Global Macro Weekly

Desk Strategy

23 April 2021

The slow train to normalisation leaves Ottawa

Our confidence in recovery continues to build. We turn bearish on US rates, where the 5y is the point on the curve to sell. Add that to your short in gilts, which wasn't knocked off track by the lighter remit. The Bank of Canada took a big step towards monetary policy normalization this week. Propagation down the G-10 chain may continue with the Bank of England next month. At the other end, the FOMC next week will go to lengths to keep it bland, and the ECB this week was more circumspect than we thought it might be. That's good news for EM FX, where strong trade balances and carry are pulling in FI flows in a cycle that should continue. We like TRY, BRL and RUB. DM commodity currencies AUD and CAD should also continue to perform. SEK/USD is our favourite European catch-up cross right now. For reflation-watchers, EUR inflation should rise further in April, although the signal is dominated by the technicals right now – ECI and PCE releases in the US on Friday may have more value for the global theme.

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John Briggs

Key Theme		Best Trades
Bond bearishness increasing (ex-EGBs)	We add to our short UK (10s) a short in US 5yrs, and sell5s on 2s5s10s, expecting the belly of the curve to lead the next leg of the selloff. In bunds, strong supportive flows still dominate, but from June that may change. May could be a key transition month.	• EUR 10s20s swaps steepener • EUR curve caps • Long 30yr Bund ASW • Short 10y gilts • Short US 5yrs at 0.80% • Sell 5s on UST 2s5s10s
Euro area resilience in early 2021	European data continue to show resilience despite increasing lockdowns, but ECB attention will stop yields from rising. That's best news for Periphery.	• EUR 10s20s swaps steepener • Long 5y5y EURi breakevens • Short USD/SEK
Vaccine and the UK recovery	We expect a 'hawkish' shift in BoE guidance by end-2021 (though no Bank Rate hikes before 2023). Stay short 10y gilts due to downside risks for FI and expect sterling to strengthen.	• Long GBP/USD • Target 10y yields to 1%
Inflation risks are tilting higher	A continuation of ample fiscal stimulus along with CB policies that encourage higher inflation help BEs widen, especially in the US and the UK. The vaccines act as a further tailwind with ILBs seen as a means of diversification and protection.	• Long 1y1y US CPI • Long 1y1y EURi breakevens • Sell 15y UK RPI swaps
Attractive yield vs vol profile in SAGBs	The long-end of the steep local S African curve offers an appealing FX hedged yield versus EM peers.	• Long local bonds in S Africa, FX hedged
Vaccine to drive a market rotation	A vaccine should close the gap between weak consumer confidence and strength elsewhere. This should see a rotation into the 2020 laggards, including oil and oil-linked currencies; autos, real estate and banks in credit.	• Long CAD (vs EUR, AUD, NZD) • In IG credit, favour autos, real estate and banks • Core curve steepener
Long Italy vs France and Spain	A Draghi government is a paradigm shift for Italian politics, which should bring about a virtuous circle of lower rates, debt and political stability, and investor comfort (particularly from foreign investors), which should continue to push spreads tighter from here. We target 75bp in 10y BTP/bund spreads.	• Long 30y Italy vs 10y France • 5y Italy vs Spain spread tightener
Long the early CB rate hikers	Much of the monetary policy work is done, but we expect more QE from some of the larger central banks. Rate hikes will be few and far between, but certain EM central banks and Norges Bank will have to consider tightening in 2021.	• Front-end payers in Poland and Chile
Selective value in local drivers and oil-linked EMFX	We have recently increased EMFX exposure, including in high-beta BRL and TRY. We also expect RUB and COP to continue to benefit from crude upside. We are more defensive on MXN and INR.	• Short USDBRL • Long TRY vs EUR and USD • Long RUB & COP (vs USD, EUR

Key Forecasts

Euro Area (end of period)

		Macro			Central Banks	German Gov't Bond Yields				Swap spreads		Sov 10y vs Germany		
Year	End of Period	HICP y/y Headline	HICP Core, y/y	GDP, q/q	ECB depo rate	2y	5y	10y	30y	10y	30y	France	Italy	Spain
2021	Q1	1.0%	1.2%	-0.5%	-0.50%	-0.65%	-0.55%	-0.30%	0.15%	35bp	31bp	25bp	85bp	60bp
	Q2	1.5%	0.9%	1.5%	-0.50%	-0.60%	-0.50%	-0.25%	0.30%	37bp	35bp	30bp	80bp	55bp
	Q3	1.8%	1.1%	3.4%	-0.50%	-0.55%	-0.30%	0.00%	0.60%	40bp	35bp	30bp	75bp	50bp
	Q4	2.1%	1.6%	1.7%	-0.50%	-0.50%	-0.25%	0.25%	0.80%	40bp	35bp	30bp	75bp	50bp

United States

		Macro			Central Banks	Gov't Yields
Year	End of Period	PCE y/y Headline	PCE Core, y/y	GDP, q/q SAAR	Fed Funds Target Range	10y yield
2021	Q1	1.7%	1.6%	7.5%	0.00 - 0.25%	1.70%
	Q2	2.9%	2.3%	10.0%	0.00 - 0.25%	1.80%
	Q3	2.4%	1.9%	11.0%	0.00 - 0.25%	1.90%
	Q4	2.5%	2.1%	9.5%	0.00 - 0.25%	2.00%

United Kingdom

		Macro			Central Banks	Gov't Yields
Year	End of Period	CPI y/y Headline	RPI y/y	GDP q/q	BoE Bank Rate, %	10y yield
2021	Q1	0.60%	1.4%	-1.50%	0.10%	0.80%
	Q2	1.60%	2.6%	2.80%	0.10%	1.00%
	Q3	1.90%	2.8%	3.20%	0.10%	1.00%
	Q4	2.40%	3.1%	2.60%	0.10%	1.00%

Japan

		Macro			Central Banks
Year	End of Period	CPI y/y Headline	Core CPI y/y	GDP q/q	BoJ Bank Rate, %
2021	Q1	-0.7%	-0.6%	-3.1%	-0.10%
	Q2	-0.3%	-0.1%	3.9%	-0.10%
	Q3	0.0%	0.2%	0.2%	-0.10%
	Q4	0.6%	0.4%	0.4%	-0.10%

China

		Macro			Central Banks
Year	End of Period	CPI y/y Headline	PPI Inflation y/y	GDP y/y	1Y Loan Prime Rate, %
2021	Q1	0.1%	1.8%	18.9%	3.85%
	Q2	2.5%	4.7%	6.8%	3.85%
	Q3	2.2%	4.2%	4.8%	3.85%
	Q4	2.3%	3.7%	4.2%	3.85%

FX

Year	End of Period	EUR	GBP	JPY	CNY	EUR/GBP
2021	Q2	1.22	1.41	110	6.39	0.87
	Q3	1.24	1.43	111	6.37	0.87
	Q4	1.24	1.41	110	6.38	0.88
2022	Q1	1.23	1.38	108	6.40	0.89

Giovanni Zanni
Imogen Bachra, CFA
Giles Gale
Paul Robson

E-zzz-B Review

- **The meeting was largely uneventful, as widely expected.** The introductory statement was a repeat of the March one, and there was no change to the economic backdrop, policy decisions, and assessment of risks.

- **We did get some (kind of) clarification on what "significantly" higher PEPP purchases means…** Lagarde, in the Q&A specifically mentioned July as a reference pace for what to expect in the coming weeks and months (in Q2 overall). *That reference to July would suggest a higher pace of weekly purchases relative to the one seen since the March meeting: to ~20bn/week*.

- **… and we were also told that no decision has been taken (yet) to slow PEPP purchases again.** Lagarde said that such a decision was "premature" and that it hadn't been even discussed in today's meeting. So, while we still expect some slowdown in purchases from Q3, in light with our forecasts (and with, we believe, the central scenario of the ECB), the more hawkish signalling of some of the ECB Council members were not taken on board by Lagarde today, removing any hawkish bias to today's meeting.

- **We feel the risks to the GDP scenario are slowly, implicitly, moving to the upside, though.** On the macro front, Lagarde was very explicit in stressing short-term *downside* risks. On the medium-term, while the emphasis was on "balanced" risks – again as in the March meeting –, our sense is that implicitly the message was starting to move more clearly towards the upside… True, there are remaining risks related to Covid infections, the logistics of the roll out of vaccines, and possible scary variants… But it is also the case that the global economy is rebounding swiftly and that the impact of restrictions on GDP growth appears to be on a waning path, as we documented elsewhere.

There were three key takeaways for rates markets today:

- **You can continue to believe whatever you like about PEPP after June.** It all depends on vaccinations and the forecasts in six weeks' time. We still expect that the pace will be reduced at that point.

- **But the moment when that will become a tradable theme may be a little further away.** The purchase pace over the remaining six weeks of this PEPP 'surge' may be a little faster and a little less flexible than markets had in mind. We infer this from Lagarde's comment that the pace now is intended to be similar to last July. Last July the average pace was around €85bn. We appear to be on track for net €70bn-€75bn so far this surge, so we might conclude that Ms. Lagarde had a higher number in mind, in which case purchases may actually have upside risk in the short term. Supply, meanwhile is likely to be slower for the coming weeks. Now looks an unlikely moment for taking on the flows to be successful.

- **Finally, no early end to NIRP.** There was no sympathy for savers or concern about the 'transmission mechanism' for those hoping for signs of an earlier exit from negative rate policy.

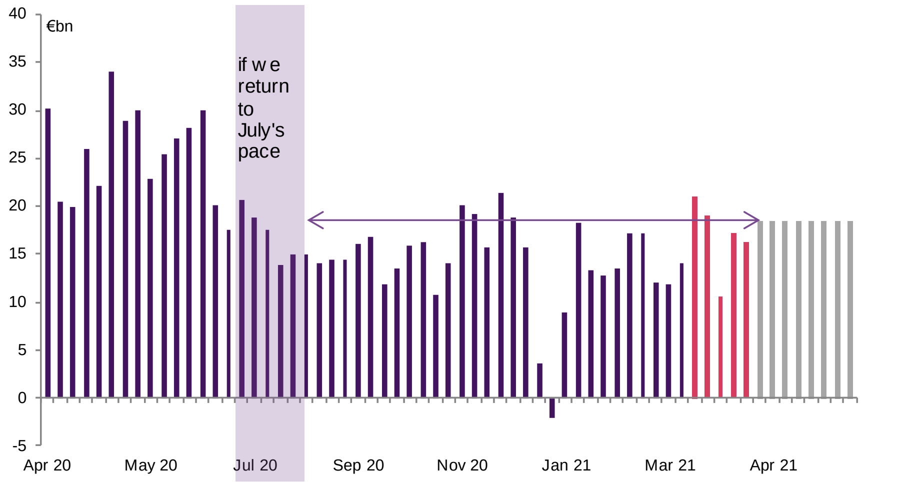
Conclusions: Bullish bunds to -0.35%. Volatility to remain supressed. Relief for recent pressure on carry trades, including long-end steepening. Positive for credit and periphery.

- **For FX, EUR/USD is lower and this largely looks to reflect disappointment that there wasn't a discussion about the phasing out of PEPP.** The language on the exchange rate was largely unchanged, with the Governing Council said to be monitoring the impact on inflation as normal and was 'very attentive' to this. Relative growth expectations have been an important gauge of EUR/USD sentiment, picking the major turning points. A very strong US growth outlook looks increasingly priced, while the Euro area economy will benefit from strong US domestic demand and strengthening global growth.

Conclusions: We do not expect EUR/USD to trade much lower. We remain short USD/SEK as a higher beta long EUR/USD trade.

ECB net weekly PEPP purchases, and projection if the target is €80bn/month, with July 2020 as the guide. With slowing supply it will be hard for the market to sell-off soon with these flows.

Source: NWM



Giovanni Zanni
Giles Gale

Inflation Monitor #17 – Higher and more to go

We expect inflation to continue its ascent in April, largely driven by energy prices' large base effects from the extreme drop recorded in April 2020. Year-on-year, the energy component should jump from 4.3% to 10.5%, on our estimates. Some attenuating factors are in play, as a consequence of the 2021 HICP basket reweighting: the "Easter effect" is subdued this year given the much smaller weight of package holidays and other hospitality subcomponents this year. **Overall, we expect inflation to rise to 1.5%, up from 1.3% in March.**

Roller-coaster prints in 2021-22. Inflation should hover around 1½% or slightly higher until August, and then surpass 2% in the remaining months of the year… before falling quite abruptly again (i.e. to ~1%) in Q1 2022. Meanwhile, underlying inflation should continue to moderately improve throughout the projection period.

The ECB continued to downplay this inflation volatility in its communication (see also our <u>ECB review</u>): "*Inflation has picked up over recent months on account of some idiosyncratic and temporary factors and an increase in energy price inflation. At the same time, underlying price pressures remain subdued (…). Headline inflation is likely to increase further in the coming months, but some volatility is expected throughout the year reflecting the changing dynamics of (…) temporary factors. These factors can be expected to fade out (…) early next year. Underlying price pressures are expected to increase somewhat (…), although they remain subdued overall."*

Market views: long breakevens, real yield steepeners.

Monthly HICP projections

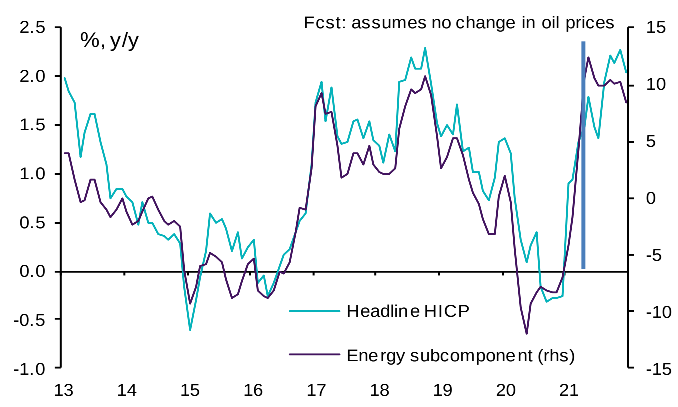
Source: Eurostat, NWM

	Headline			Core		HICP ex-Tobacco		
	y/y	m/m	Index	y/y	m/m	y/y	m/m	Index
Mar-21	*1.3*	*0.9*	*106.5*	*0.9*	*1.0*	*1.3*	*0.9*	*106.1*
Apr-21	1.5	0.4	107.0	0.8	0.6	1.4	0.4	106.5
May-21	1.8	0.2	107.2	1.0	0.2	1.7	0.2	106.8
Jun-21	1.5	0.0	107.3	0.8	0.1	1.4	0.0	106.8
Jul-21	1.4	-0.5	106.8	0.5	-0.6	1.3	-0.5	106.3
Aug-21	1.9	0.2	106.9	1.3	0.2	1.9	0.1	106.4
Sep-21	2.2	0.4	107.3	1.6	0.5	2.2	0.4	106.8
Oct-21	2.1	0.1	107.4	1.6	0.1	2.1	0.1	106.9
Nov-21	2.3	-0.2	107.2	1.5	-0.5	2.3	-0.2	106.7
Dec-21	2.0	0.1	107.3	1.5	0.3	2.0	0.1	106.8

We expect inflation to continue its ascent in April. Euro area inflation increased sharply in Q1 21 (to 1.1%, up from -0.3% in Q4 20). The upswing reflected a number of factors, such as the reversal of the July temporary VAT cut in Germany, carbon tax increases (in Germany again), delayed winter sales in some euro area countries and the significant impact of changes in HICP weights for 2021 on the back of last year's pandemic – as well as higher energy price inflation. The rise in April should be fully attributed to energy. 2021 basket re-weightings should push in the other direction, as was the case in March (see chart below): the seasonal rise in (Easter-related) prices impacts less the HICP index this year compared to last.

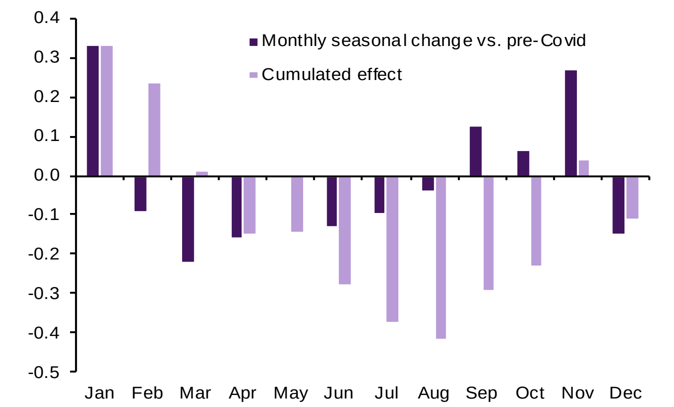
Year-on-year energy prices surging on base effects

Source: Eurostat, NWM estimates



Basket reweighting dampening April print, too

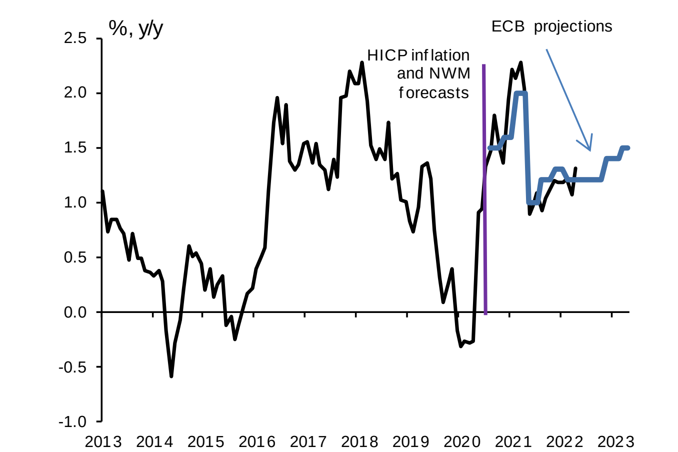
Source: Eurostat, NWM estimates



The medium-term outlook should see underlying inflation pressures increasing somewhat due to the recovery in demand and some supply constraints. Headline inflation will continue to be supported by energy base effects this year, but the overall increase in underlying inflation should be limited by low wage pressures and the impact of the past appreciation of the euro, even once the economy reopens fully again as the effects of the pandemic wane.

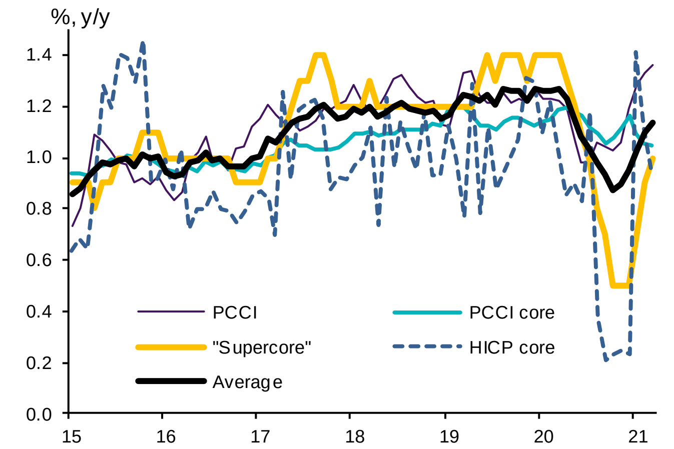
Euro area inflation dynamics – our and ECB's projections

Source: Eurostat, ECB, NWM



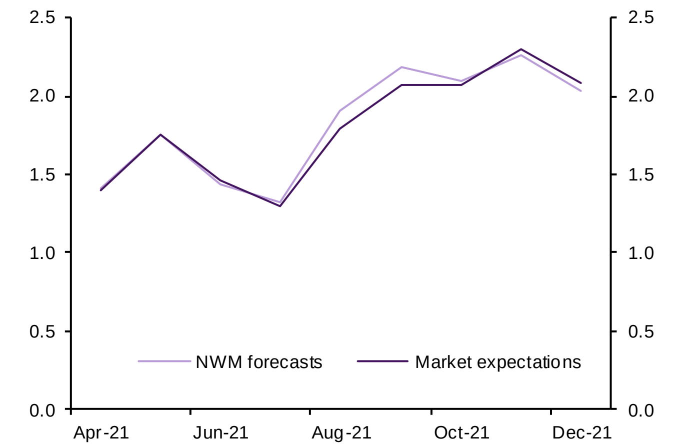
Underlying inflation measures: on the rise again, overall

Source: : [ECB's various official measures of underlying inflation](), Eurostat, NWM



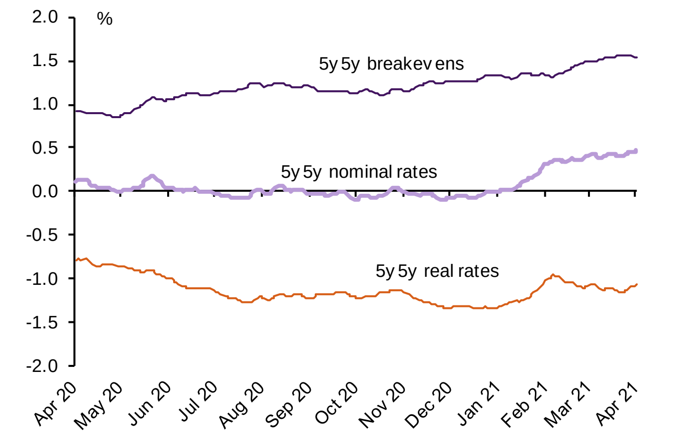
NWM inflation HICPxT projections vs. market expectations

Source: Bloomberg, NWM



Nominal, real and breakeven swap rates

Source: Datastream, NWM



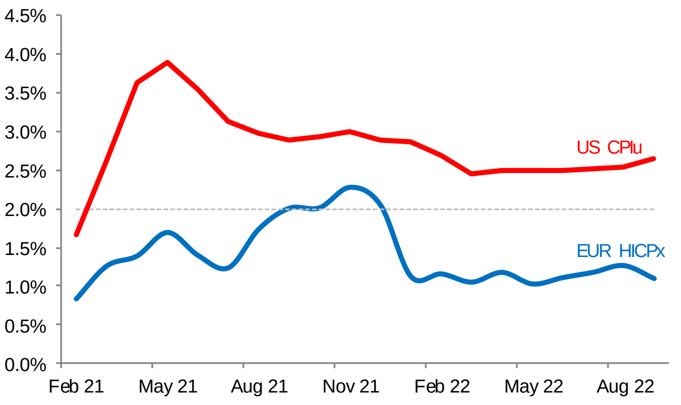
Market views: Long breakevens. Real yield steepeners.

Front end reflation is justified, and should continue. But expectations for 2022 aren't there. The market seems to understand the technical factors that will dominate 2021 very well. The key question is whether inflation will simply collapse back to around 1% in 2022. Risks to higher inflation look asymmetric to us. A strong economic recovery in H2, reflation in the US, the start of the recovery plans, discussion of reform to the SGP, very easy financial conditions, and ongoing fiscal support on the scale of 2020 all suggest that we may not simply return to where we were in 2019. The market currently prices a relatively sharp pick up for y/y inflation in 2023. That can move further, but the market could turn bolder about 2022.

We are far from the tipping point where inflation brings forward ECB rate hikes meaningfully. Long short-end real yield rates, and real rate steepening. There is a concern spreading the market that the ECB may try to back away from negative rates sooner. We disagree. If breakevens are right, the ECB is very far from raising rates. We guess it might be right to begin to start to factor in some chance of rate hikes from around 1.5% mean assessment of likely inflation outcomes. At the moment that isn't less than five years from now. Inflation expectations can run without taking short-end rates with them – or in other words, front end real rates can perform strongly.

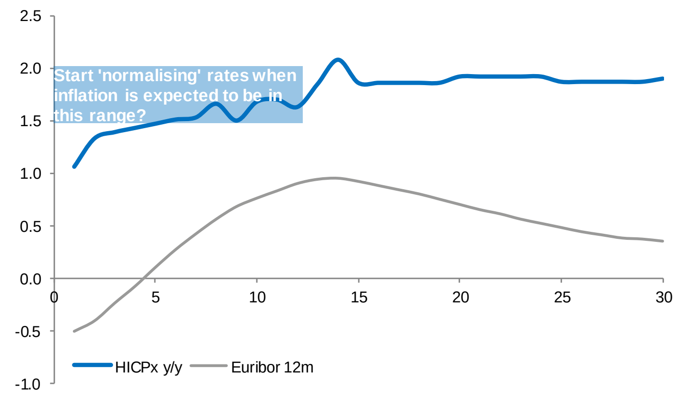
Inflation to collapse again in 2022 only to recover slowly in 2023? 1y1y has value.

Source: NWM



5y5y doesn't 'need' higher 1y1y. But would inflation belief would benefit from inflation-soon. 1y1y/5y5y steepeners.

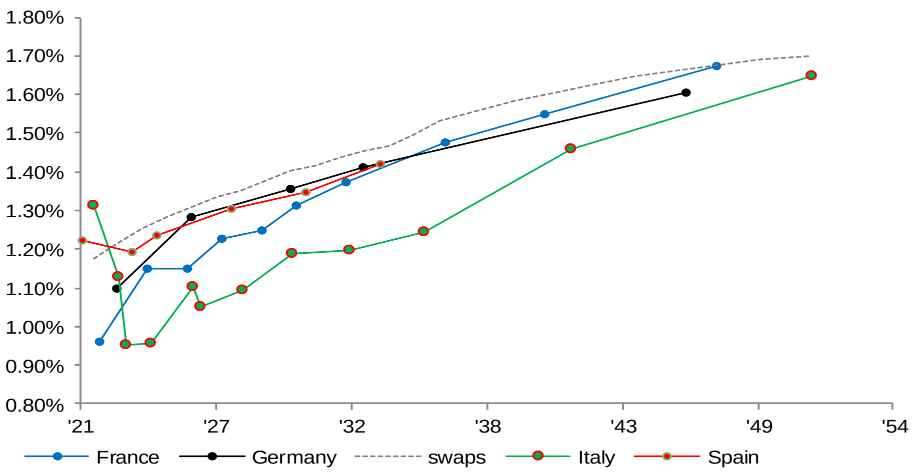
Source: NWM



Value in linkers. We like front-end OATei and BTPei28s and 32s.

EURi breakevens. Seasonally adjusted. Discounting on fitted issuer curves.

Source: NWM



Giovanni Zanni

Euro area Q1 GDP preview

- **GDP growth remained weak at the start of 2021** amid “third” waves and related restrictions. Preliminary Q1 21 GDP data will be released next week (30/4).
- **We look for a 0.5% q/q fall in Q1 euro area GDP.** Models based on PMIs point to a more marginal slowdown, of 0.1%, but our hard-data model suggests the potential for a steep contraction, of 1.9%. Estimates from central banks and from the OECD new “GDP tracker” provide a similar range of estimates for next week’s release – closer to our central estimate of -0.5%.
- **Signs of recovery for Q2…** Forward looking components in most surveys point to a swift rebound in the coming months, starting with Q2 and accelerating in H2. That’s consistent with our broader macro forecast for this year.
- **….and beyond.** The carry-over effects from the normalisation post-pandemic, coupled with still accommodative monetary policy and increasingly – structurally – supportive fiscal policy, should provide several more quarters of strong growth beyond 2021, in our view.

We look for a modest decline, of 0.5%, in GDP in Q1. That’s lying within the range of our model based estimates. Our basic hard-data model estimate points to a relatively steeper contraction of 1.9% (amid current “third” wave and new restrictions). In contrast, PMI-based models suggest an almost flat Q1 (-0.1%), reflecting more optimism on account of firms’ behaviours (Chart 1). Similar to our own expectations, real time GDP trackers such as the OECD one also points towards a very modest fall in Q1 (Chart 2).

Chart 1: Growth expectations – Central estimate and model-based estimates

Source: Eurostat, IHS Markit, NWM estimates

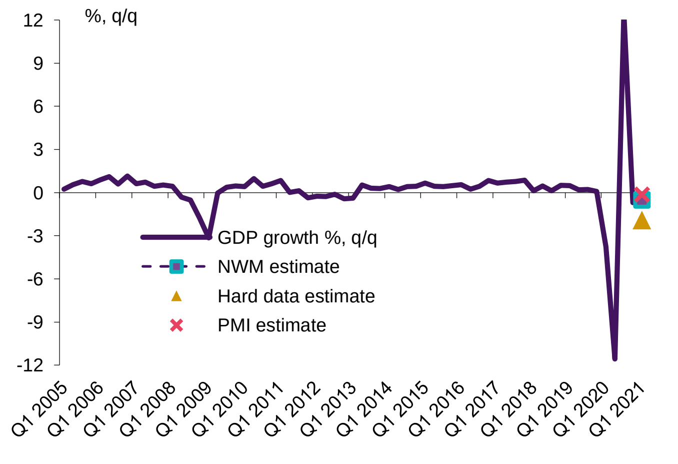


Chart 2: Flat-ish GDP growth in Q1… before a rapid reconvergence to pre-pandemic levels starting in Q2

Source: OECD GDP weekly tracker, Eurostat, NWM estimates

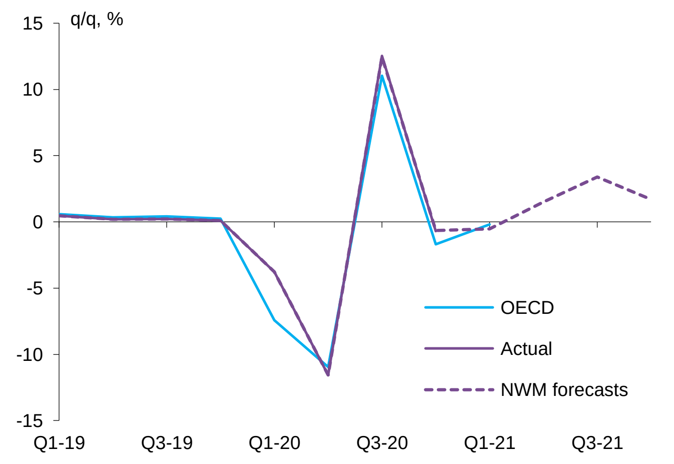


Chart 3: Hard data suggests a (relative) steeper decline

Source: Eurostat, NWM estimates

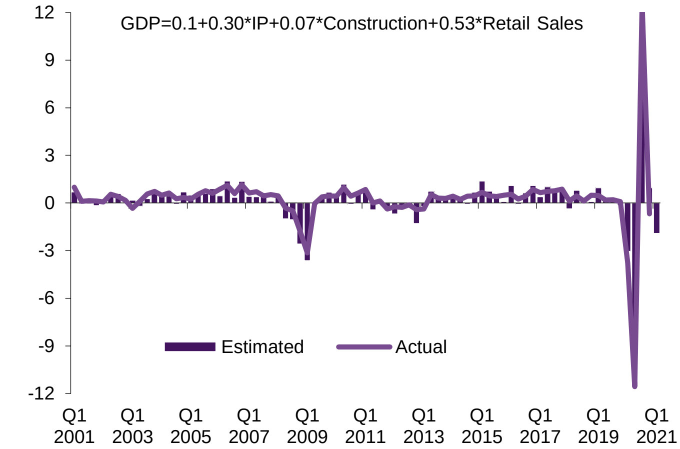
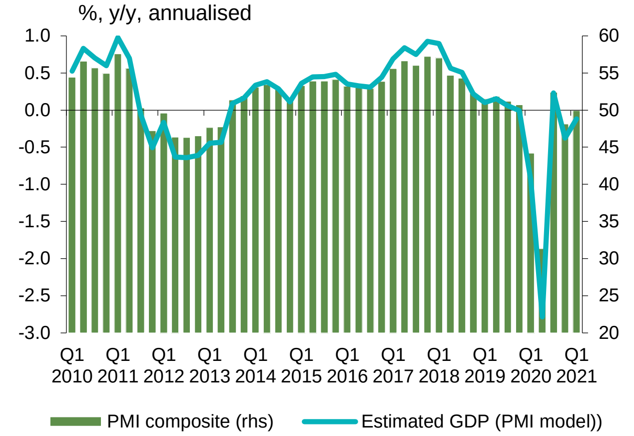


Chart 4: PMIs point to only a very marginal fall

Source: Eurostat, IHS Markit, NWM estimates



Restrictions are a short-term brake on activity. Vaccine roll outs and the end to restrictions are likely to boost activity in the coming weeks. Google mobility sub-components such as retail & recreation and workplaces – arguably the ones most related to economic activity – show that euro area countries have restricted less than the UK until the first week of April (though more than the US, see Chart 5). UK experienced a large jump from the first week of this month as next phase of reopening was initiated. Mobility in euro area countries is expected to further improve as countries plan to re-open in the coming weeks (see Table 1).

Chart 5: Google Mobility- Recreation/Retail & Workplaces

Source: Google Mobility Tracker, NWM

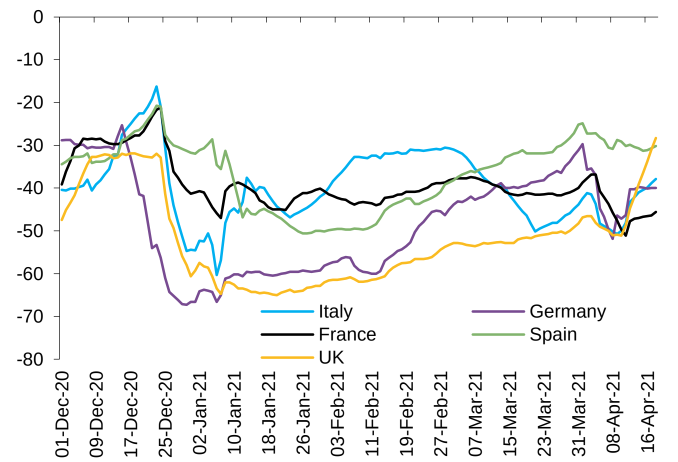


Table 1: Re-opening plans

Source: National sources, NWM

Country	Timeline
Germany	09-May
France	mid-May
Italy	Gradual relaxation starting **next week** (April 26). Priority to schools and "open-air business activities". Schools and universities to resume in yellow and orange zones (with limited restrictions). Restaurants in yellow zones to be open for outdoor seating. The comprehensive plan covers reopening timelines until July 31.
Spain	09-May

Prospects for Q2 and beyond are bright – for several reasons. Firstly, the future outlook in several business surveys is at all-time highs, with companies believing (and preparing) for the recovery (Chart 6 and 7). Forward looking survey, such as PMI, came out better than expected for April (with Germany being an outlier), suggesting ongoing resilience despite the "third" waves and lockdown restrictions (Chart 8). That points to activity already starting to pick up in Q2 with strong momentum and expectations going into H2. Secondly, increasing vaccine inoculations raise optimism – with Q2 expected to witness a significant increase in EU vaccine supply (see our latest European Covid Monitor) – sufficient to vaccinate more than 70% of the EU adult population by the end of June. Moreover, a large improvement was witnessed in consumer confidence in April (Chart 9), much better than expected (-8.1 vs -11 expected and -10.8 in March). Even though there is still some way to go to a full return to normality, those findings are consistent with our central scenario of a recovery accelerating in Q2 – and more so in H2 21.

Chart 6: Euro area firms' expectations remain bullish

Source: IHS Markit, NWM

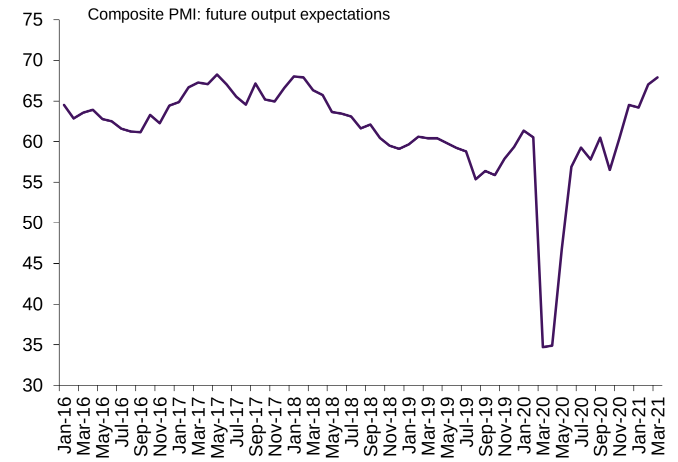


Chart 7: Germany improving and expectations remain high

Source: ZEW, NWM

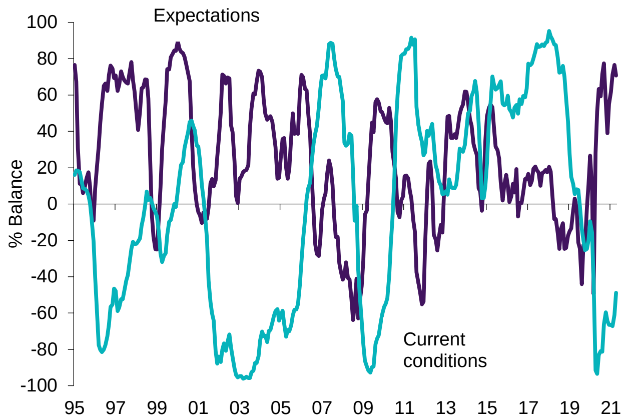


Chart 8: Resilience in activity despite lockdown restrictions

Source: IHS Markit, NWM

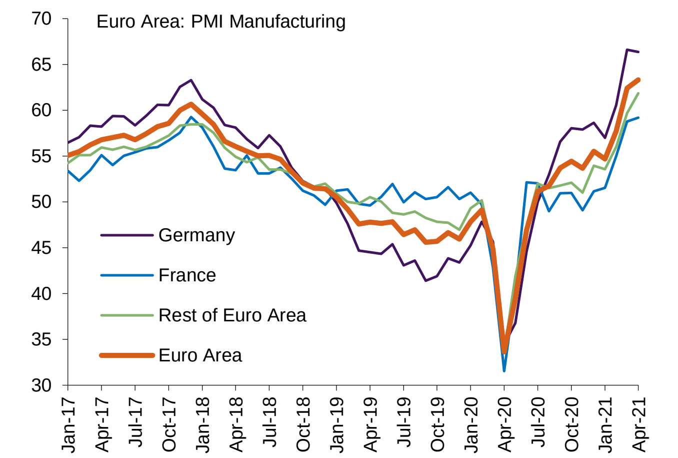
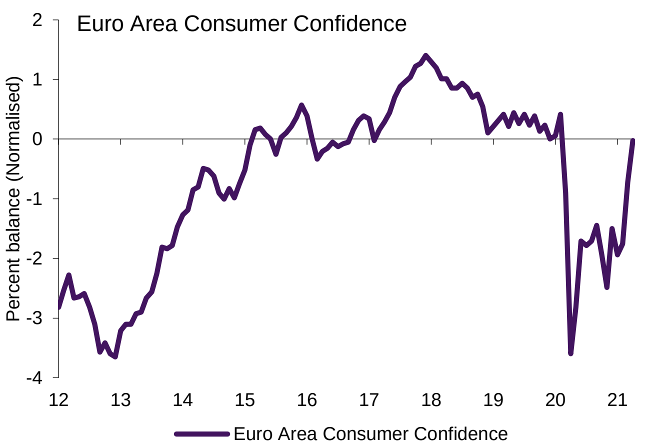


Chart 9: Significant improvement in consumer confidence

Source: European Commission, GfK, NWM



Euro Area forecast summary

Source: Eurostat, ECB, NWM	% q/q, non-annualised								% y/y		
	Q1 21	**Q2 21**	**Q3 21**	**Q4 21**	**Q1 22**	**Q2 22**	**Q3 22**	**Q4 22**	**2020**	**2021**	**2022**
Real GDP	-0.5	1.5	3.4	1.7	1.0	0.9	1.0	0.9	-6.8	5.0	5.8
- Household consumption	-1.1	1.9	5.8	2.3	0.8	0.7	1.0	0.4	-8.1	4.7	7.1
- Investment expenditure	0.5	2.0	3.5	2.0	1.5	1.5	1.5	1.5	-8.5	7.6	7.7
- Government consumption	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	1.1	3.8	2.8
- Dom. Dem. (incl. stocks)	-0.3	1.6	4.3	1.9	0.9	0.9	1.0	0.7	-6.5	5.0	6.3
- Net exports (% pt)	-0.3	0.1	-0.6	0.1	0.1	0.1	0.1	0.1	-0.6	0.4	0.2
Nominal GDP, % y/y	-0.7	14.3	5.5	8.3	8.7	8.2	5.9	5.1	-6.6	6.6	6.9
Unemployment rate, %	8.1	8.3	8.3	8.2	8.0	7.8	7.6	7.4	7.9	8.2	7.7
HICP inflation, % y/y	1.0	1.5	1.8	2.1	0.9	1.0	1.2	1.2	0.2	1.6	1.1
HICP core inflation, % y/y	1.2	0.9	1.1	1.6	0.8	1.2	1.3	1.2	0.7	1.1	1.1
ECB depo rate (EoP), %	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
QE (PSPP/PEPP), EoP, trillion									3.1	4.3	4.8
Fiscal balance (national, agg.)									-8.0	-7.0	-5.0

Thanks to Aastha Gupta for her contribution to this publication

Giles Gale

Euro Area Rates Strategy

1. Don't fight the flows. The European fixed income fight today is fundamentals (bearish) vs flows (bullish). The market's share of supply might have collapsed in Q2. But looking ahead, the squeeze might not last. Cross-border bond flows will be also ongoing, and when the ECB steps back, that will matter. **2. Buy breakevens for rate hikes in 2023?** The other key take away from the ECB this week was very little sympathy for those who don't like negative rates. 2023 hikes are being priced. It's possible, but a stretch. If we get there, breakevens have 10s of basis points to climb. **3. What will the EU do with its swap tool. Asymmetric asw widening risk.** This is an old theme for us that we have repeated frequently and is tracking well, now that the EU confirms it will sign swap lines. That doesn't mean an ESM style programme, but it's on the table**.**

1. Formidable flows. Don't fight them, yet.

The European fixed income fight today is fundamentals (bearish) vs flows (bullish). There were good reasons to think that the ECB this week could be a significant moment in the transition to a more bearish stance. We are half way through the surge in asset purchases and perhaps should be thinking about the next phase. Alas we were given nothing. Ms Lagarde was as opaque as possible on the subject and you can still think whatever you like about asset purchases after June. We happen to think purchases will be stepped back down again to around €70bn net per month.

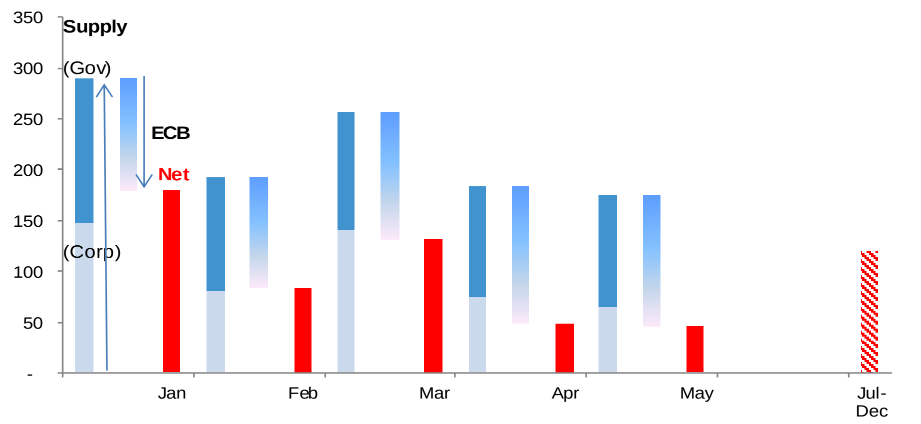
Don't fight the flows, yet. The most significant thing Ms Lagarde said was that asset purchases right now should be close to €100bn per month (i.e. similar to last July's €85bn net PEPP). That implies possibly heavier buying in the short term. After a first half of April that was unusually supply heavy, flows are going to be substantially more supportive for the next few weeks. This isn't the moment to go against them.

The market's share of supply might have collapsed in Q2. Let's just quickly sketch the situation. So far this year, net of the eurosystem's share, IG outstanding has probably been roughly flat (we estimate just +€10bn). But, especially in the short-term, net *new* supply is what matters. The chart below does the talking. The market was relatively well supplied in Q1, especially in January and March. That collapsed in April and is likely to stay tight in May.

But looking ahead, the squeeze might not last. We still expect total net supply for the year to reach around €1200bn. If all this is right, the monthly pace of gross issuance net of Eurosystem purchases for the rest of the year may accelerate to an average of around €120bn/month from this summer. That should be enough to allow the market to relax again a little and re-engage with bearish fundamentals. But that's not yet.

Gross supply in European IG.

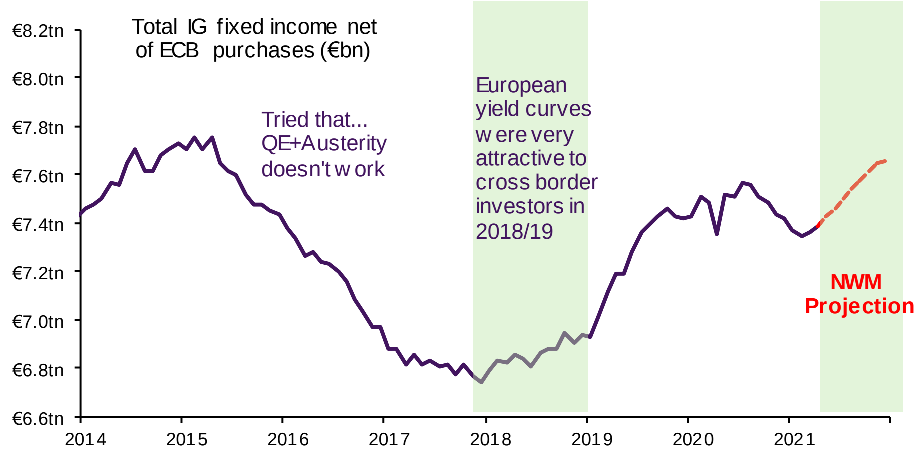
Source: NWM estimates, €bn



The availability of bonds may be less of a problem in H2. While gross supply is what matters for duration over the short term, over the longer term, net supply is the better lens. How does that look? Again, the chart does the talking. The market should not be too tight in H2.

Gross European investment grade bonds outstanding, net of Eurosystem holdings

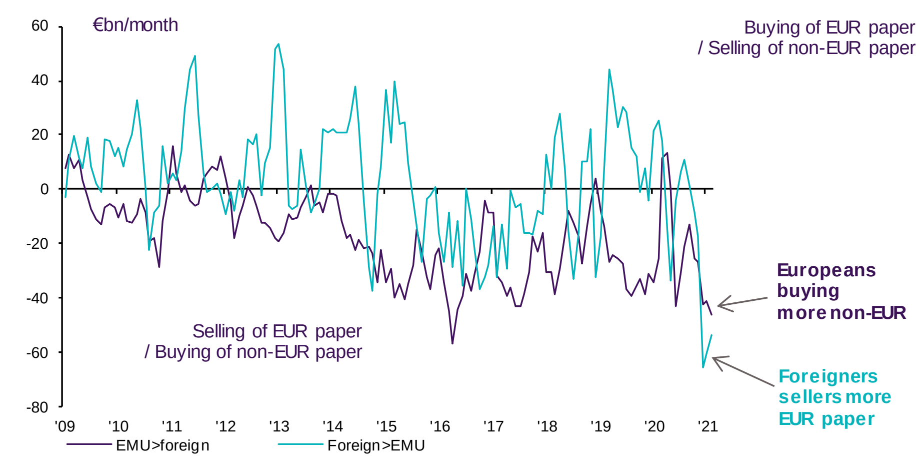
Source: NWM estimates, €bn



Euro into everywhere else bond flows will be ongoing. When the ECB steps back, that will matter. To round off this discussion, the BoP figures out this week are a good excuse to make the point that a European into US fixed income will continue to be a big, big story for as long as the US has both higher yields and a steeper curve to lure investors. Foreigners have been selling around €50bn per month of European fixed income in the past few months on average. Europeans meanwhile have been getting their duration abroad on a similar scale. This should be more than enough to plug the gap between net supply and demands of other European investors who are mainly on the sidelines in all this.

Cross border flows in EUR long-term bonds. European fixed income is not the flavour of 2021.

Source: ECB

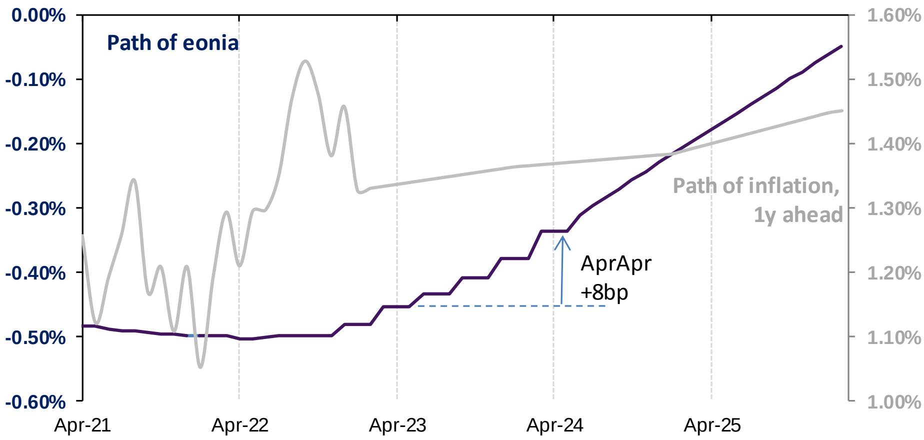


2. Buy breakevens for rate hikes in 2023

Rate hikes in 2023? It's a stretch – inflation is the trade if you want to take this on. The other key take away from the ECB yesterday was that there was very little sympathy for those who don't like negative rates. If there is to be a change in stance regarding negative rates for the long-term, we don't see it so far. The BLS this week didn't suggest any real risk to the transmission mechanism through bank profitability, and the ECB hasn't been as aggressive in tiering as it could have been if it were more concerned. The market now sees rate hikes in 2023. Is that possible? It would imply asset purchases ending around the end of 2022. We are much more optimistic about reflation than most, but even to us that looks a stretch. Far better to look first for higher inflation to motivate that shift by receiving short-end breakevens (or just any breakevens really).The path to rates hikes leads first through lower real rates. That's the trade.

When markets don't talk to each other. Front end traders (the big one) think the ECB might start raising rates in 2023… for that QE has to end in 2022. But if inflation is going to be close to 1.4% with little upward momentum, how is that going to happen. Put the cart before the horse, and buy breakevens!

Source: NWM



3. What will the EU do with its swap tool. Asymmetric asw widening risk.

EU rate locking? Stay long BUXL spreads. We highlighted the asymmetric risk the EU might pose to spreads nearly a year ago when weighing up the likely consequences of the EU's transformation as an issuer in size (see here), and it has not once left our list of reasons to be long buxl spreads since (see here, here and here). Pushback has been mainly that *'SURE doesn't do it', 'no one is talking about it', 'do they have the ability?'* and *'what bureaucrat would take the risk of being blamed if rate locks lose money?'*. The first is easy to address: SURE didn't use swaps partly because it was too soon, and partly because it was a short programme and loans were back-to-backed. We'll come back to the other objections below, starting with ability.

We know now the EU will be able to use swaps. On the latest EC decision regarding implementation details for the NGEU borrowing, the Commission mentions (p2, emphasis ours) *"Debt management operations enable better management of interest rate and other financial risk.* ***It is therefore appropriate to allow the use of derivatives such as swaps to manage interest rate*** *or other financial risks in relation to loans for the Member States…"* Therefore we still think the possibility of rate locking is an asymmetric risk that investors should take seriously.

How will the EU use this tool? We see three possible ways by which a hedging programme would be implemented by the EU:

1) Technical ALM. EU might rate-lock tactically transaction by transaction, smoothening its cash raised in short-term versus long-term, hedging overfunding in bonds, and so on. The EU may also **re-profile debts to match loan programmes for cost apportionment.** The NGEU will not back-to-back funding as for SURE. But it will pass through funding costs to member states who take up loans, and loans will be made available semi-annually (schedule to be determined, it seems). Derivatives may make it easier to link costs to country programmes through a kind of 'synthetic back-to-back'. We think this is the market's base case and clearly the price impact would be lowest.

2. Hedge longer-term refunding risk. The ESM fixed the refunding risk it was running on Greece's behalf in 2017. To the extent that there is a duration mismatch between NGEU lending and borrowing, the EU may choose to manage rollover risk by paying in long-dated forwards.

3. Prehedge expected issuance to back loans, or grants. European governments no longer aggressively use swaps to manage duration in most cases because they know they will be large issuers for centuries to come. The EU isn't like that: it has a big programme that will be largely complete within 4 years. NGEU is largely a spread game – the EU pays less of a spread than Periphery. But it may also care about rate levels and should consider whether to fix rates for loans.

Who carries the can if rates rally and rate locks are underwater? Such substantial risk decisions are above the paygrade of any Eurocrat …this is perhaps the most compelling pushback on the notion of a major rate locking programme. We agree that consultation with member states expecting to receive loans is probably needed. This is how it worked in ESM's case. Note that member states are keen to receive grants before loans as far as possible, so they run more market risk on their future loans. The EU as debt manager may, however, also consider locking the funding for the grant portions, for which it retains the market risk.

Conclusion? Long Buxl spreads, target 45bp. Bobl/Buxl steepeners, target 10bp. The EU is only one dimension to Buxl spreads, which is topical today to discuss. We should add our expectation that the ECB's support for bonds, ASW demand due to low yields, and strong mortgage origination also push in the same direction.

We therefore maintain our long buxl spread view. Bobl/Buxl spread steepeners may be the ideal way to position here: positive carry (small, around 0.5bp/quarter) and protected against shocks to Euribor and German GC. Realised volatility for the asw steepener is around 2/3 of the Buxl outright.

Buxl spread widening will continue to be a theme for 2021. The EU adds asymmetric risk to a constellation of reasons to pay fixed.

Source: NWM, Bloomberg

Ross Walker

UK Inflation Forecasts (April 2021)

UK inflation is forecast to rise sharply in April, principally on energy prices. We forecast headline CPI inflation to climb to 1.4% (y/y) from 0.7%, its highest level for just over a year. Core CPI inflation is forecast to edge up to a 3-month high of 1.2% from 1.1%. RPI is forecast to jump to 2.4% from 1.5%, driven by energy and with additional modest upside contributions from MIPs and Council Tax.

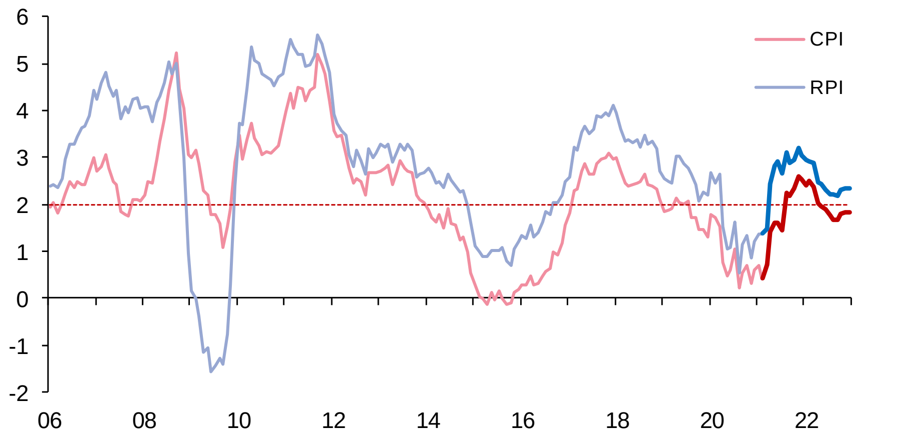
Energy price rises in April reflect both regulated domestic utility prices (the 9.2% m/m increase mandated by Ofgem) as well as sizeable (~3% m/m) petrol price increases. Soft base effects (the impact of the first Covid lockdown) compound the upside effects for inflation in April 2021.

Although we expect consumer *goods* pricing patterns to remain benign, data for April 2021 are expected to capture some early upside price effects for consumer *leisure services* – eg, in the 'restaurants & hotels' (1.4% y/y from 1.1%) and 'recreation & culture' (2.6% from 2.3%) components. Needless to say, we forecast ongoing sizeable, if temporary, gains in these categories in subsequent months.

Our medium-term CPI & RPI inflation forecasts are little altered vs their previous vintage a month ago. We forecast CPI inflation to breach its 2% target as soon as August 2021 (2.2%), peaking at 2.6% in November 2021. There is considerable uncertainty around consumer services inflation in H2 2021. On balance, there are probably upside risks to our forecasts, though the greater the overshoot on one-off post-pandemic pent-up demand effects, the faster inflation will gravitate back down over the course of 2022.

UK CPI & RPI inflation, actual & NWM forecast, %

Source: ONS, NWM



March 2021 data

UK inflation data outturns were broadly as expected in March. CPI rebounded to 0.7% y/y from 0.4% (consensus & NWM 0.8%, City forecast range: 0.4% to 1.0%); Core CPI to 1.1% from 0.9% (consensus & NWM 1.1%, City forecast range: 0.9% to 1.4%); RPI to 1.5% from 1.4% (consensus 1.6%, NWM 1.5%, City forecast range: 1.4% to 1.9%).

As expected, the rise in inflation in March was driven by higher petrol prices: +2.9% m/m, raising the y/y rate to +3.5% from -3.5% and contributing 19bp to the rise in CPI inflation in the month. There was a further, marginal, upside effect from utility prices which added 2bp to CPI inflation in the month.

Clothing & footwear inflation rebounded in March (-3.9% y/y) following February's unusually low outturn (-5.7%), contributing 13bp to the rise in CPI inflation.

Also of note was the softer food price inflation print in March: -1.4% y/y was the lowest outturn this year and went against the recent trend of less deflationary outturns. The move was entirely in non-seasonal foods, so might prove less erratic than one driven by temporary seasonal factors.

Most of the other main CPI & RPI sub-categories reported little change in March 2021, typically an uneventful month from a pricing perspective and therefore leaving the latest inflation data with a more 'normal' feel – albeit one that is likely to be short-lived (see below).

April 2021 forecast

<u>We forecast CPI inflation to surge in April, principally on energy prices (domestic utility prices and motor fuel). Headline CPI is forecast to rise to 1.4% (y/y) from 0.7%. By contrast, Core CPI inflation is forecast to edge up to 1.2% from 1.1%.</u>

<u>RPI inflation is forecast to rise to 2.4% in April from 1.5% in March.</u>

The Ofgem energy regulator's 9.2% m/m rise in its domestic default tariff price cap took effect on 1 April 2021. This hefty increase (essentially a return to pre-pandemic levels) is running off a weak base of price falls in April 2020 (around -2% m/m) and is likely to boost CPI and RPI inflation by ~35bp & ~40bp in April 2021. ONS methodology (using standard tariffs) means that reported domestic energy price changes in the CPI & RPI inflation data in April and October are usually very closely aligned to the regulated Ofgem default tariff cap changes which take effect in those months.

Petrol prices are forecast to rise 2¾% m/m in April 2021. This increase will be accentuated by base effects (a 7.8% m/m fall in April 2020), propelling the y/y rate up to 15.3% from 3.5% and adding ~30bp to CPI inflation.

Food price deflation is forecast to unwind a little in April: -1.1% y/y from -1.4%, providing a modest boost to inflation (~4bp to CPI). Volatile price movements and base effects give rise to greater-than-usual uncertainty around the seasonal produce component. PPI data show a clear uptrend in domestically-produced food price inflation over the past year, in contrast to more variable trends in imported prices. Imported PPI food price inflation has fallen quite sharply during 2021 (-2.4% y/y in March 2021 vs +3.2% y/y in December 2020), presumably in part a consequence of sterling's appreciation.

<u>Overall FBTE inflation is forecast to jump to 2.1% in April from -1.1% in March, adding almost 70bp to CPI inflation.</u>

For RPI, there is a modest rise in Council Tax rise of 4.4% in April 2021 (average Band D increase in England), ½% point higher than the 3.9% rise in April 2020 (adding ~2bp to RPI inflation in April).

In general, among the CPI & RPI goods components, we expect a continuation of benign pricing trends. In the coming months, the focus will shift to consumer services and the extent to which prices are hiked up in the face of substantial pent-up demand. April's data will provide a very early hint of this and we look for higher inflation in the 'restaurants & hotels' (1.4% y/y from 1.0%) and 'recreation & culture' (2.6% y/y from 2.3%) components.

Medium-term forecast

With the March 2021 data in line with expectations our CPI & RPI profiles in 2021 & 2022 are little altered. Pronounced energy and base effects begin to impact in April, with the re-opening of the consumer services economy expected to fuel a temporary overshoot of the CPI target during H2 2021 and H1 2022. The successful UK Covid vaccination process and recent better-than-expected GDP and labour market data provide greater confidence that the consumer-led recovery will play out as expected – see here for our latest UK GDP forecasts.

Our CPI forecasts continue to show inflation above the 2% target from August 2021 through to March 2022, with a 2.6% peak at end-2021. We expect inflation pressures to surface much more quickly in H2 2021 than would be the case in a conventional recovery – we expect significant pent-up demand for restaurant tables, theatre seats and wider consumer leisure services etc to temporarily overwhelm supply and for those businesses to try to claw-back lost income. By contrast, a recovery from a more conventional recession would be likely to see a much more gradual increase in demand. Although our central case is for this overshoot of the CPI target to be temporary, there is considerable uncertainty over how durable these price pressures might be. There are probably modest upside risks to our CPI forecasts in H1 2022.

Our crude oil price assumptions are raised, in line with futures market pricing: Brent crude by around $4 to $63 per barrel at end-2021 and by around $3 to $60pb at end-2022. Oil and natural gas futures prices suggest some upside risks for CPI/RPI motor fuel and domestic heating in H1 2021.

Our sterling profile is little altered – a modest depreciation in the second half of this year to $1.35 at end-2021, with a broadly flat profile thereafter.

BoE monetary policy expectations

Although there has been a significant re-pricing of rate expectations (higher) by markets over the past month, Bank of England policymakers have yet to alter their forward guidance. This suggests some further scope for markets to raise, and bring forward the timing of, expected rate hike. Although we continue to see significant risks of 'hawkish' shift in the latter part of 2021, we remain sceptical about 'early' Bank Rate rises (or a QE unwind) – the UK economy's medium-term prospects appear less stellar than the next 6-12 months. We do not expect the first Bank rate hike before 2023.

The sequencing of the withdrawal of policy stimulus presents a further complication. At the very least we expect policymakers to signal – in the context of the BoE Staff review – that the QE stock can begin to be unwound before Bank Rate reaches previous guidance thresholds ~1½% (probably closer to 1%, possibly even ½% if there is a perceived need to reduce the QE stock). Other things being equal, that would tend to limit how far Bank Rate will rise (QE-reversal will do some of the work) and quite possibly delay the timing of the first hike (if the QE stock is to be reduced for Bank Rate is raised).

Table 1: CPI, RPI & BoE Bank Rate forecast

	CPI		Core CPI	CPI FBTE	RPI		CPIH	BoE
	Index	% y/y	% y/y	% y/y	Index	% y/y	% y/y	Bank Rate
2020								
January	108.2	1.8	1.6	2.5	290.6	2.7	1.8	0.75
February	108.6	1.7	1.7	1.8	292.0	2.5	1.7	0.75
March	108.6	1.5	1.6	1.2	292.6	2.6	1.5	0.10
April	108.5	0.8	1.4	-1.8	292.6	1.5	0.9	0.10
May	108.5	0.5	1.2	-2.4	292.2	1.0	0.7	0.10
June	108.6	0.6	1.4	-2.7	292.7	1.1	0.8	0.10
July	109.1	1.0	1.8	-2.0	294.2	1.6	1.1	0.10
August	108.6	0.2	0.9	-2.3	293.3	0.5	0.5	0.10
September	109.1	0.5	1.3	-2.4	294.3	1.1	0.7	0.10
October	109.1	0.7	1.5	-2.3	294.3	1.3	0.9	0.10
November	108.9	0.3	1.1	-2.8	293.5	0.9	0.6	0.10
December	109.2	0.6	1.4	-2.7	295.4	1.2	0.8	0.10
2021								
January	109.0	0.7	1.4	-2.4	294.6	1.4	0.9	0.10
February	109.1	0.4	0.9	-1.6	296.0	1.4	0.7	0.10
March	109.4	0.7	1.1	-1.1	296.9	1.5	1.0	0.10
April	**110.0**	**1.4**	**1.2**	**2.1**	**299.8**	**2.4**	**1.5**	**0.10**
May	110.2	1.6	1.4	2.2	300.4	2.8	1.7	0.10
June	110.3	1.6	1.3	2.5	301.2	2.9	1.6	0.10
July	110.6	1.4	1.2	2.2	302.1	2.7	1.5	0.10
August	111.0	2.2	2.1	2.4	302.4	3.1	2.2	0.10
September	111.4	2.2	2.0	2.7	302.7	2.9	2.1	0.10
October	111.6	2.3	2.1	3.2	302.9	2.9	2.2	0.10
November	111.7	2.6	2.3	3.7	302.9	3.2	2.4	0.10
December	112.0	2.5	2.2	3.7	304.4	3.0	2.3	0.10
2022								
January	111.6	2.4	2.1	3.4	303.3	2.9	2.2	0.10
February	111.8	2.5	2.3	3.1	304.6	2.9	2.3	0.10
March	112.0	2.4	2.2	3.1	305.4	2.9	2.1	0.10
April	112.2	2.0	2.2	1.5	307.2	2.5	1.8	0.10
May	112.4	1.9	2.0	1.6	307.7	2.4	1.8	0.10
June	112.4	1.9	2.0	1.5	308.2	2.3	1.7	0.10
July	112.6	1.8	1.9	1.4	308.8	2.2	1.6	0.10
August	112.9	1.7	1.8	1.3	309.1	2.2	1.5	0.10
September	113.3	1.7	1.8	1.1	309.4	2.2	1.5	0.10
October	113.6	1.8	1.8	1.6	309.9	2.3	1.6	0.10
November	113.8	1.8	1.9	1.5	310.0	2.3	1.7	0.10
December	114.0	1.8	1.9	1.4	311.5	2.3	1.7	0.10

Source: ONS, NWM

Ross Walker

UK economic data & events previews

A very light UK economic data calendar in the coming week.

BRC shop price inflation is forecast to rise sharply to -1.6% y/y in April from -2.4% in March, principally on base effects (that is, large price falls in the early stages of the first lockdown: -1.3% m/m in April 2020). In general, we expect *retail goods* price pressures to remain modest as non-essential shops re-open. Our expectations for a consumer *services*-led recovery mean the BRC 'shop price inflation' data will probably not best reflect re-emerging price pressures in leisure services, but will still be important as subdued pricing trends for retail goods will provide an important offset.

The **CBI retail survey** is forecast to report sizeable gains in April as non-essential stores re-opened around the middle of the month. The survey plummeted in January 2021 and made only a negligible recovery in February-March. We forecast a rise to -15 in April.

UK data & events, week beginning 26 April 2021

	Time	Period	NatWest	Median	Previous	Comments
Tuesday 27 April						
CBI retail sales survey, % balance	11:00	Apr	-15	n/a	-45	Retail surveys have tended to strengthen this spring. Re-opening of non-essential stores should provide a boost.
Wednesday 28 April						
BRC shop price inflation, % y/y	00:01	Apr	-1.6	n/a	-2.4	Large (upside) base effects from 1st lockdown
Nationwide house prices, % m/m		Apr	0.5	0.7	-0.2	
Nationwide house prices, % y/y		Apr	4.9	5.1	5.7	
Friday 30 April						
Lloyds business barometer	00:01	Apr	20	n/a	15	LBB has tended to lag/under-shoot the PMIs. Rising PMIs in April suggest some further upside.

Theo Chapsalis, CFA

Gilt supply | Big revision from a high base

- **The muted reaction to the £43.3bn gilt issuance reduction indicates that the market had high expectations into today's event. No changes to the Apr-Jun issuance calendar**
- **The BoE is likely to deliver a technical tapering of buybacks at the May meeting and this will be the next driver of net DV01**
- **A healthy economic recovery and stronger macro data will warrant higher yields. Maintain 1% target for 10y**

Big revision without a big market move

A lower outturn of the 2020-21 CGNCR leads to a reduction in the 2021-22 NFR from £297.7bn to £254.4bn and consequently to a £43.3bn reduction in gilt issuance. This is a 14.6% reduction in gross gilt issuance; definitely significant both in absolute terms and relative to previous years. Below you can find our main thoughts in that regard:

- Probably the main driver of gilt yields is net DV01 over the next 1-3 months (see Chart 1). Despite the supply revision and the reduction in net DV01 in the forward space, there is no change in net DV01 until the end of June. The market will need to navigate first through any **gilt tapering announcement** that is likely to be announced at the May meeting.
- While the supply reduction is bigger for shorts in outright terms, the **proportion** of gross DV01 being issued from various buckets remains broadly unchanged (see Table 1). The DMO successfully announced today's change without creating much of a slope or BE move

Chart 1. Above average net DV01 in the weeks ahead

Source: NWM

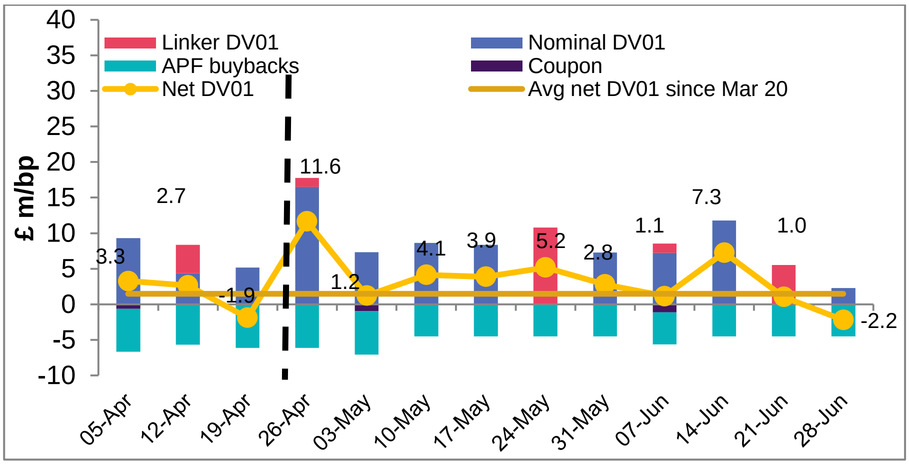


Table 1. Split of DV01 contributions

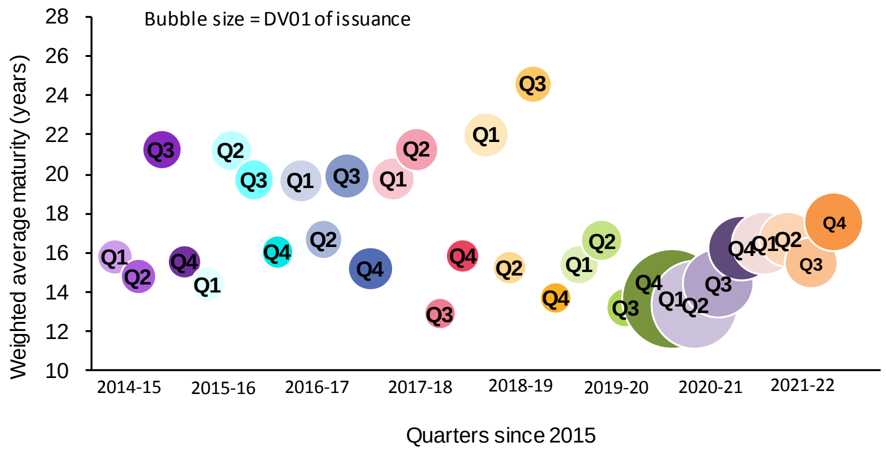
	March'21	April'21
Short	10%	9%
Medium	17%	16%
Long	56%	58%
IL	17%	17%

Source: NWM

- Today's supply news is supportive for ASW spreads, especially short dated. So the richness in the sector will take longer than otherwise to dissipate.
- The DMO has provided us with an updated auction calendar for the FY 2021-22. For the Jul-Sep period, we estimate about £30m/bp less issuance (vs Apr-Jun) but also around £15m/bp less in buybacks (assuming a tapering at the May). On top of that we should account for green gilts that depending on size and maturity will affect the net figures. Chart 2 shows our estimated bubble chart for conventionals.

Chart 2. Conventional gilts –bubble chart including estimates for Q2-Q4

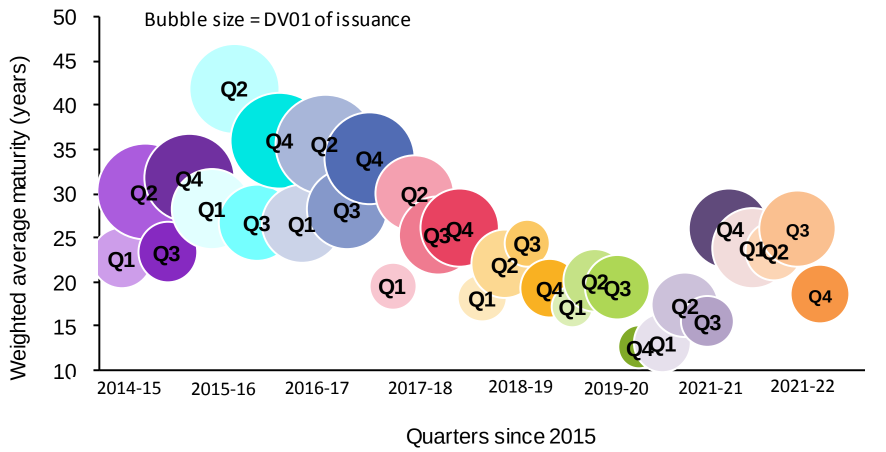
Source: NWM, Bloomberg



- Chart 3 shows the equivalent bubble chart for linkers. The cancellation of a linker syndication will be felt towards the end of the FY 2021-22. In the meantime, we expect the DMO to focus on issuing long linkers, given demand by the market.

Chart 3. Linkers –bubble chart including estimates for Q2-Q4

Source: NWM



Thanks to Sushant Arora for his contribution in this report

Public

Kevin Cummins

Thanks to Deepika Dayal for her contribution to this section.

US: April FOMC Preview

April 27-28 FOMC Meeting Preview

The April FOMC meeting should be fairly uneventful. The Fed has been very clear in signaling that rates will remain at zero for a very long time and we don't expect this to change. FOMC participants continue to emphasize that they will need to see actual evidence of data and not just forecasts that they are reaching their goals before liftoff will begin. We suspect that message will continue to be reiterated at the upcoming FOMC meeting. We don't expect any new information on the timing or the path of tapering to be unveiled. Nor do we expect a technical adjustment to the interest on excess reserve (IOER) rate and the O/N RRP rate, although we can't rule it out entirely we expect that it is more likely to happen in June/July (see link). The policy statement will be released on Wednesday at 2:00pm (EDT) and the post-meeting press conference will begin at 2:30pm (EDT). The first paragraph of the policy statement could sound a bit more upbeat, but our best guess is that the rest will not deviate from the previous statement. On the inflation front, we expect the Committee to note that, on a 12-month basis, inflation has moved up owing largely to base effects.

Changes to statement probably limited to some routine updating

We don't expect significant changes to the FOMC statement. We expect the Fed to keep any changes to the statement fairly simple. In fact, the wording on the economy can largely be repeated from last time. However, if officials decide to make modest changes, the description of current economic conditions could have a slightly more positive tone than in March (consistent with much stronger economic data since the March FOMC meeting—see accompanying table at the end of this note), although the language is unlikely to change enough to send any new signals about the future path of policy. For instance, officials could modestly strengthen the line that begins with: "*Following a moderation in the pace of the recovery, indicators of economic activity and employment have turned up recently"* by adding "sharply". The re-worked line could read: "*Following a moderation in the pace of the recovery, indicators of economic activity and employment have turned up sharply in recent months*." Officials could also upgrade the second part of the sentence that in March said "*although the sectors most adversely affected by the pandemic remain weak"* to instead say "*The sectors most adversely affected by the pandemic have picked up somewhat, but remain well below levels at the beginning of last year."*

As mentioned, the statement will likely rework the reference to inflation since the year-over-year pace is in process of surpassing 2%, by acknowledging that inflation has moved up but adding something similar to the Chairman's view that "*one-time increases in prices from base effects are likely to have only transient effects on inflation*". In May 2018, when base effects pushed up inflation, the economic conditions paragraph in the policy statement noted: "*On a 12-month basis, both overall inflation and inflation for items other than food and energy have moved close to 2 percent*." In addition, the outlook paragraph added "*Inflation on a 12-month basis is expected to run near the Committee's symmetric 2 percent objective over the medium term*." We could envision a change to the inflation language similar to this at the upcoming meeting. Eventually the risks paragraph section, which discusses the economic outlook, could have a somewhat more positive tone—consistent with downside risks lessening—but it still seems premature to remove the reference that the pandemic "*poses considerable risks to the economic outlook*". In any case, these sorts of changes would be considered minor enough and viewed as marking time rather than providing very much new insight.

In our view, market participants can be sure that the Fed's outcome-based forward guidance language that was adopted last year as part of the Fed's new framework will remain identical to the March statement (and for quite some time going forward). Nor do we expect any changes to the "*substantial further progress*" guidance on asset purchases. In his March press conference, Powell mentioned that the Fed has "*laid out what I think is very clear guidance on liftoff. And it's really three things labor market conditions that are consistent with our estimates of maximum employment—and, as I*

Annotated Statement (March)

Source: Federal Reserve and Natwest Markets

March 17~~January 27~~, 2021

Federal Reserve issues FOMC statement

For release at 2:00 p.m. EDT~~EST~~

- Share

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

The COVID-19 pandemic is causing tremendous human and economic hardship across the United States and around the world. Following a moderation in the~~The~~ pace of the recovery, indicators of ~~in~~ economic activity and employment have turned up recently, although~~has moderated in recent months, with weakness concentrated in~~ the sectors most adversely affected by the pandemic remain weak. Inflation continues to run below 2 percent~~. Weaker demand and earlier declines in oil prices have been holding down consumer price inflation~~. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. In addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals. These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Charles L. Evans; Randal K. Quarles; and Christopher J. Waller.

Implementation Note issued March 17, 2021

Last Update: March 17, 2021
~~Implementation Note issued January 27, 2021~~

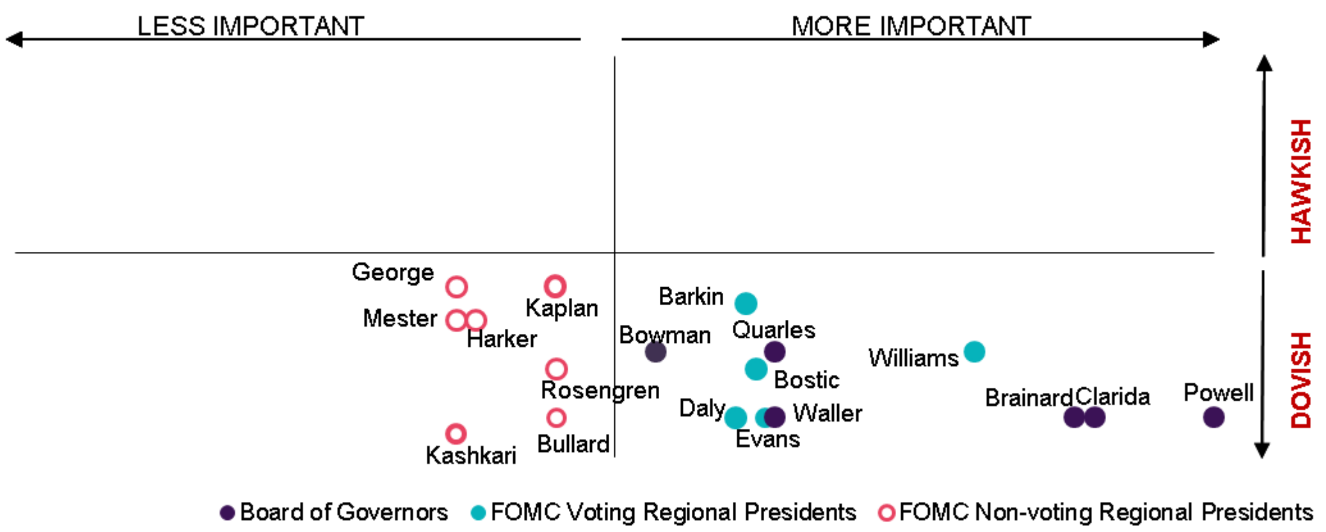
mentioned, we consider a wide range of indicators in assessing labor market conditions, not just the unemployment rate; inflation that has reached 2 percent, and not just on a transitory basis; and inflation that's on track to run moderately above 2 percent for some time. The first two of those three are very much data based; the third does have a little bit of a—of an element of expectations in it. So we are very much determined to implement this guidance in a robust way. It is the guidance that we chose carefully to implement our new framework. And to meet these standards, we'll need to see data, as I mentioned." We also don't expect any new, specific guidance on tapering to be provided next week. Instead, the chair will likely once again indicate that *"it will take some time to achieve substantial further progress"* toward the 2% inflation goal and the maximum employment goal.

More broadly, we expect the Fed chair will reiterate comments he made in a recent CBS News 60-Minutes interview when he said that the economy is at an "*inflection point*", with stronger growth and hiring ahead: "*We feel like we're at a place where the economy's about to start growing much more quickly and job creation coming in much more quickly. So that's really where we are*." On inflation, the chairman said: "*Well, what we said was we want to see inflation move up to 2%. And we mean that on a sustainable basis. We don't mean just tap the base once. But then we'd also like to see it on track to move moderately above 2% for some time. And the reason for that is we want inflation to average 2% over time. Inflation has been below 2%. We want it to be just moderately above 2%. So that's what we're looking for. That's the situation we're looking for. And when we get that, that's when we'll raise interest rates.*"

Powell continued to emphasize the Fed "*can afford to wait to see actual inflation appear before we raise interest rates. Now, we don't want inflation to go up materially above 2% and go back to, you know, the bad, old inflation days that we had when you and I were in college back a long time ago. But at the same time, we do have the ability to wait to see real inflation. And that's what we plan on doing…You know, I don't want to put a date on it [liftoff]. It really comes down to outcome-based guidance is what we call it. And it will not depend on the calendar. It will depend on the progress of the economy toward the goals that we've set, which are 2% inflation and maximum employment. When we get to that place and inflation is expected to run moderately above 2% for some time, then we'll look at raising interest rates. And that day will come.*" We expect Powell will largely reiterate those points at his press conference.

NWM Hawk-Dove Map 2021

Source: Federal Reserve, NatWest Markets.



Economic Data Before March and April FOMC Meeting

	March 16-17 FOMC meeting				April 27-28 FOMC meeting				What has changed? (+ stronger; - weaker; ↔little chg)
Monthly	**Dec**	**Jan**	**Feb**	**Mar**	**Jan**	**Feb**	**Mar**	**Apr**	
Labor Market									
Nonfarm Payrolls (ch, 000s)	-306	166	379		233	468	916		+
Unemployment Rate (%)	6.7	6.3	6.2		6.3	6.2	6.0		+
U-6	11.7	11.1	11.1		11.1	11.1	10.7		+
Investment & Production									
Durable Goods Orders (m/m % ch)	1.3	3.4			3.6	-1.2			-
Core Capital Goods Orders (m/m % ch)	1.5	0.4			0.7	-0.9			-
Industrial Production, Manufacturing (m/m% ch)	0.9	1.0			1.3	-3.7	2.7		+
Capacity Utilization, Manufacturing (%)	73.9	74.6			74.6	71.9	73.8		↔
Manufacturing ISM Index	60.5	58.7	60.8		58.7	60.8	64.7		+
Services ISM Index	57.7	58.7	55.3		58.7	55.3	63.7		+
Consumer									
Personal Consumption Expenditure (m/m% chg)	-0.4	2.4			3.4	-1.0			↔
Personal Income (m/m%chg)	0.6	10.0			10.1	-7.1			+
Nonauto Retail Sales (m/m % ch)	-1.8	5.9			8.4	-2.5	8.5		+
Light Vehicle Sales (mil, SAAR)	16.2	16.6	15.7		16.7	15.8	17.7		+
U. of Michigan Consumer Sentiment Index	80.7	79.0	76.8		79.0	76.8	84.9		+
Conference Board Consumer Confidence Index	87.1	88.9	91.3		88.9	90.4	109.7		+
Housing									
NAHB's Housing Market Index	86	83	84		83	84	82	83	↔
Pending Home Sales Index	126	123			123	110			-
Housing Starts (000s, SAAR)	1680	1580			1642	1457	1739		+
Existing Home Sales (000s, SAAR)	6650	6690			6660	6240	6010		-
New Home Sales (000s, SAAR)	885	923			948	775			-
Inflation									
PCE Prices (y/y % ch)	1.26	1.45			1.41	1.55			+
Core PCE Prices (m/m % ch)	0.30	0.25			0.25	0.09			-
Core PCE Prices (y/y % ch)	1.45	1.53			1.48	1.41			-
CPI (y/y % ch)	1.4	1.4	1.7		1.4	1.7	2.6		+
Core CPI (m/m % ch)	0.0	0.0	0.1		0.0	0.1	0.3		+
Core CPI (y/y % ch)	1.6	1.4	1.3		1.4	1.3	1.6		+
Average Hourly Earnings (y/y% ch)	5.5	5.3	5.3		5.2	5.2	4.2		-
U. of Michigan 5-10yr Inflation Expectations (%)	2.5	2.7	2.7		2.7	2.7	2.8	2.7	↔
Weekly	3 month ago	2 month ago	1 month ago	Latest	3 month ago	2 month ago	1 month ago	Latest	
Bloomberg Consumer Comfort Index	49.0	43.2	44.9	49.4	45.7	47.3	49.1	54.2	+
Initial Jobless Claims (000s, 4-week avg)	776	834	823	759	812	736	658	547	+
Mortgage Applications Purchase Ind (4-wk avg)	331.6	338.9	318.8	289	334.2	264.9	301.9	295.5	-
Retail Gasoline Prices ($/gal, regular)	2.20	2.38	2.50	2.83	2.42	2.71	2.87	2.89	+
Bloomberg Financial Conditions Index	0.6	0.7	0.9	0.7	0.5	0.5	0.9	1.1	+
Wilshire 5000 Index	38505	39508	41489	40889	39652	40194	41301	43459	+
S&P 500 Index	3701	3768	3935	3899	3787	3811	3971	4173	+
10-year Treasury Yield (%)	0.92	1.08	1.21	1.52	1.04	1.40	1.71	1.56	+
30-year Conforming Fixed Mortgage Rate (%)	2.86	2.89	2.86	3.21	2.86	3.25	3.25	3.08	-
Crude Oil (WTI, $/bbl)	47.82	52.36	59.47	64.44	52.34	61.50	61.56	61.35	-
TIPS Breakeven (%): 5-Yr, 5-Yr Ahead	1.92	2.03	2.13	2.12	2.09	1.95	2.23	2.19	+

Source: Labor Department, Institute for Supply Management, Federal Reserve Board, Commerce Department, University of Michigan, National Association of Home Builders, National Association of Realtors, Bloomberg, and NatWest Markets ; *We've added a + to personal income because policymakers are well aware that March income is going to surge due to the fiscal stimulus payments last month.

Kevin Cummins

US Economy Preview

Thanks to Deepika Dayal and Garima Ahuja for their contribution to this section.

Highlight of the week: The headline on the upcoming week's calendar is the FOMC meeting (which we expect to be fairly uneventful—see accompanying note). Meanwhile, the economic calendar is full, with the three key reports: Q1 reports on GDP (Thursday) and the employment cost index and the core PCE deflator (both due on Friday). GDP growth is widely anticipated to have been strong—we look for an increase of 7.5% annualized. Meanwhile, given the Fed's focus on inflation, any surprise with the ECI (the Fed's preferred gauge of compensation) and core PCE prices (forecast: 0.271%) could also prove to be sort of interesting. Other data to be released this week that may condition views on the economy include durable goods orders, consumer confidence, and personal income and spending.

Key US data & events, week beginning 26th April, 2021

	Time	Period	NatWest	Median	Previous	Comments
Monday 26 April						
Durable Goods Orders, % m/m	08:30	Mar	+1.0	+2.0	-1.2	Boost from aircrafts and defence orders
Tuesday 27 April						
Consumer Confidence Index	10:00	Apr	113.0	111.7	109.7	Vaccine availability, fiscal stimuli and job recovery
Wednesday 28 April						
Fed Meeting						Fairly uneventful
- Fed decision on target FF Range	14:00		0.00-0.25	0.00-0.25	0.00-0.25	No new information on tapering expected
- Press Conference	14:30					More of the same
Advance Wholesale Inventories, $ billion	08:30	Mar			682.5	
Advance Retail Inventories, $ billion	08:30	Mar			625.9	
Advance Goods Trade Balance, $ billion	08:30	Mar		-87.1	-86.7	Widest deficit on record in February
Thursday 29 April						
Initial Unemployment Claims	08:30	Apr-24	520,000		547,000	4-week moving average
Real GDP (Preliminary), % q/q saar	08:30	Q1	+7.5	+6.1	+4.3	A strong start to 2021 GDP growth
- GDP Price Index, % q/q saar	08:30	Q1	+2.1	+2.5	+2.0	
Pending Homes Sales Index, % m/m	10:00	Mar		+4.0	-10.6	Feb was curtailed by weather /inventory shortages
Friday 30 April						
Employment Cost Index, 3 mon % chg	08:30	Q1	+0.7	+0.7	+0.7	Some moderation in wages, increases in benefits
Personal Income, % m/m	08:30	Mar	+20.5	+20.0	-7.1	Huge boost from another round of fiscal stimulus
Personal Spending, % m/m	08:30	Mar	+3.5	+4.0	-1.0	Stimulus checks propelled spending too
Core PCE Deflator, % m/m	08:30	Mar	+0.3	+0.3	+0.1	Base effects to push y/y to 1.8%
Chicago PMI	09:45	Apr		64.0	66.3	Feb ISM-adjusted reading was 64.9, a 3-year high
University of Michigan Sentiment - Final	10:00	Apr		88.2	86.5	

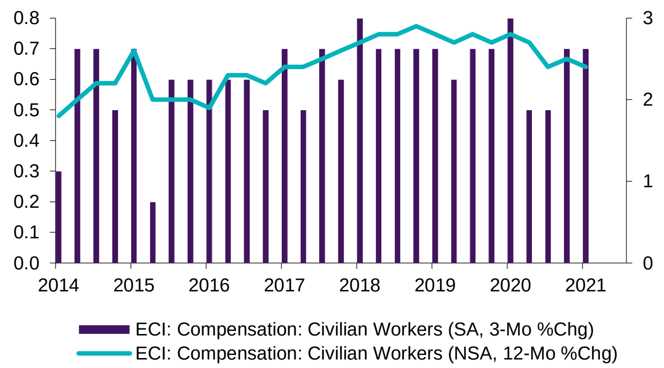
Source: NWM, Bloomberg

Fed's preferred measure of compensation costs and inflation due

The employment cost index likely advanced by 0.7% for the three months ending March 2021, matching the pace registered in the three months ending December 2020. The wages and salaries component of the ECI may have posted a 0.6% gain at the end of March, moderating a bit from the above-trend 0.9% gain in the three months ending December. In general, wage pressures since the onset of the pandemic have been muted. Average hourly earnings, which are impacted by compositional effects, surged at the beginning of the outbreak (as low wage sectors with a typically high share of employment saw unprecedented declines) but have moderated since then. In Q1 2021, average hourly earnings were up 0.2% versus 1.2% spike in the prior quarter. In contrast, the ECI for wages and salaries is aggregated using fixed weights for employment sectors and could have firmed by more than the AHE gain. Meanwhile, the benefits component of the ECI may post a faster clip for the three months ending March, after back-to back gains of 0.6%. Readings in line with our estimates would push down the year/year pace for the ECI lower from 2.5% at the end of 2020 to 2.4% at the end of March 2021.

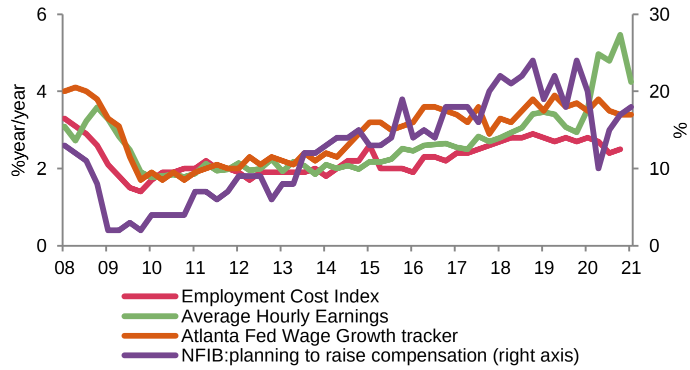
Employment cost index

Source: Bureau of Labor Statistics and NatWest Markets; 2021 shows NWM forecast



Select wage growth indicators

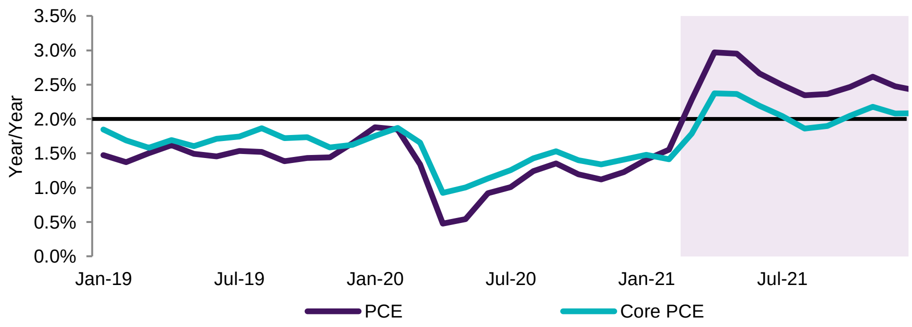
Source: National Federation of Independent Business, Atlanta Federal Reserve Bank, Bureau of Labor Statistics and NatWest Markets



Meanwhile in March, the CPI and PPI reports indicate that the core PCE deflator- the Fed's preferred inflation guage- may have advanced by 0.3% last month. While most of the strength from the CPI report (such as lodging away from home, household furnishings, recreation and rents) and some strength from the PPI (airfares and financial services)will feed through to the core PCE deflator, strength in other CPI components (such as motor vehicle insurance) will not. On an unrounded basis, our 0.271% estimate for the core PCE deflator is lower than the 0.339% gain in the core CPI. Additionally, base effects from last spring will boost year/year PCE inflation numbers this spring as low readings from last year fall out of calculation. These low base effects and a realization of our March 2021 estimate would push up core PCE deflator from 1.4% in February to 1.8% in March. Meanwhile, the headline PCE deflator could have firmed by 0.5% in March, pushing up the year/year rate from 1.6% in February to 2.3% in March. Also, the passage of a $1.9 trillion fiscal stimulus package in March likely boosted personal income and spending in the March report. We expect personal income soared last month, as a fresh set of economic impact payments (up to $1,400 each) augmented taxpayer wallets.

PCE inflation

Source: Bureau of Economic Analysis and NatWest Markets



A strong start to 2021

We forecast that real GDP increased 7.5%q/q, saar in Q1. The advance retail sales report for March was exceptionally strong, as renewed improvement in the labor market and the fiscal stimulus that began to be distributed in mid-March helped generate strong spending. To some extent services spending will dampen the impact of the retail surge in the broader PCE data, but the increase will still be substantial. We expect (nominal) spending rose 3.5% in March, and real consumption advanced 3.0% for the month (monthly data will be reported on Friday, April 30), and look for real PCE to increase 10.0% (annualized) in Q1 as a whole. Furthermore, the strength in spending in March, also positions for a very strong trajectory for continued strength in Q2, even if spending moderates (or temporarily dips) in April.

Residential investment is on track for another solid gain in Q1, and appears on track to carry solid upward momentum into Q2, as housing starts reached surged 19% to a 15-year high in March and builder sentiment remains extremely positive. In contrast, business investment in equipment should continue to provide a small boost to GDP, given what appears to be another solid performance in capex spending so far in Q1. Real investment in intellectual property products are expected to be up again solidly, rising by an estimated 9 ½% pace (after 10.5% in Q4 and 8.4% in Q3). Meanwhile, nonresidential structures investment spending may be down for the fifth consecutive quarter, while public construction spending may show little net change. At the same time, the overall inventory sector appears to be on pace for a drag of about 1 1/4 pct pts from growth in Q1. Net exports significantly dragged down growth in H2(20), and we look for trade to shave another 0.7 percentage points from growth in Q1. Assuming vaccines remain effective against new variants of the virus, the economy should experience significant growth for the rest of the year. The combination of several positives: an extraordinary amount of fiscal stimulus; highly accommodative monetary policy; an extremely positive supply shock as the economy re-opens; and a pile of ‘excess’ savings to support consumption make us extremely optimistic about GDP growth in 2021 and 2022. We forecast real GDP growth at a 9.5% (Q4/Q4) in 2021 and 3.2% in 2022.

For the main price deflators, we estimate that the GDP price index increased 2.1% saar in Q1 while the PCE price index rose 1.3% and the core PCE price index rose 1.6%. We also look for nominal income growth of 50% in Q1, with wages and salaries up 6.0% and transfer payments surging almost 475% due to two rounds of economic impact payments. With overall income growth far outpacing consumption growth, the saving rate should move up to around 18½% in Q1 from 13% in Q4. We estimate that Q1 disposable personal income (DPI) was 14% above the level prevailing in late 2019, despite the still-low level of employment. Meanwhile, nominal consumer spending was up 2.5% across that same reference period, as normal spending by consumers was largely repurposed into savings due to social distancing, quarantine, and a reticence to spend. As a result, this accumulated “excess” or “forced” savings (i.e., savings above normal levels) bodes well for future consumption. For more, see link.

Some secondary indicators to round out the rest of the coming week

Durable goods orders likely bounced back by about 1% in March after falling 1.2% in February. We expect the headline measure to have been boosted by a rise in bookings for civilian aircraft. Orders for capital goods excluding defense and aircraft (the measure that serves as a proxy for business investment) could have edged up, perhaps by about 0.2%. Finally, confidence indicators could have signalled a continued recovery in consumer attitudes in April. We look for the Conference Board’s consumer confidence gauge to have increased to 113.0 in April from 109.7 in March. This would coincide with the rise in the University of Michigan’s consumer sentiment index in early April (86.5 after 84.9 in March). The final April University of Michigan reading is due Friday, April 30.

John Briggs

Waking From Hibernation

Last week in our piece Goldilocks and the Three Bears, we covered how we currently had three degrees of bearishness regarding the US, UK, and European bond markets: outright bearish in the UK, neutral in bunds as we await a momentum shift to Europe and don't want to fight the ECB, and neutral but slumbering bears in the US getting ready to awaken.

This week our conviction has risen to be outright bearish on the US rate market. As also discussed last week in comparing the present move to that of 2016-2017:

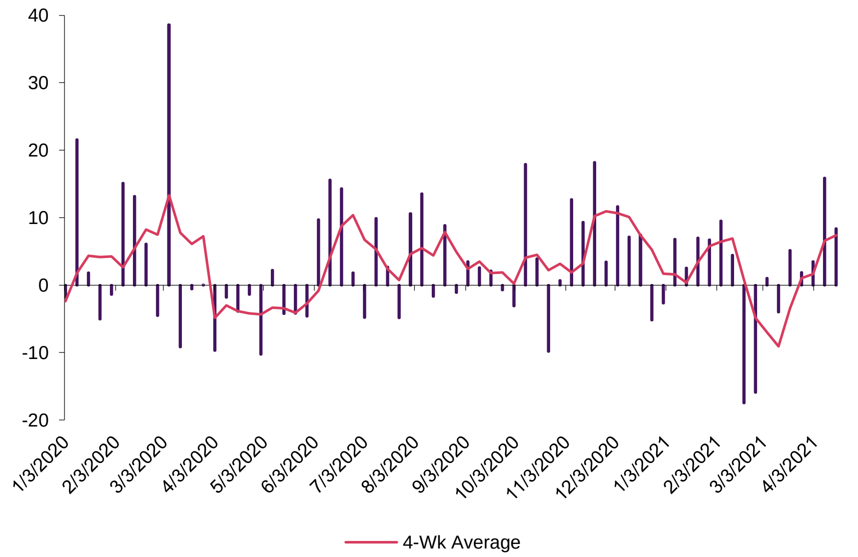
"We do not think we are looking forward to a year of range trading as in 2016-2017 [after the initial move]; Q3 we expect the taper discussion to begin in earnest, the 2021 recovery story is a much stronger one than 2017, and if inflation delivers later this year, the market may resume its selloff. Thus, we want to sell rallies in the current environment, to be prepared in case the duration of the pause is shorter than in 2017, and the second leg of the move resumes.

We see another similarity: the yield curve. In 2016 the first move was a bear steepener, in 2018 it was a bear flattener (and the curve flattened during the 2017 "pause"). This mirrors our current view that the Q1 move was dominated by curve steepening and that the next leg will be led by the belly and eventually the front end as long as the recovery and inflation outlook are verified, the Fed tapers (we see setup for a 1Q22 taper starting in 3Q21), and the market believes the Fed will relatively soon after head towards liftoff. Hence as we look to sell rallies, we are focused more on the belly of the curve rather than the long end, after being bearish 10yr yields and in 5s30s steepeners coming into 2021."

So while at the time we wanted to see if the current rally would extend into this week, and recommended shorting 5s at 0.75%, **we are now initiating this recommendation at current levels of 0.80% (alternatively, pay 2y2y at 0.85%). We also like selling 5s on 2s5s10s, currently at -10bps.**

We do this for several reasons. First, we feel that short positioning has lessened, supported by decent real money flows and evidenced by fairly well supported long end auctions, as well as simple anecdotal conversations with our client base. Second, while the expected Japanese and other foreign real money flow has continued, the pace has slowed this week (+$8.4bn) from the very large purchases ($15.9bn) the week before (chart on following page).

Japan Net Purchases of Foreign Medium- and Long-term Bonds ($bn)
Source: Bloomberg, NWM



Third, we should be through the bulk of the receiving flows coming from financial issuance. Lastly, from a technical perspective, momentum has entered overbought after being oversold for some time, near the 38.2% retracement level of 0.76%. So, given all this, we initiate our short exposures here. While we are not expecting the Fed to make any changes to its QE guidance at the April meeting next week, we still nevertheless believe that strong US economic data will lead market focus on Fed tapering and future rate hike timing to rise in the next couple of months.

US 10yr Yields

Source: Bloomberg, NWM

Paul Robson
Brian Daingerfield

Global FX Themes

The Long Road to Policy Normalisation

This week, Canada became one of the first G10 central banks to take a big step towards monetary policy normalization. But the road from here to whatever the new, post-Covid-19 "normal" monetary policy looks like in the G10 is likely to be long and differentiated across economies. We don't expect the FOMC to take any steps towards a taper of its asset purchases at the April meeting next week – the Fed wants "substantial further progress" towards its inflation and employment goals before tapering, and we don't think they are there quite yet. (NWM Preview)

The fact that reduction of stimulus is being considered at all in several economies is a testament to strong global growth. Economic data continues to suggest an ongoing recovery, though the recent trend of Covid-19 case growth in Asia is more troubling of late. But underlying growth in Asia remains robust, and strong Korean export growth reported this week is encouraging. The US economy is growing strongly and European growth prospects are improving. That leaves us comfortable to retain a risk positive bias in our portfolio of trades.

Positive underlying global growth and a timid Fed is a strong combination for EMFX, which we think can continue near-term. Three fundamental factors support broad EM valuations at this time: a) strong trade balances in most countries given global commodity demand; b) improving FI inflows as US rates have stabilized; and c) the restoration of carry as EM central banks start responding to vaccine progress, growth rebound and in some cases budding inflation. We think the market might be underestimating the impact of higher carry for broad EMFX valuations – we are long TRY, BRL and RUB, with each seen as benefitting from carry in an environment where US rate are falling (or, at least, not rapidly rising anymore). These drivers are also supportive for risk/growth sensitive currencies in the G10 including AUD, SEK and CAD – and we hold long positions in each.

The ECB meeting this week was largely uneventful (NWM ECB Review), and sources stories suggest that the ECB had few discussions about the modalities of PEPP beyond June. But we continue to think pessimism in Europe is likely overdone, and increasing vaccine supplies should soon filter into a wider recovery in Europe. This week's meeting has the look of the high water mark for dovish ECB policy guidance. We are short USD/SEK as a higher beta EUR/USD long position.

For Sterling, we are noticing a pickup in interest in May's Scottish elections. The election appears delicately poised in terms of whether a SNP majority is returned. The immediate risks centre on a nationalist out-performance which might force earlier Westminster engagement around another independence referendum. This is not obviously fully reflected in current market pricing. Although the optics around the UK remain positive with a further significant easing of lockdown restrictions and encouraging Covid-19 trends, the elections do present event risk to the near-term outlook. Positioning and shifting (negative) seasonals in May suggest a reduction of long GBP positions into the event is possible. Sentiment will be sensitive to the size of any majority for Nationalist parties (and hence polling in the run-up). Last week we closed EUR/GBP and GBP/CHF, though we still hold a long GBP/USD position.

We expect the Riksbank to keep policy rates unchanged next week, supported by economic resilience despite tightening restrictions, accelerating vaccine distribution both locally and globally, and better anchored long run inflation expectations. It should keep to its forecast for a swift recovery once the economy reopens and European/global recovery accelerates in H2. Near-term GDP and inflation projections are likely to be revised higher again. However, the statement should emphasise that it will use the full envelope of asset purchases through to the end of the year, reiterating its expansionary policy stance. Relative growth expectations are a more important driver of the SEK at the moment than monetary policy. We thus remain short

USD/SEK given the SEK's traditional high beta to strengthening Euro area growth and growing optimism in the global recovery.

USD | For the Fed, How Much Progress Qualifies as Substantial?

CAD | Tale of the Taper

SEK | Riksbank to be cautiously optimistic

Asia | What to watch next week

Next week | FOMC/Riksbank/BoJ/NBH/BanRep Decisions, US/Euro-area/Canada GDP, Euro-area/Australia CPI, US Consumer Confidence, Japan IP/Mfg PMI, Sweden Economic Tendency Survey/Retail Sales, Riksbank's Breman speaks

Open Trades

Carry and valuations trump policy concerns - Long TRY vs EUR, USD

Peak pessimism on European growth becoming closer - Short USD/SEK

Compression of significant risk premia - Short USD/BRL

EM Beyond USTs: Tail winds still on the horizon - Long USD/INR

Looking on the bright side - Short EUR/CAD

Higher US yields and growth - Long USD vs JPY and CHF

Weak industry and risk-prone flows - Long USD/MXN

Finding value in reflation - Long COP and RUB vs basket

Market to test the BoI – USD/ILS 6m put spread

Brexit and early vaccine rollout – Long GBP/USD

Leg Into Reflation Trades - Long AUD/USD

FX Models

G10 FX Ranker | AUD, NZD favoured over CHF & SEK (link)

EMFX Macro Ranker | Long MXN, RUB and SGD, short PEN, BRL and HUF (link)

G10 Long-term Drivers | AUD, NOK Cheap vs the EUR & JPY (link)

G30 FX Long-term valuations | Long AUD, sell NOK (link)

G10 Valuation Snapshot | Long NOK, AUD vs CHF, EUR

G10 Valuation snapshot

Source: Bloomberg, Natwest Markets

Valuation snapshot

FX	Long term value	Short term value	Carry	Positioning*	Momentum**	Equal weighted score	Rank (1,2= buy. 9,10= sell)
USD	10	NA	2	7	8	6.8	7
EUR	9	5	9	6	7	7.2	9
GBP	6	3	5	4	3	4.2	4
JPY	5	7	7	5	10	6.8	8
NOK	1	6	4	NA	1	3.0	2
SEK	3	8	8	NA	5	6.0	6
CHF	7	9	10	3	9	7.6	10
AUD	2	1	6	1	4	2.8	1
NZD	8	2	1	2	6	3.8	3
CAD	4	4	3	8	2	4.2	5

1= Top rated , 10= bottom rated currency across coloumns
*Gap between signal implied positioning and actual CTA positioning (1=most positive, 8=most negative)
**FX Momentum rank (avg. rank of deviation from 100-day MA & 30 day RSI) (1= high mom., 10 = low)

Alvaro Vivanco
Paul Molander

Peru: Higher risks, but too binary for now

We remain neutral looking for more clarity to add

- **Peruvian voters are stuck between two political extremes that do not represent the greater will of the electorate**
- **Castillo's policies challenge Peru's economic order, however he will likely lack a strong political mandate should he be elected**
- **Fujimori remains challenged by her significant unpopularity, but would largely maintain Peru's current framework if elected**
- **We prefer to remain neutral on both FX and rates as we await a clearer political picture and more attractive levels to reengage**

Radical change vs status quo

Pedro Castillo and Keiko Fujimori, the candidates heading off to the second round of the Presidential elections on June 6th, represent the opposite ends of the Peruvian political and economic spectrum. The election essentially comes down to a shift towards a statist economic model under Castillo versus the continuation of the current policy framework that has defined Peru for the past few decades under Fujimori. As such, it is difficult to overemphasize the binary nature of the outcome, even if both camps move somewhat towards the middle over the next month and half.

Their personal backgrounds are also strikingly different. Castillo is an elementary school teacher and activist who gained national attention as he led unions during the 2017 teacher's strike. He ran for mayor of a small city in 2002 but has never held office and his party organization was formed as a platform for the current election. Fujimori, on the other hand has been known for her neoliberal economic views and tough stance on security issues. She has kept a constant political presence since being elected as a Congresswoman in 2006. This is her third time as a Presidential candidate in the second round: she lost to Humala in 2011 (48% vs 51%) and to Kuczynski (by a very small margin) in 2016 even after winning the first round by a large margin.

From a wider perspective, the choice that Peruvians face is not dissimilar from the increasing political polarization both in Latin America and globally. Although they each have their own idiosyncrasies, they reflect the general discontent with the status quo. Social tensions, including in stable economies such as Chile, have obviously been exacerbated by the pandemic and have manifested (or will likely manifest in the next electoral cycle) in pretty much every LatAm country.

There is also the perspective of previous similar fears about a move towards unfriendly market administrations from Peru's own Humala, to Lula, to AMLO more recently. They all highlight the potential for exaggerated asset moves as the fears compile, followed by relief once the change in policy direction is moderated.

Will this be the case for Peru this time? We approach this below, focusing on what Castillo has proposed as a platform, the chances of them materializing and how that relates to what the polls so far are highlighting.

Public

What are Castillo's policy proposals?

Peru Libre's political doctrine (here) presents a strong anti-neoliberal stance, focusing of a shift towards a much bigger and active state as it takes over some of the market functions. Indeed, it offers a strategy to save Peru from "the dictatorship of the market". The document pays tribute to political personalities such as Lenin, Castro and Chávez.

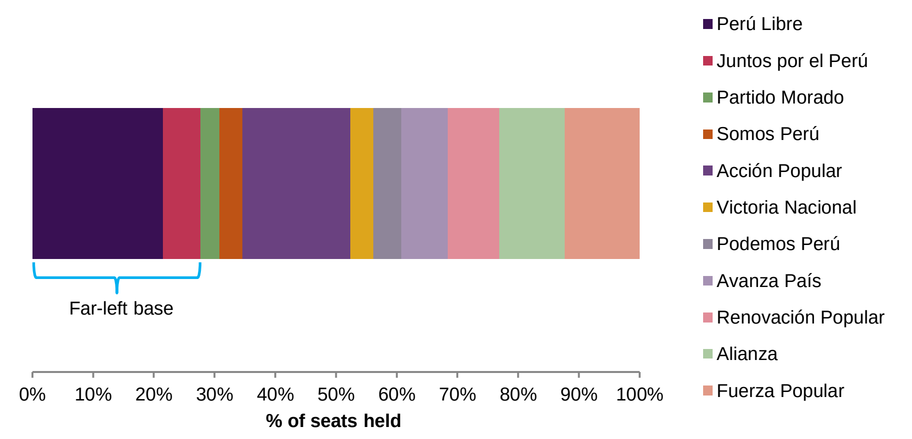
The party proposes a number of policies that would, if implemented, constitute a historical shift for the country. In more practical terms, these include:

- Establishing a new constitution with the government as the primary market regulator and redistributor of wealth;
- Calls to nationalize economic assets, including copper mines and energy assets, with a focus on changing the revenue sharing from foreign-owned projects;
- Renegotiation of foreign debt in order to pay it, which in turn would allow the re-investment in social projects (also coming from the nationalization and revision of revenue sharing contracts with private companies);
- Revision or annulation of trade agreements and pushing back on US influence across the Americas.

As we have argued in the past, we believe that such proposals would be difficult to implement to their full extent due to Peru's sizeable economically conservative electorate and relatively strong domestic institutions. Even if the left-leaning parties came together in a coalition, it would be far from an outright majority in the upcoming Congress (see Chart below). That is, a much broader and stronger political mandate would be required for Castillo to begin to implement his economic agenda, which seems unlikely at this point.

New congressional composition would make a Castillo presidency difficult

Source: ONPE, NWM Strategy



It is also worth noting that this platform was created prior to Castillo announcing his candidacy and that he has made moves to soften some of the proposals, particularly related to mining. To some extent, Castillo's ability to capture a larger share of the electorate in the second round will depend on some moderation of his rhetoric to capitalize on Fujimori's rejection (very much like Humala did in 2011). However, this also runs the risk of alienating his core supporters, which has already been highlighted by some leaders of his movement.

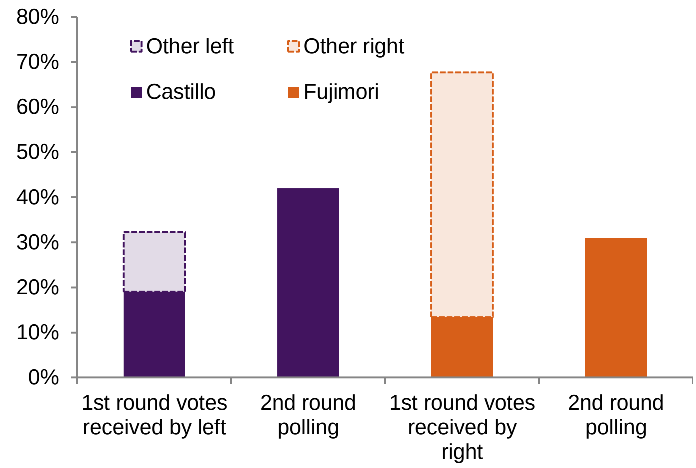
In addition, his own party's anti-media orientation may prevent him from having his voice heard, as was exhibited recently when his supporters physically blocked him from giving a statement to the media at a campaign event. This puts Castillo in a difficult balancing act.

What are the polls telling us?

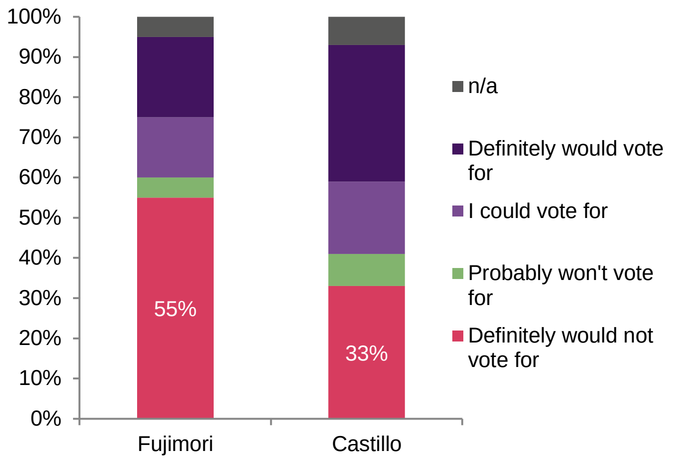
Against Castillo's policy stance stands Fujimori's personal appeal. One of the most important features in the first round was the significant fragmentation among many candidates, which effectively split the center-right vote much more than among the left-leaning candidates. In this context, both Castillo and Fujimori surprised compared to the previous polling as they captured the most votes within each camp. Importantly, they both had stronger momentum towards the end of the campaign, particularly Castillo who was able to climb very quickly from low starting numbers.

But less than one-third of Peruvians voted for Castillo and Fujimori combined and neither candidate received more than 20% of the vote, leaving a sizeable sector of the electorate undecided and presumably frustrated with their options. This is the first critical message for the markets: the uncertainty remains very high and we could see shifts in both directions up to the last minute.

Castillo has gained support beyond first-round base
Source: ONPE, Ipsos, NWM Strategy



Fujimori has a high rejection rate among voters
Source: Ipsos, NWM Strategy



This is further complicated as Peruvians seem to prefer a conservative candidate, at least based on the first round performance. In fact, nearly 68% of voters selected a candidate that is right-leaning. However, the latest polling shows that Fujimori has lost some of this right-wing support moving into the second round, with Castillo capturing 10% of the previously right-wing vote, and 16% of voters choosing to select neither candidate.

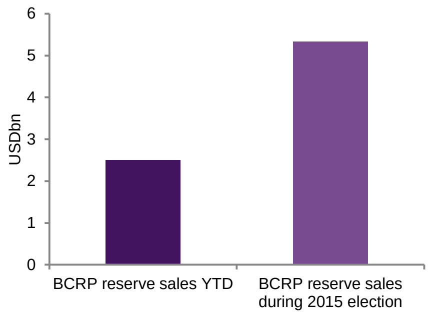
This very preliminary evidence pushes back against the idea of approaching voting blocks as "monolithic" ones that can be transferred from one candidate to another, which is often the case when it comes to second choices. At the same time, one would imagine that a sizable portion of the electorate is uncomfortable with some of the more extreme Castillo proposals.

This is partly due to Fujimori's high disapproval rating (at around 55% in the latest poll) amongst voters, which presumably reflect both a rejection of the political/economic status quo, as well as her personal appeal in light of going corruption investigations. Whether these negatives factors dominate the concerns about the country moving towards a much more uncertain economic system remain to be determined. From our perspective, our base case has been that Fujimori will be able to put together a larger coalition of voters than Castillo, but our confidence around has certainly decreased following the most recent polling.

How are markets likely to react?

BCRP actively reduces volatility during election cycles

Source: Bloomberg, NWM Strategy



Given this much tighter electoral scenario, last week we recommended taking profits on our remaining short CLP trade vs PEN (and dollar as well, details here). While our base case remains relatively constructive for Peruvian assets, we think the risks have increased materially and we prefer to wait for both a) more clarity on how the undecided voter preferences evolve over the next couple of weeks, and b) better entry levels, before adding Peru rate and FX longs.

In particular, we highlight the following points:

- We think PEN is currently under-pricing the chances of a Castillo win. While it is difficult to point to where PEN would trade under each election scenario, we think the downside risks under Castillo are significantly higher even if we attach a less than 50% probability of him winning.

  In fact, the sol has been rather resilient as a large portion of Soberanos offshore holdings have already been FX-hedged. This was our rationale for being defensive on Peru throughout 2020 (here) as the effects of the much lower FX carry changed the equation for bond investors.

  In addition, the BCRP has room to increase intervention on the FX market if volatility were to increase significantly, which they have highlighted recently. The side chart shows the FX intervention in the previous elections compared to the amount implement so far this year.

- We view the Soberano curve pricing in a more negative scenario than the sol. Long-end yields have widened ~125bps from December lows. This has been mostly on the back of the external environment and in line with EM peers, but the last 25bps are more reflective of the electoral concerns.

  This responds to the still sizable foreign ownership of local bonds (48.2% as of the end of March) which will be much more difficult to manage under times of stress. Indeed, the appetite of local banks and pension funds to increase local duration would likely be challenged if polls continue to point towards a Castillo win.

- From this perspective, we remain cautious on both assets and prefer to wait for more clarity before adding with a bias towards the long-end of curve rather than the sol.

Paul Robson
Yuan Cheng

Looking beyond near-term headwinds

Incrementally more optimistic

We expect the Riksbank to keep policy rates unchanged at the April 27th meeting, supported by economic resilience despite tightening restrictions, accelerating vaccine distribution both locally and globally, and better anchored long run inflation expectations. The Riksbank will continue to forecast a swift recovery once the economy reopens and European/global recovery accelerates in H2. Near-term GDP and inflation projections are likely to be revised higher again. However, the statement should emphasise that it will use the full envelope of asset purchases through to the end of the year, reiterating its expansionary policy stance. Relative growth expectations are a more important driver of the SEK at the moment than monetary policy. We thus remain short USD/SEK given the SEK's traditional high beta to strengthening Euro area growth and growing optimism in the global recovery.

At the February 10th meeting, the Riksbank kept the policy rate unchanged and said **purchase assets would continue within the envelope of SEK 700bn**, but some of its asset purchases in H2 would be brought forward to Q2. Near-term GDP and inflation projections were revised higher as the central bank acknowledged that the economy was more resilient to the second wave of the pandemic than to the first.

The focus for **the April 27th meeting will be the impact of the 3rd wave and extended restrictions in Q2 on the economic recovery, the prospect on vaccine rollout and easing of restrictions, and the inflation outlook**. The monetary policy statement will likely mention the uncertainties around rising infections, extended restrictions and on-going vaccine rollout, but at the same time stress the resilience of Swedish economic recovery despite the uncertainties.

The Riksbank will likely look through near-term headwinds of the 3rd wave and continues to forecast a swift recovery once the Swedish economy reopens, and European/global recovery accelerates in H2. Meanwhile, given the extent of the crisis, the central bank is likely to reiterate its expansionary policy stance "to facilitate the recovery and help inflation rise towards the target" and continue to indicate that it could take until 2023 before inflation is close to the 2% target more permanently.

Economy has been resilient amid restrictions

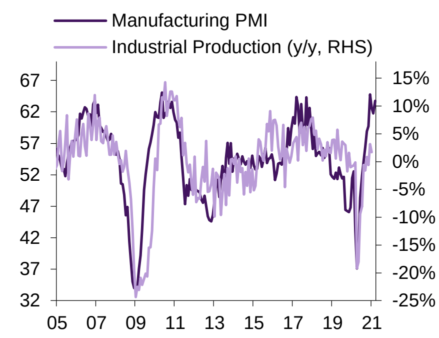
Swedish economic growth has been resilient to tightening restrictions. February's GDP indicator increased by 0.7% m/m, suggesting that Q1 growth might turn out stronger than the Riksbank's -0.4% forecast. Q2 GDP might be lower than projected given the 3rd wave and better-than-expected performance in Q1, but H2 higher given the expectation of a swift rebound in recovery. In all, '21 calendar-adjusted GDP may be revised higher to 3.3% from 2.9%.

Sweden's Economic Tendency Survey data has been tracking GDP. March survey data showed another rise to the highest since end of 2018, mainly supported by strong manufacturing, while retail and services confidence remained relatively weak. The domestic sector is likely to remain relatively soft in the near team due to the extended restrictions, but the improving confidence suggests that businesses are seeing through near term headwinds, which points to swift recovery in GDP once the restrictions are removed and as the vaccine rollout moves forward as expected.

Sweden March manufacturing PMI showed another pick up, while services PMI fell slightly, but both remained at expansionary territory. The resilience in manufacturing sector corresponds to the strong NIER economic tendency survey sentiment in manufacturing sector.

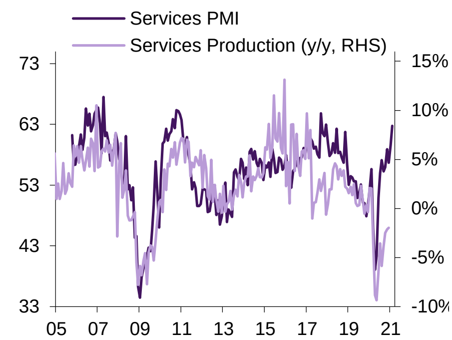
Manufacturing output vs PMI

Source: Macrobond, NWM FX Strategy



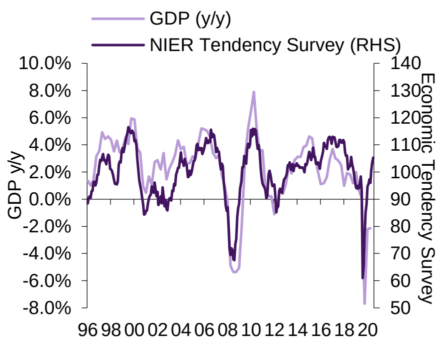
Service output vs PMI

Source: Macrobond, NWM FX Strategy



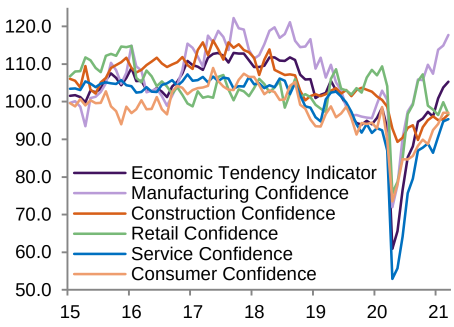
GDP Growth vs NIER Economic Tendency Survey

Source: Macrobond, NWM FX Strategy



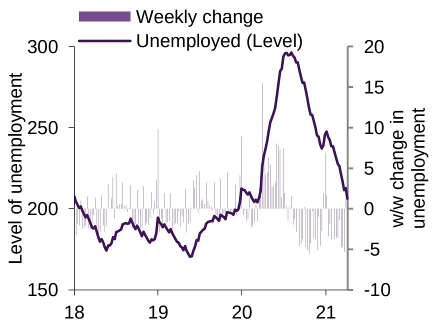
NIER Economic Tendency Survey Component

Source: NWM FX Strategy, Macrobond



Unemployment

Source: Macrobond, NWM FX Strategy



Inflation rose in March after an unexpected fall in February, with CPIF inflation slightly better than consensus expectations and in line with the Riksbank's projection. The rise was mainly driven by the rise in transport, clothing & footwear, housing & utilities. **March inflation expectations also showed a further improvement**.

Policymakers will take comfort in higher-than-expected inflation and better anchored inflation expectations to some extent. Deputy Governor Henry Ohlsson noted that "inflation expectations signal trust in target".

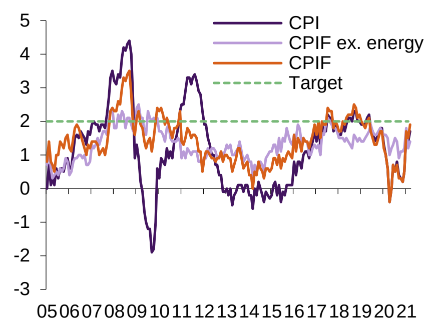
However, inflation in the near term will be calculated against a period with very low energy prices last year. As such, the rise is likely to be seen as only temporary.

Ohlsson recently said that as inflation data remains harder than usual to interpret, general macroeconomic factors including unemployment will need to be taken into account.

Weekly PES unemployment data continued to fall in recent weeks, leading the unemployed levels to trend lower to pre-pandemic levels, which shows **solid recovery in labour market despite extended restrictions**.

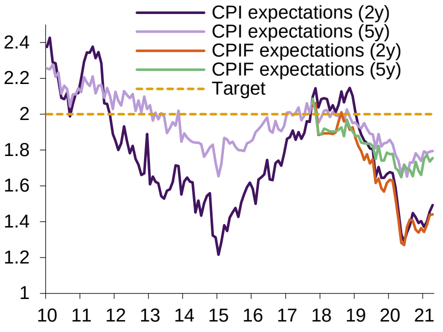
CPI inflation

Source: Bloomberg, NWM FX Strategy



Inflation expectations

Source: Bloomberg, NWM FX Strategy



Covid-19 developments and vaccination progress remain critical for the reopening of Swedish economy and easing of extended restrictions. Sweden is currently experiencing a 3rd Covid-19 wave with the highest number of Covid-19 cases in the Nordics. New daily cases showed another pick up after the Easter holiday period, but have shown signs of trending lower afterwards. It appears that the peak of new daily cases has passed. The government has postponed a planned easing of the toughest restrictions until 3rd May to combat the 3rd wave while the vaccination programme is progressing.

Vaccinations are picking up. Sweden currently has 25.58% of population vaccinated, a similar pace with its Nordics neighbours, but slightly faster than European average (Norway 25.26%; Finland 26.56%; Denmark 27.91%; Europe: 24.84%). April, as expected, has been the turning point for European vaccination campaigns. **The accelerated pace of vaccination in Europe could push forward the pace vaccinations in Sweden and suggest that the latest round of restrictions could be eased on the planned timeline, giving a boost to economic activities.**

Overall, we expect the Riksbank to keep policy unchanged, as Swedish economy has been resilient despite the third Covid-19 wave and tightening restrictions. Policymakers will likely see through near-term headwinds of the third wave and expect swift recovery once Swedish economy reopens, and European and global recovery accelerates in H2 of the year**.**

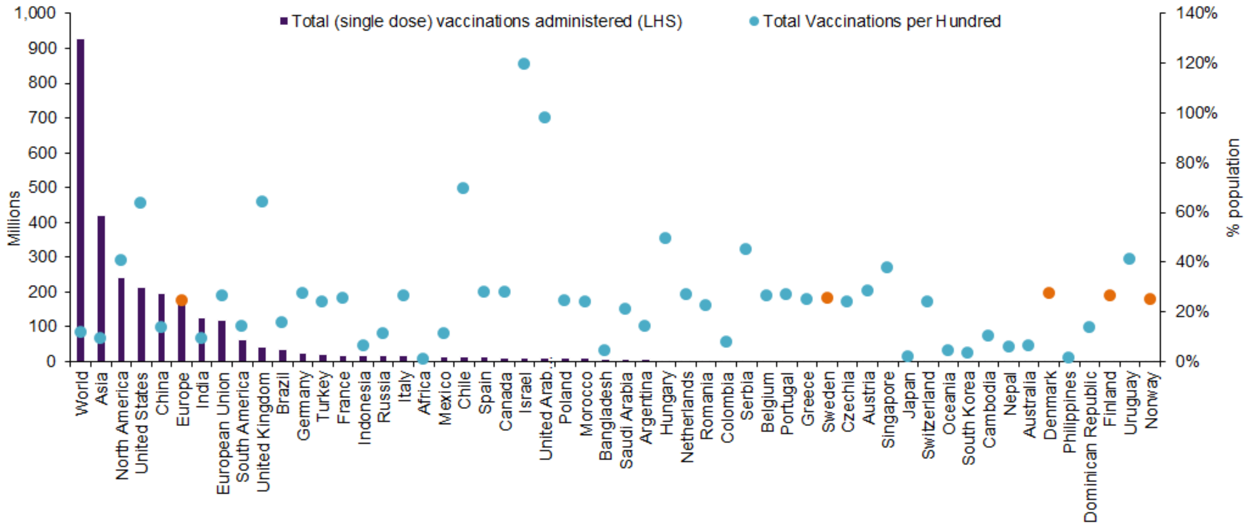
Uncertainties around Covid-19 trends, extended restrictions and on-going vaccine rollout remain high. Therefore, the Riksbank is expected to reiterate its expansionary policy stance “to facilitate the recovery and help inflation rise towards the target”.

Negative rates will likely remain in Riksbank’s toolbox. But we believe the hurdle to negative rates is high given the economic resilience despite tightening restrictions, accelerating vaccine distribution both locally and globally, and better anchored long run inflation expectations.

Relative growth expectations are a more important driver of the SEK at the moment than monetary policy. **<u>We thus remain short USD/SEK given SEK’s traditional high beta to strengthening Euro area growth and growing optimism in the global recovery.</u>**

Vaccine distribution progress so far globally

Source: OurWorldinData.org



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Historic Trade ideas log

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