply and demand side, such as industrial production (IP) and retail sales, continue to expand but with some deceleration since May, which continued until August. Furthermore, we consider the stagnation of the full vaccination rate a serious drag (currently at ca. 40%) with its impact expected to unwind in the running last quarter. The inflation outlook remains challenging, as consumer prices picked up to 4.3% YoY in August from 3.3% YoY in July and June and 3.6% YoY in May, marking 8-year highs but remaining within the target tolerance band of 3%±1.5pps. The key driver of the increase was food prices, which surged by 5.2% YoY compared to 1.7% YoY in July. However, core inflation inched down to 1.8% YoY in August from 1.9% YoY in the previous month, implying that the inflationary pressures could prove temporary. If they prove more persistent, monetary tightening is always an option, following in the footsteps of the Hungarian and the Czech Central Banks this summer. September was a loaded month on the IR front, as President Aleksandar Vucic held bilateral meetings with the outgoing Chancellor of Germany, Angela Merkel, the President of the EC, Ursula von den Leyen and the Turkish President, Recep Tayyip Erdogan. However, the edgiest and most essential meeting, that with the Prime Minister of Kosovo Albin Kurti, was cancelled, stalling negotiations and leaving the dispute in a lingering mode.

Figure 25: Economy remains on track but with some loss of steam on the supply side...



Source: Bloomberg, Eurobank Research

Figure 25: while the inflationary pressures on the supply side show limited pass through so far to the headline inflation



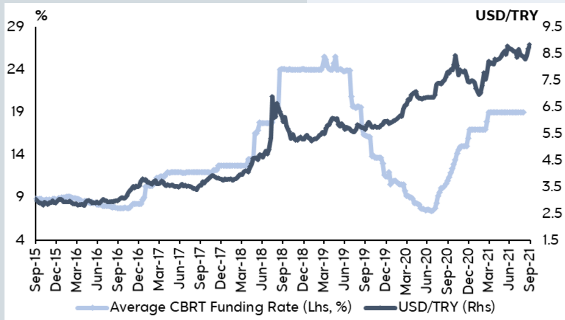
Source: Bloomberg Eurobank Research

Turkey

Surprise CBRT interest rate cut magnifies downside risks for Turkish lira assets

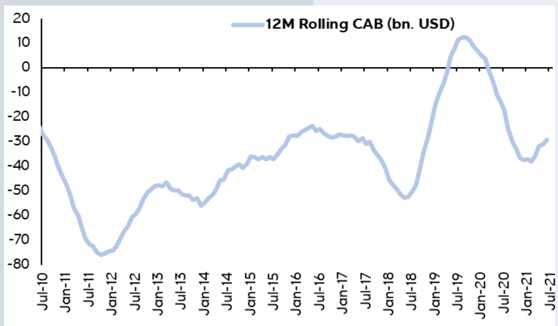
The Central Bank of Turkey (CBRT) cut its key policy rate (KPR) – the 1-week repo rate – by 100bps to 18.0% in late September. Although the decision surprised analysts' consensus, who expected rates to remain unchanged, it confirmed the shift in the CBRT focus from headline inflation to core metrics developments. The CBRT Governor's earlier remarks in his presentation at the German-Turkish Chamber of Commerce business event had given markets a signal of the Central Bank's intentions. In early September, the Governor had warned that the "extraordinary conditions, especially due to the pandemic, increase the importance of core inflation indicators" and "core indicators excluding transitory factors emanating from areas outside monetary policy's influence are taken into account worldwide". In the press release, the CBRT attributed the recent inflation spike to "supply side actors, such as a rise in food and import prices and supply constraints, increase in administered prices and demand developments due to the reopening". From the CBRT's point of view, "these effects are due to transitory factors" prompting it to shift its focus to core inflation. On top, the CBRT assessed that a revision in the policy stance was warranted because of the earlier higher than envisaged tightening impact on credit and domestic demand. In our view, this is a premature move, which undermines the disinflation process and magnifies downside risks for Turkish lira assets. In reaction, the lira traded much lower to 8.88/$ in late September down by 19.4% year-to-date, while the 10Y government bond yield climbed to 17.9% at the highest level since late March. First of all, we need to point out that CBRT has reduced rates at a time when all major Central Banks around the world are tightening or looking for a window of opportunity to tighten their policies. Second, the Central Bank frequent change of leadership and policy orientation has undermined its efficiency and credibility. The Governor himself has cautioned that the "CBRT doesn't have sufficiently strong credibility to control the narrative and to impose on the market its view that core inflation is more important than headline". Third, the statement drops the commitment to maintain tight policies, namely to maintain the nominal interest rate above headline inflation, which by itself provides no clear future guidance making it even more unpredictable. While headline inflation accelerated to a two-year high at 19.6% in September vs 19.25% YoY in August, above the key policy rate, core reached 17.0% against 16.8% YoY in the previous month. In an illustration of the increasing cost-led price pressures, PPI inched down to 44% YoY in September from 45.5% YoY in August.

Figure 27: Lira came under strong depreciation pressure on concerns for CBRT independence



Source: Bloomberg, Eurobank Research

Figure 28: 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)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World	-3.2	6.0	4.5	3.2	3.5	3.2									
Advanced Economies															
USA	-3.4	6.6	4.0	1.2	4.2	3.0	8.1	5.5	4.2	-3.0	-3.6	-3.3	-15.6	-13.5	-6.5
Eurozone	-6.3	4.8	4.3	0.3	2.2	1.6	7.9	8.0	7.8	2.0	2.6	2.5	-7.2	-7.5	-4.0
Germany	-4.6	3.1	4.5	0.4	2.9	2.1	5.9	5.8	5.4	6.9	6.8	6.6	-4.2	-6.0	-2.5
France	-8.0	6.1	4.2	0.5	1.8	1.5	8.0	8.1	8.2	-1.9	-1.5	-1.9	-9.2	-8.5	-5.2
Periphery															
Cyprus	-5.1	5.5	4.0	-1.1	1.8	1.5	7.8	7.5	6.7	-11.4	-10.0	-8.0	-5.7	-5.0	-2.5
Italy	-8.9	5.8	4.2	-0.2	1.6	1.3	9.3	10.0	9.5	3.2	3.2	2.9	-9.5	-11.5	-8.5
Spain	-10.8	5.8	5.6	-0.3	2.4	1.5	15.5	14.8	14.2	0.7	1.7	1.9	-11.0	-8.4	-4.9
Portugal	-7.6	4.1	4.5	-0.1	0.9	1.3	7.0	7.0	6.5	-1.3	-0.9	-0.5	-5.7	-5.0	-3.4
UK	-9.8	6.4	5.3	0.9	2.4	2.5	4.3	5.0	5.2	-3.5	-3.2	-3.6	-12.3	-9.6	-4.8
Japan	-4.7	2.5	2.5	0.0	0.0	0.5	2.8	2.9	2.7	3.2	3.5	3.5	-10.1	-8.5	-5.5
Emerging Economies															
BRICs															
Brazil	-4.0	4.7	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	8.0	5.5	2.5	1.5	2.3	4.2	3.9	3.6	1.5	1.7	1.3	-6.9	-5.8	-4.3
India	-7.7	9.5	6.9	6.2	5.5	4.8		*NA*		0.9	-0.8	-1.2	-9.3	-6.8	-6.0
Russia	-3.0	3.5	2.5	3.4	5.5	4.0	5.8	5.5	5.0	2.2	3.5	3.0	-4.3	-1.5	-0.7
CESEE															
Bulgaria	-4.2	4.2	4.1	1.7	2.5	2.3	5.1	4.8	4.5	1.2	2.0	1.5	-3.0	-4.4	-2.5
Romania	-3.9	8.0	6.0	2.3	4.0	3.5	5.0	5.3	4.8	-5.0	-6.0	-5.5	-9.0	-8.0	-6.0
Serbia	-1.0	6.3	4.5	1.6	2.8	2.2	9.7	12.8	10.4	-4.3	-4.5	-4.7	-8.1	-6.9	-3.0
Turkey	1.8	9.0	4.0	12.3	17.0	15.0	13.7	12.5	12.0	-5.5	-3.5	-2.5	-4.5	-4.0	-3.5

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

Eurobank Fixed Income Forecasts

	Current	December 2021	March 2022	June 2022	September 2022
USA					
Fed Funds Rate	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.03-0.30%
1 m Libor	0.08%	0.12%	0.14%	0.16%	0.20%
3m Libor	0.13%	0.22%	0.24%	0.28%	0.36%
2yr Notes	0.26%	0.30%	0.38%	0.49%	0.58%
10 yr Bonds	1.48%	1.59%	1.69%	1.82%	1.99%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.55%	-0.52%	-0.51%	-0.50%	-0.48%
2yr Bunds	-0.70%	-0.66%	-0.66%	-0.64%	-0.60%
10yr Bunds	-0.21%	-0.21%	-0.13%	-0.08%	0.00%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.20%	0.20%
3m	0.08%	0.11%	0.13%	0.17%	0.20%
10-yr Gilt	1.02%	0.85%	0.97%	1.05%	1.12%
Switzerland					
3m Libor Target	-0.76%	-0.74%	-0.74%	-0.74%	-0.74%
10-yr Bond	-0.19%	-0.18%	-0.11%	-0.06%	0.00%

Source: Bloomberg (market implied forecasts)

Eurobank

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