# Quarterly Outlook

SAXO BANK

Q2 2011

# To QE or not to QE, is that the only question?

Commodities remained elevated in this year's first quarter, whether as a result of a strong economy or the side effect of loose central bank monetary policy - particular in the form of the Fed's QE2 and its implications for the US dollar. And with the inflation cat clearly out of the bag now, policy-makers have been busy ratcheting higher the expectations for a normalisation of policy rates. Even several US Federal Reserve members have been arguing in favour of. So the question that begs in the second quarter is to what degree markets have been propped up by the Fed's QE2 program and how markets will deal with the prospect of its expiration at the end of the quarter.

Economic growth has been strong almost across the board so far this year, but that is not an all-clear for loading up in risky assets. Rather, we look for increased volatility in the second quarter as Middle East uprisings, a wounded Japanese economy, and the expectation of the end of quantitative easing to bring far more "two-way" action than we have seen in the recent past. We therefore take a modestly bullish view on equities while instability should see gold aim for USD 1,500. The USD may finally try to make a stand if it becomes clear that QE2 will end with no immediate prospect of a QE3.

This second quarter outlook for the global economy is a short analysis examining the global economic outlook for the forthcoming quarter.

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# MARKET COMMENT: CAN RISK STAND ON ITS OWN TWO LEGS WITHOUT QE?

The global recession of 2008/2009 forced central banks to be creative. As unemployment rates shot up, GDP fell and stock markets panicked, they dreamt up a whole alphabet soup of solutions. Quantitative Easing was one such solution and in the case of the U.S. it was even extended in late 2010, sparking a rally in equities and commodities, in particular.

But as the global recovery is seemingly turning into a fully-fledged expansion, inflation has come to the fore as the unwelcome guest banging on the door. Markets have reacted swiftly and are now pricing in several rate hikes in most major economies and the question is: can risk stand on its own two legs when the punch bowl is removed? While the ramp-up in equities in late 2010 was partly based on improving fundamentals, we cannot help but see it as a reaction to the Fed's promise to keep rates low and provide enough liquidity for as long as is needed for the 'wealth effect' to kick in through increased consumption as Americans see the value of their portfolios rise. Can the current equity valuations survive in an environment without 'free liquidity for everybody'?

Like others we have been caught on the heels by the European Central Bank's hawkish rhetoric, which seems more political than anything else, given the current low core inflation rate in the Euro area. But for the world's largest economy we maintain that hikes are off the table this year and we instead contemplate whether the Bernanke-led Federal Reserve will engage in QE3. The new Congress has done nothing to stop Bernanke's experiments, and it seems as if the Fed is only waiting for renewed economic weakness to occur to have sufficient arguments in favour of further monetary easing. Surely, our bullish cyclical view on the U.S. dollar is dependent not just on our outperformance outlook for the U.S. economy this year, but also on a failure of the Federal Reserve to instigate QE3.

Much attention has understandably been given to the tragic loss of life and property caused by the earthquake and ensuing tsunami in Japan, but based on economics alone we do not expect the events to derail global growth, which we see at 4.2 percent in 2011. Rather, the events unfolding in the Middle East and North Africa (MENA) are of much greater concern and if the supply of oil from other MENA countries is also cut off, causing oil prices to rise further, our GDP forecast for the global economy is probably too optimistic. In the absence of a a spreading of the Libyan uprising, our view on crude oil is now that it should range between $90-110/barrel ( an increase from our yearly outlook).

Meanwhile, GDP is not the only thing affected by such an outcome. Our warning of cyclical peaks in company margins has so far been premature, but pressure is building on input prices across the world and unless companies can pass them on to customers – thereby increasing CPI and encouraging central banks to raise rates – earnings growth is expected to slow as we progress through the year. We are therefore only modestly optimistic on equities.

Our yearly outlook speculated that China and the Eurozone both pose potential risks and these problems have not been solved. Instead, Portugal is more or less in the bag as far as a bailout goes, giving bond vigilantes plenty of months to prepare for an attack on Spain. For China, our below consensus GDP forecast of 8 percent is maintained. The People's Bank of China is raising interest rates as consumer prices tick up by the day while the property market is slowing alongside new loans - not the optimal cocktail for 10 percent growth in our eyes. Buckle up, volatility is here to stay!

# MACRO OUTLOOK: GLOBAL EXPANSION ON TRACK DESPITE QUAKES

The resilience of the expansion in the global economy is plain to see with 'expansion' replacing 'recovery' when pundits and experts alike describe the macroeconomic picture. By and large we agree, but we do have some reservations to this rather rosy view as indicated by our mostly below-consensus outlook for major economies. In other words, global growth is expected to remain robust in the second quarter and should top 4.2 percent this year.

**U.S.: CAN THE CONSUMER SUSTAIN MOMENTUM?**

We expect the U.S. economy to outperform other major economies in 2011 and we repeat our stance from the Yearly Outlook that the consumer is capable of contributing solidly to the economy via increased spending.

Our expectation is that the U.S. will grow healthily in the second quarter based on our belief that the consumer will be able to re-lever her balance sheet in nominal terms and thereby increase consumption. This is still part of an overall deleveraging process as long as income – or net worth – grows faster than liabilities.

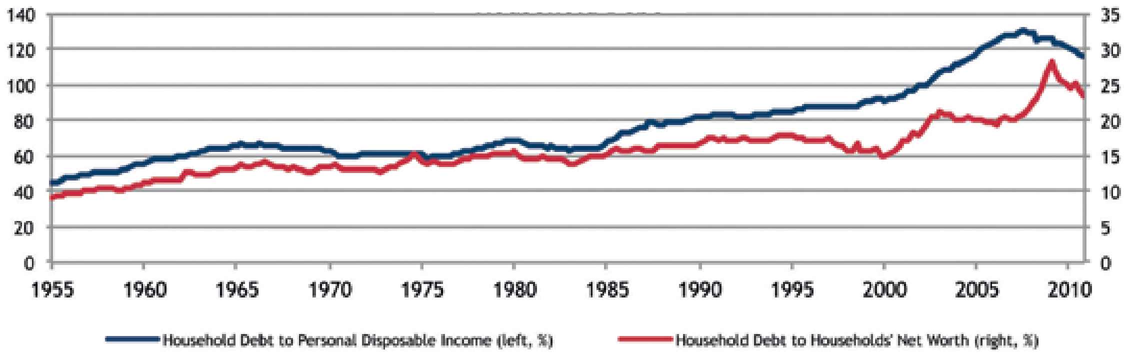
A key contributor to growth last year was the manufacturing sector, which restocked inventories concurrently with the recovery. The impact on economic activity from this part of the economy will be more muted in 2011, but we believe the consumer should in our view be able to carry the additional workload.

Our bearish stance on the unemployment rate in the Yearly Outlook 2011 was quickly shot down as the rate dropped from 9.8 percent in November to 8.9 percent in February. However, we believe our case is still intact since the labour pool should increase as job prospects increase, which will be a drag on the unemployment rate. Changes to nonfarm payrolls are expected to remain stuck in

| **Saxo Bank Forecasts** | | **United States** | | **Eurozone** | | **United Kingdom** | | **Japan** | |
|---|---|---|---|---|---|---|---|---|---|
| | | 2Q-2011 | FY-2011 | 2Q-2011 | FY-2011 | 2Q-2011 | FY-2011 | 2Q-2011 | FY-2011 |
| Gross Domestic Product | YoY (%) | 2.4 | 2.7 | 1.9 | 1.5 | 1.6 | 1.6 | -0.5 | 0.7 |
| Unemployment Rate | % | 9.0 | 9.2 | 10.0 | 9.8 | 8.0 | 7.9 | 4.9 | 4.7 |
| Consumer Price Index | YoY (%) | 2.5 | 2.5 | 2.5 | 2.1 | 4.3 | 3.7 | 0.0 | 0.2 |
| Consumer Price Index, Core | YoY (%) | 1.2 | 1.4 | 1.1 | 1.4 | 3.2 | 3.0 | -0.3 | -0.1 |

*Source: Saxo Bank Strategy & Research.*

**Household Debt**




*Source: Bloomberg. Our calculations.*

a range around 150,000 in the second quarter, though some upside risk is present.

As headline CPI has risen in the major economies so too have the cries warning of high inflation. But with deleveraging still an ongoing process, plenty of spare capacity, and soft wage growth, we refrain from joining the crows and instead expect only mild increases in core consumer prices.

**EUROZONE: IS GERMANY UP FOR THE TASK?**

With several PIGS countries still mired in recession as headwinds from austerity measures became more and more apparent, the thesis from our yearly outlook is intact: the growers (read: Germany) can keep the Eurozone afloat as far as growth goes in the second quarter.  But we still fail to see how consumers can increasingly take over and carry the Eurozone economy on their shoulders with the unfortunate combination of high private debt levels, high unemployment, low wage growth, and decelerating foreign trade growth still a part of everyday life.

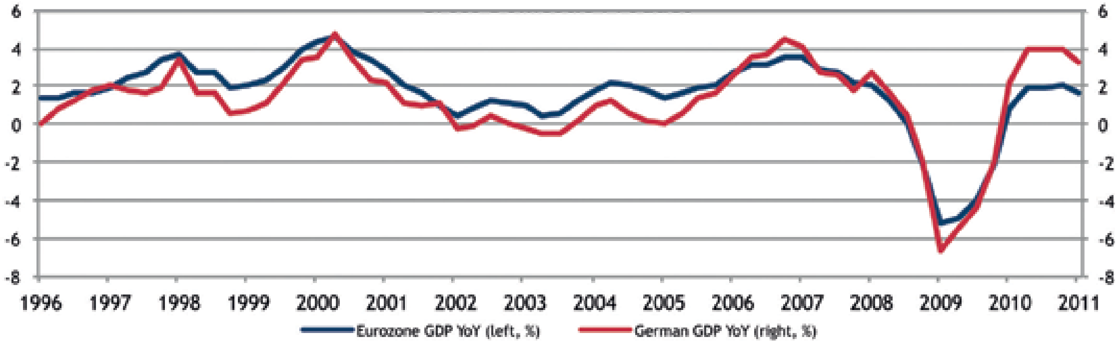
We have revised our GDP forecast up a notch to 1.5 percent, from 1.4 percent in the yearly outlook, but maintain that growth will decelerate throughout the year and this will only be amplified should the ECB carry on and hike rates as has been signalled at its most recent meeting, and which is now part of our forecasts on monetary policy rates. The sovereign debt crisis remains unresolved with the EU still attempting to solve an insolvency issue with more debt, leaving downside risk to our forecast.

**U.K.: FISCAL RESTRAINT LEAVES A MARK**

The U.K. economy is in a transition phase in which the looming public deficit is brought under control. This will be a drag on growth in the second quarter and into the second half of the year though we expect the effect to fade as the economy adjusts to the changes. We agree with the actions undertaken by the Cameron-led government, but stress that a public deficit is still projected for years to come. In other words, in the U.K. we do not have a junkie going cold turkey but rather one attempting to reduce his dose little by little.

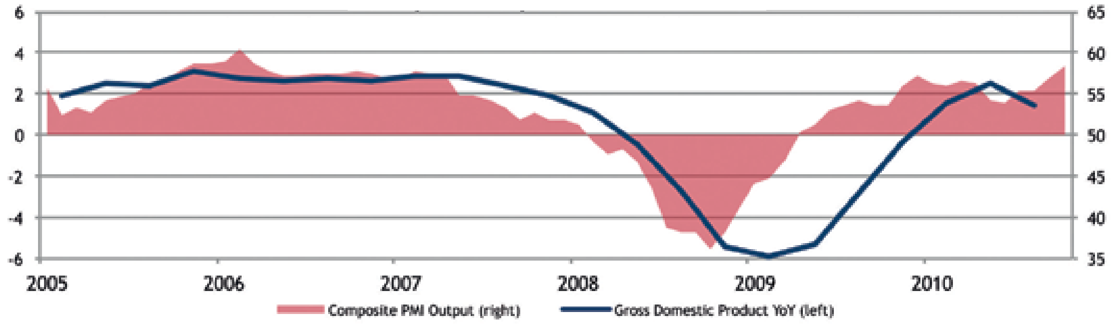
Tax hikes and budget cuts will hamper growth, but the private sector has shown resilience so far, which is key to getting the U.K. economy back on track once the immediate negative effects of the austerity measures weaken. We lower our GDP forecast to 1.6 percent this year, but still expect a reasonable finish to the year. The lowered expectations will impact the labour market with the unemployment rate holding steady around 8 percent while CPI is expected to remain north of 4 percent in the second quarter. However, heading into the second half prices should give back some of the recent gains as temporary effects from austerity measures fade.

**Gross Domestic Product**




*Source: Bloomberg. Our calculations.*

## Companies Report Robust Growth



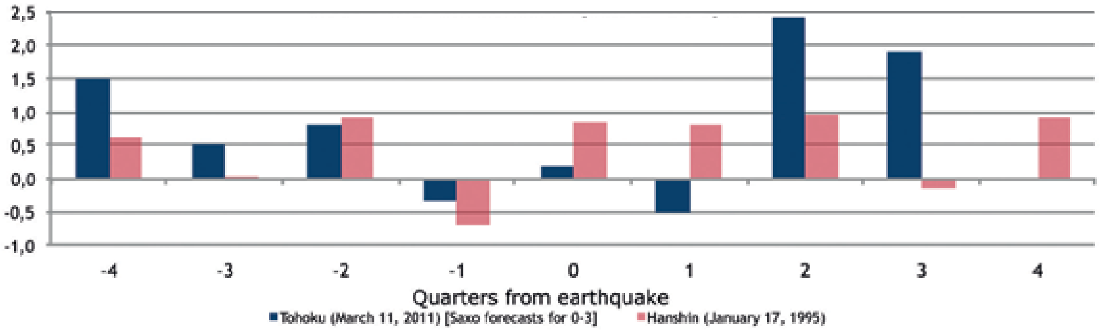

*Source: Bloomberg. Our calculations.*

**JAPAN: QUAKE, TSUNAMI, AND NUCLEAR MELTDOWN TAKE THEIR TOLL**

Several Black Swans at once made for the "worst crisis since World War II" according to Prime Minister Kan, but like clockwork it did not take long for the pundits to rejoice and determine that this triple whammy – while a disaster no doubt – could actually be good for the deflation-ridden Land of the Rising Sun. This is obviously nonsense, though we acknowledge that GDP may see higher growth rates as we progress through the year. But this fact only amplifies the shortcomings of GDP. Rather, the disaster means that Japan now has to spend years rebuilding, meaning that resources will be drawn from other productive endeavours. And all the while the debt clock keeps ticking.

The key question for the Japanese economy in the second quarter is the extent to which the destruction, including power shortages, which sets the March 11 earthquake apart from the 1995 one, will impact GDP. Our forecasts rely on the assumption that power shortages will only impact the first half of the year materially - but downside risk to our forecast is apparent should shortages be prolonged and extend into the third quarter and beyond. Compared to our 1.3 percent GDP forecast for 2011 in our Yearly Outlook, we now look for only 0.7 percent.

## Gross Domestic Product




*Source: Bloomberg. Our calculations.*

**U.S. MONETARY POLICY**

The Federal Reserve's monetary policy committee, the Federal Open Market Committee (FOMC), announced the results of its most recent meeting on March 15 and the accompanying statement did nothing to change our expectation that the FED Funds rate will remain unchanged throughout 2011. One should hardly find this surprising, given three potentially cataclysmic problems that could yet derail the U.S. and indeed the global recovery, namely the popular uprisings across North Africa and the Middle East, the rumbling Eurozone debt crisis, and the dreadful events in Japan.

The committee agreed unanimously that economic conditions will "warrant exceptionally low levels for the federal funds rate for an extended period" and maintained its policy of reinvesting maturing proceeds from its existing investments. There was also no question of curtailing the programme of Quantitative Easing, (QE2), before the full US$600bn has been disbursed.

There were a number of nuanced upgrades to the FOMC's description of economic activity, but none that could in any way be described as hidden messages presaging impending changes in policy. According to the statement, the committee felt the economic recovery was now on a 'firmer footing', as opposed to the previous 'continuing' and, instead of "insufficient to bring about a significant reduction in labour market conditions", the labour market was described as 'improving gradually'. Measures of underlying inflation were described as 'subdued', rather than 'trending downward', and perhaps the most hawkish comment in the statement was a commitment to "pay close attention to the evolution of inflation and inflation expectations".

Let us consider the threats to economic recovery one-by-one.

The overthrow of dictators in Tunisia and Egypt, and even the unrest in Libya, were sideshows for the financial markets, given the limited global impact of even the complete cessation of Libyan oil exports; the real concern arises of course from the possibility of the spread of trouble to Saudi Arabia, Iran and Algeria, and this has driven the recent increase in crude oil prices. In the eyes of the FOMC, the potential dilemma as to whether it should worry more about the impact of oil prices on discretionary consumer spending and corporate profitability, or instead focus on the inflationary implications, will have been easily resolved. Its so-called dual mandate, to pursue the highest possible level of employment commensuration with stable prices, means that it will steadfastly 'look through' any short-term oil-driven boost to inflation, viewing it as transitory, with little fear of the dreaded 'second round' effects, where headline inflation feeds excessive pay demands, potentially creating a wage/price spiral.

The Eurozone debt crisis continues to rumble on, temporarily demoted to the inside pages by first the Africa/Middle East political unrest and then the Japanese earthquake, but surely destined to take centre stage again over the coming months. A glimmer of light seemed visible following the deliberations of the Eurozone Heads of State at their special March 11 meeting, at which it was agreed, amongst other things, to increase the practical lending capacity of the European Financial Stability Facility (EFSF), from Euro 250m to the originally touted Euro 500m. However, we feel that the light is in all probability fixed to the front of the oncoming train of eventual bail-out for Portugal and possible Greek and Irish defaults, leading to enhanced pressure on Spain - the Eurozone's 'too-big –to-rescue elephant in the room'. Now, it will probably be the case that the richer Eurozone states will go to enormous lengths to try and avoid any sovereign defaults until the advent of the European Stability Mechanism, (ESM) - the son of EFSF- in 2013 as, before then, the EFSF's guarantor states will rank pari passu with all other bond holders whereas, under the ESM, they will be Senior, suffering losses only after private creditors.

The problem is that investors know this and will immediately discount this story's eventual denouement-Portugal's borrowing costs are stuck above 7% and speak eloquently for themselves.

Finally, we must turn to the Japanese earthquake, tsunami and nuclear power crisis. Estimates of the eventual cost to Japan of the disaster vary between US$50bn and US$150bn and a recession now seems inevitable by the generally accepted definition - being two successive quarters of negative GDP growth. There will then be a reconstruction bounce-back, as observed after the Kobe earthquake in 1995, but our concern here is also with the global effects, not least supply chain interruption. These will be most severely felt in the automotive and electronics sectors - for instance, Japan supplies 30% of the world's flash memories, (used in the production of smartphones and cameras).

So much for the tangible dangers to global recovery, but maybe the main concern we should have with respect to the U.S. economy is for the consumer - representing 70% of U.S. output. The amalgamation of concerns associated with all of the above, coupled with unemployment still close to 9%, will surely mean that March surveys of consumer confidence will show a marked deterioration. Indeed, perhaps the first harbinger of this was the disappointing preliminary release of the University of Michigan Confidence survey for March - which came out at 68.2, versus expectations for 76.3.

With the U.S. housing market also still massively weak, we feel the Federal Reserve will keep rates on hold at least until the end of 2011, very possibly until 2013.

**EUROZONE MONETARY POLICY**

Oops, it did it again! Or, at least, it threatened to. In a repeat of its July 2008 performance, when the European Central Bank (ECB) raised rates a few weeks before Lehman went bankrupt and the world's financial system teetered on the brink of oblivion, the ECB once again seemed determined to prove its inflation-fighting credentials when its President, M.Trichet, signalled at his monthly post-meeting news conference that he and his colleagues were maintaining 'strong vigilance' over Eurozone inflation - one of the ECB's dreaded code phrases, used to foreshadow impending interest rate rises.

It was only thwarted in its desire to raise rates last year by the unfolding Eurozone sovereign debt crisis and one wonders whether the Japanese earthquake and/or the escalation of Middle Eastern unrest, especially the gradual involvement of Saudi Arabia, will have a similar effect on its extraordinary zeal this time. On the other hand, the ECB's mandate is purely to keep inflation below, but close to 2% and, in contrast to the FED, it will be very uncomfortable with 'looking through' rises in headline inflation caused by oil price hikes and, furthermore, prone to ignore the threat to growth.

We admit to being surprised by the turn of events and would say things hang in the balance now, with at least a 50% chance that rates are raised before the end of Q2 and therefore a similar possibility of a 1.75% target for the Refinance Rate by end 2011.

**JAPANESE MONETARY POLICY**

We always felt there was no prospect whatsoever of any increase in policy rates from their current level of 0.1% during 2011 and, of course, the tragic events of March 11 reinforce this view, and also the possibility that the Bank of Japan has to embark on massive quantitative easing, if for no other reason than to counteract possible yen strength that could ensue from repatriation flows. But watch carefully, the BOJ will in effect be monetising the huge Japanese government debt..

**U.K. MONETARY POLICY**

The Bank of England's Monetary Policy Committee (MPC) has recently become divided between those who favour an immediate 0.25% or 0.5% hike in rates and the majority who still fear the economy will be not be strong enough to withstand higher rates in the face of the massive fiscal tightening which the U.K. coalition is implementing; it sees inflation back at its 2% target in the medium term.

Despite the geo-political and economic developments which we have discussed at length above, not to mention the Japanese disaster, it's still a very close call, but we think the MPC will leave rates on hold at 0.5% throughout 2011.

# FX OUTLOOK: CRITICAL CHALLENGES FOR THE MAJOR CURRENCIES

The rest of this year should see large swings in currencies, with each of the three super-major currencies facing huge challenges in the coming quarter. Namely, in the US: how will the Federal Reserve deal with the anticipation of the phase-out of QE2 and will it provide hints of QE3+? In Europe: will Europe maintain its resolve to bailout the PIGS (Portugal, Ireland, Greece and Spain) and will the PIGS show signs of rejecting the bailout in favour of a clean slate? And in Japan: how will Japan fiscally cope with the devastation from the terrible earthquake and tsunami of March 11? Elsewhere, the most important question is whether the Chinese regime will be able to engineer a soft landing for its overheated economy that has been over-reliant on relentless fixed asset investment and a property bubble. The stakes are very high around the world on these themes, and the dip to multi-year lows in FX volatility in early March was by no means a reliable barometer of the market environment in coming quarters, more likely serving as a period of calm before the storm. The remainder of 2011 should provide plenty of fireworks, judging from the themes that are in play.

**2011 OUTLOOK REVISITED**

The world looks very different than it did when we began putting pen to paper on our outlook for this year. Two devastating earthquakes have altered the landscape for New Zealand and especially Japan, both in terms of the terrible loss of life and property, and due to the enormous fiscal and financial challenges these tragedies present. At the same time, revolutions in the Middle East/North Africa have rocked not only world politics, but also energy and all other markets with their implications.

Revisiting our outlook for the year, one of our main points was our belief that equity prices, and therefore risk appetite, would have a hard time rising simultaneously with bond yields and commodity prices as they did in late 2010. Eventually, we felt, either the rise in bond yields or the rise in key input prices (especially considering the notable output gap) would serve as a damper on risk - particularly in emerging markets due to their higher per capita exposure to commodity prices. Indeed, the further rise in commodities early this year saw many emerging market currencies taking a beating and their equity markets underperforming. Elsewhere, spiking food prices clearly provided at least some of the spark for the revolutions in North Africa and on the Arabian peninsula.

In Q2, the trajectory of commodity prices will remain a critical factor – especially food and energy prices, of course. But even aside from commodity prices, we expect that most of the G-10 currencies could become more volatile as the themes pushing and pulling on the market are no longer so clearly aligned along the axis of risk appetite (though risk appetite is still a large general theme) as they were during the 2008-09 crisis and in its aftermath. Here we refresh our outlook for all of the G-10 currencies for the coming quarter and beyond – an exercise that is particularly challenging as we are writing this in the nervous days just after the catastrophic Japanese earthquake and tsunami.

**USD: QE TO INFINITY?**

We asked in our yearly outlook whether the USD might find itself in a win-win situation this year, as risk appetite might correct lower later in the year (the USD has been negatively correlated with risk for years now) and on relative outperformance of the U.S. economy stemming from some of the stimuli put in place by the Fed and Obama administration. Instead, we have largely seen a lose-lose situation. The greenback has more or less fizzled slowly to start the year – first as risk appetite was strong and other central banks were engaging in increasingly hawkish rhetoric while the U.S. Fed remained clearly committed to completing the QE2 (Quantitative Easing) programme. Then, when risk appetite finally faltered, it was due to unrest in the Middle East and spiking oil prices, with negative implications for the U.S. based on its reliance on crude imports and to the risk to the USD from reserve diversification from massive profits in the various petro-currencies etc. Throughout, the animating anti-greenback theme has been the complete lack of Fed credibility on monetary policy response to the inflation threat and its maintenance of an easy money policy.

Going forward then, the only hopes for the greenback come from two directions: first, relative economic weakness elsewhere in the world that forces a reassessment of the policy response of the other central banks relative to the Fed and second, an end to QE2 with no move toward QE3 and beyond. Markets are very forward looking and although QE2 is scheduled to end at the end of Q2, odds are clearly already being taken on QE3 and beyond. And why not? The new Congress, which we expected to present a tougher face to the Bernanke Fed, has done virtually nothing to stop the money printing or even show signs that it really wants to. If the economy weakens again, the Fed is ever-ready to wheel out the printing press once again, it seems. One interesting scenario is the idea that the Fed might let QE2 expire for a time in order to test the real strength of the economy and markets and "sweat" the politicians a bit before moving ahead with QE3. We've been predicting a USD comeback for quite some time now, particularly in the event of a faltering global growth picture and the Fed finally being forced to stop its printing ways. If no one stands up to Bernanke's machinations, however, the USD will have a tough time making the expected comeback (which we only expected as a significant rally within a secular period of decline in the first place). A third dark horse that lies outside of the above assumptions includes a new Homeland Improvement Act, à la 2005, which boosted the USD as U.S. corporations repatriated billions in profits.

**EUR: TURBO-DEFLATION**

The Euro has seen a big comeback since the beginning of the year as the PIGS sovereign debt crisis has so far been relatively contained, even as the situation in Greece, Ireland and Portugal is tenuous at best and still points toward eventual debt restructuring in those countries. Meanwhile, the ECB has been rattling its sabre on the need to raise rates to fight the threat of inflation from commodity prices. A strongly flattening yield curve on ECB hike threats, vicious austerity at the Eurozone periphery and a possible slowdown in export markets as China clamps down on growth all point to deflationary effects on the economy and even turbo-deflation.

The Eurozone politicians in March were able to agree in principle on an update and expansion of the existing European Financial Stability Fund (EFSF) bailout mechanism, though not all of the details have emerged and the EU summit on March 25 is a further test of how strong the European political resolve remains as the voters are clearly getting restless. For how long can European politicians fail to represent their populations, most of whom are dead set against further bailouts (the Germans, who are footing most of the bill) or the Euro itself (the most peripheral countries that can't devalue their way out of the crisis and face endless years of austerity)? So the Euro may enjoy a bit of a resurgence for a while in Q2 if the politicians can put enough fingers in the dike for now and the ECB ploughs ahead with its first rate hike, but the entire dike will continue to erode as it has for the last several years as long as bailouts remain in place and the longer term viability of the Eurozone project is still very much in question. Euro tailwinds may continue into Q2, but we haven't seen the final test of the European banking system and sovereign debt issue.

**JPY: DOES THE SOVEREIGN DEBT LOAD EVER MATTER?**

The earthquake/tsunami disaster of March 11 was an awful blow to an already weak Japanese economy. The country posted an outright decline in GDP in Q4 and is certain not to grow at all in Q1 after the tsunami. The initial response to the March 11 catastrophe was a stronger JPY as the market counted on a similar pattern to the 1995 Kobe quake, when the JPY spiked to its strongest level ever just below 80 on anticipation and the reality of repatriated funds going towards paying for the damage. This kind of strength could continue as the market tries to replay the reaction in markets to the 1995 quake. If rates stay low and flows are sustained for a time, this could indeed result in a further spike in the JPY to the strong side for a time to new record lows in USDJPY well below 80.

But the Japanese economy and fiscal wherewithal of 2011 is not the same this time around as it was then, as the domestic Japanese saver is more or less tapped out, and the outstanding question is how the government will finance the payment of disaster relief in the long run. The inevitable answer is that the Bank of Japan will have to print the money, and eventually, if the greenback is getting hammered for money printing and the expansion of the Fed's balance sheet, the JPY will have to pay the piper on the same account. Eventually, this could mean a sharply weaker JPY as Japan is the country farthest along in the "Keynesian endgame" as hedge fund manager Kyle Bass calls it. That eventuality may lie beyond the end of Q2, but the disaster has brought the date with the consequences of public insolvency significantly forward. Keep in mind that the Japanese financial year ends March 31.

**GBP**

The pound has outperformed the USD during Q1 as the Bank of England's (BOE) Monetary Policy Committee (MPC) is taking increasing note of persistently higher inflation levels and the need to signal a move on interest rates (though one wonders whether the bank's doves will possibly use the situation in Japan as an excuse to wait as long as possible on a policy move). Still, a growing minority of three hawks on the MPC has already voted for a rate hike at a recent meeting. So important for the pound's outlook in Q2 is whether BoE chairman King and his more dovish cohort may be finally dragged into hiking rates. Even if they are still very reluctant to do so with the economy faced with the challenge of so much public sector austerity taking hold this year after Q4 saw an ugly decline in GDP, though that was to some degree driven by extremely poor weather in December and an exaggerated trade deficit at the tail end of the year, partially attributable to new tax law in 2011.

We suspect that the GBP will continue to echo the USD in terms of the intermarket factors that are supportive for the currency. The BoE is likely to be very slow with any interest rate move, though perhaps faster than the Fed – so when CB rate expectations heat up, the pound will outperform and when they are cooling, the pound may underperform. The pound will do well in a scenario in which the market begins to sell off riskier assets and moves in expectation of weaker global growth going forward. Important for the longer term health of the pound will be the country's trade picture, as it has alarmingly failed to show any consistent improvement in terms of trade despite the sharp weakening in the pound since the onset of the financial crisis. The degree to which austerity measures will affect growth from here on in are another focus.

**CHF: TO REMAIN THE ANTI-EURO?**

The Swiss franc has historically been a safe haven currency of note, but that behaviour has been less consistent over the last 15 months or more of the Eurozone sovereign debt. During that time, the franc has only served as a safe haven vis-à-vis the Euro, tending to the strong side as a safe haven when the PIGS crisis becomes the focus and easing back once the ECB started feeling comfortable enough to start rattling its sabre on fighting inflation. Note that the Euro comeback for the first two months of this year also saw a flailing Swiss currency during the same time period. Otherwise, the currency's behaviour has been erratic, generally looking less-good when the focus is on rising potential for central bank tightening and looking better when interest rate spreads collapse (on falling rates since Swiss yields are so low). Going forward, it appears the CHF will continue to trade off the Euro and interest rate expectations. On the latter subject, if higher rates and rate expectations ever bring a sovereign debt angle to the fore in the macro environment, the franc may also be able to thrive well, since its sovereign debt picture is matched by few other major currencies.

**THE OTHER DOLLARS – AUD, NZD AND CAD**

The Aussie, Kiwi, and Loonie are often thrown into the same boat together as commodity currencies, but that isn't a fair thing to do, considering the degree to which their fortunes have varied of late. The Aussie has finally taken a bit of a back seat to the rest of the G-10 in Q1 of this year after a torrid performance in

2010. Rate expectations from the Reserve Bank of Australia (RBA) are virtually nil as dovish comments have crept into the RBA's rhetoric and it is clear that the Australian economy is actually quite weak outside of its overgrown mining sector. The pivotal question for Australia for the remainder of 2011 is the trajectory of the Chinese economy, which is showing signs of stress and is in for a landing of one kind or another. If the Chinese landing becomes a hard one and worse, if that country is racked with a banking crisis, AUD would likely see the most downside of any of the G-10 currencies as it is the most purely commodity-driven currency among the G-10.

The Canadian dollar has had a bit of a back and forth start to the year, but has tended a bit higher with the rise in energy prices as the Middle East crisis went into full swing. Unfortunately, while the country has been a paragon of relative strength due to its robust financial institutions and relatively strong growth, considering the relatively weak economy of its massive neighbour to the south, there are structural challenges going forward: reliance on extractive industries, the world's most leveraged consumer and the risk of a new decline in its terms of trade. We prefer CAD to some of the most pro-cyclical currencies, particularly the Aussie, but it may begin to face headwinds later in the year as the highest fliers may get their wings clipped.

After a strong rally attempt to start the year after an exceptionally weak finish to 2010, New Zealand was struck with a devastating earthquake that will cost a significant percentage of GDP (in the 10%+ neighbourhood). The damage was sufficiently worrisome for the Reserve Bank of New Zealand (RBNZ) to actually cut rates 50 basis points just when other central banks were making the most noise about hiking rates. The RBNZ may not cut much more, but New Zealand will be in rebuilding mode for some time and will likely tend to the weak side for the next couple of quarters.

**THE SCANDIES – HEADED IN OPPOSITE DIRECTIONS?**

The Swedish krona continued its rallying ways in early 2011, even gaining on top of a strong Euro as EURSEK plummeted to its lowest level since the year 2000 (as low as 8.70). SEK is a generally pro-cyclical currency and its trajectory is largely similar to that of major European equity markets. With a more challenging environment going forward for risk and for the European economy more broadly speaking, the SEK may take an extensive breather here as it may have achieved the lion's share of its pro-cyclical potential.

The Norwegian krone could fare far better than its cousin to the east. It was generally a laggard during the post 2009 upswing in risk appetite and recovering markets, but has performed better of late on the rise in crude oil prices and after the Norges Bank finally stirred on the inflation threat. From a valuation perspective it looks more reasonable as well, and if sovereign debt issues crop up again, Norway has few equals in the robustness of its national balance sheet.

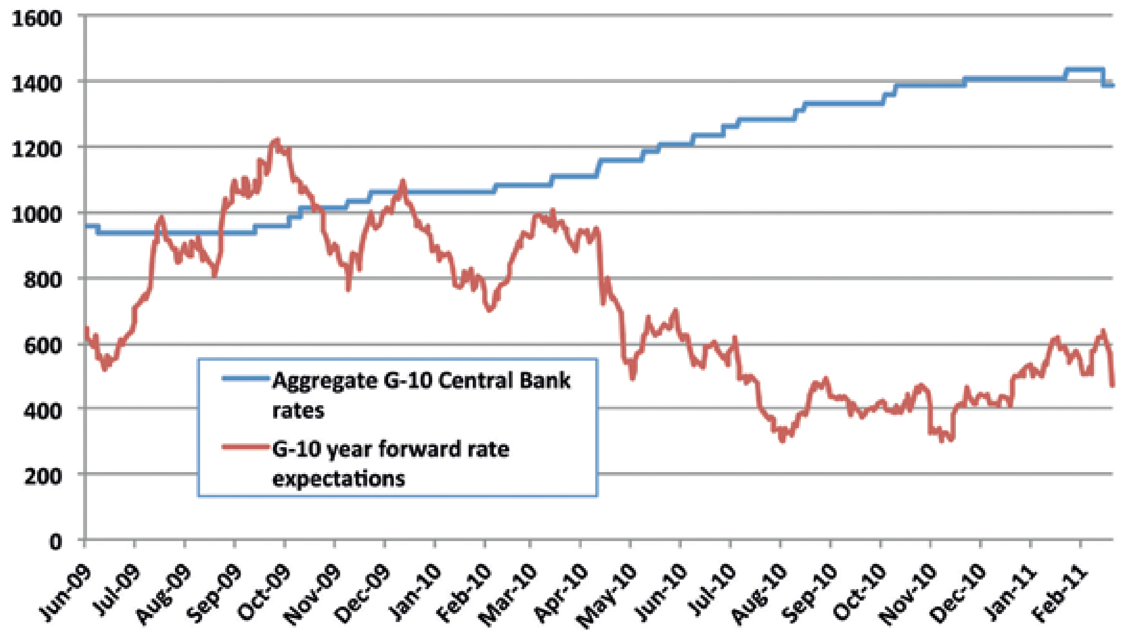
**TRADE THEMES**

For the coming quarter, we would propose that if the market moves in accordance with our bias and outlook, the following trading themes may emerge: Long EURAUD, Short AUDNZD, Long NOKSEK and Short GBPUSD. We leave the JPY out this time around as the situation in Japan is so fluid at the moment.

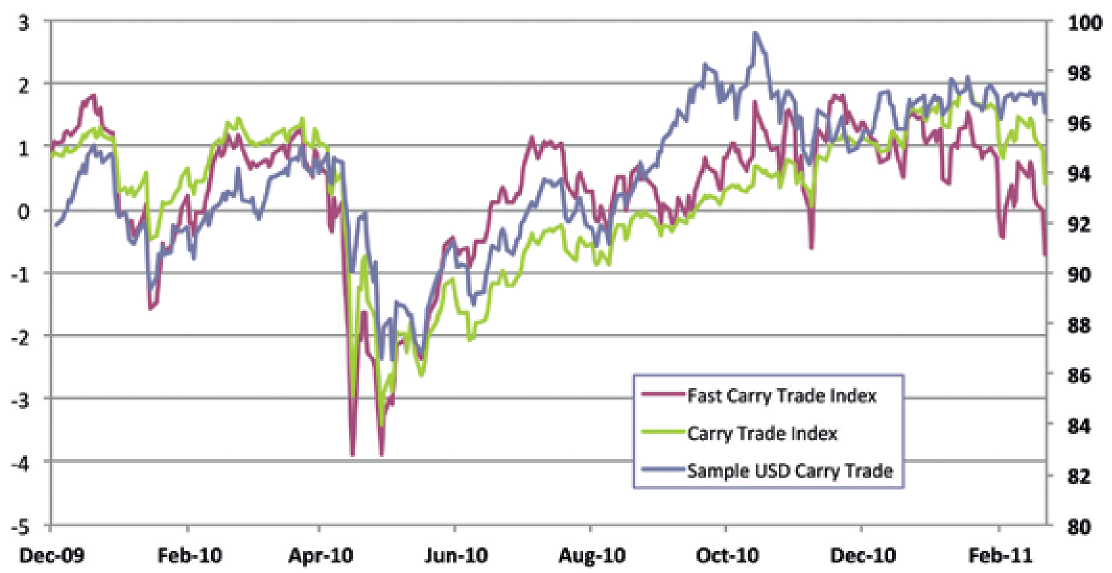
Moves in rate expectations have been critical for the relative movement in the major currencies in the first quarter of the year. Note how expectations ratcheted higher in the first part of this year until the New Zealand and Japan earthquakes deflated expectations (and even the actual rate in the case of the RBNZ). Going forward, will central banks continue to ease off the pedal on growth fears from Asia? Or will crude oil and other critical commodities spike higher again on all of the money printing and cause some central banks to continue to hike rates to fight inflation?

Our measures of risk have seen two dips in the first quarter of this year, the first on MENA revolutions and the second after the March 11 catastrophe in Japan. The USD has tended to respond to risk aversion with strength in the past, but recent market behaviour has suggested that the relationship is no guarantee. Will risk appetite (as indicated by our Carry Trade Index and its "fast" version shown in the chart) continue to head south and will the USD follow its lead? The USD carry trade (the sample in the chart below is the USD's performance versus seven higher yielding currencies) has been one of the most salient themes among the major currencies over the last three years.

G-10 Aggregate Central Bank Rates and Expectations




Saxo Bank Carry Trade Model



## FX OPTIONS: CAUTIOUSLY SHORT

It is hard not to focus on the recent events that have shaken the world over the last couple of months (and still are very much driving market sentiment ), notably the Middle-East turmoil and the devastating earthquake in Japan. As a result, mid-March saw some extreme moves in Foreign Exchange, not only in spot but also in the option market: a clear lack of liquidity drove USDJPY down well below 77.0 at the close of day on March 16, triggering a dramatic increase in implied volatilities. The rise of volatility in the JPY products actually started as soon as the Earthquake hit Japan and gathered momentum as stock markets tumbled across the world and overall uncertainty increased. The March 16 events therefore happened in a very nervous market, which explains why implied volatility jumped up so dramatically.

The market has since calmed down and volatility has dropped significantly, with 1mth JPY now quoted around 11.0… still high considering very recent spot moves, but well off the highs seen in the Asia open of March 17 where it was quoted at 19.0/21.0. The charts below show 1 month implied volatility in USDJPY over the last month and year. Please note the dramatic rise and fall.

**Legend:**

1. Japan earthquake
2. Stock markets under pressure across the board
3. USDJPY collapses at the end of day (March16)
4. BOJ intervenes
5. Markets quieten down
6. Recent buying of upside USDJPY options pushes vols slightly higher

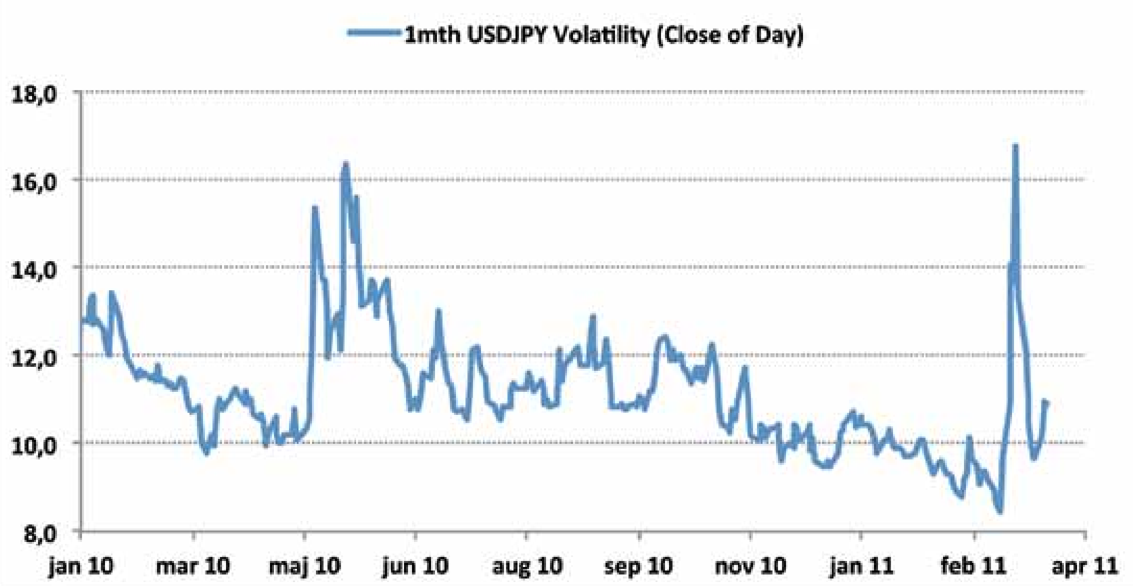
**Chart 1: USDJPY 1mth implied volatility over the last month**


*source: Bloomberg*

So where do we go from here? Well, the world certainly is uncertain right now! However, we believe that the current situation merits a cautious approach to sell implied volatility. As always, a word of caution as selling options presents: this presents large potential risk and every short option position should be managed in a disciplined manner.

All this being said, the recent developments in Japan and in particular the concerted intervention in the JPY market makes us lean toward a short volatility position: selling outright puts or calls should of course be done sparingly, but one could imagine using covered call or put strategies to enhance returns. Despite talk of JPY repatriations following the earthquake, we would not want to go against the many central banks and would favour a long spot position whose entry level could be improved by selling USD Call / JPY Puts.

**Chart 2: USDJPY 1mth implied volatility over the last year**




*source: Bloomberg*

Equities have gone from party to hangover as a series of uncertaintaies have engulfed markets, namely tensions in the Middle East impacting energy markets and the Tohoku earthquake creating the 'worst crisis in Japan since the Second World War'. But we are still modestly optimistic about equities compared to other asset classes, though equities will experience short-term turbulence on their way higher.

**OUR TAKE ON GLOBAL EQUITIES**

Developed equities entered 2011 on a wave of investor optimism generated back at the beginning of September 2010 as economic data pointed towards a recovery having legs and there were high expectations ahead of the now-ended fourth-quarter earnings season. It all went well until tensions in the Middle East broke out and Japan was hit by an earthquake; the impact of the two events alone erased this year's gains. So, are equities attractive at this point?

We have collated data on the MSCI World Index in order to appraise the valuation of global equities. It is clear that, from a conservative investor's point of view, global equities are not outright attractive as they were back in late 2008 when stocks yielded 1.76 times that of corporate bond yields. Valuations are near the levels seen back in 2007 measured by earnings yields and thus despite expected growth in corporate earnings in 2011, investors should not be all in on equities due to current valuations and looming risk factors, which we will discuss later.

We are currently mid-range in valuation which normally produces adequate returns for investors. This observation has been made on the S&P 500 index since 1958 (see figure below). Our conclusion is that equities are still attractive given current valuations but investors should not be fully exposed to equities. In fact if equities continue to rally towards year-end it would be prudent to increase exposure in fixed-income at the expense of equities.

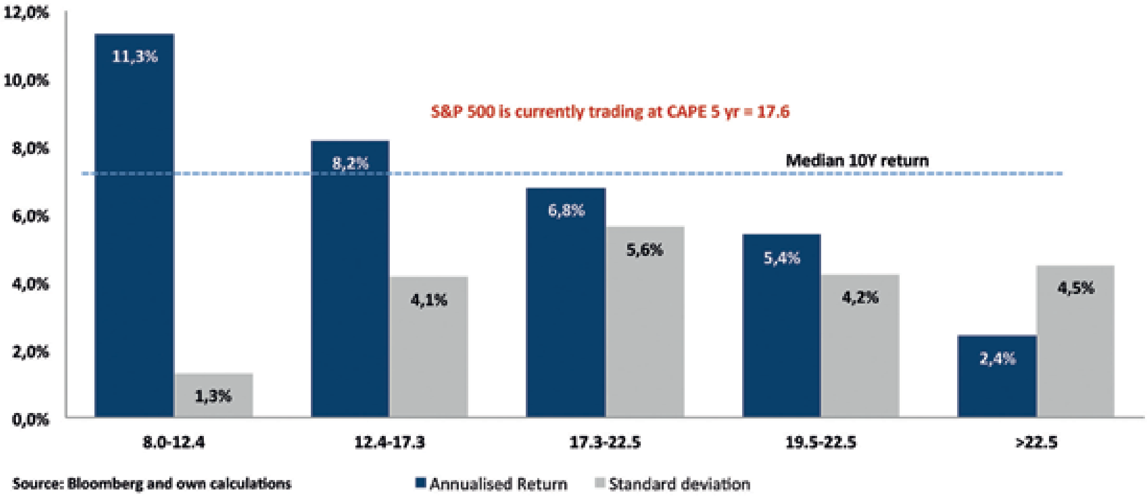
It is important to remember that based on elevated equity valuations bonds have historically outperformed equities. For example U.S. 10 year treasuries returned around 5.8 percent annualised since 1997 compared to 4.1 percent for the S&P 500 Total Return Index.

**MSCI World Index (USD)**

| **Year** | **1997** | **1999** | **2002** | **2005** | **2007** | **2008** | **2010** |
|---|---|---|---|---|---|---|---|
| Closing price* | 936.59 | 1420.89 | 792.21 | 1257.78 | 1588.80 | 920.23 | 1311.01 |
| Earnings in current year | 40.12 | 42.96 | 31.06 | 72.27 | 100.32 | 59.97 | 87.35 |
| Average earnings last 3 years | 36.40 | 41.37 | 37.77 | 62.74 | 86.82 | 82.72 | 67.45 |
| Dividend in current year | 16.41 | 18.34 | 17.84 | 25.68 | 37.72 | 36.71 | 30.30 |
| High-grade bond interest** | 6.76% | 7.55% | 6.21% | 5.37% | 5.49% | 5.05% | 5.01% |
| **Ratios:** | | | | | | | |
| Price/last year's earnings | 23.3 | 33.1 | 25.5 | 17.4 | 15.8 | 15.3 | 15.0 |
| Price/3-years' earnings | 25.7 | 34.3 | 21.0 | 20.0 | 18.3 | 11.1 | 19.4 |
| 3-Years' "earnings yield" | 3.9% | 2.9% | 4.8% | 5.0% | 5.5% | 9.0% | 5.1% |
| Dividend Yield | 1.8% | 1.3% | 2.3% | 2.0% | 2.4% | 4.0% | 2.3% |
| Stock-earnings yield/bond yield | 0.57 | 0.39 | 0.77 | 0.93 | 1.00 | 1.78 | 1.03 |
| Dividend yield/bond yield | 0.26 | 0.17 | 0.36 | 0.38 | 0.43 | 0.79 | 0.46 |
| Earnings/book value*** | 11.5% | 12.1% | 10.5% | 13.8% | 15.4% | 13.9% | 10.5% |

Source: Bloomberg and own calculations
* Closing price 2010 is the latest closing price as of March 22. 2011
** Moody's Bond Indices Corporate AAA
*** Three-year average figures

**Annualised 10Y return on S&P500 from different starting points of trend P/E (1958-2001)**




Looking at equities from a geographical perspective, we have revised down our year-end target on the Nikkei 225 index due to the earthquake's impact on Japan's economy. Given current development in food and energy prices we are also less optimistic about emerging market equities compared to developed equities as a whole, and thus have revised down emerging market stock outlooks.

The reason is simply that record food and energy prices[1] will hurt the purchasing power in emerging markets harder relative to developed markets. Monetary authorities in emerging economies will have to tighten policy or let inflation go higher; neither of which are particularly good for emerging equities. However, we believe Russia is a good play within emerging markets as it will benefit from higher energy demand in 2011, regardless of rising food prices.

Predictions about future price levels in global equities are always prone to error as physical and financial markets are determined by human actions which, per definition, tend to be unpredictable and dynamic. Therefore we find it most fitting to outline the various risk factors that could shatter the bull market that began in March 2009

### IS MARGIN PRESSURE ON THE RISE?

With net profit margins almost back at peak levels observed in 2007 investors are beginning to question whether companies will experience operating margin pressure as they will find it difficult to pass rapidly rising commodity prices on to the consumer.

Major consumer companies such as Proctor & Gamble, Danone and Kraft Foods have all reported rising input costs in the fourth quarter and say they will raise prices in 2011. Will they succeed in passing on rising energy costs to consumers in order to protect profit margins and grow revenues at the same time?

Well, it may be difficult to pass on rising input costs but one argument could be that it does not matter if growth in revenue compensates for a falling profit

1) FOA Food Price Index reached an all-time high in February at 236.04, up 67.2 percent from February 2010.

**Saxo Bank 2011 Forecasts**

| | S&P 500 | DJ STOXX 600 | Nikkei 225 | MSCI EM |
|---|---|---|---|---|
| Yearly Outlook | 1.420 | 315 | 11.400 | 1.350 |
| Revision | 0.0% | 0.0% | -7.9% | -7.4% |
| 2nd Quarter Outlook | 1.420 | 315 | 10.500 | 1.250 |

Source: Bloomberg and Saxo Bank Strategy & Research margin so earnings per share keeps rising. The problem is changes in earnings per share and profit margin are 95 percent correlated so when profit margin falls, then despite revenue normally continuing to grow for an additional 3-4 quarters, earnings per share falls in tandem with profit margin.

We expect the expansion in profit margins to slow down but expect margins to continue expanding through 2011 as we are still early in the growth cycle - unless oil prices go above USD 130 per barrel or China slows down significantly. But make sure you understand this: profit margins will fall at some point in this expansionary economic cycle (probably in 2012 or 2013) and when that change comes you should position yourself accordingly.

**WILL EQUITIES SKID IN OIL?**

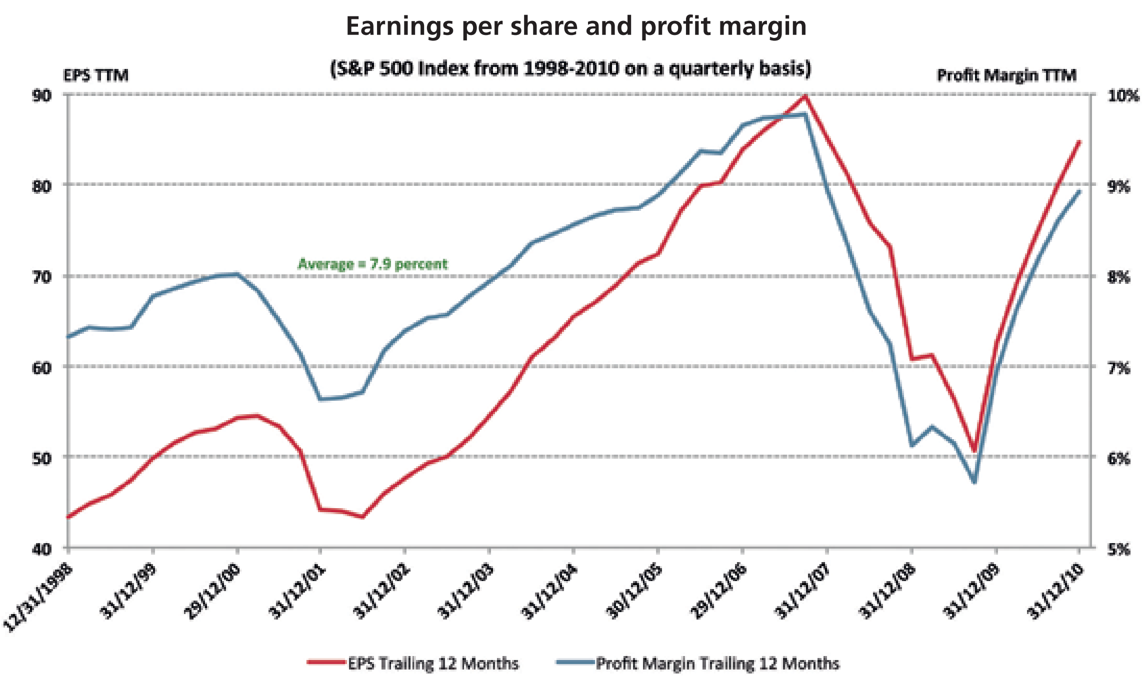
Crude oil prices are a key driver of real GDP growth through their impact on operating margins, prices and earnings. Thus, can rising oil prices derail the economic recovery?

Gradually rising oil prices are normally a healthy sign and we believe demand for energy, particularly oil demand, will rise faster than supply as we expect the global economy to grow by around 4.2 percent in 2011 leading to higher energy prices. We believe the recent price shock in oil prices will impact economic growth somewhat but not enough to derail expected growth in 2011. In this base case scenario we suggest investors overweight exposure to energy stocks and lower exposure to consumer discretionary stocks (especially automobile).

If oil prices advance too fast, or  experience a new upside shock, it will slow down economic growth, lower disposable income and squeeze profit margins – which may, in turn, weigh on equities. This is a real risk with the tensions currently percolating in the Middle East; the key is how the situation in Saudi Arabia evolves

**PERIPHERAL EUROPE'S DEBT CRISIS WILL NOT GO AWAY**

Pressure in peripheral Europe's credit markets persists and poses a huge threat to Europe and stability in the region. Bond yields in Greece, Ireland, Portugal and Spain are at record highs and more bailouts could shake the vulnerable and under capitalised European banking system. If the ECB decides to raise the benchmark interest rate too fast, this



might push peripheral Europe off the cliff and then Europe's kitchen is on fire.

The only way for investors to mitigate this risk is to lower exposure to European stocks relative to U.S. stocks and if the debt crisis escalates, then quickly allocate more of the portfolio into U.S., Swiss and German government bonds; and yes, not for yield, but for capital preservation.

**CHINA IS A QUESTION MARK**

China is really difficult to analyse due to the lack of transparency in economic data. What we do know is that the housing market is slowing down, though prices are still rising 6.4 percent year-over-year as of December, which will hurt the economy and the financial sector. But if China remains overheated, and the People's Bank of China tightens more aggressively, then it becomes a risk to current equity valuation levels. If this scenario plays out in 2011 it will impact global growth, company earnings and equities as an asset class.

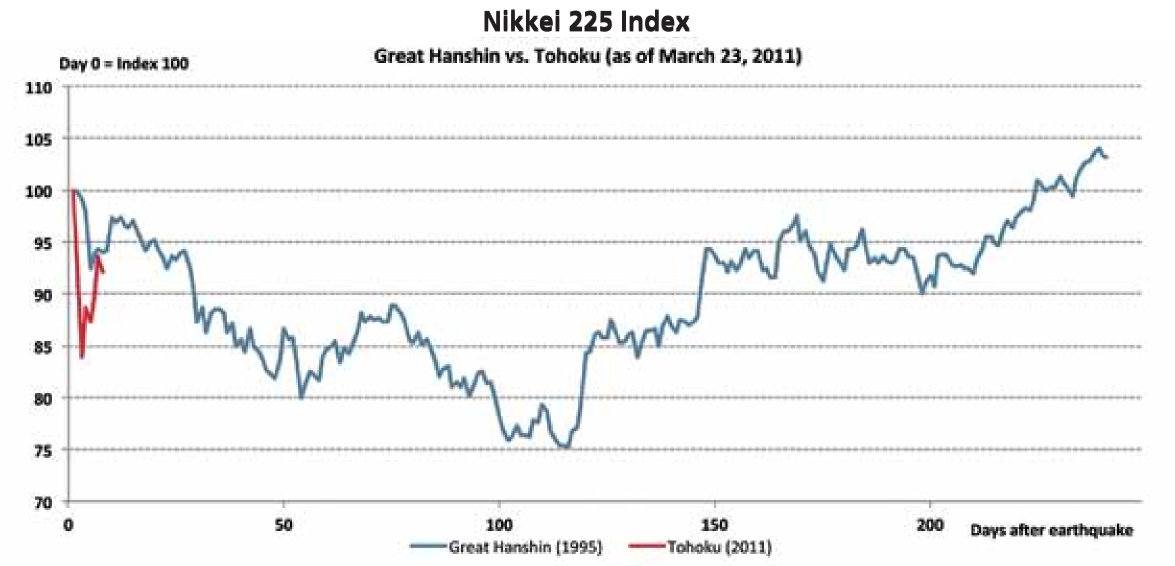
The best ways to mitigate a significant slowdown in China, if it happens in 2011, is to underweight or go against oil and gas companies as demand for energy will decline. On a country level, Australia's commodity economy will be hit hard and underperform relative to other equity markets.

**JAPAN'S CHAIN REACTION OF UNCERTAINTY CREATES OPPORTUNITIES**

Both the human and physical damage to Japan has been devastating and the earthquake is estimated to have cost the country about USD 309 billion[2], which is around 4.6 percent of real GDP. But we believe Japanese stocks have been oversold in the chaotic aftermath and we believe Japan's economy will quickly pick up as it did after the 1995 earthquake; in fact GDP kept on growing throughout 1995.

We believe great opportunities exist in Japanese stocks; especially in the large quality companies with a broad revenue base outside Japan and those having reasonable valuations. But given the lack of information and numerous revisions to the final cost of the disaster on the economy, we urge investors to wait on the sideline as Japanese stocks could go lower during the next months before bottoming out, as happened after the Great Hanshin earthquake in 1995.

2) According to Japan's government as of March 22, 2011



# COMMODITY OUTLOOK: COMMODITIES FACING A STEEPLECHASE OF UNCERTAINTIES

Investors have had to deal with an unusual number of shocks during the first quarter of 2011. What began with an almost unanimous belief that the global economy would shift up a gear in 2011, which in turn would trigger higher energy and base metal prices, has turned into a steeplechase with one obstacle following another.

The low interest rate environment that investors have been getting used to since the financial crisis in 2008, and particularly after the QE2 liquidity boost last autumn, is slowly drawing to a close. Now the European Central Bank is expected to make the first move during April. Whether the U.S. Federal Reserve opts for quantitative easing round three or makes a move to normalise its interest rate environment could have a major impact on non-interest bearing commodities, like precious metals, in the months ahead.

Among the first quarter obstacles were: geopolitical tensions in MENA (Middle East & North Africa) resulting in a potential oil price shock, food price inflation, the Japanese earthquake and concerns about the fiscal crisis in the Eurozone. These have all, in one way or another, led to a slight reduction in growth expectations for 2011. But for now we do not expect them to have a material impact on the overall outlook.

**GOLD AND SILVER**

Gold has lost some of its 2010 support with silver being the preferred metal. The latter has enjoyed the attention from industrial users and investors looking for a store of value or a hedge against inflation. On that basis, many rightly or wrongly, have come to the conclusion that no matter what happens, silver will continue to be in demand. During the past six months it has outperformed gold by more than 40%, despite ample supply from mining and scrap, with the bulls having their sights on the old record at 50 dollars an ounce from 1980. One should, however, not forget  silver continues to be a high beta version of gold and as such the private investor can experience severe washouts which can make it hard to hold on to.

**Gold**

Against the backdrop of elevated uncertainties we expect silver and gold especially to continue to consolidate and perform well during the second quarter. Gold has the potential of reaching $1,500/oz while silver points towards $38/oz.

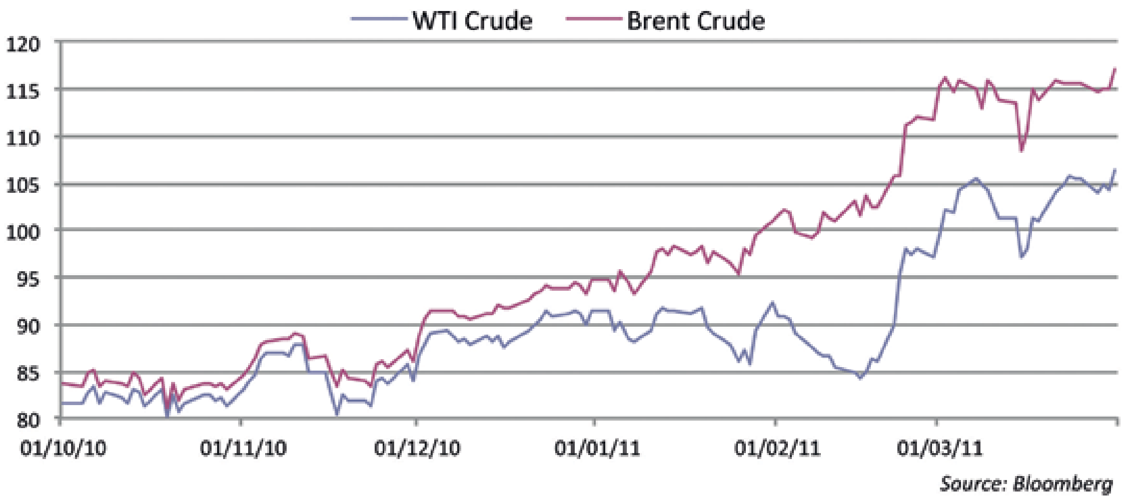
**WTI AND BRENT CRUDE**

During January the price of crude oil rallied with rising stock markets and increased demand forecasts but accelerated when unrest broke out in the MENA region. The tensions resulted in Libyan oil exports being halted and raised fears about contagion to the rest of the Middle East. Another significant event was the widening of the spread between North Sea Brent and WTI crude. Historically, WTI trades USD 1.50 higher than Brent as the inferior quality of the latter makes the refining process more expensive. Recently, however, the spread has seen a dramatic widening with Brent at one point trading 15 dollars over WTI.

Apart from the well publicised over supply at Cushing where WTI is delivered, the timing of the widening could indicate Brent carries a political premium as it is considered the benchmark price in Europe, Asia and the Middle East. Despite only representing 2% of global production it is now the reference price of choice for almost 65% of global transactions. With the risk of the Libyan crisis spilling over to the Middle East the events have had a greater impact on the price of Brent than on WTI. On this basis, we can assume the spread will only begin to normalise once the current situation stabilises.

Should oil prices stay elevated above 100 dollars a barrel for a prolonged period of time,  the impact on consumption and growth cannot be ignored. Back in 2008 the spike in oil prices no doubt helped bring about the subsequent recession. During that year WTI traded above 100 dollars for seven months averaging just below 120 dollars.  Countries vary in their sensitivity to the oil price, but in the U.S., for example, it is widely believed that a 10% rise in oil causes GDP to fall by only 0.2%.

We expect the overall global pickup in consumption, combined with the political unrest and subsequent risk of supply disruptions, to keep oil prices sup-




*source: Bloomberg*

ported during the second quarter. The downside risk is primarily coming from the investment community itself as the speculative long position in WTI, which reached a record 300 million barrels during March, compounds the risk of corrections like we saw after the Japanese earthquake. In the unlikely event of risk reduction by investors an unwound back to normal levels could result in a price drop of 10 to 15 dollars.

**AGRICULTURE**

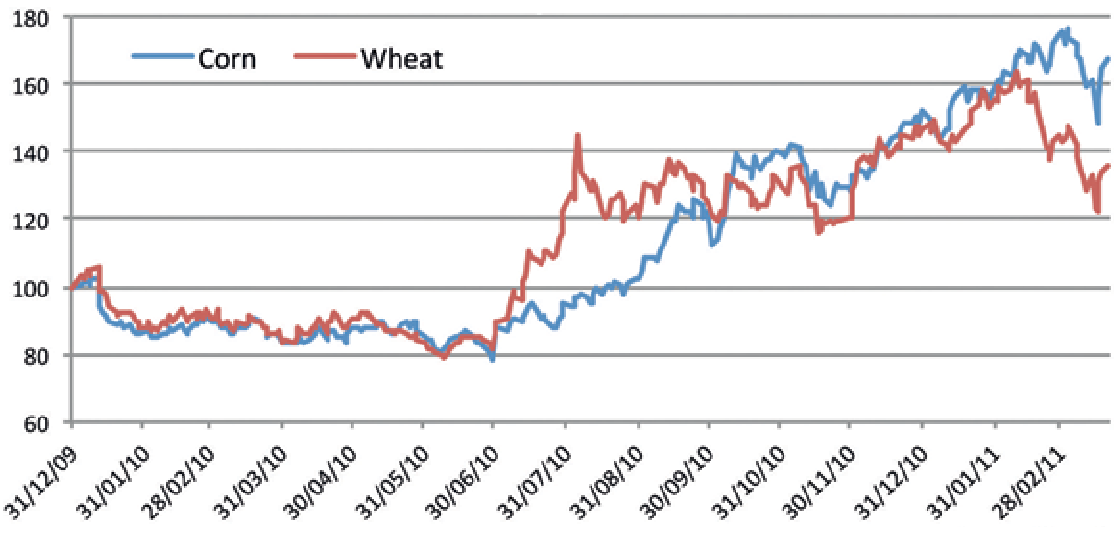
The drought related surge in food prices has continued into 2011 with agricultural prices rallying strongly during the first quarter, compounded by government hoarding in the MENA region. And that is before attention turned to the new crop season and who would win the annual fight for acreage. Favourable harvest projections in South America for soybeans, increased availability of wheat and lower Japanese demand due to a damaged infrastructure helped trigger a round of risk reduction during March. Average weather conditions in 2011 will not be sufficient to rebuild low inventories caused by the weather shocks in 2010 and, on that basis, we expect agricultural prices to remain elevated for the foreseeable future.

Given the outlook for very low stocks of corn and soybeans we continue to favour these over wheat during the coming months. A large percentage of U.S. corn production goes towards producing ethanol. This trade is profitable, up to 9 dollars per bushel, given the recent strong rally in gasoline prices. Meanwhile, soybeans remain supported by continued growth in emerging market feed demand.

**HEATING ENERGY AND BASE METALS**

Coal and liquefied Natyral Gas will be supported in the aftermath of the Japanese disaster as Japan seeks alternative energies to replace lost nuclear production. The rebuilding process should also raise demand for base metals. Platinum and palladium was sold off during March on demand destruction from Japan as car production was halted. Depending on how soon production returns to normal, a pick-up in demand should support prices going forward.

**Relative performance**




*source: Bloomberg*

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