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GRAND REOPENING: NEW OPPORTUNITIES, OLD RISKS

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- **Vaccine security will shape the grand reopening.** While advanced economies delivered on immunization campaigns, vaccine hesitancy and second-generation vaccines are first-order priorities. In the meantime, under-vaccination in Asia and in Emerging Markets may cause desynchronized growth paths.

- **A multifaceted recovery: high-pressure economics in the US, low-pressure economics in Europe.** We expect global GDP to grow by +5.5% in 2021, with the US being a clear outperformer. In Europe, the return to pre-crisis levels will take one year more compared to the US (Q1 2022) and the return to the pre-Covid-19 growth path an extra four years – if it happens at all.

- **Revenge spending is happening but residual savings to amount to EUR500bn in Europe, and USD1trn in the US.** Consumption will lead the recovery as we expect pent-up demand to reach 3% of GDP in the US and the UK, and around 1.5% of GDP in Europe. However, hoarding behaviors remain for precautionary reasons, complicating policy choices down the road.

- **Inflation, what inflation? Bottlenecks in terms of supply (raw materials, transportation capacity, workers) will likely keep cost inflation at a five-year high until the end of 2021.** Companies' pricing power remains limited, notably in Europe. Households' purchasing power will be under pressure as the employment gap (4 million jobs in the Eurozone and more than 7 million in the US) will keep wage inflation in check. But no monetary inflation is likely as the velocity of money is at a record low.

- **The Faustian pact between expansionary fiscal and monetary policies is here to stay.** We expect central banks to be patient before hiking rates in 2023 (some exceptions: Norway, New Zealand, the UK by September 2022). Total global debt increased by more than USD24trn in 2020, including USD12trn of public debt and USD12trn of private debt. Emerging Markets are more exposed to a sudden shift in market sentiment, which would impose a disorderly adjustment of currencies and debt.

- **Political crossroads ahead for Europe but no repeat of the 2012 crisis in 2022.** In the Eurozone the Next Generation EU fund and the ECB will support the recovery and keep financial stress at bay while German-French elections may create policy surprises. Yet, watch out for heterogeneity.

- **Credit risk under control.** The insolvency puzzle continues as corporate debt increased to new highs but cash on the balance sheet did, too, and liquidity support to firms will continue into 2022. European non-financial companies will have to increase their margins by 1.5pp on average in order to make their debt sustainable.

- **Green is the new black of industrial policy.** The transition towards a cleaner model of growth will require the definition of a real new industrial policy, consisting of generating new fiscal resources, subsidizing the transition, protecting domestic producers and investing in infrastructure. Over the 2021-50 period, annual energy sector investment has to increase by around 1% of global GDP compared to today's levels to enable a net-zero energy transition. With USD1.3trn, investment in renewable electricity will need to surpass the highest level ever spent on fossil fuel supply (USD1.2trn in 2014).

- **Political risk remains amid a new US paternalism and tactical multilateralism**. The US has launched a new wave of global and multilateral initiatives for climate change and tax policies. But such a revival in international engagement does not necessarily mean unselective multilateralism: so far in 2021, the US has been the most active with trade protectionist measures and China and Germany the most targeted (in net terms). While the Asia-Pacific region could see some acceleration in the expansion and implementation of free trade agreements (eg. RCEP, CPTPP etc.), it is not immune to pre-existing geopolitical tensions that have worsened with the Covid-19 crisis (eg. China and the "Quad").

- **Markets' risk-on music keeps on playing but mind endogenous financial instabilities.** Most asset classes are front-running the grand reopening and strong policy support far better than expected. But the upside is limited now while growing imbalances increase risks to the downside.

Figure 1: Real GDP growth forecasts, %

	2019	2020	2021	2022
World GDP growth	**2.4**	**-3.5**	**5.5**	**4.1**
United States	2.2	-3.5	6.3	4.0
Latin America	**0.2**	**-7.1**	**5.2**	**2.9**
Brazil	1.4	-4.4	3.8	2.5
United Kingdom	1.4	-9.9	6.0	4.9
Eurozone members	**1.3**	**-6.5**	**4.2**	**4.2**
Germany	0.6	-5.1	3.4	3.8
France	1.5	-8.2	5.4	3.6
Italy	0.3	-8.9	4.4	4.6
Spain	2.0	-10.8	5.1	5.3
Russia	2.0	-3.1	3.1	3.2
Turkey	0.9	1.8	8.3	4.1
Asia-Pacific	**4.1**	**-1.1**	**6.3**	**4.8**
China	6.0	2.3	8.2	5.4
Japan	0.3	-4.9	2.5	1.9
India	4.1	-7.5	7.9	6.4
Middle East	**0.0**	**-5.0**	**2.8**	**3.0**
Saudi Arabia	0.3	-4.1	2.4	2.9
Africa	**1.7**	**-2.8**	**2.7**	**3.5**
South Africa	0.3	-7.0	2.2	1.9

NB: Weights in gloabl GDP at market price

NB: fiscal year for India

Sources: Euler Hermes, Allianz Research

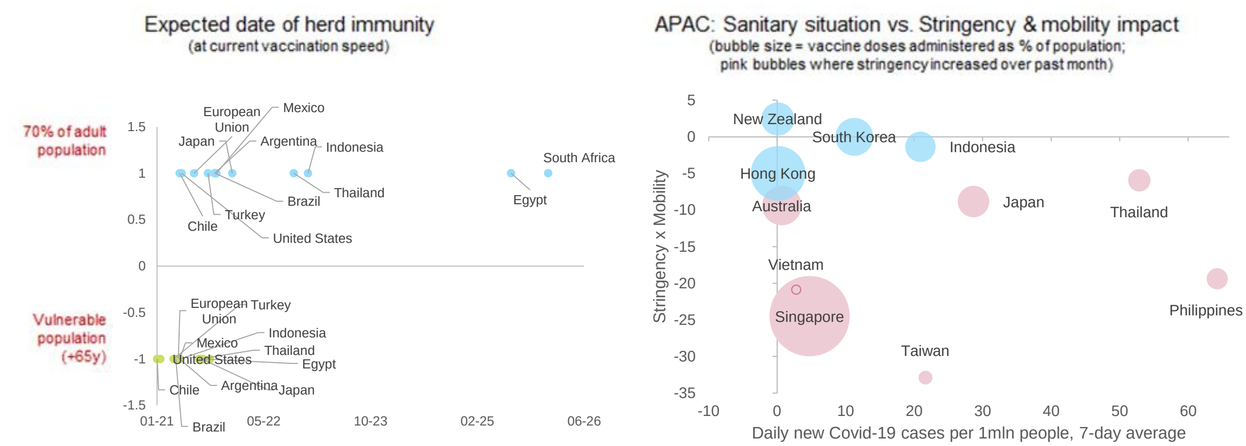
A GRAND REOPENING, BUT A MULTIFACETED RECOVERY

Vaccine security to shape grand reopening. While advanced economies delivered on immunization campaigns, vaccine hesitancy, and second-generation vaccines, are first-order priorities. However, avoiding the vaccination fatigue trap will be key for a sustainable reopening as demand-side hurdles are now following the supply-side ones. In the meantime, under-vaccination in Asia and in Emerging Markets may cause desynchronized growth paths. Stop-and-go government strategies to cope with the increase in new cases – albeit more moderate than previous waves - are still likely to continue.

Multifaceted recovery. High-pressure economics in the US, low-pressure economics in Europe. After nearing pre-crisis levels of growth in Q1 2021, fueled by the US and China, the global economy looks set for a strong mechanical recovery in the coming quarters amidst a grand reopening in several advanced economies. We expect global GDP to grow by +5.5% in 2021, with the US being a clear outperformer and the only economy where growth will exceed its pre-Covid-19 path from the end of the year. In Europe, the return to pre-crisis levels will take one year more compared to the US (Q1 2022) and the return to the pre-Covid-19 growth path an extra four years – if it happens at all.

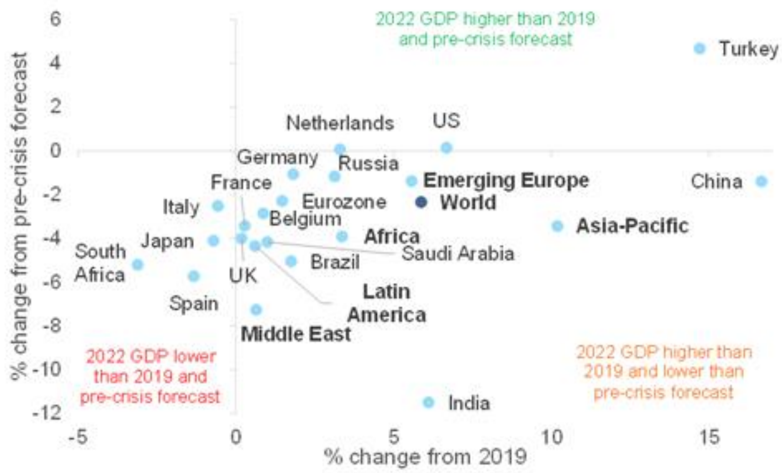
Global trade is set to rebound strongly in 2021, but bottlenecks will lead to short-term hurdles. We forecast growth of +7.7% in volume terms (after -8.0% in 2020) and +15.9% in value terms (after -9.9% in 2020), supported by favorable base effects, a stronger-than-expected momentum in the first months of the year and expectations of robust exports out of Asia-Pacific, as well as strong imports in the US, Europe and China.

Figure 2: Covid-19 sanitary and vaccination situation



Sources: Our World in data, Duke university, Euler Hermes, Allianz Research

Figure 3: 2022 GDP, compared to 2019 and to pre-crisis forecast



Sources: Various, Euler Hermes, Allianz Research

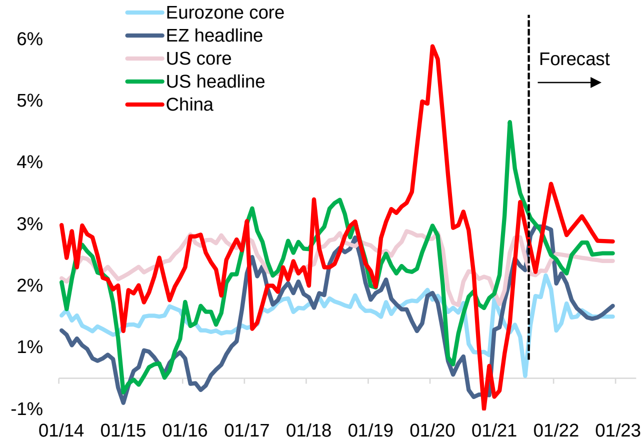
Indeed, the global exports rebound has until now clearly been driven by the Asia-Pacific region, with exports from most other regions still below pre-crisis averages. However, the global supply-demand imbalance could be exacerbated during the summer, given new Covid-19 outbreaks in Asia-Pacific, notably in Taiwan, on which the world has become increasingly dependent in the electronics sector. The impact of these outbreaks on trade volume is likely to be temporary and limited to Q2 (after which the epidemics in Asia-Pacific trade hubs should be controlled), while high prices due to input shortages are likely to remain for most of this year.

Revenge spending is happening but residual savings to amount to EUR500bn in Europe, and USD1trn in the US. The grand reopening sets the stage for a V-shaped recovery, but global supply still needs to catch up. We estimate pent-up consumption at 3% of GDP in the US and UK in 2021, and at around 1.5% in most European countries. Consumption will lead the recovery but hoarding behaviors remain for precautionary reasons, complicating policy choices down the road. At the same time, global supply chains remain disrupted, with suppliers' delivery times and container prices from Asia at record highs. As effects from fiscal stimuli will start to be even more visible in the US as well as in the Eurozone in the coming months, demand for goods will remain high (notably for building materials and semiconductors), bringing input prices to a record high during the summer. This situation is likely to prevail until the end of the year before demand starts normalizing and production capacity ramps up, thanks to upcoming business investments. The key question will remain companies' pricing power capacity, which is limited, notably in Europe[1].

Inflation, what inflation? Bottlenecks in terms of supply (raw materials, transportation capacity, workers) will likely keep cost inflation at a five-year high until the end of 2021. Global inflationary pressures are at record high levels but the good news is that they are mainly driven by energy prices and USD appreciation, which should prove temporary. The cost inflation is likely to prevail until 2022, when pressures from labor shortages should reduce along with the rise in input and asset prices. Competition to access the workforce will significantly intensify with the grand reopening. The time needed for the reallocation of the workforce, the lower incentive to work in the immediate aftermath of the reopening (relief effect) and the persistence of high social transfers could weigh on the pace of the job market's recovery as mirrored by disappointing numbers of non-farm US payrolls in April. In the UK, job shortages have continued to intensify since the second stage of eased restrictions in April, notably in the transportation, construction and catering and hospitality sectors. In the medium-run, negative output gaps should keep wage pressure in check as well as the employment gap compared to the long-term average (4 million jobs in the Eurozone and more than 7 million in the US). In addition, companies have limited pricing power, notably in Europe. Finally, there is no monetary inflation as the velocity of money is at a record low.

[1] See our recent report *Pricing superpowers: Which sectors have them in the Eurozone?*

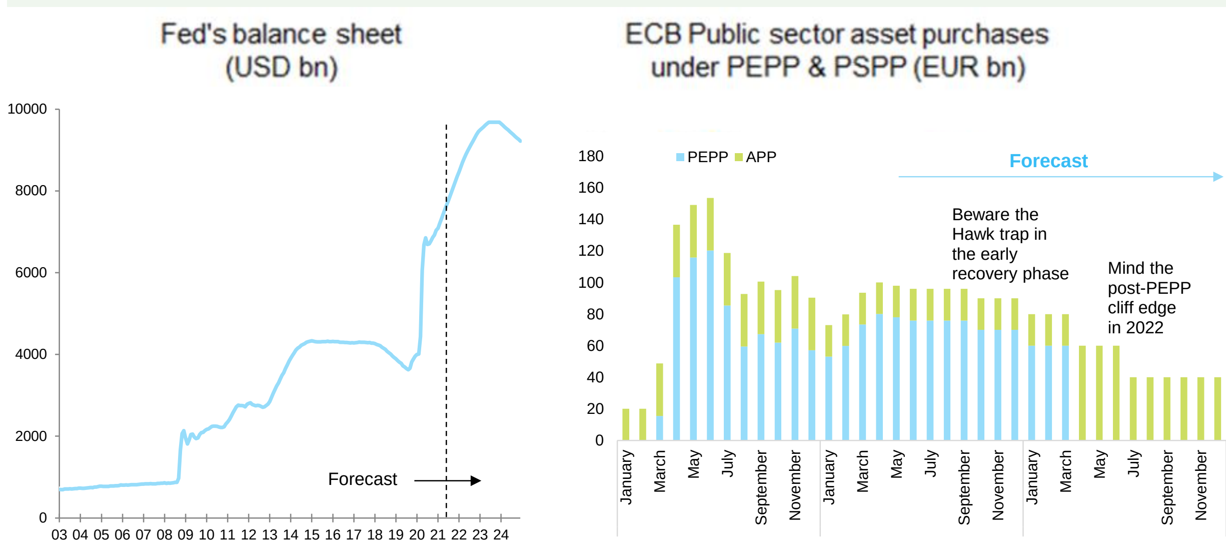
Figure 4: Inflation forecast



Sources: Refinitiv, Euler Hermes, Allianz Research

Faustian pact between expansionary fiscal and monetary policies to stay. In the short-term, central banks will continue remaining highly accommodative (with some exemptions such as Norway, New Zealand and the UK by September 2022). The Fed is expected to deploy some elements of language on tapering starting next year, with an operation twist from Q2 2022 and then a gradual reduction in securities purchases from USD120bn per month to 0 in H2 2023, followed by a first rate hike in H2 2023. The ECB will continue to ensure favorable financing conditions during the early phase of the recovery even as Eurozone inflation is likely to overshoot at 2.5% y/y in H2 2021. Ideally, it should move away from pre-committing to a quarterly purchase pace in an effort to make full use of PEPP's inherent flexibility. From September onwards, the ECB should start to give more guidance on what "life after PEPP" will look like. In particular, the focus will shift to the management of the PEPP cliff-edge when the programs end in March 2022. The monthly asset purchases under the APP will most likely have to be lifted – at least for a few months – to EUR40-60bn to continue to ensure favorable financing conditions. However, this could see the ECB run into German debt limits: We calculate that EUR40-60bn in monthly APP purchases would only allow for the APP to continue for seven to 10 months after March 2022. As we have learnt in the past, the ECB tends to have another trick up its sleeve i.e. limits can be moved. In that regard, the results of the ongoing ECB strategy review expected in September could come as a game-changer, including by rolling over PEPP's flexibility to APP. Some Emerging Markets should be an exception against rising imported inflation as protection of real household purchasing power will remain the focus in an environment of increasing middle-income traps and social risk. Brazil, Romania, Czechia, South Africa and Nigeria are likely to hike three times by mid-2022.

Figure 5: Fed & ECB scenarios



Sources: Refinitiv, Euler Hermes, Allianz Research

Political crossroads ahead for Europe but no repeat of the 2012 crisis in 2022. Europe has learned from its crisis mistakes of the past, so don't expect to see any active fiscal or monetary tightening before H2 2022. In fact, the Next Generation EU fund, next to providing a GDP boost of +1pp in 2021, will also cushion fiscal consolidation needs with grants not included in national deficit calculations. Meanwhile the ECB will look through the temporary inflation overshoot and focus on maintaining favorable financing conditions, closing spreads (i.e. Italian fiscal heterogeneity will be managed) and boosting policy room for maneuvering via the strategy review as German debt limits are moving closer. Among the large EU countries, Italy will stretch its national fiscal space the most (public deficit of 11.8% and 5.8% of GDP in 2021 and 2022) and, at the same time, will receive by far the largest share from the EU Recovery Fund (EUR192bn, of which EUR69bn in grants). The prospect of a lasting fiscal integration in the EU therefore depends on the success of the Italian recovery plan. If the implementation is effective, Italy could indeed regain political credibility in the eyes of the "frugal" sceptics. Capital markets have yet been complacent with Italy's aggressive fiscal policy. The 10y spread over Germany has stabilized in a range of 110 to 90bp. With ECB purchases, fiscal variables have indeed lost much of their explanatory power for spread movements; a dangerous spread-widening is only likely if the "Draghi put" expires and political risk ("Italexit") reappears. In this context, the general elections of H1 2023 are the next decisive event. Factoring in national elections in other key political heavyweights Germany (base case: CDU/Green party coalition) and France will keep a lid on EU integration momentum until spring 2022 while thereafter we expect to see more evolution (investment in green & digital) than revolution. In France, on the one hand, to avoid any social discontent, we do not expect the government to implement any ambitious and controversial reforms until the elections. On the other hand, President Macron will also need to reassure the electorate regarding pre-Covid commitments such as the pension reform that it still qualifies as an "absolute necessity". In this context, there is a slim chance that the government pushes for a softened version of the reform that is likely to trigger protests and social unrest again.

Herd policymaking: interventionism will still be at work in 2021. Switching from short-term to long-term policy will be gradual, and a complete withdrawal can take up to one year. Removing state support means a higher risk of policy mistakes, especially as in theory firms still hold high cash balances[2], which might tempt some policymakers to withdraw assistance mechanisms faster. The increase in cash balances of non-financial companies as of April 2021 was EUR180bn in France, EUR169bn in the UK, EUR 95bn in Germany and EUR81bn in Italy. However, this cash should finance the recovery (i.e. stocks and WCR) and the new investment cycle, not a deleveraging process.

Avoiding the mistakes of an early or disorderly fiscal tightening will be key for the sustainability of the recovery. China is already engaged in reducing its monetary and fiscal impulses and other countries could be tempted to follow suit. However, terminating assistance mechanisms in a premature manner could, for example, be the trigger of a new wave of insolvencies among non-financial companies. Bringing long-term perspectives to the corporate sector with infrastructure projects and clearly defined industrial policies could restore confidence and liberate excess cash in the corporate sector. In the UK, for example, the phase-out of policy support measures is set to take a full year. The furlough scheme ends in September 2021 though the reopening started in April. Meanwhile, the state-guaranteed recovery loan scheme ends in December 2021, all the discounted business rates end in March 2022, the reduced VAT rate ends in April 2022 and the state-guaranteed mortgage loan scheme ends in December 2022.

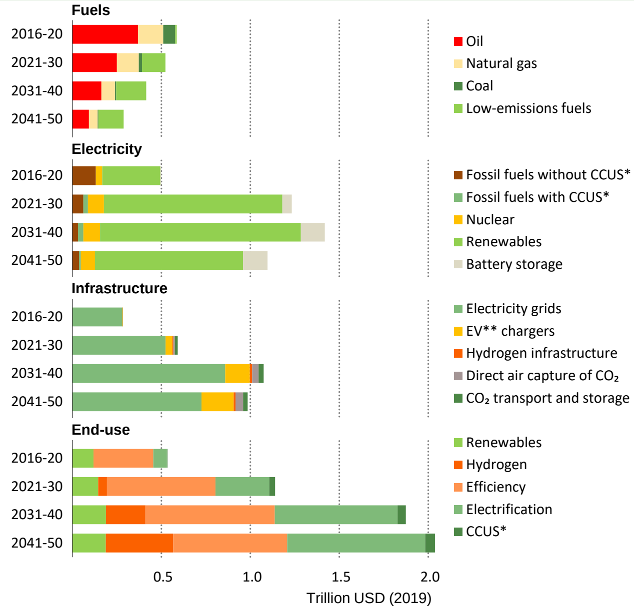
An asymmetric normalization of credit risk across sectors. Massive state interventions helped suppress a significant wave of insolvencies in 2020, with the year ending with a -12% drop globally rather than a +40% surge (ceteris paribus estimation). We expect a pragmatic and fine-tuned phasing-out of support measures in order to manage the pressure on companies' liquidity and solvability. Indeed, cash on balance sheets increased to new highs at a global level but so did corporate debt[3]. This will command European non-financial companies to increase their operating margins to keep their debt sustainable (by 1.5pp on average, everything else being equal). In addition, the sectorial asymmetry of the shock led to wide heterogeneity across sectors in terms of revenue, profits and impact on balance sheets. De facto, credit risk ratings recorded a stronger hit in sectors that bore the brunt of social and mobility restrictions, such as hotels and restaurants and transportation, with substantial positive performance conversely in chemicals, pharmaceuticals, retail and agrifood. The V-shaped global recovery will lead to a rebalancing in credit ratings from the wave of deteriorations posted in 2020 but the heterogeneity across sectors is likely to prevail until 2023.

The global economy could spontaneously converge toward a new Marshall plan for a climate-friendly recovery. We calculate that the USD2.3trn infrastructure package has the potential to maintain the US economy's growth potential at close to +2% by 2030 instead of +1.4% without it. However, execution risk could pose a problem for the EU EUR750bn Recovery Fund. Accompanying demand over the medium-term will be key in order to liberate excess savings not consumed via pent-up demand. Around 40% of the excess cash from households and companies (currently at more than 10% of GDP in both the US and Europe) will morph into spending by year-end, thanks to high pent-up demand. The unleashing of the 60% remaining will depend on the size of a positive confidence shock that only a long-term, massive and coordinated fiscal plan can initiate. In the IEA projections (Figure 6), for a net-zero emission compatible transition, investments need to increase rapidly in electricity generation, infrastructure and end-use sectors while fossil fuel investment drops sharply.

[2] See our recent report *European corporates: cash-rich sectors get richer*

[3] See our recent report *European corporates: It could take 5 years to offload Covid-19 debt.*

Figure 6: Projected global average annual energy investment needs for the net-zero energy transition



*Source: International Energy Agency (2021), Net Zero by 2050, IEA, Paris: Net Zero by 2050 Scenario. *CCUS: Carbon capture, utilization and storage; **EV: Electric vehicle.*

In particular, annual investment in electricity generation would need to increase from about USD0.5trn to USD1.6trn in 2030. The USD1.3trn of investment in renewable electricity is in the range of the highest level ever spent on fossil fuel supply (USD1.2trn in 2014). Energy infrastructure should increase from around USD290bn to USD880bn in 2030 and include electricity networks, public electric vehicle (EV) charging stations, hydrogen refueling stations and import and export terminals, direct air capture and CO2 pipelines and storage facilities. Investments in end-use sectors should rise from USD530bn to USD1.7trn in 2030 and include spending on deep retrofitting of buildings, transformation of industrial processes and the purchase of new low-emissions vehicles and more efficient appliances.

Besides supporting demand, large infrastructure projects will define new industrial policies with similarities across countries, pushing via innovation and subventions towards cleaner energy models, fostering digitization. They will not only maintain a high level of protectionism, but also result in more coordination at a global level in terms of tax policy, using multilateralism and climate policy as a tactical tool of domination by the law. The US will be at the forefront of what we could consider as a new form of paternalism. Disclosure can play an important role in fostering protectionism as supply chain laws coupled with ESG KPIs that, for instance, include labor and human rights, result in diverging investment flows away from foreign "red-flagged" activities into domestic ESG overperformers.

Political risk remains with a form of US paternalism and tactical multilateralism. Joe Biden's foreign policy marks a revival of large-scale multilateral initiatives such as the organization of a virtual two-day climate summit in April 2021 or the proposal of a global minimum corporate tax rate of 15%. This approach, which could be compared with a form of paternalism or a leadership by the law or norms, initiates in our view a form of tactical multilateralism. In the case of the tax initiative, there is a strong need to find new fiscal resources. Total global debt has increased by more than USD24trn between Q4 2019 and Q4 2020, including USD12trn of public debt and USD12trn of private debt. USD10trn of supplementary debt is expected to be issued in 2021. The need to find new sources of fiscal revenues will imply not only raised taxes at a domestic level but also at an international level. In terms of climate change policy, a leadership position will offer the possibility to impose new norms (of trade among others) internationally.

Such a revival in international engagement indeed does not necessarily mean unselective multilateralism. Indeed, trade protectionist measures are still being implemented in 2021, with the US being the most active and China and Germany the most targeted (in net terms). Regulation affecting digital commerce is also becoming increasingly apparent at the global level. While the Asia-Pacific region could see some acceleration in the expansion and implementation of free trade agreements (e.g. RCEP, CPTPP etc.), it is not immune to pre-existing geopolitical tensions that have worsened with the Covid-19 crisis. Notably, China's relations with each of the Quadrilateral Security Dialogue members (the US, Australia, India and Japan) have become more tense over the past year, with trade tensions and territorial disputes. While we do not expect these issues to become economically significant in the short term, they are symptomatic of a change of dynamics in the geopolitical and global initiative spheres.

MARKETS HAVE ALREADY CELEBRATED, NOW THEY HAVE TO DIGEST

The Fed Funds future market does not expect more than a 25bps hike in the next two years. Investors remain thus aligned with the Fed's communication to deliberately take the risk of being behind the curve. However, so far in Q2, movements in capital markets have been much more muted and contrasted than in Q1, during which a clear growth positioning took hold of all market segments. Markets have not challenged the reflation trade that dominated Q1, but they are now showing more concern about the inflation risk and the future course of monetary policy. So while the economy is gearing up for the grand reopening, capital markets are already one step ahead.

This rising uncertainty can be seen very clearly when decomposing nominal long-term US yields into their expectation and risk components (nominal term premium). Since the beginning of the year, the 60bp increase of US 10y yields is almost entirely due to the risk component (nominal term premium), reflecting heightened uncertainty about the economic and monetary equilibrium of the post-Covid era. Long-term expectations about inflation and the real equilibrium rate have so far remained anchored.

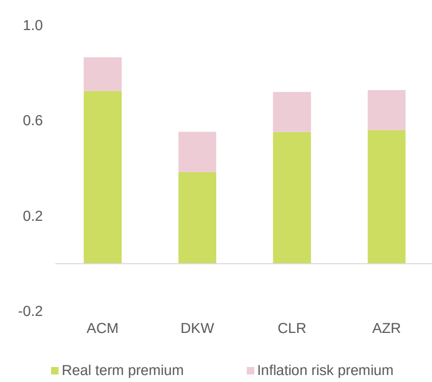
At first glance, this seems to be at odds with the development of break-even inflation, which rose by another 10bps to close to 2.5% for the 10-year maturity, pushing real yields further into negative territory (-25bp). But again, the breakdown of risk and expectation components shows that the recent rise is not due to a change of long-term expectations but to tight market conditions (liquidity risk premium). The reflation trade is becoming increasingly crowded (eg. strong inflows into TIPS ETFs) while TIPS supply is withdrawn by central bank purchases. Adjusted for the liquidity risk premium, real yields have actually recovered to pre-crisis levels, so the recovery is already fully priced in.

Figure 7: US 10y - breakdown of YtD increase (different term structure models*)

*Term structure models used: ACM (Adrian, Crump & Moench, 2013), DKW (D'Amico, Kim & Wei, 2018), CLR (Christensen, Lopez & Rudebusch, 2010) and AZR (proprietary Allianz Research Model)

Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 8: US 10y term premium – breakdown of YtD increase (different term structure models*)



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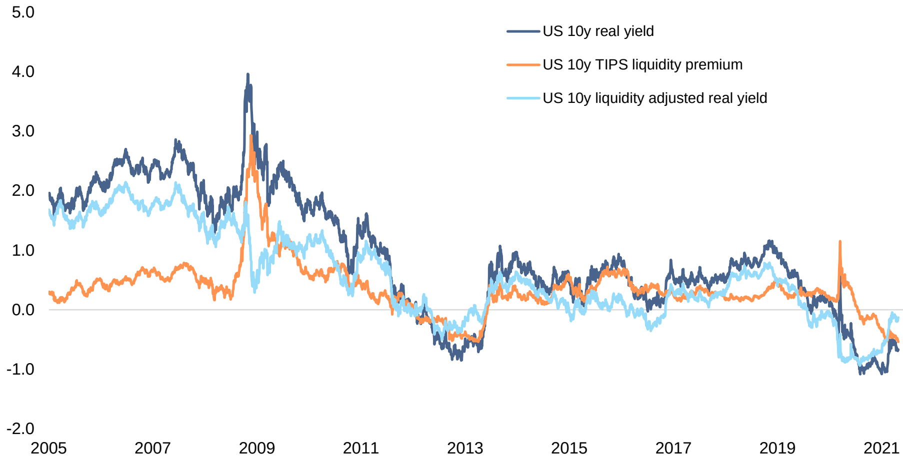
Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 9: US 10y real yield – recovery fully priced in after adjusting for market frictions*



Sources: Refinitiv, Euler Hermes, Allianz Research

In our view, markets now have limited upside potential. Sovereign bond markets in the US but also the Eurozone have rebuilt a cushion against uncertainty. Their risk component of nominal yields is large by historical standards. The distribution of potential outcomes is skewed to the downside, especially in the US. We see only a 14% probability for the US 10y yield to finish the year above 2%. The rise of the US curve also impacted European yields and helped the Bund 10y to catch up to fair value (-0.25%). Improving economic momentum and increasing tapering rumors have also contributed. We think that a switch into positive territory could be possible (18% probability), but we would not consider it sustainable.

On the one hand, monetary and financial conditions will continue to be supportive, especially for risky assets. On the other hand, perceived inflation risk, a new global sharing of the value added, regulation and new assertive industrial policies create the potential for financial instability. Monetary aggregates show strong fluctuations as the velocity of money (the flow of "liquidity") is far more unstable, especially in financial markets, than its quantity (the stock of "liquidity" generated by QE). Risky assets are thus not totally in a safe spot.

Credit spreads have remained close to the year lows, but the most interest rate-sensitive stocks or equity sectors have moved sideways or fallen. Former market darlings such as Tesla or the Ark Innovation ETF now trade close to ~35% below the year high.

Other highly speculative plays, such as cryptocurrencies, have also taken a hit. Note that the correlation between Tesla and Bitcoin has recently increased (Figure 9). In the wake of the reflation trade, the gold sector (gold itself and gold mines) is on track to deliver double-digit returns in Q2 after posting negative returns in Q1.

All in all, it is past midnight for risky assets! As we showed in our last quarterly publication, our Kindleberger market cycle clock[4] keeps ticking and has now made it past midnight. The combination of extreme valuations paired with elevated levels of overtrading has led to large but isolated market corrections and is increasing the current market fragility. Among several late market cycle indicators, the rapid market correction of "new" overtraded assets, as is the case for SPACs (Special Purpose Acquisition Companies) and cryptocurrencies, have caught the eyes of many market participants.

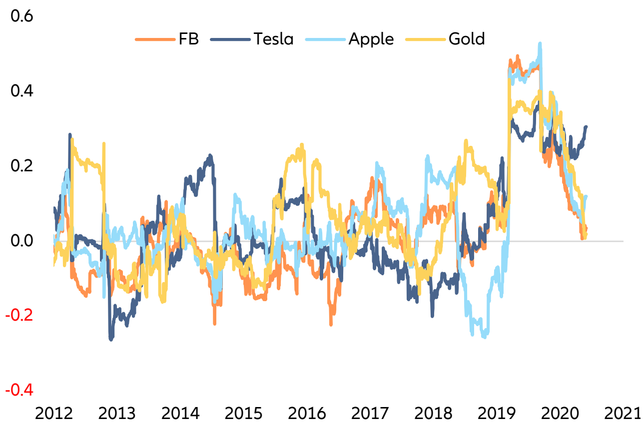
SPAC IPOs have come to a halt in Q2 2021, leading the market to substantially correct. This comes after a substantial acceleration in both volumes and prices of this "new" financial instrument in 2020 and Q1 2021. As of today, more than 60% of the SPAC mergers that have been announced since the start of the year are now trading below the IPO price of their SPAC.

As for cryptocurrencies, in early Q1 2021 the aggregated market cap of cryptocurrencies skyrocketed above the USD2trn mark, only to lose more than USD500bn in a matter of days. It must be conceded that cryptocurrencies are no strangers to such sharp movements but the natural question that arises is where did this money go? Although the answer in this "new" investment is not straightforward, it confirms the recent market exuberance, overtrading and irrationality.

Another clear red flag that combines overtrading with increased moral hazard is the rapid increase in money velocity within financial markets. This increase is relevant as it shows that the recent equity rally has partly occurred thanks to the market's unconditional trust in central banks' unconditional put protection, which has, in turn, led to a rapid increase in financial money velocity. This red flag is particularly important as **it is not the quantity of money but its circulation that causes asset prices to rise or fall** and historical experience shows us that central banks do not control the velocity of money, especially in capital markets.

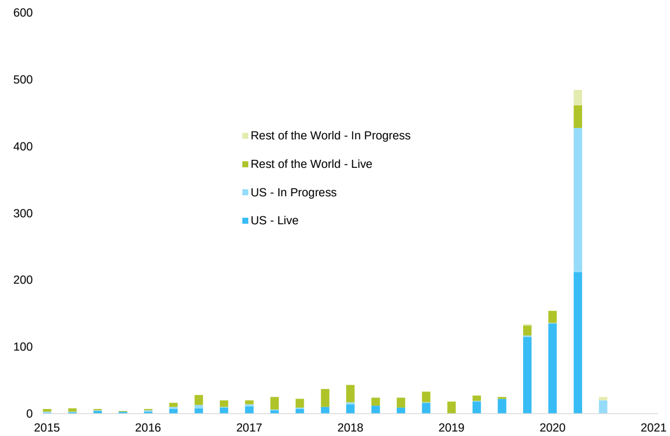
[4] See our Q1 2021 global economic outlook *Race to the post Covid-19 recovery: 7 obstacles to overcome*.

Figure 10: Bitcoin correlations



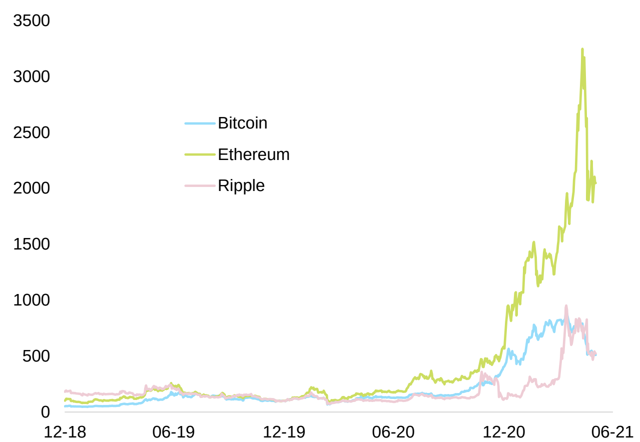
Sources: Refinitiv, Euler Hermes, Allianz Research. Correlations are computed using a 6M rolling correlation on daily changes

Figure 11: # of SPAC IPOs (live & in progress)



Sources: Refinitiv, Euler Hermes, Allianz Research.

Figure 12: Cryptocurrencies vs USD (100 = 31.12.2019)



Sources: Refinitiv, Euler Hermes, Allianz Research.

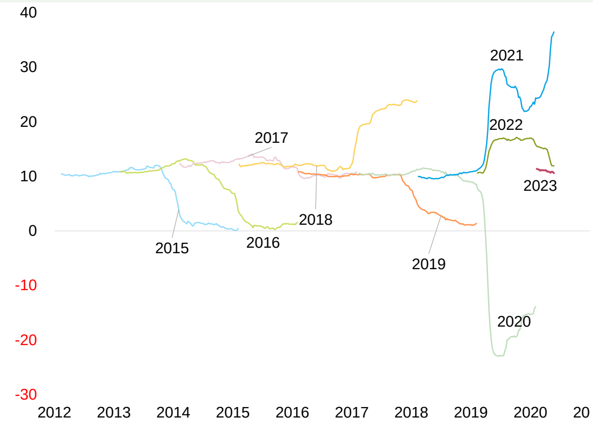
Figure 13: Capital markets transactions velocity

Sources: Refinitiv, Euiler Hermes, Allianz Research.

Finally, another signal of the recent market frothiness and overtrading can be found in the increasing amount of margin debt and deposits in US clearinghouses, triggered by the rapid increase in options trading volumes since March 2020. At this point, things start to take a systemic flavor and although we maintain that, at current levels, there is enough public and private liquidity in the market to absorb the increased trading volumes, it is an overtrading red flag.

On the fundamentals side, there has been a clear global frontloading of "good" earnings surprises into 2021, to the detriment of 2022 earnings expectations. This pattern can be observed across the globe and specifically in the Eurozone and Emerging Markets. Despite being a normal consequence of the strong Q1 earnings season, the grand reopening may not grant enough positive earnings tailwinds to warrant the extreme amount of frothiness and positive expectations. Because of this, the current over-stretched earnings expectations leave little to no room for further upside potential as the probability of experiencing at or below expectations earnings numbers far outpaces that of experiencing upside earnings surprises. This leaves markets in a really fragile spot and at the mercy of changes in investor sentiment.

Figure 14: S&P 500 consensus EPS growth (in %)

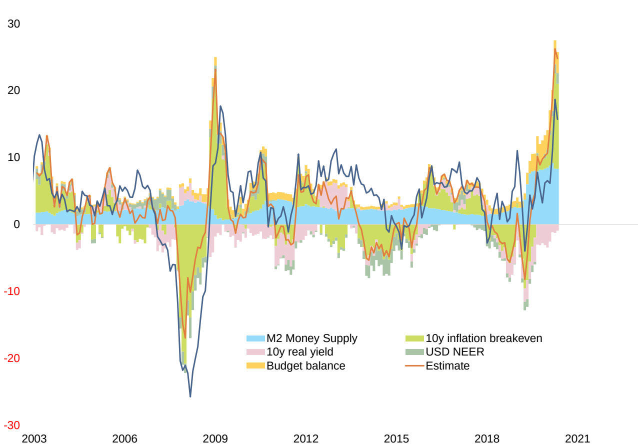


Sources: IBES, Refinitiv, Euler Hermes, Allianz Research

But what does this all mean for risky assets? Despite the mounting evidence of an upcoming market clean-up/ consolidation, we remain convinced that policymakers are fully aware of the situation and would backstop any sign of a full-fledged market erosion. Due to that, we expect the unplugging of key support measures to be contained and extremely gradual to allow for a mild but structural re-convergence to fundamentals. In this regard, we expect global equity markets to finish 2021 with upper single-digit returns but to converge towards long-term average returns (~5 to 7%) in 2022. In this context, we still expect the Eurozone and the UK to outperform both US and EM equities.

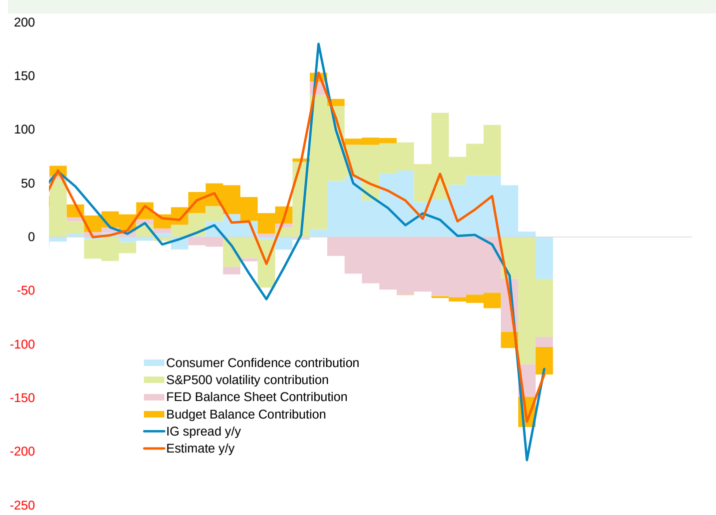
Similarly, and on the back of lax policies, credit spreads are set to range-trade for the remaining of the year while allowing for some initial market clean-up within the high yield space. Because of that, we believe investment grade credit will remain contained close to current levels until year-end while we expect some mild widening within the high-yield space due to early market consolidation. For 2022, we expect credit spreads to structurally widen at a 20 to 30bps rate for investment grade and 50 to 70bps for high yield as companies reattach to fundamentals and markets start repricing fundamental credit risk.

Figure 15: S&P 500 decomposition (in %)



Sources: Refinitiv, Euler Hermes, Allianz Research.

Figure 16: US investment grade spread decomposition (in %)



Sources: Refinitiv, Euler Hermes, Allianz Research.

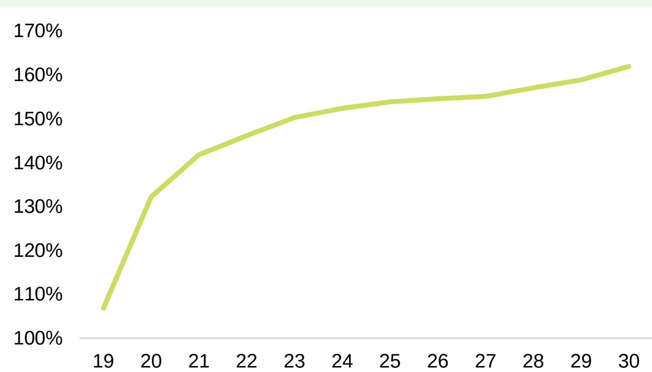
REGIONAL OUTLOOKS

In the US, fiscal policy remains at the forefront of economic policy initiatives to restore growth and create jobs post Covid-19. The proposal for an infrastructure package, initially estimated at USD2.3trn, has been revised on the downside to USD1.7trn by Democrats to give a chance for a bi-partisan agreement in the Congress by June 2021. Regarding the American Families Plan, the White House has reiterated its intention to increase public spending for childcare, healthcare and education by USD1.8trn by 2030.

Between Q1 2020 and Q1 2021, the US saw USD5trn of public spending. The multiplier effect has been impressive as mirrored by a strong rebound of growth, which was estimated at +6.4% q/q annualized in Q1 2021, coinciding with a level of national production already above the pre-crisis level. This impressive performance obviously resulted from the strength of both fiscal and monetary stimuli, but also from the success of the vaccination campaign (close to 65% of the adult population has been vaccinated, approaching the 70% herd immunity threshold). The latter has allowed for a swift reopening of the economy, boosting the effectiveness of economic policy.

We expect US GDP growth to reach +6.3% in 2021 and +4% in 2022 compared to the contraction of -3.5% in 2020. However, the window of opportunity to vote in new fiscal packages could be rapidly closing as mid-term elections are to be held in November 2022. On the back of a stronger fiscal impulse now penciled in our macroeconomic scenario, and as a result of stronger growth, we expect the slack of the US job market (8 million jobs lost during the crisis still need to be recovered) to rapidly decline and produce an acceleration of salaries, which should evolve close to +3.8% y/y at the horizon of 2022. Embodying a form of overheating, salaries will question the Fed's assumption that the current overshoot of inflation will be temporary. The ongoing acceleration of housing prices will also contribute to challenge this assumption as it announces an acceleration of the shelter subcomponent of the CPI index. Despite all of this, we expect US CPI to broadly normalize at 2.1% in 2022 compared with 2.5% on average in 2021 after the dilution of significant basis effects. This will give the Fed the opportunity to wait and see through H2 2021 before envisaging a tapering. However, stronger growth and higher inflation compared with our previous scenario could see a new Operation Twist announced in H1 2022 in order to reduce the size of MBS purchases and augment that of Treasuries in the USD120bn securities purchases that the Fed operates on a monthly basis. Any rate hike is still expected to take place in H2 2023 only.

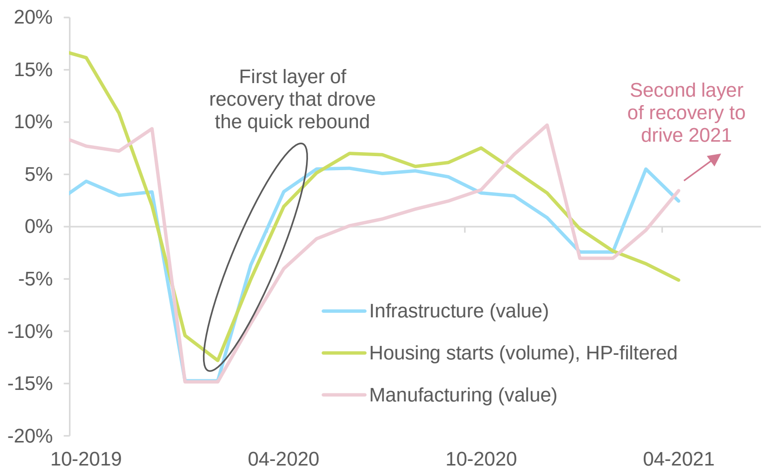
Figure 17: US public debt (as % of GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research.

In China, the overall solid recovery still needs to broaden, which means that gradual policy normalization remains the baseline scenario. We maintain our GDP growth forecasts at +8.2% in 2021 (after +2.3% in 2020) and +5.4% in 2022. The post-Covid-19 recovery of the domestic economy can be broken down into three layers. The first layer of public and policy-driven investment (infrastructure and real estate) was behind the quick rebound in 2020. 2021 is likely to be more focused on the second layer of private business investment in the manufacturing sector. Our proprietary credit impulse index is indeed a little more resilient for the private sector than overall. To make the domestic recovery fully broad-based, the third layer that needs to recover is private consumption. Labor market indicators are encouraging, with the unemployment rate at the lowest level since 2019, but household confidence is not yet back to normal. In such a context, policy normalization carried out in a gradual and flexible manner remains our baseline scenario. Authorities aim to control structural vulnerabilities (eg. in the real estate and financial markets) without jeopardizing the economic recovery. Short-term pressures related to rising input prices not transmitting to output prices support our expectation that the PBOC is likely to refrain from hiking policy rates this year. These pressures should ease going forward (producer inflation to peak in the coming months, while consumer core inflation is expected at 1.3% in 2021 vs. 0.8% in 2020), giving more room for the PBOC to use liquidity tools and macroprudential regulation to tighten the overall monetary policy stance, while directing loans to areas most in need. We expect the USDCNY rate at 6.3 at year-end. We estimate that fiscal support in 2021 (4.6% of GDP) will remain generous but lower than in 2020 (7.1%). The year-to-date local government special bond issuance has already dropped sharply (RMB230bn in April vs. RMB1,150bn a year ago), in line with slowing infrastructure investment.

Figure 18: China fixed asset investment by sector, 2y CAGR (%)



Sources: National Bureau of Statistics of China, Euler Hermes, Allianz Research

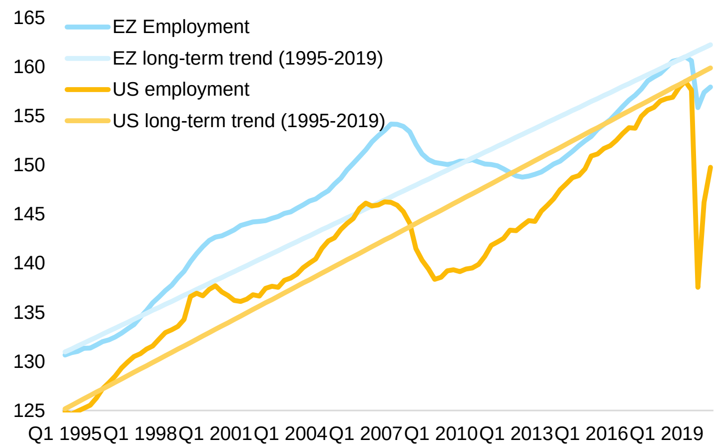
We expect Eurozone GDP to expand by +4.2% in both 2021 and 2022, with a return to pre-crisis levels in Q1 2022, almost a full year after the US. However, some member states, including Spain and Italy, will only reach this milestone at the turn of 2022/23.

The third wave of Covid-19 infections postponed the Eurozone's economic resurrection in Q1 2021. However, we see the economic stars aligning to set the stage for an unprecedented economic rebound over the rest of 2021. We expect the Eurozone to record some of the strongest quarterly expansion rates on record (second only to Q3 2020). Abruptly receding new Covid-19 cases and progress on the vaccination front (herd immunity should be within reach by late summer across the EU) will see Covid-19 restrictions eased swiftly (the stringency index should drop back to Q3 2020 lows in 2021).

In Q2 2021, the Eurozone recovery will be kicked off with GDP growing close to +2% q/q, thanks to strong base effects in those sectors that have been stuck in economic hibernation. Reduced economic uncertainty will in turn set the stage for a consumption-led catch-up growth spurt in the second half of the year (with excess savings to the tune of 1.5% of GDP turbocharging the recovery). Last but not least, Eurozone domestic demand will receive some tailwind from the EUR750bn EU Recovery Fund (GDP should be lifted by +1% in 2021 assuming no meaningful implementation delay) even though we expect it to be 20% smaller than advertised due to a lower loan take-up. Meanwhile continuous strong export demand, driven by the ongoing Chinese recovery and supercharged, stimulus-induced US GDP growth, will continue to boost GDP growth in the coming quarters as the global recovery momentum becomes more synchronized, even though industries will face lingering bottlenecks for the remainder of 2021 in the form of longer delivery times and component shortages.

At the same time, policymakers will continue to do "whatever it takes" to safeguard the recovery and shore up public support ahead of key elections in Germany (September 2021) and France (Spring 2022). Flagship fiscal measures, including furlough schemes (which will see the unemployment rate peak below 9%) and public guarantees, will be extended until at least fall 2021, whereas the ECB will continue to ensure favorable financing conditions during the early phase of the recovery, even as Eurozone inflation is likely to overshoot at 2.5% y/y in H2 2021.

Figure 19: Employment in millions, Eurozone vs US

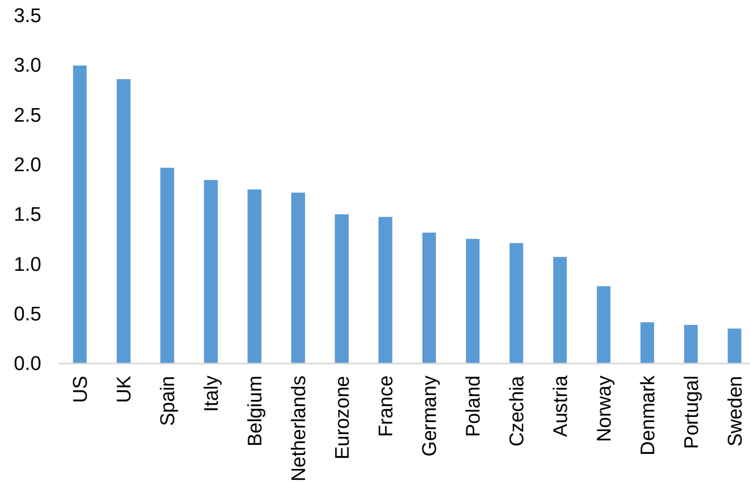


Sources: Refinitiv, Euler Hermes, Allianz Research

In Germany, after a rather disappointing start to 2021, the economic prospects are now very promising. In view of the recent decline in new infections and good progress on the vaccination front, the service sector is likely to have already started to catch up in May, accompanied by the first easing of restrictions. In the coming months, one positive economic record after the next can be expected in contrast to last year's plunge into the abyss. We expect an unprecedented consumption rebound (+3% in Q2/Q3), fueled by pent-up demand in a context of sharply declining economic uncertainty. Meanwhile, the ongoing industrial upswing – despite lingering rebound bottlenecks in the form of component shortages that should hold back production momentum – should fuel a capex boom. Overall, GDP growth should come in at +3.4% in 2021 and +3.8% in 2022. As a result, the German economy will return to pre-crisis GDP levels already by late 2021. However, one should be prepared for some economic restart difficulties. The abrupt reopening of the economy is likely to lead to acute labor shortages, especially in sectors that have been stuck in hibernation for months, including accommodation and food services. The imbalance between rapidly rising labor demand and impaired supply – Covid-19 has weighed on immigration and vocational training programs and, in view of poor prospects in some sectors, led to a reorientation of workers to sectors with brighter prospects - can be reduced by training offensives and at least temporarily higher wages. Given the notable rebound momentum, the German labor market should also embark on a firm recovery trend. By the end of 2021, almost one in two people who lost their jobs in the wake of the Covid-19 crisis should find new employment. The unemployment rate will, however, remain elevated at 5.8% in 2021 after 6% in 2020.

In France, the domestic economy will be the major driver of the post Covid-19 recovery. With the accelerating pace of vaccination and the progressive re-opening of all sectors, we maintain our growth forecast at +5.4% in 2021 and +3.6% in 2022. French households' excess savings reached over EUR140bn in the first quarter of 2021, thanks to supportive state measures that curbed the impact of the crisis on incomes. With the grand reopening, we expect the pent-up demand to boost GDP growth by around +2pp in 2021. In May, business confidence soared to a three-year high (above its historical average), while retail and services sectors have registered strong confidence gains. This rebound in confidence in the services sector, unprecedented in history, finally gives us a glimpse of the end of the multi-speed recovery between sectors. The presidential election will take place in less than a year, though only a few candidates, including Marine Le Pen, have officially announced that they will run. President Macron has unofficially started his re-election campaign on the back of easing sanitary restrictions. In addition to security and immigration, we expect the following economic issues to shape campaigns: (i) boosting industrial competitiveness and export performance via production tax cuts and other economic incentives, (ii) achieving a green transition and implementing socially acceptable environmental policies, (iii) how to support the incomes of those in precarious conditions and (iv) pension and social security reforms.

Figure 20: Catch-up consumption in 2021, % of GDP

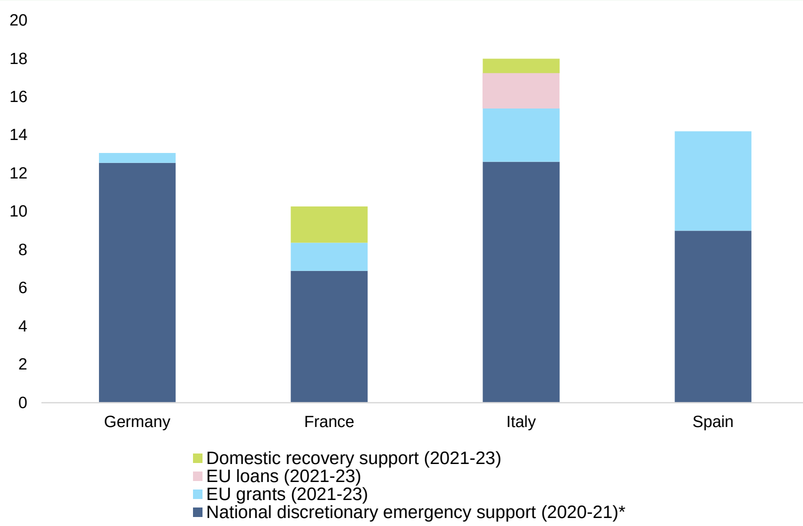


Sources: Eurostat, Euler Hermes, Allianz Research

Italy is targeting the biggest fiscal stimulus among Eurozone peers in 2021-22. Prime Minister Draghi's "calculated risk" of accelerating the reopening at an early stage of the vaccination campaign seems to be paying off so far as infection numbers continue to decline. Moreover, the summer seems to be saved for the tourism sector (13% of GDP). Consumption will rebound as the economy reopens. The recent strength of investment could be a signal of borrowing switching from crisis mode (focused on working capital and debt restructuring) towards new investment. We expect real GDP to grow by +4.4% in 2021 and +4.6% in 2022.

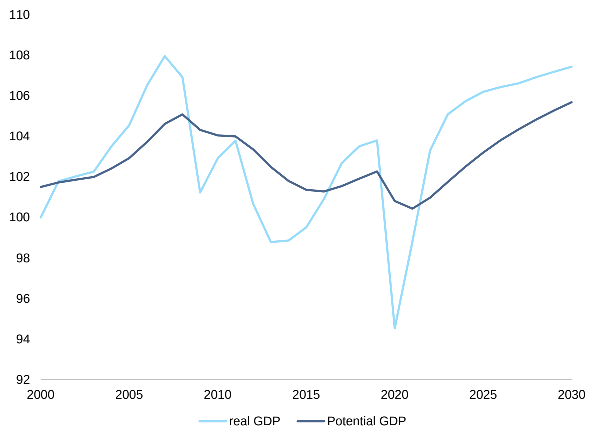
The strong fiscal stimulus remains the underlying force of the recovery. Italy has played the fiscal card more than other Eurozone countries, with the government so far mobilizing EUR170bn (10% of GDP). This year alone, the deficit has been revised twice from -7.5% to -11.8% of GDP. It is still expected at -5.8% of GDP in 2022 in addition to disbursements of the NGEU (around 1.2% of GDP in 2022). The flipside is the public debt level rising to 159% of GDP, and likely to remain above 140% for the next 15 years. But this need not be a problem if the national recovery plan (EUR248bn, of which EUR192bn by NGEU) succeeds in increasing potential growth (target of 0.4% to 0.6% p.a.) while financing costs remain low.

Figure 21: Italy's fiscal spending plans



Sources: PNRR, EU Comission, Euler Hermes, Allianz Research

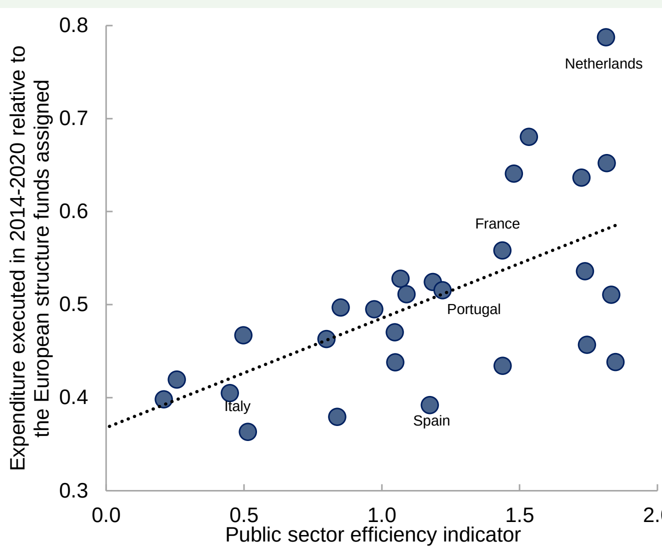
Figure 22: Italy's potential GDP growth



Sources: : PNRR, Euler Hermes, Allianz Research

In Spain, mobility has improved over the first half of the year and will continue to boost growth in the short-term. The grand reopening and relaxation of restrictions in Europe will prove to be good news for the service-heavy economy. GDP growth in the first quarter proved more resilient than expected (-0.5% q/q) and with the return to normalcy we expect GDP to grow by +5.1% in 2021 and +5.3% in 2022, helped by the tourism sector. In addition, upside risks come from the fiscal stimulus planned within the 2021 budget. This latter has already allocated EUR26bn of the NGEU grants. The NGEU funds have allocation constraints, while Spain has already requested EUR69.5bn in grants from the Resilience and Recovery Funds (RRF) but will not be able to support companies with them. The percentage of companies subjected to great financial pressure has increased very significantly (27pp) between 2019 and 2020 to 40%. Having more flexibility on spending would boost vulnerable companies so being able to negotiate the use of the RRF would be monumental for Spanish companies that are struggling financially. In the past, there have been institutional hurdles to implementing public spending. The Spain 2050 Plan could boost productivity and innovation to bridge the productivity and growth gap between Spain and the EU-8. In addition, we see the unemployment rate remaining high in 2021 (15.9%) as emergency pandemic measures are phased out, and starting to improve in 2022, with an average of 14.8%. We do not expect economic activity to return to pre-pandemic levels in the next two years as political risks and stimulus implementation hurdles could delay the recovery.

Figure 23: Public sector efficiency by country vs expenditure executed in 2014-20



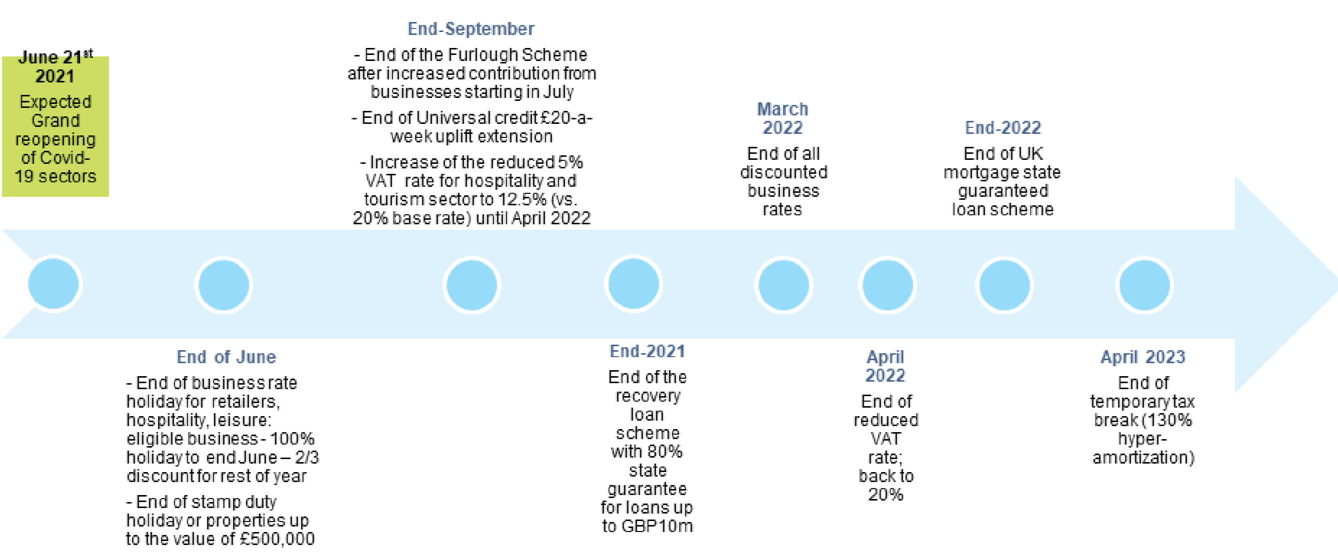
Sources: : IMF Fiscal Monitor, Euler Hermes, Allianz Research

In the UK, the grand reopening will allow pent-up demand equivalent to at least 3% of GDP to materialize in 2021 and push GDP up by +6%, one of the highest European growth rates. The rapid pace of vaccination allowed the economy to reopen, with mobility data improving and economic data strongly recovering since April, notably within the sectors that faced heavy restrictions during lockdowns. We expect companies to invest actively in 2021 (+11.8% followed by +8.9%), supported by excess cash (GBP122bn or more than 5% of GDP). The hyper-amortization scheme until end-2023 should support business investment and sectors such as manufacturing, transportation, food and accommodation stand among those most willing to use the tax break in view of their higher share of total assets accounted for by the plants and vehicles to which the scheme applies. In the short run, a demand catch-up and the reduction in spare capacities will drive a business investment recovery. However, it could take up to four years to return to long-term growth trends[5] : Credit conditions during the recovery phase may be tighter and excessive levels of corporate debt could limit companies' ability to borrow once state -support schemes are phased out.

Bottlenecks to the recovery are more and more visible and probably exacerbated by Brexit, particularly in the form of labor shortages in transport, construction and sectors such as tourism and catering and hospitality. Hence, pressures on wages are rising and we expect overall growth to accelerate up to +2.9% on average in 2022. In 2022, we expect GDP growth to slow down to +4.9% as fiscal assistance mechanisms will fully end and the UK will be one of the first countries to start fiscal and monetary consolidation: in total, GBP30bn (1.3% of GDP) through a rise in personal income tax in 2022, followed by the rise in corporate tax to 23% in 2023. The Bank of England is also expected to raise the key interest rate as soon as September 2022 (+15bp), embarking on an early, but timid monetary normalization cycle.

In the medium-run, Brexit will continue to have a negative impact on trade flows with the EU. In Q1 2021, the impact on imports from the EU fell by more than -20% against monthly flows in 2019 while imports from outside the EU remained in positive territory despite the increased supply-chain disruption. Hence, the increase in import prices from the EU of about +5% due to non-tariff barriers after Brexit is not so far from the tariff barriers for imports from China, i.e. 6.5% excluding exchange rate effects. The question of the trade rotation remains high if trade hurdles are not resolved, notably when the UK will also implement border controls on imports from the EU from October onwards. In addition, the end of the transition period for EU derivative products clearance in the UK in mid-2022 could bring more downside risks to the sector, given the tough negotiations on "equivalence".

Figure 24: Planned end-dates for state support in the UK



Sources: UK government, Euler Hermes, Allianz Research

[5] See our recent report *Investment is back: harder, better, faster, stronger?*

Bidirectional pressures on central banks in Emerging Markets. The first quarter of 2021 saw the reemergence of the concept of a Taper Tantrum[6]. As inflation figures are released, the prophecies are coming closer to fulfillment. Central banks either have undertaken rate hikes or are planning to (or even both). In some countries, market expectations exceed central bank targets for 2021. Furthermore, they also exceed the long-term inflation expectations from our models.

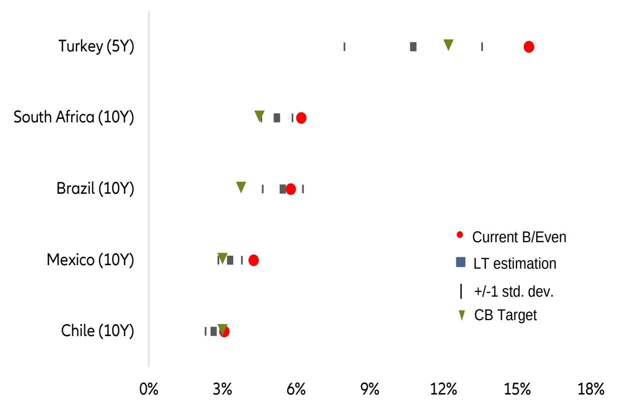
The situation puts policymakers in a difficult tessitura: the idiosyncratic structural problems and the severe damage from Covid-19 require a specific type of policy support, while fighting inflation needs a different one. The events around the Turkish central bank or the political instability wave in Latin America are some examples.

These pressures have affected the sovereign debt markets (Figure 26), particularly in some of the TUCKANS[7], but also in Latin America as a region and in Russia.

Up until now and with exceptions, Asia appears to be the region less influenced by this hazard. However, the sanitary situation may modify this: Besides India, other countries previously characterized by low levels of contagion are now experiencing outbreaks and new lockdown measures.

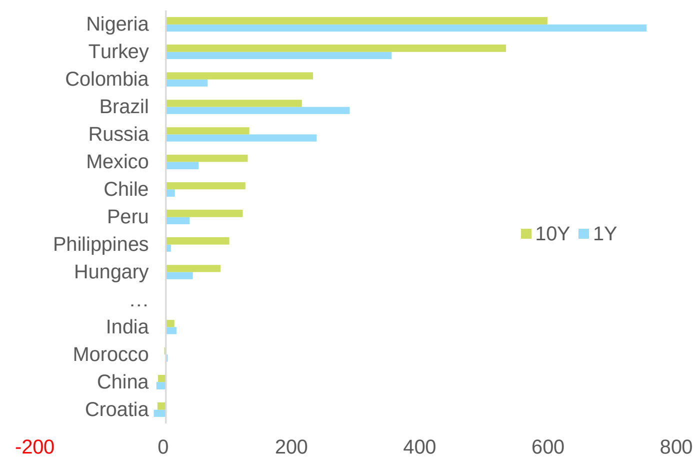
Taking the above-mentioned factors into account, the following months could unveil Eastern EU countries as some of the top performers of the grand reopening. For sovereign bonds, some of these countries may look like an investment opportunity, with still decent coupons, a relatively more optimistic perspective than their other EM counterparts and bond prices not as crowded as in Asia.

Figure 25: Proxy to EM breakeven inflation estimations.



Sources: Refinitiv, BofA, Euler Hermes, Allianz Research; Inflation Target for the Central Bank of Turkey has been revised to 12.2% to adjust to reality, the aim is conversion to 5% in 2023.

Figure 26: Largest increases (decreases) in LC Sovereign bonds yields. Year to date.

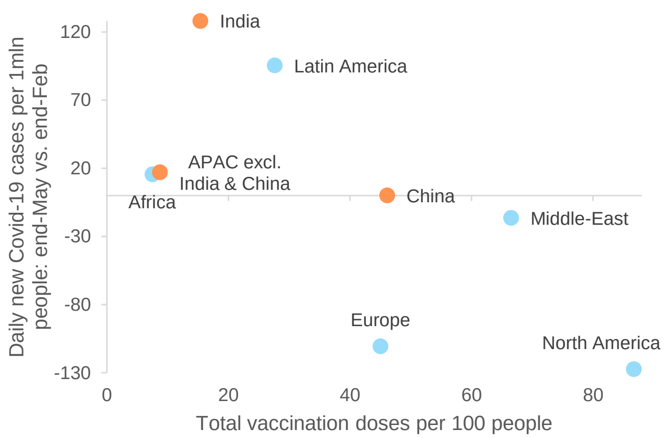


Sources: Refinitiv, BofA, Euler Hermes, Allianz Research. When the 10Y or 1Y are not references, the nearest maturity is taken into account.

[6] See our recent report [Taper Tantrum in 2021-22: Beware of the TUCKANS]
[7] Acronym used to designate the group made by Turkey, Ukraine, Chile, Kenya, Argentina, Nigeria and South Africa. Some of these countries, especially Argentina and Ukraine, do not appear in Figure 24 as the point on 31.12.2020 was already high.

Asia-Pacific overall is likely to continue outperforming other regions of the world, though disparities and downside risks have increased over the past quarter. Externally, the environment remains supportive, with Taiwan, South Korea, Singapore and Vietnam in particular well exposed to growth drivers (eg. China's recovery, the US stimulus, the electronics sectors, strong intra-regional trade etc.). As a result, their economic performances in the first months of 2021 mostly surprised on the upside. However, they are at risk of stalling in Q2 due to negative drivers and risks that come from the domestic side: Taiwan, Vietnam, Thailand and Singapore are now seeing rising infections amidst relatively slow vaccine rollouts. The accompanying tightening of containment measures will affect mobility and activity and we now expect their GDPs to contract in Q2 – although the shock is smaller than that of 2020 and likely to be temporary. This is a negative surprise as these economies had managed the pandemic well in 2020. Conversely, over the course of 2020, we had identified India, Indonesia, Malaysia and the Philippines as most vulnerable to sanitary risk. Their policy leeway is also relatively more limited, meaning that the medium-term scarring effects of the pandemic could be felt more strongly. Overall, after contracting by -1.1% in 2020, we expect Asia-Pacific's aggregate GDP to grow by +6.3% in 2021 (revised from +6.6%) and +4.8% in 2022 (revised from +4.7%).

Figure 27: Covid-19 spread vs. vaccination progress



Sources: Our World in Data, Euler Hermes, Allianz Research

Figure 28: Expected number of policy rate hikes until mid-2022 in the Emerging Markets

Country	Expected number of rate hikes	Country	Expected number of rate hikes
China	1	Brazil	3
India	1	Mexico	2
Indonesia	1	Argentina	2
Thailand	0	Colombia	2
Philippines	0	Chile	2
Malaysia	0	Peru	2
Russia	2	Nigeria	3
Poland	2	South Africa	3
Romania	3	Egypt	2
Czechia	3	Algeria	3
Hungary	1	Morocco	1
Ukraine	2	Kenya	2

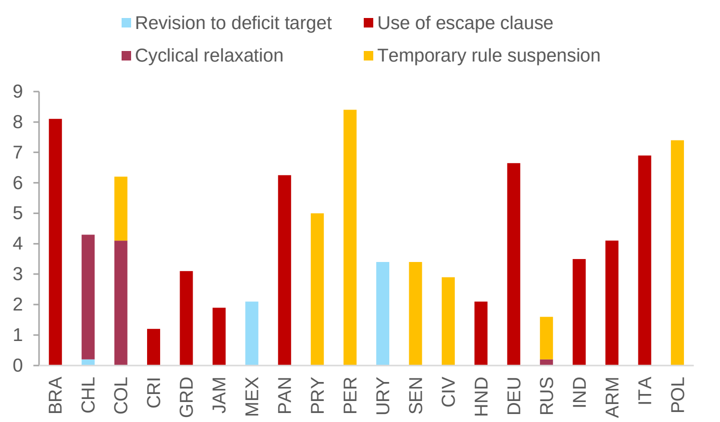
Sources: National sources, Euler Hermes, Allianz Research

In the Emerging Europe region as a whole, annual real GDP growth is forecast at +4.6% in 2021 (well offsetting the -2.7% contraction in 2020), followed by +3.7% in 2022. Economic activity data in 2021 to date have revealed a divergence in economic performance between economies amid third waves of Covid-19 occurring at different times. Hungary, Romania, Bulgaria and Turkey outperformed expectations in Q1 but should see a moderation in Q2 since the number of infections peaked again in April and supply-chain disruptions have somewhat dampened growth potential. Russia also outperformed at the start of the year and will continue to benefit from higher oil prices, which outweighs the impact of the threat of potential new sanctions. With the virus situations improving in H2, herd immunity against Covid-19 possible by fall and supply chains being restored, we expect the regional recovery to gather pace in the second half of 2021. Inflation will spike in Q2, mainly owing to base effects related to energy prices, which dropped a year ago and are now relatively much higher, but also due to rising wages amid an imperfect reallocation of the workforce. Price growth should moderate thereafter, in part thanks to some cautious interest rate hikes, though inflationary risks remain elevated in Turkey (due to currency depreciation) as well as Hungary, Poland and Romania, which have engaged in QE and experienced strong money supply growth since 2020. Unemployment will rise in 2021 as some state measures are phased out. This should contain wage growth later on and also mitigate price pressures to some extent. In addition, currency pressures have eased this year in Central Europe.

Latin America: between a rock and a hard place. Against the backdrop of the debt burden increasing by almost 15% of the regional GDP, it will be difficult to convince investors of debt sustainability and fiscal discipline without strong fiscal reforms. However, social discontent and timing are the opposing forces as the pandemic continues to rage and the region's economic situation remains fragile. There is still a need for extraordinary spending and government revenues will need to increase to close the growing fiscal gaps.

In general, in Latin America, the contribution base is low due to the high level of labor informality. This places the spotlight and stress on public finances. Given the social tensions and political risk in the region, the recovery could be slower in Latin America. We expect +5.3% GDP growth in 2021 after -7.1% in 2020, and +3.0% in 2022. Social tensions are likely to continue to dampen fiscal reforms. Supply bottlenecks could represent a downside risk, but overall, in the first quarter of 2021, we saw the trade balance of most countries recover and even hit record highs or pre-pandemic highs, as was the case of Brazil and Mexico. Demand coming from the US and China is essential for the upward trend to continue.

Figure 29: Policy relaxation relative to fiscal rule limit, in % of GDP



Sources: IMF Fiscal Monitor, Euler Hermes, Allianz Research

Figure 30: Tax rates in Latin America, in %

Sources: Datastream, KPMG, Euler Hermes, Allianz Research

In Africa, the second wave of the pandemic has been more severe while most governments face severe setbacks on their recovery paths. Due to supply constraints under the COVAX facility, most countries are not expected to reach herd immunity before 2023. Inflation is also back to double digits (Angola, Ethiopia, Nigeria, Zambia, Ghana) under the impact of rising energy and food prices and currency depreciations from last year. Most central banks (Angola, Ghana, Nigeria, South Africa) are reluctant to raise interest rates due to growth concerns. The recovery of commodity prices and sustained Chinese demand is a tailwind for exporters in 2021 (Nigeria, Algeria, Angola) whereas record high youth unemployment (above 30% in most countries) could fuel higher social and political risk. In a context of a prolonged sanitary crisis and limited space for fiscal stimulus, the region is expected to see a more timid economic recovery compared to peers: +2.7% in 2021 and +3.6% in 2022. The financing gap of Africa at the horizon of 2023 is estimated at USD300bn. The new Special Drawing Rights (SDR) allocation by the IMF will make USD34bn in additional funding, available for the region. French President Macron has called advanced economies to transfer EUR65bn SDR in profit for Africa. Yet, this initiative of a "New Deal" for Africa is unlikely to provide a quick and significant solution to the continent's looming liquidity needs. On the other hand, the inclusion of private creditors to debt relief is a thorny issue: Ethiopia's sovereign rating has been downgraded to "substantial risk" by rating agencies following the announcement that the country would seek debt relief under the new G20 common framework. In the current international setting, we do not expect a comprehensive solution to be reached in 2021 to offer a way out to Africa's debt-ridden countries.

The Middle East region as a whole is forecast to experience a sluggish recovery, with real GDP growth forecast at +2.8% in 2021 and +3% in 2022, thus reaching the pre-crisis level of GDP only at the end of next year. Economic activity has remained moderate so far in 2021 amid second or third waves of Covid-19 infections in many countries, with appropriately stringent lockdown measures in place. The grand reopening will diverge across the region in line with marked differences in the pace of vaccination, with Israel, Bahrain, Qatar and the UAE reaching herd immunity in Q3 but other countries being laggards. In the GCC economies, markedly worsened fiscal and external positions will be the legacy of the 2020 Covid-19 and oil price crises. Fiscal breakeven oil prices currently standing at above 80 USD/bbl for Oman and Bahrain and above 65 for Saudi Arabia, Kuwait and the UAE, and close to 40 for Qatar, will continue to constrain fiscal stimulus. Monetary policy will remain accommodative but usually follows the Fed, so some tightening is expected from 2022 onwards. Meanwhile still large FX assets, including SWFs, held by Saudi Arabia, the UAE, Qatar and Kuwait provide a buffer against potential external financing disruptions for at least five more years, but Bahrain and Oman are the weak spots in the region and will depend on the support and strength of their neighbors in order to avoid a default.

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