

GLOBAL & REGIONAL MONTHLY

The rebound of the global economy is gathering further momentum. The acceleration of vaccination campaigns and the improved control of the pandemic in many countries have led to a rebound in the severely hit services sector. Meanwhile, inflationary pressures continued to build further, with measures of inflation expectations and key commodity prices on the ascent. The major risk stems from an early monetary policy tightening to contain any persistent inflation overshoot, which could derail the global economic recovery. We expect global GDP to advance by 5.5% in 2021, supported by highly expansionary fiscal policy.

Macro Picture

USA The underlying momentum remains strong, though incoming data point to some moderation

EA: Services activity gradually recovers as vaccinations speed up and the economy reopens

UK: Fast pace of vaccinations and supportive fiscal policy should allow a sharp recovery this year

EM: Surging inflationary pressures in transit until supply meets recovering demand

CESEE: The Q1-2021 data set the ground for a strong rebound in H2-2021

Markets

FX: EUR strength with EU-US rates differential narrowing as the market plays the EU recovery now

Rates: EU and US rates remained pretty contained as both ECB and FED view the inflationary pressures as transitory

EM: EM external debt yields mixed, idiosyncratic country risks elevated, especially in Latin America

Credit: Spreads unchanged overall and expected to trade range-bound to moderately wider

Policy Outlook

USA: Tapering announcement not expected before Q4, Fed expects unchanged rates until 2023

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

UK: The BoE slowed down the pace of asset purchases but a rate hike still remains a long way off

CESEE: Central Banks maintain an accommodative stance despite upside inflation outlook risks

Key Downside Risks

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

India's second pandemic wave causes severe delays in the vaccination process of the EM sphere

Special Topics in this issue:

- The risk of accelerated "corporate zombification" in Europe from the pandemic relief measures

- Decoding the ESG framework and its impact on EMs

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Macro Views

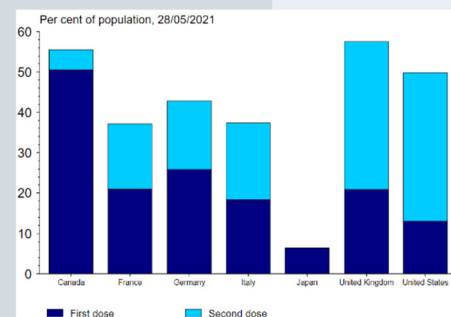
Latest Macroeconomic Developments & Outlook

World Economic Outlook

The rebound of the global economy is gathering further momentum, with world merchandise (volume) trade growth speeding up in March (+2.2%MoM from +0.1%MoM in the prior month, bringing the quarterly pace growth to +3.5% in Q1 2021) and leading indicators pointing to a positive economic outlook at the start of the second quarter. The acceleration of vaccination campaigns (Figure 1) and the improved control of the Covid-19 pandemic in many countries around the world have recently led to a rebound in the services sector that had been severely hit by the Covid-19 crisis. The Global Composite PMI advanced to an 11-year high of 56.3 in April from 54.8 in March (Figure 2), with the US and the UK outperforming. The improvement in services activity outstripped that of manufacturing for the first time since the world economy embarked on the path to recovery in mid-2020. Global Services PMI rose by 1.9pts to 56.6 in April, its highest point since July 2007, while Global Manufacturing PMI advanced by 0.8pts to a near 11-year high of 55.8. Global PMI data also revealed that international trade in goods and services rose at stronger rates in April, as pandemic-related restrictions gradually eased across a number of major countries.

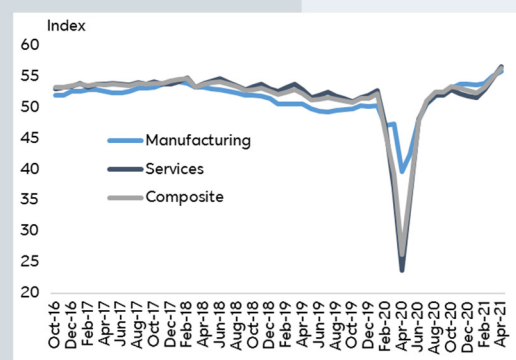
Meanwhile, inflationary pressures continued to be building, with measures of inflation expectations (Figure 3) and key commodity prices on the ascent. The April Global PMI survey highlights robust input cost increases (at the fastest pace in roughly 13 years) that drove selling prices growth to record highs, while producer price releases for April revealed strong rises in major economies (US and China). Concerns about rising inflation strengthened following the surge of the US headline CPI to a 12 ½ -year high of +4.2%YoY in April and core CPI to 3.0%YoY, the strongest rate in over two decades. Although much of the increase in prices is related to the gradual reopening of the economy, there are some signs of cost-induced inflationary pressures that major Central Banks should bring into focus as the economies return to more normal conditions. The major risk stems from an early tightening of monetary policy

Figure 1: Total Covid-19 vaccines administered in G7



*Data for Japan on second doses are not available
Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

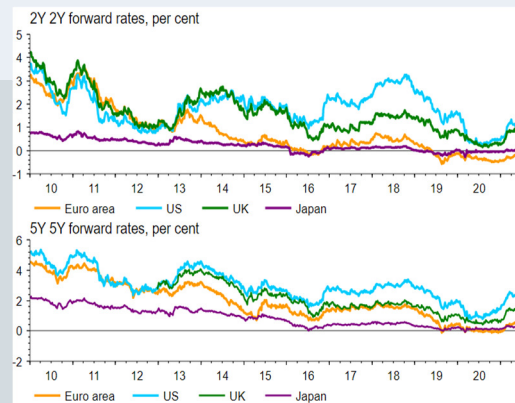
Figure 2: JP Morgan Global PMI surges to an 11-year high in April



Source: Bloomberg, Markit, Eurobank Research

to contain any persistent inflation overshoot, which could tighten financial conditions and derail the global economic recovery. Even though inflation risks have undoubtedly been on the rise recently, the drivers of higher consumer prices will likely prove to a large extent transitory over the course of the year, as highlighted by many Fed Representatives. Supported by highly expansionary fiscal policy, we expect global GDP to advance by 5.5% in 2021, provided that the vaccination campaigns progress as scheduled, allowing the US and Europe to reach herd immunity close to 70% in the summer months.

Figure 3: Inflation expectations on an uptrend



Source: Refinitiv Datastream, Fathom Consulting

Developed Economies

US: Although the underlying momentum of the economy remains vigorous, high-frequency indicators reveal some moderation in the pace of growth as favorable base effects gradually fade away. Overall, we expect real GDP to retain its positive momentum in the following quarters, leaving the annual GDP growth rate around 6.6% in 2021, provided that the current vaccination pace is maintained and about 75% of the population over 12 years of age is vaccinated by July 2021. On the monetary front, mounting inflation fears and the hawkish sign from the FOMC’s April minutes (“a number of participants suggested that if the economy continued to make rapid progress toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases”) have raised concerns over an earlier start to a Fed tapering process. Given that the inflation increase is largely driven by temporary factors and that incoming data have somewhat moderated recently, the Fed will likely await a more sustained labor market and economic recovery in the months ahead before opening up any tapering discussion.

Euro area: Business activity accelerated in May as the vaccination campaigns progress well in the euro area and the economies gradually reopen from pandemic-related restrictions. The Markit Composite PMI surged to a 39-month high of 56.9 in May from 53.8 in April, with new order growth skyrocketing to the highest level since mid-2006. The improvement in the headline index was mainly driven by a notable rise in the services PMI, while the manufacturing PMI moved slightly lower amid supply shortages. On the inflation front, increased commodity prices should continue driving headline inflation higher, expected to be lifted above the ECB’s target in Q4 2021 and average at around 1.7% in 2021 up from 0.3% in 2020, while core inflation should rebound close to 1.8% towards the end of the year amid strengthened demand and favorable base effects, bringing the annual average close to 1.2%. Although the restrictive measures that were extended into May should weigh somewhat on the recovery momentum in Q2, the progressive reopening at the end of the quarter should boost growth meaningfully in the summer months.

Emerging Economies

BRIC: Among BRIC countries, India continues to be in the spotlight following the devastating second Covid-19 wave, which although it appears to have culminated, is not expected to fade out before mid-July, according to national authorities. Most of the market participants have started to revise downwards their GDP growth forecasts for 2021, which at the time of writing concentrate around +9.0%, while unless the vaccination process gains speed in the near term, an additional wave of infections may occur in mid-autumn. On Russia, although it has attracted a lot of negative publicity lately on the geopolitical front with its possible involvement in the prosecution of an anti-regime Belarusian journalist, named Roman Protasevich, its economy seems to have weathered the pandemic; industrial production growth has returned to positive grounds after almost 12 months while GDP growth in March turned positive for the first time in a year. As a result, official government forecasts for 2021 have been revised upwards, currently standing at +4.0% YoY, while the World Bank raised its forecast to +3.2% YoY from +2.9% YoY previously, according to a country specific paper released in the previous week. In Brazil, as October 2022 general elections approach, the government is pushing the reform agenda in an effort to minimize the economic damage from the pandemic but also to polish its market-friendly agenda, underlining in this way the distance between the current president Jair Bolsonaro and his major rival, former president, Luiz Inacio Lula Da Silva. Concluding, despite worries over whether the inflationary pressures globally are in a transitory state or are about to prove more persistent, the inflation trajectory in the Chinese economy since the beginning of the year is not alarming yet, although it is in an upward circuit. The economy remains on track and heads for a GDP growth rate close to +9.0% as the partial loss of momentum that some hard data point to, is considered temporary given the gradual reopening of the global economy and the recovery of demand.

CESEE: As of late May 2021, the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE) improved further compared to one month ago. Taking into account the monthly decline in Covid-19 related infections, hospitalizations and fatalities, it would be fair to say, that the region has weathered the latest wave of infections- the third since the start of the pandemic. On the economic data front, the flash GDP estimates of the first quarter took center stage in the past month. A number of statistics authorities across the region released flash Q1-2021 GDP estimates that surprised to the upside on average, laying the foundations for a strong regional rebound in H2-2021. The better than anticipated growth performance in Q1-2021, the improvement of the epidemiological conditions and the acceleration of the vaccination programs across the CESEE region, has reignited optimism for the growth prospects of the broader CESEE region in 2021-2022.

Special Topics

I. The risk of accelerated “corporate zombification” in Europe from the pandemic relief measures

Large scale public intervention to contain the economic consequences of the Covid-19 pandemic in Europe, by national governments (e.g. public credit guarantee schemes, debt moratoriums, short-term wage subsidies, broad-based tax relief) and by central banks (e.g. targeted lending operations for banks, temporary collateral easing measures) have proved crucial in keeping the economy afloat, preventing a sharp increase in unemployment and corporate insolvencies. However, these exceptional relief measures have also triggered a debate on whether they promote lending to unprofitable but still operating companies, generally defined as “zombies”, and, thus, support “corporate zombification” in Europe. A zombification of the economy is a source of concern as it could contribute to a downward trend in potential growth through lower total factor productivity and business investment (Avouyi-Dovi et al, 2017)¹. It could lead to inefficient capital allocation and a crowding-out effect regarding the banking system as, keeping zombie firms alive, makes it more difficult for viable firms to access bank credit (Andrews and Petroulakis, 2017).²

“Zombie” firms definition

In the absence of a single, commonly accepted definition, the literature defines “zombie” companies in various ways, with the common denominator being a situation where public support keeps non-viable companies artificially alive. As regards the other characteristics of zombie companies, the most usually mentioned definitions include the one proposed by Adalet McGowan et al (2017)³, which defines a zombie firm as a firm that existed for more than ten years and whose operating profit has not covered debt servicing costs for a period of more than three consecutive years. Another usually referred definition is the one proposed by Caballero et al (2008)⁴, which defines a zombie company as a vulnerable company that benefits from particularly favorable financing conditions. Last but not least, Banerjee and Hofmann (2020)⁵ define a zombie company as an unprofitable firm with low market valuation for at least a two-year period (interest coverage rate of less than 1 and a Tobin’s Q ratio below the sector median).

The factors behind the rise in corporate zombification in Europe since the GFC

Besides differences in the definition of zombie firms, there are also variations in the methods used for counting them. Nevertheless, it is widely accepted that the share of zombie firms as a percentage of total firms has increased since the global financial crisis in advanced economies. According to the results of a study conducted by Hallak et al (2018)⁶, the share of zombie firms has increased between 2010 and 2013 across Europe, with the exception of Great Britain and Ireland. The said ratio varied significantly across European countries, with the most striking increase recorded over that period in countries that were particularly affected by the euro area sovereign debt crisis, Spain, Portugal, Italy and Greece. The share of

¹ Avouyi-Dovi, S., et al. (2017), Y-a-t-il des entreprises zombies en France? Bloc-notes Eco, Banque de France, March.

² Andrews D., and F. Petroulakis, (2017), Breaking the shackles: zombie firms, weak banks and depressed restructuring in Europe, BIS background paper, November.

³ McGowan, A., et al. (2017), The walking dead? Zombie firms and productivity performance in OECD countries, OECD working papers.

⁴ Caballero, R.J., et al. (2008), Zombie lending and depressed restructuring in Japan, American Economic Review.

⁵ Banerjee, R., and B. Hofmann, (2020), Corporate Zombies: Anatomy and life cycle: BIS Working Papers, No 882, September.

⁶ Hallak, I., et al, (2018), Fear the walking dead? Incidence and Effects of Zombie Firms in Europe, European Commission.

zombie firms in Greece stood close to 25% in 2013, followed by Spain at around 10%, five times that of France at 2%. The share of capital held by zombie firms as a percentage of fixed assets held by all firms, was also significantly higher in Greece and Spain than in France or Germany (Figure 4). The results of the aforementioned study mirror the pattern in Japan in the early 1990s when, the lack of a rapid restructuring of banks following the burst of the bubble in real estate and equity prices that led to a sharp increase in non-performing loans, forced Japanese banks to continue lending to non-viable firms (i.e. rolling-over credits) in order to avoid book losses and a deterioration of capital buffers. An ECB study that was published as part of the latest Financial Stability Review (May 2021)⁷, argues that the estimated share of zombie firms in the euro area ahead of the pandemic was relatively lower compared to the 2013 levels, but still above the levels in early 2000s before the global financial crisis.

According to a number of studies, the low interest rate environment since the early 1980s through cuts in ECB interest rates and asset purchases programmes, was likely a factor behind the increased number of zombie firms following the global financial crisis (Figure 5). That was because, the substantial decline in interest rates, encouraged increased risk-taking from vulnerable firms, which would have probably behaved differently if interest rates were not at such low levels. Inefficient insolvency frameworks and not adequately capitalized banks to withstand a negative shock, may have also contributed to the increased number of zombie firms.

Figure 4: The share of capital sunk in zombie firms (2013 %)

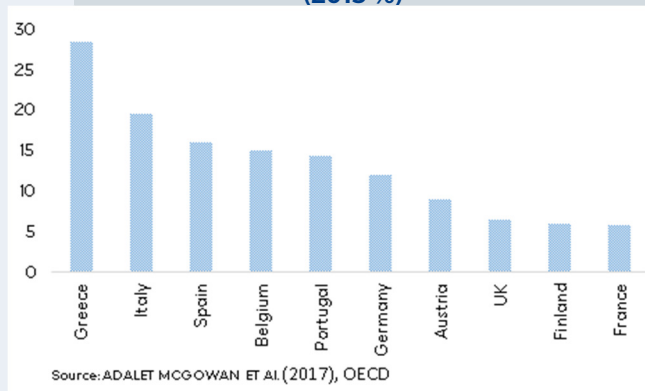
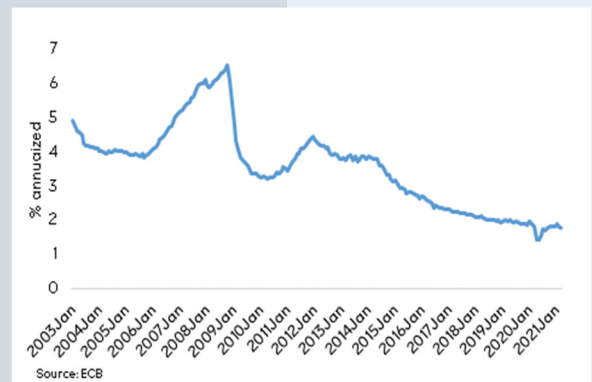


Figure 5: Average cost of new loans to NFCs in the EA



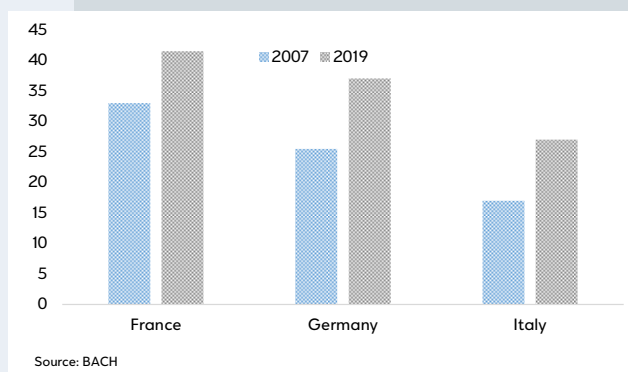
Are pandemic-related support measures accelerating corporate zombification in Europe?

The policy measures introduced by national governments to help viable firms address temporary cash flow needs arising from the pandemic and lockdowns, such as loan guarantee schemes or loan repayment breaks, may have also been used by zombie firms, taking into account the broad eligibility criteria for these measures. It is estimated that around 90% of the firms identified as zombies were eligible for these policy measures (however, eligibility does not necessarily mean that these firms actually utilised these schemes). Zombie firms may have also benefited from accommodative bank lending rates intended to increase banks' lending capacity at favorable rates. However, taking into consideration that European non-financial corporates have become more resilient by substantially increasing their capital buffers since the 2008

⁷ Helmersson, T., et al, (2021), Corporate zombification: post-pandemic risks in the euro area, ECB Financial Stability Review, May.

global financial crisis, and thus able to absorb loan losses to a larger extent, incentives for excessive lending should be lower. Supporting the above, according to the BACH database (Bank for the Accounts of Companies Harmonized), in 2019, a year before the outbreak of the pandemic, non-financial corporates in France had an equity ratio near 42%, 37% in Germany and close to 27% in Italy, compared to around 33%, 26% and 17% respectively, in 2007, a year before the global financial crisis (Figure 6). More importantly, we should bear in mind that the pandemic shock is a liquidity squeeze, not an excessive risk-taking induced one, as was the case in the 2008 global financial crisis. This means that firms that would be identified as zombies, might otherwise be fairly financially healthy and productive companies that face temporary pandemic-driven liquidity problems because of a sharp drop in aggregate demand following the adoption of social distancing measures to curb the spread of Covid-19. This holds especially for firms in sectors, which have been particularly hit by the pandemic and the relevant activity restriction measures, including retail, travel, hospitality, entertainment and recreation. That said, during a crisis of this nature, it seems difficult at this stage to distinguish illiquid from insolvent firms. Therefore, we should not rush into any conclusions but rather wait until the pandemic ends and the economy fully normalizes before sorting out the firms worthy of public support from the rest.

Figure 6: Equity ratio of non-financial corporates, in %



In any case, certain measures should be introduced beforehand in an attempt to effectively address such a risk in the post-pandemic era. Among others, firms should strengthen their balance sheets to maintain sound lending standards⁸. It is widely accepted that adequately capitalized banks have fewer incentives to lend zombie firms, while, low capitalized banks are prone to zombie lending^{9,10}. Banks should also continuously assess the creditworthiness of borrowers and ensure sufficient loss provisions to mitigate the risk of an increase in non-performing loans¹¹. Furthermore, from a longer-term perspective, efficient insolvency frameworks and bankruptcy laws could also reduce the incentive of expanding lending to zombie firms. Overall, the above measures should contribute to a boost in potential economic growth in Europe, which is the best way to keep the risk of accelerated zombification under control.

⁸ Baudchon, H., et al, (2021), Europe: the shock of Covid-1 and the fear of accelerated zombification, SUERF Policy Briefs, No 75, April

⁹ Acharya, V (2020), "Europe's zombie lending", VoxEU.org, August.

¹⁰ Schivardi, F, E Sette and G Tabellini (2020), "Identifying the Real Effects of Zombie Lending", Review of Corporate Finance Studies 9(3): 569–592.

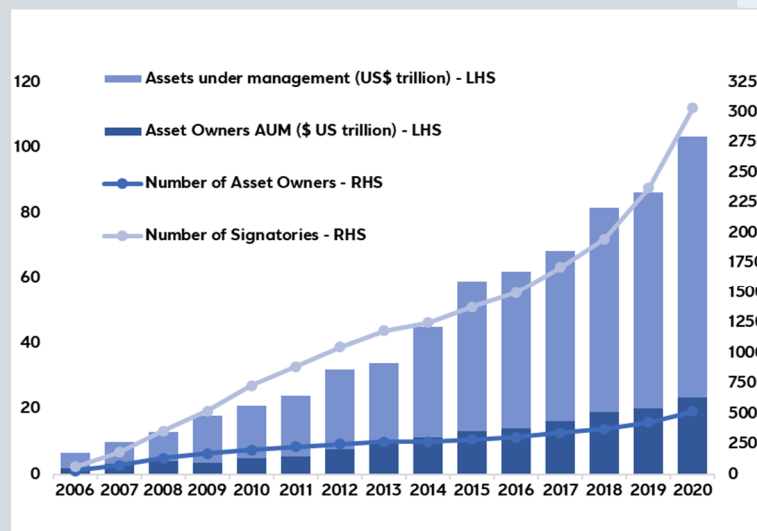
¹¹ ECB, (2020), Are the pandemic relief measures creating zombie firms?, December

II. Decoding the ESG framework and assessing its impact on Emerging Markets

✓ Origin and Whereabouts of ESG

Sustainable finance investments have grown rapidly in the past decade with a growing number of market participants incorporating various Environmental, Social and Governance (ESG) investing criteria in all asset classes – equities, corporate and sovereign bonds – primarily in developed and, to a lesser extent, in emerging markets (EM). Total Assets under management (AUM) that have embedded ESG criteria have increased by more than 300% between 2010 and 2020 (Figure 7).

Figure 7: Evident increase of AUM with embedded ESG criteria since the establishment of the framework



Source: Principle for Responsible Investment, Eurobank Research

Moreover, the last 18 months during which the pandemic is at play, the use of social bonds has flourished further resulting in environmental investments being currently viewed as broadly mainstream. ESG issues were first mentioned in the 2006 United Nation’s Principles for Responsible Investment (PRI¹²) report consisting of the “Freshfields Report¹³” and “Who Cares Wins¹⁴”. Under this initiative, ESG criteria were, for the first time, required to be incorporated in the financial evaluations of companies in an effort to boost sustainable investments and foster sustainable economic growth. Prior to the establishment of the ESG framework in 2006, the actual practice of ESG is rooted back in the 1960s in the form of socially responsible investing, with investors excluding stocks or entire industries from their portfolios if they were related, for example, with tobacco production or the South African apartheid regime.

¹² <https://www.unpri.org/pri/about-the-pri>

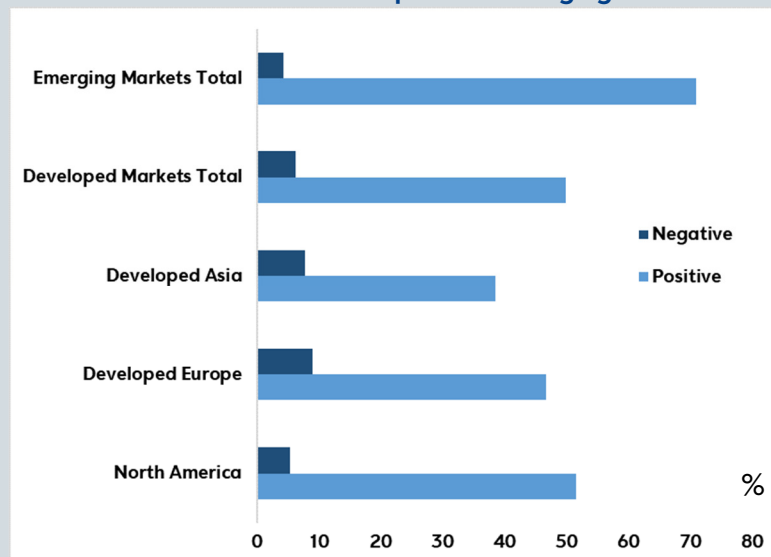
¹³ https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

¹⁴ https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf

✓ ESG investments in developed and emerging markets

While ESG investments are almost treated as plain vanilla investments in developed markets¹⁵ (DM), which practically and partially explains the clearly increasing trend in AUM for such investments (Figure 7), the same cannot be said for EM. The challenge for the latter to attract ESG investments is considered of essence as there is, evidently, a positive correlation between the compliance with ESG criteria in EM assets and the performance of corporates in the respective area from many aspects. In support of the above, Figure 8, based on data taken from a meta-analysis conducted by Friede, Busch and Bassen in 2015, which combined results from more than 2,200 unique primary studies released since the 1970s, illustrates that there is a positive ESG impact on the corporate financial performance from ESG investing in EM versus DM¹⁶.

Figure 8: Correlation between ESG criteria and Corporate Financial Performance in developed and emerging markets



Source: Friede, Busch and Bassen, Eurobank Research

Additionally, assets under ESG criteria in EM tend diachronically to over-perform the equivalents that lack the sustainability element. The above can be deduced from simultaneously observing the MSCI Emerging Markets ESG Leaders Index, which tracks companies with high performance in ESG metrics relative to their peers, and the MSCI Emerging Markets. The former keeps outperforming the latter throughout the last decade with the differential between them widening in the last 12 months. Taking into account the above, one can rightly wonder why flows through ESG placements towards EM are lagging substantially behind

¹⁵ Pax and Obvion conducted a detailed analysis of green bond issuance for the period January 2016 to March 2017 comparing 'vanilla' and green bonds, looking for any differences in pricing performance (CBI/IFC 2017). Some indicators have shown some differences (e.g. some green bonds do price tighter than the Initial Price Talk when compared to some corporate plain vanilla bonds), but generally pricing is very similar.

<https://documents1.worldbank.org/curated/en/913961524150628959/pdf/125442-REPL-PUBLIC-Incorporating-ESG-Factors-into-Fixed-Income-Investment-Final-April26-LowRes.pdf>

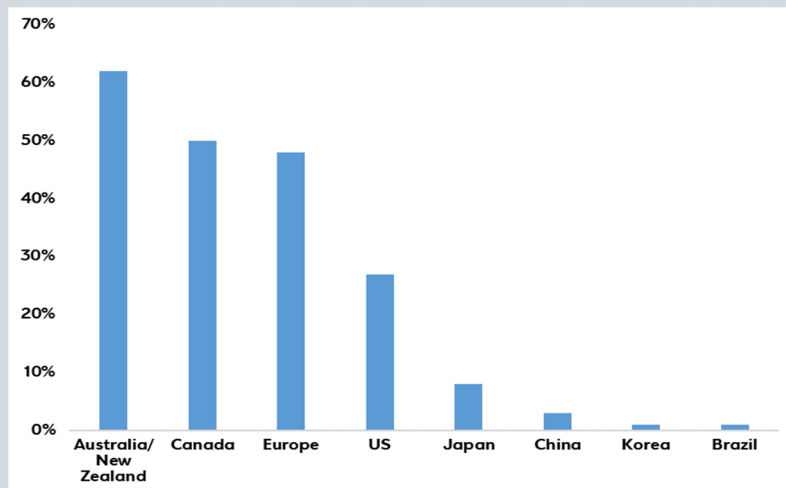
¹⁶ Gunnar Friede, Timo Busch and Alexander Bassen (2015), ESG and financial performance: Aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance and Investment

<https://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917?needAccess=true>

As Corporate Financial Performance, measures as accounting-based performance, market-based performance, operational performance, perceptual performance, growth metrics and risk measures were defined

those towards DM (Figure 9), especially if there are positive externalities from investing under ESG criteria in EM, which are also accompanied by clear positive returns for investors.

Figure 9: % of ESG investing in total AUM shows that EM lag behind DM in ESG investments



Source: Bloomberg, Eurobank Research

At first glance, the answer to this is pretty straightforward; diachronically EM tend to demonstrate greater market volatility than DM. Specific EM countries may have relatively unstable governments and less developed institutions shaping, thus, a politically risky profile while some EM economies are based on specific and limited industrial sectors, which in itself, may be a source of idiosyncratic and market risks. Given the greater perils embedded in the EM sphere, investors who are willing to impose additionally ESG screening and overlay on the EM arm of their portfolios are also confronted with the lack of proper reporting standards. ESG specific risks are not necessarily higher in EM than in DM, but it is the questionable quality of reporting, the shortage of data along with the – extensive occasionally – time lag of data availability that discourages investors from proceeding more vigorously. Greenwashing, for instance, which is an issue of critique when it comes to the fair implementation of ESG criteria, is apparent in both EM and DM, but investors are more suspicious when it comes to EM, given the limitations in the checks and balances mechanisms of these markets and their surveillance authorities.

✓ Where to from here?

Undoubtedly, EM economies are more prone than their DM peers to environmental and social risks. In general terms, EMs are more dependent on natural resources, such as soft and hard commodities and from that perspective, the environmental factor is highly important in the EM ESG universe. The latter spans in a wide geographic area and as such it cannot escape from the climate change that is visible either through increase in temperature or natural disasters. However, despite the difficulties investors encounter when it comes to investing in EM assets with ESG metrics embedded, there are hints pointing to a change in the EM ESG sphere. That said, in late May, Europe's Nordea Asset Management earmarked about 20% of its

newly-launched green bond fund with USD450bn AUM to EM. Additionally, looking at the supply side, Chile placed USD2bn of sovereign debt on May 4 with a 20-year maturity in order to fund "eligible social expenditures" with the placement considered well received by the markets in terms of pricing and demand. Prior to this, since 2019, Chile has issued more than USD15bn of ESG debt, with a total ESG debt portion close to 16.6% of its borrowings, which is one of the highest percentages worldwide. Whether the aforementioned two cases are an early sign of a potential market boom is too soon to tell. In any case, the development that cannot be overlooked and will most probably affect sizably the ESG investments in the EM part of the world, is China's recent pledge at the UN General Assembly on September 22, 2020 to achieve carbon neutrality before 2060. Coming from one of the largest economies globally, this environmental goal will lead to the creation of a new market space in order for the financing needs of China's energy mix transformation to be covered.

Macro Themes & Implications in CESEE

The Q1-2021 national accounts data for the CESEE region surprised to the upside, laying the foundations for a strong rebound in H2-2021 and 2022. Inflation is staging a comeback on higher energy and food prices.

As of late May 2021, the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE) improved further compared to one month ago. Taking into account the monthly decline in Covid-19 related infections, hospitalizations and fatalities, it would be fair to say, that the region has weathered the latest wave of infections- the third since the start of the pandemic. The third wave of infections was mostly related to the virus's mutations. The sharp deterioration has put the CESEE region in the epicenter of global media attention during the "third wave", because these countries were hit disproportionately harder than their Western European peers. Motivated by the improvement in the epidemiological situation, amid growing public pressure, these countries' authorities went ahead with further relaxing the stringent health and social distancing measures and restrictions. This is illustrated in the trajectory of the Stringency Index, a composite measure by Oxford Covid-19 Government Response Tracker (OxCGRT), which records the strictness of government policies.

On the economic data front, the flash GDP estimates of the first quarter took center stage in the past month. A number of statistics authorities across the region released flash Q1-2021 GDP estimates that surprised to the upside on average, laying the foundations for a strong regional rebound in H2-2021. On the negative side, regional divergence increased among countries. In some cases, the strength of recovery was impressive. On a seasonally adjusted basis, Bulgaria and Romania expanded by +2.5% QoQ and +2.8% QoQ respectively, accelerating the speed of recovery. The relaxation of stringent measures was the key for their output over-performance. Lithuania (+1.8% QoQ), Hungary (+1.9% QoQ) and Poland (+0.9% QoQ) followed suite posting relatively descent readings as well. In contrast, the performance of Slovakia and the Czech Republic disappointed. Slovakia and Czechia contracted by -1.8% QoQ and -0.3%QoQ respectively, reflecting the impact of stringent restrictions imposed to contain the virus spread. Nevertheless, the performance of both economies, which were among the regional underperformers, fared much better than that of the Euroarea (-0.6% QoQ) and the EU-27 (-0.4% QoQ) in Q1-2021.

The better than anticipated growth performance in Q1-2021, the improvement of the epidemiological conditions and the acceleration of the vaccination programs across the CESEE region, has reignited optimism for the growth prospects of the broader CESEE region in 2021-2022. Only a few months ago, the resurgence of infections was broadly expected to put a break on the pace of recovery – not limited to the services sector – given that restrictive measures, which had a negative impact on the economic activity in Q1-2021, have already remained in place for the larger part of Q2-2021 as well. In addition, the logistics of the production, distribution and execution of the vaccination program on such a massive scale required additional investments and time, leading to further delays.

But now, most countries have accelerated their vaccination programs converging to the EU average. As of late May, Hungary ranked first in the vaccination process and Serbia second having provided at least one dose to 53.8% and 36.3% of their population respectively. In both cases, the procurement of vaccines from China and Russia made the difference as they helped to bypass supply bottlenecks. During May, Lithuania, Poland, the Czech Republic and Slovakia made also good progress in their vaccination programs, climbing above 30%. Thus, the CESEE region is now expected to cover some of the lost ground in H2-2021 provided that the vaccination programs remain on track.

The May economic sentiment indicators for the region lured market attention in the past week. Having been on a rising trend in Q1-2021, sentiment indicators continued their strong recovery for a second consecutive month. As things stand, the vast majority of economic sentiment readings across the region have approached their February-March 2020 levels. In some cases, like Poland, they have even surpassed their pre-pandemic levels for the first time since the Covid-19 outbreak. In any case, economic sentiment readings in many countries have now surpassed their long-term average. However, on average, the pace of improvement is uneven across the CESEE region and more importantly, it still lags behind that of their Euroarea peers. The economies in the Southeast Europe (i.e. Bulgaria and Romania) are lagging behind vs. their CEE peers.

Obviously, these readings send an optimistic signal for the economic outlook, creating strong expectations for the growth readings of Q2. In fact, economic sentiment may be understating the magnitude of the rebound given the favorable base-effects from last's year general lockdowns. Yet the pandemic is still far from over and the road to normalization is full of challenges. The approval and the distribution of a number of vaccines since December has been a game changer. Moreover, the acceleration of the vaccination programs in most cases – despite the slower than anticipated pace given the urgency of the matter – together with the gradual removal of restrictions has lifted the depressed morale of consumers and corporates alike and boosted their optimism for the period ahead. Although the improvement was broad-based, its magnitude in industry outpaced that of services and consumers on a monthly basis.

Finally, in the first months, the rebound of energy and food prices on the back of unfavorable base effects from last year's pandemic impact, led headline inflation rates across the region higher from recent troughs. To the extent that this price adjustment fades away, headline and core inflation are set to remain at relatively low levels compared to the pre-crisis ones, remaining manageable in the coming months and allowing local Central Banks to maintain their accommodative stance instead of initiating a tightening process.

CESEE Markets Developments & Outlook

Bulgaria

Eurobond yields recorded sharp rises across all maturities. Yield spikes ranged between 4 and 14 bps, with the 2035 and 2050 papers posting the largest moves. Local papers also had an eventful month, with the yields of the 5, 6 and 7 year tenors sliding by 20-27bps. During May, the Ministry of Finance did not hold any auctions, as the caretaker government continues to assess the financial health of the country.

Serbia

As economies around the world recover, inflationary pressures surge. Still, the National Bank of Serbia (NBS) expects that inflation will fluctuate within the tolerance band of $3\% \pm 1.5\text{pp}$ s until Q1 2022, with the impact of temporary factors, such as global prices of oil and agricultural commodities, expected to be kept at bay. So far, any reactions in the government bonds curve in May are not considered meaningful; on average the curve shifted between 5 and 10 bps, with the 7 year paper spiking further by 15bps. Pressure on the dinar is also negligible as the NBS still holds the strings and steps to intervene on every FX imbalance that may occur. Assuming that inflationary pressures remain at tolerant levels and that major central banks continue with their easing stance, the key policy rate is not expected to increase but will most probably remain close to the current historic low levels of 1.0% in order to facilitate the ambitious GDP growth goal of more than 6.0% and the refinancing of maturing debts.

Markets View

Foreign Exchange

EUR/USD: The pair continued to trade strong reaching a high of 1.2266 with positioning skewed significantly in favour of a stronger EUR as Europe is catching up on the vaccination race and the rates differential is diminishing. We believe the pair's move higher is reaching its peak, and technically we see 1.20 as the target level for a retracement lower during the next month. On the upside, a break of 1.2266 opens the way for 1.2354 and then 1.25. We expect any moves to be volatile.

GBP/USD: A weak USD has helped the pair move higher in line with EURUSD as the UK's economy reopening continues. The pair is currently trying to test the year's high of 1.4229, a break of which would lead to significantly higher prices. We believe in a significant dollar rebound at current levels and therefore expect a reversion towards the 1.4020 and 1.3950 support, with a potential break lower. Once again, bearish USD positioning should play a significant role in the size and depth of a GPBUSD correction.

Rates

EU: EU rates remained pretty contained despite a volatile month with 10y swaps hovering around 14bps (high of 0.21% and low of 0.07%). Curve movements were also contained, with 5s-30s trading at 78bps. Looking forward we expect rates to remain at current levels as most of the good news regarding the vaccination progress and the lift of the travel restrictions are already priced in. A potential risk to this view could be a significant rise of the inflation in the Eurozone or the beginning of a discussion for the tapering of the PEPP.

US: US 10yr swap rates are closing the month 8bps lower at 1.55% as the market is positioned for higher rates and the marginal payer to push them higher seems to be missing. Interestingly, hawkish Fed minutes and significant beats in economic numbers (including inflation) have failed to push rates higher. Curve moves were small, with 5s-30s hovering around 115bps. Looking forward we expect US rates to consolidate at the current levels with a bias to move lower, which is the pain trade for the markets as positioning, given that the Federal Reserve officials see the current rise in inflation numbers as temporary and not likely to influence policy.

Emerging Markets credit

EM external debt spreads grinded tighter this month as US rates stabilized and moved lower. The EMBI Global Index is currently at 306bps, 8bps lower on the month. In CEEMEA both Turkish and South Africa sovereign bond spreads significantly tightened. In Latin America, spreads continued to trade mixed as the idiosyncratic political risks remain. Peru faces a crucial second round of elections in June with assets remaining very sensitive to the gap in polls between front-runner Castillo and Fujimori, while the S&P cut Colombia's credit rating to non-investment grade, after the government's plan to raise taxes to curb the deficit, was blocked by the congress. The Chile sovereign curve bear steepened after the mid May constitutional elections with the results probably leading to a new less market friendly Constitution. EM Asia continues to see weaker growth momentum in the second quarter of the year. We believe that the constructive EM narrative is still intact in the short term, but we are also cautious as individual country risks remain elevated.

Corporate credit

EUR IG cash corporate spreads were mostly unchanged to slightly wider in May, with spreads on most grades ending +2 bps wider overall, as supply was much more active but also selling of secondary was very limited. CDS spreads were tighter in HY and Senior fins ITRXX indices, outperforming cash, while ending unchanged in ITRXX Main in Europe, on admittedly already tight valuations. ECB signalling its intention not to change the pace of its buying programs for now, ahead of the June 10 meeting, is supportive for Credit ahead of summer. Credit underperformed the moves in equities, while rates increased volatility had small effect on longer duration. Sector-wise, in EUR IG, Real Estate, Oil & Gas, Health Care and Telecoms were +3/+4bps wider making them the slight underperformers of the month, while rest of sectors were unchanged to +2bps wider. US IG names spread moves were slightly tighter on the month, with lower rating grades outperforming on an absolute basis. Sector-wise, Oil & Gas (-6.5bps), Real Estate (-4.0bps), Core financials (-3.5bps) & Autos (-4.5bps) were the main outperformers of the month, while rest of sectors were +1/-3bps generically.

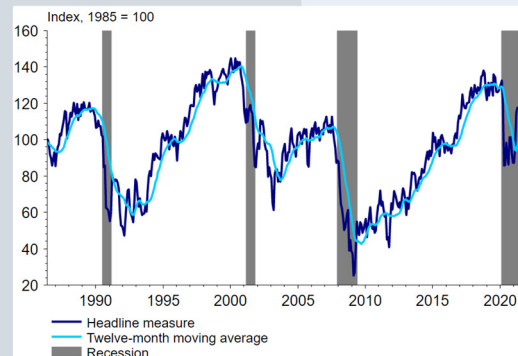
Rating-wise, EUR IG spreads in BBB- was +1.5bps, in BBB +2bps, in BBB+ +3bps, in A- +2.5bps, in A +1.5bps, in A+ +2bps, in AA- +2bps, in AA +2.5bps, and in AA+ +2bps wider. In the EUR HY universe B grade was -20 bps tighter, CCC unchanged, while BB was -2.5bps tighter. Rating-wise in US IG BBB was the outperformer (BBB- -11.5bps, BBB & BBB+ unchanged), while A and AA grade buckets were marginally tighter. Technical for cash continues to remain strong, with supply well received, and ECB on a supportive stance. EUR rates recent moves were in general well absorbed for now, and inflation overshooting is tolerated by CBs in the short term at least. We expect that spreads will trade range-bound to slightly wider in the coming month on very tight valuations. Sources of widening, apart from idiosyncratic events, are higher rates and inflation persistence, and tapering discussion entering front stage. Mid-term expected spread direction is moderately wider and steeper, given the reopening trade and continuation of stronger macro data.

USA

The underlying economic momentum remains strong, although incoming indicators point to some moderation in the pace of growth

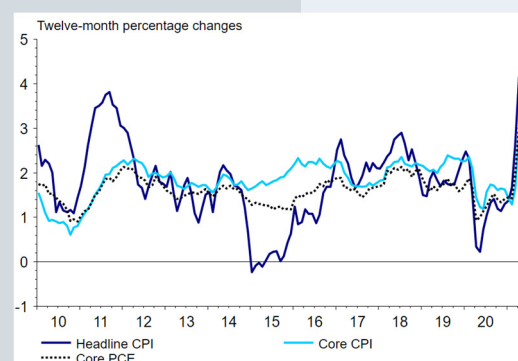
Although the underlying momentum of the economy remains vigorous, high-frequency indicators reveal some moderation in the pace of growth as favorable base effects gradually fade away. Pointing to a much softer-than-expected labor market recovery, nonfarm payrolls increased by 266k in April, more than 700k below consensus, coupled with a downward revision in the prior month to 770k from 916k. The unemployment rate unexpectedly rose for the first time in a year to 6.1% from 6.0%, against the consensus expectation for a 5.8% decline, with US employment remaining about 8.2mn below pre-crisis levels. Meanwhile, retail sales stalled in April against market expectations for a 1.0%MoM increase, while consumer surveys of the University of Michigan and the Conference Board both dropped in May, to 82.9 (-5.4pts) and to 117.2 (-0.3pts), respectively. Mirroring supply distortions, industrial production growth decelerated to 0.7%MoM in April after an upwards revised 2.4%MoM increase in the prior month, with the May Philadelphia Fed manufacturing survey pointing to further softness ahead, as the respective index dropped to 31.5 from a 50-year high of 50.2 in April. Turning to the housing market, housing starts fell by a hefty 9.5%MoM in April to 1.569mn units, due to weather-related effects and supply-chain constraints, while new and existing home sales fell in April by 5.9%MoM to 863k units and 2.7%MoM to 5.85mn saar, respectively. Despite the recent growth softening, we expect real GDP to retain its positive momentum in the following quarters, leaving the annual GDP growth rate around 6.6% in 2021, provided that the current vaccination pace is maintained and about 75% of the population over 12 years of age is vaccinated by July 2021. On the monetary front, mounting inflation fears (April headline CPI +0.8%MoM/+4.2%YoY, core CPI +0.9%MoM/+3.0%YoY) and the hawkish sign from the FOMC's April minutes have raised concerns over an earlier start to a Fed tapering process. Given that the inflation increase is largely driven by temporary factors and that incoming data have somewhat moderated recently, the Fed will likely await a more sustained labor market and economic recovery in the months ahead before opening up any tapering discussion.

Figure 10: The Conference Board Consumer Confidence Index



Source: Refinitiv Datastream, Fathom Consulting

Figure 11: US Inflation on the rise



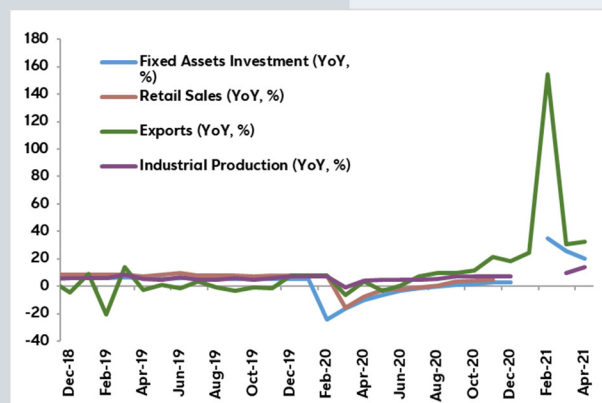
Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

China

Surging inflationary pressures and loss of momentum keep the economy from entering into a goldilocks mode

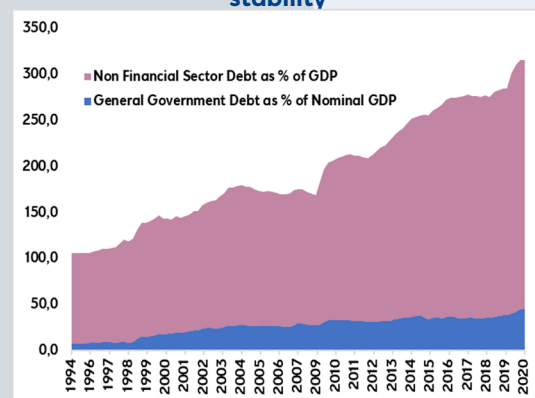
Despite worries over whether the inflationary pressures globally are in a transitory state or are about to prove more persistent, the inflation trajectory in the Chinese economy since the beginning of the year is not alarming yet, although it is in an upward circuit. Following a 12-month deflationary period, which stemmed from the burst out of the pandemic and slashed the dynamics of demand and supply, prices are soaring since January; from -0.3% YoY in January, CPI has gradually quadrupled by April, coming in at +0.9% YoY. The increase in the headline inflation is broadly in line with the core CPI (+0.7% YoY in April) while it still has distance to cover until the 3.0% target of the PBoC. Moreover, while the PPI figure came in at 6.8% YoY in April, marking the fastest increase in more than three years, its pass-through to the CPI remains for the time being limited. Whether the producers' price increase will spread wider to the consumer side mainly depends on the magnitude and duration of the PPI rise, which so far has been broadly driven by surging global commodity prices. Referring to the latter, it remains to be seen whether 2021 will be a year of a commodities super cycle and the determining factors for this to happen are the trajectory of the pandemic and the continuation of the demand recovery momentum. In an effort to control commodities prices from artificially increasing further, the Chinese authorities have outlined that they will show "zero tolerance" to monopoly behavior and hoarding by domestic commodities firms. Looking at other significant hard data of the economy, some loss of momentum was witnessed as industrial production slowed in April (+9.8% YoY in April vs 14.1% YoY in March) and retail sales came below market expectations (+17.7% YoY in April vs 24.9% YoY market consensus and +34.2% YoY in March). In any case, our GDP growth forecast remains unchanged at +8.4% YoY with risks broadly balanced amid the gradual reopening of the global economy and the recovery of demand.

Figure 12: While hard data point to a solid economic status...



Source: Bloomberg, Eurobank Research

Figure 13: ...the private debt accumulation over the years continues to cast shadows on the financial stability



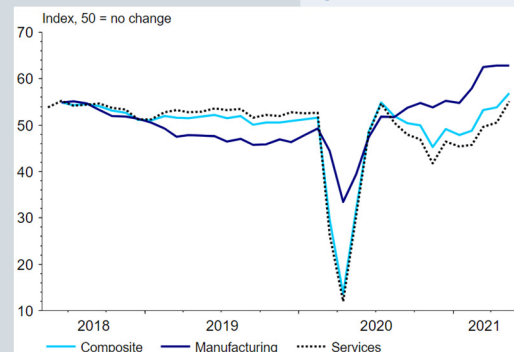
Source: National Institution for Finance and Development, Eurobank Research

Euro area

The services sector recovers as the vaccination campaigns progress and the economy gradually reopens from Covid 19-related restrictions

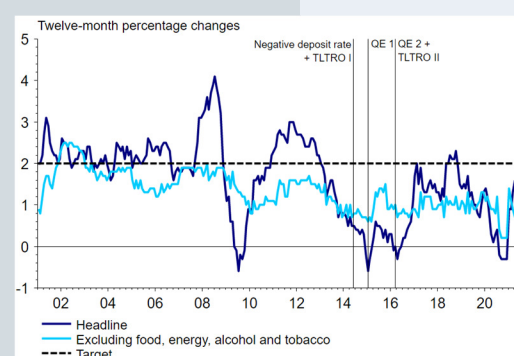
Business activity accelerated in May as the vaccination programmes progress well and the economies gradually reopen from pandemic-related restrictions. The Markit Composite PMI surged to a 39-month high of 56.9 in May from 53.8 in April, with new order growth skyrocketing to the highest level since mid-2006. The improvement in the headline index was mainly driven by a notable rise in the services PMI (+4.8pts to 55.1), while the manufacturing PMI moved slightly lower (-1.3pts to 61.9) amid supply shortages. The out-performance of the services sector was also evident in the EC Economic Sentiment Indicator (ESI) for the third consecutive month, which increased by 4.0pts to a 3 ½ -year high of 114.5 in May. The strength was broad-based across sectors, with services reporting the strongest rise of 9.1pts to 11.3. On the inflation front, headline HICP accelerated to 1.6%YoY in April from 1.3% in March, boosted by higher energy prices and positive base effects. On the flipside, core inflation moderated further to 0.7%YoY from 0.9%YoY in the prior month and its recent peak of 1.4%YoY in January, due to changes in the consumer basket weights in 2021 and a lower than normal increase in the prices of travel-related sectors. Looking ahead, higher commodity prices should continue driving headline inflation higher, expected to be lifted above the ECB's target in Q4 2021 and average at around 1.7% in 2021 up from 0.3% in 2020, while core inflation should rebound close to 1.8% towards the end of the year amid strengthened demand and favorable base effects, bringing the annual average close to 1.2%. Although the restrictive measures that were extended into May should weigh somewhat on the recovery momentum in Q2, the progressive reopening at the end of the quarter should boost growth meaningfully in the summer months, with overall GDP growth expected at 4.0% in 2021. The lack of heightened inflationary pressures in the euro area should support the ECB's ultra-accommodative monetary policies, with several ECB representatives suggesting that PEPP purchases should continue at a considerably fast pace in Q3, although all options are open for the 10 June meeting. The exact QE pace will be largely dependent on incoming economic data, with the GC aiming to preserve favorable financial and financing conditions.

Figure 14: Composite PMI hits a 39-month high in May



Source: Markit, Refinitiv Datastream, Fathom Consulting

Figure 15: Euro area inflation



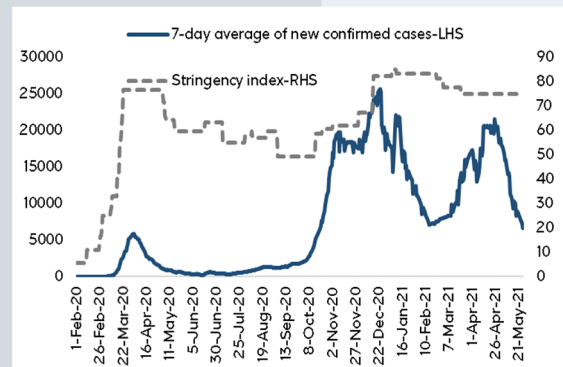
Source: Refinitiv Datastream, Fathom Consulting

Germany

Partial recovery expected in Q2 driven by the gradual reopening of the economy

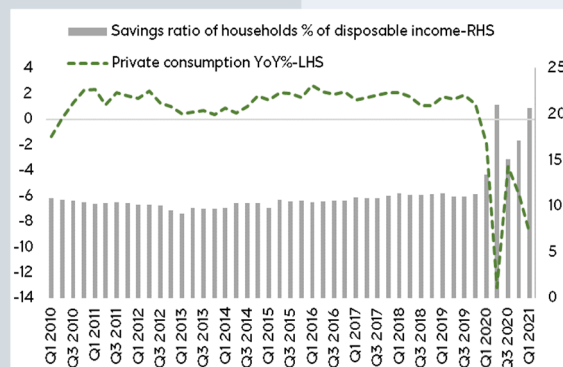
Germany's Q1 GDP was revised marginally lower to -1.8%QoQ from the -1.7%QoQ preliminary estimate, following an upward revision to H2 2020 (both Q3 and Q4 GDP up by 0.2pts to 8.7%QoQ and 0.5%QoQ, respectively), leaving output 5.2% below the pre-pandemic levels. The Q1 GDP contraction was mainly driven by private consumption which declined by 5.4%QoQ, mostly due to the prolonged second lockdown which was in place since last November and the re-hike of the VAT rate in January, making a negative contribution of 2.7ppts to GDP growth. Looking ahead, risks are for a partial recovery in Q2, as also suggested by strong sentiment surveys for May (IFO, ZEW, flash composite PMI), in view of a sharp drop in infection cases in the vast majority of the country's municipalities in recent weeks, that is expected to allow an easing in the average level of restrictions from late May onwards, offsetting any adverse effect from supply chain disruptions in the manufacturing and construction sectors (the 7-day average of new cases has dropped to just over 6,500 a month later, while c. 40% of the adult population has received at least one jab and 15% has now been fully vaccinated). A more pronounced rebound is expected in Q3 as herd immunity will be approaching, allowing an accelerated pace in the reopening of the economy, while, for the full year, GDP growth is seen reaching 3.4%. On politics, several of the latest opinion polls showed the CDU/CSU overtaking the Greens again by a small margin, while political analysts have cited some missteps of the Greens' candidate Annalena Baerbock and the gradual reopening of the economy as the main reasons behind the conservatives' improved performance. With federal elections still four months away, it is uncertain whether opinion polls will remain close to current levels and whether the CDU/CSU will manage to emerge as the largest party in September. However, it seems highly probable that there will be no new federal government without the participation of the Greens, a development that would undoubtedly have certain implications for Germany and the euro area, as the Greens' election manifesto includes a reform of the Germany's constitutional debt brake to allow more public investment, a much deeper EU integration and a looser fiscal stance at the EU level.

Figure 16: Less restrictive measures and...



Source: Our World in Data (OWID) Eurobank Research

Figure 17: ... an unleashing of pent-up demand, are expected to lead to a strong GDP growth rebound



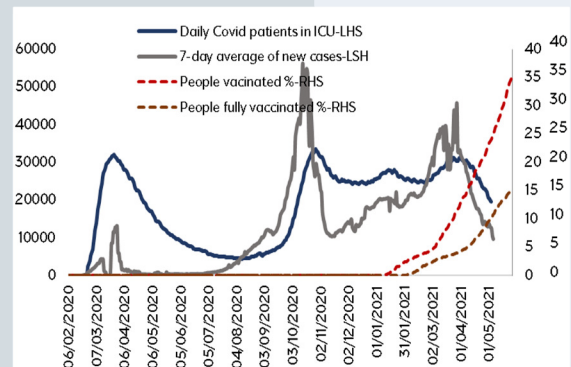
Source: Federal Statistics Office (Destatis), Eurobank Research

France

Pace of vaccinations accelerates, allowing further lifting of restrictions

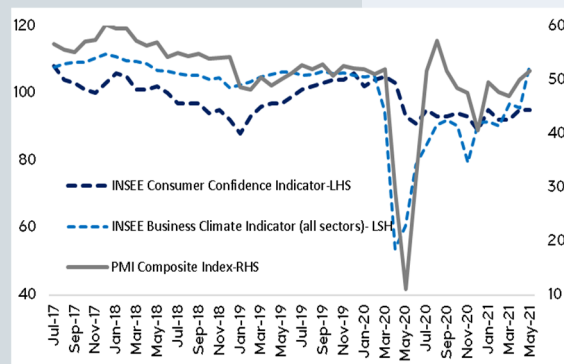
The April four-week lockdown and the accelerated pace of vaccinations have led to a sharp improvement in the country's key Covid-19 epidemiological situation in recent weeks. As of May 26, the 7-day average of new confirmed cases has dropped below 10k, the lowest level since September 2020, the number of Covid-19 patients under intensive care is also declining, while 13.6mn people (or 35% of the population) have received at least one dose (Figure 18). The improvement of the healthcare situation gave the government confidence to proceed on 19 May with the second step of its four-phase lockdown exit plan that envisions, inter alia, the limited reopening of outdoor hospitality (the next round of easing is planned for early June). One striking feature of the reopening from the April lockdown has been the more pronounced than expected improvement in sentiment surveys for May (Figure 19). The INSEE business climate indicator rose by 12.3pts to 108.0, the highest level since 2018 and well above the pre-pandemic average of 105 in Jan-Feb 2020, with all three sectors recording meaningful gains, favored by higher foreign demand and strengthening domestic demand as the economy reopens. On the consumer side, the INSEE confidence indicator rose by 2ppts to an over one year high of 97, but still below the pre-virus level (Jan-Feb 2020 average of 104.5), while, the flash composite PMI rose by 5.3pts to 57.0, driven by services (+6.3ppts to 56.6), approaching the levels seen last July when the economy fully reopened. INSEE estimates that the gap of economic activity against its pre-crisis levels widened to around -6% in April from -4% a month earlier but was still narrower compared to -7.5% in the second lockdown last November and -31% in the first lockdown in April last year. Amid some further lifting of restrictions in May, the gap could improve to -4% and continue to recover to -2.5% in June, resulting to a mild GDP gain of around 0.25%QoQ in Q2 after a 0.4%QoQ growth rate in Q1. However, given the strength of the latest sentiment indicators, risks seem skewed towards a more pronounced Q2 GDP growth rate that could lead to a GDP gain of 5.8% for the whole year, revised upwards from 5.4% previously expected.

Figure 18: Sharp improvement of the epidemiological situation



Source: Our Word In Data,, Eurobank Research

Figure 19: Sentiment indicators surprised positively in May



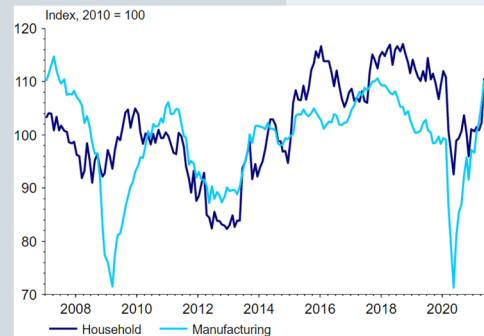
Source: INSEE, Bloomberg, Eurobank Research

Italy

Next Generation EU funds should help finance the highly supportive fiscal policy

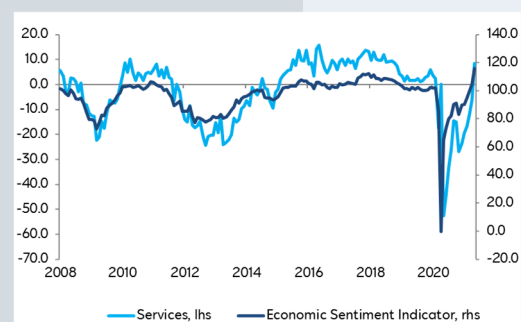
The Italian manufacturing sector registered its best performance on record in April on the back of accelerating growth of both production and new orders (strongest expansion in 21 years). The Manufacturing PMI surged to an all-time high of 60.7 from 59.8 in March, with heightened optimism that output will continue its uptrend in the following months. On the contrary, the services sector remained in a recessionary territory due to the Covid-19-related restrictions that persisted into April. The Services PMI edged down by 1.6pts to a 3-month low of 47.3, marking the ninth monthly contraction in a row. On a positive note, sentiment regarding the prospects of output in the year ahead remained enhanced, as service providers seemed broadly optimistic about the gradual opening of the economy that is expected to lead to stronger demand in the following months. Meanwhile, the May EC ESI has shown the first signs of recovery in the services sector, rising to a near 11-year high of 115.8 from 104.8 in April. In fact, the sector had a stellar performance, reporting the biggest monthly gain since the series started in 1998 (+14.6pts to 8.5 from -6.1 in April). Looking ahead, mobility restrictions that came into force in March and continued until 26 April should partly weigh on Q2 GDP growth, before recovering sharply in Q3 as the vaccination campaign progresses and the restrictive measures gradually ease, leaving the 2021 GDP growth close to 4.2%. The Italian government recently announced new fiscal measures worth around €40bn (2.5% of GDP) – on top of the stimulus package of €32bn approved in March – out of which ca. €18bn are expected to support firms and self-employed workers severely hit by the Covid-19 crisis, and ca. €5bn envisaged for the labor envelope (extension of the emergency short-time work compensation schemes until June, temporary allowances for the self-employed and seasonal workers in certain sectors like tourism, and tax incentives for businesses). Highly supportive fiscal policy should drive Italy's expected budget deficit higher, from -9.5% in 2020 to a double-digit percentage of GDP in 2021, while public debt is projected near 160% of GDP up from roughly 156% of GDP in 2020. The Next Generation EU program should help finance the government's planned fiscal expansion in 2021, with the Italian parliament having approved its National Recovery and Resilience Plan, worth around €235bn (13% of GDP) between 2021-26.

Figure 20: Consumer and Business Confidence



Source: Refinitiv Datastream, Fathom Consulting

Figure 21: European Commission ESI



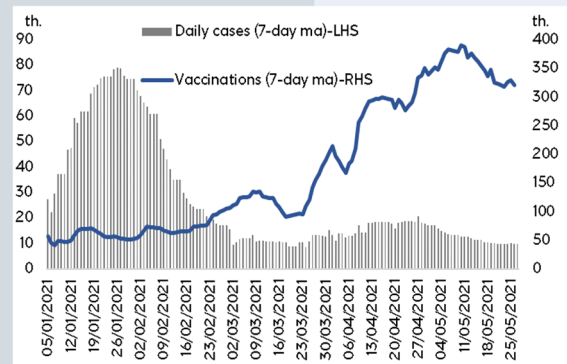
Source: EC, Eurobank Research

Spain

On the road to economic recovery after modest contraction in Q1

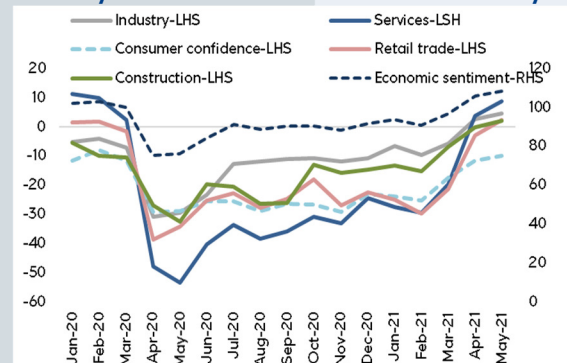
After a 0.5QoQ drop in Q1 GDP driven by weaker domestic demand, high frequency indicators suggest that a progressive normalization in Spain's economic activity seems to be on track. Improving weather, the intensified pace of vaccinations (37% of the population has received at least one dose) and the gradual relaxation of activity restrictions in the last couple of months on the back of the regional authorities' prompt intervention, have apparently boosted confidence about a progressive economic recovery in Q2 onwards. In support of the above, the April Composite PMI rose to a 1 ½-year high of 54.8 from 48.1 in March, moving back into positive territory for the first time since last July, mainly driven by services (+8.3pts, to 54.6), as the gradual lifting of restrictions has allowed more services activities to reopen. In a similar encouraging tone, the EC economic sentiment improved in May for the fourth consecutive month to a near two year high of 108.4 (+2.3pts), with the recovery being visible in all sectors, primarily in retail trade (+5.3pts at 2.3) and services (+5.2pts at 8.9), which were the most gravely hit by the Covid19 -related restrictions (Figure 23.) However, a meaningful acceleration in economic activity is not expected before Q3 when herd immunity will likely be approaching, allowing an accelerated pace in the reopening of the economy. For the whole year, we see GDP growth at 5.6%, with risks skewed towards a sharper recovery if tourism proves to be a major growth driver, taking into consideration that this sector accounts for a large share of Spain's GDP and employment (14.3% and 14.6%, respectively). EU recovery funds are also expected to contribute to the post-pandemic economic recovery. Spain, which is among the biggest recipients of the Next Generation EU facility, has been allocated c. €140bn of funds, evenly split between grants and loans. As a precondition for access to these funds though, Spain has been committed to an overhaul of the labor market, a pension reform and a gradually increase in tax revenues to reduce the budget structural deficit. However, all these prerequisites may be challenged internally and trigger political frictions within the government as the Sánchez minority administration has to rely on the cooperation with the left-wing Unidas Podemos as well as several smaller regional nationalist parties, including Catalonia's ERC.

Figure 22: Infections remain subdued while the pace in vaccinations has accelerated



Source: Our World In Data, Eurobank Research

Figure 23: EC May survey suggests economic activity seems to be on the road to recovery



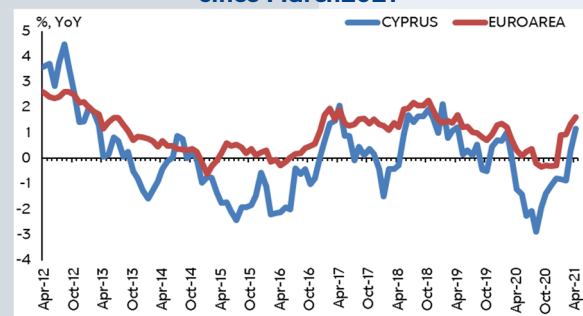
Source: European Commission, Eurobank Research

Cyprus

The economy ranks first in EA-19 for its quarterly GDP performance in Q1-2021

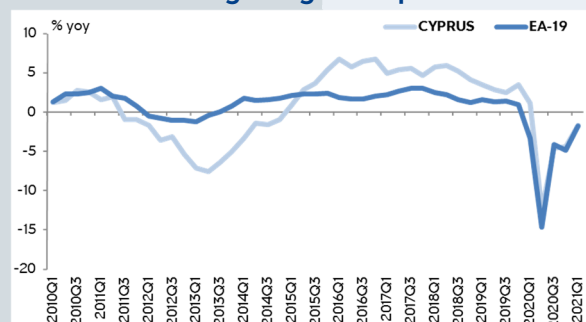
The general lockdown imposed until May 9, the acceleration of the vaccination program and the improvement of the weather conditions led to significant improvement in the Covid-19 related metrics in the second half of May. As a result, Cyprus exited the dark red categorization list of the ECDC as its 14-day cumulative rate dropped below the safety limit of 500 per 100,000 residents. The latest ECDC data show that 46.2% of the population – almost double that of the previous month – vs. 40.6% in EU/EEA-has received at least the first vaccine dose. The government’s plan to vaccinate about 60% of the population by the end of June remains on track, with Cyprus also posting one of the highest testing rates in the EU. The economy registered its lowest recession reading on an annual basis since the beginning of the pandemic in Q2-2020. According to the flash estimate, GDP on a seasonally adjusted basis expanded by +2.0% QoQ in Q1-2021 up from +1.1% QoQ in Q4-2020. The latter translates into -1.6% YoY in Q1-2021, up from -4.4% YoY in Q4-2020 compared to -4.6% YoY in Q3, -12.5% YoY in Q2, and +1.1% YoY in Q1. According to the latest EC spring economic forecasts (May 2021), the economy is anticipated to rebound by +3.1% in 2021 (vs. 3.7% in the autumn 2020 forecast) and +3.8% in 2022 (vs. 3.0% in the autumn 2020 forecast), which is below the Euro area for both years. In contrast, the Ministry of Finance (MoF) upgraded the GDP projection for 2021 from 3.7% to 4.5%-5%. The short-term prospects of the economy are dominated by the vaccination program pace, the prospect of attracting tourists in the summer period and the impact from the forthcoming parliamentary elections. After a catastrophic year (-84.1% in arrivals, -85.4% in revenues), tourism is expected to recover only partially this year. Although the prospect of attracting visitors from the tourism markets of UK, Russia and Israel, which accounted for 60% of total arrivals in 2019 looks promising, uncertainty persists both due to epidemiological and geopolitical reasons. The absorption of the funds under the EC's Recovery and Resilience Facility (RRF) is going to be pivotal for the medium-term prospects of Cyprus. The effect is expected to be mostly felt from 2022 onwards taking into account the time needed for some of the projects to mature. The Cypriot plan provides for a total of €1.2 bn. which breaks down into €1bn in grants and €0.2 billion in loans, with the MoF estimating that these resources will mobilize an additional €1.4 billion in private funds, while Investments and reforms will increase GDP by 7% cumulatively in the period 2022- 2026.

Figure 24: HICP inflation in positive territory since March2021



Source: Eurostat, Eurobank Research

Figure 25: The economy registered its lowest recession reading on an annual basis since the beginning of the pandemic



Source: Eurostat, Eurobank Research

UK

Stronger momentum at end-Q1 sets the stage for a rapid recovery from Q2

UK GDP rose by a higher than expected 2.1%MoM in March, taking output back to 94.1% of its February 2020 pre-pandemic level (Figure 26). The strong print was driven by a recovery in all sectors, especially construction which gained 5.8%MoM favored by good weather and services which rose by a strong 1.9%MoM although the only lifting of restrictions in that month was the reopening of schools. The March figure took Q1 GDP at -1.5%QoQ, when the UK was in lockdown, reflecting entirely a 2.5%MoM drop in January as February's GDP was upwards revised to 0.7%MoM from 0.4%MoM previously. As suggested by a string of positive data pertaining to April and May (including April's retail sales, April's GfK Consumer Confidence, May PMIs), the upward revision in February's GDP and the strong March GDP print should set the stage for a rapid recovery from Q2 onwards as restrictions are eased further (the government has already taken the three main steps of the road map for the easing of lockdown restrictions that was announced in February, leaving the final step to be taken on 21 June in the absence of a resurgence in Covid-19 infections). The fast pace of vaccinations and the accommodative fiscal policy should also support a sharp recovery this year, while the stronger GDP growth momentum in the last months of Q1, prompts us to revise our 2021 GDP projection higher to 6.2% from 5.6% previously. On

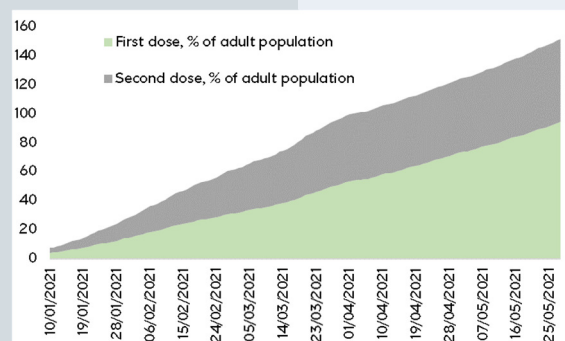
the inflation front, the headline CPI rose strongly in April to 1.5%YoY from 0.7%YoY in the prior month, as a result of higher energy prices and a hefty increase in household utility prices. Along these lines, core CPI rose to 1.3%YoY from 1.1%YoY in March on the back of a large move higher in clothing prices (following the reopening of non-essential shops in early April). In its latest monetary policy meeting in early May, the BoE indicated that it is paying close attention to the inflation data for signs of a firmer underlying trend, but for the time being it is prepared to tolerate what appears to be a temporary overshoot in inflation, driven by elevated energy prices and VAT increases. The Central Bank decided to slow the pace of asset purchases from £4.4bn per week to £3.4bn and revised its 2021 GDP growth forecast significantly higher to 7.25% from 5.0% previously. Nevertheless, it clarified that it is still a long way from a rate hike, as such a move would presuppose both a sustainable move in inflation to 2.0% and progress towards eliminating spare capacity.

Figure 26: UK March GDP climbed back to 94.1% of its Feb 2020 pre-pandemic level



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

Figure 27: 94% of adults have had their first dose, while 58% are fully vaccinated



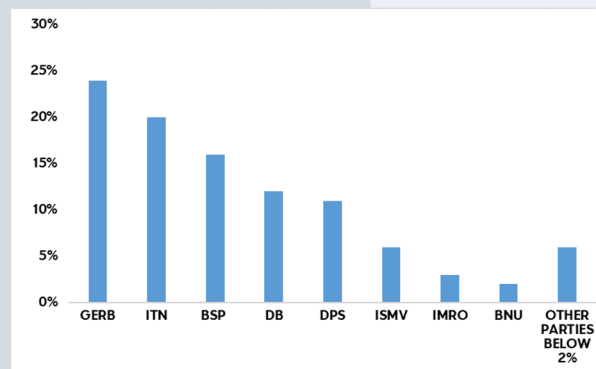
Source: Our Word in Data (OWID), Eurobank Research

Bulgaria

Political risks remain limited but undermine long-term economic growth prospects

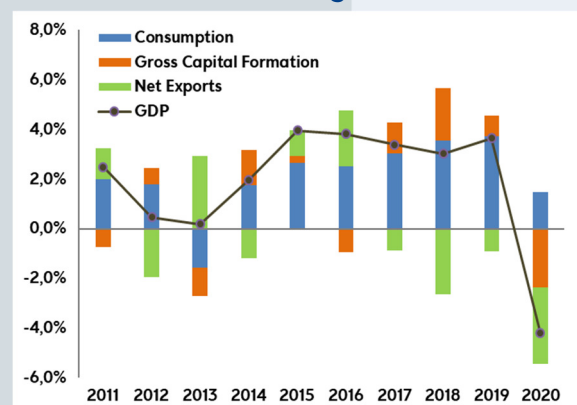
Political developments remained in the forefront in May. The failure of the third and final attempt to form a government after the April 4 parliamentary elections in Bulgaria paved the way for snap elections scheduled to be held most probably on July 11, while a caretaker government has been appointed for the interim period. According to Fitch Ratings, the possibility of failure to form a government raises the likelihood of prolonged political uncertainty, but is unlikely to result in significant changes to key economic policies. The commitment to prudent fiscal and macro policies and euro accession is broad-based and long-standing and none of the parties that entered the parliament are seeking to change relations with the EU. Consequently, for the time being, political risks appear, broadly manageable leading the EC to revise upwards its spring forecast for the country's GDP growth to 3.5% in 2021 from 2.7% in the winter forecast. The growth outlook for 2022 has also improved from 3.7% previously to 4.6%. Both years' forecasts by the EC are higher than those adopted by the outgoing government and incorporated in the Convergence Programme. The Commission's more positive view for the Bulgarian economy is broadly based on the sizeable amount of funds the country will be entitled to under the NGEU and the MFF programmes. Moreover, the recovering foreign demand will boost exports, while consumer spending is expected to accelerate in H2-2021 following the easing of the pandemic measures. According to the flash estimate released by the Bulgarian statistics office, GDP rose by +2.5% QoQ in Q1, picking up from the +2.2% QoQ print in the previous quarter. On an annual basis, the GDP contracted by -1.8% YoY, which is milder than the -3.8% YoY contraction in Q4. Both figures suggest that the economic recovery continued at a slower pace in Q1, compared to regional peers. The detailed breakdown of the national accounts is due on June 8, when the final Q1-2021 GDP print will be released.

Figure 29: Latest polls continue to point to a fragmented parliament...



Source: Politico, Eurobank Research

Figure 28: Consumption prevented the economy from contracting further...



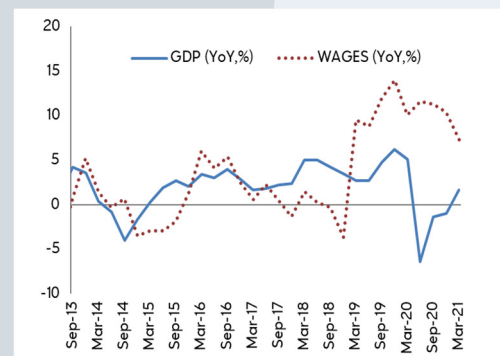
Source: National Statistical Institute, Eurobank Research

Serbia

Favorable hard data in Q1 lead to the upward revision of the current year's GDP growth forecast

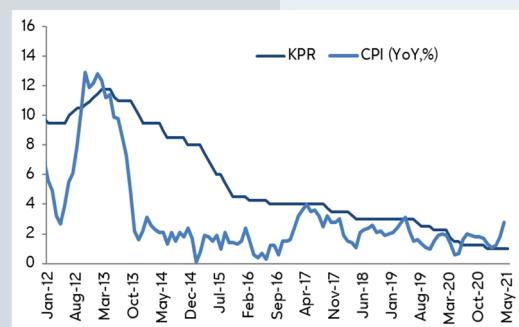
In May's session, the National Bank of Serbia (NBS) decided to keep the key policy rate at 1%, unchanged since January, amid moderate – for the time-being – inflationary pressures and stronger than anticipated economic recovery since the beginning of the year. The Executive Board of the Bank underlined that the third package of fiscal measures adopted to mitigate the negative impact of the COVID-19 pandemic, accounting to c. 4.3% of GDP, should also contribute to the quicker than projected economic turnaround. Hard economic data released since the beginning of the year have exceeded expectations and the domestic economy has returned to pre-crisis levels of economic activity upon the completion of Q1-2021, instead of Q2-2021 as previously anticipated. That said, the GDP rose by +1.2%YoY in Q1, after contracting by -1.1%YoY in the previous quarter according to the flash estimate. The print surprised positively as a -0.5%YoY recession was broadly anticipated. In the aforementioned landscape, official forecasts were revised upwards with the Ministry of Finance expecting GDP growth rate to climb above 6.0% in 2021, from 6.0% previously, and perhaps even close to 7.0%. The NBS, in the latest inflation report, raised its 2021 real GDP growth forecast to 6% from the previously projected growth between 5% and 6%. On the same footing, we have upgraded our forecast for 2021 to 5.0% from 4.5% and kept, for the time being, the 2022 forecast unchanged at 4.0%. On the pandemic front, according to epidemiologists, the normalization of life in Serbia can be expected in June as new infections and hospitalizations have been decreasing lately and the vaccination process remains on a fast track. The vaccination rate has lately been assisted by the 'quasi' bonus of RSD3k to every person who gets vaccinated, as promised by the President Aleksandar Vucic. Concluding with developments on the reforms front, by mid-June the country will most probably have reached a renewal agreement with the IMF regarding the PCI; on June 18 the government will meet the IMF representatives in order for the Article IV Consultation to be assessed and country's request for a new PCI arrangement until 2023 to be fine-tuned and approved.

Figure 30: Solid economic momentum...



Source: Statistical Office of the Republic of Serbia, Eurobank Research

Figure 31: ...amid surging still manageable inflationary pressures



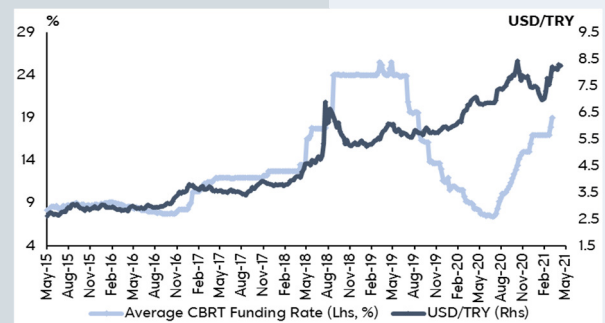
Source: Statistics Office of the Republic of Serbia, Eurobank Research

Turkey

CBRT's new leadership pledged not to cut interest rates prematurely

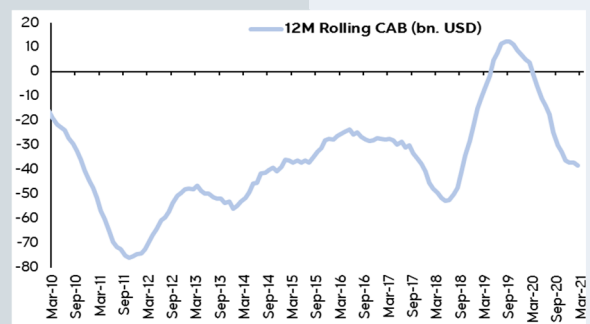
The Central Bank of Turkey (CBRT) left its key policy rate (KPR) – the 1-week repo rate – at 19.0% in early May, meeting markets' expectations in the second MPC under the leadership of the recently appointed Governor Sahap Kavcioglu. In our view, the most important element of the MPC statement is the pledge of the new CBRT leadership not to cut interest prematurely. Markets have been very anxious to look for a signal on behalf of CBRT given the clearly dovish rhetoric of the previous statement. Provided that the inflation follows the envisaged inflation report path, the door could be opened for limited rate cuts as of late Q3-2021. To that end, high inflation remains a key challenge and obliges CBRT to remain more cautious and vigilant. Inflation currently stands at 17.1% YoY in April up from 16.2% YoY in March and 15.6% YoY in February, well above the recently revised year-end target of 12.4% in 2021 and mid-term target of 5%. On top, upside inflation risks do exist from the food and energy inflation and the continued pass-through from earlier FX depreciation. In the real economy developments, the Finance Ministry's view on Q2-2021 is of a double digit growth rate on the back of strong base effects from last year's initial shock from the beginning of the pandemic (Q2-2020: -10.3% YoY). Yet, confidence indicators took a deteriorating course in Q2-2021. The reinstatement of restrictions together with the renewed lira depreciation pressures stemming from the turmoil of the replacement of the CBRT Governor keep weighing on sentiment. On a seasonally adjusted basis, the consumer confidence index declined by 2.9pts on a monthly basis to 77.3pts in May for a second consecutive month. Confidence in the services, retail trade and construction sectors deteriorated on a monthly basis in May as well. In seasonally-adjusted terms, the services confidence index fell by 1.1pts to 102.2pts and the retail sector confidence index dropped by 2.2pts to 100.9pts. On the contrary, following nine months of continuous decline, the construction sentiment increased by 2.3 pts to 79.6pts. Driven by strong favorable pandemic related base effects, lower gold imports and a rebound in goods exports, the current account deficit (CAD) improved by 39.3% YoY to USD3.4bn in March. Thus, the CAD reached USD8.8bn in January-March 2021, which translates into -4.2% of 12M rolling GDP compared to an USD7.4bn deficit in the same period of 2020. Having improved temporarily to a surplus of +0.9% in 2019, the CAD dynamics deteriorated rapidly to -4.9% in 2020 on lower tourism receipts due to the Covid19 pandemic.

Figure 32: Lira came under strong depreciation pressure on concerns for CBRT independence



Source: Bloomberg, Eurobank Research

Figure 33: Macroeconomic imbalances have been widening since mid-2019



Source: National Authorities, Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World	-3.3	5.5	4.2	3.2	3.1	3.0									
Advanced Economies															
USA	-3.5	6.6	4.0	1.2	3.0	2.2	8.1	5.5	4.2	-3.1	-3.7	-3.5	-15.8	-14.6	-6.5
Eurozone	-6.6	4.0	4.1	0.3	1.7	1.2	7.9	8.3	8.3	2.3	2.6	2.5	-7.7	-7.0	-4.2
Germany	-4.8	3.4	4.2	0.4	2.4	1.5	4.2	4.4	3.8	7.1	6.5	6.8	-4.2	-5.0	-2.0
France	-8.1	5.8	4.5	0.5	1.4	1.3	8.1	8.5	8.5	-2.3	-1.4	-1.2	-9.2	-8.4	-4.5
Periphery															
Cyprus	-5.1	4.5	4.0	-1.1	1.0	1.5	7.8	7.2	6.5	-11.4	-11.0	-10.0	-5.0	-3.5	-2.5
Italy	-8.9	4.2	3.8	-0.1	1.3	0.8	9.3	10.4	10.4	3.5	3.8	3.5	-9.5	-11.5	-6.0
Spain	-10.8	5.6	5.6	-0.3	1.5	1.2	15.6	15.8	14.5	0.8	1.6	2.0	-11.0	-8.6	-5.5
Portugal	-7.6	4.6	4.5	-0.1	0.9	1.2	6.8	7.5	6.5	-1.3	-0.6	-0.5	-5.7	-4.5	-3.5
UK	-9.8	6.2	5.5	0.9	1.6	1.8	4.5	5.4	5.8	-3.5	-4.0	-3.5	-12.4	-8.8	-5.5
Japan	-4.7	2.7	2.3	0.0	0.1	0.6	2.8	3.0	2.8	3.3	3.5	3.3	-12.6	-9.5	-5.5
Emerging Economies															
BRICs															
Brazil	-4.0	3.5	2.5	3.2	3.8	3.5	13.4	14.4	13.4	-0.8	-1.2	-1.4	-14.9	-7.2	-6.5
China	2.3	8.4	5.5	2.5	1.5	2.3	3.8	3.8	3.6	1.5	1.4	1.0	-6.9	-5.8	-4.3
India	-7.7	9.2	N/A	6.4	4.6	N/A		NA		1.1	-0.7	N/A	-7.6	-5.5	N/A
Russia	-3.1	3.0	2.5	3.4	3.9	3.8	5.8	5.7	5.3	1.9	2.4	2.9	-4.3	-2.1	-1.0
CESEE															
Bulgaria	-4.0	3.5	4.2	1.7	2.1	2.5	5.1	4.8	4.5	1.2	2.0	1.5	-3.0	-3.9	-2.5
Romania	-3.9	6.0	5.0	2.3	3.5	3.0	5.0	5.3	4.8	-5.0	-5.5	-5.2	-9.0	-8.0	-4.0
Serbia	-1.0	5.0	4.0	1.4	1.8	2.3	13.4	9.4	8.8	-6.4	-5.6	-5.5	-8.0	-3.2	-1.7
Turkey	1.9	4.8	5.0	12.3	16.0	11.0	13.7	13.5	13.0	-5.5	-3.5	-2.5	-4.5	-4.0	-3.5

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

Eurobank Fixed Income Forecasts

	Current	June 2021	September 2021	December 2021	March 2022
USA					
Fed Funds Rate	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.03-0.30%
1 m Libor	0.09%	0.13%	0.14%	0.16%	0.18%
3m Libor	0.13%	0.20%	0.22%	0.25%	0.27%
2yr Notes	0.14%	0.19%	0.25%	0.31%	0.38%
10 yr Bonds	1.59%	1.71%	1.80%	1.88%	1.93%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.54%	-0.52%	-0.51%	-0.50%	-0.48%
2yr Bunds	-0.65%	-0.66%	-0.65%	-0.64%	-0.63%
10yr Bunds	-0.16%	-0.23%	-0.18%	-0.16%	-0.08%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.10%	0.10%
3m	0.08%	0.09%	0.11%	0.12%	0.13%
10-yr Gilt	0.80%	0.86%	0.92%	0.94%	0.99%
Switzerland					
3m Libor Target	-0.77%	-0.74%	-0.74%	-0.74%	-0.74%
10-yr Bond	-0.17%	-0.20%	-0.17%	-0.13%	-0.09%

Source: Bloomberg (market implied forecasts)

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