June 10, 2010

Equity Strategy Outlook

Hot topic: Stormy weathers ahead

- **Summary:** Very short term we are concerned on the development in European sovereign debt markets. The usual warning signals are all flashing red – the CHF getting stronger, gold making new highs and yield spreads between Germany and the PIIGS countries is getting wider. If this theme plays out equities will be sold off heavily and the process will bring back memories around the Lehman collapse in 2008. For sure this will be a reoccurring theme throughout the summer and will make a significant contribution to keeping volatility high. So in terms of equity positions – it is time for caution.

- **Short run view: BEARISH.** In the next 1-3 months we have bearish stance on equities. For sure we expect a strong Q2 earnings season due to base effects and this will most likely boost equities, but the continuous concern in sovereign debt markets on the PIIGS countries ability to carry through the austerity measures will weigh on equities. Furthermore will the cut-back-on-public-spending throughout Europe over the summer fuel concern as to how this will affect growth – no only long term, but also in the medium term. Earnings growth cannot structurally be significantly above GDP growth for an extended period and on the back of our GDP growth expectations we are arriving at the conclusion that earnings expectations should be revised lower. This should trigger a process of leading equities lower.

- **Long run view: BEARISH.** In the next 3-12 months we still expect equities to retrace from current levels. Fundamentally we still do not believe that we have entered into a multi-year cyclical bull market for developed-market equities; they will remain hampered by structural headwinds. For almost the past 15 months these headwinds are more than offset by extreme policy actions that have made the current rally from the trough look like the start of a normal cycle. The triggers will most likely vary according to shifts in dominating themes in markets, but amongst our favourites are Chinese growth disappointments, a second wave of defaults from the US housing market to hit the financial sector, continued focus on public finance sustainability – especially in Europe and continued concern of the ability for the troubled European states to carry through austerity measures and the impotence of the EU bailout package.

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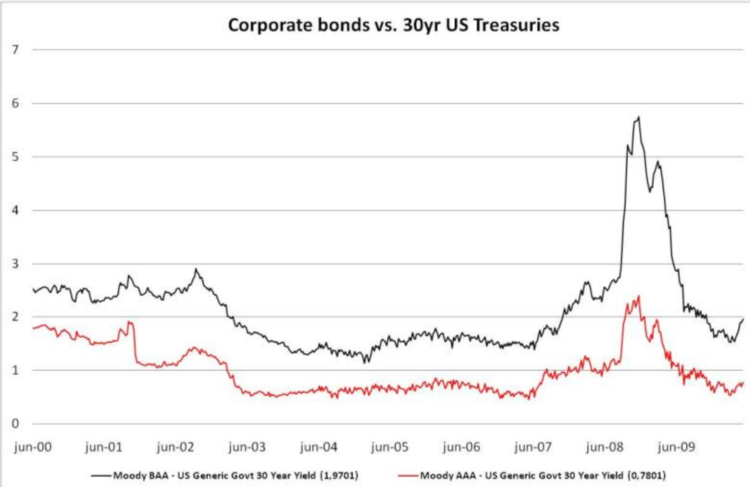
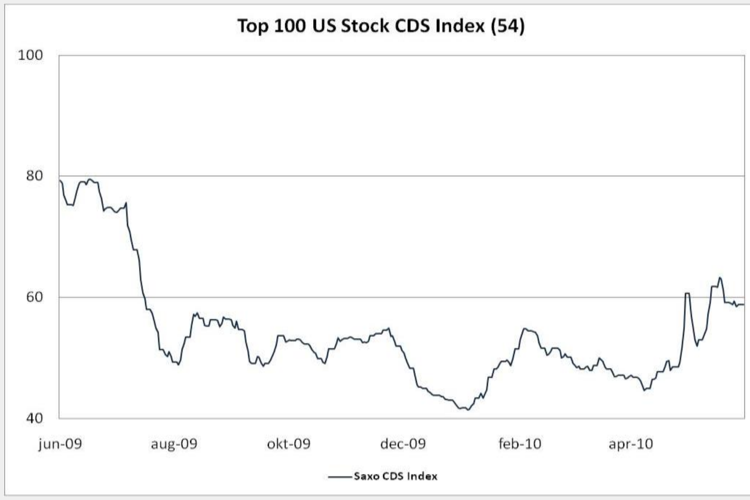
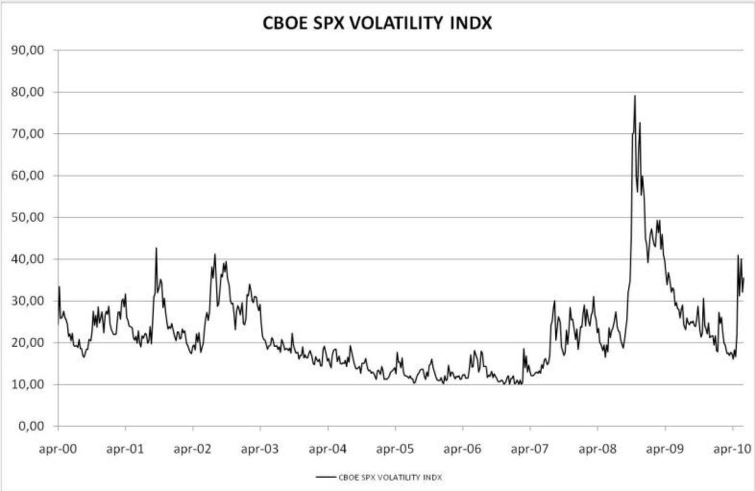
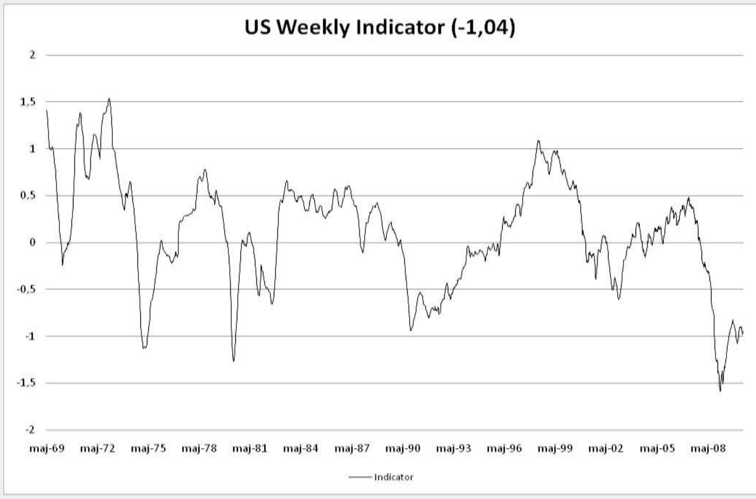
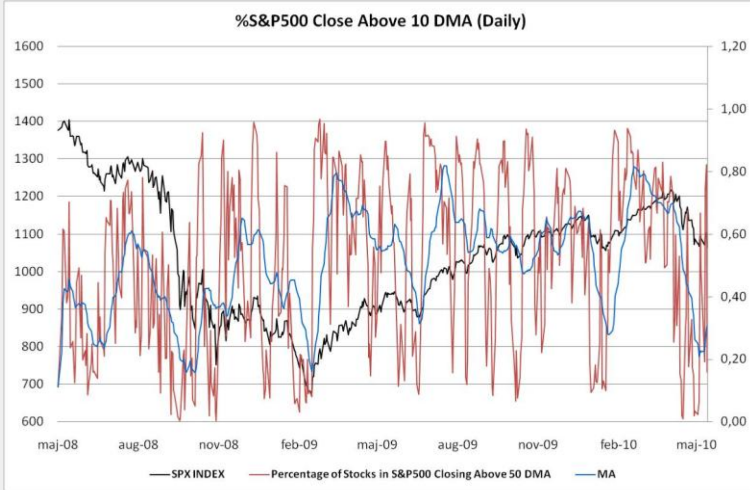






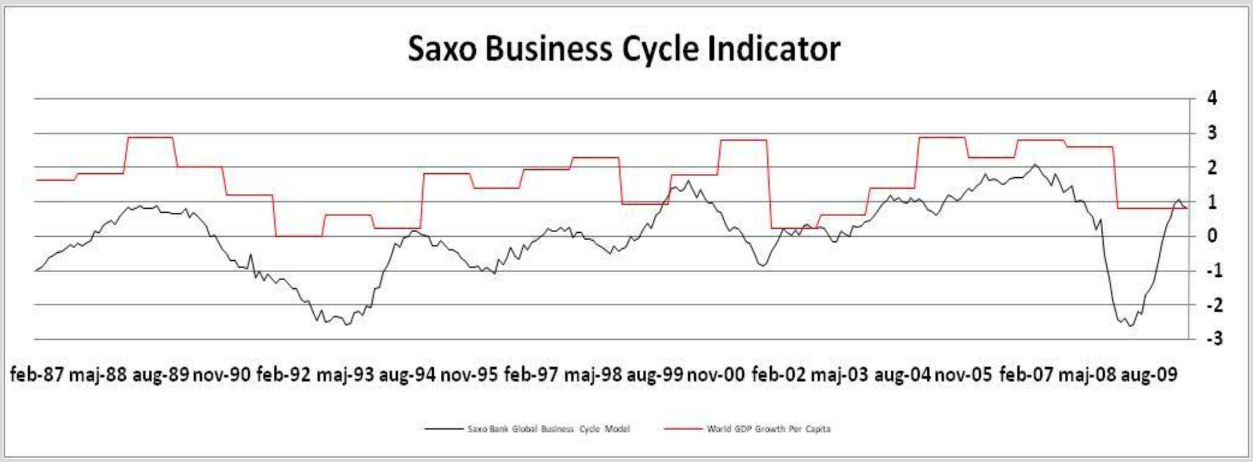




Comments: The sovereign debt crisis continues to have an impact on risk. Bond spreads are going higher, CDS-index follows suit and VIX is exploded. CAPE has retraced to 19.99, but still above the 16x long term average – stocks are clearly not attractive long term. Our US weekly indicator is heading north again after having corrected. Our new technical indicator, percentage of stocks in S&P 500 trading above their 50 day moving average (DMA), points towards that equities have potential for travelling higher short term (only around 30% of the stocks is trading above its 50 day moving average).

Equity market drivers

- The recovery is still ongoing, but at very different pace across regions. The recovery has so far shown remarkable signs of strength especially in Asia and to some extent also in the US. In Europe however the growth estimates have lately been revised down due to the sovereign debt crisis. But we do not expect the current pace of the recovery to continue simply because much of the growth has been driven by low interest rates and massively stimuli from governments – rather we expect growth to slow down globally and possibly for some countries entering a double dip. This is to some extent reflected in our Saxo Business Cycle Indicator.



- As we wrote in the May edition of the Equity Strategy Outlook macro themes have become prominent in the equity space again. A follower from the European sovereign debt risk has been that investor's short term fear a liquidity shortage in the European banking system and longer term fear the prospectus of a global double dip due to the deleveraging of government balance sheets.

- The likelihood of a liquidity shortage in the European banking system is present, but small. ECB will most likely provide all the liquidity the market can take given that the last credit crunch is still in the memory of most participants within the financial system. However, the TED spread and the European Libor has lately been on the rise, but still far from the levels that we saw during the Lehman collapse. In the case of significant increases in these liquidity measures as a follower of further escalation of the European sovereign debt crises equities will be hit massively. Short term this is clearly our biggest concern.

- Long term we are far more concerned with the prospectus of growth – especially in Europe and US due to the deleveraging both in the private households and now also the government. Our core scenario in terms of economic growth is a mild double dip starting in the beginning of 2011 and this should have a negative impact on earnings expectations. According to our view this should bring earnings growth for S&P500 in 2010 at 14%, 2011 at -1% and 2010 at 10%, while current market consensus is for 2010 at 32%, 2011 at 19% and 2012 at 12%. Most would expect that earnings would be hit hard in the second wave of a double dip, but the last 30 years history of double dips and earnings development show that most companies are lean when entering into the second wave of recession. Earnings usually do not enter into a double dip, but levels out. In terms of valuation much of this has already been priced in. The 12 month forward P/E should according to our estimates level out at 12.5x by end 2011. This is close to the low of the last bear market (10x). In other words - a double dip in the broader economy should mean still lower levels in equities before it is fully priced in.

- We follow suit with the sector allocation from May with a few minor adjustments. The main argument behind our stance is still that we expect macro economic headwinds and short term fear mainly coming from the sovereign debt crisis in Europe. This will continue to be a drag on equities for a while – despite that we expect a bounce in equity markets from the Q2 earnings season.
- On a single stock level we prefer exposure to companies within classic defensive sectors with a proven track record in paying out increasingly higher dividends – also during troubled economic times.

Sector	Exposure
Resources	
Energy	**Neutral.** Despite the reintroduction of Middle-East oil lately we find it difficult to operate with a scenario of economic growth retracement and increasing energy prices. Both valuation and the dividend yield looks attractive for this sector compared to S&P500, but we stick to our fundamental stance on the economy.
Materials	**Underweight.** Our expectation is due to general economic slowdown this sector stands first in line getting hit by the retracing demand. Valuations looks however attractive with at P/B at 1.7 vs. the S&P500's at 2.0, but we stick to our fundamental stance on the economy.
Exporters	
Industrials	**Neutral.** Valuation looks a bit stressed with a P/B vs. S&P500 of 1.8 vs. 2.0, while the dividend yield however looks attractive; 2.3 vs. S&P500s 2.1.
Technology	**Underweight.** The valuation looks a bit stressed; P/B at 2.6 vs. 2.0 for S&P500 and the dividend yield is significant below the S&P500; 1.4 vs. 2.1.
Defensives	
Consumer Staples	**Overweight.** With an expected dividend yield for 2010 at 3.1% vs. the S&P500 dividend yield at 2.1% this seems fairly attractive. The valuation could look at bit on the high range with a P/B at 2.6 for the sector vs. P/B for S&P500 at 2.
Healthcare	**Neutral.** Healthcare is a classic defensive sector, but the valuation looks a bit in the high end. P/B is at 2.4 vs. 2 for the S&P500. This is the main reason for keeping the rating at neutral. The dividend yield does look attractive – 2.8% for the sector vs. 2.1% for S&P500.
Telecom	**Overweight.** The expected dividend yield for 2010 is 5.8% for this sector vs. the dividend yield at 2.1% for S&P500. The valuation also looks attractive – P/B is 1.6 vs. 2.0 for S&P500.
Utilities	**Overweight.** This sector follows the tendency of the prior 2 defensive sectors; the dividend yield looks very attractive indeed with 4.7% vs. the S&P500 average at 2.1%. Valuations are cleary quite cheap with a P/B at 1.3 vs. the average for S&P500 at 2.0.
Other	
Consumer Discretionary	**Underweight.** The outlook for growth in EPS for this sector seems a best moderate 1 year ahead and the dividend yield is below the dividend yield for S&P500 – 2.0 vs. 2.8.
Financials	**Underweight.** Financials looks attractive judged by EPS growth, P/B and dividend yield. However we are still afraid to buy into this sector due to as we mentioned we expect problems hitting this sector from lack of sufficient write-offs and the uncertainty regarding future regulation.

Sectors and earnings

- Generally we are fare more negative on earnings expectations as we expect forceful macroeconomic headwinds during the second half of this year spiced up with significant government cutbacks in spending especially in Europe over the summer. This will obviously hit economic growth going forward and this will in our view lead to a double dip in major economies, but as we mentioned we stick to a modest scenario when making assumptions of the impact on earnings. However, in our view, consensus earnings expectations are not remotely connected with the macro economic reality that surrounds the corporate world and this is the main explanation as to why there are quite significant differences with our earnings estimates and consensus as displayed in the table below.

- A special note should be made on financials, especially banks. Actually especially European banks. In our view banks earnings will are heavily supported by the current shape of the yield curve and more generally with the unusual low level of interest rates. However it is our conviction that banks, especially European banks, has not remotely written off the losses that they have had from the subprime investments and now lately the losses coming from the European sovereign debt crisis. This the main reason for our extraordinary negative stance on the earnings growth within banks. Soon or later banks will have to do the write-offs.

Table: EPS estimates for S&P500.

	EPS Growth YoY (%)– IBES			EPS Growth YoY (%) – Saxo Bank		
Sector	2009/2010	2010/2011	2011/2012	2009/2010	2010/2011	2011/2012
S&P500	35%	17%	14%	14%	-1%	10%
Resources						
Energy	39%	25%	19%	15%	-2%	15%
Materials	69%	25%	10%	27%	-2%	8%
Exporters						
Industrials	17%	20%	17%	7%	-2%	13%
Technology	42%	12%	11%	16%	-1%	9%
Defensives						
Staples	8%	8%	10%	3%	-1%	8%
Healthcare	7%	10%	7%	3%	-1%	6%
Telecom Services	4%	15%	14%	2%	-1%	11%
Utilities	1%	5%	2%	0%	0%	2%
Other						
Discretionary	40%	19%	17%	15%	-2%	13%
Financials	135%	34%	21%	52%	-3%	17%

Source: Thomson-Reuters DataStream, Saxo Bank Research

Index levels forecast

Fear of a short term liquidity drain in the financial system and a prospect of a double dip have clearly made equities sell off. Our main argument as put forward earlier in the Equity Strategy Outlook is that most of the earnings retracement is already priced in which is also why that we do not expect equities to engage in long term violent sell offs from current levels unless markets should be hit by outright panic.

Our main scenario is that in terms of S&P500 we will close the year around 1008. We have once again lowered our level expectations from the May edition of the Equity Strategy Outlook, but the general path that we expected equities to follow in 2010 is still the same as we wrote in the Yearly Outlook: In the first half of 2010 equities will travel higher led by the overall optimism regarding the global recovery, while in second half of the year we expected retracement on the back of macro economic headwinds which will be fuelled by seriously cut backs in government spending especially in Europe. The retracement has evolved a bit before we expected, but the major themes leading to the retracement was the ones we expected.

Table: Index levels forecast

Index	Current*	Jun 10E	Sep 10E	Dec 10E	Mar 11E
S&P500	1050	1088	1048	1008	1008
Nasdaq100	1798	1867	1809	1751	1751
DAX	5838	5779	5160	4884	4884
FTSE100	5011	5037	4793	4550	4550
Nikkei225	9538	9581	9324	9007	9007
MSCI EM	890	906	873	819	819

*) Close as of 7thof June 2010. Source: Saxo Bank Research.

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