

ING's July Economic Update: Taking stock at half-time

Euro 2020 has provided a welcome distraction and an opportunity to celebrate after a long and difficult year. But the crowded stadiums are also a reminder of the dangers ahead. The Delta variant is spreading fast and the race to vaccinate has never been more urgent. In this update, we take stock of where we are at 'half-time' and review our forecasts for 2021

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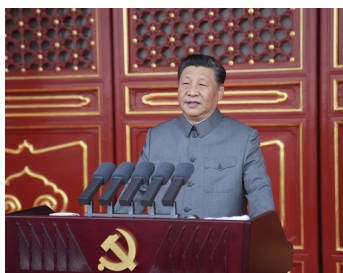


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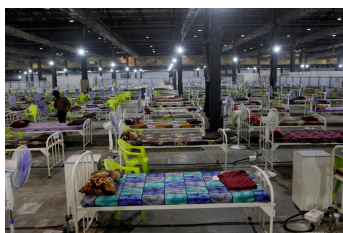
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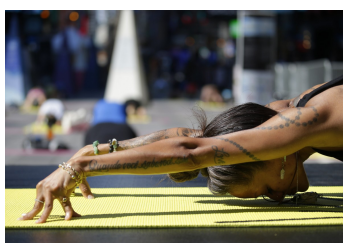


FX

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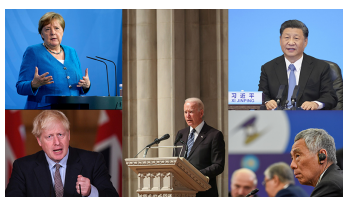
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United States

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Rising inflation in the US and Europe is likely to be transitory but the transition period may be longer and wobblier than previously anticipated

By Carsten Brzeski, James Knightley and 3 others



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Source: Shutterstock

Industrial worker people inside warehouse, USA

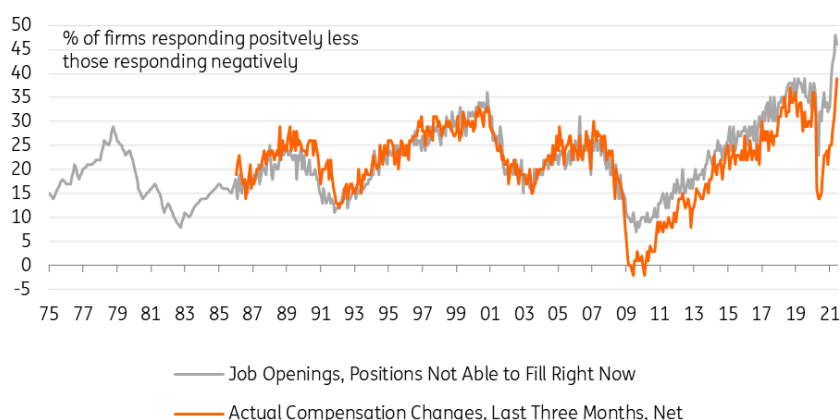
Demand is outpacing supply

Our long-held views of strong growth, elevated inflation and early Federal Reserve interest rate increases in the US are all still valid, but we have decided to add a few tweaks this month. We are revising down growth a touch, revising inflation upwards and bringing the Fed rate hike call into 2022, as evidence mounts that the supply capacity of the economy is struggling to keep pace with demand.

It is clear from a majority of business surveys that corporate America is facing bottlenecks in supply chains while also suffering from a lack of suitable workers. These capacity constraints mean that output is unlikely to be quite as strong as we had thought likely with 2Q GDP coming in closer to 10% annualised and full-year 2021 growth revised down to 6.7%.

It is important to emphasise this is not a demand issue. Companies are seeing rising order backlogs at a time when their customers are becoming increasingly desperate with record low inventory levels. The implication is that corporates have got more pricing power than they have had for years, meaning that companies facing higher costs have the ability to pass some (or all) onto customers.

NFIB survey 1974-2021: Businesses can't find workers and are raising compensation at a record pace



Source: Macrobond, ING

Persistent inflation to force the Fed's hand

The rhetoric from Fed officials surrounding the “transitory” nature of inflation has shown clear signs of cracking with the “dot plot” from their June FOMC forecast update now indicating a majority of officials expect interest rates to be increased at least twice in 2023.

Rising worker compensation is set to be a key story for 2H21, to both recruit and retain staff and coupled with surging housing costs, this means inflation looks set to linger in a 3.5-4.5% range well into next year.

We are even less confident that inflation will fade quickly. The narrative that workers would flood back into the jobs market once childcare issues fade and uprated unemployment benefits cease is being challenged by evidence that retirement rates have surged through the pandemic, fuelled by booming stock valuations in 401k plans.

Rising worker compensation is set to be a key story for 2H21, to both recruit and retain staff and coupled with surging housing costs, this means inflation looks set to linger in a 3.5-4.5% range well into next year. We suspect the Fed will start tapering its QE asset purchases before the end of this year, with the potential for two 25bp interest rate rises next year.

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Article | 8 July 2021

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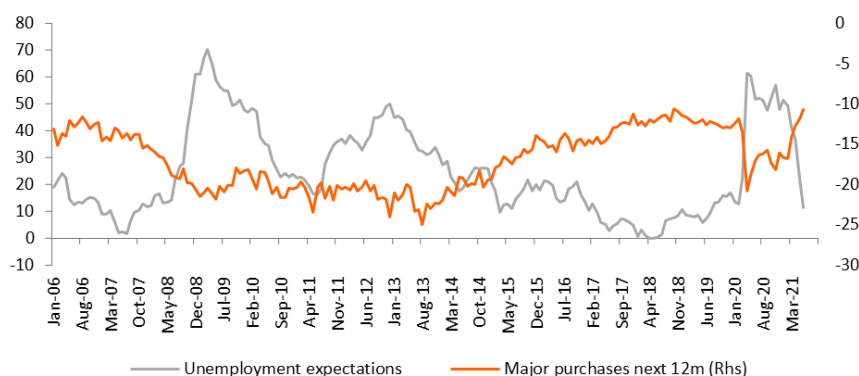
Source: Shutterstock

Consumers prepare for a spending spree

Eurozone sentiment indicators are surging as freedom from the pandemic looks to be within reach. But let's not forget that the Delta variant is now gaining ground in continental Europe, with increased travelling likely to accelerate the spread. In terms of the growth outlook, however, we don't expect this to make a big dent, as the majority of the population will probably be fully vaccinated by the end of summer, limiting the negative fallout from increased infections.

While the second quarter started on a weak footing, growth clearly picked up throughout the period. The European Commission's economic sentiment indicator hit a 21-year high in June, with confidence now way above the long-term average in all sectors. The fear of second-round increases in unemployment is now rapidly fading away and we are starting to see, albeit still anecdotally, a lack of skilled labour in certain sectors. No wonder that consumer intentions to make major purchases over the next 12 months are close to the highest level in 20 years. So we're still comfortable with our 4.5% growth forecast for this year and 4.0% for 2022.

Fading unemployment fear boosts spending plans

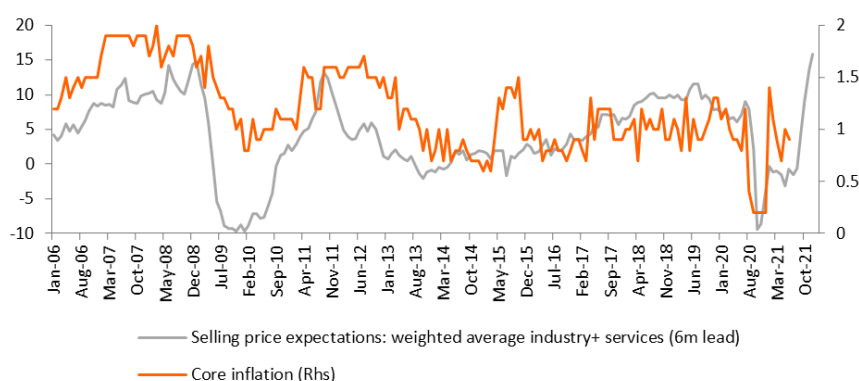


Source: Refinitiv Datastream

Companies are passing through higher costs

Inflation came in at 1.9% in June, though underlying inflation seems to be stuck at 0.9%. But goods inflation jumped from 0.4% in April to 1.2% in June, which reflects producers pricing through higher input costs to the consumer. And this is not going to end any time soon. The PMI survey reported in June that average input prices are rising at a rate exceeded only once over the 23-year survey history. While this was already seen in the manufacturing sector in the last few months, the survey also showed the steepest increase in service sector costs since July 2008. Meanwhile, the ECB remains pretty sanguine, with staff inflation forecasts of only 1.5% for 2021 and 1.4% for 2022. While we don't see inflation remaining above 2% either, we think the ECB is now definitely on the low side of potential outcomes.

Selling prices are expected to increase



Source: Refinitiv Datastream

Dovish ECB

The ECB surprised in its June meeting by actually maintaining its intention to buy bonds at a significantly higher pace. But the hawks didn't wait long to question this decision with Bundesbank President Jens Weidman pleading for a tapering of asset purchases (which will have to happen anyway, if the envelope is not increased). It will be hard to find a convincing argument to extend the Pandemic Emergency Purchase Programme beyond March 2022, though we still expect a slight

increase in the Asset Purchase Programme to make the exit from PEPP a little smoother.

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UK: Covid presses pause on the economic recovery

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Source: Shutterstock

Covid-19 cases are rocketing but hospitalisations have stayed surprisingly low (so far)

The UK economy has had a remarkably good run over recent weeks. The recent reopenings and increased optimism will likely translate into growth above 5% in the second quarter. The size of the economy is probably around 2% below pre-virus levels, if we look at where monthly GDP data is likely to be in July.

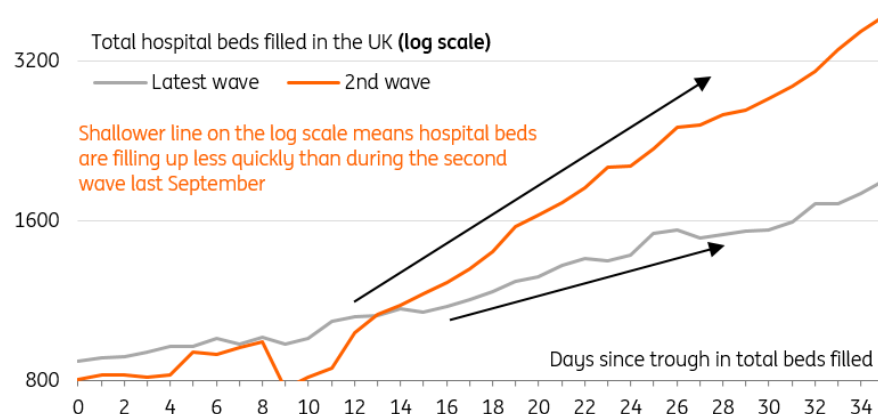
But Covid-19 cases are rising quickly again, and are showing few signs of slowing. With infection numbers doubling every 8-9 days, daily cases above 100,000 are entirely possible in the coming weeks.

The encouraging news, at least, is that hospitalisations are running much lower than you'd expect given current case numbers. Vaccines are clearly working well, and that's reflected in the lower average age of cases but also lower mortality relative to the second wave. At the time of writing, there were 17 deaths on average over the past week, compared to over 400 when cases were at a

similar level last year.

For that reason, the UK government is signalling it will press ahead with the removal of remaining restrictions on 19 July. This remains something of a calculated risk, in that rocketing case growth could in a worst-case scenario still result in hospitals being overwhelmed. But from an economic perspective, this signals that a return to business closures remains unlikely this side of winter.

Hospital beds have filled up more slowly than the second wave



Source: Gov.uk Coronavirus Dashboard, ING calculations

Trough after first wave: 2 Sept 2020. Trough after second wave: 27 May 2021

The recovery is paused - but crucially not cancelled

Still, the recovery is likely to be put on pause to some extent over the summer, and in fact, that's what the high-frequency data is already hinting at. Spending data and mobility have pulled back a little from recent highs.

Our main concern is that consumer confidence begins to decline once more. Admittedly a weekly survey of individuals doesn't yet point to increased Covid-19 concerns or reduced socialisation, but it's something we're keeping an eye on as case numbers rise.

Rising Covid-19 prevalence also means higher rates of contact tracing and self-isolation. These risks amplifying the current worker shortage in some of the consumer services industries, but could also see consumers reducing social contacts to mitigate the risk of having to stay at home for 10 days.

Having said all of that, it's important not to overstate the economic impact, relative to what's come so far in the pandemic. We're still looking at positive third-quarter growth in the region of 1.5%. And indeed assuming no new vaccine-evading variants arrive, the medium-term outlook still looks good.

But thinking about the Bank of England, the latest uncertainty is perhaps a reminder that market pricing on the timing of the first-rate hike - in a little over a year - is probably getting a bit ambitious. Unlike the US, the UK is lacking a big fiscal impulse over the coming months, and inflation is likely to moderate by the middle of next year. For now, we're in the camp looking for a first-rate rise in early 2023.

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China's centenary speech spells a long tech war ahead

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Source: Shutterstock

China Beijing Cpc Centenary Grand Gathering Xi Jinping Speech

Xi's message to the world

China's President Xi Jinping's hour-long speech marking the centenary of the ruling Communist Party last week was remarkable in many ways.

His comments against foreign rivals and the fact that Beijing would not allow "sanctimonious preaching" suggest China's stance is unlikely to soften when pressured by the US and its allies. Xi's comments seem to be directed both at Chinese nationals and foreign economies.

The tech war just became a lot more serious

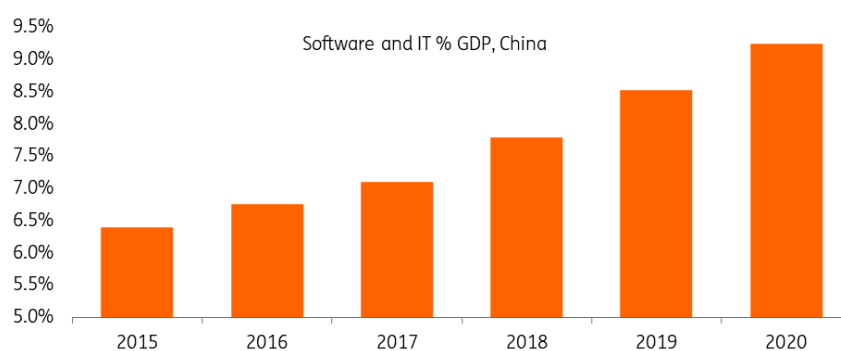
Although the speech contained little information on new initiatives and policy objectives, it is worth noting that just before the speech, Liu He, Xi's economic czar was appointed to lead the

development of chip technology. Liu was also the lead in the China-US trade negotiations in 2018 and has developed a reputation as a man for dealing with difficult tasks.

Alongside that, in early June, China also passed the Anti-Foreign Sanctions Law which allows the country to impose reciprocal sanctions on countries, companies or individuals in foreign countries. But so far, these sanctions have been limited to technology and its military use.

Putting all of this together, it would be rational to conclude that China is determined to wage a serious technology war against the US and its allies.

IT as a percentage of GDP in China



Source: CEIC, ING

Policy implications

Cleaning up industry is only the start. The most eye-catching policies so far include spinning off fintechs from technology giants' basic apps (be it a shopping app or a messaging app) and focusing on data privacy.

The first policy is to prevent a financial crisis while the second has policy implications for foreign companies operating in China. By compelling local companies to comply with data privacy rules, foreign companies in China will have to do the same.

Going forward, we expect to see more policies to support the development of advanced technology in all areas, including semiconductor chips, big data centres, ESG and artificial intelligence. All of this needs money and Liu's appointment means there should be plenty of it. Some projects may attract foreign investment, which means capital inflows and technical support for Chinese companies. In turn, China will offer its gargantuan market.

The final question is speed. With other countries advancing their own technology, it's not clear when or even if China will win the tech race. What we do know is that this investment will count towards GDP, providing the economy with the much needed extra support.

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Asia: The race to vaccinate

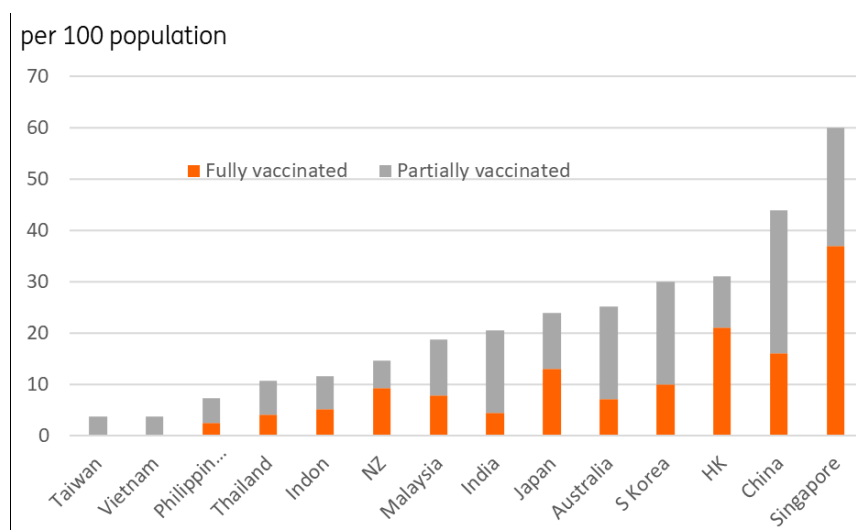
Asia has recently made better progress on vaccinations as vaccines become more widely available. But there is still a long way to go



Source: Shutterstock

Newly arranged beds lie inside a Covid-19 treatment centre set up for emergencies in the wake of spike in the numbers of positive coronavirus cases in Mumbai, India

Asia vaccinations by dose (as of 4 July, 2021)



Source: Our World in Data

A month is a long time in epidemiology

Asia's slow vaccine rollout has been a constant refrain in these notes since the beginning of the year, but in the last month, there has been some improvement. Whether this is the result of a change in heart of governments, some of which were initially very particular about which vaccines they were willing to administer to their populations, or to greater physical access to scarce vaccines, or more likely, a bit of both, the numbers are beginning to look more encouraging.

One of the biggest improvements has been in China, which is relevant for the rest of the region since it is the largest market for exports locally. A more widely vaccinated China equates to a less risky Asian export outlook, which should be good news across the whole region.

But we have also seen some pick-up in the pace of some of the early laggards on vaccination. South Korea has now fully or partially vaccinated about 30% of its population, though that is still a weak outcome compared to 60% for Singapore and 44% for China (figures accurate as of 4 July). It looks weaker still compared to equivalent figures for the US (54.5%) or the UK (66.5%) or Germany (55.2%).

And though we have seen the pace of vaccination picking up, the numbers are still fairly unimpressive. Australia comes in the top half of the APAC league table, with only 25% of its population "jabbed" - and most of these only once. As we now know, one jab of most of the widely administered vaccines provides much less protection to some of these new variants, so there is a very long way to go, and herd immunity remains a distant goal. Australia, for example, is still prone to regional movement restrictions as cases sporadically flare up.

There is also still a large and unimpressive tail in this distribution with quite a few economies in the region still showing only about 10% or lower vaccination rates. Even India has only partially or fully vaccinated about 20% of its population, in spite of (or perhaps because of) its recent problems. And it is in this long tail, including Indonesia, Malaysia, the Philippines and Thailand that, unsurprisingly, we see most of the problems with Covid in Asia, which will weigh on the prospects for growth in the region.

As the sharp pick up in the relatively well-vaccinated UK demonstrates, no economy in Asia will be able to safely reopen, and growth will remain at risk until vaccination rates rise a lot higher.

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Commodities: Losing momentum

Parts of the commodities complex appear to be running out of steam, with downward corrections seen in metals and agriculture over June. However, energy...



Source: Shutterstock

Minister of Energy of the UAE, Suhail Mohamed Al Mazrouei attends a meeting of energy ministers from OPEC and its allies

Oil bucks the trend

While large parts of the commodities complex came under pressure in June, the energy segment remains well supported.

Oil prices have hit levels last seen in 2018, with Brent edging closer towards US\$80/bbl. Recovering demand and concerns over an increasingly tight outlook have pushed prices higher. OECD oil inventories are now back in line with the 2015-19 average, highlighting the great job that OPEC+ has done in rebalancing the market. But the key for price direction will continue to be OPEC+ policy. The group has a significant amount of spare capacity, to meet the expected increase in demand, however, OPEC+ are taking a cautious approach, and so are reluctant to bring additional oil to the market without knowing there will be demand for it. This approach means that downside in oil prices will likely be limited, assuming we do not see a breakdown in the broader deal. While the market is certainly in a healthier state than it was last year, there are some concerns that the market may be getting a bit ahead of itself.

Fundamentally, it is difficult to justify Brent trading above US\$75/bbl for a sustained period and we believe OPEC+ will come to a compromise to gradually increase output

Firstly, refinery margins remain weak, and if demand was as strong as prices suggest, one would expect margins to be stronger. In addition, OPEC+ are still taking a cautious approach, which possibly means that the physical market is not as tight as the futures market suggests.

Clearly, investor sentiment is a key driver for oil prices at the moment and will likely continue to prop up the market in the near term. But fundamentally, it is difficult to justify Brent trading above US\$75/bbl for a sustained period. To see prices moving higher for longer, we would need to see the recent breakdown in OPEC+ talks leading to unchanged production from the group in the months ahead. We think this is unlikely and believe that OPEC+ will come to a compromise to gradually increase output.

The Fed & action from China rattles metal markets

There has been increased volatility in the metals markets over the last month.

The Chinese government has attempted several times to cool down rising prices, with varying degrees of success. Part of this intervention includes cracking down on speculation within the domestic market, whilst also finally confirming the release of aluminium, copper and zinc from state reserves. While this has provided some downward pressure in the short term, the effect on prices is likely to be rather short-lived. The market was underwhelmed with the volumes that the Chinese government was offering in the first stock release.

We believe copper prices have peaked for now

However, what has more potential to weigh on the market is the policy from the US Federal Reserve. The Fed is becoming increasingly hawkish, with expectations of rate hikes brought forward, along with the possibility of tapering asset purchases. This along with some renewed strength in the USD has the potential to weigh on the metals complex.

Fundamentally, we are also seeing signs at least in the copper market, that the previous tightness witnessed is easing. If we look at China, copper cathode import premiums are at multiyear lows, with downstream buyers remaining on the sideline in this relatively higher price environment. LME copper inventories have also grown significantly, and are currently at the highest levels since July last year. Copper concentrate supply also appears to be improving with treatment charges in China edging higher from the recent lows. Finally, the copper market is set to move from a deficit environment this year to a surplus next year, with a new mine supply coming onto the market.

A combination of macro and fundamentals suggest the copper market will find it difficult to return to the record levels seen in May, and as a result, we believe copper prices have peaked for now.

A volatile summer likely for agriculture

Like the metals complex, we have seen increased volatility in the agricultural space recently. Prices fell from their multiyear highs, with an improvement in weather conditions in the US, which helped to ease some concerns over the US corn and soybean crop.

The upcoming season should see global stocks for grains and soybeans edging higher, which suggests that prices should trend lower, particularly as we see new crop supply coming to the market later in the year. However, for now, the market will likely be sensitive to how the weather in the US develops over the summer. Hot and dry weather has the potential to push markets higher.

This is particularly the case, following downgrades to the Brazilian corn crop, given the drought conditions seen in the region this year. To make matters worse for Brazilian farmers, parts of Brazil have also witnessed frost more recently, which could lead to further downgrades to the current Brazilian safrinha corn crop.

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FX: Compressed Fed exit sequence prompts dollar forecast upgrade

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Source: Shutterstock

Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System

Average Inflation Targeting in abeyance

Regular readers of our FX research will know that we [had felt there was a window for EUR/USD to stage a sizable rally](#) through 2H21 and into early 2022. That window was to be provided by a Fed keeping ultra-dovish policy and negative real rates later into a cycle than normal and allowing European and global recovery cycles to drive EUR/USD higher.

What has changed is that the Fed looks less committed to Average Inflation Targeting and more towards a conventional lift-off in rates which could come as early as autumn 2022. This assumes the Fed starts tapering shortly after the August Jackson Hole gathering- a tapering process that could last until spring/summer '22.

On the assumption that the Fed starts formally tightening in 3Q22, it would be no surprise to see a bearish flattening of the US yield curve - preparing for the Fed to apply the monetary brakes - from 2Q22 onwards. That is when we would expect the dollar to embark on a broad rally.

EUR/USD upside now 1.23 not 1.28

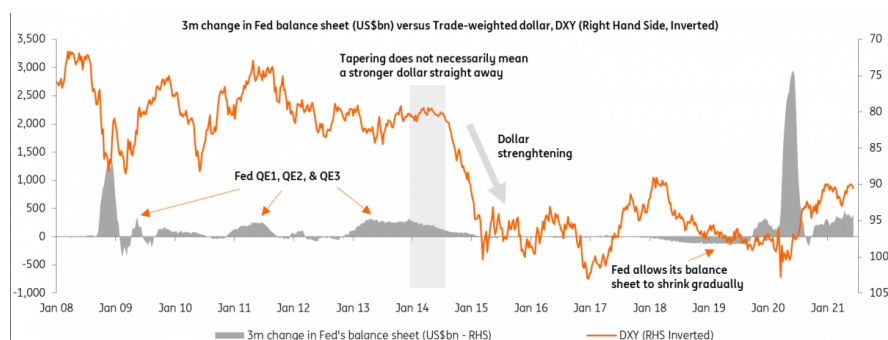
Before the broad dollar rally we expect in 2Q22, the Fed environment should allow local FX stories to play out. Tapering itself does not mean that the dollar has to rally across the board and a large part of the broad dollar rally late in 2014 (a year in which the Fed tapered) was driven by the ECB preparing markets for its quantitative easing policy – enacted in early 2015. That kind of policy divergence will not be present this time around.

That is why we still think there is scope for EUR/USD to rally into year-end – typically a seasonally weak period for the dollar – but that the upside is more likely to be limited to the 1.23 area than the 1.28 area we had expected previously. Driving EUR/USD higher should be hard eurozone data delivering on the bullish survey data, the pick-up in eurozone inflation relative to the US, and a continued rotation into European equity markets.

With quite a lot now priced for the Fed, we suspect that risk assets can continue to hold their ground this year and that in general the commodity complex and those emerging market currencies backed by front-loaded tightening cycles can continue to make gains against the dollar. Expect continued interest in the euro, Swiss franc, or Japanese yen-funded carry trades.

Into 2022, however, we see the dollar turning higher more broadly, with EUR/USD and USD/JPY ending 2022 near 1.15 and 1.20, respectively. And as 2022 evolves, the impending withdrawal of liquidity by the Fed will decrease the margin of error allowed for risk assets.

Fed tapering need not mean a stronger dollar straight away



Source: Federal Reserve, ING

Author

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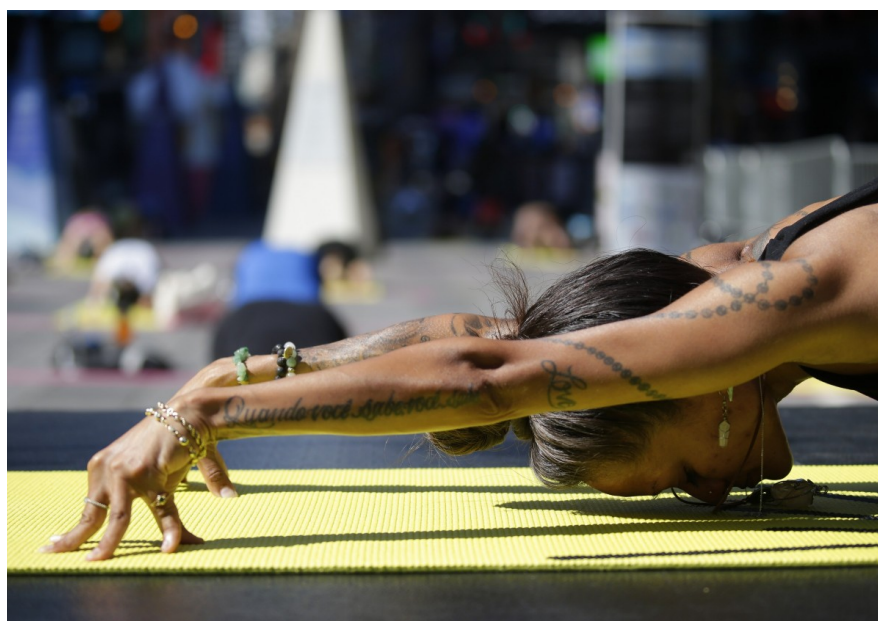
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Rates: Not bothered

Despite the upbeat macro data, market rates have lurched lower. The eurozone 10yr swap rate remains above zero, but only just. The US 10yr swap rate is...



Source: Shutterstock

Yogis return to Times Square to participate in Solstice in Times Square: Mind Over Madness Yoga,

Core rates are in low in part reflecting captive buyers, and the relative yield in Treasuries

Core rates markets continue to trade with remarkable resilience to buoyant macro prints.

Part of this reflects captive buyers of core bonds. These include central banks through bond buying programmes. It would also include pension funds that are often actuarially constrained to be long the same type of rates that their liabilities are discounted at. But also, a large rump of accounts sitting outside of the US view the level of US market rates as generous when compared to their domestic ones.

The US 10yr rate has been testing lower of late (%)

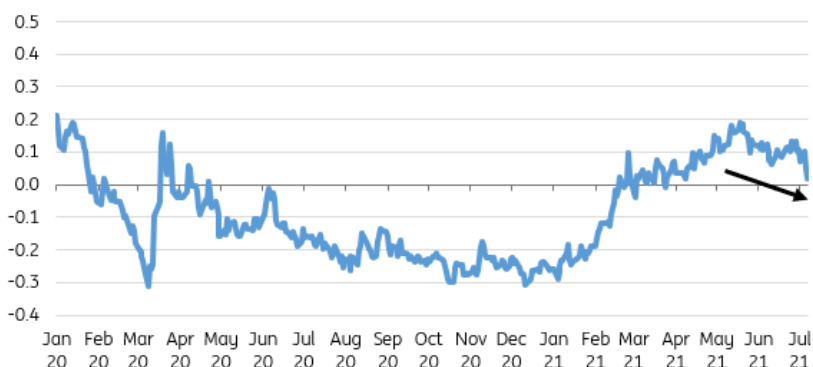


Source: Macrobond, ING estimates

But the other explanation centres on a bond market that doubts the macro positives

Another part of the explanation centres on an implied rates market objection to the medium-term sustainability of macro positivity. Simply based off market levels, the vision of the future coming from the rates market remains a troubled one. The eurozone 10yr swap rate has had its nose above zero since February, but is struggling now in low-single digits. The US 10yr is in the 1.3% area and well off the 1.75% level touched in March. It's all a bit dour.

The eurozone 10yr rate has also been easing lower of late (%)



Source: Macrobond, ING estimates

At least curves are steep - good! But arguably they should be much steeper

The good news is curves are relatively steep, with high long rates telegraphing that central bank rate hikes are coming. But arguably curves should be much steeper. The simplest means to achieve this would be through the unwinding of large negative real rates. But, even in the past week real yields have moved deeper into negative territory again (US 10yr back at -1%).

The US 10yr real rate (yield on inflation protected securities) has edged deeper into negative turf again (%)



Source: Macrobond, ING estimates

The US 10yr seems to be more attracted to 1% than 2%. Material taper talk could spark a change

The US is key here, and simplistically there are two outcomes ahead. One is a 1-handle outcome. This is where the 10yr grinds down towards 1% (extrapolate the path we are currently on). The other is a 2-handle outcome, where the US 10yr reverts higher and ends up at 2-point-something. That's our macro-inspired central view. But it's proving to be a heavy lift. Proper taper talk should be determinative, and if that does not push us there, then it's hard to know what will.

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Article | 8 July 2021

ING mid-year update: Reviewing our 2021 forecasts

Our economists review the predictions they made in our economic outlook last November and reflect on what the implications are for the rest of the year.



Source: Shutterstock

World leaders, clockwise from top left: Angela Merkel (Chancellor of Germany), Xi Jinping (China President), Lee Hsien Loong (Singapore Prime Minister), Joe Biden (US President), Boris Johnson (UK Prime minister).

You can read our 2021 outlook from November 2020 [here](#)

✓ United States

Back in December, optimism surrounding the US economic outlook was on the rise as the effectiveness of vaccines was proven in clinical trials. Nonetheless, there was concern they wouldn't be distributed rapidly enough to head off another wave of Covid-19 cases.

There were also fears that Donald Trump's legal challenges to the election result would create such a toxic political atmosphere that it would limit President Joe Biden's ability to respond to the pandemic with additional fiscal stimulus.

These concerns didn't come to fruition and the US economy posted decent first-quarter growth

versus the flat to modestly negative GDP print we anticipated. However, we were right to expect that the second quarter would experience very strong growth on re-opening and eventual government stimulus. This will mean the economy fully recovering all the lost pandemic output when 2Q GDP figures are released later this month, versus the 3Q timeframe we anticipated in December.

While we were too cautious on 1H21 economic activity, we predicted healthy momentum through the second half of the year with most of the jobs lost during the pandemic recovered by the end of 2021 - and this still looks valid.

More successfully, we were worried the recovery “could be too good” in that demand would outstrip the supply capacity of the economy and inflation would be more of an issue than the Federal Reserve and most analysts expected.

Inflation has surpassed even our high expectations and reached 5% in May. This should mark the peak, but we were right to argue that Fed would gradually change its language to indicate that they wouldn't leave it as late as 2024 before implementing the first interest rate rise.

Nonetheless, the yield curve has confounded most forecasters expectations and not steepened, which either reflects the ample liquidity environment and/or bond market caution on the medium to longer-term outlook.

Eurozone

Our growth outlook for the Eurozone at the end of 2020 was spot on. First, a double-dip in the eurozone and then a strong rebound on the back of an accelerating vaccination programme and the reopening of the economy.

When it comes to more structural developments, the eurozone is once again too late. Our calls for more digitalisation as a key driver for more convergence, a discussion on a fundamental reform of the fiscal rules and the ECB's move towards a symmetric inflation target are still valid there has been no movement on any of these topics.

The start of the NextGenerationEU programme and money paid out from the European Recovery Fund will, amongst other things, focus on investments in the digital economy and should at least limit further economic divergence. At the same time, another discussion on yet another overhaul of the fiscal rules has started but the outcome will very much depend on the results of the German elections. However, reading through the election manifestos, we think that the next German government is likely to approve more domestic investments rather than significant Eurozone fiscal rules reform.

Finally, the ECB's strategy review is close to a conclusion - and a more symmetric inflation target without explicitly calling it one seems to be on the cards. When it comes to more structural issues, the eurozone has once again taken a step back and slowed down any reform efforts, making our job of reviewing major calls for 2021 almost impossible.

United Kingdom

The UK economy is in a better place than we expected when we wrote our 2021 outlook in November last year.

Businesses weathered the winter of restrictions better than expected, and the subsequent rebound in consumer spending appetite through the spring has been vigorous. We're now looking for 6.8% growth for 2021, a good couple of percentage points higher than in November. It now looks likely that the economy will be close to – or possibly back to – pre-virus levels by the end of the year, though the recovery is likely to be a little slower through the summer given the spread of the Delta variant.

Away from the forecasts, we made three calls. Firstly, that Brexit would put some pressure on the jobs market, but wouldn't cause a Covid-19 style GDP collapse. The latter has certainly been true, though the impact on trade is still clearly visible. Exports to the EU have recovered from January's disruption, but Eurostat data shows the UK's share of the EU's total imports has fallen. As for the impact on jobs, it's harder to say, though we'd expect the higher cost burden from customs processes to gradually take its toll – particularly for some SMEs.

Secondly, we suggested that unemployment would rise in 2021. So far the jobless rate has actually ticked lower, linked to business resilience through the Q1 lockdown. But we'd still expect a rise in unemployment when the furlough scheme ends, but the fact that this support extends a few months beyond the ending of restrictions suggests the peak will be much lower than it could have otherwise been. We're looking for roughly a one-percentage-point spike.

Finally, we predicted that the Bank of England would steer clear of negative rates. That's proven correct, partly because of the economic rebound, but also because there's clearly some reticence among committee members to go down this path. Attention now turns to the first-rate hike, which we expect in early 2023, a little later than markets are currently pricing.

China

As the second half of the year arrives, were our views for 2021 still valid? Our [three convictions](#) for China 2021 at the end of 2020 were:

Economic growth upgraded from our earlier forecast

We have seen China continue to grow fast at 18.3%YoY in 1Q21 and expect this to continue at 6.0%YoY for 2Q21. This has been partly due to the low base effect as well as a sign of some domestic and external demand recovery from Covid-19. Given the faster than expected growth in 1Q21, we have revised our GDP forecast upwards from 7.0% to 8.7% in 2021. But to keep this growth path, China, as well as the world, needs to re-open international borders but this seems to be some way off as the “delta” variant is spreading quickly.

Technology war is still the number one risk in 2021

The risk of a technology war, or the realisation of this risk, has become even more obvious and imminent as the Biden government addresses China's rise as a high-risk competitor to the US and its allies. It is now even more difficult for companies in the US to do business related to technology with Chinese companies.

To react to this threat, China has assigned Liu He, Xi's economic czar, to lead the advancement of technology, and we expect this to induce a hostile reaction from the US.

Interest and exchange rate reform is both a risk and an opportunity

Though we are correct that the central bank's monetary policies would remain stable in 2021, exchange rate reform has brought more volatility to the USD/CNY market. We have revised

our USD/CNY forecast from 6.3 to 6.45 for the end of 2021.

Asia ex-China

Our 2021 forecast was supposed to be all about economic recovery in Asia. Despite relatively mild pandemics in 2020, the region's economic growth was hit hard by aggressive measures taken to slow the spread of the virus. A recovery in overseas export markets together with a re-opening of domestic economies should have delivered strong growth figures for 2021. That is the main gist of what we were forecasting. The rest was fluff.

What we didn't know back in January, was how feeble the Asian vaccine rollout would be. This has left many economies open to new variants and new waves of infection. As a result, we have had to slash many of our GDP growth forecasts which were too high.

India has been the hardest hit, though we were helped by starting with a much less upbeat view relative to the consensus.

Japan's GDP forecast also required some aggressive surgery. The timing of new waves in 2021 came early, resulting in a 1Q contraction. With more social distancing in 2Q21 ahead of the Olympics, the first half of the year will be a virtual write-off. Full-year 2021 will struggle to beat 2% growth. At the start of the year, 5% had looked plausible.

Elsewhere in North Asia, Taiwan has found the absence of vaccines a major handicap, as it suffered its first serious Covid-19 wave and has had to impose movement restrictions. South Korea has done better, though it too hasn't moved quickly on vaccinating its population, and a strong start to the year remains at risk of a downward revision until vaccination rates improve.

South-East Asia has had a torrid time amidst ineffective partial-rolling restrictions and a very slow vaccine rollout. We have cut back growth forecasts for most of the region since the start of the year. Singapore has been more resilient.

Australia has shown that tight border restrictions are an incomplete shield against new waves. Earlier choosiness over vaccine types is rapidly fading but it will take some time to protect their population given the slow start.

As the vaccine rollout continues, new waves will cause fewer problems. But as that is unlikely to happen either fully, or quickly anywhere in the region, the outlook for 2H21 is likely to be punctuated by renewed outbreaks and interruptions to recovery and perhaps further cuts to growth forecasts.

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Inflation - really nothing to worry about?

Rising inflation in the US and Europe is likely to be transitory but the transition period may be longer and wobblier than previously anticipated



The return of inflation, and its impact on major central banks' reaction functions, has been dominating financial markets since the start of the year. The longer a period of elevated inflation - or at least *fear* of elevated inflation - persists, the higher the risk that a perceived transitory phenomenon could become permanent. Early on, we had been in the camp of the 'transitorians' but as good economists we are continuously challenging our own views. Therefore, here is another look at the current inflation debate. Spoiler alert: we still believe this period will be transitory but the transition period looks longer and wobblier than previously anticipated.

Please see our related article, [Inflation in 18 charts](#) for more.

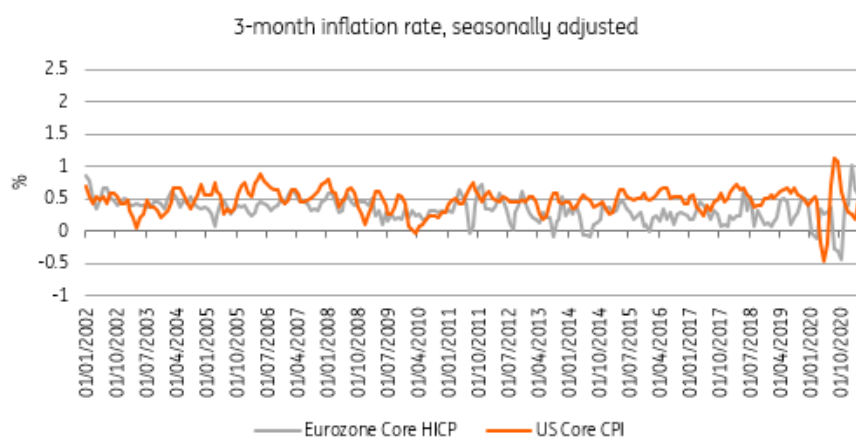
Current inflation dynamics

Headline inflation is currently running at 5% in the US, and 2% in the eurozone. And it won't stop here. In fact, the entire range of possible inflation drivers is currently at work, including higher commodity prices, supply chain disruptions, production bottlenecks, post-lockdown reopening price mark-ups and in the eurozone, the German VAT reversal.

Cost-push inflation is in full swing in the US and should accelerate in the eurozone soon.

While this cost-push inflation is already in full swing in the US, the later reopening of the eurozone economy, faced with similar global producer price pressures, should lead to an acceleration here in short order. In both the US and eurozone, producer price expectations are close to record highs. With the forthcoming summer holiday season and further reopening of economies, prices in the retail and services space are likely to pick up further. Also, don't forget that the year-on-year comparison will be one between reopening and lockdowns, accentuating YoY inflation. For the eurozone, inflation is currently still mainly driven by base effects, while the US is already seeing a strong increase in three-month inflation as well.

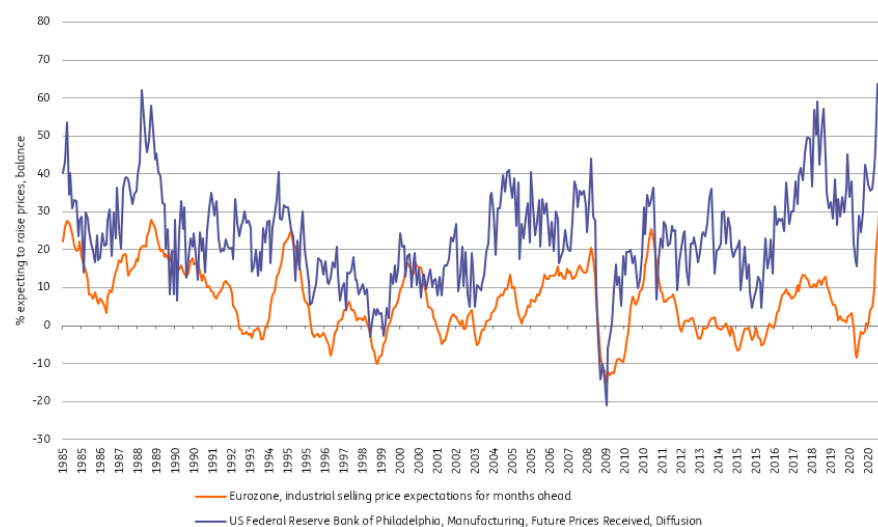
Recent price growth in the US has been much faster than in the eurozone



Source: Macrobond, ING Research calculations

Traditionally, it takes between six and twelve months before any pass-through from higher producer prices to consumer prices materialises. There are no standard estimates for this pass-through as pricing power differs depending, for example, on the state of the economic cycle or the level of competition. In the current situation, both in the US and eurozone, high backlogs in the manufacturing sector and cash-rich consumers suggest there is strong potential for a significant pass-through. Add to that the expected jump in prices in the retail space on the back of the coming holiday season and the further reopening of economies, and elevated inflation for the quarters ahead seems all but certain.

Industry price expectations have only shot up very recently in both the US and eurozone



Source: Macrobond, ING Research

All of the above suggests that elevated inflation levels will be 'transitory' but this period of transition could be longer than previously anticipated. Even if some of the one-off factors fade out of YoY inflation next year, the delayed pass-through from higher producer prices as well as lockdown-related price volatility could still impact inflation far into 2022. The good news is that credit tightening in China is going to remove some of the pressure on commodity prices towards the end of 2021.

A final driver of inflation going into 2022 could be housing costs. In the US, primary rents and owners' equivalent rent account for a third of the CPI basket and given that rents are typically only changed once a year, ongoing upward pressure in the housing sector could still show up in the US numbers. In the eurozone, the HICP includes rents but not imputed housing costs. As around 60% of eurozone households are homeowners who don't pay rent costs, it is fair to say that housing costs are not properly reflected in the eurozone's inflation measure.

A wage-price spiral in the making?

Major central banks have made clear that they are willing to look through any transitory inflation as there is very little they can do swiftly to stop such inflation and there is still a risk of prematurely choking off the economic recovery. Therefore, all (central banks') eyes will be on labour markets and wages and any sign of a wage-price spiral.

In the US, employment fell more than 22mn peak to trough, but started to recover rapidly from May 2020. Employment growth has slowed since then with employment still 7.63mn down on pre-pandemic levels. We strongly suspect that recently disappointing jobs numbers are due to a lack of supply of suitable workers rather than any lack of demand. Survey data shows more and more companies reporting vacancies that they couldn't fill. The lack of supply of workers was also acknowledged in the latest Federal Reserve Beige Book where "a growing number of firms offered signing bonuses and increased starting wages to attract and retain workers".

Recent disappointing job numbers in the US mainly due to a lack of supply of suitable workers.

There are four main reasons for the lack of worker supply. Firstly, there are ongoing childcare issues surrounding home schooling, which is forcing many parents to stay at home rather than go out to work. Secondly, there is also still some concern from some workers about returning given the pandemic isn't over. Thirdly, some older workers who lost their jobs may simply have decided to retire early, in part driven by a strong stock market recovery which has improved the financial outlook for retirement. Finally, there is the debate over the impact from extended and uprated unemployment benefits. They may have weakened the financial incentive of going out to work, particularly for low paid roles, especially when you factor in associated costs of commuting and any childcare.

Admittedly, the participation rate in the US is still low and there is the possibility that proposed government policy spending initiatives bring in more workers to fill shortages. Right now there are 1.3mn people who are unable to work, but would like to. There are a further 550,000 people who have been discouraged from seeking work, which could mean they feel as though they don't have the right skills, or wages are not attractive enough for them to look for work. Finally, there are a further 1.8mn people who are described as not in the labour force, but would like to work and are available to do so now. These may include students who previously worked in bars or restaurants while on campus, but have been unable to given remote schooling. However, as this untapped source of labour accounts for roughly 2.5% of current total employment, it's not likely to prevent wages from rising in the longer run.

Labour supply strains may not ease for another three or four months.

Consequently, we may not see labour supply strains ease for another three or four months, which will likely keep employment growth relatively subdued in the near term. This won't mean demand disappears, merely that those companies that want to expand and grow are going to have to pay more to attract staff.

Average hourly earnings rose 0.5% month-on-month last month versus the 0.2% consensus, which may offer some early evidence of rising employment costs. Note that the 1Q 2021 employment cost index has already shown the strongest increases in labour costs for 15 years, led by the private sector which showed wages and salaries rising 3% YoY with benefits up 2.5%.

Putting it all together, the demand-supply mismatch in the jobs market combined with a political and Federal Reserve aim to make sure as many people as possible feel the benefit of growth – which is only going to happen through jobs and wage growth – we are in a position where we can see some decent wage numbers for once. Federal employees now have a minimum wage of \$15/hour and companies such as Amazon have agreed to this, too, even though there is no legislation in place to force them to do so. Certainly, labour supply should become more abundant,

but for people out of the workforce for more than a year, skill sets will have deteriorated and the competition for qualified workers will remain intense.

A price-wage spiral in the US cannot be ruled out.

If wages are also now picking up that means costs will rise in tandem, and if companies feel they can pass these on, this too could mean inflation remains higher for longer. Higher wages would also give consumers more spending power. Consequently, a wage-price spiral in the US cannot be ruled out.

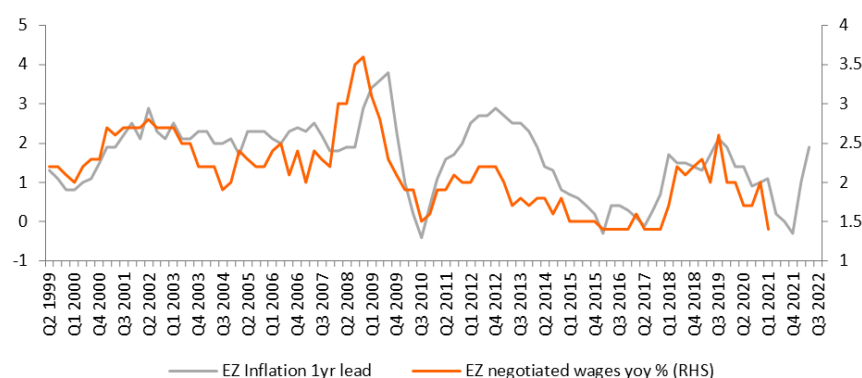
In the eurozone, the situation on the labour market is slightly different given the crucial role that furlough schemes have played. We estimate that around 6% of employment was still supported by furlough schemes in March. While the unemployment rate peaked slightly below 9% and has come down to 8% in April, it is only modestly higher than the 7.1% low seen in March 2020, with most of the labour market shock being absorbed by the schemes which were introduced last year and are still running. Slack in the labour market is much higher than unemployment figures suggest.

Following the delayed economic upswing, the lack of skilled workers may be less pressing right now than in the US. Hiring plans have improved recently but remain below historic highs in the manufacturing sector and far below all-time highs in the services sector. With the reopening of retail, hospitality and leisure services, it is possible that the eurozone will also see a temporary lack of skilled employees. However, unless new jobs emerge elsewhere, a return of people from furlough schemes into full-time employment looks like the most plausible scenario. Also, short-term shortages in the hospitality sector could be filled by young people who have been standing on the sidelines of the labour market now for more than a year. Consequently, it is very hard to see any labour market tension like that seen in the US this year.

Slack in the labour market and the eurozone economy returning to pre-crisis level by mid-2022 argue against significant wage growth.

Looking further ahead, slack in the labour market, and the eurozone economy only returning to its pre-crisis level by mid-2022, are strong arguments against any significant wage growth. Remember that even prior to the crisis when unemployment rates in many eurozone countries were at record lows, wage growth in the eurozone only reached around 2.5%. Still, a soft increase in wage growth should not be excluded given the strong link between inflation and collective labour agreements. Here, direct inflation indexation, as in Belgium, or more indirect or partial indexations, as in France or Spain, play a role. In Germany, unions often bring actual inflation developments into the negotiations. With this in mind, we could see wage growth in the eurozone coming in north of 2%.

Eurozone wage agreements react with a lag on inflation



Source: Refinitiv Datastream

Longer-term considerations

In our view, the disinflationary period of the last decade was not only the result of the balance sheet recession and subsequent deleveraging and low growth but also a result of two external developments: the emergence of China in the global economy and cheap labour as well as digitalisation (price transparency, competition and making services mobile). In addition to the trends mentioned above, including wage-price spirals and sustainably higher commodity prices, globalisation and digitalisation will also play an important role in the coming years.

Deglobalisation, protectionism and regionalisation of supply chains could push up price levels.

Regarding globalisation, it could in fact be more de-globalisation, protectionism and regionalisation of supply chains which push price levels higher. Also, with China's ambition to become a fully developed economy, the country's role in the global economy could become inflationary rather than disinflationary. Sure, there is still an enormous pool of untapped labour, be it in Africa or Asia, but the question is whether these regions will be able to surpass China quickly or whether this will only come with a long delay. Some economists even claim that the ageing of the global population and the [adverse trend of the dependency ratio](#) will result in higher real wages leading to greater inflationary pressure. The disinflationary impact from digitalisation, however, could last a while. Price transparency, increased competition and services becoming mobile have inserted disinflationary pressure on most economies over the last decade and are likely to continue to do so over the coming years. On a different note, it is still unclear how the costs of the energy transition will affect inflation going forward.

It is very early to draw strong conclusions about longer-term inflation trends on the back of the pandemic, but these moves could be far more relevant than most of the transitory factors mentioned above. Changes to underlying inflation trends will not cause large jumps in the immediate outlook, but if indeed a somewhat higher trend in inflation emerges in the aftermath of the pandemic, this would be key for central bank policy.

Implications for Fed and ECB

Almost everything is a matter of perspective. The recent increase in inflation and the future path of inflation are no exception. Indeed, the increase in inflation is mainly driven by one-off factors and therefore transitory. However, the current list of one-off factors is extremely long and varied. Consequently, the risk of seeing pass-through effects and a longer-than-expected period of somewhat stronger inflation is currently the highest since the financial crisis. A pass-through in wages is also possible. To be clear, we don't see a longer period of accelerating inflation and endless wage-price spirals but rather a longer transitory period of somewhat elevated inflation rates. The probability of seeing such a scenario unfold is definitely higher in the US than in the eurozone. Both the Federal Reserve and the European Central Bank seem willing to not only tolerate temporarily higher headline inflation but also the beginnings of a wage-price spiral. With headline inflation expected to come in at 1.4% in 2023, the ECB clearly belongs in the club of hardcore 'transitorians'. The latest Fed meeting, however, was a good reminder that any forward guidance should be taken with a pinch of salt and that central bankers are sticking with Keynes, who once said: "when the facts change, I change my mind".

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