

January 2012

Global Scenarios

Chinese engine set to start pulling again

- The global economy is expected to improve over the coming year as Chinese growth picks up
- The US economy's moderate recovery should continue
- The euro recession is likely to be short, but growth prospects remain weak
- Fading headwinds will lift Chinese growth
- The euro debt crisis will continue. We expect a continued muddle-through scenario with high volatility but no break-up

Contents

Global overview	The Chinese engine will start pulling again	4
The bad alternative	Debt crisis escalates	9
The good alternative	Headwinds fade fast	10
US	Recovery taking hold - again	11
Euro area	Recession expected to be short	15
Asia	Room to ease	19

Global Scenarios is a quarterly analysis focusing on the outlook for the global economy. Read about the perspectives 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 24 of this report.

Danske Research

Editorial deadline: 16 January 2012

Investment research – general market conditions

Editor-in-Chief:

Allan von Mehren	International Economy and Strategy	+45 45 12 80 55	alvo@danskebank.dk
------------------	------------------------------------	-----------------	--------------------

Macro economics:

Frank Øland Hansen	Euro area	+45 45 12 85 26	franh@danskebank.dk
Anders Møller Lumholtz	Euro area	+45 45 12 84 98	andjrg@danskebank.dk
Signe Roed-Frederiksen	USA (on maternity leave)	+45 45 12 82 29	sroe@danskebank.dk
Flemming J. Nielsen	Asia	+ 45 45 12 85 35	flemm@danskebank.dk
Lars Christensen	EMEA	+ 44 45 12 85 30	larch@danskebank.dk

This publication can be viewed at www.danskebank.com/danskeresearch

Where no other source is mentioned statistical sources are:

Danske Bank, Datastream, Ecwin, OECD, IMF, National Institute of Social and Economic Research, Statistics Denmark and other national statistical institutes as well as proprietary calculations.

Global overview

The Chinese engine will start pulling again

- We expect 2012 to be a year of improvement for the global economy. Given current very downbeat sentiment, we believe this will be a positive surprise. The significant headwinds that derailed the recovery in 2011 have partly faded and some even become tailwinds.
- In particular, we expect the Chinese engine to start pulling again and join the US in driving the world economy forward. The euro area recession will likely be short and euro growth resume from Q2.
- That said, we look for growth rates in the western economies to remain subdued for a long time, whereas emerging markets are still expected to see solid growth.
- Downside risks are still predominant and mainly stemming from the euro debt crisis. We expect this crisis to be with us for a long time – and continue to see bouts of financial turmoil. However, we do not expect to see a collapse of the euro.
- Inflation is expected to fall sharply in 2012 due to lower commodity prices. This leaves room for policy to be eased further, not least in emerging markets.

2009 Déjà vu

2012 has started with widespread concerns of another global recession. Equity market valuation in terms of price earnings ratios in all big markets is not far from the low levels seen at the peak of the financial crisis in 2008/2009. Fears of the crisis moving to Asia as well due to a housing collapse in China have intensified. Sentiment is not far from the lows seen at the start of 2009, when markets feared a depression following the collapse of Lehman Brothers in late 2008.

However, as in 2009, while the world is far from being a bright place at the moment, we believe current fears of a global recession will turn out to be excessive:

- First, we believe the euro debt crisis will not spiral out of control and lead to a euro break-up. Volatility will likely continue to be high and we could move to the edge of severe crisis occasionally. But we expect action from politicians and central banks will keep the world from falling into a similar financial crisis to that seen in 2008/09. We believe the world cannot risk “another Lehman”, as the room for manoeuvre in such a situation is much more limited this time due to very high budget deficits at the starting point. Hence, all efforts will be made to avoid such a situation.
- Second, while the Chinese property market is a threat, we do not believe the situation is severe enough to cause substantial damage. And the authorities have wide room to manoeuvre to fight a collapse should that happen. In fact, we believe China will be one of the engines

Global forecasts

% y/y	2012			2013		
	Danske Bank	Consensus	OECD	Danske Bank	Consensus	OECD
USA	2,5	2,1	2,0	2,6	2,5	2,5
Euro area	0,3	-0,3	0,2	1,5	1,0	1,4
Japan	2,5	1,7	2,0	1,6	1,7	1,6
China	8,5	8,5	8,5	9,1	8,3	9,5
Global	4,0			4,1		

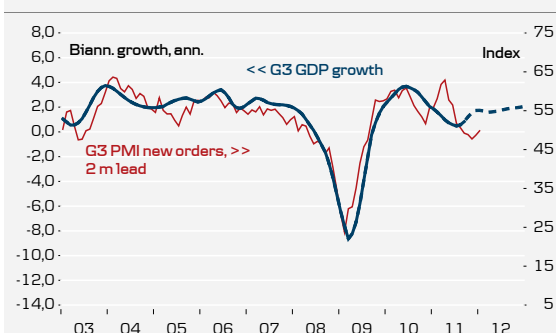
Source: Danske Markets, Bloomberg.

Equity markets almost as downbeat as in '08/'09 crisis



Source: Reuters Ecowin and Danske Markets

Global growth to recover in 2012



Source: Reuters Ecowin and Danske Markets

starting to pull the world economy again after a quite extensive slowdown in 2011.

In 2012, we believe the world economy will surprise to the upside. While risks are still high and the world economy is fragile, we believe current fears of a global recession are excessive.

Growth in 2011 was hampered by severe headwinds from a strong rise in oil and food prices and the earthquake in Japan. All of these headwinds have now reversed, however, and turned into slight tailwinds. This is giving a positive impulse to the global economy, which should recover once production has been adjusted adequately to get rid of excessive inventories. We believe we are close to that stage now from a global stand point.

We expect the global economy to move from being driven by one to two engines as China is expected to join the US economy in recovering from the low levels of growth seen in most of 2011. The euro area is expected to be in recession until Q1, but see a gradual increase in growth thereafter.

In 2013, we expect the global economy to grow close to trend growth around 4%. While there is still plenty of pent-up demand in the western world with investment levels low, structural headwinds from fiscal tightening, high debt levels and banking sectors under pressure (especially in Europe) is likely to keep growth around trend and thus leave a substantial negative output gap and high unemployment levels in the Western world.

China to start pulling again

The Chinese economy slowed down significantly during 2011. GDP growth declined from close to 12% in late 2010 to 6.5-7% in Q2 and Q3 2011. This is clearly below Chinese trend growth estimated at around 9.5% and the lowest pace of growth since the financial crisis in 2008, when growth dipped below 6% for two quarters.

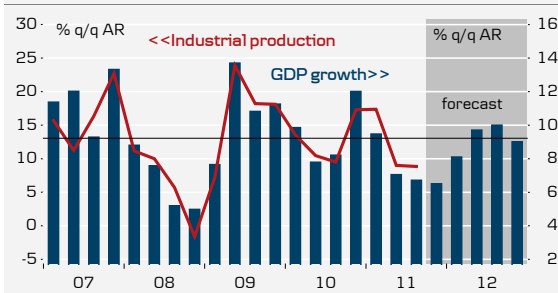
We believe China is close to the bottom, however, and look for growth to rebound to 8% in Q1 and rise further to a peak of around 10% in Q3. The Chinese growth engine is thus expected to start pulling again, and will be an important driver for the global economy in 2012.

A key factor behind the slowing of the Chinese economy has been a significant headwind from higher food prices leading to a sharp rise in inflation. Food constitutes 33% of private consumption in China and changes in food prices therefore have a strong impact on economic growth. The rise in inflation squeezed growth in two ways. Firstly, real income growth was hit significantly, reducing real consumption growth. Secondly, monetary policies were tightened in response to the rise in inflation, which in turn put a further dampener on growth.

However, the strong headwind has turned into a tailwind. Food prices are falling and inflation is coming down fast. This affects the Chinese economy through the same channels as mentioned above but with the opposite effect: it raises real income growth and it creates room for easing of economic policy.

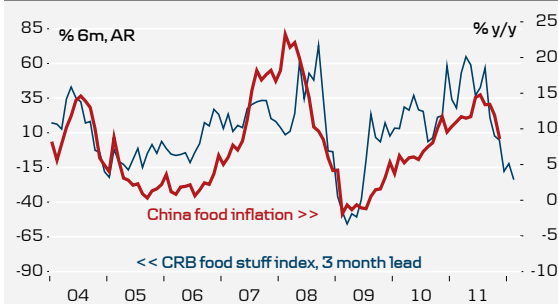
Another factor that has dampened activity in China has been a cooling of the housing market. Tightening measures from the government and central bank

Chinese growth to recover in early 2012



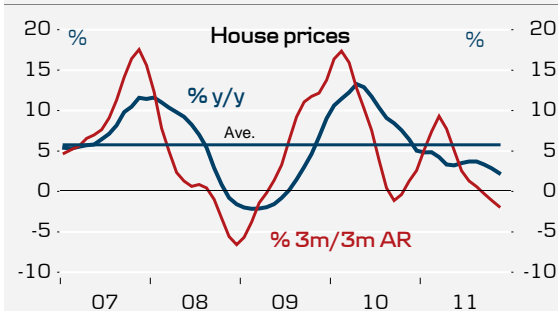
Source: Reuters Ecowin and Danske Markets

The headwind from food prices has turned into a tailwind



Source: Reuters Ecowin and Danske Markets

Chinese house prices falling – but not collapsing



Source: Reuters Ecowin and Danske Markets

have reduced activity in this sector and led to falling house prices. Housing market activity is expected to stay subdued but not to become a stronger drag – see also *China: Property market monitor*. We do not share the concerns over a housing collapse in China as: a) income growth is very high and underpinning housing demand, b) leverage in housing is low, c) urbanisation continues at a high pace and can absorb excess supply fairly quickly, and d) China has a substantial amount of savings and policy room for manoeuvre which can be used to avoid a housing collapse.

US recovery taking hold

The US economy has finished 2011 on a strong note and is so far the only region in the world to have recovered from the downturn earlier in 2011. Growth has recovered from less than 1% in H1 to 2% in Q3 and is tracking around 3% in Q4. Private consumption has recovered and very lean inventories point to a positive contribution from this factor in coming quarters following a drag in most of 2011. Housing activity is also starting to show signs of improvement and private investment has stayed fairly robust in H2, although losing some momentum towards the end of the year.

The rise in economic activity follows a period of significant headwinds in early 2011 from a sharp rise in oil prices and supply disruptions from the Japanese earthquake, which derailed the recovery. Financial conditions and political uncertainty have also weighed on economic activity due to the euro debt crisis and the turmoil related to the increase in the US debt ceiling and subsequent downgrade of the US sovereign rating.

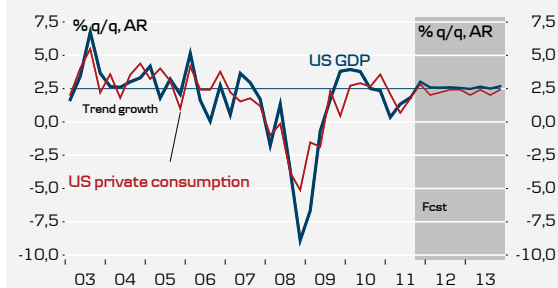
The headwind from oil prices and the Japanese earthquake has turned into a tailwind in the second half of 2011, though, as oil prices have declined and car sales and production recovered again.

Going into 2012 we expect the US economy to continue with moderate recovery, and expect growth at 2.5% for the year as a whole. The labour market has gained some momentum and should provide the foundation for decent income growth. The rise in incomes should be dented by subdued wage increases, though, as there is still substantial slack in the labour market with the unemployment rate close to 9%. Rising growth in Emerging Markets and an end to the euro recession is expected to lift export growth during the year. The corporate sector is very lean and with decent profit growth should support robust growth in corporate investments. Finally, housing looks to be providing a positive contribution for the first time since 2005, as housing starts and home sales now point to a pick-up in housing activity. Fiscal policy is likely to be a small drag in 2012, as some of the stimuli made in 2009 will run out in 2012 despite the government's measures to postpone some of the fiscal tightening.

The improvement should also pave the way for a further rise in the ISM manufacturing index and underpin more positive sentiment about the global economy and underpin risky assets.

In 2013, we expect growth to continue at a moderate pace at 2.6% - slightly above trend. Structural headwinds from high debt and rising oil prices will

US economy recovering to cruising speed



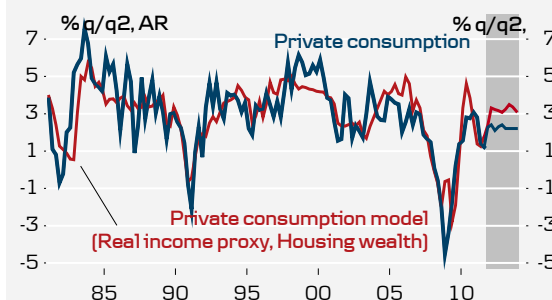
Source: Reuters Ecowin and Danske Markets

US ISM to recover further



Source: Reuters Ecowin and Danske Markets

US consumption growth to continue at moderate pace



Source: Reuters Ecowin and Danske Markets

keep activity muted despite a big output gap and plenty of pent up demand from corporate investment, housing and car sales.

Five reasons why euro recession will be short

The euro economy has been faced with severe headwinds in 2011. The global downturn has hit exports, and the euro debt crisis and rising pressure on banks have hit domestic demand. Data now suggests that the euro area entered a recession in Q4. However, we believe the recession will be fairly short. In a research note just before Christmas, we highlighted five reasons for this (see *Research - Euroland: A rising tide lifts all boats*):

1. **US recovery normally leads the euro area.** We have already seen higher growth rates in the US. In the past, the euro area has often reacted with a lag seen in recovery within 1-2 quarters.
2. **Emerging markets to drive stronger export growth.** Emerging markets have become the most important export market for the euro area and the rise in activity here is expected to support stronger export growth.
3. **The recession is partly due to inventory build-up.** European companies have built up inventories over the summer as demand faded while production kept rising. Production is therefore expected to reduce temporarily to be better aligned with demand and to reduce inventories
4. **Fiscal headwind is significant but is *not* getting stronger.** There is no doubt the fiscal tightening is dampening activity strongly. This headwind is unlikely to become stronger, though, in 2012, as fiscal tightening is not becoming more intensive but just continuing at the same pace.
5. **Financial headwinds expected to ease slightly during 2012.** Equity markets are expected to rise and credit markets to ease slightly during the second half of 2012.

We expect euro growth to be negative in both Q4 and Q1, but after that we look for a gradual pickup in growth rates toward 1½% by the end of the year. Growth is expected to stay in that neighbourhood also in 2013.

The euro debt crisis continues to be the main headwind risk for the euro area – and the global economy. In the short run, a real credit crunch in the euro area could make the recession worse as banks have to meet stricter capital requirements by the middle of 2012.

Inflation to fall sharply – and make room for easing

Inflation rates are peaking globally as the effect of lower commodity prices is kicking in now. Both oil and food prices peaked about six months ago but base effects have kept annual inflation rates from falling. Base effects should start pushing inflation lower, though, in early 2012. This is expected to be a global phenomenon – but since commodity prices are more important in emerging markets, where food takes up much more of consumption, the effect will be more significant here. Core inflation should also start to ease soon – as pass-through from previous commodity prices increases also contributes to lower core inflation. The decline will increase the room for manoeuvre in monetary policy and we see further easing from the ECB and

Euro recession to be short – but growth will stay subdued



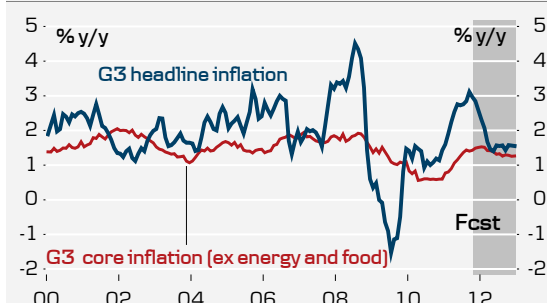
Source: Reuters Ecowin and Danske Markets

Stronger growth in China will lift the euro area too



Source: Reuters Ecowin and Danske Markets

Inflation to fall sharply from here, core also lower



Source: Reuters Ecowin and Danske Markets

in many emerging markets. It will also increase the scope for more easing in the US, but our main scenario is that the Fed will refrain from further easing as the economy improves.

Expectations on key figures and central banks over coming quarter

Country	Indicator	Comment	Measure	Latest		Apr/Q1
USA	GDP	Growth recovering to 3% in Q4, slowing slightly again in Q1 to 2.6%	% q/q, AR	1.8%	↗	2.6%
	ISM	ISM to continue higher towards 55-56 in coming months	Index	53.9	↘	55.0
	Employment	Job growth rising by 150-200k in coming quarters	3 mth. mavg.	200k	↗	175k
	Core inflation	Core inflation is peaking at the moment and is expected to fall to 1½% during 2012	% y/y	2.2%	↗	1.8%
	Federal Reserve	Fed on hold, Fed interest rate projection expected to show rate hike in H2 2013	% p.a.	0.13%	→	0.13%
Euroland	GDP	Recession is expected to be fairly short with positive growth starting from Q2	% q/q, AR	0.5%	↘	-0.3%
	PMI	Manufacturing PMI is expected to recover	Index	46.9	↗	50.0
	Inflation	Headline inflation will start to edge down towards ECB target	% y/y	2.8%	↘	1.9%
	ECB	ECB is on hold, 3-year LTRO will support government bonds in shorter maturities	% p.a.	1.00%	→	1.00%
	German ifo curr.	Germany is also feeling the global downturn	Index	116.7	→	115.0
Japan	GDP	The recovery will lose some steam following strong recovery after earthquake	% q/q, AR	5.6%	↘	2.9%
	PMI	Manufacturing activity is expected to recover in the coming months	Index	50.2	↗	52.5
	Inflation	Consumer prices is expected to continue to edge slightly lower	% y/y	-0.2%	→	-0.2%
	BoJ	BoJ on hold until 2014, additional QE expected in H1 12	% p.a.	0.1%	→	0.1%
China	GDP	Growth is expected to recover but remain slightly below trend in Q1	% q/q, AR	6.7%	↗	8.0%
	HSBC PMI	Manufacturing activity is expected to recover to above trend growth in Q2	Index	48.7	↗	53.0
	Inflation	Inflation will continue to edge markedly lower from February	% y/y	0.1%	↘	3.3%
	PBOC	Leading interest rate will remain unchanged, but reserve requirement expected to be cut	% p.a.	6.51%	→	6.51%

Source: Danske Markets

The bad alternative

Debt crisis escalates

- In this scenario the European debt crisis goes from bad to worse. The escalation is caused by a failure to find a lasting solution to Greece's debt problem and a worsening of the outlook for Italy and Spain.
- The Greek government eventually gives up and defaults – possibly as soon as 20 March when a EUR14.4bn bond matures.
- This event and the increasing likelihood of more sovereign defaults causes a sell-off in risky assets, credit tightening and a severe recession in the euro area. The rest of the world continues to grow, albeit slowly.

The resolution of the Greek debt problem has dragged on. In the meantime, the Greek economy has fallen off a cliff, which has caused the debt to GDP ratio to increase towards 160%.

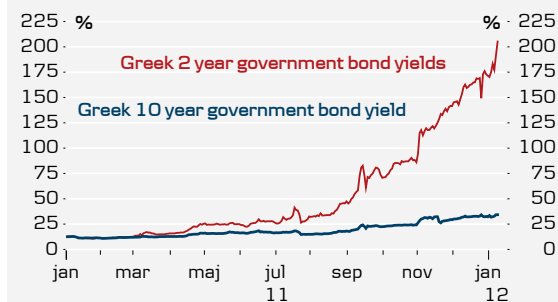
In the bad scenario the austerity measures and structural reforms that are being implemented fail to revive growth and reduce the government deficit at a satisfactory speed. The planned voluntary private sector involvement proves insufficient to stabilise debt dynamics and politicians openly discuss whether to go ahead with a sovereign default that would wipe out most of the privately held debt. The Greek government then decides not to repay investors – possibly as soon as 20 March when a large (EUR14.4bn) government bond issue matures.

The default would cause havoc in the Greek banking sector due to its large holdings of Greek government bonds and would trigger payment on CDSs on Greece. However, the market for CDS on Greece is assessed to be relatively small, so this is in itself a manageable problem although some losses could show up in unexpected places.

More importantly, a default would take away any confidence that investors might still have in European politicians and cause a rapid sell-off in risky assets. Intensified contagion to Italy and Spain and fears that these countries also risk defaulting would send yields higher and trigger another vicious cycle that would weigh down on growth. A sharp increase in non-performing loans and losses in the banking sector (in particular in Spain) would add to the problem.

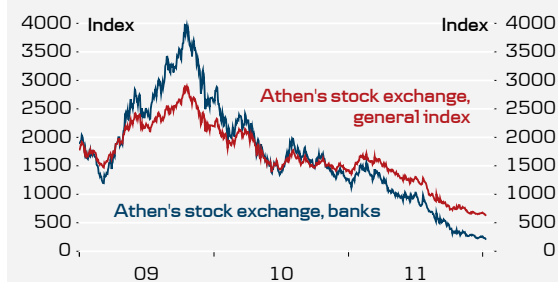
In this scenario, the sell-off in risky assets would fuel a financial crisis where many financial institutions would have to get public support or be nationalised (primarily in Europe). Credit tightening and a sharp drop in private demand would cause a severe recession in Europe and dampen growth in the rest of the world. In many countries there is little or no room left for fiscal response and the ECB cannot cut rates much further. Although the ECB would probably apply ever more massive non-standard measures, a prolonged recession with a drop in GDP in the euro area above 3% cannot be ruled out. European stock prices could decline 20-30% and EUR/USD could fall below 1.15.

Investors have no confidence in Greece



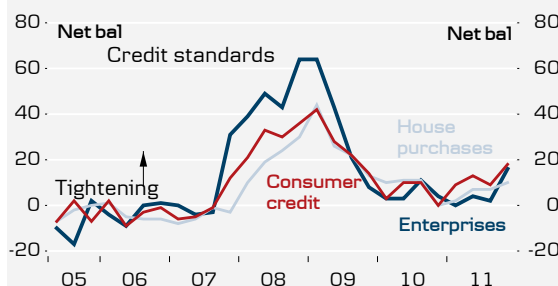
Source: Reuters EcoWin and Danske Markets

Greek shares have lost most of their value



Source: Reuters EcoWin and Danske Markets

Euro area credit tightening could intensify



Source: Reuters EcoWin and Danske Markets

The good alternative

Headwinds fade fast

- **The global economy was held back by a number of headwinds in 2011. If these fade faster than expected – or we underestimate the positive effect of the milder winds – then global growth could turn out to be stronger than expected.**

Although we have mostly been surprised on the downside in the past couple of years, we believe a more positive scenario for the global economy could materialise. The following factors could trigger such a scenario.

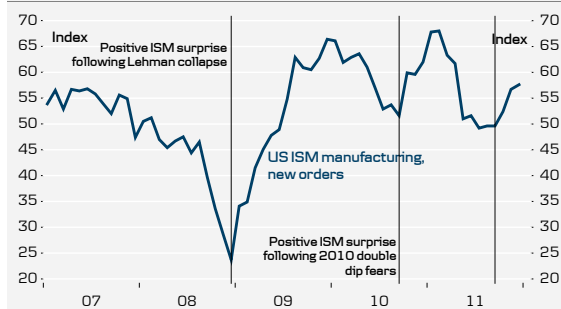
Euro crisis eases: The euro crisis eases as market sentiment improves when the global economy recovers. A positive feedback loop is started whereby investors gain confidence that the euro will survive and start investing in the high-yielding peripheral euro countries. Yields in the periphery come down to sustainable levels (around 5%). Budget consolidation continues and follows outlined plans in most countries. Eurobonds may be issued and/or the ECB could step up its ex ante commitment to buy bonds in the event of market stress.

Stronger rebound on fading headwinds: The effects of the headwinds from oil and food prices were generally underestimated and the negative impact was stronger than expected. Similarly, there is a chance that the positive effects of the reversal in oil and food prices have been underestimated and we could get a stronger recovery in the global economy. The underestimation of the swings is often because the rebound effect from the inventory cycle is sometimes stronger than expected. This was the case at the end of 2010 when the global economy recovered more strongly from the ‘double dip’ recession fears over the summer of 2010. Also in early 2009 when PMI and ISM rebounded more strongly and earlier than generally expected.

The Chinese engine runs faster than expected: If inflation comes down faster than expected in China, the government and central bank might choose to stimulate the economy and push up growth rates more than we expect. This would have positive spill-over effects on the rest of the world – not least the euro area, where exports are the main driver of the recovery and Asia has become the most important trading partner.

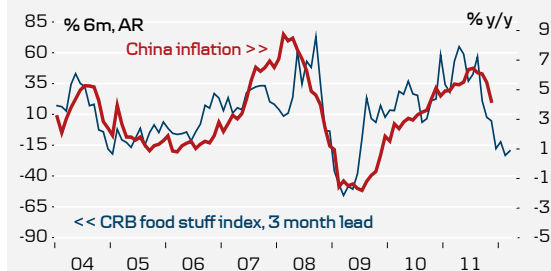
US job growth beats expectations again and strengthens the recovery: Another candidate for a positive surprise is the US labour market. Employment growth has picked up faster than expected. This also happened in early 2011 but was halted by the oil shock. There is a chance that the positive surprises will continue and employment growth will become even stronger in the coming quarters than the 150,000-200,000 we expect. If so, it would have a positive impact on income growth and on sentiment as fears of a global recession would ease further. A positive spill-over on the global economy should therefore materialise.

Recoveries are sometimes stronger than expected



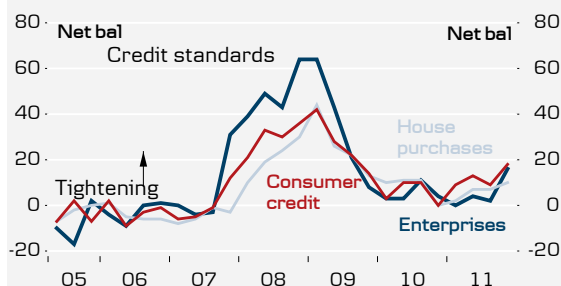
Source: Reuters EcoWin, Danske Markets

Inflation could fall steeply in China



Source: Reuters EcoWin, Danske Markets

Euro area credit tightening could intensify



Source: Reuters EcoWin, Danske Markets

US

Recovery taking hold - again

- The US economy has recovered again on the back of a reversal of headwinds from higher oil prices and the Japanese earthquake. Declining yields have contributed to a lift in the housing market.
- We estimate growth was 3% in Q4 and expect it to continue at cruising speed, with 2.5% in 2012 and 2.6% in 2013, as stronger dynamics are kept in check by a slight tightening of fiscal policy.
- Risks are no longer mainly skewed on the downside but are more evenly balanced. The improvement in housing and positive surprises in the labour market give a rising probability of a recovery with stronger momentum than currently expected.
- We expect the Fed to be on hold throughout 2012. Thus, we do not expect QE3. In our view, the Fed is likely to use its upcoming projections for the Fed funds rate to steer monetary policy through its effect on longer term yields.
- We expect both headline and core inflation to fall during 2012 on the back of lower direct and indirect effects of commodity prices.

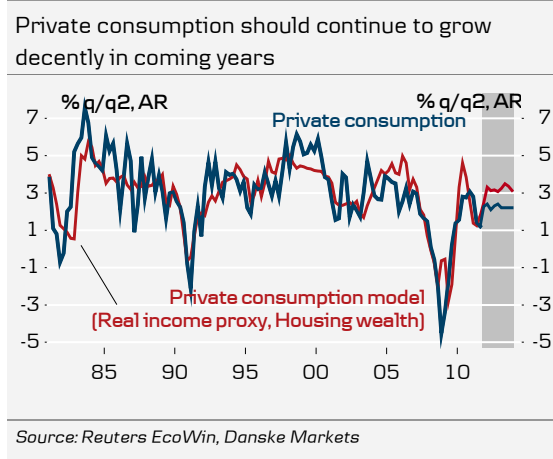
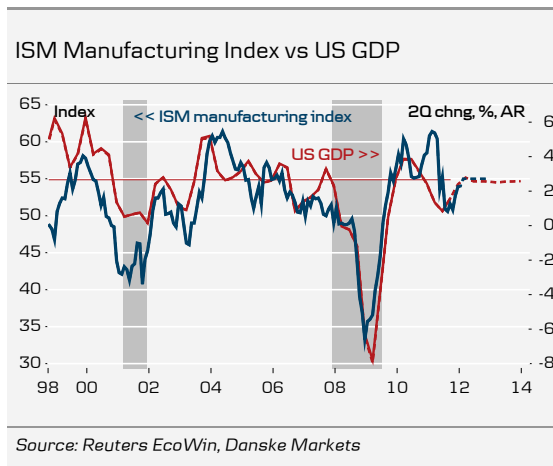
Consumption engine pulls again as shocks dissipate

Entering 2012 the US economy is on a much stronger footing than seen for most of 2011. Growth in Q4 11 is tracking slightly above 3% as private consumption has recovered and the inventory cycle has turned more supportive of economic activity. Net exports have also improved as export growth gained some steam towards the end of 2011 while import growth remained subdued. It seems the very weak USD is increasingly supporting net trade.

So why did fears of a recession prove excessive and instead the economy improved? As we wrote in *Global Scenarios: Long period of slow growth ahead* (14 September 2011), the headwinds that caused the downturn were fading and turning to tailwinds. Private consumption, in particular, was hurt in the first half of the year by the shocks that hit the economy. However, as the shocks have dissipated, private consumption growth has recovered.

First, gasoline (petrol) prices reversed sharply during the year, falling from a peak of around USD4 per gallon in early May to USD3.37 per gallon currently. This has given a decent boost to real income growth as the consumer deflator has fallen from 3.9% in Q1 to an estimated 0.5% in Q4 – a direct lift to real income growth of about 3.5 percentage points.

A second factor that supported private consumption in the second half of 2011 was a rise in car sales. This came after a significant decline in car sales in Q2 following the earthquake in Japan, which led to supply disruptions that hit the auto industry especially.



Looking into 2012, we continue to look for decent growth in private consumption. A simple model of private consumption based on real income growth and housing wealth suggests private consumption should grow about 3% in 2012. In the model we assume a rise in the PCE deflator to around 2%, which would be compensated by a pickup in non-farm payrolls to an increase of 150,000-200,000 per month.

We prefer to be a little on the cautious side though and forecast an increase in private consumption growth of 2.5% in 2012. This leaves some scope for a small increase in the savings ratio, which declined over the second half of 2011.

Housing set to start supporting growth...

Another positive surprise in the US in recent months has come from the housing market. Both sales and building activity have been better than expected and inventories of homes are coming down fairly rapidly now.

The housing market is supported by the rapid decline in bond yields as well as rising incomes. This has led to a further increase in affordability, which is running at very high levels. A barrier to a turn in the housing market has been the very low confidence among households. However, as unemployment has started to fall and more stories of improving housing activity hit the media, we expect sentiment to improve gradually and look for a further thawing of the housing market in terms of a gradual increase in house prices and a pickup in construction spending. Housing will thus increasingly move from a drag on to a boost to the overall economy and help strengthen the recovery.

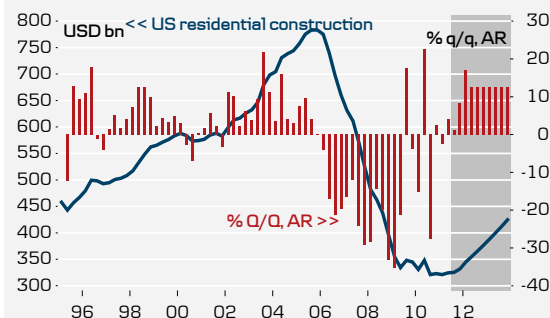
As construction is at very low levels (now only 2.5% of GDP), we believe the direct growth contribution will continue to be limited. We expect construction spending to move from a neutral factor for growth to a positive contribution to growth of 0.3 percentage points in both 2012 and 2013.

...and be counterweight to fiscal tightening

This will prove an important counterweight to the fiscal tightening, which is likely to continue in 2012. We still do not know how much the tightening will be, as it is uncertain what the budget looks like. However, we assume that the payroll tax cuts given in 2010, which were extended by two months in December last year, will be extended further to last throughout 2012. We estimate that overall fiscal policy will subtract around 0.5-1.0pp from growth in 2012.

It is uncertain how much fiscal policy affected growth in 2011 but we estimate the fiscal effect to be of a similar magnitude to in 2010. The structural deficit estimated by IMF rose to -6.4% in 2011 from -7.0% in 2010 pointing to a drag of approximately 0.5pp. Also, looking at government consumption and investment in the National Accounts, this component gave a negative growth contribution of 0.5pp in 2011. This has to be compared with an average boost from this component of +0.4%. Hence, relative to a normal year government consumption and investment contributed close to 1pp less to GDP growth. One has to add, though, a positive effect from tax cuts given in early 2011 (the cuts that have now been extended by two months).

US housing expected to recover



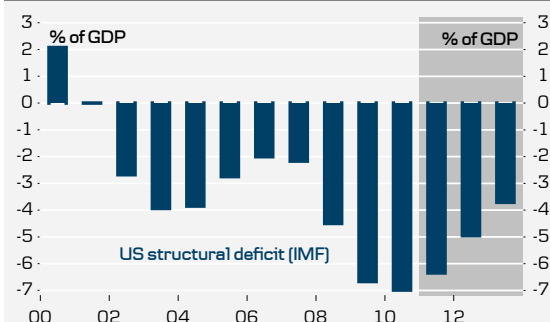
Source: Reuters EcoWin, Danske Markets

Lower prices + higher income + lower bond yields = very affordable houses



Source: Reuters EcoWin, Danske Markets

Fiscal policy tightened in 2011 – further tightening expected in coming years



Source: Reuters EcoWin, Danske Markets

As these contributed close to 0.5pp to growth it points to a net drag from fiscal policy of a little more than 0.5pp. On top of this, is there is an indirect effect of the decline in government employment in 2011. The government shed 250,000 jobs in 2011, having added 200,000 jobs per year on average per year over the previous 10 years. Judging from these data, we judge that fiscal policy subtracted 0.5-1.0pp from GDP growth in 2011 and we expect a similar drag in 2012. This means that fiscal policy should be neutral for the *change* in the growth rate from 2011 to 2012. Looking into 2013, the fiscal effect is uncertain but we have assumed a fiscal drag of 1pp as the fiscal tightening needs to be increased to stem the rise in the public debt.

Exports set to gain speed in 2012

Another supportive factor for growth in 2012 will be exports. With emerging markets slowing down and the euro area entering recession, export sales slowed in 2011, although they remained fairly strong. In Q2 and Q3 exports grew by just over 4% annualised, following 8% export growth in the previous two quarters. In 2012, we expect exports to grow close to 8% again, as emerging markets gain pace and the euro recession tapers off. In general, the end to global inventory adjustment will lead to bounce back in world trade.

Over the past couple of years, the US has actually outperformed many of its peers in terms of export performance (see chart to the right). US competitiveness has improved quite significantly over the past five years as high productivity growth has kept unit labour costs down and the historically weak dollar has made US companies much more competitive. This is not only benefiting exports but also leading to lower import growth as domestic companies are also more competitive on the home market than foreign competitors.

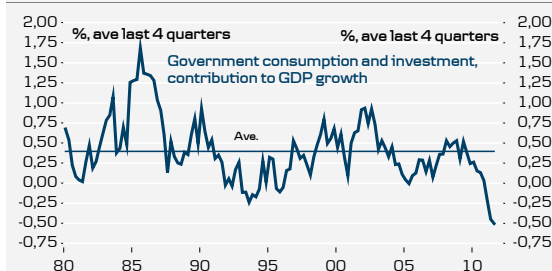
Inflation outlook more favourable

We believe headline inflation is likely to have reached a peak back in September and we expect it to continue the path lower over the coming quarters from the current level of 3.4%. We look for inflation to reach just below 2% in mid-2012 as the base effects of the decline in commodity prices kick in. Inflation has already slowed considerably on a q/q basis but it takes longer for it to kick into the y/y inflation rate.

Core inflation currently stands at 2.2% but we also expect it to decline over the coming quarters. Core inflation has also been pushed higher by the pass-through from higher commodity prices, which rose sharply in the first half of 2011. Core inflation normally reacts with a lag to commodity prices and hence the peak is likely to come six to nine months after commodity prices have peaked. Underlying price pressure is very low in the US as wage growth is very subdued around 2% and pricing power is still poor due to the slow to moderate growth in consumption. We expect core inflation to decline to 1.5% by mid-2012.

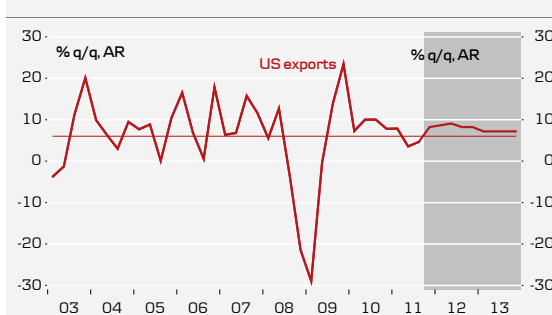
We still expect price pressure to remain subdued going into 2013 but a decline in the unemployment rate would start to put more upward pressure on wage growth and we expect pricing power to improve slowly. Hence, we expect core inflation to increase back close to 2% in 2013.

Government consumption and investment was big drag in 2011



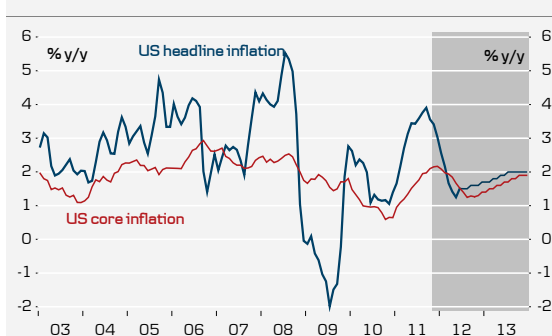
Source: Reuters EcoWin, Danske Markets

Exports to pick up some speed in 2012



Source: Reuters EcoWin, Danske Markets

Inflation heading down in 2012



Source: Reuters EcoWin, Danske Markets

Fed: QE3 not on table, interest rate path is

With the recovery ongoing and the job market gaining pace, we believe the Fed will stay on hold all next year. Hence, QE3 is no longer on the table. However, the Fed has announced it will start publishing forecasts for the Fed funds rate. Following the two-day meetings, these will be published together with the forecasts for GDP, unemployment and inflation. This forecast is likely to mean that the phrase about keeping rates exceptionally low until at least mid-2013 is likely to be removed from the statement as the Fed funds forecast will instead be used to signal the Fed's expectations of the first hike and subsequent pace of hiking rates.

With this in hand, the Fed also has a new tool to steer long-term yields. If the Fed wishes to push down long yields and add stimulus this way, it can thus move its forecast of the first hike further into the future. This way it can stimulate without increasing its balance sheet through for example quantitative easing. We expect the first hike from the Fed in mid-2013 as unemployment has crept lower and inflation is close to 2%.

US macro forecast

% Change q/q AR	2011				2012				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013
GDP	0,4	1,3	1,8	3,0	2,6	2,6	2,6	2,5	1,7	2,5	2,6
Private Consumption	2,1	0,7	1,7	2,8	2,0	2,2	2,4	2,4	2,2	2,2	2,3
Private Fixed Investments	9,8	9,2	13,0	3,5	9,1	8,3	8,3	7,5	6,7	8,2	9,1
Residential	12,6	4,2	1,2	8,2	17,0	12,6	12,6	12,6	-1,5	10,8	12,6
Non-residential	9,1	½	15,7	2,5	7,4	7,4	7,4	6,4	8,6	7,5	8,2
Change in inventories (\$bn, real)	55,0	39,1	-2,0	38,0	55,0	55,0	55,0	55,0	31,1	55,0	55,0
Change in inventories ¹	0,0	-0,3	-1,2	1,2	0,5	0,0	0,0	0,0	-0,2	0,2	0,0
Public Consumption	-1,2	-0,9	-0,1	-3,9	-1,2	-1,2	-1,2	-1,2	-2,1	-1,6	-1,2
Exports	7,2	3,6	4,7	8,2	8,7	9,1	8,2	8,2	7,0	7,8	7,6
Imports	7,4	1,4	1,2	6,1	9,1	6,7	6,9	6,7	5,1	6,2	6,8
Net exports ¹	-0,2	0,2	0,4	0,1	-0,3	0,1	0,0	0,0	0,1	0,0	-0,1
Unemployment rate (%)	8,9	9,1	9,1	8,7	8,4	8,3	8,2	8,1	8,9	8,3	7,9
CPI (y/y)	2,2	3,3	3,8	3,3	2,1	1,4	1,4	1,9	3,1	1,7	1,7
Core CPI (y/y)	1,1	1,5	1,9	2,1	2,0	1,7	1,3	1,2	1,7	1,6	1,6
Public Budget ²									-10,6	-11,4	-9,3
Public Gross Debt ²									100,0	105,0	109,0
Current Account ²									-3,1	-2,1	-1,7
Fed funds rate ³	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25			

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

Source: Danske Markets

Euro area

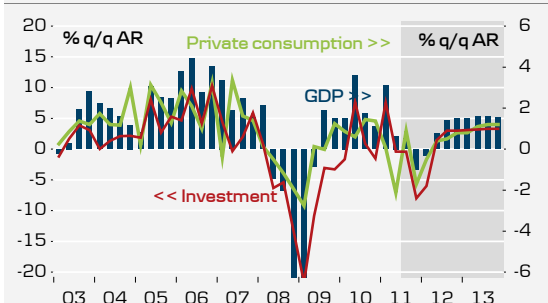
Recession expected to be short

- There are significant headwinds to the euro area economies at the moment and most indicators currently signal that the euro area is in the middle of a recession.
- However, we expect the recession to be fairly short and therefore keep our growth forecast unchanged at 1.5% for 2011 and 0.3% for 2012. In 2013 the gradual recovery is set to continue and we expect growth of 1.5%.
- The fiscal drag in the euro area is substantial, but contrary to popular belief it will not intensify in 2012. We estimate the fiscal drag on GDP in 2011 to be 1.5%-point falling to 1.0%-point in 2012.
- Since the debt crisis peak in late autumn we have moved one step back from the edge, following the introduction of 3-year LTROs. However, an array of critical events can influence sentiment in the coming months.
- The most important are the negotiations on the Greek PSI deal, the bank recapitalisation, the bond auctions in Italy and Spain and finalisation and implementation of the “fiscal compact”.
- We expect the ECB to have delivered the last cut in this cycle. The 3-year LTROs will ensure ample liquidity and the SMP purchases will be stepped up if sentiment deteriorates again.

There can be no doubt that there are significant headwinds to the euro-area economies at the moment and most indicators currently signal that the euro area is in the middle of a recession. However, as we outlined in our *Forecast update* published on 9 November 2011, we expect the recession to be fairly short. This remains our main scenario and we therefore keep our growth forecast unchanged at 1.5% for 2011 and 0.3% for 2012. In 2013 the gradual recovery is set to continue and we expect growth of 1.5%, so just around trend level.

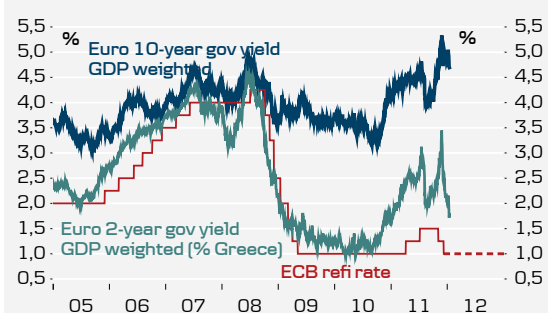
Most growth indicators currently paint a bleak picture. Euro area PMIs and German Ifo expectations are at recession levels. However, the recent stabilisation is in line with our expectation that the sharpest drop in production happened in Q4. Composite PMI rose from 47.9 in November to 48.3 in December. The leading new orders - inventory balances have turned and started to improve, which normally leads the improvement in headline PMIs. Our PMI models point towards moderate increases in the coming months. It is somewhat comforting that the PMIs seem to have bottomed out and that we will not experience the same low levels as we did in 2008/09. Based on our hard and soft data models we expect negative growth in Q4 of -0.3% q/q and -0.1% in Q1 before returning to positive growth in Q2.

Recession in the euro area will be short



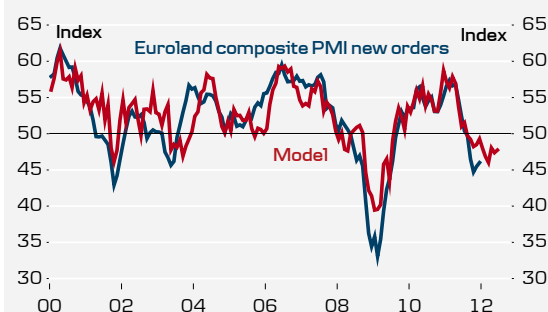
Source: Reuters EcoWin and Danske Markets

ECB's 3-year LTROs have brought relief



Source: Reuters EcoWin and Danske Markets

PMIs signal sharpest drop in Q4



Source: Reuters EcoWin and Danske Markets

It is in particular investments and private consumption that are suffering in Q4 and Q1. The European Commission's consumer confidence indicator has been falling steadily since July and in December it was at the same downbeat level as in the autumn of 2009. Retail sales show the same pattern. After the recent decline in November euro area retail sales are down by 2.5% compared to a year ago. Unemployment has risen to a new euro era high of 10.3%, which weighs on consumption. We expect private consumption to fall by 0.4% q/q in Q4 and 0.1% in Q1, before a gradual recovery sets in.

Investments are usually very sensitive to market sentiment and our model points to a sharp drop. We forecast investments will drop by 2.0% q/q in Q4 and 1.5% in Q1.

However, during 2012 some of the headwinds are going to turn into tailwinds. There are five reasons why we expect the recession to be short:

1. US recovery normally leads the euro area
2. Emerging Markets drive stronger export growth
3. Fiscal headwind is significant – but it is starting to decline
4. Financial headwinds are expected to ease in the second half of 2012
5. The recession is partly due to previous “overproduction”.

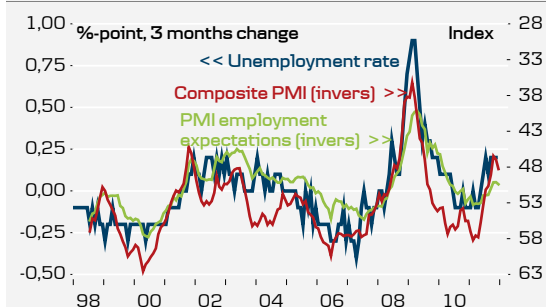
Europe seems to be unable to pull itself out of the recession currently, so the euro area is very much dependent on the rest of the world as a growth driver. If stronger growth in the rest of the world fails to materialise, it is possible that the euro area will remain in recessionary territory for a prolonged period. Especially Emerging Markets will play an important role. The slowdown here has been dampening growth in 2011, but the Emerging Markets are expected to boost exports and growth in 2012. The continued recovery in the US will support growth as well. For more details see *Research Euro area: A rising tide lifts all boats* published on 19 December 2011.

Fiscal tightening will start to decrease

The fiscal drag in the euro area is substantial, but contrary to popular belief it is not expected to intensify in 2012. Judging from forecasts from the EU Commission the maximum drag is in 2011 and will ease gradually in coming years. A simple approach to estimate the fiscal effect is to use the change in the cyclically-adjusted primary budget balance (CAPB). Our calculations are based on fiscal policy multipliers estimated in a *2009 ECB working paper*.

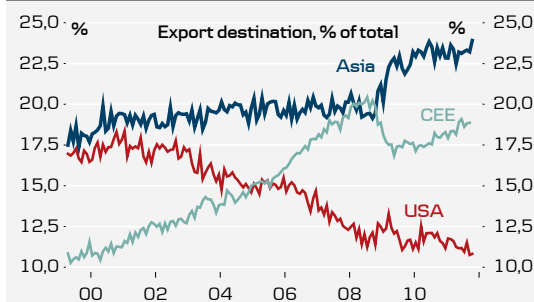
Based on these data we estimate the fiscal drag on GDP in 2011 to be 1.5%-point falling to 1.0%-point in 2012. The fiscal consolidation was substantial in 2011 and the negative impact on growth in H2 was significant. The tightening will continue, but to a lesser extent going forward. For example, in Spain the CAPB increased from -5.1% of GDP in 2010 to an estimated -2.3% of GDP in 2011 – a tightening of 2.8 percentage points. In 2012 the CAPB is forecasted to rise to -1.7%, which is an increase of only 0.6 percentage points implying that fiscal tightening will be less significant. The tightening in 2011 will also have a negative spill over effect in 2012, but even taking this into account the accumulated outcome in Spain will be a softening– and hence contribute to a lift in the GDP growth rate.

Unemployment expected to reach new highs



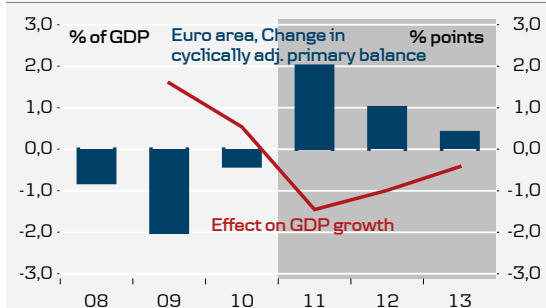
Source: Reuters EcoWin and Danske Markets

Emerging markets' importance continues to increase



Source: Reuters EcoWin and Danske Markets

The fiscal drag is peaking in 2011



Source: European Commission and Danske Markets

Interestingly, even the strongest country in the region – Germany – was tightening its policy quite significantly in 2011. The CAPB is expected to rise to 1.1% (surplus!) in 2011 from -1.0% in 2010. However, as in Spain, fiscal tightening in Germany is planned to ease a bit in 2012.

Still many issues are left unsolved

Since the debt crisis peak in late autumn we have moved one step back from the edge, following the introduction of the 3-year LTROs in December. Nevertheless, we have an array of critical events in the coming months, that will attract market attention. The bond issuance in Italy and Spain is due to be stepped up in 2012. The total issuance in these two countries amounts to around EUR450bn in 2012, and in Q1 alone it is set to be just below EUR150bn. During most of the autumn the SMP purchases have on average been around equal the total issuance of Italy and Spain. However, since the 3-year LTROs were introduced ECB has decreased its purchases. If sentiments deteriorates again ECB would most likely again step up its purchases considerably in Q1.

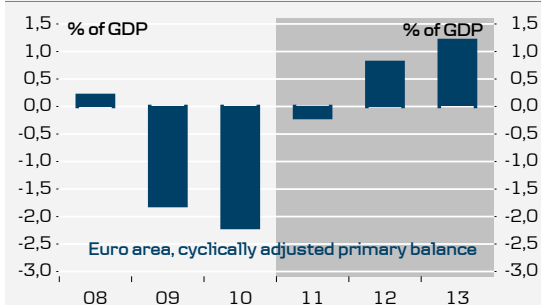
The negotiations on the size of the voluntary haircut in Greece between representatives from the Greek government and the private sector continue. The main issues are what the new interest rates should be, whether the new bonds should be issued under Greek or UK law and whether there also should be a haircut in some of the official money – for instance the ECB's holdings. The Greek commercial banks will have to endure big losses, which (according to EBA) implies that these banks will need a recapitalisation amounting to EUR30bn, which would likely be financed through the EFSF. At the European Council meeting on 26 October it was announced that the haircut in the private sector involvement (PSI) would likely be 50%.

The bank recapitalisation in Europe will take place during H1. A detailed plan on what banks intend to do to reach targets will have to be submitted by 20 January. In order to reach the targets banks should first aim at using private sources of funding, including retained earnings, reduced bonuses and new issuances of equity. Banks for which this is not an option should rely on official support from their national governments and only as a last resort the EFSF can be used. The capital shortfall estimated by the EBA is set to be EUR115bn, see [EBA statement from 8 December](#). The shortfall is biggest in Greece (EUR30bn), followed by Spain (EUR26bn), Italy (EUR15bn) and Germany (EUR13bn).

There are a number of details following the last EU summit that need to be spelled out and implemented. So far it is not clear what role the EU institutions should play and what will be required from the European Court of Justice to approve the “golden rules” (structural deficit should not exceed 0.5%). Finally, the implementation risk remains very high and historically these processes have had a tendency to take longer than planned even though EU leaders are calling for a speedy process.

Finally, EFSF's role in the secondary market and the role of the IMF need to be clarified. The EFSF “partial risk protection” model was set to be implemented in December and the second option, the a “co-investment

CAPB improved significantly in 2011



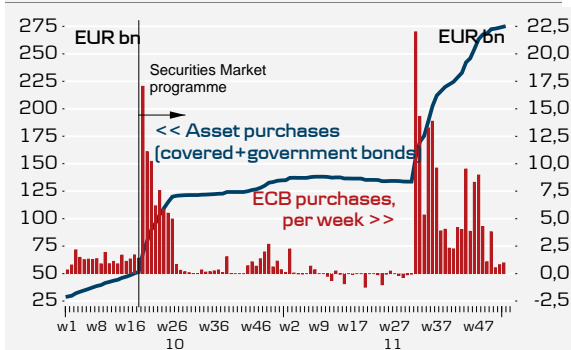
Source: European Commission and Danske Markets

Key events the coming months

1. Auctions in Italy and Spain
2. Negotiations on Greek PSI deal
3. Bank recapitalisation in Europe
4. EU summit details
5. EFSF role in secondary markets
6. IMF role in debt crisis should be clarified
7. General elections in France

Source: Danske Markets

ECB have eased SMP purchases recently



Source: Reuters EcoWin and Danske Markets

approach” was set to be implemented in January. Since the announcement in November there has been very little news on the EFSF.

The European crisis remains one of confidence. If it were to go away tomorrow it would require: 1) that public finances could be restored overnight, 2) that the euro-area leaders speak with one voice and 3) that credible back stop facilities, for instance via the ECB, could be established. This is clearly not going to happen. For more details see *Research Euro area: "What to watch" in the coming months* published on 21 December 2011.

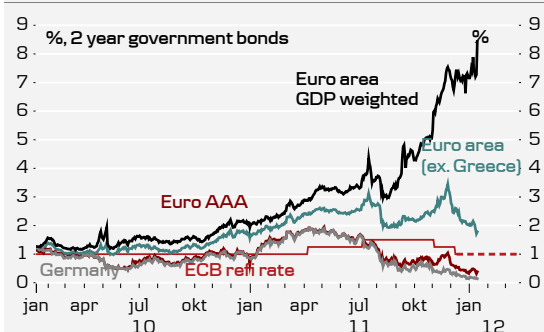
ECB has brought relief to short end with 3Y LTROs

We expect the ECB to have delivered the last cut in this cycle. Macro data appear to have stopped deteriorating and market sentiment has improved in recent weeks. If a slow economic recovery materialises, as we expect, the ECB will not cut rates any more, but will keep the refinancing rate at 1% for a prolonged period of time. However, the risk is still tilted to the downside.

The 36-month LTROs announced at the December Governing Council meeting in combination with a substantial easing of capital requirements was the most ambitious move from the ECB to combat the crisis so far. The introduction has brought relief to the market and effectively reduced yields in particularly in the short end. At the January meeting Draghi underlined that ECB expects a substantial demand at the second LTRO on 29 February. This should ensure ample liquidity. Furthermore the SMP purchases can be stepped up if sentiment deteriorates again.

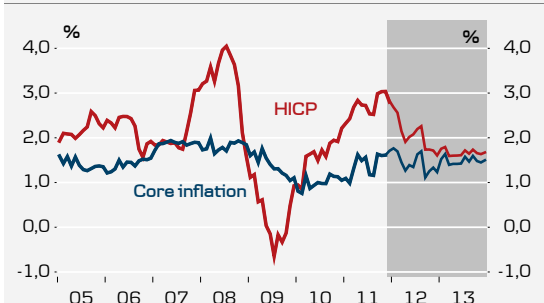
We expect inflation to stay above target in the coming months before falling below 2%. So the inflation outlook is in line with the ECB target and monetary policy can continue to remain very accommodative for a prolonged period of time.

3-year LTROs have brought relief to the short end



Source: Reuters EcoWin and Danske Markets

Headline inflation will fall to around target in 2012



Source: Reuters EcoWin and Danske Markets

Euro area macro forecast

% Change q/q AR	2011				2012				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013
GDP	3,1	0,6	0,5	-1,0	-0,3	0,8	1,4	1,5	1,5	0,3	1,5
Private Consumption	0,1	-2,1	0,9	-1,7	-0,5	0,4	0,5	0,8	0,1	-0,3	0,9
Private Fixed Investments	7,6	-0,4	-0,4	-8,0	-6,0	1,5	3,0	3,0	1,5	-2,3	3,0
Change in inventories ¹	0,2	0,7	-0,6	0,4	-0,1	0,0	0,0	0,0	0,2	0,0	0,0
Public Consumption	0,8	-0,6	-0,3	-0,2	0,0	0,0	0,0	0,0	0,1	-0,1	0,0
Exports	7,4	5,1	4,8	0,0	2,0	2,5	4,0	4,0	6,8	2,6	4,1
Imports	4,4	1,9	3,2	-2,7	-0,8	2,1	3,0	3,2	4,6	0,7	3,4
Net exports ¹	1,3	1,4	0,8	1,1	1,2	0,3	0,6	0,5	1,1	0,6	0,4
Unemployment rate (%)	10,0	10,0	10,0	10,3	10,5	10,6	10,6	10,6	10,1	10,6	10,5
CPI (y/y)	2,5	2,8	2,7	3,0	2,5	2,0	2,1	1,7	2,7	2,1	1,7
Core CPI (y/y)	1,1	1,6	1,3	1,6	1,6	1,3	1,5	1,3	1,4	1,4	1,5
Public Budget ²									-4,4	-3,5	-3,8
Public Gross Debt ²									88,5	90,8	91,0
Current Account ²									-0,2	0,1	0,2
ECB refi rate ³	1,00	1,25	1,50	1,00	1,00	1,00	1,00	1,00	1,25	1,00	1,00

Source: Danske Markets

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

Asia

Room to ease

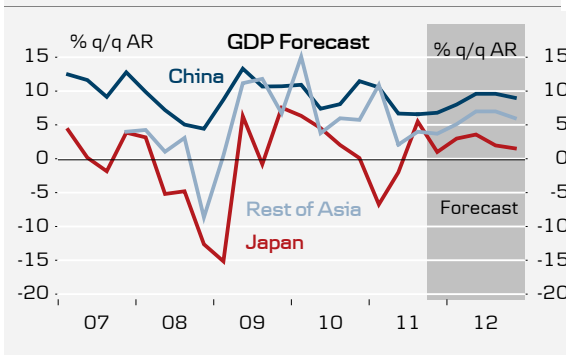
- Slower growth and lower inflationary pressure have created room for monetary and fiscal easing across Asia. This is expected to support a gradual recovery in 2012.
- China is expected to avoid a hard landing and recover in 2011 supported by fiscal and monetary easing. However, China's policy easing will be cautious and the recovery in Q1 will only be modest.
- In our view there is not a bubble on the property market for China as a whole and a full scale collapse is unlikely.
- In Japan the recovery after the earthquake has temporarily lost steam but should regain speed in H1 12 supported by reconstruction and stronger exports.
- Japan's rating might soon be cut and with the domestic saving surplus declining fast Japan could be subject to a confidence crisis.
- In India growth has slowed substantially on the back of aggressive monetary tightening. India looks increasingly vulnerable because it lacks the policy flexibility of the rest of Asia.

China: Short-term headwinds, but recovery in 2012

The Chinese economy currently faces two headwinds. The first headwind is the subdued exports in the wake of the recent slowdown in the global economy. So far the slowdown in China's exports has been much less severe than the one in the wake of the global financial meltdown in late 2008. China's exports were broadly flat in H2 11 as weaker exports to Europe were largely offset by stronger exports to other regions including the US. To put it into perspective, China's exports plunged more than 25% in late 2008. Looking ahead there should be less headwind from exports, as the impact from Europe should prove less negative in the coming quarters. That said, the European debt crisis and the external development remain a major risk for China in 2012.

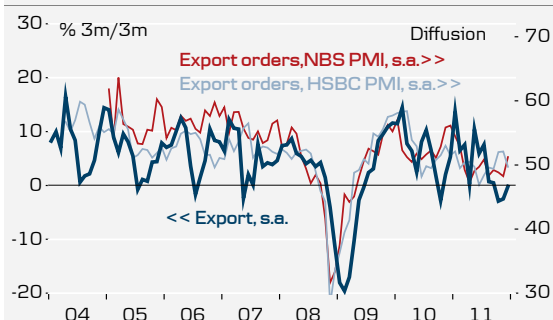
The second headwind is the lagged impact from monetary tightening over the past two years. Particularly the property market has suffered and weaker construction activity has started to weigh on growth. So far the slowdown in the property market does not appear to be as severe as in 2008, when the housing market also suffered after monetary tightening and regulatory tightening. In the short run the imbalance in the property market will continue to weigh on growth and the slowdown in the property market could turn out to be more severe than in 2008. However, we do not expect a collapse in the property market as many appear to be fearing.

Growth in Asia is expected to recover in 2012



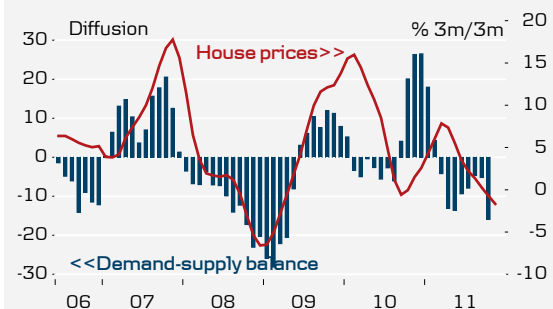
Source: Reuters EcoWin and Danske Markets

Exports have been more resilient than in 2008



Source: Reuters EcoWin and Danske Markets

The slowdown in the property market so far not as severe as in 2008



Source: Reuters EcoWin and Danske Markets

Property market weak, but not expected to collapse

We regard the current weakness in the house market as largely cyclical, driven mainly by a 20% increase supply of new homes in urban areas in 2011 while sales only increased 6%. However, we do not believe there has been excess housing construction for China as a whole in recent years. The supply of new homes in China appears to be following a path very similar to Japan and South Korea when they were at a similar stage of development. Housing starts have been declining in recent months, suggesting that the supply of new homes will start to decline in H1 12 which will create a better balance in the housing market. So far sales of new homes have been relatively resilient, but should new homes sales start to decline substantially it will prolong the supply adjustment.

In addition it should be remembered that China still has considerable policy flexibility to support the housing market and construction: 1) PBoC could ease monetary policy more aggressively, 2) the ambitious plans for construction of social housing could be speeded up and 3) the regulatory tightening targeting the property market introduced in 2007 could be rolled back. This includes substantially higher down payment requirements in connection with home purchases.

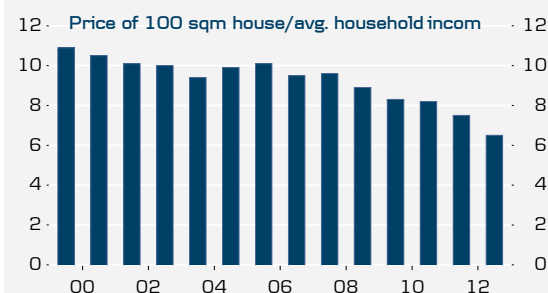
China's key advantage relative to the rest of the world remains its policy flexibility. We expect inflation to decline below 3.5% y/y by mid 2012 and hence China should again be in a position where it can ease both monetary and fiscal policy if needed. With gross central government debt only 17% of GDP, China also appears to be in a favourable position to manage any issues regarding excessive debt in local government funding vehicles (estimated to be 26% of GDP) and possible bad loans in the banking sector.

However, we expect the policy response in the coming months to be cautious as the severity of the slowdown is still uncertain: 1) The regulatory tightening measures against the property market will most likely stay in place. The government is actually targeting a minor decline in house prices to improve new home affordability that has become an important social issue, 2) We do expect the reserve requirement to be cut by at least another 150bp in H1 2012, but we do not expect the leading interest rates to be cut at this stage and 3) Fiscal policy will be eased slightly possibly by speeding up construction of social housing and restarting the ambitious railway construction programme that was temporarily put on hold after some accidents. The successful programme with consumer subsidies for purchase of durable consumer goods from 2009 could also be reintroduced as part of fiscal easing.

Policy easing to support recovery in 2012

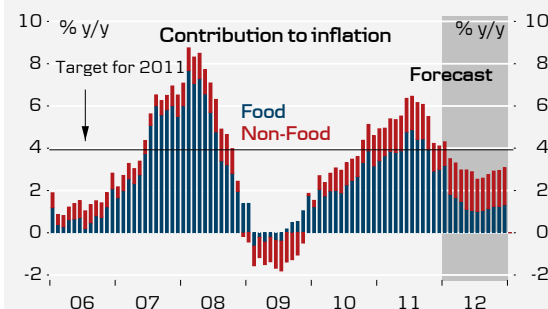
In our view China will avoid a hard landing in 2012 and the slowdown should prove less severe than the one China experienced in 2008 in the wake of the global financial crisis. This primarily reflects that the slowdown in exports should prove far less severe than in 2008 and that the slowdown in the housing market at this stage does not appear to be more severe than in 2008.

Affordability is a concern, but is improving



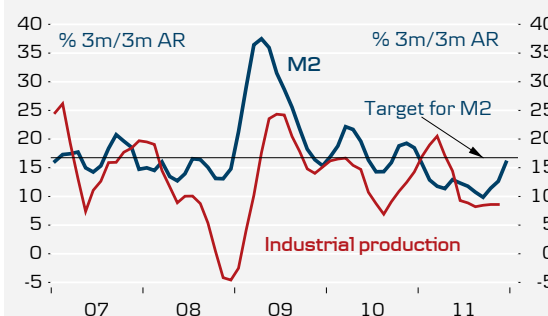
Source: Danske Market and China Economic Quarterly

Inflation again within PBOC's comfort zone



Source: Reuters EcoWin and Danske Markets

Renewed acceleration in money supply suggests growth will improve in H1 12



Source: Reuters EcoWin and Danske Markets

In the last three quarters of 2011 growth is estimated to have been around 7% q/q AR, which is below potential GDP growth (estimated at 9%). Our GDP forecast for 2012 has been revised down to 8.5% from 8.9% reflecting that growth in Q4 11 and Q1 12 have been revised lower due to a larger negative impact from the property market. We expect GDP growth to improve in the coming quarters on the back of a less negative impact from exports and a gradual impact from policy easing in China. GDP growth is expected to improve to 8% q/q AR in Q1 12 to more than 9% q/q AR in the last three quarters of the year.

We estimate that China's current account surplus declined to just 2.9% of GDP in 2011 from 5.1% of GDP in 2010. As China has also stopped accumulating FX reserves in Q4 11, it has stronger arguments for arguing that its currency is no longer substantially undervalued. Hence, we think the pace of appreciation of CNY will slow to about 3% in 2012 from close to 6% last year.

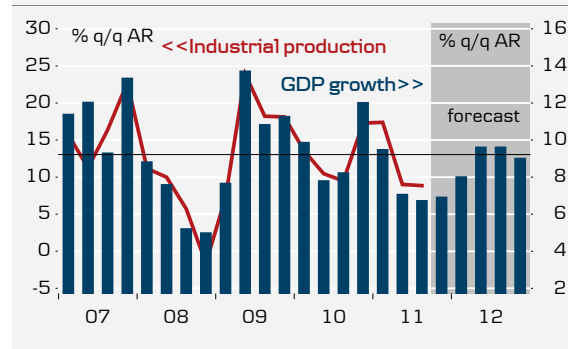
Japan: Recovery has temporarily lost steam

In Q3 11 the economy largely recovered from the devastating earthquake and tsunami that hit Japan in March 2011. However, the recovery has lost steam and we now estimate that GDP expanded just 0.7% q/q AR in Q4 11 after surging close to 6% q/q AR in Q3 11. Part of the explanation is slower export growth in the wake of the global slowdown. In addition, the supply chain of many Japanese manufacturers has again been disrupted, this time by the flooding in Thailand in October and November. Reconstruction after the earthquake has also temporarily lost pace. Finally, private consumption appears to have contracted in Q4 11 after extraordinary strong private consumption in Q3 11, when private consumption was boosted by pent-up demand and restocking of durable consumer goods.

We do not expect Japan to slip back into recession. Firstly, while the global development remains the single biggest risk for Japan in 2012, the impact on exports is expected to be less negative in the coming quarters. Secondly, a resilient labour market suggests that private consumption will resume expanding moderately. Finally, the approval of the JPY12trn third supplementary budget by the Diet in November has also cleared the way for accelerated spending on reconstruction in the coming quarters.

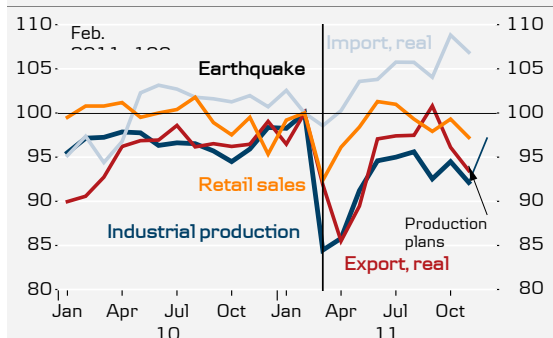
The impact from fiscal policy on growth will be also expansionary in 2012 because of reconstruction and despite the recovery the public deficit in 2012 will remain largely unchanged, close to 10% of GDP. Gross public debt is expected to exceed 235% of GDP. Political negotiations about a long-term plan for consolidation of public finances have started. The government's proposal includes raising the consumption tax from 5% to 10% in two steps starting from 2014. An agreement on fiscal consolidation will most likely not include any major new fiscal tightening before the next election for the Diet, which is due before September 2013. That said, the impact on growth from fiscal policy is poised to be substantially negative in 2013 as reconstruction activity gradually declines.

China is still expected to recover in 2012



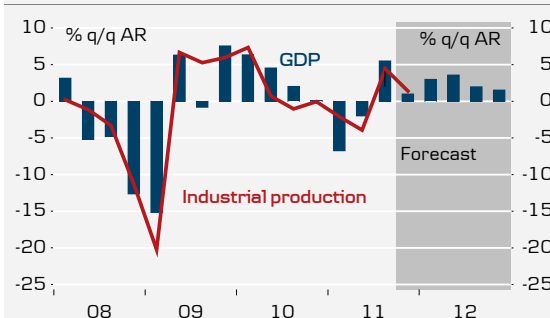
Source: Reuters EcoWin and Danske Markets

In Japan the recovery after the earthquake has lost steam



Source: Reuters EcoWin and Danske Markets

Growth is expected to improve again in H1 12



Source: Reuters EcoWin and Danske Markets

We expect Japan's sovereign debt rating to be downgraded in 2012 (current ratings are AA- by Standard & Poor's and Aa3 by Moody's). So far there has been no spill over from the European debt crisis because Japan's debt is financed primarily by Japan's large domestic saving surplus, but it should be remembered that Japan - just like Italy - is vulnerable to a possible confidence crisis and higher interest rates due to its huge gross debt - not least because its saving surplus is now declining fast.

Japan in 2012 will face headwinds from the stronger JPY. In real terms the effective JPY exchange rate has appreciated by about 25% since 2007 and we estimate that the appreciation of JPY could subtract as much as 0.5%-points from GDP growth in 2012. Japan's current account surplus is expected to decline substantially from 3.5% of GDP to just 1.5% of GDP in 2012. A surge in natural gas imports due to the permanent closure of nuclear plants has contributed to the large decline in the current account surplus.

With the recovery losing considerable steam in late 2011, continued appreciation pressure of JPY and consumer prices still declining, we expect Bank of Japan to expand its asset purchases further in 2012. Should JPY continue to appreciate against USD, we also expect Japan to continue to intervene in the FX market if needed.

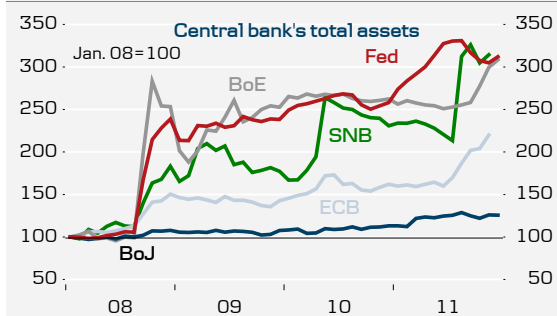
Fiscal easing to support recovery across Asia

In the rest of Asia growth has slowed substantially on the back of slower export growth and monetary tightening. With the exception of Indonesia growth has been below potential in H2 2011. However, inflationary pressure have also eased substantially driven not least by lower food price inflation. Hence leading interest rates have peaked across Asia and both monetary and fiscal policy are now moving in a more growth-supportive direction. Real interest rates remain very low and for that reason monetary policy is only being eased cautiously. So far only Indonesia, Thailand and the Philippines have cut their leading interest rates. In Thailand the cut in the leading interest rate was mainly the result of the sharp contraction in the economy in the wake of the flooding in October and November.

However, contrary to the developed countries, fiscal policy is again turning expansionary across Asia. Indonesia, South Korea, Thailand, the Philippines and Malaysia will all ease fiscal policy. Together with lower inflation and a gradual improvement in exports this is expected to support recovery in H1 2012.

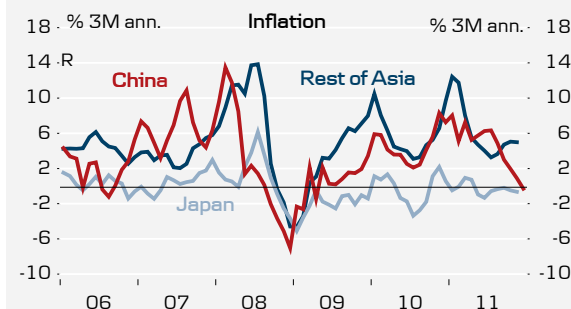
India looks increasingly vulnerable, because unlike the rest of Asia it does not have the policy flexibility ease fiscal and monetary policy due to resilient elevate inflation, high budget deficit and public debt and a 3% current account deficit. While there are signs that the Indian economy started to recover in late 2011 there is an increasing risk of a relatively hard landing.

BoJ's QE has so far been modest compared to major central banks



Source: Reuters EcoWin and Danske Markets

Inflationary pressure has eased across Asia



Source: Reuters EcoWin and Danske Markets

The worst may be over for Asia's exports



Source: Reuters and Danske Markets

Macro forecasts for Asia

	GDP				CPI inflation				Current account			
% Change y/y	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013
Asia	8.5	5.9	6.6	6.9	3.9	4.9	3.9	3.6	3.5	2.1	2.0	2.2
Japan	4.4	-0.8	2.5	1.6	-0.7	-0.3	-0.1	0.2	3.5	2.0	1.5	1.9
China	10.3	9.0	8.5	9.1	3.3	5.4	3.2	3.1	5.2	2.9	3.1	3.4
Asia excl. Japan & China	8.5	5.4	6.1	6.4	6.6	6.6	6.2	5.4	1.7	1.4	0.9	1.0
India	10.1	6.9	7.3	8.2	10.4	8.0	7.7	7.1	-2.6	-2.8	-3.0	-2.3
NIC	8.4	4.1	4.6	4.7	2.3	3.7	3.3	2.7	7.0	6.5	6.3	6.0
South Korea	6.2	3.8	4.5	4.5	3.0	4.3	3.8	3.0	2.8	1.5	1.4	1.3
Taiwan	10.9	4.1	5.0	4.9	1.0	1.8	1.8	2.0	9.3	11.0	11.0	10.3
Hong Kong	7.0	4.8	4.3	4.6	2.3	5.0	4.7	3.0	6.2	5.4	5.5	5.8
Singapore	14.5	4.8	4.3	5.5	2.8	4.3	3.1	2.4	22.2	19.8	18.5	17.3
ASEAN	6.9	4.9	6.1	5.4	4.4	6.3	5.8	4.6	3.3	2.6	1.8	1.5
Indonesia	6.1	6.2	6.8	5.5	5.1	5.7	6.5	5.4	0.8	0.2	-0.4	-0.6
Thailand	7.8	2.5	5.4	4.8	3.3	4.0	4.1	4.2	4.6	4.8	2.5	1.6
Philippines	7.6	4.9	5.7	4.7	3.8	5.0	4.5	4.0	4.2	1.7	1.3	1.2
Malaysia	7.2	4.5	5.1	5.5	1.7	3.5	3.2	2.4	11.5	11.3	10.8	10.3

Source: Danske Markets and and IMF

Disclosure

This research report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority.

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish Securities Dealers Association.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors upon request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Global Scenarios is a quarterly forecast, but new statistical data may give rise to changes in our views on individual economies.

First date of publication

Please see the front page of this research report.

General disclaimer

This research has been prepared by Danske Markets (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ("Relevant Financial Instruments").

The research report has been prepared independently and solely on the basis of publicly available information which Danske Bank considers to be reliable. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness, and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgment as of the date hereof. These opinions are subject to change, and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in the research report.

This research report is not intended for retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to "U.S. institutional investors" as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to "U.S. institutional investors".

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA, but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.