Danske Markets

Investment Research

March 2010

Global Scenarios

Powerful lift-off but gravity still strong

- Global recovery on track, but growth close to peaking
- Asia will continue to lead, but inflationary pressure is a risk
- Job growth to support US recovery
- Euroland the weakest link, but limited risk of a double dip
- Asia will lead monetary normalisation, while ECB will lag

Danske Research

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Contents

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

Powerful lift-off but gravity still strong

- **2010 will be the moment of truth for the global economy: it will become apparent whether the recovery is sustainable or whether a double-dip scenario will materialise. Since 2010 is effectively a 'make or break' year, the markets are expected to be more volatile than in 2009.**
- **We continue to be cautiously optimistic and expect a road of sustained recovery. It will, however, be moderate by historical standards. Global growth momentum is likely to peak in Q1 as strong cyclical tailwinds from stimuli and inventories taper off.**
- **We leave our growth forecasts for the US and Asia broadly unchanged. We have revised down our projections for Euroland slightly in 2010 based on the growth disappointment in late 2009. Our projections are still slightly above consensus in all regions.**
- **Key for sustainability will be a return of US job growth. We expect the strong US economic growth in the second half of 2009 to translate into decent gains in employment of around 200-250k per month. This should lead to sustained growth in US final demand of 2.5-3.0% in the coming years.**
- **We expect the Euroland recovery to continue in 2010 mainly driven by exports. The Asian upswing is one step ahead and we already see strong growth in final demand. Focus is changing to policy tightening to avoid inflation and bubbles in asset markets.**
- **Monetary exit strategies in the US and Euroland are likely to be slow as inflation is not yet an issue and the recovery is moderate. We look for a first hike from the Fed in November while the ECB is expected to hike in early 2011. In China we expect a resumption of the gradual CNY appreciation in Q2.**

Recovery broadly on track

The global recovery has continued broadly on track over the past three to six months. The US delivered a positive surprise in Q4 with growth close to 6% q/q annualised and growth in H2 09 has been in line with our expectations of 4.0-4.5% growth. Although the inventory cycle has provided some of the boost, it is encouraging that final demand has also picked up (see chart). In particular, investment in equipment and software grew strongly in Q4.

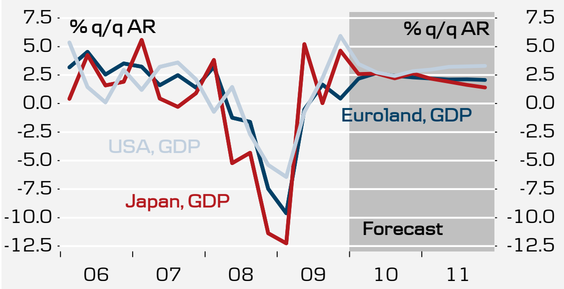
While the US recovery is on track, Euroland disappointed in late 2009. GDP only grew 0.5% annualised in Q4. In particular Germany posted a negative surprise with GDP stagnating in late 2009. However, factory orders for January suggest that activity has picked up again in early 2010. This is also signalled by continued increases in the German ifo expectations index and PMI new orders which tend to give good signals on Euroland growth.

Growth forecasts: Still slightly above consensus

% y/y	2010 Danske Bank	2010 Consensus	2010 IMF	2010 OECD	2011 Danske Bank	2011 Consensus	2011 IMF	2011 OECD
USA	3.2	3.0	2.7	2.5	3.0	3.0	2.4	3.0
Euroland	1.8	1.2	1.0	1.2	2.2	1.5	1.6	2.0
Japan	2.7	1.8	1.7	1.4	2.1	1.8	2.2	2.2
China	9.5	9.6	10.0	10.2	9.5	8.9	9.7	9.3
Global	4.2		3.9		4.4		4.3	
Asia (ex Japan and China)	6.6				6.1			
CEE and CIS	0.8				3.5			
	Change from previous fcst							
USA	0.0				0.0			
Euroland	-0.4				+0.1			
Japan	-0.2				-0.2			
China	-0.1				+0.3			

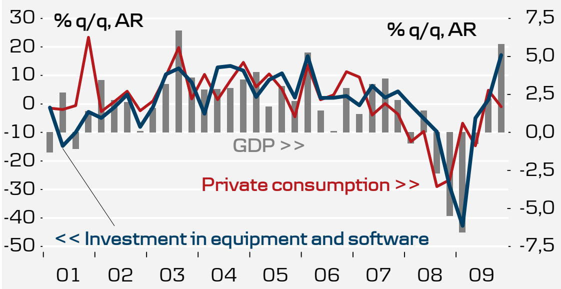
Source: Danske Markets, Bloomberg, OECD, IMF

G3 growth profiles



Source: Reuters Ecowin and Danske Markets

US final demand picking up



Source: Reuters Ecowin and Danske Markets

In Asia, economic data have continued at a strong pace into 2010. Asia continues to be ahead in the cycle and has already reached the phase of self-sustained recovery with declines in unemployment rates throughout the region. Exports are performing again and private domestic demand has also picked up nicely.

The next phase is critical

While the global recovery has been broadly on track so far, it is too soon to break open the champagne. The next six months will prove critical for the global economy as the baton in the Western economies has to be delivered from massive stimulus and inventory correction to job growth and sustained recovery in final demand.

In *Global Scenarios* in December, we compared the global recovery to a space ship. In order to fight gravity and get lift-off, we need a massive amount of fuel. At some point though, the fuel will taper off, and the rocket should by then have escaped gravity in order to continue the path upwards. If not, it will crash.

We are now at the stage in the global economy where the fuel will taper off. It will therefore become increasingly obvious whether the global economy will manage to escape the gravity pull. The task is quite big since gravity is particularly strong this time due to the damage to the banking sector, high debt levels and massive wealth losses that are still lingering.

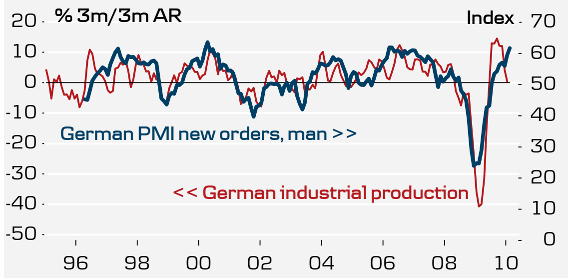
Another reason why this phase is so critical is that we do not have much fuel left to use should it be needed again if the economy falters. Fiscal policy is more or less maxed out everywhere and there is also a limit as to how much more can be done through monetary policy – although more money can be printed. Indeed, 2010 is likely to prove to be a 'make or break' year.

Encouraging signs of real lift-off...

Fortunately, we see increasing signs that labour markets are improving globally which is the main precondition for a real lift-off. Unemployment rates have either fallen or stabilised in most Western economies and in Asia unemployment is already on a clear downward path. A short-term model for US non-farm payrolls suggests decent job gains over the next three to six months and our expectation is monthly job growth of around 200-250k over this horizon.

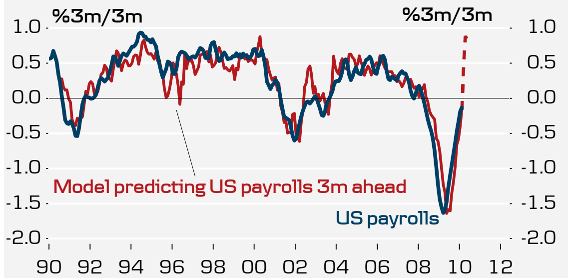
All evidence suggests that once unemployment starts to go down it normally continues to decline for a considerable period: it becomes a sustainable recovery that feeds on itself. The process works through a variety of channels. First, employment gains increase disposable income growth for households and support consumption growth. Second, the decline in unemployment gives rise to higher job security and therefore reduces the need for precautionary savings. Third, the improvement in consumer demand triggers companies to scale up investment plans as the uncertainty over demand fades and focus shifts from crisis management to strategic management. Finally, as this is a process taking place in most of the world

Mixed signals in Germany: Hard data weaker while soft data point to strengthening recovery



Source: Reuters Ecowin and Danske Markets

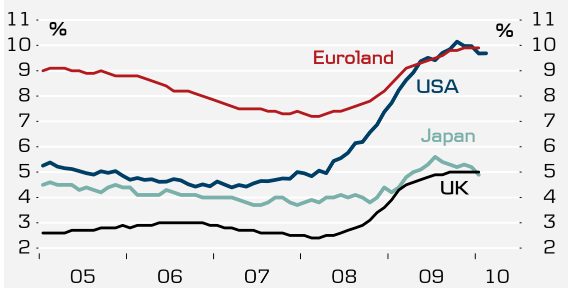
Strong signs of US job recovery coming soon



Source: Reuters Ecowin and Danske Markets

Note: US payrolls is modelled on temporary help workers, weekly jobless claims, hours worked, ISM new orders, NFIB small bus. Optimism and "jobs plentiful minus jobs hard to get"

Looks like global unemployment is peaking earlier than expected



Source: Reuters Ecowin and Danske Markets

economy, it will improve external demand as well and give a lift to export growth and world trade will benefit.

It is still too early to conclude that we have entered this positive spiral. The global economy is still fragile during this transition phase and in the past we have seen double-dip recoveries because new shocks have hit the economy during this critical period when sentiment is vulnerable. It is therefore important that we don't get hit by new shocks over the next 6-12 months. By definition, shocks are difficult to forecast but there are a number of candidates to watch out for: an acceleration of the public debt crisis, renewed significant bank losses damaging market confidence, a spike in oil prices or a rise in protectionism.

... but going from acceleration to cruising speed creates jitters in the markets

Although growth is probably becoming more sustainable, we expect the global economy to lose some speed after reaching a growth peak in the first half of 2010. The global economy currently has maximum fuel from stimulus and the inventory cycle and this effect is about to taper off. We already see signs of the growth peak in some leading indicators. For example, global PMI new orders fell in January and momentum in OECD's leading indicator has been on a downward path for some months now.

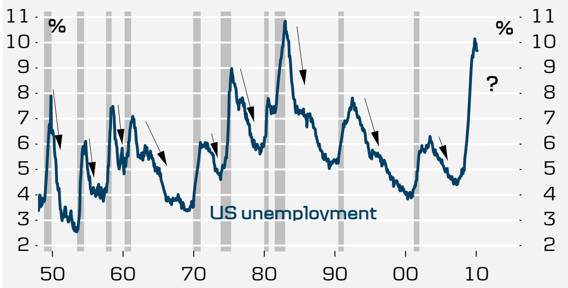
The transition from acceleration to cruising speed is likely to create more (realised) volatility in financial markets in 2010. Indeed, we have already witnessed this in early 2010 where equity markets saw the biggest correction since early 2009 when equity markets bottomed. Markets will be caught between (a) slowing speed which tends to spur fears that growth will slow too much and cause a double-dip scenario, and (b) rising signs of sustainability from improving labour markets which should work as comfort that a double-dip scenario will not materialise. At the same time, expectations for earnings growth are quite high, leaving scope for disappointments.

A moderate recovery with strong regional differences

Seen in a historical context, the recovery in the western world is expected to be quite moderate (see chart on the US). There are several reasons for this. First, there will be a need for significant tightening of fiscal policy already in 2011 and 2012 as countries need to reduce unsustainably high budget deficits. Plans for this have already been outlined. Second, considerable financial regulation is expected, which will dampen banks' ability to increase lending. Finally, private consumption growth in the western world will probably be more moderate as high unemployment rates put downward pressure on wage gains and there may be further need to repair household balance sheets.

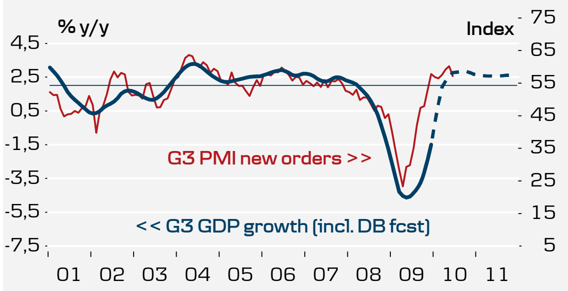
On the other hand, the Asian recovery has already proven quite strong and a recovery in final demand is starting to take hold. In particular China and India have proven very strong and this has significant positive spill-over to the whole region. The Asian recovery also has significant positive effects on commodity exporters such as Russia and Latin America. Asia has proven to be a considerable stabilising force in the global economy, providing an

When unemployment starts falling it normally continues for a longer period



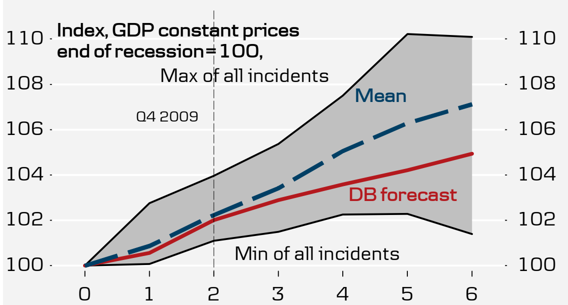
Source: Reuters Ecowin and Danske Markets

Global growth close to a peak but expected to stay above trend growth



Source: Reuters Ecowin and Danske Markets

A moderate US recovery in a historical context



Source: Reuters Ecowin and Danske Markets

important engine of demand for other regions including the Western countries.

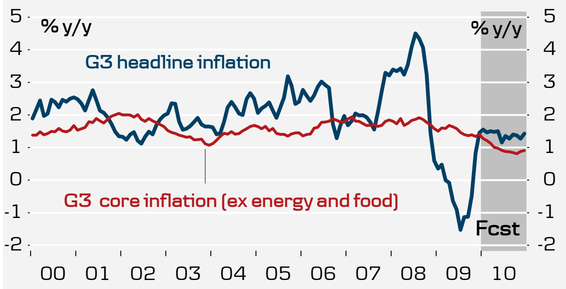
Monetary exit will be slow

Although the global economy is recovering, central banks are likely to move slowly in their exit strategies. Inflation is expected to stay at moderate levels in the Western economies as wage pressures are low and pricing power poor. In the US, unemployment has risen to very high levels and there will be plenty of slack in the economy for a long time. Non-standard measures will be scaled out gradually during 2010 but we don't expect the Fed to hike before late 2010 (see *Research US: A roadmap for the Fed's exit*).

In Euroland, the jitters around fiscal sustainability have postponed the ECB's exit and we do not foresee the first hike until early 2011 (*see Flash Comment Euroland: ECB will not hike before early 2011*).

In Asia the situation is a bit different. Here focus has shifted rapidly to fighting inflation and new bubbles and some tightening has already started in China. In Q2 we expect most Asian central banks to raise their leading interest rates and China is expected to resume its gradual appreciation of the CNY versus the USD.

Inflation to stay at moderate levels



Source: Reuters Ecowin and Danske Markets

Road map for sustainability

Our expectations for key drivers to judge sustainability:

1. **Labour market:** US payrolls to show job gains of 200-250k in mid 2010. Unemployment to decline in most economies during Q2.
2. **Confidence**: Business confidence should stay high and moderate only slightly during spring/summer. Consumer confidence to climb gradually.
3. **Oil prices:** Should rise only slowly. If it spikes higher on rising demand, we could face new downturn.
4. **Fiscal sustainability:** Although fiscal issues will probably stay high on the agenda, an escalation of the confidence crisis involving the US and the UK should be avoided.
5. **Equity markets:** Should hang on to gains although no strong performance is expected. If sentiment falters and equities drop strongly, we could see hit to confidence affecting consumption and investment.
6. **Asian growth**: Should continue at robust pace as it is important demand engine for the world economy - not least Euroland and commodity exporters

Expectations on key figures and central banks over coming quarter

Indicator	Comment	Measure	Latest		Jun/Q2
GDP	Economic recovery will take GDP growth slightly above trend in the coming quarters	% q/q, AR	0.5%	↗	2.2%
PMI	Composite PMI dipped around new year, but manufacturing sector improves further	Index	53.7	↗	57.2
Inflation	Very limited inflationary pressures during the coming quarters	% y/y	1.0%	→	1.0%
ECB	The ECB keeps rates on hold until 2011	% p.a.	1.00%	→	1.00%
Ifo	The German economy will benefit from a rebound in global trade	Index	89.8	↗	98.0
GDP	GDP growth has peaked but will remain slightly above trend through 2010	% q/q, AR	5.9%	↗	2.7%
ISM	ISM may have peaked but will hover in upper 50s during H1 10	Index	56.5	↗	58.0
Employment	A turnaround in the labour market is imminent	3 mth. mavg.	-35K	↗	150K
Core inflation	Core inflation will trend lower as slack in the labour market continues to build	% y/y	1.4%	↘	0.8%
Federal Reserve	Fed on hold and no new quantitative easing measures	% p.a.	0.13%	→	0.13%
GDP	Pace of the recovery will lose some steam in early 2010	% q/q, AR	4.6%	↘	2.9%
PMI	Manufacturing activity will continue to improve but lose some momentum	Index	52.5	↗	54.0
Inflation	Deflationary pressure will only slowly ease	% y/y	-1.3%	↗	-0.4%
BoJ	BoJ on hold until 2011, further non-conventional easing cannot be ruled out	% p.a.	0.10%	→	0.10%

Alternative 1

Stronger for longer

- **US job growth recovers at express pace fostering a positive spill-over on domestic demand**
- **Euroland and Asian exports benefit from higher US demand leading to a prolonged period of high global growth**
- **Oil and raw materials prices are pushed higher and the global monetary policy tightening cycle is fast forwarded**

Express recovery in US employment

Recent indicators on the US labour market have been mixed, leading to fears about a repeat of the 1991 and 2002 jobless recoveries. However, in many ways, the recession we have just been through corresponds more to the deep recessions in the 1970s and 1980s than the shallow downturns in 2001 and 1990-91. Jobs have been cut hard during the downturn and businesses are leaner than following the two previous recessions. With production picking up rapidly in Q4 09, the need for increased labour input is building. Lately this has been reflected in a jump in hours worked and temporary help service.

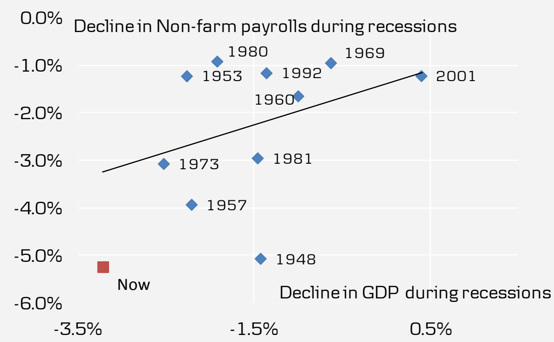
In this alternative scenario employment growth recovers at an express pace, reaching above 350,000 persons per month in H1 10. The leap in job growth should foster positive dynamics in the rest of the economy with domestic demand recovering fast as private consumption and investments growth get a boost.

Global dynamics to push interest rates higher

A strong recovery in US domestic demand will have positive spill-over effects on Euroland and Asian exports. Euroland exports will be further supported by a strengthening in the dollar against the euro as relative growth and interest rates lend support to the currency.

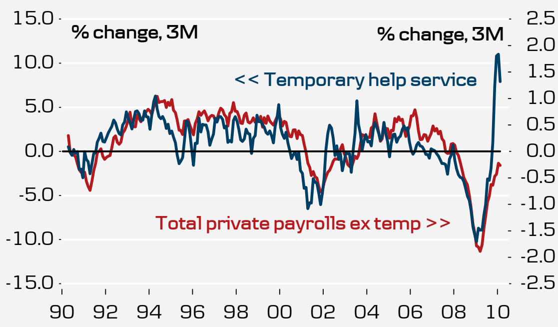
With the output gap in Asia close to zero, a re-acceleration in growth is likely to bring forward monetary policy tightening in the region. Further, raw materials and oil prices will be pushed higher, which should trigger a more hawkish stance at the ECB. The global monetary tightening cycle will thus be fast-forwarded starting in Asia, followed by a Fed hike by late summer and the ECB to follow suit thereafter. This will push interest rates higher on both sides of the Atlantic and lead to a flatter yield curve. Risky asset markets will benefit from improved risk appetite as the risk of a severe debt crisis and a double-dip fades.

Jobs were cut hard in the US during the recession



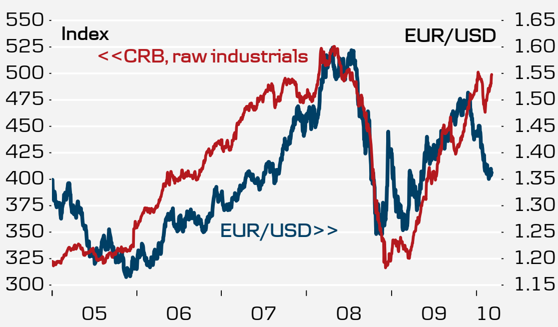
Source: Reuters Ecowin and Danske Markets

Temporary help services flag for a rapid rebound in US employment



Source: Reuters Ecowin and Danske Markets

Commodity prices to increase and USD to strengthen against EUR



Source: Reuters Ecowin and Danske Markets

Alternative 2

Eurosclerosis returns

- **Concerns about sustainability intensify in the Western economies and policymakers are forced to front-load fiscal tightening.**
- **The recovery in Euroland is derailed and growth slows in the US. Asia, which has healthy balances, outperforms.**
- **Fiscal tightening crowds out monetary normalisation. ECB and Fed keep rates unchanged through 2011.**
- **Yield curves become even steeper. The euro weakens, while Asian currencies appreciate.**

Dangerous debt

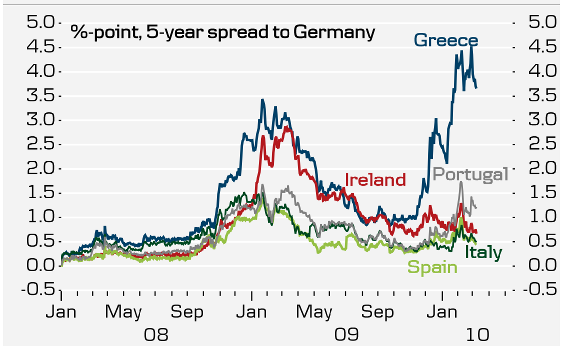
Worries about Greek public finances become a more general concern about global sustainability of public deficits, but remain mostly focused on some Euro area countries and the UK. As a consequence, public financing cost increases, with many countries' long-term budget policies starting to lose credibility. Some countries are downgraded. Concerns partly spill over to the US, which also faces more expensive sovereign funding.

This renewed round of scepticism is a toxic cocktail for the fragile recovery that is materialising in the Euro area. The loss of credibility in the financial market forces policymakers to front-load tightening of public budgets, which is not optimal at the current stage of the business cycle. The fiscal tightening derails the recovery in Euroland, but also takes air out of US growth. Macro data continues to disappoint and Euroland faces high unemployment and subpar growth for a prolonged period – this time anchored in the structural problems caused by the European welfare state model. Asia, which has the most sound balances, outperforms in this scenario.

Dismal growth and fiscal tightening leaves very limited – if any – room for central banks to normalise monetary policy. Both the ECB and the Fed leave rates on hold through 2011 and withdraw liquidity only very gradually from the system. At some point, further quantitative easing is considered likely. With fiscal credibility problems adding to longer-term sovereign funding costs, yield curves steepen further in both Euroland and the US.

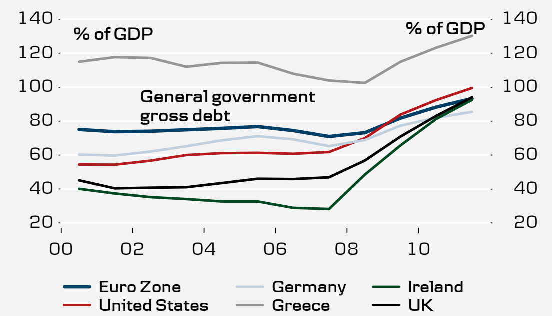
In this scenario, concerns about the euro as a single currency intensify and the currency weakens further. On the other hand, Asian currencies appreciate as the region remains the global power house and monetary tightening continues and macroeconomic balances are healthy. Growth in Asia prevents a decline in commodity prices that would otherwise have been a welcome boost to western economies. Eurosclerosis is back – but this time on a more global scale.

Country spreads have widened



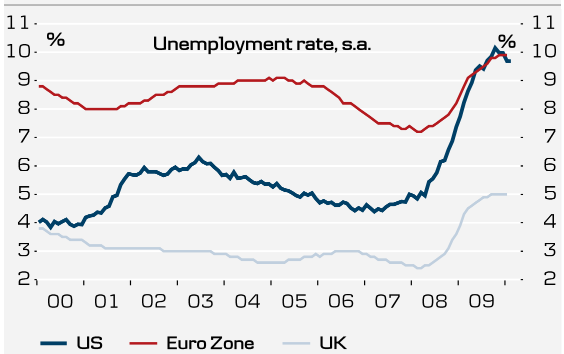
Source: Reuters Ecowin and Danske Markets

Explosive rise in public debt



Source: OECD Economic Outlook.

Rising unemployment is a threat for final demand



Source: Reuters Ecowin and Danske Markets

US

Recovery on track, but not fast track

- **The recovery remains on track, but is now entering a more critical phase where the boost from inventories, fiscal policy and normalisation of financial conditions is fading.**
- **Going forward, the fate of the recovery will depend upon the strength of underlying demand. In this respect, a turnaround in jobs remains essential for the economy to settle on self-sustained recovery path.**
- **The longer-term outlook remains one of moderate growth as tough fiscal consolidation and financial regulation lie ahead.**
- **Inflation is heading lower with headline CPI hovering around 1.6% from mid-2010 and core inflation bottoming at 0.5%. Strong deflationary forces will keep core inflation subdued throughout 2011.**
- **Monetary policy will be tightened in small and gradual steps. The first rate hike is likely to arrive late this year and reflect a desire to move away from ZIRP. Fundamentals may lead Fed to pause in 2011.**

Slower, but sustained, growth ahead

The economic recovery is on track with ongoing, but gradual, signs of progress among consumers and businesses, but with some more erratic developments in housing. In Q4 09, the economy delivered its second positive quarter on growth following the recession, with GDP expanding at 5.9% q/q AR. Indeed this turned out to be even stronger than we had forecast in December's *Global Scenarios*, the main reason being a faster-than-anticipated stabilisation of inventories.

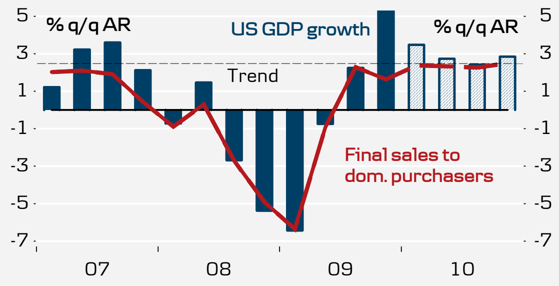
Given this front-loaded impact from inventories, the short-term growth profile is somewhat lower. The forecast is now for a 3.5%q/q AR growth rate in Q1 slowing to 2.5-3.0% for the remainder of the year. The forecasts for annual growth for 2010 and 2011 remain unchanged at 3.2% and 3.0%, respectively. Hence, we still expect a moderate recovery compared with historical standards and relative to the depth of the recession.

The boost from inventories is over. Now what?

There is little doubt that the majority of the boost from the inventory cycle has already arrived. A stabilisation in inventories will add around 0.25pp to annualised growth in H1, while a return to a normal post-recession pace of inventory building could boost this estimate to 1pp. In any case, this is minuscule compared with the 2.5pp boost that arrived in H2 09.

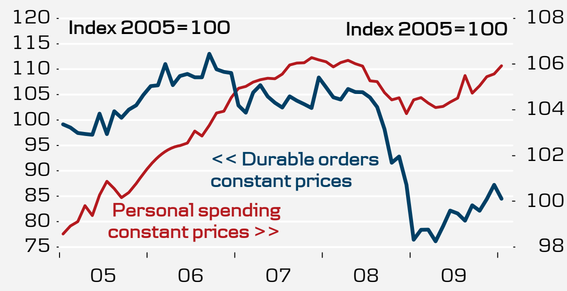
The concern is now how the recovery should proceed. Domestic demand growth is still running subpar and the impact of fiscal stimulus is fading. Furthermore, much of the positive snapback effect on growth from improving financial conditions has already arrived and there has been renewed weakness in housing data lately.

Sustained, but moderate, recovery



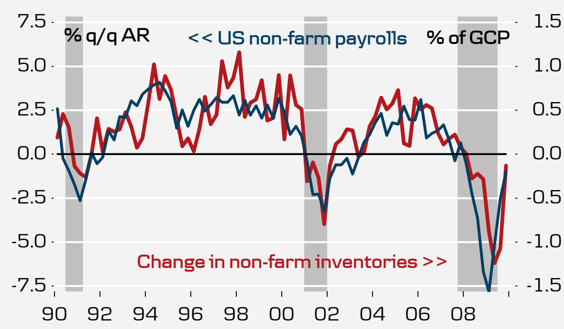
Source: Reuters Ecowin and Danske Markets

Signs of progress in underlying demand



Source: Reuters Ecowin and Danske Markets

Don't underestimate the dynamic effects of the inventory cycle



Source: Reuters Ecowin and Danske Markets

The post-dynamics of the inventory cycle

Fortunately inventory cycles usually have dynamic effects and there is little reason to believe that this time should be different. Most recoveries have been helped by a significant boost from inventories, in turn materialising into job and capex growth. In fact there are already signs of this happening.

Equipment and software spending recovered sharply in Q4 09 and is set to enjoy further solid progress in the coming quarters helped by an ongoing manufacturing recovery, pent-up demand for new production equipment and maintenance. Furthermore, most indicators now point to an imminent and possibly rapid recovery in the job market. In addition, employment is set to get a significant short-term boost from census hiring in the coming months (*Research US: Census – a springtime hiring shot*).

Consumers in better shape

With the recovery now entering a phase where underlying demand – in particular private consumption – is needed to take over, a return to positive job growth remains essential. Despite the slower-than-anticipated turnaround in the job markets, the outlook for consumers has turned somewhat brighter over the past few months.

First, compensation growth has picked up to about 4-5% propelled by a recovery in total working hours and a slower-than-anticipated decline in hourly earnings. Second, the unemployment rate has peaked and is now set to move gradually lower. Third, the pressure on household balance sheets is easing as credit tightening is ceasing and net wealth is recovering (*Research US: Limited risk of a violent rise in the savings rate*). Finally, oil prices have been steady, giving room for the disinflationary dynamics to support real purchasing power.

Although wage dynamics are set to slow further due to the huge slack in the labour market, a recovery in job growth during this year should facilitate an ongoing, but moderate, growth in personal consumption.

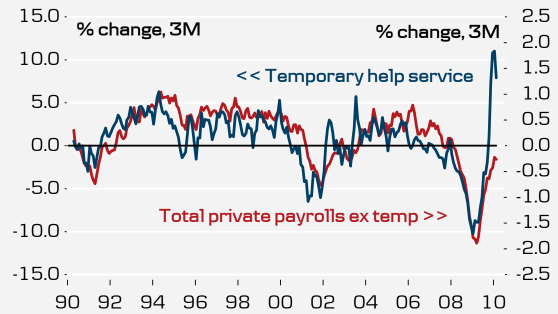
Don't expect a very strong recovery

Aside from a slower-than-usual recovery in consumption, there are other headwinds which will keep a lid on the pace of recovery both in the near and longer term.

Up-front is the recent severe setback in housing demand, which will most likely drag residential construction back into the red for a couple of quarters. In combination with a huge amount of foreclosed homes heading for the market, this could add some renewed downward pressure on home prices. That said, the adjustment in housing is close to complete and the weakness is most likely temporary and caused by the impact of the first-time home buyer tax credit and unusually inclement winter weather. On the longer horizon, pent-up demand and improving economic conditions should lift home sales and support prices.

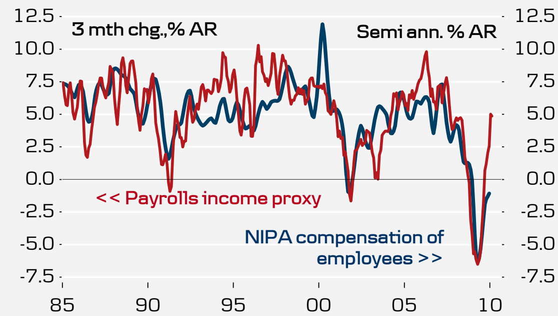
Meanwhile, there are other reasons to be cautious about the outlook for 2011 and 2012.

Job growth is imminent – possibly strong



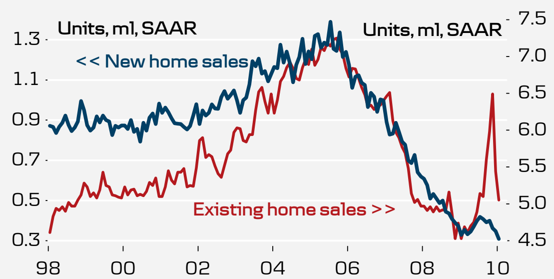
Source: Reuters Ecowin and Danske Markets

Compensation growth is recovering



Source: Reuters Ecowin and Danske Markets

Renewed setback in housing



Source: Reuters Ecowin and Danske Markets

The most obvious is the relatively tough fiscal consolidation that lies ahead for the coming years. The current budget proposal from the Obama administration looks for a tightening of the structural budget from -7.3% in 2010 to -3.0% in 2012. This is likely to produce a negative growth effect in the region of 1.6-1.7% for 2011 and 2012. Hence, to obtain a 3% growth rate, the underlying pace of demand must be 4.5-5.0% – a level that could be hard to achieve. Another and much more difficult assessable factor is financial regulation, which comes on the top of this and might act as a monetary tightening on the economy.

In spite of these obvious long-term headwinds, we expect the recovery to be sustained but, due to these headwinds, moderate. As emphasised in December's *Global Scenarios*, pent-up demand for housing, investments and durables in combination with a smaller drag from net exports are likely to make up for some of the missing strength in consumer demand over the coming years, providing some much needed support for the economy. Further, as emphasised below, monetary policy will only be tightened to the extent that economic conditions, fiscal tightening and financial regulation allows.

Public balances and impact on GDP growth

	2009	2010	2011	2012
DB estimate of budget surplus*	-9.9%	-10.6%	-8.3%	-5.3%
DB estimate of public debt*	83.8%	93.2%	98.3%	99.7%
OMB estimate of structural surplus*	7.6%	7.3%	5.1%	3.0%
Effect on GDP growth from discretionary fiscal spending**	3.1%	0.6%	-1.6%	-1.7%

*Pct of GDP, FY **Pct-point, calendar year, Q4/Q4 effect

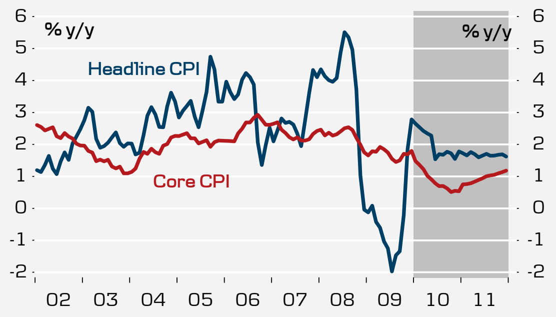
Note: GDP multipliers are calculated as an average of multipliers from OECD's interlink model and the FRB/US model. It is assumed that 2/3 of discretionary fiscal spending relates to tax cuts or transfers while 1/3 is governement spending

Source: Reuters Ecowin and Danske Markets

Core inflation is heading to uncomfortably low levels

Annual headline inflation has started its descent towards 2% following the spike in late 2009 caused by base effects from the low raw material prices at end-2008. We expect inflation to break below the 2% y/y level by June and fluctuate around a modest 1.6% y/y for the remainder of the forecast period. Underlying this forecast is an assumption of a moderate increase in oil and food prices over the next two years and a muted path for core inflation.

Inflation will be on a slow path for the next years

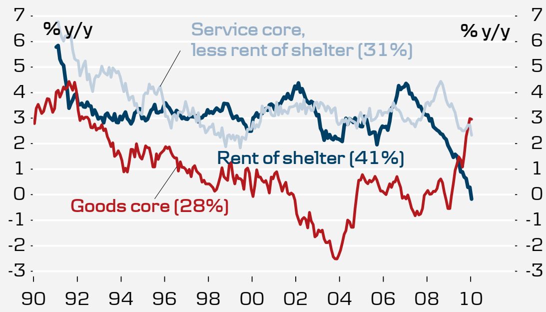


Source: Reuters Ecowin and Danske Markets

There is little doubt that significant deflationary pressures will push core inflation lower over the coming year (*Research US: Core inflation – a worry for the Fed*). The NAIRU gap has reached its highest since WW2 and will only trend gradually lower over the coming years. This will put significant downward pressure on labour costs and core inflation. In addition, the correction in the housing market has sent vacancy rates higher which is keeping rents and owners' equivalent rent for houses down. Finally, low capacity utilisation in manufacturing industries is putting downward pressure on core producer prices. We thus expect core inflation to trough at 0.5% by late 2010 and increase only gradually to 1.2% by end-2011.

Over the past nine months, core inflation has stayed surprisingly high given the intense deflationary forces. A closer look at the data shows that core goods prices have been rising rapidly. This can largely be attributed to an extraordinarily large increase in vehicle prices and a tax-related boost to tobacco prices. Both are temporary in nature. This implies that when price developments in these components return to normal, core inflation touching zero is a non-negligible risk.

Core goods prices are keeping core inflation up but this is set to reverse



Source: Reuters Ecowin and Danske Markets

Policy tightening in small and gradual steps

There is no doubt that the projection for core inflation presented above is well below the Fed's comfort zone. Add to that a fragile economic recovery which is sensitive to new negative shocks and you have the reason why the

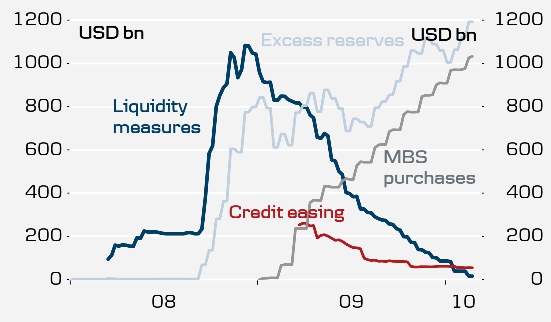
Fed will be cautious not to tighten too aggressively. We look for the first fed funds rate hike to arrive in November this year, reflecting the desire to move away from a zero interest rate policy. The Fed may pause hiking already close to the 1% level in 2011 (*Research US: A roadmap for the Fed's exit*).

The exit is however already under way. Most short-term liquidity and lending facilities have already been terminated and the Fed has started to normalise the discount rate. The unwinding of the extraordinary measures has so far been smooth as the use of these facilities has shrunk to almost nothing. We see the biggest risk for a disruptive market reaction from the termination of the MBS/agency purchase programme by end-March. A surge in mortgage yields could potentially delay the first rate hike.

We expect that the next step in the exit strategy will be to remove the 'extended period' language from the policy statement, in order to prepare markets for a rate hike. This is likely to be implemented in Q2 and will be followed by an active draining of excess reserves through reverse repos or term deposits starting by late Q2 or Q3.

Given the benign outlook for core inflation, the uncertainty surrounding the timing and size of fiscal tightening and the impact of possible new financial regulation, we judge the risk to our forecast to be tilted towards rate hikes arriving later than in our main scenario.

Unwinding of alternative measures has begun but active draining of liquidity is needed later on



Source: Reuters Ecowin and Danske Markets

US macro forecast

% Change q/q AR	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	Calendar year average 2009	2010	2011
GDP	3.5	2.7	2.4	2.8	3.0	3.2	3.3	3.3	-2.4	3.2	3.0
Private Consumption	2.5	2.2	2.2	2.2	2.5	2.5	2.5	2.5	-0.6	2.1	2.4
Private Fixed Investments	5.0	4.1	4.2	6.7	7.6	10.6	10.6	10.7	-18.3	3.1	7.9
Residential	-3.9	0.0	4.1	7.2	10.4	21.6	21.6	21.6	-20.4	1.3	12.4
Non-residential	7.6	5.2	4.2	6.6	6.9	7.7	7.7	7.7	-17.7	3.6	6.7
Change in inventories ($bn, rea	0.0	10.0	15.0	15.0	15.0	15.0	15.0	15.0	-107.6	10.0	15.0
Change in inventories [1]	0.5	0.3	0.1	0.0	0.0	0.0	0.0	0.0	-0.6	0.9	0.0
Public Consumption	2.0	1.6	1.2	0.8	0.0	-0.6	-0.6	-0.6	1.9	1.5	0.2
Exports	17.0	10.4	8.2	7.2	8.2	9.3	9.3	9.3	-9.6	13.6	8.6
Imports	12.6	8.2	7.2	4.1	5.1	6.1	6.1	6.1	-13.9	10.1	5.7
Net exports [1]	0.2	0.0	-0.1	0.3	0.3	0.2	0.3	0.3	1.0	0.1	0.2
Unemployment rate (%)	9.7	9.6	9.4	9.2	9.0	8.8	8.6	8.4	9.3	9.5	8.7
CPI (y/y)	2.5	2.1	1.7	1.7	1.7	1.6	1.7	1.7	-0.3	2.0	1.7
Core CPI (y/y)	1.4	0.9	0.7	0.5	0.8	0.9	1.0	1.1	1.7	0.9	1.0
Public Budget [2]									-9.9	-10.6	-8.3
Public Gross Debt [2]									83.8	93.2	98.3
Current Account [2]									-3.0	-3.4	-3.2
Fed funds rate [3]	0-0.25	0-0.25	0-0.25	0.75	1.00	1.00	1.00	1.00			

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

Source: Ecowin and Danske Bank

Euroland

The weakest link

- **In recent months we have seen several indications of lacklustre growth in Euroland and the news that GDP hardly grew in the last quarter of 2009 was pretty terrifying.**
- **If Euroland slides back into a double dip at the current juncture not much can be done. The gas pedal is already at full speed with the loosest monetary and fiscal policy ever.**
- **Fortunately most forward looking indicators give more upbeat signals. Exports are likely to be a key driver of growth in the coming quarters. We expect the economic recovery to continue, but due to a weak Q4 reading, we lowered our GDP projection for 2010 to 1.8% y/y. This is still above the consensus projection of 1.3% y/y.**
- **The fiscal chaos in Greece has been a key driver of the financial markets. Greece is now moving in the right direction as it has put rather ambitious austerity plans forward.**
- **ECB will continue with its exit strategy for non-standard measures. We expect a first interest rate hike in Q1 2011. Inflation will remain low in both 2010 and 2011.**

Overview

Euroland growth was surprisingly weak in Q4 2009 with GDP growing a mere 0.1% q/q. France saw highest growth (0.6% q/q) among the larger euro area members, while Germany saw a flat GDP. Spain remained in recession (-0.1% q/q), while Italy slipped back into recession (-0.2% q/q) after a more impressive Q3 reading of 0.6% q/q.

The breakdown of growth in Q4 indicates that overall domestic demand excluding public spending remains weak and is pulling down activity, while public consumption stayed strong in Q4 supporting growth. Net exports contributed positively to economic activity in all major countries. Germany benefitted in particular from rising exports to the non-euro area, as exports to Asia have accelerated sharply in recent quarters. Despite the tiny growth unemployment has been stable at 9.9% over the past three months.

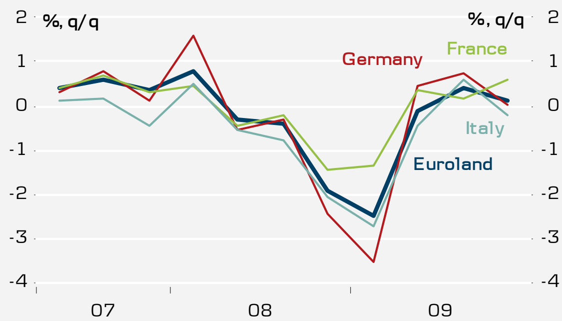
The latest data for retail sales and industrial production have been disappointing too. This bodes for a somewhat weak Q1 2010. It is difficult to gauge the effect from the hard winter across Europe, but we suspect that if anything it has been a drag on activity over the past couple of months.

While downside risks for Europe clearly have risen in the past months, we take comfort in more upbeat signals from "soft data". Manufacturing surveys indicate that new export orders accelerate, while employment components support our view that a labour market stabilisation may not be as far away as indicated by the GDP data. German business and consumer expectation indicators have improved too.

Double dip?

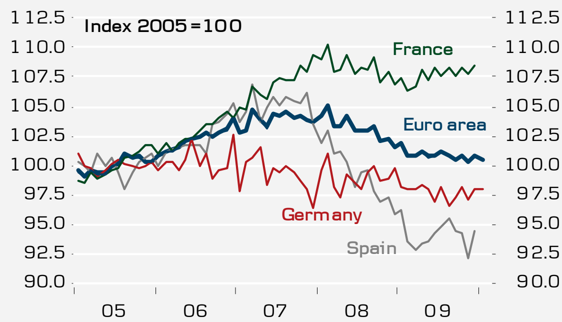
Source: Reuters Ecowin and Danske Markets

Terrifying lack of GDP-growth in Q4



Source: Reuters Ecowin and Danske Markets

Lacklustre retail sales



Source: Reuters Ecowin and Danske Markets

We have revised our growth projection for the whole of 2010 to 1.8% from 2.2%. The main reason is the base effect of the weak Q4 2009 GDP reading. Going forward we expect growth mainly to be supported by net exports, but we do also anticipate private spending and investments to gradually begin to lift economic activity during H1. We expect growth at 2.2% in 2011. This is an abnormally slow rebound, but growth is kept at bay by the fiscal tightening that will take place across Euroland.

Downside risks to our growth projections have in general increased. There is a significant risk that supportive measures will be withdrawn before domestic demand gathers momentum and labour markets stabilise.

Is Euroland in for a double dip or "just" falling behind?

In recent months we have seen several indications of lacklustre growth in Euroland and the news that GDP growth was "next to nothing" in Q4 was plain terrifying. Industrial production was on a strong upward trend from April to September 2009, but it then headed south and the latest figures show that industrial production in January 2010 was below the September 2009 in Germany. Retail sales are on a declining trend too, which was underlined by a 0.5% m/m decline in January. Manufacturing new orders in December were stable in Euroland, but fell notably in Germany. In January, German orders data however improve substantially.

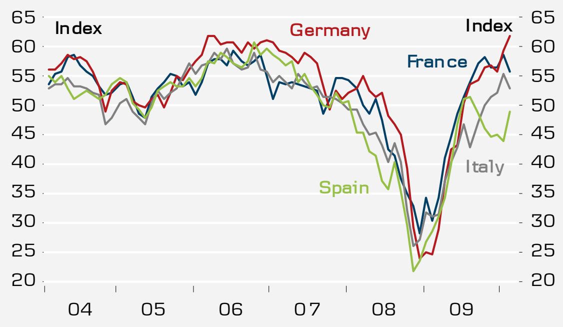
If Euroland slides back into a double dip at the current juncture not much can be done. The gas pedal is already at full speed with the loosest monetary and fiscal policy ever. Not much more stimulus can be added. On the contrary, the next step is to take the foot away from the gas pedal – and with regard to the fiscal policy this will have to be done sooner rather than later.

What is really concerning is that if Euroland fails to show stronger growth in the coming quarters there is no chance that the labour market will stabilise and private consumption will not recover. We could then see a Japanese-like lost decade in Euroland. This is what keeps us awake at night.

Fortunately most of the forward looking indicators give more upbeat signals. German PMI manufacturing new orders index has risen strongly in recent months from an already high level of 55.9 in December 2009 to 61.7 in February 2010. This is at par with the peak in March 2006, and apart from that this is the highest level for the new orders index since 2000. This indicates sharply increasing German orders and production in early 2010 albeit from a low level. The aggregate Euroland manufacturing PMI new orders index shows the same development albeit at somewhat lower levels, as Spain, Greece etc are pulling the index down. Other upbeat indicators are the Ifo expectations index, which has risen for 14 months in a row and shows that production and export expectations on a three-month horizon are sharply increasing, and the OECD leading indicator for Euroland, which is still at a very high level.

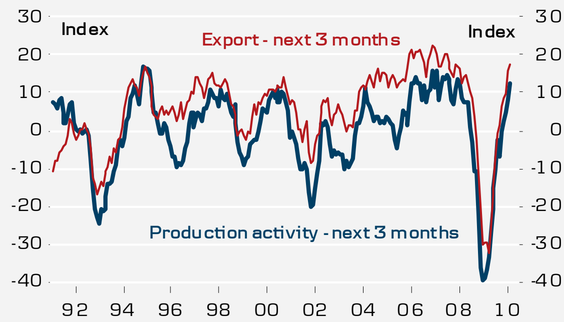
Export market growth is very strong at the moment and the euro has weakened notably. The prospect is thus that exports will be a key driver of growth in the coming quarters. Euroland manufacturing PMI new export orders thus jumped from 53.8 in January to 56.0 in February 2010. The order-

Manufacturing PMI new orders are more upbeat



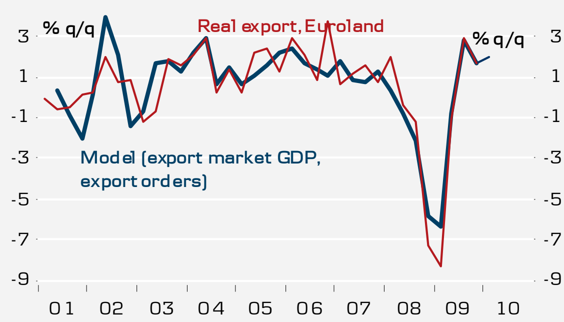
Source: Reuters Ecowin and Danske Markets

Ifo expectations are sharply increasing



Source: Reuters Ecowin and Danske Markets

Export markets are pulling Euroland up



Source: Reuters Ecowin and Danske Markets

inventory balance still indicates that we can also expect a positive growth contribution from the inventory cycle in the coming quarters.

Another positive thing is that the labour market stabilisation may not be as far away as the dismal GDP growth data seem to indicate. For the past three months the unemployment rate has been unchanged at 9.9% although the number of unemployed is still increasing at a slowing pace. Manufacturing PMI – traditionally a good indicator of unemployment – indicates that a labour market stabilisation is imminent. The PMI employment indices have improved notably, although they still indicate further increases in unemployment. Unemployment is a strong driver of private consumption, so a stabilisation of the labour market will be a critical turning point for domestic demand. One more positive signal is that lending for house purchases is improving, driven by low interest rates, which also tends to signal that an improvement in private consumption is forthcoming.

In conclusion we are relatively optimistic that exports and the inventory cycle will be able to drive growth for a couple of quarters and that a labour market stabilisation is not that far away. The housing market is also seeing better days, driven by the very low interest rates. These factors will fuel a slow recovery in private consumption. Strong exports and an improved outlook for construction will also drive investments upwards. We expect to see strong investment growth later this year. Euroland is falling behind the US and Asia, but it does not look like a double dip at the moment. However, downside risks have increased and the urgent need to tighten fiscal policy in some countries before sustainable growth has returned is worrisome. We will not sleep well at night before we see reliable evidence of a recovery in domestic demand.

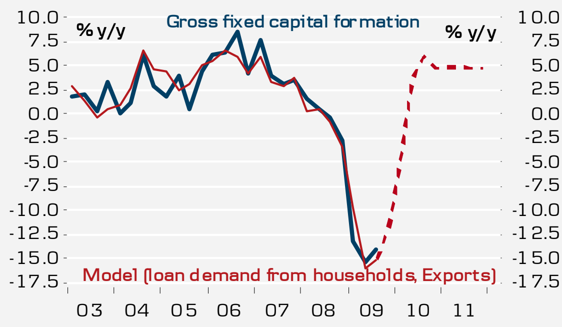
Fiscal crisis in Greece

We have made projections of debt developments across Euroland until 2020 in the research paper "*Debt on a dangerous path*", 4 January 2010. In a no-change scenario Greek government debt will hit 238% of GDP in 2020 up from the current estimated 113% of GDP. The calculations also show that for most countries it will be almost impossible to fulfil the Stability and Growth Pacts 60% debt-to-GDP criteria within a decade. Greece would have to tighten the budget by 4% of GDP, not just in 2010 as planned, but every year for five years in a row in order to achieve this.

But what is most important for now is not to fulfil the Stability and Growth pact's criteria, but to regain market confidence and get access to funding on normal terms. In this respect Greece is moving in the right direction as it has put rather ambitious austerity plans forward. There have been strikes, but public support for necessary tightening is not as absent as one might think. A poll has shown that 75% of Greeks think there should be no strike action until the crisis has passed and 57 % thinks that the belt-tightening is going in the right direction.

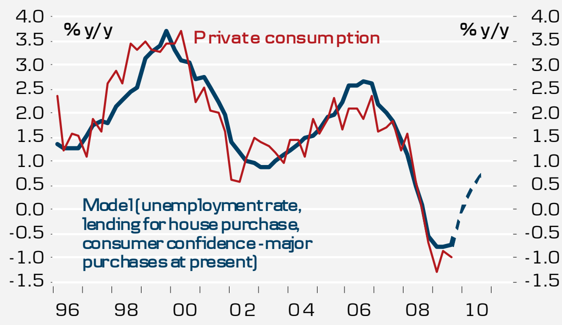
Greece has so far received nothing but verbal support from the rest of Euroland. The Commission, the Council and the ECB have sent mixed messages as they wanted to assure the market that Greece would not default while at the same time telling Greece to solve the problem on its own. A

Investments will soon recover



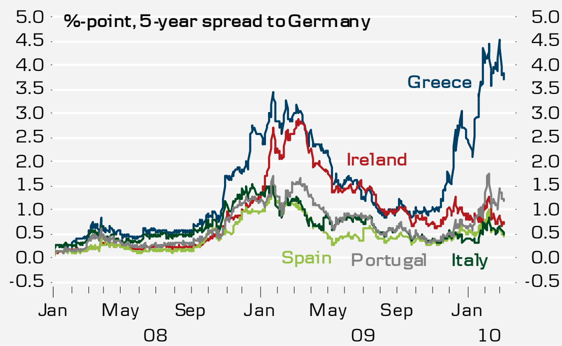
Source: Reuters Ecowin and Danske Markets

Labour market stabilisation will support private consumption



Source: Reuters Ecowin and Danske Markets

Greek spreads have widened further, but there are no signs of contagion



Source: Reuters Ecowin and Danske Markets

rescue package involving German KfW buying Greek bonds is most likely ready to be implemented, but there is still a hope that Greece can handle this on its own. If Greece is rescued there is a moral hazard problem and the solution is probably closer fiscal monitoring and a more strict application of the rules. If on the other hand Greece is allowed to default contagion is likely. The EU will not let that happen.

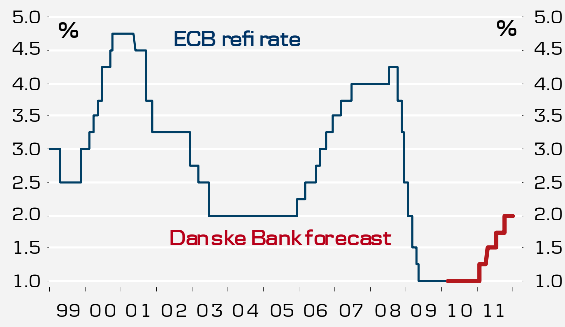
ECB on the exit path

Looking at the economic analysis the ECB still expects a very slow economic recovery and low inflationary pressure. Inflation in both 2010 and 2011 is projected to be well below the ECB's target. In addition, the monetary analysis is not sending any signals that the ECB needs to "lean against the wind" and hike rates.

The ECB announced at its March meeting that it will keep full allotment in place at its weekly main refinancing operations and at its one-month auctions until October. In this light we think that a hike in November 2010 is too early and we thus move our projection of a first hike to Q1 2011 (see *Flash Comment Euroland: ECB will not hike before early 2011,* 5 March 2010).

There will be headwinds from substantial fiscal tightening in most Euroland countries in 2011. We therefore expect that the ECB will hike the refinancing rate at a slow pace (by 0.25%-point every third month) bringing the refinancing rate to 2.0% at end 2011.

No hikes before Q1 2011



Source: Reuters Ecowin and Danske Markets

Macro forecast, Euroland

% Change q/q AR	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	Calendar year average 2009	2010	2011
GDP	2.2	2.7	2.4	2.3	2.2	2.1	2.1	2.1	-3.9	1.8	2.2
Private Consumption	0.0	0.8	1.2	1.4	1.6	1.6	1.7	1.7	-0.6	0.3	1.5
Private Fixed Investments	-0.4	3.5	4.9	5.1	4.9	4.6	4.4	4.2	-10.9	-0.1	4.7
Change in inventories [1]	0.9	0.8	0.1	0.0	0.0	0.0	0.0	0.0	-0.7	0.5	0.1
Public Consumption	1.8	1.8	1.8	1.7	1.6	1.5	1.5	1.5	2.2	1.7	1.6
Exports	7.4	7.1	6.3	5.6	5.0	4.8	4.8	4.7	-13.0	6.8	5.3
Imports	5.1	6.4	5.8	5.5	5.3	5.1	5.1	5.0	-11.7	4.9	5.4
Net exports [1]	1.0	0.4	0.3	0.1	0.0	0.0	-0.1	-0.1	-0.8	0.8	0.1
Unemployment rate (%)	9.9	9.8	9.7	9.6	9.6	9.5	9.5	9.4	9.6	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	1.0	1.5
Core CPI (y/y)	0.7	0.5	0.6	0.7	1.0	1.0	1.0	1.1	1.4	0.6	1.0
Public Budget [2]									-7.0	-7.2	-6.1
Public Gross Debt [2]									79.8	83.7	87.4
Current Account [2]									-0.7	-0.4	-0.6
ECB refi rate [3]	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00	1.00	1.00	2.00

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

Source: Reuters Ecowin and Danske Bank projections

Asia

Recovery still looks strong

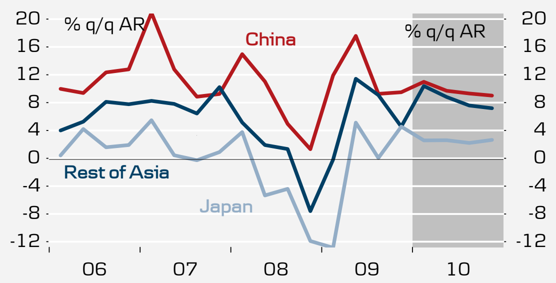
- **The recovery in Asia looks increasingly sustainable. Across Asia unemployment is declining, property prices are increasing and manufacturing investments are rebounding sharply on the back of surging exports and industrial activity.**
- **In addition, growth in Asia has become more broad based with growth momentum currently strongest outside China and Japan. Our 2010 GDP forecast for India, Indonesia, South Korea and Taiwan has been raised, China is largely unchanged, while our forecast for Japan has been revised slightly lower**
- **In Asia excluding Japan, GDP growth has overall been stronger than expected and the pace of the recovery is unlikely to ease in Q1 10. However, with the output gap closing fast, GDP growth is expected to gradually slow from Q2 10. In Japan, the recovery so far has been reasonably strong, but growth will slow substantially in Q1 10. However, a double-dip recession is unlikely in Japan.**
- **Inflationary pressure has started to emerge across Asia and, with the exception of Japan, inflation has increased more than expected. In Q2 and Q3 10, we expect most Asian central banks to start raising their leading interest rates and we expect China to resume its gradual appreciation of CNY in Q2. On the other hand, we cannot rule out further monetary easing in Japan.**

All well on the Eastern front

With the exception of India and South Korea, GDP growth in Asia was stronger than expected in Q4 09. GDP growth in Asia excluding Japan in Q4 09 declined to 7.5% q/q AR from 9.26% q/q AR in Q3 09, mainly because of the weak Indian GDP number in Q4 09. While the early recovery phase in Asia in H1 09 was to a large extent driven by China, the recovery has since become more broad based and currently the momentum appears to be strongest outside China and Japan in countries like India, Indonesia, Thailand, South Korea and Taiwan.

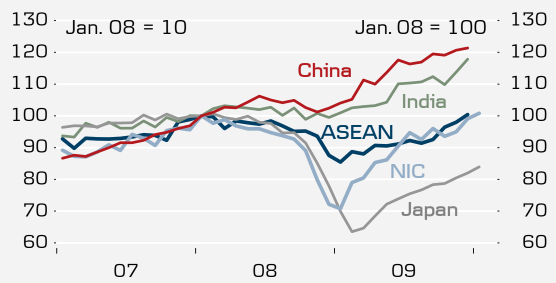
Besides Japan, there are few signs that the pace of the recovery has eased in Q1 10. GDP growth in China will probably increase slightly from 9.5% q/q AR in Q4 09 and data so far suggest GDP growth in India and South Korea will increase significantly in Q1 10. In fact, GDP growth in India might exceed 9% q/q AR in Q1 and Q2 – hence, we cannot rule out the possibility that India will be growing faster than China at some stage next year. For that reason, GDP growth in Asia excluding Japan is likely to again exceed 9.5% q/q AR in Q1 10. However, with the output gap closing fast and growth in exports gradually easing, we expect GDP growth to peak in Q1 10 and gradually ease to around 6.8 q/q AR by the end of 2010.

Forecast for GDP growth in Asia



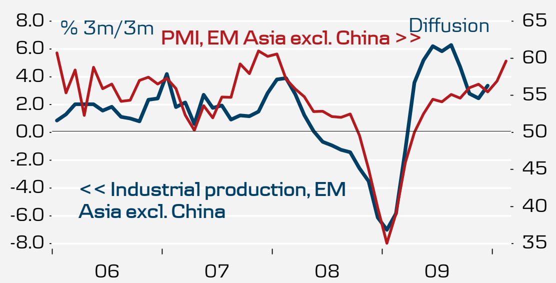
Source: Reuters Ecowin and Danske Markets

Industrial production has strong momentum outside China



Source: Reuters Ecowin and Danske Markets

Manufacturing PMIs suggest strong start to industrial production in 2010

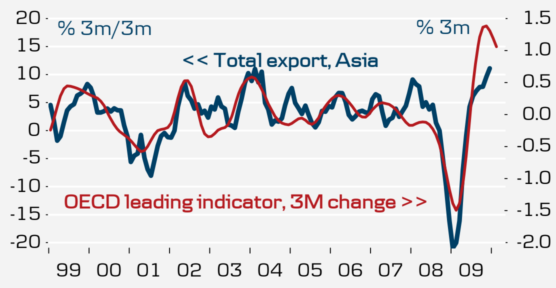


Source: Reuters Ecowin and Danske Markets

Recovery looks sustainable

The recovery in Asia looks increasingly sustainable. The recovery in exports has continued and hard export data so far show no signs that growth in exports has started to ease in Asia. Hard export data released for January and February so far has been strong. In addition, manufacturing PMIs outside China and Japan have improved substantially in recent months. However, as seen in the chart, OECD's leading indicator suggests that growth in exports will probably peak in Q1 10.

OECD leading indicator suggests growth in exports will peak in Q1 10

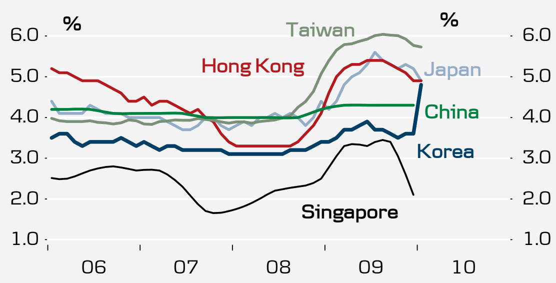


Source: Reuters Ecowin and Danske Markets

For the recovery in Asia to be self-sustaining, there needs to be sufficient strength in domestic demand within Asia. This is particularly the case when the positive impact from fiscal stimulus starts to wane. We believe three conditions need to be satisfied for the recovery to be self-sustaining.

First, we need to see the labour market turn and employment to resume growth. Labour market data in Asia are generally poor, but where we do have reliable unemployment data, they all show unemployment has started to decline (the sharp increase in unemployment in January in South Korea is weather related). Overall unemployment in Asia peaked in Q3 09. This is the case even in Japan, which remain the weakest link in Asia.

Unemployment has peaked across Asia

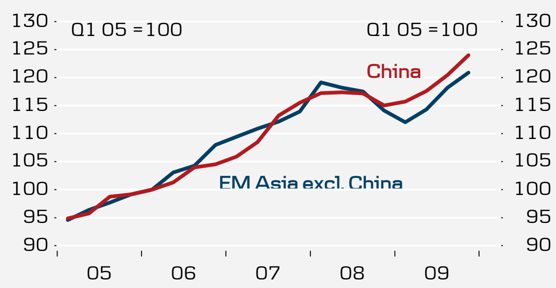


Source: Reuters Ecowin and Danske Markets

Second, we need to see a turnaround in the housing market. As can be seen in the chart, property prices in Asia declined in the wake of the global financial crisis, but have since rebounded sharply. Note that the development in house prices in China has actually not deviated markedly from the development in property prices in the rest of Asia, despite the fear of bubbles in property prices in Asia has mostly focused on. While the sharp rebound in house prices might create concern about asset bubbles, it will nonetheless be a boost to both private consumption and residential investments in Asia.

The *third* condition is a recovery in manufacturing investments. This has been regarded by many as possibly the biggest hindrance for a sustainable recovery because huge excess capacity was created in the wake of the global financial crisis. However, the output gap has since closed fast and manufacturing investments in machinery have surged. In South Korea for example, investment in machinery and equipment has so far increased by 32% from its trough earlier in 2009.

Sharp rebound in house prices



Source: Reuters Ecowin and Danske Markets

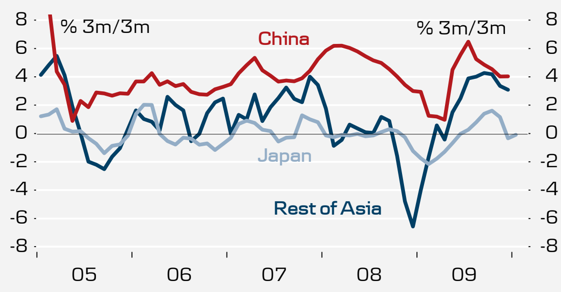
Growth to slow temporarily in Japan

Retail sales in Asia have remained relatively strong with the sharpest rebound happening outside Japan and China (see chart on next page). The recovery in Japan remains fragile despite a so far reasonably strong recovery with GDP growth on average close to 3% q/q AR from Q2 to Q4 last year. Measured on industrial production, Japan has now caught up with Euroland. However, compared with the rest of Asia, Japan has so far not seen a major improvement in investment demand. In addition, private consumption started to weaken substantially in late 2009 as the impact from fiscal easing started to fade and low year-end bonuses hit household incomes.

Unlike the rest of Asia, Japan's GDP growth will slow substantially in Q1 10 - in our view to just 2.2% q/q AR. However, in our opinion, Japan will avoid a double-dip recession. As mentioned above, employment in Japan is again increasing and wages are no longer declining. In addition, investments have at least stabilised and should start to increase in the coming quarters.

Our GDP forecast for Japan has been revised down slightly to 2.7% for 2010 mainly because our forecast for GDP growth in Q1 10 has been revised lower. However, our forecast remains significantly above consensus. In our view, Japan has mainly been hit by an external demand shock and as long as the global recovery continues, Japan's recovery should remain on track. Not least does Japan benefit from its larger exposure to the strong Asian markets compared with Europe and the US.

Retail sales in Japan takes another hit, rebound sharply outside Japan and China

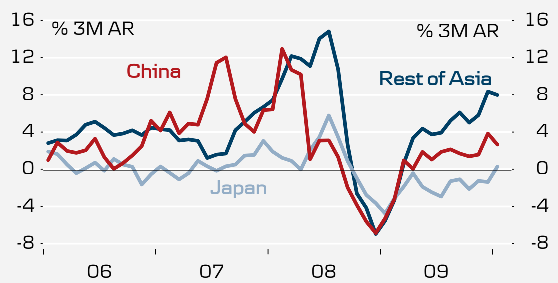


Source: Reuters Ecowin and Danske Markets

Inflationary pressure emerging across Asia

With the output gap closing fast, inflationary pressure has started to emerge across Asia – again with Japan as the main exception. Overall inflation has increased faster than expected and real interest rates have started to turn negative across Asia. For that reason, there is a completely different risk balance in Asia between higher inflation and lower growth compared with Europe and the US, and central banks in Asia consequently need to acknowledge that they cannot wait for the ECB and the Fed before they start raising interest rates. We do expect sense to eventually prevail and expect most Asian central banks to start raising interest rates in Q2 or Q3 10 starting with the Indian central bank in April.

Inflation on the rise across Asia; however, deflation resilient in Japan



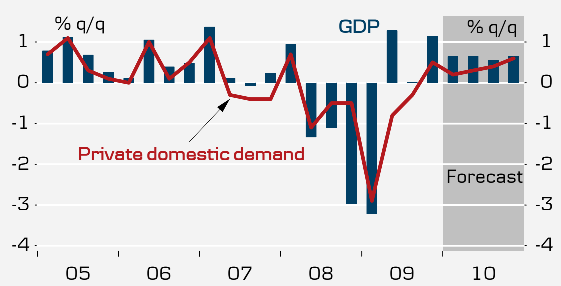
Source: Reuters Ecowin and Danske Markets

Deflation resilient in Japan and BoJ might ease further

Japan of course is a completely different story. While the recovery has continued, deflationary pressure in Japan has not eased as fast as expected. The relatively strong JPY and not least Japan's very weak competitive position against its main Asian competitors South Korea and Taiwan is a concern. We cannot completely rule out further monetary easing from Bank of Japan (BoJ). If BoJ eases further, it will be by providing liquidity at longer maturities in the money market at a fixed interest rate. BoJ already provides liquidity for three-month maturities at 0.1% interest rates and if BoJ eases further, maturities will probably be extended to six months.

BoJ is far from raising interest rates. A necessary condition for BoJ starting to raise interest rates is that the year-on-year inflation rate turns positive and in our view this is unlikely to happen until early 2011 and the risks mainly are that it will happen even later.

Forecast for Japan – growth will slow in Q1 10 on weaker domestic demand



Source: Reuters Ecowin and Danske Markets

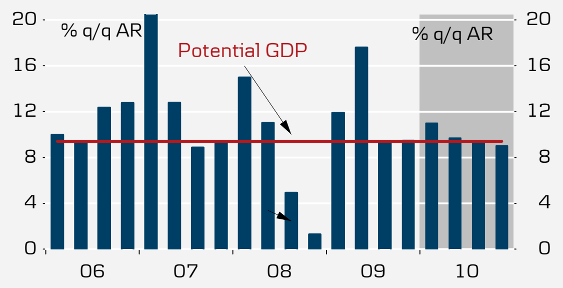
China – concern about overheating and asset bubbles

China continues to get most of the attention in Asia, albeit Asia is no longer just a Chinese growth story. Concerns about China have over the past years turned 180 degrees from fears about a collapse in growth in the wake of the global financial crisis to concerns about overheating and a possible asset bubble in the property market. Both threats are real but need to be put into perspective.

According to our calculations, GDP growth in China was around 9.5% in both Q3 and Q4 last year, which should be largely sustainable in the long run (see chart). Thus, the main challenge for China appears to be to prevent GDP growth from accelerating further.

Admittedly, it is extremely difficult to estimate how fast China can grow without generating higher inflation. This is not least the case because, as a consequence of the government's stimulus, there has been a major resource allocation from exporting manufacturers to construction. Labour productivity might be lower in construction and hence longer-term sustainable growth might now be lower in China because of this resource reallocation. This might be the reason why inflation is currently increasing despite GDP growth currently being close to what we would normally regard as sustainable.

GDP growth does not yet suggest China is overheating



Source: Reuters Ecowin and Danske Markets

Cautious unwinding of stimulus has started

China has already started unwinding some of its stimulus measures, but it is not the aggressive unwinding many in the financial markets apparently fear. In fact, it is a very cautious unwinding and the main risk could be it is too little too late. For example, the Chinese government is planning for credit growth to slow from 30% in 2009 to 17% in 2010. However, it is still credit growth exceeding nominal GDP growth and should be regarded as a comparatively accommodative monetary policy.

In addition, it should be remembered that the massive CNY4.0trn investment programme commenced last year is a two-year programme covering both 2009 and 2010. The high level of construction activity on investment projects will largely be maintained in 2010, while only a few new investment projects will be initiated this year. For that reason, there will be no major decline in construction activity until 2011. The big question is if the continued high level of construction activity from a macroeconomic point of view is consistent with a continued strong recovery in exports. As seen in the chart, exports in China are now close to being back at pre-crisis levels.

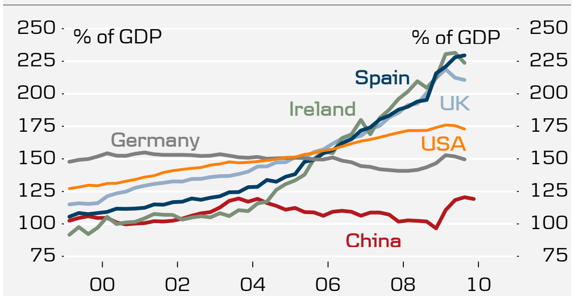
China's exports back at pre-crisis levels

Source: Reuters Ecowin and Danske Markets

What about the risk of asset bubbles? Some regard China as "one big ponzi game" or the "mother of all Dubais." So far we see little evidence of major bubble in the property market or the financial market, albeit they might emerge if economic policies are not adjusted sufficiently. That said, China looks more like Germany than Spain, Ireland or the UK if one looks at the amount of debt that has been created in recent years. True debt leverage has increased recently in China, but it still pales in comparison to what countries like Spain, Ireland, the UK and the US for that matter have experienced in recent years.

Consequently we believe that unsustainable inflation is the biggest near-term threat to the Chinese economy. We expect inflation in China to exceed 4% by mid-2010 and we believe this will kick off a real tightening process in Q2 10 including hikes in the leading interest rates and reserve requirements and a resumption of the appreciation of CNY.

Debt leverage – China compared with different developed economies



Source: Reuters Ecowin, IMF's International Financial Statistics

Asia macro forecasts

% Change y/y	GDP 2008	GDP 2009	GDP 2010	GDP 2011	CPI inflation 2008	CPI inflation 2009	CPI inflation 2010	CPI inflation 2011	Current account 2008	Current account 2009	Current account 2010	Current account 2011
Asia	5.2	3.6	6.9	6.8	5.7	1.6	3.9	4.0	4.5	3.2	3.5	3.7
Japan	-0.7	-5.1	2.7	2.1	1.4	-1.3	-0.7	0.3	3.2	2.8	4.0	4.5
China	9.0	8.7	9.5	9.5	5.9	-0.9	3.4	3.7	9.8	4.8	5.5	6.0
Asia excl. Japan & China	4.6	3.0	6.4	6.3	7.7	5.4	6.6	5.9	0.3	2.0	1.2	1.0
India	7.3	7.2	8.5	8.3	8.3	8.7	10.5	9.0	-3.1	-1.3	-1.9	-2.4
NIC	1.5	-1.2	5.0	4.8	4.5	1.1	2.4	2.5	4.6	6.4	5.9	5.9
South Korea	2.2	0.4	5.1	4.7	4.7	2.8	3.0	3.0	-0.7	3.4	2.2	2.2
Taiwan	0.1	-2.8	5.1	4.9	3.5	-0.5	1.5	1.5	6.4	7.9	8.0	8.4
Hong Kong	2.4	-3.2	3.8	4.3	4.3	-1.0	2.8	3.0	14.2	10.7	10.8	10.0
Singapore	1.1	-2.2	6.0	5.5	6.5	-0.2	1.6	1.9	14.8	12.6	12.5	12.9
ASEAN	4.7	1.5	5.4	5.3	9.3	2.7	4.9	4.8	2.0	3.3	1.9	1.8
Indonesia	6.1	4.3	5.8	5.5	9.8	4.8	6.8	7.0	0.1	1.6	0.8	0.8
Thailand	2.6	-2.3	4.5	4.9	5.5	-1.2	2.1	1.8	-0.1	4.9	2.7	2.3
Philippines	3.8	1.8	4.2	4.7	9.3	2.8	4.0	4.5	2.5	3.2	1.2	1.1
Malaysia	4.6	-2.0	6.1	5.5	5.4	-0.1	1.2	1.9	17.9	13.4	11.0	10.7

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.*

Disclosure

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First date of publication
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