
The Big Picture

Investment Research
10 June 2019

Renewed trade dispute casts shadow over global economy

Highlights

Re-escalation of the trade war between China and the US is weighing on global economic outlook

We have lowered our projections for global growth to 3.2% in 2019 and 3.4% in 2020

A modest recovery is projected on the back of a US-China trade deal in H2 2019 and further stimulus by global central banks

Risks are skewed to the downside from possible failure to strike a US-China trade deal and lack of timely policy action

The risk of recession over the next year is still relatively low given the room for further global policy stimulus

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Editorial deadline: 7 June 2019
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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

Renewed trade dispute casts shadow over global economy

- Re-escalation of the trade war between China and the US and weakening market confidence are weighing on the global economic outlook.
- As a result, we have lowered our projections for global growth to 3.2% in 2019 and 3.4% in 2020 (from 3.6% and 3.5%, respectively).
- We see a modest recovery on the back of a trade deal between the US and China in H2 2019 and further stimulus measures by China and US central banks.
- However, risks are skewed to the downside given the possibility of no China-US trade agreement (or even possible further escalation) and lack of timely policy action.
- The risk of a recession over the next year is, in our view, still relatively low given the room for central banks to ease and fiscal expansion amid low government yields

Global economic momentum weakening...

The moderation in the global economy in the first half of 2019 that we called for in Big Picture - No recession yet, 4 December, has indeed materialised. However, the downturn has been deeper than we thought. Financial markets confidence took a sharp dive in December following the softening outlook for the global economy and uncertainty about the trade relations between the US and China. The slowdown has been evident in manufacturing PMIs, mainly in advanced economies, which have fallen, in particular, for the eurozone, albeit coming off of high levels.

In response to the weakening momentum in the global economy and sharply declining inflation expectations, major central banks reacted at the beginning of the year. The Federal Reserve in the US lowered its rate expectations from two hikes in 2019 to no hikes and expecting only one hike from two hikes next year. The ECB announced new liquidity operations (TLTRO) and extended forward guidance in March. These efforts together with policy stimulus in China in H2 18 stimulated recovery in global risk sentiment in Q1.

...with renewed stand-off between US and China further challenging global outlook

In early May, the trade dispute between China and the US took a turn for the worse after President Donald Trump decided to increase tariffs from 10% to 25% on another USD200bn of imports from China. The US move was prompted by concerns about backtracking on the deal from the Chinese side. China retaliated immediately by levying tariffs on US exports. The new trade tensions throw into doubt the prospects of the two sides finding an agreement. However, we still think there is a good chance of an agreement in second half of 2019 but possibly only after a substantial deterioration in market sentiment and possible further trade war escalation with US imposing tariffs on the remaining USD300bn of imports from China over the summer (we see 50% chance of such action).

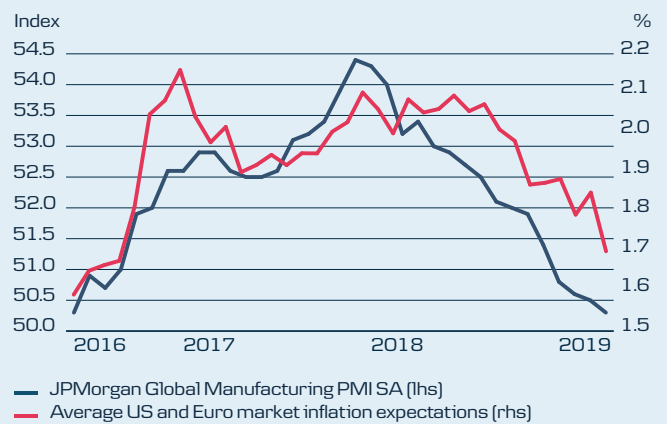
The uncertainty prompted by renewed trade tensions between the world's two biggest economies will weigh on sentiment. As a result, we see further downside for PMI manufacturing in coming months, mostly in China but spilling over to the eurozone and other close China trading partners such as Japan and Australia.

As a result, we lower our global growth forecasts

Given the heightened uncertainty and delays in finding a China and US trade agreement, we lower our outlook for the global economy, expecting it to grow by 3.2% in 2019 and 3.4% in 2020 compared with 3.6% and 3.5%, respectively, in Big Picture - No recession yet, 4 December. The eurozone and emerging markets such as India, Turkey and Latin America are the main factors behind the downgrade.

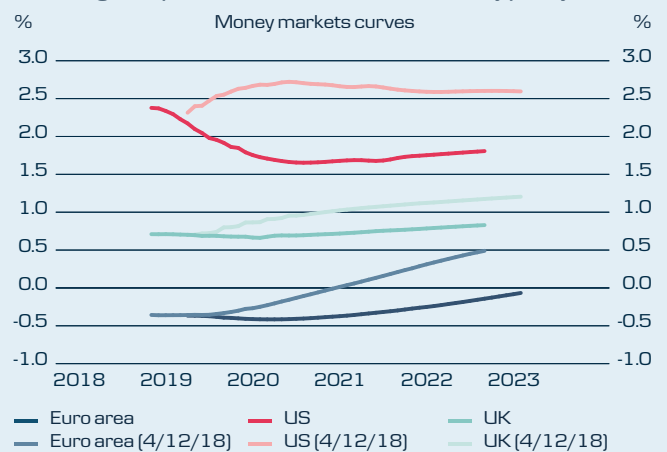
In late 2019, we expect the global economy to see a modest recovery due to a recovery in investment and private consumption on the back of a trade deal between the US and China and monetary stimulus measures in China and the US. This recovery will carry into 2020 aiding especially the eurozone and emerging markets and partly benefiting from a weaker US Dollar and easier global liquidity conditions.

Global economy and inflation expectations have dived over the past half year...



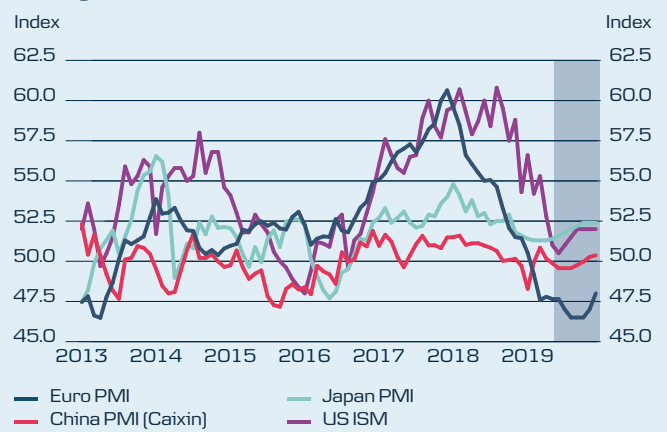
Source: Macrobond Financial, Danske Bank

...Leading to expectations of an easier monetary policy stance



Note: The chart shows the money-market curves in the respective countries on 4 December 2018 and 28 May 2019; a downward shift indicates market expects lower interest rates
Source: Macrobond Financial, Danske Bank

A further fall in PMI manufacturing is expected in the coming months



Source: Macrobond Financial, Danske Bank

Muted inflation pressures and weak market sentiment keep central bank easing options open

Following the almost decade long economic expansion, unemployment remains at record-low levels in advanced economies. Given the tight labour market, wage growth has continued to tick up, reaching the highest levels since the financial crisis. Despite the solid wage growth, inflation pressures continue to remain muted in most advanced economies. Even in the US, despite being furthest in the business cycle and implementing a sizeable fiscal expansion in 2018, headline and PCE core inflation are only 1.7% and 1.5%, respectively, well below the Fed's 2.0% target. Eurozone inflation is even lower with core inflation around 1%.

Weak market sentiment and muted inflation pressures will in our view prompt a sizeable response from the Fed, expecting three cuts over the next six months. In the same vein, we expect the Chinese central bank to implement additional stimulus and the Bank of Japan to keep its accommodative policy. In contrast we expect the ECB to keep rates unchanged until at least 2021.

Global outlook clouded by uncertainty

Our forecast is clouded by considerable uncertainty about US-China trade relations and reactions by central banks. On aggregate, the risks to our forecast are skewed on the downside, notably by a further deterioration in China-US trade relations but possibly also by US action against other of its key trading partners such as the EU, Mexico and Japan. Among other downside risks are a no-deal Brexit in the autumn, when the EU deadline expires, military conflict in the Middle East between Iran and the US and a prolonged stand-off between Italy and the EU.

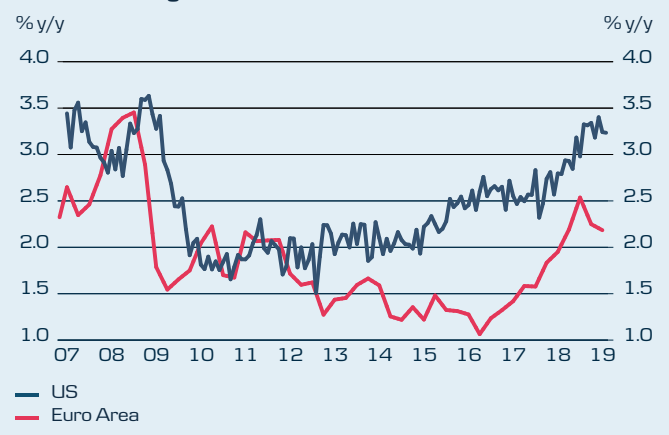
But a recession is not around the corner

Despite the downside risk, we still see a relative low risk of a recession in the world economy over the next year. Consumer sentiment still remain relatively high given low unemployment rate and significant real wage growth. Furthermore, we think that central banks will have ammunition to fend off a possible economic downturn, notably the Fed, given the muted inflation outlook mentioned above. Typically, a recession sets in when the economy runs too hot and inflation outpaces the inflation target, prompting the central bank to step on the brakes [see box for further discussion]. Furthermore, with government yields at the present low levels, governments have more fiscal space to stimulate the economy in the event of a downturn.

Financial markets outlook

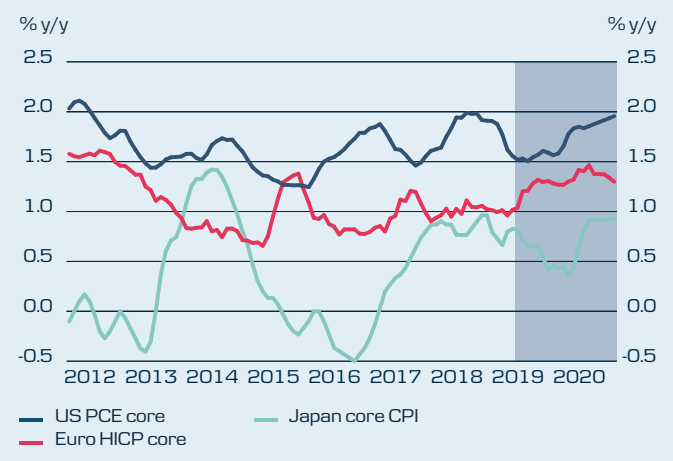
Financial markets will continue to be in the hands of trade war developments and prospects of policy actions by central banks. Given the softer outlook for the global economy and more dovish central banks, we see bond yields to remain at current low levels in the remainder of 2019. A possible US-China trade deal together with Fed cuts and China easing measures could support equity markets in the fall. In the Fx markets, the divergence between the Fed and ECB together with a fundamentally undervalued euro imply EUR/USD will rise to 1.17 in 12 months in our view.

Wage growth moderating in euro zone, while still rising in the US



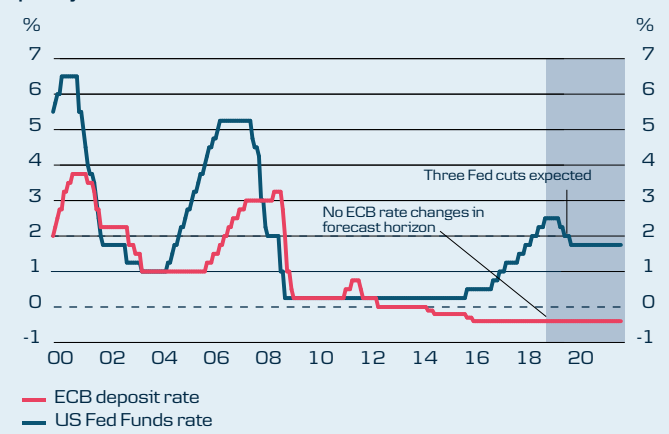
Source: Macrobond Financial, Danske Bank

Underlying inflation still at modest levels globally



Source: Macrobond Financial, Danske Bank

Global central banks will not tighten monetary policy in near future



Source: Macrobond Financial, Danske Bank

GDP forecasts - Global overview

% y/y	2018		2019		2020		2021	
	Actual	Danske Bank	Con-sensus	Danske Bank	Con-sensus	Danske Bank	Con-sensus	
Global	3.5	3.2	3.3	3.4	3.3	3.4	3.1	
Developed markets	2.1	1.7	-	1.6	-	1.5	-	
USA	2.9	2.5	2.6	2.0	1.9	2.0	1.9	
Euro area	1.8	1.2	1.2	1.4	1.4	1.3	1.4	
Japan	0.8	1.0	0.6	0.5	0.5	0.5	0.9	
UK	1.4	1.5	1.3	1.6	1.4	1.3	1.6	
Emerging Markets	4.5	4.2	-	4.6	-	4.7	-	
China	6.6	6.2	6.3	6.1	6.0	6.1	5.8	
India	7.3	7.3	7.0	7.5	7.2	7.5	7.3	
Russia	2.3	1.3	1.4	1.8	1.7	2.4	1.8	
Brazil	1.1	1.2	1.5	2.1	2.3	2.3	2.5	
Turkey	3.2	-2.0	-1.3	1.7	2.5	3.0	3.6	
South Africa	0.8	0.7	1.1	1.9	1.8	2.2	2.1	
ASEAN-5 ²	5.2	5.1	-	5.2	-	5.2	-	
Middle East and NA ^{1,2}	1.0	1.4	-	2.4	-	2.6	-	
Sub-Saharan Africa (ex SA) ²	3.0	3.5	-	3.7	-	3.7	-	
LatAm (ex Brazil) ²	1.0	1.4	-	2.4	-	2.6	-	

1. NA is North Africa

2. IMF projections World Economic Outlook April 2019

Source: Bloomberg, IMF, Danske Bank

The risk of a global recession over the next year

The current headwinds facing the global economy, the R-word has become more prevalent. Indeed typical recession predictor such as the inversion of the yield curve is sending warning signals. And the current expansion is the longest in US history. However, first of all expansions don't die of old age --- just look at Australia that has been in a continuous expansion in 18 years.

In order to judge the risk of recessions it is useful to look at typical triggers and how likely they are in the current global situation: The likelihood of a recession depends on not only the scale of possible shocks, but also if the economies are facing financial or real bubbles that can suddenly burst, but also the risk of contractionary policies if the economies are operating close to full potential and the central banks have to step on the brakes. The risk of recession (or the depth of it) also depend on room for manoeuvre for central banks and governments if the economies are heading into recession. Currently we don't see a bubble in equity markets as the pricing is not stretched. Fixed income markets particularly in Europe and leverage loan market in the US look more stretched, but given the prospect for higher rates is

small with the muted inflation pressures, the risk of a major sell-off is smaller. Neither do we see major imbalances in the real economy as investment and consumption growth have been muted compared to the period before the financial crisis in 2008. The key risks as we see currently is a further serious escalation of the trade war hitting economic sentiment of both companies and consumers combined with a slow reaction of central banks to the downside risks to the global economy. However, given the muted inflation pressures central banks are rather on track to stimulate the economies (as we are now expecting the Fed to do) rather than stepping on the brakes. Of course it is more debatable whether ECB can ease more given the low interest rates, but if push comes to shove there should be room to support the economy such as expanding its balance sheet further. The balance sheets of the Fed and Eurozone are only about 40% and 80% of GDP, respectively, i.e. much smaller than in Japan where the balance amounts to 200% of GDP. We also think there is room to use fiscal policies in countries like China, Germany and even the US to fend off a downturn as the fiscal space is inevitable larger given the low borrowing costs facing governments.



US

Longest expansion set to become even longer

- The US expansion is the longest in history but expansions do not die of old age. We believe it can run a little longer but growth will slow, as fiscal policy will no longer be expansionary.
- The US economy is likely strong enough to withstand the trade war unless confidence takes a big hit. The trade war is one of the key risks to our forecasts.
- We expect the Federal Reserve to step in easing monetary policy over the next six months to support markets and lift inflation, which continues to run below the 2%. This should also support the expansion.

Longest expansion in history

The US expansion is now officially the longest in history and it is only natural to ask how long it can continue? Not least, the flattening of the US yield curve and the stock market correction in Q4 18 have attracted a lot of attention. We think it is important to remember that expansions do not die of old age, meaning that just because the expansion has lasted a long time, a crisis is not necessarily just around the corner. Something needs to go wrong for the economy to turn around. The clearest case is Australia, which have avoided a recession (at least in GDP terms) for more than 25 years.

For a long time, our base case has been that a downturn this year is unlikely, as optimism is high, fiscal policy remains expansionary, real wage growth is solid and employment continues to grow at a sturdy pace. However, the Markit PMI indicators for May caught us by surprise, as they indicate growth of just 1% annualised. It is not surprising that the manufacturing sector is not immune to what happens in manufacturing globally, but the large setback in service sector growth is puzzling. The big question is whether this is just a blip or whether it is the first of a string of weak indicators. The forward-looking indicators are, in our view, telling different stories. As PMIs are among the earliest indicators to be released, the jury is still out.

We remain more concerned about 2020 and further out. In 2020, fiscal policy will no longer be expansionary but most likely neutral. It is difficult to forecast the timing of a recession, and given how gradual the expansion has been, our base case is that growth will remain around trend or even slightly higher. However, we stress that the risks are bigger in 2020 and beyond. Potential growth in the US is in the range 1.75-2.00%.

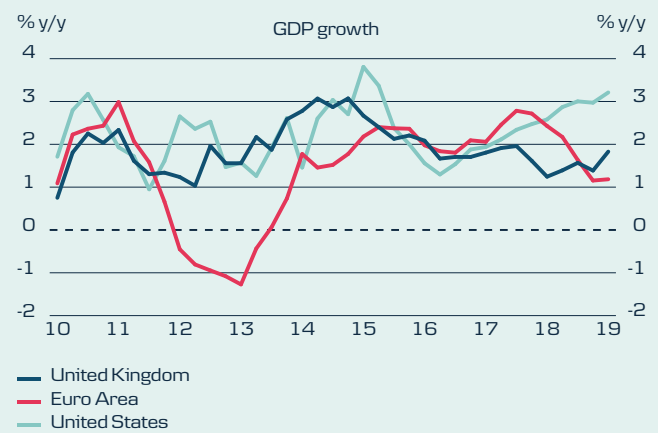
Other risks to the outlook are the ongoing trade war with China and the housing market. While higher tariff rates are bad from an economic point of view, this should not be enough to derail the expansion, unless business confidence takes a hit and, so far, business confidence remains high. Also the US economy is relatively closed and the domestic factors driving growth are more important. The risk stemming from the housing market has become less severe, as mortgage rates have declined, which has had a supportive impact on the housing market.

Domestic policy more important than trade

So far, the US-China trade war has had limited impact on the US economy and US GDP growth actually accelerated in 2018 despite uncertainty. As the US economy is a quite closed economy, the expansionary fiscal policy stemming from Donald Trump's tax cuts and increased federal spending has more than offset the negative impact of trade uncertainty. At the end of the day, the US economy is more about what is going on domestically, which, however, is also looking more uncertain than we thought just a couple of months ago.

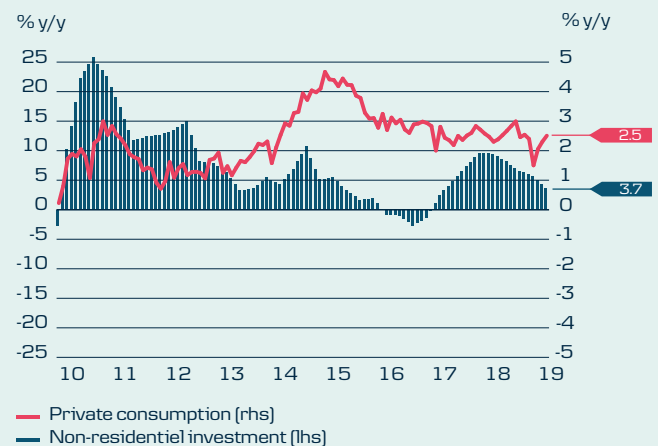
That said, as the impact of fiscal policy fades, the impact of trade uncertainty may become more visible, particularly now that we cannot exclude the possibility of a full-blown trade war with high tariff rates on all imported goods from China. Protectionist trade policy does not need to have a big short-term impact but the long-term impact may be larger, as it distorts the global supply chains.

US growth has outperformed European growth



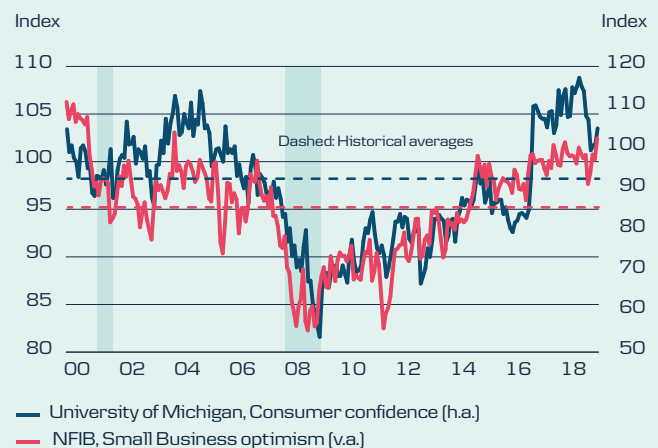
Source: Eurostat, ONS, BEA, Macrobond Financial

Growth still driven primarily by consumption



Source: BEA, Macrobond Financial

Optimism remains high despite trade war uncertainty



Source: University of Michigan, NFIB, Macrobond Financial

Most analyses show that the biggest short-term impact will come from a hit to business confidence leading to slower, or even negative, investment growth. Business confidence remains high but we monitor this closely.

Labour market strong on all parameters

Employment has been rising for more than 100 consecutive months and the labour market seems strong on almost all parameters. Many indicators suggest there is not much, if any, slack left in the labour market and that some problems are supply-side issues such as mismatch problems between demand for and supply of skills. This may also explain why productivity growth has finally moved higher. If we are right that the expansion will continue but at a slower pace, we should also expect employment growth to slow but remain at healthy levels. Real wage growth has strengthened, as inflation has declined and nominal wage growth has increased.

We monitor employment growth closely, as it is a fast real economic indicator of how the real economy is doing.

Inflation remains in control

While many were mistaken that core inflation would accelerate in 2018, it also seems to be the case for 2019, with PCE core inflation currently at 1.5% y/y. Despite higher wage growth and expansionary fiscal policy, it does not seem that underlying inflation pressure is rising. One reason is probably that inflation is quite persistent. When inflation is low (high), it is likely to remain low (high) for a while. Both survey- and market-based inflation expectation measures are on the low side compared with the historical averages since 2000 and, given inflation expectations play a key role in explaining actual inflation, we do not think core inflation will increase significantly. We expect core inflation to increase towards but not move above 2%.

Fed is set to ease

A year ago at the Fed's , the Fed signalled it would raise rates three times this year but the Fed has turned around and it now seems more likely that the Fed will ease monetary policy by cutting rates. Despite the labour market being strong on almost all parameters, the Fed is concerned about inflation, which has been running consistently below the 2% target. Inflation expectations also remain on the low side. We expect a total of 75bp cuts over the next six months, which should be enough to support market sentiment and the economy. If not, we could see further cuts over the forecast horizon.

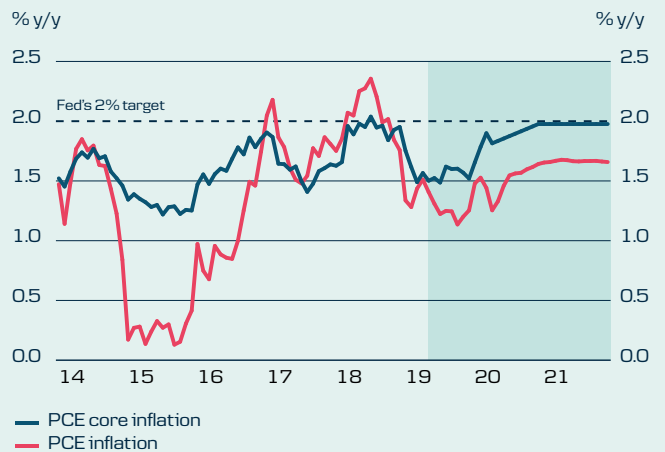
We think there are good arguments for EUR/USD to rise to 1.17 in 12 months. However, a 5% increase from the current level hinges on policy action on different levels. A combination of a US-China trade deal and/or monetary policy easing in the US and China are key prerequisites for the market to start reversing its short position in EUR/USD. Neither looks probable to us in the short term, which would create downside risks to EUR/USD if the current policy inaction leads to a further erosion in confidence.

Slower employment growth usually a sign that the economy is slowing down



Source: BLS, Macrobond Financial

Inflation is running below 2%



Source: BEA, Macrobond Financial, Danske Bank

Fed is set to cut rates in the second half of the year



Source: Federal Reserve, Macrobond Financial, Danske Bank

Macro forecasts - US

% change q/q AR	2019				2020				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2021
GDP	3.1	1.3	2.1	2.3	2.1	2.1	2.0	2.0	2.9	2.5	2.0	2.0
Private Consumption	1.3	2.2	2.2	2.2	2.0	2.0	2.0	2.0	2.6	2.3	2.1	2.0
Private Fixed Investments	1.0	2.5	2.7	3.7	3.7	3.8	3.2	3.2	5.2	2.4	3.4	3.3
Residential	-3.5	-2.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	-2.7	-0.1	0.0
Non-residential	2.3	3.7	3.4	4.7	4.7	4.7	4.1	4.1	6.9	3.8	4.4	4.1
Change in inventories ¹	0.6	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.0	0.0
Public Consumption	2.5	2.0	1.2	1.2	0.8	0.8	0.8	0.8	1.5	1.6	1.0	0.8
Exports	4.8	2.0	3.0	3.0	3.0	3.0	2.0	2.0	4.0	2.4	2.8	2.1
Imports	-2.5	4.1	3.0	3.0	3.0	3.0	2.4	2.4	4.5	2.1	3.0	2.5
Net exports ¹	1.1	-0.5	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.3	-0.1	-0.2	-0.2
Unemployment rate (%)	3.8	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.9	3.6	3.4	3.3
Inflation (CPI) (y/y)	1.9	2.1	2.2	2.5	2.4	2.1	2.1	2.2	2.4	2.0	2.3	2.1
Core inflation (CPI) (y/y)	2.0	2.1	2.1	2.0	2.1	2.2	2.3	2.3	2.1	2.1	2.2	2.3
Public Budget ²									-3.9	-4.2	-4.2	-4.3
Public Gross Debt ²									106	106	106	107
Current Account ²									-2.3	-2.6	-2.7	0.0
Fed funds rate ³	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75	2.50	1.75	1.75	1.75

1. Contribution to annualised GDP growth

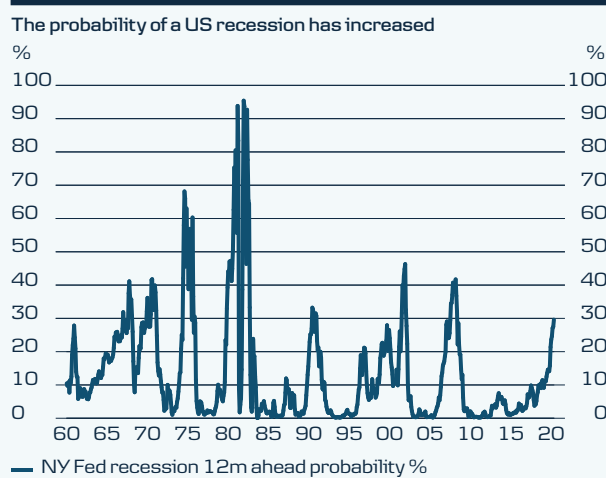
2. Pct. of GDP (CBO and IMF)

3. Upper limit, end of period

Source: CBO, IMF, Danske Bank

There are increasing concerns the US faces a recession soon

This month, the US expansion is officially the longest on record and the discussions are now about when, not if, it will end, not least with the flattening of the US yield curve. A traditional indicator is the yield spread between 10-year US Treasuries and 3M T-bills, which according to the NY Fed's model signals nearly 30% probability of a recession within the next 12 months. This may not sound high but, in comparison, the same indicator was only slightly above 40% ahead of the financial crisis. We think it is important to remember that expansions do not die of old age, meaning that just because the expansion has lasted a long time, a crisis is not necessarily just around the corner. We see two important drivers for the US avoiding a more severe slowdown. One is that the trade uncertainties fade (despite the US economy being relatively closed). The other, more important, driver is the Fed easing monetary policy.



Source: NYFed, Macrobond Financial



Euro area

At inflection point

- Recession risk remains low despite a tougher external environment, which will remain a defining feature for the growth outlook in the coming years. Expansionary fiscal policies and rising wages should support domestic demand.
- Many fragilities are lingering in the background and labour market resilience is an important precondition for the expansion to continue.
- Underlying inflation pressures continue to build, supporting a gradual uptrend.
- We expect no ECB policy rate changes until the end of 2021.

Fires burning on many fronts...

Economic activity in Europe missed expectations in 2018, as a rougher external environment took its toll on the open euro area economy. While weaker external demand has been an important driver behind the slowdown, the euro area was also hurt by a number of sector- and country-specific factors. These included the introduction of new emissions test standards that hit European carmakers, disruptions due to the French 'gilet jaune' protests, political uncertainty in Italy on the back of the escalating budget fight and transport problems due to a low water level in the Rhine river.

Amid ongoing subdued readings in leading indicators, questions about an impending recession have intensified. Although we expect the expansion pace in the euro area to slow down further in 2019, we still see the risk of an imminent recession as low. We expect a less favourable external environment will remain a defining feature for the growth outlook in the coming years, but many of the temporary factors will start/or have already started to unwind and domestic demand remains an important backbone of the ongoing expansion. Hence, we expect the euro area economy to grow by 1.2% in 2019 and 1.4% in 2020, before moderating back to potential at 1.3% in 2021.

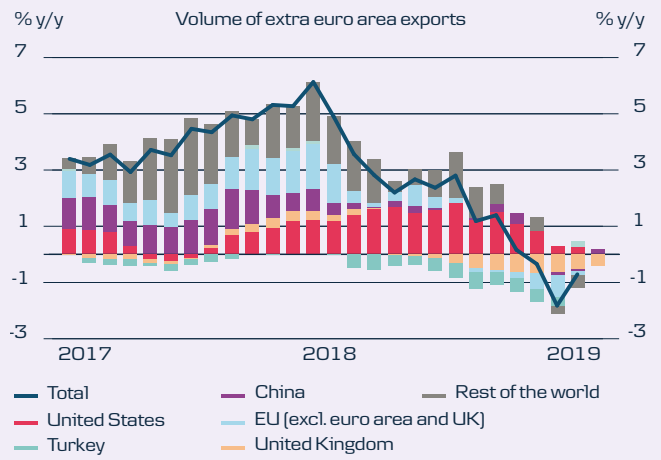
At the start of 2019, the quarterly growth pace already picked up some speed to 0.4% q/q, but we remain sceptical that the economy can maintain its current momentum for the remainder of the year, as the export outlook remains cloudy. In 2020, the economic fundamentals should remain relatively firm, underpinned by accommodative monetary and fiscal policies and a strong labour market, while the growth rate will also get an 'artificial' boost from a larger number of working days in several countries.

... but expansion is not yet out of fuel

Since the beginning of 2013, private consumption has been the main driver of the recovery. Still, private consumption growth was slower than we previously expected as households responded to the growth moderation by increasing precautionary savings, while there were also some knock-on effects from the car production issues mentioned above. That said, we still see scope for consumer spending growth to hold up in light of robust demand for credit, low borrowing costs and rising real wages amid abating inflation pressures. Expansionary fiscal measures in some countries should further contribute to disposable income growth. An important factor here remains the resilience of the labour market situation. Although we could see employment growth slowing somewhat in line with the slackening growth, we still expect the unemployment rate to reach 7.5% in 2020, with nominal wage growth at 2.3% remaining at the highest rate in 10 years.

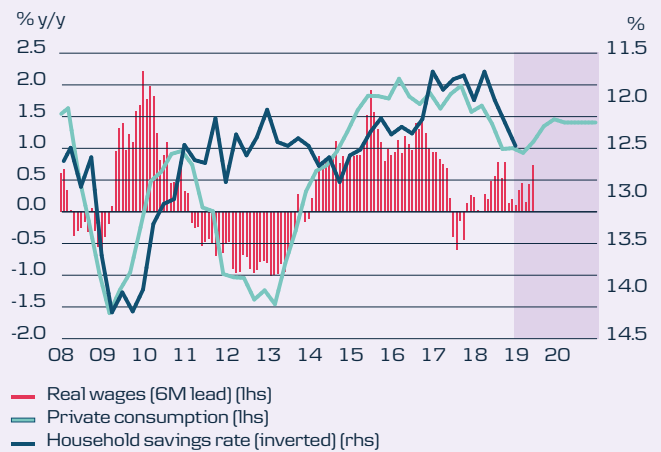
The outlook for investments, on the other hand, remains more mixed. Investment spending so far has remained quite resilient to the manufacturing weakness, not least of all due to strong activity in the construction sector. Favourable financing conditions, high capacity utilisation (at 83% in Q1) and somewhat higher public investments should help underpin investment growth in our view. However, despite these positive factors, elevated global uncertainty, declining profit margins and lower sales expectations might induce firms to adopt a 'wait-and-see' strategy. While the ongoing slowing of investment growth will

Demand from key export markets has cooled



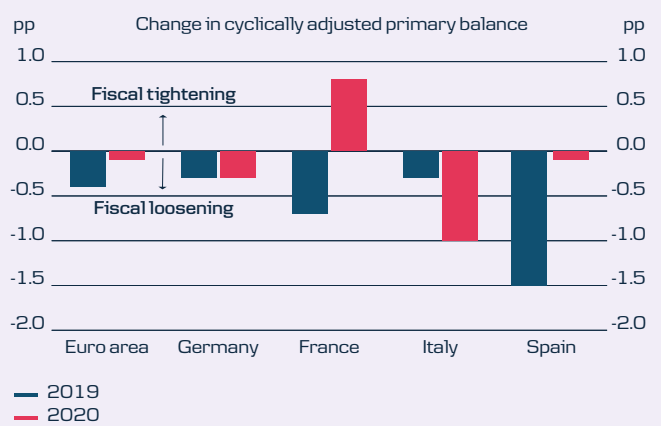
Source: Eurostat, Macrobond Financial, Danske Bank

Private consumption remains the engine of growth



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

More expansionary fiscal policies also help underpin growth



Source: European Commission, Danske Bank

take its toll on import growth, we still expect net exports to remain a drag on growth in light of the adverse global trade environment and a weaker growth outlook in key export markets, not least of all China, the US and Turkey.

Many fragilities lingering in the background

Although we think the expansion will continue, it remains a fragile one, with the euro area facing multiple headwinds. As mentioned above, the strength of the employment-consumption relationship is an important factor underpinning domestic demand. However, strong wage growth is increasingly outpacing GDP growth, raising the risk that firms react by starting to cut staffing and thereby weaken the 'motor of growth'. From the external side, the biggest risk, in our view, stems from further escalation in the US-China trade war and US tariffs on European car imports, which could further weigh on sentiment and investments. However, risks also loom from a disorderly Brexit and a re-play of the Italian budget fight in the autumn spilling over to tighter financial conditions. Progress on reforms to strengthen the EMU has been disappointing so far and momentum is likely to remain lacklustre even after the EU parliamentary elections, leaving questions about how to address the next crisis.

Core inflation pressures continue to build

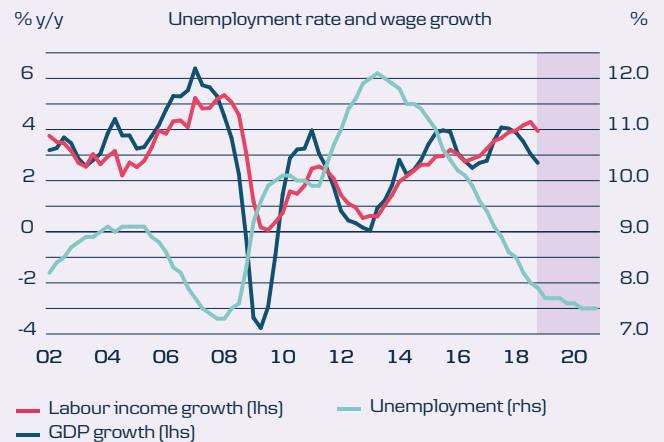
After headline inflation reached 1.8% in 2018 on the back of a strong rise in oil prices, we expect inflationary pressures to abate in the coming years to reach 1.5% in 2019 and 1.4% in 2020. However, with regard to monetary policy, the key inflation metric remains the inflation excluding volatile food and energy prices. Overall, underlying inflation pressures are still subdued, averaging only 1.0% in 2018. However, with the economic expansion continuing, unit labour costs rising and firms' margins increasingly being squeezed, the structural conditions for a pass-through from wages to prices remain in place. We see scope for core inflation reaching rates of 1.3-1.4% by year-end (see Inflation under the microscope: simmering, not boiling).

ECB policy normalisation postponed

ECB opened for an easing bias at the March meeting by announcing a new series of liquidity operations (TLTROs) and extended rate forward guidance to the end of this year, on the back of a sustained slowdown that extended into 2019. With ECB entering easing mode, we no longer expect any changes in the policy rate until the end of 2021, as the lack of strong inflationary pressures and only moderate euro area growth outlook do not warrant policy tightening. However, our baseline does not include new accommodative monetary policy either. Further stimulus measures could be warranted if we see a deterioration of economic fundamentals that stands to jeopardise the rise in core inflation (see also Guns (and not bazookas) dominate ECB's crisis arsenal). The market-based inflation expectations (5y5y, illustrating the expected inflation from 5 years to 10 years) are trading close to all-time lows. The ECB has previously stepped up its policy stimuli when inflation expectations were at much higher levels, which has led to the market speculating about the next stimuli measure.

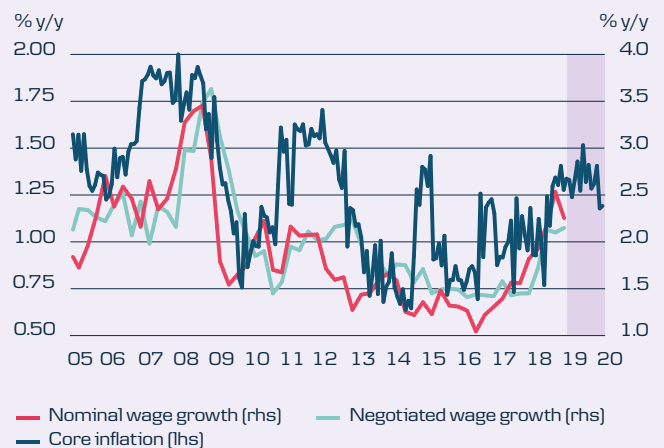
In sum, compared to the Big Picture published in December, the normalisation bias to a tighter monetary policy has been replaced with a neutral to easing bias (should the data warrant it).

Employment growth to slow down amid rising labour costs



Source: ECB, EC, Eurostat, Macrobond Financial, Danske Bank

Core inflation rise still on the horizon



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Deteriorating market-based inflation expectations pose a headache for ECB



Note: Vertical line; August 2014 (Mario Draghi warming up to QE), December 2015 (re-anchoring inflation expectations via rate cut and QE extension)
Source: Bloomberg, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

% Change q/q	2019				2020				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2021
Annualised rate												
GDP	1.6	1.1	1.1	1.1	1.5	1.5	1.5	1.5	1.8	1.2	1.4	1.3
Private Consumption	1.6	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.3	1.2	1.4	1.3
Private Fixed Investments	2.0	1.2	1.2	1.2	2.0	2.0	2.0	2.0	3.3	2.6	1.7	2.0
Public Consumption	2.0	2.0	2.0	2.0	1.6	1.6	1.6	1.6	1.1	1.9	1.8	1.1
Exports	1.8	1.6	1.6	1.6	2.6	2.6	2.6	2.6	3.1	2.3	2.2	2.5
Imports	2.4	2.4	2.4	2.4	2.8	2.8	2.8	2.8	3.1	3.2	2.7	2.8
Net exports ¹	-0.2	-0.3	-0.3	-0.3	0.0	0.0	0.0	0.0	0.1	-0.3	-0.1	-0.1
Unemployment rate (%)									8.2	7.7	7.5	7.4
HICP (y/y)	1.4	1.6	1.6	1.5	1.7	1.5	1.3	1.1	1.8	1.5	1.4	1.7
Core HICP (y/y)	1.0	1.2	1.3	1.3	1.3	1.4	1.4	1.3	1.0	1.2	1.3	1.4
Public Budget ²									-0.5	-0.9	-0.9	-0.8
Public Gross Debt ²									87.1	85.8	84.3	84.0
Current Account ²									3.6	3.3	3.2	3.2
ECB deposit rate ³	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4

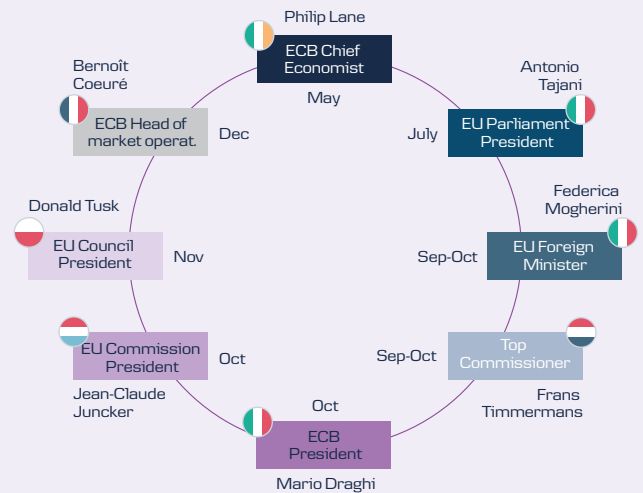
1. Contribution to GDP growth
 2. Pct. of GDP
 3. End of period
 Source: Eurostat. Danske Bank estimates

The European Game Of Thrones

The European parliamentary elections have brought the starting shot for the European 'Game of Thrones' to play out in the coming months, where a range of top EU positions will be up for grabs. Informal rules about the balance of power between Northern and Southern member states will guide the political 'horse trading'.

Over the coming weeks, discussions will intensify over the choice of EU Commission president. Current frontrunners are Germany's Manfred Weber, the Netherlands' Frans Timmermans and Denmark's Margrethe Vestager (see more here). That said, financial markets are equally, if not more, interested in the new ECB president.

The nationality of the next EU Commission president will have important implications for the ECB presidency succession when Mario Draghi steps down in October. With Germany seemingly preferring to secure the Commission presidency, this could pave the way for a more moderate consensus candidate from France or Finland to take over the reins at the ECB. We would expect such policy continuity to be seen as a positive/calming factor for markets. Almost irrespective of the new ECB president, we do



not expect a sudden shift in the ECB's current monetary policy outlook, however the responsiveness and innovative qualities of the next ECB president would be instrumental in shaping the policy response in the next crisis.



Germany

In the crosswinds of trade war

- In the near-term a rocky road still lies ahead for the German economy with renewed headwinds to external demand, but over time we expect the growth pace to gather some speed reaching 1.6% in 2021.
- The domestic side of the economy remains fairly resilient and rising real wages and fiscal stimulus should continue to underpin growth.
- We project core inflation pressures to continue to build up in light of a strong labour market and dynamic wage growth.
- Many risks to the growth outlook for the German economy continue to linger from the external side, the most prominent remaining the threat of US car tariffs.

In stormy waters

The German economy has been at the epicentre of the euro area slowdown, finding itself caught in the crosswinds of the US-China trade war and ensuing decline in global trade growth. Although the export-dependent economy narrowly avoided a recession in Q4, a rocky road still lies ahead with renewed headwinds to external demand. This expectation is also reflected in our GDP growth forecasts, which see the German economy expanding by only 0.7% in 2019 (1.7% previously) and 1.3% in 2020, with some acceleration in 2021 back to potential growth at 1.6%.

A slowdown in global trade volumes on the back of rising protectionism and weaker growth in key export markets such as Turkey, China and the UK has taken its toll on the export-driven German manufacturing sector. Export growth came more or less to a halt at the end of 2018, as both extra- and intra-euro area trade slowed steeply. Added headwinds came in the form of bottlenecks in the car sector related to new emission test procedures (WLTP) and significant transport problems caused by a low water level in the Rhine river in Q4, which alone are estimated to have dragged GDP growth down by some 0.4pp in Q3 and 0.3pp in Q4. Although water levels have returned to normal, another dry spell in the summer could reignite the problem in the autumn of 2019 and, while car manufacturing and exports have improved from the trough in Q3, both have yet to return to previous levels. The sluggish recovery in the car sector might also reflect structural changes that will remain a headache for the industry in coming years, such as driving bans on diesel cars in a growing number of German cities and shifting consumer preferences towards electric and hybrid cars, where Volkswagen, Daimler, BMW and co. have long remained dormant and are now lagging behind international competitors.

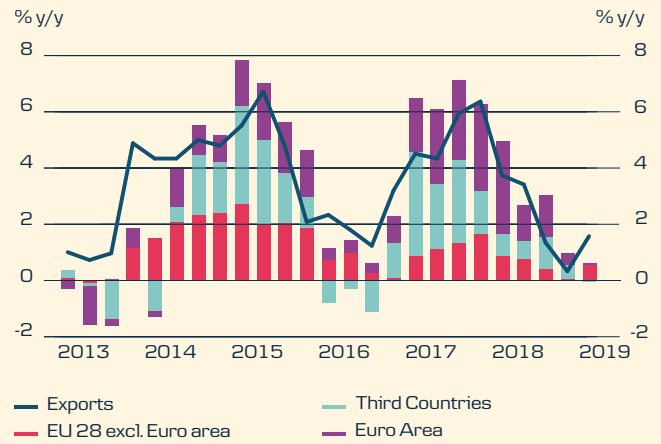
Whereas labour shortages and capacity constraints were firms' top worries at the start of 2018, a lack of demand has now become the main factor limiting production according to business surveys. Combined with more uncertainty on the global trade front, this leaves us expecting a more moderate pace of export growth ahead, as many German companies are highly integrated into global value chains and we believe collateral damage will be difficult to avoid. In theory, the US-China trade conflict could also lead to positive spill-over effects for Europe, as trade flows are diverted to products and countries not affected by the tariff hikes (the so-called 'substitution effect'). However, we expect this effect to be limited, as the German export performance remains highly correlated with global trade volumes.

Despite the US decision to extend the deadline for car import tariffs until the end of the year, as negotiations over a trade agreement with the EU on industrial goods are ongoing, it remains a significant downside risk for the German economy in 2020. Germany is the fourth-largest car exporter to the US, accounting for some 8% (EUR28.5bn) of total US car imports in 2018. According to an ifo study, just the direct effects of a 25% tariff hike could reduce German real GDP by around EUR-5bn (0.2% of GDP). However, the economic effects will depend not least of all on the retaliatory response from the EU side.

Labour market strength remains key

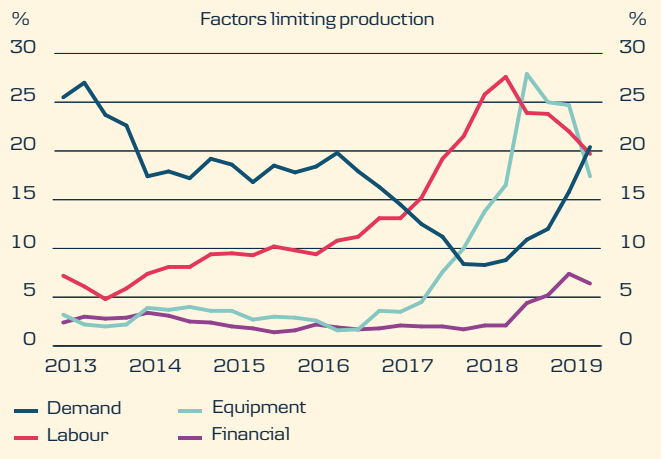
While the 2018 growth weakness can be attributed mainly to

Export outlook remains challenged



Source: Eurostat, Destatis, Macrobond Financial, Danske Bank

Lack of demand has become number one concern for firms



Source: EC, Macrobond Financial, Danske Bank

German export performance remains closely linked to global trade volumes



Source: Eurostat, CPB, Macrobond Financial, Danske Bank

supply-side issues and weaker external demand, the domestic side of the economy remained fairly resilient. This said, private consumption growth still stagnated in H2, as car sales cooled due to production bottlenecks and consumers reacted to the rising economic uncertainty by saving a larger share of their income, with the savings rate standing at 18.3% in Q4 18 (the highest level since 1999). We expect private consumption to remain the most important growth driver, supported by rising real wages and a stabilising savings rate in light of the continued strong labour market situation.

In our view, a buoyant construction sector (that remains supported by government initiatives to spur residential building and infrastructure investments) and low financing conditions will continue to underpin the investment outlook. However, we remain sceptical about whether the current pace can be maintained in light of growing uncertainty about global sales prospects, declining margins and biting capacity constraints in the construction sector.

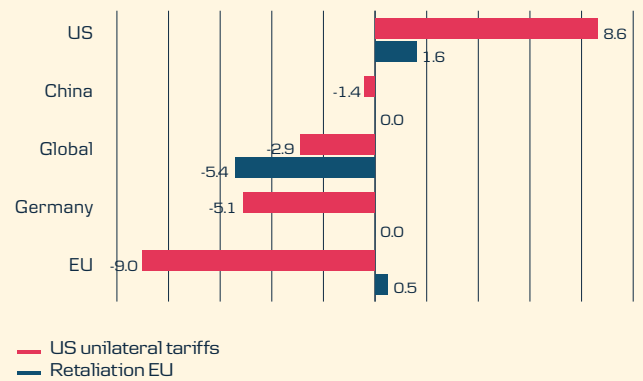
Despite the cooling growth momentum, employment growth has remained dynamic, with the unemployment rate at 3.2% in Q1 19, remaining below the NAIRU. We see scope for the unemployment rate to decline further to 3.0% in 2020 but compared with previous years, we expect job creation to slow down. The tight labour market and increasing labour shortages gave rise to higher negotiated wage agreements in 2018, taking nominal wage growth to its highest rate since 1995. We expect wage growth to remain elevated at 3.0% in 2019 but flatten out somewhat in 2020 at 2.8%, as both wage drift and negotiated wage growth abate. We project core inflation pressures to continue to build up in light of dynamic wage growth, reaching 1.7% in 2019, while we expect headline inflation to decline to 1.6% due to moderating energy prices.

While we believe households' spending power will continue to benefit from real wage gains, we expect fiscal policy to become an additional tailwind for the growth outlook. However, government measures remain heavily skewed towards supporting household incomes rather than ramping up public investment, despite crumbling transport infrastructure. In total, we expect fiscal policy to lift GDP growth by 0.4-0.6pp over the coming two years, with around one-third of the fiscal easing achieved directly through higher public consumption growth (mainly through higher spending on defence, police personnel, kindergartens and other public investments).

Is Europe's growth engine heading for recession? As long as the domestic side of the economy remains underpinned by strong fundamentals, notably the labour market and private and public consumption, we still do not think so. However, the resilience of the employment-consumption relationship remains an important precondition. The manufacturing sector in particular remains vulnerable to a trend shift in employment dynamics, with the recent high collective wage agreements increasingly at odds with the waning order situation. Many risks to the growth outlook for the German economy continue to linger from the external side, where further escalation in the US-China trade conflict and the risk of a no-deal Brexit could exert a stronger drag on the economy than initially expected. Additionally, policy uncertainty is looming in the background, with the current CDU/CSU-SPD grand coalition remaining a fragile truce.

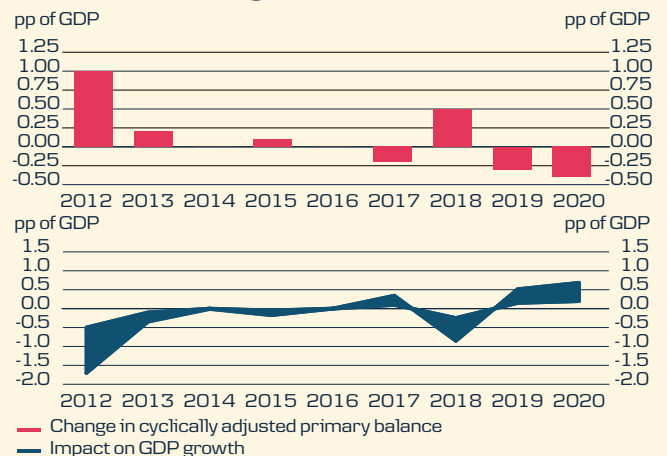
Car tariff effects will depend on retaliatory response from the EU

Real income effects of US car tariffs with and without retaliation (EUR bn)



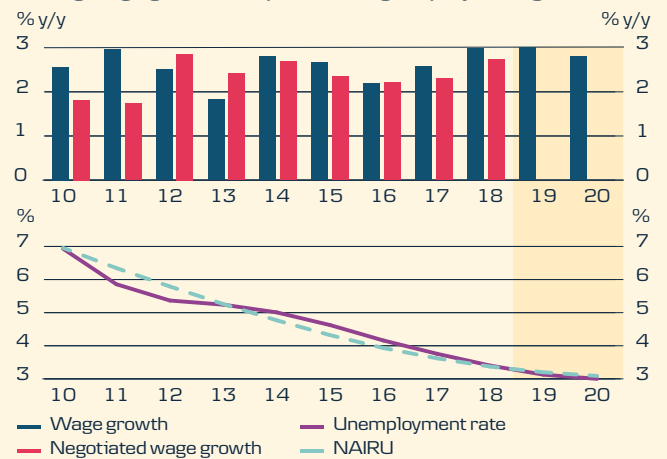
Source: Ifo Institute

Fiscal headwind turning into tailwind in 2019 and 2020



Source: Gemeinschaftsprgnose, Macrobond Financial, Danske Bank

Strong wage growth despite slowing employment gains



Source: Eurostat, ECB, Bundesbank, Macrobond Financial, Danske Bank

Macro forecasts - Germany

% change q/q	2019				2020				Calendar year average			
	Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020
GDP	1.7	0.7	0.7	0.7	1.7	1.7	1.7	1.7	1.5	0.7	1.3	1.6
Private Consumption	5.0	1.2	1.2	1.2	1.4	1.4	1.4	1.4	1.1	1.9	1.3	1.3
Private Fixed Investments	4.7	2.0	2.0	2.0	2.4	2.4	2.4	2.4	2.7	2.9	2.3	2.7
Public Consumption	-1.1	2.4	2.4	2.4	2.2	2.2	2.2	2.2	1.0	1.7	2.3	2.6
Exports	4.2	0.8	0.4	0.4	2.4	2.4	2.4	2.4	2.2	1.5	1.7	2.7
Imports	2.7	2.8	2.4	2.4	2.8	2.8	2.8	2.8	3.4	3.2	2.7	3.3
Net exports ¹	0.2	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.4	-0.7	-0.4	-0.2
Unemployment rate (%)									3.4	3.1	3.0	2.9
HICP (y/y)	1.7	1.8	1.7	1.5	2.0	1.7	1.6	1.3	1.9	1.6	1.6	1.8
Core HICP (y/y)	1.4	1.8	1.8	1.8	1.8	1.8	1.9	1.8	1.3	1.7	1.8	1.9
Public Budget ²									1.7	1.0	0.8	0.7
Public Gross Debt ²									60.9	58.4	55.6	55.0
Current Account ²									6.8	6.0	5.9	5.8

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

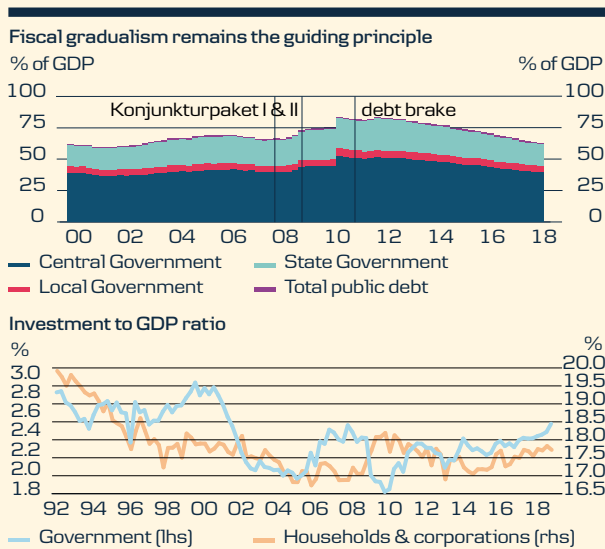
Fiscal policy - loosening the brake

During the global financial crisis the German government launched two 'Konjunkturpakete' (fiscal stimulus packages) totalling some EUR73bn. Although the packages helped to cushion the economic downturn, they also left sizable holes in state coffers. To bring public debt back on a downward trend the so called 'debt brake' came into force in 2011, which restricts structural deficits to a maximum of 0.35% of GDP.

While the debt brake has succeeded in reversing the debt dynamics it has also been blamed for aggravating Germany's infrastructure problems, with crumbling bridges, traffic jams and capacity constraints in the railway system becoming ever more pressing. Although the public investment share has crept up somewhat since 2016, it remains well below the levels observed in the 1990s. As the German growth engine has started to stutter and borrowing costs remain at rock bottom, discussions about a loosening of the debt brake have gathered pace.

However, although the fiscal situation remains favourable in the euro area comparison - with a budget surplus of 1.7% in 2018 and public debt close to 60% of GDP - the weaker growth outlook already leaves a EUR10.5bn gap in the budget until 2023 according to the finance ministry. Furthermore, changes to the debt brake require a change to the constitution which seems unlikely at the current

stage as it lacks support from a two-thirds majority in parliament. In light of this we expect the threshold for additional fiscal stimulus to be high. However, should the outlook for 2020 start to weaken materially and the economy edge closer to recessionary territory, we would be surprised to see politicians just sitting on their hands.



Source: Eurostat, Macrobond Financial, Danske Bank



UK

High Brexit uncertainty continues

- GDP growth in Q1 was strong, mostly due to stockpiling ahead of the original Brexit day. Underlying growth remains in the range 1.0-1.5% in the years ahead.
- Brexit remains the key source of uncertainty. Our base case is that Brexit will be postponed again, as the arithmetic in the House of Commons does not change just because of a new Prime Minister.
- The end game is still: no-deal Brexit, no Brexit or the Withdrawal Agreement. British politicians are unlikely to shift position until pressure starts mounting again ahead of the October deadline.
- We expect Bank of England to remain on hold, as Brexit is unresolved and economic indicators are mixed both in the UK and globally.

Brexit uncertainty messes with the indicators

The first estimate of GDP growth in Q1 showed growth of 0.5% q/q, which looks solid on the surface but not when digging deeper. In Q1, as part of preparing for Brexit, UK companies stockpiled goods from Europe, as they feared it would be difficult (and more expensive) for goods to cross the border in case of a no-deal Brexit. This is clear both when looking at imports and inventories' components.

In our view, the underlying growth momentum in the UK is not 0.5% but probably more realistically around 0.25%. Private consumption remains the main growth driver but it is not growing as fast as previously, as uncertainty has also hit consumption to some degree. Business investments surprised by growing in Q1 19 after four consecutive quarters of decline in 2018. A large share of companies think Brexit is the top source of uncertainty and many companies have postponed investments decisions due to Brexit. With Brexit postponed and no signs of imminent clarification, the outlook for business investments is also weak. Despite the UK expansion being nearly 10 years old, business investments are declining in year-on-year terms, which is quite extraordinary compared with previous expansions and other European countries. Even if we get an orderly Brexit in October, we do not expect investments to accelerate, as businesses still do not know what future relationships look like. It could be that we are too pessimistic here and that companies may start to invest in more projects than they had postponed due to Brexit.

We are having a hard time seeing much higher growth over the forecast horizon and think underlying growth will remain in the 1.0-1.5% range over the coming years (against 2.0-3.0% before Brexit was a theme). We probably do not surprise anyone by saying that Brexit makes it difficult to make precise forecasts for the economy. We forecast GDP growth of 1.5% this year and 1.6% next year but stress that Brexit remains a big source of uncertainty. Forecasting GDP growth is not made easier by the fact that the stockpiling European goods are messing with both the inventory and imports components of GDP. This may imply that UK growth looks more promising than it really is.

Labour market has been quite resilient

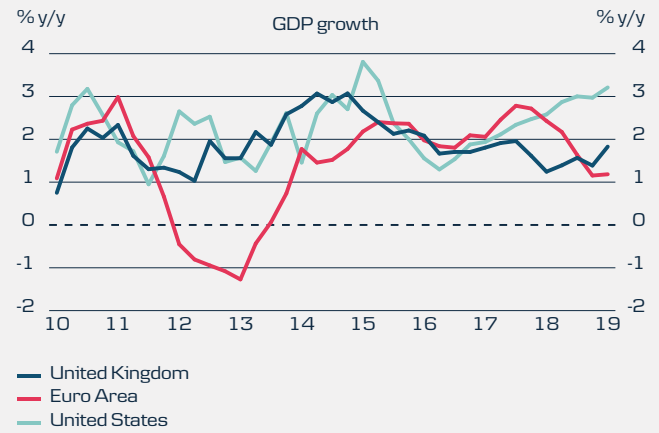
While the labour market has been quite resilient to Brexit uncertainties, most indicators suggest employment growth is slowing. This is probably not a sign of crisis but more likely due to labour shortages (or skills mismatch between supply and demand for labour). The index for recruitment difficulties remains high and wage growth is increasing. In our base case, the unemployment rate is set to continue to move lower but probably at a slower pace. We estimate productivity growth will pick up slightly.

In our view, Brexit is mostly a supply-side story, which is supported by migration flows from the EU to the UK slowing down. 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 as the UK has labour shortages to begin with.

New Prime Minister, same arithmetic

While the UK was supposed to leave the EU no later than 29 March, the formal exit date has been postponed twice. Brexit

UK GDP growth is set to remain around 1.5%



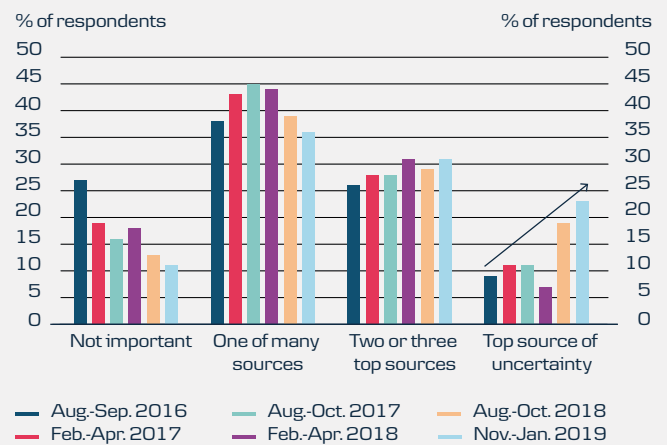
Source: ONS, BEA, Eurostat, Macrobond Financial data, Danske Bank

Businesses have postponed and cancelled investment plans



Source: ONS, Macrobond Financial data, Danske Bank

Brexit is one of the most important sources of uncertainty



Source: Bank of England's Inflation Report November 2018

day is now 31 October and some EU leaders have already sounded open to the possibility of a further extension (although France remains very sceptical to this). Some British politicians are open to this as well.

It remains difficult to predict what will happen especially now with the ongoing Conservative leadership contest. Our base case is that the October deadline will be postponed further again but it is not a high conviction call. One reason is that the next Prime Minister does not have much time to settle down. Another reason is that a new Prime Minister does not change the arithmetic in the House of Commons and there is still no majority for anything in the House of Commons. Extensions mean prolonging of the period with high uncertainty for businesses and consumers, which is not good from an economic perspective. It is also clear from the chart to the right showing economic sentiment in the UK has fallen more than in the rest of Europe. The fall in sentiment is especially driven by lower business confidence.

The Conservatives are clearly under pressure from Nigel Farage's new Brexit party (see opinion polls to the right) and the next party leader may move in a more pro-Brexit direction. We acknowledge this increases the chance of a no-deal Brexit but there is no majority in the House of Commons for leaving without a deal and if a new government pursues a no-deal Brexit policy, it may be brought down in a no-confidence vote, as moderate Conservatives may join forces with the opposition in this scenario. Snap elections would be a disaster for the Conservatives, who will most likely lose power and many seats. Labour is under pressure as well, as the party has not taken a clear stance on Brexit, either. Labour is losing Brexit voters to both the Brexit party and remain voters to LibDems.

With respect to the Brexit end-game, we think there are three options. The Withdrawal Agreement as it is, no-deal Brexit or a second EU referendum. Polls suggest the UK would vote to remain but the lead is not big. Also, it is not without costs to call for a referendum again, as it would upset half of the population. Right now we are too far away from the deadline for the members of parliament to change Brexit positions.

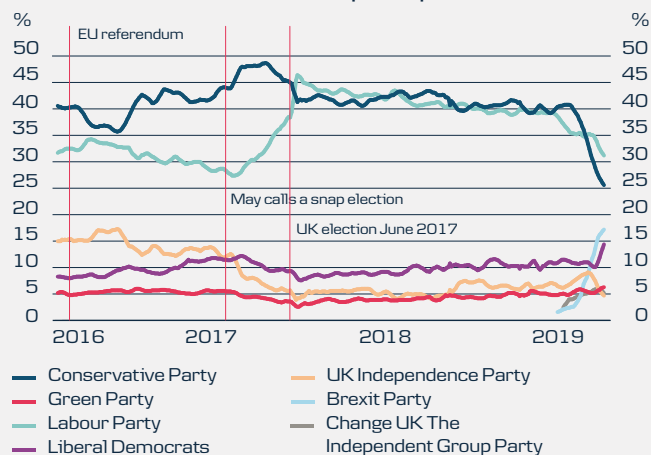
GBP in the hands of Brexit

Brexit remains the most important driver for GBP. GBP has weakened over the past couple of months, as markets have started repricing a higher risk of a no deal Brexit on the back of the Conservative leadership contest and economic indicators have started to surprise to the downside. GBP will continue to trade on Brexit headlines and given it is difficult to predict what will happen with Brexit, it is difficult to predict the exact level for EUR/GBP. In case the Brexit deal passes, we expect EUR/GBP to move down to around 0.83. In case of a no-deal Brexit, we expect the cross to move towards 1.00.

Bank of England on pause for now

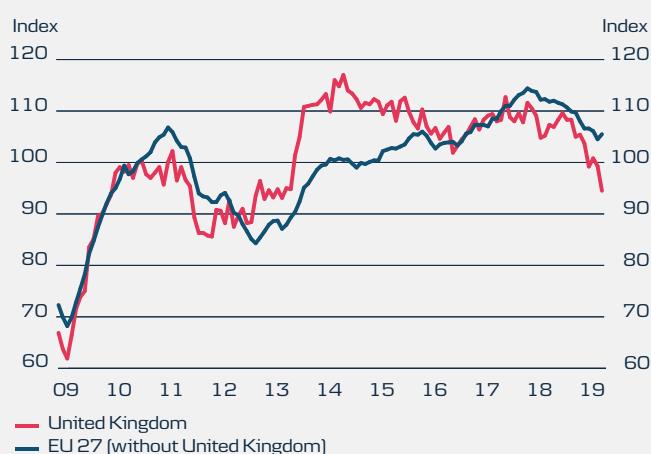
We do not expect Bank of England to tighten monetary policy further near term despite it maintaining its tightening bias. With slower than expected growth in Europe, mixed data in the UK due to Brexit and with both the Fed and ECB on hold, we do not expect the Bank of England to deliver on the promised rate hikes. What the Bank of England will do eventually depends on how Brexit plays out, which is difficult to predict.

Conservatives are in free fall in opinion polls



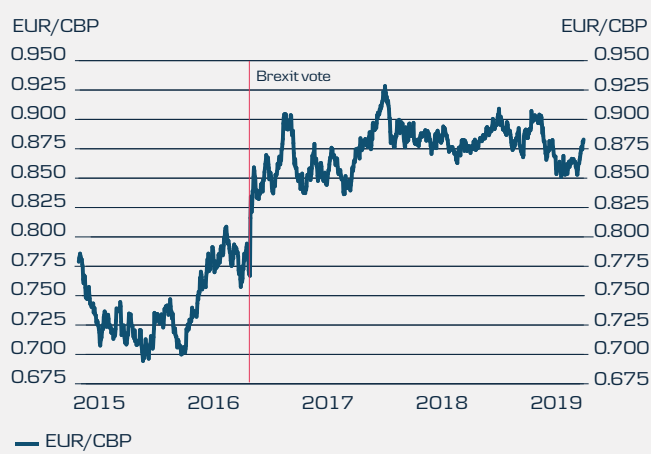
Source: British Elects, Macrobond Financial

Economic sentiment has soured more than in rest of Europe



Source: DG ECFIN, Macrobond Financial

Brexit is the key driver for GBP



Source: Bank of England, Macrobond Financial

Macro forecasts - UK

% change q/q	2019				2020				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2018	2019	2020	2021
GDP	0.5	0.2	0.3	0.2	0.7	0.2	0.7	0.3	1.4	1.5	1.6	1.3
Private consumption	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4	1.8	1.8	1.4	1.4
Government consumption	1.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.4	2.5	0.6	0.4
Fixed investments	2.1	-0.5	0.0	0.0	0.0	0.0	0.25	0.25	0.2	1.5	0.1	0.9
Exports	0.0	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.1	2.0	2.0	2.0
Imports	6.8	-2.0	2.0	0.5	-2.0	0.5	-4.5	0.5	0.7	8.5	-2.9	-0.6
Domestic demand ¹	1.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3	1.2	1.9	1.3	1.3
Net exports ¹	-2.1	0.7	-0.5	0.0	0.8	0.0	1.6	0.0	-0.2	-2.0	1.5	0.8
Inventories ¹	1.5	-0.7	0.6	0.0	-0.4	0.0	-1.1	0.0	0.3	1.7	-0.9	-0.6
Unemployment rate (%)	3.9	3.8	3.7	3.6	3.5	3.5	3.4	3.4	4.1	3.7	3.4	3.3
Wage growth [% y/y] ²	3.7	3.2	2.7	2.4	2.4	3.1	3.4	3.6	3.1	2.9	3.3	3.8
CPI [% y/y]	1.8	2.0	1.8	1.7	1.9	1.3	1.2	1.3	2.5	1.8	1.4	1.4
Core CPI [% y/y]	1.9	1.7	1.5	1.6	1.5	1.3	1.3	1.4	2.1	1.6	1.4	1.5
Public budget ³									-1.5	-1.4	-1.1	-1.1
Public debt ³									86.8	83.8	82.9	82.2
Current account ⁴									-4.00	-3.80	-3.50	-3.50
BoE Bank Rate (%) (end of period)	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

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 Brexit. In our view, a '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 an extension of the Brexit deadline, we think GDP growth would take a hit in a '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 potential GDP growth would be lower than it is now.

Brexit remains a key driver for GBP, which weakens whenever investors fear the no deal outcome is becoming more likely. If there is a 'decent Brexit', we would expect EUR/GBP to break lower and settle around 0.83. 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	2021
Base case	1.5%	1.6%	1.3%
"No deal" Brexit	1.4%	-0.3%	0.5%

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

Increasingly dependent on global recovery by the day

- Demand has been slowing in Japan. A record fiscal budget will keep the economy afloat in 2019, along with hoarding effects in the run-up to the VAT hike in October. From 2020 onwards, the economy will have to find support abroad to keep growing. We expect GDP growth of 1.0% in 2019 and 0.5% in 2020 and 2021.
- With a shrinking population, exports are key to growth, even if the Japanese economy is quite closed. A rebound in global growth therefore remains paramount to the outlook.
- The VAT hike poses a risk to domestic demand, although the impact should be much smaller than after previous tax hikes. Future trade negotiations between the US and Japan could also cause some turbulence.
- The inflation outlook still looks modest and we expect the Bank of Japan to remain on hold through 2021.

Weak demand supported by public spending

The underlying strength of the Japanese economy has weakened in 2019. Exporters have struggled with the Chinese slowdown, which has pulled much of the rest of Asia down with it. Declining demand from China and the South East Asian countries, which combined amount for 35% of total exports, has weighed heavy on Japan. This is also reflected in industrial production, as more than half of China's imports from Japan are machinery and transport equipment.

What started as weakness in the manufacturing sector has spread to domestic demand, where retail sales in particular have declined markedly. On an annual basis, private consumption is still the biggest growth contributor, along with government consumption, even if consumers have remained cautious.

Looking ahead, the basis for a strong pick-up in consumption remains fairly weak. Employment has continued to increase, but despite a historically tight labour market, the spring wage negotiations resulted in only modest wage growth. The uncertain outlook for many Japanese businesses due to the global slowdown and trade war has made companies more reluctant to raise wages than last year and real labour cash earnings declined markedly in Q1. Japanese firms usually prefer to offer one-off bonuses and other benefits instead of raising the base pay. When you have unions with relatively high company loyalty and a strong preference for job security on the other side of the table, wage increases are bound to be modest. If we get the global growth rebound we expect later this year, there could be room for a stronger bonus season around New Year, but a significant pick-up in wages is not in the cards, we believe.

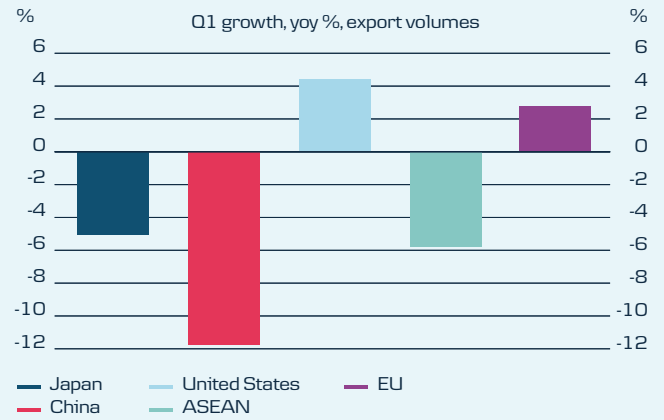
Bumpy road ahead

With an 8-10% VAT hike planned in October, private consumption is in for a bumpy ride, with hoarding effects likely to boost consumption in Q3 before a sharp drop in Q4. The National Diet has approved a record budget, which will provide a significant boost to the economy during Fiscal year 2019, see also box. Another risk is posed by President Donald Trump's critique of the Japanese trade surplus with the US, the third largest in the world. Japanese cars and US soybeans could end up as key bargaining chips in future Trump-Abe trade negotiations. PM Abe could be forced to break a deal affecting sensitive sectors such as Japanese agriculture and with an upper-house election in July in mind and the US-China trade dispute still unsettled, a US-Japan trade deal does not look to be right around the corner.

Looking beyond the VAT hike and the 2020 Tokyo Olympic games, which is likely to boost demand for a short period, the shrinking population will remain a drag on private consumption and Japan has to look abroad for sustainable growth drivers. Investments have also been boosted by construction spending related to the 2020 Tokyo Olympics. This effect will start to wane next year.

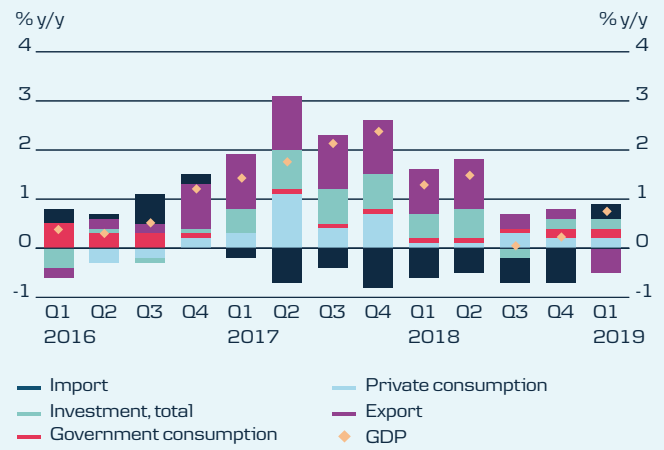
Supported heavily by public spending, we think GDP growth will end up at 1.0% in 2019. 2020 should be more self-driven, but we expect growth to end up at just 0.5%. In 2021, business investments and public support are bound to wane, but the ba-

Slowing China and South East Asia has weighed on exporters



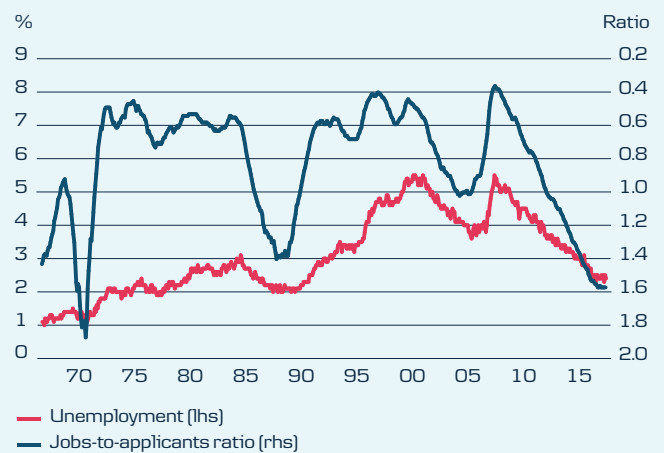
Source: Japanese Ministry of Finance, Macrobond Financial

Domestic demand the sole driver of modest growth



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

Tight labour market still no inflation trigger



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

sis for slightly stronger private consumption should be in place. We expect growth to end up at 0.5% in 2021.

Bank of Japan forced to be patient

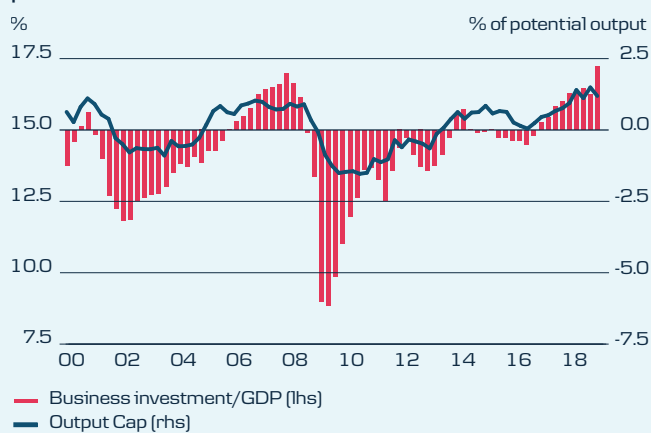
The share of decreasing items in the inflation basket has declined from 54% to 33% since Haruhiko Kuroda was appointed as the new Bank of Japan (BoJ) Governor back in March 2013. However, this has demanded a tremendous effort. The BoJ has introduced a negative policy rate and guided the 10-year government bond yield below zero. The balance sheet has grown from ¥1.75tr to ¥557tr, equivalent to 100% of annual GDP. A strange comparison between stock and flow, but it says something about the magnitude of the BoJ's QE programme when you compare it to the Fed and the ECB with balance sheets of around 20% and 40% of GDP, respectively.

Slowly the BoJ has realised that reflating the economy will be a long struggle and has taken measures to prolong the durability of the easing policy. Under the current framework with quantitative and qualitative easing and yield curve control, the BoJ 'only' needs to grow its balance sheet by ¥30tr a year to keep the yield curve in check, making the easing framework much more sustainable. However, it has also induced a decline in broad money growth, (Q1 GDP growth does not reflect the very weak demand), which is likely slowing economic activity and inflation. The issue now is that the most tangible policy measures have already been deployed. The promise at the April meeting to keep rates low until at least spring 2020 was 'free' in the sense that it is not likely to demand further stimulus, but the market reaction was also non-existent, probably because no one actually believed the BoJ would engage in any tightening measures before they know the full effects of the October VAT hike.

As we see it, there is not a lot for the BoJ to do currently but hope the global economic recovery regains momentum and continues long enough to kick-start the Philips curve. Despite the tight labour market, there are still very limited signs that inflation is moving much higher. Several supply shocks are set to weigh on inflation over the coming year. A warning from Japan's biggest mobile phone carrier about significant cuts in mobile subscription charges will pull inflation lower to begin with. After that, free early childhood education and free higher education for low-income families will cause a big decline in inflation. In the short run, this means the outlook for reflating the economy deteriorates for the following year.

We find it difficult to see a scenario where the BoJ can start tightening even in 2021. An ageing population and a declining equity risk premium has pulled the natural rate of interest into negative territory, according to the IMF. That means an interest rate level of -0.1% is barely expansionary as it is. An older population only stands to weigh more heavily on the natural rate of interest in the coming years, and the challenge of low productivity growth does not stand to be fixed any time soon either. If economic activity deteriorates further, a first reaction could be further tweaks to the forward guidance but we do not expect any significant changes to the current policy framework from the BoJ through 2021.

Waning Olympic boost and slowing growth ahead will take pressure off investment need



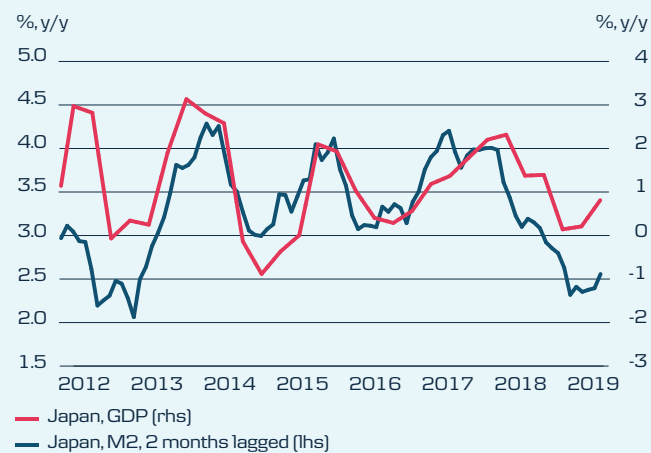
Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Deflation battle not won yet



Source: Bank of Japan, Macrobond Financial

Declining money growth weighing on real economy?



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

Macro forecasts - Japan

% y/y	2017	2018	2019	2020	2021
GDP	1.9	0.8	1.0	0.5	0.5
Private Consumption	1.1	0.3	0.3	-0.4	0.8
Private Fixed Investments	3.6	2.3	1.3	0.1	0.0
- Residential investment	2.2	-5.9	1.3	-0.8	1.3
- Non-residential	3.9	3.9	1.3	0.2	-1.5
Public Investments	0.8	-3.4	0.0	1.0	0.0
Public Consumption	0.3	0.7	1.7	0.8	0.0
Exports	6.8	3.3	-1.1	3.5	2.7
Imports	3.5	3.4	-1.8	1.1	1.2
Unemployment rate (%)	2.8	2.4	2.5	2.5	2.5
CPI. excl. fresh food (y/y)	0.5	0.9	1.0	1.6	1.0
- Excluding consumption tax hike	0.5	0.9	0.7	0.8	1.0
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

Initial effect of VAT-hike will be cushioned

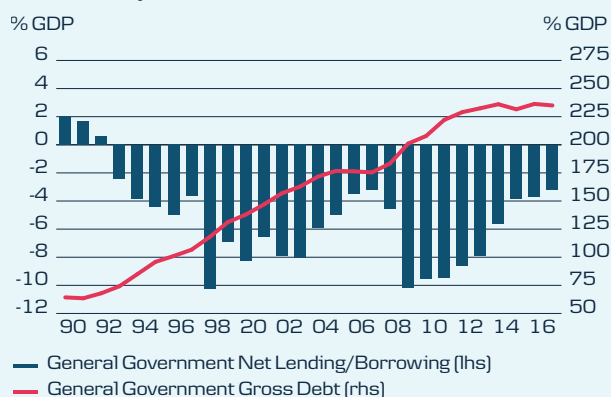
The VAT tax hike from 8% to 10%, originally planned for 2015, is scheduled for October this year. The Abe government has delayed the hike twice already. One reason for this is that it is unpopular with the public. A poll conducted by the daily Asahi Shimbun in May showed 54% of respondents were against the tax hike. Another reason is the fear of plunging the economy into recession – a legitimate fear considering the 1.8% q/q decline in GDP back in Q2 14, when the tax was increased from 5% to 8%.

This time, a delay is not so likely, although a further deterioration in demand will increase the likelihood. A new law would have to be enacted, it would be a hassle to rally support in time and the revenue has already been included in the record-high annual budget for fiscal year 2019, featuring increased spending on welfare, public works and defence. Several mitigating measures have been put in place to avoid an incident like 2014. Y2tr of the Y101tr budget are earmarked for fiscal measures, mitigating the VAT hike. Groceries will be excluded from the tax hike and home and car buyers will also experience tax relief. For a limited time, cashless transactions to small and medium retailers will even be subject to a 2% refund and

low-income households and those with small children will receive shopping vouchers.

Thus, the tax hike will not restore fiscal balance now, but it is paramount to the plans to achieve a primary budget surplus in the fiscal year 2026.

VAT-hike key to restore fiscal balance



Source: IMF, Macrobond Financial



China

Trade war puts recovery at risk

- Growth recovery to be delayed by further trade war escalation. However, stimulus is set to cushion the drag from higher uncertainty. We look for growth to fall to 6.2% in 2019 from 6.6% in 2018. In 2020 we expect the economy to grow 6.1%.
- We look for a trade deal in H2, which should pave the way for a recovery in Q4. Uncertainty is elevated, though, and an all-out trade war that runs into 2020 would delay any lift to growth.
- We expect more policy stimulus with a further cut in the RRR and subsidies for consumer goods. USD/CNY to rise to 7.10 over the next quarter.
- China is set to face some headwinds from production moving to other Asian countries and US export controls in tech. China's likely response will be more focus on self-reliance, even more investments in the tech industry and new efforts to create a better business environment for foreign companies in order to attract FDI.
- China has stepped up measures to support the private sector and continues to highlight 'reform and opening'. We expect China to stay on a catching-up path and to surpass the US economy by 2030.

Recovery delayed but stimulus set to cushion the drag

In the early months of 2019, signs of a bottom in the Chinese business cycle emerged. PMI manufacturing rebounded and higher metal markets supported the view of a lift to activity. However, the outlook turned darker in early May, when the US-China trade talks took a dramatic turn for the worse. US President Donald Trump shifted back to his 'maximum pressure' strategy and increased tariffs from 10% to 25% on USD-200bn of Chinese goods and started the process of adding 25% tariffs on the rest of imports from China of USD300bn. Uncertainty has thus increased significantly, which we expect to put a break on the brewing recovery (see top chart). However, it is still our baseline scenario that we reach a deal during H2 and have pencilled it into our forecast in late Q3 (see below). If this proves correct, we should merely see a postponement of the recovery to Q4. However, we also stress that a deal is far from certain and there is a risk that Trump goes the whole way and adds tariffs on all Chinese goods and delays a Chinese recovery into 2020.

There will be some mitigating factors for the Chinese economy in the midst of all the uncertainty. First, China added stimulus to both consumers and companies last year, which is increasingly having an effect. The stimulus covered both tax cuts and monetary and credit easing. Second, the construction sector is supported by a low level of inventories. Hence, the monetary easing that is set to push up home sales should quickly translate into even more robust construction spending.

Private consumption, corporate investments and exports, on the other hand, have all suffered from the trade war. Car sales, for example, are at their lowest levels in three years. However, we believe China will add more stimulus in the form of subsidies for purchases of cars and home appliances as well as further monetary easing through one or more cuts in the Reserve Requirement Ratio (RRR). China will also continue to do targeted lending through its liquidity measures to the banks, which is conditioned on loans to the real economy.

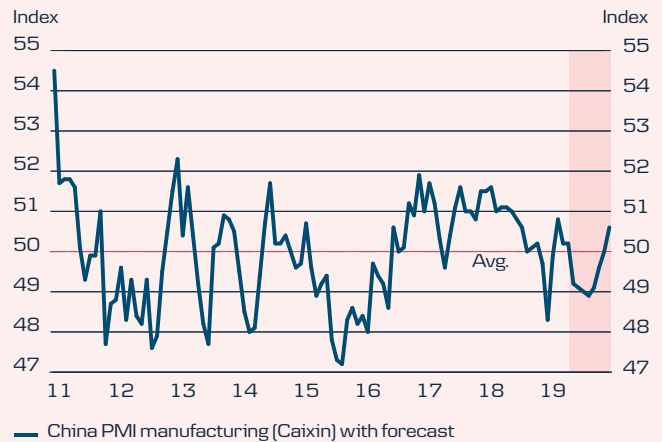
Even if China fends off some of the short-term drag, there will likely be long-term negative effects from companies moving more production from China to other Asian countries such as Vietnam, Bangladesh and Malaysia. The recent US ban on exporting products to Huawei has also shown that China is likely to face less access to US technological products in the future, which will make it less attractive as a production or assembly base for high-tech products. On the other hand, it is increasing China's efforts even more to develop its own technology sector and Chinese President Xi Jinping has repeated the need for 'indigenous innovation'.

The CNY started to weaken again versus the USD when the trade war re-ignited. We expect further depreciation to 7.10 in 3 months, as monetary easing and growth worries will add to the downside pressure on the currency. On the other side of a trade deal, we look for the CNY to strengthen again to 6.8 in 12 months.

Trade deal in H2 our baseline but uncertainty is high

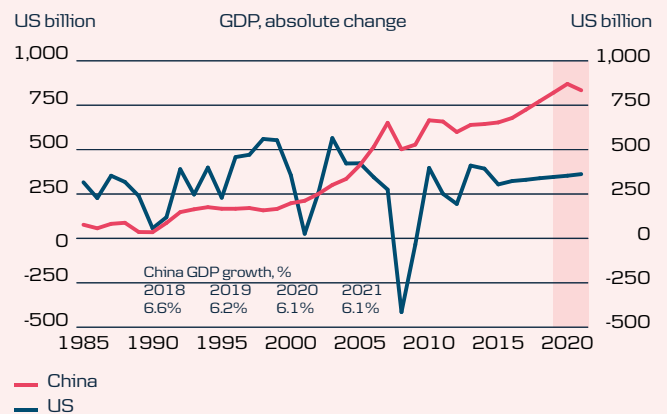
Both the US and China are currently digging in and showing no signs of a willingness to compromise. However, we believe this

Recovery hitting a bump from trade war escalation



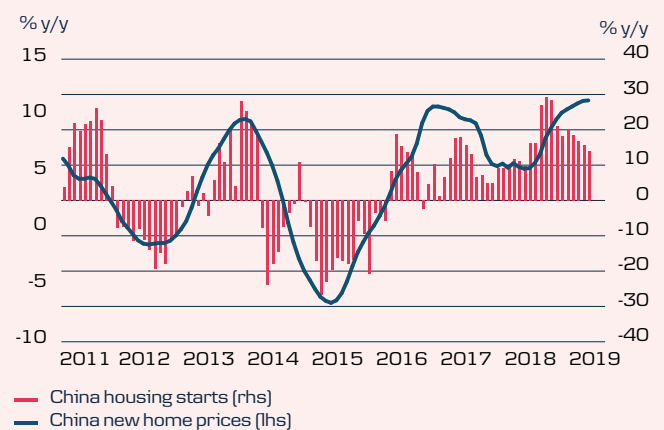
Source: Macrobond Financial, Danske Bank forecasts

Chinese growth is slowing in percent - but not in absolute terms



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

Construction sector is acting as a buffer amid headwind from the trade war



Source: Macrobond Financial, Danske Bank.

will eventually change as a failure to break the deadlock, in our view, will lead to a bigger market sell-off as fears of a full-blown trade war grow. Trump has previously proven to be sensitive to sell-offs in the equity markets and China may try to test his tolerance for pain if he refuses to meet them half way in.

The first test of how far we are from a deal is a meeting between Trump and Xi Jinping at the G20 meeting in late June. It can go two ways: Either they find compromise and get talks back on track or they fail to find a solution and the war of attrition continues. In this case, markets are likely to sell off sharply, especially if Trump decides to follow through on his threat to impose tariffs on all Chinese goods. We see a 50-50 risk of this happening. If we go down that path, China's next steps may be restrictions on rare earth exports to the US and a boycott of US goods by more consumers. This would have a clear negative effect on both the US and Chinese economies and markets. In our view this would get the two sides to eventually make a deal later in H2 (our working assumption is late Q3).

China steps up efforts to support private sector

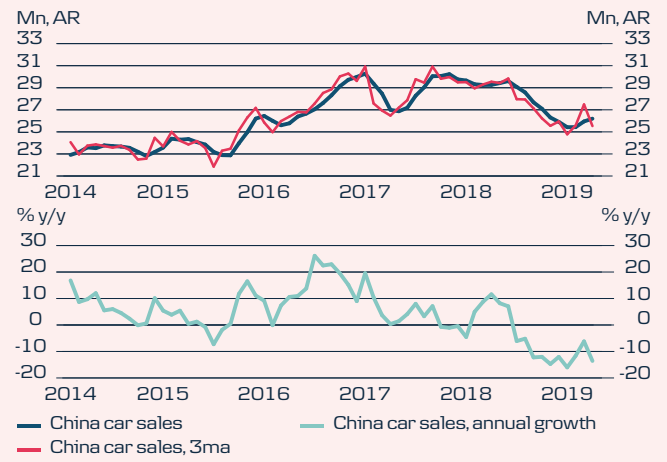
China's economic strategy is to put more focus on 'quality over quantity' and facilitate a further transition away from infrastructure investments and low-end manufacturing towards private consumption, the service sector and high-end manufacturing. With 600m people still living in rural areas and GDP per capita at 15% of the US level, China still has a long way to go. But in some high-tech areas, China is now at the frontier of technology. For example, when it comes to the development of 5G technology, e-commerce and digital payments.

China's polices also focus on increased efficiency in the state-owned sector, closing 'zombie' companies, fighting financial risks, eliminating poverty, reducing inequality across regions and incomes and fighting pollution. China also has a challenge with a significant ageing of the population. Heavy investment in robots is partly seen as one solution to this problem.

Xi Jinping last year stressed support for the private sector as concerns mounted that he will increasingly prioritise the state sector at the expense of the private sector. 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". This message was repeated at the annual National People's Congress in March by Premier Li Keqiang, where he said that "We will work to energise market entities and improve the business environment" and "we will uphold the 'two irresolutions' principle and encourage, support and guide the development of the non-public sector".

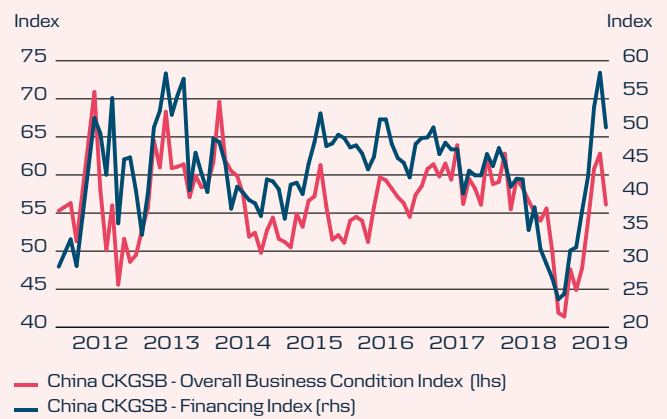
Over the past year, China took steps to lower costs for private companies by cutting taxes and social contributions. It also ordered state-owned banks to increase private sector credit by 30% y/y, as the private sector in particular has been hit by the crack-down on shadow banking. IMF said this month that "progress on structural reforms has led to a further opening up of the economy and a greater role for market forces" but also that "SOE reform should continue and help achieve competitive neutrality by hardening SOE budget constraints and removing their implicit guarantees" (SOE is State Owned Enterprise).

China to take measures to lift car sales



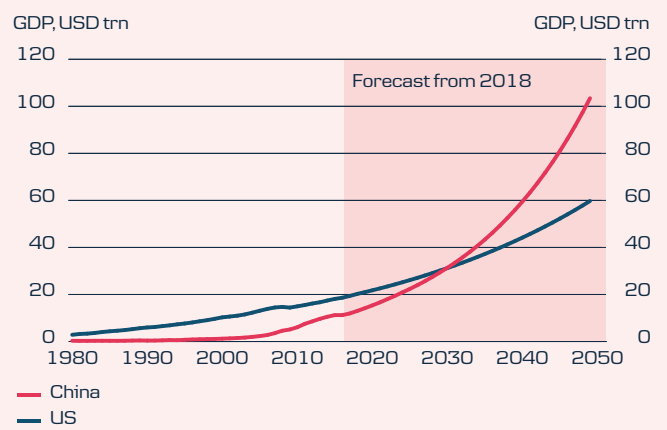
Source: Macrobond Financial, Danske Bank forecasts

Chinese measures to improve credit availability is starting to show up in data



Source: Macrobond Financial, Danske Bank

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	2021
GDP ¹	6.7	6.8	6.6	6.2	6.1	6.1
Private consumption ¹	8.4	8.5	8.2	7.5	7.8	7.5
Investment ¹	6.3	5.2	5.0	5.0	4.6	4.8
Net exports ²	-0.5	-0.3	-0.2	-0.2	-0.1	-0.1
Total investment share ³	44.2	43.8	43.2	43.0	42.6	42.2
Total savings rate ³	45.9	46	44.6	43.5	42.5	41.9
Current account balance ³	1.8	1.4	0.4	0.0	-0.1	-0.3
CPI ¹	2.0	1.6	2.1	2.5	2.2	2.2
Household income (real) ¹	7.8	8.3	8.0	7.5	7.3	7.0
Household savings rate. % of disp income	36.0	35.8	35.6	35.4	35.0	34.6
Wage growth (nominal. urban) ¹	9.1	9.0	8.5	8	7.5	7.5
Government budget balance ³	-3.7	-3.9	-4.8	-6.1	-5.5	-5.4
Augmented fiscal balance (IMF) ^{3,4}	-10.4	-10.8	-10.7	-10.9	-10.8	-10.7
USD/CNY ⁵	6.96	6.6	6.88	6.9	-	-
EUR/CNY ⁵	7.3	7.9	7.95	7.9	-	-
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

How can China strike back in an all-out trade war?

With the trade war escalating and China running out of US goods to put tariffs on, the question is how China can retaliate if Trump pushes through with the threat to tax another USD300bn worth of imports from China. The following options have been mentioned for China:

- 1. Stop buying more goods:** During autumn 2018 when the US-China trade war escalated, China put a halt to purchases of a range of US agricultural products. It is unclear if China could increase this list to include other items. One option could be to halt new orders of Boeing aircraft. But the challenge with this is that it is hard to reverse as part of a trade deal if the order has already been placed with Airbus instead.
- 2. Restricting exports of rare earths:** China has close to a monopoly on these minerals, which are used in mobile phones, electric vehicles, missiles, etc. The Chinese media has clearly flagged that this could be the next step from China. It would probably only work in the short term as other suppliers could emerge. But even short-term pain might make Trump more inclined
- 3. Consumer boycott:** The biggest risk for the US would be a consumer boycott of US products in China. This could hurt brands such as Apple, GM, Nike, etc. Apple in particular is at risk if consumers support Huawei at the expense of Apple. Chinese state media has increasingly beat the nationalist drum, which may lead more consumers to shy away from US products.
- 4. Currency depreciation:** China could choose to devalue the currency through selling CNY in the market. However, we believe China would be careful to do this as a sharp depreciation could get out of control and lead to capital outflows, as was the case in 2015/16.
- 5. Sell US Treasury holdings:** China has more than US-D1tr in US bonds as part of its currency reserves and could liquidate these to push up US bond yields. However, we see a small risk of this happening as it could also backfire by destabilising the financial system.



Emerging Markets

Further slowdown amid improving resilience

- Emerging markets have been under pressure in late spring 2019 mostly from escalating China-US trade war, while Fed's softening stance has helped to avoid a turmoil in currencies.
- Solid macro fundamentals and improved flexibility offer protection against external shocks.
- We expect growth to slow down further in Asia and Eastern European economies, while monetary easing would help economies late 2019 - early 2020 in Latin America, South Africa, Russia and Turkey.
- A possibly more severe slowdown in the EU and the US economies and an escalation of trade tensions remain the major negative risk factors for the growth outlook in emerging markets.

Emerging markets have demonstrated increased flexibility to changing external conditions

Emerging markets continued to show their increasing ability to adjust to a rapidly changing external environment since December 2018 meltdown, which was followed by a more dovish signals from major central banks such as the ECB and the US Federal Reserve. Several emerging markets central banks also made u-turn in their monetary policies switching to cuts or halting tightening despite accelerated inflation. Worsening prospects in global trade continue to weigh on economic growth in Asia and we expect the pressure to remain in the third quarter of 2019. The US looming attack on trade conditions with the EU is likely to shake up economic growth prospects in Central and Eastern European economies. Across several emerging markets, we believe fiscal issues are set to remain in focus. We expect a more conservative stance on fiscal policy in Brazil and Turkey to continue.

Economic slowdown in emerging markets set to stop in the second half of 2019

In our view, emerging markets will continue to adjust to rising trade challenges, while getting relief from easier monetary stances in China, the EU and the US. Free-floating exchange rate regimes are set to stabilize further external balances across emerging markets, keeping current account deficits in control. While inflation rose in many emerging markets in early 2019, we expect inflation to come down again in the second half of 2019. We also see economic slowdown across the majority of emerging markets to stop in late 2019 due to resumed monetary easing following rate cuts by the Fed and possible US-China trade agreement. The Fed cuts and weaker USD will also aide EM currencies.

The Chinese economy remains an important driver for emerging market growth. We see that overall economic growth in China is slowing to 6.2% in 2019 from 6.6% a year earlier. We expect Russia and South Africa to grow below 2%, with Turkey's GDP shrinking 2%. In our opinion, the Asian economies still have potential to outperform the rest of the emerging markets, especially China, India, Indonesia, Malaysia and Thailand, will deliver above 3% GDP growth in 2020-2021. In Central and Eastern Europe, prolonged easy monetary policy is set to continue over 2019, provoked by eased stance of the European Central Bank. However, we believe that economic expansion in Czech Republic, Hungary and Poland will still exceed 3% in 2019, but start decelerating back to the potential growth, remaining below 3% in 2020-2021.

Protectionism, China, the US slowdown and geopolitics are key risks

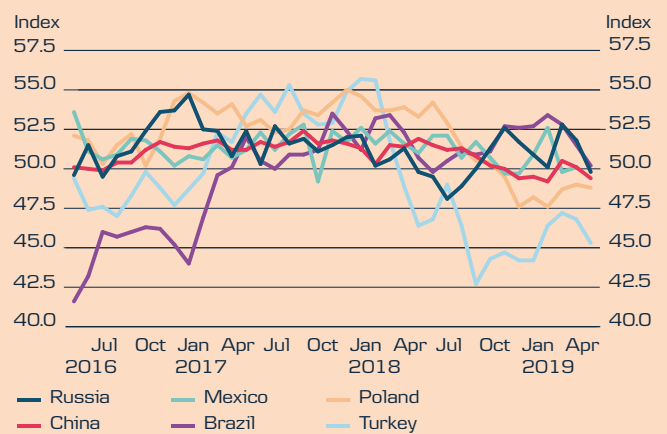
see short-term downside risks for emerging markets from the trade-war effect on foreign trade and fixed investments, while domestic demand across emerging markets and especially in China should mitigate the slowdown. While China's slowdown would bring relief to commodity markets and notable relief for net oil importers such as India and Turkey, geopolitical confrontation amid Iran and the US could jeopardize oil supply flows from the Middle East offsetting economic weakness effect on the crude. We believe sanction risks will remain topical for China, Hungary, India, Iran, Poland, Russia, Saudi Arabia, Turkey and Venezuela.

Macro forecasts - Emerging markets

% y/y	2018	2019	2020	2021
Emerging Markets of which	4.5	4.2	4.6	4.7
China	6.6	6.2	6.1	6.1
India	7.3	7.3	7.5	7.5
Russia	2.3	1.3	1.8	2.4
Brazil	1.1	1.2	2.1	2.3
Turkey	3.2	-2.0	1.7	3.0
South Africa (SA)	0.8	0.7	1.9	2.2
Poland	5.1	4.2	4.0	2.7
Hungary	4.9	3.5	2.7	2.3
Czech Republic	5.1	3.5	4.1	0.0

Source: Danske Bank and Macrobond

Manufacturing PMIs in many emerging markets have closely followed developments in China



Source: Bloomberg, Macrobond Financial, Danske Bank

Disclosures

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Report completed: 7 June 2019, 15:30 CEST

Report first disseminated: 10 June 2019, 20:00 CEST

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