Quarterly Outlook

SAXO BANK

Q3 2010

The Crisis Is Not Contained

With Greek 2-year rates now above 10% again, it would be wrong to assume that the PIIGS debt crisis is contained. Containment is only possible through drastic budget cuts, says Saxo Bank, the trading and investment specialist, in its Half-Yearly Outlook for the global economy.

Government profligate spending is crowding-out private investments and consumption and we expect markets to react negatively to the continuation of the huge imbalances in government debt markets. The reset of Option-ARM and Alt-A mortgages in 2011, 2012 and 2013 and very big budget deficits in the E-Z countries pose very uncomfortable obstacles to the stock market and we expect stocks to be very uninspiring investments well into 2011.

This Half-Yearly Outlook for the global economy is a short analysis examining the global economic outlook for the forthcoming quarter. The Half-Yearly Outlook will be followed by a Q4 Outlook in October.

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Make no mistake, the current PIIGS debt crisis is not contained and the only way to get rid of it is by cutting budget deficits much quicker and much more dramatically than what is being done currently. The German budget cuts are a good start, but they are not enough. Greek 2-year yields are now trading above 8.6% again, but the equity market seemingly only cares about the next earnings season (beginning in July), which is expected to be strong.

Contrary to the common perception, running big budget deficits kills growth – and that is especially the case in a cash-strapped environment like the one we are currently in. It is perhaps the most distinct feature of this crisis that small and mid-sized companies are almost completely cut off from financing. Yes, corporate bond issuance has been ample until recently, but that is drying out with the lack of risk-willingness and small caps rarely participate in corporate bond markets.

The recent Flow of Funds from the Fed also indicates that the corporate deleveraging of especially financials is almost completely a mirror image of the continued spending by government. The same can be said about Europe. The reckless government spending continues to make GDP figures look "nice" in the short-run but it comes at the cost of long-term growth and it increasingly builds larger imbalances.

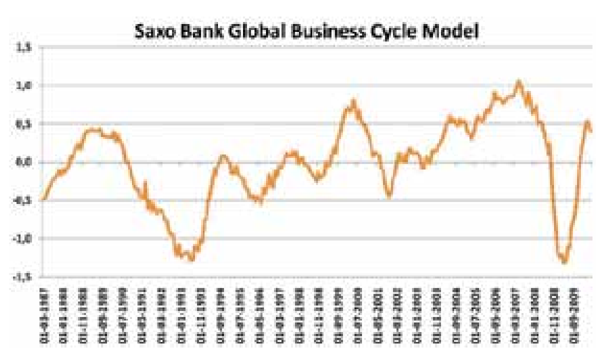
The market will have to worry about those larger imbalances and that already happened in the sell-off in May. However, we believe that we will see some optimism linked to the strengthening corporate earnings to be announced in the coming earnings season (beginning in July).

A short-term bounce is risky assets therefore seems likely, but we fear that such a bounce in stocks will only materialize in the creation of the right shoulder in a big head-and-shoulders formation with neckline around 1040. If that is true, the trend in equity prices should be lower well into 2011.

What could cause such a negative drift in equities? We see several factors. 1) A Chinese slow-down looks increasingly likely. 2) Corporate earnings are caused by cost-cutting rather than topline growth and we are thoroughly in the deflationist/disinflationist camp, so we don't expect inflation and topline growth any time soon. 3) Continued destabilization in PIIGS debt markets demanding a response from the less insolvent E-Z members. 4) Draconian cuts to government spending and 5) Worries about the reset of Alt-A and Option ARM mortgages in the US and a further surge in defaults and delinquencies.

One or more of these factors will impair the earnings outlook of equities in 2011 and 2012 and we believe that they are currently not sufficiently priced-in.

We also maintain our expectation for very low policy rates in the foreseeable future. The market prices the 1-year Fed tightening at 33 bps. (down from 50 bps. only two weeks ago), but we still believe that is too much. Count on policy rates in the US, UK, E-Z and Switzerland to stay at current levels (or lower) until the end of 2011.



The Saxo Bank Business Cycle Model shows a strong rebound from the bottom in early 2009, but the latest couple of months have indicated some deceleration of economic activity, which in combination with the slowing leading indicators worldwide should be a cause for concern.

US: A LETTER-SOUP OF STIMULUS FADES AWAY

With the first half of 2010 drawing to a close, the US economy faces renewed headwinds. Despite the fact that the economy grew an expected 3% annualized in the first six months of the year, we stick to our story for subdued growth in the second half of the year. The tailwinds will fade and the headwinds will grow strong.

Changes to inventories have been a large factor in explaining the solid GDP growth numbers since 3Q09, which is equal to 3.6% on an annual basis through 1Q10. If we subtract inventories and only look at final sales growth during the same time span we get 1.9% - despite government support. Following a panicky reduction in inventories as producers overshot demand weakness, inventories have bounced back, but this cycle is almost over and we only expect a mild impact on 3Q growth.

Inventories are not the sole cause of the recent rebound in the economy as consumer spending has also picked up somewhat. However, emergency programmes have had an important part to play in this spending revival led by the roughly $800bn. expensive ARRA package passed in early 2009. This stimulus is already waning and will probably dry out in the second half of the year. Indeed, we could potentially see a negative contribution to growth in late 2010.

Investment will be subdued due to still low – albeit improving – capacity utilization and a residential sector which has a large overhang of unsold properties. The market should be allowed to run its course and clear malinvestment, but that has so far not been the case. Indeed, the market has been propped up by a couple of expensive tax credits, which are not just ineffectual, but downright harmful to a sustainable recovery. Both sales and prices are expected to decline heading into the third quarter as demand will go AWOL without the tax credit. Meanwhile, the commercial part of the residential sector is still in deep distress with prices once again declining following a slight resurgence in the winter months. Often a leading indicator, this time is different for residential investment, which will remain weak in the third quarter.

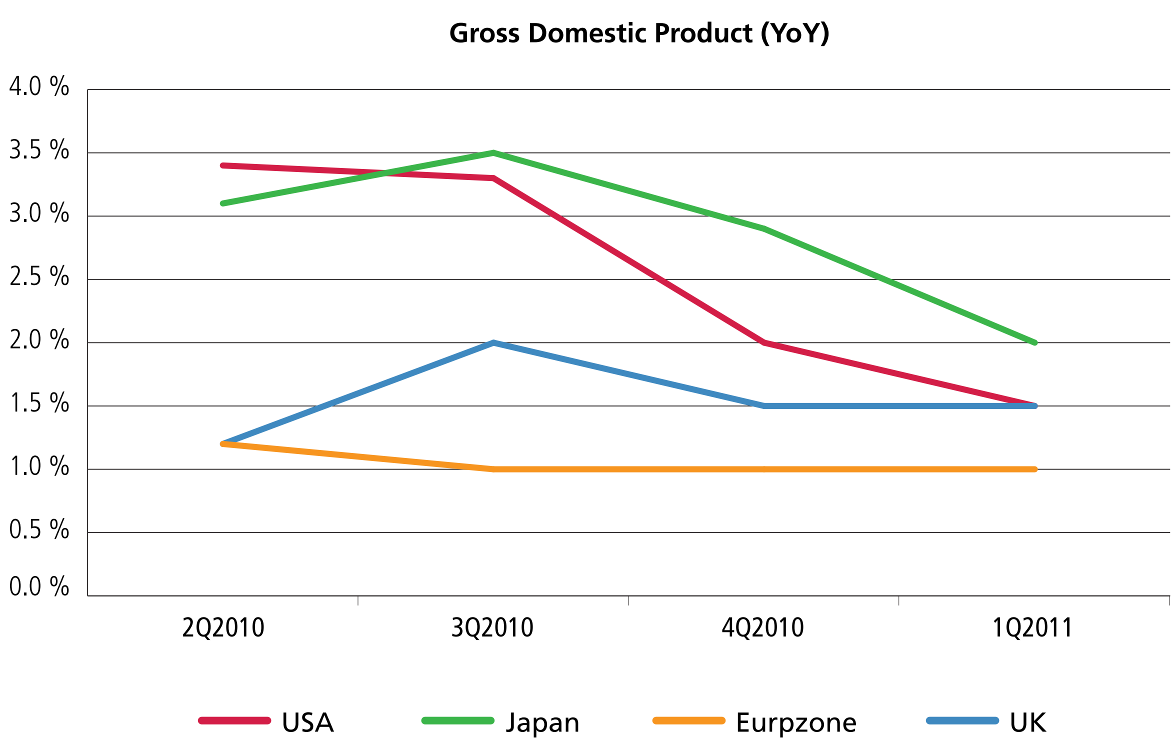
United States	**2010Q2**	**2010Q3**	**2010Q4**	**2011Q1**
Gross Domestic Product (QoQ, SAAR)	3.0 %	1.5 %	0.5 %	1.0 %
Consumer Prices (YoY)	2.5 %	1.5 %	1.0 %	1.0 %
Unemployment Rate	9.8 %	10.0 %	9.9 %	9.7 %

JAPAN: REBOUND TO LOSE MOMENTUM

Japan has perhaps not received as much attention as the US, but its rebound has been just as solid, growing 4.2% year-on-year in 1Q10. We expect further growth, but the pace is likely to decelerate. Net exports have rallied sharply since the trough in early 2009, but the contribution will lessen in the third quarter as a strong JPY weighs on Japanese manufacturers. The toothless EUR may be a tailwind for the Eurozone, but Japan's export-led growth will be hurt by the currency's weakness.

Stimulus has also been a major support pillar behind the increase in economic activity, but this too is expected to slow down in the second half of the year. Consumption growth is expected to weaken as signalled by consumer sentiment, and the slowdown will only be enhanced if rumoured tax hikes are implemented.

Japan	2010Q2	2010Q3	2010Q4	2011Q1
Gross Domestic Product (QoQ, SAAR)	2.5 %	2.0 %	2.0 %	1.5 %
Consumer Prices (YoY)	-1.2 %	-1.0 %	-0.5 %	-0.5 %
Unemployment Rate	5.1 %	5.0 %	5.0 %	4.8 %



EUROZONE:
EUR SCORES AN OWN GOAL, BOOSTS EXPORTS

Sovereign debt worries have overshadowed everything else in Europe so far this year, but it should not be overlooked that the recovery would have been fragile even in the absence of the current crisis. There is no doubt that too much debt is the fundamental problem for many countries in the Eurozone, but other imminent issues are restricting economic activity.

Just like in the US, the consumer in Europe is still over levered as a result of housing-bubble induced consumption of goods beyond what could be supported without rapid growth in home equity. This will remain a drag on private spending in the third quarter and the very soft labour market is not exactly helping matters. And for those businesses and consumers that want to borrow, credit is hard to come by as evidenced by the disturbing trends in the various money supply measures; in fact, the broadest measure, M3, is just below naught on a year-to-year basis.

What was previously another obstacle has rapidly flipped around to become a badly needed tailwind. We are of course talking about the substantial decline in the EUR so far this year, which is starting to rub off on industrial production and exports. PMIs across the region point to further strength in the coming quarter, and the Eurozone might as well put all its eggs in this basket; it does not have much else going for it. However, due to the base effect the yearly growth in GDP should be somewhat better going into the second half of the year even if austerity measures will put further dents in the recovery; and even cause another bout of recession for some countries.

The UK recovery will likewise be bumpy though the economy is more flexible due to having its own currency. But spending cuts are also needed to balance the books here. Unlike the US, Eurozone, and Japan, the UK is fighting off somewhat high inflation though it is partly due to temporary effects.

Eurozone	**2010Q2**	**2010Q3**	**2010Q4**	**2011Q1**
Gross Domestic Product (YoY)	1.2 %	1.0 %	1.0 %	1.0 %
Consumer Prices (YoY)	1.4 %	1.0 %	0.5 %	1.0 %
Unemployment Rate	10.1 %	10.2 %	10.3 %	10.2 %

United Kingdom	**2010Q2**	**2010Q3**	**2010Q4**	**2011Q1**
Gross Domestic Product (YoY)	1.2 %	2.0 %	1.5 %	1.5 %
Consumer Prices (YoY)	1.4 %	3.0 %	2.5 %	1.5 %
Unemployment Rate	7.9 %	7.8 %	7.8 %	7.8 %

Q3 2010 FX OUTLOOK: IT'S NOT JUST ABOUT THE EURO ANY MORE

All markets were extremely focused on the EuroZone situation in Q2, even though FX had been looking at this problem since the Euro downtrend really took off in December of 2009. The difference towards the end of Q2 versus earlier was that the EuroZone sovereign debt issue was finally judged to be critical enough to affect risk appetite across all markets and around the world, rather than in FX only. This was remarkably similar to the way in which the market obstinately tried to contain the subprime issue as a US-only problem until well into 2008, even as Bernanke cut rates for the first time in September 2007.

As we ponder the landscape for FX in the quarter ahead and beyond, we suspect that the main theme currently occupying a significant portion of the market's bandwidth of attention – the EuroZone situation and its effect on risk appetite generally – will remain important. But we also suspect that this theme is occupying far too much of the market's attention relative to other macro themes that could come to the fore in the coming quarter. Below we have a look at three of these themes.

COMMODITY CURRENCY COUNTRIES – NOT JUST ABOUT RISK ANYMORE

In economic boom and bust cycles, the market expects the commodity currencies to act as high beta plays on global risk appetite and global growth, with the assumption that they will see the highest growth rates and interest rates during good times and appreciate the quickest on capital flows and carry trading, but will likewise see the fastest decline rates on the downside of the growth cycle as capital flows reverse due to quickly contracting interest rate spreads and as key commodity prices fall and see a contraction in key domestic export industries. Most of these elements were in play in the boom and subsequent 2008-09 bust in commodity currencies. As global growth was suddenly in doubt in 2008, AUDUSD (to take a popular example) tumbled from a 25-year high to a five year low in the space of a couple of months.

But what about economic fundamentals in countries like Australia and Canada during and after the crisis? On that account, growth actually performed very well as neither country had the degree of overleveraging in their banking system. As well, as central banks around the world quickly moved to cut rates, private borrowing suddenly stepped in and drove asset prices higher – especially in housing. In Australia's case, the incredible stimulus response from China provided a quick additional medicine for the hangover as well as key industrial commodity prices quickly rebounded.

So some countries escaped the turmoil relatively unscathed – but they won't be so lucky this next time around as global growth begins to weaken in coming months. That's because Australia, Canada, New Zealand, Norway and Sweden (an exporter, if not a commodity exporter) are all suffering under the weight of tremendous housing bubbles – each of them worse than the US housing bubble in terms of price appreciation from 2002 levels. When these bubbles pop in a weak global environment, this is likely to serve as a double whammy to these countries, particularly Australia and Canada, whose currencies are the strongest, and where private indebtedness is as bad or worse than it has ever been in the US or the UK. This story could begin to unfold already in Q3 – and there are already signs that Australia's housing market is turning over. The commodity currency levels could look very different when 2011 rolls around.

AUSTERITY: SAVING OUR WAY TO THE DOUBLE DIP

There is a massive political impetus now toward more austerity in the public sector after the enormity of the public response to the 2008-09 financial crisis has made it clear that the public sector can't borrow forever in an attempt to both avoid the pain of decisions of the past and try to stimulate the economy into recovery mode. With a private sector already desperately looking to deleverage (this theme is the most mature in the US, but Europe is very quickly catching up due to the crisis and Australia and Canada are, too, even if they don't realize it yet) and now a public sector that is looking to deleverage as well out of political necessity.

Already, in the US, states and local governments are slashing budgets because they can't print money, and the Tea Party will make a huge splash at the mid-terms in November. In Europe, Greece is making unprecedented austerity experiments and it looks like Spain must soon follow suit. In France, they are trying to raise the retirement age and reduce pensions. In Germany, the government is teetering and trying to shore up credibility with new fiscal austerity measures of its own. In Japan, the BoJ has begun to talk up the need to defend faith in the currency and prevent a further upward spiral in debt levels.

The new impetus toward public deleveraging will move into full swing in Q3 and put enormous pressure on economic growth, thus withdrawing the public sector support that enabled the recovery in the first place. In FX, this will mean more weakness for those currencies for which current interest rate expectations and growth expectations are too high: that's right, we're talking about the commodity currencies again. Other countries will need to ensure that they balance austerity with economic growth, or the lack thereof, and avoid an attack on the country's sovereign debt rating, as we are seeing what this can do to a country like Greece. An important guinea pig on that front will be the UK – where the shaky new coalition will need to keep the market's trust with plausible plans for the economy.

CHINA AND EMERGING MARKETS – THE GROWTH HOPES ON THE ROPES?

China's move to forcefully grow itself out of the catastrophic contraction in its export-related industries was as impressive as it may have been misguided. Too much of the growth has been a matter of throwing funds at economically non-viable infrastructure projects. And the flooding of the bank system with easy credit has resulted in perhaps the world's largest housing bubble. This enormous growth of possible very poor quality could come back and haunt Chinese officialdom and we wouldn't be surprised if the cracks in the Chinese economy become more evident in Q3. If the Chinese economy drives off a cliff (or even if we simply see a sharp slowdown), this will further aggravate the most popular risk plays out there: emerging market equities and the currencies that are so dependent on related capital flows for their stability.

CONCLUSION – IT'S ALL ABOUT TIMING

The old saying in equity markets goes: stay away in May, as the May 1 to November 1 period is historically a terrible one in equity markets (and therefore for risk – in FX, this means a bad period for carry trades). One might think of the summer as a period of complacency and range trading, but there are far too many instances of the summer period seeing very deep sell-offs in risk. Examples include 1966, 1969, 1974, 1977, 1981, 2002, and 2008. While we might see a short-term recovery in risk as corporations parade stellar Q2 results, the eventual risk lies to the downside for risk as we simply have not come to grips with the problems laid bare by the crisis. Volatility in FX is likely to swing sharply higher in response, so stay careful out there.

Q3 2010 EQUITY OUTLOOK: MACRO THEMES HAVE REGAINED DOMINANCE IN THE EQUITY SPACE

With the half year turn in sight the year so far has played out close to our expectations from the Yearly Outlook. We had a strong start of the year and reached a top in S&P500 at 1217 in April, while we originally expected the level of 1250 to be reached by the end of June. For the second half of the year we continue to expect further hurdles for equity markets which will keep the risk premium higher for an extended period and lead to lower earnings expectations for 2011 and 2012. However there will be bounces in equity markets as earnings are likely to surprise to the upside.

One of the major hurdles for the economy is the process of unwinding the over-leveraged economies (especially the Eurozone). The unsustainably high fiscal deficits that resulted from the government-injected stimuli in the economies now need to be worked down. This is likely to be a drag on economic growth, especially in the developed world for many years to come. We expect growth in the US to slow to 1.5% and 0.5% qoq annualized in Q3 and Q4 respectively. Furthermore we do see a high risk of a double dip when entering into 2011. At the same time, China's economy is likely to gradually slow to 5-6% from 2011 and onwards as tighter monetary conditions impact on growth. Finally, the concerns about the policy framework in Europe are unlikely to be fully addressed over the next few months.

Given this, we expect that the equity risk premium is likely to stay higher for an extended period of time and we expect earnings to be revised lower for 2011 and 2012. From previous double dips we know that corporate profits are more resilient to the second downturn than the first. For example in the US in the early 1980's the second economic contraction was more significant than the first, but the corporate profits fell by less. Perhaps this was because the US corporate sector entered the second downturn with an early cycle cost base and with management already well into the process of cutting expenses. So the negative profit impact of weaker revenue growth was not as great as it would have been given the late cycle cost base.

The impact on earnings in our scenario is a 14% growth in earnings for S&P500 for 2010, -1% in 2011 and 10% in 2012. Consensus is currently higher with an expectation of 35% earnings growth in 2010, 17% in 2011 and 14% in 2010. But according to our view we should expect forward earnings to moderate considerably. It is at the same time important to stress that we do not expect earnings to double dip, but to level out. Nevertheless it seems like investors already have gone some way down the path of pricing in a double dip in GDP even if they haven't fully thought through the implications for earnings. So valuations for global equities are still looking fairly priced. Based on current analyst's consensus forecasts, the 12 month forward estimated P/E ratio for S&P500 is now close to 12x. This is about 23.5% lower than the 20 year average.

Given our scenario analysis, even if the earnings outlook reflects an economic double dip, then the 12 month forward estimated P/E would end 2011 at 16.5x. Still not high based on what we have seen in the past.

Index	Closing Level at 14th of December 2009	December 2010 target		
		Yearly Outlook	2nd Quarter Outlook	3rd Quarter Outlook
S&P500	1114	1150	1100	1000
DJ Stoxx 600	247	260	248	230
Nikkei225	10106	10320	9875	9180
MSCI EM	979	1050	1000	820

Q3 2010 COMMODITY OUTLOOK: GOLD - A BUBBLE EMERGING?

Risk adversity driven by worries about the level of sovereign debt and the subsequent risk of a double dip recession will stay with us into the third quarter. The month of May saw risk reduction on a large scale with the Reuters Jefferies CRB index dropping ten percent, wiping out six months of gains.

The one-year recovery has primarily come about due to the most extraordinary policy response ever seen. As governments are left heavily indebted and weak, their response to a new crisis will be questionable. China, the global growth engine, is fighting a two-way battle against inflation and a speculative bubble and will have to stay tight on policy.

With the forecast of a Chinese slowdown and considering they consume between a fifth and a seventh of all global commodity production, we see downside risk to the Reuters Jefferies CRB index. This will primarily be driven by renewed selling, especially in base metals and the energy sector. After a strong rally over the summer from the USD 247 low it will find resistance at 268 before heading lower to 235 at year end and ultimately towards a re-test of the 2009 low at 200.

Crude Oil fell out of favour with investors as prices dropped 23 percent in just ten days during May — in the process wiping out most of the speculative long position on NYMEX. This leaves the market open to another attempt to the upside, however we feel that the high for the year has already been made and that the risk heading into the second half points towards lower prices. Continued dollar strength combined with the global recovery heading into slow motion will leave the market well supplied and subsequently put downside pressure on prices.

A summer rally back towards USD 79.50 resistance will be followed by renewed selling that can ultimately drive prices lower towards a year-end target of USD 60, barring geopolitics or devastating hurricane.

Gold continues to attract record amounts of investments from investors seeking a safe haven against current uncertainties. Holdings in Gold ETFs now exceed 2000 tonnes having risen by 300 tonnes since early April. Some respectable investors have begun to describe gold as emerging into a bubble situation and that it could get messy once it pops.

The top of a bubble is usually marked by a final surge that explodes higher. Considering gold is "only" up 12 percent year to date such a move remains to be seen. We are constructive into the second half as outside factors will keep the safe haven theme alive. Above 1,252 resistance is not found until 1,375 leaving ample room to the upside. The mentioned bubble fear will only become a theme should the price drop below 1,150 and more importantly 1,125.

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