Quarterly Outlook

SAXO BANK

Q1 2012

2012 will be a year of great change

A perfect storm is coming and it will likely already break out in the first quarter as tensions are mounting unbearably, but there is no need to panic. Three critical ingredients will conspire to make the perfect storm: the EU crisis, public sector austerity and social tension. These factors will leave no nation untouched and could result in the most pivotal year by far since the global financial crisis of 2008.

We feel that the onrushing Crisis 2.0 will however prove constructive in the sense that it forces the hands of policymakers and politicians so that 2012 will be a year in which we fundamentally alter our assumptions not only about economics and monetary policy, but also about our way of life. But before we get there, we'll see yet another quarter of extending-and-pretending that will most likely prove counterproductive and lead us quickly to this new crisis.

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A perfect storm is brewing in the New Year, and will likely already break out in its first quarter as tensions are mounting unbearably. The key ingredients are already clear: the combination of the ongoing EU crisis, slowing aggregate global demand as the public debt bubble can no longer be grown, and rising social tensions. These factors will leave no nation untouched and could result in the most pivotal year by far since the global financial crisis of 2008. That crisis unleashed the combined forces of governments and central banks, who reached deep into their policy toolboxes – and even into their hidden unconventional reaches – to intervene massively at every turn to keep the economy and its zombie balance sheets liquid and avoid anything that smacked of "collapse". The Lehman bankruptcy experience, after all, supposedly provided the object lesson for avoiding short-term pain even if it might mean higher long-term costs.

Now, we are reaching the end of the line for extend-and-pretend/kicking the can/printing money/interventionism/call-it-what-you-will from the public sector puppeteers. After the recent beginning-of-the-end phase that we have dubbed Maximum Intervention, the marionettes in the economy are tiring and will soon no longer be able to respond to government and central bank manipulations. The EU is in the hottest water at the moment due to its awkward political and fiscal framework, but the rest of the developed world and possibly also China also face this critical inflection point - the point at which ever mounting intervention from the public sector only finds rapidly diminishing returns. The other name for this point is Crisis 2.0 – the needed destruction of the old order that allows the construction of the new. Sure, a crisis is almost always considered a bad thing and inevitably brings with it painful short-term disruptions, but the hope must be that 2012 ushers us quickly towards that turning point at which we begin planning for the future, rather than pretending that we can pay for all of our past mistakes. So despite the pessimistic title, 2012 will be a year for the optimists as we might finally see the world start to head in the right direction again – towards the future and away from the tired and misguided efforts of the interventionists. To reiterate, there are three critical ingredients here that will conspire to make a perfect storm in the New Year:

EU CRISIS

The EU crisis has not been solved after the endless series of summits in 2011, and will not even approach a solution unless we see a combination of an EU-wide commitment to credible debt brakes combined with debt restructuring for the periphery and a more active role for the European Central Bank, which must ensure that the financial system is functioning smoothly as those debt restructurings take place. The "peripheral" crisis has even spread to core countries like France, and to a lesser extent, Germany itself. The question is whether the endless series of EU summits has merely shown us that the EU as it is currently imagined simply does not work, forcing something more dramatic from EU leadership – but more on that below.

PUBLIC SECTOR AUSTERITY

In the EU, the coming austerity will be the most vicious and is thoroughly entwined with the sovereign debt crisis, as the German preference for discipline over the printing press will ensure a particularly severe deflationary spiral as long as the EU holds together under the sway of the austerity impulse. Somewhere along the line, the siren song of the ECB printing press may finally be yielded to, but in the meantime, the die is cast for a very sharp recession in the EU. Elsewhere, the US may attempt "just one more" round of stimulus, but this will mostly represent a feeble extension of existing breaks and must be credibly counterbalanced with fiscal reductions elsewhere. In China, the leadership is dealing not only with a regime change, but is looking at an economy with grotesque distortions brought about by its reliance on over investment in infrastructure and property. All in all, global growth is likely to be effectively recessionary in the first half of the year, even if nominally not so.

SOCIAL TENSION

The global financial crisis and the drift in society towards a larger gap between rich and poor and higher unemployment, particularly among the young, means that we have an explosive social cocktail across the developed world. The first indications of the potential for strife have popped up in the Occupy movements starting in the US and spreading rapidly. In Europe we have a historically strong anti-EU sentiment that will represent a serial challenge as the elections get underway all over Europe, most critically in 2012 in France. The rise of True Finns of Finland in 2011 might be a strong indication of what kinds of parties will gain increasing popularity. We've also got an election year in the US. Could this one be the most socially volatile since 1968 as the Republicans might get their way and as unemployment benefits begin running out?

And as if that isn't enough, we've also got to worry about the potential for geopolitical strife in the Middle East – can Iraq function on its own, what is the fate of Iran and its nuclear programme and how will Egypt's election proceed?

OUTLOOK

With so many pressing issues, the path uncertainties are extreme in the New Year, but nonetheless, there is the overall certainty that something extreme and dramatic is actually far more likely than simply muddling through. On that note, I offer our general outlook for the coming quarter:

EU CRISIS

As the EU leaders have failed to address the fact that the banking/sovereign debt crisis is one of solvency, not liquidity provision (and they haven't even done that particularly well) a renewed crisis is inevitable. After all, the funding needs for Italy quickly mount toward EUR 300 billion by the end of January and Spain's funding needs are of similar magnitude in the New Year. This time around, we may finally see a true systemic climax, with a liquidity freezing over across the financial system and European equity markets dropping 25 percent or more in short order. Basically, this would be a crisis so intense that it forces EU leaders to pull together, shut down markets and hold the summit to end all summits to design a new EU, somewhat like how cardinals select a new pope at a papal conclave. A new EU would likely mean massive debt restructurings, bank nationalisations and possibly two or more nations dropping out of the 17 nation EMU. It would also almost have to mean a new and stronger role for the ECB, even if that role bears little resemblance to the excesses of the likes of the Federal Reserve and the Bank of England. Despite the drama, the European Financial Stability Facility and the European Stability Mechanism rescue funds (or plans to have funds…) never really take off and Euro Bonds are never issued and it becomes clear that the United States of Europe was always a mirage. The good news? The new EU establishes a more workable framework, finally begins to address the solvency issue and offers a fresh start.

ECONOMIC GROWTH

The growth outlook for Europe is clearly very negative. In the US, while it looks like the administration may hammer together some kind of deal with the Republicans on the extension of tax cuts, the austerity cat is out of the bag and all the talk will be of offsetting spending cuts for potential tax cuts/spending progress. US growth will likely be somewhat stronger than elsewhere. In Asia, growth will likely look far weaker than consensus, as China faces some heavy lifting on rebalancing its economy. Uncertainty is great there because the regime is capable of forcing activity and behaviour to a degree not attainable elsewhere.

EQUITY MARKETS

Valuations in many markets appear quite reasonable, but forward expectations are far too high given that profits as a percentage of GDP are still near record levels and given our outlook for weak demand growth. The tensions around the world from the ongoing EU crisis and possibly from higher interest rates could increase the risk premium for owning stocks. Still, values will likely be found when the markets overreact.

INTEREST RATES

Interest rates will go up in 2012. After all, the credit cake is getting smaller as the ongoing balance sheet recession around the world is already seeing the private sector deleveraging in most areas. Banks must move towards compliance with Basel 2.5 and Basel 3.0 to reduce the leverage on their balance sheets. And market discipline and fiscal reality will increasingly force the public sector to at least curtail its growth if not begin to shrink outright. The most interesting test case for fiscal dynamics could be Japan, though that may lie beyond the horizon of this outlook.

CURRENCIES

Among the major currencies, the USD is likely to perform very well, particularly during periods of risk aversion, as the world continues to deleverage. The JPY outlook is tricky due to interest rates, but the JPY could continue stronger for the initial part of the year. Other strong currencies might include NOK and SEK, which could find a bid on their sovereign balance sheets and distance from EU strife. The currencies likely to do poorly include the EUR, CHF (forced devaluation can be done!) and CNY and its satellites, like AUD and NZD.

A COUPLE OF ALTERNATIVE SCENARIOS

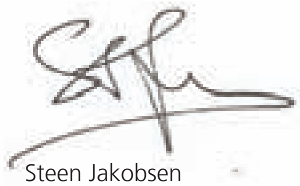
With so much potential energy in the still overleveraged and limping economies of the world and with social tensions building, it's critical to underline that there are an endless variety of paths the markets may take in the New Year, even in its initial several weeks. We have simply outlined here the scenario we judge to have the higher odds. Outcomes could look far different, of course. If, for example, the EU manages to keep the debt boat afloat far more successfully than we anticipate (likely in the short term with fancy footwork on liquidity measures) then the Crisis 2.0 and perfect storm could see a surprising delay and not materialise until beyond Q2.

CONCLUSION

The perfect storm is coming but there is no need to panic. We feel that the onrushing Crisis 2.0 will prove constructive in the sense that it forces the hands of the policymakers and politicians. Ultimately we need to find a long-term solution anchored by popular support. The "non-elected" government leaders in Italy and Greece shouldn't be seen as a model for a solution nor a promise for longer term stability, but rather as a warning sign of the alternative.

Only through accountability and owning up to reality can economic renewal and growth return. We are optimistic that 2012 will be a year of great change – a year in which we fundamentally alter our assumptions not only about economics and monetary policy, but also about our way of life. But before we get there, we'll see yet another quarter of extending-and-pretending from the policymakers that will most likely prove counterproductive and lead us quickly to this new crisis. And here we mean crisis in its first definition in the Merriam-Webster dictionary: "a turning point" – not a state of cowering in fear or suffering pain. After all, you can only fight the negative economic consequences of compounding policy mistakes for so long before being forced to make better choices. Therein lies the hope for the balance of 2012.

Sincerely,



Steen Jakobsen

MACRO OUTLOOK: NAVIGATING THE ROUGH SEAS OF THE PERFECT STORM

The world economy eased off the accelerator in 2011 as foreign trade growth and government stimuli faded and the prospects for 2012 are for more of the same. The developed economies will struggle with weak domestic demand as austerity programmes and soft labour markets take their toll while emerging economies see foreign trade ease, meaning reliance will have to be more on domestic demand, which will see central banks swinging into action and loosening monetary policy. Overall, we look for world growth to slow further in 2012 to 3 percent.

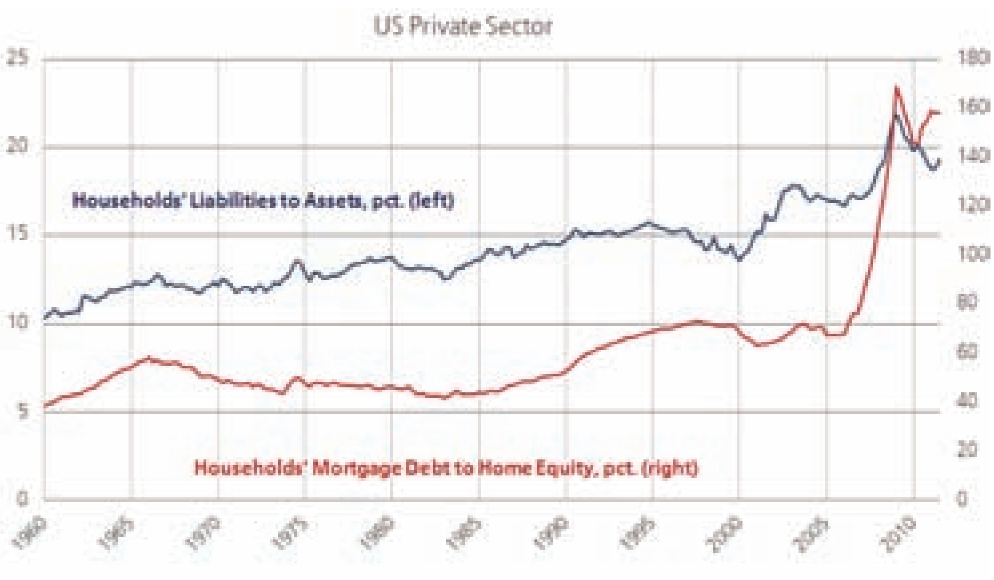
Forecasts (2012)	World	US	Eurozone	UK	Japan	China
Gross Domestic Product (YoY, pct.)	3.0	2.0	0.0	1.5	1.5	7.5
Consumer Price Index (YoY, pct.)		2.3	1.5	3.0	0.5	4.0
Unemployment Rate (oct.)		8.6	10.3	8.5	4.0	4.2

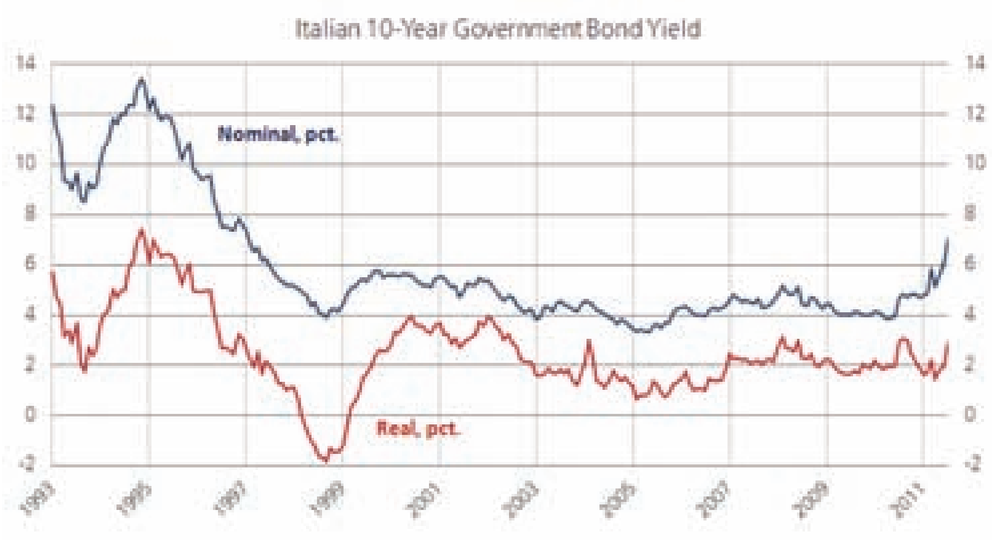
US – THE OUTPERFORMER AMONG DEVELOPED ECONOMIES

The Great Recession was an entirely different animal to previous recessions as the impact on the economy from the liquidation of malinvestments has been exasperated by a still ongoing private sector deleveraging process. The US economy has struggled with the ramifications of this private sector indebtedness for the better part of a decade now and while the deleveraging process is slowing down that it is still a far cry from the happy-go-lucky days of the early noughties when debt and a growing economy went hand in hand. The process continues to put a damper on private sector contribution to the current expansion and with a mostly uncooperative Congress the public sector will not receive much additional help in 2012. With these two factors combined you have a continuation of the timid expansion seen in 2011 with subsiding inflation and a softening labour market. Though the risks from the Eurozone sovereign debt crisis and a weaker Asia (China) loom so large that a recession cannot be ruled out it is not our preferred scenario; rather we look for the US to 'muddle through'.

EUROPE – ON THE RECEIVING END OF THE PERFECT STORM

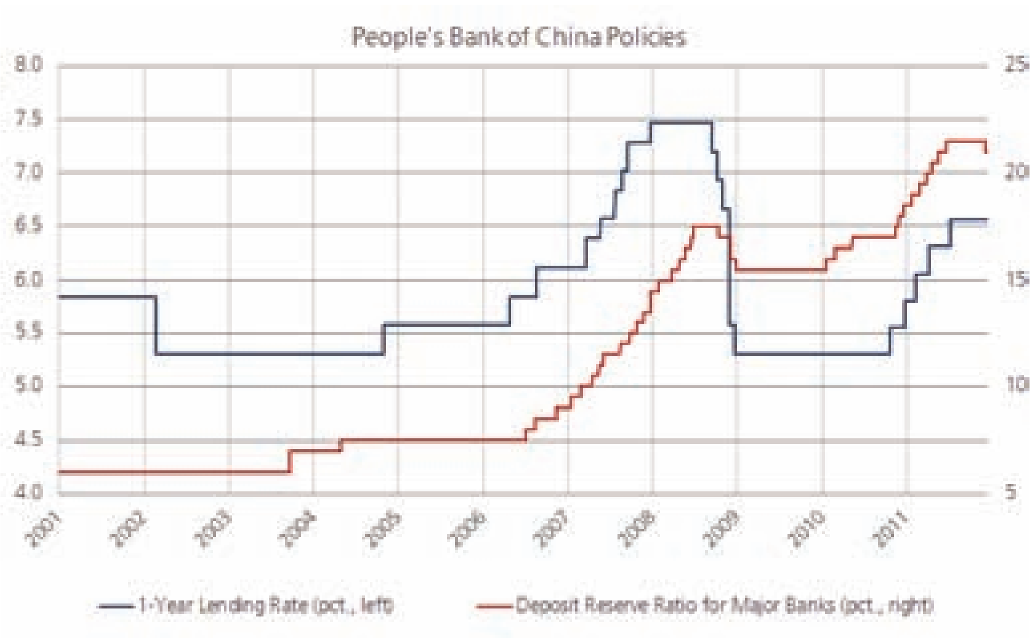
While we expect the US to muddle through the same cannot be said about Europe where public sector austerity prevails to a degree not seen across the Atlantic. The US and Europe share many of the same





problems - high unemployment, weak wage growth and an indebted private sector - but the management, or rather mismanagement, of the bloated public deficits is not one of them.

The US, as a sovereign currency issuer, does not have a problem financing itself, a position many Eurozone countries would kill for presently as they see yields shoot up to untenable levels; illustrated by Italy in the above chart, which has passed the infamous 7 percent level several times recently (though we note that real rates are not too high on a historical basis). With Germany adamant (for now) that the European Central Bank should not engage in unsterilised sovereign bond purchases this is not an option for the beleaguered Eurozone, which has instead chosen a rather painful exercise of cutting public sector costs just enough for the economy to remain in a state of prolonged recession, but not enough to deal quickly and efficiently with the real issues. The Eurozone is expected to tip into negative growth in the fourth quarter of 2011 and stay there in the first quarter of 2012 thereby confirming the recession. The UK, which is in a similar position to the US, is expected to



outperform the Euro area next year though the UK has plenty of rough seas to steer clear of itself.

ASIA – HURT BY THE SLOWDOWN IN THE DEVELOPED WORLD

The headwinds faced by Western economies are finding their way to Asia. Even the Chinese "growth miracle", which has based its economy on investments and exports, has to cope with weaker trade growth as evidenced by its trade balance which is down 19 percent in the twelve months through November compared to the year before. The decline in global trade growth is bound to continue and requires China to find growth elsewhere, an undertaking we expect the Chinese are only partly able to achieve – hence our below consensus forecast for Chinese GDP of 8 percent.

China however has a weapon that most developed economies do not possess, namely rate cuts. The tightening phase, which began in 2010 as the economy regained traction and inflation pressures started to build, has been on hold at the People's Bank of China lately. Indeed we have already witnessed the first cut in reserve ratio requirements. The tightening phase thus points to plenty of available firepower should the central bank deem it necessary to stimulate more to keep Chinese growth at a respectable level and with inflation on retreat the first hurdle is out of the way. We look for a succession of cuts to reserve ratio requirements and interest rates this year as China moves to strengthen the investment side of its economy to compensate for the weakness in foreign trade.

EQUITY OUTLOOK: ACCEPT THE FUTURE IS UNCERTAIN AND EMBRACE IT

Life is like an ocean voyage. Some days the sun shines, others it rains and in rare cases Poseidon demonstrates his wrath. In order to navigate in this world we need a compass. As we head into the perfect storm, we introduce an investment compass to better embrace the uncertainty and avoid the white noise clouding our minds. Instead of trying to forecast the next three months we will instead provide a 10,000 feet perspective on equities.

EQUITIES ARE HISTORICALLY CHEAP BUT ARE THEY WORTH BUYING?

Global equities measured by our valuation model are relatively cheap in a historical perspective due to record low debt leveraging in companies and benign valuations. One factor that is dangerously high is return on assets driven by historically high profit margins as high returns on assets normally precede a plunge in aggregate profits. Given the massive excess capacity in the labour force and recent downward pressure on commodities, we believe companies can maintain current profit margins in the first six months of 2012.

Based on current valuations, a setback in the first half of 2012, due to political and economic developments in Europe, would not be outright bloody as equity markets have already adjusted valuations for a low growth scenario and more turmoil in Europe.

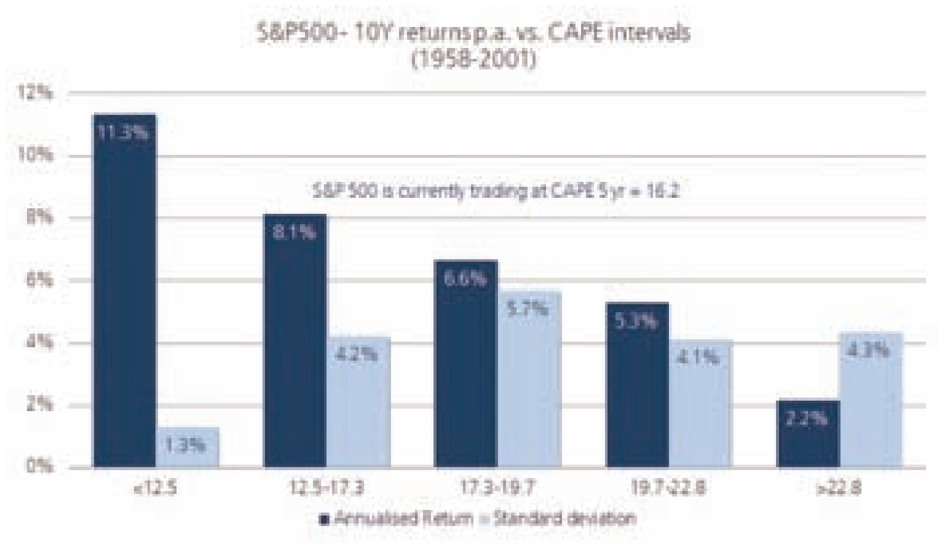
Our index valuation model on the S&P 500 below indicates a 2012 year-end level of 1,215 based on an Earnings Per Share (EPS) of 104.5 and Price Earnings (P/E) of 11.6. Given the current data equities are in aggregate terms poised for a flat year in our base case scenario with most downward pressure expected in the first six months as the earnings yield is likely to increase reflecting a contraction in growth expectations.

However with historically decent earnings yields and other asset classes providing no income stream to speak of, we believe a net neutral equity position[1] is attractive going into 2012.

ARE EQUITIES CLOSE TO A LOW POINT BEFORE A SECULAR BULL MARKET?

Investors are in a thick fog with low visibility and many are scared about the future of equities. While humans can certainly be too optimistic and they can also certainly be too pessimistic, we definitely tilt towards the latter at this point in time.

The chart on the next page compares the current CAPE (cyclically adjusted price earnings – price over the last five years' of earnings) on the S&P 500 with

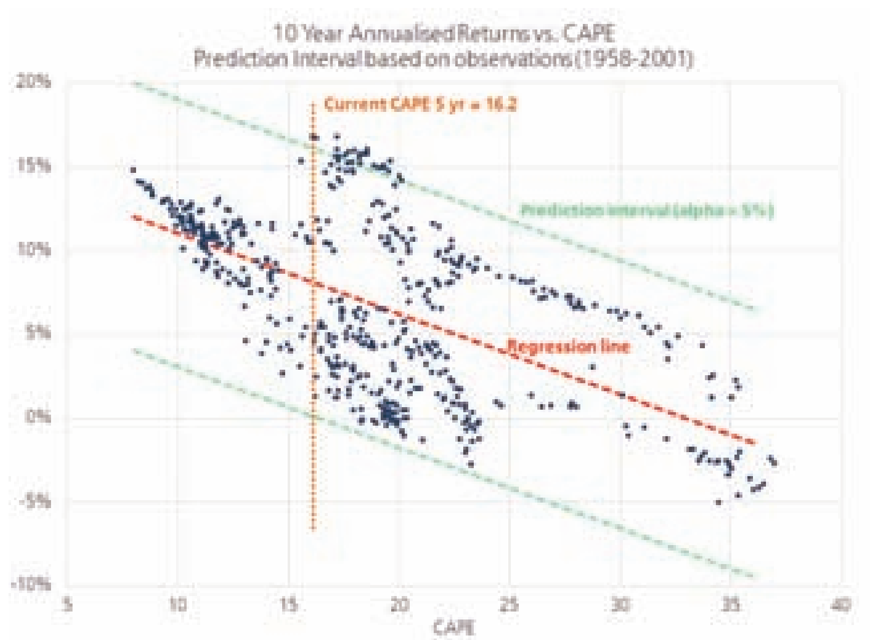


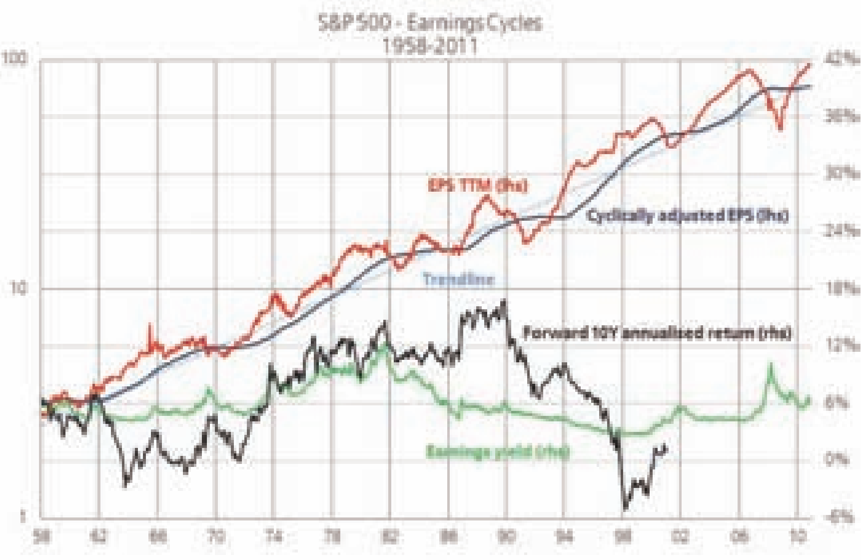
the following 10-year annualised return since 1958. It shows that we have entered a valuation range that is normally a very good starting point for a secular bull market with good probability of delivering more than a five percent annualised return.

The chart below shows the prediction interval of the regression, which shows that since 1958 equities have never returned below zero percent (annualised over 10 years) if investors bought at these current valuations. In other words, if we enter the perfect storm and stock prices plunge even more we might be in a perfect low point before the next secular bull market.

WHITE NOISE: INVESTORS' NUMBER ONE ENEMY

Investors tend to forget that equities reflect the underlying nominal growth of the economy. Thus as the monetary base and productivity are





continuously growing we would expect equities to trend up, adjusted for the business cycle over the long term. Stocks can temporarily experience negative real rate returns though.

The chart above shows the helicopter perspective on the trend in earnings, price to cyclically adjusted earnings and forward 10-year annualised returns. Despite energy crises, wars, terrorism and financial crises the human race and asset markets continue to move forward. What we want to demonstrate with the chart is that given the current earnings cycle in relation to price, there is a high probability of good long-term returns. In the short-term though volatility can be high which is why we recommend a neutral position at this point. Yes the Eurozone is seeing cracks and China might be experiencing a bust in real estate but these would not be the first asset markets hiccups in history.

The biggest risk to our compass (built on data since 1958) is that the current deleveraging is a replay of the 1930s Great Depression where the economy and stocks will significantly deviate from the trend to the downside.

IF THE STORM HITS HOW DEEP CAN EQUITIES GO?

According to our investment compass going back to 1958 the lowest 20 percent observations on price to cyclically adjusted earnings have been between eight and thirteen. If the markets enter the perfect storm could stock valuations fall into that range? Yes it is plausible and the agnostic bet would be mid-point in the range which is 11.5 times cyclically adjusted earnings. With the current five years' earnings cycle of 77 per share in the S&P 500 that would imply an index price of 890 or a decline of roughly 28 percent.

More realistically we believe the ultimate floor lies around the price point when the present value of growth opportunities is zero thus the S&P 500 valuation is the present value of a perpetual stream of current cyclically adjusted earnings discounted with an eight percent required return on equity; this would imply a floor round 960 in the S&P 500 or a decline of 23 percent from current levels. Put very simply if we go below 1,000 in the S&P 500 investors should probably begin to aggressively invest in equities as the future will most likely deliver more than zero economic growth.

[1] A net neutral equity position means holding a quality portfolio of long positions expected to relatively outperform the market and hedge the market risk (beta) equally, meaning hedging the long position value 1:1.

FX OUTLOOK: THE SONG REMAINS (MOSTLY) THE SAME

With a perfect storm in sight for the beginning of 2012, one would expect we had something dramatic and new to say about the currency outlook relative to our most recent quarterly musings. But with a couple of notable exceptions, our song for this outlook remains mostly the same for the majority of the G10 currencies. In broad strokes, we expect the USD rally to pick up further steam in early 2012 on global uncertainty and continued deleveraging and on the flipside of that development, we expect that the procyclical currencies will generally face an uphill battle. The Euro is likely to continue to weaken against the USD, JPY and GBP as the EU crisis looks to reach a crescendo some time in Q1.

EURO TO CONTINUE STRUGGLING

The December 8-9 summit outcome once again failed to shore up confidence that the Eurozone is moving toward fiscal and political sustainability. The agreement on a new EU treaty by March will be a critical focus in Q1, though the cracks on political resolve were already beginning to show merely days after the summit. And any refusal of various members of the EU-27 to sign on to the proposed treaty could render their connection to the EU potentially tenuous to say the least.

Meanwhile, for the European Central Bank, we'll paraphrase Forrest Gump and say that "easy is as easy does", meaning that, while the ECB stance is far different from that of the Federal Reserve or Bank of England, which are happy to more directly monetise debt, the December 8 ECB announcements did see further ECB easing moves of a kind. The lowering of reserve ratios and the launch of 3-year Long-Term Refinancing Operations (LTRO's) are a possible back door for sufficient liquidity to ease some of the pressure on the banks and EU peripheral sovereign debt in the short-term, even if this is yet another delaying tactic and does not address the overall longer term problem of insolvency.

Regardless, as we have said in the past regarding the Euro – the situation is "lose-lose". Scenario One is simply more of the same: as long as the EU dithers on fiscal union and the ECB dithers on true Quantitative Easing, the crisis will be re-aggravated and the EU will tilt quickly to the brink of a hard default and/or EMU exits or wholesale/partial devaluations of debt back into local currencies and the prominent risk of widespread bank nationalisations. Scenario Two is one in which the ECB either overtly or covertly provides sufficiently massive liquidity to keep the system out of a crisis for the near term while the solvency question is once again kicked down the road. This would be de facto QE and bearish for the Euro.

The two scenarios above are not discrete, but more a description of two dynamics that are working at all times, and to them we must add the political dimension, such that the most likely eventual scenario is along the lines of: the ECB provides covert liquidity that keeps the crisis at bay for a time, but the political fragility is what in the end undermines market confidence and we end in a serious reorganisation of the EU, along with said bank nationalisations, partial defaults, etc. – the true Crisis 2.0 we have discussed in this publication and previously. However reality plays out in 2012, the Euro is likely to fade against the USD, GBP, the JPY, and possibly the Scandies as well.

THE USD RALLY TO EXTEND FURTHER

In our fourth quarter outlook, we suggested that the USD rally would extend in Q4 as global markets faced uncertainty and as we might see a new US corporate profit repatriation scheme in 2012 similar to the one that boosted the USD back in 2005. We were both right and wrong in that outlook. While markets have zigged and zagged, the general rise in global growth uncertainty has increasingly plagued markets and kept the USD well bid, such that it broke to new 11-month highs ahead of year-end. On the other hand, we've seen no signs that a new corporate profits repatriation bill is imminent.

The US economy had a rip-roaring Q4 even as the EU sank into a funk and Chinese growth worries mounted. Going forward, those relative strengths are likely to persist, with the US perhaps only relatively resilient, if not particularly strong. Meanwhile, the compelling political rewards to be reaped from a new profit repatriation scheme as we go into election year still offer compelling odds that new legislation comes to pass early in 2012. That and the continued deleveraging in the world economy and shrinking carry as the other central banks have kicked off a new easing cycle, are factors likely to boost the US dollar, an accommodative Fed notwithstanding.

THE POUND STERLING – STRONGER THAN IT OUGHT TO BE?

There is nothing at all to like about the pound sterling from an objective standpoint. The currency sports a virtually non-existent yield, the economic outlook is poor, the country's twin deficits remain massive, and its central bank has an overtly bearish and dovish president willing to offer endless helicopter drops of cash. Even some of the more determined efforts at austerity are failing to shore up budget deficit credibility as much as hoped. And yet, the pound has been recovering slowly in recent months and that demands an explanation. Part of the reason can be found in shrinking carry disadvantage as other central banks began easing in the second half of 2011.

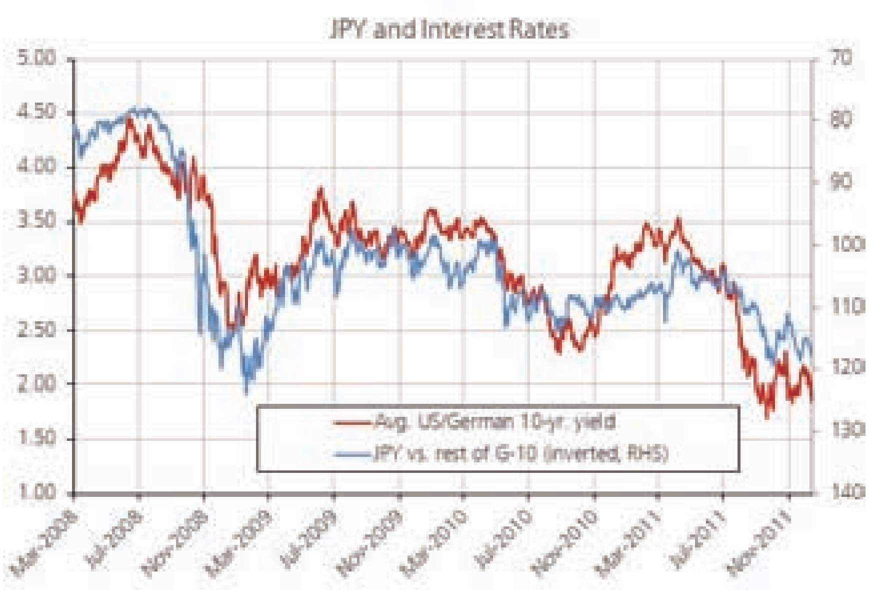
And from a capital flow standpoint, and even from a positioning/sentiment standpoint, we have to wonder whether the currency might actually do relatively well in our favoured scenario over the next quarter or two. After all, as long as the sovereign debt timebomb is not detonated in the coming several months, the ongoing risks of balance sheet deleveraging and safe haven seeking are possibly sterling positive. (Not only could sterling continue to find a bid as the EU seems to be doing everything in its power to drive investors away, the geopolitical angle is interesting as well, with the still huge UK financial sector's ties to world financial flows, not the least from oil-producing nations.) It is clear from the EU debate that the UK has no interest in signing on to the new EU treaty proposals, both because of intolerance for the loss of sovereignty, but also because the UK recognises the importance of its financial services sector and wants no part in possible new taxes on financial/currency transactions.

SWISS FRANC

The Swiss National Bank and Swiss government must be quite happy with themselves after their dramatic efforts to halt an aggravated rise in the Swiss Franc in 2011 took EURCHF from collapse to parity all the way back to 1.20 and higher once the new EURCHF floor was introduced and so-called sight deposits were employed to force massive liquidity into the banking system. In 2012, we should expect more of the same, the question only being one of timing and whether the SNB will act forcefully in the midst of EU turmoil early on in the year and possibly bide its time until Q2 or later. Regardless, the pressure on EURCHF is generally higher as the central bank and government will simply not tolerate damage to the Swiss economy from an overvalued currency. Additional expansions in sight deposits are a given in 2012, but other measures that are already having an effect are Swiss agreements with the UK and Germany on cracking down on tax dodgers and possibly even the application of negative interest rates on foreign deposits. In 2012, the combined forces of the Swiss government and the SNB will show that intervention can work, if it is done "the right way".

JAPANESE YEN – WILD CARD OF THE G-10

The Japanese Yen seems interminably associated with the carry trade – always strengthening when risk is off and weakening against higher yielding currencies when the market is risk-seeking. In early 2012, the JPY may just manage to continue its past behaviour, with brakes applied by the Ministry of Finance/Bank of Japan intervention on market attempts to push USDJPY below 75. The question we have asked for so long, however, is what happens when world government interest rates rise? Japan has the world's heaviest public debt load, a shrinking current account surplus, and a demographic structure that is tilting Japan towards a nation of net spenders rather than net savers, so there is a potentially explosive direction change in store for the JPY from strength to weakness if/when the government can no longer roll its debt at virtually free rates and the population loses faith in its paper. The Japanese Yen will not be a



The wild-card of the year is the Japanese Yen. The fate of the JPY is clearly bound up with the direction of interest rates, as the above chart shows. The two lines are the average US and German government 10-year yield vs. the spot (carry-free) level of the JPY vs. an evenly weighted basket of the remainder of the G-10 currencies. If interest rates remain very low, the JPY may strengthen further, but the currency's days of strength will be numbered if the 30-year bull market in government bonds comes to an end in the New Year.

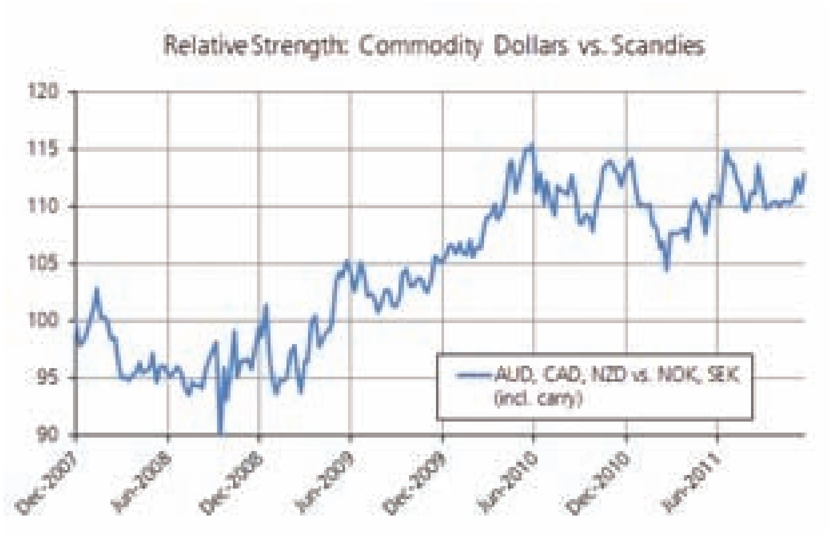
currency for the faint hearted trader once it reaches this inflection point.

THE COMMODITY DOLLARS (AUD, CAD, NZD)

We're throwing the "commodity dollars" of the G10 together here in one paragraph, but their fortunes are likely to diverge considerably in the New Year. The Aussie's ability to navigate the turmoil of late 2011 with relative aplomb fascinates. Normally, one would expect that the bouts of risk asset selling, commodity prices plunging and Reserve Bank of Australia expectations nose-diving due to the weak domestic economy would have resulted in a far weaker currency. This demands an explanation – and that explanation might just be that the Aussie has been a kind of safe haven for capital flight flows from China, where worries are increasing that a hard, post-bubble landing is in the making. How long such flows might sustain the Aussie is unclear, but the massive erosion of fundamental support for the currency could mean a very significant reality check rather early on in 2012 if a perfect storm is brewing. Relatively speaking, NZD and CAD will likely be stronger than AUD, as they don't have this premium built in. CAD may be the best performer of the three because of its proximity to the relatively strong US dollar and more resilient US economy, though Canada still faces an extensive deleveraging in its private sector, even as its public sector has remained fiscally very prudent.

THE SCANDIES (NOK AND SEK) – SAFE HAVENS BY DEFAULT?

The European investor is desperate for a safe place to park capital. The SNB after all is bent on devaluing the former franc safe haven, and EU banks and EU sovereign debt are in a parlous state and possible bank nationalisations, devaluations and debt haircuts on the agenda. As if that wasn't enough, EU politicians are also pounding the table on the need for financial and currency transaction taxes. Enter the Scandies and their relatively open, capital friendly



Who will be the relative winner in early 2012 - the generally pro-cyclical, but resource-backed commodity dollars, or the possible European safe havens known as the Scandies? Odds lean to the latter given our overall scenario for the coming quarter.

economies, with low sovereign debt loads to boot. For those willing to brave the low liquidity of NOK and SEK (one of the main reasons we rejected their potential as safe haven currencies in the past), there may be further appreciation ahead. The liquidity point is still a challenge for strong appreciation, as is the Swedish krona's normally more pro-cyclical behaviour due to its dependence on exports. But given the external environment, these two currencies are unlikely to replay the sharp weakening they saw in 2008/09 and instead may default to the strong side in early 2012. Another potential source of trouble for Sweden is its housing bubble, which finally appears to be unwinding and could drag on the health of the country's banking system.

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US

The statement released after the last meeting of the Federal Open Market Committee on December 13 reveals a Federal Reserve which is somewhat surprisingly concerned about the economic landscape than might perhaps have been expected, given the moderate upside surprises which can be said to have characterised economic releases in the fourth quarter of 2011.

The statement made reference to only "some improvement" to the labour market, perhaps wisely spurning the euphoria which greeted the fall in the headline unemployment rate to 8.6 percent in November, as the FOMC realised the historically low participation rate of 64.0 percent means the report flatters to deceive and still paints a picture of a discouraged workforce, many of whom have given up even seeking employment - the wider "U-6" measure, which includes the discouraged and the underemployed, remains depressingly high, at 15.6 percent. The statement was also confident that inflation "has moderated".

Federal measures which are already baked-in, combined with state-level cutbacks, mean fiscal policy will impose a small drag, if anything, in 2012 and it will essentially remain paralysed until 2013, as Presidential and Congressional candidates struggle to devise the stance they believe will please the voters most. With the rating agencies poised with fingers on triggers, the nightmare outcome would probably be an Obama re-election, with Republican control of the House and Senate. All of this will do nothing for consumer confidence - even the big bounce in the Conference Board survey in November still left the headline figure below the lows seen in the decade preceding the Financial Crisis.

Finally, the Elephant in the Room, Europe. Suffice it to say the EU is the US' no.1 trading partner, with 14 percent of the revenue of the Top 500 US companies coming from Europe. It is also highly likely that European banks' desperate attempts to meet capital ratio requirements will mean they cut back on lending to US firms - which currently amounts to approximately US$2 trn. We would estimate that US growth will be at least 1 percentage point lower as a result of the recession in Europe that we may well see in 2012.

It is vital to note that, due to the annual rotation of voting members, the uber-dovish permanent voter ruling class on the FOMC will be joined in January by three like-minded Regional Fed Presidents, (and one completely isolated hawk - Lacker), whereas three hawks and only one dove will depart.

It therefore seems probable that the Fed will be predisposed towards further easing; certainly in the event we see one or more of the following - a weak stock market, declining inflation, or a strong dollar. In fact, all of the above seem eminently likely and so we would expect to see further Quantitative Easing, (QE3), in 2012, with the April 25 meeting a highly likely announcement date, given that this meeting will be followed by a Chairman's press conference.

EUROZONE

The 17th EU summit-to-end-all-summits, on December 8/9 marked the start of the long march towards fiscal union - it dare not yet speak its name (we have to call it a 'fiscal compact') - but the problem is the march will indeed be long and dangerous, taking two years to complete, as a conservative estimate.

The trouble is that way before then the market will demand blood, if for no other reason than the completely understandable fear that the march will never reach its destination, for the journey to fiscal union will inevitably enjoy unpleasant travelling companions in the form of austerity and soaring unemployment, leading to social unrest and probable regime changes.

The market's fears will centre upon the re-financing needs of Italy and Spain - Euro 300 bn for Italy alone, (excluding any state support for banks) - with the combined needs of Italy and Spain amounting to Euro 500bn a year between 2012 and 2015.

The probability is we will see yet another crisis summit in Q1 and Germany will cave in - maybe agreeing to the issuance of Eurobonds with joint and several liability - causing bund yields to soar. One way or another we will finally see the European Central Bank satisfied that is has wrung enough fiscal quid pro quo out of politicians and, hiding behind its statutory requirement to 'ensure monetary stability', coming to the rescue by explicitly buying distressed sovereign bonds. In fact one can argue that they have already implemented this policy via the back door; December's announcement of unlimited, 3-year liquidity enables banks to borrow from the ECB at 1 percent, (or lower in time probably), and invest in the bonds of their mother country at maybe 6 percent or more. Thus we see the classic mechanism by which banks can rebuild capital, (without equity issuance), and the states can apparently stay liquid. Did someone say Ponzi?

In addition to this overt or covert quantitative easing, we'd expect the main Refinance Rate to hit 0.75 percent in Q1, with a further cut to 0.5 percent later in the year.

JAPAN

Japan continues to represent a casebook study in the dangers of the liquidity trap, with monetary policy apparently emasculated and unable to improve economic conditions. That being the case, the bulk of the heavy lifting falls on the shoulders of fiscal policy and new Prime Minister Noda seems to be displaying an encouraging level of activism in this regard.

In the face of extreme global uncertainty, the Bank of Japan will probably keep its powder dry during Q1, waiting to see whether events in Europe and/or a strengthening of the yen mean they feel the necessity to either increase the amount or duration of JGB purchases or remove the 0.1 percent paid on excess bank reserves.

UK

UK Chancellor George Osborne's Autumn Budget Statement could hardly have made for more depressing reading - the UK looks set to endure at least another five years of low growth, high unemployment and fiscal austerity.

Whereas the UK economy managed to grow by 1.9 percent in 2010, official projections from the Office of Budget Responsibility, (OBR), now forecast growth of 0.9 percent, and 0.7 percent in 2011 and 2012 respectively, before a 'blistering' 2.1 percent recovery in 2013.

In light of the above, the Bank of England will continue to feel that the government is sticking to its side of the 'bargain' re. fiscal policy and the Bank will therefore respond with further QE in Q1. The purchase of the additional £75bn of Gilts announced on October 6 will be finished by February 10, and it is therefore possible that additional QE will be announced after the February 8/9 meeting, but we would put our money on March 8. Rates will be held at 0.5 percent throughout 2012.

SWITZERLAND

Despite the introduction of its 1.2 'floor' for EUR/CHF, with its accompanying commitment to print as many Francs as necessary, Switzerland remains in danger of slipping into a deflationary quagmire in 2012. A danger that will only be compounded by the EU's tribulations. The Swiss National Bank's, (SNB), latest inflation forecasts, released at its December 15 meeting, nudged its 2013 expectation down to 0.4 percent from 0.5 percent and even at the end of its forecast horizon, in Q3 2014, it sees only 0.8 percent - surely too close to deflation for comfort.

Given what we expect to happen in the EU – austerity cubed and zero growth in 2012 at best - by end-Q1 we would expect the writing to be on the wall and expect the SNB's EUR/CHF floor to be raised to 1.3.

FIXED INCOME MARKETS

2012 may usher in a new paradigm for fixed income markets with intense competition for capital, meaning we have seen the bottom in yields in most markets. Let's be clear, this is not the 'old normal' world where risk-free sovereign bond yields formed a base for returns, predicated purely upon the classic ingredients, namely expectations for short rates and inflation over the life of the bond, and the yield on lower grade bonds also reflected the price of credit risk.

The new normal means that virtually no sovereign bonds can truly be regarded as risk-free and many factors point to higher yields:

- Bank deleveraging to meet new, punitive capital ratio requirements will mean less lending to corporates and therefore more corporate issuance.

- One of the world's prime borrowers, Germany, faces a potentially huge bill to ensure the survival of the Euro - and it is a safe bet that the German people will eventually decide to pay this bill, as they realise how beneficial the Euro has been for Germany and what a cataclysm its demise would bring.

- The market can stay irrational longer than governments can stay solvent, if fear dominates greed.

As ever, in an increasingly correlated global economy, the key to success will be the analysis of spreads between issuers, and pure corporate credit analysis will also have to be overlaid with country risk. For instance, the UK has come to be seen as something of a safe haven, due to the coalition government's extreme commitment to fiscal probity, and so corporate issuance has exploded. (According to Dealogic, Sterling-denominated non-financial corporate bond sales, across all grades, are up 43 percent during the first 11 months of 2012, while euro and dollar markets have collapsed and stagnated, respectively. WM Morrison, the UK supermarket chain, could have sold £1.5bn of its recent 12-year issue, rather than the £400m it looked to raise. QE has probably also helped.

ASIA OUTLOOK: FASTEN YOUR SEATBELTS, WE ARE ABOUT TO LAND

While our recent commentaries on the macro situation in the developed world have drawn the analogy of a plane flying on one remaining engine, Asia's economies have the benefit of still flying on all engines but with tremendous hope placed in the hands of the pilot – the powers-that-be in China – to determine the smoothness of the next landing.

There is no doubt that the Chinese economy is coming in to land – export growth has been in steady decline since mid-2010 after the healthy rebound after the 2008 crisis as global demand falters. Import growth is dead in the water as manufacturing slows and both industrial production and PMI data echo the same theme. The much-vaunted switch to domestic consumption rather than reliance on export markets has yet failed to materialise as efforts to change a much-ingrained mindset make miniscule steps forward. Yet we are still talking of above 9 percent growth for 2011, though most of this was front-loaded into the first-half of 2012. From here on in, the outlook appears bleak and our analysis suggests we could face growth of a mere 5-6 percent for 2012, well below median market forecasts of around 8.5 percent.

With no change in the current dismal global outlook in sight, what are the authorities doing to mitigate the much-feared hard landing? The People's Bank of China recently initiated a shift in monetary policy with the first easing step in three years announced end-November, a 50 basis point cut in the reserve ratio requirement, with more expected near-term (Note a 50 bp cut is expected to boost total liquidity by about Yuan 400 bn (USD 63 bn)). With time running out for an additional cut this year (though in the past the PBOC has announced moves during western market holidays) it is odds-on for further cuts - at least two we predict - during Q1 2012 with the first before the Lunar New year holidays in late-January.

What about the bubbles? Property-related bubbles were very much the talk of the markets in the first half of 2011 and the government has been consistent in applying measures to cool this sector (for example: higher lending rates, purchasing limits and a ban on mortgages for third homes). While there have been broad signs of a cooling off, latest data for November shows that there are still hotspots recording 6 percent annualised price increases so this issue is still not completely and uniformly resolved.

Another issue for China is the Yuan. Despite continued pressure from the US (and more lately from the European Central Bank), a resurgent US Dollar and a shift in investment flows have seen the Yuan weaken some 0.6 percent versus the US dollar from its peak mid-November. That month saw an almost 10 percent drop in Foreign Direct Investment (FDI), the first drop in 28 months, and most likely caused by the grim and complicated global outlook. At the same time, Overseas Direct Investment in non-financial sectors originating from China rose to over \$50 bn in the first 11 months of this year, an increase of 5.2 percent y/y, aggravating the negative impact on the currency of such portfolio flows. Given such flows it would take great effort to continue the so-called path of "slow, gradual appreciation of the Yuan" that has been advocated/demanded by the Western world (which leads to our Outrageous Prediction number 8 that USDCNY rises 10 percent to 7.00).

SO WHAT ARE THE IMPLICATIONS FOR THE REST OF ASIA?

We all know how much the Australian resource sector depends on exports to China. Indeed the Chinese thirst for natural resources has produced one of the biggest mining booms in decades for the country. Unfortunately, if we take away the mining sector's contribution to the economy there does not appear to be much left. The manufacturing sector has been struggling during the second half of 2011 (manufacturing PMI languishing below the 50 mark since July) and the service sector is dependent on the recycled dollars from the mining sector. A marked slowdown for China will undoubtedly cause issues for this one-trick pony.

Singapore has had a great emphasis on electronics exports in its strong growth history, but the roller-coaster nature of this sector since end-2008 is currently struggling for traction, especially given the backdrop of weak global growth. There has been some diversification into the pharmaceutical sector but the overall trend for non-oil domestic exports remains weak. With the global economy in dramatic slowdown, no change in this trend is expected in the near term. Indeed, Singapore's PM Lee has, quite realistically, warned that growth of between 1-3 percent (compared with 5 percent on average over the last four years) may become the norm over the next few years.

As for Hong Kong, the question remains whether China leads Hong Kong or vice-versa. In November, Mads Koefoed's research pointed out that the two economies are coincident and as such co-dependent. Our expectations of slower Chinese growth, mixed with independent external chatter of Hong Kong heading towards zero growth, suggests the prospects for Hong Kong are not healthy.

In the event of a hard or even crash landing, we will find out over the next few quarters if it matters whether you are sitting in first, business, or economy class with the risk increasing that we are all at the back of the plane.

Against the backdrop of an uncertain global economic outlook, with Europe looking very bad, Asia probably worse than consensus and the US improving somewhat, commodity traders will be looking towards 2012 with some confusion. The first quarter will most likely produce a great amount of uncertainty as the market will be looking for clarity on many of the unanswered questions left from 2011, especially the all-important unknown of whether we will face another global recession in 2012.

With our expectations for further dollar appreciation during the early stages of 2012, the upside for the major commodity indices seems to be limited during the first quarter with investors likely to be very selective. However we believe that the multi-year uptrend, also called the commodity super-cycle, has not yet run its course and long-term investors should view the next few months as an opportunity to accumulate, a view that will be further supported should the central banks of emerging markets (EM) and developed markets (DM) engage in simultaneous aggressive monetary easing.

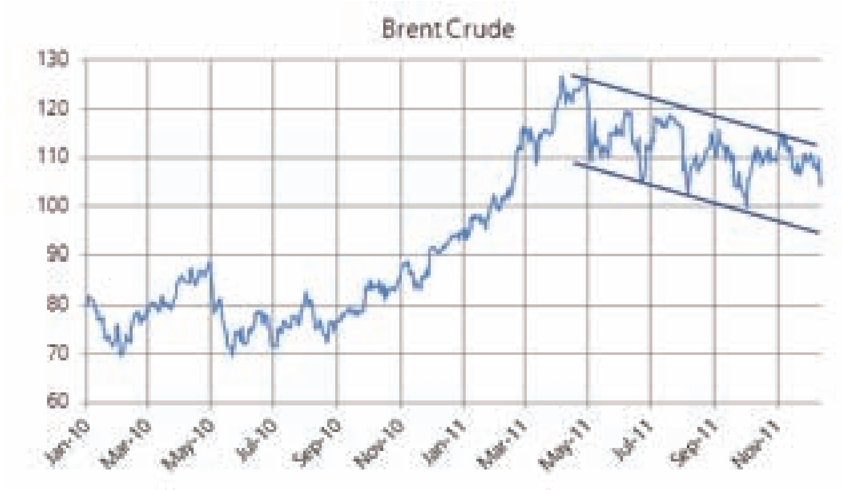
investors. We see prices stabilising after a late 2011 correction with fresh investment flows driving the price towards 1,800 during Q1 and even higher later in the year.

Base metals will, despite a deteriorating outlook for new supply, continue to struggle through the early parts of 2012 on growing concern of a recession in developed markets, combined with emerging markets slowing down. The long-term prospect however remains positive as lower prices should meet restocking demand, especially from countries like China. However with industrial metals being viewed as an economic indicator for growth any traction during the early parts of 2012 remains limited as focus will be firmly on the demand side.

The agricultural sector suffered a major setback during 2011 on a combination of normalised weather and farmers across the globe reacting to the high prices during 2010/11 by planting record amounts of new crops. The stronger dollar hurt prices and US exports as buyers turned to other suppliers, especially

Precious metals like gold and to a certain extent silver will continue to benefit from continued risk aversion. Supporting factors also include the negative yield environment, currently seen among more than half of the G20 nations, combined with strong physical demand from central banks and emerging market

in the Former Soviet Union and South America. The accumulative speculative long position held by hedge funds across the sector has fallen to the lowest level in two and half years and on that basis (combined with the potential challenges of weather related supply issues) we see good potential for higher prices,



especially among commodities with constrained supply, such as corn and soybeans. Livestock should also hold up well due to strong fundamentals combined with its defensive character.

The energy sector, excluding US natural gas which is stuck in a bear market amid ample US supply from shale gas, looks set to remain range-bound during the early parts of 2012. Such is the uncertainty about the direction that fat tails on the options curve have emerged with investors buying out of money protection in both directions. The renewed slowdown in 2011 largely occurred due to the spike in energy prices, which saw the average price of Brent crude rising by more than one third from 2010.

Increased energy demand from EM looks set to continue to outweigh the slowdown in DM and this combined with many oil producing nations now requiring higher prices to pay for increased social spending, especially after the Arab Spring, should keep prices supported despite slowing economies. Brent crude has the potential of making a low around 95 dollars and should average 100 dollars during Q1 before rising later in the year.

Options´ implied volatilities give an insight into both the current behaviour of financial markets and their expected volatility and the FX options market is now at a crucial juncture.

On the one hand, some currency pairs are moving a great deal, with for instance EURUSD closing the year on the lows. On the other hand though, some pairs such as USDJPY or GBPUSD remain lacklustre. As for CHF a long period of low volatility could be followed by a short period of extreme movements (from intervention or other). It is therefore important to look at volatilities in the context of what has been happening and what could happen over a short to medium-term horizon.

The below chart displays three-month At-the-Money implied volatilities for five major currency pairs since mid-2006. Clearly, implied volatilities have increased over this five-year period, spiking to record highs in the fall of 2008, but it is important to note that volatilities themselves have become a lot more volatile! This is of course not surprising: the global financial crisis has made markets a lot more uncertain and liquidity has dried up a great deal.

That said, a few things do stand out: despite the recent developments in the European situation, implied volatilities in EUR-centric pairs (EURUSD, EURCHF, EURGBP for instance) still seem to provide decent upside potential. A premise to the 2008 turmoil was a huge widening in credit default swaps for financial institutions and the failing of many of those institutions. Replace "financial institutions" with "European countries" or "sovereign entities" and you have a somewhat valid statement describing the situation today. It is therefore easy to imagine that a worsening of the financial crisis would lead to implied volatilities reaching and surpassing the extreme levels seen in 2008.

In addition, some currency pairs such as USDJPY, GBPUSD or USDCAD are actually seeing their volatilities at a relatively low level compared to the last three years. This is symptomatic of the crisis being perceived as EUR-centric. A failing Europe would hardly leave the rest of the world unscathed. As such, long option positions, in say USDJPY, could provide a great deal of leverage to the astute investor: offering great potential whilst facing a somewhat limited downside.

Owning options could prove to be an invaluable addition to an investment portfolio - more so now than ever, as we continue to face what could become a perfect storm financially, economically, politically and sociologically. Let's not be deterred by what might, at first glance, appear to be high implied volatility levels; those could easily prove to be cheap entry levels.

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