BARINGS INVESTMENT INSTITUTE

May 2021

Coiled Spring

MONTHLY MACRO DASHBOARD

BARINGS

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May Outlook: Coiled Spring

Exceptional garden pinks and yellows mark the arrival of seasonal spring, but the world's economic data outline a "coiled spring," to borrow a phrase from Bank of England's Andrew Haldane. Expanding vaccination programs, generous government spending, cheap money, and strong household balance sheets all point to **a global economy that is about to pop**. Lingering concerns around COVID cases in Japan and other emerging markets paint a gloomier picture, but those risks have also kept yields from rising too fast as some investors seek safety in U.S. Treasuries.

Listening to our investment teams, we still seem headed for **"The Best of All Possible Worlds,"** a scenario of strong growth, temporary inflationary pressures, and **a supportive backdrop for risk assets, including equities, credit, and private markets**. Whether this picture proves durable over a longer term remains uncertain, but we continue to assign it 50% odds over the next 12-18 months. The **euro** may continue to regain some of its ground against the dollar as European growth accelerates over the next few months. **Duration** may benefit, too, as yields drift lower amid stubborn pandemic pockets and fears the recovery may stall in the face of large, new U.S. tax increases. Still, these trends will likely prove temporary with the arrival of much stronger summer data.

"Inflation Anxiety" that could force a much sharper rise in yields and a tightening of financial conditions remains the biggest risk to our base case, and we maintain this scenario at a 30% probability. Price data surprises will spook investors given the strength of the recovery, rising demand for commodities, and global supply bottlenecks even if we remain confident these pressures are transitory. If anything, the odds that **"Gravity Prevails"** as demand sputters out or governments tighten too soon look slimmer than ever, but a resurgence of new pandemic strains might force a reassessment.

Restrictions are easing in the United States faster than elsewhere, which, when combined with fiscal stimulus, is supporting strong in-person consumption. Moreover, additional fiscal spending should provide more fuel for growth. Base effects and energy prices have begun to boost inflation, but persistent price pressures are nowhere to be found. Despite rising inflation, the 10-year Treasury yield has drifted lower since the end of March. Tax increases to fund further spending have been announced but are likely not fully priced in.

In **Europe,** thanks to vaccinations finally taking off, **tourism may provide a significant boost to growth this summer**. With consumers in the starting blocks, the momentum is building for strong Q3 performance. There is room for financial markets to continue rallying. Without any ECB tapering in sight, financing conditions keep as supportive as ever. A sustained recovery will require investments from the Recovery Plan to raise productivity.

The **pandemic remains a risk in Asia, where vaccine rollout has only inoculated a small part of the population.** China's rebound is broadening as consumption activity perks up after the Lunar New Year lockdowns. Exports have been a source of strength for the region, with China providing the anchor. In Japan, the consumer outlook is more mixed, despite there being ingredients for a decent rebound. Persistent COVID outbreaks and social distancing restrictions mean the job market has yet to completely heal. A strong export environment and broadening economic growth outlook should provide further lift to Asia FX.

What Changed in April

WHAT'S NEW

- The short-term market focus is now on Europe's ongoing bounce. Vaccinations have accelerated and the region will be able to receive tourists this summer. The strength of the recovery is not yet priced in.
- U.S. spending plans, backed by tax hikes, look like they will support growth starting this year and well into the future.
- China's advance toward full capacity keeps pulling commodity prices higher, squeezing margins in the rest of the world.
- In the absence of vaccination, the virus spreads and mutates. The pandemic was thought to be controlled in India until a double mutation rendered it even more virulent.

WHAT WE LEARNED

- It's Europe's turn to drive capital flows, with the euro appreciating versus the dollar as upside surprises to growth get priced in.
- It's also the turn of the real economy to front-run the vaccines. Before herd immunity is reached, the demand for labor is rising, including in those service sectors that have lagged.
- Financial markets still have their eyes on risks from the spread of the virus and its mutations. As the pandemic continues to roll out in some countries, U.S. Treasuries have remained attractive as the worlds' safe asset and rallied, even as data are good overall.

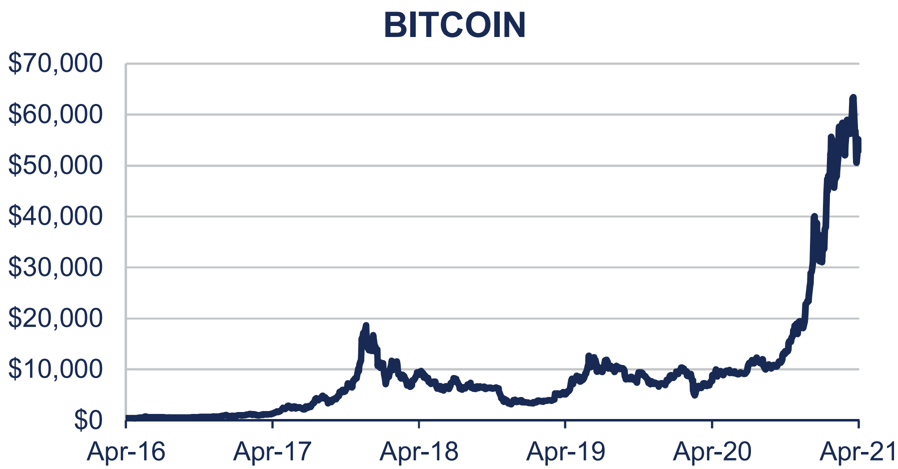
WHAT WE ARE HEARING FROM OUR TEAMS

- H2 recovery for EM is still largely on track even as COVID cases rise. Some countries are lagging behind in the vaccination rollout – South Africa likely won't reach herd immunity until next year, and smaller EM countries like Georgia and Armenia have only begun and haven't secured enough doses.
- Retail investors are pouring money onto the stock market, pushing it to new highs. Tax hikes are on the horizon, but a good earnings season supports the rally.
- Corporate priorities so far have been deleveraging first before any shareholder-friendly activities. Concerns about valuations, rising rates, and political noise may dominate price action in the near-term despite solid fundamentals.

WHAT WE ARE WATCHING

- Signs of pass-through of commodity inflation to the CPI.
- Whether markets overreact to the temporary rise in inflation.
- New COVID waves, variants, and summer travel restrictions.
- The transition from income support from fiscal stimulus to wage and salary growth from job gains.
- Semiconductor shortages.
- NPL data as firms reopen, in particular in retail and services.

Monthly Spotlight: The Dirt On Bitcoin Mining



What is bitcoin?

Bitcoin was introduced in 2008 as a decentralized, electronic global payment network where transactions do not flow through traditional bank intermediaries. It relies on a technology that allows for transfer of ownership without the need for a trusted third party.

Where does blockchain fit in?

All transactions are recorded in a digital ledger, called the blockchain. The peer-to-peer network prevents deletion and alteration of previously validated transactions, offering security without the need for a central administrator.

Curious what drives those prices?

The supply of bitcoin is designed to escape human decision. Hard coded in the bitcoin network is a cap of 21 million coins that can ever be minted, a move aimed at eliminating the inflation risk. The rules behind bitcoin supply make price the only adjustment variable to changes in demand, which also results in the high volatility of bitcoin prices.

Source: Bloomberg, as of April 30, 2021.

What are economists saying about bitcoin?

If there is nothing but trust behind fiat money, the issuers are, for the most part, credible institutions. Its purchasing power does not deviate from a fair value determined by economic demand and supply fundamentals. Bitcoin's value is all but stable as it fluctuates with demand on a thin market, where a large transaction has a major impact on its price.

The value of bitcoin can only emerge from the service it provides. Today, we observe demand from a number of holders using bitcoin to perform peer-to-peer transactions outside the traditional banking system. PayPal has made it easier for U.S. customers to use cryptocurrencies as a form of payment. There is also a growing list of vendors that accept bitcoin payment, including Wikipedia, Microsoft and AT&T.

And in a few instances, in countries where the official currency is even more unstable than bitcoin and subject to hyperinflation, the population has made use of it. In Zimbabwe, where foreign units of account such as the U.S. dollar are banned, bitcoin is used to transact. In Venezuela, savings are made in bitcoin to preserve the value. Elsewhere, its volatility represents a major obstacle for its adoption.

In addition, as more people have been buying bitcoin, including asset managers who announced entry into the market, a network effect is attracting speculative interest.

In the ESG spirit, what about the high energy use of mining?

Miners rely on large amounts of energy to continually verify secure transactions, and the network's annual energy consumption rivals that of small countries. This remains a small fraction (10% by some reports) of the energy required to operate traditional financial systems, and alternative blockchain platforms are being planned. Also, the mining of gold is one of the most destructive industries in the world of healthy ecosystems.

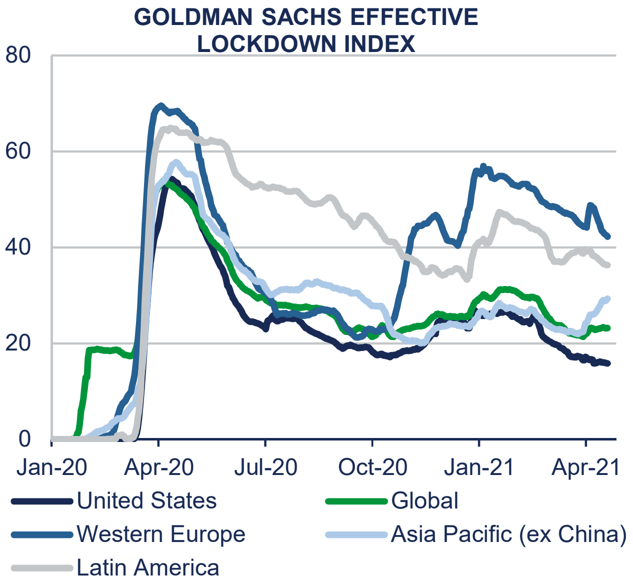
Only time will tell if there is a happy energy ending, but surely it's a story to keep watching.

United States

RESTRICTIONS are easing in the U.S. faster than elsewhere…

…which, combined with fiscal stimulus, is supporting strong IN-PERSON CONSUMPTION.

Additional FISCAL SPENDING should provide further fuel for growth.



Fiscal Bill	$trill of Spending
CARES Act -$1,200 stimulus check, $600 UI benefit	$2
Emergency COVID Relief Act -$600 stimulus check, $300 UI benefit	$0.908
American Rescue Plan Act of 2021 -$1,400 stimulus check, UI benefits through September	$1.9
American Jobs Plan* -Transportation, broadband, power infrastructure, clean energy tax credits, etc.	$2.7
American Families Plan* -Extend CTC, paid family/medical leave, universal Pre-K, free community college, etc.	$1.8

*Proposed bill

- With over 30% of the U.S. population fully vaccinated, restrictions are lifting across the country to a greater degree than in Europe and Asia.
- If vaccine rollout continues at the current pace, it would take three more months to cover 75% of the population, according to Bloomberg.
- The key now is to vaccinate those who are resisting.

- March retail sales rose nearly 10% M/M, beating consensus expectations. Spending in all major categories increased. A notable shift towards in-person shopping and dining at restaurants was apparent. While non-store retail sales rose 5.6%, this was only one-third of the rise following the last round of stimulus checks as more choose to shop in stores.
- While consumer spending will likely ease as one-off stimulus checks fade, spending should remain strong given healthy consumer finances.

- Following unprecedented levels of fiscal support, the Biden administration is proposing another $4 trillion in spending.
- Infrastructure spending, outlined in the American Jobs Plan, would be spread over a decade and boost longer-term growth.
- Support to individuals through the American Families Plan could take effect in the near-term and ease fears of a sharp decline in the fiscal impulse following the COVID relief bills.

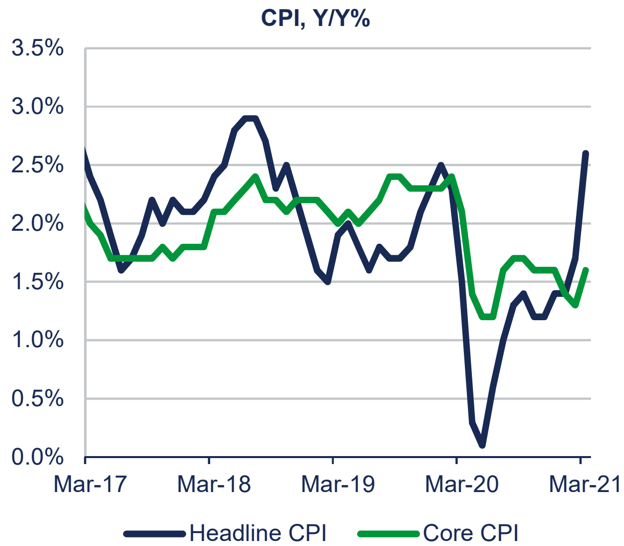
Source: Goldman Sachs, Haver, and Cornerstone Macro. As of April 29, 2021.

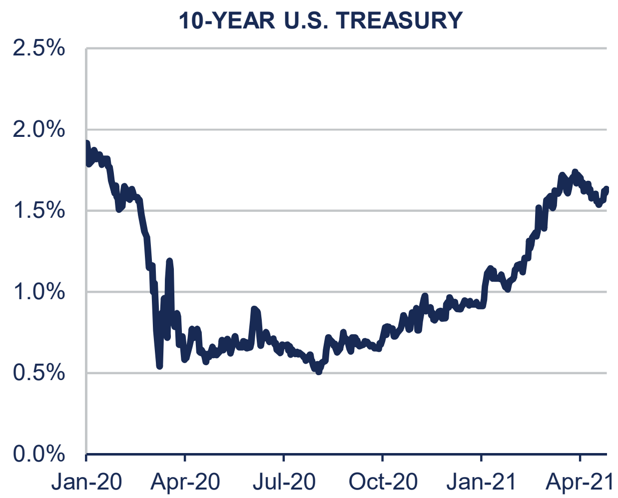
United States

Base effects and energy prices have begun to boost INFLATION but persistent price pressures are nowhere to be found.

Despite rising inflation, the 10-YEAR TREASURY YIELD has drifted lower since the end of March.

TAX INCREASES to fund further spending have been announced, but are likely not fully priced in.





Tax Policy	Billion USD
28% Corporate Rate	754
Tax Enforcement	700
21% GILTI, no QBAI, CbC	497
Capital Gains/Div @ 39.6%	429
Apply 3.8% NIIT/SECA Tax Above $400,000	200
Permanent Active Loss Limitation	138
Top Rate of 39.6%	112

- March CPI jumped 2.6% Y/Y, driven largely by base effects due to the lockdown a year earlier, as well as rising energy prices.
- However, underlying inflation pressures remain tame, with core CPI—excluding food and energy—up only 1.6% Y/Y.
- While inflation will likely rise over the next few months due to base effects and reopenings, our baseline scenario sees this as temporary, and inflation will likely drift back closer to the Fed's target by year-end.

- While inflation spiked in March, markets barely reacted with 10-year yields in April drifting slightly lower and inflation expectations holding largely steady.
- Re-emerging COVID fears in other areas of the world are keeping a lid on Treasury yields as the world's safe asset. Proposed U.S. tax increases could drive them lower.
- In the near-term, this benefits long duration, until the rest of the world catches up on the path to recovery. Yields should rise again as the global recovery takes hold.

- Taxes and spending were split between two proposals, but what is eventually passed may come through one bill. The first outlines raising corporate taxes to pay for infrastructure, and the other funds support for the lower and middle class by raising taxes on the wealthy.
- Current tax proposals are about 1.3% of GDP. However, large revisions are likely in order to garner enough support to pass.
- With revisions still likely, we could see further market reaction as this becomes more accurately priced in.

Source: Haver, Bloomberg, and Cornerstone Macro. As of April 29, 2021.

United States

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

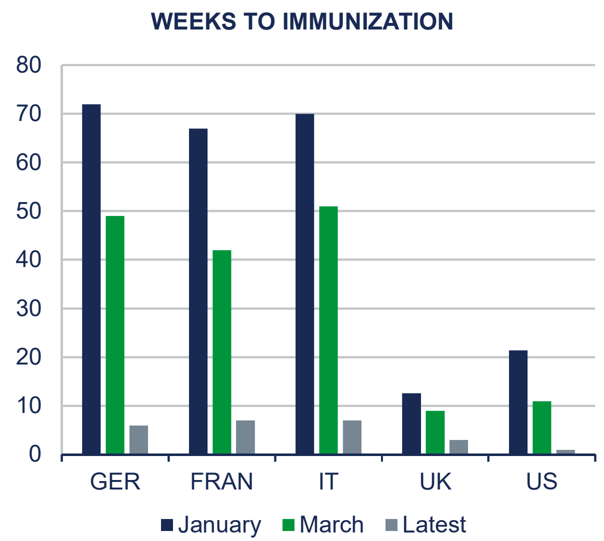
Economic Growth	05/03/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Real GDP (Y/Y %)	0.4	3.0	2.2	-3.5	6.3 ▲	4.0 ▲
Inflation						
CPI (Y/Y %)	2.6	2.5	1.8	1.2	2.6 ▲	2.2 --
Core PCE (Y/Y %)	1.8	2.0	1.7	1.4	1.9 ▲	2.0 ▲
Labor Market						
Unemployment (%)	6.0	3.9	3.7	8.1	5.5 ▼	4.3 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.13	0.25 --	0.35 --
2Y Treasury	0.16	2.52	1.57	0.12	0.31 --	0.63 ▲
10Y Treasury	1.58	2.72	1.92	0.92	1.83 ▲	2.12 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 3, 2021. (E)—Bloomberg private market consensus estimates.

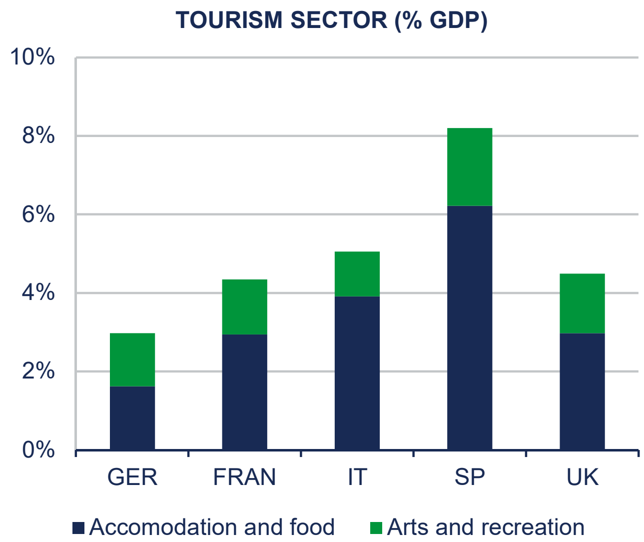
Europe

Thanks to VACCINATIONS finally taking off…



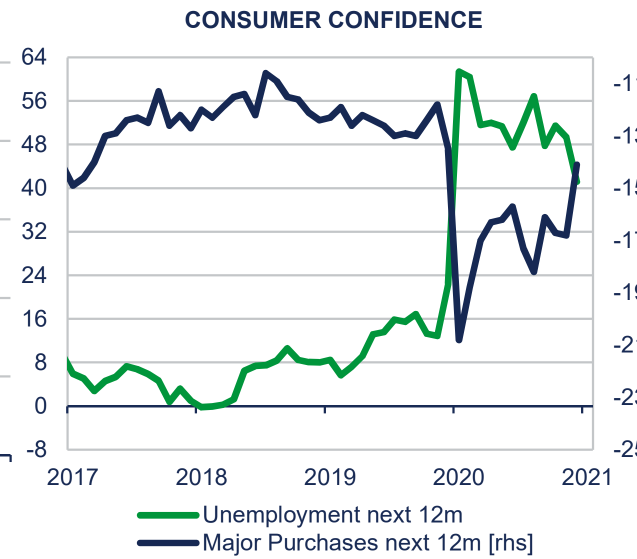
- With supplies getting closer to amounts contractually agreed upon, vaccinations have picked up speed substantially.
- Major EU economies have now caught up with the pace of the U.K. and U.S. (4-5% of population inoculated weekly).
- The 30% vulnerable share of the population should received the second dose in six-to-seven weeks. The EU is on track to reach its 70% vaccination target by the end of summer.

…TOURISM may provide a significant boost to growth this summer.



- Vaccinations should allow the reopening of accommodation, leisure, and restaurants by mid-June.
- This is crucial for southern European countries, for which tourism is a major source of income, and the summer provides the lion's share of tourism revenue.

With CONSUMERS in the starting blocks, the momentum is strong for a good Q3 performance.



- The latest consumer survey shows that fears of job loss are finally moving back towards pre-COVID levels and spending intentions are rising.
- Even under new restrictions imposed by EU governments in March, consumers appear to be hopeful. This bodes well for the release of the very large savings accumulated during the last 12 months.

Source: Bloomberg and Haver. As of April 23, 2021.

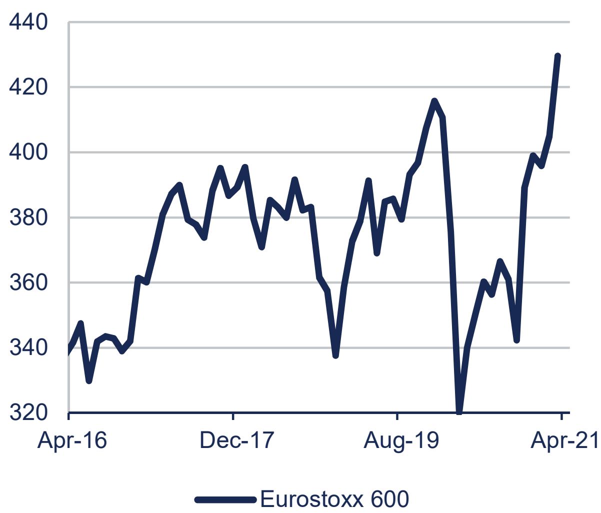
Europe

There is room for FINANCIAL MARKETS to continue rallying.

Without any ECB tapering in sight, FINANCING CONDITIONS remain as supportive as ever.

A SUSTAINED RECOVERY will require investments from the Recovery Plan to raise productivity.

Eurostoxx 600



EURO AREA REAL RATES

EURO AREA PRODUCTIVITY

- Stock markets have started to price in the prospects of good growth without inflation.
- After a lackluster start of the year, euro area stocks are thus rallying, shrugging off renewed restrictions and subdued economic data.
- With accelerating growth and no risks of disorderly inflation dynamics, the "Best of all Possible Worlds" scenario should play out in the second half of the year.

- Real borrowing costs (proxied German Bund yields minus inflation expectations), have never been so low.
- There is no tightening of financing conditions for households and firms in sight, as the ECB stays put.
- At the margin, this may provide more support to the economic rebound than in the U.S., where markets may have started to price in an exit from accommodation.

- After the reopening-led rebound, only productivity enhancements can sustain economic growth.
- The European Recovery Fund (ERF) cleared the last hurdle with the rejection of claims against its constitutionality in Germany.
- It will finance productivity-enhancing reform programs. These will be released in May and implemented beginning in July.

Source: Bloomberg and Haver. As of April 23, 2021.

CONSENSUS FORECASTS

- Euro area growth should beat consensus expectations, at 5%, fueled by vaccine rollouts, full reopenings, and the release of savings
- U.K. growth will likely come in slightly below consensus, at 4.5%, as Brexit-related trade disruptions partially offset the effects of a speedy vaccination program

Economic Growth	05/03/2021	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	-1.8	1.9	1.3	-6.6	4.1 ▼	4.1 ▼
U.K. Real GDP (Y/Y %)	-7.3	1.2	1.5	-9.9	5.5 ▲	5.5 ▼
Inflation						
EZ CPI (Y/Y %)	1.6	1.8	1.2	0.3	1.6 ▲	1.3 ▲
U.K. CPI (Y/Y %)	0.7	2.5	1.8	0.9	1.5 ▼	1.9 --
Labor Market						
EZ Unemployment (%)	8.1	8.2	7.6	8.0	8.6 ▼	8.3 --
U.K. Unemployment (%)	4.9	4.1	3.8	4.4	5.8 ▼	5.4 --
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.00 --	0.00 --
EZ 2Y Note	-0.69	-0.62	-0.61	-0.72	-0.64 ▼	-0.52 ▼
EZ 10Y Bond	-0.21	0.24	-0.19	-0.57	-0.16 ▲	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	0.16 ▲	0.29 ▲
U.K. 10Y Gilts	0.84	1.27	0.82	0.19	0.94 ▲	1.13 ▲
Currencies						
EUR/USD	1.21	1.14	1.12	1.22	1.22 ▼	1.23 --
GBP/USD	1.39	1.27	1.33	1.37	1.40 --	1.44 ▲

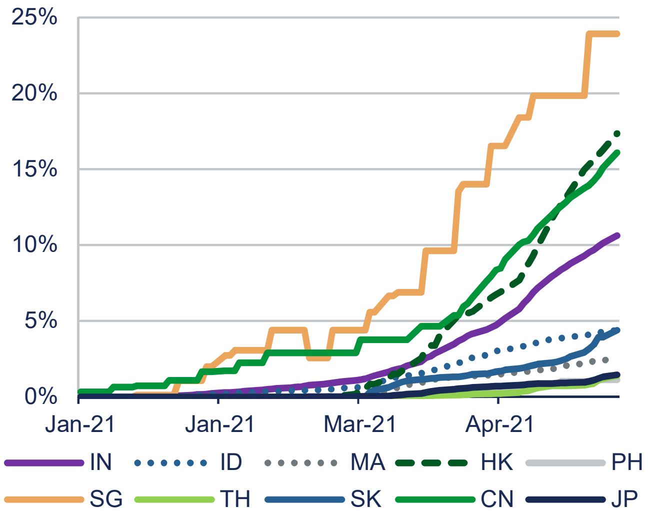
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 3, 2021. (E)—Bloomberg private market consensus estimates.
*Represents actual data.

Asia Pacific

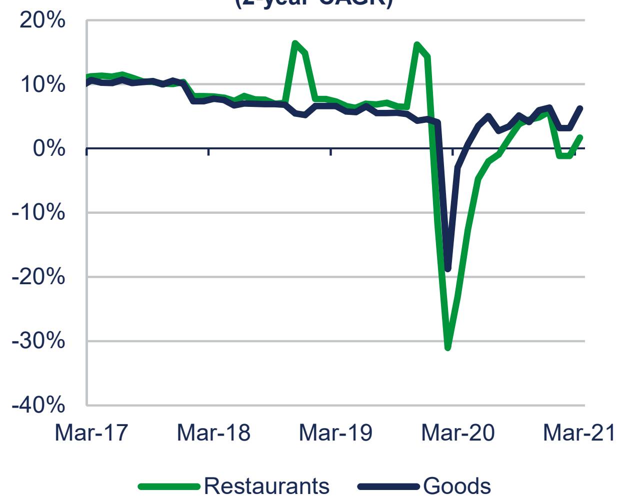
The pandemic remains a risk in Asia, where **VACCINE ROLLOUT** has only seen a small part of the population get inoculated.

PERCENTAGE OF THE POPULATION WITH AT LEAST ONE VACCINE DOSE



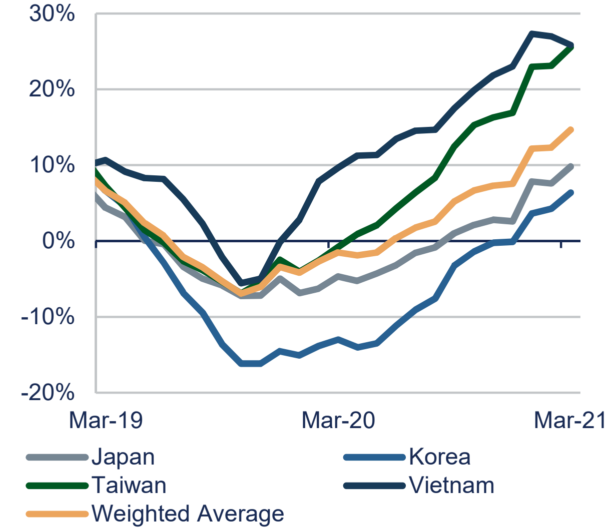
China's rebound is broadening as **CONSUMPTION ACTIVTY** perks up after the Lunar New Year lockdowns.

CHINA RETAIL SALES GROWTH (2-year CAGR)



EXPORTS have been a source of strength for the region, with China providing the anchor.

EXPORTS TO CHINA BY SOURCE



- Singapore and Hong Kong are leading inoculations are could reach herd immunity by year-end. China is not far behind, with the current pace implying herd immunity by Q1 2022.
- Supply constraints remains the largest hurdle, particularly for ASEAN and EM Asia. But the health system being near capacity to administer additional doses is also a factor, particularly in Japan.

- The damage from the February restrictions was far less than a year ago, even in restaurants, with the rebound also coming far quicker.
- Further strength in consumption should be expected in the months ahead, especially as the surveyed unemployment rate edged lower to 5.3% in March and per capita disposable income grew 7% (2-year CAGR), close to pre-pandemic levels of growth.

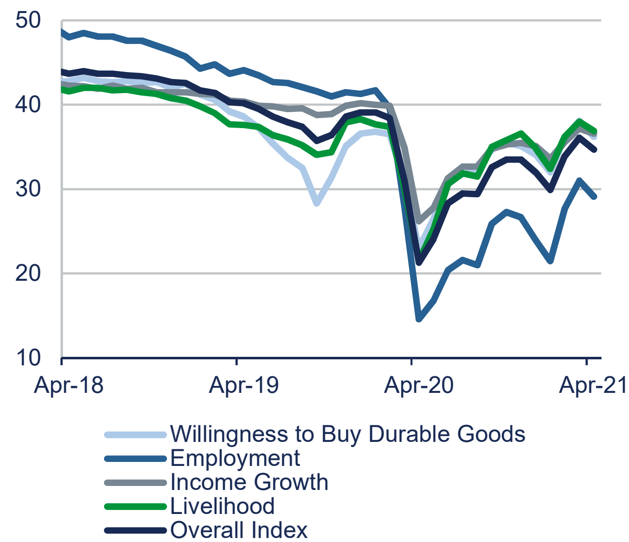
- With activity in China normalizing, buoyed by the tailwind from U.S. stimulus, external demand should continue to be a bright-spot for the region.
- External demand will likely be a primary driver of activity this year, with Taiwan, Japan, and Korea the largest beneficiaries to China's rebound.

Source: Bloomberg, Haver. As of April 28, 2021.

Asia Pacific

In Japan, the CONSUMER OUTLOOK is more mixed, despite the ingredients being there for a decent rebound.

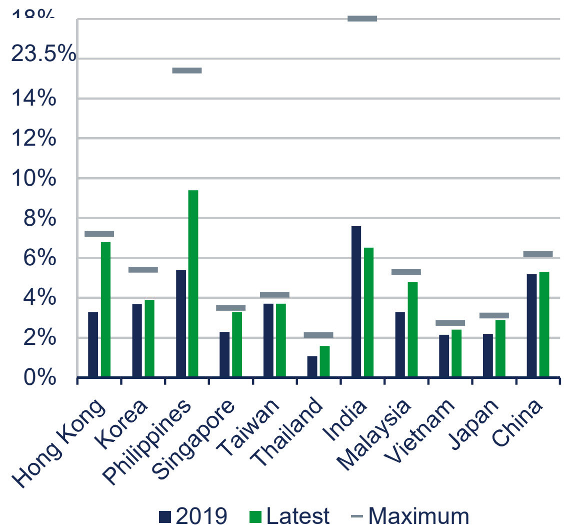
JAPAN CONSUMER CONFIDENCE



- Government transfers and wages declining less than expected have led to incomes rising by the most since 1991. That said, most savings have gone to high-income and elderly households.
- The third state of emergency and ongoing pandemic volatility should limit consumer enthusiasm to go out and spend. It also clouds sentiment around employment, which remains depressed.

Persistent COVID outbreaks and social distancing restrictions mean the JOB MARKET has yet to completely heal.

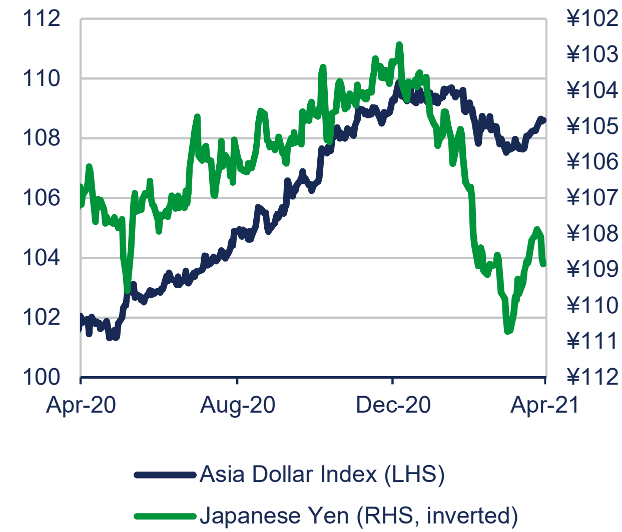
UNEMPLOYMENT RATE



- High informal employment share, mostly in agriculture, helps limit upward unemployment spikes in Vietnam, Thailand and Malaysia. But at the same time it masks underlying weakness given fewer formal protections and lower wages.
- Until broad economic reopenings are achieved, labor market weakness should keep a lid on price pressures.

A strong export environment and broadening economic growth outlook should provide further lift to ASIA FX.

ASIA CURRENCY



- Asia currency weakness has started to reverse since April, likely as the global growth story broadens out. Export-driven economies such as Taiwan, Korea and China have led this rally.
- But, the yen is seeing signs of declining sentiment amid another surge in infectionshe Indian rupee has also underperformed. Both are a reminder that pandemic-induced volatility should stay until immunity is reached.

Source: Bloomberg, Haver, Goldman Sachs. As of April 30, 2021.

CONSENSUS FORECAST

- While we revise lower our 2021 GDP expectations for Japan, the tailwind from fiscal spending and the revival in private capex should imply 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	05/03/2021	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	2.9 ▲	2.0 ▼
China Real GDP (Y/Y %)	18.3	6.7	6.0	2.3	8.5 --	5.5 --
Inflation						
Japan CPI (Y/Y %)	-0.2	1.0	0.5	0.0	0.2 ▲	0.6 ▲
China CPI (Y/Y %)	0.4	2.1	2.9	2.5	1.5 ▼	2.3 --
Labor Market						
Japan Unemployment (%)	2.6	2.4	2.4	2.8	3.0 --	2.8 --
China Unemployment (%)	4.2	3.8	3.6	4.2	3.8 --	3.7 ▲
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 --	0.00 --
Japan 2Y Note	-0.13	-0.15	-0.13	-0.13	-0.09 --	-0.12 ▼
Japan 10Y Bond	0.09	-0.01	-0.02	0.02	0.12 ▲	0.13 ▲
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.63	2.75	2.75	2.75	2.80 ▼	2.59 ▲
China 10Y Bond	3.16	3.30	3.13	3.14	3.21 ▼	3.16 ▼
Currencies						
USD/JPY	108.96	110.27	108.61	103.25	108.00 ▲	108.00 ▼
USD/CNY	6.47	6.86	6.98	6.52	6.44 ▲	6.38 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 3, 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 groundwork for 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 the wounds that remain beneath the surface 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 May 3, 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 supply chain 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 boost from reopenings 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 to be 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 increases 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 vaccinations progress 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	3.5%*	3.5%*	2%*	2.5%*	2.5%*	2%	Firm commitment to fiscal stimulus and structural support should limit downside risks to growth, though the latest resurgence in cases and accompanying state of emergency declaration are new downside shocks
	Inflation	0.5%	1%	1%	0.5%	0%	0.5%	
	Unemployment	2.5%	2.5%	3%	2.5%	3%	3%	
China	Growth	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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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	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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