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R&R Weekly Column
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Central Banks Are Fighting Inflation Fears And Higher Bond Yields

Financial markets have been volatile during the past couple of weeks. Anti-Covid vaccination campaigns are attracting the attention of market participants, as the speed and effectiveness of the vaccination campaigns vary greatly around the world. In the US, President Biden managed to convince Johnson & Johnson (J&J), the producer of the last-approved anti-Covid vaccine, to cooperate with Merck, its long-term arch-rival, to increase the production capacity of the new vaccine. This way, the US will have three domestically produced vaccines – by Pfizer-BioNTech, Moderna and J&J, respectively – available for its population. For this reason, Biden said that all adults in the US may be given the chance of being vaccinated by May, which is two months earlier than had previously been expected. A similar success story is taking place in the UK, where 21 million people (more than 30% of the country's total population) have received at least the first dosage of a Covid vaccine.

Much less successful are the campaigns in the EU and Russia. In the EU, the limited availability of vaccines, a more vaccine-sceptical population, and logistical difficulties are making the beginning of the vaccination campaign extremely slow, with only around 5% of the EU population having received a first dosage. The Commission may be blamed for the reduced availability of vaccines, as it wanted to negotiate on the price with the pharmaceutical companies, and its contracts were much less detailed, and hence enforceable, than those signed by the US and the UK. The limited supply has reached a point that Italy has forbidden AstraZeneca to export vaccines to Australia, attracting the criticism by UK PM Boris Johnson. Russia, meanwhile, is a peculiar case. Though having developed a vaccine much faster than its competitors (the notorious Sputnik vaccine), the level of scepticism among the general population against something offered by the government is such that only around 3% of the population has decided to be vaccinated. The fact that President Putin has not been willing to inoculate himself with the Sputnik vaccine certainly has not helped the cause.

Vaccination campaigns began while a lot of countries were still implementing severely restrictive measures, including full lockdowns in countries such as Germany and the UK. As such, economic activity remains subdued and Q1 2021 will likely be a quarter of very low or even negative GDP growth. Governments continue to provide generous fiscal stimuli: in the US for example the USD 1.9tn fiscal stimulus plan is likely to be implemented soon; and in the UK the Chancellor of the Exchequer has just announced another "spend now, tax later" Budget. Central banks remain fully accommodative, in part so as to monetise the large deficits exhibited by national governments.

Given this background, those countries such as the US, where vaccination campaigns are progressing more smoothly and the policy support is ample, economic activity has started to show early signs of vitality. Accompanying it there has been the return of some inflation fears, motivated by market participants' awareness of the huge amount of liquidity injected by central banks into the system at a time when large fiscal stimuli have been provided and the output gaps are starting to close. In our recent in-depth analysis, we discussed how the return of high inflation is a risk scenario, rather than our baseline assumption of what will occur. Still, inflation fears have brought a sell-off in bonds, and therefore a rise in short- and long-term yields, as investors re-estimated the timing of central banks' policy normalisation phases. This in turn has led to volatility in equity markets, which are sensitive to rises in long-term yields.

Central banks around the globe (with the Fed and the ECB at the forefront) were keen to reassure market participants that they are ready to look through short-term rises in inflation, perhaps even rises above the target levels the banks have set, as long as such rises are temporary. The US Fed has even changed its policy strategy to allow temporary inflation overshoots, as long as they are limited in size. Other, smaller central banks, such as the Reserve Bank of Australia, had to resort to additional market intervention in order to bring yields back in line with the policy targets.

In any case, central banks will have a hard time in coming years as they attempt to combine their traditional role as guardians against inflation with their current strategy of monetising the large deficits produced by countries combating the pandemic.

Our Recent Publications

- Preview: ECB To Continue Focusing on Maintaining Favourable Market Conditions, *by Brunello Rosa, Nouriel Roubini and Alessandro Magnoli Bocchi, 5 March 2021*
- China: Recovery Underway, As Global Liquidity Drives 'Risk On' Sentiment, *by Alessandro Magnoli Bocchi, Fawaz Sulaiman Al Mughrabi and Karmen Meneses, 4 March 2021*
- RBA Ready To Increase QE to Combat Rising Yields, *by Brunello Rosa and Fawaz Sulaiman Al Mughrabi, 2 March 2021*
- Flash Preview: RBA To Stand Pat While Fighting Rises in Market Rates, *by Brunello Rosa and Fawaz Sulaiman Al Mughrabi, 25 February 2021*

Looking Ahead

The Week Ahead: US CPI Is Expected To Rise, While The ECB Remains On Hold

In the EZ, January's IP is expected to ease to -0.3% y-o-y (*p:* -0.8%).

In the US, February's CPI inflation is expected to rise to 1.7% y-o-y (*p:* 1.4%), while core-CPI inflation is likely to stay unchanged at 1.4% y-o-y.

Still In the EZ, the ECB is expected to maintain the: *i)* interest rate at 0.00%; and *ii)* deposit rate at -0.50%.

The Quarter Ahead: COVID-19 Vaccines Reach 111 Countries; Inflationary Worries Rise; CBs To Maintain Easing Stance

Investors are divided about whether the rise in longer-term UST yields is due to: *1)* an upswing in growth expectations – driven by optimism over the rollout of COVID-19 vaccines; or *2)* a worrisome increase in inflationary pressures.

Despite rising long-term interest rates, the US Fed Chair Powell continues to emphasize his willingness to *"see inflation temporarily rise above 2%"*, as well as his "*satisfaction with the current stance of monetary policy*" – disappointing investors, and unsettling equity and bond markets.

In the US, the government began distributing the Johnson & Johnson single-dose vaccine – approved by regulators – and President Biden announced *"new deals with drug makers"*, to ensure that every American adult have access to vaccines by the end of May – two months earlier than anticipated.

The US Senate approved the USD 1.9tn package - as Vice President Harris broke the 50-50 tie, in Democrats' favor. Most elements of the bill - including the USD 400 per week in unemployment benefits - remained intact and in-line with the legislation passed in the House of Representatives. Critics of the bill continued to point to the danger of reigniting inflation by overheating the economy.

The EU and the US reached a deal to suspend punitive tariffs both on aircraft and non-aircraft products, for an initial period of four months – a sign that the 16-year-old transatlantic trade battle over state aid to Airbus and Boeing could be coming to an end.

Last Week's Review

Real Economy: Global Growth Recovery Driven By Vaccine Rollout And Eased Restrictions

In the US, February's labor-market data showed signs of strength, as: *i)* 'non-farm payrolls' rose above-consensus to 379k (*c:* 182k; *p:* 166k); *ii)* 'average hourly earnings' remained unchanged at 5.3% y-o-y; *iii)* the unemployment rate declined to 6.2% (*c:* 6.3%; *p:* 6.3%); and *iv)* in the week ended on February 27, the number of 'filings for unemployment benefits' rose below-consensus to 745k (*c:* 750k; *p:* 736k) – as the US economy still struggles to sustain the labor market recovery amid the COVID-19 induced restrictions and a lack of fiscal support.

In the EZ, in January: *i)* retail sales slumped to -6.4% y-o-y (*c:* -1.2%; *p:* 0.9%), the steepest decline in nine months, as a number of member states re-imposed or extended lockdown measures; and *ii)* the unemployment rate stayed unchanged at 8.3%, the lowest level since June 2020.

In Australia, during its March meeting the RBA left its 'cash rate' unchanged at a record low of 0.1%, as widely expected.

Financial Markets: Rising Yields Continue To Hamper Investor Sentiment; USD And Oil Prices Up

Market drivers: Uncertainties hit most markets, prompting investors to pull money from stocks and bonds. In particular, the rise in rates weighed on growth stocks, by increasing the discount on future earnings, while value stocks managed gains.

Yet, ***global equities closed higher w-o-w*** (MSCI ACWI, +0.1%, to 657). In the *US*, the S&P 500 Index rose (+0.8%, to 3,842), as: *i)* energy shares outperformed, as oil prices hit their highest levels in over a year; *ii)* technology shares were broadly weak; while *iii)* consumer discretionary stocks continued to be dragged lower by Tesla. In the *EZ*, shares rose (Eurostoxx 50, +0.9%, to 3,670), buoyed by the prospect that: *1)* easing restrictions implemented to curb the coronavirus's spread; and *2)* supportive monetary and fiscal policies could set the stage for an economic recovery.

Fixed Income: w-o-w global bonds remained flat (BAML Global, 0.0% to 292.3); tax-exempt bond funds experienced outflows during the week, marking the first period of outflows in nearly four months. In the *US*, 10-year UST yields rose (+10 bps, to 1.55%).

FX: w-o-w, the USD rose against other currencies (DXY, +1.2%, to 91.977; EUR/USD -1.3%, to 1.192).

Commodities: OPEC's decision to maintain current production levels instead of the widely expected increase sent oil prices higher (Brent, +4.9% to 69.4 USD/b). Gold continued to fall (-1.9% to 1,701 USD/Oz), due to rising US bond yields, and a stronger-than-expected USD.

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*

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