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# GLOBAL & REGIONAL MONTHLY

The global economy continues to exhibit relative resilience to the current, fierce headwinds, but downside risks intensify, as the significant slowdown in China amid strict Covid-19 zero tolerance policy, adds another challenge for its near-term outlook. On the inflation front, pressures remain elevated, reinforcing the intention of several Central Banks to continue policy normalization amid concerns about second round effects and de-anchoring of inflation expectations. However, investors are getting more worried about growth than inflation, as tighter central bank policy will further depress growth, risking to push various economies into recession.

### Macro Picture

**USA**: Signs of a slowdown in activity across sectors in May; inflation eased slightly in April

**EA**: Inflation keeps rising, while economic activity, though moderated, remains resilient

**UK**: Further fiscal support for households unlikely to deter a sharp slowdown in GDP growth

**EM:** China's deceleration in Q2 from extensive lockdowns clouds the wider outlook

**CESEE:** Positive carry over effect from Q1 to Q2 hits on the inflationary impasse

### Markets

**FX:** USD, CHF and commodity currencies act as safe havens as Russia/Ukraine war rattles markets

**Rates:** EU and US rally pause due to growth concerns

**EM:** Widening in bond spreads reversed at the 2nd half of May. Food and energy inflation and growth concerns pose significant risks for assets.

**Credit:** Spreads mostly wider in May, expected to trade in a wide range with increased dispersion in Q2, on inflation and growth risks

### Policy Outlook

**USA:** Markets expect less aggressive rate tightening ahead by the Fed, on growth concerns

**EA:** Clear signal for July rates lift-off and consecutive hikes by end-Q3

**UK:** Further BoE tightening likely amid elevated inflation and labour market tightness

**CESEE:** Regional central banks continue the monetary tightening as inflation keeps surging

### Key Downside Risks

**DM:** Ukraine crisis escalates, sharp slowdown in China, renewed Covid-19 restrictions, de-anchoring of inflation expectations

**EM:** US dollar strengthening undermines the purchasing power of local currencies; US interest rate increases weigh on capital outflows

**Special Topics in this issue**

→ECB: Clear signal for a rate lift-off in July

→French legislative elections


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Special thanks to the Global Markets team (Global_Markets_Trading@eurobank.gr), Eurobank Bulgaria and Eurobank Serbia

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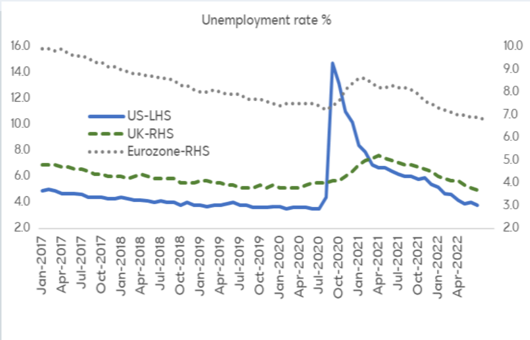
## The global economy continues to exhibit relative resilience to the current fierce headwinds, but downside risks intensify

Despite growing growth concerns, the majority of activity data show a slowing momentum, but also attest to relative resilience against the fierce headwinds that the global economy is currently facing. Strong pre-war fundamentals, supportive government policies to mitigate the impact of higher energy prices and continued labor market strength across much of the world — as underscored by the strong readings in the April global employment PMI — that supports households with solid labor income (Figure 1), are among the key driving forces that assist the global economy to continue expanding by an above-trend pace. That said, the all-industry index, according to the DM flash May PMIs, dropped by 1.8ppts to 53.6, remaining though not far from its pre-pandemic average and above the boom-or-bust level of 50, pointing to continuing, albeit slower, expansion. However, downside risks intensify. In addition to the Ukraine war-induced supply shock, surging inflation and tightening financial conditions stemming from several Central Banks' hawkish pivot, the significant contraction underway in China, caused by repeated and prolonged multi-city lockdowns as its strict Covid-19 zero tolerance policy is maintained, adds another challenge for the near-term global outlook, amid potential spillovers via a sharp weakening of domestic demand and further supply chain disruptions.

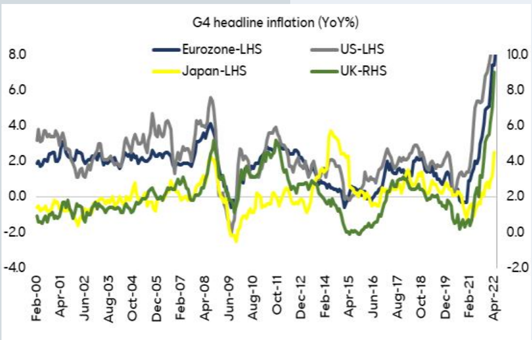
**Figure 1: Continued labor market strengthening in major economies**




Source: BLS, ONS, Eurostat, Eurobank Research

Meanwhile, on the inflation front, the latest CPI releases across a wide range of economies show continuing elevated pressures on the back of high energy prices and sharply rising food prices (Figure 2), reinforcing the intention of several Central Banks to lift off rates and continue policy normalization, amid concerns about de-anchoring inflation expectations and second round effects on wages, on the back of continued labor market strengthening. The Fed emphasized at the 3-4 May meeting its intention to raise the fed funds rate "expeditiously" to neutral (including 50bps rate hikes in the next couple of meetings), ECB President Christine Lagarde effectively committed to a rates lift off in July followed by a subsequent hike in September that would

**Figure 2: Inflation keeps rising worldwide**




Source: Reuters, Eurobank Research

take interest rates out of negative territory, and the BoE left the door open at its latest meeting on 4 May to further rate tightening in the foreseeable future, despite the looming recession risk due to the cost-of-living crisis. That said, several Central Banks signal a sense of urgency to 'frontload' rate hikes aiming to boost their credibility in light of persistently high inflation prints. However, investors are getting more worried about growth than inflation, as tighter central bank policy is going to dent growth further and risks pushing various economies into a sharp slowdown or even recession. Under such a scenario, price pressures should diminish and ultimately there should be less need for policy rate hikes further out to bring inflation back to target, prompting investors to dial back the amount of expected tightening from several Central Banks.

## Developed Economies

**US:** Business activity expanded in May across sectors, supported by stronger client demand as the reopening of the economy still has a positive, yet fading, impact. Nevertheless, the pace of expansion has slowed, dragged by elevated inflationary pressures and a deterioration in supplier delivery times owing to the continuing Russia/Ukraine war and the lockdowns in China. In the housing market , record-high home prices and rising mortgages depress home sales. Against this context, consumer confidence as measured by the Conference Board, declined in May, with consumers assessing that both the current business and labour market conditions, as well as the outlook have deteriorated. Separately, the April readings allow some optimism that inflation may be easing although it remains at elevated levels, well above the 2% Fed target. Nevertheless, concerns over growth also mount with the markets now (as of 1 June) expecting the implied rate to reach 2.75% by the end of the year, from 2.9% a month earlier, suggesting that the Fed may follow a less aggressive rate tightening path.

**Euro area:** Price pressures continue to build and broaden out, with both headline CPI and core inflation rising to fresh record highs in May at 8.1%YoY and 3.8%YoY, respectively. Furthermore, negotiated wage growth surprised to the upside in Q1 2022, hitting a more than ten-year high of 2.8%YoY after rising by just 1.6%YoY in Q4 2021 and a record low of 1.4%YoY in Q3 2021, suggesting that the risk of a wage-price spiral cannot be ruled out, especially in view of the continued improvement in labor market conditions. Meanwhile, although economic activity has moderated since Russia's invasion of Ukraine mostly on the back of higher energy prices, ongoing supply chain bottlenecks and weaker external demand, growth has remained overall relatively resilient. The flash May Composite PMI fell to 54.9 from April's 55.8 on a moderate decline in both the manufacturing and the services PMI indices (to 54.8 and 56.3, respectively), pointing to ongoing expansion and a low risk of a recession in the near term. Against this background, pressure on the ECB to accelerate its policy normalization is increasing, with President Christine Lagarde giving a clear signal for a rate lift-off in July and additional tightening by end Q3 to take rates out of negative territory.

# Emerging Economies

**EM:** Worries continue to pile up in the emerging market sphere as the war in Ukraine lingers. The geopolitical uncertainty and the weaponization by Russia of its energy resources cast a thick shadow over the European and global economic outlook, enhancing, thus, the US dollar's safe-haven appeal. The stronger dollar along with the recent and - presumably continuing - lift in the US interest rates paint a less rosy picture for the financial conditions in emerging and developing economies. According to the International Institute of Finance (IIF), in the last couple of months, emerging debt and equity markets experience capital flights on the back of a wider and protracted risk aversion and higher yields on US papers. Along these lines, the accumulated level of debt issued by EM market participants, either sovereign or corporate, is harder to be serviced, while EM's creditworthiness with substantial portion of debt denominated in US dollar face additional pressure from the latter's appreciation and the respective weakening of local EM currencies. The landscape described above comes at a moment when the EM world, as a whole, is still struggling to return to its pre-pandemic levels of economic activity and with the Chief Economist of the IMF, Gita Gopinath, stating at the Davos summit in May, that even by 2024, when growth in the developed world will have recovered, the EM will be still lagging by 5%.

**CESEE:** With most Q1-2022 GDP growth prints having been released in May, it is apparent that the region experienced a favourable momentum in the first three months of 2022, which was abruptly interrupted by the war in Ukraine. Czechia and Serbia posted growth readings above 4% and Poland above 8%. However, the scenery is about to change from Q2-2022 onwards as the war in Ukraine has escalated further the inflationary pressures, whose toll will be visible in the growth reading of the current quarter. The said course of economic things is mirrored in the deterioration of the spring EC forecasts for the regional economies released in May compared to the winter ones published in February. All growth forecasts have been revised downwards sizably, with inflation expected to come in at a double digit for 2022. In view of the above, all central banks (CBs) continue the interest rate hiking path with some, like Czechia's CB moving more quickly and others like Serbia's, lagging and having just embarked on the tightening cycle.

# CESEE Markets Developments & Outlook

## Bulgaria

Yield spreads opened up significantly in the global markets during May, following the higher-than-expected inflation figures, as well as the ongoing invasion of Ukraine by Russia. Eurobond yields continued their upward trajectory on almost all maturities, with similar moves across the entire curve. 2027-2028 tenors recorded 20-25 bps rises, while the longer maturity bonds, namely the 30 and 35 ones witnessed 13-26 bps spikes, while the 50 fell by 15bps. In the short-term, the 2024 Eurobonds fell by 5 bps. Local papers saw weak yield spikes with the most active one being the 20-year tenor, while the 10-year tenor spiked by 5 bps. The Ministry of Finance continued its auction activity after resuming it in March and April. During May one auction was held for EUR150mn, on the short-term end of the curve, namely the 3.5-year papers, which was considered successful. The Ministry of Finance confirmed that a new Eurobond issue is incubated with the tenor and amount remaining undisclosed.

## Serbia

An additional wave of inflation could be underway stemming from the soaring electricity prices, as they have risen recently, moving in tandem with global commodity markets Despite the price instability, the dinar holds firm backed by the interventions of the National Bank of Serbia in the FX market, which are estimated to have reached almost EUR2bn, translating into a reduction of ca 15% of its euro reserves since the end of 2021. Assuming that the pressure on the dinar continues and such brave amounts of interventions are required in the near-term future so as to prevent the dinar from appreciating, the said tactic of the central bank may not be feasible for long.

Passing to the fixed income market, yields of the RSD-denominated T-bonds continue to move higher. They increased by an average of 100bps compared to the previous month, with 4-year, 6-year and 11-year bonds trading in the secondary market at 6.00%, 6.30% and 6.80% respectively at the end of May. There is an evident price gap between the primary and the secondary market, which led to a significant decrease in volumes on primary auctions organized by the Public Debt Administration (PDA). If the PDA continues defying market expectations, a complete absence in demand is highly expected.

# Markets View

## Foreign Exchange

**EUR/USD:** A combination of the recent drop in the US-EU yield differential, the bearish positioning in the EUR and the further rise in European inflation data, has pushed the pair higher above 1.07. We retain our view for higher levels towards 1.10 as the ECB is continuing with more hawkish rhetoric and is catching up with the Fed, while US inflation seems to be moderating.

**EUR/GBP:** Again all eyes on the UK and EU inflation numbers, with the pair range trading between 0.84 and 0.86. We believe that a move higher towards 0.87 is in the cards in the medium term. A fail to break higher will cause the pair to revisit the lows of the above-mentioned range.

## Rates

**EU:** EU rates remained range-bound despite a volatile month, with 10y swap hovering around 178bps despite having traded as high as 195bps. The swap curve has steepened sharply with 5s-30s trading at 23bps up from 3bps at the beginning of the month. Looking forward we expect yields to move marginally higher as German inflation accelerated to 8.7% in May but at the same time, energy prices are posing a growing problem for European economies.

**US:** US rates ended the month mixed following significant volatility. The 10yr swap rate is trading at 290bps, down from 315bps at the beginning of the month and having traded as low as 280bps. The curve steepened sharply, with 5s30s trading at -2bps up from -35bps at the beginning of the month. Going forward, we expect the yields' drop to be sustained for a while longer as parts of the economy that are sensitive to rising interest rates are faltering. Figures released on May 24th showed that new home sales fell by almost 17% between March and April.

## Emerging Markets Sovereign credit

EM sovereign bond spreads continued their widening trend at the beginning of the month but reversed most of these losses after mid-May. The EMBI Global Index closed at 390bps at the end of May, 12bps wider on the month. In CEEMEA, Romanian bonds underperformed on expectations for a new USD issuance, while Russian local currency bonds rebounded to levels seen before the war, especially after the 300bps rate cut to 11% by the CBR. In LatAm, spreads seem to have stabilized, while the political noise returned with the Colombian elections that were held on May 29th and as none of the presidential nominees obtained at least 50% of the votes, a runoff is scheduled to be held on 19 June 2022, between the top two candidates, Gustavo Petro and Rodolfo Hernández Suárez. In Asia, the heavy weights of food and energy in India and the Philippines have weighed on bond yields, while Beijing and Shanghai have announced some lockdown relaxations, something that is clearly positive for Chinese growth. We remain very cautious in adding EM risk as the focus of global markets shifts from inflation to growth concerns and recession fears, and as the sensitivity of EM bonds to rising food and energy prices is still high.

## Corporate credit

EUR investment grade bond spreads on all rating grades and sectors were +10/+25bps wider in the past month (with some sectors like Real Estate around +45bps wider). CDS Index spreads were unchanged in HY and around -5bps tighter in IG, after having reached year-to-date highs (~500 in Itrx Xover 5y, 101 in Itrx Main 5y). Widening was fed by the ongoing mix of Russia/Ukraine war, higher rates/inflation prints, growth estimates recalibrating lower globally, and China Covid-19 lockdowns. Fed in it's steep hiking path, while ECB expected to follow in July, after stopping asset purchases in June. Sector-wise, in EUR IG, Financials were +13.5bps wider, Real Estate +45bps wider, Energy +10bps wider, Health Care +14bps wider, Telecoms +13.5bps wider, Industrials +17.5bps wider, Consumer Goods +16.5bps wider, Utilities +25bps wider, Technology +22bps wider and Basic Materials +26bps wider. US IG names spread were unchanged to +10bps wider in the same period (with Real Estate underpforming), outperforming EUR ones. Specifically, Financials were +6bps wider, Real Estate +24bps wider, Energy +2bps wider, Healthcare -3bps tighter, Telecoms unchanged, Technology +2.5bps wider, Industrials +5.5bps wider, Consumer Goods +4bps wider, Utilities +5.5bps wider, while Basic Materials were +7bps wider.

Rating-wise, EUR IG spreads in BBB were +23bps, in A +14.5bps, in AA +13bps, and in AAA +6.5bps wider. In the EUR HY universe CCC spreads were +200bps, B were +65bps, while BB were +45bps wider. In the USD IG space spreads in BBB were +7.5bps wider, in A +1.5bps wider, in AA unchanged, and in AAA -5bps tighter. Ukraine war now on the back seat, with the major exception of the energy issue in Europe. Inflation persistence and the impact on growth from higher rates, potentially leading to a recession next year, is the key theme. Coupled with speculation on CBs' reactions to the dire situation, no wonder increased volatility is here to stay. Liquidity remains scarse in many ways, inducing abrupt and violent spread moves. We expect elevated spread volatility to persist in the short and medium term. Additionally, we expect high spread dispersion to persist and potentially intensify, directly linked to the growth slowdown/recession story. We expect spreads to trade in a wide range, secondary to reprice wider when windows for primary issuance open, and EUR names to be more affected by the expected macro weak-ness. Summer might be a short-term pause for risk repricing, due to many seasonal technicalities, but the overall picture is strongly skewed to risk weakening. The potential backstop of high cash on the sidelines, and higher all-in-yields can put a bid in higher quality names in the medium term, and so up-in-quality is definitely preferred and affordable around here.

# Special Topics
# I. ECB: Clear signal for July rates lift-off

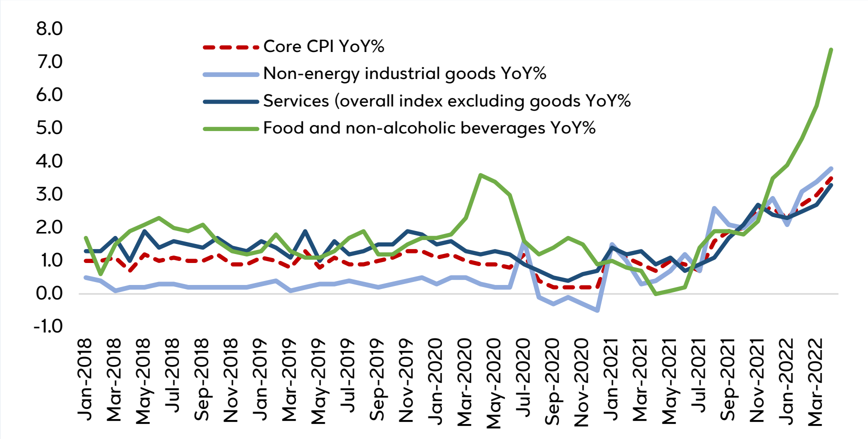
The ECB's rhetoric since the latest monetary policy meeting on 14 April has shifted in a clear hawkish direction, with a growing number of Governing Council members speaking publicly in favor of a rate hike as soon as in July, signaling, thus, a sense of urgency for faster policy normalization. Combined with the resilience of economic activity data since the onset of the Ukraine war which suggests that a sharp growth slowdown is unlikely in the near-term, the ECB's focus has apparently shifted towards restoring price stability amid concerns about second round effects on wages and a de-anchoring of inflation expectations against a backdrop of persistently high price pressures. Along these lines, ECB President Christine Lagarde sent a clear message in a blog post on the central bank's website recently that the July policy meeting is the most likely time for a rate hike, the first in more than a decade, after net purchases under the APP conclude "very early" in Q3. Furthermore, she opined that, on the current outlook, interest rates will exit negative territory by the end of Q3, implying a second rate hike at the subsequent meeting in September, while for the period thereafter, the pace of further policy normalization should be gradual and "cannot be determined ex ante".

The ECB's hawkish pivot that indicates a growing consensus in the Governing Council to not delay a rate lift-off further, has contributed to a significant repricing in market expectations. From almost zero at the start of the year, as of late May the implied ECB policy rate after the July policy meeting has risen and priced in at 28bps, while for the end of this year the market expects more than 100bps of cumulative rate tightening (Figure 6).

- **Inflation pressures are broadening out beyond pandemic-related items**

According to Eurostat's final estimate, Eurozone headline inflation for April was revised down by 0.1pp compared to the flash estimate of 7.4%YoY, unchanged from March after rising steadily in the last nine months. On a monthly basis, headline prices were up by 0.6%MoM, lower compared to an average gain of 1.2%MoM in Q1, on the back of lower inflationary pressures coming from energy prices (down by 6.9pts to 37.5%YoY) and temporary government measures aiming at easing the burden of rising energy prices on consumers (i.e., energy tax cuts, fuel rebates). However, underlying inflation continued to strengthen. Core inflation (ex. energy, food, alcohol & tobacco) surprised again to the upside, rising from 3.0%YoY in March to 3.5%YoY (Figure 3), fueling concerns about persistency of high inflation as the details suggest that second-round inflation effects continue to strengthen and price increases are broadening out. Core goods gained further (+0.4pts to 3.8%YoY) amid exacerbated supply chain issues linked to the Ukraine war and China's zero-Covid policy, as well as surging factory gate prices that put pressure on firms' profit margin. Services price inflation also accelerated (+0.6pts to 3.3%YoY) probably affected by the April holiday season, while food prices (20% of the basket) rose sharply, up by 1.3pts to 2.3%MoM, the largest monthly gain since the creation of the EMU (+1.7pts to 7.4%YoY) on higher energy costs and shortages of fertilizers, as well as certain edible vegetable fats such as sunflower oil, of which Ukraine and Russia are among the world's biggest exporters.

Figure 3: Inflation pressures are broadening out




Source: Eurostat Eurobank Research

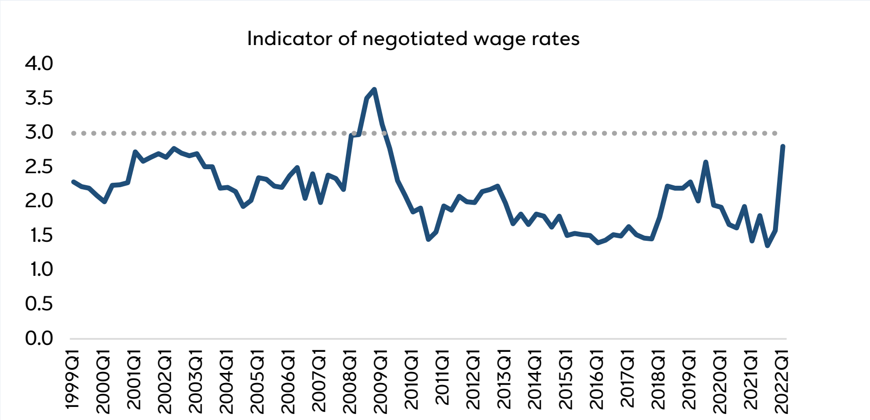
Looking ahead, a rapid decline in the inflation rate does not seem to be in sight, suggesting that price pressures will likely remain elevated for long. EU leaders' agreement to impose a partial ban on most Russian oil imports by the end of 2022, should keep energy prices high for some time, while, as is also suggested by surging factory gate prices (PPI up at a record high of 36.8%YoY in March) the ongoing material and supply bottlenecks should continue to exert pressure on firms' profits, pushing up industrial goods inflation. Meanwhile, the lifting of the remaining Covid-19 restrictions, excess savings, post-pandemic normalization and the expected recovery of tourism in the EU this summer, should sustain price pressure in services. That said, if energy prices stabilize, inflation should fall throughout H2 2022 but is not anticipated to move close to the ECB's 2.0% target before late 2023/early 2024.

In its Spring 2022 economic forecast released in mid-May, the European Commission revised upwards the HICP inflation forecast for 2022 from 2.2% to 6.1% and for 2023 from 1.4% to 2.7%, standing higher from those of the ECB's at 5.1% and 2.1%, respectively. Higher medium-term inflation is backed up by higher wage growth (compensation per employee), that was revised up for 2022 and 2023 to 3.4% for both years from 2.9% and 2.4% respectively, partially reflecting a tighter labour market (unemployment rate at a fresh all-time low of 6.8% in April).

➢ **Fears over a wage-price spiral emerging**

According to the latest ECB data, negotiated wage growth surprised to the upside in Q1 2022, rebounding to a more than ten-year high of 2.8%YoY (Figure 4), distorted upwards by Germany, where one-off payments were agreed a few months ago under collective bargaining agreements and were paid in the first quarter of the year (such lump-sum payments over permanent wage increases were opted in many of Germany pay deals during the pandemic). The Q1 2022 print was 1.2pp up from Q4 2021 and above a record low of 1.4% in Q3 2021, poising upside risks to expectations for an acceleration of wage growth close to 3.0%YoY for the full year 2022 (i.e. a level consistent with inflation stabilizing at 2.0% in the medium-term). Two important collective bargaining rounds in H2 2022 in Germany — which has the tightest labor market among the largest Eurozone countries — covering more than 4.5mn employees (metal and chemistry industry) could be an important bellwether for wage growth momentum in the medium term.

Figure 4: Negotiated wage growth surprised to the upside in Q1 2022

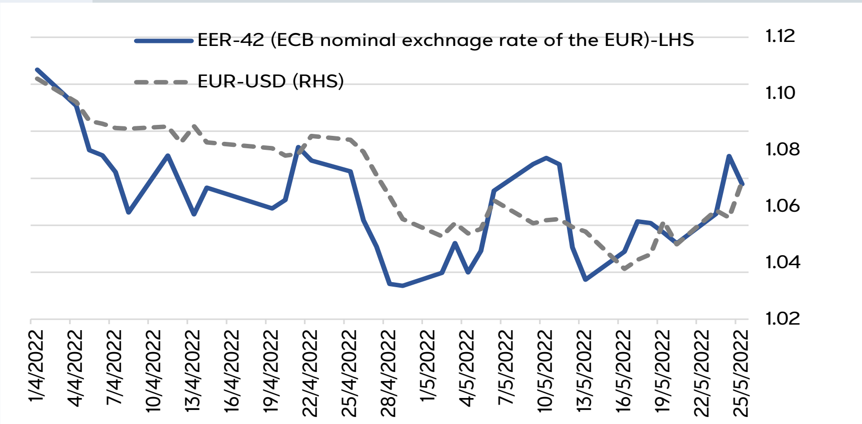



Source: ECB, Eurobank Research

- **EUR depreciation**

The EUR's recent depreciation could add to underlying inflationary pressures, with ECB Economist Philip Lane noting in a recent interview that "the currency depreciation will be an important factor shaping the June projections". The EUR-USD has lost c. 3.2% since early April on the back of widening interest rate differentials, though the drop in the EUR is more contained in trade-weighted terms and it is around 1.4% as measured by the ECB's EER-42 index, given the contemporaneous fall of the CNY and GBP (Figure 5). According to the ECB, a 1% depreciation of the euro increases HICP inflation by 0.10% after one year and 0.23% after three years.[1]

Figure 5: EUR depreciation




ECB, Reuters, Eurobank Research

[1] https://www.ecb.europa.eu/pub/pdf/other/eb201607_article01.en.pdf

➢ **Renewed increases in long-term inflation expectations seem likely**

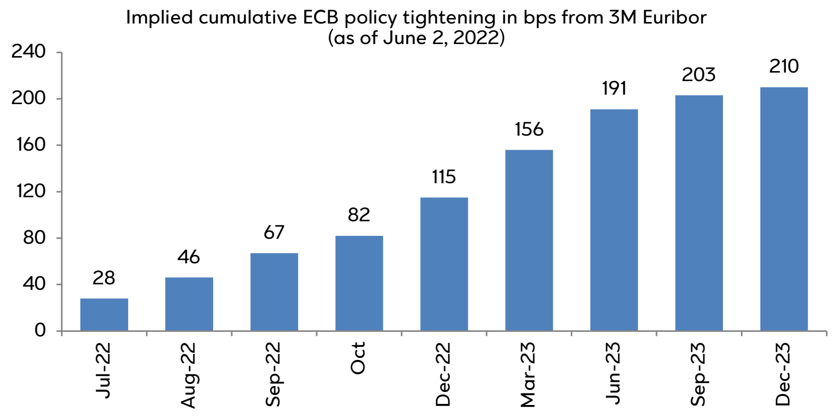
After hitting a multi-year peak of 2.49% in late April, the 5y5y forward inflation swaps for the Euro area, which look at inflation over the five years starting in five years' time, has come down to 2.20% in early June, not too far from the central bank's 2.0% target, as investors' expectations about future ECB tightening have increased. Nevertheless, they still stand above levels of around 1.75% in the early months of 2022 and renewed increases seem more likely than decreases in the near term until the peak in inflation is over, highlighting risks of second-round effects. The rise in the ECB's Survey of Professional Forecasters long-run inflation forecast to 2.1%, above 2.0% for the first time in the survey's history, has probably also caught the ECB's attention.

Emboldening the ECB to lift-off rates as soon as July, high-frequency indicators remain more resilient than expected since the onset of the Ukraine war. Indicatively, after a Q1 GDP growth rate of 0.3%QoQ, in line with ECB forecasts, the composite PMI fell marginally to 54.9 in May from April's seven-month high of 55.8, still above the long-term average level of 53.3, pointing to ongoing expansion as the service sector, boosted by the reopening of the economy and pent-up demand, partially offsets the impact of supply chain disruptions, geopolitical uncertainty and high inflation on manufacturing. Adding to the hawkish tone of the flash PMI May report, the indices of input and output prices remained close to record high levels, while job growth accelerated further to 55.9, the highest level since mid-2007.

**Nevertheless, there are many focal reasons for the ECB to be cautious on the policy normalization path**

Although the ECB is widely expected to push interest rates higher in the coming months, it may be hard for the Central Bank to lift interest rates by a cumulative 210bps by the end of 2023, as markets currently expect (Figure 6). In fact, there are many focal reasons for the ECB to be cautious with the pace of the normalization process.

Figure 6: Cumulative ECB policy tightening of 210bps expected by end-2023




Source: Bloomberg, Eurobank Research

Though economic activity data have proved relatively resilient so far to the Ukraine war and China's strict zero-Covid policy, clear warning signs over the Eurozone growth outlook have emerged. Indicatively, forward-looking May PMI subcomponents point to risks of a potential sharp downturn in economic activity as new orders in the manufacturing sector dropped below the boom-or-bust level of 50 for the first time since the outbreak of the pandemic, while export orders moved further into contraction territory at a time when there are still no signs of secular improvement in supply conditions. In addition, the rising cost of living and subdued consumer confidence (close to its April 2020 all-time low mostly due to households' real income worries) suggest that the strength in services could wane soon as the reopening effect gradually fades. Accumulated savings and government interventions to curb energy prices and alleviate the impact on purchasing power should provide some support but are not expected to prevent a squeeze in households' real incomes from an inflation perspective.

Meanwhile, headwinds for the global economy are increasing, partly due to global monetary policy tightening and China's strict zero-Covid policy, while financial conditions are already moving towards tightening. The pressure on periphery spreads is starting to build up, with the 10-yr IT/Bund yield spread widening above 200bps for the first time in around two years, as the prospect of tighter monetary policy and the ECB's looming exit from QE, raise concerns about the sustainability of highly indebted Eurozone member states (since December, the ECB's policy statement has included a general commitment to policy flexibility as the Central Bank is aware of the risk of market fragmentation, with the PEPP reinvestment program remaining the first line of defense).

Although all the above risks do not pose an argument against rates lift-off in July and an exit from negative rates by September as the domestic economy weathers fairly well short-term headwinds, high uncertainty about the evolution of the Ukraine war and the Eurozone's growth outlook suggest that the pace of policy normalization thereafter should be flexible, gradual and data-dependent, in line with the ECB's principles that frame the path of its monetary policy. That means that the normalization process will be decided meeting-by-meeting and the ECB will make each policy decision on the basis of the data available at that time, namely growth, inflation and financial conditions. Consequently, the option of a potential delay of subsequent rate hikes or a pause should not be ruled out amid high uncertainty about the Eurozone and the global growth outlook.

# II. French legislative elections

In April, centrist incumbent Emmanuel Macron secured a second five-year term as President of the Fifth French Republic, defeating his opponent far right leader Marin Le Pen with a 17% lead in the second round of the presidential elections. Attention now turns to the legislative elections that will be held in two rounds on June 12th and 19th, to elect the 577 members of the 16th National Assembly of the Fifth French Republic.

The French Constitution foresees clear division of powers. It states that the government "determines and conducts the policy of the nation" and the parliament votes on laws and can overturn the government. The president ensures the "normal functioning of public powers" and the "continuity of the State", guarantees "national independence, territorial integrity and respect for the treaties" and is the commander-in-chief of the armed forces and the only one who can approve a nuclear strike. He also appoints the prime minister as well as the cabinet over which he presides, issues laws, submits bills for approval by referendum, and has the power to dissolve the lower house of parliament, the National Assembly. The president also sets the reform agenda for his / her government.

When the president gains the support of the National Assembly, his role is strengthened, and his legislative capacity expands in a way that his power is often described as more important than that of Heads of State in other countries. If, however, after legislative elections, the National Assembly is dominated by a party other than the president's own party, there is "cohabitation", a situation where the President and the Prime minister come from different sides of the political spectrum, as the President is obliged to name a premier that will be acceptable to the majority party within parliament. When in cohabitation, in effect the prime minister controls the legislative agenda and the president is confined to foreign policy and defense, which may result in frictions and put a break on policy. Following the reduction of the president's term from seven to five years in 2000, legislative elections are scheduled shortly after the presidential ones, reducing the risk of cohabitation, as public opinion is unlikely to change between the two elections. Yet, cohabitation does remain a possibility.

Against this background, President Macron's aim is to achieve a parliamentary majority that will allow him to get legislation through, whereas his main rivals, far right Marine Le Pen and far left Jean-Luc Mélenchon, will also seek to win a majority in order to block his reform agenda, considering the deep political divides that separate them. To raise his stakes for parliamentary prevalence, "the third man" Jean-Luc Mélenchon formed the broad alliance "NUPES" ("Nouvelle Union Populaire Ecologique et Sociale") with other left-wing parties (the Greens, the France Unbowed movement, and the Socialist party). If Le Pen's or Mélenchon's parties prevail, bringing about cohabitation and depriving Macron of the votes he needs to legislate, he may invoke Article 49.3 whereby he can bypass MPs to pass laws, unless the opposition launches a vote of no confidence requiring fresh parliamentary elections. Resorting to Article 49.3 however, is generally considered an undesirable and precarious option, as it causes great controversy and may result in challenging the legitimacy of the government. As things stand though, opinion polls suggest that Macron will secure a parliamentary majority.

The presidential elections, although victorious for Emmanuel Macron, brought to the fore deep divides in French society, which will make the work of the President and his government more difficult. For this reason, after his election, Macron tried to reconstruct his profile, highlighting a more popular and humble side, while he chose as his prime minister Élisabeth Borne, a woman who comes from the Socialist faction. A civil engineer, former government official and manager of state enterprises in the transport and construction sectors, Élisabeth Borne is also a technocrat on whose qualifications and ability to form useful alliances Macron counts, in order to pass key reforms.

The major internal policy challenges ahead are:

**Cost of living**. Raging price increases have led to a cost-of-living crisis in France. Le Pen had put the issue at the center of her presidential election campaign and managed to win over a large number of voters who do not traditionally belong to her own political space. Now, this problem has become a first priority for Macron, who has pledged to index pensions to inflation and reduce costs for the self-employed. But France's high public debt (112.9% of GDP in 2021) and the prospect of rising interest rates ahead, reduce budgetary margins and make Macron's task more difficult.

**Pension reform**. At 13.6% of GDP, France's spending on pensions is the third highest among OECD countries, behind Italy and Greece. Emmanuel Macron aims at the progressive increase of the retirement age from 62 to 65 years, although recently he said that he is open to raising it to 64 years and changing the implementation timeline. This would be the second attempt to this reform, which was initially met with strong resistance from trade unions and workers, whilst his major opponents feel strongly against it with Marine Le Pen advocating no increase and Jean-Luc Mélenchon favouring bringing the retirement age back to 60 years.

**Labour market reform**. Emmanuel Macron supports the continuation of the labour market reforms that were implemented in the period 2017-2019 and included, among others, more flexibility in the wage bargaining process and lower social security contributions. Marine Le Pen shares different views on a number of issues, while during the presidential campaign, Jean-Luc Mélenchon argued in favour of the increase of the minimum wage and a 32-hour working week for certain professions.

**National health system**. Two years after the outbreak of the Covid-19 pandemic, emergency measures in hospitals remain in place and the pressure on the health system continues. Hospitals are understaffed and health workers demand higher salaries and, in general, better working conditions to make these jobs more attractive.

**Climate change**. Due to the relatively high share of nuclear energy in the energy production mix, the French economy relies less on oil, natural gas and solid fossil fuels than most other EU countries. Macron has pledged to move "twice as fast" to reduce greenhouse gas emissions, bringing them down by 40% by 2030. The plan foresees decarbonizing electricity production by significantly increasing nuclear reactors, windfarms and solar power output.

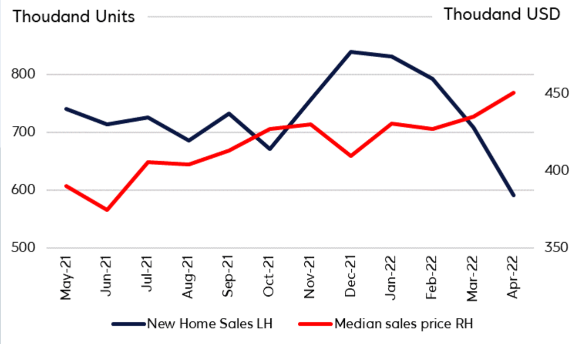
At the time of writing, less than two weeks before the 1st round of the legislative elections, the polls indicate that Macron's party will prevail in the 2nd round. However, the road after the elections will still be rough, as the challenges become more and more urgent and the internal, as well as the external environment remains unfavourable.

# US

## Inflation may have peaked but remains elevated

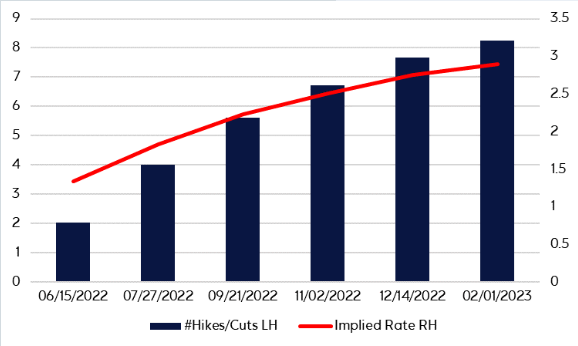
Business activity showed signs of slowdown in May, with the S&P Flash PMI Composite Output Index recording 53.8 (4-month low) from 56.0 in April, which indicates continued expansion but at a slower pace. The deceleration was evident across sectors with the Services Flash PMI registering 53.5 from 55.6 and the Manufacturing Flash PMI 57.5 from 59.2. Activity was driven mainly by a sharp uptick in client demand (particularly in manufacturing) with the reopening of the economy still having a positive, yet fading, impact, whilst the drags to activity were the elevated inflationary pressures and the further deterioration in supplier delivery times. In the housing market, record-high home prices and rising mortgages depress new home sales, which in April dropped for the fourth month in a row, recording their sharpest monthly decline since the beginning of the year (-16.6%MM) and coming in at 591K s.a., the lowest since April 2020, when the outbreak of the pandemic had caused severe uncertainty. Meanwhile, house prices continued their upward trend in April, with the median price of new houses climbing to a record-high of USD451K, up by 20%YY and more than 45% higher than in April 2020 (Figure 7). Separately, in May, CB consumer confidence dropped to 106.4 from 108.6 previously. Turning to inflation, the April readings suggest that it may be easing with the PCE index growth rate at 6.3%YY / 0.2%MM from 6.6%YY / 0.9%MM and core PCE (general index excl. food and energy) at 4.9%YY / 0.3%MM from 5.2%YY / 0.3%MM. The trimmed mean PCE inflation – a measure watched closely by the Fed – remained almost unchanged on an annual basis coming in at 3.75% from 3.70%YY in March. Having said that, despite the aforementioned signs of peaking, inflation remains well above the Fed's 2% target, and the issue has emerged as a priority in US public life as was also underscored by the relevant meeting between US President Joe Biden and Fed Chair Jerome Powell held on 31st May. Bear in mind that mid-term elections are due in November and Democrats' majority in Congress is razor-thin. Nevertheless, concerns over growth also mount with the markets now (as of 1 June) expecting the implied rate to reach 2.75% by the end of the year, from 2.9% a month earlier, suggesting that the Fed may follow a less aggressive rate tightening path (Figure 8).

**Figure 7: Record-high home prices and rising mortgages depress new home sales**




Source: U.S. Census Bureau, U.S. Department of Housing and Urban Development, Eurobank Research

**Figure 8: Markets price less hawkish Fed tightening on worries over growth**



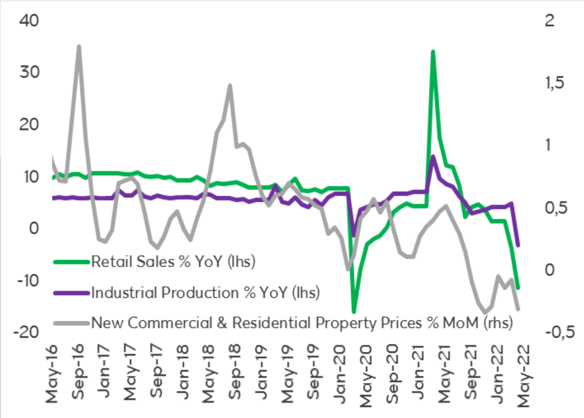

Source: Bloomberg, Eurobank Research

# China

## Data-driven policy ahead after the damage from lockdowns

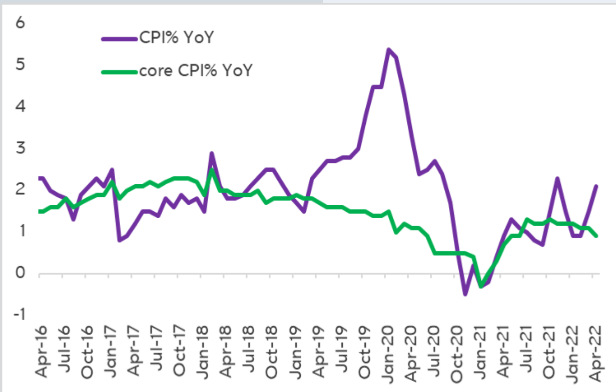
May's key developments come from the pandemic front, as after almost two months of strict lockdowns in major cities, such as Shanghai, restrictive measures have started to ease aiming, as officially stated, to restore normality by mid-June. Despite the heavy toll the lockdowns had on the economy based on recently released hard data, they also managed to partially contain the number of daily infections, leading to the decision to be gradually phased out. April's industrial production contracted by -2.9% YoY from a 5.0% YoY expansion in March, while the same month's retail sales plunged by -11.1% YoY vs -3.5% YoY in the previous month, with both proxies of the supply and demand side coming substantially below market expectations. April's CPI reading also reveals the challenging and contradictive dynamics that shape the economic landscape; the headline reading came in at 2.1% YoY from 1.5% YoY reflecting the pressure from the energy and commodity markets, but the core print eased to 0.9% YoY from 1.1% in March, approaching 10-month lows and mirroring the subdued consumption in both goods and services due to the extensive lockdowns. Looking ahead, concerns over the FY GDP growth rate mount, with the 5.5% official target likely to be undershot. The said target was set just before the Omicron variant began to be rapidly transmitted within major cities. It resulted in the adoption of radical restrictions that sizably affected the economic parameters upon which the 2022 economic policy targets set by the Politburo in early March were based. Fiscal and monetary policy will be heavily data-driven for the remaining of the year with the Q2 GDP print, due in mid-July, considered a focal point in terms of how much the policy agenda needs to be recalibrated. This is particularly important in the run-up to the upcoming elections in September for General Secretary of the Chinese Communist Party, in which Xi Jinping will try to win a third term, contrary to usual practice.

**Figure 9: Continuing loss of steam in the economy…**




Source: Bloomberg, Eurobank Research

**Figure 10:..with contradictive signals from the Inflationary front**



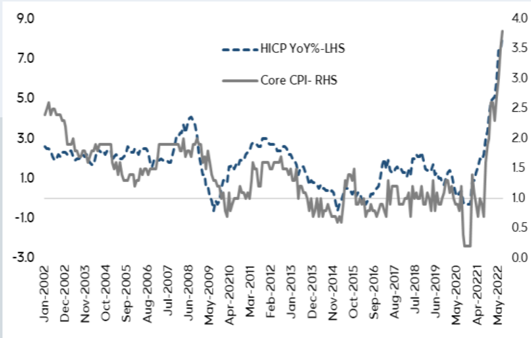

Source: Bloomberg, Eurobank Research

# Euro area

## Price pressures continue to build, forcing the ECB to lift rates

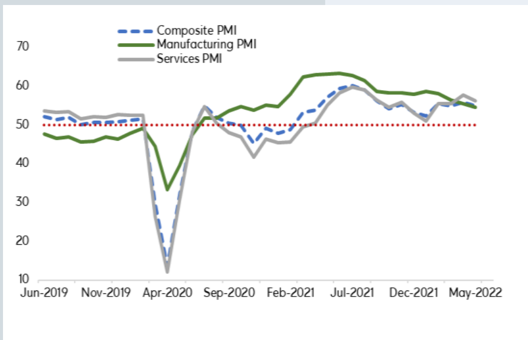
Price pressures in the Eurozone continue to build and broaden out, with both headline CPI and core inflation rising to fresh record highs in May at 8.1%YoY (from 7.4%YoY in April) and 3.8%YoY (from 3.5%YoY), respectively. Energy prices were up again (39.2%YoY), food inflation increased to a new all-time peak (7.5%YoY) amid rising input and global agricultural commodity prices, core services inflation accelerated further (3.5%YoY) on the back of the re-reopening effect from Covid-related restrictions and higher rents in some EA countries (e.g., Germany), while core goods gained (4.2%YoY) on EUR weakness and continuing increases in factory-gate prices. Looking ahead, the renewed increase in oil prices following the EU agreement for a ban on oil imports from Russia by the end of 2022, combined with the expected strong recovery of tourism in the EU this summer and ongoing supply shortages, suggest that inflation has probably not peaked yet, and both headline and core inflation will likely accelerate further in the coming months. Meanwhile, according to the ECB, negotiated wage growth surprised to the upside in Q1 2022, hitting a more than ten-year high of 2.8%YoY, after rising by just 1.6%YoY in Q4 2021 and a record low of 1.4%YoY in Q3 2021. Though the Q1 2022 print has been distorted upwards by one-off payments in Germany that were agreed many months ago, lump-sum payments instead of wage increases could continue given elevated uncertainty on the economic outlook. That said, the risk of a wage-price spiral cannot be ruled out, especially in view of the continued improvement in labor market conditions (Eurozone unemployment rate at a record low of 6.8% in April). Meanwhile, although economic activity has moderated since Russia's invasion of Ukraine mostly on the back of higher energy prices, ongoing supply chain bottlenecks and weaker external demand, growth has remained overall relatively resilient. The May Composite PMI fell to 54.9 from April's 55.8 on a moderate decline in both the manufacturing and the services PMI indices (to 54.4 and 56.3, respectively), pointing to ongoing expansion and a low risk of a recession in the near term. Against this background, pressure on the ECB to accelerate its policy normalization is increasing, with President Christine Lagarde giving a clear signal for a rate lift-off in July after net purchases under the APP conclude "very early" in Q3 (see Theme page).

**Figure 11: Inflation hits new record highs**




Source: Eurostat, Eurobank Research

**Figure 12: May PMIs point to ongoing expansion**



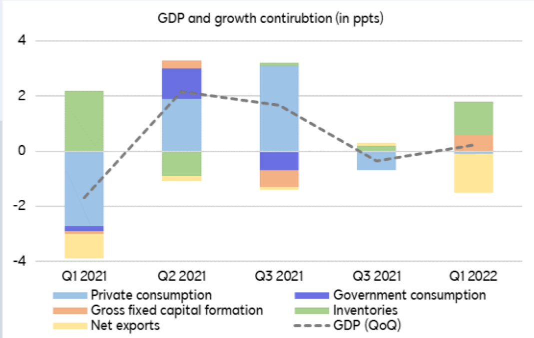

Source: Bloomberg, Eurobank Research

# Germany

## Technical recession avoided but growth outlook clouded

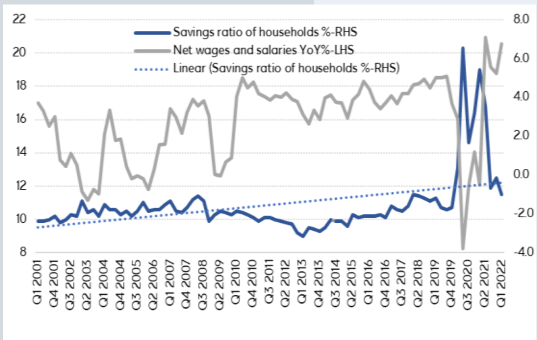
According to the final estimate, Q1 GDP grew by 0.2%QoQ (3.8%YoY) after a 0.3%QoQ contraction in Q4 2021 (1.8%YoY), suggesting that the economy managed to avoid a technical recession. On the expenditure side, net trade was a huge drag on growth (-1.4ppts), as exports dropped by -2.1%QoQ due to lower exports of goods on the back of global supply chain issues, while imports expanded by +0.9%QoQ amid higher services imports favored by increased travel activity. The biggest support to growth came from inventory changes (+1.2ppts), while investment was also a growth driver (+0.6pts) mostly helped by a weather-assisted bounce in construction (Figure 13). Private consumption shrank by 0.1%QoQ after having already declined by 1.3%QoQ in the prior quarter on Covid-19 related restrictions and government spending grew by a modest +0.1%QoQ. However, looking ahead, the growth outlook looks cloudy as clear warning signs have emerged. The increased geopolitical risks stemming from the Ukraine war and China's strict zero-Covid policy, which has exacerbated supply bottlenecks, could potentially undermine companies' willingness for goods investment spending. The IFO business climate index rose by more than expected in May (to 93.0pts from April's 91.9), but the bounce was solely driven by a better assessment of current conditions, while forward looking business expectations for the coming six months were virtually unchanged, failing to recover significantly from a record drop in March. In a similar gloomy tone, although there was an unexpected modest improvement in Germany's May manufacturing PMI (to 54.8 from April's 54.6), new orders fell for the second month running and at the quickest rate since June 2020, while manufacturers also faced a particularly steep decline in new export orders. Adding to downside risks for GDP growth in the short-term, persistently high inflation (CPI at a fresh multi-decade high of 8.7%YoY in May) and subdued consumer confidence (June's GfK consumer climate indicator at -26.0pts, within distance from May's -26.6pts record low) on geopolitical uncertainty and concerns about personal finances, pose headwinds to private consumption. At the same time, the savings rate has dropped below the long-term trend (11.5% in Q1), while the increase in (net) wages and salaries (6.8%YoY in Q1) mainly reflects one-off payments (Figure 14). For 2022, the government now projects GDP growth at 2.2%, down from 3.6% expected earlier this year.

**Figure 13: Inventories were the biggest growth driver in Q1**




Source: Federal Statistical Office, Eurobank Research

**Figure 14: Household saving ratio below long-term trend**



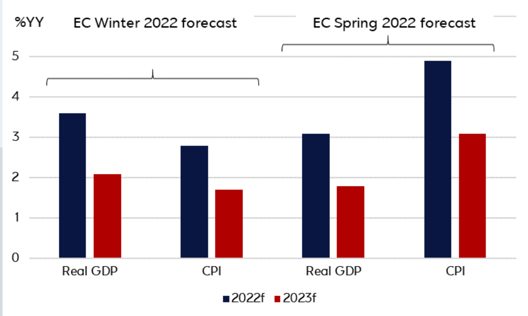

Source: Federal Statistical Office, Eurobank Research

# France

## Resilient economy but higher cost of living ahead of the legislative elections

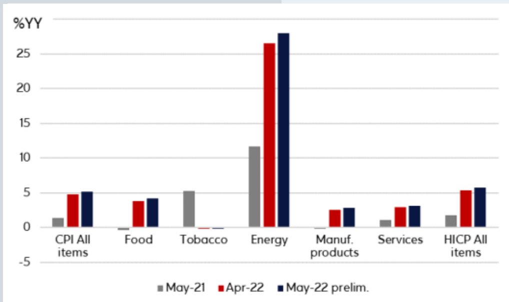
According to the European Commission (EC), growth will remain positive in 2022 but subdued amid high inflation, continuing supply disruptions and increased uncertainty stemming from the war in Ukraine. In the spring economic forecast released in May, the EC downgraded its real GDP forecast for France to 3.1% in 2022 and 1.8% in 2023, from 3.6% and 2.1% respectively in the winter forecasts (Figure 15). Meanwhile, the Q1-2022 real GDP final estimate was downwards revised, pinned at -0.2%QQ (from 0.0%QQ in the previous estimate and 4%QQ in Q4-2021), due to weaker household consumption than previously estimated. Overall, final domestic demand excluding inventories contributed negatively to GDP by -0.6 points (after +0.2 points in the previous quarter). Looking at Q2-2022, the French economy exhibits resilience in spite of mounting headwinds, with services leading the way supported by the withdrawal of Covid 19-related restrictions and manufacturing following suit but at a more sluggish pace. The French private sector economic activity expanded for the 14th consecutive month in May with the S&P PMI Composite Output index standing at 57.1 only slightly below the 51-month high of 57.6 in April. In the services sector (May PMI at 58.4 from 58.9), business picked up with the resumption of various projects that had previously been put on hold due to Covid, such as trade shows and public events. Activity in the manufacturing sector also continued to expand (May PMI at 54.6 from 55.7), but was weighed down by weaker demand due to higher prices, with rates of input cost and output price inflation accelerating to fresh record highs. Employment grew at the fastest pace since March 2001 across the private sector underpinned by positive expectations for the outlook ahead, although the level of optimism varies across sectors, being clearly higher among service businesses. The Economic Sentiment Indicator (ESI) recovered slightly in May (103.7 from 102.2), with confidence boosted in all sectors, but the 3-month average Mar-May stands 8.1% lower compared to the previous 3-month average Dec-Feb. Inflation remains elevated and broad-based, with the May flash HICP coming in at 5.8%YY / 0.7%MM from 5.4%YY / 0.5%MM in April (Figure 16). To tackle the rising cost of living, the minimum wage was increased by 2.65% in May, several social benefits were raised and a price cap has been put on gas. Additionally, Emmanuel Macron has pledged to index pensions to inflation and reduce several costs for the self-employed. Such measures however, will be implemented after the June legislative elections and depending on the outcome.

**Figure 15: EC spring economic forecast revised projections for real GPD downwards**




Source: EC Economic Forecasts Spring and Winter 2022, Eurobank Research

**Figure 16: Inflation continues to rise across product categories**



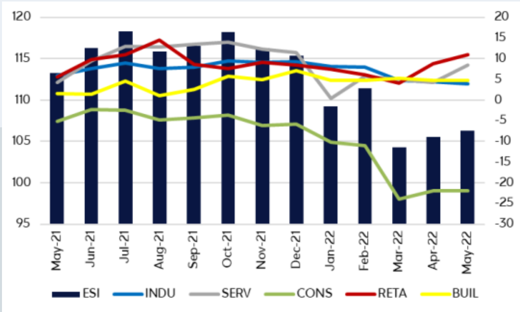

Source: INSEE, Eurobank Research

# Italy

## Sentiment slowly recovers but risks skewed to the downside

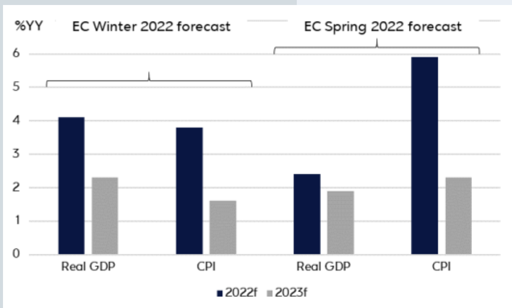
The Italian economy started the year struggling, with the Q1-2022 real GDP declining by -0.2%QQ. This drop owed more to the tightening of Covid-19 restrictions, rather than the impact of the war, as was reflected in retail sales, (average volume of retail trade sales index fell by -18%QQ in Q1-2022), whereas industrial production remained almost unchanged on a quarterly basis. The effect from the war may be more felt in Q2-2022 as the price pressures stemming from the Russian invasion in Ukraine erode households' real income thus weighing on consumption, whilst rising input prices and supply bottlenecks affect manufacturing (May S&P PMI declined to 51.9 from 54.5 in April). In fact, the NY Fed Global Supply Chain Pressure Index (GSCPI) suggests that in April, global supply pressures increased for the first time since Dec-21, with China and the Euro area longer delivery times contributing the most to the deterioration. So far the picture is mixed with consumers and businesses in the services sector expressing more optimism, whereas manufacturing and construction businesses appear more reserved on their outlook assumptions. Overall, the EC economic sentiment indicator for May increased for the third month in a row coming in at 106.3 from 105.5 previously, led by improvements in services and retail, while confidence in industry declined slightly (Figure 17). On a similar tone, consumer confidence as measured by the corresponding ISTAT index has clearly improved (102.7 in May from 100 in April), whilst interviewees from the manufacturing and construction sectors voiced concerns over new orders. Takig into account Italy's large industrial base, a slowdown in manufacturing and construction would have a tangible impact on growth. Along these lines, in the spring economic forecast (released in May), the EC revised downwards its 2022 real GDP projection to 2.4% from 4.1% in the winter forecast (released in February). For 2023, growth is expected to moderate to 1.9% from 2.3% in the winter forecast, still sizeably above the long-term average (Figure 18). The return of the economy to a more sustained path of expansion in 2023 is expected to be largely supported by the investments funded by the Recovery and Resilience Facility (RRF) but risks to the outlook are skewed to the downside not least because of Italy's strong dependency on energy imports.

**Figure 17: Economic sentiment slowly recovers**




Source: European Commission, Eurobank Research

**Figure 18: EC forecasts lower real GDP and higher inflation for 2022 and 2023**



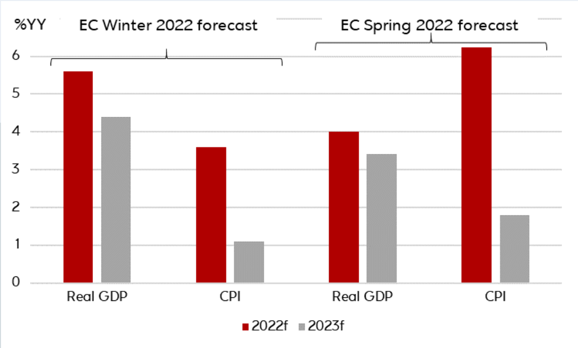

Source: EC Economic Forecasts Spring and Winter 2022, Eurobank Research

# Spain

## Economic sentiment rebounds in spite of increasing inflation

Expectations that inflation may have peaked in April were not confirmed by the preliminary May CPI print, which came in at 8.7%MM / 0.8%MM from 8.5%YY / -0.2%MM in the previous month. This development is mainly due to higher fuel and food and non-alcoholic beverages prices on an annual basis. Electricity prices however, moved to the opposite direction, as the Spanish government imposed a ceiling on the price of gas used in electricity generation at €40/MWh, which will stay in place until the end of the year. Remember that the EU granted Spain and Portugal permission – the so called "Iberian exception" – to put a cap on electricity market prices, on the grounds that the Iberian peninsula is largely detached from the rest of the EU power grid. As regards core inflation (general index excl. food and energy) the estimated annual change was 4.9%, which if confirmed, will be the highest since October 1995. The deterioration of households' purchasing power caused by sustained high inflation and lower real wages is expected to weigh on the this year's growth, with GDP not expected to reach its pre-pandemic level before mid-2023.

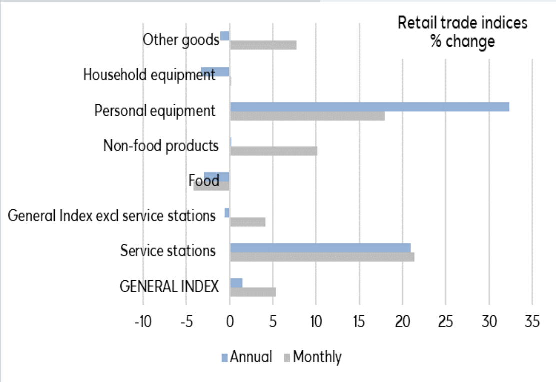
**Figure 19: EC forecasts lower real GDP and higher inflation for 2022 and 2023**




Source: EC Economic Forecasts Spring and Winter 2022, Eurobank Research

Along these lines, the EC revised downwards its real GDP growth forecasts for 2022 and 2023 to 4.0% and 3.4% respectively from 5.6% and 4.4% previously (Figure 19). On the other hand, growth will likely be supported by net exports, if the expectations for a strong tourism recovery are met. In fact, international tourist expenditure in April, reached €6,901mn, reaching 98% of the corresponding figure of April 2019, the year before the pandemic. Strong tourism and, generally, boosted optimism following the full withdrawal of pandemic protection measures likely led to the notable increase in the Economic Sentiment Indicator (ESI) in May, which rose to 104.3 from 100.2 in April, driven by improved sentiment across all sectors, and particularly in construction (+12.1 units), retail (+6.9 units) and among consumers (+4.3 units). In fact, in April, the s.a. retail sales index at constant prices rebounded by 5.3%MM / 1.5%YY, after a slump of -4.3%MM / -4.1%YY in March (Figure 20).

**Figure 20: Retail trade rebounds in April**



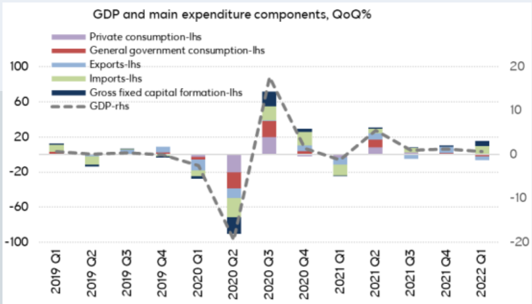

Source: INE, Eurobank Research

# UK

## Further policy stimulus unlikely to deter a sharp economic slowdown

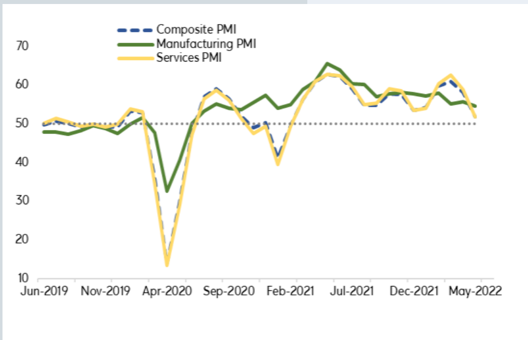
The UK economy was weaker than expected in March, with GDP growth recording an unexpected drop of 0.1%MoM. Services were the main drag on growth (-0.2%MoM), reflecting a sharp decline in the wholesale and retail trade, repair of motor vehicles and motorcycles (-15.1%MoM), mainly on the back of supply chain bottlenecks in the automotive industry. Industrial production also fell (-0.2%MoM), while construction had a better performance with output rising (+1.7%MoM). The unexpected GDP growth contraction in March, combined with a 0.1ppt downward revision to monthly GDP for February and January, took the QoQ rate for Q1 to 0.8%, a tad lower than 0.9% the BoE expected. Private consumption remained relatively subdued (+0.6QoQ), as the cost-of-living crisis continues to take a toll on households' real disposable incomes, while investment was the only subcomponent that surprised to the upside (5.4%QoQ) supported by government investment in buildings and structures (Figure 21). Net exports exerted a huge drag on growth (-4ppts), as exports fell by -4.9%QoQ and imports rose by 9.3%QoQ. Looking ahead, the economic environment looks more challenging, as suggested by a renewed drop in the GfK consumer confidence to a fresh record low of -40 points in May. Adding to downside growth risks, the May composite PMI recorded the fourth largest drop on record (-6.4 points) coming in at a 15-month low of 51.8, driven by the services PMI (-7.1ppts to 51.8) on the back of geopolitical and global headwinds, combined with the spiraling cost-of-living (Figure 22). After energy regulator Ofgem make known that the household energy cap is set to increase by a further 42% in October (following a 54% rise in April) and with an aim to tackle the cost-of-living increase amid persistently high inflation (CPI at a fresh multi-decade high of 9.0%YoY in May), the government announced new measures worth £15bn (0.6% of GDP). However, with most of the support measures not expected to reach households before Q4 2022, consumers will have to continue weathering the squeeze in their real incomes in the coming months without much added support, leaving the economy on the brink of a sharp slowdown. Meanwhile, combined with a tight labor market (unemployment at a near 50-yr low of 3.7%), the additional fiscal support, supports the case for some further BoE tightening near-term.

**Figure 21: Investment was the only subcomponent that came in firmer than expected in Q1**




Source: ONS, Eurobank Research

**Figure 22: The sharp drop in May composite PMI driven by services**



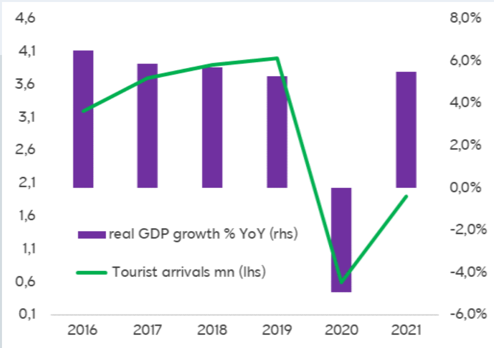

Source: Bloomberg, Eurobank Research

# Cyprus

## Solid Q1-2022 GDP growth as risks unfold from Q2 onwards

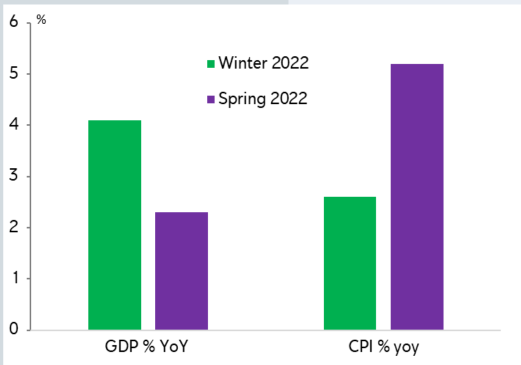
Both the final and flash estimates for Q1-2022 GDP growth released in May confirmed the solid economic momentum. GDP expanded by 5.6% YoY and 1.0% QoQ compared to 5.9% YoY and 0.7% QoQ in Q4-2022. Despite the robust momentum in Q1-2022, our view, as stated in April's issue, i.e. that the Q4's carry over effect into Q1-2022 may not be enough for the economy to continue on such a solid footing in 2022 given the challenges ahead, was also shared by international and domestic Financial Institutions in their relative reports released in May. Namely, the EC, in its Spring economic forecast, slashed the 2022 real GDP growth projection to 2.3% from 4.1% in February, on the back of the geopolitical turmoil that will weigh heavily on tourism and the surging inflation that already harms private consumption. From a FY-2021 2.3% YoY inflation print, the current forecast has more than doubled its projection to 5.6%, when in the winter forecast it was pinned at 2.6%. On the same footing with the Commission as regards GDP growth, the Central Bank of Cyprus now forecasts a 2.3% growth rate from 3.6% in December, while its forecast of 6.8% inflation exceeds that of the EC. Indeed, inflationary pressures do not appear to be easing yet, as in April the HICP inflation spiked further to 8.6% YoY from 6.2% in March, with the pressure remaining elevated on a monthly basis as well (3.1% in April vs 1.8% in March). Another important document for the Cypriot economy was released in the previous month, the Post-Programme Surveillance Report, which, along with the aforementioned risks (lower tourist income and inflation), also highlighted the fiscal perils from the adverse geopolitical momentum. Following the necessary anticyclical fiscal measures in 2020 and 2021, which widened the fiscal deficits to -5.8% and -3.0% of GDP in 2020 and 2021 respectively, the 2022 budget envisaged in October a mild consolidating process to ensure the return to milder deficits of c. -1.1% of GDP. Having said that, the reduced tax revenues from tourism and professional services constitute serious downside risks to the budget execution, which will most probably be mitigated however, by the gradual phasing out of the pandemic support measures, resulting in reduced public expenditure

**Figure 23: The pivotal role of tourism in the Cypriot economy put under stress..**




Source: CYSTAT, Bloomberg Eurobank Research

**Figure 24: ...forcing, among other factors, the EC, to revise sizably its forecasts**



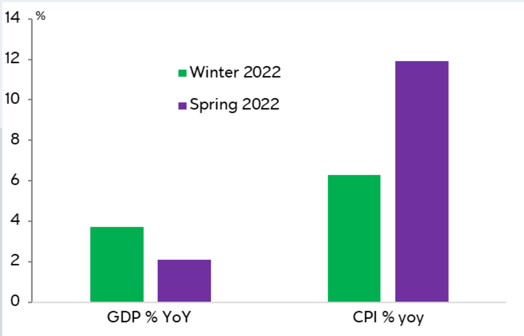

Source: EC, Eurobank Research

# Bulgaria

## Q1-2022 flash estimate points to firm GDP growth but risks loom ahead

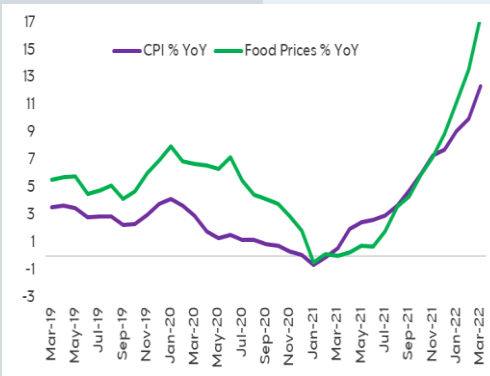
The Q1-2022 GDP growth flash estimate came in at 4.5% YoY, beating to the upside the Bloomberg consensus at 3.10% but pointing to some loss of steam once compared to the 5.2% YoY estimate of the previous quarter. On a quarterly basis, signs of cooling remain present as GDP expanded by 1.0% in Q1-2022 vs 1.4% in Q4-2021. With further breakdown of national accounts due on June 8, based on available high frequency data, the economy has held firm up to March, with retail sales and industrial production continuing to grow on a yearly basis by 9.6% YoY and 19.0% YoY respectively, both more vigorously compared to February. More importantly, net foreign direct investment (FDI) in Bulgaria reached EUR1.05bn in January-March, which is fourfold higher compared to the net flows directed to Bulgaria a year earlier. Beneath the increase in the FDIs we read, inter alia, the restoration of the political stability in the country, following the inability to form a government in 2021, which, however, is put under stress again. Very briefly, as the governing coalition consists of four parties with some being more pro-Russian than others, rifts within the government's cabinet have emerged, fueled by the decision to send military aid to Ukraine. As things stand, the key concern of the economy remains inflation, as it kept spiraling for a 14th month in a row, coming in at 14.4% YoY in April from 12.4%YoY in March and 10.0%YoY in February and being so far the highest in the region. Along these lines, the EC, in its Spring economic forecast released in mid-May, cut almost by half the 2022 GDP growth forecast to 2.1% from 4.1% in winter forecast, with the negative implications of inflation constituting the main concern. On the matter, the Commission recommended a more vigorous approach towards the exploitation of the RRF funds, so as to curb as soon and as much as possible the adverse impact of inflation on consumption and investments. It also argued for stronger energy independence through a shift in the country's energy mix from fossil fuels to renewables. The latter suggestion over energy independence came as no surprise following the halt of the natural gas supply from Russia in late April.

**Figure 25: The EC revised sizably its fore-casts ....**




Source: EC, Eurobank Research

**Figure 26: ...as the continuing price pressure on vital goods, among others, poses serious risks**



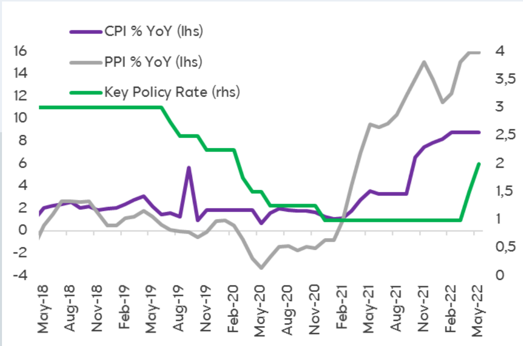

Source: NSI, Eurobank Research

# Serbia

## The NBS about to catch up gradually with its peers on monetary tightening

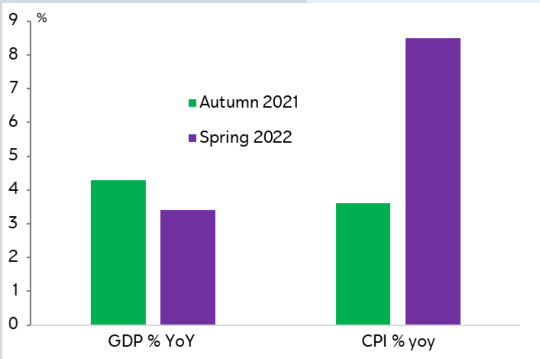
Q1-2022 GDP growth reading verified the flash estimate of 4.3%YoY released in early May, coming in at 4.4% YoY and 0.5% QoQ. In terms of expenditure, the key driver of growth was private consumption with net exports contributing negatively. The key concern of the economy remains the persistent inflationary pressures stemming from the energy and food segments. In April, CPI came in at 9.6% from 9.1% YoY and 8.8% YoY in March and February respectively, when for FY-2021 inflation averaged at just 4.1%. The core print gained as well in April climbing to 5.5% YoY from 4.8%YoY in March and 4.4% YoY in February, implying that expectations over continuing price increases are getting more entrenched. On a monthly basis, pressure remains elevated as prices rose by 1.5% compared to 0.8% in March. In view of the above, in this month's meeting, the National Bank of Serbia (NBS) delivered an additional hike of 50bps for a second month in a row, bringing the Key Policy Interest Rate (KPR) to 2%. It also increased the deposit facility interest rate to 1% from 0.50% and the lending facility interest rate to 3.0% from 2.50%. In the quarterly inflation report, which was also published in May, the GDP growth forecast for 2022 was trimmed by 0.5ppt compared to the previous quarter, standing between 3.5% and 4.5% on the assumption of no further escalation in the geopolitical conflict and continuity of oil and natural gas flows towards Europe. The drag in this year's growth print will come from still subdued compared to previous years private consumption and investments, both weighed by trimmed disposable income and earnings. The EC and EBRD projections were in line with those of the NBS, with the EC forecasting growth rates of 3.4% and 3.8% for 2022 and 2023 respectively and the EBRD forecasting slightly lower growth for 2022 and a 4.0% rebound in 2023. All in all, as things stand, the impact from the war on the economy is considered manageable. The three-year natural gas deal that Russia and Serbia are about to ink, following the expiration of the existing contract at the end of 2022, will prove supportive. While the agreement is yet to be finalized, it is expected that natural gas prices will remain favorable for Serbia, even though not to the current extent

**Figure 27: The Central Bank finally entered the tightening circle in the region…**




Source: Bloomberg, Eurobank Research

**Figure 28: ..as risks are tilted to the downside for growth and to the upside for inflation**




Source: EC, 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) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2021 | 2022f | 2023f | 2021 | 2022 | 2023f | 2021 | 2022f | 2023f | 2021 | 2022f | 2023f | 2021 | 2022f | 2023f |
| **World** | 6.1 | 3.3 | 3.3 | 4.7 | 6.5 | 3.8 | | | | | | | | | |
| **Advanced Economies** | | | | | | | | | | | | | | | |
| **USA** | 5.7 | 3.1 | 2.1 | 4.7 | 6.9 | 3.0 | 5.4 | 3.6 | 3.5 | -3.5 | -3.7 | -3.5 | -10.2 | -4.8 | -4.2 |
| **Eurozone** | 5.4 | 2.6 | 2.2 | 2.6 | 6.8 | 2.7 | 7.7 | 6.9 | 6.9 | 2.4 | 2.2 | 2.2 | -5.1 | -4.6 | -3.1 |
| Germany | 2.9 | 2.0 | 2.5 | 3.2 | 6.9 | 2.8 | 3.6 | 3.5 | 3.3 | 6.7 | 5.5 | 6.0 | -3.7 | -3.4 | -1.6 |
| France | 7.0 | 3.1 | 2.1 | 2.1 | 4.6 | 2.3 | 7.9 | 7.3 | 7.1 | -0.9 | -1.4 | -1.3 | -7.0 | -5.2 | -4.2 |
| **Periphery** | | | | | | | | | | | | | | | |
| Cyprus | 5.5 | 2.3 | 3.2 | 2.2 | 6.5 | 3.0 | 7.5 | 7.7 | 7.0 | -7.6 | -9.0 | -8.0 | -1.8 | -1.5 | -1.0 |
| Italy | 6.6 | 2.7 | 2.0 | 2.0 | 6.1 | 2.0 | 9.5 | 8.9 | 8.6 | 3.3 | 2.0 | 2.2 | -7.2 | -5.5 | -4,0 |
| Portugal | 5.4 | 5.0 | 2.6 | 0.9 | 4.4 | 1.8 | 6.6 | 6.1 | 5.9 | -0.7 | -1.5 | -1.4 | -2.8 | -2.9 | -2.4 |
| Spain | 5.1 | 4.7 | 3.2 | 3.1 | 6.9 | 2.1 | 14.8 | 13.5 | 13.1 | 0.9 | 1.1 | 1.4 | -7.0 | -5.7 | -4.3 |
| **UK** | 7.2 | 3.7 | 1.4 | 2.6 | 7.7 | 4.0 | 4.6 | 3.9 | 4.1 | -3.4 | -3.6 | -3.5 | -7.6 | -4.0 | -2.6 |
| **Japan** | 1.8 | 1.9 | 1.8 | -0.3 | 1.8 | 1.1 | 2.8 | 2.6 | 2.5 | 2.8 | 1.8 | 2.1 | -6.4 | -6.5 | -4.5 |
| **Emerging Economies** | | | | | | | | | | | | | | | |
| **BRICs** | | | | | | | | | | | | | | | |
| Brazil | 4.8 | 0.5 | 1.6 | 8.3 | 8.4 | 4.4 | 13.6 | 11.6 | 11.1 | -1.6 | -1.0 | -1.3 | -5.1 | -7.5 | -6.9 |
| China | 8.1 | 4.5 | 5.1 | 0.9 | 2.2 | 2.2 | 4.4 | 4.0 | 3.7 | 1.8 | 1.5 | 1.1 | -3.8 | -4.7 | -4.5 |
| India | 8.8 | 7.5 | 6.5 | 5.4 | 6.5 | 5.0 | | *NA* | | -1.5 | -2.7 | -2.3 | -6.9 | -6.5 | -6.0 |
| Russia | 4.7 | -10.3 | -1.5 | 6.7 | 19.0 | 11.2 | 7.5 | 7.0 | 6.0 | 6.5 | 9.7 | 6.5 | 0.4 | -2.5 | -2.0 |
| **CESEE** | | | | | | | | | | | | | | | |
| Bulgaria | 4.2 | 2.6 | 2.8 | 3.3 | 10.4 | 5.1 | 5.5 | 5.5 | 5.5 | -0.4 | -1.8 | 0.7 | -4.1 | -4.0 | -3.5 |
| Serbia | 7.0 | 3.2 | 3.7 | 4.1 | 8.1 | 4.7 | 10.1 | 10.4 | 9.5 | -4.4 | -5.5 | -5.3 | -4.2 | -3.0 | -2.0 |
| Turkey | 11.0 | 3.0 | 3.3 | 19.4 | 60.0 | 25.0 | 12.0 | 12.5 | 12.8 | -2.2 | -3.0 | -2.6 | -3.4 | -4.5 | -4.5 |

Sources: European Commission, IMF, OECD, Bloomberg, Eurobank Research

# Eurobank Fixed Income Forecasts

| | Current | June | September | December | March |
|---|---|---|---|---|---|
| USA | | | | | |
| Fed Funds Rate | 0.75-1.00% | 1.25-1.50% | 2.02-2.25% | 2.42-2.65% | 2.72-2.95% |
| 3m SOFR | 1.43% | 1.36% | 2.06% | 2.45% | 2.79% |
| 2yr Notes | 2.66% | 2.80% | 2.96% | 3.01% | 3.11% |
| 10 yr Bonds | 2.91% | 3.01% | 3.10% | 3.09% | 3.17% |
| **Eurozone** | | | | | |
| Refi Rate | 0.00% | 0.00% | 0.20% | 0.45% | 0.65% |
| 3m Euribor | -0.34% | -0.40% | -0.04% | -0.17% | 0.35% |
| 2yr Bunds | 0.56% | 0.24% | 0.35% | 0.44% | 0.55% |
| 10yr Bunds | 1.19% | 0.98% | 1.07% | 1.04% | 1.10% |
| **UK** | | | | | |
| Repo Rate | 1.00% | 1.20% | 1.50% | 1.60% | 1.70% |
| 3m Sonia | 1.30% | 1.26% | 1.45% | 1.52% | 1.59% |
| 10-yr Gilt | 2.16% | 1.87% | 1.86% | 1.87% | 1.91% |
| **Switzerland** | | | | | |
| 3m Saron | -0.75% | -0.75% | -0.68% | 0.55% | -0.34% |
| 10-yr Bond | 0.90% | 0.87% | 0.90% | 0.98% | 1.06% |

Source: Bloomberg (market implied forecasts)

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