



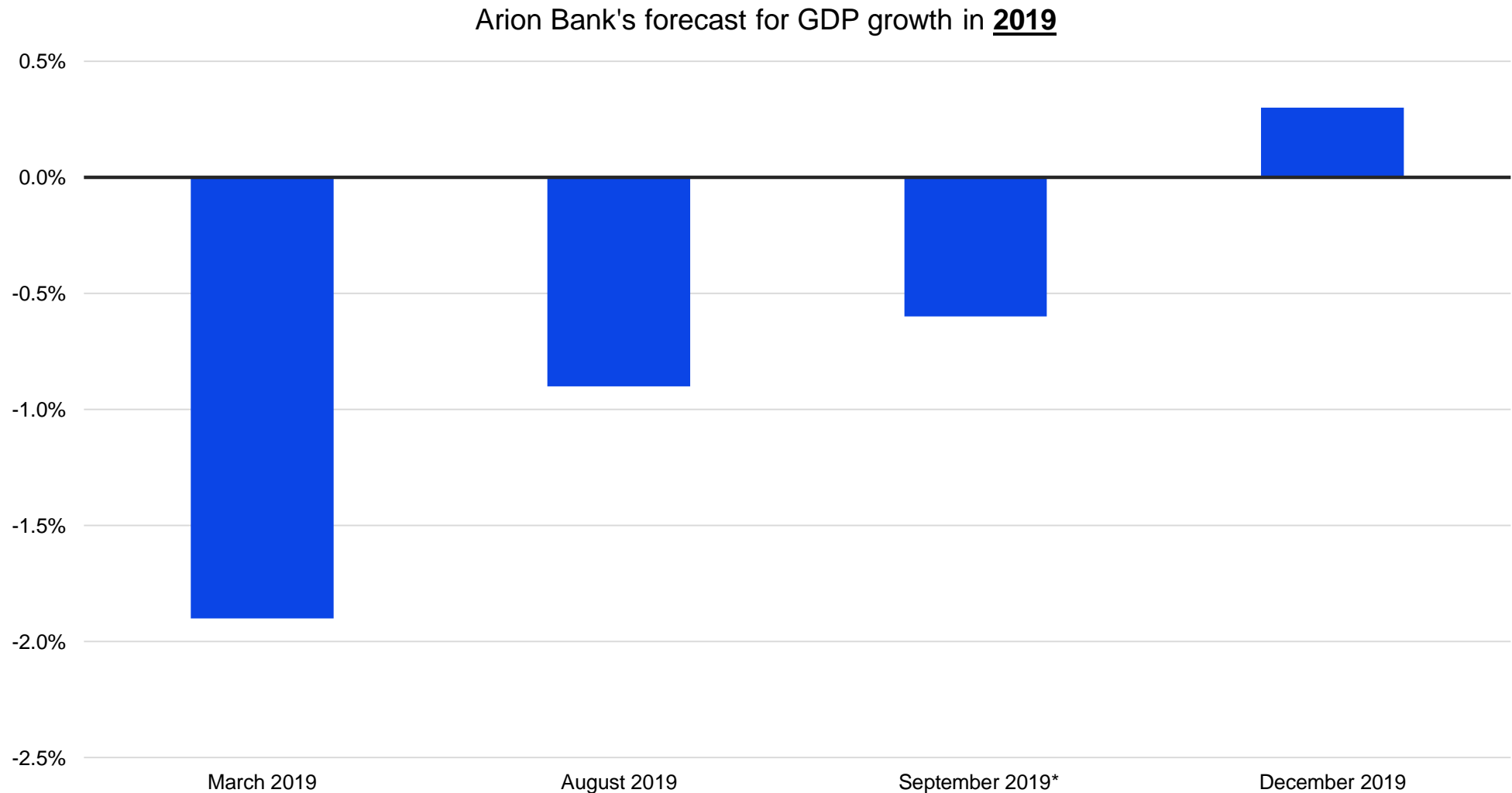
Economic outlook 2019 – 2022:

Mild winter, cold spring



The recession that never came!

Times are changing, analysts too – when the facts change, we change our minds

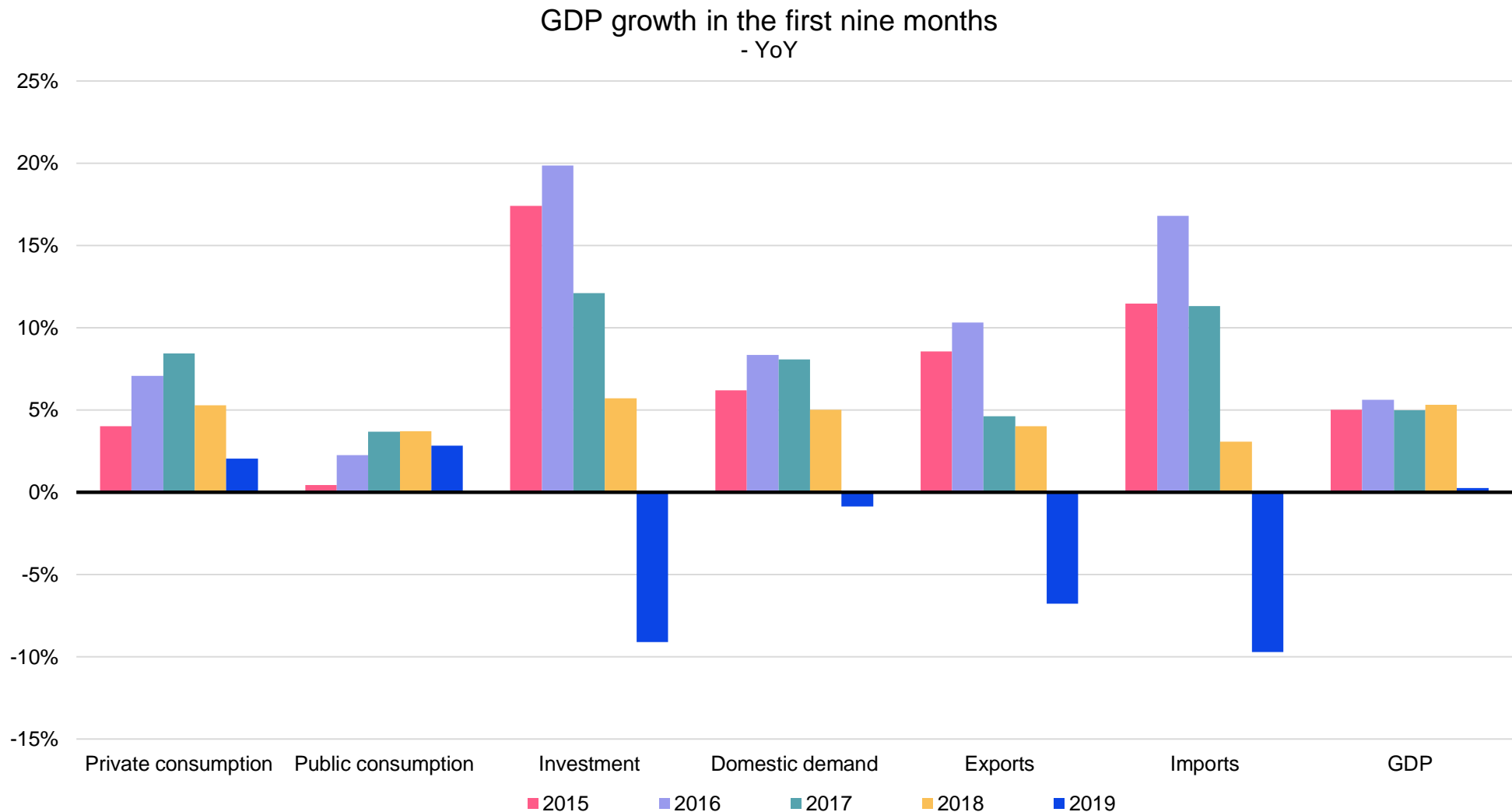


Sources: Arion Research, Arion Bank. * Not an official forecast, August forecast updated with 2H GDP figures.



A 9-month rollercoaster

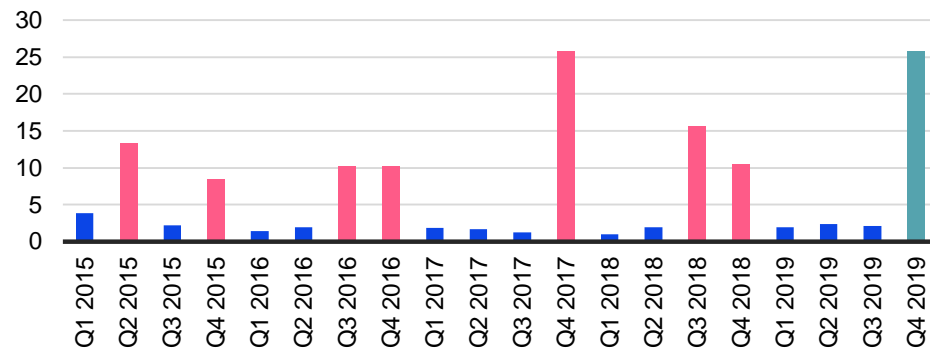
According to preliminary figures from Statistics Iceland, GDP growth measured 0.2% in the first 9 months of the year. Although GDP is increasing, the subcomponents clearly indicate that the economy is in a downturn.



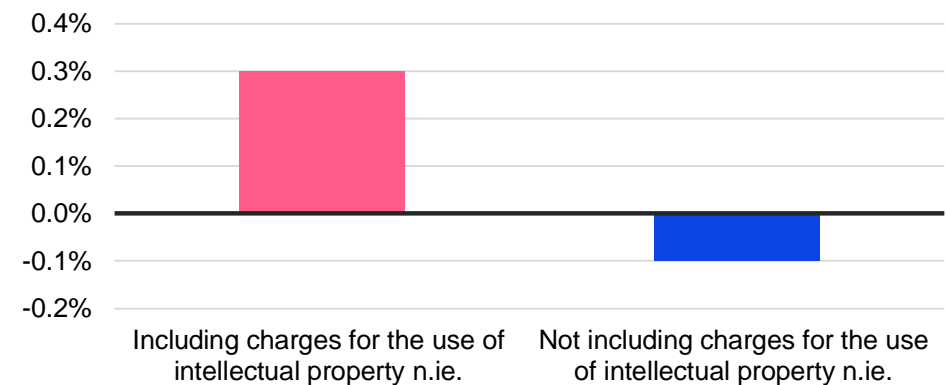
Assumptions are made, some more important than others

GDP growth in Q4 2019, and therefore the whole year, depends on certain assumptions

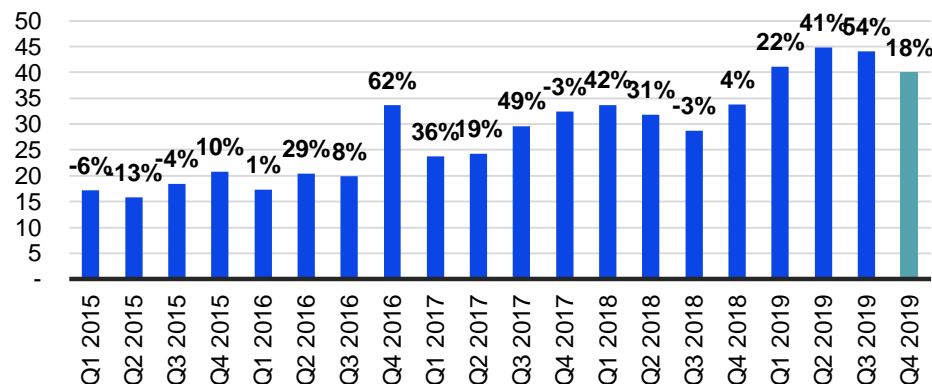
Exports of services: Charges for the use of intellectual property n.ie.
- bn. ISK at constant exchange rate



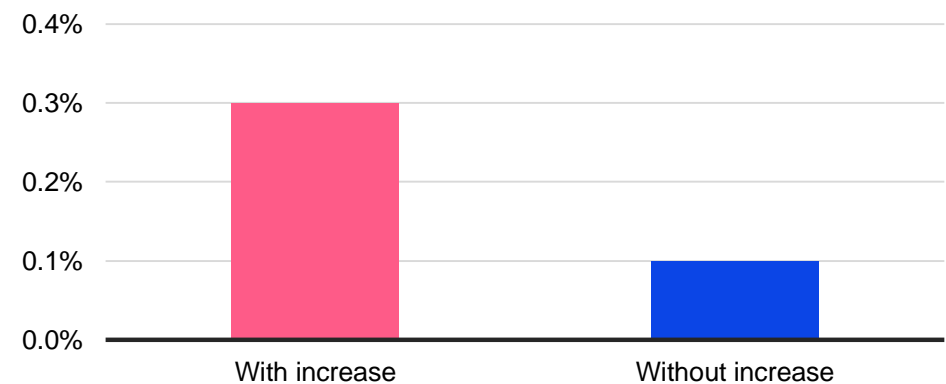
GDP growth in 2019 with and without charges for the use of intellectual property n.ie. in Q4



Housing investment at 2019 prices
- bn. ISK and YoY



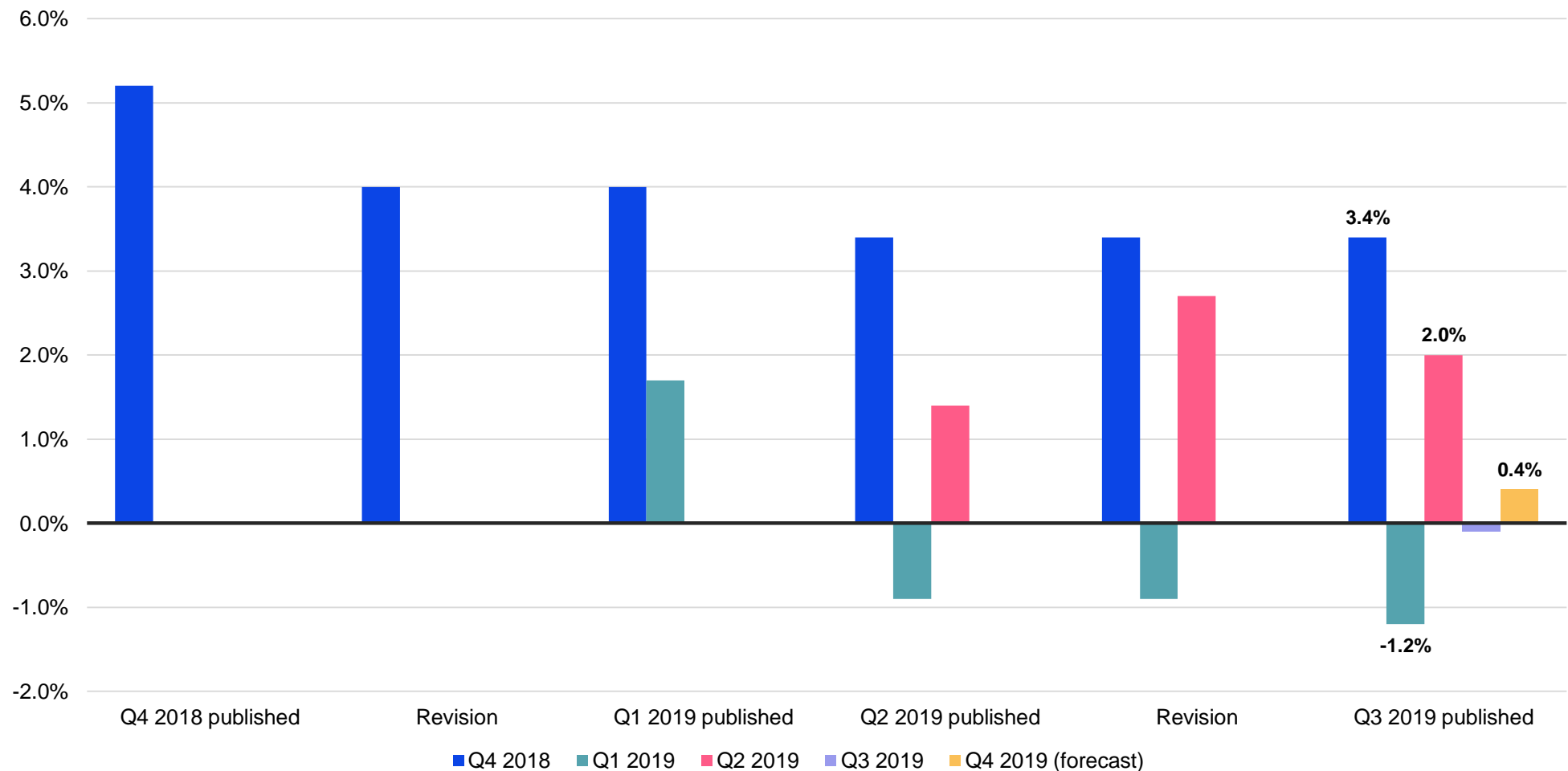
GDP growth in 2019 with and without increase in housing investment in Q4



A foolish man builds his house on the sand

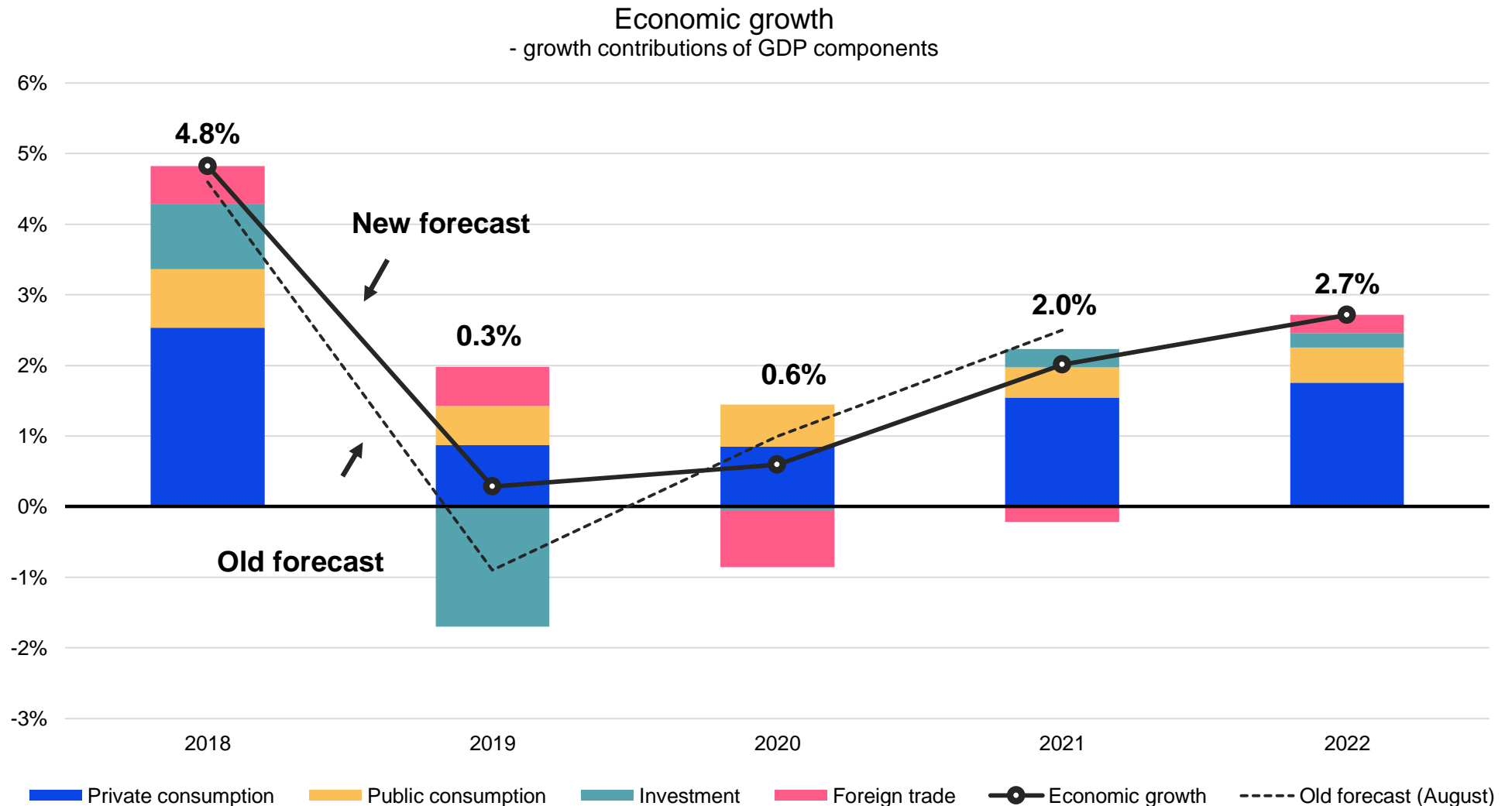
GDP growth is simply a change in gross domestic product between years. As it is a YoY comparison, it can be difficult to forecast when the basis undergoes constant change.

GDP growth per quarters, before and after revisions



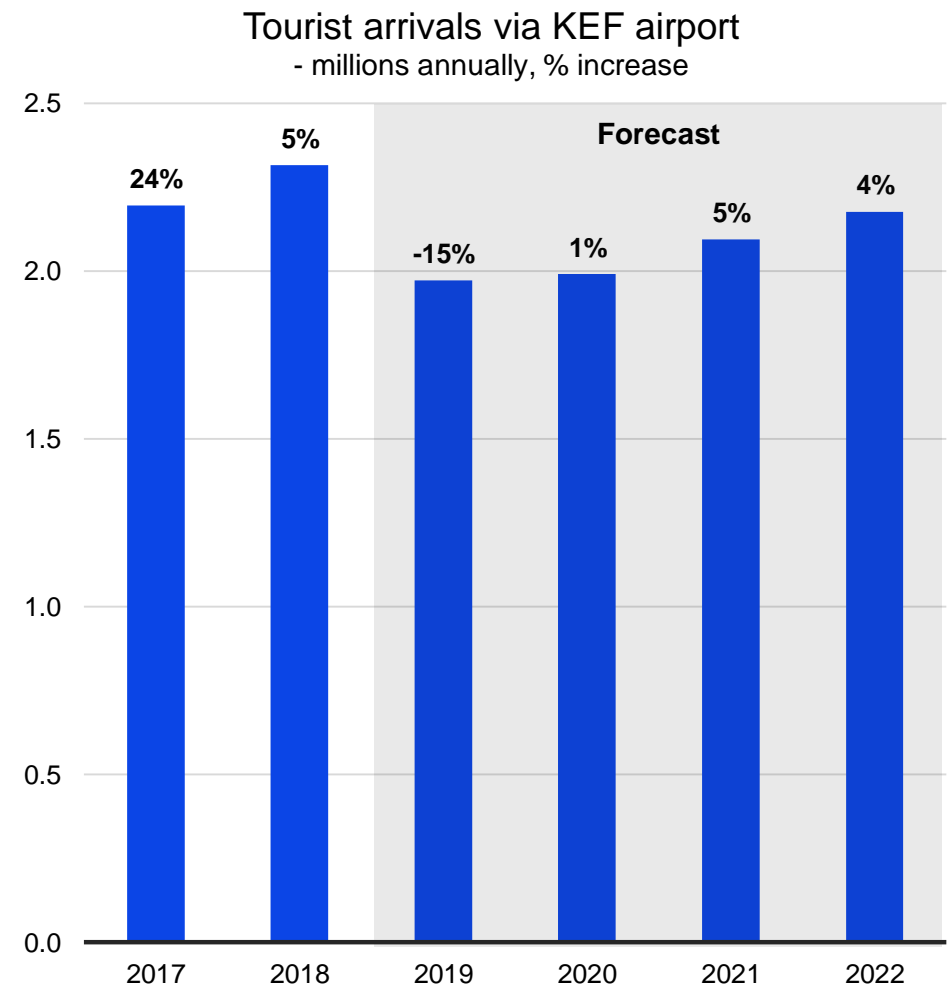
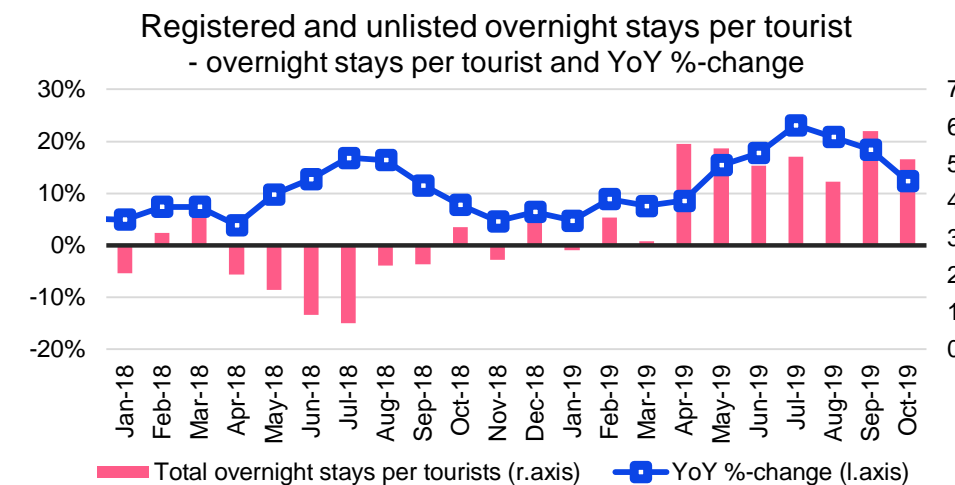
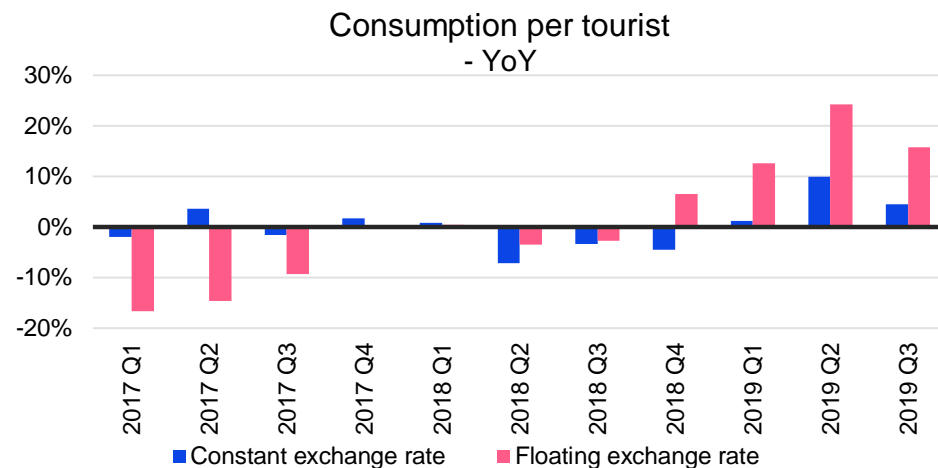
Old story (slow takeoff) and new (GDP growth in 2019!)

Although GDP growth will be on the right side of zero in 2019, the overall picture has remained the same; after a difficult 2019, the turnaround will be gradual.



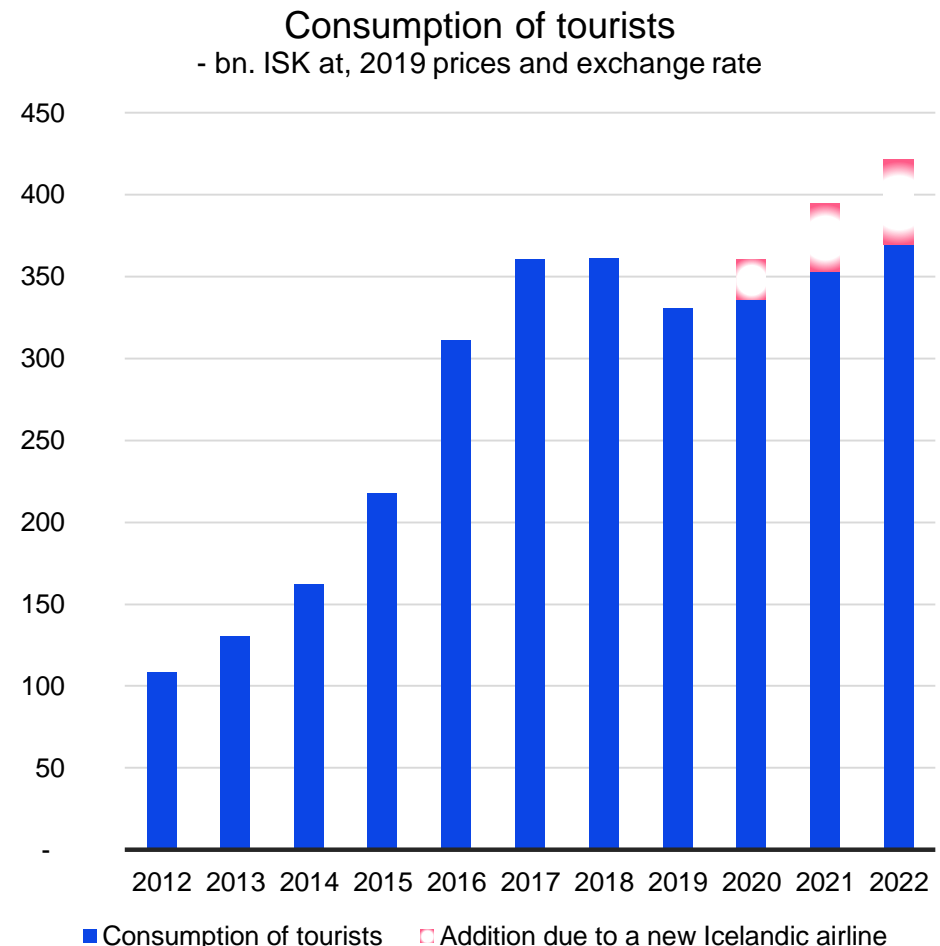
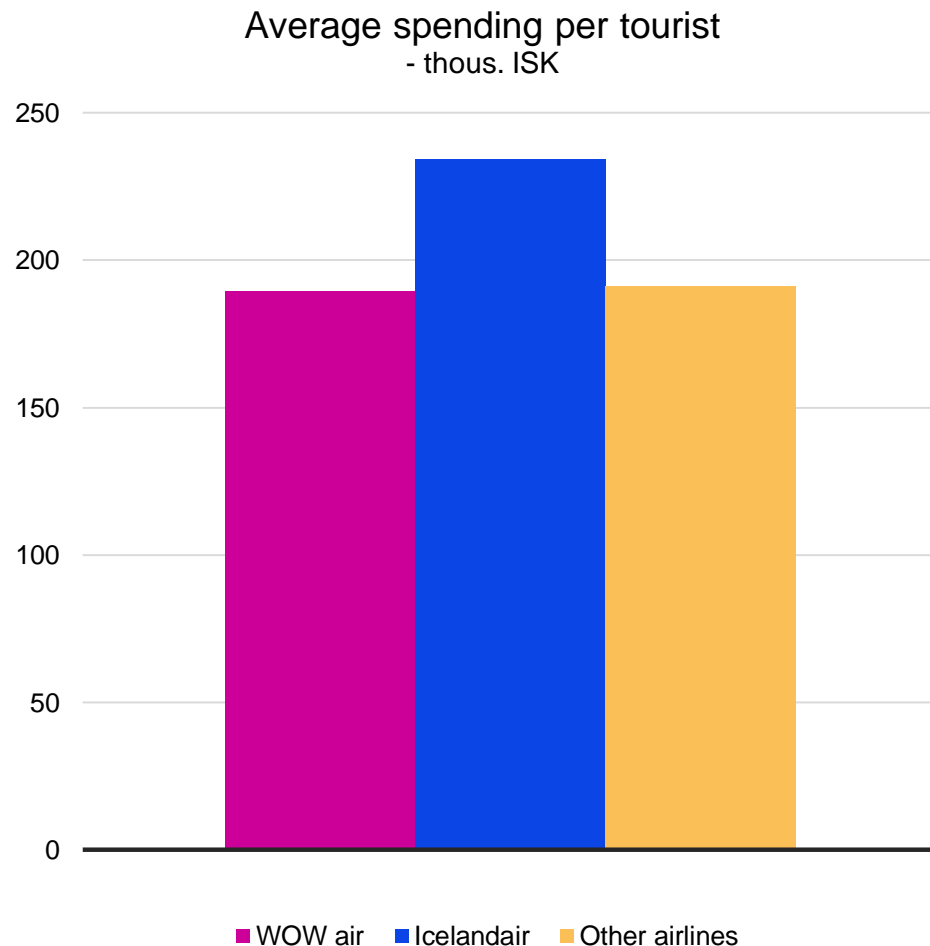
Tourism industry: The battle is over but the war goes on

The average tourist stays longer in Iceland than last year, and spends more money, both in ISK and foreign currency, which softens the economic blow of the collapse of WOW air. The sector is not yet out of the woods as only a minor increase in tourist arrivals is expected next year. A decline in tourist arrivals for the second year in a row is a very real possibility.



Playing with numbers

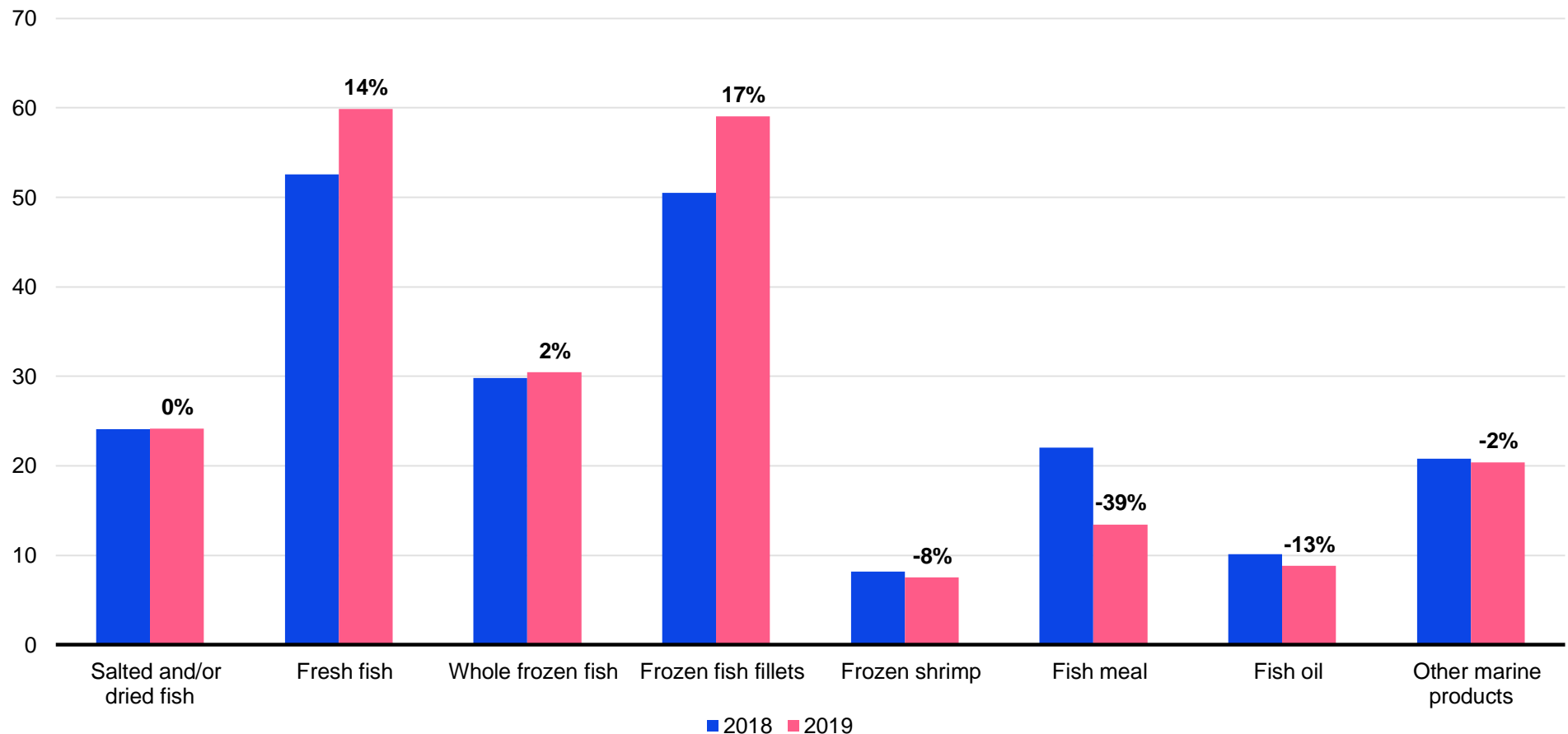
There has been a lot of talk about setting up a new Icelandic airline, either on the foundations of WOW air or a new budget airline. It would undoubtedly have a positive impact on the tourism industry, but it should be kept in mind that the exponential growth of previous years would not be the case. A new airline would also most likely attract some passengers who would have chosen other airlines to fly to Iceland.



Not just tourism which surprised us this year

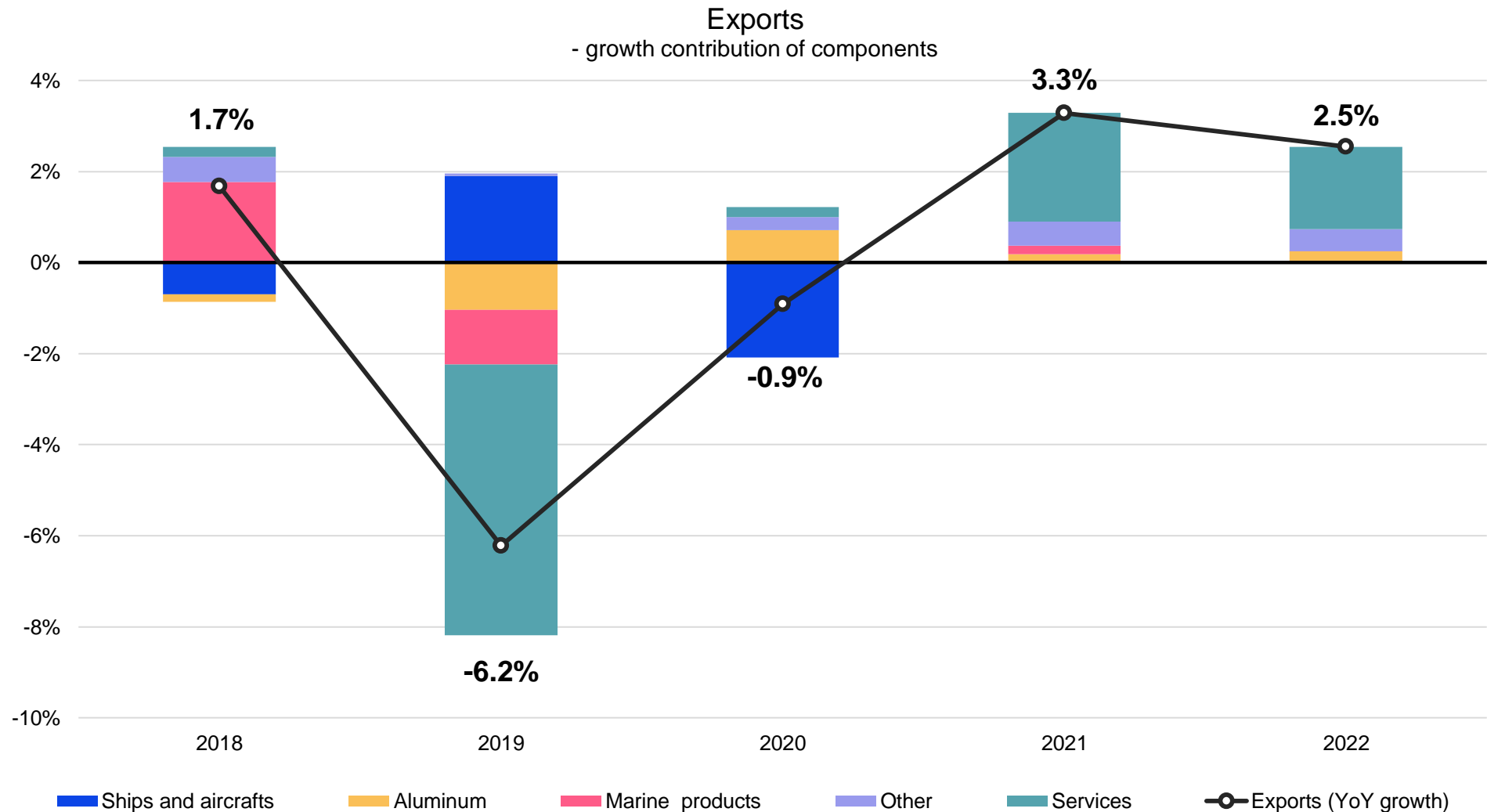
Exports of marine products increased by 2.6% in first 10 months of year, at a fixed exchange rate, despite no capelin being caught. Note that due to a rise in the price of marine products, the value of exports increased; measured in tons there was a 7% decrease YoY.

Export of marine products January - October
- bn. ISK at constant exchange rate



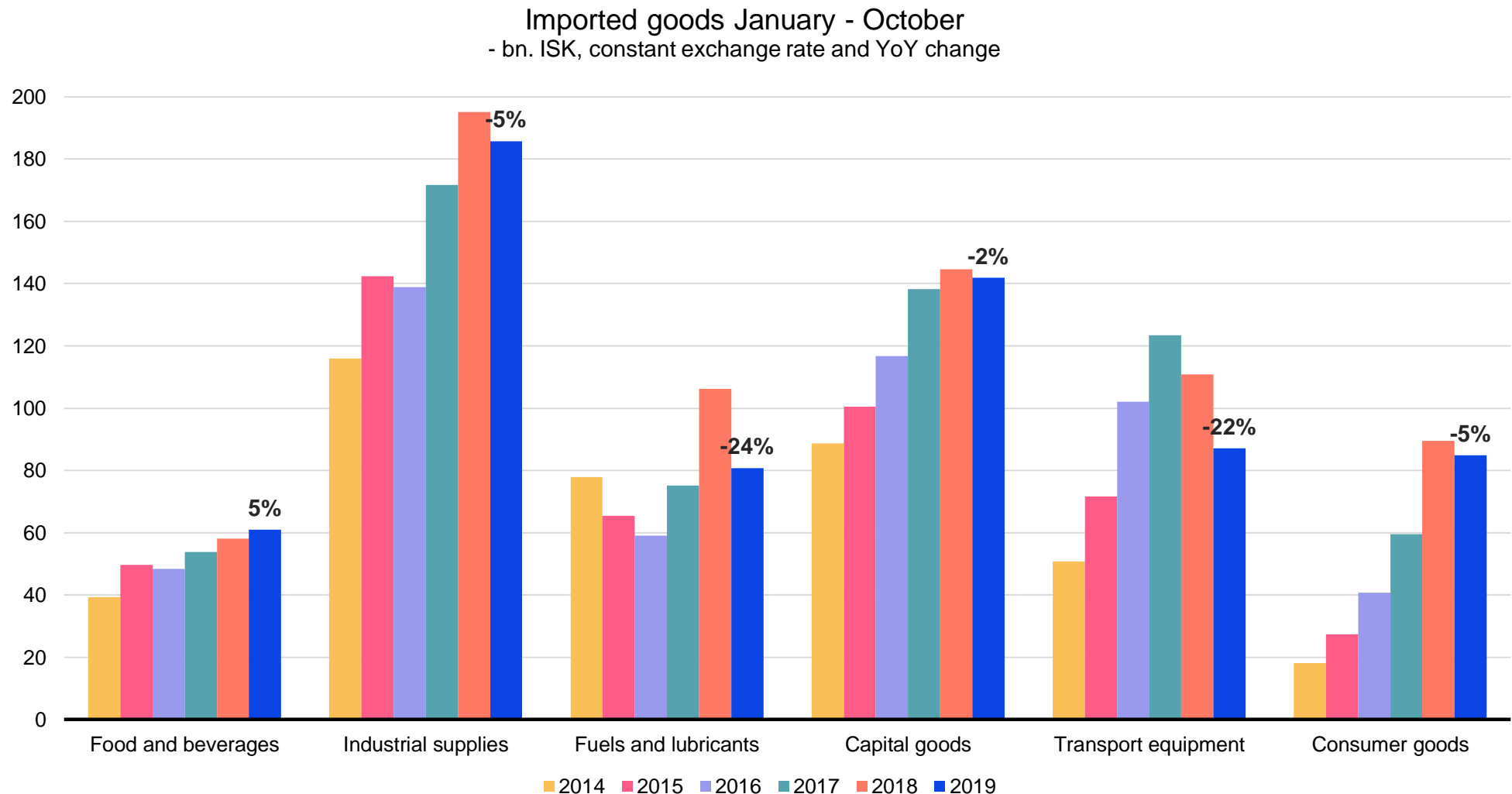
Base effect results in drop in exports next year

Aluminum recovers but tourism and seafood industries are still under pressure. Decrease in goods exports is primarily due to a drop in aircraft exports.



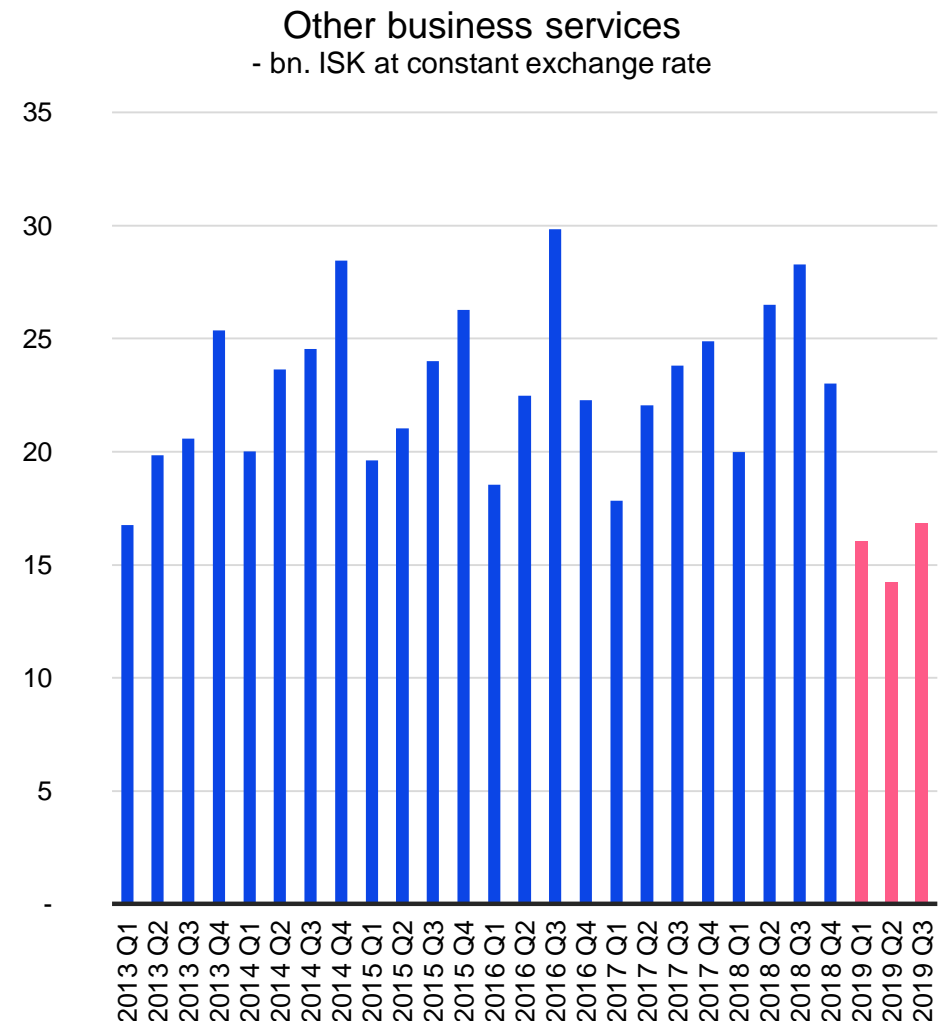
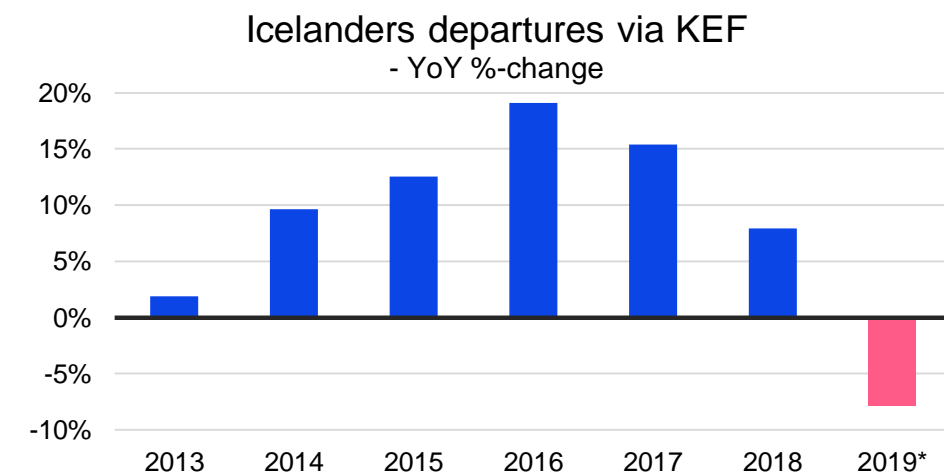
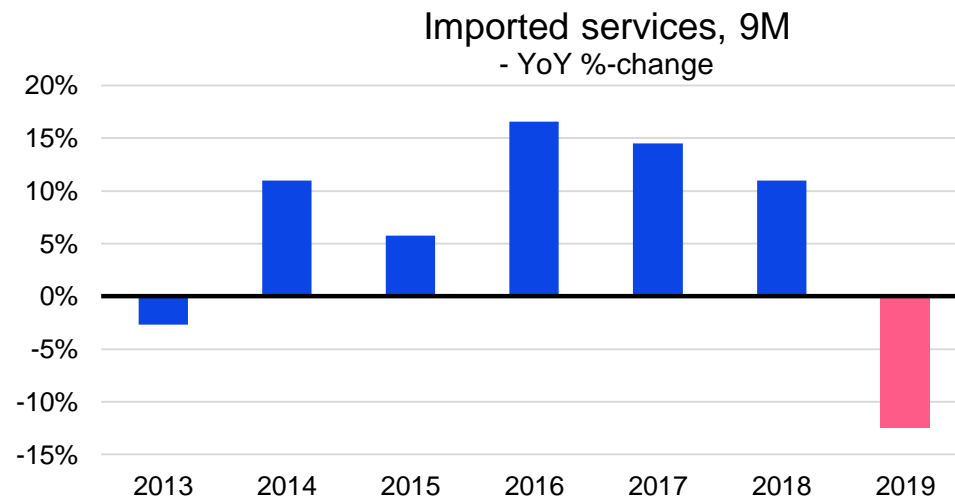
Goods imports affected by falling exports

The contraction in the tourism industry is most clearly reflected in imports of fuel and lubricants (e.g. aviation fuel) and transport equipment



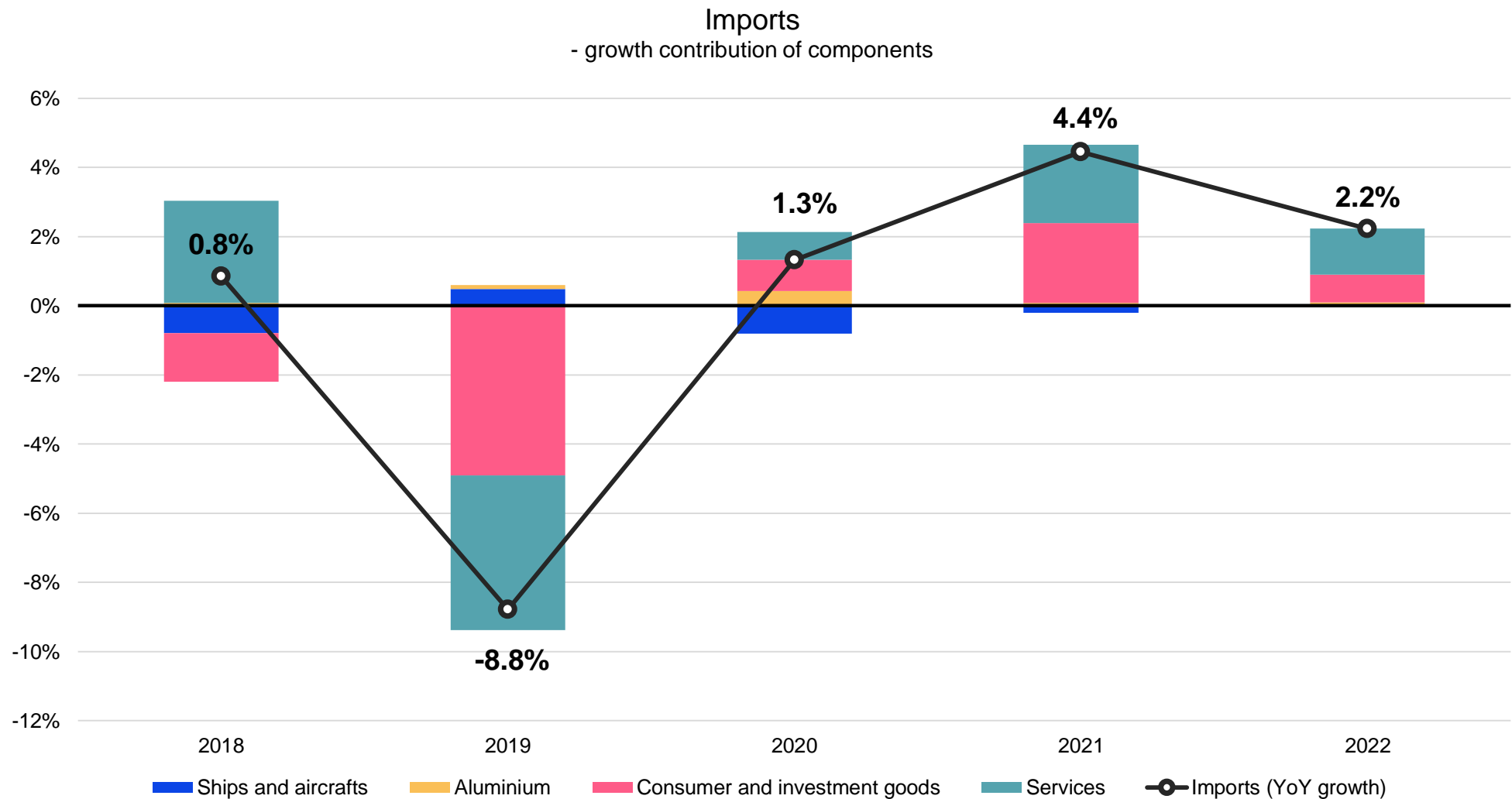
Fewer aircrafts = less service imports

The decrease in imported services plays a key role in this year's GDP growth. Overseas trips by residents have decreased, but the key factor is the sharp decrease in other business services, which includes aircraft leasing.



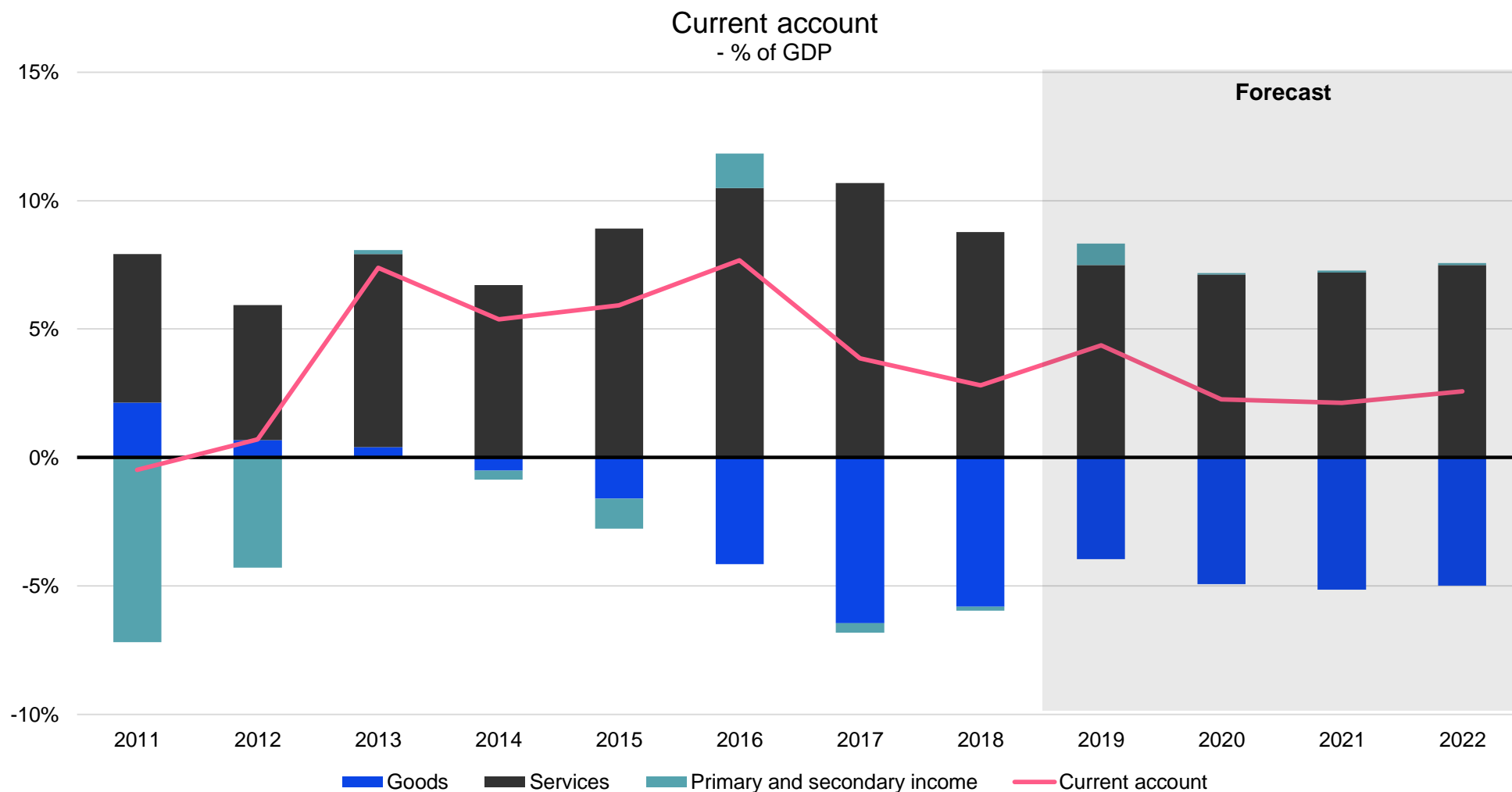
Imports take their time

We forecast a slight growth in imports next year, after a substantial decrease this year



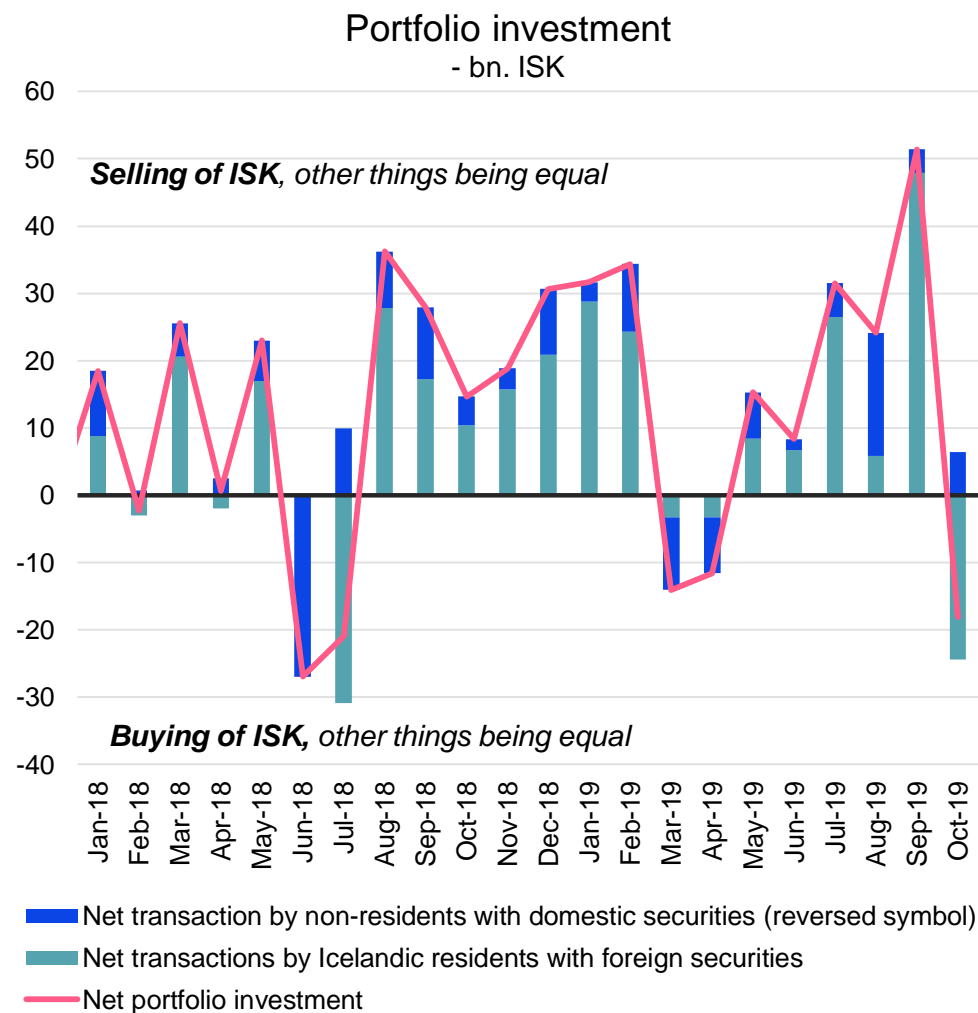
A sizeable current account surplus throughout the forecast period

Smaller deficit of trade in goods outweighs smaller surplus of balance of trade in services

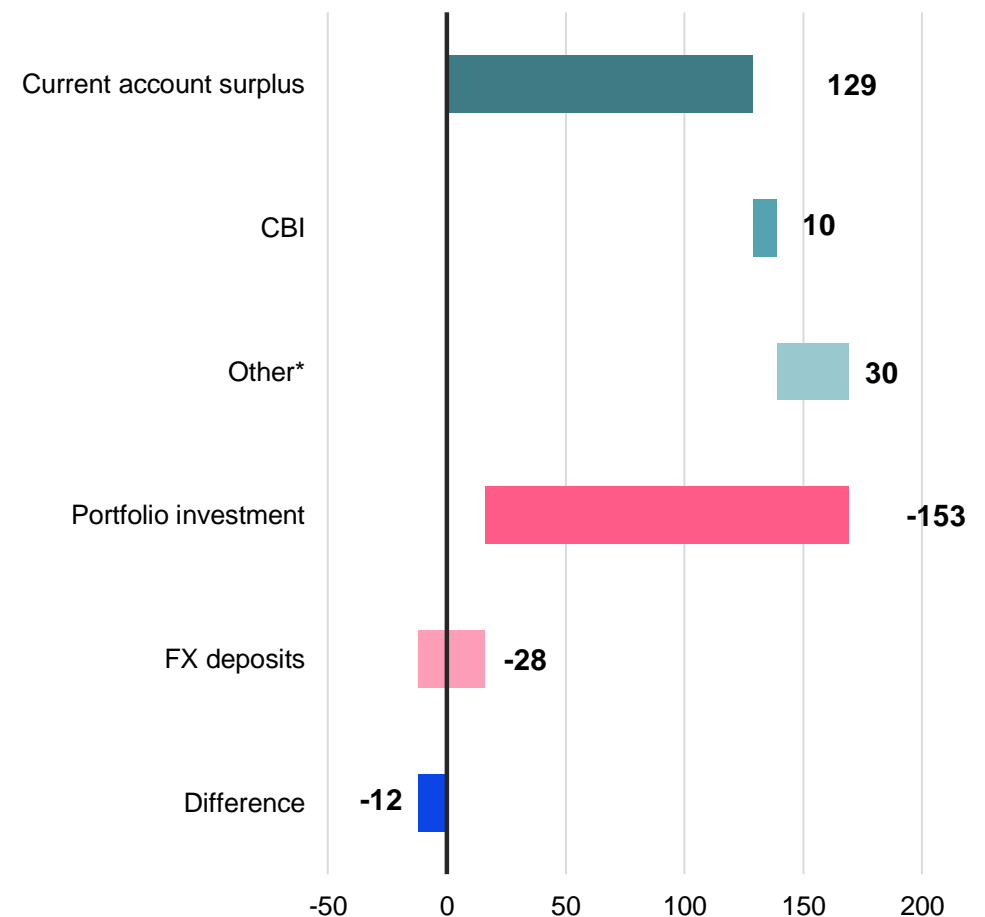


Get out: The year of foreign investment

In 2019 Icelandic investors have been keen to invest in international securities, resulting in a substantial outflow on the FX market. The pension funds are likely responsible for the majority of this outflow. This is counterbalanced by a significant current account surplus, which means, all other things being equal, minimal depreciation pressure this year.



Estimated currency flows in 2019



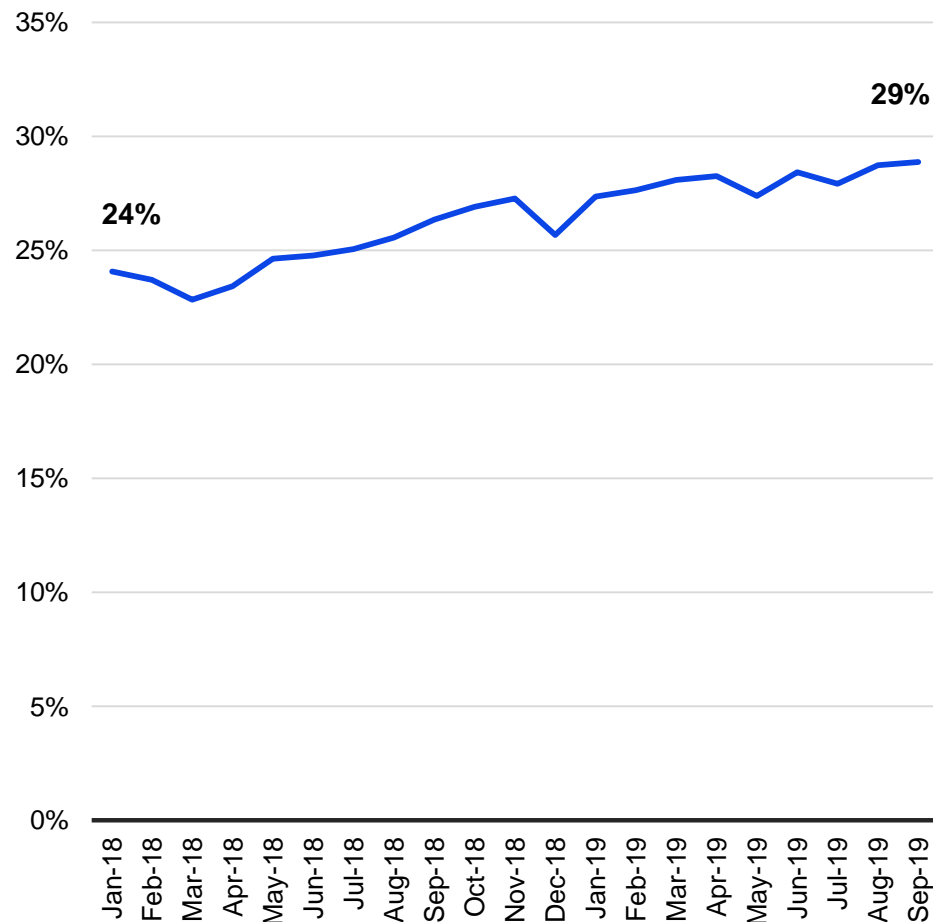
Sources: CBI, Arion Bank. * This is the most uncertain component, as it includes many items which are unclear whether cause direct currency movements or not.



Foreign assets of pension funds +/- 30% of total assets

Target of 40% is the general view. Net inflow to the pension system is expected to continue to increase in next few years, which means that the system needs to invest heavily abroad just to maintain current levels.

Foreign assets of the pension system
- % of total assets

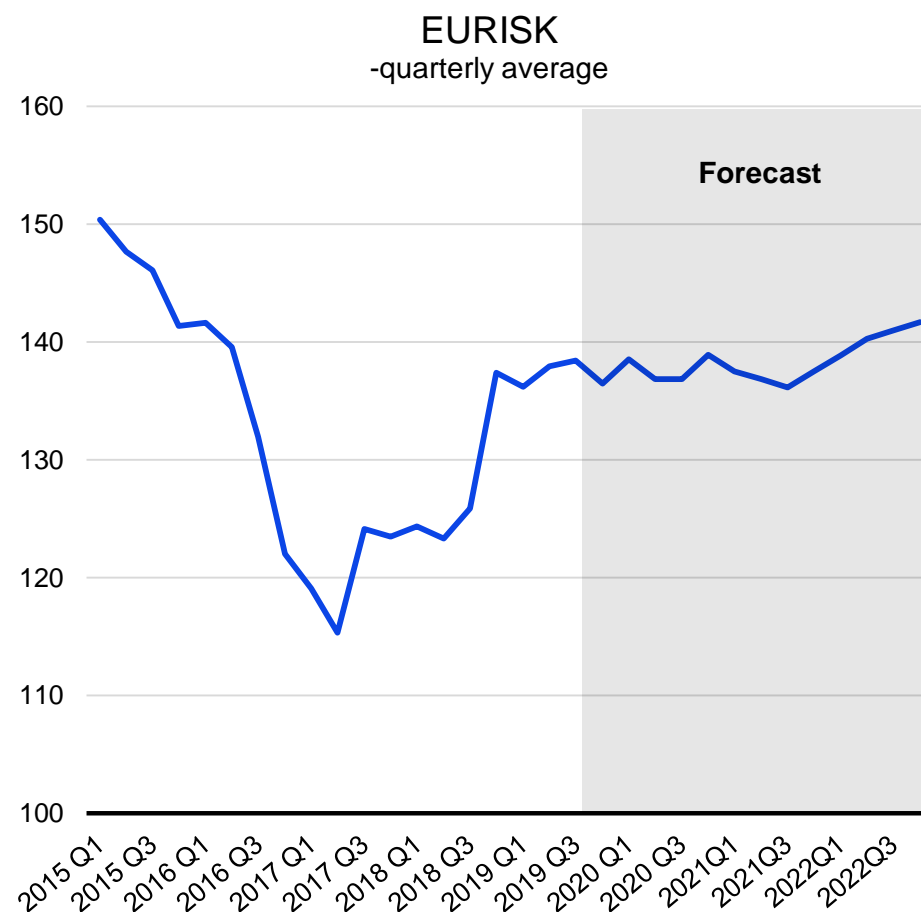
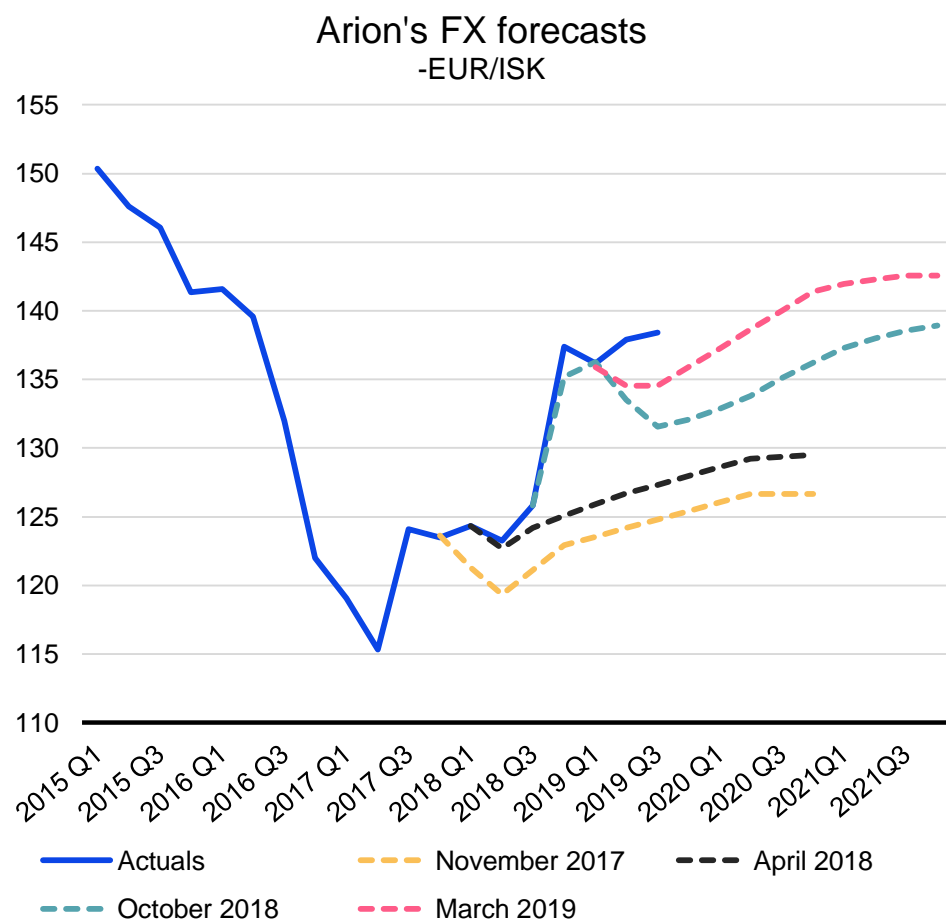


	% of foreign assets 31.03. 2018	% of foreign assets 30.09.2019
Almennir	25%	32%
Birta	26%	31%
Brú	15%	23%
EFÍA	17%	30%
Festa	24%	32%
Frjálsi	20%	26%
Gildi	31%	38%
Íslenski	14%	25%
Lífeyrissjóður bankam.	8%	12%
Lífeyrissjóður bænda	21%	24%
Lífeyrissjóður Rang.	13%	20%
Lífeyrissj. starfsm. Akureyrarb.	6%	7%
Lífeyrissj. starfsm. Búnaðarb.Ísl.	9%	12%
Lífeyrissj. starfsm. Reykjav.	3%	8%
LSR	28%	36%
Lífeyrissj. Tannlækna	16%	25%
Lífeyrissj. Verslunarm.	32%	39%
Lífeyrissj. Vestm.	35%	40%
Lífsverk	17%	23%
Stapi	25%	32%
Söfnunarsj.	26%	32%
Total	25%	32%



Stable króna, but constant fluctuations

All other things being equal, the króna is expected to fluctuate in a relatively narrow range in the medium term. In the short term it is primarily the flow on the FX market which controls the exchange rate, i.e. the current account surplus, the outflow from the pension funds and other Icelandic market participants, and the interest of international investors in Icelandic assets. In the long term we expect the nominal exchange rate to depreciate, reflecting higher inflation and salary increases in Iceland than in its main trading partners.

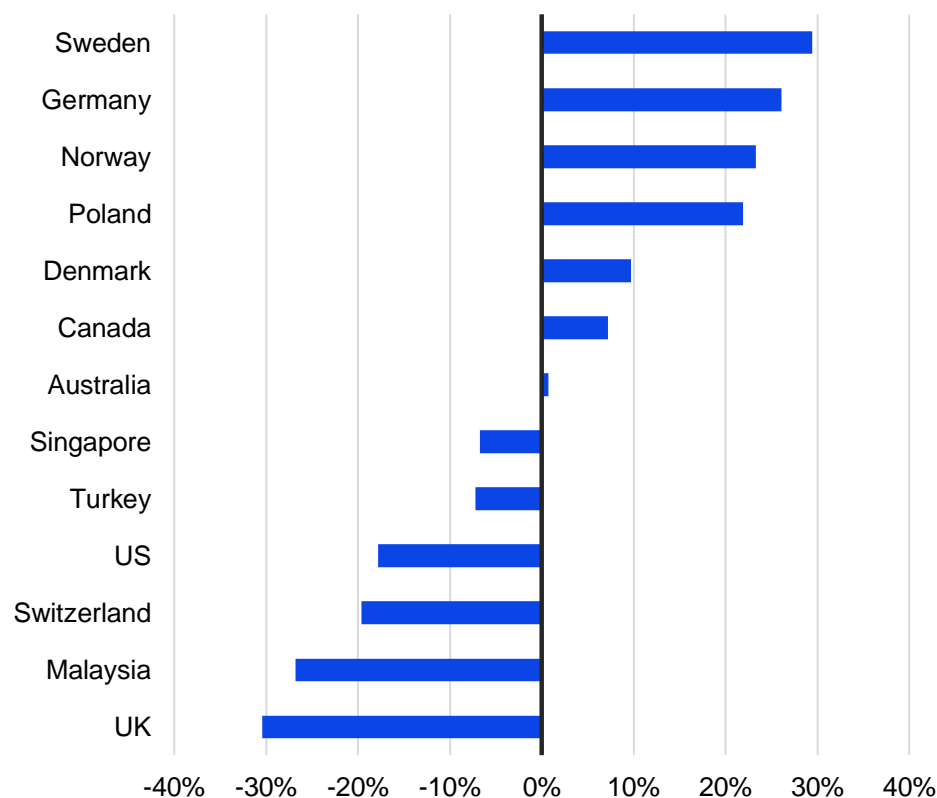


Billy indicates a slight depreciation of the króna

The purchasing power parity (PPP) between two currencies can be measured by comparing what a homogeneous product costs in both locations, after adjusting for the nominal exchange rate. The Billy bookshelf is an example of such a product, as it is exactly the same no matter where the consumer is located. According to informal survey, the ISK is overvalued against many of the major trading currencies, which should indicate depreciation in the future.

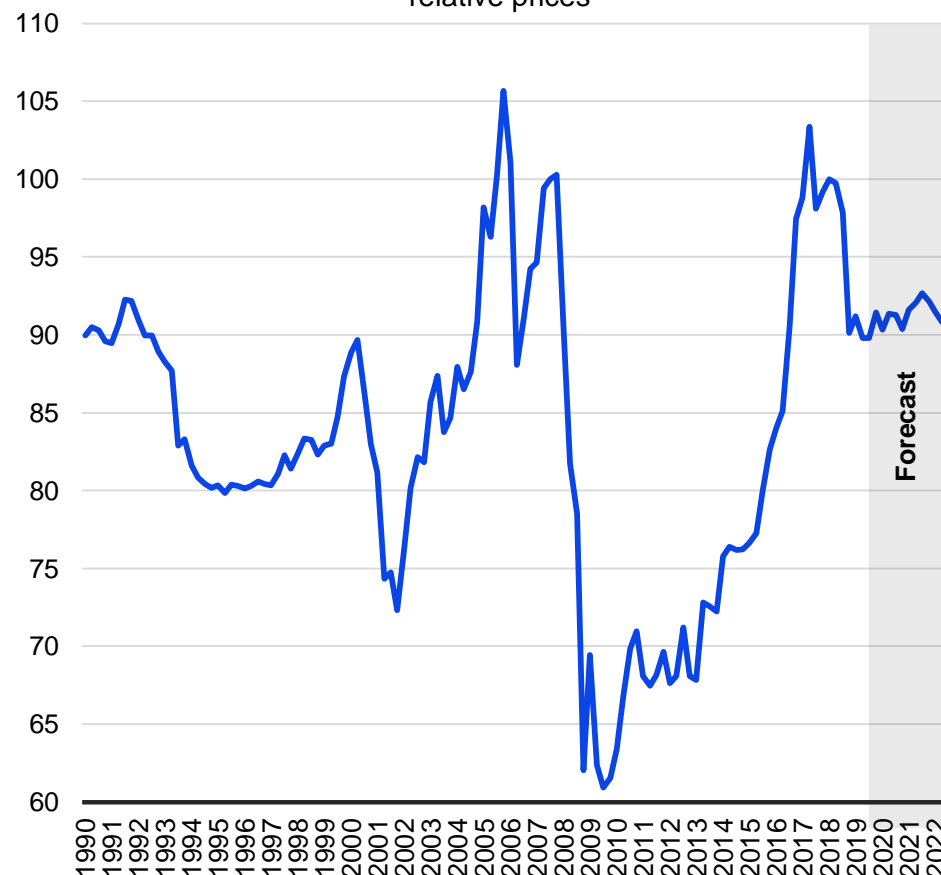
How is the króna valued based on the Billy bookshelf?

- under/over valued, %



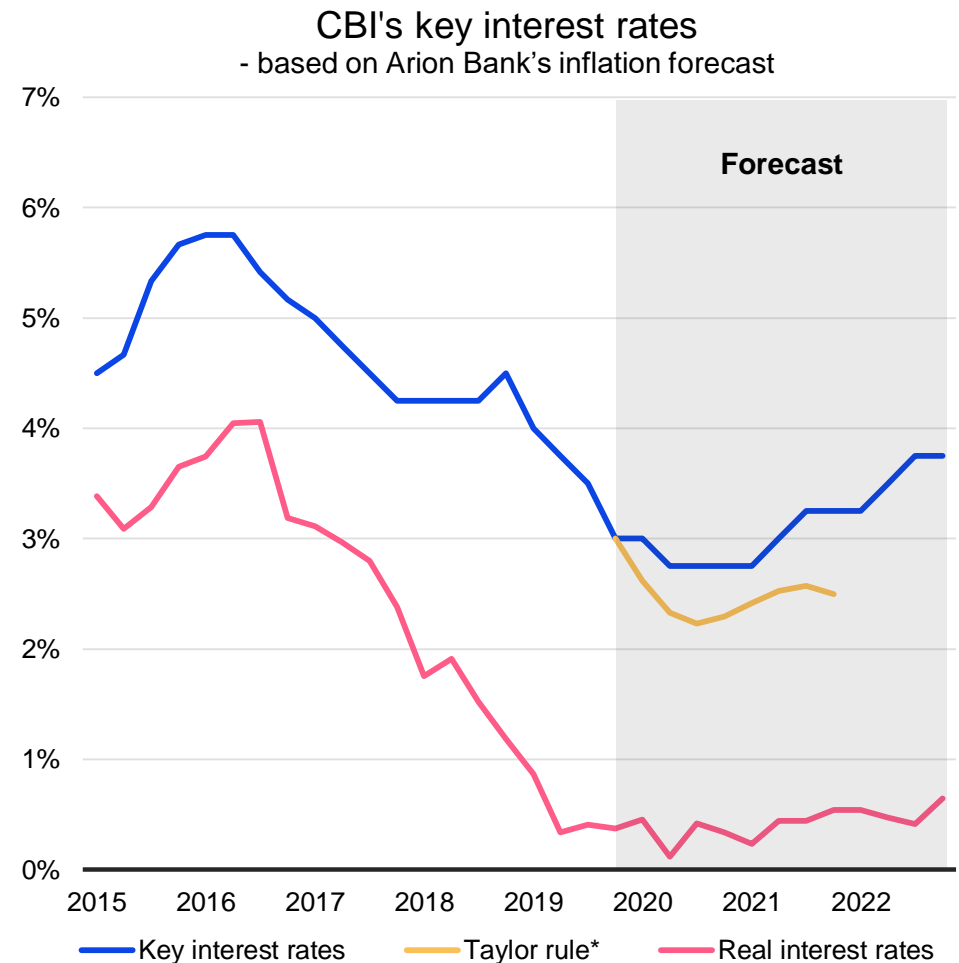
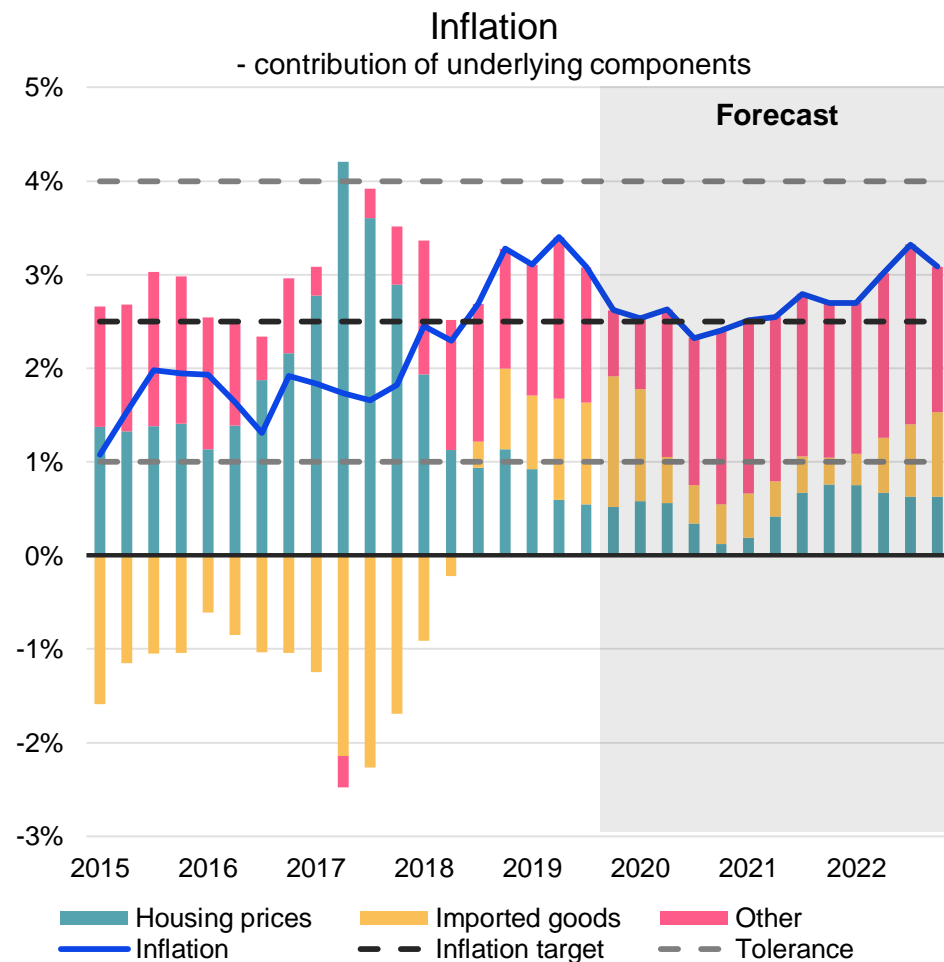
Real exchange rate

- relative prices



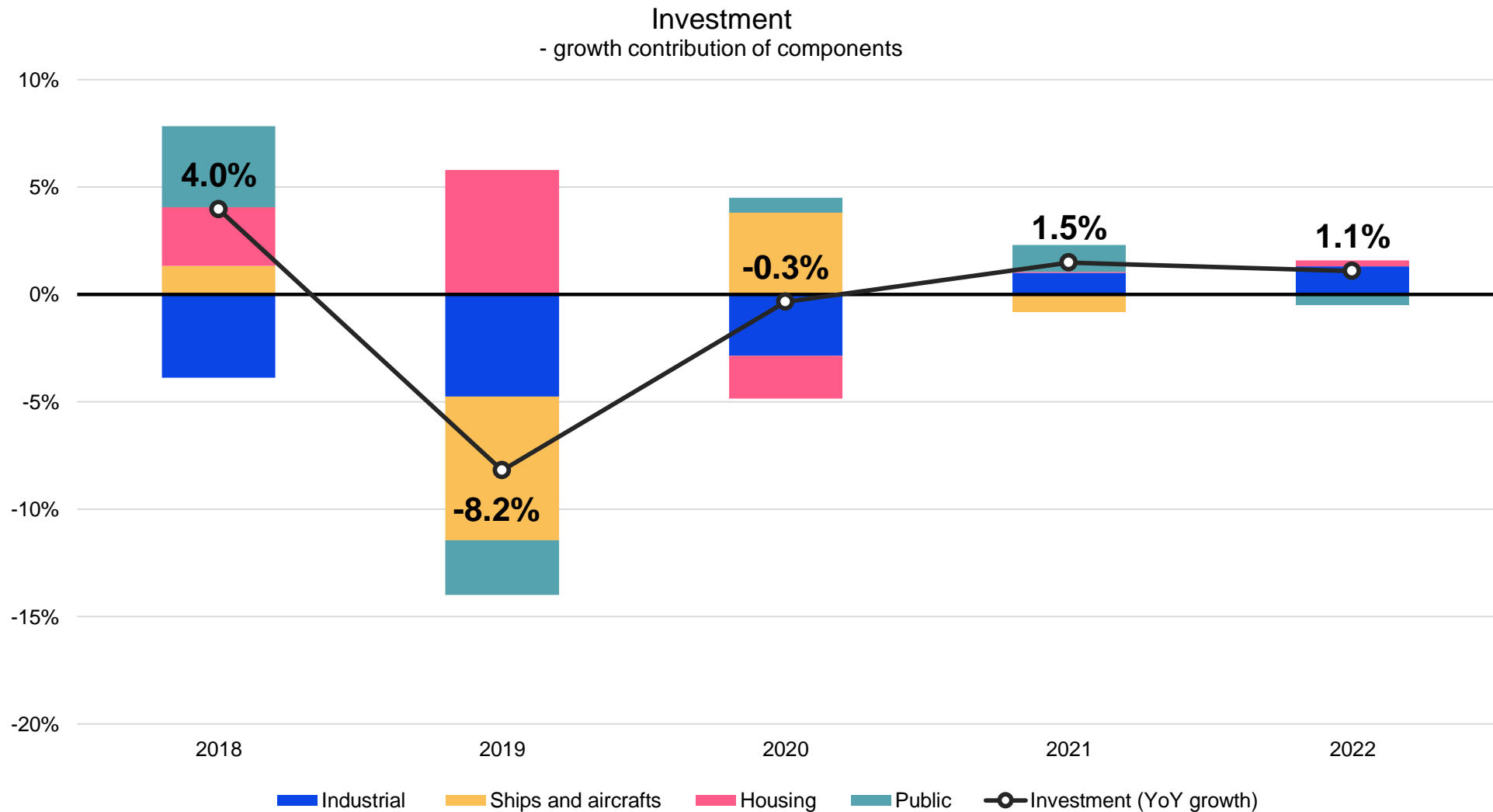
Inflation hovers around the inflation target

The Central Bank's MPC has hinted that further rate cuts are not in the offing, unless the economic outlook deteriorates compared with the bank's baseline forecast. In our opinion the Central Bank is overly optimistic when it comes to next year's economic and investment growth. Because of that, we expect the MPC to cut rates further next year to stimulate the economy.



Investment is hard-pressed

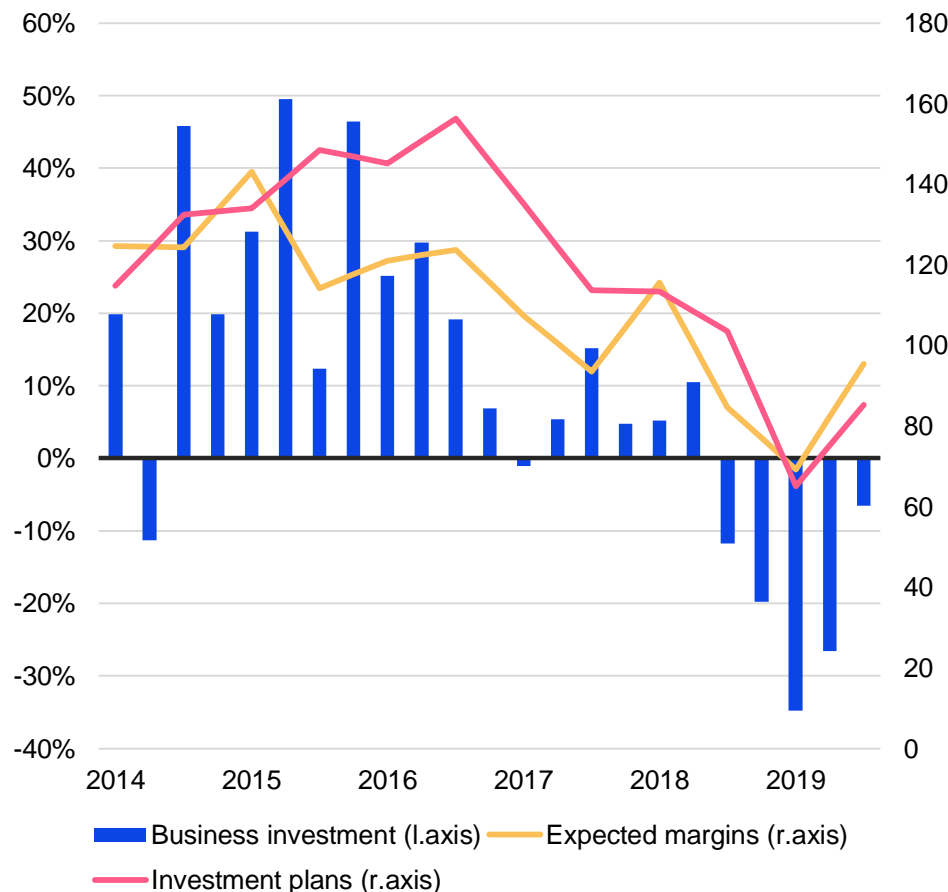
Despite rate cuts, it appears that general business investment will continue to decline well into next year. The drop in housing investment and the growth in investment in ships and aircrafts is explained by base effects.



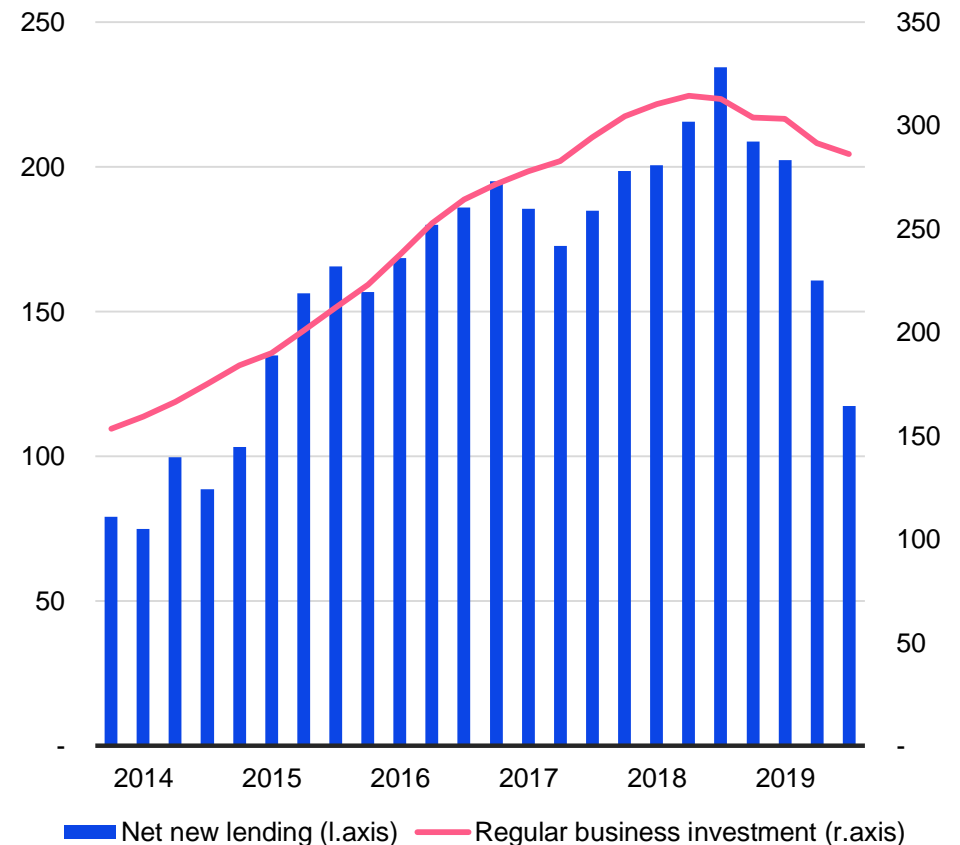
When will we see growth?

General business investment has declined six quarters in a row. Rate cuts have thus yet to materialize in investment figures, and in lending figures of the banking system. In light of this, and a slower economic recovery, we don't expect to see growth until late next year.

Business investment and its indicators
- YoY %-change and indices

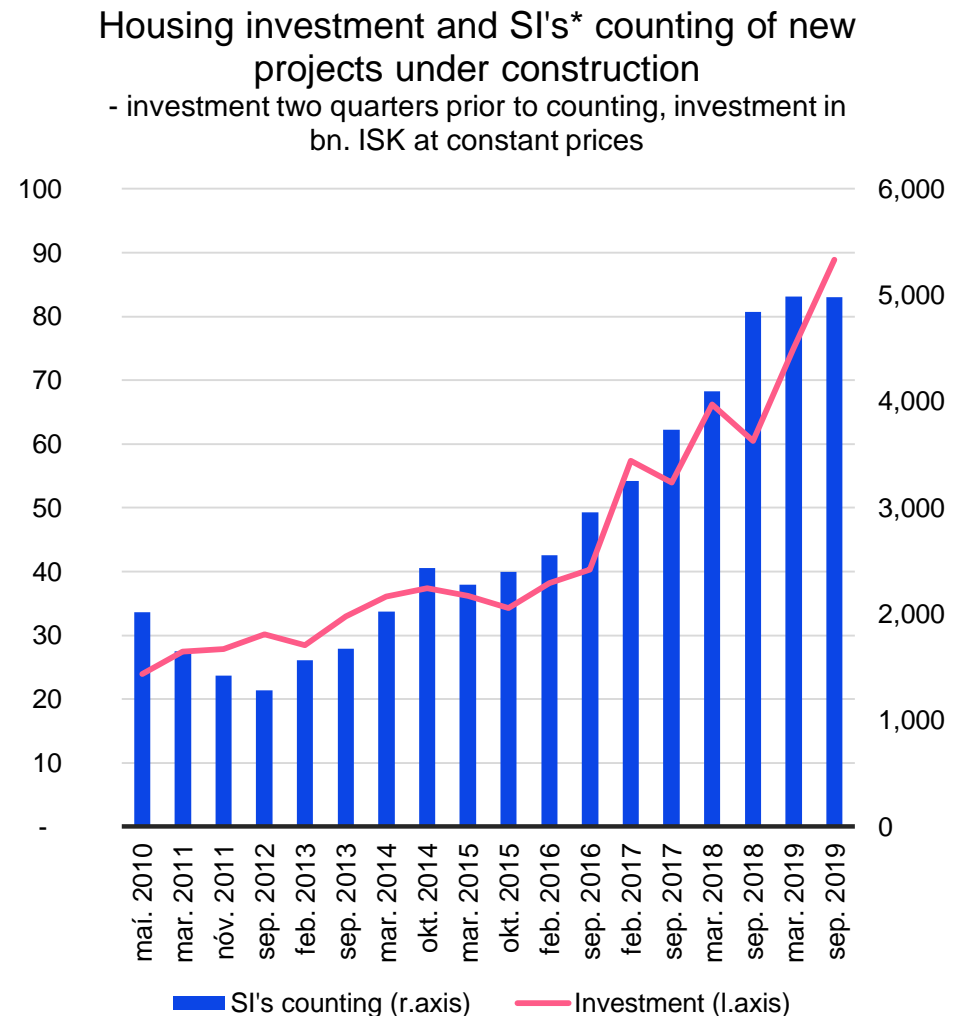
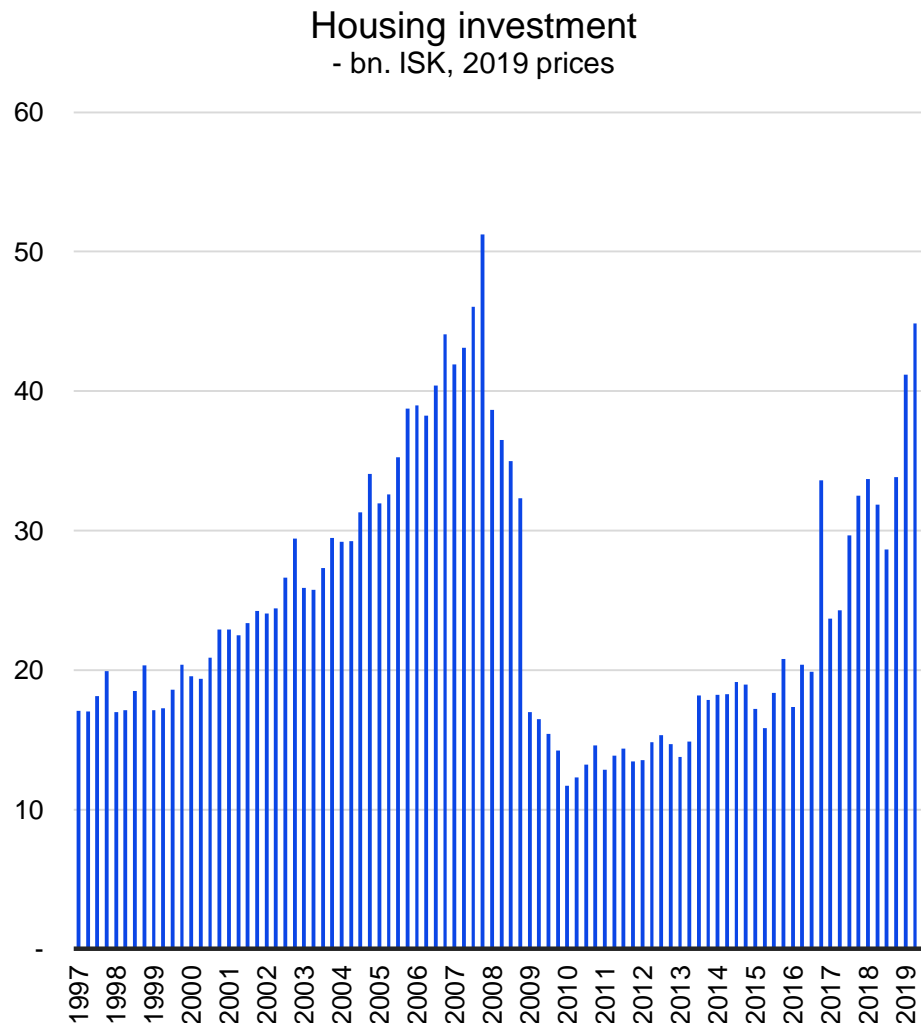


The banking system's loans to corporates
and regular business investment
- bn. ISK nominal prices



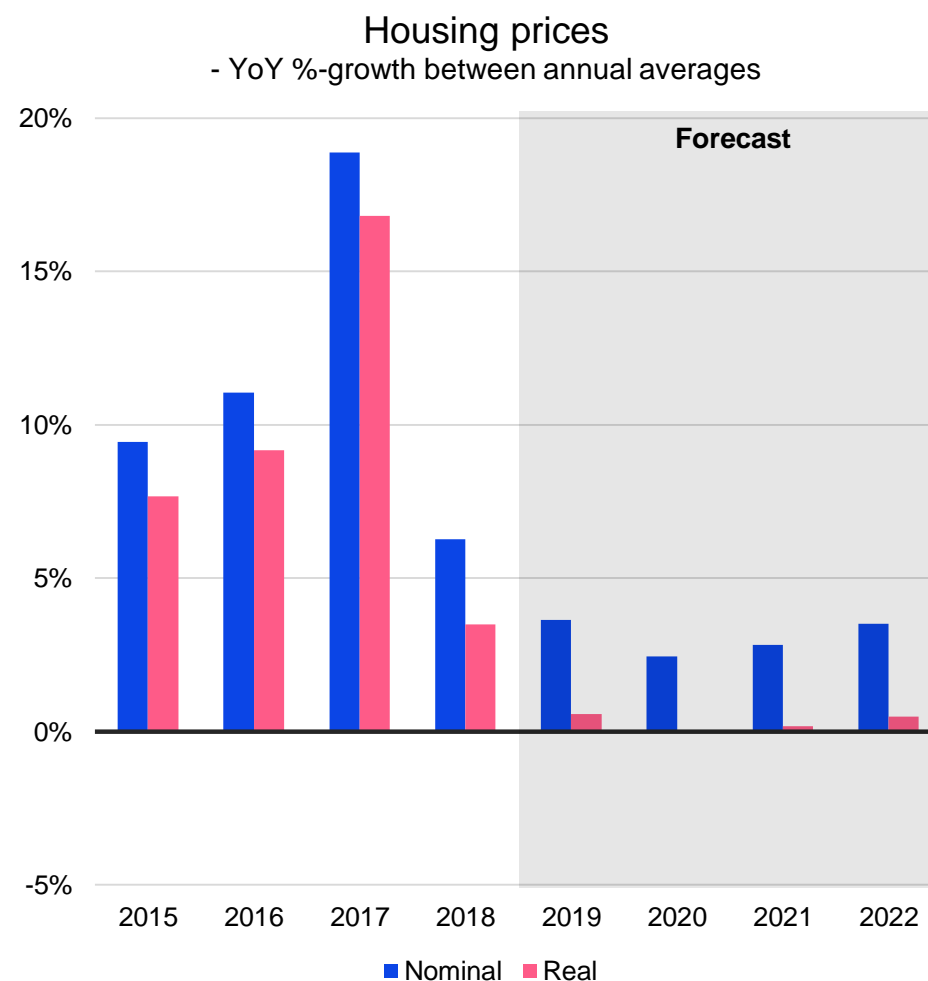
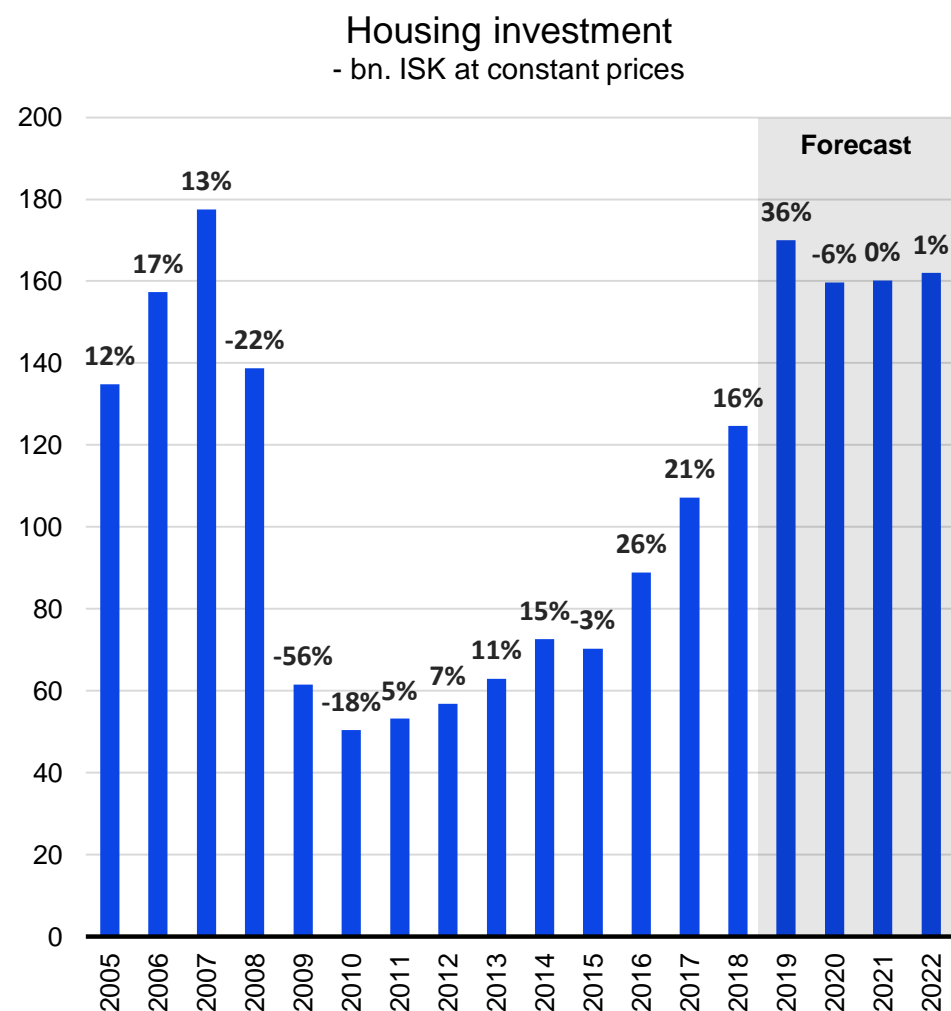
Wait, what is happening with housing investment?

Housing investment in the first 9 months was only ISK 1 billion less than the first 9 months of the record breaking 2007! Is this real investment or a registration problem? A survey by SI suggests the latter.



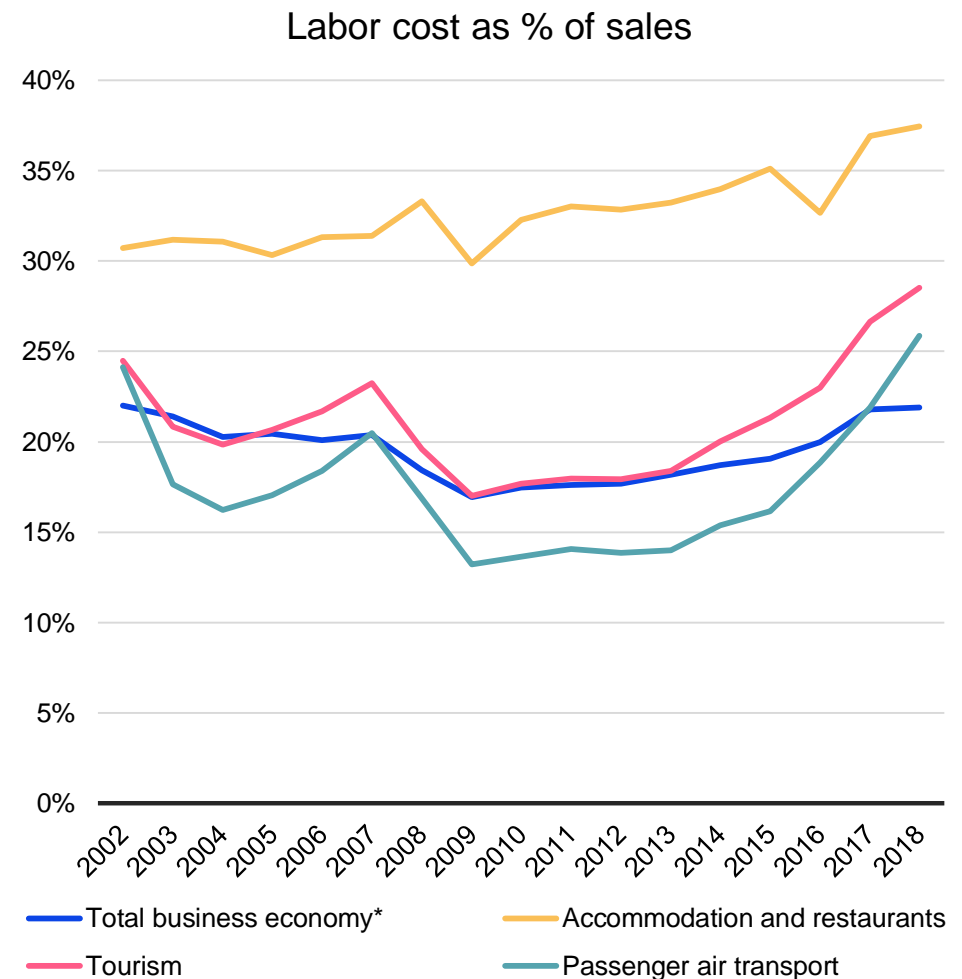
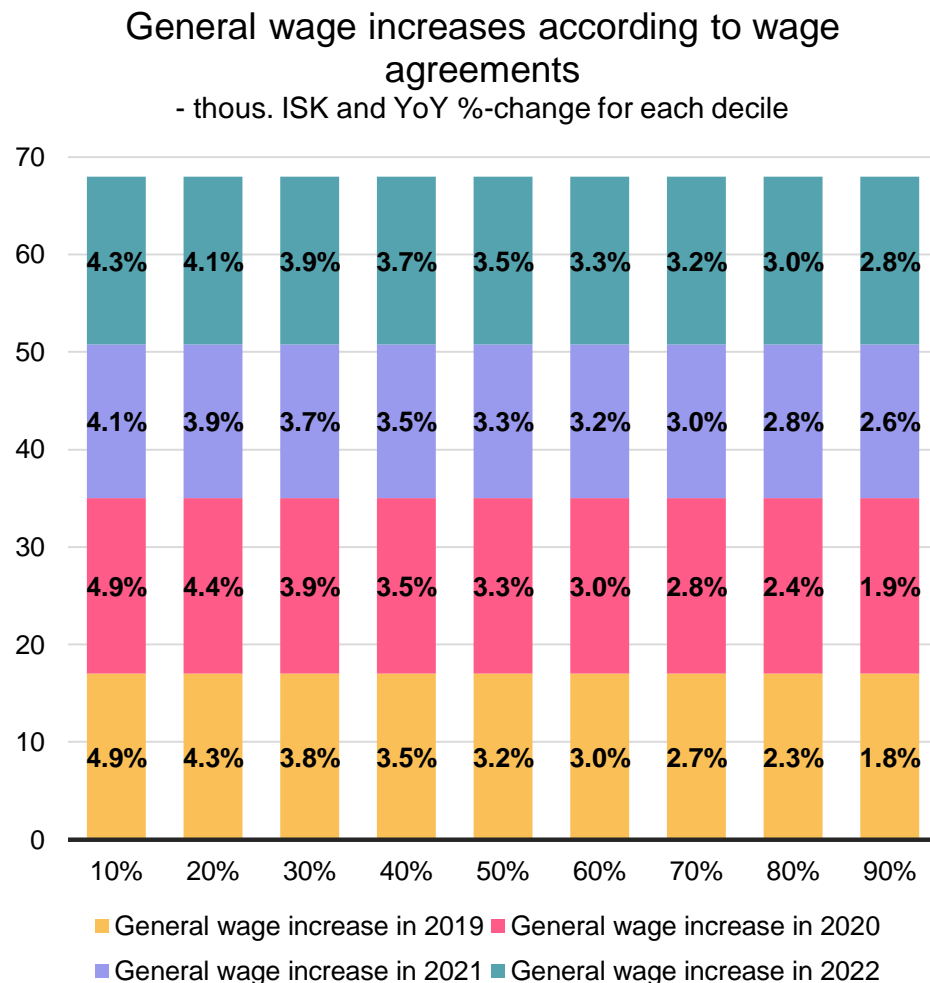
Interest rates and government measures support housing market

Despite an increase of new properties over the forecast period, we expect that nominal housing prices will continue to increase. A drop in investment in housing next year is largely explained by the massive increase this year, which in all likelihood does not reflect the actual construction of new housing at present time.



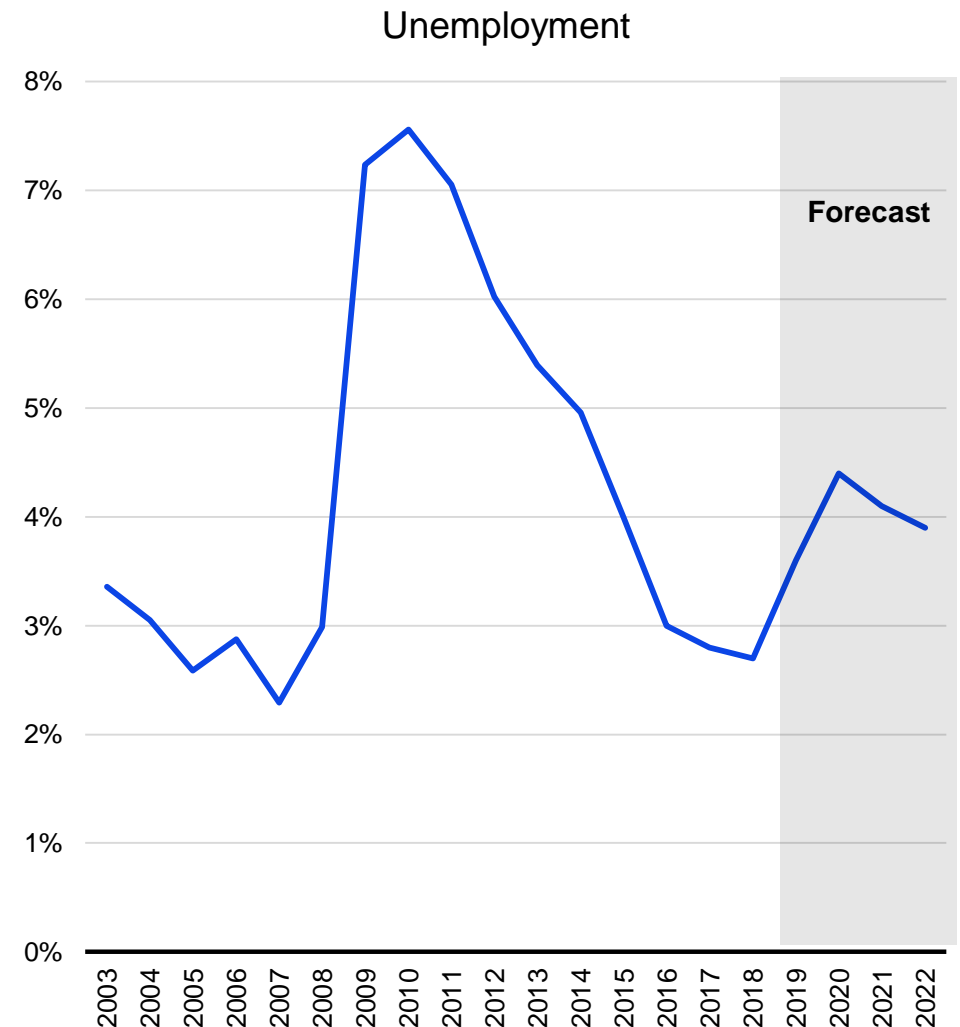
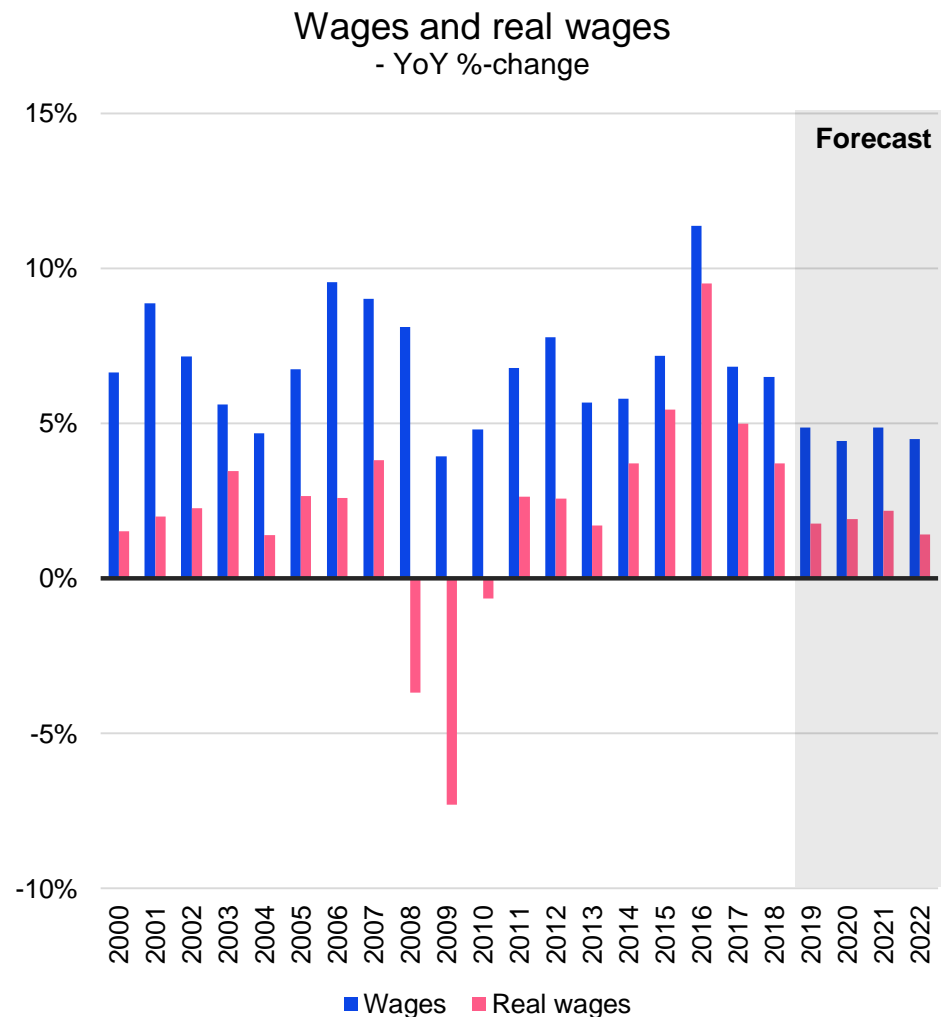
Moderate wage agreements, at least historically

Although the collective wage agreements negotiated this spring made more moderate demands than we expected, representing a step in the right direction, they nevertheless provide for substantial wage increases which could prove difficult for companies which already have high wage ratios.



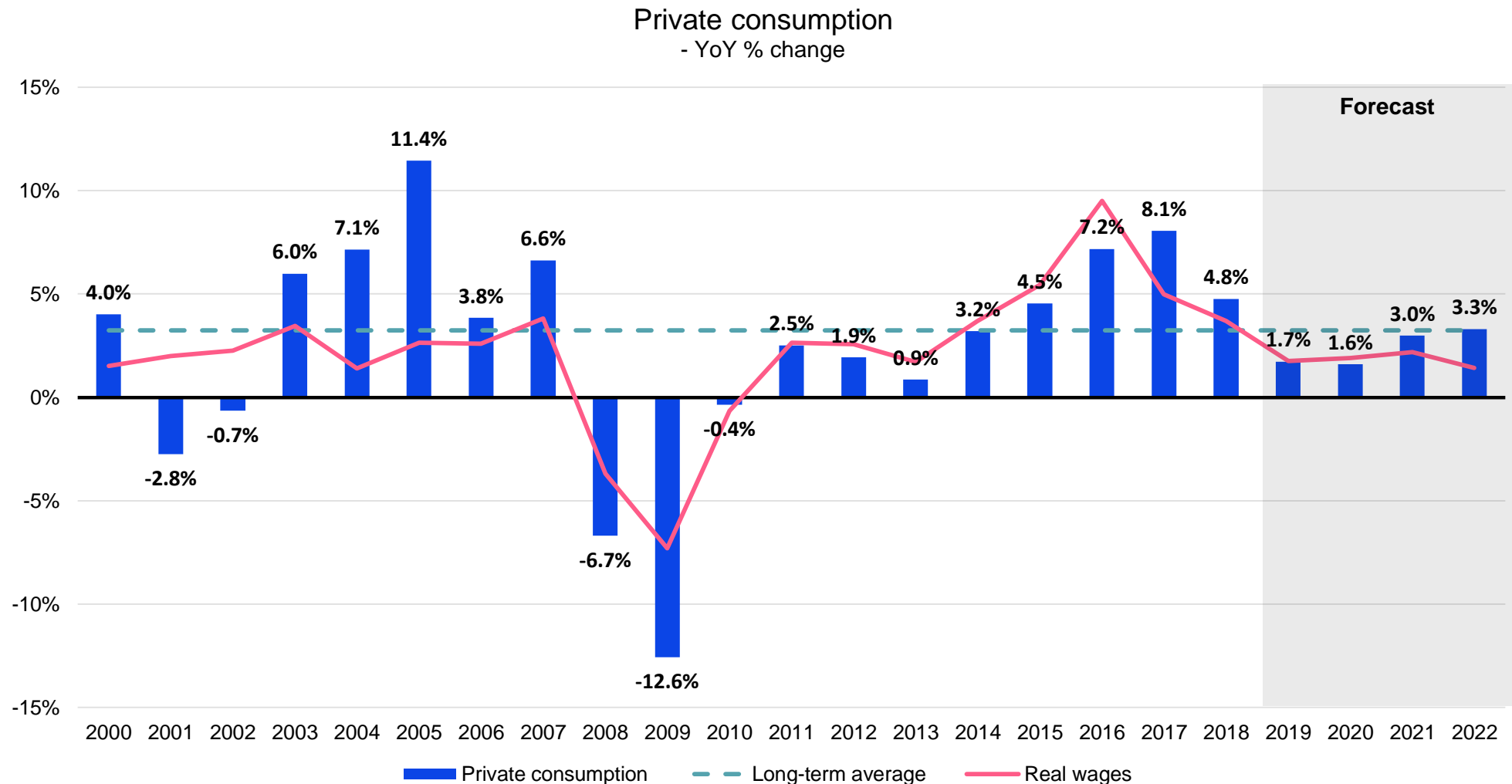
Economic adjustment through the labor market

We forecast moderate wage increases, historically speaking, and rising unemployment, which will peak next year



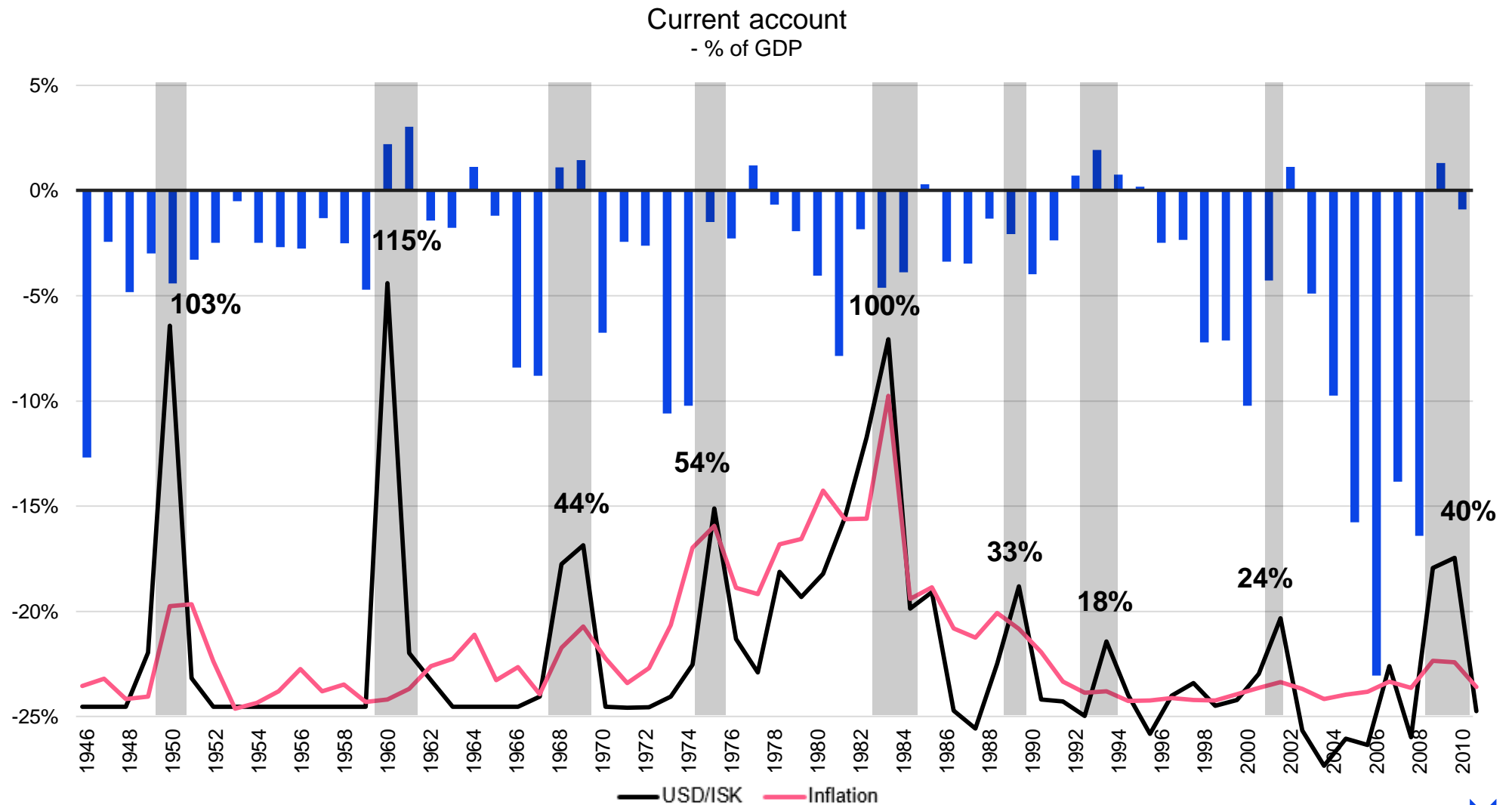
Households cutting their coats according to their cloth

Private consumption growth has slowed down and we forecast this to continue into next year. Government measures, e.g. tax cuts, support private consumption over the next few years as well as real wage growth.



Getting rid of old habits

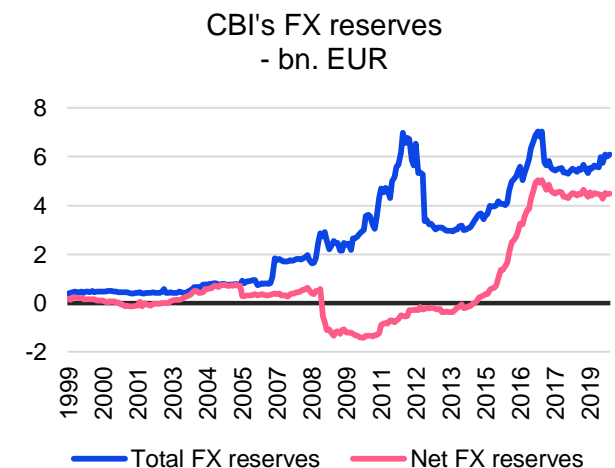
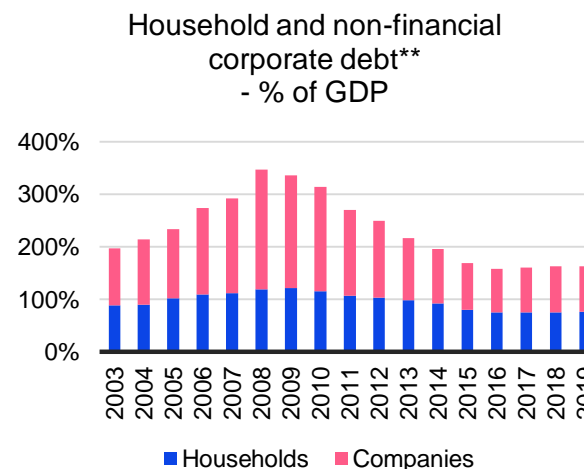
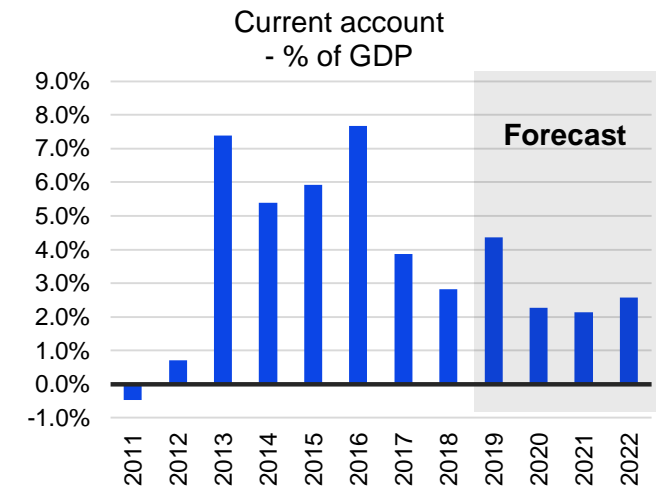
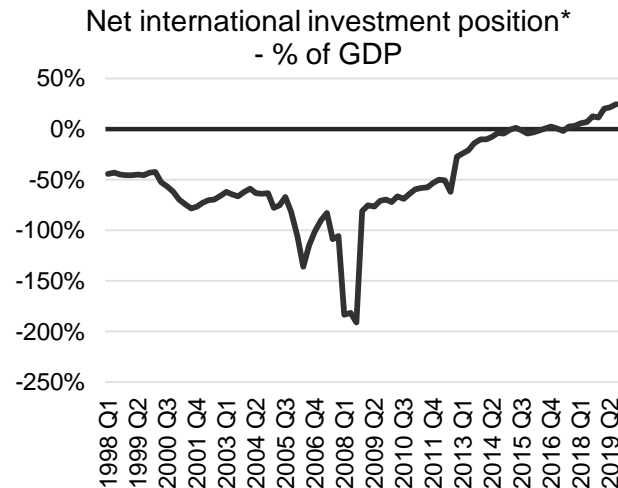
Until now growth periods have ended in overheating, debt accumulation and a devaluation of the currency. This makes the current situation that more interesting, with current account surplus, fairly stable ISK and low inflation.



There are risks but we are in a good position

As always, certain risks exist, but this time around we are well equipped to handle a slowdown. Even if the economic outlook deteriorates further, the economy is well prepared to withstand it.

- The main challenges facing the Icelandic economy are for example:
 - How to stimulate **business investment**, which is the mainstay of value creation in the economy?
 - Are **interest rates** effective? Will rate cuts result in increased investment?
 - Is flexibility of the **labor market** in jeopardy? Unemployment is increasing at same time as wages rise sharply.
 - Is yet another cycle in the **housing market** ahead?
 - How will the **tourism industry** fare when it is no longer possible to rely on increase in tourist numbers?
- Furthermore, the international economic outlook has deteriorated, reducing demand for Icelandic goods.



Main economic indicators

GDP components

<i>Change from previous year (%)</i>	2018	2019	2020	2021	2022
Private consumption	4.7	1.7	1.6	3.0	3.3
Public consumption	3.5	2.8	2.8	2.1	2.3
Investment	4.0	-8.2	-0.3	1.5	1.1
<i>Business investment</i>	-4.1	-17.6	3.1	0.3	2.1
<i>Housing investment</i>	16.3	32.8	-6.0	0.2	1.2
<i>Public investment</i>	28.3	-16.4	7.9	8.0	-2.7
Domestic demand	4.6	-0.6	1.6	2.4	2.5
Exports of goods and services	1.7	-6.2	-0.9	3.3	2.5
Imports of goods and services	0.8	-8.8	1.3	4.4	2.2
Gross domestic product (GDP)	4.8	0.3	0.6	2.0	2.7



Main economic indicators

<i>Proportion of GDP (%)</i>	2018	2019	2020	2021	2022
Current account	2.8	4.4	2.3	2.1	2.6
Investment	22.3	20.9	20.8	20.6	20.6
<i>Change from previous year (%)</i>					
Inflation	2.7	3.0	2.5	2.6	3.0
Nominal wages	6.5	4.9	4.4	4.9	4.5
Real wages	3.7	1.8	1.9	2.2	1.4
Housing price	6.3	3.6	2.4	2.8	3.5
Real housing price	3.5	0.6	-0.1	0.2	0.5
Real effective exchange rate	-2.9	-6.6	0.3	1.4	-1.4
<i>Annual averages</i>					
Unemployment (%)	2.7	3.6	4.4	4.1	3.9
EUR/ISK	128	137	138	137	140



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