Group Economics | 21 May 2021

Global Monthly

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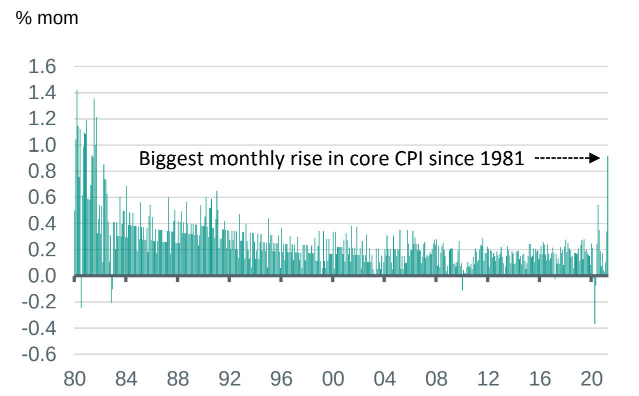
What overheating could look like

- **The eurozone is finally starting to close the recovery gap with the US, with vaccinations enabling countries to take their first significant reopening steps**
- **Meanwhile, surging inflation is stoking fears that the US economy will overheat**
- **While not our base case, we find that such a scenario would ultimately drive a sharp rise in interest rates that would tip the US economy into a recession – with global macro and market spill overs**
- **Regional updates: in *the eurozone*, and *the Netherlands*, a rapid vaccination pace and lockdown easing steps mean that these economies look to have turned a corner**
- **In *the US*, growth momentum looks to be peaking, and we expect a cooling in H2 2021**
- **We take a special look at the pandemic situation in *India*, and the economic implications**

Global View: Overheating could trigger a US recession by 2024, with global spill overs

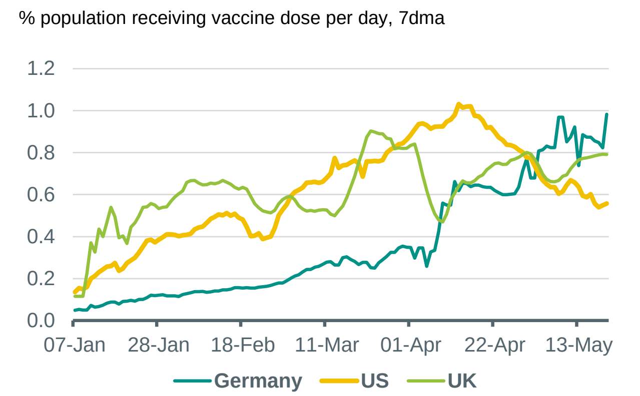
This month, the eurozone finally started closing the recovery gap with the US, with vaccinations in the eurozone now running at a faster pace than both the US and the UK, enabling countries to take their first significant reopening steps. We continue to think the bulk of the rebound will be apparent in Q3 in the eurozone. In the Netherlands, that recovery is more front-loaded, and an upside surprise in Q1 GDP led us to significantly raise our 2021 growth forecast, to 3.7% from 2.1% previously. Meanwhile, a range of indicators suggest the recovery momentum in the US is now peaking. While the data on the whole remains very strong, the pace of growth has cooled, and we expect that cooling trend to persist into H2 2021. A cooling will not come too soon to curb overheating fears in the US, which were spurred this month by the biggest monthly rise in the core CPI since 1981. This is the main topic of our *Global View* this month. Elsewhere, a key focus this month has been the resurgent pandemic in India. We find that while the impact of renewed lockdowns is less than last year, it is one of the factors driving a divergence in growth fortunes with North Asia – a region that is benefiting from the export-led global growth rebound.

US inflation jump raises overheating fears



Source: Refinitiv,,ABN AMRO Group Economics

Germany vaccinating faster than the UK at its peak



Source: Bloomberg, ABN AMRO Group Economics

US overheating – not a base case…

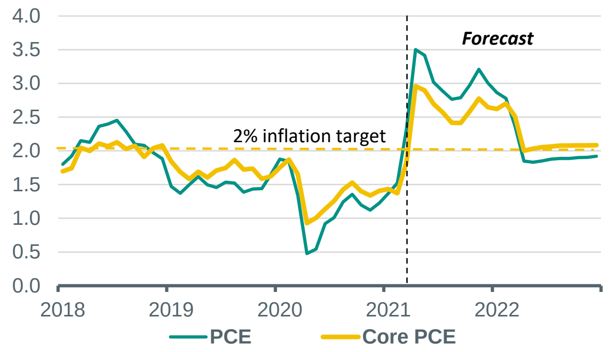
Last week's inflation surge in the US – which saw annual headline price growth topping 4% – came at about the worst possible time for investors fretting over a potential overheating of the US economy. Fears had already built over such a scenario due to: 1) exceptional policy stimulus, 2) supply-side bottlenecks 3) the rapid pace of recovery. However, while seeming to vindicate the concerns **recently expressed** by veteran economists Larry Summers and Olivier Blanchard, the jump in inflation (so far at least) **reflects temporary factors** linked to the reopening of the economy and the recovery in demand. Just as the pandemic itself was an exceptional shock to both demand and supply, so is the recovery phase. We expect a period of catch-up growth in prices to make up for the shortfalls during the pandemic – perhaps exacerbated by temporary supply-side bottlenecks (see box on p4) – but we do not see this degree of price growth being sustained.

…but not without risks

While our base case is that the rise in inflation will be temporary, there are two key risks to this benign scenario: 1) that sustained above-trend growth causes unemployment to fall more rapidly and to a lower level than we currently forecast, and 2) that the temporary rise in actual inflation could push inflation expectations higher. This would in turn put upward pressure on realised inflation, and this de-anchoring of expectations could spark a vicious inflationary cycle. There was an early warning sign of this in the latest University of Michigan survey measure of inflation expectations – the 5-10y measure jumped 0.4pp to 3.1% in April, the highest level since 2011. Such spikes are not unusual historically speaking, but if sustained, this could well be one of the drivers of an overheating scenario.

US inflation spike should be temporary…

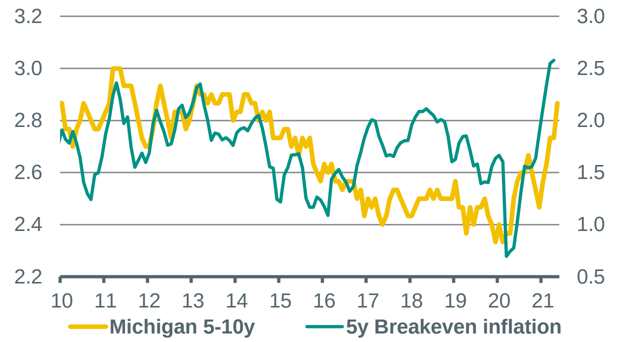
PCE inflation, % yoy – including ABN AMRO baseline forecast



Source: Refinitiv, ABN AMRO Group Economics

…but higher expectations are a risk to the outlook

Inflation expectations, % yoy



Source: Refinitiv, ABN AMRO Group Economics

What would an overheating scenario look like?

Let's suppose hypothetically – what if the US economy does overheat? How could such a scenario play out?

We would expect this to start with two things: 1) rapid growth that causes output to rise unsustainably above trend (in our hypothetical scenario, we assume a positive output gap of around 3pp – see figure on p3), 2) inflation expectations to become unanchored. The economy is already growing very rapidly, and as a base case we expect growth to cool in H2 2021 and to be back at trend by the end of 2022. However, it could well be the case that excessive policy stimulus leads to more persistently strong growth lasting a number of years. For inflation expectations to then become unanchored, this can happen due to the aforementioned temporary factors, or – more durably – due to a tight labour market pushing wage growth higher. These factors would in turn keep inflation – already elevated – above the Fed's 2% goal for a prolonged period.

Overheating would eventually trigger a forceful Fed response…

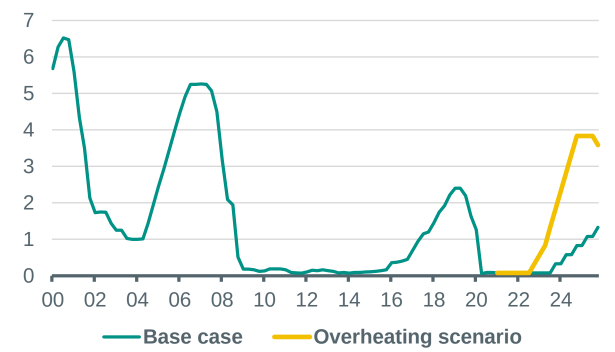
Sustained above-2% inflation would not be an immediate cause of concern for the Fed, as it has promised in its new average inflation target framework to tolerate such conditions for a time in order to make up for past shortfalls from target. However, it would eventually trigger a more forceful response than the economy has grown used to in recent years. While the Fed has not been entirely clear on how long it would tolerate an inflation overshoot, in an overheating scenario we would expect the Fed to begin tightening policy at the end of 2022, picking up the pace of rate hikes later in 2023 as it becomes apparent that a gradual tightening is insufficient to cool the economy. Ultimately, we would expect a more rapid pace of rate hikes more akin to the cycles prior to the Global Financial Crisis – one 25bp hike at every meeting (i.e. eight per year), with rates needing to be raised to well above neutral (c.2.5%), to around 4% by end 2024, in order to put a sufficient brake on the economy. This could well be accompanied by a tightening of fiscal policy.

…tipping the economy into a recession

The goal of significantly tighter monetary and fiscal policy would be to engineer a soft landing of the US economy, sufficient to cool inflation and inflation expectations. However, with markets and the economy having grown accustomed to low rates for many years, the hit to financial market sentiment and to consumer and business confidence of such a policy change would be huge. This will make a soft landing difficult to achieve, and we would expect the combination of tight policy and a deeply negative market reaction to cause a shallow recession in the US. This would ultimately push output below trend, with a sustained negative output gap likely necessary for a time to re-anchor inflation expectations at a level consistent with 2% inflation (see below).

A significant tightening of monetary policy…

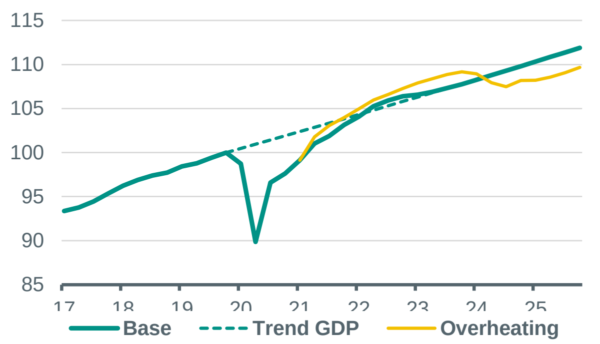
Federal funds rate, %



Source: Federal Reserve

…would cause a US recession by 2024

GDP, Q4 19 = 100



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

What about a eurozone overheating? The chances are low

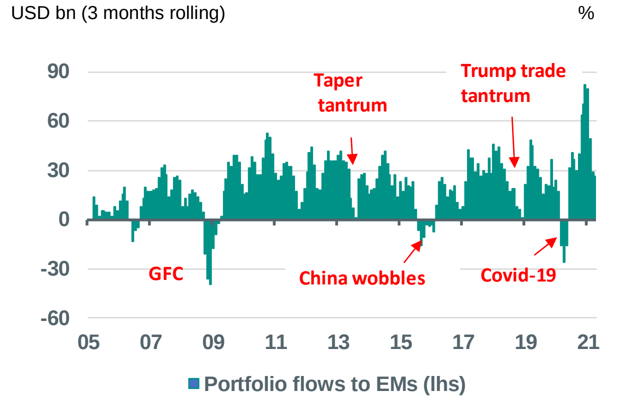
The chances of the eurozone economy overheating are much lower than in the US. This is mainly because fiscal policy has been much less expansionary in the eurozone than in the US, but also because there was more damage to the eurozone economy from the pandemic. Fiscal measures implemented during the pandemic have offset some of the losses in activity, but not fully. Eurozone GDP is expected to return to pre-pandemic levels around the middle of 2022, whereas this gap was already closed in the US at the start of 2021. In contrast to the US, fiscal support is expected to be unwound in the eurozone in the coming years. Part of this tightening of fiscal policy will be compensated in some countries by support (consisting of grants and loans) from the European Recovery and Resilience Facility (RRF) during the years 2021-2026. However, the impact on growth will be spread over a long period, and for the eurozone in aggregate, the impact on GDP is expected to be around 0.3-0.4 percent per year over the next couple of years. As a result, we expect eurozone GDP to remain below the trend level in 2022-2023 (i.e. there will remain an output gap) despite a strong rebound in economic activity in the second half of 2021. A final argument against an overheating scenario for the eurozone is that a lot of slack has built up in the eurozone labour market during the pandemic. This is expected to keep wage growth and underlying inflationary pressure subdued in the coming years. At the moment, headline inflation is being lifted by a number of transitory factors, e.g. changes in indirect taxes during the pandemic that are being unwound, a temporary jump in energy price inflation and distortions in the prices of services during lockdown. Overall, we expect core inflation in the eurozone to remain subdued, implying that inflation will continue to undershoot the ECB's inflation target in the medium-term.

Emerging markets impacted by tighter financial conditions and lower global growth

A US overheating scenario followed by aggressive rate hikes by the Fed and a short recession in the US would lead to a 'double whammy' for emerging markets (EMs). First, we assume Fed rate hikes would likely have to be followed by rate hikes in many other EMs, particularly the more externally vulnerable ones, and would go hand in hand with a global tightening of financial conditions. We anticipate a rise in risk-free rates to put pressure on EM currencies and asset markets, while triggering a reduction in portfolio flows into EMs. That would be similar to previous episodes of Fed tightening, such as the taper tantrum period in 2013-14, although investors' risk appetite versus EMs and portfolio flows to EMs will be shaped by other factors as well.

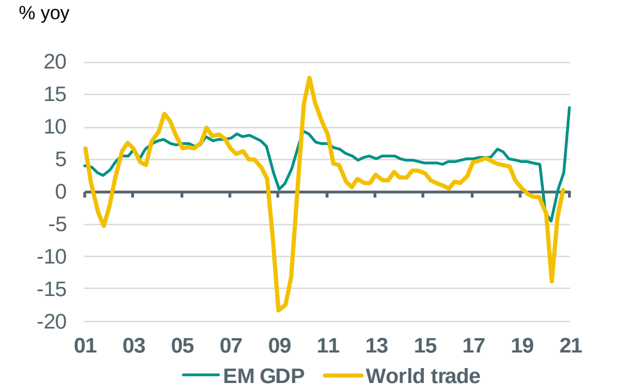
The effects of this market turbulence would naturally be largest for EMs that are relatively dependent on external financing and have vulnerable fiscal and/or external metrics (such as Turkey, India or South Africa). Second, a recession in the US and a deceleration in other advanced economies, China and in global trade would hit EM exports. On top of that, commodity-exporting EMs would be faced with the negative impact of lower global growth on commodity prices. All in all, EM growth would be materially lower compared to the base case (for China, we anticipate annual growth in 2024 to be 0.8pp lower in a US overheating scenario).

Portfolio flows to EMs



Source: IIF, Bloomberg, ABN AMRO Group Economics

EM growth and world trade



Source: Bloomberg, CPB

Spillovers from US overheating to the eurozone mainly via global financial markets

While we see an overheating scenario to be much less likely in the eurozone, it would still be impacted by a potential overheating of the US economy due to the tightening of US monetary policy and a subsequent contraction in US GDP. The impact of changes in US GDP via the international trade channel tend to be quite modest. For instance, the ECB has calculated that the impact of the USD 1.9 trillion stimulus by the Biden Administration would lift eurozone GDP growth by only 0.1pp in 2021 and 0.2pp in 2022. This is in line with our own estimates of around 2.5pp extra growth in the US and one tenth of that in the eurozone. However, in a US overheating scenario that triggers aggressive monetary policy tightening by the Fed and a (mild) recession in the US, the impact on the eurozone would be larger given the significant spillovers to financial markets (also see here). Eurozone financial conditions tighten when the Fed hikes rates, as this raises government bond yields and corporate bond spreads, and depresses equity prices. Moreover, a slowdown in EM growth due to Fed rate hikes would have a significant impact on the eurozone economy, as more than half of all extra-eurozone exports are to EMs (versus 15% to the US). The combined effect of the US economy going through a mild recession, a tightening of global financial conditions, and a considerable slowdown in EM growth, would have a significant impact on eurozone GDP. Quarterly GDP growth would probably be close to zero for a couple of quarters in 2024 (when the US would be in recession), whereas in the base case it would probably grow at a rate of around 0.5-0.6% qoq – somewhat above the trend rate. (Bill Diviney, Arjen van Dijkhuizen, Aline Schuiling)

Rising inflationary pressures from supply bottlenecks

In the post-pandemic global recovery, strong demand for goods coupled with inelasticities in global supply has led to bottlenecks such as longer delivery times and higher transport rates. The April global manufacturing PMI subindex pointed to the longest delivery times on record. A global scarcity in semiconductors is a particular problem, partly driven by strategic, geopolitical considerations. Average lead times for chips have risen to record highs, creating operational problems and temporary production stops in automotive and other high tech sectors. All of this goes hand in hand with rising cost prices, with the global manufacturing PMI's subindex for input prices reaching a 10-year high of 69.6 in April. On the global transport front, a combination of demand and supply factors, including inelasticities in the supply of containers and ships triggered a jump in freight rates in H2 2020. With the ongoing recovery in global trade, freight rates have picked up again recently, after stabilising in early 2021. It may take until next year before these disturbances in global supply chains subside. That said, we still think they are a temporary phenomenon shaped by the a-typical demand and supply imbalances of the post-pandemic global recovery. While clearly in play on the short-term, these should fade over time, as vaccination rollouts facilitate a further easing of restrictions and normalisation in economic activity, and global demand rebalances towards services again. That said, risks of a longer path to normalisation and a stronger than anticipated passthrough into consumer prices remain.

Eurozone: Past the low point

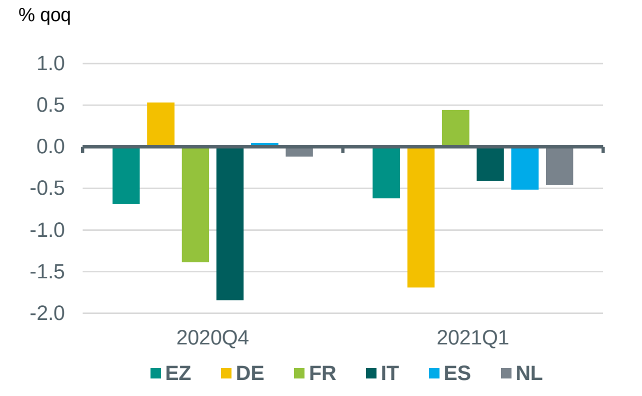
Aline Schuiling – Senior Economist | aline.schuiling@nl.abnamro.com

- **The faster pace of vaccination in the eurozone has allowed governments to relax some of the strictest lockdown measures**
- **The economy has moved out of recession and GDP is expected to grow strongly in Q2, yet the largest rebound in activity should be in Q3**
- **Core inflation has been declining since the start of the year, but should rise in the next few months**
- **Underlying inflation will remain subdued, allowing the ECB to keep policy accommodative**

Eurozone GDP fell by 0.6% qoq in Q1, following a decline by 0.7% qoq in 2020Q4. The numbers for the individual countries illustrate well that the changes in economic activity are dominated by the timing of changes in lockdown measures. For instance in France GDP contracted by 1.4% qoq in Q4 and rebounded to +0.4% qoq in Q1, whereas in Germany the almost exact opposite happened, with GDP growing by 0.5% qoq in Q4 and subsequently contracting by 1.7% in Q1.

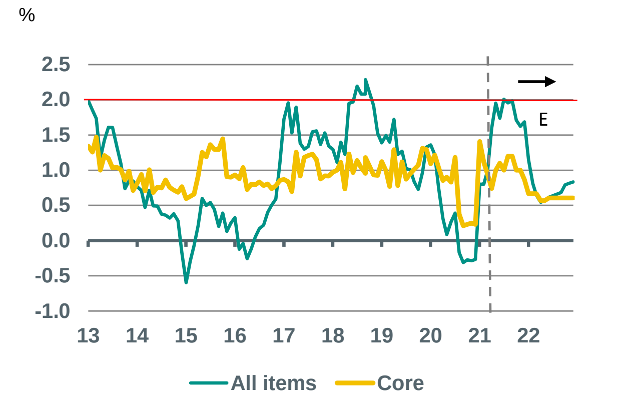
Looking forward, the outlook for growth during the rest of this year will remain dominated by the further unwinding of lockdown measures. For instance, France has published a detailed roadmap and plans to ease measures considerably in May and June. Italy and the Netherlands have eased in several small steps, starting at the end of April. Greece has announced that it will allow foreign tourist back into the country as from the middle of May onwards, while France will do the same starting in early June. Overall we have assumed that easing of existing measures will lift GDP noticeably in Q2 (we have penciled in 0.8%). Nevertheless, we think that the sharpest rebound in growth will be in Q3, as the bulk of lockdown measures (also on tourism and the leisure industry) will probably be unwound as from June onwards. In any case, irrespective of whether the big rebound in growth is timed in Q2 or Q3 of this year, we expect eurozone GDP to return to its pre-pandemic level in the second quarter of 2022. Despite the strong rebound in growth, GDP should remain well below trend levels throughout our forecast period, suggesting inflation will remain sluggish over the medium term horizon.

Growth numbers largest countries vary widely



Source: Refinitiv, ABN AMRO Group Economics

Core inflation to remain subdued



Source: Refinitiv, estimates ABN AMRO Group Economics

Headline inflation increased to 1.6% yoy in April, up from 1.3% in March. However, the core rate declined to 0.7%, down from 0.9% in March. Looking at the components, service sector inflation was the driver behind the fall (down to 0.9% from 1.3%). Looking forward, there are some potential sources of upward pressure for core inflation. There is a base effect from last year's German VAT cut, which should push up inflation this summer. In addition, prices in some sectors most impacted by the restrictions which have fallen sharply, could see some normalisation. More fundamentally, we think core inflation will settle at very low levels in 2022 and 2023. Despite the economic recovery, we will likely remain in an environment of substantial economic slack. This is likely to also become increasingly evident in the unemployment figures in the coming months. The combination of falling labour market participation and wide-spread use of short-time work schemes means there is currently a great deal of hidden unemployment. All in all, we expect core inflation to remain well below the ECB target during the next 2-3 years. This should allow the ECB to keep monetary policy very accommodative.

Netherlands: Turning the corner

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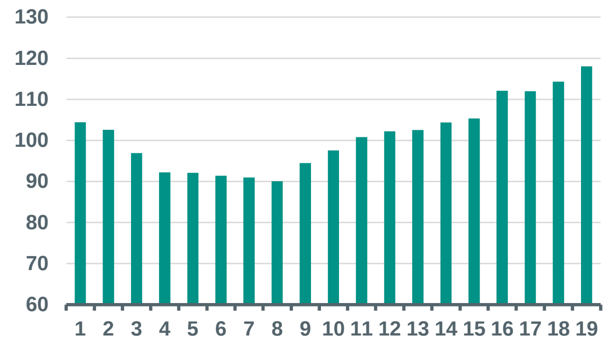
- **The economy contracted 0.5% in Q1, outperforming consensus forecasts (ABN: -1% qoq)**
- **The latest reading followed a 0.1% contraction in Q4 20, meaning that the Netherlands has endured its second technical recession in a year**
- **We raised our growth forecast for 2021 to 3.7% from 2.1% on the back of the stronger Q1 print, rapid vaccination pace, faster than expected easing of restrictions, and a smaller rise in unemployment**

The Dutch economy shrank by 0.5% in Q1, less than our (-1%) and market expectations (-0.6%). This followed a 0.1% contraction in the previous quarter, meaning the Netherlands has endured its second technical recession in a year. Household consumption, due to the tightening of restrictions in December last year, saw a large drop (3.5% qoq). On the other hand, investment grew by 3.7% (vs 1.7% in Q4) and net trade contributed positively. Given the vaccination pace and the continued drop in hospitalized Covid-19 patients, the economy has turned the corner, and Q2 will likely show a solid recovery. Some restrictions were already eased in recent weeks, including the opening of non-essential shops and outdoor dining, resulting in a sharp rebound in consumption according to our transaction data (see graph). Moreover, from 18 May– slightly earlier than previously expected – most restrictions were withdrawn, leading to the reopening of an estimated 98% of the economy. For the outlook, the future path of consumption is key. This depends on the willingness of consumers to spend excess savings as well as labour market developments. Dutch households hold a substantial amount of excess savings: around EUR 44bn. (c.5% of GDP). But as we discuss in last months' Global View, higher income households hold a disproportionally large part of these savings while having a lower marginal propensity to consume, and given the limited scope for catch-up growth in services, there is a natural lid on the consumption spree resulting from these savings.

We have become more positive on the labour market. During the pandemic, the unemployment rate has been held down by generous government support measures such as the wage subsidy scheme and the fixed cost compensation scheme. Despite these measures, the labour market remains flexible and some adjustments have already taken place. The unemployment rate has declined from a peak of 4.6% in August last year to the current rate of 3.5%. This is not attributable to discouraged workers; more workers are entering the labour market than exiting. One of the reasons for the drop in unemployment is the flexibility of the labour market. Workers who lost their jobs at the beginning of the crisis (mostly flex workers), later found work again in the relatively labour-intensive sectors benefiting from the pandemic, such as distribution centres, delivery services but also Covid-19 vaccination and test centres. Indeed, companies that are unlikely to survive the post-pandemic reality – either due to structural changes in the economy or because of a severe debt burden – have already started to let employees go. The labour supply also seems to be declining more rapidly than we initially envisioned. Some workers that have left the labour force during the pandemic are unlikely to return, mainly because they have gone into early retirement. Moreover, we expect government fiscal support to be extended until the end of this year, postponing some of the potential insolvencies to next year. We expect unemployment to rise only moderately, peaking at 4.4% in April next year.

Recovery of consumption since half March

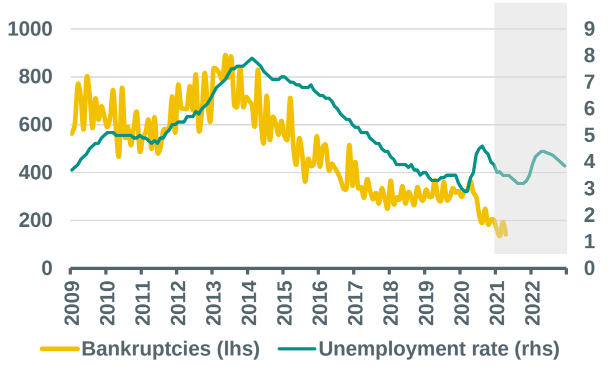
Pin, online and creditcard transactions by AAB clients (euro's)
Week numbers in 2021; 2019 = 100



Source: ABN AMRO Group Economics

We expect a moderate peak in unemployment

Unemployment rate (as % of total labour population) and bankruptcies (absolute); AAB unemployment forecast in shaded area



Source: Refinitiv, ABN AMRO Group Economics

US: Recovery has downshifted

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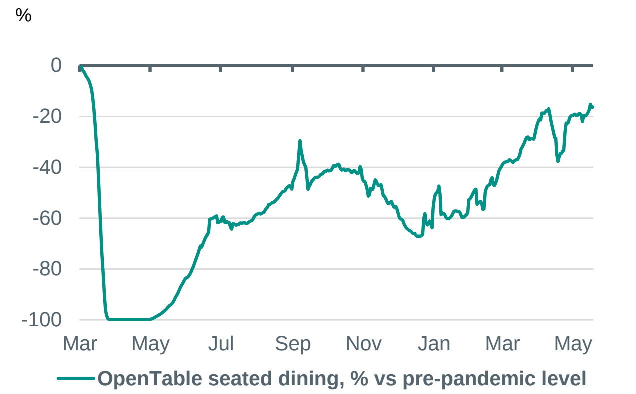
- **A range of indicators suggest growth momentum is now peaking in the US**
- **This is to be expected given how rapid the recovery so far has been, and is a healthy development, in our view. Cooling growth will help avert an overheating scenario**

Growth momentum is probably peaking

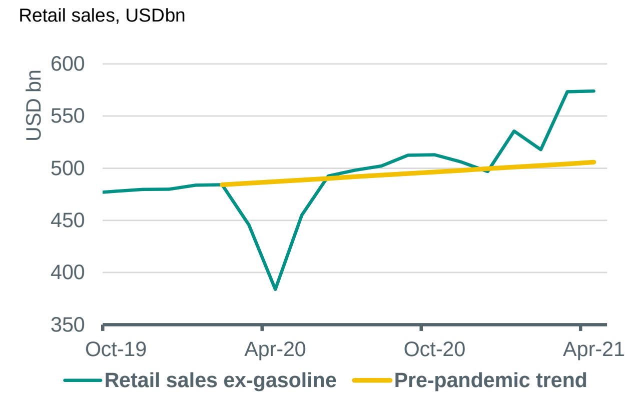
A slew of US macro indicators have disappointed consensus expectations of late – last week, we saw downside surprises in April retail sales and industrial production, and this followed a weak payrolls print earlier in the month. This week, housing data for April also disappointed to the downside, with anecdotal reports that despite strong demand for housing, the construction sector is struggling to keep pace with that demand due to skills shortages. High frequency indicators also suggest the recovery is now entering a slower phase – restaurant dining continues to rise modestly, up around 3pp since the beginning of May, but this pace of recovery is a far cry from the double digit growth we saw in the months prior. A similar picture is apparent in air passenger numbers – while the recovery has resumed following a stalling in April, the pace of recovery is much slower than it was earlier in the year. Most macro indicators are therefore pointing to a recovery that has noticeably downshifted.

Hospitality recovery has lost momentum…



Source: Refinitiv, ABN AMRO Group Economics

…while retail sales are likely due a correction



Source: Refinitiv, ABN AMRO Group Economics

Growth will cool in H2, but remain well above trend

We continue to see significant room for a further recovery in consumption, despite most pandemic-related restrictions on activity having now been eased. Aside from the obvious sectors such as hospitality and travel, we identified some surprisingly large sources of potential recovery in the services sector in our April Global Monthly, such as in healthcare (where there remains a significant backlog in elective procedures due to the pandemic). With that said, we also find that a significant amount of goods consumption has likely been pulled forward from the future, encouraged by successive direct stimulus payments to households over the past year. We saw the first signs of a stalling in goods consumption in the April retail sales numbers – which were flat after an exceptionally strong March print – and we see room for payback over the coming months in certain key categories, such as auto sales (which make up 20% of retail sales).

Cooling growth lowers the risk of an overheating scenario

This would be an inevitable and healthy correction, in our view, particularly in light of the demand-led inflationary pressure that became evident in last week's CPI print – used cars contributed 1/3 to the dramatic 0.9% m/m jump in April. At the same time, we do not think payback in goods consumption will be enough to fully offset the recovery in services, and as such, while we expect a cooling in growth momentum in the second half of 2021, we still expect growth to be well above trend (we forecast growth to average 4.2% annualised in H2, down from a projected 7.1% in H1). More generally, a cooling in growth will lower the risk of the kind of overheating scenario we outlined in this month's Global View.

Asia: India's covid-19 nightmare widens regional divergence

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- **In May so far, India has been responsible for over 50% of new covid-19 cases registered worldwide**
- **Widening divergence in South and North Asia shows pandemic control and vaccination still key**
- **Growth forecasts cut for South Asia, but raised for North Asia on the back of strong exports**

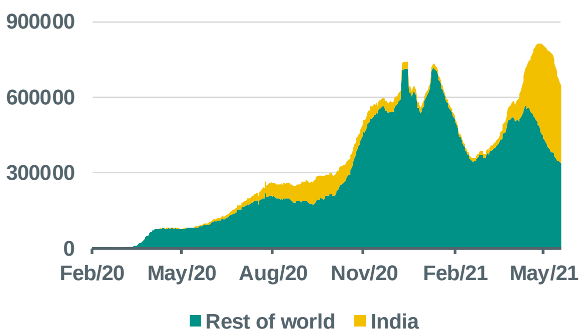
The pandemic situation in India has deteriorated dramatically. Since March, daily registered covid-19 cases and deaths have risen sharply. So far in May, India contributed to over 50% of new cases registered worldwide. Obviously, these numbers should be placed in perspective, given India's population of around 1.4 bn. In relative terms, the number of new cases registered over the past week was for instance still lower than in the Netherlands or Brazil. However, according to experts there is a large underreporting of cases and deaths. What is more, the fact that such a large country has big problems with getting the pandemic under control is a risk to the global health situation, as this opens the door for new mutations to develop. Also, there are signs of cross-border contagion, most notably in the Indian subcontinent and South East Asia.

India halted vaccine exports in order to ramp up domestic roll-out

During the first wave of the pandemic, the government installed a nationwide lockdown causing a stunning GDP contraction of 25% qoq in Q2-2020. While that helped to stem the pandemic to some extent, it contributed to complacency in late 2020. Religious and political mass gatherings were for instance being allowed, while signals of an emerging second wave have been picked up rather late. What is more, while India is a large producer of covid-19 vaccines, its own vaccination roll-out is facing a range of bottlenecks. This explains why the government temporarily halted vaccine exports in March, limiting vaccine availability in other countries. Currently, only around 10% of the population has received at least one vaccination dose. Although that is a bit better than the Asian average, the need for India to have an effective vaccination programme is bigger compared to for instance North Asian countries that have remained much more in control of the pandemic.

India's covid-19 nightmare

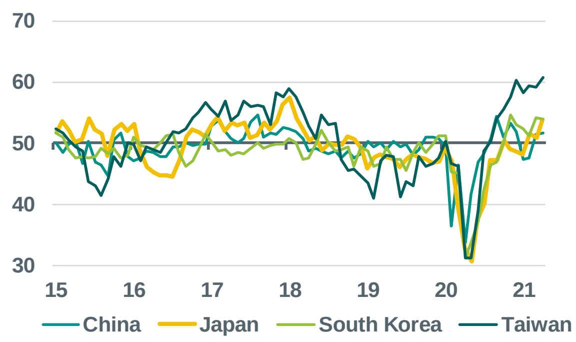
New officially reported covid-19 cases, 7 day average



Source: Bloomberg

Asian exports profit from rebound in global activity

Manufacturing PMIs, export subindices, 50 = neutral mark



Source: Refinitiv

Economic divergence between South and North Asia widens

We had already anticipated that India – with its high population density and vulnerable healthcare system – would have difficulties with getting the pandemic under control. This explains our below-consensus growth forecasts for FY 2020-21 (-8%) and FY 2021-22 (+9.5%). New regional lockdowns will weigh on economic activity in the April-June quarter of 2021, although high frequency indicators suggest that the economic fallout will be less severe compared to the nationwide lockdown one year ago. Elsewhere, we have cut our 2021 growth forecasts in recent months for other South Asian countries, particularly those that have had serious virus flare-ups and/or are relatively dependent on tourism (Indonesia, Malaysia, Philippines, Thailand). By contrast, we have raised 2021 growth forecasts for North Asian countries (China, Hong Kong, South Korea, Taiwan) and for Singapore. These countries are faring generally better in terms of containing the pandemic, despite flare-ups, and are profiting from the sharp recovery in global industry and trade that was analysed in our April Monthly. On balance, we now expect emerging Asia to grow by 7.8% this year (versus 7.3% in December 2020).

Key views on a page

The rapid vaccination pace in the eurozone is enabling a modest reopening of the economy. The focus remains on the shape of the coming recovery, and how consumers spend the massive build-up in savings. We see this driving a significant rebound in consumption this year, but this will be tempered by the skew in savings towards higher earners, and elevated unemployment. Meanwhile, the industrial sector has continued to do better than the lockdown-hampered services sector, helped by strong global trade, and recoveries in the US and China that are much more advanced. Inflation has picked up notably in the US, and although we expect this rise to be temporary, we cannot rule out an overheating scenario in the years ahead. As a base case, we expect inflation to fall back by next year and for central bank policy to stay accommodative.

Macro	Central Banks & Markets
Eurozone – The economy has passed the low point. GDP contracted by 0.6% qoq in 2021Q1, following a decline of 0.7% qoq in 2020Q4. The pace of vaccination has been stepped up noticeably. A lot of countries have already relaxed some of the strictest lockdown measures. We expect the bulk of the measures to be unwound from the end of Q2 onwards. GDP should rise in Q2, but we expect the biggest rebound to be in Q3. Irrespective of the exact timing of the rebound (Q2 or Q3), we expect eurozone GDP to return to its pre-pandemic level in the second quarter of 2022. An output gap will remain at end-2022. Underlying inflation will remain subdued, allowing the ECB to keep policy accommodative for a considerable time.	**ECB** – Since the start of the year, the ECB's strategy has been one of capping government bond yields. It still has around EUR 800 billion left in its PEPP envelope. It stepped up the monthly pace of asset purchases in Q2 and will likely sustain that pace in Q3. The PEPP will likely end in March 2022, but purchases under the APP are expected to continue beyond that point. A policy rate hike is unlikely over the coming years. We expect persistent spare capacity in coming years, while we judge that the ECB will undershoot its inflation target over the medium term. As a result, we expect that the market will price out the rate hike cycle it currently envisages.
Netherlands – The Dutch economy contracted 0.5% in Q1, outperforming consensus forecasts and our own forecast (-1%). The latest reading followed a 0.1% contraction in Q4 20, meaning that the Netherlands has endured its second technical recession in a year. The stronger than expected Q1, the ramping up of the vaccination pace and faster than expected easing of corona restrictions combined with a smaller rise in unemployment contribute to our upward revision of the 2021 growth forecast to 3.7% from 2.1%.	**Fed** – The Fed will continue buying bonds at the current $120bn monthly pace at least until the end of 2021. The Fed has promised not to raise rates until inflation has reached its 2% target and is on course to moderately overshoot this target for a time. Given these conditions, the first rate hike might come by late 2023. However any hiking cycle will be much more shallow and gradual than in the past. The FOMC currently signals no hikes until at least 2024.
US – A range of indicators suggest growth momentum is now peaking in the US. This is to be expected given how rapid the recovery so far has been, and is a healthy development, in our view. Despite a likely slower pace of expansion in H2, growth is likely to remain well above trend, with significant room for recovery in services, which will be partly offset by payback in recent exceptionally strong goods consumption. Cooling growth will help keep a lid on inflationary pressures, which have picked up due to the rapid pace of the recovery and supply bottlenecks. We do not expect an overheating scenario that prompts aggressive Fed policy action, but the pickup in inflation expectations has raised the risk of such a scenario.	**Bond yields** – Yields on US Treasuries have slipped back despite recent buoyant US data, which raises the question whether the recovery is now priced into the US Treasury market. Inflation expectations are above the levels seen in 2018, when the US economy was already at full employment. Meanwhile, markets seem to have priced in a rate hike cycle with an eventual peak in the coming years close to the previous peak. However, the rate hike cycle is expected to start earlier than we expect and much earlier than the Fed is signalling. On this basis, markets seem to have been advanced and arguably had run too far in pricing in the recovery story. Rate hikes in the eurozone are unlikely in the coming years and therefore the 10y Bund yield will likely drift back towards the deposit rate.
China –The latest macro data suggest that China's recovery from the pandemic shock is still a bit unbalanced. The industrial sector and investment are profiting from strong external demand and property sector strength, while the recovery of consumption is lagging a bit behind (but we expect it to continue). Meanwhile, the acceleration in Chinese producer prices may add to some extent to global inflation fears. Still, this acceleration is largely driven by the boom in commodity markets, while there are signals that there is no full pass-through to consumers. Meanwhile, China's credit cycle has started turning, and we expect that trend to continue without sharp policy U-turns.	**FX/EURUSD** – Yield curve dynamics continue to dominate FX markets. Weaker US macro data and higher inflation have driven a fall in real yields, weighing on the dollar. EUR/USD rose to the 1.22s. We think that the Fed will be less dovish than the ECB, and that ECB rate hikes will be priced out, weighing on the euro. We also expect US economic outperformance to support the dollar in the medium term. Our year-end 2021 forecast for EUR/USD stands at 1.15.

Main economic and financial market forecasts

GDP growth (%)	2019	2020e	2021e	2022e	3M interbank rate	5/6/2021	5/13/2021	+3M	2021e	2022e
United States	2.2	-3.5	5.8	4.1	United States	0.16	0.15	0.25	0.25	0.25
Eurozone	1.3	-6.7	3.9	4.1	Eurozone	-0.53	-0.54	-0.55	-0.55	-0.55
Japan	0.3	-4.9	2.7	2.4	Japan	-0.08	-0.09	-0.10	-0.10	-0.10
United Kingdom	1.4	-9.8	5.9	5.9	United Kingdom	0.08	0.08	0.10	0.10	0.10
China	6.0	2.3	9.0	5.5						
Netherlands	1.6	-3.7	3.7	2.8						
Inflation (%)	**2019**	**2020e**	**2021e**	**2022e**	**10Y interest rate**	**5/6/2021**	**5/13/2021**	**+3M**	**2021e**	**2022e**
United States	1.8	1.2	3.2	2.2	US Treasury	1.56	1.67	1.5	1.50	1.50
Eurozone	1.2	0.2	1.6	0.7	German Bund	-0.23	-0.11	-0.3	-0.50	-0.50
Japan	0.5	0.0	0.5	0.6	Japanese gov. bonds	0.09	0.09	0.0	0.00	0.00
United Kingdom	1.8	0.9	1.1	2.0	UK gilts	0.79	0.90	0.6	0.70	0.80
China	2.9	2.5	1.5	2.5						
Netherlands	2.7	1.1	1.8	1.0						
Key policy rate	**5/13/2021**	**+3M**	**2021e**	**2022e**	**Currencies**	**5/6/2021**	**5/13/2021**	**+3M**	**2021e**	**2022e**
Federal Reserve	0.25	0.25	0.25	0.25	EUR/USD	1.21	1.21	1.19	1.15	1.10
European Central Bank	-0.50	-0.50	-0.50	-0.50	USD/JPY	109.1	109.5	108	110	118
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.39	1.40	1.35	1.32	1.28
Bank of England	0.10	0.10	0.10	0.10	EUR/GBP	0.87	0.86	0.88	0.87	0.86
People's Bank of China	3.85	3.85	3.85	3.85	USD/CNY	6.47	6.45	6.40	6.40	6.20

Source: Refinitiv, ABN AMRO Group Economics.

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