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### DAX PLUNGES 33 PERCENT TO 5,000

The leading German stock market index DAX was one of the world's best performing stock markets in 2012 as Europe's economic juggernaut continued to fare better than most Eurozone countries, despite the crisis on the continent and weaker activity in China. This will all change in 2013 as China's economic slowdown continues, thereby putting a halt to Germany's industrial expansion. This causes large price declines in industrial stocks due to stagnating revenue and declining profits at major industry players such as Siemens, BASF and Daimler. This market stress deflates consumer confidence and as a result domestic demand, highlighted by weak retail sales. With domestic demand failing to offset weakening exports, approval ratings for Chancellor Angela Merkel plunge ahead of the German election in the third quarter, and ultimately the deteriorated economic situation obstructs her re-election attempt. With a weak economy and uncertainty about a new government, the DAX index declines to 5,000, down 33 percent for the year.

### NATIONALISATION OF MAJOR JAPANESE ELECTRONICS COMPANIES

Japan's electronics industry, once the glory of the 'Land of the Rising Sun', enters a terminal phase after being outmatched by the roaring South Korean electronics industry, with Samsung the winner. The core driver of the industry's decline is a too domestically oriented approach which has led to a high fixed cost base due to Japan's extreme living costs, pensions and the strong yen. With combined losses of USD 30 billion in the last twelve months ending September 30, 2012, for Sharp, Panasonic and Sony combined, creditworthiness deteriorates greatly and the Japanese government nationalises the electronics industry in *déjà-vu* style - similar to the government bailout of the US automobile industry. There has been no nominal growth in Japan's gross domestic product in eight out of the last 16 years and as a consequence of the bailouts, the Bank of Japan formalises nominal GDP targeting. The BoJ expands its balance sheet to almost 50 percent of nominal GDP to spur inflation and weaken the yen. As a result, USDJPY goes to 90.



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### SOYBEANS TO RISE BY 50 PERCENT

Bad weather during 2012 caused havoc to global crop production and we fear this will continue to play an unwanted role during the 2013 planting and growing season. The US soybean ending stock, which improved slightly ultimo 2012, is still precariously tight at a nine-year low. This tightness leaves the price of new crop soybeans, illustrated by the January 2014 contract on Chicago Board of Trade futures, exposed to any new weather disruptions, either in the US or South America (which is now the world's largest producing region) or in China (the world's largest consumer and biggest importer). Increased demand for biofuel, in this case soybean oil to cover biodiesel mandates, will also play its part in exposing the price to spikes should worries about supply resurface. Speculative investors, who reduced their soy sector exposure by two-thirds towards the end of 2012, will be ready to re-enter and this combination of technical and fundamental buying could potentially push the price higher by as much as 50 percent.

### GOLD CORRECTS TO USD 1,200 PER OUNCE

The strength of the US economic recovery in 2013 surprises the market and especially financial investors in gold, who in recent years have come to dominate the market thereby making the yellow metal extremely sensitive to expectations for the global interest rate environment. The changed outlook for the US economy combined with a lack of pick-up in physical demand for the precious metal from China and India, which both struggle with weak growth and rising unemployment, trigger a major round of gold liquidation. This is particularly a result of the US Federal Reserve's decision to reduce or completely cease further purchases of mortgage and treasury bonds. Hedge funds move to the sell side and once the important USD 1,500 level is broken a massive round of long liquidation follows, especially by investors in Exchange Traded Funds who have been accumulating record holdings of gold. Gold slumps to USD 1,200 before central banks, especially in emerging economies, eventually step in to take advantage of lower prices.

### WTI CRUDE HITS USD 50

US energy production continues to rise beyond expectations, primarily brought about by advanced production techniques, such as in the shale oil sector. US production of West Texas Intermediate crude oil rises strongly and with inventory levels already at a 30-year high and export options limited, WTI crude oil prices come under renewed selling pressure and slump towards USD 50 per barrel. Weaker than expected global growth compounds this process triggering a surprise drop in global consumption of oil and the price of Brent Crude, the global benchmark. The supply side, led by the Organization of the Petroleum Exporting Countries and Russia, reacts too late to this challenge as its members - desperate for revenues to pay for ever increasing public expenditure - hesitate to reduce production, so the supply glut rises even further.



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### USDJPY HEADS TO 60.00

The Liberal Democratic Party comes back into power with its supposedly JPY-punishing agenda. But the reality of office, an uncooperative parliament and resistance from the Bank of Japan, mean that only half-measures are introduced. Meanwhile, the market has become over-enamoured with the potential for LDP leadership to bring about change and over-positioned for JPY weakness. As the market loses its enthusiasm for global quantitative easing and risk appetite retrenches, the yen vaults to the fore again for a time as the world's strongest currency due to deflation and repatriation of investments, and carry trades find themselves turned on their head. USDJPY heads as low as 60.00 and other JPY crosses head even more violently lower, ironically paving the way for the LDP government and the BoJ to reach for those more radical measures aimed at weakening the yen.

### HONG KONG UNPEGS HKD FROM USD – RE-PEGS TO RMB

China deepens its political commitment to turn away from its managed peg to the US dollar. A big step in this direction is taken as Hong Kong moves to unpeg the Hong Kong dollar from the US dollar and repeg it to the Chinese renminbi. Other Asian countries show signs of wanting to follow suit in recognition of Asia's shifting trade patterns and as national policies of accumulating endless USD reserves begin to erode. China also takes steps to increase RMB convertibility to grab a larger share of global trade – part of its large ambition to hold more sway over developing and frontier economies and commodity producers. This starts a process of wresting some of the advantages of holding a major reserve currency away from the US currency. RMB volatility increases as China loosens its grip on the currency's movements, and Hong Kong quickly grows to become a major world currency trading centre and the most important centre for trading the RMB.

### EURCHF BREAKS PEG, TOUCHES 0.9500

European Union tail risks are re-aggravated – perhaps by the Italian election – or over the nature of Greece's exit from the European Monetary Union and the worry that Spain and Portugal will follow suit. This sends capital flows surging into Switzerland once again and the Swiss National Bank and Swiss Government decide it is better to abandon the Swiss franc's peg to the euro for a time, rather than let reserves accumulate to more than 100 percent of gross domestic product after they more than doubled to nearly two-thirds of GDP over the course of 2011 and 2012. Punitive measures and capital controls eventually brake the franc's appreciation, but not until EURCHF has touched a new all-time low below parity after having neared parity in 2011.



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### SPAIN TAKES ONE STEP CLOSER TO DEFAULT AS INTEREST RATES RISE TO 10 PERCENT

The market ignores the strains on the social fabric at the European Union periphery as input to EU systemic risk. This is particularly the case for Spain, where disposable income for over 1.8 million people is now less than EUR 400 a month and only 17 million out of a population of 47 million are employed. The unemployment rate is 25 percent and youth unemployment is alarmingly over 50 percent. On top of this, Catalonia is threatening to break away from Spain. While the European Central Bank and the EU are busy 'selling the success' of lower interest rates, Spain has seen total debt (public and private) explode to over 400 percent of its gross domestic product. Only Japan is in a worse state. With social tensions so high, the public sector simply cannot cut its public outlays further. In 2013, Spanish sovereign debt is downgraded to junk and the social strain pushes Spain over the edge, seeing Spain reject the extend-and-pretend policies of EU officialdom. Yields rapidly increase after the downgrade and as an inevitable default is priced in.

### 30-YEAR US YIELD DOUBLES IN 2013

The 30-year US Treasury bond tells us that the expected return over the next 30 years is a real return of 0.4 percent (2.8% yield minus a break-even inflation of 2.4%). This cannot last in a world of forced inflation via infinite monetary printing and a possible downgrade of the US - if we fail to get structural fiscal reforms. The Federal Reserve is expected to keep rates low for longer but in 2013 this could be challenged by the zero interest rate policy which forces investors to leave fixed income to attain any yield. The global bond markets is USD 157 trillion versus a stock market valuation of USD 55 trillion (Source: Mapping global capital markets 2011 - McKinsey & Company). This means that for every one dollar in equity there are three in fixed income. With no return or even negative return (after costs) the substitution of bonds with stocks is appealing. For every 10 percent the mutual funds reduce their bond weightings the equity market will see 30 percent on net inflow – this could not only lead to higher US rates, but also be the beginning of decade-long outperformance by stocks over bonds, which is long overdue.