The Big Picture

Investment Research
1 December 2020

Darkest before dawn

Highlights

- While COVID-19 restrictions are likely to stay in place until early spring...
- creating some headwinds for the global economy in Q4 20 and Q1 21.
- The roll-out of a COVID-19 vaccine will pave the wave for a solid global recovery from Q2 and onwards...
- ...and reduce the tail risk for the global economy.

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Editorial deadline: Monday 30 November at 16 CET
Economics Research

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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 32 of this report.

Global overview

Darkest before dawn

- Continuing high levels of COVID-19 cases mean that restrictions will likely remain through the early spring.
- After a strong recovery, the global economy is likely to see a soft patch in Q4 20 and Q1 21 due to the new restrictions and delays in new fiscal stimulus in the US.
- However, as a vaccine is distributed widely in H1 2021, we see brightening prospects for the global economy taking hold in Q2 and strengthening further in Q3 as pent-up demand is released.
- Overall, we look for a smaller effect from fiscal and monetary stimulus in 2021 than in 2020.
- The balance of risks to our global scenario has shifted to the upside due to the positive vaccine outlook, reducing at the same time negative tail-risks for the global economy.

Corona restrictions to remain through winter in Europe and the US...

The world has been struggling with the coronavirus for almost a year. Hot spots have been moving back and forth between regions and countries, underscoring the difficulty in getting to grips with the virus. After dealing with a severe first wave in the spring, Europe opened up over the summer but has seen a sharp rise in new cases in the autumn, triggering new restrictions in most countries. These restrictions, targeting high-risk areas such as entertainment and public events, have helped reduce the number of new cases. The US is witnessing a third wave, seeing a sharp acceleration in new cases and record high hospitalisation rates, which is more widespread across states than the first and second waves were. In response, several states have taken additional measures to stem the contagion and other states will follow suit and tighten restrictions in our view. However, restrictions are more targeted than in the spring on the service sectors while the manufacturing sector is left more or less untouched, limiting the damage to the economy.

...creating headwinds for the global economy in the next couple of quarters

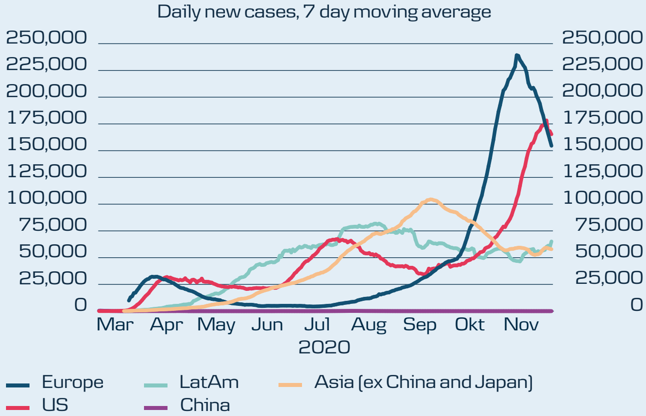
As Europe has tightened restrictions, service sector activity has been particularly hit. The same is true for the hardest-hit US states. As a result, private consumption in Europe and the US will face headwinds as more consumers stay at home to avoid shopping and travel. Furthermore, China's recovery is set to peak in Q4 2020, as the government is keen on scaling back stimulus to continue its deleveraging process. The combination of COVID-19 restrictions and waning export demand growth from the important Chinese market means the euro area will see negative growth in Q4 20 and only a small expansion in Q1 21 (hitting service PMIs in particular, while manufacturing may hold up better due to external demand). The US will also see headwinds in in the coming months due to its worsening COVID situation and new restrictions in some regions and delays in agreeing on a substantial fiscal policy package.

The roll-out of vaccines globally could pave the way for a global recovery in H1...

As described in the box, researchers and pharmaceutical companies are making good progress on developing an effective vaccine against the COVID-19 virus. The first vaccines have been approved by the US authorities and are due to be released in December. The same applies to Europe. Although there are still many unknowns about the vaccines, we assume a wider roll-out will gain speed in Q1. The most vulnerable groups and front line health officials are likely to be the to be vaccinated. Other groups would get access to vaccinations in Q2-Q4. It is uncertain how many will get vaccinated, but we assume it will be enough for things to get close to normal by the end of Q2 or early Q3 (hence reducing the need for restrictions in the fall next year). We expect that continued improvement in the treatment of the virus will also help to lower the mortality rate of those who are infected, easing fears over the disease.

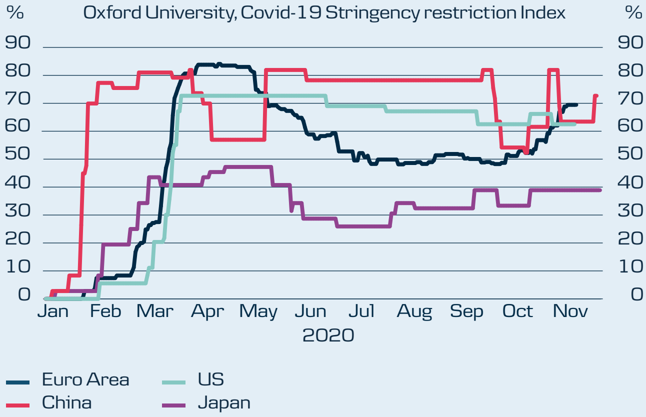
In summary, we expect the US and Europe will recover gradually from Q2 due to: 1) restrictions related to COVID being lifted gradually, 2) improving sentiment from a vaccine roll-out starting to unleash pent-up demand, 3) our expectation that growth will remain slightly above potential throughout 2021,

While the US is struggling with a third wave, Europe has managed to bend the virus curve...



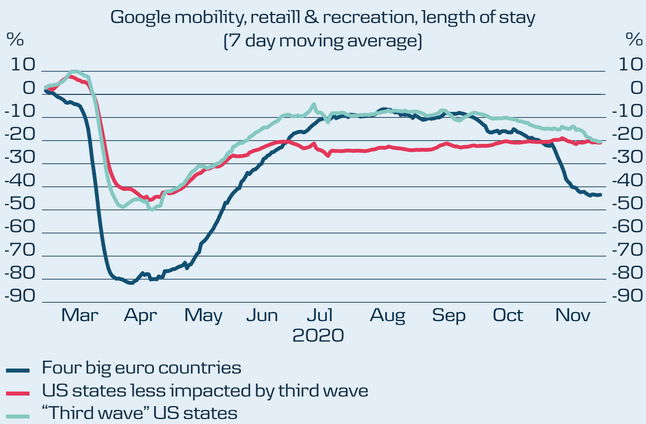
Source: Macrobond Financial, Danske Bank

...as it has re-tightened restrictions recently after substantial easing in the summer



Source: Oxford University, Macrobond Financial, Danske Bank

Service sector activity is taking a hit in the Euro area and in the hardest-hit US states



Source: Google, Macrobond Financial, Danske Bank
Note: The series show percentage deviation compared with historic numbers

despite China slowing down. In the middle of 2021, we look for the biggest effect of pent-up demand to drive a robust recovery, with growth slightly above potential and unemployment falling globally. We expect the service sector will benefit the most but also manufacturing to gain due to higher investments and more purchases of consumer durables as employment increases.

Overall, we expect G4 growth to rebound to about 6% in 2021 from -2.4% in 2020. The main driver for global growth will continue to be China, but also Europe and the US will see strengthening growth momentum through 2021. In 2022, we expect global GDP growth to fall to trend growth as economies have normalised. Compared to our previous growth forecast, the 2021 G4 GDP growth forecast has been revised down slightly due to the weaker growth momentum going into 2021 amid the new COVID-19 waves, while the outlook for 2022 is slightly higher than envisaged in August due to stronger vaccine prospects helping the service sectors to recover more strongly.

...while additional policy stimulus would be limited in 2021

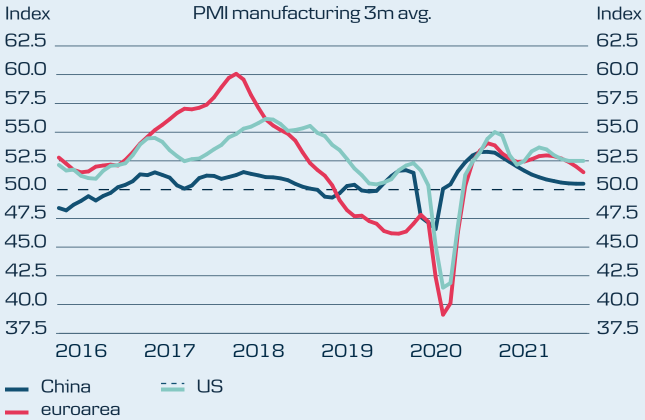
Overall, we look for a smaller effect from fiscal stimulus in 2021 than in 2020, which implies fiscal policy will have slightly negative to neutral impact impact on growth compared to 2020. In the US, policymakers have been discussing another support package since the summer but without results as the elections were looming. With the elections behind us, we look for a fiscal package in the US in the order USD800bn-1trn (between 3.8%-4.8% of GDP) but only on the other side of the new year. Furthermore, most of the measures will be continuation of existing measures that were approved in 2020 and hence will not provide much additional boost to the economy.

In the euro area, we still expect an expansionary fiscal policy in 2021 but less so than in 2020. The main focus is on backstop measures to limit bankruptcies, while employment schemes have already been extended through 2021 in most countries. The effects of the Recovery Fund will be gradual in 2021, as it will take time to roll out the green and digital investments planned. In China, fiscal policy is set to dampen growth in 2021, as publicly driven investments will be scaled back and focus returns to deleveraging the economy after a necessary break in 2020. Japan is planning a third fiscal stimulus package but it will likely be smaller than the previous ones.

On the monetary policy side, the probability of the Fed scaling up asset purchases has come down but tightening is far away. The ECB will be keen to avoid any tightening of financial conditions and hence we look for more liquidity operations (TLTROs) and an extension of the PEPP programme to be announced at the December meeting. However, we expect only a modest growth impact from these measures. We expect the People's Bank of China to be on hold for now but higher money market rates and bond yields indicate a de-facto tightening is already taking place as their focus is shifting to deleveraging the economy. This means credit growth will continue to decline, in our view.

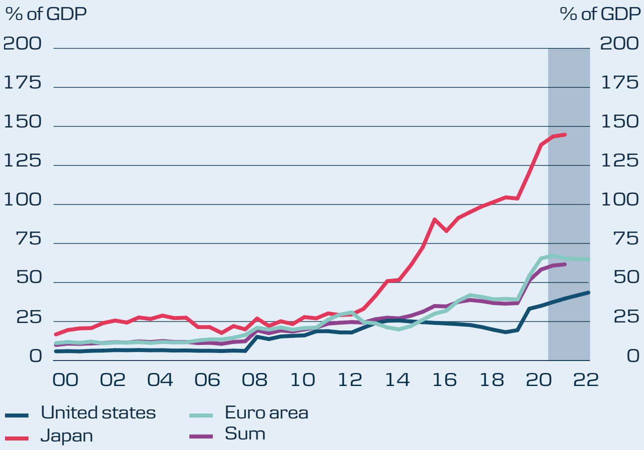
While headline inflation is expected to move higher in both Europe and the US as the drag from energy prices abate, we expect core inflation to only modestly increase, averaging 0.9% in the euro-area and 1.5% in the US in 2021.

Momentum in the global manufacturing sector is going to peak in middle of 2021



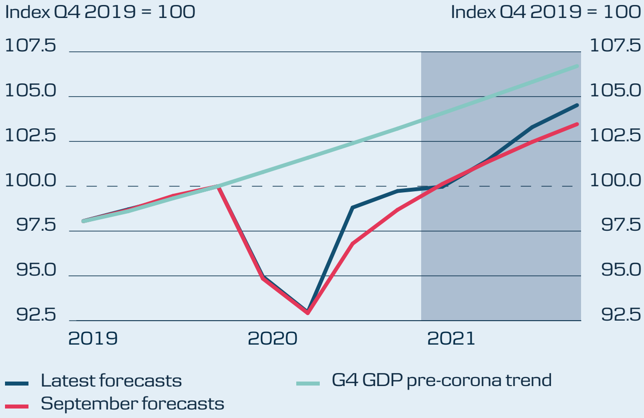
Source: Markit PMI, Macrobond Financials and Danske Bank forecasts

Central bank balances set to grow more modestly in 2021



Source: Macrobond Financials and Danske Bank

Growth momentum in late 2020 revised down, but stronger outlook in H2 2021



Source: Macrobond Financial, Danske Bank

GDP forecasts - Global overview

	2020				2021						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022
		% q/q				% q/q				% y/y	
G4	-5.0	-2.1	6.3	0.9	0.2	1.5	1.8	1.2	-2.4	5.9	4.3
United States	-1.3	-9.0	7.4	1.6	-1.4	1.2	2.3	1.1	-3.4	3.3	3.8
Euro Area	-3.7	-11.8	12.6	-1.4	0.4	2.1	1.9	1.3	-7.0	4.9	3.4
China	-10.0	11.7	2.7	1.8	1.5	1.4	1.4	1.4	1.7	9.2	5.5
Japan	-0.6	-8.2	5.0	-0.1	0.1	1.5	2.4	0.4	-5.6	2.7	2.5

Source: Macrobond Financials and Danske Bank

The prospects for an effective vaccine reduce downside risks for the global economy

In comparison with our previous edition of Big Picture, the downside risks to our global economic forecasts have declined following the positive news about a vaccine for the virus (15% probability versus 25% before). Furthermore, while a Biden administration in the US is set to maintain a tough stance towards China, the risk of new trade wars is significantly lower than under President Trump. Among the key downside risk is a hard Brexit, for which we see a 40% probability. Another key downside risk is delays in approving fiscal stimuli in the US and Eurozone. In the US, the republicans are likely to maintain a slight majority in the Senate. This means that they will be able to block Democrat's proposals. In Europe, the disagreement between Eastern European countries like Poland and Hungary and the western European countries over rule of law conditions in the new EU budget and recovery fund risk delaying approval well into 2021 (40% chance vs. a compromise between the two sides to be found at the 10-11 December meeting).

In contrast, the upside risks to the global economy have increased (25% probability now versus 15% before). Among the key upside risks is stronger-than-expected pent-up demand as companies and households look through new corona waves, spurred by early approval, distribution and take-up of an effective vaccine against the virus. We expect this will propel the normalisation of the economies to the first half of 2021, lifting investments amid easy financial conditions and increasing capacity utilisation. We expect that as the rebound will be strong and persistent, unemployment rates could reach pre-COVID-19 levels in China, the Nordic countries, the US and the Eurozone in 2021.

An effective roll-out COVID-19 vaccine holds the key to global economy in 2021

In recent weeks, several pharmaceutical companies have announced positive results of their phase 3 tests of COVID-19 vaccines. The so-called efficacy rate (measuring the reduction in COVID-19 disease between a treatment and control groups) varies between an average of 70% for AstraZeneca two full doses to about 95% for Pfizer's and Moderna's vaccines. Both Pfizer and Moderna have already submitted its emergency use authorization (EUA) request to the US FDA and may get approval in the second half of December. AstraZeneca may get its approval in early January but there are more uncertainties about their trial results. Similar process has started in Europe. It is estimated that the three companies can produce approximately 3bn doses in 2021.

Thus we expect the vaccination process for risk groups and healthcare workers to start in mid-December, continuing into Q1 21, while vaccination of the broader population is likely to start in Q1 21 or early Q2 21. A key issue is how many will want to be vaccinated as surveys show only about 50% globally will seek vaccination. However, the most important thing is to get the vulnerable groups vaccinated in our view so the threat of the virus will become more like a regular flu. As vaccines are rolled out, reducing the needs for new restrictions, improving sentiment will start to unleash pent-up demand in late spring. The service sector will benefit the most but manufacturing will also gain from more investments and more purchases of consumer durables as employment increases, pointing to a strengthening in growth momentum over most of 2021.

US

The horizon is clearing

- The near-term outlook does not look encouraging, with an increasing number of COVID-19 cases and no relief package.
- With the vaccination process soon about to start, we think the outlook now looks brighter in 2021, especially in the second half.
- We expect a USD1,000bn relief package will be approved in Q1 21 after the inauguration. We do not foresee any Fed rate hikes over the next couple of years.

... but dark clouds over the economy near-term

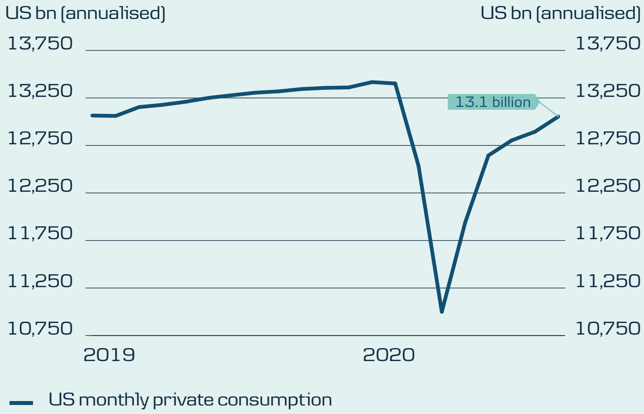
Like the rest of the advanced economies, the US economy has been hit hard by the COVID-19 crisis. At the time of writing, total monthly private consumption remains 2.2% below the peak in February. While this is a significant improvement since the bottom in April, when consumption was 17.9% lower, it is noteworthy that private consumption was never more than 2.6% down its peak during the financial crisis. Employment in October was still slightly more than 10 million below its peak in February. There is no doubt that the US economy is still in a crisis despite the recovery since the bottom in spring. Unfortunately, the near-term outlook does not look that good. We are seeing a sharp increase in number of new cases, hospitalisations and deaths in the US and unlike the first two waves, it is now nationwide. We have already seen some states starting to tighten restrictions to avoid hospitals falling under too much pressure and we think more restrictions are likely. Google's mobility index for retail and recreation, which is a good indicator of the direction of consumption, has started to move lower. At the same time, Congress has so far been unable to reach an agreement on further fiscal aid. High praise to the politicians that they were able to approve big and significant emergency support to the economy in the spring, but unfortunately the economy is not out of the woods yet. Some elements of the fiscal relief in spring have already expired, others are expiring by year-end and some funds have run out of money. The combination means that the near-term outlook has worsened in our view.

Looking further into next year we are more optimistic. It seems like we are on track to get more than one vaccine approved before year end, so that the vaccination process can get started soon. Previously, we feared that the development process would get delayed – remember this is the fastest vaccine developed in human history – but this does not seem to be the case. A vaccine does not help the near-term outlook, but it means that we do not have to experience the same thing all over again in the second half next year. We know the virus does not spread as much when it gets warmer and people start to spend more time outdoors, so we expect looser restrictions in Q2. In Q3 and Q4, the vaccination process is expected to have progressed so much that new restrictions should not be needed. We expect a significant boost to domestic consumption and investments when the economy start to operate more "normally" again. Of course, it is a big unknown how many people are willing to get vaccinated, but as long as the most vulnerable people are, we have come a long way. That said, we are concerned that politicians have not yet been able to reach an agreement on further fiscal aid despite three months of negotiations ahead of the election.

President-elect Biden won the battle, but may have lost the war

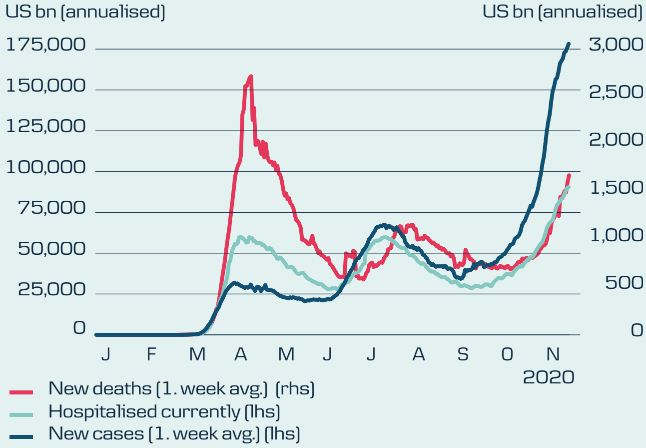
Although the Republican Party and President Donald Trump did better than expected in the election, President-elect Joe Biden won the presidential election and the Democratic Party regained the majority in the House of Representatives. We will not know the final Senate election results until two special Senate elections have been held in Georgia on 5 January. If the Democratic Party wins both seats, the party wins the majority in the Senate, otherwise the Republicans regain it. As Geor-

Private consumption remains below the February peak despite recovery



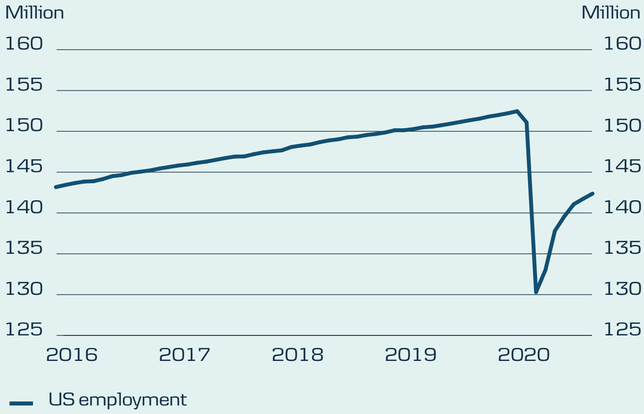
Source: BEA, Macrobond Financial

COVID-19 situation is deteriorating in the US



Source: ECDC, COVID-19 Tracking Project, Macrobond Financial

Big need for further fiscal aid with employment still 10 million below the peak in February



Source: ECDC, COVID-19 Tracking Project, Macrobond Financial gia is usually considered Republican-leaning, it seems like a difficult task for the Democratic Party and our base case is a continued Republican-controlled Senate. This means that Biden becomes a "lame duck", as it becomes very difficult for him to pass domestic policy. Near-term, it means that it is difficult for Biden to get a big and ambitious fiscal relief package over the finish line due to the cooperation difficulties over the (at least) past 30 years. We expect a small package of around USD1,000bn being approved in Q1 21 after Biden's inauguration. Government deficits will remain very high next year regardless of a new relief package being approved or not and government debt has risen sharply. Investors do not seem to care much and interest rates remain low, making the interest rate burden still low. It helps that the Federal Reserve continues to buy bonds.

What will change is foreign policy, where the President has much more power without Congressional approval. We expect Biden to continue putting pressure on China, but to remove the tariffs on imported goods from China imposed by Trump. The US-China tensions will be more gradual and less disruptive. We also expect a normalisation of the US relationships with EU, NATO, WTO and WHO. It is not first on Biden's to do list, but further down the road it will be very interesting to see if the US and the EU will restart negotiations on a free trade agreement.

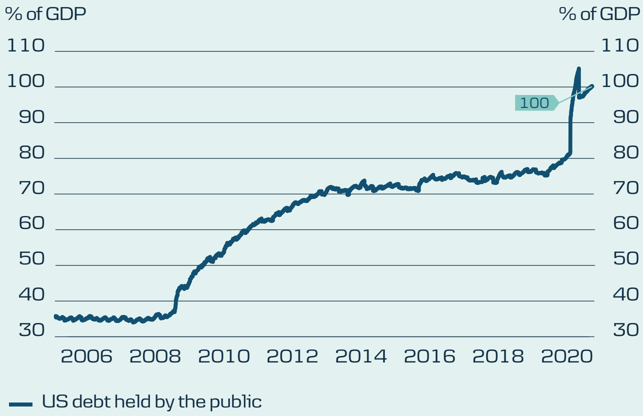
Fed on hold for a long time

In late August, Fed chair Jerome Powell announced a change to the Federal Reserve's monetary policy framework such that they now aim at reaching an average inflation rate of 2% over some years instead of the traditional 2% inflation target. While the change may sound small, it is actually quite significant, as the devil is in the detail. With the new regime, the Federal Reserve has promised to deliver inflation above 2% "for some time" to make up for inflation running below 2% (otherwise it will not be 2% on average), something which was not the case in the old regime. The reason for the change is that inflation persistently ran below 2% during the expansion after the financial crisis and until the coronavirus crisis. This means that the Federal Reserve has changed its reaction function in two important ways. First, it will no longer tighten monetary policy just because unemployment is low if wage and inflation pressure is subdued (and hence will not offset more expansionary fiscal policy to support the economy near-term). Second, the Fed will tolerate inflation above 2% without tightening monetary policy. This means that we should expect the Fed to keep the target range at 0.00-0.25% and continue buying bonds for many years.

Will we finally see higher inflation in the post coronavirus crisis world?

A big question is, of course, whether we will actually see inflation start to move higher. Inflation has been running persistently below 2% for a long time, so what should be different after the coronavirus crisis? Inflation expectations play a key role in explaining actual inflation and since both survey and market based inflation expectations remain to the low side, it is difficult to see a significant jump in inflation right now. That said, a lot of money has been injected to the system both by monetary and fiscal authorities and when things start to normalise, we will likely see a sharp increase in demand. If this is not inflationary down the road, what is? That said, it is probably more a theme for 2022-24 than for 2021.

Government debt has risen significantly but interest rates remain very low

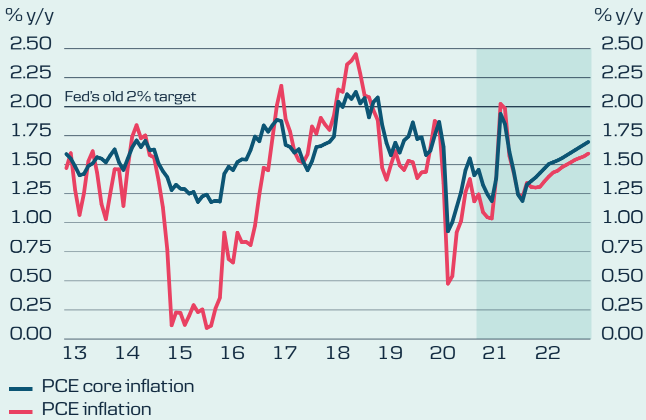


Source: US Treasury, BEA, Macrobond Financial

Fed is set to maintain the Fed funds target range at 0.00-0.25% for a long time

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

Whether inflation will start to accelerate is more a theme for 2022-24 than 2021



Source: BEA, Macrobond Financial, Danske Bank

Macro forecasts - US

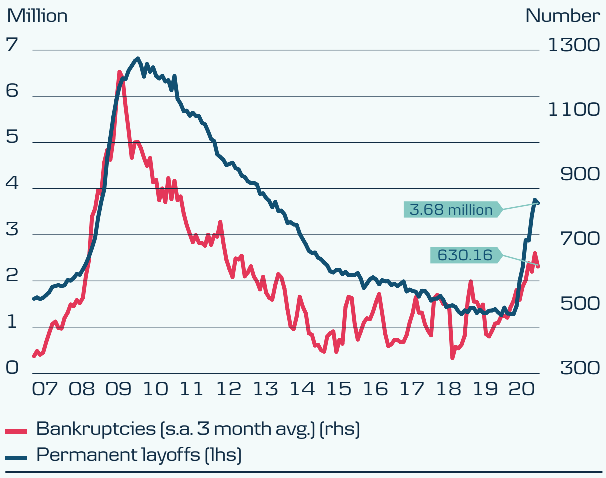
% change q/q AR	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2020	2021	2022
GDP	-5.0	-31.4	33.1	6.6	-5.3	4.7	9.5	4.6	-3.4	3.3	3.8
Private Consumption	-6.9	-33.2	40.7	5.1	-3.9	6.1	12.6	5.1	-3.8	4.6	4.3
Private Fixed Investments	-1.4	-29.2	28.5	8.6	-1.4	3.9	10.1	5.0	-2.6	4.4	4.3
Residential	-6.7	-27.2	20.3	8.9	-3.1	4.2	12.4	5.7	-4.5	3.7	4.9
Non-residential	19.0	-35.6	59.3	8.2	4.1	3.0	3.0	3.0	4.1	6.8	2.4
Change in inventories[1]	-0.4	-1.1	1.7	0.5	-1.1	0.0	0.0	0.0	-0.6	-0.2	0.0
Public Consumption	1.3	2.5	-4.5	-3.9	5.1	4.1	4.1	2.0	1.0	1.5	2.1
Exports	-9.5	-64.4	59.7	6.1	3.0	2.4	2.0	2.0	-13.7	1.7	2.0
Imports	-15.0	-54.1	91.1	2.0	-1.0	8.2	12.6	2.6	-10.8	6.4	3.8
Net exports[1]	0.4	0.1	-1.4	0.1	0.1	-0.3	-0.5	-0.1	0.1	-0.9	-0.4
Unemployment rate (%)	3.8	13.0	8.8	6.9	7.3	7.0	5.7	5.5	8.1	6.4	5.1
Inflation (CPI) (y/y)	2.1	0.4	1.3	1.1	1.1	2.3	1.4	1.4	1.2	1.6	1.6
Core inflation (CPI) (y/y)	2.2	1.3	1.7	1.5	1.3	2.0	1.4	1.4	1.7	1.5	1.8
Public Budget[2]									-16.0	-12.2	-7.2
Public Gross Debt[2]									126	132	132
Current Account[2]									-2.1	-2.1	-2.1
Fed funds rate[3]	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

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

More fiscal support needed to avoid a negative spiral

The current crisis is very different from other economic crises, as it has been caused by a pandemic. Normally, an economic crisis gets worse over time due to a negative spiral: when people lose their job, there is less money to spend, implying less business, which might lead to bankruptcy. We did not see this in spring due to significant fiscal and monetary aid but without further help, there is a risk that the current 'pandemic recession' develops into a 'traditional recession'. More fiscal aid near term would be beneficial, especially as we can see the light at the end of the tunnel now with the vaccine development progress.

Bankruptcies and permanent layoffs still below financial crisis levels



Sources: American Bankruptcy Institute, BLS, Macrobond Financial

Euro area

On a rocky road

- The euro area economy remains caught between light and shadow. Overall, we expect a rocky road to recovery that will only see the economy reaching pre-pandemic levels in 2022.

- Following a contraction of 7.0% in 2020, we expect euro area GDP to expand by 4.9% in 2021 and 3.4% in 2022. We believe private consumption is likely to be the major driver of the recovery and that the rebound in investments will be more subdued.

- The complementary and mutually reinforcing effects of monetary and fiscal policies will play a crucial role in supporting the euro area economy and reducing the risk of an asymmetric recovery among countries.

Between light and shadow

The euro area economy remains caught between light and shadow. The pandemic outbreak and associated lockdown measures took a severe toll on economic activity, which shrank by c.15% in H1 20, bringing output close to levels last seen in 2005. Helped by unprecedented policy support, an economic recovery swiftly took hold over the summer, with GDP expanding by 12.6% q/q in Q3 20. However, in recent months, a resurgence of COVID-19 infections in many countries has led to the re-introduction of partial lockdowns, which, in our view, will result in another GDP contraction in Q4 and subdued economic activity at the start of 2021. For the remainder of next year, prospects should brighten, as ample (EU and national) fiscal policy support, the arrival of a vaccine and pent-up demand will allow for some normalisation of economic activity. In sum, following a contraction of 7.0% this year, we expect euro area GDP to expand by 4.9% in 2021. As the boost from (Chinese) foreign demand starts to wear off and a number of 'pre-existing conditions', such as low productivity and adverse demographic trends, come back to the fore, we project GDP growth to moderate to 3.4% in 2022. Still, this implies that the euro area economy would only return to pre-pandemic levels in 2022.

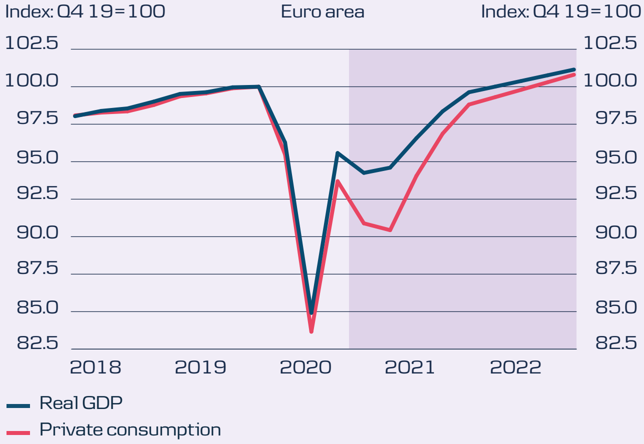
From pandemic recession to pandemic recovery

The global pandemic recession is an unusual one in many respects. Services activity, which is normally more resilient during a downturn, has been hit hardest, while activity in more 'cyclical' sectors, such as manufacturing and construction, has been less affected. This unusual dynamic has a range of implications for the euro area recovery that we expect to unfold in 2021 and 2022.

Firstly, it will remain an asymmetric one. We expect economies such as Spain and Italy, which are more dependent on tourism and have less fiscal policy space, to take significantly longer to reach pre-pandemic output levels than economies such as Germany, which not only benefits from the tailwind of resilient global manufacturing activity but also ample fiscal resources. 'Next Generation EU' has the potential to alleviate some of the asymmetry in domestic fiscal policy responses, but we expect the fiscal boost to materialise mostly from H2 21 onwards (see theme box). Greater political and market acceptance of higher debt burdens will allow fiscal policies to remain expansionary in 2021, although somewhat less so than in 2020. We expect EU budget rules will remain suspended until at least 2022, decreasing the risk of premature fiscal tightening. However, it will also be important for fiscally vulnerable countries such as Italy and France to find ways to make credible commitments to sustainable fiscal policies once their economies have returned to full employment (see Research Global - Public debt levels post COVID-19: much ado about nothing?, 30 September 2020).

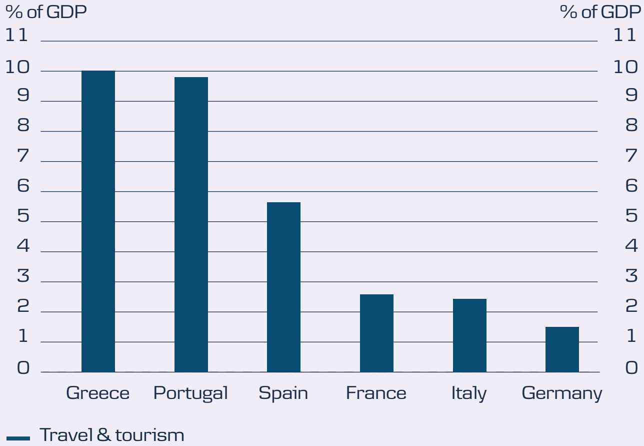
Secondly, services-induced recessions tend to have a larger effect on labour markets. That said, the swift implementation of furlough schemes by European governments has helped to cushion the negative impact on employment and incomes. Some five million workers have lost their jobs since the onset of the pandemic in the euro area but the impact on the number of employed persons has been much lower than the fall in GDP. Some countries, such as Germany, have already extended their job retention schemes until the end of 2021 and, should the

Private consumption the main driver of the recovery



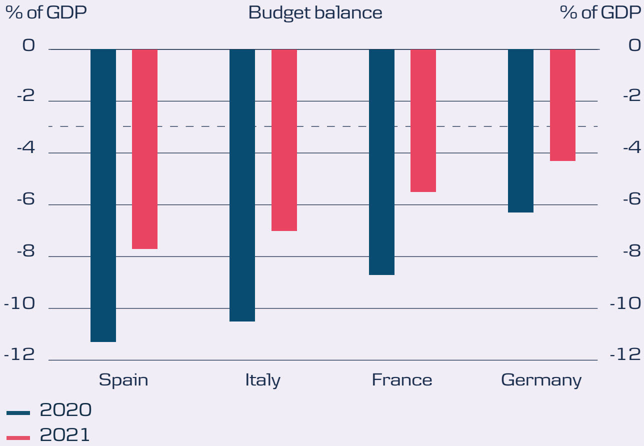
Source: Eurostat, Macrobond Financial, Danske Bank

Southern Europe most exposed to tourism hit



Source: World Bank, Macrobond Financial, Danske Bank

Fiscal policies to stay expansionary



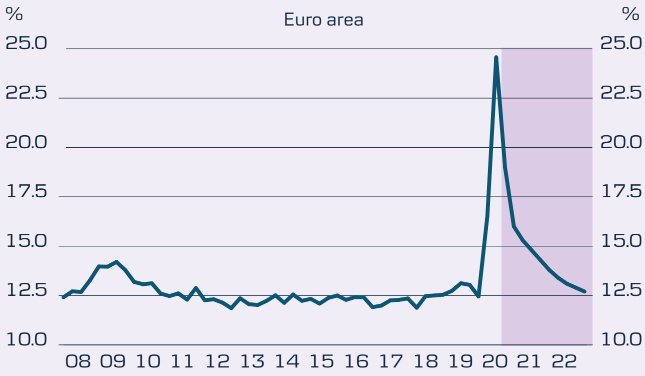
Source: European Commission, Danske Bank need arise, we would expect many other euro area countries to follow suit. Avoiding a labour market crisis will have high priority in national fiscal plans and with the EU's SURE programme providing an important backstop, funding issues are less of a headache for cash-strapped countries. Overall, we still look for an increase in the unemployment rate to 8.9% in 2021, as some temporary job losses turn permanent, but going into 2022, we look for a resumption of employment growth.

Thirdly, the progress in vaccines and other medical treatments, as well as the behaviour of households and businesses, will play a crucial part in shaping the road to recovery. The pandemic has radically changed the role of private consumption in driving growth. Under the lockdowns, the partial lack of consumption opportunities has not only resulted in an increase in (forced) savings but also a substitution away from services consumption and towards non-durable goods consumption. The availability of a vaccine and ongoing fiscal support should lead to a burst of pent-up demand in H2 21, as households gradually release accumulated savings and increase services consumption. In 2022, we expect private consumption growth to moderate but government support, resuming employment growth and subdued inflation to hold a hand under consumer spending.

The COVID-19 pandemic has also caused a significant setback in the ECB's fight to raise inflation pressures, with core inflation dropping to a new all-time low of 0.2% in September 2020. Going into 2021, we expect inflation prospects to brighten slightly. The drag from energy prices should slowly abate and the reversal of Germany's temporary VAT cut will be an important factor lifting core inflation. However, the dynamics in service prices remain more ambiguous and some form of normalisation in tourism and hospitality-related sectors is required, in our view, before service price inflation can get back to its pre-coronavirus highs. Overall, we project euro area HICP inflation at 1.0% in 2021 and 1.1% in 2022 (see Research Euro Area - Measuring the euro area inflation pulse, 9 November 2020).

The complementary and mutually reinforcing effects of monetary and fiscal policies will play a crucial role in supporting the euro area economy. The ECB's comprehensive easing measures enacted in 2020 have supported bank lending and the provision of state guarantees and tax deferrals have helped avoid a liquidity crunch and widespread bankruptcies. However, reflecting concerns about the recovery, banks have started to tighten credit standards recently. The ECB will be keen to avoid any tightening of financial conditions and hence we look for more liquidity operations (TLTROs) and an extension of the PEPP programme to be announced at the December meeting. However, ultimately, the ECB's current toolbox, which acts through the supply side, is unlikely to hold the key to a material change in euro area growth and inflation prospects (see ECB Research: Recalibrating - not reinventing - the toolbox, 12 November 2020). That said, we expect the ECB to continue to provide an important backstop to avoid financial market fragmentation and ensure the flow of credit to the real economy. With the pandemic leaving its mark on the economy for years to come, we expect gradual ECB balance sheet normalisation to start in 2023 at the very earliest and more likely in 2024-25.

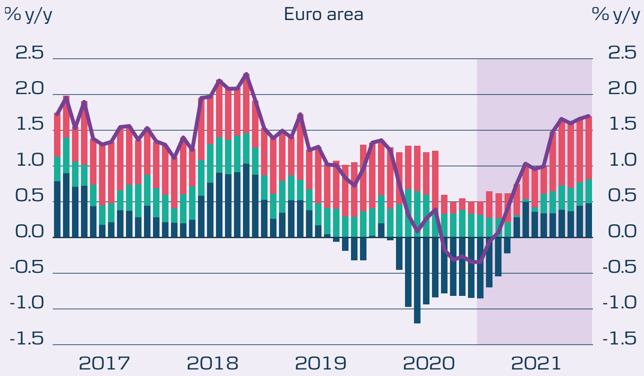
Euro area savings ratio slow to return to pre-pandemic levels



Household savings rate (% of disposable income)

Source: Eurostat, Macrobond Financial, Danske Bank

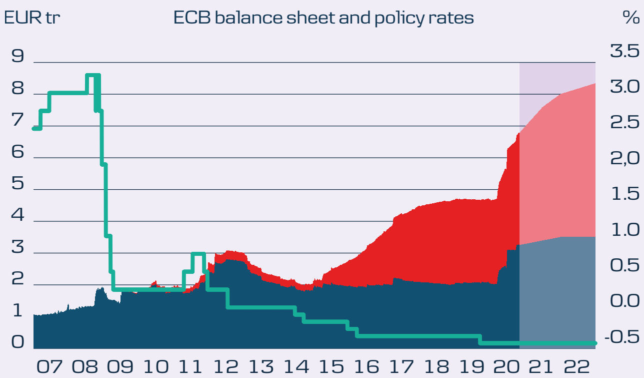
Euro inflation to pick up in 2021



Energy | Core | Food | HICP (Danske forecast)

Source: Eurostat, Macrobond Financial, Danske Bank

ECB balance sheet expansion through 2022 at least



Securities held for monetary policy purposes (QE) | Other | ECB deposit rate

Source: ECB, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

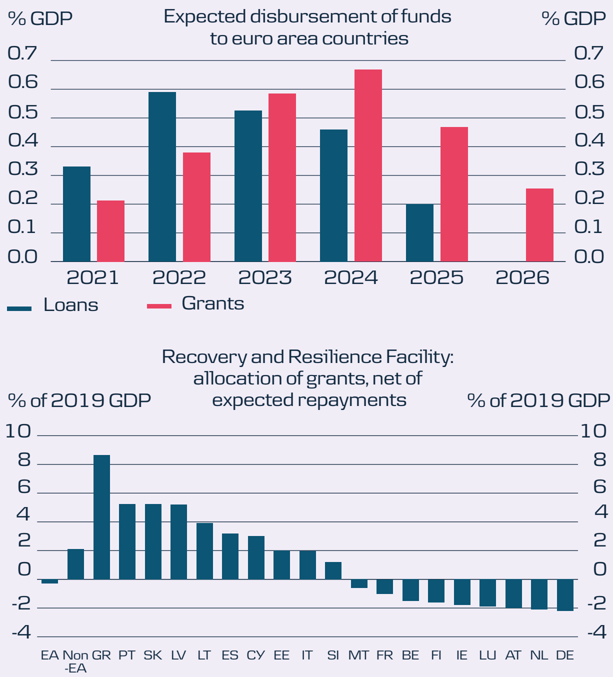
% Change q/q	2020				2021				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2019	2020	2021	2022
GDP	-3.7	-11.8	12.6	-1.4	0.4	2.1	1.9	1.3	1.3	-7.0	4.9	3.4
Private Consumption	-4.5	-12.4	12.0	-3.0	-0.5	4.0	3.0	2.0	1.4	-8.8	4.5	5.3
Fixed Investments	-5.1	-17.1	2.0	1.0	1.0	0.8	0.5	0.5	5.7	-13.7	-1.2	2.1
Public Consumption	-0.8	-2.5	2.0	1.0	1.0	1.0	0.4	0.4	1.8	-0.8	3.2	1.8
Exports	-3.8	-18.8	18.0	4.0	4.0	2.0	2.0	1.0	2.5	-9.1	13.1	3.5
Imports	-2.9	-18.3	9.0	5.0	4.0	3.0	2.0	1.0	3.9	-10.5	10.6	4.3
Net exports[1]	-2.0	-2.3	20.8	-0.8	0.9	-1.5	0.4	0.2	-0.5	0.3	1.6	-0.2
Unemployment rate (%)									7.6	7.9	8.9	8.6
HICP (y/y)	1.1	0.2	0.0	-0.3	0.1	0.9	1.4	1.7	1.2	0.2	1.0	1.1
Core HICP (y/y)	1.1	0.9	0.6	0.2	0.5	0.7	1.0	1.3	1.0	0.7	0.9	1.0
Public Budget[2]									-0.6	-8.8	-6.2	-4.4
Public Gross Debt[2]									85.9	101.7	102.1	102.3
ECB deposit rate[3]	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5

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

'Next Generation EU' – lessons learned from the Eurozone crisis?

The EU's recovery package (NGEU) represents not only an important milestone in European integration but also plays a crucial role in alleviating the risk of an asymmetric recovery. For NGEU, the European Commission has been authorised to raise up to EUR750bn on the capital markets, which means the EU will become one of the largest issuers in Europe over the coming years, in our view (c.EUR175bn issuance in 2021; the fifth largest issuer after Italy, France, Germany and Spain). To receive financial support from the fund, countries need to prepare national recovery and resilience plans setting out their reform and investment agenda (with a minimum 37% of expenditures linked to green investments and 20% to digital investments). The Commission's plans financial support to be fully committed by the end of 2023 and largely disbursed over the period from 2021 to 2024. The funds provided by NGEU lower the risk that fiscal support will be withdrawn prematurely at the national level, especially for countries that already face fiscal sustainability concerns. Although NGEU will not help the euro area recovery much in the short term, we see it as an important element of 'bridge-financing', supporting public investments at a time when some national fiscal initiatives might otherwise be scaled back. Overall, NGEU would imply a debt-based fiscal expansion of around 1% of GDP on average in the euro area over 2021-24, assuming that the support is used at the national level to finance additional expenditure.

Southern and eastern Europe to benefit most from NGEU funds



Source: ECB, European Commission, Danske Bank

Germany

From laggard to leader?

- Its manufacturing reliance has allowed the German economy to weather the coronavirus storm much better than many European peers, but future growth prospects are set to be increasingly reliant on domestic demand.
- Ample fiscal space and resuming employment growth leave significant potential for pent-up demand to materialise once containment measures are eased and we look for an expansion of the economy by 3.9% in 2021E and 2.2% in 2022E.
- The long-term growth prospects of the German economy remain mixed. Its export dependence might come back to haunt it and the important car sector remains in the midst of far-reaching upheaval.
- As the end of the ‘era Angela Merkel’ draws near, federal elections in 2021 are set to have important implications for economic and fiscal policies for years to come.

A reversal of fortunes

Until the end of 2019, the dichotomy between an expanding service sector and a stagnating or even shrinking manufacturing sector characterised the German economy. The COVID-19 crisis has reversed fortunes. Germany's manufacturing reliance has turned from a curse to a blessing that allowed the economy to weather the coronavirus storm much better than many European peers. After output in Q2 20 plunged to the lowest level since 2011, a strong recovery over the summer meant that GDP remained only 4% below pre-pandemic level at the end of Q3 20.

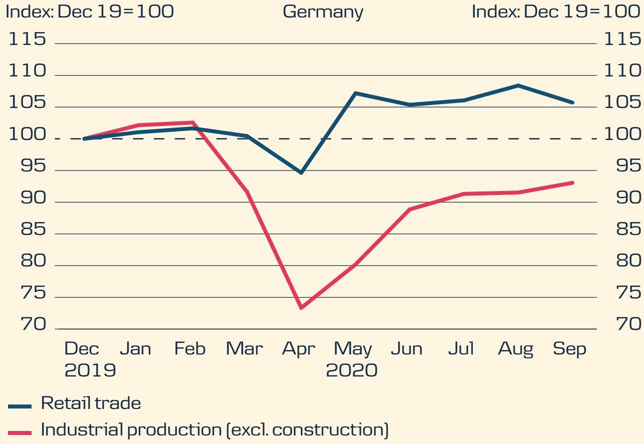
Germany's economic outperformance had several origins. Ample fiscal space allowed the government to support the economy with one of the largest stimulus packages, amounting to nearly 40% of GDP (if loan and guarantee schemes are included). As household incomes have largely been preserved during lockdowns with the 'Kurzarbeit' scheme, increased goods consumption (also due to a temporary VAT cut in H2 20) compensated for some of the weakness in services. Finally, with 22% of GDP generated by manufacturing (which is currently riding high on the tide of strong Asian demand) and only 3% of GDP generated by services linked to accommodation, food, art and entertainment, the economy's structure has also helped to mitigate the hit.

Will the outperformance last, however? Exports are set to continue to benefit from a more predictable global trade environment under President-elect Joe Biden and strengthening domestic demand in key euro area trading partners in our view. However, the risks of a no-deal Brexit still loom and with foreign demand for capital and investment goods abating (notably from China), we expect manufacturing to exert less of stabilising force on growth in 2021 and 2022.

That leaves the growth prospects of the German economy increasingly reliant on domestic demand in 2021. The return of partial lockdowns of hospitality and cultural services during Q4 20 has already brought a setback in that respect. However, we expect the headwinds to private consumption to ease during H1 21, as ongoing public stimulus and resuming employment growth leave significant potential for pent-up demand to materialise once containment measures are eased. The fiscal policy measures enacted by the government since June are expected to provide a fiscal impulse of around 0.7-1.3pp of GDP in 2021. With large parts of coronavirus support funds still being untapped, we are not too concerned about the risk of premature fiscal tightening and the government's latest fiscal plans do not foresee a return to the balanced budget ('Schwarze Null') policy from pre-coronavirus times until 2024. With a significant portion of the economic stimulus from the EU and national recovery packages planned to go into public investment, an increase in public construction activity should also hold a hand under construction investment in 2021.

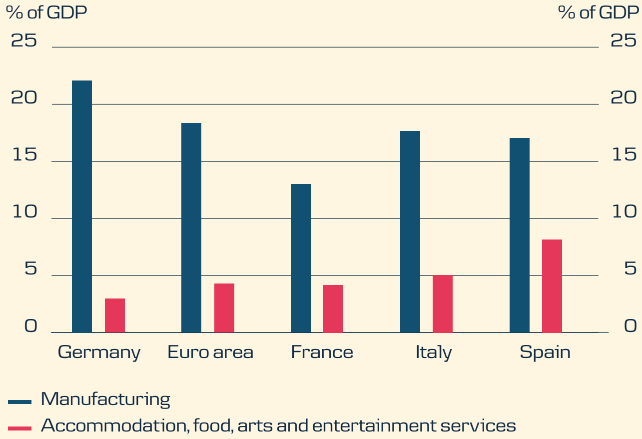
Corporate insolvencies will likely start to pick up next year, as the suspension of the obligation to file for insolvency expires. However, thanks to generally sound balance sheets and large public support measures, we do not look for a significant wave of insolvencies. This will also have important implications for the labour market. Since August employment has started to

A swift recovery in retail trade



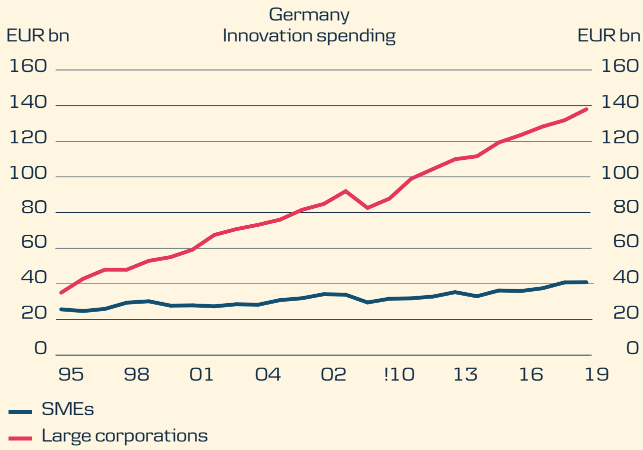
Source: Eurostat, Destatis, Macrobond Financial, Danske Bank

Germany's manufacturing reliance becomes a blessing



Source: Eurostat, Macrobond Financial, Danske Bank

Innovation process too concentrated on large companies



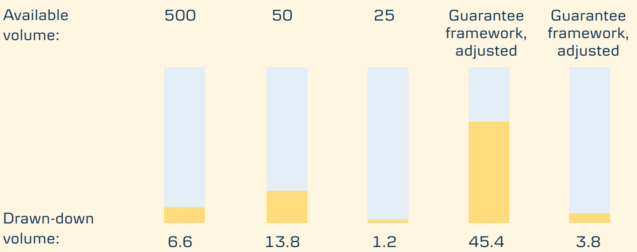
Source: Mannheim Innovation Panel, ZEW increase again and the number of workers reliant on 'Kurzarbeit' has started to come down from its peak of six million in April, even though the availability of the short-time working scheme has been prolonged until end-2021. The manufacturing and hospitality sectors remain the hardest hit by job losses and short-time work, but overall we look for employment growth to continue into 2021 and 2022.

Long-term challenges abound

In sum, following a contraction by 5.4% in 2020, we look for a strong rebound in GDP of 3.9% in 2021 and 2.2% in 2022. However, the long-term growth prospects of the German economy remain mixed. With Chinese deleveraging resuming and the risk of a no-deal Brexit still looming, its industry and export dependency might come back to haunt it. Productivity growth has been declining for several decades, as innovation expenditures are increasingly concentrated on large companies. Technological change and the planned transition to a climate-neutral economy require an adaption of business models and production processes. This continues to spell trouble, especially for Germany's car sector that remains in the midst of far-reaching upheaval (see Euro Area Research: Europe's car sector: back on the road again?, 10 September 2020). Fortunately, it seems German policymakers are starting to become aware of these challenges (see theme box).

Large parts of coronavirus support funds are still available

Corona support in EUR bn



Economic stabilisation fund (WSF)	Emergency aid for micro-businesses and sole traders	Stop-gab aid	KfW special programmes	Guarantees
Recapitalisation measures and guarantees for large companies	Grants of €9,000 or €15,000 for companies with up to 10 employees	Grants to make up for loss of revenue for companies with up to 249 employees	KfW loans and instant loans where KfW assumes between 80% and 100% og the risk	Large state guarantees (Großbürgschaften) and guarantees from the guarantee banks

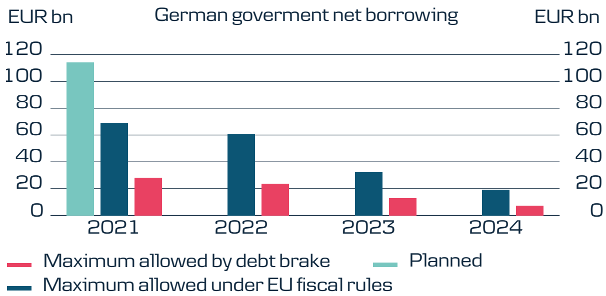
Source: Sachverständigenrat, Association of German guarantee banks, BMF, BMWi, KfW

Politics: the end of the 'era Angela Merkel' – what's next?

Germany's federal election taking place in 2021 is set to have important implications for economic and fiscal policies for years to come. The election campaign is likely to be dominated by the government's handling of the COVID-19 crisis and its economic, fiscal and societal repercussions. From current polling, the most likely outcome is a centrist coalition between the conservative CDU/CSU party and the left-wing Green party. Such a government would likely pursue a pro-European and pro-investment agenda with the potential for a more relaxed fiscal stance down the line. The Green party has long been a strong advocate of more 'strategic' public investments in the volume of EUR30bn per year. Support for a fiscal regime shift also seems to be gaining increasing traction among the German public and strong calls for a return to the balanced budget ('Schwarze Null') policy are largely absent across the political spectrum. Still, the constitutional 'debt brake' is set to become applicable again in 2022 and curtail fiscal spending to a maximum structural deficit of 0.35% of GDP. The Green party has advocated to supplement the debt brake with an investment rule based on the loss of infrastructure value, but such a constitutional change would require a broad consensus in parliament (two-thirds majority) that seems difficult to achieve.

The risk of a populist government remains very small in our view, due to the Alternative for Germany (AfD) party remaining a political outcast. Still, with the 'era Angela Merkel' drawing to an end, there is a risk that Germany might also lose some of its cloud as a European stability anchor and consensus builder. The head of the new government is set to lack some of the same diplomatic cloud and 'Feingefühl', which often allowed Angela Merkel to act as an important deal-maker in difficult European negotiations, from the Greek debt crisis to the creation of the EU recovery fund. That said, while a new German chancellor will have to 'grow into the job' (policy mishaps not excluded), we expect Germany to remain an active player on the European scene with a clear pro-European policy stance.

Debt brake will limit spending



Source: BMF, BMWi, European Commission

Macro forecasts - Germany

% Change q/q	2020				2021				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2019	2020	2021	2022
GDP	-1.9	-9.8	8.5	0.0	0.9	1.1	1.3	0.6	0.6	-5.4	3.9	2.2
Private Consumption	-2.5	-10.9	10.8	-1.5	-0.5	2.0	2.0	1.0	1.6	-6.0	3.3	3.3
Fixed Investments	-0.5	-7.9	3.6	1.0	1.0	0.8	0.5	0.5	2.6	-4.8	1.4	2.1
Public Consumption	0.6	1.5	0.8	2.0	1.0	0.5	0.4	0.4	2.7	4.3	2.4	2.1
Exports	-3.3	-20.3	18.1	4.0	5.0	3.0	1.0	0.7	1.0	-10.1	12.4	3.3
Imports	-1.9	-16.0	9.1	4.0	4.0	4.0	1.0	1.0	2.6	-8.9	10.9	4.3
Net exports [1]	-3.0	-9.8	18.6	0.8	2.9	-1.1	0.2	-0.4	-0.7	-1.0	1.9	-0.3
Unemployment rate (%)									3.1	4.2	4.2	3.7
HICP (y/y)									1.4	0.4	1.4	1.3
Public Budget [2]									1.5	-6.0	-4.0	-2.5
Public Gross Debt[2]									59.6	71.2	70.0	69.0

1: Contribution to GDP growth
2: Pct. of GDP
Source: Eurostat. Danske Bank

The German 'Game of Thrones': Angela Merkel's succession race has begun

?

CDU/CSU

Leadership election to take place in mid-January 2021

SPD – Olaf Scholz

- Current finance minister
- Centrist, fiscal moderate, pro-EU views

The Greens – Robert Habeck

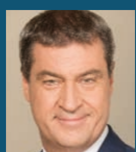
- Green party leader
- Fiscal 'dove', pro-EU views

Friedrich Merz

- Businessman
- Pro-market policies, fiscal 'hawk'

Armin Laschet

- Nordrhein-Westfalen state premier
- Pro-EU centrist, consensus builder & continuity candidate



Marcus Söder

- Bavaria state premier
- Conservative candidate (domestic policies)

Norbert Röttgen

- Head Bundestag foreign policy committee
- Centrist, continuity candidate

UK

Deal or no deal?

- We do not know the outcome of the EU-UK trade negotiations yet but our base case remains a deal – however, time is short.
- If we are right, the economic outlook for 2021 looks much brighter due to a combination of less Brexit uncertainty and a COVID-19 vaccination.
- If we are wrong, the economic outlook for 2021 looks more fragile, with the Brexit adjustment weighing on the economy near term. A COVID-19 vaccination is still positive further out.
- A no-deal Brexit does not mean no deal forever. The EU and the UK can restart negotiations whenever they see fit.

Restrictions mean setback to the recovery in Q4

The UK was hit hard by COVID-19 in spring, which eventually caused the government to impose a full and strict lockdown to get things under control. While the economy has rebounded since then, it has experienced a setback in Q4 20 due to the partial lockdowns, which, however, have been eased. The negative impact in Q4 will not be as big as in spring, as production and construction remain open and the fear factor has declined. The UK returning to the old 'tier system' means we are likely to see positive growth again in Q1 21 but we expect GDP to remain below the pre-crisis level for some time. The government extending support to businesses and employees limits the downside risk, as businesses and people remain afloat. We consider this important, as it limits the probability of negative economic spirals causing a prolonged 'traditional recession'. The Bank of England has extended its bond buying programme into 2021 but has refrained from cutting the Bank Rate into negative territory, keeping it at +0.1%. Economic visibility for 2021 is not good at the moment. On one hand, the outlook has become brighter due to positive vaccine news, which mean that the UK can also soon start the vaccination process, limiting the need for renewed tough restrictions next autumn. On the other hand, there is no Brexit deal at the time of writing, making forecasting very difficult. Hence, we have divided our forecasts into two section: in the first section we discuss the outlook if there is a deal, which remains our base case, and in the second section we discuss the outlook in case there is no deal.

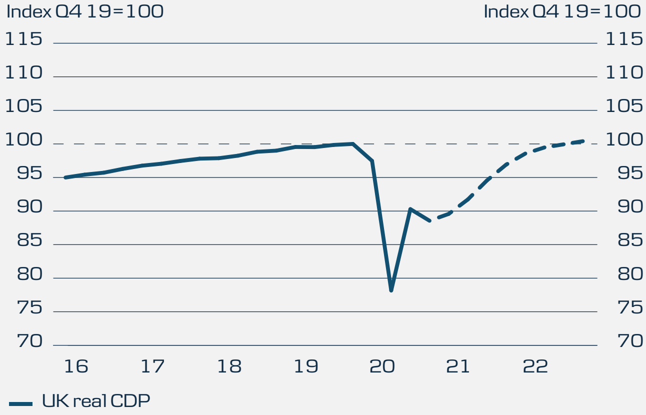
What if: Outlook if there is a Brexit agreement

Our base case remains that we will get a deal (60% probability), which would be a simple free trade agreement covering goods, i.e. no tariffs and quotas, but given the limited time left, we may need a very short transition of the 31 December 2020 deadline to get a deal ratified. While EU lawyers have said an extension is impossible, we think the politicians can find a political solution to the problem. It seems like the EU summit on 10-11 December is the last option for EU leaders to approve a deal but of course there is only one real, hard deadline: 31 December.

In this scenario, we believe the outlook for 2021 looks much brighter due to a combination of a vaccination and a sharp decline in Brexit uncertainty. While a vaccine will not help in the near term, with tight restrictions until it gets warmer in spring and the virus spreading slows down, just like we saw in spring, it means that the UK government would not likely need to impose tight restrictions (or lockdowns) next autumn. When we are approaching a point where enough people have been vaccinated such that the pandemic comes under control and all restrictions can be lifted, we expect significantly higher growth due to pent-up demand. We forecast GDP growth of -11.1% this year, +5.2% next year and +6.9% in 2022.

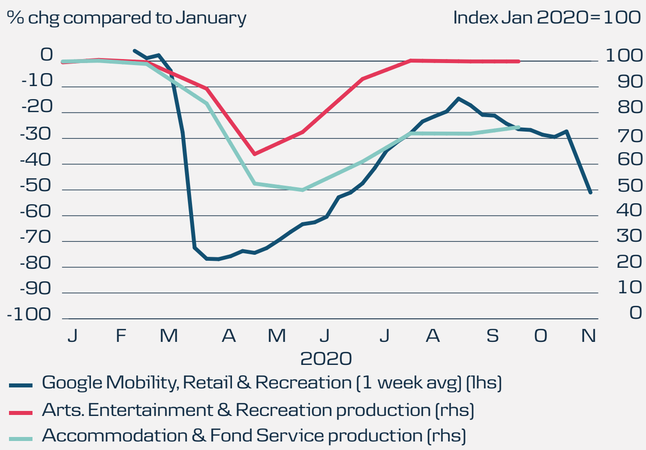
In our base case, we expect the Bank of England to keep the Bank Rate unchanged at +0.1% over the next couple of years, as we expect inflation to remain below 2% and, like other central banks, we expect the central bank will be reluctant to tighten monetary policy prematurely.

UK economy is set to rebound due to less Brexit uncertainty and COVID-19 vaccinations



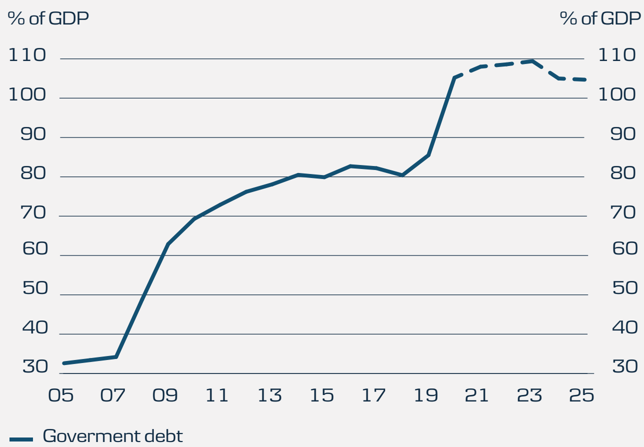
Source: ONS, Macrobond Financial, Danske Bank forecasts

Restrictions mean negative GDP growth in Q4



Source: Google, ONS, Macrobond Financial

Brexit uncertainty will decline significantly in case of a deal



Sources: Office for Budget Responsibility projections, Macrobond Financial

We have not fundamentally changed our view on the long-run growth potential in the UK in this scenario. We still think potential GDP growth in the post COVID-19 world will be in the 1.0-1.5% range.

If we are right about a Brexit deal, we expect EUR/GBP to move lower to 0.86 in a relief rally.

What if: No deal Brexit will mean another setback near term

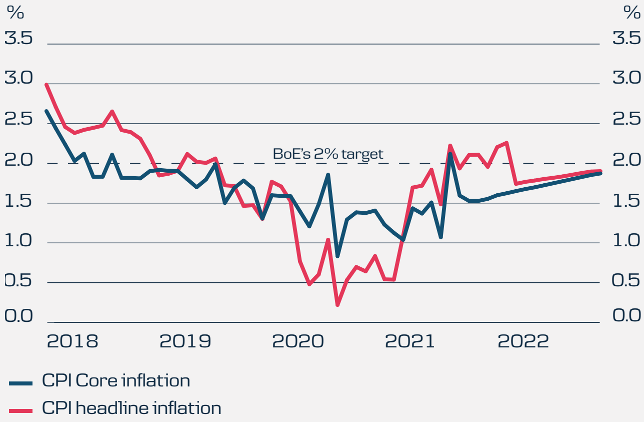
We assign a 40% probability of no deal, which would result in the EU and the UK trading on WTO terms starting from 1 January 2021. In this scenario, we have two different forces working in opposite directions at play. As in the previous section, we do not think the positive vaccine news changes the near-term outlook but it means that the government would not need to impose restrictions again next autumn. Normalisation of people's way of life will be positive in terms of releasing pent-up demand. Unfortunately, Brexit pulls in the other direction, especially near term, where in particular we expect investments to drop in the first half of the year. Private consumption is also likely to take a hit, unfortunately, as import prices and hence inflation are set to increase due to a combination of higher tariffs and a weaker GBP, just like we saw after the EU referendum in 2016. While larger companies seem ready for Brexit, we are concerned about small- and medium-sized companies, which are not able to prepare for many different scenarios to the same extent.

We expect the Bank of England to ease monetary policy significantly in early 2021 by cutting the Bank Rate to -0.5% from the current +0.10%, which we expect it to maintain at least through 2021. We also expect the QE buying pace to increase. No deal is not the end of the world and after an initial adjustment, we expect GDP growth to return, also due to pent-up demand, as people's way of life normalises. In the medium term, however, we do not expect growth to be as high as previously, as potential GDP growth will take a hit. We forecast GDP growth of -11.1% this year, 1.9% next year and 5.2% in 2022.

We want to emphasise that the no-deal scenario does not mean no deal forever. The EU and the UK can restart talks whenever they see fit. We would expect talks to resume within a year and since most of the trade agreement is completed, we believe the outlook for 2022 looks better.

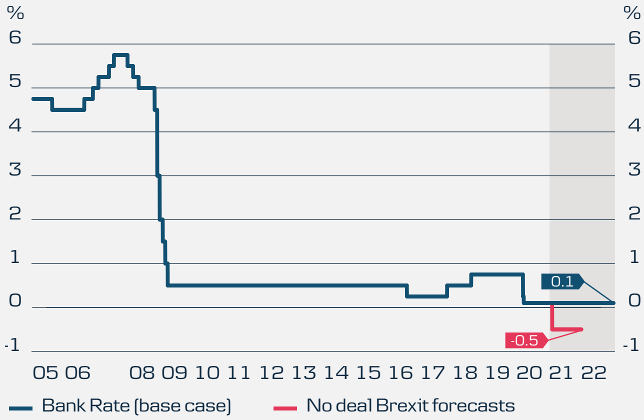
In the no-deal Brexit scenario, we expect EUR/GBP to move significantly higher, as investors are not pricing in a significant Brexit risk premium. We are targeting 0.97 short term.

Inflation is set to move higher but remain below 2% in our base case



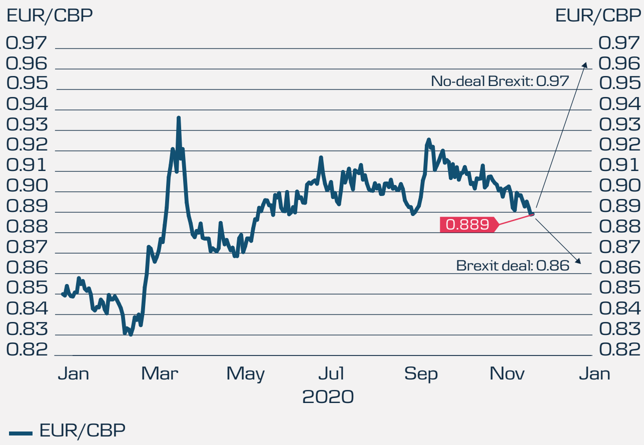
Sources: ONS, Macrobond Financial, Danske Bank forecasts

We expect the Bank of England to cut the Bank Rate to -0.5% if there is no Brexit agreement



Note: Past performance is not a reliable indicator of current or future results.
Sources: Bank of England, Macrobond Financial, Danske Bank forecasts

EUR/GBP outlook also depends on Brexit outcome



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	2021	2022
GDP	-2.5	-19.8	15.5	-1.9	1.2	2.4	3.1	2.5	-11.1	5.2	6.9
Private consumption	-3.0	-23.6	18.3	-4.0	1.0	3.0	4.0	3.0	-14.4	4.2	8.3
Government consumption	-3.9	-14.6	7.8	3.0	1.0	1.0	0.5	0.5	-9.9	4.0	2.1
Fixed investments	-1.0	-21.6	15.1	-4.0	2.0	4.0	5.0	4.0	-12.8	6.2	11.9
Exports	-10.7	-11.0	5.1	3.0	1.0	2.0	3.0	2.0	-12.5	6.4	5.9
Imports	-9.2	-22.7	13.2	1.0	1.0	3.0	4.0	2.5	-21.1	6.1	8.2
Domestic demand[1]	-2.8	-21.2	14.9	-2.5	1.1	2.6	3.3	2.6	-13.1	4.4	7.4
Net exports[1]	-0.5	3.6	-2.1	0.6	0.0	-0.2	-0.2	-0.1	3.0	0.2	-0.6
Inventories[1]	0.7	-2.2	2.7	0.0	0.0	0.0	0.0	0.0	-1.0	0.6	0.0
Unemployment rate (%)	3.9	4.0	4.3	4.9	5.1	4.9	4.9	4.8	4.4	4.9	4.6
Wage growth (% y/y)[2]	2.8	-0.1	0.9	3.4	3.3	3.7	1.1	-1.2	2.0	1.2	1.6
CPI (% y/y)	1.7	0.7	0.6	0.8	0.7	1.8	1.9	2.0	0.9	1.6	1.9
Core CPI (% y/y)	1.6	1.4	1.3	1.4	1.1	1.4	1.6	1.5	1.4	1.4	1.7
Public budget[3]									-19.0	-7.7	-4.5
Public debt[3]									109.1	109.3	108.3
Current account[4]									-2.0	-3.8	-3.6
BoE Bank Rate (%) (end of period)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

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

Macro forecasts – UK (no deal Brexit scenario)

Calendar year average	2020	2021	2022
GDP % y/y	-11.1	1.9	5.2
Private consumption (% y/y)	-14.4	3.2	7.0
Government consumption (% y/y)	-9.9	4.0	2.1
Fixed investments (% y/y)	-12.8	-7.5	6.4
Net exports (contribution. pp)	-1.0	0.6	0.0
Bank Rate (%) (end of period)	0.10	-0.50	-0.50

Sources: ONS. Bank of England. Danske Bank

Japan

Slowly crawling back

- In growth terms, the Japanese economic downturn has been worse than most despite limited exposure to COVID-19 infections. The continued presence of the disease is weighing on near-term prospects of a rebound.
- Global manufacturing rebound benefits Japan but there is still a long way back to normal and the strong yen continues to be a burden for exporters.
- Government support and high degree of labour protection have limited the impact on the labour market.
- Fiscal and monetary support has been instrumental in keeping the economy afloat. BoJ to turn to QE flexibility if necessary.

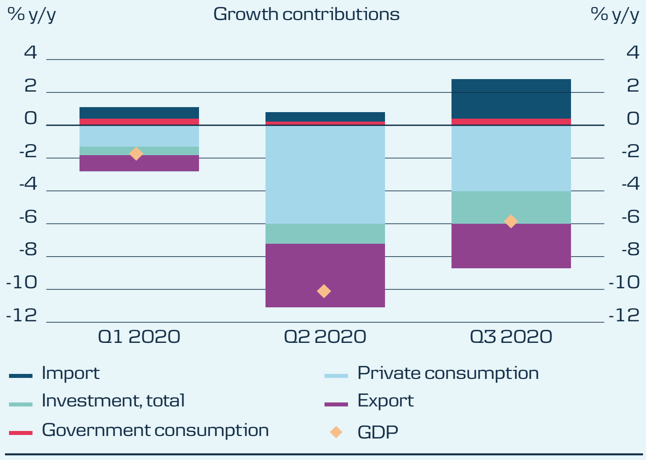
Long way back to normal

Since the summer of 2019, the economic downturn in Japan has been brutal. In Q3, GDP remained almost 6% below the Q3 19 level, registering the second worst performance among the large economies, surpassed only by the UK. The end of the 'state of emergency' in the spring when people were asked to stay at home has caused a rebound in consumption, with restaurants and nightlife open again, but things remain far from normal with private consumption still almost 8% lower than a year ago and a third wave of infections is threatening to derail spending further. The number of infected reached record-highs throughout November and in Tokyo and Osaka, restaurants and bars have been asked to close at 10 p.m. and residents are asked to stay indoors as much as possible. This will weigh on the prospects for further normalisation of spending, which will remain subdued until it is possible to open up more of the service sector. The strategy in Japan has been to find a way to live with the virus and avoid taking any extreme measures rather than seeking near elimination. The government has used a tracing approach, to find the source of infections and stop superspreaders whereas testing has been scarce compared to many other countries, and thus the full extent of the problem is hard to measure for the government.

Industrial production in Japan has suffered through 2020, also more than in many comparable countries. The car sector has been hit particularly hard, with plant shutdowns in the spring due to supply chain disruption and plunging global demand. In May, production was halved compared to January. Production has increased again since but remains below January levels. Other machinery production has struggled as well, while necessities such as medicine (chemicals) and food have fared reasonably well. The rough reality for manufacturers has also been reflected in exports, which were down 14% in Q1-Q3 compared to the same period in 2019. A strong yen has not made life easier for exporters but the global manufacturing rebound is benefitting Japan significantly and US-bound exports in particular have picked up in the autumn, increasing back above pre-COVID-19 levels. ASEAN demand has also bounced back significantly in line with the increasing economic activity there. Despite the rebound in production, businesses report the most excess production capacity in 10 years and machinery orders have plummeted. This does not bode well for business investments, which are already down almost 11% y/y. Positive news on the vaccine front indicates that normal conditions can be glimpsed on the horizon, which we expect could add some support for business capex in the near future.

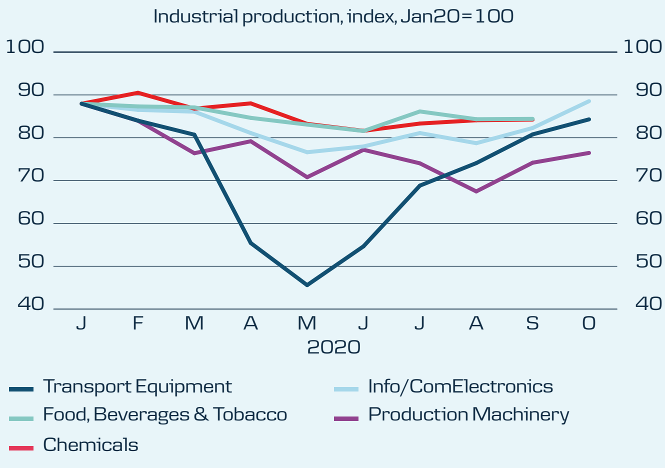
Large government spending and the high degree of labour protection has to some extent sheltered workers from the crisis and total employment declined by 'only' 1.15m between January and April, when it was at its lowest. The impact has mostly affected face-to-face service businesses such as hotels, restaurants and bars, which all employ a large proportion of non-regular workers. There has been some recovery since April but it will take a long time to regain the lost jobs. The jobs-to-applicants ratio has fallen close to one, meaning that the notoriously tight Japanese labour market now only has slightly more job offers than applicants for the first time in seven years. Workers feel the crisis in their income, which has declined

Private demand still down significantly



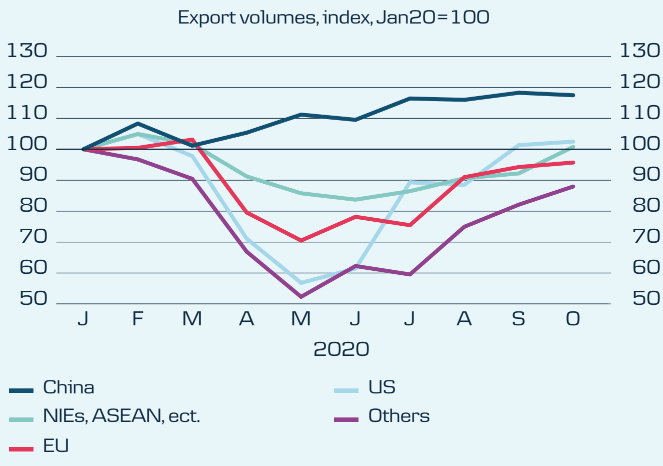
Source: Japanese Cabinet Office, Macrobond Financial

Part of car sector was closed down



Source: IMF WEO, Macrobond Financial

US demand is coming back



Source: Bank of Japan, Macrobond Financial approximately 1% over the past year, denting the prospects of a swift bounce back in private consumption.

Swift fiscal and monetary support has been key

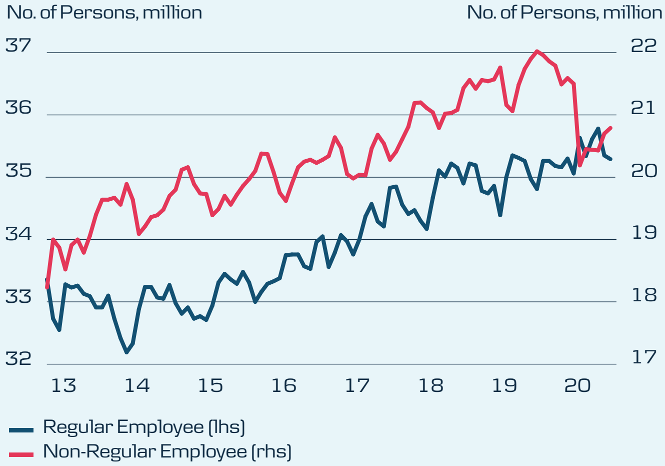
In September, Yoshihide Suga took office after Shinzo Abe's retirement due to health issues. Suga, Abe's cabinet secretary for the previous eight years, will stand for continuity, as he has also been a key figure in implementing Abenomics. He has given full support to the current policy stance of the Bank of Japan (BoJ). He has been in charge of an update to Japan's visa system to help sectors facing labour shortages and if he is re-elected in 2021 more immigration could be his way forward to alleviate some of the repercussions from a declining labour force.

The government has tried to limit the fallout from the crisis and years of effort to tighten the fiscal stance have been shattered. Fiscal easing has in particular added liquidity to businesses, with delayed taxes and social security payments, favourable credit lines offered to small and medium sized enterprises and compensation to companies for retaining jobs while temporarily closing business. A JPY100,000 cash handout to all citizens also boosted consumption temporarily.

There are limits to what the BoJ can do further to support the recovery of the economy, with rates already at reversal levels. It provided significant support in the spring and is actually paying financial institutions for tapping its crisis-response lending programme. The flexibility within the QE programme has been extended so the annual JPY80 trillion upper limit on JGB purchases no longer applies. The pace has been significantly above that in 2020H2 and we expect the BoJ to draw on this flexibility if necessary rather than cutting rates further to negative levels. With inflation in negative territory and heading lower as the effect from last year's VAT-hike disappears but the government travel discount campaign continues, we believe the BoJ will continue to stress its willingness to ease if necessary. Declining wages are not a good sign for the inflation outlook either.

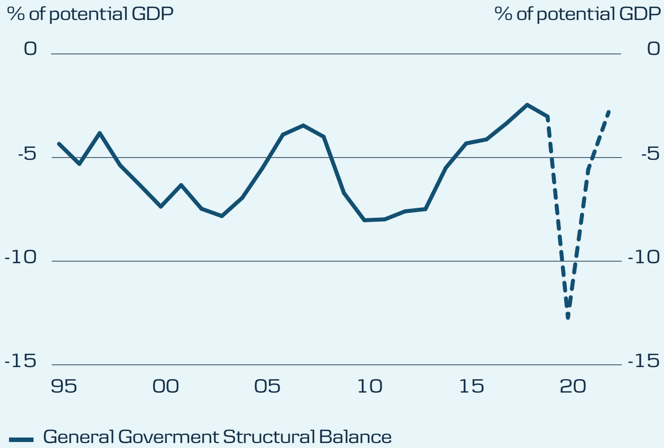
In November, the BoJ introduced a "special deposit facility" with an interest of plus 0.1%, as opposed to the regular -0.1%, in an attempt to strengthen financial stability. The BoJ has had a long-standing concern that low interest rates and population decline in rural Japan is weighing on regional banks' profitability, which poses a threat to financial stability – one that was recently shared by PM Suga. Mergers or consolidation seem to be the answer to the problem. Access to the new "special deposit facility" is given to financial institutions only if they meet certain requirements. They can either cut costs or agree to a merger or business integration with another bank. This scheme is set to run for three years. The key focus will remain the ability to supply sufficient funds to businesses affected by the crisis and implementing the new "special deposit facility".

Non-regular workers in the service industry most affected



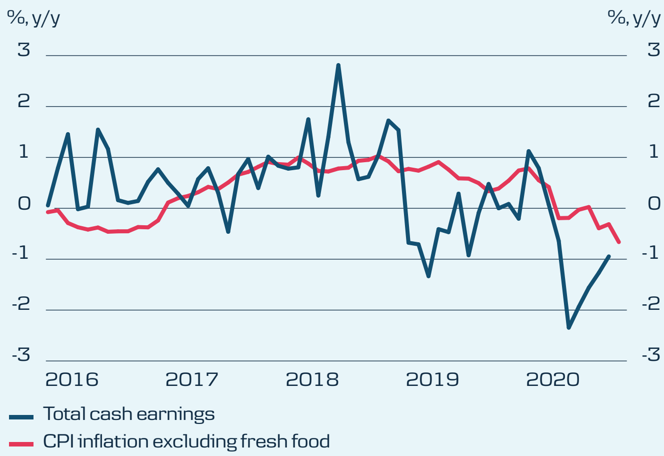
Source: Japanese Statistical Bureau, Macrobond Financial

Years of thorough fiscal consolidation shattered



Source: IMF WEO, Macrobond Financial

Declining earnings will weigh on inflation outlook



Source: Japanese Statistical Bureau, Japanese Ministry of health, labour and welfare, Macrobond Financial

Macro forecasts - Japan

% y/y	2018	2019	2020	2021	2022
GDP	0.3	0.7	-5.6	2.7	2.5
Private Consumption	0.1	0.1	-7.0	2.4	2.7
Private Fixed Investments	0.7	0.9	-7.8	-2.0	4.0
- Residential investment	-6.7	2.1	-9.8	-1.9	2.7
- Non-residential	2.2	0.7	-7.5	-2.0	4.3
Public Investments	0.3	2.8	2.2	2.3	2.4
Public Consumption	0.9	1.9	1.9	1.8	-1.1
Exports	3.5	-1.6	-12.8	9.1	5.3
Imports	3.7	-0.6	-7.5	1.5	3.0
Unemployment rate (%)	2.4	2.4	2.8	2.7	2.5
CPI. excl. fresh food (y/y)	0.9	0.6	-0.2	0.3	0.6
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

China

From rebound to cruising speed

- The Chinese economy has recovered strongly from the COVID-19 crisis, as stimulus, catch-up from lost production and a lift to exports boosted demand. We project growth will shift down a gear in 2021 towards cruising speed and that China will thus be less of a global growth booster in 2021.

- We revise our GDP growth estimate for 2020 slightly higher to 1.7% (from 1.0%) and lift our 2021 estimate from 9.0% to 9.2%. The high average growth rate for 2021 is due to a big base effect in Q1.

- Monetary policy is heading for an exit in 2021 but a pickup in bond defaults points to a slow pace of tightening. We look for further CNY strength.

- China's new Five-Year Plan puts more emphasis on technology, self-reliance and a stronger domestic market. We expect economic growth rates to moderate further in coming years but we still expect a big increase in the Chinese economy

Strong post-COVID recovery

After a substantial fall in activity levels in Q1 following the COVID-19 outbreak, China has been fast to recover. Industrial production is now back at pre-coronavirus levels and the service sector has also recovered much of the lost ground. China's strategy to fight the virus with mass testing and very rapid lockdowns when new virus clusters show up has proven very effective at keeping the disease at minimal levels. It has allowed the broader economy to return to a situation close to normal quite quickly.

The economic rebound has three main driving factors. First, there has been a catch-up effect with production recouping some of the lost activity in Q1. Second, economic stimulus boosted demand in different sectors. Infrastructure investments have seen a lift, car sales have rebounded strongly and the housing market has seen a mini-boom. Third, a turnaround in the US and Europe has given a lift to Chinese exports. With China generally pulling around one-third of global growth, the rebound has had a positive effect on the world economy and pushed up commodity prices, not least for metals. China has thus been a growth booster in 2020, although to a lesser extent than following the financial crisis in 2008/09. While China has stepped on the economic accelerator, it has not aimed for the huge stimulus it gave in 2009, as this came with significant side effects in subsequent years.

Shifting down a gear in 2021

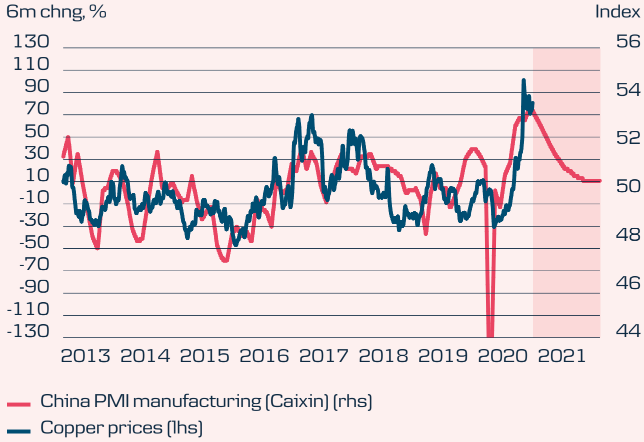
Over the coming year, we expect to see a peak in the Chinese growth cycle as economic momentum shifts down a gear. The catch-up effect from the COVID-19 crisis is behind us and with more traction in the economy, we believe China will direct its eyes back on the long term and work to put the economy on a more sustainable and sound path. This implies a return to deleveraging after a year when severe downside risks to growth forced China to sidestep deleveraging and even reverse it (see Chart).

We look for growth in 2021 to reach 9.2%, due mainly to a substantial base effect from the fall in Q1 20 pulling the average of 2020 GDP down significantly. We project the economy will rise at a more moderate 5.5% in 2022, in line with what we see as China's potential growth rate currently. We project the CNY will continue strengthening over coming quarters, as China has its eyes on monetary policy exit, while the US and the euro area are sticking to an easing bias. We expect monetary policy to be tightened gradually in 2021 but China is set to move in a gradual manner, as a recent pickup in defaults could pose a risk to financial stability if liquidity is withdrawn too fast. Looking ahead to 2025, we look for a continued gradual decline in growth towards 5%. However, with 2.5% inflation, it still points to five years of 7.5-8.0% of nominal growth. With the economy being a lot bigger today than 10 years ago, this implies adding USD1.5trn every year. This corresponds to adding what is equal to the size of Spain's GDP every year.

New Five-Year Plan with strong focus on technology

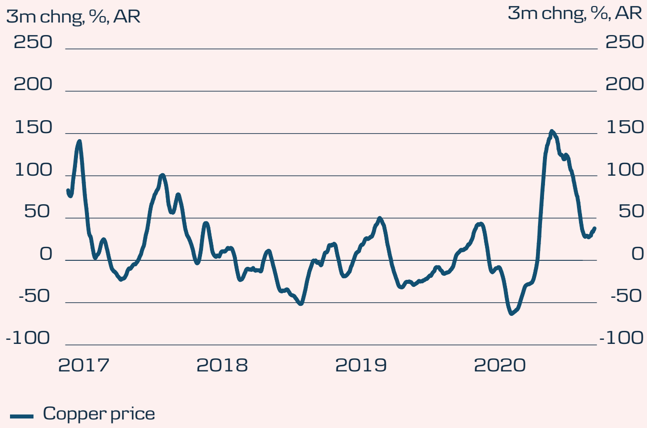
At the 5th plenum of the 19th CPC Central Committee in October, China adopted the outline of a new Five-Year Plan and laid out goals for 2035. The full Five-Year Plan is due to be finished over coming months and revealed in March next year. A key

Strong post-COVID recovery but peak is close



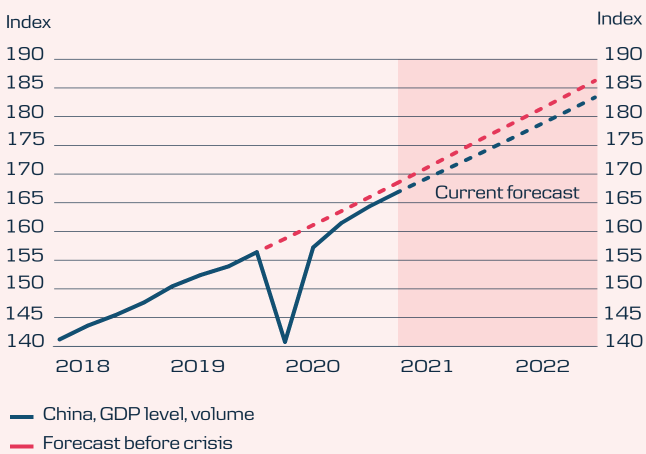
Source: Macrobond Financial, Markit, Danske Bank

Losing momentum in copper prices points to slower investment growth in China



Source: Macrobond Financial, Danske Bank

GDP has recovered a lot of ground already



Source: Macrobond Financial, Danske Bank

focus in the new Five-Year Plan is 'self-reliance' and even more focus on technology as a cornerstone of China's future development. China this year also launched the strategy of so-called 'dual circulation', which emphasises a strengthening of both foreign markets and the domestic economy, with the latter being the mainstay of the economy. Other focus points in the new Five-Year Plan are (a) deepening of reform, (b) further opening up, (c) strengthening of high-tech manufacturing, (d) CNY internationalisation at a steady pace and (e) advancing green development.

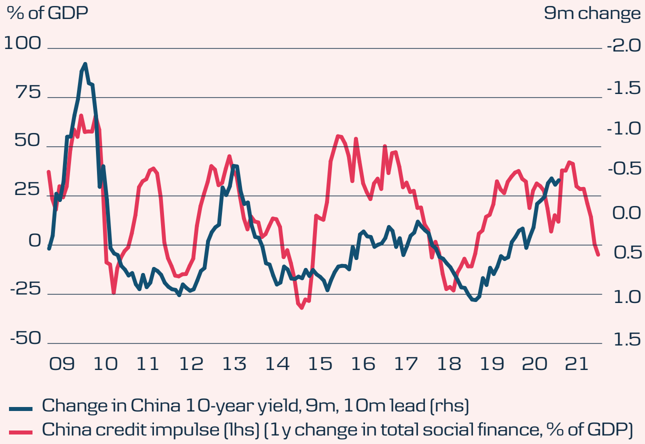
China's increasing emphasis on self-reliance is a clear consequence of the US tech war against China, and the outline refers to a 'complicated international situation'. Among other things, the US tech war against China has brought the Chinese tele-giant Huawei to its knees (see box). It is clear that China can no longer rely on the US as a partner in global trade and supplier of core technologies such as semiconductors. China is now pouring billions of US dollars into speeding up its own development in this area. While the country has come far in certain technologies such as supercomputing, fintech and 5G, it is still many years behind when it comes to microchips.
China has not revealed a growth target for the next five years but it may come with the final plan in March. Some think tanks have recommended a target of around 5% average growth for 2021-25. This is a bit below our own estimate of 5.25% but highlights China's increased focus on quality in growth over quantity with more focus on sustainable green development and a deleveraging that puts the economy on a sounder footing. For 2035, China's goal is to reach the status of a 'modern socialist country' with a level of 'moderately developed countries'. It implies seeing a significant expansion of the middle class. In a speech, President Xi Jinping said it was 'completely possible' for the economy to double by 2035 but has not stated this as a specific target.

RCEP marks more opening-up

On Sunday 15 November, China and 14 other countries in Asia-Pacific signed the world's biggest trade deal, as it covers around 30% of the global population and GDP. The name of the deal is Regional Comprehensive Economic Partnership and it implies a significant reduction in tariff rates over coming years. Participants apart from China are Japan, South Korea, Australia, New Zealand and the 10 Association of Southeast Asian Nations (ASEAN) countries. It has been negotiated since 2012 and was supposed to include India. It left the deal in 2019 though, out of fear of being flooded with cheap Chinese goods and agricultural goods from other countries.
The RCEP is set to underpin development in Asia and strengthen the economic partnership and is a clear victory for China at a time when the US has pulled out of the Trans-Pacific Partnership (TPP) trade deal and Trump has threatened many other Asian countries with tariffs during his Presidency. The RCEP also underpins China's pledge that it will continue to open up and is in favour of multilateralism.

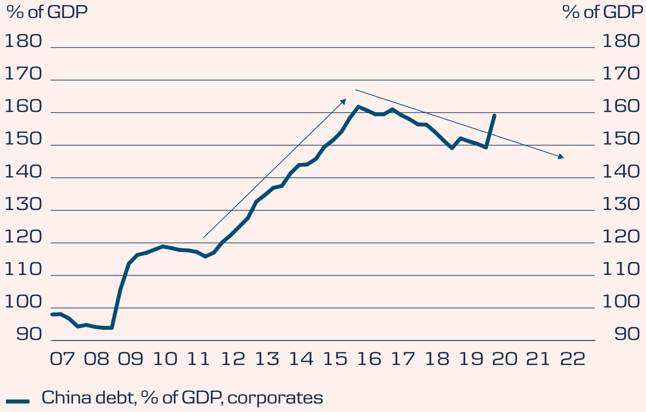
In our view, the deal will also be good for European countries that have supply chains in Asia. Today, they have to juggle many different bilateral trade deals with many rules of origin. This is now reduced to one document, which simplifies procedures a great deal. To the extent the RCEP adds to the vibrancy of Asia, it will also make it an even more attractive market.

Credit impulse to peak in Q1 as stimulus fades



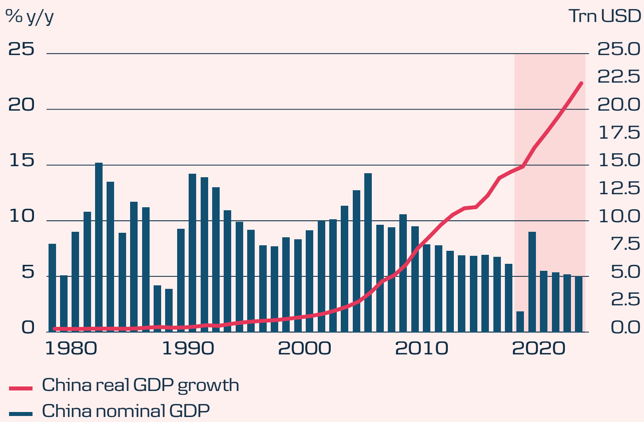
Source: Macrobond Financial, People's Bank of China, Danske Bank

China to refocus on deleveraging of indebted state companies in 2021



Source: Macrobond Financial, BIS, Danske Bank

Growth rate set to slow further but economy still set to become much bigger in coming years



Note: Grey area is own forecast
Source: Macrobond Financial, Danske Bank

Macro forecasts - China

% y/y	2018	2019	2020	2021	2022
GDP[1]	6.8	6.1	1.7	9.2	5.5
Private consumption[1]	8.2	7.4	1.5	9.0	7.0
Investment[1]	5.0	5	3.0	10.0	4.0
Net exports[2]	-0.2	-0.2	-0.7	-0.1	-0.1
Total investment share[1]	44.0	43.1	43.9	43.9	42.9
Total savings rate[1]	44.1	44.0	44.5	44.3	43.3
Current account balance[1]	0.2	0.9	0.6	0.4	0.4
CPI[1]	2.1	2.5	3.0	2.0	2.5
Household income (real)[1]	8.0	5.0	5.0	7.0	7.0
Household savings rate. % of disp income	35.6	35.4	36.0	35.4	35.4
Wage growth (nominal. urban)[1]	11.3	10.2	7.5	7.0	7.0
Government budget balance[1]	-4.7	-6.3	-11.9	-11.8	10.9
Cyclically adjusted primary balance[1]	-3.7	-5.1	-9.3	-10.0	-9.3

Notes: 2020-2022 is forecast.
1: % y/y.
2: contribution % to GDP.
3: % of GDP activity plus excludes land sale proceeds (source: IMF article IV report. July 2018).

Biden to keep tough stance on China but strategy set to be different

With President-Elect Joe Biden moving into the White House in January, we are likely to see a change of strategy towards China by the US. However, Biden is still likely to take a tough stance, as the sharp criticism of China in recent years is bipartisan with Democrats having similar critical attitudes toward China as Republicans. The disagreement has been more about strategy than direction. Donald Trump confronted China on most areas in a unilateral manner. He waged a trade war against China and in 2020 increasingly pulled out heavy weapons in a tech war against China – one that has put one of China's proudest and most successful tech companies Huawei on its knees.

So, how will Biden's strategy differ? It may prove difficult for him to take away all the tariffs on China even though he disagreed with imposing them. Although studies suggest that the US is bearing the biggest cost of the tariffs, they are also a symbol of protecting American manufacturing jobs appealing to important voters in swing states like Ohio, Pennsylvania and Michigan. However, he could choose to remove the tariffs and instead give subsidies or tax incentives to bring back production to the US. We are unlikely to see new trade wars or other disruptive measures that can threaten the global economy and financial markets. In our view, Biden is very likely to work increasingly with allies in Europe, Japan, South Korea, Australia and New Zealand to confront China in a more united manner. The EU would welcome this approach.

On the tech war, Biden is set to choose a path of self-strengthening, rather than decoupling. We expect to see support for US technology to stay ahead in key areas where it has the lead today, such as artificial intelligence and semiconductors. He may also soften the export ban on Huawei and other Chinese companies. Unfortunately, the damage is already done and China is likely to continue a self-reliance strategy, which over time we expect to hurt US tech companies, as they are set to lose out in their biggest market. China has lost trust in the US and even if Biden softens in this area, we expect it to hedge against any future President who might return to export bans.

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Jakob Christensen (Head of International Macro & Emerging Markets Research), Bjørn Tangaa Sillemann (Analyst), Aila Mihr (Senior Analyst), Piet P. H. Christiansen (Chief Analyst), Mikael Olai Milhøj (Senior Analyst) and Allan von Mehren (Chief Analyst).

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Biannually.

Date of first publication

See the front page of this research report for the date of first publication.

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Report completed: Monday 30 November 2020, 16:00 CET

Report first disseminated: Tuesday 1 December 2020, 6:00 AM CET

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