The Big Picture

Investment Research
December 2019

Rays of light for the world economy

Highlights

Global economy shows tentative signs of stabilisation

Risk of global recession has declined to 25%

Outcome of US-China trade talks a key risk

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Important disclosures and certifications are contained from page 34 of this report.

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Contents

Global overview

4 Risk of a global recession has declined

US

8 Two pace economy

Euro area

12 Struggling to escape the 'low for longer' curse

Germany

16 In twilight zone

UK

20 Brexit taking its toll on the economy

Japan

24 Sheltered for now – bumpy road ahead

China

28 Clouds are lifting

Emerging markets

32 Modest recovery on the cards

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Global overview

Risk of a global recession has declined

- Following significant headwinds over the summer, the global economy is showing tentative signs of stabilisation.
- This stabilisation comes on the back of sizeable monetary policy stimulus in both advanced and emerging markets in addition to an expansionary fiscal policy in China.
- Despite the stabilisation and expectations of a modest recovery in the global manufacturing sector in early 2020, we revise down our outlook for the global economy amid continued trade uncertainty and waning stimulus measures.
- However, the risk of a global recession over the next year or so has declined to 25% (from 30%) on the back of an improving chance of a trade deal and the receding risk of a no-deal Brexit.
- The outcome of the US-China trade talks is a key risk to the global economy in 2020. While we see a 50% chance for a permanent trade deal between the two sides, the discussions could go in either direction, prompting considerable uncertainty for our global forecasts.

Decline in global manufacturing sector has eased...

Following a notable slowdown in the global manufacturing sector, there are signs of stabilisation. As predicted in Global Economic Update: *Stuck in the mud but no hard landing yet, 22 August*, the global manufacturing sector has witnessed further headwinds from the uncertainty prompted by the US-China trade war, which escalated further over the summer, and Brexit. However, there are now signs of stabilisation in the global manufacturing sector, especially in China, where sizeable fiscal and monetary policy stimulus is aiding the economy. The US manufacturing sector is also seeing stabilisation, and even for the beaten German manufacturing sector, indicators are pointing to nascent improvement. The weakness in the manufacturing sector has been threatening to spill-over to the service sector but there also appears to be some robustness in that sector due to continuing sound employment and wage growth.

...due to sizeable policy easing globally

In response to weak global inflation pressures and expectations and the sizable slowdown in the global manufacturing sector, central banks around the world have eased monetary policy considerably in 2019 (see figure). The Fed has cut its policy rate three times since the summer, while the ECB restarted its QE programme and cut its policy rate by 0.1pp in September (though the impact on the euro area economy is probably small). In the biggest emerging markets (accounting for 30% of global GDP), policy easing has also been significant, with policy rates being cut at the fastest pace since the global financial crisis in 2009. On the fiscal side, China has cut taxes and boosted infrastructure spending amounting to 1.3% of GDP in 2019.

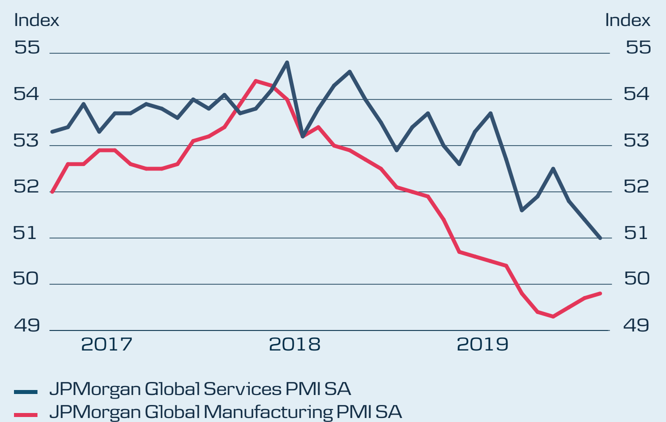
A phase one US-China trade deal alone is not likely to be a game-changer...

Following the escalation of the trade war between China and the US in August, the two sides are now negotiating a phase-one deal. The idea is to put all the parts that the two sides can agree on in phase-one and leave the stickier points to a phase-two deal. While we still believe the two sides will reach a phase-one deal, this has proven more difficult than expected. We, however, believe the two sides will come to an agreement ahead of the 15 December unofficial deadline, when US has threatened to raise tariffs further. While a phase-one deal will provide an important boost to global risk sentiment, removing some of the tail-risk of an abrupt escalation of the trade war, we do not believe it will be a game-changer for the global economy in terms of raising investments, as uncertainty is likely to still linger as the two sides move to the more difficult phase-two negotaitions in the spring. We see 50-50 chance of the two sides agreeing on a phase-two trade deal ahead of the US presidential election.

...meaning the global economy will probably experience only a modest growth rebound

While the economic policy easing and a possible phase-one trade deal will support a modest pickup in the global economy, the continued elevated uncertainty about global value chains and trade relations mean we downgrade our outlook for global growth. We now expect the global economy to grow by 2.9% in 2019 (compared with 3.0% in out August update), picking up speed slightly to 3.0% in 2020 (3.2% previously), as some of the headwinds for the global economy such as trade war fade. This will give a slight boost to private consumption and investment. The pick-up in growth is in part driven by a rebound in several key emerging markets, including India, Russia,

Global manufacturing sector is stabilising while service sector is under pressure

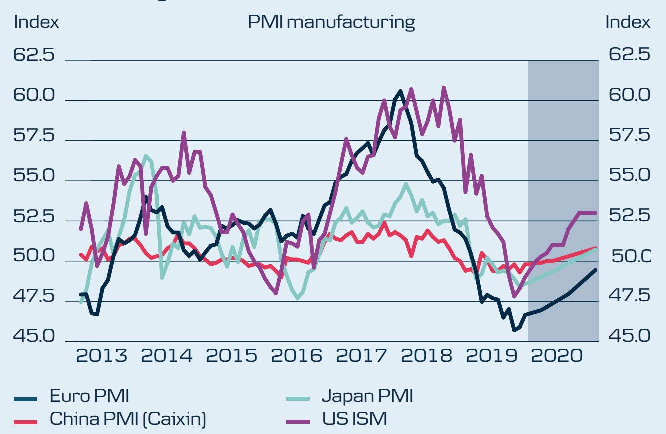


Source: Macrobond Financial, Danske Bank

Forceful monetary policy easing set to support a global recovery

Note: Three months moving GDP weighted average of G4 countries, G10 currencies and 18 biggest EM countries (excluding Turkey).
Source: Macrobond Financial, Danske Bank

We expect a modest rebound in the global manufacturing sector



Source: Macrobond Financial, Danske Bank

Brazil and Turkey as they benefit from easier monetary policy and stronger domestic demand. While economic growth is moderating in the US, Japan and euro area, a big part is due to negative carry over from 2019. In many countries, fiscal policies are projected to tighten, although this will probably remain conditional on the economic outlook.

Central banks set to keep an easing bias amid modest inflation pressure

Although the economic expansion has been record long in the US and euro area countries such as Germany, inflation pressures remain muted. Also market-based inflation expectations are at a low level. Core inflation remains low in the euro area and is projected to rise to only 1.1% by 2021, significantly below the ECB's 2.0% target. While economic growth is higher in the US, PCE core inflation continues to run below the Federal Reserve's 2% target and despite higher wage increases, it does not seem to us that underlying inflation pressure is rising. One reason is probably that low inflation is quite persistent.

As a result, we believe both the ECB and Fed will maintain an slight easing bias. While the Fed's message has switched to a 'wait-and-see' approach, we still expect one more cut in 3-6M (down from three additional cuts previously). Although we expect the ECB to be on pause amid growing divisions in the Governing Council, we believe the bias is towards further easing in the event of significant deterioration in the growth or inflation outlook.

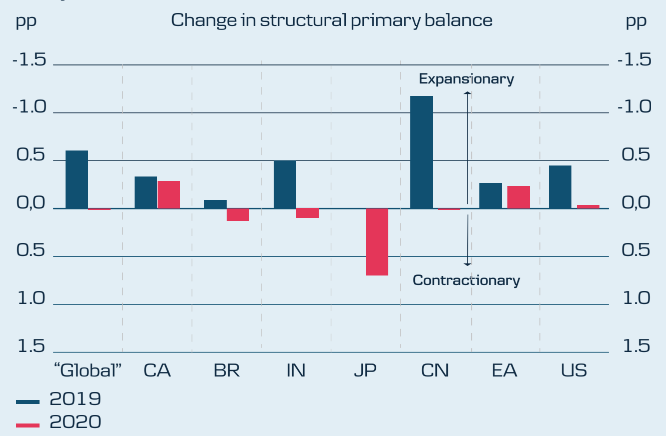
US-China trade talks a key risk to the global economy in 2020

While a phase-one agreement should be found, we see only an even chance of a bigger and more permanent US-China trade deal in the first half of 2020 (for more discussion see the China chapter). If the two sides are able to strike a comprehensive and permanent agreement, we believe this would unleash a significant global investment activity ("positive" scenario in the PMI graph), as the trade related uncertainty prompted by the US-China trade talks have curtailed investment decisions for almost two years. On the other hand, if negotiations go awry again and a renewed trade war leads to new tariff hikes, there are significant downside risks to our forecast as investor confidence will be severely hit ("negative" scenario in PMI graph). In such a scenario, we see a significant risk of the global economy falling into a recession.

Financial markets in the hands of central banks and trade talks

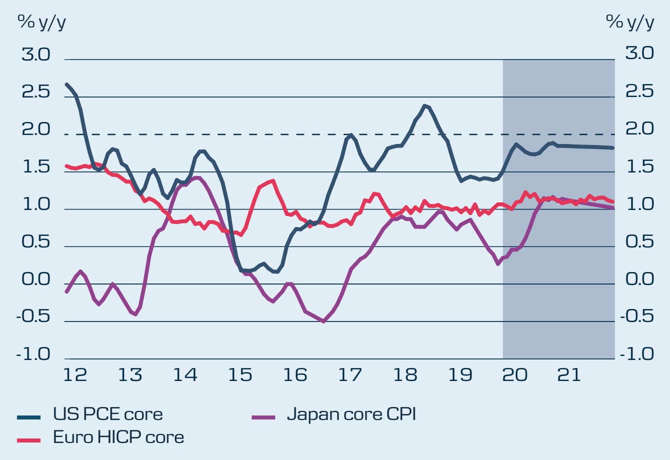
The idiosyncratic shocks (Brexit and trade talks) that affected the global financial markets this year, may still prevail next year, in particular in the first half of the year. Earnings growth will be subdued again in 2020 and with valuation already at elevated level we don't see much room for further multiple expansion in equity markets so one should expect quite low equity returns in 2020. The European fixed income markets should continue its recent range trade for most of the year and in the case of the German benchmark bond we expect it to remain between 0% and -0.5%. For the major currency pairs, we also expect the EUR/USD to remain in a relatively tight range (1.09-1.13) given little change in Fed and ECB's policy stance. Towards the summer, we see the Fed on its re-assuming its easing agenda which will lead to a EUR/USD in the higher end of our expected range.

Fiscal policy go from expansionary to neutral in many countries in 2020



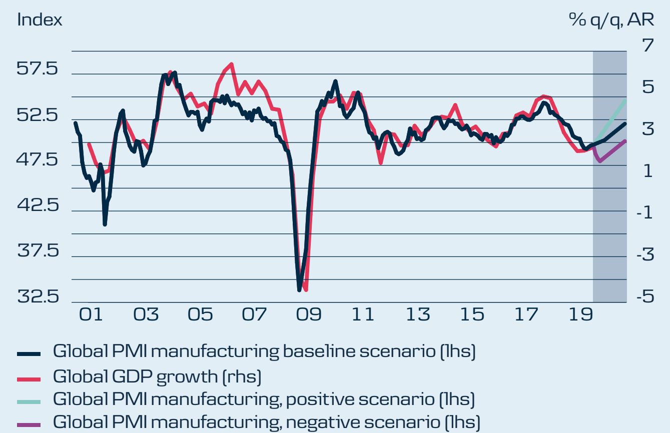
Note: "Global" is GDP-weighted average of the countries in the chart.
Source: IMF WEO October 2019 Database, Macrobond Financials, and Danske Bank

Underlying inflation still at modest levels globally



Source: Macrobond Financial, Danske Bank

US-China trade talks hold key to global manufacturing sector outlook



Source: Macrobond Financial, Danske Bank

GDP forecasts - Global overview

% y/y	2018	2019		2020		2021	
	IMF	Danske Bank	Con-sensus	Danske Bank	Con-sensus	Danske Bank	Con-sensus
Global	3.6	2.9	3.1	3.0	3.1	3.3	3.2
Developed markets	2.2	1.6	-	1.2	-	1.4	-
USA	2.9	2.3	2.3	1.7	1.8	1.9	1.9
Euro area	1.9	1.2	1.1	0.9	1.0	1.3	1.2
Japan	0.8	1.0	0.9	0.5	0.3	0.5	0.8
UK	1.4	1.4	1.2	1.0	1.1	0.9	1.5
Emerging Markets	4.5	3.7	-	4.3	-	4.7	-
China	6.6	6.2	6.1	6.0	5.8	6.1	5.8
India	7.3	6.0	6.0	6.8	5.6	7.5	6.4
Russia	2.3	1.2	1.1	1.7	1.6	2.4	1.9
Brazil	1.1	1.0	1.0	2.0	2.0	2.3	2.5
Turkey	2.8	-1.6	0.0	1.7	2.4	2.6	3.2
South Africa	0.8	0.6	0.5	1.7	1.2	2.0	1.6
ASEAN-5[2]	5.2	4.8	-	4.9	-	5.2	-
Middle East and NA[1, 2]	1.0	0.2	-	1.8	-	2.4	-
Sub-Saharan Africa (ex SA)[2]	3.2	3.2	-	3.6	-	3.7	-
LatAm (ex Brazil)[2]	1.0	0.2	-	1.8	-	2.4	-

1. NA is North Africa
2. IMF projections World Economic Outlook October 2019
Source: Bloomberg. IMF. Danske Bank

In late September, we published a study on the risk of a global recession. Traditional indicators of recessions, such as the slope of the yield curve, have recently been pointing to heightened recession risk, but we think the signals are distorted by the impact of central bank QE programmes, flattening the yield curves. In our view, the biggest risk to the global economy is a resumption of the trade war between US and China (or Europe for that matter). This will hurt global confidence considerably, triggering a negative spiral of lower consumption and investment. Other usual triggers of recessions, such as economic or financial imbalances are not as imminent like they were in the run-up to the global financial crisis. We also think that policy-makers have room to mitigate a possible downturn both in terms of fiscal firepower given the sharp fall in borrowing costs and on the monetary side, although Bank of Japan and ECB are more contrained by their already negative interest rates. Overall, given the rescinding fear of an all-out China-US trade war and a no-deal Brexit in recent months, we have lowered our probability of a global recession over the next two years to 25% from 30% in September.

Recession score card	US	Euro Area	Japan	China
Recession indicators	0.3	0.3	0.2	0.2
Yield curve	0.25	0	0	0
Length of recovery	0.25	0.25	0.25	0
Growth trackers	0.25	0.5	0.25	0.75
Market sentiment	0.25	0.5	0.25	0
Recession drivers	0.6	0.6	0.6	0.7
Financial bubbles	0.5	0.5	0.5	0.5
Real bubbles	0.25	0.25	0.25	0.5
Shocks	1	1	1	1
Policy space to counter a recession	0.5	0.75	0.75	0.4
Monetary policy	0.5	1	1	0.5
Fiscal policy	0.5	0.5	0.5	0.25

Score: 1= high risk; 0.5=medium risk; 0= low risk
Subcategory score is calculated as simple average
Source: Danske Bank

US

Two pace economy

- The US economy has shrugged off some of the recession fears on the back of Fed easing and renewed trade optimism.
- We expect the US economy to grow around trend in coming years. Private consumption is set to remain the main growth driver, as the fundamentals still look favourable. In our view, business investments are unlikely to kick off until we get more clarification on trade.
- The Federal Reserve has cut three times and is now likely to be on hold for a while. The outlook for the Fed funds rate is uncertain but we still pencil in another cut in the 3-6M economy, as the economy remains fragile, in particular from the producer side.

US growth has peaked, as investments struggle

US growth peaked around 3% y/y in 2018 and declined to 2% y/y in Q3 19, while the PMI and ISM indicators for Q4 signal even slower growth in Q4, although they have been poor at predicting the exact pace of the US economy as of late. Private consumption growth remains solid around 2.5% y/y but non-residential investments have declined to 1.3% y/y, which is the slowest growth rate since the investment recession in 2015.

The US expansion is the longest in history and it is only natural to ask how long it can continue. We believe it is important to remember that expansions do not die of old age but of disease. It means that just because the expansion has lasted for a long time, a crisis is not necessarily just around the corner. Something needs to go wrong for the economy to turn around. Usually, an economic downturn is worsened by a deterioration of 'animal spirits' (confidence), which reduces consumer and corporate spending. Recession fears in markets have eased supported by Fed easing and renewed trade optimism. The stock market has rebounded and the spread between long-term and short-term rates (usually a good recession indicator, see box on page 11) has moved back to positive territory.

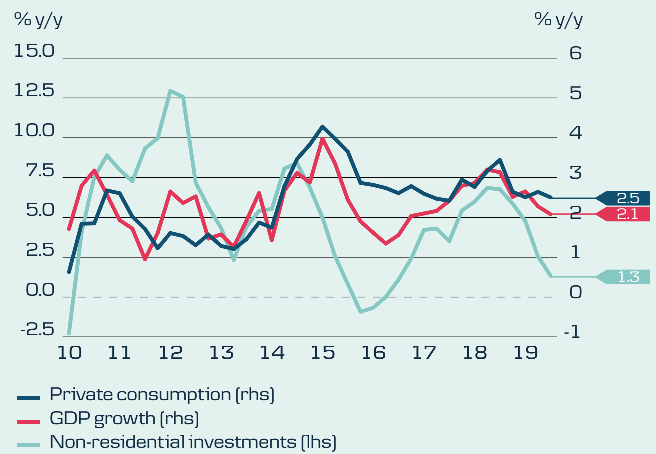
As mentioned in The Big Picture – Renewed trade dispute casts shadow over global economy, 10 June, we are more concerned about the economic outlook in coming years than we have been for the past couple of years. We do not expect a recession, as the fundamentals for continued private consumption growth, which is by far the most important GDP component, still look strong. Real wage growth is solid, house prices are rising, lower mortgage rates have increased disposable income, consumer confidence remains high and employment is still increasing. Residential investments have also begun contributing positively to growth again, as mortgage rates have declined.

However, not everything is as bright as previously. Fiscal policy is no longer expansionary as in the past two years but neutral and it is difficult to see it changing ahead of the presidential election. Fiscal policy may become expansionary in 2021 if we get a clear election victory for either side in the upcoming election. It is difficult to predict the election outcome right now, as the Democratic primaries have not even begun yet (the first primary is in February).

In addition, a combination of trade war and slower global growth has hurt non-residential investments, in particular within equipment and structures (investments in intellectual property seem unaffected). Many soft investment indicators suggest investments may fall further and a phase 1 trade deal does not change the fundamental uncertainty, which makes it a bad environment in which for companies to invest. We may see a rebound in investments in the event of a permanent US-China trade deal, to which we assign a 50% probability before the presidential election in November.

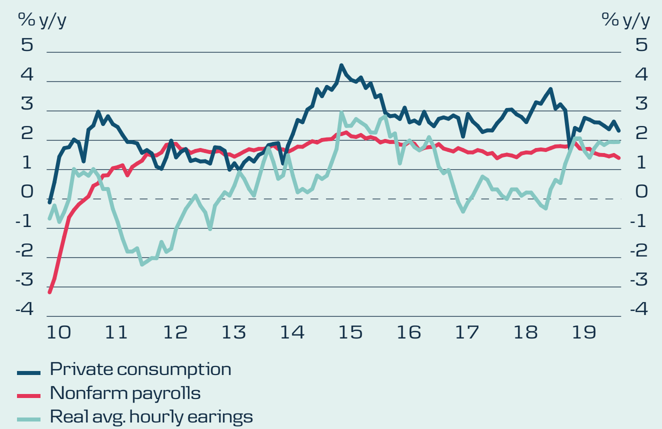
In 2019, we expect GDP growth was 2.3% y/y. We expect GDP growth of 1.7% y/y in 2020 and 1.9% y/y in 2021.

Private consumption remains the main growth driver



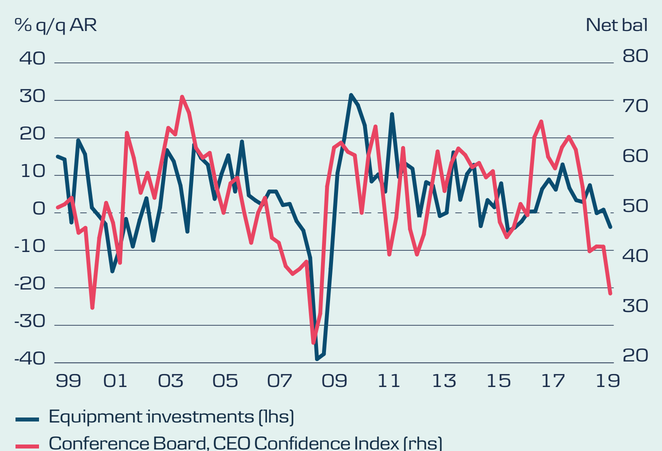
Source: BEA, Macrobond Financial

Strong real wage growth and continued employment growth are good for consumption



Source: BEA, BLS, Macrobond Financial

Some soft indicators suggest investment could fall further



Source: BEA, Conference Board, Macrobond Financial

Employment growth robust

Employment has been rising for 110 consecutive months and the labour market seems strong on many parameters. We usually consider employment a lagging indicator in the sense that employment starts declining during a recession not before. Still, employment growth usually declines ahead of a recession, as indicated by the chart on the right, and one should monitor it closely.

Jobs growth was on the weak side at the beginning of 2019 but has recovered somewhat since. Jobs growth is not as strong in 2018 but we know the Bureau of Labor Statistics is set to revise the 2018 numbers lower in early 2020, so the slowdown is less dramatic than it seems currently. Some soft indicators suggest employment growth is decelerating quickly but they have sent false signals for some time now.

We expect jobs growth to remain positive but as the economy is growing around potential, we also expect jobs growth to be around breakeven (i.e. where the unemployment rate is stable). Nominal wage growth seems to have peaked but given that inflation remains subdued, real wage growth remains fine.

Inflation remains stable but below 2%

PCE core inflation continues to run below the Federal Reserve's 2% target and despite wages rising, it does not seem that the underlying inflation pressure is rising. One reason is probably that inflation is quite persistent. When inflation is low (high), it is likely to remain low (high) for a while. Both survey- and market-based inflation expectation measures are low from an historical perspective and, given inflation expectations play a key role in explaining actual inflation, we do not believe core inflation will increase significantly. We expect core inflation to remain in the 1.50-2.00% range over coming years.

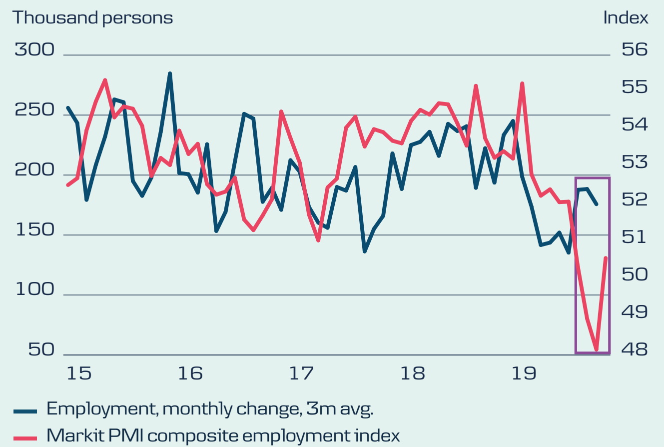
Fed may cut once more in 3-6M

The Fed has made two U-turns in 2019. At the beginning of the year, the Fed skipped its plan to raise rates further. Then, since July, the Fed has cut rates three times and the target range is currently 1.50-1.75%. At the latest meeting in October, the Federal Reserve changed its forward guidance and now believes the current stance of monetary policy is appropriate. On the back of the Fed's new 'wait-and-see' approach, we recently changed our Fed call and now expect only one more cut in 3-6M (previously three more cuts).

We keep a cut in our forecast profile, as we still believe the US economy is more fragile than the Fed believes and that the renewed trade optimism is unlikely to be enough to trigger a rebound in business investments yet.

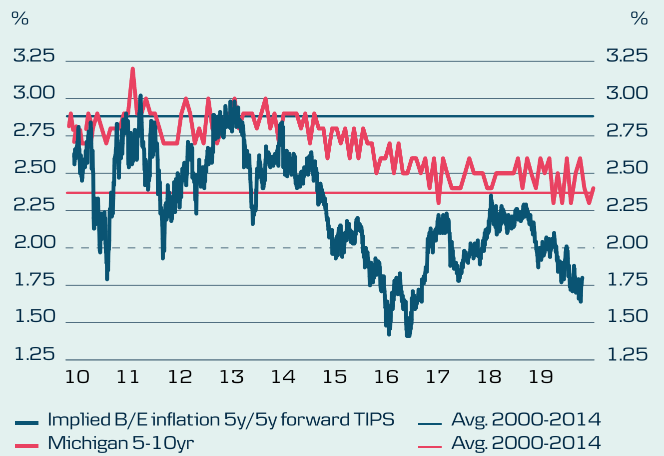
In our view, monetary policy is not as expansive as one may think. In our view, the Fed cuts have taken the Fed funds rate down only to neutral or at best marginally accommodative. Without more easing, it also increases the probability that the Fed will need to cut all the way down to 0% as a response to a recession.

Hard vs soft data gap



Source: BLS, IHS Markit, Macrobond Financial

Inflation expectations are subdued



Source: Bloomberg, University of Michigan, Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results.

Fed is set to "wait and see" the next couple of meeting before another cut may be in the cards

Source: Federal Reserve, Macrobond Financial, Danske Bank

Macro forecasts - US

% change q/q AR	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2019	2020	2021
GDP	1.2	1.9	1.8	1.9	1.9	1.9	1.9	1.9	2.3	1.7	1.9
Private Consumption	2.2	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.6	2.4	2.0
Private Fixed Investments	1.1	2.3	2.3	2.8	2.8	2.8	2.8	2.8	1.3	0.9	2.7
Residential	0.3	1.9	1.9	2.4	3.0	3.0	3.0	3.0	2.1	0.1	2.7
Non-residential	4.1	4.1	4.1	4.1	2.0	2.0	2.0	2.0	-1.6	3.7	2.8
Change in inventories[1]	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	-0.1	0.0
Public Consumption	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2.2	0.9	0.4
Exports	0.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	-0.3	0.1	2.0
Imports	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.6	1.7	1.8
Net exports[1]	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.0
Unemployment rate (%)	3.4	3.4	3.4	3.3	3.3	3.3	3.3	3.3	3.6	3.4	3.3
Inflation (CPI) (y/y)	2.3	2.1	2.2	2.2	2.2	2.2	2.2	2.2	1.8	2.2	2.2
Core inflation (CPI) (y/y)	2.3	2.4	2.3	2.3	2.4	2.4	2.4	2.4	2.2	2.3	2.4
Public Budget[2]									-4.5	-4.5	-4.5
Public Gross Debt[2]									105	106	107
Current Account[2]									-2.5	-2.6	-2.5
Fed funds rate[3]	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.50	1.50

1. Contribution to annualised GDP growth
2. Pct. of GDP (CBO and IMF)
3. Upper limit. end of period
Source: CBO. IMF. Danske Bank

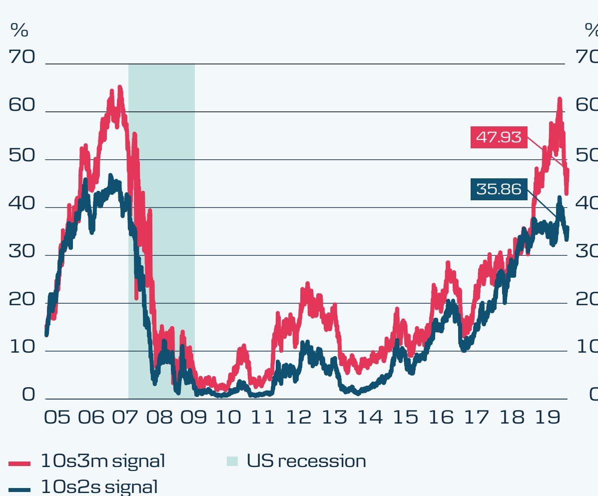
US recession fears have declined lately

The US expansion is the longest on record and it is only natural to ask how long it can continue, not least with the flattening (and temporary inversion) of the US yield curve, which historically has been a good indicator of whether or not we are heading for a recession.

According to the markets, the recession risk has declined somewhat since the peak in August, although the risk remains elevated. The risk of a US recession within 12 months is close to 50% according to the US 10s3m spread and 35% according to the US 10s2s spread. As we discuss in the main text, we think it is important to remember that expansions do not die of old age, but of disease.

Two important factors for diminishing recession fears further are more progress in the US-China trade negotiations and more Fed easing.

Probability of a ression the next 12 months



Source: Bloomberg, Macrobond Financial, Danske Bank models
**Note: Past performance is not a reliable indicator of current or future results.*

Euro area

Struggling to escape the 'low for longer' curse

- We expect the euro area to remain caught in a protracted low growth and inflation environment in the coming years, with an acceleration to potential growth at 1.3% in 2021 at best.

- Still we do not think the euro area is on the brink of recession. Robust labour markets and domestic demand remains an important backbone and heterogeneous economic models in euro area member states are also adding resilience.

- The pass-through from wage growth to core inflation will proceed only sluggishly and with goods price inflation caught below 0.5% for the coming years, the ECB's 2% inflation target seems as elusive as ever.

- In the absence of significant deterioration in the growth or inflation outlook, we expect the ECB to be on hold amid major changes in the Governing Council.

Struggling to escape the low-growth curse...

The euro area economy has been in a rough spell for some time now. Still, we do not think it is on the brink of recession. A less favourable external environment and structural shifts in manufacturing will remain defining features for the growth outlook in the coming years, but signs of a bottom in the global manufacturing cycle driven by China and resilient domestic demand form an important backbone of the ongoing expansion. Heterogeneous economic models in euro area member states are also adding resilience. While relatively open economies like Germany are feeling the heat from slower external demand, relatively closed ones such as France continue to hum along. Overall, we expect the euro area economy to remain stuck in low gear for the coming years with quarterly growth rates of 0.2-0.3% and an acceleration back to potential growth at 1.3% annually in 2021 at best.

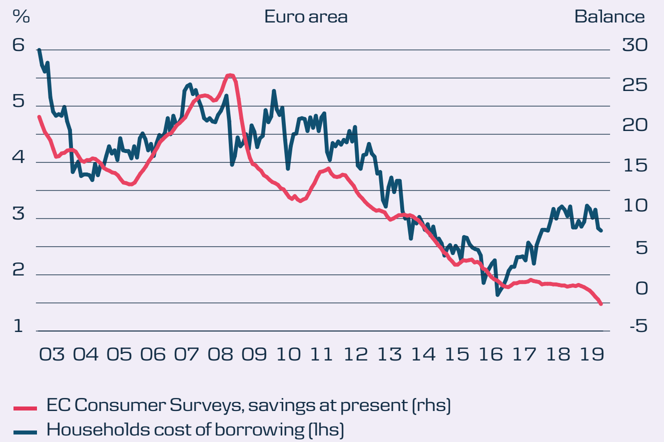
...but not on the brink of recession

An important driver for the euro area slump since 2018 has been slowing external demand, especially for machinery and transport equipment. Both extra- and intra-euro area goods exports failed to grow in H1 19. As trade war effects continue to work their way through the supply chain (see Euro Area Research: Manufacturing cycle: recession or recovery?), we expect the export outlook – especially for capital goods – to remain relatively cloudy in 2020. That said, signs are becoming more abundant that a stabilisation in global trade is taking place, which should also help underpin the European manufacturing sector.

The dichotomy between the manufacturing weakness and service sector resilience will remain a central feature of the growth outlook. Labour markets in many euro area countries – notably France – have been surprisingly resilient and continue to see ongoing job creation and rising wages. In light of a further projected decline in the unemployment rate to 7.4% in 2021 and wage growth remaining close to the highest level in 10 years, we expect consumer spending to hold up. Historically low borrowing costs thanks to accommodative monetary policies and moderate fiscal easing measures enacted in a range of euro area countries also contribute to disposable income growth. However, higher consumer savings – be it due to a less favourable employment outlook or structural factors such as an environment of prolonged negative interest rates – remain a downside risk.

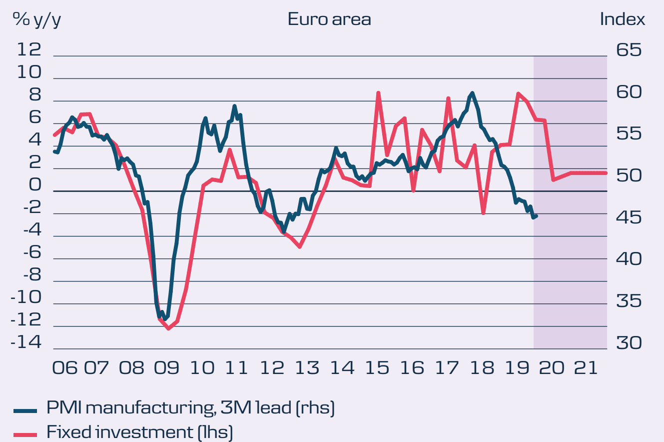
The outlook for investments remains more clouded. Investment spending so far has remained quite immune to the manufacturing weakness, not least due to a surge in Irish 'intellectual property' investments and strong activity in the (German) construction sector. With the ECB's September package, financial conditions have been loosened further. However, we expect the boost to the real economy to be relatively modest as most firms do not report availability of credit as a key factor currently limiting production and the construction sector is already labouring with growing capacity constraints. On the back of still elevated global uncertainty in the absence of a definite conclusion to the trade war and Brexit, as well as declining profit margins, we expect a less favourable investment outlook in 2020.

Consumer savings have increased despite lower rates



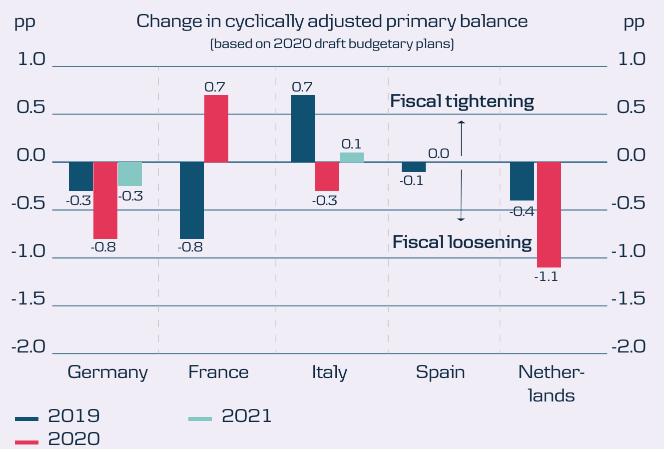
Source: ECB, European Commission, Macrobond Financial, Danske Bank

Investment growth to slow down



Source: Markit, Eurostat, Macrobond Financial, Danske Bank

Moderate fiscal expansion is already on its way



Source: European Commission, Danske Bank
Note: 2021 data not available for France, Spain and Netherlands

A toxic mix of prolonged uncertainty and policy inaction

Although we think the expansion will continue, it remains a fragile one, with multiple headwinds both internally and externally. The risk of layoffs is increasing with wage growth outpacing productivity growth and capacity utilisation abating. Externally, the biggest risk, in our view, stems from a renewed escalation in the US-China trade war a disorderly no-deal Brexit as well as lingering uncertainty regarding potential US tariffs on European car imports.

However, structural challenges also abound. The World Bank projects that the euro area working age population will fall by more than 35m by 2050 and already now a growing gap between savings and investment demand has opened up, weighing on potential growth. This also creates challenges for monetary policy: as policy rates are not set to return to pre-crisis levels, new monetary policy tools will have to be found to deal will the ongoing negative interest rate environment and reversal rate problem. With progress on reforms to strengthen the EMU being lacklustre at best and the so-called euro area budgetary instrument still lacking a meaningful stabilisation mechanism, questions about how to address the next crisis remain as yet unanswered.

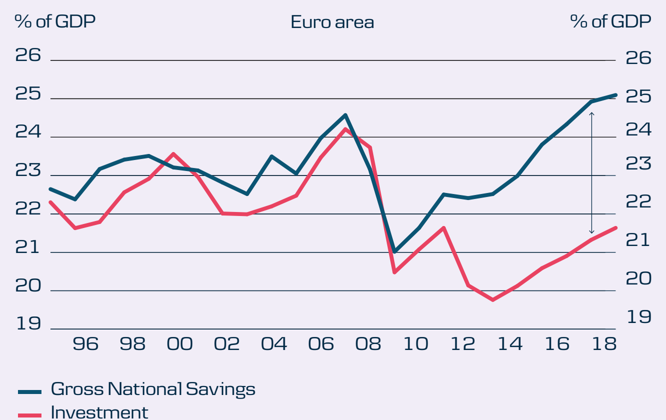
Core inflation to remain 'uncomfortably' low

Analogous to the subdued growth outlook, we expect euro area inflation pressures to remain caught in a protracted period of 'low for longer'. We think that underlying inflation pressures will rise only moderately and stay at 1.1% in 2021. However, it is not only a muted pass-through from wages to service price inflation that is becoming an increasing worry for the ECB. Service price inflation is also still too low to compensate for the drag from the goods side, and with non-energy industrial goods (NEIG) inflation likely to be caught below 0.5% for the coming years, the ECB's 2% inflation target seems as elusive as ever (see Euro Area Research - Measuring the euro area inflation pulse). This belief is increasingly also expressed in various survey- and market-based measures of inflation expectations falling to new-all-time lows.

ECB on pause unless growth falters further or deflation risk rises

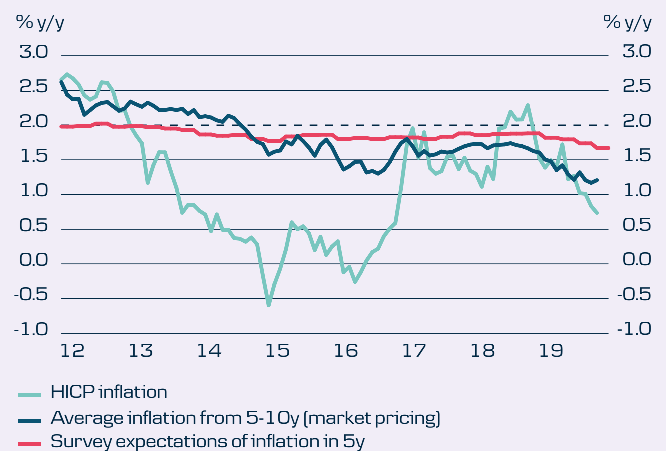
ECB credibility concerns and the need to act were important factors behind the September easing package (see ECB Review), which we think will set the tone for months to come. With the growth and inflation outlook little changed since the summer and growing discord in the Governing Council about further rate cuts, we expect no changes to the monetary policy path in the foreseeable future. A significant deterioration in either inflation or growth dynamics could change that situation, though it is not clear-cut what kind of stimulus tool the ECB would use. That said, at current juncture, we expect the ECB to be more inclined to ease monetary policies rather than tighten them. However, comments from Governing Council members suggest an increased awareness of the potential side effects of the negative interest rate policy, which would favour additional stimuli through the so-called unconventional toolbox under the new President, Christine Lagarde.

Demographic trends are contributing to low investment demand



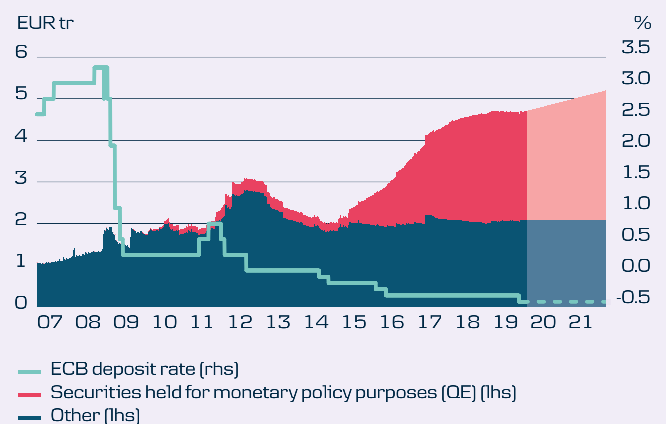
Source: IMF, Macrobond Financial, Danske Bank

Declining inflation expectations creates worries for ECB



Source: ECB, Eurostat, Bloomberg, Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results.

ECB balance sheet is expected to grow again after QE resumption



Source: ECB, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

% Change q/q Annualised rate	2020				2021				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2021
GDP	0.8	1.0	1.2	1.2	1.3	1.3	1.3	1.3	1.9	1.2	0.9	1.3
Private Consumption	1.6	1.6	1.6	1.6	1.2	1.2	1.2	1.2	1.4	1.1	1.4	1.4
Fixed Investments	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	2.4	6.8	2.5	1.6
Public Consumption	1.6	1.6	1.6	1.6	1.2	1.2	1.2	1.2	1.1	1.6	1.8	1.4
Exports	1.2	1.6	2.0	2.0	2.8	2.8	2.8	2.8	3.3	2.5	1.4	2.5
Imports	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.7	4.6	3.2	2.8
Net exports[1]	-0.7	-0.5	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	0.4	-0.8	-0.8	-0.1
Unemployment rate (%)									8.2	7.6	7.5	7.4
HICP (y/y)	1.2	1.1	1.2	1.2	1.1	1.1	1.1	1.1	1.8	1.2	1.2	1.1
Core HICP (y/y)	1.1	1.2	1.1	1.1	1.1	1.1	1.2	1.1	1.0	1.0	1.1	1.1
Public Budget[2]									-0.5	-0.8	-0.9	-1.0
Public Gross Debt[2]									87.9	86.4	85.1	84.1
Current Account[2]									3.8	3.3	3.2	3.1
ECB deposit rate[3]	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4	-0.5	-0.5	-0.5

1. Contribution to GDP growth
2. Pct. of GDP
3. End of period
Source: Eurostat. Danske Bank estimates

ECB: Change in the board, policy review and what's next

We will remember 1 November as setting a milestone for the ECB, as Christine Lagarde, former IMF head, took office after Mario Draghi's eight-year term ended. We know Lagarde, who is a trained lawyer, for a more inclusive leadership style than Draghi applied during his tenure. As the first non-trained economist to head the ECB, her competences and finesse within other policy circles as a former finance minister are welcome in an attempt for a co-ordinated effort to revive inflationary hope. Draghi has called for other policy areas to contribute as well since 2014 but his calls have remained unheard.

With the September policy package, which was heavily debated on which tools to deploy, Lagarde's first task will be to unite the 'doves' and 'hawks' in a coherent message fostering the needed policy framework and guidance should an ECB response be warranted to support the economic outlook. The upcoming review of the ECB's current monetary policy framework, also agreed upon at the September policy meeting, is a welcome exercise (the previous review took effect in 2003).

It is too soon to detail what the review will include. However, in the table below, we sketch potential ways a review could be conducted. Note that if the outcome of the exercise still falls within the 'price stability' definition, no change to the Treaty on the Functioning of the EU is required.

With the ECB on 'cruise control' for now, following the policy package in September, we do not expect new policy measures in the absence of growth and inflation expectations deteriorating significantly. However, should the ECB want to act, deciding what tools to resort to is not as straightforward and the ECB may again have to invent new policy tools, which could further blur the line between fiscal and monetary policies and, in its most extreme format, conduct outright transfers. Near-term policy tool preferences seem to favour QE rather than additional rate cuts.

	Minor revision	Large overhaul
Strategy review	Changing mandate to pre-2003 definition of 'below 2%' HICP.	All 'price stability' definitions possible (medium term, average inflation, price level target).
Market impact	Less accommodative monetary policy measures needed.	Unknown. Will depend on outcome of the exercise.
Time horizon	6 months	12-24 months

Germany

In twilight zone

- We expect the German economy to remain caught in a twilight zone of lacklustre growth of 0.6% in 2020 and 1.3% in 2021.
- Ongoing labour market resilience and expansionary fiscal policies are helping domestic demand and the service sector to withstand the recessionary pull from manufacturing.
- German industry risks falling behind global competitors when it comes to digitalisation and innovation.
- The bar for further fiscal easing is high - a change in government rather than a deep recession remains currently the mostly likely trigger for a fiscal policy re-think in our view.

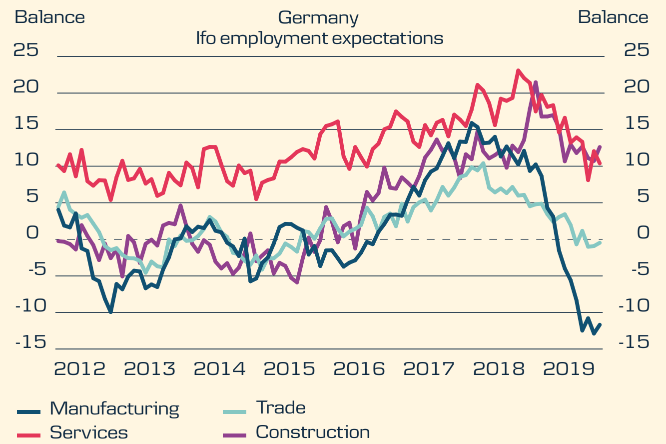
Shrugging off the downturn

In the advent of the protectionist renaissance, the fall from grace of the German economy has been spectacular: whereas the economy was still firing on all cylinders in Q4 17, recent figures confirmed that Germany just about avoided falling into 'technical recession' in Q3 19. The root for Germany's struggles continues to lie in the manufacturing sector, which is suffering from the bursting of the globalisation bubble, and has now been in recession for five quarters. We think Germany risks being caught in a twilight zone of lacklustre growth. This expectation is also reflected in our GDP growth forecasts, which see the German economy expanding by only 0.6% in 2020, with some acceleration in 2021 back to potential growth at 1.3%.

The resilience of the employment-consumption relationship plays a crucial role for whether the service sector is catching the manufacturing malaise. Since 2009 the German labour market has enjoyed a steady tailwind with new employment records reached every year. However it seems this labour market strength is now drawing to an end, as unemployment claims have ticked up. Still, we currently do not expect a broad-based labour market slump. So far the weakness remains centred on manufacturing employment, while spill-overs to other sectors – accounting for some 70% of total employment - remain contained. Furthermore, while companies have scaled back on new hiring, demand for skilled labour generally remains at a high level, not least because firms know that retiring 'baby boomers' will further curb labour supply in the coming years. Labour 'hoarding' will hence continue to exert a stabilizing effect, but we also expect policymakers to be relatively proactive in stemming an unravelling labour market situation, for example by broadening access to short-time work allowances ('Kurzarbeit' - a tool that has already proven very successful during the Financial Crisis in preventing redundancies). Sizable reserves of EUR23bn in the Federal Labour Agency could be made use of for this. However, we expect households' spending power to not only continue to benefit from a robust employment situation and positive real wage growth, but also expansionary fiscal policies, which should lift GDP growth by some 0.3-0.4pp over the coming two years (see theme box).

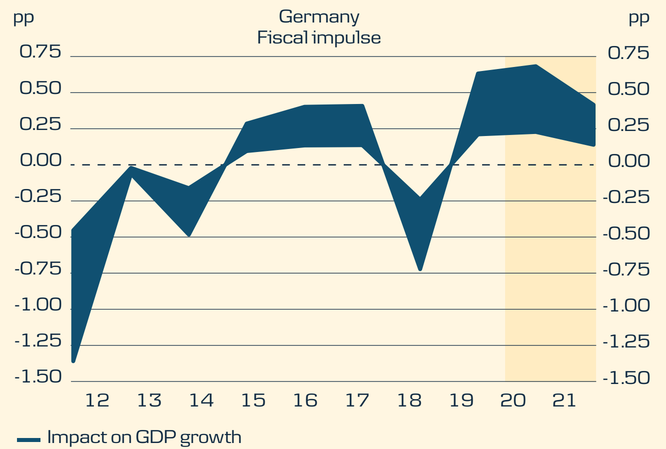
Despite our expectation that domestic demand can withstand the recessionary pull, a rebound in growth rates will depend on the manufacturing sector and external demand. Uncertainty about a new world trade order increasingly weighs on firms' investment appetite, hitting manufacturers of capital and intermediate goods. However, Germany's manufacturing struggles are partly also homemade. A switch to new emission test procedures (WLTP) triggered a collapse in car production by over 20% since mid-2018. Since then bottlenecks have abated, but the predicted rebound in production has yet to materialise. Both cyclical as well as structural factors are to blame. The production slump was preceded by a multi-year phase of strong sales that would have been difficult to sustain under growing capacity constraints anyway. However, driving bans on diesel cars in a growing number of German cities and shifting consumer preferences towards electric and hybrid cars, where Volkswagen, Daimler, BMW and co. have long remained dormant, are also part of the explanation. We remain sceptical about a strong rebound in car production given signs of saturation in China (the world's largest auto market) and continued tightening of

No broad-based labour market crisis



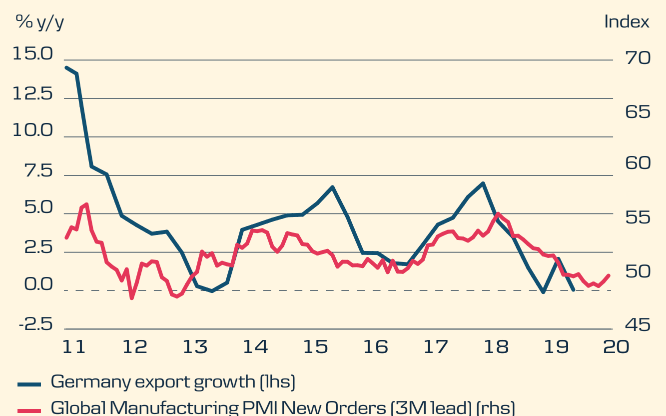
Source: Ifo, Danske Bank

Fiscal tailwind still blows in 2020-21



Source: European Commission, Danske Bank

Rays of light for global manufacturing will help German exports



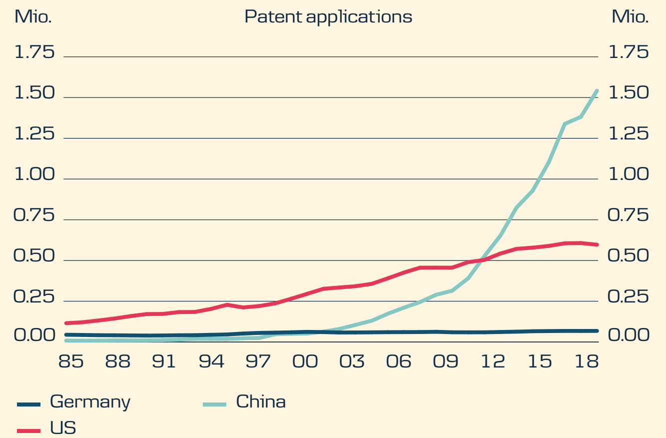
Source: Eurostat, Markit, Danske Bank

emission standards (stricter EU emission targets will again be phased in in 2020). Still there is cause to see some light for the industry going into 2020 (see also Euro Area Research - Manufacturing cycle: recession or recovery?). The US-China trade war seemingly has peaked and signs of a bottom in the Chinese and global manufacturing cycle are growing more abundant. Hence, a moderate pick-up in global trade volume growth should also help alleviate the drag on German exports.

On the look-out for a new growth model

That said, renewed US tariff escalations – be it with Europe or China – as well as a chaotic No-deal Brexit remain prominent downside risks as long as Germany cannot wean itself from its export dependency. More longer term, a growing concern is that Germany's growth model seems to have run its course and the previous industry champion risks falling behind when it comes to digitalisation and innovation. Patent applications have plateaued in recent years, the share of fibre optic connections in German broadband is just 3.2% (leaving Germany near the bottom of OECD countries) and public funds earmarked for investments in AI are a mere EUR3bn by 2025 (compared with USD16bn alone announced by the Chinese city Tianjin). Combined with growing demographic and social challenges, this should set alarm bells ringing in Berlin – at least in theory.

German industry is missing out on innovations



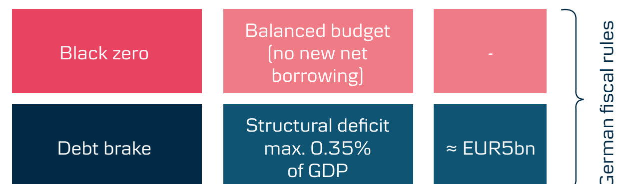
Source: WIPO

Fiscal policy: Bar for further easing is high

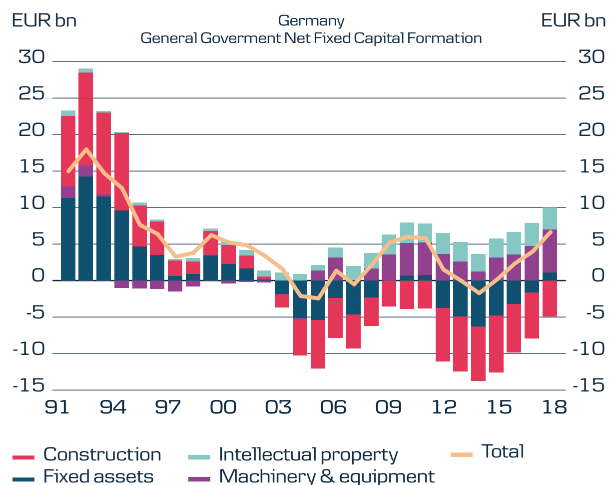
As the German economy has edged closer to recession, calls for fiscal stimulus have grown louder. However, the hurdles for significant fiscal easing remain high in our view, due to both political and constitutional constraints.

As we have argued in Research Germany - Loosening the brake, fiscal space under the 'debt brake' is limited to some extra EUR5bn (0.14% of GDP) in 2020. Furthermore, the balanced budget policy ('black zero') still enjoys widespread support amid the governing CDU party and we doubt that Germany is heading for a severe enough recession that would lead to more fiscal policy action at the current stage. This is partly also because fiscal policy is already becoming more expansionary. Fiscal measures remain primarily targeted towards private households with tax reductions, lower social security contributions and higher pensions, but amounts earmarked for public infrastructure investments remain limited. While general government gross investments have already grown by over 4% annually for the past three years, this barely sufficed to compensate for the decay of the capital stock as net investments illustrate (see chart). Still, officials in Berlin see limits to their ability to do more in light of capacity constraints in the construction industry and planning approval bottlenecks (especially at the local government level, where most construction investment is realized).

Germany's fiscal space for 2020 is limited under the debt brake



Public investments barley keep up with decaying capital stock



Source: Destatis, Danske Bank

Macro forecasts - Germany

% change q/q	2020				2021				Calendar year average			
Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2021
GDP	0.6	1.0	1.4	1.4	1.3	1.3	1.3	1.3	1.5	0.5	0.6	1.3
Private Consumption	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.6	1.2	1.2
Fixed Investments	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	3.5	2.8	1.2	1.9
Public Consumption	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	1.4	2.2	2.5	2.4
Exports	0.8	1.6	2.4	2.4	2.8	2.8	2.8	2.8	2.3	1.4	1.2	2.6
Imports	2.8	2.8	2.8	2.8	3.6	3.6	3.6	3.6	3.7	2.4	2.3	3.3
Net exports [1]	-0.9	-0.5	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.5	-0.4	-0.4	-0.2
Unemployment rate (%)									3.4	3.1	3.0	3.0
HICP (y/y)									1.9	1.3	1.5	1.4
Core HICP (y/y)									1.3	1.3	1.4	1.4
Public Budget [2]									1.7	1.0	0.8	0.7
Public Gross Debt [2]									61.9	59.2	56.8	55.0
Current Account [2]									6.8	6.0	5.9	5.8

1. Contribution to GDP growth. 2. Pct. of GDP. 3. End of period. Source: Eurostat. Danske Bank estimates

Politics: Fiscal hawks maintain the upper hand for now, but a political storm is brewing in Berlin

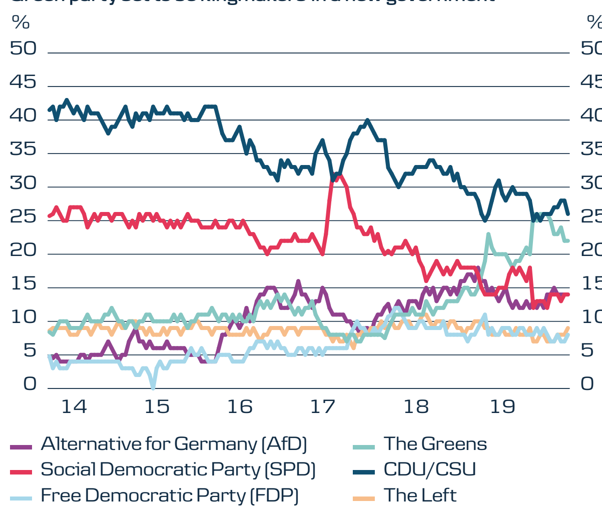
For now fiscal hawks maintain the upper hand in the government and the ECB's call is unlikely to be heeded anytime soon (see fiscal policy box). However, a political storm is brewing in Berlin. Following dire defeats in state elections in the autumn, cracks in the coalition have widened amid internal party divisions. A new SPD leadership that will be elected on 6-8 December could well be the final trigger that eventually leads to a break in the current 'grand coalition' (20% probability). Hence, investors should keep the possibility of a new government/election in Germany on the cards for 2020.

In case of a government collapse, new elections are not a foregone conclusion, as the initiative rests with the President, but either way signs are that the Green party looks set be kingmakers in any new government. The Greens have long been strong advocates of more 'strategic' public investments and an end to fiscal austerity to stem Germany's infrastructure decay. Support for a fiscal regime shift also seems to be gaining increasing traction among the German public, with a recent poll finding a small majority - 55% - in favour of abandoning the 'black zero' policy in difficult economic times. In that sense, a change in government, rather than a deep recession, remains currently the mostly likely trigger for a fiscal policy rethink in our view.

Key economic policy pledges of the Green party

- Additional 'strategic' public investments of EUR30bn per year (i.e. for transportation infrastructure, innovation, technologies and meeting climate targets)
- Supplement constitutional debt brake with an investment rule based on the loss of infrastructure value
- R&D incentives
- European venture capital fund to invest in core technologies (5G)

Green party set to be kingmakers in a new government



Source: Infratest Dimap, Danske Bank

UK

Brexit taking its toll on the economy

- Brexit continues to take its toll on the British economy. Underlying growth is likely to remain in the range of 1.0-1.5% in the years ahead. The labour market has been quite resilient for a long time but recently we have become more concerned.

- The general election is decisive for the Brexit outcome but unfortunately, it is very difficult to predict the outcome.

- The acknowledged MRP model from YouGov predicts The Conservative Party will win an absolute majority and so make it possible for Boris Johnson to pass his Brexit deal before Christmas, which is now our base case. The UK will then leave the EU by 31 January 2020 and start the negotiations on the future relationship. There is risk of a “no deal Brexit” by 31 December 2020 if no deal is reached or the transition period is not extended.

- If the opposition wins, we expect a second EU referendum. The risk is another hung Parliament with no stable majority, which would require another extension.

- We expect the Bank of England to cut at its meeting in January 2020 and think it is a close call whether or not there will be another cut in the second half of 2020.

Brexit is taking its toll on the economy

Brexit continues to take its toll on the British economy. Although the first estimate of GDP growth in Q3 showed that it grew by 0.3% q/q, GDP declined in both August and September. Looking at the annual growth rate, GDP growth is at its lowest since the European debt crisis in 2011-13. The PMIs in October were not encouraging and signalled a weak beginning to Q4.

The prolonged Brexit uncertainty has mainly hit businesses and not so much consumers. Private consumption remains the main growth driver although it is not growing as fast as a couple of years ago. The UK is still in an investment recession although business investments were flat in Q3. Looking at the year-over-year growth rate, business investments are still lower than a year ago. This is quite extraordinary nearly 10 years into the expansion when comparing to previous expansions and the rest of the world. Around 55% of the companies think Brexit is among the top three sources of uncertainty and many companies have postponed investments decisions due to Brexit. With Brexit postponed once again, the outlook for business investments still looks weak. It does not help that growth in the rest of the world has slowed due to (among other things) the ongoing US-China trade war. Hopefully, this will soon be resolved.

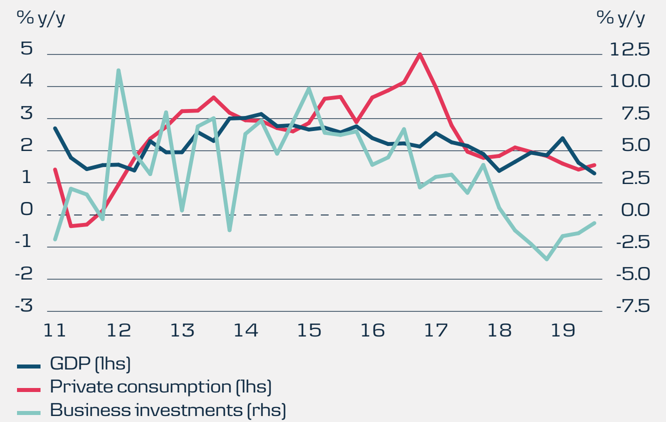
The labour market has been quite resilient to Brexit uncertainties so far, but recently we have become more concerned about its development. Although the jury is still out (employment data are very volatile), the most recent jobs reports have shown falling employment in July and August, although it rebounded slightly in September. Soft indicators suggest weak or even negative employment growth may continue. If this is the beginning of a new trend, this may start a downward spiral, which would lead to a more severe economic slowdown.

Even if we assume Brexit happens soon, we do not expect investments to kick off, as businesses still do not know what the future relationship will look like. These negotiations are only about to start when the UK leaves the EU formally, and they are going to be much more complicated than the negotiations on the withdrawal terms. It could be that we are too pessimistic here and that companies may start to invest in more projects than they had postponed due to Brexit.

We are having a hard time seeing much higher growth over the forecast horizon and think growth will remain in the 1.0-1.5% range over the coming years (against 2.0-3.0% before Brexit was a theme). We will probably not surprise anyone in saying that Brexit makes it difficult to make precise forecasts for the economy, in particular with the stockpiling ahead of the Brexit deadlines.

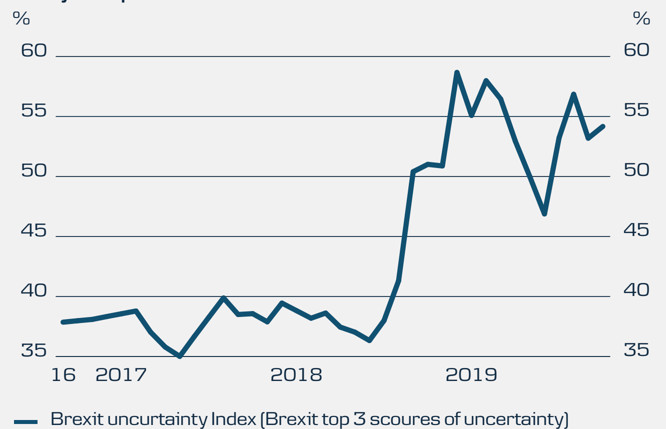
We forecast GDP growth of 1.4% this year, 1.0% in 2020 and 0.9% in 2021 but stress that Brexit remains a big source of uncertainty.

UK is still in an investment recession due to high Brexit uncertainty



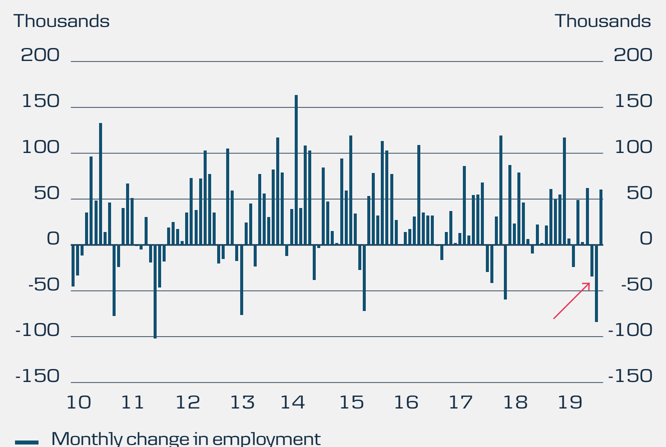
Source: ONS, Macrobond Financial

Brexit is among the top 3 sources of uncertainty for many companies



Source: Bank of England, Macrobond Financial

Early signs that the UK labour market has taken a hit



Source: ONS, Macrobond Financial

Election is an EU referendum in disguise

In line with our long-held view, Brexit has been extended again (new Brexit Day is 31 January 2020) and a general election has been called (Election Day 12 December). In our view, the election is an EU referendum in disguise. Unfortunately, it is difficult to translate polls into mandates due to the 'winner takes all' election system. The long-awaited results from YouGov's so-called MRP model predicts an absolute majority for The Conservative Party. The YouGov MRP model was the only one to correctly predict Theresa May would lose her absolute majority in 2017. Based on the model's results, we now think a Conservative majority is the most likely outcome.

If it turns out to be right, PM Boris Johnson will be able to pass his Brexit deal before Christmas without too many problems (Friday 20 December has been circulated as a potential voting day) and the negotiations on the future relationship will begin soon afterwards. The negotiations on the future relationship are complicated and there is not much time, as the transition period ends on 31 December 2020 and Johnson has rejected the idea of extending it. In other words, there is another looming risk of a no deal Brexit by the end of the transition period if the UK and the EU27 cannot agree either on a permanent deal or an extension of the transition period.

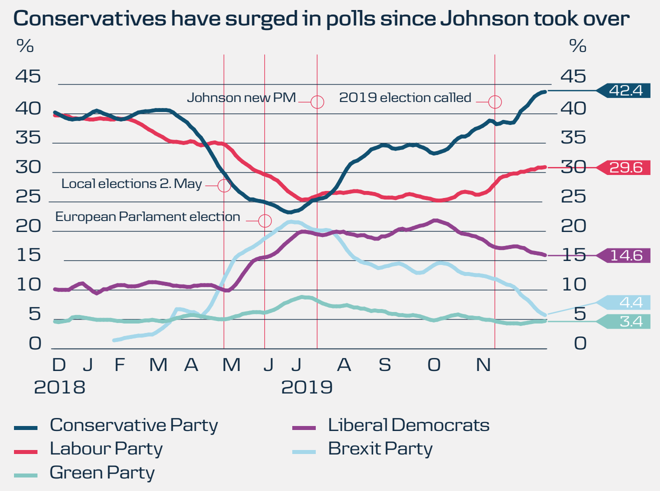
While Labour is unlikely to win an outright majority, the five opposition parties (Labour, LibDems, SNP, Plaid Cymru and Greens) may have a majority together. If so, we think a second EU referendum will be called although the parties have difficulties working together. LibDems, SNP, Plaid Cymru and Greens are all campaigning for a second EU referendum with 'remain' as one of the options on the ballot. Labour wants to renegotiate with the EU before asking the people whether to remain or leave with the 'Labour deal'. 'Remain' is slightly ahead in opinion polls.

In case of a hung parliament without a clear/stable majority, the period of high uncertainty and confusion will continue and the UK may need another extension beyond 31 January. Despite Brexit fatigue in Brussels, we expect another Brexit extension will be granted eventually.

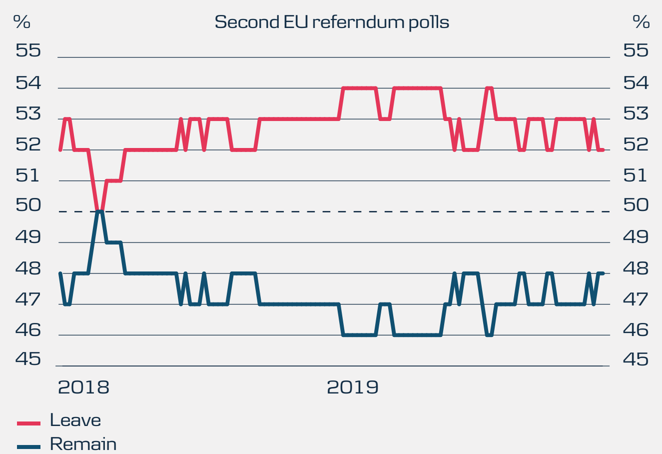
GBP in the hands of Brexit

Brexit remains the most important driver for GBP. We think the tail risk of a no deal Brexit in the short-run has declined substantially and investors have priced out a lot of negativity in GBP. EUR/GBP is currently trading just above 0.85 down from 0.93 in early August when investors thought PM Johnson's no-deal Brexit threat was credible. If PM Johnson wins the election, EUR/GBP may move slightly lower. If the opposition wins, it would spur hopes of Brexit being undone and should support GBP. A hung parliament would probably be GBP negative by creating renewed political uncertainty, but upside in EUR/GBP would still probably be capped around 0.90. If a Brexit deal passes, we see a risk that EUR/GBP will move higher again, as investors may start repricing a no-deal Brexit risk premium during the transition period.

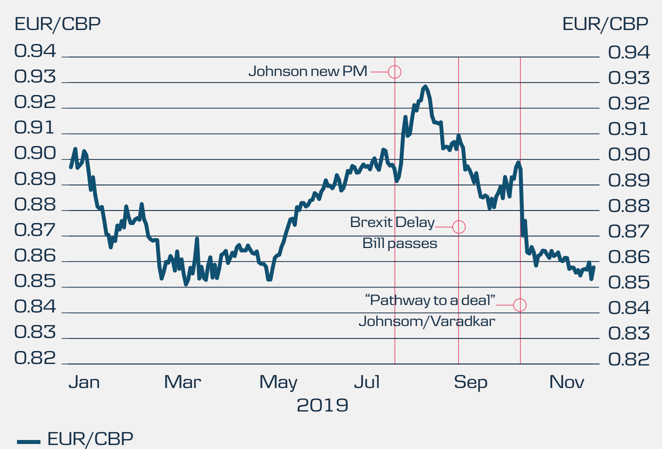
Following the dovish policy signal sent by the Bank of England at its November meeting, we now expect a 25bp cut in January 2020 and think it is a close call whether or not there will be another rate cut in the second half of 2020.



Source: Britain Elects, Macrobond Financial



Source: : NatCen Social Research, Macrobond Financial



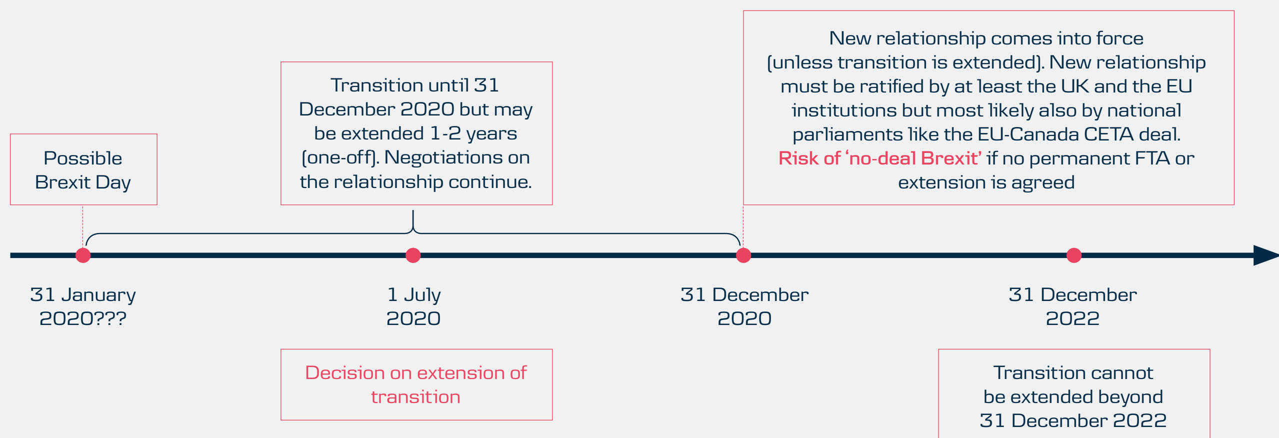
Note: Past performance is not a reliable indicator of current or future results
Source: Bank of England, Macrobond Financial

Macro forecasts - UK

% change q/q	2020				2021						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2019	2020	2021
GDP	0.4	0.2	-0.2	0.3	0.3	0.3	0.3	0.3	1.4	1.0	0.9
Private consumption	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	1.3	1.4	1.4
Government consumption	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	3.3	1.3	0.6
Fixed investments	-0.8	0.0	0.3	0.3	0.3	0.3	0.3	0.3	-0.1	-1.5	0.9
Exports	0.0	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	1.7	2.0
Imports	-1.0	-1.0	0.5	0.5	0.5	0.5	0.5	0.5	3.3	-2.4	1.6
Domestic demand[1]	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.4	0.9	1.2
Net exports[1]	0.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.9	1.2	0.1
Inventories[1]	0.0	-0.5	-0.5	0.0	0.0	0.0	0.0	0.0	0.8	-1.1	-0.4
Unemployment rate (%)	3.8	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.8	3.8	3.7
Wage growth (% y/y)[2]	3.2	3.1	3.2	3.6	3.7	3.7	3.7	3.7	3.5	3.4	3.7
CPI (% y/y)	1.7	1.3	1.2	1.6	1.6	1.6	1.6	1.7	1.8	1.4	1.6
Core CPI (% y/y)	1.8	1.7	1.7	1.8	1.8	1.7	1.7	1.8	1.8	1.7	1.8
Public budget[3]									-1.4	-1.1	-1.1
Public debt[3]									83.8	82.9	82.2
Current account[4]									-3.5	-3.7	-3.7
BoE Bank Rate (%) (end of period)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.50	0.50

1) Contribution to GDP growth
2) Average weekly earnings excluding bonuses. % y/y
3) % of GDP. OBR forecasts
4) % of GDP. EU Autumn forecast
Source: OBR. EU Autumn forecast. Danske Bank

Brexit timeline



Japan

Sheltered for now – bumpy road ahead

- Demand has been remarkably resilient in Japan despite the weaker global economy. Another record fiscal budget and the Olympics should keep the economy growing in 2020. In 2021, the economy will have to find support abroad to keep growing. We expect GDP growth to decline from 1.0% in 2019 to 0.5% in 2020 and 2021.

- The VAT hike poses an immediate risk to domestic demand. A supplementary fiscal budget for the reconstruction from typhoon Hagibis should take the edge off, though.

- Looking a little further ahead, escalation of the global trade war is the key risk for Japan, as it hits the economy in two ways: on declining demand for Japanese goods and a deterioration of competitiveness on the back of yen appreciation.

- We expect further easing of economic policy will come from the fiscal side, whereas the Bank of Japan will keep its policy largely unchanged through 2020 and 2021 and stick to fine-tuning.

Solid economy despite weaker global demand

The economy has been robust during 2019 despite several headwinds. Domestic demand has been the primary growth driver on the back of decent household consumption and investments and an accommodative fiscal stance. Under difficult circumstances, exports have weakened and were down around JPY100bn y/y in September with US, China, ASEAN and also the smaller trading partner South Korea, where exports have been weak since the bilateral trade spat began earlier this year. The strong yen has been a key reason for this.

As of 1 October, Japan entered troubled, although not uncharted, territory, when VAT was raised from 8-10%. The last time VAT was hiked the economy went straight into recession. This time the government has taken several measures to mitigate the shock to private demand. Among other things, it has excluded groceries from the tax hike and for a limited time, cashless transactions to small and medium retailers are subject to a 2% refund. The general expectation of the Bank of Japan (BoJ) and the government has been that the impact would be far less severe this time. However, we saw a big spike in September retail sales followed by a huge plunge in October, indicating that people are reacting quite strongly to the VAT hike. The October typhoon Hagibis probably also benefitted by keeping people at home, though.

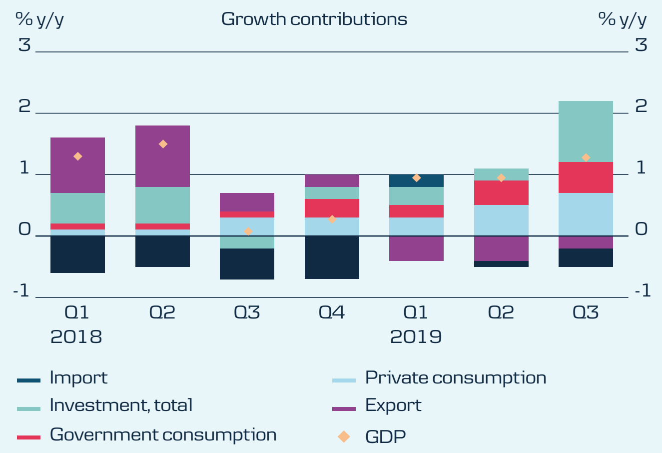
Olympics and public spending will support growth

Despite stagnating wages, the increasingly tight labour market has boosted total wage income. We expect a significant correction in consumption in Q4 due to the VAT hike and, looking ahead, we see scope for a limited pick-up in consumption. Consumers are cautious and once the impact of the VAT hike has settled, we expect private consumption to grow slowly. Massive public debt forces households to save.

2020 will be the year for the Tokyo Olympics and it will likely have a significant economic impact. According to a BoJ research paper (*Economic Impact of the Tokyo 2020 Olympic Games*) GDP has been affected already since the nomination of Tokyo back in 2013. To begin with, it was primarily investment, but tourism has also benefitted from the Olympics, even years before the actual games. Whatever the reason, tourism in Japan has exploded since the nomination in 2013, with the number of arrivals at 31.2 million in 2018 compared with 10.4 million in 2013. However, recently Japan has seen a large fall in the number of tourists, primarily driven by a decline in the number of South Korean visitors in the wake of the intensified trade spat between the two countries, see box.

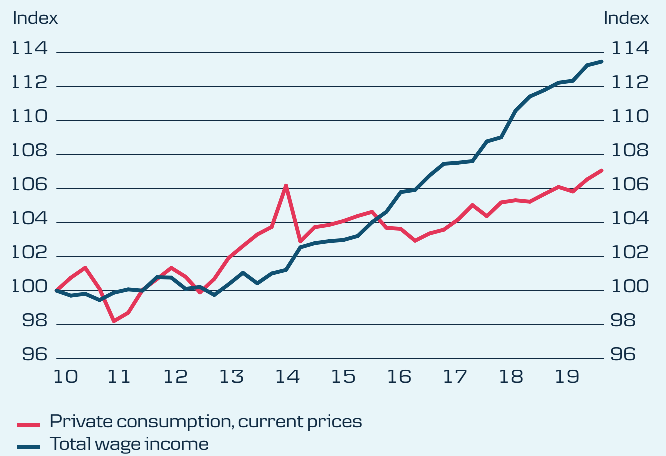
In 2020, the impact of the Olympics is going to peak, as 920,000 spectators are expected (by the organizers) to visit Tokyo per day and the BoJ expects the total contribution to GDP of the Olympics to add approximately JPY8trn to GDP in 2020, equivalent to 1.5% of GDP (just 0.2%-points more than in 2019, though). Investment in particular is going to wane as the Olympic boost disappears, but also because businesses assess that their production capacity has increased during 2019. That said, an increasing labour shortage will support the incentive to invest.

Solid private demand support growth



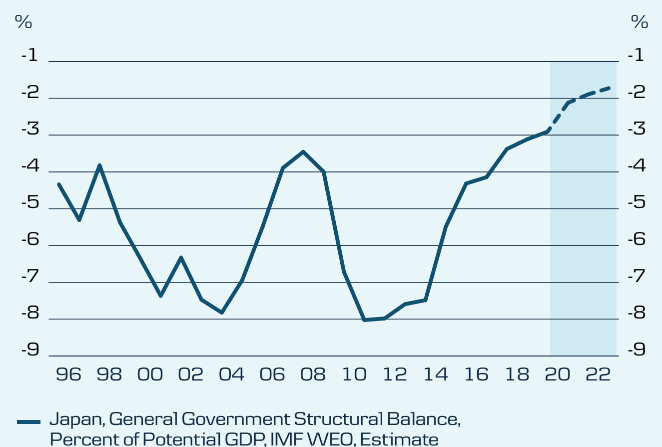
Source: Japanese Cabinet Office, Macrobond Financial

Front-loading ahead of VAT-hike - consumers remain cautious



Source: Japanese Cabinet Office, Macrobond Financial

Abe is still running large deficit to support growth



Source: IMF WEO, Macrobond Financial

The government is very much aware of the challenges ahead. Weak global demand, low inflation, fears of economic slump following the Olympics and the risks for private domestic demand from the VAT hike all push for another record fiscal budget for the fiscal year 2020. A JPY105trn budget is also in the pipeline and, following the October typhoon Hagibis, a supplementary budget including spending on reconstruction after the extensive destruction in eastern Japan is also on the way.

Bank of Japan buying time

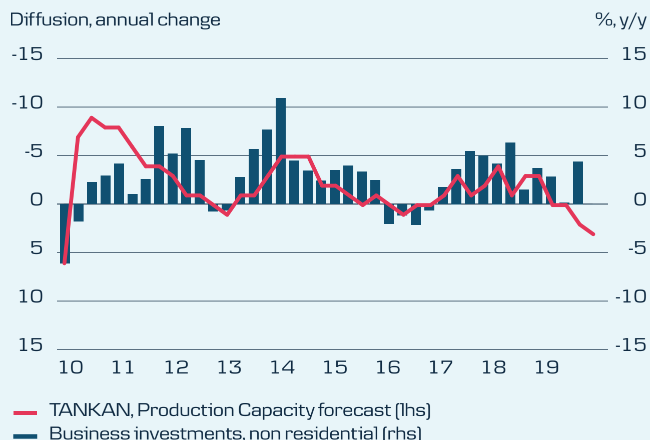
The BoJ's action plan depends heavily on where the global economy is heading. As long as foreign demand holds up, the risk of a recession does not escalate and yen strengthening is not going off the charts, then the BoJ will prefer to remain on hold. That said, the yen is not far from a seven-year high – a strong yen weighs heavily on the inflation outlook.

At the October policy meeting the BoJ changed its forward guidance and pledged to keep rates at "...present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost", a vague promise. It will be very much be at the BoJ's discretion to decide, when it is no longer necessary to pay close attention to the inflation outlook. That said, Governor Kuroda made a big deal out of assuring the markets of the willingness to act at the following press conference. In October, CPI inflation, excluding fresh food, stood at just 0.4% and one could argue the momentum towards reaching the price stability target has already been lost and doing more of the same and expecting a different result is naive. That is currently the official opinion of one member on the board and it will probably take a further turn for the worse to get more on board with that view. Kuroda has been touring with the message that a mix of fiscal and monetary stimulus is the best way to boost the economy, which indicates the BoJ is in the business of fine-tuning its policy stance at best, not inventing new tools. Finance Minister Taro Aso has iterated this by saying that "it's natural that monetary and fiscal policy should work as one to pull Japan out of deflation completely."

We have seen fine-tuning from the BoJ recently. One of the key areas of focus has been the shape of the yield curve. Kuroda has mentioned several times, that long yields have declined too much and in October, the BoJ cut its purchase of all Japanese government bonds (JGBs) with a maturity above three years. The BoJ seems generally concerned about the implications for regional banks and pension funds, and what we can count on the BoJ to do is to fine-tune its JGB purchases to ensure a positive sloping yield curve. Kuroda has also called for more government issuance in the super-long segment in order to secure this. On 50-year JGBs, Aso has said it is "a topic of consideration". Currently the maximum length of borrowing is 40 years.

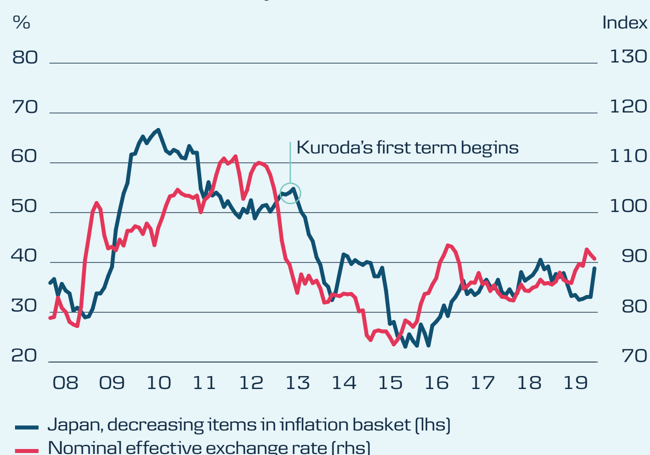
We expect inflation to remain far below target and the BoJ to keep its quantitative and qualitative easing with yield curve control unchanged throughout the forecast horizon.

More production capacity set to weigh on investments



Source: Bank of Japan, Japanese Cabinet Office, Macrobond Financial

Deflation battle not won yet



Source: Bank of Japan, Macrobond Financial

BoJ has reacted to declining slope on yield curve

Source: Macrobond Financial

Macro forecasts - Japan

% y/y	2017	2018	2019	2020	2021
GDP	1.9	0.8	1.0	0.5	0.5
Private Consumption	1.1	0.3	0.4	-0.3	0.8
Private Fixed Investments	3.7	2.3	1.7	0.1	0.0
- Residential investment	2.2	-5.9	2.9	0.9	1.3
- Non-residential	3.9	3.9	1.5	0.0	-1.0
Public Investments	0.8	-3.4	1.7	1.4	0.0
Public Consumption	0.3	0.8	2.2	1.9	0.4
Exports	6.8	3.4	-1.8	1.7	2.1
Imports	3.4	3.3	-0.5	0.8	1.2
Unemployment rate (%)	2.8	2.4	2.4	2.4	2.4
CPI. excl. fresh food (y/y)	0.5	0.9	0.7	0.7	0.9
- Excluding consumption tax hike	0.5	0.9	0.5	0.6	0.9
BoJ rate on deposit facility*	-0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.0	0.0	0.0	0.0	0.0

*Note: *end-year*
Source: Danske Bank. Macrobond Financial

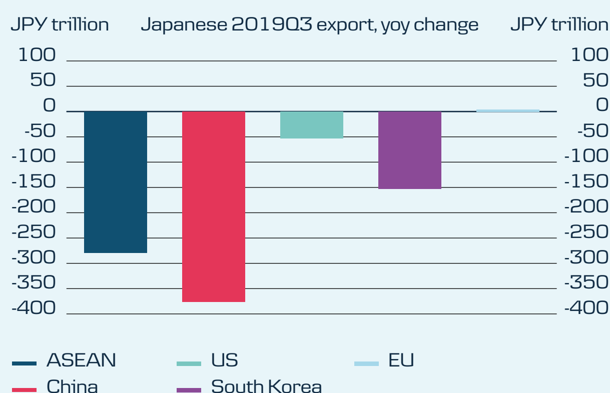
Asian trade dispute weighs on exporters

Japan-South Korean relations is at a low point and the prospects for a turnaround are hard to find. This weighs increasingly heavy on Japanese exporters as a string of boycuts of Japanese products have gained traction. South Korean imports of beverages have plummeted by 87% in August-October compared to the same period last year. Exports to South Korea have declined relatively more than any of Japan's other big trading partners. Slowing Chinese demand is still the biggest drag on Japanese exporters, but there are prospects for a rebound once the global economy and China regain momentum. The same cannot be said of South Korean demand.

According to polls, the dislike between Japanese and South Koreans has grown. There seems to be public support for a hawkish political stance from both sides of the dispute and the situation is deadlocked with the two countries off each other's list of preferred trading partners making it more cumbersome to trade. South Korea has even decided to invest USD857 million to break its de-pendence on Japanese tech materials.

The trade spat originates in the Japanese colonization of the Korean peninsula up until the end of WWII. In 1965, "The Treaty on Basic Relations" between the two coun-tries was signed and Japan payed war reparations. In 2018 South Korea's Supreme Court ruled that the 1965 pact was only designed to settle financial issues between the two countries, and that the rights of individuals to seek compensation was not terminated. Based on that, Japanese firms have been ordered to pay damages for the "mental suffering" of former wartime forced labourers. South Korea is Japan's third largest export market. With no solution to this conflict in sight, Japan has only become more dependent on a pickup in the global economy.

Asian demand has declined the most



Source: Japanese Ministry of Finance, Danske Bank, Macrobond Financial

China

Clouds are lifting

- Chinese growth took a hit from the trade war in 2019 but rays of light have emerged, that suggest the worst may be behind us. We expect a moderate increase in the manufacturing sector driven by stimulus and easing trade tensions.
- The US-China trade war has calmed down again and we see a 50% chance that the US and China will strike a big deal in 2020 and some tariffs will be rolled back.
- China has been the epicentre of the global slowdown and we expect the lift to activity to have a positive spillover to the rest of the world.
- We expect only limited further policy stimulus from here and a slight appreciation of the CNY as activity bottoms and trade fears ease.

Chinese slowdown in 2019 but no hard landing

The Chinese economy had a tough first half of the year. The trade war took its toll on exports and the uncertainty put a big dent on the appetite for spending in both the corporate sector and among consumers. The slowing of the global economy also added to the headwinds for exports and sentiment. Households have cut back on purchases of durable goods and car sales have suffered. As in Germany, the rollout of new emission standards for cars has caused havoc in the Chinese car market and added to this year's lacklustre sales. It shows that China has become more willing to sacrifice growth in the short term to achieve goals for the longer term, in this case reducing pollution.

On top of the drags from the trade war and new emission standards, China's efforts to deleverage and make the financial system more resilient have been a further headwind. The crackdown on shadow finance since 2016 has put pressure on many private companies, which have traditionally had difficulty getting loans from the big state-owned banks. Defaults have increased markedly as a result. China has taken steps to restructure credit to the private sector and force state banks to fill the gap caused by the decline in shadow finance. However, banks are likely to be more cautious than shadow finance entities that pass on the risk to investors. There are signs, though, that credit growth has picked up again this year. However, this also reflects the rise in infrastructure spending among local governments, as the central government has increased project approvals to cushion the economic downturn.

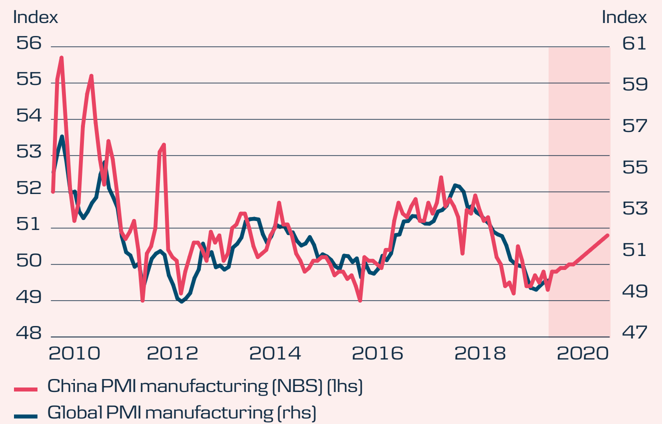
On top of the lift to infrastructure spending, the Chinese government has added stimulus in other ways. Authorities have eased policy via reductions in the reserve requirement ratio, targeted lending programmes and easing of rules for bond issuance. Fiscal policy has underpinned growth through tax cuts to both consumers and companies. The construction sector has benefited from a very low level of supply of houses as sales outpaced new construction for some time. The policy stimulus and fairly robust construction sector have added enough support this year to avoid a hard landing but an economic slowdown has been inevitable.

Rays of light

As the saying goes, it is always darkest before dawn. In recent months, we have witnessed signs that dawn may be here. PMI manufacturing data have recovered and other indicators have verified this signal. Growth in rail freight and electricity production has increased and export growth in economies close to China has improved. Prices on metals such as copper and aluminium have also stabilised. The improvement has come a bit earlier than we expected but we believe it is due to the combined effect of stimulus kicking in and a reduction of inventories.

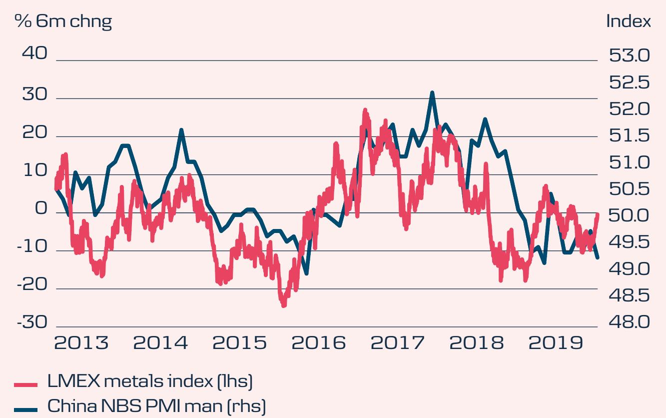
Looking ahead, we expect a moderate recovery heading into 2020. Stimulus is set to continue working its way through the system and if we are right that inventory levels have been cut down (data are not very good in this area), it should also work to lift activity. The recent positive development in the trade war has also reduced some of the uncertainty. We expect this to continue into 2020, as we look for US President Donald Trump to take the planned US tariff hike in the middle of December

Moderate recovery to have positive spill-over to the rest of the world



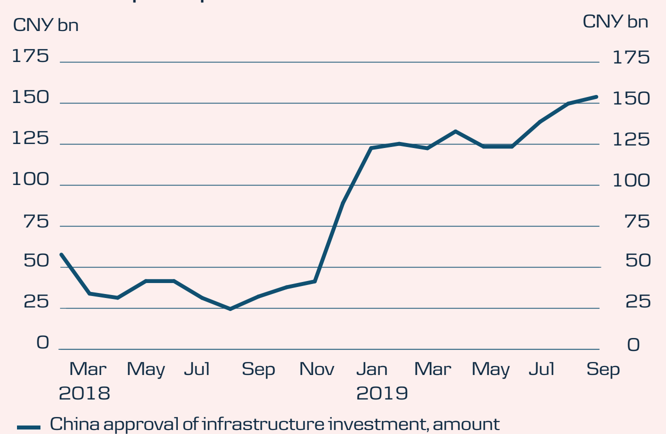
Source: Macrobond Financial, NBS, Danske Bank forecasts

Metal markets underpin picture of moderate improvement



Source: Macrobond Financial, Danske Bank forecasts

Infrastructure investments got a lift when trade headwinds piled up



Source: Macrobond Financial, Bloomberg, Danske Bank

off the table again (see box for more on the trade war). If we are right that the manufacturing sector will see a moderate recovery, it should spill over to higher profit growth as well.

While we look for a recovery in manufacturing indicators, we still expect GDP growth to moderate from 6.2% in 2019 to 6.0% in 2020. This is mostly because we do not see GDP numbers as a good indicator for short-term swings in the economy. In recent years, GDP has moved very smoothly, even when other indicators have shown upturns and downturns.
With signs of improvement in economic indicators, we believe China has almost finished adding stimulus for now. However, there may be tweaks here and there to policies and it may take steps to lift private consumption further, as it is seen as a structurally more important growth driver over the coming decade.

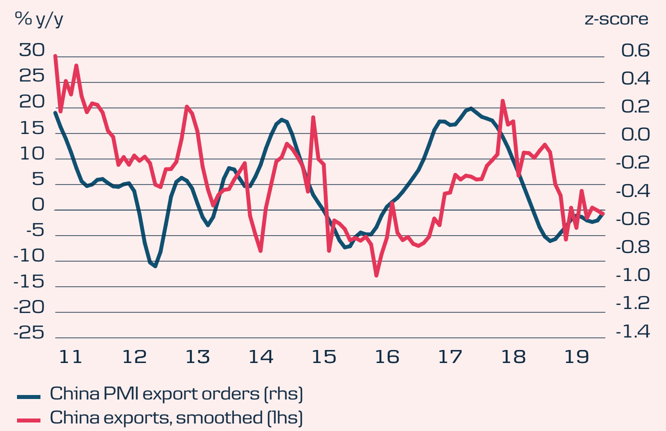
As China has been the epicentre of the global slowdown, we expect the moderate recovery in China to filter through to a gradual upturn in the global economy in 2020. Not least, Europe has suffered a big export blow but a Chinese pickup should give more tailwind to European exporters.

China to continue catching-up

We often see headlines that growth in China is the lowest in close to 30 years. However, we do not believe this is a too great cause for concern. Indeed, we may very well see this headline every year over the next 20 years, because Chinese growth is declining on a structural basis. This is normal when an economy has reached this stage of the development cycle. It is also partly a consequence of China prioritising quality over quantity, which is a good thing. More enforcement of environmental regulation, for example, hurts growth in the short run but it is necessary in the long term. The new emission standards for cars have also put a brake on growth but they should pay off in the long term. We also continue to emphasize that it is important not to be fooled by lower percentage growth rates. Over the next six years we expect growth to slow to 5.5% but this will still be enough to add USD7 trillion to the economy. It is as much as China grew in total during the first 30 years of catching up from 1980-2010 when the average real growth rate was 10.0%.

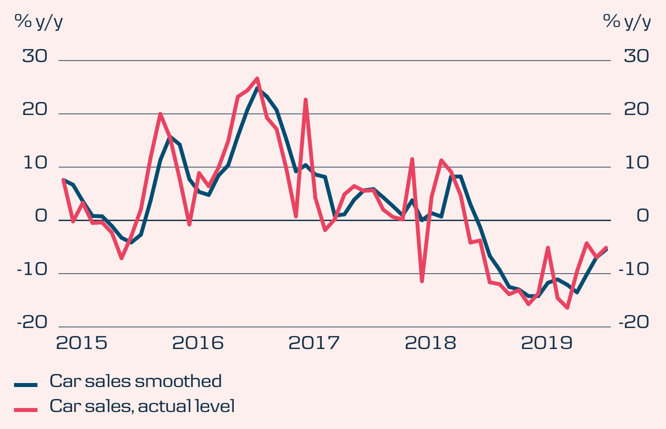
We expect China to continue reform and opening up policies in line with the message in numerous work reports and policy documents. In October, the World Bank released its ease of 'Doing Business' index for 2020, with China moving up to number 31 out of 190 countries and surpassing countries such as France and the Netherlands. China also continues to open up the economy to investments in new areas, most recently in the auto sector and finance. Reforms are slower in other areas such as state-owned enterprises. However, entrepreneurship is flourishing in China, not least in the tech sector, and in combination with more focus on research and development and education, we believe this will drive more innovation and growth in the years ahead. The blacklisting of Chinese tech companies in the US will put a brake on growth but we do not believe it will be able to stop it. Reforms have been slower in the area of state-owned enterprises but this is partly because this is where the most vested interests are to be found and partly because China tends to ease the pressure on reforms that hurt in the short term, when it is faced with other growth headwinds as is currently the case.

Early signs that the headwind from trade war and global slowdown has peaked



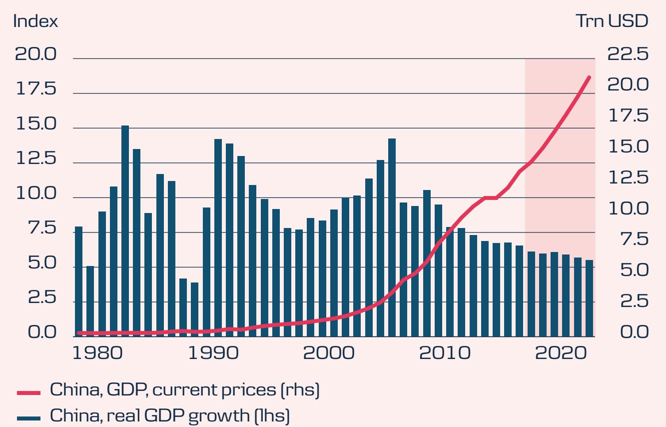
Source: Macrobond Financial, NBS, Markit, Danske Bank

Drag on car sales fading but not out of the woods yet, new emission standards added to headwinds



Source: Macrobond Financial, NBS, Markit, Danske Bank

Despite slowing real growth China will add another USD7 trn over the next five years



Source: Macrobond Financial, Danske Bank forecasts (grey area)

Macro forecasts - China

% y/y	2017	2018	2019	2020	2021
GDP[1]	6.8	6.6	6.2	6.0	6.1
Private consumption[1]	7.4	9.4	8.0	7.2	6.6
Investment[1]	5.1	4.8	3.8	5.0	5.8
Net exports[2]	0.6	-0.6	0.2	0.0	-0.1
Total investment share[3]	44.6	44.8	42.9	42.2	41.6
Total savings rate[3]	46.3	44.6	43.4	42.5	41.8
Current account balance[3]	1.6	0.4	0.5	0.4	0.2
CPI[1]	1.6	2.1	2.7	2.7	2.2
Wage growth (nominal. urban)[1]	9.0	8.5	8	7.5	7.5
Government budget balance[3]	-3.9	-4.8	-6.1	-6.3	-6.2
Augmented fiscal balance (IMF)[3,4]	-10.8	-11.2	-12.7	-12.2	-11.9
USD/CNY[5]	6.6	6.88	7.0	6.8	-
EUR/CNY[5]	7.9	7.95	7.7	8.1	-
PBoC 1-year lending rate. %[5]	4.3	4.3	4.15	4.1	-

1. % y/y.
2. contribution % to GDP.
3. % of GDP.
4. Includes local gov and off-budget activity plus excludes land sale proceeds.
5. end of year
Source: Macrobond Financial. Danske Bank forecasts

Can US and China strike a big deal?

The trade war has taken a lot of twists and turns since it started in early 2018 and it is very hard to predict developments. A six-month period of positive trade talks from December 2018 hit a major roadblock in May and the trade war escalated over the summer as Donald Trump turned to more ‘maximum pressure’ on China to get concessions out of it. A ceasefire in June lasted only a month. However, the two sides are now working on a phase one deal, which is expected to be reached during December. It should include Chinese purchases of US agricultural goods, a deal on protection of intellectual property rights and a currency pact. Agreement to pursue this phase-one deal will include Trump taking tariff hikes scheduled for 15 December off the table. We put the probability of a further phase-two deal ahead of the election in 2020 at 50%. Both sides show a strong desire to make a deal and the slowdown in the US economy is weakening Trump’s hand and threatening his re-election platform at the November 2020 Presidential election. According to some media reports, it is beliefed in the White House that Trump has a good chance of winning the election if the economy stays strong in 2020 and a trade deal secures large Chinese purchases of US agricultural goods. Hence, Trump may be willing to make the necessary compromise to meet China halfway and strike a bigger deal, possibly in the first half of 2020. A phase-two deal would be likely to include a ban on forced technology transfer, commitment to further opening up for investments, lower tariff rates and an enforcement mechanism to secure compliance with the deal. A complete rollback of tariffs to where they were before the trade war started has been a demand from China. If this were to happen, we believe it would be very positive for the global economy.

Emerging Markets

Modest recovery on the cards

- Economic prospects have improved in emerging markets on the back of a more dovish Fed, a possible US-China trade deal and economic stabilisation in China.
- We expect a modest economic recovery in Asian economies and Latin America aided by global economic recovery and modestly accommodative monetary policies.
- US-China trade talks remain both a positive and negative risk factor in 2020, depending on how talks on a permanent deal play out. Geopolitical risks in the Middle-East could lead to sharp movements in oil prices and risk sentiment affecting emerging markets.

Brightening prospects for emerging markets thanks to policy easing and possible US-China trade deal

Emerging markets (EM) witnessed a significant slowdown in 2018 and early 2019, as the Fed tightened monetary policy, triggering major economic crises in big EM countries such as Argentina and Turkey, while the trade war between the US and China also hurt sentiment. However, going into 2019, fortunes changed for EM as the Fed turned more dovish, allowing EM central banks to follow suit and cut policy rates, supporting domestic demand. The easing pattern has continued in EM in 2019 and the rate cuts across the 18 biggest EMs are the largest since the financial crisis. This easing together with the stabilisation of the Chinese economy has led to a pick-up in EM PMI manufacturing, which is defying the continuing slump in advanced economy manufacturing sectors and opening up the biggest gap between the two PMIs since the financial crisis.

Emerging markets will continue to improve

In our view, emerging markets will continue to see brightening prospects in 2020. A possible phase-one trade deal between the US and China will boost risk sentiment and lead to a strengthening economic outlook in China and global trade. We do not believe the Fed and other major central banks will be in a tightening mode in the foreseeable future. On the contrary, the Fed is likely to cut one more time as uncertainty about the US economy continues to linger. A Fed on hold will allow monetary policy in most EMs to stay accommodative and support domestic demand in EMs. The USD should weaken slightly in first half of 2020, which should spur a modest uptick in commodity prices.

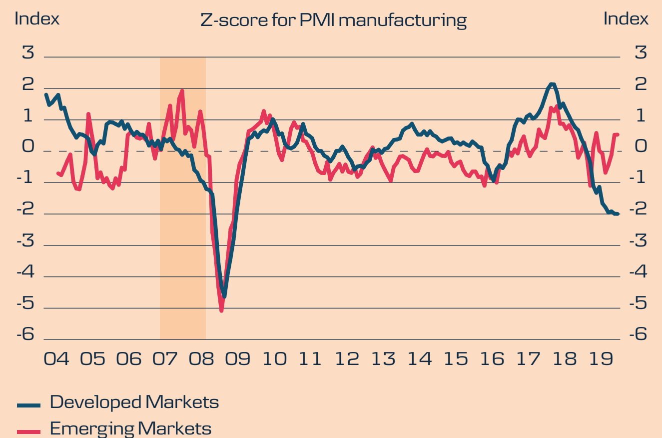
In our opinion, the Asian economies have the potential to outperform the rest of the emerging markets; India's growth rate is expected to rebound to 6.8% in 2020. In LATAM, the Brazilian economy should see slightly stronger momentum from improving Chinese economic prospects as well as stronger investment sentiment on the back of fiscal reforms.

In Central and Eastern Europe, economic growth is expected to slow in Hungary and Poland in 2020 as the absorption of EU fund investments slows, the pool of available workers shrinks and fiscal policies become less supportive. In the Czech Republic, which was hit hard by the German slowdown, we are foreseeing a slight pick-up in external demand.

China-US trade negotiations and geopolitics are key risks for EM

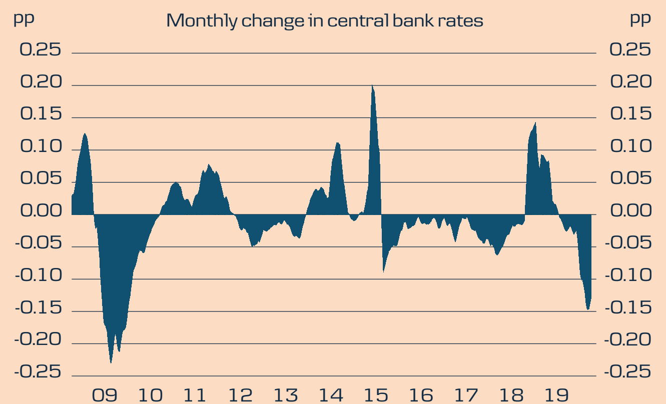
As has been the case in 2019, we expect US-China trade talks to remain a key risk factor for EMs in 2020. Should the two sides agree on a permanent deal that would roll back a significant number of tariffs, stronger global risk sentiment will help lift risk sentiment. This would likely be accompanied by a more hawkish Fed, hurting the more vulnerable EMs like Turkey and South Africa. On the other hand, if the trade war re-ignites (not a high-probability scenario), investor confidence will plummet, followed by a sell-off in EM assets and the Fed returning to its easing path. Another risk factor is the Middle East where tensions around Iran, Saudi-Arabia and Syria could create upward pressure on oil prices and deteriorating risk sentiment.

Emerging markets are leading the way...



Note: The series for PMI are standardised with their standard deviations to make them more comparable.
Source: Bloomberg, Macrobond Financial, Danske Bank

...thanks to the biggest monetary policy easing since the financial crisis...



Note: GDP weighted average of Argentina, Brazil, Chile, Columbia, Hungary, Indonesia, India, South Korea, Mexico, Malaysia, Nigeria, Peru, Poland, Russia, Thailand, Turkey, Taiwan, South Africa
Source: National central banks, Macrobond Financial

...improving economic prospects for most EMs in 2020. (Real GDP growth)

% y/y	2018	2019	2020	2021
Emerging Markets of which	4.5	3.7	4.3	4.7
China	6.6	6.2	6.0	6.1
India	7.3	6.0	6.8	7.5
Russia	2.3	1.2	1.7	2.4
Brazil	1.1	1.0	2.0	2.3
Turkey	2.8	-1.6	1.7	2.6
South Africa (SA)	0.8	0.6	1.7	2.0
Poland	5.1	4.0	3.7	2.8
Hungary	4.9	4.5	2.5	2.5
Czech Republic	3.0	2.6	2.7	2.8

Source: Danske Bank and Macrobond

Disclosures

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