

Quarterly Outlook

SAXO
BANK

Q3 2009

MACRO

Still no cause for
celebration p. 4

FX

Global economic recovery
fully priced into FX - will the
economy cooperate? p. 6

EQ

What will drive equities
from here? p. 10

CRUDE OIL

A rally fuelled by misleading
expectations p. 12

SPECIAL NOTE

Public debt and
monetisation p. 14



Where has all of the fear gone?

We expected 2009 to be an *annus horribilis* for the global economy. And as the year got under way, economic activity largely continued its freefall as all hope appeared to be lost. Equities and commodities put in spectacular new lows in early March. But since that nadir, risk appetite has increased in a nearly uninterrupted arc, as markets boldly predict a V-shaped recovery.

As we view things at the cusp of the second half of 2009, we think any imminent global recovery prediction is extremely premature. Too many worries persist as the fundamental imbalances that got the developed world into this mess in the first place remain unaddressed. In the developed economies, the consumer has yet to deleverage. In developing markets, export-oriented economies will require more time to restructure for sustainable growth in the future.

At some point in Q3, we expect risk appetite to plummet again as the market realizes it has gotten ahead of itself. The main question for the medium term will be long interest rates - which, if they continue their threatening rise, could create an even more chaotic and volatile market environment than the already ugly one we envision as our baseline scenario. As Q2 closes, it appears that the market has gotten very complacent. Buckle up for a bumpy ride in Q3, as fear may make a comeback.



DAVID BAKKEGAARD KARSBØL
CHIEF ECONOMIST

David Karsbøl is Chief Economist and Head of the Saxo Bank Strategy Team. He is responsible for the overall macroeconomic views of Saxo Bank. He has a Master's degree in economics from the University of Copenhagen, where he specialised in finance, statistics and monetary economics. His master's thesis was about the pricing of gold since 1971 and he is known for his contrarian thoughts.

David Karsbøl concentrates on Business Cycle Analysis and subscribes to the reasoning of the so-called Austrian School of Economics (Menger, Schumpeter, von Mises, von Hayek etc.). He believes that understanding debt cycles is integral to understanding the general business cycle.

He is available for comments on the macroeconomic situation and forecasts.



CHRISTIAN TEGLLUND BLAABJERG
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Christian Tegllund Blaabjerg has a broad educational background ranging from a Masters in Political Science from University of Aarhus to a degree in finance from ASB, Aarhus School of Business.

He works with equity market and single stock analysis using a top-down approach by identifying the macro forces that will affect the investment environment before they become obvious and then shift the focus towards individual issues within the sectors and single stocks. This approach determines the extent to which stocks are subject to the critical variables, are positioned to capitalize on them, and are attractively priced.

Christian Blaabjerg is available for comments on equity markets and major companies.



JOHN HARDY
FX STRATEGIST

John Hardy graduated with high honours from University of Texas at Austin. He has developed a broad following from his popular and often quoted daily Forex Market Update column, received by Saxo Bank clients and partners, the press and sales traders.

Alongside his column and media appearances, John Hardy generates trading ideas to profit from swings in the market on a 1-5 day time horizon. He also writes regular ad-hoc commentary focusing on the major currencies, central bank policies, macro-economic trends and other developments.

John Hardy is available to comment on FX and the major asset classes from a macro perspective.



MADS KOEFOED
MARKET STRATEGIST

Mads Koefoed is a Market Strategist at Saxo Bank. His primary focus is macroeconomics and equities, and he is responsible for the Bank's Cross Asset Research. In addition, Mads Koefoed focuses on the development of the Strategy Team's econometric models.

Mads Koefoed has a Master's degree in econometrics (cand.polit) from the University of Copenhagen, where he specialised in finance and econometrics. Prior to joining Saxo Bank, he spent two years with Danske Capital, where he worked in the Danish Equities team.

MACRO: STILL NO CAUSE FOR CELEBRATION

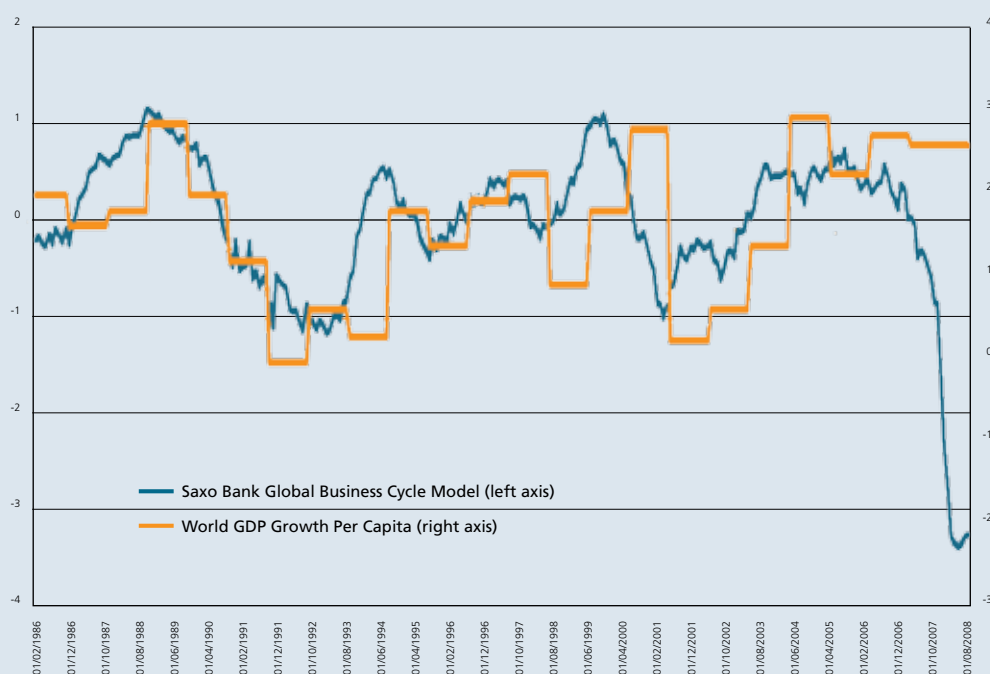
The key take-away from the last quarterly update at the end of March was 1) the ineffectiveness of quantitative easing, 2) the need to fix borrowing costs immediately, 3) that earnings would continue to drop, 4) that deflation/disinflation would spread and worsen.

Since then, the long end of the curve has shifted higher for mortgages and government treasuries. Some of the increase is clearly due to the whole “reflation trade” that has been lifting stocks and risky assets since the beginning of March. However it is also due to the Chinese worries that their USD-denominated assets will be inflated away. Earnings fell by 32% in S&P 500 during Q1 and are expected to fall an additional 35% in Q2. Of the G8 countries, two (Japan and the US) are now seeing deflation and four others are on the verge of deflation (Canada, France, Germany and Italy). Only Russia and the UK still have solidly positive CPI YoY. We expect the deflation/disinflation to continue and hurt corporate margins, as revenues fall while costs are more or less fixed.

Saxo Bank’s Global Business Cycle Indicator seems to have found a bottom around March and is now edging a tad higher, although it is still showing a dramatic contraction in economic activity at these levels. The “second derivative discussion” from the past showed to be for real, but the first derivative is still not a cause for celebration.

The market is far ahead of the curve in pricing-in the recovery, and we believe that the fundamental problems of the economy (an unsustainable debt burden leading to sub-par consumption growth and thereby writedowns and earnings recession) are still unresolved. The recovery will be flat-to-w-shaped and will take at least another 18 months to work its way through lay-offs, write downs and rationalisations.

We have still not seen any “hard choices” from the Obama administration, which means that the steepening of the yield curve will continue. We are actually afraid that irresponsible fiscal policies will lead to bond market dislocation and we are warning our clients about this possibility.



The spectacular rise in risk appetite in Q2 is the driving force shaping markets in the second half of 2009. It is no surprise to see strong bounces when markets have crossed over into outright panic mode, as they did in autumn of last year after the Lehman bankruptcy and then into the stock market low in March of this year, but the degree and persistence of the rebound in risk appetite has been remarkable and surprised many, including us. The market has gained confidence in the prospects for the global economy from an apparently resurgent China and a supposedly “slowing slow-down” in the major developed economies which many believe are the promising signs of a real economic recovery. The great hope on the Chinese front is that the authorities there can perform a miraculous transformation of the economy from an export-based manufacturing one into a consumption-based economy.

SYMPTOMS OF THE GLOBAL

RESURGENCE IN HOPE INCLUDE:

- US equities have risen nearly 50% from the lows, with only one negative week on the way up*.
- US T-bond (30-year) yields have risen well above 4.50% as they no longer hold appeal as a safe haven. Compare this with the 2.50% low during the autumn 2008 panic.
- Emerging market currencies and equities have rocketed higher. The Shanghai Composite index is up almost 70% from its lows*.
- Risk spreads in corporate debt and corporate and sovereign credit markets are narrowing by the day and are at levels close to where they were at the Lehman bankruptcy*. The short end of the US government yield curve even snapped higher* (two-year yields rose as much as 50 bps) and the finance media is now even fretting the timing of Fed hikes and the speed with which the Fed can roll back the liquidity measures and prospects for hyperinflation.

**All figures at the time this report was published*

FX: GLOBAL ECONOMIC RECOVERY FULLY PRICED INTO FX - WILL THE ECONOMY COOPERATE

The reaction in currency land to all of these developments has been fairly predictable:

- The USD has declined the most as its safe haven appeal fades and as the market looks at the risk going forward of a permanent devaluation
- Asian central banks led by China are looking to diversify their holdings and even supplant the USD in places due to lack of confidence that the US will honour its debts and will “default” by employing a bleeding devaluation via inflation.

Playing into this theme is the Chinese diversification of its assets and strategic stockpiling of commodities, even as demand collapses. Commodities and the USD have a reflexive relationship and this has also fed into the USD weakness. The JPY has suffered as well, if slightly less, as global rates have shifted higher and traders have burnished the carry trade of yore.

On the plus side, the pound has found renewed strength - or at least bounced from profoundly weak levels - on the contraction in credit spreads and hope that there are no longer any prospects for systemic risks within the banking industry. The commodity currencies have been the other major beneficiaries, with a huge resurgence in the likes of AUD and CAD on the relief in risk appetite and the China-driven commodity story.

SO WHAT SHOULD WE LOOK FOR IN Q3 AND THE REST OF 2009?

Our main thesis is that the resurgence in hope for the world economy is premature, that the seeming recovery in the developed economies is only the result of some stabilisation after the traumatic shocks of last autumn, possibly limited inventory rebuilding, and most of all a result of the unprecedented injections of liquidity carried out by the world's central banks and governments.

As we head into the dog days of summer and then the autumn, the world may come to realise that a new “de-coupling” scenario for the likes of China will take far longer than the market is currently pricing in, and that demand from the end consumer in developed economies will not rematerialise like it did in past recoveries.

This economic cycle is unlike any other since the end of World War II. This will mean a reversal in many of the trends that we have seen since early March – with the grand question being whether the USD has one more bout of strength in the near to medium term as a safe haven before the much discussed devaluation scenario takes root further out in the future.

USD: The greenback has lost ground on a “re-de-coupling” scenario, if we may call it that, due to the resonance with the theme that was all the rage just before the US financial contagion swept around the world in 2008.

The idea here is that the rest of the world, particularly China and other major EM players, are quickly getting back on track while the US remains mired in its financially prostrate state and must print money and devalue in order to come out from under the unbearable weight of its foreign-financed debt. In this scenario, traders are loathe to hold dollars.

But something doesn't sit right with this theme: if the markets are so concerned about the viability of the most important financial instrument in the world – US treasuries – then we should be seeing major risk-quakes in every direction. Where is the worry? In other words, there still seems to be a correlation between the USD and risk appetite, and we wonder if the USD might perform relatively better than less liquid currencies once again if risk aversion returns - at least for another quarter or two. The Chinese recovery story in particular looks overbought.

EUR: The market's remarkable ability to ignore the ticking time bomb that is the Euro continues to confound our increasingly negative outlook for this currency. The EUR continues to outperform the USD and JPY when risk appetite is high due to the ECB's less expansive policy and perhaps also on some measure of relief that the previous panic in the CEE countries appears to be contained for now. But when risk aversion returns, the higher beta commodity currencies experience the worst beating, even if EUR falls against the USD and JPY.

It all adds up to overall trendlessness if we look at the EUR vs. a basket of currencies. At 1.4000 in EURUSD, we have a hard time finding any scenario that is highly supportive of further strength in the EUR vs. the USD or JPY, and continue to look for a sell-off in the single currency: if the sell-off occurs in an environment of renewed risk aversion, the EUR could fall the most sharply vs. those two currencies.

But a EUR fall on a broad basis could materialise, regardless of the direction in risk appetite, due to the EuroZone's own special set of problems that we have outlined ad nauseum. The EuroZone economy is underperforming and a stronger currency is the last thing that its economy needs. Watch out for an ECB that ends up dragged deeper into QE-like territory despite the brave words of its foremost hawks, led by Weber. And especially watch out for signs of political discord within the EuroZone political framework. The worst scenario for the EuroZone seems worse than the worst elsewhere.

GBP: How ironic that a Labour government was at the helm when the entire credit crunch unfolded, as the traditionally left-leaning party gets the blame for the "evils of capitalism run amok". Will Brown be forced into calling an election soon and what will its impact be on GBP? GBP has outperformed of late on the grinding contraction in risk spreads and apparent improvements in the financial sector. A few better than

expected UK data points have also peppered the scene as some argue that the worst is over for the British housing market and consumers, and that the country may be on the road to recovery.

Our overall conviction is that the recovery story is premature – but it is more than tough to place the UK's relative merits in comparison with the EuroZone, where the potential for negative developments remain larger. On a basket basis, we would expect the pound's torrid rally of the last couple of months to ease, even if we don't go back to the bad old days of a complete rejection of the currency. Still, there is certainly the risk of a sharp pound sell-off if the idea of sovereign risk comes into play with a vengeance, considering the UK's enormous financing needs in coming years. But if ugly EuroZone developments come into play in coming weeks and months, then the GBP could find support through the important EURGBP cross, where we watch the 0.8580 low with interest.

CHF: The SNB has apparently succeeded in scotching the market's enthusiasm for trading the Swiss franc – as it has failed not only to strengthen, but also failed to weaken when risk appetite improved during the last cycle. Is this simply a sign of the market's neglect or a red flag of the currency's weakness? It is a bit surprising that the franc did not sell off more considering the rally in risk and in CEE currencies. We have a neutral outlook on this currency for now until something new comes to light and it will be interesting to see what happens with the EURCHF pair and its apparent 1.5000 barrier if the most EUR-negative scenario plays out. In general we would prefer to sell the franc vs. the JPY and buy it vs. commodity currencies in the shorter term if the risk averse scenario plays out.

AUD: Until the turn of the calendar month, AUD was on top of the world as it sat in the sweet spot of intermarket developments: the currency is a carry trad-

ing poster child as rates are rising and it enjoys a huge exposure to a supposedly recovering China with its endless commodity appetite. As well, AUD has always tended to perform well when equities do well. But the failure of the Chinalco/Rio Tinto deal was a warning sign, and if the market decides to take a second look at the timing of the global recovery theme, AUD could be in for a nasty correction in the short term. We've described our disbelief at the sustainability of the Chinese story in the medium term and we look for a pivot in risk appetite soon, so at some point, we are clearly looking for a correction in the rally in AUD, virtually across the board. Longer term, AUD could bounce back once the global economy, led by Asia, finds traction and a sustainable recovery. We simply think the market has way overplayed this idea for the near term.

NZD: The kiwi finally spread its wings over the last month, even rallying sharply vs. the strong AUD as risk appetite blossomed. But as June begins, it appears the currency may have seen a blow-off top for now with the sharp sell-off reversal. If we get another backdraft in global asset markets and renewed risk aversion, the kiwi will likely take up its old underperforming ways for some time. Its enormous current account deficit which depends on the trust of foreign bond holders and the illiquidity of the currency are ever-present background risks. The weak kiwi will hopefully help right some of the country's wrongs and we still think that its main exports – foodstuffs – are likely to see a stronger recovery relative to other commodities eventually. As well, New Zealand has generally run large budget surpluses and only had its first budget deficit in 15 years in early 2008. The strategically minded investor might have a look at a long term EURNZD short on any significant rallies.

NOK: The Norwegian krone seems to have a split personality of late after starting the year as a favourite

of the safe haven crowd, due to its unmatched fiscal credibility in an otherwise profligate world. At the same time, the currency was trying to rally in May on more robust energy prices, which is associated with the global recovery rather than safe haven worries. The outlook is cloudy for the short term, and the market has taken fright at Norges Bank coming out with further strong verbal intervention (a bit strange as NOK is at very low levels vs. the Euro on historic comparisons, the recent spike to 10.00 notwithstanding...). In general, we are very positive on the NOK almost regardless of what happens in the broader market, as the currency is simply undervalued – especially vs. the EUR when the EURNOK pair is trading around 9.00 or higher. But considering Norges Bank's strange vigilance and the currency's relative illiquidity, it may be difficult to trade the currency other than on an opportunistic basis.

SEK: The krona has weakened sharply despite the overall background of increased risk appetite as the Latvian troubles have come to the fore in the first week of June. Latvia appears to be on the possible brink of a devaluation and Sweden has by far the largest exposure to this country. But would a Latvian devaluation really be so catastrophic for Sweden, with only a few percent of GDP exposure to the country (compare with Austrian banks' 70% exposure to Eastern Europe)? And if Latvia is simply the first domino to fall for the whole CEE region, won't the EuroZone banks experience even more pain? It seems the Swedish krona is too weak in the bigger picture. There is a risk of further spikes to the downside if the Latvia story is allowed to spiral out of control (a bit hard to imagine considering the interventionism at every turn we have seen over the last six months from the IMF et. al.), but some kind of more or less controlled unwinding is a higher odds scenario than total chaos.

TRADES FOR THE NEXT THREE MONTHS:

- Short AUDNOK - AUD is overvalued and NOK is undervalued. Even if the world continues to play the commodity theme, the NOK could storm higher on that theme. On the preferred risk aversion scenario, the NOK is one of the world's more credibly safe havens, though it has a central bank that will try to frustrate speculators at every turn.
- Short GBPJPY - assuming interest rates don't head ever higher and the commodities trade eases, a renewed worry over the health of the financial sector could hurt the pound, and any relief on world inflation worries would help counter the JPY.
- Short EURUSD - alternatively, short EURJPY - there are many alarming potential negatives for the Euro, which never seem to be discussed any more, while the whole world is bemoaning the USD's inadequacies - is it time to look at shorting the Euro?
- Short EURSEK - yes, the krona tends to do poorly when risk aversion is high, but the market has perhaps overplayed the risks of Sweden's exposure to the Baltics. If any greater "domino effect" scenario plays out in the CEE region, then the EuroZone could suffer even more.

EQ: WHAT WILL DRIVE EQUITIES FROM HERE

In our latest update of The Yearly Outlook we argued that earnings would continue to decrease and prices would follow. Earnings did decrease, but equity markets have been rallying since early March and are now up by 40%. What we have witnessed is a decoupling of earnings from prices and instead equity markets have been led higher by the perception of green shoots – that is better than expected leading macroeconomic indicators (mainly survey based). However we have now reached a level in terms of pricing in equity markets where a normal recovery both in terms of the broader economy and earnings have been priced in and consequently green shoots will not be able to take us higher; instead we believe there will be a shift in focus towards earnings development again for directing equity markets.

DRIVERS OF EQUITY MARKETS FOR THE SECOND HALF OF 2009

The current consensus forecast for earnings for next year in the world (ex. financials) is 19.1%. In order to drive equity markets higher, realised earnings need to beat expectations in the upcoming and the next quarter. Even though the bar is set low we do not expect realised earnings to beat expectations. Historically, a GDP-growth rate below 3% has led to earnings growth in single digits. In this context it is important to recognise that earnings development lags GDP development by a few quarters, and since we do not expect global GDP growth to revert anytime soon, we stick to our forecast in the Yearly Outlook update that the earnings trough will happen in early-mid 2010.

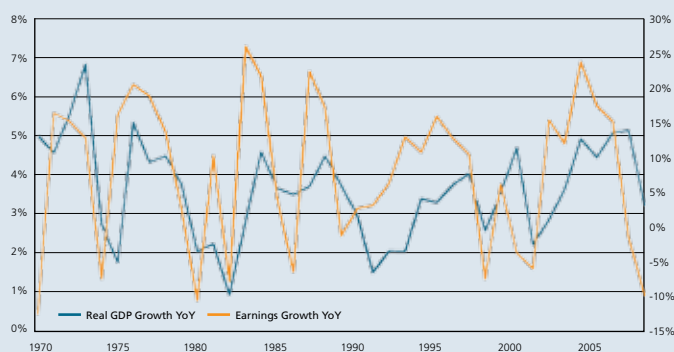
Since realised profits are unlikely to be the sustained driver of equity returns over the second half of 2009 the question remains whether valuation multiples are able to expand from current levels? We are looking at three factors that are the main drivers of the P/E-ratio according to a rewriting of the Gordon Growth model: Risk equity premium, bond yields and long-term growth.

Since March, the equity risk premium has been falling mainly due to signs of financial sector stabilisation and less bad macroeconomic dataflow compared to expectations. This has also been a key driver of equity markets alongside green shoots. A fairly good indicator of the investor risk appetite is the high yield spreads and they have narrowed sharply alongside with increasing P/E ratios. Behind this movement lies the fact that the equity market has priced in a normal recovery in earnings (cyclical). Corporate bond spreads remain extraordinarily wide and a further normalisation of the credit risk premium should lead to a lower equity risk premium. But due to the decline in the equity risk premium since March we do not expect that this should lead to an expansion of price multiples.

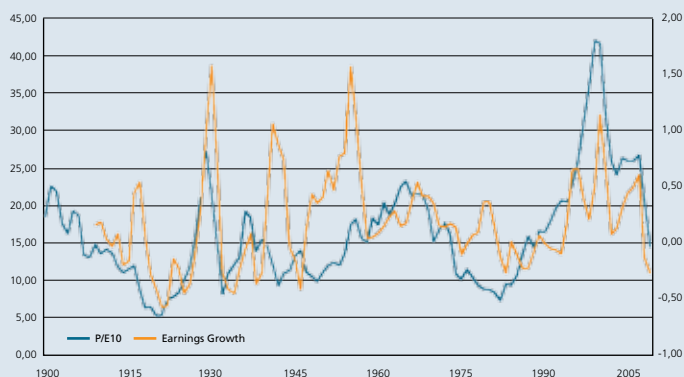
Bond yields are currently on the rise, but this is more due to worries on sovereign risk than growth expectations. The current investor behaviour in bond markets points more towards risk aversion than risk appetite and the rising bond yields have so far had a negative impact on equity prices.

Finally, this leaves us with long-term earnings growth as the driver of an expansion of valuation multiples. During normal circumstances share prices tend to move ahead of analysts' long-term earnings growth expectations and recently the re-rating of the P/E suggests that the market expects an upward adjustment of long-term earnings growth estimates in the months ahead. If this should happen it is already priced in and will most likely not affect markets. What is more important however is that we expect long-term GDP growth to be below trend growth due to the deleveraging process, large public sector and household debt and a rising share of government spending and taxation of GDP. As pointed out earlier, lower GDP growth tends to lead to lower earnings growth and as a consequence trend earnings growth is likely to be lower than we have seen in previous decades.

Global Real GDP and Earnings Growth



US Long-Term Earnings Growth and P/E10



Note: US Long-Term Earnings Growth is defined as 10yr growth in 12mth Earnings Trailing.

As shown in the graph above, there is evidence that lower equity valuations follow lower earnings trend growth rates. With inflation expectations having recently being normalised (TIPS have reverted to pre-crisis level) and given a weak GDP growth environment it is difficult to conclude that valuations will rise independently of long-term earnings expectations from current levels. Rather it is our expectation that we will see a contraction in valuation multiples as the markets start to price in earnings below the current trend driven by below trend GDP growth expectations.

FIGURE 1

Earnings Estimates

	Europe	US	Japan
Old Expected Earnings Growth (ex. Financials)	-40%	-33%	-47%
New Expected Earnings Growth (ex. Financials)	-48%	-38%	-50%

EARNINGS ESTIMATES AND INDEX TARGETS

On the back of our expectation for earnings development within the next year we revise our earnings growth expectations downwards. We are especially concerned for the European earnings growth development and consequently we have lowered our expectation here more compared to the US and Japan.

On the back of the recent rally in equity markets, we are revising our lows estimate for 2009 higher compared to the prior estimate. Despite this we believe that the current rally is driven mostly by psychology and we observe a significant overshooting, we do not expect the lows from March being taken out. As a consequence our estimates for lows during the remains of 2009 are higher than the ones reached in March.

FIGURE 2

Equity Index Targets based on DDM simulations.

	18 March 2009	Lows 2009 based on DDM Valuation (old)	Lows 2009 based on DDM Valuation (new)
DJ Stoxx600	171	164	170
S&P500	794	500	740
Nikkei225	7972	4600	7365

CRUDE OIL: A RALLY FUELLED BY MISLEADING EXPECTATIONS

The high correlation between the S&P 500, US 10-year yields and crude oil leaves us with a compelling case for herd behavior. The rally in US-10 year yields and crude oil are quite simply tied to the gains made in equities this year, as investors appear to place blind faith in equities as one of the core indicators of our economic outlook.

Taking into consideration last year's extreme market conditions, there is a growing need to stay away from the general assumptions on populist correlations, and begin to make assessments on individual products and sectors based on the distinguishing characteristics that underpin the particular market, and not just numeric laws that govern all markets.

If we do not do this, we will invariably find us in a situation where inter-market relative values begin to diverge again, and those who implicitly lay their trust in correlations might get hurt once again. So it is very important that we remember the lessons learned from the past couple of years trading and apply good discipline, especially on trend following.

FUNDAMENTALS

In general, the entire commodities complex has seen relative gains of 20% on this year alone, with energy leading the way and the dominant positive factor.

Oil inventories and demand figures are not supportive of further gains in crude oil, though. The demand for oil is closely linked to the performance of the global economy, to which we have seen signs of better economic data publications. But as a whole, it is fair to say that we have a fair way to go before we can truly believe that we are in a state of full recovery.

By and large, demand is still on the decrease and crude oil supplies are breaking through five-year highs. At present, supplies are in some places 15% higher than the cyclical averages that are normal for this time of the year. Also, according to the EIA, surplus production capacity for OPEC countries should increase by the end of 2009, as capacity should rise by 1.2 million barrels per day, over that of demand.

With excess surplus capacity and decreasing levels of global consumption, it is very hard to be supportive of any upward price action.

TECHNICALS

On the entire move up towards the highs at \$150.00, the 50-week moving average appeared to be a good support level for trend followers. We still believe that we can use this as a good indicator of the general market direction, and especially when trying to gauge good entry and exit strategies.

Presently, we are testing this as resistance at the \$71.85 level. We believe that this will hold, keeping the downward 50-week trend intact.

There is also good reason that we could have moved in to an overbought area, setting up for a correction. Although, the present "higher highs" on a weekly basis, warn of continued upside momentum. On that basis, we will resist selling into new highs, but remain unconvinced that the market will stay bullish.

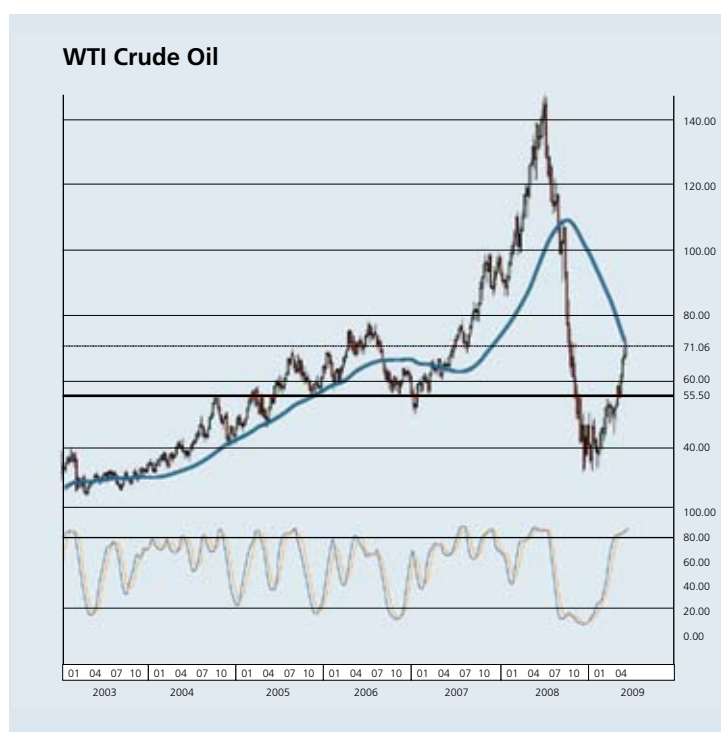
3RD QUARTER TRADE STRATEGY

If you had bought crude at the beginning of this year, you would have a return of approximately 70% until now. Given any scenario, this is a good return for just

about any investment, so banking profit at this level makes all around good sense.

Before we see some clear signals of fundamental demand side recovery, it will be hard to stay bullish above \$70.00 - \$75.00. To some extent, our technical outlook is supportive of this; however, we very much believe that we need to see a weekly close below the 50-week moving average, before we instigate shorts for a move lower. As a matter of principle, this is good market discipline.

On this basis, we believe that crude oil will be in a more corrective trend throughout the 3rd quarter of 2009, which sets up for a move towards \$55.50.

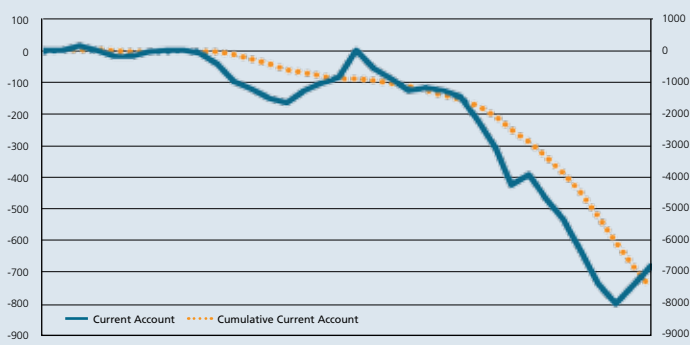


SPECIAL NOTE: PUBLIC DEBT AND MONETISATION

With a ballooning public debt, the outlook for the US economy looks bleak and we expect the dollar to weaken significantly in the long run.

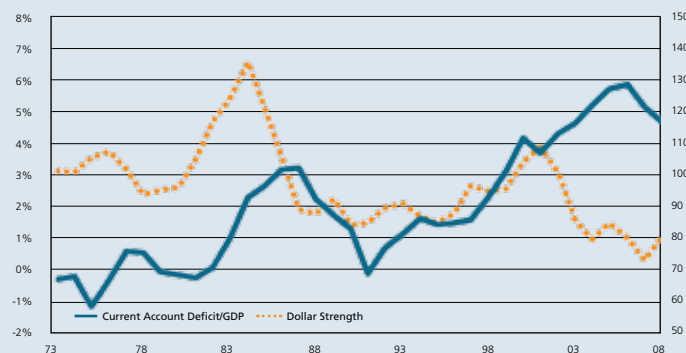
The US economy has experienced a protracted period of current account deficits with the most recent surplus dating as far back as 1991. Since 1983, the US has accumulated a vast cumulative deficit against foreign countries, primarily due to net imports of goods. This consumption has been paid for by capital asset sales and borrowing from foreigners.

FIGURE 1
Current account balance vs. cumulative current account balance since 1973



Usually when net foreign debt rises too much the exchange rate adjusts downward to reflect that the demand for foreign currency is greater than US receipts from exports, while the supply of its local currency is greater than the foreigners' demand for American produce. The lower exchange rate acts as a deterrent on foreign net exports and the current account deficit decreases as domestic products become cheaper abroad. In other words, the exchange rate brings about equilibrium whenever the current account deficit moves outside the natural range, so to speak.

FIGURE 2
US current account deficit to GDP vs. dollar strength



This time around, however, a weakened dollar has not diminished the size of the current account deficit. The deficit has continued to grow to record highs, even after a steep drop heading into the '03 recession the dollar has not continued down. We believe that the following three reasons can explain the divergence. First of all, the dollar is generally viewed as a safe haven during recessions. Keep in mind that this is not simply a US recession, but a global recession. Thus international investors are offloading local currencies and accumulating dollar-denominated assets as the dollar is still viewed as a comparatively less risky currency. This was evident during the crash in the fall of 2008 (see figure 3), where the dollar gained quite a bit versus US trading partners.

FIGURE 3
Dollar Index strength in 2008-09



Second, the fact that the US government is actively trying to combat the recession is viewed favourably even though the massive – and growing – public debt should make foreigners wary about the government’s fiscal policy. Third, central banks of emerging market countries – China, in particular – have built up vast foreign reserves in an attempt to keep the prices of their domestic produce competitive.

We believe that China will initiate policies to alleviate the dependence on exports. China’s insistence on export-driven GDP growth has benefitted Chinese exporters greatly due to artificially low input prices, making their produce very competitive internationally. However, with export-driven GDP growth expected to be a mirage chase in the near future as Western consumers tighten their belts, China is transitioning towards a relatively more consumption-driven economy.

We believe that the public debt will continue to spin out of control despite reassurances from Washington. The main driver, however, will no longer only be net imports of goods, but also net interest payments on

foreign debt, which will be a significant drag on the economy. Historically, this has been a small net interest income since US investors earned better returns abroad than foreigners have earned on holdings in the US. In addition, public spending for programs like Medicare and Social Security will increase while tax revenues will drop on weaker economic activity. And if interest rates continue their uptrend, which in all probability is due to the loose fiscal policy, interest on the foreign debt will be even harder to service.

The federal budget deficits are expected to balloon to 12.1% and 9.3% of GDP in 2009 and 2010, respectively. This is clearly unsustainable, and the government and the Fed have only two options. They can cut spending dramatically; and a reduction in the treasury budget deficit to 3% of GDP is not enough. Or, as we believe will be the case, they can monetise the debt. We believe that money printing is the most plausible escape route, and reckon that inflation will increase considerably in the long run.

In conclusion, loose fiscal and monetary policy combined with reckless private consumption has given rise to the current predicament facing the US. Instead of cutting consumption spending and increasing savings like the US residents have done, the government continues to spend wildly to alleviate the consequences of the recession. This, however, will most likely be ineffectual and only contribute to a higher net foreign debt as evidenced by the protracted economic slump in Japan. As the Fed monetises this debt, inflation will increase and in the long run the dollar will weaken against the Euro; the ECB taking a more restrained approach.

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