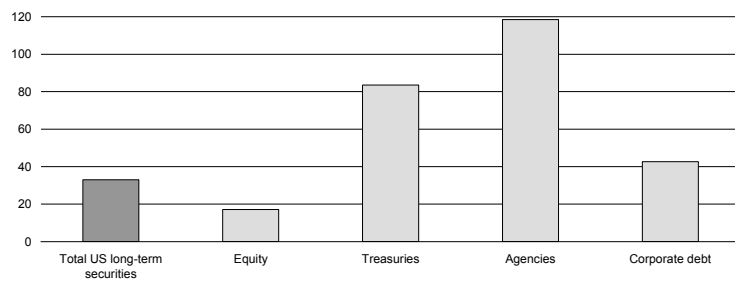


US financial markets dependent on petrodollars

- Due to soaring oil prices, the US current account deficit has doubled since 2001. This excess consumption has been financed by huge capital inflows from Emerging Asia and oil-exporting countries.
- During the last six years, foreigners have purchased US long-term securities for a cumulative USD 5.7 trillion. Between 2004 and 2007, they bought 80% of all newly issued marketable Treasuries, 120% of all new Agencies and 40% of new corporate bonds (cf. chart).
- At the beginning of the financial market crisis, foreigners held asset-backed corporate debt and asset-backed commercial paper worth more than USD 1 trillion. But the losses that they certainly took during the crisis deterred investors only briefly from buying more US securities.
- Responsible for the ongoing flow of foreign money into US capital markets are in our view primarily oil-exporting countries. Most of them have pegged their currency to the USD so that they have to buy USD denominated assets in order to defend their currency pegs.
- Our baseline scenario looks for a continuation of these dollar pegs. However, we see the risk that the Middle East oil exporters may drop the peg and revert to a currency basket, comprising mainly USD and EUR. As such a move would weaken the USD and strengthen the EUR at the same time, EUR-USD may easily surge towards 1.75 or even 1.80 in such a case.
- There is no doubt that the US Treasury and the Federal Reserve are both concerned about this possibility. Secretary Paulson's visit to the Gulf region and Chairman Bernanke's remarks about a strong USD in early June might have been concerted attempts to dispel any doubts of foreign investors about the weakness of the USD – and to convince oil-exporters to keep their dollar pegs.

US BOND MARKETS ADDICTED TO FOREIGN CAPITAL

US long-term securities: Change in foreign-owned securities as percentage of total change in securities outstanding (2004 – 2007)



Source: US Treasury, UniCredit Global Research

Author

Dr. Harm Bandholz (HVB)
 +1 212 672-5957
harm.bandholz@us.unicreditgroup.eu

Bloomberg
 UCGR, UCFR

Internet
www.globalresearch.unicreditmb.eu

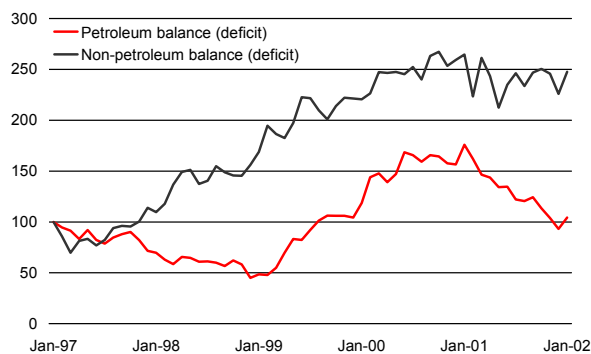
Rising global imbalances ...

Soaring oil prices aggravating global trade imbalances

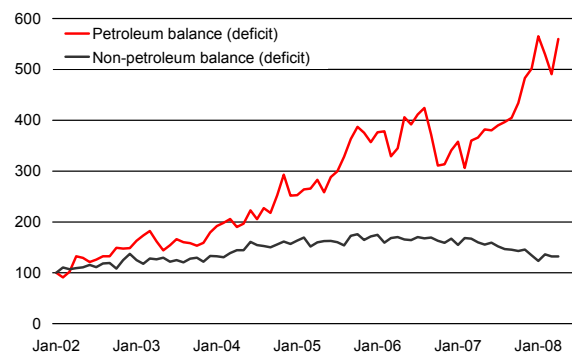
During the last few years, soaring energy prices have displaced export-oriented growth of Emerging Asia as the main source of global imbalances. In the US, the country with the single-largest trade imbalance, the current account deficit rose to USD 790 bn in 2006, which is more than twice as large as in 2001, and stayed at a high USD 730 bn in 2007. The following charts reveal the compositional shift that occurred in 2002 when the current oil price boom started: Between 1997 and 2002, the US petroleum balance remained constant, while the non-petroleum balance, i.e. the non-petroleum trade deficit, rose by 150% (cf. left chart). Since 2002, in contrast, the non-petroleum deficit has risen only a benign 30%, while the petroleum deficit has picked up by 450% (cf. right chart).

SOARING OIL PRICES IMPACTING US TRADE BALANCE

US trade deficit; January 1997 = 100



US trade deficit; January 2002 = 100



Source: Thomson Datastream, UniCredit Global Research

Huge current account surpluses in oil-exporting countries and Emerging Asia

The counterparts of the US trade deficit are rising current account (CA) surpluses in Emerging Asia (China, Taiwan, Singapore and South Korea) and above all in oil-exporting countries. The CA surplus of all OPEC countries has increased nine fold since 2002, while the surplus of Emerging Asia has "only" quadrupled during the same time. As a result, OPEC's CA surplus caught up with the combined surplus of China, Taiwan, Singapore and South Korea in 2006, and is likely to surpass it in 2008. If we include, Russia and Norway, the second and third largest oil exporters after Saudi Arabia, the combined CA surplus of major oil-exporting countries already outstripped the Asian surplus in 2000 and may be a third higher this year.

Foreigners own a big share of US long-term securities

...triggering huge capital flows into the US

The reflection of these CA surpluses in Emerging Asia and oil-exporting countries on the one hand and the US CA deficit on the other hand are huge capital flows out of the surplus countries into US financial markets. According to the US Treasury, foreigners spend since 2002 a cumulative USD 5.7 trillion to purchase US long-term securities (net purchases). As a result of these stunning inflows, 19% of US long-term securities were owned by foreigners in mid-2007. The following table reveals that the share of foreign ownership is even larger for Agencies, corporate bonds and above all for Treasuries (cf. also left chart on the following page).

FOREIGN OWNERSHIP OF US LONG-TERM SECURITIES

<i>Equity</i>	Dec 1994	Mar 2000	Jun 2002	Jun 2003	Jun 2004	Jun 2005	Jun 2006	Jun 2007
Total outstanding (in USD bn)	7,767	24,703	17,904	17,491	20,779	20,041	23,760	27,768
Percent foreign-owned	5.1	6.9	7.8	8.7	9.3	9.7	10.2	11.3
<i>Marketable US Treasuries</i>								
Total outstanding (in USD bn)	2,392	2,508	2,230	2,451	2,809	3,093	3,321	3,454
Percent foreign-owned	19.4	35.2	40.7	45.5	50.8	51.7	52.0	56.9
<i>Agencies</i>								
Total outstanding (in USD bn)	1,982	3,575	4,830	5,199	5,527	5,591	5,709	6,105
Percent foreign-owned	5.4	7.3	10.2	11.3	11.2	14.1	17.2	21.4
<i>Corporate bonds</i>								
Total outstanding (in USD bn)	3,556	5,713	7,205	7,852	8,384	8,858	10,284	11,391
Percent foreign-owned	7.8	12.3	15.7	15.7	17.6	19.5	19.7	24.0
<i>Total US long-term securities</i>								
Total outstanding (in USD bn)	15,700	36,583	32,169	33,443	37,499	39,583	43,074	48,718
Percent foreign-owned	7.9	9.7	12.2	13.5	14.5	15.8	16.6	18.8

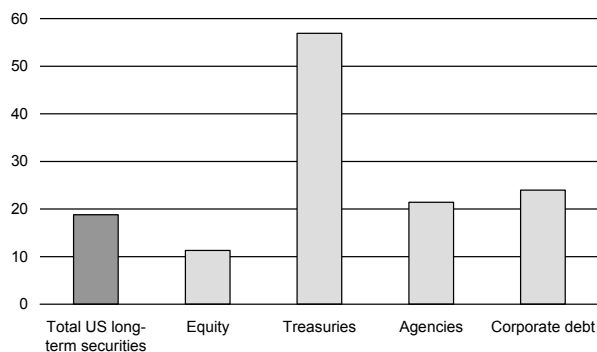
Source: US Treasury, UniCredit Global Research

US dependency on foreign capital is rising

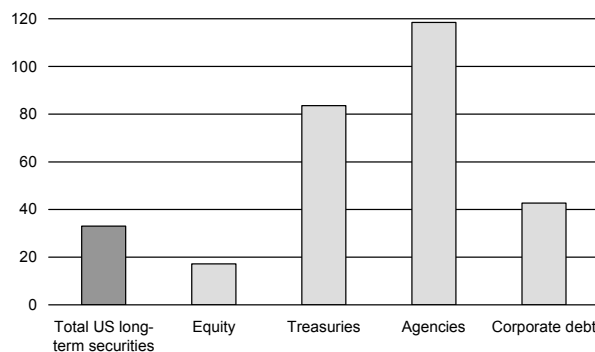
The growing dependency of US financial markets, primarily the bond markets, on foreign capital becomes even more apparent, if we look at the dynamics of capital flows in recent years. Our calculations show that between 2004 and 2007 foreigners bought a third of all newly issued US long-term securities (cf. right chart). Most stunning are the numbers for Treasuries and Agencies: Between 2004 and 2007, foreigners bought more than 80% of all newly issued marketable Treasuries and 120% (!) of all new Agencies (that means that foreigners bought all new and some of the already issued bonds). For corporate bonds, the share was still a respectable 40%.

US BOND MARKETS ADDICTED TO FOREIGN CAPITAL

US long-term securities: Percent foreign-owned, as of June 2007



US long-term securities: Change in foreign-owned securities as percentage of total change in securities outstanding (2004 – 2007)



Source: US Treasury, UniCredit Global Research

Foreign investors left with toxic debt

Structured credit products containing toxic debt

This time period when foreign investors were heavily involved in buying long-term US securities, marked exactly the heyday of securitization. Starting in late 2004, products known as asset-backed securities (ABS), mortgage-backed securities (MBS), asset-backed

commercial paper (ABCP) or collateralized debt obligations (CDO) sprang up like mushrooms and flooded financial markets. Unfortunately, the credit crisis has been a painful reminder that some of these structured credit products were stuffed with toxic debt, such as subprime mortgage loans, and often did not deserve their AAA rating.

Foreign investors held USD 1.6 trillion asset-backed securities in mid-2007

A recent report of the US Treasury reveals that at the beginning of the financial crisis, in mid-2007, foreign investors held almost USD 1.6 trillion of asset-backed securities. One third of this amount (USD 570 bn) represented mortgage-backed securities backed by US Agencies, primarily Fannie Mae and Freddie Mac. Biggest foreign holders of these virtually safe assets (there is a quasi-guarantee by the US government) in mid-2007 were Japan and China, which owned 54% of Agency ABS held abroad. The remaining USD 1 trillion consisted of potential toxic debt: asset-backed corporate debt and asset-backed commercial paper. The following table reveals that among the eight countries with the largest holdings of US asset-backed securities and commercial paper, six of them – the Cayman Islands, the United Kingdom, Ireland, Luxembourg, Belgium, and Jersey – are financial centers, which means that substantial amounts of the securities held are actually owned by residents of other countries.

FOREIGN HOLDINGS OF US LONG- AND SHORT-TERM ASSET-BACKED SECURITIES, AS OF JUNE 2007 (IN USD BN)

	Total long- and short-term asset-backed securities	Long-term corporate asset backed securities		Short-term asset-backed commercial paper
		Mortgage-backed	Others	
Cayman Islands	202	157	32	12
United Kingdom	148	90	52	6
Ireland	123	33	23	42
Luxembourg	71	39	42	15
Belgium	54	19	36	0
Netherlands	53	32	12	9
Germany	46	33	10	4
Jersey	41	24	17	0
Rest of the World	208	117	66	25
Total	1,018	594	308	116
Of which: Holdings of foreign official institutions	50	26	18	6

Source: US Treasury, UniCredit Global Research

Correspondingly, more than 50% of the USD 400 bn writedowns, reported for the entire banking sector so far, occurred outside the US, notably in Europe (cf. table). We estimate at least another USD 100 bn of reported losses for insurance companies, pension funds, and other funds.

WRITEDOWNS IN THE BANKING SECTOR SO FAR

Region	Total writedown in USD bn	Biggest Losers
Americas	177.9	Citigroup (USD 42.9 bn), Merrill Lynch (37.1), Bank of America (16.0), Morgan Stanley (14.4)
Asia	21.1	Mizuho Financial Group (6.0), Nomura Holdings (2.4), Bank of China (2.0)
Europe	202.5	UBS (38.2), HSBC (19.5), IKB (16.1), Royal Bank of Scotland (15.4), Credit Suisse (9.7)
Worldwide	401.5	

Source: Bloomberg, UniCredit Global Research

Financial crisis only short blast to investors' confidence

Financial crisis aggravated depreciation of the USD

The financial crisis, therefore, provided enough reason for foreign investors to shun US assets in the near future. First, the significant losses on opaque investment products, second the inability of rating agencies to properly identify the risks of these products, and third the depreciation of the USD. Since mid-2007 the trade-weighted USD fell by 10%, and EUR-USD has even increased by 18%. Hence, even if an investment has not been directly affected by writedowns, the total return was certainly trimmed or even turned negative.

Foreign investors temporarily shunned US assets ...

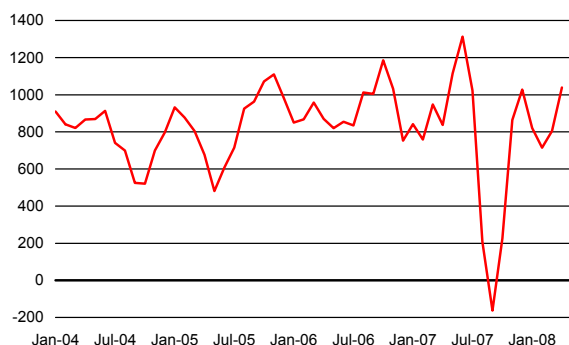
And foreign investors did indeed forgo buying US assets – but only for three months. As the following chart reveals, foreign net purchases of US long-term securities fell an annualized USD 163 bn in Q3 2007, after still growing an annualized 1,300 bn in Q2. The decline was broad based as net purchases of all securities dropped by double-digit rates in (cf. table). Foreign investors, however, reduced their investment in risky corporate bonds and stocks more significantly than their purchases of safe-haven assets, such as Treasuries and Agencies.

... but soon started to buy them again

But by Q4, foreign investors' appetite for US securities was back. They significantly increased their purchases of Treasuries, corporate bonds and equities. In the wake of the housing market crisis, only the demand for mortgage-related Agencies remained lackluster – even though it picked up an annualized USD 39 bn in Q4 as well. But if we compare foreign purchases of US debt securities before and after the third quarter, we find a striking pattern: Only the demand for Treasuries increased between Q2 and Q4, while purchases of all other securities dropped noticeably (cf. right column in the table).

DESPITE THE FINANCIAL CRISIS: FOREIGNERS ARE BUYING US SECURITIES AGAIN

Foreign net purchases of US long-term securities
3M moving sum at annual rates, in USD bn



Foreign net purchases of US long-term securities
Quarterly changes in USD bn (at annual rates)

	II/07 - III/07	III/07 - IV/07	II/07 - IV/07
Treasuries	-120	217	96
Agencies	-297	39	-258
Corporate bonds	-489	220	-269
Equity	-465	341	-124

Source: US Treasury, Thomson Datastream, UniCredit Global Research

Investors rediscovering Treasuries

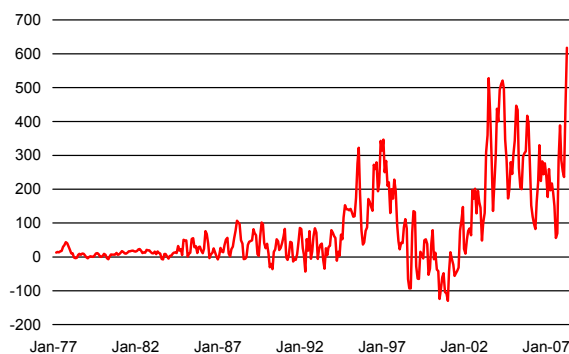
Foreign demand lowers Treasury yields by 75 basis points

There are several reasons, why foreign investors have shifted their purchases towards Treasuries amid the financial crisis. First, Treasuries are the traditional safe-haven in times of economic, financial and political uncertainty. Second, other long-term securities have certainly not been very appealing to investors after the experiences made during the first months of the crisis. This is particularly true for asset-backed securities, which in mid-2007 accounted for a third of total foreign holdings of corporate bonds. In addition, Agencies, the other potential safe-haven, are too closely related to the housing market and thus have deterred investors as

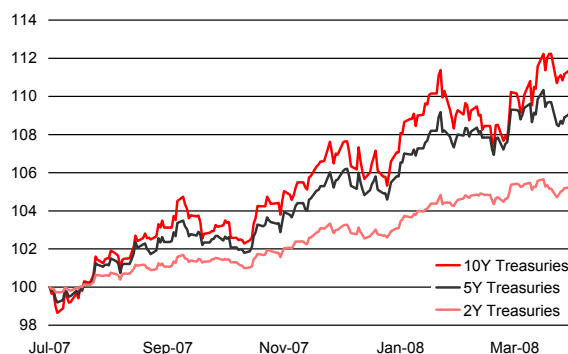
well. Third, Treasuries yielded a reasonable profit between mid-2007 and the end of Q1. The price for 10Y notes rose by 11¼% (an annualized 15½%), 5Y notes went up 9¼% (12¾%) and 2Y notes 5¼% (7%, cf. right chart). These factors lured a lot of private investors, who were not traditional buyers of Treasuries. Official statistics show that in mid-2007 only 26% of all foreign-owned Treasuries were held by private investors. The other 74% were in the hands of official institutions – central banks but also the most important Sovereign Wealth Funds like the Abu Dhabi Investment Authority (ADIA), the Norwegian Government Pension Fund or the Kuwait Investment Authority (KIA) – which enthusiastically have continued buying Treasuries in recent months.¹ The combination of ongoing purchases of official institutions and higher demand from private investors has lifted foreign net purchases of Treasuries between February and April 2008 to a new all-time high (cf. left chart).

FOREIGNERS BUYING US TREASURIES AT A RECORD PACE

Foreign net purchases of US Treasuries
3M moving sum in USD bn (at annual rates)



US Treasuries, July 2007 = 100 (ex coupon payments)



Source: Thomson Datastream, Bloomberg, UniCredit Global Research

Quantifying the impact of foreign purchases on Treasury yields

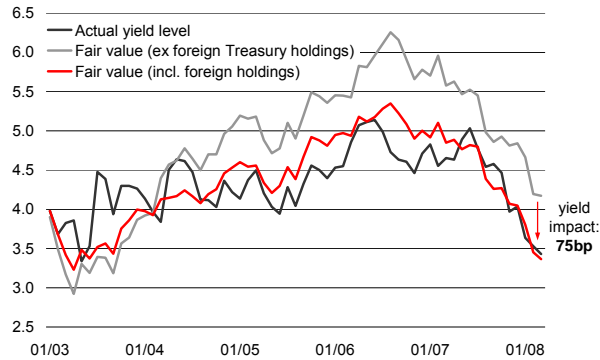
In order to quantify the impact of these foreign purchases on US Treasury yields, we have developed an econometric model. It estimates the fundamental yield level of 10Y Treasuries using (i) the 3M money market rate, (ii) core inflation, (iii) the manufacturing ISM, and (iv) foreign holdings of Treasuries.² While the first three variables are the traditional determinants of long-term interest rates, we additionally included the fourth variable to capture the yield impact of structural factors like demand from Asian central banks, the recycling of petrodollars and the strong interest of institutional investors. The model is estimated as a standard single equation error-correction model. The fundamental or "fair" value for yields is derived from the long-term cointegration equation (cf. right chart on the following page). Using the estimated parameters, we are able to isolate the yield impact of the rising foreign demand for Treasuries. The Federal Reserve's Flow of Funds shows that foreign holdings of Treasuries surged from USD 1,165 bn in Q1 1998 to USD 2,485 bn in Q1 2008. According to our calculations, this rise in foreign Treasury holdings has lowered US bond yields by about 75 basis points (cf. left chart on the following page). We estimate that Treasury purchases from Emerging Asia and oil-exporting countries have each lowered yields by about 30 to 35 bp.

¹ See the following URL for a comprehensive list of foreign official institutions according to the US Treasury: <http://www.treas.gov/tic/foi607list.html>.

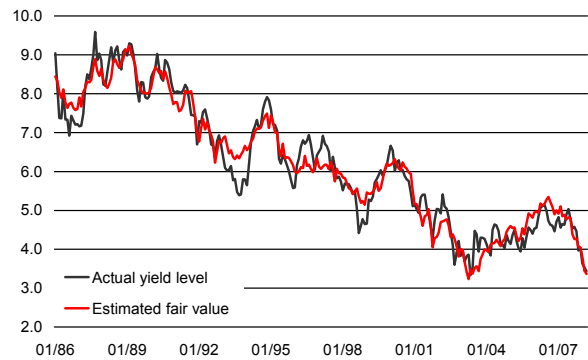
² For a more detailed description of the model, see Bandholz, H., J. Clostermann and F. Seitz, Explaining the US Bond Yield Conundrum, *Applied Financial Economics*, forthcoming (2008).

FOREIGN DEMAND DAMPENS TREASURY YIELDS BY 75 BASIS POINTS

10Y Treasury yields in %



10Y Treasury yields in %



Source: Federal Reserve, Thomson Datastream, UniCredit Global Research

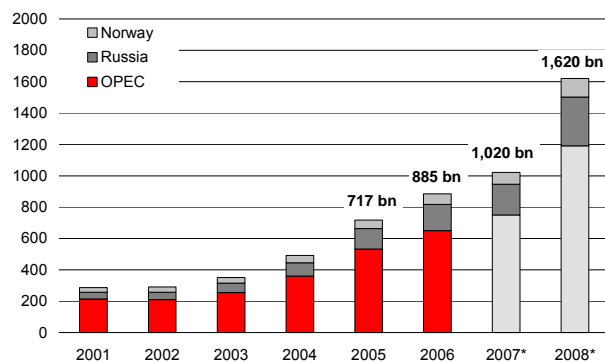
To peg or not to peg – the case of oil-exporting countries

The crucial issue

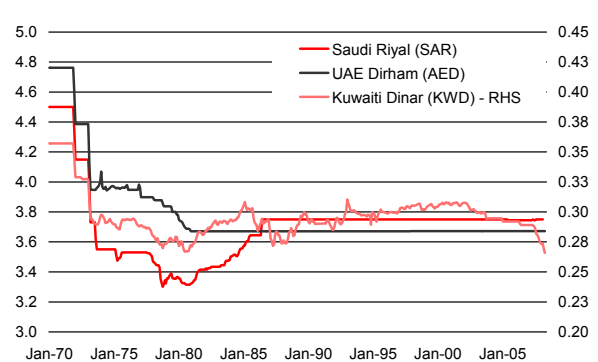
Looking forward, the most important issue for the stability of capital flows into the US and the USD in general is whether oil-exporting countries will keep their currency pegs to the USD or follow the lead of Kuwait that has removed its USD-peg in May 2007. Back then, the third largest Arab oil exporter has reverted to a basket of currencies in order to reduce imported inflation, caused by the sliding USD. Even as the USD likely makes up about 75% to 80% of the new currency basket, the Dinar has appreciated 8% against the greenback since then (cf. right chart). But other countries, such as Saudi Arabia and the United Arab Emirates have repeatedly renewed their commitment to maintaining their dollar pegs. The primary reason why the future exchange rate system of the oil-exporting countries is so crucial is the sheer amount of petrodollars that has so far been flowing into US financial markets. Assuming an average oil price of USD 115 per barrel, we estimate that the value of petroleum exports for the world's major oil exporters (OPEC plus Russia and Norway) will exceed USD 1,600 bn in 2008 (cf. left chart); for OPEC alone, this value should be about USD 1,200 bn. The total amount of petrodollars earned between 2003 and 2008 will be USD 3.7 trillion for OPEC and USD 5.0 trillion for OPEC plus Russia and Norway!

MORE THAN FIVE TRILLION PETRODOLLARS SINCE 2003

Value of petroleum exports in USD bn (*estimated values)



Units of national currency per USD



Source: OPEC, Thomson Datastream, UniCredit Global Research

OPEC is single most important buyer of US Treasuries

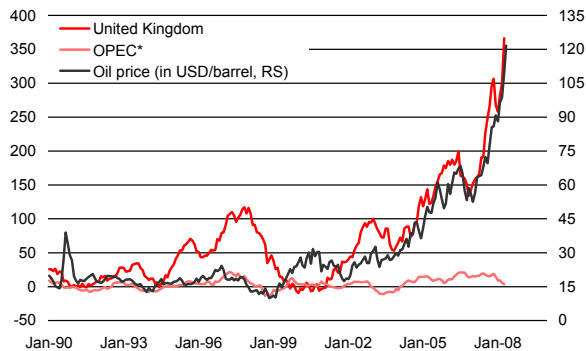
We estimate that about one third of these petrodollars has been channeled into what the Bank for International Settlement calls “other investments”. They primarily constitute deposits in foreign banks but also investment not classified elsewhere (e.g. private equity, hedge funds). The remaining two thirds likely represent portfolio investments (Treasuries, corporate bonds, Agencies, equities) – either by central banks or by Sovereign Wealth Funds and other non-monetary authorities.³ Given the currency pegs of most OPEC currencies to the USD, we assume that 75% to 80% of these portfolio investments were channeled into USD denominated assets; half of that into US Treasuries. According to these assumptions, OPEC countries bought US Treasuries worth USD 625 bn between 2003 and 2007. That is half of total foreign Treasuries purchases during this five year period.

Petrodollars take a detour via London

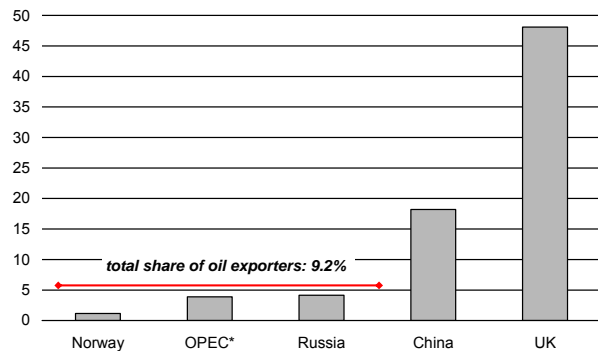
But why is the tracking of petrodollars so difficult at all? In fact, the US Treasury’s monthly TIC (Treasury International Capital) statistic lists foreign purchases of US long-term securities by country! Hence it should be easy to see, how much Treasuries, Agencies or corporate bonds have been bought by a specific country. The reason is an imperfect country attribution. The TIC statistics lists purchases according to the country where the purchase was executed – and not to the country where the ultimate beneficial owner of the securities is actually located. The Treasury itself admits that because chains of foreign financial intermediaries are often involved in the custody or management of securities, obtaining accurate information on the actual foreign owners frequently is not possible. This explains, why according to the TIC statistic the United Kingdom, a country with a notorious current account deficit has been the largest foreign buyer of US long-term securities over the last couple of years. Since the beginning of 2007, almost 50% of all foreign purchases have been done by the UK (cf. right chart). This compares to 18% for China and a meager 9% for the major oil exporters. However, the UK has not been buying US securities for their own accounts but on behalf of foreigners – primarily oil-exporting countries: The left chart shows the very high correlation between the oil price and UK reported net purchases of Treasuries and Agencies. Since the beginning of the current oil price boom in 2002, UK demand for these securities soared, took a breather in H2 2006 when oil prices fell from USD 78 per barrel to USD 50, and took off again in March 2007 as oil prices started their journey to USD 140 per barrel. This is striking support for our thesis that a lot of petrodollars take a detour via London before they finally re-enter the US.

OIL EXPORTERS MANDATE FINANCIAL INTERMEDIARIES IN THE UK TO BUY US SECURITIES

Foreign net purchases of US Treasuries and Agencies
12M moving sum in USD bn



Share in global net purchases of US long-term securities in %
January 2007 – April 2008



*OPEC comprises oil-exporting Asia, oil-exporting Africa and Venezuela; Source: US Treasury, Thomson Datastream, Bloomberg, UniCredit Global Research

³ For additional details, see: Harm Bandholz, Petrodollars – Where do they flow?, *Economic Analysis*, March 2007.

Why oil exporters are likely to keep their dollar pegs

So far, most Middle East oil exporters have reiterated that they are willing to keep the status quo. Last month the Saudi Arabian Finance Minister Al-Assaf said for example that he totally agrees with US Treasury secretary Paulson (who visited the Middle East in late May/early June) that the Riyal's USD-peg has served Saudi Arabia and the entire Gulf region well and that "as we have said many times, we have no intention of de-pegging or of revaluation." Similarly, the Prime Minister of the United Arab Emirates, Al-Maktoum, and his central bank governor, Al-Suweidi, reiterated early June that their country has "no plans to drop its dollar peg or to revalue" either. We also think that there are good reasons why the oil exporters are likely to maintain their dollar pegs:

1. The most prominent explanation for keeping the USD-peg is the plan for a currency union between the six Gulf Cooperation Council (GCC) countries United Arab Emirates, Saudi Arabia, Kuwait, Oman, Qatar and Bahrain. A common currency has been under formal consideration since 2001, when the six GCC states agreed on a timetable setting 2010 as the deadline. While in the meantime Oman has withdrawn from the union, the other members are still committed to it. And until the currency union has been finally reached, these countries use the USD as anchor currency and adopt the Fed's monetary policy as common benchmark.
2. Oil, the by far most important economic good of the GCC countries is denominated in USD. And despite efforts from the Iran or Venezuela to install a EUR-denominated oil bourse, we expect that to continue. Hence, the USD-peg shields oil exporters from exchange rate risks and lowers economic volatility.
3. As outlined before, GCC central banks and Sovereign Wealth Funds have huge exposures to USD denominated assets. A revaluation of their local currencies against the USD will, therefore, reduce the value of their investments. Mohsin Khan, Director of the IMF's Middle East and Central Asia Department estimated recently that "with a 20% revaluation, the region [GCC countries] would have to take a big hit with the value of their overseas assets shrinking by USD 400 bn."
4. There is also a political component behind financial flows from the Middle East, in particular Saudi Arabia, to the US. According to the International Currency Review, there is even a secret treaty arrangement between the US and Saudi Arabia: In exchange for the massive military assistance which the United States are providing, Saudi Arabia is not only remitting substantial sums to the US Government by way of payment for goods supplied and services rendered, but also placing petroleum revenues in US official securities. Such an arrangement – if existing – would in a way systematize and automatize capital flows from the Middle East to the US, and thus facilitate the continuation of the dollar pegs.
5. Countries that plan to loosen their peg to the USD are unlikely to switch to a free floating regime but will rather adopt a currency basket. That, however, requires that the financial markets of the basket currencies are developed, deep and large enough to absorb such a vast amount of liquidity. Apart from Europe, we do not see a lot of serious alternatives. And as Europe has in our view just passed the peak of the business cycle, GCC countries may move out of the frying pan into the fire if they decide to give greater weight to the EUR. Moreover, our previous table has shown that European banks have so far experienced more writedowns than their US pales.
6. The period of the biggest stress may be over. The Fed has ended its easing cycle and the next move will probably be a rate hike. That should strengthen the USD and give GCC central banks sooner or later an opportunity to hike rates as well.

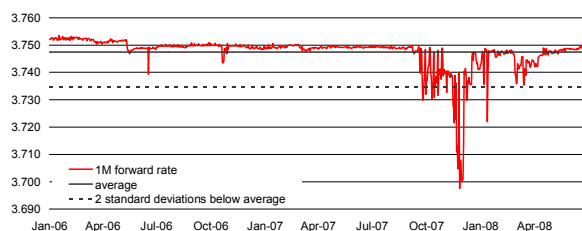
If this scenario, our baseline scenario, materializes and the oil-exporting countries keep their dollar pegs, we expect the USD to strengthen against the EUR in the coming quarters. The Fed has ended its easing cycle and is likely to start a gradual tightening cycle at the turn of the year. While the ECB has also raised the refi rate last week, we are convinced that the looming slowdown of the eurozone economy will force the ECB to ease monetary policy in 2009. These opposite policy trends are likely to push EUR-USD to 1.35-1.40 by the end of 2009.

FX market repeatedly expected GCC countries to abandon the peg

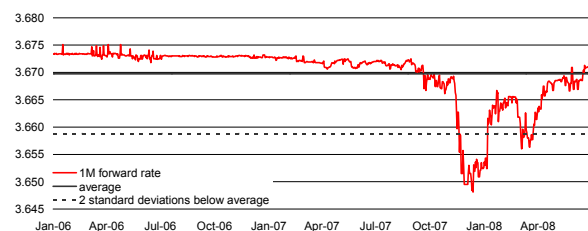
Regardless of those reasons to keep the peg, some GCC countries may be (have already been) tempted to follow the lead set by Kuwait and abandon their USD-peg. FX markets have already bet on such an outcome in recent months. As shown by the following charts, the 1M currency forward rates of these countries dropped strongly at the end of last year. The trigger was that Saudi Arabia initially has refused to cut interest rates in lockstep with the Fed. Markets interpreted this step as a signal that the country was preparing to break its dollar peg. But even after the Gulf countries finally slashed their interest rates in line with the Fed, appreciation expectations have remained particularly stubborn for the AED and the QAR. While the SAR and BHD returned to their parities (as approximated by the average) more quickly, their currency forward rates remained more volatile as well.

MARKETS BETTING ON REVALUATION OF GCC CURRENCIES

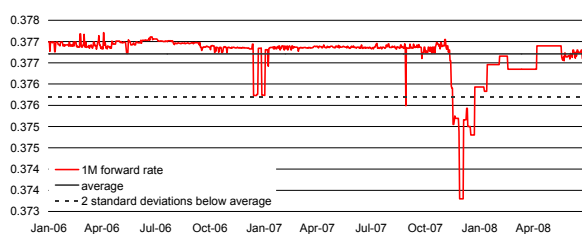
Saudi Riyal (SAR) – 1M currency forward



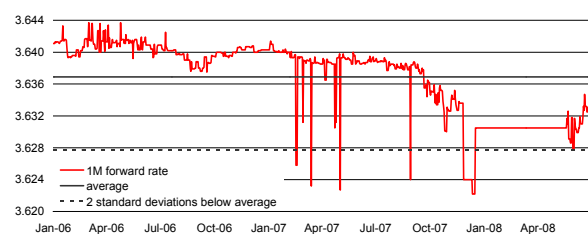
UAE Dirham (AED) – 1M currency forward



Bahrain Dinar (BHD) – 1M currency forward



Qatari Riyal (QAR) – 1M currency forward



Source: Bloomberg, UniCredit Global Research

Dropping the peg to tackle imported inflation ...

The primary motivation for the GCC countries to loosen their peg is undoubtedly rising inflationary pressures. When Kuwait removed its dollar peg in May 2007, its inflation rate had just picked up to 5.1% from 3.1% in 2006. By dropping the peg, Kuwait first and foremost tried to tackle imported inflation. Rising import prices are a huge concern for the GCC countries, as only 10% to 15% of the region's imports are stemming from the US, while 60% are from countries that have seen their currencies appreciating against the USD (cf. table on the following page). The table reveals that in this respect the strength of the EUR is one of the biggest problems. First, the European currency has gained almost 80% against the greenback since 2002, which is the largest appreciation of any major currency. Second, the eurozone is for nearly all GCC countries the most important trading partner. Saudi Arabia and the United Arab Emirates, the two largest GCC countries, for example, receive 20% to 25% of all imported goods from Europe.

CURRENCIES OF MAJOR GCC TRADING PARTNERS APPRECIATED STRONGLY AGAINST THE DOLLAR

	Nominal USD depreciation since 2002	Import shares in %					
		Saudi Arabia	UAE	Qatar	Kuwait	Oman	Bahrain
USA	-	12	11	9	14	8	6
Eurozone	78%	24	20	35	20	13	14
United Kingdom	39%	5	6	6	5	4	6
China	18%	8	11	3	6	3	4
India	21%	3	10	2	4	4	3
Japan	33%	7	6	10	8	16	7
Korea	32%	4	2	5	4	3	1
Thailand	40%	2	1	1	1	2	1
Singapore	33%	1	3	1	1	1	1
Malaysia	19%	1	2	1	1	1	1
10 Major trading partners		67	72	74	65	56	43

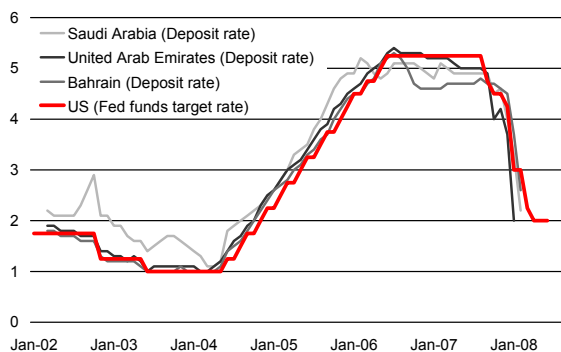
Source: IMF Direction of Trade Statistic and International Financial Statistics, NCBC Research, UniCredit Global Research

... and to gain (modest) monetary independence

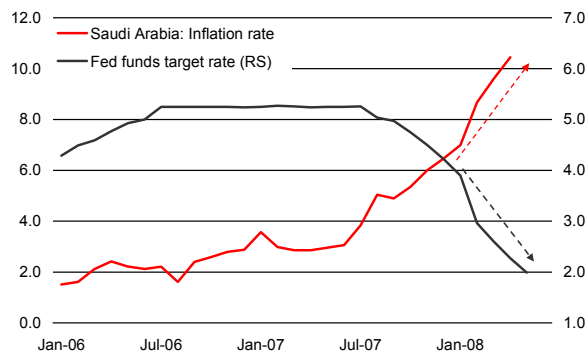
Another drawback of the USD-peg is that the GCC countries have given up monetary independence. Instead, they have to match their interest rates with the US central bank in order to eliminate virtually risk-free arbitrage opportunities and carry trade speculations (cf. left chart). While this synchronization would be no problem if business and inflation cycles were closely correlated, it was a huge problem this time: On the one hand the Fed slashed interest rates by 325 bp due to recession fears in the US, while on the other hand, the GCC countries were fighting an overheating of their economies (cf. right chart). Inflation rates in Bahrain and Saudi Arabia e.g. have just jumped to 14¾% and 10½% respectively, which is the highest in 30 years. That explains why Saudi Arabia has been reluctant to cut rates in late 2007. But in order to maintain the peg, it finally had no choice than to follow the Fed's moves. However, the Saudi Arabian Monetary Agency has only cut the deposit rates. In order to take some liquidity of the market, it at the same time raised the banks' reserve requirement from 7% in November to 13% in May, and held the lending rate at a steady 5.5%. These "creative responses" are highlighting the enormous challenges that GCC central banks are facing in the current environment to defend their dollar pegs.

GIVING UP MONETARY INDEPENDENCE IN TIMES OF SOARING INFLATION

Interest rates in %



Inflation and interest rates in %



Source: Bloomberg, UniCredit Global Research

Export sector won't suffer from a stronger currency

Another factor that would facilitate to loosen the USD-peg is the unique business structure of the GCC countries. Not surprisingly, the bulk of exports represent petroleum-related products. For OPEC as a whole, the petroleum share of exports is 75% (cf. table); for Saudi Arabia and Kuwait, this share is even higher. As oil is a scarce good and oil suppliers have seemingly unlimited pricing power these days, an appreciation of their currencies would barely harm GCC exporters.

SHARE OF PETROLEUM IN TOTAL EXPORTS OF OPEC COUNTRIES

	Value of petroleum exports as percentage of country's total exports
Saudi Arabia	89.9
United Arab Emirates	50.9
Kuwait	95.6
Qatar	79.4
OPEC	74.8

Source: OPEC, UniCredit Global Research

Severe consequences for the dollar

Weaker USD and stronger EUR at the same time

The potential decision of oil exporters, notably the GCC countries, to drop their peg to the USD would most likely have severe consequences for the greenback. We assume that in such a case these countries would follow the lead of Kuwait and revert to a currency basket, comprising of USD (about 75%), EUR (20%), GBP and JPY (2½% each). Even though the dollar remains the dominant currency in the basket regime, the higher weight for the EUR at the expense of the USD means that oil exporters, which receive most of their export revenues in USD, will have to sell dollars in order to buy euros. This shift weakens the USD and strengthens the EUR at the same time. Given the considerable amount of petrodollars, such a move will definitely be felt in FX markets.

Russia as an example

A good example is the reserve policy of Russia. The second-largest oil exporter after Saudi Arabia has adopted a currency basket, which is made up of 55% USD and 45% EUR. With soaring oil prices, Russia's USD denominated oil revenues have been swelling as well. In order to defend its currency against the basket, Russia has been heavily buying EUR during the last couple of months. Without this Russian intervention, EUR-USD would likely trade at about 5% below current levels.

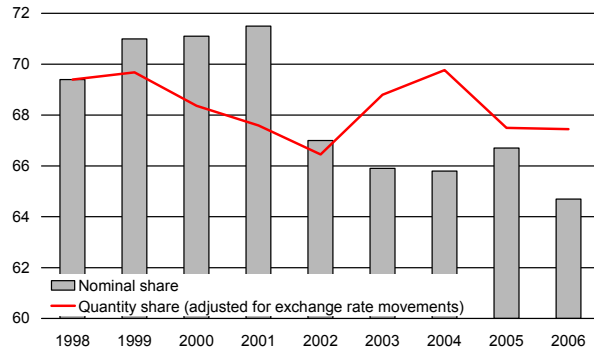
"Vote of no confidence"

The negative impact on the USD may be amplified, if markets take a de-pegging of oil exporters as a "vote of no confidence" in the USD as a reserve currency. After all, the Middle East oil exporters are some of the few remaining major countries that have still been maintaining a dollar peg. China for example dropped its peg in July 2005 and has appreciated 17% against the USD since then (cf. right chart on the following page). Worldwide, the share of currency reserves held in USD declined to 64.7% in 2006 from 71.5% in 2001. At the same time the share of reserves held in EUR increased to 25.8% from 19.2%. However, these numbers as released by the IMF exaggerate the decline of the USD as reserve currency. Backdrop is that these headline figures were affected by exchange rate movements, i.e. the value of USD reserves has declined in recent years due to the depreciation of the USD, while the appreciation of the EUR has lifted the value and thus the share of global reserves held in EUR. To correct for this problem, we have calculated a "quantity share", which represents reserve holdings adjusted for exchange rate fluctuations (cf. left chart on the following page). These calculations show that the actual share of reserves held in USD declined much more gradually; it fell from 70% to 67½%. Similarly, the adjusted share of reserves held in EUR increased only from 21% to 23%. However, a de-pegging of GCC currencies is likely to undermine the confidence in the USD and would, therefore, easily trigger a broader run out of the USD ... and probably into the EUR. As we argued before, the euro seems to us the only serious alternative to the dollar, given the fundamental soundness of the eurozone economy,

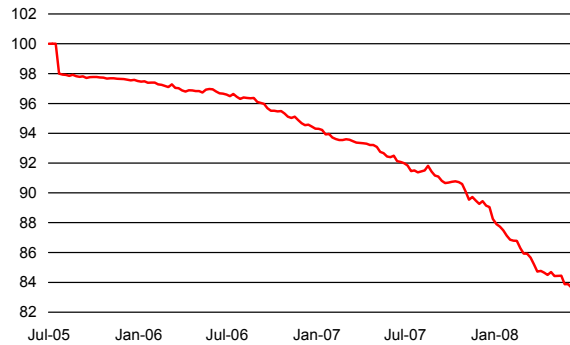
and the deepness and liquidity of its financial markets. Again, this development would weaken the USD and strengthen the EUR at the same time. So if GCC countries should really decide to drop their dollar peg, EUR-USD is going to surge, and we can easily imagine a movement towards 1.75 or even 1.80 in such a case.

USD AS GLOBAL RESERVE CURRENCY: FIRST CRACKS IN THE FOUNDATION

Share of global currency reserves held in USD, in %



USD-CNY (Jul 1, 2005 = 100)



Source: IMF Annual Report, Bloomberg, UniCredit Global Research

Long-term interest rates and inflation would rise in the US

At the same time, the dampening effect on US long-term interest rates is going to abate, as less petrodollars will flow into US financial markets to buy Treasuries. This impact on bond yields will be amplified by higher inflation rates. First, the sliding USD will lead to higher import prices, and second, oil exporters may decide to link the oil price to the same currency basket that they use for their exchange rate. As the USD is expected to depreciate against this basket, oil would become even more expensive for the US.

Treasury and Fed busy talking up the USD

So far so good

Our analysis has shown that the US economy is highly dependent on foreign capital inflows. It has to attract several hundred billion USD of portfolio investments per year, in order to finance the huge current account deficit. So far, this system has worked reliably, as indicated by the growing foreign ownership of US long-term securities in recent years. And apparently not even the ongoing financial crisis has reduced foreign appetite for US financial assets – it has just changed the composition of foreign purchases: During the last few months, foreigners have switched from risky corporate debt and equities to the safe-haven of Treasuries. A bigger risk for the stability of capital flows into the US and the USD in general is in our view the exchange rate policy of oil-exporting countries in the Middle East: will they keep their currency pegs to the USD or will they follow the lead of Kuwait that has removed its peg in May 2007? While there are a lot of reasons, why the GCC countries are likely to maintain their peg, we see at least a risk that they may switch to a currency basket regime. That in turn would have serious consequences for the greenback. As such a move would at the same time support the euro, EUR-USD is expected to surge, and we can easily imagine a movement towards 1.75 or even 1.80.

US Treasury and Fed concerned

There is no doubt that the US Treasury is highly concerned about this issue. Even though Secretary Paulson stated that the major purpose of his visit to the Middle East one month ago was “open investment”, and that changes to currency regimes in the region are “sovereign decisions”, I suspect that the threat of an exchange rate shift may have been an important – if not the most important – motive for Paulson’s trip. In fact, he made several statements during

his visit in order to allay skepticism about the weakness of the USD. He reiterated e.g. his belief in a strong dollar and said that the currency will benefit over time from the US economy, which is in a tough time right now. Paulson added that he believes the long-term economic fundamentals are going to be reflected in the USD. But not only the US Treasury should be concerned about a further slide of the dollar. New York Fed President Geithner said early June that when he was still a Treasury official, the balance of responsibility for the dollar was 60:40, with the Treasury taking the lead but the Fed clearly playing an important role as well. Chairman Bernanke apparently accepted this responsibility, when he said in early June that “over time, the Federal Reserve’s commitment to both price stability and maximum sustainable employment and the underlying strength of the US economy [...] will be key factors ensuring that the dollar remains a strong and stable currency.” This concern may be one reason to induce the Fed to start the impending rate hike cycle rather sooner than later. It is obvious that GCC central banks currently have a tough time defending their dollar pegs, and by tightening monetary policy in the US, the Fed would give their colleagues in the Gulf region some more scope to tackle inflation. That may convince them to keep their dollar peg – at least for now.

Dr. Harm Bandholz (HVB)
+1 212 672-5957
harm.bandholz@us.unicreditgroup.eu

Disclaimer

Our recommendations are based on information obtained from, or are based upon public information sources that we consider to be reliable but for the completeness and accuracy of which we assume no liability. All estimates and opinions included in the report represent the independent judgment of the analysts as of the date of the issue. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice.

This analysis is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as an advertisement thereof. The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Changes in rates of exchange may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, Bayerische Hypo- und Vereinsbank AG Milan Branch, UniCredit CAIB Securities UK Ltd. and UniCredit Aton, nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This analysis is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

Responsibility for the content of this publication lies with:

a) Bayerische Hypo- und Vereinsbank AG, Am Tucherpark 16, 80538 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). The company belongs to UCI Group.

Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

b) Bayerische Hypo- und Vereinsbank AG Milan Branch, Via Tommaso Grossi, 10, 20121 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: "Bank of Italy", Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

The UniCredit CAIB Group, consisting of

c) UniCredit CAIB AG, Julius-Tandler-Platz 3, 1090 Vienna, Austria

Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Praterstrasse 23, 1020 Vienna, Austria

d) UniCredit CAIB Securities UK Ltd., 80 Cheapside, London EC2V 6EE, United Kingdom

Regulatory authority: Financial Services Authority (FSA), 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom

e) UniCredit Aton, Boulevard Ring Office Building, 17/1 Chistoprudni Boulevard, Moscow 101000, Russia

Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

ANALYST DECLARATION

The author's remuneration has not been, and will not be, geared to the recommendations or views expressed in this study, neither directly nor indirectly.

ORGANIZATIONAL AND ADMINISTRATIVE ARRANGEMENTS TO AVOID AND PREVENT CONFLICTS OF INTEREST

To prevent or remedy conflicts of interest, Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd., Bayerische Hypo- und Vereinsbank AG Milan Branch and UniCredit Aton have established the organizational arrangements required from a legal and supervisory aspect, adherence to which is monitored by its compliance department. Conflicts of interest arising are managed by legal and physical and non-physical barriers (collectively referred to as "Chinese Walls") designed to restrict the flow of information between one area/department of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd., Bayerische Hypo- und Vereinsbank AG Milan Branch and UniCredit Aton and another. In particular, Investment Banking units, including corporate finance, capital market activities, financial advisory and other capital raising activities, are segregated by physical and non-physical boundaries from Markets Units, as well as the research department. In the case of equities execution by Bayerische Hypo- und Vereinsbank AG Milan Branch, other than as a matter of client facilitation or delta hedging of OTC and listed derivative positions, there is no proprietary trading. Disclosure of publicly available conflicts of interest and other material interests is made in the research. Analysts are supervised and managed on a day-to-day basis by line managers who do not have responsibility for Investment Banking activities, including corporate finance activities, or other activities other than the sale of securities to clients.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

Notice to Austrian investors

This document does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.

This document is confidential and is being supplied to you solely for your information and may not be reproduced, redistributed or passed on to any other person or published, in whole or part, for any purpose.

Notice to Czech investors

This report is intended for clients of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd. or Bayerische Hypo- und Vereinsbank AG Milan Branch in the Czech Republic and may not be used or relied upon by any other person for any purpose.

Notice to Italian investors

This document is not for distribution to retail clients as defined in article 26, paragraph 1(e) of Regulation n. 16190 approved by CONSOB on October 29, 2007.

In the case of a short note, we invite the investors to read the related company report that can be found on UniCredit Global Research website www.globalresearch.unicreditmb.eu.

Notice to Russian investors

As far as we are aware, not all of the financial instruments referred to in this analysis have been registered under the federal law of the Russian Federation "On the Securities Market" dated April 22, 1996, as amended, and are not being offered, sold, delivered or advertised in the Russian Federation.

Notice to Turkish investors

Investment information, comments and recommendations stated herein are not within the scope of investment advisory activities. Investment advisory services are provided in accordance with a contract of engagement on investment advisory services concluded with brokerage houses, portfolio management companies, non-deposit banks and the clients. Comments and recommendations stated herein rely on the individual opinions of the ones providing these comments and recommendations. These opinions may not suit your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely on the information stated here may not result in consequences that meet your expectations.

Notice to Investors in Japan

This document does not constitute or form part of any offer for sale or subscription for or solicitation of any offer to buy or subscribe for any securities and neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever.

Notice to UK investors

This communication is directed only at clients of Bayerische Hypo- und Vereinsbank AG, UniCredit CAIB AG, UniCredit CAIB Securities UK Ltd. or Bayerische Hypo- und Vereinsbank AG Milan Branch who (i) have professional experience in matters relating to investments or (ii) are persons falling within Article 49(2)(a) to (d) ("high net worth companies, unincorporated associations, etc.") of the United Kingdom Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 or (iii) to whom it may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This communication must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this communication relates is available only to relevant persons and will be engaged in only with relevant persons.

Notice to U.S. investors

This report is being furnished to U.S. recipients in reliance on Rule 15a-6 ("Rule 15a-6") under the U.S. Securities Exchange Act of 1934, as amended. Each U.S. recipient of this report represents and agrees, by virtue of its acceptance thereof, that it is such a "major U.S. institutional investor" (as such term is defined in Rule 15a-6) and that it understands the risks involved in executing transactions in such securities. Any U.S. recipient of this report that wishes to discuss or receive additional information regarding any security or issuer mentioned herein, or engage in any transaction to purchase or sell or solicit or offer the purchase or sale of such securities, should contact a registered representative of UniCredit Capital Markets, Inc. ("UCI Capital Markets").

Any transaction by U.S. persons (other than a registered U.S. broker-dealer or bank acting in a broker-dealer capacity) must be effected with or through UCI Capital Markets.

The securities referred to in this report may not be registered under the U.S. Securities Act of 1933, as amended, and the issuer of such securities may not be subject to U.S. reporting and/or other requirements. Available information regarding the issuers of such securities may be limited, and such issuers may not be subject to the same auditing and reporting standards as U.S. issuers.

The information contained in this report is intended solely for certain "major U.S. institutional investors" and may not be used or relied upon by any other person for any purpose. Such information is provided for informational purposes only and does not constitute a solicitation to buy or an offer to sell any securities under the Securities Act of 1933, as amended, or under any other U.S. federal or state securities laws, rules or regulations. The investment opportunities discussed in this report may be unsuitable for certain investors depending on their specific investment objectives, risk tolerance and financial position. In jurisdictions where UCI Capital Markets is not registered or licensed to trade in securities, commodities or other financial products, transactions may be executed only in accordance with applicable law and legislation, which may vary from jurisdiction to jurisdiction and which may require that a transaction be made in accordance with applicable exemptions from registration or licensing requirements.

The information in this publication is based on carefully selected sources believed to be reliable, but UCI Capital Markets does not make any representation with respect to its completeness or accuracy. All opinions expressed herein reflect the author's judgment at the original time of publication, without regard to the date on which you may receive such information, and are subject to change without notice.

UCI Capital Markets may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. These publications reflect the different assumptions, views and analytical methods of the analysts who prepared them. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is provided in relation to future performance.

UCI Capital Markets and any company affiliated with it may, with respect to any securities discussed herein: (a) take a long or short position and buy or sell such securities; (b) act as investment and/or commercial bankers for issuers of such securities; (c) act as market makers for such securities; (d) serve on the board of any issuer of such securities; and (e) act as paid consultant or advisor to any issuer.

The information contained herein may include forward-looking statements within the meaning of U.S. federal securities laws that are subject to risks and uncertainties. Factors that could cause a company's actual results and financial condition to differ from expectations include, without limitation: political uncertainty, changes in general economic conditions that adversely affect the level of demand for the company's products or services, changes in foreign exchange markets, changes in international and domestic financial markets and in the competitive environment, and other factors relating to the foregoing. All forward-looking statements contained in this report are qualified in their entirety by this cautionary statement

This document may not be distributed in Canada or Australia.

UniCredit Global Research*

Thorsten Weinelt, CFA
Global Head of Research & Chief Strategist
+49 89 378-15110
thorsten.weinelt@unicreditgroup.de

Dr. Ingo Heimig
Head of Research Operations
+49 89 378-13952
ingo.heimig@unicreditgroup.de

Global Economics & FI/FX Research

Marco Annunziata, Ph.D., Global Chief Economist
+44 20 7826-1770
marco.annunziata@unicreditgroup.co.uk

Global Economics & Commodity Research

Global Economics

Dr. Davide Stroppa
+39 02 8862-2890
davide.stroppa@unicreditgroup.de

European Economics

Aurelio Maccario, Chief Eurozone Economist
+39 02 8862-8222
aurelio.maccario@unicreditgroup.de

Andreas Rees, Chief German Economist
+49 89 378-12576
andreas.rees@unicreditgroup.de

Marco Valli, Chief Italian Economist
+39 02 8862-8688
marco.valli@unicreditgroup.de

Tullia Bucco
+39 02 8862-2079
tullia.bucco@unicreditgroup.de

Chiara Corsa
+39 02 8862-2209
chiara.corsa@unicreditgroup.de

Alexander Koch
+49 89 378-13013
alexander.koch1@unicreditgroup.de

Dr. Isabelle Kronawitter
+49 89 378-12563
isabelle.kronawitter@unicreditgroup.de

Chiara Silvestre
chiara.silvestre@unicreditgroup.de

US Economics

Roger M. Kubarych, Chief US Economist
+1 212 672-5668
roger.kubarych@us.unicreditgroup.eu

Dr. Harm Bandholz
+1 212 672 5957
harm.bandholz@us.unicreditgroup.eu

Commodity Research

Jochen Hitzfeld
+49 89 378-18709
jochen.hitzfeld@unicreditgroup.de

Nikolaus Keis
+49 89 378-12560
nikolaus.keis@unicreditgroup.de

EEMEA Economics & FI/FX Strategy

Martin Blum, Head
+43 50505-82363
martin.blum@caib.unicreditgroup.eu

Vladimir Osakovsky, Ph.D.
+7 495 777 8877 3139
vladimir.osakovsky@unicreditatton.ru

Goran Saravanja
+385 1 6006 678
goran.saravanja@unicreditgroup.zaba.hr

Pavel Sobisek
+420 2 211 12504
pavel.sobisek@unicreditgroup.cz

Gyula Toth
+43 50505-82362
gyula.toth@caib.unicreditgroup.eu

Global FI/FX Research

Michael Rottmann, Head
+49 89 378-15121
michael.rottmann1@unicreditgroup.de

Dr. Luca Cazzulani, FI Strategy
+39 02 8862-0640
luca.cazzulani@unicreditgroup.de

Chiara Cremonesi, FI Strategy
+44 20 78261771
chiara.cremonesi@unicreditgroup.co.uk

Giuseppe Maraffino, FI Strategy
+39 02 8862-2027
giuseppe.maraffino@unicreditgroup.de

Armin Mekelburg, FX Strategy
+49 89 378-14307
armin.mekelburg@unicreditgroup.de

Roberto Mialich, FX Strategy
+39 02 8862-0658
roberto.mialich@unicreditgroup.de

Kornelius Purps, FI Strategy
+49 89 378-12753
kornelius.purps@unicreditgroup.de

Herbert Sellier, Technical Analysis
+49 89 378-18024
herbert.sellier@unicreditgroup.de

Herbert Stocker, Technical Analysis
+49 89 378-14305
herbert.stocker@unicreditgroup.de

Publication Address

UniCredit Markets & Investment Banking
Bayerische Hypo- und Vereinsbank AG
Global Research
Arabellastrasse 12, D-81925 Munich
Tel. +49 89 378-12559
Fax +49 89 378-13024

Bloomberg
UCGR

Internet
www.globalresearch.unicreditmb.eu

* UniCredit Global Research is the joint research department of Bayerische Hypo- und Vereinsbank AG (HVB) and UniCredit CAIB Group (CAIB).