

Research

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Awash with cash 6: A wake-up call

- Recent jitters in financial markets have been broad-based, hitting emerging market currencies as well as energy stocks and other assets. We interpret the events as being triggered by rising risk aversion on the investor side on the back of a continuing tightening of monetary policy.
- While the turmoil will recede sooner or later, we argue that these events should be taken seriously by investors. They suggest that the “Awash with cash” theme that we laid out in a series of 5 reports early in 2005 is now beginning to end.
- While the carry theme in FX markets was the first victim of this process, other “awash with cash” themes are likely to fade away as well. This includes the strong performance in emerging market equities and emerging market debt. The commodity boom is also likely to be an eventual casualty. Volatility is likely to start rising in major markets over the next 12-18 months.
- Corporate credit markets in the developed world and blue chip stocks appear least vulnerable to tightening monetary policy and rising bond yields.

Less awash with cash

“The times they are a-changing”

During the first half of 2005 we issued the “Awash with cash” series of five reports. Throughout the reports we argued that global financial markets have been flooded by liquidity due to a combination of extremely easy US monetary policy and Asian resistance to currency appreciation.

We also argued that the low bond yields – what Greenspan famously called a “bond yield conundrum” – were part of this story (see “*Awash with cash 5: A solution to the bond yield conundrum*”). In essence our view has been that US monetary policy stayed easy for too long into this expansion, and that this created a chain of effects, namely:

- Broad-based global balance sheet improvement (both for corporations, households and emerging market countries)
- Tightening spreads on all credit products
- Low cross-market volatility
- Rising ability and willingness to leverage, implying strong risk willingness
- Bullish bond market despite tightening of US monetary policy (the conundrum)
- Bull market in commodities
- A carry-focused FX markets
- Overly lenient global credit conditions

However, recent events in the global financial world indicate that the awash with cash environment is starting to disappear.

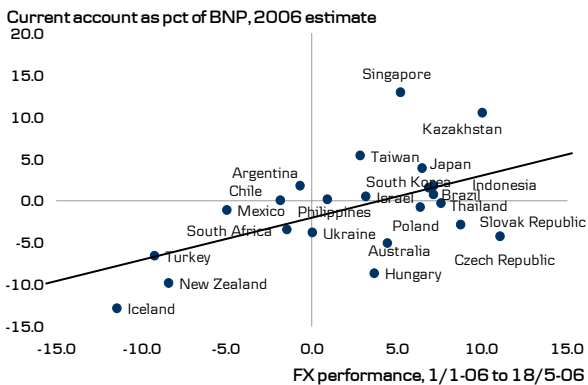
Firstly, global bond yields have risen substantially. In the short term, a softening in global industry –

partly attributable to a slowdown in demand growth and partly due to the rise in energy prices - will put downward pressure on bond yields. But on a longer-term horizon the phasing out of the lagged effect of easy US policy on bond yields will put further upward pressure on global bond yields. Indeed, our Tactical Asset Allocation models suggest that long bond yields will generally be on the rise over the next 12 months [see *Tactical Investor*, March 2006].

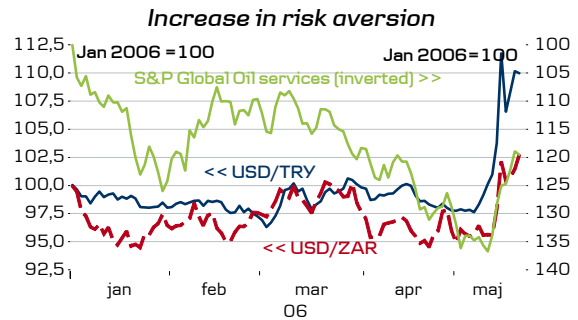


Secondly, the currency market's focus on carry has been weakening, and a focus on current account imbalances has emerged instead. This initially hit developed countries with substantial imbalances and overvalued currencies, such as Iceland and New Zealand, but then spread to the greenback in the aftermath of the G7 meeting in April which put global imbalances back on the radar screen.

Current account balances are driving FX market



Thirdly, came the surprisingly dramatic market turmoil of recent weeks.



The sell-off was not just widely distributed over several emerging market currencies, as can be seen from the similar reaction in USD/TRY and USD/ZAR. It was also visible in other asset classes, most notably in the "hottest" sectors of the equity market. S&P1200 Global Oil Services sold off at broadly the same time and in the same pattern as the two above-mentioned currencies. It is hard to see what oil services equities and the Turkish currency have in common - except the fact that both assets have been strong performers over the past year and are therefore likely to have attracted a lot of inflows from risk-seeking investors in search of return.

The fact that the sell-off has been so synchronized and that there have been few if any obvious fundamental triggers suggests the turmoil mostly reflects a rapid turnaround in investor sentiment.

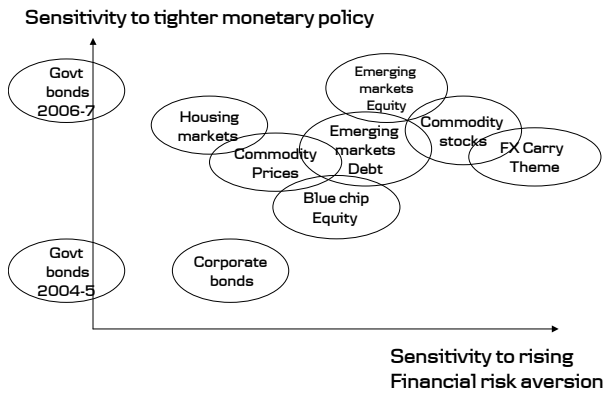
Rapid reversals in investor sentiment and dramatic shifts in volatility are not unprecedented. In fact this is a repeated and well known pattern in financial markets. There is a high probability that the current spat of risk aversion will die out again soon and that some calm will be restored to the markets.

Time to reef some sails

"Please heed the call, don't stand in the doorway"

Even so, recent financial market jitters should be seen as a wake-up call.

To take the conclusions first, we think investors should now be warned that the financial climate is changing in a more permanent way. And that it is changing for the worse, seen from the perspective of most asset classes.



The chart shows how we perceive the sensitivity of the assets mentioned above to the two most important drivers of the change: Tightening monetary policy and rising risk aversion.

As has been seen over the past week, FX sentiment, especially in emerging markets, and some of the more hyped parts of the equity market have been the first victims of heightened risk aversion. But the slowly tightening global monetary conditions are likely to claim other victims further down the road. These include long bond yields, and through them the housing boom in many advanced economies. The effect on the housing market from long bond yields would be exacerbated by a slowing in world economic growth. Emerging market equities and debt will eventually be hit too: When – if not before – commodity markets eventually turn.

Reasonably valued blue chip stocks in developed countries and the corporate bond market seem, to us, to be best positioned to withstand the end of the “awash with cash” theme over the next couple of years.

Global liquidity tightening

“Admit that the waters around you have grown”

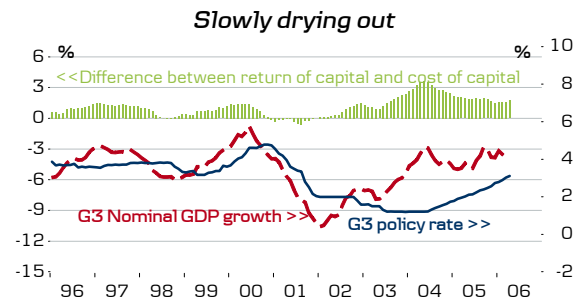
There might not be obvious fundamental reasons why the market is selling off in oil services and TRY right now. But there are very good reasons to believe that global financial market dynamics are undergoing a more permanent change. **We are now facing a very different kind of market from the one that prevailed from 2003 to early 2006: “Awash with cash” is beginning to end.**

The reasons are straightforward.

The major central banks have taken a hawkish stance. They are now viewing oil as more an infla-

tionary threat than a threat to growth. The Federal Reserve, in particular, which is facing a tight economy and rather high core inflation, cannot afford to let the expansion continue to run. This implies tight US policy within a 12-18 month timeframe.

It should be noted that the global monetary tightening seen until now has not been dramatic (see chart below). Compared to global nominal growth, overall monetary policy remains pretty easy.



However, with the US and Europe heading towards somewhat slower growth in H2 2006 while the respective central banks continue to take a hawkish stance, global liquidity will tighten further. Moreover, Bank of Japan will raise interest rates during the coming 6 months and the Chinese authorities are likely to impose further tightening measures to control its booming economy. **Therefore, the tightening of global financial conditions seen over the past half year is likely to be a continuing market theme in the time ahead.**

Rising inflation, tightening monetary policy and slower growth raise the worrying prospect of a “stagflation” theme in the markets.

Reversing awash with cash

“The wheel’s still in spin, no tellin’ who it’s namin’”

Evidently this should prompt investors to rethink all the “awash with cash themes”, including:

- Carry trades in currencies
- Commodity bull market
- Emerging market credits and equities
- Corporate credit spreads
- Equity market risk willingness
- Volatility in major asset classes

Generally we don't think that the end of “awash with cash” will be sudden. Sure, it feels that way right now with the sudden jump in volatility, espe-

cially in emerging market currencies. However, experience suggests that the change will come in "waves", as has indeed been the case so far. Some of the "awash with cash themes" will be resilient. Others will not.

Carry trades in currencies are death

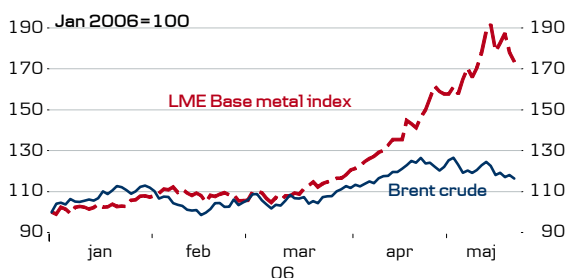
The asset class where the most dramatic effect of tightening liquidity has been seen so far has been currency markets. There has been a general shift away from focusing on interest rate differentials and carry trade (visible in the greenback's slide over recent months) and towards imbalances and risk. This change in sentiment has been evident in the emerging market universe, which has suffered in recent weeks. This is natural, since emerging market currencies have appreciated very strongly over recent years but are notorious vulnerable when risk aversion increases.

Naturally, it is likely that some relief will be witnessed in the emerging market currencies in the near term. But longer term, we are cautious because of the more challenging global financial environment. The tightening of global liquidity, additional dollar weakness and rising global risk aversion will hurt emerging market currencies further. **We believe that the bull run in emerging market currencies in 2004 and 2005 has come to an end** (see "Flash comment - Emerging markets: This is not a buying opportunity", May 15). The currencies at risk will be the ones where the external position is weak, e.g. Turkey and South Africa.

Commodity markets - is this really the end?

Commodity markets have also taken a hit, although the correction in prices has been much smaller compared to the change in risk aversion seen in currency and equity markets. Relative to the strong performance over the course of the year, metal prices are still at very high levels.

Only a minor correction



Rising global risk aversion might suggest that metals and energy prices will be some of the next victims. The substantial upward jump in metal prices

this year suggests that the downside potential is huge.

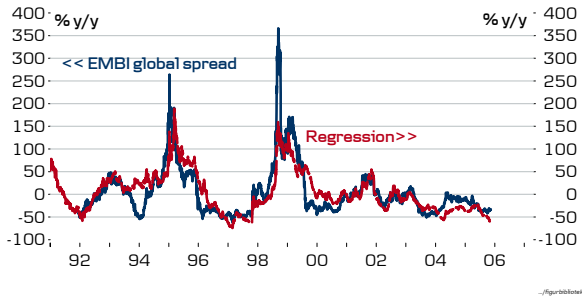
We believe, however, that there is a very strong fundamental case underpinning the rise in energy and metal prices which should put a solid floor under prices. Instead, potential further spikes in commodities - and especially energy - will only serve to intensify the stagflation theme in other markets. It will create more pressure on central banks to tighten monetary policy more, while at the same time threatening growth. Of course in the long term a tightening of global monetary policy and slower growth will put a drag on commodity prices. Hence, going forward, do not expect the same acceleration in price growth as was seen in the spring. Prices will eventually level out.

Emerging market credit and equities

The past few weeks' turmoil in emerging market currencies has also had an effect on emerging market credit. But what is surprising is that the much more challenging global financial environment seen this year for emerging markets has not had a larger effect. In fact, the JPM Emerging Market Bond Index Global, which tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities, has continued its downward trend in 2006. Part of the reason is that the strong fundamentals of many emerging markets have not changed. Furthermore, the creditworthiness of many emerging markets is indirectly tied to the commodity boom. As long as commodity prices are at a high level, so will large parts of the emerging markets' debt universe remain solid. What has been seen recently is mostly a sentiment reaction affecting the "hot" money in currency markets.

To explain developments in the EMBI we have estimated a stochastic difference equation. To capture emerging markets' improved external liquidity conditions we have included the following variable: *current account deficit + short-term external debt/foreign exchange reserves*. We have also included CPI in emerging markets, lagged ISM and the fed funds rate. All of the variables are measured in differences and - except for the ISM indicator - with only one lag. The variables are highly significant and come out with the expected positive signs.

Narrowing spread

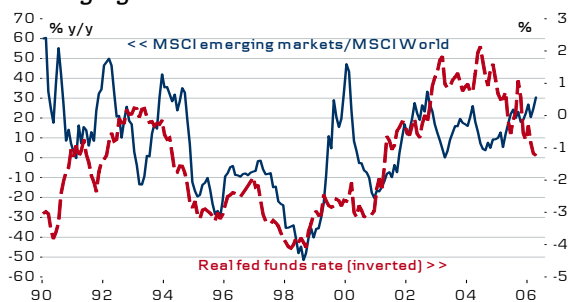


It turns out that a large part of the declining EMBI spread over recent years can be explained by improved economic fundamentals in emerging markets. As mentioned above, these improved emerging market fundamentals partly reflect strong growth and easy monetary policy in the developed world. As emerging market fundamentals have improved considerably over the past 10 years, a widening of the EMBI spread is not likely to be sudden.

However, the combination of slower world growth and a tightening of US and global monetary policies is likely to hurt emerging market credit further down the road too: When – if not before – tight policy breaks the back of the commodity bull market.

The effect of tightening global liquidity is likely to be more serious for emerging market equities. Historically, they tend to start underperforming developed markets when US monetary policy becomes tight and long bond yields rise. Whereas the improvements in the EMBI spread partly reflect fundamental changes in emerging market economies that will not change overnight, emerging market equities are likely to be hit hard when global liquidity tightens and risk aversion rises. The huge fall in the Indian stock exchanges in the past couple of days may be a sign of what to expect.

Emerging markets best with low real fed funds



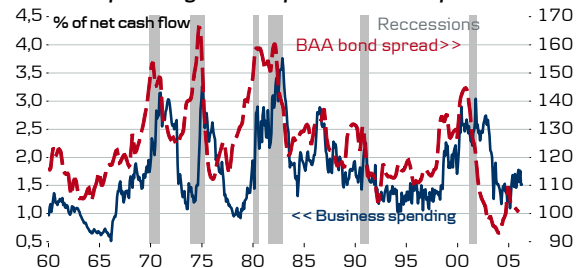
Corporate credit spread

Looking into other credit spreads, we don't see corporate credit spreads widening at the same pace as e.g. emerging market debt. Historically, corpo-

rate credit spreads have been driven by the leveraging cycle of non-financial corporations. As the global corporate sector has been famously restrained in its spending during the past couple of years, **the corporate balance sheet situation in developed markets remains very strong and credit-friendly.**

Although, we might be over the top in terms of the tightening of corporate credit spreads, high corporate savings suggest that the asset class is rather well protected. Of course, slower economic growth coupled with a tightening of monetary policy will eventually hurt the balance sheets of companies, but this is a longer-term story. So far the heightened risk aversion has not had much impact on this market. Nor is it likely to do so until a serious economic slump threatens.

Low spending = Well protected Corp. credits



Are global equity markets in for a crash?

Equity markets are always sensitive to changes in risk aversion, as could be seen in the past week. Moreover, "stagflation" as a theme in the markets is obviously not a healthy environment for equities in general.

However, we note that an equity bull market has not been an important overall part of the "awash with cash" theme, apart from in emerging equity markets – and perhaps Japan. The US stock market has seen P/E sliding downwards and has performed rather dismally. And while the European market has performed strongly, this was entirely due to the remarkable profit recovery in the European corporate sector since 2003.

While we don't think equity markets are in for a serious crash, the outlook is becoming less bright and we prefer large cap blue chips in developed markets to more risky markets at the present juncture.

Previous papers in the "Awash with cash" series:

1. "Awash with cash 1: Chinese revaluation", Jan 10, 2005
2. "Awash with cash 2: Volatility and risky assets", Jan 11, 2005
3. "Awash with cash 3: The incredible corporate balance sheet recovery", Jan 12, 2005
4. "Awash with cash 4: A new regime for real interest rates?", Jan 13, 2005
5. "Awash with cash 5: A solution to the Bond yield conundrum", April 18, 2005

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