

Quarterly Outlook

SAXO
BANK

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The final all-out effort to keep creaking debt markets and financial systems turning over

The FOMC is in full intervention mode once again just before we go to press with this report, launching Operation Twist in its latest effort to jump start the failing U.S. economy. The European Union is likely on the brink of a new and massive effort to dig itself out from under its untenable sovereign debt situation in the fourth quarter despite recent dithering and in-fighting. Meanwhile, the Swiss National Bank has launched an all-out war on the strengthening Swiss franc. And Japan might be close on its heels.

It's Maximum Intervention time – the final all-out effort by policymakers and central banks to keep creaking debt markets and financial systems turning over. While the future path from here remains uncertain, the most likely and healthiest eventual destination for the world economy and policymaker in the wake of Maximum Intervention will be Crisis 2.0 – a real confrontation with our debt demons and bad practices to eventually replace the extend and pretend routine we've seen since the global financial crisis got under way in 2008. Fasten your seatbelts, ladies and gentleman, because we are in for a rough ride – one that will very hopefully see us in a better place when we finally land.



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MARKET COMMENT: MAXIMUM INTERVENTION AND CRISIS 2.0

Since our last quarterly outlook called 'Maximum Uncertainty' the world has moved from bad to worse. Growth prospects have soured and governments and central banks are everywhere pulling out the stops to save the system once again. In Europe, renewed efforts to save the European Union from its debt crisis are foundering as EU politics have reached an all-time low in solidarity and an all-time high in playing to more domestic national agendas.

Policymakers' efforts in the developed world to salvage the economy with bailouts, stimulus and money printing have failed to build a sustainable recovery since the 2008/09 financial crisis. And yet, have policymakers and central banks learnt anything? Hardly! In fact, it appears they are ready to double down on their previous efforts, a state of affairs we call Maximum Intervention. Top-down analysis suggests that this Keynesian, extend-and-pretend approach of ever more debt creation is likely to result in one of the following three scenarios:

1. Japanisation – continuing to pile ever more debt onto the sovereign balance sheet as the private sector licks its wounds. The analogy is Japan's lost decades with the question being whether Japan's unique strong export/strong private sector savings model can ever be repeated elsewhere. Regardless, an overactive public sector that chokes the potential of more private sector dynamism is hardly the path worth taking for other developed nations.

2. Crisis 2.0 – this scenario is triggered by government bond buyers simply going on strike. It appears to be the scariest, but actually offers the fastest and least expensive way to solve the developed economies' debt dilemma. In a Crisis 2.0, the short term might get very scary in a "Lehmanesque" kind of way on deleveraging and destruction of bad debts through write-offs, etc. Further out, however, unfettered markets and allocation of capital based on gaining the highest marginal return will get the economy going from a healthier starting point and result in far more private sector job creation.

3. Monetisation – This is the favourite choice of policy makers or at least those that feel Japan went in the right direction, but it was simply not aggressive enough. This is the cult of extend-and-pretend – the endless Keynesian game of bailing out, stimulating and printing money while praying that economic growth will miraculously return if we can just buy a bit more time. It also means all governments and central banks will eventually be engaged in QE and weakening their currencies. Look no further than Japan and Switzerland to see how a strengthening currency can trigger unprecedented policy decisions!

In our last Quarterly Outlook, entitled 'Maximum Uncertainty', we discussed how uncertain economic and market outcomes might be in the wake of the end of the Fed's QE2. At the time, we suggested three potential paths that had solid probabilities: 1970s-style stagflation, Crisis 2.0 and QE-to-Infinity.

The 1970s stagflation scenario has 'died' as more countries are facing deflation rather than inflation. Still, we do have another theme from the 1970s that remains, namely that of the problems caused by 'big government'.

That leaves Crisis 2.0 and QE-to-Infinity as the main two scenarios left, with our Monetisation and Japanisation scenarios as two sides of the QE-to-Infinity coin. We feel odds are about even on the two scenarios. Will a Maximum Intervention scenario trigger a true Crisis 2.0 due to a loss of faith in sovereign debt? This would mean an unprecedented (in recent memory, at least) inability for sovereigns to access capital markets. Or do we get QE-to-Infinity, simply the continuation and even expansion of government into more and more sectors of the economy and even our everyday lives?

Politicians in the EU seem to feel that ever more intervention in the market is worth considering as they have proposed – what was once a dead concept – a Tobin tax (a tax on financial transactions).

Meanwhile, the problem and the solution remain

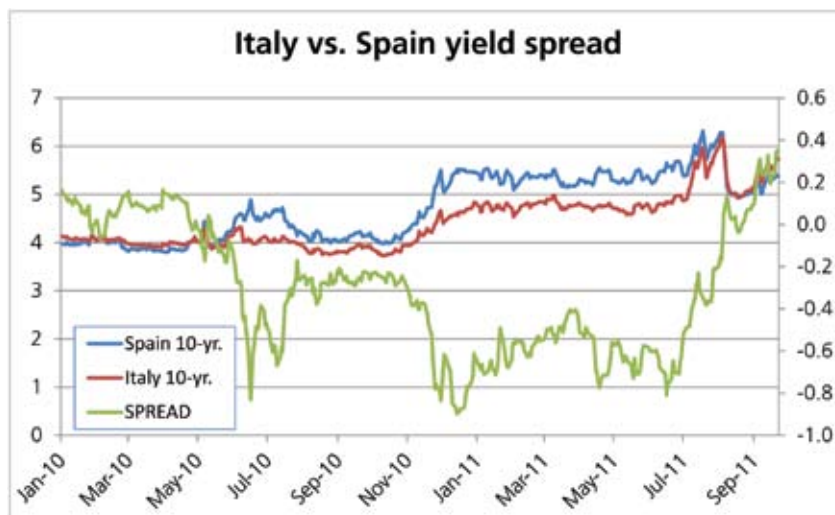


Europe - a house without foundations

pretty simple for the EU – leaders need to stop the half measures and extend-and-pretend schemes and start talking about a true monetary union if they want the EU to survive this critical challenge intact. Let me stress that I am an EU agnostic, but the only way for the EU to survive is through the creation of an EU Ministry of Finance and a common fiscal policy controlled and implemented to make sure that all member countries comply with common sense policies of keeping debt below a threshold and to secure faith in the EU as a trading zone. This would mean one credit risk for investors and trading partners rather than 27 individual bond markets and the related credit risks for each. Right now, everyone wants to have a liability in the

weak countries and assets in the strong, should or rather when the EU breaks up. The flight of capital is depleting and exposing to everyone the dependence on new issuance to pay for old debt. Nowhere is this truer than in Italy and its EUR 1 trn debt market, where political apathy is now resulting in higher yields than normally less favoured countries like Spain.

The entire exercise, started in 2008 at the depth of the crisis, of transferring private stressed debt onto the public balance sheet in order to secure low rates and easier access to capital has failed to sustain a re-



covery and has reached a saturation point after all of the rounds of debt-finance stimulus and QE money printing to finance much of the debt. At this point, one feels obliged to quote Albert Einstein; 'the definition of insanity is "doing the same thing over and over again and expecting different results".'

That's the context for the next few quarters: extend-and-pretend remains on the political agenda – and is truly global in scale as we have reached Maximum Intervention. With that as a given, how are we to manage our assets over the coming quarter and beyond?

In the next 18 months we are likely to witness investment opportunities not seen in decades. When and if the game of pretend-and-extend ends, there will be companies, real estate and other assets selling at prices which can only be described as 'deep value'.

Our approach would be to "average into" risk starting when/if the US S&P 500 breaks below 1050/1100 and then putting five percent of the risk capital into the market each month following this development. This leaves out trying to time the markets and respects the need for the markets to work through a volatile period of uncertainty.

We believe, as suggested by the title of this outlook, that the next three months will see the final desperate moves by policy makers to save the world with more of the same ineffective medicine. We also feel that the market and more importantly the voters are losing faith in the solutions on offer. If they rebel sufficiently, we get Crisis 2.0. And in that case we should be optimistic based on the belief that individuals are more than capable of dealing with a crisis scenario. You only need to think back to your grandparents and great-grandparents: they lived through two world wars, drastically changing political systems and scarcity of all goods and products beyond what most of us can imagine! And yet, they went on to produce the strongest growth and greatest welfare for all levels of society that history has ever known. The future can often look dire when the present doesn't look

so good, but it's so easy to forget how strongly individuals and companies want to survive and thrive.

Ironically, therefore, we can only hope that politicians' attempts at maximum intervention fail. Rather than extending and pretending and funding past mistakes (keeping bad debts alive), the focus should be on job creation – and to achieve that, policy should focus on writing off bad debts, encouraging the raising of risk capital and reduction of taxes and regulatory burdens.

Most of the developed countries have become Entitlement Societies where public spending and employment is crowding out the private sector. To change course, we need to hire two persons in the private sector for every one in the public sector and continue to do so for generations if we're to get back to the right balance.

The bad news is that a rebalancing will be painful. The good news is Crisis 2.0 is either here or eventually on the way; it will hopefully create visibility for what is needed and why. History tells us that only in times of distress will politicians and policy-makers ultimately take bolder, more rational action. On that note, now more than ever would be the time in which we ponder the true meaning of the word crisis: a turning point, not an extended period of doom and gloom.

MACRO OUTLOOK: EMERGING ECONOMIES DRAG DEVELOPED ALONG

Though the world economy will see robust growth of 3.8 percent this year this figure papers over a chasm between developed and emerging countries. While the developed economies led by the heavyweights (U.S. and Eurozone) are struggling to cope with the drag from deleveraging, emerging markets have hiked rates as inflationary pressures have mounted due to strong domestic demand. Domestic demand in emerging countries remains strong and should offset weakening foreign demand from developed economies.

and the fine art of kicking the insolvency can further down the road.

The drag from private sector deleveraging will continue for the rest of the year and into next year despite signs of easier credit conditions in some areas of the economy. The austerity-imposed fiscal drag will further undermine wealth in the coming quarters, especially in Europe where a failure to allow both winners and losers has resulted in a game of cat and mouse where the sovereign debt crisis rears its ugly head every few weeks before going back in hid-

Saxo Bank Forecasts 2011	Gross Domestic Product		Unemployment Rate		Consumer Price Index		Consumer Price Index, Core	
	YoY (%)		%		YoY (%)		YoY (%)	
	4Q Outlook	3Q Outlook	4Q Outlook	3Q Outlook	4Q Outlook	3Q Outlook	4Q Outlook	3Q Outlook
United States	1.8	2.4	9.0	9.2	3.1	2.7	1.4	1.4
Eurozone	1.5	1.5	10.0	9.8	2.4	2.4	1.4	1.4
United Kingdom	1.2	1.6	7.9	7.9	4.3	4.0	3.3	3.3
Japan	-0.6	0.0	4.7	4.7	0.2	0.2	-0.1	-0.1
China	9.4	8.0			5.2	5.2		
World	3.8	4.0						

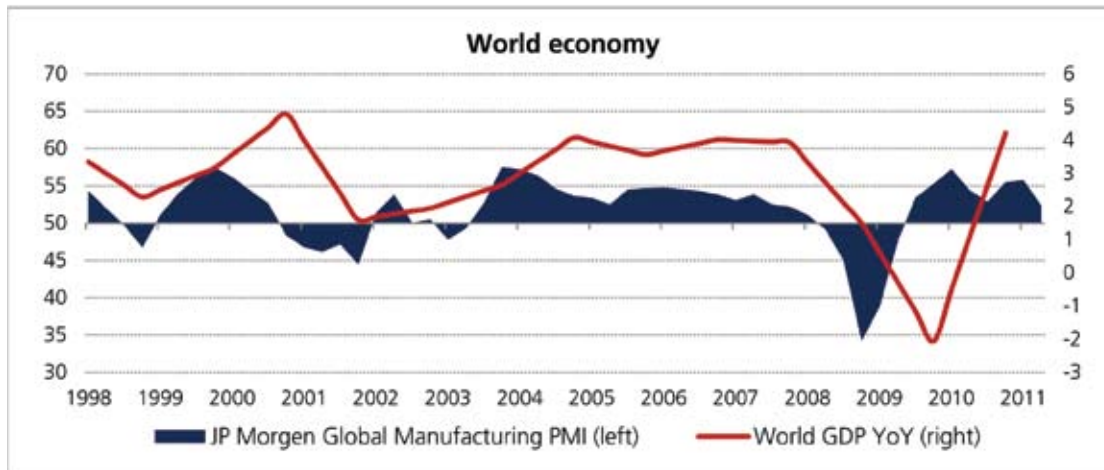
DEVELOPED ECONOMIES STRUGGLE TO GROW AMID AUSTERITY

What continues to be labelled a banking crisis, in particular now that the Eurozone is on the brink of accepting defeat in the battle for status quo in Greece, is in reality a household balance sheet crisis. The failure to understand the reasons for the global recession and the continued weakness in the major developed countries means that the establishment proposes solutions, which are not going to help much. While we have long championed deleveraging and debt restructuring as the means to quickly revert to a healthy economy, we concede defeat. Policymakers will not sacrifice short-term pain for long-term gain and are rather bound to repeat in various shapes and forms the erroneous solutions already attempted. These include demands for austerity in countries, which do nothing but push these countries further into recession and hence drive their debt-to-GDP higher, engaging in quantitative easing,

ing as policymakers plough money into the fledgling economies as the can is kicked a little bit further.

Given these obstacles, the outlook for growth this year has been and continues to be meagre and with an inventory cycle which has just about run its course, housing markets battling to find a foothold and plenty of excess capacity in labour markets as companies remain cautious, the developed economies are expected to remain in a 'muddle through' mode for the rest of this year and into the next.

- US: Private sector deleveraging at a slower pace will secure a moderate improvement in consumer spending in Q4 while residential investment remains paralysed by a non-existent housing market. The government spending drag is expected to be mitigated if a stimulus package finds support in Congress.
- EUROZONE & UK: Austerity will weigh on public



spending in Q4 and beyond while private demand will be challenged by a soft labour market. Sovereign debt concerns spreading to Spain and Italy will further undermine consumer confidence and companies' appetite for investment and hiring.

- JAPAN: The comeback in the second half of the year was not enough to combat the first half weakness due to the March earthquake. GDP is expected to decline 0.6 percent for the year. Net exports are restrained by a strong JPY (at decade high).

EMERGING ECONOMIES: ROBUST GROWTH, BUT TIGHTENING CYCLE HAVE JUST ABOUT RUN THEIR COURSE

The emerging economies of the world are a big part of the reason why the global economy will grow robustly in 2011, but there are nevertheless cracks starting to appear. The weaknesses in developed economies are spilling over into emerging economies through softer global trade growth and tighter monetary policy. The tightening cycle began in 2010 in China, India and Brazil in an attempt to fend off domestic inflation while the remaining BRIC-member Russia started tightening earlier this year. With weakness in global trade fighting inflation is no longer the only point on the agenda at the central banks.

The ability of emerging market economies to act swiftly in the face of adversity to bolster private demand by moving towards easier – or just less tight – monetary policy remains a potent weapon and one which is expected to cushion the blow from a further deterioration in global trade growth; though we should not discount the slowdown in manufacturing in some emerging markets as well. Overall, we look for domestic demand to mostly counterbalance a smaller contribution from foreign trade to economic activity in emerging markets.

- CHINA: Tighter monetary policy has not made much of a dent in Chinese growth as real interest rates remain low enough to promote speculative behaviour. Meanwhile, net exports and domestic investment are expected to power the economy to 9.4 percent GDP growth in 2011.

MONETARY POLICY IN 2011

US MONETARY POLICY

As we had previously suggested was possible at its 20/21 September meeting, the Federal Reserve announced that it would indulge in a so-called 'Twist' operation-selling \$400 bn of its holdings of under 3-year Treasuries and buying \$400bn of 6-30 year maturities in an attempt to lower long-term yields - given their direct correlation with mortgage rates and also the discount rates used by commercial enterprises to evaluate the viability of long-term business ventures.

The post-meeting statement noted "continuing weakness in overall labour market conditions" and "only a modest pace" of growth in consumer spending and repeated the committee's belief that inflation will "settle...at levels at or below those consistent with the Committee's dual mandate". As a result, 30-year yields fell below 3.00 percent - one of our '10 Outrageous Predictions for 2011', made last December.

Our feeling continues to be that risk markets will continue to be underwhelmed by the Fed's actions and that 'Operation Twist' is but the next step in an inexorable move towards what we long ago dubbed 'QE Infinite'- repeated QE's with diminishing returns.

The next instalments in the saga will be QE3 - probably in Q1 2012, as the economy fails to revive and stock markets languish. A reduction in the rate the Fed pays banks on excess reserve holdings from 25 bp to 10 bp is also highly likely within that timeframe, in a desperate attempt to encourage banks to lend to the real economy.

EUROZONE MONETARY POLICY

As predicted in our Q3 Outlook, the ECB duly raised its main refinancing rate to 1.5 percent at its July meeting and, at the time, markets expected that this was the beginning of an inexorable march higher in rates over the coming months and years. However,

unfortunately the world economic situation in general and that of the Eurozone in particular, has exhibited a marked deterioration since then.

In addition to the general gloom which has descended upon the world's largest economy, as discussed above, the main developments in the Eurozone have been as follows:

- July saw the announcement of a further package of measures from the European Council aimed at easing the Greek crisis and halting contagion into Spain and Italy. As has become the norm over the last 18 months the market was at first reasonably impressed, but enthusiasm quickly evaporated. This was principally because the European Financial Stability Facility (although newly authorised to intervene in the secondary bond markets of all European Monetary Union countries if the European Central Bank judged that 'exceptional financial market circumstances' posed a threat to financial stability) was not increased in size, and so would be completely inadequate should it become necessary to support Spain and Italy.
- Therefore, it finally dawned on the markets that the only solution that would bring an end to the debt crisis was a fiscal union, and speculation quickly arose that the natural precursor to this, the issuance of Eurobonds for which EZ governments would be jointly and severally liable, was now on the cards.
- Germany quickly and resolutely made it clear that it would not support the issuance of Eurobonds and the German Constitutional Court ruling on 7 September also underlined this position.
- A surprise fall in EZ core CPI in July from 1.6 percent to 1.2 percent, a level maintained in August.
- Weak business sentiment surveys.

Given the climate created by all of the above, it came as no surprise when fear did indeed spread to Spain and Italy (taking their 10-year bond yields well above

6 percent), so the ECB had to reluctantly revive its bond buying programme or securities markets programme (SMP) in the face of a divided ECB Governing Council, with the Bundesbank implacably opposed to the measure.

It therefore also came as no surprise when ECB President Trichet adopted a much more dovish tone at the news conference following the 8 September meeting of the Governing Council. Although it was apparently too embarrassing to reverse the recent rate hikes so soon, he made it clear that further increases were now firmly off the agenda and left the door wide open for decreases in the near future.

We now expect that, at the very least, before year-end the ECB will reintroduce the provision of unlimited, fixed rate, long-term liquidity to banks, thus flushing the system with liquidity and forcing actual market rates lower than the refinancing rate, if it chooses to keep this at 1.5 percent to save face, but probably also a reduction in same back to 1 percent and in the deposit rate from 0.75 percent to 0.25 percent. If the real economic decline accelerates, or the EZ debt crisis spirals out of hand, or interbank funding dries up, then these moves could come very quickly and we may even see the refinancing rate reduced to 0.5 percent.

JAPANESE MONETARY POLICY

Mindful of the worsening economic situation, The Bank of Japan increased its Asset Purchase Programme by Yen 10 trn at its meeting on 4 August. The measure was also no doubt intended to reinforce that day's foreign exchange market intervention, aimed at weakening the yen. Although this achieved initial success, with the yen dropping from approx 77.00 to the dollar to 80.24 on the day, global financial turmoil has since fostered investors' continued search for safe-havens, quickly taking the dollar back below 77.00.

We maintain our call for unchanged Japanese rates throughout 2011, and indeed also through 2012,

and feel further quantitative easing is very likely.

UK MONETARY POLICY

The minutes of the 8 September Bank of England's Monetary Policy Committee (MPC) meeting revealed that the decision to leave rates unchanged at 0.5 percent was of course unanimous. This came as no surprise to us or to the markets and, although Adam Posen remained the only member calling for increased asset purchases, (voting again for an additional £50 bn), "some" other members also moved towards QE2 - "This meant that the balance of risks to inflation in the medium term was likely to have shifted further to the downside. Most of these members thought that it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point"

As a result, we now feel that QE2 before Christmas is extremely likely, and rates are certainly not going to rise before 2013.

FX OUTLOOK: USD RALLY TO EXTEND

Waiting for a US dollar rally this year has felt like Waiting for Godot at times as we anticipated one for a long time before the greenback finally rallied sharply in late August and early September after a long period of stagnation over the summer, despite a number of market developments that have normally proven positive for the currency in the past. Those included falling equity markets, rising signs of worry in other risk indicators and in global growth concerns, particularly in Asia and emerging markets.

In our Q3 FX outlook, we discussed the “ugly horse-race” among the G-10 currencies because we felt that few if any of the major or minor developed economies would offer compelling reasons to buy their currencies and that it would be a question of which currencies appeared the least hobbled by fundamentals. The basic outlines of such a development have come to pass, though the USD was very slow to begin rallying as economic data out of the U.S. was terrible as well. But, the relative slowing in other economies and thus a tightening in interest rate spreads was indeed a positive driver for the eventual

USD rally. And because U.S. rates were already so low, the tightening has even occurred despite Federal Reserve Chairman Ben Bernanke’s promise to keep the monetary pedal to the metal on low rates until at least mid 2013 – and despite hints that QE3 in some shape or form is on the way. To take the most pronounced example of falling yield spreads, the highest yielding currency among the G-10, the Australian dollar (overnight rate at 4.75 percent as of mid-September) saw its 2-year government bond yields drop from 4.75 percent at the beginning of Q3 to about 3.50 percent by mid-September, a 125-bp drop as compared with a drop in US 2-year rates of a mere 25 bps or so in the same time frame.

We suspect a further tightening in yield spreads between the USD and other currencies will continue to unwind the carry advantage built up against the USD last year and at the beginning of 2011 as economies around the world, particularly in Europe and to some degree in Asia and in developing markets, stumble through a soft patch in growth or worse. At the same time, yet another round of government stimu-

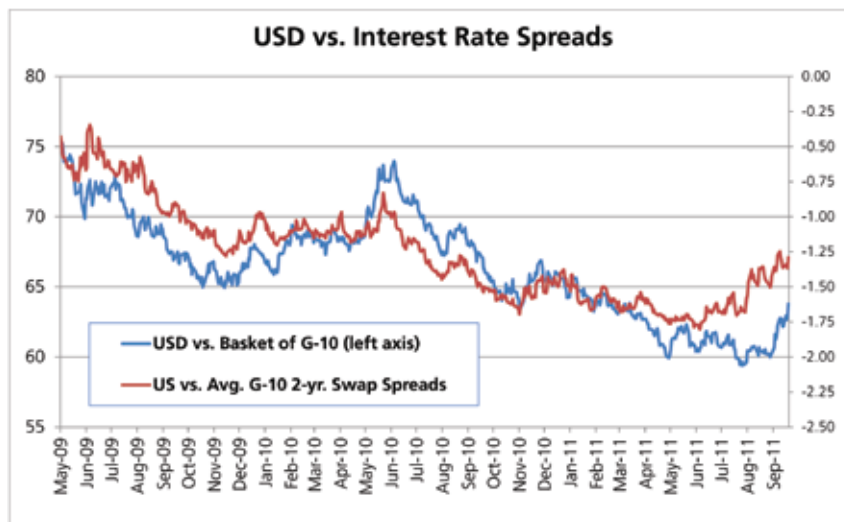


Chart: US 2-year yields vs. average G-10 currency yield. In the chart above we have plotted the spread of the 2-year swap rates for the USD vs. an average of the 2-year swap rates for the remainder of the G10 currencies. We’ve then compared this with the USD’s performance vs. an evenly weighted basket of the remainder of the G10 currencies. It is clear that from a yield perspective, owning the USD is far less unattractive than it was just a few months ago. It is also clear from the chart above that the USD has been slow to respond to this development.

lus and Fed QE could see a few quarters of solid GDP performance as US politicians pull out all the stops to get the economy going and then jostle to take credit for it ahead of the presidential election next November. Efforts in this direction will be aided by the long period of dollar weakness, which has made the U.S. extremely competitive for sourcing production and services and attractive for investment.

There are two further potential sources of USD strength – one is the likely return of the Homeland Investment Act (HIA), the original version of which allowed U.S. companies to repatriate profits tax free back in 2005. Q4 would appear to be the most likely timeframe to discuss and enact an HIA2, which would then go into effect in the New Year. Estimates of the amounts that might be repatriated this time around are far higher than the original HIA and could reach far over half a trillion dollars.

The other potential source of strength for the USD is that there is simply no alternative in a deleveraging world going where participants are unwinding their previous bets on “everything up versus the USD”. The lack of credibility of the Euro as the single currency faces an existential crisis now and in the coming few quarters will also continue to delay the demise of the USD’s status as the world’s reserve currency. Of course, these developments will not boost the U.S. currency forever and we wonder how long it will be until the long run accumulation of the twin U.S. deficits eventually returns to haunt the U.S. debt market and its currency.

EUROPE – CRUNCH TIME

As we discuss in our introductory article to this publication, it is crunch time for the European Union, as the efforts of the European Central Bank and EU politicians have failed to outrun the galloping problems caused by the awkward framework of a single currency and 17 finance ministries and 17 sovereign bond markets. As we are leaving Q3, the situation is fast reaching the ultimate crossroads: either the EU makes a strong show of solidarity or a solution will

quickly be forced upon it by the markets.

The Euro could see a relief rally if the EU manages to muddle through with the solidarity enforced by the market’s discipline, but a longer term solution to European debt woes would likely involve some form of QE by the ECB to keep bond markets orderly and dig European banks out of their liquidity pinch. And if the USD has been so punished for the Fed’s various rounds of QE, why shouldn’t a similarly dim view be taken of the Euro for also engaging in money printing? Of course, the immediate relief that sovereign debt investments won’t go immediately bad could offset some of the deleterious effects of a European version of QE (save for Greece, where a severe haircut or Greek exit is a question of time). And a more stable sovereign debt and financial services environment could see the Euro rewarded for its deep liquidity versus higher beta, more pro-cyclical currencies as global growth possibly hits a soft patch over the next couple of quarters.

THE SCANDIES – SAFE HAVENS?

There was a flurry of talk about the potential for NOK and SEK to become safe haven currencies in the wake of the Swiss National Bank’s frantic and so far successful efforts to put a floor in EURCHF at 1.20. Immediately in the wake of the SNB’s announcement in early September, the market drove both NOK and SEK sharply stronger, completely out of proportion to any other development that could have explained the situation besides the idea of safe haven seeking (or reversals based on positioning?). Afterwards, however, the strengthening in these currencies was erased. So are they potential safe havens or not? There are two important features a currency must have in order to be considered a safe haven in today’s environment – a superior sovereign balance sheet and deep liquidity. CHF used to be the best option until the franc’s incredible strength made the SNB and Swiss government “go nuclear” in their intervention. Sweden has a very solid balance sheet and Norway has an impeccable one, but both SEK and NOK fail the liquidity requirement for a true safe

haven. Also, SEK is traditionally a pro-cyclical currency due to its economy's dependence on export markets. NOK is similarly dependent on oil exports, though it tries to sterilise oil revenues with its pension fund. Of the two, NOK would appear a safer harbour than many of the rest of the G-10 currencies, but it would be surprising to see performance similar to the Swiss franc's (where the oversized Swiss financial industry was an additional contributor to the franc's aggravated rise).

THE ANTIPODEANS: STILL WAITING FOR THE FALL

Last time around we asked whether the strength in the Aussie and Kiwi versus the rest of the market was a bit overdone. Both currencies have begun to trade a bit more sideways in Q3, including one particularly sharp sell-off as equities slid off a cliff in early Au-

gust. The kiwi has been the stronger of the two due to a few months of perkier economic data and the belief that the Reserve Bank of New Zealand might unwind the emergency rate cut taken in the wake of the earthquake earlier this year. But both rather extremely overvalued – particularly the Aussie, given present market circumstances and our expected scenario for Q4. Because Australia has the highest policy rate among the G10 currencies, it also will likely have the highest beta to risk as the Reserve Bank of Australia has more potential for policy accommodation. The housing bubble appears to be in near full deflation phase now Down Under and could cause a considerable pinch in the Australian banking sector, suggesting that eventually even the RBA has to get in on the Maximum Intervention game in the quarters to come.



Chart: AUD and NZD against the rest of the G-10. Aussie and kiwi rose to new multi-year highs against the rest of the major currencies during 2011 and were remarkably resilient despite the heavy sell-off in risk and weakening emerging market currencies. Just before publishing time, however, they suffered a setback in the wake of the FOMC meeting, which may serve as a catalyst that pushes them lower to a fairer value, given the darkening clouds in the global economic outlook and their normal pro-cyclical correlation.

G-10: THE BOTTOM LINES

USD: A lack of alternatives and Maximum Intervention gone global will make the USD continue to look less unattractive in Q4 and the currency has been so weak for so long that the U.S. economy could reap some of the benefit.

EUR: It is crunch time for the Eurozone, which will need to pull together or face a further – and this time more urgent – existential challenge. Will Germany step up to foot the bill for the periphery?

JPY: The government bond rally and declining interest rate spreads (the carry in the carry trade) are the only real supports, as the domestic Japanese economy is relatively moribund. If bond markets pivot some day, so will the JPY, until then, it could remain strong for a while yet.

GBP: Sterling shows us the degree to which the Euro's woes are driven by its untenable political and central bank framework rather than by the absolute magnitude of its sovereign debt as the UK debt load and deficits are far worse. Yet, GBP has already been endlessly punished, and similar to the USD, could rally "by default" due to dimmer prospects elsewhere relative to previous expectations.

CHF: The Swiss franc has become the latest, most impressive victim of maximum intervention, which makes the world believe that no fiat currency can be a true safe haven forever. We assume that the determination of the SNB and Swiss Government will keep the CHF weaker.

AUD: Aussie did sell-off when risk appetite swooned in early August, but it is far too resilient given risk averse circumstances, prospects for slower growth in Asia, and on the risk of a disorderly unwinding of the domestic housing market. A heady adjustment lower could finally arrive in Q4 for the Aussie.

CAD: It will continue to trade as an "in-between" – a lower beta risk currency that may find resilience in its exposure to a less weak than feared U.S. economy. Still, the currency has only so much upside despite the solidity of the sovereign balance sheet and banks, as Canada features the world's most overleveraged consumer.

NZD: Some of its strength has derived from economic activity from earthquake rebuilding and some of it from Chinese diversification interest (which throws huge weight around in the less liquid kiwi). The rally could falter in Q4 on weaker than expected Asian growth prospects and as the RBNZ stays pat.

SEK: Likely to remain a pro-cyclical currency – the country could face a slowdown that could be multiplied by a European demand slowdown. In addition, Sweden's housing market is a raging bubble, though the signs of strain have yet to show much. Could they begin to do so in Q4?

NOK: Rate expectations have tumbled as with most other currencies where there is enough rate to cut. NOK may find a safe harbour bid to a degree due to the country's unmatched sovereign balance sheet, so strength versus the most pro-cyclical currencies might come into play in Q4 and Q1.

FX OPTIONS - FOCUS ON EURUSD AND EURCHF

EURUSD continues to be under a great deal of pressure. This has been apparent during September, not only in the spot market (falling 7 percent from 1.4500 down to 1.3500), but also in the options market: interest in purchasing downside protection have been plentiful, pushing EURUSD implied volatility to fresh highs as well as ensuring that risk-reversals keep a hefty bias for EUR puts / USD calls (downside options). As a guide, we saw one-month At-The-Money (ATM) implied volatilities as high as 17 percent, up 5 vols from the end of August. One-month 25 delta risk-reversals were showing a bias of around 4 percent for EUR puts, up 1.20 vols for the same period. This options buying has not been limited to short dated options: one-year ATM implied volatility and risk-reversals being up 2.5 and 1 vols respectively.

Such price action suggests that demand for downside protection (or leverage) far outstrips supply; clearly FX options market-makers are struggling to absorb those flows, leaving the market extremely vulnerable to further EUR weakness: on a lower spot, major option market-makers will find themselves managing significant short gamma and vega exposures which in turn could mean an acceleration of the spot moves.

As such, and despite the current high level of volatility, we would be extremely cautious towards any short EUR downside option positions, and would rather lean towards a long option position aimed at benefiting from a lower EURUSD spot.

The EURCHF options market is also worth looking at. Following the Swiss National Bank intervention, the price action in FX options implied volatility was as dramatic as it had been in spot. One-month ATM volatility currently stands at 7.0 percent, down an impressive 15 vols from the level seen prior to the SNB's actions. Going long EURCHF has been a popular speculative trade since that day - either through spot or through selling EURCHF puts with strike at or sub the 1.20 level. Indeed this is a very tempting proposition: SNB has been unequivocal in its intentions to protect 1.20. It now enjoys local and political

support and the ability to print more money should guarantee a successful result.

But whilst it is hard to see them fail, it is worth considering what might happen if they cannot protect this level. A change in local sentiment, political support or even a EUR breakdown might just prove too much for the SNB, and the all important 1.20 level could give way (whether completely or through a re-pricing exercise). Such an event would, no doubt, trigger a very sharp rise in implied volatility. Therefore short downside options positions in EURCHF should be traded very cautiously as they could prove extremely costly if SNB fails. Investors looking to benefit from a successful SNB action might consider entering short EURCHF put spread positions rather than outright options. This would allow for a very controlled risk should 1.20 give way.

ASIA: IS CHINA LOSING ITS COMPETITIVE EDGE?

In the run up to the 2008 global financial crisis, China's manufacturing sector was epitomised by a predominant focus on exports resulting in a constantly rising trade surplus and a hefty accumulation of FX reserves. In the aftermath of the crisis however, the situation has dramatically changed, partly due to a lack of external demand but also amid rising concerns that China appears to be losing its global competitive edge.

The main draw card for Chinese manufacturers to focus on these so-called "low-end", labour-intensive production lines was the abundance of a readily available, "cheap" workforce and, as some would argue, a competitive advantage from an artificially suppressed currency.

A recent "Blue Book" report from China's Academy of Social Science (CASS) acknowledged that since late 2008 China's exports to the U.S. have been in decline (China was knocked off its perch as the lead exporter) and eventually China saw its first trade deficit in six years in March 2010. But what were the reasons behind this decline?

In its Blue Book report, CASS suggested the major factors were government policy directives, which increased the cost of manufacturing in China, and escalating raw material/energy costs. This forced a number of manufacturers out of business and hence exports suffered. Indeed, if we take a quick, broad look at some of the inputs for end-product pricing - cost of raw materials is one but wage costs, shipment costs and currency pricing can also all be influencing factors, though some of these are not particularly unique to China. Specifically, raw materials and shipment costs are the same for all exporters, regardless of location, so does it boil down to wages and currencies being the major influences for end-product pricing? The USA certainly has a view on this especially if you have been listening to the constant commentary about China's undervalued currency for the past few years.

Overall Chinese exports to the US averaged \$30.41

bn in 2010 and \$31.15 bn in the first 7 months of 2011 (Source US Census Bureau) yet the CNY has risen 5.7 percent versus USD in the same period – hardly a compelling argument that the exchange rate is a dominant factor affecting exports. However, when the trade surplus is compared as a share of GDP it has actually been falling since 2007 (some two years after the first "de-pegging" of the USD-CNY rate).

Yet, if we were to break down the exports in the so-called "light manufacturing" sector, one that is perhaps more susceptible to labour issues, then China's market share of US imports has been in steady decline (as mentioned above) with a noticeably faster decline since late 2010.

A report from the Boston Consulting Group in May this year suggested that the wage gap between the U.S. and China is currently shrinking rapidly and is expected to converge within the next five years. Chinese wages are currently rising between 15-20 percent per year and any other workplace with more flexible practices could eat further into China's competitiveness. But is the U.S. the only "threat" to China's competitiveness? In the above-mentioned "low-end" manufacturing categories, it would appear that China's lower-income neighbours such as Vietnam, Bangladesh and to a lesser extent Indonesia are slowly eating into China's export pie (with regard to the U.S. and European export destinations) while Mexico is also seeing greater gains in certain "higher-value" categories such as furniture and precision instruments. So it would appear that wage costs are playing a significant role in affecting China's competitiveness and, with inflation currently running above 6 percent annually, the pressures are unlikely to disappear soon.

When it comes to the Chinese economy, exports have accounted for as much as 42 percent of China's GDP in 2008 (subsequently easing to 37 percent in 2010) (source US BEA) and loss of competitiveness may have serious growth implications. Is it possible that the Chinese recognised this and that is why they

have switched to lower, more sustainable growth targets in the country's latest five-year plan?

The 12th Five-Year-Plan has shifted focus from "quality growth" to "inclusive growth". Outright promotion of exports has been dropped as a byline (in response to declining competitiveness?) and replaced by enhancing households'/citizens' abilities to consume, redistributing wealth and aiming for slower but higher quality growth. Investment in industry is now targeted towards the energy generation and alternatives (sustainable power bases rather than pure manufacturing) and is perhaps testimony to Chinese authorities acknowledging falling external competitiveness and recognising the need for more internal-focused policies.

In summary, China is facing an erosion of its global competitiveness with wage pressures linked to high-flying inflation being the dominant factors. The Chinese currency, and its gradual revaluation, is also playing its part and China's loss of competitiveness may be seen as a helpful factor in the global rebalancing process. But Chinese authorities do not see any need to panic. If (and some may argue it is a big "if") they can succeed in pulling off the latest Five-Year-Plan then this development, and its impact on the trade balance, will not be a major issue.

EQUITY OUTLOOK: FORTUNE MAY FAVOUR THE BOLD

Global equities have been slaughtered and remain in a fog with almost zero visibility. Our macro-economic models however indicate low probability of a new U.S. recession and thus based on underlying fundamentals equities look more attractive today than last quarter. The biggest risk to our view is an unpredictable spill-over of effects from disruptions to European credit markets as a result of a Greek default. However despite high volatility and maximum intervention, as John D. Rockefeller said "The way to make money is to buy when blood is running in the streets" and that is our premise for our current equity outlook.

GLOBAL EQUITIES: ATTRACTIVENESS HAS INCREASED DESPITE SLOWDOWN IN ECONOMY

In line with our tradition, we have collected the latest data on the MSCI World Index (see table below) in order to gauge the attractiveness of global equities. Our first observation is striking. The spread between global earnings yields and the alternative yields on AAA corporate bonds is approaching levels not seen since the months after Lehman Brothers' bankruptcy, indicating equities have reached attractive levels for long-term investors as we expect the economy will slow down but not slip into a recession.

The super-long oriented investor should consider the following: The U.S. 10 year treasury yield is currently

at around 2 percent and global dividend yields are at 3 percent. If you are indifferent about these two asset classes and you assume global companies will have unchanged dividends and market values over the next 10 years then you are still better off in equities. Does anyone really believe global companies will not have higher earnings and dividends in 10 year's time?

If the U.S. and European economies can maintain a minimum of 1-1.5 percent annualised GDP growth then companies should be able to sustain current EPS levels and even see little growth in profits. Based on this we think equities look very attractive compared to the negative real rate returns investors are being offered in government bonds.

Looking also at the S&P 500 Index companies are now trading at 8.4x their trailing cash flow per share which is around 40 percent lower than the average 12.2 times observed since 1998. Naturally this indicates the market expects economic activity to decline and hence operating cash flows to decline as well. The latest data also shows that profit margins have continued to expand in the last couple of months combined with accelerating sales (currently 13.0 percent QoQ annualised) which could be an unexpected catalyst for EPS surprises in the third quarter earnings season.

MSCI World Index (USD)

Year	1997	1999	2002	2005	2007	2008	2010	2011
Closing price*	936.59	1420.89	792.21	1257.78	1588.80	920.23	1280.07	1176.03
Earnings in current year	40.21	42.94	29.5	77.6	99.93	60.36	88.11	94.8
Average earnings last 3 years***	37.81	41.97	32.99	69.33	91.84	77.96	72.61	79.02
Dividend in current year	16.41	18.34	17.84	25.68	37.78	36.69	30.29	34.26
High-grade bond interest**	6.76%	7.55%	6.21%	5.37%	5.49%	5.05%	5.01%	4.36%
Ratios:								
Price/last year's earnings	23.3	33.1	26.9	16.2	15.9	15.2	14.5	12.4
Price/3-years' earnings	24.8	33.9	24.0	18.1	17.3	11.8	17.6	14.9
3-Years' * earnings yield *	4.0%	3.0%	4.2%	5.5%	5.8%	8.5%	5.7%	6.7%
Dividend Yield	1.8%	1.3%	2.3%	2.0%	2.4%	4.0%	2.4%	2.9%
Stock-earnings yield/bond yield	0.60	0.39	0.67	1.03	1.05	1.68	1.13	1.54
Dividend yield/bond yield	0.26	0.17	0.36	0.38	0.43	0.79	0.47	0.67
Earnings/book value***	11.9%	5.8%	8.9%	15.0%	16.2%	13.0%	11.3%	12.2%

* Closing price 2011 is the latest closing price as of September 16, 2011

** Moody's Bond Indices Corporate AAA

*** Latest 12 months EPS / three-year average book value figures

Saxo Bank 2011 Forecasts	S&P 500	DJ STOXX 600	Nikkei 225	MSCI EM
Yearly Outlook	1,420	315	11,400	1,350
<i>Revision</i>	0.0%	0.0%	-7.9%	-7.4%
Second Quarter Outlook	1,420	315	10,500	1,250
<i>Revision</i>	0.0%	0.0%	0.0%	0.0%
Third Quarter Outlook	1,420	315	10,500	1,250
<i>Revision</i>	-10.6%	-22.2%	-9.5%	-8.0%
Fourth Quarter Outlook	1,270	245	9,500	1,150
Current Price*	1,216	230	8,864	977

***Index price as of September 16, 2011**

Our equity models are currently estimating trailing EPS in the S&P 500 Index to reach 96.33 (up 5.9 percent from the end of the second quarter) at the end of the fourth quarter and the earnings yield to move about 20 basis points higher (P/E down). Despite our models estimate the S&P 500 Index is seen trading around 1,300-1,350 near year-end. We remain cautious due to massive technical headwinds and potential tail-risk from Europe's debt crisis and thus our target for the S&P 500 Index is now 1,270 (see table above for all forecasts). Should unexpected events happen, such as a new recession (our macro models suggest if it happens it will only be a mild one), or panic in the financial system, our models point to around the 1,000 level in the S&P 500 Index by year-end. (Note: This is not our base scenario.)

Due to long and short-term technical headwinds, our models would not recommend investors go all-in on equities despite the compelling underlying fundamentals. It would be meaningful to keep some powder dry if stocks continue lower due to unpredictable events and thus increase exposure there if stocks tumble. This sounds nerve-racking for most investors but it is the most profitable strategy when you keep increasing exposure in risky assets and when blood is everywhere and panic goes parabolic.

If we see surprises in economic data going forward the biggest winners will be stocks in the financial, materials and industrial sectors. Investors that are willing to take on risk should consider those sectors

as that is where the largest potential risk-reward ratio exists.

CHINA IS BEGINNING TO LOSE COMPETITIVENESS

Following up on our special topic story from our previous outlook, trade data from the U.S. and Europe shows that China is beginning to lose market share in low-end light manufacturing and its IT electronics market share expansion has significantly slowed. So who is stealing market share? On exports to the U.S. it is Mexico, Vietnam, Bangladesh and Indonesia with the former as the most interesting story due to its proximity to the U.S., and it seems Mexico is seeing a boom in precision instruments and other higher value added products. This could very well be the inflection point of early signs of a big structural shift in global trade and thus investment opportunities in emerging markets. Unfortunately, relative valuation is not yet very compelling when it comes to the Mexican stock market which trades around 50 percent above comparable emerging markets' valuation ratios.

COMMODITY OUTLOOK: TRICKY ROAD AHEAD AS DOLLAR STRENGTHENS

Commodity markets will continue to be driven by worries about the potential impact of a slowing global economy. A solution to the sovereign debt crisis has still not been found and with governments running out of fresh ideas this has caused tremendous stress on the financial system. Cyclical commodities like energy and base metals have suffered as a consequence while safe haven flows and adverse weather have been the main reasons for gains across precious metals and agricultural commodities.

We believe that renewed dollar strength during September will continue into the last quarter and this could potentially have a dampening effect on the performance of commodities, ensuring a relative flat 2011 performance of the major commodity indices.

ENERGY: The dramatic spike in oil prices earlier this year has been a major reason for the surprise slowdown in economic activity witnessed during the past six months. The price of Brent crude, which has taken on the role as a global benchmark for a majority of global transactions, has so far averaged 111 dollars in 2011, well above the averages for the previous three years. Despite not reaching the record levels seen in 2008 it has nevertheless already spent more days above 100 dollars during 2011, thereby squeezing private consumption.

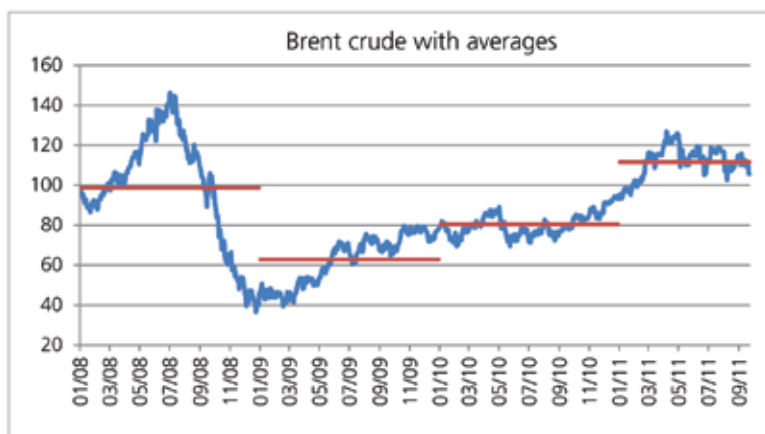
Increased demand drove prices higher in 2008 while this time supply disruptions and constraints have been the culprit for higher prices. Libyan oil production will

be limited for months while supply disruptions from Nigeria, Syria and the North Sea have ensured higher prices compared with WTI crude which has stayed at depressed levels over the summer.

All of the growth in oil demand is now stemming from Emerging Market (EM) economies and in order to determine future price movements the economic well-being of these economies will be the decider. We expect the price of Brent crude to remain range bound for the remainder of the year between 100 and 120 with an end of year target of 105 dollars.

PRECIOUS METALS: The rally in gold, which has now lasted for more than 10 years and has returned nearly 21 percent annually, is undoubtedly the world's most powerful trend. Investors and central banks have all been competing for the yellow metal over the past two years as the global financial crisis has triggered an exodus out of other asset classes into "safer assets", such as gold and silver.

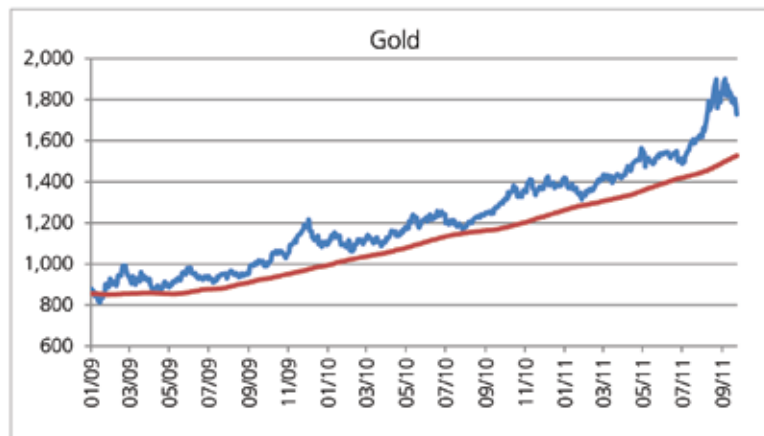
During the third quarter record high prices led to increased volatility which dented some of the lustre for gold as it became increasingly difficult to trade. As a result we saw investors pulling out of long positions, both in ETFs and futures during August and September and we began to see 100 to 200+ dollar corrections. The super trend however remains firmly intact and only a move below 1,500 could spoil the party for investors holding close to 3,000 metric tonnes through various investment vehicles. We believe that



gold may have another push to the upside reaching the magical 2,000 dollar level in early 2012 before a period of consolidation sets in.

Continued volatility could trigger additional margin increases on the major futures exchanges and force some investors to scale back positions even further. We see gold trading in a 1,650 to 1,950 range with an end of year target of 1,900. Silver has gone from being a driver to a follower of gold since the April price collapse. Given the weakened outlook for industrial metals we see silver potentially weakening further relative to gold with the value of one ounce of gold going from 50 to 55 ounces of silver.

AGRICULTURE: Despite record planted acreage this crop year poor weather and reduced quality has led to a reduced U.S. production of corn and soybeans. This has caused a strong rally of the two over the summer in order to force demand rationing through higher prices. This rationing now seems to have begun having an impact on both feed demand and export. On this basis we believe that the prices of soybeans and corn have already peaked and could settle into 13 to 14 and 6 to 7 dollar ranges respectively for the remainder, also given our forecast for a stronger dollar which could dampen exports even further.



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