BARINGS INVESTMENT INSTITUTE

April 2021

"The Best of All Possible Worlds!"

MONTHLY MACRO DASHBOARD

BARINGS

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April Outlook: "The Best of All Possible Worlds!"

Clearer evidence is emerging that in most major economies the joint monetary, fiscal, and health policy response to the pandemic is proving faster, bigger, and better-targeted than we expected. Fiscal policy has managed to minimize income damage. Savings and wealth have grown for most households, and more support is coming. Monetary policy kept credit and money growing faster than expected, and corporates of all sizes have benefited, replenishing their cash buffers. Finally, vaccination programs are reducing contagion and fatality rates much faster than what was expected only two months ago.

As a consequence, the damage inflicted appears smaller and the scars look less deep than we feared. We call our new central scenario "The Best of All Possible Worlds!" because the next 12-18 months look likely to deliver strong growth and low inflation. Developed market economies should exit lockdowns in the next two quarters, providing an ideal summer for spending households' extra savings. Cheap funding and an improving outlook will likely maintain the current momentum behind corporate investment. Public investment will add to it. **All this should be good for risk assets with smaller exposure to rising interest rates like value stocks, high yield credit and private assets, but more challenging for duration.**

The economy will not overheat, because policy largesse is still filling the hole blown by COVID on activity and labor markets: in manufacturing, capacity utilization and hours worked are still well below pre-crisis levels, strong balance sheets on aggregate may mask weakness in some struggling sectors, and household savings rates will remain higher than normal amid lingering uncertainty. Cognizant of this, central banks will look through temporary signs of overheating, keeping the helm straight towards accommodation until unmistakable signs of closing GDP and employment gaps.

We attach a 50% probability to "The Best of All Possible Worlds!" but we put it in quotation marks because we are not convinced that current policies will make this sustainable beyond our current time frame; we will need to see strong signs of higher potential global growth to abandon the irony in our tone of voice.

For now, however, labor markets have started healing fast even in the most COVID-impacted sectors, and consumers have kept consuming all throughout the pandemic, with their confidence rebounding to 2019 ranges. Where consumption is still lagging, exports and investment fueled a sharp manufacturing rebound. Industrial production is now back at pre-crisis levels and survey data is pointing toward more to come.

The main risk to our central scenario is Inflation Anxiety, a market overreaction to rising prices that upsets the smooth transition toward a full employment regime, to which we assign a 30% probability**.** Inflation flare-ups may prove temporary, but the world could still shift towards the self-fulfilling prophecy of volatile markets, high-risk premia, and slower growth. As John Maynard Keynes famously said, markets can remain irrational longer than you can remain solvent. With earlier rate hikes and sharply higher inflation becoming priced in the U.S. yield curve, the Fed would have a harder time staying the course, resulting in tighter financing conditions and headwinds to growth. Over-levered corporates and mismanaged Emerging Markets may snap under the pressure.

We still attach a 20% probability to a more disappointing outcome, what we call Gravity Prevails. The consumer binge that everyone expects could prove short-lived as households save more for an uncertain future. Firms' investments could be curtailed or constrained to adapt to new consumption patterns, rather than expanding production. America's infrastructure talk or Europe's new recovery fund might stumble. We could then find out that most of the recovery is already largely behind us, as many sectors are already operating at full speed. Government support may fade faster than we expect, too, if old political debates re-emerge.

What Changed in March

WHAT'S NEW

- Government support has been so large that it has allowed economies to deal with the latest lockdowns, with less damage inflicted than a year ago
- In the U.S., vaccine rollout has been faster than expected, while in Europe the vaccine outlook has improved
- China's deleveraging campaign is becoming increasingly visible as China HY and equity markets underperform

WHAT WE LEARNED

- Policy support and vaccine deployment in the U.S. benefited the dollar
- Even if vaccinations have yet to bring herd immunity and reopening of the most COVID-impacted sectors has been partial, hiring in these sectors has picked up considerably in the U.S.
- Uneven vaccine distributions will penalize those countries that do not have access to supply

WHAT WE ARE HEARING FROM OUR TEAMS

- Domestic policy challenges and pandemic lockdowns in EMs proved more difficult to overcome
- Companies are finding revenues are strong but worry about margins amid rising costs
- Credit quality seems to be improving in many sectors

WHAT WE ARE WATCHING

- Whether markets overreact to base effects temporarily boosting inflation and growth
- New COVID waves or summer travel restrictions
- Vaccine distribution
- Labor compensation in the U.S.
- EMs forced to end accommodation

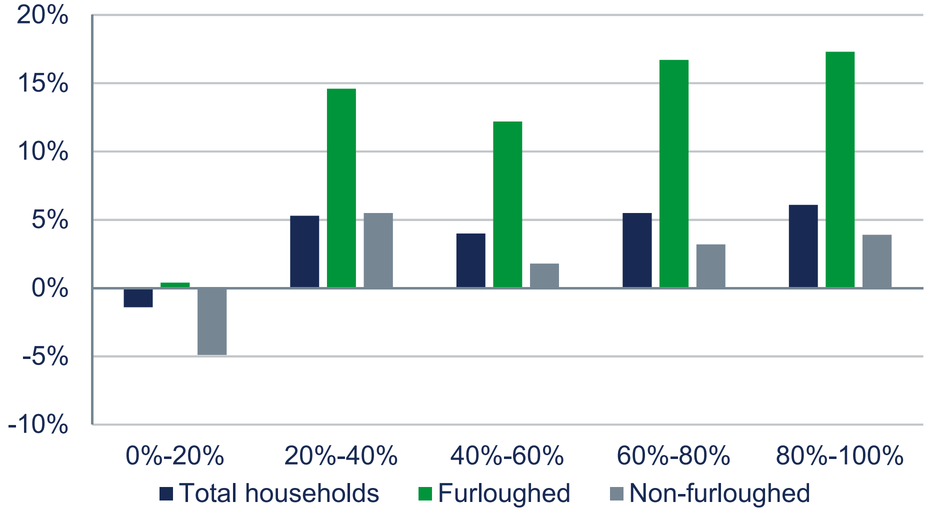
In the short term, a consumption boom is likely in the U.S. while less stimulus may deliver a more normal recovery in Europe.

CHANGE IN INCOME BY QUINTILE (CARES ACT & EMERGENCY COVID RELIEF ACT)

Income Quintile	Average Income	Change in Income
Bottom 20%	$12,000	83.8%
20%-40%	$32,800	21.8%
40%-60%	$56,800	3.7%
60%-80%	$93,400	-0.5%
80%-100%	$218,700	-4.2%

Assumes that unemployment benefits are received for maximum number of weeks allowed in each bill at the maximum benefit allowed by the 'average' U.S. state. Calculations also assume that stimulus checks are received by the bottom four income quintiles.

CHANGE IN INCOME, ITALY



Positive number represents a loss.

In the U.S., fiscal support packages drove income up 12% above pre-crisis levels when 9.5 million Americans are still out of a job. U.S. policies have been very progressive; income support from the CARES Act and the Emergency COVID Relief Act left the lowest 60% with more income than before the crisis, according to our calculations. While the highest earners did not see their incomes fully replaced, their purchasing power increased due to a rise in wealth. Here, the distributional effects have been very regressive: the vast majority of extra wealth has gone to the richest households. However, starting from very little accumulated wealth, even the lower quintiles appear to have managed to increase wealth and cash savings. Combined with the new stimulus bill, this should foster a near-term consumption boom, building a bridge to 2022. The next leg of the recovery will depend on the transition from fiscal stimulus to labor market recovery.

Fiscal support in Europe did not make up for 100% of income losses. The impact varied widely by country, suggesting some countries are poised for a stronger consumption rebound, while others will see a more modest recovery. There were also substantial disparity in income losses borne by households with jobs in furloughed sectors versus the others. EU lower-income households were likely unable to create a buffer of savings during the lockdown, while richer ones increased their wealth considerably.

So, while richer households on both sides of the Atlantic increased their wealth during the pandemic, poorer households did so only in the U.S. This suggests a similar consumption boom is unlikely to materialize in Europe. Therefore, inflation dynamics should diverge, potentially strongly, between the U.S. and EU, and with them, interest-rate differentials and the euro-dollar exchange rate. This suggests there is not much downside for the dollar.

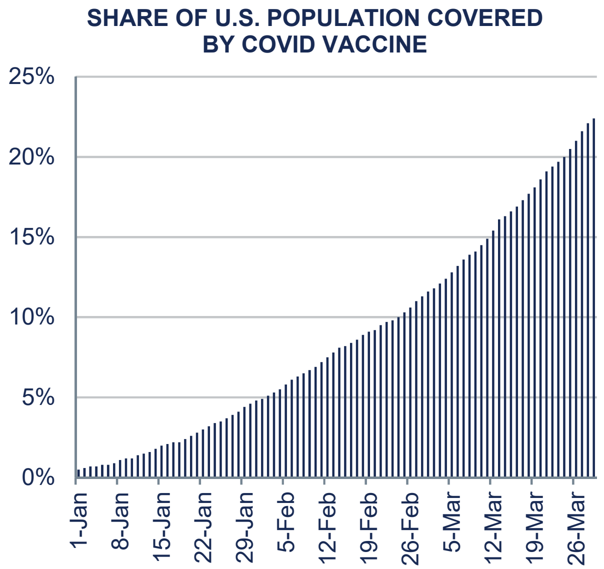
Source: Barings calculations, BLS, TrackTheRecovery.org, and Italian Treasury. As of March 9, 2021. Read more here.

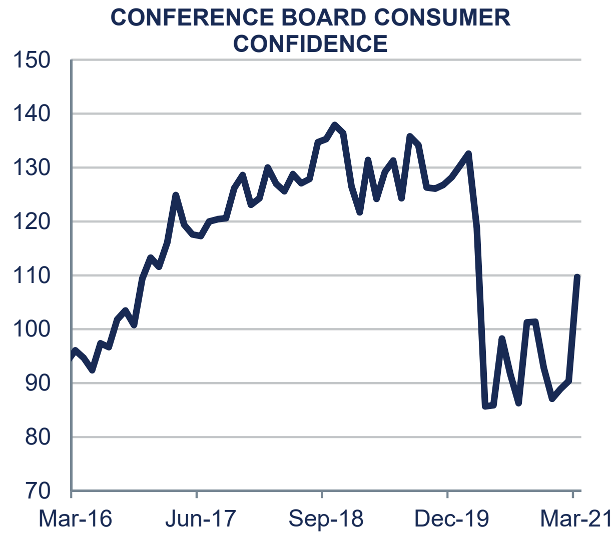
United States

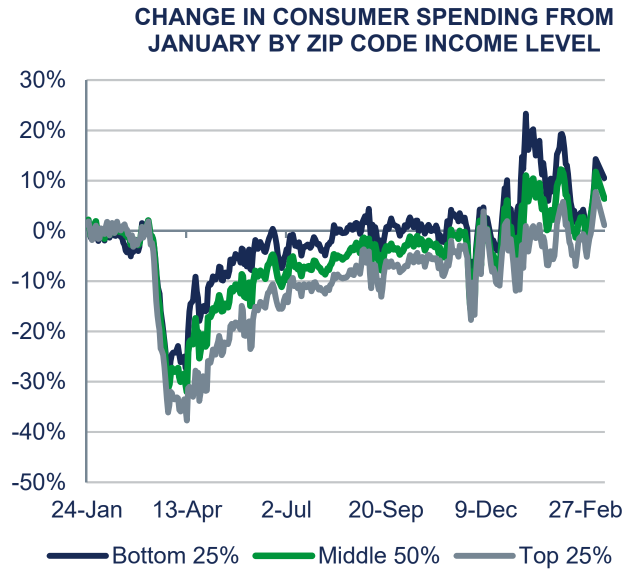
VACCINE ROLLOUT in the U.S. is progressing faster than initially expected...

...leading CONSUMER CONFIDENCE to jump in March.

Combined with massive fiscal support, CONSUMER SPENDING remains strong and above pre-crisis levels.







- Vaccine rollout is progressing at a much faster speed than originally expected, with 22.4% of the U.S. population already covered by the end of March.
- According to Bloomberg, if vaccine rollout continues at the current pace, it would take four more months to cover 75% of the population.
- If the rollout continues unabated, this suggests normality could be reached by the end of summer in the U.S.

- A ramp up in vaccine rollout, easing of restrictions, and the disbursement of fiscal stimulus has led consumers to gain confidence in both current and future conditions.
- Intentions to buy big-ticket items such as autos, homes, and major appliances all rose in March, supporting the spending outlook.

- Fiscal support, reopenings, and improving consumer confidence are leading consumer spending across income-cohorts to remain strong and above year-ago levels.
- Some spending is set to shift from consumer staples to discretionary categories—such as dining out and traveling—as restrictions ease further.
- Pent-up savings and accumulated wealth—as noted in the Monthly Spotlight on slide 5—should support a strong near-term consumption boom.

Source: Bloomberg, Haver and TrackTheRecovery.org. As of March 30, 2021.

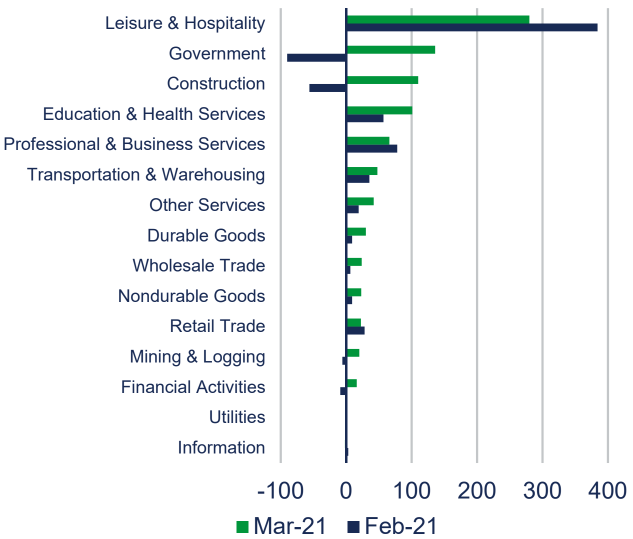
United States

The hardest-hit sectors are seeing EMPLOYMENT improve more strongly than expected.

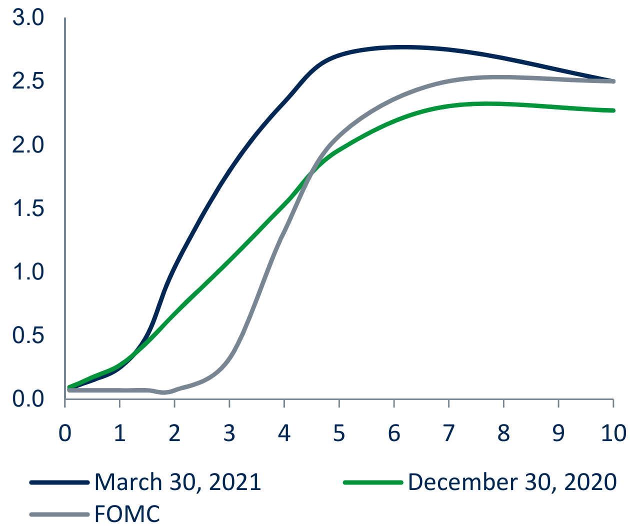
The brighter economic outlook has led markets to price in a FED RATE HIKE ahead of the FOMC...

...both of which have contributed to a rise in REAL YIELDS.

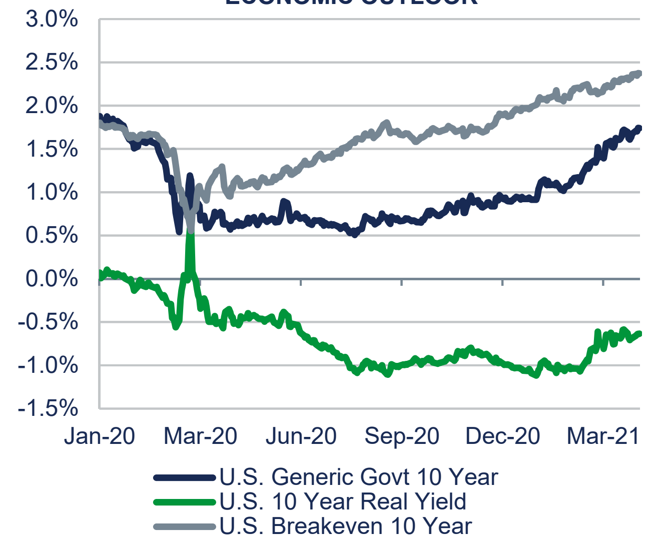
CHANGE IN NONFARM PAYROLLS, THS



MARKET VS. FED EXPECTED TRAJECTORY FOR THE FED FUNDS RATE



YIELDS MOVE HIGHER ON POSITIVE ECONOMIC OUTLOOK



- Pandemic-hit sectors such as leisure and hospitality, retail trade, and other services have already begun to recover more strongly than expected in February and March.
- It won't take herd immunity for services sectors to begin recovering.
- The pace of improvement should accelerate as restrictions ease further and vaccines continue to roll out.

- Market expectations for the trajectory of the Fed funds rate—measured as OIS rates adjusted for term premiums—have materially increased this year.
- Markets now expect the Fed funds rate to rise beginning in about a year; however, this is in stark contrast with FOMC messaging, which points to no rate hikes through 2023.
- With the Fed putting greater emphasis on the labor market, excess slack should keep the Fed accommodative, as they would prefer to be behind the curve than hike pre-emptively.

- While real yields remain negative, the brighter economic outlook, as well as markets not fully believing the FOMC, have led them higher over the past month.
- Financial conditions still remain favorable, though we will continue to watch this as tightening financial conditions would weigh on the outlook.
- The Fed will try to avoid a taper tantrum with guidance, though it's not entirely within its power. Indeed, rising yields are already having an impact on EMs and the dollar.

Source: Haver, Bloomberg, and Cornerstone Macro. As of March 30, 2021.

CONSENSUS FORECAST

- Our view is largely in line with consensus for inflation for 2021 and 2022
- However, we see a stronger GDP and labor market recovery due to the brighter fiscal spending outlook, faster vaccine rollout, and a strong consumption boom

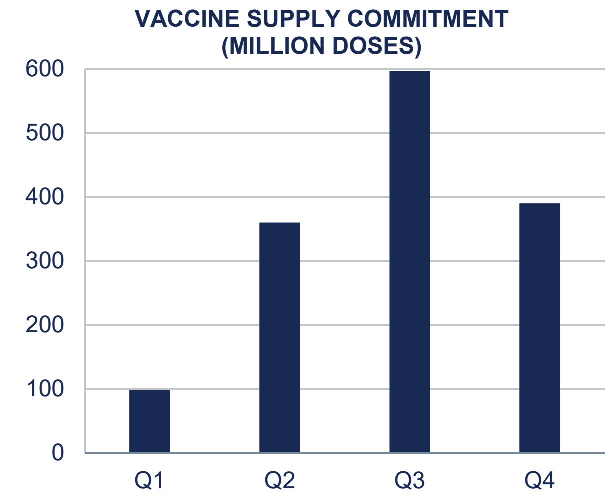
Economic Growth	04/05/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Real GDP (Y/Y %)	-2.4	3.0	2.2	-3.5	5.7 ▲	4.0 ▲
Inflation						
CPI (Y/Y %)	1.7	2.5	1.8	1.2	2.4 ▲	2.2 --
Core PCE (Y/Y %)	1.4	2.0	1.7	1.4	1.8 --	1.9 --
Labor Market						
Unemployment (%)	6.0	3.9	3.7	8.1	5.6 ▼	4.4 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.13	0.25 ▼	0.35 ▲
2Y Treasury	0.18	2.52	1.57	0.12	0.31 ▲	0.62 ▲
10Y Treasury	1.73	2.72	1.92	0.92	1.71 ▲	2.02 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 5, 2021. (E)—Bloomberg private market consensus estimates.

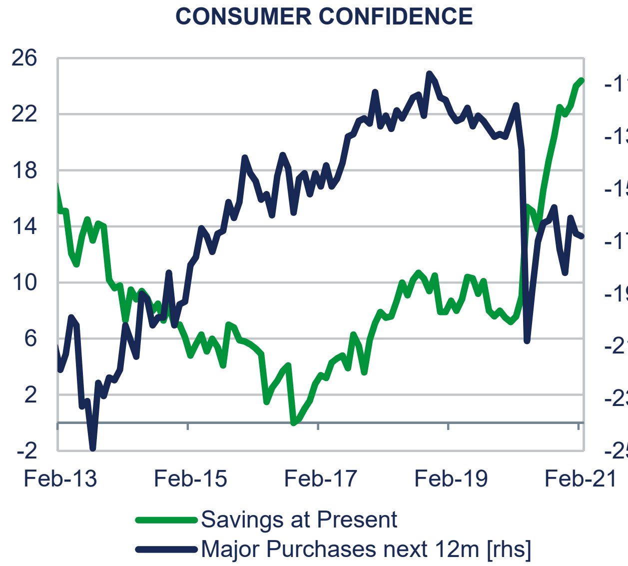
Europe

The pickup in vaccine supply should expedite VACCINATIONS…



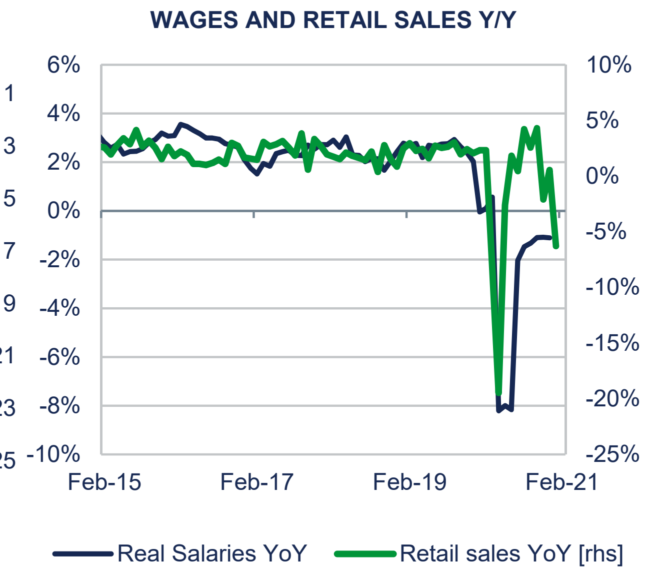
- Breaches of delivery contracts have been a major factor behind sluggish EU vaccinations (EU countries have used more than 90% of the doses received).
- With a commitment to deliver 360 million doses in Q2 and more in Q3, vaccinations should continue to speed up, as they have in recent weeks.
- EU vulnerable population should be protected by June, which would allow for a solid tourism season and recovery.

… and put an end to lockdowns that have hurt CONSUMER CONFIDENCE…



- The impact of slow vaccinations and extended lockdowns on consumer confidence has been evident.
- Confidence has not recovered much since last year, through.
- EU consumers' intentions to save are at all-time highs and major purchase plans are largely shelved, according to survey data.

…and are delaying the CONSUMPTION RECOVERY.

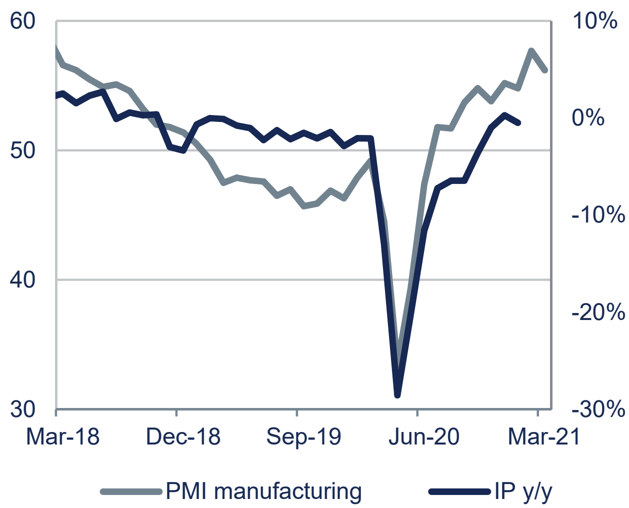


- While employment has held up well throughout the pandemic, wages have suffered and remain well below pre-COVID levels.
- This, coupled with low consumer confidence, has clipped the wings of a consumption recovery that was sharp in the last part of 2020: retail sales have rolled over.

Source: Bloomberg and Haver. As of April 6, 2021.

EXPORTS AND INVESTMENT are fueling a sharp rebound in manufacturing…

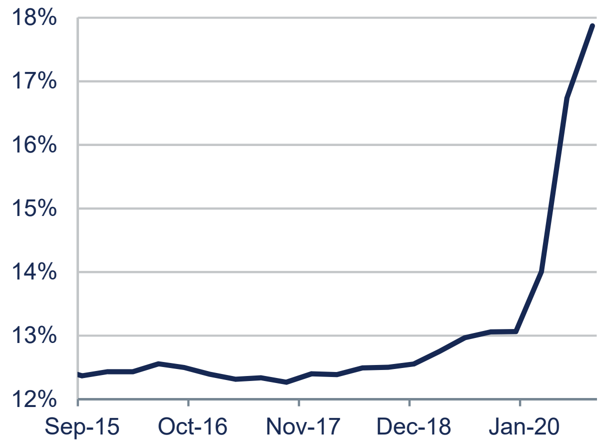
INDUSTRIAL PRODUCTION AND PMIs



- While consumption suffered, buoyant exports and resilient investment have kept demand for tradable industrial goods strong.
- This has provided a supportive backdrop for industries, in particular as industrial plants avoided lockdowns.
- Industrial production is now back at pre-COVID levels and PMIs suggests the acceleration will continue.

…and ACCUMULATED SAVINGS will support consumption when economies reopen.

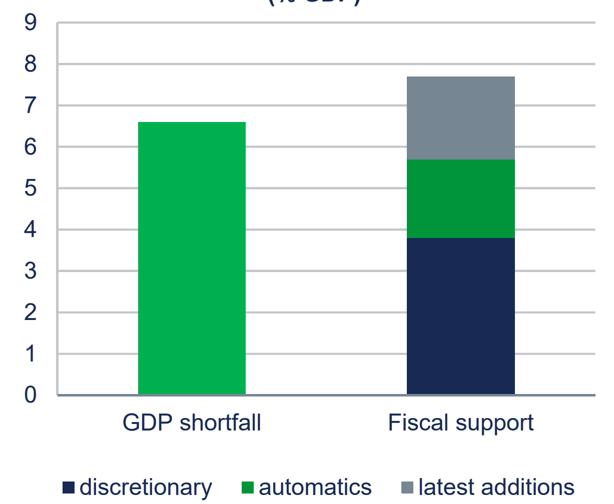
HOUSEHOLD SAVINGS (% OF DISPOSABLE INCOME)



- Policy support allowed substantial savings and wealth accumulation, albeit skewed towards richer families with lower propensity to spend it (see Monthly Spotlight, slide 5).
- Reopening economies should provide a supportive backdrop for spending in goods and services favored by high-income households (dining out, travel, leisure), the sectors most impacted by the pandemic.
- Consumption should see a solid rebound in the second half of the year.

FISCAL SUPPORT remains exceptional in 2021.

GDP SHORTFALL AND FISCAL SUPPORT (% GDP)



- Fiscal support should help close the GDP gap left by COVID.
- Between discretionary and automatic spending, and the latest measures announced in Italy and France, the fiscal impulse should reach almost 8% of GDP in 2021, higher than the gap between current euro area output and its end-of-2019 level.

Source: Bloomberg and Haver. As of April 6, 2021.

CONSENSUS FORECASTS

- Growth in the euro area should come at the top end of consensus expectations, at 5%, fueled by vaccine rollouts and full reopening of the economy in time for the tourism season
- U.K. growth will likely come in slightly below consensus, to 4.5%, as Brexit-related trade disruptions partially offset the effects of a speedy vaccination program

Economic Growth	04/05/2021	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	-4.9	1.9	1.3	-6.8 ▲	4.2 --	4.2 ▲
U.K. Real GDP (Y/Y %)	-7.3	1.2	1.5	-9.9	4.7 ▲	5.7 ▲
Inflation						
EZ CPI (Y/Y %)	1.3	1.8	1.2	0.3	1.5 ▲	1.2 --
U.K. CPI (Y/Y %)	0.4	2.5	1.8	0.9	1.6 ▲	1.9 --
Labor Market						
EZ Unemployment (%)	8.1	8.2	7.6	7.9	8.6 ▼	8.3 ▼
U.K. Unemployment (%)	5.0	4.1	3.8	4.4	6.0 ▼	5.4 ▼
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.00 --	0.00 --
EZ 2Y Note	-0.71	-0.62	-0.61	-0.72	-0.63 ▼	-0.50 ▼
EZ 10Y Bond	-0.33	0.24	-0.19	-0.57	-0.18 ▲	0.03 ▲
U.K. Central Bank	0.10	0.75	0.75	0.10	0.10 --	0.20 --
U.K. 2Y Gilts	0.07	0.74	0.53	-0.17	0.15 ▲	0.28 ▼
U.K. 10Y Gilts	0.79	1.27	0.82	0.19	0.81 ▲	1.02 ▲
Currencies						
EUR/USD	1.18	1.14	1.12	1.22	1.23 ▼	1.23 ▼
GBP/USD	1.39	1.27	1.33	1.37	1.40 ▼	1.43 ▼

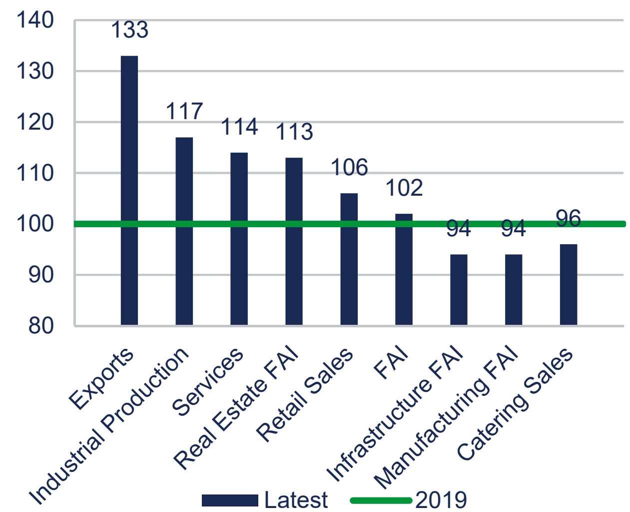
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 5, 2021. (E)—Bloomberg private market consensus estimates.
*Represents actual data.

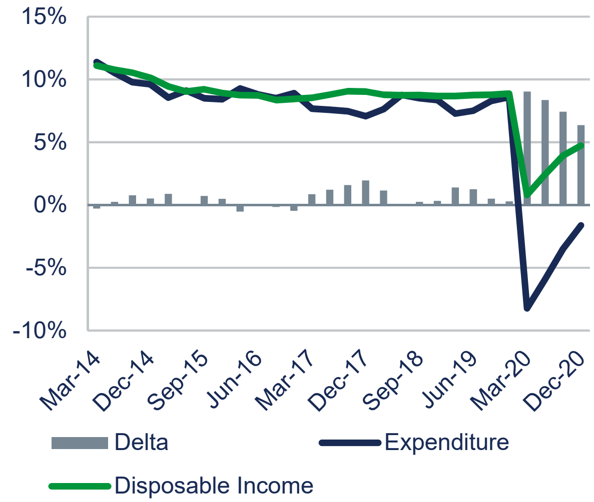
Asia Pacific

China's emphasis on **DUAL CIRCULATION** should allow it to better leverage its external strength…	…especially as most of the conditions are present for **HOUSEHOLD CONSUMPTION** to surprise to the upside…	… and **R&D INVESTMENT SPENDING** should also accelerate, providing a tailwind to long-term growth.

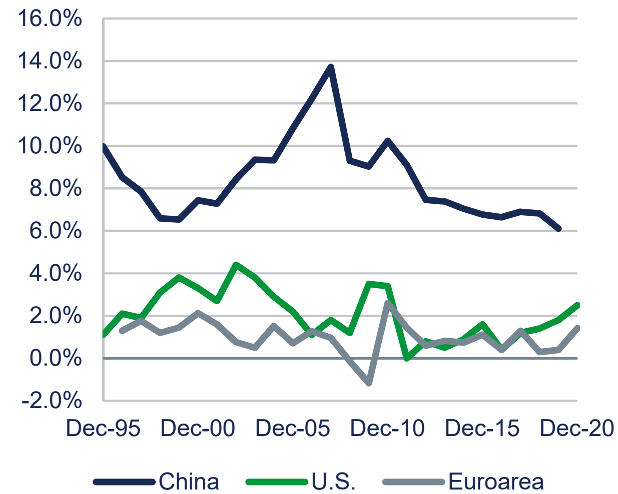
CHINA ACTIVITY LEVELS RELATIVE TO 2019



CHINA EXPENDITURE AND CONSUMPTION GROWTH



PRODUCTIVITY GROWTH



- U.S. stimulus and inventory rebuilding should benefit exports. The modest shift of consumption from goods to services in the U.S. is likely, but not a major risk.
- Continued strength in exports should drive the return of domestic demand, supported by the "dual circulation" policy objective, which emphasizes investment in innovation, technology and increasing the size of its middle class.

- Stock of excess savings worth 6% of annual disposable income can be unwound. Though unlikely to be drawn down as quickly as in the U.S., it provides upside risk to demand.
- Also supporting the revival of consumption includes a recovering labor market and robust consumer confidence and expectations.

- China is targeting 7% of GDP R&D spending per year for the next five years. The technological boost should provide legs to the next stage of its economic development.
- Heavy investments in innovation and a "greening" of the economy will allow China's productivity growth to continue outperforming that in the U.S. and Europe.

Source: Bloomberg, Haver and TSLombard. As of April 5, 2021.

Asia Pacific

Mind the BASE EFFECT this year, particularly in Japan, as it could be the latest challenge to Central Bank credibility.

For the rest of the region, INFLATION remains subdued and should lag the recovery.

IMPROVED MACRO RESILIENCY better insulates the region from potential taper tantrum spillovers.

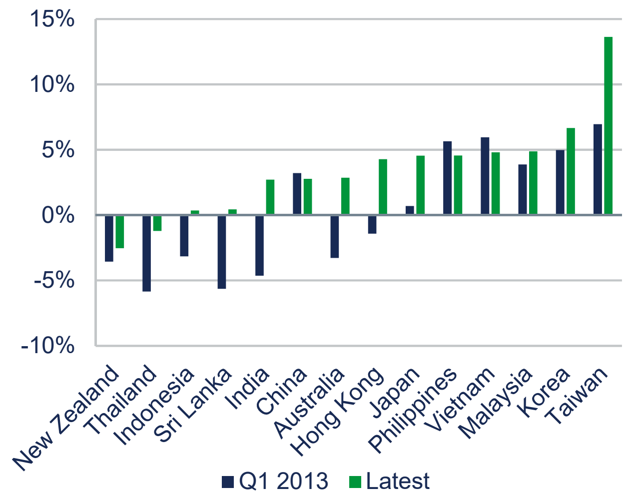
JAPAN CORE CPI Y/Y GROWTH

- Even assuming zero M/M growth in inflation, core CPI should experience positive base effects in Japan, bringing it to the highest level since 2015.
- Large inflationary pressures are unlikely to actually materialize, but inflation prints bodes close watching as it may confuse markets and un-anchor expectations.

ASIA PACIFIC HEADLINE INFLATION Y/Y

- Inflation remains low still, with certain exceptions (India and the Philippines). Inflation surprises have also been lower compared to other regions, suggesting anchored expectations.
- Labor markets are unlikely to be a source of inflation this year. But commodity price increases and supply chain disruptions, together with FX devaluation, are potential risks on the horizon.

CURRENT ACCOUNT BALANCE



- Compared to the period leading up to the taper tantrum in 2013, current account balances are healthier and FX reserves much higher, covering a larger proportion of short-term external debt.
- Different this time are higher debt levels and wider fiscal deficits. But more active central banks should limit interest rate volatility and make the impact on upside pressure on yields manageable.

Source: Bloomberg, Haver and IMF. As of April 5, 2021.

CONSENSUS FORECAST

- Our GDP expectations for Japan are higher than consensus, given the tailwind from fiscal spending and the revival in private capex, consistent with a return to pre-pandemic growth levels by 2022
- We also anticipate better-than-expected growth in China through 2022 given a successful pivot towards its dual circulation strategy supporting a gradual revival in internal demand

Economic Growth	04/05/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Japan Real GDP (Y/Y %)	-1.4	0.6	0.3	-4.9	2.8 ▲	2.1 --
China Real GDP (Y/Y %)	6.5	6.7	6.0	2.3	8.5 ▲	5.5 --
Inflation						
Japan CPI (Y/Y %)	-0.4	1.0	0.5	0.0	0.0 --	0.5 --
China CPI (Y/Y %)	-0.2	2.1	2.9	2.5	1.6 ▲	2.3 --
Labor Market						
Japan Unemployment (%)	2.9	2.4	2.4	2.8	3.0 ▼	2.8 ▼
China Unemployment (%)	4.2	3.8	3.6	4.2	3.8 --	3.6 --
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 --	0.00 --
Japan 2Y Note	-0.12	-0.15	-0.13	-0.13	-0.09 --	-0.10 --
Japan 10Y Bond	0.12	-0.01	-0.02	0.02	0.09 ▲	0.09 ▲
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.72	2.75	2.75	2.75	2.84 ▲	2.53 ▼
China 10Y Bond	3.20	3.30	3.13	3.14	3.24 ▲	3.22 ▲
Currencies						
USD/JPY	110.32	110.27	108.61	103.25	106.50 ▲	108.50 ▲
USD/CNY	6.56	6.86	6.98	6.52	6.40 ▲	6.40 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 5, 2021. (E)—Bloomberg private market consensus estimates.
*Represents actual data.

Central Scenario

Advanced economies stand a good chance to exit lockdowns in the next few months. The U.S. will mostly reopen in Q2, and Europe should recover from vaccine availability delays a few months later. In these regions, an unprecedented coordination of macroeconomic policies has successfully laid the ground for a strong demand-led growth. Consumers are coming back with a vengeance, ready to shop, dine out, travel, be merry and enjoy the life in the open they so dearly missed.

Hampered by low access to vaccines, the pandemic will affect most emerging and developing markets for longer. Still, many could see their most vulnerable populations protected against the virus in the 18-month horizon of these scenarios. In addition, the global recovery will spill over much earlier through renewed trade and financial linkages.

"THE BEST OF ALL POSSIBLE WORLDS!" (50% ODDS)

The automatic recovery of demand when developed economies reopen provides an ideal environment for animal spirits. Already, **firms have started to invest**, supported by exceptionally cheap financing conditions. **Public investment will add to the momentum**. The U.S. Congress will likely pass massive infrastructure plans and the European Recovery and Resilience funds will be deployed in the next five years for a transformative "green and digital" transition.

Some days, the economy will look like it may overheat and markets may flutter. However**, central banks will not fail in their commitment to act as tail risk managers because wounds remain beneath the surface that will keep inflation in check**. In the SME sector, not all firms recover from the long lockdowns; for those that do survive, liabilities have built up in savings that now need to be spent in restocking to restart, but also repaid. Solvency remains fragile and labor participation rates do not recover quickly as firms find they no longer need workers they shed during lockdowns. The acceleration of technology adoption does not reverse. **Labor markets will improve, but slack, productivity gains, and increased competition from online commerce keep actual inflation at bay**.

China, while taking a longer path to vaccinations, supports growth through its "dual circulation" strategy that benefits from the global recovery, but also strong growth in domestic demand with an expanding social safety net. In addition, the government engages in heavy investments that focus on technological innovation and its ambitious goal of a rapid green transition.

The resulting global capex cycle could, if well executed, set the stage for a rise in secular growth in the years beyond the horizon of this scenario. For now, we keep our title in quotation marks as growth may revert to pre-crisis trends.

Conditions

- Continued policy support
- Control of the pandemic

Indicators to watch

- Falling savings rate
- Extent of labor market scars (participation rate, employment-to-population ratio, and employment cost index relative to 2019)
- Rising capex and capacity utilization

Scenario risks

- Rising U.S.-China friction over technology
- U.S. decouples and a normal tightening of U.S. financing conditions hurts Europe and EMs
- U.S. twin deficits that exacerbate protectionism and threaten trade and financial stability

The above represent the views of Barings as of April 1, 2021, and are subject to change at any time. These predictions may not come to fruition.

INFLATION ANXIETY (30% ODDS)

In light of the powerful growth rebound and ongoing discussions about U.S. infrastructure spending, price pressures raise the threat of inflation. Strong private and public demand meets supply chain bottlenecks, giving rise to cost-pushed inflation in oil, food, and other commodities related to the digital and green transition. **With supply unable to adjust to the demand boom, inflationary pressures look more persistent than central banks expected**. Wages may also take off. Some firms are forced to preserve margins and pass through higher costs to prices, propagating inflation. **It starts to make increasing sense to market participants that inflation is really the only solution to reducing the extraordinary public debt burden accumulated during the pandemic—central banks will run the economy hot**.

A tug of war takes place between markets and the Fed. Rate hikes and higher inflation become priced in the U.S. yield curve, the risk-free curve of the world. The Fed pushes back against any permanent inflation scare, citing lingering scars and structural disinflationary forces. It remains committed to a calm display, but markets are unconvinced and tantrums ensue. Indeed, investors worry that the Fed's stress on lingering pockets of unemployment will put it well behind the curve when the market recovers. Market volatility raises risk premia and hurts consumer confidence and capex plans. **Demand remains strong but not as strong as in "The Best of All Possible Worlds!" scenario**.

The Fed regains control of the narrative by talking of yield curve control. In the meantime, **volatility and more expensive, longer-term financing conditions provide a headwind to growth**. Growth momentum is weak after the initial bounce, but inflation picks up along with macroprudential concerns about isolated asset bubbles.

Emerging markets suffer as their incomplete recovery is hindered by tightening financing conditions and a strong dollar.

Heightened tensions about a trade war with China or antagonism with Russia that leads OPEC to reduce oil supplies would only magnify the inflation dynamics described in this scenario.

Conditions
- Rising oil and commodities prices
- Persistent bottlenecks

Indicators
- Rising inflation expectations
- Higher demand for bitcoin and gold
- Falling savings rates utilization

Scenario risks
- The Fed needs or wants to signal its confidence in the strength of the recovery and talks of unneeded policy support

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GRAVITY PREVAILS (20% ODDS)

As the pandemic recedes, the rebound in demand is short-lived, because most of the recovery has already occurred. Manufacturing has already been powering back since Q3 2020 and, in services, changes in the pattern of consumption and lingering social restrictions fail to revive those sectors that lag behind. A slowdown starts in Q3 as the reopening boost fades and **developed market growth drifts back to pre-crisis levels.**

Monetary policy remains accommodative. At the lower bound, however, its capacity to relaunch demand turns out limited. Low real rates fail to spur investment, when expected demand remains weak. Only fiscal policy has the power to make a difference.

Governments make it difficult for further funding to be discussed. In the U.S., the early recovery momentum drains the urgency from meaningful infrastructure investment. Without it, corporate capex stalls, too. In Europe, early discussions of fresh fiscal discipline keep the savings rate high, in preparation of future tax payments. Any delays for the Resilience and Recovery plan worsens the scenario. Arm wrestling on the appropriate conditionality required for the disbursement of funds could take place and result in the delay, or cancelation, of public investment plans. This has the worst impact in the weakest countries that need the money most and divergence reappears.

Confidence declines. Wounds may reopen. Shops may remain closed and some SMEs become bankrupt. M&As lead to labor shedding and **many firms start to focus on deleveraging**.

Social unrest could easily flare up. A sense of inequality, police brutality, poverty, and youth anger would add to downside risks, as would a lingering pandemic, new variants, or vaccination delays.

A trade war with China, and other geopolitical risks, would also hurt badly.

Elections, in Germany, France, potentially Italy, as well as mid-term races in the U.S., could see the expression of anger and radicalism, with nefarious results for the medium term.

Conditions

- Little further spending in the U.S.
- Talks of significant tax rises that affect the middle class

Indicators

- Service PMIs, bankruptcies
- Private savings and investment
- Labor market slack
- Policy announcements

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Scenario Matrix—Economy

		Scenarios						
		Best of All Worlds		*Inflation Anxiety*		*Gravity Prevails*		
		2021	2022	2021	2022	2021	2022	Comments
U.S.	Growth	8%*	5%	5%*	3-4%	5%*	3%	A consumption boom should turbocharge the recovery as U.S. households' balance sheets look healthy, more support is coming, and vaccination progresses expeditiously
	Inflation	2.5%	1.5-2.0%	2.5-3.5%	1.5-2.0%	1.5-2.0%	2.0-2.5%	
	Unemployment	4%	3.5%	5%	4%	5.5%	4.5%	
Euro Area	Growth	6%	4%	6%	3%	4%	3%	With vaccine supply shortages coming to an end, Q2 should see vaccinations speed up and economies reopening in time for the tourist season, while policy support remains unwavering
	Inflation	1.5%	1.0-1.5%	1.5-2.5%	1.0-1.5%	1.0-1.5%	1.0-1.5%	
	Unemployment	6.5%	5%	7.5%	7%	7%	6.5%	
Japan	Growth	4%	3%	2.5%	2%	3%	2%	Firm commitment to fiscal stimulus and structural support should limit downside risks to growth, while the slow vaccine rollout is a near-term headwind
	Inflation	0.5%	1%	1%	0.5%	0%	0.5%	
	Unemployment	2.5%	2.5%	3%	2.5%	3%	3%	
China	Growth	8-9%	6%	8%	5%	7%	5.5%	Signs of plateauing are only a testament to the speed of China's solid, if uneven, recovery. Exports will continue to offset sluggish internal demand as the global economy accelerates
	Inflation	2%	2-3%	2-3%	2%	2%	2%	
	Unemployment	3.5%	3.5%	4%	3.5%	4%	3.5%	

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*Asterisks indicate updated estimates from one month ago.

Scenario Matrix—Central Bank Policy

	Scenarios			
Central Bank	***Best of All Worlds***	***Inflation Anxiety***	***Gravity Prevails***	***Comments***
FED	Fed Funds Rate: 0% Balance sheet remains accommodative	Fed Funds Rate: 0% Balance sheet turns neutral, relying mostly on forward guidance and threat of Yield Curve Control (YCC)	Fed Funds Rate: 0% Balance sheet remains accommodative and may need to grow	In the Fed is likely to respond very slowly to any upside or downside risks to inflation given its new average inflation targeting (AIT) framework and focus on labor market recovery
ECB	Some acceleration in inflation may create disagreement on accommodation within the Governing Council but no tightening action	Intervention only in jawboning market pricing	Unwavering accommodation in the form of more QE and generous liquidity provisions	Except for the Inflation Anxiety scenario, inflation will remain subdued and far below its 2% policy target, and the ECB remains under pressure to do more
BOJ	Policy rate stays negative; Balance sheet stays neutral	Policy rate stays negative; Balance sheet stays neutral with emphasis on YCC to keep financial stability in check	Policy rate stays negative; Balance sheet stays neutral with emphasis on YCC to keep expectations in check	The BOJ is going down a narrow path, with YCC the only way to enable policy exit in the future; it has managed the process well so far
PBOC	Slight tightening bias via macroprudential measures and marginally higher benchmark rates	Tightening bias via macroprudential measures	Slight tightening bias via macroprudential measures	Policymakers are focusing on financial de-risking, likely only intervening if the growth outlook gets meaningfully derailed

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Scenario Matrix—Markets

	Scenarios			
Markets	***Best of All Worlds***	***Inflation Anxiety***	***Gravity Prevails***	***Comments***
Rates	Policy rates unchanged; 10Y UST around 2-2.5%; curve bear flattens	Policy rates unchanged; 10Y UST around 3%, with overshoots possible	Policy rates unchanged; 10Y UST around 1%; curve bull flattens	Short rates anchored by central bank policy with most of the volatility in the mid- to long-end of the curve
Corporate Credit	Spreads move tighter, benefitting loans over HY bonds, which would outperform IG amid higher rates	Spreads widen amid tightening financial conditions and credit risks in focus	Spreads range-bound	Spread changes should largely be a function of rates, the exception being the Inflation Anxiety scenario
Equities	Value and higher-quality cyclicals outperforming	Quality outperforming with leverage a concern	Rotation back into growth and tech	Much of the reopening has already been priced-in so earnings will play a greater role in determining upside
FX	USD weakness resumes	USD strengthens as U.S. yields rise compared to other developed markets	USD strengthens in flight to safety as growth stalls	A desynchronized growth outlook has been supportive of the USD, but expect this to end toward H2 2021
Commodities	Industrial metals, energy and gold drift modestly higher	Industrial metals, energy and gold move higher	Oil, copper and gold generally range-bound	Commodities should benefit both from either the tailwind of global economic recovery or increased inflation worries

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