

Alternative 2: Strong rebound in demand

- In this scenario demand and global trade bounce back strongly in Q2 and Q3 as some basic credit flows are re-established, impact from global fiscal easing starts to kick in and the inventory cutbacks are finally brought to an end. As is not unusual when the contraction has been extraordinary sharp, the early phase of the recovery is very strong and GDP growth accelerates fast above trend.
- This scenario might prove to be a difficult balancing act for policy makers. With output gaps remaining significant we are unlikely to see central banks returning to a tightening bias. However, further interest cuts and quantitative measures could be off the cards as central banks might gradually start to focus on medium-term price stability.
- Market focus will increasingly turn to government bond supply and longer-term inflation. In addition expectations of quantitative easing will stop being an anchor for long-term bond yields. Hence, bond yields are likely to increase significantly in this scenario.
- Pressure on emerging markets will ease as risk aversion decreases, at least temporarily. With risk aversion decreasing and the market possibly starting to focus on imbalances in the US economy it cannot be ruled out that USD will start to lose some of its shine.

Demand recovers fast from extraordinary depressed levels

A difficult balancing act for policy makers

In light of the unprecedented decline in global demand it cannot be ruled out that demand rebounds strongly in the short run and GDP growth accelerates fast above trend. It is not unusual for countries experiencing extraordinary sharp contractions to have extraordinary strong growth in the early recovery phase as happened for most countries hit by the Asian crisis in 97/98.

In this scenario demand and global trade bounce back during Q2 and Q3 as some basic credit flows, for example within foreign trade and auto finance, are re-established. In addition we start to see the early impact from global fiscal easing and inventory cutbacks are finally brought to an end. In this scenario growth accelerates significantly above trend in the short run contrary to our main scenario in which we expect GDP growth to remain below trend for most of 2009.

However, a strong short-term rebound could prove to be a major policy challenge. At least in the short run it probably will restore some confidence in the market with risk aversion decreasing and commodity prices increasing. With output gaps still significant we are unlikely to see major changes in monetary and fiscal policy in the short run. However, with financial market awash with

liquidity central banks will start to at least consider medium-term stabilisation efforts. Further quantitative easing and even further interest rate cuts will be off the cards. Central banks will increasingly be concerned about preventing laying the foundation for the next bubble

In this scenario expectations for quantitative easing will no longer be an anchor for long-term interest rates and focus will increasingly turn to concern about government bond supplies and the possible inflationary impact from central banks' and government's stabilisation efforts.

With industrial activity recovering fast in the short run, higher commodity prices and lower risk aversion, pressure on emerging markets will ease. With risk aversion decreasing and the market starting to focus on imbalances in the US economy it cannot be ruled out that USD will start to lose some of its shine.

There is the risk that the recovery in this scenario will prove to be self-defeating and will end up being a false dawn. Deleveraging is an ongoing process and longer-term adjustment in savings will continue to weigh on demand in the longer term. In the end higher interest rates and "wait and see" monetary policies might contribute to growth slowing again, possibly below trend in 2010.

USA: Darkest before dawn

- During the last few months of 2008 the credit crunch hammered into an already fragile US economy leaving businesses and households in shell shock. The severity and global nature of the slowdown have left the US economy and financial system in an unusually bad state. Domestic and foreign demand has been imploding with a force not experienced for decades.
- Continued downward pressure from deleveraging, wealth destruction, credit tightening and negative recession dynamics, i.e. skyrocketing unemployment and business destocking, have kept the economy in deeply negative growth rates from early this year. This is set to continue into early Q2.
- In the middle quarters of the year a range of stabilising factors will kick in. A slower pace of credit tightening, an income boost from tax rebates and transfers, lower commodity prices and lower mortgage rates will act to stabilise demand. In combination with a slower pace of business destocking this will facilitate a recovery in the ISM index to the 45-50 range by mid-year.
- In H2 positive growth rates will return gradually fostered by a significant public spending boost, less negative labour market dynamics, less tight financial conditions and a beginning stabilisation in housing. The recovery will be moderate by historical standards due to ongoing balance sheet pressures, a slow revival of credit markets and little support from foreign demand growth. The economy will not return to above-trend growth before late this year or early 2010.
- Inflation will continue to decline. Headline inflation is expected to reach a trough of -2.5% by mid-year before ascending back towards 2%. Core inflation is on a longer-term downward trajectory heading for 1% by early 2010. Stable long-term inflation expectations, continued robust hourly wage growth, and a forceful policy response will prevent the economy from entering a long-term deflationary spiral.
- The Federal Reserve will keep policy rates unchanged at a close-to-zero level for a prolonged period. Further, the central bank is likely to continue the expansion of its balance sheet to ease the access to credit for the private sector as long as the credit markets remain dysfunctional.

Shell-shocked

The worst recession in decades

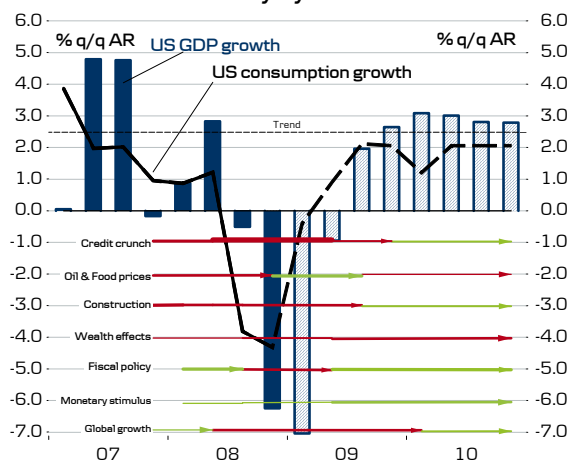
Over the past several months the US recession has grown unexpectedly deep leaving businesses and households shell-shocked. With Q4 GDP printing -6.2% q/q AR and the current quarter on track for a similar disastrous performance, the economy is currently facing a setback in economic activity of historical dimensions.

Even though signs of economic stabilisation are expected to mature during Q2, the economy is likely to contract throughout H1. This now leaves the year 2009 on track for a 2.7% decline in GDP growth and a peak in the unemployment rate of 9.4% by early 2010.

Looking into 2010 we remain optimistic that the bold policy responses and a diminishing drag on growth rates from the financial shock will be able to revive the economy (see below for further explanation). However, the recovery is likely to be

relatively moderate by historical standards, with GDP growth returning to above-trend growth not until late this year or early next year. Our annual-average growth estimate for 2010 is 2.5%.

A moderate recovery by historical standards



Source: Danske Bank & Reuters/Ecowin

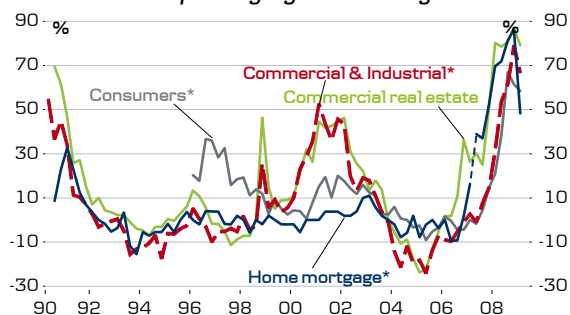
The risk to our forecast remains a more prolonged downturn, but a faster recovery once it materialises.

Less drag from credit, but more from wealth

There is little doubt that negative effects from the financial crisis will be lingering for a prolonged period, as it will take time to uncover all financial losses and recapitalise the banking system. The credit crunch is responsible for a large part of the extraordinary fast contraction in activity in Q4 and Q1 and we expect financial deleveraging to continue through 2009. However, a slowing pace of credit tightening will imply a fading drag on growth rates in the coming quarters.

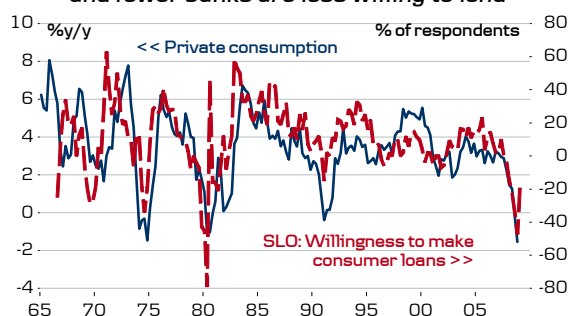
Firstly, the credit system is now approaching a point where it becomes more difficult to tighten access to credit. Simply because much of the tightening has already been done, i.e. consumer and housing credit are already contracting.

Fewer banks reporting tighter lending standards...



Source: Danske Bank & Reuters/Ecowin

and fewer banks are less willing to lend



Source: Danske Bank & Reuters/Ecowin

This is readily visible in the Fed's Senior Loan Officer Opinion Survey, with fewer banks now reporting tighter conditions and a diminishing number of banks reporting less willingness to lend.

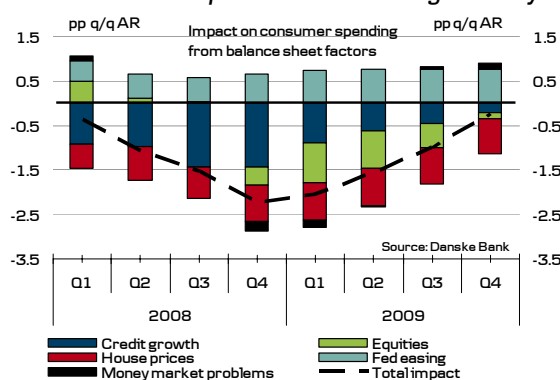
Moreover, there has been some improvement in credit markets, with spreads narrowing

considerably since late last year. This includes mortgage credit, long-term corporate credit and money markets.

Finally, the Federal Reserve has worked intensively to shore up the credit intermediation process by launching several credit facilities directly accessible for non-financial businesses. So far it has been successful in preventing a collapse in non-financial business credit and soon it will begin to provide credit to consumers.

While the drag from credit on growth rates is set to ease, the negative impetus from declining net wealth is set to intensify, as the impact from lower equity and house prices feeds through, c.f. below. Lower house prices are likely to put a brake on consumption for several years ahead.

Balance sheet pressures to ease gradually



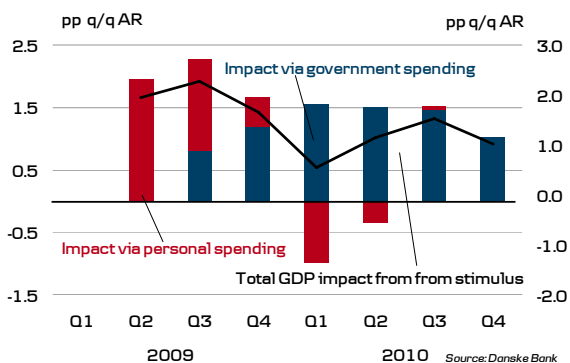
Source: Danske Bank

By historical standards, there will be little help from the balance sheet to generate a pick-up in demand growth in 2009. This is why the recovery is likely to be more moderate than usual.

A helping hand

With the monetary policy transmission mechanism out of order, fiscal policy has become an important instrument.

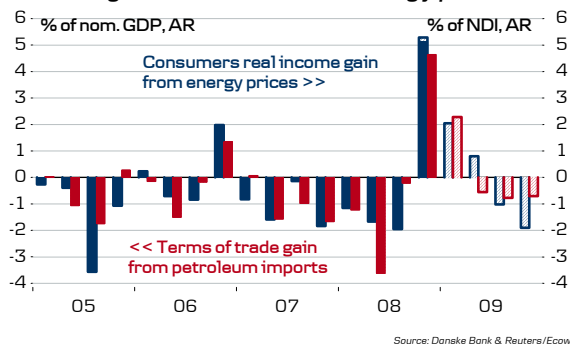
Stimulus to kick in very soon



To boost the economy, the US administration has signed a USD 787bn stimulus package for 2009 and 2010 (see [Research US: How much bang for the Obama buck?](#)).

On top of the fiscal stimulus package the economy - and in particular households - has received an enormous windfall gain from lower energy prices. Eventually this will help support domestic demand.

A significant boost from energy prices



Finally the significant drop in agency mortgage rates caused by Fed's USD 600bn purchase programme has and will in combination with the Foreclosure Prevention Plan initiate a wave of refinancing. This entails two positive spin-offs.

Firstly, households refinancing into lower mortgage rates will experience an improvement in purchasing power as the debt service burden falls. Secondly, lower mortgage rates in combination with the drop in house prices have taken housing affordability to an all time high. At some point, this will help to stabilise housing markets and remove the drag from falling construction spending during 2009. We continue to see falling house prices all the way into 2010, but some improvement in demand is likely by H2 this year (see [Research](#)

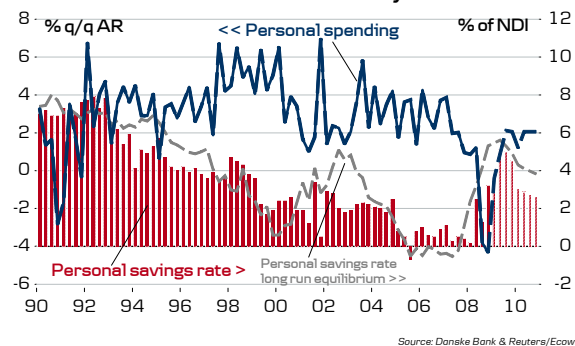
[USA: Housing adjustment has further to go](#) and [Global Scenarios - December 2008](#)).

Given the significant boost to purchasing power from all these sources, a scenario in which the savings rate moves higher and personal spending recovers moderately is feasible (see chart in the opposite column above).

Recession dynamics to turn milder

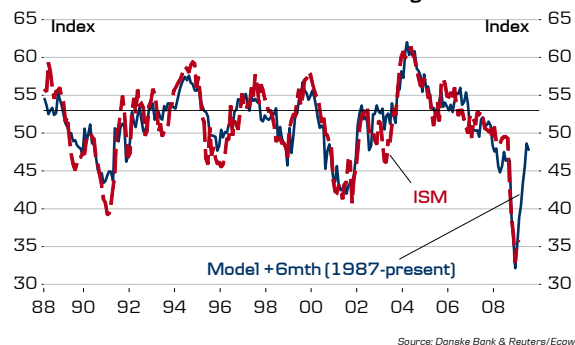
Recessions always come with their own negative (non-linear and unpredictable) dynamics. These involve inventory destocking, rising unemployment and suppressed demand. We believe these factors will turn milder in the coming quarters.

Balance consolidation to go hand-in-hand with a moderate recovery



Businesses are currently cutting back inventories at a very fast pace, which contributes significantly to the negative growth rate in Q1. As we emphasised in [Research USA: Manufacturing recovery ahead](#) the undershooting in manufacturing production will reverse during the coming quarters producing a pick-up in the ISM index to around 45-50 by mid-year. Hence inventories will turn from a significant drag into a considerable tailwind for GDP growth over the next few quarters.

Rebound ahead in manufacturing indicators



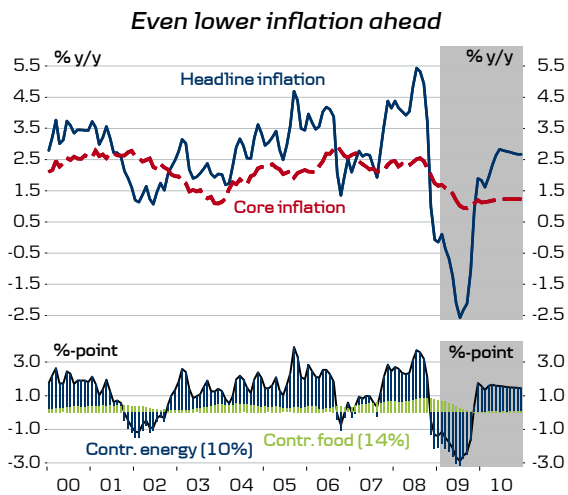
However, despite our expectation of mid-year stabilisation in manufacturing, the demand for investment goods will remain under pressure for a prolonged period. The path of the ISM as we go into H2 will largely be determined by the extent to which domestic and foreign demand will be able to recover.

Provided that the economy stabilises during summer, the pace of increase in the unemployment rate will gradually start to ease off. In turn this will remove a part of the upward pressure on the savings rate and give way to some of the pent-up demand that is currently being built up, i.e. vehicle and home sales.

Quantitative easing to continue

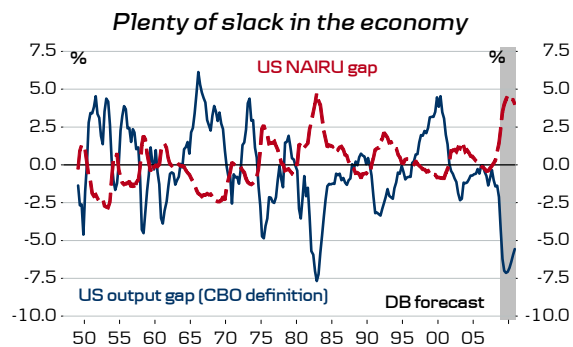
Plenty of slack to keep inflation permanently low

As the global recession deepened, commodity prices collapsed during H2. Most of this has already been absorbed in lower energy and food price inflation in the monthly headline inflation data. Due to a huge base effect, the annual inflation will continue to decline in the coming months reaching a trough at - 2.5% y/y by mid-year. Thereafter the headline is expected to ascend back to above 2%.



Source: Danske Bank & Reuters/Ecowin

Even with our relatively optimistic forecast, the recession will leave the economy with a significant output gap of around 6% and a peak in the unemployment rate of 9.4%. This will take several years to reverse.



Source: Danske Bank & Reuters/Ecowin

With that amount of slack in labour and product markets underlying wage and price pressures should be absent for the next many years. Hence, core inflation will continue its gradual downward trajectory. We expect the core to reach slightly below 1% by year-end and stay below 1.5% for the foreseeable future.

Don't worry about fed hikes anytime soon

Worries about entering a permanent deflation scenario have been very present in the market and at the Federal Reserve. However, we see no signs that long-term inflation expectations or wage dynamics are heading dangerously low. Neither do we feel that there is a lack of policy response in the US. Hence, we believe that the risk of the economy entering a deflationary trap is limited, albeit present.

So far, the Federal Reserve has gone far to accommodate the economy and the financial markets. It has taken policy rates close to zero, implemented a wide range of credit facilities and expanded its balance sheet significantly in an attempt to re-inflate the economy. In the near term the Federal Reserve will continue down this road. While the central bank seems to have stepped back on the idea to directly buy US treasures, a further expansion of credit facilities and/or an increase in the mortgage purchase programme are likely measures of further quantitative easing.