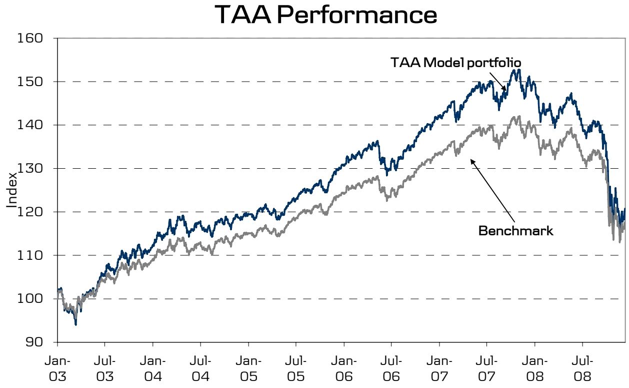
Tactical Asset Allocation

Danske Capital – 12 December 2008

This is the last edition of the TAA publication in its current form. From January 2009 onwards this publication will be aimed at Institutional clients due to regulatory and compliance issues.

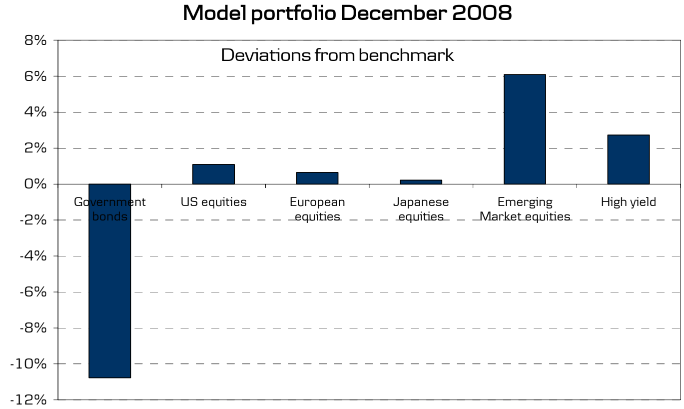
We wish all our readers a prosperous 2009 – and beyond.

Historical Performance



Information Ratio: 0.4

Current recommendation



Note: Benchmark is rebalanced at the beginning of each year

Performance results:

Model portfolio 2008 (ytd):	-19.3 percentage points
Performance 2008 (ytd):	-3.6 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 stay overweight equities by 8 percentage points (out of 20pp) and maintain our 3 percentage points overweight in corporate high yield. However, we will use year-end rebalancing to adjust our allocation, most likely decreasing the equity overweight while increasing the credit overweight.

"…I believe that there is now overwhelming evidence that the main factor depressing aggregate demand was a worldwide contraction in money supplies", ("Essays on the Great Depression", 2000, Bernanke, p.8).

"… I make my own mistakes but I do not want to make somebody else's mistake" (Ben Bernanke during Q&A at a conference in Texas, December 1st 2008).

If you want an explanation for what the Fed is doing, we think you need look no further. At the helm of the Fed sits an academic who has spent a lot of his career researching why things went so terribly wrong in the 30s. A key explanatory factor was a Fed policy error as it let the money supply contract. Hence witness the recent increase in the Fed balance sheet and the announcement that the Fed will buy GSE debt and GSE MBS – unsterilized it seems. In addition, we think it is the natural extension of the risk management approach to monetary policy as the Fed funds rate approaches the zero lower bound and expect the Fed to become increasingly innovative (if needed). Will it work? Your guess is as good as ours – this has never been tried before and the consequences of these actions are beyond us. Therefore, we will confine ourselves to underline once again that uncertainty is high.

Finally, we find the following quote quite interesting. Asked to comment on the range of liquidity and credit facilities that the Fed is unleashing, Bernanke emphasised that most of the facilities are well collateralised (he actually used the word *over-collateralized*) and mainly with recourse to participating institutions. He went on to note *"… so we are not putting money at risk, in fact we expect to make some money on this…."* This is in line with our view that many credit markets are extremely distressed, offering attractive longer term investments to investors or entities (such as the Fed) that are able to buy and hold. That, of course, has not prevented valuations from becoming ever more attractive as the financial turmoil has continued to spread.

So far, though, the Fed has been successful in bringing down mortgage rates, stabilising the CP market as well as bringing down money market rates (and spreads to some degree). The former is critical to stabilise the housing sector (and thus the economy more broadly). Hence, from a real economy perspective, the Fed has so far made valuable progress.

Having said this, we still think that from a financial stability perspective, the actions taken by the US government via capital injections into US financial institutions (of which Citigroup is the latest) is equally important. Restoring confidence in (and in between) financial intermediaries is absolutely critical to prevent a complete collapse in the real economy as well as setting the stage for a proper recovery. As highlighted by Bernanke in the speech mentioned earlier, the second major error made during the 30s was to let a large share of domestic banks go bankrupt. Today, although the Government has clearly underestimated the extent of the financial turmoil and thus the appropriate response to the crisis, we think they finally understand. In the words of Bernanke (same speech);

"… We at the Federal Reserve and our colleagues at other federal agencies will carefully monitor the conditions of all key financial institutions and stand ready to act as needed to preserve their viability in this difficult financial environment."

We think this effectively means that there will not be another Lehman Brothers and this is the key reason why we think the macro outlook and financial market developments will improve from here. We do think the initiatives put out on a global scale is – sadly – what is needed, but political practicalities (more capital might be needed) along with the high uncertainty surrounding the macro (the current recession itself will force many interesting issues into the spotlight) make us question whether financial markets are finished worrying about insolvency issues. We thus continue to recommend moderate levels of risk and are considering our equity allocation as year-end approaches.

In short – we agree with Bernanke that no fair comparison can be made between the current episode and the Great Depression. However, we think the lessons learned from that period provide the intellectual framework behind the current policy response. We think policymakers will succeed and aided by solid fundamentals in key parts of EM, we expect the global economic outlook to be much less negative when 2009 comes to an end. We thus judge that being overweight risky assets in 2009 is the right allocation. But uncertainty is simply so high that this in itself is enough reason for us to stay fairly moderately exposed.

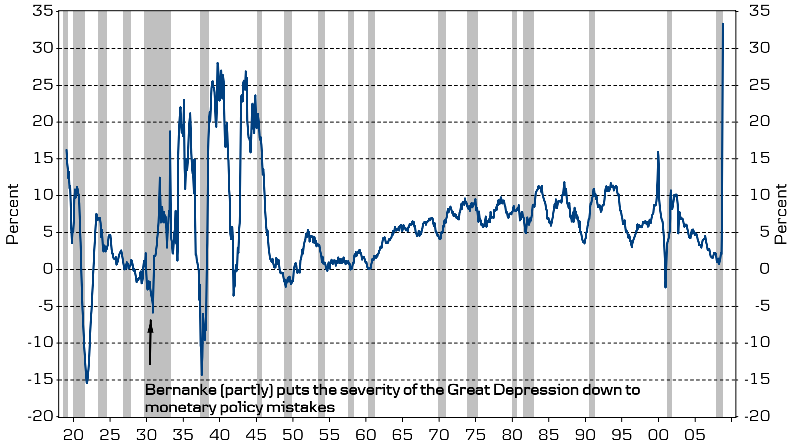
We wish our readers a happy and peaceful Christmas and look forward to working with you in 2009.

Quantitative indicators for Tactical Asset Allocation

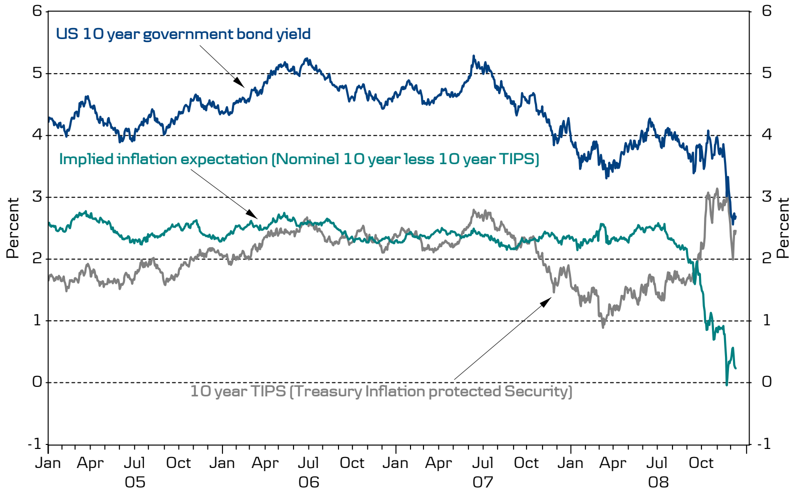
Asset classes	Equities/Bonds	High Yield/Equities	High Yield/Bonds
Valuation (+/- 2)	buy(+2) Yield gap	sell(-2) High Yield gap	buy (+1) Credit Spread
Trigger 1 (+/- 1)	buy (+1) Risk appetite	buy (+1) Slope of the yield curve	buy (+1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Investor sentiment	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**

USA: Adjusted monetary base

Commercial bank reserves at Fed plus currency in circulation (yoy)

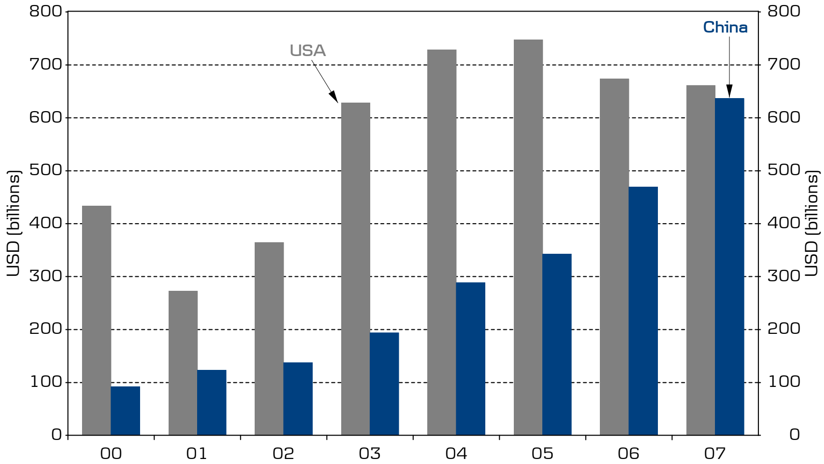


USA: Rates and implied inflation expectations



Global: USA vs China

Absolute annual change in USD GDP (at market exchange rates)



Experimenting with monetary policy ...
It should be crystal clear to everyone that the Fed is engaged in a huge experiment. The initial expansion of the Fed's balance sheet was partially sterilised through the Supplementary Financing Account (SFA) with the Treasury depositing the proceeds with the central bank. That programme is already being wound down and with the Fed announcing that it will buy GSE MBS directly, the Fed now seems to have moved to de facto printing money. We have no way of knowing how this will work, if the Fed will succeed and if so, what the consequences will be longer term. Currently, we do think the Fed is primarily substituting for the lack of private credit creation and compensating for the lack of demand for riskier assets. Furthermore, with the money multiplier collapsing and the economy very weak over the coming months, inflation is not an issue.

Financial markets have taken the cue from the deflationary threat (while probably also anticipating future Fed purchases of treasuries. We note that we think this is definitely an option but think the Fed could do more to ease monetary conditions by buying non-treasury securities and think this route is more likely). As the chart on the left illustrates, the ten year breakeven inflation rate in the US is close to zero. Shorter term break-even inflation rates are actually negative. Although this kind of pricing is definitely partly due to the TIPS market being illiquid, it is certainly a sign that deflation rules currently. And as long as risk aversion is so high and the private sector savings rate rising, the Fed should be able to do more or less whatever it wants. We also agree that inflation in the US will be subdued going forward, as the amount of spare capacity opening up right now is massive.

Before we conclude on the inflation/deflation issue we have to pass by China. The Chinese economy has now slowed much more than we expected due to a combination of weak domestic demand (via a significant slowdown in the housing sector,) weak global demand and a breakdown in the financial infrastructure (trade finance). However, as we noted in the last publication, we expect Chinese growth to stabilise during H1 followed by a meaningful though not explosive reacceleration. The main driver should be a relaxation of the tightening measures put in place through 2007 targeted at the housing sector (already removed), renewed momentum in domestic credit creation and fiscal stimulus. Why does this matter? It matters because as illustrated in the chart to the left, on the margin, China is becoming important to global demand. As such, we expect a reacceleration in China to help put a floor under the global industrial cycle and commodity prices.

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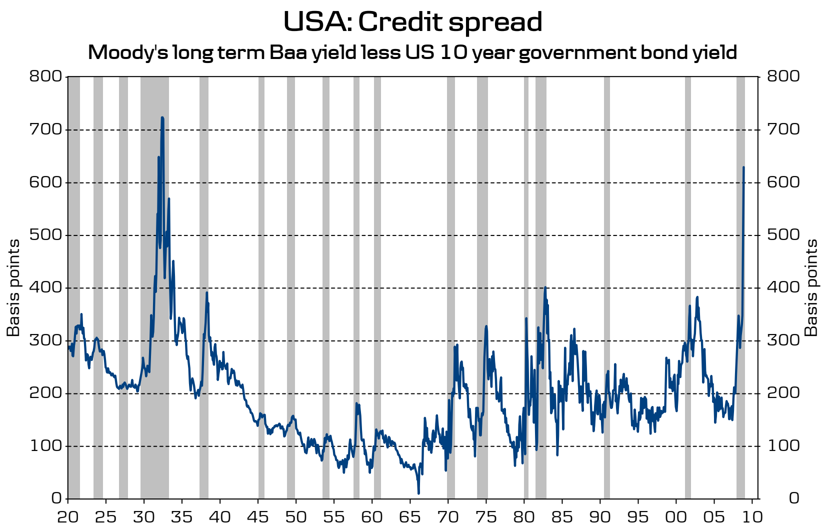

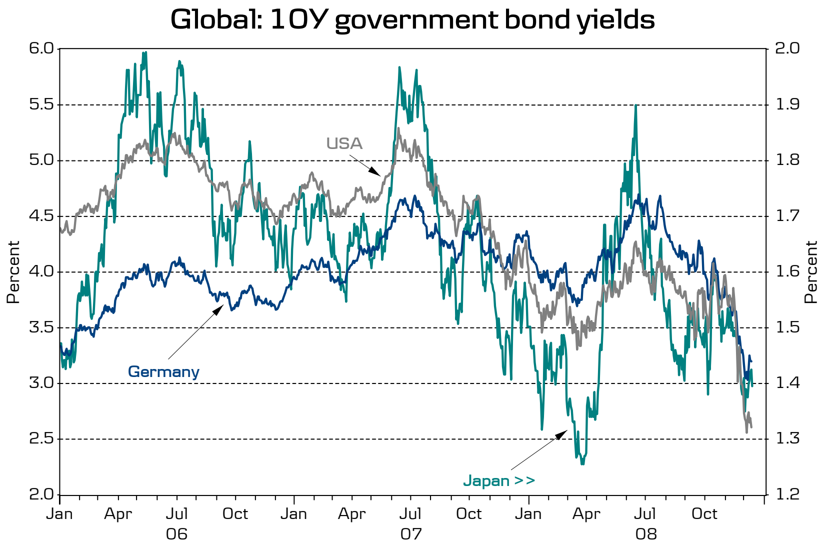

We mention this not because we think of commodities as an asset class (we caution against this in general), but because the outlook for commodity prices is so important for the medium growth outlook for key bits of EM.

The other side of the drop in risk-free rates is of course extreme risk aversion and financial deleveraging. As shown to the left, credit spreads are now at very elevated levels. Overall we judge credit to be very attractive, though there are differences across rating categories. When we introduce our new model portfolio in January, we will include more asset classes within credit. For now, we note that credit and spreads hold the key to both macro developments and sustained performance in equities.

This brings us to the conclusion on risk-free rates. We have long argued that these were too low. We thought bond markets underestimated the inflationary threat and thus had priced in too low risk premiums. Instead we got a big jump in credit spreads, while risk-free rates are flirting with decadal lows.

What will happen going forward? For the medium term, we uphold our fundamental assessment that inflation volatility has risen due to the structural rise of EM. In passing, we note that given the experience of the past few years we think policy makers will chose a different (most likely more rapid) route to monetary policy tightening. Overall, we do not think the current episode is the start of *Japanization* of US and European long term risk free rates, although in the very short term, deflation should remain the key concern.