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Although it is too early to assess the impact from the geopolitical tensions over Ukraine as the situation is very uncertain and still evolving, the global economy will be affected through a number of channels, primarily energy, via higher oil and gas prices. With respect to global monetary policy, investors appear to tilt to the view that, although high and potentially entrenched inflation is a factor of concern, downside risks to growth and financial market volatility will likely require a more gradual monetary policy normalization than projected before the recent dramatic escalation of the Russia-Ukraine crisis.

Macro Picture

USA: Economy on a good growth momentum but persisting inflation dampens outlook

EA: The virus drag is fading but geopolitical tensions raise risks of negative effects on growth

UK: Looming increases in taxes and energy prices likely to limit the strength of economic recovery

EM: The Russia-Ukraine war found many EMs with signs of weakening economic activity

CESEE: The proximity to the riskful zone of Russia adds to the challenging economic outlook

Markets

FX: USD and CHF act as safe havens along with commodity currencies as Russia/Ukraine crisis hits the markets.

Rates: EU and US rates extremely volatile due to geopolitical concerns and uncertainty on the next moves by the Fed and the ECB.

EM: EM assets severely hit by the Russian invasion in Ukraine. The combination of upside risks to inflation and downside risks to growth complicates CB policies.

Credit: Spreads wider in February, expected to continue widening with increased volatility/dispersion in Q1 on inflation/Ukraine risks.

Policy Outlook

USA: Fed likely to raise federal funds rates by 25bps in March

EA: Growth and inflation risks from the geopolitical turmoil create a challenging environment for the ECB

UK Persistent inflation pressures suggest further tightening in BoE monetary policy

CESEE: Monetary tightening holds firmly amid continuing inflationary pressures

Key Downside Risks

DM: Heightened and prolonged geopolitical uncertainty, de-anchoring of inflation expectations, emergence of new infectious variants

EM: Geopolitical risks intensify, energy and soft commodities prices continue to rally, contagion risks towards EM from the Russian assets plunge

Special Topics in this issue

Fed: Factors that will affect the monetary policy ahead

Ukraine-Russia crisis: A lose-lose economic balance

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March 2022

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

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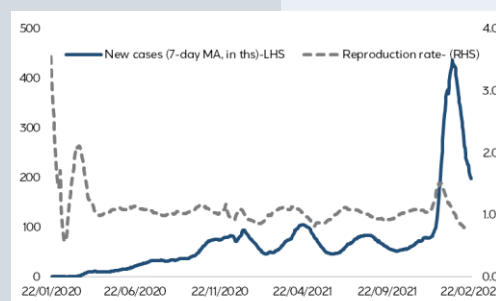
March 2022

Macro Views
Latest world economic & market developments

The growing geopolitical tensions after Russia's full-scale invasion of Ukraine cast immense uncertainty over the outlook of the global economy

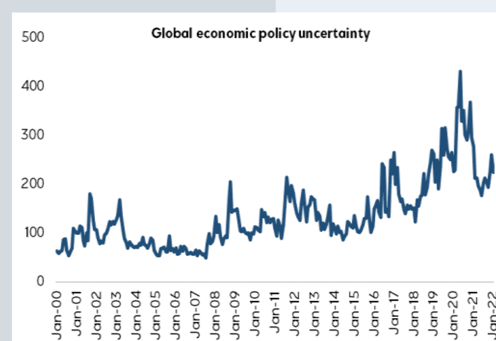
The growing geopolitical tensions after Russia's full-scale invasion of Ukraine and US and Western Europeans' governments decision, in retaliation, to impose sanctions against Russia that have been escalating in severity along with Russia's continued military advance in Ukraine, dominate international headlines and cast immense uncertainty over the outlook of the global economy. Although it is too early to assess the impact as the situation in Ukraine is very uncertain and still evolving, the global economy will be affected through a number of channels. These include, inter alia, heightened economic uncertainty, trade relations, banking and investment exposure, financial conditions but primarily, energy, via higher oil and gas prices, with Europe likely to bear the brunt of the effect due to its high exposure to Russian energy exports. While sanctions to Russia sought exceptions for oil and natural gas exports, risk premium from geopolitical tensions led to a fresh rise in the price of Brent crude to above $110/bbl for the first time since 2014, while the European natural gas price spiked briefly to a fresh record high above €195MWh. Besides energy commodity prices, agricultural and industrial metal prices also took another leg higher to fresh multi-year highs amid concerns over potential supply constraints, given the role of Russia and Ukraine as major exporters of several commodities (i.e., wheat, platinum, palladium, neon). The spike in commodity prices represents an acute risk to growth and inflation globally, at a time when inflation is already elevated, with January CPI releases (outside China) continuing, generally, to surprise to the upside. Against this background, global GDP growth is likely to move lower near-term, dashing earlier hopes for a rebound thanks to the fading Omicron drag. However, it is still expected to remain above potential, as activity bounces (as evidenced by the DM flash February PMIs, except for Japan) after many countries began relaxing activity restrictions noticeably. With respect to global monetary policy, investors appear to tilt to the view that, although high inflation and the risk

While the Omicron wave ebbs...



Source: Our World In Data, Eurobank Research

... geopolitical risks have surged to the forefront



Source: Economic Policy Uncertainty, Eurobank Research

of becoming entrenched is a factor of concern, downside risks to growth and financial market volatility will likely require a more gradual monetary policy normalization than projected before the recent dramatic escalation of the Russia-Ukraine crisis.

Developed Economies

US: Real GDP growth in Q4-2021 was revised upwards to 7.0%YoY annualised in the second estimate, reflecting upward revisions to nonresidential fixed investment, government spending and residential fixed investment. For the full year 2021, real GDP grew by 5.9%YoY, unchanged from the prior estimate. Coming to 2022, several data such as home sales, retail sales and industrial production, have so far surprised to the upside pointing to a strong growth momentum in economic activity, while labour market conditions continue to improve. Consumer confidence however, appears slightly eased mainly on inflation concerns. In this environment, it appears almost inevitable that the Fed will begin its monetary policy tightening at the March FOMC meeting, but taking into consideration the recent geopolitical tensions, the pace and magnitude of tightening are likely to be more gradual and cautious than previously expected. This view was corroborated by Fed Chair Powell who stated that he would propose and support a 25bps rate hike at the March meeting. Incoming economic data and the evolution of the Russia-Ukraine conflict until then will be closely watched.

Euro area: After GDP growth decelerated to 0.3%QoQ in Q4 from 2.3%QoQ in the prior quarter, probably due to the resurgence in pandemic cases and the associated reintroduction of tighter activity measures in several countries, sentiment surveys for February suggest that the Eurozone may be regaining some momentum in Q1 2022. In support of the above, the Composite PMI rose by a higher-than-expected 3.5pts in February to a 5-month high of 55.8 while the ECSI halted a three monthly declining streak and rose by 1.3pts to 114.0 in the same month. However, both surveys were conducted before the recent escalation of the Ukraine-Russia crisis. That said, they did not take into account potential spillovers into the Eurozone growth via a number of transmission channels, but primarily via energy, given the economy's heavy reliance on energy imports from Russia (Russia accounts for c. 40% of EU gas imports and c. 30% of EU crude imports). Therefore, inflation risks are skewed to the upside, create a challenging environment for the ECB as the Central Bank has to balance the risk of more persistently high inflation and second-round effects on wages vs. the risk of meaningful negative effects on Eurozone growth from the Ukraine-Russia crisis.

Emerging Economies

EM & CESEE: The outlook of the entire emerging sphere is dampened by the elevated geopolitical risks which increased worryingly at the close of February. The Russia-Ukraine war found many EMs with signs of weakening economic activity. Additionally, energy and soft commodities have been broadly rallying throughout February with the increasing course continuing at the time of writing. The collapse of the Russian rouble which has lost more than 50% of its value against the USD since early February along with the imposed sanctions to the Central Bank of Russia (CBR), which is translated to limited access to the

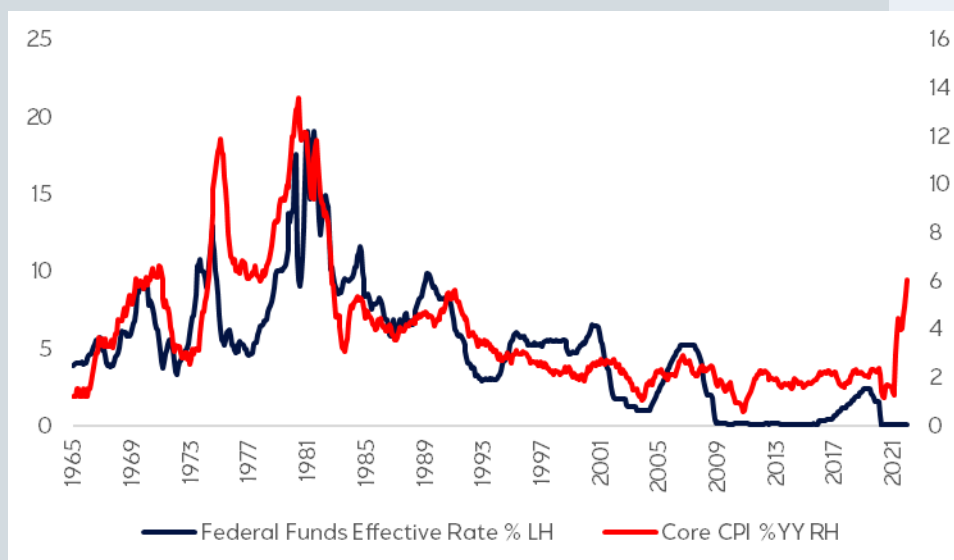
CBR's reserves, has spurred uncertainty in the wider EM area increasing markets' volatility. Under this spectrum, contagion risks of a wider crisis are tilted to the upside while inflationary pressures stemming from the boiling commodities market are expected to intensify further and weigh on the GDP growth outlook. The European developing part of the EM, the CESEE region, is expected to be more adversely affected. Apart from the increased geopolitical risks arising from the geographical proximity of these areas to Russia, the said region is still at a developing course in economic terms with intense energy dependence on Russia. On top of that, the neighboring countries of Ukraine, such as Poland, Slovakia and Romania are already receiving huge refugees' flows, the hosting of which, apart from its own crucial humanitarian importance, may have a significant economic and social cost for each welcoming country per se. Meanwhile, on the economic policy front, many regional central banks continued with their tightening stance following the continuously surging inflation readings since the beginning of 2022.

Special Topics

I. Fed: Factors that will affect the monetary policy ahead

In the past few months and in light of mounting inflation pressures worldwide, focus has turned to monetary policy and the time and magnitude of the reaction of major economies' central banks. Needless to say, these will by no means be uniform as each economy is at a different point of the business cycle, while the underlying causes of inflation also vary. On the one hand, soaring energy prices drive inflation globally, while on the other hand, varying core inflation data justify different monetary policy paths among countries. For example, the Bank of England decided to increase the Bank Rate by 0.35pps cumulatively in December (15pps) and February (25pps), to 0.5%, whereas the Bank of Japan is maintaining the monetary easing. When it comes to the US economy and the Fed in particular, the last tightening cycle took place between October 2015 and January 2019 when the federal funds effective rate increased by 225bps, reaching 2.40%. Later on, in response to the outbreak of the Covid-19 pandemic in spring 2020, the Fed reacted decisively, cutting the fed funds rate to 0-0.25% and introducing open-ended quantitative easing (QE) combined with many credit and liquidity facilities to improve operation in asset markets.
Taking a brief historical look back at the last decades, we see that the Fed's rate hikes relate to the behaviour of inflation (Figure 1) and broadly aim at containing it, as well as addressing other conjunctural issues.

Figure 1: Historically federal funds rate movements relate to inflation changes



Source: Bureau of Labour Statistics, Board of Governors of the Federal Reserve System

Coming to the present, the annual inflation rate, as measured by the core CPI (CPI excluding food and energy), has climbed from 1.3% in February 2021 to 6.0% in January 2022, which constitutes a four-decade high, while average core inflation growth for the 12-month period from Feb-21 to Jan-22 stands at 4.0%, an almost three-decade high. During this time, the Fed has maintained its accommodative stance keeping rates unchanged. This was largely due to the prevalent uncertainty stemming from the Covid-19 pandemic and the perception that the nature of this inflation episode is transitory, stemming mainly from supply disruptions that will subside along with the pandemic. Given, however, the magnitude of the most recent

inflation readings, concerns have been raised that the Fed has been significantly behind in its reaction and that its policymaking strategy should return to a somewhat more preemptive footing.

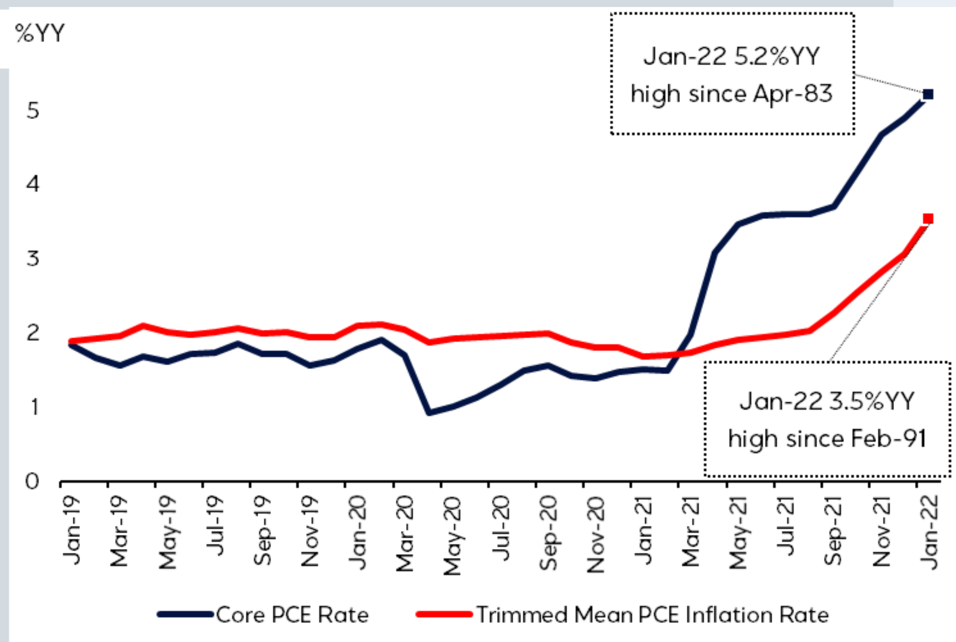
This is now apparently changing and at the 25-26 January meeting the Federal Open Market Committee (FOMC) signaled its intention to shift away from its accommodative policy stance, initially by raising the target range for the federal funds rate. The size and pace of rate hikes was left open in order for the Bank to maintain the maximum possible flexibility as new economic data flow in. The process of reducing the balance sheet would begin after the process of increasing the target range of the federal funds rate has commenced, while the timing is to be determined with the aim to promote the Committee's price-stability and maximum-employment goals.

Below we look at the recent evolution of basic indicators of price stability and employment factored in the Fed's decision-making process.

Price stability

As regards the price stability goal, the Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures (PCE), is most consistent over the longer run with the Federal Reserve's statutory mandate. Another indicator closely followed by the Fed is the trimmed mean inflation rate as an alternative measure of core inflation, which has been shown to outperform the more conventional "excluding food and energy" measure as a gauge of core inflation. From the first months of last year, these two indicators, core PCE and trimmed mean inflation rate, are on the rise, repeatedly exceeding expectations, reaching in January 2022 multi-decade highs and leaving no doubt that inflation is broad–based (Figure 2).

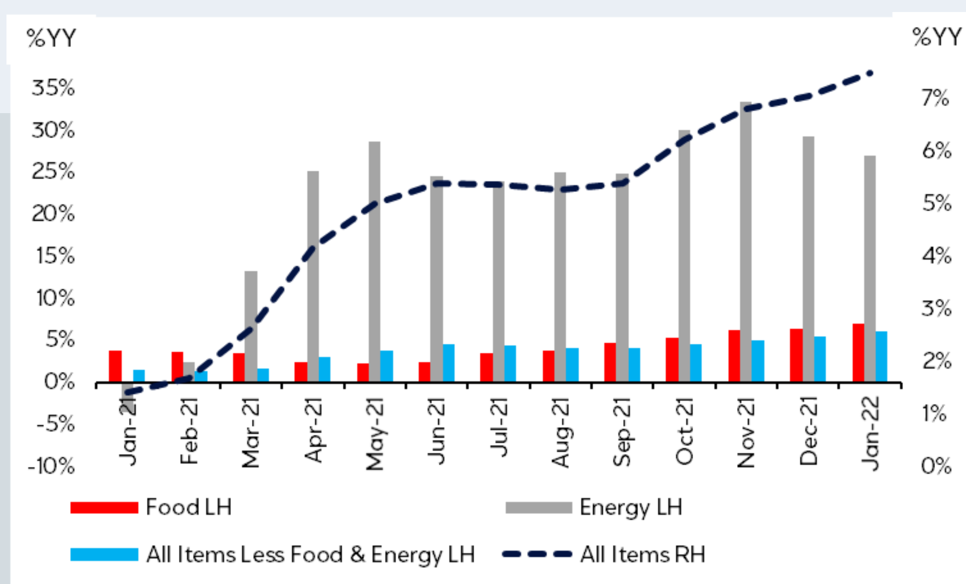
Figure 2: Core PCE and Trimmed Mean Inflation Rate



Source: Bureau of Economic Analysis, Federal Reserve Bank of Dallas

The headline Consumer Price Index (CPI) climbed to 7.5%YoY and the core CPI (excl. food and energy) to 6.0%YoY, both around 40-year highs. The energy component has posted by far the steepest increases, reaching as much as 33.3% in November 2021. Nevertheless, energy prices growth slowed in December and January creating expectations that this will lead to the gradual deflation of the headline index as well (Figure 3).

Figure 3: CPI All Items, Food, Energy and All Items Less Food and Energy



Source: Bureau of Labour Statistics

In the same direction, the easing of the pandemic and the shift away from the zero-Covid policy in Asia is expected to allow production to pick up leading to greater availability of goods, while the apparent normalisation of ports' congestion will improve delivery times, mitigating supply-driven inflation. As a result, inflation is expected to peak in Q1-2022 and start falling in Q2-2022. Having said that, the ongoing crisis in Ukraine may drive energy prices further up, although it is too early to assess the magnitude and duration of this effect.

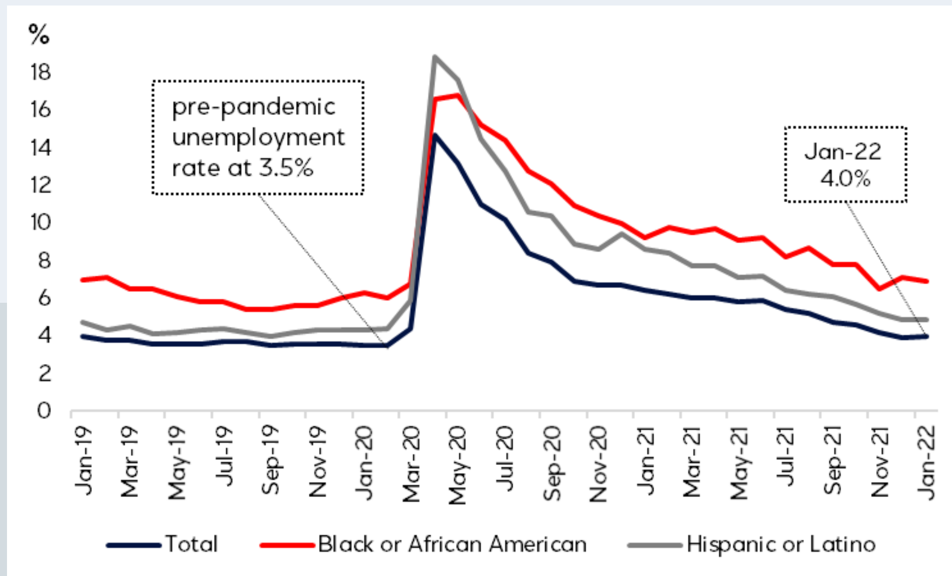
Employment

As regards the maximum-employment goal, the Committee judges[1] that for a number of reasons a fixed goal for employment would not be appropriate to specify and its decisions are founded on assessments of the shortfalls of employment from its maximum level. These assessments, which are subject to uncertainty and revisions, are based on a wide range of indicators. Below we will look at how some of the labor market indicators monitored by the FOMC have evolved recently.

The unemployment rate stood at 4.0% in January 2022, steadily approaching the pre-pandemic unemployment rate of 3.5%. The trend appears to be broad-based among different ethnic groups, as the unemployment rate for Black or African American and Hispanic or Latino has been declining as well (Figure 4).

[1] As stated in the "Statement on Longer-Run Goals and Monetary Policy Strategy" adopted effective 24 January 2012 and reaffirmed effective 25 January 2022.

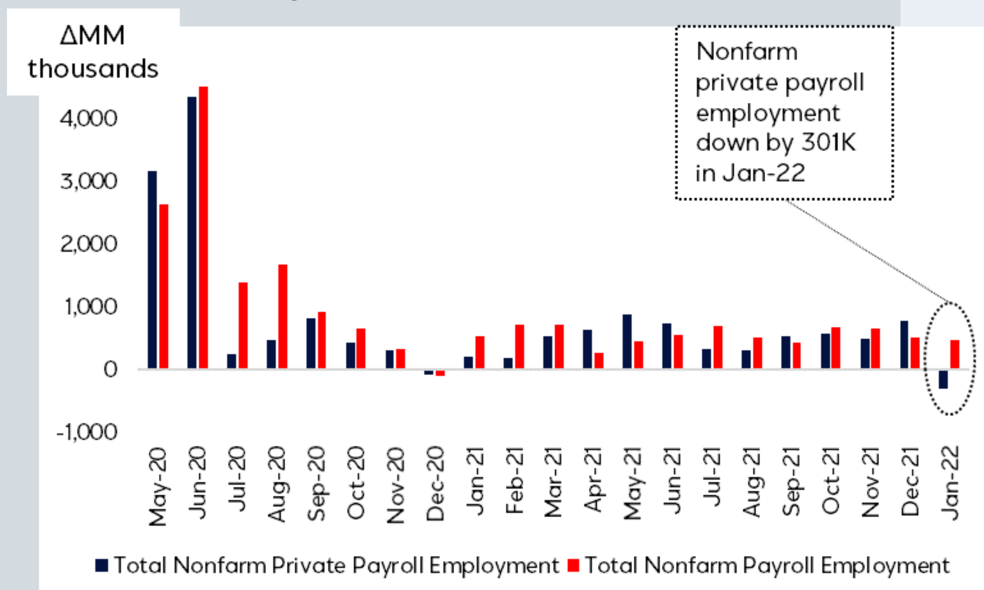
Figure 4: Unemployment rate



Source: Bureau of Labour Statistics

Total nonfarm payroll employment, which represents the number of jobs added or lost in the economy, has been increasing for 13 months in a row at an average monthly rate of 549K. Additionally, from the 21,991K jobs lost during March-April 2020, 19,116K have so far been recovered. Nevertheless, private sector employment took a step back at the start of 2022 due to the impact of the Omicron variant on jobs growth. The majority of industry sectors experienced job loss, with leisure and hospitality seeing the largest setback after substantial gains in Q4-2021 (Figure 5).

Figure 5: Nonfarm payroll employment

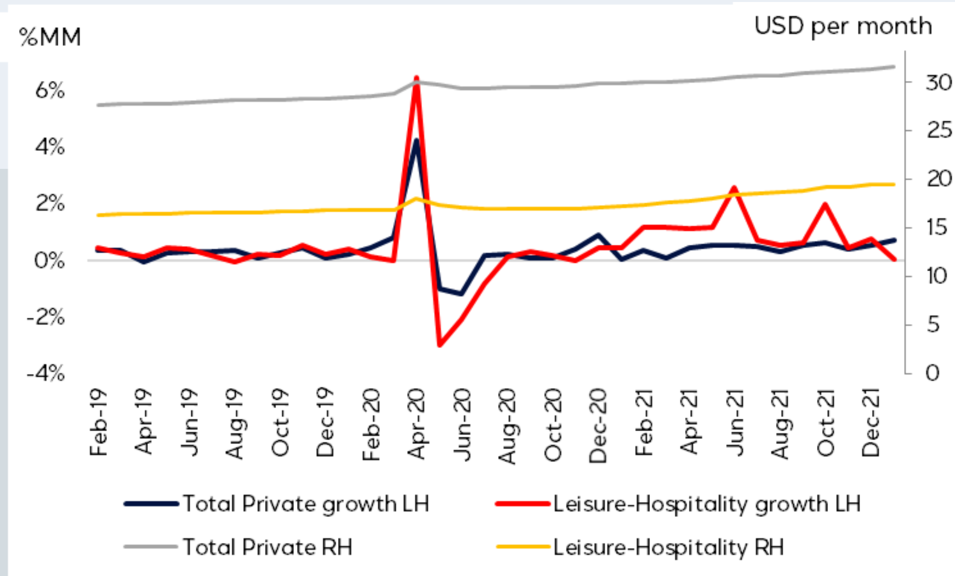


Source: Bureau of Labour Statistics, ADP National Employment Report

Average hourly earnings in the private sector have recovered and surpassed their pre-pandemic level by USD3.07 per hour, standing at USD31.63 per hour in January. Nevertheless, in the leisure and hospitality

sector, where performance is more gravely affected by the pandemic, the fluctuations in the average hourly earnings growth rate have been sharper indicating that a potential resurgence of Covid-19 is still a risk (Figure 6).

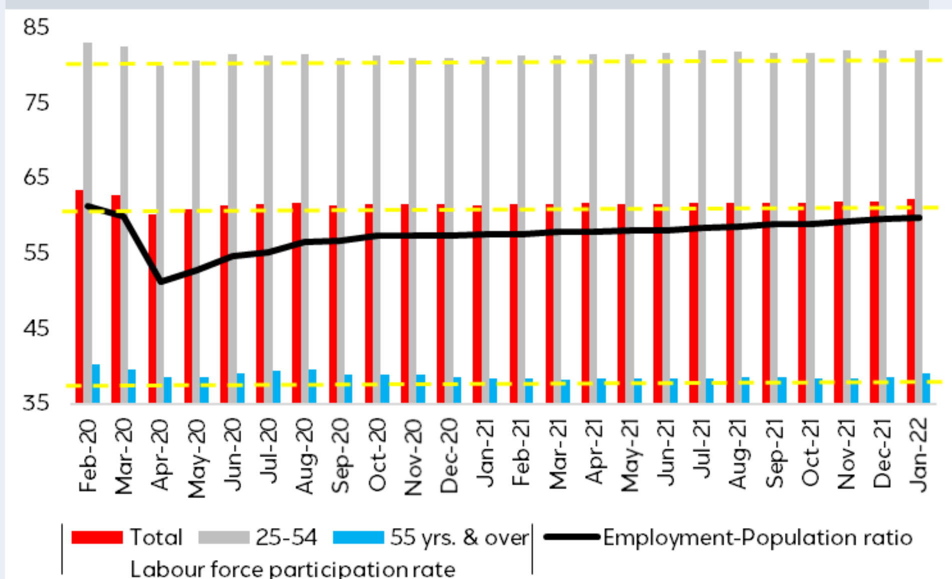
Figure 6: Average Hourly Earnings



Source: Bureau of Labour Statistics

The return of workers to the labour force is continuing as pandemic-related disruptions subside. The employment to population ratio and the labour force participation rate approach pre-pandemic levels, while this normalisation appears to be broad-based among age groups (Figure 7).

Figure 7: Labour force participation rate and employment to population ratio



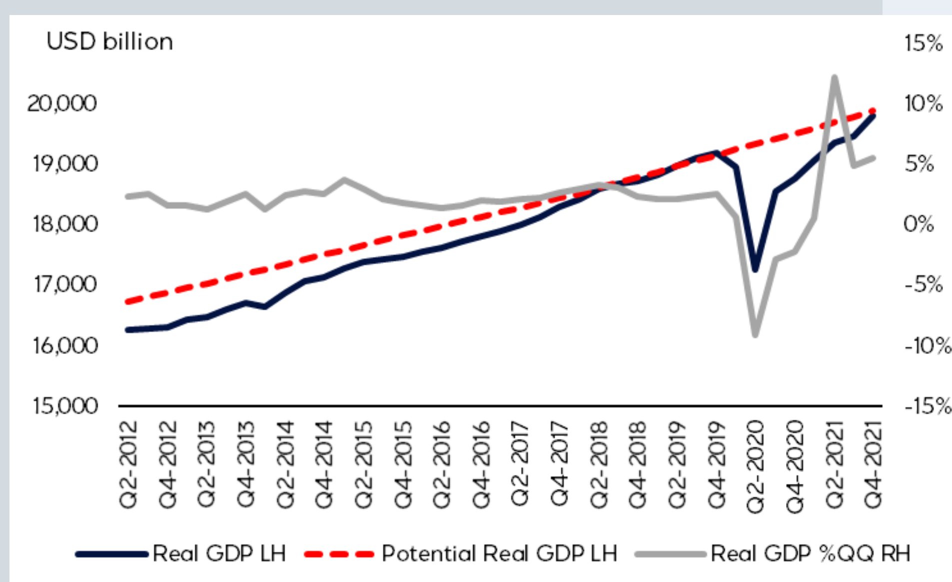
Source: Bureau of Labour Statistics

Overall, labor market conditions have been improving, earnings are recovering and workers of all ages are returning to the workforce. Nevertheless, sectors that are more exposed to the pandemic, may still experience setbacks in case of a potential new wave.

Overall assessment of the economy

The economy grew by 5.7% in 2021, the fastest pace since 1984, after contracting by 3.4% in 2020, the biggest decline in 74 years. Real GDP increased by 7.0% annualized in Q4-2021 (from 2.3% in Q3), primarily reflecting increases in private inventory investment. Real GDP has been recovering for the past 4 quarters, surpassed pre-covid levels in Q2-2021 and almost reached real potential GDP in Q4-2021 (Figure 8).

Figure 8: Real GDP and real potential GDP



Source: Bureau of Economic Analysis, US Congressional Budget Office

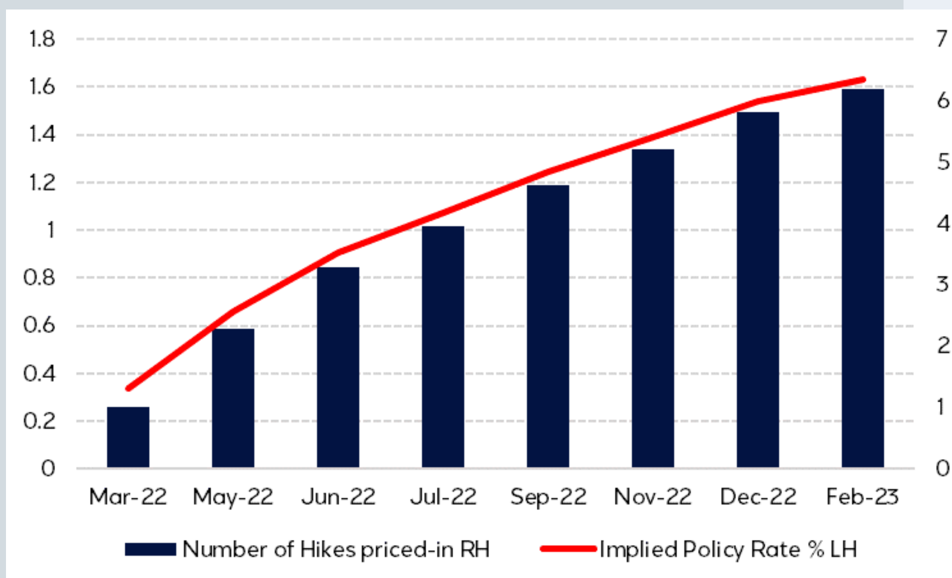
Onto 2022, economic activity growth is expected to continue albeit at a slower pace than initially expected, with 2022 real GDP projection pinned at a healthy 3.9% (consensus) on the back of strong household balance sheets, pent-up demand and robust business spending. Inflation should peak in H1-2022 and then decline later in the year, as goods demand growth moderates and supply side pressures ease. Job creation is expected to continue with improving labour participation and the pre-pandemic level of employment is likely to be reached later in the year. Risks to the downside include persisting high inflation that erodes purchasing power, sustained labour shortages and the recent crisis in Ukraine.

In spite of risks to growth, it is considered certain that the Fed will raise interest rates in March as signaled at the FOMC January meeting and in statements by a number of Fed officials, but the first move is likely to be cautious. Until recently, the view that sharp and sustained increases in inflation would push the Fed to launch a front-loaded tightening policy with a 50bps rate hike in March, in order to prevent inflation from becoming embedded, was gaining ground. Over the past weeks however, the necessity of an aggressive kick-off move has been called into question. Geopolitical tensions – cited as a source of risk already in January by Fed Chair Powell and more recently by other Fed officials – have intensified, reinforcing the

view that the Fed should act prudently to allay volatility rather than contribute to it. As stated in the FOMC January meeting minutes "some participants commented on the risk that financial conditions might tighten unduly in response to a rapid removal of policy accommodation". Having said that, no hike at all in March is also highly unlikely. The prevalent view is that the current economic situation justifies the tightening, while the geopolitical crisis in Ukraine will have a limited impact on the US economy, due to its lower exposure to Russian energy and fewer trade links. On this matter, Fed Chair Powell stated[2] that the Fed intends to raise its policy interest rate in March, despite uncertainties from the Russian invasion of Ukraine and that he is inclined to propose and support a 25bps rate hike in March.

For the whole tightening cycle however, the pivot may be more hawkish overall. The minutes from the January FOMC meeting state that if inflation does not move down as expected, it would be appropriate for the Committee to remove policy accommodation at a faster pace than they currently anticipate. This narrative was corroborated by Fed Chair Powell who stated[3] that the Committee has an expectation that inflation will peak and begin to come down this year and to the expent that inflation comes in higher or more persistently high than that, then the Committee would be prepared to move more aggressively by raising the federal funds rate by more than 25bps at a meeting or meetings. As things stand, there is a 99.8% probability for a 25bps hike in March and zero probability for a 50bps rate hike in March, while five to six hikes in total are anticipated until the end of the year (Figure 9).

Figure 9: Implied policy rate and number of rate hikes



Source: Bloomberg, Updated as of 3 March 2022, 11:16am EEST

To conclude, the economic data are conducive to the beginning of the tightening of the Fed's monetary policy in March. However, the geopolitical tensions around Ukraine that have escalated unexpectedly

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[2] Fed Chair Jerome H. Powell testimony before the Committee on Financial Servies, U.S. House of Representatives, Washington D.C. (2 March, 2022)

[3] Fed Chair Jerome H. Powell testimony before the Committee on Financial Servies, U.S. House of Representatives, Washington D.C. (2 March, 2022)

sharply in recent days, are a source of uncertainty and will undoubtedly be taken into account by the FOMC. The evolution of events until the meeting will be crucial.

II. Ukraine-Russia crisis: A commonly shared lose-lose economic balance

Disappointingly, the tensions between Russia and Ukraine, which had been intensifying since October 2021, took a dismal turn at the close of February as Russia launched a full-scale invasion against Ukraine with meaningful implications not only for the global economy, but also for the humanity as a whole. While dark pages of history are currently being written, in the following lines we will attempt to shed light on the rapidly evolving economic sanctions regime Russia is confronted with in order for the latter to be urged to reassess its aggressiveness as regards to its global standing.

Following the first three rounds of sanctions back in 2014, current economic sanctions began to be discussed by the US in early 2022 when it stated formally and at the highest level of representation that Russia intended to invade Ukraine. Two months later, sanctions are already imposed, and they are under an incremental mode, dependant on Russia's next moves.

So far, the biggest developed economies among which the US, the EU, the UK, Canada, Australia and Japan along with smaller ones such as Switzerland, New Zealand, South Korea and Taiwan have decided an unprecedent bundle of financial restrictions, which aim at "asphyxiating Russia's economy" as put by the French Foreign Minister Jean-Yves Le Drian. The measures span from the freeze of assets belonging to the Central Bank of Russia, its President Vladimir Putin, the Minister of Foreign Affairs Sergei Lavrov and other Russian moguls who support the current political regime of Russia, to broader restrictions on high-technology items, such as semiconductors and encryption security equipment. Among the most prominent actions, we outline the freeze of Nord Stream II, which has been ready since September 2021 and waiting for final authorisations in order for natural gas to start flowing from Russia towards Germany, has now been put on hold indefinitely. Last but not least, a plethora of Russian financial institutions has been excluded from the SWIFT system of payments, which is a move that took time to be digested by the EU before eventually being decided, as it was considered the move with the biggest, still uncertain towards which direction, impact.

The SWIFT system was founded in 1973 in Brussels in order to provide secure messaging for international payments. It counts around 11,000 member banks from 200 countries and territories, providing messaging systems that allow interbank and trade finance payments to be conducted safely and monitored at a worldwide scale. It is calculated that SWIFT handles around 40 million payment messages each day, adding value of around USD$1tnper year to the global economy[4]. Whereas the said system is dominant in global transactional banking, it should be kept in mind that Russian banks, following the first imposition of sanctions in 2014, have developed in the same year a parallel system

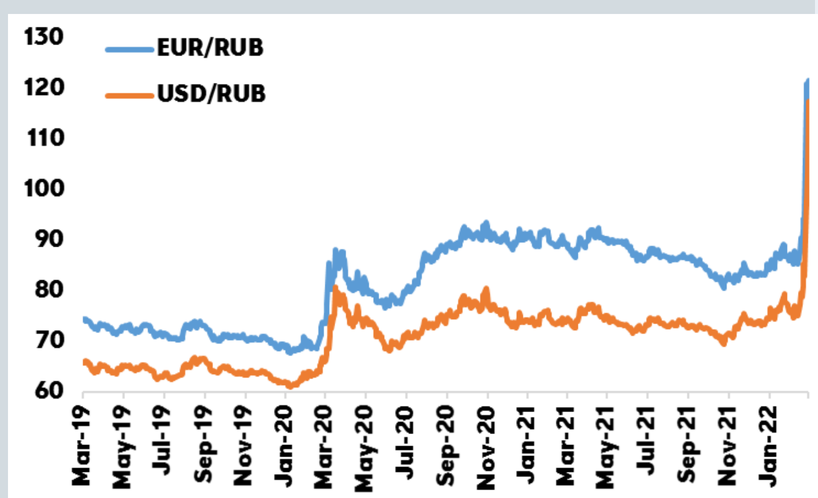
[4] https://theconversation.com/swift-ejecting-russia-is-largely-symbolic-heres-why-178065

named SPFS, founded by the Central Bank of Russia and which is currently used by a plethora of international banks when dealing with Russian banks.

While the magnitude and geographical spread of the current punitive package is exceptional, curve outs on the cash flows from energy supply payments remain in place, revealing the sensitive underbelly of the EU as regards to its energy sufficiency and its dependency on Russia. The cut off on commercial ties within the energy sphere is not known who would hurt more, the EU or Russia, and since sanctions are a tool designed to hurt the victim more than the principal, this type of arsenal has been kept aside for the moment.

In order to understand Europe's energy dependency on Russia, it is of essence to lay down the energy profile of the EU. According to Eurostat, up to 2019, oil (crude oil and petroleum products) continued to be the most significant energy source for the European economy, despite a long downward trend, while natural gas remained the second largest energy source. After a slight increase in the period between 2014 and 2017, the use of oil was again on the decline, whereas a certain fluctuation was observed in natural gas, with levels picking up again in 2019. As the continent is not self-sufficient is energy supplies, imports cover the deficit with the main imported energy products being petroleum products (including crude oil, which is the main component), accounting for almost two thirds of energy imports into the EU, followed by gas (27%) and solid fossil fuels (6%). In 2019, almost two thirds of the extra-EU's crude oil imports came from Russia (27%), Iraq (9 %), Nigeria and Saudi Arabia (both 8%) and Kazakhstan and Norway (both 7%). A similar analysis shows that almost three quarters of the EU's imports of natural gas came from Russia (41%), Norway (16%), Algeria (8%) and Qatar (5%), while over three quarters of solid fuel (mostly coal) imports originated from Russia (47%), the United States (18%) and Australia (14%). The aforementioned figures reveal Russia's key role as the main EU supplier of crude oil, natural gas and solid fossil fuels.

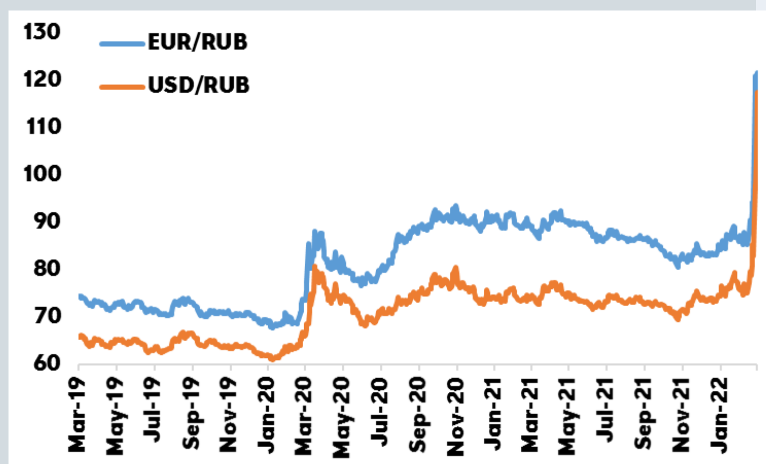
Figure 10: The Russian rouble under severe pressure



Source: Bloomberg, Eurobank Research

The prevailing view among market participants and accredited academics is that the adopted measures will suffocate Russia's liquidity and every day that passes, with sanctions active and war expenditures running, weighs on Russia's economic standing. There are estimates by the IMF[5], back in 2015, that the sanctions imposed back in 2014 in order to prevent an identical but evidently of smaller scale attack, reduced the Russian GDP by 1% -1.5% in the first year sanctions were imposed, while the medium-term effects may have been even greater, leading to a 9% decrease in GDP. One can assume that since a smaller scale of sanctions dented Russia's economy back in 2014, a more intense approach in 2022 could result in a pro-rata effect. However, it should not evade our analysis that during the last eight years, the Russian economy has been positioned not only for minimising the sanctions impact but also for growing under a sanctions regime. That said, Russia's GDP after remaining almost stable between 2014 and 2016, from 2017 and until the outbreak of the pandemic in 2020 has expanded modestly, i.e. by an average 2.4% YoY between 2017 and 2019, while in 2021 it has surpassed its pre-pandemic level, as from a mild contraction of -1.8% in 2020 it is projected to have expanded by ca.5.8%. Along these lines, the Russian economy has never reported a current account deficit, while the beginning of 2022 found the Central Bank of the country sitting on a vast reserves buffer with deposits reaching the amount of USD600bn and being substantially diversified compared to 2014 in terms of foreign currencies weights. Indicatively, the Russian reserves from ca 25% of GDP in 2014 have hiked to ca 40% in mid-2021 with the dependency on the US dollar within this time frame reduced by more than half and that on the Euro sizably reduced. However, the recent freeze of the Central Bank's of Russia assets is estimated to cut access to the aforementioned reserves even by almost half. Additionally, the plunge on the rouble currently at play along with the sanctions on some of the major banks of Russia will undoubtedly trim 2022's GDP growth. Namely, Oxford Economics in a recent focus note, expects the Russian GDP to contract by 3.1% in 2022, rebounding by only by 1.4% in 2023, driven, among other factors, by weak private consumption as the rouble's weakening will push inflation upside and trim the disposable income.

Figure 11: The Russian rouble under severe pressure



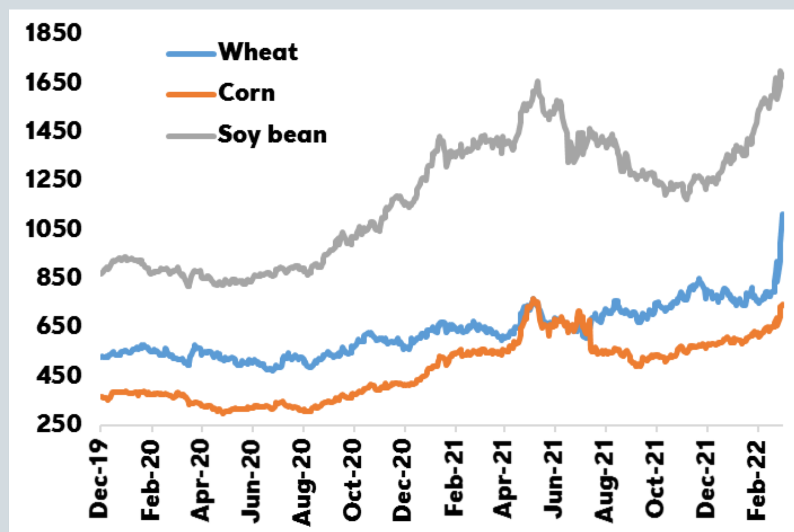
Source: Bloomberg, Eurobank Research

[5] https://www.imf.org/external/pubs/ft/scr/2015/cr15211.pdf

On the flipside, the EU's GDP growth outlook will also face headwinds from the frenzied energy prices rally since the beginning of the invasion. Assuming that natural gas and oil continue to be imported, their skyrocketing prices and the weaponization of the latter could be a very painful retaliation until the 40% of total natural gas imports of the EU from Russia are in the long run substituted by alternative energy sources and/or sellers, as these transitions take time to materialise. The continental economy will be affected in many ways; mounting inflationary pressures that will dampen private consumption, the financial markets volatility that will weigh on investments' decisions and limited export trade volumes with Russia being EU's 5th trading partner is terms of exports from the latter to the former. As the economic channels of the crisis transmission may be evident, but the size of their impact remains difficult to assess, we quote the estimate by the ECB's chief economist Philip according to which the Ukraine conflict might have a negative impact on this year's euro area GDP between 0.3% to 0.4%. while under a severe scenario, the reduction could be close to -1%.

Another aspect, equally important, in our view, when it comes to the quality of living standards in the continent and maybe less highlighted than it deserved so far by the media and analysts, is the consequences from the current rampage on the soft commodities outlook. Russia holds a pivotal role in the global commodities market as it is the world's largest exporter of wheat and Ukraine is lagging only by a little, with wheat being considered as a commodity with limited elasticity in terms of demand and use. Wheat future prices have increased by 33% since the beginning of the year, with corn and soybean on the same footing. Given the tendency commodities markets have to price in instantly anticipated future developments, beneath the pressure on future contracts prices, lie market worries over a disruption in the supply chains in case of Russian control over the sea of Azov, as it is a pivotal link in the commodities supply chain between Russia, Ukraine and the EU. Moreover, disasters in this year's harvest due to prolonged military operations and destruction of related infrastructure on the Ukrainian grounds increase the perils that inflate today's prices.

Figure 12: Soft commodities on the rise amid mounting tensions



Source: Bloomberg, Eurobank Research

Concluding, among the most adversely affected regions in the EU is the CESEE region. Apart from the increased geopolitical risks arising from the geographical proximity of these areas to Russia, the said region is still at a developing course in economic terms with increased energy dependence on Russia. On top of that, the neighbouring countries of Ukraine, such as Poland, Slovakia and Romania are already receiving huge refugees' flows, the hosting of which, apart from its own crucial humanitarian importance, may have a significant economic and social cost for each welcoming country per se.

CESEE Markets Developments & Outlook

Bulgaria

Yield spreads widened significantly in the global markets, following the higher than expected inflation figures as well as the recent invasion of Ukraine by Russia. Eurobond yields shot up to positive levels on all maturities, with similar moves across the entire curve. 2027-2028 tenors saw 61-75 bps rises, while the longer maturity bonds, namely the 30, 35 and 50 saw 73-89 bps spikes. On the short-term spectrum, 2023 and 2024 Eurobonds rose 39 and 59 bps respectively. Local papers also saw strong yield spikes with the most active being the 8 and 10 year tenors with 30 and 37 bps hikes respectively. The Ministry of Finance is still surprisingly inactive on the local auction market and is widely expected to step up the borrowing within the next few weeks.

Serbia

The dinar suffered heavy depreciation pressures immediately after Russia's invasion to Ukraine but remained resilient amid the heavy off-load of foreign currency by the National Bank of Serbia (NBS). Thus, it lost just a minor part of its value, closing the week at 117.62/68 with uncertainty starting to build up over for how long the intervening by the NBS could last.

On the fixed income space, Eurobonds' performance reflects the prevailing uncertainty. Just a month ago, a Eurobond maturing in 2027 was traded at 1.72%, which is 150bps lower than the level reached in late February. Needless to say that the rally is strongly driven by the war in Ukraine but the spike is also stemming from the presumption that yields of Serbian government bonds were too low compared to the macroeconomic fundamentals of the Serbian economy.

When it comes to the local sovereign bond market, yields reacted to the aforementioned uncertainties, but not to the same extent. On the last day of February 4-year, 6-year and 11-year RSD denominated bonds were trading at 3.25%, 3.60% and 4.00% respectively, increasing by an average of 25bps compared to the levels before the conflict.

Markets View

Foreign Exchange

Global focus is on the Ukraine/Russia turmoil. RUB had its 15 minutes of fame with EUR/RUB rallying by +40% in one day, before finding a clearing level +30% (121). The USD and CHF acting as the main safe haven currencies but also commodity ones. Risk-aversion has pushed the EUR/USD lower towards the 1.10 territory with implied volatility increasing significantly given the shock effect on global foreign exchange markets. An additional factor contributing to the moves is the generalised EUR weakness against almost every currency, including the GBP, CHF, JPY, CAD, AUD and NZD as Europe is the primary economic victim of this crisis, after Ukraine. EUR/CHF is heading for parity for the first time since 2015. The commodity currencies (CAD, AUD, NZD) remain strong on the back of relatively hawkish central banks and increasing commodity prices. Of course a lot depend on the March Fed and ECB meetings, but market is already pricing out expected hikes from a month ago and discussions about the ECB extending its QE program abound.

Rates

EU: EU rates had a very volatile month rising swiftly in the first half of February but taking back a large part of the move higher at the time of writing. At the time of writing 10yr swaps are trading at 0.65% up from 0.45% at the start of February and having printed a high of 0.88%. 2yr swap rates made a round trip from -0.12 to 0.26% and back to -0.05%. The 2s-10s spread increased sharply from 25bps to 75bps, while the 5s-30s are trading at 32bps up from 15bps a month ago. Looking forward we expect rates to remain volatile as the market is news headline driven by the developments in the geopolitical front.

US: US rates closed the month mixed following significant volatility. The 10yr swap rate is trading at 180bps, down from 185bps at the beginning of the month and having traded as high as 2.10%. The 2yr swap rates at 1.50% are 18bps higher than at the end of January but 33bps lower than the high of the month. The 2s-10s spread dropped from 56bps to 31bps as the curve bear flattened on discussions that 2023 might be a recession year or at minimum a significant slowdown in growth is approaching. The 5s-30s spread is trading at 30bps after hitting a low of 4bps in the middle of February. We expect US rates to remain driven by both the Fed communication and the geopolitical developments. Implied volatility is at all-time highs and liquidity remains thin adding to the violent moves.

Emerging Markets credit

A sharp rise in US rates at the beginning of the month and mainly the escalation of geopolitical risks with Russia invading Ukraine put significant pressure on EM assets. The EMBI Global Index closed at 411 bps at the end of February, 67 bps wider on the month. The market's worst-case scenario materialized with Russia's invasion in Ukraine and indications that it will seek a regime change. The US and EU reacted by

imposing or considering to impose a broad range of sanctions, which include Russian banks (exclusion form SWIFT), individuals, access to international capital markets for the sovereign, blocking technology exports and freezing the foreign assets of the Russian central bank. Obviously, Russia and Ukraine suffered the largest impact with sovereign yields sky-rocketing. The Russia USD sovereign curve is trading flat at 25pts pricing a very high probability of default. In order to provide support to the RUB, the Bank of Russia raised the key rate to 20% from 9.5%. S&P downgraded Russia's debt rating to one level below IG, from BBB- to BB+ and Ukraine from B to B- but spreads already price significantly lower ratings. The rest of the EM space also traded weak with CEEMEA getting hit the most. Oil and commodities exporters outperformed as expected. In South Africa, the National Treasury presented a market supportive budget with faster consolidation, earlier and lower debt peak, social grant support, and tax relief. We stay on the side lines until the situation evolves and becomes clearer, while we favour commodity exporters and alternative suppliers away from Russia and Ukraine.

Corporate credit

EUR investment grade bond spreads on most rating grades and sectors were +10/+30bps wider in the past month. CDS Index spreads were on average +20/25bps wider in investment grade and +80/90bps wider in high yield. Covid19 related fears now fully on the backseat. Increasing inflation and rates with the Russia/Ukraine crisis now have centre stage. Fed and ECB March meetings to be critical for market direction. Volatility and spreads have increased dramatically given recent macro developments. Sector wise, in EUR IG, Financials were +15bps wider, Real Estate +30bps wider, Energy +20bps wider, Health Care +10bps wider, Telecoms +10bps wider, Industrials +12bps wider, Consumer Goods +12bps wider, Utilities +20bps wider, Technology +9bps wider and Basic Materials +18bps wider. US IG names spread were +15 to +40bps wider in the same period. Specifically, Financials were +28bps wider, Real Estate +37bps wider, Energy +25bps wider, Health care +23bps wider, Telecoms +24bps wider, Technology +19bps wider, Industrials +24bps wider, Consumer Goods +26bps wider, Utilities +28bps wider, while Basic Materials were +28bps wider.

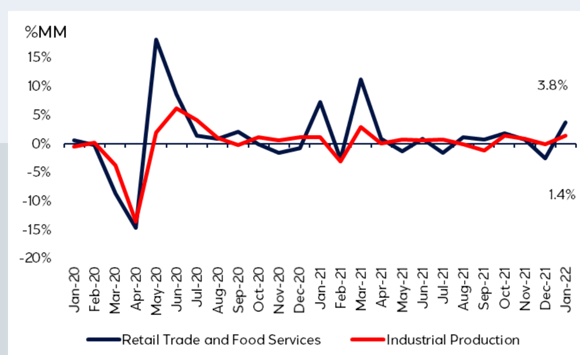
Rating wise, spreads in BBB were +41bps, in A +15bps, in AA +11bps, and in AAA +5bps. In the EUR HY universe CCC spreads were +215bps, B were +77bps, while BB were +90bps. In the USD IG space spreads in BBB were +40bps, in A +17bps, in AA +12bps, and in AAAs +11bps. The Ukraine situation has only increased inflation fears making CBs balancing act even more difficult. We expect spread volatility to remain elevated in the short/medium term. Additionally we expect spread dispersion to increase. A potential backstop to substantially wider spread might be the high cash on the side-lines waiting to get invested. We expect the recent EUR IG spread outperformance versus the USD to reverse, given the substantially higher economic hit to Europe from the Ukrainian crisis.

US

Good performance but persisting inflation raises concerns

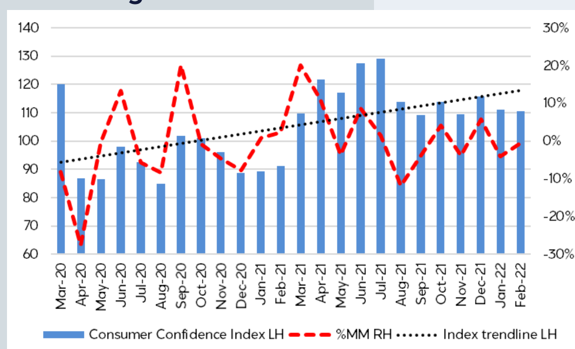
Real GDP growth in Q4-2021 was revised upwards by 0.1ppt in the 2nd estimate, coming in at 7.0%YoY annualised, after an increase of 2.3%YoY in Q3-2021. The updated estimate primarily reflects upward revisions to nonresidential fixed investment, government spending and residential fixed investment that were partly offset by downward revisions to personal consumption expenditures and exports. For FY 2021, real GDP grew by 5.9%YoY, unchanged from the prior estimate. Coming to 2022, several data have surprised to the upside pointing to a stong growth momentum of economic activity. In January, existing home sales s.a. rose by 6.7%MoM after dropping by 3.8%MoM in December, while the median existing-home sales price rose at a stronger pace of 15.4%YoY, to USD350,300. Retail sales increased by a strong 3.8%MoM/13%YoY reaching record-high levels of USD649.8bn, while industrial production rose by 1.4%MoM/4.1%YoY, both above expectations. A more mixed picture is drawn however by the February consumer confidence data with the Conference Board Consumer Confidence Index falling slightly to 110.5 in February from 111.1 in January, as expectations dampen mainly on inflation concerns. Indeed, core CPI hit a multi-decade high in January at 6%YoY. Meanwhile, labour market conditions continue to improve as the pandemic subsides and people return to work, the unemployment rate approaches pre-pandemic levels and average hourly earnings recover. In this environment, it appears almost inevitable that the Fed will begin its monetary policy tightening at the March FOMC meeting, although taking into consideration the recent Russia – Ukraine military conflict, the Fed may tighten policy less aggressively than previously expected. Indeed, Fed Chair Jerome Powell spoke in favour of a 25bps interest rate hike in March, while forthcoming economic data and the evolution of the geopolitical tensions are being closely monitored. For the whole year, the tone may turn more hawkish, with the Committee being prepared to raise the federal funds rate by more than 25bps at a meeting or meetings in order to tame inflation and prevent the de-anchoring of expectations.

Figure 13: Retail sales and industrial production growth



Source: US Census Bureau, Board of Governors of the Federal Reserve System, Eurobank Research

Figure 14: Consumer confidence



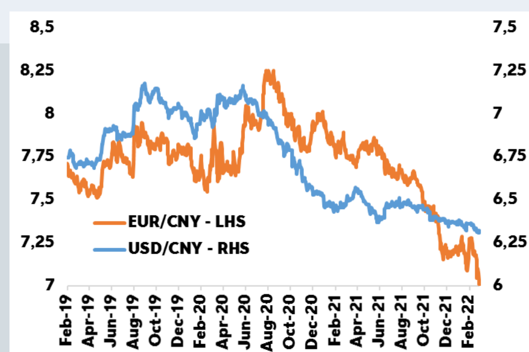
Source: Conference Board, Refinitiv, Eurobank Research

China

Deployed monetary policy space widens as the yuan strengthens

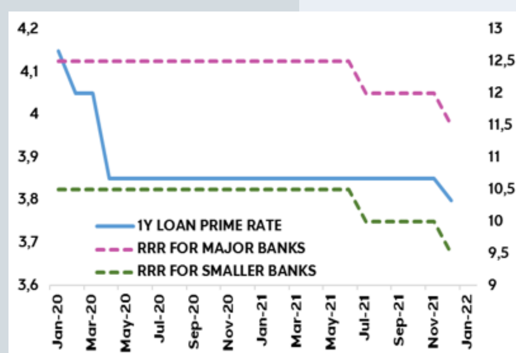
February was a month with limited releases of hard data due to the Lunar Year festivities, while PMIs of the same month may not be capturing the precise sentiment for the near-term outlook, due to the pause of the economic activity. The official manufacturing PMI rose to 50.2, from 50.1 in January, beating market expectations of 49.8. On the same footing, the Caixin reading rose to 50.4 from contractionary grounds of 49.1 in January, while the official non-manufacturing PMI surprised to the upside, rising to 51.6 from 51.1 in the previous month and standing above the 50.7 market consensus. While the optimism spurred by the aforementioned readings should be handled cautiously, once they are assessed along with the backstop in the new home prices slide in January, as these have been decreasing since September, after continuously growing for more than 6 years, they point to monetary stimulus deployed since late 2021 having started to kick in. Ahead of the Two Sessions, i.e. the Chinese People's Political Consultative Conference (CPPCC) and the 14th National People's Congress (NPC) for 2022, which will commence in the next couple of days and where robust economic growth is expected to take centre stage, the monetary policy is expected to remain proactive and accommodative throughout 2022 with additional RRR and Loan Prime Rate cuts on the cards. The said expectations are not only cultivated by the soft Q4 GDP growth reading (+4.0% YoY, the softest in 2021) but also by the subdued inflationary landscape, which moves counter-clockwise with almost the entire world. Inflation receded to 0.9% YoY in January from 1.5% YoY in December, aligned with the PPI inflation, which eased to 9.1%YoY in January from 10.3% YoY in December. Last but not least, the momentum for further monetary stimulus remains favorable amid the recent strengthening of the Yuan, as it has lately obtained safe haven characteristics amid the mounting geopolitical uncertainty between the West and Russia. That said, the CNY has appreciated since the beginning of the year by ca 2% against the USD, with the USD/CNY rate touching late-2015 lows.

Figure 15: As yuan strengthens against major Currencies...



Sources: Bloomberg, Eurobank Research

Figure 16:... there is space for monetary policy remaining accommodative



Sources: Bloomberg, Eurobank Research

Euro area

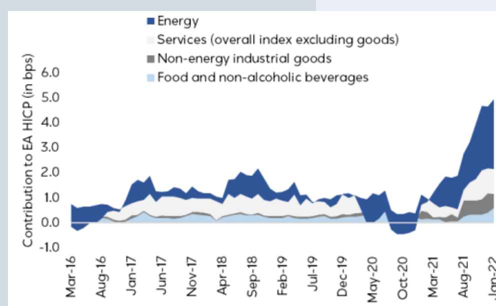
Omicron drag is fading but geopolitical tensions pose risks to growth

After GDP growth decelerated to 0.3%QoQ in Q4 from 2.3%QoQ in the prior quarter, probably due to the resurgence in pandemic cases and the associated reintroduction of tighter activity measures in several countries, sentiment surveys for February suggest that the Eurozone may be regaining some momentum in Q1 2022. In support of the above, after softening in December and January amid Covid-19 related disruptions, the Composite PMI rose by a higher-than-expected 3.5pts in February to a 5-month high of 55.8. The rebound was entirely driven by services, which advanced to 55.8 (+4.7pts) as improved virus conditions allowed many countries to begin relaxing activity restrictions noticeably. Manufacturing PMI declined slightly to 58.4 (-0.3pts), but the drop was solely due to shorter delivery times (that is counted as negative in PMI calculation), hindering supply-side improvement in the current environment rather than weaker demand. Mirroring the flash Composite PMI bounce in February, the ECSI halted a three monthly declining streak and rose by 1.3pts to 114.0 in the same month, mainly driven by services, which rose by 3.9pts, recovering part of the 9.1pts cumulative decline in the period December to January, as the Omicron drag is fading after peaking in January. However, both PMI and ESI surveys were conducted before the recent escalation of the Ukraine-Russia crisis. That said, they did not take into account potential spillovers into the Eurozone growth outlook via a number of transmission channels, but primarily via energy given the economy's heavy reliance on energy imports from Russia (Russia accounts for around 40% and 30% of EU gas and crude imports, respectively). Therefore, inflation risks are skewed to the upside, creating a challenging environment for the ECB as the Central Bank has to balance the risk of more persistently elevated inflation becoming entrenched vs. the risk of meaningful negative effects on Eurozone growth from the Ukraine-Russia crisis. Awaiting the outcome of the next ECB policy meeting on 10 March where the impact of the severe escalation of the conflict in Ukraine will be high on the agenda, Eurozone headline inflation surprised on the upside in February for the eight consecutive month, rising from 5.1%YoY in January to a new record high of 5.8%YoY.

Figure 17: Risks from the escalation of the Ukraine crisis through the trade channel largely contained to the Baltic countries

Source: IMF, Eurobank Research

Figure 18: The geopolitical turmoil raises risk of more persistently high inflation



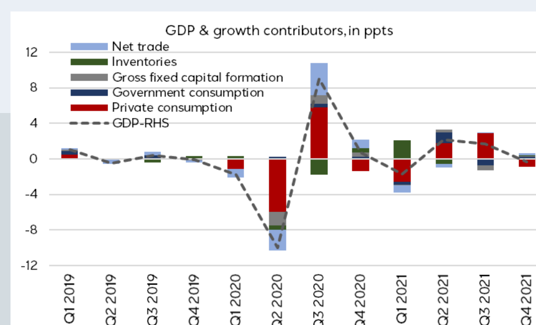
Source: Eurostat, Eurobank Research

Germany

Likely to fall into a technical recession before recovering in Q2

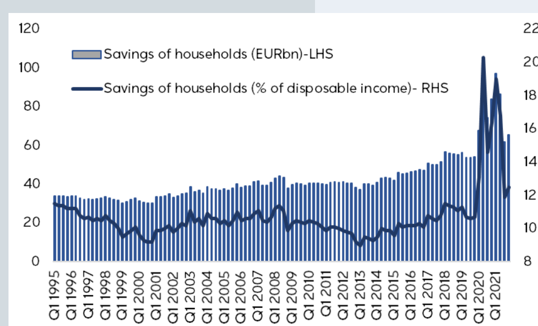
The The German economy performed much better than initially estimated in Q4 2021, contracting by -0.3%QoQ rather than -0.7%QoQ according to the flash estimate in late January. Failing to capitalize on an improving labour market, private consumption was a drag (the only one) on growth, dropping by 1.8%QoQ and subtracting 0.9ppts from GDP, weighted down by the virus resurgence and the adoption of renewed tighter activity restrictions (Figure 19). In addition, sharp and broad-based price increases mostly due to higher energy costs and severe supply constraints (inflation for CPI at 5.1%YoY in February from January's 4.9%YoY, not far from December's almost 30-yr high of 5.3%, and at 5.5%YoY for HICP from January's 5.1%YoY) also exerted a negative influence on private consumption. The substantial upward revision in Q4, took GDP growth for FY 2021 at 2.9%YoY, higher than 2.8% initially reported, indicating a positive statistical carry over effect of +1.1pts into 2022. Looking into Q1 2022, another modest GDP growth contraction cannot be ruled out, with Germany likely to fall into a technical recession. While pandemic cases appear to have already reached a peak encouraging the government to announce in mid-February a three-step easing of restrictions, the Omicron wave and the stricter measures have likely continued to exert a negative impact on economic activity, while supply shortages and China's zero-Covid policy continued to hamper manufacturing output. In addition, the notable upward revision in Q4 GDP puts mechanic downward pressure on Q1 GDP. However, as suggested by a recent string of encouraging business sentiment indicators (PMIs, IFO, ZEW for February) after the gradual lifting of most Covid-19 measures, activity should bounce back in Q2, on the back of a service sector re-opening effect and a strong rebound in IP given the substantial backlog of orders as supply constraints are anticipated to ease further. The accumulation of a large stock of household savings during the pandemic (Figure 20) should also provide a cushion for private consumption, especially as inflation is likely to remain high for longer following the recent surge in oil prices due to the Ukraine crisis. For FY 2022, economic recovery is anticipated to expand by 3.6%, with recent geopolitical developments, though, posing a threat to the anticipated recovery.

Figure 19: Private consumption was the only drag on GDP growth in Q4 2021



Source: Eurostat, Eurobank Research

Figure 20: Plenty of savings accumulated during the pandemic



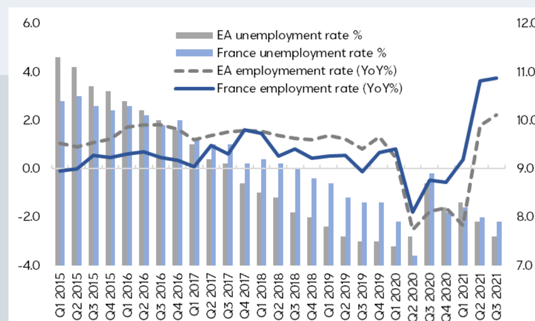
Source: DESTATIS, Eurobank Research

France

Economic activity has likely weakened in Q1 but still remains relatively healthy

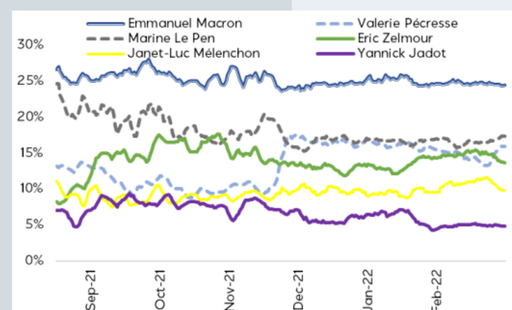
The final Q4 2021 GDP estimate confirmed that France's GDP slowed to 0.7%QoQ from 3.1%QoQ in Q3, with the growth rate for the whole year 2021 rising to a more than five-decade high of 7.0%YoY. The economy's relatively lower vulnerability to supply chain disruptions was among the main drivers behind France's impressive performance in 2021, along with the swift rebound in private consumption thanks to the significant recovery of the labor market, as structural reforms undertaken to improve its functioning are bearing fruits, with total employment already above pre-crisis level (Figure 21). Looking ahead, sentiment indicators pertaining to the early months of Q1 2022 suggest that economic activity has likely weakened further but still remains relatively healthy, supported by the improved pandemic situation that allowed the government to start gradually relaxing Covid-19 related restrictions in February. The INSEE business climate indicator improved from a nine-month low of 107.2 in January to 112.3 in February, matching last October's four-year high, as businesses catch up with January's significant increase in orders. In spite of the February improvement, the Jan-Feb average stood at 109.8, below 111.6 in Q4 2021 as supply constraints, albeit easing, remain severe and labour shortages prevail. Meanwhile, INSEE consumer confidence eased to 98 in February from January's 99, below its long-term average, as elevated price pressures weigh on perception of living standards and major purchases intentions. Mostly due to higher oil prices, inflation measured by CPI bounced back by 0.7pts to 3.9%YoY in February and by 0.8pts to 4.1%YoY for HICP, though it has to be noted that the rise in inflation has been more limited in France compared to the rest of the EA thanks to the government's measures to cap the rise in gas and electricity prices. For FY 2022, we pencil in an annual GDP growth rate of 4.0%, with the recent geopolitical developments, though, likely to pose a threat to the anticipated recovery. On politics, President Emmanuel Macron continues to lead all opinion polls with a comfortable margin (24%) ahead of the first round of presidential elections on 10 April, followed by far-right Marine Le Pen (17%) who is still head-to-head with center-right Valerie Pécresse (16%) in the race to make the runoff against the incumbent president (Figure 22).

Figure 21: Labor market has staged an impressive recovery



Source: Eurostat, Eurobank Research

Figure 22: President Emmanuel Macron continues to lead opinion polls by a wide margin



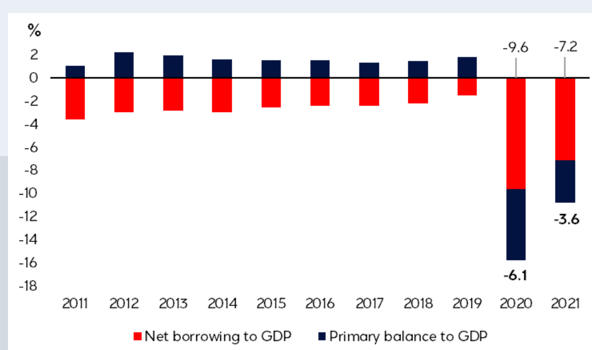
Source: Press reports, Eurobank Research

Italy

Strong momentum dampened by geopolitical turmoil

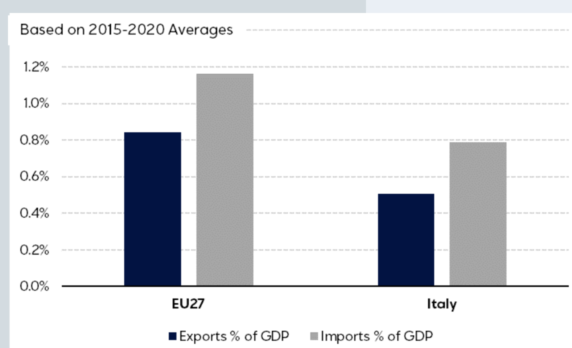
In 2021 the Italian real GDP increased by 6.6%, with national demand (excl. changes in inventories) contributing 6.2pps, net exports 0.2pps and changes in inventories 0.2pps. At current prices, 2021 GDP grew by 7.5% bringing the general government net borrowing to -7.2% of GDP and the primary balance to -3.6% of GDP (Figure). Debt to GDP fell to 150.4% from 155.3% in the previous year. Coming onto the first months of 2022, inflation pressures continue to mount with the flash HICP skyrocketing to 6.2% in February, from 5.1% in January. The differential of inflation with the Euro zone turned positive as the HICP in the EA came in at 5.8% implying a loss of competitiveness. Economic Sentiment picked up in February (+1 unit), after a significant decline in January (-6 units) driven primarily by the services sector and less so by building activity. The improvement in confidence likely reflects the apparent recession of the pandemic and the lifting of the remaining restrictions, which will mainly favor those activities more sensitive to the pandemic, such as travel and tourism. As of late, new Covid-19 infections have been dropping quickly and restrictions have been loosening. Since 11 February, masks are no longer obligatory outdoors, while travelers from the EU are no longer required to quarantine. Meanwhile, the manufacturing sector remained firmly in expansionary territory in February with the PMI Manufacturing Index registering 58.3, unchanged from the previous month, indicating the 20th consecutive month of expansion, driven by rising order volumes. Costs faced by manufacturers were affected downwards by the easing of supply shortages but upwards by rising energy prices. Going forward, the Ukraine crisis is expected to affect the economy through increased uncertainty, financial markets volatility, reduced exports and higher prices for oil, gas and certain other commodities. Note that the Italian economy is among the most exposed, as Italy imports almost half of its gas from Russia. As regards the disruption of trade, Italy's exports to Russia account for almost 0.5% of GDP (Figure), while the Italian financial sector is more exposed amounting to c. EUR20bn, or 1.2% of GDP. Exports to Ukraine are less significant, accounting for less than 0.1% of GDP.

Figure 23: Net borrowing and primary balance as a percentage of GDP



Source: ISTAT, Eurobank Research

Figure 24: Total imports and exports to Russia



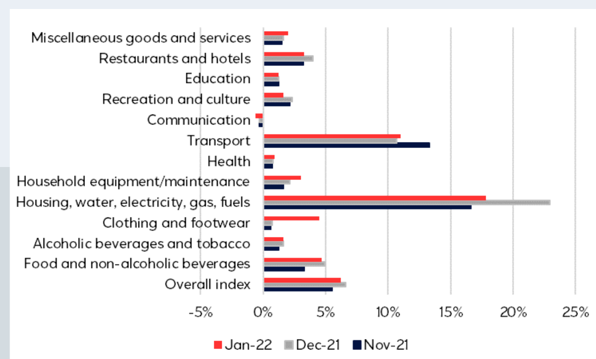
Source: Eurostat, Eurobank Research

Spain

High inflation weighs on good momentum

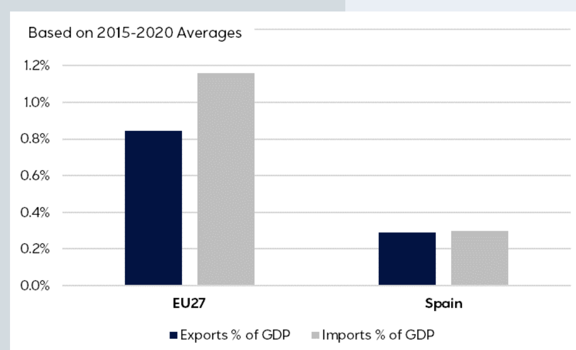
The picture is mixed as we head towards the end of Q1-2022 with inflation continuing to draw attention. In January the HICP reading eased slightly to 6.2%YoY from 6.6%YoY in December, raising hopes that inflation may have peaked and will begin to decline thereafter as the pace of increase in many sub-indices, including energy, slowed down (Figure). These expectations are dissipating however as the February flash reading skyrocketed to 7.5%YoY against 5.8% in the Euro zone. On a more positive tone, the February Manufacturing PMI stood at a 3-month high of 56.9, up from January's 56.2 with output expanding at an accelerated pace and operating conditions improving for the 13th month in a row. The strong reading was underpinned by the sharpest rise in production in five months owing to higher new orders, which led to increased staffing levels. Nevertheless, supply shortages continue to drive input costs higher. Economic sentiment improved for the 2nd month in a row in February (+2.4 units) on the back of increased optimism in all sectors except from services, although the deterioration was relatively mild (-1.3 units). The apparent containment of the pandemic has likely contributed to the elevated confidence. The share of vaccinated people in Spain exceeds 80% and new infections are dropping, despite a modest rebound recently. As a result, restrictions are being withdrawn and as of 8 February masks are no longer required outdoors. The outlook is recently blurred by geopolitical tensions, whose impact is too early to assess. The Ukraine – Russia conflict and the potential restricted gas supply could have a profound negative impact on economic activity, as gas is a key primary energy source for manufacturing, households and the services sector. Another concern relates to the disruption of trade, although Spain's trade exposure is limited. Total exports to Russia account for c. 0.3% of GDP (Figure) and those to Ukraine amount to less than 0.05% of GDP, while the financial sector's exposure to Russia is insignificant. The growing uncertainty, however, as to when and how this situation will be resolved, will likely weigh on sentiment affecting consumption and investment decisions.

Figure 24: HICP total and sub-categories %YoY



Source: INE, Eurobank Research

Figure 26: Total imports and exports to Russia



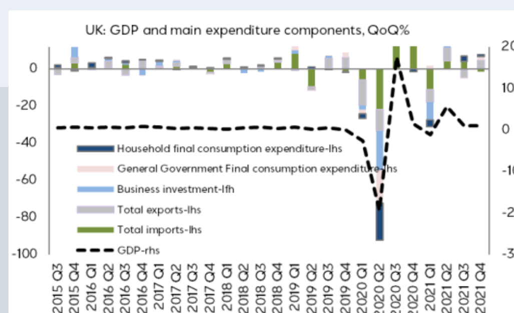
Source: Eurostat, Eurobank Research

UK

The rising cost of living should limit the strength of economic recovery in 2022

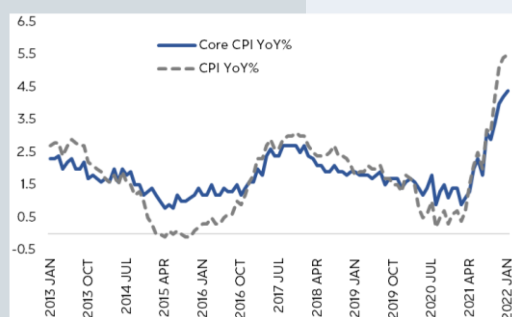
After a 0.2pp downward revision in November GDP growth to 0.7%MoM, UK December GDP fell by 0.2%MoM amid the continuing spread of the Omicron variant and the adoption of new associated activity restrictions. As a result, Q4 GDP grew by 1.0%QoQ, 0.4% below pre-pandemic levels (Figure 27). Domestic demand grew relatively strongly, primarily due to a 1.2%QoQ gain in personal consumption. Government consumption and gross fixed capital formation also rose markedly, with gains of 1.9%QoQ and 2.2%QoQ respectively, while net trade had a strong 1.7% positive contribution to GDP growth amid especially weak imports. Despite the softer than expected Q4 GDP growth print, upward revisions to earlier quarters (Q4 2020 +0.4%, Q1 2021 +0.1%, Q2 2021 +0.2%) resulted in GDP growth of 7.5% for FY 2021, the highest in the post-war period. Looking into 2022, a soft GDP print is anticipated in January due to pandemic-related measures, that will likely be followed by a rebound in activity in February and March as the impact of activity restrictions dissipates, keeping Q1 GDP growth firmly into positive territory. Amid an improved epidemiological situation, the UK government announced the end of remaining activity restrictions from February 24, as part of a shift towards learning to live with COVID-19, while most of the latest UK data have been positive, including a surprising 6pts rise in the flash composite PMI for February to an eight-month high of 60.2, led by a significant gain in services (+6.7pts to 60.8). While the pandemic-related effects should fade, the rising cost of living that could get worse due to higher oil prices, concurrent with fiscal and monetary tightening, should take centre stage in the quarters ahead as consumers' spending power should decline, limiting the strength of economic recovery. CPI inflation rose in January to a new 30-year high of 5.5%YoY amid strong goods prices (Figure 28), and is expected to move further higher above 7.0% in April, when Ofgem is set to update its regulated energy price cap by 54% and National Insurance contributions to increase by 1.25%. Persistent inflation pressure and labor market tightness suggest that the BoE will likely continue tightening policy in the coming months, although the rising cost of living should moderate GDP growth to 4.0% in 2022.

Figure 27: Overall GDP just 0.4% below pre-pandemic levels in Q4 2021



Source: ONS, Eurobank Research

Figure 28: CPI inflation at 30-yr highs in Jan 2022 and is expected to rise further



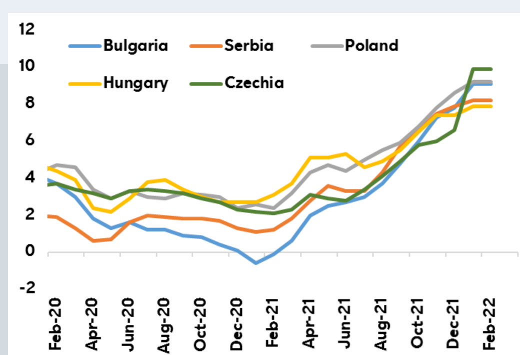
Source: ONS, Eurobank Research

Bulgaria

Inflationary pressure and elevated geopolitical risks undermine growth prospects

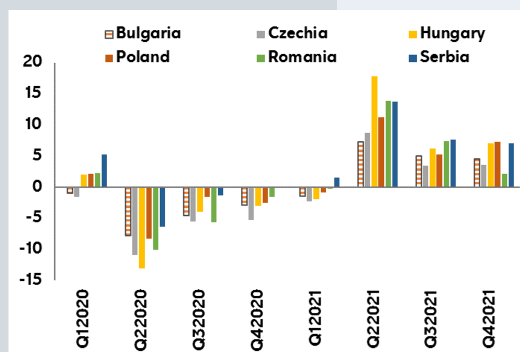
According to the official flash estimate released in mid-February, the GDP growth rate came in at +4.5% YoY in Q4 compared to +5.0% YoY in Q3 and +7.3% YoY and -1.4% YoY in Q2 and Q1 respectively. Assuming that the preliminary figure due on March 9 verifies the flash estimate, GDP in 2021 expanded by +3.9% after contracting by -4.4% in 2020, pointing to some more distance needed to be covered so as for the economy to return to its pre-pandemic levels of activity. With an ambitious fiscal budget ratified by the parliament only a few days ago that targets an expanded fiscal deficit in 2022 compared to that of 2021 (4.1% in 2022 from 3.0% in 2021 and 4.0% in 2020), risks are tilted to the upside, given the optimistic assumption as regards the GDP growth rate for 2022, amid the prevailing uncertainty from the recent escalation in the Russia – Ukraine conflict, which could also render extraordinary fiscal expenditures necessary. Along these lines, the inflationary outlook continues to weigh on the outlook, as inflation picked up to 9.1% YoY in January from 7.8% YoY in December, hitting the highest reading since November 2008. The acceleration of the annual print was broadly driven by rising food prices (+10.9% YoY), under the pressure of persistently increasing prices in soft commodities. Prior to January's spike, inflation increased to 7.0% in the last quarter of 2021, pushing the full year's print to 3.3% from 1.7% in 2020. The current budget comes with an ambitious investment agenda with investments budgeted at 5.8% of GDP in 2022 from 2.9% of GDP in 2021, which, however, could be undermined, not only by the volatile inflationary landscape but also by the fragile geopolitics dynamics currently at play. Under this spectrum, and having in mind that the government has agreed, prior to the ratification, to review the budget in June, a sizable and perhaps earlier revision cannot be ruled out.

Figure 29: Increasing inflation, synched with that of regional peers



Sources: Bloomberg, Eurobank Research

Figure 30: and similar landscape as regards to the GDP growth performance



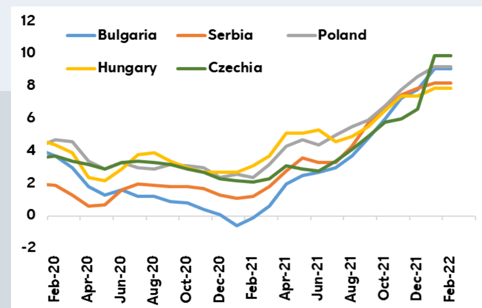
Sources: Bloomberg, Eurobank Research

Serbia

Fiscal consolidation amid persistent monetary pressure

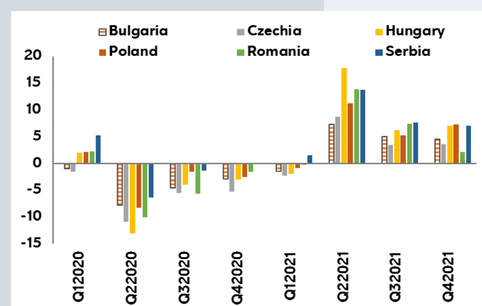
Serbia concluded 2021 with a fiscal deficit of RSD 259.4bn or 4.2% of GDP, undershooting the initial target for a 4.9% of GDP deficit. From an expanded 8.0% fiscal deficit in 2020, driven broadly by pandemic-related supportive measures, the fiscal outcome narrowed substantially in 2021 with the economy expected to undergo some further fiscal consolidation that will lead to milder deficits in the next two years, not exceeding the level of 3% of the projected GDP. The return to fiscal prudency is envisaged in the Reform Economic Programme (ERP), a document that tabulates the key economic priorities for the period 2022-2024, which was concluded at a national level in late January and submitted to the European Commission for further consultation. The decision for return to milder deficits coincides with a turbulent period as regards the evolution of prices. Inflation has been on a hiking path for at least the past six months, averaging at 4.1% YoY in 2021 from 1.6% YoY in 2020. Specifically, in the last quarter of 2021 inflation spiked to 7.3% YoY from 3.3% YoY during the first nine months of the year, while the rally continued in January with CPI climbing further to 8.2% YoY from 7.9% in December. While the surge of prices is broadly attributed to the increasing global energy prices and soft commodities, expectations over inflation remaining at higher levels seem to have been entrenched in the core print as well. The core reading accelerated to 4.1% YoY in January from 3.5% YoY in December, after the headline print continuously stands above the tolerance band of the NBS (3% ± 1.5%) during the past 5 months. According to a recent survey published by the National Bank of Serbia (NBS), one-year inflation expectations of corporates remained at 6% in January, unchanged compared to December, while those of households remain substantially higher close to 10%. In this challenging monetary landscape, which will be further undermined by the adverse turn in the relations between Russia and Ukraine, the NBS, unlike major regional Central Banks in the Czech Republic, Hungary, Poland and Romania, has not opened fire yet, leaving the key policy interest rate stable at 1% since December 2020. Following the upcoming elections on April 3 and having assessed the price dynamics for one more month, some material tightening by the NBS is expected from mid-Q2 onwards.

Figure 31: Increasing inflation, synched with that of regional peers



Sources: Bloomberg, Eurobank Research

Figure 32: and outperforming in terms of GDP growth in FY2021



Sources: Bloomberg, 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	5.9	4.3	3.6	4.3	4.7	2.8									
Advanced Economies															
USA	5.7	3.9	2.5	4.7	4.8	2.4	5.4	3.7	3.5	-3,5	-3.4	-3.3	-10.8	-6.1	-4.6
Eurozone	5.2	4.0	2.5	2.6	3.9	1.8	7.7	7.1	6.9	2.6	2.4	2.5	-7.1	-4.3	-2.6
Germany	2.9	3.6	2.6	3.2	3.3	1.8	5.7	5.0	4.9	6.8	6.5	6.0	-3.7	-2.5	-1.0
France	7.0	4.0	2.5	2.1	2.7	1.7	7.9	7.4	7.0	-1.0	-1.4	-0.9	-8.1	-5.0	-4.1
Periphery															
Cyprus	5,5	4,1	3,3	2,5	1,7	1,5	7,5	6,7	5,0	-10,0	-8,0	-8,0	-3,5	-2,0	-2,0
Italy	6.3	4.2	2.1	2.0	3.0	1.4	9.5	9.0	8.6	3.4	3.0	2.9	-9.4	-5.5	-3,8
Portugal	5.4	5.3	2.5	0.9	1.8	1.3	6.0	6.3	5.9	-0.7	-0.4	-0.4	-4.4	-3.2	-2.3
Spain	5.0	5.4	3.5	3.0	3.6	1.5	14.8	14.4	13.1	0.8	1.4	1.4	-8.4	-5.4	-4.3
UK	7.5	4.0	2.0	2.6	5.5	2.4	4.6	4.0	4.2	-3.2	-3.5	-3.2	-8.1	-3.9	-2.6
Japan	1.9	2.8	1.7	-0.3	0.9	0.7	2.8	2.6	2.5	2.8	2.9	3.0	-6.4	-6.4	-4.5
Emerging Economies															
BRICs															
Brazil	4,7	0,7	2,0	8,3	7,4	3,8	13,6	12,5	11,7	-1,4	-1,3	-1,3	-5,7	-6,8	-7,1
China	8,1	5,2	5,1	0,9	2,3	2,2	4,9	3,7	3,7	1,9	1,5	1,3	-5,6	-4,27	-4,7
India	9,2	7,8	7,0	5,4	5,0	4,6		*NA*		-1,5	-1,8	-1,5	-6,8	-6,0	-5,0
Russia	4,2	2,6	2,1	6,7	6,4	4,1	4,9	4,6	4,5	6,8	6,0	3,6	-0,3	0,7	0,3
CESEE															
Bulgaria	3,9	4,1	3,5	3,3	5,0	2,6	5,5	5,0	4,7	-0,5	0,9	2,3	-3,9	-2,5	-2,1
Serbia	7,5	4,5	4,1	3,0	5,0	3,2	9,3	10,3	9,5	-4,1	-4,2	-4,2	-4,2	-3,0	-2,0
Turkey	9,0	3,3	3,3	19,4	39,0	17,0	13,1	12,5	12,0	-3,2	-2,2	-2,0	-3,4	-4,2	-3,5

Eurobank Fixed Income Forecasts

	Current	March	June	September	December
USA					
Fed Funds Rate	0.00-0.25%	0.25-0.50%	0.59-0.85%	0.85-1.10%	1.09-1.35%
3m Libor	0.51%	0.48%	0.79%	1.07%	1.27%
2yr Notes	1.40%	1.27%	1.44%	1.57%	1.69%
10 yr Bonds	1.75%	1.90%	2.03%	2.12%	2.21%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.05%
3m Euribor	-0.53%	-0.54%	-0.52%	-0.45%	-0.33%
2yr Bunds	-0.69%	-0.38%	-0.36%	-0.30%	-0.25%
10yr Bunds	-0,03%	0,17%	0.21%	0.28%	0.35%
UK					
Repo Rate	0.50%	0.70%	0.90%	1.05%	1.10%
3m Sonia	0.77%	0.74%	0.95%	1.14%	1.27%
10-yr Gilt	1.20%	1.36%	1.44%	1.48%	1.54%
Switzerland					
3m Saron	-0.75%	-0.74%	-0.74%	-0,.70%	-0.65%
10-yr Bond	0.11%	0.10%	0.15%	0.22%	0.29%

Source: Bloomberg (market implied forecasts)

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