BARINGS INVESTMENT INSTITUTE

June 2021

Stop-and-Go Economy Refuses to be Stopped

MONTHLY MACRO DASHBOARD

BARINGS

21-1686310

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If last year's life-under-a-pandemic experience was unusual for every human on the planet, **this year's recovery stands apart in the history of recoveries**. After the sudden stop, it has been all go. It starts with inflation roaring back. The confusion is real. Normally the symptom of overheating in a dynamic economy reaching full speed, **inflation this time reflects a weakened economy taken by surprise**. It was hard for anyone at home under government support to believe, if not to dream, that a solution for living with a mutant virus would be found so quickly. It makes for the happy end to a science fiction movie, but in reality it also creates a new type of economic havoc.

The rush to reclaim the life of "before," and in even bigger quantities, is meeting the constraints of a globalized world. Differences in vaccine availability around the world have resulted **in a global upturn more sequenced than synchronized**. Bottlenecks in the shipping of key inputs and resource constraints are creating shortages. With people not yet ready, or able, or eager to come back to work, firms are signalling a willingness to raise wages to incentivize their return. In the U.S., the largest economy in the world and among the most advanced in terms of vaccinations, prices are rising.

This type of **inflation will abate**. It is not taking place anywhere near the peak of an expansion cycle, as serious inflation concerns would. Ample slack remains in the U.S. labor market, and **labor shortages should ease in the fall**. Supply chain bottlenecks, related to the good surprise of an early reopening, will resolve with time. The Fed remains calm and committed to keeping a watchful eye on undesirable inflation pressure; markets appear to understand the message. In the longer run, notable technological investments during the pandemic will help increase productivity, providing room for wage growth without accelerating inflation.

Europe's recovery looks strong. Service activities are following in manufacturing's steps, and the summer will see both engines of growth firing on all cylinders. Inflation is accelerating, driven by the same dynamics as in the U.S. before it. It will also prove to be **a symptom of the stop-and-go economy that refuses to be stopped**, rather than point to a need to slow down already. This time, fiscal policy has been done right. The coordinated spending financed by European institutions points to a new dawn for the economic union. There is a good chance it will **defeat the forces of gravity** in European growth. The rise in euro-denominated safe assets will also enhance the stability and depth of the region's financial markets.

It is now emerging markets' time to shine. China, catching up on vaccinations at light speed, is confirming its return as a global growth engine. It will likely continue to pull other emerging markets along with it, particularly in Asia, via increased trade. Outside of Asia, emerging markets remain dragged down by pandemic headwinds and a lack of expansionary policy space. Expedited vaccine exports to the region will help them catch up, and loose global financial conditions will give them time to do so.

We raise the odds of our baseline scenario, "The Best of All Possible Worlds!," from 50% to 60% for the coming 12-18 months. Strong growth with fading extraordinary inflation pressure supports a gradual rise in U.S. interest rates, which provides a good backdrop for risk assets, including equities and emerging markets. Rate differentials may boost the dollar temporarily, but only temporarily. **Markets seem to be convinced but have made it clear they will take any new data as a test**. Thus, the odds of "Inflation Anxiety" remain at 30%; however, those of "Gravity Prevails" are halved to 10%. We feel more assured than before that **2022 will be a memorable vintage**.

What Changed in May

WHAT'S NEW

- Services take the baton in the U.S. and Europe and start gaining momentum in Asia.
- A shift towards more global coordination is taking shape following the G7's decision to back a global minimum corporate tax.
- Vaccine rollout is accelerating throughout Asia.
- Improvement in the European economy has not been lost on markets: its stock market is the best-performing, year-to-date.
- Growth in industrial metals prices have moderated.

WHAT WE LEARNED

- Global bond markets have remained calm despite above-expectation inflation data.
- Real rates have declined in the first half of June, suggesting markets believe central banks' call on transitory price pressures.
- Vaccinations are helping alleviate the impact of new variants, so far.

WHAT WE ARE HEARING FROM OUR TEAMS

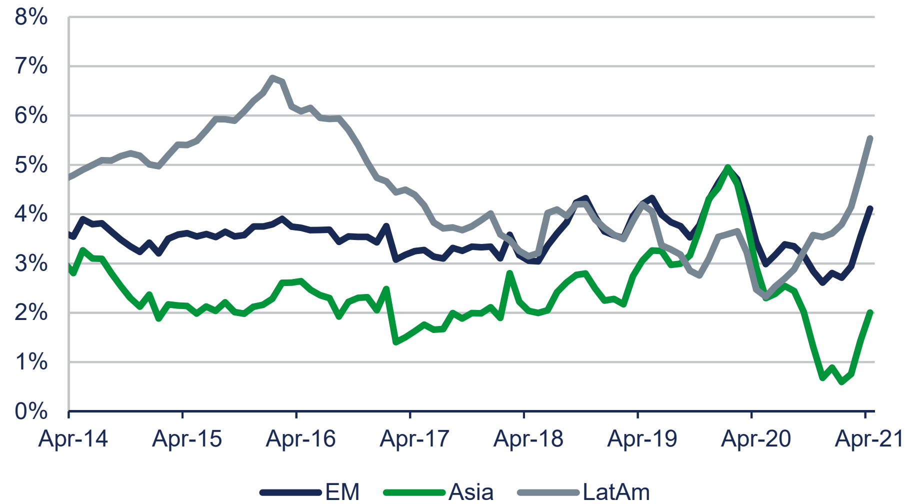
- The sentiment is risk-off in IG amid record tight spreads.
- Inflation anxiety is calming down but HY remains vigilant because the sell-off would be sharp should inflation not be temporary.
- A sell-off in emerging markets, mostly due to idiosyncratic events, has resulted in good buying opportunities.
- Equity markets will remain volatile on inflation anxiety until the Fed starts tapering.

WHAT WE ARE WATCHING

- Broad-based wage growth from job gains, inflation expectations, and signs of pass-through of commodity inflation to the CPI.
- Market reactions to inflation releases.
- The speed of savings deployment.
- U.S. infrastructure spending negotiations.
- New COVID waves, variants, and summer travel restrictions.
- Signs of scarring in the corporate sector, including in NPL data in retail and services, and in the labor market.

EM TRADE BALANCE, ENERGY EXPORTERS (12-Month Rolling)

CONSUMER PRICE INFLATION



Green shoots to Emerging Market growth are materializing as activity in Developed Markets and China starts to gradually normalize. The tailwind is coming in the form of robust trade, which has returned to now exceed pre-pandemic levels in EM Asia. Industrial production has also benefited. The fiscal impulse in the U.S. and the start of a new global capex cycle suggests external demand should remain supportive.

However, while retail sales have generally remained strong in aggregate, there has been some volatility, given the recent viral resurgences. Labor markets have also yet to fully heal, as unemployment remains elevated in most parts of EM, the exception being North Asia.

Political risks should not to be underestimated, either. Societal backlash from government mismanagement of the pandemic and newly rising inequality has materialized in less market-friendly election outcomes, which could have lasting implications.

A key to achieving a more complete recovery will be easing of pandemic uncertainty. Vaccination programs are most optimistic in China so far, followed by Brazil and Mexico. Indeed, absent herd immunity, some economies may find it challenging for demand-pull inflationary pressures to build significantly and derail the recovery. Nevertheless, it has materialized recently in Latin America, where a few central banks, including Brazil, are raising rates to anchor credibility, particularly in the face of rising fiscal spending. In Central and Eastern European Countries (CEEC), cost-push inflation is adding to pressure that pre-dates the pandemic, though policymakers there have been reluctant to hike interest rates.

Still-benign EM services inflation (a reflection of weak underlying internal demand) should give policymakers some time; those that will have the discipline to raise rates when needed will be protected when the Fed starts to normalize interest rates. Given the Fed's intention to be intentionally late to act, the window could be very sizable for EM policymakers.

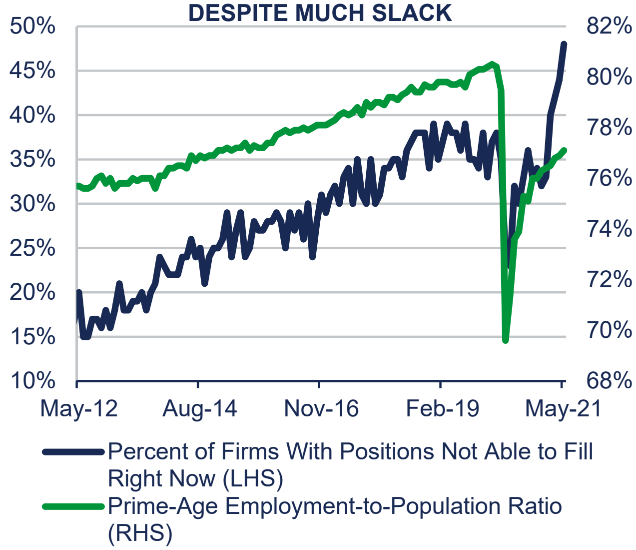
Source: Haver, as of June 11, 2021.

While the LABOR MARKET appears tight in certain segments, this should ease into fall as ample slack eases constraints.

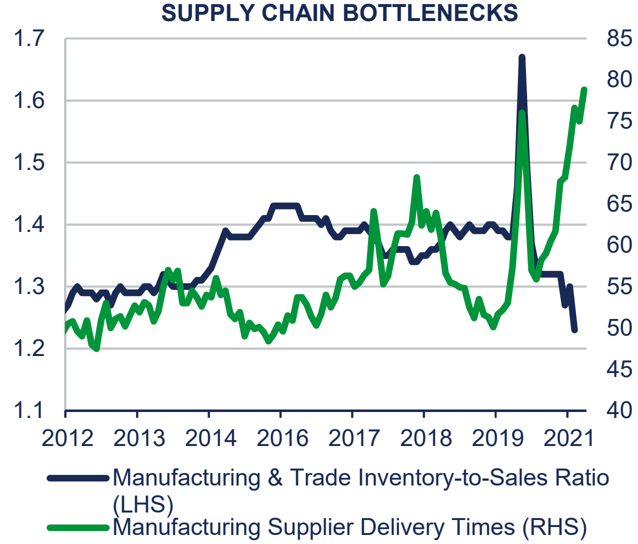
SUPPLY CHAIN BOTTLENECKS due to a quick return of demand and low inventories is putting upward pressure on prices...

...but SUPPLY is adjusting so these pressures should be temporary.

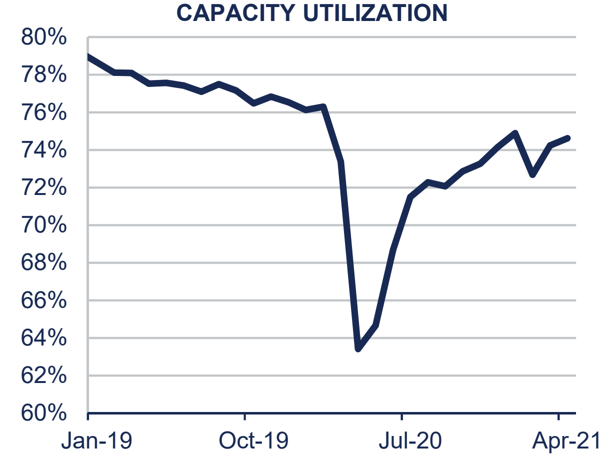
SIGNS OF TIGHT LABOR MARKET DESPITE MUCH SLACK



SUPPLY CHAIN BOTTLENECKS



CAPACITY UTILIZATION



- The faster-than-expected reopening has led labor demand to quickly rebound. However, this is being met by constraints that include childcare needs, lingering health concerns, and UI benefits that give low-wage workers more money. The supply-demand mismatch is causing some indicators to show a tight labor market and incentives offered for low-wage leisure/hospitality jobs.
- However, these impacts will should be temporary and fade with the arrival of fall, as schools reopen and benefits expire. Along with the ample slack in the labor market, this should keep wage pressures in check.

- Supply chain bottlenecks continue across the economy as supply struggles to keep up with demand following the draw down of inventories at the onset of the crisis.
- This has left inventory-to-sales ratios far below pre-crisis levels and led to extremely long supplier delivery times. It was also resulted in rising input prices for companies, with a portion being passed on to consumers.

- While demand has quickly rebounded in many segments of the economy, supply is adjusting as capacity utilization and manufacturing inventories improve.
- While some areas of the economy—such as the transportation sector—may take longer to fully adjust, bottlenecks and the corresponding price pressures should ease once supply and demand come back in line.

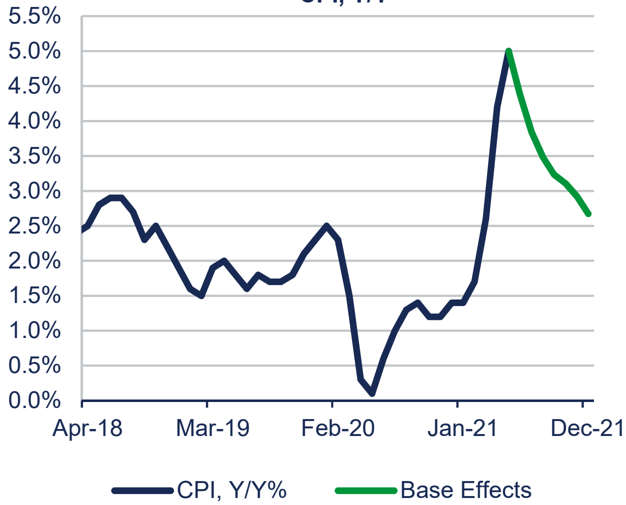
Source: Haver and Bloomberg. As of June 10, 2021.

In addition to easing supply chain bottlenecks, diminishing base effects will likely lead INFLATION lower.

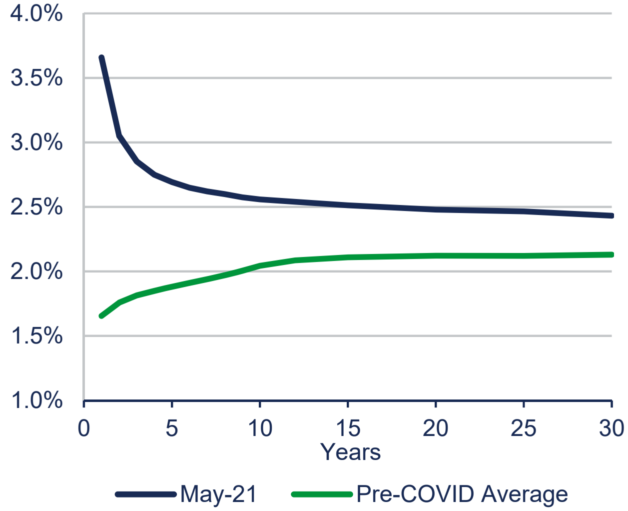
Elevated near-term inflation is already PRICED INTO MARKETS, and they appear to believe the Fed's messaging.

Impressive TECH CAPEX during the crisis is set to support stronger productivity growth longer-term.

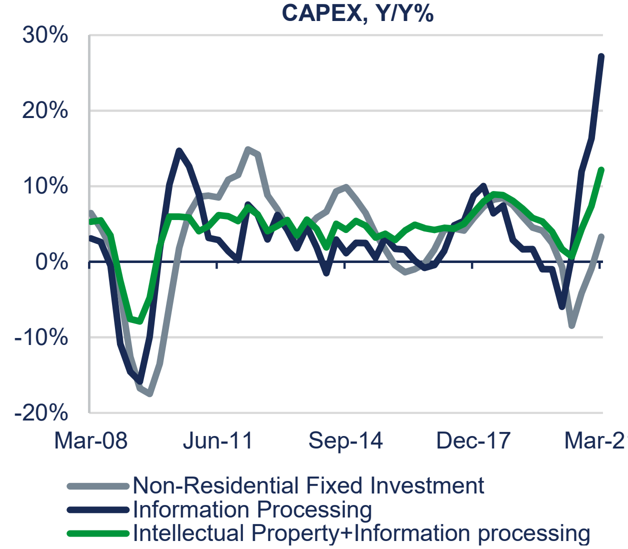
CPI, Y/Y



U.S. INFLATION SWAP CURVE



CAPEX, Y/Y%



- Base effects, a rebound in commodities, and the fast reopening have boosted headline inflation over the past few months, which has led to greater inflation anxiety.
- However, base effects from the lockdown peaked in May—which alone would have led to a 4.3% Y/Y rise in CPI—suggesting that the May print is set to be the peak and should normalize from here. If there is no M/M growth in inflation, base effects suggest that CPI will end the year at 2.7% Y/Y.
- Our central scenario, as well as those of central banks, continues to see these inflationary pressures as transitory.

- While inflation data have come in high, market reaction has been relatively muted; this is due in part to much of this already being priced in. Contrary to normal pre-COVID times, the inflation swap curve shows inflation expectations in the long-term are much lower than in the near-term.
- This implies that markets largely believe the Federal Reserve's messaging around transitory price pressures.
- With inflation expectations likely capped given the peak in base effects, this increases the odds of our central scenario, rather than Inflation Anxiety from the market.

- A need to adopt technology, combined with low interest rates and greater liquidity, has led companies to materially boost capital expenditures, most notably in tech.
- While crisis capex and productivity growth were weak prior to this crisis, this will provide support for stronger productivity growth going forward.
- If wages do begin to rise once the labor market is fully healed (in the medium-term), productivity growth will allow this to take place without boosting inflation.

Source: Haver and Bloomberg. As of June 10, 2021.

CONSENSUS FORECAST

- Our view is largely in line with consensus for inflation in 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. Positive economic data surprises support our outlook.

Economic Growth	06/14/2021	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	6.6 ▲	4.1 ▲
Inflation						
CPI (Y/Y %)	5.0	2.5	1.8	1.2	3.4 ▲	2.5 ▲
Core PCE (Y/Y %)	3.1	2.0	1.7	1.4	2.5 ▲	2.2 ▲
Labor Market						
Unemployment (%)	5.8	3.9	3.7	8.1	5.4 --	4.2 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.13	0.25 ▼	0.35 ▲
2Y Treasury	0.15	2.52	1.57	0.12	0.31 --	0.62 ▼
10Y Treasury	1.46	2.72	1.92	0.92	1.88 --	2.17 ▲

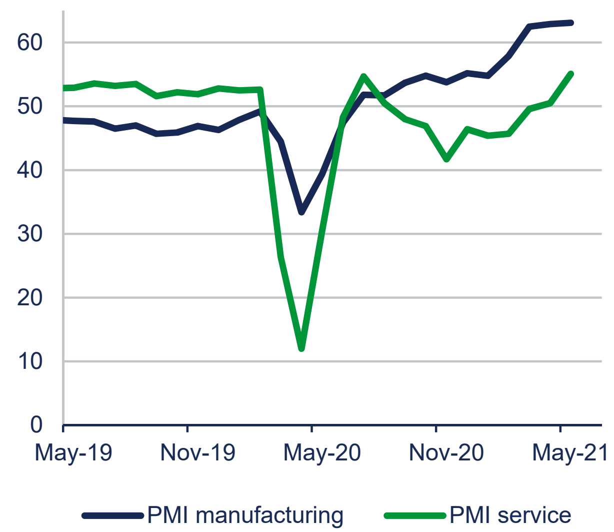
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of June 14, 2021. (E)—Bloomberg private market consensus estimates.

Europe

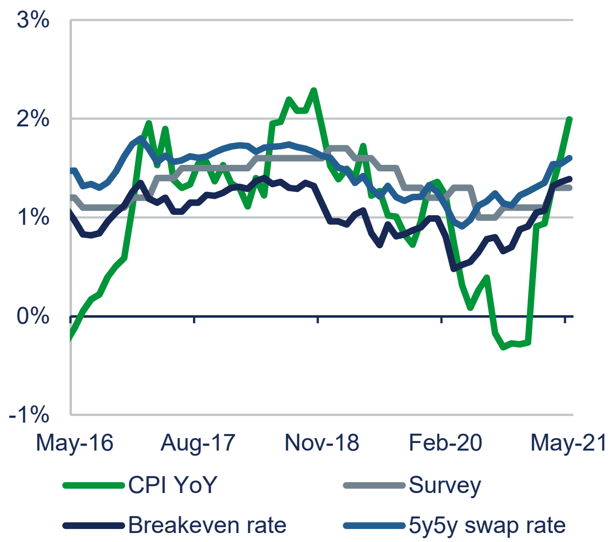
Services are following in manufacturing's tracks, and BOTH ENGINES OF GROWTH will be firing on all cylinders this summer.	Driven by supply disruptions, INFLATION has accelerated but will prove temporary.	The ECB has been fast to act and is reluctant to withdraw support too early.

PMI



- With vaccination programs taking off, service sector activity has turned strongly expansionary.
- Together with continued manufacturing strength (manufacturing PMIs are at all-time highs), this points toward a sharp acceleration in activity underway.
- A good tourism season should help the recovery take hold, and consensus is expecting very strong growth ahead.

INFLATION AND EXPECTATIONS



- There is more slack than meets the eye. Some 10% of the labor force remains in furlough, and there is spare capacity to be used before inflation pressures arise.
- Markets and surveys show that inflation expectations are rising only gradually.
- Accelerating growth with benign inflation provide an ideal setting for markets, and European stocks have outperformed other major areas lately.

ECB ASSETS (Y/Y %)

- The ECB response to COVID was an immediate sharp expansion of its balance sheet.
- In comparison, the ECB balance sheet expansion peaked in October 2008, slowing down precipitously after the Lehman Brothers collapse while tightening financing conditions, when the opposite was needed.
- This shows how much more proactive and effective the ECB has turned this time.

Source: Bloomberg and Haver. As of June 9, 2021.

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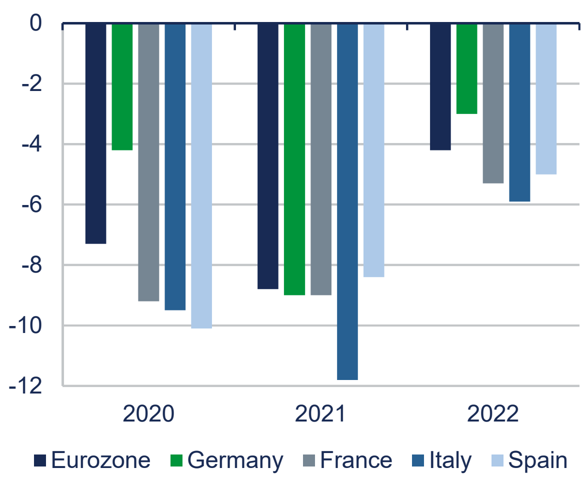
Europe

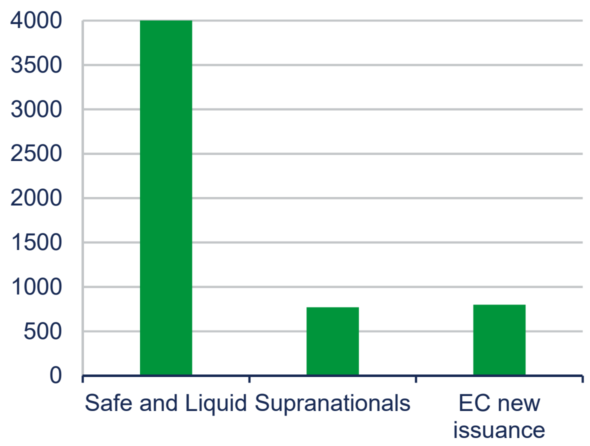
FISCAL POLICY has been done right during this crisis.	Near doubling of safe assets will enhance the STABILITY AND DEPTH OF EURO FINANCIAL MARKETS.	INVESTORS believe Europe's growth may well "defeat the force of gravity."

PUBLIC DEFICIT (% of GDP)



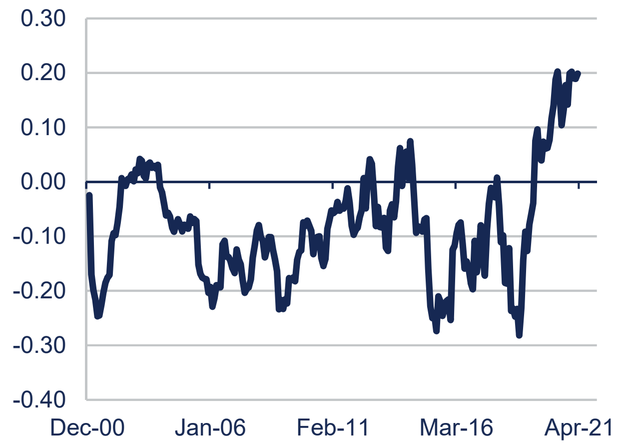
- Governments' handling of this crisis has also been incomparably more effective.
- During the Global Financial Crisis (GFC), markets cut funding access to sovereigns, calling for bailout loans associated with conditionality on austerity. This led to a sharp recession, contributing to a lost decade for EU growth and employment.
- This time is different, and countries are using all their might to push, pull, and drag their economies out of the crisis.

SAFE AND LIQUID ASSETS (€ billions)



- The expanding availability of euro-denominated safe assets allows banks and investors to park liquidity in investments that remain safe during turbulence. It also ensures smooth functioning of key markets such as repo and derivatives.
- The EU will start tapping markets this month to fund its recovery plan, adding an even bigger pool of euro-safe assets.
- The EU will be the largest issuer of green and sustainable bonds and the euro the currency of these highly demanded assets.

NET FDI FLOWS (12M sum, € trillions)



- The structural changes just described provide a reasonable basis to believe that European growth should not revert to its subdued post-GFC levels.
- This is recognized by investors, who never invested so heavily in the EU before, as per foreign direct investment (FDI) flows.
- Elections in Germany and France, as well as PM Mario Draghi's ability to reform Italy, will be watched closely to assess the realization of these positive expectations.

Source: Bloomberg and Haver. As of June 9, 2021.

Europe

CONSENSUS FORECASTS

- We maintain our above-consensus call for 2021 euro area growth at 6%, fueled by vaccine rollouts, full reopening of the economy, savings release, and unwavering policy support.
- U.K. growth will likely come in slightly below consensus, to 5%, as Brexit-related trade disruptions partially offset the effects of a weak currency on trade.

Economic Growth	06/14/2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	-1.3	1.9	1.3	-6.5	4.3 ▲	4.2 ▲
U.K. Real GDP (Y/Y %)	-6.1	1.2	1.5	-9.9	6.4 ▲	5.5 ▼
Inflation						
EZ CPI (Y/Y %)	2.0	1.8	1.2	0.3	1.8 ▲	1.4 ▲
U.K. CPI (Y/Y %)	1.5	2.5	1.8	0.9	1.6 ▲	2.0 ▲
Labor Market						
EZ Unemployment (%)	8.0	8.2	7.6	8.0	8.3 ▼	8.1 ▼
U.K. Unemployment (%)	4.8	4.1	3.8	4.4	5.2 ▼	5.1 ▼
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.00 --	0.00 --
EZ 2Y Note	-0.68	-0.62	-0.61	-0.72	-0.64 --	-0.50 ▲
EZ 10Y Bond	-0.27	0.24	-0.19	-0.57	-0.02 ▲	0.16 ▲
U.K. Central Bank	0.10	0.75	0.75	0.10	0.10 --	0.20 --
U.K. 2Y Gilts	0.05	0.74	0.53	-0.17	0.14 ▼	0.29 --
U.K. 10Y Gilts	0.71	1.27	0.82	0.19	0.99 ▲	1.25 ▲
Currencies						
EUR/USD	1.21	1.14	1.12	1.22	1.22 --	1.23 --
GBP/USD	1.41	1.27	1.33	1.37	1.42 ▲	1.44 ▲

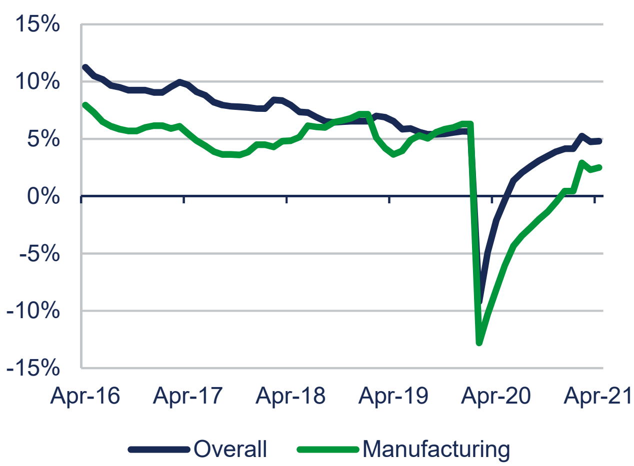
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of June 14, 2021. (E)—Bloomberg private market consensus estimates.
*Represents actual data.

Asia Pacific

Fears of a China slowdown may be overdone. INVESTMENT remains robust…

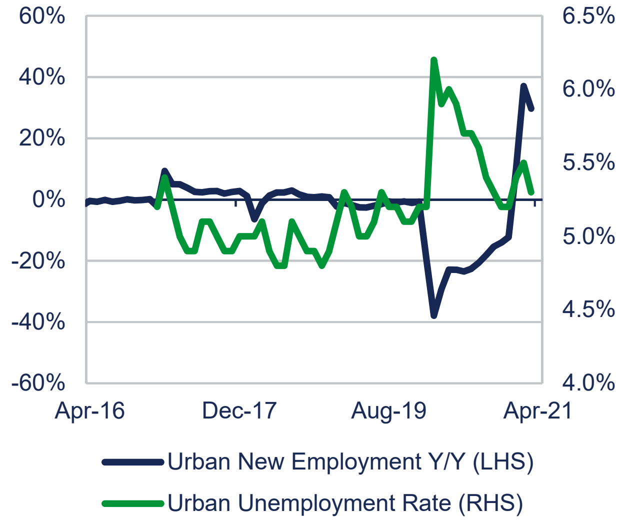
CHINA FIXED ASSET INVESTMENT GROWTH
(2-year Average)



- China is a key beneficiary of aggressive stimulus in the U.S.; exports should also benefit from restocking of global inventories, which remain depressed.
- This should support a continued upswing in private investment, particularly in manufacturing and downstream sectors.
- Credit normalization has yet to impact mid- to long-term loan demand for corporates, implying robust capex intentions.

…while consumption should continue building momentum amid steadily improving LABOR MARKETS.

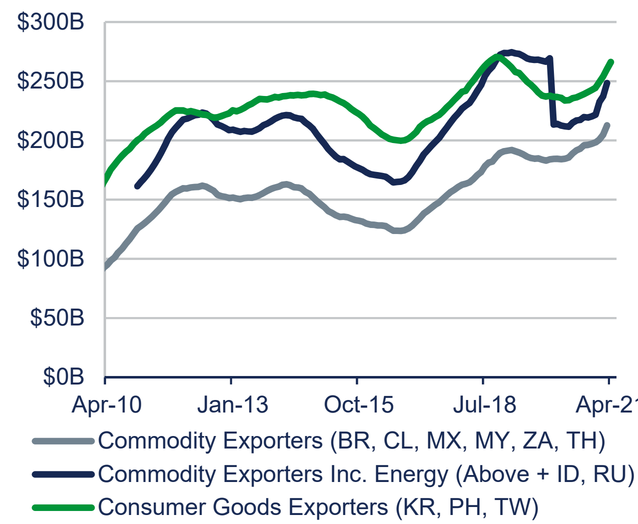
CHINA LABOR MARKET



- Subdued unemployment, rising new employment, recovering incomes, upbeat consumer confidence and expectations, and a big stock of excess savings worth 6% of annual disposable income are all supportive of a solid consumer recovery.
- The recent volatility in consumption can be mostly attributed to pandemic uncertainty. Accelerating vaccinations should allow this to dissipate with China likely reaching herd immunity by year-end.

Exporting EM countries are getting more and more integrated with China via INCREASED TRADE.

EM EXPORTS TO CHINA
(12-month rolling)



- Exporters to China benefit from China's links to U.S. demand, but also from China's own internal demand. The latter's recovery should provide another tailwind to EM net exporters to China, particularly those in Developing Asia, Malaysia, Brazil, and South Korea.
- Exports have mostly remained strong, with the exception of energy, which should recover gradually as mobility in China picks up.

Source: Bloomberg, Haver. As of June 9, 2021.

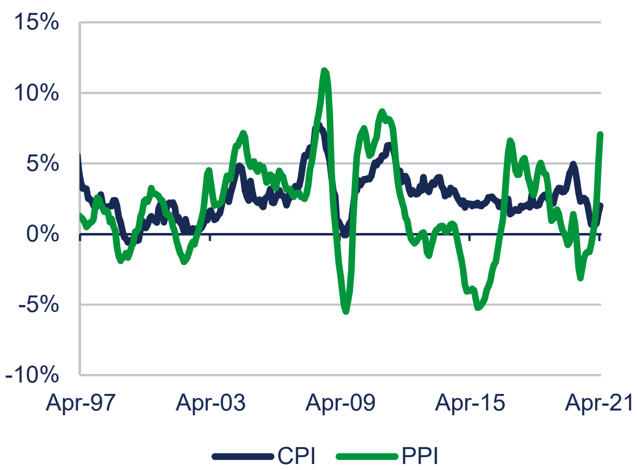
Asia Pacific

INFLATIONARY PRESSURES are cost-push and commodity-driven, rather than demand-pull.

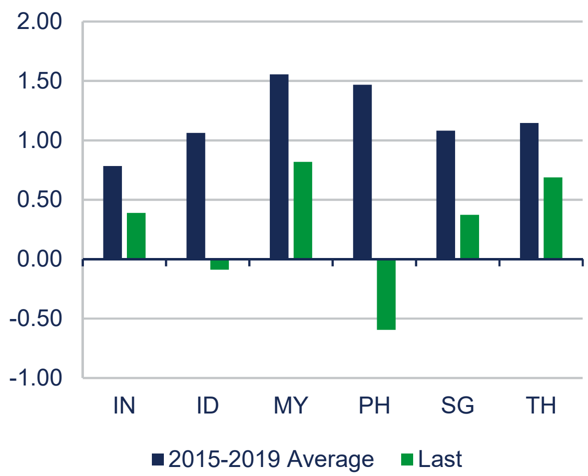
Easy monetary policy hasn't led to CREDIT GROWTH in South Asia yet, which remains tepid given lingering uncertainty.

EM EQUITIES have been mostly unloved and could have room to catch up.

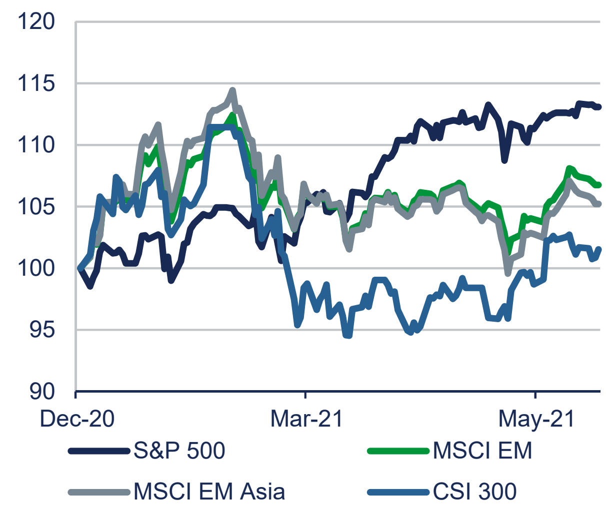
EM ASIA CONSUMER VS. PRODUCER PRICES



LOAN GROWTH TO BROAD MONEY GROWTH



YEAR-TO-DATE TOTAL RETURN



- Structural changes, such as increasing competition, mean the pass through from PPI to CPI has diminished since 2011.
- Food inflation is a risk, but mostly for India, Vietnam, Indonesia, and Sri Lanka. The sensitivity is low for China, Korea, Thailand, the Philippines, and Malaysia.
- Absent a sharp wage increase, a persistent rise in inflation may be difficult to achieve.

- The Philippines, Indonesia, India, and Thailand have conducted QE purchase programs worth 1-9% of GDP. But this has yet to translate into loan growth, limiting the potential for demand-pull inflation.
- The Fed intentionally staying behind the curve means EM policy normalization will likely come first, which requires the return of demand.

- Unlike the S&P 500, EM assets have generally lagged behind despite a decent start to the year.
- With exports being a tailwind, and as vaccination campaigns make further progress in the coming months, the outlook could improve drastically.
- Valuations are modestly elevated, but both EPS growth and earnings revisions show the underlying trend is still positive.

Source: Bloomberg, Haver, Goldman Sachs. As of June 9, 2021.

CONSENSUS FORECAST

- We lower our 2021 GDP expectations for Japan again, given the latest headwinds from recent viral resurgence. But, the revival in private capex should be supportive of 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	06/14//2021	12/31/2018	12/31/2019	12/31/2020	2021 (E)	2022 (E)
Japan Real GDP (Y/Y %)	-1.6	0.6	0.0	-4.7	2.6 ▼	2.3 ▲
China Real GDP (Y/Y %)	18.3	6.7	6.0	2.3	8.5 --	5.5 --
Inflation						
Japan CPI (Y/Y %)	-0.4	1.0	0.5	0.0	0.1 --	0.6 --
China CPI (Y/Y %)	1.3	2.1	2.9	2.5	1.5 --	2.3 --
Labor Market						
Japan Unemployment (%)	2.8	2.4	2.4	2.8	2.9 ▼	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 --	-0.11 ▲
Japan 10Y Bond	0.03	-0.01	-0.02	0.02	0.11 ▼	0.11 ▼
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.73	2.75	2.75	2.75	2.80 --	2.59 --
China 10Y Bond	3.14	3.30	3.13	3.14	3.24 ▲	3.27 ▲
Currencies						
USD/JPY	109.76	110.27	108.61	103.25	109.50 ▲	110.00 ▲
USD/CNY	6.39	6.86	6.98	6.52	6.38 ▼	6.30 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of June 14, 2021. (E)—Bloomberg private market consensus estimates.
*Represents actual data.

Advanced economies stand a good chance to exit lockdowns in the coming months. The U.S. has mostly reopened in Q2, and Europe should recover from vaccine 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 sooner through renewed trade and financial links.

"THE BEST OF ALL POSSIBLE WORLDS!" (60% ODDS)

The automatic recovery of demand when developed economies reopen provides an ideal environment for animal spirits, the Keynesian term for human emotions that affect consumer confidence. 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 European Recovery and Resilience funds will be deployed over the next five years as part of 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 small and medium enterprises (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 on 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 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

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 meet supply chain bottlenecks, giving rise to cost-push 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 with talk 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 trade wars 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

The above represent the views of Barings as of June 14, 2021, and are subject to change at any time. These predictions may not come to fruition.

GRAVITY PREVAILS (10% 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 worsen 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 go 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

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.

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	2.5-3.0%*	2.0-2.5%*	2.5-3.5%	1.5-2.0%	1.5-2.0%	2.0-2.5%	
	Unemployment	4.5%*	3.5%	5%	4%	5.5%	4.5%	
Euro Area	Growth	6%	4.5%*	5%*	3%	4%	3%	Successful vaccination programs allow service sectors to join manufacturing in a solid rebound, 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	7%*	6.5%*	7%*	7.5%*	8%*	7.5%*	
Japan	Growth	3%*	3.5%	2%	2.5%	2%	2%	The latest extension of the State of Emergency and lingering pandemic risks highlight the downside risks to growth. Nevertheless, drivers of an investment upswing are present.
	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 starts to turn more neutral in 2022	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	The acceleration in inflation is expected by the ECB and will not cause any tapering; it may cause some unease with Governing Council hawks	Intervention only in jawboning market pricing	Unwavering accommodation in the form of more QE and generous liquidity provisions. Returning worries on the ineffectiveness of monetary policy	Except for the Inflation Anxiety scenario, inflation will remain benign and 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 continues	USD strengthens as U.S. yields rise compared to other developed markets and haven flows add to it	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 from either the tailwind of global economic recovery or increased inflation worries

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As of March 31, 2021.