Sunday Wrap

Greetings from the Danish coast, where I went to celebrate the lunar New Year. Chúc mừng năm mới, as we say in my family (while eating a lot of very good food…).

This past week saw a number of really important statements, with one more likely tonight, for how our world will be shaped this year – and well into the future. I'll discuss them below, starting with the "important one" for European growth the next couple of years, ascending via issues of even greater consequence for global markets and the real economy, to the most critical longer-term issue at hand, namely that of further European coordination in the face of increasing government intervention in the US and China.

There was also plenty of media coverage this past week of Germany's continued refusal to grant export licenses for its famed Leopard tank to be sent to Ukraine. It's surely an extremely important question, but I'm not a military expert, so I'll leave that one to those better equipped to comment.

In today's note I'll address:

- **The unmistakably clear statement on Thursday by ECB President Christine Lagarde: She told markets that they were wrong to price in an earlier end to the rate hikes than what had been communicated in December.**

- **US Treasury Secretary Janet Yellen announcement also on Thursday that the US government has hit its debt ceiling. While this has happened before, the risk of a default by the US government later this year is real this time.**

- **The meeting in Paris today between French President Emmanuel Macron and German Chancellor Olaf Scholz. We are moving rapidly towards a new European industrial policy. Hopefully, today's meeting will reach agreement on some of the general components.**

1. Lagarde kills off any dream of the ECB cooling down its hiking cycle.

During a panel discussion in Davos on Thursday, ECB President Lagarde told the world in no uncertain terms that financial markets were wrong to bet on a slowing of the ECB's rate hikes.

After the ECB's December meeting, markets had priced in – more or less – two more hikes of 50bp a piece, followed by two more hikes of 25bp a piece, for a terminal rate of around 3.5%. Subsequently, all statements by GC members confirmed this intention - triggering reactions by probably 80% of those in the private sector I spoke with along the lines: "Really, but why?" (I share the assessment that this will be an excessive tightening, but as I have discussed before, the ECB communication has been clear on their intentions since the December meeting.)

As a clear illustration of the overwhelming view by most people outside the ECB that the indicated rate path would be damaging, it took no more than a single Bloomberg story this past week, based on unidentified sources, that the ECB will slow down the rate hikes for markets to reprice the curve back to where it was before the December meeting.

As I tweeted on Thursday (at @ErikFossing), I thought markets were silly to buy into the Bloomberg story. With the December communication, the ECB has tied itself to its 2024 inflation forecast and only a sharp reduction in growth and/or core inflation during 2023 will make them change their mind. Neither is likely until, at least, the second half of the year, but probably not even by then. Following Lagarde's stern message to markets on Thursday, the curve has returned, more or less, to its post-December meeting level where – in my opinion – it should remain for several months.

As noted, based on the most likely outcome for inflation, I think the ECB is making a mistake. I suspect the ECB is driven by a heavily skewed incentive function aimed first and foremost at cementing its credibility following the inflation shock. But it'll dampen European growth relative to what it otherwise would have been during 2023-25. But none of this will be conclusively clear until well into 2024, unfortunately.

2. The risk of a US government default.

Also on Thursday, but far away from glitzy Davos, US Treasury Secretary Yellen announced that the US government's debt ceiling of USD 31.4 trillion had been hit, forcing the Treasury to take a number of extraordinary measures to remain current on its financial obligations. Such measures include a suspension of payments into various public sector retirement and disability funds. This will keep the government current at least until 5 June. Beyond that, Social Security and Medicare will be at risk, according to the government, and ultimately its debt service payments.

It's long been known that the debt ceiling would be reached around this time – and its long been expected that the Republican majority in the House of Representatives would use the request from the administration to increase it (as it has done repeatedly and as needed for decades) as a bargaining tool for radical policy changes.

We have been here before, of course, but because of the radicalization of parts of the GOP, and the rest of the GOP's willingness to let it be ruled by extremes (and we are talking real crazies here in the so-called Freedom Caucus…), this year is different.

I worry that this could indeed be the year when it all goes wrong, and the US government defaults. The 1-year US credit default swaps (CDS) jumped from less than 20bp to 69bp on the news this past week. Dramatic as that is, I don't know why it took this long for markets to begin to acknowledge the complete breakdown in orderly policymaking in the US Congress. Granted, it takes a lot to envisage that the world's most powerful government, the anchor of global liberal democracy and issuer of the world's number one reserve currency may be no more than six months from defaulting on its debt. But it's the reality of what has happened to the US Republican Party in recent years.

The moderately good news is that on Friday, Donald Trump – no doubt reading the politics correctly here – issued a video in which he "directed his party not to cut Social Security or Medicare, which some House Republicans have put on the table as part of any solution to the standoff over raising the … debt ceiling", according to the Bloomberg write-up. But whether he'll persuade his disciples at the extreme wing of the party remains to be seen. They didn't follow his appeal to back Kevin McCarthy to become Speaker until, against Trump's advice, they had extracted still further commitments for the conduct of the House under McCarthy. A key concession granted them by McCarthy is a one-member motion to vacate, which means that any one single GOP member of the House can call a vote on McCarthy's role as Speaker.

Last time we were on the edge of default was when the GOP House majority, under Speaker Boehner, with McCarthy as their number three, drove us there by insisting on a number of concessions by the Obama administration. Back then, almost ten years ago, the GOP only relented after most of Wall Street's CEOs had travelled to Washington to explain to them the danger of what they were contemplating. But that was before Trump and the crazies gained so much power, and before the unhinging of the GOP from being the party of big business. This time feels different, therefore.

With the extremely narrow GOP majority in the House, I'm looking for one of the following two ways in which a default can be avoided: Either the "GOP crazies" (i.e. the 20-30 most extreme members) will practically all have to fall in line behind whatever compromise McCarthy can reach with the government; McCarthy and the GOP are looking for massive spending cuts. Or – less likely - the seemingly even smaller number of "traditional GOP members" will have to cross the aisle and vote with the Democrats on some alternative compromise and the lifting of the debt ceiling. Neither route looks passable at this time, but since this is predominantly political theatre things may change.

One thing is virtually clear, however. It will go down to the wire with little chance of an agreement until the 11th hour, in some six months' time. If no agreement is reached, be clear on this: Even a brief so-called "technical" default by the US government would have devastating consequences for the world – which was exactly the message conveyed to the GOP leadership by the Wall Street CEO delegation almost ten year ago, and which McCarthy, at the time, understood and appreciated. While the risk of a default is not properly quantifiable, it's not small. Maybe one third? Scary stuff, and that in the global anchor for liberal democracy…

3. The prospect of a marked shift to a European industrial policy.

Today, German Chancellor Scholz and French President Macron, along with their cabinets, meet in Paris to celebrate the 60th anniversary of the Élysée Treaty, and to move the European agenda forward, including by trying to agree on the parameters for a common European industrial policy.

First, it's worthwhile – on this day - yet again to step back for a moment to appreciate the extraordinary achievement in Europe of changing centuries of repeated periods of hostilities between nations into friendships, cooperation and integration. This has never been done by any other countries in history!

Following the Treaty of Rome in 1957, the Élysée Treaty in 1963 formalized the French-German friendship. It then became the cornerstone in establishing the Franco-German leadership of the European process of integration. Lots has been written in recent months about the increased frustration between France and Germany, but it all seems to me little more serious than what most European countries live with domestically when governing in coalitions. Indeed, Angela Merkel was known to often characterize relations with France as those one sees and works with in a coalition government.

Several big issues are on the agenda at today's meetings, but I'll limit myself to the issue of the call for a European industrial policy:

Europe has always had an ambivalent relationship with industrial policy. Germany, strongly supported by the UK, when it was in the EU, as well as the Netherlands and Scandinavia, has been advocating a minimum of government intervention and free trade, while France, supported by much of Southern Europe, has argued for a bigger role of governments in directing society's preferences.

Three related events have now tipped the balance of this disagreement heavily in France's favor: First, the role of government intervention, subsidies, etc., in China's rise has long been known, but as Chinese companies became globally important in recent years, the impact on European businesses and politics, including in security matters, has become a clear concern. Second, the USD 369bn US Inflation Reduction Act (IRA) provides extensive subsidies and tax breaks to companies which invest in the green transition. While that's welcome for the green agenda, it threatens the (relatively even) playing field between the US and Europe. Third, with Brexit, Germany has lost its single most important "free-trade" partner in the EU.

But while lots of good arguments can now be made for a European industrial policy, the design is politically complicated.

On 15 January, EU Council President Charles Michel published an op-ed in Politico in which he called for a four-pillar approach to be discussed at the Council meeting in February: (i) More leeway for member states in providing state aid to their businesses while (somehow) protecting the single market; (ii) increased flexibility to disburse untapped EU budget and NGEU funds; (iii) an extension of the SURE program to grant all member states access to affordable borrowing to support their businesses and workforce; and (iv) the creation of an EU Sovereignty Fund for equity investment in new and strategically important projects in green energy, digital technology and defense, with the European Investment Bank as the "backbone". His piece is here: Going big for EU industry

This past week in Davos, EU Commission President Ursula von der Leyen expanded on her earlier discussions of a proper European response by laying out her own four-pillar plan, a so-called "Green Deal Industrial Plan" - "to make Europe the home of clean tech and industrial innovation on the road to net zero", as she put it. It includes: (i) A Net-Zero Industry Act to increase speed and access for green investment via de- or re-regulations, as well as a way to "make Important Projects of Common European Interest on clean tech faster to process, easier to fund and simpler to access for small businesses"; (ii) a temporary adjustment of EU state aid rules to speed up and simplify key investments, e.g., via tax breaks, followed by a European Sovereignty Fund to boost the resources for upstream research, innovation and strategic industrial projects key to reaching net zero; (iii) a (so-far unidentified) plan to boost skills in critical areas; and (iv) a commitment to free trade with foreign trading partners, including by reaching agreement on trade deals with, e.g., China and the UK. Her speech is here: Special Address by President von der Leyen at the World Economic Forum

Lots of good ideas, but also a lot of remaining questions. These are the key issues which need to be addressed and which one would hope Macron and Scholz may reach some sort of general understanding on today or – more realistically – in coming weeks:

First, a shift towards European industrial policies is inevitable – and indeed needed. It's also an emerging reality already. But it'll be critically important to do so at a European level, and not as a series of national policies. This is a matter of preserving the Single Market; the single most important part of European integration in terms of positive effects on growth and living standards. If it were to become the product of what fiscal space is available in each country at this specific time, the Single Market de facto cease to exist.

While there are funds available in the EU budget, NGEU and Sure, this is almost certainly insufficient for what's needed. The EIB may be useful as well, as called for by Michel, but to match the policy changes in the US and the long-running policies in China, this is a task not just of allocation of financing on commercial – or near-commercial – terms, but of outright subsidies. von der Leyen's call for a European Sovereign Fund is therefore critically important. How fast can this be approved and implemented?

Second, which sectors should benefit from this new European industrial policy? Greening investments are obvious, but this is also a matter of security so, presumably, the tech sector, pharma, military? How does one draw lines between sectors which are deeply intertwined?

Third, how much will be needed over, e.g., the next ten years? How does one allocate between public investment and incentives for private investment (not least at a time when monetary policy is set to discourage private investment for the next few years)? This would surely be facilitated by the a properly designed Capital Markets Union to help allocate risk-willing private capital across Europe. Why has that gone on the back-burner?

Fourth, how will the process be governed?

I'll leave it like this for today and re-join the family to celebrate this first day of the Year of the Cat (as it is in Vietnam). It'll include some more eating, including of the fantastic left-overs…

Best

Erik

Erik F. Nielsen, Group Chief Economics Advisor* (UniCredit Bank, London)
+44 207 826-1765

erik.nielsen@unicredit.eu

** Erik Nielsen is an advisor to the UniCredit group and not a member of the research team. This note, however, is published and confined within the laws and regulation for research.*

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

Disclaimer

Our recommendations are based on information obtained from or are based upon public information sources that we consider to be reliable, but for the completeness and accuracy of which we assume no liability. All information, estimates, opinions, projections and forecasts included in this report represent the independent judgment of the analysts as of the date of the issue unless stated otherwise. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice. This report may contain links to websites of third parties, the content of which is not controlled by UniCredit Bank. No liability is assumed for the content of these third-party websites.

This report is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as marketing material within the meaning of applicable prospectus law . The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Fluctuations in exchange rates may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank AG, UniCredit Bank AG London Branch, UniCredit Bank AG Milan Branch, UniCredit Bank AG Vienna Branch, UniCredit Bank Austria AG, UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia, UniCredit Bank Czech Republic and Slovakia Slovakia Branch, UniCredit Bank Romania, UniCredit Bank AG New York Branch nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This report is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

This report was completed and first published on 22 January 2023 at 12:22.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §85 WpHG). Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: "Bank of Italy", Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst's remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst's views, which have not been influenced by considerations of UniCredit Bank's business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 20/1

UniCredit Research* Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

UniCredit Research, UniCredit Bank AG, Arabellastraße 12, D-81925 Munich, globalresearch@unicredit.de
Bloomberg: UCGR, Internet: www.unicreditresearch.eu

MR 22/3

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.