

March Economic Update: The great reflation story

Financial market participants and economists have been discussing one hot topic in recent weeks: the return of inflation. In our March economic update, we look at whether impending price pressures will be fleeting or something more permanent, and what that could mean for global growth and financial markets

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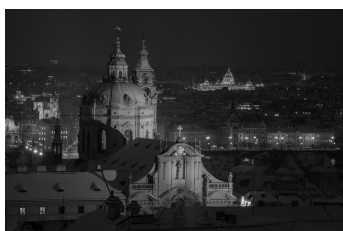
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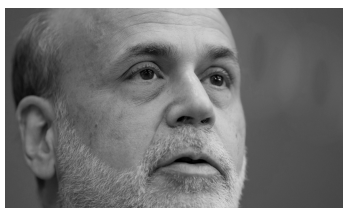


FX

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US: On your marks...

Firm household fundamentals, a booming housing market and a revived manufacturing sector provide a strong platform for growth as the economy re-opens later this year. With another \$1.9tn stimulus in the offing, there is the potential for the economy to run extra hot and inflation to accelerate. The Fed is relaxed right now, but that may change



Source: Shutterstock

Reopening to a consumer boom

It has been a strong start to 2021 despite the ongoing Covid-19 restrictions.

Robust manufacturing and construction numbers have been backed up by stellar consumer spending figures as the latest \$600 stimulus payment boosted household buying power. Winter storms probably prompted a slight pullback in February. But with President Biden promising enough vaccines for all adult Americans by the end of May, consumers and businesses can look forward to the realistic prospect of a broad reopening of the economy from the second quarter onwards.

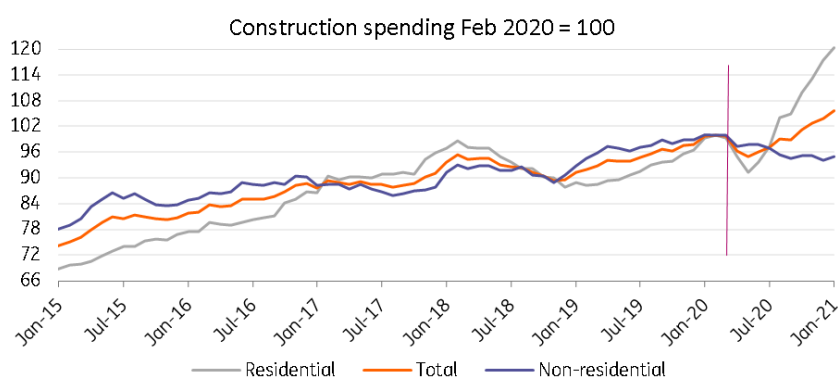
There is strong reason to believe that improvements in household finances in the US are more evenly spread across the income

distribution than in Europe

This means heavily impacted sectors including leisure, entertainment, hospitality and travel can finally open their doors and hire back workers. With an additional \$1400 stimulus payment being part of President Joe Biden \$1.9tn fiscal support package, economic momentum will surely build through 2Q into 3Q.

Moreover, household balance sheets are in great shape, with savings accumulated and credit card debts paid down. On household savings, [as we write here](#), there is strong reason to believe that improvements in finances are more evenly spread across the income distribution than in Europe. Consequently, with job opportunities set to expand on the reopening, a sizeable proportion of households may have the confidence to spend a portion of the accrued savings.

Residential property building is leading a construction boom



Source: Macrobond, ING

A broad based recovery

Corporate investment is also going to be making a major contribution to US GDP growth as businesses make up for the lost time.

The durable goods report points to a very strong growth story and with inventory levels looking low by historic standards a rebuild of stocks can also support the recovery. Then there is residential investment, which looks set to be well supported by the booming property market. The inventory of available homes for sale is at incredibly low levels – less than the equivalent of two months of sales for existing homes – which is likely to keep prices elevated and encourage construction.

The result is that we believe the US economy can grow in excess of 6% this year and if the \$3tn+ Build Back Better programme of infrastructure and clean energy investment gets the green light this will keep the strong growth and job creation momentum moving forward into 2022 and beyond.

This economic vigour raises the potential threat of inflation

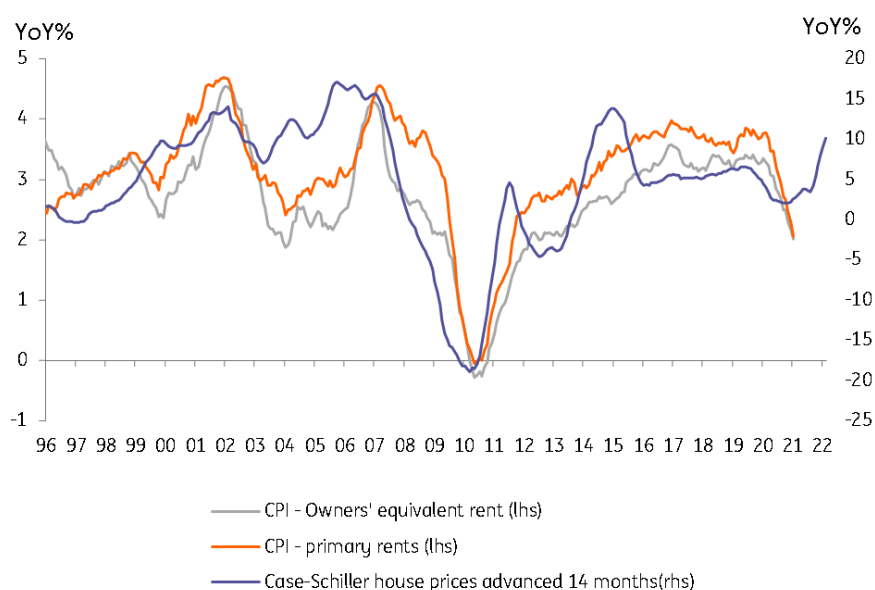
Annual inflation rates will rise significantly in the coming months as depressed price levels in the depths of the pandemic 12 months ago are compared with price levels in what we hope is a vibrant, reopened economy. On top of this, there could also be supply constraints in many

industries; thousands of bars, restaurants and entertainment venues have closed, airlines have laid off staff and mothballed aircraft, and leisure and hospitality staff need to be hired and trained. If consumers have fewer options of where to spend money, businesses will have more pricing power and this could add to the inflation risk.

Supply constraints in many sectors might mean consumers have fewer options. Therefore, businesses will have more pricing power adding to the inflation risk

Freight bottlenecks and rising commodity and energy prices are an added threat for higher inflation readings while the red-hot housing market could translate into more sustained elevated inflation readings through the housing CPI components - owners' equivalent rent component (24.3% of the total inflation basket) and primary rents (7.9% of the inflation basket).

Rising house prices could leave CPI higher for longer



Source: Macrobond, ING

And it could be stickier than the Fed anticipates

For now, Federal Reserve officials sound relaxed and are very much focused on ensuring the recovery happens, citing risks around the vaccine rollout and potential mutant Covid-19 strains. Officials also argue that there is spare capacity in the economy and that any spike in inflation will prove to be temporary. This has been enough to calm financial markets after the recent bond market sell-off, but there will be more challenges to come.

Our forecasts have inflation running in excess of 3% for much of this year and the economy growing 6.5% in real terms. This

effectively gives us 10% nominal GDP growth

Our forecasts have inflation running in excess of 3% for much of this year and the economy growing 6.5% in real terms. This effectively gives us 10% nominal GDP growth. In such an environment and where fiscal policy is unambiguously expansionary, the case for ongoing monthly QE purchases of \$120bn of Treasuries and mortgage-backed securities will be increasingly difficult to justify.

Federal Reserve risks are skewed towards earlier policy action

The Fed has suggested it will keep buying until there is “substantial further progress” towards meeting its inflation and labour market goals and this could take “some time”.

It is a very vague statement, but our interpretation of it involves a point where there is the imminent prospect of herd immunity, the economy is reopening with jobs being created plus the emergency of price pressures. All of this could materialise in the second quarter, so we wouldn't be surprised to see the Fed signalling as soon as June that they will begin a gradual tapering of asset purchases before the end of the year.

This could also involve a “twist” to shift a greater weighting of the remaining purchases towards the longer end of the curve to perhaps limit the scope for any resulting yield curve steepening. In any case, we increasingly doubt the Fed will wait until 2024 before raising rates, as they are currently signalling.

We suspect a mid-2023 start point is more likely.

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Eurozone: The underachiever

The sluggish pace of the vaccination campaign continues to jeopardise the eurozone recovery, though stronger manufacturing and construction activity are limiting the damage. Inflation is moving up and is likely to top 2% in the summer, albeit temporarily. Meanwhile, the European Central Bank is trying to prevent too much steepening of the yield curve



Source: Shutterstock

An elderly lady leaves after receiving a pfizer vaccine during a COVID-19 vaccination campaign in Pamplona, northern Spain

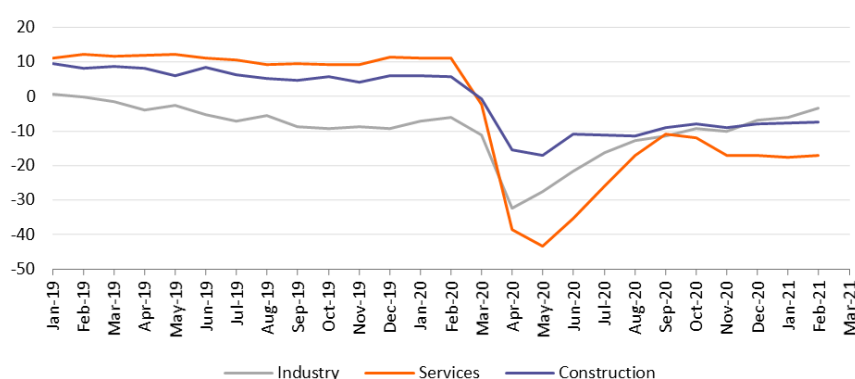
Sluggish vaccination campaign

At the risk of sounding like doomsdayers, we unfortunately have to repeat that the sluggish pace of vaccination continues to jeopardise the recovery in the eurozone. At the end of February, less than 5% of the population in the eurozone had received at least one dose of one of the vaccines. With Johnson & Johnson most probably able to step into the game from April onwards, supply constraints will ease, but the vaccination process also needs an urgent makeover in many countries if herd immunity is to be reached over the course of this year. This also explains why most eurozone countries have already announced that they will keep lockdown measures in place at least until the second half of March and probably even longer.

Industry and construction save the day

That said, eurozone companies are getting better at coping with the lockdown measures. While services are still heavily affected by the restrictions, both construction and industry are increasingly compensating for this. On the back of swelling order books, helped by the recovery in the rest of the world, confidence in industry rose in February to the highest level since May 2019. And while the first quarter is still likely to show a small contraction, a gradual reopening of the economy from the second quarter onwards should allow a recovery to take hold. Vaccinations probably won't be advanced enough to see a normal tourism season this year, but we still think the eurozone should manage to grow by 3.8% in 2021, followed by 3.5% in 2022 on the back of some decline in the savings ratio. Bear in mind that even then, the pre-crisis GDP level will only be reached by the end of 2022, about one year later than in the US.

Stronger industry & construction, weak services

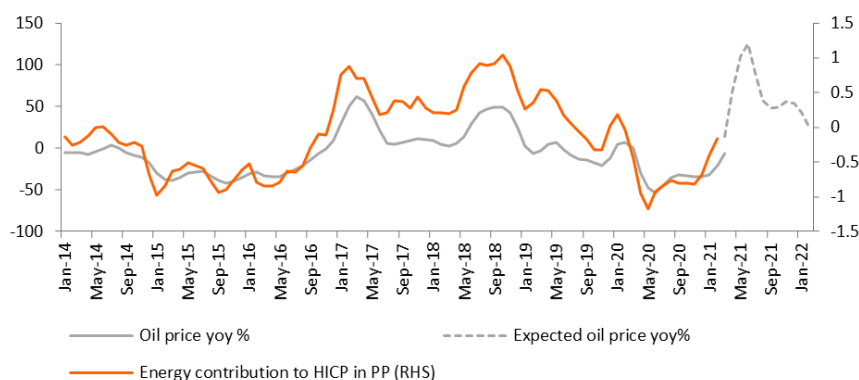


Source: Refinitiv Datastream

Inflation to top 2%

Meanwhile, inflation remained at 0.9% in February, with core inflation at 1.1%. Because of base effects in energy prices, combined with likely price increases in the services that reopen and the full swing of the German VAT reversal unfolding from July onwards, we now expect inflation to top 2% over the summer months. Though most of these effects will disappear in 2022 and for the time being there's little reason to expect a wage-inflation spiral, underlying inflation might remain slightly above 1% beyond 2021. We expect an above consensus 1.8% inflation rate this year and 1.5% in 2022 (compared with an average inflation of 1.0% in 2016-2020). In other words, a little upward drift that the ECB is likely to welcome, but still at the low end of the ECB's inflation objective.

Oil prices will push inflation higher



Source: Refinitiv Datastream

Yield curve steepening

Through different speeches, the ECB has given some colour on what it is looking at in order to maintain favourable financing conditions - though some might call it too colourful to fully distil the ECB's reaction function. In our view, the GDP-weighted sovereign bond yield curve could be a key element in determining overall financing conditions. However, it would not be easy for the ECB to actually reshape this yield curve. For ECB Executive Board member Isabel Schnabel it is clear that "a rise in real long-term rates at the early stages of the recovery, even if reflecting improved growth prospects, may withdraw vital policy support too early and too abruptly given the still fragile state of the economy. Policy will then have to step up its level of support". In other words, the ECB will continue to lean against the US-induced upward push in bond yields, through its Pandemic Emergency Purchase Programme. That said, we continue to expect the recovery to lead to some curve steepening, with the German 10yr bond yield likely to leave negative territory by the first quarter of 2022.

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UK: Poised for a spring recovery

Fast vaccinations and tumbling Covid-19 cases bode well for the UK's spring reopening. We expect 6% second quarter growth, but higher unemployment and a more nuanced savings story compared to the US, suggesting inflation may struggle to stay at-or-above target into 2022



Source: Shutterstock

A girl runs through the daffodils in bloom in St James's Park in central London, 26 February 2021

Fast vaccinations and tumbling cases bode well for spring

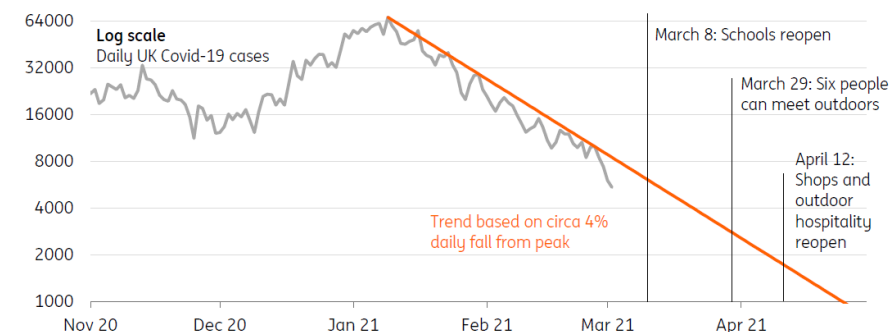
UK bonds were front-and-centre in the recent reflation-driven sell-off, with gilt yields rising 50 basis points through February. Some of this is undoubtedly down to a reappraisal of growth prospects after a lacklustre post-Brexit period of activity. But it still poses an interesting question - is the UK really set to follow the US with surging inflation, or does it sit more closely with a more benign eurozone story?

When it comes to vaccines at least, the UK remains at the front of the pack. The government has hinted that the rate of inoculations will double over coming weeks, leaving open the possibility of all adults receiving both doses of a vaccine by early in the third quarter.

Combined with the relentless downtrend in case numbers (daily figures have fallen by roughly 90% on the January peak), there's no reason to doubt the UK's planned reopening through April and

May, which will see the bulk of sectors reopen. The government hopes to remove the majority of restrictions on social gatherings by mid-June, though the risk is this is pushed back given concerns about new variants.

UK Covid-19 cases are down 90% on the January peak



Source: Macrobond, ING

6% second quarter growth means the BoE won't be in a rush to add more stimulus

It's likely that the reopening will drive 6% growth in GDP through the second quarter, and we think the economy may only be down around 2-3% on pre-Covid levels by year-end. However we should stress the picture has been heavily skewed by the inclusion of the government's Test-and-Trace spending, which on its own saw the level of monthly GDP revised up by around 1-1.5% by the end of 2020. This infrastructure is likely to remain necessary for some time, given the need for accurate intelligence on how the virus is spreading into next winter.

Still, the prospect of a decent spring recovery means the Bank of England has taken a fairly relaxed stance on the rise in yields so far. We also find it hard to see negative rates being enacted later this year assuming the outlook plays out as hoped.

We don't expect the US inflation story to be replicated in the UK

That said, where the UK story differs to the US is on inflation. Much of this comes down to fiscal support, which has arguably seen a greater boost for lower-earners across the Atlantic. While UK savings have risen sharply through the pandemic, lower-income groups have seen the opposite according to surveys - no doubt because the hardest-hit sectors tend to have the lowest wages.

While there is likely to be some pent-up demand, it may not have such a lasting impact on UK inflation.

Indeed, we expect to see a further rise in unemployment over coming months as the furlough scheme is unwound, but also as new Brexit-related costs put pressure on jobs. Consumer confidence surveys aren't yet consistent with households spending all of their newly-accrued savings.

So while there is likely to be some pent-up demand, undoubtedly driving up prices for certain supply-constrained services, it may not have such a lasting impact on UK inflation. Unlike the US, we also haven't seen so much supply erosion. Business closures in the hospitality sector haven't risen above 2.5%, and are heavily concentrated in the smallest businesses, according to ONS surveys.

That may help explain why services inflation hasn't actually slowed that much during the pandemic, outside of restaurants/hotels etc which benefited from a VAT cut. Over time, services prices tend to be much stickier relative to goods in the UK.

In short, we do expect inflation to reach the 2% target in the fourth quarter, helped mainly by energy, but also some demand/supply imbalances and higher shipping costs. But we think these price pressures will dissipate a little in 2022, reducing pressure on the Bank of England to shift abruptly towards tightening policy.

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China: Two Sessions – what to expect on reforms

We recently wrote a note on what to expect from this year's Two Session meetings. That note focused on the economic aspects of the Two Sessions. This note focuses more on the three main reform targets



Source: Shutterstock

Great Hall of the People in Beijing, capital of China where Two Sessions will be held.

1 Social reform

The Two Sessions will likely focus on how to reform the household registration system at a faster pace. The current system separates urban and rural social systems so that rural workers cannot enjoy social benefits if they move to work and live in a city. There are already some experimental policies to include rural residents in the urban social security system. But the speed of adjustment is slow, and the number of people that can be “removed” from the household registration system is small compared to the whole population. More [pilot projects](#) have been started recently but this does not cover the biggest cities in China, which means many workers cannot enjoy social benefits. The ultimate solution is to replace the current household registration system with a unified national social security system. The main difficulty with this is fiscal redistribution between the central and local governments. Consequently, we only expect experimental steps until there is further progress in the fiscal structure.

Anti-corruption

There has been one story after another about corrupt officials being arrested in China over the past month. This has not been unusual in the period prior to the Two Sessions whilst Chairman Xi has been in office. Anti-corruption reforms were put on hold during 2020. But now that the government has more room to look at agendas other than Covid, one of the top priorities will be to clean up government. Some of these top officials are C-suites of SOEs (state-owned enterprises). If the same happens to POEs (Privately-owned enterprises), investors may lose confidence in the company, but this is not relevant for SOEs. Investors understand that the C-suites of SOEs rotate every few years, and the decision maker behind those decisions is the central government.

3 Exchange rate and interest rate reform

The People's Bank of China, China's central bank, has already started reforming the exchange rate system by fading out the counter-cyclical factors used in the daily exchange rate fixing mechanism. The goal of this is to increase transparency in yuan movements. We also expect interest rate reform to speed up this year to match these exchange rate reforms. Short-term interest rates should better reflect daily open market operations and be linked to financial products. This will help the PBoC in the future (maybe not for a decade) to shift gradually from the current myriad policy rates ranging from 7D to 5Y to a single policy rate.

Author

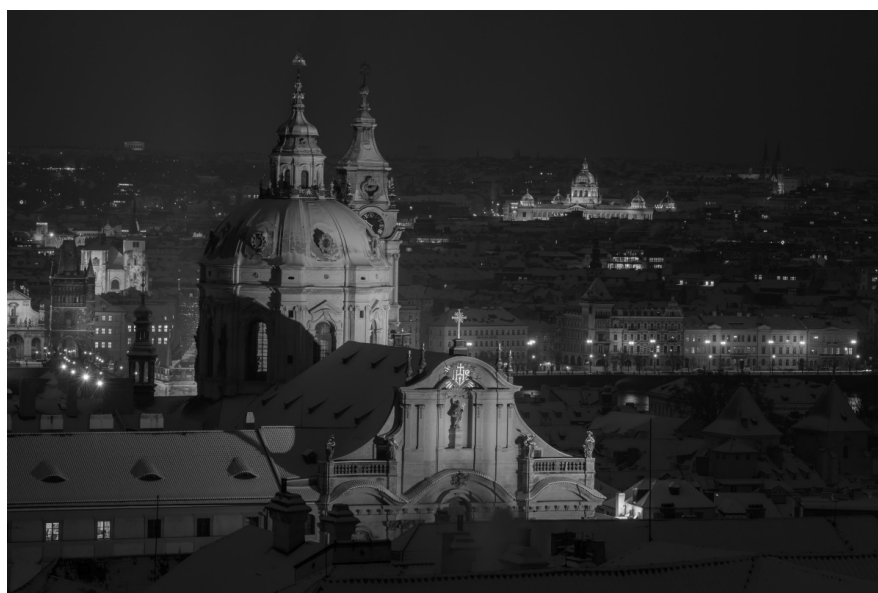
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CEE: Reflation theme intact despite more lockdown measures

Despite prolonged lockdowns, the reflation theme is intact. CPI will be running above target, but some are more willing than others to tolerate it. The Czech Republic is set to tighten later in the year but Hungary might be the first to hike, forced by FX. Look for steeper CEE curves. Steepening pressure on high yielders Turkey and Russia should be limited



Source: Shutterstock

Capital City of Prague, Czech republic, Feb 2021

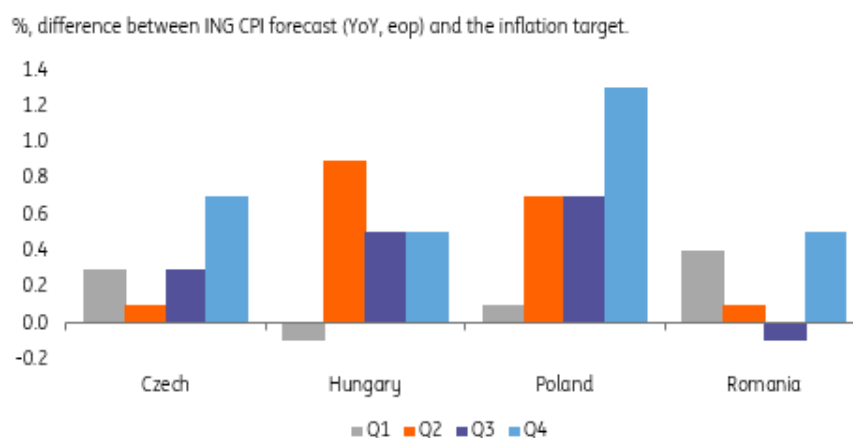
More lockdowns, but reflation theme intact

Despite the extension of lockdown measures across Central and Eastern Europe, the reflation theme remains intact. Inflation readings have been surprising on the upside across the region and headline CPIs are set to rise further. The recent inflation overshoots were, in large part, driven by volatile factors (food prices in the Czech Republic and Poland, energy prices in Romania) but the core inflation measures have also remained elevated (Poland and Hungary providing a case in point, with core prices around 4% in January).

For now, local central banks should take a Fed-like approach, tolerating the inflation overshoot with no imminent desire to hike rates, particularly given that domestic economies are struggling with

the extension of lockdowns. For some, however, the tolerance for inflation overshoots is larger than it is for others.

Figure 1: CEE CPIs to persistently overshoot the inflation targets



Source: ING

Some are more willing than others to tolerate the CPI overshoot

We continue to see two Czech National Bank rate hikes delivered this year, with the tightening being backloaded into the latter part of the year, due in part to the current (and regionally most pressing) Covid situation. The National Bank of Romania should take the second most hawkish (ex ante) approach, with another rate cut now being out of the question. The upside risks to Romanian CPI point to more stability in the managed EUR/RON, with limited upside potential to the cross (as Romania has relatively high FX pass-through).

While the National Bank of Hungary's ex ante approach is less hawkish than that of the CNB and NBR (unlike these two central banks, the NBH still engages into quantitative easing), ex post there is a high probability that it will be the first central bank to tighten in the low yielding CEE space. The expected sharp acceleration in Hungarian CPI inflation in April and May (above 4% year-on-year) may reinstate selling pressure on the forint and in turn lead to emergency hikes. At least one 15bp hike in the 1-week depo rate in the second quarter is now our base.

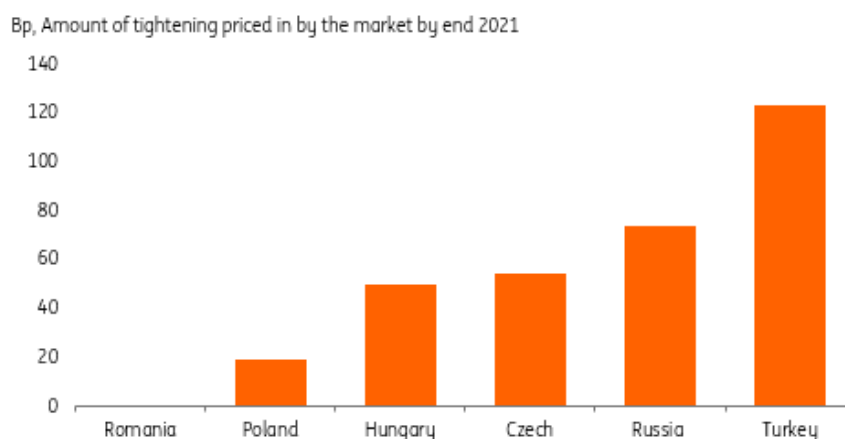
The dovish CEE spectrum is dominated by the National Bank of Poland, which is likely to look through the consistently above-target CPI this year, keeping rates unchanged and signalling little need for tight monetary policy. With the zloty less vulnerable than the forint given the vastly different current account positions (surplus in Poland vs deficit in Hungary), the odds of FX stabilising hikes in Poland are meaningfully lower than in Hungary. If anything, the NBP continues to verbally fight the zloty's strength.

Steeper curve for CEE low yielders...

The low probability of imminent tightening among most of the CEE central banks beyond and above what is already priced in (Fig 2), the inflation premium being built into the back end of domestic curves (mainly the case for Poland and Hungary) and rising US Treasury yields (our developed markets rates team targets 2.0% on the 10y UST by 3Q) all suggest further steepening of local curves in coming weeks. Eventually, the steepening pressure on CZK rates should fade as we

get into 2Q and the post-Covid recovery brings us closer to the first hike, while the steepening trend should remain intact for PLN given the NBP's dovish bias. The HUF curve is likely to continue steepening for now, but should the forint come under pressure in the second quarter and the NBH is forced into emergency rate hikes, the curve should re-flatten. However, we are still some time away from this.

Figure 2: Market is already pricing a meaningful tightening for most central banks



Source: ING, Refinitiv

... limited room for steepening among the EMEA high yielders

In contrast, we see more limited room for curve steepening in Turkey and Russia. In Turkey, the challenging inflation outlook over the coming months (not helped by rising commodity prices) keeps the possibility of additional central bank rate hikes in place. Also, should the risk of a further UST sell off materialise (which would in turn add pressure to long-end TURGBs) the associated currency weakness would also increase the case for hikes and limit the curve steepening potential. In Russia, bonds and rates sold off meaningfully, but with the vigilant central bank (which, due to a deteriorating CPI outlook, ruled out rate cuts and might be inclined to hike if CPI continues to surprise on the upside) and higher commodity prices, local bonds should show some resilience from here.

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Asia Pacific - Held back by the lack of vaccines

Asia may have had a better pandemic compared to the rest of the world, but it is lagging well behind in the push to roll out vaccines. With the political tolerance of Covid-19 very low, this means the removal of restrictions is likely to be slow, and this will weigh on growth this year



Source: Shutterstock

An army doctor prepares to inject the Sinovac vaccine from China during a vaccination at Fort Bonifacio, Metro Manila, Philippines

A different appetite for Covid-19 and a lack of vaccines is a bad mix

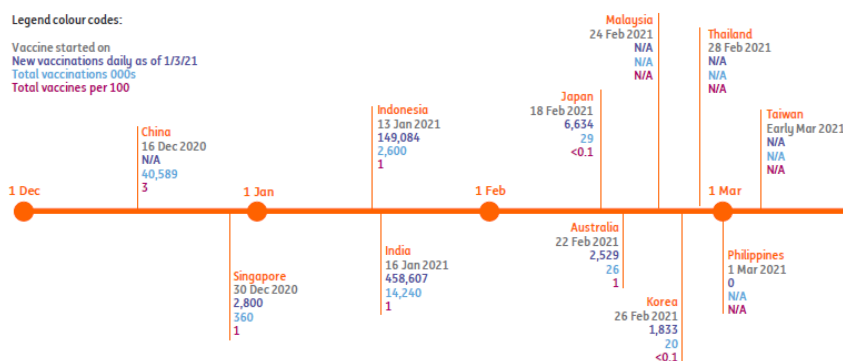
With many times the daily confirmed cases of the Philippines', the UK is mulling a slow reopening plan for its economy. In contrast, in metro-Manila, the unwinding of the lockdown has been pushed out once again, meaning that it will have lasted a full year by the middle of this month.

The Philippines may be an extreme example of Asian governments' reactions to Covid-19, but it is not totally out of line with the rest of the region. Singapore, for example, which has averaged less than one community case a day in recent weeks, has said that it is not about to move out of phase three restrictions any time soon, at least until more widespread vaccinations have been rolled out across the population, their effectiveness has been proved, and the rest of the world has Covid-19 under control.

With much of the region taking a similarly cautious approach and resting the case for any reopening on the vaccine rollout, this has highlighted a glaring problem. That is that Asia has, for the most part, been extremely slow to roll out its vaccination programme.

Even compared to the dithering and mismanagement evident in Continental Europe, Asia is lagging globally. Japan, for example, had, as of 1 March, vaccinated fewer than 30,000 of its population. For comparison, the latest United Kingdom figures showed a daily vaccination total of 530,000 the day before.

Vaccine rollout



- China** Beijing city set a target to complete vaccinations for Beijing city residents by May 2021. We expect other major cities to follow suit to set a timelines target for vaccination completion.
- Singapore** The vaccination drive started with the front-line workers. It's extended to elderly population from 22 February. There are 14 vaccination centres in operation currently. The number is planned to be increased to 40 by end-April. The planned completion of vaccination drive by late 2021.
- Indonesia** The authorities have decided to vaccinate the population between 18-59 years first as it needs to cover two-thirds of total population to reach the herd immunity.
- India** One of the biggest vaccination drive in the world started in mid-January. The authorities aim to inoculate 22% of total 1.4 billion population by July.
- Japan** Japan has been very slow to authorise vaccines due to low public trust in vaccines and is being very cautious with its rollout.
- Australia** The vaccination started with priority population and will be rolled out in stages, depending on age and other risks, to the rest of the population. The authorities plan to inoculate the entire population by October 2021.
- Malaysia** Vaccination started on 24 February with PM Muhyiddin. The government aims to vaccinate at least 80% of the 32 million population by February 2022.
- Korea** The vaccination programme has been delayed due to late arrival of vaccines from Covax, and concern over the Astra Zeneca vaccine. Korea now plans to vaccinate 750,00 people by end 1Q21, down from the initial target of 1.5 million.
- Thailand** Thailand started its vaccination on Sunday 28 Feb with ministers, health officials and medical professionals. The mass vaccination campaign is expected to be in full swing by mid-2021 when the authorities plan to administer 10 million doses a month.
- Philippines** The first vaccines were given to Ministers on 1 March — Sinovac vaccines donated by China. Legislators are still debating a bill that would grant vaccine producers protection from lawsuits. The government aims to vaccinate 70% of the 110 million population but timelines have varied.

Source: ING

Why the delay?

There are several reasons why Asia is lagging behind the rest of the world in vaccinating its populations. Here are our top four:

- **Queue jumping by others**

There has, without much doubt, been a degree of queue jumping by some countries. Those at the very front of the queues argue to have taken a risk in paying up for vaccines before they were even proven. This gamble seems to have paid off, with countries like the UK, UAE and Israel getting access to the vaccines they paid up for in advance, especially as many of them achieved successful phase three trials and received accelerated regulatory approval by local medical bodies.

- **Lack of locally produced vaccines**

The US and UK also benefited from having substantial vaccine production facilities within their

countries which surely helps. But so do India and China, yet they are still falling behind (though India is having a fairly decent go at rolling out vaccines to their population). With billion-plus populations, their goal is admittedly a more challenging one than for most European countries. Europe too has extensive vaccine production facilities on-site, so there is a limit to how much weight we can put on this excuse. We have to look elsewhere for the causes of failure.

- **Widespread vaccine mistrust/anxiety**

Population mistrust of vaccines is arguably a bigger problem in Asia than in some other parts of the world. Japan has endured a fraught history of alleged and real adverse reactions to various vaccines over the years, including the combined MMR vaccine. And the government has variously supported the vaccines' safety before withdrawing them and then re-introducing them. Not surprisingly, faith in government advice on vaccines is very low, with people more prepared to get their advice from friends and the internet. In the Philippines, Sanofi's Denvaxia vaccine for Dengue fever, a mosquito-borne killer in the tropics, was approved and then subsequently linked to the deaths of children and subsequently withdrawn. That vaccine had been in the works for 20 years. Understandably, there may be anxiety about vaccines that have been cooked up in less than a year combined with a lack of trust in government advice.

- **Legal framework for litigation of side-effects**

The vulnerability of vaccine makers to class action lawsuits in the event of real or alleged serious side-effects means that not only have the medical regulatory bodies been languid to provide their approval for vaccines, but the developers have also been in no rush to deliver physical vaccines to a region with relatively low Covid-prevalence, matched with an equally low appetite for vaccine risk. In some countries, the rollout has been delayed while legislation is passed to protect the vaccine companies from litigation in problems.

Central banks to sit on their hands all year

With Asia's economies likely to remain at least partially restricted for much of the year, the outlook for monetary policy in the region remains mostly one of inaction.

At one end of the spectrum, the normally hawkish Bank of Korea (BoK) may be one of the first central banks in the region to start unwinding emergency accommodation, with background concerns over house price growth and household debt accumulation the main reasons for normalisation. But the BoK will be very unlikely to make any move towards tightening policy until next year at the earliest. Despite potentially viewing a repricing of Korean Treasury Bond yields as a reasonable market response that could help rebalance the economy, they did intervene recently to try to stem the rise in local government bond yields, suggesting that on balance, they would prefer any such adjustment to be very gradual indeed.

Unsurprisingly, given recent market gyrations, no central bank in Asia looks like wanting to be either the first in the region to normalise or to steal a march on the US Fed

The same economic imbalance criticisms could also be levelled at a central bank at the

opposite end of the hawk-dove spectrum, the Reserve Bank of Australia (RBA). Yet they have committed to no tightening until 2024 at the earliest - which looks like a fairly obvious attempt to sound no more hawkish and probably a little bit more dovish than the US Federal Reserve. The RBA has been hard at work fighting the recent bond sell-off by upping their pace of general bond purchases under their QE scheme and driving their target 3-year bond yield back below its 0.1% target.

Bank Indonesia recently cut rates, so they are in no sense likely to reverse their policy stance any time soon. That said, Governor Perry Warjiyo has been hinting lately that despite ongoing problems tackling Covid-19 in Indonesia and extended movement restrictions, this is it as far as rate cuts go. Bank Negara Malaysia is also probably done with easing now that inflation has troughed and will likely return to positive territory in the coming months. But they won't be in a hurry to hike rates while Malaysia struggles more than most in the region with the pandemic. The tepid macroeconomy of Thailand and insipid Philippine recovery should also keep both the Bank of Thailand (BoT) and Bangko Sentral ng Pilipinas (BSP) inactive this year too.

Singapore's neutral nominal effective exchange rate index target will also almost certainly be left alone at the MAS April meeting. And the Bank of Japan (BoJ) will most likely resort to its usual playbook of talking about the potential for actions to stem unwelcome market moves but actually doing almost nothing of any substance. BoJ Governor Haruhiko Kuroda, as recently as January, seemed to suggest allowing benchmark Japanese Government Bond (JGB) yields to fluctuate in a wider band. However, there doesn't seem much appetite for that right now.

Unsurprisingly, given recent market gyrations, no central bank in Asia looks like wanting to be either the first in the region to normalise or to steal a march on the US Fed.

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FX: Dollar bounce underwhelms

If, at the start of the year, we had been told that US bonds would sell off 50bp at a time that Europe's slow vaccine rollout had meant lockdown extensions, what reaction would we have expected of EUR/USD? Probably most of us would have expected far greater losses than the 1% actually seen



Source: Shutterstock

Dollar bounce underwhelms

The dollar should have done much better in the first two months of the year. This should have been the quarter when the dollar advanced either on: a) the far superior vaccine rollout in the US relative to continental Europe or b) a dramatic, (verging on the disorderly) rise in US bond yields which necessitated a re-pricing of risk assets.

In the G10 space, true, the dollar is 3% higher against the most defensive low-yielders of the Japanese yen and the Swiss franc. Yet many of the commodity currencies are still up 1-2% against the dollar since the start of the year. The fact that EUR/USD has 'only' dropped 1% year-to-date we read as the euro being traded as a cyclical currency and one that should benefit when 2Q21 provides broader indications of a synchronised recovery – which we still expect to be the case.

In other words, the recovery is a conviction trade.

Also denting the dollar's credentials may be the sense that the US is racking up more debt to be spent on consumption. This has implications for the trade deficit as well as a desire from Washington to keep the dollar soft, such that trading partners are not taking advantage of US

consumption with under-valued currencies.

The Fed plays its part here by keeping real rates as negative as possible for the parts of the yield over which it has control.

FX takes a back seat to bonds

Over the last month, FX markets have certainly played second fiddle to bonds – so much so that the European Central Bank is closely monitoring events in the bond markets rather than in FX. We are still of the view, however, that a broadening recovery in 2Q can push EUR/USD to the 1.25 level – where the ECB's verbal intervention will presumably power up again.

In our [Timing the Tantrum cross-market piece](#), we also highlighted how the FX market might perform if the Treasury sell-off escalated into a full-scale tantrum similar to the one seen in 2013.

There have been instances where a repeat of the 2013 sell-off has started to reappear – especially in high yield emerging market FX such as the South African rand as Turkish lira. However, EM economies have more stable external positions than those seen in 2013 and we would not expect to see a repeat of the 15-20% adjustment suffered by the most vulnerable countries back then.

Instead, we think position-adjustment would play a greater role today, with those most exposed to a further Treasury sell-off such as the heavily-backed Czech koruna in Europe, or the Korean won in Asia – the latter being exposed to equity outflows.

Yet our base case is that the recovery/reflation trade dominates in 2021, such that any corrective dip in currencies exposed to the global business cycle (including the EUR) proves short-lived and 5-8% rallies are achievable by year-end.

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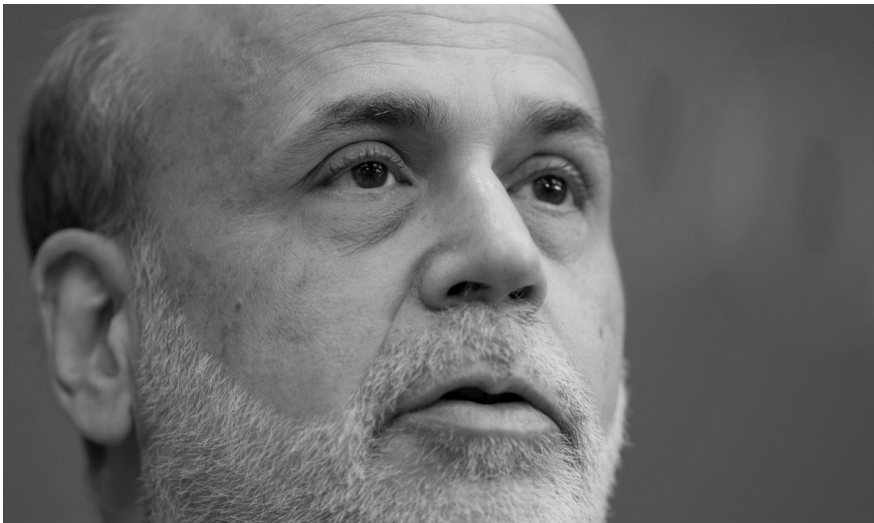
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Article | 4 March 2021

Rates: Escape velocity

Ben Bernanke coined the phrase "escape velocity" in 2010, essentially saying that there needed to be plenty of oomph to growth, so the gravitational forces of deflation were left behind. Although an aspiration at the time, two years later, the Fed was discussing how best to taper bonds. The metaphor is quite apt again, for both the economy and the bond market



Source: Former Federal Reserve Chairman Ben Bernanke

The big driver here goes beyond reflation to an inflation spurt

It was only a month ago that the US 10-year threatened to break below 1%. Crucially it didn't, and indeed at the time, we noted that, if it did, it would not be down for long.

But since then, not only has it held above 1%, but that platform facilitated a leap to 1.5% in the space of just a few weeks. The tail end of that saw a 15 basis points rise in yield in intra-day trading in just a day (that's pretty big, by the way, if you're not a bond guru).

This certainly had the feeling of escape velocity. It coincided with a classic underperformance of the 5yr to the curve - the kind of thing you would look for to really class this a bear market for bonds.

And this move had nothing to do with supply pressure, by the way. It was and still is all about the build of a reflection theme. Moreover, it is a reflation theme with a very significant tint of an inflation spurt, one that may prove to be more persistent than many had thought possible.

Morphing the deflationary tail risk to one of inflation - we like that one

The Federal Reserve has, in a very persistent way, managed to morph the deflation tail risk into an inflation one - a risk they prefer to deal with. Moreover, aiming in that direction ticks other important boxes, such as growth and implied employment objectives. For bonds, though, this is a dangerous game, as inflation is a bond investor's worst enemy.

In fact, inflation is a significant risk for any security that pays the holder a set fixed amount with regularity into the future; inflation just eats away the value of that in real terms. Hence the rise in yields as compensation for higher inflation expectations. As we face a growth and inflation combination of at least 6% and 3%, respectively, it should be no surprise for us to be looking for 2% as the next big level to aim for on the US 10yr Treasury yield.

We have successfully escaped the deflationary pit of despair - staying comfortably above 1% keeps that at bay. Next stop is 2% to price in a 2% inflation environment on a zero real yield.

Even at that level, an implied zero real yield still does not feel like an equilibrium. If there has really been escape velocity, then the 10yr is still looking up from there, rather than fearing a lurch back.

There are risks to this in the guise of Europe and risk assets

So what are the risks? There are many, in fact.

The first is the juxtaposition between the US clamber to exit from the threat of negative rates to the eurozone's seeming reluctance to cast off those very same shackles. The ECB's soundings have been more along the lines of viewing the rise in yields (which has turned into a global thing, in fact) as detrimental to the recovery rather than as a sign of one.

In that sense, there are two risks. One is that eurozone yields remain a drag for US yields, so that, say, a 200bp Treasury - Bund spread presents a ceiling for the US 10yr. The other is that the rise in US rates is so abrupt that it does, in fact, result in self-harming, negating the benefits of escape velocity as the economy and yields flop back down again.

Should the Federal Reserve start to contemplate a taper of bond purchases, the experience in 2013 shows that risk assets can get very unnerved by it.

The third risk links this to the prognosis for equities and credit spreads. So far, so-called risk assets have held up fine. In fact, equities hit new highs in places. The trouble in fixed income is all about the rise in core rates, as credit spreads have been contained. But, this space is littered with risk, especially if inflation and market rates continue to rise. That combination leaves corporates with higher re-funding costs and discounts future earnings more deeply, pushing up price/earnings ratios.

A tapering discussion from the Fed could be as good a catalyst as any for a risk asset underperformance, perhaps a severe one. And it would act to curb the upside to bond yields as cash would then flow back to the relative "safety" of bonds. [This could happen as early as the summer.](#)

Until then, it looks and feels like market rates will continue to test higher. From the Fed's view, this is tolerable as it discounts a success for them, as they are seen to be successfully generating reflation. The eurozone views it through a different prism, almost as a threat to the recovery, perhaps for good reason as they have been burnt many times before.

We'd like to think this is the real deal. It certainly feels like escape velocity in the US, and might just be enough to put some tempered optimism into the eurozone too. The holy grail of a positive 10-year swap rate is here, far sooner than we'd expected. Better not to get sucked back down to the depths of the inverted upside-down world of negative rates.

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Article | 4 March 2021

Commodity supercycle calls grow

It has been an exceptional month for commodity markets, with growing inflation expectations increasing investor interest in the complex. Meanwhile, fundamental developments, particularly in the oil market have only provided a further boost. We still see further upside for oil as we move through the year



Source: Shutterstock

Oil pump jacks work in unison, Williston, USA

Investors flock to commodities

The commodities complex has had its best start to the year since at least 2008, with the Bloomberg commodities index finishing February more than 9% up since the start of the year, whilst recently the index had been up as much as 12% YTD.

We have continued to see increased investor interest in commodities with the expectation that as we see a global recovery from Covid-19 it will be bullish for commodity demand. In addition, given the loose monetary policy we have seen, coupled with fiscal stimulus, inflation expectations have only grown in recent months, which has increased the attractiveness of commodities for investors, given they are seen as an inflation hedge. Meanwhile, the broader weakness that we have seen in the US dollar for much of the last year has only provided further support.

All parts of the complex have seen a boost in speculative interest, including metals, agriculture and energy. If we look specifically at oil, the managed money net long position in ICE Brent stands at almost 350k lots, levels we last saw back in February 2020, and up around 292k lots from the lows

seen in March last year. What is also interesting has been the fact that speculators have been increasing their spread positions in the oil market, and given that the forward curve has flipped from contango to a fairly deep backwardation, this shouldn't be too much of a surprise, given the positive roll yield on offer.

However, if speculators are buying the oil market, there needs to be someone who is selling it, and positioning data shows pretty clearly that as we have seen the market rally, producers have been happy to hedge into this strength. The producer short position in ICE Brent is the largest we have seen since late 2019. For NYMEX WTI, the producer short has recently been at its highest level since 2017. It is pretty clear though, that this producer hedging in the oil market has provided little resistance to the market moving higher.

Are we entering a new commodities supercycle?

As commodities have rallied this year, more market participants have suggested that we are at the start of a new commodities supercycle. So, what exactly is a supercycle? It is an extended period of time where you see above-trend movements across large parts of the complex. A supercycle can last for decades, and the last one was back in the early 2000s, with rapid growth in China driving strong demand for commodities. That cycle lasted basically from early 2000 all the way until around 2014.

The sizeable amount of fiscal stimulus, along with loose monetary policy that we have seen over the last year to help with the post Covid-19 recovery is certainly a supportive factor for commodities demand. This is already evident when looking at the strong post Covid-19 recovery from China. Sizeable stimulus in China has boosted infrastructure projects and as a result, demand for commodities. All across the complex, China has featured as a strong buyer, with record oil, iron ore, copper and certain agri imports in 2020. If we are to see the start of a new supercycle, this robust demand growth that we are seeing from China will have to be sustainable for several years. This is something that we are less likely to see. However, China can still be the catalyst, we will just need to see other economies coming through with stronger demand growth. Energy transition has the potential to provide this. Investment in renewable energy infrastructure would provide a significant boost to demand for commodities, although this would be more beneficial for metals than fossil fuels.

On the supply side, a lack of investment does mean that markets are left potentially quite tight further out, supporting the idea that we could be at the foothills of a supercycle. Although for oil, US shale may be a limiting factor for prices rallying too strongly. During the previous supercycle, US shale was still in its infancy, and so producers were unable to respond quickly to stronger prices. However, with the US shale industry now more mature, their response to higher prices should be quicker.

Overall, while there are a number of factors which suggest that we could be at the start of a supercycle, we still believe it is too early to call. We would need to see robust and sustainable demand growth in the years ahead.

Oil balance set to continue tightening

We came into 2021 with [a bullish view for the oil market](#), but clearly Saudi Arabia's additional supply cuts, US supply disruptions due to freezing cold conditions, growing demand hopes, rising inflation expectations and the broader USD weakness have meant that the market outlook is even

more bullish than we had anticipated.

As a result, [we recently revised higher our oil forecasts](#), and now expect ICE Brent to average US\$65/bbl over 2021. While we see limited further upside in the first half of this year, it is over the second half of this year where we see more upside, given the expectation of a stronger demand recovery over this period. The continued tightening in the oil balance means that we see Brent trading at US\$70/bbl by year-end.

Downside risks for oil

However, there are still clear downside risks. Firstly, while we are seeing the rollout of vaccines, there is the risk that we still see further waves of Covid-19, which would weigh on demand. Secondly, in the near term, higher prices could see some buyers hold back. In recent weeks, Chinese buying seems to have eased. Thirdly, a swift return of Iranian barrels could slow the market rebalancing process. However, for now we do not see a significant return of Iranian supply until later this year at the earliest. Finally, there is always a risk that OPEC+ fails to agree on the next steps with regards to production cuts at its meeting on 4 March.

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Savings: the two-sided wildcard for growth

In the first lockdown, surging savings rates across the Western hemisphere were mainly the result of involuntary savings. As a result, the reopening of economies led to an almost full reversal of the excess savings into consumption. In 2021, the rotation from savings into consumption could be much more uneven on both sides of the Atlantic

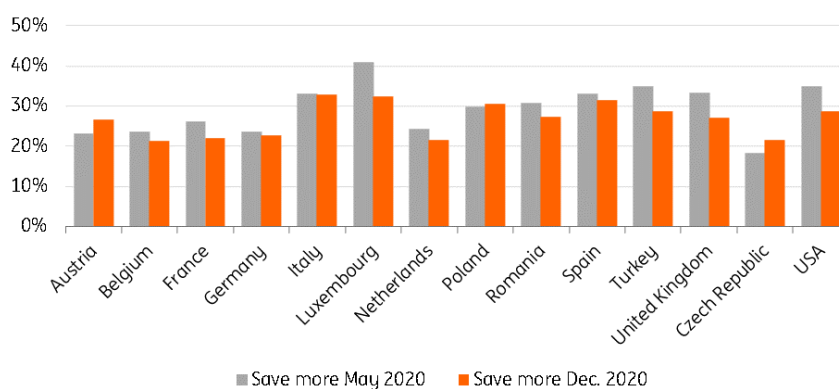


Source: Shutterstock

The savings-consumption rotation during the first lockdown

The first lockdown saw an unprecedented surge in savings in the US and Europe. 'Involuntary savings' was the buzz phrase of the moment. With people suddenly sitting at home, retail stores, restaurants, bars and cultural events all closed, savings rates increased significantly. Planned vacations had to be cancelled, also adding to the increase in savings. The fact that these savings were mainly involuntary is also reflected in the relatively muted fall in consumers' willingness to spend. With the reopening of economies, savings dropped and consumption surged. In fact, the flow of savings equalled the flow of consumption almost entirely in the second and third quarters.

Did you save more or less?



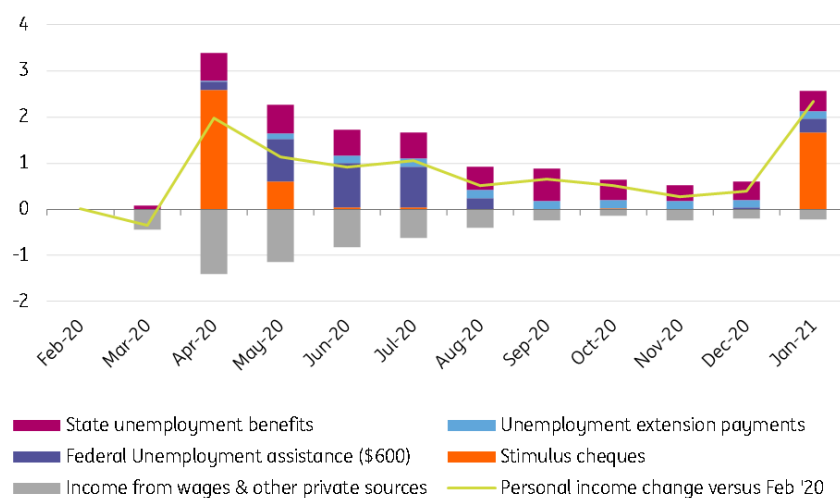
Source: ING International Survey

In the eurozone, short-time work schemes helped support household incomes. Unemployment rates remained relatively stable and the fear of potential job losses was high but short-lived. Savings rates across the eurozone surged on the back of involuntary and precautionary savings. According to European Commission surveys, the assessment of households' own financial situation worsened but only to historic averages and not below. Interestingly, the intention to save did not drop again in the third quarter, while excess savings were reduced and private consumption surged. The countries hit most by the crisis saw only half of these excess savings in 3Q actually spent in that quarter. In all countries, the savings rate remained higher than before the start of the crisis. This suggests that a larger part of the population increased savings as a precaution and not simply due to the lack of spending opportunities.

In the US, the story is slightly different. Rather than adopt the European style furlough schemes which were designed to preserve jobs, the US government took the decision to avoid interfering directly in the labour market. Instead, they chose to strengthen the financial safety net for those who lost their jobs by extending the duration of unemployment benefits, expanding the number of people who could receive them and then initiating a new \$600 weekly Federal unemployment benefit to boost incomes. In consequence, the University of Chicago calculated that 69% of unemployment benefit recipients actually earned more money being unemployed than when [they were working](#). The median recipient received 134% of their previous after-tax compensation.

This has promoted a broad strengthening of the US household balance sheet with cash, checking and savings deposits increasing by \$2 trillion between 4Q 2019 and 3Q 2020 while outstanding credit card balances have fallen to a four-year low. Given the upscaled and expanded unemployment benefits and the \$1200 CARES Act stimulus payment, increases in US savings are likely to have been spread more broadly across the income spectrum versus Europe. ING's own international savings survey backs this up based on responses to who has increased savings rather than run them down.

Factors that have boosted US household incomes each month (annualised change in income versus February 2020 - USD tn)



Source: Macrobond, ING

The savings-consumption rotation during the second lockdown

Savings increased again during the second lockdown but in the eurozone, the willingness to spend has weakened, falling to the lowest level since June. This drop masks significant changes between what are basically two groups; the countries which entered a second lockdown in November like France or Belgium and the countries which entered a strict lockdown only at the end of 2020, like Germany. The former have seen a very subdued willingness to spend since the initial spike after the reopening, while the latter saw the hit to consumer confidence only recently. Overall, the willingness to spend remains low, which argues against a sharp surge in consumption once economies reopen. In fact, it looks as if involuntary savings have been replaced by precautionary savings. At the same time, however, don't forget that a reopening will boost demand for services like hospitality, leisure and culture as well, something that is not fully captured by traditional surveys.

It is also worth noting that consumption has not collapsed as much as it did during the first lockdown as both retail stores and customers have been able to adapt to new circumstances, shifting towards online shopping, and fewer planned expenditures had to be cancelled. Therefore, with the more subdued downswing, an accentuated rebound looks less likely.

Unlike Europe, the US did not enter a full second lockdown with the most onerous restrictions experienced only by Californians. Now that California's stay at home order has been rescinded and New York and other cities are again open for eat-in dining there is more opportunity to spend.

Recent data has shown that the improved financial position of US households means that when presented with a windfall payment, such as the latest \$600 stimulus cheque, consumers have the confidence to spend it. This contributed to a 5% month-on-month jump in retail sales in January with daily credit and debit card transaction data from www.tracktherecovery.org indicating that the bulk of the additional spending came from lower income households.

This is an encouraging precedent for the outlook for consumer spending since President Biden is proposing to raise the extra Federal weekly unemployment benefit back to \$400 per week after it

was tapered in 2H20 while also providing an extra \$1400 individual stimulus payment. He also has aspirations to raise the minimum wage to \$15/hour nationally, which if implemented would further boost the earning power of lower income households.

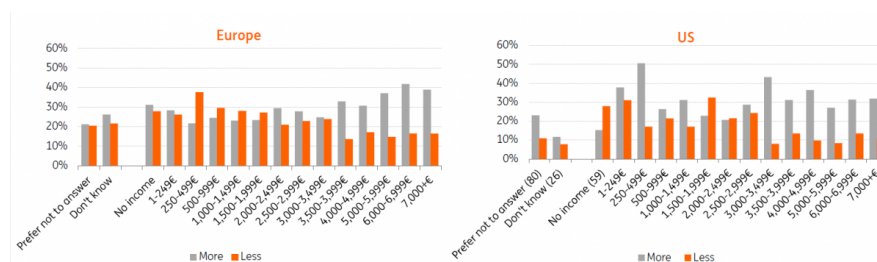
With the US Covid vaccination programme gaining momentum, there is a realistic chance of a broad economic reopening in mid to late 2Q 2020, including for consumer services, leisure and hospitality. This is potentially one to two quarters ahead of Europe. US job opportunities will therefore improve more swiftly, with surveys already suggesting that households expect jobs to become more plentiful, which could boost the chances that households use some of their accrued savings for spending over coming months. Significantly, the unemployed also have the guarantee of robust unemployment benefits to fall back on should they fail to find work.

Outlook: Pent-up demand or too elevated expectations?

Looking ahead, the key question for the economic outlook is whether the great rotation between savings and consumption in 2Q and 3Q will repeat itself or whether the latest increase in savings will be left unspent. The US and eurozone patterns differ significantly mainly due to two factors: the distribution of savings across different income categories and the sheer size of the income subsidies.

An important determinant of potential consumption is the distribution of excess savings across the different income groups. In theory, the propensity to spend is lower in high-income households than in low-income households. Against this background, the results of an ING survey give interesting insights. While in the eurozone between 30% and 40% of the higher-income households saw their savings increase during the pandemic, only around 20% of the lower-income households reported higher savings. In the US, these numbers are much more dispersed across the entire income range.

Changes in savings behaviour according to income



Source: ING International Survey

The size of the direct income subsidies has also been much larger in the US than in the eurozone. While in the eurozone even short-time work schemes mean at least a small drop in disposable income, the fact is that at least initially almost 70% of US unemployment benefit recipients earned more money due to the government support than when they were working. Additional payments of \$1200 and \$600 (with a third proposed payment of \$1400) helped further improve the financial position of millions of households.

Fiscal stimulus more targeted to the lower-income US households should lead to a stronger

boost of private consumption than the more indirect stimulus in the eurozone. Also, the second lockdown seems to have anchored fears of potential job losses in the eurozone, shifting involuntary savings to precautionary savings. This is not something we have seen in the US.

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Global Central Banks Outlook

The Federal Reserve's position of no rate hike until 2024 will be increasingly difficult to reconcile with the data, the European Central Bank will likely look through rising inflation and the Bank of England is likely to slow the pace of purchases this year



Source: Shutterstock

The outlook for central banks

European Central Bank

Higher headline inflation and bond yields combined with a disappointing start of the vaccination roll-out pose a new challenge for the ECB. However, higher inflation on the back of higher energy prices and one-off factors is not the kind of inflation the ECB has been looking for. To put a cap on bond yields, the ECB could be forced to frontload its asset purchases, engaging in a yield curve control of the GDP-weighted eurozone yield curve.

Federal Reserve

The economy has started 2021 strongly and with the vaccine program gaining momentum there is a realistic chance of a full 2Q re-opening. Strong household fundamentals, a housing boom and a vibrant manufacturing sector plus another \$1.9tn fiscal stimulus means 6%+ growth looks achievable while supply constraints makes 3%+ inflation readings likely. The Fed's position of no rate hike until 2024 will be increasingly difficult to reconcile while a QE taper looks likely late this year.

Bank of Japan

As recently as January, BoJ Governor Kuroda was mulling about letting JGB yields fluctuate in wider bands around their zero target rate. Though it doesn't seem as if the BoJ really has any appetite for the latest bond yield volatility which they actively resisted

Bank of England

Inflation is less of an issue in the UK, but recovery prospects mean the BoE appears relaxed about higher yields. We continue to doubt that negative rates will materialise later in 2022, despite policymakers asking banks to adjust systems to keep the option open.

China (PBoC)

The PBoC would not change 7D, 1Y and 5Y policy rates and RRR. It will maintain 7d market rates at 2% to 2.5% by managing daily liquidity. It can't tighten for deleveraging reform as external demand is yet to fully recovered under restrictive travels.

Bank of Canada

The BoC have tapered their weekly asset purchases from C\$5bn to C\$4bn per week, but refocused buying at the longer end of the curve. No further tapering is likely soon given recent Covid lockdowns while the BoC's guidance of a 2023 rate hike looks fair.

Reserve Bank of Australia

The RBA has kept both the cash rate and 3-yr yield target at 0.25%. 3-year yields have fallen steadily since early-Sept, requiring no additional asset purchases. A falling unemployment rate removes pressure for further incremental easing. We see no further easing this year.

Reserve Bank of New Zealand

The RNBZ is considering new tools including funding for lending (FLL), negative cash rate, and purchase of foreign assets. Of these, the FLL is likely to be ready to deploy first, and is more likely to be utilised either now or in the future compared to the other policies.

Riksbank

Inflation is not a major concern for Sweden, implying rate hikes are likely to be 2023 story at the earliest. Before then, a further QE expansion is possible if downside risks materialize, but a negative repo rate remains unlikely.

Swiss National Bank

The SNB is expected to keep rates unchanged at -0.75% and continues to use FX intervention to limit the appreciation of the franc when necessary. Fortunately, reflation is limiting FX pressure, making the SNB's task easier.

Norges Bank

NB remains something of a hawkish outlier, with rate hikes possible as early as 1H22. However like other parts of Europe, inflation prospects are likely to stay relatively benign.

Source: ING

Federal Reserve

The economy has started 2021 strongly with the \$600 stimulus payments boosting consumer spending while manufacturing and the construction sector are firing on all cylinders. With the vaccine programme gaining momentum there is a realistic chance of a full 2Q reopening.

Household balance sheets are strong with high levels of savings and low levels of credit card debt meaning consumers have cash to spend. Significantly, this isn't just for high earners, with extended and uprated unemployment benefits and stimulus cheques clearly benefiting lower income households. With another \$1400 stimulus payment heading their way as part of President Biden's \$1.9tn fiscal package, 6%+ GDP growth looks achievable this year.

However, we anticipate some supply side capacity constraints in the service sector, which when faced with vigorous demand means 3%+ inflation readings are probable. Improved corporate pricing power and a roaring housing market could also make inflation somewhat sticky.

We suspect that the Fed's position of no rate hike until 2024 will be increasingly difficult to reconcile with the data flow while expectations of quantitative easing being tapered this year are likely to grow. We would imagine the Fed would incorporate a "twist" whereby they would lower the \$120bn of monthly purchases but focus them more towards the longer end of the Treasury curve.

Bank of England

The Bank of England appears to be taking a leaf out of the Fed's book when it comes to the 50bp rise in yields we saw last month. Policymakers seem fairly relaxed so far, and in fact we think it's more likely that the pace of purchases is slowly lowered through the remainder of 2021 before the

BoE stops actively expanding its balance sheet at the end of this year. A further QE extension can't be ruled out if conditions warrant it, but it's not our base case. As for negative rates, we think this is a path the Bank is unlikely to cross, despite the operational planning steps being taken to enable the policy's usage from the autumn if needed. Several committee members remain unconvinced of the merits of negative rates, and in any case the economic outlook is unlikely to warrant a move given the improving economic outlook.

European Central Bank

Higher headline inflation and bond yields combined with a disappointing start of the vaccination rollout pose a new challenge for the ECB. The ECB's current rather benign approach to inflation will be put to the test in the coming months as inflation looks set to reach 2% in the summer months, in our view. However, higher inflation on the back of higher energy prices and one-off factors is not the kind of inflation the ECB has been looking for. Consequently, we expect the ECB to look through higher inflation, but only as long as higher bond yields do not undermine what the ECB calls "favourable financing conditions". To put a cap on bond yields, the ECB could be forced to frontload its asset purchases, engaging in a yield curve control of the GDP-weighted eurozone yield curve.

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