

September 2010

# Global Scenarios

## On a knife's edge

- Limited risk of recession, but double dip fear to stay
- US growth to remain slow through early next year
- Asia headed for a soft landing with Chinese growth improving again in Q4
- Euro area will lose steam in the coming quarters
- Central bank exit on hold

# Danske Research

Editorial deadline: 6 September 2010

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.

# Introduction

## On a knife's edge

- A flow of disappointing news – particularly in the US – has led us to revise down our global growth expectations. Focus will probably continue to be on the US where the economy is expected to balance on a knife's edge between recovery and another downturn. Double-dip fears are likely to be an ongoing theme for some time.
- We now have below-consensus forecasts for US growth at 2.6% and 2.3% for 2010 and 2011 respectively – a downward revision of around one percentage point in both years compared with our June forecasts. We look for the economy to grow by 1.5-2.0% in H2 10 before recovering gradually during 2011. The main risk is that the economy gets stuck at a low growth level. We see the risk of a new recession as very low.
- In Euroland, activity surprised strongly on the upside in Q2 10, leading to an upward revision of our 2010 growth expectations. We have probably seen the peak, though, and we see the economy growing more in line with the long-term trend at around 2% in 2011 as the export engine loses some steam. Our forecasts for Euroland continue to be above consensus.
- The Asian economy surprised on the downside during the spring, leading to a downward revision of our growth expectations for 2010. However, we expect Asia to recover during the coming quarters.
- Inflation is expected to remain subdued and policymakers in G3 will continue to focus on supporting growth. We see a 40% probability that the Fed will start another round of quantitative easing (QEII). The ECB is expected to keep rates on hold throughout most of 2011. Chinese policymakers are sidelined but we expect tightening to resume in 2011.

### All eyes on the US

Newsflow since the last edition of *Global Scenarios* has been disappointing overall. But focus has shifted from the debt crisis in Euroland to a tsunami of bad data in the US and weaker growth in Asia. Although the global economy has become much more than just the US, developments here will probably continue to be at the forefront of the minds of investors and policymakers.

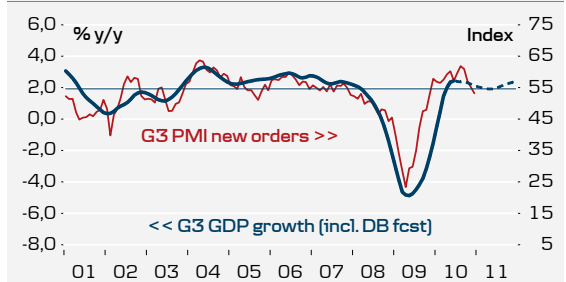
The disappointments in the US have come from three sides. First and foremost, employment growth has been weaker than expected. So far this year average private payrolls gains have averaged 95k – about 50-100k below expectations. This is critical as jobs are needed for consumers to keep spending after the initial stimulus fades away. Second, leading indicators have declined earlier and faster than expected – probably because the Euroland debt crisis during the spring made companies more cautious. Finally, US housing data has cooled more than expected after the expiry of the first-time home buyer credit.

### Global growth forecasts

% y/y	2010				2011			
	Danske Bank	Consensus	IMF	OECD	Danske Bank	Consensus	IMF	OECD
USA	2.6	3.0	3.3	3.2	2.3	2.8	2.9	3.2
Euroland	1.7	1.5	1.0	1.2	2.0	1.4	1.3	1.8
Japan	3.1	3.4	2.4	3.0	1.9	1.6	1.8	2.0
China	9.9	10.0	10.5	11.1	9.0	8.9	9.6	9.7
Global	4.1		4.6		4.1		4.3	
Asia (ex Japan and China)	7.2				6.2			
CEE and CIS	3.8		3.2		4.6		3.4	
	Change from June-10 fcst							
USA	-0.8				-1.0			
Euroland	0.4				-0.1			
Japan	-0.2				-0.2			
China	-0.3				-0.5			

Source: Danske Markets, Bloomberg, OECD, IMF

### PMI data point to slowdown



Source: Reuters Ecowin and Danske Markets

In Asia there have also been clear signs of cooling – especially in China where import growth has slowed and leading indicators fell sharply during the spring. However, we see the first signs of a bottoming in Chinese growth, as PMI rose in August for the first time in four months.

Euroland has been the main source of good news over the past three months. Like ketchup out of a bottle, Euroland data has suddenly surprised strongly on the upside driven by a very strong export recovery and rebuilding of inventories.

### Tailwinds are fading while new headwinds appear

We have expected a global slowdown in growth during H2 10 for some time. This is because the strong tailwinds during 2009 and early 2010 were bound to fade and new headwinds appear. This is illustrated in the tailwind-headwind scorecard to the right.

The **inventory cycle** has worked to give a strong boost to growth but the effect has now run its course. **Fiscal policy** has provided another strong tailwind but is now turning into a headwind in most countries as policy tightening kicks in. A very strong recovery in **Emerging Markets** – particularly Asia – supported exports in the US and Europe but growth here has been expected to slow as tightening measures take effect. A strong performance of **risky assets** has also supported rising confidence in the corporate sector. The renewed headwinds during the spring from the Euro debt crisis and subsequent volatility are denting corporate confidence, leading to more caution among business leaders. Finally, the **first-time buyer credit** in the US housing market provided a much-needed tailwind. But the credit probably brought forward some housing demand and is thus now acting as a drag on growth. One tailwind that is still very much in place is **monetary policy**. Due to the recent return to an easing bias by the Fed and the postponement of the ECB's exit, bond yields have fallen sharply, reducing **financing costs** for businesses and house buyers.

Some of the new headwinds have been stronger than expected (Emerging markets, risky assets, expiry of first-time buyer credit in the US) and this confluence of factors is probably the main reason why growth has disappointed.

### A different US recovery is hurting job growth

As tailwinds fade, it is paramount that the baton can be passed on to employment growth if the US recovery is to become self-sustained. We are in the critical phase where this baton is to be delivered. If employment fails to come through in the next six months, the baton will be dropped and the US will face serious difficulties in sustaining the recovery.

So far employment growth has disappointed as private payrolls have averaged only 80k in the past three months. The lack of job gains has mainly been concentrated in the service sector whereas the manufacturing sector has behaved 'normally' and added the jobs that should be expected.

Part of the explanation may very well be that the US recovery has been primarily driven by inventories and investment which mainly benefit the

### Leading indicators have turned sharply lower



Source: Reuters Ecowin

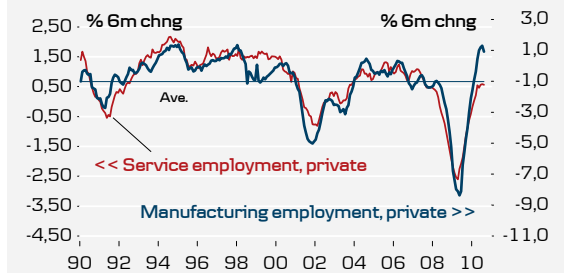
### Tailwinds are fading, headwinds appearing

	Recovery 2009H2-2010H1	Slowdown 2010H2-2011H1
Inventories	↑↑↑	→
Fiscal policy	↑↑↑	↓↓↓
Emerging markets	↑↑↑	→
Risky assets	↑↑↑	↓
Housing subsidies (US)	↑	↓
Monetary policy	↑↑↑	↑↑↑
Pent up demand	↓	↑↑
Savings rate (US)	↓↓↓	↑
Credit conditions	↓↓↓	↑

Note: Arrows indicates whether factor adds or subtracts relative to trend growth

Source: Danske Markets

### Job growth in the US service sector is lagging behind



Source: Reuters Ecowin

manufacturing sector. Private consumption has experienced the weakest post-recession recovery since WWII. Adding to this picture, the financial sector is still shedding labour and the construction sector remains downbeat.

Going forward, we expect US private payrolls to increase by close to 100k per month in the rest of 2010 and rise towards 200k by the end of 2011. With productivity stretched, businesses will find it difficult to grow without adding labour. And very low yields, still low inventory levels and pent-up demand for cars and investments should underpin the economy in 2011.

The pattern of weak consumer recovery and a strong manufacturing sector has been a general phenomenon in G3 economies. The hangover from the crisis has led to rising savings and slow employment growth. However, as labour markets improve, private consumption should move up a notch.

### Asia has slowed but should recover to trend in 2011

The slowdown in Asia – and particularly China – is due to a confluence of domestic factors aimed at slowing growth from the breakneck pace seen in 2009. Consumption growth has levelled off as the effect of subsidies for purchases of durables has lessened. Investment growth has slowed considerably as credit has been reined in after the massive stimulus in 2009. Tighter rules in the housing market to avoid a property market bubble have dampened growth in this sector. The inventory cycle has run its course, taking away the production boost from this factor. And finally, tough measures towards large polluting companies have triggered production cutbacks recently.

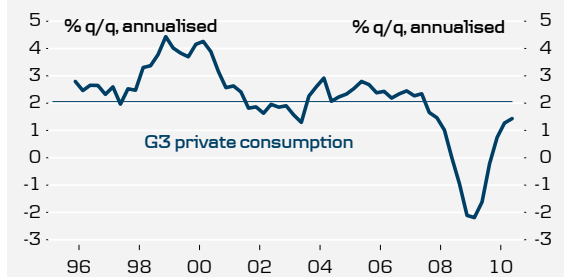
Although export growth is expected to decline as the US and Europe slows, we believe growth will recover to levels around trend growth in 2011. China has paused on the tightening measures and would be ready to push a bit on the gas pedal if needed. We do not expect this to be necessary, though.

### Euroland to slow – divergence continues

Although Euroland has surprised on the upside recently, it comes after a couple of disappointing quarters and is partly due to some catching up with the US and Asia. We believe GDP growth is likely to slow from the 4% pace in Q2 10 to around 2% in 2011. Export growth is likely to slow down as Europe feels the effect of the slowdown in the US and not least Asia which has been the dominant driver behind the Euroland recovery. In fact, exports to Asia are twice as high as to US – and hence the development in Asia is much more important.

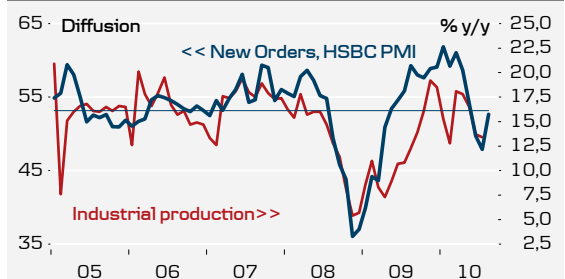
Growth in Euroland continues to be very divided with Germany being the main performer as exports power ahead and consumption shows signs of recovering. The labour market in Germany has also improved and employment is now higher than before the crisis. Southern Europe and Ireland will continue to be a major drag on Euroland, though, as the lingering effects of the housing bubbles and massive fiscal tightening will keep these countries in economic crisis for several years.

#### G3 consumption growth still soft



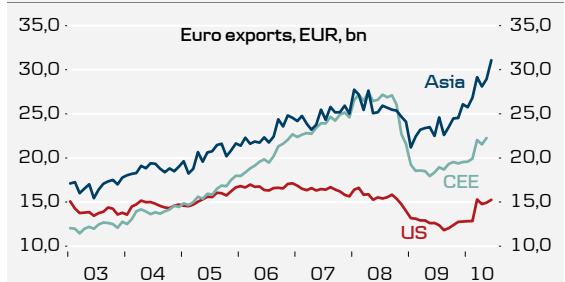
Source: Reuters Ecowin

#### Signs of China bottoming now



Source: Reuters Ecowin

#### Asia more important for Euroland than US



Source: Reuters Ecowin

## Fears of double-dip to keep markets in limbo

Overall we look for global growth to weaken in the coming quarters and the US in particular will be in danger of falling into a new downturn. Fears of a double-dip are unlikely to go away soon as ISM moves lower towards 50 by the end of the year and payrolls continue to rise at a pace too slow to get the unemployment rate down. Markets are therefore likely to stay volatile and we believe the downward pressure on bond yields will remain intact.

We believe the main downside risk, though, would be a scenario of low growth for a long period, whereas we see the risk of a new recession as quite small. The corporate sector is extremely lean in terms of inventories and labour, and investment is still at a very low level relative to GDP. Hence there is not much more fat to be cut away. A new recession would be likely to require a new shock such as a return of significant financial distress.

## Inflation subdued – policymakers focus on growth

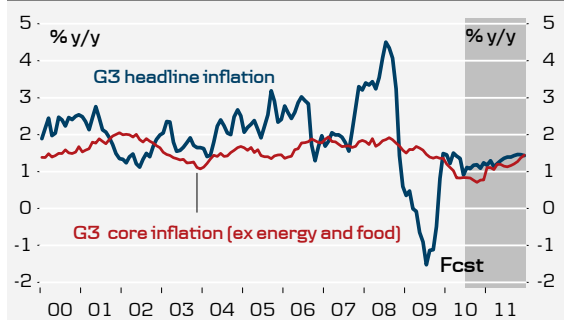
Inflation is generally expected to remain subdued in the developed countries. High unemployment rates are keeping wage pressures low and sluggish consumption growth is hurting companies' pricing power. Core inflation is expected to hover around 1% in both the US and Euroland whereas Japan continues to struggle with deflation. We do not see deflation as an immediate threat in the US or Euroland. In China, inflation has probably peaked for now, but inflation pressures will be brewing next year as the economy recovers from the current slowdown.

With inflation subdued and the recovery in a fragile state, monetary policy will continue to focus on supporting growth. We see a 40% probability that the Fed will launch another round of quantitative easing to add stimulus to the economy and compensate for the headwind provided by planned fiscal tightening. In Euroland, we expect the ECB to keep rates on hold until Q4 11.

### Watch list for sustainability vs. 'double-dip'

- 1. Labour market:** US private payrolls should average 100,000 in coming quarters. Weekly jobless claims to decline slowly.
- 2. Confidence:** ISM to fall gradually towards 50-51 by year-end (currently 56.3). US consumer confidence to be unchanged or rise slightly. Euro PMI and German ifo index to decline gradually. Chinese PMI to rise.
- 3. Euro debt crisis:** Spreads have widened a bit recently but markets should continue to work fairly orderly. New turbulence could jeopardise corporate confidence further.

### Inflation to stay subdued



Source: Reuters Ecowin

### Expectations on key figures and central banks over coming quarter

Country	Indicator	Comment	Measure	Latest		Dec/Q4
Euroland	GDP	An early mid-cycle slowdown will take growth slightly below trend in Q4	% q/q, AR	3.9%	↘	1.5%
	PMI	Manufacturing PMI will decline for some months before beginning to climb up again	Index	55.1	↘	52.0
	Inflation	Limited inflationary pressures due to large economic slack, but impact from energy	% y/y	1.6%	↗	1.9%
	ECB	The ECB is taking a pause on the exit path. ECB will keep rates on hold until Q4 11	% p.a.	1.0%	→	1.0%
Germany	ifo	The German recovery looks very robust for the coming quarters	Index	99.4	↗	103.0
USA	GDP	GDP growth below trend until early 2011	% q/q, AR	1.6%	→	2.0%
	ISM	ISM will approach 50 around year turn	Index	56.3	↘	51.0
	Private employ.	Job growth will remain moderate for the rest of the year	3 mth. mavg.	78K	→	100K
	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. Risk of further QE	% p.a.	0.13%	→	0.13%
Japan	GDP	Pace of the recovery has eased, but growth is expected to be slightly above trend in H2	% q/q, AR	0.4%	↗	1.9%
	PMI	Could turn lower in coming months, but should start to improve by the end of the year	Index	50.1	→	50.0
	Inflation	Deflationary pressure is easing only very slowly	% y/y	-1.1%	→	-1.0%
	BoJ	BoJ on hold until early 2012, further non-conventional easing likely	% p.a.	0.10%	→	0.10%

Source: Danske Markets

# The bad alternative

## Stuck below trend

- US households remain too cautious on spending. Growth gets stuck below trend and unemployment begins to move higher.
- The fiscal outlook deteriorates and the Fed announces further large scale asset purchases.
- Asia and Germany outperform. China adds more stimulus and Germany benefits from its exposure to the EM.
- Bond yields decline and risk appetite comes under pressure.

### Euro sclerosis turns American

A key element in our main scenario is that growth must become more demand-driven to ensure a sustainable recovery. Basically, this comes down to US household spending – that must be ramped on services and housing, which have remained depressed so far.

With unemployment remaining high and home prices under pressures from high foreclosure rates, the risk is that US households continue to increase the savings rate. This would prevent the necessary growth rotation into service and construction, which is needed to take job growth recovery to a sustainable level.

In this scenario US growth becomes stuck below trend growth for a prolonged period and the unemployment rate starts to rise again. There is an elevated risk that US moves into a Euro sclerosis scenario – where high unemployment becomes more permanent, with a negative implications for long-term potential growth.

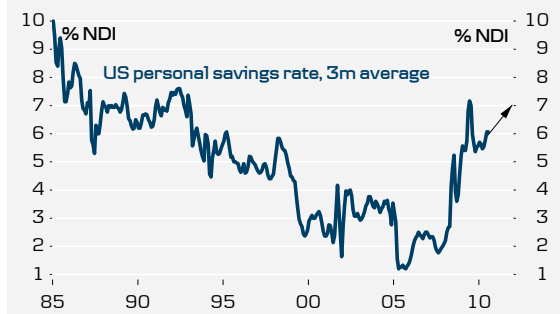
This worsens the public budget outlook and restrains the options for additional fiscal stimulus. Around year-end, the Fed would take dramatic action and announce large scale asset purchases of a minimum USD1000bn in long-dated US Treasuries.

The US treasury curves flattens further and the market postpones Fed hikes to 2013. Risk appetite comes under renewed pressure, but much of negative surprises have already been priced into the market.

### Asian and German outperforms

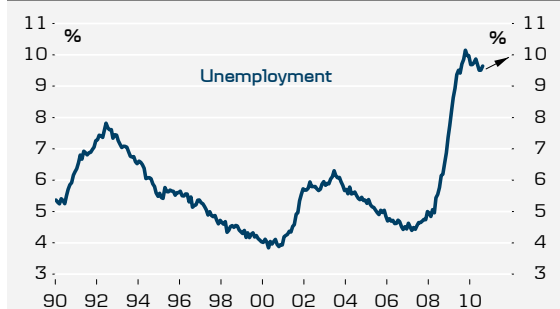
Global growth slows, but with Asia outperforming. With demand faltering in western export markets, the Chinese authorities add further stimulus to the economy. This boosts domestic demand enough to keep growth close to trend. In Europe, the recovery remains divided between North and South. In southern Europe the budget woes flare up as slower growth threatens the stabilisation programmes. In Germany things looks better as export demand from Emerging markets continues to support German industry.

US households continue to increase savings



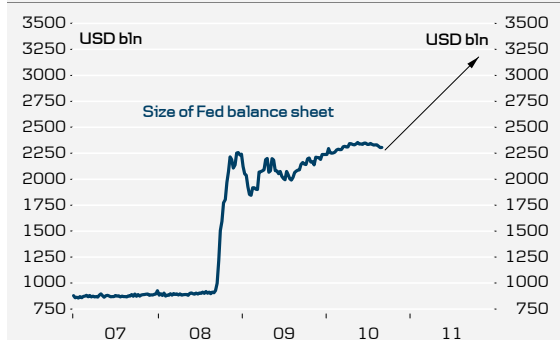
Source: Danske Markets, Bloomberg, OECD, IMF

US unemployment moves higher



Source: Reuters Ecowin and Danske Markets

Fed resumes large scale asset purchases



Source: Reuters Ecowin and Danske Markets

# The good alternative

## In Asia we trust

- In this scenario, growth remains strong in China and the rest of Asia and the slump in the US turns out to be short-lived.
- The healing in the European banking sector progresses faster than expected and the debt crisis fades away.
- Commodity prices are pushed higher, risk appetite improves and monetary policy is tightened.

### A strong China

Strong Chinese PMIs hint that we might not see as much softness in China and the rest of Asia as expected. In our positive scenario, Chinese demand grows strongly despite the government's attempts to slow down the economy. Further signs of overheating do not materialise and the government decides to go ahead with fiscal easing – primarily in the form of more investments. As a result, the Chinese economy motors on at full speed and this helps the whole region maintain a strong growth momentum. European exports and in particular German exports benefit substantially.

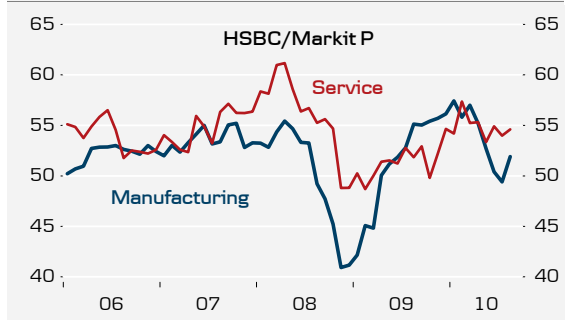
### Debt crisis fades away

Partly because of the strong growth impulse from Asia, the healing in the European banking sector progresses faster than expected and makes the fiscal situation in e.g. Ireland look much more promising. The sovereign debt crisis thus gradually moves off the radar screen. As a result, confidence improves and both private consumption and investment across Europe strengthen. This process is reinforced as it becomes evident that unemployment in the euro area begins to trend downwards. In a few European countries, the improved economic outlook (and tighter government bond spreads) makes politicians opt for 'growing out of the crisis' instead of making more painful expenditure cuts. Nevertheless, European growth remains very uneven.

The US is in for modest growth in Q3, but already in Q4 growth picks up again due to positive risk sentiment and export growth. Non-farm payrolls improve sharply and ISM starts to climb again after briefly reaching a trough well above 50.

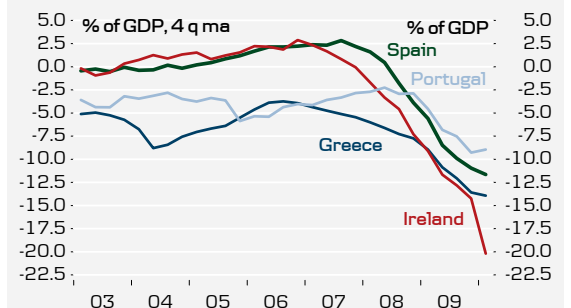
As global growth picks up again, commodity prices are pushed higher. Higher oil prices result in strong growth in Russia as money and lending growth picks up. Headline inflation begins to pick up and central banks begin to take a more hawkish stance. The ECB with its sole focus on headline inflation unexpectedly hikes next summer. The Fed begins its hiking cycle shortly afterwards. This pushes interest rates higher on both sides of the Atlantic and leads to a flatter yield curve. Risky assets benefit from improved risk appetite as the risk of a severe debt crisis and a sharp slowdown fades.

Chinese PMIs hint towards positive surprise



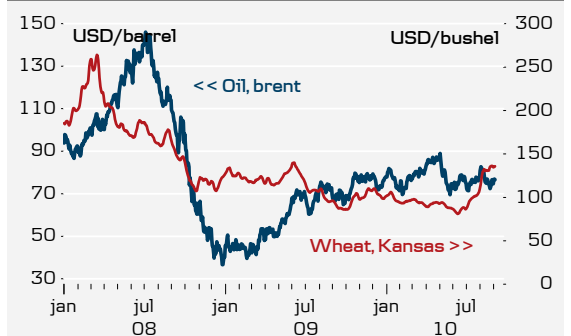
Source: Reuters Ecowin and Danske Markets

Government net lending - it can get better



Source: Reuters Ecowin and Danske Markets

Commodity prices far from historical highs



Source: Reuters Ecowin and Danske Markets

# US

## Slowdown, but no recession

- The switch from an inventory-stimulus driven recovery to a demand-driven recovery has proved tougher than expected, as job and spending dynamics remain weak.
- In the coming quarters, growth will remain below par as the manufacturing cycle will slow and fiscal tightening will provide headwinds to final demand. However, the risk of recession is limited.
- Economic growth will return to an above trend pace in 2011. Easy financial conditions, easier access to credit and pent-up demand will help the needed rotation towards more demand-driven growth.
- Core inflation is expected to slow toward 0.5%, while headline inflation will move back into the 1.5-2% range. The risk of outright deflation remains relatively low.
- Fed hikes have been postponed to H1 12 and the softer outlook increases the possibility of further Fed easing. Currently, we attach a 40% probability to the Fed resuming large scale asset purchases.

### Below-trend growth in the near term

Following a solid start to the year, economic growth slowed from 3.7% to 1.6% q/q AR during Q2. However, a major part of this slowdown was driven by a -3.4% contribution from net exports. In the same period domestic demand growth picked up from 1.3% to 4.3% q/q AR – the strongest quarter so far in this recovery.

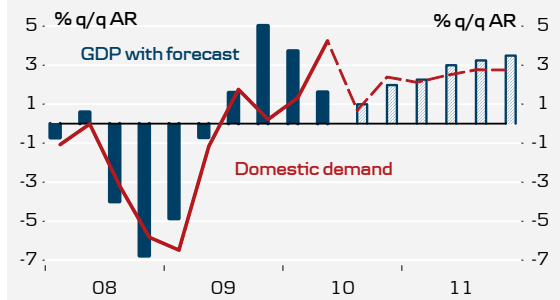
However, over the past two to three months, monthly indicators have been surprisingly weak and now suggest a much more pronounced slowdown. With job growth not yet sufficiently strong to fully back a self-sustained expansion, the outlook for the coming quarters has deteriorated. See our interim update *Research US – deeper slowdown, but no recession*.

We now forecast H2 GDP growth of 1.5-2.0% AR versus 3.25% AR in Global Scenarios, June 2010. The annual growth estimates for 2010 and 2011 have been revised down to 2.6% and 2.3% from their previous 3.3% and 3.2%, both below consensus.

### Usual suspects behind slowdown

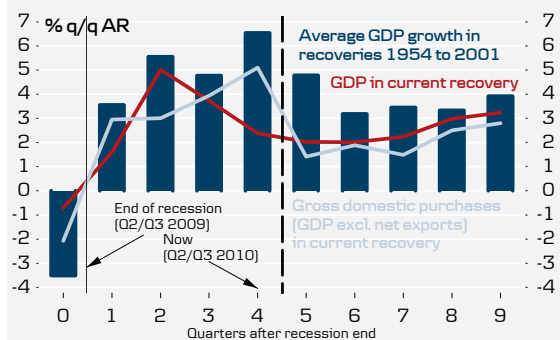
In our view, the slowdown reflects several issues: those which are very common to recoveries and others more specifically negative to this cycle. We are now four quarters into the recovery. It is quite normal that growth peaks at this time in the cycle (see chart to the right), as the forceful tailwinds from the inventory dynamics and fiscal and monetary stimuli begin to taper off. From this point, underlying demand has to drive the recovery, which usually involves a slower pace of growth. This is exactly what is happening right now.

Below par growth ahead



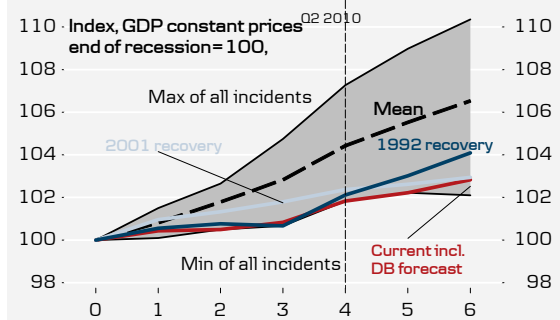
Source: Danske Markets, Bloomberg, OECD, IMF

GDP growth usually peaks after 4 quarters



Source: Reuters Ecowin and Danske Markets

A historically weak recovery in demand



Source: Reuters Ecowin and Danske Markets

**Inventory dynamics are turning much less favourable.** Over the past four quarters, the inventory cycle has boosted GDP growth by 1.8%. Most of this has arrived through the recovery in the manufacturing sector, but this has now come to an end.

As we highlighted in *Research US: Euro crisis could speed up the manufacturing slowdown*, published in the spring, manufacturing production was bound to slow during H2, reflecting the gradual narrowing of the gap between production and sales. On top of this, we warned that the pace of the slowdown might even become accelerated due to the uncertainty arising from the euro crisis. Moreover, the relatively sharp slowdown in Asia has added to the slowdown. Since May, the ISM index has slowed from a peak above 60 to 56.3 in August.

However, the good news is that there are no signs of overshooting in manufacturing production. This implies that if demand growth holds up at a moderate pace, the possibility of the ISM index moving deep below 50 is relatively limited. Going forward, we expect the index to reach a trough slightly above 50 early next year.

**The other major negative factor is fiscal policy, which is now turning negative to growth.** The growth impact from the USD787bln stimulus package which has boosted growth over the past six quarters is now turning negative. The CBO estimates a negative impact on GDP growth of 0.8-1.2% AR in Q3 and 1.6-2.4% AR in Q4. In 2011 and 2012 we estimate that fiscal tightening will provide a headwind of around 1.5% GDP growth.

Given the very dire budget situation, with a deficit of currently 9% of GDP and plenty of long-term sustainability issues, room for further fiscal easing is very limited (See *Research US: A deeper slowdown, but no recession*).

**Finally, the positive impetus from the initial improvement in financial conditions is tapering off.** Much of the growth impact from the sharp reduction in fed funds interest rates, the sharp rise in equities and the tightening of credit spreads during 2009 has already filtered through to the economy.

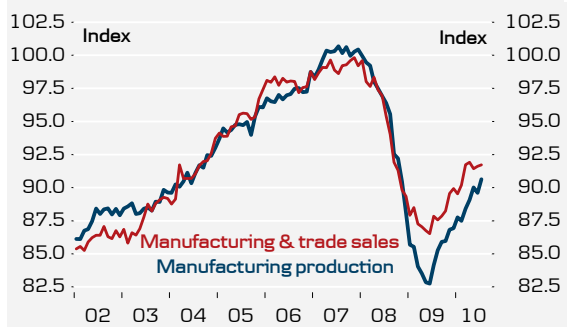
### Growth rotation needed for sustainable recovery

When excluding net trade (which has been unusually volatile this time around) the pattern of increasing GDP growth for the first four quarters does not differ that much from the historical norm. But as usual the devil is in the details. There are several important differences.

The support from inventory dynamics and fiscal policy, which is now tapering off, has been historically big. Given that domestic demand has seen one of its weakest recoveries, this combination increases the likelihood of being stuck below trend growth for too long.

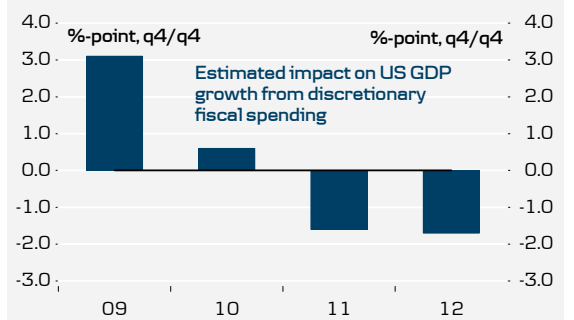
On top of this, the weakness in demand is located in some of the most labour intensive sectors such as services and construction. Indeed, this might explain some of the slow recovery in the labour market. Furthermore, this highlights that the risks surrounding the 2011 outlook are unusually high, as an acceleration in hiring is the key to a sustainable recovery.

### Manufacturing production catching up with sales



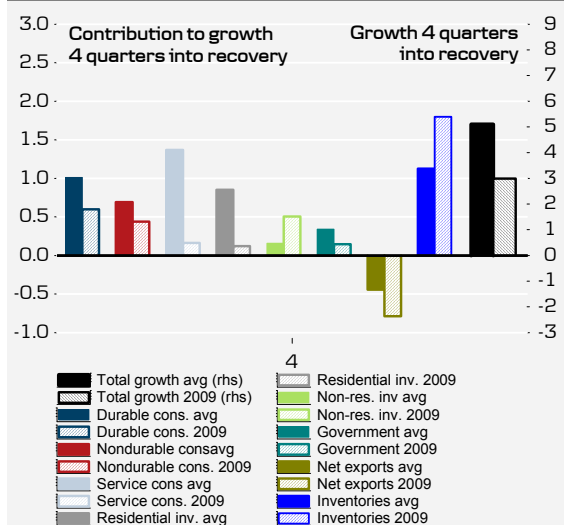
Source: Reuters Ecowin

### Fiscal policy turning into headwinds



Source: Reuters Ecowin

### Contributions to growth



Source: Reuters Ecowin

Going forward, a growth rotation from manufacturing into services and construction is needed to initiate the positive dynamics between demand and hiring. Fortunately, there are signs of progress in services, which comprises the biggest share of GDP. Over the past three to four months, services consumption has showed signs of recovery.

**Limited risk of a recession**

Although growth is set to slow to below 2% in H2 and the fear level is likely remain elevated for the rest of the year, the risk of recession seems relatively limited. With inventories close to cyclical lows, residential construction historically depressed, much less financial leverage and low growth expectations priced in to the financial markets, there are no obvious triggers for a period of negative growth. The biggest risk remains a new shock.

The risk is whether growth will remain stuck below trend for a longer period. However, this is not our main scenario. For several reasons, we believe that job recovery will get a lift and growth will return to trend by early 2011.

First, **personal spending growth should not slow further** from its current level of 2% as personal income growth remains relatively robust despite the sluggish job recovery. The reason is that businesses have been expanding hours instead of hiring and that hourly earnings growth have slowed more gradually than expected. Further, inflation remains very low, leaving real compensation growth around 2-2.5%. Also, there seems to be no further need for adjustment in the personal savings rate. Indeed, it could start to move lower if sentiment improves.

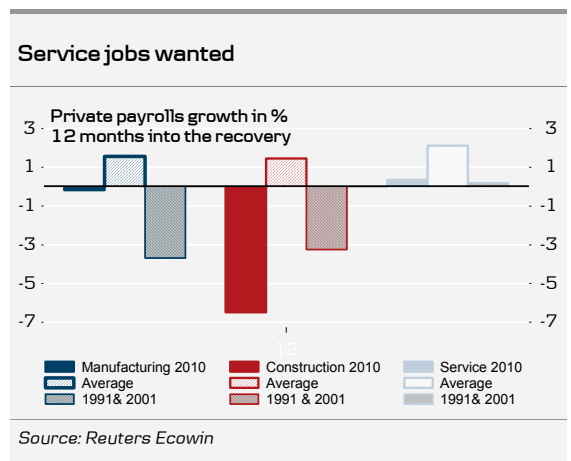
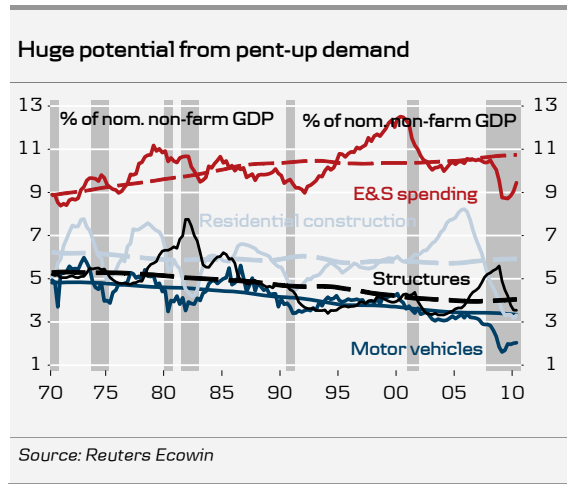
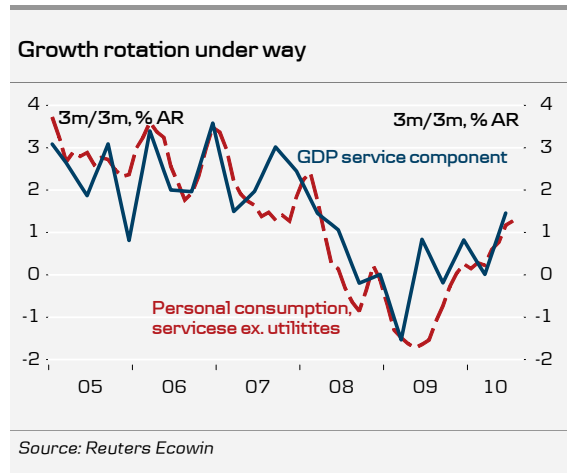
Second, there are early signs that the **credit multiplier is starting to work**. The senior loan officer opinion survey from the Fed indicates that credit standards are now being eased in all sectors but commercial real estate. This broadens the recovery to small businesses, which are important for job creation.

Third, **pent-up demand remains huge**. If confidence in the recovery does not continue to deteriorate, consumption ratios in autos, residential construction, CAPEX and consumer durables will start to adjust back towards historical levels. This could boost growth by up to 1% over several quarters.

Fourth, the recent **decline in long bond yields and mortgage rates** is easing financial conditions. With its usual lag, this should kick in early next year and lend some support to the housing market.

Fifth, **the huge -3.4% contribution from net exports in Q2 is not sustainable**. Furthermore, we expect net trade to benefit from a rebound in emerging market growth during 2011. With underlying demand remaining weak, the contribution from net trade is much more likely to average close to zero.

Finally, it is worth mentioning that currently the level of productivity is very stretched, as businesses have been relatively conservative in hiring. Hence, the scope for increasing output without hiring is very limited. Therefore, the bar to boosting job growth is much lower than it was four quarters ago. We expect job growth to average 100,000 by early 2011 and about 200,000 late 2011.



### Core inflation to move lower, but not dangerously low

Core inflation will remain on a slowing path for several more months. While we expect core CPI to reach a trough of around 0.5% y/y by year end, the core PCE index (the preferred Fed measure of inflation) will slow to 0.9% y/y.

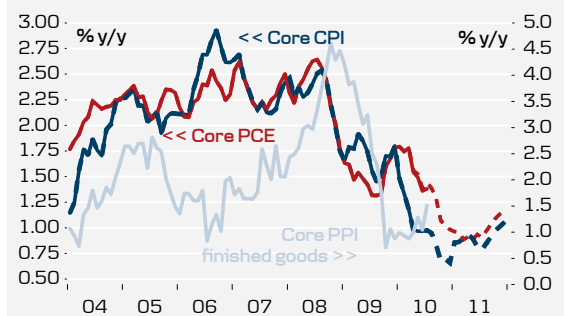
While continued elevated unemployment rate is likely to add downward pressure on wage growth and service inflation, there are other reasons to expect a stabilisation in core inflation early next year. First, there are signs of stabilisation in housing inflation. Further, with excess capacity being much smaller in the manufacturing sector than elsewhere in the economy, the downward pressure on core goods inflation is likely to ease. In fact, this is already visible in the producer prices.

### Fed up with economic slack

Given the recent deterioration in data, we have postponed Fed hikes to H1 2012. The Fed has put the exit process on hold and announced to re-invest principal payment from its mortgage portfolio. Moreover, recent Fed communication indicates that the central bank is ready to accommodate further through large scale asset purchases should the outlook deteriorate significantly. However, at the same time there is wide disagreement in the monetary policy committee about how to cope with this problem and no triggers for such action have yet been communicated.

In the table to the right we have listed data thresholds, which usually trigger Fed easing. While we believe that it will be a very close call, our forecast remains mostly consistent with no action from the Fed. Currently, we believe that there is around 40% probability that the Fed will make large-scale purchase of Treasury securities (see *Research US – Fed up with QEII*).

### Core inflation to move below 1%



Source: Reuters Ecowin

### Triggers for QEII

Last datapoint before rate cut	Threshold	Current
ISM	<50	56.3
Unemployment rate, 3M change	>+0.3	-0.4
Private payrolls, 3M average change	<0K	+51K
Real personal spending, 3M change AR	<1.5%	2.0%
Michigan 5yr inflation expectations, 6M change	<-0.3	+0.1

Source: Reuters Ecowin

### US macro forecast

% Change q/q AR	2010				2011				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011
GDP	3.7	1.6	1.0	2.0	2.3	3.0	3.2	3.5	-2.6	2.6	2.3
Private Consumption	1.9	2.0	2.0	2.5	2.2	2.5	2.5	2.5	-1.2	1.6	2.3
Private Fixed Investments	3.4	19.5	-3.1	4.4	6.2	8.7	10.1	10.1	-18.3	3.3	6.6
Residential	-12.3	27.1	-28.4	0.0	12.6	17.0	21.6	21.6	-22.9	-3.1	7.2
Non-residential	7.8	17.6	4.4	5.4	4.8	6.8	7.4	7.4	-17.1	5.0	6.5
Change in inventories (\$bn, rea)	44.1	63.2	70.0	53.0	32.0	33.0	34.0	43.0	-113.1	57.6	35.5
Change in inventories <sup>1</sup>	2.5	0.6	0.2	-0.5	-0.6	0.0	0.0	0.3	-0.6	1.3	-0.2
Public Consumption	-1.6	4.3	0.8	0.8	-0.8	-1.6	-1.0	-1.2	1.6	0.8	-0.2
Exports	11.4	9.2	8.2	4.1	8.2	8.2	10.4	10.4	-9.5	11.6	7.9
Imports	11.2	32.4	8.9	3.0	2.1	4.1	6.1	6.1	-13.8	12.6	5.9
Net exports <sup>1</sup>	-0.3	-3.2	-0.4	0.0	0.7	0.4	0.3	0.4	1.1	-0.5	0.1
Unemployment rate (%)	9.7	9.7	9.6	9.7	9.6	9.4	9.2	9.0	9.3	9.7	9.3
CPI (y/y)	2.4	1.8	1.4	1.4	1.5	1.7	1.8	1.8	-0.3	1.7	1.7
Core CPI (y/y)	1.3	1.0	0.9	0.7	0.9	0.9	0.9	1.0	1.7	1.0	0.9
Public Budget <sup>2</sup>									-9.9	-9.2	-7.0
Public Gross Debt <sup>2</sup>									83.6	92.0	90.7
Current Account <sup>2</sup>									-2.9	-3.4	-3.3
Fed funds rate <sup>3</sup>	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25			

Source: Danske Markets

1. Contribution to GDP growth, 2. Pct of GDP, 3. End of Period

# Euroland

## Between a rock and a hard place

- The euro area posted strong growth in Q2, but there are signs that the slowdown in the US and Asia is now beginning to be a drag on euro area growth. We project a slowdown with growth just below trend in the coming quarter.
- Internal demand has started to gain strength, which makes the recovery less dependent on the pull from export markets. However, the recovery is not fully sustainable until we see declining unemployment and a stronger recovery in private consumption.
- The unemployment rate has been stable at 10.0% since March. We project that unemployment will begin to decline soon albeit slowly, but this result is very sensitive to developments in labour-intensive sectors, such as construction.
- The southern European debt crisis is not all over. Lower growth and higher spreads make a harmful cocktail. Targets are still achievable, but depend on reform willingness. Our primary concern is that public support for necessary reforms may falter.
- The ECB is taking a pause on the exit path. The risk of an economic downturn has increased and the monetary analysis, which shows that loan flows have turned softer in recent months, does not support a more hawkish stance. We expect a first ECB hike in Q4 2011.

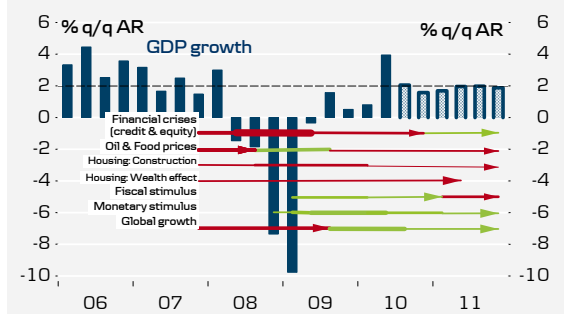
### Strong Q2

The euro area surprised everyone when it grew an impressive 1.0% q/q in Q2. The growth was, however, rather uneven. Germany grew as much as 2.2% q/q while the Greek economy continued to shrink. German growth has been driven by a strong rebound in exports – not least to Asia – reflecting that the open German economy was also among the hardest hit when global trade collapsed.

The recovery is getting more resilient to external shocks as domestic demand has begun to pick up. Private consumption in the euro area increased 0.5% q/q in Q2 and has now been growing for three consecutive quarters. This is in line with German retail sales, which have been revised considerably and now appear to have been on an upward trend since September last year (when the car scrapping scheme was terminated). Euro area investments also grew strongly in Q2 (1.9% q/q) while the contribution from inventories is fading. GDP growth in Q1 was revised up from 0.2% q/q to 0.3% q/q.

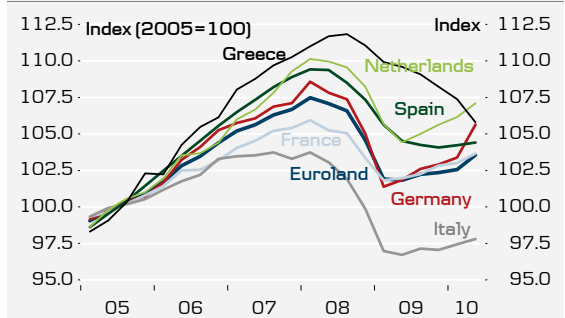
Even though domestic demand is now taking over, foreign trade is still an important growth driver and the euro area will be affected as the US and Asia slow down.

An early mid-cycle slowdown



Source: Reuters Ecowin and Danske Markets

Uneven growth



Source: Reuters Ecowin and Danske Markets

The German consumer is back



Source: Reuters Ecowin and Danske Markets

## An early slowdown

Industrial orders for June show that the euro area economy entered Q3 with strong growth momentum. But confidence indicators now point to weakening growth; so while we might see growth above trend in Q3, the outcome for Q4 is likely to be more dismal.

Most importantly, PMI data indicates that the US slowdown is beginning to drag on euro area growth. Manufacturing PMI new export orders point to a notable decline in export growth (from 9% q/q to 4% q/q). The slowdown is also affecting the rest of the euro area economy. Both composite PMI and the new orders index indicate slowing growth. Looking forward, we expect to see further declines in the PMI. Our six-month model indicates that manufacturing PMI will decline to just above 50 before beginning to climb up again.

Ifo expectations point to a slowdown in German industrial production growth. At the same time, sub indices indicate that a rebound in retail and services is in the making, which helps to put the recovery on a more sustainable path.

These indications are in line with a slowdown where growth will dip to slightly below trend in Q4 and then recover somewhat next year. In line with this, we expect growth to slow to around 0.5% q/q in Q3 and 0.4% q/q in Q4. That the slowdown in the US isn't hitting the euro area harder might come as a surprise. It is, however, important to note that although US production growth has slowed, US import growth is still high (though partly driven by temporary factors that have lifted imports from China). All in all, given that Q2 was much stronger than expected, we revise our forecast up from 1.3% to 1.7% for 2010.

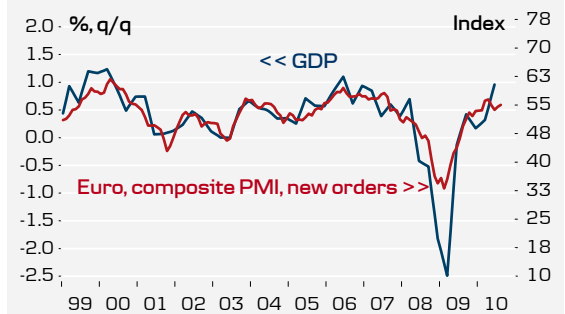
There is a non-negligible risk that the shock from the US might become severe and/or that fears escalate in the financial market and become somewhat self-fulfilling. Then the euro area isn't far from entering a 'new normal' scenario, where growth gets stuck below trend, unemployment remains high and deflationary pressures keeps the ECB from tightening monetary policy for a very long time. In such a low growth scenario, fiscal sustainability would be questioned and sovereign spreads widen.

An even worse scenario, a double-dip, is a possibility, but we find it unlikely. The recovery has matured enough to withstand smaller shocks, and although US data are soft they are not that alarming. But if another recession hits, fiscal policy will find itself toothless. Too many governments within the euro area have such large debts and deficits that they have no choice but to tighten fiscal policy even against the background of tumbling growth.

## Expansionary fiscal contraction is a possibility

Fiscal tightening across the euro area is primarily targeted for 2011. It has been argued – most recently by Mr. Trichet at Jackson Hole on 20 August – that well-designed fiscal tightening can promote growth. We agree that “expansionary fiscal contraction” is a possibility when the public sector has grown too large and embraced the economy. Nevertheless, we stick to results based on the new OECD model, which indicates that fiscal tightening will lower GDP growth by about 1.0% in 2011. Against this background, we expect growth of around 2.0 % in 2011, down from 2.1% in our previous global scenario.

GDP growth is set to slow



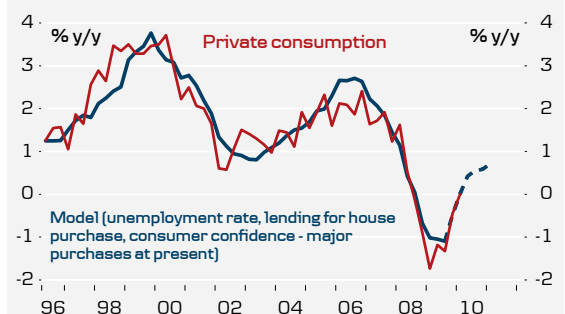
Source: Reuters Ecowin and Danske Markets

Export growth slows down



Source: Reuters Ecowin and Danske Markets

Domestic demand is recovering



Source: Reuters Ecowin and Danske Markets

## Unemployment has stabilised, but will it ever fall?

Euro area unemployment has been stable at 10.0% since March, so what's next? If we refer to historical experience, the recovery in industrial production including construction looks very similar to the recovery in 1993-94 and it is thus tempting to look here for guidance on the labour market reaction. Back then, unemployment started declining 10 months after production bottomed. Today the bottom is 15 months behind us, so history seems to indicate that unemployment should have peaked already. But there is a notable difference between then and now. The decline in production during the current crisis has been much more pronounced than in the 1992-93 downturn. The sharper fall in production in the recent crisis was accompanied by a sharper increase in unemployment, but not as much as could have been expected. This is partly due to the use of schemes like the German Kurzarbeit (short work), which runs until March 2012. These schemes are now slowing the impact of renewed production growth on unemployment. The slower turnaround in unemployment today compared with 1992-93 thus makes a lot of sense.

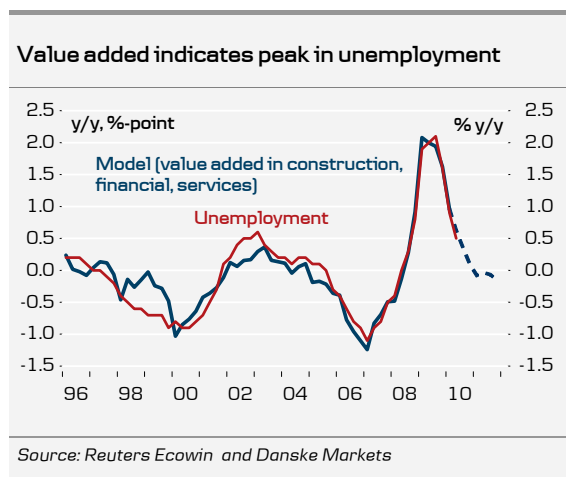
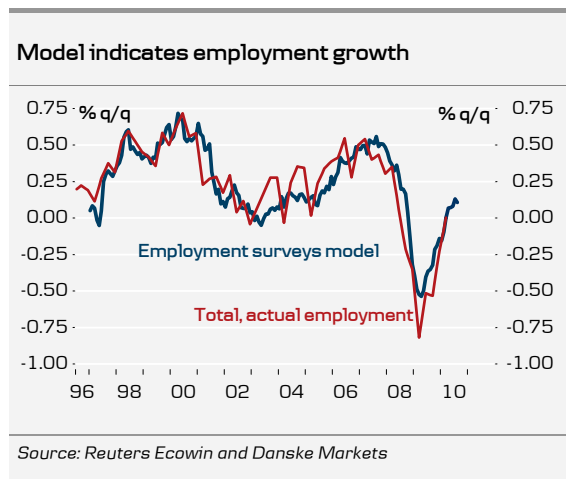
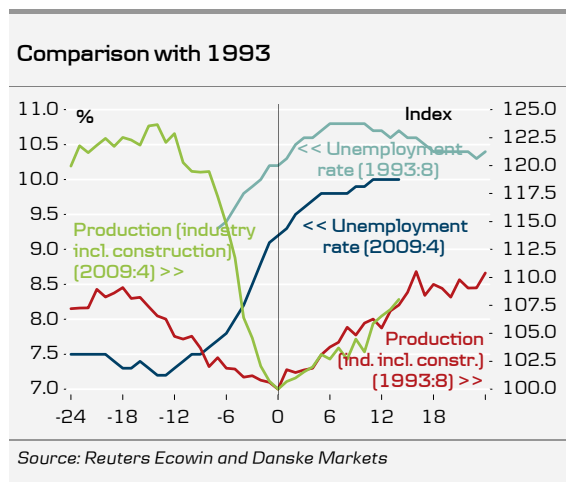
Nevertheless, both our employment survey model and the PMI employment expectations indicate that we are about to see a decline in unemployment soon although the decline will be rather slow. We have also looked at the how value added in different sectors drives unemployment. Not surprisingly, we find that increases in value added in labour intensive sectors, e.g. construction, matters the most for unemployment. Based on changes in value added in three sectors (construction, financial, services), we can explain as much as 90% of the annual changes in the unemployment rate. Manufacturing has almost no impact. We foresee a slow stabilisation in construction, a moderate recovery in the financial sector and a somewhat stronger recovery in services. Based on this, we find that unemployment should peak in Q3, but also that the decline in unemployment will be slow and that the risk of a resurgence in unemployment should economic growth slow is very real.

## The southern European debt crisis

Sovereign spreads in the euro area periphery (Ireland, Greece, Spain and Portugal) have widened considerably during the past weeks. The increase has been most pronounced for Ireland and can only to a lesser extent be explained by the general increase in risk aversion.

The primary cause appears to be renewed concern about the cost of saving the Irish banking sector and also about the periphery countries getting caught in a vicious circle of budget cuts and faltering growth. Spreads have widened notably for Portugal and Greece as well while the increase for Spain has been less pronounced.

The head of the Irish central bank estimates that the total cost of bailouts will be around 20 percent of GDP. However, the total cost will remain a 'known-unknown' until the process of pricing and transferring loans to the National Asset Management Agency (NAMA) is complete and the future trajectory of the property market becomes clearer. Irish house prices, which have fallen by 34% from the peak, have not stabilised yet.



We continue to believe the risk of default is very small in all of the periphery countries. It is however a non-negligible risk. The risk is most pronounced in Greece, which is facing considerable hardship. Reform fatigue is a danger. Indeed the reforms have already resulted in many strikes, which have in particular crippled the Greek transport sector. In Ireland and Spain the default risk increases if the governments face significantly higher than expected costs of saving the banking sector, e.g. if house prices continues to fall.

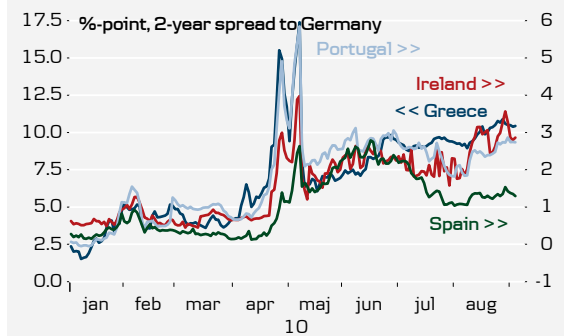
### The ECB is taking a pause on the exit path

The risk of an economic downturn has increased and the monetary analysis, which shows that loan flows have turned softer in recent months, does not support a hawkish stance. In addition, the inflation outlook is for HICP to remain well below the ECB target throughout the forecast period. We therefore expect that the ECB will take a pause on the exit path and that the exit from non-standard measures in 2011 will be slow.

We continue to expect a first ECB hike in Q4 2011, which is in line with other ECB observers in a recent Reuters opinion poll. The current market pricing suggest no hikes from the ECB within the next couple of years.

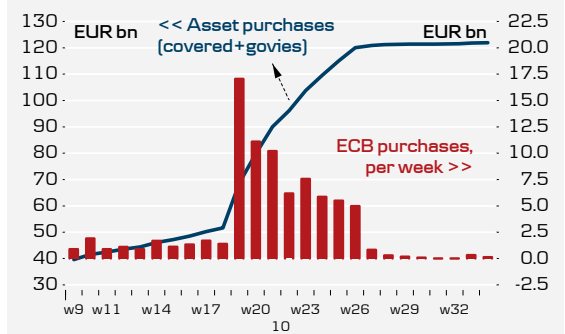
The ECB hasn't purchased government bonds for significant amounts for many weeks now despite the widening spreads. We reckon the ECB stands ready to scale up the purchases if really needed, but it seems very reluctant to do so as long as there is a relatively well-functioning (though thin) secondary market.

### Sovereign spreads are widening



Source: Reuters Ecowin and Danske Markets

### ECB asset purchase on standby



Source: Reuters Ecowin and Danske Markets

### 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	1.3	3.9	2.1	1.5	1.7	2.0	2.0	1.9	-4.0	1.7	2.0
Private Consumption	0.6	1.9	0.8	0.7	1.2	1.3	1.5	1.6	-1.1	0.8	1.2
Private Fixed Investments	-1.6	7.5	2.9	1.8	2.6	3.4	4.0	3.9	-11.3	-0.5	3.2
Change in inventories <sup>1</sup>	3.6	0.8	0.4	0.0	0.0	0.0	0.0	0.0	-0.7	1.2	0.1
Public Consumption	0.9	1.9	1.0	1.0	0.7	0.9	1.0	1.0	2.5	1.1	1.0
Exports	9.8	18.6	6.4	4.8	4.7	5.2	5.0	4.8	-12.8	9.6	5.9
Imports	17.2	18.6	5.4	3.7	3.9	4.5	4.7	4.8	-11.5	10.0	5.2
Net exports <sup>1</sup>	-2.6	0.1	0.5	0.5	0.4	0.3	0.2	0.0	-0.8	-0.1	0.1
Unemployment rate (%)	9.9	10.0	10.0	9.9	9.9	9.8	9.8	9.7	9.4	10.0	9.8
CPI (y/y)	1.1	1.5	1.7	1.8	1.7	1.4	1.5	1.5	0.3	1.5	1.6
Core CPI (y/y)	0.9	0.8	1.0	1.0	1.0	1.1	1.1	1.2	1.4	0.9	1.1
Public Budget <sup>2</sup>									-6.3	-6.7	-6.0
Public Gross Debt <sup>2</sup>									78.7	84.8	88.5
Current Account <sup>2</sup>									-0.7	-0.3	-0.2
ECB refi rate <sup>3</sup>	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.00	1.00	1.25

1: Contribution to GDP growth, 2: Pct. of GDP, 3: End of period

Source: Danske Markets

# Asia

## It looks like a soft landing

- Growth in Asia has slowed more than expected, mainly due to weaker domestic demand. A sharp slowdown in China's import growth in the wake of its tightening measures has been an important driver behind the recent weakness in the region.
- On the other hand, Asia's exports to Europe and the US have improved in H1 10. This has particularly benefitted China, where virtually all growth was driven by net exports in Q2.
- In Asia, GDP growth was below trend in Q2 and is expected to slow further as exports to developed markets lose some momentum. The slowdown in demand has mainly been driven by the unwinding of fiscal stimulus and less tailwind from the inventory cycle.
- With strong income growth, high capacity utilisation and low real interest rates, fundamentals for private demand remain strong. Growth is expected to improve again in Q4 10, starting with China.
- Despite the recent slowdown we still believe that Asia, with the exception of Japan, is in a tightening cycle – although this is expected to be cautious for the rest of year. The risk of overheating has subsided considerable and Asia has ample room to ease fiscal and monetary policy again if needed.

### Growth has slowed more than expected

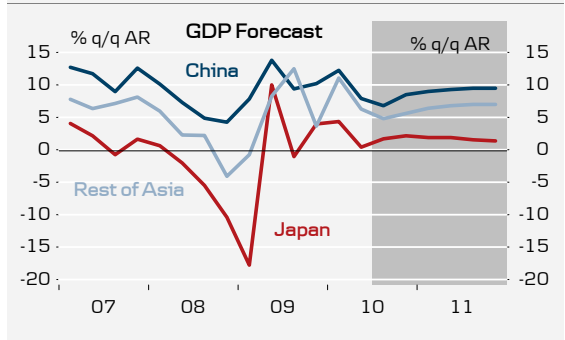
As expected GDP growth in Asia peaked in Q1 10, but the slowdown in growth has so far been more pronounced than expected. Excluding Japan, GDP growth in Asia fell to 7.1% q/q AR in Q2 from 11.4% q/q AR in Q1. Japan barely grew in Q2 with GDP only edging 0.4% q/q AR higher following a solid 4.7% q/q AR growth in the previous quarter. In China growth also slowed sharply to just 8% q/q AR in Q2 from 12.2% q/q AR in the previous quarter. In Q2 growth was below trend in all Asia's three major economies China, Japan and India.

Across Asia the slowdown was even more evident in industrial activity. For Asia as a whole growth in industrial production was cut more than half in Q2 to just 2.7% q/q compared with the solid 5.6% q/q growth in the previous quarter. Leading indicators suggest growth in industrial production will slow further in Q3.

### Slowdown driven mainly by demand within Asia

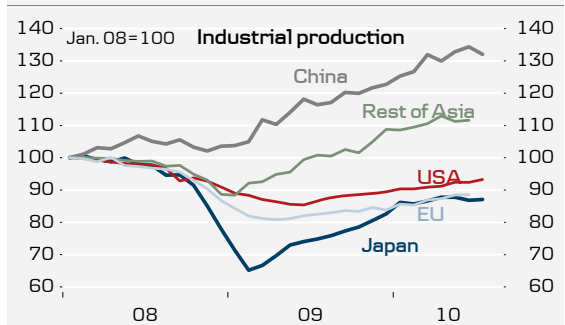
The slowdown in H1 10 has been mainly driven by weaker demand within the Asian region. This has particularly been the case in China and India, but also to some degree in Japan. Just as China was an important driver behind the sharp recovery in Asia in 2009, China has been an important driver behind the recent slowdown. According to our calculations virtually all of China's growth in Q2 was driven by net exports, while the contribution to

Growth in Asia will slow further in the short run, but should improve again in Q4



Source: Reuters Ecowin and Danske Markets

Industrial activity has slowed substantially in Asia in H1 10



Source: Reuters Ecowin and Danske Markets

China lower import growth has been an important driver behind the recent slowdown



Source: Reuters Ecowin and Danske Markets

growth from domestic demand was only slightly positive and the contribution from inventories slightly negative.

In Q2 China's import growth dropped to just 2.7% q/q following a whopping 12.2% q/q in the previous quarter. China's slower import growth has hurt the rest of Asia. For example South Korea's and Taiwan's export to China was broadly flat in Q2. On the other hand, exports to developed markets have improved, despite all the talk about European debt crisis and jobless recovery in the US. As seen on the chart South Korea's and Taiwan's exports to the US and Europe both increased by about 10% q/q in Q2: China's exports to the US and EU also increased by around 10% q/q in Q2, while its exports to Asia (excluding Japan) only increased 5.3%.

Because China is Asia's manufacturing hub for exports to developed markets, it has benefitted most from the recovery in exports to Europe and USA in H1 10. In Q2 China has been by far the strongest export performer in Asia and net exports are estimated to have contributed 2 percentage points to quarterly GDP growth in Q2. On the other hand, net exports have only contributed slightly to GDP growth in the NIC countries (South Korea, Taiwan, Singapore and Hong Kong) and in most ASEAN countries the contribution from net export has even turned negative. That said some of the recent resilience in China's exports might be due the expiry of some export tax rebates in mid-July. This expiry has probably frontloaded some of China's exports and some payback should be expected in coming months.

### Decoupling still appears to be a valid case

The trade pattern within Asia suggests that the recent slowdown in Asia has been mainly driven by domestic demand within the region and not least less demand from China. Hence the business cycle in Asia still appears to have decoupled somewhat from the business cycle in Europe and the US. It underlines that one should be very careful in basing forecasts for the global manufacturing cycle mainly on the development in Europe and the US.

However, this is not to say that exports to developed markets are not important. The improvement in exports to Europe and US has so far been positive for Asia in H1 10 and growth in Asia will be vulnerable if exports to these markets start to lose momentum. As the recovery in the US and Europe is likely to lose some momentum in H2 10, we expect weaker export growth to Europe and the US to add further to a slowdown in Asia in the short run. The continued decline in the OECD leading indicator supports this view. However, we still believe that demand within the Asian region – particularly China – will be decisive for fate of the Asian business cycle.

### Why has demand weakened in Asia?

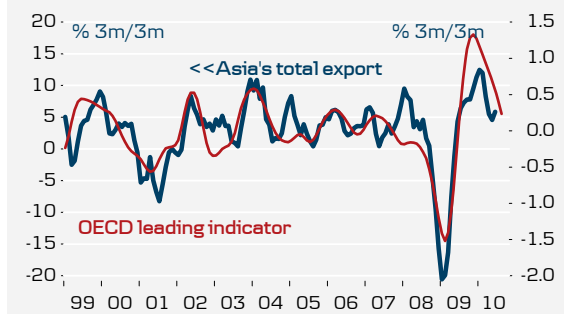
Overall there are three main reasons for the slowdown in domestic demand in Asia. The *first* and probably most important is **unwinding of the fiscal stimulus** initiated in the wake of the global financial crisis in 2009. In most Asian countries public investments are now declining following the surge in 2009. In China construction activity appears to have been broadly flat in H1 2010, but is not planned to be substantially reduced until next year. The

South Korea's and Taiwan's exports to developed countries have held up well so far



Source: Reuters Ecowin

OECD's leading indicator suggests export growth will slow further



Source: Reuters Ecowin and Danske Markets

Weakness in retail sales has been the negative surprise



Source: Reuters Ecowin and Danske Markets

negative impact from structure investment is broadly in line with expectations.

It appears we have underestimated the impact from subsidies for the purchase of durable consumer goods, introduced as part of the fiscal stimulus in several Asian countries. Both Japan and China have introduced subsidies for purchase of consumer durables and these programmes were extremely effective in boosting demand for durable consumer goods last year. However, although these programmes remain in place, demand for durable consumer goods has started to wane from extremely elevated levels.

The *second* reason is that the **inventory cycle** is gradually coming to an end and now adding less to growth. On the other hand, except China there have so far not been any significant increases in inventories. Hence inventories appear to be much leaner if we compared with the situation before the global meltdown in late 2008. This is an argument for a less severe slowdown in manufacturing activity this time. That said inventory cuts appear to be an important explanation for the recent sharp decline in China's import growth.

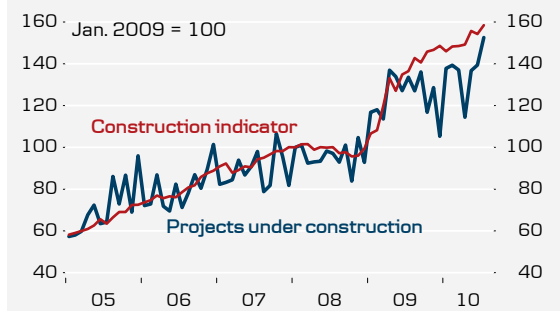
The *third* and final explanation for weaker demand in Asia is **monetary tightening**. Most Asian countries except Japan have now started tightening monetary policy. However, the impact on the economy should not be exaggerated as tightening has so far been modest from extremely accommodative levels. The biggest impact from monetary tightening has been in China, despite the Peoples Bank of China (PBoC) so far having chosen not to increase its leading interest rate. However, in China the impact from lending curbs and administrative tightening measures targeting the real estate sector have been substantial.

### Inflationary pressure is easing

The recent slowdown in Asia is not entirely unwelcome as we have previously regarded overheating as the main risk for Asia. In Q2 10 GDP growth in Asia was slightly below potential and expected to remain below potential in the current quarter. Hence, inflationary pressure has eased particularly in countries such as China and India, where the risk of overheating was most substantial. For that reason we have revised our inflation forecast for Asia lower across the board. In China's case inflation is now expected to peak at about 3.5%, while Japan is expected to remain in deflation for most of 2011. Albeit it is too early to turn off the inflation alarm, Asia is currently far from the situation in late-2007 and early-2008, where Asia overheated.

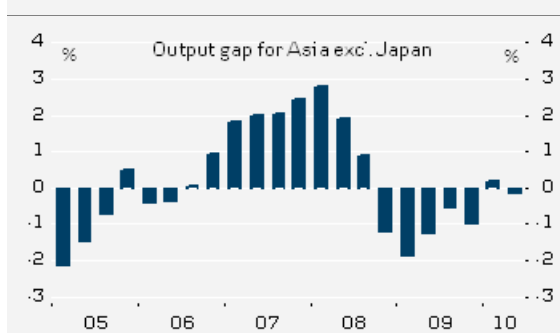
Growth in Asia has mainly slowed in H1 10 because of temporary factors (unwinding of fiscal stimulus and the inventory cycle). There will still be some headwind from the unwinding of fiscal stimulus not least in China where public infrastructure investments are planned to reduce substantially next year. However, household income growth remains strong, capacity utilisation is high and real interest rates remain low despite recent tightening and hence the fundamentals for private demand remain strong.

Construction activity has been flat in China in H1 10, but appears to be improving again



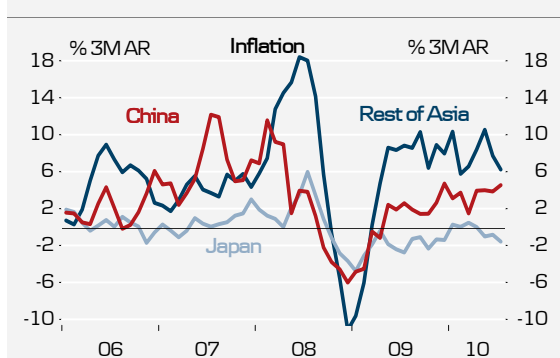
Source: Reuters Ecowin and Danske Markets

The output gap has widened in Asia in Q2 10



Source: Reuters Ecowin and Danske Markets

Risk of overheating is subsiding in Asia



Source: Reuters Ecowin and Danske Markets

Recently leading indicators like Chinese manufacturing and service PMI has again started to improve, suggesting Chinese growth will start to pick up again in Q4 10. In the rest of Asia excluding Japan and India, where monetary tightening and unwinding of fiscal stimulus in general has been less, domestic demand has so far been more resilient and GDP growth above trend. However, in these countries the export recovery and industrial activity has lost considerable steam in recent months and this will weigh on domestic demand in H2 10. Hence GDP growth will slow in the ASEAN and NIC countries – possible even below trend.

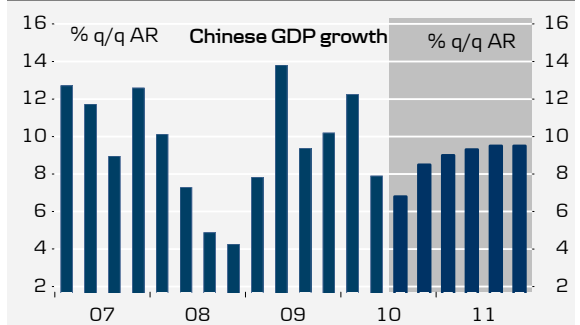
Despite all the focus on the strong yen the slowdown in Japan in Q2 10 was mainly driven by domestic demand. We believe GDP growth will return above trend in Q3 10, but contrary to the rest of Asia, Japan’s output gap remains substantial and is now only expected to close slowly.

### Asia is still in a tightening cycle

With inflationary pressure easing the important implication for Asia is that it has considerable flexibility to ease monetary and fiscal policy if needed. This is an important reason why we believe growth in Asia will remain healthy, even if growth in developed markets slows more than expected. Nonetheless, with the exception of Japan, we still believe Asia is in a tightening cycle, albeit tightening from here will gradually become more cautious and possible even temporarily stopped later in H2 10. We expect further interest rate hikes in India and in several of NIC and ASEAN countries in H2 10.

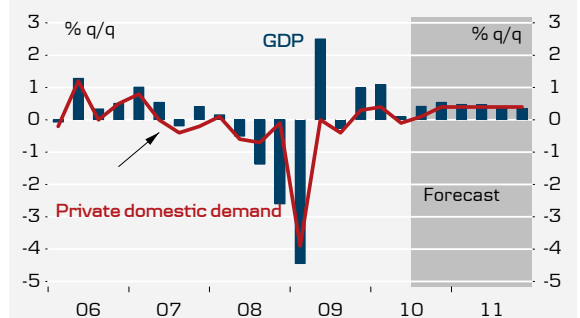
In China interest rates hikes are off the table for the rest of this year, but will be back on the agenda in Q1 11. Further administrative tightening targeting particularly the property sector is possible, as the decline in property prices so far has been modest and less than policymakers have targeted. Japan remains the odd one in Asia. Following the disappointing growth in Q2 and the recent appreciation of the yen, the Japanese government has announced a new fiscal stimulus package (growth impact less than 0.2% of GDP) and the Bank of Japan has resumed quantitative easing.

Growth in China expected to remain below trend in Q3, but should then start to pick up



Source: Reuters Ecowin and Danske Markets

No double-dip in Japan, but the output-gap is now only closing slowly



Source: Reuters Ecowin

### Macro forecast for Asia

% Change y/y	GDP				CPI inflation				Current account			
	2008	2009	2010	2011	2008	2009	2010	2011	2008	2009	2010	2011
<b>Asia</b>	5.3	3.5	7.6	6.6	5.7	2.1	3.7	3.0	4.5	4.0	3.7	3.7
Japan	-1.2	-5.2	3.1	1.8	1.4	-1.4	-1.2	-0.3	3.2	2.8	2.8	2.1
China	9.6	8.7	9.9	9.0	5.9	-0.7	3.1	3.2	9.4	5.8	6.2	6.5
<b>Asia excl. Japan &amp; China</b>	4.7	2.5	7.2	6.2	7.7	6.4	6.6	4.3	0.7	2.7	1.6	1.4
India	7.3	5.7	8.8	8.3	8.3	10.9	10.2	5.0	-2.2	-2.1	-2.2	-2.0
<b>NIC</b>	1.8	-0.9	6.5	4.6	4.5	1.3	2.4	2.6	4.8	8.7	6.2	6.5
South Korea	2.3	0.2	5.8	4.3	4.7	2.8	2.9	3.1	-0.6	5.1	1.6	2.2
Taiwan	0.7	-1.9	7.3	4.9	3.5	-0.9	1.5	2.1	6.2	11.2	8.5	7.7
Hong Kong	2.1	-2.7	5.4	4.7	4.3	-1.0	0.5	1.5	13.6	11.1	12.1	10.1
<b>Singapore</b>	1.4	-2.0	9.7	5.5	6.5	0.2	2.4	1.9	19.2	19.1	18.0	22.4
<b>ASEAN</b>	4.7	1.7	6.2	5.3	9.4	2.7	4.7	4.6	2.0	4.9	3.2	2.1
Indonesia	6.0	4.5	6.0	5.8	9.8	2.9	4.8	5.8	0.0	2.0	1.4	0.4
Thailand	2.5	-2.3	6.1	4.7	5.5	-0.8	3.2	1.9	0.6	7.7	2.5	0.3
Philippines	3.8	0.9	5.0	4.6	9.3	3.2	5.0	4.0	2.2	5.3	3.5	2.3
Malaysia	4.6	-1.7	7.1	5.0	5.4	0.6	2.0	2.1	17.5	16.7	15.4	14.7

Source: Ecowin and Danske Markets. Note: ASEAN = Indonesia, Thailand, Malaysia, Philippines and Vietnam. NIC = South Korea, Taiwan, Singapore and Hong Kong.

# CEE

## Recovery continues

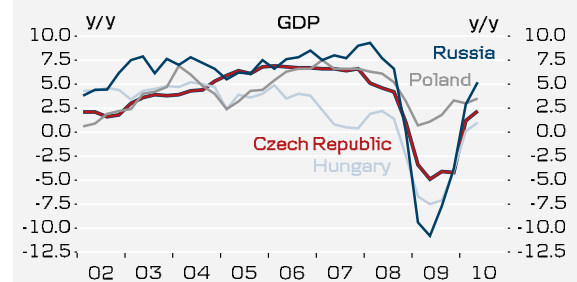
- The Central and Eastern European (CEE) economies have in general continued to recover over the last couple of months, supported mainly by a recovery in manufacturing sectors, but a strong rise in exports has also contributed positively to growth.
- We expect most economies in CEE, with the exception of Latvia and Hungary, to show positive growth in 2010. However, there are clear risks that the economic upswing will lose steam in the second half of the year, given the worsening of the global economic situation.
- Furthermore, private demand remains subdued, as unemployment rates are high or even continuing to rise, and the need for restrictive public spending means that private consumption will fail to recover this year.
- With no demand-side pressures, there is currently little inflationary pressure in the region, with the exception of Hungary, where the weak currency creates additional pressures on inflation despite consumer spending being weak. In Russia, inflation is bound to accelerate rapidly on the back of a sharp rise in food prices.
- Even though we previously expected monetary easing to come to an end in first half of this year, the worsening of global economic conditions probably means that any monetary tightening will likely be postponed, or even that further monetary easing cannot be ruled out in some countries.

### Recovery continues but future less bright

The CEE economies continued to recover in the first half of this year, supported by the recovery in the manufacturing sector. Furthermore, exports surged as foreign demand, especially from Germany, intensified.

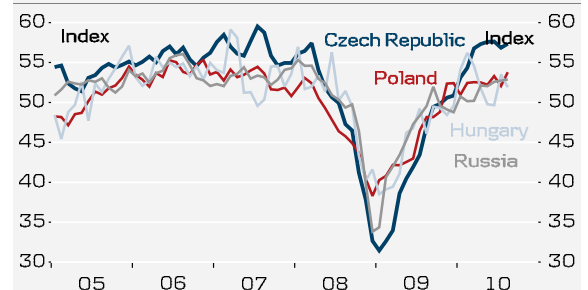
Even though there are big differences within the region, the outcome of second-quarter GDP surprised somewhat on the upside in most countries. Nonetheless, it is important to stress that the Q2 GDP outcome was probably the peak of economic growth, both in Europe and the CEE region, and concerns about growth in the coming quarters have increased sharply given the sharply deteriorating global economy.

Recovery continued in Q2



Source: Danske Markets, Reuters Ecowin, IMF

Manufacturing surveys still above 50



Source: Reuters Ecowin

### Outlook for CEE3

The recovery continued in Q2 in the CEE3 countries – Poland, Hungary and the Czech Republic – but there are clear differences between the three countries. While the recovery in the Polish economy looks quite robust and broad-based, Hungary in particular is on more shaky ground. Hungary still seems to be caught in a low-growth trap, with any major expansion in growth likely to reignite fears of external imbalances. Furthermore, due to large foreign currency lending, both among households and companies, the Hungarian economy remains extremely sensitive to currency swings, which makes the economic recovery extremely fragile. The Czech recovery is somewhere between Hungary and Poland. There is no doubt that the Czech economy is fundamentally the most healthy of the three, but the recovery is almost exclusively driven by strong export growth, mainly from the automobile industry, while domestic demand remains quite weak. Furthermore, with significant fiscal tightening on the cards in the Czech Republic, domestic demand is likely to remain subdued going into 2011.

Weak domestic demand is also keeping inflation well under control in the Czech Republic. Even though some Czech monetary policymakers have been talking about possible rate hikes, it is hard to find a reason why the central bank should be in a hurry to hike rates as inflation is likely to stay below the CNB's inflation target of 2% in the 1-1½ years. Similarly, the Polish inflation outlook is relatively benign, but the upside risk to inflation is higher in Poland than in the Czech Republic, due to stronger growth in domestic demand in Poland and a continued improvement in the Polish labour market.

In Hungary, the challenges for policymakers seems a lot greater, and the newly-elected government has not got off to a good start. Uncertainty about the outlook for a possible new loan agreement with the IMF and EU has increased significantly, and the Hungarian government has done plenty to upset the market, with numerous unfortunate comments about the conduct of economic policy. Furthermore, uncertainty has also increased due to the government's continued attacks on the central bank. The large uncertainty on the economic policy outlook, problems with foreign currency lending and continued high inflation effectively mean that the Hungarian central bank is unable to ease monetary policy, despite the continued lacklustre growth in the economy.

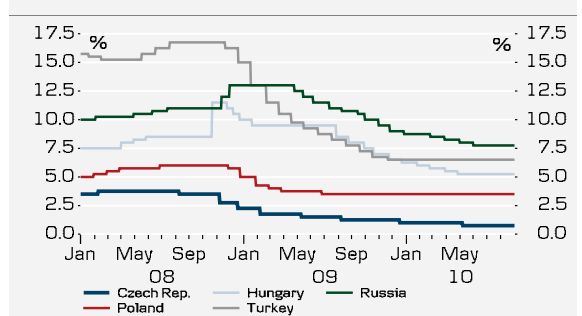
On the fiscal side, there is no doubt that the Czech government is well ahead of Poland and Hungary. The newly-elected Czech coalition government has already put forward an ambitious fiscal consolidation plan based on serious structural reforms. In contrast, the Polish government has put forward a plan for fiscal consolidation that is almost entirely based on a VAT hike of 1 percentage point – hardly an ambitious plan and most likely far from sufficient to reduce the budget deficit to a sustainable long-term level. In fact, even though the market is not overly concerned public finances in Poland at the moment, we think that the country faces serious challenges on the fiscal side and that much more needs to be done to reduce the budget deficit to a sustainable level. Similarly in Hungary, where the government's very mixed signals on public finances give cause for concern about the future.

Hungarian inflation outlook not rosy



Source: Reuters Ecowin, Danske Markets

Key policy rate in CEE3 and Russia



Source: Reuters Ecowin

Poland forecasts

Poland		2009	2010	2011	2012
<b>Macro indicators</b>					
GDP, av over period	% y/y	1.8	3.1	4.6	4.1
Fixed investment	% y/y	-1.0	-1.6	13.2	7.6
Household consumption	% y/y	2.2	3.5	3.7	3.5
Industrial production	% y/y	-3.6	12.1	7.9	6.8
C/A balance, ann. total	% of GDP	-1.6	-1.9	-2.1	-2.2
Unemployment	% year-end	11.9	12.0	10.8	10.5
Inflation, average year	% y/y	3.5	2.6	2.6	2.6

Source: Reuters Ecowin, Danske Markets

## Outlook for the Baltic states

The recovery of the Baltic states has started to accelerate, although there are significant differences in macroeconomic trends between the three countries. The economies of Lithuania and Estonia performed significantly better than expected in Q2 10 and should grow on average this year. Latvia remains the weakest of the Baltic states and it is unlikely to get out of recession in 2010. Although the international lenders – primarily the EU and IMF – have for now solved Latvia’s short-term funding problems, the country must implement the fiscal austerity measures further. The main ways to achieve this goal are decreasing spending and privatising state enterprises.

The main factor that will determine growth in the Baltic region is exports. The key export markets – Germany, Poland and Northern Europe and Russia – are recovering quite rapidly, which should stimulate growth in the Baltic economies.

However, domestic demand in all three Baltic countries is still very weak. We should not forget that, at least in part, positive growth is driven by one-off factors – the low base effect and restocking – and the latter will probably come already in the second half of this year and disappear completely in 2011.

Thus, looking at the future prospects, only a sustainable recovery in domestic demand would offset the deceleration in external demand growth and the end of the positive inventory cycle. In general, rapid recovery of domestic demand in the Baltic states is significantly dependent on fixed investment, which depends on a stable macroeconomic environment. Restrictive fiscal policy will remain one of the key topics in all three countries. We believe that the tightening of fiscal policy will have a generally positive effect on growth – when a stable macroeconomic environment stimulates the recovery of capital inflows and investment.

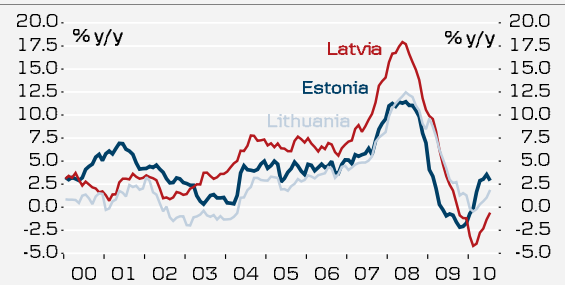
## Outlook for Russia and CIS

Russian GDP growth exceeded 4% in H1 10, driven by exports and consumption. However, the rest of the year looks less benign, as the benefit of the low base effect is fading. A recovery in bank lending has not really started yet, which is holding back the economy in 2010. We expect GDP growth of 3.6% this year and 4.1% in 2011. Unfortunately, consumption sector remains the only growth driver for now, but we expect it to be further supported by bank lending growth in 2011. A recovery in investment still looks distant, but we remain optimistic on investment growth reaching decent 10% y/y growth in late 2011.

Inflation is bound to accelerate rapidly, with the recent rise in food prices being just the beginning. We think that the government is continuing to ignore the inflation pressures, to justify the loose monetary policy. Inflation targeting is not likely to become a key policy for the Russian central bank for some years.

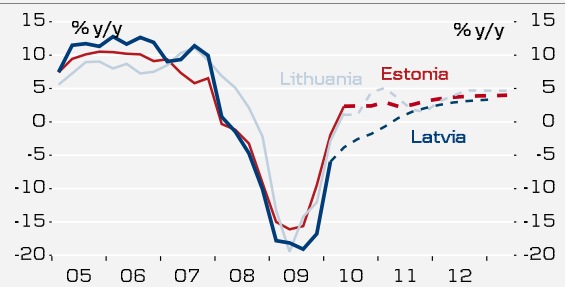
Key risks for the countries in Commonwealth of Independent States (CIS) are concentrated on commodity prices, as manufacturing sectors remain extremely weak in the area.

Inflation development in the Baltics



Source: Reuters Ecowin

Outlook for GDP growth in the Baltics



Source: Reuters Ecowin, Danske Markets

Russia forecasts

Russia		2009	2010	2011	2012
<b>Macro indicators</b>					
GDP, av over period	% y/y	-7.9	3.6	4.1	5.0
Fixed investment	% y/y	-15.9	1.0	7.0	7.5
Household cons	% y/y	-7.8	4.5	5.9	6.0
Industrial production	% y/y	-10.9	5.2	3.6	4.0
C/A balance,	% of GDP	3.8	4.5	3.1	2.5
Unemployment	% year-end	8.2	7.9	7.3	7.0
Inflation, average year	% y/y	11.7	7.0	9.2	7.5

Source: Reuters Ecowin, Danske Markets

## CEE macro forecasts

% Change y/y	GDP				Inflation			
	2009	2010	2011	2012	2009	2010	2011	2012
<b>CEE</b>	-6.9	1.7	3.8	4.6	6.1	4.6	4.8	4.5
<b>CEE3</b>	-1.0	1.6	3.5	4.0	3.1	2.8	3.0	3.0
Czech Republic	-4.0	0.5	2.4	3.7	1.1	1.5	2.0	2.4
Hungary	-6.3	-1.9	3.0	3.7	4.2	5.2	4.6	4.0
Poland	1.8	3.1	4.6	4.1	3.5	2.6	2.6	2.6
<b>Baltics</b>	-15.6	-0.4	2.6	3.8	3.3	0.5	1.3	1.6
Estonia	-14.1	0.3	2.0	3.6	-0.1	2.5	3.3	2.7
Latvia	-18.0	-3.5	1.5	3.1	3.6	-1.7	0.1	0.8
Lithuania	-14.8	1.2	3.6	4.2	4.5	1.0	1.1	1.5
<b>CIS</b>	-6.9	3.7	4.1	4.8	9.3	7.8	8.1	7.0
Kazakhstan	1.2	2.8	3.4	4.4	7.3	6.3	3.0	3.8
Russia	-7.9	3.6	4.1	4.9	8.8	8.0	9.2	7.9
Ukraine	-15.1	4.1	3.3	3.9	15.9	8.2	5.4	4.8

Source: Reuters Ecowin, IMF, Danske Markets estimates

Note: **CEE3** comprises Czech Republic, Hungary and Poland. **CIS** includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. **CEE** is CEE3, Baltics and CIS, plus Albania, Bosnia, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia and Turkey.

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