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Persistently high inflation, elevated geopolitical tensions and tightening financial conditions stemming from several Central Banks' hawkish pivot, are weighing heavily on global consumer sentiment, despite continued labor market strength across most economies. Incoming business surveys have also surprised negatively, adding to the view that the global economy is losing momentum. Despite increasing growth concerns, several major Central Banks front-load and accelerate their hiking cycle to bring inflation back to target, aiming to avoid a de-anchoring of inflation expectations and ringfence their credibility.

Macro Picture

USA: A broad-based slowdown in economic activity since May on tightening financial conditions

EA: Sentiment indicators point to a slowdown in growth, while inflation keeps rising

UK: Cost-of-living squeeze and Jubilee bank holiday add to risks for GDP contraction in Q2

EM: Tightening global financial conditions weigh on the available economic policy space

CESEE: Strong labor markets support economic activity which continues, however, to be dampened by persistent high inflation

Markets

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

Rates: EU and US remain very volatile due to recession concerns

EM: Assets remain under heavy pressure as risks of high inflation give their place to recession fears

Credit: Spreads much wider in June, expected to trade in a broad range

Policy Outlook

USA: The Fed is committed to restore price stability even at some cost to the growth outlook

EA: Persistently high inflation motivates the ECB to front-load policy tightening

UK: BoE inclined to “act forcefully” if signs of persistently high inflation continue

CESEE: With inflationary pressures unabated, CBs stick up to interest rate hikes

Key Downside Risks

DM: Persistency of inflation, abrupt interruption of Russian gas flows to Europe, Ukraine crisis escalates, sharp slowdown in China, emergence of more infectious variants

EM: Further US dollar strengthening; more protracted tightening of global financial conditions

Special Topic in this issue

→Cyprus Macroeconomic Outlook

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Contents

Macro Views 3

World Economic Outlook 3

Developed Economies.......................................4

Emerging Economies..5

CESEE Markets Developments & Outlook.........6

Markets View...7

Special Topic 9

US..12

China 13

Euro area 14

Germany...15

France 16

UK 17

Cyprus 18

Bulgaria 19

Serbia..20

Eurobank Macro Forecasts...................................21

Eurobank Fixed Income Forecasts 22

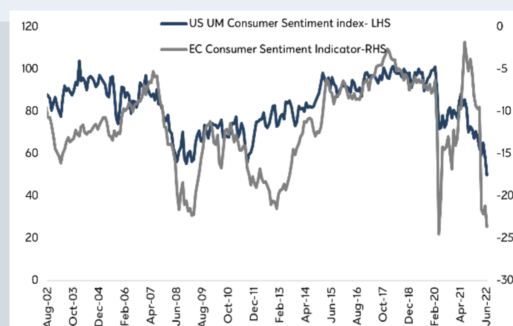
Research Team..23

Macro Views
Latest world economic & market developments

Flashing warning signs for the global economy

Persistently high inflation, elevated geopolitical tensions and tightening financial conditions stemming from several Central Banks' hawkish pivot, are weighing heavily on global consumer sentiment (Figure 1), in spite of continued labor market strength across most economies. The slump in confidence that started less than a year ago has been relatively larger in developed rather than in emerging markets. The respective index in the US University of Michigan survey nosedived to a fresh record low in June and the European Commission consumer confidence indicator for the Eurozone dropped close to the April 2020 record low when confidence collapsed following the Covid-19 outbreak. Though declining consumer confidence is a source of concern for consumer spending, households have managed so far to partially mitigate the impact of high inflation on their purchasing power by drawing down excess savings built up during the pandemic. However, this tactic cannot continue indefinitely, and consumers may be willing to increase pre-cautionary savings amid protracted geopolitical uncertainty. In fact, we may already be witnessing tentative signs of a slowdown in consumer spending, with the respective US figure recording in May the smallest monthly increase in five months, while the savings rate remained below pre-pandemic levels and down substantially from a peak of 26.6% during the pandemic.

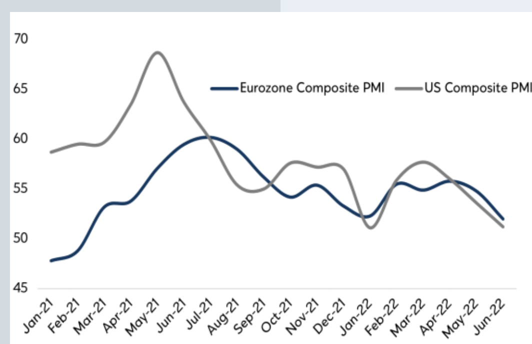
Figure 1: Inflation, uncertainty, tightening financial conditions, all weigh heavily on consumer sentiment



Source: Bloomberg, Eurobank Research

Echoing the message from consumer sentiment surveys, incoming business surveys have also surprised negatively (Figure 2), adding to the view that the global economy may be losing momentum. Mostly driven by sharp declines in the US and the Eurozone, the flash DM composite PMI dropped by 2ppts in June, the third consecutive monthly decline, coming in at a five-month low of 52.1. This deterioration was broad-based across sectors, but more worryingly, forward-looking new orders flash PMIs dropped below the critical level of 50 across both goods and services, potentially pointing to further growth slowdown ahead. The renewed surge in European gas prices amid reduced gas supplies from Russia

Figure 2: Business surveys have negatively surprised in most major economies



Source: Bloomberg, Eurobank Research

through the Nord Stream 1 pipeline that could lead to energy rationing during the winter, also adds to downside growth risks, especially for the Euro area.

On the inflation front, the latest CPI releases across a wide range of economies show that inflation continues to run strong globally on the back of high energy prices and broad-based food price gains, with annual inflation readings reaching fresh multi-decade highs. Meanwhile, pressures are broadening with core inflation remaining strong in almost all advanced economies, as services inflation continues to move upwards on pressures from services-sector reopening, and core goods price inflation remaining elevated. In response to the ongoing surge in inflation, several Central Banks front-load and accelerate their hiking cycle to bring inflation back to target, aiming to avoid a de-anchoring of inflation expectations and ringfence their credibility. The Fed raised rates by 75bps in June, instead of the previously signaled 50bps move, while the updated so-called dot plot signaled the Central Bank's intention to move rates to a modestly restrictive level by the end of the year with a terminal rate at 3.8% sometime in 2023, 130bps above the long-term natural rate of 2.5%, while Chair Jerome Powell acknowledged that achieving a soft landing will be "very challenging". Ongoing upside surprises on inflation are also pressuring the ECB to act more decisively, pre-announcing in June its intention for a 25bps liftoff at the July meeting and leaving the door open for a more aggressive pace of tightening after the summer if the medium-term inflation outlook "persists or deteriorates". Against this background, investors are getting more worried about growth than inflation, as more aggressive Central Bank policy action will dent growth further, risking to push various economies into a sharp slowdown or even recession.

Developed Economies

US: The headline CPI surprised to the upside in May, rising to a fresh multi-year high of 8.6%YoY from April's 8.3%YoY, mainly supported by higher energy and food prices. Reflecting broad-based price pressures, core CPI was also firmer than expected, reaching a still high 6.0%YoY from 6.2%YoY in April. Persistently high inflation is weighing heavily on consumers' real disposable income, translating into an all-time low consumer confidence reading in the June UM survey. On the back of weakening consumer sentiment, high inflation and tightening financial conditions, retail sales which looked solid through April, unexpectedly dropped in May for the first time so far this year, industrial production rose by just 0.2%MoM in May following a string of solid gains so far this year, many housing-related indicators have weakened in recent months as higher interest rates are weighing on the housing market and the ISM manufacturing index fell in June to a two-year low. On the monetary front, the "usually high" 75bps rate hike at the June meeting, combined with the upward revised so-called dot plot, suggest that the Fed is 'strongly committed' to restore price stability, even at some cost to the US medium-term growth outlook.

Euro area: Headline inflation surged to a fresh record high of 8.6%YoY in June from 8.1%YoY in May, on the back of higher energy and food prices, while persistently high inflation is starting to feed through to wage demands. Meanwhile, as reflected by incoming sentiment indicators, Eurozone growth is slowing down after Q1 GDP was revised significantly up from 0.3%QoQ to 0.6%QoQ on Irish volatile GDP data. In

more detail, weighed down by geopolitical uncertainty and elevated inflation, EC consumer confidence dropped by 2.5ppts to -23.6 in June, close to its April 2020 historical low, while the composite PMI fell sharply from May's 54.8 to a 16-month low of 52.0, with broad-based weakness across sectors and sub-components pointing to further growth slowdown ahead. But with the majority of the Governing Council members firmly focused on high inflation amid concerns over a de-anchoring of inflation expectations, the ECB adopted a more hawkish stance at its June policy meeting. It pre-announced a 25bps rate liftoff in July and left the door open for a more aggressive rightening pace in September while a gradual path of further rate hikes should follow thereafter.

Emerging Economies

EM: Both economic outlooks released by the World Bank (WB) and the OECD in June underline the perils for the emerging space that stem from the prolonged war between Russia and Ukraine. The WB revised downwards its GDP growth forecast for the emerging and developing economies (EMDE) to 3.4% in 2022 from 4.6% previously, in January 2022. The institution grounds the deterioration of the outlook on negative spillovers from the invasion of Ukraine which more than offset any near-term boost to some EMDE-commodity exporters from higher energy prices. Additionally, global financial conditions have tightened pushing borrowing costs higher, particularly for emerging EMDEs, trimming thus, the available fiscal space for a concise response to inflationary pressures, elevated uncertainty, and heightened geopolitical risks. In the said context, the OECD added the underlying risk of disruptions in the wheat supplies in a group of EMDEs, among which some are located in the neighboring Eastern Mediterranean. OECD's GDP growth forecasts have been downwards revised for almost all large EMDEs, apart from Argentina, Saudi Arabia and Turkey. Another important development in June is the 14th BRICS summit that took place virtually in China. Among the key undertakings was the growing membership of the New Development Bank (NDB). The NDB was established in 2015 by BRICS countries – Brazil, Russia, India, China and South Africa - with membership open to members of the United Nations. The extroversion of the institution was broadly read by market participants as an effort of the developing world and the larger countries of that universe to enhance the economic cooperation among them and gradually reduce the EMDEs' dependency on long-lived and well established global IFIs such as the WB and the IMF.

CESEE: With almost all HICP prints in May continuing to keep coming in at double digit, on the back of soaring energy and food prices, monetary tightening continues unabated in the region. In Czechia, Hungary, Poland and Serbia, Central Banks (CB) proceeded with additional hikes in the key policy rates in June and so did the CB of Romania in late May. Although too soon to tell as June's prints are not published yet for most of the peers, indications from Slovakia and Slovenia for June whose figures came in at 12.5% from 11.8% and at 10.8% from 8.7% respectively, point to continuing pressure. While risks over consumption and GDP growth are titled to the downside, the strong labor market conditions in the region with unemployment on a downward path, reaching historic lows for a plethora of regional peers, is expected to act, at some point, as a strong mitigant towards the said direction.

CESEE Markets Developments & Outlook

Bulgaria

Yield spreads opened significantly in the global markets, following the persistently higher inflation figures as well as the ongoing war between Russia and Ukraine. Eurobond yields continued their upward trajectory on almost all maturities, with similar moves across the entire curve. 2027-2028 tenors saw 20-25 bps rises, longer maturity bonds, namely the 2030 and 2035, saw 89-96 bps spikes, while the 2050 rose by 47 bps. On the short-term spectrum, the 2024 Eurobonds rose by 70 bps. Local papers showed increasing yield spikes with the most active one being the 5-year tenor – up by 154 bps, while the 20-year tenor spiked by 20 bps. The Ministry of Finance did not hold any auctions in June. As the government was toppled by a no-confidence vote on Wednesday, June 22nd, any issuance of titles is preferred to be scheduled in the foreseeable future.

Serbia

Surprisingly, the dinar appeared to be defying fears over recession in large, developed economies and stubbornly elevated energy prices, trading slightly stronger against the euro compared to the previous month and keeping the EUR/RSD rate close to the recent lows of 117.35-36 despite the consistent intervention by the National Bank of Serbia (NBS) in the FX market in order to avert an even temporary wave of strength.

However, Serbian government bonds are still witnessing some sort of risk on and risk off movements with increased volatility as regards yields. The most liquid bonds, i.e. the 7-, 10- and 12.5-year tenors, have been traded in the ranges between 6%-6.25%, 6.20%- 6.60% and 6.95-7.30% respectively.

Concluding with a brief macro view, the inflows of capital and foreign exchange reserves have decreased while the cost of borrowing has risen as mirrored in the last 10-year government bond denominated in dinar, auctioned at a 6.7% yield. The picture is not rosy on the external payments front as well, as about 70% of the increase in the trade deficit derived from the energy market, as larger quantities were imported at higher prices. Along these lines, inflation remains stubbornly high, suggesting that the NBS will have to stick up to some additional monetary tightening in order to sooth the pace of inflation but, as inflationary prices are mostly imported, it will not be able to avert it completely.

Markets View

Foreign Exchange

EUR/USD: The Fed's commitment to tame inflation even at the cost of slowing down economic growth has increased demand for the greenback against euro, with the DXY climbing even above 1.05. Currently at the 1.02 territory, we still remain bullish for a short-term target range levelled up at 1.04-1.05, while still expecting a break-out towards the 1.10 space in the medium run.

EUR/GBP: With two main forces acting on the pair currently, firstly the UK recession fears, and the ECB's "expected" hawkish bias by the long-sided investors, the pair touched the 0.87 level during the month, while it keeps ranging around the 0.8650 territory for the second half of June. We remain bullish on the pair from an entry level at 0.84 and a target level at 0.88 and above. A short-term consolidation at the current level will probably lead us on an adding positioning, while a stop-loss would be set at the 0.83.

Rates

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: 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

As global recession risks rise, even though China's growth is improving, EM assets continue to suffer heavy losses with outflows from local debt now outpacing those of the external debt on a YTD basis, particularly due to the outflows from China. The EMBI Global Index closed at 459 bps at the end of June, 81 bps wider on the month. CEEMEA continued performing very poorly with Russia defaulting on its foreign-currency sovereign debt for the first time in a century, something that is mostly symbolic giv-en the damage already done to its economy. In Hungary, the NBH hiked its base rate by 185bps to 7.75%, with 50bps expected. In Latam, spreads ended wider, with politics heating up and moving left-ward, while in Asia spreads remain

the outperformers in the EM space, with the Chinese PMIs returning to expansion. We remain bearish on EM sovereign fixed income but see some value when local central banks will start focusing on recession fears rather than inflation risks.

Corporate credit

Inflation and recession worries as well as concerns around Central Banks (CBs) policies hit the markets. On the back of that, Europe's Investment Grade (IG) corporate market was very weak and volatile in the past month (underperforming the US IG one) amid poor liquidity which exacerbated price moves. More specifically, EUR IG bond spreads on all rating grades and sectors ended wider (around +47bps) with the Real Estate sector greatly underperforming (+118 bps wider). Volumes in Europe's primary market remained light with a few deals being pulled or downsized reflecting the volatile market conditions ra-ther than corporates' willingness to raise funds. On the back of the nervous and volatile environment, EU CDS indices moved +30bps wider in IG while +135bps wider in High Yield (HY) reaching the highest levels since the Covid-19 spike (March/April 2020).

In more detail; sector-wise, in EUR IG, Financials were around +51bps wider, Real Estate +118bps wider, Energy +39bps wider, Health Care +31bps wider, Telecoms +28bps wider, Industrials +38bps wider, Consumer Goods +42bps wider, Utilities +46bps wider, Technology +42bps wider and Basic Materials +46bps wider. US IG names spread were around +30bps wider in the same period outperforming EUR ones. Specifically, Financials were +27bps wider, Real Estate +89bps wider, Energy +26bps wider, Healthcare +22bps wider, Telecoms +23bps wider, Technology +21bps wider, Industrials +22bps wider, Consumer Goods +28bps wider, Utilities +20bps wider, while Basic Materials were +31bps wider.

Key themes remain the inflation persistence and the impact on growth from higher rates, potentially leading to a recession, as well as speculation on CBs reactions. Therefore, markets are expected to re-main nervous and volatile unless we see evidence that inflation is at least stabilizing while in terms of liquidity, we believe it remains low.

Special Topic: Cyprus Macroeconomic Outlook

- After a 5.2% real GDP growth contraction in 2020, the economy grew by 5.5% in 2021. 2022 has started with a solid economic momentum, as GDP expanded by 5.6%YoY/1.0%QoQ in 2022Q1, compared to 5.9%YoY/0.7%QoQ in 2022Q4
- Despite the challenges ahead, which stem primarily from the elevated geopolitical risks, focus on reforms could unleash the country's economic growth potential

After a 5.2% real GDP growth contraction in 2020, the economy grew by 5.5% in 2021, returning to its pre-pandemic level in 2021Q3, despite the lag in the recovery of the tourism sector. Both domestic and external demand contributed to the rebound, with the former benefitting by fiscal support measures and a successful vaccination rollout and the latter based on a bounce of professional and financial services. The tourism sector recovered only partially compared to pre-pandemic levels, with arrivals reaching 48.7% and revenues 56.4% of 2019 levels respectively.

2022 has started with a solid economic momentum, as GDP expanded by 5.6%YoY/1.0%QoQ in 2022Q1, compared to 5.9%YoY/0.7%QoQ in 2021Q4, but the geopolitical situation in Ukraine has added uncertainty to the growth outlook. The economy started with a positive carry over effect into 2022Q1, yet headwinds are expected in the remainder of the year. The negative spill over from the Ukraine war is expected to be primarily transmitted through the external demand channel, given that Russians account for more than 20% of tourist arrivals in Cyprus and 20% of the financial services Cyprus provides outside the EU. In addition, energy and commodity prices, along with supply chain disruptions, continue to inflate the cost of living and erode the purchasing power of consumers. In the above context, all major international financial institutions slashed their GDP growth forecasts for 2022, as is the case for the entire Euroarea. The European Commission (EC), in its Spring economic forecast released in mid-May, cut the growth projection to 2.3%, from 4.1% foreseen in the winter forecast in February; more recently, in early June, the IMF, in the article IV consultation for 2022, carved its forecast to 2%, from 3.6% in October. Our 2022 GDP growth baseline scenario aligns with that of the EC with the evaporated tourist flows from and services exports to Russia identified as the key drags. By contrast, the expected rebound of investments, supported by the Recovery and Resilience Funds (RRF) and the Multiannual Financial Framework (MFF) comprise a key growth driver. The RRF effect is expected to be mostly felt from mid-2022 onwards taking into account the time needed for some of the projects to mature. The Cypriot Recovery and Resilience Plan (RRP) provides for a total of €1.2bn, which breaks down into €1bn in grants and €0.2bn in loans to be deployed up to 2026, while the funds under the MFF are estimated at €1bn extending between 2021 and 2027.

The labour market remained broadly stable in 2021 with the unemployment rate standing at 7.5% and decreasing to 6.6% in 2022Q1. Yet, the slowdown of the economy is expected to cause a slight spike in 2022, close to 7.5% in our view, given the expected deceleration of tourism, which is a labour- intensive sector. In the medium term, the unemployment rate is expected to recede gradually, returning to its historical long-term trend.

Tourism has crucial weight for the Cypriot economy. The sector contributed by 13.4% in 2019 GDP, resulting in a stellar year in terms of growth; in 2020, when its contribution diminished to 3.7%, a 5.2% recession was recorded. The same holds for the labour market as well, with jobs related to the said sector accounting for more than 13% of total employment in both 2019 and 2020. Tourist arrivals between January and May increased more than fivefold on an annual basis. The current level of arrivals so far in 2022 approaches 76% of those in 2019, based on May's data, when in March the respective figure stood at 70%. All in, although the contribution of the Russian market is significant, this performance is not too dissimilar from that of competitors. In addition, May's data allows for some optimism regarding the magnitude of the hit and the speed with which the Russian arrivals can be substituted with alternative markets.

Inflation hitting the economy since 2021Q4 is an equally important consideration. HICP, after a FY-2021 2.3%YoY increase, spiked to 9.1% in June, from 8.8%YoY in May and 8.6%YoY in April, driven by increases in energy and food prices. This brought the year-to-June average rate of change at 7.3% YoY, slightly outpacing the 7.1% respective figure for the Eurozone. High inflation readings for a prolonged period erode the purchasing power of disposable incomes with an adverse impact expected on private consumption for 2022, when in previous years, consumption was a main contributor to GDP.

Before the burst out of the pandemic, Cyprus was rapidly recovering from the 2012-2013 financial crisis. Nevertheless, the latter inherited economic impediments such as the high share of NPLs and excessive indebtedness, both private and public, that, despite the progress, still remain not fully resolved. The pandemic added further pressure to the public debt, which rose to an all-time high of 115% of GDP in 2020. Yet, the ratio fell to 103.9% in 2021, with the medium-term trend posed for further reduction on the back of expected GDP growth and return to fiscal stability. Towards that end, fiscal consolidation underway proceeded much faster than expected in 2021, with the fiscal deficit falling to 1.8% of GDP, from 5.6% of GDP in 2020, mainly due to strong revenue growth. With the fiscal adjustment flagged as key priority on the economic policy agenda, fiscal deficits in the medium term could continue shrinking as a percentage of GDP, anticipated at 1.3% in 2022 by the IMF, and fiscal surpluses or at least balanced budgets could return from 2023 onwards. Certainly, the adverse geopolitical momentum could spur fiscal perils stemming from the reduced tax revenues from tourism and professional services, posing serious downside risks to the budget execution. However, those will most probably be mitigated by the gradual phasing out of the pandemic support measures, resulting in reduced public expenditure. The outlook of the external payments appears more challenging, taking also into account that historically growth is accompanied by trade deficits due to the high reliance on imports of goods and energy and the deficits in the income accounts. Specifically, for 2022, the limited income from tourism, along with the increasing payments for energy goods will widen the current account deficit, from -7.5% of GDP in 2021, to levels close or even above 8% in 2022. Last but not least, the further reduction of non-performing loans (NPLs) remains a challenge for the banking system, despite past progress. NPL ratio stood at 11.1% in Q42021, down from 15.4% in Q32021 and 17.7% in FY2020, yet it continues to lie above EA levels. The seal of the agreement of the Starlight project in April through which the Hellenic Bank of Cyprus will dispose ca €1bn of NPLs, could push the ratio to lower levels, notwithstanding further pressures from increased inflation and lower GDP growth.

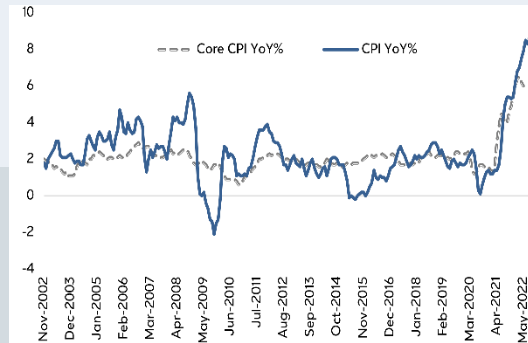
Despite the challenges, Cyprus maintains uninterrupted market access and investment-grade status. As an indication of Cyprus's actual economic standing and market participants perceptions of the country's effort and progress so far, DBRS Morningstar upgraded in April the sovereign credit rating, from BBB (low) to BBB, changing the trend from positive to stable, on the grounds of, inter alia, stronger-than-anticipated growth and public finances during 2021 and supportive conditions for debt reduction in the medium-term. On the same footing, in late June, Scope Ratings affirmed the BBB- long-term issuer and senior unsecured local- and foreign-currency rating and revised the Outlook from Stable to Positive, on the back of solid growth prospects, structural reforms and renewed commitment to fiscal discipline, among other factors. Having said all the above, the geopolitical upheaval in the Eastern Mediterranean Sea remains always at sight as a potential source of instability. However, the potential for growth from the future exploitation of natural gas reserves also remains. Policy continuity and political stability are important prerequisites for growth, noting that in early 2023 presidential elections will be held.

US

A broad-based slowdown in economic activity since May

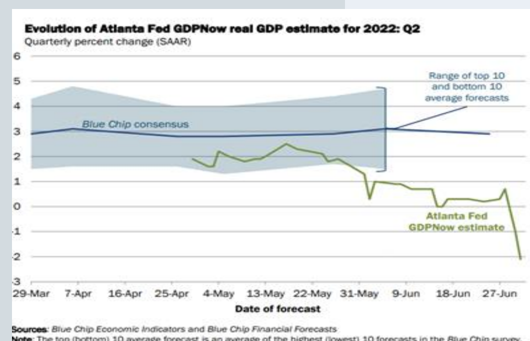
The headline CPI surprised to the upside in May, rising to a fresh multi-year high of 8.6%YoY from April's 8.3%YoY (Figure 3), mainly supported by higher energy and food prices. Reflecting broad-based price pressures, core CPI was also firmer than expected, reaching a still high 6.0%YoY from 6.2%YoY in April. Core goods prices re-accelerated (8.5%YoY) mostly driven by hefty gains in new and used vehicle prices after both categories declined in the prior two months, while core services remained strong (5.2%YoY), primarily due to higher rent measures and a further strong increase in airline fare prices. Persistently high inflation is weighing heavily on consumers' real disposable income, translating into an all-time low consumer confidence reading in the June UM survey (50.0). On the back of weakening consumer sentiment, high inflation and tightening financial conditions, retail sales which looked solid through April, unexpectedly dropped by 0.3%MoM in May, the first decline so far this year, and real consumer spending fell by 0.4%MoM, the weakest monthly change since last December, with the savings rate (5.4%) remaining below pre-pandemic levels and down substantially from its peak (26.6%) during the pandemic. Adding to evidence for a material loss of growth momentum in recent months, industrial production rose by just 0.2%MoM in May following a string of solid gains so far this year, many housing-related indicators have weakened in recent months as higher interest rates are weighing on the housing market and the ISM manufacturing index fell by 3.1ppts in June to a two-year low of 53.0, reflecting a sharp drop in most of major components, especially new orders, which moved below the critical level of 50 for the first time since the Covid-19 lockdowns during spring 2020. As of July 1, the Altanta Fed GDPNow forecasting model estimates real GDP growth at -2.1%QoQ annualised in Q2 (Figure 4), suggesting that the economy is likely in the midst of a technical recession after growth contracted by 1.6%QoQ annualized in Q1. On the monetary front, the "usually high" 75bps rate hike at the June meeting, combined with the upward revised dots that envision lifting rates into a 'modestly restrictive level' in coming months made clear that fighting high inflation and maintaining its credibility is the Fed's top priority. In other words, the Fed is 'strongly committed' to restore price stability, even at some cost to the US medium-term growth outlook.

Figure 3: Persistently high inflation pressures



Source: BLA, Eurobank Research

Figure 4: Atlanta Fed GDPNow forecasting model- US economy likely in the midst of a technical recession



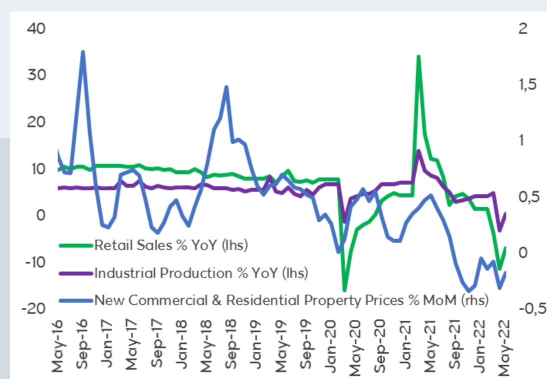
Source: Federal Reserve Bank of Atlanta, Eurobank Research

China

Economy may have bottomed out, but fragility and challenges remain

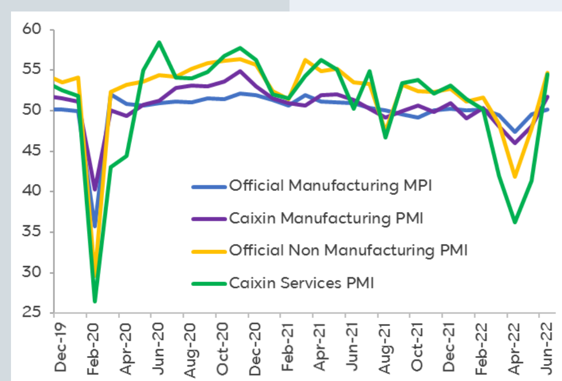
May's hard and June's soft data suggest that the worst may be behind us following the extensive lockdowns that lasted close to two months and took a heavy toll on the economy. Industrial production increased on an annual basis by 0.7% in May from -2.9% in April, beating the Bloomberg consensus which was for a 0.9% contraction. Retail sales did not follow towards the same direction, still they decelerated at a milder pace of -6.7% compared to -11.1% in April and to the market consensus for a decrease of 7.1%. Turning to forward-looking data, all PMIs for June came in upbeat compared to those of May. Official manufacturing PMI came in at 50.2, enhanced from May's 49.6 and above the 50-unit threshold that separates contraction from expansion. The respective index by Caixin that includes smaller and focused on exports firms suggests a stronger kickoff as it came in at 51.7 from 48.1 in the previous month and above the 50.2 market expectation. The most prominent rebound was mirrored in the Caixin services PMI as it jumped to 54.5 in June - the highest reading over the last 11 months- from 41.4 in May. While May's data allow for some optimism for the second half of the year, the lockdowns have taken a sizable toll on the economy with market participants anticipating the Q2-2022 print to come in marginally above 0%. Assuming the estimate is verified in mid-July when the print is due, H1-2022 GDP growth will land somewhere close to 2.5%, following the 4.8% Q1-2022 growth rate. That said, the downwards revisions for the FY-2022 that came into light in June by IFIs and rating agencies came as no surprise as an ambitious GDP growth rate above 5% will have to be achieved in H2-2022 so as for the FY-2022 to stand above 4% at a period when lockdowns may have eased but the virus has not stopped being transmitted and with zero covid-19 policy still in place. The described dynamics do not rule out a new wave of lockdowns, constituting, in turn, the economic sentiment rather fragile. In the above context, the World Bank, in its latest outlook, trimmed GDP growth to 4.3% from 5.1% in December with the OECD standing around the same area, at 4.4%. More conservatively, the S&P and Fitch Ratings slashed their forecasts to 3.3% and 3.7% respectively from 4.9% and 4.8% in March.

Figure 5: Hard data suggest that the economy has hit the bottom…



Source: Bloomberg, Eurobank Research

Figure 6:..and the same is implied in terms of economic sentiment



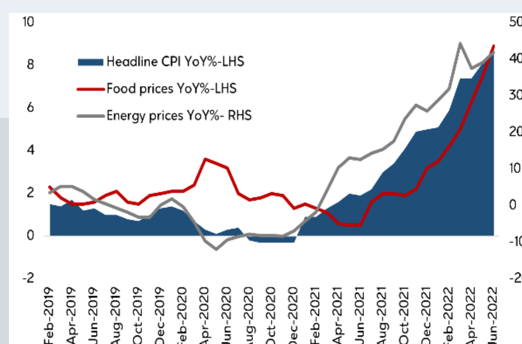
Source: Bloomberg, Eurobank Research

Euro area

Persistently high inflation motivates the ECB to front-load tightening

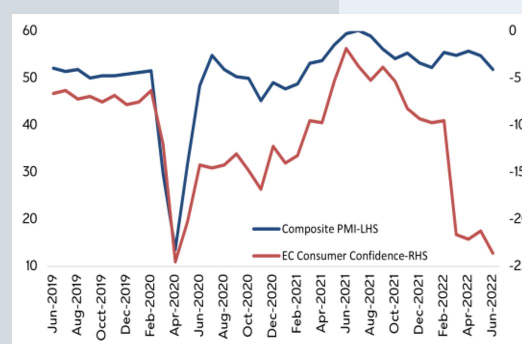
Euro area headline inflation surged to a fresh record high of 8.6%YoY in June from 8.1%YoY in May, on the back of higher energy and food prices (Figure 7). On the other hand, although non-energy industrial good prices accelerated further (4.3%YoY), core inflation dropped to 3.7%YoY from May's 3.8%YoY on the back of a modest decline in service prices (3.4%YoY). This was mostly due to government support measures in Germany, in particular the introduction of the special discounted public transport ticket (so-called "9-Euro ticket"). But as things stand, this technical inflation distortion is set to unwind in September when the said travel subsidy expires. Furthermore, the anticipated strong recovery of tourism in the EU this summer could push service prices up again in the coming months, while factory-gate prices continue to increase strongly (36.3%YoY in May, close to April's 37.2% record high). That said, in spite of the unexpected June decline, we might not have yet witnessed the end of the pressures on core inflation, while recent rises in energy prices after the reduction of gas deliveries to a number of EU countries, suggest that headline inflation has probably not yet reached a peak. Meanwhile, persistently high inflation is starting to feed through to wage demands, with Germany's largest labour union IG Metall achieving a 6.5% rise in wages for its steel workers over a period of 18 months, and announcing a 13-year high 7-8% wage rise demand for its metals and electronics workers. In the meantime, as reflected by incoming sentiment indicators (Figure 8), Eurozone growth is slowing down following a significant upward revision in Q1 GDP from 0.3%QoQ to 0.6%QoQ on Irish volatile GDP data. In more detail, weighed down by geopolitical uncertainty and elevated inflation, EC consumer confidence dropped by 2.5ppts to -23.6 in June, close to the April 2020 historical low, while the composite PMI sustained a sharp decline to a 16-month low of 52.0, with broad-based weakness in both sectors and sub-components. But with the majority of the Governing Council members firmly focused on high inflation amid concerns over a de-anchoring of inflation expectations, the ECB adopted a more hawkish stance at its June policy meeting. It pre-announced a 25bps rate liftoff at the July meeting and left the door open for a more aggressive rightening pace in September while a gradual path of further rate hikes should follow thereafter.

Figure 7: Headline inflation mainly driven by higher energy and food prices



Source: Eurostat, Eurobank Research

Figure 8: Disappointing sentiment indicators for June point to a slowdown in



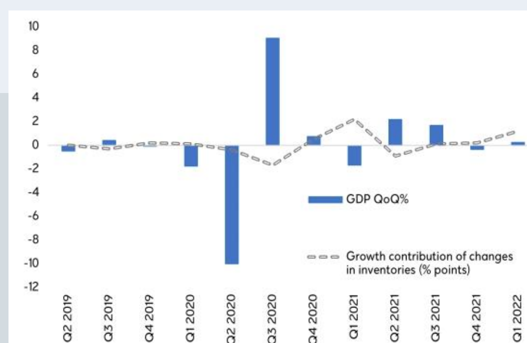
Source: Bloomberg, Eurobank Research

Germany

Technical recession avoided but growth outlook clouded

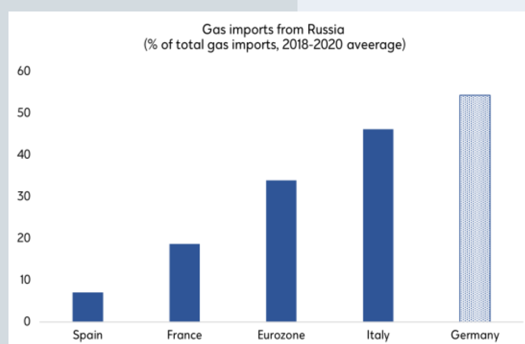
The German economy narrowly escaped a technical recession after Q1 grew by 0.2%QoQ following a 0.3%QoQ growth contraction in the prior quarter (Figure 9), thanks to inventory changes and a surge in investment on a weather-assisted bounce in construction. However, looking ahead, the growth outlook seems cloudy given high geopolitical risks, rising energy prices, the still high gas supply dependency on Russia (Figure 10) and ongoing supply bottlenecks which have been exacerbated by China's strict zero-Covid policy. Germany's composite PMI fell in June for the fourth consecutive month to a six-month low of 51.3, pressured by a loss of momentum in both sectors, as pent-up demand after the reopening of the economy is probably waning, while a number of manufacturing sub-indices, including output and orders, fell into contractionary territory inflicted by high inflation and weaker demand. Adding to downside short-term growth risks, the IFO business climate index dropped further below the 100-threshold in June to 92.3, mostly driven by deteriorated business expectations for the coming six months, indicating mounting pessimism among German businesses. Meanwhile, though a still tight labor market, accumulated excess savings and the 22% increase in the minimum wage as of October 2022 should provide some support, subdued consumer confidence (July's GfK consumer climate indicator at a fresh record low of -27.4ppts) and high inflation, pose headwinds to private consumption. Germany's HICP unexpectedly dropped to 8.2%YoY in June from a multi-year high of 8.8%YoY in May, but that was owning to the temporary government initiatives, namely reduction in the energy tax on fuels and introduction of a monthly €9 public transport ticket. Looking ahead, a renewed increase seems highly likely in the coming months, especially in September when the aforementioned relief measures come to an end, while supply issues prevail and energy pressures will likely persist. More worryingly, Germany has raised the alarm status of the natural gas emergency plan from the first to the second following recent significant decline in Russian gas supplies and the risk of moving to stage 3 (emergency level) has clearly increased with the likelihood of gas rationing being imposed.

Figure 9: Germany narrowly escaped a technical recession in Q1, mostly thanks to inventories



Source: Federal Statistical Office, Eurobank Research

Figure 10: Germany is heavily reliant on gas imports from Russia



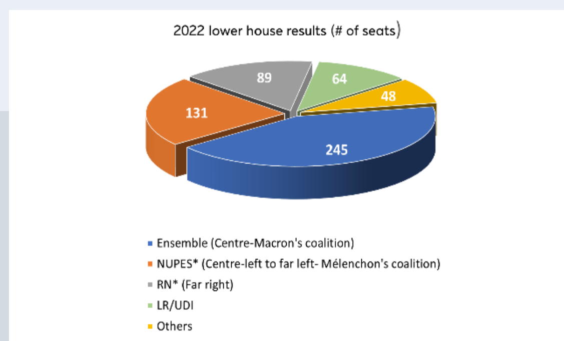
Source: Eurostat, Eurobank Research

France

Hard time ahead for Emmanuel Macron to implement his reform agenda

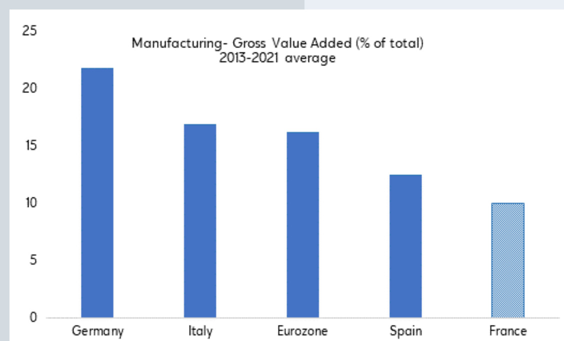
The second round of the legislative elections that was held on June 19 resulted in a hung parliament as, for the first time since the establishment of the five-year presidential term in 2000, no party obtained an absolute majority in the 577-seat National Assembly (Figure 11). Ensemble, the coalition of parties backing President Emmanuel Macron, came first, obtaining 245 seats, well below the 350 won at the 2017 election and, more importantly, far below the minimum required of 289 for an absolute majority. The NUPES coalition of the main left-wing parties will represent the largest opposition bloc (131 seats), while the far-right Rassemblement National (RN) led by Marine Le Pen multiplied its number of seats and came in third (89 seats) followed by the centre-right Les Républicains (LR, 64 seats) whose economic programme is very close to that of Ensemble. However, LR rejected the scenario of a coalition agreement shortly after the election results. Therefore, the only option left for Emmanuel Macron to pass important legislation and implement his reform agenda, including the pension reform that was central to his presidential campaign, is to rely on MPs from other parties on a case-by-case basis after the cabinet reshuffle on 4 July revealed that Emmanuel Macron failed to build a formal coalition agreement with other parliamentary parties. If the government is unable to pass any laws in the coming months, the French President has the power to dissolve the National Assembly and call early elections, but not earlier than one year after the latest legislative elections. Meanwhile, following a 0.2%QoQ GDP contraction in Q1, sentiment indicators pertaining to Q2 suggest that economic activity remained subdued, as the combination of geopolitical jitters and broad-based elevated inflation (HICP up to 5.8%YoY in June) are weighing on consumer confidence (INSEE May index down to a nine-year low of 82), while supply chain disruptions and pipeline price pressure appear far from abating in the manufacturing sector (PMI manufacturing at a 19-month low of 51.4 in June). However, the government rebate on fuel prices, higher wage growth (minimum wage up by 2.65% in May), high accumulated excess savings (16.9% in Q4 2021) and the economy's relatively lower vulnerability to supply bottlenecks (Figure 13), should provide some support, suggesting that a technical recession is unlikely near-term.

Figure 11: Ensemble lost absolute majority at the National Assembly



Source: French Interior Ministry, Eurobank Research

Figure 12: France less exposed to supply chain disruptions



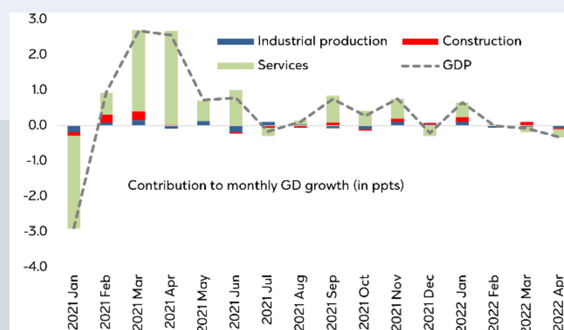
Source: Eurostat, Eurobank Research

UK

Cost-of-living crisis and Jubilee bank holiday add to risks for Q2 GDP contraction

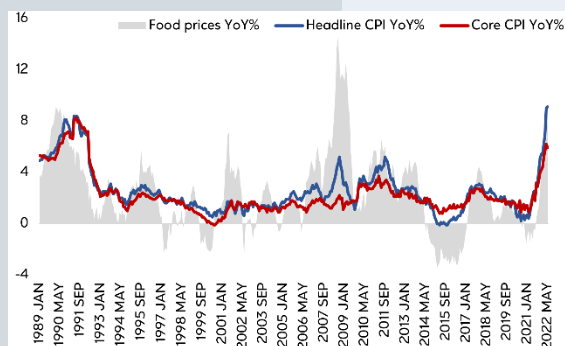
UK GDP unexpectedly shrunk by 0.3%MoM in April following a 0.1%MoM contraction in March and zero growth in February, with all three main sectors recording output decreases for the first time since January 2021 (Figure 13). In particular, industrial production dropped by 0.6%MoM, driven by manufacturing (-1.0%MoM) due to supply chain shortages and increases in petrol and energy prices. Construction fell by 0.4%MoM, recording the first decline since October 2021, after a hefty increase of 1.7%MoM in March, with the ONS attributing April's weakness to the unwinding of strong repair and maintenance activity in the prior month after the heavy storms in the second half of February. The biggest surprise came from services, where output dropped by 0.3%MoM, contributing the most to April's GDP contraction (-0.5ppts), due to a large decrease in human health and social work (-5.6%MoM) related to a significant reduction in NHS test and trace activity following the end of social restrictions. The Q2 carry-over stands at -0.4% and with GDP likely to contract again in May and June due to the large national rail strike, the extra Bank holiday that was held for the Queen's Platinum Jubilee and the large squeeze in household real disposable income amid higher prices, taxes and interest rates, risks are for a GDP contraction in Q2 (BoE Q2 GDP estimate: -0.3%QoQ). However, due to fiscal stimulus measures recently announced by the Chancellor (worth £15bn or 0.6% of GDP) that are likely to mostly benefit households mostly in H2 2022, high savings accumulated during the pandemic (6.8% in Q4 2021), a tight labor market (unemployment at 3.8% in April, slightly above March's 50-year low of 3.7%) and the expected reversal from the temporary drag stemming from the extra Bank Holiday and rail strikes, the UK economy is likely to escape a technical recession this year, with growth, though, expected to remain subdued in H2 2022 due to the cost-of-living squeeze and tighter financial conditions. Headline CPI rose to a fresh 40-year high of 9.1%YoY in May, mainly on the back of higher food prices and is expected to rise further in the coming months (Figure 14) as energy regulator Ofgem has announced a further increase of 42% in October (after a 54% rise in April), supporting the case for additional BoE rate tightening near-term.

Figure 13: All three main sectors saw output fall in April



Source: ONS, Eurobank Research

Figure 14: Inflation likely to remain high in the coming months



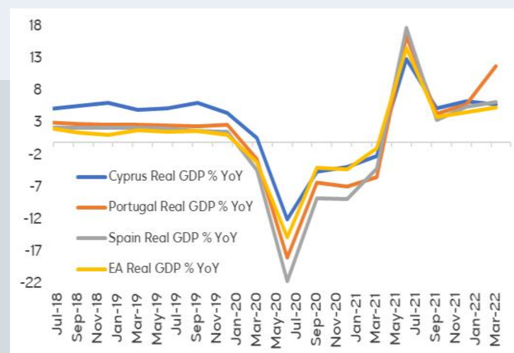
Source: ONS, Eurobank Research

Cyprus

Soothing signals from the tourist sector but challenges remain

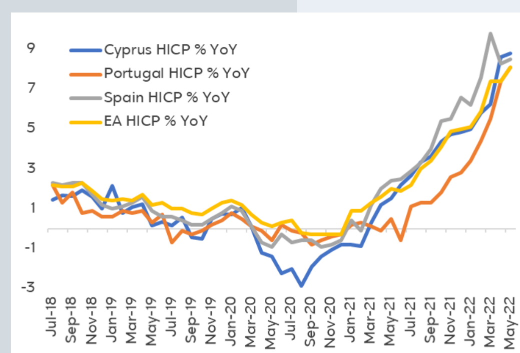
Tourist arrivals data in May sent a positive signal for the recovery of the respective sector following the serious concerns at play since March over the magnitude of the hit from the absence of Russian tourist inflows. January-to-May arrivals increased more than fivefold on an annual basis. They may stand at 76% of their pre-pandemic level, improved, however, compared to March, when the respective figure stood at 70%. All in, although the contribution of the Russian market is significant, the performance so far allows for some optimism regarding the speed with which the Russian arrivals can be substituted with alternative markets. Developments on the steamy front of prices continue to worry as HICP picked up to 9.1% YoY in June up from 8.8% in May. June was, also, a month with a plethora of releases as regards macroeconomic forecasts and ratings assessments. The IMF, in the article IV consultation for 2022, carved its forecast to 2.1%, from 3.6% in October on the grounds of elevated risks at sight, primarily those resulting from an extended war in Ukraine and on a second level from potentially unrestrained Covid-19 outbreaks. Additionally, extensive, and rapid monetary tightening in larger and more advanced economies sharpens the risks further. On a more favorable tone, Scope Ratings affirmed the BBB- long-term issuer local- and foreign-currency rating and revised the outlook from Stable to Positive, on the back of solid growth prospects, structural reforms and renewed commitment to fiscal discipline, among other factors. We, in turn, keep our GDP growth forecast stable at 2.3% for 2022 and pay close attention to the political impasse that has built up lately and which blocks the disbursements of the first tranche of the RRF. In detail, the lack of political consensus over two bills that enhance the legal framework for the NPLs delays the RRF disbursement as the said reform constitutes the last milestone that unlocks the payment of the first installment of EUR85mn.

Figure 15:…in terms of GDP growth , Cyprus performs similarly to peripheral peers and EA average…



Source: Eurostat, Eurobank Research

Figure 16: …but it has a small lead as regards inflationary pressures



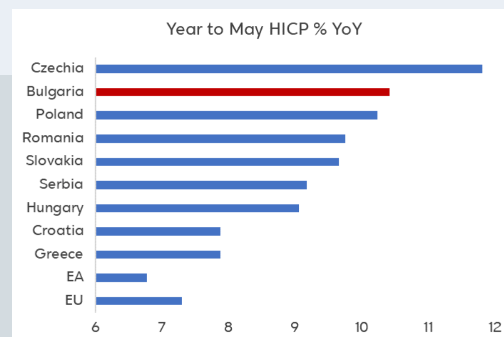
Source: Eurostat, Eurobank Research

Bulgaria

Political instability weighs on the softening momentum of the economy

The final Q1 2022 GDP print on a seasonally adjusted basis came in at 4.0% YoY, beating to the downside the 4.5% flash estimate released in mid-May. Economic growth cooled down once compared to the previous three quarters in both annual and quarterly terms. That said, GDP expanded by 4.0% YoY in Q1 2022 down from 5.0% YoY, 5.1% YoY and 7.8% YoY in the previous three quarters respectively, while in quarterly terms GDP growth came in at 0.8% in Q1-2022 from 1.3% in Q4 2022 and 0.9% in both Q3 and Q2 in 2022. The key drivers behind the slowdown are the weakened growth of consumption on the back of soaring prices and the subdued expansion of exports. Hard data point to continuing deceleration in Q2 2022 as retail sales, industrial production and construction output came in weaker in April compared to March, with the developments on the price front shaping unfavorable dynamics for a quick turnaround of the economy. Inflation accelerated to 15.6% YoY in May from 14.4% YoY in April, reaching the highest level in the last twenty years and bringing the average year-to-date reading to 10.3% YoY. Along these lines, in the convergence reports released in early June, the EC and the ECB stressed out that the country is not ready for eurozone accession yet. They both noted that Bulgaria meets the criteria over stable sustainable public finances, stability of exchange rates and long-term interest rates but does not fulfil the price stability conditionality as the twelve-month average inflation rate in April was 5.9%, higher than the reference value of 4.9%. With the geopolitical instability remaining unabated since the beginning of the war, the favorable labor market conditions -unemployment fell to a record low of 4.5% in May -, the affirmation of the BBB rating and the maintenance of the positive outlook by Fitch Ratings were not enough to ease the pressure from the above outlined developments. As a result, the four-parties coalition government under the leadership of the WCC party cracked in late June and, following the parliamentary no-confidence vote, efforts for formation of a new government are put, which, if not fruitful, elections will have to be called, just six months after the last ballot.

Figure 17: Inflationary pressures, among the highest in the region, jeopardize the 1.1.2024 date for the Euro adoption



Source: Eurostat, Eurobank Research

Figure 18: ...while Q1-2022 growth rates were among the weakest regionally

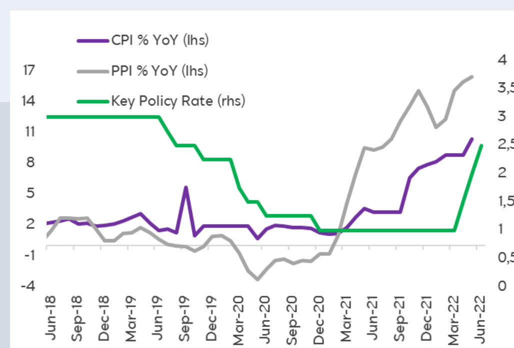
Source: Eurostat, Eurobank Research

Serbia

The NBS is heading for catch up with its peers on monetary tightening

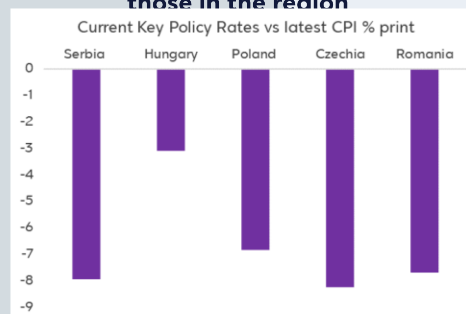
Q1 2022 GDP growth reading verified the flash estimate of 4.3%YoY released in early May, coming in at 4.4% YoY and 0.5% QoQ. In terms of expenditure, the key driver of growth was private consumption with net exports contributing negatively. The key concern of the economy remains the persistent inflationary pressures stemming from the energy and food segments. In May, CPI came in at 10.4% YoY from 9.6% YoY and 9.1% YoY in April and March respectively, when for FY-2021 inflation averaged at just 4.1%. The core print gained as well in March climbing to 6.3% YoY from 5.5% YoY in April and 4.8% YoY in March, implying that expectations over continuing price increases are getting more entrenched. In view of the above, in this month's meeting, the National Bank of Serbia (NBS) delivered an additional hike of 50bps for a third month in a row, bringing the Key Policy Interest Rate (KPR) to 2.5%. In its quarterly inflation report, a month earlier, the NBS trimmed the 2022 GDP growth forecast by 0.5ppt compared to the previous quarter, setting between the range of 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. On the same footing, the Ministry of Finance, in its fiscal strategy for 2023 released in early June, also trimmed its forecast for 2022 to 3.5% from 4.5% previously on the back of rising geopolitical tensions, energy crisis and heightened global uncertainty. The downward revisions by both domestic authorities and their relevant rationale bode well with those of the World Bank and the IMF at 3.2% and 3.5% respectively, both released in June and kept unchanged compared to their previous releases in April. In our view, 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. Despite the limited direct trade and financial ties with Russia and Ukraine, an additional toll on the economy will be taken by external demand primarily through Serbia's exposure to Europe, which was the key driver for S&P's change in the outlook from positive to stable in the recent affirmation of the BB+ rating.

Figure 19: The NBS speeds up with interest rate hikes



Source: Bloomberg, Eurobank Research

Figure 20: ..as real interest rates need to approach those in the region



Source: National Central Banks & Statistics Offices, 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	3.2	3.2	4.7	6.7	4.1									
Advanced Economies															
USA	5.7	2.5	1.8	4.7	7.5	3.4	5.4	3.6	3.6	-3.7	-3.9	-3.7	-10.8	-4.5	-4.1
Eurozone	5.4	2.7	1.9	2.6	7.2	3.2	7.7	6.9	6.9	2.4	1.7	2.0	-5.1	-4.5	-3.0
Germany	2.9	1.8	2.0	3.2	7.3	3.4	3.6	3.5	3.3	6.7	5.3	5.7	-3.7	-3.4	-1.8
France	6.8	2.4	1.7	2.1	5.2	2.9	7.9	7.3	7.3	-0.9	-1.1	-1.0	-6.5	-5.5	-4.5
Periphery															
Cyprus	5.5	2.3	3.2	2.2	6.5	3.0	7.5	7.5	7.2	-7.2	-9.0	-8.0	-1.8	-1.5	-1.0
Italy	6.6	2.8	1.5	2.0	6.6	2.7	9.5	8.4	8.6	3.4	1.3	1.2	-7.2	-5.8	-4.5
Portugal	5.4	5.6	2.0	0.9	6.1	2.0	6.6	5.9	5.7	-0.7	-2.0	-1.5	-2.8	-2.2	-1.6
Spain	5.1	4.3	2.8	3.0	7.6	2.7	14.8	13.4	13.1	0.9	0.7	1.3	-6.9	-5.5	-4.4
UK	7.2	3.5	1.0	2.6	8.4	4.8	4.6	3.9	4.1	-3.4	-4.2	-3.8	-7.4	-4.3	-2.8
Japan	1.8	1.7	1.8	-0.3	1.9	1.2	2.8	2.6	2.5	2.8	1.8	2.1	-6.4	-6.5	-4.5
Emerging Economies															
BRICs															
Brazil	4.8	1.2	1.1	8.3	9.9	5.4	13.6	11.0	10.5	-1.6	-1.0	-1.5	-5.1	-7.1	-7.2
China	8.1	4.1	5.2	0.9	2.2	2.3	4.4	4.1	3.9	1.8	1.5	1.1	-3.8	-4.7	-4.5
India	8.7	7.1	6.4	5.4	6.7	5.0		*NA*		-1.5	-3.0	-2.1	-6.9	-6.6	-6.0
Russia	4.7	-9.6	-1.5	6.7	15.7	9.0	4.8	7.3	6.8	6.7	9.5	6.5	0.4	-1.9	-2.1
CESEE															
Bulgaria	4.2	2.6	2.8	3.3	10.4	5.1	5.3	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	8.5	4.9	11.0	10.4	9.5	-4.4	-5.5	-5.3	-4.1	-3.0	-2.0
Turkey	10.3	3.0	3.3	19.4	69.0	34.0	12.0	12.5	12.8	-2.2	-4.7	-3.6	-3.2	-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	1.50-1.75%	2.59-2.85%	3.18-3.45%	3.42-3.70%	3.50-3.75%
3m SOFR	2.11%	2.14%	2.57%	2.82%	2.87%
2yr Notes	2.84%	3.06%	3.11%	3.16%	3.16%
10 yr Bonds	2.83%	3.19%	3.17%	3.22%	3.26%
Eurozone					
Refi Rate	0.00%	0.70%	1.15%	1.40%	1.60%
3m Euribor	-0.14%	0.49%	0.98%	1.25%	1.44%
2yr Bunds	0.46%	0.66%	0.81%	0.92%	1.01%
10yr Bunds	1.26%	1.17%	1.21%	1.27%	1.30%
UK					
Repo Rate	1.25%	1.75%	1.95%	2.00%	2.05%
3m Sonia	1.60%	1.61%	1.73%	1.80%	1.91%
10-yr Gilt	2.12%	2.03%	2.03%	2.04%	2.01%
Switzerland					
3m Saron	-0.16%	-0.53%	-0.31%	-0.09%	0.18%
10-yr Bond	0.77%	0.96%	1.03%	1.07%	1.12%

Source: Bloomberg (market implied forecasts)

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