



CAPITAL MARKETS

Outlook 2006

Asia Goes It Alone

Foreword:

Foreword: Welcome to our outlook for the global economy and developments in the major global asset classes over the coming 12 months. Summing up our basic theme for the coming year, we believe Asia will experience a revival lead by a Japanese recovery from 15 years of deflationary hibernation. Rates will go even higher in the US than the market expects, but by year-end, the rate outlook will deteriorate with the housing market. The European economy will be uninspiring in 2006 and again show low growth rates. Gold and silver will again surprise to the upside and one major US automaker will default.

The Saxo Bank Market Strategy Team

Copenhagen, December 30, 2005

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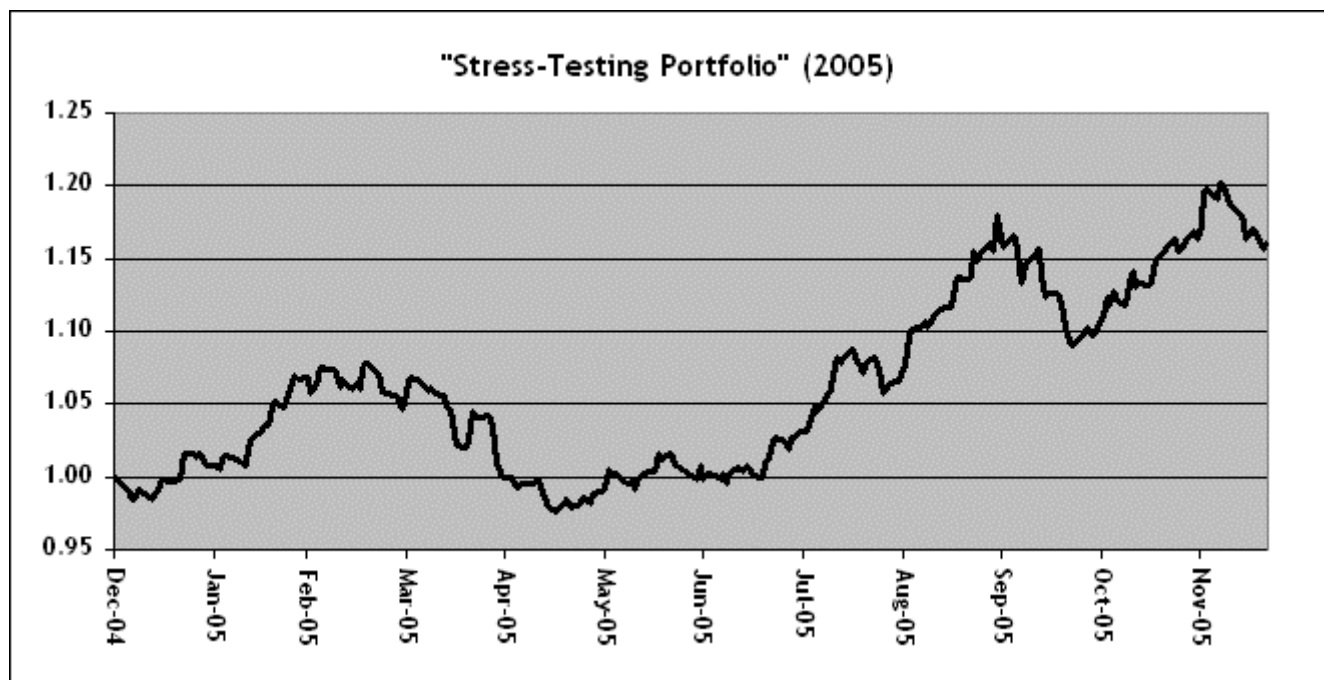
2006: the Global and Asian Revival Portfolio

Heading into 2006, we take ten new theoretical positions based on the analysis we have presented in this outlook – combining the *Asia Goes It Alone* theme with other themes in interest rate and forex market

A quick look back at our 2005 calls

Our "Stress-Testing Portfolio" for 2005 of ten individual stocks fared well (about 18%). We picked out shares on the basis of a scenario of rising rates, overheating global trade logistics, rising energy costs, commodity inflation and

an increased need for capital goods. Our biggest gainers in the 10-item portfolio were Cia Vale do Rio Doce (long), which was up 61% YoY and Maersk (long), which gained 42% YoY. Our biggest losers were Astra Zeneca (short), which lost 33% and Toll Brothers (short), which lost 16%.



P&L of the Saxo Bank Stress-Testing Portfolio of 2005 for all of 2005.

The Portfolio for 2006 - Forex

1) +Long JPY basket: Short 33% NZD/JPY, short 33% USD/JPY, and short 33% AUD/JPY

In our opinion, Japan will wake from the deflationary hibernation in 2006. Rates will

rise and JPY should shrug-off the negative sentiment from the doldrums of the 1990's.

2) -Short GBP basket: 33% Short GBP/SEK, Short 33% GBPCHF, long 33% EUR/GBP

The UK rate outlook is fast falling and the traditionally high-yielding currency will be sold

in an unwinding of the GBP-related carry trades. This is a relatively low-risk play in the forex market, despite having the carry against you.

Commodities

3) +Long Spot Crude Oil

Energy is in for a rough year in 2006, but we are looking for generally higher prices in 2006 than in 2005. The worst that could happen for this part of the portfolio is that global growth stalled and energy consumption declined.

4) +Long Spot 50% Silver and 50% Spot Gold

2006 turned out to be the year where precious metals manifested their secular bull market. Both gold and silver are higher in terms of all the major currencies. Everyone is talking about the lack of central bank selling or outright central bank demand.

Equities

5) -Short General Motors (GM.N)

The company is in bad shape in several key areas. Off balance sheet liabilities are the main concern internally while competition from its rivals is beginning to take its toll. The outlook is gloomy to say the least and we can't see much supporting the stock.

6) +Long Chevron (CVX.N)

Overall energy prices will remain at lofty levels in 2006 and oil-related look to have another

great year. The company will likely benefit from further margin improvements and appear cheap compared to its rivals.

7) +Long Pfizer (PFE.N)

Big Pharma has had a rough year and is now trading at far from inflated levels. Pfizer, the maker of Viagra, should emerge from its slump in 2006 and offer potent returns. It is fundamentally inexpensive with a high yield.

8) +Long Deutsche Telekom (DTGn.F)

A solid company in a beaten down sector. We like its dividend yield and the likelihood of a rebound following a sluggish year. A good and conservative play and our only exposure to the European equity market.

9) +Long Sekisui House (1928.T)

Domestic demand holds the key in the “go it alone” scenario and we like the prospects of the housing market for 2006. The stock's valuation is a concern but not when comparing it to the sector.

10) +Long IShares Brazil (EWZ.N)

With the WTO negotiations soon concluded and significant promises on the table to cut farm subsidies, import tariffs and export subsidies, Brazil stands to gain an important advantage from the negotiations if only half of these promises become true.

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Outrageous Predictions for 2006

We renew our tradition this year of offering our 10 outrageous claims, which in most cases are extreme but in our opinion have a fair chance of actually happening. Our clients are asked if they agree or disagree on these issues and the results can be found below.

Of the ten Outrageous Claims for 2005, only three came true (Fannie Mae declined to 50, Crude Oil did advance to 60 USD/bbl and Gold did go to 500 and beyond). We were almost right in calling for the ECB to leave rates unchanged for the whole of 2005, but they decided to hike in mid-December.

We were most wrong in calling for much higher interest rates in 2005. This is perhaps the single biggest mistake of our Yearly Outlook 2005, but also our “trade of the year” (EUR/JPY to 125) now seems outright foolish, although it might happen in 2006.

As always, we are making these calls to stimulate thought and make our clients think about their portfolio in a new way. This year’s Outrageous Calls are somewhat less related to the overall theme of the Outlook.

We are generally looking for an Asian Revival, for weakness in the US economy later in the year and an uninspiring European economy. We also expect problems in the derivatives markets and the auto industry as well as the financial industry. Perhaps the most significant event of 2006 would be a turnaround in the US housing market, which would have far-reaching implications for the world economy.

	Prediction	Ratio
1	Nikkei to test 10-Year highs (22750+)	2.53
2	Feds Funds Rate to 5.00%	2.22
3	10-Year JGB's to 123 (currently 136.50)	1.89
4	US house prices down 7%	1.61
5	30-Year Moodys baa graded spread to governments to 2.5% (currently 1.6%)	1.25
6	NZDJPY to 67 (currently 80.50)	1.11
7	GM to default.	1.03
8	S&P Financials to underperform 15% vs. S&P500.	0.97
9	USDTRY to 113 (currently 135)	0.58
10	New German Elections will be held.	0.27

We should point out here that a ratio close to 1 is remarkable. since based on previous trading ranges and volatility most predictions *are* pretty outrageous.

This year, our clients agree a lot more with our claims than last year. In only three cases did a majority of clients disagree with us.

Clients wholeheartedly agree with our bullish stance on Japan, since a large majority expects Nikkei to test 10-year highs (on claim we ourselves find very outrageous) and since

they expect the 10-year JGB's to sell-off violently.

All in all, we are a bit disappointed with ourselves, since our Outrageous Calls in the eyes of our clients almost look mainstream. Well, we will have another chance next year.

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2006: Asia Goes It Alone

It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time.
- Sir Winston Churchill

Asia is about to leave Europe and the US in the dirt. The growth prospects for Asian countries are immensely more attractive than in the old, Western economies. In the long run, it is all about saving, investment, hard work and dedication. Debt-financed consumption and high taxes Western style are not a path to growth. This is a theme that will gain momentum in 2006, where we will Asia continue to pull ahead.

Over the last two or three decades scores of economic analysts and cultural commentators have been eager to announce the new Asian century or even millennium. The optimism in Japan in the 80's, however, turned out to be based on an equity and housing market bubble and ended in ruin, stagnation and loads of bad debt in the 1990's. The new-found Chinese growth dynamic has flooded Western markets with cheap goods of dramatically improving quality, keeping down core inflation in most countries, but so far the prosperity has failed to spill-over to the Chinese stock market and to the broader, Chinese classes. Customer services – everything from accounting to call centers are being outsourced to India, but also here the positive effects are not really spreading to the broader population. Most of India still has very poor infrastructure and no social mobility.

A relatively new proverb underscores the basic problem of Asia: The Chinese have no customer service but lots of cheap goods, productive capacity and infrastructure, while the Indians have lots of service but no infrastructure and no productive capacity. Japan is some sort of a hybrid with a hard working populace and an overregulated market that stopped functioning years ago.

In the last five years, Asia has been primarily driven by exports to Western markets. The populations of Asia have saved and invested in a clever, growth oriented strategy that nevertheless depends almost exclusively on the willingness of European consumers and US consumers to debt-finance their consumption of Asian goods and services. The future growth potential does in our opinion lie in Asia, since they are by far out-investing their Western counterparts that are burdened with debt, taxes and consumption-oriented politicians.

The main regional differences

How big is the difference in growth potential between the three big regions (the Euro-Zone, the US and Japan) in the world? Judging by fixed asset investments per capita, it seems the difference is very much in favor of the Japanese economy. Here, every Japanese on average contribute \$5771 for fixed asset investments, while US citizens only contribute \$3403 and the Europeans contribute a measly \$1370, only 59% and 24% of the Japanese level, respectively. Sure, a lot of Japanese investments are just misguided Government activities with a zero or negative return, but there is no doubt that the Japanese after 15 years of deflation and saving have a lot of pent-up demand and that their private, productive

capital is newer and more productive than in Europe.

Elsewhere in this publication, we argue that this debt-financing, upon which the Asian exports are based, ultimately has to stop and that the likely trigger behind a change in these habits would be a slowing or sliding housing market in the most important Western countries. The question is how Asians would adapt to such a change.

Given the large pent-up demand in especially Japan, we expect the Asian region to increasingly go it alone – i.e. demand goods and services from each other. The trade between especially China and the Western countries is essentially based on very large differences in input costs and wages. These differences would still persist in the case of an increasing intra-regional trade.

We think that 2006 will be the beginning of a very long and increasingly important trend, which is really about the economic leadership of the world. Europe and the US are too burdened by debt and too under-invested to maintain their current leaderships in living standards, in technology and in research. Asia will catch up and this will be increasingly evident in 2006, where Asian growth rates will once again outstrip both the US and Europe. The Chinese will control higher and higher levels of the production and distribution process for Western consumption – just like Japan has moved ever higher and higher in the production process since the 1970's.

What matters

In the end, it does count, how many thousands engineers and PhD's you educate, it does count, how much you save and invest, and it does count what mix of capital and

labor you use. It also counts, how many hours you work, how much government encourages research and development and what share of the fruits of your labor you keep. On many of these important criteria, Europe and the US are hopelessly behind the Asian countries. Why else can you buy a Hyundai or a Kia at a 20 or 50 percent discount of the price of a Citroen or a Volkswagen and still get the same car?

The only game European and US companies still dominate in full, is the ability to sell products, but in a world with only marginal growth (Europe) or with loads of debt and negative saving rates (the US), this could soon become a dead end. Soon, they should learn to produce cheaper and more efficiently. The reader might be confused about this assertion: Isn't Western labor productivity high by historical standards? Not in our opinion. The figures in recent years are artificially high due to artificially low estimates of inflation (by the methodology used before Clinton's changes, we are now running at 6-7% YoY). We might also add: Why are wages not increasing at a faster pace, if labor productivity is so high and usually a reliable precursor for wage inflation?

All in all, the growth potential in Asia is much greater than for Europe and the US. They did their homework, we didn't. This is where you should put your pension funds.

China and India

The markets, analysts and commentator seem to be very uniform in expecting higher Western growth, higher stock markets and slightly higher yields in fixed income. The only thing they are afraid of is that China may cool or even collapse, taking commodities with it as

well as Australia, Emerging Markets, Japan and so on. With cooling Western housing markets and therefore less equity extraction from housing, we should see some negative impact on the Chinese economy, but China has positioned itself as the primary low-price producer and in the case of slowing consumption, China could actually benefit from a substitution of more pricey, Western products with Chinese and Asian products in general.

The fears somehow also neglect the fact that China is already cooling after the monetary tightening and the small revaluation in 2004. The frantic talk in 2005 about how China consumes between one fifth and one seventh of the supply of every important raw material has somehow been sidelined. Despite the tightening, China is still doing well. Besides, if Japan gets going in 2006, China will be able to expand production in the direction of Japan as well.

Despite the hard work and effort put into production in Asia, production is still inefficient. With the introduction of Western style, market-based management principles, If the dollar is not allowed to depreciate considerably versus the Asian currencies, unit labor costs in the US will remain too high and continue to punish a labor market already weakened by the malinvestment boom in the late 1990ies. To add insult to injury, there is a lack of private, productive capital formation in the US. The share of GDP that goes to add and replace existing capital has been falling for decades and too much is invested in housing market related activities and in the

Asia stands to benefit significantly. Surely, this will not happen overnight, but 2006 will mark the beginning of this important trend in especially India.

The Rate Outlook for Japan

The Bank of Japan governor, Toshihiko Fukui has almost literally promised to keep Japanese monetary policy extremely loose until we see CPI changes YoY stable and above zero. This must cap the short end of the Japanese curve in the first half of the year, but rate expectations will increase as YoY changes in CPI get higher and higher throughout the year. Thus, the long-dated Japanese fixed income stands to get punished as inflation increasingly erodes the future cash stream of the bonds.

The coming improvement in the Japanese rate outlook is also likely to put an abrupt end to the JPY-related carry trades involving high-yielding currencies like GBP, NZD and AUD. Thus, we expect the JPY to strengthen massively for most of the year. (More on that in the forex part of this publication)

unproductive defense sector. US wages are simply too high when compared to the productive capacity and the costs of producing in the US. Therefore, the labor market will stay very weak in 2005.

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The US: Rates to Top Out

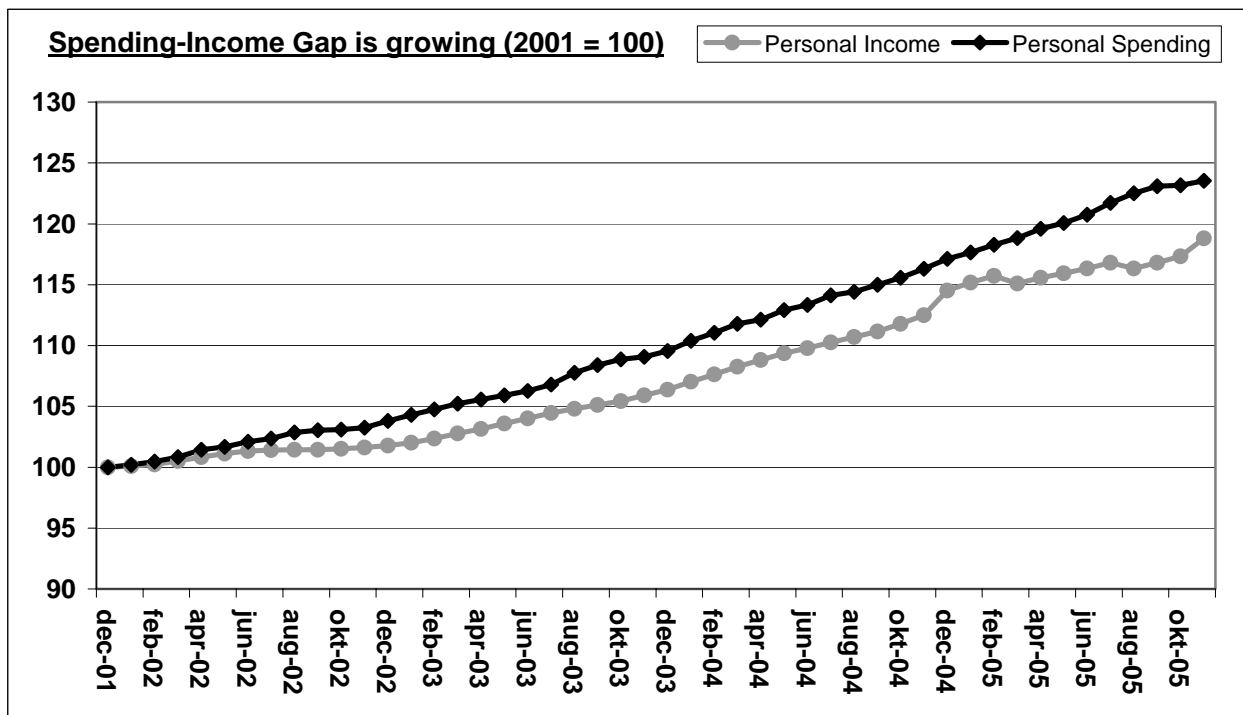
The US economy is looking healthy on the surface, driven by momentum, optimism and creativity. But what happens when the housing market cools? This is the accident waiting to happen late in 2006. The interest rate market is already pricing this in. We just think interest rates could go as high as 5.50% before falling again.

The market is currently looking for US interest rates to top out around midyear and then fall back at year-end. The explanation? A fall in the US housing market involving a slowing extraction of home equity is now scheduled for late 2006. This would also mean lower inflationary pressure and economic growth, which would imply a looser monetary policy. We tend to agree with the market, but we think that rates can go even higher than the 4.50-4.75% currently priced in. We might even see rates as high as 5.50%, if so-called second-round effects pop up in the CPI statistics during the first half of the year. We don't think second-round effects from higher energy prices are unlikely in 2006. Bondholders have clearly been hurt by the higher energy prices, so it's about time they get paid to take the risk of yet higher energy prices in 2006.

US business surveys have been fairly strong in 2005. The balance sheets of US companies are also strong and investors are still pricing equities conservatively with the horribly

overpriced stock market of 2000 in memory. Balance sheets have probably been aided by the Home Investment Act capital flow and the still relatively low interest rates.

The fate of the world economy to a large extent depends on the ability of the Fed to avoid deflating asset prices. Had the monetary policy in the aftermath of the stock market bubble of 2000 been less aggressively loosened, the US economy would have experienced a much more severe downturn. The Fed managed to avoid the negative consequences of the bursting stock market bubble by creating asset inflation – i.e. by stimulating prices of other assets than stocks. Invariably, housing prices have gone up because of artificially low interest rates and this has helped to maintain a quite high level of consumption. Actually, consumption growth has been as high as GDP growth and higher than income growth, which is unsustainable. The US has for the first time ever been experiencing a negative savings rate.



With interest rates going higher, with housing prices cooling, with energy prices still at lofty levels, with debt at all time highs and with a still soft labor market, it is not hard to imagine that consumers eventually will respond by cutting their purchases. This is the big thing waiting to happen in the US economy and this is why stocks are still trading at relatively conservative multiples – the market is waiting for an accident to happen. The bond market is also confirming this, stubbornly refusing to buy the Fed story that all is OK, yields are still very low despite the Fed tightening. Our “waiting-for-the-accident-to-happen”-theory explains Greenspan’s so-called conundrum – i.e. why long-term interest rates are not rising when the Fed is tightening. In effect, the bond market is telling the Fed that it is suffocating the fragile recovery after the burst of the stock market bubble.

Most sectors of the US economy more or less disregard these fears. The lackluster labor market is the only, important indicator pointing to troubles at the core. The optimists, whose opinions we think will dominate the first half of 2006, argue that GDP growth, productivity and technological evolution are simply too strong in the US for consumption and the general economy to falter. History is on their side. Every time, the US economy has found itself in trouble, creative entrepreneurs, strong consumption and a flexible labor force have helped it through. These forces are likely to aid the US economy once again in 2006, but several factors are still posing a threat and they tend to collide in the second half of the New Year where the pessimists will take over:

1. The housing market is seasonally weak in winter months and we expect the US housing market to lose its inertia

through 2006. Thus, late 2006 will be the time where everyone begins to talk about the lack of asset price appreciation. The equity extraction that has supported consumption so far is not likely to continue if homeowners are not confident that the values of their houses continue to increase. Historically, a lack of appreciation in housing has twice the impact on consumption as a lack of appreciation in the stocks owned by households. In general, housing markets don't just reverse their trend in a single year. Historically, they just lose their inertia and remain flat for half a decade. The big counter-example is Japan in 1990, but this market was clearly more leveraged and influenced by speculation than even the US market today.

2. The Fed will probably end the rate hiking cycle by mid-year. Several of the FOMC members have been hinting to even higher rates than 5%, but when Ben Bernanke takes over the Fed chairmanship on January 31, they will have a dominant, dovish voice in their midst, even if this voice is not expressed until later in the year until the market expects. He might not exercise his influence in full from day one, but by mid-year where the other negative factors start to kick in, Bernanke – who is known to be creative

and unorthodox – could lead the choir in promoting a more relaxed monetary policy.

3. Energy prices will stay high in 2006, which is likely to have a negative influence on economic growth. This calls for lower interest rates. The risks of so-called “Second-round effects” are most likely to show up as an argument for further tightening in the first half of the year, where the Fed is tightening anyway.

Overall, a huge momentum and a stubbornly optimistic sentiment characterize the US economy. It would be foolish not to recognize this, but at the same time it is also difficult not to be worried by the imbalances of the US economy, which might wreak havoc in the world economy, if they were to unwind rapidly. The trade deficit, the current account deficit and debt-financed consumption are really one and the same problem and it cannot continue forever, but it might continue longer than anyone imagines. We dare call for a resolution of these important problems in the second half of 2006. Thus, growth will be relatively strong (3-4%) in the first half of the year, but low (1-2%) in the second half. Business investments and consumption will decline seriously in the second half.

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Europe: What a Mess

The political disintegration of Europe with the French and Dutch rejection of the European constitution is one of the major problems of Europe. To top it off, we now have a Conservative-Social Democratic government in Germany, which is not able to deliver the necessary reforms. In Italy, Berlusconi will be replaced in 2006. Economic growth is likely to pick up in 2006, but it will still be historically low.

The European economies are simply not investing enough to increase their production capacity. The governments of Europe are confiscating too much of the wealth that should have replaced or expanded the existing capital. That is the primary reason for the very low growth in Europe.

As a political project, the European Union suffered a serious defeat in 2006 caused by the rejection of the European Constitution Treaty. The EUR has been weak ever since. This rejection was then followed by the disappointed expectation for a new, Conservative chancellor with the mandate and courage to do something about the inflexible, German labor market. In stead, the Germans got a Grand Coalition consisting of Conservatives and Social Democrats. This government is not likely to change the status quo in any important way, so the result will be more years with below-2% growth, and above-10% unemployment. In short, the expectations for Angela Merkel have been disappointed.

The European rate outlook is not yet very attractive. Two factors point to higher rates: Higher energy costs and ample liquidity in the markets. On numeral occasions, the ECB has emphasized that energy costs are included in their calculation of the inflation rate. Therefore, the significantly higher energy costs in 2006 should lead to higher rates. Furthermore, the M2 Money Supply growth currently runs at more than 8% YoY – a level

not exceeded since 1985. Although the monetary policy has been tightened a tad with the rate hike in December, it is still extremely loose.

Despite these factors, rates are still very low and the primary reason is probably the miserable growth in the Euro-Zone as well as the quite low inflation rates. It is not comfortable to think about what the growth in the Euro-Zone would have been with rates at a normal level...

The only major economy in Europe that is having a solid/normal growth rate is Spain. France and Italy are both having miserably low growth rates, in the case of Italy close to recession. The fact that most of Europe economically is in the doldrums puts a lid to how high ECB can increase the rates. All in all the ECB's rates will only go modestly higher in 2006 – 3 percent should be the maximum, unless we see a significant drop in European unemployment rates and a stronger economic growth.

Despite the weak European economies, the positive economic sentiment from the US is likely to have a positive influence on Europe in the first half of the year. In this period, European long-term interest rates will generally go higher and stocks will be supported. These trends will reverse by mid-year with the increasing talk about a cooling US housing market and the higher rates.

Other European economies are also likely to have an uninspiring year. The Bank of England optimistically hiked rates in 2004, but was forced to humiliate itself by cutting them again in 2005. In 2005, economic data has confirms that the UK needs still lower rates. In many ways, the UK is a model for what could happen to the US once the housing market stalls. For many years, the UK housing market was among the fastest increasing ones in Europe, but the appreciations stopped when the BoE hiked rates in 2004. This has hit retail sales and production hard.

The economic fate of Switzerland is closely intertwined to that of Germany and it is no wonder that the Swiss National Bank still has a target rate at 1% and GDP growth of only 2.3%.

The only strong European economies – except Spain – are the ones with a looser relationship to the Mainland Euro-Zone – especially Ireland and the Scandinavian countries. Denmark is a special case with a fixed currency regime vis-à-

vis the EUR and thus an interest rate that is “locked” to the ECB rate. Mainland Europe is economically weak and therefore – in the eyes of a Keynesian or a central banker – demand low interest rates, but the Danish economy is strong and at the same time benefiting from a low ECB rate. This is extra stimulating for Danish consumption, the Danish stock market and the Danish housing market.

Overall, we don’t expect that much from Europe in 2006. The drive for reform has come to a crunching halt with the German Grand Coalition and taxes are simply too high for Europe to gain a sustainable productive momentum. Look to the East Asian economies and to the US or Emerging Markets for the highest expected return in 2006. We would be surprised to see Euro-Zone economic growth higher than 2.5% YoY in 2006.

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Equities in 2006: Plenty of Risk, but Valuations Still Reasonable

Strategizing on the coming year for equity markets is indeed no easy task. That's because we see 2006 unfold in two separate phases: before and after the end of the Fed's tightening cycle. Thus, devising a plan for the year as a whole is tricky and several risks to our outlook has to be noted.

First, at what level will the Fed stop hiking its funds rate and does Bernanke manage to soft-land the U.S. economy? We believe so, but unfortunately history is against him. Secondly, will energy prices continue to build and thereby remain a worry for companies in general and exporters in particular? Thirdly, will U.S. corporations finally uncover the true scale of their massive off balance sheet liabilities with regards to pensions schemes and health care costs? Conceding that our crystal ball has its limits we simply hope that markets will be offering decent answers to these urgent questions.

Above all, macroeconomics decides where stock markets go this year. In general, that's of course always true, but looking strictly at equity valuations we're really not that concerned about the performance of 2006. EPS growth looks healthy and multiples could easily expand without any alarms going off. But, regional preferences are important and we clearly favor Asia and emerging markets to the U.S. and expect Europe to hold up decently. In our minds, Japan is the place to put most of your money as economic conditions shape up there. The country's stock markets have already started to discount the longer-term effects of an improving Japanese economy and as noted above gains can easily be had under our "go it alone" scenario.

The US: Nearing the end of the cycle

U.S. stocks are roughly breaking even this year and have sorely lagged Europe and Asia. Thus the post-2002 bull-run stalled and this market could be in for more hardship next year. Higher energy prices and borrowing costs were the culprits primarily, along with relative valuations compared to stocks elsewhere. USD strength probably also contributed to a year that saw General Motors' credit worries making waves (see below).

The post-2002 bull-run is beginning to look very tired indeed and in general we don't have a lot of hopes for corporate America in 2006. Compared to other regions, valuations in the States are richer and several risks appear on the radar heading in to the New Year. Granted, multiples aren't excessive and EPS growth looks solid, but the real concern for American stock markets comes from the macro scene: the Fed's tightening cycle ending and a possibly correction in the housing markets. The latter could trigger a severe sell-off, but not until we reach H2. Our scenario is this: H1 will provide decent gains while H2 is likely to deal a blow to the broader market. Again, much of our reasoning rests on our macroeconomic outlook. We anticipate the Fed to be able to soft-land the economy, regardless of where the bank leaves its funds rate. If not, and if 2006 is the year where we see the

broader cycle deteriorate, stocks are in for a very unpleasant ride.

Accordingly, we tread cautiously when picking sectors for the coming year. Energies should record another stellar 12 months as broader energy price levels look to remain lofty. To us, both refining margins and capital spending projections indicate that the sector is in good shape while valuations continue to be far from inflated. Long Chevron Texaco (CVX.N) is our pick here. Health care, which lagged the market again this year, must be ripe for a comeback, if for nothing else than its excellent

defensive traits. In terms of valuations, the sector looks cheap, earnings growth stand to pick up and there’s no denying the highly advantageous demographics going forward. About the same thing can be said for Pharmaceuticals and among several decent candidates we’ll enter longs in Pfizer Inc (PFE.N).

Shorting candidates include mortgage-related, REITs and homebuilders. If our call on housing is correct, these sectors obviously will be hurt.

CFD : S&P 500 Index , Monthly , # 80, Real-time data



All things considered, U.S. equities are bound to underperform next year. We expect the S&P 500 to eke out a 4-6 percent gain next year, most of this coming in H1. Thus, our target range here is 1315-1340.

Then there’s General Motors and carmakers in general. Many question whether one of America’s icons can honor its liabilities going forward. We happen to be in this camp and

one of our outrageous claims for 2006 is for GM to go bankrupt. The main issue with GM and indeed a lot of other household names is the scale of their off balance sheet items.

Pensions schemes and health care costs have been kept off the books for years, we believe. Numerous estimates indicate that as much as 85 percent of S&P 500 companies' net pension obligations are currently not accounted for. GM leads the pack by a wide margin and in the event that the company is forced to adjust its balance sheet it could have dire consequences. Speculation on this issue ran so wild that GM CEO Richard Wagoner felt it necessary to comfort the market by saying that the company was in good shape and no such event will take place. Would you expect anything else out of him? His announcement is lost on us as the numbers clearly speak for themselves.

Looking past GM's internal problems, there's perhaps and even bigger argument in the fact that U.S. automakers in general are losing market share on a daily basis. Competition from Asian rivals is taking its toll on Ford and GM and as we've stated throughout 2005, there's really only one place to invest if you want a position in this sector. Toyota is expected to surpass GM in terms of sales in the U.S. next year, a truly remarkable event. Cost structures are blatantly in favor of Honda, Nissan and Toyota when compared to the U.S. and Europe. We're taking a neutral stance on the latter and recommend our clients to focus on Asia. For our portfolio we're going short GM (GM.N).

Japan: Will the sun continue to rise?

Japanese equities have had an outstanding year with the Topix and Nikkei 225 indices adding in excess of 40 percent. Many of those who were around in the 1990s, were skeptical of the rally that exploded higher just before the summer. But, vastly improved economics in Japan and a more pragmatic approach to policy making convinced investors that the bull-run was here to stay. Naturally, as more

and more people acknowledged the positive developments in the world's second-largest economy, funds were plowed in to every single sector as broader risk-willingness increased. This meant that the Nikkei 225 quickly advanced to 13500, then 15000 and is closing above 16000 at the end of 2005. One note of caution: the latest rises have been perhaps a bit steep and unhealthy in the short term, even if we believe in superior performance going forward.

We expect domestic demand in Japan to finally start picking up, curbing the complete dependence on exports to determine the trajectory of the economy. Also, corporate balance sheets have improved immensely and earnings power in general has been boosted within the last 5 years. Add to this that we are starting to see the first benefits of the structural reforms that begun after the 1997 crisis. Cross-shareholdings are down sharply and the cost of labor is now running at advantageous levels to other regions. It's clear that Japan's rebound is for real and that fundamental values are in place.

But before getting over-excited you have to consider the low base from which equities are rallying. Relative performance should be the focus but there's no denying that Japan is in very good shape at the moment and as outlined above, we do regard it as highly possible that the Asian region can "go it alone". A lot is riding on how domestic consumption shapes up, and in what way a likely slowdown in the U.S. will affect the confidence of the Japanese consumer. He or she will need to step in under such a scenario as exporters naturally stand to underperform. This is essentially what we believe when calling the Nikkei 225 higher. We are also pinning our call on the postal privatization bill that President Koizumi pulled off earlier this year. Massive

amounts of pensions funds stand to enter the market, i.e. bond holding will increasingly shift in to equities.

So what's the bottom line for the coming year in Japan? Our preferred call is to focus on domestic demand driven sectors, preferably

those that haven't seen freakish appreciations yet. We concede that these are hard to find, but opportunities are still out there in banking, real estate and construction. Retailers have also room to grow still. For our portfolio we have chosen to go long in Sekisui House Ltd. (1928.T).



We believe the Nikkei will record another set of multi-year highs before eventually testing its 10-year high of 22750. That puts us solidly in the bullish camp for 2006. Ultimately, the global quest for alpha will lead more and more investors to Japan as other regions, the U.S. in particular, struggle.

Europe: Valuations still attractive, but ECB's move is key

Euro-land GDP growth rates seem to have bottomed and are on a rising trajectory from a very low base as we leave 2005 and European stock markets had a banner year overall. The market gains looked even more impressive when compared to the U.S. Germany's DAX

index is up almost 30 percent, France's CAC 40 close to 25 percent while the UK's FTSE 100 lags behind, gaining only 17 percent. Eastern Europe thrived once again and rocketed higher. Scandinavian bourses pushed higher too, fueled not least by frantic M&A activity. EUR weakness was a major driver, putting stocks of exporters at the front of the pack of gainers. Corporates enjoyed above-

average EPS growth and valuations continue to run at sustainable levels.

We find it interesting that indices managed these sorts of returns in times of sluggish Euro-land economics and the botched EU constitution ratification attempt. At the center of economic weakness, of course, we have Germany. Europe's biggest country held elections and CDU's Angela Merkel moved into the chancellor's office. The DAX index, a multi-year laggard, finally showed signs of strength and lead the region. It's understandable, since she is viewed as far more pro-business than Schroeder was and the thinking here is, that she could spark optimism in a country that really needs a boost. We believe that's possible but any true revival could be far off, especially with a potentially unworkable "grand coalition" that forms the government. Europe can't close its eyes to external factors and there's no chance of the German stocks rallying strongly if the worst-case scenario plays out in the States.

Thus, we expect roughly the same thing to happen in continental Europe as in the US: strong H1, weaker H2. Under this prediction, the moves of the ECB are key. We see the rate situation spilling over into equity markets in the second half of the year and thus indices to end 2006 on a weak note. The first six months of the year, we believe, will be strong. At current multiples no specific trigger is needed,

as valuations still look appealing. 12-months forward price-earnings run at attractive discounts to the U.S. and we see this as ample reason for increased institutional buying and thus an argument for a strong first half of the year.

Earnings momentum, specifically in Financials, Industrials and, of course, Energies, is impressive and we feel confident that these sectors will continue to perform under the current environment. Banks, offering compelling valuations right now, are a somewhat riskier bet considering what's to unfold with regards to the rate situation. However, we regard the sector to be less vulnerable to these sorts of shifts after years of improvement to rate immune business areas such as advisory services and increased fee generation. We are turning increasingly bullish on high yielding stocks and several candidates emerge when searching through the large cap segment. Above all, this group, we believe, should evolve to be the refuge of choice when bears take over six months from now. Telecoms appear most attractive, not least after a year of below-average performance. Vodafone's recent profit warning only added insult to injury and so we can't help ourselves in taking a long position at these levels. We'll go with Deutsche Telekom (DTEGn.F), changing hands at 12x next year's earnings and a dividend yield of 4.39 percent.



Taking a step back, we expect broader indices to deliver decent gains in 2006. We like DAX over the CAC 40 and the FTSE 100 but do point out that the latter is the cheapest on a fundamental basis. UK economics look weak, though, and regardless of the rates issue, Germany should be in the driver’s seat next year. We see the German benchmark advancing beyond 6300, equivalent to a 15 percent gain.

Sweden

The outlook for Sweden is pretty much the same as for the rest of Europe. The overall performance in the equity markets in 2005 has been far greater than most predicted. We are looking at an approximate gain of 30%. What picture are we likely to see in 2006? As in the rest of Europe, interest rates are on the rise and most likely we will see the Riksbank raise rates already in January and probably by 50bp, for the funds rate to stand at 2% again.

A stronger SEK and higher interest rates are of course negative items for the stock market. We have, in our view, not yet seen any of these

events getting priced in equity markets. Looking at the corporate climate in Sweden, it is quite easy to see why markets have been strong in 2005. Strong profit growth, strong balance sheets, weak SEK and historically very fair valuations. Going into the first half of next year there are few clouds on the horizon. A strong set of pension money will pour into the markets in January and February, and Q1 earnings should reap the last effects from the weak SEK in Q4 this year. With lagging effects it is quite likely that Q2 will see strong profit growth, and this is where the cash flow from dividends will reenter markets as well. In the second half of 2006 though we see the US

market weaken and a much stronger SEK, hurting the bottom line for Swedish exporters. In the OMX there is not a single company, except for TeliaSonera, that does not have at least 50% of their revenue stream coming from abroad. Let's face it – higher rates and stronger SEK will have a sharp negative effect on earnings and going into Q3 and Q4, corporates will face very tough competition.

Denmark

Danish stocks catapulted higher and the key benchmark, OMXc20, is up almost 40 percent this year. Shares were supported by strong domestic economics and the strengthening of USD aided exporting companies. Perhaps the biggest driver in 2005 was the enormous amounts of money pouring in to the market from buy-out firms. Three major companies were acquired: ISS, Københavns Lufthavne and TDC.

We believe the Danish stock market will do just fine in the coming year, although we don't expect returns to run above 25 percent this time. The rally is essentially liquidity based

and next year's flows come from three major sources: Danish homeowners continue to extract equity from a red-hot housing market and deploy some of these funds in to stock markets. Danes are exceptionally home biased, explaining some of the move in the OMXc20. Additionally, private equity funds is perceived to play a major role in Denmark again, and thus we're likely to see more delistings going forward. Finally, as is the case with Sweden, another round of pension funds will be placed in the market.

Overall, we're not that concerned with the performance of Danish stocks in 2006. They should do respectively but risks to this outlook are present of course. Events in the U.S. are key but the strength of Danish housing market is equally important.

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Forex in 2006: The JPY strikes back

The suffering JPY was the big surprise in 2005. It was hit heavily by the disappointment over China's lack of a Yuan revaluation move. But most of all, the obsession with the rate hiking cycle from the US Fed pushed the "carry trade" back to the fore in a spectacular way as Japanese investors sold their own currency in search of superior yields abroad. But the market will soon have pushed this trade too far and the carry trade will likely reverse in 2006. USD/JPY may head to 100.00 and EUR/JPY to 125.00. Elsewhere, the big losers of the year may be GBP and NZD.

JPY: The Big Mover Again

The Japan recovery story is becoming a compelling one, as awareness increases that the long economic funk that Japan has found itself in for so many years may be drawing to a close. Strangely, however, as the Japan story has garnered increasing recognition, the JPY was spectacularly weak for the balance of 2005 as the focus was more on interest rates differentials (where Japan is the world's laggard) and Japanese investors sought yield on foreign shores. Japan's stock market skyrocketed as export-oriented companies reaped the rewards of a weaker currency and the banking system anticipated further reforms.

2006 may bring a very different story for the yen. With the growing confidence in the recovery of the Japanese economy, The Bank of Japan will at long last increasingly signal the end of the quantitative easing. Also, increasing domestic demand from a more confident consumer and heavy foreign interest in investing in Japan will also eventually even out the capital flows and exceed yield-seeking outflows. The housing market, depressed for a decade and a half after the explosion of the insane 80's real estate bubble, is showing very strong signs of a comeback in terms of construction of new houses and could be a leading indicator on what the Japanese

consumer will do going forward as real estate prices may also end their 15 year slide and begin to turn up – creating a different mentality for homeowners – in a country with a 60% rate of home ownership. Also, the privatization of the Japan Post postal system could create more anticipation of a more dynamic banking sector that will put the gigantic Japanese savings to work in a better way than simply reflexively buying low yielding government paper.

Short-term, the continued focus on higher yields could put USD/JPY may top out in Q1 of 2006 if it hasn't topped out already and head quickly toward 100.00 for the balance of the year. But JPY may also make significant headway vs. the broader market as well, and a long JPY (perhaps against GBP, USD and EUR or AUD) basket trade may be the best way to play for a stronger JPY.

USD: More strength possible short term, but weaker in the second half.

The USD has been strong for most of 2005 as the market has squarely focused on the Fed's leading role in the global hiking interest rates and the greenback's increasing attractiveness from a carry perspective as US short interest rates rose 200 basis points in 2005. The other huge driver of the USD stronger in 2005 was the Homeland Investment Act. Under this

legislation, American companies could bring home (“repatriate”) profits earned abroad at a very advantageous tax rate that only was applicable for the 2005 calendar year. So Jan.

1 of 2006 automatically puts an end to the tens of billions of dollars of pressure on the USD that were seen in the final quarters of 2005.



USD/JPY may reverse course in 2006 despite last year’s on the popularity of JPY carry trades and disappointment over the lack of a Chinese move on revaluing its currency.

But continued interest in investing in US assets and a surprisingly hawkish and persistent Fed could keep a floor under the USD for half or more of 2006 – so our USD outlook for 2006 is “split” in the sense that short term risk may still be to the upside as we enter the year, but eventually – a clear top in US interest rates and clear pressure on the US consumer from a topping housing markets and tighter credit will combine with the massive

and chronic US twin deficits to smack the greenback with big declines somewhere in the latter half of 2006. Of course – any early signs of a weak consumer and crumbling confidence could move the weak USD scenario further forward than we expect.

EUR: Still the largest central bank reserve alternative

The EuroZone put in a terrible performance in 2005. Low yields in the EuroZone and a generally high valuation threatened the EUR as 2005 started. Then in mid-year, the massive French and Dutch “NO!” to the EU constitution was the big focus as the whole EU concept

look increasingly like a botched project – and at a time when more and more countries are looking to join. All this makes the world wonder whether the EU will be able to function at all as an institution going forward. The Euro also faced headwinds, as the German elections seemed to show political gridlock going forward with the “grand” coalition government.



EUR/USD may have a “split year” in 2006 as the USD could power stronger in the first half of the year before weakening later in the year.

Later in the year, the Euro found some support as the ECB signaled that it would finally move on rates and hinted at more to come, even if it promised not to use the Fed model of a “series” of hikes. As we work through 2006, therefore, the EUR may find itself under pressure from

the outperforming USD and JPY, but its day may come later in the year as a respectable, if low-key performance by EU economies and, more importantly, the constant need for central banks to diversify away from the US dollar could offer the single currency support.

So EUR/USD may trade toward 1.10 in the first quarter or possibly half of the year – but we expect a return toward 1.3000 in the second half.

GBP – Europe’s weakling in 2006

The UK and Australia may provide advanced examples of what happens to economies when their housing markets finally begin to top out – namely, a weaker consumer. The UK never stimulated its economy to the degree seen in Europe and especially the US as the central bank was sufficiently concerned with an ongoing housing bubble there to keep short rates well north of 4% for the duration. But now, with the UK economy clearly in bad shape, the Bank of England may be forced to buck the trend in the rest of the world and may actually begin to cut rates while they are being hiked elsewhere.

The pound has generally been overvalued over the last couple of years due to its popularity in carry trades in the 2003 and 2004 and then as it found “default strength” as it was bought versus the struggling Euro in 2005. But as we exit 2005, the UK rate outlook is looking south on what increasing looks like a limping economy. GBP may fall heavily vs. its European counterparts and we would look to short GBP vs. EUR, CHF, and SEK in 2006.

CHF: Weak now, but It’s day will come

Heading into the end of 2005, CHF is looking weak after recent disappointment over the SNB’s apparent rate stance going forward

while the ECB looks to hike a bit more and thus widen the rate spread further between EUR and CHF. EUR/CHF put in a rangebound 2005, a respectable performance considering the franc’s anemic yield and the focus on carry trades. But as we expect an unwinding of the carry trades going forward once interest rates begin to max out in 2006 – and a possible move to safe havens later in 2006 if the US economy is showing signs of failing, CHF could pick up the pace at some point later in the year and actually become a star performer in Q3 and certainly Q4. We would look to buy CHF whenever sentiment seems excessively against it.

NOK and SEK: Strong Scandinavians

SEK could be one of the more interesting plays in 2006 as it is perhaps the most undervalued currency in our survey as the market has used it as the funding currency for carry trades as the Riksbank was practically alone in cutting rates in 2005. But as we look for a reversal of the carry trade in 2006, the SEK weakness could quickly flip to SEK strength on a relative valuation play and as the Riksbank looks to bring rates more back into line with those for Europe.



EUR/GBP in 2006: The pair has been in a tightening range for most of 2005 and it may finally look to resolve higher as the UK lags the rest of the world in rate moves and economic performance.

The Norwegian Krone had a banner year for the first three quarters of 2005, as the massive advance in energy prices made the NOK a “commodity currency” comparable to CAD (the impact of higher energy prices is far greater on Norway than on Canada as Norway is a far larger exporter of oil with a fraction of Canada’s population). Also, the first tightening moves in deposit rates by Norges Bank in June and October of this year from an unprecedented low of 1.75% also gave NOK support after the massive cutting regime in 2003 and 2004 that saw 475 basis points of

rate easing. As we close the year, though, NOK is struggling a bit as crude oil prices are trading close to recent lows and some of the recent economic data has suggested little pressure on the central bank there to move into a hawkish stance.

We expect enough uncertainty though in the future of energy prices to continue to give NOK support and have a hard time seeing EURNOK back through the big 8.07 area (an old head and shoulders neckline on the way down) for any sustained period of time.

AUD, NZD and CAD: The “other dollars” in trouble?

2005 was the year of the dollar – and especially the “other dollars”, including the Kiwi (New Zealand dollar) Loonie (Canadian dollar) and Aussie (Australian dollar). CAD was the one major that outperformed the USD in 2005 as oil prices and investment flows aimed at acquisitions in Canada’s huge natural resource industries saw spectacular strength in CAD for the full calendar year. Canada may continue to do well in 2006 – but will be highly reliant on energy prices for any outperformance and could generally follow the USD’s trajectory.

The Australia’s case, we have found a remarkable correlation between the strength of AUD and metals prices. With metals – both base and precious - having a banner year on demand from China (not to mention Australia’s massive and growing coal exports to China), AUD managed to perform well despite a central bank that was not moving on currencies and a mixed performance for the Australian economy. But we wonder if metals can continue to give AUD the kind of support it has received in the past. Even if base metals continue to have a strong price gains, the contribution of these gains to the current account balance of Australia thus far has not been enough to bring Australia’s current account balance into positive territory, though deficits have shrunk somewhat. Also, one of the main sources of AUD strength, besides metals, has likely been the weak JPY as long AUD/JPY has been a popular carry trade in recent years – one we expect to reverse in 2006.

The NZD may really be in the doghouse in 2006. This small country faces a critical problem with its giant current account deficit,

which has reached a fearsome 8% of GDP. But the currency remained strong as the RBNZ hiked rates all the way to 7.25% in an effort to stem consumption and a perceived housing bubble and the market bought NZD for the fat carry differential. Cracks began to show when the S&P rating agency threatened to downgrade the currency late in 2005 due to its current account woes. The country’s own finance minister has also tried to talk down the currency. The country desperately needs a weaker currency going forward – and it will get what it needs in 2006.

Conclusion

Combine the views above and you get some pretty creative currency crosses for our favourite trades for 2006. But that’s okay – 2005 was very much a “year of the cross” as well with the likes of NZDJPY and EURCAD showing spectacular moves. In 2006, we expect the USD view will be difficult on a calendar year basis because we are expecting it to perform a pivot at some time during the year from strength to weakness. But elsewhere, we see clear sailing for other currencies. GBP and NZD weaker, for example, and SEK and JPY stronger (though perhaps not until Q2). So feel free to get creative. Our favourite “intra-European” trade for the balance of 2006 is a short GBP/SEK and our favourite “intra-Asian” Trade is short NZD/JPY – but if you like to mix up your continents, feel free to have a look at shorting NZD/SEK or shorting GBP/JPY. For traders looking at the broader view, a basket of long JPY positions or short GBP positions is an alternative. The trades in our portfolio for the year include a long JPY basket and a short GBP basket.

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Energy in 2006: A Rough Ride Ahead

Heading into 2006, US Crude Oil stocks are well above their historic norms, and yet oil is more expensive now than at any time before the beginning of the 2005 calendar year. What gives? This conundrum in the energy markets is driven by a perception that, while short-term supplies are plentiful, future world oil supplies may be woefully insufficient for future demand projections.

Energy markets saw a spectacular roller coaster ride in 2005 with a price spike to an unprecedented \$70 a barrel in the wake of Hurricane Katrina in early September. But the term structure of the energy markets has seen an even more radical development than any simple investigation of the movements in the spot price shows. By term structure, we mean how the market is pricing oil at various points out in the future as compared to the spot price of oil. Let's make a comparison of what was going on in oil markets as crude oil prices briefly peaked for the 2004 calendar year compared to here at the end of 2005.

Turn back the clock to mid-October 2004, several weeks after Hurricane Ivan ravaged Gulf of Mexico production facilities. NYMEX oil prices peaked at a then record price above 55 dollars a barrel in mid-October as US crude oil stocks dropped precipitously. Looking at the term structure of the NYMEX crude oil futures and spot prices elsewhere in the world, however, one could see that the market perceived the Ivan-related disruption as a one-off event that would only causing a short-term squeeze on prices. One-year forward NYMEX crude traded at 47 dollars (an 8-dollar discount) and tellingly, world supplies were not considered under threat – as the more sour “Dubai crude”, the grade consumed by Asia, where demand has shown galloping advances in recent years, sold at under 38 dollars - a huge 17-dollar discount to NYMEX crude (Dubai crude currently normally trades at a 5-

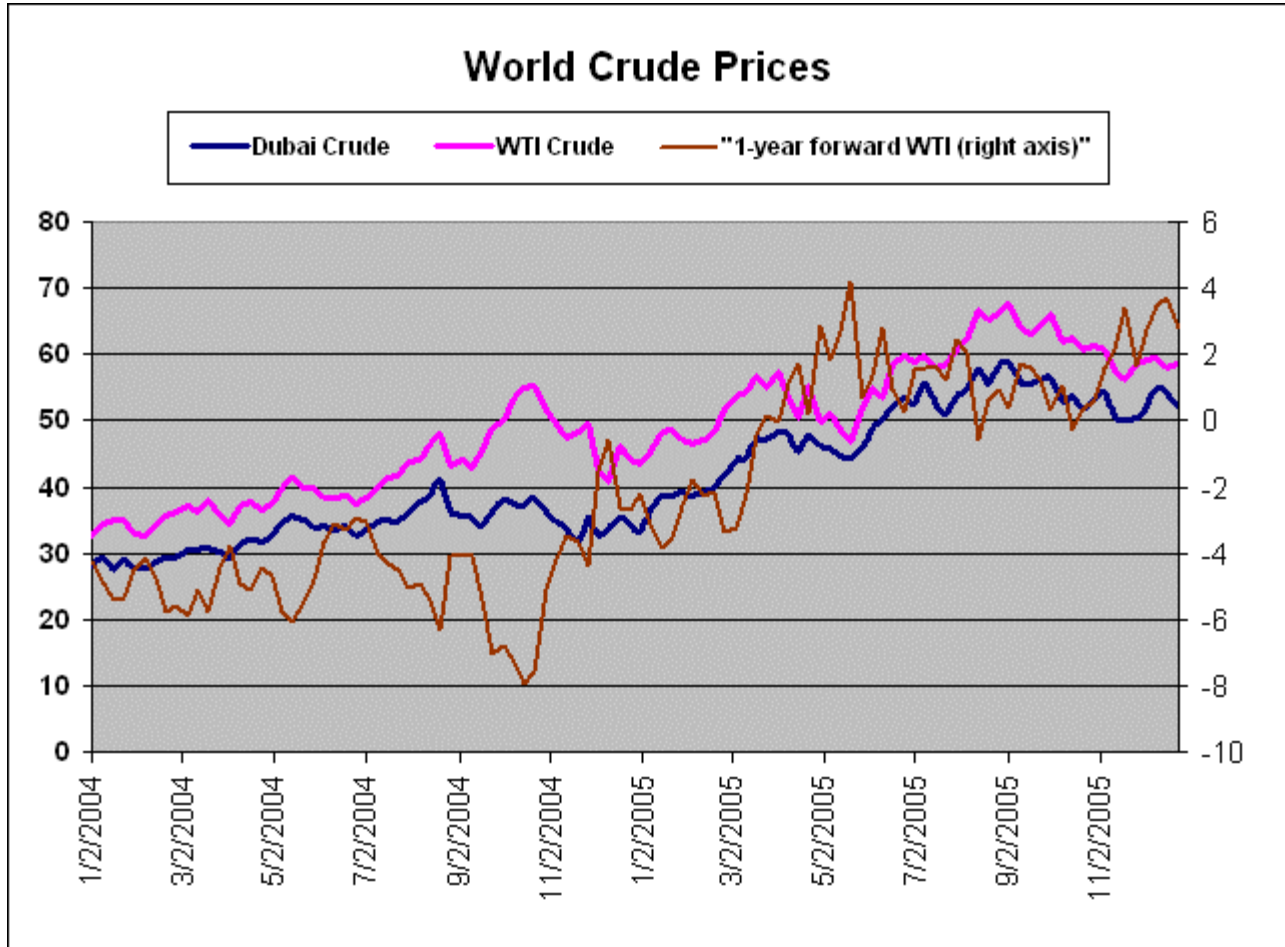
8 dollar discount because it is an inferior grade of oil). The Dubai crude price had in fact actually declined slightly in price from its previous peak in August of 2004 – warning the market that the NYMEX crude spike was a temporary squeeze.

Now lets look at the crude oil market as we exit 2005. The front NYMEX crude oil contract is trading just below 60 dollars a barrel – well off the post-Hurricane Katrina spike of 70 dollars, but still several dollars higher than the highest post-Ivan price seen in 2004. Meanwhile, US crude oil supplies have never looked healthier as the storage complex has over 30 million more barrels in storage than it had at the beginning of 2005. What is the market's perception, then, of what oil should cost in the future? Current NYMEX crude oil prices are actually depressed compared to what the market expects down the road – as one-year forward crude actually trades at a 3-dollar premium to current spot-month crude. In other words – while the spot crude price from the post Hurricane Ivan spike to now has risen about four dollars – the one-year forward price is now 13 dollars higher than it was post-Ivan. Plainly, the energy market is expressing a massive doubt that future supply/demand equation will be as healthy as the current one.

But what is the cause of this growing uncertainty? If US energy supplies are so plentiful – far above the norms for the last five years, in fact, then why is the market pricing

in more expensive oil down the road? Here are the main reasons why the risk for crude oil prices continues to be skewed to the upside

and why the market’s expression of risk is justified:



Graphic: WTI crude prices for the spot month in pink compared to Dubai crud prices. The brown line shows the spread of the 1-year forward WTI price to the spot month. Note how the perception of forward prices has changed radically. In the past, whenever crude prices advanced sharply, forward prices traded at increasingly large discounts, but now, the forward oil is trading at a sizeable premium to the current historically high prices.

Galloping global demand.

The rate of increase in world oil demand has surprised most analysts over the last several years, as many market analysts just a few years ago were projecting that oil demand growth would tail off and even decline. Now, if anything, demand is projected to accelerate, as

the 1.4% annual increase in oil demand from 1990-2002 is now projected to grow to a 2.0% annual increase over the next 10 years (according to the US government’s Energy Information Administration). The biggest single surprise on the demand front has been China, where demand has grown so fast that China

has gone from net oil exporter in 1993 to the world's third largest oil importer this year. Much of China's demand is due to an economy that is very energy intensive. India is another large and high-growth economy that has intensive energy use per unit of GDP. With oil supplies expected to max out soon (see the note about "peak oil" below), only increased efficiency in energy use will allow GDP to continue growing for the same amount of oil – and only higher and higher oil prices will promote increased efficiency.

Expanded awareness of the "Peak Oil" concept.

"Peak Oil" is the point at which the oil supply maxes out and the daily supply begins to decline (not when oil "runs out") has gained widespread attention with the dramatic rise in oil prices over the last two years. The originator of the peak idea was King Hubbert, a US geologist who used statistical analysis of oil discoveries in the US to predict in 1956 that oil production in the US would peak in the early 1970's and decline ever after. Despite everyone ridiculing him at the time, his prediction proved correct as US production peak at over 10 million barrels a day in late 1970 and has declined since. Using the same techniques as Hubbert, Kenneth Deffeyes, among others, has employed Hubbert's technique to predict a peak in world oil production as early as 2005.

More specifically, Matthew Simmons, Chairman of the world's largest and most prestigious energy investment banking company, Simmons & Co. International, published a book this year called *Twilight in the Desert: The Coming Oil Shock and the World Economy*, in which he outlines the reasons why the future supplies from the Saudi Arabia, the world's most important

energy exporter, may be threatened in coming years. This exhaustively researched and well argued work outlines why Saudi oil production could be prone to a sudden and rapid decline due to the lack of sufficient new oil discoveries and the risk of a quick blowout decline in some of its major fields. Mr. Simmons indicates that the latter risk is due to the way that oil is produced via a water injection system that keeps production rates high while there is still oil to recover, but gives out very suddenly once the majority of recoverable oil has been "pushed" out of the ground. A mere handful of huge fields have supplied Saudi oil to the world for half a century now and Saudi claims that they still have 265 billion barrels of reserves are doubtful considering no major new oilfield discoveries since the 1960's. According to Simmons, many of the western oil companies who worked in Saudi before the oil industry was nationalized made total Saudi oil reserve estimates far short of what Saudi Arabia is now claiming and we could be getting near the point where major declines in Saudi production set in. The reason Saudi is continuing to claim that it can pump at higher and higher levels down the road may have to do with maintaining its political position as the most dominant member of OPEC and a desire to maintain price stability.

Elsewhere in the world, one of the world's largest single oilfields – Mexico's Cantarell complex – faces blowout declines of at least 14 percent a year within another two years – and this single field currently represents over 2½ percent of the entire world oil supply.

No major oil field discoveries have been made since the early 1970's and there is a well-defined statistical relationship between the peaking of the rate of discovery and the eventual peaking of actual supply. Some oil field technology has done a lot to sustain oil

fields at higher production rates than was previously possible, but no oil field technology can put more oil into the ground, and the dangerous aspect of better technology is that it “hides” how quickly depletion will occur once production rates due begin to drop. So we may now be “beyond” the peak – something that will only be provable after the fact. In other words – if we have peaked in oil – any increase in energy demand will have to be met from other sources – almost all of which are more expensive.

Geopolitical Uncertainty

Since September 11, many have discussed the idea that energy markets have contained a “terror premium” due to the generalized threat of a terror strike on oil production facilities anywhere in the world. But, while terror is a constant threat in Iraq, there’s really another threat to oil supply stability that comes from another source than rag-tag groups of terrorists, who have so far failed to inflict any lasting damage anywhere in the world: heads of important oil states with international ambitions.

Most oil exporters are very responsible players in international markets. Saudi Arabia, the world’s largest oil exporter bar none, is the shining example of a supplier that tries to keep markets orderly and meet supply needs to the best of its ability. Unfortunately, the world also contains a few big oil exporters with an axe to grind: including Russia, Venezuela, and especially Iran. With all oil sources pumping at full capacity and any disruption so critical to the global economies, these countries are flexing their muscles in a way never seen before. Putin has virtually nationalized the Russian oil industry – where oil output equals Saudi Arabia’s - as the energy industry has

become the nation’s main source of international political and economic power.

Venezuela’s Chavez has developed a populist dictatorship and is trying to increase his influence in South America on an anti-USA platform. He is also supporting the likes of Cuba with cheap oil and has indicated a preference for exporting to China rather than the US.

Iran seems to be the biggest danger in 2006, with some kind of confrontation over Iran’s nuclear weapons program an inevitability for the coming year. Iran’s new leader, Mr. Ahmadinejad, has a confrontational approach to international diplomacy and is transparently trying to arrange international energy agreements with India, Russia and China in an effort to entangle these countries with Iran’s interests and therefore protect the country from attacks from the US. Iran is a vital oil power that produces close to 5% of the world’s oil and it must continue to supply the market at full capacity if the world is to avoid risking an oil spike.

Any kind of blockade by the likes of Venezuela or especially Iran, and \$150 oil will quickly look cheap – that’s how little the market can afford a shortfall of any kind as every wellhead has been jammed open at full throttle for months now.

Weather

This is very straightforward. Climatologists have discussed whether the record 2005 hurricane season, with its is a result of global warming or simply due to a cyclical weather pattern that will cause more active hurricane seasons for up to another 20 years. The evidence for the latter seems quite clear, global warming aside. After the devastation 2004 and

2005, energy markets should and need to price in a couple of dollars or more of uncertainty at all times. After all, over 28 % of US production lies in the Gulf of Mexico – and here at the end of December, a full four months after Katrina’s rampage, nearly a fourth of the oil production and a fifth of the natural gas production from the Gulf is still out of commission.

Conclusion

2006 may offer a very rough ride for energy traders. If everything somehow stays calm on the weather and geopolitical front and demand for oil steadies a bit later in the year due to weaker growth, then oil prices may stay relatively calm as well as the supply pinch

could then occur further out. But we believe there are simply too many risks in this most important of all markets and that we could easily see \$150 dollar oil if the “right” circumstances conspire to raise concern over current and future supplies. A very large range in prices is the highest risk, increasing uncertainty in other markets in the process. As we close 2005, prices actually look relatively low and we see little risk to the downside, so we’re tucking a long crude position into our theoretical portfolio for 2006.

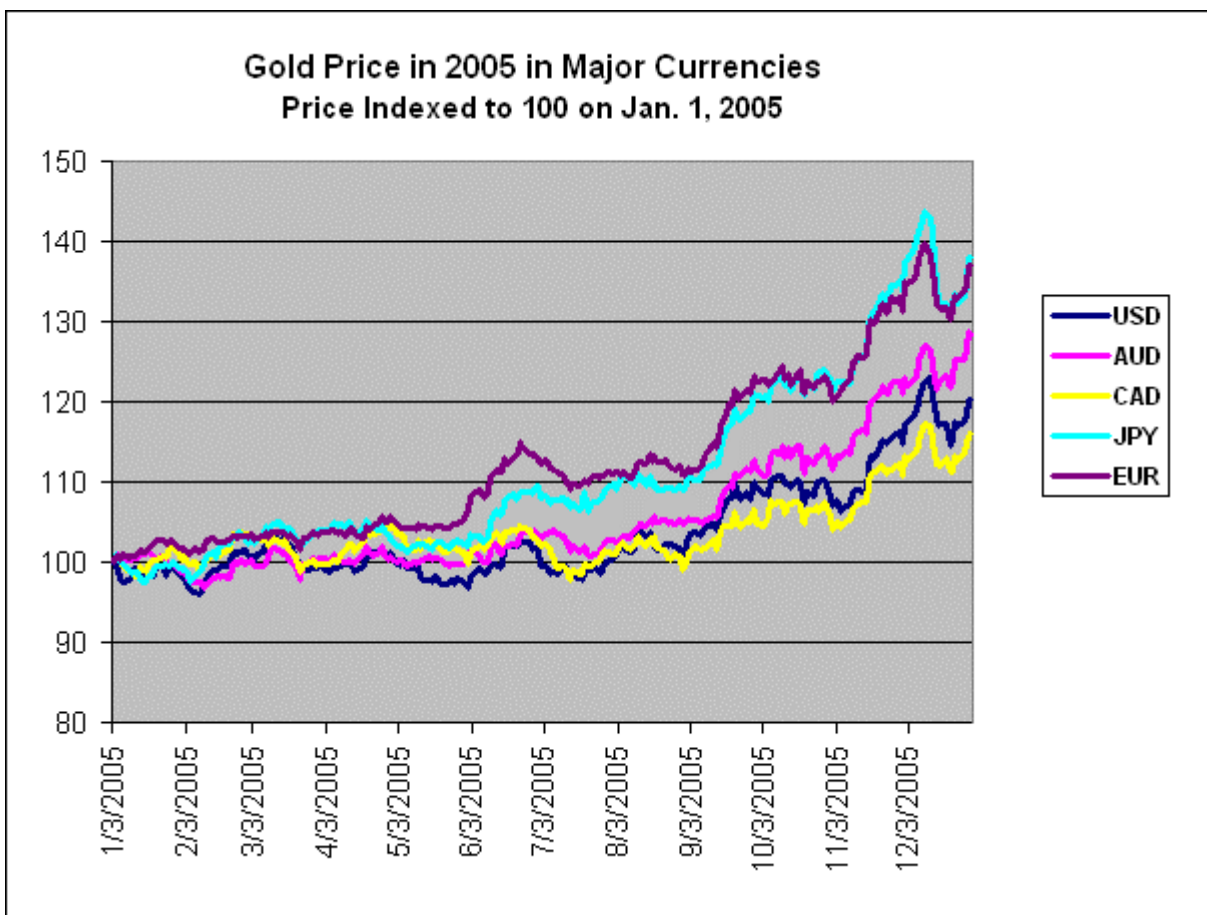
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Metals in 2006: Can Anything Hold Them Back?

Gold saw a spectacular spike in 2005 as it finally came uncoupled from the US dollar ball and chain that normally determines its destiny. One of the drivers was a new force in the market: Japanese investors looked for a creative way to hedge their weak currency. 2006 may bring higher and higher prices as the world deals with excess liquidities and central banks also potentially getting in on the action.

The conventional wisdom for the gold market – that gold prices follow inversely with the USD – was finally shattered beyond all recognition as you can see in the chart below of gold prices versus some of the world’s major currencies. There were a few reasons for the rise in gold –

one of them was the general rise in interest rates, which brought back the old “gold as inflation hedge” argument. But the main driver may simply be the massive liquidity in global markets with fewer and fewer places for investors to place their money.



Gold: better than any currency in 2005, this chart shows the development in gold prices as priced in some of the world’s major currencies.

The excess money out there has found its way to gold as the fear of excessive housing prices in the face of interest rates and the fears that bonds are overpriced has risen. Gold and silver, after all, are hard assets that have an intrinsic value. This basic theme may continue next year as well.

The great JPY weakening later in 2005 was responsible for the biggest move in gold –to over 540 dollars an ounce at one point - before it corrected a bit from the froth. Also, the world witnessed a statement from one of Russia’s central bank reserve managers that a doubling of Russia’s central bank gold holdings was worth consideration.

Historically, central banks have been the world’s worst timers in the metals markets – selling gold at historical lows during the 90’s. And they will probably begin to buy again next year with prices well north of 500 dollars. One of the areas of the world that may see significant gold demand as Middle East oil exporters may have a falling interest in holding too much US paper as new US legislation

related to “homeland security” is making it increasingly cumbersome to deal in US instruments. Asia has hardly any gold in its central banks either. Another support for gold may come with increasing attention on the environmental destruction related to gold mining, as the world’s gold mines are becoming increasingly low-grade and require therefore the processing of inconceivable amounts of ore for every gram of gold extracted. More focus and specific stories related to the environmental costs of gold mining cropped up already in 2005.

The silver market will track gold, as physical supplies of the metal have been impossibly tight. Gold may continue higher to \$700 and Silver to \$15.

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