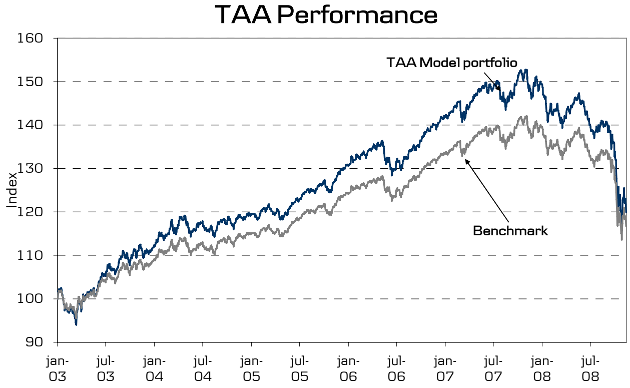
Tactical Asset Allocation

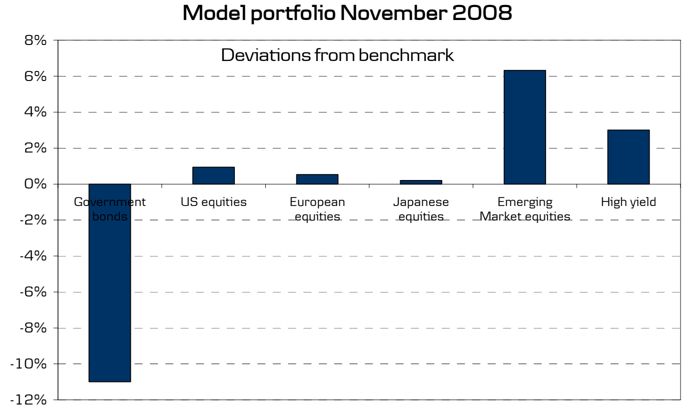
Danske Capital – 14 November 2008

Historical Performance



Information Ratio: 0.4

Current recommendation



Note: Benchmark is rebalanced at the beginning of each year

Performance results:

Model portfolio 2008 (ytd):	-19.6 percentage points
Performance 2008 (ytd):	-3.3 percentage points

Latest strategy changes:

15/10/08: Global equities upweighted 5%, High Yield upweighted 3%, government bonds downweighted accordingly.

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

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We are lining up to raise our equity weight. We emphasize that we have a limit of 20 percentage points and will not be fully exposed when we execute the allocation change. We will publish an update of the TAA publication when appropriate along with an update regarding developments in China (the latter should be out next week).

The primary reasons are, 1) continued (although slow) improvements in financial stability, 2) commodity prices, 3) the global policy response (including in particular recent actions in China – specifically the turn in the monetary policy stance and the change in policy towards the housing sector).

"The Fed is going to 1 percent, but it is not going to matter". Those were the words of seasoned economist Jim Walker in September 2007 at a conference in Hong Kong. The lead author of this publication thought Mr Walker was out of his mind and felt very strongly that he should reconsider his future. You simply could not say this and still retain a role in our industry.

15 months – and many hard earned lessons – later, his forecast was the most precise we have come across in all the various research we receive. And for that, we have to pay our respect – consider it done!

In our interpretation, what Mr Walker had seen – from a financial sector perspective – was that given the significant credit creation over the past few years, some of that lending simply had to be fundamentally bad. And given the sheer scale of credit creation, the turn of the credit cycle would have global consequences. As we have written before, we argued back then that the distribution of risk would make the system more stable, when, in fact, its distribution is the main reason why the entire global financial system has been so severely shaken. In the end, to save the system and prevent complete failure, governments had to step in.

Although we want to emphasize that Mr Walker nailed it more than most, we would also like to mention that when asked by the lead author what his scenario would mean for commodity prices, Mr Walker replied they would come down by 40-50%. In the end, this was also true. But not before rising 100%. Regular readers will know that we attach high significance to the magnitude of the commodity price cycle, as it tends to put pressure on corporate margins (thus slowing profit growth, potentially leading to slower investment growth and hiring activity) and erodes consumer purchasing power, thus slowing final demand. Hence, we continue to think that Mr Walker's forecast of global growth would have been less accurate, had we not seen the major run-up in commodity prices during the spring.

As such, we are very pleased to see commodity prices – especially oil prices – at current levels. From a macro perspective, we need all the help we can get. Having just returned from New York, where we attended a global Industrials conference, it is now very clear to us, that the signal from our preferred global growth indicator – the US manufacturing ISM – is very real. Industrial majors, including Caterpillar, Honeywell, SPX and Parker, used language such as *"mid September, the economy hit a wall"* or *"the world came to an end"*. We think they are experiencing the consequences of two major effects, including 1) a renewed shock to global confidence and 2) a real failure in vital parts of the financial system. Overall, this has now set in motion a string of events that will see the global macro outlook much weaker than we thought just a month ago.

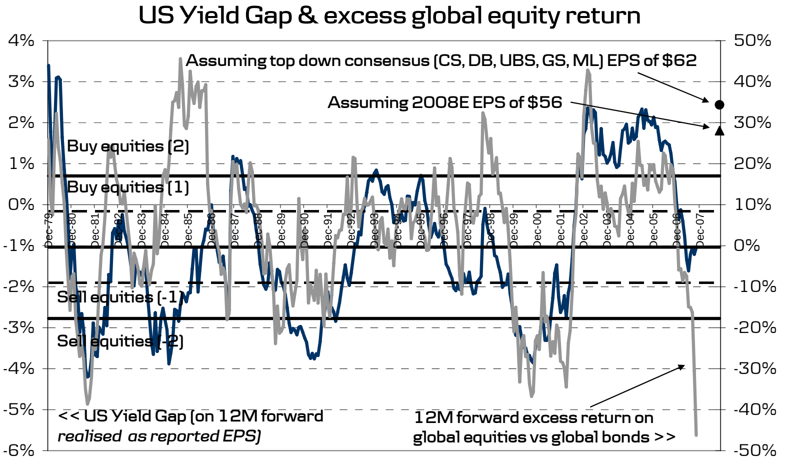
The key question thus becomes – will confidence return? We think confidence will be intimately linked to financial stability, reductions in (credit) risk premia and normalisation of credit markets in general. Lower oil and interest rates should help. However, uncertainty is still very high, which is why we are not fully exposed.

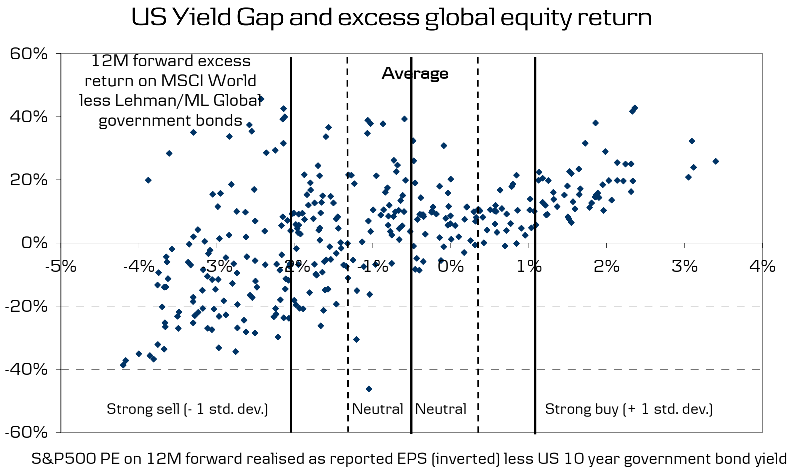
For the emerging world, things are slightly different. Lower commodity prices hurt various countries and regions such as Russia and the Middle East. However, although the EM story is much more than China, China does play a crucial role, which is why the latest developments there are so important. We will publish a special TAA update on China next week, because we want to emphasise our view that China is increasingly the economy to watch (from a *real* perspective). What we *know* from 2008 is that the US financial system – and its markets – is still at the core of the global system. Hence, when there are problems at the core, there are problems in the periphery. However, what we *think* we know from 2008 as well is that China is already a significant driver of global growth. More next week, but recent developments in China should help put a floor under the global industrial cycle, commodity prices and thus risk appetite.

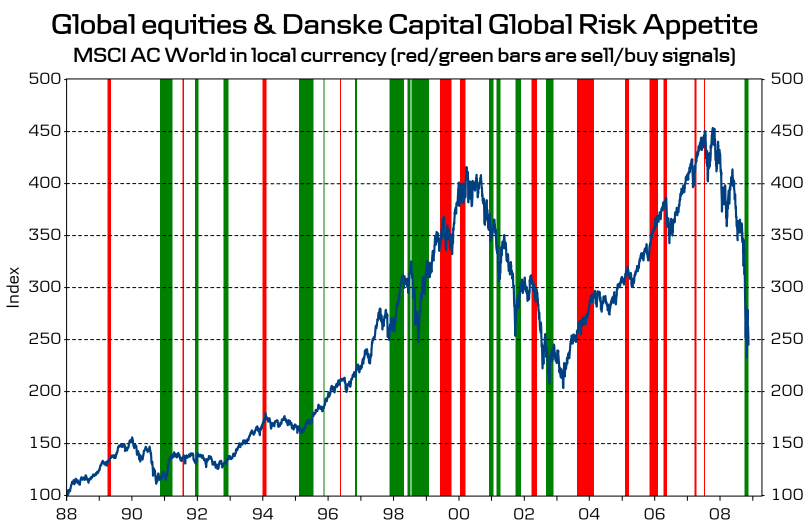
To sum it all up – stability in the US financial system is pivotal to stability in global financials markets. Going forward, we think most of the fall in key leading indicators is behind us and expect an improvement going forward. The macro risk is consumer and corporate behaviour. The financial risk is continued deleveraging.

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)	buy (+1) Risk appetite	buy (+1) Slope of the yield curve	buy (+1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Investor sentiment	buy(+1) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	neutral (0) VIX	neutral (0) Volatility	buy (+1) Investments
Total Score (+/- 5)	**+3** **buy**	**0** **neutral**	**+4** **buy**







Yet another new indicator...

We are working hard to be able to introduce a new TAA publication and model by January. For now, it looks like we will succeed. As of this publication we are introducing a new Yield Gap. Regular readers will know that the Yield Gap is our favourite valuation tool. In that respect, nothing has changed. However, going forward, we will approach it from another angle. In our old Yield Gap, the PE we used was based on a12M forward consensus *bottom up* EPS forecast. However, when we say that the Yield Gap is our favourite valuation tool, we do not mean that exact way to calculate the Yield Gap, but rather that there has to be a relationship between risk free rates and equity valuations. Therefore, when this relationship is extreme (one way or the other) it should be followed by corrections in (relative) asset prices.

The chart in the top left hand box illustrates our new approach. Instead of using a consensus bottom up forecast for S&P500 EPSr, we use actual realised *as reported earnings* 12 months forward, i.e. at any given point in time, we have had perfect foresight. The historical results are shown to the left. Data go back to 1979 and are monthly. Or put another way – if you can forecast actual earnings, you can forecast relative returns. Fairly intuitive. However, this means that we have to have an EPS forecast. For now, we have constructed a *top down* consensus, which is the mean of 5 EPS forecasts from global brokers. In time, we might introduce our own EPS forecast, but we do not think we have the analytical capability (yet).

We always stress that our indicators are work in progress. That goes for the risk appetite index as well. Motivated by gaining access to data further back, we have modified our Global Risk Appetite index. The most significant changes are replacing the sub-index measuring EM equities vs Global equities with the Goldman Sachs commodity price index. The idea being that commodity prices normally shoot up at the end of the cycle as the global economy nears its productive capacity. We thus think of it as a real economy type of risk appetite. Furthermore, run-ups in commodity prices are usually negative for the future growth outlook. The new index is in buy signal territory (beginning October 6th) and closed at -1.7 yesterday compared to an all-time low of -3 at the height of the Asian crisis (see the indicator set for history). The old index was -1.3 on October 8th. As always, please contact us for documentation.

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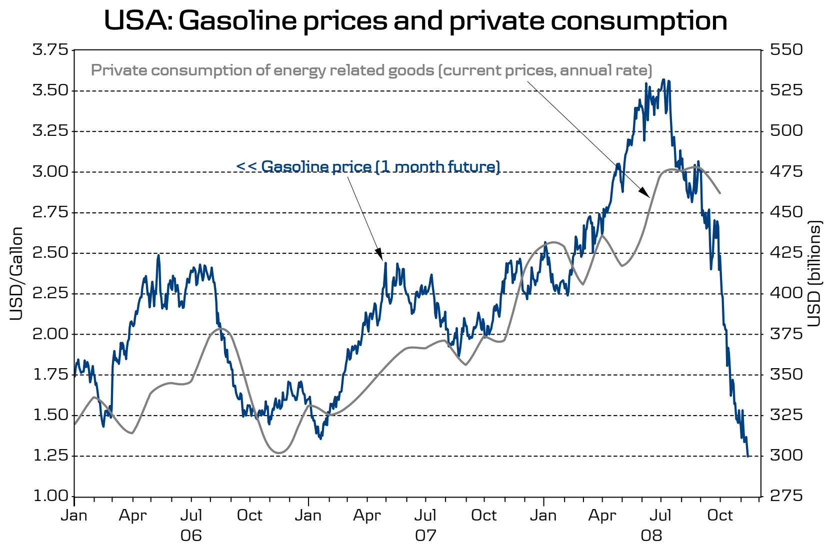

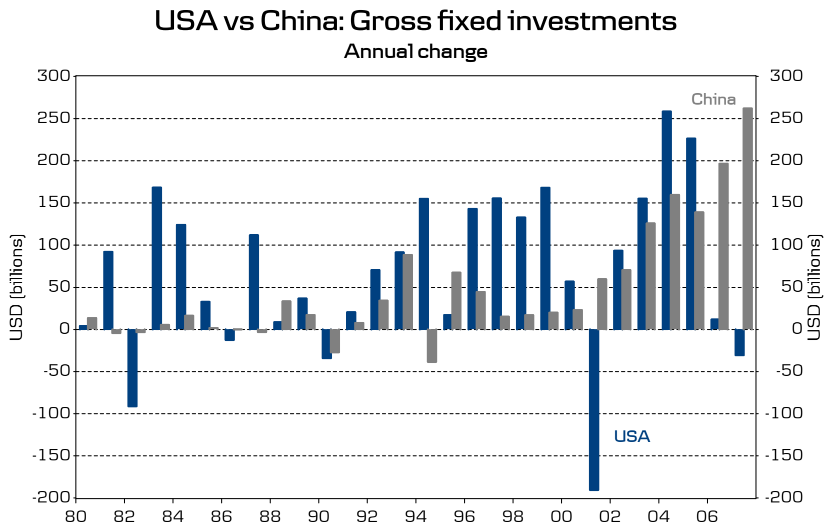

Although the drop in commodity prices – oil in particular – is surely testimony to the weakening of the global (industrial) cycle and has huge negative implications for parts of the EM space, we think it is a big positive for key economies such as the US and Euroland. Developing Asia benefits from the drop in food prices. With the global economy now hit by significant negative shocks stemming in particular from the turmoil in the financial sector, we need all the help we can get. As illustrated in the chart on the left, US consumers' energy spending is falling rapidly, generating spare cash. The key question is what they will do with the extra cash? If they raise their savings rate significantly, it would be a large negative for growth. This remains the key risk to our expectations of a standard recession.

Our approach to global TAA is one that has the US at the centre and the rest of the world as the periphery. However, from a real-economy perspective, the US is losing its dominance – fairly quickly! We attach a particular significance to China. Getting reliable data on China is difficult, but the chart on the left should suffice to make an important point. It shows annual changes in gross fixed investments – i.e. a broad definition of capital formation. The composition is of course very different from that of the US, but overall the chart should illustrate the fact that getting China right is of vital importance to the global outlook. We expect Chinese growth to stabilise around year-end and reaccelerate as we go through 09. This should put a floor under the global industrial cycle, and hence risk appetite.