What outlook for the interest rate, credit and currency markets?

January 2008

2007 was characterised by an unprecedented monetary crisis and general aversion to markets for risky assets. Is there a risk of economic recession in 2008? What does the US real estate market have in store for us? How will central banks act in 2008 and what will be the impact on interest rates?
With respect to credit markets, do Investment Grade bonds now represent an opportunity following last year's evoution in the risk premium?
Will the dollar continue to slide? Will the high-carry currencies continue to rise?
Our fixed income specialists present their perspectives on these issues for the coming year.

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1. Fixed income markets in 2008: no consensus

Last year was marked by consensus on several economic and bond market variables, including continued global growth, the continuation of tighter money policies and a general rise in long-term interest rates.
While the first part of last year was in line with these forecasts, the US real estate crisis undermined this scenario. Markets ended 2007 in a transition phase, with an unprecedented monetary crisis and general aversion for markets in risky assets. As such, the Fed lowered its key rate by the end of the year by 100 bp (to 4.25%) and the ECB had made massive liquidity injections (€350bn just in the last two weeks of the year) with all markets experiencing an upsurge in volatility. **In this context of a latent financial markets crisis, 2008 cannot be viewed as a year of consensus: several scenarios may be envisaged.**

Is a recession possible?

The key question for 2008 is whether the US will slip into a recession. The 1.50% decline in real 10-year interest rates and expectations of aggressive cuts in the Fed's key rate suggest that the market has partially accounted for such risk. **At Dexia Asset Management, however, we are looking more for a marked but limited slowdown.**
The real estate crisis is far from over: The fall in sales will lead to job losses and declining prices will continue to drag on the net worth and thus the confidence of households while the overall subprime crisis may pierce the strength of financial institutions. We are thus looking for a slackening of growth (which we estimate at well above 2% in 2008) with unemployment possibly rising to around 5%.

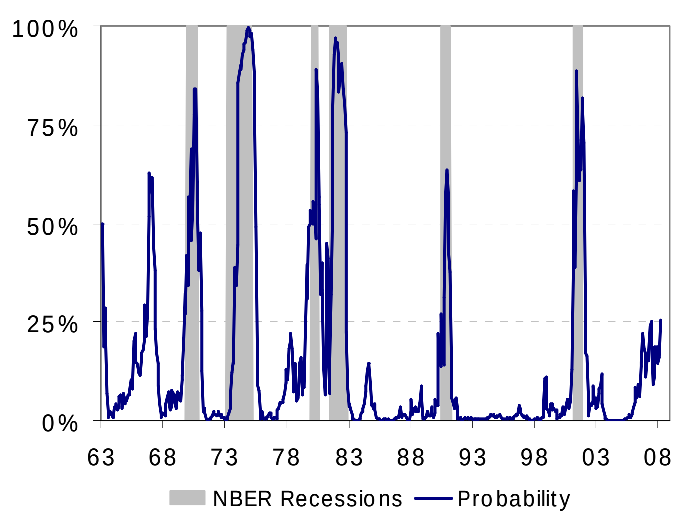
We do not expect the slowdown to turn into a recession. Why?
The Fed's 100-bp cut in its key rate and the fall in 10-year yields to around 4% will facilitate the carrying of debt and thus promote growth. The low dollar is helping exports. The US government has finally shown that it is willing to help families suffering from subprime debt. Numerous actions have been taken to bolster the US economy. Our 3-month recession model puts the likelihood of recession at just 25%: cuts in the Fed's key rate and the continued resiliency of employment are helping to reduce this probability.

Economic indicators

	NFP	ISM	GDP	CPI
Actual	94.00	50.80	4.90	2.20
March 2001	47.00	42.60	0.50	2.70
July 1990	47.00	46.60	1.00	5.00
July 1981	112.00	46.70	3.10	11.10
January 1980	95.00	44.80	1.20	11.30
March 1973	269.00	69.60	10.60	3.00
December 1969	152.00	52.00	-1.90	6.20

Source : Dexia Asset Management, Bloomberg

Probability of recession



Source : Dexia Asset Management, Bloomberg

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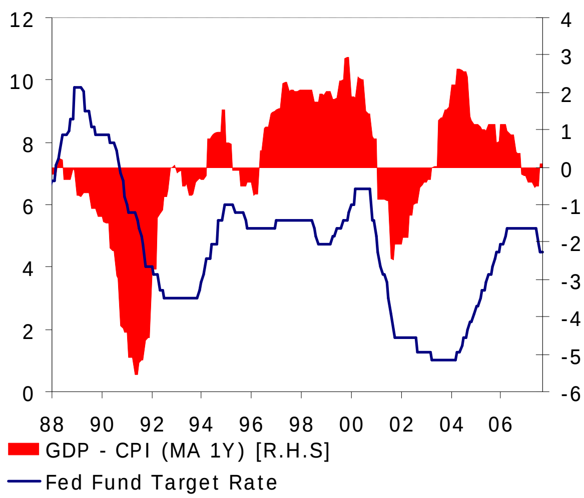
Will the US economic slowdown have an impact on the rest of the world?
The subprime crisis has affected markets throughout the world and the monetary crisis is present in many economic regions. In Europe, the 3-month Euribor rate now stands at 4.95%, which is 95 bp above the 4% base rate. Confidence indicators have hit a rough patch and the low appetite for risk has hit Europe too. And yet, we believe that **growth in the eurozone will also slowdown without giving way to a recession**. The US economy is not the only factor in Europe's economic well-being, with emerging markets providing a significant motor to worldwide growth. Moreover, Europe has yet to experience a major real estate crisis.

What central bank moves can we expect in 2008?

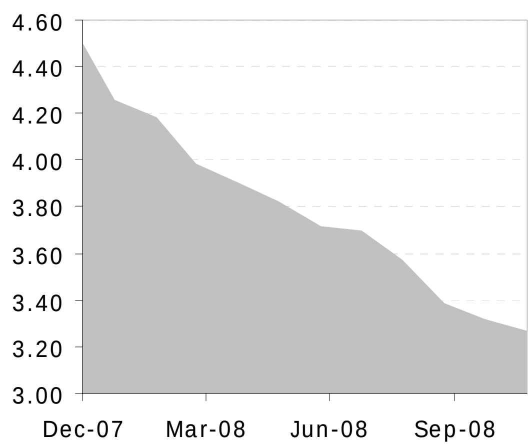
Fed policy must respond to two goals: containing inflationary expectations while favouring economic growth. With its rate cuts totalling 100 basis points in 2007, it moved to bolster economic growth. Today, however, it is faced with resurgent inflation given a core CPI that could hover around 2.50% As such, we believe that the **Fed will continue to lower its key rate but at a slower pace**, to keep inflation expectations in check. Our favoured scenario incorporates two rate cuts, bringing the key rate to 3.75%.

Two goals for the Fed: growth and inflation



Source : Dexia Asset Management, Bloomberg

Fed Fund Futures et anticipation du marché



Source : Dexia Asset Management, Bloomberg

We believe that the **ECB will maintain its status quo as long as possible**. With inflation up sharply (above 2%), but with a major monetary crisis, it has no other choice but to maintain its key rate at 4%. We believe that the ECB may lower its rate by the end of 2008, especially if confidence indicators continue to decline.

What direction for interest rates in 2008?

Given the expected cuts in the Fed's key rate, we continue to believe that Libor will decline sharply and that the liquidity premium on 3-month rates should decline significantly over time. **The decline in short-term rates should favour the steepening of the curve. The 10-year yield in the US** corrected steeply to below 4% and **could return to around 4.50%.** Above all, it is real rates that have fallen while the inflation expectations component has remained high. We believe that the latter should remain above 2.25% and that the real rate component should in time return to about 2%. As such, the Fed's rate cuts will not lead to an automatic decline in long-term rates.

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On the eurozone, 3-month rates should decline sharply once again, following the reduction in the liquidity premium. Anticipations of a decline in ECB rates should lead to a **steepening** of the 2-to-10-year segment of the yield curve. **The 10-year yield could hit 4.50%.** The rise in inflation pushes in that direction.

What are the main risks for 2008?

The main risk in our scenario is a more abrupt slowdown in the United States and a Fed that stalls on lowering its key rate. If the liquidity crisis drags on and stock markets decline further, the Fed could be provoked into acting more aggressively, pulling other central banks in its wake. Such a scenario would not contradict the prospect of a steepening of the yield curve, but it could lead to a rise in bond markets via a negative correlation with stock markets. We will be paying particularly close attention to the risk of recession in 2008.

Outlook on bond markets

Eurozone interest rate	**Today**	**End 2008**
ECB target	4.00	4.00
2-year yield	3.95	4.00
10-year yield	4.26	4.50
2-10 year spread	*0.31*	*0.50*
Duration strategy	Negative	Negative
Curve strategy	Steepening	Steepening

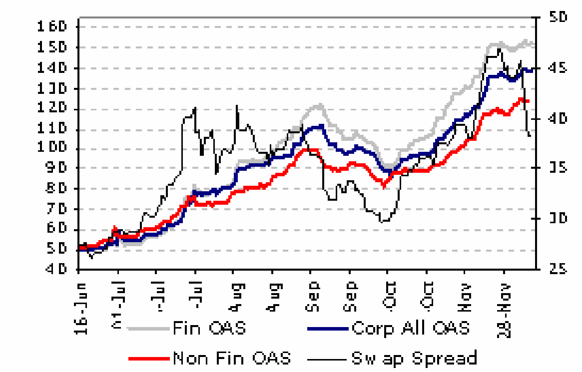
US interest rate	**Today**	**End 2008**
Fed Funds Target	4.25	3.75
2-year yield	3.07	3.25
10-year yield	4.02	4.50
2-10 year spread	*0.95*	*1.25*
Duration strategy	Neutral	Negative
Curve strategy	-	Steepening

2. Investment Grade credit: current spreads largely compensate risk

2007: a tough year for credit markets

2007 was a remarkably tough year for Investment Grade credit. The implosion of the US home mortgage system in the last six months quickly spread to numerous players, throwing a monkey wrench into the works. **In the six months following mid-June, the average risk premium on Investment Grade credit nearly tripled in comparison with sovereign bonds (rising from 0.5% to 1.4%) triggering underperformance of nearly 3%!**

Euro Credit Spreads



Source : iBoxx

Aside from the specific risk of players directly hit by the worsening US home mortgage market, US mortgage lenders and construction companies, **numerous investors and institutions were affected by the breakdown of the securitisation structures of these loans.** Indeed, almost 62% of the $10,400 bn in outstanding mortgage loans are securitised and the risk transferred from the lender to the investor. Since early last summer, in an attitude of lost confidence in the interbank system leading to a liquidity crisis, a series of dominoes has brought down the most exposed financial institutions (Countrywide, CIT, IKB, Sachsen LB, etc.). The market initially sanctioned the brokers and promoters of certain investment funds hit hard by the first rating downgrades on securitised structures. Then the most fragile financial institutions in terms of refinancing were hit by the closing of the securitisation market and the balking of the wholesale market. Since the end of summer, this liquidity crisis has spread to the ABCP[1] market (conduits and SIVs) which was quickly sanctioned by its main investors, money market funds, also seeking to maximise liquidity. The dislocation of these instruments when investors would not refinance weighed heavily on markets and will continue to impact the credit market in 2008. A number of assets and a large part of the securitisation structures were liquidated to meet reimbursement obligations which further hurt valuations that had already fallen steeply. At the same time, the bank sponsors of these off-balance sheet structures were gradually forced to consolidate or find liquidity support solutions, raising risks either way. Finally, **following a month of lower interest rates in the wake of the Fed's mid-September cut, Q3 figures testified to the depth of damage inflicted on all financial institutions, including substantial asset impairment and downward profit revisions.** The last domino fell when monoliners came under pressure of recapitalisation. For the most part, they had diversified in recent years toward guaranteeing CDO[2] ratings, and they now risked losing their Aaa rating without recapitalisation.

In addition, **the risk premiums of non-financial issuers also rose following the widening of swap spreads and extension of the crisis of confidence.**

[1] Asset Backed Commercial Papers
[2] Collateralized Debt Obligations

How to view Investment Grade credit in 2008 given the backdrop of 2007?

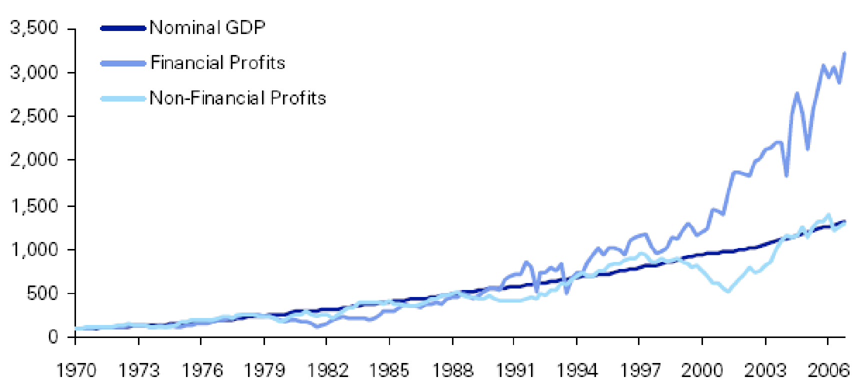
It is obvious that the end of the year will not significantly change the situation inherited from 2007. Indeed, **we anticipate a further worsening of the US real estate market in the next 12 months** given the still-substantial imbalance. Housing inventories will continue to weigh on home prices which will fall another 5% to 10% in 2008. Supply and demand will be skewed by foreclosures and forced sales in the wake of rising payment defaults. One of the payment default drivers is the large number of variable rate loans made in 2006 and 2007 whose rates will start to readjust in 2008 and 2009, respectively. The fragility of these loans reflects the total absence of the "wealth effect", because prices slowed in early 2006 and then declined in 2007. It also reflects the laxity with which loans were granted in the first place.
In order to deal with the specific problem, the US Treasury decided, in conjunction with a coalition of the largest mortgage lenders, to institute a freeze in rate revisions for borrowers in the weakest position as of January 2008. The purpose of this measure is to put a brake on the negative price spiral by enabling a large number of American households to keep their homes.
However, **the expected rise in bankruptcies and payment defaults in 2008 will lead to more deterioration in the quality of securitisation structures.**

The baggage from 2007 will be no less heavy and an improvement in the situation will require a pick-up in confidence which will take a good part of the year to develop. The publication of annual results and guidance for 2008 will surely help clarify the state of the overall banking system for investors.

The absorption and digestion of risks taken (quality of investment portfolios and loans granted) or added (like the ABCP portfolios) by some institutions will take time for the largest and most diversified, and could still prove fatal for the riskiest among them. From this standpoint, we will continue to avoid the weakest business models marked by low business diversity and high dependency on wholesale financing.

Given this rise in risks, **the banks will restrict lending conditions for all borrowers (individuals and companies). They will also reinforce their capital hedging via the issuance of (tier one) subordinated debt while reducing dividends or making share capital injections like Citigroup.** That is also the only way out for monoliners under the threat of losing their Aaa ratings.

Financial and non-financial profits and nominal US GDP



Source: Bureau of Economic Analysis

Unlike in recent years when financial engineering fuelled the results of financial institutions, results in 2008 will not be in the double digits, given the weight of provisions and asset impairment, the lost earnings from a whole range of financial activities put on hold and the hike in financing costs (although interest rates remain fairly low). The reopening of securitisation markets (in their soundest forms, such as European Covered Bonds) is a key factor driving improvement.

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Should we fear a global credit crunch leading to an economic recession?

Financial institutions will clearly take fewer lending risks especially given the widespread discrediting of the securitisation process. This analysis involves US credit institutions more than the world banking system as a whole.
However, **we still do not foresee an extension of the general credit crunch leading to a severe economic recession**.

We think it is more likely that the US economy will experience a soft landing in 2008 with a slackening in consumption compared to previous years, due to lower disposable income as a result of higher oil prices and rising mortgage costs. It is still difficult to estimate the lost share of consumption from statistics following the tightening of credit terms. Lower consumption forecasts impact corporate profit expectations. Following the November revisions, profits are now expected to grow between 4% and 7% in 2008. We must not forget, however, the role played by emerging economies in picking up for lost growth in the US.

There has historically been a correlation between tightening credit terms and rising default rates. But we would like to point out that Investment Grade companies have cut their risk considerably by taking advantage of the very advantageous credit terms of recent years to prefinance and extend their average debt payment periods. For example, as of end 2000, nearly 50% of credit lines were for less than one year versus less than 20% today, with a significant increase in payment periods to three to five years. We see this trend on all markets (euro and USD) and for all borrowing types (bank credit lines and bonds). **In the context of a macro slowdown and tighter lending conditions, companies that experience a gradual rise in defaults will see themselves limited to the lowest non-Investment Grade ratings.**

What macroeconomic scenario is factored into the current credit spreads?

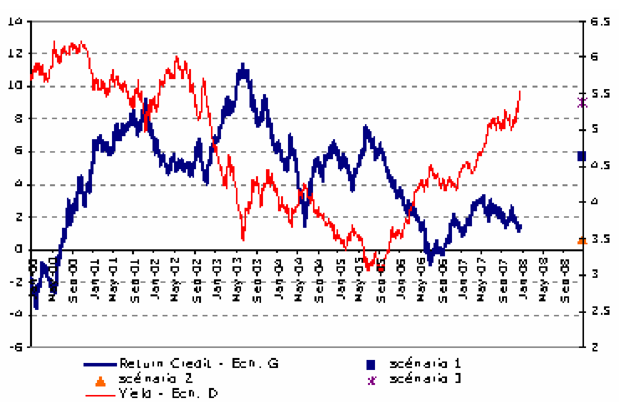
The current credit spreads largely compensate risk. Given a buy and hold approach, the main risk is issuer default which, by definition is low for the highest-rated issuers.

A comparison of current market spreads derived from a one-year projection of the default rate (i.e. 4% vs 0.8% today) reveals an excess of 0.3% on spreads for all investment-grade credit. This excess is highest for the best ratings, at 0.4% for AA and 0.5% for A. In fact, the current spreads compensate for the default rate skyrocketing to 12%!

In the long term, Investment Grade credit more than compensates for the recession scenario. Moreover, as banks' financial situation becomes clearer, the return of confidence in the system will enable swap rates to ease, mainly in the shortest maturities.

Investment Grade credit: a buying opportunity

Our long-term view on credit is positive. Current remuneration already factors in a significant amount of bad news relating to the world economy, and particularly the financial system, with respect to our main market scenario, which **constitutes a very attractive opportunity to acquire high-quality Investment Grade credit.**



In historic terms, credit yield is currently very high (5.51%), providing a big cushion for future returns. In the graph at left, the blue line indicates the return obtained from a credit investment a year ago, resulting from the yield at the time of purchase and changes in the rate over the period. This return currently stands at 1.1%. History shows us that when yields rise to high levels (as in 2000-2003), Investment Grade credit generates high returns, in the vicinity of 6%, in the succeeding periods. One-year return

Source : Dexia Asset Management, iBoxx

projections depend on which scenario you choose. Our main scenario (1) is based on an economic slowdown entailing a gradual solution to the credit crisis with an expected return of 5.6% by year-end 2008 (left scale). Other extreme scenarios (i.e. inflation with credit deterioration or recession) result in positive return projections (0.6% and 9%) given the high level of carry!

In the short term, the market will remain exposed to the continued deterioration of the US real estate market and the ensuing events that it will provoke. Moreover, the probable opening of the primary market at the beginning of the year could weigh on secondary market spreads. This volatile outlook could nonetheless include rallies during which investors cover their overweighting. In this regard, we still view primary issues as attractive opportunities for adding value in quality names, given the high new-issue premiums demanded by investors.

Investment themes for 2008

- Avoid the weakest banking business models
- Overweight quality senior bank bonds and subordinated debt
- Overweight swap spread-related bonds
- Overweight cash-flow-generating sectors (telecoms) over the more cyclical sectors or those too tied to consumption
- Take advantage of new-issue premiums and the favourable base effect

Outlook for Investment Grade credit

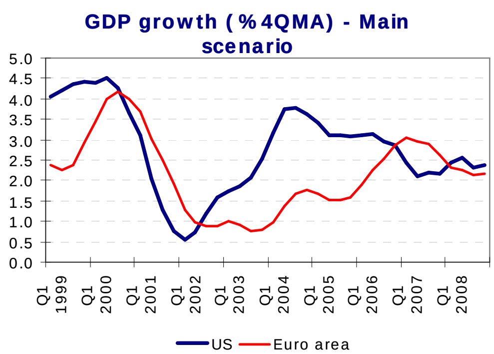
	Today	**End 2008**
Credit spread	1.38	1.10
Swap Spread	0.40	0.35
Credit exposure strategy	**Overweight**	**Overweight**
Non-financial sector	Overweight	Overweight
Financial sector	Overweight	Overweight
Swap-related sector	Overweight	Overweight

3. Currency market: what is the outlook for 2008?

2007 was the year of the dollar's decline

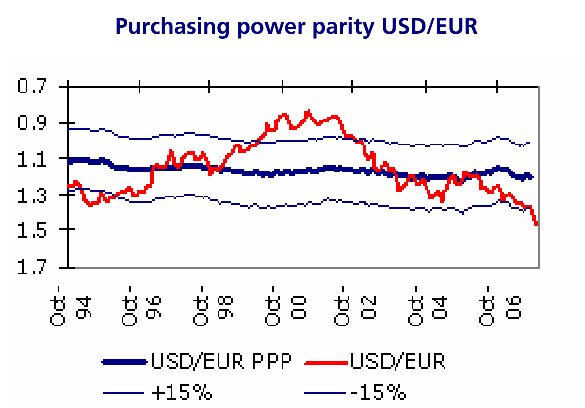
2007 was marked by the dollar's decline. The main factors driving down the dollar against the euro, pound sterling as well as Canadian, Australian and New Zealand dollars included the easing of monetary policy, the real estate crisis, the move to diversify currency reserves and rising commodities prices. Overall, the dollar's value against a weighted basket of currencies slid from 92.9 at the beginning of 2007 to 83.9 by the end of the year.

How will it hold up against European currencies in 2008?



2008 should see a continued slowdown in US economic growth with the second half marked by slowing growth in Europe. **The dollar should not fall as sharply against European currencies this year**.

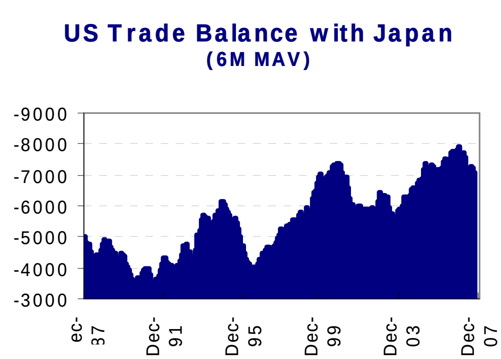
Source : Dexia Asset Mangement



On the contrary, **we believe the dollar will gradually climb to its long-term fair value by late 2008/early 2009, i.e. $1.3 against the euro and under $2 against the pound sterling**. Its depreciation in 2007 was certainly predictable but fairly excessive in view of the dollar's long-term valuation. In terms of purchasing power, for example, the dollar is undervalued by over 20%, a level at which the trend generally reverses direction. Moreover, the US economic slowdown is already beginning to have a positive impact on the trade and balance of payments deficits which, although still very negative, should continue to improve in 2008.

Source : Thomson

… and against Asian currencies?



Most of the large external deficit does not come from Europe but from Asia. This leads us to an important point, namely that **while the dollar may continue to be weak in 2008, Asian currencies, i.e. the yen, yuan and those on the entire Asia-Pacific area, should logically appreciate against it.** We know that Chinese officials are reluctant to let the yuan appreciate, but China's trade advantage is so large that political pressures may very well become so strong that they will force the government to adopt a policy of easier money. The strengthening of

Source : Thomson

the yuan would lead to an appreciation of other Asian currencies, notably the yen which was weak in 2007.

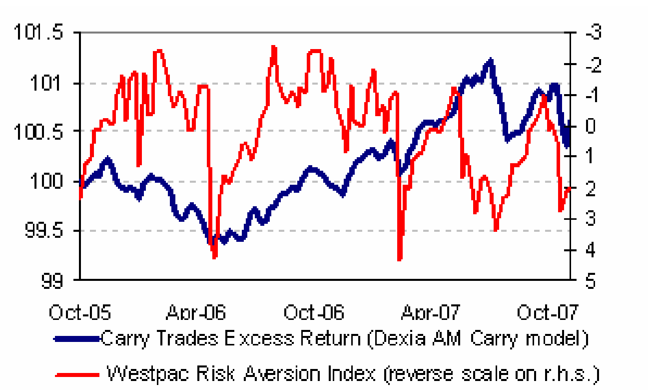
The yen contains good appreciation potential: Its long-term fair value comes to around 100 against the dollar and the country's high trade surplus should favour an appreciation of its currency, and its negative interest rate differential vis-à-vis the United States should decline in the course of 2008. Our view is thus fairly positive for the yen in 2008 with nonetheless a few caveats:

- Will the market have confidence in the prospects of an economic recovery in Japan?
- What will China's exchange rate policy look like? If the yuan continues to trade at a low rate, it is unlikely that the yen will appreciate significantly.
- And when will the market stop playing the yen solely on the basis for carry trade?

Continued rise of high carry currencies?

This third point leads us to an interesting question for 2008. **2007 was characterised by phases of very steep upswings in currencies with high carry. Is this period over?**

Stratégies de carry et aversion au risque



Source : Dexia Asset Management, Thomson

Periods in which carry strategies are most profitable are generally those in which risk aversion is low and worldwide growth is high.

That is why we believe that 2008 will provide a less favourable environment for carry strategies:

- Confidence has been seriously eroded by the US real estate crisis from which we will see more bad figures in the future. We believe that risk aversion will be generally higher in 2008 than in 2007.
- Furthermore, even though emerging economies will continue to grow, the slackening of US growth will gradually lead to a worldwide economic slowdown.
- Lastly, commodities prices should gradually top out.

Given these three considerations, we believe that the non-US dollars, bolstered in 2007 by their interest rate differentials and/or commodity prices, should begin to depreciate in 2008. The three non-US dollars are clearly overvalued (by over 20%) in relation to their long-term fair values (notable, in terms of their purchasing power parity).

Our currency strategy

Our currency strategy for 2008 is based on:
- Appreciation of the dollar against European currencies (end 2008)
- Appreciation of Asian currencies
- Depreciation of non-US dollars
- Appreciation of currencies with low carry (like the yen or Swiss franc).

Currency outlook

	Today	End 2008
EUR/USD	1.45	1.3
JYP/USD	113	95
GBP/USD	2.02	1.9
Strategy	Still short USD overall	Long USD vs EUR and GBP