

June 2010

Global Scenarios

Recovery on track, but new risks surfacing

- The global recovery has become more resilient, but momentum has peaked
- Global leading indicators will move lower in H2
- The euro debt crisis is a risk, but unlikely to derail the global recovery
- Disinflation continues in the developed world, but risk of overheating in Asia
- The market turmoil has delayed monetary normalisation across the globe

Danske Research

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Investment research – general market conditions

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Global Scenarios is a quarterly analysis focusing on the outlook for the global economy. Read about the perspectives for and the most important risks to the global economy. The publication *Nordic Outlook* presents our expectations for the Nordic economies.

Intro

Recovery on track, but new risks surfacing

- The global recovery had a strong start to 2010 with upside surprises in most regions. US final demand and job growth has picked up sooner than expected and global pent up demand is starting to come through. The global recovery has become more resilient.
- However, new headwinds have emerged from the euro debt crisis. We don't expect the crisis to derail the global recovery but risks have increased.
- The main scenario is for equity and credit markets to stabilise and recover slightly, but if contagion to these markets gathers pace and turns the headwind into a storm, a "double-dip" scenario could emerge.
- Our forecasts are revised slightly higher for US and Asia, as the new headwind is countered by stronger data. However, we are entering a stage in the recovery where momentum in growth tapers off and a decline in ISM may add to market concerns over a potential double-dip and market volatility will likely stay high.
- Euroland growth has been revised lower, as Q1 growth disappointed and the euro debt crisis is placing a stronger drag on growth in 2011 than expected. The weak euro is providing a strong counterweight, though and a real double-dip scenario is not expected to materialise. CEE growth has recovered but downside risks are rising.
- A more fragile financial environment will postpone monetary policy exit and we now look for the Fed to tighten in March 2011. The ECB is not expected to raise rates until the second half of 2011. In Asia policy tightening continues to be on the agenda but the risk now is that it comes too late and lays the ground for future inflation and property market bubbles.

Global economy more resilient

The global recovery has remained on track this year and been even stronger than expected in most regions. In the US the consumer revival has been very robust and investment spending has gathered pace, as recently witnessed by strong durable goods orders. As we highlighted in Global Scenarios in March labour market improvement is crucial for sustainability and in this area the news flow has also been positive, as US payrolls have crossed the 200,000 line earlier than expected.

Asian growth accelerated significantly in early-2010 with both exports and private demand increasingly taking over as the engine of growth from public investment and subsidies to consumption.

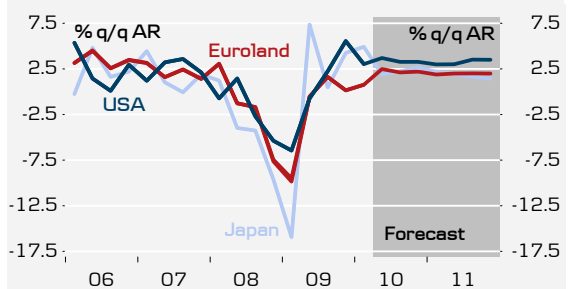
In Euroland the picture has been mixed as Q1 growth continued the slow pace from Q4. This is somewhat puzzling given very strong survey data and

Growth forecasts: Still slightly above consensus

% y/y	2010				2011			
	Danske Bank	Consensus	IMF	OECD	Danske Bank	Consensus	IMF	OECD
USA	3.4	3.2	3.1	3.2	3.3	3.1	2.6	3.2
Euroland	1.3	1.1	1.0	1.2	2.1	1.4	1.5	1.8
Japan	3.3	2.1	1.9	3.0	2.1	1.9	2.0	2.0
China	10.2	10.1	10.0	11.1	9.5	9.3	9.9	9.7
Global	4.5		4.2		4.4		4.3	
Asia [ex Japan and China]	6.8				6.5			
CEE and CIS	2.5				3.2			
Change from previous fct								
USA	0.2				0.3			
Euroland	-0.5				-0.1			
Japan	0.6				0.0			
China	0.5				0.0			

Source: Danske Markets, Bloomberg, OECD, IMF

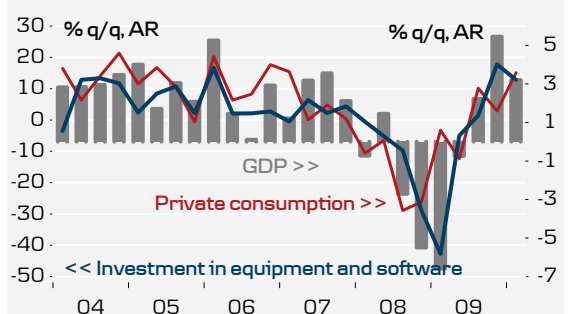
G3 GDP growth to level off a bit



Source: Reuters Ecowin and Danske Markets.

Note: Euro Q1 GDP is not released yet from Eurostat

US recovery maturing – final demand has picked up



Source: Reuters Ecowin and Danske Markets

industrial production in the same period. Strong orders and production data also point to a decent pick-up in growth in Q2 and Q3 (see chart).

The overall macro backdrop has thus been quite positive and with the recovery maturing it is also becoming more resilient to new headwinds.

Rising risk from a negative sentiment spiral

Unfortunately the good macro news has been overshadowed by the widespread contagion from the euro debt crisis to global markets, which has the potential to provide a new strong headwind to the global economy and take us into a “double-dip” scenario

A double-dip could materialise if the contagion we see at the moment to the equity and credit markets accelerates even further and if it is followed by a more aggressive and front-loaded fiscal tightening from G7 countries. The deterioration in risk markets we have seen so far is expected to have a slightly negative macro impact, but in our mind not enough to create a double dip.

However, financial crises – such as the one we are seeing in Euroland – are extremely difficult to forecast. Contagion can show up in places you hadn’t foreseen and the forces of a negative confidence spiral can be powerful once they are set in motion. A dire example of this is the Asian crisis, which continued to show up in new and surprising places (see *Research Euroland: The danger of contagion – lessons from the Asian crisis*).

Although forceful policy intervention can dampen the negative effects it is not always sufficient. If the underlying forces driving the panic are strong enough even substantial policy intervention may not be sufficient to avoid serious macro implications. The financial crisis up to – and following – the collapse of Lehman Brothers was another clear example of this.

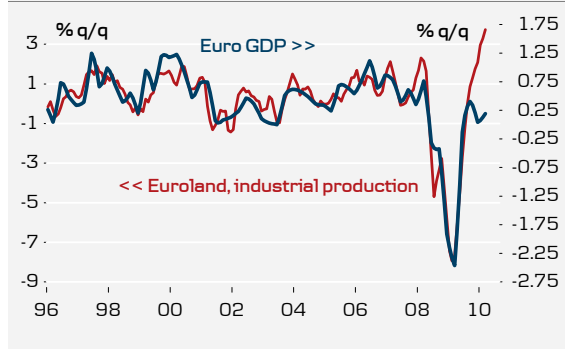
In our main scenario we don’t expect the current euro debt crisis to lead to another global financial crisis with a further massive liquidation in risk markets (see *Research Euroland: Q&A on the euro debt crisis*). The recent sell-off has likely been exacerbated by a skew to hold “recovery trades” (long risk) among investors as the macro picture have been robust and these trades have worked well until recently. We suspect that these investors have been running for the door at the same time to protect profits and it has created extraordinary selling pressure. With positioning more balanced now the market should struggle more to go down and we look for a recovery in risk markets. But given the rising uncertainty on the financial front our growth estimates are more uncertain than usual.

ISM decline points to continued high market volatility

It’s been our expectation for some time that the leading indicators and business confidence would start to slow down during H2 10. This is due to fading effect from stimulus but most importantly a lower contribution from inventory changes – an important driver of short term swings in the business cycle.

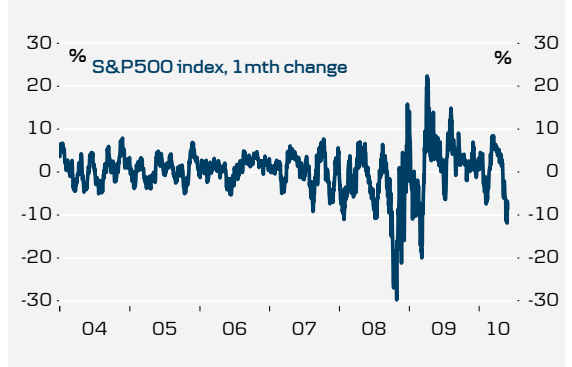
Due to the latest turmoil the decline in ISM will, according to our ISM model, come a bit sooner than otherwise expected. We now believe we have

Euroland industrial production points to strong pick-up in growth in the coming quarters



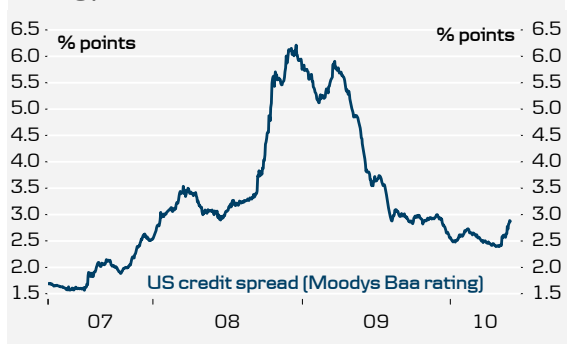
Source: Reuters Ecowin and Danske Markets

Equity market shock should not get bigger



Source: Reuters Ecowin and Danske Markets

Credit spreads widening, but still limited move in the big picture



Source: Reuters Ecowin and Danske Markets

reached the peak (see *Research US: Euro crisis could speed up manufacturing slowdown*). In our main scenario ISM declines gradually from the current level of 60.4 down to 54-55 by year-end and continues to decline to 52-53 in early-2011 before bouncing around that level. However, should the turmoil spread further, the ISM could fall quite fast and reach 52-53 as early as the autumn and go below the psychologically important level of 50 in early-2011.

Although the US recovery is maturing and the labour market is doing better a decline in ISM will likely contribute to nervousness in the markets – given the fragility of the financial system. *The rise in volatility in risky assets will therefore likely continue.* The risk is that the tail will again start wagging the dog in the sense that a further setback in risky assets could create a big enough economic headwind to justify the initial decline in the market – and possibly further declines in the market once the economic weakness showed up later in the year.

Euroland under pressure but euro helps rebalancing

The epicentre of the crisis has been Euroland and this has affected the outlook in many ways with several counterbalancing forces:

1. **Fiscal tightening** will come sooner and be stronger and hence create an even stronger headwind for growth. So far it is mostly smaller countries that have tightened significantly but we are likely to also see more tightening in some of the larger countries.
2. **Rising uncertainty and decline in risky assets** will also be a further drag on growth as they will probably postpone – or cancel – some investments and put a dent on consumption. The extent of this drag is, however, very difficult to quantify.
3. The **euro** has weakened more than 10% in trade-weighted terms, from the peak, which gives a significant boost to net exports and adds close to 1 percentage point to GDP according to model calculations.
4. A further tailwind comes from the much **lower bond yields** in most of the euro countries than would otherwise have been the case.

Overall we estimate the net impact to be slightly negative and have therefore revised down growth prospects slightly for 2011.

These effects also lead to significant shifts in growth across sectors and countries. The divergence will be even stronger with Germany and France benefiting more from the weak euro while Portugal, Spain and Greece will suffer from the austerity measures put in place. Across sectors the export-oriented companies will be the beneficiaries while consumer and public demand exposed sectors will feel the pain from tightening.

Emerging markets a strong pillar of growth

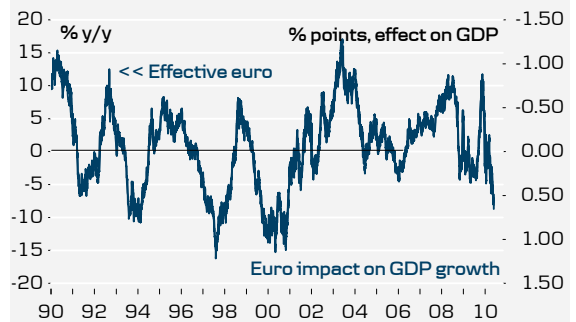
Emerging Markets continue to provide a good buffer for global growth – not least driven by a strong Asian performance. The powerful demand from Asia is having a positive spill-over to commodity exporters such as Russia and Brazil. Emerging Markets as a whole make up a little over half of the global

ISM have reached a peak but should decline only gradually – even after the recent turmoil



Source: Reuters Ecowin and Danske Markets

Euro weakening to give much needed growth boost



Source: Reuters Ecowin and Danske Markets

Emerging markets main driver of global growth

	Share of GDP (PPP)	GDP Growth		Contr. to global growth, % points	
		2010	2011	2010	2011
World	100.0	4.5	4.4		
USA	20.1	3.4	3.3	0.7	0.7
Euroland	15.2	1.3	2.1	0.2	0.3
Japan	5.9	3.3	2.1	0.2	0.1
BRIC	24.9	8.4	8.1	2.1	2.0
Rest of world	34.0	3.9	3.7	1.3	1.3

Source: Reuters Ecowin and Danske Markets. GDP weights are IMF PPP adjusted weights for 2009

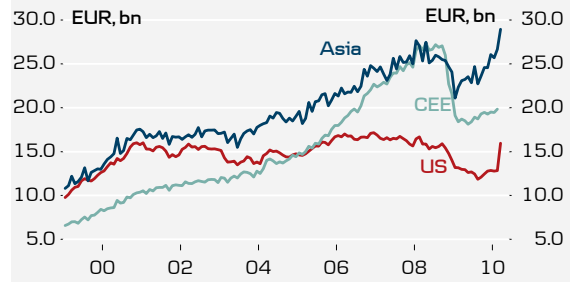
economy (measured in PPP) but have been driving 75% of growth in world production over the past year. The weak spot in Emerging Markets continues to be CEE where we see rising downside risk from potential spill-over from the euro debt crisis.

The outlook continues to be favourable, although, risks are also rising here. However, the risks are two-edged. On the one side there is the risk that a stronger negative hit from the euro crisis would put a dent on Asia as well. This speaks in favour of holding back policy tightening. However, the risk is also rising that economic policy is erring too much on the cautious side keeping stimulus for too long. The output gap is pretty much closed in most parts of Asia but policy rates are still very low. If the normalisation of rates happens too slowly there is a risk of overheating showing up either as inflation or asset price bubbles down the road. This is a risk all countries in the world are facing but it is clearly most pronounced in Asia.

Fiscal tightening crowds out monetary exit

The policy agenda has shifted markedly in past months as focus has turned from exit strategies to reintroducing liquidity facilities to support the fragile financial system. As the financial system is likely to remain fragile for quite some time monetary policy normalisation has been postponed. We now look to the Fed to make the first rate hike in March 2011, while the ECB hikes will be off the agenda for a long time. We look for the first hike from the ECB in H2 11. Another reason for monetary policy tightening being delayed is the more urgent need for a fiscal exit, which will dent growth and thus “crowd out” monetary exit. We see a risk that we fall into the trap again that created the problems in the first place: that monetary policy stays loose for too long due to the fragility of the recovery with the risk that new problems are created for the future as interest-rate sensitive sectors move to an unsustainable path – or bubble if you like. This risk is most pronounced in Asia as the need for policy tightening is strongest here.

Asia give massive support to Euroland exporters and is by far the most important region



Source: Reuters Ecowin

Road map for sustainability vs “double-dip”

Key drivers to watch to gauge sustainability:

- 1. Labour market:** US payrolls should grow 200,000-250,000 in coming quarters. Unemployment to decline gradually.
- 2. Confidence:** Business confidence is expected to level-off from the current high levels but in a gradual manner. ISM to reach 54-55 by year-end (currently 60.4). We look for consumer confidence to be unchanged or rise slightly on an improved labour market.
- 3. Fiscal sustainability:** Although fiscal issues are expected to stay high on the agenda an escalation of the confidence crisis involving US and UK should be avoided.
- 4. Risk markets:** We should avoid much further decline in equity and credit markets, as this could lead to a negative confidence spiral.
- 5. Asian growth:** Should continue at a robust pace as it is an important demand engine for the world economy - not least for Euroland exports and commodity exporters.

Expectations on key figures and central banks over coming quarter

Country	Indicator	Comment	Measure	Latest		Sep/Q3
Euroland	GDP	Economic recovery will take GDP growth slightly above trend in the coming quarters	% q/q, AR	0.8%	↗	2.1%
	PMI	PMIs have probably peaked, but momentum will remain robust in the coming months	Index	56.2	↘	54.3
	Inflation	Limited inflationary pressures due to large economic slack	% y/y	1.6%	→	1.6%
	ECB	The ECB has re-engaged in credit easing. ECB will thus keep rates on hold until H2 11	% p.a.	1.00%	→	1.00%
Germany	Ifo	The German recovery looks very robust for the coming quarters	Index	99.4	↗	103.0
USA	GDP	GDP growth will remain above trend trough 2010	% q/q, AR	3.0%	↗	3.3%
	ISM	ISM will soon peak, but continue to indicate above trend growth through H2	Index	60.4	↘	57.0
	Employment	Job growth will continue to expand at a robust pace	3 mth. mavg.	186K	↗	225K
	Core inflation	Core inflation will trend lower as slack in the labour market continues to build	% y/y	0.9%	↘	0.6%
	Federal Reserve	Fed on hold. Expected to tighten rhetoric in H2	% p.a.	0.13%	→	0.13%
Japan	GDP	Pace of the recovery will lose some steam in H2 2010 but remain above trend	% q/q, AR	4.9%	↘	2.2%
	PMI	Manufacturing activity will continue to improve but lose some momentum	Index	54.7	↘	53.0
	Inflation	Deflationary pressure will gradually ease on the back of the strong recovery	% y/y	-1.5%	↗	-0.9%
	BoJ	BoJ on hold until H2 2011, further non-conventional easing cannot be ruled out	% p.a.	0.10%	→	0.10%

Source: Danske Markets

Alternative 1

Euro debt crisis worsens

- **Concerns about fiscal sustainability within the euro area continue to worsen. Global credit markets freeze and equity markets fall further.**
- **The Euro area slips back into recession and fiscal consolidation is accelerated further. Contagion speeds up the expected decline in ISM and US growth slows markedly. Asia outperforms, but is hit by an implosion in global trade.**
- **Global investors reduce their exposure towards Europe. The ECB cuts rates and expands its balance sheet massively as it extends liquidity programs and accelerates buying of PIIGS debt.**
- **More flight-to-quality leads to even lower global bond yields and the euro extends its decline. Asian markets outperform.**

Financial distress leads to more central bank support

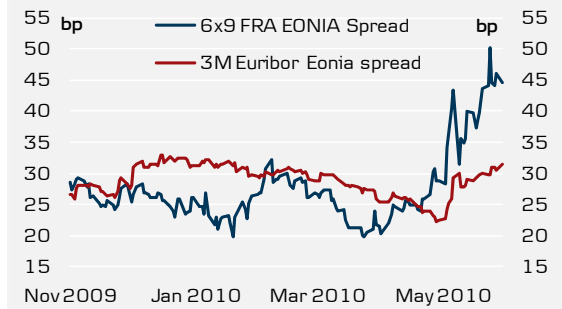
General concerns about euro area public finances grow even larger. The lack of trust leads to another widening of global credit and money market spreads. More market panic and lack of trust in the euro area proves a very toxic cocktail for the recovery that is materialising in the world economy. Financial markets force an acceleration of fiscal consolidation mainly in the euro area, which in combination with dismal financial conditions lead to more precaution in the private sector. Households increase savings, and corporates down-scale investment and production plans. The euro area slips back into recession and further labour market deterioration becomes visible. As this happens, US growth is reduced markedly. Asia, which has sound balances, outperforms in this scenario, but an implosion in global trade reduces the outlook.

More financial turmoil forces the ECB to 1) cut its key refi rate below 1.00%, 2) provide more liquidity and 3) accelerate buying of government debt. Moreover, the purchases are no longer sterilised leading to more EUR weakness. In this scenario, the Japanese yen is likely to strengthen significantly and this will prompt further liquidity measures from the Bank of Japan. Furthermore, the US Fed steps in and eases terms of the US dollar swap lines by reducing the penalty rate. Emergency policies from the ECB and the Fed leaves limited room for a normalisation of monetary policy. Neither the ECB nor the Fed will hike their key interest rates before 2012.

There is plenty of event risk

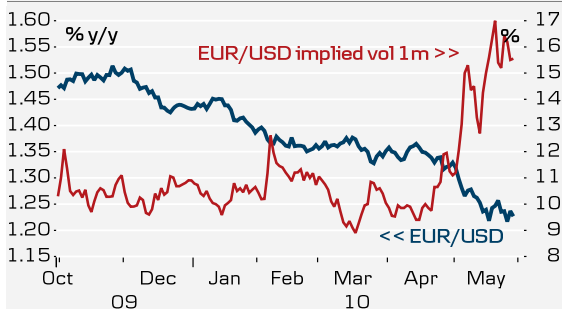
We distinguish between known and unknown unknowns. The list of known unknowns is long: For instance, Greece could ask for debt-restructuring; the Spanish banking sector collapses; policy makers engage in further uncoordinated policy actions etc. The list of unknown unknowns is even longer. Potentially one of events could lead to one or more countries leaving the euro area.

Money and credit markets are squeezed



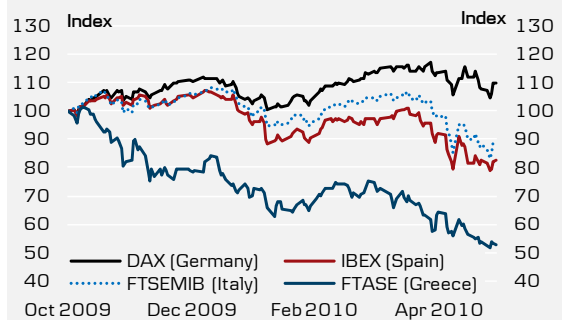
Source: Reuters Ecowin and Danske Markets

EUR weakens further and is increasingly volatile



Source: Reuters Ecowin and Danske Markets

Stock markets continue to slide



Source: Reuters Ecowin and Danske Markets

Alternative 2

On the road again

- In this scenario growth remains strong in emerging markets and the US recovery remains strong. Compared to our main scenario, growth does not ease in H2 10. In Europe the impact from fiscal tightening in PIIGS is largely offset by booming exports and lower bond yields elsewhere.
- Financial markets' focus soon returns to strong global growth and in this environment Europe's debt problems are regarded as manageable. Stress on money and credit markets eases fast
- In financial markets the European debt crisis is regarded as a 'temporary blip' that has only delayed necessary adjustments to monetary policy.

Attention returns to strong growth outside Europe

Growth continues unabated in emerging markets, where extremely accommodative monetary and fiscal policy remains in place because of concerns about the impact from the European debt crisis. In the US, the recovery remains on track with strong employment gains and solid private consumption in the coming months. The recovery in the US appears to maintain its pace in H2 10.

In Europe the impact from fiscal tightening in PIIGS countries is largely offset by booming exports and the positive impact from lower bond yields elsewhere. Business confidence remains high, supported by a strong industrial recovery.

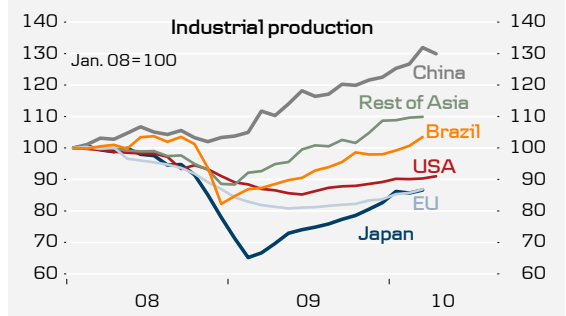
Financial markets soon turn their attention to strong global growth and with limited impact on growth in Europe, the PIIGS countries' debt problems are increasingly regarded as manageable. Liquidity returns to the European bond market and PIIGS bond yields decline markedly. Stress on money and credit markets ease relatively fast before there is any major economic impact.

Central banks are behind the curve

In this scenario commodity prices resume the fast upward trend seen in 2009. Financial markets now mainly regard the European debt crisis as a 'temporary blip' that has only delayed a necessary normalization or tightening of monetary policy across the world. Hence, central banks around the globe are increasingly feared to be behind the curve and bond yields rise significantly.

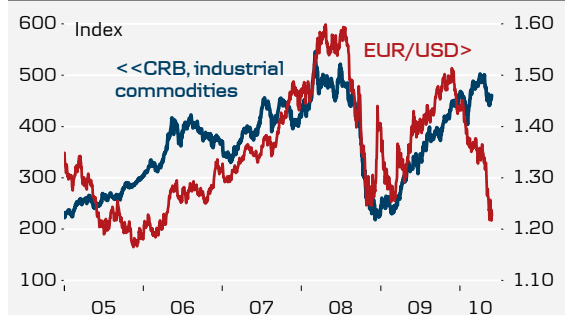
With improved risk sentiment in financial markets in general and confidence in the Eurozone restored, EUR recovers some of its losses – but only some because the Eurozone lags the global recovery. The USD weakens on the back of improved risk sentiment in the market.

Emerging markets continue to drive global growth



Source: Reuters Ecowin and Danske Markets

Commodity prices resume upward trend



Source: Reuters Ecowin and Danske Markets

Liquidity returns to European bond markets; stress on credit markets eases



Source: Reuters Ecowin and Danske Markets

US

Nothing to fear, but fear itself

- The recovery is looking increasingly robust as the labour market is turning and underlying domestic demand has improved faster than expected. Downside risks from a jobless recovery are now limited.
- The debt crisis in Europe is the main risk. It is already taking a toll on growth via deteriorating financial conditions. If market conditions do not improve a more pronounced slowdown is in the offing for H2.
- In any case the manufacturing cycle is set for a slowdown in H2 as inventory dynamics turn less favourable. Leading indicators, including the ISM, will start moving lower very soon.
- The longer-term outlook is for moderate growth with tough fiscal consolidation and financial regulation ahead. Easy monetary conditions and pent-up demand are expected to support above trend growth.
- Inflation pressure is expected to remain moderate. Core inflation will bottom around 0.5% late this year and move only gradually higher. Headline inflation is expected to remain below 2% throughout the forecast period.
- Financial turmoil will delay the initial Fed rate hike to March 2011. This will be preceded by verbal preparation of markets and liquidity draining. An escalation in market stress could reverse this process and force the Fed to reintroduce credit and liquidity programmes.

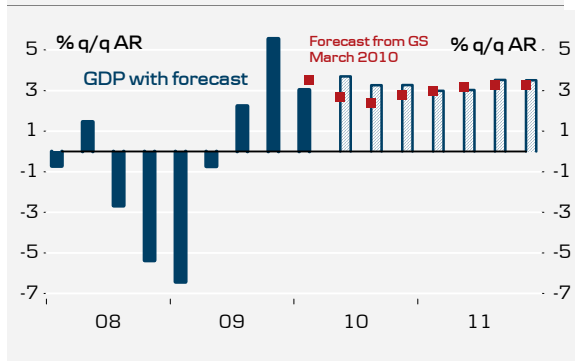
A more robust recovery

Following a solid Q4 with 5.6% q/q AR growth, the economy performed close to our expectations printing 3.0% q/q AR growth in Q1. The recovery is now looking increasingly robust as job growth has returned and consumers are ramping up spending. While there are still pockets of weakness in housing and commercial construction, the recovery has broadened with all other sectors showing progress.

Over the past few months data has been picking up further, suggesting a reacceleration in growth. Consequently, we have revised Q2-Q4 GDP growth up to 3-3.5% from 2.5-3% q/q AR previously – a revision that would have been even bigger if it was not for the recent financial turmoil. The forecasts for annual growth in 2010 and 2011 have been upped to 3.3% and 3.2% vs 3.2% and 3.0% in Global Scenarios March 2010.

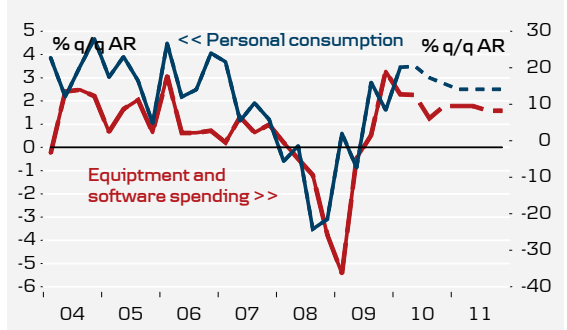
Generally, we continue to expect a moderate recovery compared with historical standards and relative to the depth of the recession, as fiscal contraction and financial regulation is set to cap growth in the medium term (see *Global Scenarios*, March 2010).

GDP forecasts: Current vs Global Scenarios March



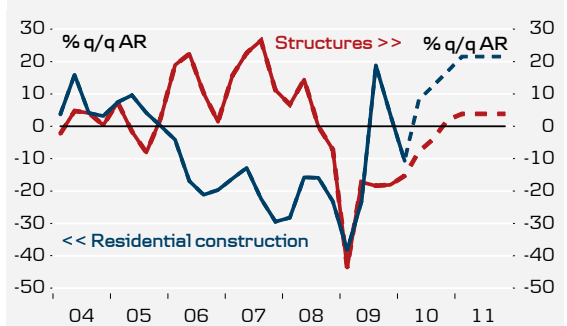
Source: Reuters Ecowin and Danske Markets

Consumers and business are recovering...



Source: Reuters Ecowin and Danske Markets

... while construction is still struggling



Source: Reuters Ecowin and Danske Markets

Inventory dynamics feeds into spending

In the previous version of Global Scenarios (March 2010) we argued, that the positive dynamics from the inventory cycle would boost the labour market sufficiently to put the economy back on a sustained recovery path.

This is indeed what has been happening over the past few months and the risk of a jobless recovery now appears very limited. Since December 2009 monthly gains in private non-farm payrolls have improved from minus 64,000 (preliminary release) to 231,000 in April. The outlook is now for monthly gains in non-farm payrolls (excluding census) in the range of 200,000-250,000 throughout the year and for a decline in unemployment to about 9% by year-end.

A return to relatively robust job growth has for some time been the cornerstone in our view of a sustained US recovery, as it is a premise for a sustained upturn in personal spending. On top of this the headwinds from huge net wealth destruction are easing and consumer credit is loosening up. Along with the declining unemployment rate, this implies that the upward pressure on the savings rate has eased considerably.

With low core inflation and oil prices only marginally higher on the year this provides room for a moderate recovery in consumption. We look for quarterly consumption growth to average 3.2% q/q AR this year, but expect it to lose some steam in 2011 when fiscal support is removed.

However, this is not the only implication of the turn in the labour market. When hiring returns businesses usually ramp up investment spending and begin restocking, as spending on labour and capital goes hand in hand. Indeed this is now acting to support the positive recovery dynamics.

Finally, as we emphasised in Global Scenarios in March continued solid exports demand and pent-up demand on cars, housing and capex will be making up for some of the missing strength in personal consumption and facilitate above trend growth through the forecast horizon.

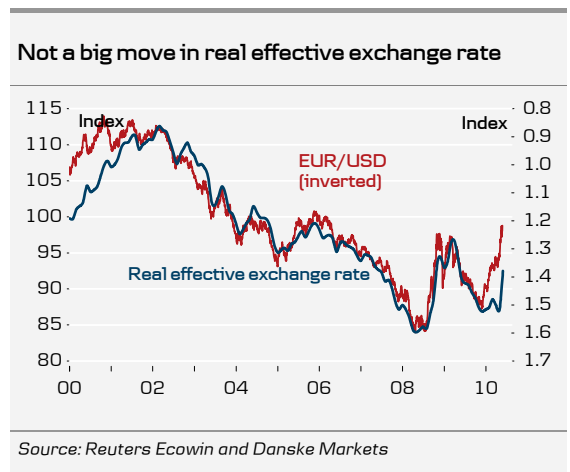
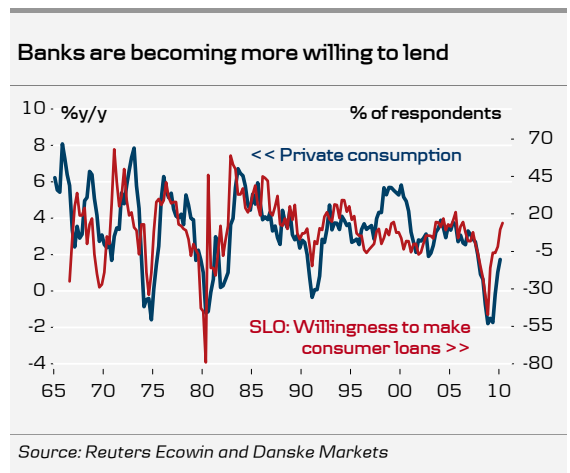
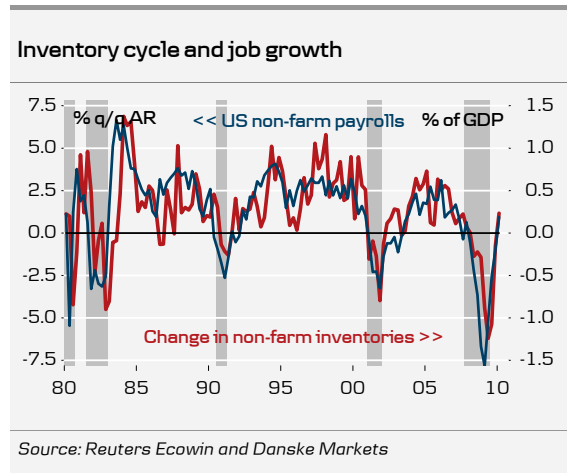
Hence, despite pockets of weakness in residential construction and structures the stage should now be set for a self-propelling recovery. The only real threat to this scenario is the appearance of any new shock.

Will the US catch a cold from Greece?

This is where the Greek debt crisis becomes relevant. First, it has battered the outlook for the eurozone and second it has led to a significant deterioration in financial market conditions over the past couple of months.

However, the impact from the debt crisis in Europe is expected to be limited. First, the eurozone makes up only 10% of US exports. Second, the contribution to export growth has not been of any significance during this recovery. Third, even though the EUR/USD has moved lower the real effective exchange rate remains not far from its 12-month average.

Much more of a concern is the general deterioration in financial conditions. The equity market has corrected some 10% from its cyclical peak, credit spreads are widening and money markets have become distressed.



This is already taking its toll on growth in the near term even with the cushion from declining commodity prices.

To assess the impact we have simulated two scenarios; one with no shock (i.e. financial variables fixed at the end-April levels) and one with the current shock (i.e. financial variable fixed at the current level).

The scenarios indicate that if the market conditions do not improve GDP growth is likely to take a hit of 1-1½pp in H2 10 and ¾pp through 2011. The simulations also demonstrate that the growth rate would probably have approached 4% in H2 if it has not been for the contagion on global financial markets.

The assumption behind our forecast is that the intervention from fiscal and monetary authorities will finally succeed in calming down the markets. In this scenario the recovery will remain intact. There will be a cost from the turmoil in the short run, but it will to some extent be paid back later on.

Contagion could speed up manufacturing slowdown

Over the past three quarters the US manufacturing sector has experienced a classical V-shaped recovery. The manufacturing ISM index reached a cyclical high of 60.4 in April, but fundamentals now suggest that leading manufacturing indicators are very close to a peak and that the pace of manufacturing growth is bound to slow in H2.

This should in fact be of little surprise. Production has been expanding faster than demand over past quarters and the gap between the two has narrowed. As output catches up with demand, production growth will eventually settle down to more average levels. We are now close to this point in the cycle and the ISM is set to move lower in H2.

While fundamentals are suggesting that the descent in the ISM will be relatively moderate, the recent deterioration in financial market conditions could speed up the slowdown in the manufacturing sector. Discounting the recent turmoil ISM should be heading for 54-55 by year-end. However, in the event that conditions do not improve these levels could be reached as early as November and the ISM would reach 50 in Q1 (see *Euro crisis could speed up manufacturing slowdown*).

Inflation to stay low but deflationary trap unlikely

Core inflation dropped to 0.9% y/y in April, its lowest level since 1963. A major disinflationary impulse from the housing component is currently dragging core service price inflation lower and there are no signs of a turnaround in housing inflation any time soon. Service prices outside housing are usually very stable, but with a major slackening in the labour market, we believe that this inflation component will move lower as well.

Outside services, there is evidence of upward pressure on core goods prices. Core crude and intermediate PPI has surged over the past year, but a sharp decline in unit labour cost growth has offset the upward price pressure and finished goods PPI has kept relatively stable. We expect the downward trend in unit labour cost growth to continue keeping a lid on core goods inflation.

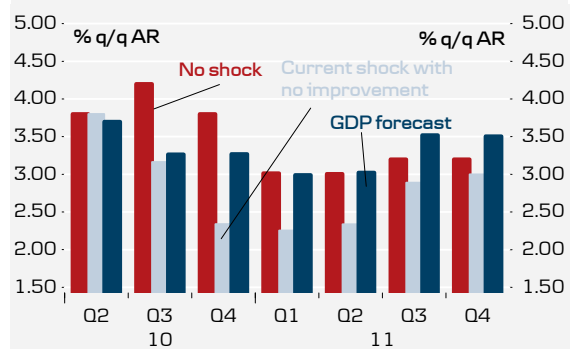
Scenarios

	No Shock		Current Shock	
	2010	2011	2010	2011
S&P500	1265	1391	1069	1176
10 year government bond	3.7	3.7	3.1	3.1
Real Effective Exchangerate	87	87	90	90
Credit Spread*	241	241	310	310
Labor Spread	15	15	26	26
NYMEX WTI	85	85	70	70

*] Moody's Baa rate minus 10yr US Treasury yield

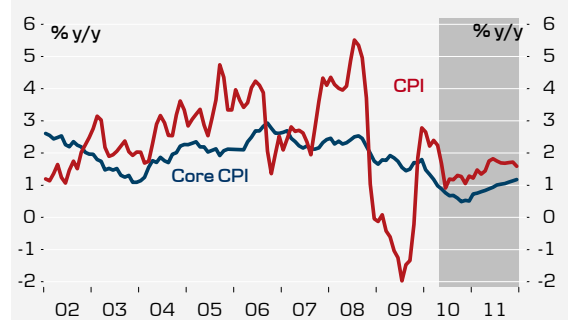
Source: Reuters Ecowin and Danske Markets

GDP growth under different scenarios



Source: Reuters Ecowin and Danske Markets

The disinflationary trend to continue for a while



Source: Reuters Ecowin and Danske Markets

In summary, we expect annual core inflation to trough at 0.5% in Q4 and trend only gradually upward to 1.2% by end-2011. Given our outlook for a moderate increase in oil prices, we expect headline inflation to bottom at just above 1% and increase to 1.7% by end-2011.

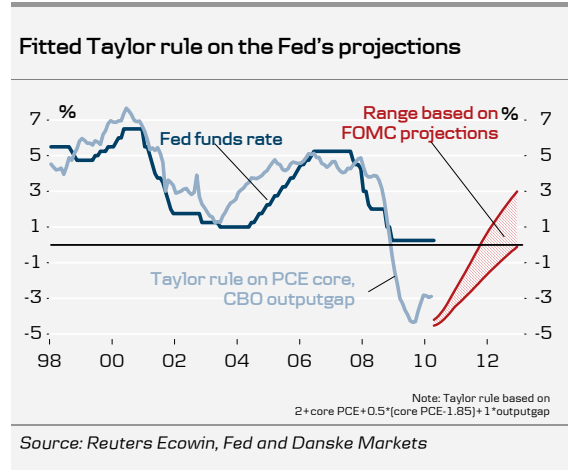
Fed exit delayed by financial turmoil

Even though growth indicators have been stronger than expected over the past few months and the outlook for H2 remains above trend GDP growth, the recent turmoil in financial markets is likely to delay policy normalisation.

Low and declining inflation pressures and a continued large output gap affords the Fed time to wait and see how the current crisis develops. The latest FOMC minutes showed that most members expect inflation to fall below target in the medium term at the same time as the European debt crisis is seen as a risk to both growth and US financial markets.

Financial contagion and de-risking has only accelerated since then. We have therefore postponed the initial Fed hike from November 2010 in the latest Global Scenarios to March 2011. This is likely to be preceded by discount rate normalisation and liquidity draining together with a moderation of the 'extended period' language. We expect the Fed to deliver a 25bp hike at each of the following meetings until the fed funds rate has reached a neutral level.

If the financial market turmoil develops further we would not rule out a re-introduction of other liquidity and credit facilities on top of the recent reopening of FX swap lines (see: *Thoughts on the Fed and the money markets*). In that event the normalisation process would be dragged out, delaying the initial Fed funds rate hike beyond March 2011.



US macro forecast

% Change q/q AR	2010				2011				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011
GDP	3.0	3.7	3.3	3.3	3.0	3.0	3.5	3.5	-2.4	3.3	3.2
Private Consumption	3.5	3.5	3.0	2.7	2.5	2.5	2.5	2.5	-0.6	2.7	2.7
Private Fixed Investments	0.1	9.6	5.4	9.6	11.0	11.0	10.4	10.4	-18.3	2.9	9.8
Residential	-10.7	8.2	12.6	17.0	21.6	21.6	21.6	21.6	-20.5	2.4	18.8
Non-residential	3.1	9.9	3.5	7.6	8.1	8.1	7.2	7.2	-17.8	3.1	7.3
Change in inventories (\$bn, real)	33.9	50.0	60.0	63.0	50.0	39.0	48.0	55.0	-108.3	51.7	48.0
Change in inventories ¹	1.6	0.5	0.3	0.1	-0.4	-0.3	0.3	0.2	-0.6	1.2	-0.4
Public Consumption	-1.9	0.8	0.8	0.8	-0.8	-1.2	-1.2	-1.2	1.8	0.3	9.4
Exports	7.2	13.0	10.4	9.3	8.2	8.2	10.4	10.4	-9.6	12.1	6.4
Imports	10.4	14.8	8.2	8.2	4.1	4.1	6.1	6.1	-13.9	11.3	48.0
Net exports ¹	-0.6	-0.6	0.0	-0.1	0.4	0.4	0.4	0.4	1.0	-0.2	8.4
Unemployment rate (%)	9.7	9.7	9.2	8.9	8.7	8.5	8.3	8.1	9.3	9.4	8.4
CPI (y/y)	2.4	1.6	1.2	1.2	1.3	1.7	1.7	1.7	-0.3	1.6	1.6
Core CPI (y/y)	1.3	0.9	0.7	0.5	0.8	0.9	1.0	1.1	1.7	0.8	1.0
Public Budget ²									-9.9	-10.2	-8.8
Public Gross Debt ²									83.6	91.6	96.8
Current Account ²									-2.9	-3.9	-3.8
Fed funds rate ³	0-0.25	0-0.25	0-0.25	0-0.25	0.50	1.00	1.50	2.00			

Note: 1) Contribution to GDP growth, 2) Pct. of GDP, 3) End of period. Source: Reuters Ecowin and Danske Markets

Euroland

Debt crisis endangers recovery

- In recent months we have seen indications of more robust growth in the euro area. Meanwhile, the euro debt crisis has escalated and the risk that the fragile European recovery will be derailed by freezing credit markets has increased.
- We revise our GDP forecast for 2010 lower due to a weak entry to the year. In the short term, there is robust economic momentum and we still expect above-trend growth in the current and coming quarters. The GDP estimate for 2011 has been revised slightly lower.
- The growth outlook is the result of large counterbalancing shifts in growth composition. Domestic demand is dampened by fiscal tightening and increased uncertainty. This is countered by a larger contribution from net exports due to the EUR weakening.
- Looking forward there are plenty of event risks. The most foreseeable risks arise from financial regulation, Greek foot-dragging and the troubled Spanish saving banks. Should the market situation worsen from here, risks are for much lower growth.
- Inflationary pressures are projected to remain subdued. The ECB has re-engaged in credit easing measures to prop up sliding markets. Hence monetary tightening is not on the table for now and we project the ECB to deliver a first hike in the latter part of 2011.

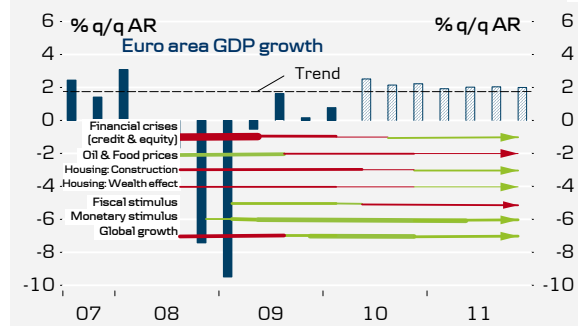
Growth momentum overshadowed by debt crisis

Euroland growth recovered a little in the first quarter of the year (+0.2% q/q) following next to no growth in Q4 2009 (+ 0.1% q/q), but the growth rates are not impressive. The weak entry to 2010 amid strong global momentum can only to some extent be explained by adverse weather effects. We would not be surprised to see an upward revision to growth in Q1 as industrial production and confidence indicators points to much stronger growth. Our projection for GDP growth in 2010 would then have to be revised upward too. Nevertheless, it is hard to get around the fact that Europe remains the weakest region in the global recovery.

German and French GDP details reveal that domestic demand excluding public spending remains weak, while public consumption supports growth. Net exports contribute positively to economic activity and especially Germany continues to benefit from export exposure to Asia.

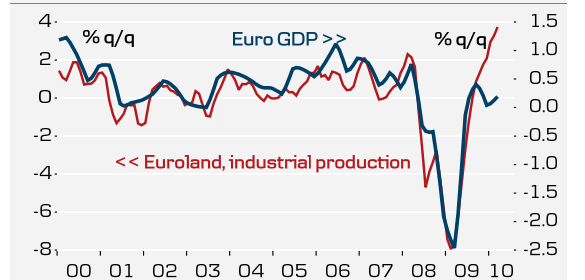
Recent data suggests robust growth in Q2 2010. PMI surveys point to expanding activities in manufacturing and service sectors, though May PMI flash estimates levelled off a little. Employment components are pointing to job creation for the first time in two years. Euro area unemployment looks to

Robust growth momentum



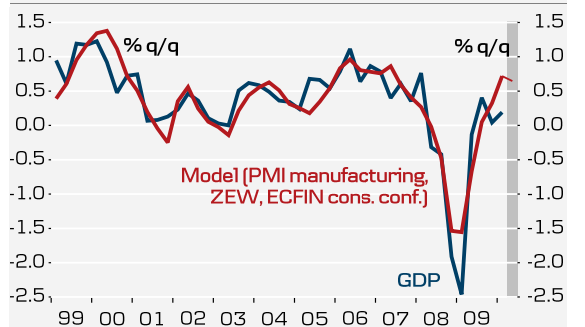
Source: Reuters Ecowin and Danske Bank

Industrial activity supports growth outlook



Source: Reuters Ecowin and Danske Bank calculations

Soft data points to above trend growth in Q2 2010



Source: Reuters Ecowin and Danske Markets

have stabilised at 10.0% in March and industrial orders are pointing strongly upwards.

Meanwhile, however, the euro debt crisis has escalated and there has been widespread contagion to most asset markets. Greece has called for an activation of a three-year EUR110bn joint EU/IMF aid deal on 2 May 2010 (see *Flash Comment - Greece: EUR110bn programme approved*), securing the country funding for its budget deficit for three years. Whether this is enough to avoid a debt restructuring remains an open question. The Greek aid deal failed to stabilise European government bond markets and it was shortly after on 10 May 2010 followed up by a massive European rescue package worth EUR720bn (see *Flash Comment - EU agreement to combat crisis*).

The package is supplemented by ECB action. The ECB is providing liquidity and is buying up debt in Portugal, Ireland and Greece. PIIGS government bond markets have stabilised, but the ECB is still the only buyer and global investor confidence in euro area sovereign debt is expected to re-emerge only gradually as countries move ahead with fiscal consolidation. (see *Research - Euroland: Q&A on the EU debt crisis*).

Portugal and Spain frontloads fiscal tightening

Portugal and Spain have decided to accelerate fiscal tightening compared to their latest Stability and convergence programmes (SCP). The Greek EU/IMF programme involves accelerated fiscal tightening in 2010 compared with the Greek SGP, but not in 2011. In Italy, the government recently gave details of how it will bring down its budget deficit below 3% of GDP by 2012.

Tighter fiscal policies will come at a cost of lower growth in the short term, mostly so in 2011. However, the accelerated fiscal consolidation will have a limited impact on euro area growth as Spain, Portugal and Greece only constitute around 18% of euro area GDP. These additional measures correspond to a euro area wide fiscal tightening of 0.1 %-point of GDP compared with available information from the SCPs, which formed the basis for our previous forecast. Hence the aggregate growth effect of the additional tightening will be very modest. However, for the involved countries the effects will be significant and the growth picture in the euro area will become less uniform in the coming years. Other member states may follow and frontload fiscal consolidation. This would dampen growth prospects for 2011 further.

EUR weakening and low interest rates support growth

The negative impact of the debt crisis on growth via fiscal tightening is countered by a positive contribution from EUR weakening and the resulting improvement in competitiveness. Since our previous Global Scenarios, the EUR has weakened about 8.8% against the USD due to the debt crisis and since the peak six months ago EUR/USD has declined as much as 18.4%. The nominal effective exchange rate (NEER) in trade-weighted terms has weakened somewhat less, namely 5.6% in the last three months and 12.7% since the peak.

Estimates of the impact from a 10% NEER depreciation on euro area GDP growth varies from about 0.5 to 1.0%-point extra GDP growth on a one-year horizon. We apply the OECD model estimate of 0.8% and find that the last

Unemployment is stabilising



Source: Reuters Ecowin

A tough challenge for Greece to overcome

Greece	Real GDP (1)	Nom GDP (1)	Primary public balance (2)	Interest payments (2)	Overall balance (2)	General govt debt (2)
2009	-2.0	-0.7	-8.6	5.0	-13.6	115
2010	-4.0	-2.8	-2.4	5.6	-8.1	133
2011	-2.6	-3.1	-0.9	6.6	-7.6	145
2012	1.1	2.1	1.0	7.5	-6.5	149
2013	2.1	2.8	3.1	8.1	-4.9	149
2014	2.1	3.1	5.9	8.4	-2.6	145
2015	2.7	3.8	6.0	8.1	-2.0	139

Note: (1) % y/y, (2) % of GDP. Source: IMF & Greek authorities

Fiscal tightening is being frontloaded

Exp. public deficits, % of GDP	2010		2011	
	New	SCP	New	SCP
Portugal	-7.3%	-8.3%	-4.6%	-6.6%
Spain	-9.3%	-9.8%	-6.5%	-7.5%
Greece	-8.1%	-8.7%	-7.6%	-5.6%

Source: Ministry's of Finance and Stability and Convergence Programmes (SCP).

three month EUR depreciation contributes with around 0.4%-point to Euro area growth. This easily outweighs the negative impact of the additional fiscal tightening that has been announced in the same period. The open economies like Ireland and Germany are going to benefit the most from the euro weakening, while less open economies like Greece and France benefit less.

The rather abrupt nature of the euro weakening is a negative factor as it may dampen international investor appetite on euro assets. In particular we have seen Asian appetite for European assets cooling in recent months. The impact on growth is difficult to assess.

The negative impact from fiscal tightening is also countered by a positive growth contribution from interest rates, which due to the debt crisis are expected to stay low for longer. We decided mid-May to move our first ECB hike from Q1 2011 to H2 2011. Lower rates may then add about 0.2% to euro area growth in 2011. Countries and banks with lower ratings are however suffering from higher spreads and the drying up of credit markets. This amplifies the bipolar nature of the euro area recovery.

We expect relatively subdued inflation over the forecasting horizon. Core inflation is expected to remain low due to large slack in the euro area economies, while energy and food prices could add some mild upside potential on inflation. We expect inflation to hover around 1.5-1.7% y/y in 2010-2011. Overall the inflation outlook is mixed. Countries like Portugal, Spain, Ireland, Greece face rebalancing and competitiveness needs to be restored. This increases deflationary risks in those countries.

All in all the impact of the debt crisis on growth seems to be positive - if it were not for the negative effect of increased uncertainty. Volatility is high at the moment and it is increasingly likely that confidence will be hard hit and as a result investments postponed and the recovery in consumption more gradual. The overall impact of the crisis on our growth projection is thus a reduction of the anticipated strong growth in the current and coming quarters and a slightly lower growth profile in 2011. The impact on growth composition is more pronounced. We now expect a notably slower recovery in domestic demand and a larger growth contribution from net exports.

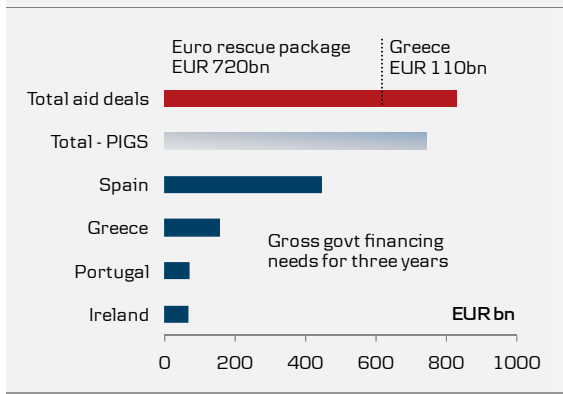
Event risks are abundant

There is a real risk that global investors will turn their back on Europe for a long time and that could derail the recovery. The German short-selling ban introduced on 19 May 2010 (see *Presentation: BaFin bans naked short-selling*) was an example of an event that hurt confidence. In order to restore confidence it is vital that European countries act in a coordinated manner and that fiscal tightening in some countries is accelerated.

Looking forward, event risks are abundant and will be so for a long period. It is not difficult to tell a story - or three for that matter - about how market sentiment and European growth could be derailed:

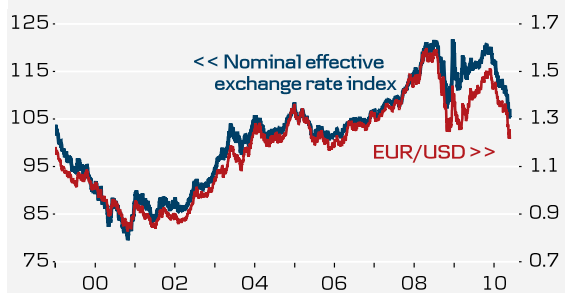
1) Tough and uncoordinated financial regulation from politicians is another obvious risk. More surprises like the German naked short-selling ban would increase uncertainty and if policies are not well designed they could hamper

Euro rescue package buys some time



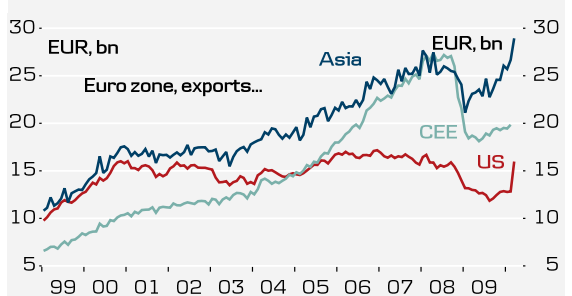
Source: Danske Bank

EUR depreciated rapidly, but is not cheap



Source: Reuters Ecowin

In Asia we trust



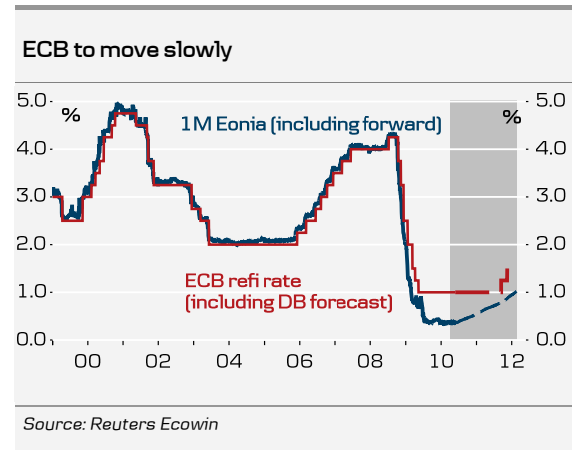
Source: Reuters Ecowin and Danske Bank calculations

the recovery in credit growth and negatively affect investments and private consumption.

2) If Greece begins to question the austerity measures and fails to deliver on its promises this would spook the markets. As an early warning that this could happen, the Greek labour minister recently announced that Greece wants to renegotiate the pension reform agreed with the EU and IMF. Greece is arguing for a smaller reform and for full implementation to be later. If we see more Greek foot-dragging debt restructuring discussions could reignite. And then there is always the risk that Greece announces new upward revisions to debt and deficit figures.

3) Spanish saving banks, which are heavily exposed to the faltering Spanish property market, are in difficulties. A EUR99bn fund for orderly bank restructuring (Frob) is in place to recapitalise saving banks when necessary and a number of mergers are expected to take place in the coming months. This process could unveil some negative surprises. There could be ripple effects and uncertainty about where the losses ultimately will have to be taken could spark a new crisis.

There are upside risks too of course. The current crisis could disappear as quickly as it came and the euro area economy could then rebound much more strongly.



Euro area macro forecast

% Change q/q AR	2010				2011				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011
GDP	0.8	2.5	2.1	2.2	1.9	2.0	2.0	2.0	-4.0	1.3	2.1
Private Consumption	-0.9	0.9	1.1	1.2	1.1	1.3	1.3	1.4	-0.5	0.1	1.2
Private Fixed Investments	-3.4	0.7	2.4	4.1	4.0	4.4	4.4	4.3	-10.8	-2.0	3.8
Change in inventories ¹	0.9	0.3	0.0	0.0	0.0	0.0	0.0	0.0	-0.8	0.4	0.0
Public Consumption	1.8	1.5	1.4	1.4	0.7	0.9	1.0	1.0	2.3	1.4	1.1
Exports	10.4	8.1	6.4	5.6	5.0	4.9	4.8	4.7	-12.6	7.9	5.4
Imports	8.9	5.3	4.8	4.8	4.4	4.6	4.6	4.6	-11.4	5.8	4.6
Net exports ¹	1.0	0.4	0.3	0.1	0.0	0.0	-0.1	-0.1	-0.8	0.9	0.4
Unemployment rate (%)	10.0	9.9	9.8	9.7	9.6	9.5	9.5	9.4	9.4	9.8	9.5
CPI (y/y)	0.9	1.0	1.2	1.4	1.5	1.5	1.5	1.6	0.3	1.4	1.6
Core CPI (y/y)	0.7	0.5	0.6	0.7	1.0	1.0	1.0	1.1	1.4	0.8	1.0
Public Budget ²									-6.3	-6.7	-6.0
Public Gross Debt ²									78.7	84.8	88.5
Current Account ²									-0.7	-0.3	-0.2
ECB refi rate ³	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.00	1.00	1.50

Note: 1: Contribution to GDP growth, 2: Pct. of GDP, 3: End of period. Source: Reuters Ecowin and Danske Bank projections.

Asia

Overheating is the main concern

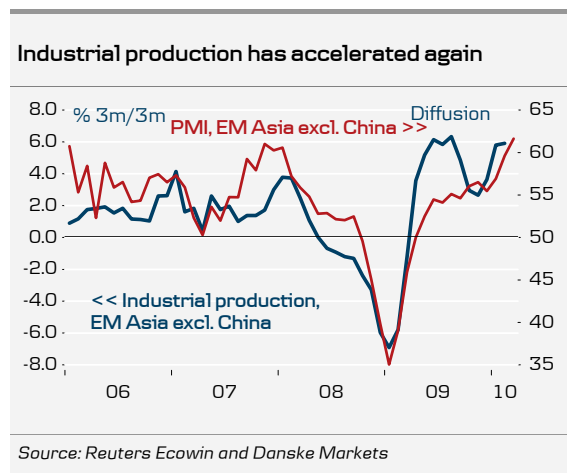
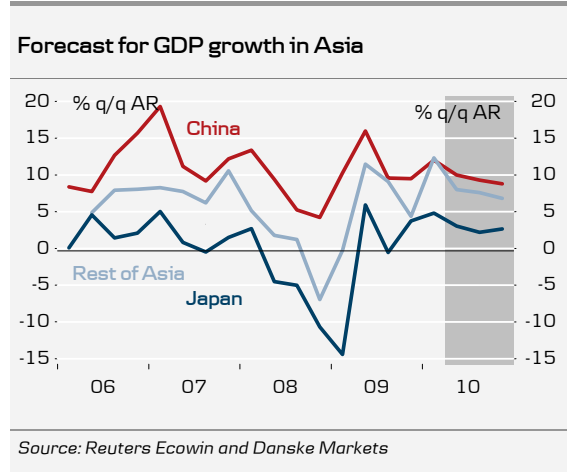
- Growth in Asia accelerated significantly in early-2010 and we have adjusted our GDP forecast up for all major Asian economies, including China and Japan. Our upward revision mainly reflects a very strong H1 10.
- We still expect GDP growth in Asia to peak in Q1 as the positive impact from inventory adjustments and policy stimulus gradually wanes and the impact from tightening kicks in, not least in China. So far we see a modest impact from the European debt crisis. With fiscal policy flexibility intact, Asia should continue to perform well even in a more negative scenario for Europe.
- Despite stronger than expected growth inflation has, with the exception of India, increased less than expected, mainly because commodity prices have stabilised globally. However, inflation is still expected to increase and reach close to 4% in China by the end of the year. In Japan, deflation is the main concern and consumer prices are not expected to start increasing until Q3 11.
- Muted inflation and increasing concern about the impact from European monetary tightening has postponed monetary tightening in most Asian countries. China's revaluation has probably been postponed until Q3, but is not off the table. In Japan monetary tightening will lag the rest of Asia and the US but we can no longer rule out that Bank of Japan will tighten before the ECB.

Growth accelerates across Asia

Asia has so far performed better than expected in 2010. In emerging Asia GDP growth in Q1 10 accelerated to 12.2% q/q AR from 8.0% q/q in the previous quarter. Even Japan continued to perform strongly with GDP expanding by a solid 4.9% q/q AR following a respectable 4.0% q/q AR growth seen in the previous quarter.

The solid performance in Asia continues to be driven by a strong recovery in industrial production. As seen in the chart, industrial production again accelerated in Asia in Q1 10, following some moderation in growth in Q4 10 on the back of the exceptionally strong growth in the early recovery phase. Manufacturers across Asia continue to adjust production to demand and inventory cuts have eased substantially. Hence, growth in industrial production has continued to improve despite some slowdown in export growth. For Asia as a whole, export growth in Q1 eased slightly to 8.2% q/q from 11.2% q/q in the previous quarter.

Growth in industrial production probably peaked in Q1 and consequently we expect Asian manufacturing PMIs to start decline slightly in coming months. OECD leading indicators suggest that growth in exports will continue to ease albeit remaining healthy. In addition the positive impact on industrial activity from the inventory cycle should be less in the coming quarters. However, this



has not yet started increasing across Asia, suggesting that there will be still be a positive impact on growth from inventories in the coming quarters, but that it would be significantly less than in the previous quarters.

Recovery looks self-sustainable

Improvement in private domestic demand also contributed to the strong performance of the Asian economies in early-2010 and the recovery in Asia is looking increasingly self-sustainable. There are signs of further improvement in private consumption in both China and Japan and in the rest of Asia private consumption remains strong overall.

Subsidies for private consumption such as ‘cash-for-clunker’ programmes and subsidies for purchase of durable consumer goods have supported private consumption substantially in the early recovery phase. These consumer subsidies remain in place in both China and Japan until at least late this year. Nonetheless, the growth impact on private consumption from these programmes has started to wane and not least the demand for cars slowed substantially following the explosive growth seen last year. If and when these consumer subsidies programmes are terminated later this year it could have a negative impact on private consumption, particularly in 2011 albeit there could be a temporary boost as some purchases could be pushed forward on the announcement of the termination.

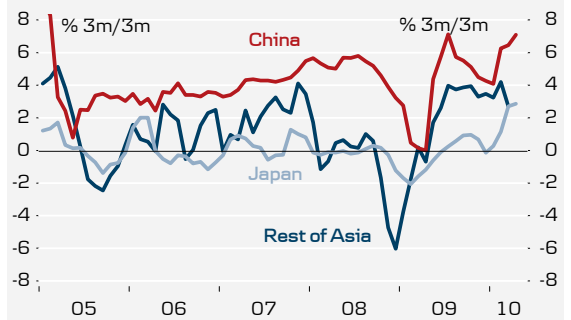
On the other hand, private consumption is increasingly being supported by stronger household real income growth. The unemployment rate is declining across Asia and private employment is increasing fast. Overall, when we look at private consumption, across Asia it looks like stronger income growth has offset the waning impact from policy measures.

Unwinding of stimulus will slow growth later in 2010

With the exception of Japan, investments in Asia have recovered relatively quickly even though investment demand is usually cyclically late. The main reasons for strong investments in the early-recovery phase are mainly higher public investments, as part of fiscal stimulus and some “normalisation” of investment demand from the extraordinarily depressed levels seen in early-2009. Some unwinding of the fiscal stimulus has started with public investments already declining in countries such as Japan and South Korea. In China, where the impact from public investments has been largest, the level of public infrastructure investments has been broadly flat and is not expected to decline until late-2010 or early-2011.

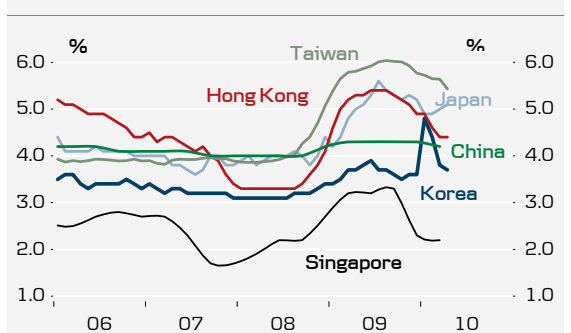
If we look at investment demand it appears that the negative impact from unwinding of fiscal stimulus is being more than offset by stronger private investment demand. Even in Japan private investment is likely to contribute significantly to growth in the coming quarters. Growth in machinery and equipment will remain strong on the back of the recovery in industrial activity. In addition real estate investments should continue to improve on the back of the recent rebound in house prices across Asia. So far there are no signs that slower credit growth in China has had any substantial impact on investment. On the contrary real estate investments appear to have accelerated in early-2010. That said the Chinese recent tightening measures target-

Retail sales have accelerated in China and Japan and remain strong in the rest of Asia



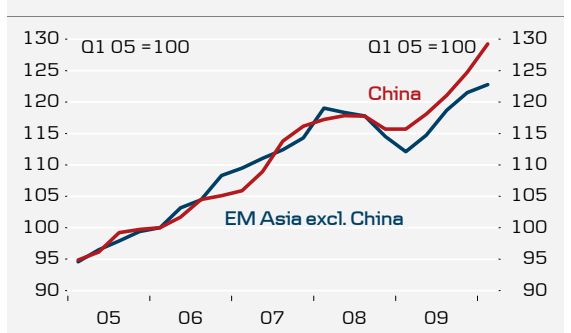
Source: Reuters Ecowin, and Danske Markets

Unemployment declining in most Asian countries



Source: Reuters Ecowin, Markit and Danske Markets

Housing prices now rising fast in Asia



Source: Reuters Ecowin and Danske Markets

ing real estate are likely to slow real estate investments in China later this year. Hence, we are likely to see a substantial slowdown in investment demand in late-2010 and early-2011.

Asia still has fiscal flexibility

So far there are no signs that the European debt crisis will force any Asian countries to front load fiscal tightening. Overall, public finances in Asia are in much better shape than in Europe and the US. Among the Asian countries Japan and India looks most vulnerable (see chart). In Japan the European debt crisis has created some concern among policymakers and the DPJ government has promised to put forward a long-term plan for reducing the government's deficit. However, the overall fiscal policy is likely to remain expansive this year, with lower taxes and higher consumer subsidies offsetting the negative impact from some reduction in public investments. As 95% of Japanese government bonds are held by domestic – to a large degree directly or indirectly controlled by the government – we believe there is little risk that the European sovereign debt crisis will spill over to Japan.

India has extensive capital controls and consequently, as in Japan's case, foreign investors have very little exposure to the Indian bond market. By far the biggest investors in the Indian bond market are the big state owned banks that are required to invest a fixed share of their balance sheets in government bonds. In addition, with nominal GDP growth exceeding 10%, India is still in a relatively favourable position to improve its public finances.

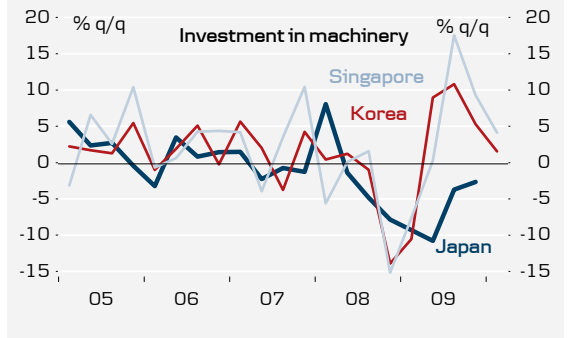
Consequently, there is still considerable fiscal policy flexibility in Asia. Only in Japan it looks like fiscal tightening could weigh on the strength of the recovery, although the Japanese government so far has not been forced to frontload fiscal tightening. Fiscally Asia, as a whole, still has at least one more bullet in its gun and could ease fiscal policy further if the Asian economies started to deteriorate.

Inflation not yet out of control

Besides Japan – where deflation remains a concern – the main concern in the rest of Asia is overheating and possible bubbles developing in asset markets. Overall, monetary policy in Asia remains extremely accommodative and the output gap really never widened substantially in major Asian economies such as China, India and Indonesia in the wake of the global financial crisis. In the rest of Asia besides Japan the output gap has closed fast on the back of the strong "V-shaped" recovery.

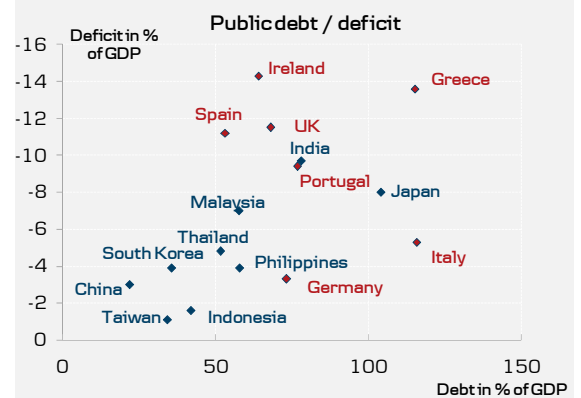
However, it is too early to say that inflation will rise substantially. Based on the development in the output-gap we are still far from a situation similar to 2007/2008, where Asia clearly overheated. So far inflation has actually increased less than expected in 2009. While year-on-year increase in consumer prices has continued to increase, month-on-month increases in consumer prices have actually eased, particularly in Asia (excluding Japan and China) as seen in the chart on the next page. The increase in inflation in 2009 was, to a large degree, driven by higher crude oil and commodity prices. In addition, a bad harvest in India last year pushed inflation in India close to 10% y/y.

Growth in machinery investments easing but is expected to improve substantially in Japan



Source: Reuters Ecowin, Markit and Danske Markets

Asia still has fiscal flexibility



Source: Reuters Ecowin and Danske Markets. Note: Japan is gone

Inflationary pressure has eased slightly



Source: Reuters Ecowin and Danske Markets

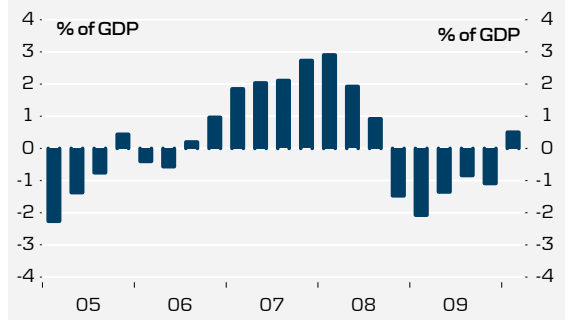
However, stabilisation in crude oil and commodity prices (and even a decline recently) and a normal harvest and lower food prices in India is currently contributing to a temporary decline in inflationary pressure.

Danger that central banks are getting behind the curve

Nonetheless, there is increasing danger that Asian central banks are getting behind the curve. So far, only central banks in India, Malaysia and Vietnam have raised their leading interest rate. In China, the Peoples' Bank of China (PBoC) has raised the reserve requirement for commercial banks and guided credit growth substantially lower. In addition, the Chinese government has made several regulatory changes, targeting the real estate sector. However, policymakers in Asia have again, in recent months, become very cautious in the wake of the European debt crisis and further tightening has been postponed, at least to Q3.

We still expect China to resume appreciation of the CNY soon but in light of the recent volatility in financial markets it has likely been postponed to Q3. We now believe that an increase in the leading interest rates in China is unlikely to happen until late-Q3. In general, we have started to raise leading interest rates for all Asian countries besides Japan during Q3. Although the recovery in Japan has been strong, Japan remains the weakest link in Asia and the Bank of Japan (BoJ) is unlikely to raise its leading interest rates until the year-on-year inflation rate turns positive and that it unlikely to happen until mid-2011. Consequently monetary tightening in Japan will lag the US, but not necessarily Euroland. In the short run further non-conventional easing from the BoJ cannot be ruled out, particularly if the yen strengthens. With Asia's growth likely to continue to outperform and monetary policy likely to be tightened earlier and faster than in Europe and the US, we still expect Asian currencies, with the exception of the yen, to appreciate.

Output-gap in Asia excl. Japan



Source: Reuters Ecowin and Danske Markets

European debt crisis has postponed Chinese re-valuation



Source: Reuters Ecowin and Danske Markets

Asia macro forecasts

% Change y/y	GDP				CPI inflation				Current account			
	2008	2009	2010	2011	2008	2009	2010	2011	2008	2009	2010	2011
Asia	5.3	3.5	7.5	7.0	5.7	2.1	4.3	3.3	4.5	4.0	3.2	3.3
Japan	-1.2	-5.2	3.3	2.1	1.4	-1.4	-1.0	0.1	3.2	2.8	3.4	3.0
China	9.6	8.7	10.2	9.5	5.9	-0.7	3.3	3.5	9.4	5.8	4.8	5.5
Asia excl. Japan & China	4.7	2.5	6.8	6.5	7.7	6.4	7.7	4.5	0.7	2.7	1.7	1.4
India	7.3	5.7	8.8	8.4	8.3	10.9	13.2	5.5	-2.2	-2.1	-2.2	-2.0
NIC	1.8	-0.9	5.2	4.9	4.5	1.3	2.3	2.5	4.8	8.7	6.5	6.5
South Korea	2.3	0.2	4.5	5.0	4.7	2.8	2.9	3.0	-0.6	5.1	1.6	2.2
Taiwan	0.7	-1.9	6.5	4.8	3.5	-0.9	1.5	1.5	6.2	11.2	8.5	7.7
Hong Kong	2.1	-2.7	5.0	4.4	4.3	0.5	2.0	2.8	13.6	11.1	12.1	10.1
Singapore	1.4	-2.0	5.7	5.3	6.5	0.2	2.1	1.9	19.2	19.1	22.0	22.4
ASEAN	4.7	1.7	5.4	5.6	9.4	2.9	4.8	4.6	2.0	4.9	3.2	2.1
Indonesia	6.0	4.5	6.0	6.2	9.8	4.8	4.7	5.8	0.0	2.0	1.4	0.4
Thailand	2.5	-2.3	5.5	5.5	5.5	-0.8	3.2	1.9	0.6	7.7	2.5	0.3
Philippines	3.8	0.9	3.6	4.0	9.3	3.2	5.0	4.0	2.2	5.3	3.5	2.3
Malaysia	4.6	-1.7	4.7	5.1	5.4	0.6	2.0	2.1	17.5	16.7	15.4	14.7

Source: Reuters Ecowin, IMF, and Danske Markets estimates. Note: ASEAN include Indonesia, Thailand, Malaysia, Philippines and Vietnam. NIC includes South Korea, Taiwan, Hong Kong and Singapore.

CEE

Significant risks to recovery in CEE

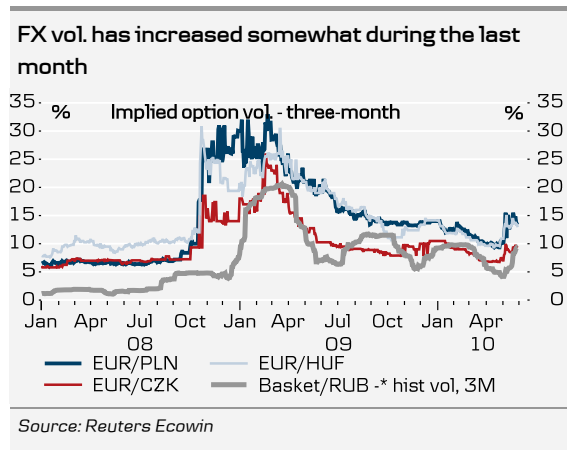
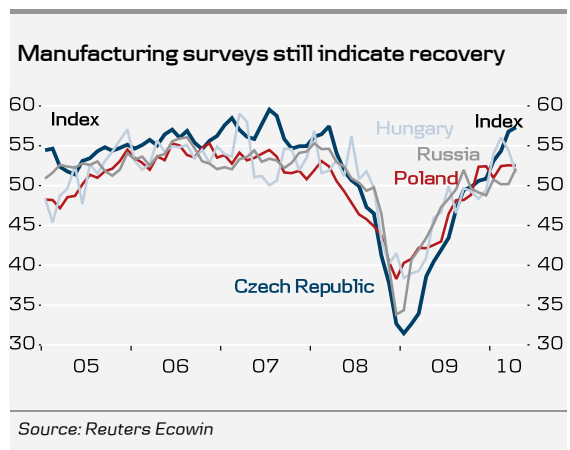
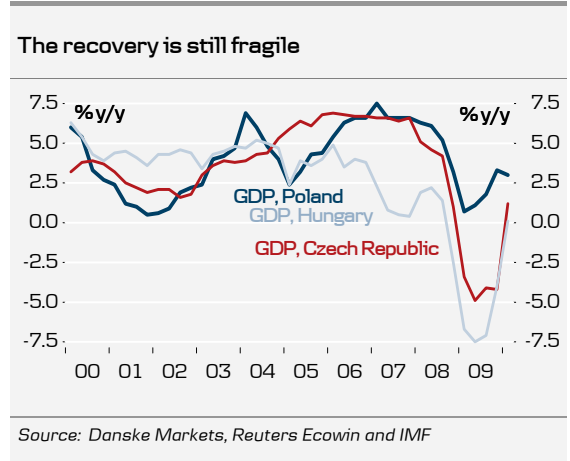
- The Central and Eastern European economies are slowly moving out of recession supported by the manufacturing sector. While the recovery in the manufacturing sector is well under way, domestic demand remains depressed as rising unemployment limits consumer spending behaviour. Nonetheless, the size of the recovery across the CEE clearly shows that it is more pronounced in countries with currency flexibility and smaller external imbalances.
- The CEE currencies were heavily overvalued when they entered the crisis in 2008. The crisis led to a sharp weakening of a number of currencies within the CEE region which are no longer considered to be overvalued. At the same time, there has been a remarkable improvement in the current account situation. The development thus bears similarities to the Asian crises in 1997-98.
- However, the recovery is unlikely to be smooth as the risks are significant. The largest risk relates to renewed shocks in the CEE financial sector, which could be a spill-over from the European sovereign debt crisis triggered by the Greek debt problems.

Manufacturing recovery pulling CEE out of recession

The Central and Eastern European economies have been hit extremely hard by the global credit crisis, but most countries are now gradually moving out of recession. As in the rest of Europe, the recovery in CEE is clearly driven by a recovery in the manufacturing sector, while the development in domestic demand still remains weak or rather very weak across the region.

The recovery is weakest in those countries that lack currency flexibility such as the Baltic countries and Bulgaria, while it is more powerful in countries such as Poland and the Czech Republic where currency flexibility and smaller external imbalances have provided a lot of support for the recovery.

Overall we are optimistic that the CEE countries are recovering from the crisis, but there are still lots of question marks and most CEE economies could fast be heading back to recession if the European recovery once again loses steam. Hence, domestic demand remains very weak across the region and there is little or no scope to use monetary and fiscal policy to stimulate growth. Furthermore, domestic demand is clearly being held back by very weak credit growth.



CEE is going Asia

Most economies in Central and Eastern Europe had very large external imbalances and heavily overvalued currencies going into the crisis in 2008. However, the crisis led to a massive weakening of a number of currencies in the region and currencies like the zloty, the forint and the Czech koruna can no longer be considered as being overvalued. Furthermore, we are seeing a remarkable turnaround in the current account situation in most countries in the region.

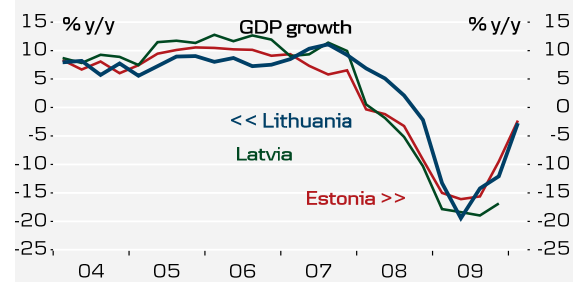
Hence, the development is very similar to what we saw in Asia following the Asian crises in 1997-98 where we saw a sharp drop in domestic demand and a massive weakening of the region's currencies. This led to a massive improvement in the current account situation which eventually opened the door for a more sustained recovery in the Asian economies. In that regard, it should be noted that this process was rather painful and took years. The same can be said about the CEE economies. There is no doubt that most CEE economies now are well-advanced in the deleveraging process, but the process is certainly not finished. Hence, many CEE economies still need to continue this process to regain competitiveness and continue to deleverage. This is especially true for the Baltic countries and the South Eastern European economies like Romania and Bulgaria where less currency flexibility has been allowed than in Poland, Hungary and the Czech Republic.

Furthermore, in the rest of Europe, the continued need for serious fiscal consolidation and very challenging funding conditions continue to curb the development in domestic demand.

But the Greek Tragedy is a major risk

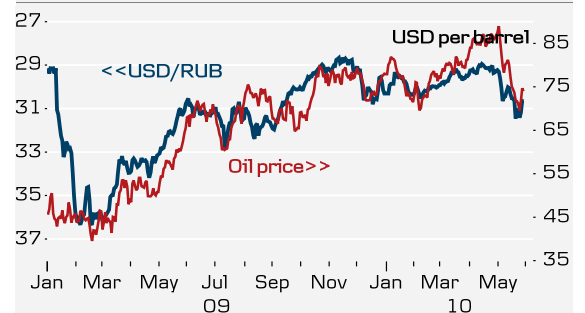
Even though the CEE economies are gradually recovering from the crisis, there are still significant risks to the recovery. The largest risk undoubtedly is connected to renewed shocks to the already hard-hit CEE financial sector. Such a shock could be a spill-over from the wider European sovereign debt crisis or more specifically from the crisis in Greece. Here the South Eastern European countries are most at risk as countries such as Romania and Bulgaria have strong financial and trading links with Greece and Greek banks have large market shares in both Romania and Bulgaria. Hungary also looks at risk from contagion from the Greek crisis while we think that the risks are smaller for Poland and the Czech Republic as the direct links to the Greek economy and financial sector are much smaller in these two countries. That said, no country will be immune to the crisis if it turns into a Europe-wide financial and economic crisis.

No positive growth in the Baltics until 2011



Source: Reuters Ecowin and Danske Markets

Oil decisive for the Russian economic activity



Source: Reuters Ecowin and Danske Markets

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