The Big Picture

Investment Research
4 December 2018

No recession yet

Highlights

The global economy is slowing but will not enter recession yet

A trade agreement between China and the US is likely in mid-2019

Central banks will proceed cautiously with monetary tightening

Political risks will continue to dominate headlines but economic impact likely to be limited

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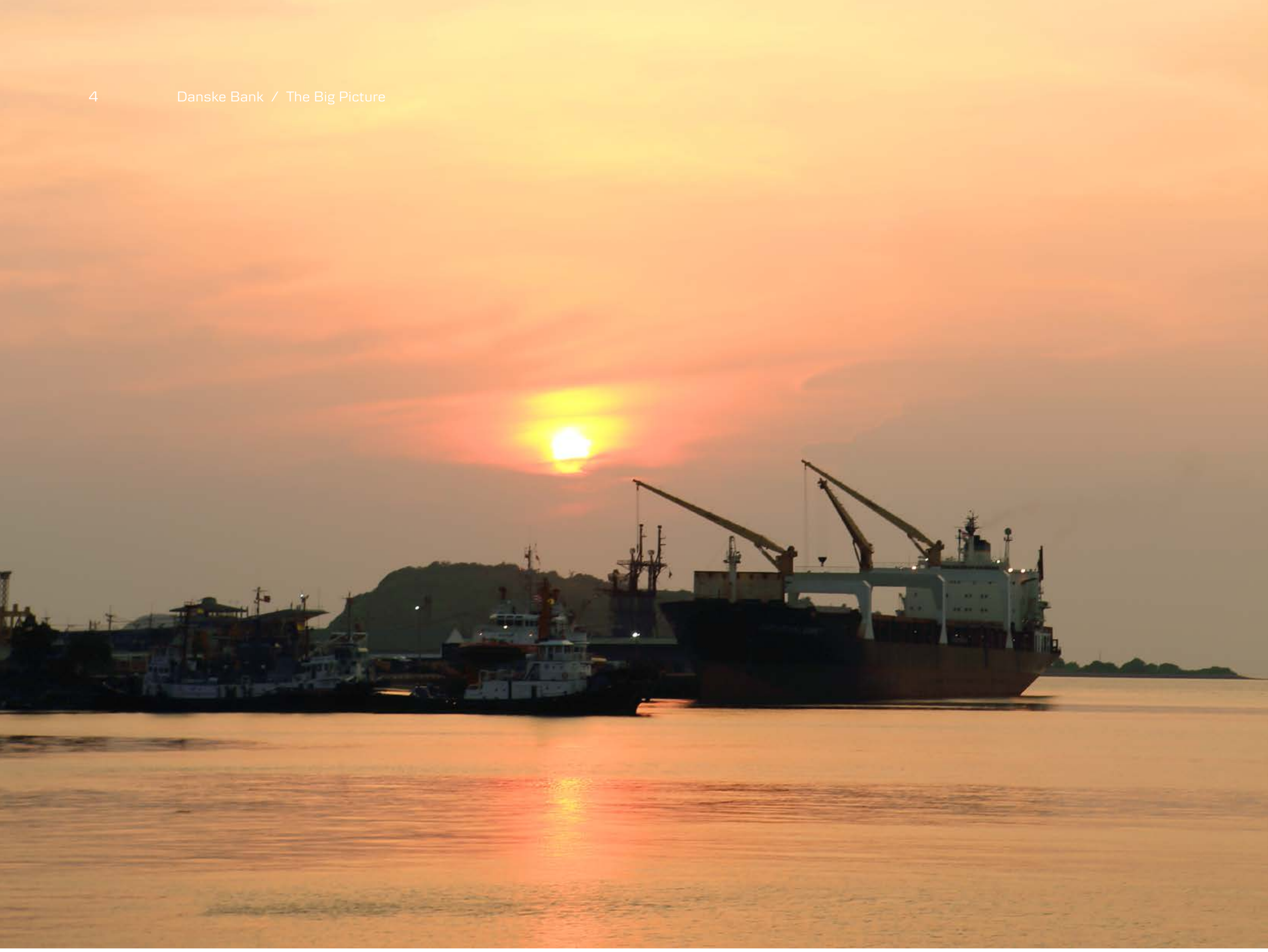
The Big Picture is a semi-annual analysis focusing on the outlook for the global economy. Read about the prospects for, and the most important risks to, the global economy. The publication Nordic Outlook presents our expectations for the Nordic economies.

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



Global overview

Slower momentum but no recession yet

- The growth momentum in global economy will continue to moderate toward its potential growth rate, but a recession is not around the corner
- A trade agreement between China and the US is likely in mid-2019
- Monetary policy outlook will continue to divert with the US seeing further tigthening while Europe and Japan will proceed more cautiuosly given the muted inflation pressures.
- Political risks from Brexit and Italy will continue to dominate headlines but the economic impact should stay muted

The global economy is losing momentum

The moderation in the global growth momentum that we called for in our June Big Picture ('from boom to cruising speed') has indeed materialised over the past months. Manufacturing PMI has fallen back both in advanced economies and emerging markets. Tightening of financial conditions, particularly in the US, which has been followed by higher US yields and Dollar, uncertainty about the future trade relations between US and China and distress in the most vulnerable emerging markets has weighed on global sentiment. The bright spot in the global economy has been the US, where fiscal stimulus has held up economic momentum.

Further moderation expected in 2019, but no recession in sight yet

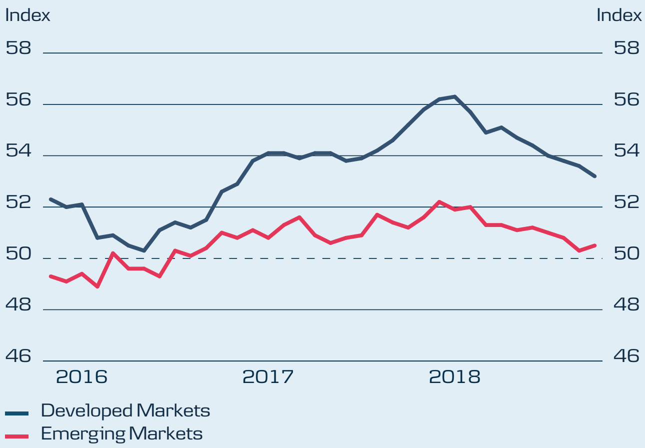
We expect the moderation in global growth momentum to continue over the next two years, seeing global growth falling from 3.8% in 2018, to 3.6% and 3.5% in 2019-20, respectively. This growth trajectory is somewhat lower than in our last Big Picture, reflecting mainly the escalation of the trade war between the US and China. This is especially going to create headwinds for the Chinese economy until an agreement is found between the two sides possibly around mid-next year (see below). Furthermore, the tensions can also affect sentiment in countries exposed to the global cycle such as the eurozone, Japan and emerging markets. Domestic demand in most economies will be supported by high levels of employment, increasing wage growth and falling energy prices. In the US, the fiscal stimulus will be a positive factor for US economic growth at least until Q3 2019.

While the growth in global economy is set to slow, we do not see a recession in the major advanced economies just around the corner. The still muted inflation pressures mean that central banks do not have to step too hard on the brakes, especially in the eurozone and Japan. Furthermore, macroeconomic imbalances are not sizeable. Instead of recession, we see economies merely slowing to their potential growth rates (see chart on the right). But there are clearly downside risks from further escalation of the trade war between the US and China, a disorderly Brexit and a sharp increase in tensions in the Middle East.

Trade discussions between US and China will continue well into 2019

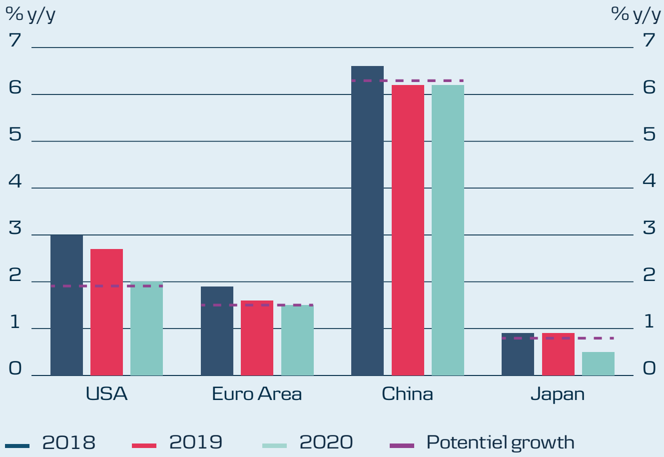
The trade war between the US and China has been a major source of uncertainty for the global economy in 2018. At the G20 meeting in Argentina in early December, China and US leaders agreed to a 90-day ceasefire period in which the two sides will seek agreement on a permanent deal. While negotiations will be intense and bumpy, we think the two sides will come to an agrement in the middle of 2019. Such a deal would clearly be positive for both global outlook and markets sentiment, as it would remove uncertainty for companies and help boost global trade. It will not least underpin a recovery in China during the year. It will thus remove a significant drag from the biggest contributor to global growth as China is driving one-third of the expansion in the global economy (see discussion in the box).

Global PMIs have declined from high levels



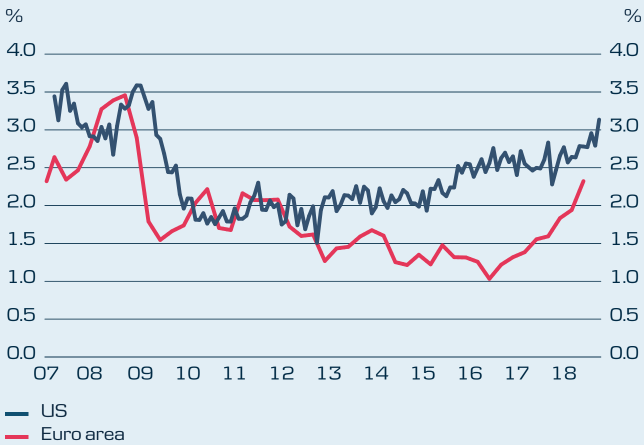
Source: Markit, Macrobond Financial

Economic growth are slowing to potential growth levels



Source: Macrobond Financial, Danske Bank

Nominal wage growth catches up speed in eurozone



Source: Macrobond Financial, Danske Bank

Inflation and central bank divergence

Amid further tightening of labour markets, wage growth continues to gradually pick-up speed in major economies given the fall in the unemployment rates. The pick-up in wage growth is supporting underlying inflation in most advanced economies, but albeit more slowly than anticipated, especially in the euro area and Japan.

Given the different inflation outlook between the US and other advanced economies, we expect further monetary policy divergence in 2019. The Fed is expected to hike rates at the December meeting and twice in first half of next year until the policy rate reaches 'the neutral rate' (eg. where monetary policy is neither expansionary nor contractionary) after which the rate path is more uncertain. In the eurozone, the ECB is expected to embark on a 'dovish tightening', ending the asset purchase programme by the end of this year and looking to hike rates in end-2019. However, at the same time it will continue to reinvest its maturing assets and offer new liquidity operations (TRTLO) in mid-2019. Meanwhile, the Bank of Japan is likely to proceed extremely cautiously given the still weak inflation pressures and is therefore expected to stay on hold at least through 2020. In contrast, we see further scope for monetary policy easing in China.

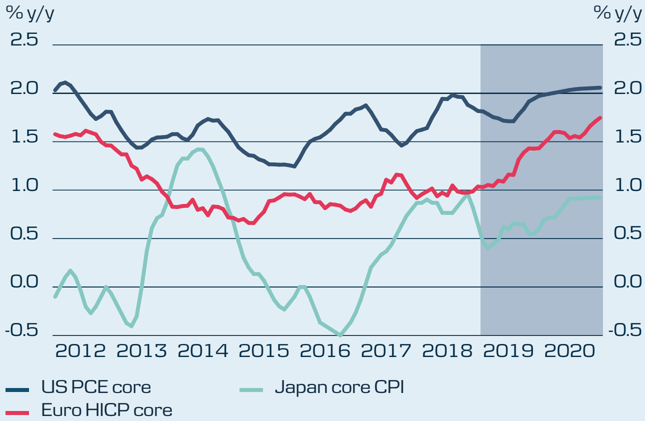
Political risks will continue to attract headlines in 2019 – but will it matter for the global economy?

Over the past years, we have witnessed heightened political uncertainty both in Europe, US and other parts of the world following the rise of populist parties. However, so far the impact on the global economy has been limited. There will be no shortage of political risk factors in 2019. Apart from the trade negotiations between China and the US, the Brexit process will be a key event for Europe, especially if the UK and EU fail to come to an agreement on the terms of the exit, which would have a material economic impact on both UK and the rest of Europe. The budget stand-off between Italy and the EU could lead to sanctions against Italy for violating EU fiscal rules, potentially triggering a political backlash in Italy and weakening market confidence, with adverse spill-over effects to the rest of the eurozone.

Further increase in US yields but USD will experience setback in H2 2019

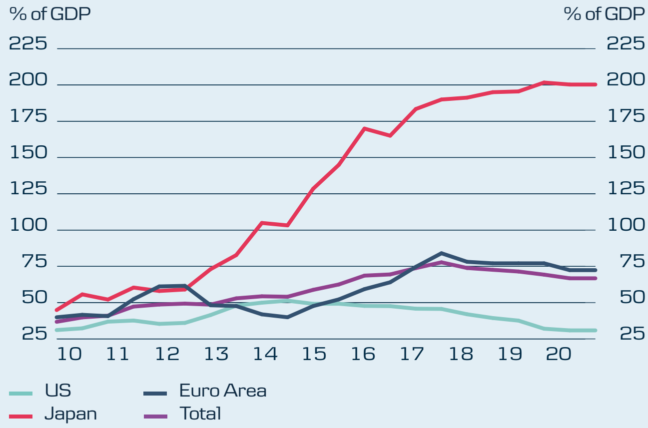
So what does the macro outlook mean for financial markets in 2019? The combination of financial tightening and expansionary fiscal policies will put upward pressure on US yields with the 10-year yield reaching 3.5% in end-2019, while German yields will increase to 0.9%. On the FX side, with the first ECB hike approaching in 2019, we expect the EUR/USD to climb higher, projecting the cross to reach 1.25 in late 2019. We expect oil prices to recover somewhat after their slump in the second half of 2018, as downward pressures abate, such as US selling from its strategic reserve and investors scale back short positions.

Underlying inflation pressures nowhere near target in Japan and eurozone



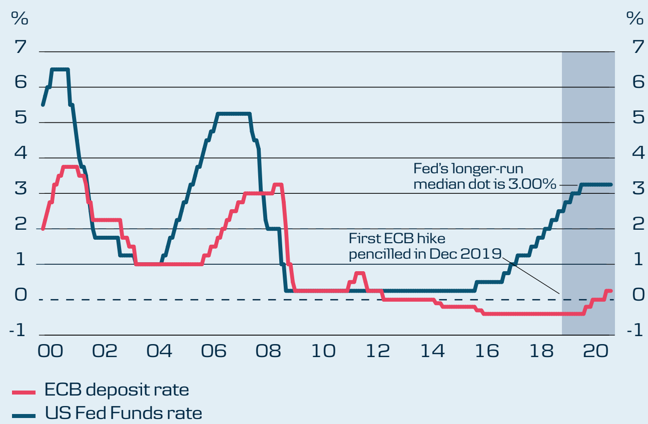
Source: Macrobond Financial, Danske Bank

Central banks going from large-scale quantitative easing to modest tightening



Note: the graph shows the central bank balances in % of GDP.
Source: Macrobond Financial, Danske Bank

Monetary policy set to diverge further between the US and Europe in 2019



Source: Macrobond Financial, Danske Bank

GDP forecasts - Global overview

	2017	2018		2019		2020	
% y/y	Actual	Danske Bank	Consensus	Danske Bank	Consensus	Danske Bank	Consensus
Global	3.7	3.8	3.8	3.6	3.6	3.5	3.3
Developed markets	2.2	2.2	2.4	2.0	2.1	1.6	1.8
USA	2.2	3.0	2.9	2.7	2.6	2.0	1.9
Euro area	2.5	1.9	2.0	1.6	1.6	1.5	1.5
Japan	1.7	0.9	1.0	0.9	1.0	0.5	0.4
UK	1.7	1.3	1.3	1.6	1.5	1.5	1.6
Emerging Markets	4.8	4.8	-	4.8	-	4.8	-
China	6.9	6.6	6.6	6.2	6.2	6.2	6.0
India	6.3	7.8	7.5	7.5	7.4	7.2	7.5
Russia	1.5	1.6	1.8	1.3	1.5	1.4	1.7
Brazil	1.0	1.4	1.3	2.0	2.3	2.6	2.5
Turkey	7.4	3.5	3.5	1.8	0.8	2.1	3.0
South Africa	1.3	0.5	0.7	1.6	1.7	2.1	2.1
ASEAN-5[2]	5.3	5.3	-	5.2	-	5.2	-
Middle East and NA[1, 2]	2.6	3.4	-	3.7	-	3.7	-
Sub-Saharan Africa (ex SA)[2]	3.1	3.6	-	4.3	-	4.4	-
LatAm (ex Brazil)[2]	1.4	1.1	-	2.1	-	2.9	-

1. NA is North Africa
Source: Bloomberg, IMF, Danske Bank

The cost of a global trade war

One of the most remarkable features of the Trump presidency has been the push for better trade deals with key trading partners, most notably China, prompting a tit for tat trade war between the two countries. The trade war between the two countries has now lasted for six months. It started in late May, when Trump left the negotiating table with China and decided to put tariffs on Chinese imports worth USD50 bn. From that moment on a tit-for-tat trade war was kicked off. In total US has slapped 10-25% on half of US imports from China. On 1 December, a termporary ceasefire was agreed paving the way for negotiations between the two sides for a permanent deal. However, while this has reduced the risk of an escalation of the trade war, the discussions can still go disarray between the two sides, causing renewed tensions.

Tariffs act as a tax on imports, which make the products more expensive for domestic consumers and companies. Furthermore, the tariffs also hit global supply chains, creating uncertainty for global companies exporting across countries, potentially hitting investment plans. There is also a possibility of a significant negative market impact, which can in turn affect consumer and investment decisions.

The global economy has indeed shown weakness following the launch of the trade war between China and US. However, it is difficult to disentangle the impact of trade war from other factors affecting the global economy, such as the tightening of global liquidity and stronger USD, which has hit emerging markets particularly hard.

It is a complicated task to assess the impact of a pronounced trade war on global growth given the interdependence across countries. The IMF and OECD have recently put an estimate on the effect of the trade war. Both the IMF and OECD estimate that global growth could fall by up to 0.8% in the worst case with the potentially biggest effect being felt by China followed by other emerging markets, while the euro area will be more immune.

US

Economy set to remain strong in 2019

- GDP growth is set to remain above potential in 2019, as fiscal policy continues to be expansionary and optimism is high. The risk of a recession is higher in 2020, but predicting the timing is difficult.
- US government debt is on an increasing path due to Trumponomics, which is unsustainable in the long run.
- Core inflation is set to move slightly higher but it is a gradual process.
- The Federal Reserve will continue to raise rates, but we still expect EUR/USD to move higher in 2019.

Next downturn unlikely in 2019

While the rest of the world has slowed, US growth has been strong with GDP growth in the range 3.5%-4.00% q/q annualised in the past two quarters and GDP growth this year is probably set to end at 3.0% y/y. The main difference between the US and everyone else is that fiscal policy is very expansionary due to Trump's tax cuts and higher fiscal spending. In the fiscal year 2018 (covering Q4 17 to Q3 18), the CBO estimates legislative changes increased the fiscal deficit by 1.4% of GDP without taking into account the impact on the economy.

As the current expansion will soon be the longest in US history, many are asking themselves, when does the next recession hit? Not least with the flattening of the US yield curve, which is considered a reliable recession indicator. We think it is important to remember that expansion does not die of old age, meaning that just because the expansion has lasted a long time, a crisis does not have to be just around the corner.

Something needs to go wrong for the economy to turn around. We are having a hard time seeing a downturn in 2019, as optimism is still high and fiscal policy remains expansionary. The CBO estimates legislative changes add an additional 0.9% of GDP to the deficit during the fiscal year 2019 (covering Q4 18 to Q3 19), so while the fiscal boost has declined, it is still considerable.

We are more concerned about 2020, when the probability of a recession is higher, as the Fed continues to raise rates further and fiscal policy is no longer expansionary (the CBO estimates it may contract 0.5% of GDP). Other risks to the outlook are the ongoing trade war with China and the housing market, which seems to be cooling down following higher mortgage rates.

We forecast GDP growth will slow over the forecast horizon. We expect quarterly GDP growth to slow to 2.2% q/q AR in 2019 and back to the range of potential growth 1.75%-2.00% in 2020. Calling the precise timing of a recession is one of the most difficult things to do, so we will abstain from that but just repeat that the risks are bigger in 2020 than in 2019.

Finally stronger wage growth

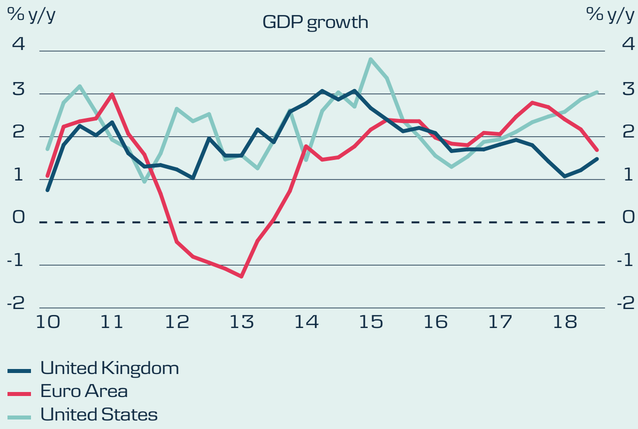
Jobs growth has been strong in 2018 with jobs growth slightly above 200,000. Many indicators suggest there is not much, if any, slack left in the labour market and that some problems are supply side issues like mismatch problems between demand for and supply of skills. We expect jobs growth will slow, as labour becomes increasingly scare, but productivity growth will probably still hover around 1%.

It has been a puzzle why wage growth has been stubbornly low in this expansion but there are signs that it has started increasing – perhaps the Phillips curve is alive after all. Wage growth is right now at the highest in this cycle and we expect it will continue to move gradually higher.

Large deficits due to tax cuts and more spending

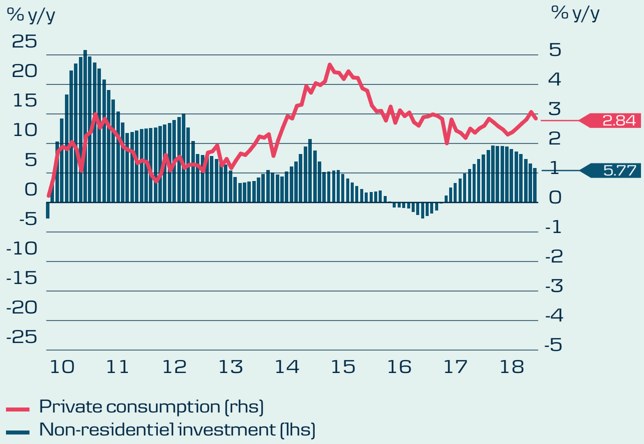
US government deficits are increasing due to the combination of deficit-financed tax cuts and higher budget spending caps, meaning a higher issuance of US Treasuries in coming years. The US Congressional Budget Office (CBO) estimates US government public debt will increase to 96% of GDP over the next 10 years on the back of deficits in the range 4-6% of

US growth has accelerated while Europe slowed



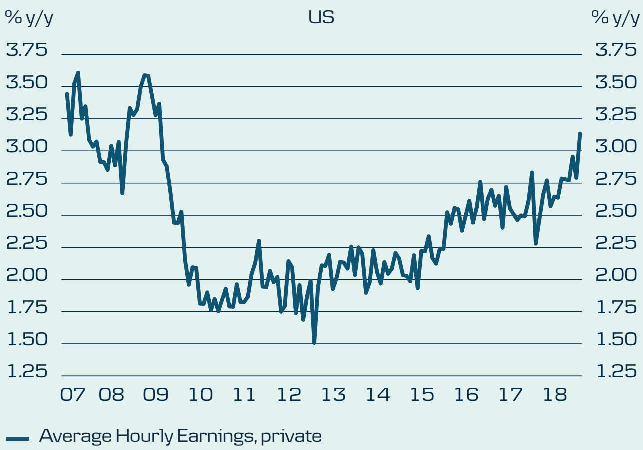
Source: ONS, BEA, Eurostat, Macrobond Financial

Growth still primarily driven by consumption



Source: BEA, Macrobond Financial

Wage growth is moving gradually higher



Source: BLS, Macrobond Financial

GDP. Debt may even move higher if the politicians decide to extend some of the temporary elements in the budget and tax reform (or make them permanent). CRFB previously estimated government public debt may be as high as 110% in 10 yearss. Markets do not seem worried at the moment, as the low rates mean interest payments are still low but this may change, especially when the economy falls into a recession next time. Here deficits may even exceed what we saw during the financial crisis, as the economic policy has increased structural government deficits.

Inflation remains in control

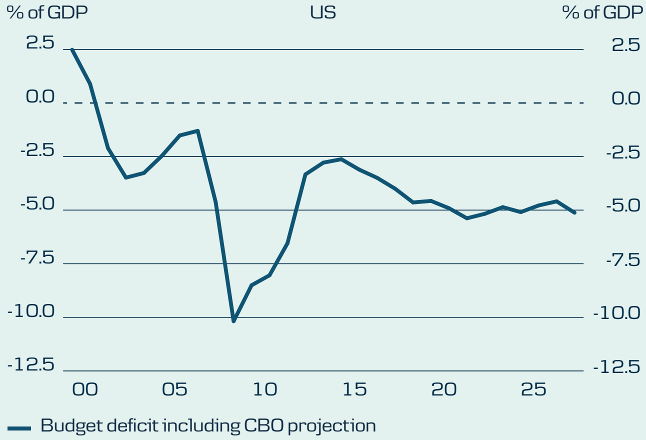
While some had feared core inflation would accelerate this year, it has not materialised yet, in line with our expectation that higher core inflation is mostly a 2019 story. Actually, core inflation has been lower than we predicted too. The reason we were cautious saying inflation would accelerate this year was that price pressure is a gradual process, as inflation is quite persistent. When inflation is low (high), it is likely to remain low (high) for a while, before it moves back towards its long-run level. We still have sympathy for the idea that core inflation will move gradually higher in 2019 but lower inflation expectations and oil prices mean there is a risk we may be too optimistic. We forecast PCE core inflation will fall in the first half of 2019 before it starts rising again. We think PCE core inflation will be 2.1% y/y by the end of the forecast horizon.

Fed wants to get to 3.00%

There has been some speculation that the Fed has turned more dovish recently. We think this is an over-interpretation, as the FOMC members overall still argue the Fed funds rate needs to go to neutral (i.e. where monetary policy is neither expansionary nor contractionary), which the Fed estimates to be 3.00%. We believe this will happen in June 2019 after hikes later here in December, March and June. After that it is probably more stop and go for the Fed and more rate hikes will depend on how the economy and the markets are doing. This is probably also the reason why more FOMC members including Fed Chair Powell and Vice Chair Clarida say that the Fed is data dependent. We think the Fed is able to hike once in the second half of 2019, i.e. a total of four hikes from now until year-end 2019. We think the Fed will stop there with the Fed funds rate at 3.25%.

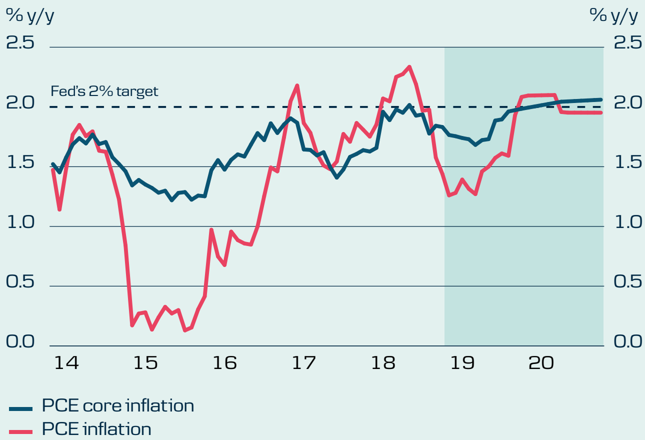
We still believe EUR/USD will move higher next year. In the near term, the next 3M, we expect the cross to trade in a range around 1.13 on a 3M horizon with the risk of a dip towards 1.11. While the ECB is more confident on inflation, we think Draghi and co are in no hurry to push for fast 'normalisation' of monetary policy. But, medium term, the euro capital outflows of recent years will fade as the first ECB hike draws closer. Alongside valuation, this is set to support EUR/USD in 6-12M. We see EUR/USD at 1.18 in 6M, and 1.25 in 12M.

Large US government deficits despite the economy doing fine



Source: BEA, US Treasury, CBO, Macrobond Financial

PCE core inflation to move lower before moving higher again



Source: BEA, Macrobond Financial, Danske Bank

Fed wants to get to 3.00%

Source: Federal Reserve, Macrobond Financial, Danske Bank

Macro forecasts - US

% change q/q AR	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	Calendar year average 2018	2019	2020
GDP	2.2	4.2	3.5	3.4	2.2	2.2	2.2	2.2	3.0	2.7	2.0
Private Consumption	0.5	3.8	4.0	3.0	2.2	2.2	2.2	2.2	2.7	2.7	2.1
Private Fixed Investments	8.0	6.4	-0.3	5.5	3.5	3.5	3.5	3.5	5.2	3.6	2.9
Residential	-3.4	-1.3	-4.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.6	-1.2
Non-residential	11.5	8.7	0.8	6.8	4.4	4.4	4.4	4.4	6.8	4.7	4.0
Change in inventories[1]	0.3	-1.5	2.4	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.0
Public Consumption	1.5	2.5	3.3	2.4	1.0	1.0	1.2	1.2	1.7	1.7	0.9
Exports	3.6	9.3	-3.5	5.1	3.0	3.0	3.0	3.0	4.3	2.9	2.4
Imports	3.0	-0.6	9.1	4.1	3.0	3.0	3.0	3.0	4.7	3.7	2.6
Net exports[1]	-0.1	1.3	-2.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.2
Unemployment rate (%)	4.1	3.9	3.8	3.7	3.6	3.6	3.6	3.5	3.9	3.6	3.5
Wage growth (% y/y)	2.7	2.7	2.8	3.1	3.1	3.2	3.1	3.2	2.8	3.2	3.5
Inflation (CPI) (y/y)	2.3	2.6	2.6	2.0	1.4	1.6	1.8	2.2	2.4	1.8	2.4
Core inflation (CPI) (y/y)	1.9	2.2	2.2	2.2	2.0	2.2	2.3	2.4	2.1	2.2	2.5
Public Budget[2]									-4.0	-4.6	-4.6
Public Gross Debt[2]									106	107	108
Current Account[2]									-3.2	-3.6	-3.7
Fed funds rate[3]	1.75	2.00	2.25	2.50	2.75	3.00	3.00	3.25	2.50	3.25	3.25

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

Trump has become a lame duck

The midterm elections ended as expected with a divided Congress, where the Democrats won control over the House and the Republicans retained power in the Senate. This means President Trump has become a 'lame duck' on domestic policy, as he will be unable to push his policy agenda through. This is also the main reason why we thought and still believe that the midterms have had limited implications for the economy and markets, as they will not lead to any major changes to economic policy. While Trump cannot make new tax cuts, the Democrats are unable to roll back tax reforms from December 2017. Trump and some Democrats have talked about making infrastructure investments but we think it is easier said than done.

With Trump as a 'lame duck', his focus is now turning to foreign and trade policy. We already know that Trump is more hawkish on foreign policy than President Obama, but the question is what Trump will do on trade policy. It is possible to argue that he will become more aggressive or more pragmatic. Based on the recent development, it seems like Trump wants to strike a deal with China, which would be positive for market risk sentiment and the economy.

Based on the election result, our base case is that Trump will lose the presidential election in 2020 but it is difficult to forecast an election result so far away. What is more interesting is that even if the Democrats are able to win the presidency, it is difficult to see the political gridlock going away, as the Democrats will have a difficult path winning Senate control also next time.

Euro area

Darker clouds on the horizon

- Recession discussions are premature and we expect the expansion to continue over the next two years, but at a slower pace in light of the maturing state of the business cycle and fading global trade growth.
- Heightened uncertainty remains on the growth outlook due to rising global trade tensions, a disorderly Brexit and domestic political risks spilling over to tighter financial conditions.
- The euro area inflation outlook has brightened due to accelerating wage growth and we expect core inflation to continue its gradual upward trend in the coming years.
- The ECB is slowly exiting crisis mode and we project the first 20bp deposit rate hike by December 2019. In 2020, we expect the ECB to continue its policy normalisation, albeit at a relatively sedate pace.

Expansion has lost momentum…

The growth pace in the euro area economy has clearly decelerated from 2017. To some degree a moderation from the exceptionally strong export growth of 2017 (5.4% y/y) was expected as the global economy shifted from boom to cruising speed, but a rougher external environment – not least due to the escalating US-China trade war and weaker EM growth – took its toll on the open euro area economy. Signs that the export-led slowdown in manufacturing activity has started to broaden out to the service sector raise the risk that trade war concerns have started to affected business confidence. Although weaker external demand has by far been the most important driver behind the slowdown, additional headwinds have also came in the form of higher energy prices, political risks flaring up in Italy and somewhat less accommodative monetary conditions.

…but recession discussions are premature

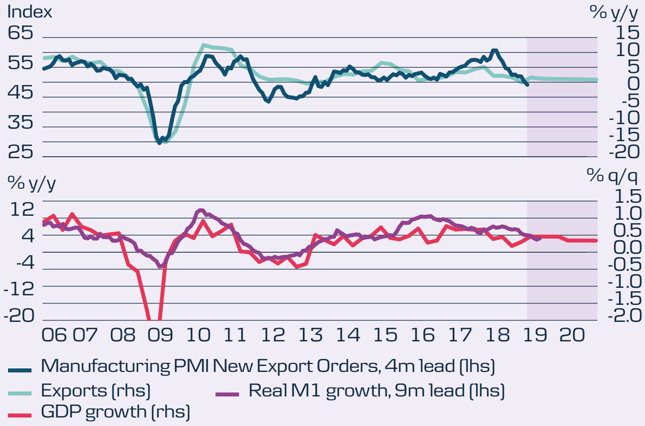
That said, we think recession discussions for the euro area economy are premature and we expect the expansion to continue over the next two years, but at a slower pace in light of the maturing state of the business cycle and fading global trade growth. We expect GDP growth to reach 1.6% in 2019 (1.7% previously), before easing to potential growth at 1.5% by 2020. Although we expect net exports to exert a drag on growth due to a rougher global trade environment as well as the strong euro in effective terms (having appreciated by around 5% this year), we project domestic demand to make up for the weakness. Especially private consumption growth will accelerate, in our view, driven by rising real wage growth as higher negotiated wages and abating energy price inflation boost households' wallets. Wage growth is expected to reach 2.4% in 2020, driven by increasing labour shortages and further improvements in the labour market with the unemployment rate falling to 7.5% by 2020. Furthermore, expansionary fiscal measures in some countries should further contribute to disposable income growth. Still favourable financing conditions and increasing capacity constraints should remain supportive factors for continued investment growth. However, despite these positive factors, weaker external demand and gradual tightening of credit conditions lead us to expect more moderate investment growth ahead.

The euro area economy is currently faced with multiple headwinds both internally and externally. The biggest risk, in our view, stems from renewed trade tensions both between the US and EU as well as China, which could further weigh on sentiment and, according to the IMF, dent euro area growth by up to 0.4pp by 2020. However, risks also loom from a disorderly Brexit, renewed EM turmoil and domestic political risks spilling over to tighter financial conditions, notably in Italy (see theme box). Progress on reforms to strengthen the EMU has been disappointing so far and the schedule risks being further delayed by political uncertainty flaring up again in Germany and European parliament elections looming in May 2019, where Eurosceptic parties are expected to gain even more prominence.

ECB slowly exiting crisis mode

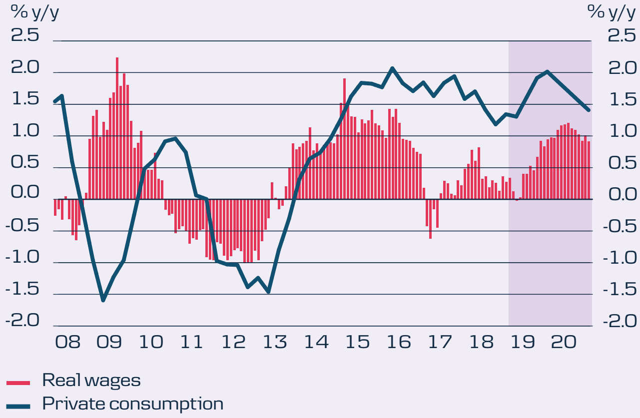
The euro area inflation outlook has brightened in 2018, as headline inflation has risen on the back of a strong rise in oil prices. However, with regard to monetary policy, the key inflation metric to watch is core inflation, i.e. inflation excluding

Rising headwinds from weaker external demand and less loose monetary conditions…



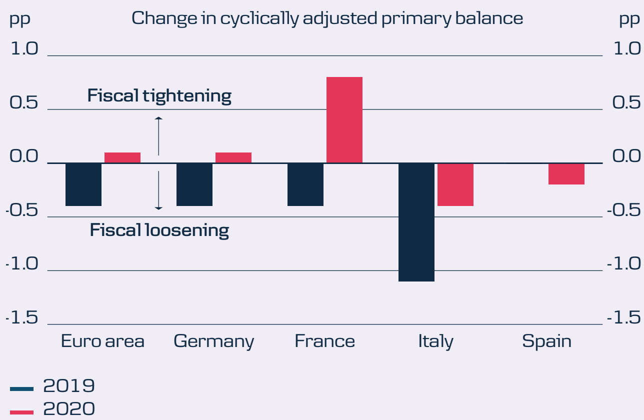
Source: Markit, Eurostat, Macrobond Financial, Danske Bank

…but stronger private consumption growth to compensate for weaker foreign demand



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

…fuelled by more expansionary fiscal policies in some countries



Source: European Commission, Danske Bank volatile food and energy prices, as the ECB wants inflation pressures to be resilient and self-sustained. Overall, underlying inflation pressures are still subdued, averaging only 1.0% in 2018. However, labour market conditions – although still somewhat heterogeneous across countries – continue to improve and the combination of tightening labour markets and higher past rates of inflation feeding into the wage setting process has given rise to accelerating wage growth. We expect these drivers to persist and hence look for a gradual acceleration in core inflation to 1.5% by end-2019 and 1.7% by end-2020.

At the December 2018 policy meeting, the ECB is widely expected to end its asset purchase programme (APP). This marks the end of the ECB's biggest crisis policy tool. However, the end of the APP is expected to be another 'dovish tightening'. The ECB will continue to keep an accommodative monetary policy stance given its still negative deposit rate, which serves as the remainder of the crisis legacy policies still in place, as well as continued reinvestments of the EUR2.2trl stock of public sector bonds bought under the APP. We expect the reinvestments to average EUR13bn per month in 2019, only marginally lower than the current EUR15bn purchase rate, thereby continuing to support the European government bond market.

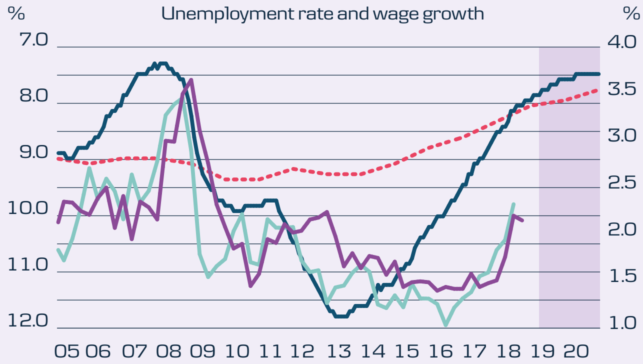
With the APP ending, the ECB's focus is turning to its standard policy tools: rate guidance and liquidity operations. We expect the first 20bp rate hike in the deposit rate in December 2019, followed by another 20bp hike in March 2020. Uncertainty prevails about the size of the rate hike, and we do not expect the ECB to announce the size of the rate hike before the actual announcement of change.

As part of the 'dovish tightening' agenda, we expect the ECB to announce another liquidity operation supporting loan growth to the private sector, a so-called TLTRO (see ECB Research - TLTRO3: Italy to be main beneficiary). We have seen some loan growth recovery during the past years, but for inflation to pick up, credit and wage growth are important ingredients. The ECB seems content with moderately higher yields, but wants to avoid a similar taper tantrum when the Federal Reserve ended its QE programme. We do not expect a sharp tightening of financial conditions due to the ECB's preference for slow and gradual normalisation as well as net negative government bond supply in some countries and high reinvestments.

All in all, we do expect the ECB to continue its normalisation of monetary policies, albeit at a slow pace. Despite growth moderating this year and next year, we expect it to remain above potential in 2019, which is also important for the ECB hiking rates next year. Should the pickup in core inflation disappoint while growth surprises on the downside, we do acknowledge a risk to our ECB call of a later than December 2019 hike. However, the risks mentioned above are currently counterweighed by an ongoing broad-based economic expansion and solid wage growth dynamics.

Looking into H2 2020, uncertainty his high about the path of ECB rate hikes. We expect one rate hike of 25bp (in December 2020) in a slow hiking cycle as ECB is expected to take a cautious stance thereby not jeopardizing the economic expansion and inflationary pressures.

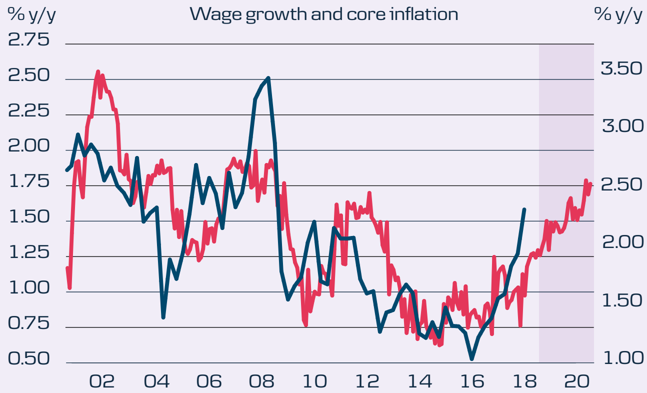
Wage growth will pick up further...



NAIRU (lhs, inv.)
Unemployment rate (lhs, inv.)
Wage growth (rhs)
Negotiated wage growth (rhs)

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

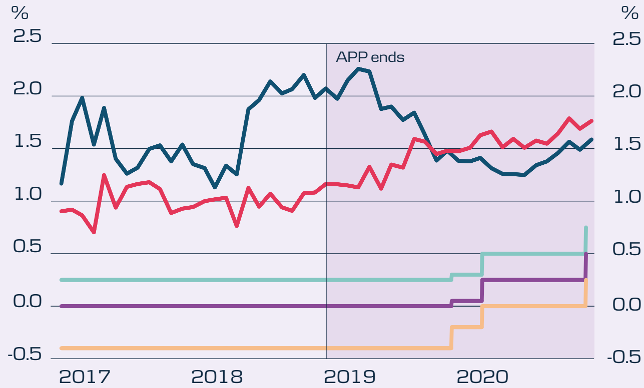
... supporting a gradual uptick in core inflation...



Core inflation (Danske forecast) (lhs)
Wage growth (rhs)

Source: ECB, Eurostat, Macrobond Financial, Danske Bank

... allowing the ECB to slowly exit crisis policies in 2019



ECB deposit rate
ECD MRO rate
ECB lending rate
Core inflation
Headline inflation

Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Expectations for key figures and central banks over coming quarters

% Change q/q	2018				2019				Calendar year average			
Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019	2020
GDP	1.6	1.8	0.7	1.2	1.8	1.8	1.8	1.8	2.5	1.9	1.6	1.5
Private Consumption	2.2	0.8	0.8	1.6	2.0	2.0	2.0	2.0	1.7	1.4	1.7	1.6
Private Fixed Investments	0.3	5.9	2.0	2.0	2.4	2.4	2.4	2.4	2.9	3.1	2.5	2.0
Public Consumption	0.3	1.5	1.6	1.6	2.4	2.4	2.4	2.4	1.2	1.1	2.1	2.4
Exports	-2.9	4.2	3.2	2.8	2.8	2.8	2.8	2.8	5.4	3.1	3.0	2.7
Imports	-1.8	4.8	4.9	4.1	3.6	3.6	3.6	3.6	4.0	3.0	3.9	3.5
Net exports[1]	-0.6	0.0	-0.6	-0.4	-0.2	-0.2	-0.3	-0.3	0.8	0.2	-0.3	-0.3
Unemployment rate (%)	8.5	8.3	8.1	8.0	7.9	7.8	7.7	7.6	9.1	8.2	7.8	7.5
HICP (y/y)	1.3	1.7	2.1	2.1	2.0	1.9	1.7	1.4	1.5	1.8	1.8	1.4
Core HICP (y/y)	1.0	0.9	1.0	1.0	1.0	1.2	1.4	1.4	1.0	1.0	1.3	1.6
Public Budget[2]									-1.0	-0.6	-0.8	-0.7
Public Gross Debt[2]									88.9	86.9	84.9	82.8
Current Account[2]									4.0	3.8	3.6	3.6
ECB deposit rate[3]	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.2	0.25

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

EU politics to stay a theme in 2019

Germany
- Angela Merkel's coalition was already twice close to breaking apart and government remains weak and fractious
- New CDU party leader raises the risk of Angela Merkel stepping down prematurely as chancellor, see German Politics Monitor: After the 'era Merkel' - what's next for Germany and Europe?
- Risk of another government crisis in H2 19 resulting in new elections cannot be ruled out

France
- After a good start, Macron's reform agenda has stalled amid flagging approval ratings and cabinet resignations
- EU parliament elections will be next big test for Macron and his party LREM

Spain
- Minority government led by the Socialists remains reliant on support from Podemos and Basque/Catalan nationalists.
- Snap elections in 2019 remain possible.
- Political risks remain contained as the three main moderate and pro-European parties poll at around 70%.

Italy
- More escalation in the budget fight with the EU is looming in 2019, with the Commission possibly opening an excessive deficit procedure (EDP), see Italian Politics Monitor: Budget truce postponed.
- Mounting market pressure or sanctions under EDP could induce Italian government to deescalate the conflict.
- EU parliament elections will be an important test for the government parties and their fragile truce.
- Recession risk has increased and amid higher yields, market concerns about a future Italian debt crisis remain alive.

Germany

Not out of steam, but past the peak

- German growth has peaked amid rising external headwinds, but we still expect continued growth above potential at 1.7% in 2019 and 1.6% in 2020.
- We expect domestic demand to drive the ongoing expansion, not least due to higher public spending, while net exports will increasingly become a headwind to growth.
- Risks to the growth outlook for the export-dependent German economy stem mainly from the external side amid protectionist tendencies in the US.
- The tight labour market has started to spill over to higher negotiated wages, leading us to expect the acceleration in core inflation to continue.

Growth has peaked amid rising external headwinds...

The German economy had a rocky start to the year and growing external headwinds have led to a clear cooling of the growth dynamic. Although we think the current boom phase still has 'air to run', we lower our GDP growth forecasts to 1.6% in 2018 and 1.7% in 2019 (2.1% and 1.9% previously) due to weaker export performance and a more clouded investment outlook. We expect the boom to increasingly lose momentum due to domestic capacity constraints as well as softer global growth and foresee growth moderating back to potential (1.6%) by 2020. Risks to the growth outlook for the export-dependent German economy stem mainly from the external side, where renewed global trade tensions could further weigh on business sentiment and investment activity. Additionally, political uncertainty also lingers in the background (see theme box below).

... but domestic demand drives the expansion

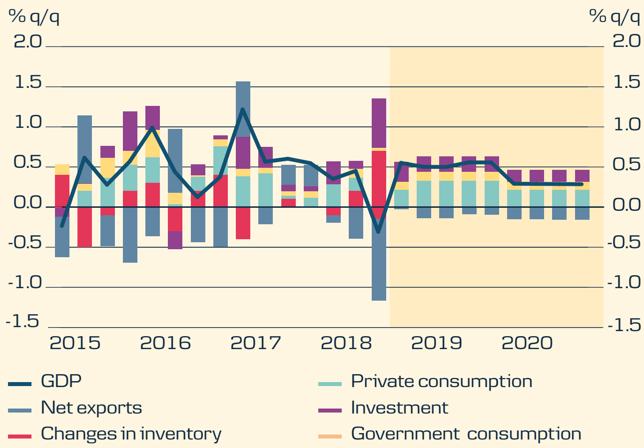
Global trade war concerns and weaker growth in key export markets have led to weaker external demand and weighed on German manufacturing activity, while the service sector thus far has proven relatively resilient to the mainly export-led slowdown. Activity in Q3 was additionally hampered by production bottlenecks in the car sector related to new emission test procedures (WLTP) coming into effect in September.

Going forward, we look for GDP growth rates of 0.4-0.5% q/q in the coming quarters, as industrial activity and exports recover some ground with the easing of testing bottlenecks. We expect private consumption to be the most important growth driver, supported by positive real wage growth, high consumer optimism and stimulative fiscal measures coming into effect in 2019 such as lower social security contributions and increased child benefits. Borrowing costs are low and labour shortages in some industries persist, which should have a positive impact on capital investments. In light of uncertainties on the global trade front, however, and the risk of further US tariff measures against Europe lingering in the background, we expect firms to take a more cautious stance towards major investments. The direct effects of current US steel and aluminium tariffs are negligible for Germany, but the indirect spill-over effects of the US-China tariff measures should not be underestimated in our view, as many German companies are highly integrated in global value chains and have subsidiaries and production facilities in China and the US, and suffer collateral damage. In light of these external risks as well as the moderating global cycle and dynamic import growth, we expect net exports to exert a drag on growth over the forecast horizon.

Strong wage increases ahead

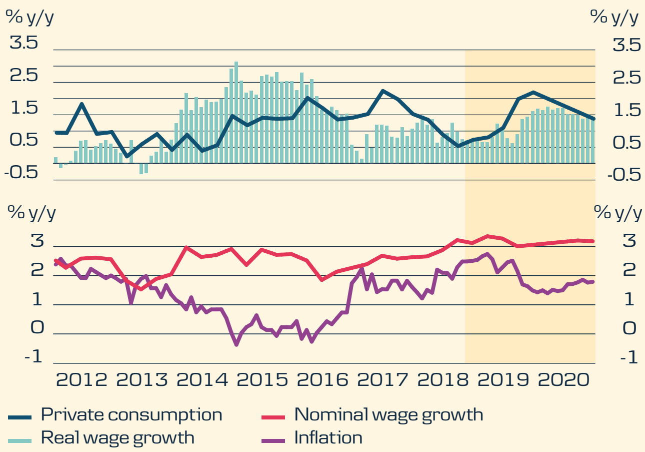
With growth staying above potential, we expect the unemployment rate to decline further below the NAIRU to 3.1% in 2019. The tight labour market and increasing labour shortages have started to spill over to higher negotiated wage agreements in 2018 and we expect wage growth in Germany to accelerate to 3.2% in 2019, also due to a 4% increase in the minimum wage by January. Inflation pressures will continue to build up in light of dynamic wage growth and we expect core inflation to reach 2.0% in 2020, while headline inflation should remain above the ECB's 2% target near-term.

Growth expected to rebound from weak spell in Q3 18



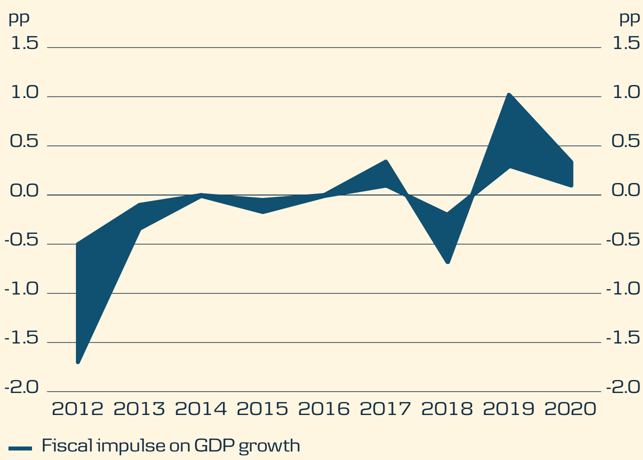
Source: Destatis, Macrobond Financial, Danske Bank

Positive real wage growth will support household spending



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Fiscal headwind turning into tailwind in 2019 and 2020



Source: Gemeinschaftsdiagnose Herbst 2018, Danske Bank

Politics – where is Germany heading after Merkel?

Similar to other European countries, Germany's political landscape has undergone major changes over the past few years with the populist AfD party becoming the largest opposition group in parliament, and further changes seem to lie ahead.

Following major regional election defeats for the two governing parties CDU and SPD, Chancellor Angela Merkel has announced her resignation as CDU party leader after 18 years. Whether she can fulfil her stated intention to remain Chancellor until the next election scheduled for 2021 will depend on her successor, to be chosen at a CDU party conference on 7-8 December. Should Mr Merz or Mr Spahn (see below) – both outspoken Merkel critics – become CDU head, we see an increased likelihood of Merkel resigning before her term ends.

Her departure would very likely also put an end to the current consensus style politics and positions between the political left and right will likely become more confrontational, both on domestic issues (i.e. immigration) but also foreign topics (i.e. eurozone reforms). Furthermore, an important and experienced mediator on the European political scene would be gone at a time when eurosceptic parties are gaining more prominence and a rocky road still lies ahead with respect to Brexit and Italy.

The current 'grand coalition' has already been close to breaking apart twice, and a new, more conservative, CDU head could make the collaboration with the centre-left SPD even more difficult. The risk of another government crisis resulting in snap elections in either 2019 or 2020 hence cannot be ruled out (see German Politics Monitor: After the 'era Merkel' - what's next for Germany and Europe?, 5 November 2018). That said, higher political uncertainty is unlikely to cause major adverse spill-overs to the economy, and the risk of a eurosceptic government led by the AfD remains remote over the coming years.

Who will succeed Merkel as CDU party leader (and eventually chancellor)?

	**Annegret Kramp-Karrenbauer**	• Former state premier of Saarland and the CDU's current secretary general • Well connected and popular within the party • Close Merkel ally, but with more socially conservative views	*"mini-Merkel"* *Policy continuity* *Positive for EMU reforms*
	**Friedrich Merz**	• Successful corporate lawyer, currently heads supervisory board of BlackRock Germany • Part of the CDU conservative wing and one of Merkel's old rivals - could make cooperation with Merkel difficult • Low-tax/pro-market views – strong business ties	*Pro-market policies* *Fiscal conservative* *Positive for EMU reforms*
	**Jens Spahn**	• Current health minister and rising star in CDU's conservative wing • Vocal critic of Merkel and her migration policies • Close to other European conservatives, such as Austrian Chancellor Sebastian Kurz and US Ambassador Grenell	*Conservative domestic policies* *Negative for EMU reforms*

Note: All three candidates are more conservative than Merkel

Macro forecasts - Germany

% change q/q	2018				2019				Calendar year average			
Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019	2020
GDP	1.5	1.8	-0.8	2.2	2.0	2.0	2.2	2.2	2.5	1.6	1.7	1.6
Private Consumption	2.1	1.2	-1.1	1.6	2.4	2.4	2.4	2.4	2.0	1.1	1.8	1.9
Private Fixed Investments	5.8	1.9	4.5	4.9	3.6	3.6	3.6	3.6	3.6	4.4	4.8	3.1
Public Consumption	-1.0	2.4	0.8	2.0	2.4	2.4	2.4	2.4	1.6	1.0	2.1	2.2
Exports	-1.0	2.8	-3.6	4.5	3.2	3.2	3.6	3.6	5.3	2.2	2.6	3.1
Imports	-0.8	7.0	5.3	5.3	4.9	4.9	4.9	4.9	5.3	3.9	5.1	4.6
Net exports [1]	0.0	-0.4	-1.0	0.0	-0.1	-0.1	-0.1	-0.1	0.3	-0.6	-0.9	-0.5
Unemployment rate (%)	3.5	3.4	3.4	3.3	3.2	3.1	3.1	2.9	3.8	3.4	3.1	2.9
HICP (y/y)	1.3	1.9	2.0	2.1	2.3	2.0	1.7	1.4	1.7	1.9	1.9	1.5
Core HICP (y/y)	1.3	1.2	1.1	1.3	1.4	1.5	1.6	1.6	1.3	1.2	1.5	1.9
Public Budget [2]									1.0	1.6	1.2	1.1
Public Gross Debt [2]									63.9	60.1	56.7	53.7
Current Account [2]									8.2	7.8	7.3	6.9

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

UK

While we are waiting for Brexit

- With the looming Brexit vote in the House of Commons, we are in the middle of the Brexit end game, which complicates forecasting. It seems likely the deal will be voted down the first time but it may be easier for Theresa May to get the necessary support the second time.

- If the deal is voted down, it opens up a range of possible outcomes. We cannot rule out either that the UK crashes out of the EU or that there is a second referendum. The latter seems more likely than the former.

- Do not be fooled by strong GDP growth in Q3. It was mostly a strong rebound in growth in July after a weak first half of 2018. In August and September, there was no growth and PMIs are not looking encouraging for Q4 either. We expect growth to remain around 1.5% in coming years.

- In our base case, where the Brexit deal is approved, we expect the Bank of England to continue hiking with the next one arriving in May. If the UK crashes out, we would probably see BoE easing.

Don't be fooled by strong growth in Q3

Looking at the surface, economic growth was strong in Q3, as GDP grew 0.6% q/q, but the strong growth came on the back of weak growth in the first half of 2018. With the new monthly GDP data, we can also see that while GDP growth was strong in July there were no growth in August and September. PMIs for October were unfortunately not encouraging either. So the bottom line is that growth remains around 0.4% q/q on average, which, however, is still high enough for the expansion to continue. Why is growth more sluggish than previously? Private consumption has been the main growth driver since the crisis but real wage growth has taken a hit after the GBP weakened significantly. Business investments have fallen for three consecutive quarters for the first time since the crisis (although the drop is not as severe as back then). Business investments are now lower than at the same time last year. The main reason is Brexit, as up to 50% have postponed investments decisions due to Brexit and 20% of the companies see Brexit as the top source of uncertainty. The weak GBP has not really stimulated net exports, as the value chains have become more global. British companies has become more competitive on foreign markets but input goods are also more expensive, offsetting the positive effect.

We are having a hard time seeing much higher growth over the forecast horizon. Real wage growth will increase but remain subdued. Business investments will probably start growing again in our base case with a 'decent Brexit' but many companies are unlikely to feel comfortable start investing again until we get more clarification on the future relationship. It could be that we are too pessimistic here and that companies may start to invest in more projects that they had postponed due to Brexit.

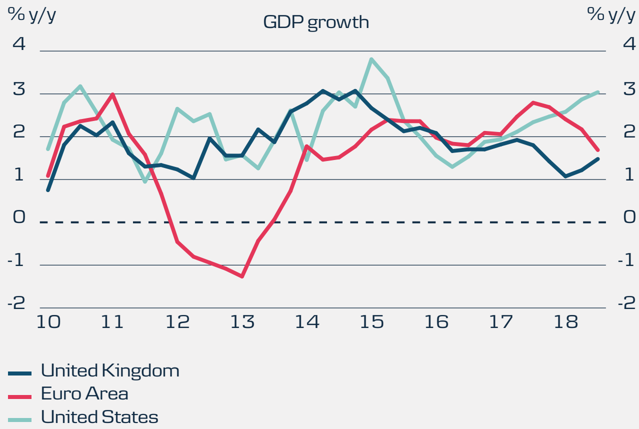
We forecast GDP growth of 1.3% this year, 1.6% next year and 1.5% in 2020 but stress that Brexit remains a big source of uncertainty.

House of Commons vote on Brexit deal looming

We are in the middle of the Brexit end-game and at the time of writing we do not know where it will all end. The risk is that our macro outlook here is outdated very soon, with the House of Commons vote taking place on 11 December. More than 400 MPs have said they are going to vote the deal down and while a small majority of the voters think PM Theresa May's Brexit deal is the best option on the table, it seems difficult for May to get her deal through. It does not make things easier that there is already talk about a second vote in the House of Commons, which makes it easier for the MPs to vote against the deal the first time. We think the deal may pass in a second vote, although it is a close call and the risk is we are simply being näive here. The reasoning goes like this: Hardliners will fear that voting against the deal may lead to a softer Brexit (or even Brexit being reversed). Moderate MPs will probably fear that voting against the deal will make the UK crash out of the EU without a deal. But again, we believe it is a close call.

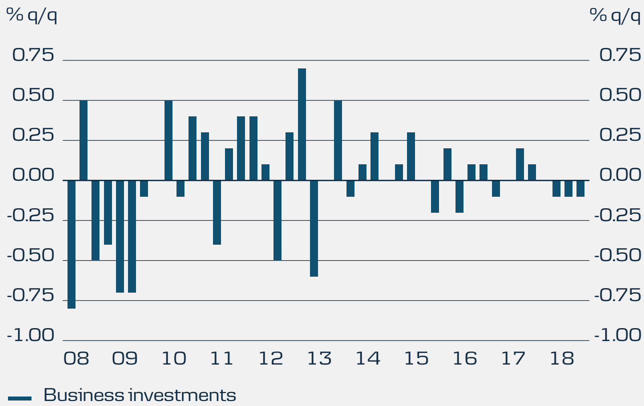
We are in uncharted territory if the deal fails (in particular after a possible second vote). First of all, it probably means Theresa May needs to step down as prime minister, opening the way for a range of possible outcomes. We cannot rule out either that the UK will crash out of the EU without a deal or that there will

UK GDP growth remains sluggish despite strong Q3



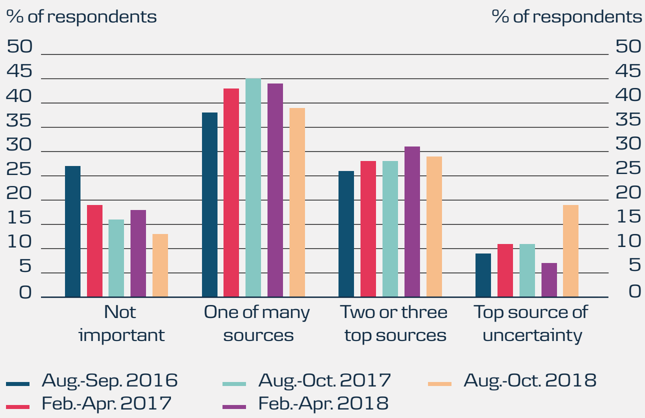
Source: ONS, BEA, Eurostat, Macrobond Financial, Danske Bank

Business investments have fallen for three consecutive quarters due to Brexit uncertainties



Source: ONS, Macrobond Financial, Danske Bank

Nearly 20% of the companies think Brexit is the top source of uncertainty for their business



Source: Bank of England's Inflation Report November 2018 be a second EU referendum. If we get a second referendum, most opinion polls show 'remain' is ahead and we may see Brexit being reversed.

The deal includes a transition period running from 30 March 2019 to 31 December 2020 with the possibility of extending the transition period for a maximum of two years. If no permanent deal has been reached before that the so-called 'backstop' (i.e. how you avoid a hard border between Ireland and Northern Ireland) is activated. The backstop means the UK stays in the customs union (including some 'level playing field' conditions on taxes, labour policy, environmental regulations etc.) although Northern Ireland must obey many single market rules. There are not many details on the future relationship yet, as negotiations will continue during the transition period, but it is difficult to see the permanent deal being worse than the backstop. Although trading with the UK will be slightly more complicated, most things will stay unchanged and the impact on the economy should be fairly limited both in the short- and long-run.

Labour market has been quite resilient

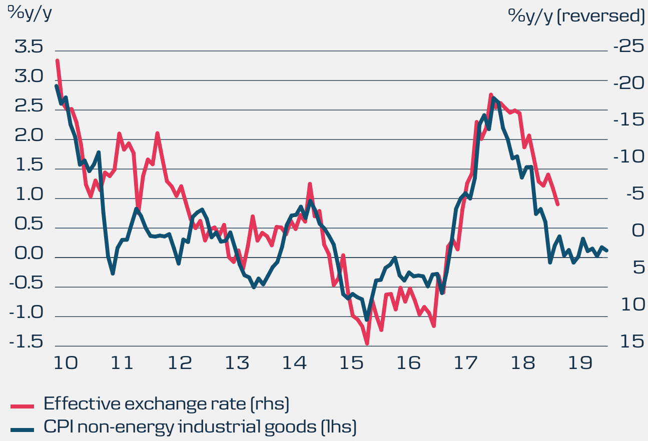
While the labour market has been quite resilient to Brexit uncertainties, there are signs that employment is no longer increasing and has stabilised at a high level. This is probably not a sign of crisis but more likely due to labour shortages (or skills mismatch between supply and demand for labour). The index for recruitment difficulties remains high and wage growth is increasing. In our base case, the unemployment rate may move slightly lower but not much. Instead, we forecast productivity may start to improve after a long period without any productivity growth at all.

In our view, Brexit is mostly a supply side story and not so much a demand side story. The fact that employment among EU27 citizens is lower now than a year ago supports this story. The weaker GBP and Brexit uncertainties mean that it is less attractive to come and work in the UK and more attractive to move back home. This is a problem in a situation where the UK has labour shortages to begin with.

BoE's rate decision depends on Brexit outcome

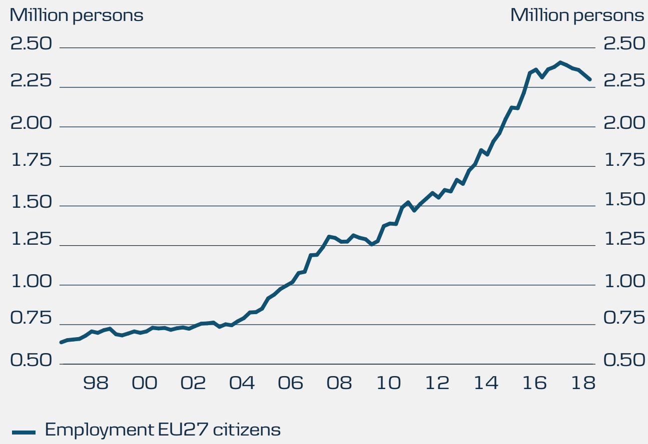
In August, the Bank of England raised the Bank Rate to 0.75% from 0.50%. We expect the next hike will arrive in May 2019, i.e. after Brexit. How Brexit ends is important for what the BoE will do. If the UK crashes out, it is difficult to see more rate hikes and actually, we believe it is more likely than not that the BoE will start easing monetary policy by cutting the Bank Rate. The outlook for EUR/GBP depends on what is going to happen with Brexit. If the Brexit deal is approved, we expect EUR/GBP to break lower and settle around 0.83. If the deal is voted down we will most likely see EUR/GBP move higher to the 0.92-0.95 area. In case of a 'no deal' Brexit, we expect a test of 1.00. If the UK calls for a second referendum, EUR/GBP would likely fall into the 0.82-0.86 range and if the UK chooses to remain in the EU, EUR/GBP could break below 0.80.

The impact of GBP depreciation on inflation is fading



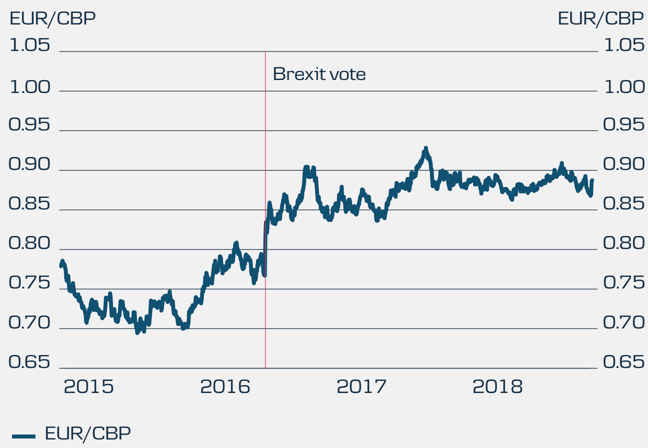
Source: ONS, Bank of England, Macrobond Financial

Employment among EU27 citizens is lower than a year ago



Source: ONS, Macrobond Financial

GBP outlook depends on how Brexit ends



Source: Bank of England, Macrobond Financial

Macro forecasts - UK

% change q/q	2018				2019				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020
GDP	0.1	0.4	0.6	0.6	0.3	0.3	0.3	0.4	1.3	1.6	1.5
Private consumption	0.5	0.4	0.5	0.5	0.4	0.4	0.4	0.4	1.7	1.7	1.6
Government consumption	0.2	-0.4	0.6	0.6	0.1	0.1	0.1	0.1	0.5	0.6	0.4
Fixed investments	-1.0	-0.5	0.8	0.8	0.3	0.3	0.3	0.5	0.2	1.3	1.9
Exports	-0.8	-2.2	2.7	2.7	0.6	0.6	0.6	0.6	1.5	2.8	2.4
Imports	-0.3	-0.2	0.0	0.0	0.5	0.5	0.5	0.5	0.4	1.6	2.0
Domestic demand[1]	0.2	0.1	0.6	0.6	0.3	0.3	0.3	0.4	1.2	1.4	1.4
Net exports[1]	-0.1	-0.6	0.8	0.8	0.0	0.0	0.0	0.0	0.3	0.4	0.1
Inventories[1]	0.0	0.9	-0.8	-0.8	0.0	0.0	0.0	0.0	-0.2	-0.2	0.0
Unemployment rate (%)	4.3	4.2	4.0	4.0	4.0	4.0	3.9	3.9	4.1	3.9	3.9
Wage growth (% y/y)[2]	2.7	2.6	3.2	3.2	3.6	3.9	3.6	3.7	3.0	3.7	3.8
CPI (% y/y)	2.7	2.4	2.5	2.2	1.8	1.7	1.4	1.4	2.5	1.6	1.5
Core CPI (% y/y)	2.4	2.0	1.9	1.7	1.7	1.7	1.6	1.8	2.0	1.7	1.7
Public budget[3]									-1.3	-1.5	-1.3
Public debt[3]									85.0	84.1	83.2
Current account[4]									-3.3	-3.2	-3.0
BoE Bank Rate (%) (end of period)	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.00	0.75	1.00	1.50

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 scenarios - implications for growth and GBP

As mentioned in the main text, the economic and financial outlook for the UK depends on the outcome of the Brexit negotiations. In our view, the 'no deal Brexit' scenario is the worst case, which would have significant negative implications. While we expect GDP growth to continue around the current pace in our base case (with upside risks due to a possible 'ketchup effect' on investments), we think GDP growth would take a hit in the 'no deal' outcome due to two factors. (1) The weaker GBP would hit private consumption through higher import prices. (2) Business investments would fall due to a combination of lower business confidence and value chain disruptions. That said, we believe Brexit is mostly a supply-side story and a 'no deal' scenario would mean UK GDP growth would be lower than it is now.

In our base case of a 'decent Brexit', we would expect EUR/GBP to break lower and settle around 0.83. The likelihood of our main scenario has declined in recent weeks, however, and the likelihood of other scenarios has increased. We would expect EUR/GBP to test 1.00 in a 'no deal' scenario, while we expect EUR/GBP to break lower into the 0.82-0.86 range if the UK calls for a second referendum. If the UK votes to reverse Brexit, EUR/GBP would break below the 0.80 mark.

Real GDP growth forecasts	2019	2020
Brexit-deal passes	1.60%	1.50%
"No deal" Brexit	1.00%	0.50%

Brexit scenarios	EUR/GBP forecast
Brexit-deal passes	0.83
Theresa May loses no confidence vote	0.92-0.95
"No deal" Brexit	Cannot rule out test of parity 1.00
Second referendum	0.82-0.86
- (Brexit is reversed)	Break below 0.80

Japan

Strong real economy but reflation nowhere in sight

- We think Japan is heading for a slowdown, but more domestically driven growth is positive news. We expect GDP growth of 0.9% in 2018 and 2019. In 2020, we expect the consumption tax hike to weigh on growth but the impact should be much smaller than after previous tax hikes. We expect growth to end up at 0.5% in 2020.

- We are seeing the first indications private demand is picking up and the economy is becoming more self-driven and less dependent on foreign demand.

- Japan's biggest trading partners are the US and China. The trade war thus poses a risk to the current economic recovery. In our view, the planned October 2019 consumer tax hike is likely to derail growth but the negative impact should be fairly short-lived as mitigating measures are in place.

- With reflation nowhere in sight, we expect the Bank of Japan to stay on hold through 2019 and 2020.

Tight labour market could start weighing on growth, but Abe has a plan

Economic activity has remained strong in Japan throughout 2018 but the composition of growth has changed somewhat. A weak third quarter with GDP growth of -1.2% annualised was an expected bump on the road caused by several typhoons and an earthquake. Exports are no longer the key growth driver as a stronger JPY has been a headwind and trade frictions have started to affect exporters. Japan has large manufacturing and electronic exports to China, much of which China uses for products shipped to the US and exports to China have suffered recently. Further trade frictions remain a risk to the outlook. In contrast, private consumption has been somewhat stronger, supported by increasing employment and higher cash earnings. However, Japan remains dependent on the global economic cycle to keep the wheels spinning fast enough to create inflation. This is one reason Prime Minister Shinzō Abe has been forging closer ties to China with a series of agreements aimed at deepening economic and trade ties between the two countries.

Even with exports slowing the economy, total demand is still strong enough to cause further tightening of the labour market. For every 100 applicants there are currently 162 job openings. This implies, employees should have a good set of cards in a bargaining situation and we saw some strong summer bonuses but cash earnings have lost momentum since then and increasing fresh food and energy prices have been digging into Japanese consumer pockets since then. The tight labour market could start weighing on growth and businesses and the small ones in particular are shouting louder for labour than at any time since the beginning of the 1990s. Businesses are reporting plans for increasing investments and we believe this will help but the economic upturn cannot continue for long before labour shortages become a serious drag.

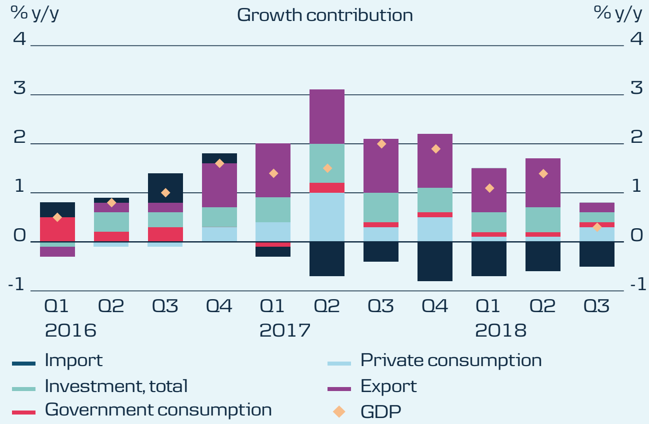
Luckily, Abe has a plan. His cabinet has approved legislation opening the way for an inflow of foreign labour not seen since the arrival of cheap labour from other Asian countries in 1993. There is no official number but half a million blue-collar workers by 2025 has been an unofficial estimate. The plan is to import two classes of foreign blue-collar workers to a series of industries, where labour supply is particularly scarce. Lower-skilled migrants will be allowed to stay for five years and cannot bring their families. More highly skilled workers will be able to bring family members and stay longer. Abe is walking a fine line on this issue in a historically very closed country, where foreigners make up less than 2% of the population, but the issue is getting more pressing every day and more elderly and women in the labour force cannot fill the increasing labour demand alone.

We think GDP growth will remain around potential in 2018 and 2019 at 0.9%. In 2020, we expect the consumption tax hike to weigh somewhat on growth, which we expect to end up at 0.5%.

With elections out of the way, focus turns to third pillar of Abenomics

With Prime Minister Abe's re-election as LDP leader in September, the last obstacle to him becoming the longest serving Prime Minster in Japanese history is out of the way. So far, his

As export drive is fading domestic demand should begin to contribute more



Note: Charts show contributions to annual GDP-growth and do not add up due to rounding errors and inventory contribution
Source: Japanese Cabinet Office, Macrobond Financial

Labour market tightening further

Source: Japan Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

Small businesses in particular crying out for labour

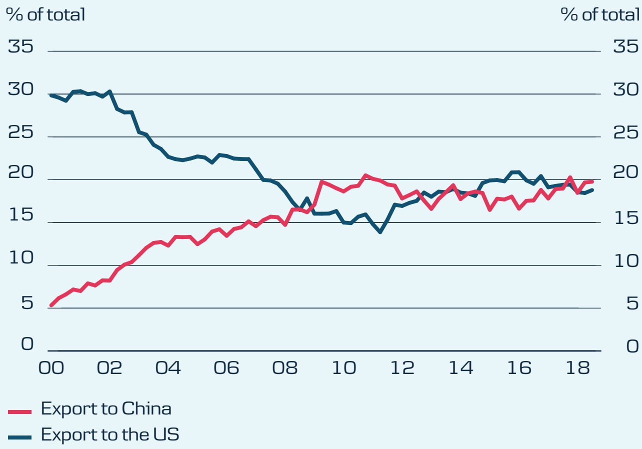
Source: Bank of Japan, Macrobond Financial economic policy has been formed primarily by monetary easing and fiscal stimulus – the first two pillars of Abenomics. The third pillar, structural reform, is still pending as challenges on labour market, agriculture and health care reform, to name a few, remain unresolved. The labour force participation rate for women and the elderly has actually increased quite significantly – a great success for Abe. Better childcare and maternity leave have paid off and there is still great potential here, for both women and elderly. This said, women largely end up in low-paid, non-regular jobs and female managers in Japanese companies remain rare. We will probably have to wait until after the upper house election in July 2019 before Abe starts to dig into these issues. However, the risk is that he focuses his political capital on revising Article 9 of the constitution in order to legitimise officially the Japanese military, the so-called Self-Defence Forces. After several scandals relating to Abe, his wife and his cabinet members, he does not have the same popularity he once did and he is likely to have to choose his battles. Article 9 is a very sensitive matter, which divides the public right down the middle and it could stand in the way of economic reform.

Bank of Japan on sidelines

With the reappointment of Governor Haruhiko Kuroda and the appointment of two new deputies in the Bank of Japan (BoJ) back in spring 2018 and Abe's re-election, the leadership of the bank is set for the future. As we see it, there is not a lot for the BoJ to do currently but hope the global economic recovery continues long enough to kick-start the Philips-curve. Despite the economy running above potential, there are still no real signs that core inflation is moving higher. Indeed, a warning from Japan's biggest mobile phone carrier about significant cuts in mobile subscription charges in spring 2019 could cause a cut in core inflation by as much as 1 percentage point if others follow suit. In the short run, this means the outlook for reflating the economy deteriorates for the following year but lower cell phone charges would boost private consumption, adding inflation pressure in the longer run. This said, we still do not see much sign of increasing price pressure and we only expect inflation to pick up slowly over the forecast horizon.

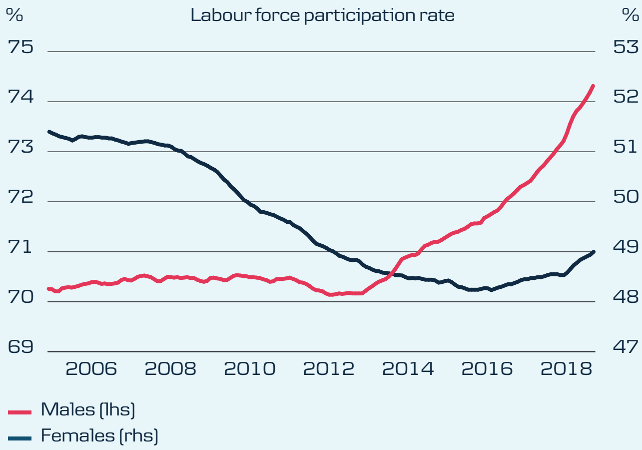
Risk taking in the financial sector is becoming an increasing focal point for the BoJ as regional banks struggle with returns on traditional lending business and consequently take on more risk. Currently, the BoJ expresses limited concern on this matter but it acknowledges risk could build up and thus pose downward pressure on the economy in a stress scenario down the line. If risk continues to build in the financial sector, further tweaks from the BoJ could become relevant at some point in order to prolong the sustainability of the policy framework. We know this has been discussed within the BoJ but risks are that more flexibility on the yield curve control could erode market confidence in the inflation target. We expect the BoJ to move steadily forward with the current policy over the forecast horizon. With a consumption tax hike coming up in October 2019 and core inflation showing no signs of moving upwards, any tightening meassures still seem far away.

Trade war poses significant risk to Japan



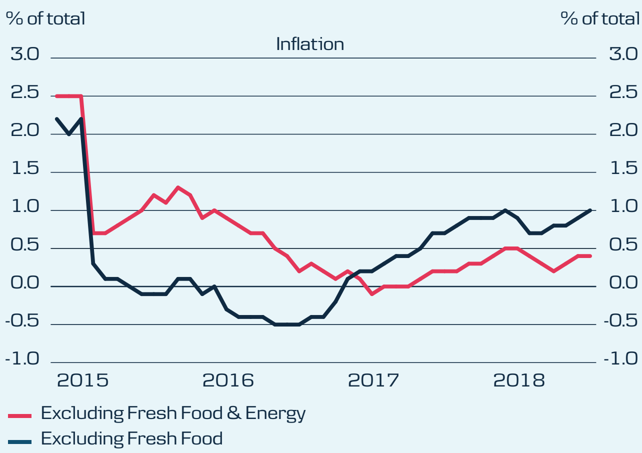
Source: Japanese Ministry of Finance, Macrobond Financial

More women in the labour market



Note: One-year moving average
Source: Japanese Statistics Bureau, Macrobond Financial

Reflation nowhere in sight



Source: Japan Statistics Bureau, Macrobond Financial

Macro forecasts - Japan

% y/y	2016	2017	2018	2019	2020
GDP	1.0	1.7	0.9	0.9	0.5
Private Consumption	-0.1	0.9	0.3	1.0	0.0
Private Fixed Investments	1.4	2.8	2.9	2.0	-0.2
- Residential investment	5.6	2.7	-5.9	-2.3	-3.9
- Non-residential	0.6	2.9	4.6	2.8	0.5
Public Investments	0.1	1.2	-2.3	-0.5	-1.0
Public Consumption	1.3	0.4	0.5	0.8	0.8
Exports	1.7	6.8	3.1	2.0	2.8
Imports	-1.6	3.5	2.7	2.1	1.2
Unemployment rate (%)	3.1	2.8	2.4	2.4	2.5
CPI. excl. fresh food (y/y)	-0.3	0.5	0.9	1.4	2.0
- Excluding consumption tax hike	-	0.5	0.9	1.1	1.2
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

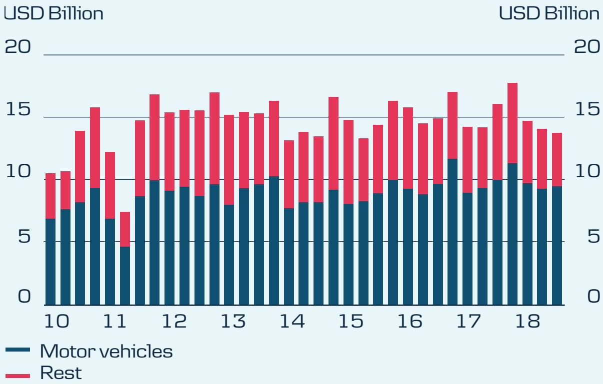
*Note: *end-year*
Source: Danske Bank, Macrobond Financial

Trade war poses risk to Japanese car industry

Exports have been an important driver of growth in recent years and considering how Japan is still struggling with pumping up domestic demand, we expect exports to remain key in the economic recovery. However, the trade war poses a threat to the outlook for Japan, not only through trade with China but also via direct trade with the US. President Donald Trump has criticised Japan's annual USD60bn trade surplus with the US, which is the world's third largest behind China and Mexico – a criticism that actually goes back 30 years. In 1989, when Japan was the US's largest trading partner and shipped more than 2.5 million cars across the Pacific, Trump said on Japan: 'They have systematically sucked the blood out of America. They have got away with murder...We have to tax the hell out of them'.

Now Trump is President, the risk is that he will follow up on his old remarks and increase the 2.5% tariff on Japanese cars – something the US has threatened to do. A 25% tariff has been mentioned, which would be a significant blow to Japan, as cars constitute the bulk of exports to the US and shipping of cars to the US makes up around 6% of total exports. There are other ways of bringing down the surplus and making Trump happy, though. Better market access for US cars and a promise to buy more soya beans and defence equipment could be ways to go. A trade war with Japan is still not at the top of Trump's agenda but we believe Shinzo Abe will probably have to face Trump's trade fury in 2019.

Japanese trade surplus vs. US



China

Short-term pain, long-term gain

- We expect growth to slow further in the short term but look for a gradual recovery during 2019 on the back of more stimulus and a trade deal.
- The ceasefire in the trade war is good news and we believe it paves the way for an end to the US-China trade war in 2019.
- We look for more policy easing next year and for USD/CNY to rise to 7.20 in 12 months, giving support to exports.
- A further escalation of the trade war is the main short-term risk for China. Debt and property markets are still medium-term risks.
- 2018 is the 40-year anniversary of the 'reform and opening' policy. China has aken steps to speed up opening for investments and trade.
- We expect China to continue the catching-up process and to surpass the US economy by 2030. A long-term rivalry with the US has only just begun.

Growth set to get worse before it gets better

The US-China trade war as well as financial tightening over the past years have taken their toll on Chinese growth this year. After a decent start to 2018, the Chinese economy slowed down over the summer and into the autumn. Stock markets are down more than 20% since Trump kicked off the trade war in May and economic indicators across the board have pointed to weaker demand. Export companies have taken a hit and the heightened uncertainty has restrained private investments as well. Consumers have also held back on big ticket purchases such as cars. The trade war with the US hit China when a slowdown was already under way due to the campaign to fight financial risks through deleveraging and a crackdown on shadow banking.

In the short term, we expect growth to suffer further. Exports will hit a vacuum in Q1 as some exporters have pushed forward shipments to Q4 due to the possibility that the announced increase in US tariffs from 10% to 25% on goods worth USD200bn will go ahead and be implemented on 1 January.

However, we do not expect China to have a hard landing. The stimulus already provided will increasingly kick in during 2019 and we expect new stimulus to further underpin demand. In addition, we are cautiously optimistic that the US and China will be able to negotiate a trade deal during 2019. Since May, US President Donald Trump has been keen to say that 'now is not the time to talk to China' – most likely because he felt his hand has been strengthening as long as the US markets and economy are strong while the Chinese markets were selling off. However, this picture seems to be changing. We are seeing signs that US markets are becoming more wobbly and some indicators suggest that growth is slowing a bit. Therefore, Trump might not be able to retain the stronger hand in the poker game with China. We see this as the main reason for the recent ceasefire and his wish to re-start trade talks. We also believe he wants a trade deal before going into the 2020 election year.

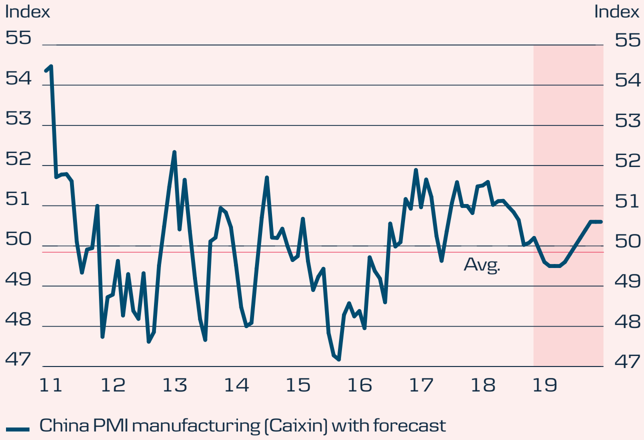
We expect that the Chinese property sector will support growth in 2019. Lower yields normally feed through to higher home sales (see chart to the right) and given that inventories of empty houses are generally low, the construction sector should see decent activity over the coming year.

Risk factors: trade war and financial developments

The key risk for China is that Trump will be unhappy with Chinese concessions and decide to escalate the trade war further after the 90-day truce agreed upon at the G20 meeting. In that case, we could be looking at US tariffs on all Chinese goods. This would clearly prolong the downturn in China.

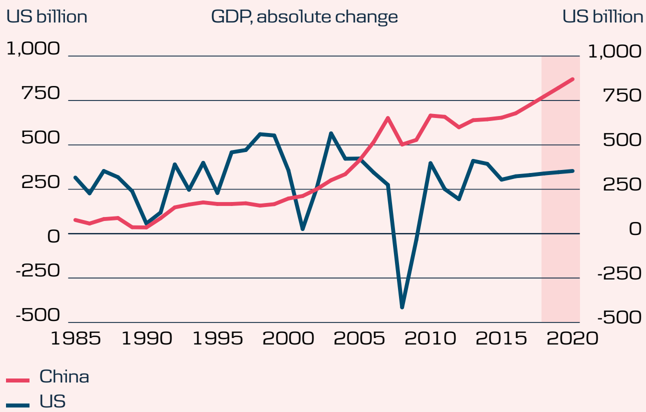
Another risk is the continued high debt level, which China has built up over the years, as well as the more interconnected financial system. China has been forced to slow down the deleveraging campaign due to the trade war. The economic slowdown and tighter financial conditions have led to a rise in bankruptcies, not least among developers. In some ways, we see more defaults as a healthy process, as more 'zombie' companies are closed and inefficient companies are not bailed out. However, it should be watched closely in case it spins out of control.

It gets worse before it gets better



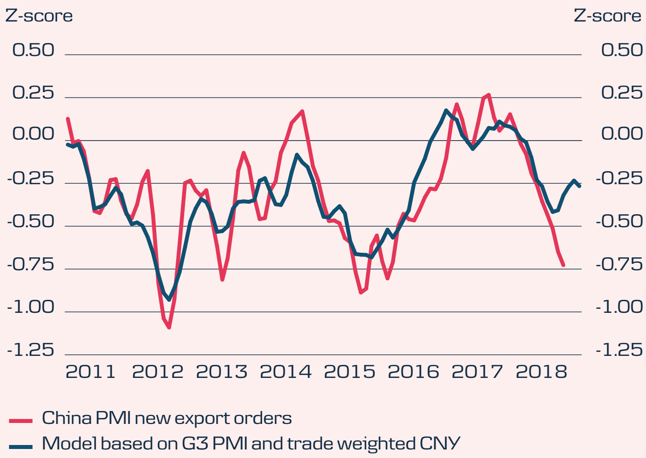
Source: Macrobond Financial, Danske Bank forecasts

While percentage growth is slowing, China's economy keeps adding more in absolute terms



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

Trade war is taking its toll on export orders



Source: Macrobond Financial, Markit, Danske Bank
Note: PMI export orders are the average of export order index from Caixin and NBS, respectively. G3 here is the US, euro area and Japan

More policy easing and weaker CNY

China has taken many steps to ease policy to compensate for the trade war headwinds:

First, monetary policy has been eased through a reduction in the Reserve Requirement Ratio three times since April. It has freed up liquidity that has fuelled a big decline in money markets rates. This in turn has been the driver behind a 10% weakening of the CNY versus USD. We look for a further weakening of CNY to 7.20 versus the USD in 12 months from the current level of 6.95.

Second, China has announced plans to boost bond financing for private firms to ease the credit squeeze in the private sector. It has also signalled bank lending targets for the private sector, not least aimed at small and medium-sized companies that are feeling the pinch from the trade war and shadow banking crackdown.

Third, China has increased infrastructure spending as the government has given the go-ahead for a series of urban infrastructure projects after a 12-month pause.

Fourth, household taxes have been reduced by raising the tax-free threshold, expanding the income range for lower tax brackets and adding new tax deductions.

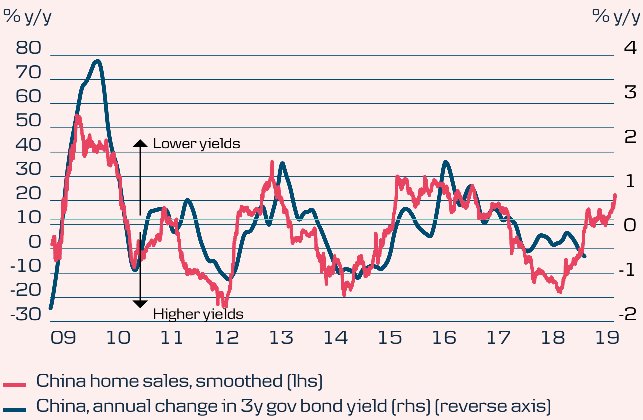
We expect more stimuli in 2019 through further tax cuts to households and a reduced tax burden for businesses. Lower taxes for the corporate sector and small businesses fit well into the long-term goal to reduce costs for the business sector – a central part of China's supply side reforms. We also look for a further reduction in the Reserve Requirement Rates for banks in Q4 18.

'Reform and opening' speed up

This year marks the 40-year anniversary of the 'reform and opening' policies, which started in December 1978 under Deng Xiaoping. Since then, China has moved along the 'reform and opening' path step-by-step in the usual gradualist way in China. However, criticism has increased not only from the US but also the EU and Japan, among others, of protectionist behaviour and failing to create a level playing field between foreign and local companies. This year, China has taken many steps to continue opening up as well as pushing along the reform processes further. According to the IMF article IV Consultation report published on 26 July 2018, China's 'reforms progressed in several key areas. A wide range of regulatory reforms reduced financial sector risks, overcapacity reduction progressed, anti-pollution efforts intensified and opening-up accelerated recently'. The IMF also stressed, though, that it is vital that reforms continue in a wide range of areas.

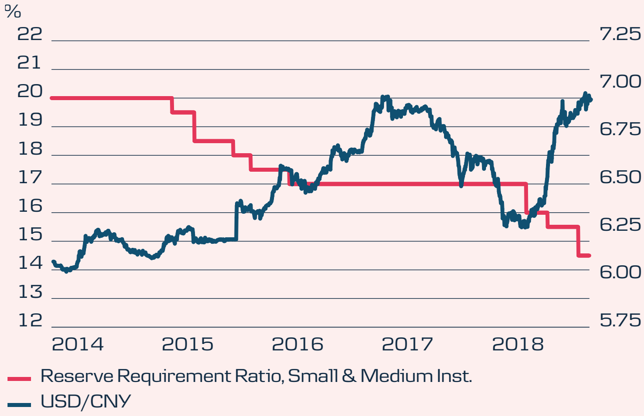
China's polices focus increasingly on quality over quantity, increased efficiency in the state-owned sector, closing 'zombie' companies, rebalancing the economy towards new growth drivers, a rising role for innovation and technology, fighting financial risks, eliminating poverty and reducing inequality across regions and incomes. Xi Jinping has stressed his support for the private sector after concerns had mounted that the government would increasingly prioritise the state sector at the expense of the private sector. On 21 October, Xi Jinping wrote an open letter to private entrepreneurs saying, 'any words or acts to negate or weaken the private economy are wrong...it is always a policy of the Central Committee of the Communist Party to support private business development, and this will be unwavering'.

Lower yields normally feed through to stronger home sales



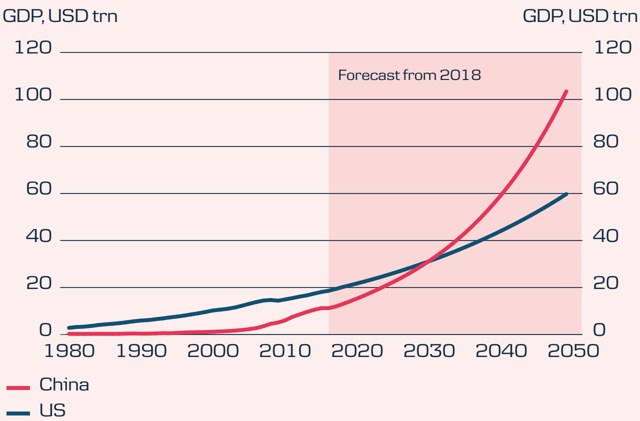
Source: Macrobond Financial, Danske Bank

Monetary policy easing has triggered weaker CNY – we look for a bit more to come



Source: Macrobond Financial, Danske Bank forecasts

China to surpass the US by 2030 and be double the size in 2050



Source: Macrobond Financial, Danske Bank forecasts from 2018

Macro forecasts - China

% y/y	2016	2017	2018	2019	2020
GDP[1]	6.7	6.8	6.6	6.2	6.2
Private consumption[1]	8.4	8.5	8.2	8.0	7.8
Investment[1]	6.3	5.2	5.0	4.7	4.6
Net exports[2]	-0.5	-0.3	-0.2	-0.4	-0.1
Total investment share[3]	44.2	43.8	43.2	43.0	42.5
Total savings rate[3]	45.9	45.8	43.9	43.7	43.2
Current account balance[3]	1.7	1.5	0.7	0.7	0.7
CPI[1]	2.0	1.6	2.2	2.0	2.2
Household income (real)[1]	7.8	8.3	8.0	7.5	7.3
Household savings rate. % of disp income	36.0	35.8	35.6	35.4	35.0
Wage growth (nominal. urban)[1]	9.1	9.0	8.5	8.3	8
Government budget balance[3]	-3.7	-3.9	-4.1	-4.5	-4.3
Augmented fiscal balance (IMF)[3,4]	-12.4	-12.6	-13.0	-13.2	-12.6
USD/CNY[5]	6.96	6.6	6.95	7.2	-
EUR/CNY[5]	7.3	7.9	7.95	9.0	-
PBoC 1-year lending rate. %[5]	4.35	4.35	4.35	4.35	-

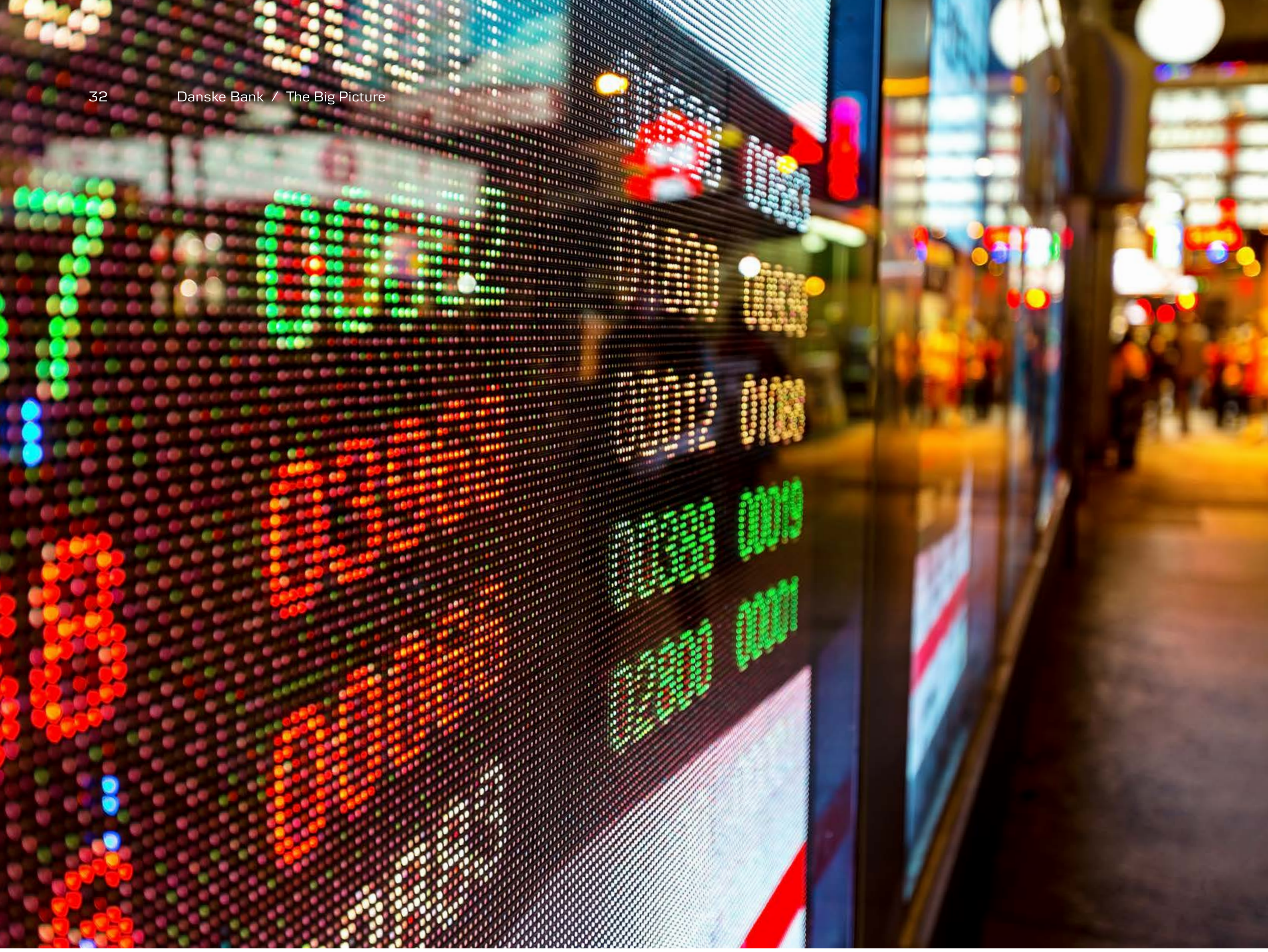
1. % y/y.
2. contribution % to GDP.
3. % of GDP.
4. Includes local gov and off-budget activity plus excludes land sale proceeds.
5. end of year
Source: Macrobond Financial, Danske Bank forecasts

China to surpass the US by 2030 – are we headed for a new Cold War?

The large US-China trade deficit is only part of the explanation behind the ongoing trade war. Equally important is the beginning of a new power rivalry between the US and China. While we expect a deal on the trade front in 2019, the rivalry is most likely here to stay. There are clear signs that sentiment has shifted fast in Washington these years from a policy of engagement to a focus on strategic competition (see, for example, the speech by Vice-President Mike Pence at the Hudson Institute on 4 October). And the shift is happening across party lines.

Most long-term projections forecast the US will be surpassed economically by China within the next 10-15 years (see for example the IMF report on the People's Republic of China: 2018 IV Article Consultation, 26 July 2018). However, it is unlikely to stop there. With four times more people than the US, we expect China to become a significantly larger economy than the US by 2050. We project China to be close to double the size of the US by the middle of the century. All it requires is that China reaches 50% of GDP per capita in the US. China's recipe to continue its ascent of the economic ladder is a strong focus on technology, innovation, education and continued reforms and opening. These are all key elements in China's development strategy as laid out in Xi Jinping's Work Report at the 19th National Congress of the Communist Party on 18 October 2017. Heavy investment in green technology is also key for the economic rise to be sustainable.

The increasingly sharp tone between the US and China and more frequent confrontations with respect to economic relations, the South China Sea, Taiwan and China's Belt and Road Initiative have led to a discussion of whether we are witnessing the beginning of a new Cold War. Our view is that the relationship between the US and China is likely to be one of intense rivalry in years to come, which may resemble the rivalry between the US and the Soviet Union. The US can be expected to work to create closer allies in opposition to China and vice versa. However, the world today is much more integrated and most countries can be expected to have significant relations with both countries rather than belonging only to one block, as was the case during the Cold War.



Emerging Markets

Segmented growth with local risks of recession

- Emerging markets have been under pressure from a rising USD, higher US yields and geopolitical turbulence.
- Solid macro fundamentals are set to offer improving protection against external shocks.
- We expect decent growth to slow down in Asia and Eastern European economies, while monetary tightening may cause technical recessions in Latin America, South Africa, Russia and Turkey.
- A possibly more hawkish Fed and an escalation of trade tensions remain the major negative risk factors for the growth outlook in emerging markets.

Emerging markets are adapting to rising external challenges

After seeing a slowdown and several crises in 2018, emerging markets have shown their increasing ability to adjust to a rapidly changing external environment. First, a rising USD and US yields led to a reversal of capital flows to emerging markets. Yet, emerging market central banks responded to a global liquidity shrinkage by tightening explicitly through rising key rates or implicitly by liquidity tools. Even less orthodox monetary policymakers in Argentina and Turkey had to deliver significant tightening in order to stabilise the financial system. Even economies with well-anchored inflation such as Brazil and Mexico have kept real rates at historically high levels. Worsening prospects in global trade have weighed on economic growth in Asia and we expect the pressure to remain in 2019. Across several emerging markets, we believe fiscal side issues will continue to be in focus. We expect a more conservative stance on fiscal policy in Brazil and Turkey to start prevailing.

Economic growth in emerging markets set to slow down in 2018-20

In our view, emerging markets will adjust further to rising trade and monetary challenges. We expect continued free-floating regimes to improve external balances further across emerging markets. Inflation acceleration is likely to continue in early 2019 but we expect it to start falling again in the second half of 2019. We expect economic growth to slow down across the majority of emerging markets due to rising rates to fight inflation and FX volatility. However, we expect less aggressive monetary tightening across emerging markets in 2019 than in 2018. The Chinese economy remains an important driver for emerging market growth. We see that overall economic growth in China will slow down from 6.6% in 2018 to 6.2% in 2019. We expect Russia and South Africa to grow more slowly in 2019 than in 2018, staying below 2%, with Turkey seeing the most significant deceleration in economic expansion.

In our opinion, the Asian economies will in general outperform the rest of the emerging markets, especially China, India, Indonesia, Malaysia and Thailand, delivering firmly above 3% GDP growth.

In Central and Eastern Europe, easy monetary policy is set to end in 2019, following possible steps by the European Central Bank. However, we believe that economic expansion in Czech Republic, Hungary and Poland will still exceed 3% in 2019, with these countries approaching their potential growth rates.

Protectionism, China slowdown, geopolitics and more aggressive Fed tightening are key risks

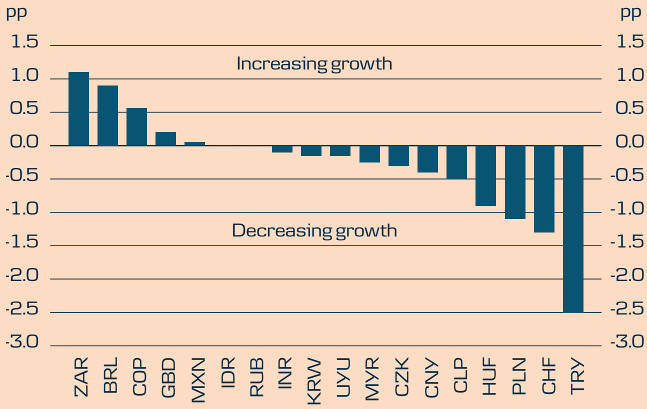
We see further short-term downside risks for our China outlook from the trade-war effect on exports and private investments, while housing and infrastructure should mitigate the slowdown. The tightening of credit conditions in China is also likely to continue. China's slowdown is bringing relief to commodity markets and notable relief for net oil importers such as India and Turkey. We believe sanction risks will continue to be topical for China, Hungary, India, Iran, Poland, Russia, Saudi Arabia and Turkey. As markets currently expect two Fed hikes in 2019, a third hike would clearly weigh on emerging market prospects in 2019-20.

Macro forecasts - Emerging markets

% y/y	2018	2019	2020
Emerging Markets of which	4.8	4.8	4.8
China	6.6	6.2	6.2
India	7.8	7.5	7.2
Russia	1.6	1.3	1.4
Brazil	1.4	2.0	2.6
Turkey	3.5	1.8	2.1
South Africa (SA)	0.5	1.6	2.0
Poland	5.1	3.8	2.7
Hungary	3.9	3.3	2.7
Czech Republic	3.3	3.1	3.0

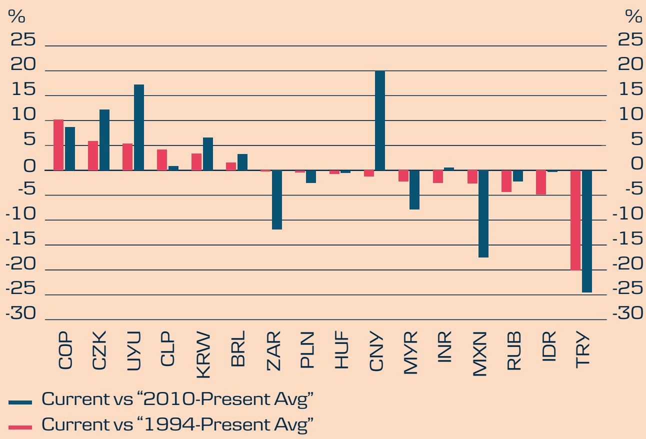
Source: Danske Bank and Macrobond

Economic growth is slowing down in most emerging markets in 2019 according to Bloomberg consensus



Note: Bloomberg consensus growth forecasts for 2019 minus the growth forecast for 2018.
Source: Bloomberg, Macrobond Financial, Danske Bank

Most emerging market currencies are fairly valued thanks to floating FX regimes



Note: Real effective exchange rate i forhold til 2010 and 1994 averages.
Source: Macrobond Financial, Danske Bank

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