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The global recovery continues but is facing another headwind, as the emergence of the Omicron variant is set to depress economic activity short-term. However, there are signs for optimism as recent evidence suggests that the new strain will likely be less severe than previous ones and may thus become less of a drag on growth. Meanwhile, several major CBs take a more hawkish stance and appear ready to start accelerating their policy normalization plans, which include both interest rate hikes and asset holdings runoff, as the economic recovery advances and inflation pressures remain elevated.

Macro Picture

USA: Q1 2022 growth prospects dampened by Covid-19 resurgence

EA: Growth momentum is fading amid tighter Covid-19 restrictions

UK: GDP growth is slowing amid supply side constraints and cost pressures

EM: Differences in the handling of the pandemic and economies' structure behind the divergence of the recovery among developing economies

CESEE: Most of regional peers kicked off 2022, having returned to pre-Covid-19 levels of economic output

Markets

FX: USD strength has paused as QE tapering seems priced in for the moment

Rates: EU and US rates remain very volatile, both curves increased due to interest rate expectations

EM: EM assets resilient in the last month of the year. Volatility should remain elevated as global rates rise in 2022

Credit: Spreads tighter in December, expected to move moderately wider in Q1, on US tapering, higher rates

Policy Outlook

USA: Fed likely to move faster on both rates and QT

EA: The ECB laid out a path out of asset purchases, but a potential rate hike still distant

UK: The BoE raised rates in December as inflation concerns outweighed uncertainty over Omicron

CESEE: Monetary tightening set to continue throughout H12022 as inflationary pressures are not expected to ease earlier

Key Downside Risks

DM: Spread of new vaccine-resistant infectious variants, new wave of national lockdowns, more persistent price increases, de-anchoring of inflation expectations, premature and aggressive withdrawal of policy support

EM: Limitations in health, fiscal and monetary policy space room across the EM sphere along with elevated geopolitical risks (e.g. Russia-Ukraine) and idiosyncratic stressed cases (e.g. Turkey) dim the overall outlook

Special Topics in this issue

2022 Developed Markets Economic Outlook

Italy's Presidential Elections

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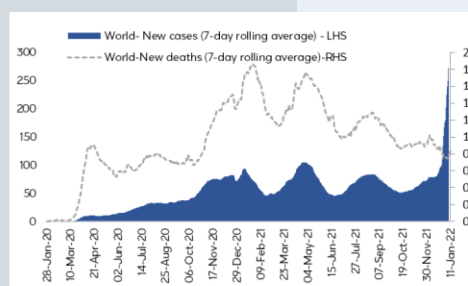
Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook

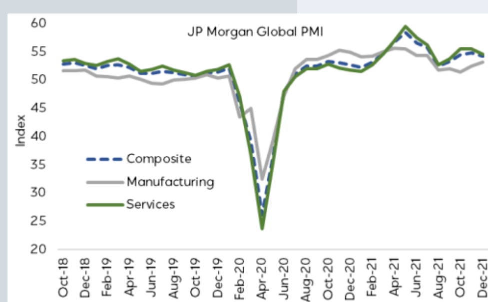
Global economic recovery continues but is facing another headwind, as the emergence of the Omicron variant is set to weigh on economic activity short-term. Global infections have hit record highs, testifying the much more contagious nature of the Omicron strain compared to previous ones. Aiming to combat the rapid spread of the new variant, several European countries have been forced to reintroduce tighter restrictions or even a lockdown, which have resulted in a reduction in mobility, while the US and emerging markets are also at risk given their relative low vaccination rates. However, there are signs for optimism. Although hospitalizations are rising, so far, they remain below previous pandemic highs, and the new death rate also stands below last year's peak thanks to the higher rates of vaccinations than during prior waves of Covid-19. That said, though the new Covid-19 variant is poised to depress growth short-term, it is likely to prove less severe than prior pandemic waves, and thus, may become less of a drop on economic growth. Supporting the view for a slowing in global growth as a result of the Omicron drag, the J.P. Morgan Global Composite Output Index dropped from 54.8 in November to a three-month low of 54.3 in December, remaining however 1.8pts higher from its August trough and above the boom-or-bust level of 50 for the 18th consecutive month. The December drop was entirely driven by services business activity, which eased to a three month low (54.6) as it bore the brunt of the new pandemic wave, which has particularly hurt consumer services providers. Nevertheless, it continued to outperform its manufacturing counterpart, which saw output growth accelerating to a five-month peak (53.3) boosted by a moderate easing in global supply chain bottlenecks. Meanwhile, global inflation has reached levels not seen since the run up to the 2008 global financial crisis, with pressures likely to remain high for longer. Against this background, several major CBs take a more hawkish stance and appear ready to start accelerating their policy normalization plans, which include both interest rate hikes and asset holdings runoff, as the economic recovery advances and inflation pressures remain elevated.

Figure 1: The number of new Covid-19 infections is rising rapidly



Source: Our World In Data, Eurobank Research

Figure 2: Global economic growth is losing steam amid another rising Covid-19 wave



Source: Bloomberg, PMI, Eurobank Research

Developed Economies

US: After the strong H1 2021 recovery, with real GDP annual growth at 6.4% in Q1 and 6.7% in Q2, economic activity lost steam, with the Q3 reading deteriorating markedly to 2.3%. The labour market tightened further towards the end of the year, increasing upward pressure on wage growth. At the same time, the headline CPI climbed further in December to 7%YoY – an almost four-decade high – with Fed funds futures pricing-in almost fully a March rate hike. Manufacturing and services continued to expand in December albeit at a slower pace. Moving on to 2022, prospects are dampened by continuing Covid-19 outbreaks, lingering supply disruptions, depletion of excess savings and the diminishing impact of fiscal support, which is gradually withdrawn. Nevertheless, should the pandemic gradually subside towards Q2, which is not unlikely, the growth momentum is expected to recover.

Euro area: Eurozone Q3 GDP was left unrevised at 2.2%QoQ in the final release, with economic output standing just 0.3% below the Feb. 20 pre-pandemic level. Private consumption was the main growth driver, on released pent-up demand following the easing of Covid-19 restrictions over that period. However, heading into Q4, growth momentum has likely moderated as a winter Covid-19 wave and the emergence of the Omicron variant led to the reintroduction of some containment measures in several countries. In addition, supply bottlenecks are far from fully resolved, contributing to higher inflation which continued to surprise to the upside in December, eroding households' purchasing power and denting sentiment. For the whole 2021, we see annual GDP growth rising by 5.1%, with elevated pandemic fears and renewed activity restrictions likely to keep growth subdued in the early months of 2022. On the monetary policy front, the ECB announced at the December meeting a clear path out of asset purchases. However, this does not mean that policy rate hikes are any closer, as the Committee's implicit forward guidance (a lift-off in rates to follow the end of the net purchases, planned for end-2022) and medium-term inflation forecasts (HICP inflation below the 2% threshold in both 2023 and 2024), make a rate hike highly unlikely before 2023.

Emerging Economies

EM: While waiting for the Q42021 GDP data to be released across the EM sphere, the full unwinding of the pandemic shock during the outgone year brought into light the evident GDP growth differential between the developing economic zones around the globe. The divergence among developing Asia, Europe, LatAm and Africa is broadly based on the different approach towards the pandemic, but also on more structural fundamentals such as the fiscal and monetary available space, the trade policy and the economic structure as a whole. Looking at the big picture, the economic output in the EM world, having shrunk by -2% in 2020, is expected to expand by +6%., according to the World Bank (WB), and this is sizably attributed, inter alia, to the economic trajectory of China in both 2020 and 2021. Witnessing the lack of homogeneity across the EM economies, idiosyncratic factors (e.g. Turkey) and elevated geopolitical risks (e.g. Russia-Ukraine) will weigh in 2022 on the overall economic growth, which is estimated at +4.5%, according to the latest WB's World Economic Outlook.

CESEE: With regional Q4GDP flash estimates due in February, the overall evaluation of the 9M2021 GDP growth performance in CESEE is rather positive, despite the cooling spotted in almost every single regional peer in Q32021 compared to Q22021. The close of 2021 will find the majority of the regional peers to their pre-Covid-19 levels of economic activity, as the region is expected to post a GDP growth rate at the range of +5% from -4% in 2020. The economic momentum is expected to last, albeit with some cooling, throughout 2022 as pent up demand unfolds and EU Next Generation funds are deployed more vigorously. The inflationary outlook will remain challenging in 2022 as price pressures, stemming to a great extent from global energy prices, are not expected to ease earlier than H22022 and as such, monetary tightening is expected to continue throughout H12022. Separately, official representatives at the highest level from Albania, North Macedonia and Serbia met in Tirana on December 21 in order to discuss and deepen their political and economic collaboration under the Open Balkan initiative, also known as the mini Schengen concept. The Open Balkan plan is part of the Berlin Process initiated by Germany and France to promote regional development between the western Balkan countries and foster their integration with the EU. The outcome of the summit was the signature of agreements on the labour market, electronic identification, agro-veterinary cooperation and lifting non-tariff barriers for businesses among the participant countries and from these memoranda "tens of thousands of people will profit directly very soon". The next summit is scheduled to be held in Skopje, North Macedonia in February 2022.

Special Topics

I. 2022 Developed Markets Economic Outlook

Global economy: After the global economy enjoyed a brink rebound from the Covid-19 crisis in 2021 with an estimated GDP growth rate of 5.9%, the highest since the bounce from the global financial crisis near a decade ago and following a severe contraction of 3.1% in 2020, the global economy is expected to remain in a recovery mode in 2022. However, the momentum is likely to lose some steam on the back of the fading effect from the lift of Covid-19 lockdowns, waning pandemic-related fiscal stimulus, the less accommodative stance of monetary policy from several major CBs, ongoing supply disruptions that continue to weigh on industrial production, higher than expected inflation and the effect on service sector activity from the renewed Covid-19 restrictions that have been introduced across most of the developed world to curb the spread of the Omicron variant. Assuming that the new Covid-19 strain does not lead to new waves of national lockdowns and the pandemic situation comes under control in the spring (as was the case last year) leading to the lift of activity restrictions, we expect a global GDP growth rate of 4.4% in 2022, sharply lower from 2021, but still exceptionally strong against the historical background where average growth for the last 40 years has been around 3.0%. The major drivers behind this year's expected ongoing economic expansion mostly include, strengthening growth in China on the back of policy stimulus, lagged effects of pandemic-related US fiscal stimulus, still favorable financing conditions and EU fund absorption from the "Next Generation EU" recovery fund. However, risks are skewed to the downside, as the emergence of the Omicron variant and the threat of new strains have increased uncertainty about how quickly the pandemic can be overcome.

Inflation is expected to fall back in 2022 due to base effects, growth moderation and expectations that global supply bottlenecks will dissipate, while labor force participation will return more fully to normal patterns. In addition, oil prices have likely already peaked as OPEC increases production quotas. However, with inflation having already reached levels far above those initially expected driven mostly by severe supply chain disruptions and higher energy prices, pressures will likely remain elevated for longer than previously anticipated, while the expected downtrend will likely be slow as the ongoing pandemic could prolong supply disruptions. The current surge and persistence of inflation have led major CBs to take a more hawkish turn, reducing gradually monetary policy stimulus. The BoE was the first major CB to raise rates since the pandemic begun, while the Fed's accelerated tapering process could likely lead to earlier and faster interest rate increases, starting probably in late Q1/early Q2, absent a significant deterioration in the activity data or virus conditions. On its part, the ECB will likely lag its peers in lifting interest rates, in part because EA wage growth is likely to remain contained. Fiscal stimulus will also be gradually reduced as major economies approach the pre-pandemic growth trend, especially in developed markets where pandemic fiscal support had been very accommodative.

US: After the strong H1 2021 recovery, with real GDP annual growth at 6.4% in Q1 and 6.7% in Q2, economic activity lost steam, with the Q3 reading deteriorating markedly to 2.3% attributed mainly to slowdowns in private consumption and manufacturing production stemming from renewed Covid-19 resurgence. Moving on to 2022, prospects are dampened by continuing Covid-19 outbreaks, lingering supply disruptions, depletion of excess savings and the diminishing impact of fiscal support, which is gradually withdrawn. Meanwhile,

inflation has climbed to extraordinary levels – well beyond the 2% Fed target – with the December headline CPI coming in at 7%YoY, the largest annual increase since June 1982 and the core CPI (excl. energy and food) registering 5.5%YoY, the largest annual increase since February 1991. These readings exacerbate fears that inflation may become deep-rooted, considering also that the labour market is tightening with persisting employment shortages pushing wages upwards but high inflation eroding wage gains.

Going forward, vaccinations will be a key determinant regarding the course of the economy in the near-term. In the US, while initially the rate of vaccinations was high, it then slowed significantly, with about 55% of the population now vaccinated, a level well below that cited as the threshold to achieve herd immunity. However, since November, there has been some acceleration in vaccinations, which, if maintained, will constitute an upside risk to the outlook. The course of the new Omicron variant will also play an important role. So far, it appears that the new strain causes a milder disease than the previous ones. However, its significantly increased transmissibility inevitably leads to more hospitalizations, which is already putting pressure on health systems. In any case, if expectations for a gradual easing of the pandemic towards Q2 materialise and supply-side constraints subside, the growth momentum is expected to recover.

On the monetary policy front, as implied by the recently released FOMC minutes and Fed Chair Jerome Powell's re-nomination testimony before Congress, the Fed will take all the necessary steps to ensure that inflation does not become entrenched and hamper the current economic expansion. Taking into consideration the latest data on inflation and the labour market, it is not unlikely that the Fed will start raising interest rates as early as March, possibly proceeding with more than three rate hikes this year and start the runoff of its balance sheet earlier than expected.

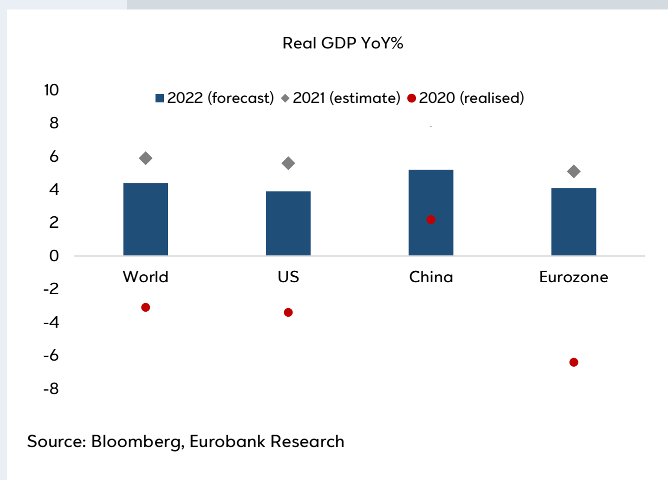
Overall, downside risks to the outlook include a worse-than-expected turn in the evolution of the pandemic and vaccinations, persistent inflation that will also call into question the effectiveness of Fed's interventions and persistent shortages in the labour market. The positive risks are summarized in the faster de-escalation of the pandemic and the consequent normalization of supply chains, the containment of inflation and the possible additional fiscal support.

Eurozone: After growing by a hefty 2.2%QoQ in Q3, a similar pace of expansion to Q2, that took output just 0.3% below its pre-pandemic levels, GDP growth momentum has lost steam. The winter Covid-19 wave and the emergence of the Omicron variant in late November, led to the reintroduction of some activity restrictions, while rising inflation is eroding households' purchasing power and lingering supply bottlenecks constrain industrial production. Heightened pandemic uncertainty amid a rapid increase in new cases, suggest that subdued growth momentum is likely to prevail in the early months of 2022. However, as was also the case back in 2020 and 2021, we assume that the pandemic situation will improve in the spring, allowing growth to rebound, helped by private consumption amid an ongoing improvement in labor market conditions, a pick-up in wages growth, excessive savings and fading inflation pressures. Meanwhile, investment and exports should favor from easing supply bottlenecks, favorable financing conditions and increased EU fund absorption from the "Next Generation EU" recovery fund. Overall, we expect an ongoing expansion of the EA in 2022 but at a moderate pace, with GDP growing by 4.1% from a projected 5.1% in 2021.

Headline CPI rose by an average decade high of 2.6%YoY in 2021 after accelerating in December for the sixth consecutive month, hitting another record peak of 5.0%YoY, despite negative oil and technical effects. Looking into 2022, base effects (last year's German VAT re-hike, delayed winter clothing sales, changing HICP weights) are anticipated to drag headline lower. However, expectations of persistently high wholesale gas prices due to renewed geopolitical tensions, ongoing demand-supply imbalances and a likely wage growth pick-up on the back of a tightening labour market, suggest that the anticipated inflation moderation is likely to be very slow and gradual, especially if the Omicron restrictions intensify supply-chain disruptions and labor shortages. With its current strong momentum unlikely to fade quickly, we do not see inflation dropping below the ECB's medium-term 2% inflation target before the final quarter of 2022.

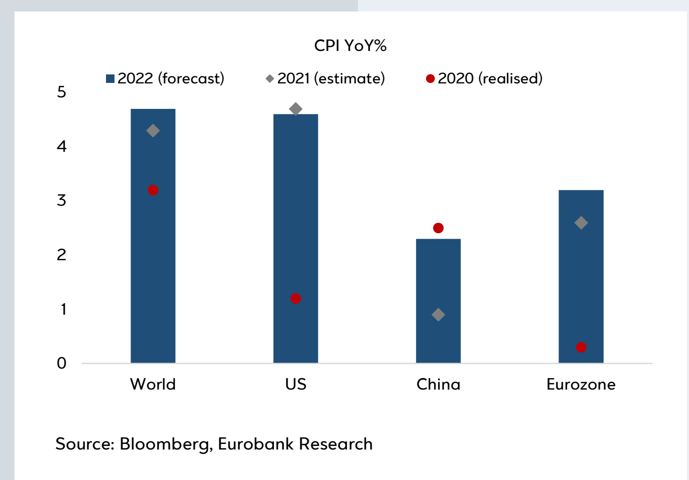
On the monetary policy front, the ECB is expected to retain a more accommodative policy stance compared to other major Central Banks. Asset purchases will continue throughout the year, while a lift-off in interest rates is unlikely before next year, as suggested by the ECB's implicit forward guidance and its latest medium-term inflation forecasts. EA fiscal policy, as recommended by the European Commission itself, is expected to remain expansionary in 2022. The general escape clause from the Stability and Growth Pact has been in place since 2020 and will continue until 2022, suggesting that governments have the room to support the economy, if needed.

Figure 3: GDP YoY% (forecasts & realizations)



Source: Bloomberg, Eurobank Research

Figure 4: CPI YoY% (forecasts & realizations)



Source: Bloomberg, Eurobank Research

Germany: After GDP advanced by a hefty pace in Q2 and Q3 following a broad reopening of the economy in May, output has likely slightly contracted in Q4 due to supply constraints, soaring price pressures and renewed stringent measures to counter the impact of the new wave led by the Delta strain and, lately, the Omicron variant that emerged in late November. For the whole year, this could result in an annual growth rate of 2.7%, mostly supported by private consumption. Looking into 2022, the pandemic-related measures and voluntary social distancing are expected to keep growth depressed in Q1. However, assuming that the

Omicron situation does not deteriorate and relevant restrictions do not have to be applied for much longer, we expect activity to rebound strongly from Q2 onwards. Supported by easing supply shortages and stronger external demand, business investment should recover swiftly, also favored by the new government's policy for energy transition to CO_2 neutrality and digitization of the economy. Meanwhile, the rapid expansion of employment and accumulated savings should continue to underpin private consumption, taking the annual growth rate for the whole year at a notably quicker pace of 4.0% in 2022.

With respect to inflation, fading base effects are anticipated to drive HICP headline inflation below 3.0% on average in 2022 after reaching a record peak above 5.0% in late 2021. However, a tightening labor market and the planned increase in the minimum wage raise the possibility of a wage-price spiral, particularly if, in contrast to our expectations, inflation has not substantially abated by the end of the year.

France: Though more seriously hit by the pandemic compared to the EA average in 2020, the economy rebounded swiftly in 2021. Real GDP almost returned to its pre-pandemic level at the end of the summer, supported by a solid recovery in private consumption on the back of a strong improvement in the labor market, while for the whole year 2021, we see the French economy outperforming its major EA pears, also favored by its better insulation against global chain supply disruptions.

Looking into 2022, economic activity is likely to remain subdued in Q1 for the second quarter in a row following the emergence of the Omicron variant. However, if the Omicron situation does not turn out to be more severe than currently assumed, we project a rebound in subsequent quarters driven by supportive fiscal policy. Accumulated savings built up during the crisis should also favor consumption growth, while the government's "France Relance" recovery plan is expected to continue supporting business investment. For the whole year, we pencil in a GDP growth rate of 4.1% from 6.7% expected in 2021, with the Omicron strain representing the main downside risk for the French economy. Politics are in focus this year as France gears up for the April presidential election. The landscape seems skewed to the right, with recent polls suggesting that a mainstream candidate (either incumbent president Emmanuel Macron or Valérie Pécresse, the candidate for the center-right party The Republicans) will ultimately win.

UK: Even though it is gravely affected by the Covid-19 pandemic, the UK economy recorded a stellar performance in 2021 with GDP growth expected just short of 7%, the biggest growth rate among all G7 economies, taking economic activity nearly back to its pre-pandemic levels. Strong resilience to pandemic-related restrictions, ample fiscal stimulus, improving labor market conditions and excess savings, were the main factors behind the UK's swift rebound that was evident in the first half of last year, but momentum lost steam sharply in the second half of 2021, amid supply chain bottlenecks and squeezing purchasing power due to rising prices.

Looking ahead into 2022, the UK economy has to face a number of additional headwinds, including, tighter social restrictions following the emergence of the Omicron variant that are set to remain in place until at least end-January, though the likelihood of stricter measures for a longer period cannot be ruled out should pressures on hospital capacity intensify. Furthermore, lingering bottlenecks across global supply chains are

expected to continue dampening the manufacturing and construction industries, in particular, while businesses are still trying to cope with the new post-Brexit EU-UK trading relationship. At the same time, tax increases, higher BoE rates and elevated inflation are likely to squeeze purchasing power, with a negative impact on household consumption. Overall, we forecast GDP growth of 4.8% this year, slower relative to 2021. Inflation, which surprised to the upside in 2021, is expected to rise further near-term peaking at around 6% in April 2022 due to the expected sharp increase in the Ofgen price cap for household electricity and gas prices, as well as the planned increase in VAT on hospitality, before starting to move back gradually in the second half of 2022, remaining though above the BoE's 2.0% target throughout the year. That said, following a 0.15% BoE rate hike in December amid mounting medium-term inflation concerns and barring any negative surprise, risks lie towards additional tightening in 2022 in order for inflation to return sustainably to the Central Bank's target.

II. Italy's Presidential elections

Focus at the beginning of the year turns to the presidential elections with the electoral process scheduled to begin on January 24. In accordance with the Constitution of Italy, the election is held in the form of a secret ballot, with 321 Senators, 630 Deputies, and 58 regional representatives entitled to vote. The procedure foresees successive ballots with the first three requiring a two-thirds majority of the 1,009 voters to elect a President, or 673 votes and, starting from the fourth ballot, an absolute majority, or 505 votes. The number of the voting rounds may be large due to the secret ballot and the often fragmented composition of the Italian parliament. The Italian Constitution establishes the Republic as a parliamentary democracy and the president has limited powers and a largely ceremonial role. Nevertheless, when political impasses occur, which is not uncommon in Italy, the president has a key role to play. This presidential election in particular, has elevated importance because the Prime Minister Mario Draghi may be a candidate, which, if he is elected, may instigate a government reshuffle or snap elections, if the current parliament cannot agree on a new PM. It should be noted, however, that the chances of a snap election are limited due to a number of factors. Firstly, two parties of the government coalition (the Five Star Movement and Forza Italia) are significantly behind in the polls in relation to the election result of 2018 and, if elections are held now, they may lose even half of their power. Additionally, the size of the new parliament will be by a bit more than a third reduced[1], which lowers the incentives of MPs to opt for elections, as they may not get re-elected. Finally, many MPs were elected for the first time in 2018 and would lose pension rights if snap elections were called before 24 September 2022. In any case, in the event of political uncertainty, which is too early to assess, this could have a considerable impact on a country with high public debt, especially in a period when the ECB reduces assets purchases and the EU fiscal rules may be revisited. It should be noted that in a recent article with French President Emmanuel Macron, Mario Draghi argued in favour of a new, more credible and transparent fiscal framework that should be in line with the European Union's strategy for the next decade. He also opined that high indebtedness should be addressed more though structural reforms and less through higher taxes and spending cuts. Therefore, the stay of Mario Draghi in an active role on the Italian political stage in conjunction with the current French presidency of the Council of the EU is increasingly important for both Italy and the EU. Internally, a possible departure of Draghi from the prime minister's office could fuel instability and jeopardize the effective implementation of RRF investments and reforms (€191.5bn is envisaged for Italy). Such a development may also lead to a widening of the spread between German and Italian 10-year bond yields, which hit its lowest level in 2021 when Draghi was appointed PM in February 2021.

[1] Following a referendum on 21 September 2020, the number of MPs in the Parliament will be reduced from 630 to 400 in the Chamber of Deputies and from 315 to 200 in the Senate. The reduction of the number of MPs is expected to happen with the next Italian general election, which is scheduled to take place no later than 28 May 2023.

CESEE Markets Developments & Outlook

Bulgaria

Eurobond yields dropped across all maturities. Specifically, the 2027 and 2035 papers slid 9 and 6 bps respectively, followed by the 2030 and 2050 papers with 4 bps each. The short end of the curve was also active, with the 2024 tenor yield dropping by 7bps. Local papers, on the other hand, saw little change within the month, with the exception of the 8-year tenor, which rose by 8 bps. During December, the Ministry of Finance did not hold any auctions, despite the initial scheduling over a EUR200mn auction. On the political front, the "We continue the change" party created a 4 – party coalition government, which has pledged to put a stop to corruption and misappropriation of government funds. They have further indicated, that they will refinance the maturing Q1 EUR1.25bn Eurobond with funds from the budget, which is a move that surprised all market participants.

Serbia

The dinar remained stable during the previous month but the effort the National Bank of Serbia (NBS) is putting in this direction is getting greater in the past few months. The NBS is present on the market almost on a daily basis, filling the gaps in commercial banks' FX positions. In November, it sold EUR110mn while the amount of Euros purchased spiked to approximately 200mn. Foreign reserves remain stable so far and the NBS will most probably remain vigilant to maintain the said trend in the near term, which is also a pre-election period until April.

In the fixed income space, in the first quarter of 2022, two-year RSD bonds with a total nominal amount of RSD60bn offered at a coupon rate of 2.75% are scheduled to be issued. Also, two issues of bonds denominated in EUR are scheduled; one with a 2-year maturity amounting to EUR200mn bearing a coupon rate of 0.75% and the other with a 25-year maturity in the amount of EUR150mn at a coupon rate of 2.30%. Considering the recent developments in the secondary market, the government will most probably need to borrow at higher rates compared to those in the last quarter of 2021. The sovereign yield curve has experienced an almost parallel upside shift by an average of 100bps during Q4 2021. That said, at the time of writing, the 2-year, 4-year, 6-year and 11-year RSD denominated bonds are trading at 2.70, 3.40%, 3.70% and 4.10%.

Markets View

Foreign Exchange

EUR/USD: The pair has consolidated around the 1.13 level with the major drivers having been weighted down on Covid-19 related talks and speculations, and focusing more on the central banks' reaction on the pandemic period's after-effects on inflation and tightening policies. More specifically, with the European inflation reaching record levels in December and the Fed signalling even more aggressive tightening with three scheduled rate hikes during 2022, the forces are concentrating towards a dollar's further strengthening and eventually a downtrend move of the pair on even lower than 1.13 level's territories. We believe that the pair will further consolidate at this level, ranging on a 150 pips band in the short term, while preparing for an uptrend during 2022's Q1 end, even higher than 1.15, since ECB will eventually be forced to align its policies and actions towards balancing Europe's "transitory" inflation dynamics, as well.

GBP/USD: With the pair having reached a low below 0.8350 mainly due to the substantial divergence between BoE and ECB interest rates policies towards inflation curbing, talks and speculations about the ECB's inflation forecasts and subsequent actions' agenda will be the main key points to monitor towards understanding and anticipating the pair's moves for Q1 2022. As mentioned before, we believe ECB will have to adjust on the rate hikes regime of all other players and as such, we expect the pair to either consolidate around the 0.83 level in the short-term, while moving higher towards the 250 day long-term average level of 0.8560.

Rates

EU: EU interest rates increased in December, with the 10y swap rate trading at 38bps up from 10bps in the previous month. The slope of the curve consolidated at the same levels, with 5s-30s trading at 40bps. Looking forward we expect the rates to remain volatile and eventually move higher. Euro area HICP inflation hit in December another all-time high and ECB is not expected to tolerate prices shooting up for much longer.

US: US interest rates increased in December, with the 10y swap rate trading at 180bps, up from 160bps at the beginning of the month. The slope of the curve remained stable, with 5s-30s trading at 30bps. In the near term we expect US rates to remain volatile and eventually move marginally higher given that four Fed hikes are already priced in. A potential risk would be a slower than expected post pandemic growth or a selloff in US equity markets, which could trigger a general risk off move.

Emerging Markets credit

The FED Chair Powell was as hawkish as was expected, with the tapering accelerating to $30bn per month, but EM external debt proved to be resilient. The EMBI Global Index closed at 330 bps at the end of December, 19 bps lower on the month. In CEEMEA, the Turkish central bank cut rates by another 100bps to 14% but also suggested a temporary pause in the currency easing cycle, while in Poland the MPC increased rates by 50bp to 2.25%. In LATAM, spreads ended the year tighter month to month. In Chile, the leftist candidate Gabriel Boric won the presidential election by a wider margin than was predicted by the polls, while in Mexico the Central Bank surprised with a 50bp hike, instead of 25bp that was expected. In Asia, spreads also ended the month tighter with the investors' interest in Chinese local government bonds remaining elevated. We expect a volatile environment for EM assets in the first quarter of 2022 due to rising US rates, a strong USD and uncertainty on inflation and growth.

Corporate credit

EUR IG cash corporate spreads were broadly tighter in December although they moved a few basis points wider at the start of January 2022. That's as the Omicron variant is seen as less severe, while FED is on full force for a first hike in Q1/22. Spreads on most rating grades and sectors were -4/-8bps tighter the period from 1/12/2021 to 11/1/2022, with lower grades, travel and leisure related, and high yield names outperforming the rest of the market. CDS Indices spreads were on average -6bps tighter in IG and -28bps tighter in HY. Omicron fears abating despite huge increase in new cases, as well as ECB support and significant cash balances on the side, helped to drive credit spreads tighter. Sector wise, in EUR IG, Financials were -6bps tighter, Real Estate -8bps tighter, Oil & Gas -5.5bps tighter, Health Care -7bps tighter, Telecoms -7.5bps tighter, Industrials -6bps tighter, Consumer Goods -8.5bps tighter, Utilities -5bps tighter, Technology -7.5bps tighter and Basic Materials -7bps tighter. US IG names spread were -5 to -11bps tighter (from 1/12/2021 to 11/1/2022). Specifically, Financials were -6bps tighter, Real Estate -2bps tighter, Oil & Gas -9bps tighter, Health care -7.5bps tighter, Telecoms -5.5bps tighter, Technology -5bps tighter, Industrials -7.5bps tighter, Consumer Goods -5bps tighter, Utilities -6bps tighter, while Basic Materials were -11bps tighter.

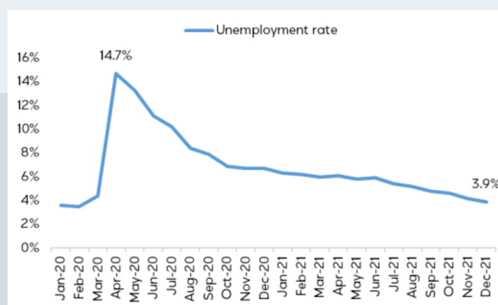
Rating Grade wise, EUR IG spreads in BBB were -7bps tighter, in A -5.5bps tighter, in AA -3.5bps tighter, and in AAA -6.5bps tighter. In the EUR HY universe CCC spreads were -75bps tighter, B grade were -40bps tighter, while BB were -25bps tighter. Rating Grade wise, US IG spreads in BBB were -8bps tighter, in A -5bps tighter, in AA -5.5bps tighter, and in AAAs -4.5bps tighter. We see Technical for cash to remain strong in EUR and US, while US cash will be more affected by FED actions in Q1. Covid19 developments can still be a surprise news item for credit (especially the most affected sectors), but US Tapering and rates path will slowly but with high certainty push spread levels and volatility progressively higher in the medium term. We therefore expect spreads to moderately widen in the coming month.

USA

Fed likely to move sooner and faster on both rates and QT

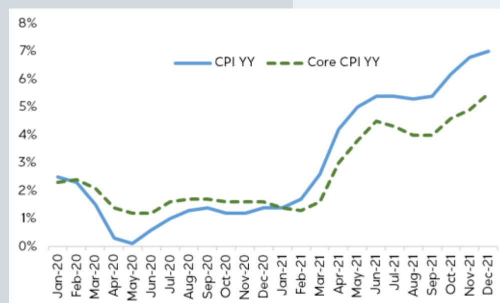
The Q3 2021 real GDP third estimate stood at an annual rate of 2.3% (from 6.7% in Q2), upwards revised from the second estimate of 2.1%. The increase reflected higher private inventory investment, private consumption expenditure (PCE), state and local government spending, and nonresidential fixed investment that were partly offset by decreases in exports, residential fixed investment, and federal government spending. Imports increased. The deterioration in real GDP in Q3 reflected the impact of the resurgence of the Covid-19 pandemic, which resulted in new restrictions, while government assistance payments to businesses, state and local governments and households all decreased. At the same time, in December total nonfarm payroll employment rose by 199,000 and the unemployment rate continued its downward course declining by 0.3ppt from November, standing at 3.9% and approaching the pre-pandemic level of 3.5% (Feb-20). The tightening of the labour market triggers upward wage pressures but high inflation erodes wage gains, with the headline CPI climbing further to an almost four-decade high of 7%YoY in December (from 6.8%YoY in November) and core CPI at 5.5%YoY (from 4.9%YoY in November). Growth in manufacturing continued for the 19th consecutive month in December, albeit at a slower pace, with the ISM Manufacturing PMI coming in at 58.7, lower by 2.4 points compared to the November reading. Pressure on the manufacturing sector from supply chain disruptions and labor supply shortages continues although there are signs of improvement, while demand remains strong. Similarly, the ISM Services PMI registered 62, lower by 7.1 points compared to November's all-time high reading of 69.1. Real growth has likely gained momentum in Q4, but the disruptions caused by the resurgence of the pandemic due to the Omicron variant are likely to mitigate this trend in Q1 2022. On monetary policy, with inflation well above the 2% Fed target and employment towards its maximum level, the Fed is now more likely to start raising interest rates as early as March. The Fed is also likely to start the process of shrinking its balance sheet earlier than expected as the economy's rapid progress towards maximum employment, robust wage growth and persistent inflation, may put pressure on the Central Bank to pull back from the high degree of policy accommodation.

Figure 5: Unemployment close to pre-pandemic levels



Source: BLS, Eurobank Research

Figure 6: Inflation at multi-year high



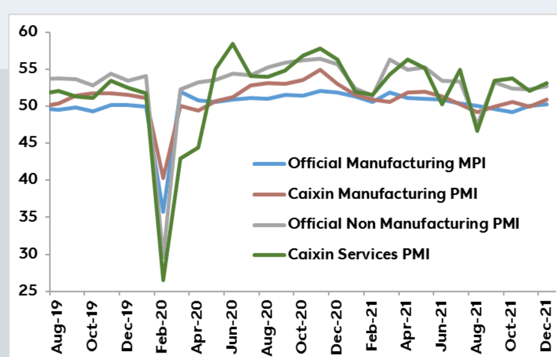
Source: BLS, Eurobank Research

China

Services and manufacturing PMIs in December reveal a turning economic point but challenges ahead remain

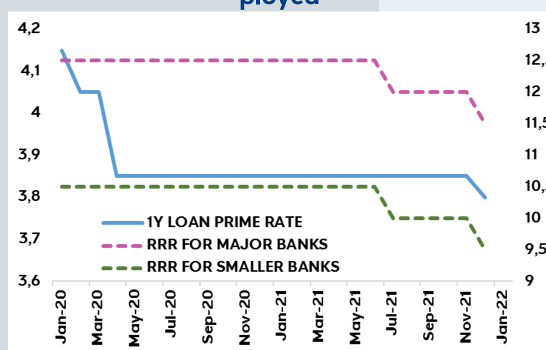
December was a month filled with decisions and actions at the economic policy level. Between December 8 and 10, the Central Economic Work Conference (CEWC) convened and the key takeaway was the commitment to "take economic development as the central task". Under this mandate, fiscal stimulus is expected to gradually unwind in Q1, with the infrastructure investments pipeline and the adjacent increases in local government special bond quotas being already deployed, while actions of monetary easing are already evident. That said, the People's Bank of China (PBoC) delivered in mid-December a 50bps RRR cut – the second such move in 2021, following the unexpected cut in July – which is translated into a ca CNY1.2tn liquidity, directed in the market in order to spur the subdued economic growth. A few days later, the PBOC proceeded with a cut in the one-year loan prime rate (LPR) for the first time since April 2020, in line with market expectations. The one-year LPR, which affects lending rates for corporate and household loans was lowered by 5 basis points to 3.80 percent from 3.85 percent previously. Whether more easing will follow is a tough puzzle as on the one hand the importance of the economic growth target takes centre stage but on the other, China is far from resolving the imminent overleverage issues and the shaky real sector. Additionally, forward looking data, such as the PMIs released at the closing of 2021 reveal a broad recovery in both the services and the manufacturing sector, with all (official and the Caixin) PMIs coming in above the 50 benchmark, surprising to the upside market expectations. With the Q4 GDP growth print due next week and the 9M2021 GDP growth rate currently standing at 10.2%, by factoring in a GDP growth rate for the last quarter at the range of 3.0% YoY, we upgrade our forecast to 8.2% for the FY2021 from 8.0% previously. Looking ahead, we read downside risks to the outlook, associated, among other factors, with the Covid-19 zero transmission policy and the evident over-transmission of the currently prevailing Omicron strain.

Figure 7: Forward looking PMIs continue to improve in December



Source: Bloomberg Eurobank Research

Figure 8: as monetary policy stimulus is deployed



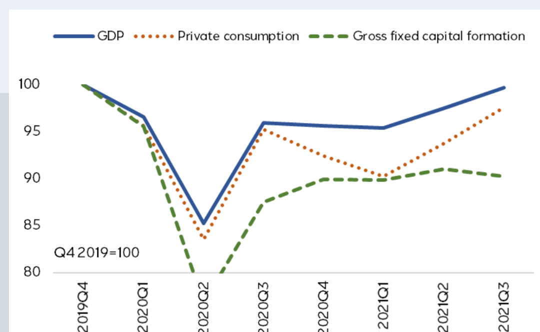
Source: Bloomberg, Eurobank Research

Euro area

Growth momentum is fading amid tighter Covid-19 restrictions

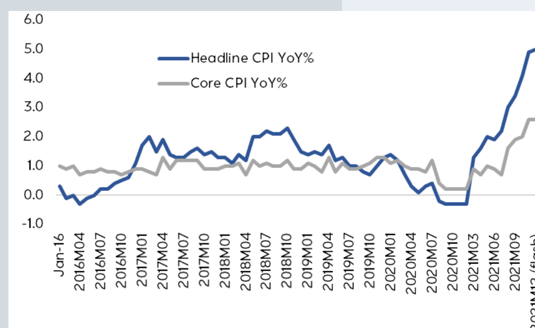
Eurozone Q3 GDP was left unrevised at 2.2%QoQ in the final release, with output standing just 0.3% below the Feb. 20 pre-pandemic level. Private consumption was the main growth driver adding 2.1ppts to the headline growth, on released pent-up demand following the easing of Covid-19 restrictions over that period. However, heading into Q4, growth momentum has likely moderated as the winter Covid-19 wave and the emergence of the Omicron variant led to the reintroduction of some containment measures in several countries. In addition, supply bottlenecks are far from fully resolved, contributing to higher inflation, which continued to surprise to the upside in December, eroding households' purchasing power and denting sentiment. Supporting the view that the EA will end 2021 on a weak note, the composite PMI dropped by a hefty 2.1pts to 53.3 in December, the softest expansion in private sector activity since March, taking the Q4 average to 54.3, sharply lower from an average of 58.5 in the prior month. The higher-than-expected December decline was entirely driven by services (-2.8pts to an eighth-month trough of 53.1) as renewed restrictions and Omicron-related concerns take a toll. On the flipside, manufacturing remained resilient with the respective index still standing well above the boom-or-bust level of 50 (58 vs. November's 58.4) amid a tentative easing in supply constraints. Meanwhile, the headline CPI rose to a new all-time high of 5.0%YoY in December from November's 4.9%YoY, as a modest drop in energy and services inflation was more than offset by surging unprocessed food prices. Rising prices and heightened pandemic-related uncertainty, were the main reasons behind the renewed deterioration in consumer confidence, which dropped for the third consecutive month in December, coming in at a nine-month low of -8.3 and marking a cumulative hefty decline of 4.3pts since October. For the whole 2021, we see annual GDP growth rising by 5.1%, with elevated pandemic fears and renewed activity restrictions likely to keep growth subdued in the early months of 2022. On the monetary policy font, the ECB announced in December a clear path out of asset purchases. However, this does not mean that policy rate hikes are any closer, as the Committee's implicit forward guidance on rates and medium-term inflation forecasts, make a rate hike highly unlikely before 2023.

Figure 9: Q3 GDP placed output just 0.3% below pre-crisis levels



Source: Eurostat, Eurobank Research

Figure 10: CPI inflation continued to surprise to the upside in December



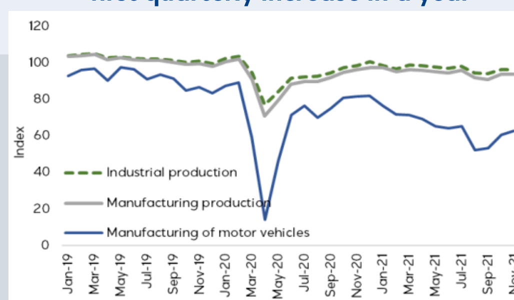
Source: Eurostat, Eurobank Research

Germany

Pandemic-induced deterioration in services offsets manufacturing improvement

Industrial production fell by 0.2%MoM in November following a hefty increase of 2.6%MoM in October, pinning the Q4 2021 carry-over effect at 0.7%QoQ, up from -2.2%QoQ in Q3. Manufacturing increased for the second month in a row (+0.1%MoM) taking output 8.0% below the Feb. 20 pre-pandemic level, supported by a 4.1%MoM rise in automotive production, the third consecutive monthly increase, amid a tentative easing in global supply restrictions. Meanwhile, industry's order books are building up, boding well for the near-term outlook of the manufacturing sector, if supply issues do not deteriorate again. Factory orders rose in November for the eighth month in 2021 (+4.5%MoM), with the respective level rising c. 15% above the pre-pandemic level and, therefore, much higher than the level of manufacturing production. That said, manufacturing is expected to make a positive contribution to economic growth in Q4, which may however, be offset by weaker services sector activity due to pandemic-related problems. The Ifo business climate index dropped for the sixth consecutive month in December by a higher than expected 1.9pts (94.7pts from November's 96.6pts). With the exception of manufacturing, the respective index declined in all major sectors, especially in services and trade, which are among the sectors primarily affected by the recently tightened Covid-19 restrictions in light of the sharp increase in the number of new infections. The PMI followed the IFO business climate downwards in December. The final composite index was revised lower into contraction territory for the first time in the last ten months (49.9), as a rise in manufacturing (57.4) was offset by a drop in services below the expansionary level (48.7), caused by the re-implementation of more stringent measures. Against this background, the German economy is expected to stagnate or even slightly contract in Q4 2021, while for the whole year, we pencil in a GDP growth rate of 2.7%. For 2022, economic recovery is anticipated to gain momentum and expand by 4.0%, on the assumption that industrial production will rebound strongly given the substantial backlog of orders as supply constraints are anticipated to ease further in the course of the year, while strong employment growth, rising wages and accumulated savings should support private consumption once pandemic-related issues abate.

Figure 11: IP is expected to post in Q4 2021 the first quarterly increase in a year



Source: Eurostat, Eurobank Research

Figure 12: Factory orders outpace manufacturing supply

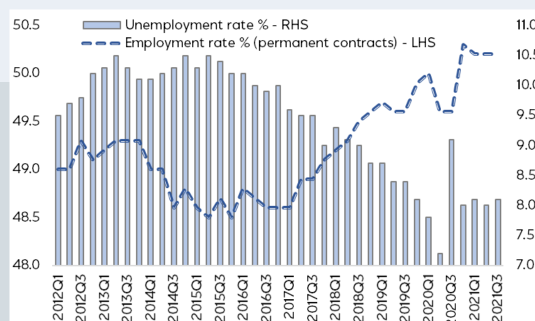
Source: German Federal Statistics, Eurobank Research

France

Underlying growth momentum likely to remain solid in spite of new headwinds

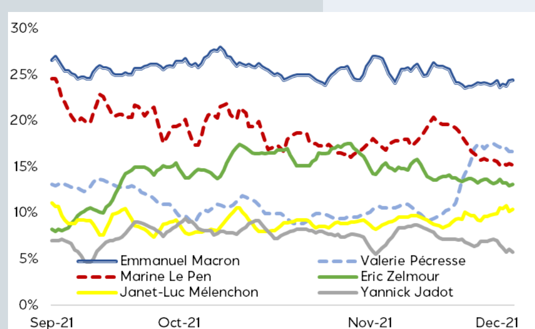
A second estimate confirmed that France's GDP grew by a solid three decades high pace of 3.0%QoQ in Q3, narrowing the gap relative to Q4 2019 pre-pandemic levels to just 0.1% from 3.0% in the prior quarter, largely on accelerating private consumption that was favored by the full reopening of the economy and strong pent-up demand. Looking ahead, high frequency indicators pertaining to Q4 (i.e. composite PMI, INSEE consumer confidence) suggest that economic activity is likely to lose some momentum due to waning reopening effects, surging inflation that is a drag on consumer spending (December headline CPI rose by a more than a decade peak of 2.8%YoY for the second month in a row) and tighter measures following the new winter wave led by the Delta strain and lately the Omicron variant. Nevertheless, the economy is anticipated to retain a reasonably solid pace of growth, mostly thanks to the strong performance of the labor market and the several measures the government recently adopted to support household purchasing power, including an "inflation premium" of €100 to low and middle-income earners and an extension of the freeze on regulated gas prices to cushion the impact of higher energy prices. Overall, we expect GDP to rise by 0.6%QoQ in Q4, and 6.7% for the whole year thanks to stronger growth carry-over effect after a better than expected Q3. That said, the French economy is expected to outperform its major EA peers in 2021, mostly thanks to the relative most complete recovery in private consumption and its relatively lower vulnerability to supply chain disruptions that hold back industrial production, mostly in Germany. On politics, France gears up for the 2022 presidential elections that will be held on 10 April with a run-off on 24 April. According to the most recent opinion polls, President Emmanuel Macron leads by a wide margin and he is highly likely to pass to the second round. At the same time, support for far-right Marie Le Pen has declined sharply in recent months, putting her in third position after Valérie Pécresse, the presidential candidate for the center-right party The Republicans, who is demonstrating a significant bounce in the polls since her nomination in early December and has emerged as one of the most serious challengers to the incumbent president.

Figure 13: Solid performance of the labour market



Source: INSEE, Eurobank Research

Figure 14: President Emmanuel Macro leads by a wide margin



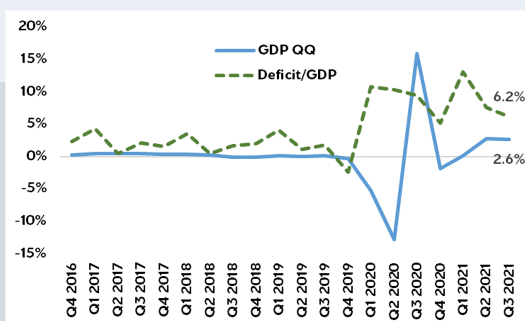
Source: Press reports, Eurobank Research

Italy

Strong momentum into Q4 but expectations toned down by Covid-19, price pressures and supply bottlenecks

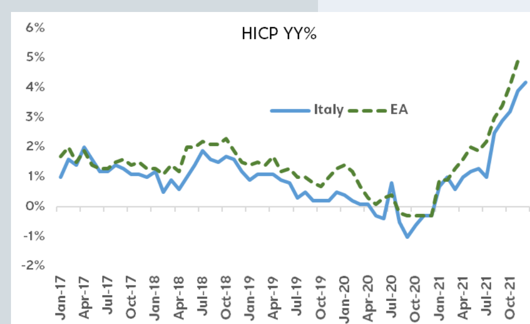
After a modest start in 2021 with Q1 GDP growth rising by 0.3%QoQ, mainly due to pandemic-related restrictions, economic activity has surprised to the upside with an upwards revised growth of 2.7%QoQ in Q2 and 2.6%QoQ in Q3. The growth momentum is expected to have carried on in Q4 2021, while Q1 2022 performance may be dampened by the Covid-19 surge and the rise in energy and consumer prices. Around mid-year, the economy is expected to recover its vigorous pace supported also by the implementation of the projects under the RRF, as well as expansionary measures of €23bn (or 1.2% of GDP) envisaged in the 2022 budget, which according to the government are expected to add 0.2ppt to GDP in 2022. GDP for the full year 2021 is estimated to have grown by 6.3%; a more moderate increase of 4.2% is expected in 2022 (ISTAT). The main contributor to growth in both years is expected to be domestic demand. Unemployment in Nov declined slightly to 9.2% from 9.4% in the previous month, while prior to the pandemic, in Feb-20 it was 9.7%. The General Government deficit in Q3 2021 declined to -6.2% of GDP, from -7.6% in Q2 2021 and -9.8% in Q3 2020 (Figure 15). Inflation accelerated further in Dec, with the headline CPI increasing by 3.9% on an annual basis, from 3.7% in the previous month. For the whole year, average annual inflation stood at 1.9%, from -0.2% in 2020, while as of Nov, inflation measured by the Harmonised Index of Consumer Prices (HICP) in Italy remained below Euro area levels indicating a possible competitiveness gain (Figure 16). The Consumer Confidence index (ISTAT) in Dec-21 edged higher to 117.7, from 117.5 in the previous month, supported by tax cuts of more than €7bn set out in the government's 2021 budget and business confidence decreased from 114.8 to 113.1 due to a deterioration in sentiment in manufacturing and market services. In spite of dampened expectations, mainly due to Covid-19, price pressures and supply disruptions, manufacturing was demonstrating strong growth momentum until the end of the year, with the s.a. IHS Markit Manufacturing PMI registering 62 in Dec, falling only slightly from the Nov all-time high reading of 62.8, and reflecting the robust expansion of the sector. On the political front, focus turns to the presidential elections, which are scheduled to begin on 24 January.

Figure 15: GG deficit to GDP contracts as GDP recovers



Source: ISTAT, Eurobank Research

Figure 16: Inflation slightly lower in Italy compared to the Euro area



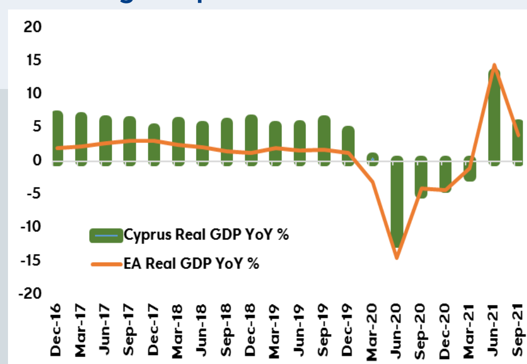
Source: ISTAT, Eurobank Research

Cyprus

Evident signs of fiscal consolidation in FY2021 and a modest fiscal target for 2022 improve the outlook, but serious challenges remain

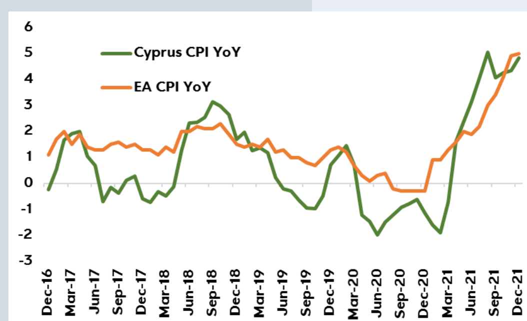
Cyprus kicked off the year on a worrying tone as since early December, the country is experiencing the most severe Covid-19 wave since the beginning of the pandemic. From the beginning of 2022, the country has recorded the world's highest Covid-19 infection rate per 100,000 inhabitants, hiking to 2,505 cases per 100,000 inhabitants, followed by Denmark (2,117), Ireland (1,946), Greece (1,762) and France (1,680). While the satisfactory vaccination rate of the Cypriot people (71.3% fully vaccinated vs 68.7% in the EU) along with the milder severity of the Omicron strain keep fatalities at relatively low levels, the national health care system is under unprecedented pressure. In the above context, restrictive measures have been imposed again, a development that will take its toll on the economic activity mainly in Q12022 and to a lesser extent in Q42021. On the fiscal front, after a brave fiscal expansion in order to tame the negative economic repercussions from the pandemic in 2020, which led to a fiscal deficit of -5.7% of GDP, fresh preliminary data up to November point to a fiscal deficit of -1% of GDP and unless December holds any unfavorable surprises, the overall fiscal deficit for 2021 is expected to be contained at the area of 3% of GDP. Further consolidation is expected in 2022 as the recently ratified budget for 2022 envisages a return to an even milder deficit at the range of 1.1% of the projected GDP. Looking ahead, structural challenges such as the vulnerabilities in the banking sector, with a declining albeit still high share of NPEs, remain, eliminating, thus, the credit supply and increasing the economy's sensitivity to shocks. From this point of view, the marked progress in the fiscal consolidation so far is timely addressed and it is of essence that it remains unaffected by the presidential elections in the country in 2023, which have already started to ruffle the political landscape. A related development is the resignation of the Minister of External Affairs Nikos Christodoulides in order to run in the presidential elections as a nominee of the governing party DYSI.

Figure 17: Q3 GDP growth pace above EA average despite the loss of steam



Source: Eurostat, Eurobank Research

Figure 18: Domestic inflationary pressures are broadly aligned with the EA average



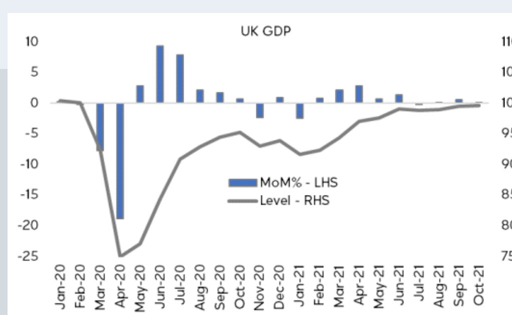
Source: Eurostat, Eurobank Research

UK

Q4 GDP likely to slow further following new restrictions in response to Omicron

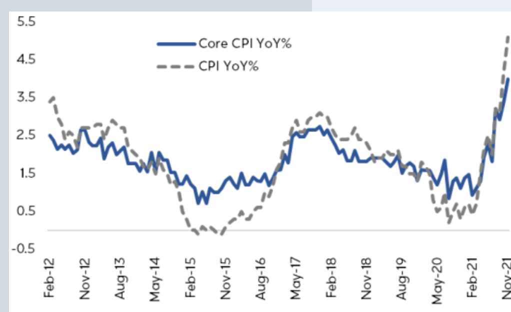
UK GDP rose by a sharply lower than expected 0.1%MoM in October, leaving economic output just 0.5% below its pre-pandemic level. The weakness was driven by industrial production which dropped for the second consecutive month (-0.6%MoM) mainly pressured by a pronounced decline in mining and quarrying due to planned maintenance of oil fields. Construction output also fell (-1.8%MoM) on the back of supply shortages, recording the biggest monthly drop since April 2020 after a hefty increase in September (+1.3%MoM). Services output that came back to its pre-pandemic level was the sole growth driver (+0.4%MoM), mostly thanks to human health activities amid a continued rise in face-to-face appointments at GP surgeries. Weak October GDP signals a further slowdown in Q4 after economic output grew by a disappointing 1.3%QoQ in Q3, not least because of the lingering supply shortages the manufacturing and construction industries are facing, in particular. Fiscal support is waning, rising prices are eroding consumers' real disposable income (CPI rose sharply in November for the second consecutive month marking a decade high of 5.1%YoY), while consumer confidence has taken a turn for the worse amid concerns about the rising cost of living. In addition, the emergence of the Omicron variant and the new restrictions the government announced in early December which are planned to remain in place at least until the end of January – though milder compared to those adopted in previous waves of Covid-19 – involving inter alia, a work from home recommendation, are expected to have a negative impact on economic activity. In spite of the slowing GDP growth momentum and growth risks from the Omicron variant, the BoE decided at the December policy meeting to raise the bank rate by 15bps to 0.25%, the first rate hike since August 2018. The Central Bank cited concerns about a likely de-anchoring of long-term inflation expectations on the back of the tightening labor market even after the end of the furlough scheme, the strength of currently underlying inflationary pressures and the output gap that appears to be closed. The BoE also argued that, on the assumption that the economy evolves in line with its central projections, some further modest monetary tightening is likely to be necessary over its forecast horizon in order to return CPI inflation sustainably to the 2.0% target.

Figure 19: The UK economy has been slowing materially before the emergence of Omicron



Source: ONS, Eurobank Research

Figure 20: UK CPI inflation well above the BoE's 2.0% target



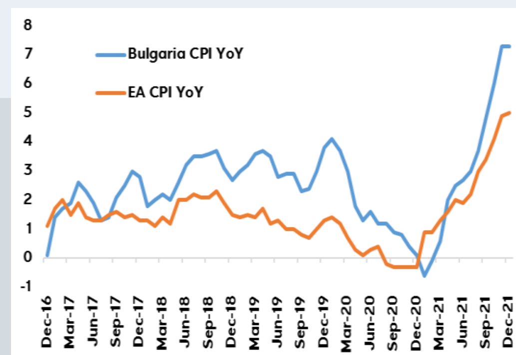
Source: ONS, Eurobank Research

Bulgaria

The formation of a coalition government spurs optimism for the near term outlook but preliminary census results pose risks in the long run

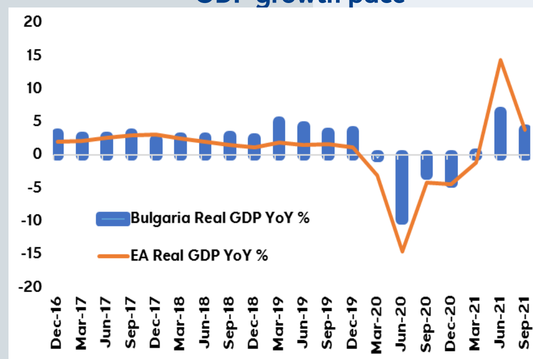
One month after the parliamentary elections in mid-November, a coalition government was finally formed, comprising of four parties, putting an end to the lingering political uncertainty since April 2021. The newly formed centrist party We Continue Change (WCC) led by the political newcomer and Harvard graduate Kiril Petkov held as its flagship commitment during the electoral campaign the wiping out of corruption in the county. Despite the ambitious endeavour, the WCC fell short of a majority and thus, along with the left-wing Socialist Party (BSP), the populist There is Such a People party (ITN) and the liberal Democratic Bulgaria (DB), which all together hold 134 seats in Bulgaria's 240-seat parliament, have formed a government with Kiril Petkov as its Prime Minister and Assen Vassilev, co-chair of the WCC, as Minister of Finance. So far, the governing agenda continues with the electoral motto of zero tolerance against corruption, while one of the strategic economic goals of the country remains the adoption of the Euro with the target date being 1/1/2024. Additionally, the maximum utilisation of the RRF funds remains key priority and towards that end, the new government will amend and re-submit the country's national recovery plan to the EC, as the latter returned the plan submitted by the caretaker cabinet in mid-October with a plethora of issues that need to be addressed. With the flash estimate of Q4 due in mid-February, we stick to our view of a +4.0% GDP growth rate in 2021, which translates into a Q4 GDP growth print close to +5.5% YoY, given that the 9M2021 performance stands at +3.5%YoY. While the +5.5% YoY growth rate in Q4 is quite ambitious given the continuing low vaccination rate in the country (rate of fully vaccinated people by 07/01/2022 in Bulgaria at 27.8% vs 68.6% in the EU), it could be achieved on the basis of favourable base effects on the respective quarter in 2020, which was the second worst since the pandemic started. Concluding on a less favourable tone, based on preliminary results of the recent census of the Bulgarian population, the population has declined to a record low number of 6,520,314 people, contracting by 844,000 people or 11.5% compared to the 2011 census outcome when the population stood at 7.4mn. The key factors behind the said development are low birth rate, high death rate and migration, and they are expected to monopolise the national strategic targets agenda ahead.

Figure 21: Inflationary pressures surge...



Source: Eurostat, Eurobank Research

Figure 22: ...amid loss of steam in the GDP growth pace



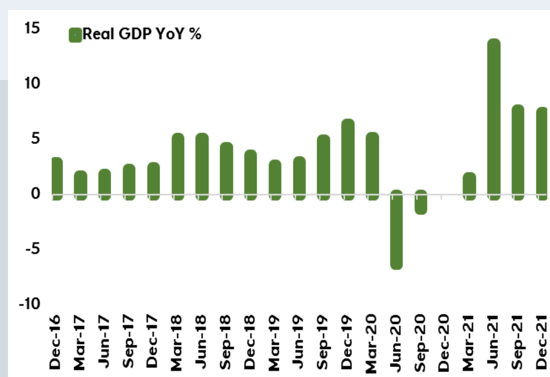
Source: Eurostat Eurobank Research

Serbia

The FY2021 GDP preliminary growth print at 7.5% YoY beats the forecasts of local authorities and IFIs.

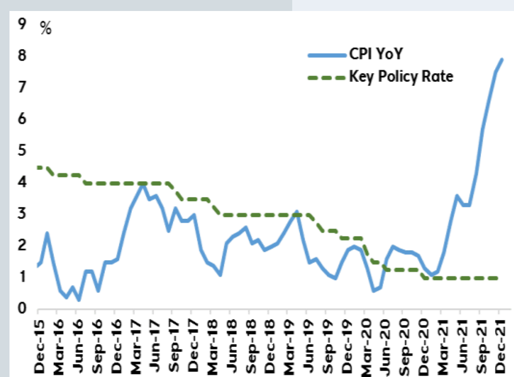
The economy concluded the outgone year on a positive footing, according to preliminary statistical estimates. The FY2021 real GDP growth rate came in at 7.5% YoY, which once confirmed by the final print due in late February, will outperform the forecasts of the local authorities and IFIs. That said, the latest GDP growth forecast by the Ministry of Finance stood at 7.0% YoY with the National Bank of Serbia (NBS) having identical expectations. On a more conservative tone, the IMF and the EBRD projected GDP growth rate of 6.5% in 2021, the European Commission of 6.7% and the World Bank of 6.0%. In terms of expenditure, the key economic growth driver of the outgone year was domestic demand, backed by the evidently effective measures the government adopted in order to tame the economic repercussions of the pandemic. Following the recent preliminary estimate along with November's hard data from both the supply and demand side that point to ongoing firm economic momentum (retail sales up by 10%YoY and industrial production up by 7%YoY in November vs 4% YoY and 0.9% YoY respectively in October), we revise our GDP growth rate estimation for 2021 to 7.2% from 6.8% previously, factoring in, thus, a Q4GDP growth forecast of 6.0%, which is due to be released, as a flash estimate, in late January. As regards other recent macroeconomic developments, the IMF Executive Board completed on December 20 the first review under the new Policy Coordination Instrument (PCI) agreed in June, with the review holding no surprises but praising the economic progress realised so far. Apart from confirming the NBS's 2022 GDP growth forecast of 4.5%, the Board also stressed out that inflation will return within the lower half of the NBS' target band (3%+/-1.5pps) in H2 2022, when the effects of the drought from this year will wane and energy prices will stabilise. Concluding on a positive note, in mid-December, Standard & Poor's affirmed the country's long-term sovereign rating at BB+ and revised the outlook to positive from stable on the grounds of strong economic growth that should remain broadly resilient to the adverse effects of the pandemic, moderate levels of public debt and a credible monetary policy.

Figure 23: Strong economic rebound in FY2021...



Source: Bloomberg, Eurobank Research

Figure 24: ..will facilitate the monetary tightening, evidently required in 2022..



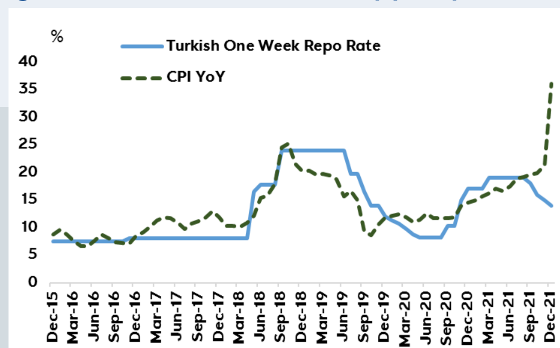
Source: Bloomberg Eurobank Research

Turkey

Unorthodox monetary policy sets an adverse pledge in terms of economic growth for the year ahead

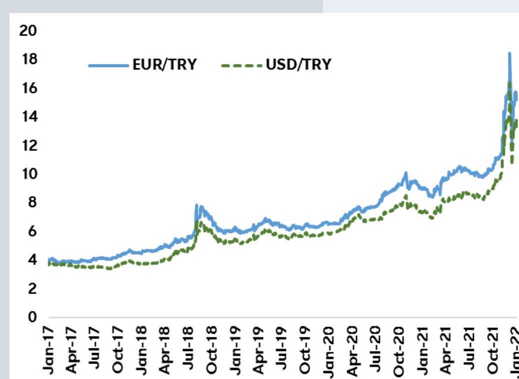
Despite the recent collapse of the Turkish lira after the Key Policy Rate (KPR) cut to 15% from 16% in November's Monetary Policy Committee (MPC). The Central Bank of Turkey (CBRT) stepped into an additional interest rate cut in December, which, albeit expected by markets, pushed the lira down again and fueled inflation's jump to even higher levels. The one-week repo rate was cut to 14% from 15% previously and while the MPC's accompanying statement implied that it will pause the monetary easing cycle for the next couple of months, following total 500bps cuts in the KPR between September and December, this was not enough to calm markets. Inflation accelerated to 36.1% YoY in December from 21.3% YoY in November, reaching 19-year highs and setting the average FY2021 print at 19.4% vs 12.3% in 2020. Note that December's print overshot the market consensus forecast which stood somewhere between 30-31% YoY. Not surprisingly, all three major rating agencies have adopted a cautious stance towards the recent monetary developments in the country. Moody's reportedly linked high inflation with a slowdown in the GDP growth rate in 2022, while it affirmed the B2 rating in the country's long term local and foreign currency sovereign rating and maintained the outlook at a negative status. Standard & Poors, on an ad-hoc basis report given the extraordinary circumstances, affirmed the sovereign's B+ long-term foreign currency and BB- long-term local currency ratings but revised the outlook to negative from stable in light of recent developments. More specifically, apart from turning the outlook of the rating into negative, Fitch Ratings assessed that the outlook on the Turkish banking sector has deteriorated as the situation is negative for banks' credit profiles and may increase the likelihood of government intervention in the banking system. Indeed, a new program was introduced that protects savings from the lira's fluctuations promising to offer FX-like returns and apparently acting as a backstop to the lira's slide. Given the above and despite the robust rebound in terms of GDP growth (our forecast remains at 8% for FY2021 vs 1.6% in 2020, with the 9M2021 GDP growth rate standing close to 12%), risks are tilted to the downside for 2022's outlook with the GDP growth rate expected to land close to 3.5%.

Figure 25: Unorthodox monetary policy continues...



Source: Bloomberg, Eurobank Research

Figure 26: testing the limits of the local currency



Source: 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)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World	-3.1	5.9	4.4	3.2	4.3	4.7									
Advanced Economies															
USA	-3.4	5.6	3.9	1.2	4.7	4.6	8.1	5.4	3.9	-3.0	-3.4	-3.3	-15.6	-12.4	-6.4
Eurozone	-6.4	5.1	4.1	0.3	2.6	3.2	7.9	7.8	7.4	2.0	2.7	2.5	-7.2	-7.2	-4.0
Germany	-4.6	2.7	4.0	0.4	3.2	3.0	5.9	5.7	5.1	6.2	6.7	6.6	-4.3	-5.5	-2.5
France	-7.9	6.7	4.1	0.5	2.1	2.6	8.0	8.0	7.7	-2.2	-1.2	-1.4	-9.1	-8.2	-5.0
Periphery															
Cyprus	-5.1	4.9	4.1	-1.1	2.5	1.7	7.6	7.5	6.7	-11.4	-10.0	-8.0	-5.7	-3.5	-2.0
Italy	-8.9	6.3	4.2	-0.2	1.9	2.5	9.3	9.6	9.1	3.2	3.4	2.9	-9.6	-9.4	-5.5
Spain	-10.8	4.5	5.6	-0.3	3.0	3.4	15.6	15.2	14.4	0.8	08	1.5	-11.0	-8.4	-5.6
Portugal	-8.4	4.5	5.2	-0.1	0.9	2.3	7.0	6.6	6.3	-1.3	-0.7	-0.4	-5.8	-4.4	-3.3
UK	-9.4	6.9	4.8	0.9	2.5	4.5	4.4	4.6	4.4	-2.3	-2.9	-3.5	-12.7	-8.1	-3.9
Japan	-4.6	1.8	2.9	0.0	-0.2	0.7	2.8	2.8	2.6	3.2	3.0	3.0	-9.5	-6.4	-6.2
Emerging Economies															
BRICs															
Brazil	-3.9	4.8	0.7	3.2	8.3	5.5	13.4	13.6	12.7	-0.8	-1.2	-1.4	-14.9	-5.5	-6.5
China	2.2	8.2	5.2	2.5	0.9	2.3	4.2	3.9	3.6	1.5	1.7	1.3	-6.2	-5.2	-4.5
India	-7.3	9.5	7.5	6.6	5.1	5.5		*NA*		1.3	-0.8	-1.2	-9.3	-6.8	-6.0
Russia	-2.7	4.2	2.6	3.4	6.7	5.8	5.8	5.1	4.7	2.2	5.5	5.0	-3.8	-0.5	0.7
CESEE															
Bulgaria	-4.2	4.0	4.1	1.7	2.5	2.7	7.4	5.5	5.0	1.2	2.0	1.5	-4.0	-3.9	-2.5
Serbia	-1.0	7.2	4.5	1.6	4.5	4.0	9.7	12.8	10.4	-4.3	-4.5	-4.7	-8.1	-6.9	-3.0
Turkey	1.8	9.0	3.5	12.3	19.4	15.0	13.1	12.5	12.0	-5.1	-3.2	-2.2	-5.3	-3.4	-4.2

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

Eurobank Fixed Income Forecasts

	Current	December 2021	March 2022	June 2022	September 2022
USA					
Fed Funds Rate	0.00-0.25%	0.10-0.35%	0.22-0.45%	0.39-0.65%	0.58-0.85%
1m Libor	0.11%	0.12%	0.17%	0.24%	0.32%
3m Libor	0.24%	0.25%	0.36%	0.52%	0.69%
2yr Notes	0.89%	0.71%	0.84%	0.98%	1.12%
10 yr Bonds	1.73%	1.71%	1.85%	1.95%	2.04%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.56%	-0.53%	-0.51%	-0.50%	-0.49%
2yr Bunds	-0.58%	-0.64%	-0.62%	-0.59%	-0.57%
10yr Bunds	-0.04%	-0.09%	-0.01%	0.06%	0.09%
UK					
Repo Rate	0.25%	0.35%	0.45%	0.60%	0.65%
3m Libor	0.50%	0.40%	0.48%	0.59%	0.70%
10-yr Gilt	1.17%	1.18%	1.29%	1.34%	1.42%
Switzerland					
3m Libor Target	-0.75%	-0.74%	-0.72%	-0.70%	-0.70%
10-yr Bond	0.02%	-0.06%	0.02%	0.07%	0.14%

Source: Bloomberg (market implied forecasts)

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