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GLOBAL & REGIONAL MONTHLY

Global economic activity remains on track for a robust recovery in 2021, but mounting worries regarding the more contagious Delta variant have recently come to the forefront. The global manufacturing sector continues to experience a solid growth phase, although strengthening demand for raw materials combined with supply chain bottlenecks have led to input delivery delays and escalating inflationary pressures. Mirroring brighter economic prospects in major advanced economies, our 2021 global GDP growth projection has been revised upwards to 6.0%, from 5.5%, boosted by unprecedented fiscal and monetary policy measures.

Macro Picture

USA: The economic momentum has likely peaked in Q2, but growth remains robust

EA: Improved near-term economic prospects amid rising business and consumer confidence

UK: Poised for a vigorous GDP rebound this year in spite of a delay in the final stage of easing

EM: Heterogeneous vaccination progress among EM regions casts shadows on the outlook

CESEE: The virus mutations raise concerns for a fourth wave of infections in H2-2021

Markets

FX: USD weakness challenged despite lower US yields and strengthening EU recovery

Rates: EU and US rates moved lower, flattening pressures on US curve after the hawkish FOMC statement

EM: Hawkish surprise by FED had little impact on EM yields. EM central banks are also turning more hawkish in order to deal with inflation concerns

Credit: Spreads slightly tighter, expected to trade range-bound during the summer and moderately widen in Q3, as tapering discussion matures

Policy Outlook

USA: Fed's hawkish shift pushed forward taper expectations; median dot plot: 50bp hike in 2023

EA: Very accommodative ECB policy stance, unchanged policy rates in the near future

UK: Any BoE rate tightening still some way off amid prevailing downside growth risks

CESEE: Central Banks in the CEE initiate the tightening cycle, Central Banks in SEE remain on hold

Key Downside Risks

Re-imposition of activity restrictions; sustained increase in inflation; premature withdrawal of fiscal/monetary support

Continuing low rates of vaccination in the EM world fails to close the vicious cycle of new variants

Special Topics in this issue:

- Inflation buildup in selected CESEE economies: latest developments & monetary policy response

- Future inflation trajectory pushes the Fed towards an earlier withdrawal of monetary policy support

Contributing Authors:

Ioannis Gkionis
Senior Economist
igkionis@eurobank.gr

Maria Kasola
Economic Analyst
mkasola@eurobank.gr

Olga Kosma
Research Economist
okosma@eurobank.gr

Paraskevi Petropoulou
Senior Economist
ppetropoulou@eurobank.gr

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Contents

Macro Views

Latest Macroeconomic Developments & Outlook

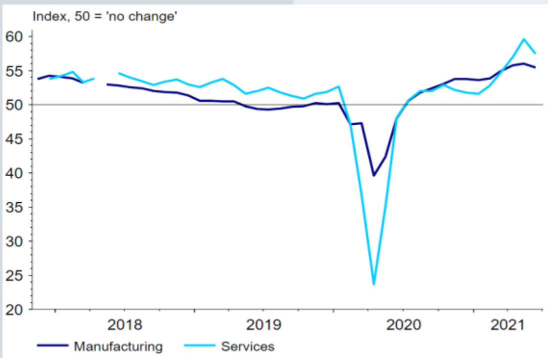
World Economic Outlook

Global economic activity remains on track for a robust recovery in 2021, but mounting worries regarding the more contagious Delta variant have recently come to the forefront. The economic expansion continues to be robust in the US and China, although the underlying momentum of both economies seems to have peaked. Meanwhile, the euro area economy has been gaining further strength in recent weeks, amid a better adjustment to restrictions and accelerating vaccination rates that drive the recovery higher as we move into the second half of the year. World merchandise trade rose for a second consecutive month in April (+0.5%MoM following a 2.3%MoM increase in March), leaving trade volumes about 25.0% up compared to April 2020 (Figure 1). The global manufacturing sector has been experiencing a solid growth phase over the past year. The J.P. Morgan Global Manufacturing PMI moderated marginally to 55.5 in June from May's 11-year high of 56.0, with output, new orders and employment all rising and business optimism at robust levels amid growing output, new orders and employment. The services sector outperformed manufacturing for the third month in a row, with the J.P. Morgan Global Services Business Activity Index falling to 57.5 in June from May's 15-year high of 59.6, still the second sharpest rate of expansion since mid-2007 (Figure 2). Meanwhile, strengthening demand for raw materials in combination with supply chain bottlenecks have led to input delivery delays (supplier delivery times lengthened to a record extent in June) and escalating commodity prices that have recorded the sharpest surge in more than 30 years (about +70% compared to pre-pandemic levels). As a consequence, CPI inflation prints in major economies have surprised to the upside over the past couple of months, making any potential persistent inflationary pressures a main cause of concern among investors and policymakers.

Figure 1: Merchandise world trade volumes

Source: CPB Netherlands, Eurobank Research

Figure 2: JP Morgan Global PMIs



Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

Following a stronger than previously envisaged economic recovery in the US and the euro area, global GDP growth for 2021 has been revised upwards to 6.0% from 5.5% in 2021, boosted by unprecedented fiscal and monetary policy measures. The Delta strain could pose a risk to the global economic outlook, if it affects consumer and business confidence in H2 2021 leading to a lower personal consumption trajectory, especially in emerging economies with low vaccination rates. Our baseline scenario suggests that the global inflation rise in 2021 is mainly attributed to base effects and transitory factors, although more persistent upward pressures in prices driven by labor shortages and wage increases cannot be ruled out.

Developed Economies

US: The economic momentum seems to be slowing, suggesting that the US recovery may have peaked in Q2. Retail sales continued to moderate from March's post-pandemic high, while industrial production data revealed that supply chain distortions continued to weigh on the manufacturing sector. Meanwhile, ISM surveys point to supply bottlenecks as manufacturers try to cope with strenghtening new orders, as well as rising price pressures. Indeed, May headline and core CPI inflation surged to 5.0%YoY and 3.8%YoY, respectively, amid base effects, supply-related jitters and enhanced demand as the economy returns to normalcy. On the housing sector, housing starts were softer than expected over the past couple of months, while existing and new home sales declined further in May reflecting higher house prices amid limited inventories. Economic activity should remain robust over the remainder of the year, albeit at a somewhat softer pace compared to Q2, boosted by heightened consumer confidence in view of the excess household savings accumulated during the Covid-19 pandemic.

Euro area: Business activity in the euro area grew in June at its fastest pace since mid-2006 as the economy continued to reopen from pandemic-related restrictions and the vaccination progress led to improved business sentiment. The manufacturing sector continued to lead the recovery reporting stronger growth pace, but the sharp improvement in business activity on the month was driven by services. The improved economic outlook for the euro area was mirrored in the updated Eurosystem staff projections released in June, with the pre-crisis GDP level expected to be reached in Q4 2021. Real GDP growth projection was upwards revised by 0.6pp over the next couple of years to 4.6% in 2021 and 4.7% in 2022, while inflation is expected to increase to 1.9% in 2021 (+0.4pp) amid temporary factors, before pulling back to 1.5% in 2022 (+0.3pp). In view of a still uncertain *economic outlook* and *subdued inflationary pressures,* asset purchases under the PEPP are expected to continue in Q3 at a "significantly higher pace" than in Q1 (~€80bn/month), before the ECB possibly reduces the pace of its asset purchases towards the end of the year when it will probably have a better assessment of the economic and the labor market recovery.

Emerging Economies

BRIC: The multi-speed vaccination rollout and the heterogeneous landscape that is shaped by the different rates of fully vaccinated people among developing economies and the BRIC countries in particular, is at the time of writing one of the key issues in the emerging sphere. As of late June, Russia and Brazil have managed to vaccinate fully only 12% of their people with the percentage being even more disappointing in India, where only ca 5% of the population has been vaccinated. On the flipside, China has attained the goal of immunizing 40% of its people by the end of H1-2021 with 50% of the total jabs globally having so far been administered to the Chinese population. In the above context, and as inflationary pressures surge at global level with the spike being felt more in commodities-based economies (all BRIC economies are heavily dependent on all types of commodities), the foreseeable limitations on the monetary policy maneuvers in the near term, cast a shadow on the economic outlook of Brazil, India and Russia. Adding to the above the transmission of the delta mutation, risks are tilted to the downside for the three aforementioned economies with China marching a different and more favourable economic path.

CESEE: As of late June 2021, the epidemiological situation in many countries of the Central, Eastern and Southeastern Europe (CESEE) improved further compared to one month ago. Motivated by the improvement in the epidemiological situation, amid growing public pressure, these countries' authorities went ahead with further relaxing the stringent health and social distancing measures and restrictions. 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, due to the probability for the region to be confronted with a fourth wave in autumn, if not by summer-end. During the past two months, most countries in the region accelerated their vaccination programs converging to the EU average. 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.

Special Topics

I. Inflation buildup in selected CESEE economies: latest developments & monetary policy response

Since the beginning of 2021, global prices have been on an upward trend, marked by the gradual reopening of the global economy and the uneven dynamics between supply and demand. That said, global inflation has plummeted from 4.2% in February 2020 to 2.0% in January 2021 and spiked thereafter to 4.1% currently. It was inevitable for the economies of the CESEE region not to be affected by the aforementioned development, given the strong trade ties of the developing region with the developed part of Europe. In the following lines we attempt to: i. present the current inflationary landscape in the CESEE region and ii. give a flavor of the near-term monetary policy outlook of the regional economies.

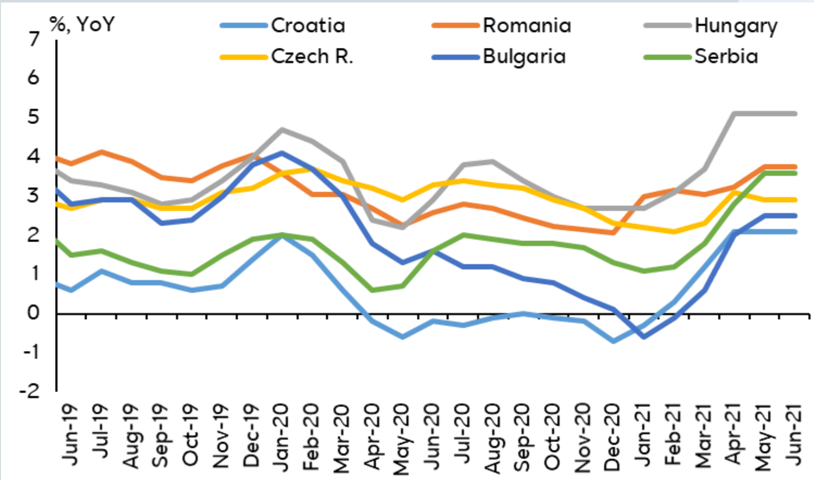
i. <u>Latest inflation developments in specific economies of the region</u>

- **Bulgaria**: From -0.6% YoY in January, inflation spiked to 2.4% YoY in May, which is a 14-month high and now approaches the pre-pandemic price levels. The stable behavior of the core inflation during the pandemic (current print at 1.3% YoY) verifies the impact that the surging oil prices had on the country's inflation since the gradual reopening of the economy in March. The price stability holds an important role for the economic endeavors of the country at this period of time given its recent accession in the ERM II. It is reminded that price stability is one of the five nominal convergence criteria that the economy must fulfil for Euro adoption. According to May's HICP figures in the EA, Bulgaria stands below the inflationary benchmark as its 2.3% YoY HICP rate exceeds the average of Greece, Malta and Portugal plus the buffer of 150bps.
- **Croatia:** On a similar footing, CPI surged to 2.1% YoY in May from negative grounds at the beginning of the year, i.e. -0.3% YoY. Signs of stabilisation are observed compared to April's print and they are attributed to the mutually offsetting impact of the accelerating housing, transport and catering prices coupled with the stronger decrease of clothing and food prices. By assessing the price trajectory since the beginning of the year, the key driver of the prices increase is surging energy prices that have inflated significantly the Producers Price Index (PPI) with the pass-through to the headline figure considered limited so far.
- **Romania:** CPI inflation kept on accelerating in May coming in at 3.8% YoY in May from 3.2% YoY in April and 3.0% in January reaching the highest level since December 2019. The print was above the 3.5% market consensus and it also surpassed the NBR's target interval (2.5% ±1pp). The acceleration was driven by faster price growth in the non-food and food segment, while service prices picked up less significantly. Non-food prices remained the major inflation driver in May, contributing about 74% to the overall index.
- **Serbia**: From 1.1% YoY in January, inflation surged to 3.6% YoY in May, staying within the tolerance band of 3%±1.5pps of the NBS, albeit hiking to June's 2017 highs. Core inflation accelerated to 2.0% YoY in May after staying at 1.8% YoY in the previous three months. The inflationary pressure was felt more in the last month (+3.6% in May from +2.8% in April) with the NBS attributing the fact to temporary factors such as last year's low base of oil product prices as well as higher than usual prices of vegetables during that season. While PPI inflation decelerated to 9.4% YoY in June from 9.9% YoY in May, in H1 producers' prices

increased by 4.7% YoY, when for the entire 2020 industrial prices had kept deflating. Energy prices was the main factor behind the acceleration of PPI inflation in the first half of the year and the trend will likely be preserved.

- **Turkey**: The inflationary landscape in Turkey is a completely different story compared to that in the European CESEE economies, which despite the differences between them, they all have common characteristics in the behavior of prices in general terms. Double-digit headline CPI inflation prints is a usual phenomenon in the last 5 years.

Figure 3: Evident inflationary pressures since the beginning of 2021



Source: National Statistics, Eurobank Research

ii. <u>Central Banks' response</u>

This part aims to describe the monetary policy response so far at a regional level given the increasing price pressures. During the first months of the year, the rebound of energy and food prices on the back of unfavorable base effects from last year's pandemic impact, led headline inflation rates across the region much higher from recent troughs. The stronger than anticipated growth rebound both in the region and globally, the tighter labor markets and the inflation come-back compels Central Banks to reassess their policy options so as for inflation expectations not to be de-anchored. Even though every case is unique, unless there is another supply side shock, our base scenario assumes that the current price adjustment will fade away, but both headline and core inflation across the region are set to remain in the coming months at higher, yet relatively manageable levels, compared to the pre-crisis ones.

The Central Banks of the Central Eastern Europe (CEE) region were the first to initiate the monetary policy tightening cycle. More specifically, during the past month, the Central Banks of Hungary and Czech Republic were the first to hike rates in a demonstration of their willingness to proceed with policy normalization in the aftermath of the pandemic. On the flipside, the Central Banks of Southeastern Europe (SEE region) appear more reluctant to discontinue their accommodative monetary policy stance. The Central Banks of

Serbia and Romania 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 vaccination in both countries. Even though Turkey comes from a different path, the CBRT has also left the key policy rate unchanged in recent months. Finally, the Central Banks of Bulgaria and Croatia follow a supportive policy within their fixed exchange rate regimes. In the following lines we attempt to shed some light on a case by case basis:

- **Czech Republic**: In late June, in line with expectations, the Central Bank (CNB) became the second CEE Central Bank to raise its policy rate by 25bps to 0.50%. This is the first hike since February 2020, when it reached 2.25%. Since the pandemic started in February 2020, the CNB lowered its policy rate by a cumulative 200bps from 2.25%. The move marks the beginning of a period of interest rate normalization. The market discounts that this period will be long and highly dependent on the pandemic developments. According to the CNB Vice Governor, the hike carries a signaling role that the CNB will not tolerate high inflation. The MPC meeting minutes suggest that tightening will continue albeit at a more gradual pace which would depend upon also on the pandemic. The need and the severity of new restrictions imposed will weigh on the Board decision. Currently, the prevailing view is that even if a new pandemic wave takes place, the restrictions will not be as harsh as in the previous waves, given that a higher percentage of population is now inoculated. That said, two more hikes of 25bps are the most probable scenario until year end.
- **Hungary**: The Central Bank of Hungary (MNB) became the first to initiate the tightening cycle in the CEE region. In the MPC held on June 22, the MNB decided to hike the policy rate by 30bps to 0.90% in line with market expectations. In the accompanying press statement, the MPC stressed that inflation risks remained tilted to the upside, monetary tightening aims to prevent the lasting effects of inflation risks and in order to anchor inflation expectations, further tightening will be necessary. Inflation climbed to 5.1% YoY in May, at the highest rate since 2012, and above the MNB's target (3+/-1%) and at the same time core inflation picked up to 3.4% YoY compared to 2.8% YoY in March. The MNB revised its forecasts for GDP growth in 2021 upwards from 5.0% to 6.2% and for inflation from 3.9% to 4.1%
- **Romania**: In order to support the economy, the NBR has cut the benchmark rate by 125bps down to 1.25% since the pandemic started, with the last cut delivered in January 2021. The NBR has so far refrained from starting the tightening cycle even though inflation has now exceeded the upper limit of the inflation target band (2.5+/-1%). Inflation dynamics have surprised to the upside throughout 2021. Thus, NBR revised its end-2021 inflation forecast significantly upwards to 4.1% in its latest inflation report, from 3.4% projected back in March acknowledging that it will miss the target. According to the NBR communication, inflation developments are broadly driven by the temporary factors outside the control of monetary policy, namely the higher energy prices. In addition, core inflation has increased to around 3% but remains at a relatively low level. In addition, the policy rate remains currently the highest in EU-27. That said, the need to adjust rates is not so imminent and NBR buys time to assess the situation more thoroughly. Looking ahead, the rosy growth outlook is highly likely to be accompanied with increased inflationary pressures. Eventually, that will most probably deliver the first hike in Q1-2022. To that end, the NBR Governor Mugur Isarescu has highlighted recently that local interest rates are at historically low levels,

although they are not as low as in other countries in the region due to the twin-current account and fiscal-deficits, which are sizeable by regional standards.

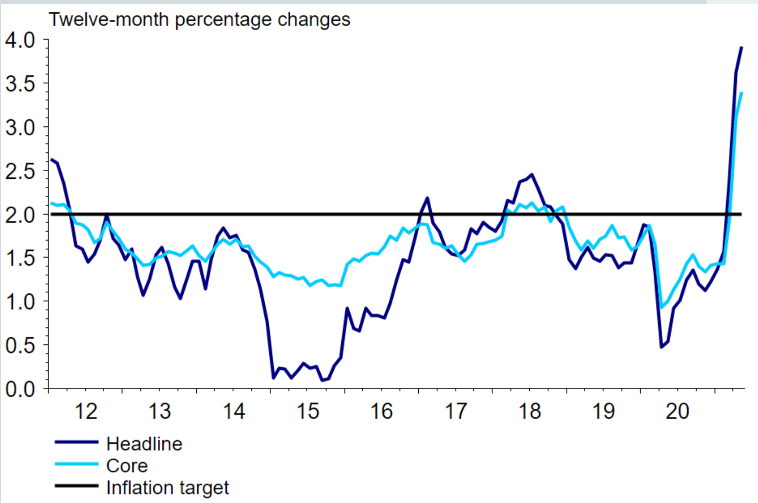
- **Serbia**: The NBS has followed an expansionary monetary policy since early 2019, even before the onset of Covid-19. The onset of the Covid-19 crisis, which substantiated the need to provide additional support to credit and economic activity accelerated the trend. Thus, the NBS delivered a cumulative 300bps of rate cuts in six moves (two of them in 2019 and four of them in 2020 with the last one taking place in November 2020) bringing the key policy rate (KPR) from 3.0% to 1.0%, which is the lowest level since the inception of the inflation targeting regime of the Central Bank. However, year-to-date, inflation has jumped from 1.1% YoY in January - an eight month low – to 3.6% YoY in May, overshooting the 3% target for the first time since April 2019. NBS has stated that May's print is expected to be the peak of this year. As things stand inflation has entered the upper half of the inflation target band, and the real policy rate is in negative territory. Thus, from a rate setting point of view, the trough of the monetary policy easing cycle has most likely been reached. Provided that the epidemiological situation doesn't deteriorate in the H2-2021, the need to provide additional monetary policy stimulus will subside. Moreover, even though the NBS believes that inflation spike is only transitory, risks to the forecast are tilted to the upside thus leaving no room for further rate cuts. To that end, core inflation has only inched up to 2% in May, against 1.8% in February-April in an illustration of low underlying inflationary pressures. On top, inflation expectations remain relatively well–anchored. According to the May survey of NBS, the short & medium-term inflation expectations of the financial and corporate sectors edged up, remaining though within the lower tolerance target band (3±1.5%). The short and medium term inflation expectations of the financial sector climbed to 2.5%, while those of the corporate sector stood a bit lower at the level of 2.0% and 1.7% respectively. As a result, the baseline scenario assumes that the NBS will adopt a wait and see stance until there is more visibility in the post-Covid-19 landscape.
- **Turkey**: The case of Turkey is idiosyncratic from a regional point of view. The economy has been hit by market turmoil instigated by the sudden change of leadership in the Central Bank of Turkey (CBRT) back in the spring. Under the previous leadership, the (CBRT) had hiked its key policy rate (KPR) – the 1-week repo rate – by a cumulative 875bps to 19% between November 2020 -and March 2021 in an attempt to rein in inflation expectations, helping to restore some of its lost credibility. Ever since, the CBRT left its key policy rate (KPR) – the 1-week repo rate – at 19.0% in the last three MPC meetings under the leadership of the recently appointed Governor Sahap Kavcioglu meeting markets' expectations. Despite the wide market concerns for the opposite, the new leadership has pledged not to cut interest rates prematurely and provide clarity and transparency to the markets for its decision making. To that end, high inflation remains a key challenge and obliges the CBRT to remain more cautious and vigilant. Inflation has climbed to 17.5% YoY in June – a two year high – up from 16.6% YoY in May, 17.1% YoY in April, 16.2% YoY in March and 15.6% YoY in February, well above the recently revised year-end target of 12.4% YoY in 2021 and the mid-term target of 5% YoY. In an illustration of the increasing cost-led price pressures, PPI increased further to 42.9% YoY in June up from 38.3% YoY in May and 35.2% YoY in April. On top, upside inflation risks do exist from the food and energy inflation and the continued pass-through from earlier FX depreciation. Provided that the inflation follows the envisaged inflation report path, the door could be opened for limited rate cuts as of Q4-2021.

II. Future inflation trajectory pushes the Fed towards an earlier withdrawal of monetary policy support

As widely expected, the Fed maintained the Fed funds rate target range at 0.00-0.25% and its asset purchase program at the monthly pace of $120bn at its June 15-16 FOMC meeting. Helping to preserve smooth money market conditions and keep the Fed funds rate within the target range by providing a floor under money market rates, the central bank made a technical adjustment to the IOER and Overnight RRP rates, increasing them by 5bp to 5bp and 15bp, respectively. The upward adjustment to the two administered rates actually offsets the downward pressure on short-term rates given that the Treasury general account and the bill supply are shrinking.

Nevertheless, the June FOMC policy meeting was more hawkish than previously expected, with the median FOMC member now anticipating two rate hikes of 25bp each in 2023 (versus zero hikes previously) and 7 out of 18 members signaling at least one rate increase in 2022. The major drivers behind the upgraded 2023 Fed dots are likely the improved US economic and labor market conditions as well as a higher inflation trajectory, with both the April and the May prints surprising to the upside. Indeed, headline CPI rose by 0.6%MoM in May following a sharp increase of 0.8%MoM in April, with the annual rate skyrocketing in May to 5.0%, its highest rate since August 2008. Excluding food and energy prices, May core PCI advanced by 0.7%MoM after a 0.9% increase in April, rising by 3.8%YoY, the highest rate since May 1992. Along these lines, headline PCE advanced by 0.4%MoM in May, bringing the annual rate up to 3.9%YoY from 3.6% in April, while core PCE rose by 0.5% on the month and was up by 3.4% on an annual basis from 3.1%YoY in the prior month (Figure 4). Although the Fed did reiterate that the recent price acceleration is largely attributed to transitory factors, Fed Chair Jerome Powell argued that as the economy gradually reopens, shifts in demand, bottlenecks and hiring difficulties raise the risk that “inflation could turn out to be higher and more persistent than we expect”.

Figure 4: US PCE Inflation



Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

Mirroring a stronger US economic outlook and a higher inflation trajectory in 2021, GDP growth median projection of Federal Reserve Board members and Federal Reserve Bank presidents was upgraded by 0.5pp to 7.0%, while headline and core PCE inflation forecasts were revised significantly upwards, to 3.4% and 3.0% respectively, from 2.4% and 2.2% in March. Looking ahead into the next couple of years, the GDP growth forecast remained unchanged at 3.3% in 2022 and increased modestly by 0.2pp to 2.4% in 2023. On the inflation front, the median FOMC 2022 forecasts for both the headline and core PCE rose by 0.1pp to 2.1%, while in 2023 headline PCE is currently anticipated at 2.2% (from 2.1% in March) and core PCE is expected to remain unchanged at 2.1%. Regarding the labor market, the unemployment rate projections remained broadly stable, with only a modest revision by -0.1pp to 3.8% in 2022 (4.5% in 2021, 3.5% in 2023, Table 1).

Table 1: Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2021

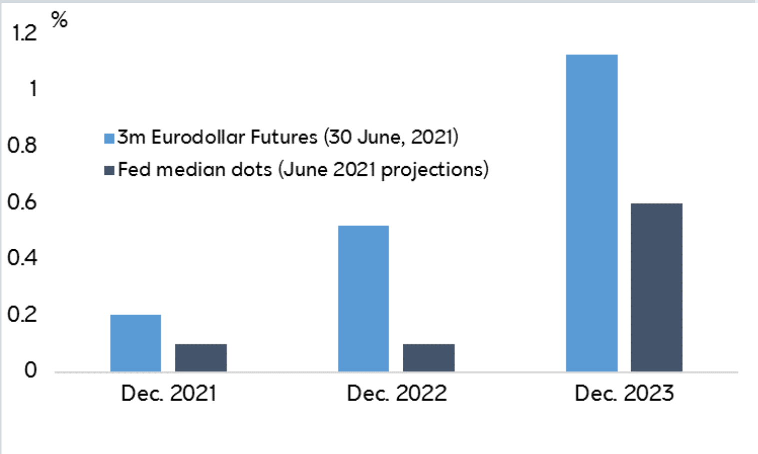
	Median*			
Variable	**2021**	**2022**	**2023**	**Longer run**
Change in real GDP	**7.0**	**3.3**	**2.4**	**1.8**
March projection	6.5	3.3	2.2	1.8
Unemployment rate	**4.5**	**3.8**	**3.5**	**4.0**
March projection	4.5	3.9	3.5	4.0
PCE inflation	**3.4**	**2.1**	**2.2**	**2.0**
March projection	2.4	2.0	2.1	2.0
Core PCE inflation	**3.0**	**2.1**	**2.1**	
March projection	2.2	2.0	2.1	
Fed Funds Rate	**0.1**	**0.1**	**0.6**	**2.5**
March projection	0.1	0.1	0.1	2.5

* For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.
Source: Federal Reserve, Eurobank Research

With a hawkish takeaway from the June FOMC meeting, the Fed seems closer to tapering with incoming data pointing to further progress towards its dual mandate goals of maximum employment and symmetric inflation target around 2%. Trying to soften some of the hawkish Fed's shift, Fed Chair Powell noted that despite the improvement of the economy "we are still a ways from our goal of substantial further progress". Nevertheless, the change in the central bank's tone intensified doubts about whether it will stay committed to the Flexible Average Inflation Targeting (FAIT) framework. Given the major dot plot revision in the face of a virtually unchanged expected inflation trajectory in the medium and longer run (~2%), markets seem skeptical about Fed's credibility regarding its new framework, as the 2021 inflation overshoot seems to have weighed heavily into the Fed's updated median dot plot. The significant fall in market-based inflation expectations (5y/5y forward breakevens) and the nominal curve sharp flattening in the aftermath of the FOMC meeting provided further evidence that the market considers that the Fed may not tolerate higher inflation losing its credibility to keep its inflation target around 2% in the long term.

All told, the Fed's hawkish shift at the June monetary policy meeting has pushed forward taper projections, with the market now anticipating the first rate hike in December 2022 and implying an even faster pace for rate hiking than previously anticipated (Figure 5). We expect the Fed to provide more monetary policy withdrawal signals in the months ahead, possibly at the Jackson Hole Symposium at the end of August or at the 21-22 September FOMC meeting. An official statement could come towards the end of 2021, as the central bank will keep looking through incoming economic data and inflation prints so as to have a thorough knowledge of the progress of the US economy. The tapering process could start in Q1 or Q2 2021, with the risks skewed towards an earlier tapering, should inflation data releases and inflation expectations prove stronger relative to the Committee's current expectations.

Figure 5: Market expectations for rate hikes vs. Fed median dots



Source: Bloomberg, Eurobank Research

Macro Themes & Implications in CESEE

Virus mutations raise concerns for a fourth wave of infections in the region. Sentiment in most countries jumped for the first time above its pre-pandemic levels in June. Central Banks in the CEE region become the first to initiate the tightening cycle.

As of late June 2021, the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE) improved further compared to one month ago. Taking into account the continuous declining trend in Covid-19 infections, hospitalizations and fatalities, it would be fair to say, that the region has weathered the latest wave of infections – the third since the start of the pandemic. Motivated by the improvement in the epidemiological situation, amid growing public pressure, these countries' authorities went ahead with further relaxing the stringent health and social distancing measures and restrictions. This is illustrated in the trajectory of the Stringency Index, a composite measure by Oxford Covid-19 Government Response Tracker (OxCGRT), which records the strictness of government policies. 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, due to the probability for the region to be confronted with a fourth wave in autumn, if not by summer-end.

During the past two months, most countries in the region accelerated their vaccination programs converging to the EU average. 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. Nevertheless, progress is not even among countries. As of late June, Hungary ranked first in the vaccination process having provided at least one dose to 67.1% of its population. The procurement of vaccines from China and Russia made the difference as it helped bypass supply bottlenecks. The Czech Republic and Poland ranked second and third having provided at least one dose to 55.7% and 54.0% of their population respectively. During the previous month, Turkey made impressive progress in its vaccination program doubling the vaccination rate from 19.7% in late May to 40.2% in late June. In contrast, both Bulgaria and Romania disappointed, lagging behind with only 16.3% and 29.6% respectively. On a more alarming note, having missed the target of inoculating 5mn of its population by the end of May, the government of Romania decided to sell the excess stock of vaccines (1.17mn doses) to the government of Denmark.

The June economic sentiment indicators for the region lured market attention in the past week. Having been on a rising trend in Q1-2021, sentiment indicators jumped in the past month, expanding their gains for a third consecutive month. Although the improvement was broad-based, its magnitude in services and retail outpaced that of consumers and industry on a monthly basis. The improvement in the retail and services mirror the upward revision of future demand expectations underpinned by the acceleration of the vaccination program and the lift of the containment measures lift. The acceleration of the vaccination programs in most cases together with the gradual removal of restrictions has lifted the depressed morale of consumers and corporates alike and boosted their optimism for the period ahead.

As things stand, the vast majority of economic sentiment readings across the region have reached their January-February 2020 levels, surpassing their pre-pandemic levels for the first time since the Covid-19 outbreak. In addition, for many countries, economic sentiment stands above their long-term average. However, on average, the pace of improvement is uneven across the CESEE region and more importantly, it still lags behind that of their Euroarea peers. Obviously, these readings send an optimistic signal for the economic outlook, creating strong expectations for the growth readings of Q2. In fact, economic sentiment may be understating the magnitude of the rebound given the favorable base-effects from last year's general lockdowns.

The better than anticipated growth performance in Q1-2021, the upbeat high frequency data announcements in Q2 so far across the board, the improvement of the epidemiological conditions 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. The second GDP estimates of the CESEE region released for Q1-2021 confirmed the flash estimates. These had come out stronger than expected in most cases and on average fared much better than those of the Euroarea (-0.6% QoQ) and the EU-27 (-0.4% QoQ) in Q1-2021. 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 cover more quickly some of the lost ground in 2020. As a result, on average, regional economies could reach their pre-pandemic GDP levels by the end of 2021 instead of in H2-2022 as previously expected. The impact of the RFF funds is expected to be felt on the medium-term prospects.

Finally, the Central Banks of the Central Eastern Europe (CEE) region were the first to initiate the monetary policy tightening cycle. More specifically, during the past month, the Central Banks of Hungary and the Czech Republic were the first to hike rates, demonstrating their willingness to proceed with policy normalization in the aftermath of the pandemic. The stronger than anticipated growth rebound both in the region and globally, the tighter labor markets and the inflation come-back compels the Central Banks to reassess their policy options for inflation expectations not to be de-anchored.

CESEE Markets Developments & Outlook

Bulgaria

Eurobond yields slid across all maturities, with notable drops being registered on the long-end of the curve, namely the 2030 and 2035 papers with 11 and 9 bps decline respectively. Local papers on the other hand, remained unchanged across the entire yield curve. During June, the Ministry of Finance continued to stay on the sidelines by not holding any auctions, as the caretaker government continued to assess the financial standing of the country. The July 11th elections are just around the corner and as polls continue to point to a fragmented parliament, risks related to the short- and medium-term political stability are on the rise.

Serbia

In late June, the National Bank of Serbia (NBS) announced that three RSD-denominated Serbian bonds have been included in the J.P. Morgan GBI-EM Global Diversified index, one of the benchmark indices of bonds issued in local currencies of emerging economies. The Central Bank Governor, Jorgovanka Tabakovic pointed out that the inclusion came as a result of the strengthening of the domestic macroeconomic environment and year-long efforts to develop the local financial market. The three benchmark issues of RSD bonds that will be included in the J.P. Morgan index have residual maturities of 4.5, 6.5 and 11 years, while their weight in the index equals 0.3%.

The aforementioned bonds will be also included in the GBI-Aggregate (GBI-AGG) and the GBI-AGG Diversified indices, which cover government bonds in domestic currencies of both advanced and emerging economies, as well as in the J.P. Morgan ESG (JESG) GBI-EM index, which incorporates ESG factors. After hitting 2021 highs during the first week of June, the yields of the bonds included in the indices have dropped, with the increased demand explaining the drop, especially during the last days of June. The yield drops ranged from 15 to 20 bps, compared to the levels of the previous month. The yields of the 4.5-year, 6.5-year and 11-year bonds declined by 20, 16 and 15 bps, trading currently at 2.30%, 2.54% and 3.40%, respectively.

The inclusion of these bonds in the J.P. Morgan indices had an impact on the FX market as well, with the EUR/RSD pair experiencing appreciation pressures due to FX inflows from international bond investors. The attempt to breach the level of 117.55 was a trigger for the NBS to intervene by buying EUR150mn euros during the last two days of June, which resulted in keeping the pair within the range of 117.55-58.

Markets View

Foreign Exchange

EUR/USD: Recent price action of the pair suggests a change in the uptrend consensus of the euro strengthening against the US dollar, towards the 1.20 level, with the main drivers being the Fed's hawkish talk and remarks that inflation "increased notably in recent months", as well as the recent upbeat US data. We believe the same sentiment of the policy makers to back the tapering of bond purchases will continue at least for the upcoming couple of months and the release of new macro data, with our short-term target level being the 1.1750 and a longer-term at 1.16.

GBP/USD: Further to the Fed signalling of the last meeting and a stronger USD even against the GBP, the extra factor of the challenges against the Delta variant and its potential outburst in the UK, again injects concerns regarding the country's recovery gain momentum. We do not believe that these concerns will soon be smoothed out and we set our short-term level further downwards at 1.36, with an even a more bearish one at 1.35.

Rates

EU: EU rates remained broadly unchanged and moved inside a trading range of 9 bps (low 0.05%, high 0.14%). Curve faced flattening pressures, with 5s-30s trading at 74bps. Looking forward we expect rates to remain at current levels as we enter the summer and the market is balancing between the uncertainty of the pandemic evolution and economic data releases. A potential risk to this view could be a significant rise of the inflation in the Eurozone or a significant move in the US yields.

US: US 10yr swap rates are trading 10bps lower at 1.44% as the market is positioned for higher rates, but the catalyst to push them higher seems to be missing. Interestingly, a hawkish FOMC statement and the repricing of dots by the FED as well as significant beats in economic numbers have failed to push long-term rates higher. Curve flattening was huge, with 5s-30s trading around 77 bps posting a 33bps decline since last month. Looking forward we expect US rates to consolidate at the current levels with a bias towards lower yields, which is the pain trade for the markets, given positioning.

Emerging Markets credit

In June's meeting, the FED appeared more hawkish than expected. However, the US rates quickly reversed the initial move higher and volatility remained around or below historical averages, something that is supportive for EM assets. The EMBI Global Index closed at 312bps, 7bps higher on the month. In CEEMEA, Turkish spreads tightened, while South African spreads ending wider. The latter could diverge from the rest of the CEEMEA curves as the vaccination rate is low and the Covid-19 cases are rising. In Latin America, spreads continued to trade mixed. Banxico hiked the policy rate by 25bp, surprising the market, which was expecting the central bank to hold, while in Brazil the hawkish rhetoric continues. Peru credit finally stabilized after the elections, with investors trying to gather more information about the policy direction of the Castillo administration. EM Asia spreads were little changed. According to our view, EM bonds will remain stable during the summer, as investors remain on the sidelines as risk appetite at this stage is very data dependent.

Corporate credit

EUR IG cash corporate spreads were mildly tighter in June, with spreads on most grades and sectors ending -4/-5bps overall, as supply was generally well accepted and ECB postponed any tapering discussion for well after the summer. CDS Indices spreads were tighter both in IG and HY, mostly in line with cash, hovering around YTD tights. ECB guidance at the June 10 meeting supported credit ahead of summer. Credit moved mostly in line with equites, while rates retracement helped the overall risk on sentiment. Sector-wise, in EUR IG, Financials were -5bps tighter, Real Estate -4.5bps tighter, Oil & Gas -5bps tighter, Health Care -6bps tighter, Telecoms -3.5bps tighter, Industrials -4bps tighter, Consumer Goods -5.5bps tighter, Utilities -3.5bps tighter, Technology -3.5bps tighter and Basic Materials -5.5bps tighter. US IG names spread were also -4/-6bps tighter on the month, with Real Estate +12bps wider making it the underperformer. Financials were -5bps tighter, Oil & Gas -6bps tighter, Health Care -3bps tighter, Telecoms -5.5bps tighter, Industrials -9bps tighter, Consumer Goods -5.5bps tighter, Utilities -3bps tighter, Technology -5.5bps tighter and Basic Materials -8.5bps tighter.

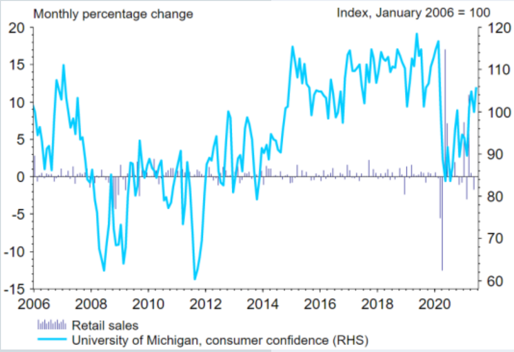
Rating-wise, EUR IG spreads in BBB- was -7bps, in BBB -5bps, in BBB+ -4.5bps, in A- -3.5bps, in A -3.5bps, in A+ -3.5bps, in AA- -3.5bps, in AA -3.5bps and in AA+ -1.5bps wider. In the EUR HY universe CCC was -10bps tighter, B grade was -8 bps tighter, while BB was -11.5bps tighter. Rating-wise in US IG the BBB rating bucket was the outperformer (BBB- -11.5bps, BBB -7bps, BBB+ -5.5), while A was -3.5bps and AA -1.5bps tighter. Technical for cash continues to remain strong both in EUR and US, with supply well received and CBs on strong supportive stance. Given inflation overshooting tolerance by CBs in the short term, we expect spreads to trade range bound during the summer, and possibly moderately widen towards the end of Q3. Sources of widening, apart from idiosyncratic events, are tapering discussions entering a more mature phase, especially in US, and/or persistence of strong inflation data. In the medium-term we expect moderately wider spreads and steeper curves, given the continuation of stronger macro data.

USA

The economic momentum may have peaked in Q2, but underlying growth remains robust

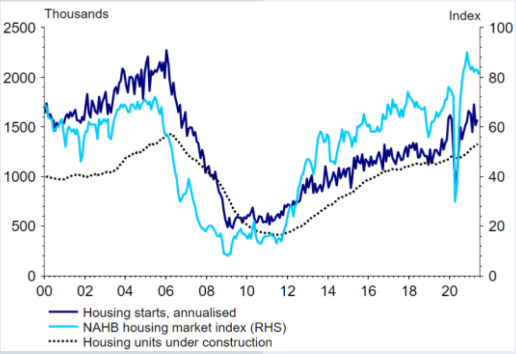
The economic momentum seems to be slowing, suggesting that the US recovery may have peaked in Q2. Retail sales continued to moderate from March's post-pandemic high, falling by 1.3%MoM in May, though still running at relatively elevated levels. Although this softening likely reflects a pullback of sales following March's surge amid the distribution of stimulus checks under the American Rescue Plan Act, upwards revised retail sales in April point to double-digit GDP growth in Q2. Furthermore, industrial production rose by a firm 0.8%MoM in May, but downward revisions to the prior month's reading left the production roughly 1.5% below its pre-crisis level, as supply chain distortions continued to weigh on the manufacturing sector. Looking at the housing sector, housing starts were softer than expected over the past couple of months (+3.6% in May to 1.57mn units), while existing and new home sales declined further in May reflecting higher house prices amid limited inventories. Indeed, the Case-Shiller US house price index rose by 14.6%YoY in April following a 13.3%YoY increase in the prior month, reporting its highest annual pace of growth on record. Meanwhile, ISM surveys point to supply chain distortions as manufacturers try to cope with strenghtening new orders, as well as rising price pressures. Indeed, May headline and core CPI inflation surged to 5.0%YoY (highest since August 2008) and 3.8%YoY (highest since May 1992) respectively, amid base effects, supply bottlenecks and enhanced demand as the economy returns to normalcy. Economic activity should remain robust over the remainder of the year, albeit at a somewhat softer pace compared to Q2, boosted by heightened consumer confidence in view of the excess household savings accumulated during the Covid-19 pandemic (the CB's consumer confidence index skyrocketed in June to 127.3, its highest level since February 2020). On the monetary front, the hawkish pivot at the June FOMC meeting has brought forward taper projections, with the median Fed dot plot projecting two rate hikes of 50bp cumulatively until the end of 2023. The central bank is expected to look into incoming economic data and inflation prints in the following months so as to have a thorough knowledge of the US economic progress before making an official tapering statement towards year-end.

Figure 6: US retail sales and consumer confidence



Source: Refinitiv Datastream, Fathom Consulting

Figure 7: US housing market



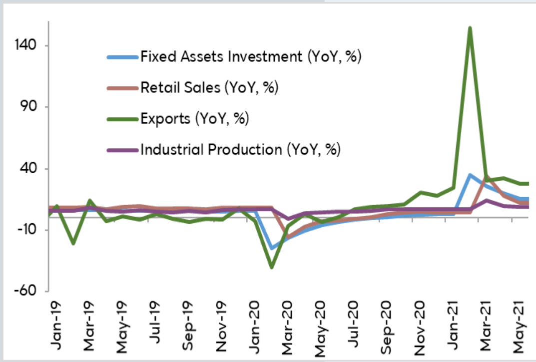
Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

China

Soft and hard data point to some cooling of the economy in Q1-2021, but ambitious vaccination roll out spurs the flame for further demand pick up in H2-2021

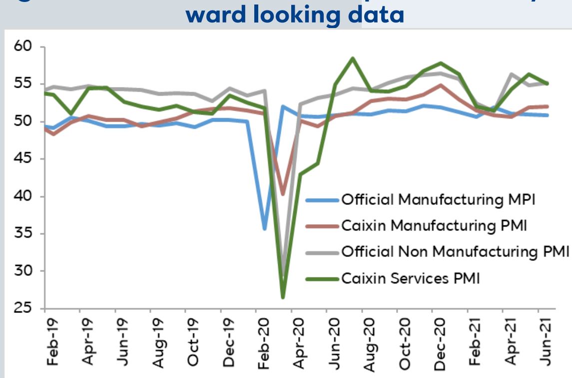
The economic hard data of May released in June point to some cooling of the economy in Q2-2021 while the same is implied for Q3 by forward looking data such as the official and Caixin PMIs. Industrial production on a yearly basis has passed on an easing trend since March as the low base effects from last year's Q1 have evaporated. On a similar footing, retail sales, through the proxies reflecting the supply and the demand side of the economy in May, were below market expectations. While manufacturing PMIs in June were firm, those measuring services, both the official and the Caixin, weakened (the Caixin more visibly) implying that the peak of the growth trajectory could be behind us and that the economy is entering a plateauing phase. A game changer that could re-spur demand in the near term is the galloping rate of the vaccination roll out in the country. In fact, more than 1bn doses of Covid-19 vaccines had been administered in China by the end of June, marking a milestone for the country in its effort to vaccinate at least 70% of its eligible population and achieve herd immunity by the end of the year. The figure is the highest for a single country and accounts for 40% of the 2.5bn doses administered globally. Returning to the PMIs, specific sub-indices of the Caixin services PMI point to an easing of inflationary pressures despite the fact that producers prices keep galloping since April 2020, approaching 2008 highs. Although the PPI inflation pass through to the headline is limited, capacity constraints and supply chain disruptions emerge as determinants of the pressure on the production side prices. Assuming that the current vigorous pace of vaccination is maintained and domestic demand picks up further by the end of the year, a mismatch between supply and demand dynamics in the economy could reappear.

Figure 8: May's hard data point to some cooling of the economy in Q2-2021



Source: Bloomberg, Eurobank Research

Figure 9:... while the same is implied for Q3 by forward looking data



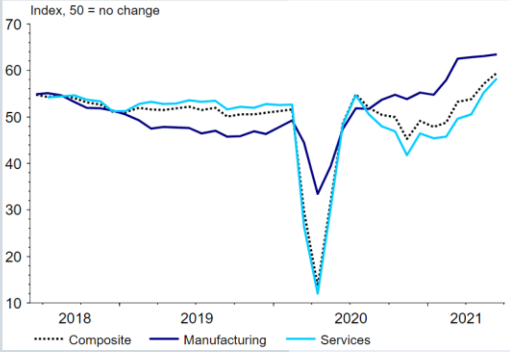
Source: Bloomberg, Eurobank Research

Euro area

Improved near-term economic prospects amid rising confidence

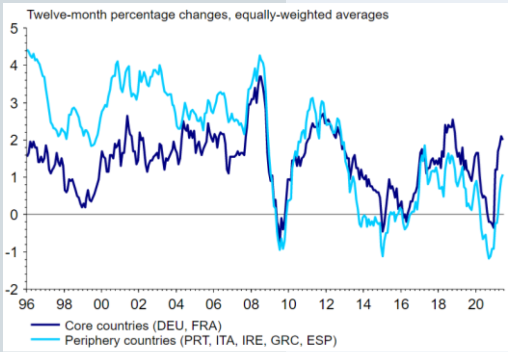
Business activity in the euro area accelerated in June at its fastest pace since mid-2006 as the economy continued to reopen from pandemic-related restrictions and the vaccination progress led to improved business sentiment. The Flash Markit Composite PMI surged to a 15-year high of 59.5 in June from 57.1 in May, with further demand gains and new order growth rising at their fastest rate since June 2006. The manufacturing sector continued to lead the recovery reporting stronger growth pace, with the Manufacturing PMI rising by 0.3pts to a new record high of 63.4. Nevertheless, the sharp improvement in business activity on the month was driven by the Services PMI that accelerated by 3.1pts to a 41-month high of 58.3. Along the same lines, the Services confidence indicator outperformed the respective industrial, consumer, retail and construction indicators for the fourth month in a row in June (+6.6pt to 17.9), pushing the EC ESI up by a hefty 3.4pts to a 21-year high of 117.9. On the inflation front, headline HICP moderated marginally to 1.9%YoY in June from 2.0%YoY in May, amid fading energy base effects, while core inflation also softened slightly to 0.9%YoY from 1.0%YoY in the prior month, as technical effects pushed down services inflation offsetting the increase in core goods prices amid rising costs that were likely passed on to consumers. The improved economic outlook for the euro area was mirrored in the updated Eurosystem staff projections released in June, with the pre-crisis GDP level expected to be reached in Q4 2021. The real GDP growth projection was upwards revised by 0.6pp over the next couple of years to 4.6% in 2021 and 4.7% in 2022, while inflation is expected to increase to 1.9% in 2021 (+0.4pp) due to temporary factors (German VAT rate cut reversal, rising energy prices due to base effects, supply disruptions), before pulling back to 1.5% in 2022 (+0.3pp). Despite the upgraded economic prospects, ECB President Christine Lagarde noted that the *economic outlook* is still *uncertain* and that *inflationary pressures* remain *subdued* and far from the ECB's target amid still significant economic slack. Hence, PEPP purchases in Q3 are expected to continue at a "significantly higher pace" than in Q1 (~€80bn/month) as in Q2, before the ECB possibly reduces the pace of its asset purchases towards the end of the year, when it will probably have a better assessment of the economic and the labor market recovery.

Figure 10: Flash Composite PMI surges to a 15-year high in June



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

Figure 11: Euro area HICP inflation



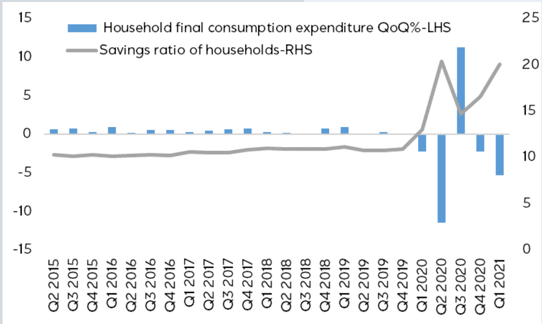
Source: Refinitiv Datastream, Fathom Consulting

Germany

The gradual reopening sets the stage for a return of Q2 GDP to positive growth

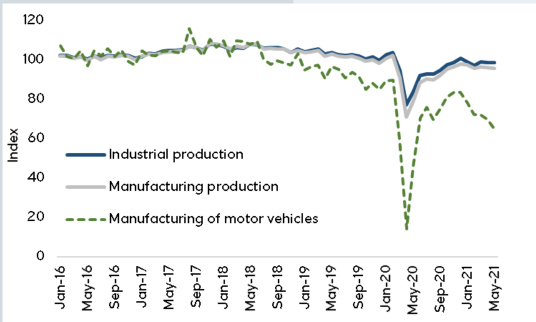
A prolonged national lockdown and the re-hike of the VAT rate in January, were the main drivers behind the 5.4%QoQ decline in private consumption in Q1, which led to a 1.8%QoQ GDP contraction. However, after the sharp drop in new Covid-19 cases in May that allowed a broad reopening of the economy and a significant rebound in services activity and retail, expectations are for a return of GDP to positive growth in Q2. Supporting the above, retail sales rose by 4.2%MoM in May, partially offsetting April's 6.8%MoM drop, while additional gains are expected in June after a further decline in new cases to the lowest level seen last summer allowed the further relaxation of measures in retail shops, such as strict appointments for going to a shop. In addition, the Composite PMI rose by 3.9pts in June to a near decade high of 60.1, mainly driven by an increase in services (+4.7pts, to 57.5), while the IFO business climate index rose strongly in June, climbing above the 100pts threshold and returning to optimism for the first time since April 2019 (+2.6pts to 101.8), on the back of a hefty improvement in the trade and services sectors, as these benefited the most from the recent lifting of the lockdown measures. After the summer, we expect the economy to rebound more strongly as pent up demand will be increasingly unloading (savings ratio of private households stood at 20.1% of disposable income in Q1, double its long-term average of ca. 10%) and herd immunity will be approaching given that the largest part of the adult population will have been fully vaccinated by then. Should this be the case, full year GDP could reach 3.4%, with downside risks mainly stemming from the highly infectious Delta variant, which has raised worries over another wave of infections in the autumn and global supply chain distortions, which have severely affected the recovery in the export-oriented manufacturing sector. The biggest concern is on auto production which fell in May for the fifth consecutive month (-7.2%MoM) standing 28% below the Feb. 2020 pre-pandemic level, mostly due to the chip shortage. On politics, the CDU/CSU has overtaken the Greens in all national polls in recent weeks, which, if sustained, would reduce the likelihood of a Green-led government after the 26 September federal election.

Figure 12: Excess savings could boost post-pandemic household consumption



Source: Federal Statistical Office, Eurobank Research

Figure 13: Chip shortage keeps vehicle production below pre-pandemic levels



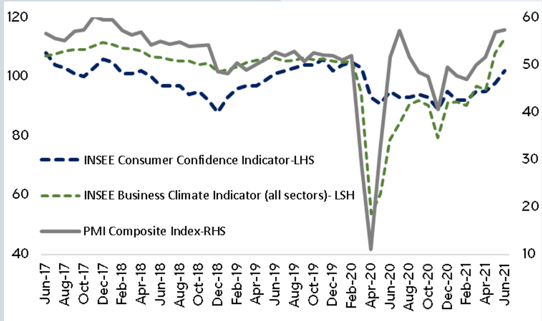
Source: Federal Statistical Office, Eurobank Research

France

Sentiment indicators point to a shift of GDP to positive growth in Q2

Sentiment indicators pertaining to Q2 continued to surprise to the upside in recent weeks after the on-going improvement in the country's Covid-19 epidemiological situation, giving the government confidence to proceed in mid-May with the second step of its four-phase lockdown exit plan and rein-forcing optimism for a shift of GDP growth to positive territory after the economy contracted in Q1 for the second consecutive quarter. Following May's 12.3pts gain, the INSEE business climate indicator rose by a further 5pts in June to 113.0, the highest level since July 2007, exceeding the Jan-Feb 2020 pre-pandemic average of 105 for the second consec-utive month, with all three sectors recording meaningful gains as the economy reopens. Along these lines, the June composite PMI rose by 0.4pts to 57.4, averaging 55.3 in Q2, an increase of 7.1pts vs. Q1, while the INSEE confidence indicator rose by 4ppts to a 15-month high of 102 in June, above the historical average of 100 for the first time since March 2020. As a result, we expect GDP growth at around 0.4%QoQ in Q2, while a further acceleration in Q3 is anticipated after the steady decline in new cases allowing the govern-ment to proceed with further easing in restrictions in mid-June (including the lifting of the nighttime cur-few), that could lead to a GDP gain of 5.8% for the whole year, barring another pandemic wave. On poli-tics, amid a record low turnout at the regional elections held on 20 and 27 June – the last elections before next April's presidential contest– President Emmanuel Macron's party LREM disappointed relative to polls, reaching around 10% of the vote nationally (c. 3pp lower than polls). Le Pen's National Rally (RN) also performed poorly as the party's candidates lost by a decisive margin in all regions where they reached the second round, in contrast with opinion polls published ahead of the first round, which suggested that the party could win control of at least one region for the first time ever. On the other side, mainstream parties, The Republicans and the Socialist Party, performed strongly, maintaining power in all the regions they held. In spite of the poor performance of Macron's and Le Pen's parties, recent opinion polls suggest that the two politicians would reach the second round of the presidential election next year, with the former likely to win by a tighter margin though than in the 2017 election.

Figure 14: Sentiment indicators point to positive GDP growth in Q2



Source: iNSEE, Eurobank Research

Table 2: Poor performance of Macron's and Le Pen's parties in regional elections

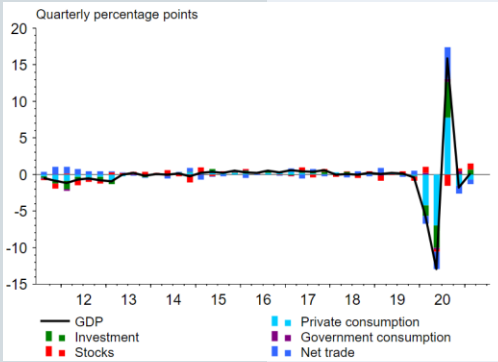
Parties winning regions	2015	2021
Left & centre left (including the Socialist Party)	5	7
Centre (including Macron's party LREM)	2	1
Centre-right & right (including The Republicans)	8	7
Regional parties	2	2
Far right (including Le Pen's RN)	0	0
Total	17	17

Source: French government, Eurobank Research

Italy

The upward revision in Q1 GDP leads to a more optimistic economic outlook

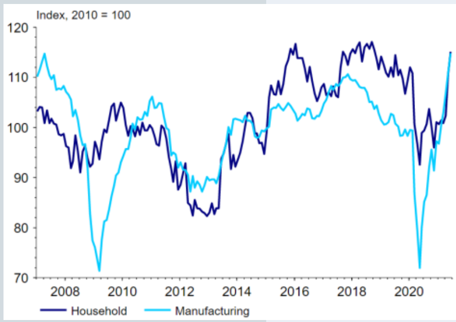
Figure 15: Italy contributions to GDP growth



Source: Refinitiv Datastream, Fathom Consulting

The Italian Q1 GDP growth was upwards revised from a negative print of -0.4%QoQ to a slightly positive rate of +0.1%QoQ, following a drop of -1.8%QoQ in Q4 2020, on the back of a better than expected gross fixed capital formation (+3.7%QoQ from +0.4%QoQ in the prior quarter) and a positive contribution from inventory accumulation (+0.6pp from +0.4pp in Q4 2020). In the face of another Covid-19 wave that led to renewed restrictive measures to contain the spread of the virus, real personal consumption remained restricted falling for the second consecutive quarter by -1.2%QoQ following a -2.7%QoQ fall in the prior quarter, while net trade subtracted -0.4pp from overall GDP after -1.0pp in Q4 2020. With the Italian economy having avoided a technical recession, high frequency indicators provide further evidence for a robust momentum in Q2. Industrial production advanced by 1.8%MoM in April after an increase of 0.3%MoM in March, while in June the manufacturing PMI remained close to May's record high (62.2 from 62.3 in May) amid a rapid expansion of both new orders and output. Meanwhile, confidence among households and businesses continued to improve, with the Istat's consumer confidence indicator surging in June to 115.1 from 110.6 in the prior month, the highest level since October 2018. On a positive tone, the composite business confidence indicator (IESI) increased in June for a 7th month in a row to a 14-year high of 112.8 from 107.3 in May, while the EC Economic Sentiment Indicator (ESI) rose by 2.1pts to 117.9 in the same month, its highest level since August 2000 on broad-based strength across sectors (except for the construction confidence indicator), with services outperforming. Following the significant upward revision in Q1, the Italian Statistical Agency raised its 2021 GDP growth forecast to 4.7% (from 4.0% in December), expected to decelerate to 4.4% in 2022. Domestic demand is expected to be the main growth driver compared to net trade, which is projected to provide only a slight positive contribution. In line with the recent upgraded economic forecasts by the Italian government, we have revised upwards our 2021 GDP growth projection to 5.0% from 4.2% previously. The economic recovery should be supported by expansionary fiscal policy following the formal approval of Italy's recovery and resilience plan of €191.5bn (€122.6bn loans, €68.9bn grants).

Figure 16: Italy consumer and business confidence



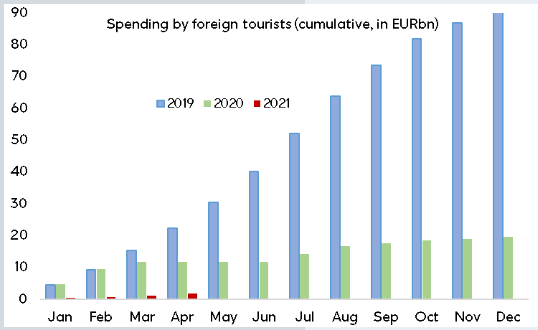
Source: Refinitiv Datastream, Fathom Consulting

Spain

On the road for a near-term economic rebound

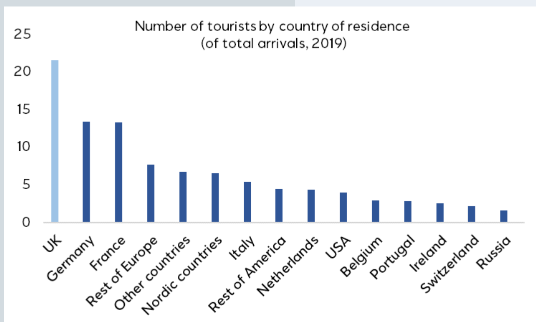
After a 0.4%QoQ contraction in Q1 GDP which left output around 10pp below pre-Covid levels - much lower compared to the other major EA economies - high frequency data and sentiment indicators pertaining to Q2 suggest that the Spanish economy is poised for a sharp rebound, supported by the intensified pace of vaccinations that opened the way for a gradual easing of coronavirus-induced restrictions (as of 1 July, 38% of the population has been fully vaccinated), with the state of emergency and the travel ban within regions lifted in early May. In support of the above, IP started Q2 strongly with a 1.2%MoM rise in April following May's 0.6%MoM gain, the EC consumer confidence rose by 0.9pts to 103.6 in June, approaching March's more than one-year peak of 104.9, while the Composite PMI rose in June for the fifth consecutive month to 62.4, the highest pace of expansion since February 2000, reflecting stronger growth in both the manufacturing and the services sectors amid easing restrictions. Against this background, Q2 GDP is seen rebounding by ca. 1.5%QoQ before gaining further momentum, exceeding 2.5%QoQ in Q3 when herd immunity will likely have been achieved, while risks are for a higher pace of growth if international tourists return to Spain at the peak of the summer tourism season. Spain relies heavily on tourism, which is among the sectors most gravely hit by the pandemic, accounting for 14.6% of GDP, both directly and indirectly, a share much higher than the 6.9% average of the other three major EA economies. Undoubtedly, the EU Digital Green Certificate should revive tourism within the region but does not cover the UK, which is Spain's single biggest tourism market. Spain does not require that visitors from the UK be tested, but so far, the UK keeps Spain on the list of amber countries, for which quarantine is required upon return, discouraging British tourists from visiting the country. Meanwhile, the European Commission approved the country's recovery plan, with the disbursement of the first tranche of funds amounting to €19bn (or 1.6% of GDP) expected in July, a bigger disbursement relative to the 13% pre-financing available within the Recovery and Resilience Facility. For the full year, we project GDP to reach 5.8%, against the Bank of Spain's more optimistic view for a growth rate of 6.2%.

Figure 17: Foreign tourism expenditure have plunged by 83.3%YoY in Jan.-Apr. 2021



Source: Spanish Statistical Office (INE), Eurobank Research

Figure 18: The UK is Spain's single biggest tourism market



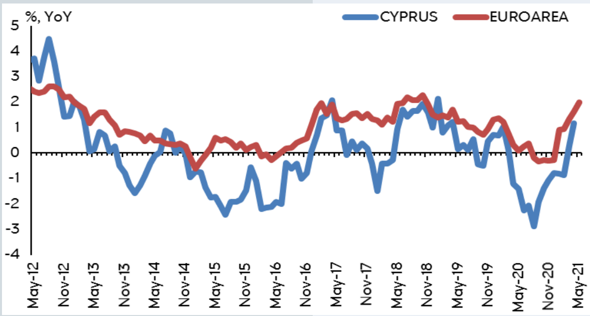
Source: Spanish Statistical Office (INE), Eurobank Research

Cyprus

Parliamentary election results pose no risk to policy continuity

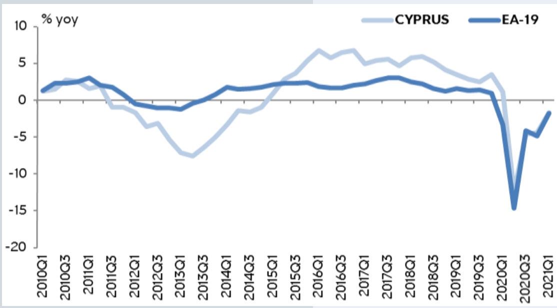
In the parliamentary elections held in late May, the parliament that emerged was more fragmented than previously, with all three major political parties having suffered electoral losses. Even though fewer parties are represented in the new parliament, smaller ones managed to win two seats more than in the previous one. The ruling right-wing party DHSY received 27.8% of the vote (17 seats), the main opposition left-wing party AKEL 22.3% (15 seats), and DHKO 11.3% (9 seats). Other four smaller parties, the far right-wing ELAM: 6.8% (4 seats), EDEK: 6.7% (4 seats), DEPA: 6.1% (4 seats) and the Green Party: 4.4% (2 seats) were allocated a total of 14 seats. The ruling DHSY party gained the first place but for one more time not the majority in MPs while neither of the two major opposition parties (AKEL and DIKO) managed to capitalize on the discontent for the golden passports scandal. In principle, the parliamentary election results are not a game changer as the system of the Republic is presidential. Policy continuity is not at risk, however, the efficiency of the government cabinet will depend on the ability of the ruling DHSY party to form alliances with four smaller parties to pass legislation in the parliament. This is critical given that a number of structural reforms are deemed as prerequisites for Cyprus to tap the EC's Recovery and Resilience Facility (RRF) funds. The absorption of the RRF funds is going to be pivotal for the medium-term economic prospects. The effect is expected to be felt mostly from 2022 onwards taking into account the time needed for some of the projects to mature. The Cypriot plan provides for a total of €1.2bn, which breaks down into €1bn in grants and €0.2 bn. in loans, with the MoF estimating that these resources will mobilize an additional €1.4bn in private funds, while investments and reforms will raise GDP by 7% cumulatively in the period 2022- 2026. Meanwhile, according to the revised estimate, GDP on a seasonally adjusted basis expanded by +2.0% QoQ in Q1-2021, the second highest pace in EA-19, up from +1.1% QoQ in Q4-2020. The latter translates into -1.6% YoY in Q1-2021, up from -4.4% YoY in Q4-2020, -4.6% YoY in Q3-2020 and -12.5% YoY in Q2. The acceleration of the vaccination program and the improvement of the weather conditions led to further improvement in the Covid-19 related metrics in June. The latest ECDC data show that 60.5% of the population vs. 54.8% in EU/EEA has received at least the first vaccine dose and 41.6% has been fully vaccinated.

Figure 19: HICP inflation in positive territory since March 2021



Source: Eurostat, Eurobank Research

Figure 20: The economy registered its lowest recession reading on an annual basis in Q1-2021 since the beginning of the pandemic



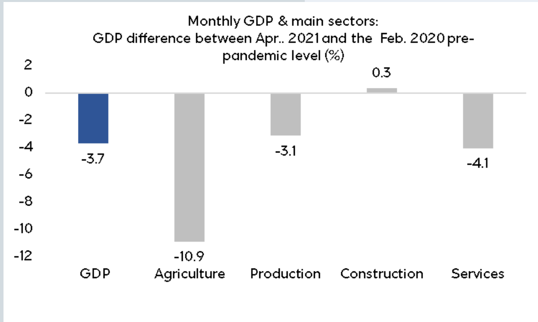
Source: Eurostat, Eurobank Research

UK

4-weeks delay in the final stage of easing, unlikely to be economically significant

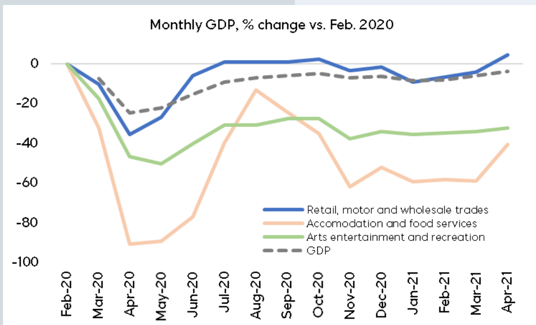
After a lower-than-expected 1.5%QoQ GDP contraction in Q1 when the country was in the third national lockdown, economic activity rebounded strongly in April, leaving output 3.7% below the Feb. 2020 pre-pandemic level. GDP expanded by 2.6%MoM, the largest growth rate since July 2020, following the second major easing of lock-down restrictions on the 12th of the month. The main growth driver was services (+3.4%MoM), with retail spending, accommodation and food & beverages services leading the recovery. This was partially offset by an unexpected drop in IP (-1.3%MoM) on the back of a hefty fall in mining output (-15.0%MoM) due to the temporary closure of oil fields for maintenance, while manufacturing also printed negatively (-0.3%MoM), probably affected by supply chain disruptions. Construction also surprised negatively (-2.0%MoM) following large gains in the previous two months. Timelier data (including May's retail sales and June PMIs) suggest that economic recovery continued in May and June, albeit at a slightly lower pace as the economy moves closer to normal, with Q2 GDP growth seen at around 5.5%QoQ, in line with the BoE's latest forecast, following exceptional strength in April. Overall, we expect the economy to rebound vigorously this year, favored by the fast pace of vaccinations and supportive monetary and fiscal policy (the Spring Budget 2021 revealed fiscal measures worth £529bn this year or 2.8% of GDP), with GDP printing 6.7%, upwards revised from 6.2% previously, amid expectations for stronger than earlier projected H1 GDP growth. The government's decision to delay the final stage of easing lockdown restrictions by four weeks to July 19 after the recent surge in Covid-19 cases due to the more transmissible Delta strain, is unlikely to have a material economic impact as big restrictions have already been eased and confidence has already recovered significantly. The prospect of a vigorous GDP growth rebound this year should provide sufficient reassurance to the BoE to end asset purchases once the existing QE target of £845bn has been met. However, any BoE rate tightening is still some way off due to the still elevated level of uncertainty linked to the ongoing pandemic, the nature of above target inflation, and the labor market outlook once the Job Retention Scheme phases out in September.

Figure 21: Strong April rebound left GDP 3.7% below pre-pandemic levels



Source: Office for National Statistics (ONS), Eurobank Research

Figure 22: Consumer-facing services were the main drivers behind April GDP rebound



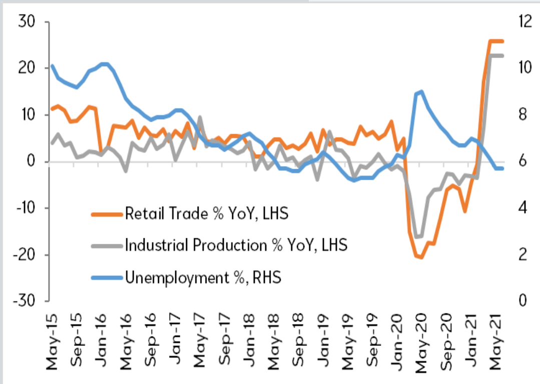
Source: Office for National Statistics (ONS), Eurobank Research

Bulgaria

Lingering political uncertainty casts shadows on the outlook, despite the solid economic performance

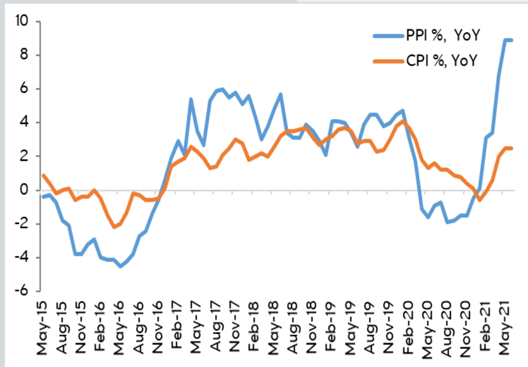
The detailed breakdown of Q1-2021 GDP's national accounts verified May's flash estimate according to which GDP rose by +2.5% QoQ, picking up from the +2.2% QoQ print in the previous quarter. On an annual basis, the GDP contracted by -1.8% YoY, which is milder than the -3.8% YoY contraction in Q4. Apparently, the less stringent measures during the 3rd wave of the pandemic supported the economy in Q1-2021; private consumption contributed significantly in containing the recession, broadly driven by negative net exports amid subdued external demand from the EU. The economic activity appears to have gained further steam in Q2-2022 according to recent high frequency data; Retail sales surged further by 25.9% YoY in April, from 17.3% YoY in March. Additionally, industrial output soared by 22.8% YoY in April, accelerating from 7.2% YoY in the previous month while May's unemployment official data point to a recovering labor market since the outbreak of the pandemic. The registered unemployment came in at 5.7% in May, falling by 0.4pps and 3.3pps on a monthly and annual basis respectively, reaching the lowest level since October 2019. The economic rebound is evident from developments in the monetary front as well; May's inflation print demonstrated that pressures have been building up since the beginning of the year. Inflation accelerated to 2.5% YoY in May, from 2.0% YoY and 0.6% YoY in April and March respectively, while in the first two months of the year, CPI stood in negative grounds close to zero. Despite the overall positive sentiment over the economy for the remainder of the year, the lingering political uncertainty discourages us from revising our forecast for 2021, thus we keep it unchanged at 3.5% and focus on the outcome of the upcoming elections on July 11. Another point of concern that prevents us from revising upwards our 2021 forecast is the low rate of vaccination with the delta mutation spread standing ante portas. Unless a drastic change materializes on the respective front, the second half of the year and most probably the last quarter could prove disruptive for the envisaged GDP growth rebound.

Figure 23: Both supply and demand recovery firm the labour market



Source: Bloomberg, Eurobank Research

Figure 24: while the recovery is felt in the monetary sphere as well



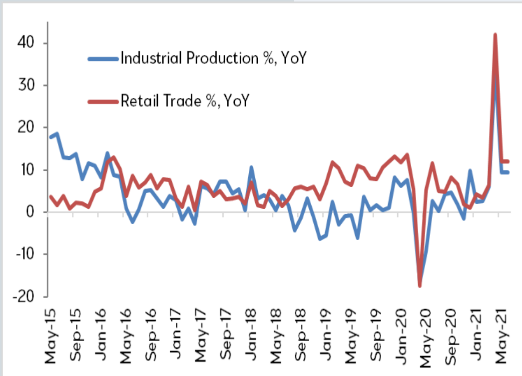
Source: Bloomberg Eurobank Research

Serbia

The lack of further progress in the vaccination program undermines the continuity of the solid GDP growth momentum

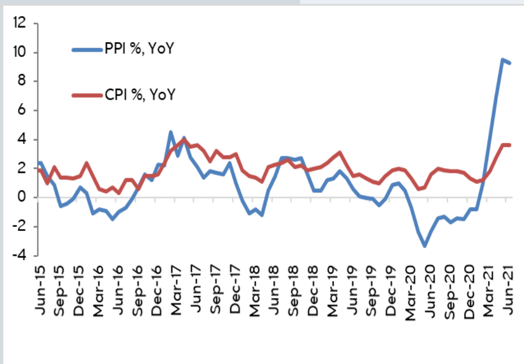
June was a month filled with a plethora of positive economic developments in the country. The detailed Q1-2021 GDP print surprised positively as it came in at 1.7% YoY, i.e. 0.5ppt higher compared to the flash estimate of 1.2% in early May. Investments and net exports jointly wiped out negative contribution from public spending and private consumption, emerging as the key growth drivers of the past semester. Taking into account the solid economic growth momentum and the fact that Q2-2020 was the worst quarter in terms of GDP performance in the past year (-6.2% YoY), officials' expectations over a double digit GDP growth print for Q2-2021 seem within reach and set the ground for a strong GDP growth performance. Recent reports by IFIs this month, i.e. namely the World Bank, the EBRD and the IMF, having taken into account, inter alia, the above rationale, end up with a 6.0% GDP growth forecast for 2021, which is among the strongest in the region, along with Croatia, Romania and Hungary. It is worth mentioning that the latter three economies face tailwinds regarding their 2021 economic growth outlook from low base effects of the previous year while Serbia managed to contain FY's recession to -1.0% due to its more diversified economic structure combined with large government aid packages and less restrictive lockdown measures for most of the year. In view of the above, we revise our forecast to 5.5% from 5.0% for 2021 and to 4.5% from 4.0% for 2022 and we ground our more prudent stance compared to the 6.0% forecast of the government and the aforementioned IFIs on the loss of steam in the vaccination progress in the past month, that coincides with the appearance of the delta variant in the country. While Serbia kicked off the vaccination roll out very ambitiously, the percentage of people administered with at least one dose in the country has remained stable overtime, jeopardizing the 'quasi' pre-Covid normality under which the economy has been operating in the last quarter and which is broadly factored in the prevailing base scenario.

Figure 25: Hard data from both the demand and supply side point to solid economic momentum



Source: Bloomberg, Eurobank Research

Figure 26: while the inflationary pressures on the supply side show limited pass through so far to the headline inflation



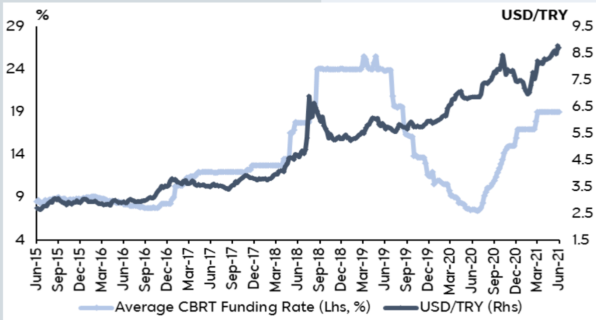
Source: Bloomberg Eurobank Research

Turkey

GDP growth is expected to overshoot in 2021

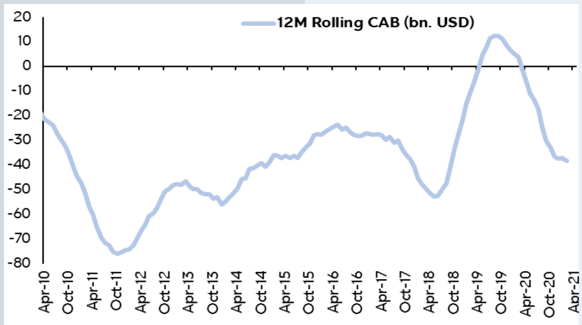
GDP performance surprised to the upside in Q1-2021. On a seasonally and calendar adjusted basis, GDP expanded by 1.7% QoQ for a second consecutive quarter, albeit slowing from 15.9% QoQ in Q3-2020 and compared to -11.0% QoQ in Q2-2020. On an annual basis, GDP expanded by 7.3% YoY in Q1-2021 up from 5.8% YoY in Q4-2020 and 4.1% YoY in Q1-2020. Consumption, both private and public, was the main contributor to GDP growth, investments remained on a recovery trend, while net exports' contribution turned positive after five quarters. Private consumption (7.4% YoY, 4.4ppts) remained strong driven by high demand for durable and semi-durable goods. Public consumption (1.3% YoY, 0.9ppts) remained supportive but less compared to previous quarters mirroring the slowdown in fiscal expansion. Gross fixed capital formation (11.4% YoY, 4.4pts) registered a double digit expansion rate for a third consecutive quarter driven by the companies' investment in machinery & equipment. Having been supportive for some quarters, inventories building (-1.5ppts) weighed on growth performance. Finally, net exports contributed 1.1ppts to the print, mirroring the combined effect of exports rebound by 3.3% YoY (up from -1.8% YoY in Q1-2020) as a result of stronger export markets and the decline of imports by -1.1% YoY in Q1 (down from +21.4% YoY in Q1-2020). High-frequency indicators (sentiment and PMI) trajectory reflect a deteriorating course on a sequential basis in Q2-2021. The reinstatement of restrictions together with the renewed lira depreciation pressures stemming from the turmoil caused by the replacement of the CBRT Governor and the slowdown in bank sentiment are expected to weigh on economic activity. Overall, even though downside risks to the growth outlook in the H2 do exist, GDP growth is expected to overshoot in 2021. According to the latest IMF Article IV Consultation, GDP is forecasted to rebound by 5.8% in 2021 and settle back to trend growth of 3.3% in 2022. The rebound reflects a large positive carryover from the sharp activity rebound in H2-2020. Turkey was among the few economies in the world to avoid a recession in 2020 expanding by 1.9%. The expansion was driven by large credit provision by state-owned banks and extensive liquidity support at the expense of exacerbating pre-pandemic vulnerabilities such as high inflation, low FX reserves, large external financing needs, and dollarization.

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	-3.3	6.0	4.5	3.2	3.3	3.0									
Advanced Economies															
USA	-3.5	7.0	4.0	1.2	3.5	2.5	8.1	5.5	4.2	-3.1	-3.7	-3.5	-15.8	-14.6	-6.5
Eurozone	-6.5	4.6	4.3	0.3	1.9	1.4	7.9	8.3	8.0	2.3	2.6	2.5	-7.7	-7.0	-4.2
Germany	-4.8	3.4	4.6	0.4	2.5	1.6	4.2	4.4	4.3	7.1	7.2	6.8	-4.2	-6.0	-2.4
France	-8.0	5.8	4.1	0.5	1.6	1.4	8.0	8.4	8.5	-1.9	-1.4	-1.2	-9.2	-8.5	-5.2
Periphery															
Cyprus	-5.1	4.5	4.0	-1.1	1.0	1.5	7.8	7.2	6.5	-11.4	-10.0	-8.0	-5.7	-3.5	-2.5
Italy	-8.9	5.0	4.2	-0.1	1.3	1.1	9.3	10.4	10.0	3.5	3.8	3.5	-9.5	-11.5	-6.0
Spain	-10.8	5.8	5.6	-0.3	1.8	1.4	15.6	15.8	15.0	0.7	1.7	1.9	-11.2	-8.6	-4.9
Portugal	-7.6	4.2	4.8	-0.1	0.9	1.3	6.8	7.0	6.4	-1.3	-0.5	-0.5	-5.7	-5.0	-3.5
UK	-9.8	6.7	5.5	0.9	2.0	2.1	4.5	5.0	5.2	-3.5	-3.6	-3.8	-12.4	-8.8	-4.8
Japan	-4.7	2.6	2.4	0.0	0.1	0.6	2.8	3.0	2.8	3.3	3.5	3.3	-12.6	-9.5	-5.5
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	6.0	5.0	2.3	3.5	3.0	5.0	5.3	4.8	-5.0	-5.5	-5.2	-9.0	-8.0	-4.0
Serbia	-1.0	5.5	4.5	1.4	2.0	2.3	13.4	9.1	8.2	-6.4	-5.6	-5.5	-8.0	-6.9	-2.5
Turkey	1.8	6.0	4.0	12.3	16.0	12.5	13.2	12.5	12.0	-5.1	-3.5	-2.5	-4.5	-4.0	-3.5

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

Eurobank

Eurobank Research

Eurobank Fixed Income Forecasts

	Current	September 2021	December 2021	March 2022	June 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	0.10%	0.17%	0.19%	0.20%	0.23%
3m Libor	0.14%	0.22%	0.25%	0.27%	0.30%
2yr Notes	0.24%	0.25%	0.31%	0.38%	0.46%
10 yr Bonds	1.44%	1.79%	1.88%	1.95%	2.02%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.54%	-0.52%	-0.51%	-0.50%	-0.48%
2yr Bunds	-0.66%	-0.64%	-0.63%	-0.61%	-0.59%
10yr Bunds	-0.20%	-0.13%	-0.04%	-0.40%	0.01%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.10%	0.10%
3m	0.08%	0.11%	0.12%	0.10%	0.11%
10-yr Gilt	0.71%	0.93%	0.99%	1.03%	1.10%
Switzerland					
3m Libor Target	-0.75%	-0.74%	-0.74%	-0.74%	-0.74%
10-yr Bond	-0.24%	-0.10%	-0.70%	-0.02%	0.01%

Source: Bloomberg (market implied forecasts)

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Eurobank Research

Research Team

Dr. Tasos Anastasatos | Group Chief Economist
tanastasatos@eurobank.gr | + 30 214 40 59 706

Anna Dimitriadou
Economic Analyst
andimitriadou@eurobank.gr
+ 30 210 37 18 793

Ioannis Gkionis
Senior Economist
igkionis@eurobank.gr
+ 30 214 40 59 707

Dr. Stylianos Gogos
Economic Analyst
sgogos@eurobank.gr
+ 30 210 37 18 733

Maria Kasola
Economic Analyst
mkasola@eurobank.gr
+ 30 210 33 18 708

Olga Kosma
Research Economist
okosma@eurobank.gr
+ 30 210 37 18 728

Paraskevi Petropoulou
Senior Economist
ppetropoulou@eurobank.gr
+ 30 210 37 18 991

Dr. Theodoros Rapanos
Economic Analyst
v-trapanos@eurobank.gr
+ 30 214 40 59 711

Dr. Theodoros Stamatiou
Senior Economist
tstamatiou@eurobank.gr
+ 30 214 40 59 708

Elia Tsiampaou
Economic Analyst
etsiampaou@eurobank.gr
+ 30 214 40 59 712

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