



# OUTLOOK 2011

BUBBLES AND BULLS AND BEARS... OH MY!

SAXO  
BANK



## Introduction

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*Saxo Bank, the online trading and investment specialist, tends to be somewhat more pessimistic than the average financial analyst and were quite pessimistic on the whole recovery since 2003, assuming the low-rate environment would lead to speculative excesses worse than that of the dot-com bubble. Events during 2008, unfortunately, proved the thesis right.*

As we head into 2011, Saxo Bank's analysts worry about the quality of the foundation on which the recovery that began in 2009 is built. While the global economy has improved, we believe that we're dealing with a stimulus-induced cyclical recovery within the context of a secular deleveraging process. There is still too much debt in the system and we're concerned that the failure to properly address the need to reduce private and especially public debt levels will result in a relatively halting recovery with rather weak, if still positive, growth in the developed countries in 2011.

The attempts by politicians and central banks to sweep the problems generated by the past credit super-cycle under the rug may seem to be bearing fruit at present. But these efforts are not addressing the root cause of the entire challenge: the enormous debt overhang at all levels. In fact, all of the attempts at stimulus, bail-outs and money printing are adding to the developed economies' overall debt burden and are tantamount to treating a drug addict with more drugs. Instead of going through a short, painful withdrawal process and starting afresh, all efforts have so far been a kicking of the can down the road, a process that minimizes the short term costs, but only maximizes the eventual extent of the final costs.

So bulls may continue to find reasons for celebration in the New Year, but the bears will eventually be on the prowl further down the road as the great public bond bubble moves one year closer to its eventual confrontation with fiscal reality.

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**DAVID KARSBØL**  
DIRECTOR, CHIEF ECONOMIST  
dka@saxobank.com



**CHRISTIAN TEGLLUND BLAABJERG**  
CHIEF EQUITY STRATEGIST  
ctb@saxobank.com



**PETER GARNRY**  
EQUITY STRATEGIST  
pg@saxobank.com



**MADS KOEFOED**  
MACRO STRATEGIST  
mkof@saxobank.com



**JOHN J. HARDY**  
CONSULTING FX STRATEGIST  
jjh@saxobank.com



**NICK BEECROFT**  
SENIOR MARKETS CONSULTANT  
xnbe@saxobank.com



**GUSTAVE RIEUNIER**  
GLOBAL HEAD OF FX OPTIONS  
gr@saxobank.com



**ALAN PLAUGMANN**  
COMMODITY STRATEGY  
apl@saxobank.com



**OLE SLOTH HANSEN**  
COMMODITY STRATEGY  
olh@saxobank.com

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## CONTENTS

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<b>PREMISES FOR 2011: BUBBLES AND BULLS AND BEARS... OH MY!</b> .....	<b>P. 5</b>
<b>GROWTH PERSPECTIVES IN 2011</b> .....	<b>P. 8</b>
USA: NEW NORMAL OR THE GOOD OLD DAYS? .....	P. 8
<b>EUROZONE: A YEAR TO REMEMBER OR A YEAR TO FORGET?</b> .....	<b>P. 11</b>
<b>UK: THE SURPRISE STORY OF 2011?</b> .....	<b>P. 12</b>
<b>JAPAN: ANOTHER DIP IN THE ROAD?</b> .....	<b>P. 13</b>
<b>POLICY RATES IN 2011</b> .....	<b>P. 15</b>
<b>FX OUTLOOK 2011: GREENBACK TO REIGN SUPREME?</b> .....	<b>P. 18</b>
THE CUSP OF 2011: SETTING THE SCENE .....	P. 18
USD: WIN-WIN IN 2011? .....	P. 19
EUR: WHERE'S THE BOTTOM? .....	P. 20
JPY: DR. JEKYLL OR MR. HYDE? .....	P. 20
GBP: SURPRISING STRENGTH? .....	P. 20
CHF: A CONUNDRUM .....	P. 21
AUD: ONE TRICK PONY TO STUMBLE? .....	P. 21
CAD: MIDDLE OF THE ROAD .....	P. 21
NZD: OVERVALUED .....	P. 22
SEK: NEITHER HERE NOR THERE .....	P. 22
NOK: TOO CHEAP .....	P. 22
G-10 FX TRADE IDEAS FOR 2011 .....	P. 22
<b>FX OPTIONS: NAVIGATING IN A SEA OF RISK</b> .....	<b>P. 23</b>
<b>EQUITIES: BULLS TO CONTINUE TO GET THEIR WAY?</b> .....	<b>P. 25</b>
USA: MORE TO COME FROM EQUITIES .....	P. 26
EUROPE: SUBDUED EARNINGS GROWTH .....	P. 27
<b>COMMODITIES: A STRONG BEGINNING, BUT DANGER LIES AHEAD</b> .....	<b>P. 30</b>
<b>WHAT NEEDS TO BE DONE? A 10 STEP PLAN TO FINANCIAL STABILITY AND GROWTH</b> .....	<b>P. 32</b>
<b>SPECIAL REPORT: SOLAR ENERGY TO SHINE IN 2011?</b> .....	<b>P. 33</b>
SOLAR STOCKS WILL RISE LIKE A PHOENIX FROM THE ASHES .....	P. 33
WHY DO WE LIKE SOLAR MORE THAN WIND? .....	P. 33
HOW TO INVEST IN SOLAR STOCKS .....	P. 34
RISK ASSESSMENT .....	P. 34
SOLAR ENERGY IS THE FUTURE .....	P. 35
DROP THE IDEOLOGY AND GO FOR PERFORMANCE .....	P. 35
DISCLAIMER .....	P. 36

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## PREMISES FOR 2011: BUBBLES AND BULLS AND BEARS... OH MY!

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Sovereign debt crises, bailouts, stock market melt-down, head-spinning stock market rally, low interest rates, hyperinflation worries and galloping commodity prices: 2010 had it all. But if you are afraid that 2011 will be dull in comparison, then fear not. Not many of the causes of the global financial crisis have been resolved over the last two years as authorities have unfortunately worked overtime to mask the symptoms instead. The expression “kicking the can down the road” has become public property as banking institutions and even sovereigns have been offered a lifeline funded by central bank printing presses, savers and tax-payer IOU's in the form of new sovereign debt. The fundamental idea that not only profits, but also losses are an important part of a market economy has been ignored – instead we have a mantra of loss prevention in the name of “stability”. Owners of senior debt may have been saved for now, but there are no free lunches, and the longer we try to pretend there are, the worse the cold shock of reality once we reach the end of the road.

Sound too depressing? There are indeed unresolved issues in the world economy, particularly those relating to all forms of debt, but the common characteristic of these is that they are longer-term issues that will take years to address. We believe that within this secular debt deleveraging process that the West is undergoing, a cyclical recovery is currently present, which will manifest itself in 2011, at least in some corners of the globe.

The recent improvements in the U.S. economy, which come on the back of a summer where double dip was the major buzzword and cause for concern, have seen risk rally into the New Year with the S&P 500 more than 20 percent from its summer lows. And despite household deleveraging and overcapacity, companies have managed to squeeze so much productivity out of their reduced staffs that profit margins are near record highs.

Particularly the first half of the year is bound to present further upside surprises to company earnings, but the flipside is that earnings surprises will likely be fewer and farther between by the second half of 2011 as

companies struggle to maintain margins in an environment where end demand and revenue growth are still sluggish while input costs have spiked higher.

### **QE2 MARKET REACTION: A CAUSE FOR CELEBRATION?**

Is US Federal Reserve Chairman Ben Bernanke flooding the system with money? Arguments abound on the answer to that question. A look at the commodities rally of late 2010 suggests the answer is in the affirmative while a glance at core inflation reveals clear-cut disinflation, albeit not outright deflation. Technically, the Federal Reserve does not print money itself (a department of the U.S. Treasury does), but there is no question that the already enormous balance sheet of the Federal Reserve (already approaching 20% of US GDP) will balloon further as the second round of quantitative easing takes place into mid-2011. The important question, however, is not just the size of the Fed's balance sheet, but what happens to the funds the Fed effectively creates from thin air. So far they have not – to any material degree – entered the economy, but rather sit as excess reserves on the balance sheets of financial institutions, as deleveraging consumers have no need for new loans. And as long as that is the case, which we expect it will be in 2011 as well, there will be neither significant inflationary pressure nor a money printing-induced asset bubble.

The charging markets we witnessed as 2010 drew to a close were in our opinion largely driven by speculation that the Fed's QE2 will work, not because it is working. After a brief buy-the-rumour, sell the fact reaction to the Fed's actual Nov. 3 QE2 announcement, the rally proceeded again apace in December and the US S&P500 was trading to new highs since the Lehman bankruptcy. Our stance on risk is hence only mildly positive as the QE-boost only has so far to run and on the possibility that corporate have little more to squeeze out of corporate margins. Potential downside risks include a disruption in the sovereign debt markets – especially in Europe, and a commodities rally that gets out of hand and squeezes final demand and corporate margins.

It is our belief that quantitative easing will not do much for the real economy. It certainly has not eased interest rates, as government bonds have sold off all along the curve since the Nov. 3 QE2 announcement. The U.S. 10-year yield has risen no less than 100bps since the trough in early October. Given that QE2 has been an utter failure if Main Street or interest rates were the target, we question whether it was instead an attempt to boost demand through the wealth effect via higher equity prices? If so, then we must admit that the Federal Reserve has succeeded – so far! Equities are no doubt higher, but we question whether this will give people the confidence to increase spending and lending and justify rosy expectations of earnings growth. Rather we think stocks will hit a crossroad at some point in 2011. Either the global – specifically the U.S. – economy has improved to an extent that supports the higher valuations, which call for 17 percent annualised growth in earnings per share over the next couple of years or the Fed-induced surge in risk sentiment will come to a grinding halt.

#### **THE EU INVITES THE FOXES INTO THE HENHOUSE**

At the height of the Greece sovereign crisis the EU acted swiftly to set up an emergency fund in case another country would need help – though policymakers insisted it would never be used. The fund consists of a EUR 440 billion European Financial Stability Fund (EFSF), 60 billion from the European Financial Stability Mechanism (EFSM), and 250 billion from the International Monetary Fund (IMF). Ireland, as is well-known by now, became the first and so far only country to apply for help.

The fund, however, may have been dreamt up a wee bit too quickly. Not only is the fund currently not even remotely big enough to handle a bailout from a bigger country like Spain, but it also relies on all EU members to provide their piece of the guarantees that acts as collateral; something that of course rules out Greece and Ireland, and other coming bailout applicants. This also creates moral hazard as struggling countries scrambled to apply for a bailout and thus avoid their share of the burden. Eventually, this could put pressure on the triple-A rated EFSF itself, causing higher interest rates for the countries receiving a bailout.

#### **CHINA, THE JOKER**

The Middle Kingdom of the East is a joker in both directions in 2011. Rising inflation and quotas on loans in China have economists rethinking their earlier bullish calls for +10 percent growth this year and instead “only” looking for 9 percent. We have been concerned about the Chinese economy and particularly the real estate market for a long time and so far nothing has alleviated those concerns. The bust will come eventually. In the meantime, however, the Chinese regime may try once again to manipulate the economy into reaching some artificial GDP target, whether with additional white elephant infrastructure projects or other efforts aimed at increased consumption. It is thus not inconceivable that China may beat the consensus in another act to assert its position in the world.

Despite the possibility of a surprise to the upside, we remain sceptical of the ability of the Chinese authorities to achieve real 10 percent growth in 2011. Lending quotas have been surpassed in 2010 as demand for loans remain high, but this is more or less another way of saying that growth is only kept high due to a continual surge in investments. Consumers are still not ready to carry the economy on their backs, which forces the regions to look elsewhere for growth; and the choice almost always ends up being investment-driven growth. With global trade not expected to grow by leaps and bounds in 2011, China will be hard pressed to find growth elsewhere. As it becomes harder and harder to extract GDP from each yuan allocated to domestic investment, we expect economic activity to fall below market expectations reaching 8 percent year-on-year at the end of 2011.

#### **WHAT TO MAKE OF IT ALL?**

We must credit the members of the Eurozone for their acceptance of the reality that deficits need to come down - even if this realisation is mostly due to pressure from bond vigilantes rather than prudent foresight on the governments' part. And while a more austere Europe is more or less priced into the markets, the looming troubles surrounding the peripheral members of the Eurozone, as well as the EFSF itself are reasons for a cautious approach toward risk assets.

On the other hand, we cannot deny that the U.S. seems to be in recovery mode, even if that recovery has in large part been enabled by a government that has yet to show any credibility in addressing its enormous budget shortfalls. We do not welcome the approach of solving debt problems with more debt, but we also recognise its positive contribution to GDP in the short run. Add to that the lean, mean, profit-generating machines also known as U.S. companies and you have a case of steadily improving earnings in 2011, barring a commodities price shock. We say steadily improving rather than surging earnings as we project sales growth will remain subdued due to sluggish growth in final demand in the economy. Risks to our call on economic growth and prospects for risk assets in 2011 are mainly to the downside, but stocks may yet eke out gains on solid company fundamentals.

The U.S. dollar is undervalued in our eyes as the “Everything up versus the U.S. dollar-trade” dominated proceedings in 2010 and simply on a partial unwind of that trade, the U.S. dollar could see a recovery next year. Neither Europe nor Japan look like attractive alter-

natives to the U.S., and the overambitious expectations for China and thus emerging market, particularly if commodities continue sharply higher into the New Year could mean a significant pullback in short USD/long EM carry trades.

Interest rates have risen strongly in the U.S. and Europe from pre-QE2 lows in October. The resumption of quantitative easing must assume its share of the blame, but a rebound in risk appetite as U.S. macro reports continued to rule out a double dip also chipped in. Despite the rosier U.S. macro picture, we remain bullish on the bonds of the sovereign debt of major developed economies in 2011. Rising fiscal austerity and continued household deleveraging does not warrant a continuation of the recent surge in yields, even if growth continues to stumble higher in 2011. U.S. Treasuries in particular could be a popular investment in 2011 if the sovereign debt situation in Europe gets ugly.

## GROWTH PERSPECTIVES IN 2011

### USA: new normal or the good old days?

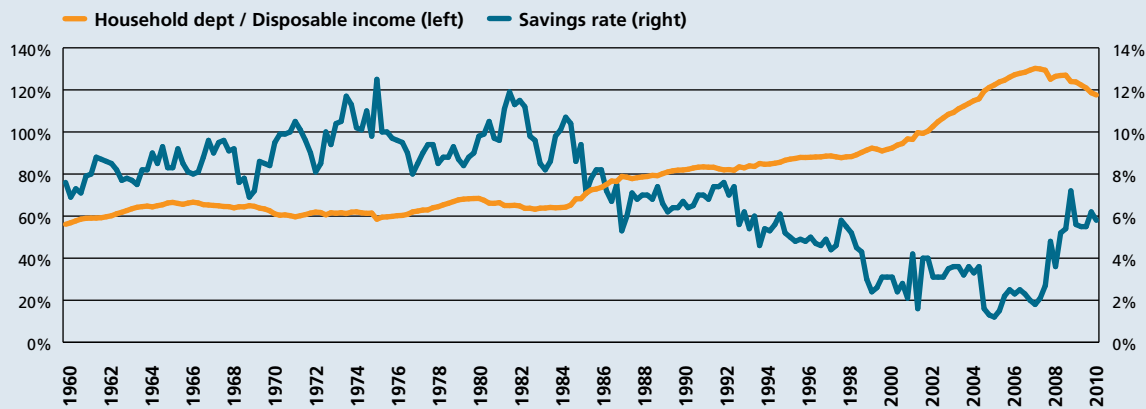
Looking back at the Great Recession and the stock market crash of more than 50 percent, the markets and the U.S. economy have come a long way since the horrors of 2008-09. The problem is that the U.S. recovery has failed to close the output gap with its feeble recovery of below-trend growth. Unemployment is still hovering close to 10 percent 18 months after the official end of the recession, weekly initial claims for jobless benefits are still above the 400,000 mark, and a record 45+ million Americans receive food stamps. History tells us that the unemployment rate is a lagging indicator, but we have other worries: mortgage delinquency rates are still above 9 percent, private balance sheet deleveraging is ongoing with consumer credit contracting at an annual rate of 2.9 percent, and disinflation still rages outside of the commodity spectrum.

### SECULAR HOUSEHOLD DELEVERAGING CONTINUES

The U.S. is suffering a balance sheet recession, an entirely different animal from your garden-variety post World War II inventory-led recession. Every recession between 1945 and 2008 was arguably related to the inventory cycle, which is to say that companies invested in the capacity to produce more and more goods – often durable goods – in anticipation of future demand and then a recession sets in when demand falls short and companies cut back sharply on investment.

The private sector has been deleveraging (paying off debt and/or defaulting on it) for all of 2010 and, while this has brought us closer to sustainable levels, there is much farther to go relative to historic norms (see chart). Consumer credit is in the dumps, especially when we subtract out the sudden inclusion of student loans in the data. Loans extended for commercial and

Chart 1: US household finances



Source: Bloomberg. Our calculations.

Standing on the brink of New Year what can we expect from the world's largest economy in the twelve months to come? Will manufacturing continue to contribute to economic activity through an inventory cycle, which has run longer than we initially expected? Will the consumer step up to the plate?

Industrial purposes are still contracting at a run rate of 8 percent per year and we only look for loans to flatten and possibly increase slightly in 2011. While the U.S. economy will grow in 2011, let us not get carried away. The unemployment rate will remain very high, even if it edges lower towards year-end. This will mean many consumers will continue to look to deleverage their balance sheets, even as others increase their spending. Overall, the rate of deleveraging must



decrease next year to see the reasonable growth we project.

The big question for 2011 is whether these are indeed new times for the American consumer or whether old habits quickly return. Is this a 'new normal' or was 2008-2010 simply an intermezzo before the U.S. returns to the "good ol' days" of 2-3 percent savings rates and Ipads for everyone! The savings rate currently hovers around 5.7 percent, much higher than the 2 percent observed in 2006-07, but down somewhat from a post-recession high of 6 percent. While we encourage Americans to continue this newfound frugality and prefer consumers to cultivate it even more, wishful thinking and the eventual reality rarely share the same destiny.

Given the improved outlook for 2011, aided by the Obama package, we expect the savings rate will not move higher from the current level. Rather, we even see a possibility of a slightly lower rate, which will be much cheered by policy makers. The reason is that a decline in the savings rate feeds into consumer spending and with private consumption accounting for roughly 70 percent of GDP, any reduction in the savings rate will provide an immediate boost to GDP. While we prefer higher savings and investment for sustainable growth the lure of a short-term fix, which a

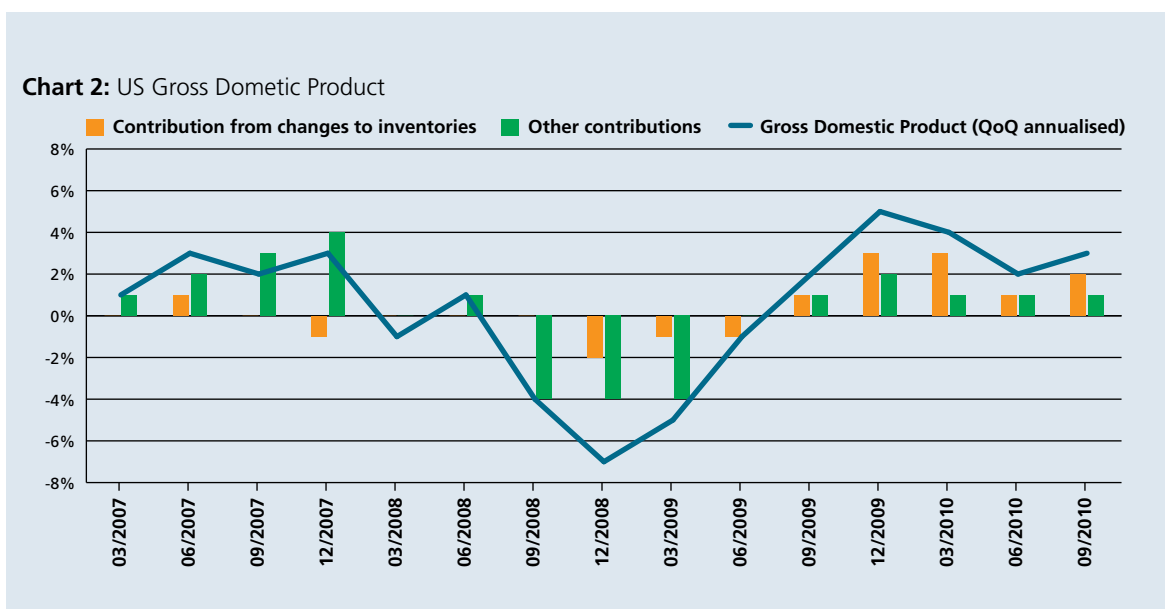
lower savings rate amounts to, is about as far ahead as most policy makers seem to think.

**SHORT-TERM BOOST FROM MONEY-SQUANDERING GOVERNMENT POLICIES**

Waning stimulus programs, among them the American Recovery and Reinvestment Act (ARRA), led us in our Yearly Outlook 2010 to predict that the second half of this year would see fiscal stimulus reverse into a drag. However, no such thing took place. And given the expected passage of the Christmas package that is President Obama's extension of former President Bush's tax cuts, jobless benefits and a payroll tax break, we expect the public sector to be less of a drag in 2011 than projected earlier. We look for the initiatives to boost GDP growth by 0.5 percent point in 2011.

**PRIVATE INVESTMENT SUBDUED AS INVENTORY CYCLE FADES**

As panic erupted in the fall of 2008, firms slashed inventories and investment at a ferocious pace, which dragged growth even deeper into negative territory. Since then an inventory rebuilding cycle set in as it turned out that companies over-reacted to the crisis. We are now back to pre-crisis inventory levels and further expansion in the manufacturing sector therefore rest on consumer spending. We therefore expect the



Source: Bloomberg. Our calculations.

inventory cycle to have run its course come the second half of the year.

Turning to residential investment, we expect the housing slump to continue throughout 2011. Indeed, house prices may well fall for most months of the year, enough so that it will likely serve as a drag on the economy in general. Our base case for housing is a weak market of slowly falling prices, with the assumption that delinquency rates remain fairly stable since much of the mortgage rate reset shock is behind us, though there is still a good deal in the pipeline. Great efforts have been made by the Fed and the administration to revive the housing market, including low mortgage rates and homebuyer tax credits, which have all failed to stop the cycle of price correction. In the process the problem of low mortgage rates seems to have been either misunderstood – or worse – ignored. As the herd refinanced in the last decade, little attention was given to the fact that not only do you get lower interest expenses when you refinance, you also re-extend the duration, which will be particularly

unpleasant for baby boomers who are upside down on their home equity and are on the brink of retirement.

#### **DISINFLATION IS STILL THE NAME OF THE GAME**

We expect disinflation to stay with us throughout 2011, especially as it pertains to the core index of consumer prices. We view the recent surge in assets as a combination of lower demand for readily available cash and a misguided inference that quantitative easing will eventually cause money to flow into the economy and push up prices for everything. There is still a huge output gap of excess capacity and unutilized potential labor (the unemployed) that must be closed before we see more any worrisome inflation rates.

We like the U.S. economy compared to other major western economies such as the UK, the Euro-Zone, and Japan, and look for growth to accelerate in 2011 and end the year with GDP growth of 2.7 percent with further upside potential, but a weak labour market, continued disinflation, and household deleveraging remain threats for sustaining the strength of the recovery.

<b>Forecasts</b>		<b>FY-2010</b>	<b>Q1-2011</b>	<b>Q2-2011</b>	<b>Q3-2011</b>	<b>Q4-2011</b>	<b>FY-2011</b>
USA							
Gross Domestic Product	YoY (%)	2.8	2.5	2.7	2.8	3	2.7
Unemployment Rate	%	9.7	10	10	9.8	9.5	9.8
Consumer Price Index	YoY (%)	1.4	1.2	1.5	1.5	1.5	1.4

**Source: Saxo Bank Strategy & Research**

## EUROZONE: A YEAR TO REMEMBER OR A YEAR TO FORGET?

A quick glance at key economic indicators may give the impression that the Eurozone has recovered reasonably well from its deep recession. GDP growth for 2010 was an estimated 1.7 percent in 2010, but the aggregate Eurozone growth figure hides a huge gap in economic performance among the individual member states. Export-dependent Germany boomed last year while the peripheral countries are mired in a sovereign debt crisis. The best of times and worst of times were seen in Europe in 2010, depending on your focus.

### FUEL SUPPLY DWINDLES FOR GERMAN LOCOMOTIVE

Germany saw the economy collapse by 6.6 percent year-on-year in the first quarter of 2009 as manufacturing crashed due to dwindling global demand for German goods. In particular, domestic investment in machinery and exports plummeted, bottoming at -23.6 percent and -18 percent, respectively in mid-2009. A quick turnaround soon followed as global demand for German products flourished despite a strengthening Euro.

The German locomotive will lose steam this year as the supply of fuel declines. Internal Eurozone demand will be meagre as most members engage in some degree of austerity. Not much benefit will be derived from the Euro either; the performance of which we expect will be distinctly average, (and German exports are less Euro sensitive anyway). More than 70 percent of German trade with foreign countries involves European trading partners and while German exporters are increasingly turning their eyes in the direction of Asia, the continued weak growth expected in most Eurozone countries, the peripherals in particular, will not be kind to the German export machine.

### THE NEXT PIG TO ROAST...

The PIIGS acronym gained much notoriety in 2010 as Greece and then Ireland struggled with skyrocketing

yields, and we do expect Portugal and Spain to come under similar fire from the credit market over the funding of its sovereign debt. Italy is the dangerous wild card. Spain may be different to the other PIIGS in terms of the magnitude of its outstanding debt, but it still faces other problems, like as a devastated post-bubble housing market and looming troubles at the regional banks (cajas), not to mention enormous amounts of debt that must be rolled and fiscal deficits that must be funded by someone. In addition, Spain has significant exposure to Portuguese debt, meaning that if and when Portuguese debt is restructured, the potential for contagion is a threat to Spain as well.

The problem for the Eurozone is that it is a monetary union without an accompanying fiscal union, so monetary policy may not be tailored to each specific country's needs. While this often results in a cry for a fiscal union to address trade imbalances, we rather argue that the peripheral countries have been living beyond their means as they feasted on interest rates that encouraged credit and housing bubbles and loss of competitiveness. Over the last 10 years, the PIIGS have seen poor productivity gains, excessive consumption, and increasingly uncompetitive wages. This must be corrected internally and is not Germany's fault. Germany does not force its goods on other nations, they choose to buy them, and now they must realise that this is something they can no longer afford.

2011 is shaping up to be an eventful year for the Eurozone. Either the Euro bloc muddles through without another sovereign casualty or Germany will have to accept a solution that involves either E-bonds or ECB monetisation. We look for weak growth in the Eurozone of 1.4 percent next year, but fear that risks are mainly to the downside. Inflation should retrace a bit while unemployment remains disturbingly high.

Forecasts		FY-2010	Q1-2011	Q2-2011	Q3-2011	Q4-2011	FY-2011
Eurozone							
Gross Domestic Product	YoY (%)	1.7	1.8	1.5	1.1	1.3	1.4
Unemployment Rate	%	10	10	10	9.8	9.8	9.9
Consumer Price Index	YoY (%)	1.6	1.5	1	1	1.5	1.2

Source: Saxo Bank Strategy & Research

## UK: THE SURPRISE STORY OF 2011?

The UK economy is in bullish mood as we stand on the brink of 2011. The latest batch of data have outperformed market expectations and suggests an economy in good shape ready to tackle the looming drag that will arrive with impressive austerity measures decreed by the new government. Is this a correct description or simply a case of demand pulled forward as the entire nation is aware of the hammer that will fall at the beginning of the New Year? While there can be no doubt that the coming budget cuts will impact short-term economic activity, we believe that the economy may bounce back towards the end of the year and into 2012.

### DOMESTIC DEMAND TAKES A HIT

The austerity measures call for a GBP 81 billion reduction over a four-year period, of which 9 percent or 7 billion will be in welfare support. In addition, public-sector jobs will be reduced by almost half a million in five years and the retirement age will also be raised. All of these will contribute to weaker contributions from the public sector to GDP in years to come. Our expectation is, however, that the cuts are so narrow in scope that consumer sentiment will not be hurt excessively meaning that consumption is unlikely to take a big hit in 2011.

With that said the recent improvement in retail sales ahead of new increases in taxes such as the VAT, which

will be raised to 20 percent in January 2011 from 17.5 percent, suggests that demand has been pulled forward in the short term as consumers made one final stand before the austerity measures begin in earnest. Hence, we look for a weak first half of the year in terms of consumer spending, but expect the great force of mean reversion to be a cause for improvement in the second half of the year.

### GROWING INVESTMENT AMID WEAK HOUSING MARKET

Like many other developed economies, the UK is struggling with a housing sector that is in a post bubble environment. The correction that began in 2007-08 was temporarily reversed by the tremendous lowering of interest rates, but now prices seem to be falling in earnest again, and could continue to do so in 2011 as prices revert slowly back to their long term mean.

Overall, this leads us to conclude that sentiment on the UK economy is likely too negative at the moment and that a revival will be underway as we exit 2011. We thus look for GDP growth to average 2 percent in 2011, but with a early-to-mid slump before reaccelerating into 2012. Unemployment, hurt by the layoffs in the public sector, and CPI will both remain high though the latter will come down to 2.3 percent for 2011 from an expected 3.2 percent in 2010.

Forecasts		FY-2010	Q1-2011	Q2-2011	Q3-2011	Q4-2011	FY-2011
UK							
Gross Domestic Product	YoY (%)	1.7	2.5	1.8	1.6	2.2	2
Unemployment Rate	%	7.8	8	8	7.8	7.5	7.8
Consumer Price Index	YoY (%)	3.2	2.8	2.6	2.1	1.9	2.3

Source: Saxo Bank Strategy & Research

## JAPAN: ANOTHER DIP IN THE ROAD?

It would be an understatement to say that Japan could possibly see a double dip in 2011. The country is a perennial recession risk and looks set to start the year on a weak note and should a dip materialise, it will be the nineteenth dip since 1989 if we look at quarter-on-quarter growth rates and the seventh using year-on-year growth rates. Regardless, Japan just cannot seem to escape its flirt with stagnation as the 1.1 percent annual growth rate since 1989 can attest to. So what is in store for the underachieving Land of the Rising Sun?

### DOMESTIC DEMAND TO EASE BACK AT FIRST, THEN EXPAND MODERATELY

A quick glance at domestic demand in 2010 shows vigorous growth, but this picture of the domestic economy was heavily influenced by a bevy of government programmes. These have distorted consumption growth by pulling demand forward into 2010, but are now expiring. Furthermore, the employment picture remains bleak, which will inhibit growth on the consumer level in 2011.

Employment has been a rollercoaster ride in the last ten years with unemployment peaking at 5.5 percent in 2002-2003 before it dove to 3.6 percent in mid-2007. A reacceleration then took the rate to its highest rate on record of 5.6 percent in July 2009 and we currently stand at 5.1 percent despite solid economic growth of no less than 5 percent in the most recent four quarters. With growth set to decelerate in 2011 with the possibility of negative growth in one or more quarters, employment will not receive much support from this front. At the same time, however, growth is set to slow down because unemployment is so wide-

spread, which means that private consumption will have a difficult time getting traction.

### IT'S THE TRADE SURPLUS, STUPID!

A slight rephrasing of the well-known slogan from former U.S. President Bill Clinton's successful campaign of '92 makes it apt for the Japanese economy, which has spent the better part of three decades in a trade surplus. Unlike its neighbour, China, Japan has not been accused – officially at least – of engaging in active currency devaluation and out of generosity we will refrain from pointing out the Bank of Japan's futile endeavours in this area in mid-September. That should not distract us from the fact that Japan's economy ebbs and flows with global trade, but perhaps the picture is a tad more nuanced than often discussed. The net exports-to-GDP ratio currently stands at 1.2 percent, which is a far cry from the heyday of the eighties when it was routinely above 2 percent with a peak of 4 percent in 1986. Indeed, in the last decade the ratio has averaged 1.2 percent as Japan has struggled to escape another "lost decade". The flipside of the coin is of course that domestic demand has averaged just below 99 percent of gross domestic production in the 2000's.

Is the Japanese export machine damaged for good or will Japan bounce back in style? The first half of the year looks tough for the economy in general and the exporters in particular. First, the yen has had a strong year on a trade weighted basis, which was basically due to a weak U.S. dollar. This has had a dampening effect on net exports, which have been running consistently around JPY 600 billion in the second half of 2010. Our view on the U.S. dollar, however, may be

Forecasts		FY-2010	Q1-2011	Q2-2011	Q3-2011	Q4-2011	FY-2011
Japan							
Gross Domestic Product	YoY (%)	4.3	1.6	1.2	0.7	1.6	1.3
Unemployment Rate	%	5.1	5	4.8	4.5	4.5	4.7
Consumer Price Index	YoY (%)	-0.5	0	-0.5	-1	-1	-0.6

Source: Saxo Bank Strategy & Research

the lifejacket Japan has been searching for. With USD-JPY set to surge in our base scenario combined with a fairly flat EURJPY, net exports appear to be set for a comeback as we progress through the year.

Overall, our expectations for the Japanese economy are – unsurprisingly – nothing to be excited about. Economic activity is expected to decelerate in the first half

of the year as stimulus wanes before picking up some momentum as global trade shifts into a higher gear. Prices will stagnate at first before deflation returns as the temporary drivers of upward price pressure vanish.

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## POLICY RATES IN 2011

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**U.S.:** The final weeks of 2010 were characterized by what might be described as an outbreak of 'irrational exuberance', to borrow Alan Greenspan's famous phrase.

Choosing to ignore continuing downbeat housing market reports and the extremely disappointing U.S. Labour report, released on December 3rd, which featured a paltry 50,000 increase in private payrolls and a surprise move higher in the unemployment rate to 9.8 percent, the market decided to focus instead upon marginal improvements in consumer confidence, the Institute of Supply Managers report on Manufacturing, and a modestly robust Retail Sales report—a notoriously volatile series of data.

It may also be that investors were unduly influenced by the apparent agreement between Democrats and Republicans to extend the Bush-era tax cuts, across the board, accompanied by cuts in payroll taxes. In fact, the boost to GDP growth is expected to be relatively muted—of the order of 0.5-1.0 percent—leaving GDP still only growing at 2.5-3 percent in 2011. There is a famous law of economics, known as Okun's Law, which states that for every 1 percent by which actual real growth exceeds trend growth, (the long-term median growth potential for the economy), the unemployment rate will fall by 0.5 percent so, according to this tried and tested correlation, one might expect the incremental impact of the tax cut extensions on the unemployment rate to be a median reduction of the order of 0.375 percent—hardly 'game-changing', against a headline unemployment rate of 9.8 percent, (with the wider 'U6' measure of unemployment, including discouraged part-time workers, standing at 17 percent).

The Federal Reserve seems to be taking a more cautious approach to developments. The most recently released 'Beige Book', which collates reports from its 12 districts, was still distinctly measured in tone. Although one could describe it as cautiously optimistic in aggregate, it continued to portray consumers, (70 percent of the economy, let us not forget), as price sensitive and determined to limit discretionary expenditure, but the really chilling part remains the housing market story,

with residential activity described as remaining, 'at a low level', and the commercial market 'mixed'.

Recent reports for Housing Starts, Building Permits, Existing and New Home Sales and Price Indices have all been below expectations, and still mired at historically dreadful absolute levels.

This is why the most recent meeting of the Fed's interest rate-setting committee, the FOMC, contained only the remotest scintilla of improvement in its description of economic conditions. Indeed, one almost needs to be a code-breaker to even discern any significant improvement in outlook in the post-meeting statement.

The words used to describe the recovery in output and employment became "economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment" whereas, after the previous meeting the characterization was simply "slow". Consumer spending was said to be 'increasing at a moderate pace', instead of 'increasing gradually'. Which is better?

There were similarly Delphic references to the depressed state of the housing market and the fact that, "measures of underlying inflation" continued to trend downward"—if anything more downbeat than the previous, "have trended lower in recent quarters".

Finally, although the FOMC was silent on this occasion with regard to its Quantitative Easing programme, Chairman Bernanke recently confirmed in a 60 Minutes interview that additional bond purchases were "certainly possible". This was hardly a ringing endorsement of growth prospects.

The decision as to whether to extend Quantitative Easing has become quite politicized, in light of recent Senatorial moves threatening to change the Fed's dual mandate to a single, inflation-focussed objective. The question is whether such threats can be realized or if they will prove empty in the face of continuing, historically high unemployment.

*Against this back-drop we expect the Federal Reserve to maintain its current target for the Fed Funds rate of 0 to 0.25 percent throughout 2011, and see a 50 percent chance of further purchases of U.S. Treasuries by the Fed, as unemployment and inflation rates remain stubbornly mandate-inconsistent.*

*Top idea: Buy the June 2012 Eurodollar future at 98.61, and 'ride down the curve'; this contract should be trading at 99.40 by year-end 2011.*

**Eurozone:** When observing the somewhat contorted deliberations of the ECB, (as in all things 'Euro' often a desperate exercise in consensus management), one is vividly reminded of an alcoholic, addicted to monetary conservatism, suffering from Delirium Tremens hallucinations in the form of an imaginary inflation demon.

If things had gone according to script, the ECB's headline overnight interest rate would long ago have been raised from the current crisis level of 1 percent to more 'normal' levels and all those tiresome extraordinary liquidity provision schemes, (or LTRO's as they are known), would long ago have been consigned to the waste bin-where, no doubt, the prevailing orthodoxy which tends to dominate ECB thinking would believe they belong.

Instead of this, all that the inflation warriors have managed to achieve is a technically induced stealth tightening of the interbank interest rate market, (with 3-month money now costing just over 1.0 percent, as opposed to a low of 0.634 percent in March 2010), and 3-month LTRO's are set to continue for at least another three months, in January, February and March. Eurozone banks in many countries are still dependent on the drip-feed of liquidity from the ECB, since interbank lending remains inaccessible for them. To cap it all, the ECB continues to have to buy the sovereign bonds of many weaker, peripheral nations, just to put a floor under prices, in some cases.

Meanwhile, although growth in Germany is looking relatively robust, the economies of Southern Europe and Ireland seemed doomed to endure anaemic growth at best, and in some cases contraction or reces-

sion, due to the extraordinarily acute deficit reduction measure which have been forced upon them by the sovereign debt crisis, which shows signs of rumbling on throughout 2011. Indeed, the crisis may yet intensify, as a sort of Paradox of Thrift starts to appear at a national level in the weaker economies-although fiscal austerity is both desirable and unavoidable in Portugal, Ireland, Italy, Greece and Spain, it will be difficult, if not impossible, to avoid the unintended consequence that this austerity leads to a decline in economic activity, and hence in tax revenues, in turn exacerbating the very deficit problems it is meant to address.

*In light of all of the above, there seems little prospect that Eurozone interest rates will be rising any time soon, and we predict that the official Refinancing Rate will remain at 1 percent throughout 2011.*

**Japan:** The predominantly export-driven nature of the Japanese economy should mean that it continues to be supported by the recovery in global growth that we expect to see in 2011, although exporters will also continue to face the challenge of a stubbornly strong yen.

However, we see little scope for any meaningful increase in momentum coming from domestic consumption, with scant opportunity to deploy further significant fiscal stimulus, due to the dangerous debt mountain which Japan has already amassed.

*Turning to monetary policy, there is no prospect whatsoever of any increase in policy rates from their current level of 0.1 percent during 2011, indeed one should expect further non-conventional monetary stimulus, in the form of Bank of Japan purchases, (mostly of JGB's), beginning possibly as early as the February meeting, and continuing periodically throughout the year to counter-balance the lack of additional fiscal boost.*

**U.K.:** December's release of CPI for November at 3.3 percent, year-on-year, was still stubbornly above the Bank of England's 2 percent target, and slightly above expectations. This continues to present the Monetary Policy Committee with an uncomfortable dilemma; their expectation is for CPI to peak at 3.6 percent in Q1



2011 and, thenceforth, to begin a gradual decline so that, within 18 months, it will be below target.

However, in January the VAT rate will increase from 17.5 percent to 20 percent, leading to an increase in CPI-maybe by as much as 0.5 percent, depending on the ability of businesses to pass on the hike. This is obviously a one-off effect and the MPC continue to 'look through' this, and the current blip in CPI, (as they see it).

The trouble is that this is a long game and they have been 'looking through' above target numbers for more than a year now and the risk is a loss of credibility for the MPC, leading to an increase in medium-term infla-

tionary expectations. The offsetting factor is obviously the impending tightening of fiscal policy which is of unprecedented proportions in living memory.

*For all of the above reasons, this is a very close call, but we think the MPC will leave rates on hold at 0.5 percent throughout 2011, and, very probably have to increase Quantitative Easing, as fiscal tightening bites.*

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## FX OUTLOOK 2011: GREENBACK TO REIGN SUPREME?

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Last year, our 2010 outlook asked whether the never ending theme of hyper correlation of risk appetite with the USD- and JPY-funded carry trades would end. The answer was “maybe” for the JPY and “definitely not” for the USD, which traded almost the entire year as the flipside of risk appetite. We suspect that 2011, however, could finally see some decoupling of this pattern. Perhaps surprisingly, we wonder if the USD is set for a win-win situation in 2011, even if we dislike the currency’s longer term potential. Elsewhere, the G-10 FX landscape is littered with extreme valuations as we leave 2010. Aussie is in the ionosphere and the Euro, GBP and the USD are in the dumps. We expect some mean reversion in currency valuations in 2011, though the path to that mean reversion remains cloudy. One thing seems certain: volatility promises to go nowhere but up, especially considering the tense dynamics of the global macroeconomic picture as we head into the New Year.

### **THE CUSP OF 2011: SETTING THE SCENE**

As we head into the New Year, the macro-economic dynamics are very different from those we saw as we headed into 2010. Recovery or not, the major developed countries are in a woefully vulnerable state for one reason or another, and, outside of (Fed- and stimulus-enabled) reasonable growth expectations in the U.S., growth projections aren’t particularly inspiring for the world’s largest developed economies. What growth there is and will be in the New Year has been enabled by over-active central banks that have dropped all talk of exit strategies (all the rage last December, we must recall) and are engaged in the fight of their lives to get their economies’ growth rates back to trend.

Meanwhile, too much of the easy money from the major developed countries seems to be winding up as capital flows to emerging markets, where asset markets and domestic economies are on fire once again and the threat is more one of overheating than anything else. Also, the developed world’s central banks have been so ready to reach after the printing press as the solution to all problems, that the theme of the demise of fiat currencies has gripped the market’s attention and sent hard asset prices rocketing higher. Central bank policies are heightening global trade tensions and already, a number of EM countries like South

Korea and Brazil have already moved to stem strength in their currencies with capital controls and punitive taxes on foreign owned assets within their countries.

In 2011, the ECB, Fed, BoJ and BoE will all remain in easy money mode, while major emerging market economies – China, in particular – are in the fight of their lives to put down potential asset and credit bubbles and overwhelming capital flows from the virtually non-yielding developed. This mismatch of policy needs could prove an explosive cocktail and promises plenty of volatility; in particular if the various participants dig in with further punitive measures aimed at curbing currency movements. The irony of all attempts to control a currency is that they often prolong imbalances and make the eventual fall-out from misguided policy that much worse.

A couple of potential scenarios in 2011: commodities continue to march higher until growth is reduced by collapsing corporate margins and a higher percentage of global workers’ pay dedicated to the bare essentials rather than discretionary spending. Another scenario: China slams on the brakes and the country lurches into a hard landing that sees a profound reassessment of global growth potential, particularly since China and its satellites have been such a significant global growth driver since the dark days of early 2009. Neither scenario is particularly emerging market positive nor positive for risk appetite.

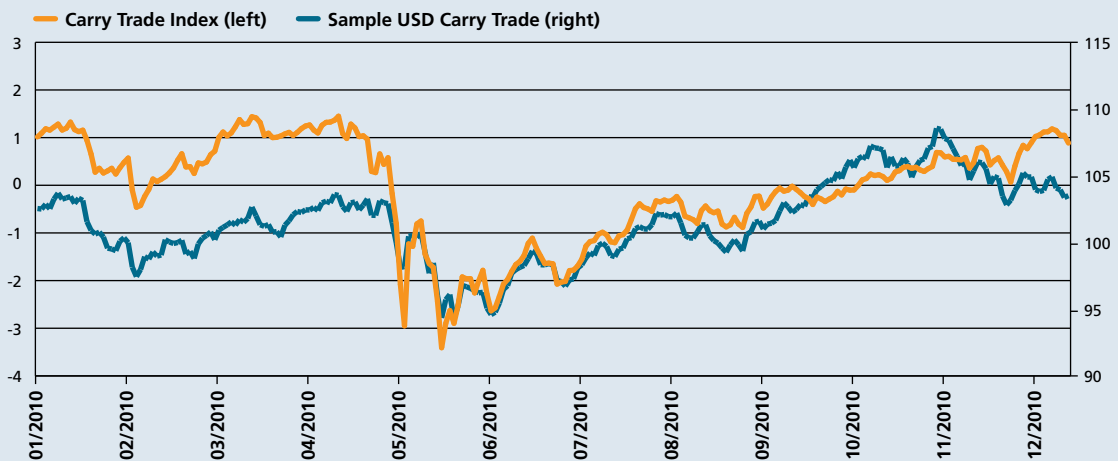
Whether one of these two scenarios proves the correct one, we have a hard time imagining an extension of the current environment of a simultaneous rise of interest rates, commodities prices and equity prices for any appreciable length of time in the New Year. Something’s got to give eventually: while all three can eventually fall if growth projections prove overoptimistic, not all three can continue the upward spiral we’ve seen since early November. Eventually, risk would have to consolidate if interest rates or commodity prices continue to rise from their late 2010 levels. The only way we get the Goldilocks scenario is if growth continues while interest rates and commodities remain range-bound, a scenario that would continue to favour risk assets. Our FX forecast for 2011 assumes a less sanguine outcome for risk – as you can see below in our outlook for the G-10 currencies.

**USD: WIN-WIN IN 2011?**

At the tail end of 2010, the USD has bounced significantly after the steep sell-off in anticipation of the QE2 announcement in early November. That rally can be written off as a result of overzealous market positioning in USD-funded carry trades and a classic sell-the-rumour, buy the fact kind of reaction to the Fed's well anticipated QE2 move. But that explanation is a bit too easy, and the fact is that despite the Fed's huge new commitment to purchase \$600 billion in U.S. Treasuries by mid-2011, interest rates have surged since the QE2 announcement, helping the USD to look far less unat-

tractive in terms of yield comparisons with the rest of the world. The return of the Euro sovereign debt crisis and a BoJ lurching into massive new QE moves have also helped the USD to look less bad in what amounts to an ugly contest among the G3 currencies. Against other currencies, the scenarios outlined in our main outlook both favor the USD as the market has a profoundly large structural short in the USD heading into 2011, and complacency on global growth is extremely high. Any disappointment of the anticipated strong continuation of the global recovery would see an unwinding of USD-funded pro-risk positions. (An alternative argument is that even if the growth stumbles along quite well in the U.S. and elsewhere, the world may look elsewhere for funding currencies where yields are even lower – CHF, JPY and even EUR come to mind). So it appears that it may be a win-win year

**Chart 3: Saxo Bank Carry Trade Model**



*Saxo Bank Carry Trade Index. Our Carry Trade Index looks at a variety of risk appetite indicators to determine whether the trading environment favours carry trades, which generally only thrive when markets are in a positive mood. Over most of 2010, the USD, with its very low yield, rather sombre economic outlook and large twin deficits, was the ideal funding currency in conditions of improving risk appetite (any time the Carry Trade Index was rising) and generally rallied when markets moved into risk aversion mode (Carry Trade Index falling). Note, however, that not long after the Fed announced its QE2 measures in early November, the USD's performance began to improve – this is a dramatic divergence from one of the most stable and tight intermarket correlations of the last couple of years, and begs the question: is this a sign that the USD bear market is ending and that the USD could be a leading indicator for worsening risk appetite (the Fed's easing was instrumental in much of the speculation in global asset markets in the second half of 2010) or is this just a brief USD rally as US rates have risen considerably as the market assumes that the Fed is done for now and a handful of other, even lower yielding currencies like the JPY, CHF or even the Euro eventually could become preferable for carry trades in the future? Either scenario looks relatively positive for the US dollar.*

**Source: Bloomberg. Our calculations.**

tractive in terms of yield comparisons with the rest of the world. The return of the Euro sovereign debt crisis and a BoJ lurching into massive new QE moves have also helped the USD to look less bad in what amounts to an ugly contest among the G3 currencies.

for the USD, despite the awful long term implications of fiscally imprudent moves like the budget-shredding Obama/Republican tax deal. It is an important caveat to our outlook that the U.S. begins to show signs of moving toward fiscal austerity in 2011, perhaps driven by a Tea Party-invigorated Congress.

Another important factor to consider in the coming year is the possibility that the Fed's star has peaked and that it could come under increasing pressure from the obstreperous new Congress that will take office in January. It is clear that Bernanke wouldn't hesitate to launch further rounds of QE to address the mounting debt crisis at the municipal and state level if he felt the need was there. But will the Congress move to block further Fed activism? Certainly, resistance to the Fed is growing on both the political and even popular fronts.

#### **EUR: WHERE'S THE BOTTOM?**

It is clear that the Eurozone is headed for a very critical test for its survival – a test we believe it will eventually fail in the longer run beyond the horizon of this outlook, but not before EU politicians and ECB make a significant effort to keep the motley crew of nations in political and monetary union. Any effort, regardless of the form it takes (enlargement of the rescue fund and/or some new powers granted to the ECB that make possible new, unsterilized quantitative easing), it has Euro-negative implications. There are also reasonable odds that one or more of the nations at the Eurozone periphery actually defaults, considering how obviously in their best interest such a move would be. An example: why should Irish taxpayers be put on the hook and make foreign banks 100 percent whole for unwise decisions made in commercial real estate market in the bubble days? Any default would clearly throw the already highly leveraged European banking system into disarray, with a massive need for public backing of banks and all of the negative implications a banking crisis would have on the currency and economic growth. Such a move would also see an explosion in debt spreads on contagion fears – fears that the ECB and EU political leadership would have a very hard time putting a lid on. The EU is headed for the fight of its life.

While the year may be one of win-win for the USD, it could be one of lose-lose for the Euro in the short to medium term. The only solace some investors might find is that the world is already very pessimistic on the Eurozone's prospects and that the currency might be a safer harbour than some of the most pro-risk currencies in 2011.

#### **JPY: DR. JEKYLL OR MR. HYDE?**

The outlook for Japan in 2011 clearly hinges on the interest rate outlook, as it nearly always does. As long as interest rates head higher in an environment of positive risk appetite, the JPY will remain relatively weak as domestic investors look to foreign shores for superior yield and the JPY could even become a favoured funding currency for carry. This is the Dr. Jekyll side of the JPY's potential in 2011.

A more dramatic Mr. Hyde scenario for the JPY is this: if interest rates go into a tailspin once again as risk appetite contracts at some point during the year and the commodities rally fades, the JPY could see an aggravated rally as domestic investors bring their funds home and carry trades are unwound. The BoJ would inevitably crank up the printing presses in response to such a development, and it could finally succeed in setting off a JPY devaluation if the Japanese bondholders (almost all JGB's are held by domestic savers) revolt as they consider the implications of the eventual QE straw that will break the Japanese Yen's back on an impossibly high public debt burden. The domestic market has reached the saturation point on its JGB holdings and can't absorb any more and foreign buyers would demand a higher yield. Even with rates at almost zero and at no more than 125 bps for 10-year bonds, more than a quarter of the Japanese budget is used on interest payments for the public debt. Any further rise in already stupefying debt levels could see an amazing lurch from deflation to high inflation in the blink of an eye if the least crisis in confidence triggers any kind of "run on the bank". That run becomes an eventuality whether the route to such a run is via higher interest rates or via the printing press. So 2011 is a year of two-way risks for the currency, but all scenarios point to eventual JPY weakness.

#### **GBP: SURPRISING STRENGTH?**

The pound sterling and the USD saw a similar trajectory in 2010, as their fundamentals were largely similar: two countries overwhelmed by dysfunctional banks, massive twin deficits, and central banks more or less in continued QE mode. Where the two currencies dramatically diverge going into the New Year is on the political front. While the U.S. administration

and Congress have connived to bloat the short term deficit further in the coming year with what amounts to a new stimulus bill, the freshly minted UK government has gone on an “austerity spree” if there is such a thing. The new government’s measures will include a rise in the VAT, public wage freezes and other spending cuts. While not a harbinger of super strong growth rates, these new measures do show a kind of dynamism and political willpower not at all evident in the U.S. – a good sign for the longer term potential for the UK economy to return to proper health and balance, especially if a good solution is found to the hobbled UK banking dinosaurs. To boot, the UK can congratulate itself that it never chose not to join the continent’s currency union, a decision that could bring plenty of strength versus the single currency in 2011. As an alternative to mounting problems and unrealistic expectations elsewhere and due to its very cheap valuation, the pound could be a surprisingly strong performer next year.

#### **CHF: A CONUNDRUM**

Something structural has happened over the last year to the Swiss franc: the currency has entirely decoupled from the kind of safe haven behaviour it exhibited for the last 10-12 years, in which it more or less moved in negative correlation with risk appetite. Instead, the franc is incredibly strong considering its virtually non-existent yield and the resurgence in risk appetite in the second half of the last year. The newfound CHF strength has come on the back of the European sovereign debt debacle (Switzerland has very modest public debt to GDP ratio relative to most of the other developed economies) and perhaps as well due to a positive feedback loop from hedging due to its appreciation as so many loans abroad were financed in Swiss franc during the boom years. In 2011, the franc may appreciate further as the Eurozone crisis wends its way to a climax of one kind or another, but at some point, the franc’s very strength becomes a self-correcting phenomenon, damaging competitiveness and braking Swiss economic activity, which may have gotten an artificial boost in 2010 from the monetary stimulus provided by the SNB’s misguided and failed efforts to intervene against the currency’s strength. The country’s enormous financial sector (with assets more than

six times GDP) is also a risk, considering our negative view on risk appetite and the likelihood for a tougher regulatory environment going forward. Once EURCHF bottoms out in the New Year, the currency could go from strength to pronounced weakness for a time.

#### **AUD: ONE TRICK PONY TO STUMBLE?**

The Australian dollar hit its stride in 2010 again as if the global financial crisis never happened. After all, here is a country with little public debt, a relatively high interest rate, and an economy fully leveraged to piggyback the Chinese growth juggernaut with its commodity export complex of coal, metals, and other materials. But looking at the currency and the Australian economy as we head into 2011, we see several warning lights flashing. The economy is almost exclusively reliant on its resource extraction industries for continued strength, meaning any hiccup in Chinese demand as the regime there potentially launches a more determined effort to bring the country’s property bubble and inflation under control could see a dramatic fallout for the Australian economy. As well, on the domestic front, a number of worries include weak economic activity surveys outside of the mining sector, and the combination of an overleveraged consumer and a housing bubble that appears on the cusp of unwinding. AUD is overvalued and could end 2011 significantly lower.

#### **CAD: MIDDLE OF THE ROAD**

The Canadian dollar had its ups and downs over the course of the 2010, at first strong on the general resurgence in risk appetite during the first quarter of the year and sharply higher expectations for the Bank of Canada’s interest rate, but later weaker as the U.S. economic outlook deteriorated and as energy prices – the most important commodity prices for Canada’s resource mix – underperformed much of the rest of the commodities complex. With USDCAD threatening parity for much of the year, the Bank of Canada has been quick to slam the lid on further interest rate hike expectations. And, while economic strength in the U.S. could serve as a boon for Canada’s export industries in 2011, there are other worries for the Canadian economy, including a housing bubble that risks unwinding and a consumer that is even more overleveraged than

the U.S. consumer ever was during the credit bubble preceding the global financial crisis. USDCAD could head much higher in 2011. On the more CAD-positive side, however, Canada's finances and banking sector are in tip-top shape and can weather a considerable storm and the currency looks ridiculously undervalued against the other commodity currencies, especially the Australian dollar.

#### **NZD: OVERVALUED**

The kiwi rose to new highs versus the rest of the G-10 currencies during 2010, but by the end of the year saw its strength fading despite a generally positive environment for risk appetite and virtually all commodities. A relatively weak domestic economy was partially to blame, particularly as drought conditions seemed to be taking hold by the end of the year, which threaten the country's important agricultural exports. A lacklustre outlook from the RBNZ was no boost to the currency either. In 2011, we see risk appetite becoming a two-way street again, with significant risk for downside, and the kiwi, while much weaker than it was at its highs, could have much farther to fall relative to the rest of the G-10. Against, the Aussie, however, the currency is beginning to look underpriced, particularly if weather conditions for New Zealand's key food commodity exports improve.

#### **SEK: NEITHER HERE NOR THERE**

The Swedish krona enjoyed a strong resurgence in 2010 as it began the year at undervalued levels and as its export economy enjoyed a huge boom on generally strong external demand. The Swedish krona is generally a pro-cyclical currency, so it enjoyed strength whenever risk appetite was on the rise in 2010, and also looked like an attractive alternative to the Euro due to the single currency's special challenges. In 2011, the krona could enjoy some further strength on the expectation of a continued economic recovery, but trouble in asset markets could mean that the currency finds a ceiling relatively quickly.

#### **NOK: TOO CHEAP**

NOK receives the 2010 blue ribbon for "Quietest G-10 currency" after a year of very little volatility versus the broader market. Norges Bank was the first of the G-10

banks to hike all the way back in 2009, but quickly put on the brakes as its domestic economy (housing price pressure notwithstanding) saw anaemic growth and as crude oil prices were relatively flat for most of the year. Going into 2011, expectations for the Norges Bank are very weak, but the currency looks rather undervalued versus the commodity currencies in particular and could look especially attractive at any time the focus shifts to countries' public balance sheets, as Norway is a paragon of financial solidity. NOK is a buy against a basket of riskier currencies in 2011.

#### **G-10 FX TRADE IDEAS FOR 2011**

**Long GBPAUD** – the market positioning at the end of 2011 suggests that the UK's prospects are in the dumps where the belief for Down Under seems to be that trees can grow into the sky. This trade is a way to express the belief that the UK is at the vanguard in addressing its fiscal challenges and could see a better than expected trajectory in the new year while the AUD is at nosebleed levels and too dependent on a mining sector that could falter in 2011.

**Short EURUSD** – The Eurozone sovereign debt situation will take some time to sort through and policy efforts by the ECB can only mean easing monetary conditions and uncertainty at a time when the U.S. Fed may find itself increasingly sidelined by reasonable U.S. fundamentals and a hamstrung Fed. EURUSD could head toward 1.10-1.15 during the course of the year.

**Long CADJPY** – If the focus shifts to credibility on sovereign debt, here is your trade. Japan's problems will quickly accelerate and require a devaluation of the yen if interest rates head much higher in the New Year, while Canada is one of the best positioned major countries in terms of banking sector and sovereign debt credibility.

**Short NZDNOK** – this is a valuation play more than anything else. The Norwegian krone has been neglected while the kiwi's rise has been at least partially built on lazy assumptions and its exposure to Asia. Also, if risk appetite faces challenges in the New Year, NZD would likely suffer more than NOK.

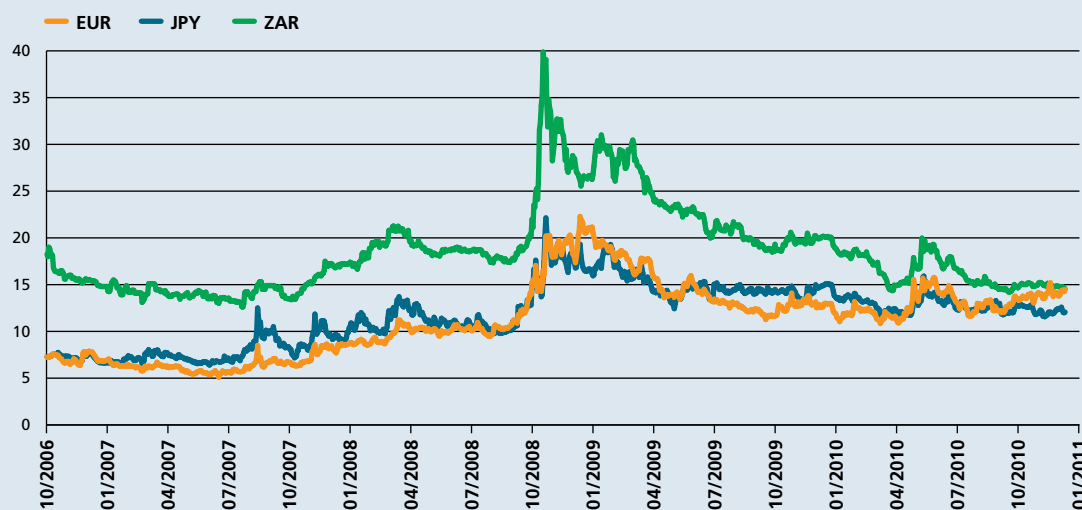
## FX OPTIONS: NAVIGATING IN A SEA OF RISK

Overall we see 2011 as a key period for FX, with economies across the globe still facing serious risks: unprecedented level of quantitative easing, sovereign credibility, and European tensions (politically and economically). All those, and many more, might well prove to be a non-issue in 12 month time and all might be well in the world. However, whilst hoping for the best, we need to be prepared for the worst. An option portfolio presents a unique opportunity to do so as it can provide great leverage in extreme market

*Long a 1 year 1.6000 GBP Call / USD Put, premium paid 535 USD pips (spot ref 1.5550)*

The UK government having put forward some tough measures from the start now seems to be in a better position to withstand further shocks. In particular, the pound seems a better tool than EUR to hedge a bullish USD view, with continuing concerns in the EUR zone and if one wants to play the angle of the UK gaining more credibility than the U.S. on the fiscal austerity

**Chart 4:** 6 mth implied volatilities



**Source:** Bloomberg. Our calculations.

conditions. We would therefore be on the lookout for cheap options to purchase and be keen to maintain an overall long implied volatility position.

The attached chart displays six month implied volatilities in EURUSD, USDJPY and USDZAR over the last four years. Volatilities are not back to their pre-crisis level, but we clearly see the explosive nature of option volatility under stress conditions.

With this in mind, we would favour the following strategies for the upcoming year:

front. In addition, the risk reversal still favours GBP puts heavily, making upside strikes trade at an implied volatility discount. Note that a long EUR Put / GBP call position might be chosen instead.

### **Long 1 year emerging market volatilities:**

*Long a 1 year 4.0500 EUR/PLN straddle for 3900 pips*

*Long a 1 year 7.1250 USD/ZAR straddle for 8400 pips*

Any market shock as the potential to unnerve emerging markets: as such we believe being long a basket of emerging market options could provide some interesting leverage should FX see the active year we expect. We chose EUR/PLN and USD/ZAR to try to diversify

somewhat, but more currency pairs could be added to the mix. This strategy provides a positive exposure to implied volatilities and could also provide many opportunities for delta hedging and active management.

*Long a 1 year 95.00 USD Call / JPY Put, premium paid 119 pips (spot ref 84.30)*

Low delta JPY puts have been a very crowded trade ever since USDJPY spot fell firmly below 95-100... as always with options (and trading), timing is everything. It might sound strange to enter a bullish USD trade despite relentless QE, but we feel the situation in Japan does not warrant going long JPY. As with the GBP trade, this strategy benefits from a discount for upside options due to the volatility skew.

*Short a 1 year 1270 XAU Puts / USD Calls, premium received \$71.5 per ounce*

Our only short volatility position is in Metals. We believe Gold (and other precious metals) will retain their safe haven status for the coming year (whereas you can print USD, the transmutation of base metals into gold is proving slightly more challenging!). With this in mind, we are happy to sell downside options in Gold to benefit from the high level of implied volatility. If exercised, the all-in entry level of the long Gold position will be sub-1200.



## EQUITIES: BULLS TO CONTINUE TO GET THEIR WAY?

We look for reasonable returns from equity markets in 2011 as we enter the mature phase of the earnings cycle in 2011. A period of cyclical strength in the US economy in particular could have the market projecting further reason to continue to bid up risk assets, though earnings growth could prove more sluggish than the consensus expects. We have a year-end target for MSCI World of 1,400, roughly a 10 percent gain on the end of 2010 level around 1,275.

### THE DRIVERS

We expect economic growth in 2011, especially in the U.S. and emerging markets. The increased confidence of investors and corporate executives in the sustainability of the economic recovery is the very foundation of our belief that solid returns in equity markets will materialize in 2011. As corporate executives gain confidence in the recovery they will start to re-leverage their balance sheets, spend more on hiring and increase capital expenditures (capex), which will support earnings growth and increase risk appetite for equities. Investors will applaud these actions to improve profitability from companies and lead to higher valuations as uncertainty about future free cash flow is reduced. Higher valuations in particular will drive returns in equity markets in 2011.

Normally at this stage of the earnings cycle, margins are peaking while sales have yet to really get going. We do not expect a strong pick-up in sales this time around, however, as final demand will only grow slowly in developed economies. Hence we expect continual margin improvement, but at a slower rate compared to previous years and we therefore doubt that the bot-

tom-up consensus of earnings growth will be achieved. The current forecast is for 15 percent globally, but we only target 7 percent. With a revenue growth forecast of only 6 percent globally, it is left to margin expansion to deliver growth in earnings. The last time margins peaked was back in 2006, but this was under unusually strong macroeconomic conditions. These are not around to support such an overshoot in margin expansion now, so margins will grow at a slower pace.

One of the main drivers of return in equity markets next year will be corporate re-leveraging. Return on Equity (RoE) will remain under pressure as cash balances are currently very high while profit margins are peaking. In order to protect profitability companies will start to increase their leverage through hiring, buyback share programs, dividend payouts and M&A to improve RoE. This will lead to P/E multiple expansions, which will in our view be the main driver of returns in 2011. And there is plenty of room for P/E multiple expansion; currently the 1-year forward P/E of MSCI World is 30 percent below the long-term historical average and even with modest earnings growth assumptions of 7 percent the implied global P/E would be 12.8; leaving sufficient headroom for further P/E multiple expansion offsetting slower growth in earnings.

### OUR REGIONAL PREFERENCES

In terms of regional preferences our first preference are still emerging markets, as this is in our view is where we will experience the highest earnings growth led by GDP growth. The BRIC countries will as such not be in sweet-spot as prior, but rather single countries in both Asia, Latin America and to lesser extent Central- and

#### Saxo Bank Forecasts world indices: Year-end 2011 level forecasts.

Index	S&P500	DJSTOXX600	Nikkei225	MSCI EM
Year-end forecast	1,420	315	11,400	1,350
Implied price return	13.6%	12.5%	10.2%	19.4%

Source: Bloomberg and Saxo Bank Strategy & Research. Closing prices at 29th of December used for calculating price returns.

Eastern Europe will be amongst our favorites. The less enthusiasm surrounding countries in Central- and Eastern Europe is due to the dependency of the Eurozone, which in our view will be the region where the least growth is – both in terms of earnings and GDP.

The U.S. is coming in as a strong second in the region hierarchy and here payrolls holds the key to equity market performance and the Eurozone will be in last as we still expect the sovereign debt problems emerge from time to time putting pressure on equity markets. Japan is clearly the joker here and we cannot stop thinking that we will see a rebound here.

### USA: more to come from equities

Valuation metrics for the U.S. S&P500 indicate that U.S. equities are attractive as earnings have recovered faster than prices. For 2011-12 we forecast earnings per share of USD 92 and 99, respectively, which imply earnings growth of 9.5 percent and 7.6 percent. This is below bottom-up consensus, which forecasts USD 96 per share for 2011 and USD 108 per share for 2012. Our year-end forecast for S&P500 is 1,420, a 13+ percent return for the year. If we decompose it, two-thirds comes from earnings growth and one-third originates from P/E expansion. However, it is clear from the multiple expansions that we could see a surprise to the upside in our year-end estimate.

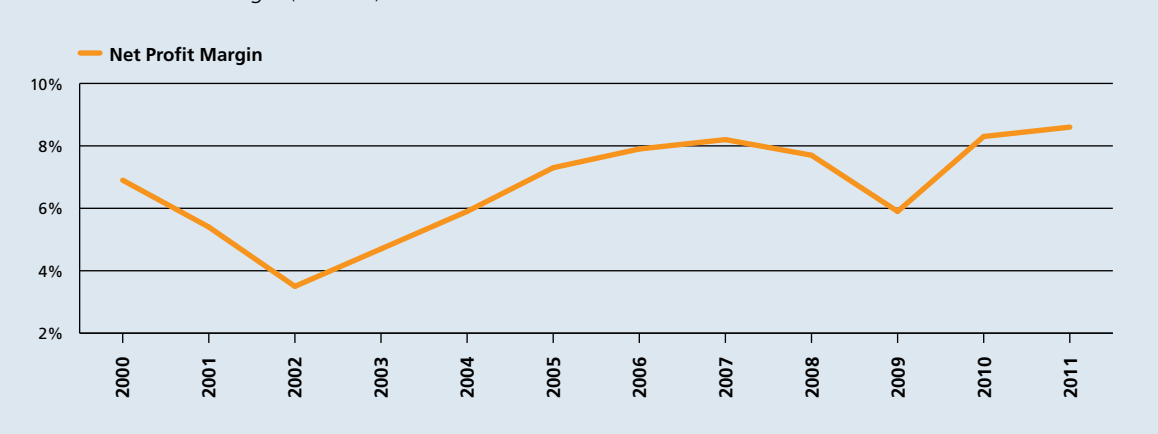
The macroeconomic background for earnings development in the U.S. is supportive. The cost of borrowing money is very low – the Fed Funds rate is virtually zero and we do not expect any change to the rate in 2011. Our inflation expectations are also low as we forecast headline inflation to average 1.4 percent, which is clearly below the Fed’s target range of 2 percent. And finally GDP growth is expected to grow by 2.7 percent year-over-year. In total this is a supportive macroeconomic environment for equities.

### SALES GROWTH, PROFIT MARGINS, AND EARNINGS

In 2010, we expected very little in terms of sales growth, but foresaw increases in margin expansion; this year it the other way around. The main driver behind sales growth over the long term is GDP growth, which we forecast to average 2.7 percent this year. This will drive domestic demand and hence help sales growth in S&P500. We forecast sales growth of 6.5 percent, while bottom-up consensus is expecting 6.8 percent.

What surprised us in 2010 was the strength of the comeback in profit margins. The corporate reaction to the setback in the economy in the last few years has truly been amazing. We have seen accelerating margin improvements in this recovery and standing on the verge of 2011 the question is: can it continue? The short answer is no.

Chart 7: Net Profit Margin (S&P500)



Source: Thomson-Reuters Data-Stream and Saxo Bank Strategy & Research.

The low interest rate regime and the possibility of refinancing debt at lower costs combined with higher GDP growth will be supportive of further increases in margins, but we look for smaller improvements in 2011. This is partly due to our expectation of higher input costs. Commodity prices are expected to increase, especially industrial metals, which will inhibit growth in margins. Add to this that further increases in productivity will translate into demands for higher salaries and you have our case for why the growth in margins observed in the last few years will not continue in 2011. Bottom-up consensus for S&P500 ex. financials is for a profit margin at 9 percent, but we look for 8.6 percent.

Besides sales growth and continued high profit margins there is an additional reason for solid earnings growth in 2011. The cash/asset balance for S&P500 ex. financials is now at 10.8 percent, which is a record high. We look for the ratio to come down this year as future earnings growth will be bought through share repurchases, M&A, and spending on capex.

of the world increased the cost of equity and this put downward pressure on valuations as investors were reluctant to hold risky assets. These are still present, but expect the economic recovery to overshadow them and give investors more confidence of a robust longer-term expansion.

#### SECTOR PREFERENCES

In terms of sector preferences we prefer in the first half of year to ride along with the pro-cyclical wave and get exposure to companies within energy, technology and basic materials as these sectors are the ones who will benefit the most from further signs of the economic recovery. Besides this sector we look for companies with a part of their sales outside the U.S. and preferably within emerging markets. In the second half of 2011 we expect a rotation in equity markets towards a more midterm earnings cycle portfolio so we look to increase exposure to healthcare and industrials.

#### Saxo Bank Forecasts for S&P500 ex. financials

Index	Sales Growth (YoY)	EBIT Margin (level)	Earnings Growth (YoY)
S&P500	6.5%	8.6%	9.5%

Source: Thomson-Reuters Data-Stream and Saxo Bank Strategy & Research.

#### P/E EXPANSION IS KEY IN 2011

If we assume no expansion in P/E during 2011 this would leave us with a year-end target of S&P500 at 1,370. However as S&P500 is currently trading at a P/E multiple of 13.6 of our 2011 estimated EPS and given the current low interest rate this implies a P/E multiple in the range of 14 to 16. This leaves considerable headroom for P/E multiple expansion pushing prices higher. The major driver of P/E multiple expansions is the cost of equity, which is directly linked to investors' willingness to carry risk. The macro risks that were present in 2010, especially the fear of contagion of the sovereign debt crisis from Europe and to the rest

#### Europe: subdued earnings growth

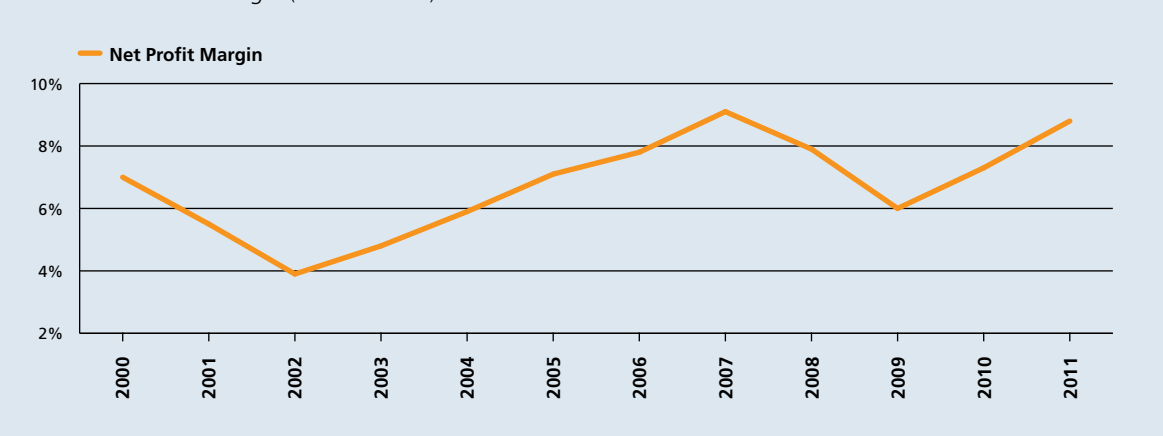
The major difference compared with the equity market outlook for the U.S. is the expected weaker growth within the Eurozone and U.K. For the companies in DJSTOXX600, around 62 percent of their sales are within the Eurozone or the U.K. and given the weak outlook for economic growth in Europe, earnings growth will be hurt by slow sales growth. In terms of valuation, Europe should follow the U.S. and see higher stock prices on the back of P/E expansion. For 2011 we forecast earnings in DJSTOXX600 at EUR 23.9 per share and for 2012 earnings at EUR 25.9 per

share, which imply earnings growth of 7.2 percent and 8 percent, respectively. This is way below bottom-up consensus, which forecasts earnings at EUR 25.7 per share for 2011 and EUR 28.8 per share for 2012.

Our year-end forecast for DJSTOXX600 is 315, a return of about 12.5 percent for the year and if we decompose this, roughly half comes from earnings growth and the other half from P/E expansion. Compared with the U.S. more weight is put on P/E expansion as the driver for European equities.

is partly due to more rigid labor markets in Europe. We forecast growth in margins of 12.9 percent for 2011 while bottom-up consensus is looking for 16 percent. This leaves us with an estimated margin of 8.8 percent for DJSTOXX600 companies – somewhat higher than the margin of 8.6 percent expected for S&P500 companies, but still not passing the all-time high back from 2007. Despite stronger profit margin development in Europe the lack of sales growth weighs heavily leaving earnings growth of 7.2 percent for DJSTOXX600 compared to an expected earnings growth rate of 9.5 percent in S&P500.

**Chart 8: Net Profit Margin (DJSTOXX600)**



**Source: Thomson-Reuters Data-Stream and Saxo Bank Strategy & Research.**

**SALES GROWTH, PROFIT MARGINS, AND EARNINGS**

The macroeconomic environment in the Eurozone is not supportive for earnings growth as 62 percent of revenues of DJSTOXX600 companies is from the Eurozone or U.K. Given our GDP estimates of 1.4 percent and 2 percent for the Eurozone and the U.K., respectively, earnings for these companies are not going to be supported as much by improving macroeconomic conditions compared to the U.S. We forecast a sales growth of 5.0 percent compared to an expected U.S. sales growth rate of 6.5 percent.

The margin expansion outlook is, however, somewhat better in Europe than in the U.S. European companies have not been as efficient in their efforts to streamline their operations as their American counterparts, which

As in the US besides sales growth and continued high profit margins there is an additional reason for reasonable solid earnings growth in 2011. The cash/asset balance for DJSTOXX600 ex. financials is at roughly 10% though somewhat away from breaking all time high, but like in the U.S. case we look for the ratio to come down this year as future earnings growth will be bought through share repurchases, M&A, and spending on capex.

**P/E EXPANSION IS KEY IN 2011**

European equities will need to get more help from P/E expansion in order to reach the expected target for DJSTOXX600 compared to the S&P500. If we assume no expansion in P/E during 2011 this would leave us with a yearend target of 300. However given our

**Saxo Bank Forecasts for DJSTOXX600 ex. financials**

<b>Index</b>	<b>Sales Growth (YoY)</b>	<b>EBIT Margin (level)</b>	<b>Earnings Growth (YoY)</b>
DJSTOXX600	5.0%	8.8%	7.2%

Source: Thomson-Reuters Data-Stream and Saxo Bank Strategy & Research.

2011 EPS estimate the 1-year forward P/E multiple is trading at 11.7 whereas the P/E multiple in these market conditions might be expected to reach 13-14, which leaves potential upside for stocks. The trigger for further upside is higher investor confidence in the economic recovery – though less so in Europe compared to the other major developed countries. However this is expected to lower the cost of equity and boost valuations.

**EUROPE: WEAKER OUTLOOK COMPARED WITH OTHER MARKETS**

In a global setting, European equities look weaker than other markets, mainly due to the weaker expected GDP growth, which affect sales growth as analyzed before in this section. The main beneficiaries of the relatively stronger growth in the U.S. and strong growth in emerging markets are exporters who have their major part of their sales outside the Eurozone or the U.K.

**SECTOR PREFERENCES**

In terms of sector preferences Europe is aligned with the U.S. case where we prefer to ride along the pro-cyclical wave in the first half of the year and get exposure to companies within energy, technology and basic materials as these sectors are the ones who will benefit the most from further signs of the economic recovery. Unlike the U.S. case we are only looking for companies with major part of their sales outside the Eurozone and U.K. as these regions will experience low sales growth. Our preference is getting exposure to emerging markets, but exposure to the US will also suffice. We expect a rotation in equity markets towards a more midterm earnings cycle portfolio so we look to increase exposure to healthcare and industrials.

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## COMMODITIES: A STRONG BEGINNING, BUT DANGER LIES AHEAD

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The commodity sector had a strong finish to 2010 as cheap money combined with an improved economic outlook supported cyclical commodities such as base metals and energy products. The weather shocks throughout the year left global supplies of agricultural products struggling to keep up with demand, leaving it vulnerable to additional price appreciations.

Commodity prices look set to continue to the move higher during H1 of 2011 with the potential for another double digit return on the TR Jefferies CRB index. Demand from emerging markets like China, Brazil and India is expected to remain strong while emerging signs of a U.S. recovery will increase the competition for basic resources.

We do, however, see a risk of commodity prices overshooting due to high growth expectations for China and the U.S. When this last occurred in 2008 commodities spiked higher before tumbling as the global economy went into reverse gear.

Other factors that could have an adverse impact on commodity prices is the continued risk of sovereign debt defaults, which twice led to corrections during 2010, China applying the economic brakes even harder and, as we forecast, a stronger dollar.

The phenomenal growth in exchange traded funds and commodity index funds continues, after investor holdings reached a new record during 2010. Very low real rates will continue to support investments in alternatives, such as commodities. Tight physical supplies have lead to several commodities going into backwardation with the price of the near term contract trading higher than the price for later deliveries. This is benefitting passive investments through ETFs and index funds as the cost of rolling forward positions on these has been removed.

### **PICTURE OF WTI CRUDE SPOT MONTH**

Towards the end of 2010 global inventories of energy began to shrink fast. This helped WTI crude oil rise towards levels not seen during the previous two years and this is the main reason for raising the price esti-

mates for 2011. Improved economic indicators from the U.S., the world's largest oil consumer, have been an important catalyst for this move.

During December, the spot price moved above the forward price for the first time in two years as tightening inventory levels from increased demand helped change the shape of the forward curve. This again will improve the return that investors receive on passive investments in ETFs and index funds and help to support prices.

With global oil demand expected to mirror the record from 2010 we see the potential for WTI crude trading in a range between 80 and 100 dollars during 2011 with the outside chance of overshooting through 100 dollars before correcting. OPEC, with a spare capacity of six million barrels per day, has indicated that 90 dollars is the top of their comfort zone with any sustained move above likely to trigger a response. The speculative long position in crude oil is at an all time high and that will probably be one of the biggest worries ahead as it can lead to major corrections along the way.

### **PICTURE OF GOLD SPOT**

We believe that gold still has some way to go and see a potential for reaching 1,600 dollars over the next 12 months.

The investment space for gold has become very crowded over the past few years and that combined with our forecast of a stronger dollar poses the biggest risks for a further price appreciation. It will therefore at times be volatile, experiencing corrections of 5-10 percent, but the overall direction will be higher.

The factors that drove Gold to a new all time nominal high in 2010 look set to continue and a positive return for the 11th year in a row can be expected. Central Banks became net buyers of gold for the first time in two decades in 2010, especially those in emerging economies such as China and India. At the same time, mining companies have stopped forward selling their production.

It is a popular belief that gold should be a hedge against inflation. We believe that to be inaccurate, it is a hedge against instability. The quantitative easing introduced by the U.S. Federal Reserve increased the demand for hedges against the possible threat of deflation or subsequent inflation due to the growth in money supply. The sovereign debt crisis in Europe remains unresolved and it continues to attract safe-haven buyers.

Investments in gold have become much easier for retail investors to access over the last couple of years, so much so that total holdings of gold by exchange traded funds stands above 2,000 tons, more than twice the amount in China's national gold reserves. These types of investments are non-leveraged and as such will be held by investors as long-term investments like stocks thereby removing some of the volatility and risks that normally accompanies investments in leveraged gold futures.

#### **PICTURE OF CORN FRONT**

The crop most supported by fundamentals is corn with inventory levels at a 15-year low due to reduced yield and robust demand, especially from increased ethanol production and feed demand. In 2010 more than 35

percent of U.S. corn production went towards producing ethanol and with the forecast for higher gasoline prices over the next year, this will support ethanol/corn prices. Demand for corn feed has also shown an increase, especially from China where the increased wealth has shifted people's dietary behaviour towards meat products (and corn is a popular feed grain for livestock and poultry).

Grain and soybean prices increased dramatically in 2010 driven by exceptional weather shocks across the globe that limited supplies and drew down stocks at a time when demand was growing strongly. China increased its imports of soybeans and became a net importer of corn for the first time in years. Tight supplies are also expected in 2011, but higher prices are expected to trigger increased production which should leave prices at elevated but stable levels barring any additional weather shocks.

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## WHAT NEEDS TO BE DONE? A 10 STEP PLAN TO FINANCIAL STABILITY AND GROWTH

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While we forecast that the odds favour the continuation of the relatively feeble recovery in 2011 for the major economies, we are concerned that this recovery continues to rest on a very unhealthy foundation of endless public sector debt and artificial life support provided by central bank printing presses and accounting gimmicks. Here we suggest the 10 steps necessary to truly get the major developed economies back on a healthy trajectory. And yes, we are fully cognizant that these steps will not be carried out, but even a move in their general direction in the New Year would be a great victory for the economy and a remarkable sign that sanity is gaining a foothold among the powers that be.

- All bank assets need to be marked to market. If some assets are illiquid, a tenth of the position should be sold in the market and the resultant price should be used to mark the rest of the position on market on the balance sheet. This step will help to regain trust in the financial system.
- Banks revealed to be insolvent by marking to market should either be closed down via a normal, old-school bankruptcy process or – assuming they are Too Big To Fail – be taken over by government, which should erase all shareholder equity, let the bondholders suffer a loss and convert the bonds to equity and then let the bank float again with new equity. If the last step is not enough, depositors should take a hit and their cash should then be converted to equity. This step will help to reduce moral-hazard and let reckless speculators take responsibility for their actions rather than letting tax payers pay.
- All government guarantees on behalf of the financial sector should be discontinued. This includes depositor insurance and bond issues. It should be made perfectly clear that any failing bank will be left on its own. No bank should be Too Big To Fail and every bank should be subject to the tough discipline of the (interbank) market.
- The board of banks should be made personally liable if the bank they control is becoming insolvent (as was the case with the previous partnerships in the financial sector). This step will help make boards act in a responsible and risk-averse way.
- All government budgets should as a minimum be balanced immediately via spending cuts. While not a pleasant exercise, it should be done in order to stabilize government debt markets. The cuts should concentrate on social welfare and pension schemes, which are grossly underfunded and unrealistic relative to the future tax base. This step will help reduce government borrowing costs and make them serviceable.
- Governments should set out to cut taxes (especially income taxes and capital gains taxes) dramatically within a two-year horizon. This step will make capital available to small and mid-sized companies, which deliver most of the growth in GDP and labour utilization. It will at the same time make it more attractive to work rather than receive government welfare.
- Central banks should tighten monetary policy in order to stimulate savings and discourage debt financing. This will help to clear the market for savings and investments.
- Interest rate expenses should not be tax-deductible so as to not encourage excess debt financing.
- Any resulting deflation should be welcomed as a way to achieve cheaper products and restore competitiveness in export markets.
- Wages should be allowed to drop as well, since the unit labour costs (adjusted for PPP) are way too high in the Western world.

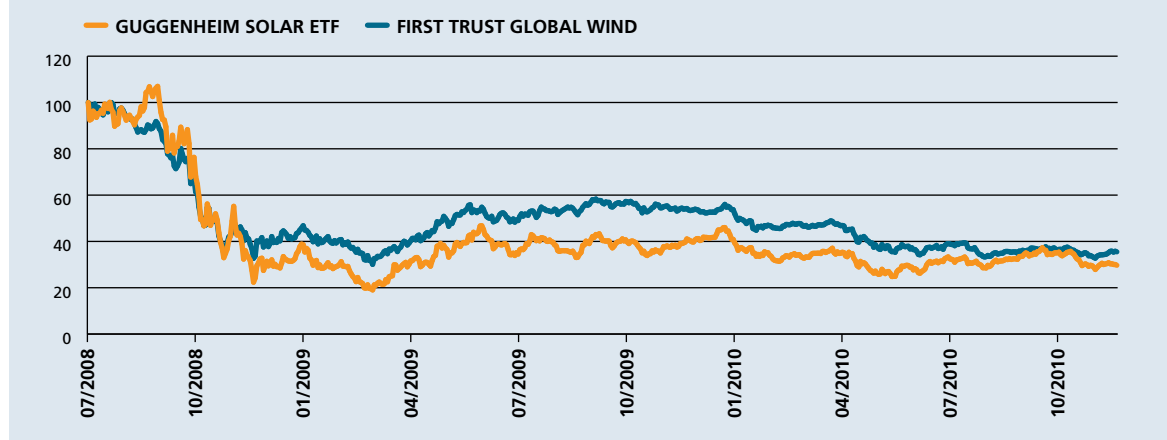


## SPECIAL REPORT: SOLAR ENERGY TO SHINE IN 2011?

Despite the failure to make “progress” on climate change issues at the Cancun climate change conference in Mexico, climate change and energy policy are still hot international topics. We expect the sun will shine on solar stocks in 2011 with a potential upside of at least 30 percent from current levels. The main drivers are strong demand, expansion of valuation multiples, a stable political outlook and lower production costs.

2011 quarterly earnings are released, we expect the market will change its mind on solar stocks and send P/E valuations much higher from current levels for trailing 12-month earnings of around 9.6. An industry for which demand is projected to grow 9.6 percent annually until 2030 should not be valued at 9.6 times earnings because earnings growth normally exceeds growth in volume (demand) due to higher operating

**Chart 5:** Share price development Solar and wind Industry (2008-2010)



Source: Bloomberg. Our calculations.

### SOLAR STOCKS WILL RISE LIKE A PHOENIX FROM THE ASHES

The latest years have been brutal for the solar and wind industry, as seen in the performance of the Guggenheim Solar ETF and First Trust Global Wind Energy ETF that track the solar and wind industries. The indices are still trading 60-70 percent lower compared to the summer of 2008 and even had a lousy performance for 2010.

Valuations on solar stocks have been held back by concerns that excess supply relative to demand will crush the industry's profits.

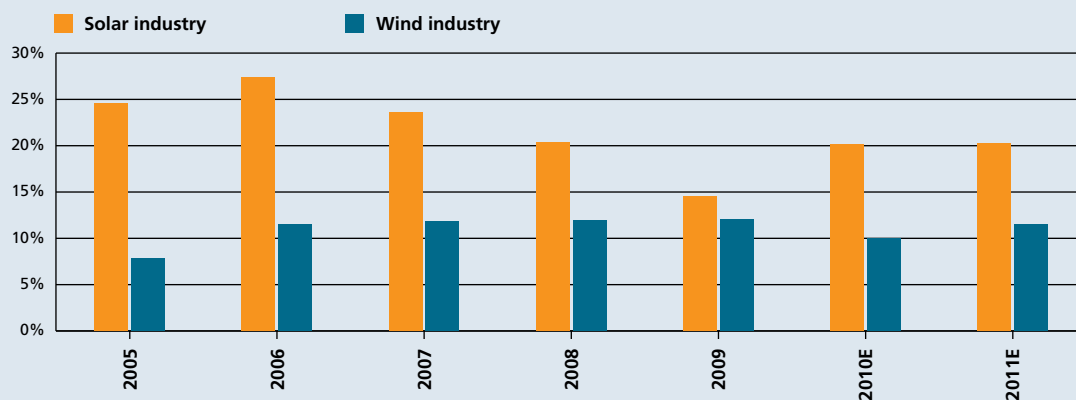
We believe the market is far too pessimistic and the latest outlook for 2011 demand from the leading solar companies First Solar and Trina Solar indicate higher demand in 2011 – even in Europe despite concern over subsidies and tighter budgets. As the

efficiency and share buy-back programs later in an industry's growth cycle.

### WHY DO WE LIKE SOLAR MORE THAN WIND?

Let us look at market pricing relative to expectations. The solar industry's revenue is expected to grow 22.5 percent in 2011 compared to 15.4 percent for wind. Profits in the solar industry are expected to grow at 28.7 percent compared to 71 percent for wind. The high growth rate expectations for wind are due to the decline in 2010 profits. With 2011 forward P/E for the solar industry at 7.5 compared to 15 for wind, the margin of safety is way larger in solar stocks. The current forward P/E for solar stocks indicates that investors doubt the earnings growth rate in solar stocks and this is where the upside lies. If the solar industry even gets close to 28.7 percent growth in earnings (anything over 15 percent might even suffice), this could send solar stock valuations way higher. On the other hand, the current forward P/E of 15 for wind on a

**Chart 6:** EBITDA margin (%) (2005-2011E)



**Source:** Bloomberg. Our calculations.

71 percent expected earnings growth makes wind stocks unattractive compared to solar stocks. If the wind industry does not deliver there will be pressure on wind stocks throughout 2011 unless expectations for 2012 earnings are revised significantly higher.

From the perspective of industry profitability, solar energy is also more attractive than wind energy. Solar companies have historically produced slightly lower returns on equity compared to the wind industry with the drag coming from lower leverage and asset utilization. This is about to change and the solar industry is expected to deliver higher return on equity in 2010 and 2011 compared to wind driven by increasing asset utilization and significantly higher profit margin.

Generally, the solar industry has higher operating (EBITDA) margins and less leverage compared to wind. This signals a healthier competitive situation, and if the solar industry is able to increase asset utilization, return on equity could easily pass the 15 percent mark in 2012.

The extended tax grant program (1603) in the U.S. will support solar demand in 2011 and into 2012 and we believe it will compensate the expected slowdown in Spain and Germany due to cutbacks on subsidies there.

With bullish expectations for 2011 from all solar companies, low valuations, increasing asset utilization and stable EBITDA margins, we expect solar stocks are positioned to go much higher in 2011 when valuations multiples are expanding on strong earnings.

#### HOW TO INVEST IN SOLAR STOCKS

One way to gain basic equity exposure to solar energy is through the Guggenheim Solar ETF, which is a broad basket of solar stocks – from pure producers of wafers and PV solar panels, to producers of the new solar thin films and end-sellers across the U.S., Europe and Asia. It gives you diversification, but not necessarily the highest return.

Another way to play solar stocks is through individual stocks. Taking into account expectations about revenue, margin and profit growth for 2011 following stocks look attractive with low forward P/E ratios and expected EBITDA margins expansions above the industry; JA Solar Holdings Co. (4.62), Solarfun Power Holdings Co. (4.90), LDK Solar Co. (5.44), Trina Solar (6.39) and GCL Poly Energy Holdings Ltd. (9.90).

#### RISK ASSESSMENT

Investing in solar stocks provides huge upside but it obviously comes with a couple of risk factors such as political, currency, demand and supply risk.

The political risk in solar investments is high because the industry is still heavily dependent on government subsidies. Germany is talking about cutting the feed-in tariffs for PV solar systems by 16 percent on July 1, 2011; political decisions are obviously an important risk factor. As the industry moves closer to grid parity the political risk will, however, slowly decrease which will lower the risk premium on solar stocks. With Obama's extension of the tax grant program (1603) political stability in the U.S. is secured in the short-term and the road to strong growth in U.S. renewable energy in 2011 is paved.

With Europe's 75 percent share of new installed solar capacity in 2009, the Euro remain an important risk factor because most of the revenue is settled in Euro and most of production costs are denominated in Chinese yuan, which lead to strong correlation between earnings and the Euro. According to Bloomberg, the two most respected and accurate currency forecasters, Standard Chartered and Westpac Banking, are both short-term bearish on the Euro and expect it to decline to around \$1.20-1.25 by mid-2011. Third quarter statements from solar companies indicate the industry believes U.S. demand will compensate the falling Euro and demand in the Eurozone.

Concerns over low demand in 2011 (particularly in Europe due to declining feed-in tariff environment and tighter budgets) and excess production of solar panels have previously prevented multiples to expand despite increasing aggregate earnings in the solar industry. The latest outlook for orders in 2011 somewhat contradict this concern. The extended tax cuts in the U.S. will also add support for solar demand.

#### **SOLAR ENERGY IS THE FUTURE**

The solar industry has evolved from infancy into a rapidly growing industry with increasingly economics of scale. According to Exxon Mobil's "Outlook for Energy – A View to 2030" renewable energy including solar is set to grow at 9.6 percent annually until 2030.

General Electric's chief engineer, Jim Lyons, is predicting grid parity in sunny parts of the United States by around 2015 and that solar will eventually be bigger

than wind. The biggest driver in achieving grid parity is production costs on solar panels. Renewable Energy Corporation and Q-Cells, the two biggest makers of solar cells expect to continue lowering costs for solar panels next year.

Life insurance companies are also a supporting driver for solar demand because they have entered the market as owners and are providing financing because solar parks provide a relatively stable income stream that is also independent of other assets classes. With internal rates of return on solar projects running around 8-10 percent with fairly low risk, this is a great opportunity for insurance companies to diversify their investment income.

The growth potential is enormous. The largest PV market in Europe is currently Germany and here solar only supplies around 0.3-0.5 percent of the total power production so there is plenty of room for growth on a global basis.

#### **DROP THE IDEOLOGY AND GO FOR PERFORMANCE**

Whether global warming is a true trend or not renewable energy is here to stay because governments around the world want a cleaner and more fossil fuel independent energy source.

What we have learned through the financial crisis is that when governments and central banks intervene in the markets it tends to do it forcefully and investors should not underestimate its impact on investment opportunities.

Our message is this; do not underestimate the will of governments to support the solar industry going forward. We do not prefer subsidies to certain sectors, but we have to be realistic. Solar is rapidly moving towards grid parity, demand is soaring, governments want this energy source, the solar industry will eventually become competitive without subsidies and its size will eventually dwarf the wind industry. In 2011, the sun may shine on solar energy.

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### **SAXO BANK INVESTMENT**

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