

## Week ahead

Eurozone – Inflation in February expected at around +2.0% y/y

Eurozone – Bond market volatility increases

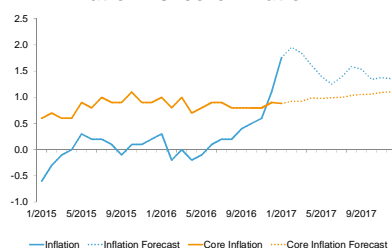
Emerging Markets – Industry sentiment expected to ascend in February

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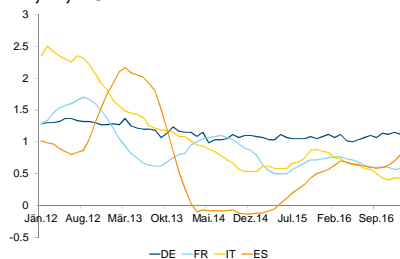
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### EZ – inflation vs. core inflation



Source: Eurostat, Erste Group Research

### Core inflation 6-month averages: DE, FR, IT, ES



Source: Eurostat, Erste Group Research

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Indications of past performance are no guarantee of a positive performance in the future!

### Eurozone – energy component should lead to further increase in inflation in February

Next week (February 28), flash estimates for Eurozone inflation in February will be released. Inflation rose in January to +1.8% y/y – above market expectations. The main driver for the strong increase of inflation in January was the energy component (+8.1 y/y), which is in turn strongly dependent on the development of oil prices. In addition, soft commodity prices rose significantly (+3.5% y/y). Core inflation in comparison remained stable, at +0.9% y/y in January. On a regional level, diverging developments are visible. In Germany, the level of core inflation has been stable for many years at around 1.0 to 1.2%. French and Italian core inflation based on semiannual averages, seem to have bottomed out on different levels (FR: +0.6% y/y; IT: +0.4% y/y). By contrast, Spain's core inflation has confirmed an ongoing upswing since mid-2016 (recently at +1.2% y/y).

*Due to the persistent base effects from energy prices, we expect the energy component to continue to contribute substantially to inflation dynamics in the Eurozone in February. **We expect a further slight increase in headline inflation in February to approx. 2.0%.** For the upcoming months, we forecast inflation rates declining somewhat, based on the slightly lower pressure from energy prices. Considering the stronger than expected pricing pressure (energy & food) YTD, we up our inflation forecast for 2017 from +1.3% to +1.5%.*

*ECB's further monetary policy decisions will depend on the development of core inflation in the various member states. Accompanied by the ongoing recovery of the Eurozone economy, we expect a steady gradual increase of core inflation until the end of the year, to approx. +1.1% to +1.2% y/y.*

### German yields fall, despite good economic data

In the course of the week, yields declined severely on the Euro sovereign bond market, which was in clear contrast to the published macro data. The PMI data for the Eurozone published this week showed even further momentum when compared to the already strong January data, thus exceeding market expectations. This confirms the sustained positive economic development within the Eurozone. The decline of German yields started already in January from a high level. The surprise was how far the movement continued this week, especially at the short end. The yield on 2-year German bonds reached historic lows of -0.95%. Basically, we see two causes for the most recent movement. On the one side, the market seems to be experiencing a shortage, driven by two different factors, and on the other side the market is reacting to rising political risks

that stem from the approaching parliamentary elections in the Netherlands (March 15) and the presidential election in France (April 23 and run-off May 7). In addition, the risk of new elections in Italy is looming as well.

The shortage seems to result from the high demand for German bonds as collateral (e.g. short sales, derivatives), alongside high stocks of German bonds held by the central bank. As of January, bonds with a yield below -0.40% are – if necessary – eligible under the terms of the ECB’s asset purchase program, which in turn might caused additional downward pressure on shorter-term yields. We assume that this shortage was behind the movements this week, since spreads for French or Dutch over German bonds did not rise further. Nevertheless, the fact remains that political developments exert pressure, which is evident in the substantial widening of spreads since the end of January.

*From our perspective, the reaction of markets to political risks is exaggerated. Obviously, the market’s wrong assessment of political risks in 2016 (Brexit, US elections) seems to still be deeply embedded, which has now turned into high levels of nervousness. The presidential election in France will take place in two months’ time and the poll data sees Le Pen as the clear loser. The wrong predictions of poll data ahead of the Brexit vote and the US presidential election do not make the current French poll data invalid. In 2016, polls indicated a difference between the two political camps at just a few percentage points and was thus quite slim. Le Pen, however, trails her likely opponents substantially. In the run-off election, 40-44% of interviewees would vote for her, while the most likely counter candidates (Fillon or Macron) would reach 56-60%. Nevertheless, the nervousness of the markets could prevail. In the short term, the election results in the Netherlands could dampen or amplify the worries. In the end, we do not expect either of the two countries to leave the Eurozone.*

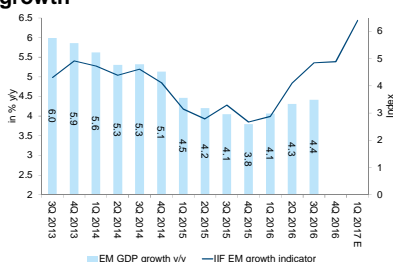
*The other factor that likely contributed to the recent yield declines, the scarcity of German government bonds, is more difficult to gauge. Should the obvious distortions, especially at the short end of the curve, persist, the ECB could alter the settings of its security lending program to increase supply. However, there is a risk that the tensions in the repo market could increase further, as the ECB’s purchasing program takes more bonds off the market. In total, the situation on the bond market remains highly uncertain. For the time being, we leave our yield forecasts unchanged and remain confident that, after the French election, the macro data will again be the main determinant for the bond market, which points to higher yields. However, in the short term, we expect volatility to remain high.*

**Emerging Markets – upswing continues; industry sentiment expected to rise in February**

Over the course of the next week, industry sentiment data on important Emerging Markets will be released. In January, the data has turned out differently depending on the country. In Russia, sentiment reached – spurred on by rising oil prices – a multiannual high. In India and China, the data is located in slightly expansive territory and in Brazil sentiment remained subdued.

*The IIF Emerging Markets growth indicator improved markedly and reached a 5½-year high in January, indicating a growth acceleration of Emerging Markets in 1Q17. In our view, the strengthening of Emerging Market currencies compared to the dollar, as well as the continued increase in commodity prices are additional supportive elements for*

**IIF EM leading indicator vs. EM GDP-growth**



Source: Eurostat, Erste Group Research

**Erste Group Research**

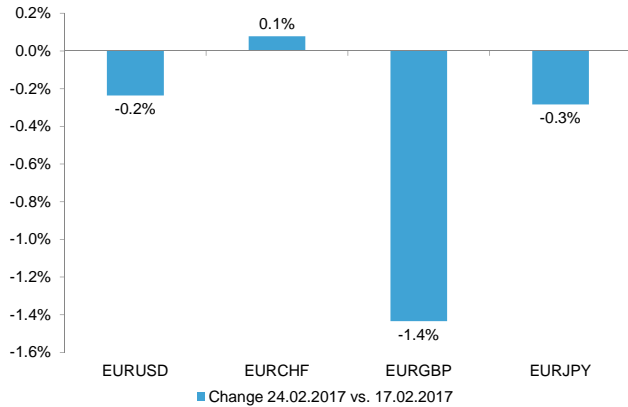
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*growth in the Emerging Markets. We thus expect industry sentiment to rise in February in most Emerging Markets. This is also good news for the Eurozone's export dynamics and therefore – due to the importance of exports for investment activity – for overall economic dynamics in the Eurozone in 2017.*

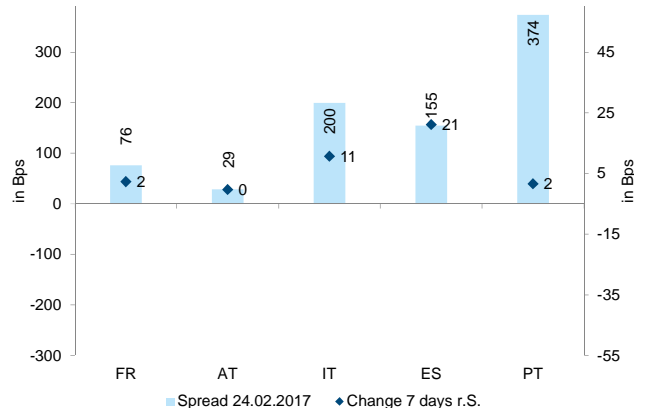
**Forex and government bond markets**

**Exchange rates EUR: USD, CHF, GBP and JPY**  
change last week  
(+ stronger euro / - weaker euro)



Source: Bloomberg, Erste Group Research

**Eurozone – spreads vs. Germany**  
10Y government bonds



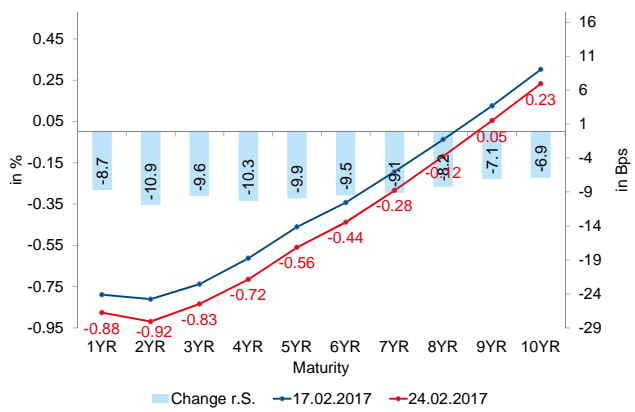
Source: Bloomberg, Erste Group Research

**US Treasuries yield curve**  
change last week



Source: Bloomberg, Erste Group Research

**DE Bund yield curve**  
change last week



Source: Bloomberg, Erste Group Research

**Economic calendar**

Date	Time	Ctry	Release	Period	Consens	Prior	
24-Feb	9:00	AT	Ind. Prod. y/y	Dec		2.3%	
	16:00	US	Univ. Michigan Index	Feb F	96.0 index	95.7 index	
27-Feb	n.a.	US	New Home Sales	Jan	573.0 thd	536.0 thd	
		FR	Consumer Conf.	Feb		-8.6 index	
		DE	Consumer Conf.	Feb		0.2 index	
		IT	Consumer Conf.	Feb		-12.9 index	
		AT	Consumer Conf.	Feb		-2.6 index	
	10:00	DE	Retail Sales y/y	Jan		-1.1%	
		AT	PMI Manufacturing	Feb		57.3 index	
		EA	Consumer Conf.	Feb F	-6.2 index	-6.2 index	
		EA	Business Conf.	Feb	107.8 index	107.9 index	
		14:30	US	Durable Goods Orders	Jan P	1.6%	-0.5%
28-Feb	8:45	FR	CPI m/m	Feb P		-0.3%	
		FR	PPI y/y	Jan		1.7%	
		FR	GDP y/y	4Q P		1.1%	
		FR	Inflation y/y	Feb P		1.6%	
		FR	GDP q/q	4Q P		0.4%	
	9:00	AT	GDP q/q	4Q F		0.6%	
		AT	GDP y/y	4Q F		1.8%	
		11:00	IT	Inflation y/y	Feb P	1.3%	1.0%
		IT	CPI m/m	Feb P	-0.2%	-1.7%	
		14:30	US	GDP q/q	4Q S	2.1%	1.9%
1-Mar	16:00	US	Consumer Conf.	Feb	111.1 index	111.8 index	
	3:45	CN	PMI Manufacturing	Feb	50.7 index	51.0 index	
	9:50	FR	PMI Manufacturing	Feb F		52.3 index	
	9:45	IT	PMI Manufacturing	Feb F		53.0 index	
	9:55	DE	PMI Manufacturing	Feb F	57.0 index	57.0 index	
	10:00	EA	PMI Manufacturing	Feb F	55.5 index	55.5 index	
	14:00	DE	Inflation y/y	Feb P	2.1%	1.9%	
		DE	CPI m/m	Feb P	0.6%	-0.8%	
		14:30	US	PCE Deflator	Jan	2.0%	1.6%
	16:00	US	PMI Manufacturing	Feb	56.0 index	56.0 index	
2-Mar	9:00	AT	PPI y/y	Jan		0.8%	
	11:00	EA	Unempl. Rate	Jan	9.6%	9.6%	
		EA	PPI y/y	Jan	3.0%	1.6%	
14:30	US	Jobless Claims	-	240.8 thd	244.0 thd		
3-Mar	10:00	IT	GDP y/y	4Q F		1.1%	
	10:00	IT	GDP q/q	4Q F	1.1%	0.2%	
	11:00	EA	Retail Sales y/y	Jan	1.2%	1.1%	

Source: Bloomberg, Erste Group Research

**FORECASTS<sup>1)</sup>**

<b>GDP</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>Eurozone</b>	1.2	2.0	1.7	1.9	1.7
<b>US</b>	2.4	2.4	1.6	2.1	2.2

<b>Inflation</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>Eurozone</b>	0.5	0.1	0.2	1.5	1.5
<b>US</b>	1.6	0.1	1.2	2.0	2.3

<b>Interest rates</b>	<b>current</b>	<b>Mar.17</b>	<b>Jun.17</b>	<b>Sep.17</b>	<b>Dec.17</b>
<b>ECB MRR</b>	0.00	0.00	0.00	0.00	0.00
<b>3M Euribor</b>	-0.33	-0.30	-0.30	-0.30	-0.30
<b>Germany Govt. 10Y</b>	0.20	0.50	0.80	0.80	1.00
<b>Swap 10Y</b>	0.69	0.80	1.10	1.10	1.30

<b>Interest rates</b>	<b>current</b>	<b>Mar.17</b>	<b>Jun.17</b>	<b>Sep.17</b>	<b>Dec.17</b>
<b>Fed Funds Target Rate*</b>	0.66	0.60	0.90	1.10	1.40
<b>3M Libor</b>	1.05	1.00	1.30	1.50	1.80
<b>US Govt. 10Y</b>	2.37	2.40	2.60	2.70	2.80
<b>EURUSD</b>	1.06	1.05	1.08	1.10	1.12

\*Mid of target range

Source: Bloomberg, Erste Group Research

<sup>1</sup> By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

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Week ahead | Macro, Fixed Income | Eurozone, USA

24 February 2017

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