Quarterly Outlook

SAXO BANK

Q4 2009

The Japanization of Financial Markets

There is growing evidence that record fiscal and monetary stimulus has mitigated an extremely negative outcome in the global financial system and economy. Most indicators of economic activity are stabilizing, but at very depressed levels. Prices, however, are continuing to drift lower – both with regards to Housing and the general price level, which is suffering from massive lay-offs, uncertainty and deleveraging. We believe that consumer deleveraging will continue for years and that the demand will stay subdued. Especially the monetary stimulus is likely to continue and that might foster a "Japanization" of financial markets. In other words, we might see even higher P/E's and lower yields on both corporate bonds and treasuries. Government budget deficits will continue to result in sizeable issuance of treasuries, but it appears that increased savings and deflationary pressures will stand in the way of higher rates… for now.

DAVID BAKKEGAARD KARSBØL
CHIEF ECONOMIST

David Karsbøl is Chief Economist and Head of the Saxo Bank Strategy Team. He is responsible for the overall macroeconomic views of Saxo Bank. He has a Master's degree in Economics from the University of Copenhagen, where he specialised in finance, statistics and monetary economics.

David Karsbøl concentrates on Business Cycle Analysis and subscribes to the reasoning of the Austrian School of Economics (Menger, Schumpeter, von Mises, von Hayek etc.). He believes that an understanding of debt cycle is integral to understanding the general business cycle. He started in Saxo Bank in 2003 as a macro strategist and joined the Strategy Team two years later. He has headed the Strategy Team since summer 2007.

David is one of the bank's most visible strategists and his contrarian thinking has made him a frequently quoted commentator on macroeconomic issues and he is a regular contributor to CNBC Europe. David is available for comments on the macroeconomic situation and forecasts.

CHRISTIAN TEGLLUND BLAABJERG
CHIEF EQUITY STRATEGIST

Christian Tegllund Blaabjerg is responsible for the overall equity view of Saxo Bank. He has a Masters degree in Political Science from University of Aarhus and a degree in Finance from Aarhus School of Business.

Christian works with equity market and single stock analysis using a top-down approach. He identifies macro forces that could affect the investment environment before they become obvious, and then focuses on individual issues within sectors and single stocks to determine how they will be affected, whether they can capitalize on them, and if the stocks are attractively priced.

Christian appears regularly on major financial networks including CNBC and Bloomberg and in printed media. He is available for comments on equity markets and major companies.

JOHN HARDY
CONSULTING FX STRATEGIST

John Hardy graduated with honours from the University of Texas at Austin and is Consulting FX Strategist for Saxo Bank. John has developed a broad following from his popular and often quoted daily Forex Market Update column, received by Saxo Bank clients and partners, the press and sales traders.

John is a regular guest and commentator on several television networks, including CNBC and Bloomberg. He also writes regular ad-hoc commentary focusing on the major currencies, Central Bank policies, macroeconomic trends and other developments. He is also one of the authors of the Saxo Bank Yearly Outlooks and 10 Outrageous Predictions.

MADS KOFOED
MARKET STRATEGIST

Mads Koefoed is a Market Strategist at Saxo Bank and has been part of the Strategy Team since May 2009.

Mads' primary focus is macroeconomics and equities, and he is responsible for the Bank's Cross Asset Research. In addition, Mads will focus on the development of the Strategy Team's econometric models.

Mads has a Master's degree in Economics (cand.polit) from the University of Copenhagen, where he specialised in finance and econometrics.

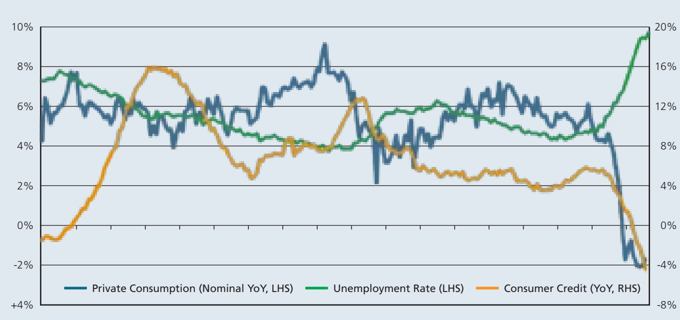
Prior to joining Saxo Bank, Mads spent two years with Danske Capital, where he worked in the Danish Equities team.

The American economy will return to positive GDP growth in the second half of the year, but the sustainability of this growth is questionable and will be due in large part to government spending and inventory restocking. The American consumers, meanwhile, are still on life-support as balance sheets are deleveraged.

Americans have hit the brakes in terms of spending and are only willing to consume when the government dangles a carrot in front of them. Apart from such taxpayer-funded consumption, income is used to pay off debt – some 110 billion in consumer debt alone from the peak – and a slowdown is nowhere in sight.

There is no point denying that the stimulus packages work – momentarily, at least. The auto rebate (cash for clunkers) will provide a welcome boost to Q3 private consumption (and Q4 inventories), but we worry that most of this is simply forward pulled demand and will instead be missing in 2010. The housing market has stabilised of late and sales are once again increasing. This will also boost private consumption in Q3 and Q4 and help make the American consumers appear healthier than they actually are.

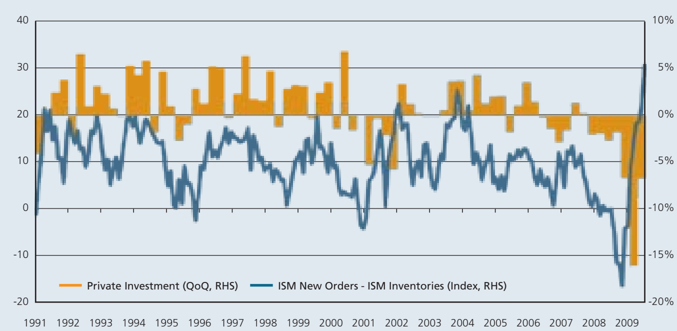
Private Consumption, Consumer Credit, and Unemployment Rate



Other problems besides debt exist, however. Unemployment keeps rising and will – if past recessions are anything to go by, continue to do so for many months. This will hinder both debt repayments and consumption as demand is not pent up to the same degree as savings are going into balance sheet restructuring instead of actual savings.

Expectations abound that inventory changes will drive GDP growth in the second half of 2009, and we reluctantly embrace this view – for Q4 at least. Some restocking of inventories will eventually take place as stockpiles are depleted, but we remain sceptical that the effect will be as large as expected (business inventories for July fell another 1% and were revised down for June to 1.4%). The inventory-to-sales ratio is still elevated relative to the trend in the last decade and will come down even further in Q3 as businesses remain wary of refilling their inventories until more signs of a sustainable recovery are present.

ISM New Orders - ISM Inventories and Private Invstment



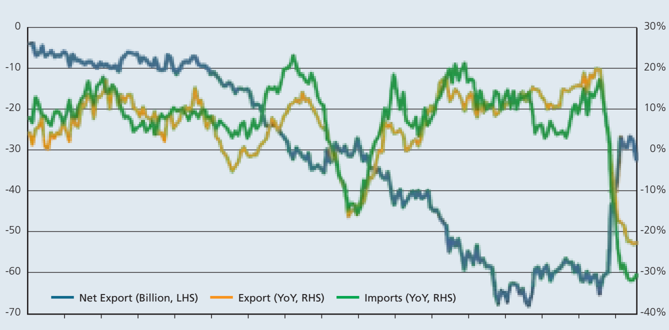
Q4 GDP growth will be aided by inventory changes as auto dealers seek to replenish inventories from cash for clunkers. Their inventories are running low and we expect some restocking to occur in Q4. In addition the gap between ISM new orders and ISM inventories and orders for durable goods are rising rapidly and confirm our expectation of pending inventory replenishments in the fourth quarter.

US government spending has been rampant in Q2, but the government faces two obstacles that must be addressed for it to provide the same amount of growth to the third and fourth quarters. First, national defence rose by a ridiculous amount in the second quarter after a first quarter decline. The growth in national defence spending must continue at the same pace (13.3%), otherwise it will reduce GDP growth. Second, part of the debt-financed stimulus introduced through transfer payments is not being used for consumption as intended. Instead, American consumers are restructuring their balance sheets by paying off debt. This is recognised as savings in the national accounts, but should not be confused with private investment. Until balance sheets are restructured, savings will not go into securing long-term growth through investment but rather to reduce debt.

State and local spending, which increased 3.6% annualised, contributed nicely to second quarter GDP and it is questionable whether they can keep this up. Tax receipts are way down and many states have problems balancing their budgets. To achieve this they need to cut spending, increase taxes, or further draw down their already practically depleted funds.

Alongside government spending, net exports were the main positive contributor to second quarter GDP (1.60%). We do not expect the rapid improvement in net exports – which was caused by large declines in exports, but even greater declines in imports – to continue in the second half of the year. Trade flows are on the rise again – albeit from very low levels – and imports are actually rising faster than exports despite the crumbling dollar. Oil has risen from low levels earlier this year and will need to fall again for net exports to contribute positively to GDP in Q4.

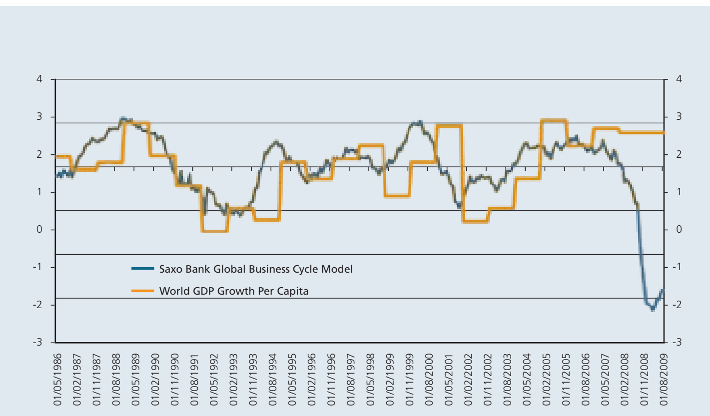
Net Export



Fiscal stimulus on the grandest scale ever seen will make sure that the largest economy in the world posts positive growth rates in the second half of the year. Government spending will remain high in Q3 and Q4, but the effect is smaller transfer payments ending up as private savings. Private gross investment will contribute less negatively in the third quarter compared with the second quarter, while actual inventory restocking is expected in the fourth quarter. Inventories will, in other words, take over somewhat from government spending as the main driver of growth come Q4. Net exports have done what they can to support growth, but will not contribute much going forward. The American consumers will contribute somewhat to third quarter growth, but it will mostly disappear again in the fourth quarter due to debt repayments and unemployment.

Market consensus for US Q3 annualised GDP growth is 2.7%. We expect 3.0%.

Our Business Cycle Indicator is showing a beginning turnaround in economic activity. It has actually showed a slight improvement in each of the last five months. But since the indicator itself is built to show whether the economy is accelerating or decelerating, a reading as negative as the one from the last half year is still not very comforting.



Although we are sceptical about the current market rally in risky assets and believe that the voracious growth that is currently priced-in will disappoint, it is perhaps too easy to be pessimistic. So many things – and especially the huge debt burden in Western economies – are negative. It is in times like these that we have to remind ourselves that growth is a natural state in the economy. Humankind is able to restructure society in multiple ways to encompass changes in economies, risk-willingness, natural resources etc.

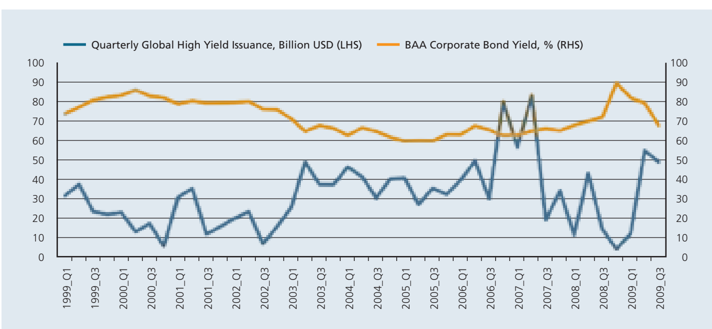
It more and more looks like we have entered a new regime, in which everyone assumes that big companies – whether financial players, blue chip companies or Eastern European countries – will be bailed-out, if need be. In such a scenario, default risk needs to be "priced-out", which means higher price/earning ratios and lower yield on everything. It is increasingly evident that the scenario bears a close resemblance to post-1990 Japan.

What happened in Japan was a deep reluctance to make big companies fail (especially banks). A combination of bad debt, deflation, negative demographic development, cultural preferences and Ricardian Equivalence has pushed down yields on all Japanese assets. In retrospect, it looks like the only thing that has gone higher in Japan is government debt levels and perhaps the price earning on the Nikkei. Half the time since 1990, the Nikkei has been trading at a P/E of more than 73. This amounts to not one, but two lost decades with miserable (but positive) growth, eternal deleveraging and falling home prices.

We don't think that things will get as bad in the Western economies. Our flexibility is bigger (although our savings aren't) and our culture to a larger extent embraces the necessary change. Furthermore, asset prices probably didn't get as much out of sync with reality as they did in Japan in 1990. But we do believe that we are witnessing a small-scale Japanization of financial markets. The P/E on all global stock indices have shifted markedly higher in the past half year and the "search for yield" that characterized 2004-2007 is again dominating the market.

The extremely lax monetary policies of Western central banks are flooding the market. Implicit and explicit bail-outs are taking impaired assets off the books of the financial sector and give them freshly printed money to park anew on the roulette wheel. The new money is pushing down yields on government treasuries and corporate bonds, which helps keeping the recovery-party going. We especially look at credit markets for guidance on how long this optimism can continue.

So far credit markets are doing quite well. Our High Yield asset management department is frustrated due to the oversubscription of HY issuance these months. Issuance is often oversubscribed by a factor of 5. Looking at total issuance, we are seeing a real return of appetite for risk.



For Q4-2009, we expect more Japanization of markets: lower volatility, lower VIX, lower yields on Treasuries and corporate debt, lower spreads. We also expect higher stock prices and target the 1121 in S&P500, which is the 50% Fibonacci Retracement in the "big picture". However, we believe that should be the top in this cycle and that the negative impact from the debt burden (lack of demand) should start to manifest itself by then.

FX: RECESSION ON HOLD - BUT FOR HOW LONG?

In our Q3 FX Outlook, we envisioned a macroeconomic scenario in which markets dove back into risk aversion mode as we felt hopes for a recovery would prove premature. Clearly this was not the case, as risk appetite remained very robust instead - punishing the USD and supporting especially the growth-sensitive commodity currencies. The recovery story has moved far enough along that the market is pricing in interest rate hikes in Q4 for the most confident central banks. Looking back, our main misjudgement was failing to appreciate the amazing power of unprecedented stimulus that not only managed to stop the meltdown, to actually reverse the negative developments and create such widespread hope. Of course, with the Japanization of markets as our theme, our view is that this recovery will prove a false dawn.

While clearly we underestimated governments' and central banks' determination and ability to resuscitate the economy in the near term, the actions of the public sector have failed to provide a sustainable foundation for a strong recovery, though they may provide enough momentum to keep the economy on life-support into the New Year. Still, in FX, we suspect that the very persistent one-way trends in risk appetite evident in Q2 and Q3 will begin to yield to more varied and treacherous action in Q4, as the market may begin to doubt the recovery's resilience.

We have tried to identify a few key themes that the market is bound to focus on as we head into 2010.

ARE WE REALLY IN A RECOVERY?
Maximum stimulus is in the rear view mirror and austerity and exit strategies are increasingly on the menu. The FX market as a whole may begin to shift away from the rosier recovery projection that is already priced in, even if we fail to move back into all out risk aversion a la 2008 just yet. This could likely mean the exhaustion of many of the trends that are currently in place in FX, where so many trades are aligned along the ubiquitous risk appetite axis. The likes of the strong AUD and NZD are the most extended if the answer is "No", though we're not sure that Q4 will provide any definite answers, which may first arrive next year.

USD WEAKNESS - HOW MUCH FURTHER TO GO?
A USD short seems to be a vote for the global recovery and has become the "newer and better" carry trade. The country's pathetic yields and need for external financing and increasing reluctance from China to buy greenbacks is a toxic cocktail that could drive the currency even weaker in the near term. There may be enough momentum already in place for the weak USD trade as we head into Q4 to see another modest leg down for the greenback, but if volatility rises again in the new quarter, the USD devaluation story may falter ahead of the New Year. Already, market positioning in this trade has become stretched. Perhaps the quarter will see a new low since last summer and then the beginning of a comeback attempt.

WILL WE SEE THE CENTRAL BANKS BEGINNING TO ROLL OUT THEIR EXIT STRATEGIES AS CURRENTLY PRICED IN?
The market has priced in tightening for most of the major central banks, the more aggressive ones like the RBA and Norges Bank starting in Q4, while the Fed is not seen tightening until the spring of next year. Will these predictions prove accurate or is exit strategy talk premature? As the stimulus fades, all eyes will be focused on whether a real recovery can gain altitude of its own accord. The beginnings of a tightening regime may lay the foundation for unwinding some of the moves we have seen since March, though Q4 may be a bit premature to call for a full reversal.

THE EUROZONE - ARE ANY SPECIAL RISKS FOR THE SINGLE CURRENCY?

The Eurozone is in the crosshairs as Q4 gets underway with the Irish referendum on the Lisbon Treaty in early October. Ireland is among the Eurozone's many economic weaklings, all of whom are suffering with high unemployment, imploded asset markets, ugly current account deficits and a too-strong currency. A recovery is nowhere in sight as we head into Q4 for these weaklings and we still have to wonder to what degree many large Eurozone banks have swept their problems under the rug. Challenging the viability of the Eurozone is premature here, but internal strife could certainly become more evident in Q4 and give reflex buyers of overvalued euros a pause.

FORECASTS FOR Q4:

USD: The sell-off will not turn disorderly - EURUSD maintaining above 1.50 for long is unlikely assuming that the equity market bull doesn't go into overdrive. A very weak Christmas shopping season out of the US is likely to remind the world that the US consumer is out for the count. Seasonality is against the greenback if we are to take recent history as a guide, so picking entry points may be a challenge, but we could see a bottom for the greenback in Q4.

EUR: The ECB has turned very dovish relatively to its formerly brave rhetoric. It is unjust to watch as the euro has appreciated against the likes of the renminbi over the last six months - as the world's imbalances will not be aided by continued knee-jerk reserve diversification and EURUSD buying. The EUR has already been extraordinarily weak vs. the AUD and other riskier currencies, so it may not be a "high beta" weakling if the going gets tougher for risk appetite at some point in Q4, but it could weaken against GBP, JPY and the USD if we see a shift in the market paradigm in Q4.

GBP: The tendency may be for the pound sterling to strengthen relative to the higher beta currencies in the G-10 if risk appetite begins to finally wane at some point during Q4, but at the same time to weaken versus the JPY and the USD. A pair like GBPAUD is certainly at remarkable, near multi-decade low, and we wonder if this kind of action within the G-10 is getting overstretched.

Chart: The USD is the new carry trade as this chart shows: here the USD is shown together with the VIX measure of equity market volatility, global emerging market equities, and spreads on US treasuries versus Emerging Market bonds. (Note: all lines are inverted except for MXEF, the pink line showing EM equities)

JPY: The market will have a new government to try and acquaint itself with. JPY seems likely to remain in solid shape as long as interest rates remain very low and it is unlikely that the BoJ indulges in JPY-weakening attempts like it has in the past, especially with the change of political guard. However, even a modest rally in rates combined with another extension up in equities could mean bouts of weakness in Q4. Eventually we would expect the JPY to show signs of more durable firming against the commodity currencies.

CHF: The Swiss franc has lost its correlation with risk appetite, and may have received a boost from the persistent rally/resilience in bonds and the stabilisation of key CEE currencies (due to their heavy indebtedness in CHF-denominated loans) over the last quarter. Does that make it a surprisingly risky currency if the pendulum swings the other way now? A CHF forecast is also complicated by the cat and mouse game of determining when and where the SNB will intervene. GBPCHF will be an interesting trade to watch to see if it can turn the corner to the upside: while the market is punishing the pound for its QE measures, we must also remember that Switzerland is also doing its own form of QE through direct currency intervention.

CAD: The BoC is talking down CAD as a threat to the recovery. Regardless, CAD is mostly bound up with risk appetite and the global recovery scenario. The currency's recent strength is not helping Canada and the country is still very dependent on its neighbour to the south for much of its economy, and with end demand expected to be down for the count for years, it is tough to see CAD outpacing the broader market for the longer term. The current account is headed in the wrong direction and the strong CAD will not help that development. We also have the prospect of yet another election as the shaky Harper government may not survive the quarter. CAD could top out vs. the USD down within a stone's throw of parity, but then we could see it weaker against the market.

NZD: AUD and NZD have become the poster children for the resurgence in confidence that things are looking up for the global economy. We would give NZD the edge over AUD in Q4, but NZD has rallied too much and the central bank will begin to fight the appreciation tooth and nail, as the stronger currency is the last thing the country's nascent recovery needs.

AUD: The Chinese recovery has been a key for Aussie strength. If China's withdrawal of credit stimulus begins to bite in Q4, then it may become apparent that an AUDUSD north of 0.8500 and GBPAUD below 2.000 is already pricing Australia for perfection. There are a few signs in the Australian data that the speed of the recovery is faltering a bit, perhaps as the already announced stimulus measures are petering out. Q4 could be the beginning of a rockier road for the currency and the RBA's actions will be critical with the market's expectation that it will be one of the major central banks to hike.

NOK: The Norwegian krone traded sharply stronger in the quarter as oil prices rose and the market took note of the Norges Bank's more hawkish posture. NOK could continue to perform well vs. a shaky EUR and relative to other due to its unmatched balance sheet when the world is worrying about currency devaluation and due to its commodity exposure if the risk run-up barrels ahead more than expected in Q4. EURNOK may be on a path to 8.00 by mid 2010.

SEK: has performed very well with the recovery in risk appetite and the bailout of Eastern European countries - particularly Latvia. As long as the "everything will be bailed out" mentality holds, the SEK is likely to shine during Q4 and EURSEK could dip below 10.00 at times in the quarter. A blowout of EM risk spreads and decline in equities would derail the SEK recovery. Equity and risk bears should consider long USDSEK positions on dips. The Riksbank has been one of the more aggressively dovish Central Banks - interesting that the market has largely ignored this in favour of risk indicators.

REVIEW OF Q3 POSITIONS

Our Q3 currency trade portfolio ideas were sufficiently mixed to avoid major damage to the portfolio's price performance over the quarter despite the basic macro scenario not playing out as expected as we spent considerable effort trying to find trades that are not correlated with the omni-present risk appetite theme which seemed to make almost every trade an "either/or" proposition.

Performance (Jul. 1 - Sep. 15):

Short EURUSD: - 4.50% The USD was pummelled as risk appetite failed. Always gluttons for punishment, we ponder a USDCHF long for Q4.

Short GBPJPY: + 5.26% Persistently low interest rates helped the JPY, while disappointment about the BoE's persistent QE battered the pound.

Short EURSEK: + 5.74% Falling MA and general risk premia and a weak EUR were a great combination for the Swedish krona.

Short AUDNOK: +0.88% NOK caught fire in Q3, but so too did the Aussie - we'll try this trade again in Q4.

FX TRADE IDEAS FOR Q4

The basic assumption for Q4 is that no new meltdown occurs, but that the melt-up scenario starts to play itself out in the coming quarter. The main challenge to this portfolio would be a runaway bull market in equities in this memorable year's final quarter.

Short NZDJPY: (Sep. 15 rate: 64.00) Here's a risky, high beta trade for those who really want to take the risk bulls by the horns. This is an all out bet that equity markets will top out in Q4 and that the NZD longs take a longer look down the road at some point in Q4. It is also a bet that the low interest rate environment could persist longer than the market seems to think it will. Be careful, though, this currency pair's correlation with the S&P 500 in Q3 was 0.91.

Long USDCHF: (Sep. 15 rate: 1.0350) The Swiss Franc has benefited from two developments over the last quarter: continued low interest rates have been relatively supportive of this former safe haven of a currency. As well, stabilisation in CEE currencies helped to stem the risk of a default on CEE holders of CHF debt. This latter factor may have been a big contributor to the franc losing its normal correlation with risk appetite over the last quarter. This position is an attempt to find a trade among the low yielders and a way to look for a USD consolidation at some point before year-end. The pair might have a run at parity before a rebound sets in, however.

Short EURGBP: (Sep. 15 rate: 0.8875) If a Euro-negative scenario is to play out, then the valuation of the single currency vs. the pound looks very steep. If risk premia begin to widen at some point, the market may also be far less prejudicial in valuing the "QE-heavy" central banks. As with our NZDJPY and USDCHF ideas, though, there is a risk that this trade is a bit premature at the very beginning of the quarter.

Short AUDNOK: (Sep. 15 rate: 5.08) - we still like this idea from our Q3 outlook. It performed well at some points, but the broad AUD strength nearly matched the NOK in the end. This is still a trade that is all about valuation - NOK is undervalued and AUD is overvalued. Other angles include the potential for the market to get a bit nervous about the status of the Chinese recovery now that the Chinese authorities are beginning to clamp down on the credit stimulus unleashed earlier this year.

COMMODITIES: GOING INTO Q4 ON A HIGH

As we move through the last quarter of 2009 commodity markets will increasingly be looking for proof that the global economy has indeed turned the corner and will continue to recover. The sector as a whole has generally been driven by the return of risk willingness shown in the strength of stock markets and the weakness of the US dollar and, more importantly, the yen.

One year on from the Lehman collapse the market is full of the liquidity it lacked a year ago. Investors have continued to look for investment opportunities and the resulting liquidity has helped drive some sectors of the commodity market higher over the summer.

Crude oil (CL) has spent most of this time in a USD15 range with much reduced volatility compared with the panicky days seen early in the year. Expectations of a swift global recovery and fears about future supply were the main drivers of the recovery seen so far this year.

OPEC has been largely successful in changing the sentiment, despite their lack of compliance with agreed production targets. Recent comments expressing satisfaction with current levels has left the market range-bound for now.

The global oversupply has begun to dwindle, albeit at a slow pace, which leaves the system well supplied in the months ahead. Beyond this there is a chance that prices will continue to recover into the New Year, finding a new range between USD75 and USD85.

Near-term, however, we fear that recovery has been all but priced into current levels. The autumn is often the launch pad for significant market themes and there is a real risk that the chain could come off and lead to a period of negative returns. As always, given the very high correlations to the US dollar and yen we continue to follow developments in currency markets closely.

Crude oil is stuck in a USD67 to USD75.50 range at the time of writing. Continue to play the range, but look out for the risk of a break that we find to be highest on the downside, near-term. A break below USD67 leaves the market exposed for a move towards USD60, with the risk of overshooting towards the 200-day moving average at USD55 where support will be firm.

We expect year-end crude to be trading in the USD60-65 range.

Natural gas (NG) has been the focus of much debate and frustration from market participants as it continued to sell off over the summer as supply outweighed demand by a considerable margin. This resulted in spot natural gas reaching a multi-year low of USD2.41 in early September before the historically profitable trade being long NG and short of CL into the winter began to lend support.

With storage in the US filling up well ahead of the winter, only a cold snap or a pickup in industrial demand will keep it from trading weak in the weeks ahead.

Gold suddenly came back to life in early September after months of just tracking the ups and downs of the dollar, reaching the psychological level of USD 1,000 for the third time in history.

We find the timing of the break above USD1,000 a bit questionable compared with the two previous occurrences. The first time in March 2008, the dollar hit an all-time low versus the euro and a multi-year low on the dollar index. This was a time when the talk was about the EURUSD reaching 2.0000. This euphoria about a weaker dollar drove gold prices to its current record at USD1032.70.

The second time, in February this year, was in the midst of the financial crisis which drove investors into gold as a safe haven. This particular move was also aided by strong physical demand and strong inflows into ETF (Exchange Traded Funds).

During this current rally we have seen and heard of little or no physical demand and the dollar is weaker, though not as weak as the first time round. Investment flows into ETFs have been steady without any major pick up. What has increased significantly is the speculative open interest on COMEX which indicates that the move is primarily driven by short term speculators who have been looking for a big follow through on the break above USD1000.

We managed to reach a high of USD 1,024.28 before moving back to USD1,000. We recommend buying dips above USD 970 and would look for the creation of a new trading range towards USD 1,300 should 1,032.70 be breached.

However, if the all-time high is not broken, we target 950 end of year.

Grain markets have traded lower over the summer as continued perfect growth conditions in the U.S. has increased the likelihood of a record crop year for corn and soybeans. During the next few weeks look out for any forecast about frost, which could change the scenario. Also news about severe drought in China's corn producing regions could lead to increased level of imports, which again would support prices.

Much hedging and expectations are now priced into these markets and we feel the upside risk is now greater and would look for support in corn at USD300 and soybeans at USD880.

EQ: EQUITY VALUATION IN JAPAN-LIKE SCENARIO

The rally across global equity markets has been overwhelming. For our part we continue to be sceptical over whether the rally was fundamentally justified as we still anticipate a sluggish recovery in global demand. Even so, valuations are no longer as supportive for markets as they were earlier this year, making substantial gains more unlikely. First, a further multiple expansion is likely to require more visibility about the cycle, but it will in the short run most likely be driven by the large amount of liquidity in the market and second, substantial earnings upgrades are likely to require a stronger growth trajectory than now appears likely.

As we are looking towards end of the year, market dynamics indicates a shift from the main drivers of this year's performance. We anticipate a shift away from macro trends towards micro trends. In particular we expect that the outperformance of cyclical, high beta, high risk and low quality has run its course and instead heading towards a more balanced portfolio driven by specific growth and valuation properties. We especially advise underweighting financials due to relaxation of accounting standards.

We believe investors should continue to take cyclical risk through regional allocations. We remain positive towards emerging markets, while we are more sceptical towards Europe and the US.

WHAT WE HAVE SEEN SO FAR THIS YEAR

During the latter part of 2008 and 2009, the sharp rise in equity premiums and associated collapse in market multiples suggest that global equity markets were driven mostly by fear. In addition, worries about growth prospects were acute, which led to a substantial downgrades in earnings expectations. This led sectors and stocks more exposed to cyclical risks to underperform in many cases resulting in extreme valuation imbalances.

As economic indicators began to stabilise and policy initiatives took hold, equity markets rebounded as disaster scenarios were averted. The global equity market rallied 59% from the March lows through August. This move has been accompanied by substantial increase in risk appetite. Moreover cyclical sectors have substantially outperformed (by more than 30% from March to August) more defensive sectors. The consequence has been that cyclical relative performance has rebounded back to September 2008 levels. Furthermore the relative valuation case for cyclical has become much less supportive and consequently we believe the period of broad cyclical outperformance is largely done.

WHERE WE ARE HEADING
– TOWARDS EMERGING MARKETS

We believe a shift in performance trends is likely. As valuations have moved closer towards estimated fair value (the MSCI World is close to 14x forward 12-month earnings) and a number of economic headwinds remain, we see the influence of recent market drivers as likely to moderate. As we argue in "The Japanization of Financial Markets", multiples might go even higher, since most of the default risk has been avoided due to government interventions, but earnings are not likely to improve significantly from here.

In our view a unifying driver (increased risk appetite) will not drive markets as we have seen since March. Rather, many different factors will drive markets, suggesting that micro trends will become more important. Hence, we believe sector-specific growth and valuation stories will be increasingly important driving markets. An important part in these stories will be the different growth outlook for regions – where growth can be maintained and improved.

As we are moving away from an outright defensive allocation under the assumption that market continues to price in a normal earnings recovery we suggesting three themes will be the important drivers within sectors – namely: 1) Domestic cyclical recovery, 2) Global secular growth and 3) Dividend growth. Following these themes we are exposing ourselves towards energy, materials and consumer staples. We reiterate that we do not suggest entering long positions in financials, despite the rally within this sector due to relaxation of accounting standards. This relaxation has led to a situation where it is very difficult to perform a valuation of banks because there are no standard after which their assets is valued on their balance sheets.

This cyclical risk exposure should however be moderated within a regional setting. In that regard we prefer an overweight position in emerging markets and underweighting Europe and the US.

EARNINGS AND INDEX FORECAST

On the back of our expectation for earnings development within the next year (12 month forwards) we revise our earnings growth expectations marginally upwards. We are especially concerned for the European and the US earnings growth development.

Figure 1: Earnings Estimates 2008/2009 YoY

	Europe (Stoxx600)	**US (S&P 500)**	**Japan (Nikkei225)**
Old Expected Earnings Growth (ex.financials)	-46%	-40%	-50%
New Expected Earnings Growth (ex. Financials)	-44%	-39%	-50%

On the back of the recent rally in equity markets, we are revising our lows estimate for 2009 higher compared to the prior estimate. Despite the fact that we believe that the current rally is driven mostly by psychology and we observe a significant overshooting, we do not expect the lows from March being taken out within the rest of this year. As a consequence our estimates for the lows during the remainder of 2009 are higher than the ones reached in March.

Figure 2: Equity Index Targets based on DMM simulations.

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	18 March 2009	**Lows 2009 (March)**	**Estimated lows in the remains of 2009 based on DDM valuation**
DJ Stoxx600	171	158	212
S&P500	794	667	975
Nikkei225	7972	7055	9238

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