Outlook 2006 – Q1 Update

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Update on our outrageous predictions for 2006

We made ten outrageous claims in our Yearly Outlook 2006. As three of our claims made for 2005 came true, we are of course looking to beat that this year. Below you can see the table with our claims, and how much our clients agreed with us. So how do things look so far?

	Prediction	Ratio
1	Nikkei to test 10-Year highs (22750+)	2.53
2	Feds Funds Rate to 5.00%	2.22
3	10-Year JGB's to 123 (currently 136.50)	1.89
4	US house prices down 7%	1.61
5	30-Year Moody's baa graded spread to governments to 2.5% (currently 1.6%)	1.25
6	NZDJPY to 67 (Traded at 80.50 at the turn of the year)	1.11
7	GM to default.	1.03
8	S&P Financials to underperform 15% vs. S&P500.	0.97
9	USDTRY to 113 (Traded at 135 at the turn of the year)	0.58
10	New German Elections will be held.	0.27

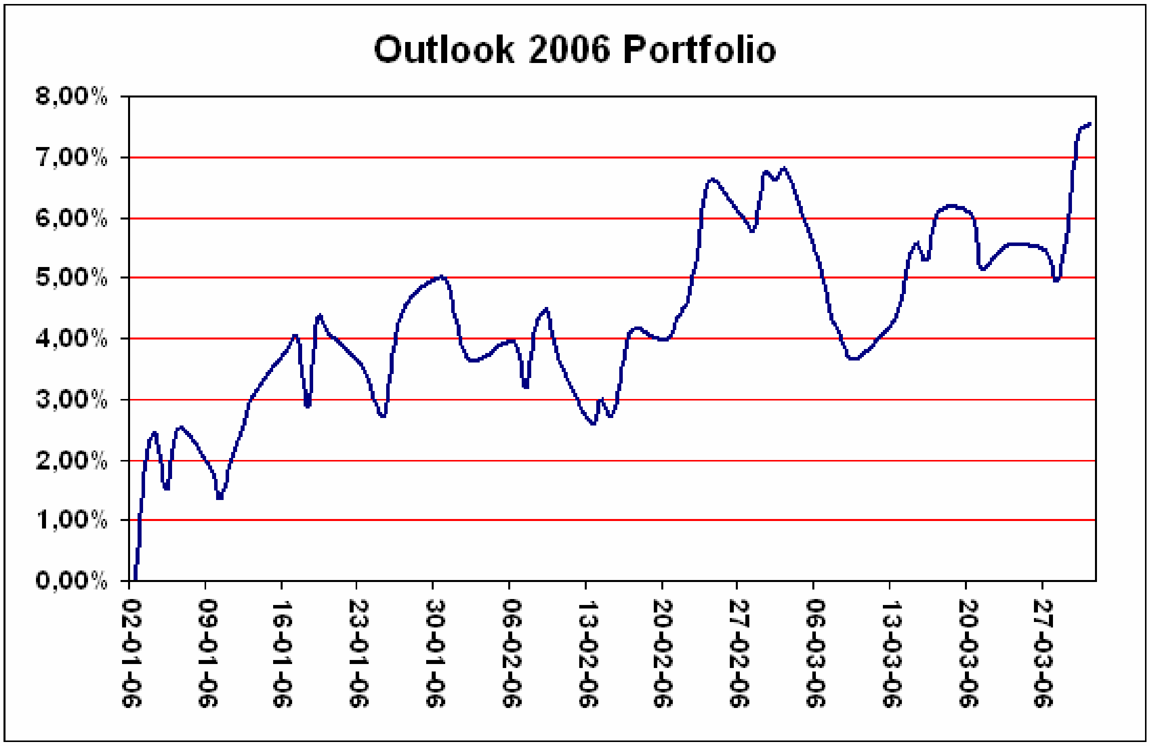
1. **Nikkei** – Well the year came off to a bad start, but lately we have seen the sun rise in Japan. The Nikkei strength seen in late 2005 was perhaps overstretched, and some consolidation was natural. Since the New Year we have seen the Bank of Japan put an end to their super easy monetary policy (QEP) and the market expects BoJ to raise rates in the second half of this year. This comes as Japan leaves more than a decade of deflation behind them. The recent break of 17000 in Nikkei is very encouraging, leaving much room for upside even in the shorter term. Our call for Nikkei to reach 22750 was quite outrageous indeed, but we will leave our necks hanging out there and keep our target.
2. **FED Funds rate to 5.00%** - This was probably our least outrageous claim of all, and we firmly believe we will see Bernanke take the final step to our target in the next meeting in May.
3. **JGBs to 123** – After BoJ put and end to QEP we have seen JGBs sell off. If the current rate of declines is to be extrapolated to the coming

quarters in 2006 we will end the year in the neighborhood of our target, so we are right on track!

4. **US House prices to drop 7%** - We are behind track on this one, as house prices only have dropped about 1% nationwide in the US so far in 2006. There is seasonal weakness in the first months of the year, so we can't really draw any conclusions yet. But with US long ended yields rising, we should see an accelerated decline in the coming quarters.
5. **Credit spreads to widen to 2.5%** - Not much have happened on this front yet. This call was made as part of our call for GM to default in 2006; a risk that we feel has decreased. We would however not rule out that the rising yields will put parts of corporate America under pressure, which should lead to higher risk premiums.
6. **NZDJPY to 67** – Almost there! The low seen in NZDJPY so far is 70.48, and to date the cross is almost 9 big figures lower. New Zealand is not doing well and more unwinding of NZD carry trades can be expected. With the prospects of increasing short yields in Japan later in 2006, a move from JPY as funding currency should be seen.
7. **GM to default** – A very bold and outrageous call made in our own view. Things were not looking pretty for GM late in 2005. In the first quarter though we have seen the management take some steps in the right direction by cutting jobs, divesting non-core holdings, putting GMAC up for sale and trying hard to reach an agreement with the unions on healthcare plans. The latter is not closed yet and holds the biggest risk for GM in our view. We would say that the risk of GM default has gone from maybe 60-70% in December 2005 to about 25-30% now.
8. **S&P financials to underperform by 15% vs. S&P500** – We are moving in the right direction, although way behind schedule. So far we have seen the financials trail the S&P500 by about 1%. Much of the risk we saw in the US economy in December is still there, but in terms of timing we have probably been premature.
9. **USDTRY to 113** – The year started out very well as the emerging markets currencies were liked and we saw USDTRY at 130 in the beginning of March. But as the Iceland story unfolded we saw the emerging markets getting sold across the board. So right now we are back to were we started at 135, but having been short since the beginning of the year has earned you more than 2.5 big figures of carry. Our target looks very ambitious now,
10. **New German elections** – The point our clients disagreed mostly with and it seems they are right! We would say that the likelihood of a new German election to be held is very close to zero. Surveys suggest that the German citizens like their grand coalition and the work in the government seems to be running fairly smoothly.

The outlook 2006 portfolio – stellar Q1 performance

Our across asset class portfolio that we put together the last week of December 2005 has had a very strong performance in the first quarter of 2006. The portfolio is up 7.54%, driven by strong precious metals, Brazilian markets and a spot on stock pick in Japan.



Let's have a quick look at our portfolio holdings and how they have fared so far.

- **Long JPY vs. equal weights NZD, USD and AUD** – NZDJPY is a massive mover so far, down 9 big figures in the quarter. AUDJPY has also moved considerably lower, while USDJPY is unchanged on the year.
- **Short GBP vs. equal weights SEK, CHF and EUR** – GBP has hold up surprisingly well in the light of the poor interest rate outlook. Only moderate GBP depreciation has been seen.
- **Long Brent Crude** – This has been a roller coaster so far, but we are again approaching the highs of the year.
- **Long spot gold and silver (equal weights)** – Both gold and silver is trading far higher on back of diversification and of course the approval of the Barclays Silver ETF. Silver is up more than 30% so far this year.

- **Short General Motors** – The risk of GM defaulting has fallen dramatically since the turn of the year, and we must admit that we have considered to take this position off.
- **Long Chevron, Pfizer and Deutsche Telekom** – Mixed performers with Chevron and Pfizer higher and Deutsche Telekom lower. The telecom operators got beat early in the year on back France Telecom's profit warning, but have performed well since that sell off.
- **Long Sekisui House** – The Japanese real estate company Sekisui House is up more than 18% so far, and we firmly believe there is still massive upside in this name.
- **Long Brazil** – A true top call as the gain stands on more than 19%! We are well off the highs of the year after the Icelandic story triggered sell off in emerging markets. Potential is still very potent and we would still be buyers.

Macro Update

South East Asia

We are very upbeat about the prospects for Japanese growth this year. Japan remains the main story in financial markets in 2006. The housing market is turning higher, office rents are increasing, inflation is back, the Bank of Japan is tightening monetary policy and Nikkei continues higher.

What else can we say? Most indicators are positive for Japan and the most important indicator for the turnaround is the reemerging inflation. This will dramatically alter the Japanese consumers' psychology. We have not yet seen a convincing turnaround in spending patterns, but we believe that will happen during the course of the rest of the year.

The rate outlook has improved a lot for Japan after the end of the "quantitative easing" monetary policy of BoJ and Japanese Government Bonds has consequently sold off heavily. At the end of 2005 we called for JGB's to come massively lower and test the 123-level. So far, they are going our way, having dropped more than four figures. With a continued stream of positive inflation data we still expect the trend to extend itself and actually test 123 within year-end.

In the Outlook 2006, we identified one key aspect of the South East regional importance vs. other financial markets; a growing independence of Western demand. In our opinion, Japan, India and China are increasingly becoming less investment-driven and to an increasing extend able to get along by trading with each other. In this way, Western markets are losing importance. We have gotten several indications in the first quarter of the year that this interpretation was correct.

The Chinese leadership is preparing to guide the Chinese economy in a more consumption oriented direction. The non-coastal regions want to take part in the tremendous rise in Chinese living standards these years. It is our impression that a gradual shift of Chinese policies are on the way to direct resources from the export-investment-led growth to consumption benefiting the (also) the Western regions of the nation. This is not an issue specially related to the Q1 of 2006, but we are seeing more and more confirmations that this will be the long-run trend.

The US Rate Outlook

At year-end, 2005, the market was expecting the Fed to hike interest rates to 4.50%-4.75%. We called for even higher rates in the Outlook 2006, even

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mentioning the possibility that the Fed would hike interest rates to as much as 5.50% if so-called second-round effects from the high energy prices materialized. We believe the market is right and that Ben Bernanke will go to 5.00% in May.

We are now at 4.75% and the market is pricing in 5.00% at the next FOMC meeting in May. We believe that the Fed will not hike interest rates and invert the yield curve more than it has already done in short periods so far. By doing so, the Fed would risk to stir up more pessimism that is needed. The market is already very focused on the flat yield curve and the likelihood of a recession a couple of quarters ahead. The only way the Fed would hike interest rates above the 5.00% level is if the long end of the yield curve keeps rising and/or if inflationary pressures build substantially from here.

US 10-yrs: If the strong sell off in US long ended fixed income continues, the likelihood that we will see a FED Funds rate above 5% increases.

Housing prices have not yet fallen in a material way. Although we outrageously predicted at nationwide fall of 7 percent, prices seem only to have moved 5 percent lower from their peak in August 2005 and this move might as well be attributed to seasonal factors.

At year-end 2005 we predicted that the US economy would substantially weaken and eventually even go into recession late in 2006. The primary reason for this call was primarily that the variable rate mortgage debt that had to be rolled in 2006 and for the first time exposing a significant share of households to rising interest rate costs of housing.

However, recent data suggests that the US economy has coped quite well with the tighter monetary policy. Consumer Confidence is high and stocks are doing fine – two important indicators for the state of the economy. Thus, we are revising our outlook for a recession to the very end of the year to early or mid-2007. We do, however, still believe that consumption and construction activity will slow significantly in the second half of the year and that the imbalances driving the USD lower in 2003-2004 will be on everybody's mind late in the year.

An accelerating Europe in Q2

Since our last outlook at the end of 2005, things are looking moderately better for the Euro-Zone. The European economy is gathering momentum, and we expect an upward trend in the growth rate. Furthermore is the rate outlook is looking good.

In the case of Germany, the grand coalition has been in office for a full 100 days, and the German public appears to be more than willing to continue their support of the conservative CDU/CSU and Social Democrat (SPD) alliance. Merkel is enjoying massive popularity, and opinion polls suggest that her party is steaming ahead of their coalition partner, the SPD. At an international level, Merkel has made a good first impression, but we are still not getting any results from the German economy that can improve the outlook, apart from the fact that it looks like the German economy is in a period of stabilization, and improving results might be revealed in the Q2-figures.

In Italy we still expect Berlusconi to lose the referendum in the beginning of April. The latest polls confirm that the majority will vote Prodi, but there are still many voters undecided. We do not expect any economic impact from the election in Q2.

The European rate outlook has since our last report improved and is beginning to look more attractive. The rate hikes from ECB has strengthened the EUR in Q1, and with the continuing hawkish rhetoric, several more rate hikes are expected in 2006. The ECB has only just begun the cycle to increase the rates, while the Fed is expected to be finalizing their series of rate hikes. In ECB's last statement, they suggested an average annual growth in real GDP between 1.7% and 2.5% in 2006. The last quarterly forecast for Q2 suggested a growth in a range between 0.4% and 0.9%. We agree with the ranges, but expect the growth rate to be in the upper area of the intervals.

The rising energy costs support the rate hikes, as the ECB has pointed out on several occasions that the energy costs take part in their calculation of the

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inflation. Inflation remains in the upper area of the ECB wants to see, and in the short run we expect the inflation to be above the target rate of 2.0%.

The consumption in the Euro-area might be temporarily boosted by the football World Cup in Germany, as we saw at the Winter Olympics in Italy, but apart from that we do not expect any other influences in the consumption growth.

The European sentiment indicators are in an ongoing series of considerable improvements. The German indicators are boosting higher – the IFO has no been higher since April 1991, and the ZEW indices are also looking unusually good. For the Euro-zone area as a whole we are seeing strong gains on both the business confidence and the consumer confidence – a trend we expect to continue.

With the increasing rates and the signs on continuing recovery, we are expecting positive results that can support the accelerating growth rate although the fixed income markets are struggling in response. The EUR should be supported by the higher rate outlook.

Energy Update - the rough ride continues

Our "rough ride" scenario for energy markets in 2006 seems to be the correct one as crude has ranged wildly back and forth in the first quarter of 2006. We doubt that the arrival of the North American hurricane season and "driving season" in the US, nor the situations in Nigeria and Iran, will ease the nervousness in the market.

Over the course of the first quarter of 2006, the market finally seemed to be responding to the obvious plenitude of crude oil and natural gas supplies in the US. This should have been no head-scratcher, as the mildest January in the history of the climate measurement in the Northeast US meant light demand for natural gas and heating oil. Record natural gas prices in December of last year north of $15 quickly halved and then some to under $7 by late February. Crude ranged wildly back and forth from below 60 to almost 70 dollars and back again, but never really followed through lower even as US storage supplies persistently built all winter. In fact, US crude oil inventories are now at the highest level since 1999.

So again the question begs: why the high prices in the face of plentiful supplies? As the year wears on, we can only highlight the same themes we were looking three months ago as we penned the outlook for this year: namely, the long term growth in demand and the perception that long-term supplies are far from secure as global oil production capacity may be peaking as it did in the US in 1970 – meaning the world may soon be faced with a long slow decline in oil supplies.

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Brent Crude has had a wild ride in 2006 – first zooming close to the 70 dollar record again, then collapsing below 60 dollars again before taking off northward once again after a pair of large false starts.

In the short-term, more dire supply concerns are driven especially by the situation in Iran, where the UN Security Council members are having a difficult time hammering out an agreement on what to do with Iran and its nuclear ambitions. Iran has until the end of April to halt its enrichment program or else face whatever “punishment” the UN Security Council is able to agree on. Also important for short term supply, unrest in Nigeria continues to plague the supply situation there as Shell has been forced to shut in up to 20% of Nigeria’s total production capacity of 2.5mill bbl/day. Native insurgents of the Nigerian delta have promised to continue to wreak havoc on supplies as they demand that more oil revenues are diverted to local development. Insurgent attacks are expected to increase as Nigeria heads into elections – just as they wreaked havoc on supply in the pre-election season in 2003.

In short, despite the bountiful supply situation, we still feel comfortable with our long position in crude oil and will be happy to carry this one on the books for the remainder of the year. Consider buying crude far forward (say, Dec. 07 crude) to reduce volatility and make a long term bet.

Metal Update

Metals in 2006 – so far nothing has held them back!

At year-end 2005, we called precious metals higher. 15 dollar silver and 700 dollar gold would not surprise us at year-end 2006. Until now, metals are moving our way. Silver has increased 2.67 dollars (30%) and gold has increased 67.9 dollars (13%). Surprisingly, silver seems to have been center-piece in this development, gaining more attention than gold. The physical market is extremely tight, judging by rumors of supply disruptions and the permanently higher lease rates. And now Barclay's Capital has finally gotten the SEC's approval to launch their Silver ETF, which will take of a significant amount of physical chips of the table. What will that do to the price of silver? Just the pure speculation of the approval of the Silver ETF has pushed silver much higher.

With the USD more and more looking like it is entering a period of structural weakness, gold and silver should be supported in the mid-term. The move higher in silver, however, might be prone for a corrective move lower, entering a consolidation phase, after which it could continue higher towards our year-end target of 15 dollars.

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Equity markets

So far all is well

2006 is off to a flying start as far as equities are concerned. Again we find Europe in a leading role with CAC40 and DAX outperforming FTSE100 – the exact same pattern seen in 2005. US shares are doing well too, up 4 percent for S&P 500 and more than 6 percent for the Nasdaq Composite. Then there is Asia. After some rangy moves early on, March's price action suggests that the Nikkei 225 (+5.9 percent) will finally stretch its leg for real and pull well clear of 17000.

The rate outlook on both sides of the Atlantic has been the main focus thus far and above all, our aggregate call on equity markets has been notably accurate. FED is nearing the end of their hiking cycle while Europe's about to up their rates. These developments open up for some interesting divergences but we have no intention of altering our baseline call from here: US will eventually face resistance as we enter H2 as will Europe but not in quite the same manner. Asia in general and Japan in particular will outperform and we feel as strongly today as we did at the turn of the year about our fundamental case for Japanese equities extending gains and thus our Nikkei 225 end-of-year target of 22750 is still intact.

Nikkei 225: Broke the February high and now looks to accelerate well beyond 17000. Our year-end target remains 22750.

In 2006 we will most probably see above 3 percent growth in all the major regions of the world, something we rarely see. Europe is rising from the ashes, Japan is back in a big way and the US isn't ready to throw in the towel just yet. The rally has been broad based and although poor economics shouldn't be ignored, 2006 is shaping up nicely for equity markets. Strength, it seems, is coming out of all corners of the globe and if the first quarter is any guide, stock investors are doing just fine. But H2 looms…

Forex 2006 Review:

JPY: The pressure is on for a stronger JPY

The Bank of Japan made a key fundamental change by ending the quantitative easing, but we are still yet to see a significant JPY rally. One of the main reasons for this is that the BoJ has still not made a clear signal to when we will actually see a shift from the current zero interest rate policy. But we expect this to be no later than the start of Q3 (with USDJPY testing the 100.00 area before year end).

We have already seen popular carry trades from 2005 being unwind, something we believe is only in the early stages and should further out trigger a more substantial reversal in the JPY. Supporting this view is that Japanese investors are likely to start selling the massive amount of foreign bonds they have accumulated in recent years and start focusing on there own domestic stock market.

We suggested a possible basket trade of long JPY which we continue to strongly believe in and we suggest looking at a long JPY against GBP, USD, AUD and NZD.

USD: The 2005 strength looks to be running out of steam

The Federal Reserve began a new era the 28th of March under Fed Chairman Ben Bernanke, who raised the US rates as expected to 4.75% and left uncertainty to what is in store for the remaining part of 2006. We strongly believe that the rate hike cycle is coming to an end soon, possibly in May and that more important economic factors will be in focus starting in Q3. The main risk is the US housing market, which could be in for a beating. It has provided significant support for the US economy, but a slowdown in US home sales and prices, which we expect for the later part of 2006, will put the dollar under serious pressure. In addition to this we are seeing clear signs of central banks around the world shying away from the USD, looking to diversify their FX-reserves into more EUR, but also into gold. This suggests a reversal of the flow into USD that was seen in 2005 on back of the repatriation act.

CHF: Still awaiting strength

We are convinced that the time will come in 2006 when CHF will show its potential. The SNB's rate stand has still been difficult to read, but we expect the USD weakness to translate into the CHF becoming a star performer.

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NZD, AUD and CAD: Kiwi dollar steals the attention

The search for higher yields in the past years has attracted a large inflow of funds from offshore accounts in to NZD. However, disappointing data since December 2005 and large bond maturities coming up in the near future, give us reason to believe that other factors such as economic growth and the present out of control current account deficit will play a major role looking forward into the spring of 2006. With the market focusing on this development, it should cause investors to take their risk elsewhere. This would cause the supply of funds into the Kiwi economy to sharply decrease, which would give even greater concern to the country's deficit, which is largely debt financed giving scope for large scale NZD depreciation. A 0.5300 target for 2006 in NZDUSD is not out of the question

AUD saw a massive drawdown through March on unwinding of AUDJPY carry trades, which we believe has left the Aussie overdone. It seems as if the AUD has been compared too much with its neighboring country New Zealand. Granted, there are some shortfalls in Australia's trade and current account deficits, but AUD continues to be supported by the strong metal prices.

The Canadian dollar printed a 15-year high against the USD in March, but has since showed weakness on lower commodity prices. The BOC has toned down their language and looks to be at the end of their current cycle. The key question for the remaining part of 2006 is whether or not energy prices will remain elevated. If so, this would leave CAD looking bullish in the coming quarters.

EUR: Surprise of the year

Hawkish statements by the ECB after the expected rate hike in March have fuelled the Euro. German IFO data in March was the highest reading in 15 years and with talks of both Asian and Middle East diversifying their FX reserves from dollars to Euros, more upside is more than likely in 2006. So the prediction of a split year in 2006 seems to hold its ground.

GBP: Europe's weakling in 2006

We left the headline from our original 2006 outlook, as the fact remains. The pound continues to be overvalued as the currency has been a popular long in carry trades in 2003 and 2004. Also M&A activity has helped the pound in the start of 2006, but the "default weakness" will likely send the pound significantly lower against European counterparties. So the original basket, short GBP vs. EUR, CHF and SEK in 2006 is still our preferred view.

NOK and SEK: Still stronger Scandinavians

We still favor the SEK and the currency is still in our view undervalued and thereby stick with a stronger SEK for the remainder of 2006. The uncertainty surrounding energy prices has continued and should continue to give NOK support.

Conclusion

Our view from the original 2006 outlook has been proved right, but we feel the story to come in the remaining part of 2006 is the USD weakness outlook. This should soon become the major event in the FX market. For EURUSD a break of 1.2600 should bring more medium term buyers in the market and set the pair for a possible test of 1.3000. The long JPY basket against NZD, GBP and USD is still a favorite as the unwinding of carry trades has only just begun. In our "Intra European" trade we stick with our short GBP against SEK, CHF for the remainder of 2006.

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