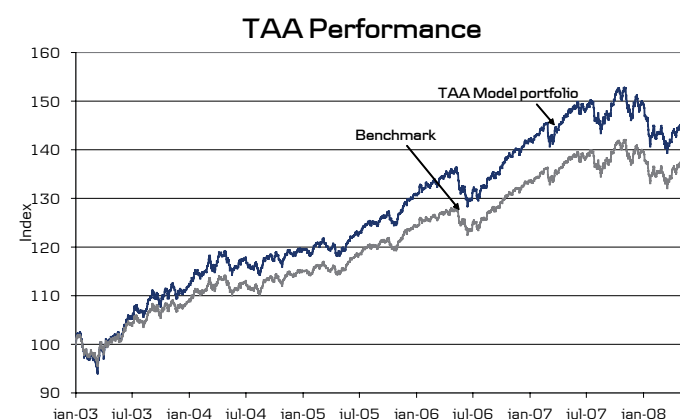


# Tactical Asset Allocation

Danske Capital • 9 May 2008

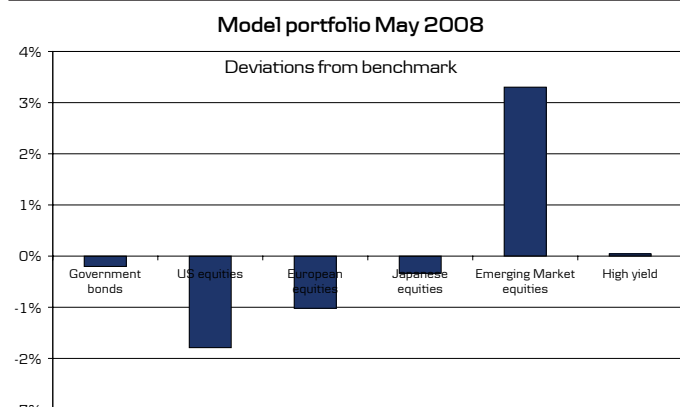


## Historical Performance



Information Ratio: 0.9

## Current recommendation



Note: Benchmark is rebalanced at the beginning of each year

Ouch - being overweight equities in Q1 was tough for us, but being neutral while at the same time global equities are performing strongly (and retaining our relatively positive stance on the macro outlook and equity valuations) is even worse. So what do we do? We stay neutral - for now. The past month has seen some important improvements, most notably a tentative stabilisation of the US economy in line with our expectations. As such we are closer to increasing our equity weight once again, but we are not there yet. We continue to recommend a regional overweight to EM within our overall neutral equity allocation.

Global equities posted strong gains in April and the obvious question to ask is - why? We think the answer is what we have been advocating for the past six months, i.e. that a lot of bad news was in the price. As such, when the news flow improves from "continuously worse" to "better than feared", extreme risk premiums cannot be sustained.

In our opinion, US equities and thus global equities were (and partly still are) priced for a severe global growth slowdown. Hence, given the Fed's move in the Bear Stearns case and the fact that US economic data proved better than feared, risk premiums had to decline. Above all, however, we think the key lesson from April is the following - we can worry about everything from money market spreads to macroeconomic data points and disruptions of oil supply from OPEC. But in the end, what really matters is (US) corporate earnings - and they too have been "better than feared".

With around 3/4 of market cap reporting at the time of writing, Q1 S&P500 EPS (after financial write downs) is 19.3 USD, down 15 percent yoy. However, excluding financials, EPS is up 11 percent yoy. As we have highlighted before, even an EPS number in the low 80s for 2008 as a whole leaves our yield gap signalling continued strong outperformance of equities over bonds. We think the yield gap will be right. Furthermore, there are three important aspects to note about corporate profits - the first relates to financials, the last two to corporate profits in general. With respect to financials, profits in this sector have been devastated by escalating write downs. However, as noted by the Bank of England in its recent Financial Stability Report, many assets in the credit space have probably been oversold, which means that their prices have under-shot massively (or in their words "... prices are likely to reflect substantial discounts for illiquidity and uncertainty..."). What does that mean? It means that it is quite possible that the buzzword in 12 to 18 months will not be write

### Performance results:

Model portfolio 2008 (ytd): -2.0 percentage points

Performance 2008 (ytd): -1.3 percentage points

downs but write backs. In relation to overall corporate profits, we have been arguing that the biggest threat has been and always will be labour costs. And with unit labour costs receding and corporate pricing power not collapsing, the outlook for (non-financial) corporate profits is OK in our opinion. And finally, if our macro outlook proves to be fairly correct, the worst loss of overall growth momentum is behind us, which means that the downward pressures on revenues should be decreasing over the coming quarters.

We do, however, choose to stay on the sidelines for now – the reason for which is twofold. Although we are pleased to see a stabilisation of the US outlook, there are still considerable uncertainties surrounding the housing and labour market, as well as the drag from commodities. To this should be added the still significant problems in key parts of the financial system, as signalled by the elevated

money market spreads. Having said that, at one point we want to re-enter and expose ourselves to our relatively optimistic outlook – and we cannot wait forever. However, if our outlook and indicators prove fairly accurate, there is a very long way to go for global equities and part of that performance should still be there, when we decide to move back into equities. Finally, should global equities fall by 5 to 10 percent in the term, that would also make us increase our weighting.

For internally managed mandates we have chosen to further increase our credit exposure through Senior Bank Loans. We fully concur that defaults will be increasing, but think that SBL has been hit the hard by the liquidity risk mentioned above. Furthermore, although underwriting standards probably also deteriorated in this asset class, their senior status in the capital structure should limit losses given defaults. We thus prefer SBL to traditional corporate High Yield.

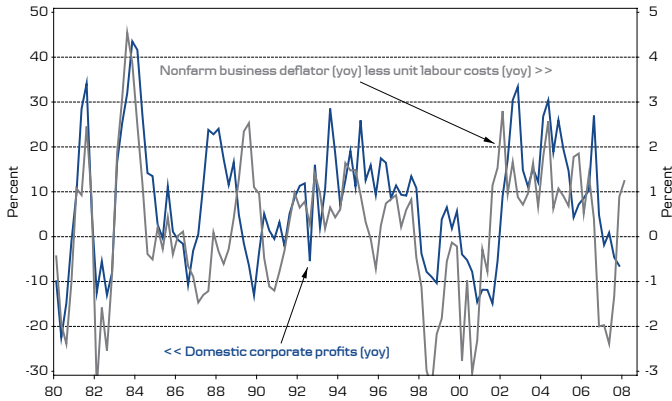
## Latest strategy changes:

12/03/08:	Equities downweighted to neutral, government bonds upweighted accordingly. EM upweighted 3 % at the expense of the rest of the MSCI AC World index.	25/04/07:	Global equities downweighted 2% to 8% overweight, bonds upweighted accordingly, European equity 2% overweight retained, overall equity overweight 10%
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

## 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	buy (+1) Slope of the yield curve	buy (+1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Production	buy (+1) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	sell (-1) Volatility	buy (+1) Volatility	buy (+1) Investments
Total Score (+/- 5)	+1 buy	+1 buy	+4 buy

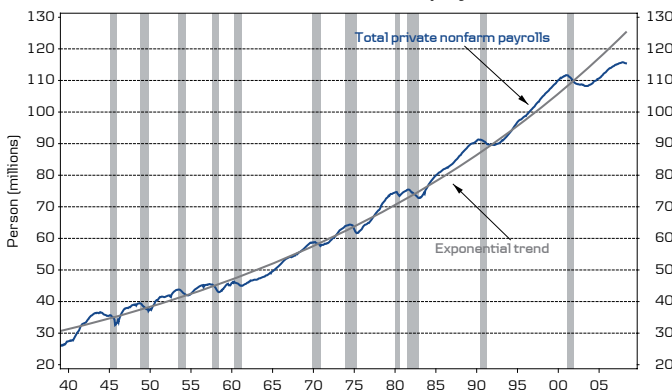
USA: Corporate profits and corporate pricing power



**Corporate profits: revisited**

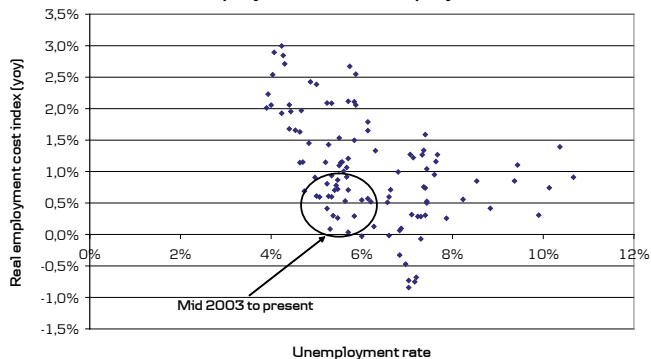
We wrote about corporate profits in the last edition of this publication. However, as illustrated by developments in April, profits are crucial to the outlook for equities – hence we dig deeper in this publication. As illustrated on the left, a good part of the substantial rise in corporate profits over the past few years can be fully explained by fundamental factors including the lack of labour pricing power. We think there are three main reasons for this phenomenon. First of all, corporates were the irrational ones during the last recession as they overinvested, overhired and overleveraged. Hence, their prudent behaviour and extreme cost awareness in this cycle. On the labour input side, as illustrated by the second chart to the left, that resulted in extremely lean corporate payrolls.

USA: Private nonfarm payrolls



Even allowing for a decrease in the trend growth rate of the US economy (and thus in the labour force) it seems clear to us that companies have been managing their labour input in a very prudent manner, thus limiting growth in the most important cost factor. This also leads us to the second point. With subdued hiring, the labour market never really tightened significantly in the first place, thus preventing true wage pressures to build. More specifically, the US unemployment rate bottomed at 3.8 percent before the last recession, compared to 4.4 in this cycle (during the last bit of 2006 and first part of 2007).

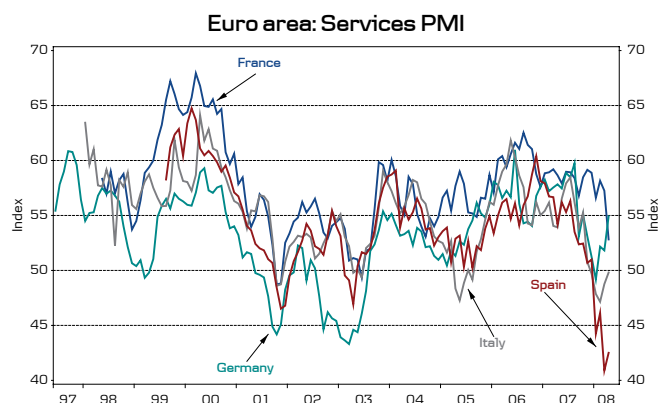
USA: Unemployment rate & employment cost



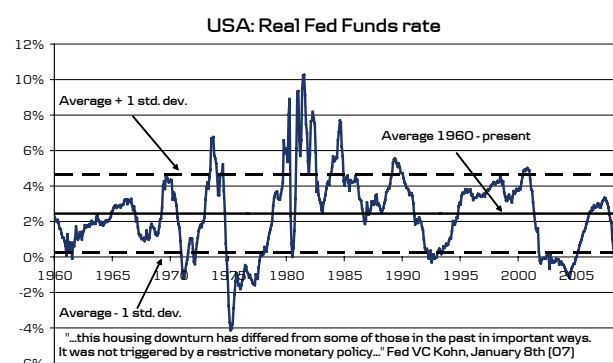
Finally, western labour has been squeezed by the integration of the EM countries into the global labour force. As pointed out before and illustrated in the last chart on this page, even taking labour market tightness into account, still leaves us with relatively benign labour cost growth.

Crucially, although these data are from the US, these three points apply to the rest of the world as well. Until recently, Western European companies displayed the same kind of prudence with their payrolls, although the European labour market has clearly improved over the past two years.

In conclusion, we continue to think that the downside for (non-financial) corporate profits is limited from here. And we still think that even flattish earnings will be a major surprise to markets as we progress through 2008. As such, we conclude that although we never saw the financial calamities of the past six months, we think there are few nasty surprises left and thus continue to think that equity markets will react strongly to favourable valuations over the coming 12 months.



A few words on the monetary policy outlook. We have been advocating that the ECB will be on hold for quite some time and lately markets have readjusted their expectations along these lines. However, the latest set of numbers has fuelled renewed speculation about the need for the ECB to cut. We continue to think that easing monetary policy will not be necessary for the ECB. Growth will slow more than normally at this stage in the cycle, due to the strong currency, financial sector uncertainty and the commodity shock. However, these should subside in coming quarters. That of course does not mean that it will be a walk in the park for the ECB. As illustrated to the left, major divergences have surfaced between the Euro area economies, with Germany looking solid and Spain showing signs of severe stress.



Key to us, however, is that apart from Spain and Ireland, the Euro area faces few severe imbalances and furthermore, we think the ECB wants slower growth. As such, it is a close call, but we continue to expect the ECB to be on hold for the remainder of this year and into the next.

On the other side of the Atlantic, the Fed eased to 2 percent last week. As we continue to think that the Fed has partly been driven into its extreme monetary easing, as illustrated to the left, by the turmoil in financial markets and that fiscal and monetary policy stimulus will secure a gradual acceleration back towards trend growth or better in H209, we also think the Fed is done at 2 percent. We expect renewed tightening to begin in H209 or sooner.

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