Global Macro Weekly

Desk Strategy

19 March 2021

Treasuries abandoned to their FAIT

It started slow, but the *Reflation Rout* can now hold its head high with the great Tantrums of the decade. This week concluded the March cycle for the most heavily anticipated central banks. Brazil's hike leaves us bullish BRL. The DM majors were dovish, as expected, but not enough to declare that higher rates threaten financial conditions enough to demand push-back. Stocks started to get nervous again at the end of this week. Fed members saw more inflation sooner, but only one more thought it would mean a 2023 hike. Welcome to FAIT. Europe's Astra flip-flop was more distraction than market-mover. We accentuate the positives: and one is that when Europe does reopen, savings will part of the rescue party sent in search of Private C (consumption). In Nordics, we take profits on longs against the euro. And in EM, higher Treasury yields remain a key risk driver, but it is important to look beyond and continue to assess the holistic picture.

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John Briggs

Key Theme		Best Trades
Reflation Rout in bonds	Yields continue to head higher, reflation will be hard to disprove near term as it is based on expectations re: reopenings months from now. Supply an added problem. Policy makers, except the ECB, so far have been unable to push back effectively.	• EUR 10s20s swaps steepener • EUR curve caps • USD long term steepening bias, near term neutral • Short 10y gilts
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.	• Long 5y Italy • EUR 10s20s swaps steepener • Long 5y5y EURi breakevens
Vaccine and the UK recovery	BoE signals no move to negative rates before August 2020. Probability thereafter has also diminished: pay 5y SONIA swaps, stay short 10y Gilts (though fair value ~0.75% target has been reached) and sterling to strengthen.	• Long GBP vs EUR, CHF • Target 10y yields to 0.75% • Pay 5y SONIA swaps
Inflation risks are tilting higher	A continuation of ample fiscal stimulus along with CB policies that encourage higher inflation help BEs widen. The vaccines act as a further tailwind with ILBs seen as a means of diversification and protection.	• Long 1y1y US CPI • Long 5y5y EURi breakevens • Sell 5y 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 Germany 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.	• 10y Italy vs Germany spread tightener • 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	Fundamentals still suggest ILS appreciation and the market will test the BoI. CLP remains expensive as policy premia increases. Oil FX (COP, RUB) has room to catch up with reflation, and we see MXN as a good hedge to this position as valuation is relatively rich.	• ILS 6m put spreads • Shot CLP vs USD & PEN • Long RUB & COP (vs USD, EUR • Short MXN vs USD

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	1.9%	1.6%	9.0%	0.00 - 0.25%	1.50%
	Q2	2.9%	2.3%	4.0%	0.00 - 0.25%	1.55%
	Q3	2.4%	1.9%	7.0%	0.00 - 0.25%	1.60%
	Q4	2.4%	2.0%	5.0%	0.00 - 0.25%	1.70%

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	0.80%	1.3%	-3.50%	0.10%	0.80%
	Q2	1.90%	2.3%	3.60%	0.10%	1.00%
	Q3	2.10%	2.3%	4.10%	0.10%	1.00%
	Q4	2.30%	2.3%	2.20%	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%	-0.9%	18.6%	3.85%
	Q2	2.5%	1.6%	6.6%	3.85%
	Q3	1.9%	1.1%	4.4%	3.85%
	Q4	2.4%	1.2%	4.3%	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

Giles Gale
Jan Nevruzi

Euro Rates

Bullish euro rates, but monitoring the ECB closely. This week seems to have been more about easing in than shock and awe. Long-end steepeners are stronger conviction: positive carry and the long end is more likely to feel the Anglosphere's gravitational pull. Asset swaps should be widening, again at the long end especially, as the ECB works harder to hold back a tide to higher global rates and nervous investors cover duration in swaps. We target 40bp on the Buxl. Long periphery, especially Italy. In Spain, under a surface of stability, politics is being remade, only not fast enough. Be short Spain versus Italy in 5y.

The ECB vs the world. No shock and awe yet. Last week we put our money on the ECB, precisely because it has so much… er… money. This week they seem to have been easing in, if anything, rather than going for shock-and-awe. As we rarely tire of repeating, foreigners are a key market that will be looking at better rates everywhere and selling. The ECB can do enough to plug that gap if it wants to, but this requires monitoring. The other key question for European rates will be whether their credibility is enough to shift the investor demand schedule a little in its direction. We explained our tactical shift to bullish bunds more in detail last week (*ECB Review* and *Euro Area Rates* in last week's *Global Macro Weekly*).

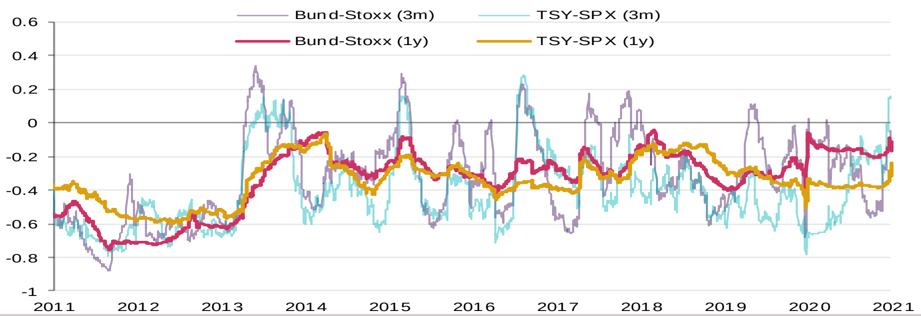
The global environment matters… steepeners. We don't expect the ECB to try to defy the gravitational pull of a Treasury led sell-off entirely, at least without a strong local economic negative, which we don't see (the Astra soap opera this week included). But this side of the Atlantic, it looks like the great reflation debate is still finding its consensus-point. Therefore, we prefer to express our tactical Bund outperformance view vs. Treasuries, particularly past the 10y point. Curve steepening may be an easier call in the US where the Fed's dovishness has been focused in the front end, in contrast to the ECB where it's focussed further along the curve. But beyond 10y, we feel gravity is likely to pull harder. Curve steepening is also the positive carry choice (last week we showed the league table of positive carry steepeners and will refresh on demand). Curve steepening is therefore also a stronger view now for us than the duration call in Europe.

And so does resisting the global environment… asset swap wideners. We also have high conviction on asset swap widening in the long end. The more the ECB holds back the tide of higher rates, the more it supports cash, and encourages buyers to swap duration. We develop this further below.

Risk correlations continue to point to lightening up in duration. That's a global steepener that's only just begun. The death of the macro hedge is a major slow burn theme for this year and beyond. We don't expect many to notice that we have been banging this drum for nearly a year now. But they might notice Ray Dalio's thoughts – here's the update: the bond-stock return relationships have been weakening even further this year. Correlations have been getting closer to zero and this dynamic should add to the global fixed income selling, particularly in the US, driving along the long end yields in core Euro Area higher.

Stock-Bond correlations have been approaching zero

Source: NWM, Bloomberg



The economics of investing in bonds (and most financial assets) has become stupid…
…Rather than get paid less than inflation why not instead buy stuff—any stuff—that will equal inflation or better?
Ray Dalio gives the view from Risk Parity, March 15

ECB support and lower vol = long Italy. The ECB's strategy now appears to be a form of vol control or 'crawling yield curve control'. Lower volatility, higher purchases should be good for Periphery. We are still long Italy with high conviction.

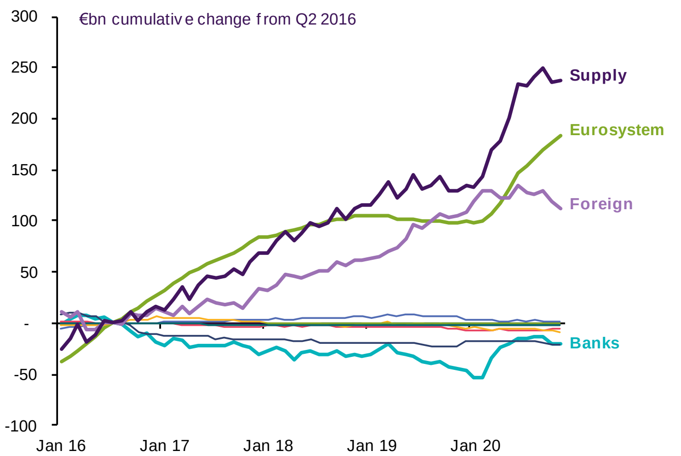
Or Italy vs Spain. For those who are less confident, there are no standout RV themes that we have our eye on, but our conviction on Italy against Spain has been hardening.

Spanish politics are stable, despite being remade beneath the surface. If you enjoy political intrigue, Italy is now a disappointment, but in Spain the political map is rapidly being remade. Ciudadanos (Cs) appears to be in the final stages of collapse, and Pablo Iglesias (left-wing firebrand by market reputation) has left the government to try to rally the left in snap elections called for Madrid. At some point this will require a fuller analysis, because the loss of Cs leaves middle ground to be fought over by the main parties, and Podemos also seems to a diminished force on the left. But for now, the bottom line is that Sanchez government should survive, probably to 2023.

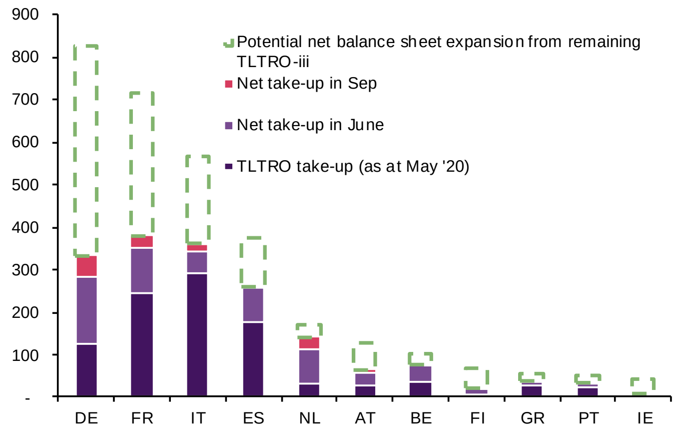
But Spain's stability is second-best. Although political stability is normally good news, even if just skin deep, minority government has not been good for Spain which has been overtaken by Portugal. If the market senses that the Draghi government is able to deploy recovery funds more effectively, for example, it is easy to see investors continuing to shift to the higher yielder with the stronger story.

Italy should win the race for attention from TLTRO-iii-flush banks and foreigners too. At the sectoral level, TLRO-iii this week (€330bn) is also a relative positive for Italy, we think. Italian and French banks had much more borrowing capacity than Spanish, so we guess that relatively more money has gone there. Clearly Italian banks are more likely to follow home bias, and we suspect French may have more room on Italy. Starting with other Europeans, Italy has a lot more room than Spain here to regain market share. And finally Italy is the only sovereign issuer in Europe now which competes with rates elsewhere.

Sector flows in SPGBs since 2016. The Eurosystem has been squeezing the big holders: Foreigners and Banks
Source: NWM, BdE



TLRO-iii support? Most of the borrowing space was in the big-3
Source: NWM

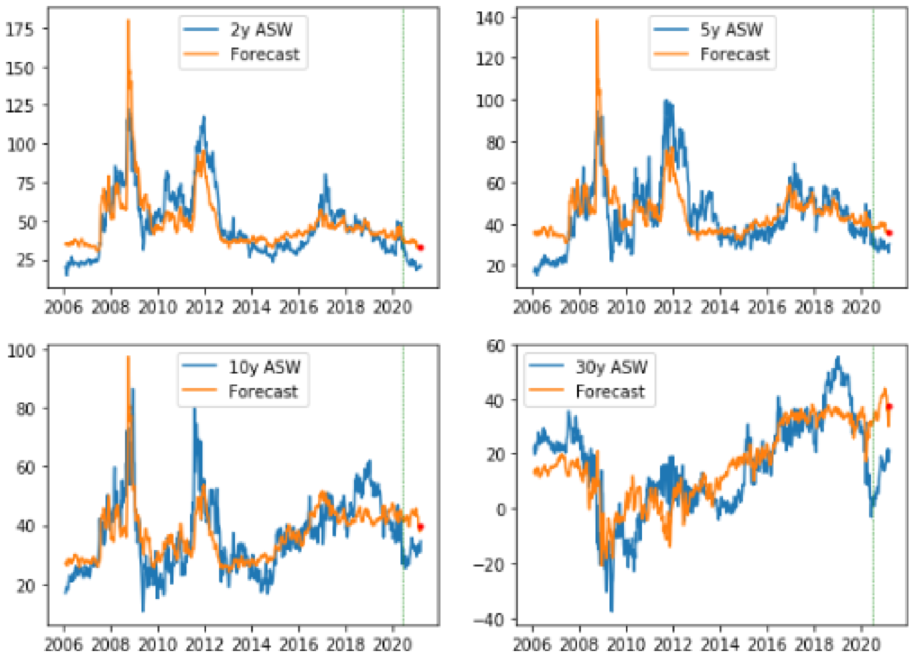


Short Spain 5y vs Italy. Where on the curve? The main RV theme in Periphery, and especially Spain has been curve steepening (and relative steepening). It makes sense to position short in the 5y, especially since this is the area most likely to be supported by TLTRO-iii on the Italian curve.

The steepening should be led by swaps. We revisited our ASW model, which uses funding rate differentials for the front end, as well as net supply, mortgage origination, and volatility as inputs to determine fair value for swap spreads. While the model is in line with our view for wider spreads (chart below), particularly at the long end, there are additional qualitative factors that we do not think are captured in it.

Our ASW model points to further widening in the long end

Source: NWM, Bloomberg



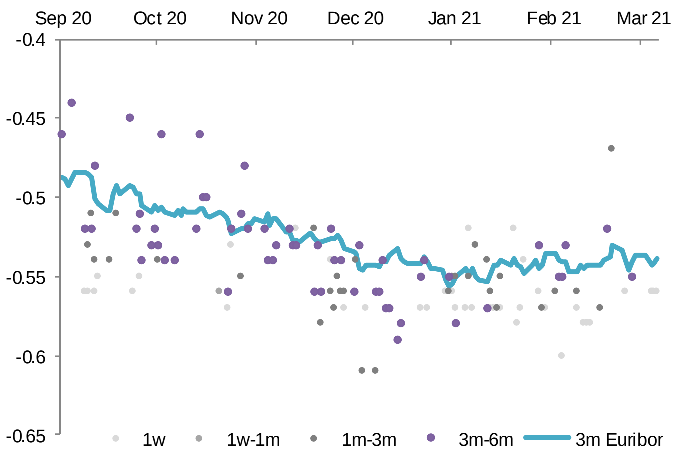
Rates volatility is the most powerful driver of long end swap spreads in our models. Historically, a spike in volatility was usually followed by episodes of heavy receiving in the long end. As we have mentioned before, we think the 2019 and 2020 volatility spikes left long end swaps at extremely and potentially unjustified levels. The 30y ASW spread subsequently has performed well since the last sharp tightening exactly a year ago. More interestingly, the increase in implied volatilities this year, on the back of rates moving higher globally, did not lead to tighter swap spreads. We attribute that to the nature of the higher volatility this time around – rates have going up for the 'good reasons'. We think the current positioning still has plenty of short ASW positions and could lead to future sell-offs in the long end being driven by swaps rather than bunds

The ECB's increased buying is a swap spread widener. We think the ECB will boost their purchases from about ~€14bn a month in PEPP to roughly ~€20bn (in line with current consensus). The upsizing in PEPP might be uneven week/week and be tweaked around to better respond to supply and seasonality patterns. However, on aggregate we know the ECB will buy 'significantly' more and that should weigh on swap spreads by increasing the demand for the underlying.

TLTROs should provide an additional bid for ASW. The additional liquidity injected into the system could keep repo rich and overall widen unsecured vs. secured funding rates. STEP data from the ECB indicates EONIA should be slightly lower based on observed market lending rates, possibly one of the reasons for the tight front end ASW spreads (as well as the positive carry – more on that below).

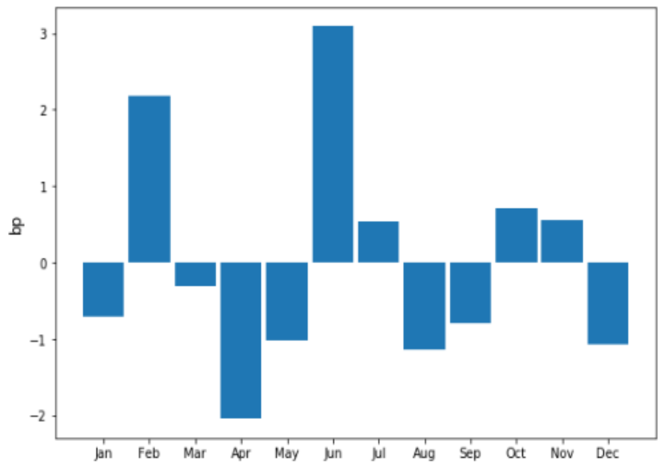
MFI lending in ECB STEP data points towards lower EONIA

Source: NWM, ECB



Seasonality in April is a headwind against wider spreads

Source: NWM, Bloomberg



Rate locking possibilities are an additional tail risk for wider spreads. The EU did not lock in rates for their SURE issuance, which is understandable given the relatively small size of the package compared to the upcoming issuance from the Next Generation EU programme. At the time, there was a more widespread perception that while rates could go up, it was unlikely to happen in the near term, particularly in the Euro Area. Now with the Bund at -0.3% and reflation as the main topic of discussion, we think a possible rate locking plan can be revisited. If an issuer the size of EU decides to hedge their funding risk, even with a carefully thought out schedule to minimize market impact, we think the sheer paying volume would add to the widening pressures.

Conclusion: wider long end spread, target Buxl spread to 40bp. Most of the distance to this target is a reversion toward fair value in our model. To this we add the risk that the vol dynamic changes, the ECB's effort to restrain rates, and ratelock risks.

Risks: carry, seasonals. However, we see two headwinds against our view. First, selling ASW spreads is a positive carry trade. Repo has been trading very rich around the belly, which chips away from the C&R there, but the 2y and 10y carry about 3 and 4bps respectively, per quarter. The pick-up for being short ASW on the long end is positive, but very small (~1bp/3m) to justify holding it purely for the carry. Finally, from a seasonality standpoint, April and May have been supportive of tighter ASW spreads, which reverses as we go into the summer (*Chart 4*).

Giovanni Zanni

Saving Private C

Vaccine rollout (and fiscal support) key… but saving behaviour important for private consumption, too. The key driver of any recovery will be the speed at which economies can exit pandemic-related restrictions (see our latest Covid Monitor). Beyond that, markets are focusing on fiscal support to gauge the magnitude of the upcoming recovery. That's important, but they should look at saving behaviours, too.

Saving dynamics should drive a large private consumption growth episode in 2021 and 2022. Fiscal policy support was an important element of resilience in 2020, but since most of the fiscal help was saved and not spent (due to covid-related restrictions) it constitutes the basis for a response this year and in 2022 – that will mainly materialise via a normalisation of private saving patterns.

We estimate that the saving rate will fall from the current 20% of disposable income to just over 10% by the end of 2022. Despite limited additional fiscal support this year and subdued disposable income dynamics, that should still allow consumption to record large increases – of around 5% this year and 7% in 2022, on our estimates.

All about savings

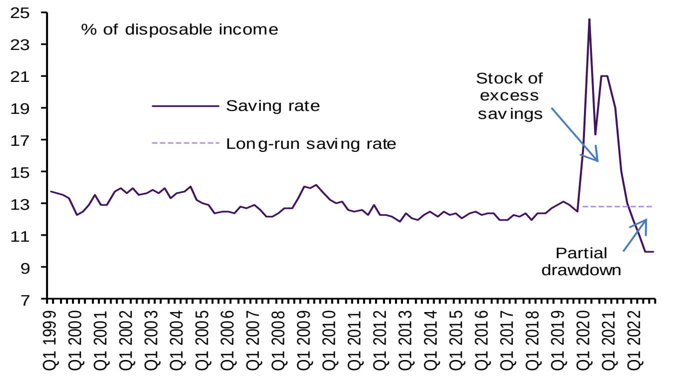
The prospect for euro area growth in the coming quarters heavily depends on the behaviour of households. Indeed, the saving ratio has risen to extraordinary levels during the pandemic (see chart overleaf). What happens to the saving ratio in the coming quarters will drive euro area consumption growth and GDP more in general – much more than fiscal policy developments (at least in the euro area).

Normalisation of consumption patterns and dealing with "excess savings". Private consumption dynamics will depend on two interrelated drivers: the first refers to the normalisation of consumption ***flows***: we should expect the pre-pandemic relation between disposable income, savings and consumption to be restored over the next several quarters, as restrictions are unwound. The second has to do with the drawdown of the ***stock*** of excess savings accumulated during the pandemic.

Some quantifications. The saving ratio was hovering just under 13% of disposable income before the pandemic. It increased to the unprecedented level of 20% in 2020. It stayed around those higher levels in the early part of 2021 and is expected to only progressively normalise over the course of 2021. That will provide a first boost to consumption relative to current dynamics (that's the "flow" adjustment). Meanwhile, the stock of "excess savings" accumulated in 2020 and 2021 (i.e. the difference between the trend-like saving ratio and the actual one recorded over the period, see chart overleaf) will be worth close to 10pp of disposable income, on our estimates: the drawdown from this pool of savings to finance (also) consumption should provide a further boost to private expenditure in the next several quarters. ***The normalisation of the saving flows together with the partial drawdown of the stock should boost private consumption growth by around 10pp over 2021-22, on our estimates.***

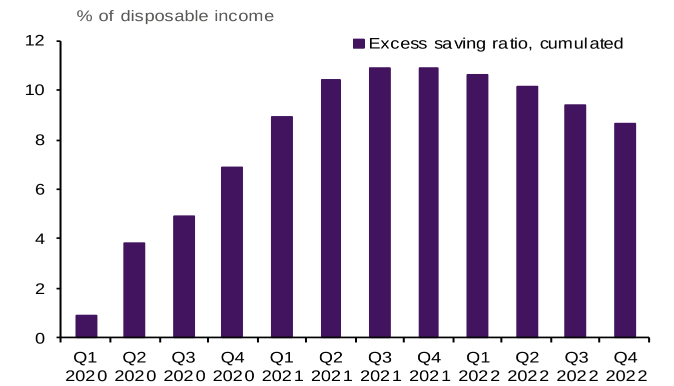
Saving ratio at unprecedented levels

Source: Eurostat, NWM estimates



2020-21 excess savings worth 10pp of disposable income

Source: Eurostat, NWM estimates

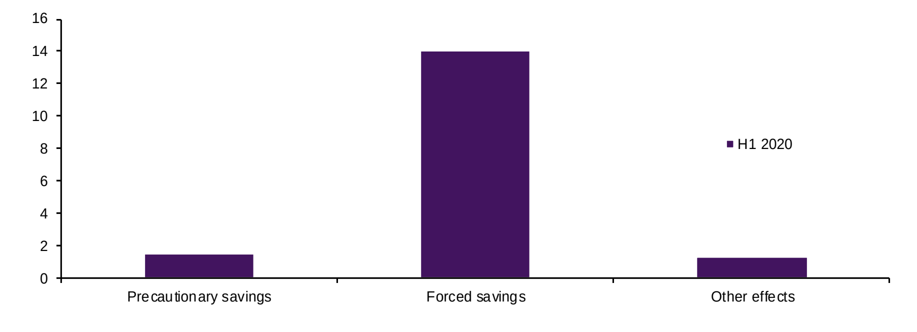


Beyond the *flow* and *stock* division discussed above, there is a further relevant distinction to be made in respect to the increase in the saving ratio: as the ECB puts it, *"the increase in household savings is potentially explained by two prominent factors. First, the lockdown measures imposed to contain the virus prohibited households from consuming a large share of their normal expenditure basket, leading to **"forced", or in other words involuntary, savings.** Second, the sudden outbreak of the pandemic caused uncertainty regarding future income, and in particular the risk of future unemployment, to shoot up, leading to **precautionary savings.** This raises the question of how to quantify the contribution of both factors to the increase in household savings".* A rise in the saving ratio for precautionary reasons should be more persistent than and rise in savings that was forced by external factors: if involuntary, it is likely to be reversed as soon as restrictions are lifted.

The ECB conclusion is that: "***forced savings seem to be the main driver of the recent spike in household*** savings (the chart below has the ECB estimate of the various drivers for H1 2020). The Banque de France has done similar simulations to separate the forced from the precautionary motive, using the unemployment rate, financial stress indices and the "intention to buy big items" in the consumer confidence survey as explanatory variables. According to their analysis, ***around ¾ of the saving rate rise can be attributed to forced savings, while ¼ to precautionary motives.***

Drivers in the increase in the saving rate

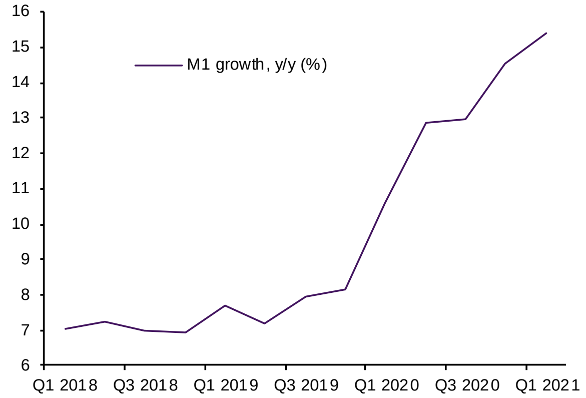
Source: NWM, ECB estimates



The fact that the spike in savings is mainly reflected in a spike in (short-term) bank deposits (see charts overleaf) is further evidence that increased savings are involuntary – and likely temporary in nature. An additional indication is that the saving ratio fell significantly in Q3 20 – when many restrictions were lifted – before rising again in Q4 20 on the back of "Lockdown 2". Finally, it is also relevant to note that the current increase in the saving rate is unprecedented: a similar dynamic didn't happen during the financial crisis – when no restrictions to consumption were imposed and despite a similar loss of output – again suggesting that any precautionary increase in savings would have been small relative to the overall increase in savings recorded.

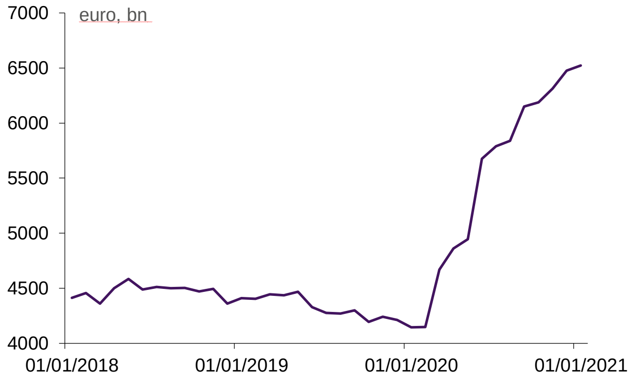
M1

Source: NWM, ECB



Euro area residents' deposits

Source: ECB, NWM



So the *flow effect* should largely normalise as and when restrictions are lifted (in H2 2021, in our central scenario). What about the excess savings accumulated so far: will those be spent and to what extent? As we mentioned above, we estimate that the latter will represent by mid-2021 around 10pp of disposable income. Some economists consider this accumulation fundamentally similar to that of other components of wealth, and as such do not expect those excess savings to be spent, other than marginally. A common rule of thumb suggests that only around 5% of a wealth increase is spent in the subsequent year. There are also other well-known caveats that would suggest only a partial use of these funds for immediate consumption:

1/ the extra savings have been generated by a fiscal expansion, that some believe may entail higher future tax payments (the so-called Ricardian equivalence);

2/ extra savings were due to the impossibility to consume some services, and pent up demand there will be limited (i.e. you can't make up for all the restaurants and holidays not taken);

3/ savings have accumulated much more to the higher quintiles of the income distribution. The marginal propensity to consume of higher income households is notoriously lower – a further factor keeping the drawdown of excess savings limited.

These arguments are pertinent, we believe, but should be weighted in front of other aspects – some specific to the current crisis – that would instead argue for a much higher share of spending of these extra savings. First, the Ricardian equivalence doesn't hold in practice – or at least only partially. Surveys show, in the case of the US for example, that the initial 2020 fiscal package was spent to the tune of 25-40%. The lack of pent up demand in services looks like a 'partial equilibrium' fallacy: the extra consumption doesn't have to be in services, even if the savings originated from the lack of services consumption… Finally, although the distribution of savings across the population does argue for a lower than average consumption propensity of those extra savings, it is also the case – as we have argued above – that a large share of these savings is involuntary and has been parked in short-term deposits... The potential for seeing these savings reinjected in the economy via new spending as restrictions are lifted should thus be higher than with usual, voluntary, wealth creation. A recent survey in the UK suggests that 26% of the savings made during lockdown will be spent.

Bottom line: We would expect a relatively quick normalisation of the saving rate in its *flow* component and would argue for a significant use of the accumulated *stock* of excess savings – of around 25% – in the year following the lifting of the restrictions.

Disposable income and fiscal support considerations

Before presenting our detailed projections for private consumption in 2021 and 2022, it is worth spending a few words on what is, in normal times, the main driver of private spending, i.e. disposable income. Indeed:

Consumption growth = disposable income growth[1] + Δ saving rate

Calculations are complicated in the current context: furlough schemes and other fiscal support measures are blurring the picture. The European Commission provides a sober estimate of real disposable income growth: of just above 0% in 2021 and close to 1% in 2022. **That's a negligible support to consumption coming from disposable income this year, in comparison with the saving ratio drivers discussed in the previous section.**

In a sense, the fiscal support is already included in the increase in the saving ratio experienced in 2020: fiscal measures allowed employment to remain sustained during the pandemic. As such, the excess savings are already a reflection of the (past, delayed) fiscal boost seen this year.

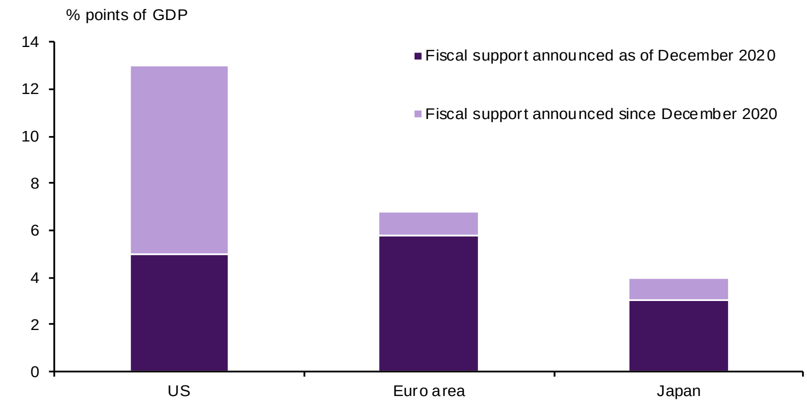
The additional fiscal boost is limited this year in the euro area, at least in comparison with the US. Some additional support is expected, through the EU Next Generation (i.e. Recovery) Fund, but the impact of that will only show up from late this year and more forcefully only in 2022-24 – and would also reinforce investments more than private consumption.

As the OECD recently put it*: "Additional discretionary fiscal measures announced in several countries during the past three months will add to the overall support this year, including in the United States (…).* ***In Europe, spending from the Next Generation recovery fund is due to begin later this year, but the total discretionary fiscal stimulus in 2021 appears likely to be relatively mild, at around 1% of GDP in the euro area, despite considerable spare capacity."***

OECD's estimate is broadly in line with our own: we projected between 1 and 2pp of discretionary fiscal stimulus in 2021 in an earlier note ("A new fiscal paradigm").

Fiscal support, selected economic areas

Source: OECD



Overall, the conclusion is again that the saving ratio will "save" private consumption growth – this year and the next. We expect a strong bounce in consumer spending and activity not on the back of disposable income growth or fiscal support, but thanks to that normalisation of saving patterns.

[1] with disposable income growth = employment growth + real wage growth + financial income + fiscal support.

Our projections

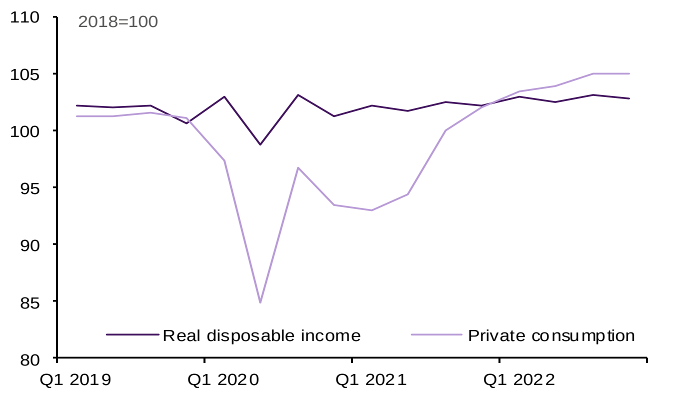
Assumptions for the profile of consumption and savings in 2021 and 2022. Based on the discussions and quantifications above, we have projected a scenario for private spending, as a function of disposable income and the projected normalisation of the saving behaviour, in all its various components.

We see the saving ratio falling from currently 21% of disposable income to ~13% (its long-term average), progressively, in the course of 2021 - falling down to 10% by end 2022 as some of the “excess savings” are spent, too, driving the saving ratio effectively below its steady-state rate. In yearly average terms, this scenario corresponds to a fall of the saving ratio from 20% in 2020, to 17% in 2021 and 11% in 2022: the impact on the yearly average consumption growth is significantly stronger in 2022 than in 2021, as a consequence. It also implies that, of the 10pp of “excess savings” cumulated over 2020/2021, “only” 20% (i.e. 2pp) are recouped in 2022 – with a bit more to be recovered over the following years.

Real private consumption would grow by 4.7% in 2021 and by 7.1% in 2022 in such a scenario – that also considers a modest increase in real disposable income in both 2021 and 2022 (as discussed above).

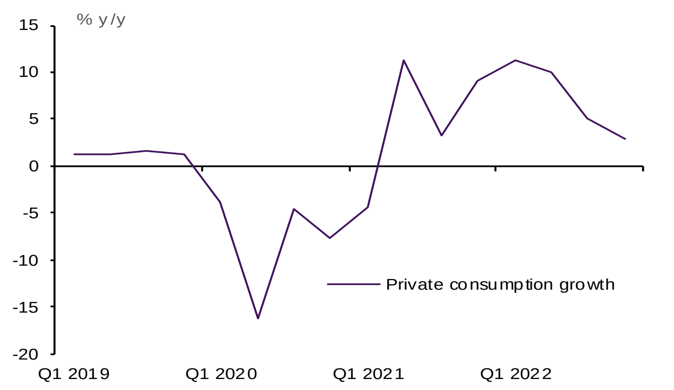
Disposable income and private consumption dynamics

Source: Eurostat, NWM estimates



Private consumption growth

Source: Eurostat, NWM estimates



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

Ross Walker

Theo Chapsalis, CFA

BoE Policy Monitor

No slowdown in QE pace (yet), short 10y gilts

The MPC voted unanimously to leave monetary policy settings unaltered in March (0.10% Bank Rate, £895bn QE target), as was universally expected. There was no slowdown in the QE purchase pace, in line with market expectations and contrary to our forecast for a reduction to ~£15bn a month from ~£18bn a month.

The most significant reference in the March Minutes was probably the judgement that overall financial conditions were *'broadly unchanged'* – surprising given the sharp rise in gilt yields over the past month. This tends to reinforce notions that the MPC will be confident enough to slow the QE purchase pace in the near future – we now expect this to be announced at the next MPC meeting on 6 May.

** 'An aggregate measure of UK financial conditions had been broadly unchanged since the February Report'*

MPC Minutes, March 2021

The BoE's broader policy guidance remains intact, with no intentions to tighten monetary policy*' at least until there was clear evidence that significant progress was being made in eliminating spare capacity.'* NWM does not expect any rise in Bank Rate, or active reversal of QE during 2021 or 2022.

Rates views and trades: Gilt have just received the green light for the sell-off to continue as the BoE did not provide any pushback to the rise in yields which was attributed to the improvement in the macro backdrop. We keep things simple and **focus our shorts in 10y gilts targeting 1%**. A reduction in the pace of QE will likely come at the May meeting but the last weeks of March and the fairly low net issuance (before the major pick-up in April) may support long UK duration. Also, maintain any short positions in 5y spreads as current valuations look stretched and vulnerable to a correction.

Table 1: NWM sterling interest rate forecasts, %

	Current	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22
BoE Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3m SONIA	0.07	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
5y SONIA swap	0.45	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
10y gilts	0.87	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00
30y gilts	1.41	1.45	1.50	1.50	1.50	1.50	1.50	1.50	1.50

Expected QE purchase schedule

Table 2 shows our estimates for the stock of gilt and corporate bond QE for the coming months. The numbers reflect our expectations for a slower QE purchase pace from May 2021, a £50bn increase in the stock of QE at the February 2022 MPC meeting together with scheduled bond redemptions (June 2021, September 2021, March 2022, July 2022 and September 2022).

Table 2: BoE QE purchase totals, actual & NWM forecast, £bn

End-period totals, Source: NWM, BoE

	Gilts	Corporate bonds	Total QE
Pre-crisis baseline	*435*	*10*	*445*
January 2021	743	20	763
February 2021	750	20	770
March 2021	**772**	**20**	**792**
April 2021	791	20	811
May 2021	807	20	827
June 2021	**806**	**20**	**826**
July 2021	822	20	842
August 2021	833	20	853
September 2021	**832**	**20**	**852**
October 2021	846	20	866
November 2021	861	20	881
December 2021	**875**	**20**	**895**
January 2022	875	20	895
February 2022	888	20	908
March 2022	**875**	**20**	**895**
April 2022	887	20	907
May 2022	900	20	920
June 2022	**912**	**20**	**932**
July 2022	915	20	935
August 2022	925	20	945
September 2022	**925**	**20**	**945**
October 2022	925	20	945
November 2022	925	20	945
December 2022	925	20	945
Change vs baseline	***490***	***10***	***500***

Policy guidance

The BoE's core policy guidance was repeated in March:

> *'The Committee did not intend to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably.'*

The MPC's overall cautious/dovish bias remains, though the March Minutes indicate that a wider range of views is emerging:

> *'Risk management considerations had implied that policy should lean strongly against downside risks to the outlook, to support the economy and to help to ensure that weakness in the economy was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target. These considerations still applied.'*

However, differences around some of the fundamental policy judgements are seemingly becoming more pronounced (Charts 1 & 2 illustrate MPC voting trends):

> *'There was a range of views across MPC members on the degree of spare capacity in the economy currently, whether demand would outstrip supply during the recovery from the pandemic, and how the assessment of supply should take into account the unique nature of the economic shock from the pandemic.'*

Chart 1: MPC votes by meeting (dark bars = policy changes)

Source: BoE, NWM

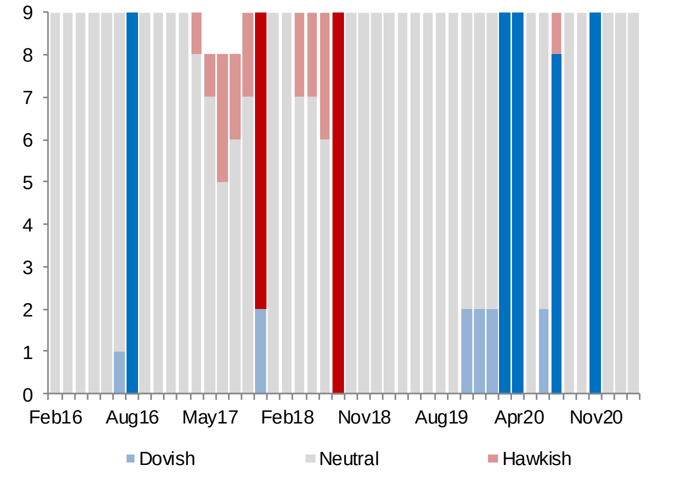
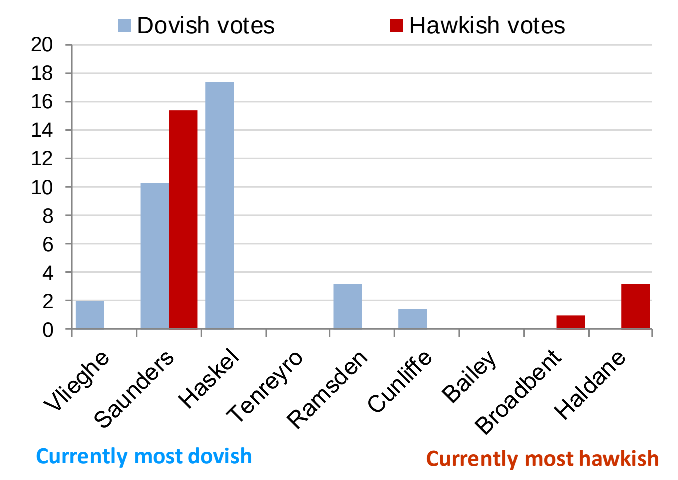


Chart 2: MPC dissent (% of meetings with dissenting vote)

Source: BoE, NWM



Notes. Chart 1: The bars illustrate the MPC vote split. Coloured bars depict a vote to alter policy settings: red (hawkish) and blue (dovish), with darker shades denoting a majority vote for a change in policy.

Chart 2: The bars record the % of times dissenting votes from the majority have been cast and in which direction (Michael Saunders is the only current MPC member to have dissented in both directions). The ordering of MPC members on the x-axis is our subjective view of policymakers' current disposition: from most dovish on the left (Vlieghe) to most hawkish on the right (Haldane).

The most interesting – perplexing, perhaps – reference in the March Minutes was the MPC's assessment that UK financial conditions are *'broadly unchanged'*, despite the surge in yields over the past month:

> *'The sterling effective exchange rate had appreciated and mortgage credit conditions had eased a little. An aggregate measure of UK financial conditions had been broadly unchanged since the February Report.'*

It may well be that this gauge of financial conditions is a very consumer-centric one – so the rise in market yields has yet to filter through to mortgage rates and 'real world' interest rates more generally. Given that over three-quarters of the UK mortgage *stock* is at fixed rates, and that the recent *flow* of new mortgages shows an even higher proportion of fixed rate coverage (over 90% in Q4 2020), the pass-through from financial markets to mortgage rates may be a little slower than usual (though average rates on new mortgages are now inching up).

The mortgage market structure and the MPC's 'broadly unchanged' reference will tend to reinforce the impression that the MPC does not regard the recent rise in yields as excessive or posing any material risk to the economic recovery or returning inflation to target. Indeed, near-term economic developments were deemed to be *'positive'*. The Minutes noted that *'plans for the easing of restrictions on activity might be consistent with a slightly stronger outlook for consumption growth in 2021 Q2 than had been anticipated in the February Report, although it was less clear that this represented news to the MPC's medium-term forecast.'* All of which tends to support notions that the pace of QE purchases is likely to be slowed in the coming months – we now expect this to occur at the next MPC meeting on 6th May.

The Minutes noted the 'material' near-term loosening in the Budget but opted to delay a more detailed assessment until the May *MPR* forecast round. With substantial fiscal deficits are expected to persist for some time (averaging almost 5% of GDP per year over the next 5 years), we continue to believe that additional QE will be required to lean against any unwarranted monetary tightening in financial markets: the NWM forecast remains for a £50bn QE uplift in Q1 2022.

Rates implications – stay bearish 10y gilts

The minutes mention that "*The Committee continued to envisage that the pace of purchases could remain at around its current level initially, with flexibility to slow the pace of purchases later".* We had envisioned a slowdown of purchases at the March meeting but the BoE did not act**. A reduction in the pace seems more likely to happen at the 6 May BoE meeting.** This will likely be the least disruptive (the weekly pace of purchases will fall from £4.44bn to £3.60bn) and we find a broad investor base being comfortable with that. Probably inflation and growth data will have improved by then so a reduction in accommodation may be warranted.

Chart 3 shows changes in the shape of the SONIA term structure. We believe that the change since the February meeting is a superposition of three themes 1) Negative rates being fully priced out 2) No pushback by the BoE on higher yields with QE tapering being on the table and 3) Global FI sell-off.

We believe that the bearish theme is still best expressed through **10y gilt shorts.** With the drivers of the sell-off being present, there is no reason to expect a change in behaviour

Chart 3: Underperformance of forwards around the 10y sector

Source: NWM

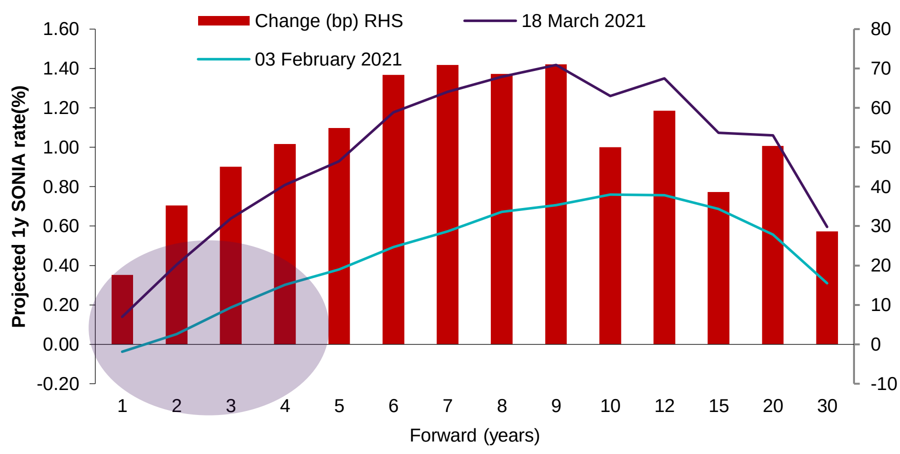


Chart 4 shows net DV01 until the end of June. Investors will clearly notice the reduction in the net pace over the coming 2 weeks and this will probably make the steepener guys reduce. We recommend reducing any long end steepening risk now (say 10s30s) while we continue to expect the curve to bow out, driven by the 10y sector, ie the 2s10s30s fly to cheapen even though 10s looks already cheap in various historical RV metrics. History might be irrelevant right now.

Chart 4. Slightly lower net DV01 in the week of 29 Mar before big April pick-up

Source: NWM

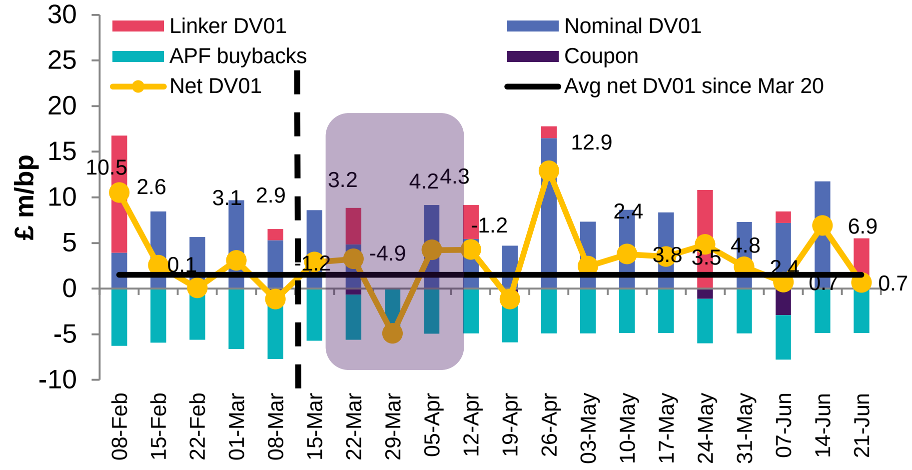
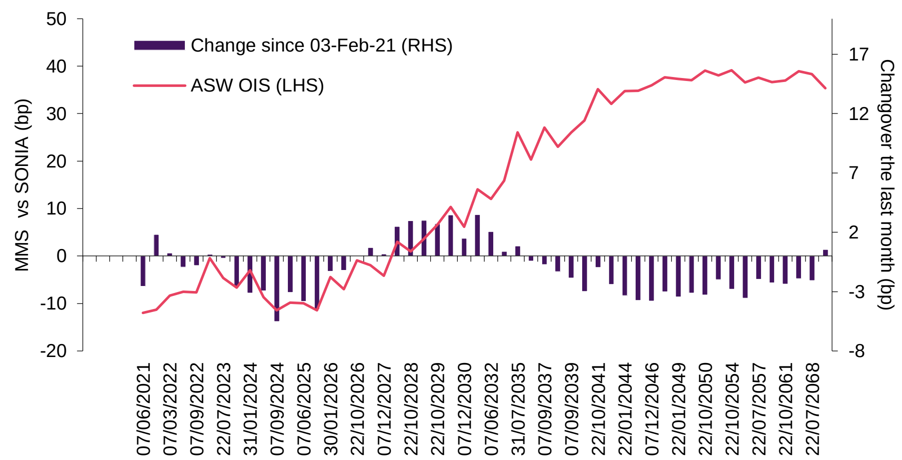


Chart 5 shows the richness of the 5y sector and particular the 2025 line. It is the sector that has performed best since February, largely aided by the lack of issuance and repo richness. Basically there is no 2025 being re-opened during the April-June period but we expect this topic to be discussed in the next DMO-investor meeting and from a valuation point of view, this sector in gilts is just too rich and reflects only repo richness. Stay patiently short spreads.

Chart 5. Maintain short spreads in the 5y sector

Source: NWM



Ross Walker

UK economic data & events previews

UK CPI **inflation** is forecast to rise to 0.8% (y/y) in February from 0.7% in January. The rise is driven by energy prices (contributing ~14bp to the projected rise in CPI) and food price inflation (~9bp). Core CPI is forecast to be unchanged at 1.4% (though moving from a 'high' to a 'low' 1.4%: 1.437% to 1.366%). RPI inflation is forecast to rise to 1.5% in February from 1.4% in January.

Although the ILO **unemployment** rate is forecast to rise to 5.3% in the 3 months to January, the more informative data-point is likely to the PAYE tax-system based measure of employee jobs, which we forecast to record a third consecutive monthly increase (+40k in February).

The 'flash' **PMI surveys** are forecast to show a further improvement in March as lockdown restrictions were eased and the vaccination process bolstered expectations. We forecast a ~2-point rise in the services PMI to 51.5 alongside a more modest ~½-point gain in the (already elevated) manufacturing index to 55.5. That would raise the composite PMI to 51.4 from 49.7, levels notionally consistent with GDP growth of ¾%.

UK data & events, week beginning 22 March 2021

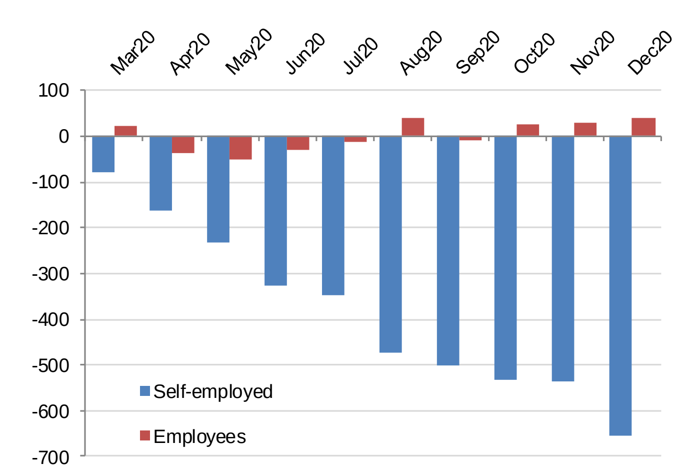
	Time	Period	NatWest	Median	Previous	Comments
Tuesday 23 February						
PAYE employees, 1m change, 000s	**07:00**	**Feb**	**40**	**n/a**	**83**	
ILO employment, 3m change, 000s	07:00	Jan	-170	n/a	-114	
ILO unemployment rate, %	**07:00**	**Jan**	**5.3**	**5.2**	**5.1**	Upside risks (5.4%).
Average Weekly Earnings, % 3m y/y	07:00	Jan	5.0	5.0	4.7	
AWE ex-bonuses, % 3m y/y	07:00	Jan	4.5	4.3	4.1	
CBI industry orders, % balance	11:00	Mar	-16	-20	-24	CBI survey has shown much less improvement than PMI.
Wednesday 24 February						
CPI, % m/m	07:00	Feb	0.5	0.5	-0.2	
CPI, % y/y	**07:00**	**Feb**	**0.8**	**0.8**	**0.7**	Energy-led rise in February.
Core CPI, % m/m	07:00	Feb	0.5	0.5	-0.5	
Core CPI, % y/y	**07:00**	**Feb**	**1.4**	**1.4**	**1.4**	Core inflation to stabilise, though heightened uncertainties
CPIH, % y/y	07:00	Feb	1.1	1.0	0.9	around Covid impact and seasonal pricing variations.
Retail Price Index	07:00	Feb	296.3	n/a	294.6	
RPI, % m/m	07:00	Feb	0.6	0.5	-0.3	
RPI, % y/y	**07:00**	**Feb**	**1.5**	**1.5**	**1.4**	
PPI input, % m/m	07:00	Feb	0.9	n/a	0.7	Surge in £-denominated crude oil costs.
PPI input, % y/y	07:00	Feb	2.6	n/a	1.3	
PPI output, % m/m	07:00	Feb	0.3	n/a	0.4	
PPI output, % y/y	07:00	Feb	0.3	n/a	-0.2	
Manufacturing PMI ('flash')	09:30	Mar	55.5	55.0	55.1	Lockdown easing in March to boost sentiment and orders.
Services PMI ('flash')	09:30	Mar	51.5	50.8	49.5	Covid 'stringency index' at 3-month lows in March.
Composite PMI ('flash')	09:30	Mar	51.4	51.0	49.6	
Friday 26 March						
Retail sales volumes (total), % m/m	07:00	Feb	3.0	2.1	-8.2	BRC data reported a rebound in February.
Retail sales volumes (total), % y/y	07:00	Feb	-2.5	-3.5	-5.9	
Retail sales volumes (ex-fuel), % m/m	07:00	Feb	3.5	2.0	-8.8	
Retail sales volumes (ex-fuel), % y/y	07:00	Feb	-1.2	-2.7	-3.8	

Labour market – third month of employee job gains

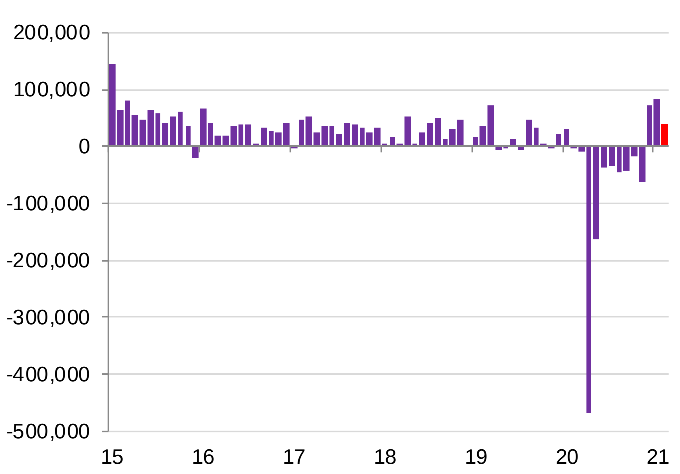
The UK labour market has been much more resilient than expected during the pandemic. The furlough scheme and related support for business (grants, tax deferrals) have shored-up employment levels – or, more accurately, 'employee' levels (left-hand Chart below contrasts the cumulative change in the Labour Force Survey measures of employees and self-employed). The strain has fallen disproportionately on the self-employed.

The most timely and theoretically reliable measure – the PAYE tax-system employee series – has reported back-to-back months of gains totalling 156k. We forecast the PAYE measure to show a rise of 40k in February (right-hand chart below).

LFS cumulative change during the pandemic (000s)
Source: ONS, NWM



PAYE employees, monthly change
Source: ONS, NWM



The LFS/ILO unemployment measure is forecast to rise to 5.3% in the three months to January from 5.1% in the three months to December/Q4. There are probably upside risks around this forecast (as we assume a sizeable, ~110k, rise in inactivity).

We look for ILO employment growth to fall 170k in the three months to January 2021 – weighed down principally by the weak December 2020 data rather than any marked deterioration in January. As noted above, trends in employees turned positive

Wage inflation is forecast to climb further – though uncertainties continue to surround the impact of the lockdown. We forecast headline Average Weekly Earnings to rise to 5.0% 3m y/y in January from 4.7% in December and the AWE ex-bonuses rate to rise to 4.5% 3m y/y from 4.1%.

Inflation – edging up in February

UK CPI inflation is forecast to rise to 0.8% (y/y) in February from 0.7% in January. The rise is driven by energy prices (contributing ~14bp to the projected rise in CPI) and food price inflation (~9bp). Core CPI is forecast to be unchanged at 1.4% (though moving from a 'high' to a 'low' 1.4%: 1.437% to 1.366%). RPI inflation is forecast to rise to 1.5% in February from 1.4% in January.

January 2021 data re-cap

Despite demanding base effects, inflation edged up in January 2021. Upside price pressures in the month were fairly broad-based, if modest. More variable pricing patterns against the backdrop of Covid-19 restrictions continue to complicate the forecasting process. In this context, January's data raise more questions than they answer. New Year sales trends were mixed: evident in clothing & footwear but not in furniture or household appliances. It is not clear whether this is simply another random variation in pricing/timing stemming from Covid restrictions, or something more fundamental (perhaps reflecting stronger housing market activity). Some of the moves in January jarred a little with survey data (notably the rise in CPI/RPI food inflation) – so might conceivably correct in subsequent months. Moves in other components are harder to rationalise – eg, the (largely imputed) rise in hotel & restaurant inflation.

Energy price deflation continues to unwind gently – with the pace of this unwinding set to accelerate in the coming months, initially via higher petrol prices then via regulator-imposed price cap rises (as well as base effects from the first lockdown in Q2 2020).

February 2021 forecast

<u>We forecast CPI inflation to rise to 0.8% y/y in February from 0.7% in January, with Core CPI remaining at 1.4%. RPI is forecast to rise to 1.5% in February from 1.4%.</u>

February inflation data are typically about the reversal of the New Year sales discounting. There is less price discounting to reverse in February 2021 but we remain wary about random price moves which have whipped the inflation data around over the past year.

Energy components are expected to pick-up in February. Motor fuel prices are forecast to rise 2.5% m/m in February, pushing the y/y rate up to -3.9% from -8.2%, contributing 12bp to the rise in CPI inflation. We forecast utility prices to rise 0.3% m/m in February, nudging the inflation rate up to -7.9% from -8.4% and contributing almost 2bp to the rise in inflation.

Food price inflation surprised to the upside in January. Producer price inflation trends in food had been rising for much of the second half of 2020, though some survey data (BRC) had indicated modest inflation falls. The latest PPI data reported modest declines in both home and imported food prices so we forecast CPI food price inflation to be little altered in February: -0.6% y/y from -0.7%. The risks here are to the upside given reports of higher transportation costs and some Brexit trade frictions.

BRC shop price inflation fell to a 9-month low of -2.4% y/y in February from -2.2% in January, led by non-food prices (-3.9% y/y from -3.6%) alongside stable food price inflation (0.2% y/y). Price deflation was most marked in clothing & footwear but also evident in consumer electrical goods and furniture.

Medium-term inflation outlook

Our CPI profile in 2021 was raised moderately on our last forecast (17th February), principally a reflection of energy price influences – the administered Ofgem regulator price cap rise (9.2% from 1st April) and increases in wholesale market prices. Sterling's recent appreciation provides only a partial offset.

CPI basket weight changes bring about a sizeable skew away from services and towards goods, to 56.8% goods / 43.2% services from 51.0% / 49.0%. Those shifting weights tend to lower our inflation forecasts a little – though we continue to assume pockets of higher consumer services inflation during Q2/Q3 2021 as these sectors are re-opened.

Overall, we remain somewhat sceptical about some of the 'reflation' narrative – to the extent that we do not expect any significant or sustained overshoot of the target in 2021 or 2022. It is a stretch to depict base effect-driven rises as 'reflation'. Still, some upside price pressures will become increasingly apparent and it will be difficult to disentangle underlying demand-driven moves from Covid-induced timing variations and administered price rises (indirect tax changes, regulator-imposed prices).

A key test for the Bank of England (and markets) is likely in the autumn. With CPI quite possibly above-target at that time (temporarily, in our view), MPC rhetoric, and possibly formal policy guidance, will change. As ever, a lot will hinge on the MPC's assessment of the output gap (their ‘excess demand/excess supply’ metric). The February 2021 *Monetary Policy Report (MPR)* projected excess demand of ¼% of GDP in Q1 2022, which feels rather imminent – and jars somewhat with the BoE’s unemployment rate projections (6.4% in Q4 2020 & 5.7% in Q1 2022). In other words, there appears to be a significant risk that MPC rhetoric, even formal policy guidance, becomes markedly more ‘hawkish’ at the tail-end of this year.

Kevin Cummins

Thanks to Deepika Dayal for her contribution to this publication

US: March FOMC Review

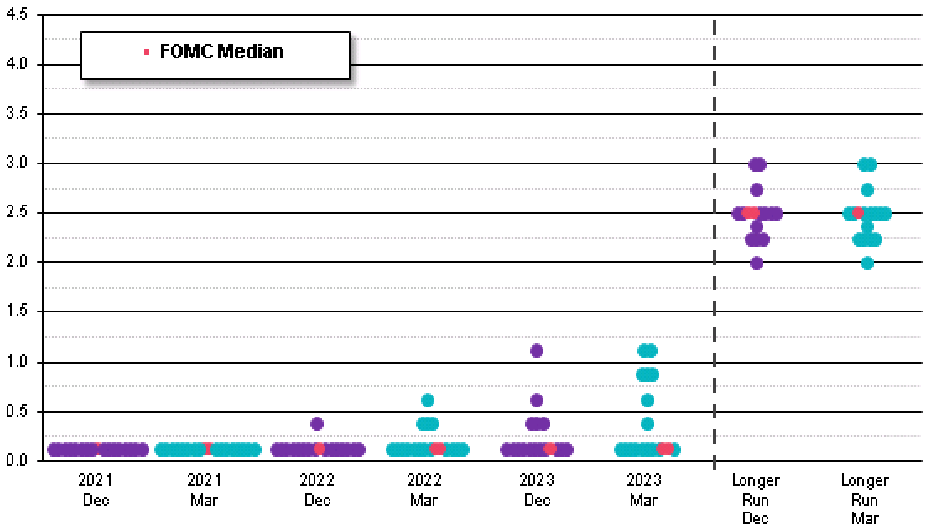
The FOMC delivered just about all we were looking for: the median dots were unchanged through 2023—no hikes through the forecast horizon, a more upbeat statement, a message of patience, a much stronger near-term growth forecast, and a dovish press conference. Fed Chair Powell portrayed the economic outlook as being broadly consistent with the Fed's revised forecast, and noted that the Fed's policy guidance remained largely intact.

FOMC Dot Plot

As we expected, the median fed funds estimates for year-end 2021, 2022, and 2023 all remained at zero, while the long run dot stayed at 2.50%. The updated set of projections showed four out of 18 Fed officials with some tightening by the end of 2022 (up from just one in December); and seven out of 18 with some tightening by the end of 2023 (up from five in December). Meanwhile, the trimmed means edged up, with the 2022 now at 0.146% (versus 0.125% in Dec) and 2023 at 0.313% (versus 0.150%) as the dispersion of dots slightly widened relative to December. (See chart below.)

FOMC Dot Plot: March vs. December

Source: Federal Reserve, NatWest Markets



In Q&A, Powell played made clear not to "*read too much into the March 2020 SEP dot plot. Remember what it is. It's a compilation of individual projections by individual members. They are all making different assessments. They have different forecasts. Economic forecasts. Some have more optimistic ones, some less optimistic. And also remember that the SEP doesn't actually include all the things that go into maximum employment. Right? It only includes unemployment. So I would just say we've set out clear guidance. The message from the SEP that I would like to leave with people is we set out clear guidance. I mentioned what it was. It's inflation -- sorry. It's labor market conditions consistent with our estimates of maximum employment, and that's not just unemployment; it's all the other indicators. But overall totaling up to maximum employment. It's inflation at 2% and not on a transient basis. And inflation on track to exceed 2% moderately for some time. Those are the criteria. We are committed to robustly implementing that guidance. And that's what this says. That's really all it says. We are going to wait until those requirements are met. And again, you know, the state of the economy in two or three years is highly uncertain, and I wouldn't want to focus too much on the exact timing of a potential rate increase that far into the future.*"

FOMC Year-End Fed Funds Projections
Source: Federal Reserve and NatWest Markets

2021	**Jun-20**		**Sep-20**		**Dec-20**		**Mar-21**
Median	0.125%		0.125%		0.125%		0.125%
Trimmed Mean	0.125%		0.125%		0.125%		0.125%
2022	**Jun-20**		**Sep-20**		**Dec-20**		**Mar-21**
Median	0.125%		0.125%		0.125%		0.125%
Trimmed Mean	0.125%		0.125%		0.125%		0.146%
2023	**Jun-20**		**Sep-20**		**Dec-20**		**Mar-21**
Median			0.125%		0.125%		0.125%
Trimmed Mean			0.125%		0.150%		0.313%
Long Run	**Jun-20**		**Sep-20**		**Dec-20**		**Mar-21**
Median	2.500%		2.500%		2.500%		2.500%
Trimmed Mean	2.463%		2.463%		2.463%		2.443%

Policy statement

As expected, the FOMC statement reflected the better data since the January meeting and provided a little bit more of a balanced assessment of the current economy, while keeping the tone fairly cautious. All of the changes were confined to the opening paragraph, which discussed current economic conditions. Reflecting recent data, the statement upgraded the characterization of growth and the labor market to *"Following a moderation in the pace of the recovery, indicators of economic activity and employment have turned up recently, although the sectors most adversely affected by the pandemic remain weak"* from *"The pace of the recovery in economic activity and employment has moderated in recent months, with weakness concentrated in the sectors most adversely affected by the pandemic*." On inflation, the statement simply said: "Inflation continues to run below 2 percent" versus the prior line that read: "Weaker demand and earlier declines in oil prices have been holding down consumer price inflation." The rest of the statement remained fully intact. Today’s FOMC decision and statement was unanimous among all 11 voting members. Below is an annotated version of the March FOMC statement.

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~~

Summary of Economic Projections

The updated economic projections showed much stronger GDP growth in 2021 than the projections released after the December meeting (now 6.5% vs earlier 4.2%)--the booming pace reflected a combination of additional fiscal stimulus and more encouraging news on COVID cases and vaccines. In turn, the unemployment rate estimate now shows 4.5% by year end (versus 5.0%). Officials also showed a slightly higher inflation profile but still not much of an overshoot after what will look like a temporary rise in the Fed's view. See details below.

March 2021 Summary Economic Projections (SEP)

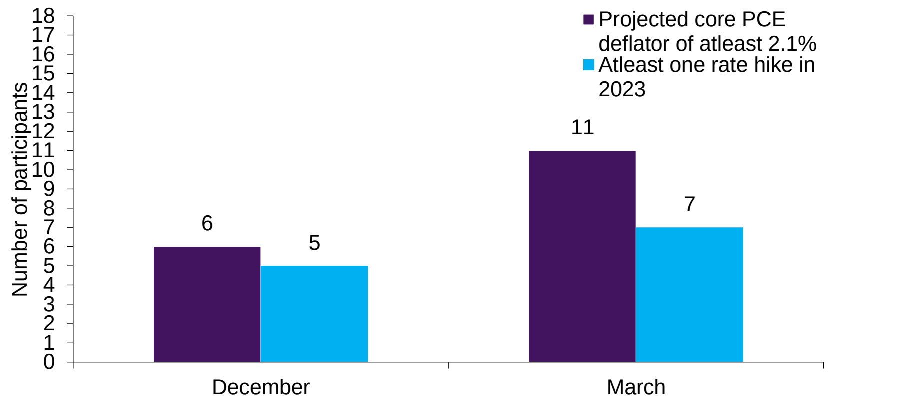
Source: Federal Reserve

% Changes	2021	2022	2023	Longer Run
Real GDP (Q4 to Q4)	6.5	3.3	2.2	1.8
December Projections	4.2	3.2	2.4	1.8
Unemployment Rate (Q4 avg)	4.5	3.9	3.5	4.0
December Projections	5.0	4.2	3.7	4.1
PCE Price Index (Q4 to Q4)	2.4	2.0	2.1	2.0
December Projections	1.8	1.9	2.0	2.0
Core PCE Price Index (Q4 to Q4)	2.2	2.0	2.1	
December Projections	1.8	1.9	2.0	
Memo: Projected appropriate policy path				
Federal Funds Rate	0.1	0.1	0.1	2.5
December Projections	0.1	0.1	0.1	2.5

On a more dovish note, the detailed tables in the SEP showed there were 11 participants who projected the core PCE deflator of at least 2.1% in 2023 and seven participants showed at least one hike in 2023. That compares with December when six participants forecasted the core PCE deflator of at least 2.1% in 2023 and five participants showed liftoff. In other words, even with an additional five members who modestly pushed up their core inflation forecast only two members showed an implied higher funds rate—consistent with the guidance that officials will be "patient" on liftoff.

Some more insight from Fed reaction function in 2023

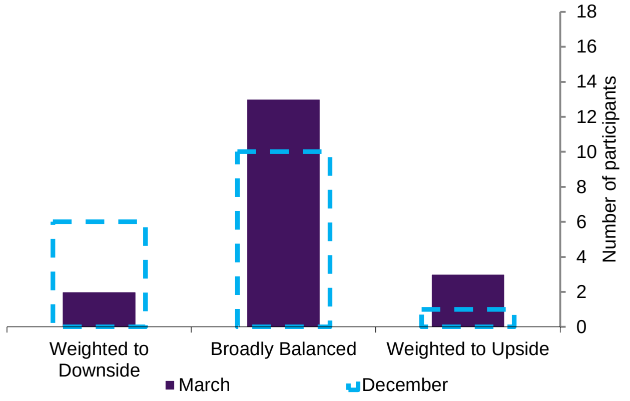
Source: Federal Reserve, NatWest Markets



In addition to the SEP, the package of information released along with SEP includes FOMC participants' assessments of uncertainty and risks around their economic projections. In both September and December, these new charts mostly emphasized downside risks to the outlook. However, in part due to additional fiscal stimulus, today's charts showed a much more balanced assessments when FOMC participants considered the risks surrounding GDP, unemployment, and inflation.

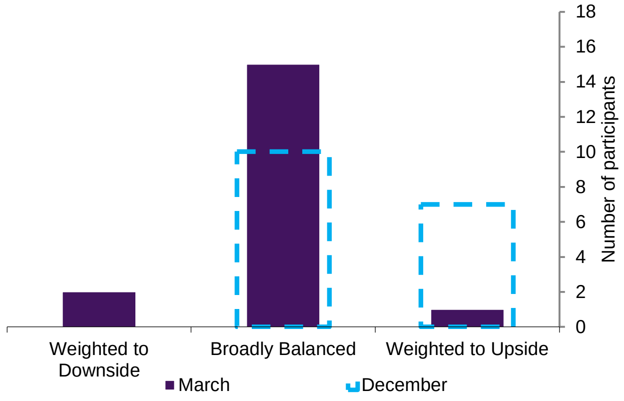
Risks to GDP Growth

Source: Federal Reserve, Natwest Markets



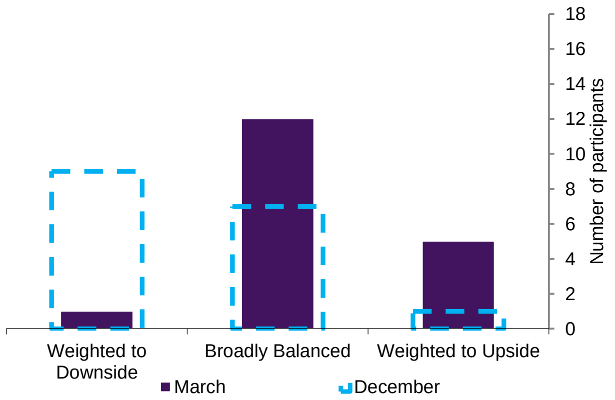
Risks to Unemployment Rate

Source: Federal Reserve, Natwest Markets



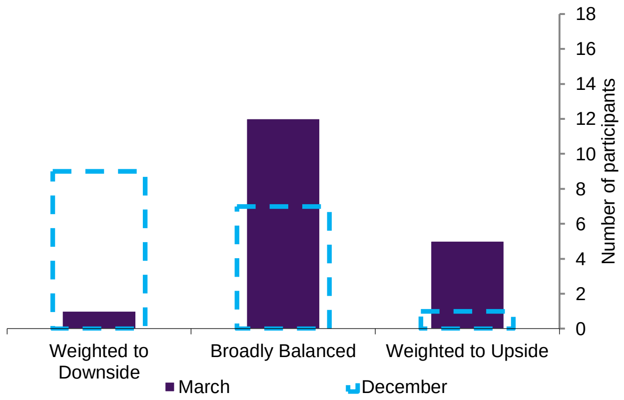
Risks to PCE Inflation

Source: Federal Reserve, Natwest Markets



Risks to Core PCE Inflation

Source: Federal reserve, Natwest Markets



The outcome-based forward guidance was identical to last time. That means no tapering until officials conclude that there has been "substantial further progress" toward the 2% inflation goal as well as the "maximum employment" goal, and no tightening until the labor market is at "maximum employment," inflation is at least 2%, and inflation is "on track to moderately exceed 2% for "some time". In Q&A, the Fed chair continued to emphasize that officials will provide ample notice ahead of the start of tapering "*we want to see that the labor markets have moved -- labor market conditions have moved, you know, have made substantial progress toward maximum employment and inflation has made substantial progress toward the 2% goal. That's what we are going to want to see. Now, that, obviously, includes an element of judgment, and when we see -- we will be carefully looking ahead. We also understand that we will want to provide as much advance notice of any potential taper as possible. So when we see that we are on track, when we see actual data coming in that suggests that we are on track to perhaps achieve substantial further progress, then we'll say so. And we'll say so well in advance of any decision to actually taper.*"

In the press conference, the Fed chair reiterated a lot of the points he made recently expressing optimism on the labor market and GDP, but also noting that the employment situation has a "long way" to go before it is recovered. Once again, he continued to sound skeptical about the trend in inflation suddenly picking up significantly, even if there's base effects or other transitory factors.

Kevin Cummins

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

US Economy Preview

Highlight of the week: The upcoming calendar is fairly light from a key data standpoint in the upcoming week. Monthly data will likely show a massive payback in personal income and consumer spending midway through Q1 after fiscal stimulus boosted income and spending at the start of the year. On the inflation front, we forecast the core PCE deflator rose 0.107%—leaving the year/year rate at just 1.5% in February.

Key US data & events, week beginning 22nd March 2021

	Time	Period	NatWest	Median	Previous	Comments
Monday 22 March						
Existing Home Sales, million	10:00	Feb	6.50	6.54	6.69	Inventory shortages pushing prices higher
Tuesday 23 March						
New Home Sales	10:00	Feb	970,000	885,000	923,000	Supported by low mortgage rates
Thursday 24 March						
Durable Goods Order, % m/m	08:30	Feb	+0.5	+0.9	+3.4	Boost from aircrafts
Markit Manufacturing PMI (Flash)	09:45	Mar		59.5	58.6	
Markit Services PMI (Flash)	09:45	Mar		60.0	59.8	
Thursday 25 March						
Initial Unemployment Claims	08:30	Mar-20	730,000		770,000	4 week moving avg: 746,250
Real GDP (2nd Revision), % q/q saar	08:30	Q4	4.5%	+4.1	+4.1	
- GDP Price Index, % q/q saar	08:30	Q4	+2.1		+2.1	
Friday 26 March						
Advance Wholesale Inventories, $ billion	08:30	Feb			661.7	
Advance Retail Inventories, $ billion	08:30	Feb			624.4	
Advance Goods Trade Balance, $ billion	08:30	Feb		-84.8	-83.7	
Personal Income, % m/m	08:30	Feb	-4.2	-7.2	+10.0	
Personal Spending, % m/m	08:30	Feb	-1.2	0.0	+2.4	
Core PCE Deflator, % m/m	08:30	Feb	0.1	+0.1	+0.3	Unrounded estimated forecast of 0.107%
University of Michigan Sentiment - Final	10:00	Mar		83.6	83.0p	

Source: NatWest, Bloomberg

Core PCE deflator likely stayed tame in February

The February CPI and PPI reports suggest that the core PCE deflator may have increased by 0.1% (0.107% unrounded) last month, moderating a bit after back-to back gains of 0.3%. Indeed, the core CPI advanced by 0.1% in February though much of the strength in the core CPI was concentrated in components (motor vehicle insurance, medical care services) that do not feed in to the core PCE deflator. In addition, strength in rents will feed through with a smaller weight and will be offset by weakness in components such as used cars, apparel, household goods, and lodging away from home in the core PCE deflator. Moreover, the 0.2% gain in the core PPI will be a net positive contribution for the core PCE deflator, as airfares rose while prices for financial and healthcare services were mixed. All these components combined would put the core PCE deflator’s February clip largely in line with that of the core CPI.

A reading in line with our estimate would keep the year/year core PCE inflation rate steady at 1.5%. Meanwhile, the headline PCE deflator is expected to have advanced by 0.2%, pushing up the year/year change from 1.5% in January to 1.6% in February.

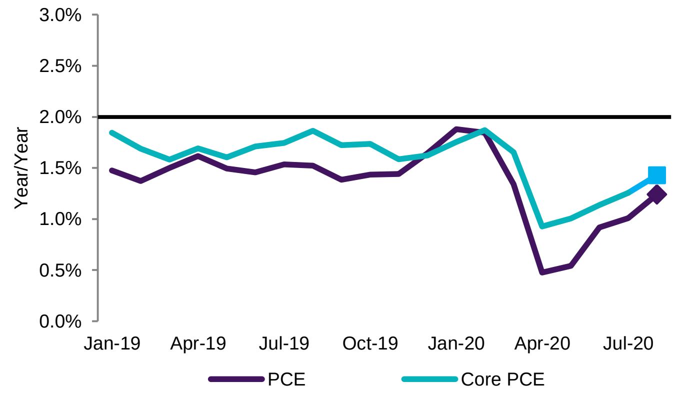
Forecast contributions to core PCE Deflator in February

Source: BLS, BEA and NatWest Markets
**Non-profit Institutions Serving Households*
***Includes imputed costs, such as Financial Services Furnished Without Payments, and also Expenditures Abroad and Expenditures on Foreign Travel*

A	**CORE CPI**	**0.101%**
	CPI categories relevant to Core PCE (CPI weights)	0.066%
B	Contribution from CPI to core PCE (based on PCE weights)	0.045%
C	Contribution from PPI to core PCE	0.061%
D	Contribution from NPISHs* (Forecast)	-0.044%
E	Contribution from other PCE categories not sourced from PPI or CPI ** (Forecast)	0.025%
F	Seasonal adjustment effects (Forecast)	0.020%
G=B+C+D+E+F	**CORE PCE forecast**	**0.107%**

PCE Inflation

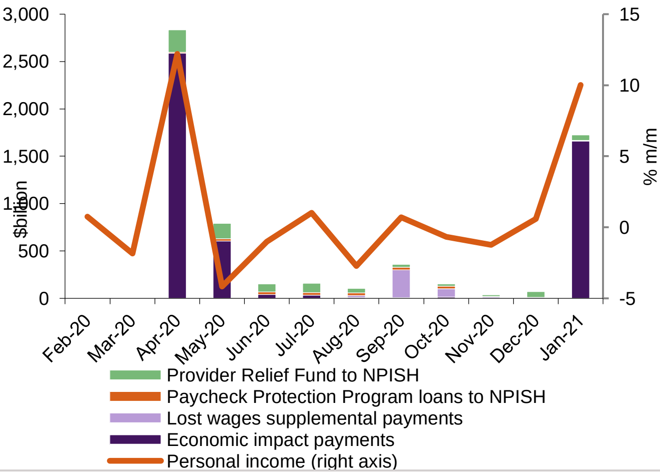
Source: BEA and NatWest Markets
Markers denote NWM forecast for February



The income and spending data will also be weak. Real consumer spending is expected to have declined by about 1% in April. Coming on the heels of sharp surge at the start of Q1 (+2.0%), an increase in line with our forecast would suggest spending still in the ballpark of what we have been assuming for the quarter (+7% annualized). Meanwhile, personal income likely plummeted by around 7% m/m in February, dragged down by a sharp drop in transfer payments. Households received a massive boost in income in January, due to the stimulus package that was passed in late December. Stimulus checks accounted for about $1.7 trillion or almost 9% of disposable personal income in January. With a bigger pullback in income than spending in February, the household savings rate likely slipped from 20.0% in January to around 14.7% in January.

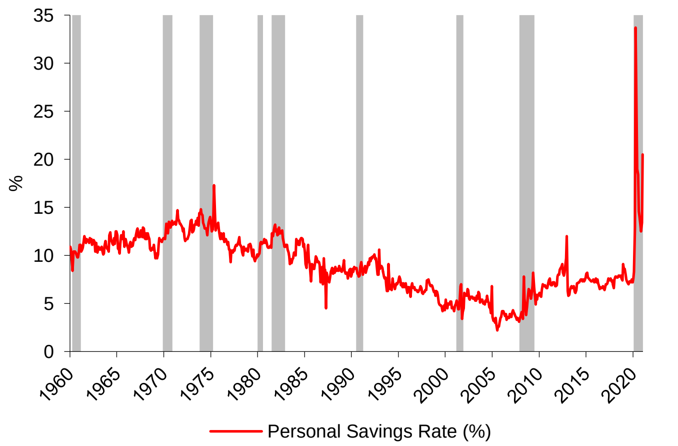
Transfer payments & personal income growth

Source: Bureau of Economic Analysis and NatWest Markets



Personal saving rate

Shaded bars represent periods of recession.
Source: Bureau of Economic Analysis and NatWest Markets

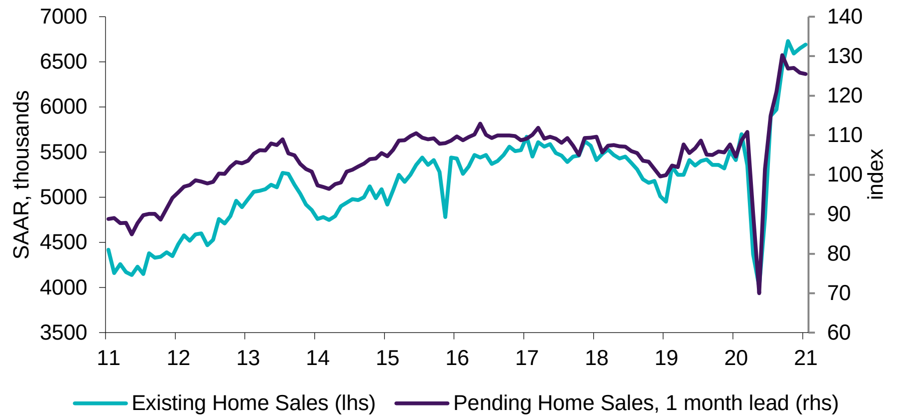


Home sales trend likely remained healthy

As mortgage rates were at historic lows, the housing market continued to witness strong demand, as existing home sales increased by 0.6% to a seasonally adjusted annual rate of 6.69 million in January after 6.65 million in December. Additionally, purchases of new single-family homes rose to 923,000 annualized pace in January from an upwardly revised 885,000 rate in the prior month. However, as record low inventories continue to push up home prices, we expect a slight pullback in existing home sales in February (forecast: 6.50 million SAAR). Our forecast is consistent with the performance of pending home sales index (tracks contract signing activity and tends to lead resales by a month or two), which declined to a six-month low of 122.8 in January from 126.4 in December. In contrast, new home sales may have surged further in February to 970,000 units from 923,000 in January.

Existing Home Sales and Pending Home Sales

Source: National Association of Realtors, Natwest Markets



Alvaro Vivanco
Galvin Chia
Maximillian Lin
Paul Molander

EM Beyond USTs: Tail winds still on the horizon

- **USTs and the dollar remain key drivers for EM. Stabilising, if not a peak in yields, will be necessary for EM to perform more broadly. However, the other factors that we follow remain broadly supportive:**
- **Crude oil: a positive outlook supports staying long RUB and COP, but will pressure INR which we recommend shorting vs USD.**
- **Growth and vaccines: the EM rebound has helped bottom out carry. Israel, Chile, South Korea, and India make noteworthy vaccine progress. Brazil disappoints.**
- **Current accounts: still a positive, but surpluses are shrinking. Higher balances foreseen in Russia, Thailand and Turkey**
- **FI outflows: challenging, but likely not indiscriminate. We still like FX-hedged SAGBs and selective front-end payers.**

Time to start looking beyond US rates only

Last November we highlighted five key factors for our bullish outlook for EM (here), and in January recommend reducing risk across board, particularly among higher-beta EM currencies (here). The focus since has stayed on US rates, as both positive and negative effects of the reflation trade have spilled over into EM sentiment. This prompted us to further close two of our recommendations last month: short USD vs low-beta growth outperformers and long TRYMXN (here).

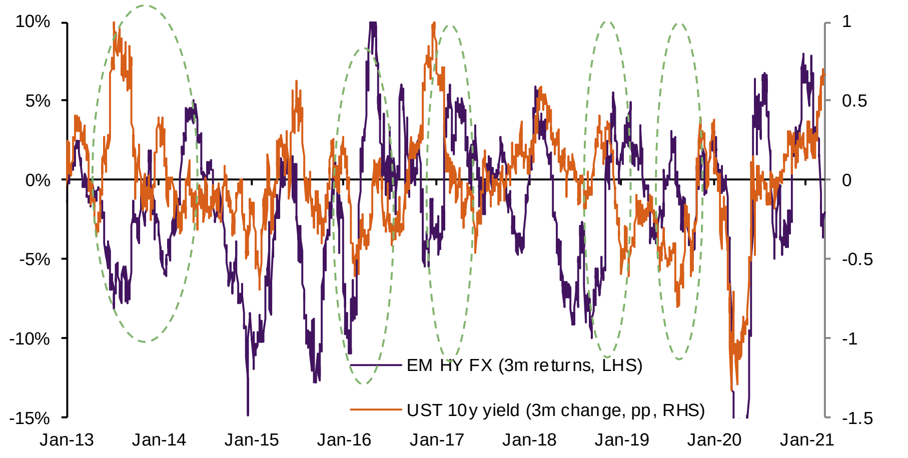
EM has started to stabilize over the past few sessions, but it remains closely correlated to UST performance, in some cases almost tick-by-tick. For EM assets to perform more broadly we would need, at a minimum, to see better-behaved US yields, if not a peak. Our analysis identified that rapid spikes in UST yields on the order of 30 – 50bp over 3 months coincided with peaks in EM FX returns, while larger tantrums of around 70bp saw EM returns quickly turn negative.

Importantly, in several prior instances, EM FX consolidated alongside yields after rapid UST selloffs. Rapid falls in yields then translated into broader and rapidly rising EM FX returns. The choice of funding currencies has also become critical as we expect some stabilization of EM vs G3 before dollar funding becomes a theme again. Our most recent longs (COP and RUB last month) already included both dollars and euros as the shorts.

Even as we head towards the FOMC, we should be reminded of the other four factors that we identified would be supportive of EM FX: 1) crude oil, 2) EM growth (now factoring in the pace of the vaccine roll out), 3) external account adjustments, and 4) positioning in local fixed income markets. The importance of these will undoubtedly increase over time, especially if UST volatility decreases.

EM FX stabilises alongside yields, and rallies when yields start falling

Source: Bloomberg, NatWest Markets

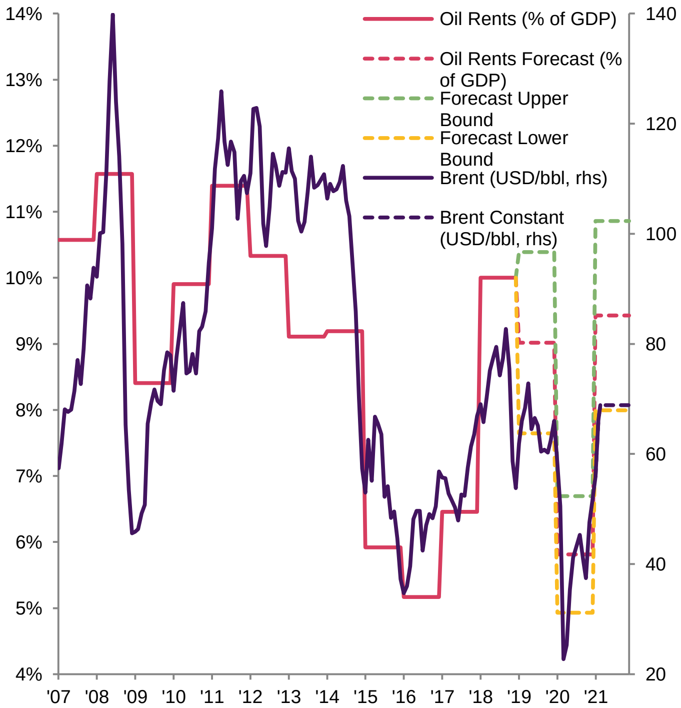


1/ Crude oil: OPEC and growth provide further upside

Oil has had the most significant change among our indicators, taking off after the first round of vaccine announcements in November – Brent has rallied from $40 to about $68 at the time of writing.

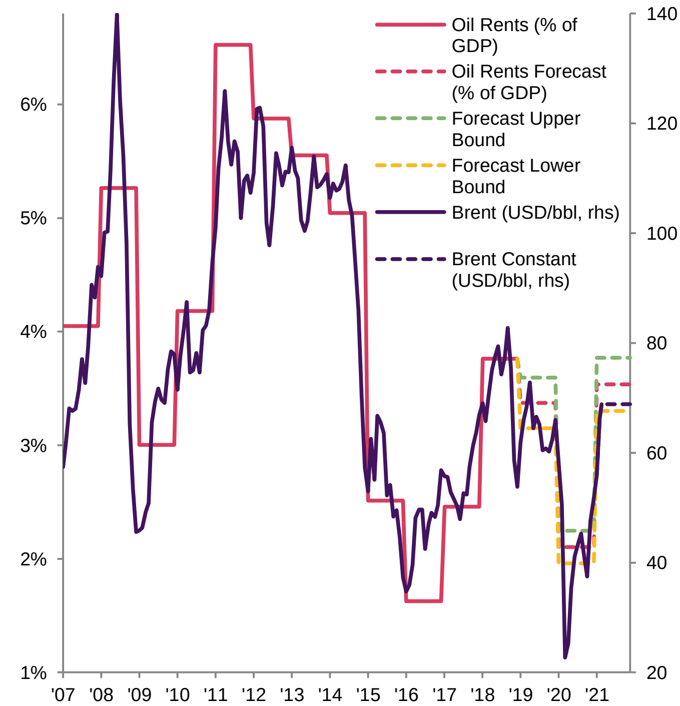
We forecast Russian oil rents at 9.4% of GDP in 2021

Source: World Bank, NWM Strategy



…and in Colombia at 3.75% of GDP in 2021

Source: World Bank, NWM Strategy



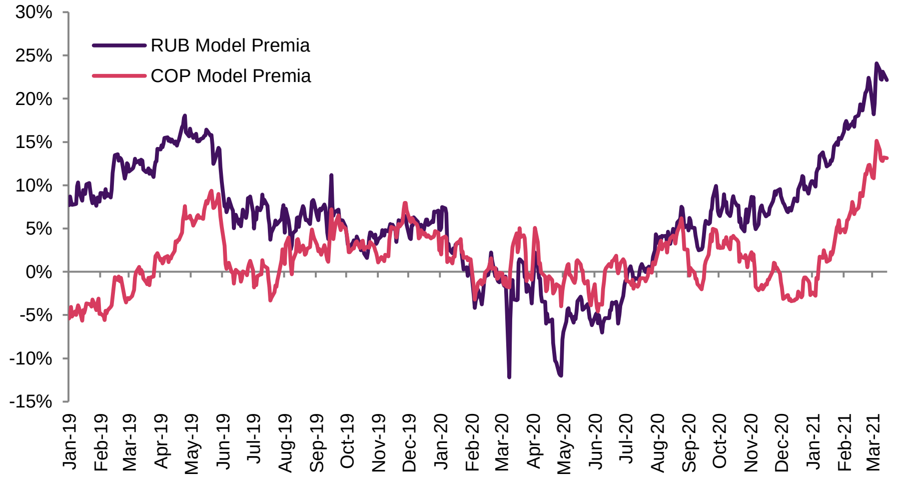
The outlook remains positive. As our colleagues have highlighted, the OPEC+ decision earlier this month represented a major event risk. The decision to fight for market share by dramatically increasing supplies from April onward was not out of the question. However, instead of committing to even a modest increase in April, OPEC+ opted to leave its production targets unchanged, with Saudi Arabia opting not to end its voluntary over-commitment to its supply quotas. In addition, there is the demand angle as service-oriented economies lead the next stage of the pandemic recovery, providing support for oil to catch-up with the other commodities that have already priced in a substantial global growth recovery.

We think the most direct consequence is for crude currencies to simply catch-up to oil prices – this doesn't necessarily need further oil upside for the likes of COP and RUB to benefit (our piece on finding value in reflation here). This parallels our colleagues' recommendation to be short EURNOK in the G10 FX space.

The impact of higher crude on Russian and Colombian fundamentals is hard to overstate as fiscal revenues recover from a difficult 2020 to spur new growth momentum in 2021. The charts above forecasts Russia's oil rents as a % of GDP in 2021 at 9.4% from 5.8% in 2020 and in Colombia 3.75% from 2.3% respectively, and assumes no further oil upside (although it is certainly feasible that we see another leg up as reopenings materialize).

Premia have grown in our RUB and COP models as oil rallies

Source: Bloomberg, NWM Strategy



In Asia, a "catch-up" in oil currencies to the oil spot price would suggest downside weakness for oil importers. Although most Asian economies are net oil importers, we think India and the rupee stand-out most, given India's export growth has lagged other Asian peers. For the rupee we think the reflation catch-up trade is higher USD/INR due to the gradual recovery in Indian consumption. Vaccination in India has also proceeded at a decent pace (see next section). As life returns to normal in India, the country's demand for oil will also rise. We think the rise in oil import volumes, along with a higher oil spot price, will have a meaningful impact on India's trade deficit.

2/ Growth and vaccine roll out differentiator

Likewise, the expectations for quicker normalization of policy rates and more significant front-loading of EM hiking cycles has been stronger than expected, also as certain countries have made significant progress in their vaccination plans, at least compared to a few weeks ago.

As we identified in late January (here) vaccination has emerged as a growth differentiator in Israel and Chile, who are first and fourth respectively in the global rankings of vaccines administered per-capita. South Korea, our third EM that we identified as a leader in vaccines, has just begun a highly organized campaign with officials targeting herd immunity by autumn. We continue to favour Chilean front-end payers and South Korean 5y payers, with the vaccine rollout key to our growth thesis. In Israel the curve remains stubbornly supressed, however inflation expectations have begun to marginally move higher.

Colombia, South Africa and the Philippines continue to lag on both the procurement and rollout forefronts, with none of the three countries expected to reach herd immunity in 2021. This leaves us bearish on overall growth, however Colombia and South Africa will likely benefit from commodity reflation.

India's vaccine drive has outperformed other middle-income economy peers, helped by India's vaccine manufacturing capabilities. India's locally manufactured Covishield (developed by Oxford / AstraZeneca) and Covaxin (developed locally by Bharat Biotech) were approved for domestic use earlier this year. Vaccination in India has proceeded at a decent pace (1.5 doses have been administered per 100 people as of 5 March, according to Our World in Data) with 3 million doses administered per day.

As we noted earlier however, the rise in India's economic activity, and a return to normal consumption and investment activity suggest upside for USD/INR, not just for oil imports but also goods imports. After the brief (but volatile moves) in USD/INR in late February / early March to 73.55, USD/INR is now again approaching its YTD lows of 72.30. We think the central bank could resume accumulating USD again near the 72.00 level, capping strength in the rupee. If FX volatility returns the RBI could again sell USD, but we think intervention involving USD selling is aimed at "smoothening" volatility, not to strengthen the rupee vs USD. **We thus recommend going long USDINR at an indicative spot price of 72.55 at the time of writing.**

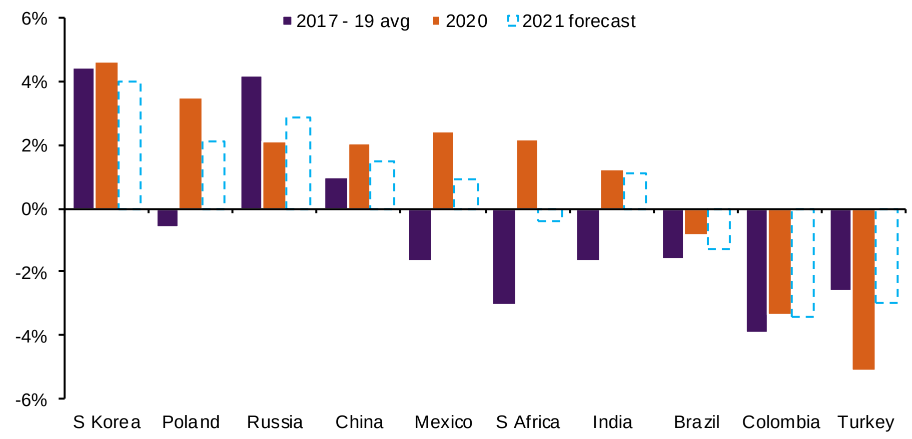
The largest disappointment in vaccines since we published our original piece in late January has been Brazil, where caseloads are currently reaching new heights. Despite a large number of doses secured, domestic production infrastructure, and a strong history of successful vaccine rollouts through the National Immunization Program, the delivery has been slow amidst supply chain troubles, challenging negotiations with pharmaceutical companies, and a weak public information campaign. Despite the slow vaccine rollout, we are calling for *at least* a 50bp BCB hike this week (here) as fiscal woes, political volatility and inflationary pressures meet.

3/ CA adjustments – still tailwinds for now

Tailwinds from the adjustment of EM external accounts are likely to decrease over time as global growth conditions normalize and current accounts shift back towards either historic or "equilibrium" settings. On the whole, we expect rising domestic demand and imports to exert downwards pressure on trade balances that have shifted to positive during the pandemic. The process of reversion should be gradual, and real flows stemming from still-positive (but shrinking) deficits should remain supportive of FX.

C/A: adjustments to persist in some, others to revert

Source: Haver, Bloomberg consensus forecasts, NatWest Markets



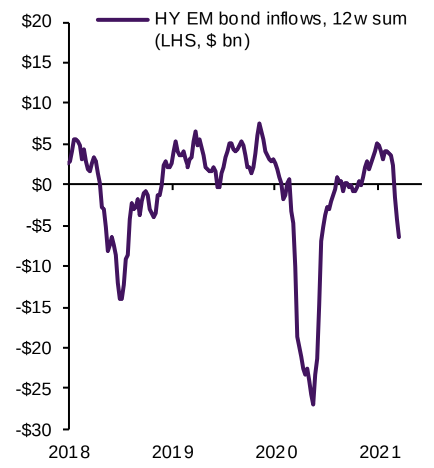
The exceptions are likely to be found in countries like Russia and Thailand, where pandemic-induced hits to exports (from oil and tourism, respectively) are expected to unwind. Turkey's deficit is expected to contract, though this is contingent on the central bank maintaining contractionary policy, which remains our base case.

We have also been particularly focused on countries that have gained export market share in global trade, such as China, Poland, and Taiwan. These cases reflect an improvement in competitiveness that should persist for some time, and prove supportive for the C/A and real flows.

2021: very sharp foreign FI outflows

Sum of Indonesia, India, Mexico, Turkey, South Africa

Source: Bloomberg, NatWest Markets



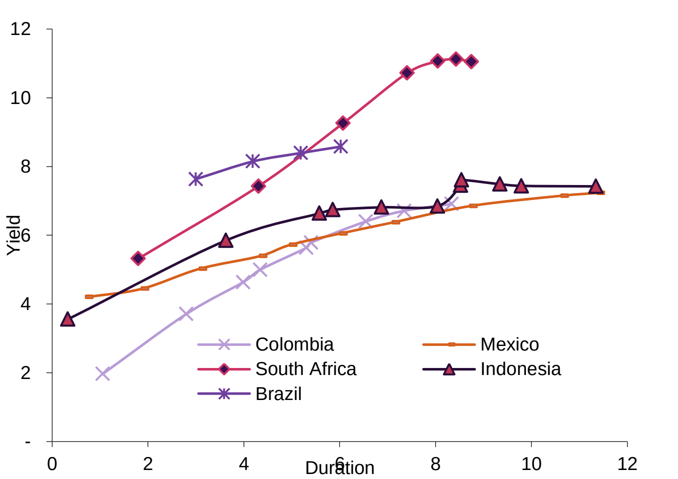
4/ FI outflows are more of a challenge

We view the recent outflows from local EM fixed income markets more as a reflection of the shift in global asset allocations than necessarily an expression of heightened risks for EM, although risks have clearly risen as global financial conditions are tighter. The sell-off has been fairly indiscriminate across EM local curves over the past couple of months as higher global rates raised the bar for fixed income portfolios. However, curves with lower yields, including the front-end of places like Peru, Philippines, as well as Brazil and Turkey where fiscal/inflation concerns have spiked, have underperformed significantly.

Indeed, the silver lining in this EM adjustment has been South Africa, where much higher SAGB yields – both on an unhedged and FX-hedged basis – have anchored performance (long-end wider about 20bps since Jan 4th vs 65bps in Mbonos and 90bps in Peru, for instance). This suggests at least some discrimination across EM rather than panic sell-offs. From an absolute perspective, we believe that global liquidity will remain very high for some time, and we anticipate more inflows into EM as rate differentials widen and foreign positioning remains very low.

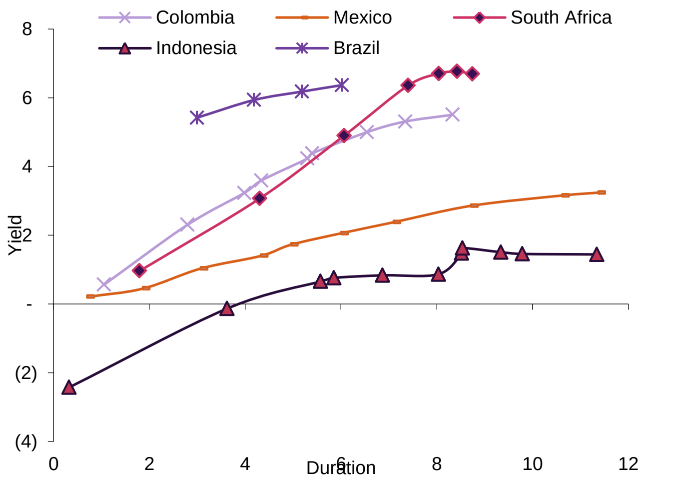
SAGBs duration stands out on nominal…

Source: Bloomberg, NWM Strategy



…as well as on FX-hedged basis

Source: Bloomberg, NWM Strategy



For now, we maintain our very selective recommendations on local duration with our only call remaining long SAGBs on a FX-hedged basis – the very steep curve still allows for significant pick-up even after hedging out ZAR volatility. In fact, as we highlighted here, the mix of FX vol and curve steepness puts SAGBs in a unique position. Our read of the budget and fiscal performance (here) has been that it will likely be good enough to not be a source of additional pressure.

In Brazil, on the other hand, recent political noise around Petrobras and the 2022 elections underscore some of the recent concerns (here) keeps us on the sidelines for now. Likewise, we still see the need for peso exposure to maintain reasonable yields in Mexico as a weakness for the MXN (here for details).

EM central banks remain a theme for divergence. In the front-end of the curve we have recommended 5Y Korean payers on the strength of vaccinations, low output gap and rising inflation. Likewise in Russia, we expect the growth rebound and threat of sanctions to continue to put pressure to the front-end, particularly as the CBR scales up its hawkish rhetoric as well. We also favour Indian 1Y receivers, as we don't see the RBI hiking rates vs already sizable premia.

Paul Robson
Yuan Cheng

Time to take profit

… but stay long NOK/SEK

The Nordic currencies have been among the best performing G10 currencies since we established our short EUR/NOK and EUR/SEK positions last May. Both have been supported by global reflation. It's a theme that has further to run. However, we believe that the risk/reward balance has shifted. The expected rate path in the Norges Bank March MPR finally mirrors our own expectation, further oil price gains will face the risk of increased supplies from OPEC+ and rising long-end US yields are a challenge for all risk sensitive currencies. We thus take profit on our short EUR/NOK position (P/L +9.9%). A move to 9.75 is still possible with a fair-wind, but we'll wait for positioning to clear before re-entering. We have also decided to take profit on our short EUR/SEK position (P/L +2.4%). Recent weak inflation data will be a concern for the Riksbank, as will Europe's relatively slow vaccination progress amid an apparent third wave. However, we maintain our long NOK/SEK position on relative monetary policy stance, relative valuation, and diverging flow outlook (target 1.05).

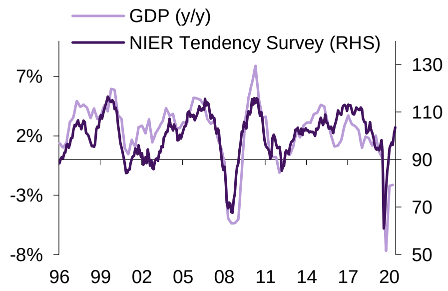
The Nordic currencies have been among the best performing currencies in G10 since we established our short EUR/NOK and EUR/SEK position last May, with the NOK rising 9.9% and SEK up 4.4% vs EUR. We took some profits on short EUR/SEK in June after it hit our initial target of 10.40, but re-established short EUR/SEK in October, with the SEK gaining 2.4% since then. We also added a long NOK/SEK position in January after the Riksbank announced to shift to self-financed FX reserves, and the pair has risen 2.7%.

Relative economic outperformance

SEK has benefited from its relative economic outperformance versus peers due to less stringent lockdown measures imposed in the period after the first outbreak of Covid-19. The pace of economic recovery slowed down towards the end of last year amid renewed pick-up in Covid-19 cases and tightening restrictions. However, the latest economic data have been consistent with continued recovery.

Sweden | GDP vs NIER Economic Tendency Survey

Source: Macrobond, NIER, Natwest Markets

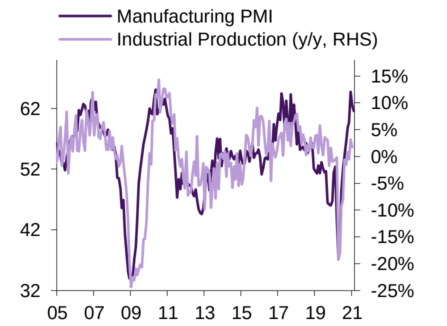


The NIER Economic Tendency Survey for February rose to 103.6, the highest since early 2019. The manufacturing PMI fell slightly in Feb, but was still well within expansionary territory and held up better than peers (61.6 vs 54.8). The services sector showed a strong recovery, with the index jumping to 62.7 in Feb (the highest in 3 years), vs 45.4 in Euro-zone. Other timely high frequency data including rebounding retail sales (up 3.4% m/m in Jan from -4.9% prior, vs Est 2%) and improving trade balance suggest that we'll see a better-than-expected recovery in Q1 GDP.

However, the impact of tighter restrictions imposed recently amid third wave fears could pose a threat to continued economic recovery in the region, and its impact will need to be watched.

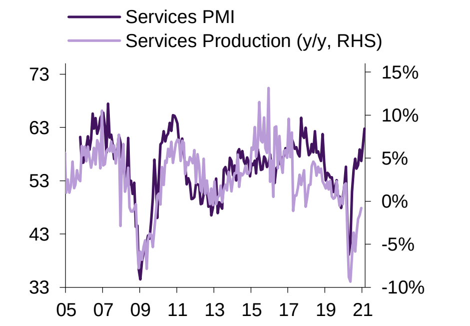
Sweden | Manufacturing output vs PMI

Source: Bloomberg, NWM FX Strategy



Sweden | Services output vs PMI

Source: NWM FX Strategy, Bloomberg

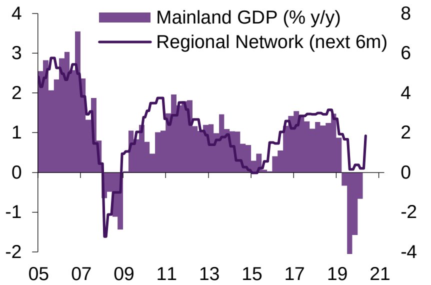


Norway meanwhile has also navigated the Covid-19 crisis relatively well versus peers, and the economic recovery has been stronger than Norges Bank's expectation thanks to an effective lockdown strategy, fiscal support and a much stronger oil price.

Q4 mainland GDP expanded 1.9% despite a second Covid-19 wave, higher than the consensus of 1.3% and Norges Bank forecast of 0.8%. For '20 as a whole, Norway's mainland GDP contracted 2.5%, much better than Norges Bank's forecast of -3.5%. The latest manufacturing PMI and regional network survey suggests continued economic recovery.

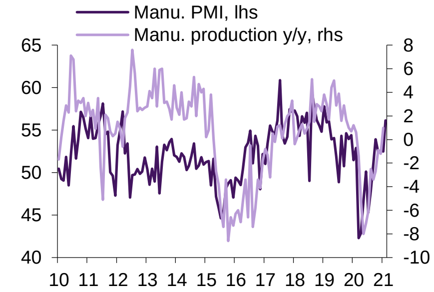
Norway | GDP vs Regional network survey

Source: Macrobond, NWM FX Strategy



Norway | Manufacturing output vs PMI

Source: Macrobond, NWM FX Strategy



Covid-19 trends and vaccination progress

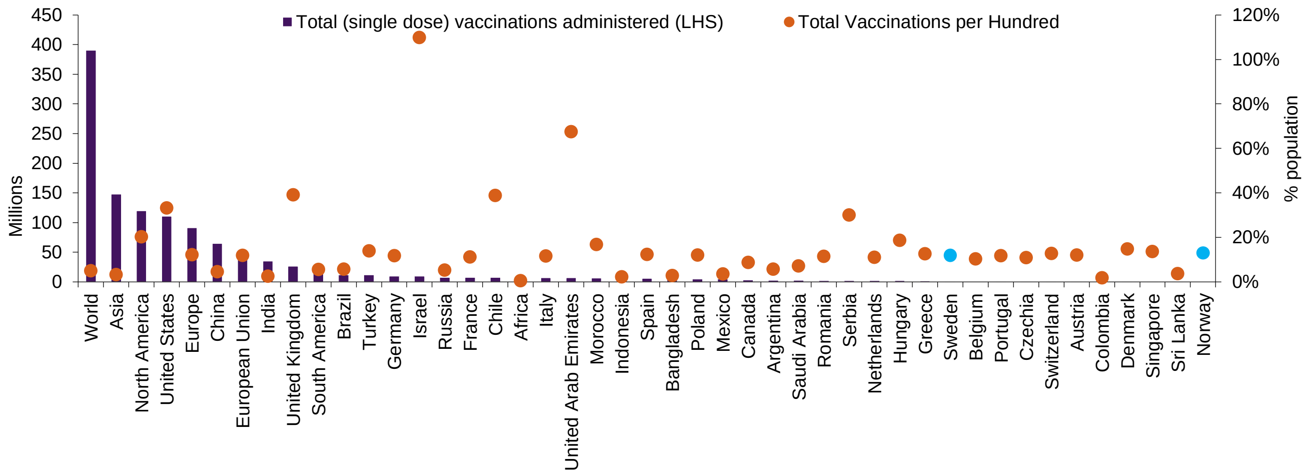
Vaccine rollout looks an incremental driver of the growth expectations. Up until 16th March, Norway has vaccinated around 13.02% of its population, while Sweden is relatively behind, with around 11.90% of its population vaccinated. The progress in both countries seems relatively slow amid the sluggish rollout of the EU-wide vaccination programme.

Europe's vaccination programme should start to quicken during April as supplies pick up from Pfizer and J&J deliveries begin. This should push forward the vaccination rollouts in Sweden and Norway. If vaccine deliveries are scaled up as expected, it could give a boost to activity from Q2 and provide further support to the currencies.

However, rising infections and tightening restrictions continue to be a downside risk. Norway's health minister recently said that Norway is currently experiencing a third wave, and Sweden's state epidemiologist have also warned about this. Restrictions have been tighter in both countries because of such risks. Further, both Sweden and Norway are among the countries that have suspended the use of the AstraZeneca vaccine on reports of possible side effects. Therefore, short-term uncertainties remain and will need to be watched.

Vaccine distribution progress so far globally

Source: OurWorldinData.org



Central bank outlook

Riksbank left policy settings unchanged at the February meeting, and acknowledged that the economy has been more resilient to the second wave of the pandemic than to the first. '21 GDP and near-term inflation projections were revised up. The Riksbank remained open to negative rates, but returning to negative rates would probably require another material round of weakening or de-anchoring in long-run inflation expectations.

Long run inflation expectations in Sweden have been relatively stable and better anchored. However, recent downside surprises in inflation data could increase the Riksbank's concern on maintaining credibility of the inflation target.

Norges Bank revised upward its policy rate path at the March meeting and brought forward the timing of the first rate hike to latter half of this year. The policy rate path was revised up to 0.13% (vs 0% prior) by December this year, 0.75% (vs 0.51%) by end of 2022, and 1.09% (vs 0.93) by end of 2023. This leaves open the door to a rate hike by the end of this year, followed by two rate hikes in 2022, and one rate hike in 2023.

The adjustment on the rate path was made as "*there are prospects that economic activity will approach a normal level earlier than projected in the December*" amid better-than-expected vaccination progress and global economic developments. Norges Bank also highlighted that *"information from the health authorities suggests that a large portion of the adult population in Norway will be vaccinated before the end of summer".*

According to the Monetary Policy Statement, the rate path decision and economic projections were made based on the scenario that "*all risk groups, including health personnel, will be offered a first dose before the end of May and the remainder of the adult population by the end of July*". Norges Bank also envisage that "*the lifting of containment measures can roughly be divided into three phases*", with current strictest containment measures to be lifted by April, followed by less strict containment measures during summer and autumn, and few or no containment measures towards the end of the year.

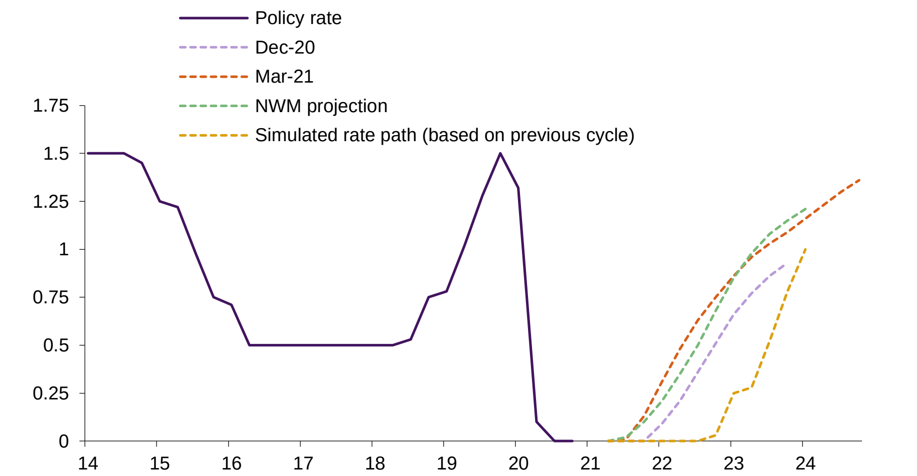
Under these assumptions, Norges Bank expects that mainland activity will return to pre-pandemic levels in 2021 Q3. As a result, vaccination progress, containment measures and infection rates and their impact on the economic recovery will need to be monitored.

The key differentiator for Norges Bank is well-anchored inflation expectations. This provides scope for a more flexible approach to the inflation target with greater focus on financial stability issues due to rising house prices. Along with stronger-than-expected economic recovery thanks to relatively better Covid-19 management and fiscal support and improving oil outlook, Norges Bank is finding increasingly difficult to ignore them as the vaccine rollout gathers paces. This will likely continue to be reflected in further uplifts to the expected rate path in the future Monetary Policy Meetings.

A December rate hike remains our base case, but a September rate hike appears likely if vaccine and economic developments turn out to be better than Norges Bank projections.

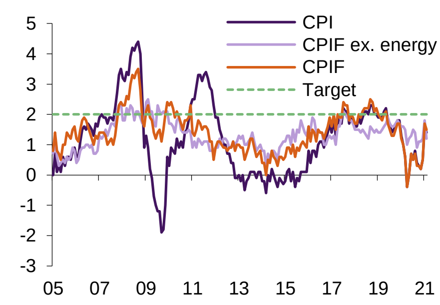
Norges Bank rate path

Source: Norges Bank, Natwest Markets



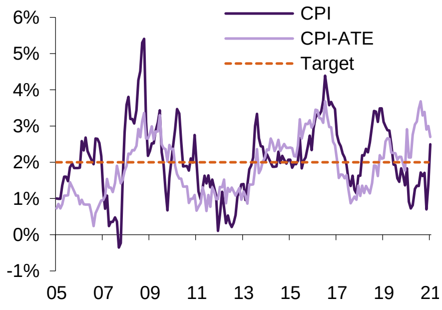
Sweden: Inflation

Source: Macrobond, NWM FX Strategy



Norway: Inflation

Source: Macrobond, NWM FX Strategy



Flow outlook

Norges Bank's increased NOK purchases since Feb could continue to benefit the NOK. Norges Bank is now buying NOK1.7b/day in March vs NOK0.8b/day in Jan, mainly because increased government spending is financed by petroleum revenue in USDs, which must be converted into domestic currency.

On the other hand, Riksbank announced in Jan to replace external financing of the FX reserves by purchasing around SEK5b per month in FX market, which could exert some downward pressure on the SEK.

Supports from global reflation theme and oil

As is usual, EUR/NOK has been tracking oil prices. Oil has been resilient recently amid reduced production due to OPEC+'s cautious approach on oil supply. Meanwhile, oil demand has continued to strengthen as global activity recovers.

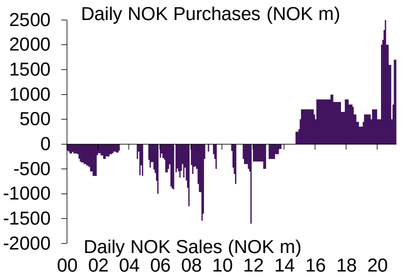
According to our rich/cheap model, EUR/NOK appears fairly valued. With the Norges Bank outlook now looking fully priced, further NOK gains will need to see further oil price gains these face the obstacle of possible increases in OPEC+ supply. We have thus decided to take profit on our short EUR/NOK position (P/L +9.9%). A move to 9.75 is still possible with a fair-wind, but we'll wait for positioning to clear before re-entering.

We have also decided to take profit on our short EUR/SEK position (P/L +2.4%). Recent weak inflation data will be a concern for the Riksbank, as will Europe's relatively slow vaccination progress amid an apparent third wave.

At the same time, NOK/SEK continues to trade before our estimate of short-term fair value. We maintain our long NOK/SEK position on relative monetary policy stance, relative valuation, and diverging flow outlook (target 1.05).

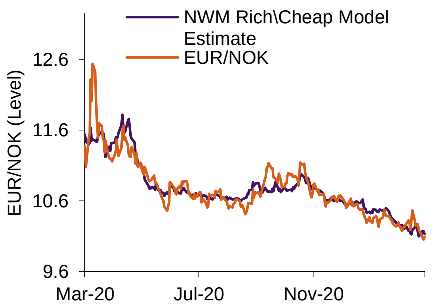
Norges Bank has ramped up NOK purchases since Feb

Source: Bloomberg, Natwest Markets



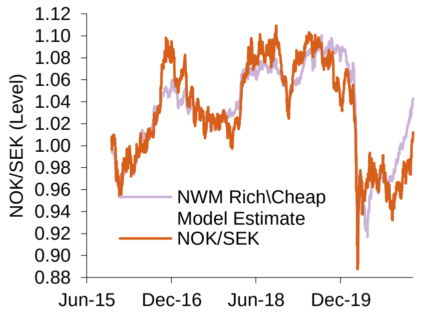
EUR/NOK rich/cheap model

Source: Macrobond, NWM FX Strategy



NOK/SEK rich/cheap model

Source: Macrobond, NWM FX Strategy



Paul Molander

BRL: The balance of risks has tilted to bid

- **This morning we went short USD/BRL at 5.50 (here) as the BCB signals autonomy and adherence to their inflation mandate**
- **We believe that the hawkish surprise eliminates a key barrier to BRL beginning to compress some of the significant risk premia currently priced in relative to core commodity drivers**
- **Furthermore, we see scope for fixed income flows to return in an increasingly unhedged manner as they look to capture higher rates and carry, providing some cushioning against rising UST yields**

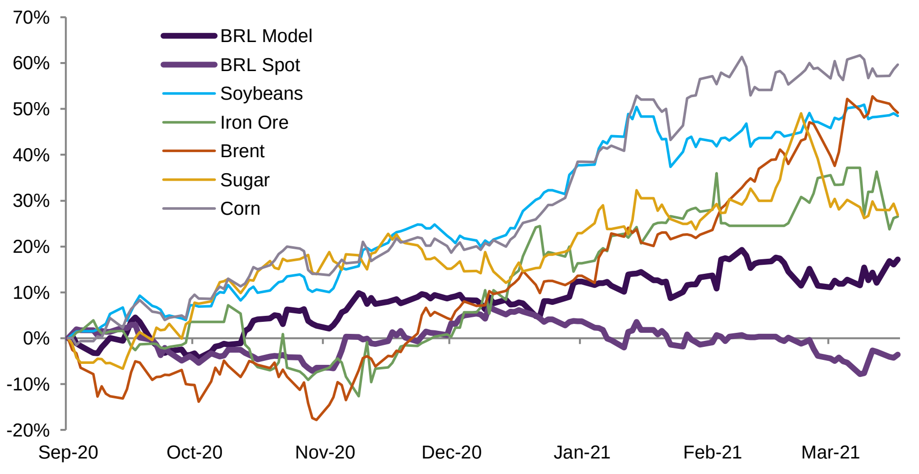
With the BCB's 75bp hike to Selic (our call, and the consensus view, was a 50bp hike) and accompanying hawkish statement, BRL has returned to becoming an attractive value proposition.

The decision to raise rates, particularly in the context of a complex fiscal and health environment, and the forward guidance that Copom is looking to hike another 75bp at May's meeting is a significant testament to the autonomy and independence of Governor Campos Neto and the BCB. The meagre carry, in addition to uncertainty around the willingness of the BCB to pursue a materially higher rates trajectory, was one of our core reasons for keeping clear of BRL.

We think that the BCB's decision will help to capitalize on some of the value priced into BRL's wide premia to fair value; our model has significantly diverged from spot since September as political noise prevented BRL from participating in the commodity rally.

BRL is cheap relative to fair value and key commodity drivers

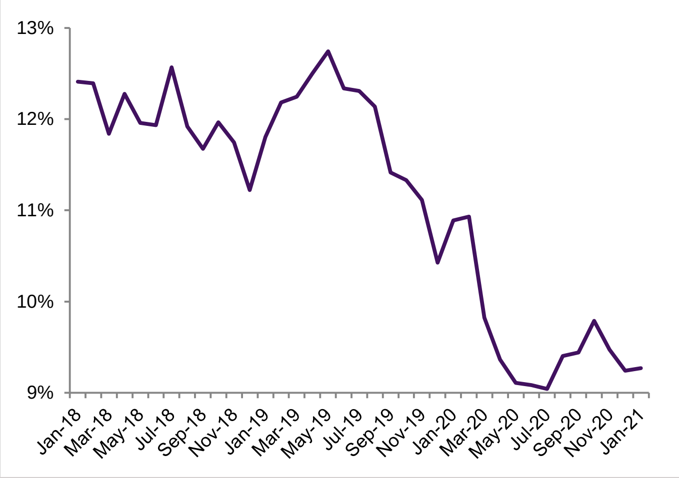
Source: Bloomberg, NWM Strartegy



Furthermore, higher rates will help to attract greater foreign capital into local debt, with foreign holdings of public debt still suppressed at 9.27% of total holdings versus 10.93% pre-pandemic. As carry returns for BRL an increasing amount of foreign investment will likely opt for FX exposure, which should provide a growing amount of support for BRL as the BCB increases rates over the coming meetings.

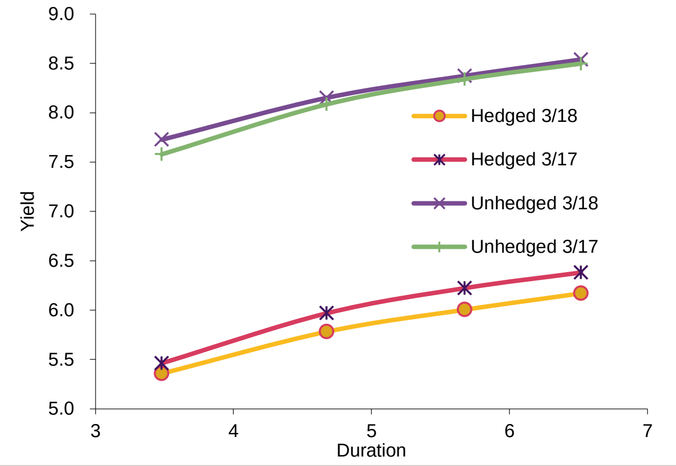
Foreign ownership of local debt remains depressed

Source: Bloomberg, NWM Strategy



Hedged yields become increasingly unattractive on hikes

Source: Bloomberg, NWM Strategy



On the political forefront, we think that noise should be reduced over the coming weeks with the recent passage of the PEC Emergencial; this was a major fiscal hump for the government to get over, but it is now in the rear-view mirror. As Brazilians receive emergency aid checks President Bolsonaro's falling approval rating should begin to rise, which is likely to reduce his inclination for political volatility. Recent successes in the reform agenda, including the recent passage of reform to the natural gas sector, are also encouraging developments that the administration is working productively again with congress.

What remains a key priority for the government now is to get the pandemic under control; Brazil currently has the highest global new case load, reaching 90k new cases yesterday as health systems across the country come under immense strain, pushing deaths up to 2.85k/day. Our hope is that the newly appointed Minister of Health Queiroga will be able to improve the federal-level response and accelerate vaccine distribution, which has disappointed thus far, but accelerate into the coming months due to the large number of doses secured (nearly 135% of the population), domestic capabilities for Sinovac and soon for AstraZeneca, and a strong history of vaccine rollouts through the National Immunization Program.

From a pure economics standpoint, the implied reduced mobility of the high infection rates, in addition to any government-mandated mobility restrictions that may be imposed in the coming days, should work to maintain the large trade surplus, which stands at nearly $50.5bn annualized as of February.

While we are sceptical about Brazilian assets over the longer term, particularly as 2022 election noise picks up, we believe that in the coming months BRL has an opportunity to realize some of its value as the general risk environment becomes more constructive.

Brian Daingerfield
Paul Robson

Global FX Themes

The Wides of March

- The Fed was resolutely dovish, making it clear that it will let the economy run hot. Higher inflation and growth forecasts but no corresponding change to the dot plot / asset purchase signals the desire not to pre-empt. As we expected, the Fed did not throw the Treasury market a life-jacket, keeping a nonchalant attitude on US yield moves. For the global rate complex, and for risk-sensitive FX, the reflation rout continues to be too much of a good thing. Higher real yields support of the USD against safe havens, and leave us defensive on using the USD as a funder for risk-sensitive currencies that should benefit from surging global growth expectations.
- Europe's vaccination rollout continues to disappoint, and we think it may be difficult for the market to price toward a brighter outlook in Europe without evidence of a pickup in vaccinations – while we expect this to start in April, markets may need to see the proof – if anything, right now the risks appear skewed toward a 3rd wave of the virus rather than a first wave of vaccine optimism. The ECB's desire to stand against, rather than brush off, nominal yield moves may also present a challenge for the EUR.
- The BoE didn't deliver the modest tapering that we expected, but that announcement doesn't change our position view on the currency. We see the UK economy as still on track for a mini consumer boom from Q2 to Q4, and the UK's vaccination programme continues to stand out relative to the EU. We thus stay short EUR/GBP and long GBP/CHF. GBP/JPY also has further upside, in our view.
- The Nordic currencies have been among the best performing currencies in G10 since we established our short EUR/NOK and EUR/SEK positions last May. Both have been supported by global reflation. It's a theme that has further to run. However, we believe that the risk/reward balance has now shifted. This week we took profit on our short EUR/NOK position (P/L +9.9%) and our short EUR/SEK position (P/L 2.4%). However, we maintain our long NOK/SEK position on relative monetary policy stance, relative valuation, and diverging flow outlook (target 1.05).
- Our profit-taking on EUR/NOK short aside, our FX trading portfolio generally leans quite bullish on the crude complex. We are long CAD, NOK, COP, and RUB in different variations. Thursday's oil plunge, while appearing to be more positioning related than fundamental, can certainly sap momentum near-term. That said, the reflation narrative and Saudi supply strategy both remain positive for crude.
- This week marked a critical juncture for EM central banks and, for the BCB and CBRT, hawkish surprises were delivered. The relative carry story in Brazil is poised to improve meaningfully following the BCB's 75bp hike and clear signal of more tightening to come – our EM team established short USD/BRL this week as monetary policy becomes supportive alongside expectations of quieter fiscal noise. The CBRT also delivered a hawkish surprise, hiking rates 200bps, against our call and the consensus view of 100bps. As the reflationary theme deepens, and as markets look outside of Treasury yields for signals, carry may return as an another signal for FX performance, favouring earlier hikers. For EM FX, the team think that crude oil, carry, current accounts, and FI flows will be the drivers for differentiation.
- Looking ahead, Powell testifies alongside Treasury Secretary Yellen in Congress next week where he'll have another opportunity to weigh in on UST price action, as well as the USD (Congress will likely ask Yellen, at least, about the USD). The SNB rounds out the G10 central bank decisions next week, but the calendar is jammed with key decisions across EMFX.

USD | Just do it

Nordics | Taking profit on short EUR/NOK and EUR/SEK

AUD | Strong labor market recovery underway

NZD | Growth disappoints, relative yields matter no more

EMFX | Beyond USTs, tail risks are still on the horizon

BRL | Entering short USD/BRL position

Next week | SNB/NBH/SARB/CNB/Banxico/BanRep/BoT/BSP decisions, US GDP, UK/Euro-area/Japan PMIs, UK employment, UK/Japan CPI, UK/Sweden retail sales

New Trades | **Compression of significant risk premia** - Short USD/BRL

Closed Trades | **Nordic currencies favoured** - Long NOK, SEK vs EUR

Open Trades

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

LatAm valuations – Long USD/CLP and long PEN/CLP

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

Relative monetary policy - Long NOK/SEK

Brexit and early vaccine rollout – Long GBP/CHF and Short EUR/GBP

Leg Into Reflation Trades - Long AUD/USD

FX Models

G10 FX Ranker | NZD, NOK favoured over SEK & JPY (link)

EMFX Macro Ranker | MXN, MYR and TRY; shorts in RON, PEN and HUF (link)

G10 Long-term Drivers – Long GBP, NOK vs USD, EUR, JPY & CAD (link)

G30 FX Long-term valuations – Long Latam FX, sell INR (link)

G10 Valuation Snapshot – Long NOK, AUD vs EUR, JPY

G10 Valuation snapshot

Source: Bloomberg, Natwest Markets

FX	Long term value	Short term value	Carry	Positioning*	Momentum**	Equal weighted score	Rank (1,2= buy. 9,10= sell)
USD	10	NA	3	6	5	6.0	6
EUR	9	7	9	7	8	8.0	10
GBP	3	4	5	5	1	3.6	4
JPY	6	8	8	3	10	7.0	9
NOK	1	2	2	NA	3	2.0	1
SEK	4	9	7	NA	7	6.8	8
CHF	5	5	10	4	9	6.6	7
AUD	2	3	6	1	4	3.2	2
NZD	7	1	1	2	6	3.4	3
CAD	8	6	4	8	2	5.6	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)

Galvin Chia

NWM EMFX Macro Ranker – March

The **NWM EMFX Macro Ranker** is our short-term tool which looks at macroeconomic variables to pick three 'buy' and 'sell' currencies in the EM space. The white paper on the Ranker can be found here.

While the Ranker provides a quantitative approach to determining which macro variables drive currencies, results do not necessarily coincide with our existing (discretionary) recommendations. We also maintain the caveat that the Ranker uses of backward-looking data and may not reflect current developments, particularly as the effects of the COVID pandemic linger.

Table 1: Ranker signals in March

Source: NatWest Markets

Ranker signal		Main drivers
Long 1	RUB	High expected real rates and interest rates
Long 2	MXN	Relatively high real interest rate, large C/A surplus
Long 3	SGD	Large C/A surplus and relatively strong fiscal balance
Short 1	PEN	Weak PMI, large fiscal and C/A deficits
Short 2	CLP	Low real rates, relatively large fiscal deficit
Short 3	HUF	Deteriorating fiscal balance, Weak PMI and low real rates

March signals: long signals in **RUB, MXN, and SGD**; shorts in **PEN, CLP and HUF**.

These signals share some of our discretionary views. We added COP and RUB vs a basket of USD and EUR as we anticipate the currencies to catch up on higher crude prices, while we are still long USD vs MXN as we see the Mexican peso as a good hedge against our longs in crude currencies. We continue to remain long PEN vs CLP and USD vs CLP given PEN's strong fundamentals and increasing political noise in Chile.

Table 2: Ranker's spot performance (excluding carry)

Source: NatWest Markets, Bloomberg

Ranker signals - FX spot returns vs USD (% end-of-month vs 4th of the month)		Oct		Nov		Dec		Jan		Feb	
Ranker	Long 1	TRY	-7.0%	THB	2.3%	INR	1.0%	THB	0.0%	MXN	-2.2%
	Long 2	CNY	1.5%	INR	0.2%	TWD	0.4%	CNY	0.5%	MYR	0.2%
	Long 3	THB	0.5%	MYR	2.2%	CNY	0.1%	RUB	-1.9%	TRY	-3.9%
	Avg return		-1.7%		1.6%		0.5%		-0.5%		-1.9%
	Short 1	COP	-1.0%	RON	1.5%	ILS	1.7%	PEN	-0.4%	RON	0.9%
	Short 2	BRL	-2.8%	HUF	3.1%	CZK	1.7%	HUF	0.3%	PEN	-0.1%
	Short 3	RON	-0.9%	PEN	-0.2%	HUF	-0.3%	RON	-1.0%	HUF	-0.9%
	Avg return		1.6%		-1.5%		-1.0%		0.4%		0.0%
	Long vs Shorts		0.0%		0.1%		-0.3%		-0.05%		-0.95%

Ranker marginally outperforms February EM FX

Our ranker portfolio posted a marginally better return of -0.66% (including carry) in February compared to an average return of -0.70% from our basket of 22 liquid EM currencies. EMFX has underperformed this year as US Treasury yields continue to rise.

What's driving current signals?

RUB and SGD replace MYR and TRY as long signals, while CLP replaces RON as a short. HUF continues to appear as a short signal for the fifth month in a row.

Higher expected real rates and rising interest rates characterise the long RUB signal, while the MXN and SGD signals were driven by large current account surpluses and higher real interest rates.

Our shorts were mainly characterised by a deteriorating fiscal position. For PEN and HUF, a weak PMI reading (relative to historical levels) also drove the short signal.

A C/A based strategy outperformed over the last year

A detailed look at last twelve month's signals showed a long-only current account strategy gave maximum returns, outperforming the average EMFX return.

Chart 1 shows the performance of a long-only basket of three currencies, selected on the basis of countries that are ranked 1,2,3 on four key parameters: current account balance (% of GDP, sa), short-term real (ex-ante) interest rate (%), expected change in real interest rate in 12 months (%) and manufacturing PMI (z-score, latest month). We observe that a current account based selection strategy outperformed the average EMFX return over the last one-year. The short-term real interest rate strategy based on 3m implied interest rates also yielded good results but we saw more volatility in returns. Table 3 shows monthly returns for different strategies starting Apr-20. The year-to-date performance of a short-term interest rate strategy gave fairly good returns (~6%) especially compared to the benchmark average EMFX return (~3%).

Chart 2 shows a strategy constructed by selecting 3 longs and 3 shorts, with currencies selected using the constituent drivers mentioned above. Three shorts are decided on the basis of countries that are ranked the lowest. The C/A rule also outperforms with a year-to-date return of 4.6% versus 3.1% for the average EMFX. However, our short term interest rate rule doesn't work well here and yields lower returns. Importantly, the PMI and the expected change in real rate strategies have been poor signals over this time period, both for long-only and 3 long-3 short strategies.

Finally when we compare the two strategies i.e. a long-only and the 3 long- 3 short strategy, we found that former did better. The C/A rule gave consistently better returns since Aug'20 for a long-only strategy, while for the 3 long-3 short strategy; the returns have been more volatile. The YTD results are also significantly better in the case of a long-only strategy as compared to the 3 long- 3 short strategy.

Chart 1: Current account long only rule outperformed EMFX returns

Cumulative spot returns of ranker outcome as well as different subgroup returns plotted with average EMFX return for the sample

Source: Haver, Bloomberg, Natwest Markets

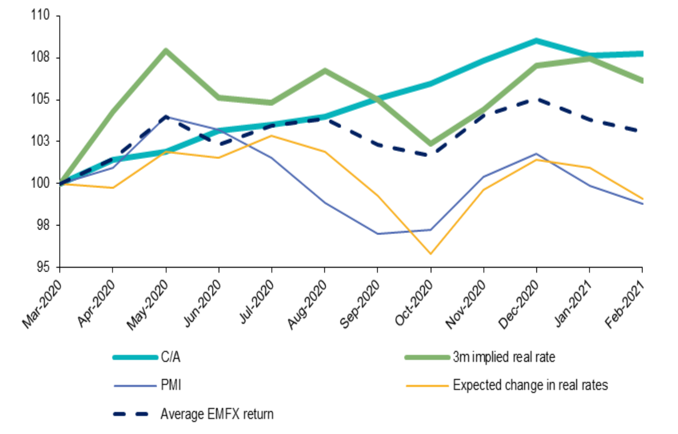


Chart 2:…with the rule working pretty well for long-short strategy too

Cumulative spot returns of ranker outcome as well as different subgroup returns plotted with average EMFX return for the sample

Source: Haver, Bloomberg, Natwest Markets

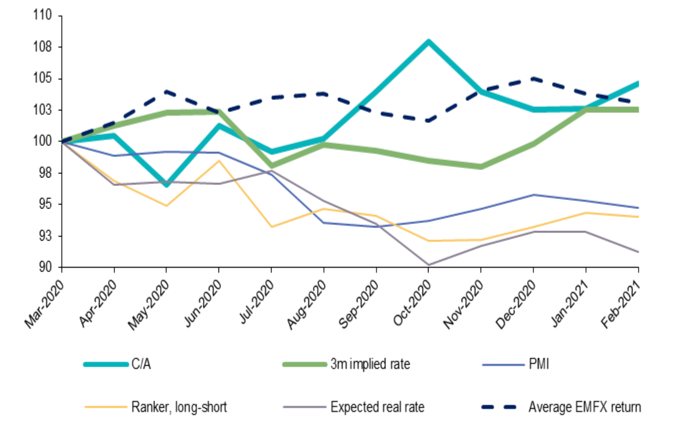


Table 3: Month-on-month returns from different strategies

Source: Natwest Markets

m/m returns		Long-only strategy					Long-short strategy				
Date	Average EMFX return	Ranker	C/A	3m implied real rate	Expected change in real rates	PMI	Ranker	C/A	3m implied rate	Expected change in real rates	PMI
Apr-2020	1.5%	-0.2%	1.4%	4.3%	-0.2%	0.9%	-3.1%	0.5%	1.3%	-3.4%	-1.1%
May-2020	2.4%	3.1%	0.5%	3.5%	2.1%	3.0%	-2.0%	-3.9%	1.0%	0.2%	0.3%
Jun-2020	-1.6%	-1.5%	1.2%	-2.6%	-0.3%	-0.7%	3.7%	4.9%	0.1%	-0.1%	-0.1%
Jul-2020	1.1%	-0.7%	0.4%	-0.3%	1.3%	-1.6%	-5.3%	-2.1%	-4.2%	1.0%	-1.8%
Aug-2020	0.3%	1.2%	0.5%	1.8%	-0.9%	-2.7%	1.5%	1.1%	1.6%	-2.4%	-3.9%
Sep-2020	-1.5%	-2.2%	1.0%	-1.6%	-2.6%	-1.9%	-0.6%	3.7%	-0.4%	-1.9%	-0.3%
Oct-2020	-0.6%	-1.7%	0.8%	-2.5%	-3.5%	0.2%	-2.1%	3.8%	-0.8%	-3.5%	0.4%
Nov-2020	2.3%	1.6%	1.3%	2.0%	4.0%	3.3%	0.1%	-3.7%	-0.6%	1.6%	1.0%
Dec-2020	0.9%	1.9%	1.1%	2.5%	1.8%	1.4%	1.1%	-1.4%	1.9%	1.3%	1.2%
Jan-2021	-1.1%	0.0%	-0.8%	0.4%	-0.5%	-1.9%	1.2%	0.1%	2.7%	0.0%	-0.5%
Feb-2021	-0.7%	-0.9%	0.1%	-1.2%	-1.9%	-1.1%	-0.4%	1.9%	0.0%	-1.7%	-0.6%
Ytd returns	3.1%	-6.0%	7.7%	6.1%	-0.9%	-1.2%	-6.0%	4.6%	2.6%	-8.8%	-5.3%

Table 4: Descriptive statistics – 3 long vs 3 short vs USD (incl carry)

Source: Natwest Markets

Total return since Nov12	41.6%
Maximum	3.14%
2nd highest	2.40%
3rd highest	2.10%
Minimum	-2.52%
2nd lowest	-1.48%
3rd lowest	-1.27%
Average monthly return	0.35%
Standard deviation monthly	0.90%
Average annual return	4.33%
Standard deviation annual	3.13%
Sharpe ratio	1.38
Postiive return (% of time)	65.0%
Negative return (% of time)	35.0%

NWM's discretionary views

While the Ranker may provide a quantitative macro approach, they do not necessarily coincide with our existing recommendations.

We maintain our selective approach on EMFX as global environment remains challenging and higher US yields are having an impact on EM currencies (see the attached here). In this backdrop we recommend the following trades:

- Added COP and RUB vs basket as they offer the most value in EM as they catch-up on the recent crude rally
- Remain long USDCLP and PENCLP as we expect the policy noise around the Constitution to pick up over the next few weeks against already tight valuations vs. copper. We like the PEN as a cross because of its lower beta and better fundamentals.
- Long USD vs MXN as we see the Mexican peso as a good hedge against our longs in crude currencies (COP and RUB)

Table 5: Historical ranker signals, previous 12 months

Source: NatWest Markets

	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21
THB	2	4	1	4	5	4	7	3	1	9	1	8
MYR	3	3	14	5	2	5	4	4	3	6	11	2
PHP	10	17	7	18	7	13	18	17	11	14	7	9
SGD	4	6	6	8	8	3	9	10	4	8	4	4
KRW	12	7	5	15	15	12	12	6	12	18	16	12
TWD	6	10	12	10	16	14	13	15	16	2	10	6
CNY	8	5	2	7	6	6	5	2	5	3	2	10
IDR	10	13	18	13	10	8	8	13	6	7	9	11
INR	1	2	8	3	13	15	10	5	2	1	6	15
HUF	21	22	21	22	19	18	21	18	21	22	22	22
CZK	19	15	16	19	20	19	16	14	19	21	18	13
TRY	13	1	11	2	4	9	3	1	7	5	5	3
ILS	12	11	9	9	18	21	17	11	18	20	12	18
RON	20	20	19	16	17	22	19	22	20	17	21	20
PLN	17	14	4	11	12	10	11	12	8	4	8	16
RUB	5	9	10	1	1	1	1	9	9	11	3	7
ZAR	18	12	15	12	9	7	6	8	10	13	14	5
CLP	22	21	20	21	21	17	20	19	15	12	13	19
BRL	15	16	17	20	22	20	22	21	14	15	19	17
MXN	7	8	3	6	3	2	2	7	13	10	15	1
COP	16	18	22	14	11	11	15	20	17	16	17	14
PEN	14	19	13	17	14	16	14	16	22	19	20	21

Peiqian Liu

China: Mixed Recovery Momentum

- China's January and February industrial production and retail sales were better than expected, while fixed assets investment missed market expectations. Even though growth compared to a year ago surged significantly, the pace of recovery was stable as month-on-month growth was much more moderate and showed continued gradual recovery.
- Today's very strong year-on-year real activities data was partly flattered by the low base in 2020 (the height of China's COVID lockdowns occurred in February 2020). In 2021 the impact of tighter travel restrictions during the Chinese New Year period onto activities data was mixed. Sequential data indicated that growth momentum recovered further in supply-side sectors, as industrial production growth has been well supported by stable labour supply and improving external demand. Consumer recovery was more uneven and was led by goods-related retail sales while services-related retail sales are still below the pre-COVID levels.
- The National People's Congress (NPC) this year has set a very conservative GDP target of "above 6%", leaving ample room for the government to prioritise long-term reforms instead of pursuing credit-fuelled stimulus. Beyond 2021 we think China's real GDP will gradually normalise to long term potential growth of around 5-5.5%, and we expect the Authorities to manage a gradual and orderly transition away from pandemic-related stimulus in coming quarters.

January and February real activities data indicated that the demand side recovery slowed marginally as retail sales briefly fell into month-on-month contraction in January. Supply side recovery momentum remained strong however, supported by a better-than-expected external demand rebound. Key points from today's data are:

- Retail sales surged by 33.8% yoy in the first two months of 2021, significantly higher than the 4.6% rate of growth in December 2020 and slightly higher than market expectations of 33.0% yoy growth. In sequential terms, January and February data are broken out as separate months; retail sales fell 1.4% mom in January and improved 0.6% mom in February, notably slower than the 1.3% mom pace in December.
- Fixed assets investment (FAI) jumped by 35.0% yoy in January-February period, lower than the Bloomberg surveyed consensus of 40.9% yoy. In sequential terms FAI improved steadily by 2.5% mom in January and 2.4% in February. The January and February sequential growth rates were a slowdown from the 2.1% mom rate in December.
- Industrial production grew 35.1% yoy in the first two months, higher than Bloomberg estimate of 32.2%. IP rose 0.7% mom in both January and February, roughly on par with the 0.6% growth seen in December.
- The surveyed unemployment rate saw an uptick to 5.5% from 5.2% in December but is in line with the government target this year. China created 1.48 million new urban jobs in the first two months, higher than 1.08 million in 2020.

Retail sales recovery slowed sequentially although headline year-on-year growth beat expectations. In month-on-month terms, retail sales fell 1.4% mom in January due to tighter travel restrictions during the Chinese New Year Period and returned to moderate 0.6% mom growth in February after the social distancing policies were relaxed. Both January and February sequential retail sales data are notably slower than the 1.3% mom pace in December. The details suggested that the improvement was uneven. Goods related retail sales showed 34.5%yoy growth while 2-year average growth (January and February in 2020 and 2021 compared to 2019) was more moderate at 3.4%. Services related retail sales as represented by restaurant revenues rose 68.9% yoy but 2-year average growth is still below 2019 trend at -2.0%.

We think that the strict travel and social distancing policies in response to localised COVID outbreaks, coupled with the lack of direct cash handouts to households with fiscal stimulus may lead to more gradual recovery in the consumer sector in China compared to the consumer-led US recovery. Improving employment and household income will provide a more sustainable but also a more gradual support to China's consumption recovery in 2021. We do not expect any sharp surge in consumption in the recovery phase.

Within fixed assets investment, growth was also more broad-based as manufacturing, infrastructure and property sectors surged by 37.3% yoy, 36.6% and 38.3% respectively, up from 10.2%, -0.1% and 9.3% in 2020. The strong recovery in the manufacturing sector investments is likely supported by resilient export performance and a positive tech cycle driven by more work from home demand for data processing equipment, consumer electrical and electronic products. Infrastructure investments are expected to slow gradually this year as the National People's Congress (NPC) approved a CNY3.65 trillion quota for local government special bond issuance, lower than CNY3.75 trillion previously.

Industrial production growth accelerated in mom terms to 0.7%, marginally higher the long term average month-on-month growth of 0.6%. The labour supply in the industrial sector was unaffected by tighter travel policies during the Chinese New Year. The National Statistics Bureau (NBS) conducted an ad-hoc survey with 5,000 corporates on Chinese New Year migrant workers' situation and found that the average holiday for migrant workers this year was significantly shorter at 7.5 days, which may have helped corporates to resume full operation and production earlier than expected and contributed partly to the industrial and manufacturing sectors outperformance. On the demand side, we think the prospects of near-term external demand continue to improve, especially when developed economies step up with further fiscal stimulus support in coming months.

The official surveyed unemployment rate saw an uptick to 5.5% in February compared to 5.2% in December 2020. The rebound in unemployment rate was likely due to tighter travel restrictions during the Chinese New Year period, which also negatively affected the retail and services sectors as we noted earlier. Going forward, we think the outlook of employment remains challenging with the lingering pandemic uncertainties. The expected 9 million new graduates will also add additional pressures to creating employment later this year. The Government Work Report this year set an employment target of creating 11 million new urban jobs and maintaining unemployment rate target at 5.5%, similar to pre-COVID employment targets as the economic recovery gains momentum. China's policymakers have also prioritised the employment target during this year's National People's Congress (NPC), and with the employment outlook still under pressure, policymakers will likely slow the pace of tightening and maintains stable and prudent policy stance.

In conclusion, we think today's data indicated that the supply-side recovery is leading the overall growth momentum again while demand-side recovery slowed due to travel restrictions imposed during the Chinese New Year period. The very strong year-on-year growth numbers are likely transitory as base effects pass and we expect China to gradually return to long term potential growth rate of around 5.0-5.5% in late 2021.

China's NPC set a conservative GDP target of "above 6%" this year compared to consensus forecasts of 2021 GDP of around 8% (which is high partly due to 2020's low base). This conservative target gives policymakers more flexibility to focus on medium term priorities and less stress to stimulate short term growth as pandemic uncertainties persist. We think China's leaders will not ease or tighten policies aggressively, and will continue to prioritise policy stability during the recovery phase. We expect the authorities will avoid "flood-style stimulus" or pre-mature tightening amid the pandemic and will maintain a measured and targeted easing bias to stabilise the growth momentum as needed.

Chart 1: Fixed Assets Investment

Source: CEIC, NWM

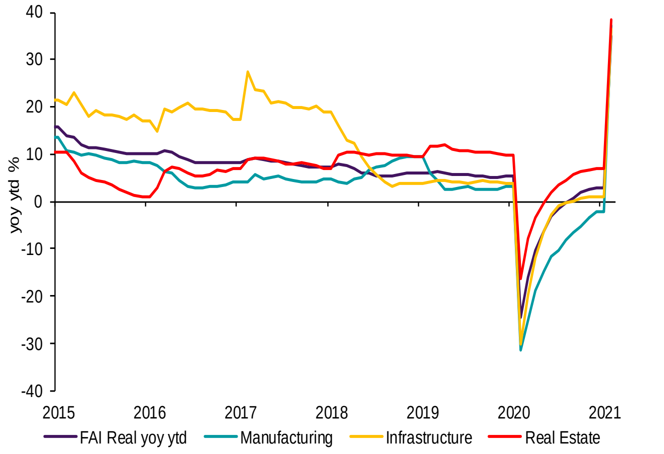


Chart 2: Retail Sales

Source: CEIC,NWM

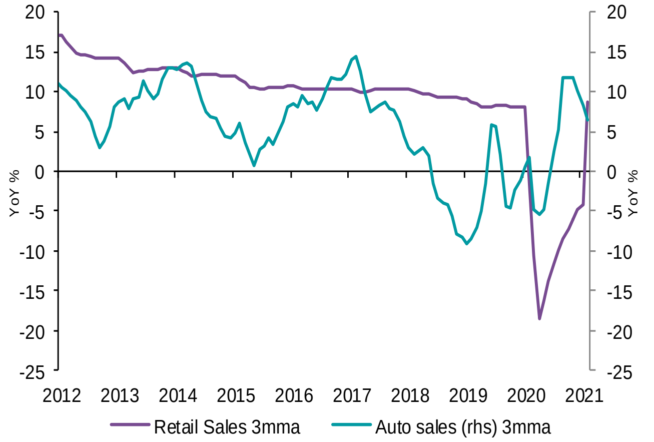


Chart 3: Industrial Production

Source: CEIC, NWM

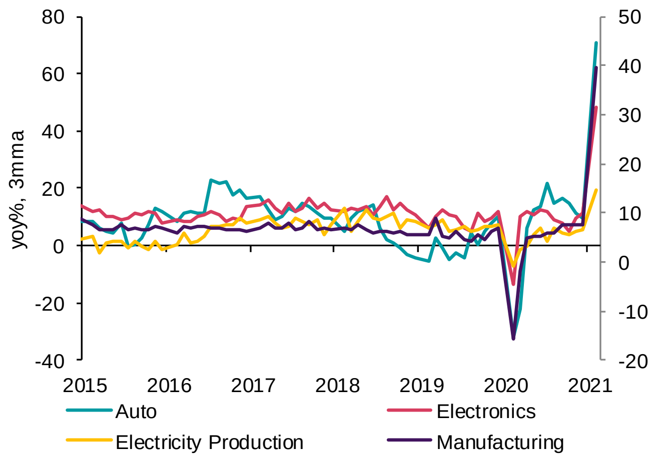
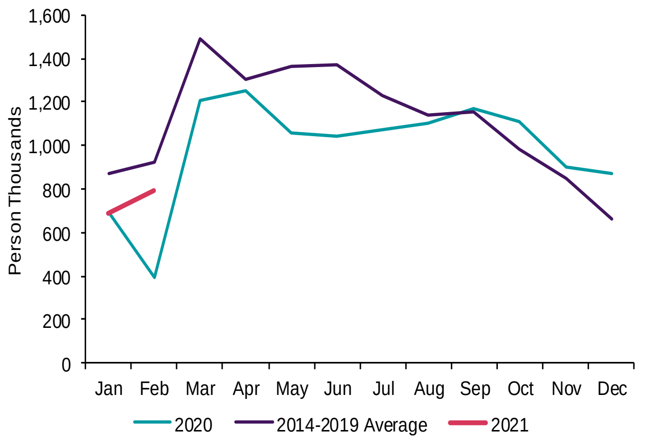


Chart 4: New Urban Jobs Created

Source: National Bureau of Statistics, NWM



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