Brexit – what if?

Implications for euro and Nordic markets

13 April 2016

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Important disclosures and certifications are contained from page 46 of this report.
Purpose of this document

Brexit is one of the biggest economic and financial risks in 2016. Our base case is that the UK votes to stay in the EU. We have written about the implications for the UK and GBP should the UK decide to leave the EU. (See, for example, The UK’s EU Referendum: Brexit – what if?, 22 February 2016, and FX Strategy: Hedging EUR/GBP exposure in a Brexit risk scenario, 9 March 2016).

In this presentation, we lay out our take on the economic and financial implications for Europe with a particular focus on the Nordic region if the UK were to leave the EU. We analyse how a likely recession in the UK could spread to the eurozone and the Nordic countries, how central banks might respond and the implications for FX, rates and equity markets.

We look at asymmetric market views and hedging ideas which appear right, in our view, no matter whether we have a Brexit or not. Several views stand out. First, we expect EUR/USD to fall over the coming 3M on relative rates with or without a Brexit. Second, downward pressure on EUR/DKK is likely to remain independent of the Brexit risk due to the tight liquidity situation in the DKK money market and the cheapness of Danish fixed income assets. Finally, downward pressure on core euro yields should remain, where a Brexit will only add further fuel to the low eurozone inflation expectations and a likely upscale of the ECB’s QE programme.
Brexit – What if? Conclusions

• **UK and GBP:** The economy is likely to fall into a recession in H2 16 in the event of a Brexit; the BoE is likely to expand the APF programme and EUR/GBP could reach 0.90. Clients should hedge GBP exposure with volatility and skew at extremes.

• **Eurozone, EUR and EUR yields:** The eurozone is likely to fall into a recession in H2 16 if the UK exits the EU, while the ECB would respond with further QE. We expect EUR/USD to fall independently of a Brexit over the coming 3M and clients should be positioned accordingly. Core EUR yields should fall and periphery to underperform on a Brexit.

• **Denmark, DKK and DKK rates:** Denmark could enter a recession in H2 16 in the event of a Brexit. A Brexit may increase downward pressure on EUR/DKK and force Danmarks Nationalbank to intervene in the FX market. DKK yield spreads to tighten versus bunds in case of a Brexit.

• **Sweden and SEK:** We estimate that Sweden could slow to 2% in 2017 in a Brexit scenario and the QE programme will be extended. EUR/SEK could rise on risk aversion.

• **Finland:** Finland could enter a recession starting in late 2016 if in case of a Brexit.

• **Norway and NOK:** A Brexit could shave 0.7-0.9pp off Norway’s GDP growth in 2017, while Norges Bank would cut rates to 0%. EUR/NOK could rise to 9.50-9.70 in H2.

• **Equities:** UK equities could fall 10-20%; major European indices could fall 10-15%.

Thomas Harr, Global Head of FICC Research, thhar@danskebank.com, +45 45 13 67 31
UK:
Recession, more QE and EUR/GBP at 0.90
Brexit timeline after a ‘leave’ vote

The full process could take several years

- Referendum bill passed by Parliament
- Negotiations between UK and EU
- UK’s EU in/out referendum to be held on 23 June
- In the event of Brexit, the UK government has 2 years to negotiate the terms of withdrawal cf. Article 50 of the EU Treaty
- Further negotiations to define relationship (Swiss model or FTA approach)
- EU laws still apply in the UK during the withdrawal negotiations
- UK formally exits EU

Note: Two years of negotiations can be extended (unanimous agreement)

Source: Danske Bank Markets

Mikael Olai Milhøj, Analyst, milh@danskebank.com, +45 45 12 76 07
UK likely to fall into recession in H2 16 in case of ‘Brexit’

- In the case of ‘Brexit’, we expect the UK to fall into technical recession in H2 16 or early 2017. Also, it would likely cause unemployment to rise with a lag.

- The UK is likely to be hit by falling investments in H2 16 due to higher uncertainty about the future economic environment for British firms.

- It is also likely that private consumption will slow due to higher uncertainty.

- In 2017, the growth outlook depends on how the withdrawal negotiations are progressing.

- The longer-run macroeconomic consequences depend on the future UK/EU relationship.

- If many partial agreements are reached, the negative impact could be minor. If no agreements can be made, the negative impact could be major.

Source: ONS, Danske Bank Markets

Mikael Olai Milhøj, Analyst, milh@danskebank.com, +45 45 12 76 07
BoE will likely be forced to act – prefers to use QE tool

• The recession is likely to force the BoE to ease monetary policy.

• The Bank Rate has been at the *de facto* lower bound of 0.50% since the financial crisis.

• BoE Governor Mark Carney has stated that while the Bank Rate could be lowered to 0.00%, he will not lower it down to negative territory due to concerns over bank profitability.

• While a cut down to 0.00% cannot be ruled out, we think the BoE prefers to increase its APF programme by buying more assets in order to stimulate the economy.

• We think the size of the Asset Purchase Facility (APF) programme will be expanded in the range of GBP150-200bn.
Outlook for EUR/GBP in a ‘no Brexit’ scenario

**Short term**: higher ahead of referendum due to uncertainty

- The EU referendum represents a significant a digital event risk for GBP.
- The FX option market’s pricing implies that large fluctuations in either direction are highly likely.
- Given the high uncertainty surrounding the EU referendum, we see risks skewed to the upside for EUR/GBP ahead of 23 June.
- Volatility is likely to remain high and EUR/GBP is likely to be very sensitive to newsflow, changes in polls and so on.

**Lower 6-12M in a ‘no Brexit scenario’**

- Longer term, the outlook for EUR/GBP very much depends on the outcome of the EU referendum.
- We estimate that a Brexit risk premium in the magnitude of 3.5-7pp relative to spot (median estimate 5.25pp) is currently priced in. This implies that EUR/GBP would most likely fall to 0.75-0.7740 immediately after the referendum in case of a ‘stay’ outcome.
- Longer term, we project further EUR/GBP downside driven by relative growth and relative monetary policy. We target EUR/GBP at 0.74 in 6M and 0.75 in 12M but stress that these forecasts are subject to significant digital risk.

Morten Helt Analyst, mohel@danskebank.com, +45 45 12 85 18

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**Main scenario forecast:**

0.79 (1M), 0.80 (3M), 0.74 (6M) and 0.75 (12M)
EUR/GBP in a Brexit scenario

- The main risk for sterling is associated with the UK’s large current account deficit and its negative net international investment position (NIIP). In a Brexit scenario, the short-term risk would be a possible withdrawal of short-term funding and hot money outflow (portfolio investments) from the UK. Hence, risks are clearly skewed toward a weaker GBP.

Medium-term drivers suggest further GBP weakness
- Besides the risk of volatility after the election, we would also emphasise that uncertainty about the medium-term outlook for GBP has increased significantly as well.
  
  **Flows:** A decline in foreign direct investments and portfolio flows would tend to maintain depreciation pressure on the GBP over the medium-term horizon.
  
  **Growth outlook:** Uncertainty about growth outlook would increase further in a Brexit scenario, with downside risk to investments and private consumption.
  
  **Monetary policy:** A more accommodative monetary policy may be needed to underpin the economy in a Brexit scenario.

Fundamental valuation models suggest that EUR/GBP at 0.90 should not be ruled out
- Looking at fundamental valuations, both our medium-term models (MEVA) and our PPP-estimate imply that EUR/GBP currently trades very close to what is assumed to be ‘fair value’. The confidence bands derived from both our medium-term model and the PPP estimate imply that EUR/GBP as high as 0.90 for a period of time would be stretched but within the ‘norm.

Morten Helt Analyst, mohel@danskebank.com, +45 45 12 85 18
Hedging GBP exposure with volatility and skew at extremes

**GBP income:**

- Due to the exceptional situation, we generally recommend that companies with GBP-denominated income consider hedging longer maturities than usual.
- Also, given the high ‘digital’ risk, we recommend hedging GBP-denominated income via options.
- Buying GBP put options offers a safe but quite expensive way of hedging GBP income due to high implied GBP volatility, in our view. Not least, GBP put options now look very expensive relative to call options due to the market [correctly] pricing an upside to EUR/GBP.
- As an alternative to buying vanilla GBP put options, clients could consider hedging GBP income via boosted risk reversals.

**GBP expenses**

- For companies with GBP-denominated expenses, the recent increase in EUR/GBP, together with the forward premium, has made it possible to hedge GBP expenses at what would be attractive long-term levels in a Yes scenario.
- Given the risk of a significant increase in EUR/GBP in the event of a Brexit, we recommend hedging around 50% of future GBP-denominated expenses via FX forwards, while leaving the remaining exposure unhedged.

Morten Helt Analyst, mohel@danskebank.com, +45 45 12 85 18
Eurozone:
Recession, more QE, EUR/USD to fall modestly and lower EUR yields
Brexit: Economic and financial impact on Europe

**Political:**
- A Brexit could increase the political uncertainty in the EU
- The opinion among the population in Greece, Italy, Austria and France seems to be most anti-EU and at the same time less optimistic about the future of the EU.
- A decline in German optimism about the EU, a sharp increase in refugees and a German election in 2017 could all affect sentiment. Also, an uncertain French election in 2017 is coming up. Ultimately, euro break-up fears could resume.

**Financial:**
- The financial impact would be negative, as a Brexit will question the commitment to the common currency.
- A political/exit risk premium should be priced in the periphery, as it should be perceived as most likely to follow the political demands in the UK.
- France could come under some market pressure, but a very liquid French government bond market has so far prevented any substantial stress.
- The ECB will be ready to do ‘whatever it takes’ to limit financial contagion.

**Economic:**
- A Brexit is likely to result in a technical recession (two consecutive quarters of negative economic growth) in the euro area as the uncertainty would bring a sharp deterioration in business sentiment and hence result in failing investments.
- We expect the biggest impact on the euro area economy to be indirect through weaker sentiment.
- Ireland, Belgium and the Netherlands have the highest direct exposure to the UK in terms of trade and foreign direct investments.
- A strong political response could limit the uncertainty.
Market could focus on other potential leavers

**We expect a strong policy response if UK leaves the EU**

- The euro group would respond strongly to a Brexit and clearly communicate that leaving the EU cannot be compared to leaving the euro. The heads of states and governments of the euro area are also likely to gather and jointly present unity.
- That said, voter opinion across the euro area is sceptical as seen in the latest elections and opinion polls. In light of this, the market could focus on ‘who’s next’ to leave the EU or the euro area.
- **We do not believe the voter scepticism will result in a euro break-up.** There is a strong willingness to keep the euro together and the experience is that across countries individual conditions can be accepted.
- **The ECB will again be ready to do ‘whatever it takes’ to limit contagion.** We believe it will start by using some of the existing measures.

The biggest euro area countries are for the single currency

Source: European Commission Eurobarometer 84 (Autumn 2015), Danske Bank Markets
Political risk could increase

There are important elections coming up in Germany and France which could affect sentiment.

EU-sceptic parties are gaining in recent polls

- **DE: Alternative for Germany**
- **FR: Front national**
- **IT: Five Star**
- **SP: Podemos**
- **NL: Dutch Freedom Party**
- **BE: Vlaams Belang**
- **AT: Austrian Freedom Party**
- **FI: Finland’s Finns Party**
- **GR: Syriza**
- **GR: Golden Dawn**
- **PT: Left Bloc**
- **IE: Sinn Fein**
- **UK: UK Independence Party**
- **SE: Sweden Democrats**
- **DK: Danish People’s Party**

<table>
<thead>
<tr>
<th>Polls (Jan-Feb)</th>
<th>Last national election</th>
<th>EP 2014</th>
<th>EP 2009</th>
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<tbody>
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<td></td>
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</table>

Source: National polls, Danske Bank Markets

Source: Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
The optimism about the future of the EU faded in autumn 2015

Most countries are optimistic about the future of the EU, but the ratio declined in autumn 2015.

Particularly, German optimism about the future of the EU declined sharply in autumn 2015 and is below crisis levels.

On the EU level, the optimism about the future of the EU declined to 53% in autumn 2015 from 58% in Spring 2015.

In Germany the optimism about the future of the EU is below crisis levels after declining sharply in autumn 2015.

Source: European Commission Eurobarometer 84 (Autumn 2015), Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
Immigration is increasingly seen as a threat to the EU

Immigration is seen as the most important issue facing especially the Nordic countries

In the EU, immigration is seen as a more important issue than unemployment and the economic situation

In autumn 2015 immigration was seen as a more important issue than unemployment – the opposite was the case in spring 2014.

Source: European Commission Eurobarometer 84 (Autumn 2015), Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
A Brexit could result in a recession in the euro area
- In case of Brexit, we expect euro growth of 1.1% in 2016 and 0.7% in 2017

The biggest economic impact should be through sentiment

- **Sentiment**: We expect a very negative impact on overall sentiment and especially on business confidence, which is likely to result in lower investments. A long period of negotiations may drag out the uncertainty, but the biggest impact should be seen in a sharp deterioration in H2 16, where we expect the euro area to be in technical recession.

- **Trade**: We expect a direct negative impact on trade, as the trade relationship between the UK and the EU should be less beneficial than it currently is. To what extent the trade channel weakens depends on the future relationship between the UK and the EU.

- **Financial**: European banks’ exposure to the UK is substantial and a Brexit would be costly, although it could move some financial services to the EU over time. The financial sector also accounts for a large share of foreign direct investments into the UK, which could be hurt if investors believe in lower return on UK investments.

Source: Bloomberg, Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
A Brexit will weaken business sentiment substantially

In our main scenario where UK stays in the EU we expect investments will grow slowly, but in case of a Brexit, we look for declining investments in H216.

Consumption of major purchases would be most vulnerable to Brexit.

Source: European Commission, Eurostat, Danske Bank Markets
The UK is a large trading partner for the euro area and some countries have a very high exposure to the UK in terms of goods exports.

Across the major euro area countries only Ireland has a trade deficit with the UK.

**Goods exports to UK (in % of GDP), 2014**

<table>
<thead>
<tr>
<th>Country</th>
<th>Goods exports to UK (in % of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>7.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>6.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.0</td>
</tr>
<tr>
<td>Germany</td>
<td>4.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>3.0</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.0</td>
</tr>
<tr>
<td>Spain</td>
<td>0.0</td>
</tr>
<tr>
<td>Finland</td>
<td>0.0</td>
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<tr>
<td>France</td>
<td>0.0</td>
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<tr>
<td>Italy</td>
<td>0.0</td>
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<tr>
<td>Austria</td>
<td>0.0</td>
</tr>
<tr>
<td>Greece</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Trade surplus with the UK (in % of GDP), 2014**

<table>
<thead>
<tr>
<th>Country</th>
<th>Trade surplus with the UK (in % of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>2.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.0</td>
</tr>
<tr>
<td>Spain</td>
<td>0.0</td>
</tr>
<tr>
<td>Germany</td>
<td>0.0</td>
</tr>
<tr>
<td>Austria</td>
<td>0.0</td>
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<tr>
<td>Greece</td>
<td>0.0</td>
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<tr>
<td>Italy</td>
<td>0.0</td>
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<tr>
<td>France</td>
<td>0.0</td>
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<td>Sweden</td>
<td>0.0</td>
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<tr>
<td>Finland</td>
<td>0.0</td>
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<tr>
<td>Denmark</td>
<td>0.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>-7.0</td>
</tr>
</tbody>
</table>

Source: European Commission Eurobarometer 84 (Autumn 2015), Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
European banks’ exposure to the UK is substantial

European banks exposure to the UK is substantial – UK has the highest financial service activity in EU. The financial sector also accounts for a large share of FDI into the UK.

Share of EU financial services activity, gross value added

Source: OECD, ONS, Danske Bank Markets

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
ECB is ready to use existing measures to limit contagion

**ECB will limit contagion – we expect it to use existing tools**

- A Brexit is likely to result in higher yields in particular in the periphery countries. In these countries, the risk of exiting the euro should be perceived as higher as the commitment to the common currency should be considered smaller in these countries.

- In our view, the spread widening should be somewhat limited as the ECB stands ready to dampen contagion. When the Grexit risk was looming, Draghi clearly communicated the ECB’s readiness to act in case of a crisis, as he said ‘we have enough instruments at this point in time with OMT, QE which, though they have been designed for other purposes, they would certainly be used at a crisis time if needed’.

- Among the existing ECB programmes we find it most likely that the ECB will use the flexibility under the QE purchases. It could also be that the ESM’s SMPF programme will be initiated. This programme can be used for countries outside an adjustment programme, but subject to financial market disruptions. (Rate cuts are not expected as a tool aimed at limiting contagion).

The biggest euro area countries are for the single currency

In Portugal, increased market pressure and risk of losing the investment grade rating from DBRS implied the Portuguese parliament approved an updated budget for 2016

Pernille Bomholdt Henneberg, Senior Analyst, perni@danskebank.com, +45 45 13 20 21
EUR/USD in a Brexit outcome

• EUR/USD negatives
  - Politics: Start of a disintegration process in EU – although less of a eurozone crisis, initially.
  - Trade flows: Less trade between EU and UK → Negative for eurozone growth (eurozone recession likely near term, but longer-term impact depends on ‘type’ of UK exit)
  - Sentiment: EU uncertainty prolonged → Impaired euro-area business/consumer sentiment
  - ECB: More easing to wear off negative impact on growth and inflation

• EUR/USD positives
  - Politics: Larger cohesion among remaining EU member countries → Easier to move on with closer integration process?
  - FDI flows: EU financing a significant amount of UK current-account deficit which could be redirected → EU domestic investment to increase near term
  - ECB: Unlikely to use rate cuts but rather QE (not as EUR negative as rate cuts)
  - EUR as safe haven: Sourcing risk appetite in itself a EUR positive (if euro remains a preferred funding currency)

→ EUR/USD: some but, after all, limited downside in event of a Brexit
  - No Brexit (baseline scenario): 1.12 (Danske 3M forecast)
  - Brexit (risk scenario): 1.09 as knee-jerk reaction
Little evidence of Brexit premia in EUR/USD and EUR/CHF - but both should drop in event of a Brexit

ECB: to stay in easing mode longer in event of a Brexit - but notably more likely to use QE (rather than rates)  
Fed: little policy reaction - but could delay tightening

CHF remains a preferred safe haven (alongside JPY) and SNB's commitment to wear off EUR/CHF downside would likely be tested in event of a Brexit

➔ EUR/USD: to test the 1.09 level in the event of a Brexit on euro break-up fears, lower activity and ECB in easing mode for longer

➔ EUR/CHF: still potential for negative risk premium in event of a Brexit - but SNB unlikely to tolerate the cross below 1.075

Sources: Bloomberg, Macrobond, Danske Bank Markets.

Christin Tuxen, Senior Analyst, tux@danskebank.com, +45 45 13 78 67
EUR Fixed Income in case of a Brexit

- Downward pressure on core yields
  - A Brexit is expected to give a downward pressure on growth and inflation in the eurozone
  - Inflation expectations in the market could drop further, though a move lower in EUR/USD would mitigate impact
  - Further flattening of the yield curve 2Y10Y and 5Y10Y. Investors will be pushed further out on the curve, whereas the short-end 0-5Y will be more less ‘locked’ as ECB will be very reluctant to cut further into negative and buy bonds below the deposit rate currently at -0.40%
  - 10Y Germany to trade below zero
  - Wider asset swap spread (risk-off move)

- Initial widening of Peripheral spread
  - The initial reaction to Brexit would be wider spreads for periphery bonds
  - Investors will move away from risky assets fuelled by a fear that political support to periphery could fall and that local support to ‘austerity’ could fade
  - Despite very strong growth Ireland could be particularly exposed due to its trade links with the UK and sensitivity to a weaker sterling
  - If growth slows significantly, fear of new rating downgrades in e.g. Spain could emerge
  - A potential step-up in ECB QE and the current sizeable QE programme means that the negative impact on ‘periphery’ is expected to be temporary
Denmark: Recession, EUR/DKK downward pressure to remain and lower DKK-bund spread
Economic impact of Brexit could be significant

• A Brexit would hamper investment and exports.
• GDP influence similar to euro area; hence recession in 2016 and growth below 1% in 2017 is clearly possible.

Las Olsen, Chief Economist, Denmark laso@danskebank.dk +45 45 12 85 36
Denmark has large of assets and liabilities in EU

• 10% of Denmark’s foreign assets are UK and 15% of foreign liabilities are UK.

• UK assets are held by most sectors, while UK liabilities are mainly held by non-financial corporations and banks.

• Denmark has a current account surplus versus the UK and a current account deficit versus the EU, excluding the UK.

Source: Macrobond Financial, Danmarks Nationalbank, Danske Bank Markets
Danmarks Nationalbank has ample fire power to curb depreciation pressure on DKK

Source: Macrobond Financial, Danske Bank Markets

Jens Nærvig Pedersen, Senior Analyst, jenpe@danskebank.dk +45 45 12 80 61
DKK is supported by strong economic balances

Source: Macrobond Financial, Danmarks Nationalbank, Danske Bank Markets

Las Olsen, Chief Economist laso@danskebank.dk +45 45 12 85 36
DanishFixed Income: A ‘hedge’ versus Brexit?

• A ‘Brexit’ creates uncertainty regarding the growth outlook for the eurozone and fuels anti-EU sentiment. Investors will be looking for alternatives to the ‘euro mess’

• ECB to step-up/prolong the current QE programme and investors will be forced further out on the yield curve. We would expect 10Y yields in Germany to drop below zero. The move lower in EUR core yields would tend to push investors to the triple A bonds of Denmark including the high-yielding callable bonds

• A more gradual move compared to the sudden move last year after SNB gave up the floor below EUR/CHF is expected

• We expect spreads against Germany to tighten somewhat from here on a Brexit. However, investors are likely to be cautious buying Denmark aggressively given the liquidity offered by a relatively small market.

DGB’s spreads vs Germany at attractive level

Foreign investor holdings stable at a high level

Source: Macrobond Financial, Danmarks Nationalbank, Danske Bank Markets

Arne Lohmann Rasmussen, Chief Analyst, Head of Fixed Income Research, arr@danskebank.com, +45 45 12 85 32
Still many EUR unhedged assets in Danish L&P sector

- Danish Life insurance companies and pension funds (L&P sector) still have very large holdings of EUR assets (primarily EUR swaps and bonds) that are unhedged.

- Note that the EUR exposure has grown in 2015 as pension funds have moved hedges from USD/DKK to EUR/USD.

- One key source of potential inflow could be increased hedging of EUR assets by the Danish L&P sector if a Brexit leads to speculation about the future of the EUR and strong inflow into DKK assets (downward pressure on EUR/DKK). ‘Domestic hedging’ was the main reason behind the demand for DKK last year after the SNB removed the floor below EUR/CHF.

- Again a Brexit will be less of a surprise compared to the SNB event last year. But still ‘relatively’ cheap for L&P sector to hedge EUR exposure.

Unhedged EUR assets in Danish L&P sector sizeable

The ‘cost’ of hedging EUR exposure important

Sources. The Danish Central Bank, Monetary review Q4 15, and Danske Bank
Danmarks Nationalbank would follow its normal reaction function

- However, for the Brexit hedge to work – then EUR uncertainty has to escalate in the financial markets.

- In this case we would expect downward pressure on EUR/DKK and Danmarks Nationalbank to intervene to weaken DKK around the level of 7.43-7.44.

- If inflow into the FX reserve reached DKK10-20bn, we expect it would cut the key policy rate to minus 0.75%, which we see as the lower bound.

- If the downward pressure continues it has unlimited room to build up the FX reserve.

- We do not expect DN to use the option of suspending DGB issuance again.

- Larger scale buy back of DGB using government deposits is a possibility.

Source: Macrobond Financial

Jens Nærvig Pedersen, Senior Analyst, jenpe@danskebank.dk +45 45 12 80 61
Sweden:
Weaker growth, more QE and a higher EUR/SEK
The direct impact on Sweden from UK recession is likely to be small

Sweden – UK trade relations

<table>
<thead>
<tr>
<th>2015</th>
<th>SEK bn</th>
<th>% YoY</th>
<th>% share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Input goods, exports</td>
<td>34</td>
<td>-3.9</td>
<td>41</td>
</tr>
<tr>
<td>Investment goods, exports</td>
<td>50</td>
<td>11.9</td>
<td>59</td>
</tr>
<tr>
<td>Total goods, exports</td>
<td>85</td>
<td>4.9</td>
<td>7*</td>
</tr>
<tr>
<td>Input goods, imports</td>
<td>13</td>
<td>-37</td>
<td>20</td>
</tr>
<tr>
<td>Investment goods, imports</td>
<td>52</td>
<td>0</td>
<td>80</td>
</tr>
<tr>
<td>Total goods, imports</td>
<td>64</td>
<td>-10</td>
<td>5**</td>
</tr>
</tbody>
</table>

Trade Balance | 21 | 73 |

* Denotes share of total goods exports
** Denotes share of total goods imports

Source: Statistics Sweden, SCB and Danske Bank Markets

- The UK is Sweden’s fourth largest goods export market and the fifth largest supplier. The bilateral trade balance is currently around SEK21bn (in annual terms) and has risen rapidly over the past years due, *inter alia*, to the beneficial exchange rate developments. The main export products to the UK are investment goods in general and vehicles in particular. Forest related products (of all forms and shapes) are also a large share of Swedish goods exports to the UK.

- *Ceteris Paribus*, a 10% drop in goods exports to the UK would lower Swedish GDP by 0.2% and a Nigem simulation (on total exports) suggests immediate effects of comparable size, but waning completely after only a couple of years.
Larger impact from a eurozone recession

• **However**, according to a more thorough simulation run in Nigem, and if paired with a European recession sketched out in the previous Euroland and UK sections, the effect would be much stronger, close to \(-\frac{3}{4}\) pp on GDP in both 2016 and 2017, and \(-\frac{1}{4}\) pp on inflation.

• This, *nota bene*, is in spite of an expected monetary policy response of prolonged QE from the Riksbank and a weaker SEK. (No further interest rate cuts.) In fact, our estimate of growth is a conservative estimate as it does not fully take into account the potential hit to consumer and business confidence.

• In the quantitative exercise mentioned above, the main negative effects are on exports and investments and, to a lesser extent, on consumption. Nonetheless, employment holds up quite well, but profit and wage developments remain all too weak for the Riksbank to push inflation towards the inflation target (2%), having a negative effect on term risk premia but simultaneously widening market interest rate spreads.

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**Impact on selected key variables**

<table>
<thead>
<tr>
<th>% y/y (base) and p.p. (sim)</th>
<th>Base 2016</th>
<th>Sim 2016</th>
<th>Base 2017</th>
<th>Sim 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>3.0</td>
<td>-0.8</td>
<td>2.0</td>
<td>-0.7</td>
</tr>
<tr>
<td>CPI-Inflation</td>
<td>0.6</td>
<td>-0.2</td>
<td>0.6</td>
<td>-0.3</td>
</tr>
<tr>
<td>UNR</td>
<td>6.9</td>
<td>+0.1</td>
<td>6.5</td>
<td>+0.4</td>
</tr>
<tr>
<td>Gov prim bal</td>
<td>-0.9</td>
<td>-0.2</td>
<td>-1.0</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

*Source: Statistics Sweden, SCB and Danske Bank Markets*
With its procyclical properties the krona is expected to take a hit by a heightened recession risk in Europe and an export- and investment-induced slowdown in the Swedish economy.

The risk-off behaviour that would follow a Brexit vote would, in our view, weaken the risk-sensitive SEK vs EUR and USD alongside other defensive and high-liquid currencies like JPY.

The Riksbank may decide to step up its current QE programme at the monetary policy meeting in July. Further easing measures from the Riksbank would, in our view, send EURSEK higher.

That said, there is a non-negligible risk that we would see a repeat of ‘flight to quality’ that dominated the markets during 2012, hence fuelling renewed flows into SEK-denominated assets.

A scenario where EUR/SEK trades sharply lower may prompt a swift response by the Riksbank, where it undertakes direct currency interventions and tries to stabilise the exchange rate.

Short term, we expect ‘negatives’ to dominate where EUR/SEK may retest the upper end of the 9.10-9.60 range. Medium term, EURSEK should trend lower on fundamentals and valuation.

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Finland: Recession could hit late 2016
Brexit and Finland

The UK is the sixth largest export market (5% of value of goods exports). Exports to the UK have fallen during the past 10 years, reflecting the fall in electrotechnical exports (Nokia) especially. Trade balance has been positive.

A Brexit would cause headwinds for Finnish exports due to weaker UK demand and trade barriers. Mechanically counting, a 10% drop in exports to UK would shrink Finnish GDP by 0.2%. Indirect impact from a weaker euro area outlook on the export and investment outlook could be large and cause a recession in Finland starting in late 2016.

Finland has often supported market liberal politics within the EU and sees the UK as a potential ally. Brexit could change the EU politics towards less liberal politics.

Finland joined the EU for both security, political (Finland is not a NATO-member) and economic reasons. EU is popular among Finns, although many would like to see net contribution to the EU budget reduced. Brexit might imply higher contribution to the EU budget.

Decision to join the euro was made by the government (as a part of belonging to EU) and not via a referendum. In a recent study by EVA 23% of Finns supported exit and 58% wanted to keep the euro within the next 10 years.
Norway:
‘Brexit’ to postpone recovery, but still no recession; EUR/NOK to rise to 9.50-9.70
Brexit and Norway – economy challenged, but no recession

The Norwegian economy would take double hit from the Brexit-scenario described above

1. First, a recession in the Euro-area and the UK, including the overall effects on global trade, would hurt the export sector. Based on our expected GDP growth rates, growth in mainland-exports could drop from 3.8% in 2017 to 2.5% as growth among our main trading partners (Euro area, Sweden, UK; Denmark) will take a hit. This would subtract 0.4 pp. from mainland-GDP.

2. Second, the oil price will be affected by lower demand, and in our Brexit scenario, the price will drop by roughly 10% initially and then stay below USD 40/bbl for the rest of the year. Although this will probably lead to further cancelations and postponements of new investment projects on the Norwegian shelf, the effect should not be overestimated. Having said this, neither Johan Castberg nor Snorre 2040 will be profitable at such prices, and will probably be postponed. We think the level of oil investments will be roughly 5 pp. lower in 2017 compared to the base scenario. As oil investments currently are around 7% of mainland-GDP, this would subtract another 0.3-0.4 pp. from mainland-GDP.

... but Norway would still avoid a recession

• However, Norges Bank would cut interest rates further to at least zero and the NOK would weaken (see next slide) thereby supporting other areas of the economy and counteracting some of the negative effects. In addition, such a scenario could trigger a more severe response from fiscal policy. All in all, we expect 2017 mainland-growth to end up at 1.3-1.5% in a ‘Brexit’ scenario compared to 2.2% in the base scenario.
EUR/NOK – higher on ‘Brexit’

Brexit would send EUR/NOK higher

• In case of a ‘Brexit’ three factors would weigh on the NOK.

1. **Oil price.** The prolonged period of uncertainty that would follow a ‘Leave’-vote would trigger an initial knee-jerk reaction lower in oil prices of roughly 10% and then keep a lid on oil in the following year on the back of lower global demand and investments.

2. **Markets speculating on more Norges Bank easing.** Monetary policy is the first line of defence against external shocks. While markets already price in roughly 40bp worth of rate cuts from Norges Bank on a 12M horizon (sight deposit rate currently at 0.50%) a ‘Brexit’ could be characterised as the ‘major shock’ that Norges Bank referred to in the latest monetary policy report as being a trigger of negative rates.

3. **Risk off.** While the NOK just 5 years ago had status as a ‘safe haven’ currency this is no longer the case. This is partly due to the oil price now being heavily interlinked to global growth worries and general risk sentiment. Also the NOK sell-off initiated in 2013 – which followed a four year NOK appreciation period - was amplified by poor market liquidity. Market participants are now much more aware of the liquidity issue in Norway which limits the inflow potential into Norway in case of a ‘Brexit’.

• In terms of EUR/NOK also note that we see limited EUR-downside in case of a ‘Brexit’ (see page 22).

• In our main “stay” scenario we forecast EUR/NOK at 9.40 in 3M and 9.30 in 6M. In a ‘Brexit’ scenario we think EUR/NOK volatility would increase and that the factors above would lift the EUR/NOK range to 9.50-9.70 in H2.

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Equities:
UK equities to fall 10-20%; European equities 10-15%
Equities: Uncertainty to trigger significant drops in European equities

- A Brexit could make FTSE100 drop in the range of 10-15%, but FTSE250 could get much more badly hit with a likely drop in the range of 15-20%. However, if UK stays in the EU FTSE100 could rally 10-15%, while FTSE250 could rally 15-20%.

- But European equity markets like CAC, DAX and broader European indices like Eurostoxx50 would also be hit as a political uncertainty surrounding the EU could arise after a Brexit. We expect major European indices to drop 10-15%. However, if the UK stays in the EU broad European indices could rise by 10-15%.

Increased political uncertainty will lead to an equity downturn

Source: Danske Bank Markets and Macrobond
Equities: FTSE100 should be better off in a Brexit than FTSE250 due to GBP cushion

- A fall in GBP will not act as a cushion for FTSE250 due to its UK domestic exposure, but it will work as a cushion for FTSE100 as 80% of the sales is outside the UK. Factors like GBP, oil and commodities are very important drivers of the FTSE100. Oil and commodities will not start pricing in a global recession despite the outlook for a retracement in the UK and Euro Area economies hence it will support FTSE100.

Source Danske Bank Markets and Macrobond
Equities: Mainland European indices to take hit due to increased political uncertainty

- A Brexit would impact mainland European equities as well. Trade links between EU and the UK is substantial and the UK is a net contributor to the EU hence there would be a financing gap to fill. The most important impact, though, would still be the political uncertainty that it could create in the EU.

Source: Danske Bank Markets and Macrobond

Increased political uncertainty will lead to an equity downturn in mainland Europe
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