Outlook 2007

Year of Deceleration

Foreword:

Welcome to our outlook for the global economy and developments for the major global asset classes in the coming 12 months. Our prognosis? A resolutely bearish affair for the US economy.

We believe the capital markets will take their cue from persistent doldrums in the US housing market, with home prices decelerating more sharply than at any time in history. This, simply put, will culminate in a mild recession by Q4. The Eurozone will follow largely in tact with the US - the much-talked-about theme of decoupling failing to bear out in 2006 - with growth moderating slightly in Q4, though nowhere near the zero-growth scenario forecast for the US. On the FX side, look for USD bearishness to gain momentum as EUR gains slightly on comparison. The robust system of carry trades that "carried the day" in 2006 will continue into the first half of 2007, before precipitously unwinding later in the year as NZD stands for a fall. Equity markets will take their cue from the desolate spiral of US home sales, but could find relief in M&A deal flow. We favor exposure to mature sectors with strong fundamentals like health care, oil services, technology, telecoms and insurance. On the commodity side, gold will grind gradually higher as silver explodes onto the scene with ongoing shortages and delays in futures deliveries. And we're still oil bulls given the raft of alarming geopolitical scenarios with alarming implications for global supply.

As always, we are pleased to honor Saxo Bank tradition by presenting "10 Outrageous Predictions" for 2007, which are loosely correlated with our broader economic outlook and prevailing themes for the year.

The Saxo Bank Market Strategy Team

Copenhagen, January 10, 2007

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2007: The year of deceleration

In our prediction for the US economy anno 2006, we foresaw tighter monetary policy than what most analysts expected at that time. We said that the Fed Funds Rate would go to 5.50, when most analysts expected only 4.50%. The Fed Funds Rate topped out at 5.25% under new Fed Chairman Ben Bernanke.

As for the Eurozone economy, we were relatively hawkish, along with most of the analyst community in 2006. We did manage to call EURUSD at 1.30 – more out of USD bearishness than EUR bullishness. As it turned out, the cross went to 1.3367. One year ago we didn't believe that ECB rates would surpass 3 percent, but they're now at 3.50% and most economic releases for the last half of 2006 have been surprising to the upside.

Our central prediction for 2007 is that the first half of the year will offer a continuation of trends already familiar from 2006. Carry trades will continue higher vs. JPY, stock markets will continue higher and precious metals will test or make new highs. The only exception will be energy prices, which in our prediction will pick up steam again from the beginning of 2007.

But by mid-year these trends will be exhausted, both from a fundamental and a technical perspective. Carry Trades will run into technical resistance and analysts across the world will look at JPY fundamentals and scream about how undervalued it is.

Also by mid-year, a sharp deceleration in the US housing market will materialize in the broader economic picture. Long rates, both in the Eurozone and the US, will edge higher during the first half of the year, reverting by mid-year to levels seen two years ago.

Outrageous Predictions for 2007

We continue our tradition this year of positing 10 outrageous claims for the markets in the coming year. These claims are in many cases extreme - but we believe a valid case can be made for them actually coming true. We usually get 2-3 of the claims right.

As always, we make these calls to stimulate thought and encourage our clients to think about their portfolios in new ways. This year's Outrageous Claims are fairly closely correlated to the overall theme of the outlook:

1. US recession at year's end 2007

Never before in modern history has there been a sharper deceleration in US home prices: Home Equity Loans, Mortgage Refinances, Construction... the housing boom has been a significant driver. International and historical experience with slowdowns as significant as this suggests that we will see a recession by year's end 2007.

2. A "Big oil" company to be de-listed

Next year should see yet another record in terms of private equity deals and we see an expansion in this playing field expand to include the oil-related sector, a group largely untouched so far. Also, we expect deal size to increase dramatically, leading to one of the truly big oil companies to be targeted. Home Depot is currently rumored to be in play, a $80B company, but we think a deal worth twice as much is possible next year.

3. Patterson (PTEN) to double

We are bullish on oil services next year and believe the underperformance of the past year for this group was unwarranted. Increased demand for drilling etc. will underpin the sector and we have pegged several stocks that offer compelling value. Our favorite among the pack is Patterson, a stock that currently trades at 5.9 forward earnings and commands a conservative balance sheet. To us, this company could easily become a buy-out target next year.

4. AUDJPY to 100 then to 85

We expect the carry trade theme to continue through the first half of 2007. We also call an additional rate hike by the RBA, which will squeeze the pair higher. Then we predict most rate hike cycles from traditional high yields to peak, along with BoJ continuing their process of normalizing rates.

5. S&P 1500 Home Building Index to 795, then to test lows of 521

The index is now trading around 690. We expect the index to go higher during the first half of the year. It might even test the neckline of the big head-and-shoulders formation from 2005. But deteriorating housing figures will weigh heavily on the index, especially during the second half of the year.

6. USDNOK to 5.40

Our expectation of a significant downside move in this cross contrasts sharply to market consensus. We expect Norges Bank to go to 5.0%, with the Fed cutting to 4.0%, giving the pair one of the most attractive yield spreads in the market. We also expect oil to firm above $65 in 2007, a development which will lend additional support to the krone.

7. NZDSEK to 4.00

We predict a breakdown in Kiwi in 2007. Rates, in our view, have peaked at 7.25% and we expect Uridashi redemptions, along with a mass unloading of carry trades, to weigh heavily on the NZD. SEK should continue to strengthen on strong fundamentals while Riksbank maintains an tighter monetary policy throughout 2007.

8. Silver to $20

We remain silver bulls and continue to favor an extremely tight supply/demand set-up. Furthermore, it is common these days to hear of shortages and delays in deliveries on futures, which will continue to take a toll, sending silver higher through 2007.

9. USDTRY to 135 then to 155

We expect the present downtrend to remain intact through the first part of 2007, but as the unwinding of carry trades starts, the lack of risk will be felt in emerging markets where we expect TRY to feel the pain.

10. Fed fund rate to 4.00% by year's end

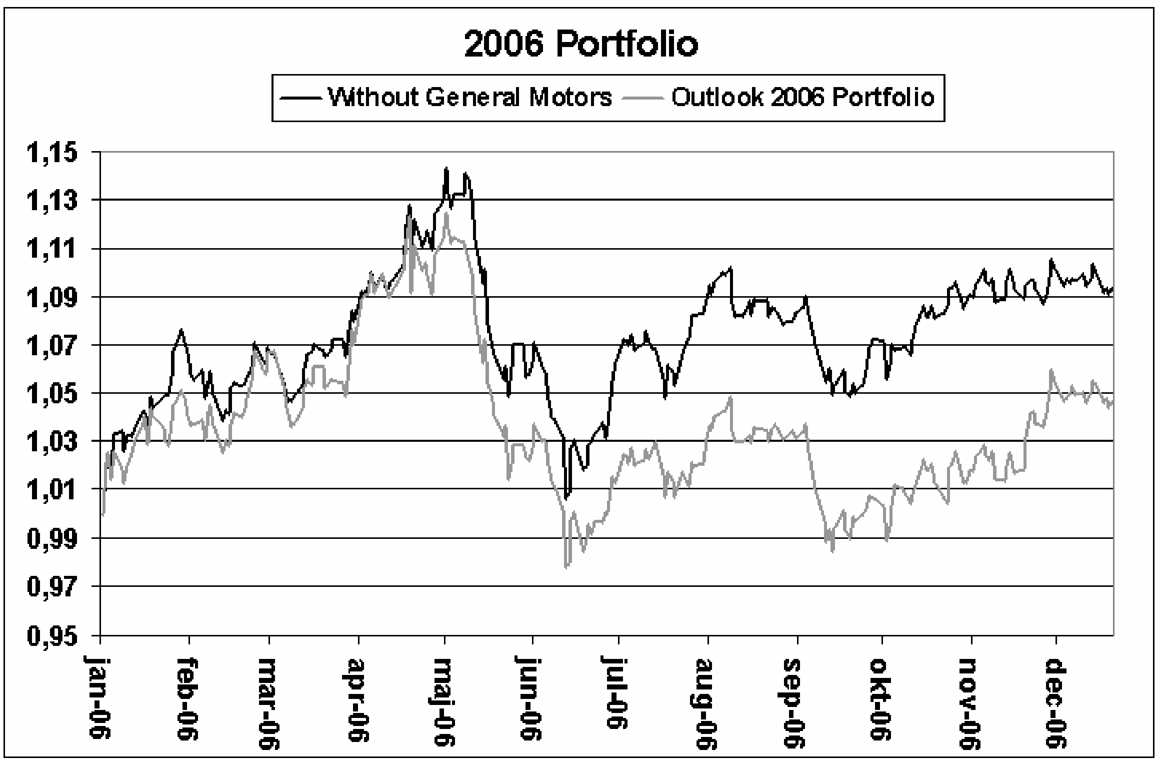
We predict a recession by year's end 2007. Under these circumstances, the Fed's policy response will be to cut rates beyond the 4.75% currently expected by the market. Most of the year will be relatively strong, in our view, but economic growth will decelerate sharply towards the latter part of the year. This won't leave the Fed much room (time) to cut more rates to more than 4.00%.

The 2007 – "Stagflation Light" Portfolio

In 2006, we were quite cautious when picking stocks for our yearly portfolio. Only conservative, dividend-rich stocks were chosen (Deutsche Telecom and Pfizer). At the same time, we were bullish on precious metals and crude oil, short General Motors and short GBP and NZD. We were also long on Chevron, Brazilian shares and a Japanese home builder (Sekisui House).

The informed investor will recall that General Motors outperformed the broader stock markets in 2006. Shortly after the turn of the year, a series of large, corporate reconstruction programs was announced, which us to recommend taking off this position in a quarterly update in the spring. Both of our FX plays were losers (short NZD and GBP), but our call for Brazilian stocks to go higher was especially good.

We therefore present two graphs for the performance of the suggested top picks for 2006: one with and one without a short position in General Motors.



Traders following our advice to get out of the short GM position in the spring would have made around 9.5 percent in the space of a year. In the same period, the FTSE World Index rose by around 19 percent, but Bunds and US 10-Year Treasuries have fallen in the same period. Surely our return is half of what we made last year, but the portfolio is intended more to induce thought than to make a return. After all, we are pretty much abstaining from a dynamic approach by choosing a fixed composition of the portfolio at year's end. With conspicuous exception made for the case of General Motors, we usually don't make changes throughout the year.

Our recommendations for 2007 are naturally closely related to the predictions in this report:

2007 top picks:

We recommend taking a 10 percent position in each of these assets

Long spot silver and spot gold (half and half)

Like last year, we remain bullish on precious metals. We still see an extremely tight supply/demand set-up for silver. It is common these days to hear of shortages and delays in deliveries on futures, which will continue to take a toll, sending silver higher through 2007. Gold should also test the previous highs at 730, when a stronger JPY will cause turmoil in Emerging Markets.

Long WTI Crude Futures

Asymmetrical risk favours the upside, also in 2007: consider Nigerian elections in April, a potential meltdown in Iraq (or Iran), and the miracle of Russian supply growth to peter out. OPEC will likely cut more to maintain oil field pressures and keep prices above 60 dollars per barrel. There are a number of reasons to be long on energy in 2007, especially from this rather low entry point.

Short USDNOK

Our expectation of a significant downside move in this cross contrasts sharply to market consensus. We expect Norges Bank to go 5.0%, with the Fed cutting to 4.0% giving this pair one of the most attractive change in Yield. We also expect oil to firm above $65 in 2007 adding additional support.

Short NZDSEK

We predict a breakdown in Kiwi in 2007. Rates, in our view, have peaked at 7.25% and we expect Uridashi redemptions, along with a mass unloading of carry trades, to weigh heavily on the NZD. SEK should continue to strengthen on strong fundamentals while Riksbank maintains an expansionary monetary policy throughout 2007.

Long Patterson UTI (PTEN:xnas)

Despite a solid year with increased EPS and crucial capital investments, the stock dropped below $30. We believed this development to be wholly unwarranted, as the stock now trades on deeply depressed multiples. We expect oil services in general to see a strong year in 2007.

Humana (HUM:xnys)

With a cloudy economic outlook next year, defensive stocks should perform well. Like its sector peer CVH, Humana offers an attractive mix of low risk and attractive growth. We believe the sector in general will benefit from demographic changes in the years to come.

Novartis (NOVN:xvtx)

Our favorite European drugmaker, we believe this company is uniquely positioned in cancer and cardiovascular segments in the mid- and long-term. This stock trades at attractive multiples compared to peers.

CSR (CSR:xlon)

We believe CSR is a turnaround story for 2007. It's well positioned in the Bluetooth arena but the stock has been hit hard this year and is therefore trading at extremely interesting multiples. Above all, CSR is a decent buyout target, not least considering the acquisitions seen thus far within chipmakers.

Munich Re (MUVGn:xetr)

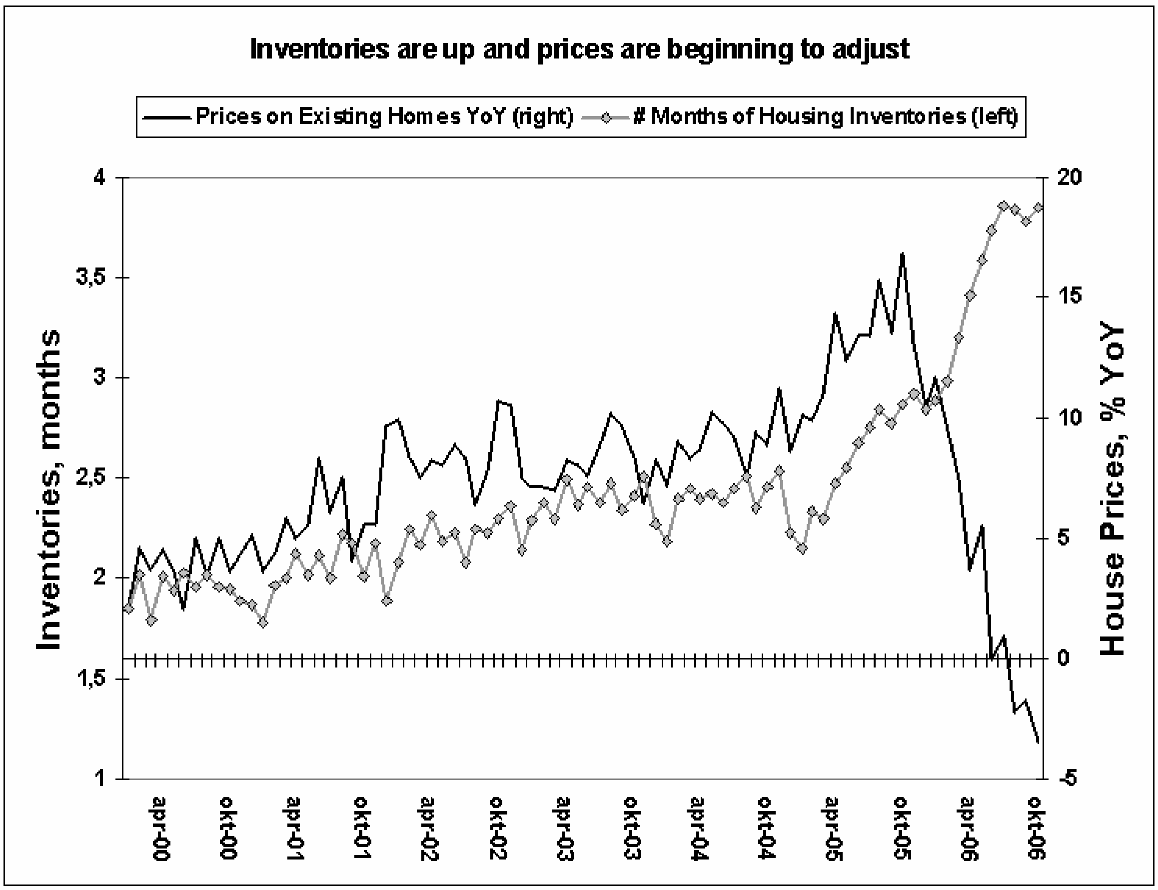
We expect further improvement in both top- and bottom line at Munich Re, and there's certainly room for multiple expansion compared to other European insurance companies.

NTT Docomo (9437:xtks)

This is the leading wireless provider in the Asian region and a frontrunner in delivering rich content to end users. We believe the stock's two-and-a-half-year slump is drawing to an end, as the company looks poised for considerable growth, not least if we see a pickup in Japanese domestic demand.

The impact of the housing cycle

In our yearly Outlook for 2006, we predicted a seven-percent drop in US house prices in 2006. This seemed a pretty outrageous call, seen from the purview of year's end 2006, since the last time this happened was during the Great Depression, but housing figures did indeed see massive deceleration throughout the year. By June we were seeing the top of the housing market with a YoY change of 0% and as we approach year's end, prices have fallen almost 4 percent. We will have to wait until spring 2007 to see if we were right, but the trend is on our side and we are confident in our prediction.



The US housing market is enjoying quite a prominent perch in macro analysis for the US economy – and with good reason. When the stock market bubble burst in 1999-2000, the Fed's aggressive monetary policy saved the economy in the short term by inducing debt-financing and punishing savings. Nowhere has the effect of this monetary policy been more evident than in housing and construction activity. The only sector that comes close is the financial sector, where new and aggressive debt products have been invented and marketed with great enthusiasm.

On the employment side, (especially residential) construction and financing have supported the job market more than most sectors. On the consumption side, the withdrawal of seemingly ever-increasing Home Equity through Loans has turned housing froth into red-hot ATM's. Corporate USA has benefited from Americans' willingness to go into debt. This is all coming to and end. Don't trust us, trust the

Fed. They did a comprehensive study of international experience with falling housing markets (International Study Paper # 841) – it's a manuscript for the macro economic development of the US over the next many quarters. Let us summarize the findings, which are based on data from 30 countries since 1970. When the housing market tops:

1. Policy rates usually continue higher in the subsequent four quarters, usually by several percentage points. They then continue to fall during the next 10-16 quarters. This is probably the reason for Bernanke's bold stance on rates, which surprised the market by mid-2006. At the time, Bernanke said that the decision to keep rates unchanged was taken, despite relatively high inflation, because said inflation was likely to ease off further out. In our opinion, Bernanke has been inspired by the tendency of central banks to err on the upside in policy rates in the aftermath of a top in the housing market. He is trying to avoid making the same mistake. For that reason, the Fed Funds rate will probably stay relatively high until we see a more significant downtrend in core inflation data.
2. Inflation usually increases and stays high until 4-5 quarters after the peak in the housing market. It then falls continuously in the subsequent 10-14 quarters. This is also close to a description of what happened in 2006.
3. Real GDP growth usually weakens 1-2 quarters before the peak in the housing market (and this has already happened). This growth continues to decelerate until five quarters after the peak, before it turns into a recession. Real growth then edges higher, but doesn't regain its pre-peak strength until 18-20 quarters after the peak.
4. Consumption and investment growth both weaken prior to, and then fall significantly after the peak in house prices. They do not usually regain pre-peak levels until 15-20 quarters after the peak.

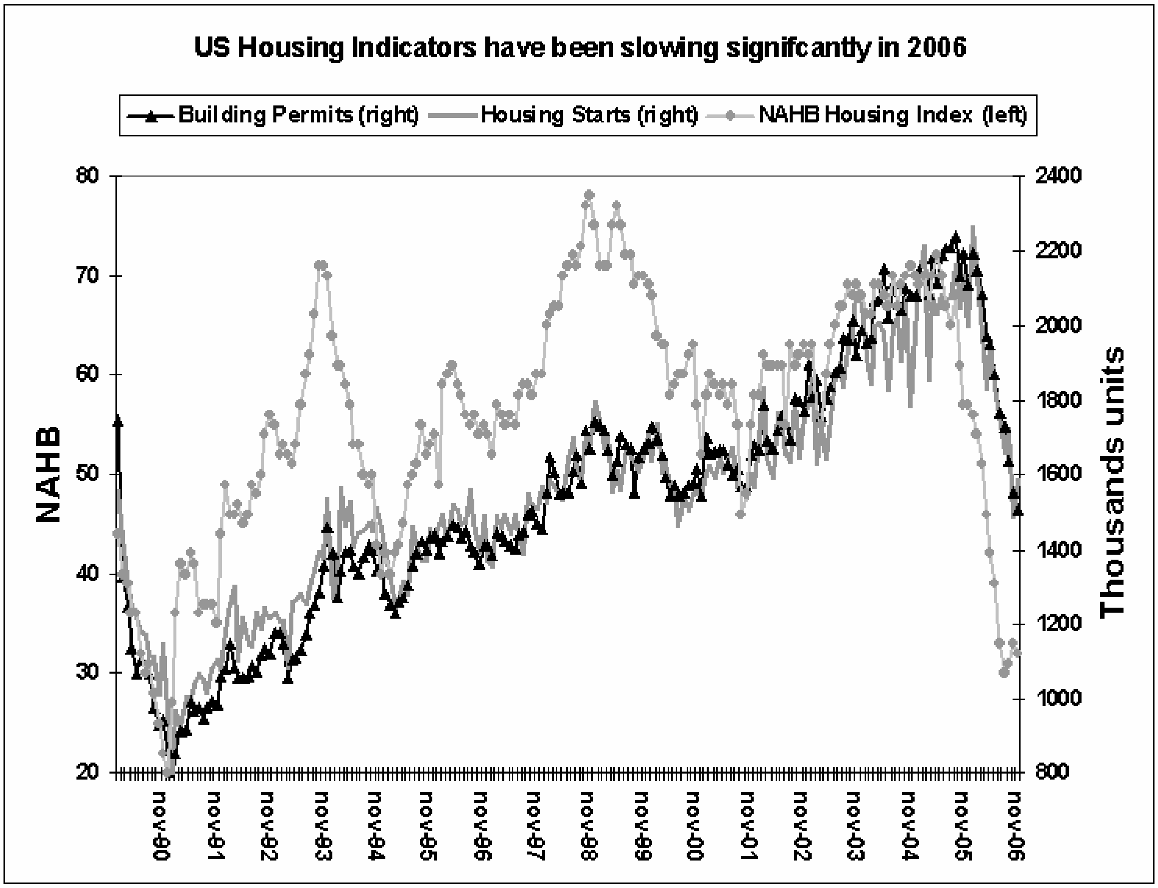
US Housing Prices in 2007

What's in store for the US housing market in 2007? What we saw in 2006 was historic. This is probably the sharpest deceleration in US housing prices ever – from posting 17% YoY changes by the end of 2005 to now actually falling significantly. In 2007, the negative stimulus will come from three sources:

1) First, a tightening of monetary policy at the Fed. Changes in monetary policy traditionally lag 6-9 months before having a real impact on the broader economy. With this in mind, we have barely begun noticing the impact of the last hikes of the Fed Funds rate from the summer of 2006.

2) Housing affordability hit an all-time low this autumn. Prices have improved slightly since the autumn bottom, but an American home is still very expensive, effectively blocking entry for a large number of first-time American buyers. The number of months' worth of inventories at current volume has almost doubled since late 2004, serving only to underscore the fact that we are in the midst of a turnaround from a seller's market to a buyer's market. Buyers will be pickier and will spend more time choosing a home in 2007 than in previous years.

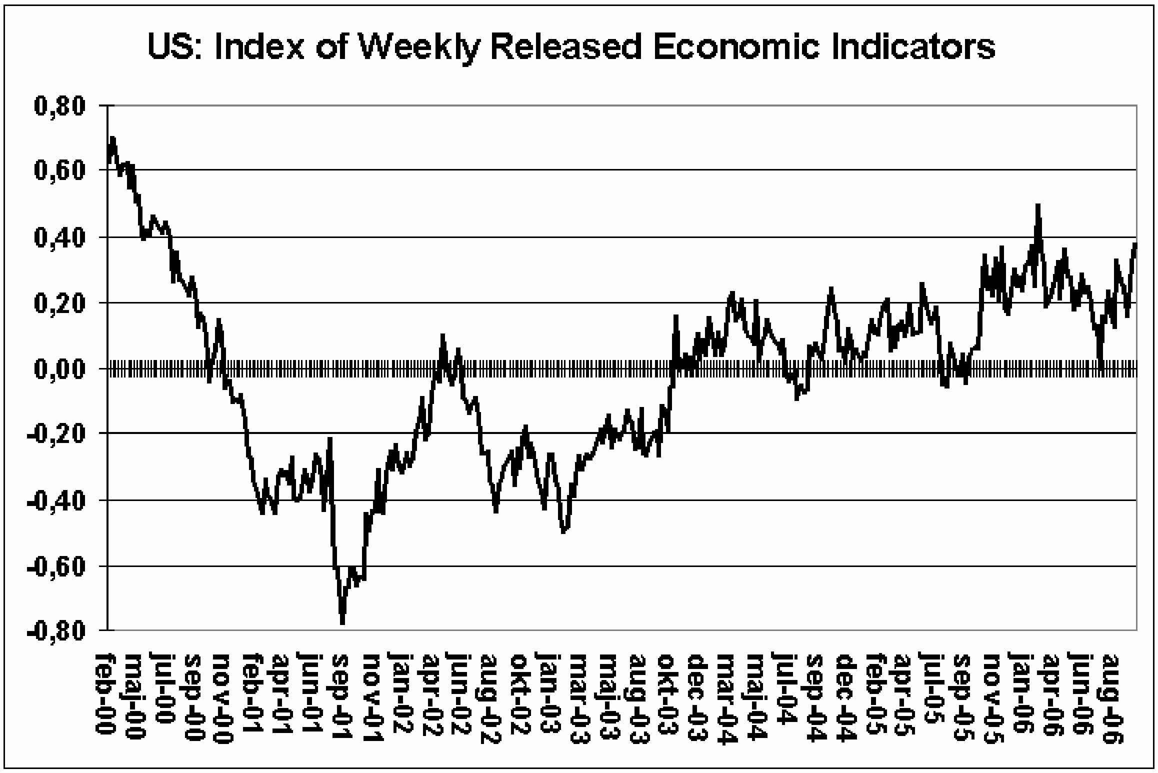
3) The refinancing of aggressive ARM-mortgages with zero-down payment, negative amortization etc. only got started in autumn of 2006. The housing flippers, the red-hot money, the real estate developers and the greater-fool-theory true-believers will be feeling the first impact of the financing side in their investment schemes. Red-hot money flow will dry up in 2007, if it hasn't done so already. Additionally, the housing desperadoes that entered the market too late will increasingly be forced to liquidate their investment projects as prices continue to fall. This effect will reinforce the trend toward lower prices.



Based on the above three negative factors, we predict that house prices will actually fall an additional 5 percent in 2007. While a fall of 12 percent for a two-year change (2006 + 2007) is a lot to a buyer that entered the housing market at the end of 2005, it is no catastrophe for the national economy.

The US economy in 2007 – Stagflation Light

We believe that the housing scenario laid forth in the Fed study above is likely to play out for the US economy in 2007. Most of the trends in macro economic variables described by the Fed have already manifested. Only Real Consumption growth remains strong, which as previously mentioned, and in international experience, is fundamentally at odds with the usual development after a peak in the housing market. Our proprietary Index of Weekly Updated Economic Indicators also continues to show a strong level of US economic activity at year's end (see below). This strength is likely to continue in the first half of 2007 and then gradually deteriorate.



Perhaps the culture of debt-financing and living-beyond-one's-means has become an ingrained part of American life. And to such a profound degree that it is actually self-perpetuating. The more this is the case, the harder the US economy will fall, once the housing market starts to unravel for real. The bond market is already getting ready for a slowdown in 2007. STIR futures are also pointing much lower for the Fed Funds Rate in 2007. But are they ready for a recession?

The Fed Funds Rate

In order to answer that question, we will once again point to the Fed's own study. The Fed has observed that there is a historical tendency for central banks to continue tightening monetary policy in the aftermath of a falling housing market, and that central banks have then usually been forced to cut rates again after a considerable slowdown in economic activity. In this case, Bernanke has made a short-cut at this stage in the housing cycle by keeping rates unchanged, when other central banks have historically continued to hike. In other words, when the US economy starts to slow, Bernanke's starting point in the relative (historic) sense is lower than that of his colleagues in previous housing cycles.

In this sense, the Fed Funds Rate is fairly low. The market expects the Fed to cut rates twice in 2007, to 4.75 percent, but the market doesn't expect a recession in 2007. We predict that the Fed will cut rates to 4.00% to accommodate monetary policy to a sharp deceleration in economic growth during the second half of 2007. A Fed Funds Rate of 4 percent might seem high when predicting a recession, but our reasoning is that inflationary pressure is still a very prescient issue in the US. This will be a crushing dilemma for the Fed.

Inflation

Inflation has trended higher in most regions, especially in the first part of 2006. The sharp sell-off in energy products in 2006 helped to ease inflationary pressures in the second half. We predict that inflation will stay relatively high in 2007. Core CPI will stay above two percent in the US. Wage pressures and the lag effect of an excessive monetary policy should still put upward pressure on prices in the US.

External factors are also pivotal. Chinese inflation is now about to run above a change of 2% YoY again, and we are still bullish on energy. Furthermore, labor markets in the Eurozone are extremely tight and it is nothing short of a miracle that we haven't yet seen greater wage pressures than what we saw in 2006. In today's globalized markets, inflation is an international phenomenon, and the fact that other parts of the world are still going to experience elevated levels of inflation will also spill over to the US. Elevated inflationary readings and respectably strong (though far from impressive) economic activity will drive down US 10-Year Treasury Notes to test the bull trend support level from January 2000 at the start of the year, only to bounce higher and break through the bear trend resistance level from 2003. Further down the path of a decelerating housing market, the long end of the curve will sense trouble ahead and predict a recession 2-3 months ahead of other markets.

Growth

The negative impact of a decelerating housing market will most likely result in a mild recession by Q4 of 2007. The primary indicator we look for to confirm this expectation is consumption growth in the coming quarters, and that is the last indicator that needs to corroborate the pattern of international experience with topping housing markets. We project average growth for the year at 1.8% with a negative Q4.

Eurozone economy in 2007 –Continuing Upside Surprise

The most dominant trend in the Eurozone in 2006 was a strong tendency to upside figures, taking most analysts by surprise. Take the pivotal German IFO and ZEW surveys, both of which came out positively, much to the market's amazement. In fact, there seems to be a prevalent bias against the Eurozone in the analyst community.

The European economies are more rigid and less free market-oriented than the US economy. At least that's what common sense tells us, but it may not be the whole truth. Corporate taxes are high in the US and the effects of draconian Sarbanes-Oxley legislation are costly. Huge risks to successful businesses from anti-trust lawsuits also contribute to increasing expected corporate costs.

We are now seeing a noteworthy shift in capital raising patterns as the result of a less business-friendly environment in the US. Business owners and M&A arbitrageurs are now turning to Europe for IPO's and Private Equity deals. The capital funds have been extremely active in Europe throughout 2006. Another way of looking at the relative strength of Europe is the fact that Eastern European markets are increasingly becoming part of the pan-European division of labor. The resulting increase in trade is benefiting all parts of Europe and contributing to European competitiveness.

The ECB rate outlook

Up to now, German corporations in particular have benefited from the succession of Poland to the European Community. IG Metal, Germany's benchmark trade union, previously posted some really aggressive goals for wage negotiations with employers. However, by pointing across the border to job-hungry Poland, German employers have hitherto been able to dampen wage pressures. With an unemployment rate approaching new lows and actually dipping below levels prior to the stock market peak in 2000, wage pressures are likely to build, counterbalancing the negative effect from Eastern-European economies.

Additionally, from a business cycle perspective, the Eurozone economies are less mature than the US, which is topping out now, if it hasn't done so already. The fact that GDP growth in the Eurozone now looks to outpace US growth by the start of 2007 illustrates this point perfectly. The Eurozone rate outlook still has some upside. In our opinion, the ECB policy rate will move to 4% by mid-year 2007 and remain there for the rest of the year.

We believe that Eurozone growth will likely track the US, but will also be somewhat more stable. According to our models, growth is likely to average 2.1 percent for the year, and although Q4 growth will moderate, it will – unlike the US – remain above zero.

Japan's Economy in 2007: The Dark Horse

We, like most of the analyst community, had an emphatic, positive belief in the Japanese economy by the end of 2005. Among our analyst peers, we still detect high hopes about Japan and analysts are still preoccupied with the special discipline of calculating just how much JPY is currently undervalued.

Most measures point to serious undervaluation, using PPP-data, its deviations from long-term trends and fundamental equilibrium exchange rate (FEER) models. Analysts apparently agree that JPY is now undervalued by 10-15 percent – despite the sell-off during the latter part of 2006.

The impact of the Yen

One of our central FX predictions for 2007 is that JPY weakness will continue during the first half of the year – especially against the popular high-yielding currencies AUD, NZD and GBP. But Japanese export-oriented sectors are already benefiting immensely from the weak JPY. We expect labor demand to strengthen noticeably during the first two quarters, introducing something almost forgotten in Japan: wage pressures. The BoJ's policy response should be at least one additional hike to 0.5% by Q2. This may not seem like a lot, but given the events of May 2006, could have a lasting impact on markets.

In May, after the first Japanese monetary tightening in years, we saw massive sell-offs in the market's hitherto strongest and most persistent trends. Emerging markets were hit hard in particular, and we expect the same thing to happen around mid-year 2007.

Triggers for Japanese growth

The market has been looking for a turnaround trigger in the Japanese economy for years. The two most convincing triggers in our opinion are the impact of a weaker JPY and the long-term turnaround in the Japanese property market. Rents are higher and property prices bottomed out in 2006. This has probably been one of the most determining factors behind the weak domestic consumption patterns we have seen in the Japanese economy. Too many Japanese consumers have been relying on negative and falling home equity to really get Japan's consumer spending going.

Outlook for FX and Metals in 2007

USD will continue to weaken

The questions remain whether and much US growth will slow as the Fed considers starting to ease monetary policy.

The long awaited slide in the US dollar has at last begun, after a 2006 in which the dollar remained largely resilient, shrugging off the conviction of many market participants that the Fed would not increase short-term rates again in their present cycle. So with interest rates and growth not moving in the dollar's favor, investors have once again shifted their attention to the US economy's massive external deficits. This is a theme that should be watched closely as core inflation remains high. Headline inflation fell sharply in late 2006, driven by a slide in oil prices in September and October.

Despite Fed comments on the relative lack of importance of headline inflation, the pick we expect in 2007 should help limit the dollar slide. A strong housing market has been key for US growth, and by extension the dollar, but further deterioration in the housing market looks set to continue into 2007. The declining housing market has yet to show any impact on growth in private consumption, one of the key factors to a more substantial sell-off in the dollar. But the jury is still out as to whether this can be traded on a short-term basis. We still believe that the market will focus on external imbalances and the much-ballyhooed theme of decoupling through most of 2007, but this view will gradually decline, with historical factors painting a very clear picture. In our opinion, the lower growth outlook will eventually be felt in Europe, giving the dollar some downside relief in late 2007. The key downside risk for the dollar will be the diversification of Asian central banks and petrodollars away from USD.

EUR to move gradually higher – especially during first half of '07

We still don't buy the theme of European decoupling - expect history to repeat itself!

The EUR has gained strength throughout 2006 and we expect this to continue through the first three quarters of 2007. The Eurozone economic outlook remains positive, with growth slightly above trend. ECB has continued its hawkish tone toward normalizing rates, with a likely hike of 25 bps in March or April. We expect rates to top out at 4.0% in 2007, as Europe wakes up to the fact that they remain largely dependent on the USD outlook. We look for a gradual upward trend in EURUSD, approaching the USDDEM high of 1.3700 from back in 1985. Renewed USD strength will likely become a theme by Q4, where we would take a neutral stance on the EUR. This is supported by the fact that we expect political opposition to be felt in the EURUSD pair, helping to cap the present upward trend. During 2006, we saw numerous statements from European finance ministers to the effect that a EURUSD rate hovering around the old 2004-era highs was tenable. That said, any break of these levels is certain to cause quite a stir among European policy makers.

Germany's already approved VAT hike should be a key theme for the EUR as it will have a strong impact on consumers, but it remains to be seen how much of the burden retailers will be able to pass on to consumers. In conclusion, we are no great fans of the EUR - we just dislike USD more. The main upside risk in our view will come from stronger indications from Asian central banks and oil exporting countries to diversify their portfolios away from dollars and into Euros.

JPY: Possibly the year's big turnaround story

The story of JPY: If something seems too good to be true, it usually is. We do not believe JPY will find strength until the second half of 2007.

Japan's recovery has been weaker than the market originally anticipated, which with a few years' hindsight seems to be the key driver for JPY selling. Growth estimates never seem to quite meet expectations. Over the past three years, most major banks have put their 12-month forecast at the beginning of each year at around 98-100. Why is JPY appreciation so difficult? First of all, domestic Japanese data continues to be mixed at best. This will likely carry into Q1 of 2007, giving the BoJ enough headway to keep rate hikes to a minimum. And let's not forget what's driving FX markets at the moment! Like it or not, carry trades still carry the day, and given the lack of volatility in currency markets in 2006 this is unlikely to change overnight.

Our view is to stick with the carry trade theme for the first half of 2007, and then expect some unloading as consumer prices and spending start to pick up. Looking ahead, there are several factors working for the JPY. Firming domestic demand could be key for consumer prices, as companies are able to pass along higher costs to consumers. Once the JPY starts to rise, it will be driven mainly on back of narrowing interest-rate differentials, as BoJ normalizes rates and the Fed eases following the recent end to their rate hike cycle. This fits well with our projected timeline of JPY strength. The risk of this happening earlier than our prediction is an unexpected positive turn in Japanese data, as the BoJ increases the pace of normalization. Summing up: we favor staying short in JPY during the first half of the year, and look for investors to lose their risk appetite for higher yielding currencies. You may wonder how this will actually play out, given our view of a weaker JPY and USD, but the fact of the matter is that it's happening as we speak. The JPY and USD Trade Weighted Index tells a pretty compelling story as to why the current theme will outlast consensus.

CHF – in for a correction higher?

2007 will see the end of CHF as a funding currency

CHF sold off in 2006, especially against the EUR. The key driver behind this is the continuation of investors using the currency to fund investments in higher-yielding currencies. We believe the Swiss Franc will move significantly stronger during the second half of 2007 as risk appetite and the demand for carry trades deteriorates, especially against AUD and NZD. Despite the downward revision and dovish tone of the inflation report issued in connection with SNB's December meeting, SNB President Jean-Pierre Roth's accompanying statement gives reason to believe that there is still more tightening to come. This is supported by strong growth and financial conditions remaining accommodative, factors which bolster our forecast of Swiss rates at 2.5% at year's end. The franc's appreciation should also be supported by concerns about major risks to the global economy, which periodically send investors to Swiss denominated assets, though this is not as correlated as much to geopolitical risks as we have seen in the past.

GBP – Weakness vs. Europe

Was sterling overvalued by investors in 2006? We think so, but not against the dollar.

The correlation between EURUSD and GBPUSD has been increasing recently. This makes good sense to us, as Cable should be traded primarily on the likelihood of US monetary easing, alongside the risk of the US current account deficit. Looking back at 2006, GBP has also shown persistent strength against EUR and CHF, but this strength should be short-lived after Q2 of 2007 by dint of the fact that it has been driven by rate differentials: MPC raised rates to 5.0% in November to support the currency in a low-volatility FX market. The new year should help to turn things around. The Bank of England has seen inflation at uncomfortable levels and has shown signs of concern about second round effects. We believe that even despite another rate hike or two, rates have peaked in the UK, and investors will likely start leaning toward economies that are expansionary, leaving the Pound extremely vulnerable in 2007 against both the EUR and CHF, as well as Scandinavian currencies.

NZD – King of Carry, Overvalued in the extreme

Join the queue of investment banks looking to jump off the roller coaster ride in 2007

Despite the Kiwi's sharp depreciation in Q1 of 2006, the currency has been on the rebound ever since. But we still expect 2007 to bring about the fall of NZD, very much similar to what happened in 1997. NZD was able to keep its head above water in 2006, as the FX market was squeezed for volatility. This lent increasing volatility to the carry trade complex, especially in New Zealand, where rates hit a whopping 7.25%. The phenomenon has also been supported by recent hawkish comments from the RBNZ. We will use net foreign bond holdings in New Zealand as the key indicator for the kiwi dollar's performance, as it has proved valuable in the past. Foreign holdings look set to top out around 70% in 2007, which was also the peak level prior to the 1997 sell-off when NZDJPY tumbled more than 51% in the 2½ years that followed. New Zealand's current account deficit, which constituted 9.7% of GDP in Q2, will continue to weigh on the Kiwi, and coupled with increasing maturities of Uridashi bonds in 2007 will send NZD significantly lower. Given recent hawkish rhetoric from RBNZ and Q3 GDP data before year's end (all NZD supportive), along with the 3-6 months' lack in net foreign bond holdings, we stand by our view that Q3 of 2007 will mark the beginning of a long slide for the Kiwi.

The AUD – Commodity and Carry

Another high-yielding currency at risk of selloff in 2007

As for this high-yielding currency, 2007 will be a year of unwinding AUD long positions, especially against JPY and CHF. But this will only happen after a continuation of the carry trade theme through the first part of 2007. The RBA has tightened rates by 75 bps to 6.0% over the past six months, which helped to strengthed the currency, but as with other "high-yielders," look for rates to peak out in early 2007 at 6.25%, with a downward bias for the rest of the year. This should turn sentiment toward a downward bias, particularly against European currencies. Other parameters supporting this view are Australia's link to commodity prices, its large current account deficit and its continued vulnerability to changes in global sentiment.

SEK and the NOK – Scandinavian strength to surprise

We expect these Nordic power currencies to outperform the rest of the pack in 2007

The SEK started to show some strength in late 2006, and we think this is only the beginning. The Riksbank is in the process of tightening its monetary policy, and given Sweden's continued strong growth, we believe that Swedish interest rates will outpace the ECB in 2007. Sweden's strong fundamentals, its current account surplus, and the new liberal government's ideas about privatization and tax relief programs should help to strengthen SEK in 2007.

The NOK should continue to show the same kind of strength in 2007 as it did in Q4, supported by firming oil prices. Rising interest rates in Norway, along with continued hawkish rhetoric from Norges Bank should see the currency strengthen against both EUR and USD. Lending further credence to this scenario is the fact that Norwegian unemployment is at an all-time low, resulting in rising wages and a strong industrial production data. All of these factors favor a stronger NOK through 2007.

Gold to move gradually higher

The metal will reflect increased uncertainty and lack of trust in the USD

At year's end 2006, we predicted that gold would move to 700 dollars/oz. Gold was trading at that time around 520, having gone to 730 in May. We believe that the metal will move gradually higher throughout 2007, testing previous highs. While the metal has lost some of its sex appeal since the sell-off over the summer, we expect a weak USD to support it, along with the return of volatility in all markets. In particular, gold is likely to move higher when/if JPY and BoJ spark turmoil in the Emerging Markets complex by mid-year.

Silver to explode

The metal has a compelling supply/demand set-up, and the concentrated short position on COMEX will be difficult to maintain.

OUTLOOK 2007 – Year of Deceleration

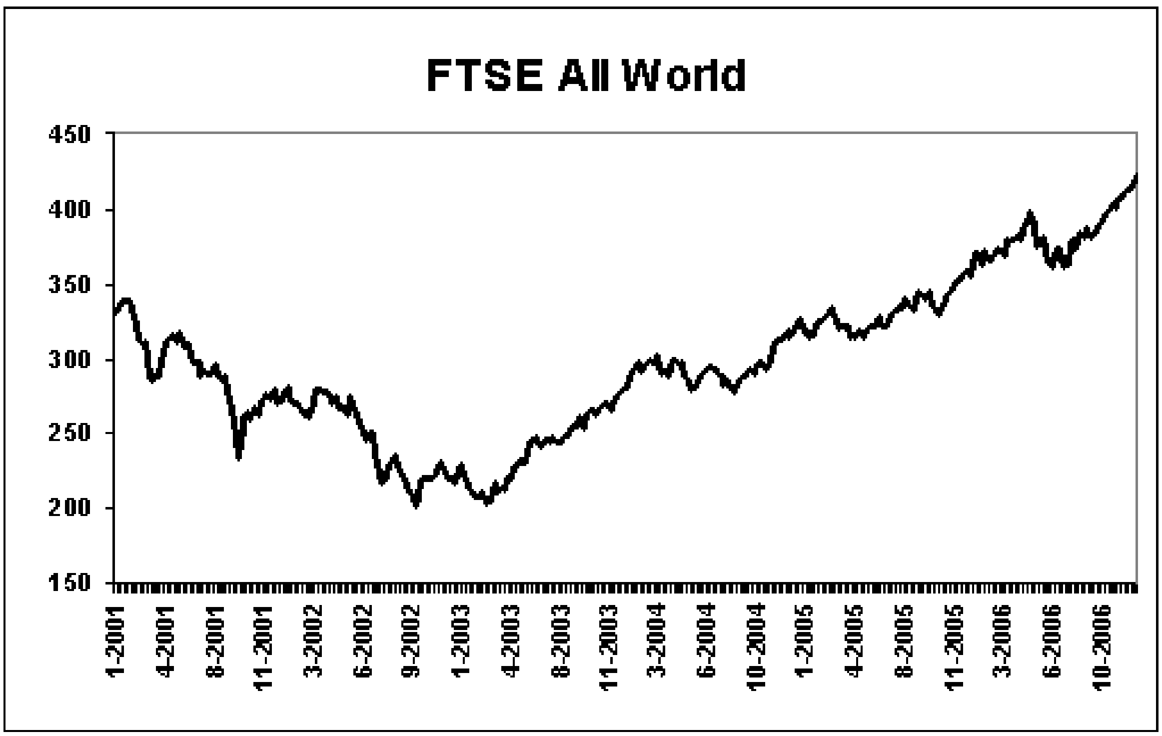
We've been committed silver bulls for many a year. In 2005, we predicted a move to 15 dollars/oz. (i.e. a 70% change). This happened in the first five months of the year. We are still seeing an extremely tight supply/demand set-up and regularly hear about shortages and delays in deliveries on futures.

Barclays Capital's Silver ETF has now taken 112 mio. ounces off the table, and we expect this to be a contributing factor in the resolution of the gigantic short position on COMEX sometime in 2007. As always, look for extreme volatility in silver in 2007.

Equities – Late in the Cycle

The state of the global economy is, by and large, the primary catalyst for equity returns in the extreme long run. Looking into 2007, however, we judge that economics - and not least, the state of the housing market will completely determine the size of investor returns. In general, we're positive on equity performance next year, and still see stocks as the most attractive asset class, ahead of commodities, as risk premiums remain elevated. In a low-yield world, the biggest (and riskiest) returns by far are to be found in the stock markets.

That said, we are rather uneasy about the rosy, one-sided manner in which equity sentiment has shaped up over the last two months. Everyone, from institutional investors to your friendly neighborhood broker to any number of cab drivers will tell you that a soft landing for the US is a done deal, and that equity returns in excess of 10 percent are a lock. We're a lot more cautious than consensus opinion and we certainly won't believe in a soft landing until we see it. It would be a huge accomplishment if the Fed came through in satisfying all the "Goldilockers" by making 2007 a year of reasonable growth, solid profit margins, contained inflation and historically low interest rates. Under such circumstances, of course, the angry bull will surely grind higher…



The current picture gives us plenty of reasons to cheer. Corporate margins are at record levels but we believe earnings growth, which has been very impressive this year, will decelerate as wage pressures begin to impact bottom lines. Our baseline forecast assumes that EPS growth will slow down, but not collapse. As far as price action goes, we see 2007 divided into two very different periods: H1 will continue the grind higher that started back in the summer, while H2 will begin to price in a potentially severe US slowdown.

	Forecasts			Asset Allocation		
Index	**Mid-year**	**Year-end**	**%-Return**	**US**	**Europe**	**Asia**
S&P 500	1575	1525	5-7	25	40	35
Nasdaq 100	2050	1970	8-10			
DAX	7800	7521	13-15			
FTSE 100	7220	7010	11-13			
Nikkei 225	21600	20470	20-22			

We prefer Asian and European equities to American ones, and see sector weightings and geographic preferences as equally important. Given the present mood of uncertainty surrounding the economic outlook, and the fact that the current bull market will be entering its fifth year, out-performance on the sector level is likely to come from other parts of the market than what we've seen since 2003.

M&A to Remain a Major Theme

Like many of our colleagues, we too see a major catalyst for next year in increased M&A activity. 2006 was indeed a banner year for private equity and so far, we can't point to anything hinting that aggregate deal flow will slow. This provides a cushion for the markets, along with the relentless corporate bid: major buy-back programs are also expected to continue in coming quarters, especially in the US.

Accordingly, an examination of probable buy-out targets makes sense to us and we've looked at both Russell 1000 and Dow Jones. Here, all the names are ranked using several key metrics that buy-out funds deem important. As you can see, we've produced a list for the entire benchmark, plus the top pick for each sector (two for Russell 1000):

Russell 1000, Benchmark

Ranking	Company	Sector
1	PATTERSON-UTI	Oil&Gas Drilling
2	KB HOME	Bldg-Residential/Commer
3	HELMERICH & PAYN	Oil&Gas Drilling
4	STANDARD-PACIFIC	Bldg-Residential/Commer
5	BEAZER HOMES USA	Bldg-Residential/Commer
6	CONOCOPHILLIPS	Oil Comp-Integrated
7	MARATHON OIL	Oil Comp-Integrated
8	VALERO ENERGY	Oil Refining&Marketing
9	LENNAR CORP	Bldg-Residential/Commer
10	RYLAND GROUP	Bldg-Residential/Commer
11	SUNOCO INC	Oil Refining&Marketing
12	UNIT CORP	Oil Comp-Explor&Prodtn
13	TESORO CORP	Oil Refining&Marketing
14	NVR	Bldg-Residential/Commer
15	US STEEL CORP	Steel-Producers
16	MDC HOLDINGS	Bldg-Residential/Commer
17	PHELPS DODGE	Metal-Copper
18	YRC WORLDWIDE IN	Transport-Truck
19	DR HORTON	Bldg-Residential/Commer
20	ANADARKO PETROLE	Oil Comp-Explor&Prodtn

Russell 1000, Sector Top Pick

Ranking	Company	Sector
1	Patterson-UTI Energy	Oil&Gas Drilling
2	Western Digital Corp	Computers-Memory Devices
3	KB Home	Bldg-Residential/Commer
4	Helmerich & Payne	Oil&Gas Drilling
5	Whirlpool Corp	Appliances
6	Standard-Pacific Corp	Bldg-Residential/Commer
7	Autonation	Retail-Automobile
8	King Pharmaceuticals	Medical-Drugs
9	United States Steel Corp	Steel-Producers
10	Ingram Micro	Distribution/Wholesale
11	YRC Worldwide	Transport-Truck
12	Westlake Chemical Corp	Chemicals-Diversified
13	Aetna	Medical-HMO
14	Ryder System	Transport-Services
15	First Data Corp	Data Processing/Mgmt
16	TRW Automotive	Auto/Trk Prts&Equip-Orig
17	Supervalu	Food-Wholesale/Distrib
18	Brunswick Corp	Leisure&Rec Products
19	Oneok	Pipelines
20	Centerpoint Energy	Electric-Integrated
21	CVS Corp	Retail-Drug Store
22	ConocoPhillips	Oil Comp-Integrated
23	Marathon Oil Corp	Oil Comp-Integrated
24	Johnson Controls	Auto/Trk Prts&Equip-Orig

Dow Jones Euro Stoxx 600, Benchmark

Ranking	Short Name	Sector
1	SALZGITTER AG	Steel-Producers
2	BRITISH ENERGY	Electric-Generation
3	PARTYGAMING PLC	Internet Gambling
4	TOMKINS PLC	Diversified Operations
5	ROYAL DUTCH SHELL	Oil Comp-Integrated
6	BRIT AIRWAYS PLC	Airlines
7	THYSSENKRUPP AG	Steel-Producers
8	WIMPEY PLC	Bldg-Residential/Commer
9	STATOIL ASA	Oil Comp-Integrated
10	TAYLOR WOODROW	Bldg-Residential/Commer
11	VIVENDI	Multimedia
12	OMV AG	Oil Comp-Integrated
13	NORSK HYDRO ASA	Oil Comp-Explor&Prodtn
14	BARRATT DEV	Bldg-Residential/Commer
15	BASF AG	Chemicals-Diversified
16	ROLLS-ROYCE	Aerospace/Defense
17	ENI SPA	Oil Comp-Integrated
18	INDUSTRIVARDEN	Diversified Operations
19	ENDESA	Electric-Integrated
20	VEDANTA RESOURCE	Metal-Diversified

Dow Jones Euro Stoxx 600, Sector Top Pick

Ranking	Company	Sector
1	SALZGITTER AG	Steel-Producers
2	PARTYGAMING PLC	Internet Gambling
3	BRITISH ENERGY GROUP	Electric-Generation
4	TOMKINS PLC	Diversified Operations
5	VIVENDI	Multimedia
6	BARRATT DEVELOPMENTS	Bldg-Residential/Commer
7	MUENCHENER RUECKVER	Reinsurance
8	INDUSTRIVARDEN AB	Diversified Operations
9	ROYAL DUTCH SHELL	Oil Comp-Integrated
10	HEINEKEN HOLDING NV	Brewery
11	CSR PLC	Semicon Compo-Intg Circu
12	BASF AG	Chemicals-Diversified
13	ITALCEMENTI SPA	Bldg Prod-Cement/Aggreg
14	GLAXOSMITHKLINE PLC	Medical-Drugs
15	DEUTSCHE BANK AG	Commer Banks Non-US
16	FRANCE TELECOM SA	Telephone-Integrated
17	DSG INTERNATIONAL PLC	Retail-Consumer Electron
18	VALEO SA	Auto/Trk Prts&Equip-Orig

Source: Saxo Strategy Team, Bloomberg

There's a couple of points we'd like to make about these lists:

- Commodity-related stocks, especially those exposed to oil prices, are in the majority when scanning entire benchmarks. As discussed below, valuations for both the integrated and services sectors appear compelling, and underlying fundamentals for these businesses are extremely sound. What's more, these sectors are expected to be the next major field in which private equity makes a splash. So far, the length of investment cycles and apparent lack of know-how have kept buy-out funds from entering major deals. This is about to change, we believe, and increased M&A activity in oil-related stocks should be a theme for 2007.

- Six US homebuilders made it into the benchmark list. We strongly recommend against exposure to this sector, and cannot see any major deals going through, regardless of their compressed multiples and thereby favorable valuations.
- There are plenty of quality names here that should perform well on a stand-alone basis. Companies such as Patterson UTI, Marathon Oil, British Energy, Salzgitter and Munich Re all have excellent fundamentals and, we predict, a solid 2007 ahead of them.

Searching For Undervalued Growth

The basic theme for next year is investment in the more mature sectors with strong fundamentals, relatively cheap valuations and - not least – capability to grow earnings despite slowing economic growth. These attributes are most easily found in healthcare, oil services, technology, insurance and telecoms. Our recommendations rely primarily on our sector ranking model which compares a number of key metrics across peer groups. For 2007, we'll also look toward the potential target companies listed above.

Healthcare

Although the political environment overseas could represent more of a challenge going forward, managed health care and pharmaceuticals are both positioned for strong growth. With plenty of room for multiple expansion and obvious demographic catalysts for years to come, this group should outperform. Recommended stocks:

- Europe: Novartis, Glaxo Smithkline.
- US: Alpharma, King Pharma, Perrigo, Aetna, Humana, CVH.
- Asia: Dainippon Sumitomo Pharma, Il Dong Pharma.

Oil Services

There's extremely deep value to be had here, both in Europe and the US. The group is trading at compelling P/E discounts and longer-term demand for drilling etc. remains firm. Investor focus should ultimately turn to the sector's impressive valuations, less on energy market price action and its impact on share prices. Recommended stocks:

- Europe: Saipem, Aker Kvaerner.
- US: Patterson UTI, Helmerich & Payne, Unit Corp, Apache, Nabors Industries.

Technology

It's all about capex spending here and we see the cycle continuing well into 2007, which should support most areas of technology. Stock-picking is of the essence and companies with pricing power and those positioned to scoop up market share should be preferred, as they offer a cushion to the broader economy. Recommended stocks:

- Europe: CSR, Tietoenator.
- US: Avaya, General Dynamics, Sanmina-SCI.
- Asia: NEC Mobiling, NS Solutions, Isupetasys, LS Industrial Systems.

Insurance

Valuations are more attractive in Europe, and stricter solvency standards pushed by the EU will be an important catalyst in the mid-term. 2006 has been a very quiet year and premium payouts modest – this could change in 2007. Still, excellent balance sheets and near-perfect execution should only bolster market sentiment in this group. Recommended stocks:

- EU: Munich Re, Swiss Life
- US: LandAmerica Financial, Selective Insurance
- Asia: Mitsui Sumitomo Insurance, First Fire & Marine Insurance.

Telecoms

Fixed line companies face a number of challenges from new and emerging technologies, and market chatter on the subject is unlikely to fall silent next year. Regardless, sector consolidation and the possibility of leveraging customer bases to new and richer content is a decent investment case, and valuations are far from excessive. Recommended stocks:

- EU: France Telecom, Mobistar.
- US: Sprint Nextel, Verizon, Cincinnati Bell.
- NTT Docomo.

Cyclical stocks, consumer-oriented and most financial companies will be underweighted by us, owing to our cautious stance on the economic outlook. Utilities, a strong performer in 2006, are likely to see yet another solid year but valuations are beginning to look stretched, as M&A activity has pushed share prices beyond reasonable levels. Noting also the political risks (not least in the Eurozone), we have chosen to underweight this sector. Natural resource stocks could also have a strong 2007 and we certainly like the supply-demand equations for most industrial metals. But considering the risk of a broader economic slowdown toward the end of next year, share prices for this space will likely trade lower, so we retain a neutral stance.

Energy in 2007: More room for upside than downside in crude

Again this year, we see asymmetric risks in the energy markets, as a multitude of upside risks outweighs any potential downside risks from slack demand.

Although oil prices reached new and impressive highs in early 2006, the "perfect calm" on the geopolitical and weather fronts - rather than the feared perfect storm - meant that bearish supply fundamentals finally caught up with energy markets. Crude first surged to near $80 a barrel on fears of hurricane season and an anticipated decision on Iran's nuclear program. When these fears failed to bear out, crude took a brief nosedive back below $60 levels. But as of the close of 2006, crude prices have risen enough to end the year virtually unchanged.

Looking ahead at 2007, we're in a dilemma – on the one hand, US supply fundamentals, while still bearish in absolute terms, are showing alarming weekly drops as the year draws to its denouement – both in crude and refinery products. If this short-term trend stretches into the New Year, and if OPEC follows through on commitments to reduce oil on the market, it could create a supply train-wreck that could see crude prices challenging the highs of spring 2006 within months. On the other hand, the risk of a US recession later in the year could mean declining demand from the world's largest oil consumer.

On a global scale, however, we feel that the upside risks far outweigh any downside potential from declining demand. Here are a few highlights of what could pull energy prices higher – and even trigger a buying panic – in 2007:

Crude oil: Upside risk highlights for 2007

Geopolitical concerns – What's the risk of an Iraq meltdown?

This is by far the largest and most obvious risk in the market, but about which the market appears surprisingly sanguine. Will political exigencies within the current US administration force Bush to pull out of Iraq "early," leaving an insufficiently robust Iraqi center that will quickly crumble? Looking at the almost totally autonomous Kurdish region within Iraq, one is compelled to ask whether there is such a thing as Iraq. The scenarios for Iraq are endlessly complex and fraught with risk, as an imploding center would inevitably open up wider ethnic and religious fault-lines that could draw every surrounding country into the abyss, whether Turkey and Iran on the issue of Kurdistan, and/or Saudi Arabia and Iran on the great Shiite/Sunni divide. Almost any scenario will add up to a reduction in Iraqi oil supplies to the world market.

Nigerian elections in April, 2007. Nigeria is headed for a new round of elections –the most important since the first real national elections four years ago. Those 2003 elections saw a wave of unrest and oil worker kidnappings by ethnic groups on whose land most Nigerian oil is produced. Their efforts resulted in a steep reduction in Nigerian oil output. This Nigerian unrest coincided with moves by Venezuelan tin-pot dictator Chavez to fire the PDVSA employees who had kept Venezuela's oil industry going. These tandem events conspired to send crude oil close to 40 dollars in the beginning of 2003, up from 25 dollars only months previously. The natives are restless again, it would seem, as April 2007 elections approach in Nigeria. Insurgent activities have already directly caused a dramatic reduction in Nigerian output. Rhetoric has also stepped up recently, with alarming new threats to not only kidnap – but even kill – oil worker hostages for the first time.

Russia – Is the miracle of Russian supply growth over? 2006 saw President Putin tightening his vice grip on Russia's oil supplies, as the Russian oil industry is now effectively fully nationalized. The new master of the Kremlin used everything from cheap Soviet-style installation of political sycophants in key posts within the Russian oil industry to trumped up "environmental damage" charges at the Sakhalin projects in an embarrassingly transparent attempt to boot private foreign interests from the scene. Heavy export duties also mean that Russian companies are receiving 30-40% less for the oil they sell than a fully private Western oil company receives when selling on the world market.

Since the mid-1990's Russian oil output has been a veritable phoenix rising from the flames, with a head-spinning surge in supply as the privatized industry refitted creaking Soviet-era oil field infrastructure and introduced modern corporate management techniques. But now, with a nouveau-Soviet glaze quickly settling on the Russian oil industry, one can only surmise that a politically led industry with heavy export duties won't exhibit the kind of dynamism needed to keep the oil flowing. Russian output will likely stagnate in 2007, and could even begin a long decline.

Peak Oil – Has world oil supply peaked? Whether crude oil supplies have reached an all time high can only be known with several months and even years of looking in the rear view mirror at production statistics. But looking at the available data from the US Energy Information Administration, the evidence is clear that global supply growth has slowed, if not completely stagnated as we head into 2007. In fact, US EIA estimates that average daily production in the first nine months of 2006 was slightly below the average output for 2005. The developing world is using more oil every month, even if European and US consumption seems to have steadied. Have we seen a production peak? Can supply grow any longer? 2007 may begin to provide the answer.

Weather. In addition to the factors outlined above, we can only add the usual suspect, Mother Nature. Any surprisingly cold late winter weather similar to the late chiller of 2003, or a ferocious hurricane season in the Gulf of Mexico could bring about a further heavy draw on stocks. Fortunately, the 2006 hurricane season was a fizzler and didn't live up to alarming expectations. The first predictions for the 2007 season are suggesting that risks are high for a more active than normal season. Will the forecasters prove right this time? If supplies are as stretched as we expect them to be in 2007, another outage of 1 million-plus barrels of daily production for a month or more could cause plenty of trouble in tight markets.

We're long crude in 2007

Our strategy in energy markets for 2007? Buy, and then buy more on any dips toward $60 and reduce on any spikes higher, while keeping at least half of the position for the calendar year. We feel that the asymmetric risks in the market suggest there is far less downside risk than upside risk in the crude market for 2007. Unless we see a steep and sudden global recession of sufficient magnitude to reduce global consumption of crude for the first time since the early 80's (a freak scenario, in our view), crude should trade within the 55-75 dollar range – with significant further upside potential to unimaginable levels ($150?) if any one of the significant potential risks rears its ugly head – especially any kind of wider meltdown in Iraq.