

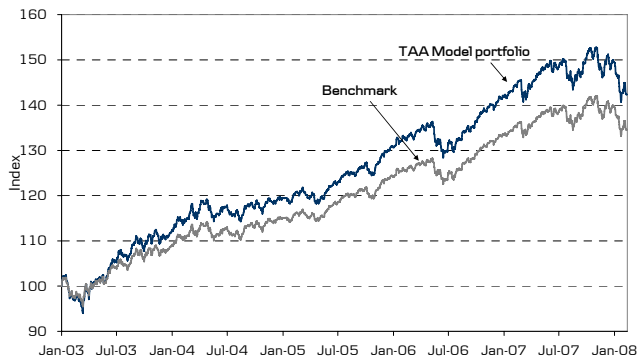
# Tactical Asset Allocation

Danske Capital – 13 February 2008



## Historical Performance

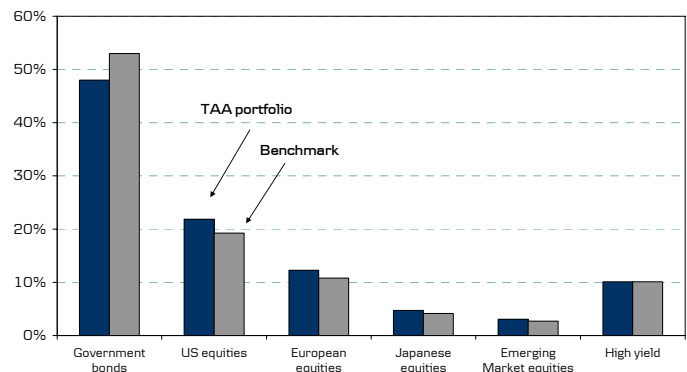
TAA Performance



Information Ratio: 1.4

## Current recommendation

Model portfolio February 2008



Note: Benchmark is rebalanced at the beginning of each year

### Performance results:

Model portfolio 2008 (ytd): -4.8 percentage points

Performance 2008 (ytd): -1.2 percentage points

### Latest strategy changes:

- |  |   |
|--|---|
| 08/02/08: Equities downweighted from 8% to 5% (allocated according to MSCI AC World). European overweight neutralised.   | 01/01/07: Equities upweighted 2%, bonds downweighted accordingly  |
| 09/11/07: Emerging Market equities downweighted 3%, global equities upweighted accordingly. Overall equity overweight unchanged  | 22/08/06: European equities upweighted 2%, bonds downweighted accordingly   |
| 13/09/07: Emerging Market equities upweighted 3%, bonds downweighted accordingly.  | 07/06/06: Japan, Emerging Markets downweighted to neutral, USA upweighted to neutral  |
| 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% | 01/01/06: Equities overweight increased to 8% at the expense of bonds   |
| 25/04/07: Global equities downweighted 2% to 8% overweight, bonds upweighted accordingly, European equity 2% overweight retained, overall equity overweight 10%                          | 06/12/05: Cash downweighted to neutral 0%, bonds upweighted accordingly<br>Europe downweighted to neutral, US upweighted accordingly to -5% |

We take our cue from the Federal Reserve and opt to perform some risk management of our own. We are reducing our equity overweight from 8 to 5 percentage points. The key reason is that risks to our macro call, i.e. slow growth/no recession in the US, have increased over the past month as the labour market shows signs of weakness.

There is no doubt that US growth has weakened and will be weaker than we expected 6 months ago. However, we think the key questions now are: 1) Which shocks have hit the US (and global) economy over the past 6 months, how severe are they and will they persist and 2) will US monetary policy work as it normally does?

Starting with 1) first up is the drag from rapidly rising food and energy prices. In December 07 the US PCE Energy Goods deflator was up by 30 percent yoy causing US households to spend around \$85 bn (representing 0.9 percent of total consumption in annual terms) more in Q4 07 than a year earlier on energy related goods. The crucial point to note here is that the global economy is certainly cooling, which should limit the drag going forward – on the contrary, a renewed (non-economic growth related) shock stemming from e.g. a supply disruption would severely weaken the growth outlook in the US and rest of the world.

Secondly, we have the shock from housing and financial markets. On this score, we would note that, in absolute dollar amounts, US mortgage equity withdrawal (MEW) has been declining since mid 2006. As such, the stimulus to household consumption *growth* from this channel has been *negative* for more than a year thus providing some evidence that the significance of MEW over the past few years has been overestimated (consumption actually reaccelerated (in nominal terms) through 07). Instead, we continue to think that the wealth effect from housing is a slow moving one that has just started to become negative.

On the financial side of things, the most important aspect is how much of a credit crunch we are in? With bank lending surveys in both the US and Euro area showing clear signs of much tighter credit, this is a concern. However, based on offi-

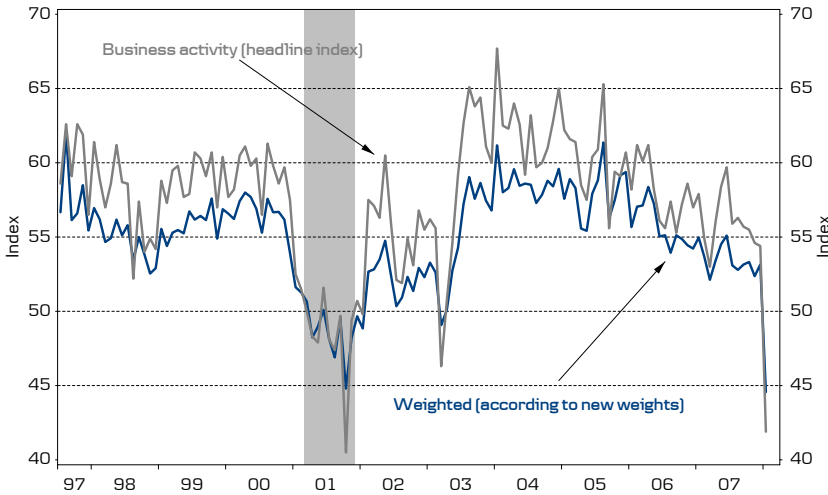
cial data to December, bank lending to US and Euro area corporates as well as households still seems to be flowing. In addition, that is also the message from key anecdotal reports including the US Beige Book and ECB monthly bulletin. However, uncertainty from the financial sector will continue to linger and include the US bond insurer problem. We still think that this problem (as well as the overall real estate problem) is manageable for the banking system. The OECD estimates that bond insurers hold around 10 percent (\$ 300 bn) of outstanding CDOs. Even on very harsh loss assumptions, the amount of fresh capital needed to solve the problem is manageable. We thus expect this problem to be solved and think the current negotiations involving the regulator of the insurers will succeed. Having said this, continued instability in financial markets could further destabilise the situation, including spreading meaningfully to other sectors (commercial real estate – a source of significant strength in the real economy so far – comes to mind). As such, we will be monitoring money and credit markets closely.

Finally, we have the shock to corporate and consumer confidence. Consumer confidence has historically been a poor guide to consumer behaviour in periods of shocks; hence we do not attach great importance to the various confidence measures. We put more emphasis on the corporate surveys and key here are the US manufacturing ISM and German IFO. They rebounded in January. However, hiring activity has clearly been hit and this is what concerns us the most. The various service sector confidence measures probably reflect the first two shocks mentioned above. Hence we expect them to be transitory in nature. However if the US labour market finally breaks, people will not be able to spend or service their debt. This, in turn, poses a massive risk to the financial system and hence the monetary transmission mechanism. Thus our answer to question 2) is, yes, we think the monetary policy transmission mechanism will work as credit will still flow, there is no equity bubble and hence a low probability for a significant negative equity wealth effect and thus the labour market should not break. But risks have increased and that is why we have reduced our equity overweight.

### Quantitative indicators for Tactical Asset Allocation

Asset classes	Equities/Bonds	High Yield/Equities	High Yield/Bonds
Valuation (+/- 2)	buy(+2) Yield gap	sell(-2) High Yield gap	buy (+1) Credit Spread
Trigger 1 (+/- 1)	neutral (0) Risk appetite	sell (-1) Slope of the yield curve	slope (-1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Production	neutral(0) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	buy (+1) Volatility	sell (-1) Volatility	buy (+1) Investments
Total Score (+/- 5)	+3 buy	-4 sell	+2 buy

### USA: ISM non manufacturing

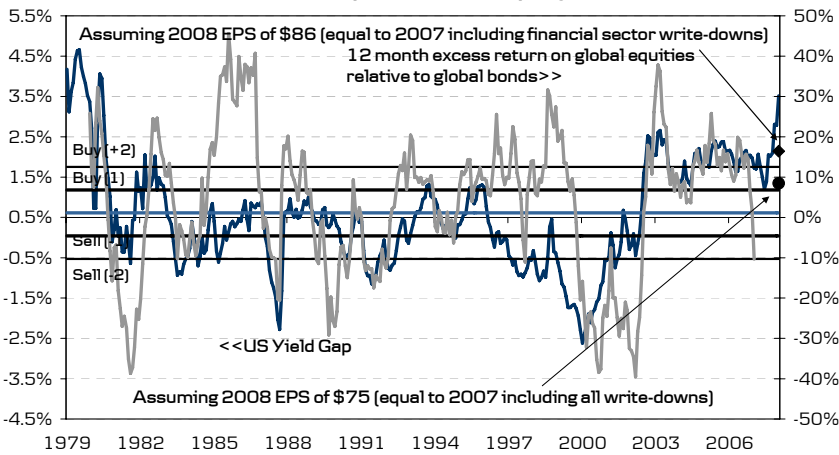


### What are the opportunities?

Even though key statistics generally improved in January (including the manufacturing ISM, claims and money markets) other data raised question marks around our core expectation of “no recession” in the US. This caused severe damage to global equity markets and thus to our performance. We continue to think that the US is not *currently* in recession, but growth is clearly much weaker than we expected it to be 6 months ago.

The risks include a contracting service sector (as signalled by the non-manufacturing ISM) and thus a weaker labour market. We cannot ignore such risks, which is why we have opted to reduce equity exposure.

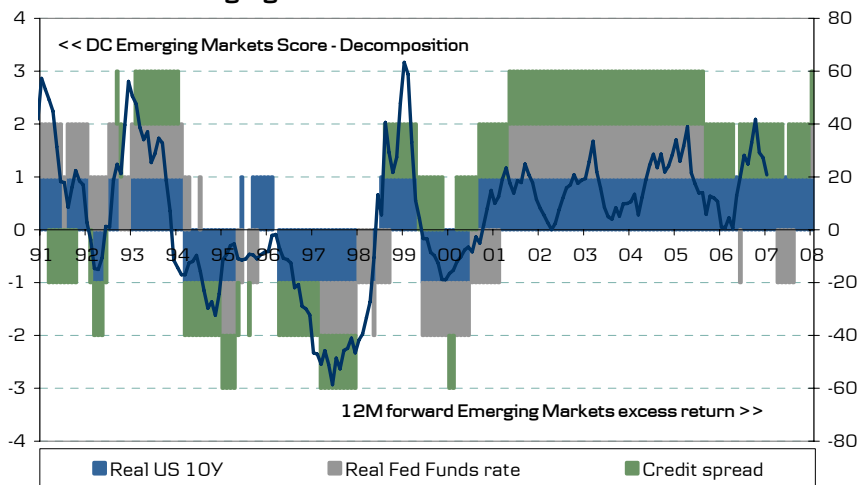
### Real Yield Gap & excess equity return



However, in these dark times we have decided to highlight the opportunities as we see them for the next 12 months. We continue to think that global equities offer significant value as illustrated by the yield gap to the left. There is room for earnings to fall substantially from 07 levels, without equities looking expensive. That of course will not prevent equities from looking even cheaper in the very short run.

However, if stress in financial markets subsides, commodity and food prices stabilise (or stop rising at the same pace as in 07), credit continues to flow (though on tighter terms than prior to the liquidity crisis) and people do not get fired, then aggregate demand should hold up eventually promoting a strengthening in economic growth. That would come as a big surprise to markets implying huge upside to global equities

### DC Emerging Markets Score and EM excess return

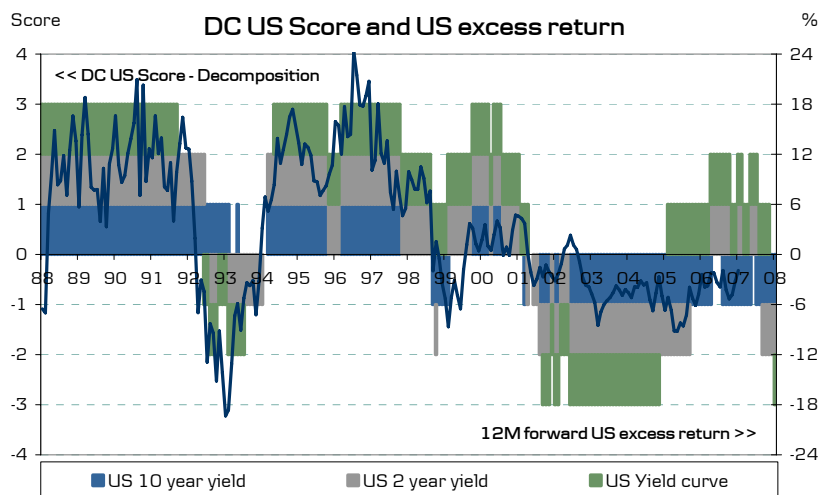


If the growth cycle does indeed stabilise and later turn for the better as US monetary (and even fiscal) stimulus starts to kick in, history suggests that cyclical assets will do best. This is also the message from our regional equity allocation models.

For the first time in almost 2 ½ years our EM model is at a strong buy, i.e. plus 3 as US interest rates have fallen (providing the US and global economy with monetary stimulus) and credit spreads have widened (they normally mean revert and in that process EM tends to outperform as well). If the past 18 years is any guide that means that EM equities will outperform developed market equities substantially over the next 12 months.

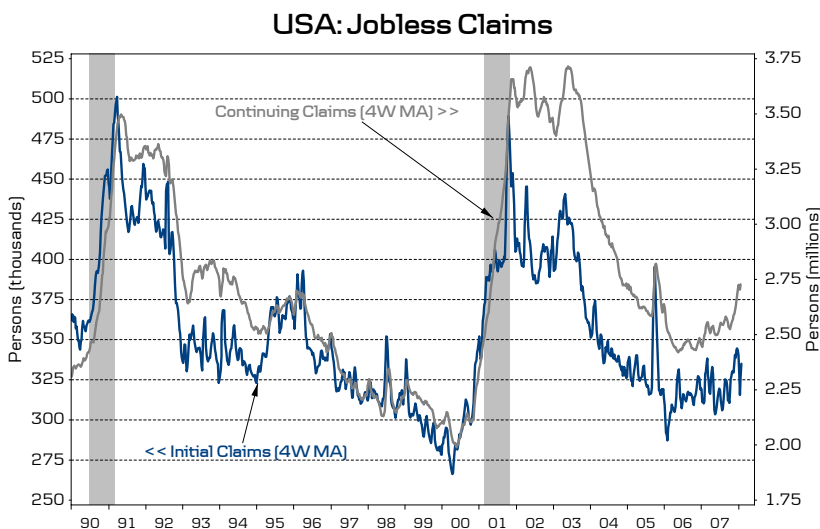
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On the contrary, lower US yields and a steeper yield curve has historically been associated with future underperformance by US equities. As such, our relative US model, shown on the left, has now moved to strong sell for the first time in more than three years.

If our macro scenario holds, we think our regional models will as well. Still, we opt to be neutral in a regional context (taking down our longstanding European overweight). On one hand, the US will surely outperform in an environment of continued risk aversion. On the other, if growth (and - more importantly - sentiment) rebounds as we expect, then cyclical assets, especially EM equities will most likely leave US equities in the dust.



For now however, we want to gain higher conviction in our “no recession” call for the US. There are signs that the negative feed back loop that the Fed has been worrying openly about for the past 6 months is materialising, since the labour market shows signs of breaking. However, we still think that most (reliable) evidence points to a *weaker* but not *broken* labour market. This includes the initial jobless claims data.

There is no doubt that job *creation* is decelerating but for the labour market to break decisively we would need firings to increase substantially. Hence, we continue to recommend keeping an eye on the claims data (for the firing bit) and ISM manufacturing (for the growth bit).

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