02 June 2022

Big Picture

A (mild) recession in western economies seems unavoidable

Key takeaways

- **The war in Ukraine is contributing to the biggest commodity price shock in decades, adding to already significant inflation pressures and need for vigilant central bank tightening.**
- **Yet near-term economic growth will continue to be supported by pent-up demand, savings, and the re-opening of economies, benefiting especially service sector activity.**
- **However, substantial monetary policy tightening will increasingly weigh on economic growth, prompting a mild recession in the US around Q2 23, spilling over to other western economies and EMs later next year.**
- **Recovery in the Chinese economy in 23 will mitigate some of the setback, but still we expect unemployment to rise in the US and later in other western economies.**
- **The risk is skewed toward an earlier recession given the scale of financial tightening and erosion of purchasing power from high inflation.**

The global economy is facing a series of negative supply shocks

The global economy is finding itself in a difficult place. The war in Ukraine and the sanctions against Russia are providing a new hit to the global economy, notably through higher food and energy prices, just as most western economies are emerging from the COVID-19 pandemic. At the same time, new COVID-19 outbreaks in China are not only hitting the Chinese economy, but also creating new challenges to global supply chains, as well as hitting countries with large export shares in the Chinese markets, such as the euro area.

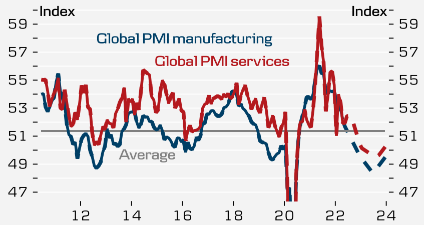
While the global economy is facing new headwinds, current growth momentum remains relatively strong in western economies. Despite waning goods consumption, service sector activity remains high due to pent-up demand after the re-opening of economies. Although the high inflation is reducing real purchasing power, causing significant setbacks in consumer sentiment, consumers are holding up consumption using accumulated savings during the pandemic and from government transfers. Investment growth in the US has been strong on the back of the pandemic, but still has some catch-up to do in the euro area. Overall, manufacturing activity is waning while the service sector is still seeing solid growth (albeit some countries like UK and US have seen setbacks in the service PMIs).

The average quarterly growth in US, euro area and Japan is estimated to be 0.6% in Q2. The Chinese economy is however witnessing a significant drop in economic activity primarily relating to lockdowns to contain the spread of the COVID-19 virus; we estimate that the Chinese economy will contract by 1.0% in Q2.

Other readings

- *Research Global - Five trends to drive the global economy regardless of the outcome of the war in Ukraine*, 18 May

Manufacturing sector will be hit the hardest



Source: Markit, Macrobond Financial, Danske Bank

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We expect to see a mild recession next year

GDP	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2022		2023	
	q/q, %								y/y, %			
Euro Area	0.3%	0.1%	0.3%	0.5%	0.7%	0.7%	0.2%	-0.3%	2.5% (2.5%)	➔	1.8% (2.8%)	↘
China	1.3%	-1.0%	1.8%	1.7%	1.7%	1.3%	1.3%	1.3%	3.7% (4.7%)	↘	5.7% (5.3%)	↗
US	-0.4%	0.7%	0.5%	0.4%	0.2%	-0.6%	-0.6%	-0.1%	2.4% (2.8%)	↘	0.1% (2.0%)	↘
Japan	-0.2%	1.1%	0.9%	0.8%	0.3%	0.2%	0.0%	-0.1%	1.7% (2.1%)	↘	1.8% (1.0%)	↗

Source: Macrobond Financial, Danske Bank

Parenthesis are the previous Danske Bank projections (from March 2022).

We see price pressures easing as economic growth slows, but inflation will still remain above target in the euro area and US

Inflation	2022		2023	
	y/y, %			
Euro Area	7.3% (7.0%)	↗	2.8% (2.0%)	↗
China	2.5% (3.0%)	↘	2.5% (2.5%)	➔
US	8.2% (7.2%)	↗	4.6% (3.0%)	↗
Japan	1.7% (1.6%)	↗	1.2% (1.1%)	↗

Source: Danske Bank

Parenthesis are the previous Danske Bank projections (from March 2022).

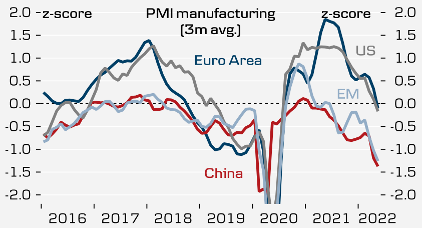
Surge in inflation prompts front-loading of monetary policy tightening

Western economies are seeing the strongest inflation pressures in decades. Inflation was already on the rise prior to the war, as a result of expansionary fiscal and monetary policies implemented in the wake of the COVID-19 crisis, supply chain problems, tight labour markets caused by strong demand and lower labour supply in the several western economies and the recovery in commodity prices.

The war in Ukraine and sanctions on Russia are adding to the inflation pressures. This is mainly due to higher commodity prices as Russia and Ukraine are key producers of many commodities such as oil/gas, metals and food products, exacerbating supply problems from years of underinvestment in the oil and gas and mining sectors. With these new supply side problems in combination with strong demand generated from policy stimulus, and re-opening of economies, the global economy is now facing the biggest commodity price shock since the late 1970s (see graph on the right). Given little spare capacity due to underinvestment, the supply and demand mismatch may point to further upside price pressures for many commodities, especially if the Chinese economy picks up speed, which would maintain commodity demand.

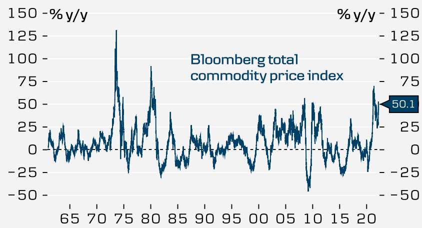
While inflation initially surged faster in the US, euro area inflation has caught up lately. In May, inflation in the euro area reached 8.1% and core inflation accelerated to 3.8%. While headline inflation is likely near its peak, underlying inflation pressures remain strong and broad-based both in the euro area as well as in the US. Importantly, core inflation has continued to pick up in seasonally adjusted m/m terms, increasing the pressure to tighten monetary policy. Market-based long-term inflation expectations have moderated

Waning momentum in the global manufacturing sector



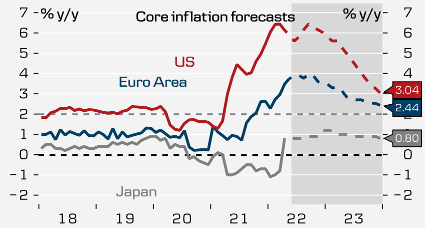
Source: Markit, ISM, Macrobond Financial, Danske Bank

Global economy hit by the biggest commodity price shock since the 1970s



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

US and euro area core inflation remaining above 2% also in 2023



Source: Macrobond Financial, Danske Bank recently, although they still remain above pre-war levels. Rising inflation expectations could have second-round effects in the wage setting dynamics, and early 2022 data points towards a pick-up in wage growth also in the euro area. China remains an exception in the global inflation picture, as price pressures still remain moderate.

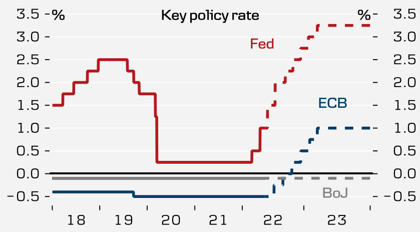
To reign in inflation pressures, central banks in both emerging and developed markets have started tightening monetary policies. We expect the Fed to hike interest rates by an additional cumulative 225 basis points while also embarking on a quick run-down of its balance sheet at a much faster pace than in 2017. The ECB will in our base-case raise its policy rates by four times of 25 basis point in 2022 (July, September, October and December) and twice in 2023 (February and March). On top of the tightening from rate hikes, the euro area markets will also see tightening from the lack of duration extraction (no new net asset purchases), TLTROs (LT) and the end of tiering. Bank of Japan is expected to maintain its yield curve control as inflation pressures are more muted, while the Chinese central bank will stimulate the economy in 2022 amid weak growth and inflation pressures. Looking ahead, we think the combination of policy tightening and the associated economic slowdown will cause inflation to fall back. However, the slowdown is going to be gradual and inflation will likely remain above central banks' targets longer than we previously anticipated. We forecast euro area core inflation falling below 2.5% only by the end of 2023.

Monetary policy tightening will lead to a significant global economic slowdown

Near-term we expect economic growth in western economies to hold up relatively well as the service sector continues to enjoy solid demand re-opening of economies and significant household savings. Hence, we expect the service sector growth to remain solid in both the US and euro area over the summer. Meanwhile we expect the manufacturing sector to slow further as goods demand slows and supply bottlenecks remain an issue. However, as the service sector accounts for roughly 70% of economic activity, job prospects will continue to remain good. The solid growth in western economies will outweigh lingering weakness in the Chinese economy, until policy support and re-opening begin to have an effect in early H2.

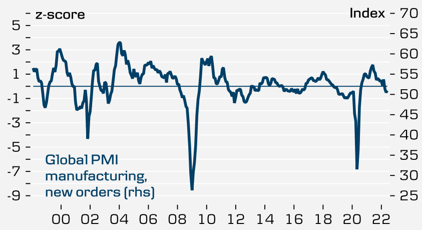
Given the scale of tightening of monetary policies, we think it is difficult for western economies to escape a recession. The monetary policy tightening in the US, involving both upfront large rate hikes and significant reduction in the Fed's balance sheet, is already leading to a substantial tightening of financial conditions through falling equity prices, wider credit spreads and higher mortgage yields, while high energy prices are also sapping consumer purchasing power. Typically this kind of tightening acts as a "growth tax" (see figure on the right) with 6-9 months lag and we therefore expect growth to be hit increasingly during the fall; private consumption will be hit by wealth effects from setbacks in housing and equity markets while private investments will also feel the pinch from higher interest rates. As a result, we see the US economy falling into a mild recession in the early parts of 2023, although the exact timing is difficult to pinpoint due to lingering effects from high savings and pent-up demand from the COVID crisis. Furthermore, given the amount of unfilled positions (two for every unemployed), economic growth can be weak for some quarters without it leading to higher unemployment. However, given the economic backlash, we expect unemployment to creep higher in the US and later in other western economies in 2023.

We look for aggressive but short tightening cycles by both Fed and ECB



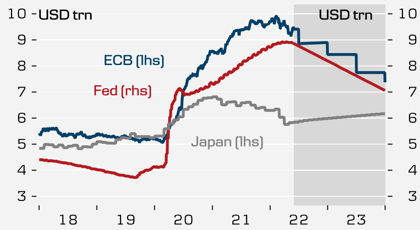
Note: Past performance is not a reliable indicator of current or future results
Source: Fed. ECB, Bank of Japan, Macrobond Financial, Danske Bank

The tightening of financial conditions and high oil prices will be a significant drag on growth



Note: Impulse includes 6m changes in stocks, credit spread, mortgage rate and oil price
Source: Bloomberg

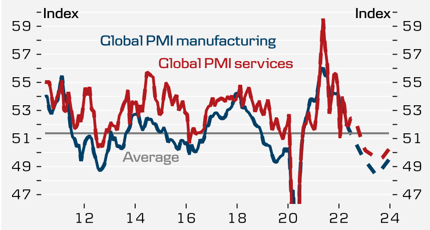
We expect Fed and ECB balance sheets to shrink, while BoJ will stick to more dovish policy



Source: Macrobond Financial, ECB, Fed, Bank of Japan, Danske Bank

An economic setback in the US will have spill over effects on the rest of the global economy later in 2023; indeed over the past three decades, a US recession has also forced a recession in the euro area. The euro area will also face growth headwinds from ECB's own tightening, although the scale will be less pronounced than in the US. However, we do expect the euro area to see substantial growth slowdown or even a recession in H2 2023. Another headwind to growth comes from the significant erosion of real wages, as households' excess savings are increasingly depleted. Part of the economic setback especially in Europe will be offset by a pick-up in economic growth in China in H2 2022 supported by the current policy stimulus. However, this will only partly outweigh the impact of monetary policy tightening in western economies.

Manufacturing sector will be hit the hardest



Source: Markit, Macrobond Financial, Danske Bank

Risks are skewed towards an earlier and deeper recession

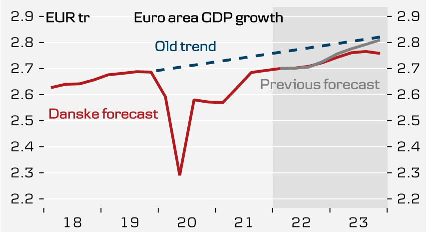
The global economy is facing a combination of shocks that are putting it in unchartered waters. While we are factoring a hit to growth from the financial tightening and erosion of household purchasing power, the combination of tightening monetary policies and weakening growth together with the record high debt burden following the COVID-crisis can easily cause significant fall-outs in credit and sovereign debt markets similar to global financial and debt crises in 2008-11. This can provide large negative feedback loops to the economy as it will constrain banks' ability to provide credit, thereby exacerbating the economic setback**.** In a downside risk scenario with financial market backlash and/or faster tigthening of monetary policies than assumed in our baseline scenario**, the western economies will fall into an earlier recession, likely around the end of this year, and the setback may also be bigger than in our baseline. We see risks particularly to the downside in the euro area in H2 2023 as it may be hit earlier than assumed by the US recession and the ongoing struggle to wean itself of Russian energy supplies**.

There may also be upside risks from 1) a stronger than expected recovery in china, 2) resilient private consumption given excess savings and 3) central banks trying to stabilise output at the expense of higher inflation.

Euro area: growing external headwinds

With its geographical proximity to Russia and Ukraine, heavy reliance on imported fossil fuels and high integration in global value chains, the euro area economy finds itself in the perfect storm. In light of renewed supply chain disruptions and rising consumer headwinds from accelerating inflation pressures, the growth momentum held up better than feared in Q1 22 (0.3% q/q). However, it also remains a two-speed economy: **While a slowdown in manufacturing looms during Q2, rebounding service activity after the lifting of pandemic restrictions is compensating for the weakness.** Despite sharp declines in consumer confidence, we do not think the euro area is headed for recession in the near-term. We look for a broad growth stagnation during the coming quarters, as government measures to offset high energy prices (ca. 0.5% of GDP) and pandemic savings (currently standing at ca. EUR 600bn) support private consumption. The possibility of a sudden Russian gas supply stop constitutes a significant downside risk (especially for manufacturing in Germany and Italy), that could shave off 2.5pp of GDP in 2022 and 1pp in 2023 according to the *EU Commission*, while further lifting inflation by another 1-3pp.

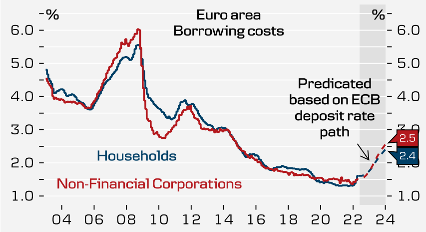
Increasing recession risk for 2023



Source: Eurostat, Macrobond, Financial, Danske Bank

Going into 2023, the outlook for the euro area becomes more uncertain amid rising external headwinds. We project a moderate growth rebound with the turn of the year, as economic activity remains supported by an improving labour market, easing supply chain disruptions and accelerated investment spending on defence and the green transition. NGEU funding will boost euro area GDP by around 0.5% in 2023 according to *ECB estimates* and under its *REPowerEU plan*, the Commission has outlined additional investment needs of EUR 300bn until 2030 (read more below). That said, heightened

Rise in borrowing costs on the back of ECB hikes should be manageable



Source: ECB, Macrobond, Financial, Danske Bank uncertainty around the unfolding of the geopolitical situation and its impact on demand could weigh on companies' investment decisions and lingering supply shortages might also delay the implementation of investment plans.

Labour demand remains high and we expect employment growth to continue over the forecast horizon, although at a slowing pace. While real wages will see a sharp decline this year, we look for a moderate increase in 2023 that should keep a hand under consumer spending (read more about the outlook for wages in *Euro inflation notes - The wage conundrum*, 1 April). With the stabilization in commodity prices, headline inflation should peak in mid-2022 amid slowing energy inflation. However, **underlying inflation will remain uncomfortably high for ECB and we revise our core inflation outlook up to 3.5% on average in 2022 and 2.9% in 2023.** Rising input costs are still working their way through the pricing chain, keeping goods price inflation elevated well into 2023 in our view. Service price inflation also remains supported by pent-up demand for travel and recreational services and the outlook for stronger wage growth in 2023. Overall, we project HICP inflation to remain above the ECB's target, averaging 7.3% in 2022 and 2.8% in 2023.

With ECB becoming increasingly concerned about the risk of de-anchoring inflation expectations, **we look for a first 25bp hike in July, followed by consecutive hikes in September, October, December, February and a last hike in March 2023, taking the policy rate back to 1.0%.** Despite QE reinvestments continuing at least until 2024, liquidity tightening (up to EUR 1.5tr could be withdrawn by end-2023 through TLTRO repayments) will further reduce monetary accommodation. The implied rise in borrowing costs for households and firms seems manageable (see chart), but in combination with less supportive fiscal policies will weigh on domestic demand in our view.

As we look for aggressive Fed tightening to push the US economy into recession in Q2 23, we also expect weaker foreign demand to weigh significantly on the euro area growth momentum and see an elevated recession risk for H2 23. Consequently, following an expansion of 2.5% in 2022, we revise euro area GDP growth down to 1.8% in 2023 (2.8% previously).

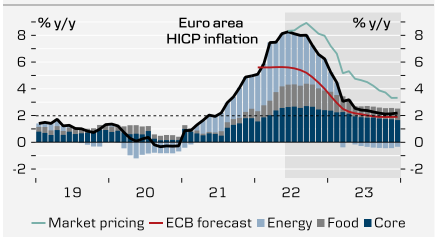
EU green transition: Ending reliance on Russian energy will not come without short-term pain

The war in Ukraine is speeding up the European green transition. Russia supplies approximately 40% of the EU's gas and 27% of its imported oil. Massive investments in green transition were already in the pipeline before Russia started its war on Ukraine, and in late May, **the EU commission announced a *REPowerEU plan* where it intends to mobilize up to EUR300 billion by 2030 for the EU to become independent of Russian energy imports**. The measures will focus on 1) energy efficiency, 2) diversification of energy supplies, and 3) accelerated roll-out of renewable energy to replace fossil fuels in homes, industry and power generation.

The EU plan consists of approximately EUR72 bn in grants and EUR225 bn in loans targeting up to EUR10 bn investments into gas infrastructure, up to EUR2 bn investments into oil infrastructure with a view to stopping the shipment of Russian oil. According to Commission President von der Leyen, all the rest of the financing will go into speeding and scaling up clean energy.

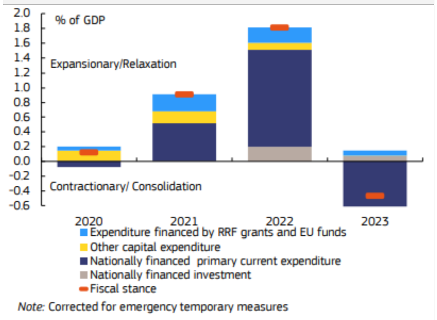
A complete transformation of an energy system can typically take decades, as there is a multi-year lag between an investment decision and having new capacity in use. Hence, energy savings are the fastest and most affordable way to tackle the current energy crisis. In the new EU plan, the bloc's energy efficiency target for 2030 will be

Inflation remains uncomfortably high



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

Fiscal headwinds are growing



Source: EU Commission

The new EU plan to reduce reliance on Russian energy

- EUR 300bn invested in energy efficiency, diversification of energy supplies and renewable energy by 2030.
- Energy system transformations take time, and during transition period, the easiest and most low-cost way to tackle the ongoing energy crisis is by improving energy efficiency.
- Russia has already cut off gas deliveries to some EU countries and more disruptions are expected. The EU is looking for alternative sources but, towards next winter, gas prices are likely to remain elevated and volatile.
- Supportive policies will ensure a favourable environment for green investments going forward. Businesses enabling the transition and providing the right solutions are likely to benefit from sustained capital inflows.

increased from 9% to 13%, and the 2030 target for EU renewable energy from 40% to 45%. In this context, *the Commission also recommends* behavioural changes for citizens in member states and encourages fiscal measures such as reduced VAT rates to promote the deployment of energy efficient solutions. Reducing heating temperatures at home, driving more economically and shifting to more public transport, using household appliances and air-conditioning more efficiently and switching off the lights can deliver substantial, short-term savings. According to IEA, such measures could cut oil and gas demand by 5% over a year.

The second part of the new EU plan focuses on diversifying energy supplies. There is a plan to cut demand for Russian gas by two-thirds by the end of 2022. Russia has already cut off gas supplies to some EU member states, such as Poland, Bulgaria and Finland and more disruptions are likely. During the last months, the EU has managed to secure record levels of LNG imports and higher pipeline deliveries to compensate for the lower imports from Russia. Going forward, the EU will develop a joint purchasing mechanism to negotiate and contract gas and renewable hydrogen purchases on behalf of participating member states. While we think joint efforts are helpful at best, they are also voluntary, and hence, may not prevent a scenario where EU countries end up competing against each other in tight markets, leading to increased price volatility and higher prices.

The third part of the new EU plan calls for a massive scaling-up and speeding-up of renewable energy in power generation, industry, buildings and transport. The Commission proposes to increase the headline 2030 target for renewables from 40% to 45%. The plan includes doubling of solar photovoltaic capacity by 2025 and a Solar Rooftop Initiative with a phased-in legal obligation for solar panel installations on new buildings. The plan also entails doubling the rate of deployment of heat pumps, tackling the slow and complex permitting processes of renewable projects and a target of 10 million tonnes of domestic hydrogen production to replace fossil fuels, and decarbonise industries and transport sectors.

Looking at the current plans across major EU economies and the Nordics, the investment pipeline includes projects targeting renewable energy infrastructure, energy storing and electrification of industries and transportation. The current political support should ensure a favourable environment for such investments going forward amid accelerated planning processes, and capital inflows and investments are expected to benefit businesses that enable such technologies and solutions over the next few years.

In the coming years, green transition could fuel more persistent price pressures, or at least, contribute to more volatility in headline inflation through supply-demand mismatches in raw materials, despite green energy being cheaper than fossil energy. *The IEA has estimated* that sustainable development scenarios imply a scale of demand growth for metals and minerals well above the levels seen in recent decades. Electrification will require large amounts of industrial metals such as nickel and cobalt, whose average demand growth is expected two and five times higher in the period to 2040 compared to levels seen in 2010. And while clean energy is cheaper than fossil energy in the long run, increased volatility in metal prices as a result from supply-demand mismatches could, at times, contribute to upwards inflation pressures (read more in *Research Euro Area - Europe's green transition: the heat is on for euro inflation*, 16 September 2021).

Over time, green investments support growth and could buffer economies in case we end up in a new 'cold war' period where a collapse in confidence hampers private investments and consumption, as focus on energy self-sufficiency is likely to dominate even in such a negative scenario. In the best case, focus on green innovations and new technologies will boost productivity, raising the potential of an economy longer term.

However, in the short run, we see the ongoing energy crisis and the cut-off from Russian energy posing more downside than upside risks to growth in Europe. While consumption will take a hit from the elevated energy prices and the erosion of real income, the impact on European industries from a complete cut-off from Russian gas would be devastating at worst. Petro-chemical industry is the most vulnerable, and several industries that use raw materials produced from hydrocarbon molecules, such as agriculture and food, cosmetics, pharmaceuticals, automotive, construction, packaging and electronics would ultimately be affected. Europe can, and eventually will, end its reliance from Russian energy but the short-term energy and material transition will not be without pain.

US: a recession seems unavoidable

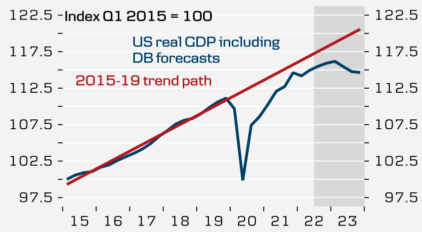
According to the latest data, the US economy is still in the middle of a solid expansion. US GDP fell in Q1 2022 but a drop in exports and a negative contribution from inventories mostly drove it, as domestic demand was solid. **Real GDP remains below the old 2015-19 trend path but that is because of permanent damages to the economy created by (among other things) the COVID-19 crisis**, which led to a decline in labour force participation. It is not unusual that crises lead to permanent GDP losses. Employment is still rising and labour demand remains strong, as the number of job openings is record-high.

The current level of inflation is at the highest level in 40 years and although inflation is now coming down (sharp price increases on certain items in 2021 are now starting to fall out), **underlying inflation pressure remains significantly above 2%.** Monthly increases in CPI core correspond to underlying inflation running around 5-6% annualised. Commodity prices remain high, businesses say they expect to raise prices in coming months, nominal wage growth is higher than before COVID-19 because of the tight labour market and inflation expectations are high. **The economic environment is overall very inflationary reflecting that aggregate demand is much higher than aggregate supply/production**.

Looking forward, we are not so sure that the expansion can continue for so much longer. There are many headwinds facing the US economy and it is difficult not to see an economic slowdown down the road. It is, unfortunately, very difficult to predict the timing, depth and length of a recession. In our base case, we pencil in a mild-to-average recession starting in Q2 2023, but some indicators suggest that it may come earlier. Historically, the US has fallen into recession whenever inflation has increased to or above 5%.

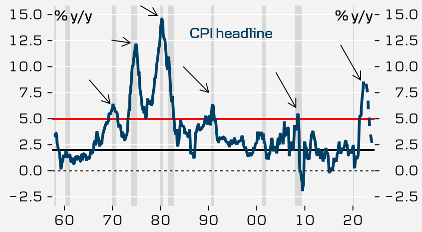
In our view, the biggest headwind to growth is the significant tightening of monetary and financial conditions. Underlying inflation pressure is simply too high for the Federal Reserve, which explains why the Fed is front-loading rate hikes. The Fed hiked by 50bp in May, which was the biggest rate hike since May 2000, and **the Fed signals that base case is at least two more 50bp rate hikes at the next meetings**. Simultaneously the Fed is shrinking the balance sheet at a rapid pace. The inconvenient true is that demand is too high relative to supply and the Fed needs to bring it down in order to get inflation under control and the problem is **that financial conditions remain too easy despite markets are pricing in a lot of Fed rate hikes this year**. Easy financial conditions may force the Fed to follow the "emerging market central bank" playbook by out-hiking expectations, which would only increase the risk of a recession.

We expect the US to fall into recession in Q2 2023



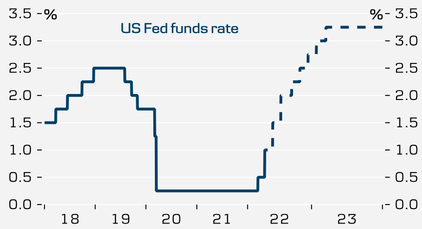
Sources: BEA, Macrobond Financial, Danske Bank forecasts

US usually falls into recession after inflation increases to above 5%



Note: Grey areas are US recessions (NBER)
Sources: BLS, Macrobond Financial, Danske Bank forecasts

The Fed will continue to hike by 50bp at the next two meetings (at least)



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

There are also other headwinds facing the US economy. Despite higher nominal wage growth, **consumers are hit by the biggest negative real wage growth since the 70s because nominal wage growth is not high enough to compensate for very high inflation.** Negative real wage growth is a significant headwind to private consumption (the most important driver of growth). **The joker is the significant accumulation of savings** during the COVID-19 crisis, which means that households are more robust financially. Unfortunately, it is difficult to say how liquid savings are and in our view it is a bad sign that consumer credit growth is accelerating at a very fast pace currently. **High inflation also explains why we have seen a significant drop in consumer confidence and the index from the University of Michigan is now in recession territory**, although there is a gap between the Michigan and the Conference Board measures. **Another headwind is rising mortgage rates**, which is likely to slow the housing market, although low inventories are pushing in the other direction.

Overall, we forecast US GDP growth of 2.4% this year and 0.1% next year.

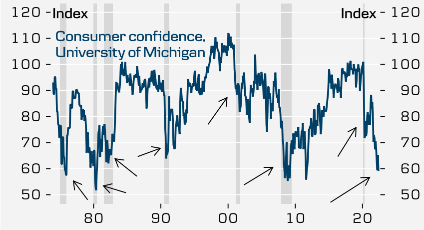
China: significant growth challenges

China is facing some of the most severe headwinds to the economy since the Global Financial Crisis. It has sent the economy into what can be characterised as a Chinese recession with activity and employment under severe downside pressure. The list of growth challenges is long:

1. **New covid outbreaks** has led to a long and severe lockdown in Shanghai and other areas have struggled to contain waves of covid cases.
2. **A deep property crisis** continues to be a big drag on activity and the recent covid outbreaks have provided new challenges in lifting home buyer appetite. After a rebound in home sales in Q1, lockdowns in April and May led to a sharp decline in purchases. Most private developers are struggling to cover financing needs and at risk of default.
3. **New supply disruptions** have also resulted from the covid outbreaks and lockdowns. Delivery times domestically are again very long.
4. **Financial stress increased** following the outbreak of the Ukraine war, as it triggered fire sales of Chinese assets among foreign investors on fear that China could be hit by sanctions as well. While volatility has come down, asset prices are still at depressed levels still, which leaves little appetite for private companies to make new investments
5. **The Ukraine war has raised the risk of a global recession** and export orders are already under pressure. Exports were the main pillar of strength in the Chinese economy in 2021, but this sector looks set to face stiff headwinds over the coming quarters

On the back of the strong headwinds, the Chinese government has stepped up stimulus. Chinese President Xi Jinping has called for "*all-out efforts*" on infrastructure investments and Premier Li Keqiang stated recently there was a need for "*decisive action*" by provinces and highlighted that everyone should "*add a sense of urgency*" to counter "*further intensified new downside pressure*". Stimulus is launched across the board but with a focus on fiscal policy through infrastructure investments. Measures to support the housing market are also implemented and state banks are set to provide more funding for ailing developers. Finally, China has started to give out vouchers and coupons to households and look into extending subsidies for purchases of electric vehicles that are set to expire in 2022. Other incentives to spur consumption can be expected in the provinces.

Consumer confidence is in recession territory

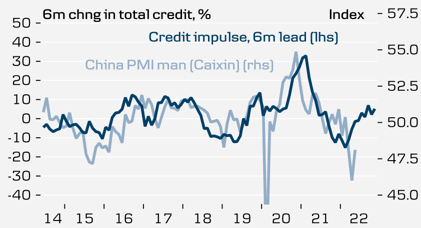


Sources: University of Michigan, Macrobond Financial

Sharp hit to consumption from lockdowns

Source: Macrobond Financial, NBS, PBOC, Danske Bank

Credit impulse should see a further lift in H2 on the back of more stimulus



Source: Macrobond Financial, NBS, PBOC, Danske Bank

Sharp downward revision to 2022 growth

GDP forecast	Danske Bank	Previous	Change
2022	3.7	4.7	-1.0
2023	5.7	5.3	0.4

Source: Danske Bank

The path from here will depend on how China manages to deal with future covid outbreaks. We see no signs China will leave the 'dynamic zero-covid policy' on this side of the Communist Party Congress in the autumn, which leaves a lot of uncertainty to the economic outlook. Another uncertainty is how much Chinese policy makers are willing to throw after getting closer to their 5.5% growth target. They do seem to have increased their sense of urgency and thus signals more willingness to step harder on the gas.

We now expect negative q/q growth in Q2 of -1.0% q/q and have revised down our GDP forecast for 2022 to 3.7% from 4.7%. We look for growth to remain weak in H2 on continued covid challenges and weak activity in property investments, manufacturing investments and exports. However, our baseline scenario is a gradual lift to growth during H2 driven by more significant stimulus measures and a 'normalisation effect' of activity in May and June from the harsh Shanghai lockdown in April and May. We also look for the drag from the property sector to ease gradually in H2. In our baseline scenario, we expect China to leave the zero-covid policy not long after the autumn CPC Congress, which should reduce the headwind on consumption and investments from regular outbreaks and lockdowns. We project export growth to be soft for most of the forecast horizon due to the weak global backdrop. **We see the internal drivers as the main swing factor, though, and have raised our GDP forecast for 2023 to 5.7% from 5.3% on the back of the domestic 'catch-up'. The risks to our outlook are skewed to the downside, especially stemming for more frequent 'hard lockdowns' than we project in the rest of 2022**.

Japan: Behind the pack

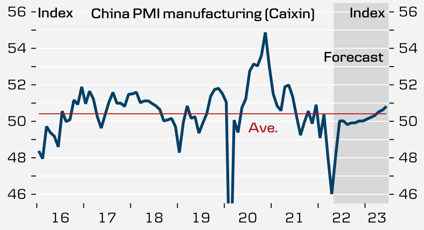
Japan is the worst post-pandemic performer among the G7 with still 3½% to go before GDP hits 2019Q3 levels. The Japanese economy went into recession already in 2019Q4 following a VAT hike and domestic demand has not recovered yet. Both private consumption and investments have been weak largely affected by the soft lockdowns throughout the pandemic. Exporters are currently struggling with Chinese lockdowns.

Along with surging import prices, this has caused a serious deterioration in the trade balance recently. Overall, exports have been the main growth driver though, driven by the global demand for goods but limited by lack of supplies.

Even with the unemployment rate at 2.5% there is still room for improvement in the labour market with employment still 750,000 persons below pre pandemic levels; a level that did not induce increased wage/price pressures. The labour shortage reported by businesses has increased but there remains some way to go to pre-pandemic levels and the jobs-to-applicants ratio has only returned to 2015 levels, still far off 2019 levels. **Thus, we still see slack on the labour market, which gives some growth potential for this year.**

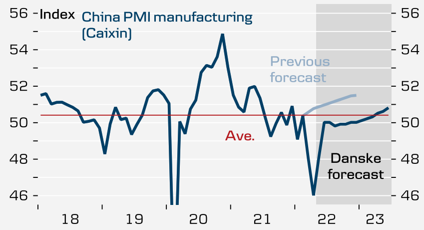
In Q2, reopening of particularly the service sector contributes to a nice growth rebound. Looking further ahead, the benefits of a weak currency should increase when supply constraints ease and exporters can start to enjoy the tailwinds from better competitiveness. We do not expect the economy to reach its potential (close the output gap) this year and we see a moderate recovery ahead. As high energy and food prices have started to erode consumers' purchasing power, we have seen consumer confidence decline. So far, there are no signs that businesses are increasing wages to compensate employees. According to a survey among 81 major Japanese companies made by the Japan Business Federation, the spring wage increase adds up to 2.27%, which is more than the

Weak growth rest of 2022 but a gradual lift back to trend



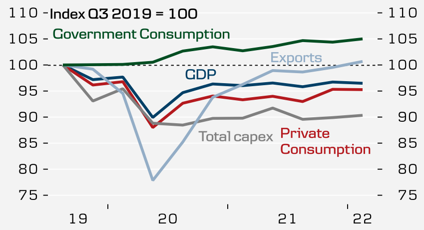
Source: Macrobond Financial, NBS, PBOC, Danske Bank

PMI to stay subdued in H1, recovering in H2 22



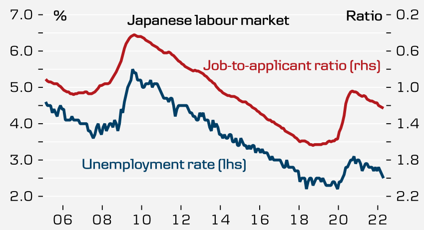
Source: Markit, Macrobond Financial, Danske Bank

Japan: Not recovered yet



Source: Japanese Cabinet Office, Macrobond Financial

Still some labour market slack

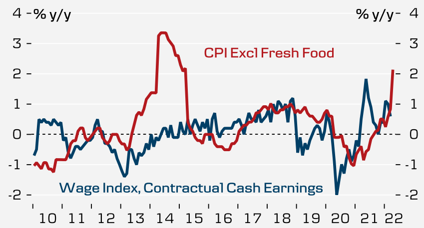


Source: Japanese Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

1.82% last year but still far from PM Kishida's targeted 3%. Considering how a significantly tighter labour market before the pandemic did not spur wage increases either, we believe we need to see a broader based inflation rise before we get spill over to the labour market. As long as businesses are not hiking prices, they will be inclined to keep costs low.

A price-wage spiral is exactly what the Bank of Japan is aiming for. Inflation has slowly started to climb higher. However, it is still only driven by energy and food. Companies are reporting higher input and output prices ahead, though. We expect inflation pressures to build slowly this year but we do not expect BoJ to reach their inflation target in a sustained manner that will allow them to loosen the grip on the yield curve. **We think it is most likely that a global slowdown will knock the air out of reflation in Japan before it comes to that.**

Real wages declining

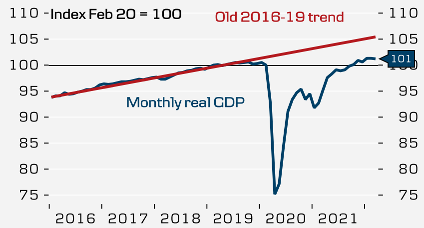


Source: Japanese Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

UK: Global factors dominate

It is difficult to say exactly what the current state of the UK economy is. On the one hand, there has been no economic growth from November 2021 to March 2022, according to the monthly GDP estimates. On the other hand, labour demand remains high and employment continues to increase. It is true that real GDP remains below the old 2015-19 trend path but it is because of permanent economic damages created by the COVID-19 crisis and Brexit (lower potential GDP). There was a lot of focus on the sharp decline in the PMI service index but it is too early to say whether it is a "true" or "false" signal. The index is more volatile by nature relative to the equivalent index for the euro area and the index was significantly higher than the euro area index for several months but that is something we need to monitor in coming months.

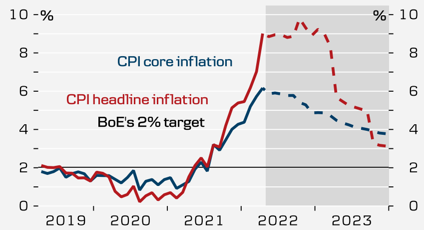
UK: Economic activity moved sideways from November to March



Sources: ONS, Macrobond Financial

The UK is facing the exact same problems as the euro area and the US are, as business cycles are correlated in the advanced economies. So also in the UK, the biggest problem is that inflation is simply too high. CPI headline reached 9.0% y/y in April and price increases are broad-based, as CPI core inflation rose to 6.2% y/y in April. Both headline and core inflation are higher than in the euro area. As a result, real wage growth is very negative and consumer confidence is the lowest on record (i.e. at least since 1974 according to the GfK survey), both are headwinds to private consumption going forward. Inflation is likely to remain high for quite some time, not least because the UK energy price cap is set to increase by 42% in October, according to the CEO of UK energy regulator Ofgem.

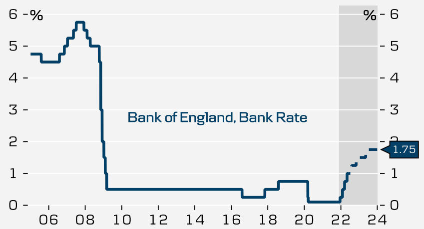
Inflation will remain high in coming years



Sources: ONS, Macrobond Financial, Danske Bank forecasts

The Bank of England (BoE) started hiking the Bank Rate in December 2021 and the Bank Rate is now at 1.00%. **We expect the BoE will continue to tighten monetary policy but most likely at a slower pace going forward.** While inflation is way too high for the BoE's taste, some of the policymakers are concerned about slower growth, so the forward guidance is not as strong, as it is the case for e.g. the Fed. We expect the BoE to hike by 25bp in June, August and November, which is dovish compared to current market pricing. Risk is, however, that the BoE will hike more than what we are pencilling in.

BoE will continue to hike rates until the recession hits



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

In our view, the UK cannot avoid a recession if the US and the euro area fall into one. Historically, the UK has fallen into recession whenever the US has. Since our key assumption for this global macro outlook is that the US falls into a recession in Q2 2023, we expect the UK economy will follow suit. Like in the US and in the euro area, we expect the recession will be a mild-to-average one.

Overall, we expect GDP growth of 4.0% this year and -0.2% next year.

We got what we would describe a "decent" Brexit with a free trade agreement (FTA) covering mostly goods. Businesses are getting used to the new trading regime and Brexit is no longer a market theme. However, that may not be the case for much longer. **The UK and the EU are still discussing the implementation of the Northern Ireland protocol and the UK threatens to make unilateral changes to the protocol. In the worst of worst cases, the EU may decide to pull out of the FTA, which would then basically restart the Brexit clock and the risk of no deal Brexit. We do not believe it will come down to this, as we have learned both sides are willing to compromise eventually**, but it is a risk we need to monitor in the coming year. We believe it is important to take into account that Brexit is more about domestic than foreign policy and Boris Johnson is under heavy pressure, also within the Conservative Party, because of the "partygate" scandal.

Emerging Markets: Looming global food crisis marks another shock

The war in Ukraine is sending yet another shockwave globally and will hit emerging markets at a challenging time. Tighter financial conditions, weaker external demand and high inflation all weigh on the EM economies. In longer term, demographic dividend and technological 'leapfrogging' continue to support the case for investing in EM, but ramifications from the pandemic and the war in Ukraine could hamper such investments if western businesses resort to broad-based near-sourcing of production and supply chains.

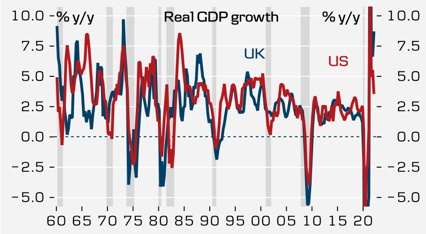
Economic activity in EM Europe is expected to contract this year while growth in EM Asia will slow down markedly. Same time, a growth rate near 4% in Sub-Saharan Africa is insufficient to produce better living standards for an average African. Given the recent weakness in the Chinese economy, we see downside risks to IMF's forecast of 5.4% growth for Asia this year. Weaker momentum in the Chinese manufacturing and the risk of US recession will also weigh on LatAm commodity exporters.

The war in Ukraine has severely disrupted supply chains of agricultural products. Russia and Ukraine combined have a substantial market share in several cereals such as wheat and barley, as well as in the global sunflower oil market. The disruptions together with weather-related shocks have lifted the FAO food price index to all-time highs. Concerning signals continue to mount as food-producing countries have recently started to implement export bans to ensure domestic food security.

The situation has similarities to 2008-09 when the world last grappled with a food crisis. Most EM and developing economies rely on food imports to feed their growing population and low-income countries in Africa and Asia are the most exposed to high prices and disruptions in trade. Majority of Ukraine's wheat exports target countries in Middle East and North Africa, leaving countries like Egypt and Turkey also vulnerable.

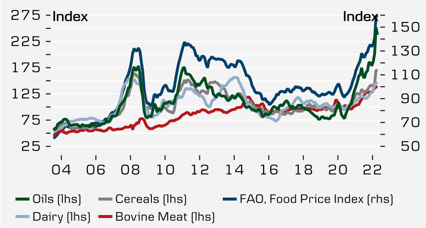
The continuous need to support the most vulnerable in the context of a protracted pandemic, and now, in the context of rising costs of living, will challenge EM public finances at a time when overall debt levels are at all-time highs and financing costs are rising on the back of tighter global financing conditions. The risk of further capital outflows raises the risk of debt rollover problems and local currency depreciation particularly for economies with unsustainable debt levels and twin deficits[1]. Real rates are negative across EM implying more tightening of local monetary policy is also needed. According to our estimates, economies most vulnerable to further outflows are the ones with the weakest external position, such as Sri Lanka, Egypt, India, Turkey and Brazil[2].

The UK and the US business cycles are highly correlated



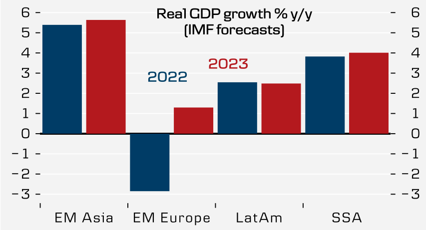
Sources: ONS, BEA, Macrobond Financial

Food prices are at all-time highs driven by oils and cereals



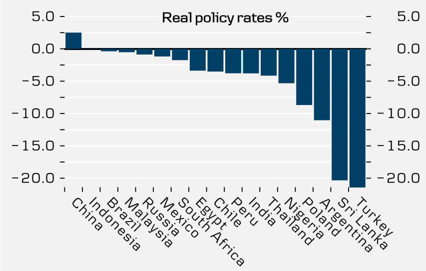
Source: FAO, Macrobond Financial

IMF WEO regional GDP projections



Source: IMF WEO, Macrobond Financial
SSA=Sub-Saharan Africa

Real rates are negative across EM implying more monetary policy tightening is needed

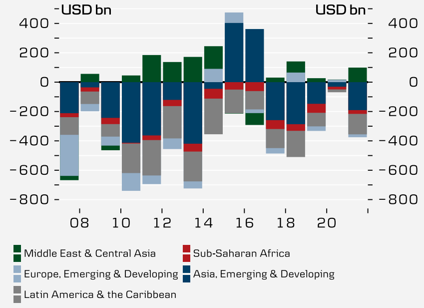


Source: National Central Banks, Macrobond Financial

1 Twin deficit = current account and budget deficits.
2 Danske Bank EM heatmap analysis takes into account a range of external vulnerability indicators such as debt-to-GDP, budget balance, net international investment position and FX reserves.

Risks of acute sovereign debt distress are concentrated on low-income countries, where direct spillover to global markets will likely be limited. In longer term, however, rising inequality, shocks related to climate-change and the food crisis raise the risk of social unrest. In the worst case, new conflicts and consequent humanitarian suffering trigger new waves of migration towards Europe, as was the case with the Syrian refugee crisis, the root causes of which trace back to food price riots ahead of Arab spring in 2010.

Total investment flows to EM have been negative since 2017



Source: IMF WEO, Macrobond Financial (net direct, portfolio and other investments, billion USD)

Disclosures

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Expected updates

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Date of first publication

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Report completed: 2 June 2022, 17:18 CET

Report first disseminated: 3 June 2022, 06:00 CET