The Big Picture

Investment Research
7 June 2018

From boom to cruising speed

Highligths

- After a strong 2017, the global economy has lost some momentum in 2018
- However, the global economy will still grow at a decent pace in 2018-19
- Inflation pressures to rise only gradually, prompting cautious monetary policy tigthening
- The risks to our forecast are tilted to the downside from a possible Italy debt crisis and an escalation of global trade tensions

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Editorial deadline: 4 June 2018
Economics Research

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The Big Picture is a semi-annual analysis focusing on the outlook for the global economy.
Read about the prospects for, and the most important risks to, the global economy.
The publication Nordic Outlook presents our expectations for the Nordic economies.

Important disclosures and certifications are contained from page 34 of this report.

Global overview

From boom to cruising speed

- After a strong end to 2017, we see clear signs that the global business cycle is losing momentum in early 2018.
- While the global cycle is softening, we still expect growth to stay above potential in 2018 and 2019, led by the US, China and Emerging Markets.
- Inflation pressures will rise modestly, implying a gradual withdrawal of monetary policy support in advanced economies.
- The risks to our forecast are tilted to the downside from an escalation of trade tension into a full-blown trade war and renewed Italian debt crisis.

The global manufacturing cycle peaked in early 2018...

After a strong synchronised upturn in the global industrial cycle since early 2016, the global economy has seen a rocky start to 2018. This comes amid signs that the global manufacturing cycle is losing momentum, with PMIs falling back (albeit from high levels) and signals from our medium-term business cycle model. Furthermore, market sentiment was hit by inflation concerns in early February and rising yields in the US, which has hurt EM assets. Recently, trade tensions between the US and its major trading partners, notably China, have added to the wobbly market sentiment.

...But the global economy should still grow above potential

While global growth might be decelerating, we do not expect it to turn into a marked downturn over the next two years – rather, growth in the world economy should go from boom to cruising speed in line with its potential. As a result, we expect the global economy to grow 3.8% in 2018, falling to 3.7% and 3.6% over the course of 2019-20 as major central banks tighten monetary policies and capacity constraints weigh on production.

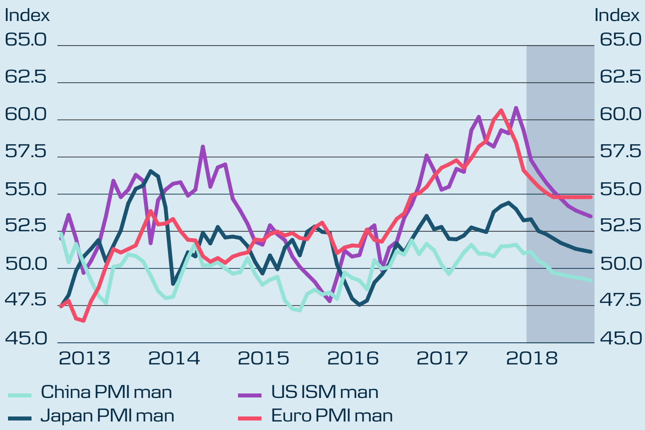
Since our forecast in December, we have become slightly more upbeat on US economic growth, mainly attributable to the sizeable fiscal expansion approved over the winter. Furthermore, China's economic growth has held up better than we expected as external demand has offset the negative impact of financial tightening. In the Euro area, our forecast from December remains unchanged, seeing a pick-up in real GDP growth to 2.1% in 2018, but slowing to 1.7% and 1.6% in 2019 and 2020, respectively, as the stronger Euro and global growth moderation would weigh on net exports, offsetting modest investment growth.

A pertinent question, in our view, is how long the recovery can go on for, with our current forecast suggesting that the current US expansion is the longest since the Second World War. At the same time, we question whether the flattening of the yield curve signals a US recession ahead (see box). We believe the short answer is yes, but the yield curve has to flatten further and then only after about 1.5 years would the recession set in, in our view. This would suggest the recession in the US is still at least three years away.

Gradual monetary policy tightening amid muted inflation pressures

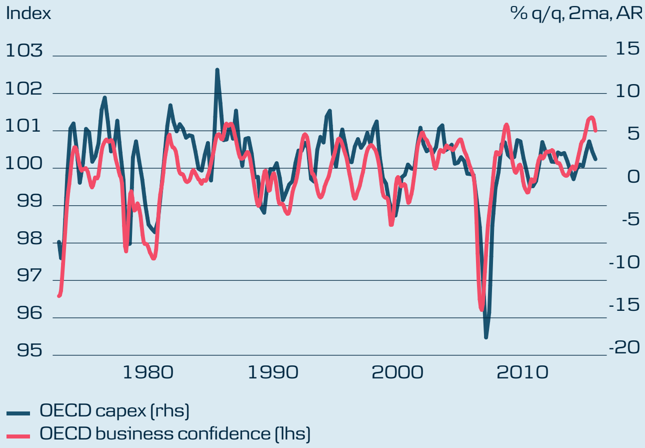
Typically, a recovery ends when central banks have to step on the brakes if inflation threatens to permanently exceed the central bank's target. However, despite solid economic growth and a tightening of labour markets in many countries, we are still not seeing a rapid rise in inflation pressures. Of course, headline inflation is being boosted by the rise in oil prices, but in our base case that the rise in oil prices is temporary, the impact on inflation should fade. Core inflation is rising only modestly as wage growth is still subdued even in economies with low unemployment rates, such as the US, Germany and Japan, due to limited wage demands, driven by relatively muted inflation expectations and globalisation pressures. Hence, we see core

Global manufacturing from acceleration to deceleration across regions...



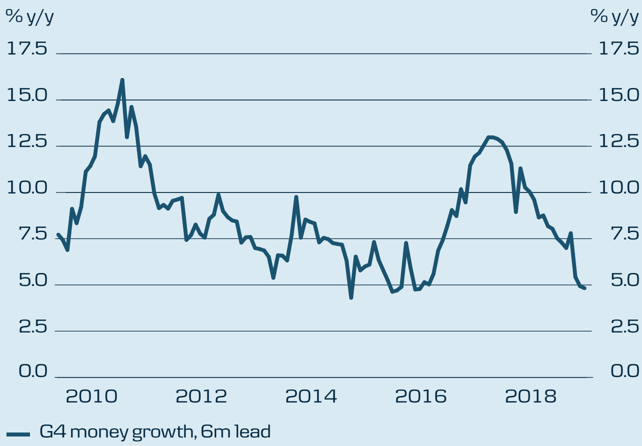
Source: Macrobond Financial, Danske Bank

Global capex boom not kicking off



Source: Macrobond Financial, Danske Bank

Global monetary conditions are tightening



Source: Danske Bank, Macrobond Financial inflation only reaching 1.4% in the euro area and 2.2% in the US by 2019. We believe the biggest upside risk to inflation is in the US given its sizeable fiscal expansion and limited slack in the economy.

Given the muted inflation outlook, we continue to expect a gradual tightening of monetary policy in G3. The Federal Reserve is widely expected to raise its interest rate two to three times more this year, followed by three hikes next year, still marking a very gradual hiking cycle compared with the past. In the euro area, the ECB is expected to gradually end its bond buying programme in Q4 2018 as the economic growth outlook has strengthened. However, given the muted inflation outlook, we recently postponed our call for the first ECB hike from June 2019 to December 2019. The same goes for Bank of Japan, which is also struggling to get inflation back towards its 2% target. This will only happen very slowly and therefore we expect BOJ to raise its yield target cautiously in 2019 by 0.10% as a first step towards removing the unprecedented policy support.

Political risk on the rise in Europe again

The risks to our forecast are tilted to the downside. One clear risks for the eurozone is the new Italian government and flaring up of the european debt crisis. The new government has signalled fiscal expansions which may likely lead to a breach of EU deficit rules and possible rating downgrades. Furthermore, the government is likely to push for significant euro area reforms that may not go down well with Germany and therefore could put the two countries on confrontational path. This could weigh on both euro area sentiment but also global risk appetite given the size of the Italian economy and debt (Italy accounts for 11% of total EU output).

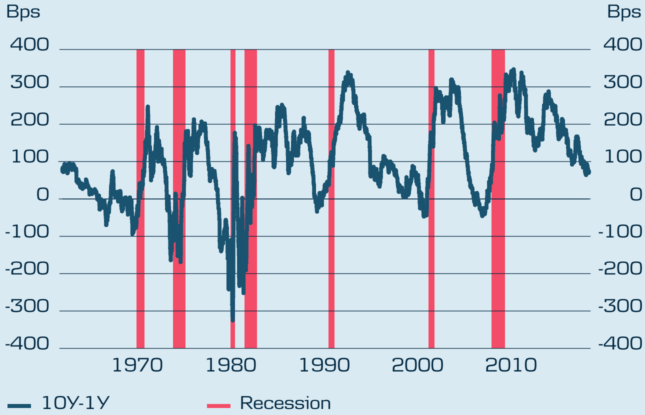
Risks from global trade war and an inflation surprise

Another significant risk downside risk is further escalation of the trade conflict between the US and major trading partners such as EU and China. In late May US imposed tariffs on steel and aluminium imports from EU, Canada and Mexico prompting retaliation from the affected countries. The same goes for China where there is also a risk for tit-for-tat trade war escalation. Such an escalation will weigh on global trade- and investor sentiment. Another important risk is a surprise acceleration in inflation, which can trigger a more aggresive monetary policy tightening in advanced economies. Among upside risks is the recovery in capex may be stronger than projected as companies seek to alleviate capacity constraints.

Global yields and the Euro are going to rise over the next year

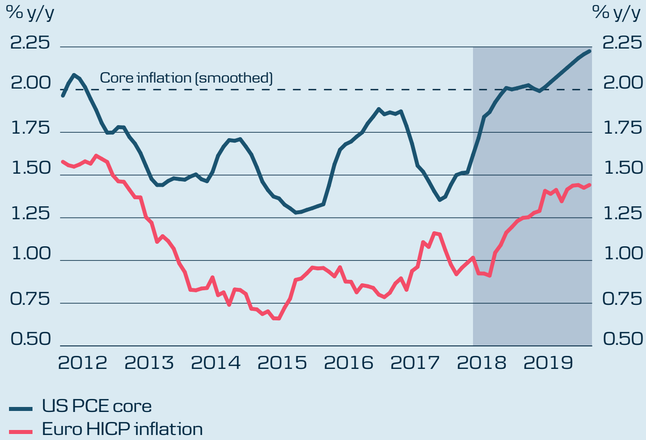
Over the past six months, global yields have started to move higher. We expect this trend to continue as inflation slowly picks up and term premium increases due to higher volatility and fiscal expansion in the US. Hence we see the US 10 year yield increasing to 3.3% in a year's time, up from 2.8% today. The higher US yields will push up yields in Germany with the 10-year yield increasing to 1.1% next year. We also see the EUR/USD moving higher eventually as the yield difference between euro and US narrows and high current account support FX flows into Europe.

A US recession is still some time away judging from the US yield curve



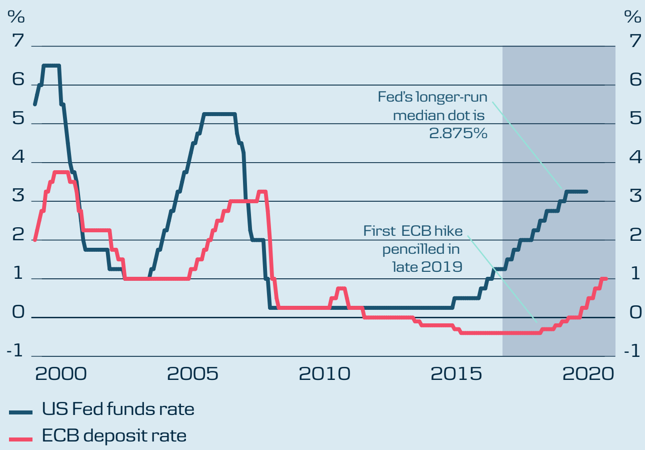
Note: Difference between one and 10 years US treasury yield.
Source: Macrobond Financial and Danske Bank

...Global inflation pressures are rising gradually



Source: Macrobond Financial, Danske Bank

Implying only gradual tightening of global monetary policies



Source: Macrobond Financial, Danske Bank

GDP forecasts - Global overview

	2017	2018		2019		2020	
% y/y	Actual	Danske Bank	Consensus	Danske Bank	Consensus	Danske Bank	Consensus
Global	3.7	3.8	3.8	3.7	3.7	3.6	3.3
Developed markets	2.2	2.1	2.4	1.9	2.2	1.6	1.9
USA	2.3	2.6	2.8	2.4	2.5	2.0	1.9
Euro area	2.4	2.1	2.3	1.7	2.0	1.6	1.7
Japan	1.7	1.0	1.2	1.1	1.0	0.5	0.4
UK	1.8	1.1	1.4	1.2	1.6	1.2	1.8
Emerging Markets	4.7	4.9	-	5.0	-	4.9	-
China	6.9	6.6	6.5	6.4	6.3	6.2	6.1
India	6.3	7.0	6.6	7.2	7.3	7.0	7.6
Russia	1.5	2.0	1.8	2.1	1.7	2.2	1.6
Brazil	1.0	2.2	2.5	2.4	2.8	2.6	2.8
Turkey	6.8	3.5	4.2	3.0	4.0	2.7	3.8
South Africa	1.3	2.3	1.9	2.3	2.0	2.6	2.1
ASEAN-5[2]	5.3	5.3	-	5.4	-	5.4	-
Middle East and NA[1, 2]	2.6	3.4	-	3.7	-	3.7	-
Sub-Saharan Africa (ex SA)[2]	3.2	3.9	-	4.2	-	4.3	-
LatAm (ex Brazil)[2]	1.4	1.9	-	2.9	-	3.1	-

1. NA is North Africat
2. IMF WEO October 2017 projections
Source: Bloomberg. IMF. Danske Bank

Does the US yield curve foresee a recession around the corner?

What is the experience of the yield curve as a predictor of recessions in the US?
The term spread, i.e. the difference between long-term and short-term interest rates, has typically been a very good predictor of future economic activity. Every US recession in the past 60 years has been preceded by a negative term spread, i.e. short-term interest rates exceeding longer ones.

What is the rationale behind the slope of the yield curve as a recession predictor?
During an economic expansion, the Fed normally tightens its monetary policy stance by gradually raising short-term interest rates. Long-term rates, which typically reflect expectations of future economic conditions, tend to move up with short-term rates during the early part of the expansion but then stop doing so once investors' economic outlook becomes increasingly pessimistic. This first flattens and then ultimately inverts the yield curve.

Does the current slope of the yield curve predict a near-term US recession?
While the yield curve has flattened quite significantly, the difference between the one-year and 10-year yield is still 74bp, still a long way from inverting. Our current 12M forecast is for the term spread to fall to around 30bp. Based on this trajectory, the yield curve would first invert around end-2019. From then on, it usually takes around 16 months before the recession sets in, i.e. around the first half of 2021. Some caution needs to be taken against relying solely on this measure, as each expansion and recession may have its distinct features.

US

Decent growth ahead of midterm elections

- GDP growth is expected to slow gradually but remain above trend both this year and next.
- Fiscal policy has become even more expansionary but it is not the right time to do it.
- Core inflation is set to move higher but it is a gradual process.
- The Fed will continue to raise rates gradually but EUR/USD is still set to move higher eventually.

Growth is set to slow slightly

The US economy is still in good shape although GDP growth slowed slightly in Q1 18. It is the first time since the investment downturn hit the economy that GDP growth has been above 2% annualised in four consecutive quarters. Confidence remains high among both consumers and businesses, so we expect decent domestic demand growth in coming years but probably at a slightly slower pace, as there are signs growth has peaked for now despite more expansionary fiscal policy. Private consumption has grown quite steadily at around 2.5% in recent years, but we expect slightly slower growth in the coming years, as real wage growth has slowed due to higher inflation and still subdued nominal wage growth and employment growth is not as high as previously. While non-residential investments have recovered after the investment recession in 2014-16 in the wake of the oil price collapse, we have seen softness in recent months. It is probably linked to the peak we have seen in manufacturing PMIs globally, as the manufacturing sector is more investment heavy than the service sector.

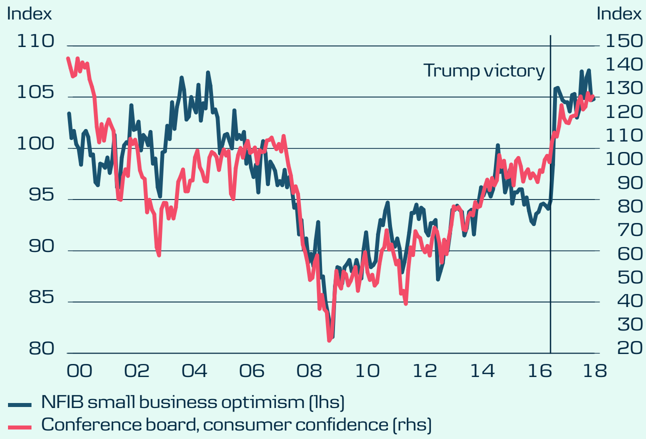
We forecast annual GDP growth will increase to 2.6% this year from 2.3% last year, but this is partly due to overhang effects, as our quarterly GDP growth profile is actually slightly lower this year than last year. The biggest change since our latest forecast is that fiscal policy has become even more expansionary since the Congress decided to lift the budget caps for fiscal years 2018 and 2019. We forecast GDP growth to slow to 2.3% in 2019 and 1.9% in 2020, as the impact of the more expansionary fiscal policy fades and economic growth falls back to more sustainable rates. In our view, potential GDP growth in the US is in the 1.75-2.00% range. That growth remains above potential, at least this year and next, means the labour market continues to tighten and we expect the unemployment rate to reach 3.5% by the end of 2019. One big question is how much slack is left in the labour market and, if the expansion continues, whether we may see some of the discouraged workers returning to the labour force. After many years of decline, the participation rate has stabilised around the current level of 62.8%.

Expansions do not die of old age

It is natural to ask how much further the expansion can last and whether the economy may soon be heading for a downturn. Especially the continuing flattening of the US yield curve has attracted a lot of attention recently, as an inversion is considered a good recession indicator by some. The Fed is unlikely to let it invert, so it may have lost its predictive power and even if it does invert, it is difficult to predict how long it will take before a recession hits. However, we think one should focus elsewhere, as the yield curve is almost certain to invert ahead of a recession as the markets start to price in Fed cuts. Instead, one should look out for factors that could initiate this repricing.

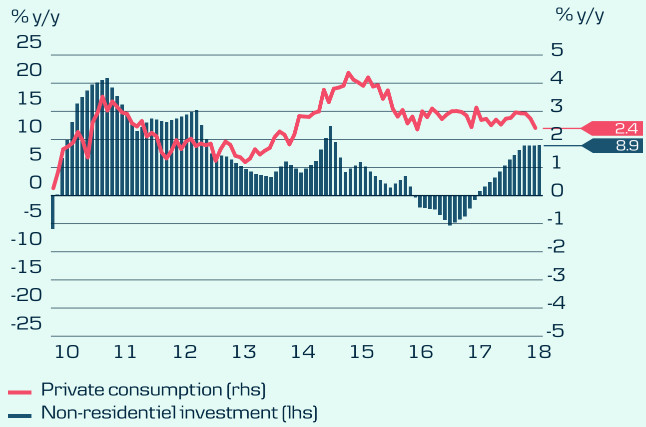
We think it is important to remember that expansions do not die of old age, meaning that just because the expansion has lasted for a long time, a crisis does not have to be just around the corner. Something needs to go wrong for the economy to turn around and at the moment optimism remains. Also, the expansion has been more gradual than previous expansions. The risk of a recession in coming years is low at the moment, in our view. Right now, there are only a few triggers for a downturn but a few are a sharp increase in yields, a financial crisis in China and the possibility of a full-blown trade war.

Optimism remains high



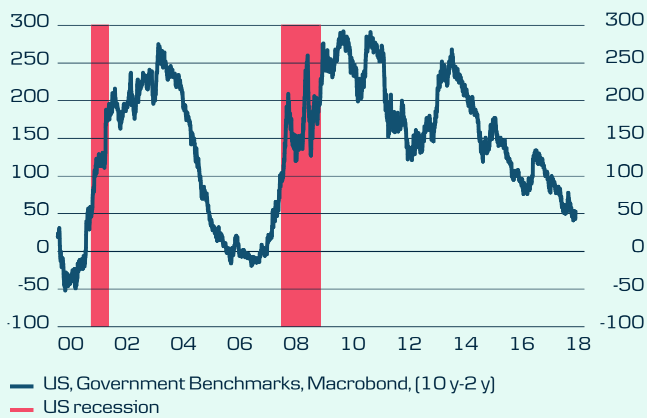
Source: Conference board, NFIB, Macrobond Financial

Growth now driven by both consumption and investments



Source: BEA, Macrobond Financial

Is a recession around the corner? Yield curve is flattening



Source: Macrobond Financial

Expansionary fiscal policy means higher debt

Fiscal policy has become more expansionary due to the combination of deficit-financed tax cuts and higher budget spending caps. From a Keynesian point of view, the US should tighten fiscal policy now, not expand it, as fiscal policy should be countercyclical, not pro-cyclical. This means that the US Congressional Budget Office (CBO) estimates US government debt will increase from around 76% of GDP to 96% over the next 10 years, up from 91% previously. In practice, it is likely to move even higher, as the CBO assumes some elements of tax reform and budget deal are temporary despite the politicians' intention to extend them (or make them permanent). If so, debt may increase as much as to 110% over 10 years. Markets do not seem worried at the moment, as the low rates mean interest payments are still low but this may change, especially when the economy falls into recession next time. What the US should have done was to make reforms, which boost productivity growth, which has been very low in this expansion.

Upside risks to inflation

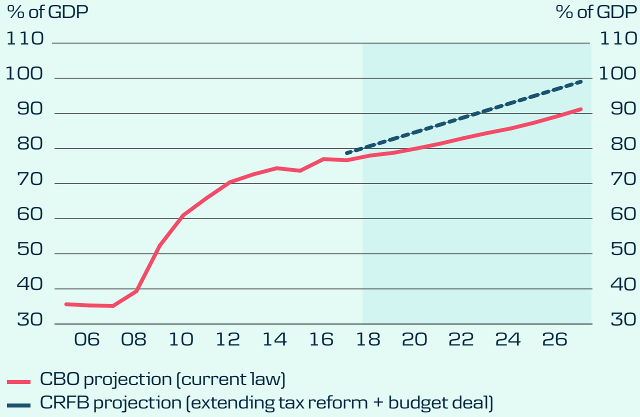
From a theoretical point of view, more expansionary fiscal policy should be inflationary when we are at this point of the cycle and it is also the main reason why we think there is upside risk to US inflation. Our base case is still that underlying inflation is set to move higher but it will be a gradual process, as inflation is quite persistent. When inflation is low (high), it is likely to remain low (high) for a while, before it moves back towards its long-run level. Also, it takes time for fiscal policy to actually have an effect on the economy. Despite the labour market continuing to tighten, nominal wage growth remains subdued, suggesting underlying inflation pressure is not that high at the moment. One reason is probably that inflation expectations are still low in an historical perspective, which means wage growth demands are also low. Inflation expectation is a more important factor determining actual inflation than the tightness of the labour market.

Fed on autopilot – EUR/USD still set to move higher

The Fed is expected to continue its hiking cycle and seems more or less on autopilot. The biggest change since our last edition of Big Picture is that the Fed is now signalling that it is about to raise the Fed funds target range above the so-called natural rate (which is the rate where monetary policy is neither expansionary nor contractionary) over the coming years. The reason is that fiscal policy has become more expansionary and the Fed fears the economy may overheat if it does not offset it at least partly. Still, we believe the total policy mix has become more expansionary, which is another reason why we believe inflation will increase. We forecast two-three additional hikes this year (with the next one coming at the June meeting) depending on how data actually evolves.

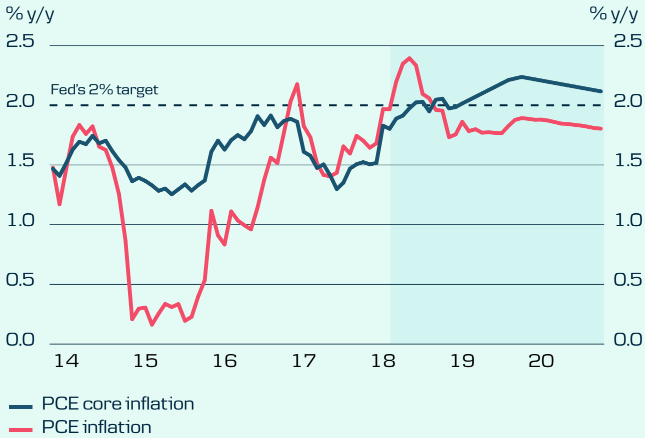
EUR/USD has been on a rollercoaster ride this year. In February, it went above 1.25 but it is currently trading around 1.16. In our view, EUR/USD will be stuck below 1.20 for longer due to a combination of the political situation in Italy, higher US yields and the ECB turning more dovish. We still believe the next big move in EUR/USD will be up when we see a turn in the capital tide from USD to EUR but it may take longer for it to materialise than we previously thought.

Deficit-financed tax reform and higher spending lead to higher debt



Source: CBO, Committee for a Responsible Federal Budget, Macrobond Financial

PCE core inflation is set to move gradually higher



Source: BEA, Macrobond Financial, Danske Bank

Fed to raise the target range above 3% over the next few years

Source: Federal Reserve, Macrobond Financial, Danske Bank

Macro forecasts - US

	2018				2019				Calendar year average		
% change q/q AR	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020
GDP	2.2	2.6	2.4	2.4	2.3	2.3	2.3	2.3	2.6	2.4	2.0
Private Consumption	1.0	2.4	2.4	2.4	2.2	2.2	2.2	2.2	2.4	2.3	2.0
Private Fixed Investments	6.5	4.3	4.0	4.0	4.0	4.0	4.0	4.0	5.2	4.0	3.4
Residential	-2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.4	2.0	2.0
Non-residential	9.2	4.9	4.4	4.4	4.4	4.4	4.5	4.5	6.3	4.5	3.7
Change in inventories[1]	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public Consumption	1.1	1.0	1.0	1.0	1.2	1.2	1.2	1.2	1.3	1.1	1.0
Exports	4.2	4.1	3.0	3.0	3.0	3.0	3.0	3.0	4.2	3.1	2.4
Imports	2.8	3.2	3.0	3.0	3.0	3.0	3.0	3.0	4.4	3.0	2.6
Net exports[1]	0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1
Unemployment rate (%)	4.1	3.9	3.8	3.7	3.6	3.6	3.6	3.5	3.9	3.6	3.5
Inflation (CPI) (y/y)	2.4	2.9	2.5	2.3	2.2	2.0	2.0	2.1	2.5	2.0	2.1
Core inflation (CPI) (y/y)	2.1	2.3	2.3	2.4	2.3	2.5	2.6	2.6	2.2	2.5	2.5
Public Budget[2]									-4.0	-4.6	-4.6
Public Gross Debt[2]									106	107	108
Current Account[2]									-3.0	-3.4	-3.7
Fed funds rate[3]	1.75	2.00	2.00	2.25	2.50	2.75	2.75	3.00	2.25	3.00	3.25

1. Contribution to annualised GDP growth
2. Pct. of GDP (CBO and IMF)
3. Upper limit. end of period
Source: CBO. IMF. Danske Bank

Midterm elections in November

The midterm elections take place on 6 November this year, with all 435 voting seats in the House of Representatives and 35 seats in the Senate up for election. The election is important, as President Trump needs support from Congress to pass legislation, which is difficult if the House and the Senate have different majorities. Historically, a new-elected President loses the majority at the first coming midterm elections (exceptions in modern times are Bill Clinton in 1993 and George W. Bush in 2001), which speaks in favour of Donald Trump becoming a lame duck (politically speaking) next year. This also seems to be most political analysts' base case. However, it is not going to be easy for the Democrats despite Trump's low approval ratings and the Democrats leading in the opinion polls and having good results in recent local elections.

In the House, the Republicans hold 241 seats, meaning the Democrats need to win 24 seats to gain control (and 17 out of 21 considered toss-up seats). This may be the case given the opinion polls and that the President's party usually loses seats in the midterm election. The problem for the Democrats is that the elections are 'winner-takes-all' elections and many Democrats are gathered in fewer districts, so they need to win with a big margin in order to gain control. The Republicans have held the majority in the House every year since 1994, except 2006-10.

Looking at the Senate, the Democrats hold 24 of the 35 seats up for election (and two independents who support the Democrats). The Democrats need to win their own seats and both Republican toss-ups to take the Senate and the problem for the Democrats is that some of the Democrats' seats are in states where Trump is popular and had a good election.

Euro area

Soft landing – cautious ECB

- We expect the euro area economy to expand by 2.1% in 2018, 1.7% in 2019 and 1.6% in 2020, driven by stronger domestic demand, while net exports are likely to become a moderate drag in 2019 and 2020. Risks to the growth outlook loom from the trade war/protectionism and a shortage of skilled labour.

- Despite the narrowing output gap and continued employment gains, we expect wage growth to stay below the long-term average due to significant slack in the labour market.

- We expect core inflation to pick up gradually until end-2019, while headline inflation should stay below target without a lift from energy prices.

- We expect the ECB to end its QE programme in December 2018, before embarking on a slow hiking cycle starting in December 2019.

Moderation recently, but still solid growth

While growth is expected to accelerate to 2.1% in 2018, according to our projections, well above its potential growth rates, we expect a soft landing in 2019 of 1.7% and 2020 of 1.6% (forecasts are broadly unchanged from December's Big Picture although here we include our 2020 forecast). The expansion will be driven primarily by domestic demand (private consumption and investments). In Q1 18, the euro area economy expanded by 0.4% from the previous quarter, likely to have been driven by domestic demand but with less support from net exports. Although temporary factors have been at play, we also see increasing arguments for why the recent moderation is more than just a soft-patch and more permanent factors are at play, in particular capacity constraints such as a shortage of skilled labour.

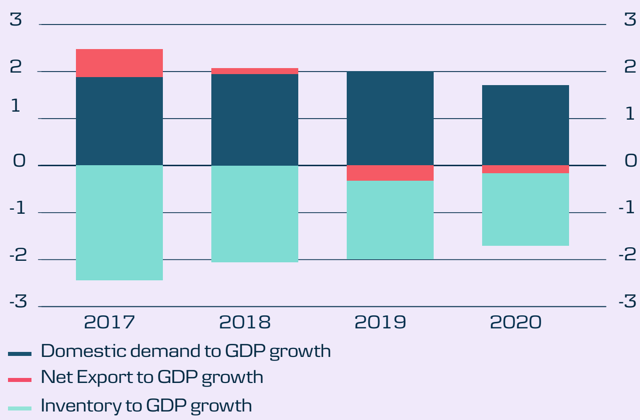
The combination of low borrowing costs and continuing employment gains means that we are still positive on the outlook for private consumption in the euro area. However, US protectionism/trade war intentions have hampered confidence. Some weakness spilling over via the trade channel in coming quarters is also possible. Import growth rates are expected to slow marginally, but still grow to record high levels, driven by stronger domestic demand. This means that the contribution from net exports to GDP growth will turn negative form 2019. For 2019 and 2020, we expect GDP growth to moderate to 1.7% and 1.6% respectively, staying well above potential growth, which the European Commission (EC) estimates at 1.5%. Hence, the output gap is expected to turn positive this year, supported by a continued fall in the unemployment rate from its current level of 8.5% to 8.4% by end-2018 and 7.9% by end-2019.

However, uncertainties regarding the slack in the labour market are high. The broader unemployment measure, the so-called U6, indicates that there is still a fair amount of slack in the labour market. The EC estimates NAIRU at 8.3% in 2018. We expect the unemployment rate to fall below the NAIRU in late 2018/early 2019, meaning that wage growth will stay muted despite the recent modest acceleration in certain jurisdictions.

The political landscape in Europe has changed recently. In particular, there are concerns about Italy remaining the most fragile among the big eurozone countries due to a combination of banking sector weaknesses, a high public debt burden combined with a weak growth outlook and political risks. The appointment of a populist government between Five Star Movement and League has brought Italian risks back into the spotlight. Their policy programme, which envisions a big fiscal expansion in clear violation of EU budget rules, has spooked financial markets given Italy's high public debt burden. Although we see the risk of a pro-longed stand-off between the populist government and the EU, our base case remains that it will eventually abide by EU rules. We assess the risk of Italy exiting the single currency as very low, not only due to constitutional hurdles, but also because a majority of the population is still in favour of the euro (see also Italian Election Monitor, 1 June 2018).

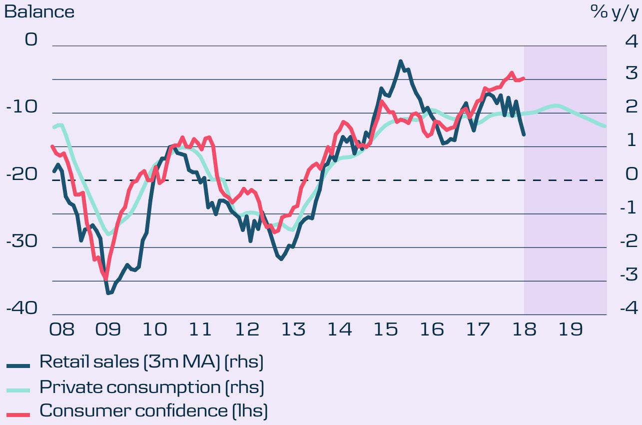
At the same time, calls for deeper EU integration led by France's President Emmanuel Macron have been met with opposition from Germany's more reluctant stance. The main differences in view related mainly to increased risk sharing

Domestic demand set to drive the economic expansion while inventories will drag



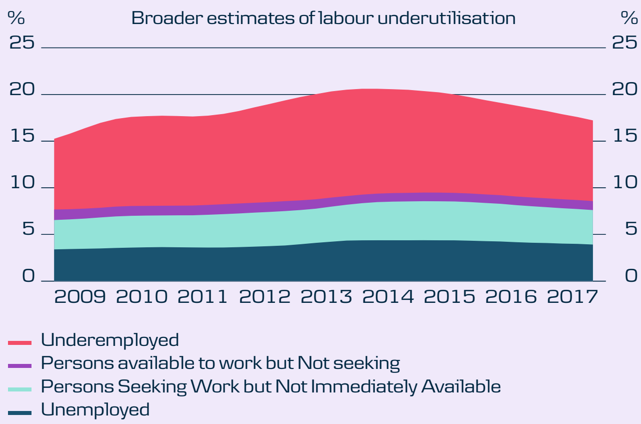
Source: Eurostat, Macrobond Financial, Danske Bank

Private consumption growth to accelerate in 2018 and to moderate in 2019



Source: Eurostat, EC, Macrobond Financial, Danske Bank

Broader unemployment measures indicate slack in the economy (% of extended labour force)



Source: Macrobond Financial, Danske Bank

(France's view) and the risk reduction view (Germany's view). The EU summit in late June has long been the key event for embarking on further integration; however, we expect only cosmetic initiatives, in particular given the strong resistance from Germany.

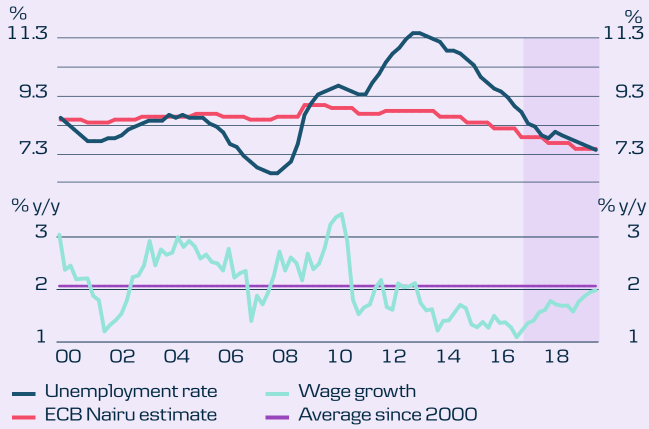
The ECB 'will cross the bridge when it gets there'

In March 2018, the ECB took its latest step in gradually removing its very accommodative monetary policy stance, when it removed its QE flexibility of being ready to scale up the purchase volume again. That means that the ECB's purchases programme will continue at least until September at EUR-30bn/month, a purchase rate it commenced in January 2018. We expect a further reduction in the purchase rate in Q4 18 to EUR15bn/month, before the last bond under the government bond purchase programme is bought by the end of the year. Overall, we expect the ECB to adopt a cautious stance on normalising monetary policy in which it will be reactive and not proactive in removing its stimuli measures. While any discussion of the first rate hike is premature in the ECB's view, we expect the first 20bp rate hike in the deposit rate to come in December 2019. See also, Not on Draghi's watch, 20 April 2018. Markets have started speculating on this, in particular given the uncertainty prevailing about the size of the hike. We reflected on this in 10bp, 20bp or ...? ECB in uncharted waters, 20 March 2018, although the ECB will only communicate on this at a relatively late stage.

The ECB's reinvestment policies will gain more importance in its guidance going forward. With reinvestments set to average around EUR10bn/month over the next year, the accommodative monetary policy stance will be ensured. This also supports the ECB's very conscious approach to a gradual normalisation. The ECB seems content with moderately higher yields, but the pace of a potential sharp rise in yields is a concern to it. We believe the ECB is too optimistic on its growth outlook, where the March staff projections pointed to 2.4% in March. With the recent moderation in both soft and hard data, we expect the ECB to revise this figure down closer to our estimate of 2.1%. See Research: Global business cycle is moving lower, 19 April 2018.

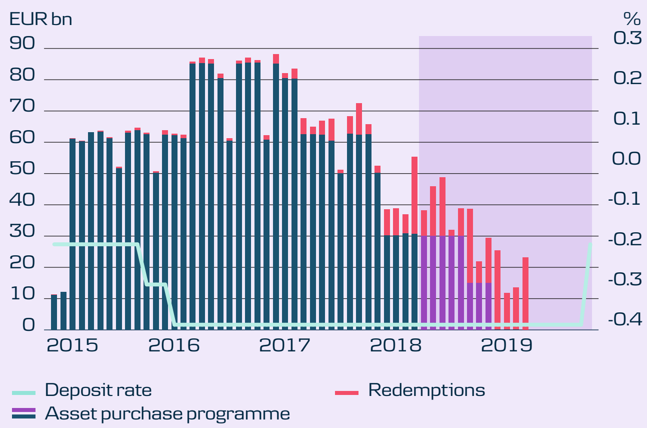
While price stability, according to the ECB's definition, is headline inflation 'below but close to 2%', the key inflation metric to assess is the core inflation, i.e. inflation excluding the volatile food and energy prices, as the ECB also wants a self-sustained inflation path. However, with core inflation only reaching 1.5% by the end of next year, from its current level of around 1%, there is still some way to go. Wage growth in certain jurisdictions will provide some upward pressure on core inflation in particular in 2019. However, at the same time, slack in other parts of the euro area will restrict core inflation from rising markedly in the near future.

Wage growth to slowly converge to long-term average by end-2019, amid continuing employment gains



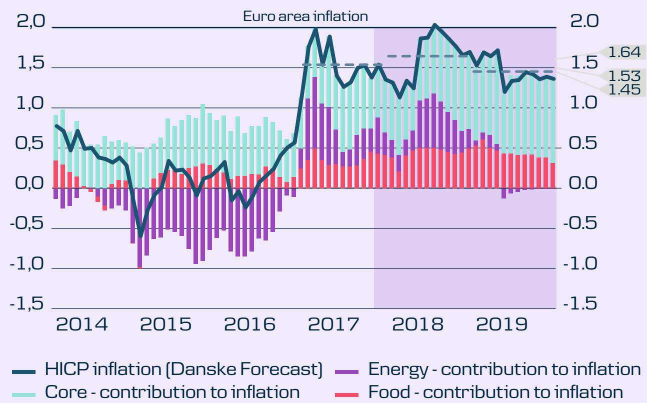
Source: Eurostat, EC, ECB, Macrobond Financial, Danske Bank

We expect the ECB to end PSPP purchases in Q4 18 and hike the deposit rate in December 2019



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Inflation set to pick up in 2019 but stay below target without a lift from energy prices



Source: ECB, Macrobond Financial, Danske Bank

Expectations for key figures and central banks over coming quarters

% Change q/q	2018				2019				Calendar year average			
Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019	2020
GDP	1.7	1.6	1.6	1.6	1.8	1.8	1.7	1.7	2.5	2.0	1.7	1.5
Private Consumption	1.6	1.8	1.8	1.8	1.8	1.8	1.6	1.6	1.7	1.5	1.8	1.6
Private Fixed Investments	4.5	4.5	4.5	4.5	3.2	3.2	3.2	3.2	3.2	4.0	3.7	2.9
Public Consumption	1.4	1.4	1.4	1.4	1.2	1.2	1.2	1.2	1.2	1.4	1.3	1.1
Exports	3.2	3.2	3.2	3.2	3.4	3.4	3.4	3.4	5.4	4.9	3.4	3.4
Imports	4.9	4.9	4.9	4.9	4.1	4.1	4.1	4.1	4.5	5.0	4.4	4.1
Net exports[1]	-1.6	-1.6	-1.6	-1.6	-0.6	-0.6	-0.6	-0.6	0.9	-0.2	-1.0	-0.6
Unemployment rate (%)	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.8	9.1	8.4	8.0	7.6
CPI (y/y)	1.3	1.7	1.9	1.7	1.6	1.4	1.4	1.4	1.5	1.6	1.5	1.6
Core CPI (y/y)	1.0	1.0	1.2	1.3	1.4	1.4	1.4	1.4	1.0	1.1	1.4	1.5
Public Budget[2]									-0.9	-0.7	-0.6	-0.5
Public Gross Debt[2]									88.8	86.5	84.1	82.0
Current Account[2]									3.5	3.4	3.4	3.4
ECB deposit rate[3]	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.2	-0.4	-0.4	-0.2	0.5

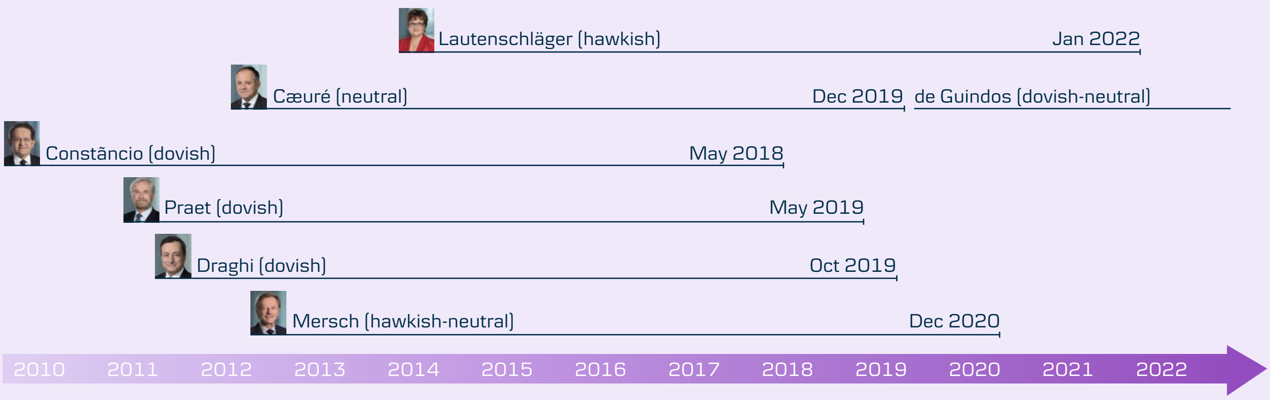
1. Contribution to GDP growth
2. Pct. of GDP
3. End of period
Source: Eurostat, Danske Bank estimates

Changing composition of the ECB board

By the end of December 2019, the ECB's board (GC) will have undergone a marked change in its composition. The ECB's president Mario Draghi, Vice-president Vitor Constancio, Chief economist Peter Praet and head of market operations Benoit Coeuré will all be replaced. While VP Constancio's replacement has been announced, the verdict is still out on who will succeed the other three candidates. Spain's Luis de Guindo will take the VP position on 1 June.

The changing composition, which is likely to lead to a slightly more hawkish ECB, could also change its overall tone – but only towards the end of 2019.

The selection of new board members is not a straightforward exercise and this process will be part of a bigger horse-trading exercise alongside the European Parliament elections next year. Germany's Bundesbank President Weidmann is often mentioned as a frontrunner for the position. However, with the current German political landscape, Chancellor Merkel may want to use the political capital elsewhere. Adding to the complexity of the discussions, unwritten rules about country of origin and the European Parliament's continued call for a better gender balance should not be underestimated.



Source: ECB, Danske Bank

Germany

Cruising along, but vulnerable

- We think the current boom phase still has 'air to run' with growth to remain above potential at 2.1% in 2018E and 1.9% in 2019E, before moderating to 1.6% in 2020E.

- We expect domestic demand to rebound, not least due to higher public spending under the new government, while net exports would increasingly become a headwind to growth.

- Risks to the growth outlook for the export-dependent German economy stem mainly from the external side amid the ongoing US-China trade spat and its implication for global trade.

- The tight labour market has started to spill over to higher negotiated wages, leading us to expect a gradual rise in core inflation from H2 18 onwards.

Smooth sailing as boom continues

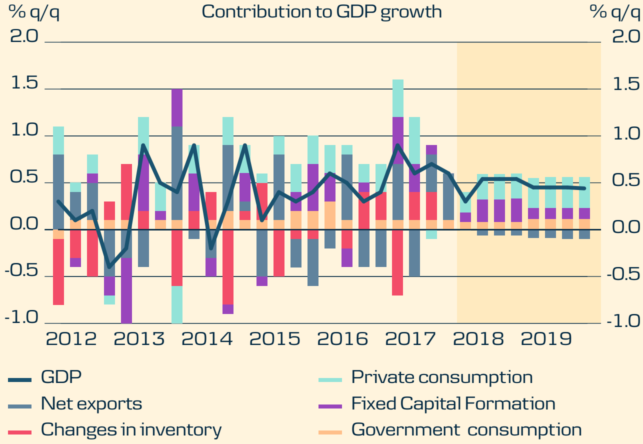
The German economy experienced strong growth of 2.5% in 2017 and we think the current boom phase still has 'air to run' in the next two years as capacity utilisation remains below historical peaks despite increasing labour shortages. Overall, we expect growth to remain above potential at 2.1% in 2018 and 1.9% in 2019, before moderating to its potential level at 1.6% in 2020. We expect the German economic momentum to be supported by continued employment gains, easy monetary conditions, solid global growth and not least, the more expansionary fiscal policy of the new government. Risks to the growth outlook for the export-dependent German economy stem mainly from the external side, where the euro appreciation and US-China trade conflicts could adversely affect business sentiment and investment activity.

Although economic activity lost momentum in Q1 18, with growth moderating to 0.3% q/q (from 0.6% q/q in Q4 17), this was partly due to temporary factors, such as an unusually severe flu season and several days of strikes in the metal industry during the - now resolved - IG Metall bargaining round. We look for slightly higher GDP growth rates of 0.5% q/q in the coming quarters, as some of these temporary headwinds fade. Following a weak spell in H2 17, we expect private consumption to become an important growth driver again, supported by positive real wage growth, low borrowing costs and simulative fiscal measures such as a lowering of unemployment insurance and pension contributions as well as the return to parity in the financing of the statutory health insurance. But as many of the coalition agreement's planned measures would take effect only at the turn of the year, we expect the boost to public and private consumption to be more pronounced in 2019. We project investment activity to remain dynamic in the absence of an escalating global trade war, not least because sentiment indicators such as Ifo remain at high levels, credit standards remain loose and increasing capacity constraints and labour shortages favour productivity-enhancing capital investments. In our view, the momentum in global growth will abate only slowly, meaning that robust foreign demand for German products would continue to fuel net exports in 2018. However, in light of the moderating global cycle and dynamic import growth, we expect net exports to become a drag on growth in 2019.

Core inflation rising gradually

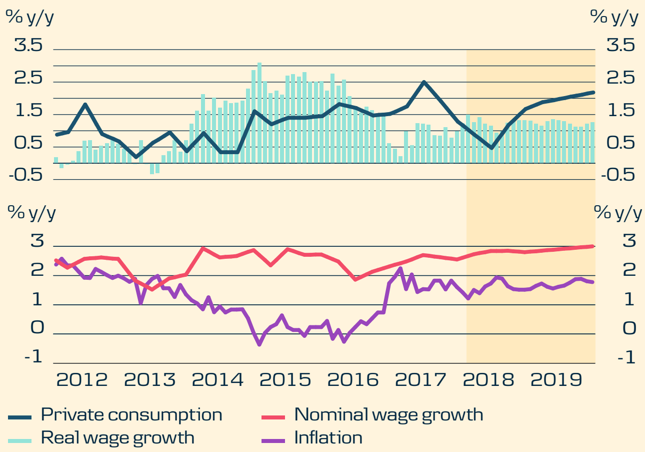
With growth staying above potential, we expect the unemployment rate to decline further to 3.3% in 2019. The tight labour market has started to spill over to higher negotiated wages and we expect wage growth in Germany to accelerate to 3.0% in 2019, also due to a possible increase in the minimum wage and falling net immigration from Eastern European countries (see Part 2: Eurozone Inflation - Upside risks from oil prices and rising wage pressures). Although we expect core inflation to increase to 1.8% in 2019, supported by rising wages, headline inflation should remain below the ECB's 2% target over the forecast horizon as global factors and a stronger euro will continue to be mostly headwinds.

Domestic demand set to rebound



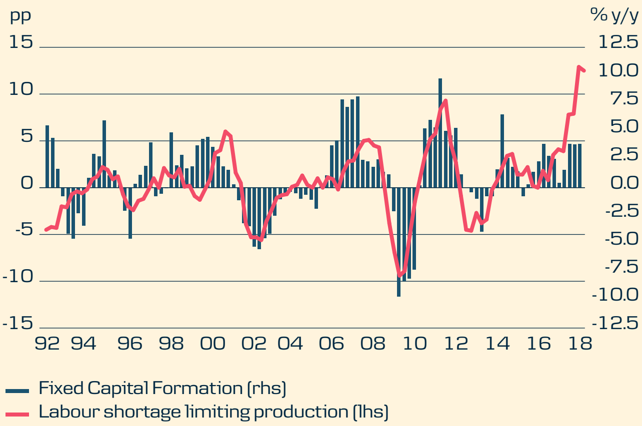
Source: Destatis, Macrobond Financial, Danske Bank

Positive real wage growth despite increasing inflation



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Increasing labour shortages favour investment spending



Source: Eurostat, EC, Macrobond Financial, Danske Bank

Germany's trade vulnerability

The German economy is characterised by a high degree of openness, with exports accounting for roughly 50% of GDP. This makes the economy very susceptible to a deterioration in the global trade environment and especially recent protectionist tendencies from the US. President Trump plans to impose tariffs on European steel and aluminium, but the direct impact would be negligible for Germany: steel and aluminium account only for 3% of total German exports, of which the US' share is only 4.3%. Hence, only 0.13% of total German exports would be affected by such tariffs. However, the indirect effect of such measures should not underestimated in our view, as the lingering threat of additional tariffs on other sectors risks weighing on German business sentiment and investment activity. Many German companies are also highly integrated in global value chains and have set up subsidiaries and production facilities in China and the US. They would, hence, suffer significant collateral damage from either US or Chinese tariff measures. The important German car industry in particular could become a target in case of further escalation in the trade conflict, which would impair the German growth outlook significantly. BMW and Daimler are the largest vehicle exporters from the US by value and China is their number one market, making them among the prime victims of possible Chinese import tariffs on US cars.

Germany's car industry in a soft spot

Source: Destatis, Macrobond Financial, Danske Bank

Macro forecasts - Germany

% change q/q Annualised rate	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	Calendar year average 2017	2018	2019	2020
GDP	1.2	2.2	2.2	2.2	1.8	1.8	1.8	1.8	2.5	2.1	1.9	1.6
Private Consumption	1.6	2.0	2.0	2.0	2.4	2.4	2.4	2.4	2.1	1.3	2.3	2.0
Private Fixed Investments	4.1	4.9	4.9	4.9	2.4	2.4	2.4	2.4	3.9	3.5	3.3	2.2
Public Consumption	-2.0	1.6	1.6	1.6	2.4	2.4	2.4	2.4	1.6	0.8	2.1	2.2
Exports	-3.9	4.1	4.1	4.1	3.6	3.6	3.6	3.6	5.3	3.7	3.8	3.1
Imports	-4.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.6	3.5	5.3	4.5
Net exports [1]	-0.1	-0.2	-0.2	-0.2	-0.5	-0.5	-0.5	-0.5	0.2	0.3	-0.4	-0.4
Unemployment rate (%)	3.5	3.5	3.4	3.4	3.3	3.3	3.2	3.2	3.8	3.4	3.3	3.2
CPI (y/y)	1.3	1.9	2.3	2.0	2.1	1.7	1.7	1.8	1.7	1.9	1.8	1.8
Core CPI (y/y)	1.3	1.2	1.6	1.6	1.8	1.8	1.9	2.0	1.3	1.4	1.9	1.9
Public Budget[2]									1.3	1.2	1.4	1.0
Public Gross Debt[2]									64.1	60.2	56.3	54.0
Current Account [2]									8.0	7.9	7.6	7.3

1: Contribution to GDP growth, 2: Pct. of GDP, 3:End of period
Source: Eurostat, Danske Bank

UK

It is still all about Brexit

- The domestic leg is struggling due to a combination of weak real wage growth limiting the scope for private consumption growth and Brexit uncertainties weighing on business investments. Economic growth is set to remain weak in coming years.
- Inflation is set to move lower, as the effect of the GBP depreciation is fading.
- Our base case for Brexit remains a 'decent Brexit' where the UK leaves the single market and most likely also the customs union but strikes a free trade deal agreement similar to the one the EU has with Canada (probably more comprehensive on services). We expect a lot of noise ahead of the important EU summits later in June and in October.
- We still expect the Bank of England to tighten monetary policy but believe it will do this more gradually than we previously expected, as economic data have surprised on the downside.

Growth set to remain weak

Economic growth surprised positively in the second half of 2017 but was off to a weak start in Q1 18, as GDP grew by just 0.1% q/q, which is among the weakest in Europe (EU28 grew 0.4% q/q as a whole in the same quarter). While some argue that the weather was to blame, the UK Office for National Statistics said the weather only had a limited impact on growth in Q1 and the PMIs remained weak in April. We think it is important to see what has driven growth. In 2017, global growth accelerated, which also benefitted the UK manufacturing sector while the domestic leg struggled due a combination of negative real wage growth limiting the scope for private consumption growth and Brexit uncertainties weighing on business investments. Now that the period with increasing manufacturing growth is over and growth has slowed slightly, the slowdown in the domestic leg is more visible in the numbers. It is also very striking that annual GDP growth has slowed in the UK while it accelerated in the rest of the world. Unfortunately, we expect economic growth in the UK to remain weak over the forecast horizon. While the real wage squeeze has come to an end, it will remain weak and it is difficult to see much higher private consumption growth in this scenario. Between one-third and one-half of the UK companies still say Brexit uncertainties mean that it is not a good time to invest. We forecast GDP growth of 1.1% this year, 1.2% next year and 1.2% in 2020 but stress that Brexit remains a big source of uncertainty. Note the Bank of England has estimated that potential GDP growth has declined to 1.5% y/y (which we think may be too optimistic) so despite slower GDP growth, it may still be enough for the recovery to continue.

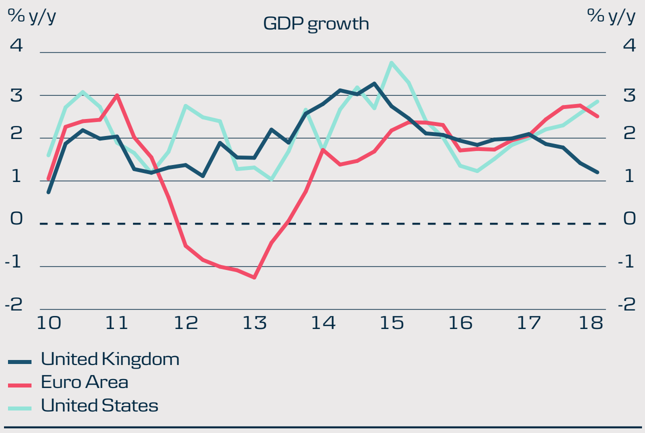
Inflation will move lower

The significant GBP depreciation is the main reason why CPI inflation remains above 2%, as it has increased import prices, which have slowly passed through to consumer prices. However, it seems that this effect has peaked and although inflation remains high compared to the US and the rest of Europe, it is on its way down again and at a faster pace than we expected in our latest edition of Big Picture. We expect headline inflation to run above core inflation this year but move below next year, as the positive contributions from energy and in particular food diminish. We forecast CPI headline to remain above 2% this year while CPI core inflation will hover around 2% before falling to the range 1.50-1.75%. The overall underlying inflation pressure is not that high, as nominal wage growth remains subdued despite recent increases and inflation expectations are well-anchored.

Labour market has been quite resilient

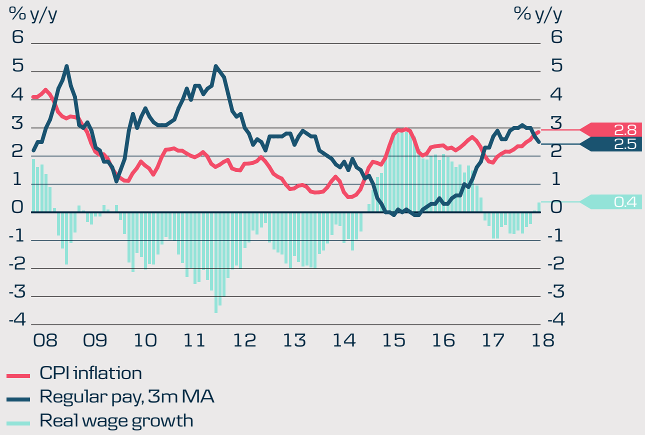
The labour market has proven to be quite resilient to slower growth and Brexit uncertainties and the unemployment rate has fallen to 4.2%, the lowest since the 1970s and marginally lower than the Bank of England's estimate of the 'normal' unemployment rate (also called NAIRU) of 4.25%. However, this is not the same as saying Brexit has not had an impact, as the higher inflation, driven by the weaker GBP, has corresponded to a de facto wage cut, as real wage growth has been negative for a while. So instead of firms letting people go, wages have taken the adjustment instead. In our view, it is difficult to see a pickup in nominal wage growth right now. While we expect the unemployment rate to fall further over the forecast horizon, we expect it to do so at a slower pace. We forecast the

UK growth has decelerated, while the rest of the world has accelerated



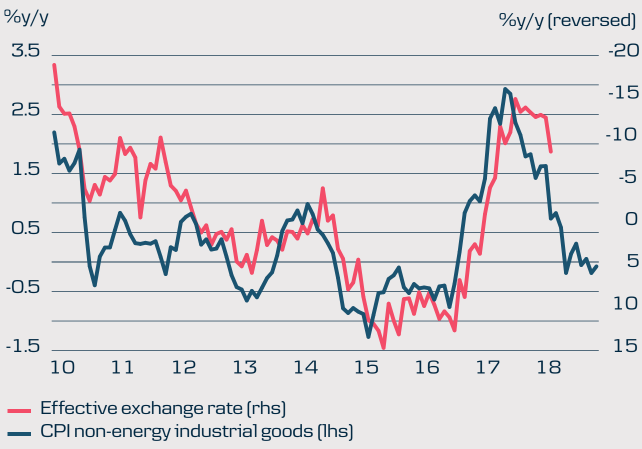
Source: ONS, BEA, Eurostat, Macrobond Financial data, Danske Bank

The real wage squeeze is over but still not supportive of private consumption.



Source: ONS, Macrobond Financial, Danske Bank

The impact of GBP depreciation on inflation is fading



Source: ONS, Bank of England, Macrobond Financial unemployment rate will decline to 4.0% by the end of 2019. Also very interestingly, the UK has begun to experience more labour shortages, as immigration to the UK has slowed after the Brexit vote, which has made it more difficult find labour in some sectors. This highlights that Brexit is, at least in the long-run, more a supply-side story than a demand-side story.

Brexit uncertainties remain high

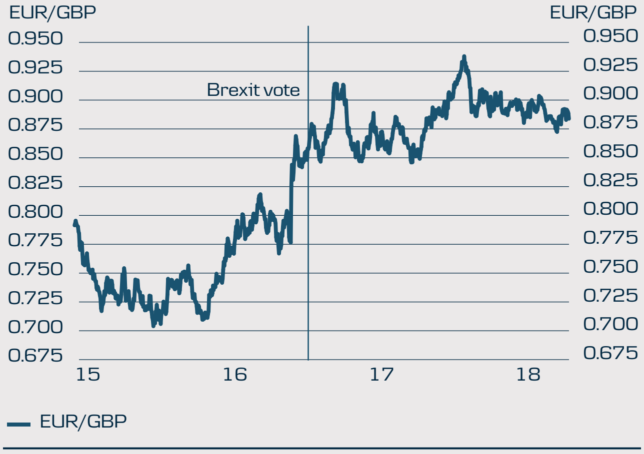
The biggest source of uncertainty in the UK is the Brexit negotiations, as the formal date of the exit is moving closer. The appetite for a new referendum or general election is low so it seems unlikely that the Brexit is going to be derailed unless something unexpected happens, especially now that we are less than a year away from the UK formally leaving the EU. This could be the case if the government blows up due to the internal disagreements on how to proceed with the Brexit negotiations. While the conclusions of the first phase of the negotiations (sufficient progress on divorce bill, Irish border and citizens' rights) and phase 2a (transition) were positive, this was not a game changer, as had been widely expected. The biggest obstacle remains the Irish border, as both the UK and EU want to avoid a hard border, which is difficult with the respective red lines. The EU leaders have said that a solution on the Irish border issue must be found before the EU summit later this month. Also the UK politicians are very divided on what the future customs relationship with the EU should look like. This is also the reason we have not seen a big appreciation of the GBP – it is simply too early for markets to price out the Brexit risk premium. We need more clarification of what Brexit really means before we expect to see the GBP strengthening despite it being undervalued currently.

At this point, we think the probability of a hard Brexit (defined as the UK leaving the single market and probably the customs union) is 80%. However, this is not the same as saying it is going to be a disorderly cliff-edge Brexit. Our base case for Brexit remains what we call a 'decent Brexit' in which the final deal for the future relationship after transition ends on 31 December 2020 looks something like the EU-Canada CETA deal, which reduces/removes trade barriers such as tariffs for goods but is weaker on services. It is in both sides' economic interest to reach an agreement due to the large trade flows between the UK and the rest of EU. The UK is still at least the third largest economy in the EU (depending on measurement). We still believe the deal will be more comprehensive on services compared to the CETA deal. While the transition is due to end on 31 December 2020, it may end up being extended if the future arrangements are not in place.

BoE hiking cycle postponed, not cancelled

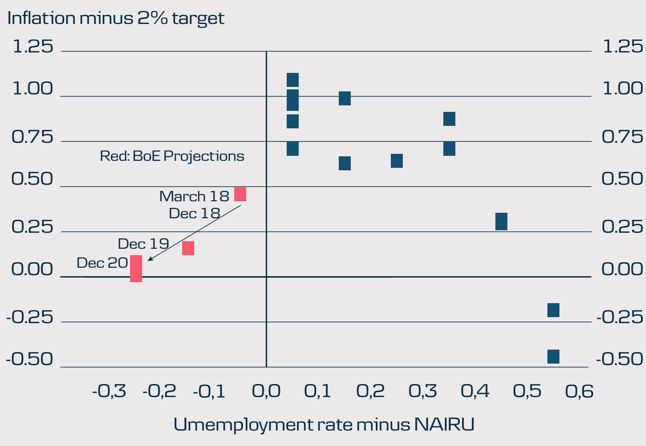
The Bank of England decided not to raise the Bank Rate in May, as economic data surprised on the downside and the policy-makers thought the costs of raising rates were greater than the benefits of waiting for additional data. In our view, the hiking cycle has not been cancelled, just postponed, but there will be fewer rate hikes over the coming years than we previously thought, not least now that the ECB also seems to have become a bit more dovish. At least, the committee still thinks *'ongoing tightening [...] would be appropriate'* if economic data evolves broadly in line with expectations. The dilemma for the Bank of England is the combination of weaker GDP growth, lower inflation (although still above the 2% target) and an unemployment rate below NAIRU. We believe the Bank of England will raise rates once in the second half of 2018 and one more time in 2019.

Too early for markets to price out Brexit premium just yet



Source: Bank of England, Macrobond Financial

Hiking cycle postponed, not cancelled.



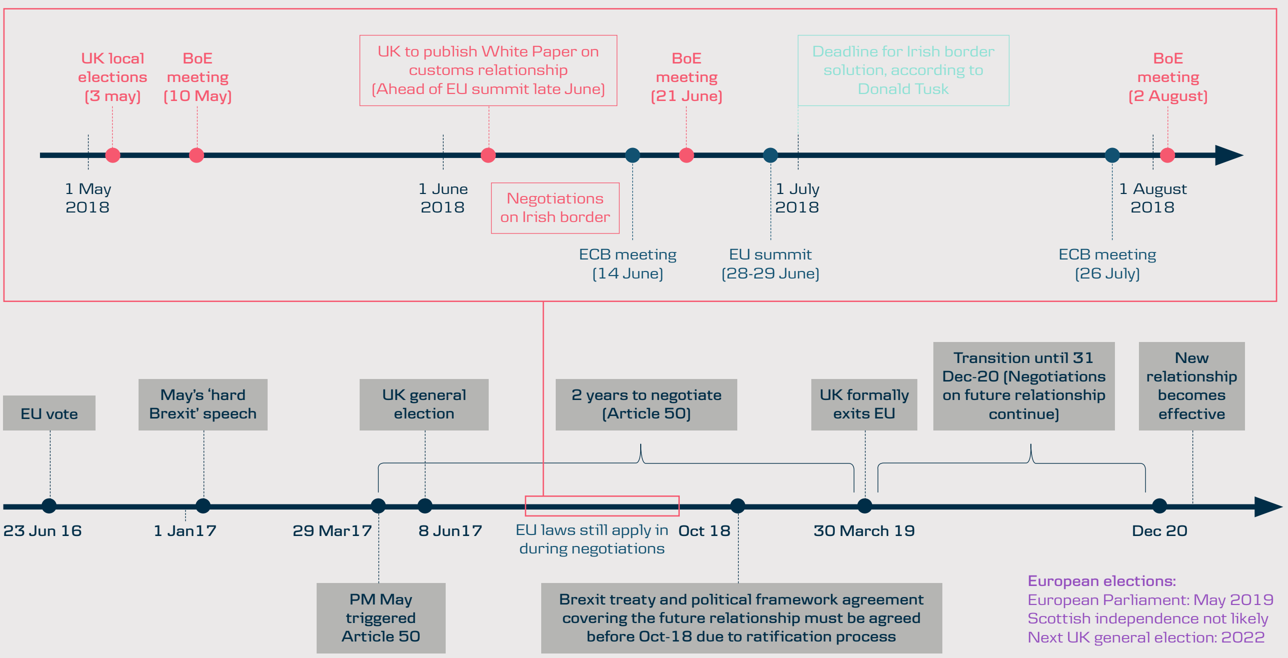
Source: ONS, Bank of England (including projections), Macrobond Financial

Macro forecasts - UK

% change q/q	2018				2019				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020
GDP	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.1	1.2	1.2
Private consumption	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.1	1.2	1.2
Government consumption	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.1	0.4	0.4
Fixed investments	0.9	0.3	0.3	0.3	0.3	0.3	0.3	0.5	2.9	1.3	1.9
Exports	-0.5	0.7	0.7	0.7	0.6	0.6	0.6	0.6	1.3	2.6	2.4
Imports	-0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	1.2	2.0	2.0
Domestic demand[1]	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.4	1.1	1.2
Net exports[1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Inventories[1]	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.0
Unemployment rate (%)	4.3	4.2	4.2	4.1	4.1	4.1	4.1	4.0	4.2	4.1	4.0
CPI (% y/y)	2.7	2.6	2.5	2.2	1.9	1.5	1.3	1.4	2.5	1.5	1.5
Core CPI (% y/y)	2.4	2.1	1.9	2.0	1.9	1.7	1.6	1.6	2.1	1.7	1.7
Public budget[2]									-1.8	-1.7	-1.5
Public debt[2]									85.4	85.3	84.9
Current account[3]									-4.4	-4.0	-3.7
BoE Bank Rate (%) (end of period)[4]	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.00	0.75	1.00	1.25

1. Contribution to GDP growth
2. % of GDP. OBR forecasts
3. %. end of period
Source: OBR. Danske Bank

Brexit timeline – Brexit-clock is ticking



Japan

Heading for lower but perhaps more self-driven growth

- We think the fast pace from last year is over for now and expect GDP growth at 1.0% this year and 1.1% in 2019. In 2020 the consumption tax hike will weigh on growth, which we expect will end up at 0.5%.
- We are seeing the first indications private demand is picking up and the economy is becoming more self-driven and less dependent on foreign demand.
- We see the main risks to the current economic recovery as a Chinese slowdown and the planned October 2019 consumer tax hike.
- We expect the Bank of Japan to stay on hold for the coming 12 months and then very cautiously start a normalising process by raising the 10-year target rate to 0.10 % during summer 2019 and again to 0.20% before end-2020.

Foreign demand remains key but private spending likely to start chipping in as well

Economic activity has slowed down in Japan this year after a very strong 2017. Q1 GDP-growth was slightly negative for the first time since 2016. This was highly due to preliminary factors, though, and overall the economy is still running hot. Although growth rates have been moderate in a historic context during the recent year, the economy has operated above long term potential since end-2016, that is the output gap is positive, and the labour market has reached a tightness of historic proportions.

Growth very much depends on exports and has benefitted largely from the global economic recovery, with Chinese demand for Japanese goods having been especially crucial to momentum through 2017. In Q1 18, China passed the US as the most important Japanese trading partner. Thus, Japan is also vulnerable to a possible Chinese slowdown. Exports have slowed recently along with export orders, likely due to the JPY strengthening through Q1. The JPY weakened again in Q2 and going forward, we expect exports to remain the key growth driver in Japan, not at least on the back of US fiscal expansion.

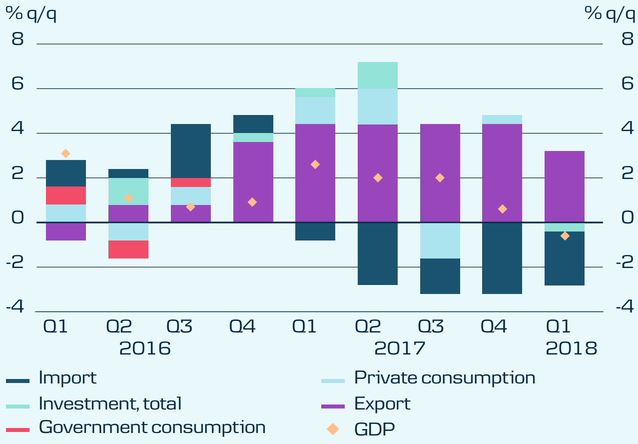
On the other hand, domestic demand has remained fairly weak. Even though private consumption constitutes almost 75% of GDP, the growth contribution during the past few years has been negligible. Through the previous year the labour market turned increasingly tight, and for every 100 applicants there are currently around 160 job openings and businesses, especially small ones, have been screaming for labour, all implying a labour market where employees have the best cards in their hand since the mid-1970s. Even so, growth in cash earnings has been modest, rising energy and food prices have eroded consumers' purchasing power, and real cash earnings growth has been hovering around zero for long. That has made it hard to kick-start private consumption.

With the spring wage negotiations we finally got some higher wage increases compared to last year, which has also showed in recent earnings. In PMI figures domestic demand has also shown positive signs lately. This should begin to spill over to private spending, although we expect this process to be slow moving.

Business investment was strong during the previous year and we expect it to stay on track during 2018. As the unemployment pool becomes increasingly scarce and the output gap widens, investments will have to keep a decent pace if businesses want to avoid hitting capacity constraints. Businesses are also reporting plans for increasing investments this year. To some extent, investments are currently driven by imminent 2020-Olympics related projects and we expect investments to slow down somewhat through next year.

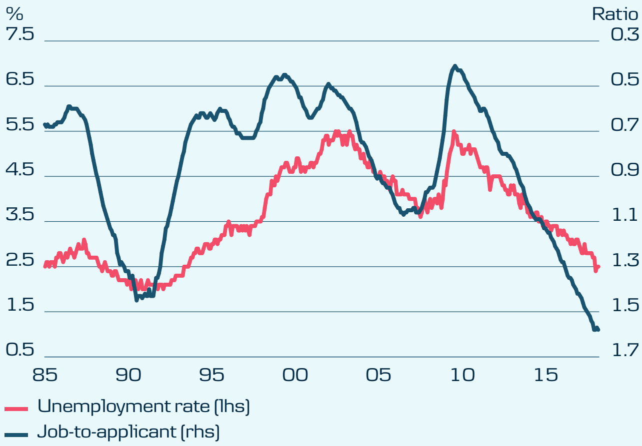
We do not think, the economy will continue in the 2017 fast track, and with the poor start to 2018, we expect GDP-growth will slow this year to 1.0%. In 2019 we expect private consumption to begin contributing to growth and with the benefit from hamstring effects before the tax hike, we expect growth for the year at 1.1%.

Exports the key growth driver



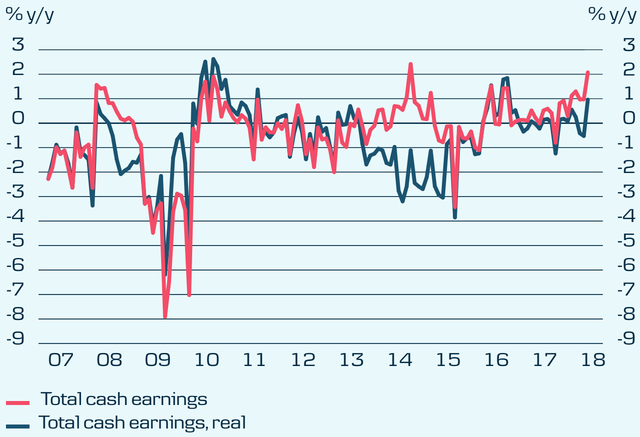
Note: Charts show contributions to annual GDP-growth and do not add up due to rounding errors and inventory contribution.
Source: Japanese Cabinet Office, Macrobond Financial

Labour market historically tight



Source: Japan Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

Earnings finally picking up?



Source: Japan Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

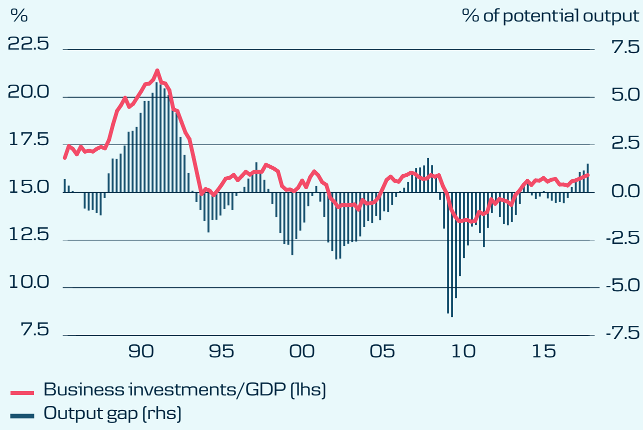
Consumers' reaction to tax hike fundamental to 2020 growth prospects

The prospects of a continuation of the economic recovery beyond 2019 to a large extent depends on consumers' reaction to the rise in consumer tax from 8% to 10% in October next year. In 2012, the Japanese diet passed a bill to double the tax from 5% to 10%. The first hike to 8% came in April 2014, causing a huge plunge in private consumption and tossing the economy straight into recession. The second hike, which was originally due in October 2015, was later postponed twice by the Abe government. Another delay, however, is not likely, since Abe has already used the proceeds on child care and education. The government will probably try to counter the negative impact on the economy in order to avoid a 2014-like setback, but the tax hike is needed in order to strengthen public finances and thus needs to be contractionary in order to make any sense. We expect a short-lived dip in the economy in Q4 next year although still with a lasting negative impact on 2020, leaving growth at 0.5% for the year.

Bank of Japan will remain very cautious but change in political landscape poses risk

Despite the economy running above potential there are still only scarce signs inflation is moving much higher. Energy prices have caused a steady increase in inflation since late 2016, but core inflation remains low along with expectations. Haruhiko Kuroda has been appointed for a second five-year term as governor of the Bank of Japan (BoJ), making him the first governor to serve two terms since the 1950s, which underlines his key role in Abenomics. Along with him, two new deputies were appointed; career central banker Masayoshi Amamiya and economics professor Masazumi Wakatabe. The new central bank executive board certainly has their job cut out for them, and if inflation momentum wears off in the coming months it is not unlikely we could see further easing measures from the BoJ. Wakatabe has been a strong advocate for aggressive easing and we did see the BoJ turn slightly more dovish with his arrival on the April meeting, as reference to the timing of hitting the 2% inflation target was moved from the outlook report. We expect the BoJ to move steadily forward with the current policy framework for the coming 12 months. With the current pace at which the BoJ is picking up government bonds, policies are long lasting and currently we consider the potential gains from tightening to be largely outweighed by the risk of causing damage to the economic recovery. We expect the BoJ will prefer to start a very gentle policy normalisation process in due time before the tax hike in October next year as this already imposes a risk for growth momentum. The BoJ has shown us before, they do not shy away from using all the tools in the tool box and thus this could be done in various ways. We expect the 10-year zero target rate to be raised to 0.10% sometime during the summer 2019 and at the same time do its utmost to reassure markets that this is not tightening, in the sense that it is meant to close the output gap. The normalisation process is likely to be a very long and cautious one. Once it is official the economy has regained momentum after the consumer tax hike we expect the BoJ to increase the rate target again to 0.20% before end-2020. Abe's declining approval ratings pose a risk to the outlook for the BoJ, though. If he is not re-elected as leader of the Liberal Democratic Party, they could unwind stimulus sooner rather than later, see box.

Slowly increasing output gap induces higher business investments

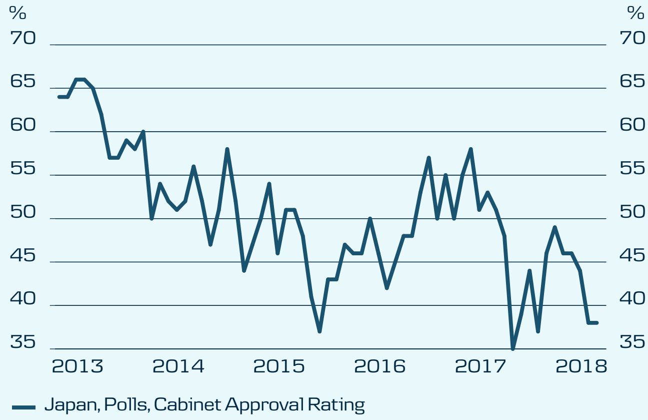


Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Inflation expectations remain muted...

Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Abe under pressure before party leadership election in September



Source: JBRC, Macrobond Financial

Macro forecasts - Japan

% y/y	2015	2016	2017	2018	2019	2020
GDP	1.4	1.0	1.7	1.0	1.1	0.5
Private Consumption	-0.2	-0.1	0.9	0.4	1.2	0.0
Private Fixed Investments	2.6	1.4	2.9	1.6	1.8	0.5
- Residential investment	-1.2	5.6	2.8	-3.7	2.1	2.4
- Non-residential	3.4	0.6	2.9	2.6	1.8	0.1
Public Investments	-1.3	0.1	1.2	-1.2	-1.5	-0.8
Public Consumption	1.5	1.3	0.2	-0.2	-0.2	-0.1
Exports	2.9	1.7	6.7	5.0	3.6	3.2
Imports	0.7	-1.6	3.4	3.0	2.4	0.6
Unemployment rate (%)	3.4	3.1	2.8	2.5	2.5	2.5
CPI. excl. fresh food (y/y)	0.5	-0.3	0.5	0.9	1.2	1.9
- Excluding consumption tax hike	-	-	0.5	0.9	1.0	1.1
BoJ rate on deposit facility*	0.1	0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.3	0.0	0.0	0.0	0.1	0.2

*Note: *end-year*
Source: Danske Bank, Macrobond Financial

Abe-exit could ease political pressure for ultra-lose monetary policy

No later than September this year, Japan's ruling party, the Liberal Democratic Party (LDP), will hold internal elections for the office of party president. This will in effect choose Japan's next prime minister. Even though PM Abe and the LDP won a landslide election in October last year resulting in regaining a majority of the seats in the Japanese lower house, it is far from certain Abe will get another three-year term as LDP-leader. The October election win was largely a result of a divided and chaotic opposition with no clear governing alternative to Abe, and since then Abe's approval ratings have plummeted further, largely due to raging scandals hinting at abuse of power. During this spring, last year's scandal about a discounted sale of a plot of state-owned land in Osaka has regained attention as it has transformed into a cover-up story. In an attempt to shield Abe from further attention regarding the case, the Finance ministry has altered official documents, removing Abe, his wife and Finance Minister Taro Aso's names. This has had the opposite effect, and now the question is, who has ordered the cover-up?

So far Aso has blamed a small circle of bureaucrats in his ministry but pressures have mounted on Aso with many calling for his resignation. If it should come to that, Abe will lose a very influential ally in the party, which would likely hurt his chances of re-election. Currently, the only official contender to Abe is Minister for Internal Affairs and Communications Seiko Noda, who intended to run in 2015 as well but did not concede to gather adequate endorsement. Other likely candidates are Fumio Kishida and Shigeru Ishiba, both former top ministers in Abe's cabinet and probably more likely to gather enough support to win.

All three alternative candidates have expressed concern about Abe's accommodative fiscal stance and the ultra-loose monetary policy. Especially Noda is worried and last year she has said "it is frightening to think where the BoJ's exit from unconventional easing is". Ishiba and Kishida have commented on the BoJ' policy stance more pragmatically, but also expressed concerns about it during the past year. By law, the BoJ is politically independent, but if Abe is replaced, the political pressure to meet the inflation target as quickly as possible could ease, and we may see a more moderate approach from the BoJ.

China

Soft landing - still big long-term potential

- Chinese growth rates are set to slow over the coming years, as the potential growth rate comes down. We look for GDP growth to fall from 6.9% in 2017 to 6.6% in 2018 and 6.4% in 2019.

- However, do not get fooled by lower growth rates. In absolute terms the economy keeps adding more and more every year and is set to continue to pull around one-third of global growth.

- We expect housing to slow down a bit further this year, while consumption growth should stay robust. Inflation is still contained and the People's Bank of China (PBoC) has taken the foot slightly off the brake recently.

- The main risk is a trade war with the US. We believe a trade deal will eventually materialise but it will likely involve some protectionist measures between the two countries.

Chinese growth in a soft landing

The Chinese economy has surprised to the upside over the past year eking out 6.9% growth in 2017. We expect growth rates to move lower over the coming years as monetary policy has been tightened and a deleveraging push engineered by the Chinese leadership is weighing on some sectors. We also expect export growth to move down a notch as a stronger CNY is causing some headwind and export markets are growing a bit slower. With growth slowing inflation is also contained and we expect it to stay close to the 2% level in the coming years.

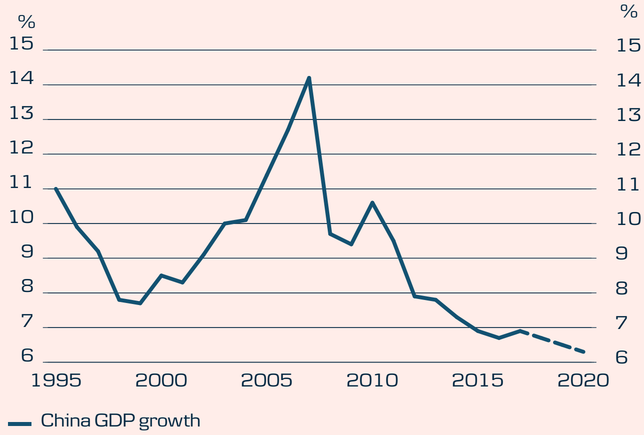
Even with lower growth rates the Chinese economy continues to expand rapidly. The fact that the economy is much bigger today than for example 10 years ago implies that the absolute growth rate is actually continuously rising even if the percentage rise is lower. For example, in the mid-2000s when the growth rate was more than 10% the economy increased by around USD500bn per year (chart). In 2017 a much lower growth rate at 6.9% led to an increase of USD750bn and by 2020 an expected growth rate of 6.2% will lead to an increase of close to USD1000bn. This is close to three times bigger than the increase of the US economy - and similar to adding what corresponds to the size of the Dutch economy every year. The composition of growth is also changing, as the economy continues to rebalance. An increasing share of the added value stems from the consumer and service sector as well as from investments in high-tech sectors. China's 'Made-in-China 2025' strategy has led to focus on innovation and technology and has set targets for 10 sectors for 2025. R&D spending as well as education of engineers are on the rise.

'Reform and opening' at 40-year anniversary

Ultimately Chinese growth has to come from a rising productivity of its people through (a) more capital (machines) per worker, (b) increasing education level, (c) better management and organisation of the work and (d) innovation. China's 'reform and opening' policy that has a 40-year anniversary aims at this and will continue in the coming years. While reforms have been slow in some areas, China is taking big steps when it comes to education, rising capital per worker and has also focussed on innovation in recent years. On the matter of management and organisation of work, China is still struggling with governance reforms in the State Owned Enterprises. However, about 70% of the Chinese economy are private sector companies, where competition is fierce and entrepreneurship is thriving. For example, China now has 34% of global unicorns (start-ups that have reached more than USD1bn in market value). Similarly, five out of the biggest 10 venture capital investments in Q4 17 were Chinese. The recent pressure from the US on the trade front seems to speed up China's policy of opening up (see box).

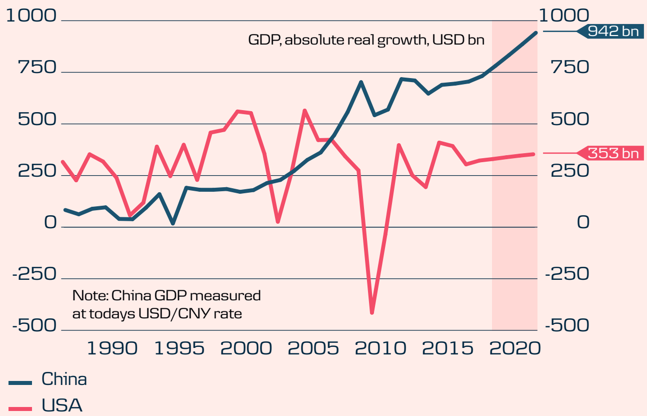
While China has grown rapidly, there is still big potential in the world's most populous country. GDP per capita in USD is still only 15% of the US level and China still has 300m workers in agriculture with very low income levels. On our estimates China will surpass the US economy in size in 2030 and by 2050 be close to double the size of the US. As China's population of 1.4bn people is four times bigger than the US's, it only requires GDP per capita of half the US to achieve this. This corresponds to the level of South Korea and Spain today.

Growth rates moving lower...



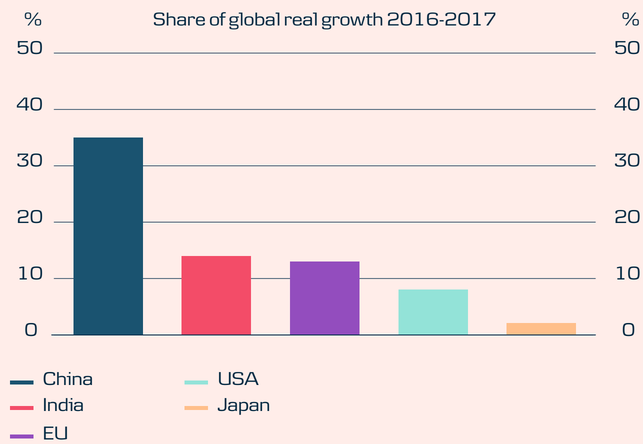
Source: Macrobond Financial, Danske Bank

... but annual absolute growth keeps rising



Source: Macrobond Financial, Danske Bank

China pulls one-third of global growth



Source: Macrobond Financial, Danske Bank

Main risks from trade war - less so from debt

In the short term, there is no doubt that the main risk for the Chinese economy is a trade war with the US. Our baseline scenario is that the two countries end up with a deal after a period of negotiations and we avoid a tit-for-tat trade war. However, the ultimate deal is also expected to involve increased US protection in the tech area - both when it comes to tariffs on imports as well as restrictions on Chinese investments in the US.

Another big risk in recent years has been the rapid rise in debt and shadow banking. However, since 2015 China has moved the fight against financial risks to the top of the policy agenda and taken many steps to defuse the debt bomb. We are increasingly optimistic that China will succeed but it requires that the deleveraging push and the crack-down on shadow banking continue in the coming years.

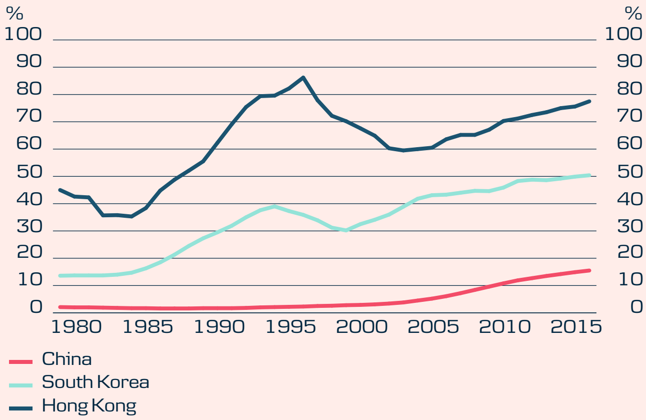
Why innovation is a cornerstone of China's strategy

Over the past five years, innovation and technology have played a central role in China's development strategy. The Five-Year plan for 2016-20 announced in late 2015 puts innovation at the centre of China's development strategy and the launch of the 'Made in China 2025' in 2015 is one of the key elements in this strategy. It identifies 10 sectors mainly focusing on technology that China will invest in and sets specific targets for global market shares and a higher domestic market share for Chinese companies. More R&D spending, measures to spur entrepreneurship and improve funding for start-ups and small companies are other elements in the innovation strategy.

The focus on innovation is motivated by research on how to avoid the so-called 'Middle Income Trap'. The 'Middle Income Trap' is a situation where growth in an economy slows after reaching middle income status of around USD10,000-15,000 per capita. China's GDP per capita today is around USD9.000 – 15% of the US level. According to World Bank estimates, only 13 out of 101 middle income countries in 1960 had reached high-income status by 2008. The main explanation for why countries stall is a failure to move from low-wage and low-quality production to more high-end production, see for example *Asian Development Bank: Growing Beyond the Low-Cost Advantage: How the People's Republic in China can Avoid the Middle Income Trap, 2012*. Innovation and technology is key in this process as well as other factors such as education, fighting corruption and improved corporate governance.

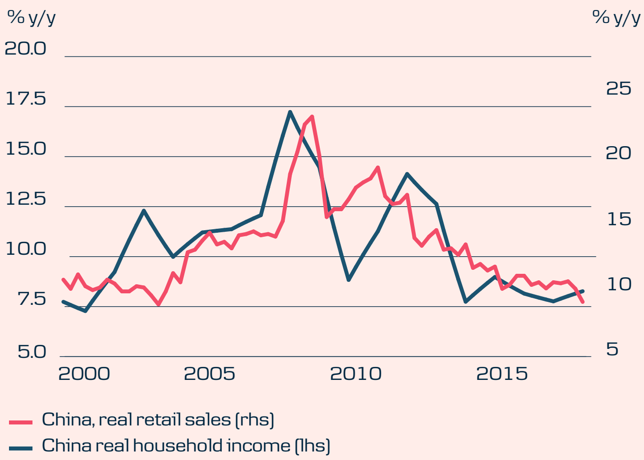
This is also why China's 'Made in China 2025' strategy is not up for negotiation for China in the ongoing trade negotiations with the US (see box). In addition, the rising threat that China cannot rely on imports of tech products from the US has led China to see its own investments in this area as even more important.

China still has plenty of catching up to do - only at 15% of US GDP per capita (at market prices)



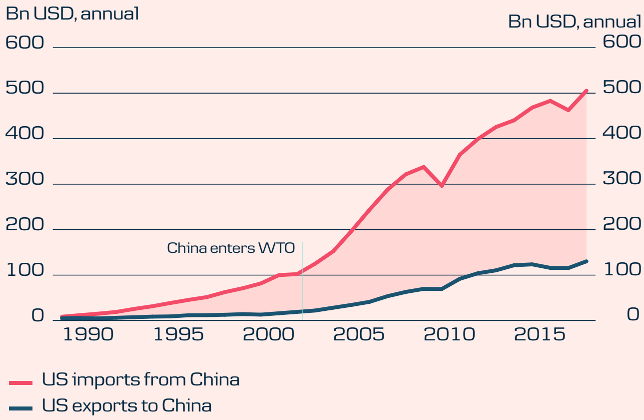
Source: IMF, Macrobond Financial, Danske Bank

Chinese consumption growth to stay robust



Source: Macrobond Financial, Danske Bank

US trade deficit a cause for tension - and tech rivalry is a challenge here to stay



Source: Macrobond Financial, Danske Bank

Macro forecasts - China

% y/y	2016	2017	2018	2019	2020
GDP[1]	6,7	6,8	6,6	6,4	6,2
Private consumption[1]	8,4	8,5	8,5	8,3	7,7
Investment[1]	6,3	5,2	5,0	4,8	4,6
Net exports[2]	-0,5	-0,3	-0,1	-0,2	-0,2
Total investment share[3]	44,2	43,8	43,4	43,0	42,5
Total savings rate[3]	45,9	45,8	44,3	44	44
Current account balance[3]	1,7	1,5	1,3	1,2	1,2
CPI[1]	2,0	1,6	2,0	2,3	2,3
Household income (real)[1]	7,8	8,3	8,3	7,5	7,3
Household savings rate, % of disp income	36,0	35,8	35,6	35,4	35,0
Wage growth (nominal, urban)[1]	9,1	9,0	9,0	8,7	8,5
Government budget balance[3]	-3,7	-4,0	-4,1	-4,3	-4,3
Augmented fiscal balance (IMF)[3,4]	-12,4	-12,6	-12,6	-12,6	-12,6
USD/CNY[5]	6,96	6,6	6,3	6,0	-
EUR/CNY[5]	7,3	7,9	8,0	7,7	-
PBoC 1-year lending rate, %[5]	4,35	4,35	4,1	3,85	3,85

1. % y/y,
2. contribution % to GDP,
3. % of GDP,
4. Includes local gov and off-budget activity plus excludes land sale proceeds,
5. end of year
Source: Danske Bank and Macrobond

US-China trade war or not?

While for a long time US President Donald Trump was the dog with a lot of bark but little bite, the situation changed rapidly this year. Tariffs on steel and aluminium and a threat to put a 25% tariff on Chinese goods worth USD150bn became a reality in March and April. China has responded by announcing tariffs on US exports worth USD50bn and warned of measures that will correspond to a 1-1 hit back at the US if Trump moves on with the tariffs. For now, there is a hearing period and the US tariffs on most of the goods are not yet implemented.
Our baseline scenario is that a trade war with tit-for-tat escalation will be avoided, as this would do significant damage to both countries. Fortunately negotiations have started, which gives hope that a deal will be eventually be struck. However, some of the US demands are quite unlikely to be met by China and it remains to be seen whether Trump will end up raising the bets by going through with the announced tariffs - resulting in Chinese retaliation. It can thus still not be ruled out that things get worse before they get better. We should also expect that a deal will ultimately include some US barriers on trade and investment and in the area of technology, where the US administration increasingly views China as a long-term rival and wants to put up a barrier to limit Chinese access to US technology.

Why now?
The trigger for the sudden change of mood in the US is not only that Trump, who has been in favour of more US protectionism for a long time, has taken over the presidency, it is also that China in 2015 launched a strategy called 'Made-in-China 2025', highlighting 10 sectors primarily within the tech area, which China will invest in and promote in the years to come. China also aims for a rising domestic share of companies supplying the tech goods for Chinese production. The 'Made-in-China 2025' strategy has fuelled fears in both the US and Europe that Chinese companies are now entering the tech scene with big subsidies and investments that lead to overcapacity and low prices. China's increasing role on the global stage through the Belt and Road Initiative as well as no sign of political governance reforms in China have added to the anxieties over the rise of China in Western economies.

Emerging markets

Good growth prospects despite market volatility

- Emerging markets have come under pressure from a rising USD and higher US yields.
- However, solid macro fundamentals will help most emerging markets to weather market volatility.
- Asia and Eastern Europe are set to see the fastest growth, while many Latin American countries and Russia are plagued by low growth potential.
- A possibly more hawkish Fed and an escalation of trade tensions remain the major negative risk factors for the growth outlook in EM.

Emerging markets face a more challenging external environment

After enjoying a strong 2017, Emerging Markets (EMs) have come under pressure in Q2 18. The main driver has been a rising USD and US yields, which historically have led to a reversal of capital flows to emerging markets. This has weighed more on EM countries with notable external imbalances or FX exposure in the corporate and banking sectors such as Argentina Brazil, Mexico and Turkey. At the same time, rising protectionism fed by the US trade wars is another uncertainty factor notably for Asian countries. There are also emerging markets that face significant fiscal challenges which will require fiscally conservative policies, such as Brazil, South Africa and Turkey.

Economic growth should hold up well in most EMs in 2018-19

Can the emerging markets weather the challenging external environment? Yes, we think so. First of all, most emerging markets have seen significant improvements in their macro-fundamentals. After the taper tantrum hit EM, their currencies weakened and their external balances improved. Inflation has remained low in the largest markets thanks to independent EM central banks. The USD strength may not last, in our view, which should give some tailwind to EMs over the coming years. We expect the economic recovery in emerging markets to continue in 2018/19. However, growth acceleration could be postponed in many EMs, as conservative central banks limit their monetary easing path on increased FX volatility, while several countries such as Argentina, Mexico, Turkey and the Ukraine have significantly tightened their monetary policies in order to soften major exodus of foreign investors from local currencies. The Chinese economy remains an important driver for EM growth. We see that overall economic growth in China should still be around 6.4% in 2018.

We believe Brazil, South Africa and Russia should continue to show a modest economic recovery after years of subpar economic growth. All three continue to see various structural obstacles that we forecast should limit their economic growth potential to around 2% per year in 2018-19.

In contrast, the Asian economies in general boast much stronger growth potential: we expect the Indian economy to grow by 6.5% in 2018/19 due to a relatively young population, structural reforms (tax reform and bank recapitalisation), relatively low debt (compared to China) and macroeconomic stability. In central and eastern Europe, the combination of easy monetary policy and increasing absorption of EU funds should support economic growth of 3.5-4.0% in 2018-19 in the Czech Republic, Hungary and Poland on our forecasts, which is above their potential growth rates.

Protectionism, China slowdown and more aggressive Fed tightening remain key risks

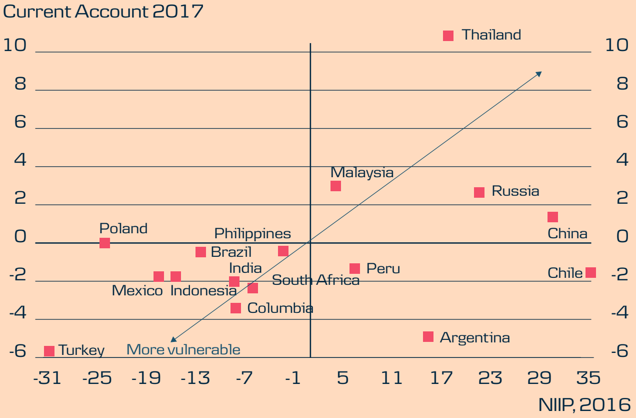
We expect a tightening of credit conditions in China, which we think will weigh on the Chinese construction sector in the coming quarters. This would affect the global metal markets and hence commodity-producing EMs, notably in Africa and Latin America. Accelerating trade war actions by the US, possibly three more hikes by the Fed in 2018, are generally downside risks for all EM economies.

GDP forecasts for key emerging markets

% y/y	2017	2018	2019
Emerging Markets of which	4.7	4.9	5.0
China	6.9	6.6	6.4
India	6.3	7.0	7.2
Russia	1.5	2.0	2.1
Brazil	1.0	2.2	2.4
Turkey	6.8	3.5	3.0
South Africa	1.3	2.3	2.3
Poland	4.7	4.5	3.3
Hungary	4.0	3.9	3.3
Czech Republic	4.6	3.3	3.1

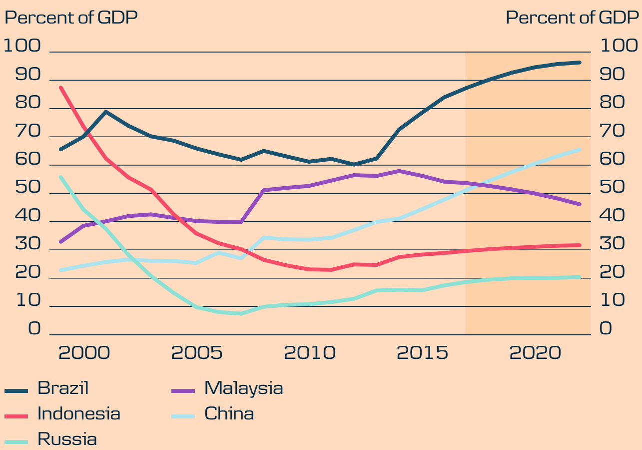
Source: Danske Bank

Some Emerging Markets, notably Turkey still have sizeable external funding needs



Source: Macrobond, Bloomberg and Danske Bank

Divergent fiscal debt paths in EMs



Source: IMF WEO April 2018,, Macrobond, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Jakob Ekholdt Christensen (Chief Analyst), Allan von Mehren (Chief Analyst), Mikael Olai Milhøj (Senior Analyst), Piet Christiansen (Senior Analyst), Aila Mihr (Analyst), Bjørn Tangaa Sillemann (Analyst) and Vladimir Miklashevsky (Senior Analyst).

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Expected updates

This publication is published twice a year.

Date of first publication
See the front page of this research report for the date of first publication.

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Report completed: 4 June 2018, 13:00 CEST

Report first disseminated: 7 June 2018, 06:00 CEST

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