Macro economic overview

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- Macro economic forecasts have been going through a series of relatively large changes of opinion during the past three months. Taking the rapid degradation of the US housing market into account, combined with sharply higher energy prices, the effect on consumer spending power looked threatening enough to become the source of a potentially serious fall in the economic activity. The matter had some importance, since it would obviously lead to a fundamentally different climate on the bond, stock and currency exchange markets. The only indicator, which consistently proved to be immune to the scenarios of weakening, has been the stock market. Since the summer months of last year, the market has almost constantly been in an upbeat mood, indicating confidence in the evolution of earnings and growth. The past couple of months have proven that this confidence was warranted.
- In the final quarter of last year, it became indeed more and more evident that the housing market would not show the kind of catastrophic fall, which is often identified with a real estate crisis. The activity level in home construction fell sharply indeed, but the numbers of home sales, existing ones as well as new homes, have been showing signs of stabilization for some time and prices are bottoming out. There is of course still the inventory overhang, which has to pass through the system before there is any possibility of home equity going north again. This may well take the remainder of this year. The important thing is however that there is more than just a glimmer of hope that real estate prices will hold up relatively well. While home equity as a source of household income will still be absent for some time, chances are now that home prices will not become the cause of a bubble/bust scenario that was expected until not so long ago.
- The main question now is where we go from here. The dream scenario is of course that after some modest cooling, the second phase of the cycle can kick in. In this second phase corporate investment should take over from consumer spending as the main driving force. So far we have seen only modest indications of a acceleration in corporate investment. The overinvestment of the late nineties and the ensuing restructuring is still a rather recent experience and companies are clearly wary of stepping on the gas too soon.
- On the other hand company cash flows have been restored for some years now and investment has lagged to the extent that at least maintenance investment should show an increase in the coming years. Expansionary investment may require a bit more time. Growth in Asia clearly has an impact on the investment in some pockets of the world economy, such as the base materials segment, where the sharp price increases are now being followed by investment in new capacity. It is however not yet an overall investment boom. Consumer spending still looks quite vulnerable in the US, is not the driving force yet in large parts of Asia and has been lagging in parts of Europe, such as Germany, as well.
- It may take some further build up of consumer spending power now before companies are sufficiently confident that investment in capacity will be sufficiently rewarding. For that, the housing market may need to have really turned the counter and that could take until the end of this year, or even the start of next year since there is still an important excess inventory to be worked off.
- It makes the current year a transition year with all the implicit dangers for the financial markets. After four years of strong positive returns and after a strong run in the past six months, it is not surprising that stock markets show signs of caution, even in the face of 4th quarter earnings which were once again better than expected, and in the face of earnings growth which is still looking promising for the next three years. Earnings are at a peak level in terms of GDP. It suggests that the coming period could bring a backlash with wages increasing faster and earnings stabilizing in terms of GDP (which would mean company earnings growing at about the pace of nominal GDP) rather than growing at the rates, which are currently projected.
- In the short run the threat of margin pressure due to excessive wage demand, still looks rather remote. The basic shift, which has led to a fundamental change in the labor/capital ratio will not change again so rapidly. The shift in the relative reward for labor and capital is of such a magnitude that its impact will be felt for quite some time to come yet. In short, margin pressure and the probability of a fall in the overall earnings is mainly determined by the economic cycle.
- Since over 50 percent of the world's economic growth in the new millennium is generated by Asian economies, the fortunes of China, India and a series of other emerging economies has obviously become more decisive than it was even 10 years ago. So far, there seems little in the way for a continuation of the strong growth we have seen in the past 10 years or so. The urbanization process in Asia, which should result in the migration of over 800 million people migrating from the countryside to the cities in the next couple of decades, forces China, India and other Asian countries into keeping a high growth rate. A question mark is if China, which has shown a remarkably steady growth path so far, will be able to keep up the balancing act after the 2008 Olympics.
- From a valuation point of view, the world remains a relatively simple place. European stocks, at the current analyst estimates, still have an implicit risk premium of about 4 percent, indicating stocks are expected to earn on average about double the yield on risk free bonds. It leaves little choice for investors and asset managers. Since there is little reason to believe that bond yields will fall substantially in the coming period, risk free income will, in the best of circumstances, hover around the current bond yield. Most of the other scenarios lead to lower, or even negative returns.
- Interest rates have indeed been moving quite substantially during the past two months. From a low at the start of December, a jump of almost 50 basis points has taken bond yields back to a level somewhere between the level one would expect in an economy going at cruise speed and an economy which is still prone to

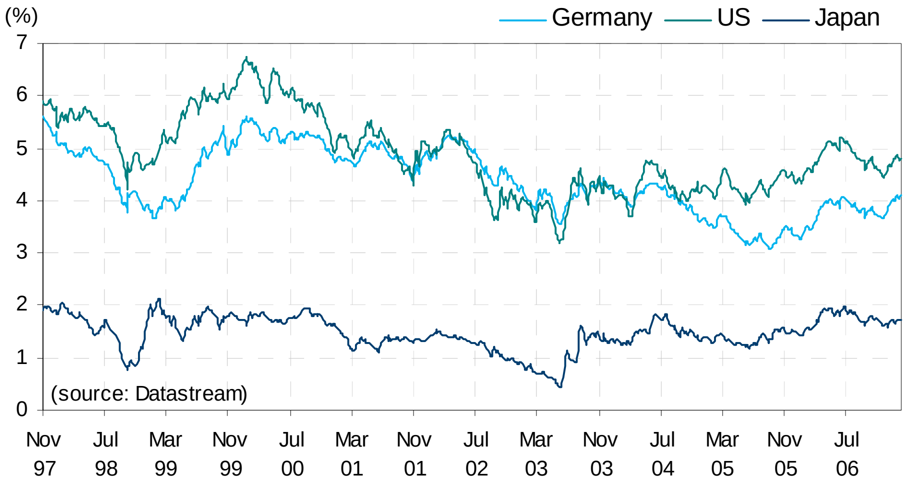
Investment summary

intermediate weakening. If the scenario plays out as we expect it, and the slow-down is only temporary, the probability for a further increase in bond rates remains clearly higher than chances that yields will drop back again to the recent lows.

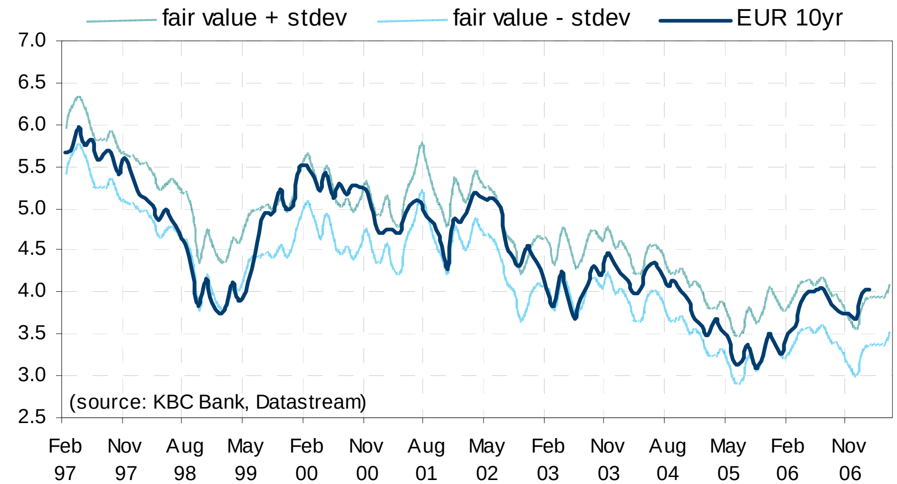
- For the moment, the level of the interest rates still remains characterized by Greenspan's "conundrum". Taken the pace of growth in the last couple of years (world growth surpassed the best levels seen since the second world war), it can at least be called surprising that bond yields, in real terms, have lagged behind real economic growth. On top of that it is at least surprising to see interest rates at the current level, taken the size of the US current account gap, into account. It may well be that the globalization has led to a sharply increased mobility of capital, on a global level savings and investments still have to be balanced and a savings deficit of this magnitude in the US means there must be a combined massive savings surplus elsewhere.
- It is still unclear in how far currency markets play a role in keeping bond yields lower than we would expect under the circumstances. The build up of currency reserves by Asian central banks is a well-known and well-documented fact. There is little doubt that these activities have had a positive impact on US rates (keeping them lower than this would otherwise have been the case).
- A different story is what the influence has been of the so-called yen-carry. It has become fashionable recently to warn sternly against the dangers of unwinding the borrowing in yen to invest in higher yielding dollar or other currency denominated assets. Proponents of the yen carry-trade dangers see their suspicion confirmed in the fact that the yen is relatively weak against the dollar and has been so for some time. Objective balance of payments data on the other hand do not show an unusual amount of lending to foreign investors by Japanese banks. If anything these loans have fallen back in the course of last year and are nowhere near the level we have seen in '97 or '98 (when the Asian currency crisis led to a sharp appreciation of the yen against the dollar and a rather unorthodox unwinding of all kinds of carry positions).
- That there are nevertheless reasons to be wary about the way sudden currency fluctuations can influence interest rate movements. There are ample examples of that in the past. The concern that a change in the Japanese interest rate policy could be the trigger of a number of unwinding operations is therefore warranted. The Japanese central bank has also given considerable attention to the problem. Since quite early in 2006 the hint has been given that the next move in the interest rates would be up. It would be surprising therefore that there could still be massive speculative positions that would be caught wrong-footed if Japanese rates finally rise.
- Unwinding some of the imbalances, which have grown in the aftermath of the stock market bubble may indeed prove to be the name of the game in the years to come. In the US base rates, which were expected to be cut two to three times in 2007, may now remain stable, or only cut once, resulting in a 5 to 5.25 percent level. In Europe the ECB has made it no secret that base rates will be increased again in March to 3.75%. The probability that another rate increase may still follow before the summer months is quite high, meaning European rates will probably be around 4 percent for most of 2007. A major remaining question hinges around what the Japanese central bank will do. Some expect an increase in base rates as soon as February, others are still putting it further off. Probably inspired by self interest, there has been a remarkable lack of pressure from the US on Japan, despite the obvious competitive edge, which results from the yen's weakening. Japan's interest in the matter is clear enough. It needs the export driven growth to put the deflationary weak performance of the past 7 years behind it; the US's interest is that the implicitly rising inflation is not brought to the fore at this moment in time and that an disorderly unwinding of positions does not lead to sharp rise in the interest rates now.
- The main message is nonetheless quite clear. Mopping up the excess liquidity which was created in the period following the stock market crash, is still clearly a priority for the monetary authorities. There may be a difference of opinion between the US and Europe as far as the importance of money supply data are concerned, there is little dispute about the fact that excess liquidity tends to result in excessive consumer spending and distorted asset prices. A difference with the past is that, as a result of globalization and the vastly increased mobility of capital, central banks have lost a major part of the control they seemed to have over the money supply in the past.
- We are as a result a bit in uncharted territory. Central banks seem inclined to flatten the yield curve as far and as long as the economy does not show signs of serious weakness. The hope clearly is to avoid undue asset inflation or other distortions in the system further down the line. The risk is obviously that the liquidity squeeze may inadvertently be overdone and bring the activity level to a grinding halt.
- On the commodity markets oil prices seem to stabilize gradually, although the real test still has to come in the following months. On top of an imbalance between production and consumption, the slow onset of winter and the unusually high temperatures until the end of 2006 have broken the back of the inexorable rising trend of the oil prices. Some of the tension, which was created by the small margin between demand and potential excess production capacity should disappear this year, but the energy market remains clearly prone to potential shocks.
- The commodity markets in general have gone through a period of consolidation. Growth in Asia will undoubtedly keep demand for energy and raw materials high, but the sharp divergence between demand and available capacity is gradually being bridged by new investment and the probability of supply shocks is therefore slowly disappearing. While we believe commodity prices will need to show a price evolution which is sufficient to warrant investment in new capacity, we believe also that the largest part of the price move has been made.

Interest rates

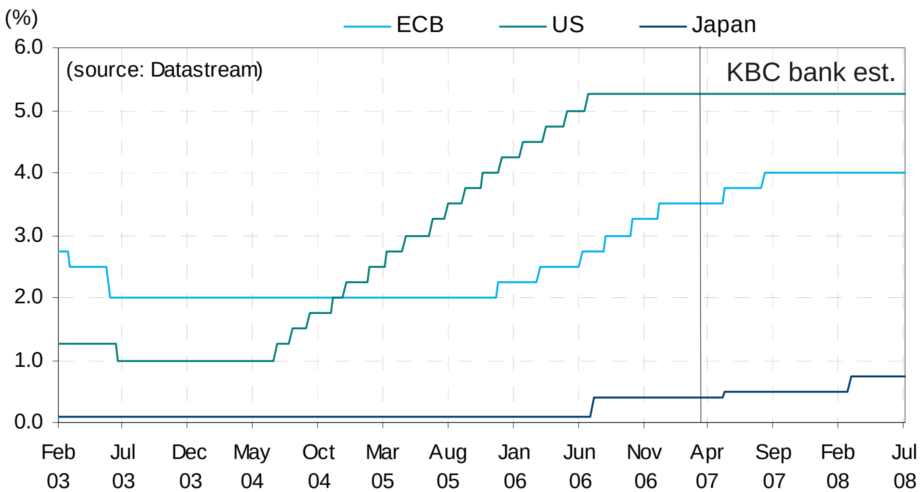
International interest rate evolution



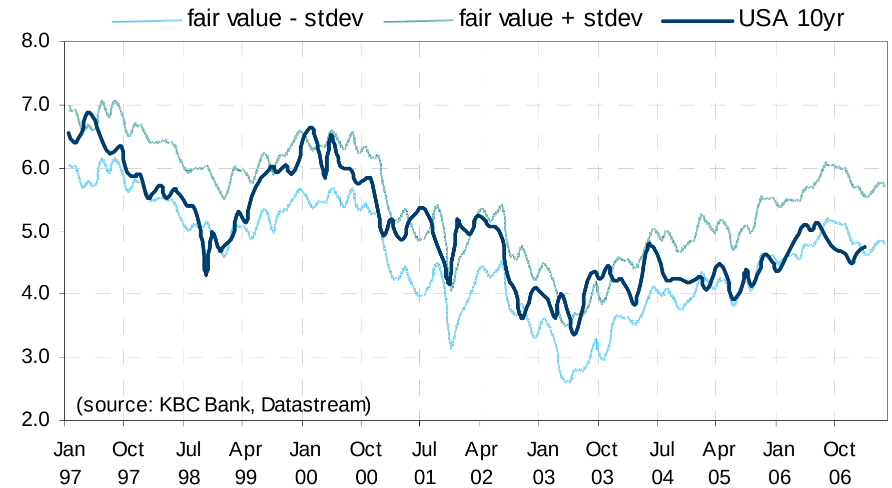
Fair value 10 year Euro (German government bond rate)



Central Bank official rates



Fair value 10 year US rate (US government rate)



Central bank rates

	Historical				*KBC estimates*		
	-1Y	*-6M*	*-3M*		*3M*	*6M*	*1Y*
US	4.50%	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%
Japan	0.10%	0.40%	0.40%	0.01%	0.50%	0.50%	0.75%
Europe	2.25%	3.00%	3.50%	3.50%	3.75%	4.00%	4.00%

source: Datastream, KBC estimates

10 year bond yield

		KBC est.			*Consensus*	
		3M	*6M*	*1Y*	*3M*	*1Y*
US	4.81%	4.80%	4.95%	5.10%	4.77%	4.88%
Japan	1.73%	1.75%	1.80%	1.85%	1.82%	2.09%
Europe	4.12%	4.15%	4.20%	4.30%	3.93%	4.07%

source: Datastream, KBC estimates

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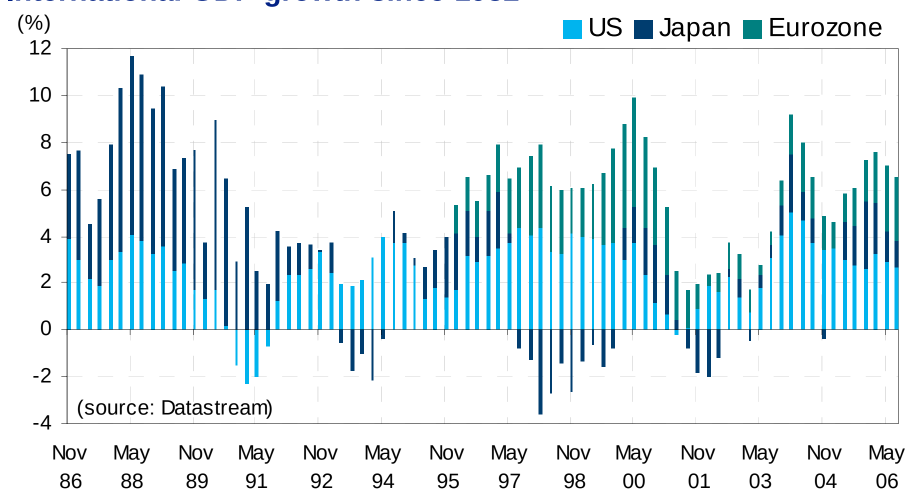
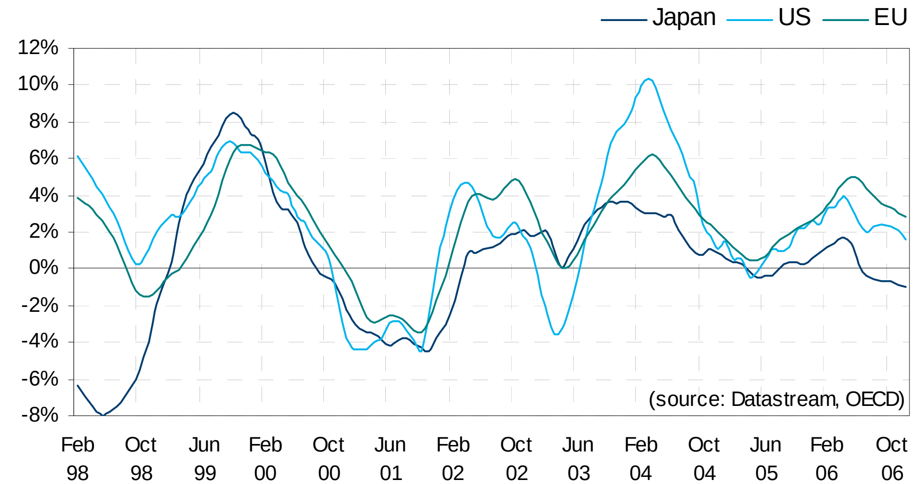
Growth scenario

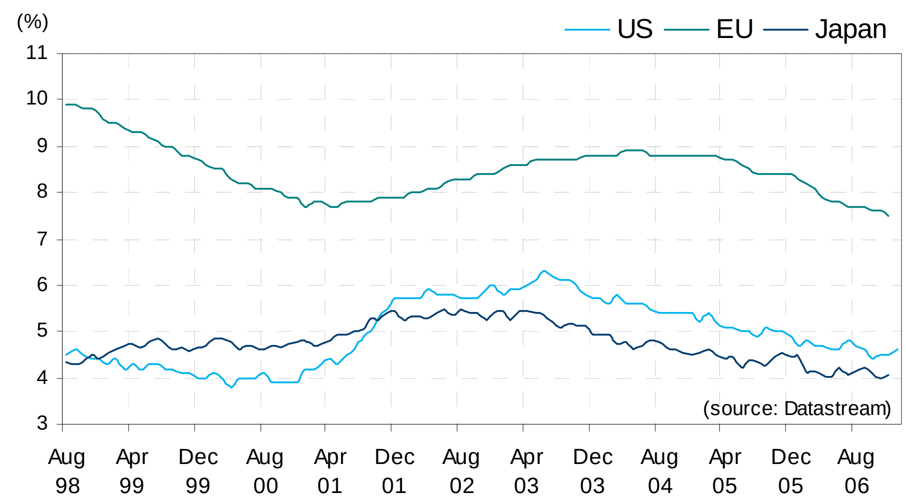
International GDP growth since 1982



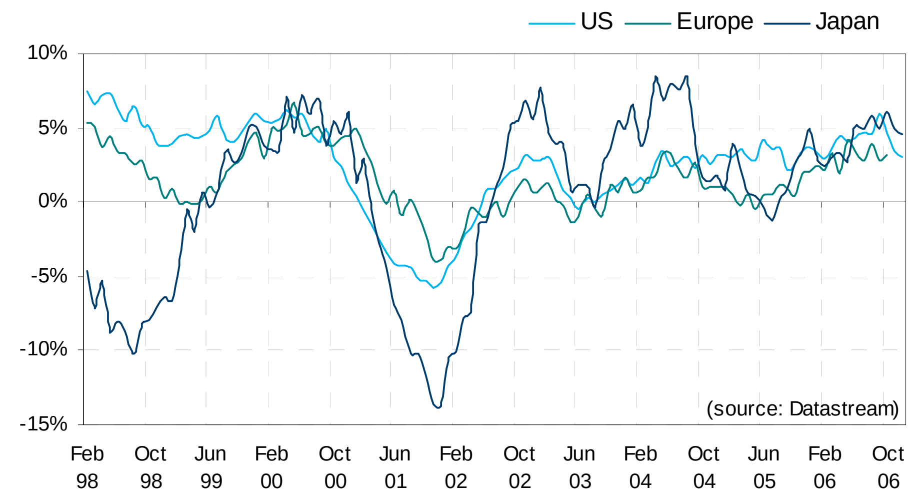
Leading indicators (% chng YOY)



International unemployment rates (nominal)



Industrial production (% chng YOY)



Projected unemployment rates (OECD estimates)

		OECD estimates		*Consensus estimates*	
	2006	2007	2008	2007	2008
Euro area	7.85%	7.44%	7.08%	7.44%	7.08%
VS	4.65%	4.79%	5.09%	4.81%	4.90%
Japan	4.16%	3.86%	3.57%	3.92%	3.76%

source: OECD, Datastream

Projected real GDP growth (%, year average)

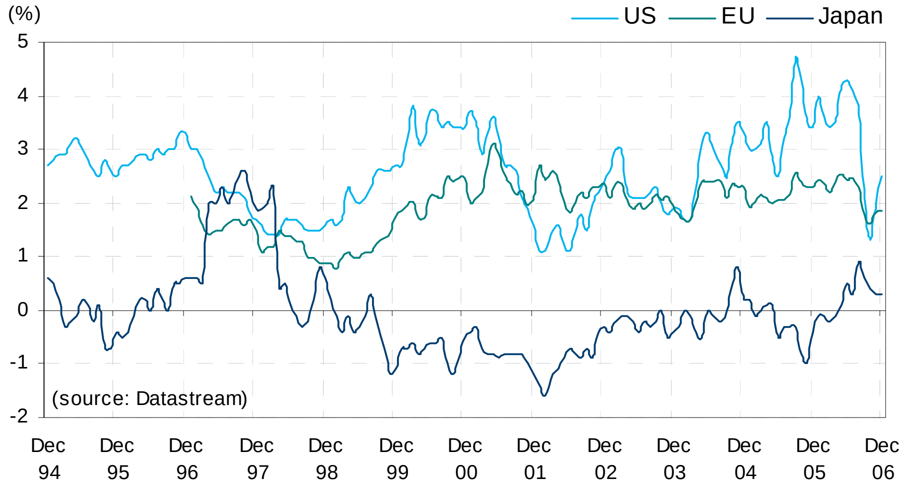
		KBC est.		*OECD est.*		*Consensus*	
	2006	2007	2008	2007	2008	2007	2008
Euro area	2.6	2.2	2.1	2.3	2.4	2.2	2.3
US	3.2	2.8	3.3	2.4	2.7	2.4	3.0
Japan	2.7	1.7	2.5	2.0	2.0	1.8	2.3

source: Datastream, KBC estimates, OECD

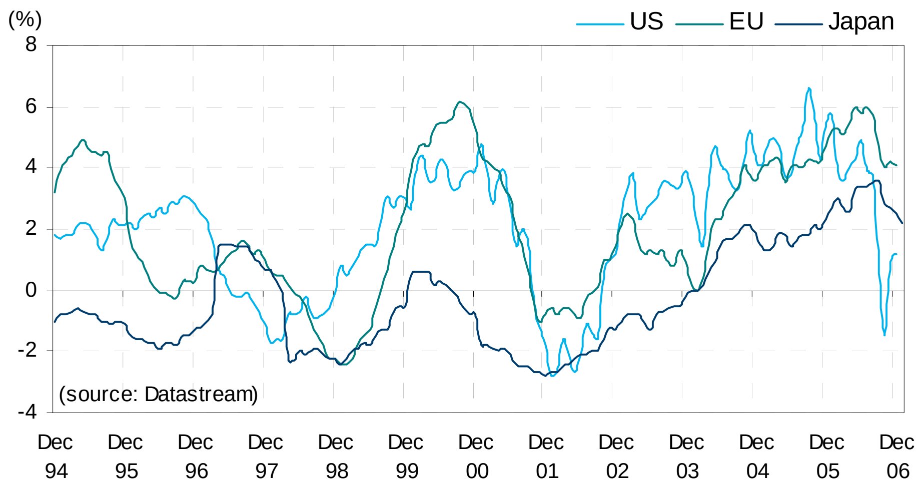
KBC Securities

Consumer prices

Consumer prices (% chng YOY)



Producer prices (% chng YOY)



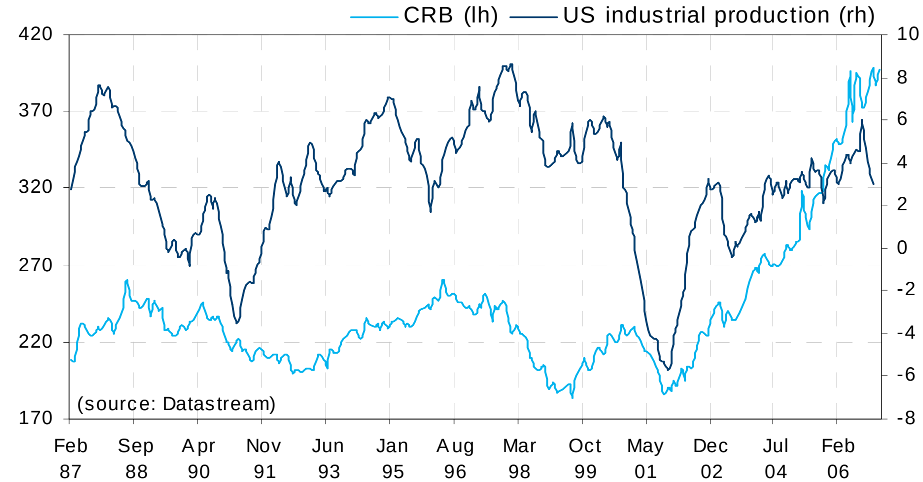
Projected consumer price evolution (%, year average)

	KBC est.			Consensus		OECD	
	2006	2007	2008	2007	2008	2007	2008
Euro area	2.2	1.9	2.1	2.07	1.89	1.89	1.79
US	3.2	1.9	2.8	1.81	2.27	2.25	2.35
Japan	0.2	0.1	0.4	0.28	0.69	0.34	0.75

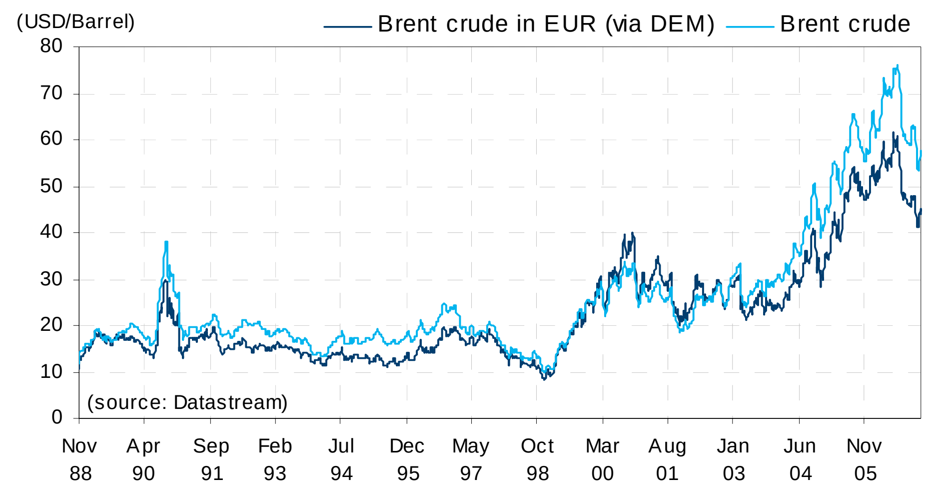
source: Datastream, KBC estimates, OECD

Commodities

CRB index



Oil price (Brent crude)



Historical commodity prices overview

	CRB index	Gold	Zinc	Copper	Aluminum	Palm oil
% chg 1M	2.9	7.4	-17.8	-3.98	1.28	0.40
% chg 6M	2.2	4.0	-7.4	-28.97	7.69	12.90
% chg 1Y	13.9	22.0	48.1	14.76	11.01	31.70
% chg 2Y	39.0	57.8	139.2	82.51	50.29	49.10

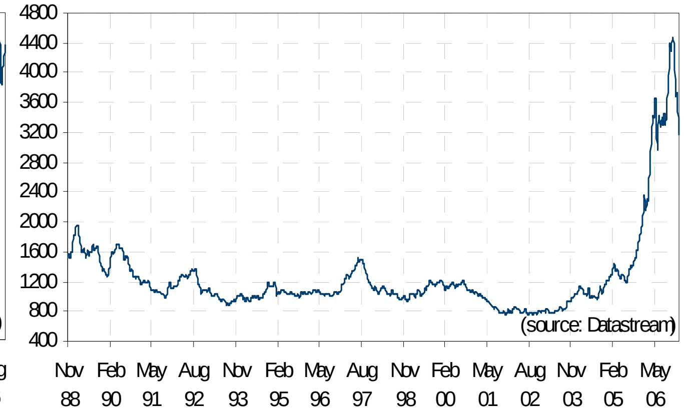
source: Datastream

Commodity graphs

Gold price (Gold bullion $/Troy ounce)

Silver price (cash cents/Troy ounce)

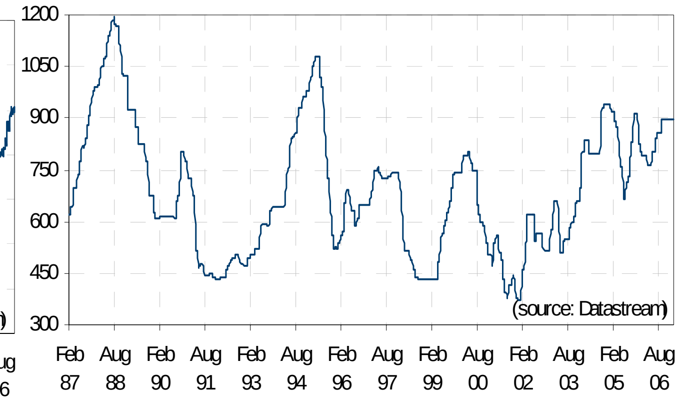
Zinc price (3mth forward US$/tonne)



Copper price (3mth forward US$/tonne)

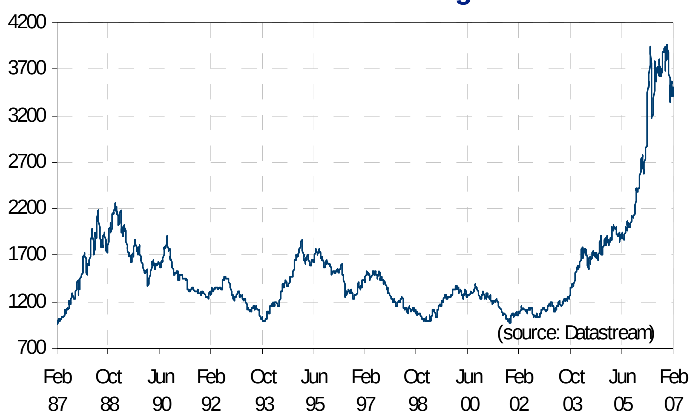
Palm Oil (US$/tonne)

PVC price (spot price US$/tonne)



Aluminum 99% 3m price (US$/tonne)

London Metals Exchange Index



Dow Jones AIG-Spot Commodity Index

Exchange rates

USD/EUR

Forecasts KBC Bank

	Last	+3M	+6M	+1Y
USD/EUR	1.30	1.30	1.30	1.28
GBP/EUR	0.67	0.68	0.68	0.68
JPY/USD	121.24	121.00	121.00	117.00

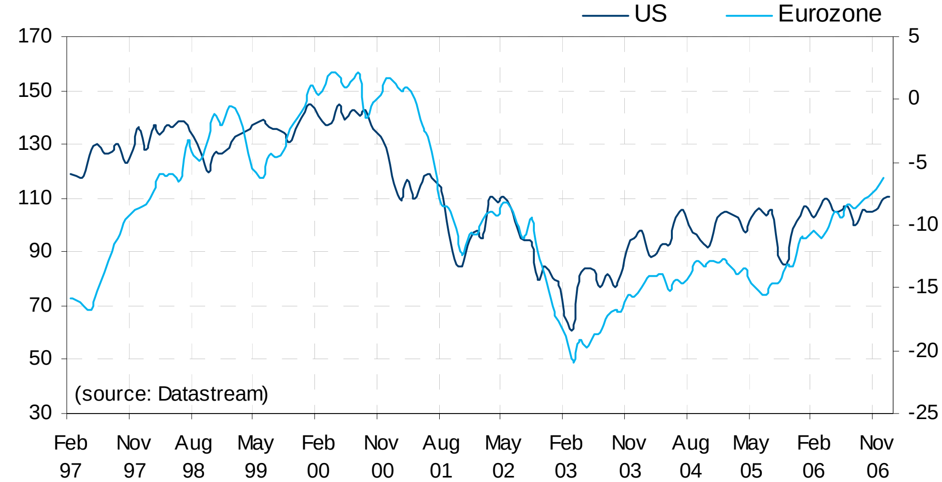
source: Datastream, KBC estimates

Forward currency rates

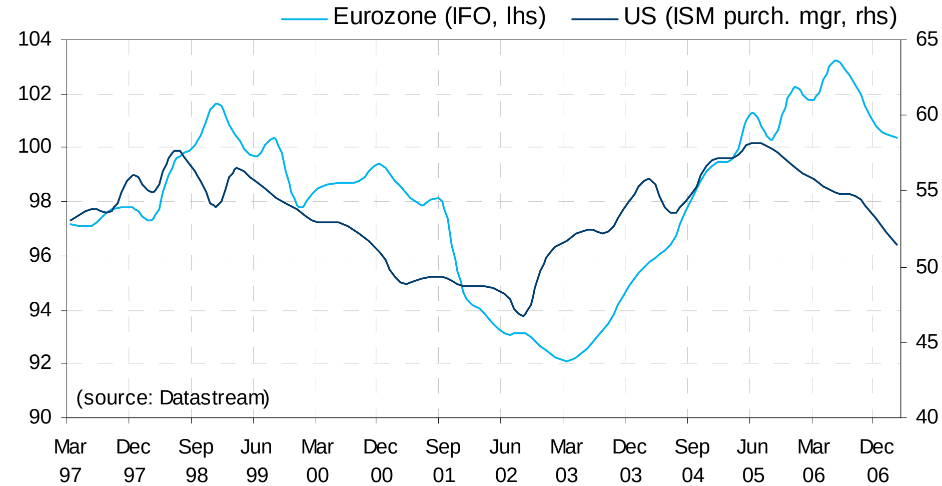
	GBP/EUR	USD/EUR	YEN/EUR	YEN/USD	USD/GBP
+1M	0.671	1.303	157.459	120.785	1.943
+3M	0.672	1.306	156.576	119.820	1.942
+6M	0.675	1.311	155.238	118.395	1.941
+1Y	0.680	1.318	152.593	115.735	1.937
+2Y	0.690	1.330	147.970	111.247	1.927

Confidence indicators

Consumer confidence



Industrial confidence



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