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Europe's recovery is cancelled

Recession is in the air, we're revising down our growth forecasts, and the European Central Bank finds itself in an ever-deepening predicament. The chaos at our airports is perhaps acting as an analogy for what's to come as cancellations mount, frustrations deepen and disappointments grow

Europe's recovery is cancelled

Carsten on the turbulence about to hit the global economy

We hear the term 'cancel culture' all the time these days. The Merriam-Webster dictionary defines it as *'the practice or tendency of engaging in a mass cancelling as a way of expressing disapproval and exerting social pressure'*. Right now, the phrase is assuming its more traditional meaning.

Look at Europe. Flights and trains are being cancelled because there aren't enough skilled workers; the industry was ill-prepared for the post-Covid summer season. High inflation is leading to 'cancellations' of consumption and increasingly also to 'cancellations' of new investments and industrial orders. As a result, the long-awaited economic recovery of the eurozone has been cancelled. The rebound of economic activity after the end of lockdowns in the hospitality, leisure and services sectors has been offset by the war in Ukraine, new supply chain frictions and high inflation. While many Europeans try to enjoy summer, a very hot economic autumn and winter period is already on the horizon. None of the current risk factors for the eurozone economy is likely to disappear soon, not least the war in Ukraine. And that will continue to pile additional pressure on energy and commodity prices, and economic sentiment.

Further afield, unless China significantly changes its zero-Covid strategy, the May lockdowns in Shanghai won't be the last to test global supply chains. And could new Covid strains bring in new restrictions as we head into the darker months? It's possible. And because of all that, we've revised downwards our growth forecasts for the eurozone and we see a recession at the turn of the year. And this is without actually predicting a full stop of Russian oil and gas.

With a looming recession but stubbornly high inflation, the European Central Bank is facing multiple dilemmas, not least the size of its first interest rate rise on 21 July. Up to now, most ECB officials have echoed the line taken at the last meeting, that the Bank 'intends' to hike rates by 25bp. It appears to be taking inspiration from the US Fed which also hiked by 'only' 25bp at the start of the recent rate lift-off. However, the euro is close to parity and there's a high risk that the ECB's own macro projections in September will show at least a stagnating economy in 2023. And that could motivate policymakers to front-load those intended hikes.

The second massive challenge is how to combine fighting inflation and hiking interest rates without destabilising bond yield spreads and risking a new euro crisis. The ECB's new anti-fragmentation tool can only work if it illustrates the ECB's willingness to be the lender of last resort in the eurozone. If financial markets start to doubt such a commitment, details on size and conditionality hardly matter anymore.

The economics of the eurozone argue against a return of the euro crisis. Public finances were more sustainable at the start of the pandemic. Governments used the long period of low and negative interest rates to roll over debt and substantially reduce interest burdens. The eurozone was hit by an external and not a country-specific shock; the European Recovery Fund provides pan-European fiscal support and the institutional set-up to deal with sovereign debt crises has also improved since 2010. Also, never underestimate the political capital which has been invested in monetary union plus the fact that with the current geopolitical uncertainty and the war in Ukraine, it is hard to see European governments consciously torpedoing the union.

However, history tells all of us to always be very cautious when economists claim that this time is *'different'*. Without a fiscal and political union, the eurozone will always be vulnerable but eventually, it will always be politics not economics deciding on the monetary union's destiny. At least the biggest project of European integration will not be cancelled this summer.

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Central banks: Our latest calls

What to expect from central banks as inflation concerns persist and recession risks rise

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Federal Reserve

Our call: 75bp in July, 50bp in September and November before switching to 25bp in December. Rate cuts from summer 2023. Quantitative tightening (QT) to continue until rate cuts begin.

Rationale: To get inflation down quickly we would ideally like to see the supply-side capacity improve to meet strong demand in the US economy. However, supply chain strains, geopolitics/energy prices, and a lack of suitable workers mean this isn't likely in the near term. Consequently, the onus is on the Fed to respond aggressively to dampen demand, but moving into restrictive territory means a rising chance of recession. Inflation could fall quickly from early next year, opening the door to rate cuts from summer 2023.

Risk to our call: Two-way. On the one hand, the tight labour market continues with rising wages making inflation stickier at high levels. Conversely, the economy reacts badly to rate hikes (the housing market is vulnerable) and recession prompts a lower peak and a more rapid reversal in Fed policy.

European Central Bank (ECB)

Our call: Rate hikes totalling 100bp before the end of the year.

Rationale: Stubbornly high inflation and longer-term inflation projections above the 2% target have made a first rate hike overdue. Still, the very gradual (read: slow) approach to normalising when other central banks have acted more aggressively suggests a still-divided ECB. Support within the ECB to end net asset purchases and the era of negative interest rates is strong but views on the timing and pace still differ. With a high risk of

the eurozone and US economy falling into technical recession towards the end of the year and inflation coming down in 2023, there will be hardly any room for the ECB to deliver additional hikes in 2023.

Risk to our call: A faster and more severe recession could push the ECB to stop normalising after 75bp and could even trigger cuts in early 2023. On the other hand, positive growth surprises and few signs of inflation weakening could motivate the ECB to hike more aggressively this year and bring the refi rate to 2% in 2023.

Bank of England

Our call: 50bp rate hike in August, 25bp in September before a pause.

Rationale: It's a very close call on August's meeting, and in isolation, there's not much in the latest data to suggest the Bank needs to move more aggressively. Core inflation looks like it is at, or close to, a peak (even if the headline will go to 11% in October), while unemployment has stopped falling. But the hawks are clearly worried about recent weakness in sterling, and the prospect of another 75bp Fed hike coupled with the fact that a 50bp rate hike is virtually priced in for August, means we narrowly think that's the most likely outcome. Still, a 50bp hike – if it happens – is likely to be a one-off. We're not far from what's arguably neutral interest rate territory now (probably around 2%), and the Bank loses one of its biggest hawks after August, who will be replaced by a more dovish official. We still doubt the Bank rate will go as high as 3% or above, as markets are still pricing.

Risk to our call: If the Fed hikes even more aggressively, or if core inflation moves unexpectedly higher in the coming months, then we could see more than one 50bp hike and a higher terminal rate.

Bank of Japan

Our call: Bank of Japan will maintain an accommodative policy stance.

Rationale: CPI will stay above 2% until the end of 2022, but the BoJ will downplay it as cost-push-driven inflation that will prove temporary. Market expectations of possible policy changes (at least broadening the long-end yield target) are still alive but are not going to materialise easily for a while.

Risk to our call: If signs of wage growth are detected and the sharp yen weakening continues over 135, then the bank could reconsider its policy stance, but that will become more likely when Governor Haruhiko Kuroda retires next April.

Fears of another eurozone crisis are overblown

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Despite a challenging outlook for the eurozone, the prospect of another debt crisis seems unlikely. There are few signs of economic divergence, debt levels are sustainable and support for the monetary union has increased significantly in recent years. Still, speculation about a crisis can be a self-fulfilling prophesy and much will depend on politics

These are worrying times for the European Central Bank President, Christine Lagarde

The de facto pre-announced European Central Bank rate hikes, the end of net asset purchases and a looming recession have led to widening spreads in the eurozone, pushing borrowing costs in some countries to their highest levels in almost 10 years. Widening spreads and high borrowing costs for governments have brought back fears of a new euro crisis. While the current economics argue against this, there is still a risk that political events could push the eurozone back into an existential crisis. The monetary union has always been a project where politics dominates economics.

The reason for this new concern over another euro crisis is clear: the ECB's announcement of normalising monetary policy; ie the end of negative interest rates, a potential further series of policy rate hikes and the end of net asset purchases. Remember that Southern European bond yields benefited relatively more from the flow of asset purchases, while Northern European bond yields benefited from the stock effect. With the ECB's dwindling support, Southern European bond yields have already started to increase. While some spread widening is normal in times of rising interest rates, there is a risk that markets start to doubt the ECB's commitment to be the lender of last resort in the eurozone, especially if more indebted countries face debt sustainability issues in the wake of rising rates. In other words, markets may question how the ECB can combine Mario Draghi's 'whatever it takes' promise with raising interest rates and going cold turkey on net bond buying.

The ECB's dilemma of hiking rates without creating bond market turmoil

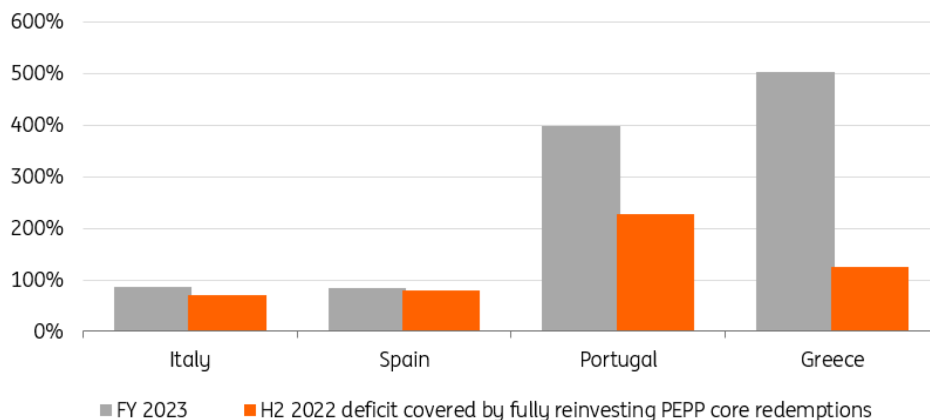
The ECB's answer to the dilemma of hiking interest rates while at the same time ensuring that spreads remain contained is twofold. Reinvestments from the central

bank's Pandemic Emergency Purchase Programme will be conducted flexibly, and the ECB is preparing a so-called anti-fragmentation tool.

Regarding PEPP reinvestments, the ECB's current plan seems to imply that it will use the proceeds from maturing bonds from what the ECB perceives as strong countries to buy bonds of the weaker countries. A third group of countries, "the neutrals", would act as a buffer if the proceeds from maturing bonds from strong countries do not suffice to quell the tensions in the bond market. All of this means that, for example, maturing German bonds can be reinvested in Italian bonds. We doubt that the German Bundesbank will really be happy to swap German bonds for Italian bonds. But more fundamentally, there will be questions as to whether this flexibility can be applied legally for the whole reinvestment period, or whether this is just a temporary measure. This would essentially mean that during the reinvestment period, the capital key would no longer be respected.

Italy has roughly €200bn of bonds maturing each year and over €100bn of bills. While daunting, we're ready to assume that, on aggregate, existing holders of peripheral bonds will roll their maturing bonds into new ones, as the ECB will do. The more pressing issue is who will buy the new issuance to finance government deficits. According to the European Commission's latest forecast, Italy's general government deficit will amount to €100bn this year, going down to €85bn next year. The majority will be financed by bond issuance, raising the question of what investor class will be willing to increase its exposure to peripheral bonds.

Full reinvestment of core redemptions into peripheral bonds would cover near term deficits



Source: Refinitiv Datastream, ING

A change in the PEPP redemption policy would go some way towards bridging that gap. Bloomberg reported that €12bn of the €17bn average monthly PEPP redemptions are in core countries, and thus available to invest in the periphery. At full capacity, and splitting this amount between Italy, Spain, Portugal, and Greece according to the ECB capital key, they could cover 70% of Italy's financing needs in the second half of 2022, and 86% in full-year 2023. Of course, these amounts are unlikely to be reinvested in their entirety into peripheral bonds, but this goes to show that at full speed, reinvestments could deliver sizeable help in financing new debt issuance. On the other hand, they are wholly insufficient to offset a run on these bond markets should existing investors decide to sell out of their holdings, or decide not to roll maturing bonds into new ones.

Regarding an anti-fragmentation tool, the ECB's mid-June announcement to speed up the ongoing work suggests that details should be presented soon. This anti-fragmentation tool has led financial markets to infer that the ECB will do "whatever it takes". But this is not necessarily what the ECB will deliver. In fact, at the start of the euro crisis, the ECB was concerned about widening spreads and disrupted monetary

policy transmission. Back then, the ECB introduced the Securities Markets Programme (SMP) - a tool allowing the ECB to purchase government bonds. But these purchases were sterilised. The programme only included very light conditionality as it came in reaction to national governments announcing certain reforms. However, when the euro crisis accelerated, the SMP turned out to be too ineffective, which prompted ECB President Mario Draghi to announce his famous 'whatever it takes' pledge, and the ECB to later formalise this in the so-called Outright Monetary Transactions (OMT). OMT was linked to strict conditionality, like a rescue or even bailout package from the European Stability Mechanism (ESM). The OMT was never used as the announcement itself turned out to be sufficient to bring spreads back to more sustainable levels.

Two main challenges for the anti-fragmentation tool

Applying the historical lessons to the current debate, the ECB is facing at least two main challenges in developing its new anti-fragmentation tool: how to determine a fundamentally 'warranted' spread between countries and how conditionality should be defined.

One option to define 'fundamentally warranted' spreads could be to refer to the official EU convergence criteria. Here, a spread of 200bp vis-à-vis the average bond yield of the three countries with the lowest inflation rate is a requirement to become a member of the monetary union. Bear in mind that this is not the same as the spread with Germany, as Germany is not necessarily one of the three countries with the lowest inflation rate. However, media reports on the anti-fragmentation tool signalled that the assessment of widening spreads was gauged against German bonds, which are the de facto benchmark for the eurozone.

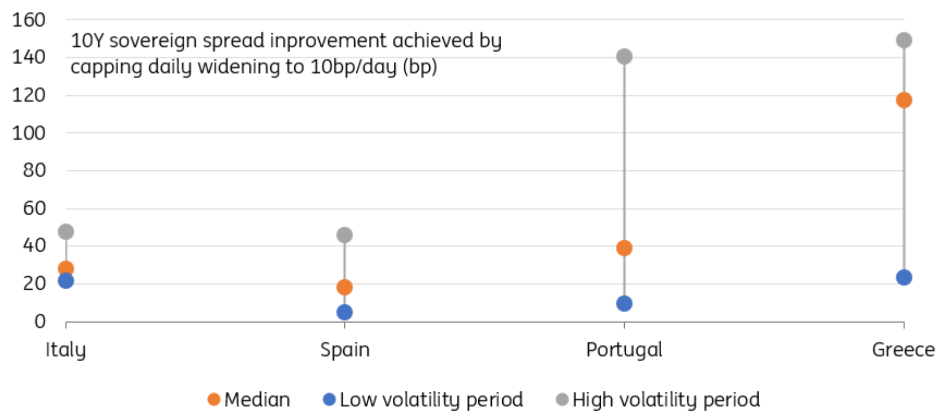
In practice, we see that the ECB decided to intervene when Italian-German spreads approached 250bp. Of course, the speed of the increase in spreads will have played a role as the ECB seems to want to stay ahead of another debt sustainability crisis, but somewhere between 200 and 250bp could be a trigger point for the ECB.

Between the (voluntary or not) leaks and public comments made by governing council members, we gather that the ECB wants to avoid making public its intervention rules. In that regard, setting firm spread targets, whether public or not, can be problematic. Instead, the focus seems to be on the speed of the widening, rather than the level of spreads. The effect would be to reduce volatility in sovereign spreads, but not to impose a hard cap. In the likely event that the buying capacity of this new instrument is limited, this is probably the best that can be achieved anyway.

Without knowing its exact buying capacity, it is difficult to say whether the new instrument would be able to prevent a full-blown run on peripheral debt. We suspect it wouldn't, but this may not be necessary. Flexible PEPP reinvestments could take care of some of the periphery's net financing needs (see above), while the new fragmentation instrument has the more important task of drawing private investors back into the peripheral bond market. Think of QE as crowding out private investors. The new instrument needs to crowd them in.

As the ECB reduces its exposure as a percentage of the amount of debt available (since it grows each year with government deficits), marginal buyers are likely to be mostly yield-sensitive investors. This means that wider spreads are part of the solution for them to grow their exposure, rather than part of the problem. This is why hard spread caps would be detrimental to the ultimate goal of restoring the market functioning, in addition to being very difficult to achieve.

By reducing volatility, the ECB would make investors more likely to accept lower spreads



Source: Refinitiv Datastream, ING

Where the ECB's new instrument has a role to play, in our view, is in reducing the realised volatility in peripheral spreads. Investors compare their returns to potential risk. An investor who knows that the risk of buying peripheral bonds has been reduced by the ECB would, in theory, expect lower yields and tighter spreads.

Regarding conditionality, an ESM bailout or even a lighter rescue package still seems to come with too much stigma for most Southern European countries. Alternatively, the ECB could try to link its anti-fragmentation tool to the national reform programmes and whether or not countries have met the criteria to be eligible for funds from the European Recovery Fund. However, such conditionality would be finite as the European Recovery Fund is not a permanent institution. Alternatively, the ECB could link any bond purchases to a country's compliance with the Stability and Growth Pact. However, the ECB can hardly do this as long as the escape clause is active, i.e. there is no excessive deficit procedure triggered for breaching the 3% of GDP deficit threshold. This basically means that it could only apply to the 2024 budget at the earliest, when the Stability and Growth Pact rules come back into effect. To further complicate things, we shouldn't forget that an exercise is underway to reform the Stability and Growth Pact, and there has actually never been a procedure against countries breaching the 60% of GDP debt threshold. Conditionality on the European semester recommendations would be a relatively light solution that is not time-limited like the European Recovery Fund reforms.

Sterilising any bond purchases would make conditionality a less pressing issue but the experience with the SMP is that sterilised purchases are not powerful enough to really fend off a speculative attack.

We expect the ECB to present some initial guidelines on an anti-fragmentation tool at the 21 July meeting. There will be a trade-off: the more rate hikes the ECB plans to implement in the coming months, the weaker the conditionality of such a tool.

The everlasting topic of lender of last resort

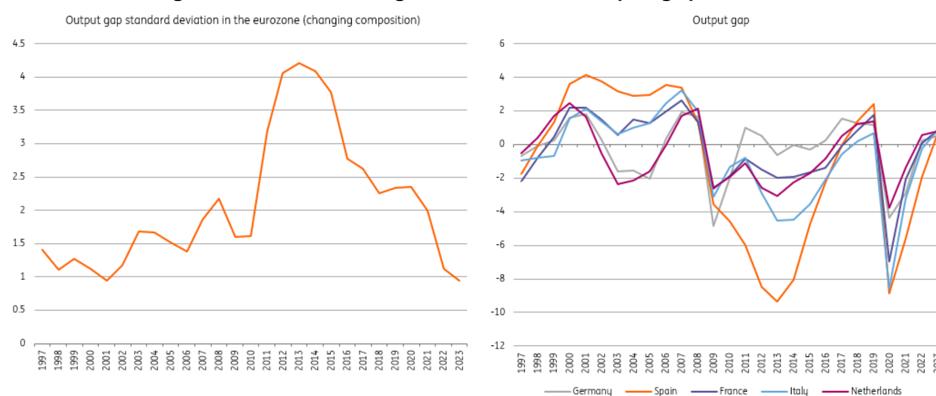
The entire discussion on an anti-fragmentation tool actually focuses on the question of the eurozone's lender of last resort. The absence of such a role and the no-bailout clause was actually a crucial element for the founders of the monetary union who hoped that this arrangement would enforce sufficient discipline on countries and governments to use structural reforms as the main adjustment tool. The euro crisis between 2010 and 2012 illustrated the flaws of this concept. In the end, there were bailouts and the ECB took over the role of lender of last resort, with Mario Draghi's 'whatever it takes' speech. The discussion on the new anti-fragmentation tool of the ECB should not blur the broader debate: who will take over the role of lender of last resort and could the monetary union survive without it?

Why this is not the return of the euro crisis

External shock vs country-specific shock

The euro crisis in 2010 started with a common shock - the financial crisis, but soon developed into country-specific shocks. Convergence in the eurozone went into reverse as housing markets imploded in many peripheral countries, leading to divergence both economically and in public finances. At the current juncture, eurozone countries are facing two exogenous shocks and at least one core eurozone country is actually being hit relatively more severely than other countries. There are very few signs of economic divergence.

Economic divergence is small as large countries see output gaps move in tandem



Forecasts are from the European Commission AMECO database
Source: European Commission AMECO database, ING Research calculations

Debt sustainability

Even if economic divergence seems less of an issue now than at the time of the euro crisis, at face value, the public finance picture is less reassuring. The Covid-19 shock, while symmetric in nature, had a nonhomogeneous impact on economic activity in member countries, hitting some countries more heavily than others because of their economic structure and response to the crisis. Southern European countries recorded sharper increases in their deficits and debt compared to most of their core peers. However, unlike a decade ago, structural public accounts remained solid throughout the crisis, with the extra expenditure incurred to limit the shock to the economy being mostly temporary in nature. The political response in the most exposed countries such as Italy and Greece was for a relatively quick return to primary surpluses, telling us that times are different.

Having said that, the prospect of an accelerated normalisation in the ECB's monetary policy has reawakened old ghosts, putting renewed pressure on spreads and bringing back to the fore doubts about debt sustainability.

For countries burdened by high public debt, sustainability remains an issue, but not one that is currently ringing alarm bells.

In the short run, the combination of long average maturities of debt, decent growth and high unanticipated inflation are all helping to counteract the incremental impact on debt coming from the sharp increase in government interest rates and from residual primary deficits, even in the most indebted countries.

Longer-term, as higher interest rates apply to a growing share of debt and unanticipated inflation is re-absorbed, decelerating real GDP growth would cause debt to snowball again, and primary surpluses would be required to secure a downward trajectory in the debt/GDP ratios. Interestingly, with non-extreme interest rate levels, and decent, but unspectacular growth, the required primary surpluses would be at levels

which have already proven to be politically bearable in the recent past. Needless to say, improving long-term real economic growth would be crucial for debt sustainability in the years ahead. This is why the European Recovery and Resilience facility was created, with an allocation of funds more generous for Southern European countries. The battle for debt sustainability will be won more convincingly if the combination of reform and investment, upon which the disbursement of the EU Recovery Fund is conditional, is properly implemented. The six-year time span covered by the plan, for once, provides a comforting medium-term view.

Support for the monetary union has increased significantly in recent years

Another factor which reduces the chances of another debt crisis is that societal support for the euro has increased steadily over recent years. Concerns about the monetary union were widespread during the euro crisis and while scepticism remains widespread, a quiet majority has become happier with it. In Belgium, 85% of respondents are now positive about the euro, while in Italy, more than 70% of those surveyed are positive.

This also translates to politics where the large eurosceptic wave in elections has failed to materialise. While eurosceptic parties still hold a large number of seats in parliaments across the continent and in Brussels, they have not risen to power. Importantly, a pure euro exit platform has mostly been shunned by parties trying to win elections, as this seems to be an unpopular policy among the electorate.

The significant steps taken by politicians and the ECB to fight the coronavirus crisis are a sign that policymakers are more comfortable in acting swiftly in times of crisis. However, if any anti-fragmentation tool comes with strict conditions attached, eurosceptic parties could quickly gain momentum again.

In the end, it's all about politics, stupid

A better institutional set-up, pan-eurozone financial support and relatively healthier public finances at the start of the pandemic have kept the risk of a new euro crisis relatively low. Despite recent memories of widening bond yield spreads in 2010-2012, the risk of a further escalation looks manageable. However, past experience shows that market speculation can quickly turn into a full-blown crisis and liquidity problems can quickly turn into solvency issues. Worryingly, at the current juncture, the ECB is no longer fighting deflation but inflation. This cannot be done successfully without creating new tension in the bond markets. Therefore, the question of who is the lender of last resort in the eurozone needs to be answered quickly and convincingly. And it is the politicians who must decide. As always, the fate of the monetary union lies in their hands.

Debt sustainability issues, once again

The rise in bond spreads in most eurozone countries could be a problem. Nevertheless, the long period of extremely low interest rates and the very gradual rollover of public debt give governments some leeway, even if spreads rise further. That said, any reduction in economic growth would diminish this buffer

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Bond yields and spreads on the rise

The dramatic adjustment in interest rates over the last few months has many implications. One of the most serious of these is the issue of debt sustainability in highly indebted countries, as the steep rise in yields together with other key geopolitical factors threaten to push the eurozone economy into stagflation, or even recession.

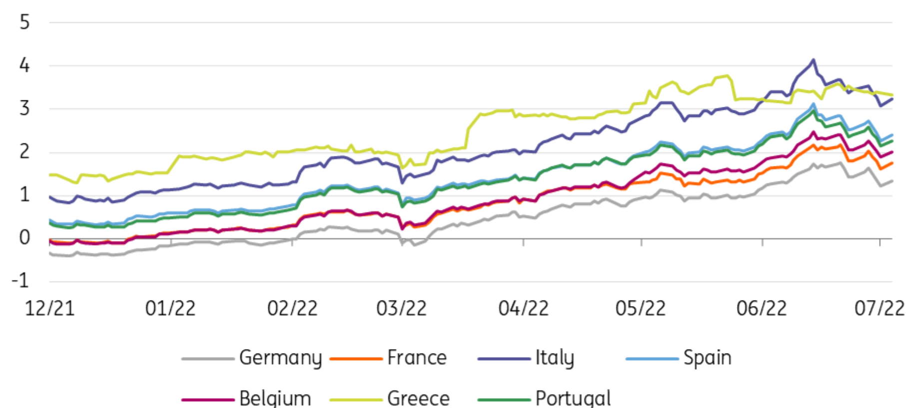
The rise in inflation, which started in 2021, has been exacerbated by the war in Ukraine, with price increases extending well beyond the energy domain. The European Central Bank's decision to accelerate its normalisation path by stopping net purchases in all of its programmes and by raising interest rates has induced a sharp increase in government debt rates, particularly in heavily indebted countries.

Since early December, the 10-year Bund yield has increased a whopping 190bp, with Italian BTPs rising some 265bp. The spread currently hovers at around 200bp. The ECB's decision to accelerate the end of net purchases under its Asset Purchase Programme has put pressure on spreads of highly indebted countries. Gone are the days of the ECB fully funding the deficits, as seen over the pandemic. However, the temporary reinvestment of bond holdings maturing under the APP, and the flexible reinvestment of maturing bonds under the Pandemic Emergency Purchase Programme will clearly help the transition towards private funding.

A widening of spreads in a rising rates environment is not surprising: as core rates rise, government bond investors may decide to switch out of peripheral bonds into German Bunds to get the same return with a better credit profile. At the current time, the widening in Italian spreads seems to be consistent with the post-sovereign debt crisis norm, while Spanish and, more markedly, Portuguese bonds are widening less than the historic statistical relationship would suggest.

The sharp increase in interest rates and the declining support from the ECB have re-awakened dormant concerns about debt sustainability, particularly for highly indebted countries. Are these concerns justified? In order to answer this question, we have made some simple public debt simulations for a selection of eurozone countries, trying to single out those more exposed to the sustainability risk under different spread assumptions, starting from our base case forecast. As a sustainability benchmark, we look at the ability of the debt-to-GDP ratio to fall or at least stabilise over time.

Bond yields have dramatically increased since the turn of the year
Reference yield in % for some eurozone countries



Source: Refinitiv Datastream

Short-run and medium-long run sustainability

A common feature of the countries examined is a relatively high weighted-average maturity of the debt, ranging from 7.1 years for Italy and Germany to 18.2 years for Greece, the latter reflecting the dominant role of ultra-long official loans in Greek debt. A relatively long average maturity is a key factor in favour of debt sustainability. The longer the average maturity, the longer it will take for an interest rate shock to affect the whole stock of the debt and, as a consequence, the average cost of debt.

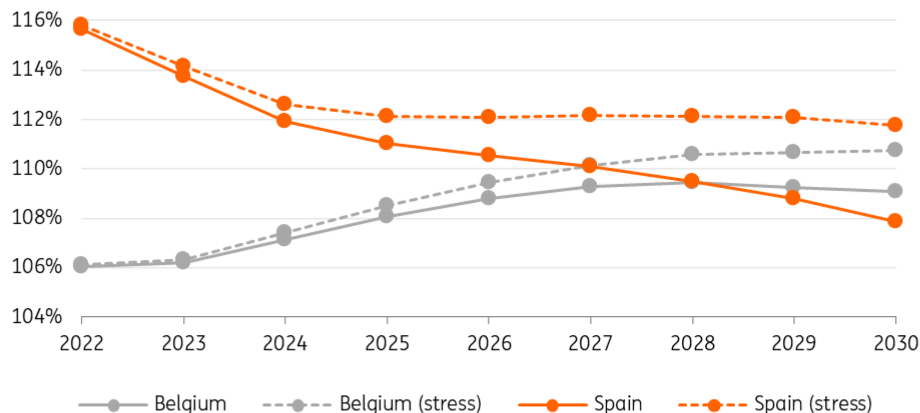
The other factor temporarily helping to secure debt sustainability in the short term is inflation, so long as the market underestimates the outlook for price growth. Inflation (in as far as it is also reflected in the GDP deflator) acts both via the fiscal drag and through the so-called inflation tax, which reduces the real value of non-indexed debt. Even though governments are spending more to help households and businesses withstand skyrocketing energy bills, higher tax revenues as a result of higher inflation, at least in the short run, outweigh the increased interest rate cost incurred to roll over maturing debt, improving public accounts.

Some buffer

The simulations we run, assuming persistent interest rate shocks, show that because the average maturity of debt is so long, the debt profile is not particularly worrying even under unspectacular projected growth profiles. Indeed, in our baseline scenario with moderate trend growth, inflation close to the ECB's medium-term target, non-zero but moderate bond spreads and fiscal efforts to reduce primary public finance deficits, no country is on a dangerous public finance path. To test the resilience of these trajectories, we simulate a doubling of bond spreads compared to our baseline scenario. In the medium term, this means a spread of 300bp for Italy and Greece, 160bp for Spain and Portugal, 90bp for Belgium and 80bp for France. In the short term (2022), spreads are set even higher. All other things being equal, such a doubling would represent an additional €420 billion interest burden for the euro area between 2022 and 2030. This being the case, the trajectory of the debt ratio for the euro area as a whole would remain on a downward path. However, this encompasses very different situations. Italy, Spain and

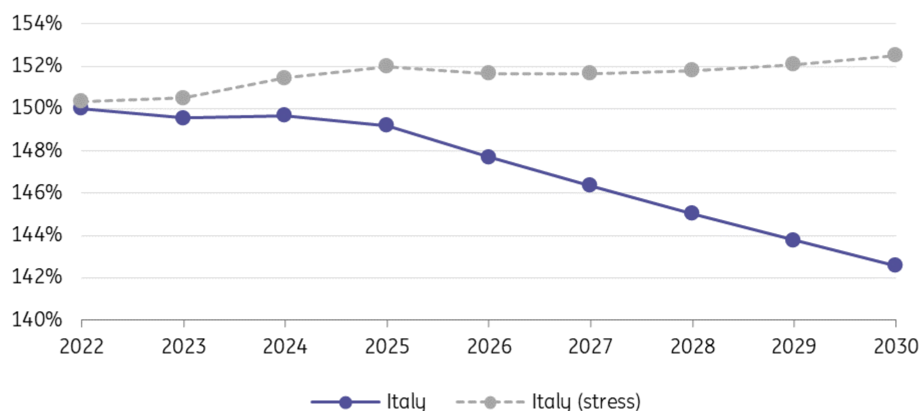
Belgium would no longer be able to reduce their debt ratio (see charts below). A snowball effect would also be observed at the end of the period in Italy and Belgium. The other countries would maintain a downward trajectory in their debt ratios.

Impact of a doubling of bond spreads on public debt trajectory
Belgium and Spain



Source: ING

Impact of a doubling of bond spreads on public debt trajectory
Italy



Source: ING

Growth is crucial

For highly indebted countries like Italy, getting the debt-to-GDP ratio onto a downward path over the medium term would require a return to stable primary surpluses. As time passes, the interest rate shock would gradually apply to a greater share of the existing debt, pushing up the average implicit interest rate. When the existing debt gets bigger than nominal GDP growth, the so-called "snowball effect" starts to kick in on the debt/GDP ratio, requiring some compensation in the form of a primary surplus.

Reducing the primary deficit and maintaining sufficient growth is therefore essential for the stability of public finances. For example, cutting economic growth by one percentage point each year over the forecast horizon relative to the baseline scenario would have a snowball effect in France, Belgium, Italy and Spain, even if one assumes that the primary deficit as a percentage of GDP does not deteriorate relative to the initial path.

Unsurprisingly, current medium-term fiscal planning documents in highly indebted countries such as Italy and Greece already foresee a return to primary surpluses over the next three years. The level of primary surplus required will depend crucially on how effectively countries can shift to a faster growth path on a sustainable basis. How

countries use the Recovery and Resilience Facility, with its blend of expenditure and reform, will play a key role here.

When examining the vulnerabilities to the sustainability risk we cannot ignore the fact that investor behaviour could bring about market fragmentation, even in the absence of relevant changes in fundamental macro drivers. The recent episode in which the BTP-Bund spread rapidly widened to the 250bp area is a case in point, inducing the ECB to call an emergency meeting to announce anti-fragmentation measures.

3 calls for the US economy as it heads toward recession

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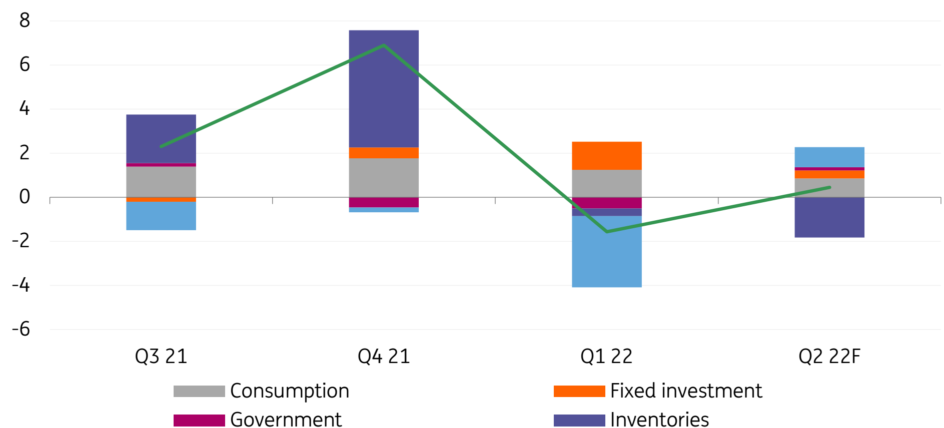
The Federal Reserve has made it clear it is prepared to sacrifice growth in order to get a grip on inflation via higher interest rates. We see the clear risks of retrenchment in consumer spending, fuelling recession fears

With consumer spending down, the risk of a technical recession is rising

1 Recession is technically possible, but it will feel more real at year-end

The US economy contracted 1.6% in the first quarter of 2022 due primarily to a massive trade deficit as strong domestic demand sucked in imports, but Covid constraints and port disruption elsewhere limited export growth. Unfortunately, the latest revisions also show consumer spending was not as strong as we were initially led to believe, while monthly data suggests that momentum weakened further in the second quarter as confidence faltered due to the rising cost of living and the threat of higher interest rates. With inventories being run down once again, we can't rule out the possibility that our tepid 0.4% quarter-on-quarter annualised second-quarter growth forecast ends up becoming a second consecutive negative GDP print. This would meet the technical definition of recession.

Contributions to US GDP growth



3Q 2021-1Q 2022 with ING's 2Q 2022 forecast
Source: Macrobond, ING

However, we doubt that the National Bureau of Economic Research's Business Cycle Dating Committee would list this as an official recession given the economy is still experiencing rising consumer and business spending and falling unemployment. However, we suspect this will only be a temporary reprieve with a strong chance of broad-based economic weakness in late 2022/early 2023.

With confidence already looking weak and the housing market showing clear signs of faltering as a lack of affordability and rising mortgage rates weaken demand, we are nervous that consumers will soon stop relying on accumulated savings to maintain their lifestyles through the current cost of living crisis. Moreover, the Federal Reserve has made it clear it is prepared to sacrifice growth as it desperately tries to get a grip on inflation via higher interest rates. This is also contributing to the strongest dollar in 20 years, which will hurt international competitiveness. In this environment, we see the clear risks of retrenchment in consumer spending while falling corporate profitability means businesses start to hunker down.

2 Inflation to fall back to 2% by end-2023

Inflation is at 40-year highs and is likely to remain at extremely elevated levels for the next six months due to high energy costs, rising food prices, and an ongoing strong contribution from housing costs tied to rising rents and home prices.

However, we are increasingly convinced that inflation will fall sharply through 2023. If the housing market slows rapidly this can translate into a sharpy reduced contribution from shelter within CPI (35% of the basket). Second-hand cars have also been a major factor contributing to elevated inflation this year, having risen more than 50% since February 2020, but if the availability of new cars improves this could lead to a collapse in prices for second-hand vehicles. Given its chunky weighting within CPI of more than 4%, this too can help get overall inflation sharply lower.

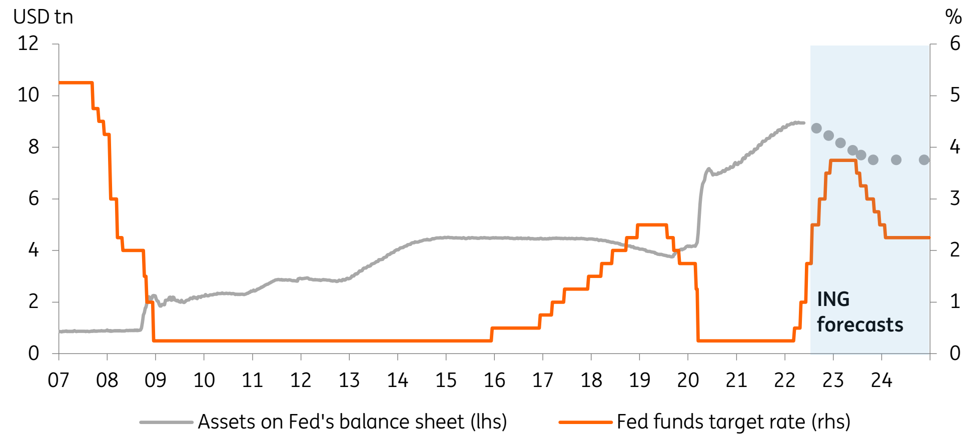
Higher interest rates will also take more of the steam out of the economy and weaken corporate pricing power, potentially even leading to some profit margin compression. Then, if we can get some relief from the supply side of the economy, and if energy prices top out and potentially even fall in 2023, this can build a strong case for 2% inflation before the end of 2023.

3 Rate cuts to be on the Fed's agenda for summer 2023

We look for the Federal Reserve to follow up June's 75bp rate hike with another 75bp move in July before switching to 50bp moves in September and November with a final 25bp hike pencilled in for December. This would leave the Fed funds rate range at 3.5-3.75%, which we think will mark the peak given our growth and inflation forecasts.

With the Fed having acknowledged the risk of recession from its moves to get a grip on inflation, it will require the central bank to be convinced that inflation is heading back towards 2% before it will seriously contemplate loosening policy.

ING's Fed funds rate forecasts (ceiling of range %)



Source: Macrobond, ING

However, as already suggested, we think that inflation has the potential to fall very sharply from 2Q23 onwards. This could open the door to rate cuts as early as summer 2023 with history showing that over the last 50 years the Fed has cut rates on average just six months after the last rate hike in a cycle. We expect the last rate hike to be in December this year and that would suggest a June 2023 timeline for the Fed moving from a “restrictive” monetary policy toward a more “neutral" one.

3 calls for the eurozone as concerns rapidly mount

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The threat of recession amid persistently high inflation is contributing to growing angst for policymakers across Europe

European leaders appear to have their backs against the wall, figuratively and literally, as problems mount

1 A recession in the eurozone

While you can argue about the precise definition of a recession, we now pencil in two consecutive quarters of negative growth, starting in the second half of 2022. The uncertainty of the Ukraine war and falling real income growth are likely to take their toll on the consumer. On top of that, the energy shock is not going to abate in the coming months, on the contrary. While oil prices are not expected to decline, natural gas prices might actually still climb higher in the winter months as reduced supply will keep the market very tight. That will further sap purchasing power and could also lead to some (temporary) closures of energy-intensive production sites. Meanwhile, the strong inventory build-up in recent months could give way to an inventory correction in the second half of the year. Finally, let's not forget that Covid-19 has not disappeared and is likely to add to the disturbances in winter.

2 ECB hikes by 100bp and then stops

With stubbornly high inflation and longer-term inflation forecasts above 2%, the European Central Bank has clearly fallen behind the curve. The very gradual process of normalising monetary policy looks increasingly misplaced. This is why we expect the ECB to step up the pace of hiking interest rates, bringing the refi rate to 1% before the end of the year. The looming recession, not only in the eurozone but also in the US, along with doubts about debt sustainability in the eurozone should prevent the ECB from going beyond the initial normalisation, keeping rates on hold in 2023.

3 Fiscal policy debate at full swing

We expect the European Commission to present its proposals on how to reform the eurozone's fiscal rules after the summer. With the ECB's anti-fragmentation tool, widening bond yield spreads and fears of a new euro crisis, the discussion of fiscal rules and debt sustainability will gain unexpected momentum towards the end of the year. Eventually, we expect this debate to lead to more powers and responsibilities but also more discretionary authority for the European Commission. A currently unused tool is

the so-called Excessive Deficit Procedure on government debt. Up to now, this procedure was never started as it would practically put countries under endless fiscal surveillance. We expect the debate to not only lead to a stronger role for the European Commission but also to give more emphasis on expenditure and debt reduction.

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3 calls for China as its economic recovery slowly begins

With the Chinese economy starting to recover with the easing of strict Covid-19 measures, the government is looking to boost infrastructure investment to achieve its 5.5% GDP growth target for 2022

China's economy is slowly recovering after Covid-related lockdowns are eased

1 The Chinese economy starts to recover

The duration of quarantine in China has been shortened, and the frequency of Covid-19 testing now depends on the risk level assessed for each location. As a result, fixed frequency Covid testing has been replaced by a more flexible arrangement. These new arrangements provide room for retail sales growth during the school holidays. We expect that there will be more cross-city and cross-province leisure trips.

Factories will benefit less than retail sales as 70% of factories were in operation even during the lockdowns as they could operate in closed-loop environments. So, the marginal gain from easing Covid measures for manufacturers should be smaller. Port operations are normalising; they are less congested and freight rates should fall from here. This should reduce delivery times and logistic costs for trade.

Consequently, we do not expect the People's Bank of China to cut policy rates further. The yuan could face appreciation pressure in the short term.

2 Infrastructure investment is needed if the government wants to achieve its growth target

The government has reiterated that it can achieve the 5.5% GDP target set for this year. This will be challenging even though the economy has started to recover. We believe the government will try to boost infrastructure investment to achieve its target, which will then turn into construction activity and create more jobs. But the government needs to act fast otherwise construction activity will start too late to support economic growth for this year.

Within infrastructure, we should see both traditional infrastructure projects, such as transportation networks, as well as new infrastructure, for instance, completing 5G coverage, and building green energy.

There are also other fiscal stimuli. Some cities have provided subsidies for households to upgrade their cars to electric vehicles and other consumer electronic products. This not only supports consumption but also creates jobs if business sales recover. The main idea of fiscal stimulus is to help sales of the private sector so that it can create more jobs and will then increase consumption, and therefore sales, to form a virtuous cycle.

3 Future Covid outbreaks cannot be ruled out

The market has been buoyed by the positive news that China has started to recover after the long lockdowns. But the risk of future lockdowns still exists. If China experiences a jump in Covid cases in key cities, like Beijing, Shanghai or Shenzhen, lockdowns would still be likely. And even though lockdowns in the future should be shorter, they would still hurt economic growth. Under such situations, monetary policy could be eased again.

3 calls for the UK as political uncertainty deepens

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The recent spike in gas prices for next winter doesn't bode well for the UK economy, which otherwise is benefiting from a tight jobs market and high savings levels. The risk of a technical recession later this year is rising, reducing the need for much additional tightening from the Bank of England. It comes as Boris Johnson resigns as British Prime Minister

The British Prime Minister, Boris Johnson, is resigning after a series of scandals

1 UK economy to flirt with recession over winter

The British Prime Minister, Boris Johnson, isn't the only one facing a crisis of confidence; so's the average British consumer. As it's announced the PM is resigning, a glance at the latest confidence numbers, which hit another all-time low last month, would ordinarily suggest a recession is inevitable. So, too, would the fact that real household incomes are set to fall by roughly 2% this year, despite fresh government support in recent weeks. However, the economy is likely to avoid a technical recession this summer.

That's partly because of an extra bank holiday last month, which will artificially boost third-quarter GDP growth. But more importantly, the jobs market remains tight.

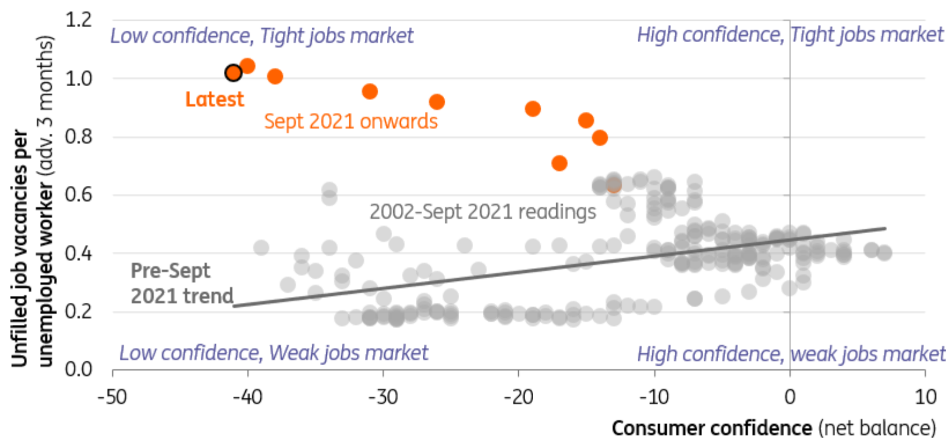
While this is undeniably a lagging indicator of economic performance, the fact that there's one job vacancy for every unemployed worker looks to be increasingly linked to structural causes. Lower inward EU migration and elevated long-term sickness rates have prompted a stark drop in participation. Hiring demand appears to have peaked, but there's a strong incentive for firms to keep staff on board even if margins are squeezed, given rehiring challenges.

If unemployment stays low, or only rises modestly, we suspect there will be a limit to how bad the consumer spending story can get for the time being. The chart below shows that it's highly unusual to see such low confidence with such a tight jobs market. High household savings levels and scope for credit card borrowing to increase may also offer scope for consumers to partially smooth the income shock.

But the story is likely to get more challenging as we head into winter. The December UK natural gas contract has hit an all-time high in recent days, reaching almost 450 pence/therm, up from 250 only a matter of weeks ago and above the 400 level reached in March. That makes it more likely that the Ofgem consumer energy price cap stays flat

or even goes slightly higher in the new year, even after the 55-60% increase we're now forecasting in October. If sustained, these high price levels also mean we could see more widespread demand destruction in heavy industry and much greater pressure on corporate margins generally. Like in the eurozone, there's a clear risk of a technical recession over winter.

Low consumer confidence with a tight jobs market is very unusual



Source: Macrobond, ING

2 Inflation to peak at 11% in October but fall back considerably in 2023

This latest rise in gas prices, coupled with the prospect of 15-20% food inflation, means headline CPI is likely to hit 11% in October. By that point, energy alone will be contributing over five percentage points, and food almost two. But some other recent sources of price pressures appear to be cooling and in fact core inflation - currently around 6% - may be roughly at its peak.

Like in the US, headline inflation is likely to drop like a stone in 2023 - especially beyond April, the one-year anniversary of the first huge electricity price increase. By the end of next year, both food and energy are likely to be a slight drag on inflation and we think headline CPI can still fall a little below target - crazy as that currently sounds.

3 Bank of England set to underdeliver on market hike expectations

Mounting recession fears have already seen markets pare back expectations for Bank Rate next year, with the peak now seen in the 2.9% area, down from over 3.5%. That's arguably still too high, though in the short-term we think the combination of a weaker pound and aggressive Fed action will lead the committee to hike by 50 basis points in August. That would take us into what's arguably neutral interest rate territory (probably around 2%), potentially negating the need for further 50bp moves. We expect rates to peak at around 2%.

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3 calls for Asia as inflation begins to fall

We believe that inflation will dip in the second half of this year across Asia, helped by declining food prices. There will be a catch-up period for those central banks which have tried to 'buy' growth with low interest rates

The last month has seen palm oil prices tumble from recent highs

1 Bank of Japan will stick to its yield curve control policy

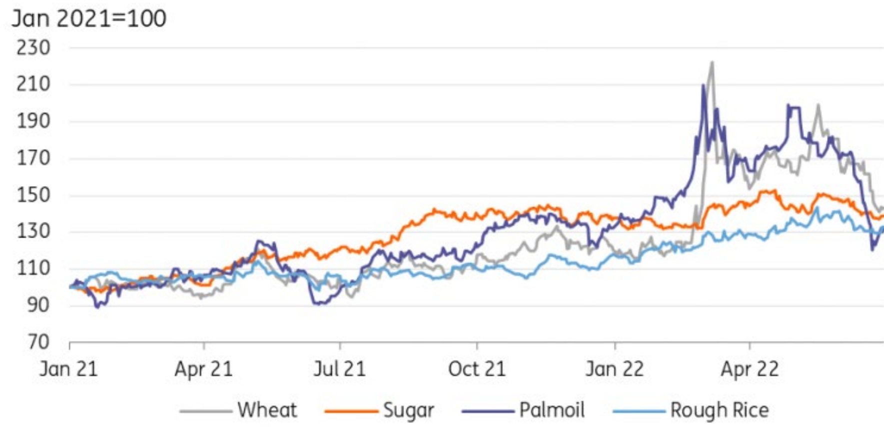
There has been a lot of speculation that the Bank of Japan (BoJ) might amend its yield curve control policy in the coming months. Most of this speculation stems from outside of Japan. Within Japan, fewer forecasters seem to think any change is likely. Yield curve control sees the BoJ in the market daily to buy unlimited 10Y Japanese government bonds (JGBs) at 0.25% as required. And yet there have still been some days when the yield has topped the 0.25% upper target (the central target range is zero).

Combined with some extreme weakness of the Japanese yen, which has helped import global inflation into Japan, this has encouraged thoughts that the BoJ might widen the band to 0.5%. However, the bank expanded its open market operation purchases from 10Y JGBs to 7Y JGBs, which signals that the BoJ will keep the current target though to the year-end, though there may be some change to this next year when BoJ governor Haruhiko Kuroda is due to step down.

2 Inflation rates across Asia could already be coming down

The last month has seen agricultural prices from wheat, sugar, rice and palm oil, among others, tumbling from recent highs. Food prices play an extremely important role in overall inflation in Asia. Those central banks that have already hiked rates aggressively to reduce the gap between inflation and policy rates may even be in a position to reduce them slightly, or at least the market will be able to anticipate some loosening earlier in 2023 than anticipated.

Agricultural prices

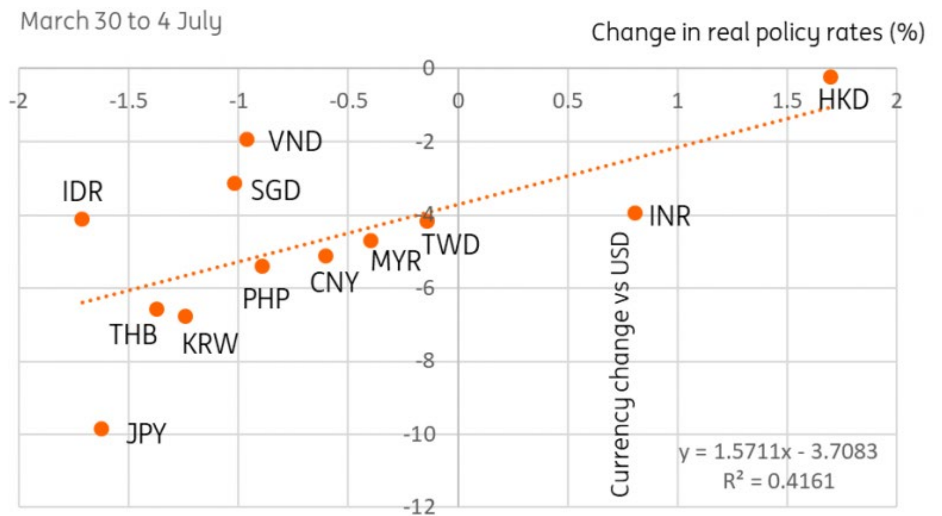


Jan 2021 = 100
Source: CEIC, ING

3 The central bank laggards will have to play catch up

One thing that's become apparent in recent months is that no economy in Asia ex-China is immune to global inflationary pressures. And even where inflation remains relatively muted, in absolute terms, it is testing central bank tolerances. A couple of central banks in Asia have made no, or only token, responses to higher inflation, and as a result their real policy interest rates have fallen, and their currencies have depreciated. This will drag in more inflation, which is ultimately a false economy. They will end up having to do more over the second half of the year than those that have been bolder.

Asian FX and change in real rates



Source: ING

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CEE: Recession fears reach central and eastern Europe

With inflation rising swiftly, economic data suggests economic storm clouds will continue to gather over the summer in the CEE region. In the Czech Republic, the hiking cycle has likely peaked but in other countries, we believe it will continue despite fears of stagflation. Fiscal policy remains in an accommodative mode

The CEE region can expect some cold economic showers this summer. Krakow's Market Square in Poland is pictured

Poland: Tricky navigation of anti-inflation policy amid stagflation risk

In the second quarter of 2022, Poland's GDP kept sound momentum of 7% year-on-year, only marginally weaker than the cyclical peak of 8.5% in the first quarter. Industry is growing at a double-digit pace, and market services even accelerated, with only the construction sector slowing. But the PMI collapse in June was the most severe in the region, with the index reaching a 25-month low. The main components, notably output and new orders, experienced a drop only seen during the pandemic and the global financial crisis. This supports our expectations for a technical recession in the second half of 2022, when GDP should slow to ca 0.9% YoY in the fourth quarter. On the other hand, consumption doesn't show any signs of a slowdown despite very poor consumer confidence and spending plans. This may be explained by aggressive fiscal stimulus of more than 3% of GDP in 2022. Still, this year's growth should reach a sound 4.7% YoY. We are more worried about growth in 2023 which may reach 2.5% YoY.

CPI reached 15.6% YoY in June. While there are some signs that CPI is losing momentum, the index has set a new 25-year high and is far from its peak. We see CPI plateauing in the summer but then reaching a local peak in October and 1Q23 when a new wave of regulated prices and minimum wage hikes appear. The long-term challenges still remain: strong second-round effects and very high inflation expectations.

The local inflation story and strong hikes of the CEE central banks boosted expectations for aggressive tightening by the National Bank of Poland (NBP). But the strong decline in PMI signals a slowdown and stagflation risk. In our opinion, if the monetary policy council gives too much attention to weak PMI and raises rates by 50bp, only then should the Polish zloty (PLN) weaken. In the case of a 75bp hike, this would cause a slightly negative PLN – and so much depends on the governor's rhetoric – while a 100bp will be

neutral/positive for the PLN. We expect an NBP hike of 75bp in July, which should be accompanied by a dovish comment.

Czech Republic: The end of the hiking cycle as a summer theme

As expected, the hard monthly data and leading indicators for the second quarter already imply a slight decline in the economy and a further drop in the coming months. The June PMI fell to its lowest reading since mid-2020 and consumer confidence plunged to a record low. Overall, we are very likely to see a cold shower during the hot summer months. Inflation, on the other hand, continues to rise, hitting 16.0% YoY in May and we think it will peak at 17.0% in June/July. However, the recently announced energy price hikes for 2H22 and the continued rise in fuel prices again imply upside risks. On the fiscal side, the government is working on a number of measures to mitigate the impact of rising prices on households. However, it has so far lagged significantly behind its regional peers in this regard. A revised draft state budget for this year is expected to be presented in mid-July, which should increase the projected deficit and take into account the migration and energy crisis. Overall, however, we remain rather on the optimistic side with a deficit of 4.5% of GDP this year and 3.7% next year.

On the monetary policy side, there has been a change in leadership at the Czech National Bank (CNB) since the beginning of July, shifting it from being the biggest hawk in the region to the dovish side. Contrary to market expectations, we do not expect another rate hike this year in the base case, but so far we have not seen much from the new board members. Thus, it cannot be ruled out that further upside inflation surprises will force the central bank to raise interest rates again. However, while we believe the new board is more open to FX intervention, the dovish shift will force the central bank to intervene more regardless of its view. Thus, we expect the koruna to remain around EUR/CZK 24.75 going forward. Alternatively, we can expect the CNB to start pushing to stronger levels due to persistent inflationary pressures.

Hungary: A gloomier future ahead

Incoming activity data shows a marked slowdown in the second quarter and in our base case we see a minor contraction on a quarterly basis. As we expect the government to maintain the anti-inflationary measures through the remainder of the year, and we still see a positive real wage growth (fuelled by public wage settlements and labour shortages), this should support domestic demand despite the weak external environment. This also means stronger demand-driven inflation, while the impact of supply shocks will be somewhat limited. Against this backdrop, we see average inflation of 11% in 2022, with a peak at a tad below 13% in the autumn months. For more details, check out our article: Six things we think about Hungary.

Since the start of 2022, the National Bank of Hungary has raised the base rate by a total of 535bp and it now sits at 7.75%. Despite carrying out the largest tightening cycle in the region, Hungarian assets have remained under pressure due to several political and geopolitical risks. The only realistic point of the monetary policy impact remains the currency. To keep EUR/HUF stable, the central bank needs to continue its decisive tightening at least until inflation peaks. We see the terminal rate in the range of 9.25-9.75% with upside risks. The forint continues to be our least favourite currency in the CEE region, but we continue to watch headlines signalling a turnaround in the Rule of Law and EU funds disputes that should unlock the hidden potential of the forint in the second half of the year (perhaps in September).

Romania: Economic activity flattening

Inflation continues to surprise to the upside and will likely exceed 15.0% in June. We estimate this year's average inflation at 13.0% and 8.9% in 2023. This could mark the peak of the current inflationary cycle but the road to lower levels will be long. A key factor for next year's inflation profile will be the decision on whether to extend the

current price caps in place for natural gas and electricity provided to households. Given that 2023 is a pre-electoral year, we doubt that the caps will be fully removed.

Economic activity is showing signs of flattening, with confidence surveys pointing to a slowdown in manufacturing and services, though the retail sector still holds strong. Our +5.0% GDP growth estimation for 2022 already assumes a quasi-stagnant economy for the rest of the year, after the major upside surprise from the first quarter.

We have recently revised marginally upwards our terminal key rate forecast from 5.50% to 6.00% based mostly on the regional central banks' latest (relatively hawkish) decisions. We see a 75bp hike in July and a similar one in August, followed by a moderation thereafter. On the FX side, the 4.95 level for the EUR/RON still looks untouchable. In the context of a persistent liquidity shortage for the rest of the year, the relevant rate will in fact remain the credit facility (100bp higher than the key rate). On the bond market, with the entire curve trading quite flat close to 9.0%, and more hikes to come both locally and internationally, it is difficult to get constructive on it. However, current levels do seem to price in most of the known risks, and spreads versus the region are attractive again, hence the upside looks rather limited as well.

3 calls for FX as the dollar stays strong

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We're expecting a strong dollar, high volatility, and more central bank intervention in the second half of this year

The second half of this year favours the dollar staying supported

1 Dollar to stay strong

FX traders talk of a dollar 'smile curve'. This is the idea that the dollar strengthens when things are either very good or very bad. And conditions in between would typically see a benign dollar decline. The second half of this year certainly tends to favour events at the extreme end of the smile curve and the dollar staying supported. At one extreme, US growth can hold up such that the Fed can push ahead with tightening, taking the overnight USD rate above 3%. That's a high rate for the world's most liquid reserve currency. The alternative is that the US and world economies cannot simply stomach these fast tightening cycles. Here equities correct lower still, perhaps in a disorderly manner. This extreme risk-off environment would see a flight to safety into the dollar even if the Fed tightening cycle were to be cut short. Energy independence stands the dollar in good stead too.

2 Volatility to stay high

FX volatility is high and is expected to remain so for large parts of the second half of the year. Driving this surge has undoubtedly been the sharp adjustment in interest rate volatility as central banks, in many cases belatedly, respond to the toughest inflation environment in 40 years. Tighter levels of liquidity as central banks tighten policy rates and shrink balance sheets also support larger realised moves in FX rates, as do the latter stages of business cycles. Having at times been under 6% over the last 15 years, EUR/USD implied volatility is now closing in on 10%. We expect these higher levels of FX volatility to be maintained or increased even further in 2H22 meaning that we all need to be prepared for bigger swings in spot FX rates.

3 Central banks to intervene more

The second half of 2022 should see even more FX intervention from central bankers. We would split this activity into two: defensive and offensive. On the defensive side, many emerging market central banks have been trying to resist local currency weakness

through FX intervention. We can think of quite a few central banks in Asia, Latin America and the EMEA region undertaking this activity with various levels of success and various levels of FX reserve adequacy. Expect the stronger dollar to demand more action from this community and greater scrutiny of FX reserve sales and their implications for US Treasuries. The Bank of Japan looks likely to join this defensive camp in 2H22 when USD/JPY pushes above 140. Into the offensive camp go the likes of the Swiss National Bank and Czech National Bank, which are selling FX to drive local currencies higher and tighten monetary conditions. More central bank FX intervention will also maintain higher FX volatility levels.

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Rates: US tops out, but ECB has barely budged

It looks like the top for US market rates is in. The coming months may see some retrace higher, but the dominant impulse now is for rates to test lower. The fact that the ECB is only starting to hike as market rates peak is a sign of vulnerability. The tightening in financial conditions is all coming from market variables. Eventually, that also pulls rates lower

Fed Chair, Jerome Powell, faced US lawmakers last month to discuss the state of America's economy

1 US rates have likely seen a peak at 3.5%, look at the 5yr

A couple of weeks back, we made a call that the US 10yr yield had peaked after hitting the 3.5% area. The de-compression seen in the influential 5yr area of the curve drove that view, and since then there has been an outright richening in the 5yr area, as it effectively pulls yields lower. We expect this process to continue, likely inverting the 2/5yr segment of the curve.

A noted easing in inflation expectations has also been in play, a process that in fact began back in early May, but the move in the 5yr area has been the bigger signal that the top in US market rates is likely in. Data in the coming weeks and months could possibly push us back up towards the peak, but that is looking less likely, especially if the 5yr actually starts to trade rich to the curve (it is still moderately cheap).

Against that backdrop, the dominant theme for the US curve should be the 5yr continuing to outperform, with the curve shape now becoming quite nuanced (as a potential peak in the Fed funds rate in the fourth quarter would mean a dramatic re-steepening of the curve).

2 Amazingly, a peak in US rates and yet the ECB has hardly budged

The tightening in financial conditions in the eurozone has come primarily from market pressure, basically driven by rises in market yields, widening in sovereign spreads and a notable widening in corporate credit spreads. In the background, the European Central Bank, remarkably, has done very little in the way of tightening, apart from ending its quantitative easing programme (and even here the de-fragmentation threat has seen the ECB suggest that it could buy again as needed).

The eurozone 10yr swap rate peaked out at 2.65% in mid-June (as the US 10yr Treasury rate approached 3.5%), and coincided with the German 10yr yield hitting the 1.8% area. All of these are now lower by some 60bp. While the ECB will belatedly hike this month, it will be quite late to a party that has seen a global response to the threat of runaway inflation.

It feels to us that there remains some residual upward pressure on eurozone market rates, and even if frustrated by the direction of US rates, spreads between US and eurozone rates should narrow.

3 Further opportunities will appear

Many will have been caught off guard by the remarkable move lower in market rates in the past few weeks. Big swings in market rates typically correlate with heightened volatility, which can also mean that market rates could easily swing back up again. That suggests that there will be opportunities to get back into the bond market at better yield levels.

One thing is for sure though - the performance of bonds in 2022 has been the worst in modern times, and as such, it was always liable to come to an end at some point. We had anticipated that this would come in the third quarter, with a marked fall in market yields in the fourth quarter, but the starting phase has been accelerated to the end of the second quarter (June).

If 3.5% for US Treasuries does prove to be the turning point, there is a lot of room to move lower from the current level of 2.9%. The 2.5% area will be a logical target. For players that have missed the first lurch lower in yields, we anticipate there will be further opportunities (as yields can still re-trace towards prior highs on data releases), as is typical when volatility spikes. Being long the market and long carry is perhaps one way to fade through the remainder of 2022

3 calls for supply chains as extreme market conditions persist

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Supply chain problems are here to stay in 2022. Looking ahead, shifts in demand will play a greater role, while structural changes to trade flows will gain momentum

As a result of the war in Ukraine, we believe that trade flows will be significantly reshaped

1 Supply chains to remain fragile

Global supply chains should expect another few months of extreme market conditions with schedule reliability a long way off, delivery times prolonged, and transport receding lower but still highly elevated. Supply chains are fragile in their current state, and an interrupted weak link can easily lead to new setbacks. Once major shipping routes face delays, this leads to various destabilising knock-on effects.

Stringent Covid-19-related lockdown measures adopted in China, and the war in Ukraine, are keeping supply chains under pressure. The situation is likely to worsen in the autumn when the heating season begins with less energy supply from Russia.

The transportation industry is still suffering from a lack

of equipment and personnel. Additionally, high inflation leads to increased worker strikes for better wages and working conditions, exacerbating the current situation.

Supply chain problems are certainly here to stay for the rest of the year.

2 Shifts in demand will play a greater role

Shifts in consumer patterns and extra inventory building from businesses have led to demand being overstretched. However, the extreme rise in energy and food prices has worsened purchasing power and pushed consumer confidence numbers back to levels last seen during the depths of the Covid-19 crisis.

Pent-up demand for travelling and other services has kept consumers spending so far, but that can change quickly. Additionally, new Covid waves in the autumn could strain activity and weigh further on demand. While the current backlog is enough to keep supply chains strained throughout the year, oversupply could re-emerge as an issue once demand drops off to more regular levels, which we expect to happen during the

second half of the year. With demand for goods retreating, transportation companies could face an oversupply of containers and fleet capacity next year.

3 Structural changes to trade flows will gain momentum

As a result of the war in Ukraine, we believe that trade flows will be significantly reshaped as market players that previously purchased commodities and goods from Russia look for alternatives, while other countries step in to benefit from discounts. There will also be substitutions, like the replacement of piped gas with LNG and coal. This results in a new world economic order, being characterised by more 'friend-shoring' – trading relationships with countries that have long-standing relationships, cooperation and share similar values might become more valuable. Ethics may also become a more important consideration in trading. Yet, shifting trade flows due to moral considerations will be mainly done by wealthy countries. This opens completely new trade opportunities which in turn could boost global trade again.

Rerouting, diversification in suppliers and or regions, more stockpiling, and inventory building will shape trade relations in the years to come.

ING global forecasts

	2022					2023					2024				
	1Q22	2Q22	3Q22	4Q22	FY	1Q23	2Q23	3Q23	4Q23	FY	1Q2	2Q24	3Q24	4Q24	FY
United States															
GDP (% QoQ, ann)	-1.6	0.4	2.6	0.1	2.0	-1.5	1.1	1.7	2.3	0.6	2.3	2.4	2	2.2	2.1
CPI headline (% YoY)	8	8.4	8.6	7.3	8.1	5.4	3.5	2.2	2.1	3.3	1.7	1.4	1.5	1.8	1.6
Federal funds (%, eop)	0.50	1.75	3.00	3.75	3.75	3.75	3.50	3.00	2.50	2.50	2.00	2.00	2.00	2.00	2.00
3-month SOFR rate (%, eop)	0.65	2.1	3.1	3.6	3.6	3.6	3.3	2.8	2.3	2.3	1.85	1.85	1.85	1.85	1.85
10-year interest rate (%, eop)	2.50	3.00	3.25	3.00	3.00	2.75	2.50	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Fiscal balance (% of GDP)					-4.9					-4.2					-3.9
Gross public debt / GDP					100.5					100.9					101.1
Eurozone															
GDP (% QoQ, ann)	2.5	1.1	0.1	-1.4	2.6	-0.3	1.3	1.6	1.6	0.3	1.6	1.4	1.4	1.2	1.5
CPI headline (% YoY)	6.0	8.0	7.7	6.8	7.1	5.7	3.1	2.2	1.1	3.0	2.2	2.2	2.3	2.3	2.2
Refi minimum bid rate (%, eop)	0.00	0.00	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3-month interest rate (%, eop)	-0.45	-0.35	0.40	0.60	0.60	0.60	0.60	0.60	0.70	0.70	0.80	0.80	0.90	0.90	0.90
10-year interest rate (%, eop)	0.60	1.40	1.50	1.25	1.25	1.15	1.00	1.00	1.10	1.10	1.10	1.10	1.20	1.20	1.20
Fiscal balance (% of GDP)					-5.1					-4.3					-3.3
Gross public debt/GDP					100.4					98					97.1
Japan															
GDP (% QoQ, ann)	-0.5	1.2	1.4	1.2	0.8	1.2	1.2	1.2	1.2	1.2	0.8	0.8	0.8	0.8	0.9
CPI headline (% YoY)	0.9	2.5	2.8	2.9	2.3	2.5	1.7	1.2	1	1.6	0.9	0.9	1	1.1	1
Interest Rate on Excess Reserves (%)	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
3-month interest rate (%, eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10-year interest rate (%, eop)	0.25	0.25	0.25	0.25	0.20	0.25	0.20	0.20	0.20	0.20	0.10	0.10	0.10	0.10	0.10
Fiscal balance (% of GDP)					-10					-9					-7
Gross public debt/GDP					280.0					270.0					250.0
China															
GDP (% YoY)	4.8	-1.0	4.6	5.8	3.6	5.2	6.5	5.5	5.0	5.6	4.8	4.0	5.0	4.5	4.6
CPI headline (% YoY)	1.1	2.3	2.5	2.6	2.1	2.8	2.6	2.0	1.8	2.3	2.2	2.2	2.3	2.5	2.3
PBOC 7-day reverse repo rate (% eop)	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.20	2.30	2.20	2.30	2.30	2.30	2.30	2.30
3M SHIBOR (% eop)	2.38	2.20	1.97	2.00	2.00	2.10	2.10	2.20	2.30	2.30	2.30	2.35	2.40	2.45	2.45
10-year T-bond yield (%, eop)	2.80	2.75	2.75	2.70	2.70	2.7	2.75	2.85	2.95	2.95	3.00	3.15	3.20	3.20	3.20
Fiscal balance (% of GDP)					-4.7					-3.0					-2.8
Public debt (% of GDP), incl. local govt.					132.0					133.0					134.0
UK															
GDP (% QoQ, ann)	3.1	-2.3	1.5	-0.7	3.3	0.4	1.2	1.2	1.4	0.5	1.7	1.5	1.5	1.5	1.5
CPI headline (% YoY)	6.2	9.1	9.7	10.7	8.9	9.6	5.4	4.0	1.2	5.0	1.0	0.9	1.1	1.4	1.1
BoE official bank rate (%, eop)	0.75	1.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
3-month interest rate (%, eop)	0.91	1.67	2.05	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
10-year interest rate (%, eop)	1.70	2.20	2.40	2.10	2.10	1.90	1.70	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.40
Fiscal balance (% of GDP)					-3.4					-2.3					-2.0
Gross public debt/GDP					95.4					94.2					92.3
EUR/USD (eop)	1.11	1.05	1.05	1.08	1.08	1.10	1.12	1.13	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	122	135	132	128	128	127	126	125	125	125	124	123	122	120	120
USD/CNY (eop)	6.34	6.69	6.70	6.60	6.60	6.50	6.40	6.30	6.20	6.20	6.15	6.10	6.05	6.00	6.00
EUR/GBP (eop)	0.84	0.86	0.86	0.86	0.86	0.86	0.87	0.87	0.88	0.88	0.88	0.88	0.88	0.88	0.88
ICE Brent -US$/bbl (average)	98	110	118	125	113	107	95	97	98	99	90	82	85	80	84

GDP forecasts are rounded to the nearest whole/half number, given the large magnitude and uncertainty surrounding our estimates
Source: ING forecasts

GDP Forecasts

%YoY	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
World (USD)	2.9	2.5	1.9	1.6	2.9	2.8	3.2
US	2.0	2.1	0.4	0.4	2.0	0.6	2.1
Japan	0.3	1.5	0.8	1.2	0.8	1.2	0.9
Germany	1.0	-1.0	-1.0	-1.3	0.7	1.0	1.8
France	3.8	0.6	-0.3	-0.2	2.1	0.3	1.4
UK	2.4	1.8	0.4	-0.3	3.3	0.5	1.5
Italy	3.7	1.4	0.4	0.2	2.9	0.8	1.9
Canada	4.7	4.0	3.1	2.7	3.7	1.9	2.0
Australia	3.3	6.1	3.1	3.1	3.9	3.1	2.7
Eurozone	3.5	1.2	0.6	-0.1	2.6	0.3	1.5
Austria	4.0	0.7	0.6	-0.8	3.5	0.2	1.8
Spain	5.5	3.1	0.6	0.4	3.8	1.0	2.1
Netherlands	3.3	1.3	0.5	0.2	2.9	0.8	2.1
Belgium	2.9	1.0	0.3	-0.2	2.2	0.5	1.5
Ireland	6.9	5.5	12.8	1.8	9.0	1.3	1.8
Greece	4.8	3.1	2.0	0.0	4.2	1.7	2.3
Portugal	7.5	4.8	2.7	0.3	6.6	1.0	1.4
Switzerland	2.7	1.2	1.0	0.4	2.3	0.7	1.4
Sweden	3.5	1.8	0.8	1.8	2.3	1.3	1.5
Norway	5.3	2.8	1.8	2.9	2.6	2.1	1.8
Bulgaria	3.4	2.9	2.2	1.7	3.2	3.0	3.0
Croatia	4.0	2.6	2.2	2.4	4.0	3.0	2.5
Czech Republic	1.2	-0.6	-1.1	0.1	1.1	3.7	3.2
Hungary	5.5	4.8	2.5	2.1	5.3	3.2	3.9
Poland	7.0	3.4	0.9	0.2	4.7	2.5	3.2
Romania	2.7	6.2	5.7	1.7	5.0	3.5	3.5
Turkey	5.2	2.6	0.1	2.5	3.5	4.0	4.0
Serbia	4.2	3.8	3.6	4.2	4.0	4.2	3.5
Russia	-5.0	-12.0	-15.0	-12.0	-8.0	-4.0	0.0
Kazakhstan	2.5	3.0	3.1	3.5	3.2	3.8	3.5
Azerbaijan	4.8	3.0	3.5	2.5	4.5	3.0	2.5
China	-1.0	4.6	5.8	5.2	3.6	5.6	4.6
India	15.2	5.9	5.0	3.9	7.4	7.5	8.0
Indonesia	5.6	4.1	4.2	4.3	4.6	4.5	4.7
Korea	2.5	2.8	1.9	1.9	2.6	2.1	1.9
Philippines	8.1	4.9	4.2	4.1	6.4	4.4	5.0
Singapore	4.9	4.1	3.2	3.1	4.0	3.5	3.1
Taiwan	3.0	4.7	4.5	6.0	3.8	5.3	5.5

Source: ING estimates

CPI forecasts (pa)

%YoY	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
World	8.3	8.5	7.6	4.8	6.2	4.1	3.0
US	8.4	8.6	7.3	5.4	8.1	3.3	1.6
Japan	2.5	2.8	2.9	2.5	2.9	1.0	1.1
Germany	7.9	8.7	8.5	6.3	7.8	3.4	1.8
France	5.9	6.9	6.7	5.5	5.9	3.3	1.8
UK	9.1	9.7	10.7	9.6	10.7	1.2	1.4
Italy	7.4	8.7	7.9	6.4	7.5	3.8	1.9
Canada	7.5	7.9	7.5	5.9	7.2	3.2	1.8
Australia	5.5	5.8	5.3	4.0	5.2	3.3	2.8
Eurozone	8.0	7.7	6.8	5.7	6.8	1.1	2.3
Austria	7.7	7.4	7.0	5.5	6.9	3.0	2.0
Spain	9.1	7.0	5.0	4.5	7.2	3.1	2.1
Netherlands	10.4	10.8	8.9	6.0	9.8	3.9	1.8
Belgium	9.0	9.3	7.4	6.0	8.4	4.1	2.1
Ireland	8.4	9.6	9.1	6.1	8.3	3.5	2.1
Greece	10.1	10.4	8.8	6.5	8.9	3.2	1.9
Portugal	8.0	6.6	4.6	3.6	5.9	2.7	2.0
Switzerland	3.0	3.5	2.7	2.3	2.8	2.0	1.3
Sweden	7.0	7.5	6.3	5.1	6.6	3.4	1.8
Norway	5.6	5.0	4.4	4.2	4.7	3.1	2.5
Bulgaria	15.6	16.5	14.5	11.9	14.3	8.4	5.0
Croatia	10.4	10.1	9.3	7.3	9.0	4.3	3.0
Czech Republic	15.7	16.4	15.1	10.7	14.6	7.2	3.8
Hungary	10.8	12.4	12.5	11.2	10.9	7.4	3.2
Poland	14.0	15.9	16.0	15.5	13.9	11.2	6.5
Romania	14.5	14.5	13.4	11.5	13.0	8.9	5.0
Turkey	78.6	81.4	64.0	41.8	71.5	34.4	24.9
Serbia	10.3	10.8	9.1	7.9	9.8	5.5	4.0
Russia	15.8	14.8	13.3	5.2	14.3	6.4	5.8
Kazakhstan	14.5	14.9	15.2	11.3	13.0	9.5	5.0
Azerbaijan	13.9	12.6	11.2	9.5	12.3	8.0	5.0
China	2.3	2.5	2.6	2.8	2.1	2.3	2.3
India	7.2	6.3	6.1	5.7	6.5	4.9	4.3
Indonesia	3.8	4.8	4.5	3.6	3.9	3.4	3.5
Korea	5.4	6.1	6.0	5.1	5.4	3.4	1.8
Philippines	5.4	5.5	5.8	4.6	5.1	5.4	3.7
Singapore	5.6	4.7	4.0	3.7	4.7	3.3	3.5
Taiwan	3.5	3.6	3.6	2.3	3.4	2.0	2.2

Source: ING estimates

Oil forecasts (avg)

$/bbl	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
Brent	112	118	125	107	113	99	84

Source: ING estimates

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