

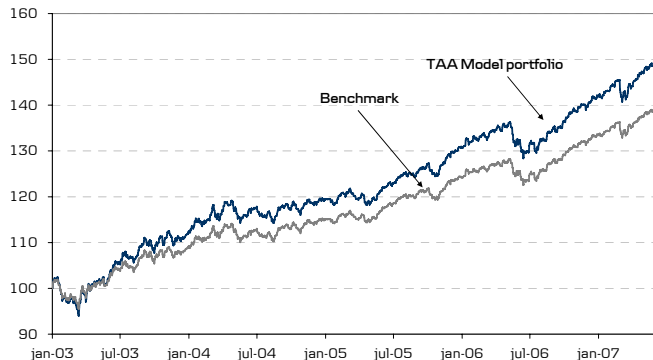
Tactical Asset Allocation

Danske Capital – 8 June 2007



Historical Performance

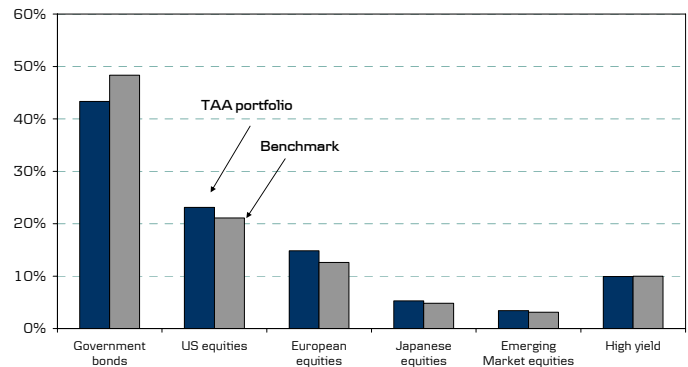
TAA Performance



Information Ratio: 1.4

Current recommendation

Model portfolio 2007



Note: Benchmark is rebalanced at the beginning of each year

Performance results:

Portfolio return 2007: 4.8 percentage points

Performance 2007: 0.9 percentage points

Latest strategy changes:

08/06/07: Equities downweighted 5%, bonds upweighted accordingly. Global equities downweighted from 8% to 4%, European equities downweighted from 2 to 1%. Overall equity overweight 5%

25/04/07: Global equities downweighted 2% to 8% overweight, bonds upweighted accordingly, European equity overweight of 2% retained, overall equity overweight 10%

01/01/07: Equities upweighted 2%, bonds downweighted accordingly

22/08/06: European equities upweighted 2%, bonds downweighted accordingly

07/06/06: Japan, Emerging Markets downweighted to neutral, USA upweighted to neutral

01/01/06: Equities overweight increased to 8% at the expense of bonds

06/12/05: Cash downweighted to neutral 0%, bonds upweighted accordingly
Europe downweighted to neutral, US upweighted accordingly to -5%

20/10/05: Japan overweighted to +3%, USA downweighted to -7%

05/09/05: Europe, Japan, Emerging Markets overweighted to +2%, USA downweighted to -6%

20/05/05: Equities downweighted 5%, bonds upweighted accordingly

The major *tactical* risk to our allocation has materialised sooner than we expected. Markets have already started contemplating that the next move by the Fed is not down but up. We have thus reduced our equity overweight to 5 percentage points. This, however, is a purely tactical decision – we are *not* trying to time what seems to be a correction in the making. Instead the decision reflects the fact that the current allocation is no longer appropriate given our judgement of the macro outlook, market sentiment and our model.

Last month saw tentative signs of a rebound in US growth. Now, one month later, markets are convinced that is the case, fuelling interest rate and inflation concerns. Although this raises the question of the magnitude of our recommended equity overweight, fundamentally, nothing has changed. Equities are still our most preferred asset class and our overall recommendation is unchanged – stay overweight equities! The magnitude of the equity overweight comes down to 1) flexibility with respect to the practical implementation of changes in allocation 2) your assessment of and willingness to bear risk and 3) confidence in your timing capabilities.

Quoting seasoned monetary policy maker and Fed vice chairman Donald Kohn “we are uncertain about where the economy has been, where it is now, and where it is going”. Taking his cue, we think understanding the past, before contemplating the future, is of the essence. In that respect, we think the first chart on the next page says it all. Real US rates have risen as markets have readjusted their expectations for the US growth outlook on the back of stronger than expected activity data, while inflation expectations have been contained (and actual inflation has continued to decelerate).

The movements in the fixed income markets over the past couple of days are clearly out of whack. Movements in global equities, however, should be seen in relation to 1) the exceptional rally over the past 12 months and 2) the increased uncertainty about the future outlook for interest rates. However, the bottom line is this: globally, monetary policy is not restrictive – it is probably still slightly loose. More importantly, overall financial conditions are definitely loose, given, among other things, the still low level of long-term real interest rates. This is due to a number of reasons, but our judgement is, that most of these reasons are cyclical – not structural. This means that long-term rates need to rise – and rise more than they have done so far as this expansion will not end before monetary conditions venture into tight territory. This process, however, and the factors driving it, should partly benefit

equities – and coupled with the fact that we do not think that we are in the midst of a serious correction, we retain an equity overweight of 5 percentage points. We intend to increase the overweight again should we be wrong and this *is* indeed a serious correction. On the other hand, we will reduce it further some time in the future, if equities shrug off recent volatility and continue to rise.

We have long been overruling our model, as this has suggested that we should fund our equity overweight through an underweight in high yield, instead of government bonds. However, we are warming to the idea of an underweight in high yield, as, in our opinion, risks are becoming increasingly asymmetric for spreads. Alongside the great puzzle of this expansion, i.e. the level of long-term interest rates lies another – the unwillingness of the corporate sector to gear up. As always, we think there is more than one explanation for this, but would highlight the following. In the aftermath of the excesses of the late 90s, and in pursuit of the all important “shareholder value”, corporates all over the world have shored up their balance sheets. Furthermore, as globalisation accelerated, company managers of the western world enjoyed an extreme level of bargaining power with respect to their most important source of cost; labour, while facing unprecedented competitive pressures, thereby facilitating profit growth through cost control.

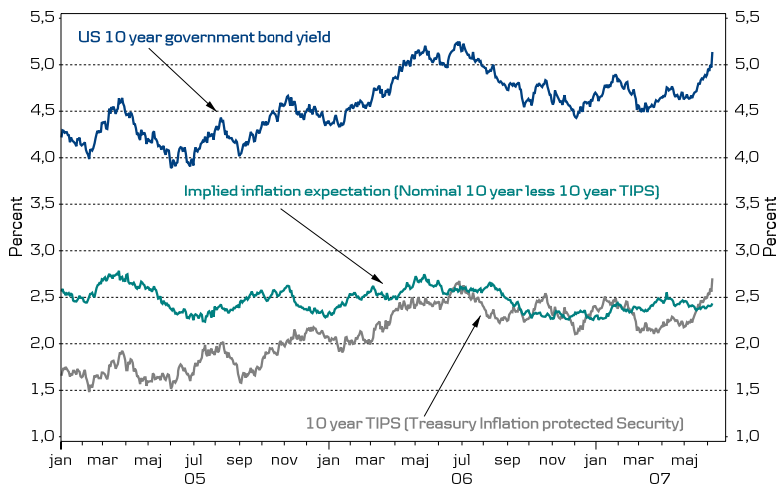
This will not continue! First, we think the high yield gap is an extreme market misevaluation, which, like all others, can be exploited. This is exactly what the private equity industry is doing – buying the inexpensive asset, equities, and selling the expensive asset, debt (or, spreads if you like). Second, although we have confidence in financial engineering we are concerned with the amount of leverage in the credit markets (or, more specifically, the uncertainty surrounding this complexity and understanding of the swathe of new products) and third, we think macro fundamentals are moving against corporate high yield as the cycle matures. In that connection, we found it very interesting to read a recent report detailing how the large investment banks are already establishing and expanding their distressed debt desks in anticipation of a proper turn in the credit cycle. It remains, however, a question of timing and we do not think that we are there just yet. For now, we recommend being extremely careful with corporate high yield, especially in the US.

In sum, as the cycle matures and extreme misevaluations disappear, our job as asset allocators becomes more difficult. The screaming buys are getting fewer by the day!

Quantitative indicators for Tactical Asset Allocation

Asset classes	Equities/Bonds	High Yield/Equities	High Yield/Bonds
Valuation (+/- 2)	buy(+1) Yield gap	sell(-2) High Yield gap	sell (-1) Credit Spread
Trigger 1 (+/- 1)	neutral (0) Risk appetite	sell (-1) Slope of the yield curve	sell (-1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Production	neutral(0) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	neutral (0) Volatility	neutral (0) Volatility	buy (+1) Investments
Total Score (+/- 5)	+1 neutral	-3 sell	0 neutral

USA: Interest rates and implied inflation expectations



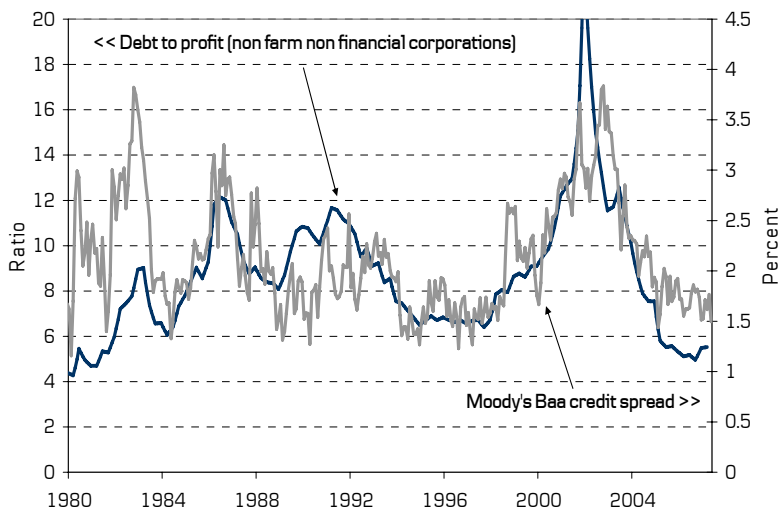
Stronger growth – subdued inflation?

Globally, interest rates have increased significantly over the past month. This brings memories of May – June last year.

As the chart on the left shows, last year both real rates and inflation expectations were driving nominal bond yields higher. This time around inflation expectations, as implied in the TIPS market, have been broadly stable. The increase in nominal rates has been driven by real rates, as markets have reassessed the outlook for US growth and monetary policy.

We think the direction is right, but the magnitude and speed of the adjustment have surprised us. This, combined with the supreme equity market performance over the past 12 months, makes us a bit cautious.

USA: Credit spread & company debt



As interest rates all over the globe rise, thus solving the rate conundrum, focus is shifting to another puzzle: the low level of spreads. As the chart on the left shows, so far, declining corporate spreads have to a large extent been justified by company fundamentals.

However, we think the bottom is near. Labour markets all over the world are tightening, globalisation (or the integration of unskilled labour in the global labour force) is no longer accelerating (and there are signs that even China has capacity constraints) and finally, companies have already made the easy gains in terms of improving their cost structure. With capacity already tight, we think companies will act more aggressively to ensure continued profit growth – that means investments and higher gearing. In terms of corporate high yield – risks are asymmetric. We are still neutral, but the next move will most likely be an underweight!

China: Shanghai A-shares



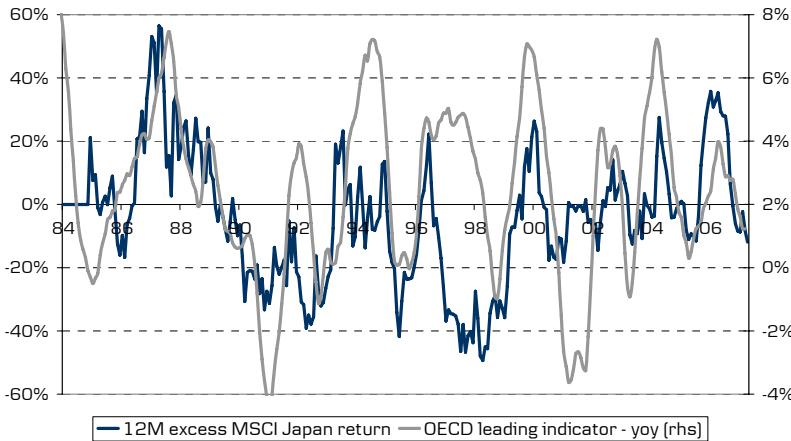
Mainland Chinese shares have continued their advance, suffering only a minor setback of about 15 percent on the back of the increase in stamp duty in late May. They are still up more than 40 percent year to date.

We continue to think that this is a domestically driven bubble with no major consequences for either the broader Chinese economy or global equity markets. First of all, very few international investors have gained exposure, second, though an increasing number of households has entered the market (the main reason for the rally), they are still relatively few and they have invested a limited share of their assets, and third, it has happened so fast that no real wealth effect has yet materialised. But the longer it continues, the higher the risk of these factors changing. Hence, expect further attempts to cool down the market.

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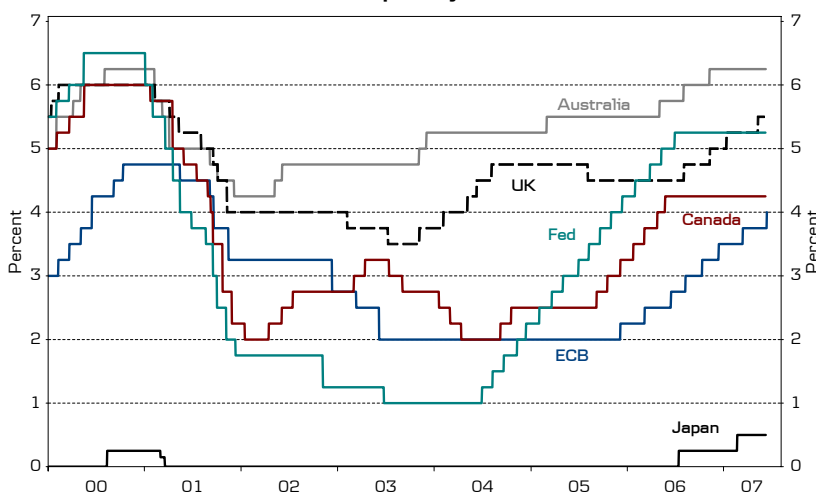
MSCI Japan relative to MSCI World ex Japan



As we noted in the last edition of this publication, Japan has been massively underperforming. There are many reasons for this, but we think the chart on the left best explains it. Japan is highly cyclical and with the global cycle decelerating over the past year, Japan has underperformed.

We think the cycle has turned, which should be a catalyst for renewed Japanese outperformance, along with a continued improvement in the underlying economy and monetary policy normalisation. However, given the recent market turmoil, we do not think that now is the best time to re-enter Japan. As such, we are still neutral, but waiting on the sidelines for a better buy opportunity.

Global policy rates



We are in a global tightening cycle - all the major central banks are normalising policy rates after a period of very lax monetary policy. The question is; how far do they need to go? We think global monetary policy will need to be taken to restrictive over the next 2 to 3 years - which means that both the Fed and the ECB, for instance, has more work to do.

So far they have tightened monetary policy because of strong growth, while inflation has remained relatively benign. The longer monetary conditions remain accommodative, the bigger the risk of excesses and inflationary pressures building. Normalisation is a good thing and equities should be able to weather this - but at some point, things will get stretched. Our judgement is that we are not there yet and thus retain equity exposure.

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First date of publication

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