The Big Picture
Fragile recovery from 2015 slump

• US economy back to cruising speed as ‘oil shock’ eases
• Euro area to continue at moderate growth pace
• Cyclical lift in China but medium-term challenges remain
• Main risk is UK Brexit, US election uncertainty looms
• G3 inflation set to rise as drag from oil fades
• The Fed to hike very slowly – ECB set to prolong QE further
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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 15 of this report.
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**Editorial deadline: 14 June 2016**

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**Macroeconomics:**

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*Where no other source is mentioned statistical sources are: Danske Bank, Datastream, Macrobond, OECD, IMF and other national statistical institutes as well as proprietary calculations.*
Global overview

Moderate recovery from 2015 slump

- In 2015 the global economy moved into a slump driven primarily by two factors: 1) a big decline in oil prices that gave a blow to US investment growth, 2) a hard landing in Chinese construction sector due to a big oversupply of houses. The slowdown spread to Emerging Markets outside China – especially commodity exporters.

- Both of the above drags have faded in 2016. Oil prices have recovered and Chinese construction is seeing a lift on the back of strong home sales and lower inventories.

- New uncertainty regarding Brexit and US election have come to the surface but overall the drags are so far smaller than last year and we predict a moderate recovery in 2016 and into 2017. The biggest risk is a Brexit.

Drags lifting – but political uncertainties remain

The global economy surprised to the downside in 2015 and early 2016. The US was pulled down by another drop in oil prices that put the economy at the brink of a new recession. Oil investment collapsed, banks started tightening credit standards and high yield spreads blew out. However, it seems that the worse may be over for the US economy and we forecast a gradual recovery from growth below 1% in Q1 to 2-2½% growth from Q2-Q4. Oil prices have increased lately from below USD30 per barrel to around USD50 per barrel. And energy investments can hardly fall further after the sharp drop last year.

Consumption growth have generally held up well in the US and kept the economy from slipping into recession. Recent weakness in the labour market has been raised as a rising recession risk. But it is in our view more an effect of the past slowdown in the US economy rather than a predictor of where US is heading. Very solid housing data and robust consumer spending is likely to keep US afloat around cruising speed rest of the year as the energy drag fades.

Another big headwind for the global economy in 2015 was a very hard landing in Chinese construction and industry. A massive oversupply of houses weighed on the construction sector and at the same time dealt a blow to global commodity markets that hit Emerging Markets commodity exporters. In 2016, though, inventory to sales levels in housing have normalized and home sales stayed very robust. This has paved the way for a recovery in Chinese construction growth. In combination with a boost to infrastructure this is lifting the overall economy. At the same time debt levels keep rising, though, and is increasing the concern over a financial crisis at some point in the future.

In the euro area growth has continued around cruising speed at 1-2%. Sentiment took a hit after the EM turmoil in January and is now held back by the Brexit risk. We look for some improvement in H2 as the Brexit risk fades if UK votes to remain in the EU as we expect.

While the Brexit risk should fade in H2 uncertainty over the US presidential election may take over as a cloud of worry for the global economy. Hence uncertainties will likely persist keeping a dent on global growth.
US
Consumption and less headwinds to keep engine running

- Although GDP growth once again disappointed in Q1 and recent jobs reports have been weak, we do not think the US is slowing significantly.

- We expect the economy to grow around 2.0-2.5% mainly driven by private consumption.

- The US faces less headwind than previously: USD has weakened, credit spreads are lower, oil prices have rebounded and China has stabilised.

- We still expect the Fed to hike again in September but risks are skewed towards a later hike.

Another disappointing Q1 GDP growth print

Once again, GDP growth in Q1 disappointed as it slowed to 0.8% q/q AR. While cold winters were to blame for the past two years, the winter was warm this year and thus the explanation lies somewhere else – we think the financial turmoil and significant drop in oil prices had a significant impact. Despite the slowdown in Q1 and weak jobs reports, we do not think the economic upturn has come to an end: Q2 data released so far has shown that the domestic economy has picked up again.

We expect the US to grow around 2.0-2.5% driven mainly by private consumption. Also, the economy faces less headwind than previously: USD has weakened, credit spreads are lower, oil prices have rebounded and China has stabilised. One major risk factor is the UK’s EU referendum, as Europe risks falling into a technical recession in case of a ‘Brexit’. The US is not immune to negative shocks from other economies and lower economic growth in Europe would hit the US too, as was the case during the European debt crisis. Another political risk factor is the upcoming US presidential election in November although we do not think it will have a significant impact on the economy.

Private consumption the main growth driver

Private consumption growth moderated to 1.9% q/q AR in Q1 despite a boost from low gasoline prices. It is likely that the impact on private consumption from the lower gasoline prices is slower than we previously assumed. Also, the financial turmoil at the beginning of the year could have affected consumption negatively. In March, the savings rate rose to 5.9%, the highest since 2012-13.

Although private consumption slowed in Q1, the retail sales report for May showed that private consumption has rebounded sharply in Q2, supporting our view that the weakness in Q1 was only temporary. Based on data releases so far, private consumption has grown around 4.0% q/q AR in Q2. We are still positive on the consumption outlook for coming years. The combination of increasing employment, positive real wage growth, housing market recovery and high consumer confidence means that we look for private consumption growth of 2.4% q/q AR in coming quarters.
Sharp fall in oil investments has been a drag

Private fixed investments pulled GDP growth down in Q1 as they fell 1.5% q/q AR - both investments in structures and equipment fell 9% q/q AR in Q1. While the financial turmoil at the beginning of the year is likely to have had an impact through lower risk sentiment, we think the significant drop in oil investments is an important explanation. Investments in shafts and wells declined 86% q/q AR in Q1 16 and are currently at the lowest level since the data series began in Q1 1999 – 70% below the top in Q4 14. The main reason for the sharp fall in oil investments is the big drop in oil prices, which have made oil investments unprofitable. While the oil sector alone accounts only for a small share of the economy, there has been an indirect impact on the rest of the economy as the oil sector has been a purchaser of capex goods. As oil prices have rebounded we think oil investments will stabilise in H2 16 and that the rest of the economy will experience less headwind from here on in. It is also important to note that the decline in oil investments is likely to be a one-off shock, to which the economy needs to adjust. The weaker USD and stabilisation in China also support investments throughout our forecast horizon.

While capex investments are struggling, residential investments are doing much better as the housing market has continued to recover. Residential investments rose 17% q/q AR in Q1 16, the highest since Q4 12. As we expect the housing market to continue to recover supported by, among other things, low rates and increasing employment, we anticipate residential investments will continue to rise at a solid pace.

We expect employment growth to pick up again

There was almost nothing good in the latest jobs report for May and the jobs report for April was not strong either. Employment rose only by 38,000, the lowest since 2010 (dragged down 35,000, however, by a Verizon strike). It is not easy to find good explanations for the weak reports. Two negative reports in a row could be a warning that the economy is slowing. The weak jobs reports could also be a result of the economic slowdown in Q4 15 and Q1 16 where employment growth was high despite weak GDP growth. We cannot rule out that it is due to pure volatility either. It is not the first time that we have been negatively surprised by a weak jobs report one month and positively surprised over a strong one the next. Overall, and given other strong economic data, we do not think this is a sign of a significant slowdown in the US economy – at least, we need more data to support this.

We expect employment growth to pick up again although it will remain lower than in 2014 and 2015 as we are very close to full employment. We expect employment to rise around 175,000 per month in the coming years, which means we expect a pick-up in productivity growth to ensure growth around 2.0-2.5%. Employment growth of around 175,000 per month is enough to ensure that the unemployment rate will continue to decline as we do not expect to see a major pick-up in participation rates. We expect the unemployment rate to reach 4.4% by year-end next year.

The tighter labour market has already led to higher wage inflation although it continues to stay relatively moderate. As we expect the labour market to tighten further, we also expect increasing wage pressure, which should help push core inflation further up. We expect PCE core inflation to crawl slowly to 1.9% y/y over the forecast horizon. We also expect headline inflation to move up as the base
effects from the oil price drop begin to fall out and as we expect food prices to rise at a higher pace.

**Fed could still hike in September but risks skewed towards a later hike**

Before the very weak jobs report the Fed was preparing markets for an upcoming hike in either June or July. In her latest speech, Fed chair Janet Yellen did not repeat that a hike 'in coming months' could be appropriate and she highlighted the downside risks to the US economic outlook although she still thinks the positive factors outweigh the negative. She mentioned that while the jobs report 'was, on balance, concerning' she thinks that 'one should never attach too much significance to any single monthly report'. Thus, it seems the Fed has adopted a 'wait and see' approach and it seems too early for the Fed to change its economic outlook significantly at this point.

We still think that the Fed will raise rates in September but that risks are currently skewed towards a later hike, as it would probably require a rebound in employment and that the UK remains in the EU. If this is the case, the Fed could prepare markets for a September hike at the July meeting. If September is off the table, the next possibility seems to be December, as the November meeting is less than a week before the US presidential election. If the UK votes to leave the EU, the second hike could be delayed even further.

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**Macro forecasts - US**

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

Source: BEA, BLS, CBO, IMF, Danske Bank
Euro area

Rising inflation – but ECB will do more

- The euro area recovery continues despite global growth weakness and financial turmoil. Looking ahead we expect stronger support from investments but some loss of momentum in private consumption.
- The unemployment rate remains on a clear downward trend and is only 0.5pp from the estimated structural level. When this level is reached, wage growth should pick-up, but slack in the labour market may delay this.
- We expect inflation to increase sharply during the rest of the year as the drag from the oil price fades. Core inflation is set to remain subdued, hence the ECB should not conclude inflation is on a sustainable path to 2%.
- The ECB will, in our view, prolong its QE purchases but in terms of rate cuts, we believe it has come to the end of easing. The QE extension is most likely after the summer as the ECB is now in implementation mode.

Weaker consumption, stronger investments

The euro area economy has expanded for three years in a row and we expect the domestic driven recovery to continue within our forecast horizon. Since mid-2014, when the oil price started to decline and employment growth picked-up speed, private consumption has added 0.25pp to quarterly GDP growth, which is around the contribution before the crisis kicked-in. Looking ahead, we expect less support from consumer spending due to the rise in the oil price but as a result of progress in the labour market we still anticipate a positive contribution to economic activity.

The expected slowdown in private consumption should not imply that the recovery will derail, as we expect growth in investments will strengthen in H2. This should follow for a number of reasons:

1. Business sentiment should improve and uncertainty should fade after the UK referendum, as we expect the UK to remain part of the EU.
2. Domestic demand has been supportive for a long time, but foreign demand should also start to contribute due to the progress in the US and China.
3. External financing is more available while the costs of borrowing are historically low and thus support the investment decision.
4. Investments have only recovered modestly following the crisis implying that the need to modernise the capital stock is currently very high.

Overall we look for GDP growth of 1.6% in 2016 increasing to 1.7% in 2017. Compared to consensus expectations our projection is 0.1 percentage point above for both 2016 and 2017. That said, our forecasts are based on the UK remaining in the EU and in the case of a Brexit, there is a very high binary risk as we believe it will result in a negative business confidence, which could result in declining investments and a GDP forecast of 1.2% in 2016 and 0.7% in 2017.
The lowest unemployment rate in nearly five years

The unemployment rate has reached the lowest level since 2011 and although the rate of 10.2% in April at a first glance seems very high, this is only 0.5pp from the European Commission’s estimate of the structural level. According to our forecast for the actual unemployment rate, the structural level of 9.7% should be reached as soon as Q1 17.

When the structural unemployment rate is reached, upward pressure on wages should – from a theoretical perspective – start to pick-up, but we expect that it will take somewhat longer before wage growth improves significantly. This is because we believe that the structural unemployment rate is likely to be revised lower as it is approached. Further, the unemployment rate does not reveal the level of slack in the labour market, which is observed in a low participation rate among prime age males and a high share of involuntary part-time employment. Finally due to the rigidity in wages it might take longer before the indirect impact from the past decline in inflation vanishes. The indirect impact on wages follows from a combination of indexation and weaker nominal wage gaining power under low price increases.

Will much needed structural reform kill the recovery?

Among international organisations there is a considerable focus on the need for structural reform aiming at lifting the potential growth of the economy and lowering the high structural unemployment rate. That said, the need for reform varies greatly across the euro area countries: Spain, Italy and Portugal need to tackle their high long-term and youth unemployment rate while Germany should focus on increasing productivity in the service sector. However, there is a common need for credible reforms that satisfy fiscal budget constraints and do not worsen confidence or hurt the ongoing recovery in other ways. To avoid such a scenario, one option would be to relocate public spending to investments in infrastructure as this would boost potential growth and at the same time increase short-term demand.

Inflation should rise sharply, but not sustainably

Following four months of negative inflation prints, we expect a significant increase in inflation during the rest of the year. We look for inflation at 1.0% in December this year rising further to 1.5% in February next year after a period when inflation has not been above 1.0% for four consecutive years.

The sharp increase in inflation reflects a fading drag from energy prices after the oil price has risen to the highest level since the end of 2015. Our inflation forecast is based on a continued slow increase in the oil price and based on this path, headline inflation should peak in Q117 reflecting the strongest support from base effects when the oil price was at its lowest level at the beginning of 2016. After this, headline inflation should decline slightly before stabilising just above 1.0%.

A more sustained increase in headline inflation requires that core inflation also picks-up from the current low level. We do believe, that it will increase slowly towards the end of this year as the stronger recovery and lower unemployment rate support the domestic driven part of core inflation. However in the near term, we estimate that such support will be countered by a negative impact from the stronger effective euro while there should also be a continued downward pressure due to a lagged, indirect impact from the oil price decline via production costs.
ECB in implementation mode until after the summer

The ECB is currently focused on the implementation of the rather aggressive easing package announced in March which included a cut in the deposit rate to -40bp, an increase in the monthly QE purchases from EUR60bn to EUR80bn – plus corporate bond purchases – and a series of loans to the banks (TLTRO-II). The higher QE purchases started in April, but corporate bonds were not included until 8 June and the first TLTRO-II auction is scheduled for the end of this month.

While waiting for these measures to be implemented the ECB expressed a patient view and argued that it was focused on the effects of the measures that had been taken. The patient stance followed although the market is not convinced that the ECB had eased sufficiently, as reflected in the market-based measure of medium-term inflation expectations (5y5y inflation swaps) which are back around an historically low level of 1.4%.

We expect the ECB will ease again and we look for a QE extension as the ECB in our view will not see inflation on a sustainable path towards 2%. As mentioned above, we look for a significant increase in inflation starting from June this year, but the main driver is energy prices and this effect is set to fade in Q217. In our view, it could be that the ECB will extend the purchases by six months to September 2017 and also announce a future tapering, where monthly QE purchases are gradually lowered by EUR20bn per month before ending in January 2018.

We do not believe that the ECB will cut policy rates again after it stepped out of the currency war at the March meeting. Back then the choice of easing showed that the ECB’s focus had shifted from the interest rate and currency channel to the bank-lending and credit channel. In our view, this was an important step, as the bank lending channel plays a crucial role in the transmission of the monetary policy in the euro area where bank lending intermediates around 80% of credit flows. Based on this, we expect the announced easing will support the recovery, but it is not a quick fix in terms of generating higher inflation and owing to this, we believe the ECB will have to extend its QE purchase beyond March 2017.

Expectations for key figures and central banks over coming quarter

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1: Contribution to GDP growth, 2: Pct. of GDP, 3: End of period

Source: Eurostat, Danske Bank Markets.
China

Fragile cyclical recovery

- We look for a continued moderate recovery in Chinese activity over the coming quarters on the back of (a) stronger housing markets and (b) a gradual increase in export growth. This follows a period of a very hard landing in the Chinese industry and construction sector.

- While short-term growth is improving, China is still facing medium-term growth challenges from (a) overcapacity in many sectors, (b) a rising concern over debt levels and (c) a difficult transition from investment-led growth to consumer-driven growth. We continue to look for GDP growth of 6.7% in 2016 and 6.6% in 2017 in line with China’s growth target.

- While China is still facing growth challenges in coming years, a strong focus on technology, R&D and innovation will, in our view, ensure that it continues to climb the development ladder in the long term by increasing efficiency through the rising use of technology and a higher education level – the real long-term growth drivers for all economies catching up. Hence, long-term opportunities persist in China – not least within the consumer and service area.

- We look for CNY to continue to weaken on a trade-weighted basis over the next 12 months and there is a risk that outflows could pick up again at some point over the next one to two years.

Hard landing in industry and construction fading

The Chinese economy may on the surface have succeeded in securing a soft landing for the overall economy. However, this is mainly due to robust service sector growth. In the manufacturing and construction sectors, the development can only be characterised as a hard landing. Growth rates in these sectors combined moved from above 20% in early 2010 to 0% in late 2015 – worse than during the financial crisis in 2008/09 (chart 1). Being mainly exposed to the manufacturing and construction side of the economy, the Chinese slowdown has indeed felt like a very hard landing for the rest of the world.

However, in the early spring months China showed signs of a cyclical rebound driven by three factors: (1) a turn in construction spending, (2) a pick-up in infrastructure projects and (3) a tentative improvement in exports.

Housing activity was boosted by a significant decline in interest rates in 2015 and a reduction in the requirement for down payments for both first- and second-time buyers in September 2015 and again in February 2016. Home sales picked up sharply in response and helped reduce some of the big oversupply of houses that had sent growth rates in the construction sector sharply lower. The rising turnover in houses has paved the way for a turn in housing starts and construction growth (see Chart 3 and 4). We expect the turn in construction investment growth to continue in coming quarters driven by a scarcity of residential housing in the big tier-1 and tier-2 cities. Oversupply is still significant in tier 3 and tier 4 cities and construction is likely to stay in the doldrums for some time in these areas.
China is consuming about 50% of the world’s production of raw materials such as metals and a large portion of this goes to the construction sector. Hence, a recovery in this sector has underpinned these commodity prices and we look for this to continue in coming quarters (Chart 4). We expect this to have a moderate positive spill-over effect on emerging market commodity exporters such as Brazil and South Africa.

Exports are another source of gradual improvement. China is seeing some relief on two fronts in this area: first, the currency has turned from a sharp headwind in H1 15 to a tailwind following the recent depreciation of the trade-weighted CNY (see Chart 5). We look for the CNY to continue to weaken on a trade-weighted basis over the next 12 months with USD/CNY hitting 6.85 on 12M (currently 6.60) and EUR/CNY climbing to 8.08 (currently 7.42). Second, we expect a gradual recovery in the US to improve foreign demand. Our Chinese export indicator, based on the two PMI statistics, points to some improvement in the export sector – partly pulled by increased US manufacturing activity (Chart 7).

Finally, a boost to infrastructure spending is providing a lift to growth in the short term. But this is only a temporary effect, which is likely to taper off during H2.

Medium-term challenges remain

While China is experiencing a cyclical recovery in the short term, challenges remain in the medium term: May data for fixed asset investment surprised on the downside despite a pick-up in planned projects, suggesting that overcapacity is still weighing on investment activity in many areas (Chart 8).

Another increasing concern in China is the continued rapid build-up of debt. It is not so much the level that is worrying. While 250% of GDP sounds high, this is actually similar to countries such as the US, UK, France and Italy. However, what it worrying is the speed at which the debt keeps rising and that it has happened alongside a sharp downturn in the economy, leaving question marks over where the credit is actually going. China needs to transition to growth and become less dependent on debt and it is unclear how it will pull this off. Another concern is that non-performing loans will rise sharply and cause a financial crisis. We do not believe the short-term risk of a financial crisis is high as the financial system in China is dominated by big state-owned banks that will not ‘crunch credit’ unless the government allows it. Of course a concern is that adding debt could lead to much higher losses in the future, creating a situation that eventually gets out of control if confidence erodes in the short-term financing channels for the banks and the tap is cut off. The concern over debt is also in itself making companies more cautious, leading to less inflow of productive capital.

The continued rebalancing away from industry-driven growth towards services is another challenge. It requires the closure of zombie companies and a move of labour from inefficient state companies with overcapacity to jobs in the service sector and in high tech industries. This is not a trivial task.

Finally, China continues to struggle with balancing the housing market and avoiding bubbles. On the one hand, China is faced with a significant oversupply of some areas and, on the other, house prices are again shooting up in an uncontrollable way in the big cities with annual increases of 30%. Regional bubbles could spell trouble in the future.
Given the above factors, the risks to Chinese growth are mostly on the downside in coming years. It also justifies why risk premia should be high in Chinese financial markets as is currently the case. When that is said, the scope for cyclical recovery does, in our view, leave potential for moderate increases in Chinese stocks over the coming quarters.

**China’s focus on technology and innovation is important**

While challenges with debt and overcapacity are real, China is doing many things that are right when it comes to the long-term development potential. China is still only at around a third of the level of living standards in the western world. Critical sources for climbing the development ladder are to improve efficiency through (a) increased use of technology, (b) innovation and (c) raising the education level. China has a strong focus in all these areas with key elements in the five-year plan being innovation and technology and focus on easing burdens on small businesses to foster entrepreneurship. Spending on R&D has also increased sharply over the past few years. These factors tend to be overlooked in the debate on China but are crucial in order for China to continue on its path to catching up with the west.

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**Macro forecast - China**

<table>
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<th></th>
<th>2016</th>
<th>2017</th>
<th>Calendar year average</th>
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<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
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<tr>
<td>GDP, % y/y</td>
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<tr>
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<tr>
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<tr>
<td>I-year benchmark lending rate</td>
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</tr>
</tbody>
</table>

1: Contribution to GDP growth, 2: Pct. of GDP, 3: End of period

Source: Danske Bank Markets, Macrobond Financial, IMF
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