

FX Crossroads

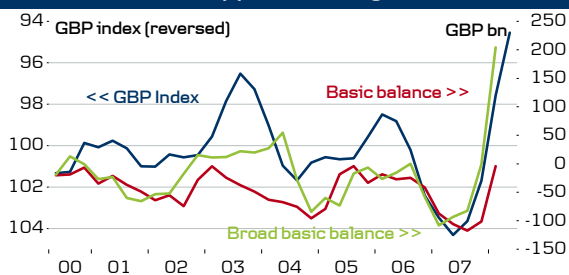
09 July 2008

GBP set to weaken further over summer

Summary and conclusions

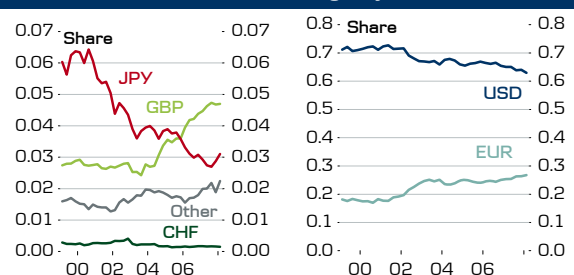
- In this edition we focus on sterling with an emphasis on the July Bank of England (BoE) meeting and the recent positive shock to the UK flow of funds.
- In the first article, we provide a preview for the upcoming BoE meeting on 10 July, when we expect the base rate to be left unchanged at 5.0%. This is also widely expected in the market; all 72 polled by Reuters last week expected no change. The market reaction should be limited.
- In the second article, we consider the puzzle of how the recent large positive shock to the UK flow of funds can coincide with broad-based sterling weakness.
- Overall, we still see the fundamental case for a weaker GBP and we expect that EUR/GBP will soon test new record-highs, having range traded for some time. Technically, a break-out of the current EUR/GBP triangle (peak 0.81 [16 April], through 0.7765 [2 May]) has the potential to send the pair towards 0.82, our three-month forecast, and possibly even beyond - perhaps as high as 0.84.
- Finally, we provide an update on the latest IMF FX reserve data, which shows that world reserves are still growing fast and that there is yet to be seen any evidence of a marked reduction in the share held in USD.
- *FX Crossroads* is published every second Wednesday. The next publication date is 23 July 2008.

Shouldn't an improvement in the broad basic balance support sterling?



Source: Reuters EcoWin

Share of world reserves held in USD has only declined slightly



Source: IMF

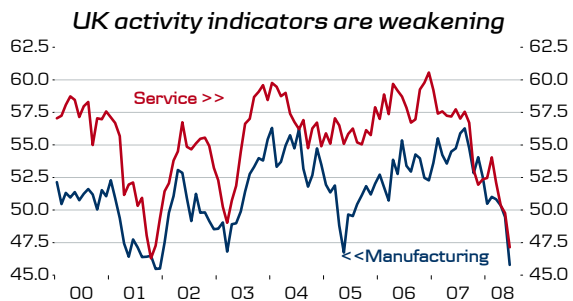
GBP: Bank of England preview

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Inflation is King

We expect the Bank of England (BoE) to leave the base rate unchanged at 5.0% at its meeting on 10 July. This is also widely expected in the market; all 72 polled by Reuters last week expected no change. The OIS market is attaching a 5% probability to a 25bp hike. The market reaction should be limited.

Data over the past month has merely been a continuation of the trend that started in early spring: inflation indicators have strengthened while activity indicators have worsened. One brief ray of light was the much better-than-expected retail sales, sparked higher by exceptionally warm weather in May, which spurred sales of seasonal food and clothing. But on the whole, data was worrying, which was best confirmed by the large drop in the important PMI index, now contracting the most since 2001.

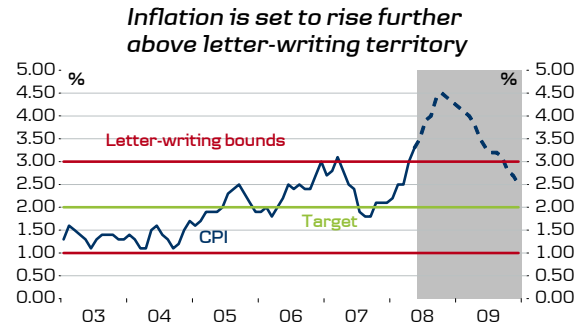


Source: Ecowin

In the short term, the BoE has its hands tied due to rising inflation. CPI inflation is set to rise further. In our forecast, inflation will move up towards 4.5% in October-November before falling back gradually. Inflation will probably be in "letter-writing" territory until late summer / early autumn 2009. This implies that the Governor of the BoE, Mervyn King, may have to write around six letters to the Chancellor (for every third month that inflation is above 3% (below 1%), a letter is required).

In the longer term, the situation is more complex for the BoE. Inflation is, in a way, deflationary. A higher inflation profile results in lower growth in

real incomes, which again feeds into weaker economic growth.



Note: The underlying assumption is that the oil price will be unchanged at the current spot level.
Source: Ecowin and Danske Bank

We do not regard monetary tightening as an option before the UK economy shows improvement. In our view, a higher base rate in 2008-2009 than currently will be devastating for UK growth prospects. A tightened monetary policy has the potential to reinforce a severe slowdown and perhaps a mild recession. Since the economy has already begun suffering, the next obvious step for BoE is a lowering of the base rate.

Some members may rattle their sabres and be tempted to raise rates to demonstrate a willingness to curb inflation. We expect, however, that they will refrain from doing so and keep their focus on the medium-term, where they can actually influence inflation.

The minutes of the July meeting, due 23 July, could well reveal that some members were unable to resist voting for higher rates. However, we are looking for lower rates, reflecting the real state of the UK economy.

We think EUR/GBP will test new record-highs soon, after range trading for some time. Technically, a break-out of the current EUR/GBP triangle (peak 0.81 (16 April), through 0.7765 (2 May)) has the potential to send the rate towards 0.82, our three-month forecast, and possibly even beyond, perhaps as far as 0.84.

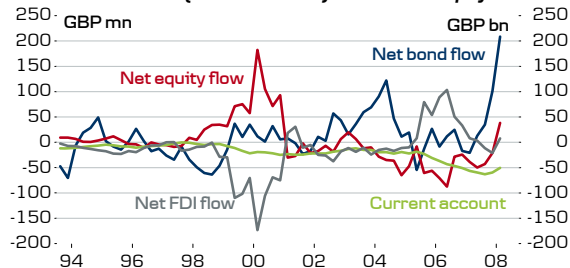
GBP: Flow of funds – what's going on?

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The curious link between the basic balance and sterling

Flow of funds data for Q1 was a positive reading. The current account surprised on the upside by posting a deficit of only £9.0bn (around 2.5% of GDP). FDI flows amounted to £31.5bn while portfolio flows totalled an astonishing £128bn in Q1. Bond flows in particular came in extremely positive, boosting the broad basic balance (current account + FDI + equities + bonds). But how does that relate to the recent sterling weakness?

Net bond flow (annualised) rises sharply in Q1

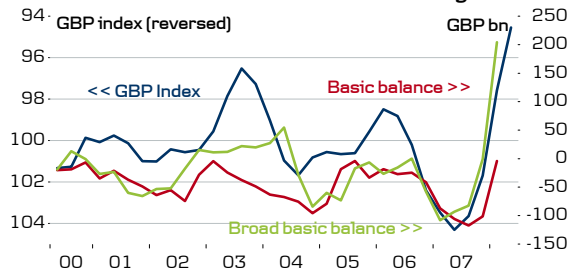


Source: Ecwin

The almost 10% decline in the effective sterling index since Q3 is worrying for central bankers as it could further boost inflation. But it also helps to improve the UK trade balance, which has been in an almost persistent deficit. Thus, as long as sterling is depreciating or just remains at this somewhat weak level, an improvement in the UK's external balance should be expected. FDI flows and equity flows were positive in Q1. This should be no surprise as the UK has recorded a large inflow stemming from M&A transactions during 2008.

A positive flow of funds into a country should, according to economic theory, imply greater demand for the country's currency, thereby leading to an appreciation. However, this has not been the case with the positive UK Q1 reading; instead the effective sterling index has fallen sharply as the broad basic balance has improved. In fact, sterling strength has been negatively related to the (broad) basic balance in this millennium (see chart).

Basic balances and effective sterling index



Source: Ecwin

What is the explanation for this rather perverse relationship? One obvious approach would be to assume one or even several factors have been more than offsetting the flow of funds in each period, resulting in either sterling depreciation or appreciation. To some extent, this is an acceptable explanation since flow of funds can easily be dominated by other factors. A second viable explanation could be a 'leaning-against-the-wind-effect' where investors sell sterling assets when the currency appreciates and buy sterling assets when the currency depreciates, i.e. balance their portfolios. A third explanation could be that sterling, seen as a risky currency due to the almost persistent current account deficit and rather large exposure to downturns in the financial sector, is being sold when risk aversion rises, but sterling assets are being bought as a hedge to even more riskier markets, such as emerging markets. This is perhaps the chief explanation for the recent period.

That sterling historically has been negatively correlated to flow of funds does not mean that it will continue to be so in the future. For example, the dominance of other factors to flow of funds could abate; the current account could improve substantially or the importance of other countries' financial sectors could rise to the UK level, meaning all currencies are perceived as equally risky

For now, we content ourselves by observing the positive UK broad basic balance and sterling at a somewhat lower level than most long term fair value models would suggest. We continue to see upside risks for EUR/GBP (up to 0.82) and notice that this could occur even with flows into the UK.

Global FX reserves: All eyes on the \$-share

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Continued high growth in reserves

On Monday 30 June, the IMF published COFER statistics covering Q1 2008. For an introduction to the IMF COFER data, see *FX Crossroads: New year, new worries*, 9 January 2008. The Q1 data confirmed two of the main trends seen in recent years: **(i) world reserves are growing fast and there are no signs of a slowdown in reserve accumulation**, and furthermore **(ii) there has been no marked change in the dollar share of total reserves, although there are tentative signs of a slow reduction in the reserve share held in dollars in favour of the euro in particular**.

The COFER data showed that growth in world reserves remained very high in Q1 2008. World total FX reserves now amount to USD 6.9tr after growing 28% y/y in Q1, which is a small acceleration of growth from the previous quarter. There are thus so far no signs in the data of a marked transfer of reserves away from official fx reserves and into other funds such as sovereign wealth funds.

The very high growth in world reserves remains driven by vast reserve accumulations in the developing countries. In Q1 total reserves rose 34.8% y/y in the developing world, while growth was only 9.8% y/y in the industrial countries.

Table 1: World FX reserves

Currency composition of official foreign exchange reserves

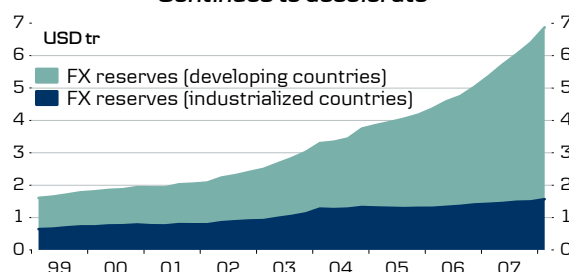
Share of world reserves	2003	2004	2005	2006	2007	Q1 2008	Chg. since '99
USD	66%	66%	67%	65%	64%	63%	-8.2 pct points
EUR	25%	25%	24%	25%	26%	27%	8.7 pct points
GBP	2.8%	3.4%	3.6%	4.4%	4.7%	4.7%	2.0 pct points
JPY	3.9%	3.8%	3.6%	3.1%	2.9%	3.1%	-2.9 pct points
CHF	0.2%	0.2%	0.1%	0.2%	0.2%	0.2%	-0.1 pct points
OTHER	2.0%	1.9%	1.7%	1.8%	1.9%	2.2%	0.6 pct points
Allocated	2,223	2,655	2,843	3,315	4,070	4,322	318%
Unallocated	802	1,094	1,332	1,722	2,326	2,552	617%
Total FX reserves (USD bn)	3026	3749	4175	5037	6396	6874	395%

Countries with the largest foreign exchange reserve stocks

USD bn	2003	2004	2005	2006	2007	Q1 2008	Chg. since 03'
China	403	610	819	1066	1528	1682	317%
Japan	653	824	828	875	948	988	51%
Russia	73	121	182	303	479	511	600%
Taiwan	207	242	253	266	270	287	39%
Korea	155	198	210	238	262	264	70%
Top-5 total	1491	1995	2292	2748	3487	3732	150%

Source: IMF COFER data and Reuters EcoWin.

Growth in the world's total FX reserves Continues to accelerate



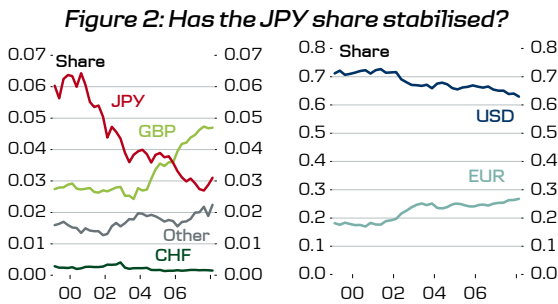
Source: IMF

However, the growth rate in developing countries reserves was unchanged in Q1, and the acceleration in world reserves in the first quarter was thus driven by an acceleration of reserve growth in the industrialised countries. Overall, however, it can be noted that world reserves are booming and that there are still no signs of a slowdown in the reserve accumulation.

Considering reserve accumulation in individual countries, it is still China and Russia that are the main drivers of the world reserve build up (see table 1). The south-east Asian region in general has accumulated vast reserves in recent years and much more than would be expected given the trade flow into the region. This suggests that reserve growth is driven by intervention on the foreign exchange market.

While the developments in overall reserves are interesting, the perhaps most interesting aspect of the IMF COFER data is that it provides an overview of the share of reserves held in the individual currencies.

For some time the focus has been on the share of reserves held in dollars and whether we were experiencing a regime shift away from the dollar as the world reserve currency. Data shows that the dollar's share of world reserves has been broadly flat since 2000 and there are no signs of a marked shift in world reserve allocations. However, recent data has shown that there might be tentative signs of a slow movement away from the dollar and mainly into the euro. This was also confirmed by the Q1 data, which showed that the dollar share of world reserves fell from 64 percent to 63 percent.



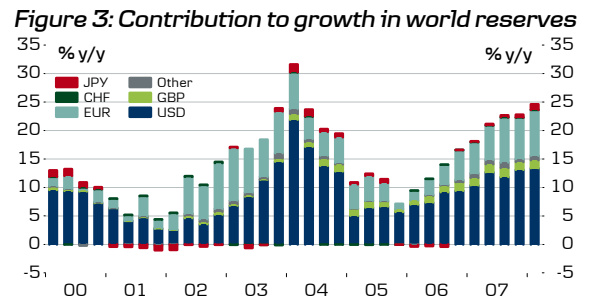
Source: IMF

Another trend in the COFER data has been the reduction of reserve shares held in Japanese yen. Recently, however, there have been signs of a stabilisation in the yen share, which also rose from 2.9 percent to 3.1 percent in the first quarter.

To conclude, the Q1 COFER data confirmed two of the main trends seen in recent years: (i) world reserves are growing fast and there are no signs of a slowdown in reserve accumulation, and (ii) there has been no marked change in the dollar share of total reserves, although there are tentative signs of a slow reduction in the reserve share held in dollars in favour of the euro in particular.

While there are signs of a fundamental flow of funds in the world reserve accumulation in favour of the euro against the dollar, it is not as large as some have

argued, and the process of reducing the dollars share in official fx reserves has so far been very gradual. The fact that the share of official reserves being held in dollars has remained broadly constant, while the dollar has seen a large depreciation, implies that central banks have been large buyers of dollars (see figure 3). There is thus still fundamental support for the dollar from official reserve flows, which is acting to curb some of the depreciative pressures from the general economic fundamentals. That the dollars reserve share has not seen a marked fall is naturally positive and the dollar would likely have fallen even further in recent years had it not been for these fundamental flows. However, this also means that the dollar is left with a large event risk, since a reduction in the dollar share by any of the major foreign reserve holders would leave the dollar under pressure.



Source: IMF

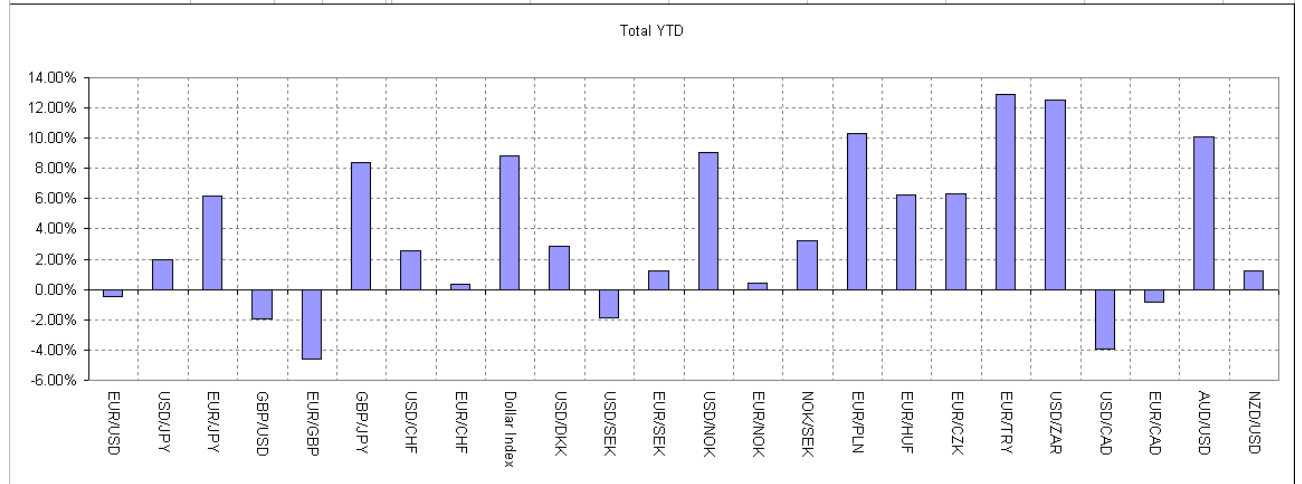
Info box: IMF's COFER data

The International Monetary Fund (IMF) releases each quarter statistics on world foreign exchange reserves in its publication: Currency Composition of Official Foreign Reserves (COFER). Official FX reserves are the monetary authorities' claims on non-residents in the form of: foreign banknotes, t-bills, etc.

When considering the IMF COFER statistics it is necessary to acknowledge some limitations to the data. Allocated reserves (i.e. FX reserves for which we know the allocation on currencies) only constitutes 63% of total reserves, and more importantly is 47 % of growth in world reserves driven by accumulation in unallocated reserves.

Trading Points

										09/07/2008	9:45	(CET)
										Strategy (Short-Medium Term)		
MARKET	LAST	Trend	5DCHG	Strategy	Stop/Entry	1st Target	2nd Target	Stop/Reverse	New Target	Total YTD		
CURRENCIES - Majors												
EUR/USD	1.5683	↘	-1.26%	Go Long>	1.5753	1.5835	Go Short<	1.5611	1.5569	-0.44%		
USD/JPY	107.61	↗	1.62%	Go Long>	107.76	108.43	Go Short<	106.25	105.42	1.99%		
EUR/JPY	168.73	↗	0.31%	LONG		169.46	170.61	167.23	166.70	6.15%		
GBP/USD	1.9683	↘	-1.25%	Go Long>	1.9798	1.9869	Go Short<	1.9665	1.9602	-1.92%		
EUR/GBP	0.7968	↗	-0.04%	LONG		0.7990	0.8020	0.7902	0.7885	-4.63%		
GBP/JPY	211.76	↘	0.33%	Go Long>	212.46	213.35	Go Short<	211.00	209.86	8.40%		
USD/CHF	1.0334	↘	1.88%	Go Long>	1.0352	1.0427	Go Short<	1.0220	1.0166	2.56%		
EUR/CHF	1.6206	↘	0.60%	Go Long>	1.6203	1.6239	Go Short<	1.6064	1.6020	0.36%		
Dollar Index	72.940	↗	0.013	Go Long>	73.1580	73.348	Go Short<	72.619	71.985	8.84%		
CURRENCIES - Scandies												
USD/DKK	4.7562	↗	1.28%	Go Long>	4.7765	4.7914	Go Short<	4.7345	4.7086	2.86%		
USD/SEK	6.0210	↗	0.82%	Go Long>	6.0360	6.0563	Go Short<	5.9812	5.9665	-1.84%		
EUR/SEK	9.4428	↘	-0.45%	LONG		9.4520		9.4060	9.3936	1.26%		
USD/NOK	5.1281	↗	1.35%	Go Long>	5.1433	5.1645	Go Short<	5.0740	5.0432	9.08%		
EUR/NOK	8.0436	↗	0.08%	Go Long>	8.0523	8.0808	Go Short<	7.9798	7.9352	0.40%		
NOK/SEK	1.1742	↘	-0.53%	SHORT		1.1677		1.1798	1.1860	3.25%		
CURRENCIES - Non Majors												
EUR/PLN	3.2926	↘	-1.75%	Go Long>	3.3275	3.3555	Go Short<	3.2860	3.2502	10.28%		
EUR/HUF	230.95	↘	-2.37%	SHORT		230.34		232.80	237.14	6.28%		
EUR/CZK	23.557	↘	-1.22%	Go Long>	23.689	23.763	Go Short<	23.450	23.229	6.33%		
EUR/TRY	1.9196	↘	-2.84%	Go Long>	1.9515	1.9769	Go Short<	1.9157	1.8932	12.87%		
USD/ZAR	7.6748	↘	-2.25%	SHORT		7.6682		7.7660	7.8672	12.53%		
USD/CAD	1.0182	↘	0.57%	SHORT		1.0122		1.0234	1.0250	-3.95%		
EUR/CAD	1.5968	↘	-0.70%	LONG		1.6077	1.6117	1.5945	1.5908	-0.82%		
AUD/USD	0.9503	↘	-1.23%	Go Long>	0.9570	0.9611	Go Short<	0.9475	0.9446	10.10%		
NZD/USD	0.7530	↘	-0.96%	Go Long>	0.7605	0.7654	Go Short<	0.7484	0.7415	1.23%		



Trading recommendations and G10 central bank overview

Directional trades

	Date	Start	Now	Target	Stop	P/L (incl carry)
Open						
We currently have no open trade recommendations						
Recently closed						
Sell NZD/NOK	16/06/08	3.9100	3.8650	3.7500	3.8650	1.07
Sell USD/JPY	19/06/08	107.8500	105.0000	105.0000	107.2500	2.65
Buy EUR/GBP	19/06/08	0.786	0.80	0.80	0.79	1.74
P/L 2008	9.43%	Open	0.00%	Closed	9.43%	
# of trades *	108	# of trades 2008		23		
- average net gain	0.38%	- average net gain		0.41%		
- batting average	0.52	- batting average		0.52		

* Since 17 November 2005

Central bank overview

Country	Official interest rate	Policy rate	Next decision*	Last change
United States	Federal funds rate	2.00	5 Aug (unch)	30 Apr (-25bp)
Euroland	Minimum bid rate	4.25	7 Aug (unch)	3 July (+25bp)
Japan	Overnight call rate	0.50	15 Jul (unch)	21 Feb 07 (+25bp)
United Kingdom	Base rate	5.00	10 Jul (unch)	10 Apr (-25bp)
Switzerland	3-month Libor	2.75	18 Sep (+25bp)	13 Sep 07 (+25bp)
Canada	Overnight rate	3.00	15 Jul (unch)	22 Apr (-50bp)
Australia	Cash rate	7.25	5 Aug (unch)	4 Mar (+25bp)
New Zealand	Cash rate	8.25	24 Jul (unch)	25 Jun 07 (+25bp)
Sweden	Repo rate	4.50	4 Sep (+25bp)	3 July (+25bp)
Norway	Sight deposit rate	5.75	13 Aug (+25bp)	23 Apr (+25bp)

* Expected decision in brackets

G10 central bank forecast overview

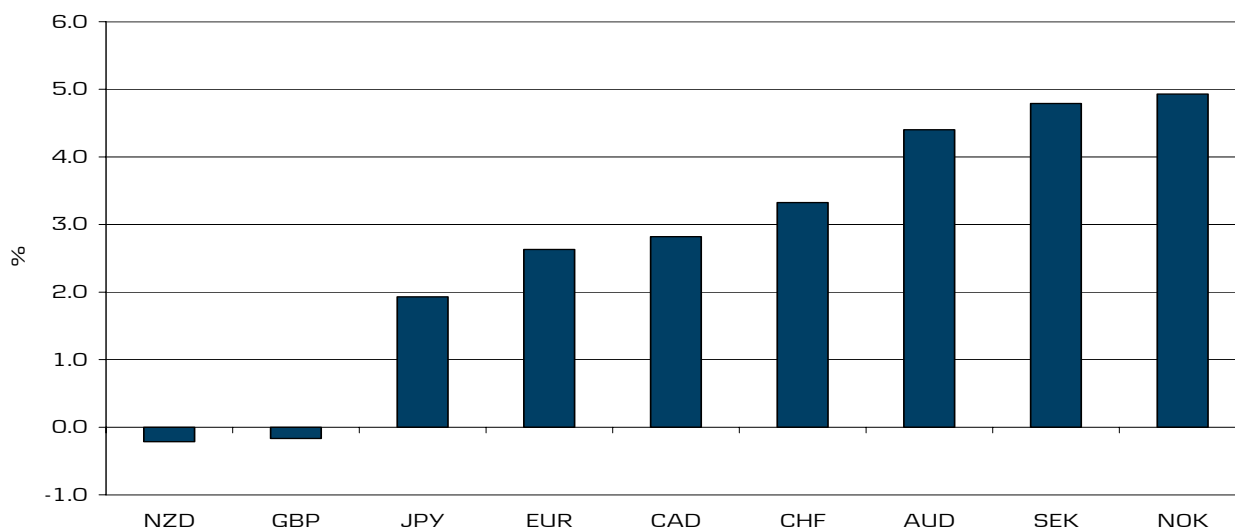
	FED	BOC	ECB	BOE	SNB	RB	NB	BOJ	RBA	RBNZ
Now	2.00	3.00	4.25	5.00	2.75	4.50	5.75	0.50	7.25	8.25
2008 Jul		15-Jul		10-Jul				15-Jul		24-Jul
Aug	05-Aug		07-Aug	07-Aug			13-Aug	19-Aug	05-Aug	
Sep	16-Sep	03-Sep	04-Sep	04-Sep	18-Sep	04-Sep	24-Sep	17-Sep	02-Sep	11-Sep
Oct	29-Oct	21-Oct	02-Oct	09-Oct		23-Oct	29-Oct	7+31-Oct	07-Oct	23-Oct
Nov			06-Nov	06-Nov				21-Nov	04-Nov	
Dec	16-Dec	09-Dec	04-Dec	04-Dec	11-Dec	17-Dec	17-Dec	19-Dec	02-Dec	04-Dec
2009 Jan	28-Jan							22-Jan		
Feb								19-Feb	03-Feb	
Mar								17-Mar	03-Mar	
Apr								7+28-Apr	07-Apr	
12M	2.00	3.00	4.25	4.50	3.00	5.00	6.00	0.50	7.25	7.25
Rate cut	Rate hike									

Exchange rate forecasts

	Spot	Forecast				Forecast vs forward outright, %			
		+1m	+3m	+6m	+12m	+1m	+3m	+6m	+12m
Exchange rates vs EUR									
USD	1.567	1.58	1.60	1.55	1.50	1.0	2.6	-0.1	-2.5
JPY	168.62	166	168	155	150	-1.3	0.6	-6.1	-7.1
GBP	0.796	0.800	0.820	0.800	0.780	0.5	2.8	0.1	-2.8
CHF	1.621	1.61	1.60	1.58	1.56	-0.5	-0.7	-1.4	-1.7
DKK	7.46	7.46	7.46	7.46	7.46	0.0	0.0	0.0	-0.1
NOK	8.06	8.00	7.90	7.75	7.75	-0.8	-2.4	-4.6	-5.4
SEK	9.46	9.40	9.25	9.20	9.20	-0.6	-2.2	-2.9	-3.1
PLN	3.29	3.40	3.40	3.40	3.45	3.4	3.2	2.8	3.8
CZK	23.56	24.00	24.00	24.25	24.50	1.9	2.1	3.4	4.8
HUF	231	240	240	245	250	3.8	3.2	4.6	5.2
TRY	1.92	2.05	2.05	2.12	2.25	5.6	3.4	3.5	3.0
Exchange rates vs USD									
DXY	72.9	71.9	71.3	71.9	72.9	-1.5	-2.4	-1.8	-0.7
JPY	107.6	105	105	100	100	-2.3	-1.9	-6.0	-4.9
GBP	1.97	1.98	1.95	1.94	1.92	0.6	-0.2	-0.2	0.3
CHF	1.04	1.02	1.00	1.02	1.04	-1.5	-3.3	-1.4	0.8
DKK	4.76	4.72	4.66	4.81	4.97	-1.0	-2.6	0.1	2.5
NOK	5.14	5.06	4.94	5.00	5.17	-1.9	-4.9	-4.6	-3.0
SEK	6.04	5.95	5.78	5.94	6.13	-1.6	-4.8	-2.8	-0.6
CAD	1.02	1.00	0.99	1.00	1.00	-1.8	-2.8	-1.9	-2.1
AUD	0.95	0.96	0.98	0.95	0.90	1.5	4.4	2.4	-0.7
NZD	0.75	0.75	0.74	0.73	0.70	0.1	-0.2	-0.3	-2.2
ZAR	7.68	7.85	7.85	8.10	8.40	1.4	-0.4	0.5	-0.4
BRL	1.61	1.62	1.62	1.67	1.70	-0.3	-1.8	-1.1	-3.9
MXN	10.31	10.30	10.35	10.55	10.70	-0.5	-0.9	-0.2	-1.4
CNY	6.86	6.90	6.79	6.63	6.43	1.0	0.4	-0.6	-1.0

Note: GBP, AUD and NZD are denominated in local currency rather than USD

Expected change in USD vs forwards, 3m



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