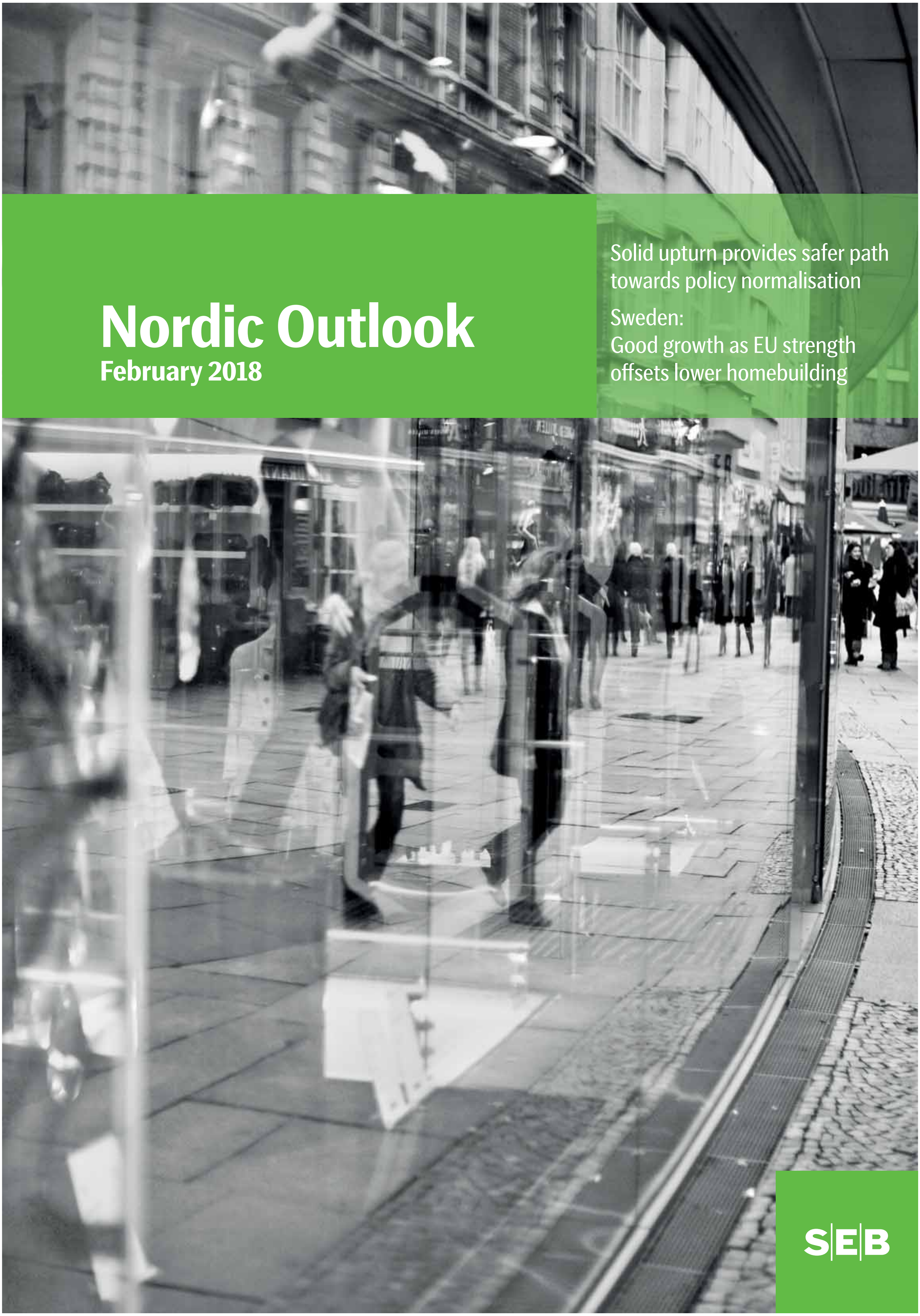


Nordic Outlook
February 2018

Solid upturn provides safer path towards policy normalisation

Sweden:
Good growth as EU strength offsets lower homebuilding

SEB

Contents

International overview	4
Theme: The volatility puzzle – is it the calm before the storm?	12
The United States	14
Japan	18
The BRIC countries	19
Theme: Oil prices – an OPEC-US tug-of-war	22
The euro zone	23
The United Kingdom	26
Sweden	27
Theme: Comparing Nordic housing markets	31
Denmark	33
Norway	34
Finland	36
Estonia	37
Latvia	38
Lithuania	39
Economic data	40

Boxes

Looking back as the Fed seeks new targets	8
Positioning and valuations may affect momentum	13
Trimming China's debt – "Korea-Light" style	19
Fresh start for the EU, without EUphoria	25

Solid upturn provides safer path towards normalisation

- **US tax cuts and EU's fresh start will lift GDP**
- **GDP growth over 5 per cent in EM sphere despite China's controlled slowdown**
- **Robust economy and fading downside inflation risks simplify CB normalisation**
- **EU optimism will push EUR/USD above 1.30, despite Fed hikes to 2.75 per cent in 2019**
- **Central banks, tax cuts and growth will drive up equities and long-term bond yields**
- **Continued Swedish boom due to industry, but low inflation a headache for Riksbank**

The global economy has recently performed impressively on a broad front. The **US economy** showed strength in the latter part of 2017. Now that the Trump administration has pushed through a relatively large tax package, the outlook will improve further. In the **euro zone**, greater political optimism and economic confidence are now mutually reinforcing – helping fuel the fastest growth in a decade. Uncertainty about future relations with the European Union is causing the **British economy** to lose ground, but the consequences look set to be less serious than feared. In **emerging market (EM) economies**, too, bright spots have predominated. In 2017, the EM economies speeded up significantly after an earlier slump. Looking ahead, they will establish overall GDP growth of around 5 per cent. In **China** a minor deceleration is under way as national leaders, after the Communist Party congress, accept slightly lower growth in order to prioritise debt reduction. In other major EM economies, led by **India**, GDP is accelerating. The **Nordic economies** are continuing their above-trend growth. Norwegian home prices are stabilising, and we foresee good prospects for limiting the price decline in **Sweden** to 10 per cent. However, Swedish growth drivers are shifting as residential construction falls while exports and industrial production gain momentum.

In the past year, we have been more optimistic than the consensus of analysts, yet we have had to make continuous upward revisions in small steps. Now we are **again adjusting our global growth forecast higher by one tenth of a percentage point per year in 2017-2019**, leading to a stable GDP upturn of around 4 per cent. Our largest adjustment is for the United States in 2019, when tax cuts are likely to provide their biggest growth impulse. We have previously been cautious about letting political uncertainty affect our growth forecasts but to some extent we, like many other observers, have **underestimated the positive impact of US tax cuts and renewed optimism about the EU project**. We are now generally seeing a growth dynamic that is rather typical of a mature expansion period. Robust labour markets and rising wealth are contributing to household optimism, while capacity utilisation is reaching levels that will drive new capital spending on a more widespread basis. **Also benefiting the world economy is that oil prices seem to be settling at a slightly higher level of around USD 65/barrel** (see the theme article "Oil prices – an OPEC-US tug-of-war"). There is also some evidence for our view that the supply side of the economy may surprise on the upside late in the economic cycle; continued weak pay hikes at least give central banks a lot of manoeuvring room to shape their monetary policy normalisation.

Global GDP growth

Year-on-year percentage change

	2016	2017	2018	2019
United States	1.5	2.3	2.8	2.5
Japan	0.9	1.5	1.2	1.0
Germany	1.9	2.2	2.5	2.2
China	6.7	6.9	6.6	6.2
United Kingdom	1.9	1.8	1.4	1.1
Euro zone	1.8	2.3	2.5	2.2
Nordic countries	2.2	2.4	2.4	2.3
Baltic countries	2.2	4.2	3.5	3.2
OECD	1.8	2.4	2.5	2.2
Emerging markets	4.3	5.0	5.2	5.1
World, PPP*	**3.2**	**3.9**	**4.0**	**3.9**

Source: OECD,IMF, SEB   * Purchasing power parities

Despite optimistic forecast for the next couple of years, a number of potential sources of concern must be kept in mind. President Donald Trump now seems more capable of gaining acceptance, and in some cases great appreciation, for his economic policy programmes. But that will not prevent today's deep US political conflicts from being dangerous further ahead. **Erratic US foreign and trade policy behaviour will also continue to create uncertainty**. If the EU project achieves a fresh start – without the United Kingdom and with French President Emmanuel Macron and a slightly more new pro-EU German government in the driver's seat – this will benefit stability in the short term. But future federalist ambitions may create tensions and dilemmas. This applies, for example, to Sweden's and Denmark's positions on EU issues as well as the role of Eastern European member countries.

As for more traditional economic risks, it is clear that **the US tax cuts are occurring at a late cyclical stage**, when there is rather little slack in the economy. They will also help decrease the room for fiscal stimulus during the next recession. That is when they will actually be more needed, since there is a major risk that there will not be enough time to build up very much monetary policy ammunition. Since the inflation response to strong economic growth and a robust labour market is so weak, the economic policy framework including inflation targeting will continue to be questioned. Around the corner are risks that **prolonged ultra-loose monetary policy will weaken pressures for change and create new financial bubbles**. Existing policies have also helped push down volatility in financial markets in a slightly insidious way, even though in our theme article "The volatility puzzle – is it the calm before the storm?" we draw the reassuring conclusion that there are important underlying reasons for the prevailing situation. Another risk is related to redistribution issues, especially since widening gaps lead to **increasing political and social tensions**. But we can also see that generally slow upturns in household purchasing power are starting to hamper consumption, although in many countries it is being propped up in the short term by less saving.

Generally speaking, most central banks now seem on their way towards reacting to strong economic signals and a changing risk picture by accelerating monetary policy normalisation. We now believe that **the Fed will speed up its pace and hike the key interest rate four times this year**, followed by one more hike to 2.75 per cent by the end of 2019. Because of the strong upswing in Europe, **the European Central Bank (ECB) is now also moving towards normalisation**. It will end bond purchases in September, followed by a hike in its deposit rate in March 2019, while other key rates will be raised in the middle of the year. By the end of 2019, the ECB's refi rate will stand at 0.50 per cent. The downturn in Sweden's housing market does not change our view that **the Riksbank will deliver its first repo rate hike in September 2018, followed by three hikes to 0.50 per cent by the end of 2019**. The low inflation that we forecast over the coming six months may, however, cause headaches for the Riksbank. In Norway, **Norges Bank** is signalling some likelihood of a rate hike as early as autumn; we believe that **the hike will occur in December and be followed by two more hikes during 2019 to 1.25 per cent**.

The clear upturn in international bond yields since mid-December reflects the changes in growth and central bank prospects. We believe yields will keep rising, driven by strong economic conditions and further central bank actions. But there are also strong forces that suggest continued low yields, such as weak inflation pressure and re-investment of the ECB's bond holdings. We forecast that government bond yields will **rise by a modest 60-80 basis points to 3.30 per cent in the US and 1.50 per cent in Germany by the end of 2019, but the risks are on the upside**.

Expectations of aggressive Fed action have not helped drive up the dollar. Forces other than relative monetary policy prospects now appear to dominate EUR/USD exchange rate movements. The strength of the euro zone economies and a more stable political landscape have boosted confidence in the euro as a reserve currency. This will help bring about a **continued gradual appreciation to USD 1.32 per euro by end-2019**.

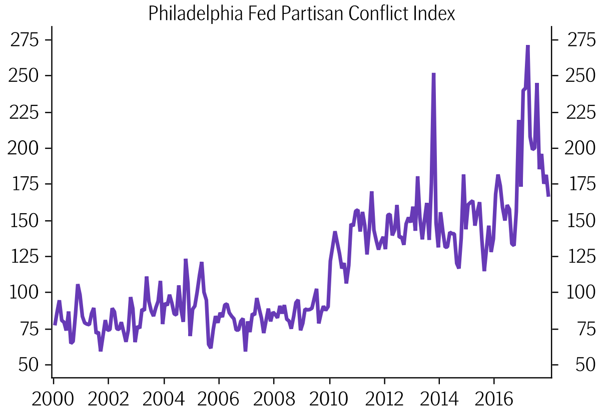
Stock markets will enjoy continued support, as a synchronised global economic upturn and increased capital spending benefit earnings performance. In addition, US tax cuts are providing extra stimulus to stock markets. But the recent stock market surge has driven up valuations to levels that make stock markets more sensitive to disappointing earnings performance.

US: Tax cuts will lift economic growth

The American economy ended 2017 in an impressive way. Although fourth quarter GDP growth did not really live up to expectations, its structure confirms underlying strength. Higher crude oil prices have contributed to a renewed upturn in oil extraction investments, while consumption continues to climb. After a lengthy congressional process, the administration was able to enact its rather large tax reform, which will improve the growth outlook. The International Monetary Fund (IMF) believes that the US tax package will lift GDP by an accumulated 1.2 per cent in 2020. Our interpretation is somewhat more cautious, among other things because affluent households – which will benefit greatly – will not be big spenders. We are nevertheless revising our GDP forecasts upward. **This is especially true of 2019 (to 2.5 per cent, from 2.0 in November), when we believe the growth impact of federal fiscal policy will be the strongest**.

US: Lower conflict level in Congress

Philadelphia Fed Partisan Conflict Index



Source: Federal Reserve Bank of Philadelphia

President Trump often still behaves in an erratic, provocative fashion, but a re-evaluation of his administration's ability and ambitions seems to be under way. This is particularly true of the US business community, which is more and more clearly pointing to the positive effects of deregulation. The administration's greater self-confidence will help reduce the risks of major trade policy reversals, especially related to North American Free Trade Agreement (NAFTA) negotiations with Canada and Mexico. As more and more demand-side uncertainties are resolved, the labour market situation will be even more crucial to the long-term growth outlook. Unemployment was 4.1 per cent in January. **Most indications are that in the first half of 2018 we will see levels under 4 per cent**: well below the US Federal Reserve's recent 4.6 per cent equilibrium estimate. But the picture is ambiguous; the

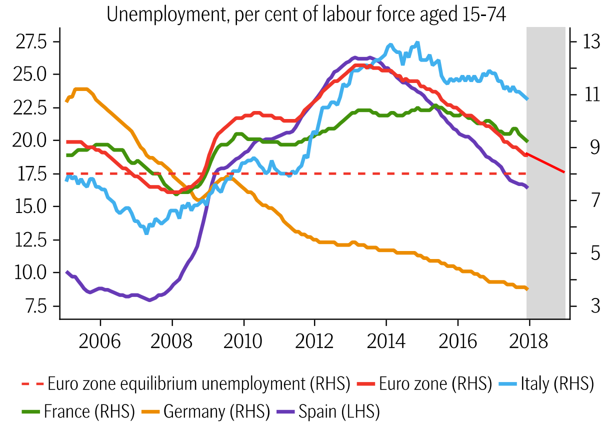
Fed is apparently about to adjust its equilibrium estimate even lower, a signal that it is not too worried about labour market overheating. Labour force participation is nearly 63 per cent, well below its peak of around 67 per cent in 2000, suggesting there is potential for **continued healthy GDP growth**.

EU: More economic and political optimism

The positive trend in the euro zone has intensified in recent months. A strong ending to 2017 is one reason **we have adjusted our GDP growth forecast for 2018 from 2.3 to 2.5 per cent**. Unemployment has gradually fallen from its peak of 12.1 per cent early in 2013 to the current 8.7 per cent. It has a bit further to go before reaching 8.0 per cent, our estimate of equilibrium unemployment. This implies that in cyclical terms, the euro zone is clearly lagging other leading industrialised countries that are already at or below equilibrium. In an environment of sustained healthy demand for labour, and in light of structural reforms in France, Spain and elsewhere, it is also not unreasonable that euro zone equilibrium can be pushed a bit lower. On the supply side, there are thus no obstacles to sustained above-trend growth in 2018-2019. **Yet we believe GDP growth will slow to 2.2 per cent in 2019**; one reason is that a stronger euro will hamper exports to some extent. Household income growth will also remain weak, and it is doubtful whether the downturn in the household savings ratio that is currently propping up consumption will continue.

Broad-based decline in unemployment

Unemployment, per cent of labour force aged 15-74



Source: Eurostat Database, Macrobond, SEB

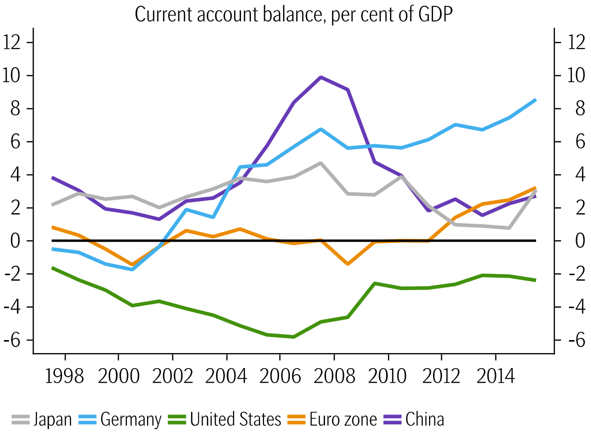
Despite great fears early in 2017, euro zone elections mainly led to reassuring outcomes. The political agenda is eventful in 2018, too, though this is unlikely to affect the economy so much in the short term. It is **hard to see how a stable Italian government can be formed after the March 4 election**. But since the populist Five Star Movement is no longer pushing for withdrawal from the euro zone, the most important issue has lost its explosive potential. Financial market interest in the election has thus cooled. **A new grand coalition government between Christian Democrats (CDU/CSU) and Social Democrats (SDP) is now finally on its way to being formed in Germany**. Since SPD delegates voted by a relatively small majority to join a coalition led by Chancellor Angela Merkel, SPD leaders are being forced to adopt a tougher attitude than before. This applies especially to EU policy, in which the SPD – led by Martin Schulz, former president of the European Parliament – appears to have many views in common with France and President Emmanuel Macron. Although CDU/CSU may slow the process a bit there are many indications that EU cooperation is moving towards a fresh start, after the resignation that reached its peak between the UK's Brexit referendum in mid-2016 and last spring's French presidential election. The next few years will show whether political leaders can find a middle path towards **progress that is clear enough to bolster public confidence in the euro project** without embarking on an **aggressively federalist path that will generate new tensions among member countries**.

Tight time frames for Brexit negotiations

So far, the economic impact of uncertainty connected to future UK-EU relations has been less than anticipated. In particular, capital spending has remained unexpectedly high. The weak pound has helped to stimulate exports, but on the other hand it has squeezed household purchasing power and consumption due to rising import prices. After the two sides agreed in December on the terms of UK withdrawal, it is time to start negotiations on future relations. Our main scenario is that a full agreement will be reached sometime this coming autumn. There are thus good prospects for an economic soft landing, with a moderate downturn in GDP from 1.8 per cent in 2017 to 1.4 per cent in 2018 and 1.1 per cent in 2019. However, the risks are significant. The time frames are very tight and various kinds of political crises may occur that would halt or delay an agreement. Individual EU countries may put up obstacles, but above all, internal British disputes may cause problems. Prime Minister Theresa May and her government appear weak and will be subject to a variety of criticisms at home.

German surpluses illustrate global imbalances

Current account balance, per cent of GDP



Source: IMF

EM growth stabilising at high level

Positive signals have predominated in emerging market (EM) economies as well. The big surge in growth occurred between 2016 and 2017, but **SEB's aggregate EM growth index is now stabilising at somewhat above 5 per cent**: its highest in more than a decade. Fed rate hikes pose certain risks of financial market disruptions ahead, but these risks are softened by an environment of strong global GDP growth. They are also not expected to result in sharp US dollar appreciation that would increase the burden of USD-denominated debt.

Last year GDP growth in China reached 6.9 per cent, thereby surpassing Beijing's 6.5 per cent target. We now expect a gradual slowdown to 6.6 per cent in 2018 and 6.2 per cent in 2019. President Xi Jinping has now strengthened his power base after last autumn's reshuffle in the Communist Party leadership and can thus increase the pace of reform work. This implies, for example, increased acceptance of lower growth as the price of bringing down the public sector debt burden.

GDP growth, BRIC countries and EM sphere

Year-on-year percentage change

	2016	2017	2018	2019
China	6.7	6.9	6.6	6.2
India	7.1	6.4	7.5	7.8
Brazil	-3.6	1.1	2.7	3.0
Russia	-0.2	1.5	2.2	2.0
Emerging markets, total	**4.3**	**5.0**	**5.2**	**5.1**

Source: OECD, SEB

In **India**, growth accelerated during the second half of 2017, after having slowed for more than a year. We expect GDP growth to accelerate to 7.5 per cent in 2018 and strengthen a bit further in 2019. Regional election victories indicate that the BJP government enjoys support for continuing its reform policies, but it is likely to act cautiously in the important labour market field until the 2019 national election. The recovery in **Brazil** has benefited from higher commodity prices and a weak currency; we expect GDP growth to reach 2.7 per cent this year and then climb somewhat in 2019. Despite continued political uncertainty, stability has increased in financial markets, but widespread dissatisfaction with established politicians may open the way for populist successes in the October presidential election. In **Russia**, growth slowed in the second half of 2017, partly due to oil production caps imposed by an agreement with the Organisation of the Petroleum Producing Countries (OPEC). The removal of these caps in mid-2018, combined with slightly higher oil prices and a weaker rouble, will enable GDP growth to reach more than 2 per cent in 2018. Vladimir Putin will announce economic reforms after his assured re-election as president in March, but strong special interests are likely to effectively cripple their implementation.

Nordics, GDP growth

Year-on-year percentage change

	2016	2017	2018	2019
Sweden	3.2	2.6	2.6	2.4
Norway	1.1	2.0	2.0	2.1
Denmark	2.0	2.1	2.4	2.3
Finland	2.1	3.1	2.5	2.4

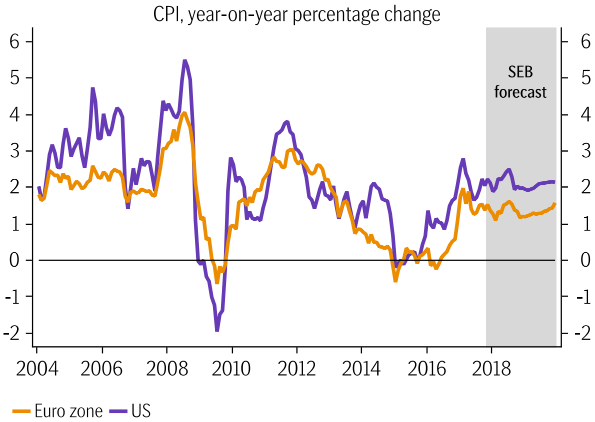
Source: OECD, SEB

Above-trend Nordic growth

Strong European conditions are benefiting the Nordic economies. Growth is above trend, yet there is no shortage of worries. In Norway and Denmark, unemployment is historically low. Supply-side restrictions may thus very soon contribute to slower growth, although strong balance sheets do not indicate any excesses. **The Swedish economy remains strong**, but growth is cooling due to falling residential investments in the wake of lower home prices. Our main scenario is that the price decline will not exceed 10 per cent, while accelerating exports and industrial production will ensure continued above-trend GDP growth: 2.6 per cent in 2018 and 2.4 per cent in 2019. Last year **the recovery in Norway** moved up to more stable ground; it is **now accelerating further**. Although residential construction is slowing, exports and industrial investments are increasing on a broad front here as well. **We expect mainland GDP to grow by about 2.5 per cent yearly in 2018-2019**. Due to accelerating oil investments, overall GDP growth will also speed up. After several tough years, **Finland closed 2017 at the top of Nordic growth charts**. The country's outlook appears good. Although households will be squeezed by weak income growth, exports and capital spending will climb. **GDP will increase by about 2.5 per cent yearly in 2018-2019**. **The Danish economy will accelerate in the next couple of years**. Exports and households, which are cautious in relation to fundamentals, will drive the recovery. **We expect GDP to rise by nearly 2.5 per cent yearly in 2018-2019**.

Low but rising inflation

CPI, year-on-year percentage change



Source: Eurostat, BLS, SEB

Not much new on the inflation front

Inflation has recently surprised somewhat on the upside. This is especially true of the US, partly driven by the weak dollar. Higher oil prices have also contributed, but their effects have been softened because petrol (gasoline) prices have not kept pace with crude oil prices. With pay increases apparently unwilling to take off, CPI inflation is mainly flat at a bit above 2 per cent. This inflation environment will give the Fed a sizeable degree of freedom, even though its favourite metric – the personal consumption expenditures deflator (core PCE) – is a little below CPI. In the euro zone, effects of higher oil prices are offset by euro appreciation. After topping 2 per cent early in 2017, the harmonised index of consumer prices (HICP) fell to 1.4 per cent in December. Early in 2018, inflation will fall towards 1 per cent. Despite stronger economic growth and labour markets, **HICP inflation will reach only 1.4 and 1.3 per cent in 2018 and 2019.** In the UK, exchange rate-driven inflation has culminated. Due to continued low pay hikes, inflation will probably fall below the 2 per cent target in late 2018.

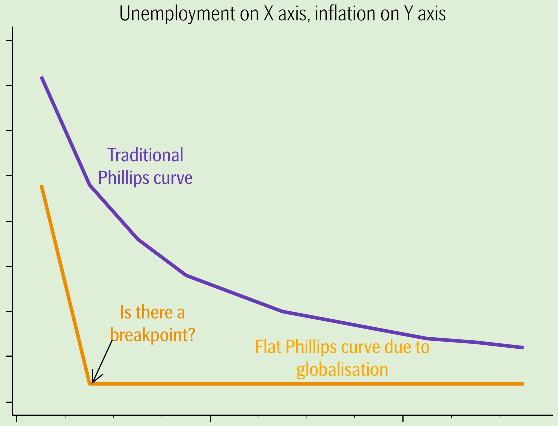
Looking back as the Fed seeks new targets

Although unemployment in many economies has now fallen to historically very low levels, pay increases have shown no clear signs of accelerating. Because decades have passed since we have seen inflation surge due to tight resource utilisation, it would be speculative to forecast a far-reaching change in the inflation environment over the next couple of years. In the last *Nordic Outlook* (the theme article "Inflation targeting in crisis?") we discussed **three approaches to the inflation process**: 1) **"Irresistibly strong disinflationary forces"** from globalisation and robotisation continue to hold down inflation on a broad front, 2) **"A Phillips curve with a trick knee"** creates the risk of an inflationary ketchup effect when the resource situation reaches a critical level and 3) **"A blurry Phillips curve"**, where the relationship between the labour market and inflation at national level is admittedly weaker than before but has not been entirely wiped out and the inflation response arrives after a lag.

We are still mostly leaning towards the third approach. Now that economic growth is speeding up, this matter is becoming more acute for central banks. A logical shift is discernible in their risk analysis. As secular stagnation – a demand-driven economic slowdown – appears less and less relevant, the risks of starting or continuing monetary policy normalisation also diminish. There is also more room to highlight various downsides of continued ultra-loose monetary policy, such as the risk that **inflation will suddenly take off**, that **ineffective financial resource allocation will harm productivity** or that **new financial bubbles will be created**. But the question is how far such a pragmatic shift in the risk picture can go. Experience shows that central banks can sometimes have legitimacy problems if they hike rates without support either in a clear analytical framework or a changed mandate. It is thus interesting to look at how these issues are evolving.

Shape of Phillips curve is one focus of policy debate

Unemployment on X axis, inflation on Y axis



Source: Macrobond, SEB

Looking at the analytical framework, one trend may be to expand traditional analysis of how labour market-related output gaps affect price and wage formation, for example via the Phillips curve. One approach by the Bank for International Settlements (BIS) in its study entitled "*Rethinking potential output gap: Embedding information about the financial cycle,"* by Borio et al, is to identify output gaps with the help of trend deviations in real interest rates, property prices and credit volumes. By showing that such financial variables can be used as indicators of output gaps and overheating risks, central banks could use them as arguments for monetary policy changes. Unlike the concept of "leaning against the wind", it would be **unnecessary to argue that financial stability was threatened**, but only that tight conditions indicate that **growth potential is starting to be exhausted, along with the benefits of continued stimulus**. Although no formal breakthrough in putting such instruments in place seems imminent, both central banks and other forecasters could use them to evaluate differences between countries when it comes to the risks and sustainability of economic expansion.

As for changes in the policy framework itself, there are actually two debates under way. One is more connected to the above analytical issues and deals with how central banks **can gain greater flexibility in order to distance themselves from a one-sided focus on inflation targets in a world of treacherously weak Phillips curve relationships**. As economic expansion enters a more mature phase, it also becomes more urgent for policymakers to look beyond the ongoing upturn. Although a near-term recession does not appear imminent, central banks are likely to face the next slowdown with interest rates well below levels prevailing before earlier downturns.

In the US, for some time there has been a discussion about devising new targets to increase the Fed's flexibility in its next easing cycle. Trump's tax cuts have decreased the room for future stimulus packages, making this issue more topical. One proposal is to **boost the inflation target from 2 to 3-4 per cent, shift to some form of price level target or focus on nominal GDP**. But the difficulty of achieving today's targets raises questions about how realistic even more ambitious inflation targets would be. The solutions being discussed are also coloured by historical rather than future challenges; if inflation should actually start surging, an upwardly adjusted inflation target is perhaps not the best recipe for calming the market. It is also probably both harder and riskier to Fed independence to try to push new targets through today's polarised US Congress. It also remains to be seen how willing to experiment the new Fed leadership will be.

Dramatic changes in frameworks are thus unlikely. Probably the most realistic proposals are those aimed at opening the way for more flexible interpretation of existing targets, for example by allowing inflation to vary within a given range or by defining target fulfilment based on an average over a long period, as Australia is already doing. But it is doubtful that this would make any major difference to the Fed's particular toolbox in the next crisis. Last year's rate hikes show that the Fed is already allowing itself a degree of manoeuvring room in relation to short-term inflation trends.

Strong growth will embolden central banks

To some extent, greater optimism about the economy will make it easier for central banks to carry out normalisation measures, despite still-subdued price and wage increases. Over the next couple of years, we expect more central banks to emulate the Fed in retreating from extreme stimulus policies. Meanwhile, due to tax cuts and more expansionary financial conditions, the bar has been raised when it comes to how much the Fed can be expected to hike its key rate. **We have revised our forecast upward and now believe that the Fed will hike its key rate four times this year (March, June, October and December), followed by one hike in 2019**, bringing it to 2.75 per cent.

In Europe, accelerating economic growth seems to have strengthened the hawkish faction at the European Central Bank, adding support to our forecast that bond purchases will end in September 2018. In March 2019, we believe the ECB will raise its deposit rate for banks to -0.25 per cent in order to restore the earlier symmetric band around the refi rate. **It will also hike the refi rate that summer, bringing it to 0.50 per cent by the end of 2019**.

Central bank key interest rates

Per cent

	Today	Jun 2018	Dec 2018	Dec 2019
Federal Reserve (Fed)	1.50	2.00	2.50	2.75
ECB (refi rate)	0.00	0.00	0.00	0.50
Bank of England (BoE)	0.50	0.50	0.50	1.00
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.60	5.10
Riksbank (Sweden)	-0.50	-0.50	-0.25	0.50
Norges Bank (Norway)	0.50	0.50	0.75	1.25

Source: Central banks and SEB

In November the Bank of England reversed the crisis rate cut that it carried out soon after the June 2016 Brexit referendum. Given our low inflation forecast, no near term rate hikes are likely, but **an orderly withdrawal from the EU will open the way for two BoE hikes to 1.00 in the second half of 2019**. The Bank of Japan's extremely expansionary policy has become more controversial as economic growth has finally picked up, but inflation is conspicuously absent and tighter fiscal policy suggests that the BoJ will continue its current monetary policy.

At recent policy meetings, Sweden's Riksbank has reiterated its forecast of an initial rate hike in mid-2018. In light of our low inflation forecast for this period, the Riksbank may face some headaches, but strong economic growth and normalisation by central banks in other countries suggest that it will hike its key rate in September. The market is now pricing this in, making the decision easier. We are thus **sticking to our forecast of a first hike in September 2018, followed by three hikes in 2019 to a repo rate of 0.50 per cent by year-end**.

Above-trend growth in Norway's mainland economy and rising resource utilisation justify a less expansionary policy. At its December meeting, the central bank signalled a certain likelihood of a rate hike as early as this coming autumn. **We are still forecasting a rate hike in December, followed by two hikes in 2019 to 1.25 per cent**. Falling home prices are not expected to be an obstacle to hikes either in Sweden or Norway, as long as the decline remains moderate and has limited repercussions on the rest of the economy.

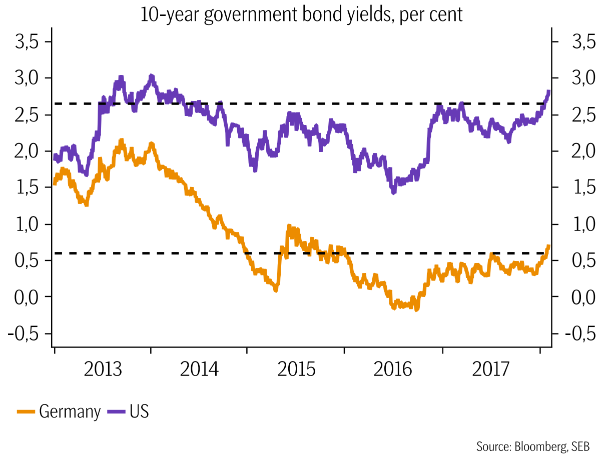
Central bank actions support higher yields

International bond yields have climbed sharply since mid-December after remaining largely flat earlier in 2017. The upturn was driven by such factors as strong statistics, the US tax reform, rising expectations of Fed rate hikes and a higher probability that the ECB's shift towards a less expansionary policy will occur earlier than expected. Our macro and central bank forecasts indicate such a trend. We thus believe yields will keep climbing in 2018, though more slowly than in recent weeks. Our new forecast of four Fed hikes in 2018 has only been partly discounted, despite the recent upturn in market pricing. Along with a continued gradual reduction in the Fed's balance sheet and a higher borrowing requirement as the US deficit grows, this suggests slightly higher bond yields.

Market valuations of inflation and recession risks will, however, determine the slope of the yield curve and the resulting bond yields. We believe that the US economy can handle four rate hikes this year and that inflation risks are actually on the upside. **Our forecast is that 10-year US Treasury yields will climb to 3.10 per cent by the end of 2018 and 3.30 per cent at the end of 2019**. This implies a continuation of the past year's trend, with the short end of the yield curve rising more than long-term yields, and the yield curve will become flatter. Bond yield risks will generally be on the upside.

Long-term yields have surpassed peak figures from 2017

10-year government bond yields, per cent



In the euro zone, strong economic growth justifies a phase-out of ECB crisis policy, but due to low inflation it will occur slowly. We forecast that the ECB will continue to re-invest all its bond holdings during the next couple of years, which also suggests continued low interest rates. **We expect 10-year German yields to climb by about 30 basis points from today's level to 1.00 per cent at the end of 2018**. In 2019 we expect this upturn to continue as the ECB begins gradual key rate hikes. The 10-year yield will climb to 1.50 per cent at the end of 2019.

This implies that the 10-year spread between US and German yields will stay around current level of just above 200 points in 2018 and then gradually converge during 2019.

Swedish government bond yields have followed international yields higher since the Riksbank again confirmed its plan to hike the repo rate starting in mid-2018, but the bank's announcement that it intends to re-invest its entire holding of bonds that mature in the spring of 2019 implies that it will keep buying nominal bonds at almost the same pace as last autumn. Combined with cutbacks in the National Debt Office's bond issue volumes, this will continue to push down Swedish yields. **We expect the 10-year yield spread against Germany to continue shrinking from today's level around 20 points in the next few months**. Later this spring as the Riksbank's rate hikes approach, the yield spread against Germany will widen, reaching 50 points by the end of 2018 and then widening somewhat further during 2019. **This implies that at the end of our forecast period, 10-year Swedish yields will be a bit above 2 per cent**.

Norwegian government bonds (NGBs) have followed international yields higher and the spread to German bonds remain historically high at levels slightly above 100 bps. The wide yield spread is partly due to depressed German yields but is also a consequence of the krone's weak performance in recent years. We believe demand for NGBs will pick up when the ECB ends its QE programme and market expectations of rate hikes increase. A change by Norges Bank in bond issuance procedures is also expected to support long-end NGBs. **We expect the 10-year yield spread against Germany to tighten to 95 bps by the end of 2018, before stabilising around 80 bps** as the Norwegian central bank gradually normalises its monetary policy.

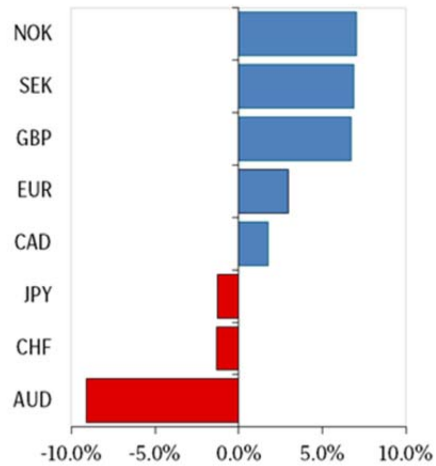
EUR/USD rate will keep climbing above 1.30

The foreign exchange (FX) market currently lacks clear patterns and drivers. Aside from significant upward and downward US dollar movements, generally speaking fluctuations are relatively small. The combination of low market volatility and high risk appetite due to continued expansionary central bank policies should benefit market strategies that seek returns in the form of higher interest rates (carry strategies). But exchange rate movements in 2017 did not reward such a strategy. Since conditions will not change especially much ahead, we will remain in an environment that has historically favoured carry strategies, which would squeeze funding currencies such as the euro and the Swedish krona. But as our currency ranking indicates, this is not our main scenario. Instead, we believe that both the euro and the undervalued Nordic currencies will appreciate.

Recent dollar depreciation has pushed the EUR/USD rate to levels higher than our equilibrium estimate (1.18). This movement has occurred even though the market has gradually priced in widening interest rate spreads between the Fed and the ECB. Stronger economic and political optimism in the euro zone has probably contributed to EUR appreciation, and we are seeing a clear trend among managers of global currency reserves to shift from USD- to EUR-denominated assets. The renewal of EU integration efforts due to Brexit and Emmanuel Macron's victory in the French presidential election suggests that this trend will continue. The US tax cuts will be larger than most observers had foreseen, which might suggest a stronger USD, but they will meanwhile contribute to larger US federal deficits and foreign trade imbalances. Although a small downward correction is likely in the short term, we thus believe that **the EUR/USD rate will keep climbing and reach 1.28 by the end of 2018, then continue to 1.32 by the end of 2019**.

The British pound is found in the middle of our ranking for the next 12 months; the Bank of England cannot allow it to fall too aggressively, but the outcome of Brexit negotiations will determine the fate of the currency a bit further ahead. **We expect the EUR/GBP rate to remain in its present range close to 0.90 until more information on future EU-UK relations emerges**. In autumn 2018 the pound will gradually start rising as negotiations begin to show positive results and will gradually move towards GDP 0.82 per euro late in 2019.

Expected change against the USD
12 months, per cent



The Bank of Japan will not let the yen strengthen much beyond today's levels vs the USD. We thus believe **the USD/JPY rate will remain in the 110-115 range this coming year**. Long-term, however, the JPY is undervalued and may appreciate to 105 per USD by the end of 2019, once the BoJ moves closer to monetary policy normalisation.

In the past six months, the EUR/SEK exchange rate has been close to 10.00, which is unsustainable in the long term, but it has now begun to creep slowly downward. The flow potential for a stronger krona will mainly be related to Swedish exporters expanding their currency hedges and exchanging their sizeable foreign-denominated reserves. Foreign institutions will undoubtedly position themselves for a stronger SEK, but since the Riksbank's policy shift is taking some time, it will remain costly to hold kronor. This is one reason why the EUR/SEK downturn will occur very gradually, reaching 9.50 by year-end. With the ECB approaching policy normalisation, the Riksbank's task will be easier. Meanwhile the krona's strong connection to euro appreciation against other currencies will automatically lead to trade-weighted SEK appreciation, which will limit the Riksbank's manoeuvring room. This, in turn will limit the room for the EUR/SEK rate to move lower, and we believe it will reach no further than 9.30 by the end of 2019 as the Riksbank hikes its repo rate to 0.5 per cent. This means the USD/SEK rate will end up close to 7.00 and that **the trade-weighted KIX index will reach a stretched level of around 107, which is about 2 per cent stronger than in the Riksbank's December exchange rate forecast**.

According to our currency ranking, the Norwegian krone has the very best outlook. Due to higher oil prices, increased oil investments and diminished fears of a deep downturn in the housing market, we expect the NOK to appreciate against the euro. The clearly undervalued krone will probably attract buyers as rate hikes approach in the second half of 2018. **Our forecast is that the EUR/NOK rate will fall to 9.20 at the end of 2018 and then further to 9.00 at the end of 2019**.

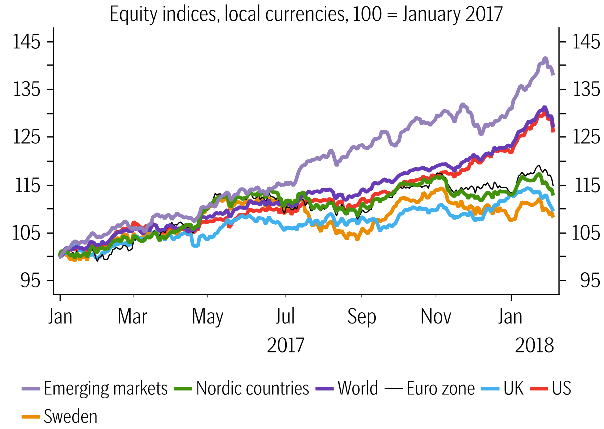
US tax cuts and global growth fuel equities

Stock markets performed strongly in 2017, with the MSCI All Country World Index gaining more than 20 per cent, but this was partly an effect of a weaker USD. In EUR terms, the return on the same index was 7 per cent. So far in 2018 (until February 1), global equities have gained another 5 per cent. The enactment of the US tax reform has been an important driver; **it is expected to boost aggregate S&P 500 company earnings by at least 5 per cent**. A synchronised global economic expansion has also led, among other things, to a higher-than-normal proportion of upside surprises in the early stages of the ongoing corporate report period. Strong reports also seem to be sectorally broad-based.

The market expects global earnings increases of just above 10 per cent in 2018 as a whole. Given our growth forecast, this is actually on the low side. Nor is it certain that such estimates have fully factored in the impact of the US tax reform. **We thus foresee a decent possibility of further upward adjustments**, suggesting that stock markets will remain strong in the next six months. Meanwhile the recent share price upturn has increased the risk of a short-term correction.

Expanding world trade and higher corporate earnings are the most obvious cyclical driving forces. These trends gained strength in 2017 and are likely to continue sustaining profits for another while. Low inflation also suggests that the favourable interest rate situation will persist, but during the second half of 2018 the actions of central banks may again generate worries about stock market performance, with the Fed expected to carry out its third and fourth rate hikes of the year while the ECB ends its bond purchases. During the autumn, the market usually shifts its focus to the earnings outlook for the following year, and uncertainty on this matter may threat a continued upturn. Yet our forecast of **continued healthy global economic growth suggests that higher earnings may still sustain share prices in a longer perspective as well**.

Stock markets have shifted gears
Equity indices, local currencies, 100 = January 2017



Source: Nasdaq OMX, Standard & Poor's, FTSE, STOXX, MSCI Barra, Macrobond, SEB

The US stock market has set the trend for the rest of the world, but the biggest upturn has occurred in emerging market countries. Stock markets in the euro zone, which is so important to the Nordic countries, have also performed strongly this year despite headwinds from an appreciating euro. Nordic stock markets lagged behind during the final quarter of 2017, but the healthy global outlook for 2018 and 2019 will help sustain corporate earnings in the Nordics as well. **After a 7-8 per cent increase in earnings during 2017, we estimate that earnings will improve by more than 10 per cent both this year and next**.

These earnings have not led to especially high valuations. Today's Nordic price/earnings (P/E) ratio is 16.9, which is close to our long-term equilibrium estimate of 16.5. The market can thus be expected to generate returns in line with earnings growth. Given that the market searches for long-term equilibrium valuations towards year-end, there is an upside of about 7 per cent. Adding this year's initial upturn and dividends equivalent to 3.5 per cent, we end up with **a total return of 13-14 per cent for 2018 as a whole**. Such a performance would lift the MSCI Nordic Index to 265 or 270 by the end of 2018, compared to the year's starting level of 243.

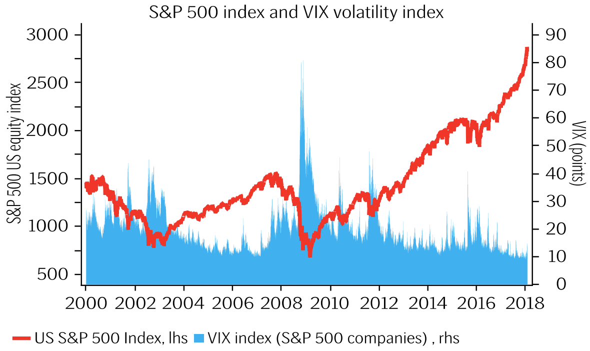
Theme: The volatility puzzle – is it the calm before the storm?

- **Low volatility is good for economic growth if it is justified by fundamentals, like now**
- **Experience, studies suggest worries about future market instability are exaggerated**
- **When the Fed's rate hiking cycle peaks, there is reason to expect higher volatility**

Financial market **volatility** – large asset price movements during a given period – reached **historical lows** in 2017. One closely followed volatility index is the **VIX**, which measures **volatility expectations** for S&P 500 share prices and is nicknamed **"the fear index"**. Last autumn, the VIX fell to its lowest since the 1960s. A low figure is interpreted as meaning that the market does not expect large or worrisome price movements, while a high figure signals greater uncertainty. Today's low VIX levels thus convey **unusually calm** conditions.

Rising stock markets, low VIX index levels

S&P 500 index and VIX volatility index



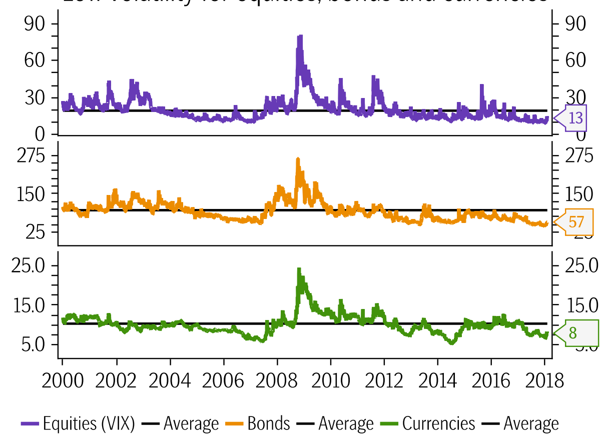
Source: Chicago Board Options Exchange (CBOE), Standard & Poor's, Macrobond, SEB

Low volatility does not apply only to VIX and equities. Fixed income and foreign exchange markets show similar trends (see chart below). The phenomenon is also global. It may seem remarkable that volatility is so depressed, for example in 2017: a year of surprising French, German and British election outcomes, geopolitical unrest in Asia and the Middle East, an unpredictable US president and Fed balance sheet reduction.

Is low volatility a problem?

Predictable market prices make **decision-making easier**, leading to better resource allocation and more efficiently functioning economies and financial markets. So if lower volatility levels reflect a new equilibrium situation, this is a welcome development from a growth perspective, although it may adversely affect financial sector returns. But if low volatility is temporary – driven by transitory factors – this situation may **create problems**. It is likely to result in **excessive risk-taking** as well as inflated debt stock and asset prices. When market price movements normalise, risks must spread to an increased number of hands, while market liquidity and depth may quickly deteriorate. This, in turn, may intensify market movements and worsen the situation even more. Record-high debts may then become an acute problem as was the case in 2008.

Low volatility for equities, bonds and currencies



Source: Bloomberg, SEB

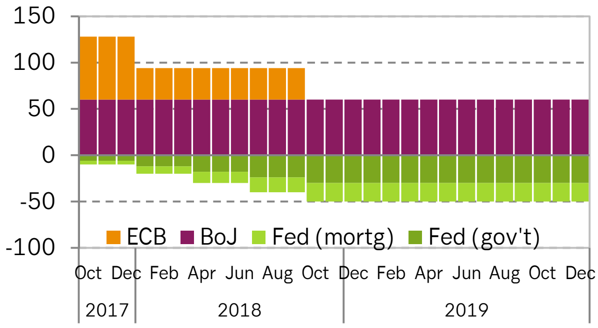
Driving forces behind volatility

A number of forces may explain why financial markets are experiencing or expecting such limited price movements and volatility. These forces are of varying but sustained natures and should **have a downward effect on volatility in 2018, too**:

1. Today the world has a surplus of **cheap central bank money**; we estimate it at USD 15 trillion or more. It will grow further in 2018. An intensive **search for yield** will thus push down volatility.
2. Monetary policies are/will be dominated by **gradualism** and **predictability** during ongoing/future normalisation processes; the Fed and the ECB are excellent examples.
3. The world economy is showing **strong synchronised growth**; the outlook for 2018-19 remains positive in most countries, and there is no immediate cyclical peak in sight.
4. The transparency and strength of the **financial system** are better today than before the autumn 2008 Lehman Brothers crash – and nowadays we have an experienced-based "instruction book" for managing banking crises.

Net supply of central bank money, 2018-19

Forecast: Fed, ECB and Bank of Japan. USD billions



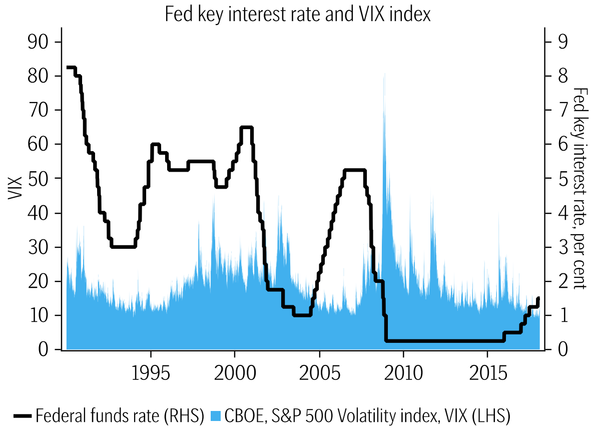
Fear... of the absence of fear

A New York Fed study (**"The Low Volatility Puzzle: Is This Time Different?"**, Nov. 2017) shows that extremely low VIX levels today predict low, not substantially higher, volatility in the future. The study thus rejects the **overly simple conclusion that low volatility today should be a source of concern**. Also reassuringly, the study finds that although the market is pricing volatility very low in the near term, the price of volatility one year ahead is not at the same extremely low levels. This means that investors are not completely complacent; instead they demand compensation for long-term volatility risk, which was not the case before the 2008 crisis.

Although the most likely development is a **continuation of today's low volatility levels**, we cannot rule out periods of surging volatility. These market storms are, however, much like ordinary storms; they appear abruptly but blow over fairly soon. Yet on various historical occasions, VIX volatility has become stuck at high levels for a long time. **History shows that after Fed's hiking cycle peaks, or when it begins to cut key rates, volatility climbs more lastingly**. We expect Fed hikes to peak in March 2019, indicating that **one possible period of higher VIX levels will be the first half of 2019**.

Higher volatility when Fed hiking cycle shifts

Fed key interest rate and VIX index



Source: Chicago Board Options Exchange (CBOE), Federal Reserve, Macrobond, SEB

Positioning and valuations may affect momentum

The momentum of volatility shifts may be greater if investors are aggressively positioned or if current prices diverge greatly from fundamentals-based valuations.

Speculative positioning: Long positioning on oil and EUR is at record levels while investors are short the USD, but far from the levels we saw as recently as October 2017. Investors are short 10-year US Treasuries (i.e. positioned for rising yields), but their positioning is modest compared to the beginning of 2017.

Fundamentals-based valuations: There are unusually small fair value divergences among currencies where the undervaluation of GBP is the largest. 10-year US yields are only a bit below what our fundamental model shows. Stock markets are at high levels, but good earnings growth does not suggest any major price adjustments.

...and things we should keep an eye on

Various studies and factors (see above) thus suggest that volatility may remain low in the future. But there are events, trends and phenomena (see below) that may change the volatility situation, both in the short and long term.

A. Inflation surprise – turns out higher than expected

Assessment: Labour markets and other resources are ever-tighter at global level. Oil prices have also climbed. **Wage and goods/services inflation already exists** but so far has been too weak for central banks to be satisfied that their inflation targets are being met. Industrial robotisation, digitisation and good global labour supplies are easing inflation pressure.

B. An economic downturn arrives

Assessment: There are many indications of slower GDP growth ahead due to increasing supply-side restrictions in various countries, but we are not there yet; the EU, the EM sphere and other countries appear to have spare capacity. Since economies are not at a turning point, uncertainty and thus volatility remains low.

C. Financial market instability – high valuation

Assessment: Global equities (MSCI index) have gained more than 27 per cent in two years. Credit spreads are record-low. Home prices are climbing in many countries. Higher valuations have **cyclical** (earnings), **structural** (lower discount rate) and **policy-related** (central bank money and tax reforms) **drivers. All these will continue to sustain today's high valuations**. The global debt level is record-high, and central banks will be forced into more securities purchases in case of instability, but global banking systems are stronger today than in 2008.

D. (Geo)political risks and trade conflicts

Assessment: The world (geo)political risk level is elevated, which may lead to weak governments, commodity price shocks and global trade disruptions, but recent years have shown their impact on economic growth and financial markets to be small.

There is logic behind low volatility

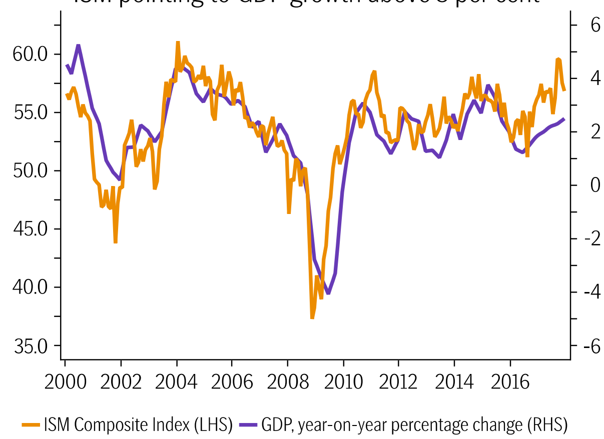
The world is full of big unknowns, but it is also characterised by stable economic growth and massive supplies of cheap money. If asset prices undergo a downward correction for a limited period, this has a stabilising effect on global stock markets, for example. It forces market players to pause and think more about fundamental economic forces and risks. Our analysis indicates that volatility will not revert sustainably to earlier high levels during the coming year, but it may climb somewhat when the Fed reaches the peak of its current interest rate hiking cycle (spring 2019).

Broad-based above-trend growth in 2018 as well as 2019

- **Tax cuts will provide significant stimulus**
- **Trade policy poses a downside risk**
- **Slow pay hikes, but slightly faster inflation**
- **Fed will speed its pace to four hikes in 2018**

Incoming economic statistics have generally surpassed expectations in recent months, and many indicators are at close to record levels. Last year ended with a strong fourth quarter, with GDP rising by an annualised 2.6 per cent after a broad-based expansion. Due to continued labour market improvement and healthy external demand, combined with an extra fiscal stimulus, we expect GDP growth to be well above trend both in 2018 and 2019. Given the strong ending to 2017 plus an upward adjustment in our estimate of the stimulus effect of tax cuts, we have revised our forecast upward and now believe that GDP growth will accelerate from 2.3 per cent in 2017 to **2.8 per cent in 2018. We have also raised our 2019 GDP growth forecast to 2.5 per cent.**

ISM pointing to GDP growth above 3 per cent



Source: U.S. Bureau of Economic Analysis (BEA), Institute for Supply Management (ISM), Macrobond, SEB

The US Federal Reserve is clearly signalling that it will continue monetary policy normalisation despite muted inflation pressure. We believe that the Fed will **raise its key interest rate four times during 2018** and then follow up with **one more hike in 2019**. The federal funds rate will thus end up at 2.75 per cent. The reduction in the central bank's balance sheet began in October and is occurring as planned.

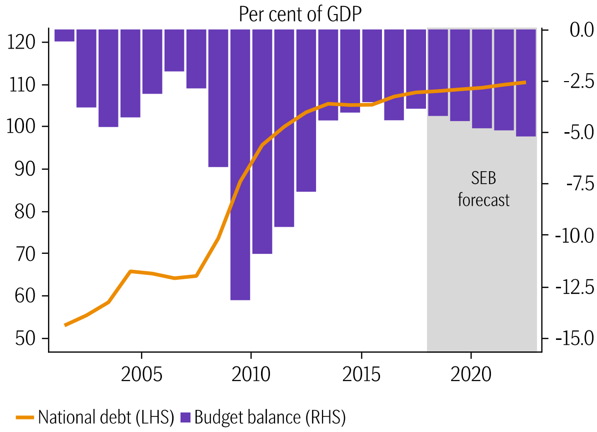
Tax cuts will provide an extra jolt...

In late December, after lengthy congressional negotiations, President Donald Trump was finally able to sign a package of tax cuts totalling more than USD 1.5 trillion over ten years. The overall package is equivalent to 7-8 per cent of GDP. It has two parts: corporate and household tax cuts. For companies, the biggest change is that corporate income tax is being lowered from 35 to 21 per cent. Another change is lower taxation of foreign profits; meanwhile certain potential deductions have been eliminated. Most households will benefit from lower taxation and a near-doubling of the standard deduction, but here too, the picture is complicated by the removal or reduction of various other deductions.

The package will have a greater impact than most observers had anticipated. The IMF estimates that it will boost the GDP level by 1.2 percentage points in 2020. The effect in 2018 will probably not be so large; instead the biggest surge in GDP will occur in 2019. Our assessment is that it will raise GDP growth by 0.3 percentage points in 2018 and 0.4 in 2019. In 2019 this is a considerably sharper dose of stimulus than we previously expected, but we see **reasons to make a somewhat more cautious estimate than the IMF**. One reason is that the current effective tax rate for companies is significantly lower than 35 per cent. Companies will also probably be cautious about using their greater financial flexibility to boost capital spending. In addition, the cut in personal income taxation will mainly benefit high-income households, which tend to save a large percentage of their disposable income.

Budget deficit expected to drive up national debt

Per cent of GDP



Source: SEB

These tax cuts will not pay for themselves in the form of higher economic growth. They are thus largely unfunded and **will cause a weakening of federal finances**. It is uncertain how severe this weakening will be, and estimates vary. The non-partisan Congressional Budget Office (CBO) estimates that tax revenues will decrease by about USD 1.1 trillion over ten years. Our assessment is that the US budget deficit will increase from 3.8 per cent of GDP in 2017 to 4.4 per cent in 2019, and we also foresee risks that the national debt will reach 110 per cent of GDP. This may possibly contribute to slightly higher interest rates and yields, although experience in both the US and other large economies with their own central bank shows only a weak correlation.

In the near term, the work of the US government will be complicated by difficulties in reaching a budget agreement. In mid-January, portions of federal operations shut down for a few days before Republicans and Democrats agreed on a temporary solution that expires on February 8. A bigger source of concern is that the federal **debt ceiling** will need to be raised in late February.

The Trump administration is working to put together a plan for **infrastructure investments**. The details are still in flux but what is being discussed is a federal appropriation of USD 200 billion over ten years. It is unclear whether this amount will be taken from existing infrastructure plans or be funded in some other way, but the plan would attract states and private companies to provide funds that would bring total investments up to at least USD 1 trillion. US infrastructure needs upgrading. This creates opportunities for bipartisan cooperation, but funding will be an obstacle since the Democrats want to use a larger share of federal money. It will take time before these infrastructure investments get started, and **we do not expect them to significantly affect economic growth during our forecast period**.

...but trade policy is a downside risk

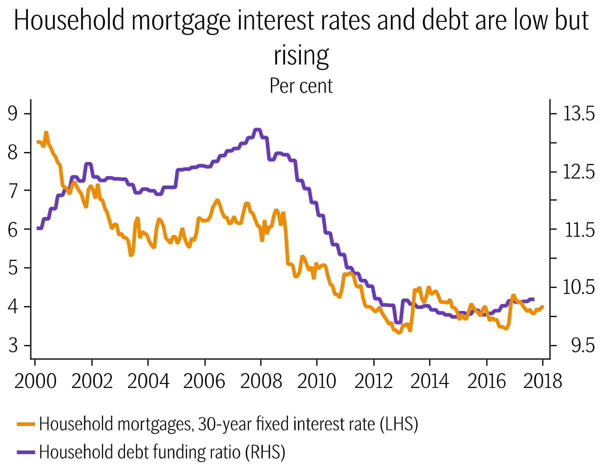
The success of the tax package may be cited as an indication that the administration has improved its ability to push through large-scale reforms. This may strengthen the chances of Republican candidates in next autumn's interim elections but also help to **reduce Trump's need to compensate for weak reform efforts with protectionist measures**. So far the administration has abstained from labelling China a currency manipulator, and Trump has not carried out his threat to withdraw from the US-South Korean trade agreement. But it is too early to declare a victory for free trade. Studies of US trade with China are under way (including imports of Chinese steel and aluminium) and may open the way for the introduction of more far-reaching trade barriers at a later stage. China accounts for most of the US trade deficit and is thus a target, as a consequence of Trump's explicit goal to reduce the deficit. **Although a full-scale trade war with China is not in the cards, future trade relations are expected to worsen.**

A more immediate threat is that the ongoing **North American Free Trade Agreement (NAFTA) renegotiations** between the US, Canada and Mexico may cause Trump to begin a US exit process from NAFTA. During the negotiations, the US has presented proposals that both Canada and Mexico find very difficult to accept. Yet Trump appears to have recently softened his stance, probably a consequence of domestic opposition, and has opened the possibility of a continued extension of talks. **We are sticking to our scenario that a renegotiated agreement can be reached**, but the risk of failure remains significant.

Source: IMF, Macrobond, SEB

Several factors will sustain consumption

Private consumption accelerated sharply in the fourth quarter, reaching an annualised upturn of 3.8 per cent. Consumption is being sustained by an ever-stronger labour market, continued share price increases and rising home prices. Most indications are that these driving forces will remain strong during 2018 as well, while the tax cuts will provide extra stimulus.



Source: Federal Reserve, Freddie Mac, Macrobond, SEB

In December, the household savings ratio fell to 2.4 per cent, its lowest level since 2005. The low savings ratio poses a long-term downside risk to consumption, but at present there is underlying support from low interest rates and rapidly increasing wealth due to the surging stock market. Household costs for funding mortgages remained at a very low level in 2017, but rising auto and study loans have caused the total household debt burden to begin creeping higher. This trend will intensify ahead as mortgage interest rates rise from low levels. During 2019 the stimulus effect of tax policy will also decrease, which will contribute to a **slowdown in consumption growth from 3.2 per cent in 2018 to 2.7 per cent in 2019**.

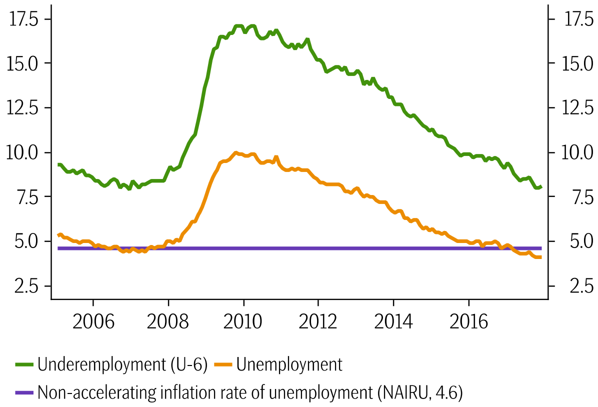
Capital spending and exports remain strong

Capital spending recovered in 2017 and accelerated late in the year. The manufacturing upturn has helped push capacity utilisation higher. In December it measured 78 per cent, not so far from the 80 per cent level where business investments usually take off more significantly. A combination of low housing supply and strong demand has triggered a wave of residential investments, which has the potential to rise further in 2018, but bottleneck problems in the form of labour and land shortages are expected to cause a slowdown in construction investments late this year. The oil price upturn has helped oil and mining sector investments to take off again. Our forecast is that business investments will increase by **3.9 per cent in 2018 and 3.1 per cent in 2019**.

The export outlook also seems bright. Strong global demand is reflected in solid order bookings, and the depreciation of the dollar in trade-weighted terms is providing further support. Our forecast is that **exports will increase by 4.5 per cent in 2018 and by 3.8 per cent in 2019**. We thus believe that net exports will contribute positively to GDP again this year. Downside risks are mainly connected to trade policy-related disruptions.

Unemployment is below the Fed's NAIRU metric

Per cent of the labour force



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

An ever-tightening labour market

During 2017 non-farm job growth averaged more than 180,000 per month, but the increases slowed compared to 2017 and we expect this deceleration to continue during 2018. Several indicators suggest that the idle resources in the labour market are relatively small. In January, unemployment was 4.1 per cent. **Most indications are that during the first half of 2018 we will see unemployment figures of less than 4 per cent.** This is well below 4.6 per cent, which has recently been the Fed's estimate of equilibrium unemployment (NAIRU). But the picture is ambiguous; the Fed seems to be moving towards adjusting its NAIRU estimate lower, thereby signalling that it is not too worried about labour market overheating. The broadest unemployment metric, U-6, is still a bit higher than when the financial crisis broke out, and in recent months its downward trend has ended. The labour force participation rate also indicates that there is still some degree of slack. During 2017 it remained just below 63 per cent, compared to a peak of around 67 per cent in 2000. Overall, there is thus **potential for further improvement in the labour market situation, making continued healthy GDP growth possible**.

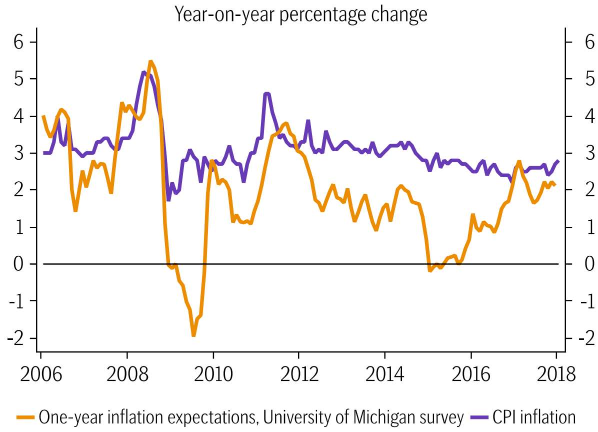
Inflation accelerating in 2018

Our assessment that there are still idle resources in the labour market is largely based on continued weakness in wage and salary increases, which is also holding back underlying inflation pressure. During 2017, the year-on-year rate of pay increases was around 2.5 per cent: a modest rate in historical terms. The lack of wage response has created **uncertainty about the inflation dynamic and the shape of the Phillips curve** (see the theme article in *Nordic Outlook*, November 2017). Our view, however, is that the Phillips curve is still alive but that the inflation response will occur after a lag when bottleneck problems finally force companies to raise prices and pay. Our forecast is that the rate of pay increases will accelerate towards 3.5 per cent during 2018.

The impression that the weak summer 2017 inflation rate was temporary has gained strength recently, among other things because earlier declines in prices for mobile phone services, vehicles and pharmaceuticals have been reversed. CPI inflation has accelerated since it bottomed out last June, and in December it stood at 2.1 per cent. Core inflation was higher than expected in December, rising to 1.8 per cent. Due to higher oil prices, a weaker dollar and a somewhat more optimistic view of economic growth, we are revising our CPI forecast a bit higher. Measured as full-year averages, **we expect CPI to increase by 2.1 per cent in 2018 and in 2019**. The Fed's main core inflation metric – using the personal consumption expenditures (PCE) deflator – has climbed somewhat in recent months. In December it was 1.5 per cent, which is still below the Fed's 2 per cent target. The forecasts unveiled at the December meeting show that the Fed expects core PCE to be just below its target by the end of 2018, which is compatible with continued monetary policy normalisation. Our own full-year forecasts are that **core PCE will increase by 1.8 per cent in 2018 and 2.0 per cent in 2019**.

The trend of **inflation expectations** is also compatible with continued key interest rate hikes. These expectations trended downward during much of 2017, but according to the University of Michigan they have now stabilised at around 2.5 per cent and showed a slight increase late in the year. Measured as break-even inflation, five-year inflation expectations have recently climbed to just below 2 per cent. This should have eased the concerns of Fed policymakers, as hinted by the central bank's communication.

Inflation and inflation expectations are rising
Year-on-year percentage change

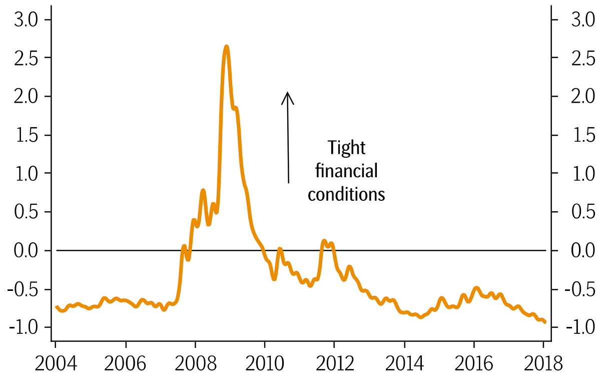


Source: University of Michigan, U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

Fed will speed up normalisation pace

As expected, the Fed hiked its key rate in December. Higher GDP growth combined with inflation and inflation expectations are creating conditions for the Fed to continue its monetary policy normalisation. Our assessment is that the Fed will choose to speed up the pace of its rate hikes in 2018. **We are revising our forecast from three to four rate hikes this year** (March, June, September and December). During **2019** the Fed will carry out **one more rate hike**, bringing its federal funds rate to 2.75 per cent. Aside from accelerating economic growth and somewhat higher inflation, looser financial conditions and a more hawkish Federal Open Market Committee membership will speed up monetary tightening.

Looser financial conditions are allowing room for tightening
Index



Source: Federal Reserve Bank of Chicago, Macrobond, SEB

Despite the Fed's key rate hikes, **financial conditions have gradually become more expansionary** during the past year, driven mainly by stock market gains and US dollar depreciation. The upturn in long-term yields has also been moderate in an environment where the market does not really trust the Fed to deliver according to plans, and where other leading central banks are continuing to expand their stimulus measures. Persistently record-loose financial conditions may eventually contribute to overheating problems and new financial bubbles. They consequently strengthen the arguments in favour of continued monetary policy normalisation.

There is still uncertainty about the **Fed's leadership team**. President Trump's latest move was to nominate Marvin **Goodfriend** to one of the seven seats on the Fed's Board of Governors. Goodfriend has previously criticised the Fed's QE programme and can thus be expected to advocate a faster reduction of its balance sheet, but it is unlikely that he can bring about a change in the plan already established by the Fed. At present, three more seats must be filled on the Fed's Board, and later on a replacement will be needed for William Dudley, head of the New York Fed, who is expected to step down in mid-2018. Most indications are that the **Fed's leadership team will generally have a more hawkish profile** than in 2017. The four regional Fed presidents who are voting this year (Thomas Barkin, Raphael Bostic, Loretta Mester and John Williams) are regarded as more inclined to tighten monetary policy than their predecessors. Goodfriend also tends to support a hawkish stance.

In October 2017 the Fed began to **reduce the size of its balance sheet**, and this process is expected to continue according to a plan in which re-investments gradually shrink according to predetermined maximum amounts (thresholds). The decrease will continue for as long as the economy or financial markets are not exposed to severe disruptions. The tightening effect during 2018 is roughly equivalent to one rate hike. The Fed has not decided the long-term size of its balance sheet but has mentioned an interval of between USD 2.4 and 3.5 trillion. This implies that the balance sheet reduction is expected to be completed around 2020-2021.

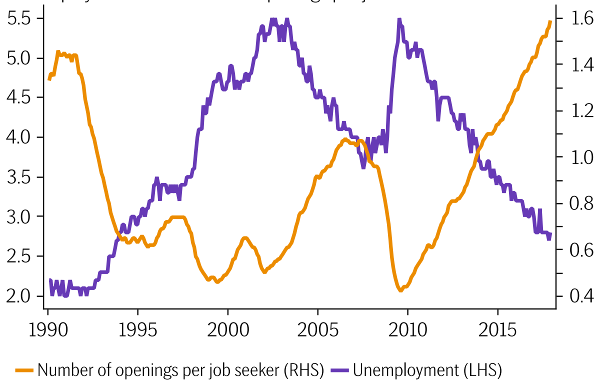
BoJ will not jeopardise hard-won inflation gains

- **Stability and sustainability of growth will be tested as fiscal stimulus fades during 2018**
- **Inflation is climbing, but not enough – Bank of Japan (BoJ) will continue extreme policies**

A unique set of economic policies ("Abenomics") and a strong world economy have contributed to a more than 5-year-long, though occasionally shaky, Japanese recovery. **We expect GDP growth in 2017 to end up at 1.5 per cent**: well above its potential, which is an estimated 0.5 per cent (OECD). Global growth will provide continued support, but domestic demand will slow as fiscal stimulus dwindles and the growth impulses from preparations for the 2020 Tokyo Olympics gradually fade. **We thus believe that GDP growth will fall to 1.2 per cent this year, cooling further to 1.0 per cent in 2019**. The continued **aggressive income and inflation policies** of the Shinzo Abe government and the BoJ plus a necessary **fiscal consolidation**, including a consumption tax hike from 8 to 10 per cent in autumn 2019, add uncertainty to our forecast.

Ever-stronger labour market

Unemployment and number of openings per job seeker. Per cent and ratio



Source: Japanese Statistics Bureau, Japanese Ministry of Health, Labour & Welfare, Macrobond, SEB

At a bit below 3 per cent, Japanese unemployment is at its lowest in a quarter century. A further decline is likely during 2018-2019. This trend is even more impressive because reforms have helped boost labour force participation among women and older people, while the percentage of foreign-born residents is rising. Although the upturn is rather small so far, it is a positive signal in light of Japan's major demographic challenges. Yet a larger labour supply, along with digitisation and robotisation, are helping keep down wages and salaries, thereby making it harder to meet the BoJ's inflation target.

Vigorous earnings performance by Japanese companies has created **room for higher pay**. The Abe government is also more strongly urging businesses to raise wages and salaries by at least 3 per cent in 2018: 1 point or so above the level set by major Japanese companies. Labour shortages will trigger somewhat faster pay hikes ahead, but problems raising prices will keep firms cautious. Lingering deflation expectations among economic players are making it harder for the BoJ to achieve its 2 per cent inflation target. **We expect CPI inflation of 1.0 per cent this year** (0.5 per cent in 2017). The tax hike in October next year will push inflation to **1.2 per cent in 2019**.

Five years of Abenomics 2013-2017

Changes – "Report card"

Nikkei 225	+120%	Monetary base, $	+3,700bn
10Y bond yield	-75bps	Unemployment	-1.6ppt
JPY effective rate	-18%	Public sector debt	±0ppt
Tokyo home prices	+21%	Inflation	+0.5ppt

Source: Macrobond, SEB

Japan's monetary policies will remain extremely loose. Several factors suggest that the **key interest rate will stay at -0.1 per cent** in 2018-2019 while **10-year government bond yields will be kept at close to 0 per cent** by expanding the monetary base (government securities-buying). The BoJ has invested much credibility in continuing its policies until inflation persistently exceeds 2 per cent. It also wants to isolate Japan's yield curve from an international rate upturn, indirectly ensuring a weak yen. With the latest fiscal stimulus package set to fade in 2018, and a fiscal consolidation waiting around the corner, the BoJ is under pressure to continue its policies.

The budget deficit has averaged 5 per cent of GDP over the past five years. The Abe government is not expected to achieve its 2020 balanced budget target, but deficits will shrink a bit. **Public sector debt remains at a record 240 per cent of GDP**, posing a risk for the long-term credibility of public finances, but Japan continues to enjoy a strong external balance that includes a large current account surplus. Low interest rates are easing the fiscal burden. too. The government also has a stable bond buyer/owner: The BoJ owns more than 40 per cent of outstanding Japanese government bonds.

A brighter growth outlook has triggered hopes among investors that the Japanese economy is nearing the end of its rocky 25-year journey. But if the yen were allowed to appreciate, this might jeopardise the BoJ's inflation target and make exporting companies less willing to hike employee pay. **We thus expect the USD/JPY exchange rate to be 110 at the end of 2018 and 105 at the end of 2019**.

A focus on political and economic reforms

- **China doing "Korea-Light" to attain stability**
- **India: Growth and inflation accelerating**
- **Russia: Recovery, but no reforms**
- **Brazil: Growth despite political uncertainty**

Beijing's new credit policy will slow growth

China's full-year 2017 growth of 6.9 per cent represented an acceleration compared to 6.7 per cent in 2016. It surpassed the official target of "*about 6.5 per cent*". Contributing factors were **stronger exports** to the US as well as Europe (+10 per cent despite a strong yuan) and **looser credit terms**, which stimulated mortgage, construction and consumption growth.

We expect **continued strong but slower GDP growth: 6.6 per cent in 2018 and 6.2 per cent in 2019**. The main reason is that Beijing's current goal is **to reduce the risk level** in the economy. President Xi Jinping is apparently worried that a growing debt burden may jeopardise future stability. **The timing of this policy shift is favourable**: due to strong global growth, domestic expansion can be curtailed without lowering total GDP growth too much. Debt growth has already slowed in the past two years and is expected to continue doing so, with total debt as a percentage of GDP falling slightly in the future.

Trimming China's debt – "Korea-Light" style

It is likely to take a few years to meet Beijing's goal of achieving lower debt exposure. There are many signs that China will follow the model used by South Korea during the 1998 Asian financial crisis. In 1997 South Korea's total debt was about 245 per cent of GDP, or close to China's current level. To manage private debt deleveraging, Seoul allowed public sector debt to rise, thus softening negative effects on the economy. China is expected to boost government borrowing during the next couple of years.

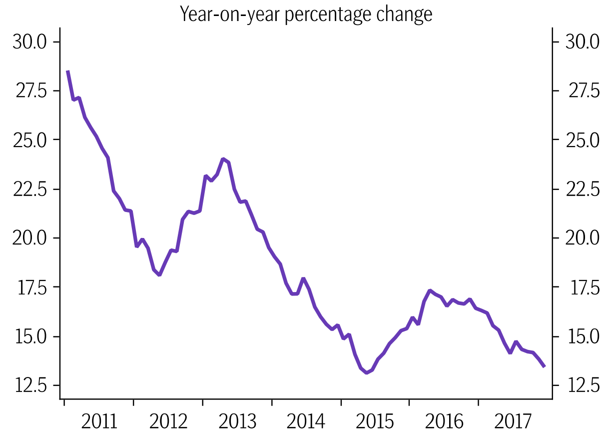
But we do not expect China to let deleveraging move as fast as in South Korea, which saw large capital outflows drive interest rates above 20 per cent to stabilise the won. More likely is "Korea Light", which means 6-12 months of debt deleveraging, then a levelling-out. China can resume deleveraging later as needed. As with so much of China's other long-term economy policy management, it will be a bit of a stop-and-go process.

Despite high growth, inflation pressure in China has been modest, partly because favourable weather has pushed down food prices. During 2017, inflation fell to 1.7 per cent (2.0 per cent in 2016). But assuming above-potential growth and stable commodity prices, **we expect inflation to climb to 2.3 per cent in 2018 and 2.5 per cent in 2019**.

At last autumn's Communist Party congress, President Xi consolidated his power base for the next five years. This will mean greater **freedom to implement reforms**. For example, Xi is expected to focus less on explicit GDP targets and more on the content of growth. Although this poses a downside risk to growth in the short term, it will create better potential for long-term economic strength. **Fiscal policy changes will be minor**. Budget deficits will stay at 3-4 per cent of GDP during the next couple of years. If growth slows more than desired due to credit tightening and debt deleveraging in central and local government activities, fiscal policy can be loosened. The People's Bank of China (PBoC) is expected to maintain a relatively neutral monetary policy. Although we expect inflation to be lower than the informal 3 per cent target in 2018-2019, we do not believe the PBoC will cut its key interest rate, since the overall official strategy is to tighten credit conditions. This is why the **PBoC will hike the key rate** starting in the second half of 2018, from 4.35 per cent to **4.60 per cent** by year-end, and to **5.10** by the end of 2019.

Slower debt growth

Year-on-year percentage change



Source: SEB

This will also strengthen the Chinese yuan. We expect a **USD/CNY** exchange rate of **6.10 at year-end** and **5.80 at the close of 2019**. The PBoC's currency strategy is to allow cautious yuan appreciation, aimed at attracting foreign capital to domestic stock and bond markets. China's export sector is expected to be able to withstand this appreciation in an environment of strong international demand in 2018 and 2019.

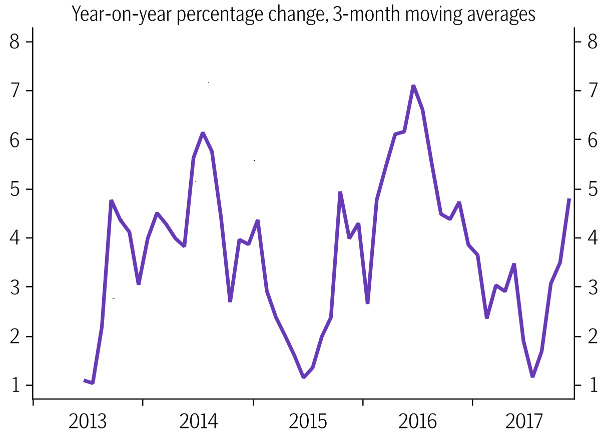
The main risk to China's positive development is unexpectedly high global inflation. This may lead to higher domestic inflation, and thus higher interest rates. China's total debt, 260 per cent of GDP, would quickly become a burden for all borrowers, triggering a disturbingly high number of defaults.

India: Growth is rebounding

It has become more apparent in recent months that India's economic growth has bottomed out. Third quarter GDP growth accelerated to 6.3 per cent year-on-year, after five quarters of slower growth. The purchasing managers' index in the manufacturing sector reached its highest level since 2012 in December. Industrial production is also clearly accelerating, but car sales have fallen in recent months and exports have slowed, although the trend has been volatile. GDP rose by an estimated 6.4 per cent in 2017. We expect GDP growth to speed up to **7.5 per cent in 2018 and 7.8 per cent in 2019**.

Industrial production has taken off

Year-on-year percentage change, 3-month moving averages



Source: Indian Ministry of Statistics & Programme Implementation (MoS&PI), Macrobond, SEB

Rising oil prices in recent months have focused attention on India's external balance, since oil imports previously contributed to large current account deficits. Yet we believe that the moderate increase in Brent oil prices to just over USD 70/barrel in 2019 that we predict will not lead to any major weakening of the current account balance. A bit more worrying is that government has trimmed excise duties on retail fuel prices, thereby weakening its finances. There is already **concern about central government finances** since national authorities will be forced to aid state governments that have made large-scale loan concessions to farmers. India's government will not achieve its target of shrinking the budget deficit for the fiscal year ending in March 2018 from 3.5 to 3.2 per cent of GDP. The **deficit target for the coming fiscal year has been relaxed** from 3.0 per cent of GDP to 3.3 per cent.

CPI inflation has climbed sharply from its low of last June, reaching 5.2 per cent in December, the highest since July 2016. Core inflation has also accelerated. We expect inflation to keep rising, driven by rising capacity utilisation. Measured as full-year averages, we expect **inflation** to rise from 3.3 per cent in 2017 to **5.5 per cent in 2018 and 2019**.

Since it cut the key interest rate to 6.0 per cent in August, the Reserve Bank of India has left the rate unchanged. The minutes of its December policy meeting show that the RBI is concerned about central government finances and the rising inflation rate. We believe that it **will hike the key rate to 6.25 per cent in the second half** and follow this up with a further hike in 2019.

Prime Minister Narendra Modi's ruling Bharatiya Janata Party (BJP) won the Gujarat and Himachal Pradesh state elections. These victories point to popular support for his government and policies. The BJP is expected eventually to achieve an upper house (Rajya Sabha) majority, though there are no signs that Modi will tackle the most important reform areas – the labour market and land purchase laws – before the 2019 national election. But the BJP's **state election successes have increased the likelihood that less controversial reforms will be pushed through**. In 2017, India enacted a national goods and services tax (GST). The government also unveiled plans to recapitalise the banking sector and boost infrastructure investments. It is also expected to continue loosening direct investment laws, despite growing resistance. The government will continue its efforts to privatise state-owned companies and has prepared a partial privatisation of the loss-making Air India.

The **rupee** has remained relatively stable against the US dollar since last autumn, but during 2017 as a whole it appreciated by around 6 per cent. In our assessment, accelerating GDP growth and a more hawkish RBI will lead to further rupee appreciation during 2018. **At the end of 2018 we expect the USD/INR rate to be 62.0; at the end of 2019 it will be 60.0**.

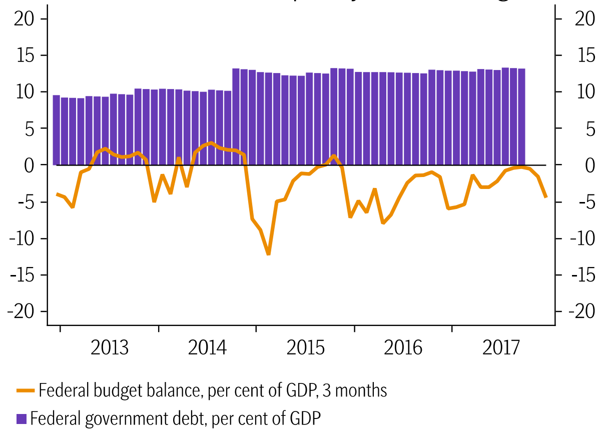
Russia: Continued recovery

Russian GDP growth cooled markedly last year, from 2.5 per cent year-on-year in the second quarter to an estimated 1.0 per cent in the fourth quarter. **The 2017 annual average is thus likely to end up around 1½ per cent.** Lower oil production due to Russia's agreement with OPEC and slowdowns in manufacturing and the agricultural sectors were behind this deceleration, but retail and car sales showed a continued stable growth rate. Domestic production of consumer goods weakened due to the strong rouble, which made imports cheaper. But this trend does not appear likely to last for long; the Finance Ministry has escalated purchases of foreign currencies for its reserve in order to weaken the rouble, thus strengthening competitiveness and boosting budget revenue.

When oil production caps are gradually removed in the second half of 2018 and early in 2019, the Russian economy will enjoy an extra stimulus, amplified by gradually higher oil prices. Following the 2015 recession there are still idle resources in the economy, making above-trend growth possible. **We expect GDP growth of 2.2 per cent in 2018 and 2.0 per cent in 2019.** Inflation has bottomed out, after reaching 2.5 per cent year-on-year in both November and December. Strong household optimism and rising real wages suggest that the prices of services and consumer goods (excluding food) will stabilise or rise moderately, thus **lifting inflation to 3.8 per cent in 2018 and 4.0 per cent in 2019**. The central bank's strategy has been to lower the key interest rate slowly, in order to push down inflation expectations too. We believe it will cut the key rate from the current **7.75 per cent to 6.75 per cent at the end of 2018, before raising it to 7.00 per cent in 2019**.

Partly due to the combination of unusually high oil prices and a relatively weak rouble, especially in recent months, Russian government finances have been stronger than the finance ministry had predicted. Although spending has been higher than budgeted, the federal deficit will be smaller than the Kremlin's target: 2 per cent of GDP. The new budget for 2018-2020 includes plans for sharp expenditure cuts, but these cuts are unlikely to be implemented during the 2018 election year. Despite certain spending increases, we believe that the federal deficit will remain limited to around **2 per cent of GDP, helping to slow the increase in central government debt from today's level of around 15 per cent of GDP**.

Government finances helped by oil and GDP growth



Source: Russian Ministry of Finance, Macrobond, SEB

There is some concern about possible new US sanctions after an analysis of corruption among Russian politicians and power-brokers was presented to Congress in February. Despite this risk, foreign investors are showing a strong appetite for Russian bonds and assets. The yield on 10-year bonds has fallen to 7.4 per cent from over 8 per cent early in 2017 and is expected to fall further. Capital inflows and a current account surplus are also helping to reduce depreciation pressure from monetary easing and the Finance Ministry's market interventions. Overall, we believe the **rouble will weaken to 60.5 per USD at the end of 2018 and to 63.0 by end-2019**.

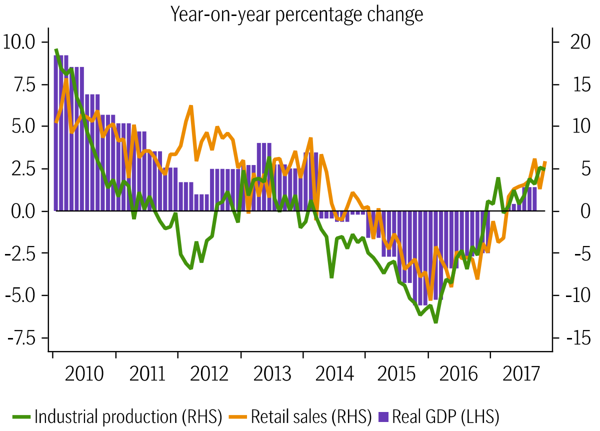
President Vladimir Putin will win the March 2018 election. No opponent has broad enough support to make the election exciting. Putin will announce new reforms after the election, but implementation will be slow and tentative. Not even Putin is strong enough to control the special interests that oppose changes in Russia's economic structure.

Brazil: Higher commodity prices will lift GDP

Brazil has recently consolidated its economic upturn. GDP grew by 1.4 per cent year-on-year in the third quarter of 2017, and monthly data indicate that growth accelerated to around 2.5 per cent in the fourth quarter. This recovery was driven at first by exports following a sharp decline in the Brazilian real, but late in 2017 rising commodity prices also provided an extra push. Consumption is on the way up, sustained by falling unemployment and pay hikes, albeit small. So far we are seeing no reaction on the capital spending side, but this often arrives rather late in the recovery process. **Overall, we expect GDP to climb by 2.7 per cent this year and by 3.0 per cent in 2019.** Higher growth is helping to improve government finances somewhat; the budget deficit fell from 10 per cent of GDP in 2016 to 8 per cent by late 2017. Gross government debt is close to 75 per cent of GDP. Central government finances are thus still too weak to allow room for active fiscal stimulus.

Monthly data are pointing to continued recovery

Year-on-year percentage change



Source: Brazilian Institute of Geography & Statistics (IBGE), Macrobond, SEB

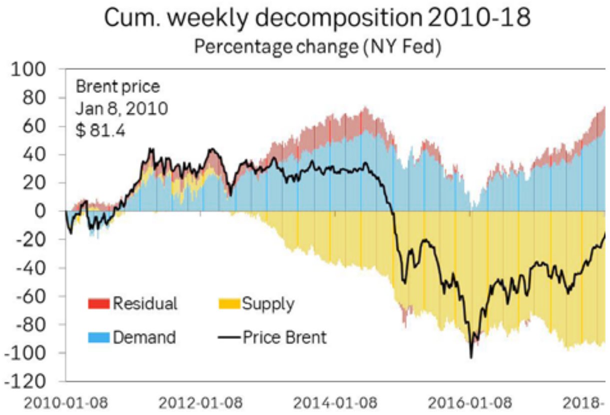
Year-on-year inflation in Brazil bottomed out in August and September 2017 at 2.5 per cent: the next-lowest level in 20 years. In December inflation stood at just below 3 per cent and we estimate that it will climb to 4.0 per cent this year and 4.3 per cent in 2019. A pent-up need to raise officially controlled prices is an especially important driver. But as consumption increases, companies will also have greater opportunities to raise their prices. Since inflation is still comparatively low and real interest rates are high, the central bank will cut its monetary policy rate (SELIC) one more time **from its current 7.00 per cent to a record low 6.75 per cent, where it will stay until the end of 2018. At the end of 2019, we expect the SELIC to reach 8.00 per cent.**

Despite the political uncertainty and controversies surrounding President Michel Temer, the real showed greater stability in 2017 than in the preceding year. Higher commodity prices have contributed to this and appear likely to support the currency in the near future as well. Monetary easing and disappointment at the lack of reforms will weigh down the real, however. The proposed pension reform, which is so important to government finances, will probably not be implemented by the current administration. Even if the reform happens, because of trade-offs between different political factions the cost savings would not be as large as intended. Brazil holds an election in October. Major public dissatisfaction with today's politicians is increasing the risk that a populist may reach the presidency. Although it is too early to predict the election outcome, political uncertainty will help **weaken the real to 3.40 per dollar by the end of 2018 and 3.60 at year-end 2019**.

Theme: Oil prices – an OPEC-US tug-of-war

- **OPEC deal, lower reserves, global growth led to USD 65 oil – despite more US output**
- **Lull in oil investments will trigger upward price pressure early in the next decade**

Brent crude oil prices showed **large movements in 2017**. During the first half, they fell by more than 20 per cent to USD 45/barrel and then closed the year at USD 68: up 20 per cent compared to the end of 2016. Although spot prices have climbed sharply, the impact on forward prices is far less: about USD 5 higher. The oil market, which is controlled by strong, speculative long-term supply and demand forces, is trying to **find a new equilibrium level**. We predict an **average price of USD 65 both in 2018 and 2019**. Late in our forecast period, the risk of higher oil prices will grow due to production caps.



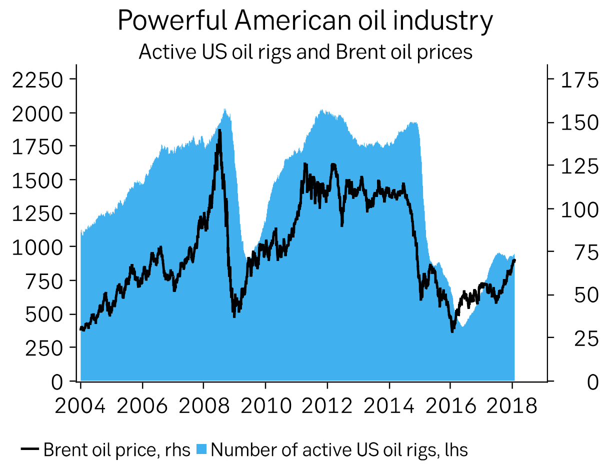
We believe that – from a narrow economic and financial market standpoint – the world will probably benefit more from higher instead of lower oil prices in 2018 and 2019:

1. Although higher prices have a **growth-inhibiting effect** on consumption and investments, this is offset today by **under-lying global economic strength**. In many countries the impact of oil prices will also be less due to **USD depreciation**.
2. Higher energy prices will give central banks some breathing room to continue moving towards their inflation targets, for example by lowering pressure on them to extend quantitative easing and by enabling them to begin policy normalisation.
3. Various oil-producing countries, such as Russia and Saudi Arabia, have run into **fiscal problems** due to earlier price declines, forcing them to slash costs and use financial reserves they had built up earlier, for example by selling US dollar assets. The price squeeze also added to **political uncertainty**.

Can OPEC's successful 2017 tactics survive?

During 2017 the Organisation of the Petroleum-Exporting Countries (OPEC) plus Russia and other countries stuck to agreed output quotas, thus increasing their influence on prices. Their output cuts are equivalent to 2 per cent of global oil supply. This helped push earlier large reserves to their current, more normal levels. **This adjustment in reserves is still under way**, confirming the influence of producers on prices.

OPEC's production caps are expected to survive during 2018 as well. Despite knowing that the US will increase its shale oil output, these producers' ability to stick to their quotas is made easier by higher prices and signs of global economic strength and growth. The **fly in the ointment**, at least in the short term, is that long speculative oil positions (bets on rising oil prices) are already at historically high levels, which may pull down prices when expectations of rising prices cool.



Source: Baker Hughes, Intercontinental Exchange (ICE), Macrobond, SEB

Although OPEC appears to have regained greater influence on oil prices, the US oil industry is expected to continue expanding in 2018-2019. **The break-even cost of producing new shale oil in the US** has continued to fall and now stands at about **USD 40** per barrel. This means that US production is expected to increase by 16 per cent this year and another 11 per cent in 2019 – but not enough to create a major price slide as long as OPEC et al stick to their production quotas.

A final oil price peak

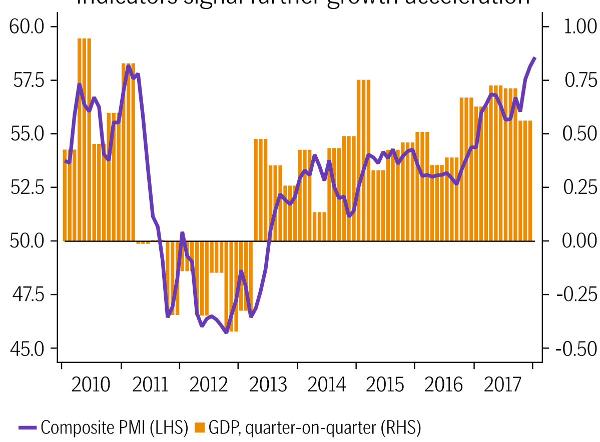
In 2014, at the time of a sharp decline in oil prices, investments in global production capacity plunged. It normally takes about five years before the effects of such a decline on production and prices become evident. This means that during 2014-2019 **the oil market has been living/will be living on the major investments that were made in 2010-2014**. This increases the risk of higher prices from 2020 onward. Today there are consequently expectations that global oil prices will undergo a final upturn early in the next decade.

Mounting optimism about economic growth

- **Strong, broad-based upturn**
- **Expansionary new German grand coalition**
- **Inflation is rising but will stay below target**
- **Clear normalisation signals from the ECB**

The euro zone remains optimistic. **Most indications are that there is plenty of fuel left in the economic boom**. GDP rose by 2.3 per cent in 2017, the highest since 2007. The year ended strongly and 2018 looks promising. Sentiment indicators are in line with earlier cyclical peaks, but various sub-indices show record-high figures. The manufacturing sector is accelerating. Due to rising capacity utilisation, companies are boosting their capital spending; euro appreciation during the past six months does not seem to be hurting them. Their hiring plans point to continued labour market improvement, which will help sustain an upturn in consumption. **GDP will increase by 2.5 per cent in 2018 and 2.2 per cent in 2019**. The European Central Bank (ECB) will **end quantitative easing (QE) in September this year and hike its key interest rate, but only in 2019**.

Indicators signal further growth acceleration

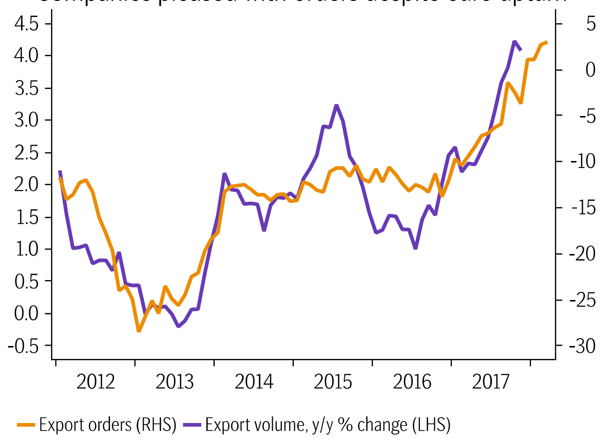


Source: Markit, Eurostat

Strong, broad-based order bookings

The upturn is geographically broad-based, but **manufacturing has assumed a clear leading role this past quarter and in December reached its highest-ever level. Order bookings are good** both in domestic and export markets. To some extent, the way companies view the order situation reflects the varying strength of growth in the region. For example, firms in the strong German economy report that their domestic order bookings are among the best in 30 years. Euro appreciation since mid-2017 (from USD 1.10 to 1.25) does not seem to have hampered the recovery. Although imports will rise somewhat more than exports in 2018-2019, this will mainly be due to strong domestic demand. **The current account balance will weaken a bit but will show a surplus of 3 per cent of GDP in 2019**.

Companies pleased with orders despite euro upturn



Source: Macrobond, SEB

Cautious relaxation of fiscal restraints

Cost-cutting and stronger economic conditions have improved **public finances**. Euro zone budget deficits fell to 1.5 per cent of GDP in 2016, and the downturn has continued. For example, in 2017 Germany showed a surplus for the fourth straight year. Countries like Italy and Spain are struggling with large budget deficits and debts, but practically all euro zone countries report deficits below 3 per cent of GDP. Stronger finances are creating **room for expansionary fiscal policies**; there is also a political desire to boost spending after years of austerity. In the wake of the 2017 elections, we expect reforms on both the expenditure and revenue sides in France and Germany. These imply a net stimulus, at least in Germany. **Because of looser fiscal policies, euro zone deficits will level out** at about 1 per cent of GDP in 2018-2019, while public debt will fall to 85 per cent. Political uncertainty and elections create some uncertainty but economic consequences are limited (see box).

GDP forecasts

Year-on-year percentage change

	2016	**2017**	**2018**	**2019**
Germany	1.9	2.2	2.5	2.2
France	1.2	1.8	2.1	2.1
Italy	0.9	1.5	1.7	1.7
Spain	3.3	3.1	3.1	3.0
Euro zone	**1.8**	**2.3**	**2.5**	**2.2**

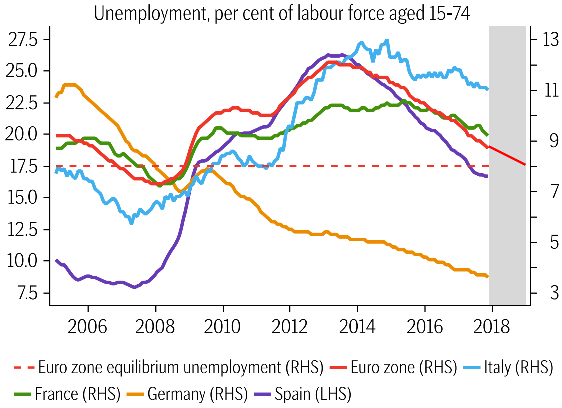
Source: Eurostat, SEB

Household confidence reaches record highs

Stronger political and economic self-confidence in the region is also apparent among households. Job growth, low interest rates, high asset prices and gradually looser fiscal policies have contributed to rising optimism. In December, consumer confidence hit **the second-highest level in the history of the EU indicator**. There are also pent-up needs after the tough crisis years; for example, in Spain and Italy the level of consumption remains lower than in 2008. Most indications are thus that consumption will be a key driver of GDP growth in the next couple of years; we predict a yearly increase of **nearly 2.5 per cent in 2018-2019**. Meanwhile low pay hikes are holding back disposable income, which is rising at less than 2 per cent yearly. This is probably one important reason why consumption is not really keeping pace with household optimism. The upturn in consumption is thus partly due to lower household saving. Our forecast implies that the household savings ratio will fall from nearly 13 per cent in 2014 to 11 per cent in 2019. This level can hardly be viewed as extremely low, given the healthy economic environment, yet a more favourable income trend will be necessary in the future in order to maintain the growth in consumption.

Broad-based decline in unemployment

Unemployment, per cent of labour force aged 15-74



Source: Eurostat Database, Macrobond, SEB

Lower joblessness, slightly faster pay hikes

Year-on-year unemployment fell more than 1 percentage point to 8.7 per cent in December: the lowest level since January 2009 and nearly 3.5 points below the peak during the crisis. This downturn is being driven mainly by higher employment, which rose by more than 2.5 million (about 1½ per cent) in one year. Job growth is clearest in Spain and Germany (about 500,000 each) but also in France and Italy (about 250,000 each). Company hiring plans are at a high level and, if anything, point to an even better trend ahead. Although labour supply restrictions are beginning to be felt in some countries, especially Germany, job growth is expected to continue at about the same pace this year. **Unemployment will fall from 9.1 per cent in 2017 to 8.4 per cent in 2018 and 8.0 per cent in 2019**. Towards the end of our forecast period, unemployment will be close to the equilibrium estimates widely discussed in recent years. But in an environment of sustainably good labour demand, and assuming structural reforms in such labour markets as France and Spain, it is reasonable to believe that equilibrium unemployment can be pushed even lower. This, in turn, would improve the outlook for an even longer expansion period.

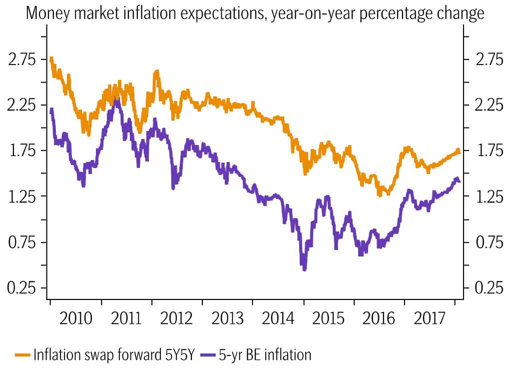
Despite improved labour markets, **pay increases remain low**. This is in line with the pattern in other OECD countries. High unemployment and the need to improve competitiveness seem to be holding back southern Europe. And although Germany's IG Metall union is now demanding 6 per cent increases, we believe that pay hikes there will total only 2.5-3.0 per cent. The acceleration in wage and salary increases will thus be very moderate in the euro zone as a whole: from just below 2 per cent in 2017 to 2.5 per cent towards the end of 2019.

Inflation accelerating, but at a slow pace

Having topped 2 per cent early in 2017, inflation fell to 1.3 per cent in January. Early in 2018 it is falling further, towards 1 per cent. Despite faster economic growth, looser fiscal policies and improved labour markets, **inflation pressure is expected to remain low, rising only moderately in 2018 and 2019**. It will reach 1.5 per cent late in 2019, but **measured as annual averages it will be only 1.4 and 1.3 per cent in 2018 and 2019**. The core harmonised index of consumer prices (HICP) has been stable at around 1 per cent in recent years and is not showing any tendencies to depart from that pattern; not until 2019 will core HICP reach 1.5 per cent, in line with total inflation. In recent years, inflation has had difficulty reaching the ECB's target without help from rising food or energy prices. Higher oil prices are providing some upward pressure, which is being partly offset by recent euro appreciation.

Rising inflation expectations

Money market inflation expectations, year-on-year percentage change



Source: Bloomberg, Macrobond, SEB

Clear normalisation signals from the ECB

Now that ECB has extended its QE bond purchases until the end of September 2018 and repeatedly signalled that it will end them before raising key interest rates, **monetary policy is set for most of 2018**. What will instead be crucial is how the ECB Governing Council positions itself on somewhat long-term policies. A combination of ever-improving economic conditions with inflation that is a bit lower than the ECB target of "below, but close to, 2 per cent" is escalating tensions between hawks and doves. Strong growth and rising inflation expectations are reinforcing the hawkish argument that **the region no longer needs a monetary crisis policy**. The minutes of the ECB's December policy meeting were also interpreted as hawkish by the market; along with hawkish speeches by various Governing

Council members, the focus has shifted to the question of when the ECB's official terminology will change. The tug-of-war between hawks and doves risks generating some volatility in the fixed income and foreign exchange markets this spring.

But looking at the big picture, all indications are that the ECB will proceed cautiously, compared to other central banks. We expect it to stick to the process it has signalled for unwinding its crisis measures: bond purchases will end before key rate hikes begin. We predict that the latest extension of the bond-buying programme was the last: **QE will end in September** 2018. The ECB will take the first interest rate step by **hiking its deposit rate for banks by 15 basis points in March 2019**. Then it will **hike the refi rate twice during 2019**. The first refi rate hike, and the only one that Mario Draghi will preside over before his term as ECB head expires in October 2019, will occur at mid-year. Another refi rate hike will follow in December.

Fresh start for the EU, without EUphoria

Despite great fears early in 2017, a series of key euro zone elections led mainly to reassuring outcomes. Populist and EU-sceptical parties gained ground but achieved few decisive breakthroughs. In 2018, too, there are various important political issues on the agenda. These include the Italian election in March and the formation of a German federal government. Brexit negotiations are moving into a new phase, in which a new UK-EU trade agreement must be put in place soon. Greece will exit its financial bail-out programme, and this is likely to revive the issue of debt restructuring. There will be other important EU and euro zone issues. A new long-term EU budget will be negotiated, taking into account the shortfall that Brexit will create. Meanwhile efforts to intensify cooperation in a number of fields (a European Monetary Fund, an EU finance minister etc.) will continue, aimed at achieving proposals before the election to the European Parliament in late May 2019.

The March 4 Italian parliamentary election is approaching. The general euro zone upturn is contributing to decent growth in Italy and a reduced volume of problem loans in the banking system. But problems like slow growth, high public sector debt and a weak banking system remain. Public opinion surveys point to an even match between three blocs (the Five Star Movement, the now-ruling Democratic Party and Forza Italia/ Lega Nord/Brothers of Italy), each with 25-35 per cent of votes. The Five Star Movement's euro-sceptical views created uncertainty, and it has now dropped its threat to withdraw Italy from the euro zone. It has also declared that it will not join any alliance, which probably means it will be kept outside any governing constellation. It is now hard to see how a strong government can be formed, given the parliamentary situation that surveys indicate. With a diminished risk that Italy will leave the euro zone, financial markets do not seem so upset about this. Considering the turbulence that often typifies Italian politics, the parties would have to become really stuck while trying to form a government before this picture will change.

It is taking a long time to put a new German government in place, but this has had little economic impact. Still, the process provides a hint of what tensions will affect Germany's political scene in the next few years. Both Liberals (FDP) and Social Democrats (SPD) have been burned by negative experiences after joining coalitions dominated by Angela Merkel's Christian Democrats (CDU). Now that the SPD has voted by a narrow majority to begin negotiations with Merkel, it is likely to demand greater influence on government policies. On many issues, Merkel will thus be squeezed between the often diametrically opposite views of the SPD and her conservative Bavarian sister party, the CSU. Our main scenario is that the negotiations will result in a new grand coalition, but that SPD/CDU/CSU collaboration will be strained, with a risk that the partnership will not survive for a full term of office.

The parties are likely to reach agreement on looser fiscal policies. On many EU policy issues the SPD led by Martin Schulz, former President of the European Parliament, will be very close to France and President Emmanuel Macron, while Merkel's Christian Democrats will be more sceptical towards far-reaching federalist proposals. Although these successes are important to Schulz, domestic policy issues are probably more important. As soon as Germany swears in a new government, we expect some support for proposals that are now on the table. Given the EU's far-flung agenda, **we expect the focus to be on reforms that can gain broad support, enabling EU leaders to show progress and unity** instead of discord. With the ECB expected to end its QE programme this year and Greece exiting its bail-out programme in August, the **proposal to turn the European Stability Mechanism (ESM) into a European Monetary Fund** will enjoy priority. It is also likely that an **EU finance minister** position will be established, even if it is mainly a matter of restructuring existing tasks and giving one person greater coordinating responsibilities within the European Commission. The **banking union** will be another focus.

The EU's long-term budget may be a tough nut to crack. No final decisions will be made until 2019, but the budget is already on the agenda. The Commission (as usual) wants to expand its efforts in fields like defence, migration and security. The post-Brexit financial hole must also be filled. More detailed proposals are due in May, but the EU's budget chief has proposed **higher membership fees and new EU tax bases**. Budget hawks including Sweden have flatly refused. While the north-south conflict line was dominant during the euro crisis, the budget process is likely to be characterised by east-west conflicts. Net payers in Western Europe have signalled that they will put pressure on recipient countries like Poland and Hungary, when it comes to accepting refugees and following EU rules on an independent judiciary. Cooperation efforts are seeing a fresh start, after the sense of resignation that dominated the EU for a long time, though Macron's and Schulz' EUphoria is dampened by Merkel's healthy, more cautious approach. The next few years will show whether the EU can find a middle path, where progress will be clear enough to strengthen faith in the European project without moving in an aggressively federalist direction that will generate new tensions among members.

Amid international pressures, households are cautious

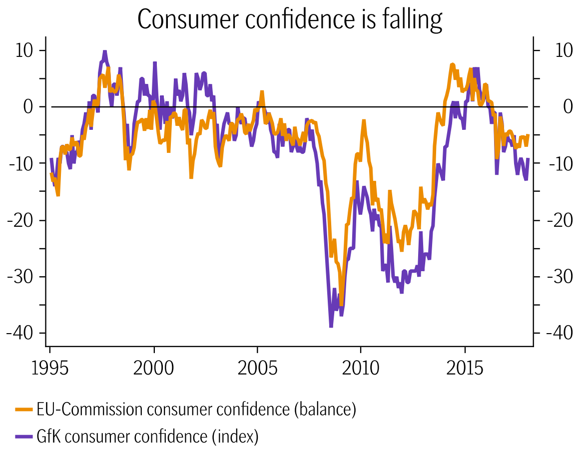
- **Brexit talks can be completed despite tough time limits, but troubles loom on both sides**
- **UK will avoid recession, although wary cautious households will slow down growth**
- **British inflation will fall during 2018**

In December, the EU and the UK reached agreement on the terms of British withdrawal ("Brexit"). This means it is now time to start negotiating about the future UK-EU relationship, with a trade pact and a transitional period as key elements. Despite tough time constraints, we expect a full agreement by autumn. **There is still a major risk that the emergence of new political crises will end or delay the talks**. Individual EU countries may block them, and internal British disputes may cause problems. Prime Minister Theresa May and her government appear weak, creating uncertainty as to whether she can hold together her Conservative Party and keep her job throughout the remaining Brexit negotiations.

Brexit-related uncertainty led to a minor economic slowdown in the first half of 2017, but several indicators later rebounded due to such factors as the continued weak pound and rising demand from the euro zone. Uncertainty connected to EU withdrawal will continue hampering growth to some extent. **We expect GDP growth to decelerate from 1.8 per cent in 2017 to 1.4 per cent in 2018**: one tenth of a point below our previous forecast, due to signs of weakness in consumption. **In conjunction with EU withdrawal, we expect 2019 growth to fall a bit further, to 1.1 per cent**. If negotiations fail, the 2019 slowdown will be substantially more severe.

The UK labour market is historically strong. **Unemployment fell last year, stabilising in recent months at 4.3 per cent, the lowest since 1975**. Yet there is no apparent upward pressure on wages and salaries, partly due to low productivity growth. At present no signs indicate that productivity or pay is about to surge. Due to weak economic growth, unemployment will move cautiously higher during our forecast period, reaching 4.8 per cent by the end of 2019.

Despite the strong labour market, household optimism is now ebbing. One reason is that purchasing power is being squeezed by relatively high inflation. Consumer confidence fell in December and is now lower than after its dramatic decline following the Brexit referendum. Retail sales growth was weak during 2017, and car sales fell year-on-year. We foresee no reversal in these trends as long as uncertainty about Brexit persists. Households will probably behave cautiously this coming year: among other things because saving is at historical lows and real incomes are squeezed. Looking ahead, home prices are also unlikely to contribute to household wealth.



Source: GfK, European Commission (DG ECFIN), Macrobond, SEB

There were fears that the uncertainty created by EU withdrawal would hamper business investments, but so far its negative impact has been less than anticipated. In the manufacturing sector, capital spending plans recovered in 2017 and investments grew by around 2 per cent year-on-year.

The weak pound mainly reflects Brexit-related uncertainty. If negotiations are successful, **we expect the risk premium that is now part of the pound exchange rate to gradually shrink, which should lead to a stronger pound during our forecast period**. We foresee a GBP/SEK rate of 11.20 at the end of 2018 and 11.35 at the end of 2019. The weak pound continues to mainly benefit the export sector, where confidence remains at very high levels. Confidence in the more domestically oriented service and construction sectors also indicates continued growth, but at a far more leisurely pace.

Inflation has kept climbing due to the falling GBP. It is now well above the Bank of England (BoE) target, but we believe inflation has peaked. Looking ahead, the question is how far and how quickly it will fall. We are more optimistic than the BoE; we believe i**nflation will fall to 1.7 per cent by the end of 2018**, then stabilise in 2019. The BoE raised the key rate by 0.25 percentage points at its November policy meeting. This hike was mainly an effort to recoup the crisis rate cut it implemented soon after the Brexit referendum. No more near-term rate hikes seem likely, given our inflation forecast, but **if EU withdrawal occurs in controlled fashion, we expect two further hikes in the second half of 2019**, bringing the key rate to 1.00 per cent at the end of our forecast period.

Industry driving growth as home construction declines

- **EU boom lifts exports and investments**
- **Falling prices slow construction of homes**
- **Optimistic households will keep consuming**
- **Low pay hikes, despite tight labour market**
- **Riksbank will hike its key rate as planned...**
- **... but low inflation is a source of concern**

Most signals in the Swedish economy continue to indicate strength. The economy has recently shown resilience to increased uncertainty in the housing market. For this reason **we continue to expect the upturn to continue. Our forecast of 2.6 per cent GDP growth in 2018 is unchanged** compared to November. **In 2019, GDP growth will remain above trend but will slow to 2.4 per cent**. Falling home prices will pull down the economy, however. For example, the contribution of residential construction to GDP growth will shift from a positive 0.7 percentage points in 2017 to a negative 0.5 points in 2018. There is a further downside risk if the overall home price decline exceeds the 10 per cent in our main forecast. Strong global economic conditions and a weak krona are lifting exports and industrial investments – boosting GDP growth.

The labour market keeps gaining strength. The downturn in unemployment was accentuated late in 2017, and large shortages indicate ever-tighter resource utilisation. Yet **pay increases have been lower than expected, holding down inflation pressure**. Service and food price inflation also looks set to slow during the next six months after an uptick in 2017 – one reason why CPIF inflation (CPI less interest rate changes) in mid-2018 will be a bit below the Riksbank's latest forecast.

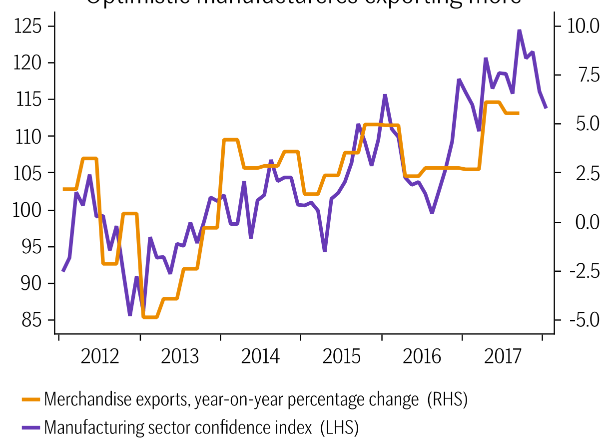
At its December 2017 meeting, the Riksbank confirmed plans to deliver a first key interest rate hike "in the middle of the year" and clearly stated that it might very well hike its key rate before the European Central Bank (ECB). **Our forecast of a first rate hike in September, followed by three hikes in 2019** – bringing the repo rate to +0.50 per cent – is unchanged. Downside inflation surprises may possibly lead to hesitation among some Executive Board members. Yet a major delay to the start of normalisation is unlikely, among other things in light of the broad international trend in this direction.

Despite fiscal stimulus measures totalling nearly one per cent of GDP during the election year 2018, strong tax revenue will help Sweden's public sector surplus remain at around 1 per cent of GDP in 2018-2019. We believe that **the National Debt Office (NDO) will again be surprised by this strength and need to greatly lower its planned bond issues in February**. Combined with continued Riksbank bond purchases, this will further squeeze the yield spread against Germany.

European strength lifts Swedish industry

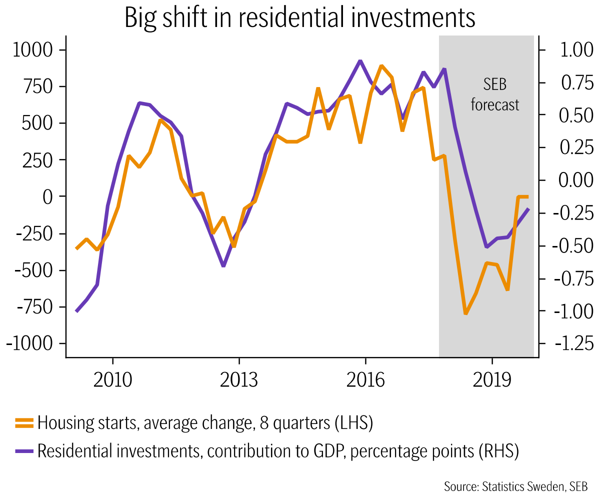
Confidence indicators in the manufacturing sector remain close to historical peaks. This upturn in sentiment is now also being confirmed by rising order bookings, production and merchandise exports. Solid economic strength in the EU, which buys nearly 75 per cent of merchandise exports, is especially important. Swedish companies are also benefiting from a high EUR/SEK exchange rate. Yet industrial investment remains muted and companies are only planning a weak increase in 2018, according to survey data from late 2017. **However, the historical pattern is that companies underestimate their capital spending needs during upturns**. We expect industrial investments to climb by 8 per cent this year.

Optimistic manufactureres exporting more



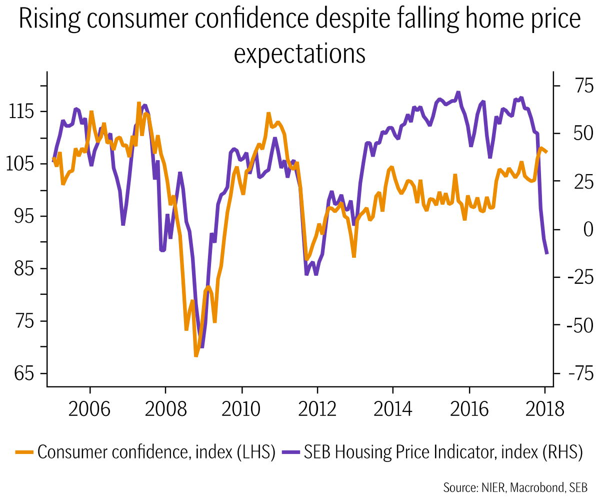
Source: NIER, Statistics Sweden, SEB

The capital spending outlook for other sectors is mixed. Strong demand for public services such as health care and education, partly due to the 2015-2016 refugee crisis, is contributing to rapid public sector expansion. In contrast, residential investments are expected to fall by 15 per cent this year after an accumulated upturn of 80 per cent during 2015-2017. The contribution of such investments to GDP growth will shift from +0.7 percentage points in 2017 to –0.5 points in 2018, but strong underlying demand for homes suggests that housing investments will recover in 2019. **Overall capital spending will grow by 5.6 per cent in 2018 and by 4.4 per cent in 2019**. This is in line with the historical average but reflects subdued growth compared to earlier economic expansions.



Optimistic, despite falling home prices

To date, there are no signs that households have been adversely affected by falling home prices. In recent months, consumer confidence has climbed to its highest levels since 2011. **This reduces the likelihood that the weak housing market will expand into a broader economic downturn**. So far, most households probably view lower home prices as a natural and welcome correction. An increase in purchasing power, driven by strong job growth, expansionary fiscal policy and falling unemployment suggest a continued upturn in consumption during the next couple of years. The household savings ratio is at a record-high level of 16.5 per cent, which also increases the potential for accelerating consumption, but at present there are no signs of a further speed-up. Rapidly increasing e-commerce, with direct imports especially from China, may create difficulties in interpreting the statistics, but we are **sticking to our forecast that the current trend – a 2-2.5 per cent yearly rate of increase – will continue**. Considering that Sweden's population is growing by about 1 per cent a year, this is a moderate per capita upturn in a historical perspective.



Mysteriously weak public consumption

The upturn in public sector consumption appears likely to reach only 0.5 per cent in 2017 as a whole: substantially lower than we had predicted. This forecasting error is mainly due to our not fully foreseeing the slightly remarkable consequences of Statistics Sweden's change in measuring methods, which **has ended the previously close correlation between work input and consumption volume**. Public sector employment rose by more than 2.5 per cent in 2017. The new measuring method thus implies sharply falling productivity. It is difficult to make any reasonable economic interpretation of this, and we are reiterating our view that the trend of employment is a better indicator of the public sector's impact on the economy (see theme article, *Nordic Outlook*, August 2017). Above all, we expect public sector employment to keep growing, though at a somewhat slower pace, among other things due to the educational, medical and social service needs of people who recently arrived in Sweden. The trend of consumption volume is hard to estimate, but we do not believe that the discrepancy with public sector employment, and thus the decline in productivity, will be as dramatic as in 2017.

Election year, with loose fiscal policy

Although GDP growth was somewhat weaker than expected in 2017, government finances were surprisingly strong. Tax bases such as wages and private consumption expanded at a healthy pace, while government spending slowed due to falling unemployment. Now that manufacturers and exporters are taking over as economic engines, there is concern that the improvement will fade, though we have not yet seen any signs of this.

Last autumn the government unveiled an expansionary budget, including new stimulus measures totalling about SEK 40 billion or nearly 1 per cent of GDP. In addition, local government employment and consumption in current prices are rapidly increasing. In spite of this, we believe that **the public sector surplus will remain at around 1 per cent of GDP throughout our forecast period**. In cyclically adjusted terms, this means that the new surplus target that goes into effect in 2019 (1/3 of a per cent of GDP) is largely being met. In light of the September 2018 election, 2019 fiscal policy is uncertain, but regardless of which parties win the election we expect fiscal policy to remain expansionary (SEK 10-20 billion). **Government debt will fall towards 35 per cent of GDP** by the end of our forecast period. **The borrowing requirement will be negative, with budget surpluses of SEK 50 billion per year in 2018 and 2019**. This implies that in February the NDO will again need to revise bond issue volumes downward.

Public finances

Per cent of GDP

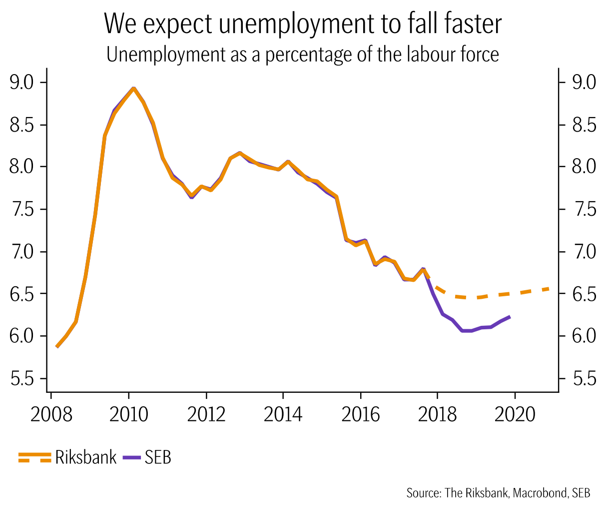
	2016	2017	2018	2019
Net lending	1.2	1.3	1.1	1.0
Borrowing req., SEK bn	-85	-62	-48	-50
Gen. gov't gross debt	42.2	40.3	37.7	35.4

Source: Statistics Sweden, SEB

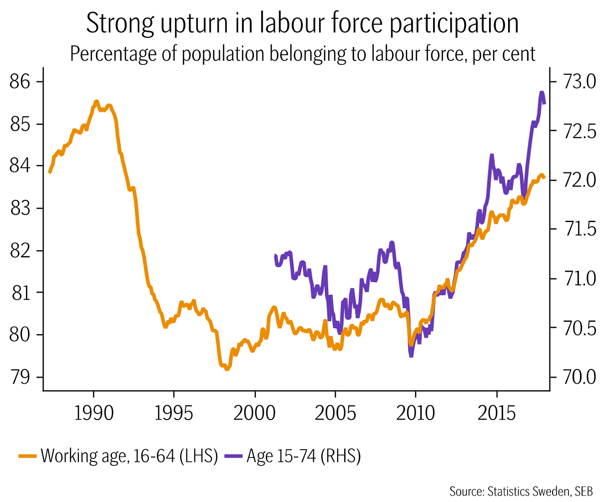
Job growth pushing down unemployment

The labour market gained further strength in the second half of 2017, partly due to accelerating job growth. We expect continue rapid job creation during the next couple of years.

The pace will slow down a bit, however, due to increasing recruitment problems and a cool-down in construction activity.



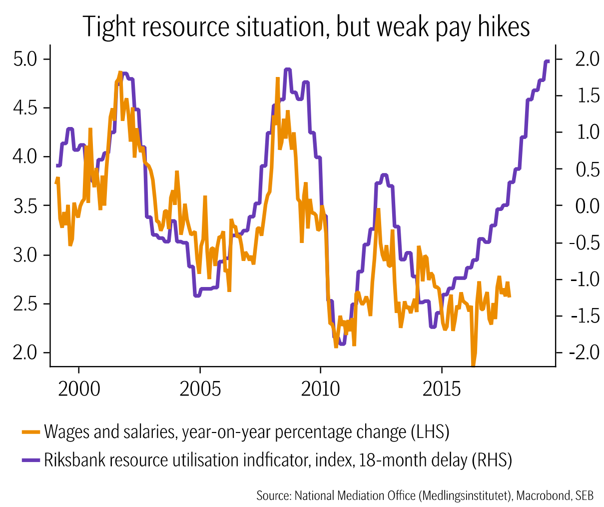
The unemployment downturn gained momentum late in 2017, but **the impressive upswing in labour force participation seems likely to continue. Looking ahead, this will slow the decline in unemployment**. One important factor is that more and more people are continuing to work after their 65th birthday, but participation is also rising in other age categories.



Yet Employment Service statistics indicate that the share of all unemployed people who have little formal education and/or are of non-European origin – that is, are among those who find it difficult to land jobs in Sweden – has now risen to a full 75 per cent. **The percentage of companies claiming a labour shortage has climbed to new record levels, thus confirming the picture of a high equilibrium unemployment level**. Because the jobless rate in countries like Germany, the UK, Norway and Denmark has been trending downward to historically low levels, Sweden is increasingly beginning to stand out in a negative light. This means that the Social Democratic-led government's target of making Sweden the EU country with the lowest unemployment by 2020 is hardly realistic. Although employer organisations and labour unions have made some progress on enacting measures that may marginally improve the chances for recent arrivals to find jobs, this does not change the big picture.

Tight job market, but sluggish pay increases

Although the Riksbank's resource utilisation (RU) indicator has climbed to a new record level, pay increases have remained subdued. The full-year 2017 upturn appears likely to end up below our expectations and those of the Riksbank. Even taking into account that the cyclical sensitivity of wages has decreased since the mid-1990s and that we now have three-year collective agreements with low pay hikes in place, **it is surprising that employer complaints about recruitment problems are not at all visible in the pay statistics**. Recent arrivals in Sweden often have lower-than-average qualifications or accept lower wages for other reasons. This may be one factor holding down the average rate of pay increases. Wage pressure from an increasingly integrated European labour market may also be a contributing factor. This phenomenon is not unique to Sweden: For example, Bundesbank President Jens Weidmann has cited it as one reason why German wages are not climbing faster, despite a very strong labour market and good economic growth. We still expect a **gradual acceleration in Swedish pay increases from just above 2.5 per cent in 2017 to 3.5 per cent during 2019**: on a par with the average level in recent decades.

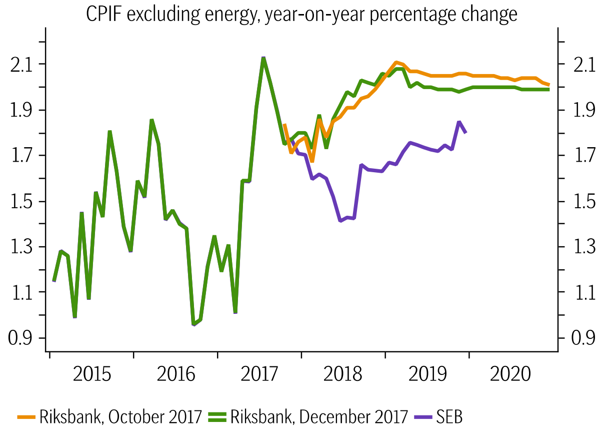


The inflation rate will fall during 2018

Annual average CPIF inflation during 2017 appears likely to end up close to 2 per cent. This means that **inflation surprised on the upside, despite unexpectedly low pay increases**. Partly due to a change in the methodology for measuring the prices of package holidays, CPIF climbed above the Riksbank's 2 per cent target last summer. But CPIF excluding energy and package holidays also recorded levels as high as 1.8-1.9 per cent in late 2017. A relatively strong upturn in service inflation was the most important driver. Since this was broad-based, it suggests that service prices will continue increasing at a healthy pace in the future, but temporarily large price increases for banking services, domestic transport services and to some extent public medical care fees in 2017 indicate that service inflation will decelerate a bit in 2018. The same pattern applies to food prices, where signals of a slowdown are even more evident. Food-related commodity prices fell during the second half of 2017, leading to a clear slowdown at the producer price level. Although the correlation with CPI prices is not always so strong, we believe that food prices will reduce the rate of inflation by 0.2-0.3 percentage points during 2018.

Core inflation well below Riksbank forecast

CPIF excluding energy, year-on-year percentage change



Source: The Riksbank, SEB

But this year CPIF will be sustained by rising energy prices – driven by higher oil prices as well as higher indirect taxes and electricity grid fees. We thus expect CPIF to increase by 1.8 per cent during 2018, i.e. rather close to the Riksbank's own target. During 2019, an increasingly mature economic expansion, both in Sweden and internationally, will contribute to somewhat higher underlying inflation pressure. But because of a smaller contribution from energy prices, CPIF does not seem likely to reach the 2 per cent target, even in 2019.

Rate hike on its way, despite low inflation

The Riksbank has shifted from a clear bias towards additional key rate cuts to a detailed discussion at its December policy meeting of a suitable date for a first rate hike. Its rate path has largely stood still since April, signalling a high probability of a July or September 2018 rate hike. Riksbank officials have said that they expect slow rate hikes starting in "the middle of the year". The December minutes show that the Executive Board has become more divided, with Henry Olsson among those advocating a first rate hike early in 2018 while Per Jansson wants the rate path to signal a later hike than it now does. But the Board agrees that inflation is now high enough to enable the bank to let go of the strong link to ECB policies that has predominated in recent years. **We believe that an Executive Board majority is now determined to follow the very gradual normalisation plan that the Riksbank has signalled for nearly one year** and we thus expect a first rate hike in September this year and three more hikes in 2019, bringing the repo rate to 0.50 per cent by year-end.

We predict that the Riksbank will be surprised by low inflation during the first half of 2018. This implies a certain probability of a later rate hike, which the doves on the Board will certainly advocate. Governor Stefan Ingves' position will probably be decisive. In December he stated that the exact timing of the rate hike will depend on incoming data, but since then he has avoided confirming that position. **In an environment where more and more central banks are moving towards monetary policy normalisation, it is unlikely that the Riksbank will further postpone its starting date**.

Strong government finances squeeze yields

Since late 2016, when Swedish 10-year bond yields were close to zero, they have moved higher as international yields have slowly risen. The spread against Germany has nevertheless shown a slight narrowing trend, driven by Riksbank bond purchases combined with the NDO's downward adjustments of bond issue volumes twice during 2017. Although a Riksbank key rate hike is approaching, **we foresee the possibility that the yield spread against Germany may continue to shrink this spring**. Swedish central government finances keep surprising on the upside, and last year's SEK 60 billion surplus surpassed the NDO's latest forecast by a wide margin. We believe that in February the NDO will again be forced to make a downward adjustment in its planned full-year 2018 issuance of nominal government bonds by at least SEK 10 billion. In December the Riksbank decided that it will continue its bond purchases at the same pace as in the second half of 2017 (just over SEK 20 billion per six-month period) until the end of June 2019. This will also help push down yields. **Our forecast is that the spread against German 10-year yields will shrink to 10 basis points in the spring 2018**. Later on, the Riksbank's rate hikes will become the dominant factor, and the yield spread against Germany will widen to 60 basis points by the end of 2019. This implies that the 10-year yield will climb from today's 0.9 per cent to 2.1 per cent at the end of 2019.

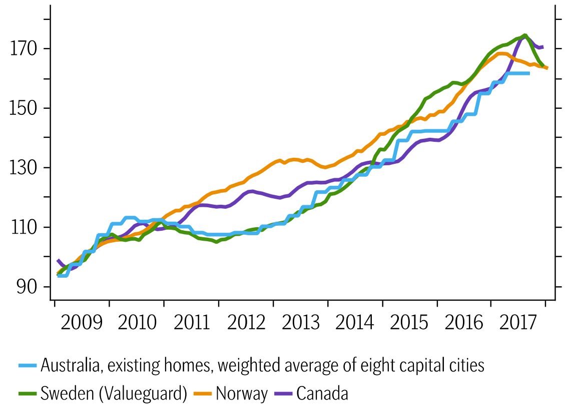
Krona will appreciate despite strong euro

In the past six months, the EUR/SEK exchange rate has been close to 10.00, which is unsustainable in the long term. Swedish fund managers have largely decreased their foreign currency positions already, in order to profit from an expected krona appreciation. We thus hardly view krona purchases by these market players as a major driver of a future SEK upturn. Instead, the flow potential for a stronger krona will be related to Swedish exporters expanding their currency hedges and also exchanging their sizeable foreign-denominated reserves. Institutions based outside Sweden will undoubtedly position themselves for a stronger SEK, but since the Riksbank's monetary policy shift is taking some time, it will remain costly to hold kronor. This is one reason why **the EUR/SEK downturn will occur very gradually, reaching 9.50 by year-end**. With the ECB moving towards policy normalisation, the Riksbank's task will be easier. Meanwhile the krona's strong connection to euro appreciation against other currencies will automatically lead to trade-weighted SEK appreciation, which will limit the Riksbank's manoeuvring room. We believe that the EUR/SEK rate may fall towards 9.30 by the end of 2019 as the Riksbank hikes its repo rate to 0.5 per cent. This means that the USD/SEK rate will end up a bit above 7.00 and that the trade-weighted KIX index will reach a level of around 107: about 2 per cent stronger than the Riksbank's December exchange rate forecast.

- **Home price correction in spite of strong economy, not only in Sweden**
- **Signs of stability in Norway support our forecast of limited downturn in Sweden**
- **Continued large sales in Swedish and Norwegian housing markets**
- **Heavy weighting towards urban and tenant-owned units boosts Valueguard's volatility**

In the last *Nordic Outlook*, we discussed the worsening prospects for Swedish home prices in a theme article entitled "The resilience of the Swedish housing market". This article provides an update as well as comparisons with other countries that show similarities with Sweden. Although so far we only have access to anecdotal information, **developments early in 2018 have not contradicted our forecast that the price decline may be limited to only about 10 per cent**.

Home prices
Index 100 = 2009



Source: Macrobond, SEB

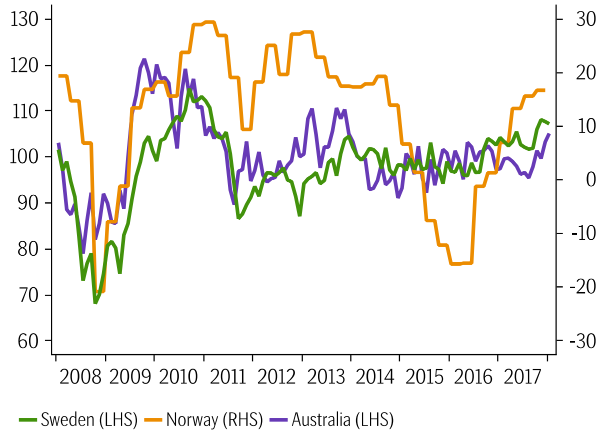
Simultaneous downturn in a few countries

In 2017 home prices fell almost simultaneously in Norway, Canada and Sweden while levelling out in Australia. These countries belong to an exclusive group of OECD economies that escaped major home price corrections during the financial crisis. Since 2009 their prices have climbed by 60-70 per cent. Home prices normally fall in an environment of both national and global recession. The exceptions have often been triggered by interest rate upturns or major tax hikes related to the housing market. Today's situation, with prices falling in an **environment of good economic growth, stable interest rates and no major rule changes is thus very unusual**.

In all these countries, the downturn was preceded by **varying degrees of new construction increases and by macroprudential or other measures aimed at slowing home price increases and lending to households**. In Canada, key interest rate hikes have played an important role. This is not true of Sweden and Norway, although their central banks have indicated that a rate hike may occur later this year.

Home prices showed their biggest decline in Sweden: nearly 9 per cent over the past four months. But the Valueguard Sweden index that we have used in this comparison has tended to be more volatile (more about home prices indices below), while also showing a clearer seasonal pattern. The downturn in Sweden also occurred after a stronger increase in the first half of 2017; if we compare the year-on-year change in December 2017 the decline in Sweden has only been one percentage point larger than in Norway.

Consumer confidence



Source: Macrobond, SEB

Signs of stabilisation in Norway

Norway is ahead of Sweden in the current price adjustment, perhaps because it was **earlier in applying loan principal repayment requirements and loan-to-income limits aimed at cooling the market**. In Sweden the process has been slower. A clear tightening of repayment ("amortisation") rules took effect only in mid-2016. For households with large home loans relative to income, repayment rules will be tightened further in March. This may amplify the market downturn, but the effect will probably be rather small. In recent months the situation in Norway has stabilised, **supporting our forecast that annual average prices would fall only 2 per cent from 2017 to 2018 and that prices would level out in mid-2018**.

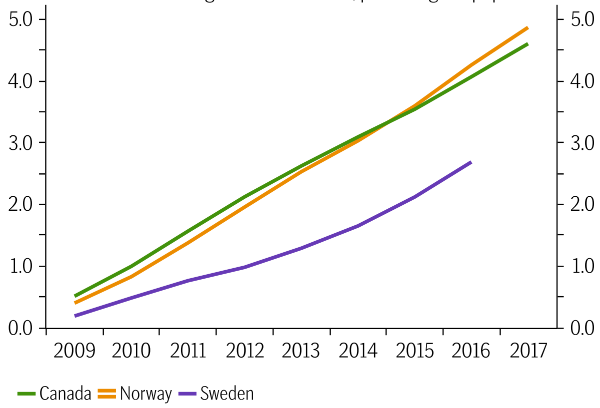
Comparing Sweden and Norway

Market stabilisation in Norway – along with our forecast that the accumulated home price decline will be only 4 per cent – may be interpreted as encouraging for Sweden as well. We see no signs that Swedish consumer confidence and consumption have been adversely affected either. **There is thus a good chance of avoiding a downward spiral**, where falling consumption and economic growth boost unemployment, which in turn would push the housing market further downward.

A structural comparison between the Norwegian and Swedish housing markets reveals both pluses and minuses. For example, rents are unregulated in Norway, so it is relatively common to own one or more rental units. Home ownership is high (77 per cent according to the latest figures), also increasing household exposure to a home price decline. In Sweden, however, strict rent regulation has limited speculation, since there is little opportunity to sub-lease, but **the speculative element appears to have increased in newly constructed units during the past few years**.

Few new homes in Sweden despite sharp upturn

Accumulated housing starts since 2009, percentage of population

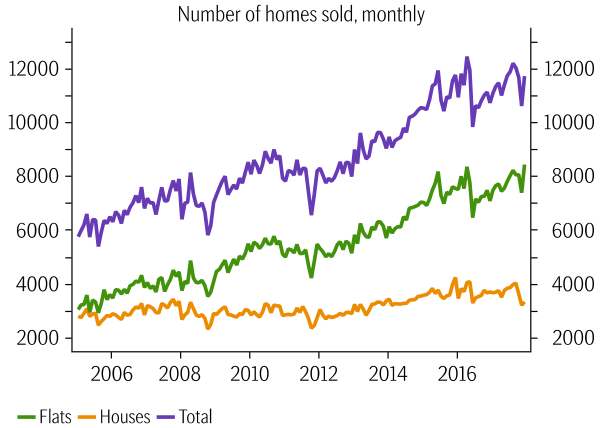


Source: Macrobond, SEB

Looking at housing supply, construction has been high in Norway for years. Relative to population, the number of new homes built in Norway since the financial crisis is thus nearly twice as high as in Sweden. **Limited total supply and strong underlying demand reduces the risk of major home price declines in Sweden**. However, the stock of newly built Swedish homes includes an oversupply of expensive tenant-owned units in major cities. Due to the regulated Swedish rental market and the difficulty in shifting construction towards cheap rental units, **the housing construction downturn in Sweden may be at least as large as in Norway**.

Continued high Swedish home sales

Number of homes sold, monthly



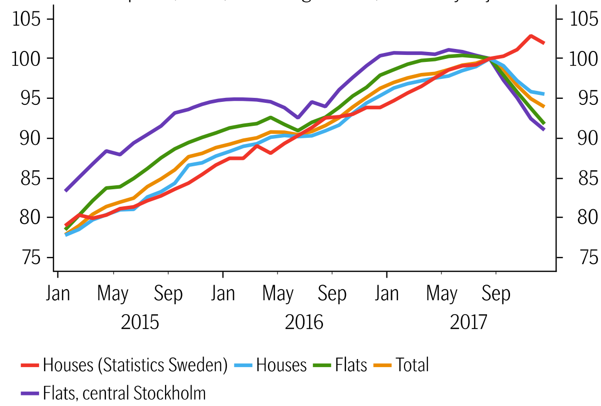
Source: Macrobond, SEB

Continued seasonally adjusted price decline

Recent information, including on home-related websites, indicates some stabilisation in Sweden as well, but the small price upturns that have been noted are probably seasonal effects that usually occur in January. Adjusted for these, prices will probably keep falling slightly, but we still believe that early 2018 trends **do not conflict with our forecast that the price decline will be only about 10 per cent and will level out in mid-2018**. One positive sign, as in Norway, is that home sales remain high; sellers and buyers thus seem to be finding each other, despite current uncertainty about the right price level.

Broad-based decline in home prices

Home prices, index, 100 = August 2017, seasonally adjusted



Source: Valueguard Sweden AB, Statistics Sweden (SCB), Macrobond, SEB

Valueguard's metric has a bias towards exaggerating price variations. It only covers home sales in greater Stockholm, Gothenburg and Malmö plus some 20 medium-sized cities and thus includes a mere 65-70 per cent of all home sales in Sweden. Nearly 60 per cent of the sales that it includes have occurred in the three largest urban areas, which generally show larger price variations. Compared to Sweden as a whole, the metric also assigns greater weight to tenant-owned units, which are more volatile in price, than to single-family houses. The Statistics Sweden (SCB) real estate price index, which measures all 1-2 family house sales in Sweden, has risen less than Valueguard's index in recent years and showed no decline at all through December, but **reports sales with a 3-4 month lag and excludes tenant-owned units**.

Because the price decline appears to be broad-based, it is nevertheless a source of uncertainty. Although the decline is largest in central Stockholm (13 per cent in actual terms and 10 per cent when seasonally adjusted), there is little difference compared to the national average for tenant-owned units. Prices for single-family houses have also fallen by 5 per cent in seasonally adjusted terms, showing that **the downturn that began in Stockholm in mid-2017 has spread quickly to the whole country**. The number of single-family housing starts remains low, which means that in this market segment the price decline cannot be attributed to the supply side.

Growth likely to rebound following temporary weakness

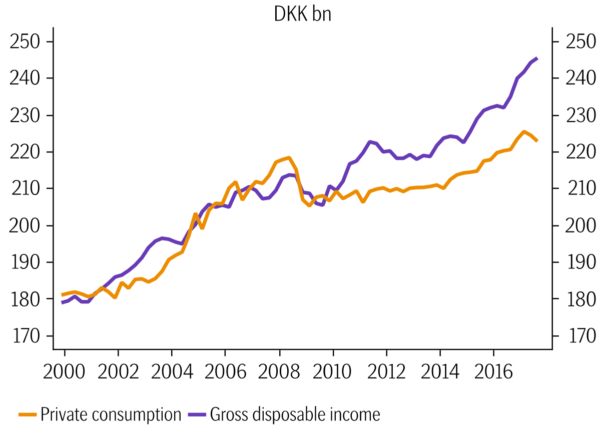
- **Weak Q3 GDP appears to be temporary**
- **Households cautious despite strong fundamentals**
- **Signs of overheating still absent**

Despite weak third quarter GDP, Denmark's economic outlook remains bright, supported by a strong European upturn and healthy domestic fundamentals. We expect growth to rebound in Q4 and 2018, leading to a minor downward revision of our **2017** GDP forecast from 2.3 to **2.1** per cent, but an increase for **2018** from 2.3 to **2.4** per cent followed by **2.3** per cent in **2019**.

The main culprit behind Q3 2017 was private consumption, posting its second straight quarterly decline. The weak demand was surprising, in light of strong employment growth, high confidence and positive wealth effects from rising home prices.

Spending decoupled from income since 2010

DKK bn



Source: Statistics Denmark, Macrobond, SEB

The Q2 and Q3 consumption declines may be an aberration, partly caused by anticipated tax changes for cars, but **private consumption has been lagging behind income for years, leaving the savings ratio at a record of almost 12 per cent**. Since 2013, disposable income has increased by 12.6 per cent but consumption by only 6 per cent. This is not what we would expect to see under current strong macroeconomic conditions.

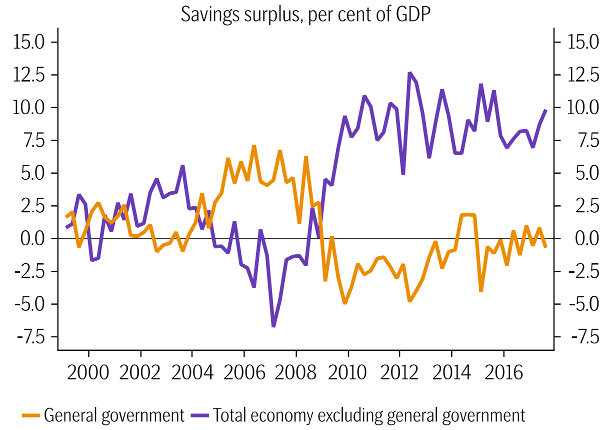
The most likely explanation for this slow spending growth is the tightening of credit standards for private households that started in 2015. Home prices have continued rising, but the supply-demand balance in the market would normally have led to double-digit price increases, and the fact we are getting only half as much suggests that lending is constrained.

Looking ahead, we expect the savings ratio to stop rising as household wealth continues to grow and job security improves, even if the Financial Supervisory Authority remains vigilant. This should allow strong income growth to be reflected in faster spending growth, with **private consumption projected to grow by 2.9 and 2.5 per cent in 2018 and 2019** respectively. With business investment and exports buoyed by strong external demand, GDP growth is thus likely to rebound in 2018.

Meanwhile the labour market continues to strengthen, with OECD harmonised **unemployment expected to fall to 5.0 per cent in 2019, but still with no signs of overheating.** Wage and salary pressures remain moderate and below those of a basket of Denmark's competitors. **Inflation is set to reach 1.4 per cent in 2019**, which is hardly a cause for concern. The current account surplus continues to widen, moving towards a record 9 per cent of GDP. Absent financial risks in the housing market, there do not appear to be any major constraints on growth during our forecast period. Indeed, looking at sectoral savings balances compared with the situation in the 2000s, the Danish economy seems to be underspending rather than overheating.

The economy is not overheating – on the contrary

Savings surplus, per cent of GDP



Source: Statistics Denmark, Macrobond, SEB

Against this backdrop, fiscal stimulus would have made sense; however, the magnitude of the planned tax cuts presented last autumn has been significantly reduced, as negotiations fell short, and fiscal policy is set to remain largely neutral in 2018.

The krone remains strong, but broad euro appreciation has eased upward pressure on the Danish currency. Supported by a sizeable current account surplus, we expect the DKK to stay above its central peg against the euro, **forcing Danmarks Nationalbank to keep key interest rates below the ECB's** throughout our forecast period, even if pressure is likely to vary depending on the overall direction of the euro.

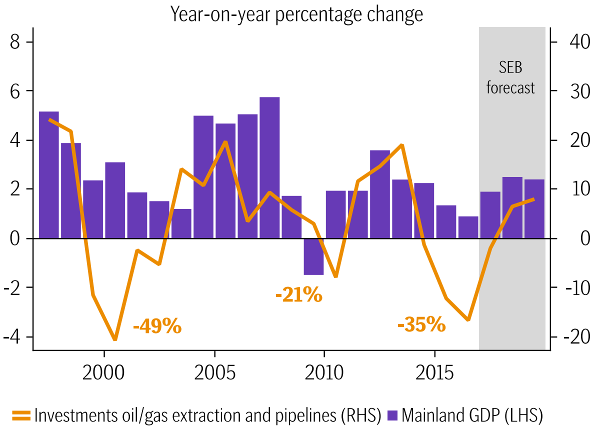
Shifting drivers of growth

- **Exports and industrial capital spending will sustain above-trend growth**
- **Home prices to stabilise this summer**
- **Norges Bank hiking rates in December**

The economic recovery gained further ground in 2017, with mainland GDP (excluding petroleum and shipping) growing above trend in the first three quarters (the Q4 GDP report will be published on February 9). The most prominent drivers that have been leading the expansion will have a neutral or negative effect on growth going forward. While the slowdown in residential investment will become more evident, exports and industrial capital spending will show a more broad-based increase. Indications of a sharp upturn in oil investment will also underpin activity in the manufacturing sector. The composition of growth is thus changing somewhat, but the broader contours from the November issue of *Nordic Outlook* remain intact. **We have lifted our above-consensus growth forecast for mainland GDP marginally**, expecting an acceleration from 1.9 per cent in 2017 **to 2.5 per cent in 2018 (2.4 per cent in 2019)**. Positive contributions from petroleum investment will lift **overall GDP to 2.0 and 2.1 per cent in 2018 and 2019, respectively**. The housing market remains a downside risk to the outlook, although confidence in our expectations of a soft landing has increased.

Sharp upturn in petroleum investment

Year-on-year percentage change



Source: Statistics Norway, Macrobond, SEB

Oil companies ramping up new investments

The petroleum sector, which accounts for roughly 13 per cent of overall GDP, has been in deep contraction since 2014. A turnaround in the capital spending cycle within oil and gas extraction was noted around a year ago, suggesting only **a moderate 2.0 per cent fall in petroleum investment in 2017**. This would imply an aggregated peak-to-trough decline of 35 per cent. While substantial, it is not abnormal by historical standards. In 2017, oil company profitability and cash flow improved significantly. With a firmer oil price outlook and a significant reduction in break-evens for new offshore projects, companies also made more investment decisions for new projects. In late 2017, a plan for development and operation (PDO) was submitted for several Norwegian projects. This will become evident in Statistics Norway's next oil investment survey, which should show oil companies having revised their investment estimates for 2018 markedly higher. Capital spending in the sector is expected to **climb by 6.5 and 8.0 per cent in 2018 and 2019, respectively**.

Higher investment activity in the petroleum sector should improve order bookings and production for the oil service industry in the next couple of years. Sentiment in the sector has improved. According to Norges Bank's regional network, for the first time since the oil slump, suppliers expect positive output growth. The rise in manufacturing sentiment has been broad-based and signals that a more convincing upturn in industrial activity is looming. Stronger global demand and a synchronised business cycle recovery will spur demand for Norwegian exports and underpin production. Exporters are benefiting from the improved competitiveness of recent years, although a stronger krone ahead will dampen this positive effect. We expect a further **rebound of 3.8 per cent in exports of traditional goods in 2018**. Net trade will be broadly neutral in both 2018 and 2019.

Mainland investment mixed but positive

The shift in the business cycle will drive higher capital spending. The underlying trend in business investment has been positive since 2016, and manufacturers remain upbeat regarding their future investments. Judging by various sentiment surveys, acceleration is imminent. We forecast that **business investment will increase by 5.6 per cent in 2018, and a further 3.9 per cent in 2019**. This is moderate compared to previous cycles, reflecting the fact that capacity utilisation in manufacturing remains below normal. The cyclical upturn in industrial capital spending will outweigh the negative impact from lower housing investment. The latter has increased sharply in recent years and reached 7 per cent of GDP in the third quarter of 2017. Housing starts have declined since last summer, and combined with falling home prices, a correction in housing investment is inevitable. A high number of homes under construction suggests that a more notable shift is to be expected **in 2019, when residential investment is forecasted to fall by 3.5 per cent**.

Home prices to stabilise during 2018

Existing home prices peaked in March 2017 and have declined in seven of the following nine months by a total of 2.7 per cent. Due to strong price increases at the start of the year, full-year average home prices were 5.9 per cent higher than in 2016, which is a clear slowing compared to the 8.4 per cent gain in the previous year. Real Estate Norway has made some methodological changes to its existing home price data. While the underlying historical trend is intact, the revised data suggest a somewhat earlier and more pronounced shift in short-term momentum than envisaged. The revised data also show a less broad-based decline; the downturn has been led by large price declines in Oslo, where prices have been the highest and the effects of stricter mortgage regulation have been more prominent. Looking ahead, we see a larger likelihood that the government will ease some of the Oslo-specific rules in the amended mortgage regulation which will be announced during spring and become effective on July 1. Other restrictions are likely to be left unchanged in order to facilitate a stabilisation in household debt levels.

Signs supporting our expectations of a soft landing in the housing market have become more evident. We are now forecasting **a slightly less pronounced price decline of 2 per cent in 2018**, implying an **aggregate decline of 4 per cent** from the peak. Considering that completions will continue to rise in 2018, high supply is likely to prevent a quick rebound in prices. We maintain our expectation of **flat prices in 2019**.

Household fundamentals remain solid

Despite lower home prices, consumer confidence has continued to improve towards the long-term average. The upturn has been driven by households' own financial situation, reflecting a recovery in real disposable income growth and employment. Last year's steady decline in joblessness was indeed a positive surprise, and registered unemployment is now at levels suggesting that very little slack remains. Employment indicators point to a further increase ahead, although sentiment in the construction sector is faltering. The sector employs less than 10 per cent of the labour force, and optimism in the vast private service sector and manufacturing is trending higher. Growth in the labour force is also likely to recover as the real economy gains ground. We expect a gradually lower **Labour Force Survey (LFS) unemployment rate of 3.8 and 3.6 per cent in 2018 and 2019, respectively**.

Private consumption has picked up noticeably in 2017. The upturn has been driven by a strong rebound in consumption of goods, in line with rising real disposable income growth. A further increase in real wages as well as higher employment should support a slight increase in consumption growth ahead. The household savings ratio has fallen, but at 6.9 per cent it remains well above pre-crisis levels. High household debt and a strong transmission mechanism (reflecting that more than 90 per cent of households have floating rates on their mortgages) are downside risks to spending as Norges Bank starts to normalise rates starting late this year. However, the household interest burden is historically low and the hiking trajectory should be slow in a historical comparison. We expect **private consumption growth of 2.7 per cent and 2.6 per cent in 2018 and 2019, respectively.**

A gradual upturn in inflation

The sharp swings in the inflation rate over the past several years are entirely explained by fluctuations in the exchange rate. This is reflected in volatile prices for imported goods, while the domestic rate of inflation has been relatively stable. The depreciation of the krone late last year will drive inflation higher in the coming months, but the impact is more difficult to interpret than usual. The exchange rate has not shown a clear trend in recent years and following the rebound in early 2018, the import-weighted krone index is in line with the average over the past 3 years. Moreover, the krone was actually somewhat stronger on average in 2017 relative to 2016. During historical periods when the krone has weakened or strengthened by roughly 5 per cent without showing any clear trend, the effect on the inflation rate has been modest. We have nonetheless assumed a moderate rise in inflation this year. Normalisation of low food prices adds to our conviction that there will be higher inflation. After being negative for most of the second half, the year-on-year change in food prices rose slightly in December. We expect prices to rise gradually towards the historical trend of 2 per cent, which will add 0.2 to 0.3 percentage points to the inflation rate.

Domestic inflationary pressures have been weak in recent years, partly reflecting depressed wage and salary increases. The stronger economy and limited labour market slack suggest wages will accelerate over the next few years. We expect **annual pay increases of 3.1 per cent in 2019**, but more is needed to bring inflation up to target. Higher service inflation nonetheless helps to stabilise core inflation in 2019 when the effect from the exchange rate fades. We share Norges Bank's assessment that **CPI-ATE inflation** (excluding taxes and energy) **reached a trough last summer** but see slight **downside risks relative to the central bank's trajectory for both 2018 and 2019**.

Norges Bank eyeing the output gap

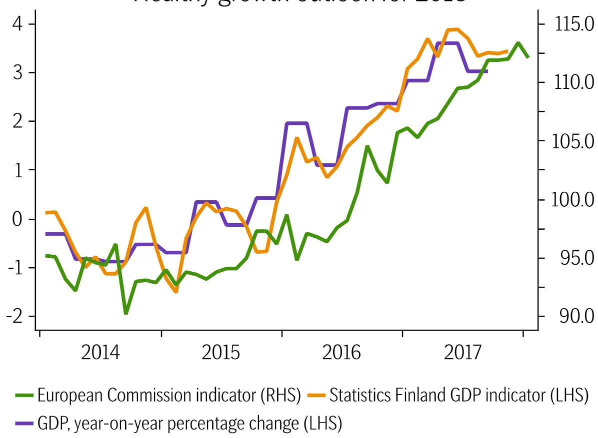
Norges Bank has kept the key rate stable at 0.50 per cent for almost two years but signalled in December that a rate hike is approaching. Above-trend growth in the mainland economy and rising capacity utilisation justify a less expansionary monetary policy. The closing of the output gap in early 2019 suggests that inflation will subsequently rise. Hence, below-target inflation in coming years is not a hurdle to initiating a hiking cycle. The rate path from the Monetary Policy Report in December signalled a fairly large likelihood of a rate hike as early as this coming autumn. We reiterate our long-held forecast of **a first key rate increase in December**. The hiking cycle will be slow by historical standards, due to low inflation and high household debt. We expect **two rate hikes during 2019 to 1.25 per cent**. Lower home prices are unlikely to delay rate hikes as long as Norges Bank forecasts a moderate 1.6 per cent decline, with limited adverse effects on demand. (See the "International overview" regarding the implications for the NOK and Norwegian bonds).

Global demand and capital spending push growth higher

- **Sharp rise in exports and capital spending**
- **Weak pay hikes, but optimistic households**
- **10 lost years – GDP in 2018 same as in 2008**

Faster growth in recent years has put the Finnish economy on more solid ground. The future outlook is also promising. Although third quarter GDP showed a slight deceleration, 2017 growth is expected to end up at 3.1 per cent: the highest in more than a decade. This upswing has been driven mainly by sharply higher capital spending and exports. Household optimism is record-strong, but slow pay and income increases are limiting the room for consumption. **We expect GDP to increase by 2.5 and 2.4 per cent respectively in 2018-2019**. This growth will bring Finland's GDP in 2018 to the same level as in 2008.

Healthy growth outlook for 2018



Source: Statistics Finland, Macrobond, SEB

The European Commission's Economic Sentiment Indicator (ESI) is approaching **earlier cyclical peaks**, and **the good mood among companies has become more broad-based**. Service-sector firms remain the most optimistic, but the manufacturing and construction sectors have improved the most in recent months and are essentially at their highest levels of the past decade. Order bookings have improved sharply, driven by both domestic and export markets. Exports rose by an estimated 8 per cent and capital spending by 9.5 per cent in 2017, contributing greatly to growth. An upturn in these portions of the economy usually leads to an import upswing, but this is arriving after a certain delay. In 2017, there were instead large-scale inventory reductions; their negative contribution to GDP was a full 2 percentage points. The main increases in exports are to other EU countries and China, but Russia is also contributing to the rise. Favourable economic growth in these countries during 2018-2019 points to continued high demand for Finnish exports, although we expect a slower rate of increase: **about 4.5-5.0 per cent annually**. Imports will grow somewhat more slowly, by 4.0-4.5 per cent a year, helping Finland's foreign trade achieve balance in 2019 after several years of current account deficits.

After a period of only weakly falling unemployment, the downturn speeded up during autumn 2017. **Unemployment** is now just below 8.5 per cent and **will fall to towards 7.5 per cent in 2019**. Looking ahead, falling labour force participation will be problematic and will increase the pressures caused by an ageing population. Pay hikes are low, as a consequence of the 2016 Competitiveness Pact between government, employers and unions. A combination of higher production, rising productivity and low pay increases have improved corporate earnings. Towards the end of our forecast period, we expect this to result in a slight acceleration in wage and salary growth to about 2.5 per cent yearly. In December, inflation fell to 0.5 per cent, the lowest in more than a year. Price pressure is low and will slowly rebound. Measured as annual averages, inflation will increase to 1.1 per cent in 2018 and 1.4 per cent in 2019, a bit below the euro zone average.

The improved economic climate has contributed to a surge in Finnish consumer confidence, which has stabilised at a high level over the past six months. Improved faith in general economic performance is the main factor behind this optimism. Although employment is rising, income increases are weak, limiting the room for boosting consumption. The household savings ratio is already record-low and in negative figures, leaving small reserves. The strained economic situation of households is reflected in consumption growth that is slower than is normally compatible with their good mood. **Consumption will rise by less than 2 per cent yearly in 2018-2019**. Although higher consumption will contribute to growth, the Finnish economy is largely dependent on exports and capital spending as driving forces; slower international growth is thus the biggest downside risk to our forecast.

Public sector finances will continue to improve in 2018-2019, driven by both stronger economic conditions and budget consolidation measures. The Competitiveness Pact will decrease certain expenditures, while tax cuts will boost incentives to hire employees and to apply for jobs. The tax burden will fall during both 2018 and 2019, while the budget deficit will shrink from 1.7 per cent of GDP in 2017 to 1 per cent in 2019. This will enable Finland to lower its government debt a bit, to a projected 61 per cent of GDP in 2019.

Broad-based growth ahead

- **Profitability has improved**
- **Employment rate highest in the euro zone**
- **Expected surge in private consumption**

Like other Baltic countries, Estonia experienced remarkable economic growth in 2017. GDP expanded by 4.8 per cent in the first three quarters. Much of the current growth reflects the **improved profitability** of the corporate sector, which is a welcome change since earnings had been declining since early 2015. **Positive trends in Estonia's main export markets** and an expected **surge of domestic demand** should result in **3.5 per cent GDP growth in 2018** and **3.0 per cent in 2019**.

The Estonian **economy relies heavily on foreign trade**, whose growth in 2017 was somewhat subdued. In Q3 the contribution of exports to GDP growth was even negative. However, this once again demonstrated how small the economy is. The decline was caused by a single company in the electronics industry, which still accounts for almost 10 per cent of total merchandise exports. Other major companies were able to boost their exports significantly. The increasingly good **health of the euro zone economy**, including a **brisk recovery in Finland**, will bolster exports in 2018. Some caution is justified, however, since an expected slowdown in the Swedish construction market may inhibit the growth of the wood product industry. Sales of prefabricated houses, furniture and other wood products to Sweden account for a large share of total merchandise exports. Yet we forecast that exports will increase by 4.3 per cent in 2018 and 4.0 per cent in 2019.

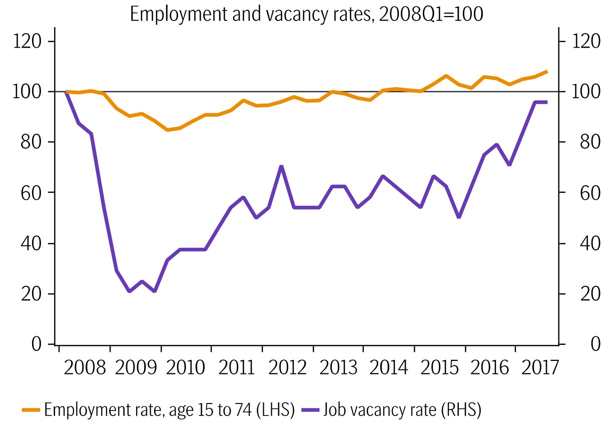
The largest contributor to GDP growth in 2017 was the construction sector, whose value-added increased by almost one fifth, largely in line with the overall growth of construction volume last year. While the private sector has been investing in new buildings for years, **construction relies heavily on public sector demand**, which again depends on the availability of financing from EU structural funds. Overall fixed capital spending increased by 16 per cent during the first three quarters. In addition to construction, investments in transport equipment had a large impact. Construction is also expected to do well this year. Together with high capacity utilisation, this will lead to an increase in capital spending of 4.6 per cent in 2018 from an already high base. In 2019, we expect capital spending growth of around 3.8 per cent.

Strong consumer confidence and a large increase in tax-exempt personal income are bound to boost private consumption in 2018. Yet we are taking a slightly more cautious view than some forecasters. This is because we expect people to reap the full benefits of the reform only in spring 2019, when the tax authorities start to refund overpaid taxes. SEB is forecasting that private consumption will increase by 4.3 per cent this year, up from 2.2 per cent in the first three quarters of 2017. Last year, private consumption growth was significantly curbed **by high inflation**, which will affect growth this year as well. The harmonised index of consumer prices (HICP) increased by 3.7 per cent in 2017 due to surging food and fuel prices and a large hike in excise duties. With all three factors expected to remain important in 2018, we **expect HICP inflation of 3.2 per cent this year and 2.5 per cent in 2019**.

Pressures in the labour market have continued to mount. **In Q3 2017, employment reached 68.5 per cent, a record both in Estonia's modern history and in the whole euro zone.** The job vacancy rate climbed to 2.3 per cent but has not yet breached the level seen just before the financial crisis. In the service sector, however, the number of vacancies already exceeds the 2008 figure. Therefore it is not surprising that wage and salary growth has not slowed, reaching 7.3 per cent in Q3 2017. The hike in tax-exempt income may ease the pressure, but since pay levels are usually negotiated on a gross basis, its influence will probably not be too large. The unemployment rate will increase somewhat during our forecast horizon because of an ongoing reform that aims to increase labour market participation among people with disabilities.

Vacancy rate yet to breach pre-crisis level

Employment and vacancy rates, 2008Q1=100



Source: Eurostat Database, Statistics Estonia, Macrobond, SEB

The government's decision to let the budget slide into a slight deficit during the next couple of years has spurred criticism, but in relative terms, Estonian fiscal policy remains very conservative. With the parliamentary elections due in spring 2019, politicians are rushing to push through reforms and investments that trigger higher government spending.

Moving into 2018 in high gear

- **Investments surging, but far from pre-crisis**
- **Tax reform in the spotlight**
- **Inflow of EU funds peaking**

Adjusted GDP data confirmed that the economy grew by 5.8 per cent year-on-year in the third quarter of 2017, Latvia's best performance since 2011. In the first nine months of the year, GDP rose by 4.7 per cent. Due to strong international conditions and positive domestic factors, largely driven by a larger influx of EU structural funds, **growth is stable**.

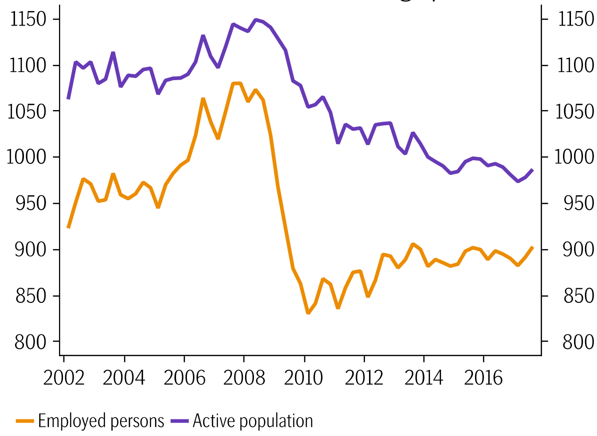
During our forecast period, the construction sector will be especially active and expansive, driven by EU funds and an increase in the number of large private projects. Owing to good global demand, solid growth will continue in manufacturing and exports – 6.5 and 4.5 per cent, respectively, this year. Economic sentiment is rising and has reached its highest level in the post-crisis period. This will facilitate a further pick-up in private consumption. Due to non-residents' capital outflows, some negative trends may persist in the banking sector, though its credit portfolio will slowly increase. Uncertainty is also lingering in the transport and storage industry, primarily driven by volatility in railway and port business volume.

Labour supply and the ability of economic actors to increase capacity utilisation will determine the speed at which the Latvian economy can grow in the coming years. Income inequality will be a major topic. **We expect Latvia's GDP to grow by 4.1 per cent this year and 3.7 per cent in 2019**.

After peaking at 3.4 per cent in March and April 2017, inflation slowed to 2.2 per cent by year-end. **Average inflation in 2017 was 2.9 per cent**. In the near future, the impact of external factors on inflation in Latvia will be limited and domestic factors will dominate. A tighter labour market and rapid wage growth will be key inflation drivers. In January 2018, excise tax increases also caused a rebound in inflation. **There is a risk that price increases may accelerate, leading to fears that the economy is overheating**. It is still too early to talk about overheating, but this does not mean that such risks cannot appear later. The risks of overheating are aggravated by the rapid inflow of EU funds and their volatility. Consequently, overheating is likely to occur in certain sectors, most notably in construction, which will lure workers away from other economic sectors and drive pay levels upward. The question is what will happen when EU funds start running out and demand decreases. In other words, will these people find work again in other sectors and accept lower wages, or will they emigrate?

In the third quarter of 2017, the average monthly wage reached 925 euros, or 7.5 per cent higher than a year earlier. Wages increased in all sectors by 2.7-10.1 per cent, except that they fell by 4.3 per cent in electricity, gas supply, heating and air conditioning and by 0.5 per cent in real estate. We expect wages to grow by 8.2 per cent this year and 7.2 per cent in 2019.

Labour market is heating up



Source: Statistics Latvia

The situation in the labour market is getting tighter. In the third quarter of 2017, unemployment dropped to 8.5 per cent. Latvia had 84,100 job seekers. Yet there is a growing shortage of employees, due to mismatches in skills and education. This means that average unemployment will remain relatively high. The number of vacancies is constantly rising, pushing policymakers to resolve the issue by allowing immigration, but due to next autumn's parliamentary election, there will be no solution in the near future. Demand for workers in construction, retail, transport and other services will be particularly strong. Residents will also continue to emigrate, and the average age of the labour force will keep rising. **By the end of 2018, unemployment will have fallen to 7.2 per cent, but next year it will decline to 6.4 per cent**.

One major issue this year will be the launch and effectiveness of tax reforms, whose impact is not clear-cut. How quickly the government can introduce many new practices and eliminate any problems, as well as how households and businesses evaluate the resulting gains and losses, may determine the outcome of the parliamentary election. It also remains to be seen how the changes in taxation will affect budget revenue.

Slower, but still decent growth ahead

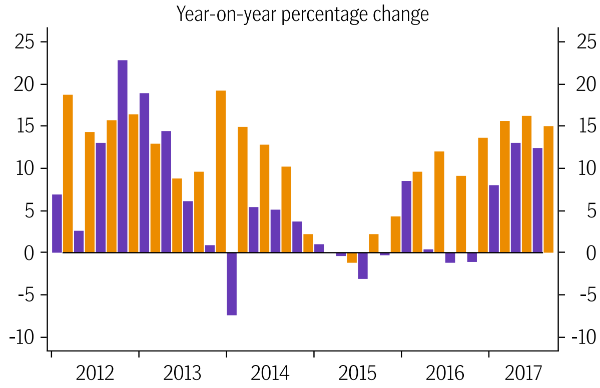
- **Capital spending will pick up in 2018**
- **Slower private consumption growth, due to high inflation and a smaller labour force**

In 2017 Lithuania posted its largest GDP gain since 2012. This amounted to 3.8 per cent and was supported mostly by solid growth in exports and a recovery in investments. Although growth in private consumption weakened considerably, it still remained a significant contributor. Investments will play an even larger role in economic growth ahead, but **slower growth in private consumption will limit the expansion of GDP to 3.2 per cent in 2018 and 3.0 per cent in 2019**.

The surging global economy boosted orders to Lithuanian manufacturers, which increased their output by 7.2 per cent in 2017. Capacity utilisation climbed to a new record. It is unlikely that manufactures will be able to maintain a similar pace of growth in 2018, despite the forecasted uptick in capital spending by businesses. Besides**, last year Lithuania was unexpectedly successful in attracting new foreign funding for large private green field investments.** The distribution of EU structural funds has been lagging recently, but finally this year they will kick-start public investments, too.

Lithuanian exports ride recovery tide

Year-on-year percentage change



Exports of goods Exports of services

Source: Statistics Lithuania

Export growth is broad-based, both in terms of geography and products. In the short term, there are **significant external uncertainties because of a possible correction in the Swedish construction market and a weaker US dollar.** However, the largest long-term issue remains the same – Lithuania's merchandise and service exports are still relatively low in value-added. Although the road transport sector is experiencing a new renaissance, it does not pay high wages. There are labour shortages in such professions as truck drivers. In 2017 the number of people from other countries (mainly Ukraine) who received work permits in Lithuania doubled.

The decline in unemployment has been slowing. The jobless rate will average 7 per cent in 2018 and 6.8 per cent in 2019. Uneven economic development among regions has led to disparities in unemployment levels within the country. **There is also a clear mismatch between the skills that employers demand and those that employees have**; the number of unemployed people thus remains rather high. The labour force has been shrinking further due to net emigration and an ageing society. However, the last quarter of 2017 brought some surprises. The number of emigrants finally fell and the number of immigrants (two thirds of them returning Lithuanians) greatly increased. **We believe that the balance of migration will be much better in the economy this year**.

Average wages and salaries jumped by 8 per cent in 2017, but in 2018 and 2019 we foresee a slight decline in pay increases to 7 per cent. Taxes for low earners are slightly lower in 2018, the monthly minimum wage is up by EUR 20 to EUR 400 and pensions are 10 per cent higher year-on-year. We expect even slower private consumption growth this year due to continued high inflation and the smaller number of people with jobs.

Last year a sharp increase in excise duties for alcoholic beverages added 0.8 percentage points to annual inflation, which amounted to 3.7 per cent in Lithuania. In 2018 there are no such major changes in the taxation of goods. The rapid growth in labour costs and oil prices will thus be the main factors behind inflation. **We forecast that inflation will slow to 2.8 per cent in 2018 and to 2.5 per cent in 2019**.

The increase in residential property prices eased at the end of 2017, since the supply of apartments has increased and demand has stabilised. In 2018 we expect prices of residential real estate to grow at a more leisurely pace, which will be lower than the increase in disposable income.

Lithuania is expected to achieve a national budget surplus of at least 0.3 per cent of GDP in 2018. In the upcoming months the government will submit proposals on how to improve the tax and pension systems. However, we hardly expect serious reforms in 2019, since presidential and municipal elections are scheduled to take place next year.

Key economic data

GLOBAL KEY INDICATORS

Yearly change in per cent

	2016	2017	2018	2019
GDP OECD	1.8	2.4	2.5	2.2
GDP world (PPP)	3.2	3.9	4.0	3.9
CPI OECD	1.1	2.3	2.0	1.9
Oil price, Brent (USD/barrel)	45.2	55.6	65.0	65.0

US

Yearly change in per cent

	2016 level, USD bn	2016	2017	2018	2019
Gross domestic product	18,906	1.5	2.3	2.8	2.5
Private consumption	13,057	2.7	2.7	3.2	2.7
Public consumption	3,287	0.8	0.1	0.7	0.6
Gross fixed investment	3,126	0.6	4.1	3.9	3.1
Stock building (change as % of GDP)		-0.4	-0.1	0.0	0.0
Exports	2,241	-0.3	3.4	4.5	3.8
Imports	2,806	1.3	3.9	4.4	3.0
Unemployment (%)		4.9	4.4	3.8	4.0
Consumer prices		1.3	2.1	2.1	2.1
Household savings ratio (%)		4.9	3.4	2.8	3.1
Public sector financial balance, % of GDP		-4.4	-3.8	-4.2	-4.4
Public sector debt, % of GDP		107.1	108.1	108.4	108.8

EURO ZONE

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	10,515	1.8	2.3	2.5	2.2
Private consumption	5,754	2.0	2.1	2.2	2.1
Public consumption	2,169	1.8	1.2	1.0	1.0
Gross fixed investment	2,078	4.5	4.5	4.5	4.0
Stock building (change as % of GDP)	0	-0.1	0.0	0.0	0.0
Exports	4,847	3.3	4.4	4.8	4.7
Imports	4,362	4.7	4.8	4.9	5.0
Unemployment (%)		10.0	9.1	8.5	8.1
Consumer prices		0.2	1.5	1.4	1.3
Household savings ratio (%)		6.2	6.3	6.2	6.0
Public sector financial balance, % of GDP		-1.5	-1.0	-1.0	-0.9
Public sector debt, % of GDP		88.9	88.2	86.5	85.0

OTHER LARGE COUNTRIES

Yearly change in per cent

	2016	2017	2018	2019
GDP				
United Kingdom	1.9	1.8	1.4	1.1
Japan	0.9	1.5	1.2	1.0
Germany	1.9	2.2	2.5	2.2
France	1.2	1.8	2.1	2.1
Italy	0.9	1.5	1.7	1.7
China	6.7	6.9	6.6	6.2
India	7.9	6.4	7.5	7.8
Brazil	-3.6	1.1	2.7	3.0
Russia	-0.2	1.5	2.2	2.0
Poland	2.7	4.4	4.0	3.2
Inflation				
United Kingdom	0.6	2.7	2.4	1.7
Japan	-0.1	0.5	1.0	1.2
Germany	1.7	1.7	1.5	1.6
France	0.8	1.2	1.3	1.4
Italy	-0.1	1.5	1.3	1.3
China	2.0	1.6	2.3	2.5
India	5.0	3.3	5.5	5.5
Brazil	8.8	3.5	4.0	4.3
Russia	7.1	3.7	3.8	4.0
Poland	-0.6	2.0	2.5	2.7
Unemployment (%)				
United Kingdom	4.9	4.4	4.3	4.6
Japan	3.1	2.8	2.5	2.3
Germany	4.1	3.8	3.7	3.8
France	9.9	9.5	9.2	8.9
Italy	11.7	11.3	10.9	10.5

FINANCIAL FORECASTS

Official interest rates		**31-Jan**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
US	Fed funds	1.50	2.00	2.50	2.75	2.75
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10
Euro zone	Refi rate	0.00	0.00	0.00	0.25	0.50
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	1.00
Bond yields						
US	10 years	2.72	2.90	3.10	3.20	3.30
Japan	10 years	0.08	0.10	0.10	0.10	0.10
Germany	10 years	0.70	0.80	1.00	1.30	1.50
United Kingdom	10 years	1.49	1.65	1.75	2.15	2.50
Exchange rate						
USD/JPY		109	111	103	102	100
EUR/USD		1.25	1.25	1.28	1.30	1.32
EUR/JPY		136	139	132	133	132
EUR/GBP		0.88	0.88	0.85	0.83	0.82
GBP/USD		1.42	1.42	1.51	1.57	1.61

SWEDEN

Yearly change in per cent

	2016 level, SEK bn	2016	2017	2018	2019
Gross domestic product	4,405	3.2	2.6	2.6	2.4
Gross domestic product, working day adjustment		3.0	2.8	2.7	2.5
Private consumption	1,950	2.2	2.4	2.2	2.2
Public consumption	1,152	3.4	1.6	0.8	0.5
Gross fixed investment	1,060	5.6	7.5	5.6	4.4
Stock building (change as % of GDP)	31	0.0	0.0	0.0	0.0
Exports	1,950	3.3	5.1	7.0	3.3
Imports	1,737	3.4	6.7	7.7	3.2
Unemployment, (%)		6.9	6.7	6.2	6.2
Employment		1.5	2.3	1.8	1.0
Industrial production		2.8	4.5	6.0	5.0
CPI		1.0	1.8	1.8	2.1
CPIF		1.4	2.0	1.8	1.8
Hourly wage increases		2.4	2.5	3.0	3.3
Household savings ratio (%)		3.3	2.2	3.4	1.4
Real disposable income		16.5	16.3	16.8	16.2
Current account, % of GDP		4.4	4.0	4.0	3.8
Central government borrowing, SEK bn		-85	-62	-48	-50
Public sector financial balance, % of GDP		1.2	1.3	1.1	1.0
Public sector debt, % of GDP		42.2	40.3	37.7	35.4

FINANCIAL FORECASTS	**31-Jan**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Repo rate	-0.50	-0.50	-0.25	0.00	0.50
3-month interest rate, STIBOR	-0.44	-0.50	-0.27	0.10	0.55
10-year bond yield	0.90	1.05	1.50	1.90	2.10
10-year spread to Germany, bp	20	25	50	60	60
USD/SEK	7.85	7.76	7.42	7.19	7.05
EUR/SEK	9.78	9.70	9.50	9.35	9.30
KIX	112.0	111.1	109.4	107.8	107.2

FINLAND

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	219	2.1	3.1	2.5	2.4
Private consumption	119	1.8	2.0	1.8	1.8
Public consumption	52	1.8	0.3	0.6	0.5
Gross fixed investment	47	7.4	9.5	4.0	3.5
Stock building (change as % of GDP)	0	0.5	-2.1	0.4	0.1
Exports	77	2.3	8.0	4.7	5.0
Imports	79	5.4	3.0	4.5	4.0
Unemployment, OECD harmonised (%)		8.9	8.6	8.1	7.8
CPI, harmonised		0.4	0.8	1.1	1.4
Hourly wage increases		0.9	-0.5	1.5	2.0
Current account, % of GDP		-1.4	-1.0	-0.5	-0.3
Public sector financial balance, % of GDP		-1.7	-1.5	-1.3	-1.0
Public sector debt, % of GDP		63.1	62.5	62.0	61.0

NORWAY

Yearly change in per cent

	2016 level, NOK bn	2016	2017	2018	2019
Gross domestic product	3,152	1.1	2.0	2.0	2.1
Gross domestic product (Mainland)	2,646	1.0	1.9	2.5	2.4
Private consumption	1,374	1.5	2.6	2.7	2.6
Public consumption	745	2.1	1.6	1.2	1.3
Gross fixed investment	740	-0.2	4.2	3.3	2.5
Stock building (change as % of GDP)		1.4	-0.2	0.1	0.0
Exports	1,155	-1.8	2.3	2.5	2.4
Imports	1,024	2.3	3.3	3.6	2.7
Unemployment (%)		4.7	4.2	3.8	3.6
CPI		3.6	1.9	1.8	1.8
CPI-ATE		3.1	1.4	1.5	1.7
Annual wage increases		1.7	2.4	2.8	3.1

FINANCIAL FORECASTS	**31-Jan**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Deposit rate	0.50	0.50	0.75	1.00	1.25
10-year bond yield	1.79	1.80	1.85	2.10	2.30
10-year spread to Germany, bp	109	105	95	80	80
USD/NOK	7.68	7.52	7.19	7.00	6.82
EUR/NOK	9.56	9.40	9.20	9.10	9.00

DENMARK

Yearly change in per cent

	2016 level, DKK bn	2016	2017	2018	2019
Gross domestic product	2,066	2.0	2.1	2.4	2.3
Private consumption	987	2.3	1.8	2.9	2.5
Public consumption	525	0.3	0.8	1.0	1.2
Gross fixed investment	422	6.0	1.7	4.7	3.6
Stock building (change as % of GDP)		0.0	-0.2	-0.4	0.0
Exports	1,107	2.9	3.9	3.6	3.6
Imports	979	3.8	2.7	3.6	4.1
Unemployment, OECD harmonised (%)		6.5	5.8	5.4	5.0
CPI, harmonised		0.0	1.1	1.2	1.4
Hourly wage increases		1.8	1.8	1.9	2.1
Current account, % of GDP		7.9	9.0	8.0	7.0
Public sector financial balance, % of GDP		-0.6	0.0	0.5	1.0
Public sector debt, % of GDP		37.7	37.0	36.0	35.0

FINANCIAL FORECASTS	**31-Jan**	**Jun-18**	**Dec-18**	**Jun-19**	**Dec-19**
Lending rate	0.05	0.05	0.05	0.30	0.55
10-year bond yield	0.78	0.85	1.00	1.40	1.60
10-year spread to Germany, bp	8	10	10	10	10
USD/DKK	5.98	5.95	5.81	5.72	5.64
EUR/DKK	7.44	7.44	7.44	7.44	7.44

LITHUANIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	39	2.3	3.8	3.2	3.0
Private consumption	25	5.0	4.0	3.6	3.5
Public consumption	7	1.3	1.5	1.3	1.3
Gross fixed investment	7	-0.5	7.0	8.0	5.0
Exports	29	3.5	12.3	4.9	3.7
Imports	28	3.5	12.4	5.8	4.3
Unemployment (%)		7.9	7.3	7.0	6.8
Consumer prices		0.7	3.7	2.8	2.5
Public sector financial balance, % of GDP		0.3	0.0	0.3	0.2
Public sector debt, % of GDP		40.2	41.0	36.5	37.5

LATVIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	25	2.1	4.5	4.1	3.7
Private consumption	15	3.4	5.1	5.6	4.4
Public consumption	4	2.7	4.1	3.4	3.1
Gross fixed investment	5	-15.0	17.5	13.5	7.5
Exports	15	4.1	5.0	4.5	3.5
Imports	14	4.5	9.6	8.0	6.0
Unemployment (%)		9.6	8.8	7.6	6.8
Consumer prices		0.1	2.9	2.7	2.5
Public sector financial balance, % of GDP		0.0	-0.6	-1.2	-1.1
Public sector debt, % of GDP		40.5	38.6	37.3	36.5

ESTONIA

Yearly change in per cent

	2016 level, EUR bn	2016	2017	2018	2019
Gross domestic product	21	2.1	4.4	3.5	3.0
Private consumption	11	4.4	2.5	4.3	3.3
Public consumption	4	1.9	1.0	2.2	2.5
Gross fixed investment	5	-1.2	14.2	4.6	3.8
Exports	17	4.1	2.9	4.3	4.0
Imports	16	5.3	3.4	4.5	4.0
Unemployment (%)		6.8	6.3	6.8	7.2
Consumer prices		0.8	3.7	3.2	2.5
Public sector financial balance, % of GDP		-0.3	-0.3	-0.3	-0.4
Public sector debt, % of GDP		9.4	9.2	8.8	8.7

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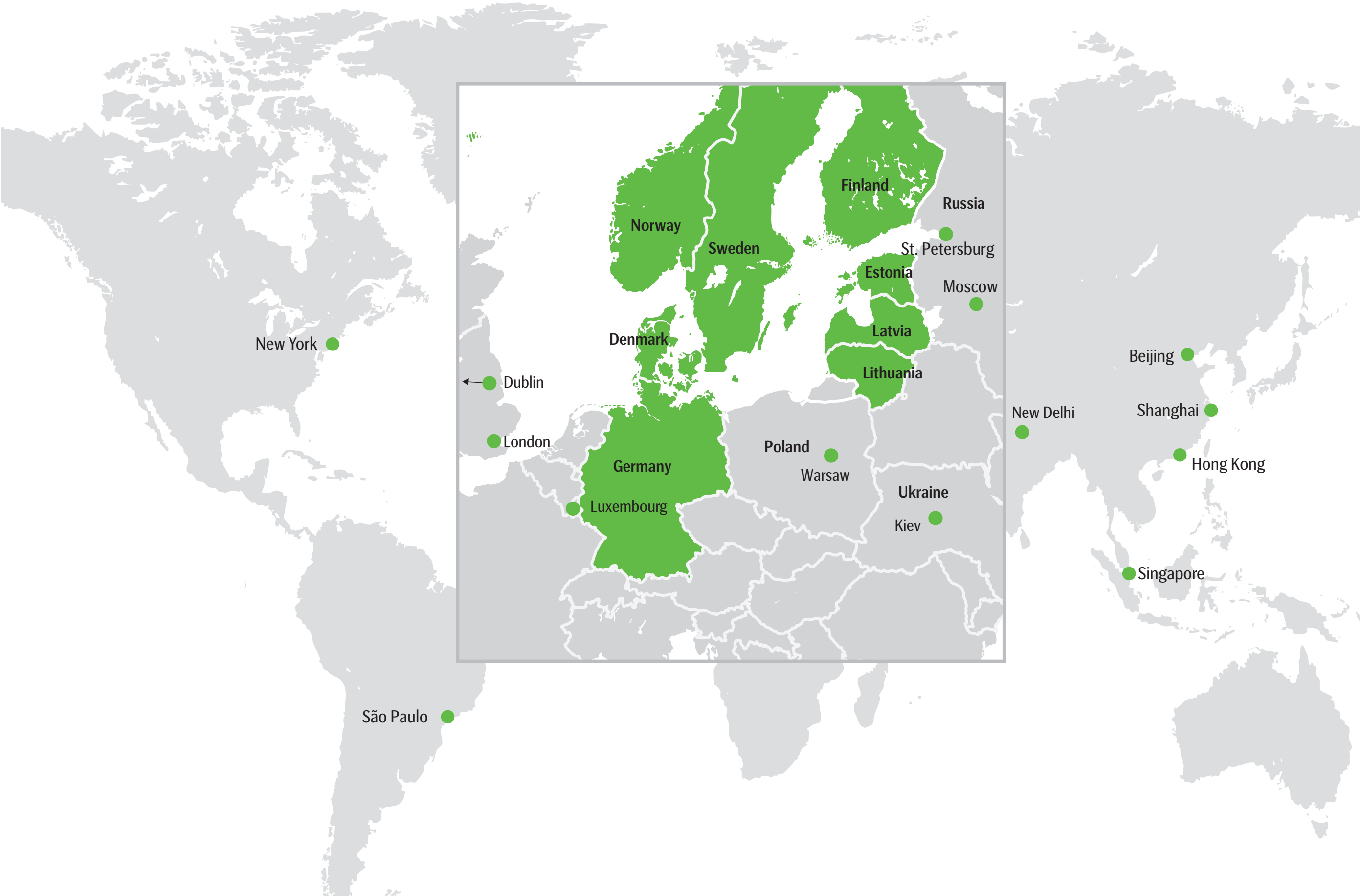

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