

September 2009

# Global Scenarios

## Rising from the ashes

### Strong global growth in the coming quarters without help from consumers

- the inventory cycle, strong stimulus and improving financial conditions will deliver a huge boost

### Risk of a soft-patch by mid 2010 when consumers are needed to take over

- a recovery in jobs, an early investment cycle and strong growth in Asia will help to sustain the upturn

### Deflationary dynamics to remain in place for years

- accelerating growth, excess liquidity and higher energy prices could trigger near-term inflation concerns

### Central banks to remain dovish for a long period

- ECB could be the first G3 central bank to hike by next summer





# Intro

## In jobs we trust

- Growth indicators have been even stronger than we envisaged in *Global Scenarios* in June. Our forecast for global growth is therefore revised higher and we continue to look for stronger growth than consensus.
- We expect the next two to three quarters to be particularly strong. The main factors behind the rapid recovery in the coming quarters are: 1) A very strong inventory cycle; 2) Record stimulus starting to feed through to demand; and 3) Substantial easing of headwinds witnessed by a strong reversal in credit markets.
- While we see some soft patch in mid-2010 we believe that the initial kick start is big enough for job creation to return and hence for consumers to revive. We are therefore cautiously optimistic that the recovery will prove sustainable.
- The rebound is quite synchronous across US and Europe. Hence Europe will not lag this time. Asia will cool a bit but continue to grow strongly and play a more important role in global rebalancing.
- Inflation is not an issue but markets might not be convinced. Disinflationary forces continue from high unemployment rates and pass-through from lower commodity prices last year.
- Exit strategies will come more into focus but exits from governments and central banks are not likely before unemployment has declined for some time. The ECB will be first to hike among G3 central banks.
- The risk factors are the same as three months ago. These mainly stem from higher oil prices, a jobless recovery, renewed financial turmoil or a new sharp rise in the US savings ratio.

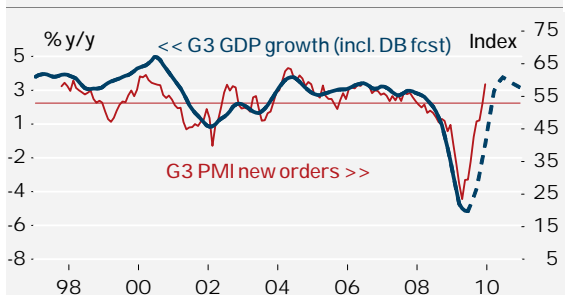
The data flow since the last *Global Scenarios* in June has generally confirmed our view of an earlier and stronger recovery than expected by consensus. We now foresee growth around 4-4½% (q/q annualised) in the US and 2-3% in Euroland over the next three quarters. Asian growth has been very strong in the first half of this year, but this has broadly been in line with our expectations. While we expect the Asian recovery to continue, growth is likely to moderate in coming quarters. Euroland has turned simultaneously with US in this cycle. The normal lag between US and Europe has not been in place this time. This is likely due to the global nature of the shocks hitting the global economies at the same time. The adjustments in the corporate sector shaping the cycle have therefore happened in a parallel move.

### Global growth forecasts

| % y/y                            | 2009        |           |      |      | 2010        |           |      |      |
|----------------------------------|-------------|-----------|------|------|-------------|-----------|------|------|
|                                  | Danske Bank | Consensus | IMF  | OECD | Danske Bank | Consensus | IMF  | OECD |
| USA                              | -2.3        | -2.6      | -2.6 | -2.8 | 3.2         | 2.3       | 0.8  | 0.9  |
| Euroland                         | -3.7        | -4.0      | -4.8 | -3.9 | 2.2         | 0.9       | -0.3 | 0.0  |
| Japan                            | -5.3        | -6.0      | -6.0 | -5.6 | 3.0         | 0.8       | 1.7  | 0.7  |
| China                            | 8.5         | 8.0       | 7.5  | 7.7  | 9.5         | 8.5       | 8.5  | 9.3  |
| <i>Change from previous fcst</i> |             |           |      |      |             |           |      |      |
| USA                              | +0.1        |           |      |      | +0.5        |           |      |      |
| Euroland                         | +0.2        |           |      |      | +0.2        |           |      |      |
| Japan                            | +0.9        |           |      |      | -0.2        |           |      |      |
| China                            | +0.0        |           |      |      | +0.0        |           |      |      |

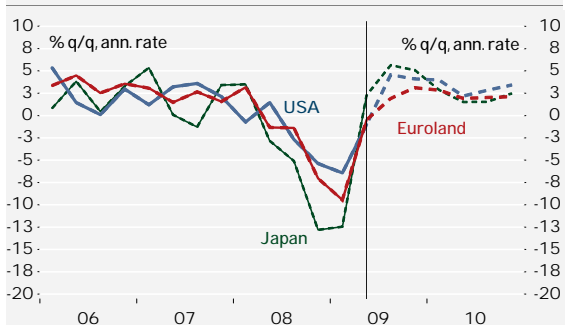
Source: Danske Markets, Bloomberg, OECD, IMF

### Global recovery under way



Source: Reuters Ecowin and Danske Markets

### Synchronous recovery



Source: Reuters Ecowin and Danske Markets

## Strong cyclical forces to kick-start the economy

Three strong forces are expected to give rise to a strong recovery in the coming quarters:

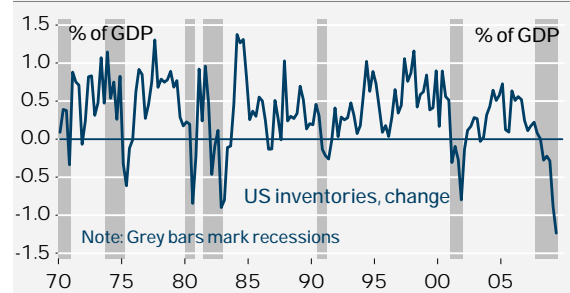
**An historic inventory cycle:** As the crisis hit very rapidly in the autumn of 2008 there was a very strong need to reduce inventories to free up liquidity. With demand falling strongly production had to be cut back substantially to lower inventories and this led to very extreme declines in production globally. The implication is that production is now running substantially below demand. With inventories leaner now production is starting to increase to catch up with demand. This is a normal pattern in the business cycle but has been much more pronounced in the current crisis. Importantly this is not a case of restocking: inventories will continue to decline for the rest of the year. It is purely a case of realigning production with demand. If restocking has to take place the pick-up in production would be even stronger than we forecast (see also *Research Global: A historic inventory cycle to boost growth*). However, given the extent of the crisis we believe businesses will aim to keep inventories at very low levels for some time.

**Record stimulus:** The amount of stimulus given by governments and central banks are also of a historical magnitude and the effect is likely to be increasingly felt. On the fiscal side tax cuts have already been implemented in the US, but have just taken effect in Germany, for example. A wide range of infrastructure investments are expected to start over the next year, which will likely have a more direct effect on demand than tax cuts that in the US case, to a large extent, have been saved by households. On the monetary side the sharp decline in interest rates is expected to start to feed through to the economy – mainly by giving support to housing markets.

**Reversal of shocks:** The credit crisis that led to the economic crisis has eased substantially. This is due to the wide range of rescue packages from governments and because investor risk appetite has been growing. Yields on corporate bonds have gone from extraordinarily high levels last year back to pre-crisis levels. This has reduced financing costs sharply. And the credit crunch in the corporate bond market last year has been exchanged with a flood of demand for credit bonds. By August, issuance of credit bonds in US and Euroland had surpassed the highest level of issuance in any full year. Hence while banks have tightened credit standards investors have been queuing up to lend money through the credit market. On top of this the quantitative easing by the Fed has led to historically low mortgage rates and liquidity provisions globally have worked to normalise money market rates this year from last year's high levels.

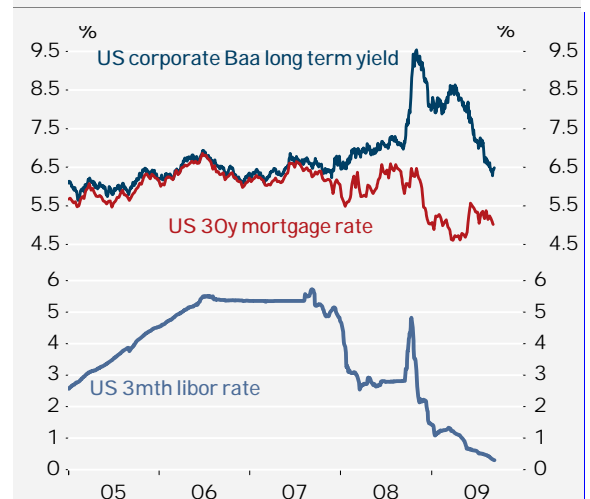
Hence, while some of the major headwinds have not disappeared, they have eased substantially. At the same time new tailwinds have gathered from the rising effect of economic stimulus. This will in our view pave the way for a strong kick start to the global economy.

The inventory cycle is of historical magnitude



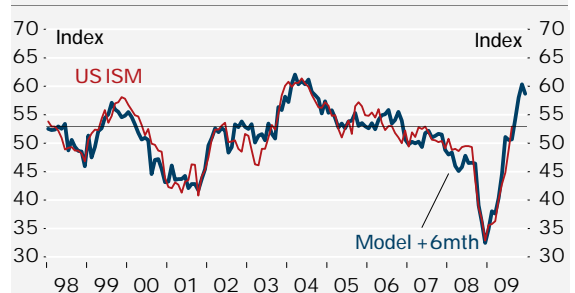
Source: Reuters Ecowin

The shock in credit and money markets reversed



Source: Reuters Ecowin

Model predicts ISM to reach 60 by end-year



Source: Reuters Ecowin

## First part of recovery does not need consumer demand

The initial phase of the recovery is expected to mostly be led by the corporate sector and the housing sector – and hence is not really dependent on consumers.

As mentioned above businesses will raise production to realign production with demand now that inventories are lean. But we also see signs that investment activity is picking up slightly from the current much suppressed levels witnessed by the rise in capital goods orders in G3 in past months. This is quite early in the cycle as investments normally lag the business cycle. However, it seems that after coming to a full stop last year some investment plans are coming out of the drawer due to the marked improvement of financial conditions. In addition investments will be underpinned by strong earnings growth in coming quarters as unit labour cost is falling rapidly and top-line growth will improve with higher GDP growth.

World trade is also starting to pick up. This has particularly been due to rising demand from Asia, but as more countries join the recovery industrial production will go up globally – and trade can be expected follow. Export demand can be expected to rise and this will be of particular importance for open economies. This is not least the case for Germany that would likely be one of the strong performers due to its very export-oriented economy – just as it was an underperformer when trade collapsed. We already see signs of export recovery in the sharp upturn in German export orders over the past three to four months (see *Research – Euroland: In Asia we trust*).

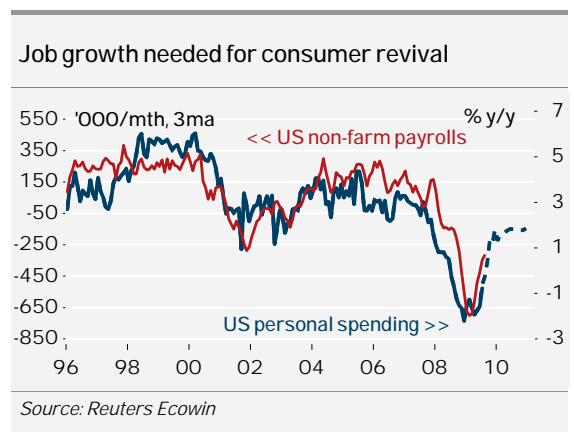
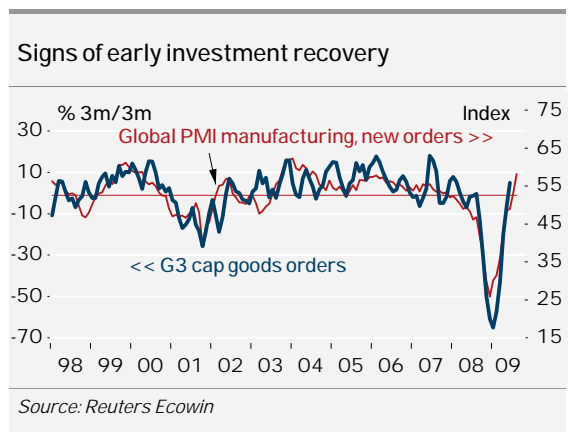
Just as economies drag each other lower through negative feedback effects, the economies are expected, in similar fashion, to get into a positive feedback loop once production turns. This is likely to be what we will see in coming quarters. We also see more indication that housing markets are bottoming globally. In the US a huge drag will be removed as construction activity bottoms out and it can be expected to start to turn into a boost during 2010 (see *Research USA: Gauging the potential from a turn in housing*)

## Initial boost to peak in Q1 – can consumers revive?

We expect the initial boost driven by the corporate sector to run into Q1 2010. This is a little further than consensus, but in line with what we have seen previously. Looking at historical recoveries from recessions the first strong phase tends to last about nine to 12 months from the end of recession before it peaks when the inventory cycle has run its course and the boost from stimulus starts to fade. In the US we will likely see ISM continue to rise in coming quarters but peak during the first half of 2010. Our ISM model now points to a level of 60 by year-end, which is in line with our expectations of US growth around 4-4½% over the next three quarters.

But after this initial jump in growth rates driven by the corporate sector consumers will have to revive for the recovery to continue. Structural consumer headwinds from deleveraging and wealth destruction are expected to continue to be strong, which means that a pick-up in income growth is crucial. In order for this to occur, job growth has to kick in early next year.

One of the key risks to our scenario would be a jobless recovery like we saw in 1991 and 2002. However, the main lesson from these two jobless recoveries was that job growth was mainly subdued because the initial



growth phase was very weak due to new strong headwinds. In all eight previous post-WWII recessions unemployment already peaked two months after the recession ended because growth was quite vibrant initially. If our scenario of 4%+ growth in the US comes through this will be much stronger than after the 1991 and 2001 recession and we believe job growth *will* follow this time. We expect US non-farm payrolls to reach 200,000-250,000 by mid-2010 (see *Research - US: Job recovery ahead*).

### Asia playing important part of global rebalancing

Asia was the last region coming into the crisis but was also the first to leave. Among some observers there was a belief that without US consumers to buy Chinese goods China would not be able to sustain growth. This has indeed been proved wrong. Chinese growth did collapse late last year – but this was only partly due to lower US consumption. It had as much to do with the sharp rise in inflation in 2008 and policy tightening to stem inflation which killed domestic demand.

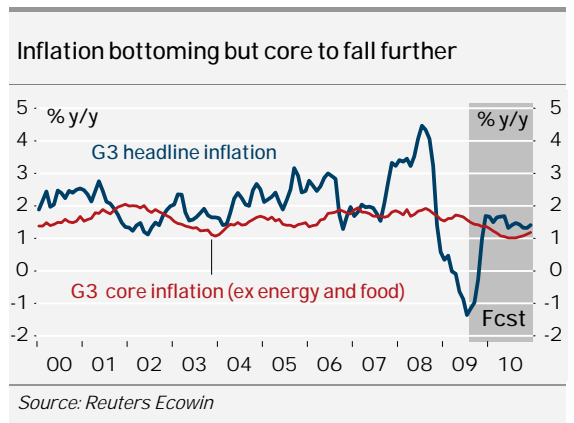
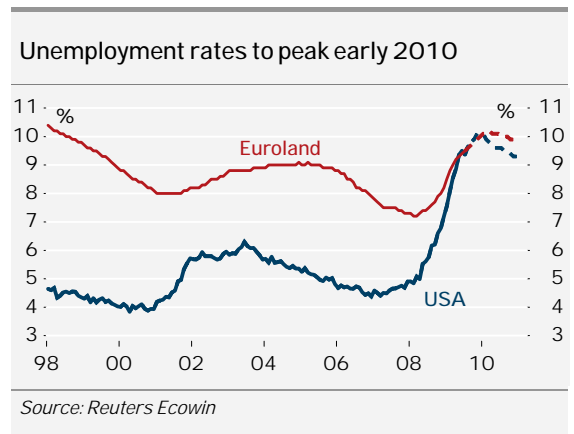
China has made an amazing comeback – without the help of US consumers – and has been a stabilising force in the world economy, contributing to strong recoveries throughout Asia. The factors behind this have been a sharp decline in inflation boosting real incomes and a forceful policy response through fiscal policy stimulus and monetary policy easing.

A key point on China is that before the collapse of US consumption China had to step on the breaks to dampen domestic demand because production for exports was growing so vibrantly. Instead China could have allowed a stronger appreciation of the yuan to dampen exports – but chose not to. The strong export growth has in some sense crowded out domestic demand – at least in the short run. With exports falling off a cliff China found room to focus on stimulating domestic demand. Hence Chinese growth is increasingly driven by domestic demand and will contribute to the global rebalancing.

Worries are starting over a new Chinese bubble after the Chinese stock market more than doubled from the lows and property prices in certain regions have gone up fast. However, we believe it is premature to talk about a bubble in China at this stage. The risk of one forming could come, though, if China does not rein in some of the abundant liquidity. Fortunately it is showing signs of doing this.

### Inflation not an issue – ECB first to hike

The outlook for inflation is in our view very benign, despite the massive quantitative easing. Unemployment is high and rising in most countries and pricing power is very low due to lack of consumer demand. Inflation rates are expected to rise from the current negative territory, but only due to the rise in oil prices. In excess money shows up in any prices it will likely be asset prices again – or commodity prices – rather than consumer prices. With low inflation pressures and a still fragile economy authorities are expected to be patient before exiting stimulus programmes. They will wait until growth is secured and this will require a period of falling unemployment. We believe ECB will be first among G3 to hike (first time in June) due to their stronger alertness to feeding new bubbles. The Fed is more scared of a Japanese scenario of a lost decade due to premature tightening and will likely be on hold throughout 2010.



### Key figure expectations

| Country  | Indicator       | Comment  | Measure      | Latest |   | Jan-10 / Q4 |
|----------|-----------------|--|--------------|--------|---|-------------|
| Euroland | GDP             | A strong rebound will take GDP growth above trend in the coming quarters         | % q/q, AR    | -0.5%  | ↗ | 3.1%        |
|          | PMI             | PMI continues to increase sharply  | Index        | 49.5   | ↗ | 58.1        |
|          | Inflation       | Inflation returns to positive territory  | % y/y        | -0.2%  | ↗ | 0.9%        |
|          | ECB             | The ECB keeps rates on hold  | % p.a.       | 1.00%  | → | 1.00%       |
| Germany  | Ifo             | The German economy will benefit from a rebound in global trade                   | Index        | 90.5   | ↗ | 99.5        |
| USA      | GDP             | A strong rebound will take GDP growth above trend in the coming quarters         | % q/q, AR    | -1.0%  | ↗ | 4.1%        |
|          | ISM             | ISM will improve fast and reach 60 before year-end                               | Index        | 52.9   | ↗ | 60.0        |
|          | Employment      | Job growth should be back in black by year-end                                   | 3 mth. mavg. | -318K  | ↗ | 90K         |
|          | Core inflation  | Core inflation will trend lower as slack in the labour market continues to build | % y/y        | 1.6%   | ↘ | 1.5%        |
|          | Federal Reserve | Fed on hold and no new quantitative easing measures                              | % p.a.       | 0.13%  | → | 0.13%       |
| Japan    | GDP             | GDP growth will be strong in the early recovery phase                            | % q/q, AR    | 2.3%   | ↗ | 4.8%        |
|          | PMI             | Manufacturing PMI activity will continue to improve                              | Index        | 53.6   | ↗ | 57.0        |
|          | Inflation       | Base impact from higher energy prices last year starts to wane                   | % y/y        | -2.2%  | ↗ | -1.3%       |
|          | BoJ             | BoJ on hold until late 2010, non-conventional easing will be removed earlier     | % p.a.       | 0.10%  | → | 0.10%       |

### Recovery road map

Below we highlight key macro drivers and what to expect for the main scenario to be on track

#### Macro signals

- Global business surveys:** We expect business surveys to continue higher over the coming quarters as the inventory cycle runs its course and demand picks up. We will continue to track the development in leading indicators in our monthly Global Business Cycle Monitor.
- US non-farm payrolls:** The pace of job losses has declined markedly already and we expect further improvement in the coming months. The kick-start to economic growth in Q3 and Q4 will ensure a turn in the labourmarket and we look for positive employment growth by year-end.
- Jobless claims:** Initial jobless claims have been fluctuating within a narrow range since late July while continuing claims have trended downwards. We look for a gradual decline in claims data over the coming months as production recovers.
- US retail sales:** Cash-for-clunkers will boost retail sales in Q3 and some payback is on the cards for Q4. A modest improvement should nevertheless be seen in underlying personal spending as we approach year-end and real incomes get support from growing employment.
- Consumer confidence:** Consumer confidence has not improved convincingly since the initial lift in sentiment in spring this year. We think that a new leg up in sentiment is due over the coming months as job losses taper off, housing markets improve and equity prices rise further.
- US housing:** The correction in housing activity over the past three years has taken both construction activity and home sales substantially below any long-term sustainable level leaving room for a significant rebound. There have been signs of both home sales and housing starts turning and we look for further improvement.
- Chinese PMI and industrial production:** We should maintain current decent levels of PMI. Industrial production has lost a bit momentum but should hold on to current levels and not lose further momentum.
- Commodity prices:** We should expect further rises in commodity prices as demand goes up. Oil prices is expected to go higher but it must not rise too much. Then it will be a threat to the recovery in 2010.

#### Financial signals

- Credit spreads:** As the financial healing has started, credit spreads have narrowed substantially. We should be able to hold on to current levels. A turn higher in credit spreads if financial turmoil comes back would threaten 2010 recovery.
- Equity markets:** We look for a bit more upside in global equity markets. A big set back would threaten sustainability.





# US

## Out of the woods

- A significant boost from the inventory cycle, fiscal stimulus, a turn in housing and a fast improvement in financial conditions will lift growth above trend in the current quarter and the following two.
- Positive job growth is key for underlying demand and the longer-term outlook. We expect employment to be back in black by year-end, but a moderate slowdown in growth in mid-2010 remains a risk.
- Headline inflation has troughed and will pick up to 2.5-3% by year end. Core will continue its gradual slowing, with a risk of dipping below 1% next year.
- The Federal Reserve will not accommodate further, but is set to remain on hold for a considerable while. Rate hikes will not be on the agenda before late next year at the earliest.

### Recovery on track for the coming quarters

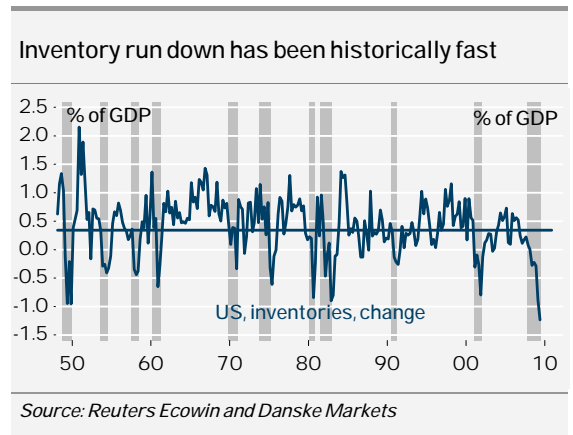
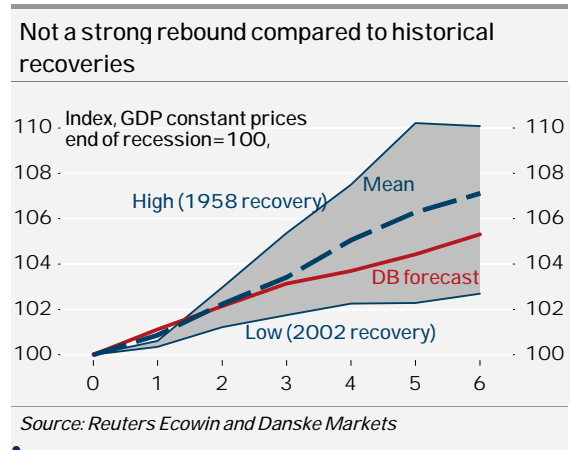
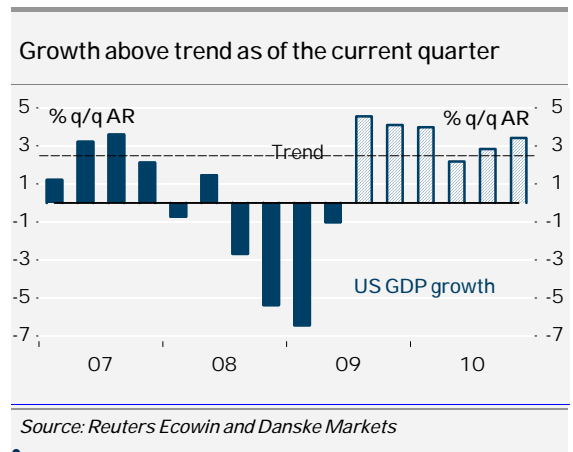
It is clear by now that the US economy is recovering from the recession at a speed that is even faster than we anticipated three months ago. From being mostly confined to the manufacturing sector, the evidence of improvement has grown stronger in other areas as well, most notably in the housing market and business investments outside structures.

Consequently, we have revised our forecast for the final quarters of 2009 and the first quarter of 2010 up to 4.6% q/q AR, 4.1% q/q AR and 4.0% q/q AR respectively, but continue to see risk of a moderate slowdown in mid-2010. This leaves annual GDP growth in 2009 at -2.3% and at 3.2% in 2010.

### More upside from the manufacturing sector

The recovery in the manufacturing sector that we have argued for since early this year is well underway. The large gap between demand growth and production growth is still far from closed and the process has further to run. We believe that the manufacturing recovery will prove stronger than the current consensus view. We look for the ISM index to reach 55-60 over the coming three months and to stay in this interval at least until year-end.

Part of the pick-up in production seen lately can be attributed to the auto sector as the “cash-for-clunkers” incentive scheme has unleashed a chunk of pent-up demand for autos (see *Research US: Auto sector to boost H2 growth*). However, evidence of improvement is by no means confined to the auto industry. In the latest ISM report 13 sectors reported growth in new orders and production while only three reported contraction.



## Housing turnaround

The correction in housing activity over the past three years has taken both construction activity and home sales substantially below any long-term sustainable level leaving room for a significant rebound (see *Research USA: Gauging the potential from a turn in housing*).

Housing fundamentals have turned considerably more positive over recent months and signs of stabilisation in the housing market have already emerged. We expect home sales to recover to the underlying trend over the coming six to eight quarters, and residential construction to turn from a considerable drag on GDP growth to contributing on average 0.6pp each quarter from Q3 this year throughout 2010.

House prices are in the process of bottoming and we look for positive growth in 2010. Unless home sales turn out even stronger than we anticipate, we do not envisage much of an increase in 2009 though. But the impact should not be underestimated. Just a stabilisation will remove a large factor of uncertainty from households and banks' balance sheets.

## Financial conditions improving fast

In general, financial conditions have turned considerably more supportive for growth over the past six months. Credit spreads have narrowed significantly, mortgage rates are at a low level and money markets have come a long way in the normalisation process. On top of this, equity markets have performed well and the S&P 500 is now up almost 50% from the bottom in March. Much of this improvement has been facilitated by accommodating intervention from US authorities and we expect both fiscal and monetary policy to stay supportive for growth for the next many quarters.

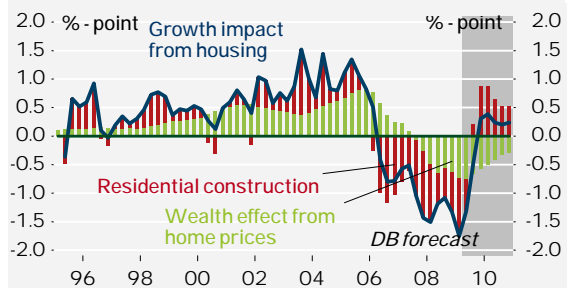
## No jobs, no consumption

The combined lift from residential construction, the inventory cycle and fiscal stimulus should be enough to ensure above-trend growth through Q1 next year. However, when the boost from the inventory cycle and fiscal stimulus fades, final demand, in particular private consumption, will be needed for the recovery to be sustained.

The labour market is crucial for the outlook for personal consumption. So far there have been few signs of improvement in consumer spending, as the crisis has left households in a very tough position. Firstly, the negative impact from the huge wealth losses and tight credit markets will linger for several more quarters. Secondly, the boost to income growth from tax rebates and transfers has already arrived. Finally, hourly wage growth will remain weak, probably decelerating, for several more quarters because of the major slack in the labour market. This leaves employment growth vital for underlying income growth.

Our main scenario is that growth above trend for the next 2-3 quarters will be enough to foster a return to positive private employment growth by late this year reaching about 200-250K persons per month by mid 2010. That would be sufficient to take consumption growth to 2% given relatively subdued inflation and some slight accommodation in the savings rate.

Residential construction turning from severe headwind to a boost



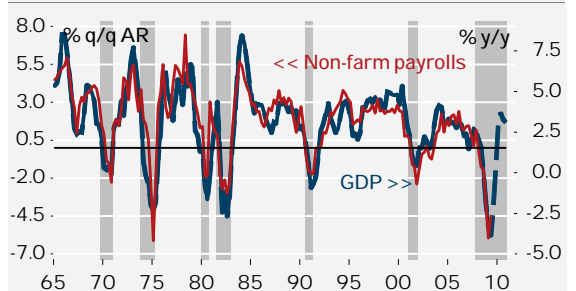
Source: Reuters Ecowin and Danske Markets

Financial conditions reversing fast



Source: Reuters Ecowin and Danske Markets

Job growth to return along with economic recovery



Source: Reuters Ecowin and Danske Markets

The biggest risk to this outlook is a new negative shock to real incomes most likely from a spike in oil prices. US consumers do not have the necessary buffer from net wealth to withstand new shocks. Another risk would be a new leg down in house prices or equities, which would put renewed upward pressure on the savings rate.

### Investment cycle could be turning earlier than usual

The latest data put equipment and software spending on track for a gain already in the current quarter, which is earlier than we had expected. Equipment and software spending has plummeted more than 20% over the past one and a half year leaving the long-run potential for a pick-up favourable. In the short run, business investments usually track GDP and employment growth closely. Given our forecast of above-trend growth as of Q3 this year and positive job growth by year-end, we expect the turn in business CAPEX to be sustainable and provide a lift to growth throughout 2010. On top of this, the sharp narrowing in the credit spreads is likely to fast-forward the recovery in business spending.

### Inflation: More headline, less core

Following a nosedive due to the plunge in energy prices during H208 headline inflation has now troughed. With oil prices almost doubled from early this year and base effects turning positive annual headline inflation is set to ascend quickly towards the 2.5%-3.0% range by year end. While it is possible that this could scare the markets, it will by no means reflect an intensification of the underlying price pressure.

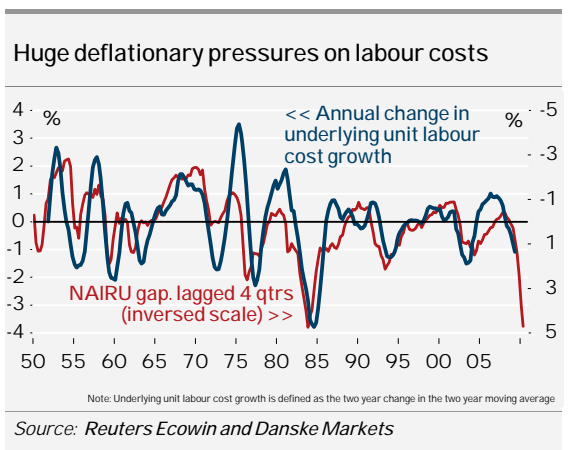
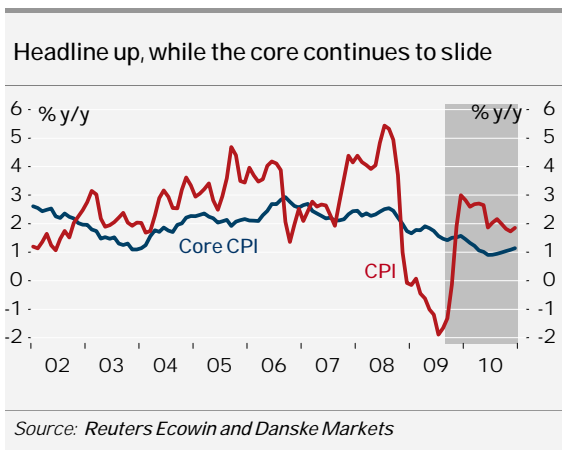
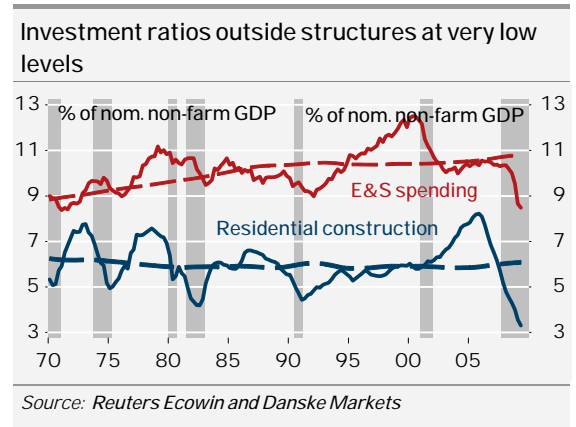
Although core inflation has, so far, been very slow to decline, significant deflationary forces are currently working their way through the price and wage chain. Firstly, the collapse in housing has led to a significant slowdown in imputed housing inflation. With interest rates low and vacancy rates high this component will stay low for a considerable time. Secondly, the impact from the collapse in raw material prices during last autumn has only now begun to show up in final goods prices. This will act to drive core PPI finished goods inflation into deep negative readings over the coming 12 months. Finally, the huge slack in the labour market is now creating significant downward pressure on wages. This is already visible in unit labour costs, which have entered deflationary territory and will continue to slow for the next several quarters. The only factor currently contributing positively to underlying inflation is the weak US dollar.

Going forward, core inflation will continue its gradual slowing with annual growth rates in core CPI reaching 1% - possibly below - by mid 2010.

### Fed: Better safe than sorry

In response to the crisis the Federal Reserve cut interest rates to near zero and expanded its balance sheet significantly to support liquidity in financial markets and credit flows in the economy. On back of the recent improvement in the financial conditions and signs that the economy is out of recession the central bank is not expected to implement further easing measures. Focus is now on the exit strategy.

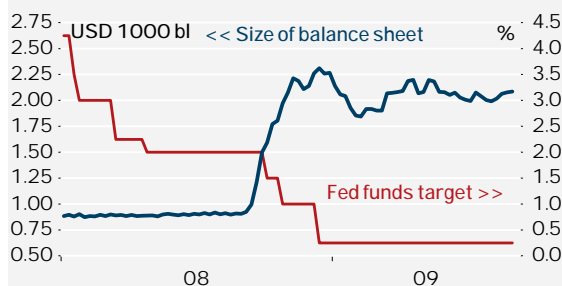
The first step will be to wind down the liquidity programmes, which by and large are set to happen automatically as conditions in money markets normalise. So far the liquidity programmes are scheduled to run through



March/June 2010. The next step will be outright tightening either in terms of selling back MBS, agencies or Treasury securities or by increasing the fed funds target rate and the interest rate paid on excess reserves.

Although we remain relatively optimistic on the economic outlook, we believe that the Fed will remain on hold for a long time. Firstly, the very low interest rates still provide much needed support to the US banking sector. Secondly, the strong deflationary forces from the large output gap and the huge slack in the labour market could take core inflation uncomfortably close to zero. Hence, the Fed will be 'better-safe-than-sorry' and postpone indications and/or talk of tightening until a self-sustaining recovery has been convincingly established. At the earliest hikes will come on the agenda in late 2010.

Fed to remain on hold for prolonged period



Source: Reuters Ecowin

US macro forecast

| % Change q/q AR                    | 2009   |        |        |        | 2010   |        |        |      | Calendar year average |        |      |
|------------------------------------|--------|--------|--------|--------|--------|--------|--------|------|-----------------------|--------|------|
|                                    | Q1     | Q2     | Q3     | Q4     | Q1     | Q2     | Q3     | Q4   | 2008                  | 2009   | 2010 |
| GDP                                | -6.4   | -1.0   | 4.6    | 4.1    | 4.0    | 2.2    | 2.8    | 3.4  | 0.4                   | -2.3   | 3.2  |
| Private Consumption                | 0.6    | -1.0   | 2.5    | 0.0    | 1.5    | 2.0    | 2.5    | 2.5  | -0.2                  | -0.8   | 1.5  |
| Private Fixed Investments          | -39.0  | -13.5  | 0.4    | 11.7   | 15.4   | 8.1    | 8.4    | 10.1 | -5.1                  | -18.0  | 8.2  |
| Residential                        | -38.2  | -22.8  | 8.2    | 36.0   | 36.0   | 26.2   | 21.6   | 21.6 | -22.9                 | -20.0  | 23.3 |
| Non-residential                    | -39.2  | -10.9  | -1.6   | 5.6    | 9.7    | 2.8    | 4.4    | 6.5  | 1.6                   | -17.5  | 3.9  |
| Change in inventories (\$bn, real) | -113.9 | -159.2 | -100.0 | -30.0  | 0.0    | 0.0    | 0.0    | 0.0  | -25.9                 | -100.8 | 0.0  |
| Change in inventories <sup>1</sup> | -2.3   | -1.4   | 1.8    | 2.2    | 0.9    | 0.0    | 0.0    | 0.0  | -0.3                  | -0.6   | 0.8  |
| Public Consumption                 | -2.6   | 6.4    | 4.1    | 2.8    | 1.9    | 1.9    | 3.1    | 2.6  | 3.1                   | 2.2    | 2.8  |
| Exports                            | -29.9  | -5.0   | 4.1    | 8.2    | 8.2    | 4.1    | 4.1    | 8.2  | 5.4                   | -11.9  | 5.5  |
| Imports                            | -36.4  | -15.0  | 3.0    | 7.2    | 8.8    | 8.0    | 8.0    | 8.0  | -3.2                  | -16.1  | 5.8  |
| Net exports <sup>1</sup>           | 2.6    | 1.7    | 0.0    | -0.1   | -0.3   | -0.6   | -0.6   | -0.2 | 1.2                   | 1.1    | -0.2 |
| Unemployment rate (%)              | 8.1    | 9.2    | 9.6    | 10.0   | 9.9    | 9.6    | 9.5    | 9.3  | 5.8                   | 9.2    | 9.6  |
| CPI (y/y)                          | -0.2   | -0.9   | -1.6   | 1.6    | 2.7    | 2.4    | 2.1    | 1.8  | 3.8                   | -0.3   | 2.2  |
| Core CPI (y/y)                     | 1.7    | 1.8    | 1.5    | 1.5    | 1.3    | 1.0    | 0.9    | 1.1  | 2.3                   | 1.6    | 1.1  |
| Public Budget <sup>2</sup>         |        |        |        |        |        |        |        |      | -3.2                  | -11.2  | -9.6 |
| Public Gross Debt <sup>2</sup>     |        |        |        |        |        |        |        |      | 68                    | 81     | 87   |
| Current Account <sup>2</sup>       |        |        |        |        |        |        |        |      | -4.9                  | -2.7   | -2.9 |
| 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 | 0.75 |                       |        |      |

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

Source: Reuters Ecowin and Danske Markets

# Euroland

## Ascending to the surface

- Over the past couple of months the economic recovery has played out pretty much as we anticipated with a strong rebound in confidence indicators and a pick-up in orders and exports.
- We now anticipate above-trend growth in the rest of 2009 followed by lower but also more broad-based growth in 2010. The recovery will be sustainable if domestic demand begins to pick up in early 2010.
- Unemployment could peak earlier and at a lower level than previously anticipated. We expect unemployment to peak in early 2010 at around 10.2%.
- Next summer the euro area will have recovered so much that the ECB will consider interest rates at historical lows as being inappropriate and will start hiking.

### Overview

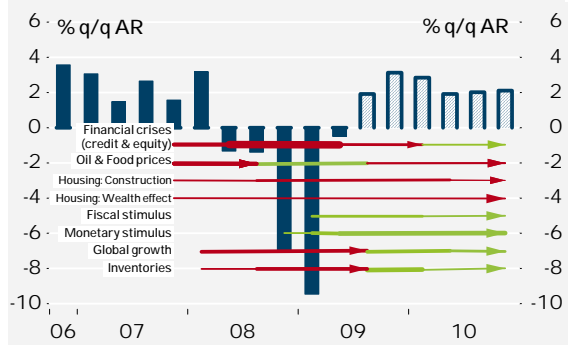
The European economy was descending towards the ocean floor at a dangerous pace in Q1 but managed to get almost neutral buoyancy in Q2. Euroland GDP only declined a modest 0.1 % q/q in Q2 and both France and Germany were already ascending towards the surface with GDP growth in positive territory. Inventories dragged growth down towards the bottom, but net trade gave an equally large push upwards as exports declined by less than imports. Both private and public consumption contributed positively too. The positive contribution from private consumption is good news, but it is important to keep in mind that consumption has been boosted temporarily by the 'cash for clunkers' programmes and other stimulus measures. Investment dragged growth down for the fifth consecutive quarter, although at a slowing pace.

Over the past couple of months the economic recovery has played out pretty much as we anticipated with a strong rebound in confidence indicators and a pick-up in orders and exports to Asia. Unemployment has increased sharply, but there are signs of an earlier stabilisation and at a lower level than we previously feared.

We continue to expect above-trend growth in the second half of this year as the inventory reductions are brought to an end and exports make a partial rebound pulled up in particular by Asian demand (see: *Research Euroland: In Asia we Trust*). We currently project GDP growth of 0.5% q/q in Q3 and 0.8% q/q in Q4. Despite this promising outlook for the rest of the year, overall growth in 2009 is set to be an historical low of about -3.7%.

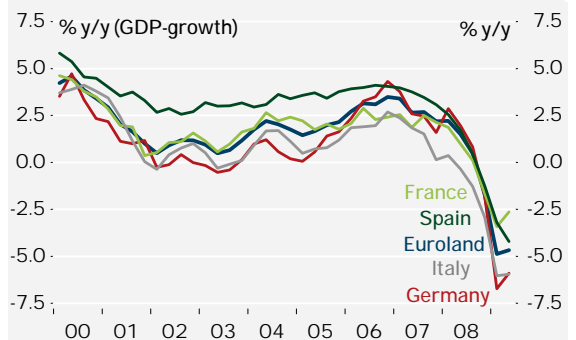
After a couple of quarters with a strong rebound from very low levels, we expect lower but also more broad-based growth. The recovery will only be sustainable if domestic demand (beyond the inventory cycle) begins to pick up in early 2010. We expect that it will, but are on the watch for signs that it won't. If domestic demand fails, we could get a nasty double-dip.

### Growth forecast



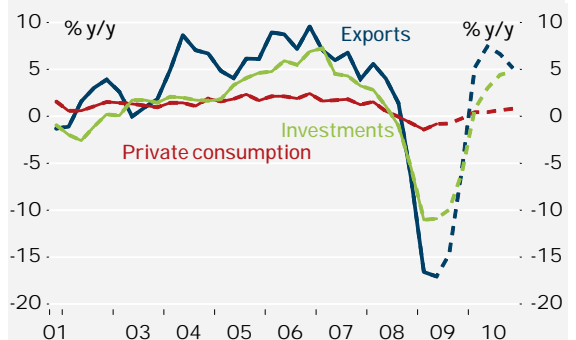
Source: Reuters Ecowin

### Descending towards the ocean floor



Source: Reuters Ecowin

### Exports rebound strongly



Source: Reuters Ecowin

Investments are projected to begin to rebound soon as companies are adjusting their expectations sharply upwards (from very depressed levels though). A precondition for private consumption to pick up is that the labour market begins to stabilise. We now expect that it might stabilise as soon as early 2010. Nevertheless, consumers will still face substantial headwinds. House prices continue to decline in many countries and be a drag on both private consumption and construction, although the negative impulse is fading. We forecast GDP growth next year of 2.2%, which is above trend, but still doesn't bring real GDP back to its 2007 level.

### Buoyant confidence signals V-shaped recovery

Business confidence is moving upwards at high speed. In August the Ifo-index showed the strongest-ever one-month gain, and PMI is now signalling expansion. ZEW is increasing sharply too.

The PMI manufacturing new orders index has increased while inventories of finished goods are almost at record lows and as a result the manufacturing new order-inventory balance is at a new record high level, signalling that the strong increases in manufacturing PMI will continue in the coming months and that the manufacturing rebound has just begun. German service PMI has also increased strongly, which signals that the recovery is not solely export and inventory driven.

Confidence within the banking sector, as measured by the Euribor-EONIA spread, improved in July and stabilised in August at levels not seen since early 2008.

### Exports to Asia rebound quickly

In many respects we should no longer expect the US to be the sole locomotive to pull Euroland out of the crisis. We should also look to Asia. We expect the strong recovery in Asia to continue. A return of Euroland exports to Asia to its previous peak level will lift Euroland GDP by about 0.35%. We project this to happen quickly and expect Asia to continue as a growth engine thereafter.

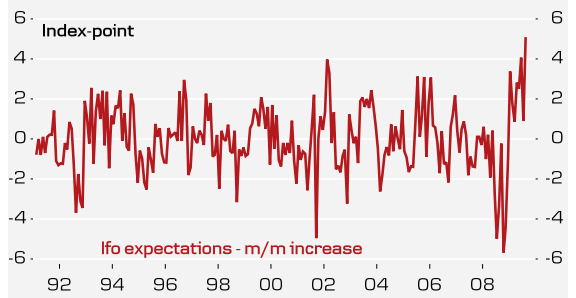
The Asian recovery will in particular benefit Germany, which is the most open of the large Euroland economies. A return of German exports to Asia to its peak level will add 0.6% to GDP. For France this would only add 0.2% to GDP. Looking further into the composition of exports, we see that Germany benefits from a favourable export mix with a high share of capital goods exported to Asia. This is likely to benefit Germany in the recovery phase.

### Domestic demand

National data indicate that car sales started to decline in July and we expect a further decline in European car sales as the 'cash for clunkers' programmes run out of money. The highly popular German car scrapping incentive scheme closed at the beginning of September. The French programme was expanded by EUR170m to EUR390m in July, but this will eventually close too (probably around the end of 2009). Retail sales should begin to rise slowly when labour markets stabilise and as a result we will see almost flat private consumption in H2 09 followed by a modest increase throughout 2010.

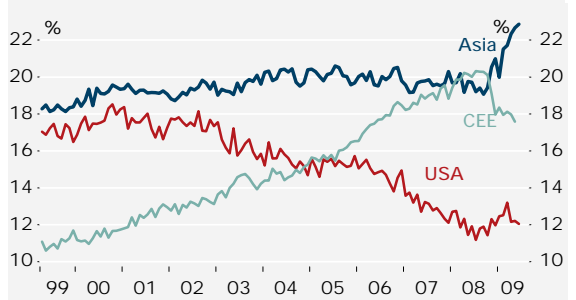
Private investments declined sharply in late 2008 and early 2009. The need for new investments is moderated by the abundant spare capacity available,

Ifo increased at highest speed ever in August



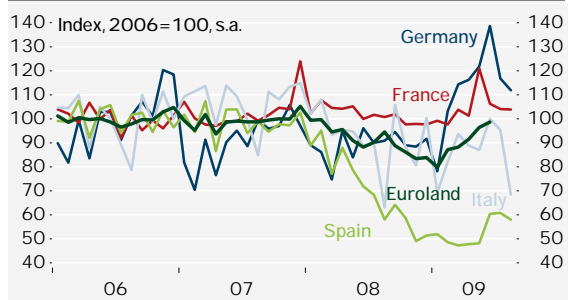
Source: Reuters Ecowin

Euroland export shares



Source: Reuters Ecowin

Car sales have peaked



Source: Reuters Ecowin

but investment growth is nevertheless expected to turn positive in Q4 09 as the economic recovery gains ground and orders and expectations improve further. Construction is an exception. We foresee that construction will decline throughout the forecast period.

## Unemployment

Unemployment in the euro area increased to 9.5% in July. The three-month increase in unemployment peaked in March and is quickly declining. Euroland composite PMI and new orders indicate that the pace of unemployment growth will decline further in the coming months and that unemployment could peak earlier and at a lower level than previously anticipated. We expect unemployment to peak in early 2010 at around 10.2%.

In Germany unemployment has been stable for the past four months. This is partly the result of widespread labour sharing. Anecdotal evidence indicates that employers are trying to avoid large-scale firing ahead of the German elections in late September. The stabilisation could thus be somewhat artificial and we might see a renewed increase in German unemployment in October.

## Budgets

Government budgets are heavily affected by the crisis due both to automatic stabilisers and discretionary fiscal easing. In Ireland the government has raised taxes in order to contain the deficit at about 10.7% of GDP this year and next. In Spain the deficit is also likely to surpass 10% of GDP this year. Nevertheless, in our current scenario, there is little reason to fear that any country within the euro area will default.

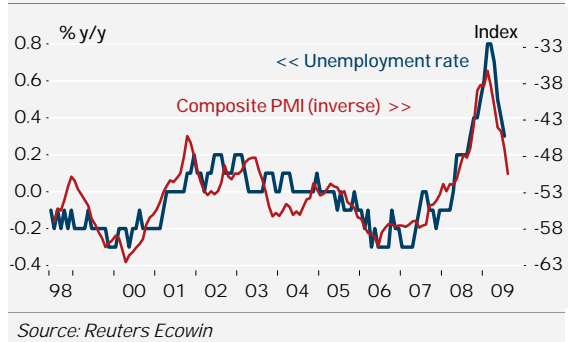
We project that the average budget deficit in Euroland will increase sharply from around 2% of GDP in 2008 to slightly below 5% of GDP in 2009 and just above 5% of GDP in 2010. As a result, average debt is increasing sharply and is expected to be around 80% of GDP in 2010. We do not expect to see significant fiscal tightening before 2011. In the medium term, the need to consolidate government budgets will dampen the growth potential.

## Monetary policy

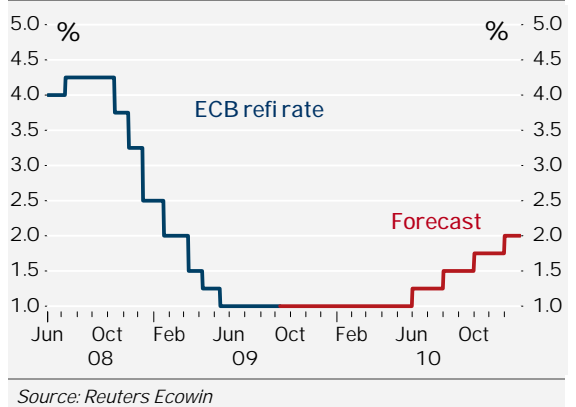
The ECB staff macroeconomic projections were revised upwards in September, but are still very downbeat. The mid-range point estimates were revised from -4.6% to -4.1% GDP growth in 2009 and from -0.3% to +0.2% GDP growth in 2010. This can be achieved by having 0.0% q/q GDP growth for the rest of this year and 0.1% q/q growth throughout 2010. If there ever was an L-recession this would be it. The upbeat data we have received in recent months does not look like an 'L' at all and we therefore expect that the ECB will have to revise its staff growth projections upwards several more times. Next summer the euro area will have recovered so much that the ECB will consider interest rates at historical lows as being inappropriate and will start hiking.

While the timing of interest rate hikes will depend on macroeconomic developments, the timing of the unwinding of the non-standard measures will depend on how fast the financial markets and the banking sector normalise.

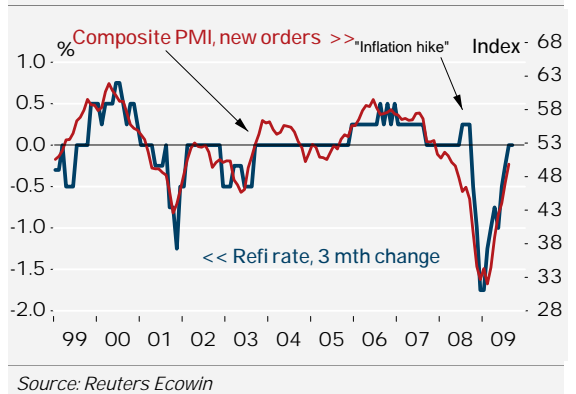
Pace of unemployment growth is declining



ECB hiking cycle begins next summer



ECB hiking speed



It is likely that a first step in an ECB exit strategy will be to alter the conditions for the long-term refinancing operations (LTRO) with guaranteed full allotment. Trichet announced at the ECB press conference in September that the 12-month LTRO in late September will be without a spread, but we think it is plausible that a spread will be included at the 12-month LTRO in mid-December. This is likely to be interpreted by the market as an indication that the ECB expects to hike the refinancing rate within the next 12 months. As a next step, the ECB could decide not to continue with new 12-month auctions in 2010 or it could decide no longer to have full allotment.

## Inflation

We expect that euro area inflation will increase to 1.2% in 2010 and will be around 1.5% in 2011. Core inflation will be on a declining trend from 1.3% in July 2009 to a bottom around 0.7% in spring next year and will then slowly recover.

### Macro forecast, Euroland

| % Change q/q AR                    | 2009  |       |      |      | 2010 |      |      |      | Calendar year average |       |      |
|------------------------------------|-------|-------|------|------|------|------|------|------|-----------------------|-------|------|
|                                    | Q1    | Q2    | Q3   | Q4   | Q1   | Q2   | Q3   | Q4   | 2008                  | 2009  | 2010 |
| GDP                                | -9.5  | -0.5  | 1.9  | 3.1  | 2.8  | 1.9  | 2.0  | 2.1  | 0.6                   | -3.7  | 2.2  |
| Private Consumption                | -2.0  | 0.7   | 0.1  | 0.4  | 0.6  | 0.7  | 0.9  | 1.1  | 0.3                   | -0.3  | 0.6  |
| Private Fixed Investments          | -19.5 | -5.0  | -1.1 | 3.2  | 6.2  | 3.8  | 4.5  | 4.7  | -0.7                  | -9.5  | 3.2  |
| Change in inventories <sup>1</sup> | -2.7  | -3.0  | 0.9  | 1.1  | 0.5  | 0.1  | 0.1  | 0.0  | 0.1                   | -0.7  | 0.3  |
| Public Consumption                 | 2.6   | 1.8   | 2.3  | 2.3  | 2.1  | 2.1  | 2.0  | 2.0  | 2.2                   | 2.3   | 2.1  |
| Exports                            | -31.0 | -4.3  | 8.0  | 11.2 | 6.5  | 4.2  | 4.8  | 5.1  | 1.1                   | -13.5 | 6.1  |
| Imports                            | -27.8 | -10.9 | 6.2  | 9.7  | 6.0  | 3.8  | 4.8  | 5.0  | 1.1                   | -11.9 | 4.9  |
| Net exports <sup>1</sup>           | -1.8  | 2.8   | 0.7  | 0.7  | 0.3  | 0.2  | 0.1  | 0.1  | 0.0                   | -1.0  | 0.5  |
| Unemployment rate (%)              | 8.8   | 9.3   | 9.6  | 9.9  | 10.1 | 10.1 | 10.0 | 9.9  | 7.6                   | 9.4   | 10.0 |
| CPI (y/y)                          | 1.0   | 0.2   | -0.4 | 0.3  | 0.9  | 1.0  | 1.3  | 1.4  | 3.3                   | 0.3   | 1.2  |
| Core CPI (y/y)                     | 1.6   | 1.6   | 1.2  | 0.8  | 0.8  | 0.8  | 1.0  | 1.2  | 1.8                   | 1.3   | 1.0  |
| Public Budget <sup>2</sup>         |       |       |      |      |      |      |      |      | -1.9                  | -4.7  | -5.2 |
| Public Gross Debt <sup>2</sup>     |       |       |      |      |      |      |      |      | 69.3                  | 77.1  | 82.1 |
| Current Account <sup>2</sup>       |       |       |      |      |      |      |      |      | -0.8                  | -1.7  | -1.5 |
| ECB refi rate <sup>2</sup>         | 1.50  | 1.00  | 1.00 | 1.00 | 1.00 | 1.25 | 1.50 | 2.00 | 2.50                  | 1.00  | 2.00 |

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

Source: Ecowin and Danske Bank projections



















