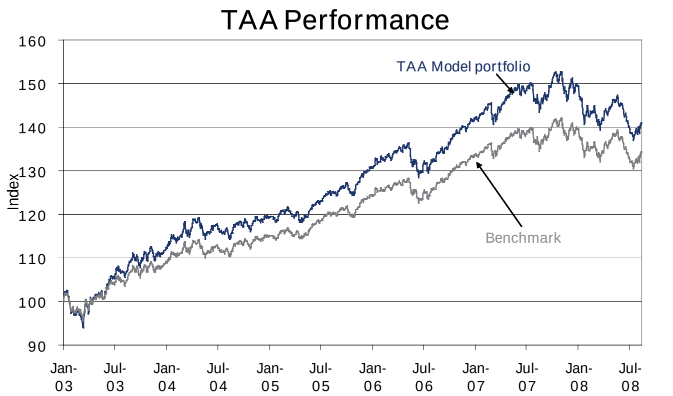
Tactical Asset Allocation

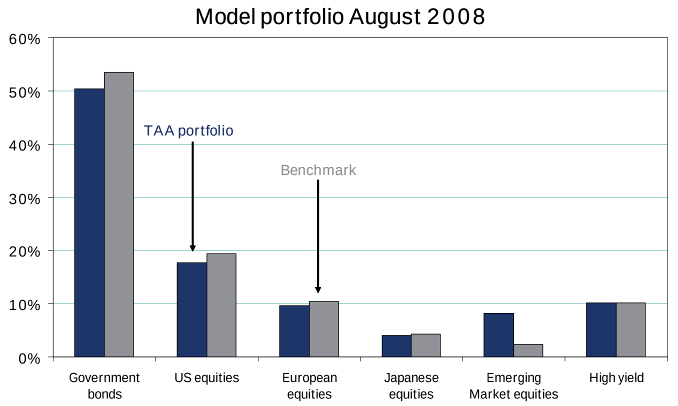
Danske Capital • 13 August 2008

Historical performance



Information Ratio: 0.8

Current recommendation



Note: Benchmark is rebalanced at the beginning of each year

Performance results:

Model portfolio 2008 (ytd):	-5.7 percentage points
Performance 2008 (ytd):	-1.9 percentage points

We are ready to increase our equity weighting by a further 3 percentage points at the expense of global government bonds. We are waiting for events between Russia and Georgia to unfold and clarify.

So we called the bottom in global equities about a week and 4 percent (on the MSCI AC World) too early – markets wanted to worry about whether the US gov-ernment would support Freddie and Fannie. This – of course – was absolutely ridiculous and irrational given the importance of the GSEs in the current housing/mortgage turmoil and goes to show how negative sentiment really is. We stick to our main message from July – the bottom for global equities (and risky assets more broadly) in 2008 has been reached and we expect things to continue to improve from here. The key risk to this forecast is a renewed acceleration in commodity – primarily oil and food – prices.

For now though, oil is falling. In our opinion this development must not be underestimated. It is clearly way too early to sound the all clear, but for the moment, the further oil prices fall, the better. What we have basically been trying to convince our audience of for the past 6 months is that whatever is going on in the global banking system, it is indeed very serious, but its importance for the global real economy is overstated. At least just as important from a real economy perspective has been the rapid rise in oil & food prices. Whenever oil prices have risen as far and as fast as they have done during the first half of this year, the global economy has experienced a significant growth slow-down, which has subsequently led to oil demand destruction. This is happening yet again – it actually has been for some time in the developed world – and combined with what looks like renewed growth in supply (according to the latest IEA data, OPEC, led by Saudi Arabia, is ramping up production) it is the main driver behind the fall in oil prices.

If we are right on this crucial subject, it has one extremely important lesson. The current growth slow-down of the developed world is very normal which means that the recovery will also be very normal. The further oil prices fall, the stronger and faster the global (especially the US) economy will reaccelerate. Luckily slack has already opened up in the US in the form of higher unemployment and lower capacity utilisation. And this dynamic is also starting to materialise in Europe. Furthermore, although we still think that the US housing market is stabilising, it – along with the slow moving shock from tightening credit standards – will continue to be a drag on US growth for quarters to come, thus limiting the

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scope for a quick recovery in growth. This is crucial, because we need inflationary pressures to stay muted.

Having said this and motivated by the recent decline in global inflation fears, we would like to reiterate our long-standing judgement – global inflation is on an upward trend and we continue to think that this threat is not fully recognised by financial markets. Hence, although we expect global inflation to decelerate over the coming 12 months driven by a) lower commodity price inflation and b) the current cyclical weakness, we would advise longer term investors to think very hard about how best to protect their portfolios against structurally higher and more volatile inflation.

Finally, with the press filled with stories on the one-year anniversary of the commonly known credit crunch, we would like to highlight the following. One year ago, we took a relatively optimistic stance on the consequences of the financial turmoil. With around USD 500bn in write offs globally, we were proven spectacularly wrong. We argued, for instance, that the fact that risk had been sliced and diced would mitigate the real economy consequences. With solid bank credit growth over the past 12 months in both the US and euro area, we think we were right on this. However, in terms of the capital market reaction, the slicing and dicing meant that the problem was global and very much scattered throughout the global system, mean-ing a higher probability of a full-scale financial panic. This is a lesson learned – the hard way. However, with Q2 earnings numbers now in, we continue to think that the financial sector earnings massacre masks solid earnings performance (S&P500 nonfinancial EPS is in solid black yoy) meaning global equities are still extremely undervalued – this should provide a catalyst for very strong equity performance over the coming 6–12 months in the order of a rise in global equities of 10 to 20 percent. We are hoping that Putin will not ruin this, with whatever it is he is trying to achive.

Latest strategy changes:

09/06/08: EM Equities upweighted 3%, government bonds downweighted accordingly.

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.

08/02/08: Equities downweigthed from 8% to 5% (allocated according to MSCI AC World). European overweight neutralised.

09/11/07: Emerging Market equities downweighted 3%, global equities upweighted accordingly. Overall equity overweight unchanged

13/09/07: Emerging Market equities upweighted 3%, bonds downweighted accordingly.

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 2% overweight retained, overall equity overweight 10%

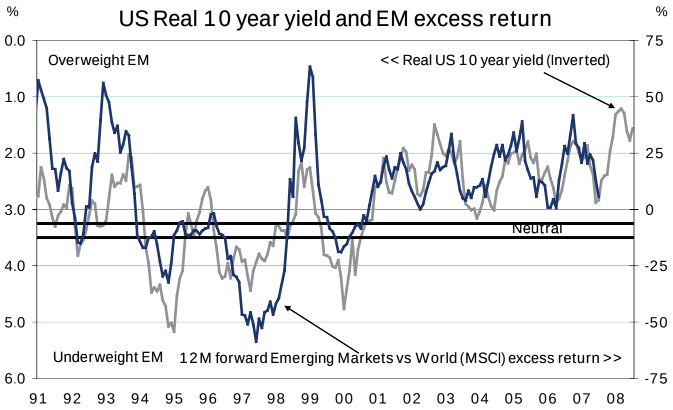
01/01/07: Equities upweighted 2%, bonds downweighted accordingly

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

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

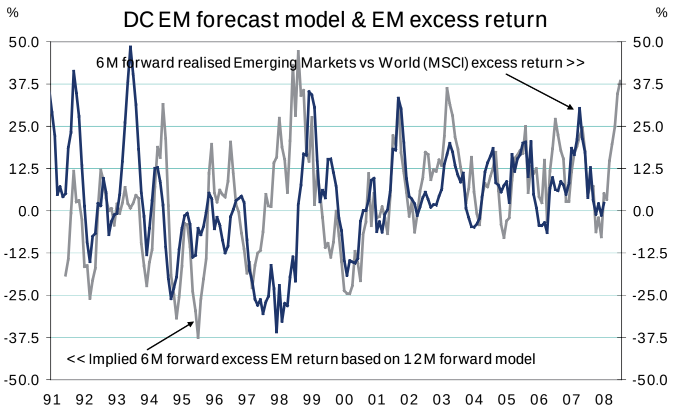
Quantitative indicators for Tactical Asset Allocation

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)	sell (-1) Production	buy (+1) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	Buy (+1) Volatility	Sell (-1) Volatility	buy (+1) Investments
Total Score (+/- 5)	+2 buy	-1 sell	+4 buy

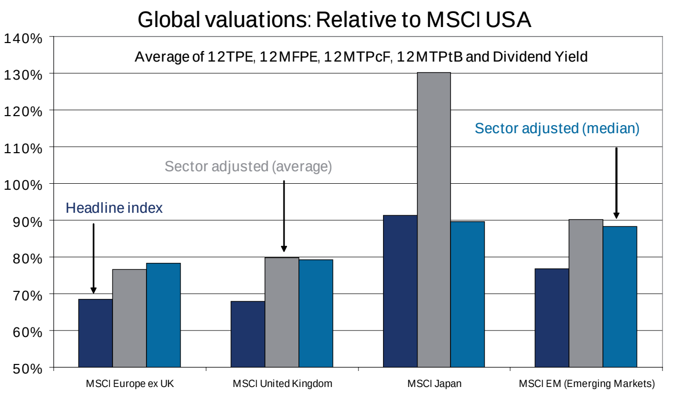


Why EM equities?

As we have highlighted consistently over the past 6 to 9 months our regional models have been signalling EM outperformance on a 12-month basis. This continues to be the case. However, 12 months ago, our models accurately flagged that the coming 12-month period would not be that exciting in terms of relative performance. This was also the case. Astonishingly, one single indicator would actually have done a perfect job all by itself – the real US 10-year government bond yield as shown to the left. As we have a tradition of sharing everything we know with our readers, try to take a closer look at the chart. See anything interesting? We do – the relationship is so tight that we can use the indicator as a 6-month model as well ...



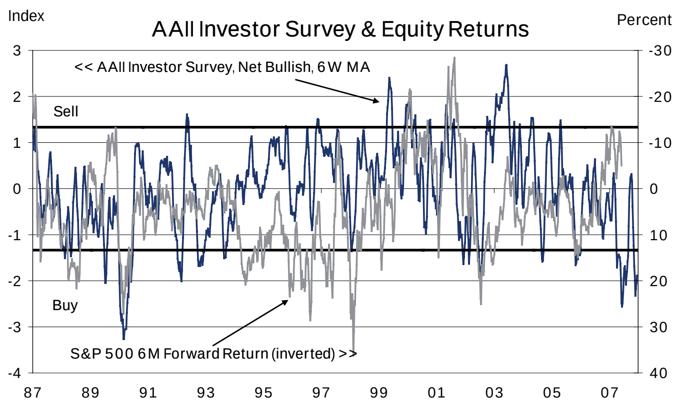
... which is what we have done in the chart to the left. First we run a simple regression of the 12M forward excess return on the US 10 year GBY back to 1990. At any point in time, we then have a forecast for the excess EM return over the coming 12 months. Furthermore, combining a 6-month realised excess return with the forecast for the12-month forward return 6 months ago will yield an implied 6-month forward return. The message? Due to the rapid rise in government bond yields through H107 and extreme EM performance in H207, EM performance should be neutral or slightly negative compared to global equities in H108. Implicitly, given that EM have been performing so strongly in the past 5 years, the message was also that global equities might not do very well in H108.



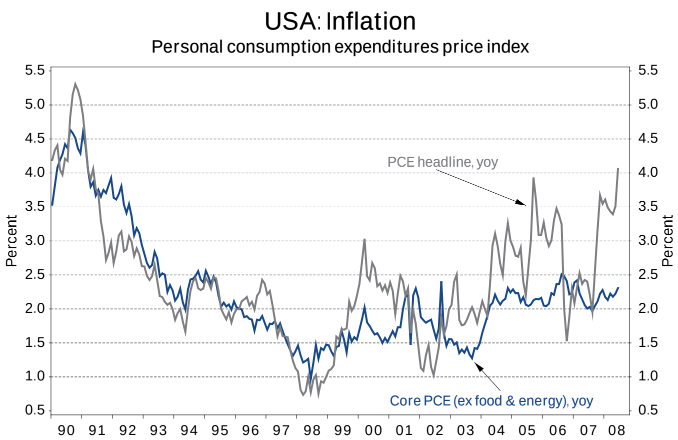
Still, we chose to overrule this signal and re-established our GEM regional overweight back in March and upgraded our overall equity weight in June. Too early for both. However, we can no longer hide behind our models. On both a 6 and 12 month forward basis, our models are signalling extreme EM outperformance. Are these numbers really realistic, given the fact that our Yield Gap is also consistent with high double digit returns on developed market equities? Our answer is – probably not, but we do think that EM will generate significant outperformance on top of whatever developed market equities deliver. As highlighted in the last chart on the left, GEM have now been downgraded relative to US equities. Combined with probable currency strengthening and – more importantly – diminishing inflation fears, we will not be surprised to see our regional models shown here perform well over the coming 6 to 12 months. The risk? Simply put – commodity price inflation!

Danske Capital
Strødamvej 46
DK-2100 Copenhagen Ø
Tel. +45 45 13 96 00
www.danskecapital.com

Contacts:
Bo Christensen +45 45 13 96 44
Frederik Engholm-Hansen +45 45 13 96 64
Søren Mose Nielsen +45 45 13 96 07



We are planning to introduce a new Global TAA model some time during autumn. The chart on the left shows the American Association of Individual Investors survey of private individual investors performed weekly going back to 1987. The indicator is measured as the difference between the share of individuals describing themselves as bullish and bearish. We treat it is a contrarian indicator, i.e. bearishness is a positive sign for short-term performance. Buy and sell signals are when the indicator is below or above 4/3 standard deviation from its long-term mean, respectively. The average S&P500 6M forward return at buy/sell signals is 9 percent and -1.5, respectively. This should be compared to an average 6M return of 4.4 percent for the S&P. Measured against this, the indicator has a hit ratio of 70 at both buy and sell signals. As of Friday last week, the index is at -1.9, i.e. a fairly strong buy. Stay tuned.



The recent benchmark revisions to the US national accounts had some very interesting features, including upward revisions to the PCE price indices. As shown to the left, with the recent revisions, US core inflation has never been within the Fed's perceived comfort zone for the past 4 years, but consistently above. Intriguingly, we would note that this is the exact same period during which global monetary policy was way too easy. We suggest it still is, but primarily in the EM complex. Conclusion? Although we continue to think that inflationary pressures will moderate going forward due to the current slowdown in growth, later on we think tight global monetary policy will have to be instigated. We will be waiting – and hopefully massively underweight risky assets!

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