SAL. OPPENHEIM

Oppenheim Research

Equity Strategy Outlook 2008

A two tier market offers opportunities

2007-12-06

Strategy

2007-12-06

TARGET	
	Yr. end
DJ Euro Stoxx 50	4,550
DAX	8,400

A TWO TIER MARKET OFFERS OPPORTUNITIES

SOFT LANDING REMAINS BASELINE BUT WITH HIGHER RISKS

In our baseline scenario we expect more economic cooling, but a soft landing of the US economy and slower, but continuing solid economic growth in the euro area. Rising inflation, slowing growth and financial markets instability are drawing a dilemma for monetary policy. We expect the Fed to continue its course of easing while the ECB rates will probably stay at current levels.

EARNINGS GROWTH IS SLOWING BUT NOT VANISHING

The slowing of the economy is not sufficiently factored into earnings estimates. Although we expect that earnings estimates for 2008 will be cut by roughly 4% and for 2009 by some 6%, there still remains roughly 8% earnings growth in 2008 in case of the DAX and 5% at the EURO STOXX 50.

CENTRAL BANKS WILL HELP, BUT NOT IMMEDIATELY

Due to persisting disturbances in the interbank markets and already rather aggressive rate cut expectations, rate cuts by the Fed will not help markets soon. Also, the weakening of the status of the dollar together with the current ugly combination of slowing growth and still rather high inflation limits the potential positive impact of further rate cuts by the FED on equity markets. Nevertheless, we expect that finally there will be a positive impact as inflation should come down and give way to rising economic confidence and as also interbank markets should then no longer offset the FED's monetary impulses.

MARKETS RECOVER WITH LOWER SPREADS AND OIL PRICES

Near term newsflow will remain problematic and investors are still too confident that the support from rate cuts by the Fed will work its traditional magic. Also investors who are outright convinced that economic problems are confined to the US will have to scale back their investments. Therefore, we expect to get better investment opportunities in the first half of 2008. Once spreads or commodity prices start to decline in earnest this should be seen as a trigger for stocks to rise. As currently risks are fairly high we calculated a base case with 70% likelihood and an index target of 8,400 in the DAX and 4,550 in the EURO STOXX 50. In a negative scenario with persisting economic weakness also in 2009, we expect the DAX at 6,600 and the EURO STOXX 50 at 3,750. The expected value of 7,900 and 4,300 is the mathematical result but not the most likely case.

BET ON FINANCIALS AND MORE DEFENSIVE SECTORS

Investors deeply discount current earnings estimates at financials, which additionally, are still dragged by the high risk premiums at money markets. But spreads are exaggerated and this is reflected in the valuation. The Fed rate cut cycle, rising margins due to a steepening yield curve, and the high flexibility on the cost side are also favorable for banks. We expect financials to outperform next year. Solid dividends and share buy backs are important factors. We stay with defensives, particularly healthcare and telecommunication.

OUR TOP PICKS AMONG THE LARGE CAPS ARE:

ABB, Adidas, Allianz, Bayer, Dt. Bank, Dt. Lufthansa, Dt. Post, Henkel, KBC, Merck, Nestlé, OMV, Porsche, Roche, RWE and Telefonica.

Matthias Jörss
+49 (69) 7134 - 5645
matthias.joerss@oppenheim.de

Dr. Volker Karb
+49 (69) 7134 – 5604
volker.karb@oppenheim.de

Dr. Ralf Zimmermann
+49 (69) 7134 - 5660
ralf.zimmermann@oppenheim.de

Executive Summary

Soft landing remains our baseline scenario, but with higher than normal risk; the Fed continues to ease

The economic euphoria at the beginning of the year has evaporated, not at the least due to the persistence of the financial markets' gyrations arising from the US real estate crisis. The rise of oil prices to record levels and the accelerating revaluation of the euro against the US dollar have caused further uncertainty. Despite these risk factors, in our baseline scenario, we expect a harder, but soft landing of the US economy and slower, but nevertheless continuing solid economic growth in the euro area. The robust state of the Emerging Market economies is now functioning as a safety cushion for the world economy. Rising inflation, slowing growth, and financial markets' instability is drawing a dilemma for monetary policy. We expect the Fed to continue its course of easing while the ECB rates will probably stay at current levels.

Earnings growth is slowing but not vanishing completely

Earnings are facing severe headwinds from the strength of the euro, but also wage growth is accelerating at least temporarily, and productivity growth is likely to slow. The slowing of the economy is not fully factored into estimates. In the case of the DAX and the EURO STOXX, we expect that earnings estimates for 2008 will be cut by roughly 4% and for 2009 by some 6%. This still leaves us with roughly 8% earnings growth in 2008 in case of the DAX and 5% at the EURO STOXX 50. In case of the German estimates, the expected earnings growth looks more ambitious than it is, as the tax reform alone will lead to an increase of the earnings in 2008 by some 4%. For 2009, we calculate with earnings on index of 395 in the case of the EURO STOXX 50 and 670 in the case of the DAX.

Central banks will help, but not immediately

Although most Fed rate cut cycles have been positive for equities, this one might only help equities with a lag. The ugly combination of slowing growth and still rather high inflation is not unusual, but with the dollar loosing its status, this is troublesome. Also, the persisting disturbances on the inter bank markets and the already rather aggressive rate cut expectations in the market make us cautious to apply past patterns too closely. Nevertheless, we expect that further rate cuts by the FED will finally have a positive impact on equity markets, as inflation should come down and give way to rising economic confidence, and also as inter bank markets should then no longer offset the FED's monetary impulses. Lower oil prices should work as an endogenous stabilizer when economic weakness is felt no longer only in the US.

Base case: DAX 8,400, EURO STOXX 50 4,550; negative scenario DAX 6,600 EURO STOXX 50 3,750, gives an expected value of 7,900 and 4,300

Based on earnings multiples and the traditional Fed model, European equities look rather attractive; but this is a reflection of high bond spreads and low growth expectations. If we take both issues into account, valuations are roughly fair. The low valuation of markets is also predominantly coming from financials, where distrust in earnings is at extreme levels for good reasons. Non-financials are hardly cheap if one takes into account the stage of the cycle. Drivers for stock markets such as M&A activity and positive earnings surprises are loosing their strength. Positive surprises may come from dividends and share buy-backs. Given the higher than normal uncertainty coming from the financial crisis, we calculated a fair value for our base scenario and a fair value for the scenario that at the end of 2008, we will continue to have persistent economic weakness, and markets will have no reason to expect a reasonable recovery in 2009. In our base scenario, for which we see a likelihood of 70%, the EURO STOXX 50 stands at 4,550 and the DAX at 8,400 at the end of 2008. In the negative scenario, the EURO STOXX 50 stands at 3,750 and the DAX at 6,600. This gives us an expected value of 4,300 for the EURO STOXX 50 and 7,900 for the DAX.

Chase stocks when spreads or commodity prices decline, but most likely performance will be backend loaded

Near term newsflow will remain problematic and investors are still too confident that the support from rate cuts by the Fed will work its traditional magic. Also, investors that are convinced that economic problems are confined to the US will have to scale back their investments. Therefore, we expect to get better investment opportunities in the first half of 2008. Once spreads or commodity prices start to decline in earnest, this should be seen as a trigger for stocks to rise.

German stocks benefited from growth in China and Eastern Europe – watch for signs of negative spill-over

Consensus expects an ongoing strength of the growth regions in Asia, ex Japan, and Eastern Europe, which had contributed in 2007 to the decoupling of the German companies from the weakness in the US. Given the rising dependency of these growth spots on the Western export markets, investors have to closely watch for signs of a spill-over into these regions. These may come to the fore in case of a more pronounced US cooling. For the German listed stocks, the most important foreign markets are the Western European countries, thus German companies can be burdened from a cooling in this core region. Eastern Europe and Asia are certainly on the rise, but the US is still as important as these two regions together. Top down, we would in general be more cautious with US-exposed stocks and would go for the domestic-exposed and selected growth-region geared stocks. But also in China, growth ought to slow somewhat and risks from a monetary tightening are being too much ignored at the moment. This, however, should affect stocks less that are supported by long-term projects such as infrastructure and energy supply.

Solid dividend and share buy backs support the DAX

For the DAX, dividends of some €27.8bn are to be expected in 2008, up by 18% vs. last year. Roughly €16bn can be added due to share buy backs. This sums up to a yield of 4.2%, which is above the current 10yr bond yield, and which should support stocks. Among the DAX stocks, Lufthansa, Deutsche Telekom, Deutsche Post, Deutsche Bank, Munich Re and Allianz are appealing. This topic argues for large caps; dividend yields at the MDAX stocks are significantly lower.

M&A: limited support for stock markets, smaller deals will dominate

Credit spreads will remain high, and this has implications for M&A: Total M&A volume will increase only moderately from current low levels. There will be a lasting shift from financial to strategic investors who will go for smaller deals. At politically insensitive companies, sovereign wealth funds may step in as buyers. This could be positive for financials. Among small and mid caps, stocks like Balda, Kontron, KUKA, Demag Cranes and Stada could become a target.

Massive fears at financials offer opportunities

Investors deeply discount current earnings estimates at financials. Also earnings will be cut and the long-term earnings path will be dragged by deleveraging. Selected capital increases will come, but still we expect financials to outperform next year. Relative valuations based on forward PEs, dividend yields, price-book ratios and normalized earnings are attractive for banks and for insurers. The Fed rate cut cycle, rising margins due to a steepening yield curve, and the high flexibility on the cost side are positive factors for banks. Financials are still dragged by the high risk premiums at money markets. A notable decline should finally be the trigger for financials.

At industrials, we remain at defensive stocks and prefer stocks geared to the German consumer

We continue to prefer defensive stocks in this environment and remain rather selective at mid and small caps. Still in the recent correction, most defensive names in the second row underperformed as well, which we see more as an opportunity. Growth at stocks geared to investment spending ought to slow, as should consumer spending in most markets. In contrast to this, in Germany, consumer spending ought to improve in 2008.

Switzerland, entering the valley?

Bottom-up we derive a year end target of 9,200 points for the SMI and 7,500 points for the SPI. The valuation looks attractive, but the problem could be earnings expectations that are too high. We prefer stocks with strong balance sheets and good earnings visibility. Our preferred picks are: ABB, Burckhardt Compression, Lonza, Nobel Biocare, Nestlé, Partners Group, PSP Swiss Property, Richemont, Roche and Schmolz & Bickenbach.

Austria: the year of diminished expectations

The macro-backdrop in CEE is raising concerns, but there are profound differences to historical precedents and we do not believe a general health warning against stocks with a high CEE-exposure is justified. Our earnings outlook would suggest an upside of 13% for the ATX, but with inflation on the rise and with growing uncertainties, one could expect some further multiple contraction. Thus, we may finish the year 2008 with an ATX only 5% to 10% up on recent levels, implying a 2008 year-end level somewhere between 4,600 and 4,800. Our top picks are Andritz, Erste and OMV.

Greece remains an attractive but spicy option

Despite some risks from its behavior, like a small cap market and some macro risks, the expected earnings growth remains in favor of the Greek market and the selected stocks that we cover there.

Underweight	Neutral	Overweight
	Automobiles	
		Banks →
←	Basic resources	
	Chemicals	
Construction & Materials		
		Financial Services
	← Food & Beverages	
		Healthcare
	Industrial Goods & Services	
		Insurance
		Media
←	Oil & Gas	
		Personal & Household Goods
		Retail
	Technology	
	←	Telecommunications
	Travel & Leisure	
	← Utilities	

Large caps		Small & mid caps	
ABB	KBC	Andritz	Intercell
Adidas	Merck	Beiersdorf	IVG
Allianz	Nestlé	Centrotec	MPC
Bayer	OMV	Demag Cranes	Solarworld
Deutsche Bank	Porsche	Deutsche Postbank	Stada
Deutsche Lufhansa	Roche	Douglas	Takkt
Deutsche Post	RWE	Fresenius	Thiel
Henkel	Telefonica	GFK	United Internet

Economics

Norbert Braems, Frank Hübner, Ulrike Kastens, Katrin Löhken, Dr. Dagmar Alpen
Phone +49 (221) 145-2674, -2251, -2348, -2577, -2328

Historical role reversal: Emerging markets as drivers of the world economic trend

"Roller-coaster ride" of sentiment

The financial markets have gone through a roller-coaster ride of sentiment this year. What began as a crisis in one segment of the American mortgage market has developed into financial market gyrations with global repercussions. The crucial question for a medium-term economic outlook is therefore whether this crisis will continue to radiate so strongly or has already set processes in motion that – like a domino effect – might cause the pillars of the still robust world economy to collapse one after the other.

Strong interdependence between financial markets and the real economy

Our answer to this question is based on two key elements. On the one hand, we consider it important to note that the current worries about the global economic outlook mainly stem from a disruption in the financial sphere and have less immediate real economic causes. A happy or sad ending for the world economy and the capital market outlook thus largely depends on whether and when the disruptions in the financial sector can be removed. Unfortunately, this circularity of argument cannot be eliminated in the present complex and uncertain situation.

Due to strong growth in emerging countries, the world economy appears robust

On the other hand, diagnosing the economic baseline situation also plays an important role. The world economy so far appears quite robust. In particular, US-centrism, which was still pronounced a while ago, is no longer present. The role of "global growth engine" has shifted to the Emerging Markets in the last four years. Since 2003, the annual growth difference between those countries and the G7 has been somewhat more than 5 percentage points. Since indicators in the industrialized countries signal a slowdown in the coming months, not least due to the international financial market gyrations, it will be vitally necessary for a continuing global upswing that the decrease of demand in the industrialized nations be offset by the Emerging Markets. In other words, the developing countries, which have often appeared as global troublemakers in the past, currently play a key role in stabilizing the world economy in the Oppenheim scenario. And although the financial crisis is generally a major risk factor for both industrial and emerging nations, the liquidity problem in certain credit and capital market segments in the G7 countries has not had a negative impact in the Emerging Markets yet. Moreover, foreign capital continues to flow undiminished into local Emerging Markets on a near-record scale.

Emerging countries contributed more than 70% to global growth

The robust state of the Emerging Market economies is now functioning as a safety cushion for the world economy. The share of total global imports attributable to imports to Emerging Markets rose by somewhat more than 6 percentage points to 29% between 2000 and 2006. The IMF expects another increase to 31.5% by 2008. The structural reforms carried out in the past years are providing positive growth impetus and improving resistance to internal and external shocks. The Emerging Markets already contributed somewhat more than 70% to global GDP growth in 2005 and 2006. For this year and next, the IMF expects that more than three-fourths of the world economy's growth will be generated in the Emerging Markets. According to IMF forecasts, the four BRIC countries alone (Brazil, Russia, India, and China) will show, at just over 50%, a threefold greater positive contribution to growth than the G7 economies will in the coming year.

More dynamic domestic demand in Emerging Markets

Growth momentum in the emerging countries no longer rests solely on export successes. Expected GDP growth of 7% to 8% is based on the forecast of an even somewhat more dynamic development of domestic demand. In the first half of 2007, consumer spending in China and India (based on actual exchange rates, not purchasing power parities) already contributed more to the growth of global GDP than the increase of private consumption in the United States did, according to data published in "The Economist". Moreover, the dependence of the Emerging Markets on the trend of established export markets is lower than it was five or ten years ago thanks to continuous expansion of intraregional trade and flows of goods to other developing countries. On the other hand, the share of imports worldwide attributable to US imports has fallen by 5 percentage points since 2000 to 14%.

	PPP-Share of world GDP*	Real GDP Growth		
		2006	2007e	2008e
World	100%	5.4	5.2	4.8
Industrialized Coun.	49.2%	2.9	2.5	2.2
Emerging Markets	50.8%	8.1	8.1	7.4
Asia	29.3%	9.8	9.8	8.8
China	16.8%	11.1	11.5	10.0
India	6.8%	9.7	8.9	8.4
Latin America	7.7%	5.5	5	4.3
Brazil	2.8%	3.7	4.4	4.0
CEE**	3.5%	6.3	5.8	5.2
CIS***	4.0%	7.7	7.8	7.0
Russia	2.7%	6.7	7.0	6.5

* Purchasing parity weighted 2008 GDP estimate of IMF
** Central and Eastern Europe *** Commonwealth of Independent States

Source: IMF

Source: IMF

China is a main contributor to growth

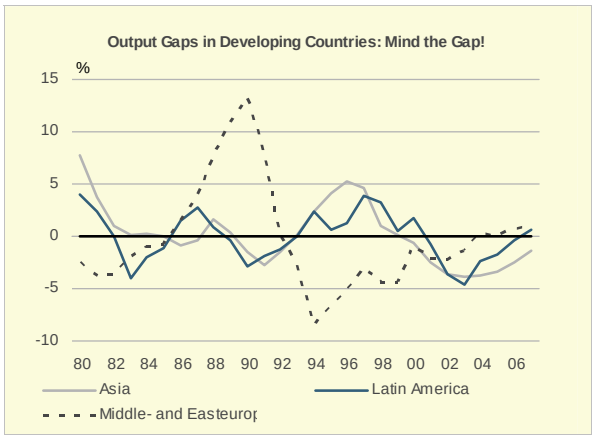
China continues to emerge as an important growth center. Its GDP increase in the third quarter was reported at 11.5% year-on-year. Chinese GDP figures are always released two weeks after the end of the quarter and are seldomly revised later. So, they may be viewed more as a political indication than as a statistical reality. In this case, the GDP curve in 2007 may be interpreted to mean that the Chinese economy is now gradually slowing somewhat at a high level after reaching a growth peak early last summer. At the same time, the structure of growth seems to be changing. Export activity has recently weakened, while growth momentum is increasing in consumer spending and capital investment.

Warning signals of overheating in China

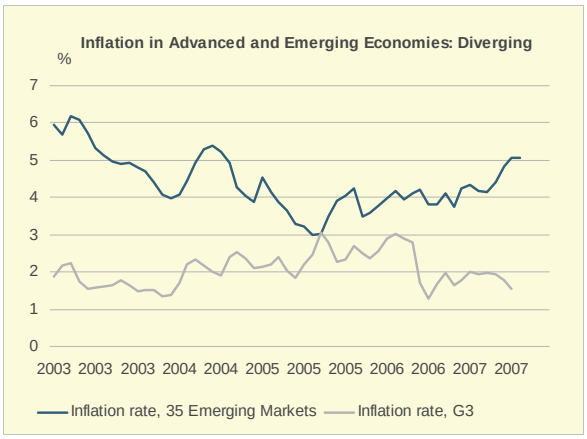
While rising increases of private consumption are likely to be welcomed by the Chinese government that is not true of accelerated capital investment. The administration in Beijing has been warning for some time of an economic overheating. Attempts to restrict capital investment by means of administrative orders have so far shown only limited success. On the one hand, the expected decrease of growth momentum should counteract possible overheating dangers. On the other hand, the pace of growth combined with a shift of driving forces towards private consumption should continue to suffice for a positive contribution to global economic growth.

Medium term threats to price stability after output gaps in developing countries have closed

The growing importance of the Emerging Markets is reflected not only in their influence on global growth forecasts, but also in price development. The rapid rise of commodity prices in the last few years has directly affected the development of headline inflation in the industrialized nations. This effect is also a main price driver in the developing countries and has likewise recently led to a noticeable increase of inflation rates there. However, there are also other reasons not to underestimate the inflation problem in the Emerging Markets. Thanks to the world economy's dynamic growth, the output gaps in the developing countries have largely closed. The IMF even already sees above-average resource utilization in Emerging Europe and Latin America. Growth rates at the level of the last two to three years therefore pose medium-term threats to stability.



Source: IMF



Source: IMF

Greater exchange rate flexibility in Asian countries necessary for more flexible monetary policy

Another globally important price also plays an important role in this connection: the US dollar exchange rate. Because the currencies of some important economies in Asia and the Middle East are more or less directly pegged to the US dollar, those economies are “importing” the orientation of US monetary policy. As a result of the dollar peg, the central banks in those countries thus have a hard time pursuing a restrictive course without a similar monetary policy bias in the United States. That is especially true now because the Fed has recently loosened its reins. This situation is sending expansionary impetus to the Emerging Markets and hence to the world economy. In the short term, that will contribute to offsetting lower demand in the industrialized nations by means of growth in the Emerging Markets. However, this situation does not seem sustainable in the medium term, particularly in view of the dangers of overheating in the developing countries. To achieve greater autonomy over their monetary policy and hence better calibration of this important parameter for adapting economic policy to the cyclical and structural needs of these national economies, there hardly seems to be a realistic alternative to greater exchange rate flexibility for some “prominent” Emerging Market currencies.

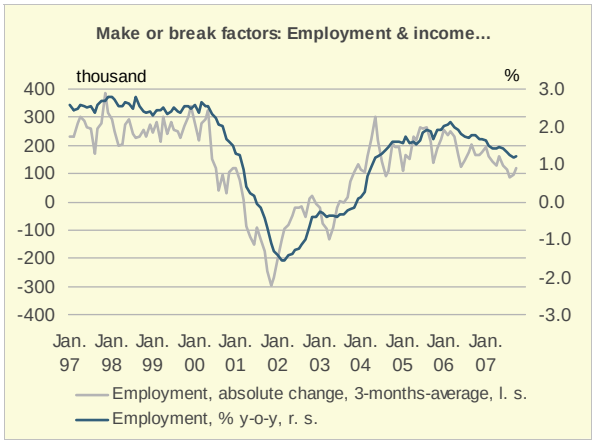
US Economy: Caution – fragile!

Disappointing, sub par US growth – this year and in the future

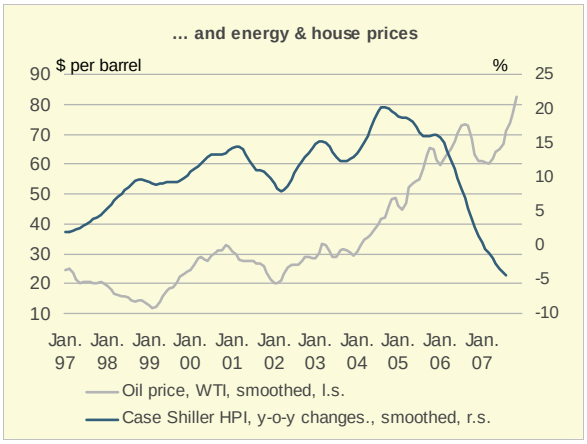
In the United States, this year and 2008 might be rather disappointing despite surprisingly strong GDP growth in the third quarter, which will probably even be revised upward to about 5% based on the latest data. The main object of doubt is the American consumer, who is currently facing headwinds from various fronts. Besides the chaos on the housing market, which is depressing consumption propensity directly via upcoming interest rate adjustments and indirectly via more restrictive lending terms and possible negative wealth effects, significantly higher energy prices are also making the consumer's life difficult in the bargain. In addition to that, a slowing of employment growth has recently emerged on the labor market. That has all occurred against the backdrop of a comparatively low saving ratio and persistent US household financing deficits. In our opinion, however, the individual negative aspects are often presented too dramatically in the discussion. That applies especially to certain estimates of the potential negative wealth effect of falling home prices. But the fact that headwind is coming from many different angles at the moment makes consumers more vulnerable than at any time since the 2001 recession.

Consumers face various headwinds and spend less generously

Sentiment is now correspondingly poor. Consumer confidence as measured by the University of Michigan has downright collapsed since last summer. After consumer spending rose in the first three quarters of this year at a rate of 2.5%, rates higher than 1.0 to1.5% are unlikely in the coming six to nine months, in our estimation. Private consumption will grow at about 2% in the rest of the forecast period, which is also far below the historical average. We expect real income increases of about 2.5% for 2008 and 2009 and a rise of the saving ratio of 0.5% to 0.75% per year. We see risks for these expectations especially in possible negative surprises on the income side (i.e., oil prices and/or the labor market). But also a further tightening of borrowing opportunities caused by aggravated financial market problems or an accelerated decline of home prices would very probably lead to a downward revision of the consumption forecast.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

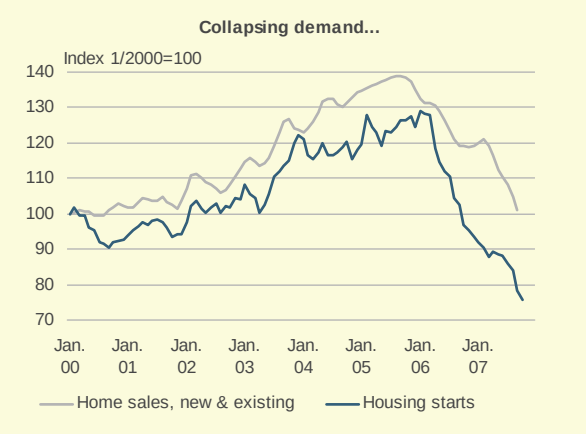
Positive fundamentals argues for moderate rise in capex

Given the less than rosy outlook for private consumption, a boom in corporate spending seems an unrealistic prospect. However, at least basic conditions are better than in the household sector and in comparison with the last recession. Profit margins and operating earnings continue to be relatively high as of the third quarter of 2007. Earnings expectations outside the financial sector and areas directly connected with residential construction have not been revised significantly downward. The positive external environment and weakness of the US dollar are giving impetus to internationally operating US companies, in particular. Financial and

balance sheet structures outside the financial sectors are solid, and capital spending has been largely financed by internally generated means. Against the backdrop of relatively normal capacity utilization, we therefore expect diminishing momentum in capital spending and new hiring in the forecast period. For the coming two years, however, we expect an employment plus of 0.7% to 1% and a real plus of non-residential construction spending by 3.6% in 2008 and 3.4% in 2009. Apart from a certain amount of inventory reduction in the fourth quarter, we expect no appreciable impetus from the inventory investment cycle on average of the coming two years.

Housing remains a mess – no recovery before end of 2008

Residential construction spending will continue to decline in the foreseeable future. The imbalance, i.e., the supply surplus on the housing market, is simply too great now for a stabilization in this sector. The decline of private residential construction accelerated in the third quarter against the backdrop of the worsening subprime mortgage crisis. We expect a continuation of the negative trend into the first few months of 2008. In our scenario, we do not foresee a stabilization of residential construction until the fourth quarter of 2008. The decline for the full year 2008 would amount to about 9.5%, meaning that residential construction spending would fall to the level of 1998. We expect a minor annual average increase in 2009 of 0.2% from these very low levels.



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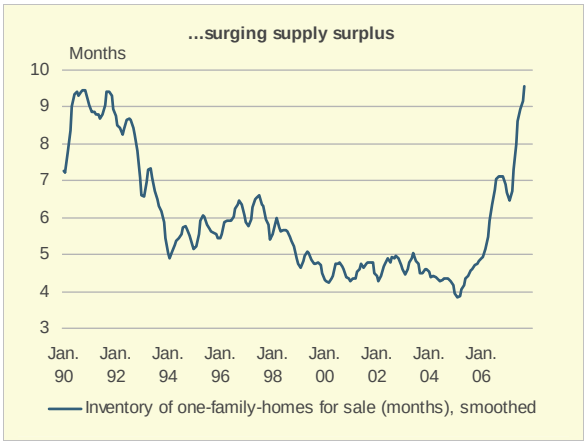


Source: Thomson Financial Datastream

Rather weak domestic demand…

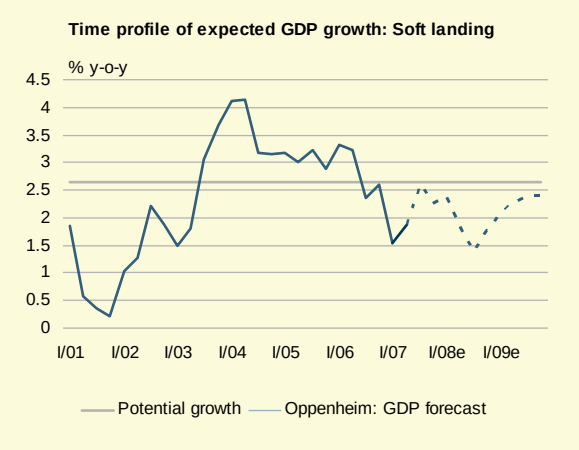
Overall, our expectations for development of domestic demand, especially in the coming months, are not very far from a stagnation scenario. Up to the second quarter of 2008, we expect annualized growth of private domestic demand by only 0.7%. After the negative growth impetus from housing construction expires and the financial market situation normalizes at the latest in the second half of 2008, our scenario foresees a plus of 2.0%, a rate below potential growth and below current market expectations.

…translates into sub par GDP growth, but no recession

The same essentially applies to our overall US GDP forecasts for 2008 and 2009. The momentum of GDP growth is likely to slow down significantly in the next two quarters. After a meager 0.8% in Q4, we look for an annualized GDP growth of 1.3% in H1 2008. From mid-2008 to the end of 2009, we expect average growth rates of about 2.3%, which are below US GDP potential growth of 2.5% to 2.75%. In general, our positioning in 2008 is at the lower end of the opinion spectrum and hence below consensus forecasts. The same is true of 2009, for which we predict growth of 2.3%. Although the landing of the US economy will thus be harder than we expected a few months ago, we would still characterize our scenario as a “soft landing”. In our opinion, a hard landing, or a recession, does not have the highest probability of occurrence because of the significantly positive net exports that we expect and potentially anti-cyclical stabilization effects from commodity prices and interest rates.

US Macro Forecasts	2006	2007e	2008e	2009e
Real GDP	2.9	2.3	1.9	2.3
Personal Consumption	3.1	2.8	1.5	1.9
Government Consumption	1.8	2.0	1.8	1.1
Nonresidental Investment	6.6	4.5	3.6	3.4
Residential Investment	-4.5	-16.2	-9.4	0.2
Exports	8.4	8.1	7.5	6.1
Imports	5.9	2.1	2.2	3.0
Inventories*	0.0	-0.3	0.0	0.1
"Headline" Inflation	3.2	2.7	2.3	2.1

Source: Thomson Financial Datastream and own forecasts



Source: Thomson Financial Datastream and own forecasts

Forecast risks higher than usual

At the end of November, the Federal Reserve began a new phase in its communication policy and released detailed macroeconomic forecasts of FOMC members. That involved asking not only for expectations, but also for parameters regarding the extent and direction of possible deviation risks. The answers were unambiguous and unsurprising. The risks are predominantly pointed downward against the backdrop of the real estate and mortgage crisis, financial market gyrations, and high oil prices, and the forecast risk is unusually high. Our central GDP forecasts are at the lower end of the "Fed range," but we agree with the US central bankers regarding the direction and possible amplitude of the forecast risks. We currently estimate the probability of recession at about 35%.

Benign inflation outlook, no stagflation

We also agree with Fed officials in the assessment of inflation prospects. Despite currently upward-pointed inflation risks due to high import prices and still tight labor market conditions, we expect core inflation rates of 2% or slightly lower in the forecast period against the backdrop of our economic scenario. Headline inflation should peak at the turn of the year and then fall during the year to near 2%, where it is likely to stay in 2009. The weakness of domestic demand allows little latitude for passing on price increases, and we expect some relief from commodity prices in the coming months. On the labor market, unit labor costs should rise in both 2008 and 2009 in a range that is compatible with a core inflation rate of about 2%. Medium-term inflation expectations, which are still anchored at a tolerable level, are a further substantial plus point, particularly in this connection.

Euro area: Economic slowing, but no crisis scenario

Eurozone baseline scenario will act supportively

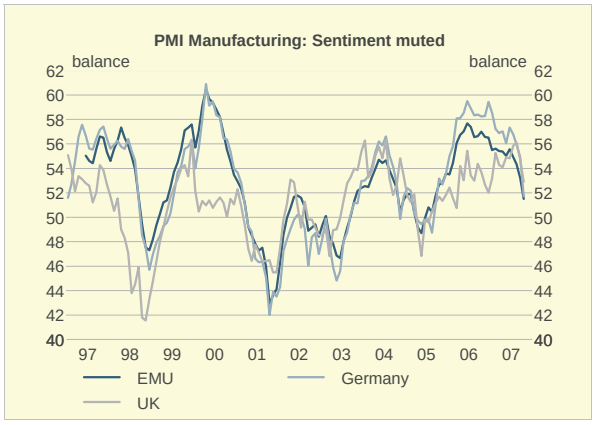
Despite increased risk factors, we expect slower, but continuing solid economic growth in the euro area. The baseline situation is very good. The European economy has been growing above potential for about two years. It registered GDP growth of almost 3% in 2006 and has still managed 2.5% this year. Growth momentum has continued. The third quarter again saw good figures with a plus of 0.7%. The acceleration in major growth regions like Asia and Latin America has made the European economy more independent of the development in the United States, in our estimation. Among other things, export successes in the oil-exporting countries and substantial improvement of demand in Eastern Europe are playing an important role in that regard.

Optimism has been waning during the year

However, the economic euphoria at the beginning of the year has evaporated. Due to external disruptions, including the financial market problems arising from the US real estate crisis, the previously very optimistic orientation of economic forecasts has been called into question. The rise of oil prices to record levels and the accelerating revaluation of the euro against the US dollar have caused further uncertainty.

Sentiment indicators are falling as well as "hard indicators"…

The sentiment indicators now primarily reflect uncertainties about economic development. The purchasing manager indices have fallen significantly, by up to five points, but in almost all EMU countries, have remained above the critical mark of 50, below which an economic contraction is indicated. In the EMU, the last flash figures from November were 52.6 in the manufacturing sector and 53.7 in the services sector. National business sentiment indices, in which particularly the expectation components have declined, show a similar development. The "hard" indicators, such as industrial production, new orders, and export figures, likewise point to a significant cooling in the coming months. This results in a weaker outlook for economic activity in general and for export demand in particular. Besides the flagging world economic trend, a worsening of the competitive situation due to the euro's revaluation will play a role here. Hit by the strong external value of the euro, net exports will not show a growth contribution in 2008 or may even have a contractive effect.



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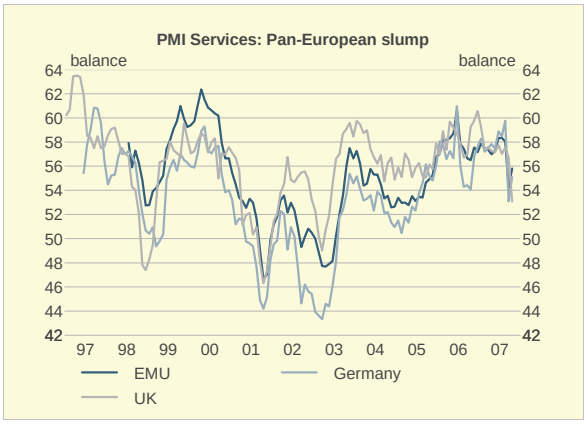


Source: Feri

… but better conditions in the labor market and corporate sector

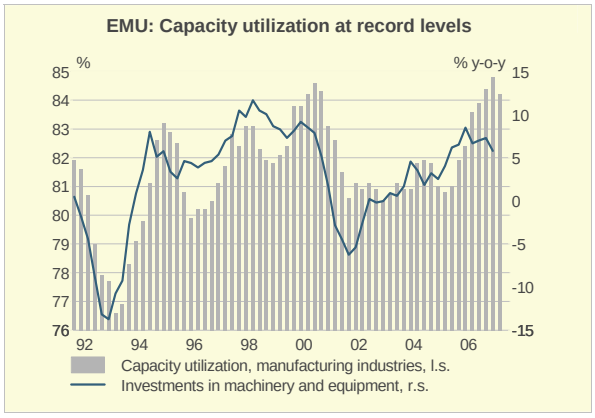
Besides the direct threats to growth posed by the US real estate crisis, the indirect effects by way of the financial markets and possible wealth effects should not be overlooked. The problem there lies in assessing the intensity and duration of the market distortions and adjustment processes. Despite the existing hazards to growth, we will not join the pessimists who even consider recessionary tendencies likely in view of the accumulating risk factors. The main reasons for our cautious optimism lie in significant structural improvement of economic fundamentals, particularly in the corporate sector, in substantially better labor market conditions, and in more favorable financing terms with falling short-term interest rates.

Price competitiveness has been rising, particularly in Germany

The flexibility and robustness of the business sector is a key factor. The corporate sector in the euro area has undergone an impressive transformation in the past years. First, it should be noted that earnings development has been exceptionally positive since 2003. Reported earnings of listed companies have reached a higher level now than in 2000, for example. But there has also been improvement in the broad economy. In Germany, the corporate earnings ratio in relation to GDP has continuously increased and is now at 36% of national income, and hence at its highest level in more than 15 years. Other measurements also point to a good trend in the business sector. Profitability (return on capital) has increased significantly, and margins also show a clear recovery. That is particularly true of the German economy, which has become significantly more competitive in the past years by hugely reducing unit labor costs. The positive development of margins has been stronger in Germany than in the other major EMU countries. In the development of return on capital, Germany has also managed to catch up with the euro area again.

Strong investment in the expansion of capacity, but momentum diminishes

Not at least due to the favorable earnings situation in the business sector investment in machinery and equipment picked up in 2007. In Germany, for example, investments will expand by around 8%. On the EMU level, combined fixed asset investments grow by about 5% in 2007, contributing substantially to improving overall GDP growth. At the same time capacity utilization has reached its highest level since the boom year of 2000 and still remains high. As a consequence, rising expenditures for equipment do not serve solely as replacement investments. In 2007 and also 2008 an additional and growing contribution will come from investments in the expansion of production facilities. Nevertheless we expect the growth momentum of investments to slow in the coming year. Corporates now face higher ratios of debt, which is also due to the increased need of financing for merger and acquisition activities. Together with higher interest rates for corporate loans, that has led to a greater interest burden. The macroeconomic situation of the business sector is therefore no longer quite as favorable as it was two years ago, but it may still be regarded as very solid. Although momentum should diminish because of uncertainty concerning the economic outlook and the expiration of favorable depreciation rules in Germany, dynamic earnings, growing domestic demand, and low real interest rates remain arguments for a continuation of the capital spending trends.



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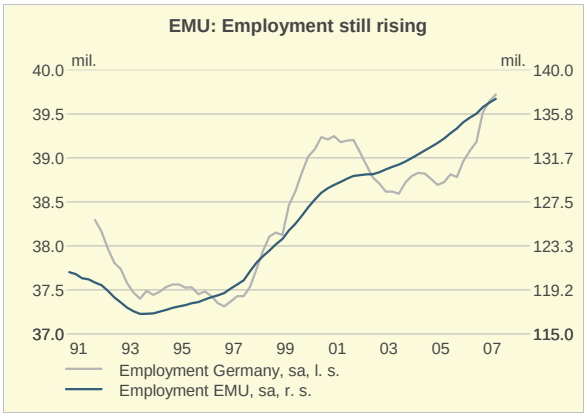


Source: Feri

Positive impact from the labor market

The second factor to serve as a stabilizing component in the forecast is the upward development of employment and income. All countries of the euro area showed a very impressive labor market performance. In Q3, growth in employment was even stronger than in US. In Germany alone, about 600,000 new jobs have been created in 2007. To a large amount jobs obliged to contribute to social insurance were responsible for this increase. Combined with an increase of wages by about 2%, this has had a positive influence on total wages and salaries, which have risen by more than 3%. However, disposable income has grown at a lower than average 2.1%

because of declining transfer payments (Hartz IV). We expect further improvement and a decline of the saving ratio in the months ahead. For German growth, that means additional support of the economic trend by private consumption. But that will also be needed inasmuch as net exports will provide no further impetus. That also applies, of course, to the other EMU countries.

Spanish real estate market will dampen growth in 2007 and 2008

Moreover, the real estate market is in greater difficulty in Spain and Great Britain. House prices are beginning to fall and Spanish building permits are signaling a weaker development in the construction sector in the next years. As building represents more than 18% of the whole GDP the Spanish economy is very vulnerable. GDP growth rates in Spain will be only a little above 2% in the next two years, after levels between 3.5% and 4% in the previous years. British mortgage approvals are on a decline as well. In Great Britain, growth will slow from 3% to about 2%, mainly due to a weaker private consumption.

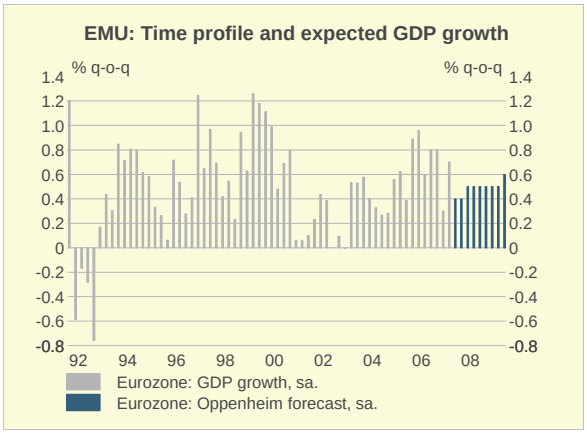
Weaker growth in 2008, stronger momentum in 2009

Altogether, we expect GDP growth of 1.8% for the euro area in 2008. While particularly Q1 should show a weaker GDP outcome, we predict a stronger momentum in the second half of the year. The prerequisites for that are a calming of the financial market, which may be expected, a 10% to 20% lower oil price, and no further strengthening of the euro. For 2009, we expect a somewhat brightening international environment and further stabilization of domestic demand to lead to economic growth of about 2% in the euro area and to a rate of similar magnitude in Germany.

EMU macro forecasts

	2006	2007e	2008e	2009e
Real GDP	2.9	2.6	1.8	2.0
Personal consumption	1.9	1.5	2.1	1.8
Government consumption	2.0	1.9	1.4	1.3
Fixed investment	5.4	4.8	2.0	1.6
Exports	8.0	6.0	4.1	3.7
Imports	7.7	5.2	4.4	3.3
Inflation	2.1	2.1	2.3	1.9

Source: Feri and own forecasts



Source: Feri and own forecasts

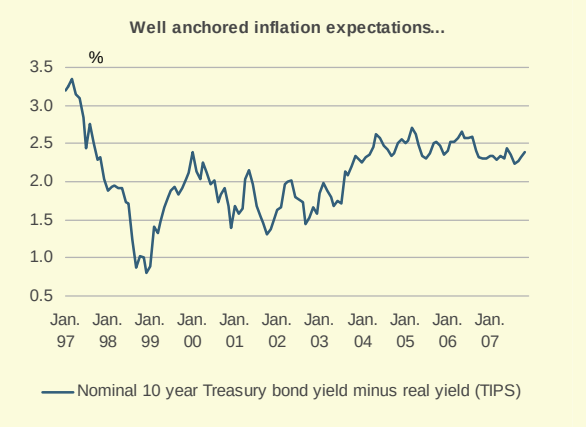
Monetary policy dilemma: Between rising inflation, slowing growth, and financial market stability

Central banks face great challenges worldwide

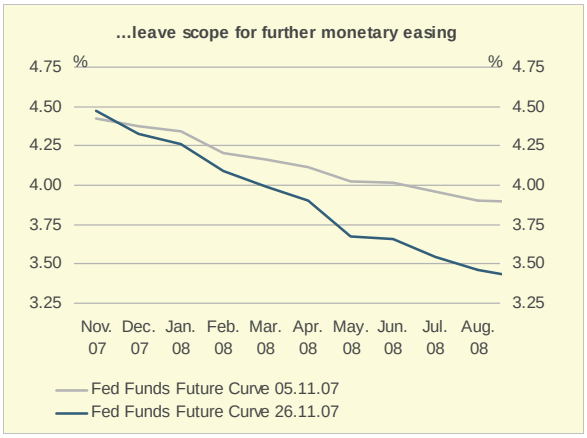
The current economic and financial market environment poses great challenges for central banks worldwide. In addition to getting the money market working again, with emphasis on making liquidity available, the central banks play a special role in limiting economic risks – but without promoting speculative exaggerations (moral hazard problem). Moreover, there continue to be dangers of accelerating inflation mostly driven by energy and food prices. Higher inflation expectations might lead in this environment to an increase of long-term interest rates.

Quick and decisive action from the Fed

It is hardly surprising that the most decisive monetary action so far came from the US central bank. The combined 75 basis points of policy easing put in place at the past two FOMC meetings in addition to the discount rate cut in August should in Fed-speak "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and should help promote moderate growth over time." In the current environment of financial instability the Fed operates in a risk management mode. The US central bank obviously views quick and decisive action as very important when it wants to buy some insurance to "get ahead of the (risk) curve". After the October FOMC meeting, the Fed issued a statement that "the upside risks to inflation roughly balance the downside risks to growth". Moreover, Fed officials expect the pace of economic expansion to slow in the near term, partly reflecting the intensification of the housing correction. These statements suggest strongly that the Fed is not on auto-pilot following a thorough monetary easing mission. Rather it sets a high bar for further easing at the December 11 FOMC meeting. That message has been confirmed by a number of recent Fed speakers.



Source: Fed



Source: Reuters

Market expectations diverge from latest Fed communication…

As already mentioned, the FOMC published its "maiden" quarterly three-year economic forecast report on November 20. These projections in addition to the accompanying extensive commentary on the potential forecast risks is intended to be a further step of the Fed's march toward more transparent communication. Ironically, it comes at a time which shows a disconnect between what the Fed is saying and what financial markets are discounting. Market participants obviously put more emphasis on the FOMC members' risk analysis and assign less importance to the central forecasts. In other words: Markets are less optimistic about the growth prospects of the US economy and, moreover, take comfort from the sanguine inflation outlook of the Fed officials. Our GDP forecast for 2008 and 2009 is at the low end of the central range of the FOMC's growth projections and thus closer to the market expectations. Despite the large write-downs already announced, more bad

news from the financial institutions is sure to come to the fore. Amid the current uncertainties about the volume of forced re-intermediation, potential strains on the funding side and dropping capital ratios, the vulnerability of the financial sector remains high. Moreover, in our view and in Fed officials' perceptions, too, growth will most likely run below trend for a while. With the incoming inflation data on the favorable side, the risks to inflation from a further moderate easing seem to be acceptable. In the current environment, the costs of potentially too much easing, thus, do not seem to be prohibitively high to us, especially if the Fed is prepared to reverse the rate cuts if inflation pressures proved stronger than expected.

…but the Oppenheim forecasts looks for additional moderate easing, too.

The Fed will need to shift materially its perceptions of risks about the outlook, in the direction of our forecast, if it is to ease. Judged by the remarks of Chairman Bernanke and Vice Chairman Kohn at the end of November, it seems that such a reassessment is already happening. If inflation expectations remain anchored around the currently acceptable levels, we believe that the Fed will take out additional "disaster insurance" and will deliver 50bp of additional ease by the end of 1Q08. However, our overall assessment of macro outlook for the US economy argues clearly against the view that an extended easing cycle is under way, so interest rates in our view stay at 4%, somewhat above market expectations of 3.5%.

Further interest rate hikes on hold in Japan

In Japan, we expect a normalization of interest rates in the medium term. Prices have trended in slightly negative territory in the second half of the year. Evidently, deflation cannot be considered entirely defeated yet. In view of economic growth still at about 2% p.a., current key interest rates of 0.5% appear significantly too low. However, the Bank of Japan will not want to raise interest rates yet in the present uncertain economic and financial environment. We expect further key interest rate hikes in the medium term, once the international capital markets have recovered.

European central banks struggle to calm tight monetary markets

The American real estate crisis has reached Europe via the financial markets. The related general loss of confidence is causing unusually tight conditions on the money market to continue. The interest rate for three-month money in the euro area peaked at 4.75% and has ranged just slightly below that for months. Only through generous injections of central bank money in the framework of quick tenders and open market operations could interest rates in the overnight money segment be partly readjusted. However, dislocations in the somewhat longer maturities (particularly in the three-month segment) are likely to continue beyond the end of this year. Additional ECB tenders with those maturities have not defused the situation further.

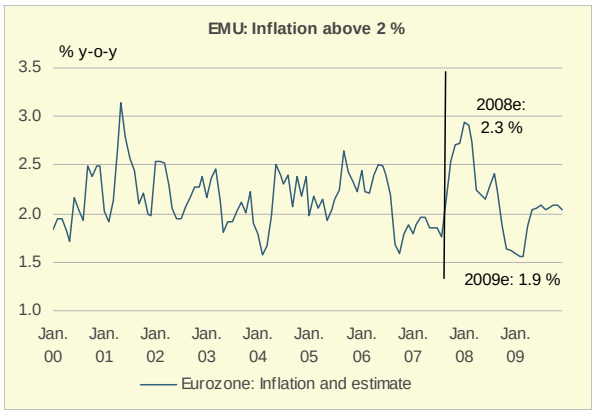
Inflation dangers not to be underestimated

The ascent of oil prices to nearly USD 100 and the further rise of food prices have heightened inflation risks in the euro area. The inflation rate there now stands at 2.6%. Rates of nearly 3% by the beginning of 2008 cannot be ruled out. To what extent this development will continue in 2008 is unclear and largely depends on import price development. Passing on higher costs to domestic prices would be possible, and even more likely if wage agreements are excessive and not differentiated. However, we expect wage pressure to diminish overall thanks to declining economic momentum. Additionally, for the corporate sector it will not be easy to pass on cost increases, so inflation rates may be expected to decline during the year due to base effects. Nevertheless, the average inflation rate for the full year will remain above the critical 2% mark.

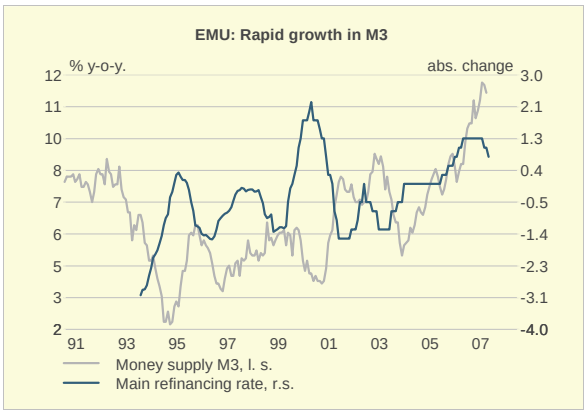
No interest rate cut in 2008 in the euro area

This price trend argues against interest rate cuts by the ECB in the near future. Furthermore, growth rates of M3 money supply have been double digit since February now, partly as a result of a shift out of non-interest-bearing instruments (M1) as well as new money in term and savings deposits. Even if the market turmoil and the additional central bank liquidity will make it difficult to interpret money-supply and loan statistics in the coming months this factor militate against a reduction of the tender rate as well. However, with the current weakness of the US dollar, growing signs of slowing economic activity in Europe, even if only temporary, and the unforeseeable long-term effects of the financial crisis on the banking system in the

medium term, a rise of refinancing costs due to a key interest rate increase is also becoming unlikely. In this field of conflicting forces, we continue to expect unchanged tender rates for the rest of the coming year.



Source: Feri and own forecasts



Source: Feri

Strong upturn of the euro to be (partially) corrected in 2008

On the currency side, the narrowed interest rate spreads between the United States and Europe have given the euro more upward impetus. At just below USD 1.50, the euro exchange rate has risen to new record levels. We do not believe that this trend can be projected into the future, however. The tendency towards shifting the currency reserves of central banks worldwide to the euro does argue against a strong US dollar. But the advancing improvement in the US current account balance, a greater devaluation of the dollar against the Asian currencies, and the correction of exaggerated expectations of interest rate reduction in the United States will tend to support the dollar next year relative to the euro. On a year's horizon, we therefore expect exchange rates below those of today, which are far from purchasing power parity.

Strategy

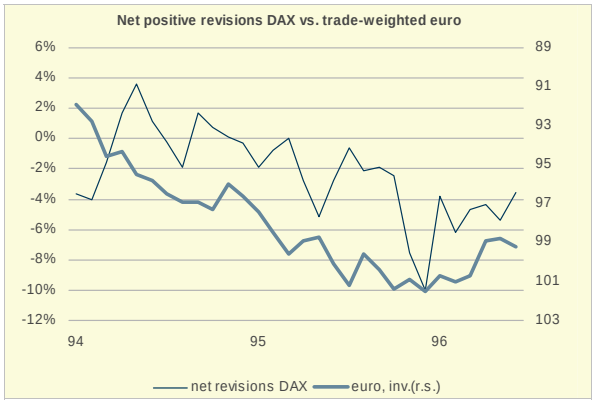
Matthias Jörss, Volker Karb, Ralf Zimmerman,
Telephone +49 (69) 7134 – 5645 – 5604 – 5660

Earnings growth is slowing, but not vanishing completely

When will the currency impact become visible in the estimates?

Since the beginning of 2005, the euro has risen some 7% on a trade weighted basis and earnings growth has still remained surprisingly resilient up to now. Markets tend to look predominantly at the translation and the more important transaction impact, but given some structural changes, both declined in their importance somewhat compared to the more midterm aspects for profitability. The trend towards a more internationally diversified production base has clearly helped to mitigate the problems coming from the transaction impact. Currency hedging has also helped to buy some time, but one has to keep in mind that, going forward, hedging is becoming more and more unattractive. The last time the dollar was this much below the value we derive from the purchasing power parity (see chart on page 32 we saw that earnings revisions were closely tracking the development in the currency market. Also, the revisions for the DAX relative to the revisions for the S&P followed the external value of the euro very closely. (We had to go back to our DAX data, as estimates for the EURO STOXX 50 simply don't exist for that time frame.) Although companies are still hedging at these levels, we believe the strength of the euro is becoming more of an issue than in the past. Therefore the overall message is that we have probably reached a level where earnings are more impacted by the development of currencies, despite the fact that the production base is now more international and despite the currency hedging. As always in an environment of a weakening economy, the exchange rate also serves as a good excuse, and we expect this to be one of the topics in companies' cautious outlook for 2008.

In our outlook we are not calling for a significantly weaker dollar (see page 18 but the current strength of the euro will most likely last for a while and this should also have medium term implications for earnings. Hedges are running out and have to be renewed at more uncomfortable levels; companies will more and more look for suppliers from the dollar area and this will also lead to relocations of production facilities into the dollar countries. Thus the strength of the euro will have strong repercussions for growth, particularly in sectors that are still relatively labor intensive and where margins are small. As a consequence we will see significant restructuring charges and this also applies to companies that will be faced sooner or later with the fact that their customers are shifting more and more production abroad. As a consequence it is hardly surprising that the recent currency shift will burden the profitability with some lag but for a pronounced period of time.



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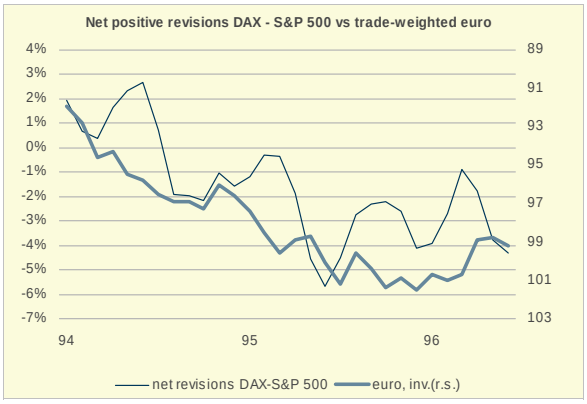

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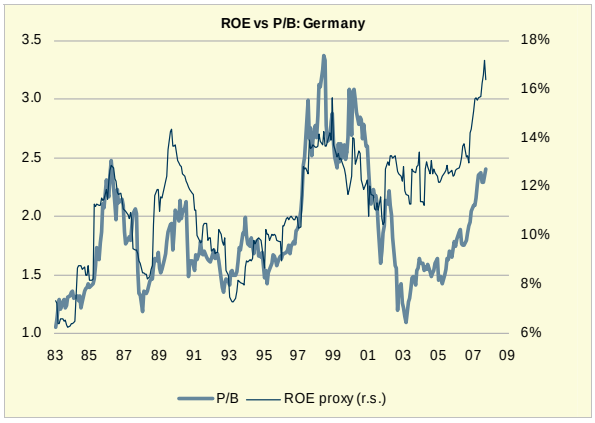
In order to exclude the impact of global growth to some extent, we looked at the relative development of return on equity in the US and Germany against the dollar. We are aware of the fact that the improvement of return on equity in Germany is based to a good part on structural issues like the weakening of unions, a stronger shareholder orientation at management and strong productivity gains by more investments in IT. Still, the chart shows that the difference in profitability has always been a lagged function of the currency up to now, and we doubt that it will be too different this time.



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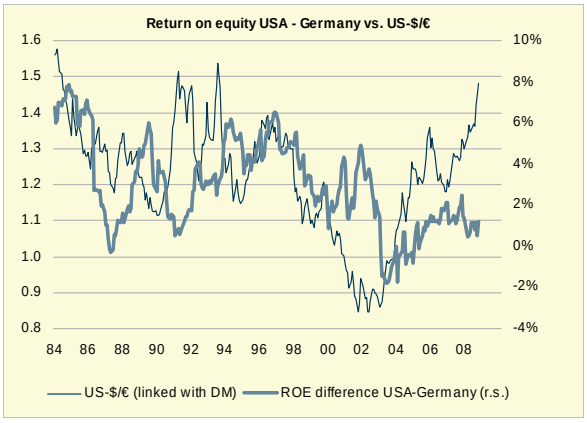

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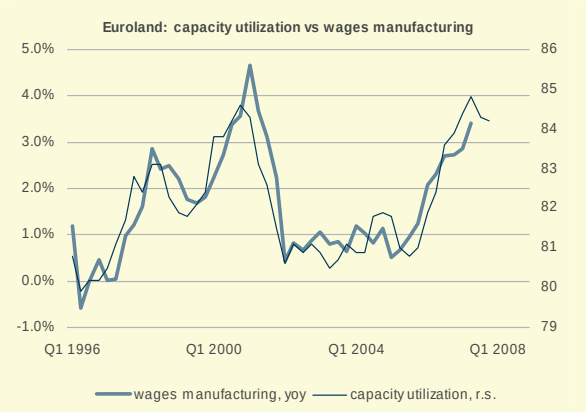
More headwinds also from wages and productivity

Prior tailwinds are also weakening, as unions, particularly in Germany, are at least temporarily regaining some power, and as low wage growth in Germany is setting the benchmark in other European countries as well. Wage growth averaged less than 2% from 2004 to 2007 in Germany but the consensus expects it to rise to some 2.5% in 2008. Also for the Eurozone, the expected wage growth is expected to accelerate slightly. The strike by German rail workers shows that there is a shift towards smaller, specialized unions that have in the past been fairly successful for their members, particularly when times were good. If German rail workers are successful with their demands, then this will clearly be a problematic signal. If our outlook is correct, however, then rising wages will not be a problem for long. Productivity growth is set to continue as managements are under ample pressure to show some earnings growth. Still, productivity growth is cyclical, and it is thus much easier to realize through an increase of production with the same number of workers than by getting the same production with fewer employees. This means productivity growth will be significantly lower going forward. Windfall profits that could be realized by relocating production facilities to low cost countries and thereby reducing costs more than what had to be passed on to customers are becoming harder to realize as wage growth in these countries has often accelerated substantially and as this has not been offset by a decline of the currency. This will most likely be particularly a problem in Eastern Europe going forward and might well mean that companies have to reconsider relocating to a further destination. As we have seen by comments from the German car supplier Leoni, there are however some logistical limitations to this strategy. Thus, together with the strong euro, we see some headwinds beyond the purely cyclical aspects at the moment. Together, these headwinds make a further increase in the share of profits in the overall economy rather unlikely.



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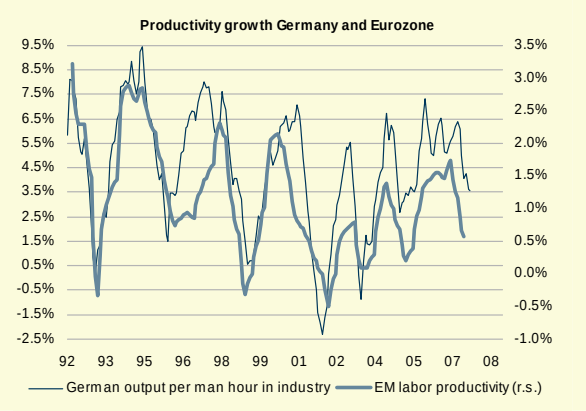

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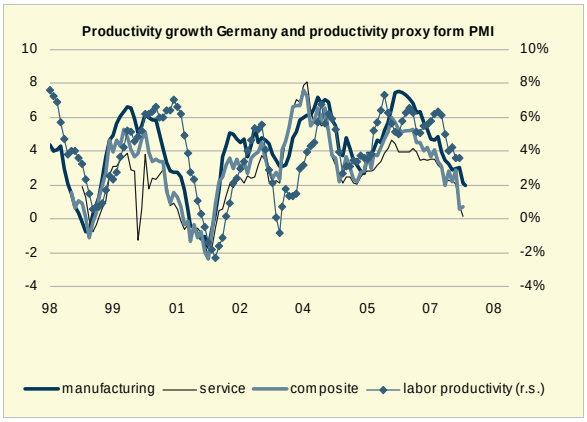

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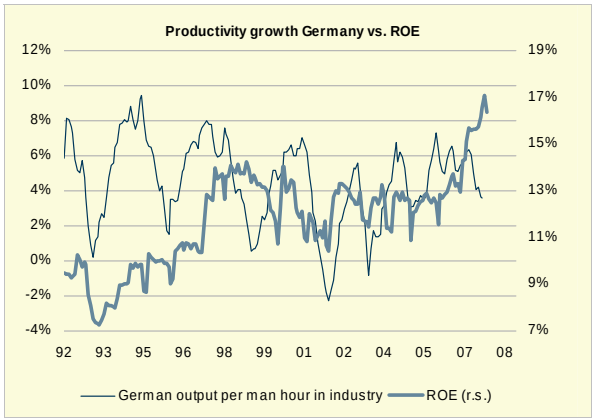

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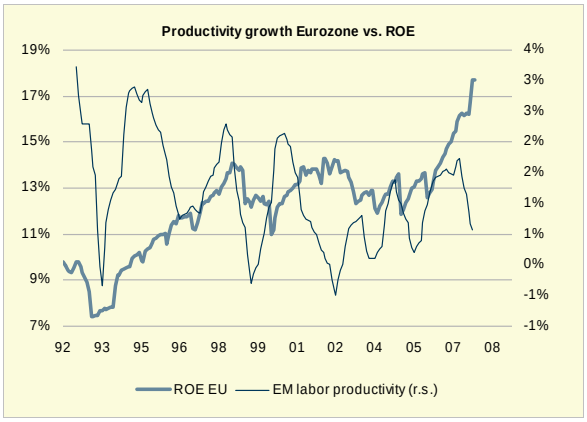


Source: Thomson Financial Datastream

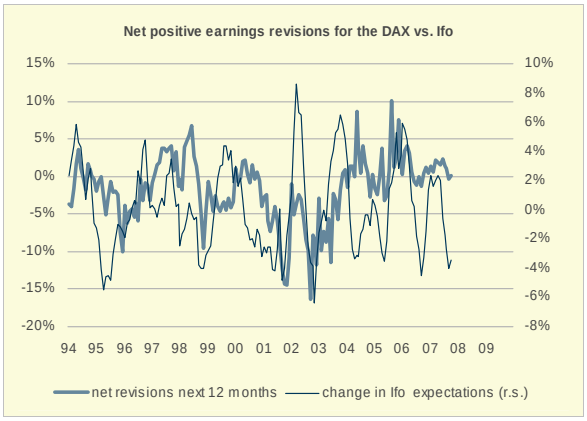
Estimates are out of line with macro data

Time series such as the Ifo business expectations or the purchasing manager indices more and more reflect these problems. If we consider the development of the Ifo business expectations, then one should already expect poor results for Q4. Looking at the chart on page 22 however, one could get the impression that Ifo expectations are sometimes even lagging compared to earnings estimates. The negative revisions in Q3 are however largely concentrated at financials and thus the chart might be a bit misleading. We would rather interpret the chart in such a way that the negative

revisions for the next 12 months are likely to start soon, as the estimates for the next 12 months are now predominantly 2008 estimates. Thus the current estimates of earnings growth of 11% for the DAX and 8% for the EURO STOXX 50 are fairly ambitious no matter how good the results for Q4 2007 are. As the order backlog was rather high up to very recently, we should not expect Q4 to pose much of a problem, particularly in sectors like engineering where order books were at extreme levels until fairly recently. Still, most macro charts that we use for assessing the development of earnings signal that the expectations for earnings growth in 2008 are too high and thus we expect negative revisions.

In this respect it might be important that most companies have less of an impression that takeover activity will remain as high as it was in 2006 and the first half of 2007. Thus, we expect companies to indicate with their Q4 results that visibility has become significantly weaker lately, which should lead to some downward revisions, even if companies can still exceed expectations for Q4. The development of earnings revisions also points to a strong slowdown at the estimated earnings momentum. In the past the earnings revisions have often led the year-over-year comparison of the estimates for the next 12 months. Given that analysts have been underestimating the earnings for the following year since 2004, however, we are reluctant to trust in strong negative revisions. Instead we expect this more cautious outlook to be more reflected in the valuation of equities by fund managers, with the consequence that valuations will look rather low based on consensus estimates.

Source: Thomson Financial Datastream



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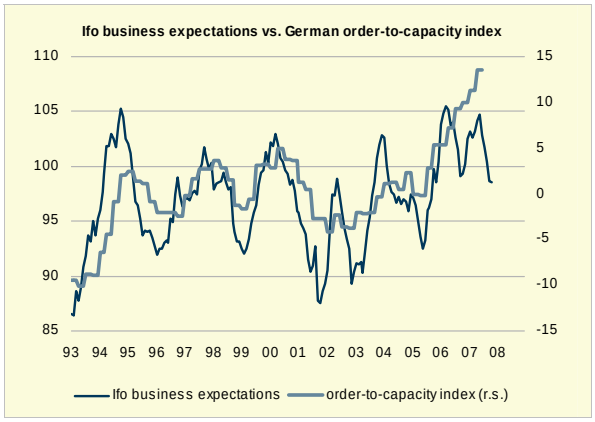

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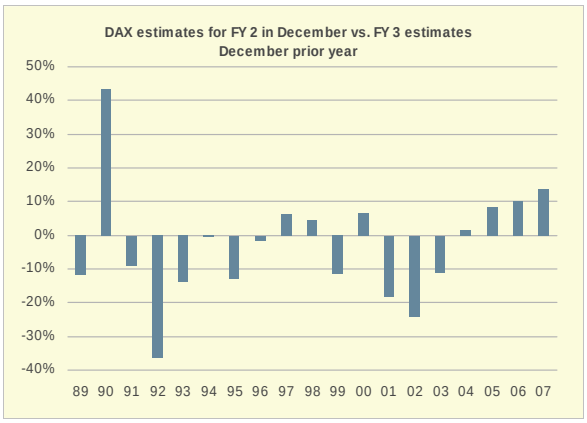


Source: Thomson Financial Datastream

Earnings growth in Germany looks more ambitious than it is, due to the tax reform in 2008

Now, the estimates for 2009 are decisive for our targets for 2008, as we believe that markets tend to price the estimates for the next 12 months. Currently we have consensus estimates for the EURO STOXX 50 of 353 for 2007, 382 for 2008 and 420 for 2009. Thus, analysts expect earnings growth of some 8% in 2008 and a further 10% in 2009. In case of the DAX, the estimates stand at 578 for 2007, at 642 for 2008 and at 715 for 2009, which implies earnings growth of 11% in both 2008 and 2009. Our own bottom-up estimates stand at 350 for 2007, 379 for 2008, and 411 for 2009 in case of the EURO STOXX 50. For the DAX our own bottom-up estimates stand at 571 for 2007, 648 for 2008, and 722 for 2009. In case of the DAX one has to consider that the 2008 estimates are roughly 4% above the level for 2007 due to the German tax reform. This, however, hardly explains the further sharp increase of estimates in 2009.

In 2008 the German tax reform leads to earnings growth of 4%

Just as a reminder, the German corporate tax reform is leading to an earnings increase of roughly 4% in a normal year. The effect will be smaller when companies are burdened by losses, as then the taxation of interest expenses can become an issue. The tax reform consists of the following measures:

Lower nominal tax rates: The current average tax rate of 38.6% – which consists of a corporate tax, a solidarity surcharge and local taxes (depending on cities) – will be lowered to 29.8% on average. German corporate taxes are going to move from the high end to the middle of the international tax scale. There are basically three factors that drive the changes of the average tax rate: 1) The federal corporate tax (Körperschaftsteuer) will be lowered from 25% to 15%; 2) The basic rate of trade tax (Gewerbesteuermeßzahl) will be lowered from 5% to 3.5%, which drives the local tax down; 3) The local tax will no longer be tax deductible from the tax base in the local tax and in the corporate tax. The changes translate into growth of after-tax earnings of some 14% if the company is solely taxed in Germany. This is positive for stocks that are profitable and strongly exposed to the German tax man.

The taxation of interest expenses in the corporate tax pillar has been scaled back a bit over the course of 2007 and is thus no longer as problematic as it would have been according to the original plans. The so called interest rate barrier (*Zinsschranke*) targets primarily large companies that are exploiting international tax arbitrage. The intended taxation only bites if the equity ratio of the German subsidiary is lower than the equity ratio of the group. Then the German tax man assumes intercompany financing from a low-tax country (usually Netherlands or Ireland) to a high-tax country (Germany), which reduces the overall tax ratio of the group. If the equity condition is fulfilled, the tax deductibility of net interest expenses will be limited to 30% of the EBITDA. That means: For all companies with net interest expenses below 30% of EBITDA nothing will change. For those companies exceeding the threshold, the tax base will be increased by the delta of net interest expense and 30% of EBITDA.

The current degressive depreciation will be changed into linear depreciation. This reduces the interest rate advantage. Reported earnings of listed companies should not be impacted, as IFRS and US GAAP already assume linear depreciation.

The winners would be stocks that 1) have a high German tax base (operations geared to Germany), 2) currently pay the relatively high German taxes (and thus the tax base is not reduced due to tax loss carry forwards or use of international tax arbitrage), 3) are highly profitable and 4) are not burdened by counter-financing measures (taxation of interest expenses or linear depreciation). The relative losers are stocks that benefit less from lower tax rates, as they pay low taxes anyway, e.g. due to low margins or tax loss carry forwards, and that are burdened at the same time by counter-financing, as they are capital intensive and highly indebted. Winners are thus stocks like Deutsche Börse, Altana, RWE, E.ON, BMW, Postbank, SAP among the DAX stocks. In general, German small and mid caps are more exposed to tax cuts, as their tax base is less globalized. From our perspective the tax reform is largely reflected in the earnings estimates; still, it is an additional earnings driver in the highlighted cases.

At the EURO STOXX 50 analysts expect that more than 50% of the earnings growth is coming from cyclicals

Looking at the details, we see that in the case of the EURO STOXX 50, roughly 44% of the 2008 earnings are coming from financials, 22% from cyclicals, 7% from oil and 25% from defensives. Given the current problems at financials, we believe this is quite a risk for earnings at the EURO STOXX 50. Even more doubtful is, however, that more than 50% of the earnings growth should come from cyclicals.

Company	Weighting in the index	Earnings in % of DJ Euro Stoxx50 EPS			Contribution to earnings growth in %		Company	Weighting in the index	Earnings in % of DJ Euro Stoxx50 EPS			Contribution to earnings growth in %	
		2007	2008	2009	08/07	09/08			2007	2008	2009	08/07	09/08
Aegon	0.7%	1.1%	1.1%	1.1%	0.5%	0.9%	Iberdrola	2.0%	1.0%	1.0%	1.2%	1.0%	3.0%
Air Liquide	1.0%	0.6%	0.6%	0.6%	0.7%	0.9%	ING Groep	2.4%	4.3%	4.5%	4.6%	6.6%	5.7%
Alcatel-Lucent	0.5%	0.2%	0.5%	0.6%	4.3%	1.9%	Intesa Sanpaolo	2.1%	2.0%	2.1%	2.3%	3.5%	3.7%
Allianz	2.7%	4.3%	4.4%	4.5%	5.7%	5.3%	L'Oréal	1.1%	0.5%	0.5%	0.5%	0.7%	0.7%
Arcelormittal	1.7%	2.1%	2.1%	1.9%	2.4%	-0.7%	LVMH Moet Hennessy	0.9%	0.6%	0.6%	0.7%	1.0%	0.9%
Assicurazioni Generali	1.6%	1.2%	1.3%	1.5%	3.0%	2.8%	Münchener Rück	1.2%	1.9%	1.7%	1.7%	-1.7%	2.5%
AXA UAP	2.1%	2.8%	3.0%	3.1%	5.1%	4.5%	Nokia	4.5%	3.3%	2.9%	2.3%	-2.6%	-4.3%
Banco Santander	4.1%	3.8%	3.8%	3.9%	4.5%	4.1%	Philips Electronics	1.3%	0.8%	0.9%	0.9%	2.7%	1.2%
BASF	2.0%	1.9%	1.9%	1.5%	0.9%	-1.8%	Renault	0.8%	1.1%	1.3%	1.4%	4.0%	2.7%
Bayer	1.9%	1.6%	1.5%	1.5%	0.3%	1.4%	Repsol YPF	0.9%	1.0%	1.0%	0.9%	0.0%	0.1%
Bco. Bilbao Vizcaya Argent.	2.7%	3.9%	3.4%	3.5%	-3.0%	4.2%	RWE	1.9%	1.5%	1.6%	1.5%	3.3%	0.4%
BNP	2.7%	4.2%	3.9%	3.8%	-0.6%	3.5%	Saint Gobain	1.1%	1.1%	1.1%	1.2%	2.1%	1.3%
Carrefour Supermarché	1.2%	0.8%	0.8%	0.8%	1.1%	1.1%	Sanofi-Aventis	2.8%	2.9%	2.8%	2.6%	0.9%	1.0%
Crédit Agricole	0.7%	1.3%	1.2%	1.2%	0.0%	1.3%	SAP	1.4%	0.8%	0.9%	1.0%	1.8%	1.9%
Daimler	2.8%	2.0%	3.4%	3.4%	21.7%	3.2%	Schneider Electric	0.9%	0.9%	0.9%	1.0%	1.5%	1.3%
Deutsche Bank	1.8%	2.9%	2.9%	3.0%	3.2%	3.9%	Siemens	3.7%	2.0%	2.3%	2.5%	7.1%	4.0%
Deutsche Börse	1.1%	0.5%	0.6%	0.6%	1.8%	1.0%	Suez	2.4%	1.4%	1.5%	1.5%	2.6%	1.4%
Deutsche Telekom	2.0%	0.8%	1.3%	1.5%	6.9%	3.8%	Telecom Italia	1.1%	0.9%	0.9%	0.9%	1.1%	0.6%
E.ON	4.1%	2.9%	2.9%	3.3%	3.0%	7.3%	Telefonica	4.2%	4.3%	3.0%	3.1%	-14.8%	4.0%
Enel	1.5%	1.1%	1.1%	1.1%	1.0%	0.2%	Total	5.6%	6.6%	6.3%	5.8%	1.8%	0.2%
ENI	2.7%	3.3%	3.1%	2.9%	0.7%	0.0%	UniCredit	3.3%	4.1%	4.5%	4.5%	9.4%	4.1%
Fortis	1.6%	3.4%	3.0%	3.2%	-2.4%	5.1%	Unilever NV	1.8%	1.3%	1.2%	1.2%	0.1%	1.3%
France Télécom	2.2%	1.7%	1.6%	1.6%	0.4%	0.7%	Vinci	1.2%	0.8%	0.8%	0.9%	1.2%	1.1%
Groupe Danone	1.3%	0.7%	0.7%	0.7%	1.2%	1.0%	Vivendi Universal	1.6%	1.5%	1.5%	1.5%	1.8%	1.5%
Groupe Société Générale	2.0%	3.1%	2.9%	2.9%	0.8%	2.8%	Volkswagen	1.0%	0.8%	0.9%	0.9%	1.8%	1.2%

Source: Oppenheim Research

In Germany, the expected earnings growth is mainly coming from Daimler, Deutsche Telekom, and Siemens

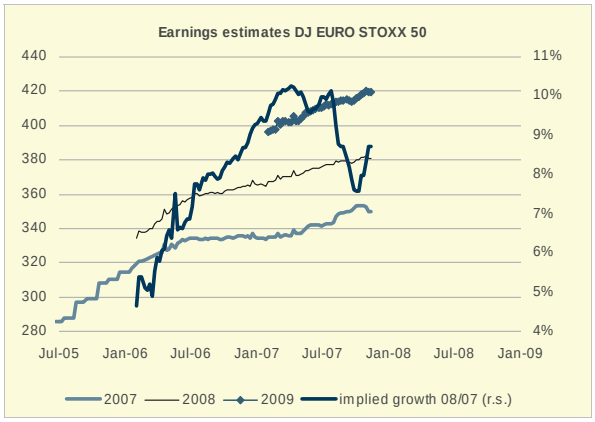
In case of the DAX, only 33% of the 2008 earnings are coming from financials, but almost 40% from cyclicals. In addition, roughly 57% of the earnings growth is expected to come from cyclicals in 2008. This looks rather ambitious, and we have some distrust that this will be achieved. Breaking it down, we see that Daimler, Deutsche Telekom, and Siemens are responsible for more than half of the expected earnings growth in 2008. At Siemens, the cost savings program should deliver €1.2bn, the new acquisitions in the medical segment should bring €700m, and the turnaround at Siemens-Nokia almost €700m. In the case of Daimler, the earnings growth primarily reflects the charges of some €2.6bn that were related to the disposal of Chrysler are no longer burdening 2008, even though they were mitigated by some €1.5bn gains from the disposal of EADS. Again, lower restructuring charges are also

an important issue for the expected earnings growth. Last but not least, at Deutsche Telekom, we have lower one off charges in 2008 than in 2007, along with significantly lower depreciation charges. All in all, this might indicate that the pure comparison of the expected earnings growth with our estimates for the economy is a bit misleading at both indices. However, we would also note that we expect to see a lot of restructuring charges that are not yet anticipated, which is always the case at this point of the cycle.

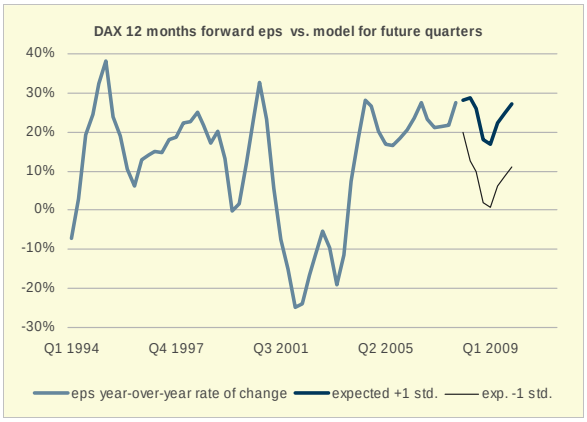
Company	Weighting in the index	Earnings in % of DAX EPS			Contribution to earnings growth in %		Company	Weighting in the index	Earnings in % of DAX EPS			Contribution to earnings growth in %	
		2007	2008	2009	08/07	09/08			2007	2008	2009	08/07	09/08
adidas	1.2%	0.9%	1.0%	1.0%	1.1%	1.1%	Henkel pref.	0.9%	0.7%	0.7%	0.7%	0.8%	0.6%
Allianz Holding	8.0%	14.4%	13.6%	13.2%	8.7%	9.4%	Hypo Real Estate	0.6%	1.1%	1.0%	1.0%	0.3%	0.9%
BASF	5.9%	6.4%	5.7%	4.6%	1.5%	-4.0%	Infineon	0.8%	loss	loss	0.4%	0.3%	7.9%
Bayer	5.7%	5.3%	4.6%	4.5%	0.4%	3.2%	Linde	1.4%	0.9%	1.0%	1.1%	1.8%	2.0%
BMW	1.7%	2.6%	2.1%	2.1%	-1.1%	1.9%	Lufthansa	1.1%	2.0%	1.9%	1.8%	1.1%	0.7%
Commerzbank	1.9%	2.5%	2.3%	2.2%	1.0%	1.2%	MAN	1.4%	1.3%	1.4%	1.4%	1.9%	1.6%
Continental	1.7%	2.2%	2.0%	2.0%	0.9%	1.5%	Merck	0.7%	0.6%	0.6%	0.6%	0.5%	0.6%
Daimler	8.4%	6.7%	10.5%	10.2%	34.3%	7.4%	Metro	0.8%	0.5%	0.5%	0.5%	0.5%	0.7%
Deutsche Bank	5.5%	9.5%	8.9%	8.9%	5.1%	8.9%	Munich Re	3.4%	6.3%	5.1%	5.2%	-2.7%	5.6%
Deutsche Börse	3.1%	1.5%	1.7%	1.8%	3.3%	2.2%	RWE	5.6%	5.0%	5.1%	4.6%	5.2%	0.8%
Deutsche Post	2.4%	2.2%	2.2%	2.5%	1.9%	5.2%	SAP	4.1%	2.6%	2.6%	2.8%	2.9%	4.3%
Deutsche Postbank	0.6%	0.5%	0.7%	0.6%	1.7%	0.4%	Siemens	10.4%	6.1%	6.7%	7.0%	10.6%	8.7%
Deutsche Telekom	5.5%	2.6%	3.6%	4.1%	10.2%	8.2%	Thyssen Krupp	1.9%	3.3%	2.7%	2.2%	-1.1%	-2.0%
E.ON	11.1%	9.1%	8.5%	9.3%	4.4%	15.7%	TUI	0.5%	0.3%	0.3%	0.5%	0.7%	1.7%
Fresenius Med.Care	0.9%	0.8%	0.8%	0.8%	0.8%	0.9%	Volkswagen	2.9%	2.7%	2.7%	2.7%	2.9%	2.7%

Source: Oppenheim Research

The charts on page 23 show that the earnings growth recently accelerated for both markets, although the estimates for 2007 stagnated or were even slightly adjusted downwards. As we showed on page 21, we believe this is not matching well the developments we see from the macro data at the moment. We admit the strong share buybacks that we expect – for example in case of Siemens and Daimler but also at other companies – mean that a regression on the macro data will ultimately more reflect the growth of corporate profits in the overall economy than the per share estimates. Given the strong impact from financials and the tendency towards more and more fair-value-accounting, we have additional uncertainty. Still, when we apply our forecasting model with our expectations we arrive at 2009 earnings on the DAX of 670. This already takes into account the German tax reform. It is some 6% below the consensus number but this barely shows the uncertainty of some input parameters. When we compare the biggest forecasting mistakes in our model last year, then it was clearly that we not only underestimated the economic growth we had in 2007 but also the fairly positive development of unit labor costs that went along with it. This forecasting error could well go into reverse soon. The deviation between our top-down forecast for 2008 and our current bottom-up estimates is some 4%, as the top-down model delivers earnings on the DAX of 615. Thus, our model assumes that we will see an increase of earnings of some 7% compared to the current consensus for 2007, of which roughly 4% comes from the German tax reform. More likely, however, is that the earnings momentum is higher, as the negative revisions for the financials in Q4 will be higher than the positive revisions we might see at some industrial companies. Thus, the actual earnings growth rate in 2008 would most likely be closer to 8% which is excluding the impact of the tax reform very roughly in line with the nominal GDP growth in the Eurozone. We would consider this relatively realistic. For 2009 this assumes earnings growth of roughly 9%, which reflects the slight acceleration in the nominal GDP growth that our economists assume and a slightly weaker euro. More important will most likely be that we should no have further burdens at financials in 2009, but might still have some problems that fall into 2008. For the EURO STOXX 50 we calculate in a similar way with earnings on index of 360 for 2008 and of 395 for 2009. Here the revisions for 2007 might be a bit higher due to the higher share of earnings coming from financials.



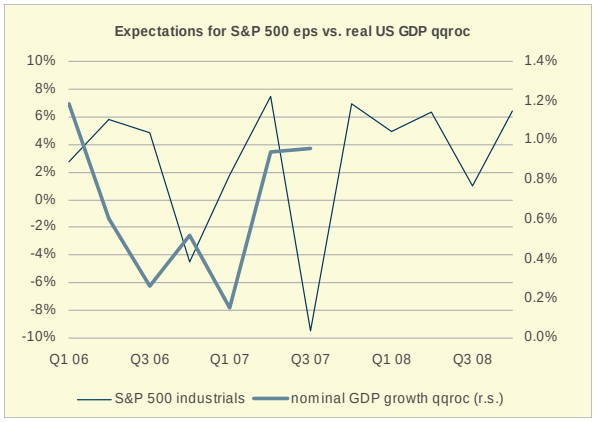
Source: Thomson Financial Datastream



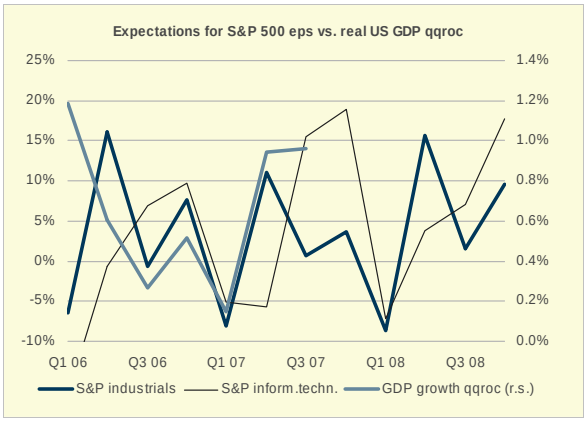
Source: Thomson Financial Datastream

Quarterly estimates would indicate that risks of negative revisions burdening stocks is more acute in the second half, at least in the US

Looking at quarterly estimates is somewhat problematic, as they barely exist for stocks in Europe at this point of the year. The data for the US, however, indicate that the expectations point to a relatively modest first half and a strong rebound of earnings in the second half. This would be understandable if it were based on large charges at financials in the second half 2007 that are hopefully then not repeated in the second half of 2008. The data, however, indicate that the expectations are also going for a rather strong increase of estimates in most cyclical sectors like industrials and technology. In our view these estimates include the view that we will see a V-shaped recovery of the underlying economy. This contrasts strongly with our view that the phase of fairly modest growth will be quite long. If we take the US data as an indication for the expectations as well in the Eurozone, we see the problem that the larger revisions might occur for the quarterly estimate for the second half. As analysts had to revise their earnings up for the last 4 years, it is likely that these revisions will come predominantly in the second half of the year. Still, we believe that markets will anticipate these revisions earlier.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

Don't mix up revisions and performance – the link is lower than you think

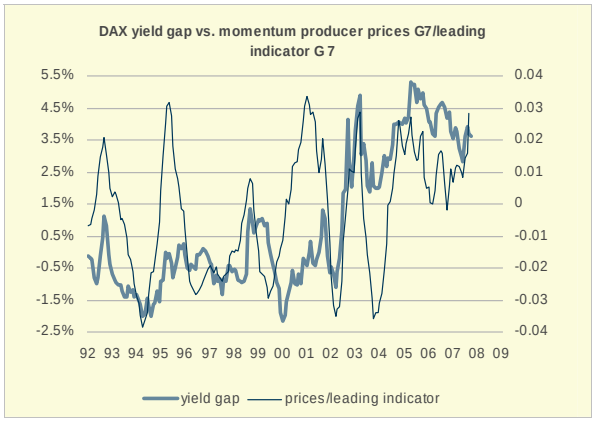
Based on the common perception of investors, there is a strong correlation between earnings revisions and the performance of markets. We looked at the recent history of earnings revisions and the performance of equity markets. The result is clearly devastating, as the correlation based on the weekly data is even negative. This is the case if we use estimates for the current year, for the next year as well as if we use the estimates for the next 12 months. Now, one might assume that this is the consequence of the fact that US reports are normally ahead of our reports but even if we use the revisions for the US, the correlation with the performance of the EURO

STOXX is marginally negative. Thus, the conclusion that one can read too much from the momentum of the earnings revisions into the performance of equity markets is probably wrong. In our view, this will most likely be seen again next year as the development of expectations for growth vs. inflation and the development of spreads is probably more important than the development of earnings estimates by analysts (see chart below).

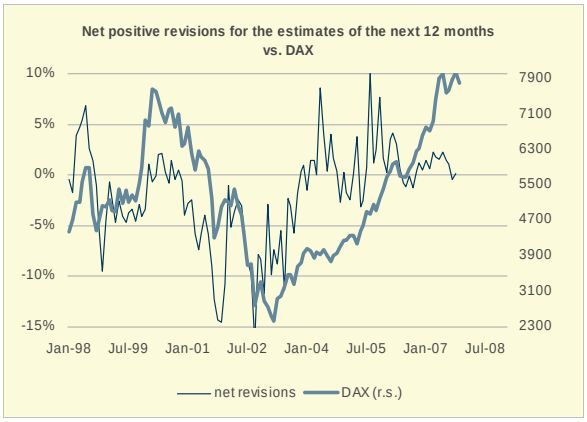
Source: Thomson Financial Datastream

Source: Thomson Financial Datastream

Over longer periods, however, it is clear that equity markets tend to profit or suffer by positive respectively negative revisions. Based on this, we believe the period with support from positive earnings surprises will slowly peter out. Again, the short history of data for the EURO STOXX 50 makes it less well suited to show this phenomenon, but the charts for the DAX are probably a good indication for stock markets in Europe in general.



Source: Thomson Financial Datastream



Source: Thomson Financial Datastream

Central banks will help, but not immediately

Most rate cut cycles have been positive for equities

As we expect further rate cuts by the Fed, we again looked at the question of whether this will drive markets going forward. If we review the major rate cut cycles in the US, we predominantly find a fairly positive reaction of equity markets. It is a bit tricky what to define as a rate cutting cycle, but in 4 out of 8 cases that we looked at, we got a positive reaction from US stocks 6 months later, and in 6 out of 8 times, 12 months later. The average gain was some 6% in the 6 months following the first rate cut and some 9% in the first year after the rate cut. Also for the equity markets in Europe, the performance was on average positive. In the table below, we highlight the DAX instead of the EURO STOXX or other European benchmarks, as the latter only exist for the later part of the history on a daily basis. Also, one has to keep in mind that the I/B/E/S data has only existed since the late 1980s for the Eurozone, while today, we see some similarities more to the 70s, which means that we consistently used the forecasts for the total market indices. The DAX also gained 5 out of the 8 times in the 6 months, as well as in the year after the first rate cut by the Fed. Concerning the question of whether these statistics are a good guidance for the future, we believe it is rather important to look at the current environment for the Fed and the markets.

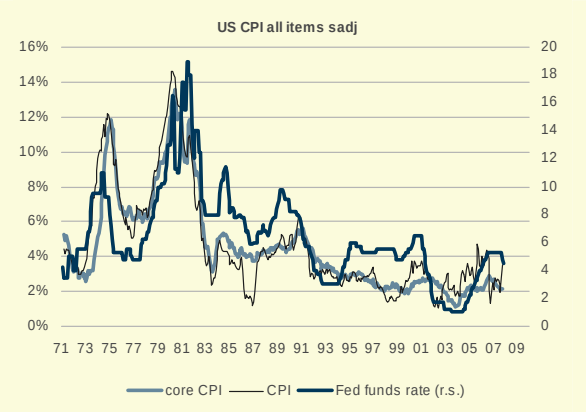
Begin of	Fed funds rate			10year treasuries			change in S&P		change in DAX		change in $ trade weighte		change in €/$ (rebased)	
rate cut	at begin	+6 months	+12 months	at begin	+6 months	+12 months	+6 months	+12 months	+6 months	+12 months	+6 months	+12 months	+6 months	+12 months
30/07/1974	11.00	7.25	5.25	7.81	7.50	8.06	-5%	10%	13%	35%	-2%	2%	10%	1%
21/04/1980	16.50	12.00	15.50	10.86	11.67	13.71	32%	34%	2%	2%	-6%	3%	0%	-15%
06/07/1981	19.00	12.00	12.50	13.80	14.56	14.45	-6%	-16%	-9%	-7%	-3%	10%	9%	-1%
29/08/1984	11.56	8.50	7.88	12.85	11.85	10.20	10%	13%	16%	44%	12%	0%	-14%	3%
21/10/1987	7.31	6.75	7.75	9.30	8.80	8.82	-1%	10%	-23%	-7%	-10%	-7%	9%	2%
05/06/1989	9.81	9.06	8.25	8.36	7.82	8.46	9%	14%	15%	32%	-3%	-4%	10%	16%
05/07/1995	6.00	5.50	5.25	6.18	5.68	7.05	13%	20%	11%	23%	6%	10%	-2%	-6%
02/01/2001	6.50	3.75	1.75	4.92	5.34	5.16	-4%	-10%	-3%	-18%	7%	7%	-11%	-5%

Source: Oppenheim Research

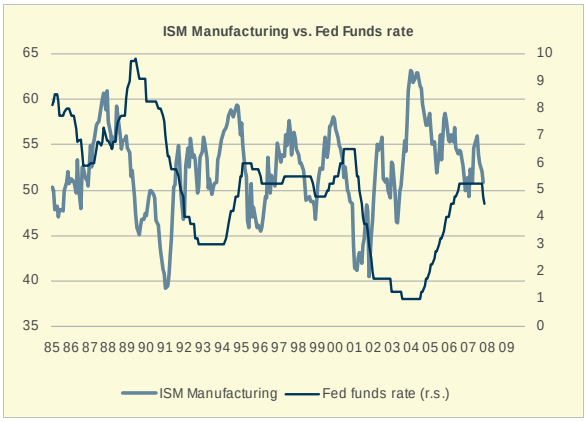
Begin of	P/E total market index USA			P/E total market index Germany			Expected eps USA		Expected eps Germany		Yield gap USA			Yield gap Germany		
rate cut	at begin	+6 months	+12 months	at begin	+6 months	+12 months	+6 months	+12 months	+6 months	+12 months	at begin	+6 months	+12 months	at begin	+6 months	+12 months
30/07/1974	10.30	9.40	12.10	11.10	12.70	12.70	2%	-7%	-4%	11%	1.90	3.14	0.20	-1.82	-1.23	-0.77
21/04/1980	6.70	8.60	8.80	9.00	9.80	9.90	0%	0%	-5%	-6%	4.07	-0.04	-2.35	2.25	1.85	0.04
06/07/1981	8.20	7.80	7.60	12.20	13.10	13.30	-1%	-6%	-14%	-15%	-1.60	-1.74	-1.29	-2.31	-2.09	-1.84
29/08/1984	9.60	10.40	11.20	14.70	17.50	15.60	2%	-2%	1%	35%	-2.44	-2.23	-1.27	-1.21	-1.91	0.01
21/10/1987	13.50	12.10	12.20	19.20	16.10	14.00	10%	20%	-3%	31%	-1.90	-0.53	-0.62	-1.74	-0.05	0.79
05/06/1989	12.90	14.20	15.70	13.90	13.80	16.40	-1%	-6%	19%	13%	-0.61	-0.78	-2.09	0.34	-0.02	-2.55
05/07/1995	17.10	17.80	18.90	16.10	17.50	16.40	9%	10%	-1%	14%	-0.33	-0.06	-1.76	-0.67	-0.24	-0.43
02/01/2001	24.40	24.30	27.90	20.80	19.90	18.20	-3%	-21%	0%	-6%	-0.82	-1.22	-1.57	0.07	-0.07	0.54

Source: Oppenheim Research

Since 1971, the average real Fed funds rate was 1.9% based on core inflation. We are currently with 2.3% based on core inflation (which is more important for the Fed) still well above this level. This suggests for equity markets that further significant rate cuts in 2008 are possible; in the past, rate cuts often came when growth was slowing, even when inflation was still not coming down.



Source: Thomson Financial Datastream



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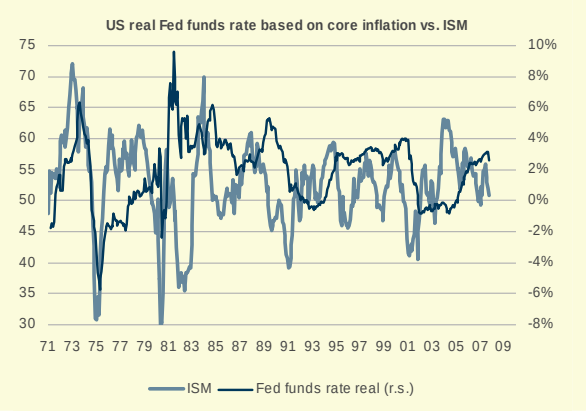

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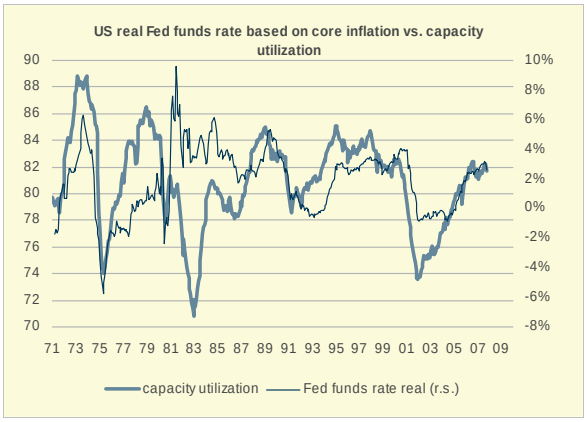

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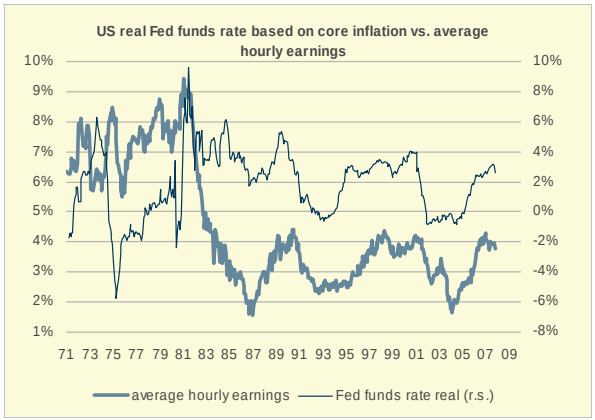

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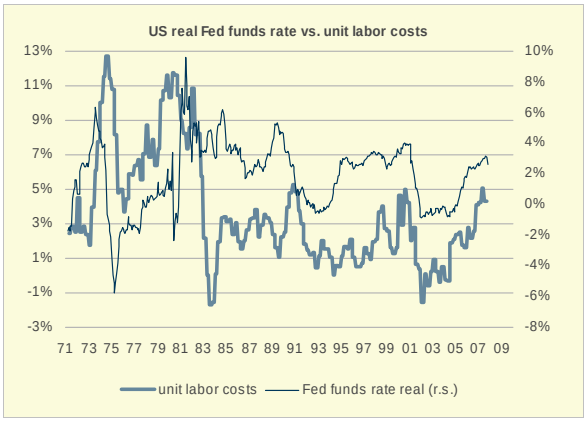

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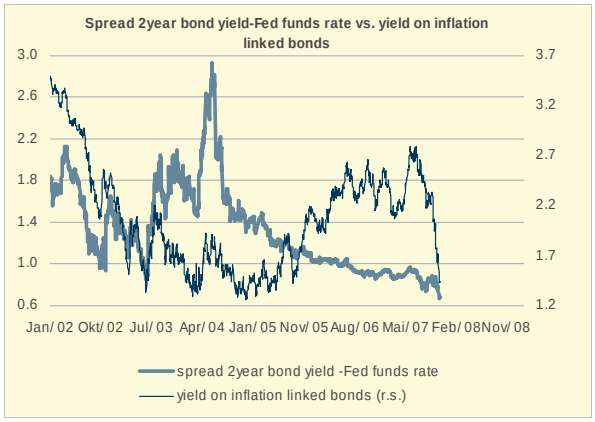
Applying the past pattern is risky this time, as conditions are a bit different

The problem is that this time, the leeway of the Fed might be smaller, as America became the largest net debtor nation, and as the dollar is already under significant pressure. An aggressive cut despite, still high inflation rates, would risk that rate cuts could currently even lead to a rise in long bond yields. This could come either by domestic investors that are expecting higher inflation going forward, or by foreign investors that are no longer willing to invest into long term treasuries. Last but not least, it could well come from countries that have up to now pegged their currencies to the dollar, but see that aggressive rate cuts hardly fit to their economic circumstances and thus might not only end their peg, but then change the structure of their largely dollar based currency reserves.

Thus, the historical pattern of past rate cycles might be risky to apply to the current situation. Rate cuts are fairly positive for markets when they are based on declining inflation rates or when they signal that the Fed is cutting aggressively with the effect that a formerly feared recession could be avoided. Good examples for the first case are 1974, 1980, 1981 and 1984. The best example for the second case is clearly 1995. Now in most of these cases, we see significant positive reactions with the exception of 1981, as back then we had a severe economic weakness, and going along with it, falling earnings estimates in the US as well as in Europe. The tables, however, also reveal that not in all cases where we got cuts in earnings estimates, we also got falling markets, as one can see in the case of 1974, 1984 and 1989 in the US and 1980 in case of the German market.

Expectations for rate cuts by the Fed are already very aggressive

In addition, one has to keep in mind that the expectations for further rate cuts by markets are already fairly aggressive. Thus, it will be rather tough for the Fed to deliver on the high expectations for further rate cuts. It is no surprise that the markets, and particularly financials that tend to profit most from rate cuts, reacted fairly negatively when the Fed calmed down hopes for further rate cuts in a statement some weeks ago. The strong hopes for rate cuts are, at the same time, at the moment contrasting with the implied expectations for inflation. This shows that hopes for rate cuts reflect only the fears for the financial system and for growth. As long as the expectations for inflation are not coming down significantly, it is therefore unlikely that equity markets will interpret the rate cuts too positively unless they achieve a more positive assessment for the economy. In recent weeks, one could even get the impression that rising expectations for rate cuts led to rising commodity prices and thus to rising expectations for US inflation, which is clearly not helpful, but rather harmful for stocks. With declines in capacity utilization and slightly rising unemployment rates, we expect that inflationary pressures will decline over the course of 2008. But the likely rate cuts by the Fed will not be a theme that will help equity markets in the near future.



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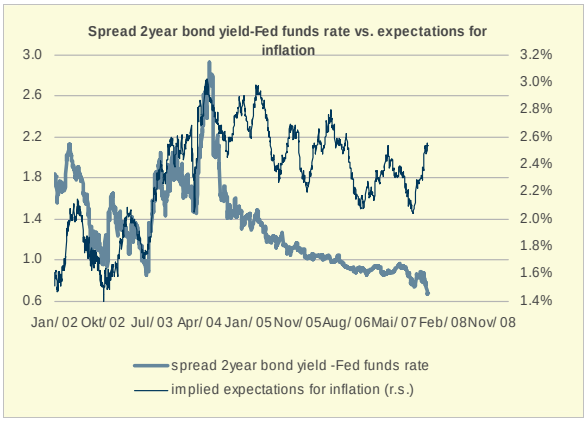

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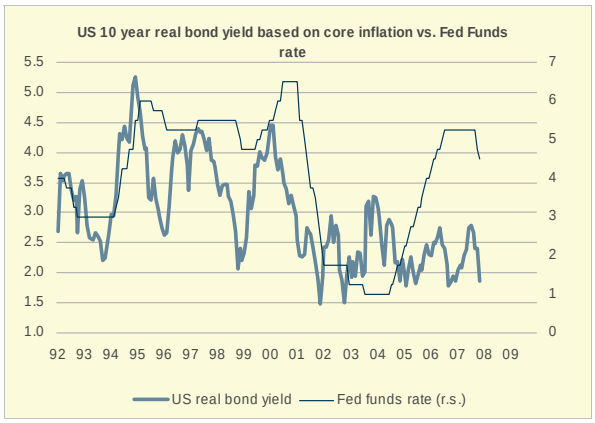
The valuation of equities is more dependent on the long bonds than on money market rates

The correlation between the earnings yield and 10 year bond yields also tends to be higher than the correlation between the earnings yield and 2 year bonds. And, 10 year real bond yields in the US are already well below the historical averages and are even low when compared to activity indicators. Also, normally rising expectations for rate cuts are leading to a steeper yield curve, which might be quite pronounced this time.



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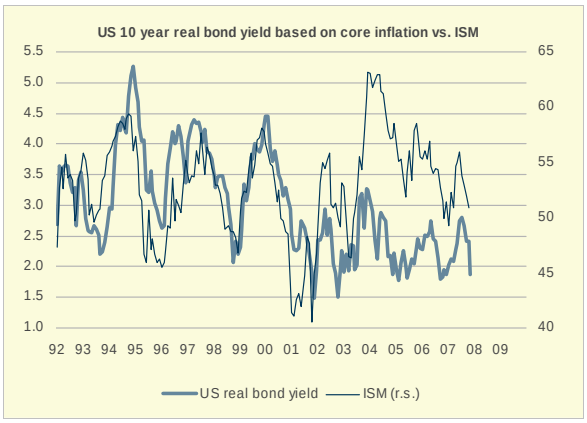

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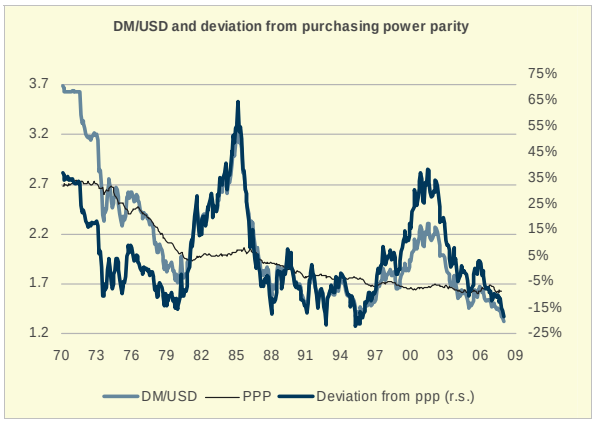
Rate cuts should have a more positive effect later in the 2008

As a consequence, we see more chances that rate cuts will have a more positive effect on equity markets once they are more backed by declining inflation expectations, and when they then hopefully lead to declining fears about a likely recession in the US. In this respect, it is quite important that the slowing of growth will ultimately also effect commodity markets and lead to some decline of raw material prices (see page 37).

One might argue that the above analysis is predominantly focused on the US, but as the table on page 28 shows, the only time that the markets diverted after Fed rate cuts was in 1987/1988 when the dollar fell significantly after being extremely strong in 1984/1985, and as European equity markets were way more expensive than US stocks in 1987 based on earnings multiples. While such a discrepancy in the valuation is clearly currently not the case, we would not be surprised if the current development leads to an outperformance of US stocks, as they should not only benefit from more aggressive rate cuts, but also from currency induced gains. Here we have to keep in mind that US companies should slowly profit from the rather substantial currency advantage vis-à-vis companies in Europe.



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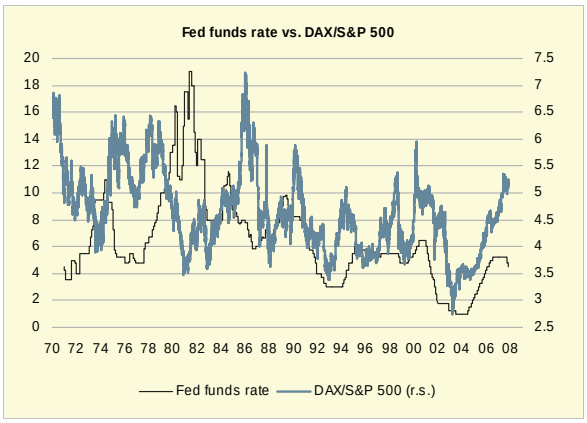

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Current credit problems offsetting the monetary impulse

With the current losses of banks, conduits, and hedge funds, players are loosing a good part of their collateral that was, up to now, available to be leveraged many times over. In addition, the conduits' financing activity was not burdened by the capital requirements which are applicable to the banks if they have to resolve them and take this indirect lending activity on their own books. Thus, this re-intermediation is forcing a significant reduction of leverage in the financial system. This gets even more pronounced if rating downgrades at the structured products, that banks have to move back on their balance sheets, lead to higher capital requirements. In addition to this, the problems in money market funds are putting those that are running these funds under enormous pressure. The 10 largest managers of U.S. money-market funds owned a total of about $50 billion in short-term debt of SIVs, some of which has defaulted. At least seven companies have bought distressed debt from money funds or committed financing to keep them from losing their top credit ratings. This is another burden for the balance sheet of banks at the moment, which is further limiting their lending.

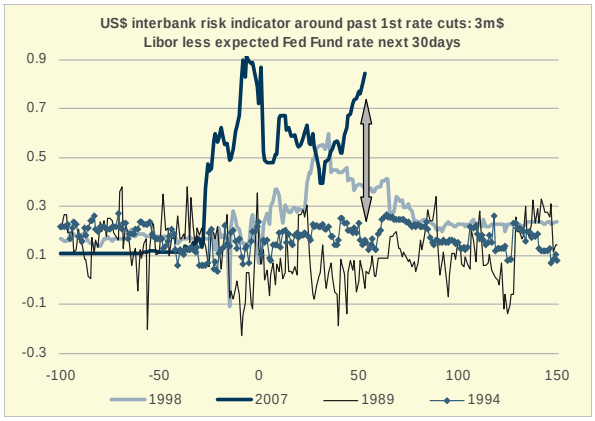
Up to now, there is no easing of monetary policy, at least for equity markets

Thus, as a consequence for markets, there is no positive impulse coming from excess money growth. Another way to look at this is to consider the increase of the Libor rate that we have seen. As Libor is the basis for all financing activity based on the short end of the curve and all instruments that are based on the evolvement of money market rates, this is more decisive than the Fed funds rate itself. For equity markets in Europe, the mandate of the ECB to achieve price stability defined as "inflation below but close to 2.0%", means that there can be little hope that these tighter monetary conditions will soon be offset by the ECB. Also, the likely spill-over of current high inflation expectations into the upcoming wage rounds argues against this. Thus, in the short-run, monetary policy is no significant help.

Ongoing high credit risks mark a notable difference to past rate cut cycles

The ongoing high risk premia at inter-bank markets mark a significant difference to past rate cut cycles. In all four recent rate cut cycles, the actual and expected Fed rate cuts quickly spilled over to lower US$ Libor rates (the chart below excludes the 2000 rate cut cycle, but it shows a similar pattern as in 1994). Thus, rate cuts were working as an automatic stabilizer for the economy. During the cycle in 1988, 1994 and 2000, our risk premium indicator (3month US$ Libor minus expected Fed fund target rate next 30 days) rarely exceeded 30bps, but currently it is close to 70bps. Relative to the lower level of the Fed fund rate, this is even more striking. In 1988 and 1994, when Libor rates fell in line with Fed expectations, rate cut hopes immediately spilled over to inter bank markets. Stocks rose basically in line with the declining Fed expectations (see charts below). 2000 was characterized by the valuation bubble at stock markets. Thus, the declining Fed expectation did not save stocks. The LTCM crisis in 1998 showed a higher inter bank risk premium compared to 1988, 1994 and 2000. But still, the risks were notably lower compared to 2007.

The risk indicator is now some 30bps above the premium at the same time period after the first rate cut in 1998. During the LTCM crisis, the risk premium peaked 25 days after the first rate cut; afterward it was steadily declining, which supported stock markets. Now, even 2 months after the first rate cut, inter-banking risks are still significant. The longer this situation continues, the bigger becomes the risk for the business cycle, as the Fed rate cuts do not bite as much as in the past, which could fortify the economic cooling which is underway.



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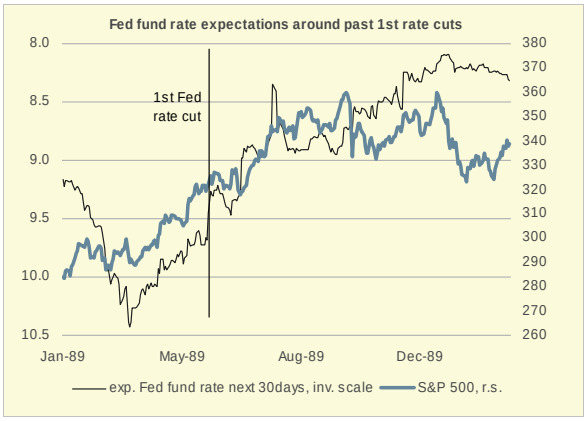

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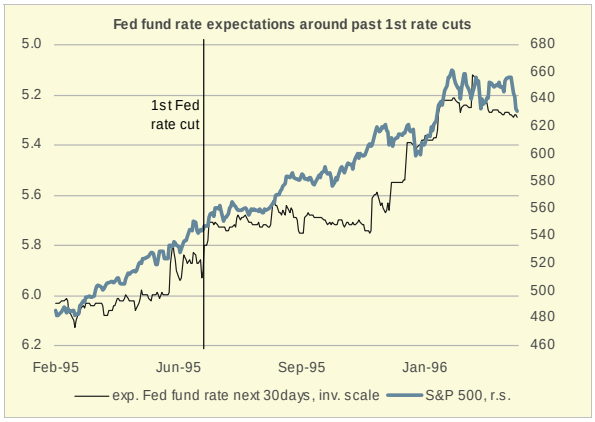

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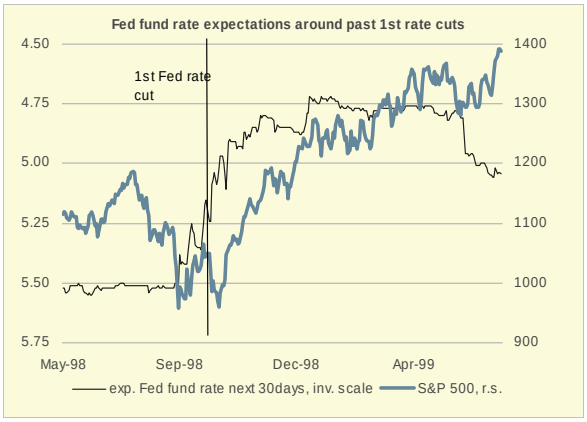

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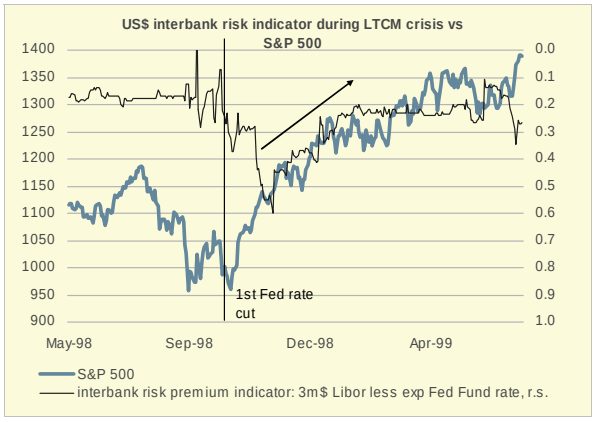

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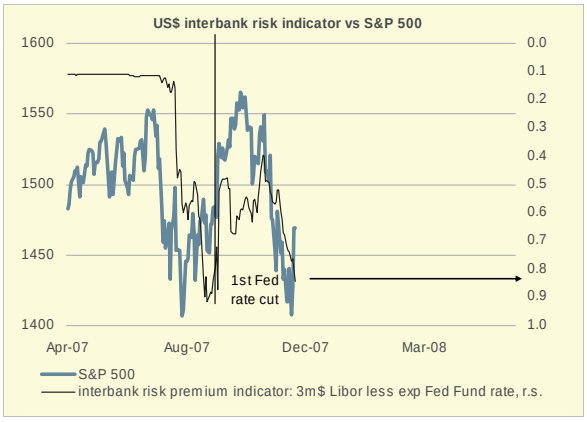

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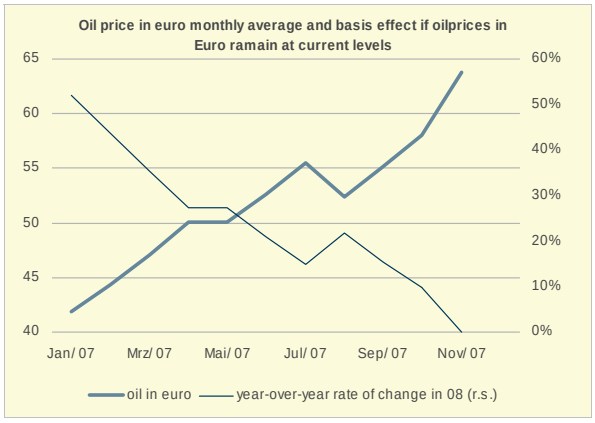
Potential rate cuts are limiting risks at equity markets

The only good news is that if we see a stronger than expected slowing of growth in Europe, then equities will have a cushion later on as then the ECB could come into the play with rate cuts. Here, the basis effect at inflation rates has to be kept in mind. Not only has the core inflation rate seen a sharp boost by the rise of the VAT in Germany, which was only seen with some lag in the core rate, but also the sharp increase in tuition fees in April boosted the core inflation rate. In addition, we have the basis effects coming from the oil prices that might well lead to a decline in the headline inflation rate, particularly towards the end of the year.



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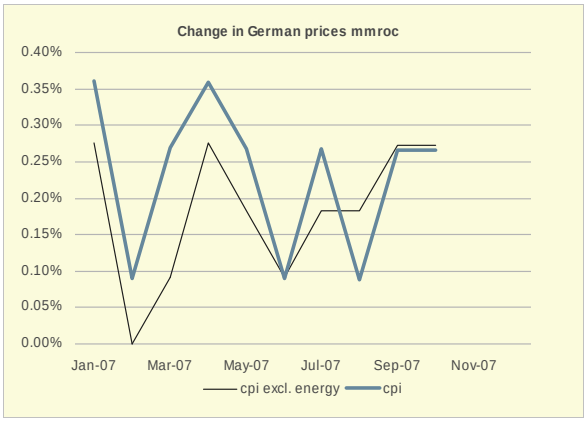

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Fed rate cut cycles and global growth

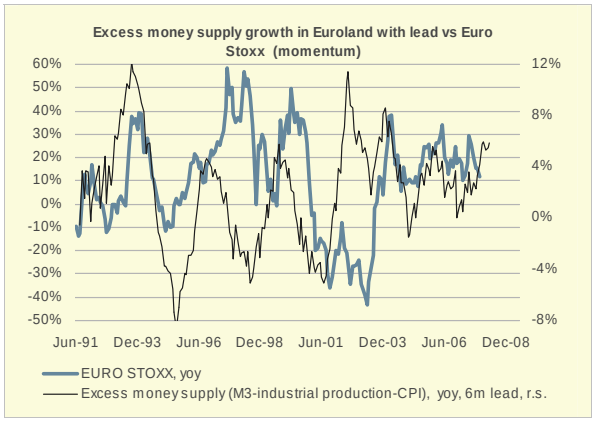
As global growth in recent years became a bit less dependent on the situation in the US, and also as the focus of markets is probably too much on the manufacturing side despite the fact that economies are more and more service driven, we also looked at whether there is a clearer pattern with respect to the behavior of markets in Fed rate cut cycles and global growth, and whether this pattern is more geared to industrial production or GDP growth. The table shows the growth rates for the G7 countries, as well as for the OECD countries in total, based on market prices as well as based on purchasing power parity at the beginning of rate cut cycles, as well as 6 and 12 months later. What the table shows is that those years where we had a decline in equity markets in the US as well as in Europe, the growth rate of industrial production fell by more than 2% points the following 12 months after the rate cuts, whereas in the other cycles, the slowdown was less pronounced. The table below also shows that sharp slowdowns, at least in the past, have affected stocks negatively, but that it is not decisive whether one took growth at market prices, based on purchasing power parity of just the G-7 countries, as the developments have been rather similar. Although we expect a quite visible slowing of growth, the last growth rate of industrial production was some 3.2%. A slowdown to less than 1% does not look likely, and thus this would at least indicate that this ultimately supports higher equity prices.

	OECD industrial production			OECD GDP at PPP			OECD GDP			G7 GDP						
Begin of	annaul growth rate			annaul growth rate			annaul growth rate			annaul growth rate			change in S&P		change in DAX	
rate cut	at begin	+6 months	+12 months	at begin	+6 months	+12 months	at begin	+6 months	+12 months	at begin	+6 months	+12 months	+6 months	+12 months	+6 months	+12 months
15/07/74	#NV	#NV	#NV	1%	-1%	0%	1%	0%	1%	1%	-1%	0%	-5%	10%	13%	35%
15/04/80	3%	-3%	-2%	1%	1%	2%	1%	1%	2%	0%	0%	2%	32%	34%	2%	2%
15/07/81	1%	0%	-2%	3%	0%	0%	3%	0%	0%	3%	0%	-1%	-6%	-16%	-9%	-7%
15/08/84	7%	3%	3%	5%	3%	4%	5%	4%	4%	5%	4%	4%	10%	13%	16%	44%
15/10/87	4%	6%	6%	4%	4%	4%	5%	5%	4%	4%	5%	4%	-1%	10%	-23%	-7%
15/06/89	3%	2%	3%	4%	3%	3%	4%	3%	4%	4%	3%	3%	9%	14%	15%	32%
15/07/95	4%	2%	2%	2%	2%	3%	2%	2%	3%	2%	2%	3%	13%	20%	11%	23%
15/01/01	3%	-2%	-6%	2%	1%	1%	2%	1%	1%	2%	1%	0%	-4%	-10%	-3%	-18%

Source: Thomson Financial Datastream

Liquidity: In the grip of the credit crunch

The orthodox liquidity data point to some upside for stock markets next year. Looking at the most important global central banks, broad nominal money supply, respectively excess money supply (nominal money supply less inflation and real growth), which had in the past a lead vs stock markets, is rising in Euroland (based on M3, not on M1), in the US, and in China, while momentum is down in UK and Japan. A GDP-weighted liquidity proxy for these countries shows that growth at nominal liquidity has been accelerating since end of last year, and that excess liquidity has again been growing since February 2007 (see chart below). But compared to the past, growth rates are still lackluster and are significantly below the central bank-driven liquidity glut in 2002 and 2003. In Euroland, it is still unclear whether M3 (up) or M1 (down) is the better guidance for stock markets. (Anyway, credit data by the ECB on credits for purchases of equities show a notable cooling of momentum).



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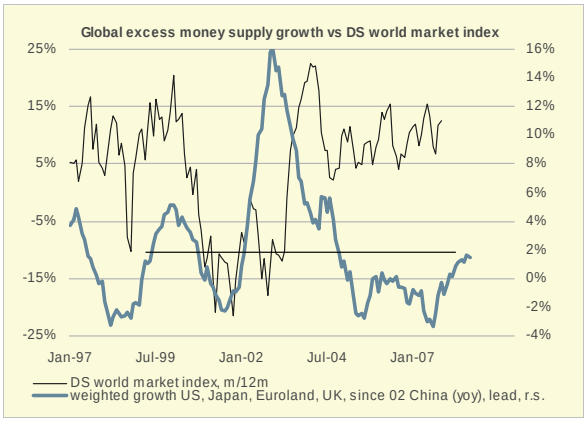

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Biggest risk: declining leverage

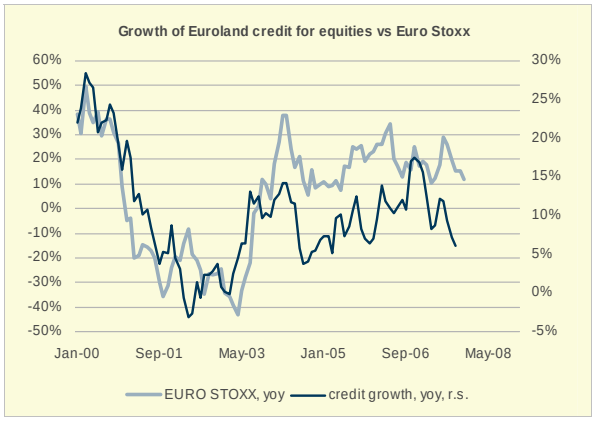
However, the biggest risk for the liquidity outlook is declining leverage. The stark increase of risk aversion among credit investors will impact the credit value chain. Credit investors will be significantly less willing to buy complex debt securities. Thus, banks will be more restrictive with lending, as they are not willing, and respectively not able, to bear the additional risk. E.g., recently European banks suspended trading in the US$2.8 trillion market for mortgage debt in order to halt a slump that has closed the main source of financing for home lenders. At corporate lending, a possible credit crunch is not yet visible at the hard lending data, while at consumer credit, particularly considering mortgages, the cooling of the housing markets in Spain is already dampening momentum. To some extent, this may be due to the fact that banks are stepping in for their failure to syndicate LBO loans to institutional investors. However, the ECB's lending survey among Euroland banks showed a sharp deterioration in Q3, which should be followed by a notably declining momentum of loans in upcoming months. Meanwhile, debt ratios (debt vs nominal GDP) have risen to record highs in Euroland, both for consumer debt as well as for corporate debt.

In the US, debt relative to GDP has also risen, both at the consumer as well as at the corporation level. The consumer looks particularly stretched, as now one fifth of the disposable income is heading for debt service, which is around the record high levels in the last 20 years. At corporates, current debt compared to historical numbers looks less stretched than at the consumer level. Nevertheless, they are close to levels which were prevailing before the two recent recessions. Current debt relative to nominal GDP is exactly at the same level as in the mid 1990s and mid 2000s. Debt relative to operating cash flows (based on the Fed's flow of fund data) is slightly below the mid 1990 and 2000 figure: Currently, total corporate debt (loans plus

securities) was 4.5 times operating cash flows in Q2 2007, up from 4.1 in Q3 2006 and compared to 4.9 times in 1990 and 2000. The current leverage is exactly in line with the long-term average. Thus, the popular saying – "corporate debt is low compared to the strong cash flows" – is less indicated by the data. Keeping in mind that a further cyclical downswing could negatively impact operating cash flows and rising corporate bond spreads could raise refinancing costs, particularly for low quality companies, there are no green lights at corporate debt.

Besides, a major investor group (hedge funds) which has become important in recent years, is built on leverage. Industry guesstimates vary widely on the size of the global hedge-fund market: from US$ 1.25 trillion (CS Tremont) up to US$2.48trillion (HedgeFund Intelligence), depending on how much leverage is included.

The rising leverage was one major source of liquidity in recent years. This, however, is at risk, and thus we would not attach too much weight to the rising money supply data.



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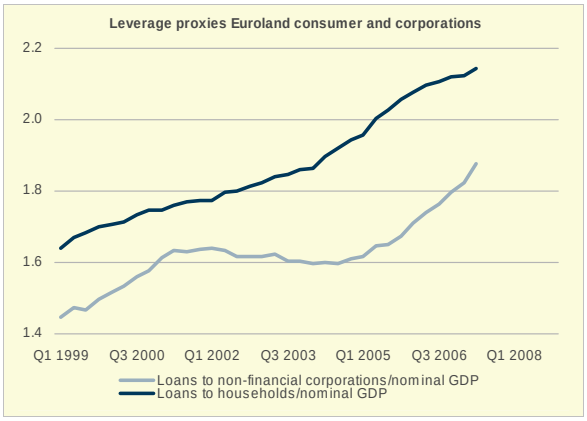

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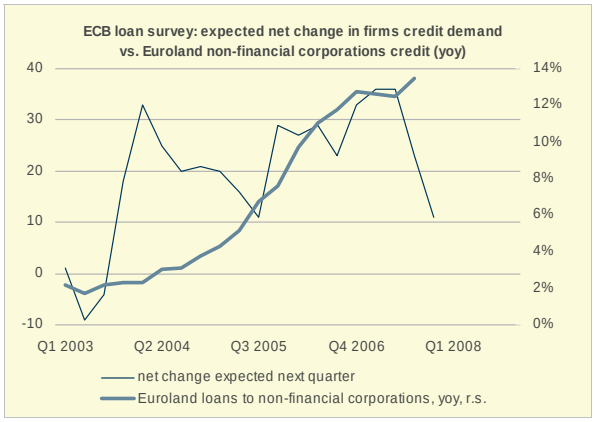

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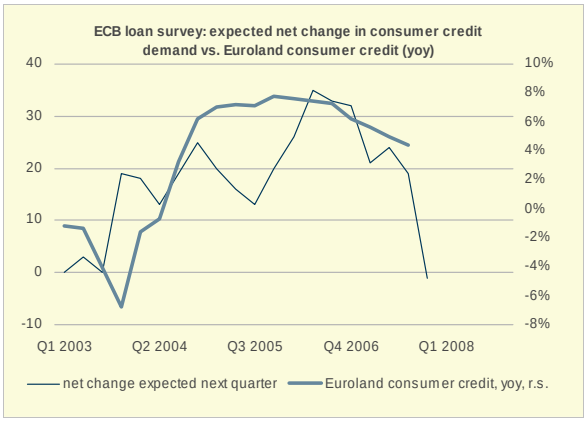

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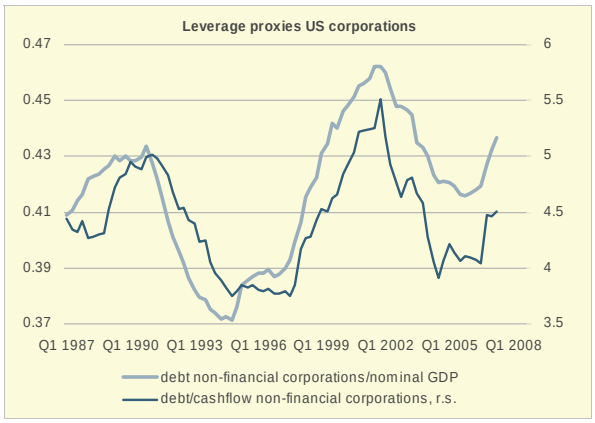

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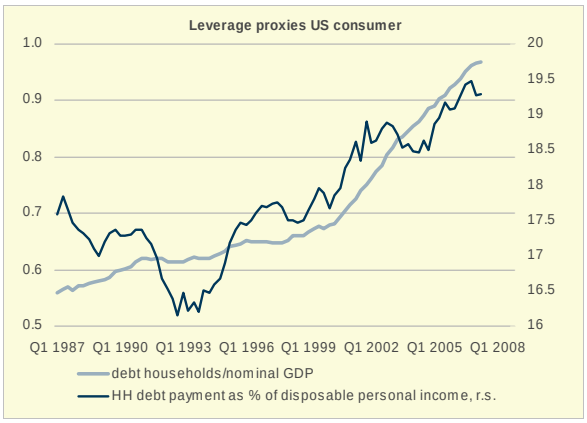

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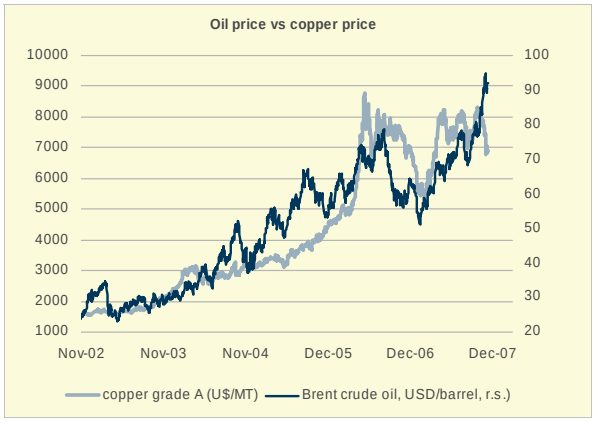
Oil prices should provide some relief particularly for Germany

The soaring oil prices that we have seen in recent months were, in addition to geopolitical tensions, to a large degree based on the dynamic global growth. Considering the continued slowdown of US and European growth and its potential negative spillovers to global growth centers such as China (see page 45), the demand, and thus the prices for oil and commodities in general, are likely to come down from the current historically high levels in over the course of 2008.

In fact, such an effect has already started to become visible at a number of industrial metal prices. The copper price, for example, which may well be considered a good benchmark indicator for global commodity demand and global growth, has recently fallen from some 8,300 US$/MT early in October to 6,850 US$/MT as of mid November, as copper inventories turned out to be higher than necessary, considering the current global demand.

Moreover, the case of China shows that the current high level of the oil price may urge emerging market governments to allow so far state-set oil and gas prices to converge gradually upward towards the shadow market prices. This reduces the incentives of private households and corporations to consume inadequately high amounts of oil and gas, and should thus also help to moderate global oil demand.



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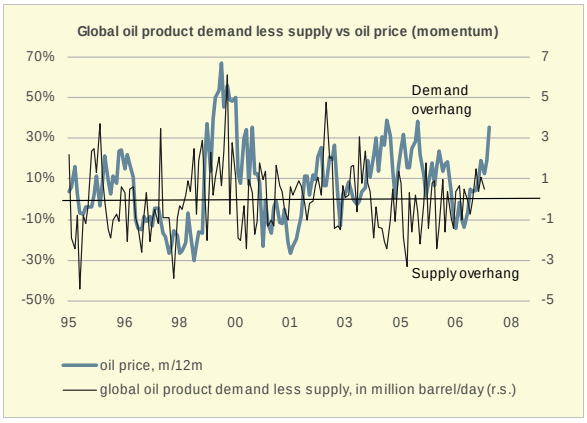
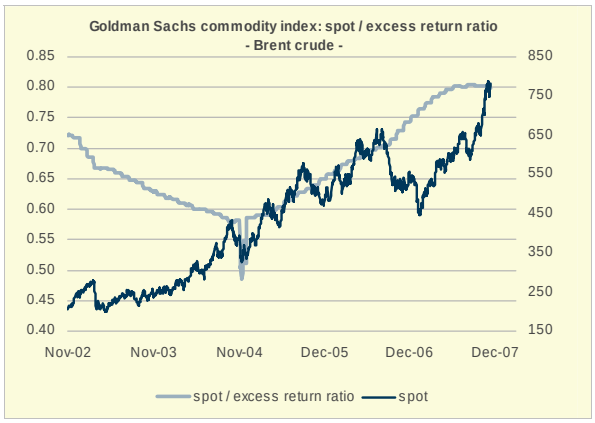


Source: Thomson Financial Datastream

In addition, the ratio of excess return to spot prices for crude oil and petroleum has lost its upward momentum since mid summer, and recently even started to decline, indicating that investing in nearby futures and rolling them over each month have become less and less attractive. This should also take some upward pressure from the crude oil price, as investing in crude becomes less and the less appealing for financial investors.



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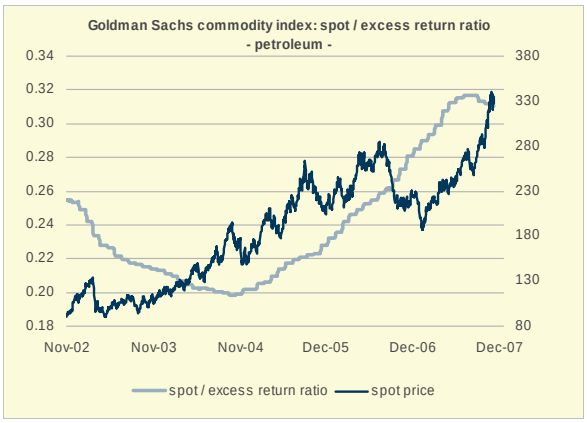
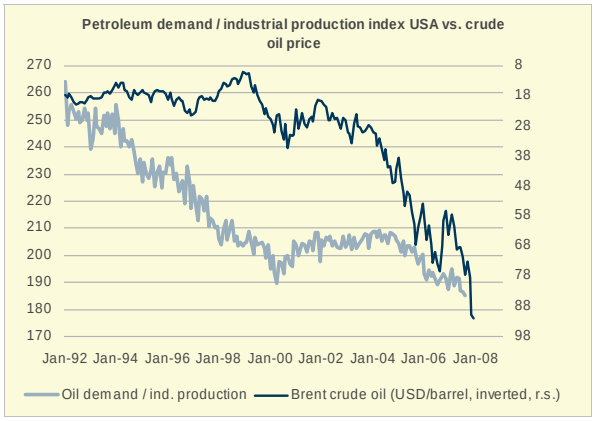


Source: Thomson Financial Datastream

In an international comparison, the German economy is to a rather large extent geared to oil

The figures below show that the oil intensity of industrial countries' economies, measured as the average consumption of crude oil per unit of industrial production, has rather steadily decreased in recent years. Even though this trend was temporarily suspended in the USA and UK between 2002 and 2005, both countries returned already in 2006 to the trend decrease. The result is also rather robust in considering oil consumption relative to GDP instead of industrial production, and this implies that mature economies have increased their ability to cope with higher oil prices compared to the past.

In an international comparison, however, the German equity market as well as the German economy are, due to their high exposure of industrials and the chemical industry, more dependent on oil than, for example, France or the UK with their relatively high share of financials. This implies that a further oil price increase would over-proportionally hurt the German economy and its equity market. Finally, one has to consider that neither in the German nor in the Swiss market oil companies are part of the blue chip index. An offsetting element, however, might be: If oil prices fall due to sharply declining global growth, this could be a burden for those German stocks which are geared to this growth.



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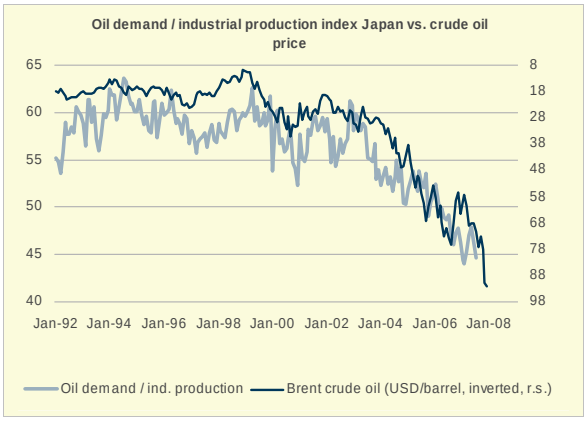

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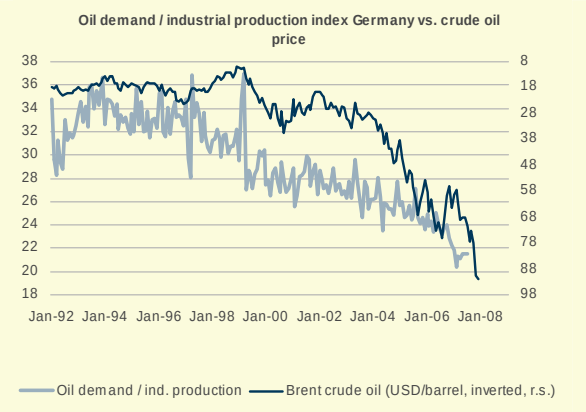

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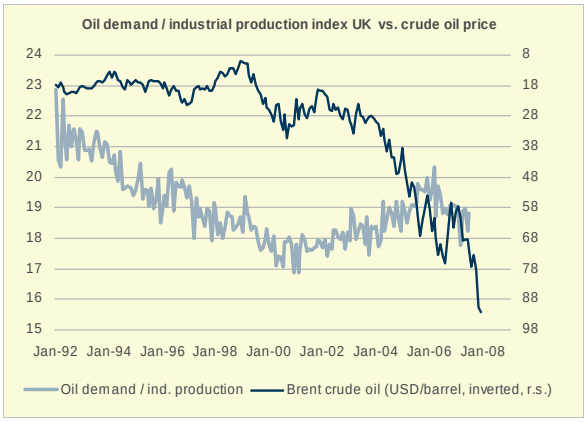

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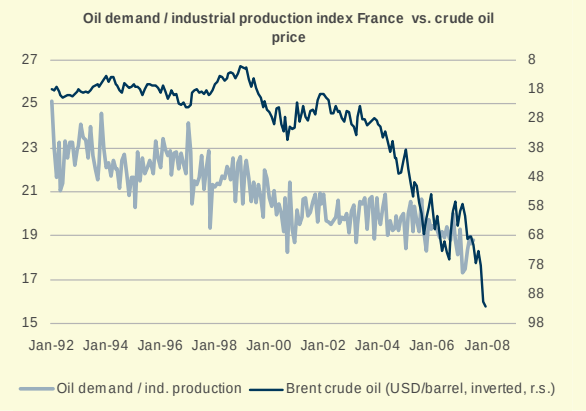

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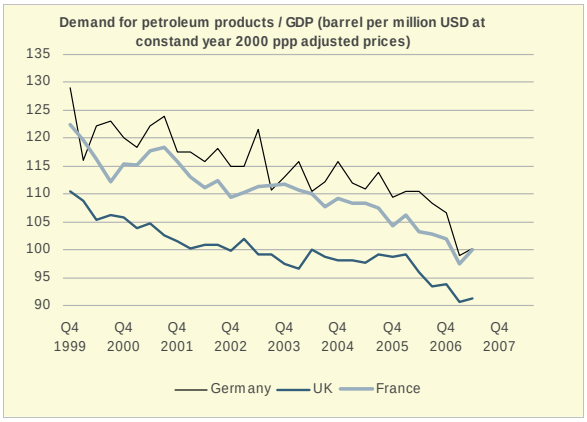
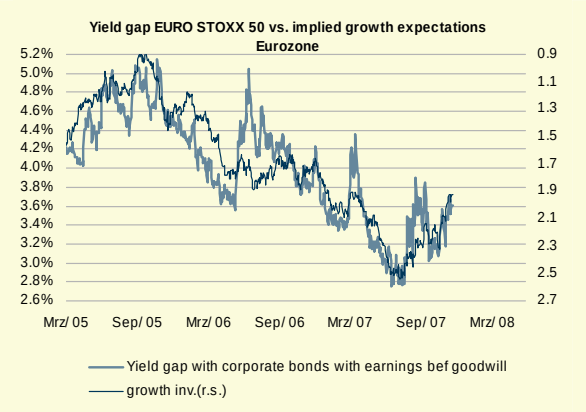


Source: Thomson Financial Datastream

Valuations will rise once the mix of growth vs. inflation improves

On a first glance, multiples are rather attractive. Based on the consensus numbers for 2008, the EURO STOXX 50 trades at a multiple of 11.4 and the DAX at a multiple of 12.1. The earnings yield thus exceeds the bond yield by 4.6% in the case of the EURO STOXX 50 and by 4.1% in the case of the DAX. In both cases, the valuation of equities against government bonds is extremely low by historical standards. From our perspective, government bonds are, however, not good benchmarks for equities, and if we include the dramatic widening of credit spreads, the valuation of equities looks less tempting. Instead, our chart shows that the yield gap is roughly in line with the development of our implied growth proxy for the Eurozone. Compared to the development of our implied growth proxy for the US, markets are not even attractive. If we take the DAX, we get a similar picture based on our growth proxy for the Eurozone. The valuation of the market is just fair, whereas based on the growth proxy for the US, the valuation is expensive. In the case of the DAX, we would also argue that the valuation based on normalized earnings – using the earnings of the last 5 years – is just about fair. The yield gap based on normalized earnings is slightly above the historical average, but it is not a screaming buy if one takes into account that the bond yield is low due to high credit spreads and fears for economic growth.



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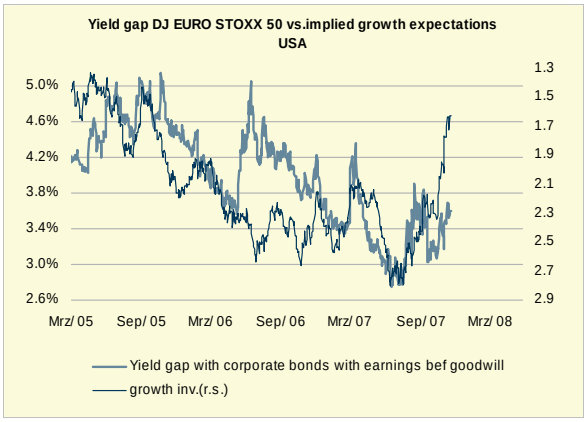

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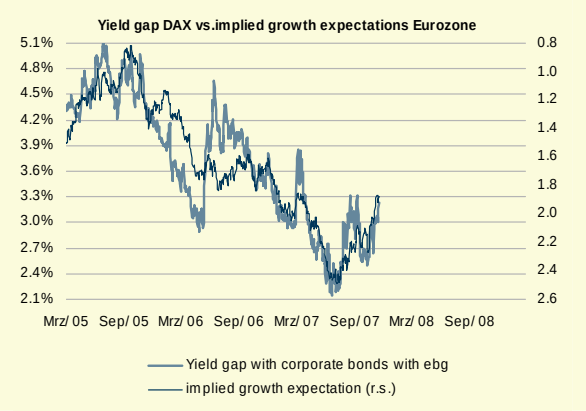

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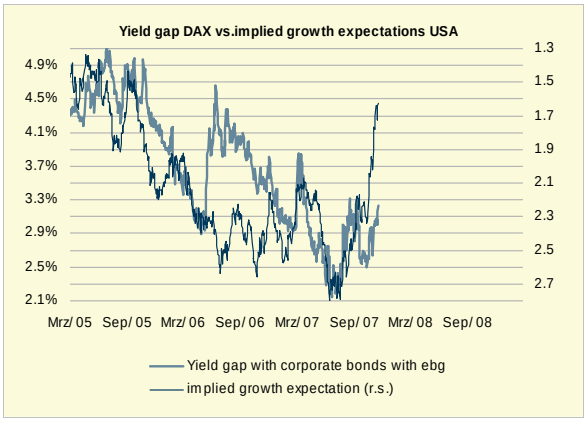

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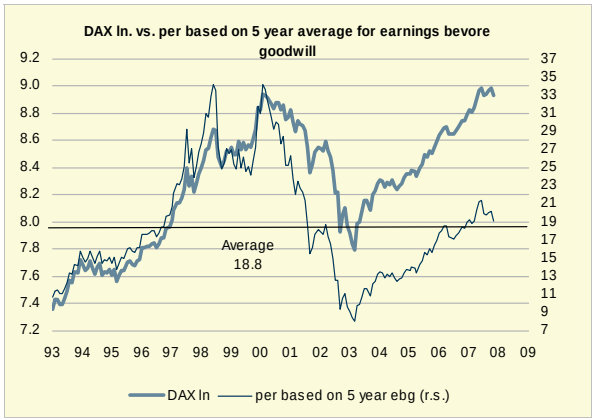

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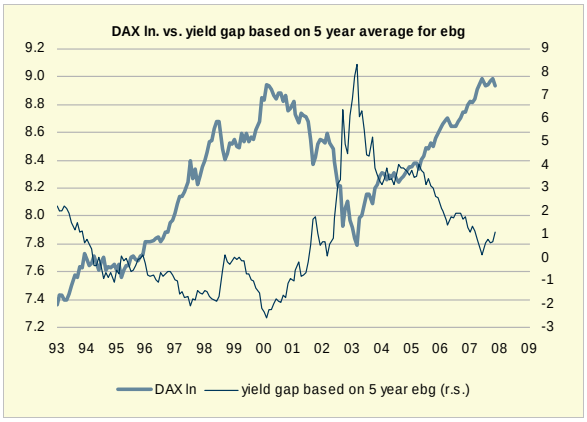

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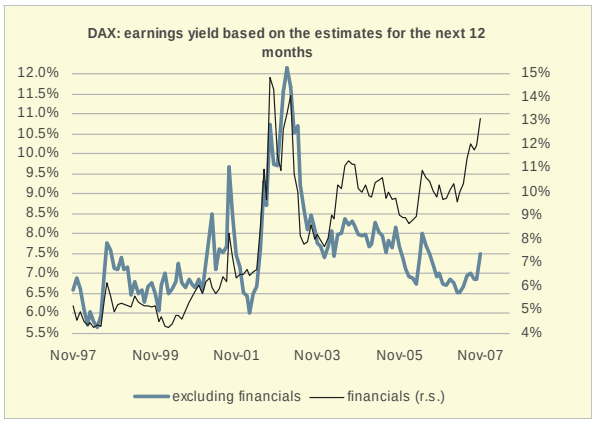
In both cases, the yield gap is very much in line with the ratio of growth to inflation expectations. Looking at the DAX, we see that the earnings multiple tends to decline when Ifo business expectations fall and the yield gap tends to rise, which argues against an interpretation of current valuation levels that is too positive. Valuations at indices are however a combination of two rather very different valuation multiples based on consensus earnings. Based on the estimates for the next 12 months,, financials in the DAX, for example, trade at a multiple of 7.6, whereas outside of the

financials the average earnings multiple stands at 13.3. Thus, although based on our estimates where more than 50% of the expected earnings are coming from cyclicals where earnings are probably less in doubt than at banks, we would agree with the market view that the consensus estimates at financials can not be taken at face value. On the other hand, the charts show that the valuation of stocks outside of financials is hardly cheap for this stage of the cycle.



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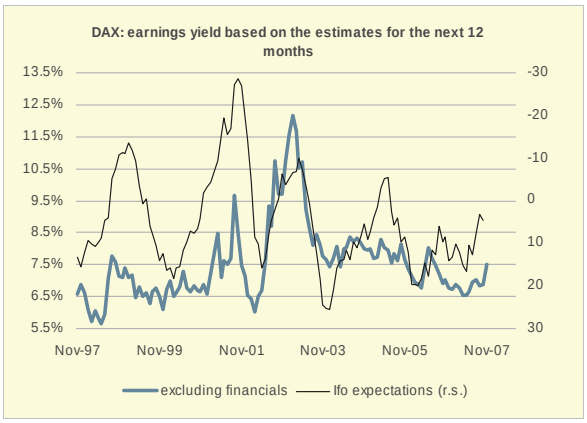

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Drivers for stocks look uninspiring

Looking for the valuation at the end of 2008, we have first to look at some drivers for equity markets in the recent past. Merger activity will decline and the targets will most likely be significantly smaller, which means that the positive impact for the market will be lower. Positive earnings surprises will only be reachable by guiding analysts down ahead of the publication of the estimates. Thus, for markets, this will be seen more as a burden. Positive surprises are likely at dividends as companies have even more cash flow than they need for their investment spending. Spreads at financials should decline somewhat from current crisis levels. Bond yields will remain low and within the vicinity of dividend yields. Although the Fed will most likely ease somewhat further, the ECB will at least in the near term give no indication for rate cuts. Data from the US and Europe will probably be weakening further in the first half of the year. At the end of the current year, fears about a recession in the US will by then either be proven as correct or should have given way to the scenario that our economists are painting, namely, that the US is not falling into a recession but that growth in 2009 will improve, though remaining slow. Clarity about this point is however nothing we expect for the next few months, thus we doubt that one can get a relief from this side anytime soon. These drivers for the valuation of equities look rather uninspiring, but this is, from our perspective, just what markets have been pricing in since the beginning of November.

For the year end the predictions have to take into account the higher risk of a negative scenario

From our perspective, it is more useful than in the past to argue as well with an expected value – as the likelihood for a bad-case-scenario is higher than in the past given the higher uncertainty that goes along with the current financial crisis and the outlook on the US economy. The expected value may have a low probability to be realized. Instead, we would see a high likelihood that at the end of the year we are either pricing in a more or less decent, although not particularly strong economy, or we are faced with a situation where we have persistent economic weakness and where markets have no reason to expect a recovery in 2009.

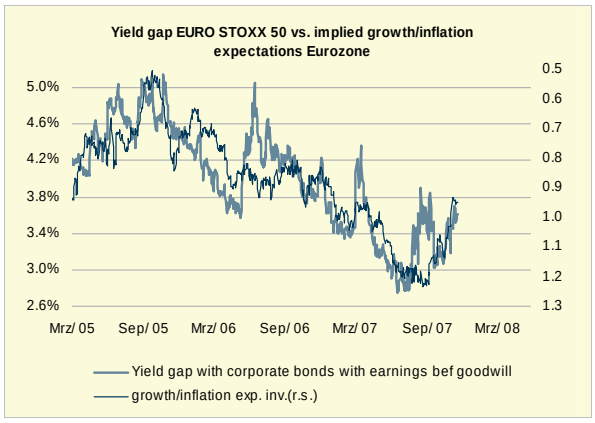
The benign case: In the more likely case, we expect that the implied growth expectations will be recovering somewhat compared to the current situation, and that credit spreads are coming down from their current levels. At the same time, we would assume that the market is faced with slightly higher bond yields. We would in this case assume that the EURO STOXX 50 can rise towards a level of 4,550. This assumes that our growth proxy rises to some 2.3%, leading to a yield gap with

corporate bonds of 3.2%. In this scenario, we would assume that the credit spreads of BBB rated bonds decline to a level of 1%, and we assume a yield on government bonds of 4.5%. In this scenario, for which we would apply a likelihood of 70%, we come to a EURO STOXX 50 level of 4,550. The bad case: We would also define an outcome with a likelihood of roughly 30% that the US economy at the end of 2008 is giving little hope for such a recovery due to the fact that the financial transmission mechanisms are not working in the usual way. In this negative scenario, we would assume that our growth proxy goes to a level of 1.2%, giving us a yield gap of 4.7%. Spreads would stand at 200bp, but at the same time, 10 year government bond yields would fall to some 3.6%. In this case, we doubt that our top down earnings estimates would be priced. More likely is that the market is pricing earnings at around 385 points, which would then give us a fair value of 3,750.

Thus, if we combine the likelihood of the 2 possible outcomes, we end up at a EURO STOXX 50 level of 4,300. In case of the DAX, the same calculation gives us in the positive case a value of 8,400 points and in the negative case of 6,600 points, including dividends, which results in an expected value of 7,900. To compare both cases, one has to keep in mind that the DAX calculation already takes into account the dividend yield of 3.3%. Concerning the DAX, the cyclical risks are higher than with the EURO STOXX 50; the upside in the positive case is higher, but in the negative case, the downside is more pronounced. Taken together, this suggests that considering the two probabilities, we would not advise overweighting the DAX.

How to position in this environment

In the near term, we have the ugly combination of persisting high inflation and of cuts in growth estimates, and markets will continue to trade at least until mid of Q2 under the assumption that there is some likelihood for a recession in the US. Although we assume that credit losses from the current crisis will be smaller than currently anticipated by spreads at financial instruments, which should lead to a strong performance at financials, we believe that although this process has already started, it will take time, as newsflow will not be supportive. Investors that have been largely convinced up to now that the traditional Fed easing will quickly help markets and that the economic problems are largely confined to the US should get more cautious on both points (see page 45).Thus, we would expect markets to trade with high volatility around current levels, and this includes a significant likelihood that we will trade closer to our negative scenario for some time. We therefore expect to get better investment opportunities over the first half of 2008. Once we see a good chance for a significant decline of spreads or a significant decline of commodity prices, we would however not hesitate to quickly increase positions at equities.



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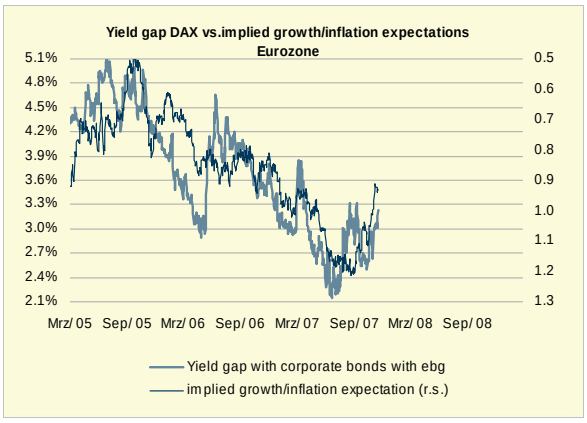

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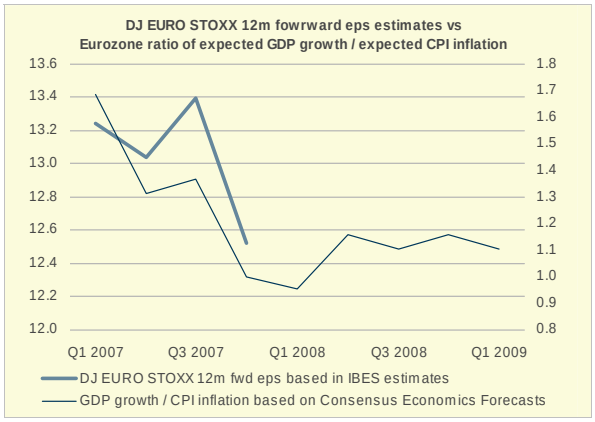

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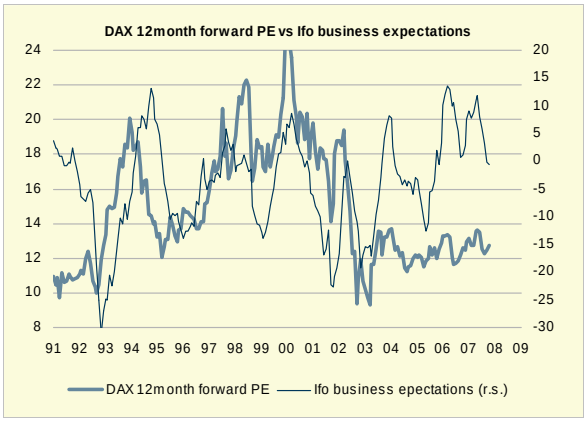


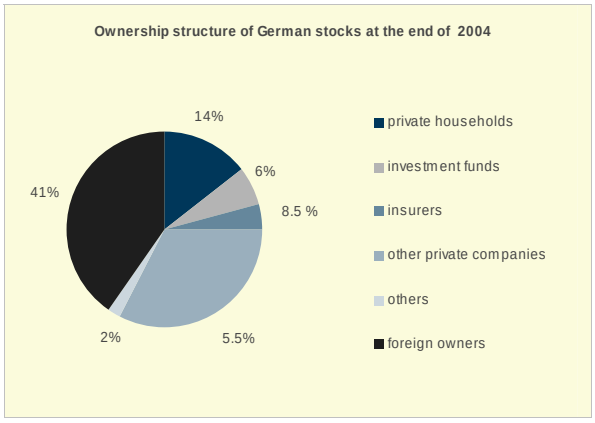
Source: Thomson Financial Datastream

The introduction of a withholding tax in Germany could lead to a temporary outperformance of German stocks but more because of hopes than due to real shifts

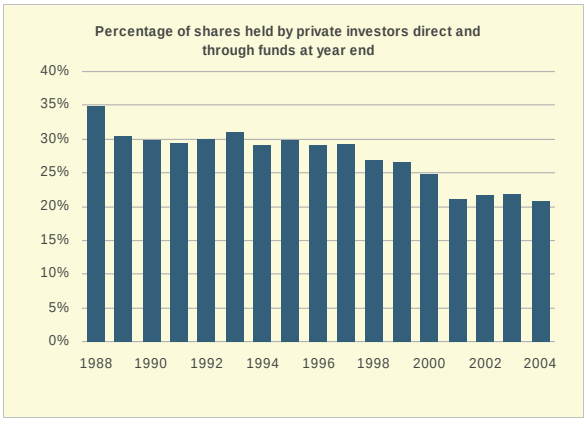
The introduction of a withholding tax in Germany should lead to a lower allocation of private investor towards stocks medium term, as capital gains are no longer tax free in contrast to the current situation. For bond holders, however, the withholding tax is leading to a lower taxation than in the past. Thus if one assumes a tax rate of some 45% including the solidarity surcharge and church tax and a total return of some 8% consisting of 3.5% dividend yield and 4.5% capital appreciation, then a total return after taxes currently stands at some 7.2%, assuming all capital appreciation is realized tax free after one year. This compares rather favorably to the coming taxation in 2009, as then the withholding tax of 25% together with the solidarity surcharge and the church tax has to be applied to the dividend and the full capital appreciation. Thus, as the combined taxes are some 28%, the total return in the example goes down to some 5.8%. This disadvantage of the new withholding tax is larger in case of a stock that pays no dividends than in case of a stock with a high dividend yield, where the new rule is actually often more attractive. The new withholding tax is thus more of a burden for growth stocks than for stocks with a high dividend yield, and it might therefore also lead to some adjustments in payout ratios.

The interesting point is that investors who are buying a stock or a fund before the end of 2008 can realize capital gains after the holding period of one year tax free. Thus, the incentive is rather high to buy a fund that is investing in growth stocks with little payouts and thus to keep the capital appreciation tax free. We have little doubt that this will lead to a major advertising campaign by investment funds in the second half of 2008 and the past has shown that German investors tend to react rather strongly to tax incentives. A good example for this was when life insurance contracts that were signed by the end of 2004 were tax exempt, which led to an increase of new life insurance policies by 37% and a rise in the amount that was insured by 29%. The impact of tax changes on the investment decisions of German investors can hardly be overestimated. Still, if markets are only remotely efficient, then a temporary, purely tax induced outperformance of German stocks is unlikely to last, as foreign investors would see this as temporary and reduce their weighting in German stocks accordingly. The last published numbers on the holdings of equities by private investors, which are for 2004, were quite disappointing. According to the figures, German private individuals were holding just some 14% of the listed shares compared to 40% that were held by foreign investors. If we combine investment funds and directly held shares by private individuals, then the statistic gives us just some 21% that were held by private German individuals. Although the combined direct and indirect holdings of private investors have varied considerably, a large portion of these changes can be explained by the change in the market value of shares. The correlation coefficient stands at 0.97 and the share of the market value that was held directly and indirectly was fairly stable.

To calculate the additional demand for equities, we assume that private investors will increase their real holdings by 10% – which is a significantly larger increase than what we have experienced in recent years – and we assume that foreigners don't realize that this is a temporary, tax-driven phenomenon. This demand would then equal roughly 2% of the current market capitalization. Now, we admit this is hardly substantial and the only good point about this calculation is that it is actually very unlikely that such huge performance will lead to selling pressure from foreigners or from private equity companies that are floating more shares.

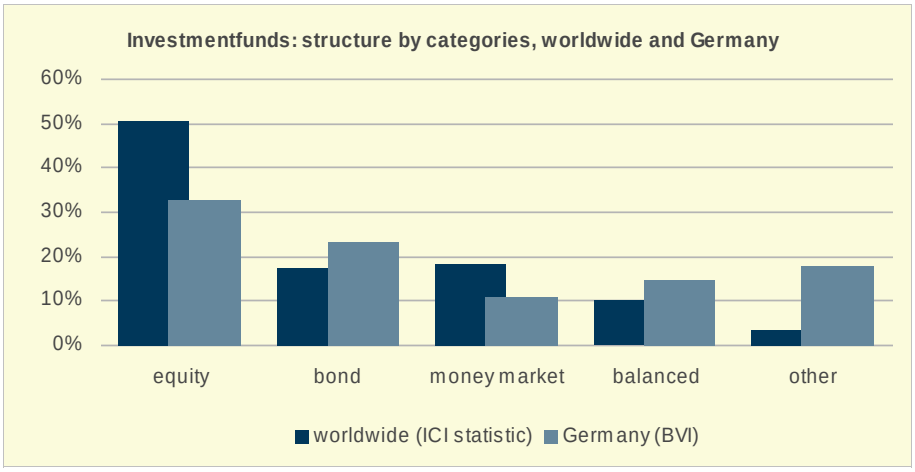


Source: Deutsche Bundesbank



Source: Deutsche Bundesbank

This does not, however, mean that we can ignore it altogether as the story that the German private investors who are holding a rather low share of their assets in equities will increase their equity positions to save taxes has some attraction and might lead to pre-emptive buying, which could actually help the German equity market. German private investors only held some 8% of their liquid assets directly in shares in 2006, which is very low compared to similar countries. If we include the investment funds of private investors and assume that mixed funds are holding 50% in equities, then German private investors are still only holding 13% in equities. Similar to this, one can see that the percentage of investment funds that are dedicated to equities is significantly lower than in other countries and here the statistics are more up to date and thus better comparable.



Source: Investment Company Institute

Decoupling does currently support, but how long will it hold?

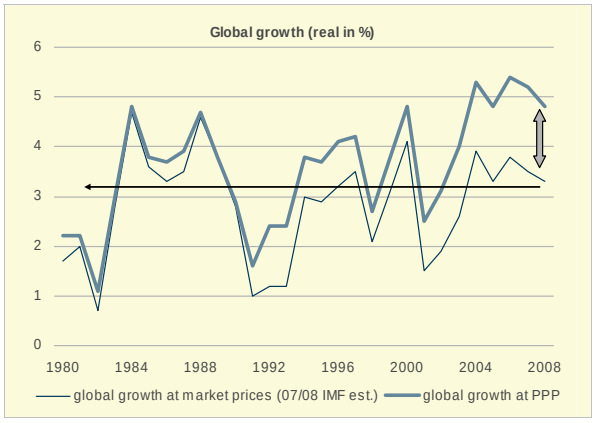
Whether decoupling will continue will drive the German stock market

Decoupling of the Euroland/German economies from the weakness in the US has been a major topic in 2007. The German stock market benefited from the perception of global investors that it is more strongly geared to global growth compared to other mature stock markets. This is due to the higher cyclical exposure of the German stock market, plus the strong exposure of German companies in growth spots Eastern Europe and China. Thus, whether decoupling is going to continue or not in 2008 will be crucial for the positioning of global investors. If yes: Global investors will further overweight Germany within portfolios and buy into stocks with pronounced exposure towards the hot regional areas. If no: Exposure towards Germany could be cut, which would over-proportionately hit stocks which had benefited from strong global growth.

First some facts which put the story into perspective:

Market-based global growth less spectacular than headline PPP-based growth

1. Consensus expects global growth to remain strong. Investors often get carried away with the published numbers. Based on the most recent headline IMF estimates, global growth is heading for 5.2% in 2007 after a record pace of 5.4% in 2006. Although some cooling is in the cards for 2008, the expected 4.8% are still more than 1 standard deviation above the long-term average growth rates – impressive indeed. However, these figures are based on purchasing-power parities which notably over-emphasize growth in Asia and under-emphasize growth particularly in the US. Looking at market-based prices – which are crucial for companies vs. the hypothetical PPP assumptions – growth is less spectacular: The world economy grew by 3.8% in 2006, IMF expectations are running for 3.5% in 2007, and for 3.3% in 2008 – still solid, but only 0.4 standard deviations above the long-term average (see charts below, which all use IMF data for the past and IMF estimates for 2007 and 2008). Such global growth does not lead in any case to strong markets, as seen, for example, from the 3.3% yield in 1986 to a lacklustre 5% at the DAX back then. A correlation of global growth with US stock markets is somewhat muted; in the case of the DAX, it is higher than at the S&P 500 (see charts below). Relative performance of the DAX seems to be geared to global growth.



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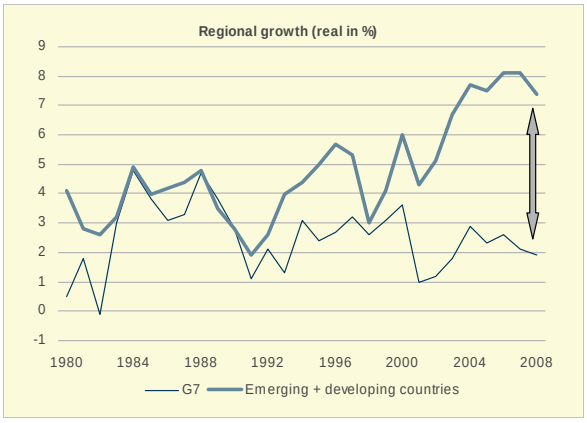

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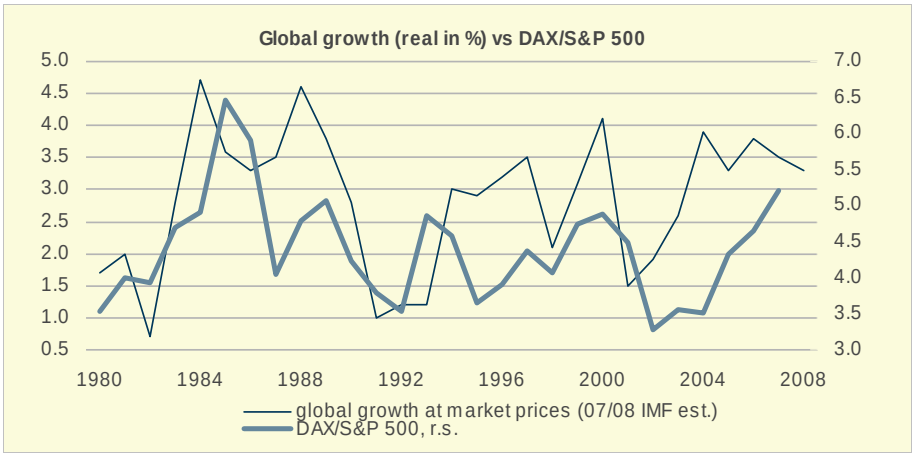
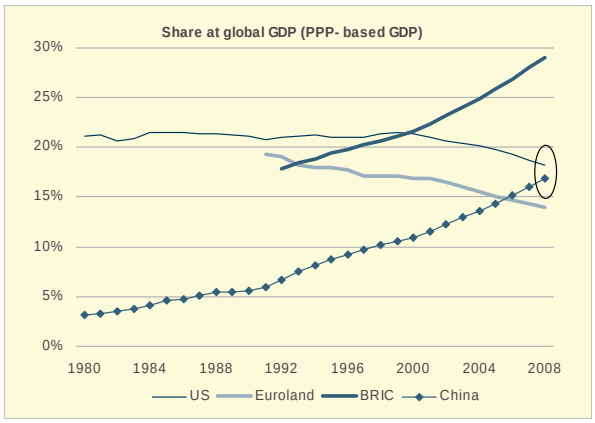


Source: Thomson Financial Datastream

Global growth more driven by emerging markets, but impact of US nevertheless remains important

2. Global growth has increasingly been driven and is expected to continue to be driven by emerging economies. Growth in G7 countries is going to decline from 2.1% in 2007 to 1.9% with less momentum, but still with a soft landing scenario in the US and in Euroland. On the other side, according to IMF estimates, emerging economies should keep running with 8.1% in 2007 and 7.4% in 2008 – with developing Asia above and Central and Eastern Europe, plus Russia and Latin America slightly below these rates (see chart below). But again, the importance of emerging markets, particularly of Asia, is overemphasized in PPP-based data. Based on the regional share of global PPP-based GDP, China surpassed Euroland in 2006 and is closing the gap to the US in 2008. Not to speak of the BRIC countries (Brazil, Russia, India and China): PPP based, they are the big elephant with a weight of close to 30% of global GDP, far above the US´ share of 18%. Looking at the *contribution* to world growth, BRIC has been delivering more than 35% of global growth each year since 2005, with a solidly rising tendency. Euroland and the US are hovering around a 10% contribution to growth in 2008. Who cares in such a BRIC-driven world about the US? However, considering market-based data (even looking at nominal data which are biased towards emerging markets with higher inflation and which we used), the old industrialized world still remains important. Although the share of the US at (nominal) global GDP declined by 700 bps since 2001 to some 25%, it is still as big as it was from 1988 to 1996. Even the Euroland has basically come close to double the economic size of the BRIC countries. There are certainly some shifts at work in favor of emerging markets. In 2007, China will be for the first time the biggest single contributor to global growth, even based on market prices. In 2008, for the first time

developing markets are expected to contribute more than half of global growth, which compares to some 30% stemming from Euroland and the US.



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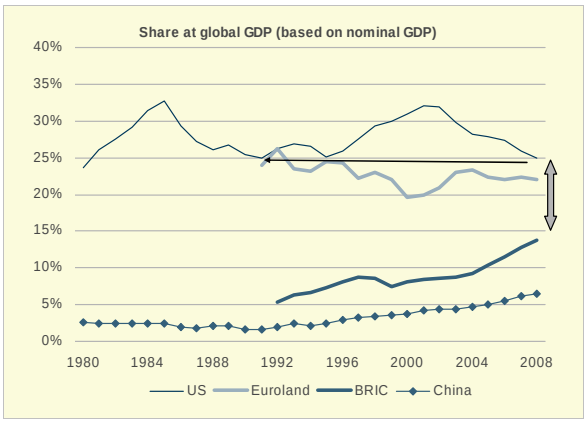

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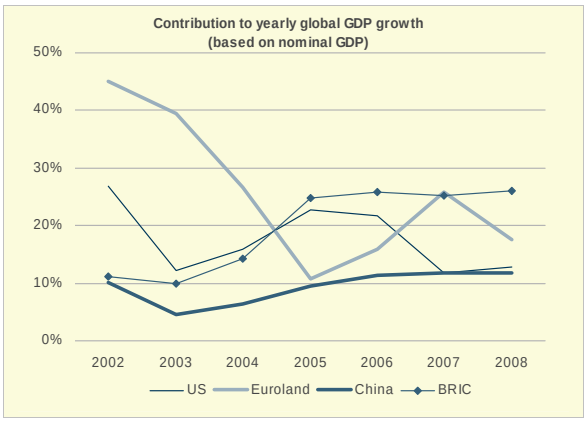
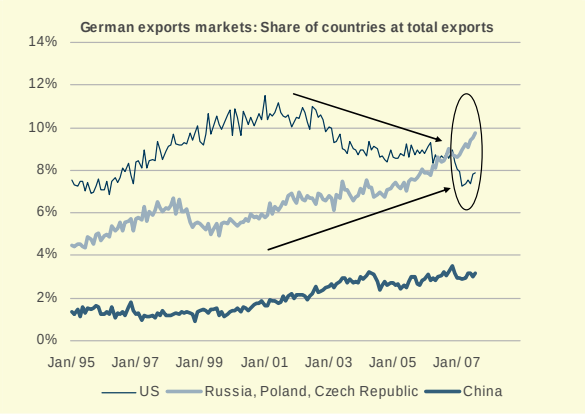


Source: Thomson Financial Datastream

At German exports, new export markets have compensated for the decline in the US – for the time being

3. Looking at Germany, the rising importance of emerging markets has definitely supported the German economy in 2007. Nominal exports to the United States (still after France the second biggest single market) have even been declining in 2007. But total exports grew ytd by some 11% for 2 reasons: Euroland, receiving the bulk of German exports for years, was still on track. And the rising stars – Poland, China, Russia and the Czech Republic, which ranked no. 10-13 in 2006 among Germany's most important single export markets, and thus were the biggest behind the big Western European neighbours, continued to show stellar growth. The biggest Eastern European export markets, including Poland, Russia and the Czech Republic, exceeded the US in late 2006.



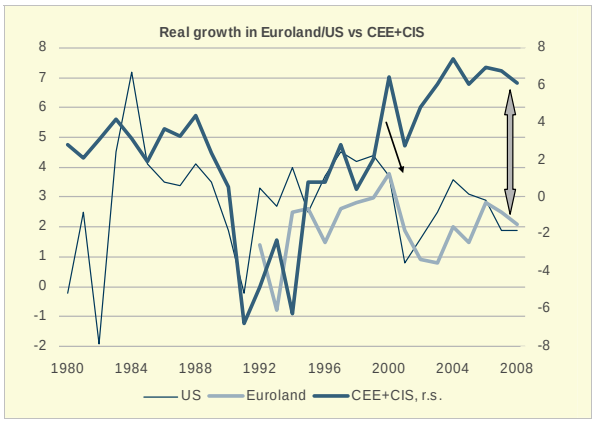
Source: Thomson Financial Datastream

Nominal German exports: regional allocation and growth			
	Share in 2007 ytd	Delta 2007 vs 2006 (Jan-Aug) in bn €	Delta 2007 vs 2006 (Jan-Aug) in %
Total		65.0	11.3%
Europe	75.3%	56.6	13.2%
thereof Euroland	**42.9%**	28.4	11.5%
Poland	3.6%	4.9	**26.6%**
Russia	2.9%	4.5	**32.1%**
Czech Republic	2.6%	2.3	**15.9%**
America	10.5%	0.1	0.2%
thereof US	7.6%	**-1.4**	**-2.8%**
Asia	11.4%	5.9	8.7%
thereof China	3.0%	2.3	**13.5%**

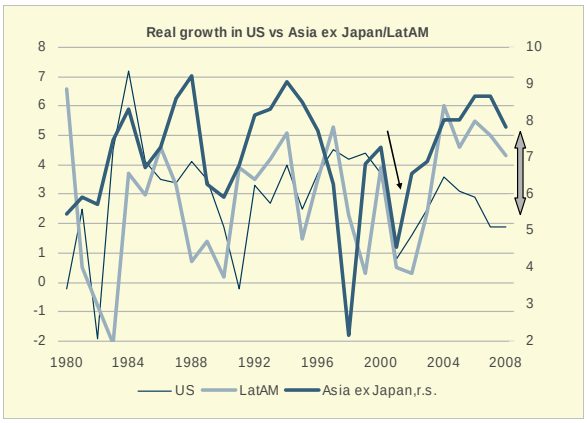
Source: Thomson Financial Datastream

Will it go on? There are two risks to the current estimates on global growth. First, given the heavy weight of the old world (Euroland, US, and Japan), any notable cooling of momentum here would itself drag global rates. If IMF's current growth expectations for the US and Euroland would be halved (which would still mean 2008 growth in these regions being above the 2001/02 rates), this would reduce global growth by 110 bps. Secondly, even a more moderate cooling of growth in the old world may drag growth in new developing markets in a more pronounced way than currently expected. Consensus obviously does favor a benign neglect stance, as it bets on an autonomous growth in China and Eastern Europe. (The IMF estimates, which are shown in the charts, are basically in line with other estimates).

During the last US-led downswing – which was, by the way, per definition no recession as there were no 2 sequential declines at quarterly GDP – the other regions were clearly affected, quite pronounced in Latin America and in Eastern Europe, but as well in Asia, excluding Japan (see charts and table below). Bulls will argue that the share of the US at global GDP has decreased from 32% to 25%. However, besides the fact that the weight is still as high as in the early 90's, the rising linkage through trade and investments may increase spill-over risks.



Source: Thomson Financial Datastream



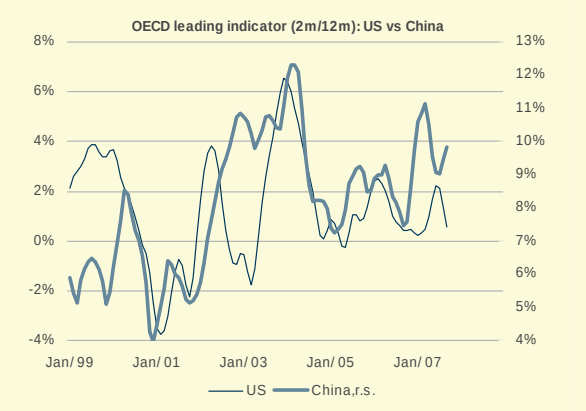
Source: Thomson Financial Datastream

Sequential change of growth in 2001							
	Weight of US economy based on nominal market-based global GDP	US	Euroland	Asia ex Japan	CEE+CIS	LatAM	MidEast+Africa
2001	32.1%	minus 2,9pp to 0,8%	minus 1,9pp to 1,9%	minus 2,8pp to 4,5%	minus 3,7pp to 2,7%	minus 3,5pp to 0,5%	minus 1,0pp to 3,5%
2008	25.0%						

Source: Thomson Financial Datastream

Chinese growth depends on the US consumer as well

Euroland is the biggest trading partner for Eastern European countries, while the US is particularly important for Latin America and Asia. In China, the relative importance of exports to the US has doubled in the recent 5 years to some 8% of Chinese GDP. This is notable, for example, as the US imports from China only account for 2% of the US GDP. Moreover, Chinese growth is widely driven by investment spending, which is finally targeting the huge US (and European) market as well. A further cooling of the US consumer, which could be accompanied by counterparts in some other major economies with falling housing markets (e.g. in UK, Spain), will raise the question: For whom are the Chinese going to produce? Although growth at the Chinese consumer level is accelerating and thus bears some hopes for a relocation of growth towards the Chinese consumer, investment spending is still pacing strongly ahead of retail sales (see chart below). The enormous build-up of capacities is clearly targeting export markets. The cyclical cooling of major export markets poses the risk of overcapacities leading to margin pressure and/or a cut of production capacities. Both would have repercussions on Chinese growth. 2000 was dominated by technology overspending in the industrialized countries; 2007 by over-investments in China? Moreover, there are notable political risks: In a recent – however annual – survey among European companies, fewer companies said that they make profits in China. Last year, 76% said they were profitable, and now only 61% say the same. The companies cite opaque and inconsistent government regulations as a major drag. For example, more recently the central bank told local commercial banks to stop issuing loans, an unexpected administrative edict. Hence, even for the breathtaking Chinese growth story, there are notable risks – besides domestic measures against inflation and overheating (see the analysis on page 57ff).



Source: Thomson Financial Datastream

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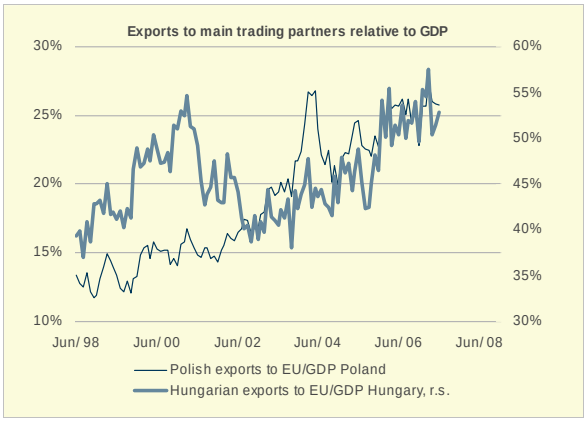
Source: Thomson Financial Datastream

Watch signs of cooling in Eastern Europe

Growth spot Eastern Europe has benefited from the integration into Europe and the catch-up towards Western Europe. Thus however, it has become more dependent on exports towards the EU (e.g. in Hungary the ratio of EU exports to GDP has increased by 15pp to above 50%, in Poland by more than 10pp to above 25%). The declining sentiment in Western Europe – where all business surveys have been heading down for months – is now showing up in eastern European sentiment indices. The Polish manufacturing PMI was at the lowest level since August 2005 in October; the correlation with the momentum of German exports to Poland is quite high (see chart below). The biggest problems may emerge in Hungary, which is currently ranking no. 16 in Germany's export league, accounting for 25% more exports than Saudi-Arabia and India together. Business sentiment fell to a multi-year low. Some recession talk in Hungary in upcoming quarters is possible, which would be the first major crisis in the CEE for years. The situation in Hungary has become increasingly difficult due to the high foreign currency denominated debt of Hungarian households and corporations: some 90% of Hungarian mortgages are based on CHF respective €; in 2006, forex debt made up some 44% of total debt; households even accelerated their borrowing in recent months in forex to compensate the tax; and there is inflation-driven pressure on purchasing power. This leads to a massive dilemma for the central bank, as the forint vs the CHF is closely driven by the differential of Hungarian vs Swiss interest rates. In order to avoid a squeeze on households and keep the Forint strong, the central bank cannot cut interest rates (strongly), as inflation and wage growth argue against notable cuts. However, as the economy has already been significantly weakening (GDP only +1.0% yoy), the high interest rates will drag the economy further. Other CEE countries with a high share of forex denominated debt are Romania (47% in 2006), Bulgaria (46%), the Ukraine (50%); countries with lower but still notable exposure include Russia (29%) and Poland (27%). In a most recent IMF working paper on South Eastern Europe, the authors conclude that "in SEE traditional vulnerability indicators (e.g. current account deficits/GDP, external debt/GDP, fiscal deficit/GDP, public debt/GDP, inflation) are currently at levels that historically have been associated with risks of growth reversals. A comparison with pre-crises East Asia shows that current external vulnerabilities in most of SEE are similar or worse." Besides, Slovakia's business sentiment fell to the lowest since early 2006, and Slovenia's to the lowest since Mid 2006. Still, consensus is calling for ongoing strength in Eastern Europe, or, in case of areas which are already visibly cooling off such as in Hungary, a notable rebound in 2008. But downside risks are emerging, which could accelerate when the cooling in Western Europe continues (due to the strong euro, rising refinancing costs for companies, more negative spill-over from the US, and drag from housing).

Source: Thomson Financial Datastream



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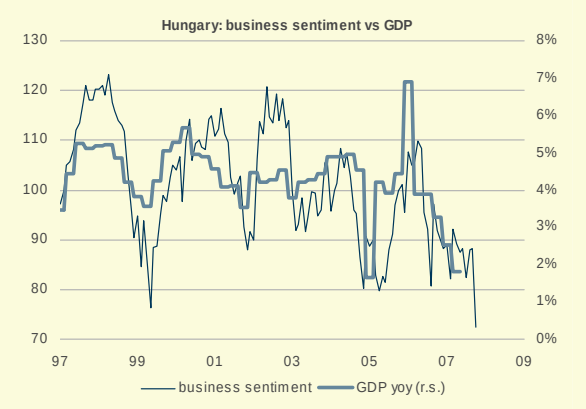

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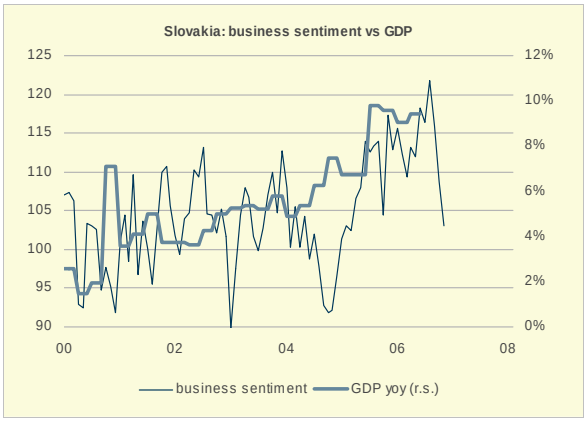

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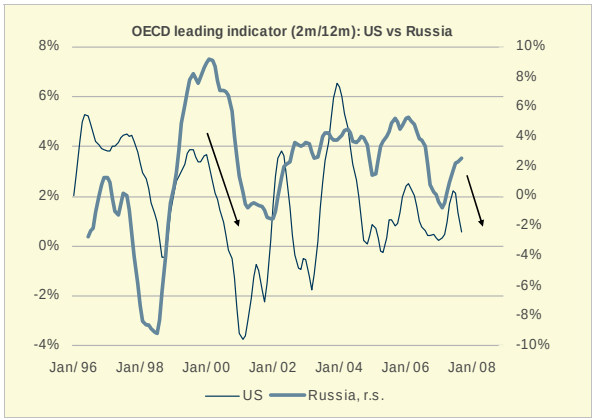


Source: Thomson Financial Datastream

Source: Thomson Financial Datastream

Downside risks at current decoupling hypothesis

Although the rising new export markets compensated for the fall of US exports, momentum of total German exports has been nevertheless declining in recent months. Basically, export momentum is following the Ifo business expectations. As the Euroland is by far the biggest export market, close to 4times the combined volumes of China, Poland, Russia and the Czech Republic, the fact that in September (nominal!) export growth to these key markets slowed notably is serious. As business sentiment in all major Euroland countries is deteriorating, these key

export markets for German companies are going to be affected. If Euroland exports fell by 1% (during the last downswing cycle in 2001, they fell by 6%), exports to e.g. China would need to rise by 14% to neutralize this negative impact – which is above the growth rates in recent months. Add some downside risks to the current consensus expectation of ongoing strength in all ex-G7 growth spots, and the decoupling thesis will face a stress test in 2008.

Source: Thomson Financial Datastream

Source: Thomson Financial Datastream

Decoupling II: Looking at German stocks

DAX: bulge in Europe, US still more important than Asia

We looked at the regional allocation of the stocks in the DAX, MDAX and TecDAX. Of course, this is a tricky job, as the regional differentiation – usually based on sales – varies from company to company. Some stocks – e.g. 6 out of 30 in the DAX – do not publish German exposure any more, as they show only their European share. Most companies do not separate between Western Europe and Central & Eastern Europe. The clusters Asia (including Australia or not?) and America (Mexico within North or Latin America?) differ as well. However, these errors should be minor.

In general, at all indices, the bulk of sales is stemming from Europe (> two thirds). North America is still more important than Asia. At the DAX, Germany accounts for somewhat above one third, market-cap weighted. One has to keep in mind that DAX heavyweights such as Eon, Deutsche Telekom, and RWE are heavily geared to Germany. The exposure to Western and Eastern Europe is difficult to identify. Looking at those 15 DAX stocks which do separate for the 2 regions, one comes up with: 29% for Western Europe and 8% for Eastern Europe. North America has twice the share of Asia (17% vs 9%).

Similar pattern at MDAX and TecDAX; MDAX slightly less geared to the US, TecDAX more to Germany

At the MDAX, the allocation is, perhaps surprisingly, quite similar: Germany accounts for around one third of aggregated sales. Europe is delivering more than another third (split at 19 stocks reporting 2 regions: 34% in WE, 9% at CEE). The US share is slightly lower (14%), along with Asia as well in the high single-digits. At the TecDAX, due the high weights of solar stocks and the domestic focus of the telecommunication stocks, the German exposure is higher with 43%, while Europe accounts for one fourth. There is less information compared to the other indices on Eastern Europe. North America (15%) and Asia (9%) look similar on average. However, there are significant differences among the stocks, with the technology camp being strongly geared to the US and Asia. Thus, besides the companies operating in regulated businesses (utilities, telecommunication), the German listed stocks have successfully decreased their exposure to the domestic market – although this is not yet negligible. Even at cars, which had been among the first of German companies to go global, Germany accounts for 20-30%. The most important

foreign markets are the Western European countries. Eastern Europe and Asia are certainly in the rise, but North America (mainly US) is still as important as these two regions together.

DAX stocks: Regional allocation

Company	Germany	Western Europe ex Germany	Eastern Europe	North America/ US	Latin America	Asia	Others	Comments
adidas	10%	25%	10%	28%	6%	21%		Oppenheim estimates for 2007; Japan 9%; net buyer of US$ 1.5bn
Allianz	30%	34%	4%	15%	1%	6%	10%	Premium income, just net profit translation exposure
BASF		53%		21%	8%	18%		Q3 07, WE incl. Germany and CEE, target to grow sales out of Asia to at least 20% in coming years
Bayer		44%		26%		16%	14%	FY 2006; WE incl. Germany and CEE, Asia and "Others", specifically LatAm, will be growth drivers
BMW	22%	38%	3%	26%		9%	2%	Source: estimated unit sales JD Power 2007. Japan 4%, net USD exposure about €7bn
Commerzbank	78%	9%	5%	6%		1%	1%	20006 gross revenues; split Europe estimated
Continental	32%	32%	5%	21%		7%	3%	Regional revenue split 2007., Japan 2%
Daimler	29%	38%	4%	18%	1%	7%	3%	Only Mercedes, Source estimated unit sales JD Power 2007, Japan 3%, net USD exposure about €7.8bn
Deutsche Bank	25%	40%	1%	25%	0%	9%		2006 gross revenue split; share of US contribution to come down sharply with financial market crisis, Japan 5%
Deutsche Börse	70%	20%		10%				Very rough Oppenheim estimates. DB1 provides no regional split - difficult to estimate because you do not know which amont e.g. Goldman Europe accounts via Frankfurt, London or NY! But minimum 95% of total turnover should come out of Europe and the US
Deutsche Lufthansa		63%		15%	2%	14%	5%	Western Europe includes Germany, Asia= Asia/Pacific
Deutsche Post	39%	25%	5%	15%	2%	9%	6%	Some of the German and European sales in Logistics and Express are Asia-related
Deutsche Postbank	94%	3%		2%		1%		2006 gross revenues; unlikely to materially change in coming years
Deutsche Telekom	52%	13%	13%	22%				
E.ON	56%	40%		3%		1%		
Fresenius Medical Care		21%		71%	4%	4%		sales 2006; WE incl. Germany, company is reporting in US$
Henkel	17%	27%	21%	20%	5%	9%	1%	Oppenheim estimates for 2007
Hypo Real Estate	41%	28%	9%	14%			8%	based on new commercial real estate business (diversification by region)
Infineon Technology	15%	16%		26%		42%	1%	Japan 9%
Linde		55%		21%	5%	15%	3%	WE incl. Germany and CEE, Growth regions in Gases are Eastern Europe, Asia Pacific
MAN	26%	47%				28%		2006 revenues, WE incl. CEE, 28% refers to North America/LatAM, Asia
Merck KGaA		48%		14%	11%	27%		based on Q3 sales, Europe incl. Germany and CEE, Asia incl. Japan
Metro	44%	32%	22%			2%		Sales 2006; strongest growth in Eastern Europe (where profitability is above-average)
Munich Re	45%	28%	2%	18%	1%	3%	3%	Premium income, just net profit translation exposure of US$
RWE	60%	29%	7%	4%				revenues 2006
SAP	20%	32%		28%		12%	8%	FY06; WE: incl. CEE+MiddleEast+Afrika; NorthAm: USA; Japan 5%
Siemens	17%	32%	3%	23%	4%	15%	6%	CEE, LatAM based on Oppenheim estimates, strong order growth from China expected
ThyssenKrupp	34%	31%		22%		6%	7%	sales 2005/06; 22% refers to Nafta; 28% EU, 3% other Europe
TUI	26%	54%		13%			7%	based on domicile of customers, WE incl. CEE (EU ex germany 51%, other Eruope 3%), North America incl. Latin America
Volkswagen	19%	34%	8%	9%	11%	18%		Source estimated unit sales JD Power 2007, Mexico 3%, China at equity consolidated not incl in revenues (exposure significant),
market-cap weighted DAX average	***32%***	***29%***	***8%***	**17%**	**2%**	**9%**	**3%**	

Note: Figures for market-cap DAX averages are to discount as 6 DAX companies do not publish their exposure to Germany any more. Thus, the German exposure is higher and the European exposure lower. The average DAX figure for Western and Eastern Europe is based only on those companies which do separate between Western and Eastern Europe. Elsewhere, there are as well some differences at North America and Asia within the companies.

Source: Oppenheim Research

MDAX stocks: Regional allocation

Company	Germany	Western Europe ex Germany	Eastern Europe	North America/ US	Latin America	Asia	Others	Comments
Aareal Bank	12%	56%	8%	17%		4%	3%	based on new commercial real estate business (diversification by region)
Altana	17%	32%		16%	8%	23%	3%	based on 9month 2007 sales, America: 24%, thereof 16% US; China 11%
AMB Generali	100%							
AWD Holding	55%	23%	22%					revenues, Eastern Europe = Austria + CEE
Beiersdorf	30%	43%		7%	7%	13%		revenues
Celesio	17%	80%	3%					based on 9m 2007 sales; UK: 27%, France 33%
Deutsche Euroshop		81%	19%					2008e with full consolidation of three shopping malls (2 Poland, 1 Hungary)
Deutz		73%		9%		4%	4%	2006 revenues; WE incl. Germany and CEE, North America incl. LatAM, others mainly include the Middle East; Europe/Africa is merged to one segment
Douglas Holding	67%	29%	3%	1%				2006/07 revenues
EADS	10%	33%		24%	3%	20%	9%	2006 sales, others is mainly MidEast will rise in upcoming years as Emirates are biggest client
Fraport	85%	10%	1%		1%	3%		Fraport intends to grow internationally via international airport tenders
Fresenius		43%		45%	4%	6%	2%	Mainly impact on sales, as high debt in US$ and high third parties interest (only 36%of FME)
GAGFAH	100%							
GEA Group	21%	37%		18%		21%	3%	2006 revenues; We incl. CEE, North America incl. LatAM, Others mainly include Africa; Asia includes Oceania
Hannover Re	15%	33%	2%	37%	1%	10%	2%	
Heidelberger Druck		44%	13%	15%	5%	22%		
Hugo Boss	22%	37%	9%	17%	2%	10%	3%	Japan 3%, US 13% + 4% Canada
IVG	80%	17%	3%					
K+S	15%	45%					40%	"others" mainly LatAm/USA/China; 2006 figs
Krones		44%	8%	26%		13%	9%	2006 revenues; WE icl. Germany, Eastern Europe is Russland/GUS; Japan/China 4%; North America incl. LAtAM; Others is Middle East/Africa
KUKA	35%	21%	3%	29%			12%	2006 revenues
Lanxess	21%	35%		27%		17%		
Leoni	47%	32%	15%			4%	8%	Asia and Eastern Europe based on Oppenheim estimates
MLP	97%	3%						sales + operating profit
MTU Aero Engines	21%	10%		42%	14%	6%	7%	2006 sales, no split within Europe
Praktiker	75%	5%	20%					
Premiere	95%	5%						estimates, 5% in Austria and Switzerland according to sales
ProSieben SAT.1 Media	65%	35%						estimates, SBS repartition still unknown
Puma	10%	34%	8%	16%	10%	19%	3%	Japan 13%
Rhön-Klinikum	100%							
Salzgitter	47%	23%	3%	12%			16%	2006 revenues; North America incl. LatAM
SGL Group	15%	34%		25%		14%	12%	Significantly higher share in Asia due to new plant in Malaysia in coming years
Stada Arzneimittel	38%	35%	23%	1%		3%		9m sales, Russian MAKIZ only consolidated from Sep, 1 onwards, thus CEE exposure actually higher
Symrise		39%	8%	18%	7%	19%	9%	Relative weight of emerging countries is increasing, Japan 4%
Südzucker	29%	67%					4%	WE incl. CEE, 92% in EU 27, ex Europe less than 5%
Techem	85%	10%	5%					revenues 2006
Tognum	20%	22%		23%		17%	18%	2006 revenues; WE incl. CEE, NA incl LatAM
Wacker Chemie	21%	30%		22%		23%	3%	WE includes EE; USA = Americas; Asia all; 2006 figs
Wincor Nixdorf	29%	51%		8%		12%		
MDAX weighted average	***31%***	***34%***	***3%***	**14%**	**2%**	**9%**	**6%**	

Note: Figures for market-cap MDAX averages are to discount as some companies do not publish their exposure to Germany any more. Thus, the German exposure is higher and the European exposure lower. Companies often do separate between Western and Eastern Europe.Elsewhere, there are as well some differences at North America and Asia within the companies.

Source: Oppenheim Research

TecDAX stocks: Regional allocation								
Company	**Germany**	**Western Europe ex Germany**	**Eastern Europe**	**North America/ US**	**Latin America**	**Asia**	**Others**	**Comments**
AT&S		45%				55%		Oppenheim estimates
Carl Zeiss Meditec	5%	26%		44%		26%		NA includes Latin America, Asia includes Japan
Conergy	42%	43%					15%	
Drägerwerk	21%	41%		21%		10%	6%	Japan 10%
Epcos	30%	27%		8%		30%	5%	
ErSol Solar Energy	57%	17%		1%		16%		Western Europe = total Europe, Asia = China 16%
Freenet	99%							
IDS Scheer	45%	18%	18%	14%		5%		FY06; NAmerica=Americas,
Kontron		41%		32%		27%		
Morphosys		60%		37%			3%	WE incl. Asia; NA incl. LatAm
Q-Cells	47%	14%					40%	
Qiagen		37%		52%		9%	2%	WE incl. Germany and CEE
QSC	99%							
Singulus		34%		35%		28%	3%	
Software AG		58%		33%		9%		Sales 9months 2007; Europe: incl. MidEast+africa
SolarWorld	57%	22%		6%		14%	1%	
Solon	35%	65%						WE predominantly Spain
United Internet	89%	10%		2%				Oppenheim estimates
Versatel	99%							
Wirecard	69%	31%						FY06; WE incl CEE
TecDAx market-cap weighted average	***43%***	***26%***	***0%***	**15%**	**0%**	**9%**	**7%**	

Note: Figures for market-cap TecDAX averages are to discount as some companies do not publish their exposure to Germany any more. Thus, the German exposure is higher and the European exposure lower. Companies often do separate between Western and Eastern Europe. Elsewhere, there are as well some differences at North America and Asia within the companies.

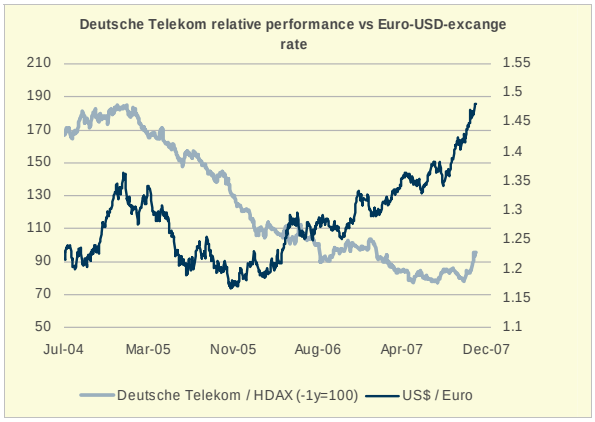
Source: Oppenheim Research

Constructing 3 baskets: domestic, US, and growth plays

Trying to simplify reality, one may build 3 clusters of stocks: firstly, the domestic plays which could outperform in case of a further rising € and/or a hard landing of the US economy; secondly, the over-proportionally US-exposed stocks which could be hit by the weakness of the US$ and the US economy; thirdly, those stocks which are over-proportionately exposed to the current growth regions CEE and Asia, and which may benefit if growth in these regions does continue, but which could be hurt if there are first signs that the engines are sputtering. Of course, the limits are fluid, particularly between the second and third group. The table below shows our allocation of the German stocks to the respective clusters. Top down, we would in general be more cautious with the US-exposed group and would go – selectively as valuation and company-specific issues are of course main drivers – for the first and third group. The assessment of the exposure to growth regions may currently still be favorable. But one has to watch closely for signs of any cooling, given the spill-over risk mentioned above. A notable cooling of the Chinese investment boom and an appreciation of the Yuan may favor consumer-dependent vs. investment–dependent stocks; the latter could be burdened. Finally, this may argue for Deutsche Telekom, Beiersdorf, Douglas, MLP, RhönKlinikum, United Internet, Henkel, and Stada.

	Domestic plays	Stocks with over-proportionate US exposure	Stocks with over-proportionated exposure to CEE and Asia
DAX	Commerzbank Deutsche Börse Deutsche Telekom Eon RWE Metro	BMW Daimler Infineon SAP Siemens ThyssenKrupp	Henkel MAN Metro VW
MDAX	AMB Beiersdorf Douglas Fraport Gagfah MLP IVG Premiere Pro7SAT1 RhönKlinikum Techem	EADS Hannover Re KUKA Lanxess MTU Aero SGL Carbon Tognum	AWD Beiersdorf Deutsche Euroshop Heideldruck Leoni Praktiker Puma Stada
TecDAX	ErSol Freenet QSC United Internet Versatel Wirecard	Carl Zeiss Meditec Qiagen Singulus Software	ErSol Solarworld AT&S

Source: Oppenheim Research



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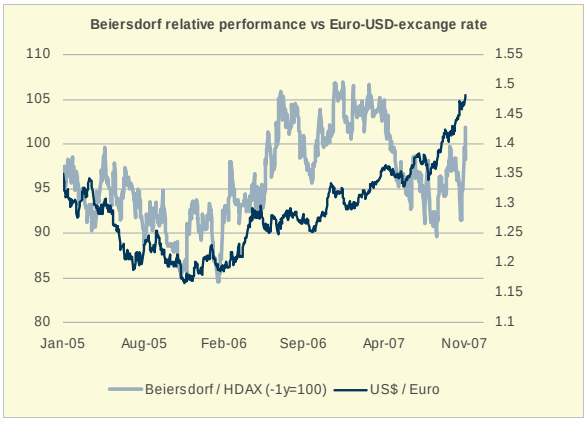

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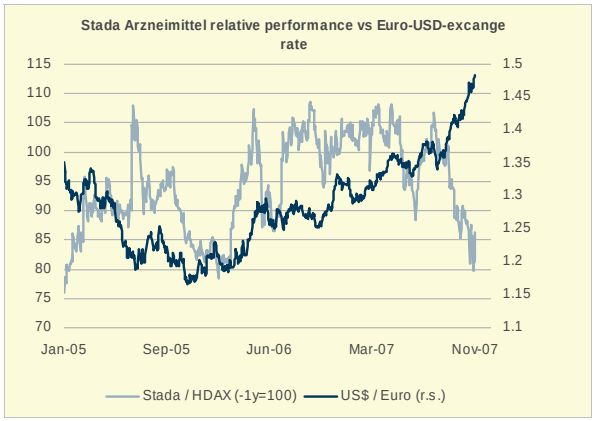

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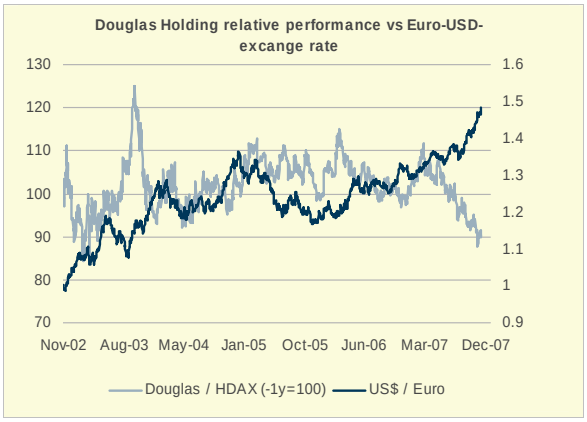

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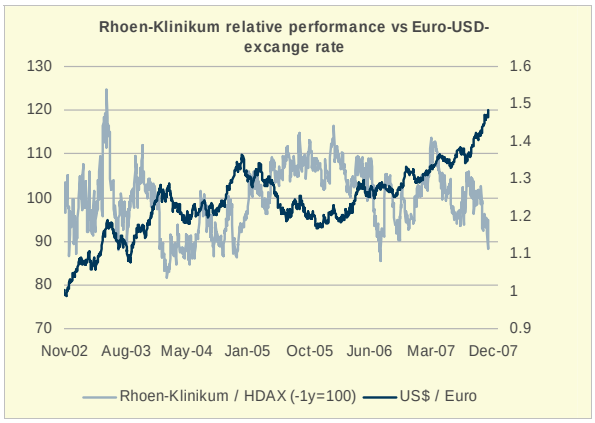

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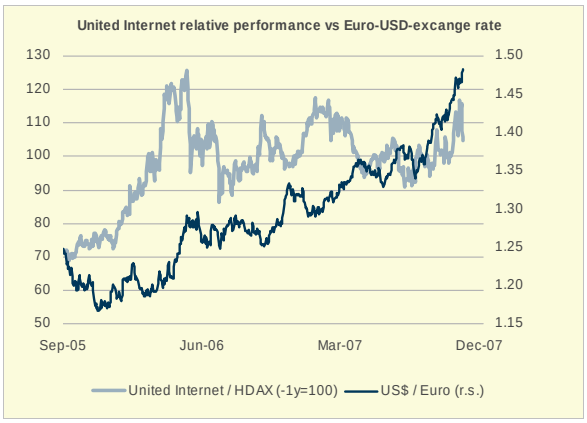

Source: Thomson Financial Datastream

China: Implications of a potential policy turnaround for European stocks

Despite the government-controlled exchange rate adjustments since 2005, the pressure on the yuan to significantly appreciate remains unchanged: A continuously rising trade surplus and the continuous growth of foreign reserves are clear indications that the yuan is still drastically undervalued.

Going forward, we expect an increase of the yuan against major trading partners. This has the positive effect that it shifts the process of the US current account adjustment process to Asia, which might dampen the upward pressure for the euro. Still, it could also have a lot of other implications that have to be taken into account for stocks in Europe.

Together with most of the major oil exporting countries and a number of other emerging markets, China belongs to a group of countries that follows an exchange rate based monetary policy with the US dollar as a nominal anchor. In this respect, these countries have become a similar kind of US dollar periphery as Europe and Japan in the early 1970s within the system of Bretton Woods.

Following a strategy of export-led growth and given the lack of reputation of emerging markets' central banks in assuring price stability, this arrangement by and large seemed to be appropriate for Asian countries until recently. Considering the continued rapid growth in China and its global macroeconomic implications (rising global demand for oil and commodities, China's vast net export overhang, the country's contribution to the demand for US dollars on global forex markets, considerably accelerating inflation within China), the appropriateness of explicit exchange rate targets has however been challenged, especially in the case of China.

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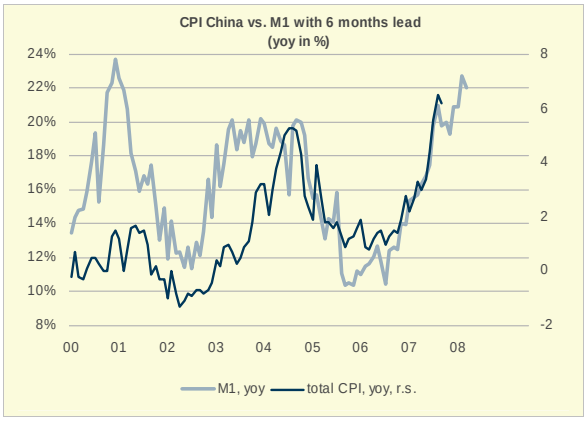

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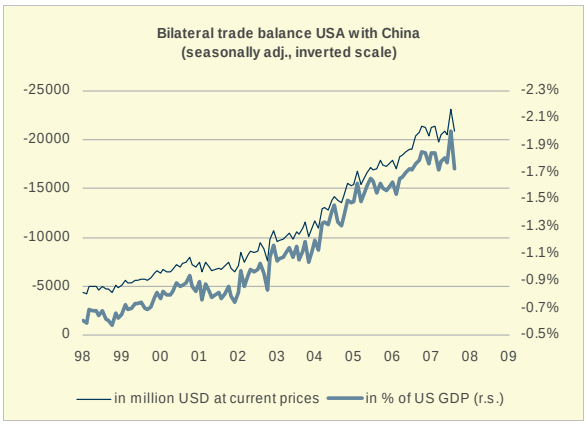

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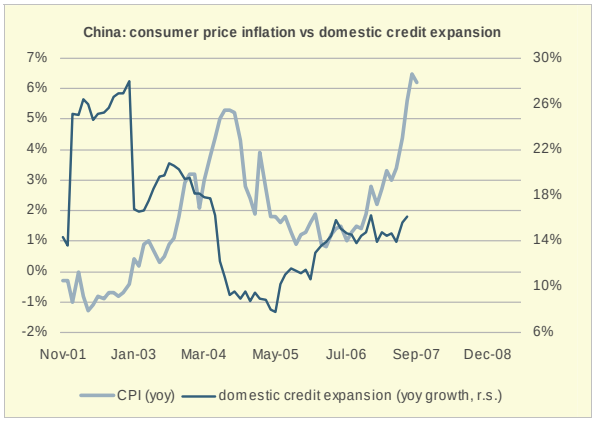
The exchange rate target implies an expansionary bias for the Chinese monetary policy, while the economy suffers from the unfavorable symptoms of overheating.

The exchange rate policy restricts the Chinese monetary authorities' sovereignty in pursuing their own monetary policy and forces them to de-facto more or less copying the US monetary policy instead. As long as the pressure on the yuan to appreciate remains while the official exchange rate target holds, they will have to accumulate further and further foreign reserves due to the intervention mechanism, thereby further inflating the money supply. Particularly given the slowing of the US economy, whereas growth is overheating in China, this becomes an increasingly serious problem for the Chinese economy: Domestic credit grew at rates of 14 to 16% over the last two years and M1 growth even accelerated from 10.5 %t in Spring 2005 to more than 22% in Autumn 2007. Based on this rapid monetary expansion, which considerably exceeded even the high GDP growth rate, inflation rose to more than 6.5% this summer, which is the highest rate for more than ten years. In addition, the structure of price increases is politically rather challenging for the Chinese government, as especially food prices, which account for roughly 37(!)% of China's CPI basket, surged by 17% this summer. In November, the state-set pump prices of fuel and gasoline were also raised by roughly 10% as a reaction to the rapid increase of crude oil prices (despite this increase, fuel prices are still well below the costs of production, causing both a permanent need for subsidies at refiners and temporary supply shortages at gas stations). In addition, China also raised the ex-factory prices for natural gas for some industrial users in November by about 50%, which negatively affects the chemical industry in particular. Prices for non-food items, in contrast, increased on average by less than 1%.

Source: Thomson Financial Datastream

Source: Thomson Financial Datastream



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Internal incentives and external political pressure both require a policy shift towards an accelerated appreciation of the yuan and more pronounced monetary tightening.

It would be in China's own interest to switch to a more flexible exchange rate mechanism, to allow the yuan to appreciate considerably faster than it has so far, and - by doing so - to allow its central bank to pursue an appropriate monetary policy to prevent the economy from further overheating and inflating. Although, in recent months, the People's Bank of China has repeatedly increased the benchmark lending and deposit rates as well as the reserve requirements of banks, the impact of these measures has been far too low to significantly cool down the overheating economy.

There is also a close connection between the re-acceleration of inflation and the current asset price inflation in China. Important interest rates, such as deposit rates, are still controlled by the Chinese government, and the interest rate level currently ranges between 3% p.a. for three month government bonds and 4.6% for ten year government bonds (as of November 2007). As these nominal rates are significantly lower than the recent 6% inflation rate, Chinese depositors face negative real interest rates. This encourages them to look for higher yielding assets and to put their money into stocks. In addition to the recent enthusiastic sentiment for stocks, this has contributed to the massive inflows to the Chinese stock market that have taken place in recent months with the consequence of a rather inflated market. In an analogous manner, the relative unattractiveness of government bonds and saving deposits has also contributed to price inflation on the Chinese real estate market. In August, property prices on average increased by more than 8% year on year, and in some major cities such as Beijing or Shenzhen, even by up to 16%.

	Shanghai A (RMB-based)	Shanghai B (USD-based)
Performance 1y	213.8%	248.5%
PE (12m fwd)	34.4	29.1
PE (2007)	30.9	39.5
PE (2008)	24.4	31.5
PE (2009)	20.2	26.1
Earnings growth (2007-08)	26.5%	25.4%
Earnings growth (2008-09)	9.9%	20.7%
Earnings yield (12m fwd)	2.9%	3.4%
10y benchmark bond yield	4.5%	4.5%
(all earnings items based on IBES estimates)		

Source: Thomson Financial Datastream

Finally, excess liquidity and the low / negative real interest rate keep distorting not only the incentives for real estate and stock market investments, but also for fixed investments in manufacturing. This has contributed to large overcapacities in some sectors (e.g. aluminum, steel).

In addition to China's internal incentives for a significant monetary tightening, there is also substantial political pressure from outside China that is urging a turnaround in China's exchange rate policy and this could even become more pronounced in the run-up to next year's US presidential elections (e.g. in July this year four US key senators announced a bill with the objective to officially denote and take action against the Chinese "currency manipulation").

To sum it up, both China's internal policy incentives and continuing external political pressure clearly point to a policy switch to a combination of more flexible exchange rates and a tighter, anti-inflationary monetary policy.

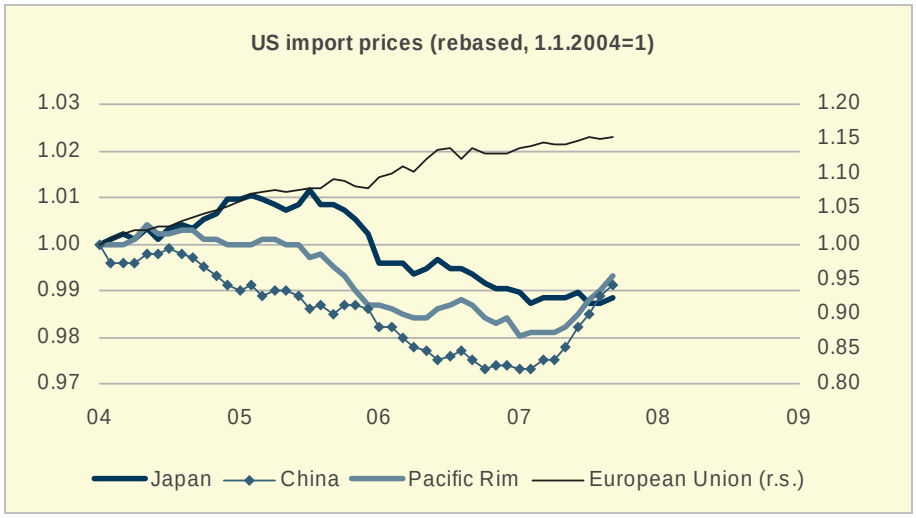
What would be the consequences and investment implications of such a step for European players? The most obvious textbook answer to this question is "Chinese exports would decline, and Chinese imports would increase". In fact, however, the implications are not that simple and straightforward, and there are some further details to consider.

Increasing export prices from China would improve the competitive position of European players in some sectors, but higher input costs could hurt others.

An appreciation of the yuan would directly increase Chinese export prices and lower its import prices. It would improve the situation of Western companies that compete with Chinese exporters on the world market – which is exactly what, e.g. European steel makers, are currently aiming at. From their customers' point of view, however, this would be negative, as lower competition on the supply side tends to increase the input costs in upper segments of the value chain. In addition, an appreciating yuan would reduce the windfall profits for European companies that have shifted their production/supply to China without transferring the full cut in production costs to their customers (e.g. sport shoes as in the case of Adidas or textiles as in the case of H&M).

The anti-inflationary bias of cheap imports from emerging markets such as China has already started to peter out.

From a macro perspective, rising import prices from China also have a downside. While low import prices from China in recent years used to support low inflation both in the USA and in Europe, this positive impact has already started to vanish, with the important negative side effect of thereby restraining the scope for further monetary easing by the Fed, and also by the ECB. In fact, such a turn-around in import prices has already started to become visible in the US. As of November 2007, US import prices from China were up 2.2% year on year and 0.3% from October. While the state-controlled appreciation of the yuan within the announced band may already have contributed to this, there are also other important factors that add to this development: Wages in Chinese manufacturing rose on average at rates of roughly 19% p.a. in recent years (see chart on page 59), and are to an increasing extent passed through to export customers. Furthermore, the structure of Chinese exports has also changed in recent years, for example in that Chinese exports include a gradually increasing share of higher quality and higher margin products than we were used to in the past.



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Lower import prices would increase China's import demand…

In the course of an accelerated yuan appreciation, the relative price of European goods becomes cheaper on the global markets from China's point of view. In combination with the assumption of steadily rising household incomes in China, this would have a direct positive effect for European exporters, e.g. in the auto sector and at luxury consumer goods which we would rather play with the latter.

…but at the same time, a monetary tightening and economic cooling would dampen the demand for further fixed investments in China. Such a negative income effect may well over-compensate the positive price and substitution effect of a yuan appreciation on the European export industry.

In addition, stricter monetary tightening in China – though predominantly aiming at fighting inflation – would also imply a slowdown of growth in China. This would imply a negative impact on both Chinese consumption and probably even more at fixed investment spending. Particularly engineering stocks are still to a large degree driven by the high demand for capital goods in emerging markets, particularly in China, and by the hope that continued high growth rates in these countries will compensate for potential shortfalls in US and European demand (see page 45ff on decoupling).

Moreover, risks remain that growth in China may suffer even without accelerated monetary tightening due to lower exports to the US and going along with that lower investment spending. According to WTO data for 2006, 21% of total Chinese exports were destined for the US, with the most part of it consisting of manufactured goods (some 94% of total Chinese exports are manufactured goods; for a closer analysis of the trade between China and the US see page 49).

Secondly, there is a considerable risk of a potential sharp decline of Chinese equity prices. Though the direct links between the Chinese stock market and the global capital markets are rather limited, one should keep in mind that among the world's six largest stocks (measured by market value) three are now from China (Petrochina, China Mobil, Industrial & Commercial Bank of China) and that in recent months the rising earnings of Chinese companies were at least partially based on reported financial gains from mutual equity holdings. Furthermore, there is also the risk that the financial losses in combination with the increased prices for food and gasoline could also imply the risk of potential political instability. A strong decline at Chinese equities would also dampen current hopes that global growth can decouple from the US even though the direct implications for growth in China are rather limited.

A shift from the US dollar to the Euro within China's foreign reserves portfolio would be a further drag for dollar-sensitive stocks.

In addition to the trade effects discussed above, the Chinese exchange rate policy may crucially affect European players also in another way. Although the currency composition of China's foreign exchange reserves is not published by the authorities, market estimates of the US dollar share in the People's Bank of China's reserves portfolio (which amounts to roughly 1.43 trillion USD in total, including gold, as of September 2007) vary between 60% and 75%. In the recent past, new reserve purchases seem to have taken place also predominantly in US dollars at a similar fraction, leaving the dollar share of total reserves rather constant over time. This means that China so far has contributed to a steady demand for US dollars on global currency markets, which helped the US dollar not only vis-à-vis the yuan, but also relative to other currencies such as the euro. This support for the US dollar may, however, gradually disappear looking forward. With the weakening of the US Dollar in the course of slowing growth and monetary easing in the US, the Chinese authorities' incentives to stick to the US dollar as a major nominal anchor and reserve currency fade away, while the advantages of a further gradual currency diversification of the reserve portfolio increase. Such a step would imply an increasing demand for euros (and other major currencies) on the global forex markets, leading to a further appreciation of the euro. In fact, China has already been active in reshuffling its reserves in recent months. E.g., looking at US treasury data, China now owns some 400 billion US dollars in US treasuries (some 18% of total holdings by foreigners). This is down by some 20 billion dollars or 5% vs the cyclical peak in March. This story seems to have already contributed to the rise of the euro versus the dollar in October / November and it is at least compensating the positive impact that goes along with the shift of the US current account adjustment to Asia.

M&A: less support for stocks in general, smaller deals will dominate

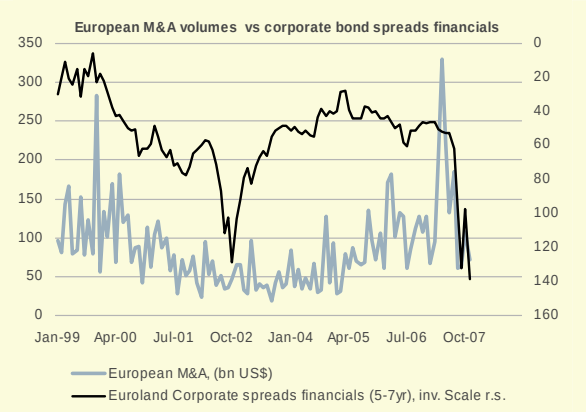
Breathtaking shift at M&A

The impact of M&A has witnessed a notable shift: In H1, it was one of the major drivers for stock markets fuelled by record M&A activity and breathtaking bidding wars, even at large caps. However, after the start of the credit crisis in summer 2007, along with the sharply risen risk aversion at credit investors, M&A volumes plummeted. In some cases, it was even negative for single stocks, as previously announced deals had been cancelled and hopes for take-overs by private equity had been reduced (e.g. at Infineon, Conti). The outlook on M&A is dominated by interest rates respective credit spreads and by the outlook on the business cycle.

We draw three implications:

Total M&A volume will increase only moderately from current low levels

1. The sharply risen risk aversion among credit investors will most likely only gradually be reduced. Driven by more rate cuts by the Fed, some more risk-taking may again be expected. Credit spreads at banks – which are currently at record high levels – should come down somewhat further as well down the road. This should lead to rising M&A activity from current outright low levels. Relative to the market cap, European M&A is around the cyclical lows seen in 2003 (see charts below). However, as risk-taking by credit investors, and thus securitization volumes, will remain sluggish compared to H1 2007 levels, there will be no return to the goldilocks levels back then. Given the constraints at banks, they will be much more selective in the financing of leverage. As a result, total leverage will be reduced, with total M&A volumes increase only moderately. Moreover, as there are downside risks for the outlook on the business cycle, a sharp reacceleration of M&A should not be expected, as usually business expectations and M&A activity run in sync. Thus, M&A should offer no support for stock markets in general.



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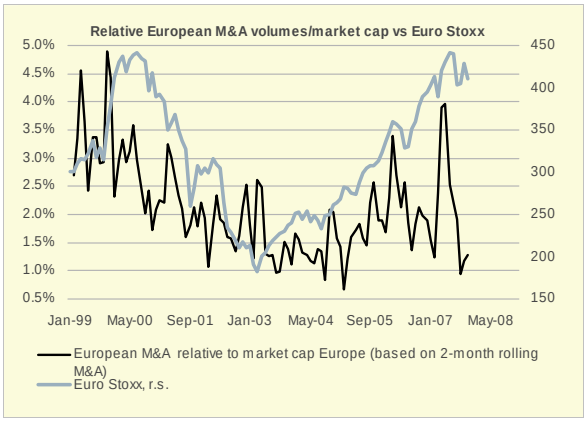

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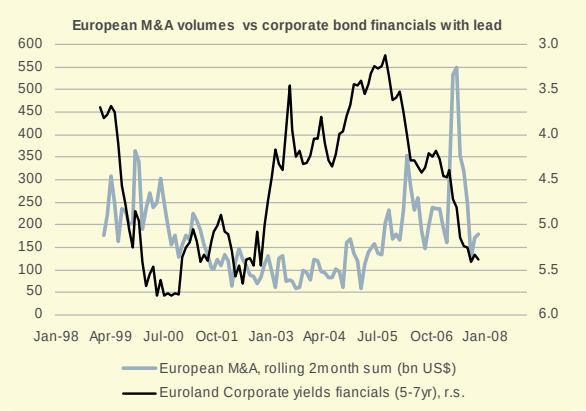

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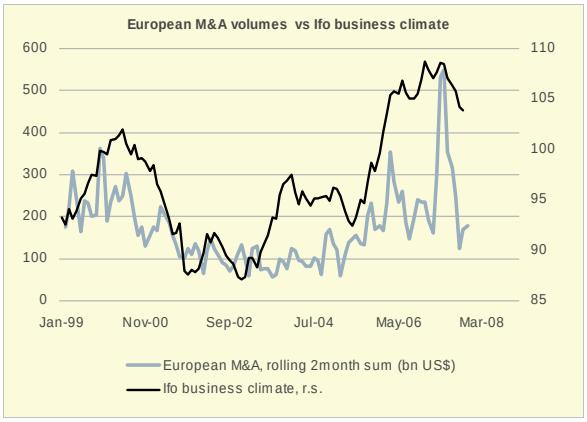

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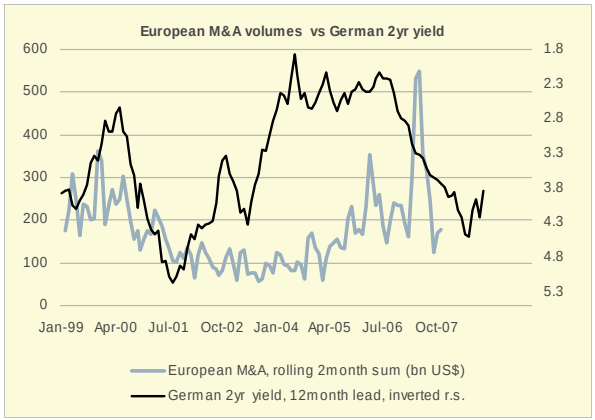

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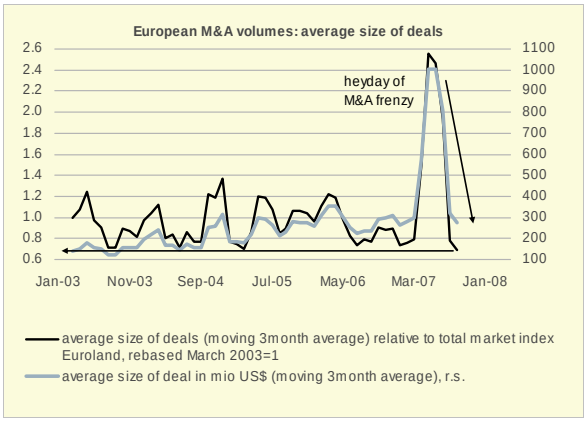


Source: Thomson Financial Datastream

Shift from financial to strategic investors who will go for smaller deals

2. There will be a shift from financial investors to strategic investors. This trend of recent months will continue. The average leverage in the upcoming deals will be significantly lower than in H1 2007 due to the aforementioned risk aversion. Financial investors, i.e. hedge funds and private equity, depend on leverage. The spread at financials rose to a multi-year high (e.g. higher than during the market lows in 2003). Bond yields at financials, which may be used as a crude proxy for the refinancing costs of financial investors, are on average around 5.40% (which

is only slightly below the levels in H2 2000). This is a sharp increase after 2005 (average 3.40%) and 2006 (4.15%). Back then, financial investors could make profits by cashing in the differential between high free cash flow yields of their targets and their low refinancing costs. As this spread has come under pressure from two sides (refinancing costs rose by 200bps and free cash flow yields declined in a lot of cases), financial investors face difficult tasks. As the cyclical outlook is now deteriorating, the margin of safety at this yield differential needs to be higher, particularly at cyclical stocks. On the other side, strategic investors had been increasingly paying with cash. Given their often strong balance sheets, they are less dependent on debt. Thus, strategic investors should be more able to use share price declines for M&A.

3. The average deal size will be significantly smaller than in the past. This has already been visible as well in the recent months. Adjusted for stock price gains, the average deal size was at 5-year lows in October (see chart above). Due to the lower leverage, deals at big caps should become less frequent. The days when private equity had been targeting even higher ranking DAX companies – or at least had been rumored to be doing so – will most likely not pop up again in the upcoming quarters. However, takeovers at small and mid caps should still remain within reach, particularly for cash-rich strategic investors.

Thus, strategic investors eyeing small and midcaps should remain a topic for 2008. The table below summarizes some stocks for which our colleagues have a positive rating, and in addition can imagine a take-over further down the road. Although a take-over is in no single case the crucial driver for the buy rating, it is an add-on.

Candidates on the radarscreen of strategic investors

Company	PE 2008	Market cap (mio euro)	Rating	Ownership > 5% (based on Reuters latest updates)	Rationale
Balda	21.7	462	BUY	15.0% Chiang Yun Ling 10.0% Sapinda	Sum of the parts > market cap: Sale of plastic segment; growing touch screen segment potential acquisition target once the business gains momentum and visibility (e.g. Sharp, Wintek, Hon Hai, Innolux).
Demag Cranes	8.7	619	STRONG BUY	100% Freefloat	Demag's Port Technology is interesting asset for several strategic buyers (e.g. Kion, Cargotec); sum-of-the-parts valuation shows that Demag's current EV of around €800m is already constituted by the well performing segments Industrial Cranes and Services, i.e. Port Technology is implicitly valued for an EV of zero. Could be interesting as well for financial investors given low capex ratio and high free cash flow yield (2008 > 9%)
Escada	21.6	414	BUY	25.4% Finartis Group SA 10.0% Wolfgang Ley	Strategic investors could be interested. Top luxury companies (e.g. LVMH) could turn the underperfomance in the accessoire business. Short-term less likely as Aksenenko has installed former LVMH top manager as CEO, but sale is long-term perspective.
Kontron	17.3	753	BUY	4% Management	General Electric and Emerson Electric bought competitors of Kontron and are seeking further (exterenal) growth at embedded computers.
Kuka	11.6	676	BUY	Wyser-Pratte 9.7% Union-Investment 5.5% Oppenheimer 5.2% LBBW 5.1%	Interesting for financial investors: high ROCE, net cash > 0, low capital intensity and high free cash flow yield (8%) allows share buy-backs
Stada	13.0	2,354	STRONG BUY	100% Free float	Ongoing consolidation trend in industry. Strategic investor possible as e.g. Teva, Mylan, Watson or Actavis.
Financials:					
Deutsche Postbank	13.4	26,974	BUY	50.0% Deutsche Post	Take-over target as Deutsche Post is likely to sell its stake midterm (cooperation with Postbank does not require 50% stake). Strong interest by strategic investors likely seeking exposure to German retail banking (e.g. Citigroup, but Deutsche Bank as well).

Source: Oppenheim Research

Solid return to shareholders supports stocks

DAX companies return some €45bn to shareholders

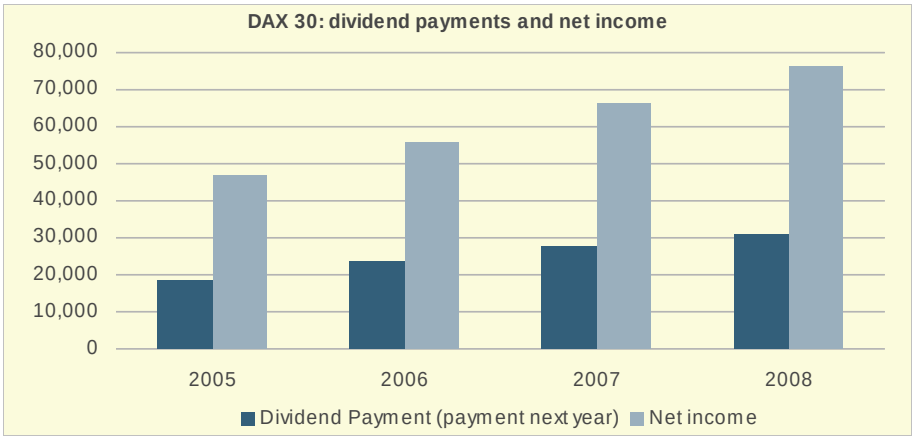
Returns to shareholders should be a cushion for stocks next year. For the DAX, dividends of some €27.8bn are to be expected, up by 18% vs last year (see chart below). Roughly €16bn due to share buy backs (including €6bn at Daimler) can be added. This sums up to a yield of 4.2%, which is above the current 10yr bond yield. Thus, the topic should be positive for stocks. Free cash flow yield to equity for the DAX industrials is at 4.5%, and thus the return to shareholders including share buy backs is covered by the current estimates of our analysts. In 2008, more than one third of total return to shareholders is stemming from share buy-backs. Although we have no time-series on share buy backs in Germany, this ratio should be a record in history, as in the past this instrument has been less used in Germany. In particular, German companies tried in the past to avoid undershooting past dividend payments. Thus, the fact that a rising share of the free cash flow is distributed to shareholders via share buy-backs, which are more temporary vs the dividends which investors often perceive as sustainable, reflects some caution from companies. But nevertheless, dividend payments in 2007 are expected to rise by 19% - which is a positive signal. In a year with a sluggish over-all performance, return to shareholders could be a crucial part of the total performance. Thus, it may now make more sense to screen for high yielding stocks respective to stocks with upside surprises, compared to years with a strong stock price expectation.

Lufthansa, Deutsche Telekom, Dt Post, Dt Bank, and insurers offer high yields

Looking at the DAX, dividend yields at 6 stocks are above the 10yr bond yield (Lufthansa, Deutsche Bank, Deutsche Telekom, Hypo Real Estate, Deutsche Post, Munich Re). We recommend 5 stocks. At Hypo Real Estate (neutral), there are notable uncertainties due to the ongoing risk aversion at inter-banking markets which could finally pose some refinancing problems for the bank. The dividend estimates at the non-financials are solidly covered by the free cash flows. Payout ratio at DPW is highest with 83%. Due to the depreciation-dragged low EPS at DTE, payout ratio is high based on EPS, but low based on FCF. In all cases, we regard the dividends as safe. (In case of DPW, it is tax-free for retail investors.) There are some risks at HypoRealEstate; consensus expects a slightly higher DPS than we do. In contrast, dividends at Deutsche Bank should be safer. The stock is offering the second highest yield in the DAX. Besides that, we regard the yields at Allianz (3.7% based on a pay-out ratio of 28%) as appealing, although consensus is expecting a slightly higher dividend.

Upside surprises at Merck possible

Stocks with currently low yields but low pay-out ratios offering upside surprises could move as well to investors' focus. This could be the case at Merck, where we expect a total dividend of €2.45, including a special dividend of €1.50 due to the sale of the generic business, while consensus is still going for €1.37. The resulting dividend yield of 2.8% is relative high for a growth stock.



Source: Oppenheim Research

DAX: dividends, free cash flow yield - ranked according to dividend yield 2008

Name	Rating	Dividend per share 2006	Dividend per share 2007	Dividend per share 2008	Dividend yield 2008 (payment in 08, Oppenheim estimates)	Free Cash Flow Yield (to share-holder) 2008	Payout ratio I: DPS/EPS 2007 (payment 08)	Payout ratio II: DPS/FCF per share 2008 (payment 08)	Enterprise value/ market cap 2007	Comment on dividends	Comment on share buy-backs
		payment next year									
Deutsche Lufthansa (5)	BUY	0.70	1.04	1.00	5.8%	8.0%	42%	72%	78%	potential additional payout from sale of TC already priced in	nothing to expect
Deutsche Bank (5)	BUY	4.00	4.70	4.80	5.6%		44%			Mininum for 2008 payment: last year (€4,00) respective 37% payout ratio. Upside surprise for consensus and investors possible	currently no topic
Deutsche Telekom (5)	BUY	0.72	0.72	0.72	4.7%	10.0%	140%	48%	195%	Oppenheim DPS 07e €0.02 above consensus. No upside surprise compared to our estimates due to lower EPS. High yield offers support for stock.	
Hypo Real Estate (5)	NEUTRAL	1.50	1.50	1.50	4.4%		33%			High dependancy on wholesale funding poses notable risks with current risk premia at interbanking markets	
Deutsche Post (5)	BUY	0.75	0.90	1.05	4.0%	4.9%	53%	83%	145%	DPW already announced for DPW to pay for 07 €0.90 div. (+20%)	The company will buy back within the next 2 years at least some €1bn of shares using the money from asset dispsoals - as the price for the assets might also be €1bn and they might in addition get some €1bn back in 08 from a EU trial - then they might spend up to €2.5bn for share buy-backs
Munich Re (5)	BUY	4.50	4.75	4.85	4.0%		29%				€5bn total share buy-back from 2007-09 including dividends (some 6.5% p.a.)
RWE (4,5,7)	BUY	3.50	3.50	5.00	3.8%	2.6%	58%	149%	146%	50-60% payout target for 2007	share buy back will only be started once American Water is sold; expected for H1 2008!
BMW (5)	BUY	0.70	1.50	1.60	3.7%	7.7%	33%	48%	89%	BMW said they want to let shareholders participate more. This is reflected in the div. Estimate; could pay more as well (€2, but €1.7 best estimate)	Does not want to do new buy back over the next 18 months
Allianz (5)	STRONG BUY	3.80	5.00	5.50	3.7%		28%			Mid-term target 30% pay-out ratio. 2007 not likely (due to minority buyout, AGF solvability ratio declined), but 2008	no share buy-back
ThyssenKrupp (4,5)	BUY	1.00	1.35	1.45	3.6%	7.8%	28%	46%	131%	upside surprise for consensus possible	nothing to expect, high investments
BASF (5)	NEUTRAL	3.00	3.10	3.15	3.3%	8.3%	40%	40%	127%	No big upside at dividends likely, possible leeway via share buy-back likely	Current share buy back program: €3bn for 2007/08 (some 6.5% of market cap)
Commerzbank (5)	NEUTRAL	0.75	0.75	0.80	3.1%		32%				
Daimler (5)	STRONG BUY	1.50	2.00	2.50	3.1%	8.4%	52%	37%	59%	Said will pay more dividend but no concrete number	10% buy back over the next 12 months, likely to do more thereafter
E.ON (5)	BUY	3.35	3.90	4.15	2.8%	-12.7%	47%	-22%	93%	E.ON is comitted to a 50-60% pay out on adjusted net income and an average dividend growth of 10-20% within the coming years.	current share buy back program of €7bn - should amount to some 51million shares or 7-8% of the total equity - 50% of SBB should be finalized at the end of 2007. For the future, the company will consider special dividends or SBB if balance sheet is overcapitalized
Bayer (5,9)	STRONG BUY	1.00	1.60	1.70	2.8%	6.9%	41%	41%	131%	Mgt. already said EUR3 dividend to be the base level.	EUR3bn in 2007 and 2008
Merck KGaA (5)	BUY	1.05	2.45	1.20	2.8%	7.1%	45%	39%	110%	Sale of generic business (€5bn) enables notable upside surprise to consensus estimates via special dividend (regular €0.95 + €1.50 bonus)	
Deutsche Postbank (2,5,7)	BUY	1.25	1.50	1.80	2.5%		44%				
MAN (5)	NEUTRAL	2.00	2.55	3.10	2.4%	7.4%	35%	32%	104%		
Continental (5)	BUY	2.00	2.00	2.00	2.3%	-1.9%	24%	-123%	110%	After acquisition higher dividend not likely	no, after acquisition
Siemens (5)	BUY	1.50	2.00	2.20	2.0%	13.9%	47%	15%	111%	Opp estimate already significantly above consensus. Given high share buy back program, no upside surprise compared to our estimates likely. Total shareholder return cushion for stock	Program announced: €8.5bn for 2008-10 (some 10% of market cap)
Linde (5)	NEUTRAL	1.50	1.60	1.70	1.9%	7.4%	40%	26%	140%	conservative dividend policy will be maintained	First priority: debt reduction
Deutsche Börse (5)	BUY	3.40	2.14	2.88	1.8%	-3.2%	52%	-56%	97%		Share buy back already running - extension is most likely - 50% pay out is meanwhile typical
Metro (5)	NEUTRAL	1.10	1.10	1.20	1.8%	-0.2%	38%	-860%	149%	some upside to dividend estimate possible, but MEO still no high yielder	
TUI (5)	NEUTRAL	0.00	0.30	0.60	1.7%	11.6%	43%	14%	203%	return to dividend announced, no surprise though consensus does not appear to be updated yet	
Volkswagen (5)	NEUTRAL	1.15	2.50	4.00	1.6%	4.8%	24%	33%	80%	Strong dividend increase likely due to strong free cash and Porsche's probable desire to fund VW stake.	Possible but less likely, dividend and funding of pension liabilities seem to have a higher priority.
Henkel (5)	BUY	0.48	0.53	0.58	1.5%	6.5%	24%	22%	115%	FCF estimates do not include National starch adhesives acquisition (€4bn); no major surprise likely, which would move Henkel into high-yielding territory	
SAP (5)	NEUTRAL	0.46	0.48	0.58	1.4%	5.4%	30%	26%	89%		
FMC (5,9)	STRONG BUY	0.42	0.46	0.50	1.3%	2.9%	28%	44%	139%	no surprise expected	no share buy back, company intends to grow
adidas (5)	BUY	0.42	0.50	0.63	1.1%	5.3%	19%	21%	122%		
Infineon Technology (5)	NEUTRAL	0.00	0.00	0.00	0.0%	-6.1%	0%	0%	81%	Loss making	
				weighted DAX 24 ex financials							
DAX 30					2.7%	4.4%					

Source: Oppenheim Research (*) Disclosure Number, see Page 130

At MDAX, dividend yields are less appealing – Douglas could be interesting

At the MDAX return to share holder is a less important topic compared to the DAX. Only 7 stocks are yielding above 4%. Even after the recent MDAX selling, the expected payments in 2008 yield only 2.1% (see table below). As well free cash flow yield 2008 of 3.6% is below the DAX figure. Our analysts are more on the cautious side. At AWD and ProSieben the high yield is based on very high and unsustainable pay-out ratios. At Gagfah, half of dividends are paid out of equity – this is medium term, and not sustainable in the long term. MLP looks more appealing as the yield of 4.8% is based on a pay-out ratio slightly below the target ratio of the company of 60%; thus it should be relative safe.

Douglas´ yield is relative high with 3.0% given the ongoing investments of the company. Moreover, it should be safe given a pay-out ratio of some 50%.

MDAX: dividends, free cash flow yield - ranked according to dividend yield 2008

Stock	Rating	Dividend per share 2006	Dividend per share 2007	Dividend per share 2008	Dividend yield 2008 (payment in 08, Oppenheim estimates)	Free Cash Flow Yield (to shareholder) 2008	Payout ratio I: DPS/EPS 2007 (payment 08)	Payout ratio II: DPS/FCF per share 2008 (payment 08)	Enterprise value/market cap 2007	Comment on dividends	Comment on share buy-backs
		payment next year									
GAGFAH (5,7)	NEUTRAL	0.59	0.75	0.82	7.0%		25%	-15%			No, company wants to grow
AWD Holding	REDUCE	1.30	1.36	1.56	6.7%	7.6%	89%	88%	84%	higher pay out ratio more likely….	than share buy-backs
ProSieben SAT.1 Media (3,5)	NEUTRAL	0.89	1.04	1.17	6.3%	10.9%	81%	58%			
Hannover Re (5)	NEUTRAL	1.60	1.80	1.65	5.9%		44%				
MLP (5)	BUY	0.35	0.41	0.53	4.8%	9.5%	55%	51%	167%	target at pay-out ratio: 60%	share buy-back announced
Heidelberger Druck (5)	BUY	0.95	0.95	1.00	4.6%	8.9%	42%	52%	132%		old program finished, new one currently less likely
Deutsche Euroshop (5)	BUY	2.10	1.05	1.08	4.3%		46%	-33%			No - company needs money for new shopping center investments
Südzucker (2,5)	NEUTRAL	0.55	0.55	0.55	3.6%		232%		350%		
Hugo Boss (5)	BUY	1.20	1.40	1.50	3.3%		64%		103%		
Techem (7)	NEUTRAL	2.00	1.79	2.32	3.0%	4.0%	85%	76%	126%		
IVG (1,3,4,5,6,7)	STRONG BUY	0.50	0.75	0.85	3.0%		36%	-9%			unlikely
Aareal Bank (5)	BUY	0.50	0.75	0.80	3.0%		32%				
Douglas Holding (3,4,5,6,7)	BUY	1.10	1.20	1.40	3.0%	0.2%	51%	1467%	121%	dividend is safe and relative high for growth profile	
Praktiker (5)	NEUTRAL	0.50	0.55	0.60	2.8%	2.8%	37%	100%	94%		
Tognum (2,5,8)	BUY	0.00	0.48	0.65	2.7%	6.5%	31%	41%	130%		
Wincor Nixdorf (5)	NEUTRAL	1.05	1.40	1.70	2.4%	5.6%	39%	43%	109%	Given strong cash flow generation a special dividend becomes a possibility in 2008. Would be a positive surprise as the focus currently is on the negative consequences of the sub prime.	
MTU Aero Engines (5)	NEUTRAL	0.82	0.85	0.90	2.4%	6.8%	29%	35%	127%		
Leoni (5)	BUY	0.80	0.80	0.97	2.3%	-16.2%	30%	-14%	124%		
AMB Generali (5,7)	NO RATING	2.00	2.20	2.42	2.2%		30%				
Deutz	BUY	0.00	0.15	0.25	2.1%	4.5%	33%	47%	114%		
Stada Arzneimittel (5)	STRONG BUY	0.62	0.85	1.10	2.1%	3.4%	35%	62%	141%		
Celesio (5)	NEUTRAL	0.75	0.80	0.90	2.1%	1.9%	31%	111%	134%		
Fraport (5)	NEUTRAL	1.15	1.07	1.15	2.1%	-19.4%	49%	-11%	101%	Dividend for 07 will be close to stable compared to last year	As the company is ahead of the high capex spending for expansion, they will not come with a buy-back program in the near future
KUKA (5)	BUY	0.00	0.50	0.70	2.0%	7.8%	27%	25%	91%		
K+S (5)	NEUTRAL	2.00	2.20	2.40	1.9%	3.8%	50%	50%	107%		
Altana (5)	BUY	0.77	0.30	0.32	1.8%	5.5%	31%	33%	116%		
Puma (5)	NEUTRAL	2.50	5.00	7.00	1.8%	6.1%	29%	30%	92%		
Symrise (2,5,7)	BUY	0.00	0.32	0.35	1.7%	7.2%	30%	24%	131%	pay-out ratio of around 30% is guided	
Lanxess (5,9)	BUY	0.25	0.50	0.60	1.7%	3.9%	16%	45%	128%	No announcement given.	External growth has a higher priority; however if there will be no target, likelihood of a share buyback program is high
Wacker Chemie (5)	REDUCE	2.50	2.80	2.90	1.6%	2.0%	32%	83%	108%		
GEA Group (4,5)	BUY	0.00	0.35	0.50	1.6%	4.1%	26%	38%	112%		
Salzgitter (5)	BUY	2.00	1.50	1.50	1.4%	11.0%	11%	13%	94%	Could easily pay something, but management prefers firepower for acquisitions. Thus, no major surprise likely.	Very minor
Rhön-Klinikum	BUY	0.25	0.28	0.30	1.4%	-0.3%	26%	-420%	141%		No. Company wants to grow
Beiersdorf (5)	BUY	0.60	0.70	0.80	1.3%	5.1%	30%	26%	91%		
Fresenius (5,9)	BUY	0.57	0.67	0.78	1.3%	7.3%	26%	17%	261%		No company wants to grow
Krones	NEUTRAL	0.53	0.57	0.60	1.1%	6.5%	18%	17%	112%		
EADS (5)	NEUTRAL	0.12	0.12	0.20	0.6%	4.2%	-22%	13%	61%		
Premiere (5)	NEUTRAL	0.00	0.00	0.00	0.0%		0%		114%		
SGL Group (3,5)	BUY	0.00	0.00	0.25	0.0%	5.3%	0%	0%		Payment of a first (small) dividend may start next year	High investments in Asia (GE) and Europe (Carbon fibers) will not allow for share buybacks
MDAX					2.1%	3.6%					

Source: Oppenheim Research(*) Disclosure Number, see Page 130

German politics: No more substantial reform steps are to be expected

When Franz Müntefering (SPD) stepped down from his positions as Federal Minister of Labor and Social Affairs and Vice-Chancellor on November 13, he caused ample speculations about the future positioning of the SPD and concerns about the future of the governing coalition with the CDU/CSU. Although official statements refer to personal reasons, Müntefering's resignation is widely seen as a consequence of the political headwinds that he faced both within the SPD and in the coalition committee. Not willing to give up the achievements of the "Agenda 2010" reform policy, but confronted with a strengthening left wing within the SPD, he recently failed in an SPD internal struggle with Kurt Beck on the question of a prolonged disbursement of unemployment compensation for older jobseekers, and just the night before his resignation he suffered a political defeat within the Cabinet against Chancellor Angela Merkel in the negotiations over minimum wages for the German postal market.

Franz Müntefering was a reliable ally for Chancellor Merkel in the grand coalition and used to remain closely in line with the Agenda 2010 reforms despite the overall leftward turn within the SPD, …

As Franz Müntefering has been broadly considered an important and influential pillar of the SPD who made a stand against a further considerable turn leftward within the party, his resignation causes concerns that the SPD will continue to gradually turn away from its reform-oriented policy and, in particular, from the recent labor market reforms that have just started to show their positive effects on the German economy. A further swing to the left will inevitably cause conflicts within the coalition and may well put the whole coalition into question.

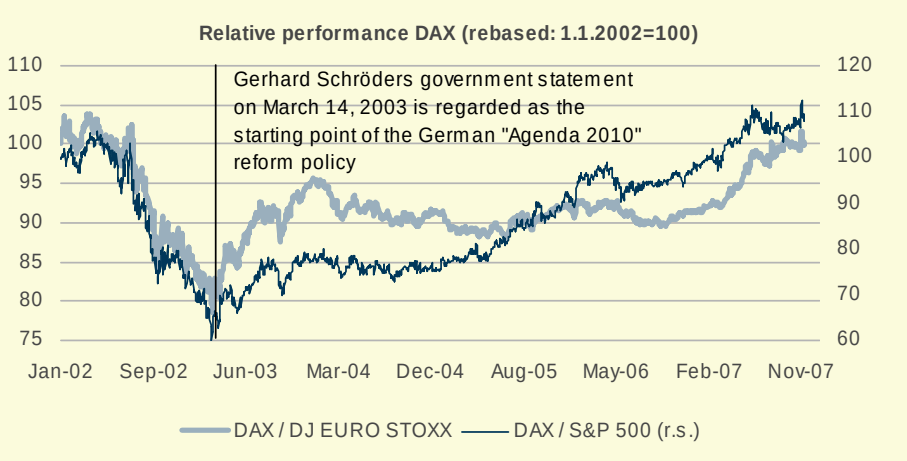
The close cooperation of Chancellor Merkel and Vice Chancellor Müntefering has contributed much to the stability of the German government in the recent past and negotiations within the coalition might now well become notably tougher without him. In particular, Angela Merkel and the CDU/CSU have lost their most reliable ally within the SPD in supporting the continuation of the Agenda 2010. They will now find it increasingly difficult to get their business-friendly policy agenda and their commitment not to recede from economically necessary welfare cuts accepted within the coalition.

… his resignation will give way for increasing divergences among the coalition partners – which may well bring the government's policy agenda to a halt.

Having this in mind, there are now basically two possible scenarios for the future of the German government. Our base scenario is that the coalition will persist, but that a number of economically important decisions will not be achieved due to increasingly diverging positions among the coalition partners. Of course, several parts of the grand coalition's policy schedule have already been completed, e.g., the recent increase in retirement age from 65 to 67 and the cutting of non-wage labor costs that has already taken effect since January 2007. Yet, there are still a number of institutional changes left on the agenda that would have been difficult to reach an agreement on, even if Franz Müntefering had remained in the cabinet.

Against this background, it is worth highlighting that the initiation of the Agenda 2010 reform is regarded as having contributed substantially to the outperformance of German stocks from 2003 onwards (see figure below). A stagnation or even selective reversion of the Agenda 2010 reform policy would cause this supportive factor for German stocks to expire.

Although the main driver was the rebound of global stock markets, the initiation of the Agenda 2010 reform has contributed to the outperformance of German stocks



Source: Thomson Financial Datastream

An alternative policy scenario implies that the divergences between CDU/CSU and SPD might increase to such an extent, that a destabilization of the government requires a re-election ahead of schedule (the next elections for the Bundestag are currently scheduled for September 2009, see the table below for the timing and current opinion surveys on forthcoming parliamentary elections on both the state and the federal level in Germany).

However, re-elections for the German Bundestag currently seem rather unlikely, yet not impossible. According to the German constitution the Bundestag has no right to suspend itself. Thus, in paving the way for new elections, the institutional framework would require Chancellor Merkel to call for a vote of confidence, as a first step, and could by doing so provoke a situation in which both the Bundestag and the Federal President must formally approve the stability of the government and hence, its capability of acting is relinquished. Such a move could, however, turn out to be fairly risky from Angela Merkel's point of view: On the one hand, she could be concerned with the possible damage to her image if she causes the breakdown of the coalition. In addition, it is also questionable whether re-elections ahead of schedule would, in fact, deliver the results which the CDU/CSU would hope for.

Dates and results of current polls on upcoming elections in Germany (in brackets results of the last election)

	CDU/CSU	SPD	FDP	Green	Left	others	source (poll as of)
Hesse (Jan 27, 2008)	43% (48.8)	30% (29.1%)	8% (7.9%)	9% (10.1%)	5% (-)	5% (4.1%)	Forsa (Sep 21, 07)
Lower Saxony (Jan 27, 2008)	45% (48.3%)	33% (33.4%)	6% (8.1%)	8% (7.6%)	5% (0.5%)	3% (2.1%)	Infratest (Oct 10, 07)
Hamburg (Feb 24, 2008)	42% (47.2%)	32% (30.5%)	4% (2.8%)	13% (12.3%)	7% (-)	2% (7.2%)	Infratest (Sep 6, 07)
Bavaria (Sep 28, 2008)	57% (60.7%)	19% (19.6%)	4% (2.6%)	9% (7.7%)	3% (-)	8% (9.4%)	Forsa (Sep 17, 07)
Thuringia (Jul-Sep 2009)	36% (43.0%)	25% (14.5%)	3% (3.6%)	3% (4.5%)	29% (26.1%)	4% (8.3%)	IfM Leipzig (Aug 22, 07)
Bundestag (Sep 20/27, 2009)	40% 40%	26% 30%	8% 7%	10% 8%	11% 10%	5% 5%	Forsa (Nov 07, 07) Forschungsgruppe Wahlen (Nov 11, 07)
(results of Sep 2005 elections)	(35.2%)	(34.2%)	(9.8%)	(8.1%)	(8.7%)	(4.0%)	

Source: Thomson Financial Datastream

Current opinion surveys show that in case of reelections the options for a new governing coalition would not at all be straightforward.

Based on the results of the most recent polls, the CDU/CSU currently stands at some 40% on the federal level. With a contribution from the FDP of some further eight percentage points, a coalition of CDU/CSU and FDP would still combine only roughly 47 to 48% of the votes. As this constellation is in fact rather tight, the Green party, which has reached 8-10% in recent polls, could get into the position to become a decisive factor for the next government coalition and a number of conservative politicians have recently already started to enjoy the idea of either a "Jamaica coalition" (CDU/CSU, FDP, Green party) as it had been discussed already after the last election, or even a pure coalition of CDU/CSU and the Green party. Based on the recent Forsa poll (Nov 07, 2007) such a pure conservative-green coalition could in fact gain a combined 50% in elections for the Bundestag.

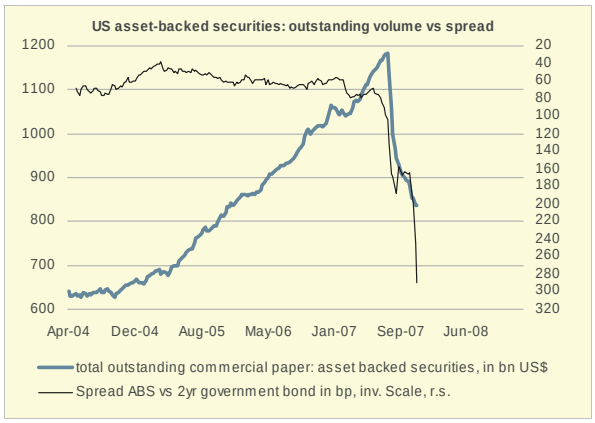
Considering the option of a conservative-green coalition, the elections to the State Parliament of Hamburg in February 2008 could become an important benchmark. Given the latest polls, a coalition of CDU (42%) and the Green party (13%) in Hamburg seems rather likely (although the Green party would prefer a coalition with the SPD which is currently at 32% in Hamburg). In any case, Hamburg's Green party recently ruled out a red-red-green coalition with the SPD and the Left party (7% in Hamburg). On the other hand, at its recent party congress (November 24, Nürnberg) it became visible that the Green party has in many respects also turned further to the left on the federal level than many observes would before have expected. The chances of a conservative-green coalition on the federal level have thus also decreased considerably but the situation in Hamburg might well become an interesting foretaste for the situation on a federal level. Foreign investors have at least less reason for the moment to expect structural reforms and are faced with some uncertainty concerning the future political development. This could be a burden particularly for M&A activity with German companies as a target.

Financials: massive fears offer opportunities

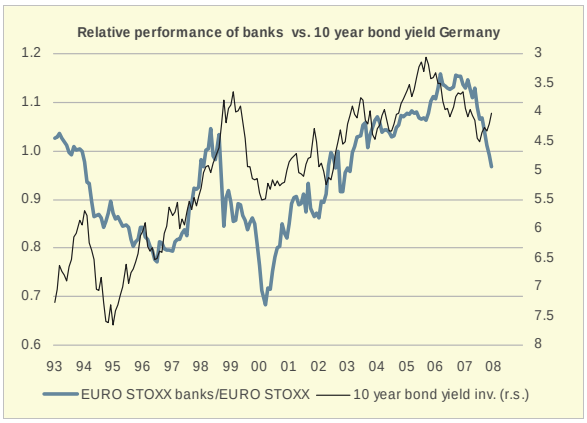
Investors only focused on risks, which are certainly significant…

Financials were the strongest underperformer this year. Insurers, and particularly banks, faced massive investor selling. The problems are severe: In the center stands the US subprime mortgage segment (a US$ 1200bn market plus US$ 1000bn Alt-A credits). Residential mortgages constitute more than half of the US ABS market. These ABS have been sold to highly leveraged conduits for subsequent repackaging. The CDO market is estimated at some US$ 1300bn, and roughly half of the cake is assumed to belong to hedge funds, a quarter to banks, and the final quarter to asset managers and insurance companies. With the falling prices of the underlying assets and the ongoing downgrades by rating agencies, risk aversion among credit investors remains high. Refinancing of the conduits via short-term commercial paper has become extremely difficult. Banks will be forced to take the off-balance vehicles on-balance – which has to be covered by expensive equity – and face write-downs, which could finally lead to capital increases. The estimates on global write-downs range from US$ 300-400bn, which equals some 2.5-3.5% of the US GDP. Thus, it is comparable with the relative impact during the savings and loan crisis. However, back then, it took some 10 years to resolve this loss and the US tax payers carried a major part of the burden.

Given the tier 1 capital of roughly US$ 2000bn at the European and US banks, the crisis should not run out of control. However, some banks may run into trouble, and selected capital increases cannot be excluded. As a result, lending by banks will be much more restrictive, and the highly profitable securitization business – an important earnings driver in the past – will decline notably. The declining leverage is a burden for earnings going forward (see analysis on page 35ff). Investors focused exclusively on these risks. Short positions seem to be high, and according to investor surveys, the community is heavily underweighted (at least at banks).



Source: Thomson Financial Datastream



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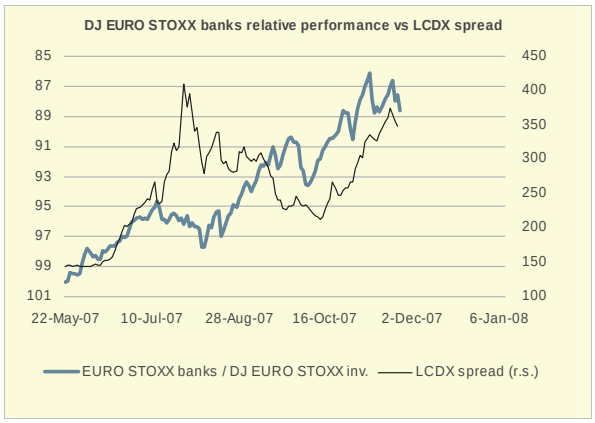

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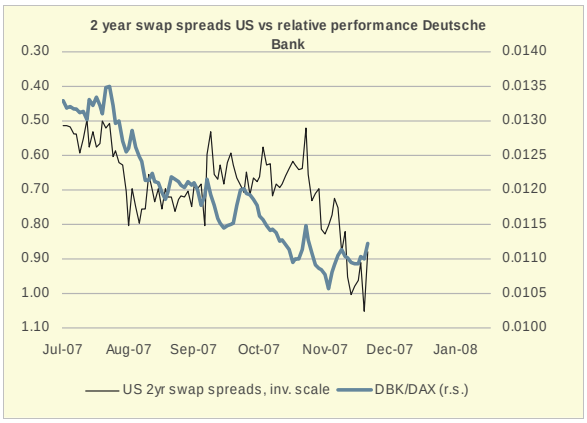

Source: Thomson Financial Datastream

…but there are positives as well

However, on the positive side is:

Banks are winners of rate cycles and lower bond yields; relative performance is closely correlated with bond yields (see chart above). Finally, the Fed will deliver on rate cut expectations, and further down the road, at least expectations on ECB rate cuts, may set in. This should finally drive down the all-important risk premium in money markets.

The rising yield curve should be positive for margins. The US yield curve is already the steepest since early 2005. In Euroland, it is still quite flat due to the anti-inflationary rhetoric of the ECB, but finally we would expect it to steepen as well in the course of 2008. Additionally, the retreat in lending, particularly of US banks and German public banks, should support margins for lenders as well. Rising margins are already visible at commercial real estate.

Banking is the sector with the highest flexibility of costs. The biggest chunk of costs is labor-related, which does depend widely on earnings. E.g., Deutsche Bank cut its provisions for bonuses strongly. This is an advantage vs other sectors – witness the difficulties to cut costs at e.g. telecoms – and a cushion on the downside pressure of earnings.

Relief by Mid East and Chinese sovereign wealth funds possible

A major relief could stem from sovereign wealth funds. Most recently, UAE's ADIA injected some US$ 7.5bn via a mandatory convertible in Citigroup. This adds to past news since summer: the Chinese took 10% of Blackstone (US$3bn), 3.1% at Barclays, and 20% at Standard Bank, the biggest African bank. Singapore's

Temasek bought smaller stakes at Barclays and Standard Chartered. Qatar bought 20% of the LSE and Dubai took 9.9% in Och-Ziff Capital Management. In addition, Ping An Insurance bought a 4.2% stake in Fortis for €1.81bn in the largest overseas acquisition by a Chinese insurer. The volume at sovereign wealth funds is estimated to be at some US$ 2,300, with UAE's US$ 875bn fund in the lead. Of course, one should not get carried away by the size of these numbers, as this money is already invested in assets. Some relocation out of US$ treasuries into higher-yielding assets might be possible. There is some fantasy with the new Chinese fund starting with a volume of US$ 200bn. Further deals in the financial area could prove a win-win situation for all partners. The benefit for the banks are obvious, as they get urgently needed capital. And what about the investors? They get highly yielding assets (see below). Besides, Chinese and Mid East funds face severe political obstacles in the US and Europe. Particularly with the Chinese, there is notable political pressure due to the undervalued yuan and the huge trade surplus. Investments into the battered financials would not only be tolerated compared to other politically sensitive sectors (utilities, defense, telecommunication), but should also yield notable political goodwill, which could reduce the pressure at other fronts. Additionally, the Chinese central bank is severely pushing their national banks to professionalize. Buying into Western assets could be one way to import knowledge.

One possibility for big Asian or Mid East investors could be: buying into smashed banks and afterwards buying into even more smashed and less liquid distressed debt, to push prices of the latter, and as a result, also the stakes in the former. ABS markets are currently hit by forced sellers and the lack of buyers, leading to a vicious circle in which falling prices trigger further sales. Thus, the prices, e.g. at the ABX indices, most likely do not reflect realistic default rates. Industry estimates are calculating implied cumulative losses of $400bn at the ABX indices, which is above the estimates on pure sub-prime related losses. This may suggest an overreaction, particularly at the senior trenches (AAA). Vulture funds are starting to look at distressed debt, but are still too small to impact prices. This could be different with sovereign wealth funds.

Relative valuation is extreme – which should be midterm positive

Midterm, valuation should finally be positive for financials. Based on Datastream indices, we looked in detail at 4 valuation ratios – PE next fiscal year, price/book, dividend yield, and PE based on normalized earnings (approximated by the moving average for the estimates for the last 5 years). If one regards a Z-score > 1 (<-1) as an extreme valuation, the result is particularly striking for German banks (index is heavily driven by Deutsche Bank) and insurers. In case of banks, 2 ratios are extreme at absolute valuation (PE, dividend yield), and all 4 are extreme at relative valuation (see table below). Even looking at normalized earnings, the valuation is not unattractive. Currently expected earnings are 74% above the average of the last 5 years, which means there could be a notable earnings decline in the cards. Even based on such normalized earnings, a forward PE of 12.5 does not look exaggerated; it is 0.6 standard deviations below the long-term average since 1990. Thus, investors seem to already anticipate deep cuts at earnings estimates (see charts below). If we calculate the relative PE vs markets based on normalized earnings (for banks and markets), banks are trading with a discount of 36% compared to an average discount of 26%. Although banks' earnings are more cyclical than those of total markets (Z-Score-1.5%), and thus such a ratio has a favorable bias towards banks, we would still regard it as positive for banks. It looks quite similar at insurers. The picture at German insurers is even more pronounced: Based on normalized earnings, insurers, looks more attractive than banks. At insurers, the earnings increase in the recent 5 years had been less steep compared to banks. Thus, any fall of earnings to normalized earnings would be less dramatic. Insurers are the more defensive game vs banks.

Within banks: prefer German vs Euroland peers

The picture at Euroland peers is pretty much the same as at insurers. Relative valuation is at all-time lows at all 4 valuation ratios (see charts below). However, it is slightly less attractive at banks. Based on normalized earnings, Euroland banks are more in line with the past (Z-Score -0.2) (see charts below). Earnings (estimates) at Euroland banks have risen more compared to their German peers. However, the relative economic situation of Germany within the Euroland has changed in the recent 5 years. During the last downswing, Germany was the sick man, but now it is a slight outperformer. Moreover, downside risks at German housing markets are limited, while there are meaningful risks in the UK, Spain, and Ireland. The core problems in the European covered bond markets are UK and Spanish mortgage backed assets. This is more of a problem for the Spanish sector heavyweights. The Spanish banks have particularly benefited from the strong rise in leverage. Admittedly, the margins in the domestic retail banking are higher in France and Spain vs Germany – which argues in relative terms against German banks. But taken all together however, we prefer the German players within banks and shy away from the Spanish peers.

Sector	Valuation ratio	Statistics				
		current	average	low	high	Z-Score
Banks Germany - absolute	Price/Book	1.4	1.4	0.7	2.1	0.1
	PE next FY	7.2	13.3	4.0	23.5	-1.7
	Dividend Yield	3.5	2.3	1.2	5.5	1.7
	PE next FY normalized (moving 5yr earnings average)	12.5	15.5	5.5	27.8	-0.6
	Ratio current expected earnings/normalized earnings	174%				
Insurance Germany - absolute	Price/Book	1.8	2.3	0.9	6.2	-0.4
	PE next FY	8.9	31.6	5.3	73.0	-1.2
	Dividend Yield	2.6	1.0	0.4	3.2	2.5
	PE next FY normalized (moving 5yr earnings average)	12.2	36.4	7.6	81.5	-1.1
	Ratio current expected earnings/normalized earnings	137%				
Banks Germany - relative vs German market	Price/Book	59%	74%	46%	99%	-1.1
	PE next FY	50%	80%	42%	142%	-2.0
	Dividend Yield	167%	120%	58%	172%	2.0
	PE next FY normalized (moving 5yr earnings average)	64%	74%	59%	91%	-1.5
	Ratio current relative earnings/normalized relative earnings	129%				
Insurance Germany - relative vs German market	Price/Book	77%	114%	74%	208%	-1.1
	PE next FY	61%	182%	52%	403%	-1.2
	Dividend Yield	126%	50%	22%	126%	2.8
	PE next FY normalized (moving 5yr earnings average)	62%	161%	61%	288%	-1.3
	Ratio current relative earnings/normalized relative earnings	101%				
Banks Euroland - absolute	Price/Book	1.7	1.4	0.5	2.8	0.6
	PE next FY	9.2	13.3	5.6	24.9	-1.2
	Dividend Yield	3.8	3.2	1.5	4.7	0.8
	PE next FY normalized (moving 5yr earnings average)	16.7	17.7	9.2	32.8	-0.2
	Ratio current expected earnings/normalized earnings	181%				
Insurance Euroland - absolute	Price/Book	1.9	2.0	1.1	4.1	-0.2
	PE next FY	9.3	20.2	7.2	34.4	-1.5
	Dividend Yield	3.5	2.1	0.9	4.6	1.6
	PE next FY normalized (moving 5yr earnings average)	14.4	25.6	8.2	52.8	-0.9
	Ratio current expected earnings/normalized earnings	154%				
Banks Euroland - relative vs Euroland market	Price/Book	73%	70%	45%	94%	0.2
	PE next FY	67%	82%	56%	109%	-1.6
	Dividend Yield	142%	122%	90%	151%	1.9
	PE next FY normalized (moving 5yr earnings average)	79%	83%	64%	103%	-0.4
	Ratio current relative earnings/normalized relative earnings	119%				
Insurance Euroland - relative vs Euroland market	Price/Book	80%	111%	78%	170%	-1.6
	PE next FY	67%	127%	62%	254%	-1.3
	Dividend Yield	130%	79%	33%	130%	1.9
	PE next FY normalized (moving 5yr earnings average)	68%	116%	68%	172%	-1.3
	Ratio current relative earnings/normalized relative earnings	102%				

Note: Valuation is based on Datastream indices. Figures being highlighted in dark beige signal an extreme valuation compared to the past as measured by Z-Score (based on averages since 1990) <-1 in case of Price/Book, PE next fiscal year, PE based on normalized earnings (moving average of last 5 yr) and as measured by Z-score > 1 in case of dividend yields

Source: Thomson Financial Datastream

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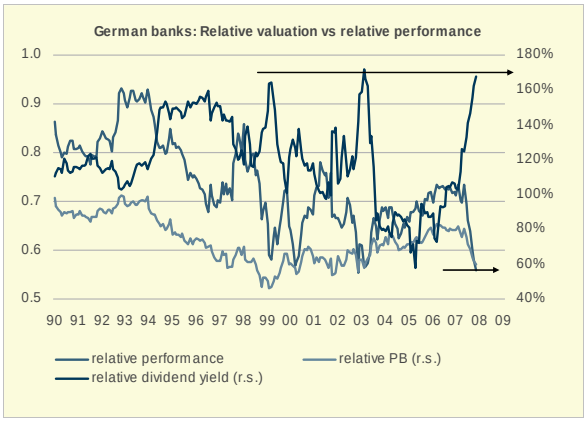

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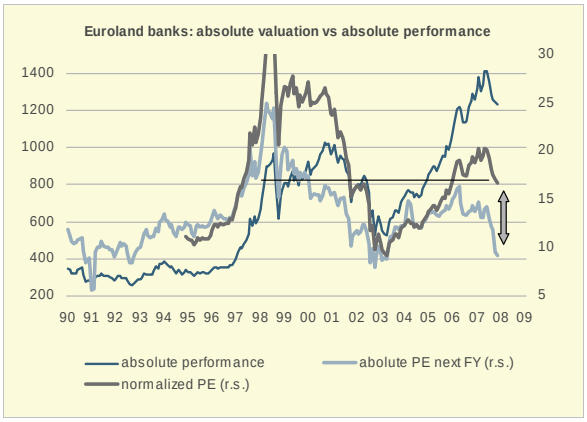

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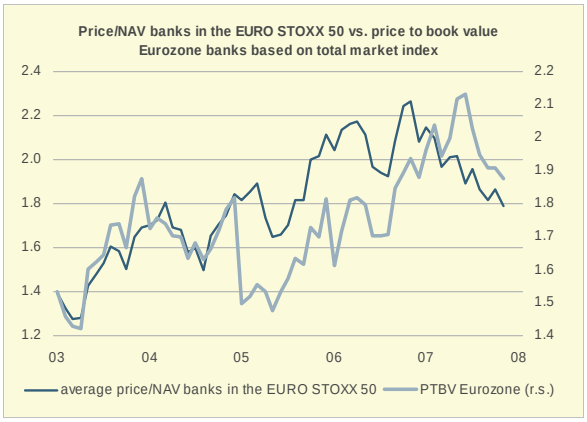

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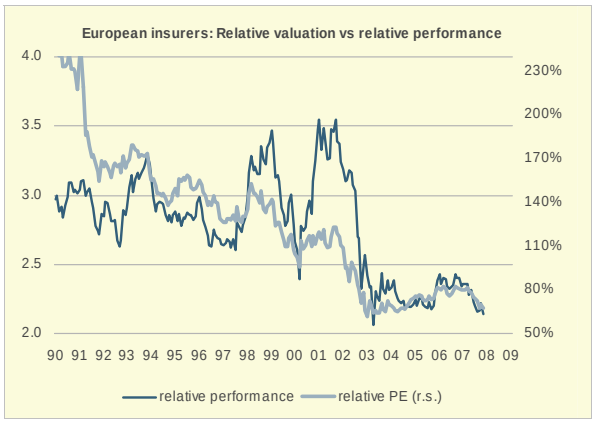

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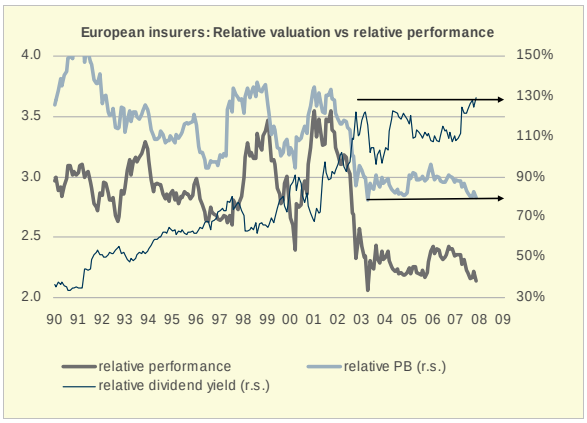

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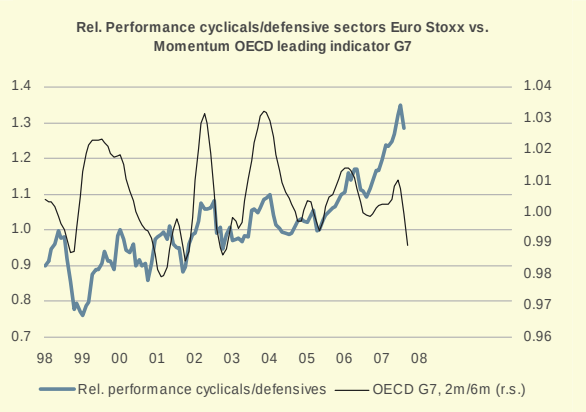
Trigger: decline in money market risk premium

We expect financials to outperform next year. There is, however, the important question of timing. A decisive trigger could be declining risk spreads at money markets. They are currently still high and drag the performance of financials. The fact that the European covered bond markets remain at least partially closed until year-end is not supportive, as it may trigger some stress test scenarios at wholesale-funded banks. We expect, that in the mid-term the Fed rate expectations and actual rate cuts combined with rising bets towards the ECB should finally lead to declining spreads. Further high-profile investments of sovereign wealth funds could serve as a trigger as well. It is a positive sign that Freddie Mac rose on the day of its capital hike announcement.

We still prefer defensive names among industrial stocks

Indicators for economic sentiment in Europe and Germany remain on a relatively high level measured by historical standards. Compared to the rather strong slowing that we see in the US, they are clearly reflecting the fact that the Eurozone is no longer as dependent on the US economy as in past cycles. Still, as we have outlined on page ´45, we see considerable risks for the pretty sanguine outlook that most investors have with respect to growth in the Eurozone and with our main trading partners. Compared to our preferred indicators for the relative performance of cyclicals vs. defensives, we still see more chances at defensive sectors in the Eurozone. Going forward, the leading indicator for the OECD should most likely stabilize first as the US yield curve is steepening strongly at the moment, which is one important element in the indicator. For the fine tuning in the Eurozone, we would however prefer to take the Ifo business expectations and the rather good lead of real bond yields in the Eurozone as a good indication. In general, we believe that a sustained strong decline of credit spreads is necessary to bring investors back into cyclical shares. We admit however that defensive stocks in the blue chip indices are no longer expensive.



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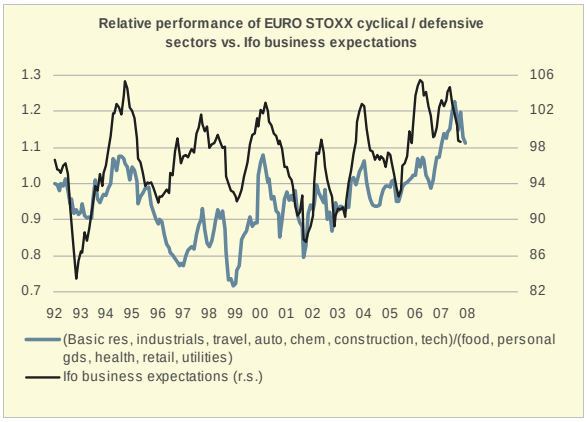

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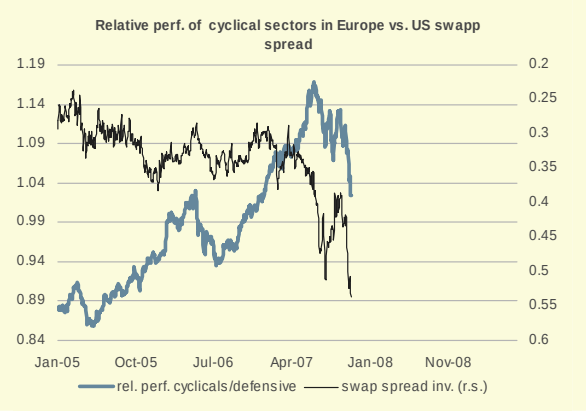

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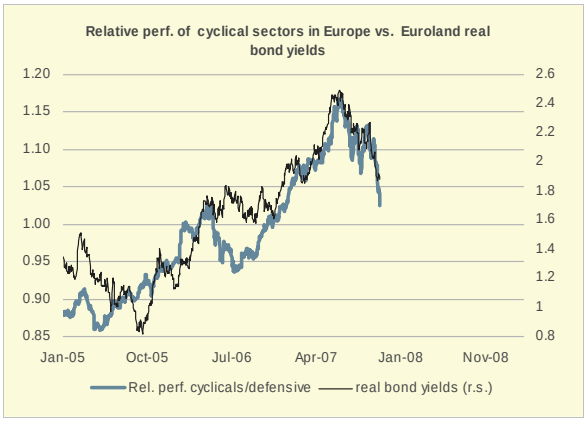

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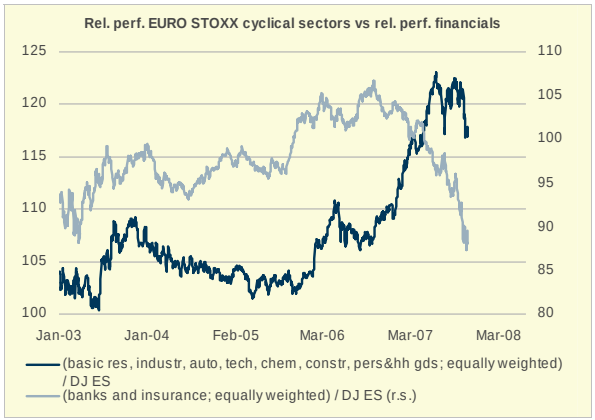

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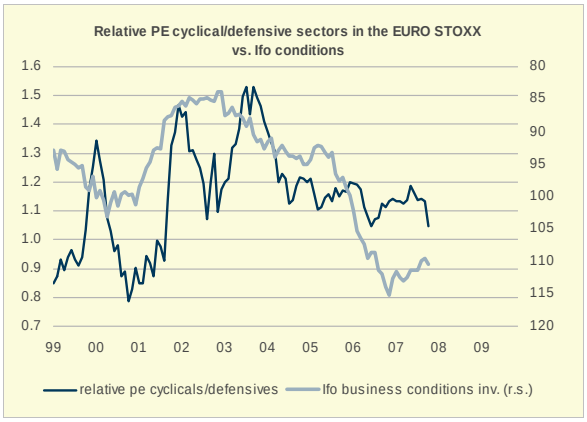

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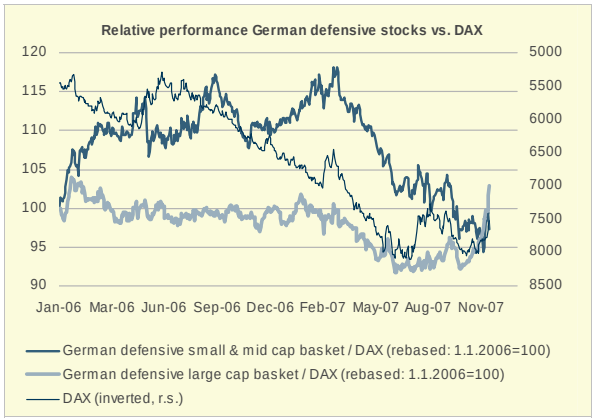
Defensive names in the second row have become attractive, as the market didn't separate between cyclicals and defensives in the recent small & mid cap sell-off

Defensive stocks, such as telecoms, utilities and health care, have outperformed during the recent stock market downturn. However, this finding holds predominantly for large caps. In contrast, a number of defensive names within the MDAX and the SDAX became victims of the rapid sell-off in mid November that hit small and mid caps to a disproportionately strong degree. The figures below illustrate this disproportionateness based on the relative performance of a large cap basket and a small & mid cap basket of defensive names. The large cap basket contains Adidas, Deutsche Boerse, Deutsche Post, Deutsche Telekom, E.ON, Henkel prefs, Merck KGaA, Metro, and RWE. The small & mid cap basket includes Beiersdorf, Celesio, Fraport, Rhoen-Klinikum, Stada, Fielmann, GFK, and MVV.



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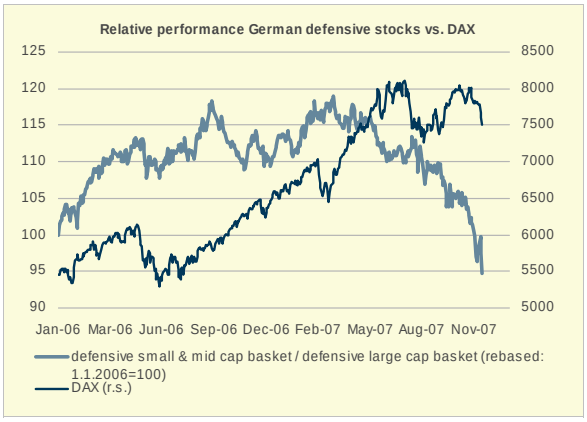

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We regard this kind of differentiation between large and small defensive stocks to be unjustified, as it seems to have taken place solely based on the market cap, but not for fundamental reasons. Instead, we expect that defensive qualities should and will be appreciated again, also among small and mid caps. We thus recommend taking advantage of the current low valuation of defensives in the second row, although we would not necessarily recommend all defensive second liners. The table below gives a review of our current recommendations and the valuation on the larger defensive German stocks that are included in the baskets above.

Price and valuation data of defensive German stocks

Large caps	Price*	Fair value	Rating	PE 2007	PE 2008	PE 2009	EV/EBITDA 2008	Dividend Yield % 2007
adidas (5)	45.76	56.00	BUY	16.8	14.0	12.2	8.2	0.9
Deutsche Börse (5)	121.61	132.00	BUY	29.5	21.8	18.8	12.9	2.8
Deutsche Post (5)	21.90	28.00	BUY	12.9	12.7	9.9	6.1	3.4
Deutsche Telekom (5)	15.24	16.50	BUY	39.4	18.2	14.2	6.1	4.7
E.ON (5)	138.23	150.00	BUY	13.8	15.2	12.4	7.3	2.4
Henkel (5)	38.51	46.50	BUY	17.9	15.4	14.0	9.5	1.2
Merck KGaA (5)	86.73	108.00	BUY	7.5	23.7	19.3	8.9	1.2
Metro (5)	64.35	50.00	NEUTRAL	22.2	19.4	18.7	8.5	1.7
RWE (4,5,7)	91.79	95.00	BUY	15.1	13.0	12.8	7.8	3.8
Small & mid caps	**Price***	**Fair value**	**Rating**	**PE 2007**	**PE 2008**	**PE 2009**	**EV/EBITDA 2008**	**Dividend Yield % 2007**
Beiersdorf (5)	53.04	58.00	BUY	25.1	22.6	17.3	11.2	1.1
Celesio (5)	37.68	44.00	NEUTRAL	14.5	12.6	11.4	9.0	2.0
Fielmann	45.65	48.00	NEUTRAL	26.1	19.2	17.1	10.0	2.6
Fraport (5)	52.91	49.50	NEUTRAL	24.6	23.0	22.7	9.6	2.2
GFK	27.79	36.50	BUY	14.4	12.5	11.3	8.6	1.2
MVV Energie (7)	31.00	32.00	BUY	13.7	15.6	14.3	8.3	3.0
Rhön-Klinikum	20.21	24.70	BUY	19.3	17.5	16.3	11.0	1.2
Stada Arzneimittel (5)	38.20	58.00	STRONG BUY	15.9	12.3	9.4	8.5	1.6
***) prices as of**	**30-Nov-07**							

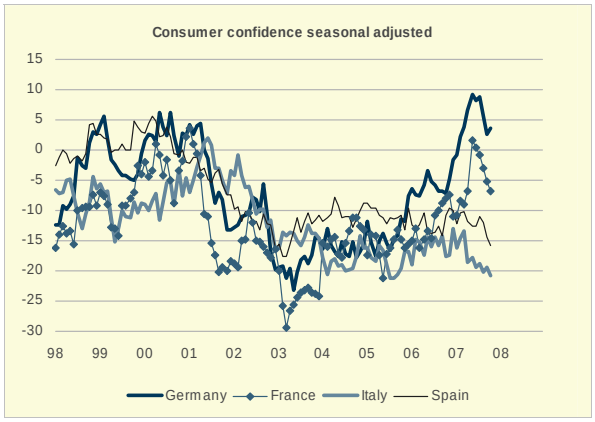
Source: Oppenheim Research; (*) Disclosure Number, see Page130

Consumer vs. investment driven stocks; the first idea is misleading

The slowdown that we as well as most other market participants forecast is first and foremost a slowdown coming from an overextended consumer that has long profited from the strong increases in the housing markets. On the other hand, we still have high order backlogs and a high capacity utilization with most industrial companies. At a first glance, this suggests keeping the bullish story on engineering stocks and industrials, but to have a rather cautious stance on stocks that are dependent on the consumer. To some extent, this stance is correct, but it is also largely the consensus trade and newsflow, at least in the case of Germany, which will most likely surprise in a way, that taking the opposite stance is more advisable.

In Q1 2007, consumer spending in Germany took a severe hit due to the strong rise of the VAT. Consumer spending fell in Q1 by 7% annualized, more than offsetting the pre-buying that led to a 3% annualized increase in Q4 2006. Total consumer spending in the first half of 2007 was down more than 1% from the second half 2006, and still down slightly from the first half 2006, despite healthy growth in the overall economy. This should lead to a rather nice basis effect in the first half of 2008, as now the positive effect is less in discussion than the negative aspect was ahead of the hike of the VAT. In addition, we have to keep in mind that the rise of the VAT lead to an increase of the German inflation rate from 1.4% in December 2006 to 1.7% in January 2007. We can clearly show that households tend to react quite negatively when they see that the inflation rate is on the rise, as wages tend to react with a lag and can often, particularly after taxes, not cope with the rising inflation. Now the basis effect will lead in January to a decline of the inflation rate in Germany, which should be seen positively. One could argue that prices remain high, and thus there is no visible improvement for the consumer. But the correlation of inflation expectations with the inflation rate measured as the year over year increase of prices is much higher than with the smoothed momentum of the monthly variation of prices. Thus, the impression that prices are high will obviously most likely not vanish, as prices are not falling. But as the inflation rate is coming down, it should slowly become less of a burden. Also, at the beginning of the year, the wage agreement with public employees covering some 1.5 million employees is running out and will most likely lead to a somewhat higher wage agreement. Last but not least, we have the reduction of the unemployment insurance contributions from 4.2% to 3.3% at the beginning of the year. Over the whole year, this will lead to a reduction of the contribution of employers and employees of together €7bn. Starting in July 2008, we have a slight offsetting element with the increase of the compulsory long term care insurance from 1.7% to 1.95%. Still, the relief at the beginning of the year is almost 1% of the monthly salary, which should be seen as helpful. The good point is not only that this should be offsetting the problems that arise from high oil prices, but it also comes at a time when the savings rate is still higher than the consumer sentiment data would suggest. While we have little illusion that the improvement in the German labor market will last into 2009, particularly given the political headwinds, see page 52 for further structural reforms.

Still, this compares rather favorably to the development of the overall consumer sentiment in the Eurozone, as there the consumer sentiment is coming down and we see little indication for a turnaround in those countries that have, up to now, profited from strongly rising real estate markets like Spain or the UK. Also, the development of the employment component in the purchasing manager indices suggests that the German consumer might be the only hope we have when it comes to consumer spending. Thus, at consumer geared stocks, it should pay off to have an exposure to the German consumer and to have a rather low exposure to the Spanish consumer.



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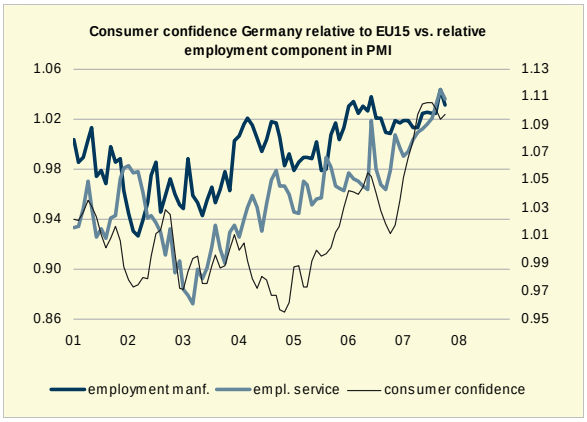

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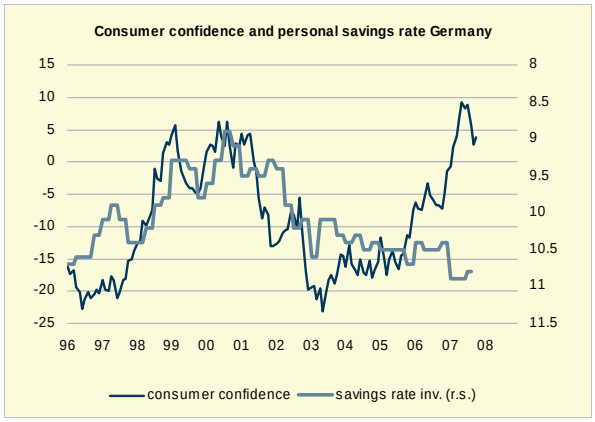

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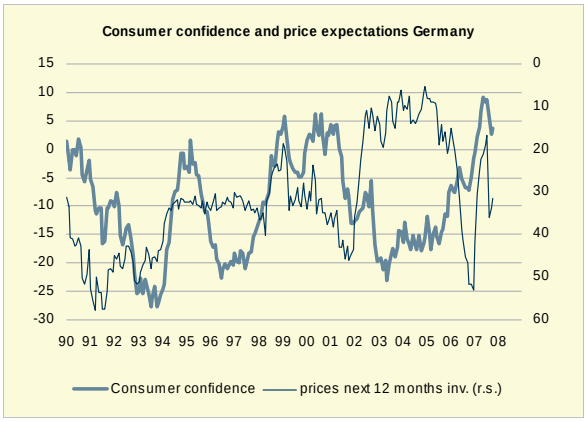

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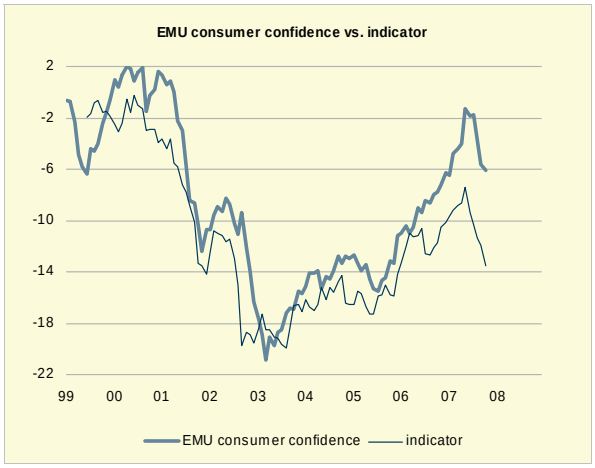

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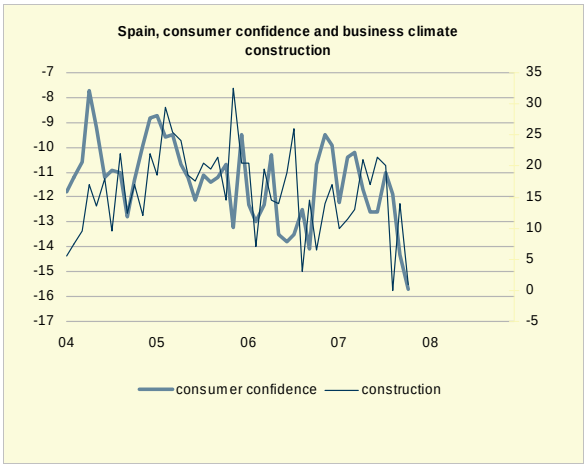

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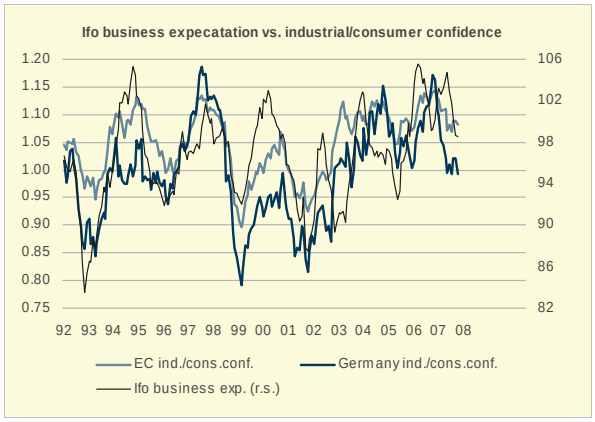
The relative better performance of consumer sentiment compared to business sentiment is also a classical development at this point of the cycle, and only if we can safely expect a re-acceleration of the business climate, we should switch back to investment driven cyclicals. In Germany, there is one additional point to be taken into consideration. Due to the end of the degressive depreciation at the end of 2007, companies had a high incentive for some pre-buying. According to the VDMA, the association of the German engineering companies, this pre-buying should have started to peter out at the end of the first half. In the very volatile monthly data, we see that for the first time in the September data that orders for domestic capital goods were some 4% below the average of the prior 6 months. Now domestic orders are only roughly one third of the total orders, but also taking into account the strong euro, it would not be surprising if the strong order books that have led to a very good visibility are slowly getting a bit thinner. This is not troubling for the near term earnings, but rather for the multiples that markets are willing to pay for these earnings. Thus, our stance is to get more on the cautious side with stocks that depend on healthy investment spending.



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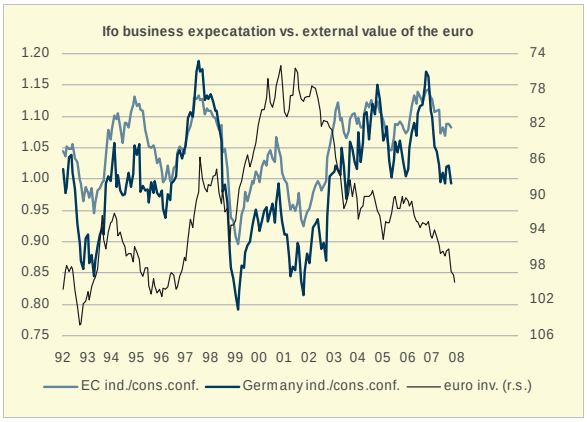

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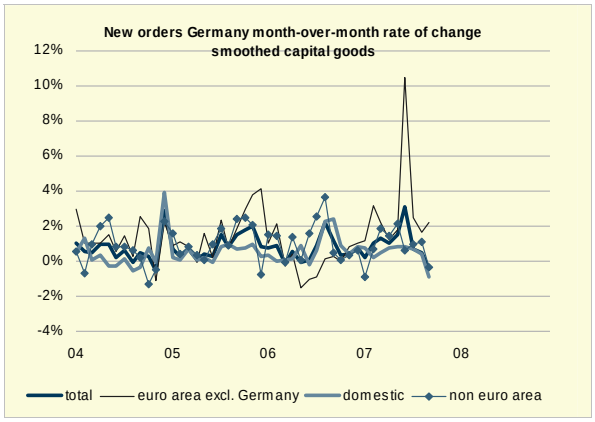

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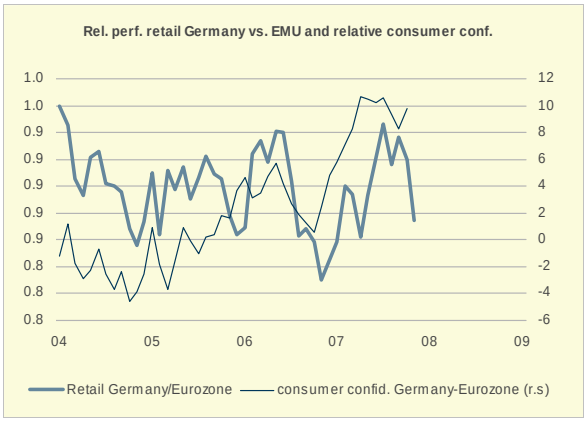


Source: Thomson Financial Datastream

Sector	current DJ Euro Stoxx weighting	Oppenheim weighting in %	Oppenheim weighting absolute	Deviation in basis points
Automobiles &Parts	5.23	**80**	4.18	-105
Banks	19.61	107	20.98	137
Basic Resources	2.14	70	1.50	-64
Chemicals	4.66	**80**	3.73	-93
Construction & Materials	4.06	50	2.03	-203
Financial Services	2.47	104	2.57	10
Food & Beverage	3.48	100	3.48	0
Health Care	3.08	**110**	3.38	31
Industrial Goods & Services	7.92	100	7.92	0
Insurance	7.74	**125**	9.68	194
Media	2.49	105	2.61	12
Oil & Gas	6.56	100	6.56	0
Personal & Household Goods	3.47	107	3.71	24
Retail	2.51	104	2.61	10
Technology	5.41	96	5.20	-22
Telecommunications	7.58	**109**	8.26	68
Travel & Leisure	1.25	100	1.25	0
Utilities	10.34	100	10.34	0

Source: Oppenheim Research

Switzerland

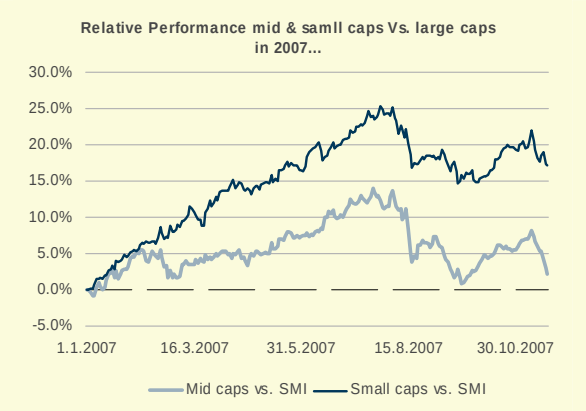
Johannes Borner, Urs Diethelm
Telephone +41 (44) 214 – 2282, - 2339

Entering the valley?

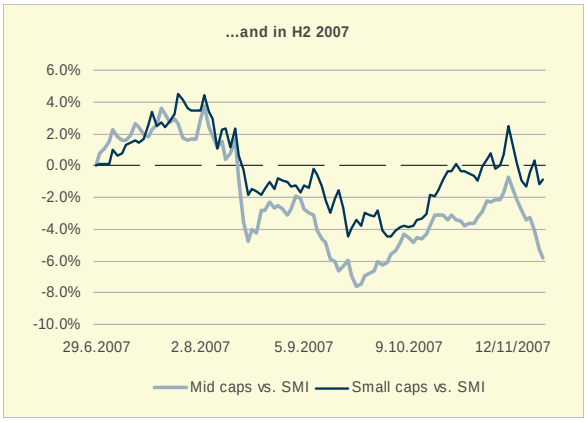
Attractive valuation, but earnings estimates at risk!

Upside of 10% for the SMI in 2008 – but the air beyond gets thin

The accumulated profits of listed Swiss companies is expected to reach a new high of about CHF81bn in 2007 and this record sum will likely be surpassed again in 2008. Our bottom-up approach suggests a Swiss Market Index (SMI) year-end 2008 target of 9,200 points, an upside of about 10% from current levels. For the Swiss Performance Index (SPI), our model yields underlying companies' earnings growth of 13%, implying 7,500 fair value for the index. While in recent years the growth difference between the two indices was more striking, the gap for FY 2008 has narrowed. The higher earnings momentum delivered by mid and small caps since 2003 has come to an end as most of the sales and restructuring driven operating leverage effects have disappeared from our FY 2008 estimates.



Source: Thomson Financial Datastream

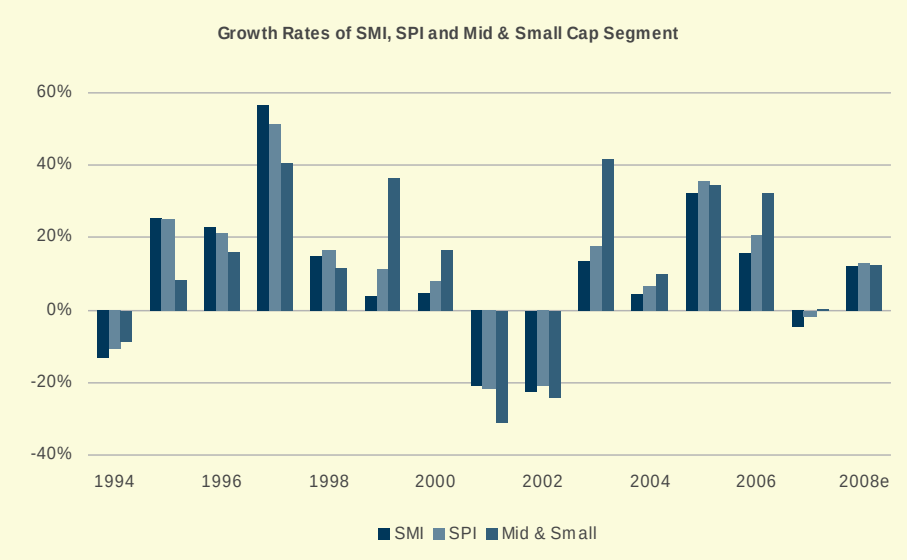


Source: Thomson Financial Datastream

Strong outperformance of large caps in H2 2007

Contrary to our assumption a year ago and despite an expected profit growth of 5% (+20% excluding banks!) for FY 2007, the Swiss stock market will likely end the year with a negative performance. On the back of an anticipated slow down in net profit growth rates and to a greater extent, due to the recent turmoil in the financial sector and related fears of spillovers to the entire global economy, indices have fallen, currently posting a single digit negative performance. Interestingly, the y-t-d performance of mid & small caps suffered less which is the result of the still higher earnings momentum on the one hand and a strong outperformance in H1 2007 on the other hand. However, due to a poor development since the summer, mid & small caps have given up almost their entire outperformance in H2 2007. The picture would be even more in favour of large caps if we stripped out the banks' share price collapses.

In 2007, the positive stock market trend experienced over the last 4 years was broken. The good performance over the last few years was driven by economic recovery, merger & acquisition activity and restructuring. As the bulk of the benefits of restructuring have largely been reflected in corporate figures and M&A activity is being held back by high market uncertainties and less cheap money available, economic development will play an even more important role for earnings growth going forward.



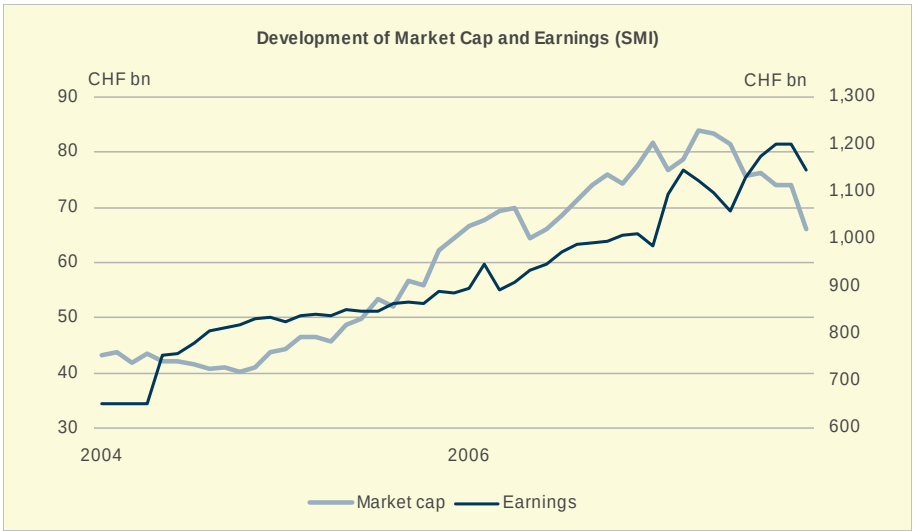
Source: Thomson Financial Datastream; Oppenheim Research

Earnings estimates 2008 are vulnerable due to higher economic risks and currencies

For next year, economists anticipate a slowdown in the USA, economic growth at lower rate in Europe and ongoing growth in Asia. In this scenario, we anticipate corporate profit growth to slow from 20% in FY 2007 to around 12% in FY 2008. Due to lower visibility on the economic development front and negative impacts from the exchange rate environment we believe that earnings forecast for 2008 are vulnerable.

Market PER 2008 of 13x suggests attractive valuation…

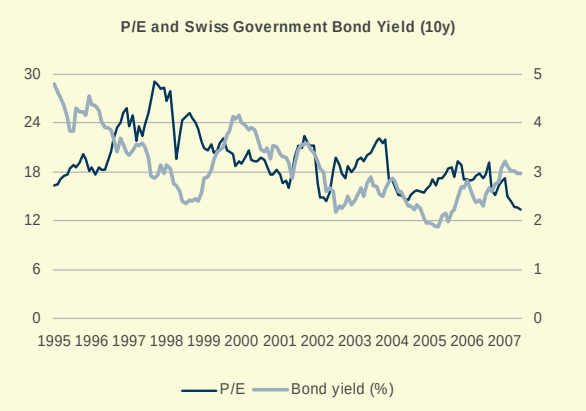
After the recent correction and based on the above mentioned market scenario, the Swiss stock market (SMI) looks attractively valued at the first glance. Our analysis points to a PER 2008 of 13x for the Swiss market, which is compelling compared to the historical 10-year average of 16.2x. Versus last year's PER of 14.7, current multiples are a significant **220bp** (170bp) lower. This is the result of the discrepancy between healthy earnings growth and poor stock market performance, particularly in the recent weeks.



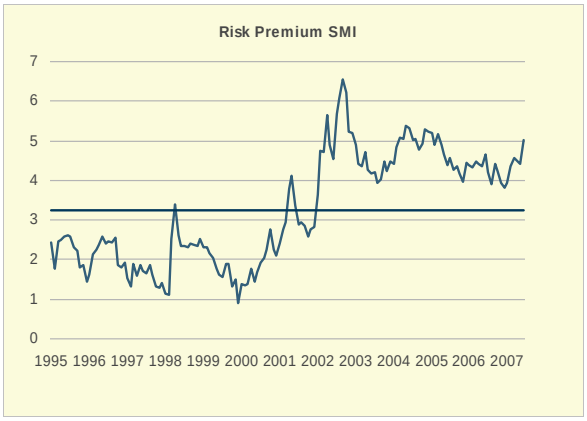
Source: Oppenheim Research

… supported by a high risk premium of almost 5%...

The overall attractiveness of the stock market is supported by a high risk premium. Lower share prices combined with ongoing low respectively slightly falling government bond yields boosted the risk premium to close to 5%, a level that is clearly above the long term average rate of 3.25%.



Source: Thomson Financial Datastream



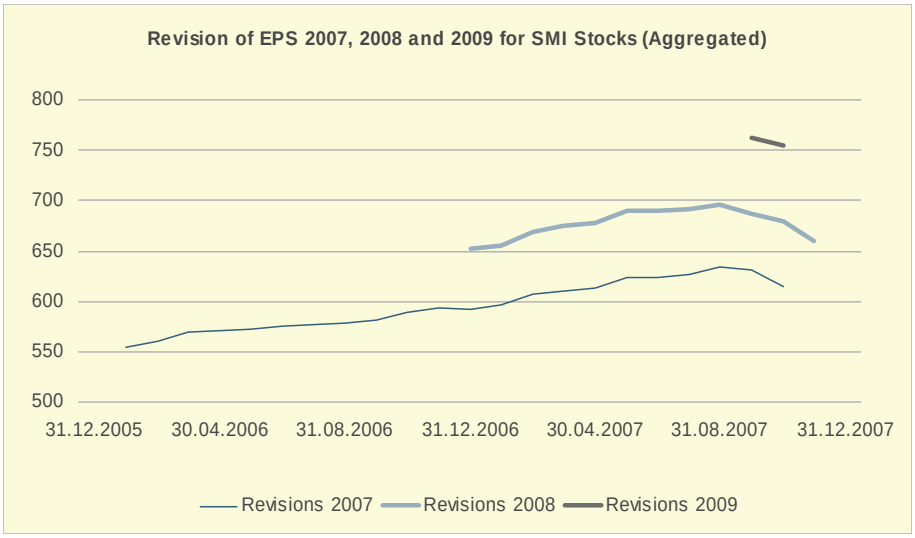
Source: Thomson Financial Datastream

… BUT the problem could be too high earnings expectations

Is this a sign for a bullish stock market in 2008? We do not think so as some reservations need to be addressed. Overly optimistic investors could be surprised by rising interest rates triggered by meaningfully higher inflation in addition to downward revisions of earnings estimates. In fact, as mentioned above, the confidence in our earnings forecast for the coming year is less high than last year – the main reason being the uncertainties regarding a potential slow down of the global economy. A more cautious view on estimates is supported by the fact that consensus estimates are currently being revised downwards for the first time in more than two years.

Forecast downgrades have been moderate so far – but there is room for more drastic action

The extent of the earnings downgrades for the SMI so far was a mere -2%, however there could be more to come. Assuming the market is currently correctly pricing the SMI applying its underlying long term PER of 16.2x, earnings estimates for 2008 would be approx. 25% too high. At this point in time, such a scenario cannot be excluded but seems quite unlikely to us.



Source: Oppenheim Research

Our SMI target valued at PER 14x implies 5% lower earnings estimates

If we base our calculation on the PER of 14.3x (average multiple of the last 3 years), the market is currently pricing in a potential earnings estimates downgrade of 16%. Finally, our index target of 9,200 gives our earnings forecast for 2008 a downside of 5%applying a PER of 14.3x – a development we consider very realistic. In terms of timing, we expect 2008 to be very much back-end loaded, the primary reason being the high y-o-y comparison base for earnings growth.

Strong balance sheets and attractive payouts limit the downside in 2008

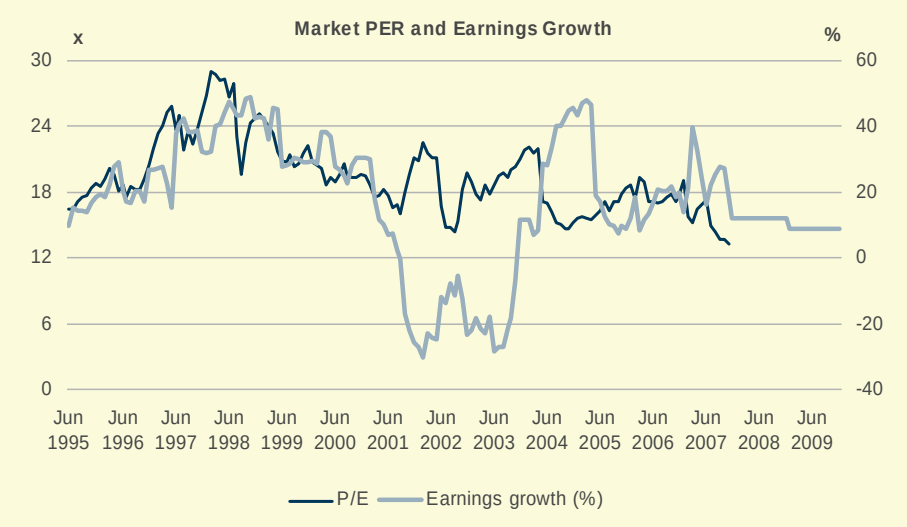
Despite the heavy pressure on share prices and the inflation of negative market scenarios, we believe that some downside protection is provided by the typically strong cash flow generation at the end of a cycle, and above all cash-rich balance sheets, anda comparably high yield from payouts to shareholders (dividends, share buybacks) of more than 2.5% versus the 5-year average of 1.5%. In addition, these lower valuations might boost/reignite M&A activity from corporates, while we expect private equity to remain on the sidelines due to the sharp fall in availability of cheap money.

A lack of earnings momentum reducing hopes for a positive stock market in 2008

To sum things up, we recognize a pattern in which equity markets move in tandem with underlying earnings growth. However, in times of high uncertainty, even good earnings have only a limited effect on share price performance. In 2008, we will definitively lack the positive earnings momentum which was a key stock market driver over the last four years.

Don't expect a multiple expansion – as long as uncertainties prevail

As valuation multiples reflect the confidence investors have in the market outlook, we might even experience further multiple contraction until visibility improves. In such a case, our SMI target for 2008 would be too aggressive. Similarly, the risk on the upside has more to do with 2009 earnings, which will start to play a role by mid 2008, in our view. For the coming 12 months, we do not expect a re-rating of the market, but a performance in line with earnings growth at best.



Source: Oppenheim Research

While we properly consider current market circumstances, our 10 favourites for next year are driven by a bottom-up approach as it was the case in the previous years. Obviously, we prefer stocks with a strong balance sheet and good earnings visibility. This approach resulted in our preference for Partners Group as our only pick in the financial segment. Accordingly, we do not have a large cap stock from the banking and insurance area in our portfolio. The remaining idea's are the following: ABB, Burckhardt Compression, Lonza, Nobel Biocare, Nestlé, PSP Swiss Property, Richemont, Roche and, Schmolz & Bickenbach

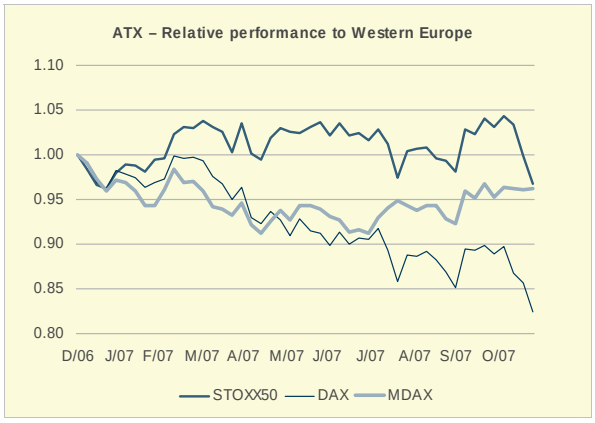
Austria

Peter Szopo
Telephone +43 (1) 518 66 2700

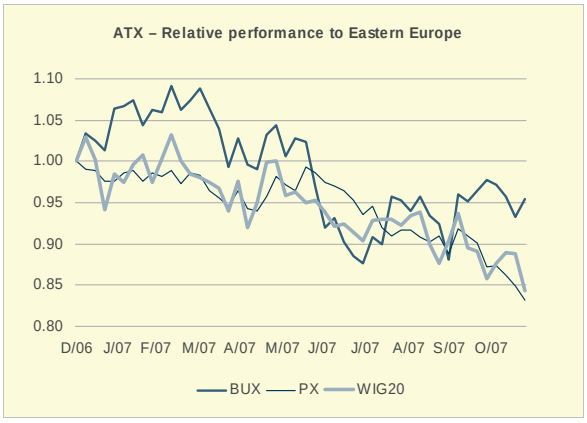
The year of diminished expectations

Like companies elsewhere in Europe, Austrian stocks are feeling the fallout from the recent financial turmoil like the anticipated softening of global growth, an even weaker dollar or a more difficult financing environment. A negative add-on, which is more relevant for Austrian equities than for most of their European peers, has been provided by concerns that Central & Eastern Europe (CEE) may be the most exposed area in case of a further deterioration in the global financial backdrop. While stock prices were in free-fall for a couple of days, fundamental casualties have been rare so far. Overall, recent interims did not disappoint, balance sheets appear to be sound and, most importantly, managements' indications for 2008 and beyond still remain constructive in most cases. While it would be foolish to ignore the significance of the current financial turbulences, we take the view that the recent sell-offs in many cases were exaggerated. This particularly applies to some of our current top-picks such as Andritz (-30% from its peak) and Wienerberger (-37%) as well as to the entire listed property sector. Our buy-list for 2008 also includes a number of CEE-driven stocks like OMV, Wiener Städtische and/or Erste, whose investment case is sufficiently robust in our opinion to withstand any temporary disruptions in CEE, as well as Intercell and Agrana.

The call for the overall market is tricky, (as always). Our earnings outlook would suggest an upside of 13% for the ATX but with inflation on the rise and growing uncertainties, one could expect some further multiple contraction. Thus, we may finish the year 2008 with an ATX only 5% to 10% up on recent levels, implying a 2008 year-end level somewhere between 4,600 and 4,800. However, given the current volatility, the upside could double in a week's time or similarly evaporate. At present being dogmatic about index targets makes even less sense than in more normal times.



Source: Reuters, Oppenheim Research 1) Weekly data



Source: Reuters, Oppenheim Research 1) Weekly data

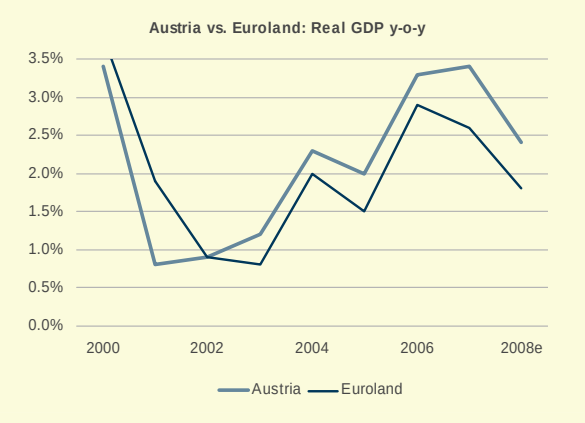
Performance driven by top-down risks

Lackluster performance in 2007 not surprising

We have been arguing for some time that the top-down factors which had supported the substantial outperformance of Austrian equities earlier this decade are gone: Old-economy cyclicals have been re-rated, the tax-reform was a one-off, further privatization is not popular anymore and the small-/mid-cap fad among international portfolio investors has run its course. Of course, the market's significant CEE-exposure will remain a long-term positive but two important catalysts – the EU-enlargements in 2004 and 2007 that substantially improved the risk/reward-profile of Austria's core markets in Central Europe and on the Balkans – are history. Thus the ATX' wobbly performance in 2007, which was just in line with the Stoxx50 (at least until recently) but weaker than the German and CEE-indices, was not really surprising.

Slowing economy but ahead of Euroland

Going forward, the main impact on Austrian equities will come from global factors that are the same for all of Europe: the threat of a US-recession and a softer European economy, a prolongation of the current financial turbulences and inflation-fears restricting the options of the ECB. As far as the domestic economy is concerned, hard-facts fail to yet show any clear signs of deterioration but consumer sentiment and the PMI were down recently. It is widely expected that during Q4 the real economy is slowing and 2008 growth will be down. However, according to domestic forecasters GDP growth is likely to stay above the European average, driven by exports and business investments.



Source: IMF, Oppenheim Research

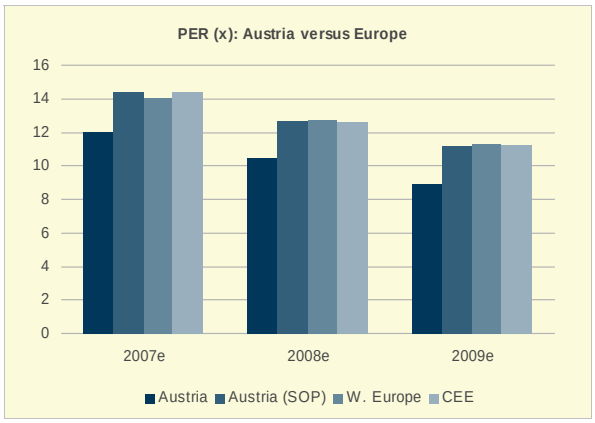
Austria: Macroeconomic forecasts	2006	2007e	2008e
GDP, y-o-y % 1)	3.3	3.4	2.4
Private consumption, y-o-y % 1)	2.1	1.9	2.1
Business investment, y-o-y % 1)	3.8	6.3	3.7
Exports, y-o-y % 1)	6.0	9.0	6.5
Imports, y-o-y % 1)	3.8	8.4	6.2
Current account/GDP %	3.2	3.5	3.7
CPI, y-o-y %	1.5	1.9	2.0
Unemployment rate %	4.8	4.3	4.2
Public sector balance/GDP %	-1.1	-0.4	-0.5

Source: Austrian Institute for Economic Research 1) At constant prices

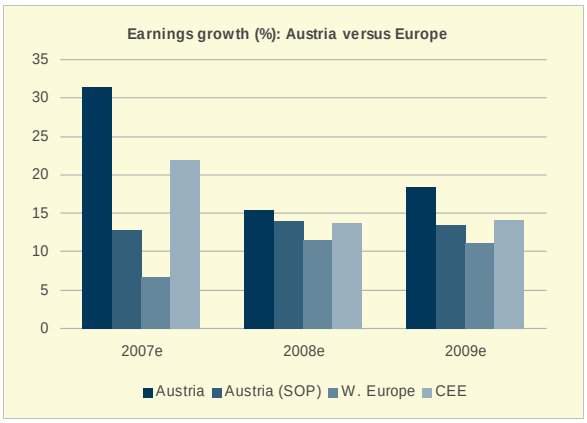
Bottom-up perspectives still surprisingly robust

However, on a corporate level neither the international financial turbulences nor the economic slowdown have left deep traces so far. Q3 interims were in line with expectations in most cases, the sub-prime effects seem contained and managements' indications for 2008 have generally not been cut. Consensus figures assume earnings to grow by 15.6% next year and our own forecast (for a partly different universe) is 14%. Both figures are well above the European average (11.5%)[1]. Consensus figures seem to imply that Austria equities, on average, are markedly cheaper than both West European and CEE equities. However, this is not confirmed by our own forecasts, which bring the valuation (2008e PER of 12.7x) in line with the European average.

[1] Note the huge difference in earnings growth forecasts for 2007 between the consensus and Oppenheim Research. We think it may be related to bwin's accounting loss of more half a billion euros in 2006 which implies an enormous swing even in aggregate earnings. This is not incorporated in our aggregates.



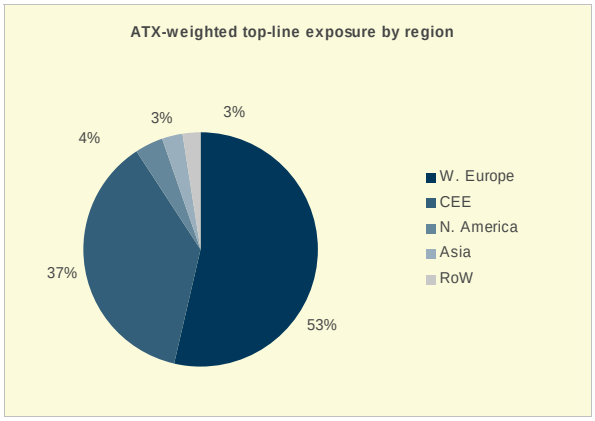
Source: Thomson Financial, Oppenheim Research



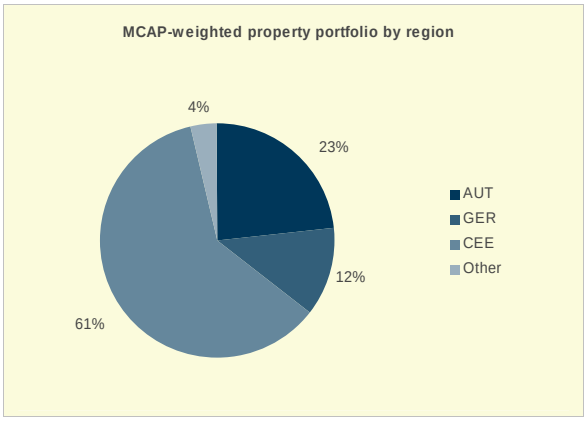
Source: Thomson Financial, Oppenheim Research

Central & Eastern Europe: Be happy, but do worry…

One of the reasons for the recent weakness of the Austrian stock market may have been its significant CEE-exposure which is higher than for any other European stock market. Despite the region's long-term potential, the market seems to be more impressed by the mounting near-term risks in a number of countries in CEE.



Source: Company data, Oppenheim Research



Source: Company data, Oppenheim Research

CEE-exposure 37% and growing

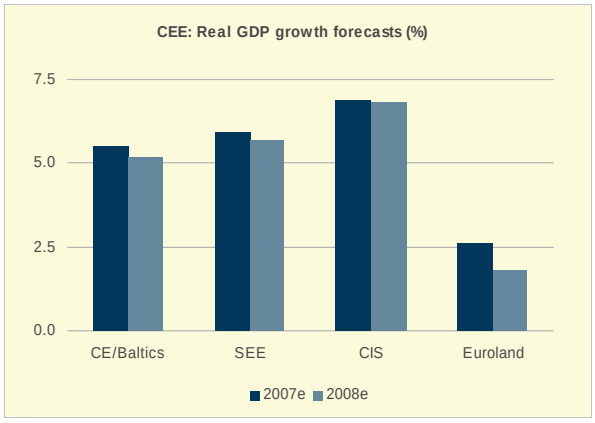
Presently, the CEE-exposure of the ATX, based on the companies' top-lines is 37%. It is particularly high (70%) in the listed financial sector and in the property sector (61% based on their real estate portfolios) but also in the industrial and service sectors, on average more than one fifth of the capitalization can be traced to the companies' business in CEE. Moreover, the CEE-exposure will continue to grow, because (a) most companies that already have a substantial presence in the region like the banks and insurers or OMV (buy, FV €54.00) and Wienerberger (buy, FV €61.40) continue to invest significantly and (b) many of those that have no or only a limited exposure are seeking to strengthen it like voestalpine (not rated) or Österreichische Post (neutral, FV €26.00). It is also important to note that the successful expansion towards the East has not been confined to the large corporates. Also a number of second-tier stocks like Kapsch TrafficCom (neutral, FV €34.00), s&t (neutral, FV €62.60) or bene (buy, FV €7.14), just to name a few, managed to establish a leading or at least decent presence in their niche in the region.

A lot to gain ….

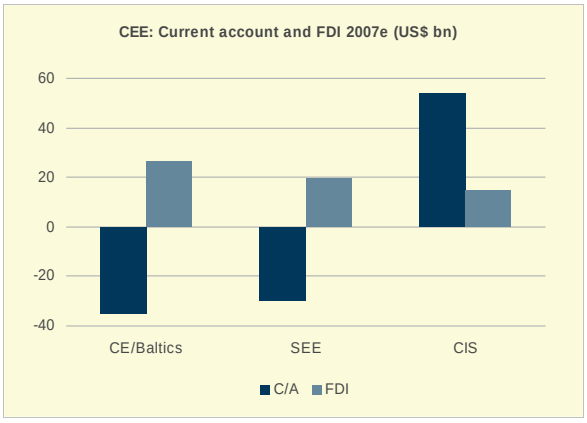
The CEE-expansion has been highly beneficial for the Austrian corporate sector, listed or non-listed. The new markets together are far bigger than Austria's domestic market, have been growing as least twice as fast as Western Europe in recent years (in fact this is another reason, why the equity market's CEE exposure will grow over time) and have been more profitable than the domestic or west European business or are likely to become so.

… but mounting short-term concerns in CEE

We are still not convinced that all equity investors are fully aware of the long-term upside provided by the companies' growing CEE-presence. This said the extended period of fast growth in CEE has resulted in widening macro-economic imbalances in recent years. Growing household incomes, strong labor markets and buoyant credit-growth (often in foreign currencies) across the region have not only fuelled private demand and economic growth but have also produced overheated economies and surging current account deficits. In 2007 and 2008 transition economies are expected to grow, on average, at 6.3% and 5.9%, respectively, which is more than three times as fast as Euroland. However, at the same time a number of countries in the Baltics (Estonia, Latvia) and on the Balkans (Romania, Bulgaria) are running current account deficits of 10% of GDP or more.



Source: EBRD, Oppenheim Research.



Source: EBRD

Differences to Asia '97

The fear is not only that those imbalances will dampen growth – this is somehow inevitable - but that the necessary correction may happen in an Asia 1997-style rather than in an orderly (i.e., gradual) fashion[2]. However, while these risks cannot be ignored, it is important to see the differences between CEE now, and Asia 10 years ago. Firstly, and most importantly: most of the vulnerable countries are EU-members and some (e.g., the Baltics) are under the ERM-II mechanism which implies access to international support in the case of a crisis. Secondly, across the region, the banking system appears to be strong and well regulated and supervised. It is important to note that everywhere in CEE (ex-CIS) the banking system is dominated by foreign-owned banks that are (a) soundly capitalized and (b) have established an extensive retail network across CEE and are unlikely to withdraw from the region like the Japanese banks withdrew from Asia. Thirdly, while credit-growth in the CEE has been fast in recent years, the level of the domestic credit to the private sector is still low relative to Western European levels as well as in comparison to the pre-crisis levels in Asia. Fourthly, with the exception of Romania, the most vulnerable countries are relatively small, limiting the risk of contagion. And finally, in most countries, particularly in Central Europe and on the Balkans, current account deficits have been covered by strong FDI inflows. In conclusion, yes, the macro-backdrop in CEE is raising concerns but there are profound differences to historical precedents and we do not believe a general health warning against stocks with a high CEE-exposure is justified.

[2] On the issues discussed here see also the recent IMF World Economic Outlook, Chapter 2, and Sirtaine & Skamnelos, Credit Growth in Emerging Europe, World Bank Working Paper 4281, July 2007.

Low US and Asian exposure

Only 4% direct US exposure of the ATX

In contrast to its bold move into CEE, Austria's corporate sector has been lagging in comparison to, say, Swiss, Scandinavian or Dutch peers in its expansion outside Europe. We estimate that less than 10% of the ATX' capitalization can be explained by the listed companies' non-European operations. The stock market's direct exposure to North America is only 4%, to Asia even less (3%). This is simply the consequence of the fact that a number of large caps, like OMV, the financials and the utilities don't have any US operations at all. Of course, we are aware that the companies' segment reporting just shows the direct exposure to a market and that in a globalized world a recession in the US, for example, would have all sorts of negative effects for companies without any business in North America as well. But this does not change the fact that companies without US operations or exports to the US will avoid some of the troubles related to a weak US economy and a dwindling US Dollar.

This said, we believe that the recent backlash against the few globally operating Austrian cyclicals was overdone. Wienerberger, with just 13% of its sales in the US (in fact outside Europe) lost 37% since its peak, Andritz and RHI around 30%. These share price drops were mainly based on top-down considerations and not really supported by company fundamentals. Andritz and RHI both confirmed their 2008 outlook only recently and Wienerberger, while implicitly cutting their 2008 guidance, maintained its longer-term return growth and return targets.

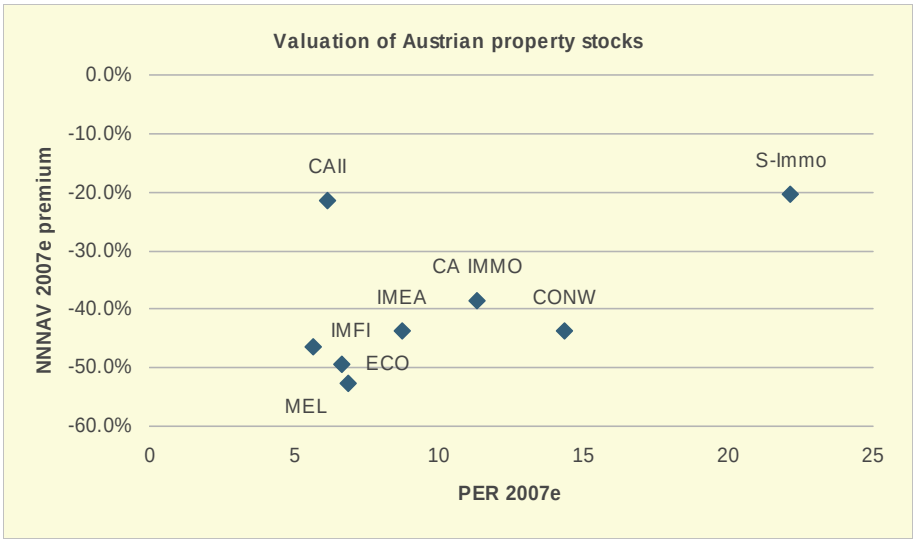
Some cyclicals are priced for disaster

We know, of course, that the cycle is not dead but this insight has been incorporated into our valuations (and those of our fellow analysts, we are fairly sure). Take for example Andritz, they will have a 2007e EBIT margin of 6%, their target is above 7% and our long-term assumption is 4.2%. All things equal, we would have to lower the margin in our terminal value estimate to 3.5% to justify the current share price. In the case of Wienerberger, the divergence is even more blatant: their expected EBIT margin this year is 14.4%, our long-term assumption is 12.5% and the margin implied by a price in the high 30s is 7%.

Nobody knows you when you're down and out

Too negative on Austrian property stocks

Similar to the cyclicals (at least some of them), we believe that the market has been too harsh on the Austrian listed property sector. Yes, a number of things went wrong like the almost sector-wide use of external management schemes, the almost insatiable demand for new equity and the limited focus on cash generation; and others proved even more devastating like the quite amazing destruction of shareholder value by Meinl European Land. And no, we are not arguing that premiums of 30% or more to the net asset valuation (in whatever definition) that we had seen by the beginning of 2007 would have been sustainable. But we also do not think that the current situation of discounts of 30% to 40% will prevail forever. In our view, all listed stocks are presently priced for a major collapse in the property sector across the companies' entire investment universe, i.e., Austria, Germany and in CEE. Maybe – and even this is not really evident across the board – the market is softening here and there, but signs of a property bubble that could burst any moment from now are clearly not visible.



Source: Company data, Thomson Financial, Oppenheim Research

It is impossible to say when exactly and at what level the listed property sector will hit the bottom, but with a median PER of 10x (and many stocks well below this figure) and – as mentioned above - discounts in the 30% to 40% range we strongly believe that stocks are below their long-term value. The interesting aspect is that none of the factors like regional focus, liquidity, the management-set-up (external vs. internal) and payout policies or any other fundamental features of the respective stocks are able to sufficiently explain their performance or their current valuations. The only exception may be the case of MEL that shows that intransparency, an erratic information policy and puzzling financing decisions are not supportive of the share price.

Our key picks

From what was said above, it is evident that we still do not give up on all cyclicals. In particular, we believe that Wienerberger (buy, FV €61.60) and Andritz (buy, FV €56.90) are significantly undervalued. Wienerberger is trading at 6.4x EV/EBITDA 2008e and a double-digit sustainable FCFY (12% in 2008e). Andritz recently came under pressure based on a weaker order intake in Q3 but the company maintained its 2008 guidance, increased its dividend outlook and is presently trading at a 30% discount to its peers. Our key picks also include OMV (buy, FV €54.00), which – on top of high crude prices – we expect to benefit from efficiency gains and which may also gain from the sector consolidation in the region.

Among the financials Erste (buy, FV €70.00) and Wiener Städtische (buy, FV €60.00), also known under its international brand 'Vienna Insurance Group', are on our buy list. However, we do not suggest owning both at the same time because in a way their investment case is fairly similar. Both are a play on the financial retail customer in CEE. Erste which regularly pops up in various lists of take-over candidates in Austria may have more near-term potential while Städtische has a more diversified portfolio of assets and thus may offer a better risk-profile.

Our buy list still includes Agrana (Buy, FV €100). The delay of the company's bio-ethanol plant and the intricacies of the European sugar market held back earnings growth this year, but during 2008 we see support from both sides. We also maintain

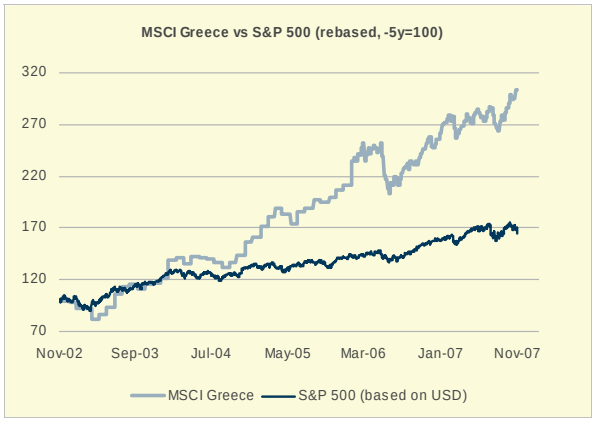
our positive stance on Intercell (buy, FV €34.00), where the newsflow regarding its product portfolio is likely to stay positive.

As mentioned above, we also believe that Austrian property stocks are substantially undervalued. In terms of regional diversification, liquidity and management set-up our key pick is CA Immo (buy, FV €20.50). However, as we have argued before in our view the entire sector seems undervalued and also other stocks in our universe such as ECO Business (buy, FV €12.40), which offers the highest FFO-yield in the sector but is unfortunately fairly illiquid, and CA Immo International (buy, FV €16.20) or even stocks that are presently not yet in our sector coverage (Sparkassen Immobilien, Warimpex, the Immofinanz-group or Conwert) offer upside and may be part of a diversified exposure to the property segment in Austria, Germany and CEE.

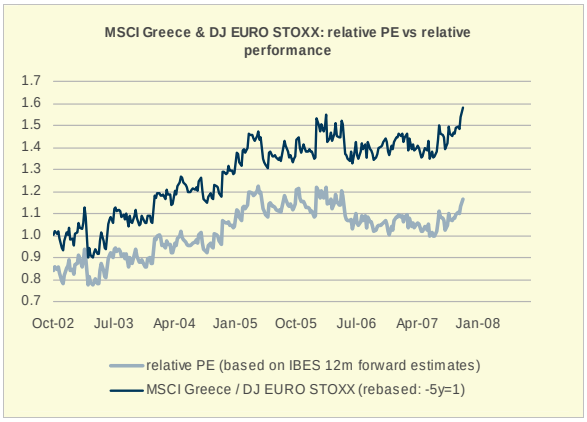
Greek stocks

An attractive but spicy option

The Greek stock market has significantly outperformed within the last two years and even though investors tend to concentrate their holdings in the larger markets when they reduce their risks by getting closer to their benchmark, we are confident that the fundamentals in Greece remain sound. The expected earnings growth for the Greek market (roughly 15% in 2007/08 and some 18% for 2008/09) is significantly higher than for Western Europe, reflecting the catch-up potential of the region. With GDP growth rates ranging between some 3.5 and 4% p.a. in recent years, the growth performance of Greece has been among the best in the OECD over the last decade, as the OECD confirmed in a Policy Brief this year in May.



Source: Thomson Financial Datastream

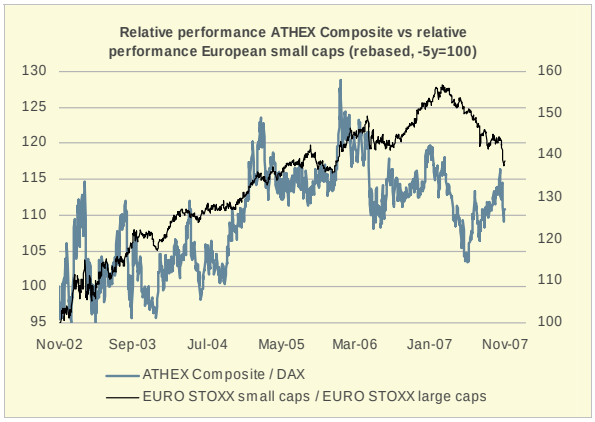


Source: Thomson Financial Datastream

Price earnings ratio, based on IBES estimates						
	PE (12m fwd)	PE (2007)	PE (2008)	PE (2009)	earnings growth (2007-08)	earnings growth (2008-09)
FTSE Greece	12.9	14.7	12.7	10.7	15.3%	18.8%
MSCI Greece	13.4	15.3	13.3	11.2	15.4%	18.7%
DAX	11.8	13.3	11.8	10.5	12.9%	11.5%
DJ EURO STOXX 50	11.2	12.1	11.2	10.2	8.4%	10.2%

Source: Consensus Economics

On the downside, however, one has to keep in mind that the Greek equity market is fairly small compared to its western European counterparts. To set the scales in perspective: the joint market value of the 60 ATHEX Composite members (roughly 141 billion euro as of November 26, 2007) is more similar in size to the MDAX (163 billion euro market value) than to the DAX (910 billion euro). As a consequence, Greek stocks are exposed in a similar manner as Western European small and mid caps to the risk of getting disproportionately hit in times of rapid sell-offs and high volatility – however, at the same time they also provide the chance of benefiting disproportionately in times of overall equity market recoveries. In this respect Greek stocks may be regarded as a kind of warrant on Western European equity indices. The figures below illustrate this pattern by comparing the relative performance of the ATHEX with the relative performance of small caps.



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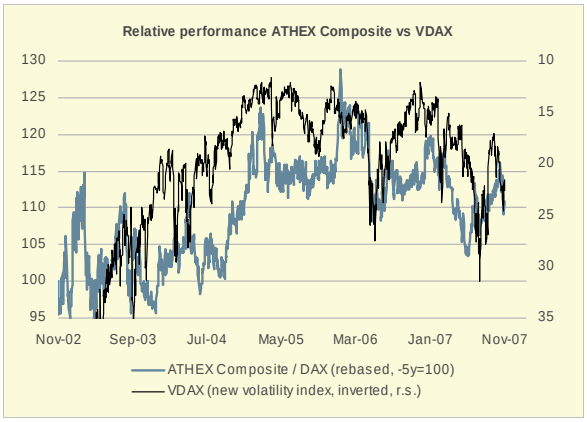


Source: Thomson Financial Datastream

Greek stocks, fundamentally, do not profit from only the above average GDP growth within their home market, but also profit from the country's excellent strategic position as a major link between the growing markets in South Eastern Europe and the mature core EU markets. According to WTO data, in 2005 53.1% of Greek exports went to the EU 25, but also 2.9 percent to Romania, 5.4% to Turkey, and 5.8% to Bulgaria. These countries were thus of similar importance for Greek exporters as the United States, with a share of 5.2% in total exports. While Greece remained a net import country in 2007, it has intensified its overall international trade considerably over the last two years (both imports and exports recently grew by some 9% year on year, see tables below). The country benefits increasingly from the advantages of the international division of labor and specialization. However, that being said, its close trade linkages to South Eastern Europe may also include some risk for the Greek economy. Considering that a number of leading indicators for central and eastern European countries have started to deteriorate (see analysis on page 50), investors in the Greek stock market should watch out for potential negative growth effects that may spread to the growth areas in South Eastern Europe.

As far as internal growth drivers are concerned, the Greek economy in recent years has made substantial progress in several respects. A number of structural reforms, financial liberalization, a dynamic privatization program and the positive effects of EMU membership, which helped to significantly reduce borrowing costs, have all contributed to the continued positive growth path of the Greek economy and set the groundwork for a substantial fiscal consolidation. Nevertheless, following the devastating wild fires this summer, the ruling conservative New Democracy party (ND) faced severe criticism regarding its crisis management and parliamentary elections were rescheduled to be held in September this year, six months ahead of schedule. Although the ND lost 13 seats in the Greek Parliament compared to the elections in 2004, the party managed to keep a diminished majority (152 of 300 seats after 165 in 2004) and will now be able to continue its policy of fiscal consolidation and structural reforms. While in the Eurozone growth of industrial production ought to slow in 2008 from 3.3% to 2.1%, consensus forecast for Greece even point to an acceleration in 2008.

Greece	historical data				consensus forecasts	
	2003	2004	2005	2006	2007	2008
GDP (year-on-year growth, %)	4.9	4.7	3.7	4.3	3.7	3.4
Industrial production (year-on-year growth, %)	0.3	1.2	-0.9	0.8	2.3	2.4
Consumer prices (year-on-year growth, %)	3.5	2.9	3.5	3.2	2.8	2.7
Current account (USD bn)	-12.7	-13.3	-17.9	-29.7	-32.8	-30.0

Source: Thomson Financial Datastream

Greece, year on year growth of GDP components							
	2001	2002	2003	2004	2005	2006	2007*
Consumer spending	4.8%	3.8%	4.2%	4.6%	3.7%	3.2%	2.7%
Fixed investments	2.3%	5.4%	11.4%	5.2%	0.0%	12.7%	10.4%
Government spending	0.4%	6.5%	-1.3%	2.5%	-0.5%	3.8%	2.8%
Exports	-3.0%	-7.7%	4.0%	7.5%	3.7%	5.4%	9.2%
Imports	-3.3%	-1.7%	4.9%	5.6%	-2.1%	9.8%	9.8%
***) Q1 + Q2 2007 relative to Q1 + Q2 2006, all data based on constant year 2000 prices**							

Source: Consensus Economics

Source: Thomson Financial Datastream

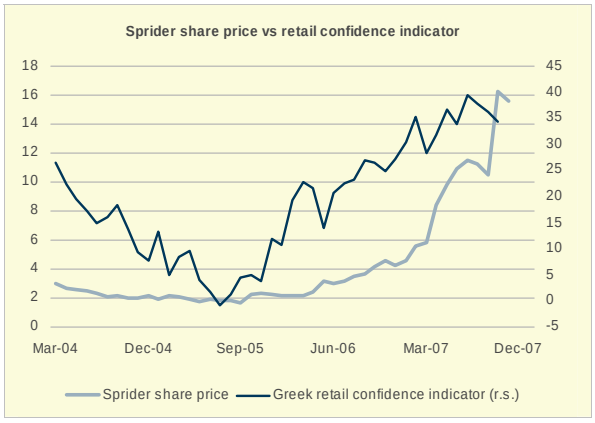
Source: Thomson Financial Datastream

Source: Thomson Financial Datastream

Source: Thomson Financial Datastream

Consumer spending recently grew at roughly 3% p.a. and investment spending, which was flat in 2005, rose by more than 10% p.a. over the last two years. Consumer confidence and especially retail confidence are on a rather high level compared to the past.

From an investment point of view, our favorite pick to play the combination of increasing incomes and positive consumer sentiment is **Sprider Stores** (buy, fair value €18.00), Greece's second largest apparel retailer and the clear leader in the value for money segment of the market. On the back of its proven store format, Sprider continues to grow both in its home market and in the growth markets of South Eastern Europe and plans to open eighteen new stores in 2007 and twenty in 2008. As the big European retail chains have not yet penetrated the region, Sprider has the potential to reap true, first mover benefits, especially as its value for money concept fits to these markets.



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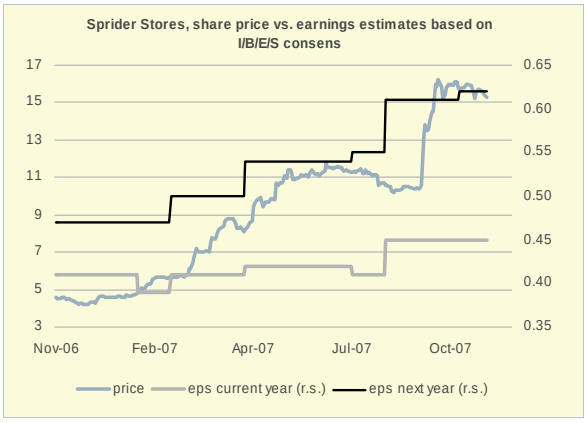
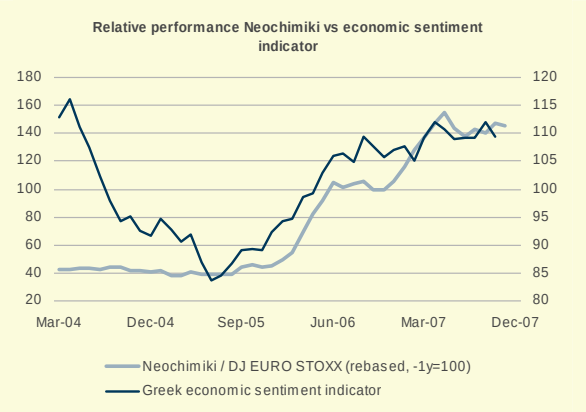


Source: Thomson Financial Datastream

Further major beneficiaries of the Greek growth story are **Alapis** (strong buy, fair value €2.86), a heavyweight in Greek healthcare, and **Neochimiki** (strong buy, fair value €27.40), which remains a continuing growth story in the Greek chemistry sector.

Alapis follows an integrated approach that continues to drive the existing business in cosmetics, detergents and veterinary products and that should also allow it to increase the penetration of the underdeveloped Greek generic market. We expect strong top and bottom line growth (sales CAGR 2007-11: 35%; EPS CAGR: 39%), which in the current environment of low prices should be additionally fueled by further acquisitions.

Neochimiki continues to persistently grow at high double-digit rates. Following strong 9M results, we expect further positive news flow from the recent acquisitions (e.g. IHP Prahovo in Serbia and the harbor in Greece) later in the year, as well as news on new targets. The penetration of the emerging Balkan states leads to strong top line growth of 70% (CAGR 2004-2008) and nearly similar bottom line growth of 68%, conservatively based mainly on existing contracts. As Neochimiki has recently strengthened its focus on the distribution side, it can now benefit even stronger from its advantageous location close to the emerging markets in the Balkans, while the steadily improving infrastructure in Greece also facilitates its sourcing activities. With a PER 2008e between 13 and 14, the share is significantly undervalued in our view, given the dynamic growth potential.



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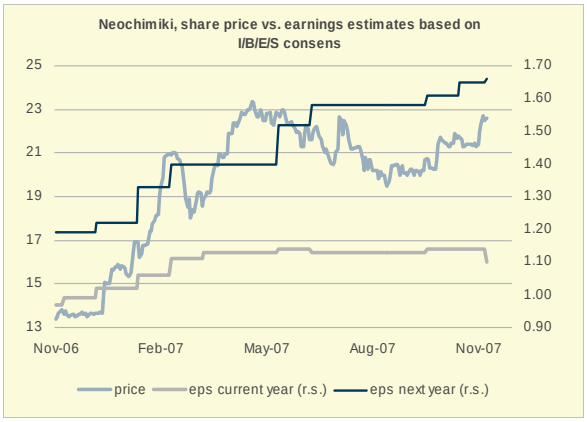


Source: Thomson Financial Datastream

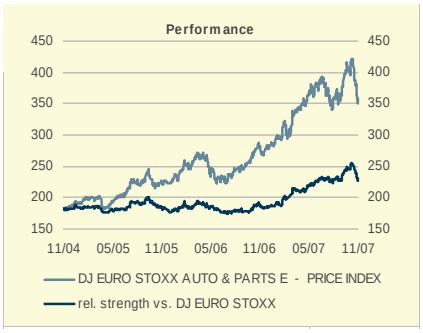
Price and valuation data							
	Price*	**Fair value**	**Rating**	**PE 2007**	**PE 2008**	**PE 2009**	**EV/EBITDA 2008**
Alapis	2.28	2.86	STRONG BUY	33.3	17.2	14.5	10.2
Neochimiki	19.20	27.40	STRONG BUY	16.6	11.8	9.3	8.0
Sprider Stores	12.02	18.00	BUY	13.8	15.7	11.9	8.4
***) prices as of**	**27-Nov-07**						

Sector Overview

Automobile & Parts

Underweight

2007-12-06



STAYING ON COURSE IN A ROUGHER SEA

The environment for the automotive sector keeps getting tougher. Consumer confidence in the US is continuously falling and the Dollar has taken a similar path. This is certainly an environment which makes upward revisions of expectations for the overall sector rather unlikely and reminds investors that the car sector is a cyclical sector after all. Nevertheless, unless we go into an outright recession we think there are a couple of good stories in the sector: Restructuring, emerging markets growth, strong free cash flow, and the return of free cash to shareholders are the themes.

US MARKET DECLINE MAINLY A PROBLEM FOR DETROIT

The consumer confidence numbers do not bode well for the US car market. However, the market has been under pressure for some time and the downward trend has not worsened after the credit bubble burst in the summer. At the same time car pricing has actually proven surprisingly resilient. So far, the downturn in the US car market is a problem for the Detroit Three while European brands with strong model momentum keep gaining share and show robust absolute growth.

EUROPEAN CAR MARKETS LIKELY TO HOLD UP

For the Western European car market the outlook is boringly flat, while the expectation for the different national markets is very diverse. Germany should recover from the VAT-hangover in 2008, Italy will suffer from running out of scrapping incentives and the UK and Spain are likely to get hit by weaker consumers on the back of a spreading real estate crisis. Overall, with a moderate economic expansion and continuing employment growth, the Western European car market should remain stable.

EMERGING MARKETS ARE THE KEY GROWTH DRIVER

With the US losing momentum, emerging markets are key for top line growth. Eastern Europe, China, and particularly the regions profiting from the high raw material prices, Brazil, Russia, and the Middle East are currently hugely profitable growth drivers. The companies most exposed to emerging market growth are VW, FIAT, and Porsche.

DOLLAR IMPACT NOT AS TOUGH AS IN THE PAST

Surely, a dollar heading towards 1.5 is a significant negative particularly for the German car manufacturers. However, the potential incremental headwinds from still more favorable hedged transaction rates moving to the current spot rates are much smaller than in the past. End of 2004, when the dollar hit 1.35, companies were still widely hedged at rates of 0.9 - 0.95. Now, they are recording transaction rates at about 1.3 to 1.35, so the incremental headwinds are much smaller than in the past.

RESTRUCTURINGS KEEP PAYING OFF

A key positive remains the ongoing restructuring efforts. At many companies these are now starting to pay-off and the benefits may still grow as a good part of them only materialize when new, more cost efficient products replace the older ones. With product life cycles of 5-7 years it can take time to feel the full impact.

TOP PICKS

Our top picks in the sector are Daimler, Porsche, and PSA among the car manufacturers and Conti among the suppliers.

Christian Breitsprecher
+49 (69) 7134 - 5066
christian.breitsprecher@oppenheim.de

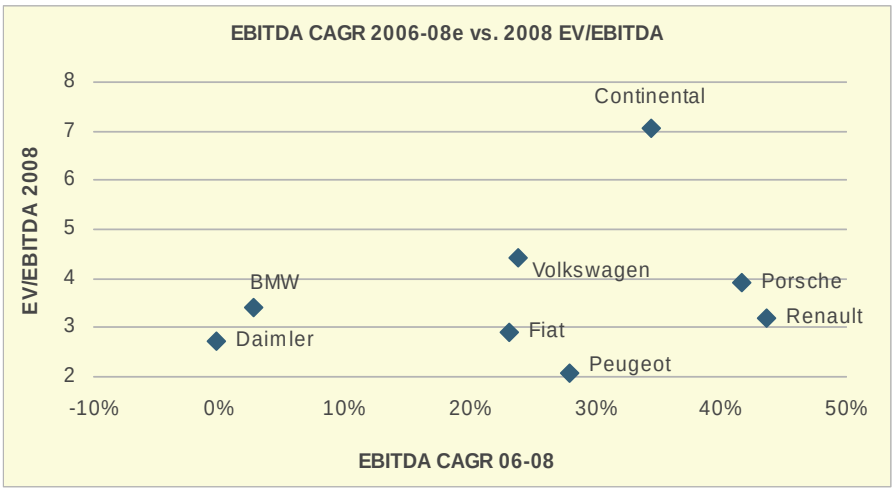
Jens Schattner
+49 (69) 7134 - 5556
jens.schattner@oppenheim.de

Daimler remains one of our top picks, even if it can be seen as a consensus call. Mercedes margins are progressing faster than originally anticipated and once the new E-Class is running at full swing, in 2010, margins should well surpass the 10% target. In the truck division the margin resilience, despite the sharp drop in the US business, sends a clear signal that the structural profitability of the business is improving significantly. A long-term free cash potential of at least €6bn per year combines with a management which is strongly positioned to drive up the share price. Thus, we can be relatively sure that the current buy back will not be the last.

Porsche combines an excellent long-term free-cash flow and luxury-goods emerging markets growth story with a highly leveraged play on the restructuring of VW. While it is probably correct to put some question marks behind the short-term growth prospects in the US, emerging markets growth remains very robust. This is combined with a stepwise expansion of the product line-up (Panamera in 2008/09, possibly followed by a smaller SUV, sharing modules with the Audi Q5). While the prospects for the Porsche core business remain strong (despite the weaker dollar), the stock is becoming a highly leveraged play on VW. If Porsche drives up its stake in VW to 50% of the ord. shares, the value of the VW stake would make up more than 80% of the market cap of Porsche.

The two most interesting plays outside of Germany are PSA and Fiat. At PSA we expect a positive trigger to materialize when the management will present the full year results on Feb. 13, 2008, combined with an update of the “CAP 2010”. At that point in time we should get more concrete numbers on cost savings and cash distribution targets which should add significant visibility to the restructuring plan. Also, Fiat is a very interesting story which gives exposure to three major macro trends, which do not look at risk at the moment: Emerging markets (Brazil makes up about 25% of Fiat sales), booming agricultural markets (CNH agricultural equipment) and the robust truck demand in Europe (IVECO), while avoiding exposure to the US consumer and US dollar transaction exposure. All this should lead to a further upgrade in company guidance regarding 2008 and a pull-forward of the 2010 targets to 2009.

Among the suppliers we favor Continental. Conti offers an outstanding long-term growth story. After combining the Motorola telematics business, and the Siemens VDO activities with Conti’s Automotive Systems, Conti is now very well positioned to profit from the long-term growth in active-passive safety (e.g., ESP, lane departure warning, distance control etc). Sure, the integration of these businesses will not be easy. However, Conti has an outstanding track-record in that respect. With a long-term free cash-flow potential in the region of €1.5bn from 2010 onwards the stock looks very attractive at the moment.

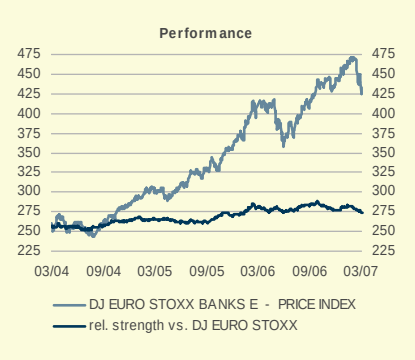


Source: Oppenheim Research

Banks

Overweight

2007-12-06



YOU SHOULD OWN BANKS!

After its disastrous performance in 2007, we see clear upside potential for the banking sector in 2008. While the news flow is likely to remain mixed, in particular ahead of the FY 2007 results, valuation levels suggest an already extremely bearish positioning of the market. We would focus on deposit-funded banks without major US or illiquid asset exposure and try to avoid wholesale-funded peers. A widening of asset margins and positive competition effects for well-capitalized market leaders will also produce beneficiaries of the current crisis. We prefer Deutsche Bank, Deutsche Postbank, KBC and Erste Bank.

PREFERENCE FOR DEPOSIT-FUNDED RETAIL NAMES

Against the background of the current crisis, we continue to favor deposit-rich retail banks rather than wholesale-funded lenders. Access to liquidity is the key asset of banks in the current environment, as it impedes a major negative interest margin impact and also reduces the likelihood of extreme risks, namely default. We would probably turn towards more aggressive positioning in case there were signs of a major monetary easing by the ECB – which is not our main scenario for the new year. On the asset side, the market focus should remain on direct US subprime exposure, as market price trends suggest the threat of further major impairment charges with FY2007 results. At the same time, the drying up of structured credit markets enlarges this issue to CDO and ABS holdlings. We would be most concerned about exposure backed by US collateral reflecting the deteriorating credit standing of the US consumer (credit cards, autos etc.). In Europe, we are most concerned about domestic UK and Spanish exposure.

BENEFICIARIES FROM CRISIS? THIS WILL BE A 2008 TOPIC!

While the market appears to have nearly exclusively focused on risks so far, we assume that 2008 is likely to be characterized by a more differentiated picture. There have already been signs with the Q3 results that asset margin attrition has come to an end. In some areas of business such as commercial real estate, asset margins have even started to markedly go up. This is a more than beneficial result for the sector as, in particular, in H1, new business margins have hardly compensated for the cost of risks. Banks with solid liquidity and capital positions will be in the best position to benefit from these opportunities. This is why we expect a clearly positive competition effect in favor of the banks with good access to liquidity and sound capital ratios. In a bull market, it may be advisable to play recovery stories. Now, it is the time to focus on the strong and well-positioned market leaders, which will improve their position to the detriment of weaker peers – and to the benefit of their shareholders.

VALUATION LEVELS HAVE MARKEDLY COME DOWN

It is true that PE multiples may be a less meaningful indicator in a downturn scenario than usual, as sell-side consensus estimates tend to drop rather slowly in a crisis-environment. The massive decline of valuation levels also relative to book values as well as our scenario analysis, such as for Deutsche Bank, appear to suggest however, that the sector in general has become attractive from a valuation perspective.

PREFERENCE FOR DEUTSCHE, POSTBANK, ERSTE AND KBC

On a European level, we see our strongest conviction in our calls on Deutsche Bank, Deutsche Postbank, Erste Bank and KBC. We would continue to be more cautious about wholesale-funded lenders with weaker access to liquidity as well as major risks on the US side.

Carsten Werle, CFA
+49 (69) 7134 - 5133
carsten.werle@oppenheim.de

Javier Lodeiro, CFA
+41 (44) 214 - 2329
javier.lodeiro@oppenheim.ch

Thomas Stögner
+49 (69) 7134 - 5602
thomas.stoegner@oppenheim.de

Reginald Veit
+49 (69) 7134 - 5669
reginald.veit@oppenheim.de

Deutsche Postbank
(Buy, FV €80)

Following Deutsche Postbank's Q3 reporting, the transparency of its bond portfolio has significantly increased. At the same time, concerns that its capital ratios might be overly stretched have not been supported. Against this background, the bank's charm of being a strong deposit taker and the sound quality of its loan portfolio should pay off. In our view, a potential disposal of DPWN makes it the most likely M&A target in the sector. With more than 14m active customers, Deutsche Postbank would also be an interesting entry into the market for potential foreign acquirers. Our fair value of €80 reflects a stand-alone value of €65, but also contains an M&A premium.

Deutsche Bank
(Buy, FV €112)

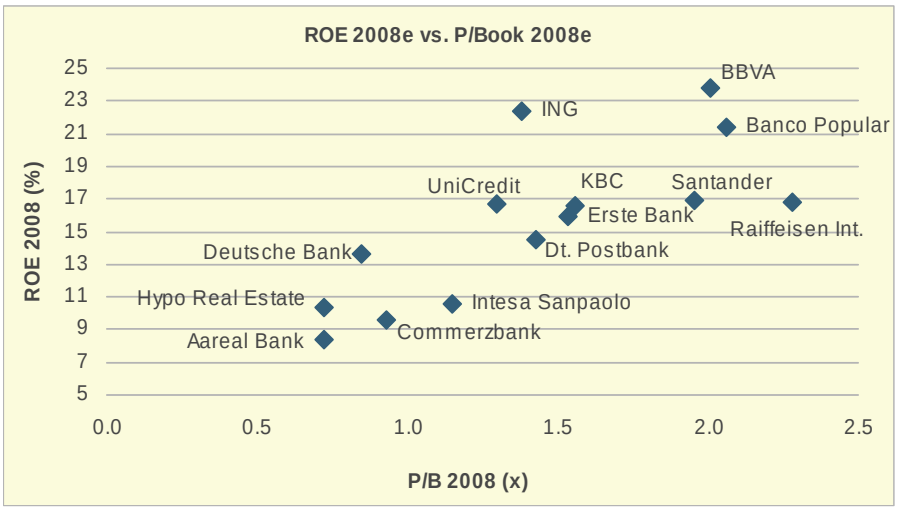
The risk of further significant impairment charges looks smaller for Deutsche Bank than for investment banking peers: In Q3, the bank reduced its CDO exposure to €1bn and has a neutral positioning towards the US residential real estate market. Despite very bullish management statements, we would not fully rule out further charges, though, as the €41bn leveraged finance exposure still looks significant. Since LCDX indices have been under less pressure than ABX prices, we do not expect further one-off charges to exceed €1bn. Based on our sum-of-the-parts valuation, the stable businesses and excess cash account for ~€58.50, implying an expected 60% decline in pre-tax profits for the 2008 cyclical units vs. 2006.

Erste Bank
(Buy, FV €70)

Despite increasing macro risk in the CEE markets, we think that four points should drive the share-price of Erste Bank in the mid-term: 1) the future revenue and cost benefits from completed restructuring projects, 2) the better operating efficiency resulting from the new group architecture program, 3) the switch from interest-intensive term-deposits to (cheaper) sight deposit in Romania that reduce funding costs and 4) the higher earnings momentum resulting from past acquisitions. Top-management will receive the variable component of the compensation only if all group targets are fulfilled. We forecast strong future earnings momentum and think that Erste Bank is likely to reduce its valuation discount in terms of multiples compared to peers.

KBC
(Buy, FV €107)

With one of the best liquidity positions and strongest solvency ratios across European banks, KBC has a comparative advantage over its peers. Corporate lending in Belgium is booming and KBC should be a main beneficiary. The quality of the debt-investment portfolio looks strong since investment standards seem to be rather conservative. Since KBC has a significant liability overhang, the bank is less vulnerable to higher wholesale-funding costs.

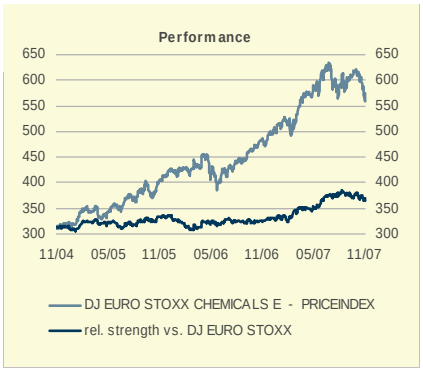


Source: Oppenheim Research

Chemicals

Underweight

2007-12-06



GOODBYE CYCLE?

2008 will be a testing year for the chemical sector. For sure, this sentence has been used as an introduction for annual outlooks for quite a few years now, but we truly believe that 2008 will be the proof in the pudding. Not only will a weakened US consumer have an impact on US directly, and to a more limited extend on Asian chemical sales, but capacities in the Middle East will add fuel to the fire. The good news is that there are only very few companies in Europe left that have a highly cyclical portfolio, i.e., that are fully exposed to the classical chemical value chain. Thus, while some valuations are very full, others still offer significant upside.

US WORRIES…

One major theme going into 2008 will be how robust chemical earnings will be against a potential storm from the US. Looking back at 2007, chemical activities in the US that were geared to automotive and housing suffered, albeit at still high levels. Chemicals as early cyclicals are thus affected by any potentially accelerating US weakness.

…WITH A POTENTIAL SPILLOVER TO ASIA

What we have selectively seen in 2007 could also be a major factor in 2008 due to a spillover effect of the current US worries into Asia (where a multitude of chemical-based consumer goods for the US are being produced). Just to play devils advocate, we feel it is important to point this potential negative factor in 2008 out to investors who are betting on the sector. Moreover, according to our data, some 15% of new ethylene capacity will be added to 2007 world capacity, predominantly in the Middle East and China. This should in all likelihood have a triggering effect throughout the chemical value chain, affecting prices and margins.

FEW FULLY EXPOSED TO CHEMICAL CYCLE…

The good news is that only a few companies in Europe are still fully exposed to the classical chemical value chain, namely: Lanxess, Ciba SC, Clariant, Rhodia and Arkema. Many other companies have successfully changed their portfolio over the last decade. Even BASF, the global leader, only has roughly 30% cyclical exposure.

…WITH RESILIENT PORTFOLIOS BEING IN THE MAJORITY

As a consequence, if and when the cyclical downturn comes, we would believe that only a handful of companies will feel a cut rather than a pinch. In fact, looking at the latest reporting season, for example, the poor trend we have seen with Clariant could even accelerate in 2008.

CONTINUED M&A IN 2008?

Globally, the past year has seen some of the biggest bangs, with Akzo Nobel's bid for ICI being the major one. With the share price weakness of late in some names, further M&A could be a possibility. Also, there are still numerous assets in private equity hands. As they are trying to finance some fresher deals, some assets might be put on the silver platter sooner than some think.

VALUATIONS – THE GUESSING GAME

We believe that the sector will not continue to sharply outperform in 2008 as it has done in 2007. Some stocks (e.g., Wacker Chemie) are over-hyped, and some, like BASF, are now fully valued. Looking at the bigger caps, only Bayer and Lonza continue to offer attractive valuations going into 2008.

Christian Faitz, CFA
+49 (69) 7134 - 5501
christian.faitz@oppenheim.de

Dr. Jürgen Reck, CEFA
+49 (221) 145 - 2765
juergen.reck@oppenheim.de

Rahul Sen Gupta, CFA
+41 (44) 214 - 2249
rahul.sengupta@oppenheim.ch

Marcus Konstanti, CEFA
+49 (221) 145 - 2556
marcus.konstanti@oppenheim.de

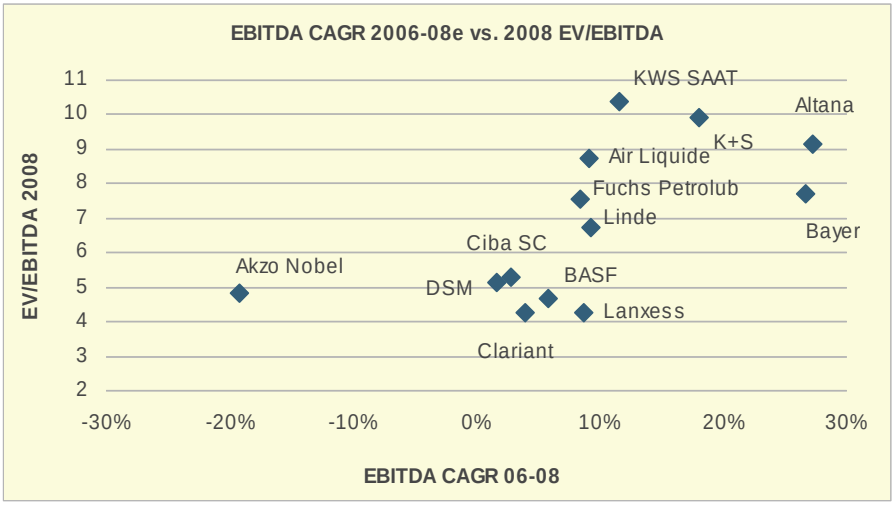
2008 will be a most interesting year for the chemicals sector. As we just mentioned, a few factors could weigh heavily on the sector: first, continued US weakness means that negative growth in the US will continue, and second, certainly two of the biggest chemical customer industries, the automotive industry and the residential building and construction industry, will continue to suffer in the NAFTA region, affecting some sub-segments of the chemical sector as well.

One highly positive aspect, but also a complicated aspect, is the diversity of the chemical sector. There is a multitude of subsegments, starting from the classical value chain to agro companies to fine chemical producers to – in fact – highly diversified companies that only have some resemblance to what one would consider a chemical company. As a consequence, the drivers that will negatively affect 2008 earnings (massive Mid-East capacity build-up, US weakness) will not affect every company in each of their segments.

For example, agro companies, both on the fertilizer side and on the pesticide and seed side, will continue to benefit from very tight soft commodity supplies coupled with high demand. However, valuations here have to be closely examined, at least from today's point of view. We currently believe, for example, that K+S, KWS and Syngenta are now fully valued, having priced in the positive business momentum that will also continue in 2008.

In our view, one of the biggest investment opportunities within the sector are the hybrid companies: Bayer, for example, is far away from valuations in its parts that some of pure play peers are seeing. On top of the parts being undervalued within the company setup, continued breakup speculation will propel the shares towards new levels. The same is true for Solvay and DSM.

To sum it up, in 2008 investors should largely avoid the over-hyped stocks of 2007 (Wacker Chemie), in addition to the clear losers (Clariant, Ciba), while those who were not fully on the radar screen, like Bayer or DSM could in fact offer quite a considerable upside. Other than that, we believe it is safer to stay on the sidelines for those who operationally performed extremely well in the past few years (BASF, K+S, Syngenta), but who right now are largely priced for continued robust earnings streams.

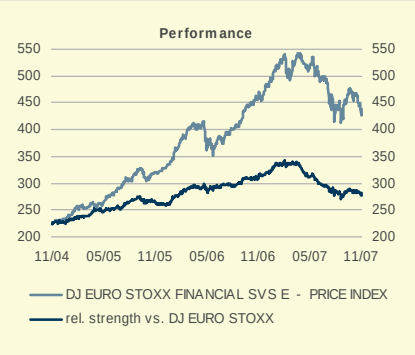


Source: Oppenheim Research

Financial Services

Neutral

2007-12-06



GAINING MOMENTUM AFTER 2007 TURBULENCES – SUB SEGMENTS ARE STILL ATTRACTIVE

We expect 2008 to bring positive momentum for some sub-segments of the financial services sector. We have seen the peak of the European/US exchange consolidation and now the focus is more on the operational business – broadly diversified exchanges, such as Deutsche Börse, as the winners. The introduction of the new capital tax law in 2009 will drive IFAs 2008 business and thus, we favor MLP, (i.e., IFAs with a strong proportion of German business will profit). Prospering ship market conditions and the tax reform will have a positive impact on the emission house business. Here, we see MPC as the best set up for the upcoming year. The uncertainty on the credit markets will make 2008 a difficult business year for private equity.

EXCHANGES – REFOCUS ON OPERATIONAL BUSINESS

After two very active years of exchange consolidation, operational business integration and extension into new areas will be the name of the game in 2008. Nevertheless, the Asian markets are in the focus of all four major exchange groups, which came up in the last year. Driven by the new Mifid regulations and the increasing pressure from alternative trading platforms, competition within the financial transaction industry will intensify. Best set up for that challenge are the broadly diversified exchange groups with a strong international derivatives business – in this context, we see Deutsche Börse as being the best set up.

MARITIME INDUSTRY – FULL STEAM FOR EMISSION HOUSES

An ongoing demand for new ship tonnage, high second hand prices, and increasing charter rates will drive the emission house business strongly in 2008. In addition, we expect the initiation of the first larger maritime industry infrastructure funds. We see the common drilling rig fund distribution of MPC and HCI as a litmus test for these large projects with financing volumes north of €1bn. Emission houses' diversification into alternative asset classes is an important factor, but the maritime products will clearly drive 2008 business.

IFA'S – BRIGHT OUTLOOK AFTER DARK 2007

Extensive changes to legal requirements in the financial industry like MiFID and the new Insurance Contract Law led to higher administrative costs and harmed the productivity of the IFA's in 2007. But for 2008, the outlook is different. We expect strong business momentum due to the introduction of the German capital tax law (*Abgeltungsteuer*) in 2009. 2008, therefore, will be the last year private investors could buy investment products like investment funds tax-free. But this new law is very complex and will generate a high degree of advice, which is an ideal situation for IFA's. Even for the years after 2008, higher sustainable revenues are to be expected for the advisors as the contracts of 2008 will have a very long maturity and will provide recurring provisions for the IFA's. Companies like MLP with a high proportion of German business will benefit most from this development.

DIFFICULT ENVIRONMENT FOR PRIVATE EQUITY

With the beginning of the sub-prime crisis, private equity markets have already seen their peak. Banks are clearly restrictive in financing highly leveraged private equity transactions. Just highly specialized small PE investors and the bulge brackets will remain attractive, but overall, PE market outlook is very cautious.

OUR TOPS

1) Deutsche Börse: Structural trend to use exchange services, cost reduction, share buy back and the ISE merger, 2) MLP: strong business growth from German tax law change in 2009) MPC Capital: Favorable ship market conditions, product innovation and tax law change

Heiko C. Frantzen
+49 (69) 7134 – 5273
heiko.frantzen@oppenheim.de

Reginald Veit
+49 (69) 7134 – 5669
reginald.veit@oppenheim.de

Deutsche Börse

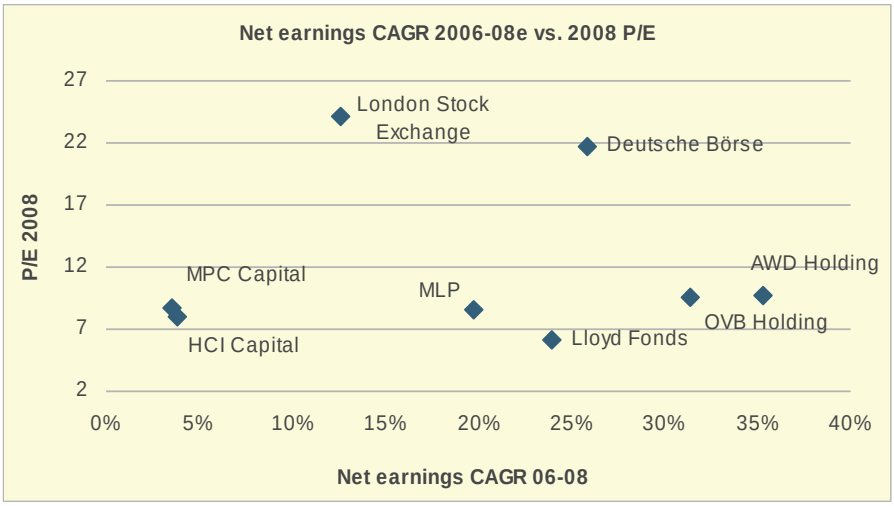
Four major factors make Deutsche Börse a very attractive investment: 1) Acquisition of the International Securities Exchange in the US (second largest options exchange) opens up access to the very important North American Market, 2) initiated cost reduction program which is, in our opinion, just the beginning of a series, 3) current share buy back program which will be most likely extended in 2008, 4) ongoing structural trend in usage of exchange transaction services for both OTC and on exchange markets. Moreover, the broad diversified business model into the five segments clearly have a P&L balancing effect in case of a business slump or increased competition driven by alternative trading platforms or fee compression. In addition to the previously mentioned four key factors, we run our very positive view of DB1 business development on an ongoing sustainable growth for the derivatives segment and moderate scenario for the cash equity markets. Within the group of the four major international exchange groups (Deutsche Börse/ISE, NYSEEuronext, CME/CBOT, NASDAQ/OMX), we see DB1 as being well set up.

MPC Capital

Within the group of listed emission houses, measured by placement volume and market capitalization, MPC is the largest player. With the Global Maritime Opportunity Fund (a private equity vehicle which should be listed within the next 12 – 18 months), the drilling rig fund, and the extension of real estate investments in to the Asian and Indian growth region, MPC shows a high degree of innovation. We value the common distribution of the drilling rig as a litmus test for larger infrastructure projects, which would open up the door for an additional highly attractive asset class for both institutional and private investors. The new organizational set up of distribution into the segment's closed funds, open products, and institutional clients should improve customer service and product sales. The recently announced share buy back program of up to 530,000 shares financed by debt will have a positive impact on both the share price and the financial structure, gaining a higher favorable leverage. MPC will use the shares for potential upcoming acquisition opportunities.

MLP

MLP's business model is intact. Due to the demographic development and the pressure on the social security systems, the need for old-age provisions will further increase. A very complex law and tax system in Germany leads to higher demand for independent advice. For both, MLP is very well positioned. The loss making activities in UK and Spain were sold. Now about 97% of the revenues are produced in Germany. For 2008, we expect new record highs for the revenues and the EBIT of MLP, supported by the introduction of the German capital tax law (*Abgeltungsteuer*), as well as the next Riester step-up. We expect MLP to benefit most from these circumstances.

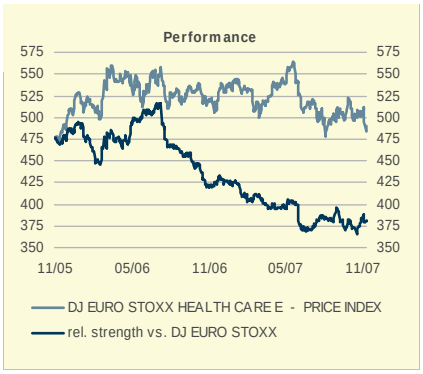


Source: Oppenheim Research

Healthcare

Overweight

2007-12-06



STILL PROBLEMS AHEAD BUT LOW VALUATION

We rate the healthcare sector overweight given its low valuation and defensive growth, referring more to the medtech sector rather than the classical pharma segment, which offers a more convincing value proposition, but which, in addition to regulatory risk, also carries substantial development and generic risk. Having been affected by some development failures recently, the Biotech sector did not succeed to get back in investors' favor. Our selection of favorites largely reflects investors' priority criteria of avoiding risk. In big pharma, we like Roche; in the smaller pharma cluster Merck KGaA and Stada; and in Medtech Fresenius AG and Nobel Biocare. Cytos and Intercell are the Biotech favorites.

NO PIPELINE RECOVERY VISIBLE, PROMINENT FAILURES

Biotech companies, particularly in Europe, have not delivered yet. Numerous failures within the industry (e.g. Desmoteplase, Satraplatin, Coley' PF3512676) darken the sentiment in the Biotech sector and will drive consolidation. However, as the number of IND submissions filed started to surge not before 2004, there is still the hope to see the wave of new products reaching the market around 2010, which gives some hope for when the generic competition rises again.

POLITICAL UNCERTAINTY TO RISE IN THE US IN 2008

While pricing pressure will remain high in 2008 in Europe due to government interventions reducing available healthcare budgets, the discussion will focus on how the next president of the US will alter the healthcare system. The current favorite Senator Clinton supports universal coverage and purchasing initiatives to reduce costs in the system in the range of USD100bn plus. On the other hand, she seems to intend to direct more funds to diagnostics to support prevention.

GENERIC PRESSURE TO EASE SLIGHTLY

While the generic threat is expected to heat up again after 2010 when more 2006 top ten products will experience generic competition (Lipitor – PFE in 2010, Nexium – AZN, Advair – GSK, Lexapro – LUN in 2011, Singulair – MRK in 2012), we expect the next two years to show limited pressure. That underlines, on the other hand, that companies like Novo Nordisk or particularly Roche are more or less safe in that respect.

LOW VALUATION

In the meantime, the sector trades near its historic lows with a PE09e of 14 (Premium about 11%; Basis: Euro Stoxx), while still offering relatively stable cash flows and the promise of major progress in the pipelines to emerge around 2010. This potential appears underestimated.

MEDTECH TO REMAIN STABLE GROWTH BUSINESS

The high growth rates and the high profitability make the Medtech sector a very attractive sector for financial investors. The sector therefore has a clear premium to the overall market of approx. 45%, which in our view, is clearly justified. As the economic uncertainties are increasing and will be reducing the earnings of the cyclical stocks, we would overweight the sector due to its defensive character.

BIOTECH WAITING FOR TURNAROUND

In 2008, Biotech again has the chance to start a sector turnaround triggered potentially by intense positive news-flow. Events at Cytos, Wilex, Intercell, Evotec, Basilea and many others may contribute to that.

Peter Düllmann, CEFA, Dipl.-Kfm.
+49 (221) 145 – 27 63
Peter.duellmann@oppenheim.de

Claudia Lakatos, Marketing Analyst
+49 (69) 7134 – 52 78
Claudia.lakatos@oppenheim.de

Dr. Tilman Dumrese
+41 (44) 214 – 23 26
Tilman.dumrese@oppenheim.ch

Dr. Christian Peter
+49 (221) 145 – 27 67
Christian.peter@oppenheim.de

Dr. Martin Vögtli
+41 (44) 214 – 23 65
Martin.voegtli@oppenheim.ch

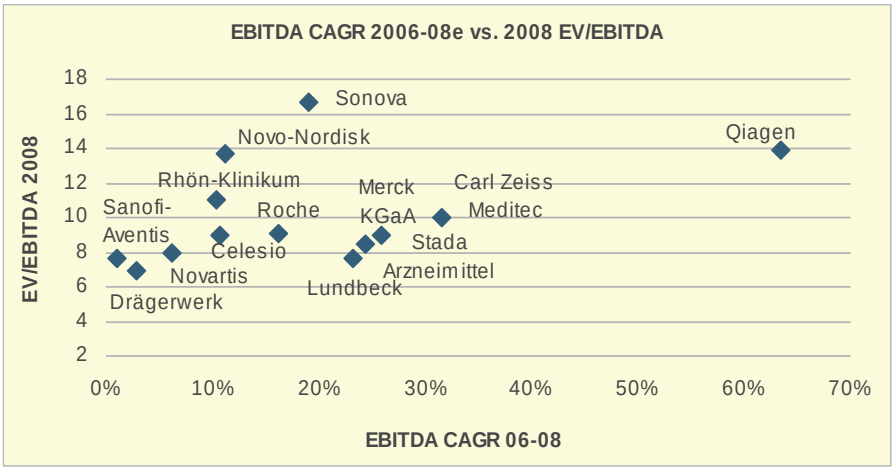
Stephan Vollert
+41 (44) 214 – 22 85
Stephan.vollert@oppenheim.ch

Roche's (Buy, FV CHF270) growth in pharmaceuticals is derived from line extensions of available drugs and is geared toward further market share gains. Today's top 3 products are expected to contribute 80% of the growth forecast until 2012e, limiting development risk. Generic threat is low, owing to the excellent patent protection profile. The margin expansion story is intact, based on significant biopharmaceuticals growth, which is set to deliver solid double digit EPS growth (CAGR 06-12e of +11.5%).

With the Serono integration moving ahead and Liquid Crystals still showing solid growth, we are confident in **Merck's** (Buy, FV€108) strong short term earnings growth perspectives. With additional potential from Erbitux (e.g. Lung Cancer) and some of the proceeds from the generics sale to be reinvested in pipeline, we keep our buy rating mirroring a not-too-demanding valuation of PE08e of <14. We expect **Stada** (Strong Buy, €58) to experience a profit jump in 08e due to underlying growth, cost optimization, earnings contribution from the Makiz and Forum acquisitions, stable price pressure in Germany, recovery of the Belgium market after spring 08, and significant synergies from the Hemofarm acquisition. Subsequent EPS-growth >20% in the next years comes at a PER 08e below 14.

Fresenius (Buy, FV €65) has a very low risk profile and generates a strong free cash flow. The company should at least reach the given mid term targets (2010e: €15bn sales, EBIT margin 15%) when including smaller acquisitions. Reasons for our optimism are new higher margin products, e.g. renal drug initiative, value adding IV drugs lifting Kabi result, and hospitals improving margins. **Nobel Biocare's** (Buy, CHF430) Q3 07 results show long-awaited signs of a slight recovery. Market recovery signs could be observed in North America as initiatives reacting to changing market dynamics appear to bear fruit. Weakness in Europe is mainly a result of the Swedish reimbursement changes that should turn positive in 08. Nobel offers a unique 1-stop shop model and is geographically broadly diversified, with Asia on the way to compensate for weaknesses in Europe or North America.

Intercell (Buy, FV €34) commands a technology with multiple validations along with a broad clinical pipeline and the valuable IC 31 immunizer. With critical mass and attractive trading liquidity, we still see upside with numerous triggers to come, e.g. IC31 deals and flu data, and the IC51 licensing deal for Japan. End 2007, the company will sit on a cash pile of around EUR300m. Having brought about 6 projects in clinical development, **Cytos** (Buy, FV CHF250) delivered proof of concept for its Immunodrug candidates in three large indications (nicotine addiction, allergy, hypertension) with blockbuster potential. The company has closed a significant license deal for its most advanced product candidate (Nicotine-Immunodrug Ph. II) with Novartis, commercially validating the project. Cash reserves should last at least until 2010.

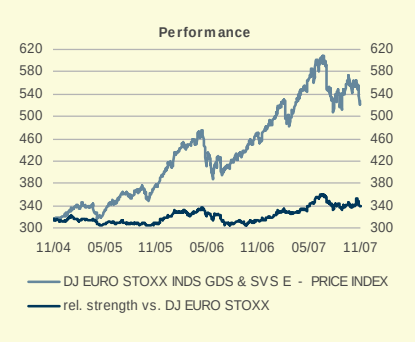


Source: Oppenheim Research

Industrial Goods & Services

Neutral

2007-12-06



WE FAVOR LOW CYCLICAL CUSTOMER SEGMENTS

Currently, the sector is still booming. Capacity utilization is at record levels, and earnings are growing this year. Looking forward, "leading indicators" have weakened since summer, as seen for example in the declining Ifo business expectations. Due to the expected declining growth momentum, we reduce our sector weighting to neutral. We favor companies that focus more on defensive markets (e.g. food related engineering) or benefit from a mega-trend (e.g. energy related engineering). The market outlook in global freight and express remains positive. Our top picks for 2008 are Deutsche Post, ABB, Demag Cranes, GEA Group, and Siemens.

ENGINEERING: DOMESTIC ORDER MOMENTUM COMES DOWN

For September, the German Engineering Association VDMA reported total order growth of 7% y-o-y. With a domestic order growth of 1%, momentum came clearly down. Due to the phase-out of declining-balance depreciation in Germany at the end of this year, we believe pre-buying impacts will result in lower domestic orders for the months to come. Foreign orders increased by 10% in September. Due to early indicators such as the Ifo business expectations, the lower GDP forecasts for the US and the depreciation change in Germany all argue for a sequential decline of sector orders, we prefer companies that focus more on defensive markets (e.g. food related engineering) or that benefit on a higher positive trend (e.g. energy related engineering).

STEEL: OPTIMISTIC 2008 OUTPUT FORECAST

The IISI (International Iron and Steel Institute) forecasts another year of growth in 2008 because of continued growth of customer industries. But expected growth in crude steel output of 7% is likely to fall short of output growth in 2007. We cannot rule out that this forecast is too optimistic, given the latest reductions of growth forecasts for major economies. With regard to pricing, European steel making companies have announced price increases either for Q1 or Q2 2008 in order to compensate for rising raw material costs (iron ore, coal). Unless the firms have hedged the USD exposure, the USD weakness tends to be positive for European steel making firms because raw material purchases are denominated in USD, whereas the greater part of revenues are denominated in €.

TRANSPORT & INFRASTRUCTURE

The key drivers of globalization and outsourcing have not really lost momentum over the last couple of quarters, in particular not for the global providers in these highly fragmented logistics markets, and should also lead to a sound volume performance in global freight forwarding in 2008. The international Express business will also remain strong while growth in domestic markets will be more modest. 2008 will be the first year of liberalization for the German and Dutch mail markets. We think the incumbents will be hurt to a lesser extent than some market participants suggest. The market for infrastructure assets like airports will remain solid, as there are numerous international tenders for the operation of airports on the agenda.

OUR TOP PICKS IN BRIEF

Siemens: 1) Less geared to the economic cycle 2) Still high cost cutting potential (SG&A cost down by 10% to 20%) 3) Large share buy back program newly established. GEA Group: 1) Resilient and well balanced business portfolio 2) With the divestment of Lurgi Group and Lurgi Lentjes, the risk/reward profile of the GEA Group will improve 3) Financial leeway for acquisitions and share buy backs. Deutsche Post: 1) Strong performance in Logistics 2) Turnaround story in Express 3) Postbank disposal in the medium term 4) Liberalization risk for the Mail cash-cow business lower than some people suggest.

Winfried Becker
+49 (69) 7134 5366
winfried.becker@oppenheim.de

Johannes Borner
+41 (44) 214 2282
johannes.borner@oppenheim.ch

Urs Diethelm
+41 (44) 214 2339
Urs.diethelm@oppenheim.ch

Marcus Hesse
+ 49 (69) 7134 – 5641
markus.hess@oppenheim.de

Peter Metzger
+ 49 (69) 7134 – 5209
peter.metzger@oppenheim.de

Christine Reitsamer
+ 43 (1) 51866 - 2710
christine.reitsamer@oppenheim.at

Frank A. Rothauge
+ 49 (69) 7134 – 5206
frank.rothauge@oppenheim.de

Ulrich Scholz.
+49 (69) 7134 – 5498
ulrich.scholz @oppenheim.de

Siemens

Siemens is our top pick in the industrial goods sector. Siemens is primarily geared toward long cycle goods like power generation and generates a large part of its earnings in the low cyclical medical area. Siemens still benefits from significant restructuring potential, e.g. its new plan to reduce SG&A cost by 10% to 20%. In addition, a new share buy back program will also help the share price. We are aware that the low US dollar and economic slowdown provide risks for Siemens, but they are much less pronounced than for most other industrial goods companies.

ABB

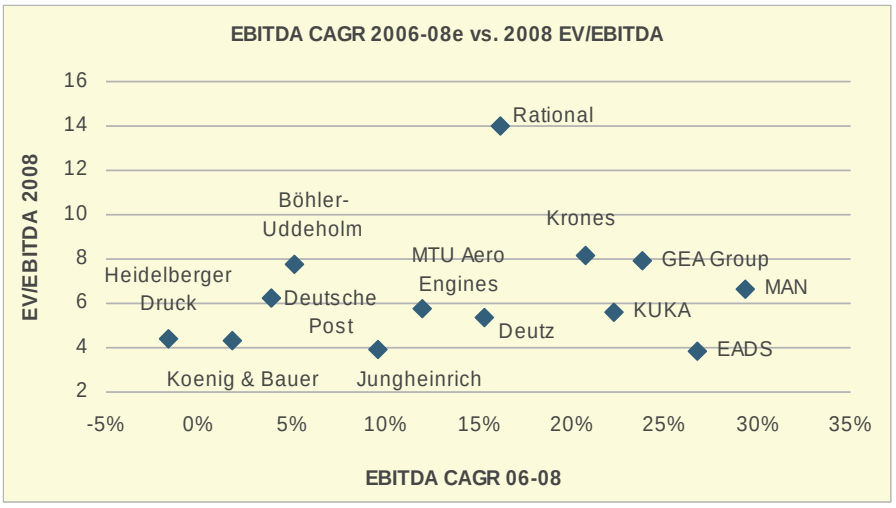
ABB is primarily a bet on investment needs in power transmission and distribution, with project momentum being particularly attractive in Europe. Infrastructure built up in Asia and the strong demand for renewable energies are sustainable mid term triggers. The pressure to enhance productivity in Western manufacturing is in favor of Automation. Double digit revenue growth with good cost and project management are expected to boost EBIT margin by 360pb. The net cash position of >USD3bn offers opportunities for external growth and/or attractive shareholder returns. ABB is an investment case in the industry sector with low exposure to the economic cycle.

GEA Group

Among GEA's major markets are low cyclical sectors such as food, beverage, and pharmaceutical industries. The aggregated sales share of these three industries amounts to 60%. After the divestment of Lurgi and Lentjes, GEA guides for a net debt position of around €-100m, or a gearing of around 6%. During the time period from 2007-2009, GEA intends to achieve a gearing of around 50-60%. In this context, GEA indicated a maximum net debt level of two times EBITDA. Consequently, GEA could raise liquid funds of up to € one billion. On September 18, GEA Group announced it would buy back shares on the stock market for an amount of up to €200m.

Deutsche Post

Deutsche Post is a revaluation story. At the latest investors' day, the new CFO of the company highlighted the company's commitment to higher transparency, a focus on cash flow drivers, a higher participation of shareholders on that increasing cash generation, as well as share buy backs (based on the proceeds from property disposals). These statements came at a time when sentiment was still poor and the valuation rather modest. Regarding the four pillar strategy, we think that 1) the priced in liberalization risk premium in Mail is too high, 2) the global logistics set up is very strong, which is not yet fully reflected in the share price, 3) Express has some continuous challenges in the US, but the business in Europe is improving and Asia is very strong, and 4) management gave the indication between the lines that a Postbank disposal might become an option. We would buy into this revaluation story.

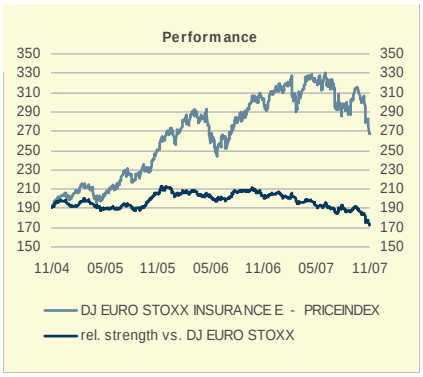


Source: Oppenheim Research

Insurance

Overweight

2007-12-06



ATTRACTIVE RISK-RETURN PATTERN

The European insurance sector offers an excellent combination of risk and return. Profit patterns in the sector have improved considerably over the last few years, with a larger share of profits coming from the underwriting activities and with much lower dependency on capital gains. As further improvements now appear more difficult, the streamlining of operations and internal consolidation are the new value drivers in the sector. However, the results will take time. In this environment we expect underwriting discipline to remain high. Income from investment is not expected to increase in the short term, as rising yields are compensated by write-downs on the bond portfolios. Our favorite picks in the sector are Allianz and Swiss Life.

IMPROVED EARNINGS QUALITY

Profit patterns in the sector have improved considerably over the last few years. With reduced equity exposures and in a low interest rate environment, the diminishing incomes from investment had to be increasingly compensated by stronger underwriting results. These have now reached historically high levels that are difficult to increase further. Thus, companies now focus on improving their operating efficiency. The most intensive initiative in this direction is currently being implemented by Allianz, who is streamlining most of its European activities.

LOW VALUATION, RISK MANAGEABLE

While the insurance sector has never fully recovered against the rest of the EuroStoxx50 in terms of PER, the value gap has further widened along with the US subprime crisis. This decline in share prices was, by and large, unjustified given the relative small exposures to troubled asset classes and, in contrast to the banking sector, good overall liquidity situation of the sector.

COMBINED RATIO EXPECTED TO REMAIN LOW

The last three years have been among the strongest underwriting years ever, with combined ratios in the mid 90s. Ahead of these results, many market participants considered such results impossible, given the strong competition in the markets. Here, the good news is clearly in the majority of the retail insurance segments, except motor as contract durations are rather long and good pricing therefore has a long persistence. Thus, even if the driver for this development, i.e., weak investment income, would turn, there would be no immediate pressure on prices across the insurance portfolios. However, with the slightly rising euro interest rates, we expect a small increase in market combined ratios in 2008. Profitability overall, however, is expected to remain strong.

LIFE INSURANCE REMAINS THE MAIN GROWTH SEGMENT

European life insurance business remains a structural growth segment, driven by demographic changes and state pension reforms in several European countries. The profitability outlook is going in the same direction, although at a lesser scale. More than the P/C business, life insurance is impacted by the still low interest environment, especially in countries where minimum guarantees exist. However, the situation has already improved and companies are more and more enforcing unit linked products, where the investment risk is with the client.

CONSOLIDATION

With solid profits over the last few years, most European insurance groups have re-built their capital base, which puts them in the position to think about optimizing their activity portfolio via selective acquisitions. Very big deals, however, should not be expected, given that the big European groups already have truly pan-European activity structures. Regions of interest are therefore mainly Eastern Europe, Southern Europe, and Asia.

Dr. Stephan Kalb, M.A., Dipl.-Vw.
+49 (69) 7134 - 5208
stephan.kalb@oppenheim.de

René Locher, Master in Econ.
+41 (44) 214 24 61
rene.locher@oppenheim.ch

Allianz

The best investment to play the "restructuring" story is Allianz. While Allianz is not the most advanced in terms of streamlining, it offers the best combination of low valuation and restructuring potential. Upon completion of the restructuring in Germany and Italy, and with the full ownership of AGF, we expect Allianz to launch European efficiency initiatives. Besides the already announced IT project, we expect a more intensified exchange of product know-how/back office operations and the full integration of all asset management activities on a global scale.

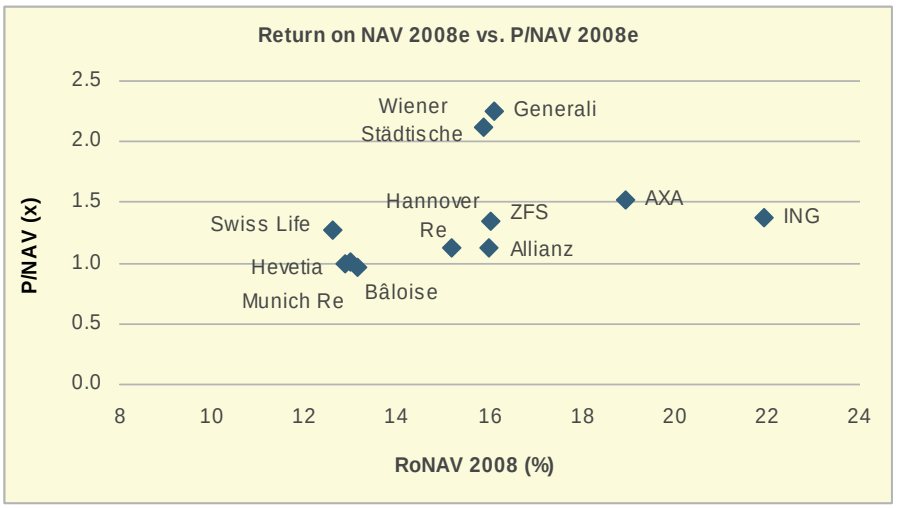
No doubt, the restructuring projects in Germany, Italy, and France are fully known by the market. However, we have the impression that the full impact of those programs is underestimated, as most of the benefits are still to come. The restructuring in Germany will be completed in 2008 with full P/L impact only in 2009. Additional measures on a European scale are also not reflected in the current valuation of the stock. The same is true for a possible value enhancing solution on the banking side.

Despite the expected earnings dynamic out of the restructurings, Allianz is trading below the European sector average in terms of earnings multiples. Our sum-of-the-parts model derives a fair value of €211.

Swiss Life

Swiss Life is one of the purest life insurance companies in Europe. At a time when non-life premium rates are peaking and growth is hard to find, we could well imagine that life insurers might get more attention from investors. Following the sale of Banca del Gottardo and the underperforming Dutch/Belgian units for a very good price, the company said that it will use part of the proceeds to buy back up to CHF2.5bn of shares over 18 months. This equals roughly 25% of Swiss Life's market capitalization and should support the share price in the coming months. On the M&A front Swiss Life could be an interesting takeover target for an international player looking for diversification.

Most likely to achieve its CHF1bn net profit target for 2008 already in FY 2007, Swiss Life is set to publish more ambitious targets on the short term business front, as well as for the longer term at its investors' day on December 4. Our investment case for Swiss Life is based on expected benefits from internal efficiency gains, strict cost control and top line growth.

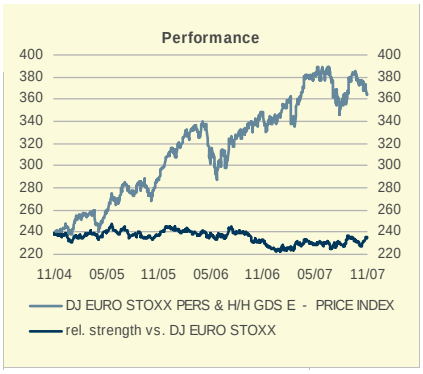


Source: Oppenheim Research

Personal & Household Goods

Overweight

2007-12-06



WESTERN EUROPE & EMERGING MARKETS SHOULD DRIVE GROWTH

The late cyclical theme of consumer confidence outperforming industrial sentiment is expected to continue. This should be positive for consumer related stocks in general. As the premium of the sector, relative to the market, is above the average of the last couple of years, we would be rather selective within the sector. We would avoid companies with high exposure to the US consumer and focus on names which benefit from growth in emerging markets as well as the core Western European markets. In the current environment we therefore like Beiersdorf and Henkel in personal care, adidas in the sporting goods sector and Hugo Boss in fashion.

PERSONAL CARE: DEFENSIVE STATUS PLAY COMBINED WITH RISING EXPOSURE TO GROWING EMERGING MARKETS

Cosmetics companies should benefit in 2008 from their defensive status considering growing signs of economic slowdown. In addition, the sector is increasingly benefiting from strong growth relays from emerging markets which should support medium term growth. Category wise, skincare should continue to enjoy the strongest growth, followed by perfumes, then make up, while hair care should continue to grow below average. Country wise, beyond strong double digit growth from emerging markets, Europe should confirm its recovery seen since end 2005, while US should slow down as witnessed since summer 2007. In 2008, investors should favor companies offering 1) favorable product mix (high share of skincare) 2) favorable country mix (high share from emerging markets) 3) limited negative margin impact from adverse forex 4) speculative appeal of mid size players (e.g., Clarins) considering growing appetite of market leaders (e.g., L'Oreal) to combine organic and external growth.

SPORTING GOODS: BENEFICIARIES OF A WEAK US-$ AND TAILWIND FROM MAJOR SPORTS EVENTS

The Olympic games in China and the European soccer championship in 2008 should lead to healthy top-line growth for the sector in 2008, despite a challenging US business. As the US mall based sporting goods retail is however already in a full swing recession since Q2 2006**,** we regard the risks for another meaningful slowdown triggered by a further deterioration of the US consumer, i.e. the market's main concern with sporting goods stocks, as rather limited. As the industry is mainly sourcing in Asia**,** it is a net US-$ purchaser and therefore benefits from a further weakness of the US-$.

FASHION & LUXURY: PRICING POWER REACHING SOME LIMITS

Following 4 years of double digit organic sales growth, (2004-2007), Q3 publications have again been above expectations, though, admittedly, combined with some more cautious outlook statement. A slowdown, with organic growth dropping to "only" high single digit growth, could thus be around the corner. Especially once you start considering the high comparison base as well as the, negative impact of the heavy price increases in recent years in both Japan and US. 2008 key drivers will remain 1) evidence of continuous support from emerging market clientele (China, Russia, Middle East), combined with sustained growth in Europe and US, more than offsetting continuous soft contribution from Japanese clientele 2) Question mark on the sector's traditional strong pricing power reaching some limits in both Japan and the US while average hedging rates on Yen/€ and $/€ are already based on 8-10% weaker rates than the 2007 levels, potentially translating into short term margin pressure 3) Valuation wise, the sector is trading up to 10% below its historic multiples, which limits downside risks, and suggests that any improvement on the currency front could translate into a significant re-rating of the sector.

Christian Bruns
+49 (69) 7134 - 5679
Christian.bruns@oppenheim.de

Joerg Philipp Frey
+49 (69) 7134 - 5279
Joerg.frey@oppenheim.de

Vincent Hamel
+33 (1) 44 94 64 19
Vincent.hamel@oppenheim.fr

Jürgen Wagner
+49 (69) 7134 - 5389
Juergen.wagner@oppenheim.de

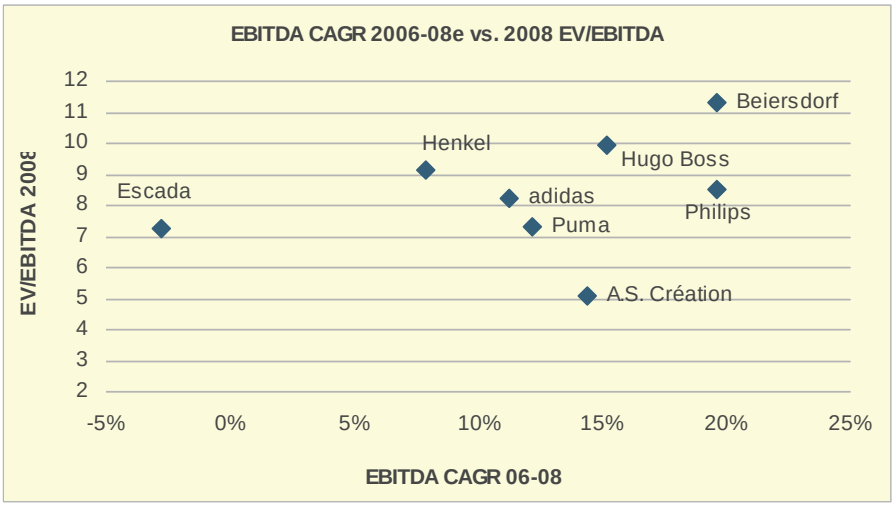
We recommend to slightly overweight the overall personal and households good sector, however we would recommend a rather selective approach.

In the personal care sector we like Beiersdorf and Henkel. The latter has a strong exposure to emerging market growth, as Henkel right now generates already 35% of sales in emerging markets, predominantly in Eastern Europe. The market is, in our view, overly concerned about a potential capital increase in order to finance its acquisition of the National Starch adhesives, however asset disposals are still more likely than a capital increase. Despite its world market leading position in adhesives and increasing organic momentum in home and personal care Henkel trades at a discount of about 10% to its peers. Beiersdorf on the other hand looks ideally positioned for the current environment. Its US exposure is low, it invests heavily into growth in the BRIC countries and should be able to leverage its leading NIVEA skin care brand further. On top, the running supply chain initiatives and cost optimization measures provide excellent visibility for a significant margin increase, at least until 2009.

In the sporting goods universe we favor adidas. Firstly, adidas' strong track record in capitalizing on its role as official sponsor of key sport events like the Beijing Olympics and the Euro 2008 soccer championship provides decent visibility for top-line growth. Secondly, improving sourcing conditions due to the weaker US$ and further progress in the Reebok integration should lead to another strong margin improvement in 2008. Lastly, we consider expectations for Reebok, right now, as rather undemanding and see signs of stabilization; therefore, Reebok should stop being the party pooper.

In fashion, we particularly like Hugo Boss. We see tremendous margin upside for the company after years of investments into new ranges (Boss Woman, accessories), IT (Columbus program) and a strong expansion of the directly operated stores network. These investments should pay off over the next few years while the exposure of Boss to the beleaguered US consumer is rather low (just 13% of sales) and we therefore expect further healthy top-line growth to follow.

Sector heavyweight, Philips, should generate shareholder value via the reallocation of capital from cash-consuming cyclical units into cash-generating growth businesses (i.e., Medical, DAP, and Lighting). In addition to operating improvements, the high cash proceeds from the sales of the cyclical businesses and further asset sales (TSMC, LG.Philips LCD) put Philips in an excellent position to expand its portfolio and return excess capital to shareholders.



Source: Oppenheim Research

Real Estate

Neutral

2007-12-06

YIELDS EXPECTED TO RISE MODERATELY

The real estate sector has been hit hard in 2007. German property stocks have seen a significant decline in value in the wake of the financial markets' turmoil. Moreover, some private equity funds that have been important players in the real estate market experienced difficulties in successfully managing such a local business. Notwithstanding these hiccups, most publicly listed property firms have published stable earnings and confirmed their guidance. In 2008, we are likely to see a more differentiated picture due to tightened financing conditions. Next year, sustainable business models could excel, while some industry laggards may become attractive takeover targets.

YIELDS SHIFT BUT MODERATE IN GERMANY

Due to the US subprime crisis, we have witnessed an accelerated increase of yields. The Royal Institution of Chartered Surveyors (RICS) remarked that we have seen a 10% valuation adjustment in the UK markets.

While London has obviously peaked, the experience on the European continent has shown a different picture during Q3. Yields in Madrid jumped by +35bp but remained unchanged in Barcelona and Paris. The development in Germany was also mixed: Yields in Berlin and Duesseldorf increased by 25bp, in Frankfurt and Munich by 45bp, but rose only moderately in Hamburg by 5% in Q3. For the FY2007, we estimate an increase by 25bp all-in-all.

STABLE LETTING MARKETS

All of Germany's top 6 office markets have seen an attractive letting performance, continuing the trend of 2006. As the development activities remain low, we see a net-take up in space, reflected in decreasing vacancy rates. However, it has to be noted that rents picked up only for prime rents.

Rents for German retail properties accelerated, driven by the rising employment rate and (still) stable consumer confidence. The largest pedestrian zones as Kaufingerstrasse (Munich), Zeil (Frankfurt), Schildergasse (Cologne) and even Tauentzienstrasse (Berlin) saw an increase in rents/sqm in 2007 from 2.3-11.1%. There has been a strong move "back to the city", which could slow down in the course of next year.

GERMAN RESIDENTIAL MARKETS "ON THE MOVE"

The greatest positive surprise has been the stronger than expected rental growth in selected regions. While the growth rate of 1.6% in 2007 for the whole Germany has been better than in the past, albeit still moderate, the increase of 5.8% in Berlin over the last two years clearly exceeded most expectations. Given the growing number of private homeowners, this trend is expected to continue in 2008. We would also expect further portfolio transactions initiated by the EK02-issue.

REITS – MORE TO COME IN 2008, HOPEFULLY!

Compared to the hyped expectations about REITS in Germany at the beginning of this year, the final number of just one REIT was rather disappointing. The exclusion of residential properties and the restrictions for disposals limit the scope for listed companies and real estate investors. If the current discount of around 20% to NAV declines in the coming weeks, we could imagine more transactions and REIT conversions to come in 2008.

Mario Davatz
+41 (44) 214 – 2417
mario.davatz@oppenheim.ch

Sven Janssen
+49 (69) 7134 – 5540
sven.janssen@oppenheim.de

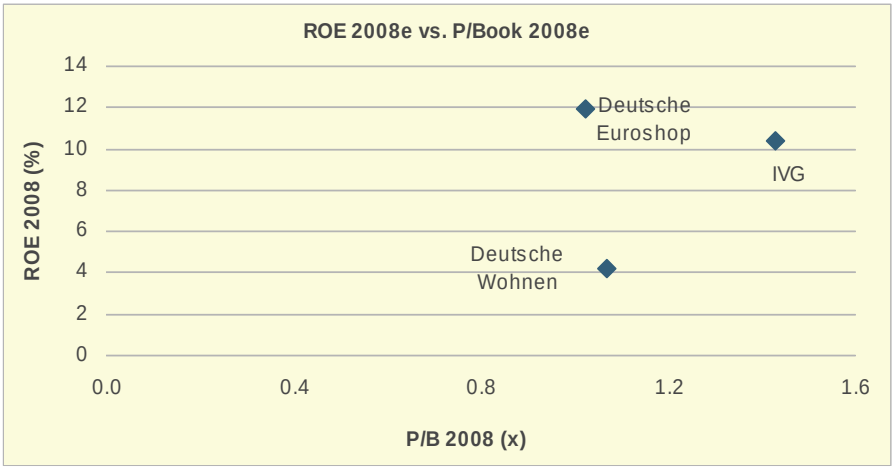
Kai Malte Klose
+49 (69) 7134 – 5235
kai.klose@oppenheim.de

Thomas Rothäusler
+49 (69) 7134 – 5132
thomas.rothaeusler@oppenheim.de

Deutsche Wohnen (DWN) is the second largest listed property company managing a standing residential portfolio, with a regional focus on Berlin and the Frankfurt/Rhine-Main region. The company's growth story is based on the vision to double its current portfolio of approximately 21,000 units by 2009, while maintaining the overall good quality of its portfolio. We think that management can realize this target and we appreciate the balanced approach of growth and quality. Our **buy** rating, with a fair value of €39, reflects DWN's current successfully managed transmission period, with Mr Zahn as the newly appointed CEO having responsibility for the management of the complete portfolio. There is growth potential from the Berlin assets and upside/cost savings potential in the "old" DWN assets. The company's published NAV stood at €39.39 (per June 2007), following the external valuation of the entire portfolio. There is a very transparent calculation of the "combined" fair value of the portfolio.

Deutsche Euroshop (DEQ) is our defensive real estate stock pick for 2008. The company is among the leading owners of shopping centers in Germany and is the only listed one. Although it is realistic to assume weaker economic growth in Germany for 2008, retail consumption is likely to recover next year relative to 2007 due to this year's one-off effect from the VAT rise. As the center management is outsourced, DEQ is acting more as a financial investor, with management being the centre of competence for the German retail markets and several years of experience in this field. The company has strict investment criteria to maintain the quality high and has been reluctant to make any new acquisitions this year against the background's substantial yield compressions of below 5% in retail real estate. Given the higher interest rate levels, we expect no further downturn, offering opportunities for DEQ. We appreciate DEQ's focus on prime shopping center space and regard the current development of two malls as attractive. We reiterate our **buy** rating and €30 fair value.

Our third pick is **IVG**: the company has €4.4 billion of its own investments, largely in office properties in selected German and European cities. IVG also provides third-party asset management through its fund management arm and is active as a project developer. While these three business lines are well managed, it is especially IVG's caverns' business that is the most attractive and least risky business of the company. Caverns are underground storage facilities for oil and gas. Currently, IVG operates 40 caverns and an additional 90 are in development. In the course of 2008, IVG is likely to launch a REIT for some of its German investments. Management recently raised its FY 2007 net profit target to EUR290 million from previously EUR250 million. The last published NAV stood at €27.7 per IVG share. Management expects it to rise to EUR 29. We rate the stock with a **strong buy** and a fair value of €41.



Source: Oppenheim Research

Renewable Energies

Neutral

2007-12-06

TECHNICAL CORRECTION PROVIDES OPPORTUNITIES

Since we became more cautious for solar stocks with our sector report on November 9, the whole sector experienced a significant correction. Based on today's share prices, we are no longer looking predominantly at turnaround candidates but good value again in market leaders such as Solarworld or Ersol, which both already provide sound upside. The current market sentiment, however, leads to some exaggerations in terms of valuation and we recommend taking opportunities in the sector as soon as the market will be driven by fundamentals again rather than by emotions. For biofuel stocks, we now have good indications of a notable improvement in the regulatory framework, which is not yet reflected in the companies' share prices. Here, we see the most attractive opportunities at Verbio.

SELECTED OPPORTUNITIES AFTER TECHNICAL CORRECTION

A broad technical correction has driven the solar stocks again to partly reasonable, partly attractive, valuation multiples. Since our sector report from November 9, which painted a rather mixed picture for the whole sector due to exaggerated valuations, Ersol's share price has decreased by some 30%, Solon by roughly 25%, Solarworld by nearly 20%, Q-Cells by some 16% and Conergy by even 50%. This development was triggered only partly by poor newsflow. Most stocks were just burdened by the worsening market sentiment in an unchanged fundamental situation. Stocks like Solarworld or ErSol are thus coming back into the limelight as soon as the market will again appreciate fundamentals rather than the sentiment.

2008 WILL STILL BENEFIT FROM FAVORABLE REGULATIONS

Fundamentally, regulation remains one of the driving forces for the solar market in the foreseeable future. In Germany, the solar industry will still benefit in 2008 from the existing EEG as the revision of the feed in tariffs will not come into force before January, 2009. The further development of the market in Spain depends on lifting the existing cap. This might, however, come at the expense of a substantial rate cut, particularly for large scale projects. Italy and Greece have introduced rather favorable regulations for the solar industry whereas intentions to support a national industry could prevent the markets from developing as fast as hoped.

SUBSTANTIAL IMPROVEMENT OF BIOFUEL MARKET AHEAD

By 2006, attractive subsidies generated strong investments in biofuel capacities, which turned into overcapacities after the weakening of the regulatory framework in August, 2006. Hiking feedstock prices worsened the situation. We now recognize the political intention to improve the situation again and expect the mandatory blending quotas to be raised again as of January, 2008. A draft law suggests a rise of the quota for bioethanol to 2.6% (currently 2% for 2008) and the introduction of a total blending quota for biofuels of 7%. Additionally, biodiesel for the public transport sector could be totally exempted from taxes, which could add another demand of some 500,000 tons of biodiesel. All in all, the demand for biodiesel could increase to some 4.5 million tons compared to an expected demand of 3.1 million tons in 2007.

BIG BIOFUEL PRODUCERS SHOULD BENEFIT MOST

Due to the critical size, reliable supply and quality standards, big biodiesel producers such as Verbio are the natural partners of oil majors companies and should benefit most from increasing blending quotas. Additionally, Verbio could benefit from sustainability requirements as soon as the planned biogas production at its bioethanol plants is up and running. Also, BDI is rather attractively valued, while we remain cautious on Petrotec.

Stephan Wulf
+49 (69) 7134 - 5207
stephan.wulf@oppenheim.de

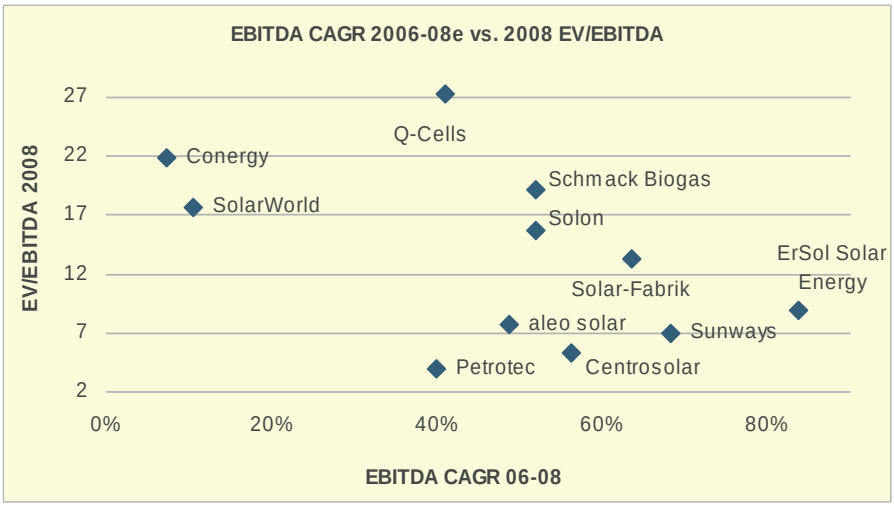
Hartmut Moers
+49 (69) 7134 - 5644
hartmut.moers@oppenheim.de

Gregor Kirstein
+49 (69) 7134 - 5623
gregor.kirstein@oppenheim.de

Aside from the regulatory environment, the development of the silicon supply situation will be crucial for the solar industry. We are likely to see an easing of the supply situation in the course of 2008, whereas the industry will not face over-capacities before 2009. Looking at capacity development along the value chain and taking into account that the feed in tariffs are still regulated, we feel that cell prices could be most vulnerable in the medium term. An integrated business concept and a presence at the upper end of the value chain are thus, in our view, very sensible for the upcoming changes in the market.

Given the status of the current political discussion and several statements especially from the SPD, we are expecting a notable increase of the mandatory blending quotas The strong increase in demand and severe penalties for not achieving the mandatory blending quota of 60 euro cents (biodiesel) and 90 euro cents (bioethanol) per liter could change the pricing mechanism on the biofuel market and could again lead to reasonable margins. In contrast to the improvement of the blending market, the cancellation of the next taxation step of 6 euro cents per liter for B100 (on top of the current 9 euro cents) remains doubtful. The change of the regulation will therefore most likely support bigger producers of biodiesel, which are the natural partners of the mineral oil industry, rather than smaller players, which are more focused on the B100 market. Therefore, companies like Verbio should be the winners of the expected political development rather than companies like Petrotec.

The essential question for the bioethanol industry will be, if the higher demand will also attract increased imports of Brazilian ethanol, which will continue to cap German bioethanol prices. Possible sustainability requirements for bioethanol, which could be attached to the mandatory blending, would protect domestic producers. It is also questionable if sufficient Brazilian bioethanol would be available to cover the additional demand.

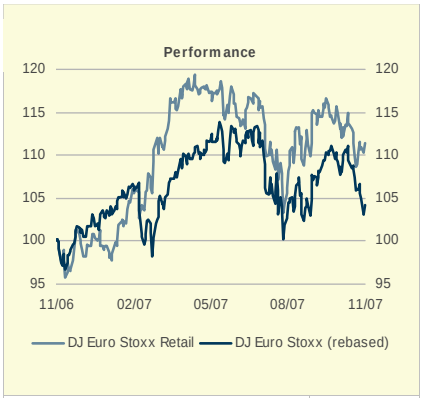


Source: Oppenheim Research

Retail

Neutral

2007-12-06



RETAIL BECOMES ATTRACTIVE AGAIN IN 2008

Having digested the VAT increase in Germany, the German consumer should show increasing confidence given strong employment figures and an uptick in wage increases. Although we are cautious about Christmas business for 2007, the sector becomes attractive again in 2008.
While the vertically integrated specialty retailers like H&M, Inditex, MediaSaturn, Praktiker, Douglas, Fielmann etc., should continue their expansion, major food retailers face strong competitive pressure and are refocusing on their core businesses and strong regional market positions. Our sector favorites are Douglas, Takkt and Sprider. We are also becoming more positive on H&M and Praktiker as well as for French food retailers, as valuations have become favorable again.

CONSUMER CLIMATE TO RECOVER ESPECIALLY IN GERMANY

We believe that strong employment markets will lead to a slight recovery of European consumer confidence. Following the VAT shock in 2007, we expect especially an uptick in private consumption of German consumers in 2008. Although high energy prices dampen purchasing power of European consumers, a strong Euro should lead to price deflation especially in Consumer Electronics and Textiles and also dampens the effect from rising oil prices. We believe that in Germany upscale specialty retailers like Douglas will clearly outperform the overall market.

MODERATE VALUATION

At some 10% premium on relative forward P/E to the DJ Euro Stoxx, European retailers' valuation is similar to its historic one and relatively attractive for a late-cycle situation, in which retailers tend to outperform the market.

LESS SUPPORT FROM REAL ESTATE AHEAD

The sector has been driven since 2005 by an asset rationalization strategy, followed by the acquisition spree taking place in the late 90's. Casino and Ahold have been the most active and to a lesser extend Metro and Carrefour. In 2008, we believe that Metro could prove the most active in divesting business units, following the change in CEO, while Carrefour and Casino should continue to dispose from non-core business, albeit at a lower pace than in 2006-2007. Another trigger should be fill-in acquisitions to strengthen existing local market positions with Carrefour as the most likely active player. On the larger M&A front, the potential merger of Ahold and Delhaize, i.e., US business on the one side, and European business on the other, are likely to resurface, potentially offsetting the impact of a weakening US consumption combined with a negative translation impact of a weakening USD on theses two Benelux retailers (some 80% of Delhaize EBIT and >50% of Ahold EBIT being generated in the US). Support from Real Estate value (for which Casino and Tesco have been, so far, the most dynamic players) will remain important but likely be less in fashion in 2008, after strong market focus in 2007, considering the US subprime crisis and its underlying negative impact on the real estate market. In Germany, rental payments are partly included in the tax base for the local "*Gewerbesteuer*", making it more favorable for retailers to own real estate.

Christian Bruns
+49 (69) 7134 – 5679
Christian.bruns@oppenheim.de

Jörg Philipp Frey
+49 (69) 7134 – 5279
Joerg.frey@oppenheim.de

Vincent Hamel
+33 1 44946419
Vincent.hamel@oppenheim.fr

- Food retailers:

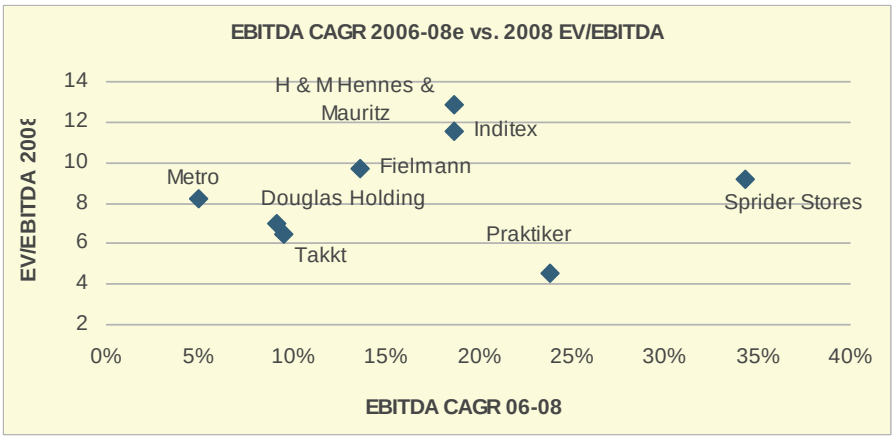
We believe that food retailers should benefit from their defensive status, at the expense of non food retailers, while specific issues are likely to remain crucial in 2008. This holds especially true for French retailers, which are moderately valued and might benefit from a potential favorable change in domestic legislation in France, which would favor a re-rating of French food retailers. In Germany, strong competitive pressure will lead to further industry consolidation (after EDEKA merged its discount business Netto with Plus). While we believe in a divestment or asset swap of Metro's extra supermarkets, we doubt that there is a strategic investor for Metro's hypermarkets out there.

In general, we believe that food retailers will come back to operational fundamentals. They will have to work for concept optimization. Metro's real hypermarket business has to improve in terms of customer satisfaction and, at the same time, cut costs significantly. Carrefour's task is to revitalize its non core sales and leverage its brand via transformation of the Champion supermarkets into a Carrefour supers concept, while at Casino the timing of the recovery of its Franprix and Leader price banners is crucial. Following its big divestments in recent years and a successful repositioning of Albert Heijn, Ahold will again look at acquisition targets in Europe.

From a valuation point of view, we would favor French retailers over Metro, as they look not only moderately valued on earnings multiples, but also in terms of cash generation. Ahold looks also interesting due to the recovery of supermarkets, but we are cautious on Ahold's exposure to a weakening US consumer. We are also cautious on Metro, as the stock trades at a premium to its sector. Although we expect some transaction in non-core assets such as Galeria Kaufhof department stores, extra supermarkets, Adler fashion stores, as well as German real estate, we doubt that Metro will be able to solve its biggest problem. Therefore, we do not expect a recovery of "real" or a sale to a strategic buyer in 2008.

- Non-food retailers:

As stated above, a lot of specialty retailers (category killers) are showing strong value creation by growing their highly profitable businesses organically. Among the vertically integrated fashion retailers we favor H&M and Sprider, while we believe Douglas (following the divestment of its value-destroying units Pohland and René Kern) offers both organic growth as well as an attractive valuation (EV/EBITDA of 7, sustainable FCF yield > 7%). While we believe Fielmann's valuation does not leave a lot upside potential, we believe that Praktiker is becoming increasingly interesting as it combines low valuation multiple with high free cash-flow generation and strong Eastern European growth. We are also impressed by Takkt's highly value-creating business model. While the group has an impressive growth track record, it is priced as a value stock (sustainable free cash-flow yield of 8%).

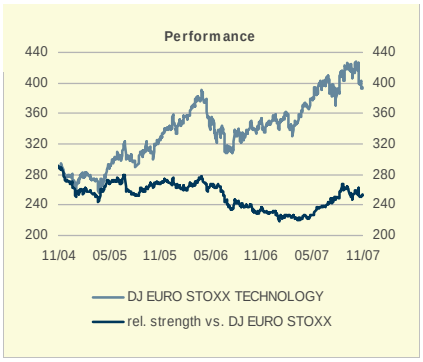


Source: Oppenheim Research

Technology

Underweight

2007-12-06



WATCH YOUR STEP

Despite recent underperformance and a contraction of valuation multiples, we believe that the near term risk factors (weakening of the US economy and the corresponding depreciation of the US-$) still overshadow mid term growth prospects for technology shares. We thus rate the technology sector as a whole as neutral. Within tech stocks, we prefer companies with a non-cyclical character and a strong growth profile, given ongoing macroeconomic uncertainties. To mention in this respect are SMARTRAC (buy, fair value €50) and Wirecard (buy, fair value €13).

SEMIS HIT BY US-$ DEPRECIATION

Semiconductor companies are severely hit by the weakness of the US-$. For the European blue chips Infineon and ST, we calculate that 1 cent depreciation against the euro costs both of them close to €10m EBIT per year. We therefore believe that this negative fundamental development will continue to burden the sector, despite significant US-$ driven share price weakness in the past. At the same time, macroeconomic risk factors have increased, so that we believe that estimates for the semiconductor market in 2008 will be scaled down over the coming months. H1 2008 should thus bring better entry points into semiconductor stocks.

SOFTWARE ALSO SUFFERS FROM THE WEAK US-$ AND SUBPRIME GHOST

Software spending is a rather discretionary item; difficult to ascertain. But the uncertain economic environment caused by high energy prices, a weak US-$, and the subprime ghost affecting other industries will certainly affect IT investment decisions in general. However, as we expect a new IT investment cycle to be forthcoming over the 2008/2009 timeframe, we believe that the spending slow-down should be rather short-term and an issue for H1 2008.

SOA MOVING ON THE HYPE CYCLE TOWARDS PRODUCTIVITY

As IT undergoes a major shift towards the use of service oriented architecture (SOA), traditional enterprise applications need to evolve to drive end-to-end business processes across silos. More companies are thus gravitating to SOA composite applications that are based on many different areas of functionality. After SOA were getting hyped in the years before, SOA made it onto the "slope of enlightenment" according to Gartner's recent Hype Cycle. We expect SOA to reach the "plateau of productivity" in the short-term as the benefits of it become widely demonstrated, triggering further software spending in the years to come. This should then help software stocks to outperform later in 2008. For the time being, however, we keep a neutral rating for software related names within our technology coverage.

STAY WITH GROWTH

Given the macroeconomic risks at the moment, we recommend a focus on technology stocks that are not driven by cyclical momentum. We thus remain buyers of SMARTRAC (FV €50), as we expect continuous strong sales and earnings growth driven by the fast adoption of RFID technology in security applications. We also recommend Wirecard (FV €13), as it benefits disproportionately from increasing e-commerce volume (CAGR 2006-10 of >+20%), which we further expect to show high double-digit growth until 2011.

Nicolas von Stackelberg
+49 (69) 7134 - 5364
nicolas.stackelberg@oppenheim.de

Jürgen Wagner
+49 (69) 7134 - 5389
juergen.wagner@oppenheim.de

Marco Zeidler
+49 (69) 7134 - 5282
marco.zeidler@oppenheim.de

Semis unlikely to see re-rating in Q1

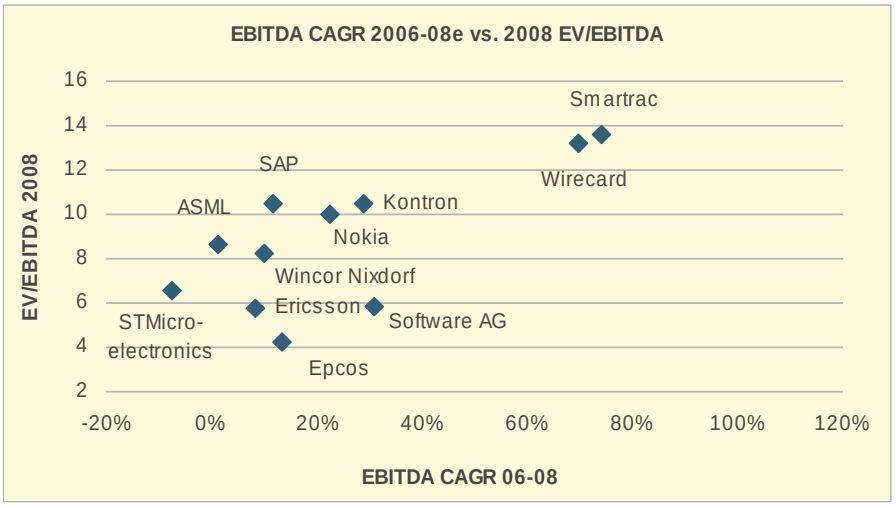
Despite the 7% semiconductor market growth (in US-$ terms) that we forecast for 2008, we believe that the unfavourable currency development will limit margin improvements for European semiconductor suppliers in 2008. While US-$ driven stocks like Infineon and ST have already underperformed over the past weeks, we don't expect a positive re-rating in the seasonally weak Q1 next year. This is especially true for Infineon where the severe DRAM price weakness in our view will continue in H1 2008 on the back of ongoing capacity expansion. For a re-rating, the company first needs to reduce its stake in the DRAM company Qimonda, which, however, will not be possible in the weak DRAM market environment that we foresee going into next year. We therefore rate semiconductor shares as neutral within our technology universe.

Next cycle of technology innovation in 2008/2009

Having a bird's eye view on IT investment patterns, Forrester has identified three distinct investment cycles in the technology economy over the past 60 years that alternate between growth and innovation, and digestion. We are currently in a period of digestion that began in 2001 when companies started absorbing the Internet technologies from the previous expansion. If past patterns hold, the next cycle of technology innovation and growth will begin in 2008-2009 as new technologies reach a tipping point of maturity. The adoption of a service-oriented architecture (SOA) will especially be a main driver for future software spending.

SOA to trigger new software spending

Note, however, that software spending is a discretionary item that could be trimmed if the economy were to enter a recession. Inflexion points are difficult to ascertain because the software industry is not as cyclical as other technology segments. But after 19 quarters of positive real software spending growth, we reached a peak level, overshooting the peak at Q1 2001. But as the IT industry undergoes a major shift towards the use of service oriented architecture (SOA), traditional enterprise applications need to evolve to drive end-to-end business processes across silos, which will likely trigger further software spending once the macroeconomic picture starts to brighten up again.

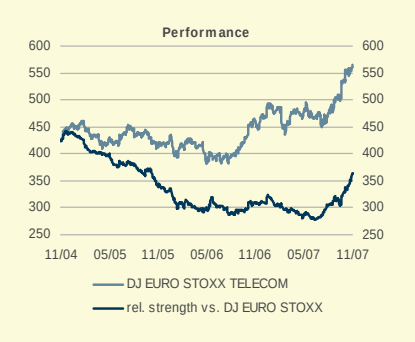


Source: Oppenheim Research

Telecommunications

Overweight

2007-12-06



DEFENSIVE STRENGTH IN SHAKY MARKETS

We continue with our overweight rating for the sector, but recommend investors to be careful when choosing individual stocks. Overall, we currently prefer large caps vs. small caps. Although most large incumbent telecom operators are still facing problems regarding saturation, competition, and regulation in their European home markets, we believe that several companies are excellently positioned to deliver mid-single-digit growth rates, decent free cash flows, and good returns to shareholders. Our top picks in the large cap universe are Deutsche Telekom and Telefonica. Our small-cap top picks are United Internet and Drillisch.

GROWTH IN MOBILE WILL BE KEY FOR SUCCESS

We believe that integrated operators who manage solid growth in mobile operations by growing their customer base and up-selling data services will show the best performance. Exposure to emerging markets with a low penetration of telecoms services is the best indicator for future subscriber growth.

COST CUTTING – THE 2ND KEY SUCCESS FACTOR

We regard continuing market share losses of incumbents in their fixed networks as nearly inevitable. However, incumbents can adapt to the declining revenue environment by reducing their costs. Cost cutting potential, but even more execution, is therefore the 2nd key success factor for incumbent operators.

BUY VODAFONE, TELEFONICA, DEUTSCHE TELEKOM AND FRANCE TELECOM

Vodafone offers significant growth potential based on emerging markets exposure and up-selling potential at a moderate valuation. Telefonica has fully integrated its latest acquisitions and shows the highest growth potential due to its exposure in Latin America. Deutsche Telekom and France Telecom are primarily restructuring stories. We expect to see successful cost reduction in the next quarters, which should lead to ongoing outperformance vs. the market.

REDUCE KPN AND BT GROUP

We have reduce-recommendations for KPN and BT Group. We believe that the organic growth options at KPN are limited due to a weak global footprint, intense competition in its home market, and slowing growth at E-Plus. BT Group is largely limited by its highly competitive British fixed network market, and we believe that the stock market overestimates the company's ability to grow abroad.

We have neutral recommendations for Swisscom, Telecom Italia, and Telekom Austria. Swisscom enjoys a less competitive home market, but we fear that Fastweb will not deliver on high growth expectations. With regard to Telekom Austria, we recognize increasing problems in the home market, Austria, and the urgent need for a larger cost cutting effort. Telecom Italia trades below its peer group, as justified by under-average growth prospects due to a weak diversification from home market risk and regulatory pressure.

TOP SMALL MID CAP: UNITED INTERNET

Even after the temporary break down of the talks with Freenet we regard United Internet as the top pick among small and mid caps because UI is able to grow its online marketing business strongly and benefits from the internationalization of the hosting business. We also regard QSC as interesting because the share price seems to bottom out at a low level after the recent profit warning.

Frank Rothauge
+49 (69) 7134 – 5206
frank.rothauge@oppenheim.de

Sonia Rabussier
+49 (69) 7134 – 5199
sonia.rabussier@oppenheim.de

Marcus Sander
+49 (69) 7134 - 5368
marcus.sander@oppenheim.de

Wolfgang Specht
+49 (69) 7134 - 5224
wolfgang.specht@oppenheim.de

Valuation remains moderate

The European Telecom sector showed a solid performance in 2007, with DJ Stoxx Telecom outperforming the Euro Stoxx 50 by 4%-points in the first 9 months. The large Telecoms stocks also showed defensive strength during the market downturns in February/March, July/August, and November. Nevertheless, we believe that several stocks in the sector are still moderately valued and offer interesting investment opportunities. EV/EBITDA multiples of our large caps universe for 2008 range from 5.5x to 7.5x, and PER from 11x to 16x. Telecom remains one of the very few sectors where cash flow yields can reach double-digit levels, and where the companies in our universe are paying a solid dividend yield of 4% to 6%.

Overweight the sector

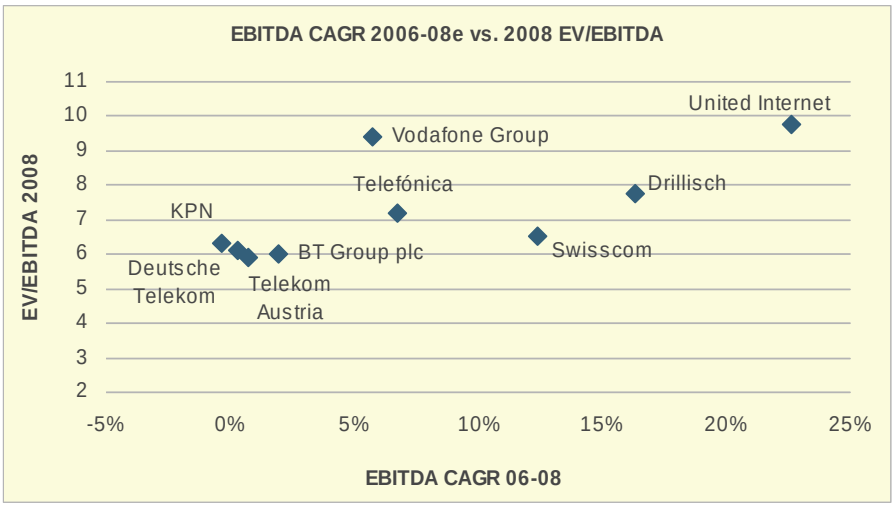
Based on the current levels, we are still convinced that the telecom sector will show positive relative performance and, therefore, we recommend overweighting telecoms-stocks in the sector allocation. The relative strengths of big cap telecom stocks will continue in the current volatile market environment due to stable revenue streams based on long term contracts, no exposure to the oil price, below average foreign-exchange-risks, and significant potential to lower costs. On the other hand, competition in saturated markets and pressure from regulation remain major threats for the European operations of our large caps universe. However, we believe that the overall picture has improved since many companies have initiated cost cutting programs that are starting to deliver results, and have also increased their exposure to growth areas.

Footprint in emerging markets secures growth

We expect the companies in our universe to show a CAGR 2006-09 of around 5% for sales and 3% for EBITDA. We believe that a significant footprint in the strong growing emerging markets and a diversification in both fixed network and mobile services, in order to offer bundles, will best secure future organic growth. Telefonica (35%), Vodafone (27%) and Telekom Austria (25%) have the highest exposure to growth markets, and thus have better growth opportunities than BT Group (3%) or KPN (2%), which are able to grow their revenues only slightly - if at all.

No relief from regulatory pressure

Overall, we do not see a high likelihood that Europe's large operators will receive significant easing of regulatory pressure in the short term. In the fixed network, both national regulators and the European Commission in Brussels continue to demand fair access for competitors to incumbent networks. In the mobile area, we rather expect worsening conditions regarding fixed to mobile termination (FTM) in the mid term.

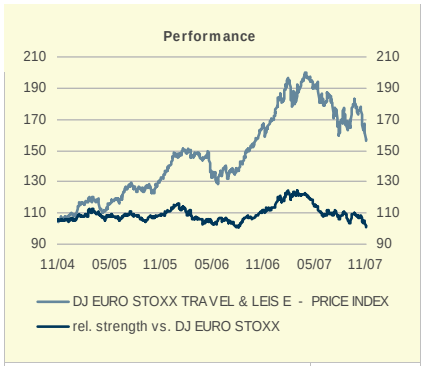


Source: Oppenheim Research

Travel & Leisure

Neutral

2007-12-06



CYCLICAL STOCKS MUST NOT BE RULED OUT

In view of a macroeconomic scenario that foresees some dangers to global economic growth, the cyclical stocks might not be regarded as a core investment for the year 2008. However, industry earnings should show good progress based on easing pressure from the oil side, the benefits from consolidation and restructuring and a still decent pricing power. In addition, valuations no longer appear ambitious and even offer a sound upside in some cases. Against this background, we feel that, in particular, the potential of the German airlines is currently underestimated to some extent.

MACROECONOMIC FACTORS DO NOT ONLY HURT

Though we expect global economic growth to weaken somewhat in 2008, we see some further weakening in the US$ and the oil price, helping in particular the airlines and shipping companies on the cost side. Given that German consumer sentiment should remain relatively stable, German airlines, i.e., Lufthansa and Air Berlin, should be better off, in particular compared to their British peers.

FEELING THE BENEFITS OF CONSOLIDATION …

The year 2007 has set significant milestones in the consolidation of the airline and tourism industry. Companies such as Air Berlin, Thomas Cook or TUI Travel are likely to realize substantial synergies from their recent acquisitions which should be a main driver of profitability in 2008.

… AND RESTRUCTURING

In particular, the tourism companies have already undertaken large restructuring efforts to bring back their business to decent profitability levels. We have already seen first signs of a turnaround in late 2007, which is likely to continue in 2008. This is supported by positive indications for the top line from the recent booking updates.

PRICING POWER IMPROVES AT THE RIGHT POINT IN TIME

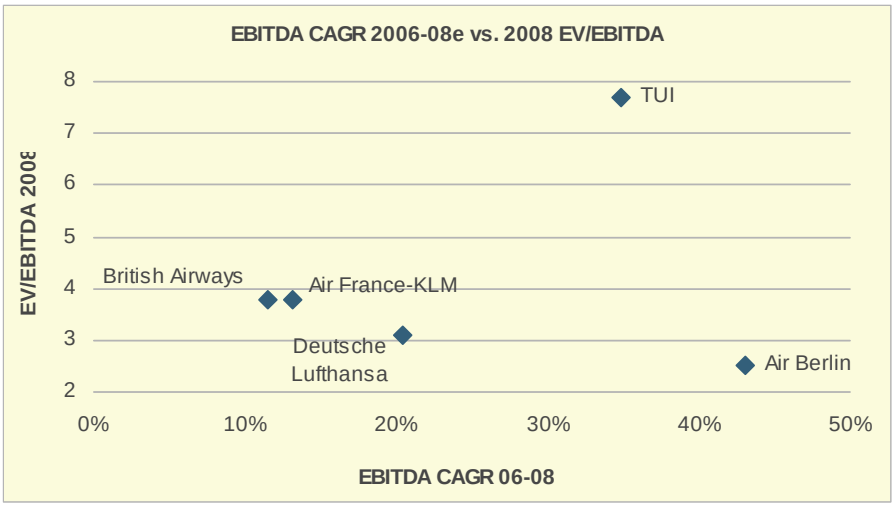
A major issue for 2008 will be to what extent the companies are able to pass on the burdens on the cost side to their customers. Fuel surcharges have worked well for airlines in 2007 and should continue to do so in 2008. On the shipping side customers have been in the stronger position in 2007. Indications are rather positive that based on strong demand at this point in time we run into a good renewal season. This would ease any pressure from an economic weakening in the course of 2008.

VALUATIONS NO LONGER AMBITIOUS

The companies under coverage have come back to quite reasonable valuation levels. In particular, the German airlines now trade at or below three times 2008 EBITDA. While we see Lufthansa as the safest bet in the industry, Air Berlin is a call on the realization of the synergies from LTU in 2008. This is, however, rewarded with the highest upside in the sector. TUI trades at a rather high multiple, which widely reflects the recovery potential on the earnings side.

Hartmut Moers
+49 (69) 7134 - 5644
Hartmut.moers@oppenheim.de

Markus Hesse
+49 (69) 7134 - 5641
Markus.hesse@oppenheim.de

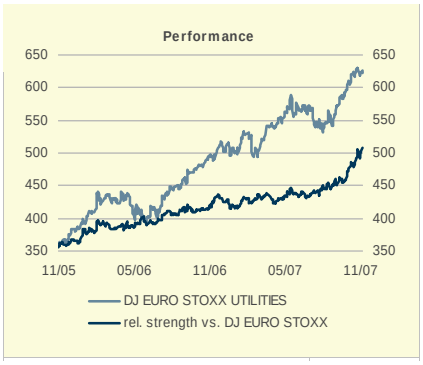


Source: Oppenheim Research

Utilities

Neutral

2007-12-06



BET ON POWER PRICES AND M&A

Double-digit earnings growth rates should support the sector in 2008 again. We continue to see political pressure under control, while power generators should continue to benefit from risen power prices and generation margins (despite lower CO2 allocations). We recommend buying E.ON, RWE, MVV and Verbund. Moreover, we still see benefits from the execution of the GDF Suez and would play this via the Suez share, which has a stronger stand-alone case. All in all, however, the strong performance in 2007 has driven the European utilities sector to its fair value, so we keep our neutral rating on the sector.

STRONG OUTLOOK FOR POWER AND CO2 PRICES

We expect Central European power prices to remain firm at levels of at least €55/MWh. Supported by high coal and CO2 prices, levels of €60-65/MWh are possible. This would primarily support "clean" power generators, such as EDF and Verbund but also E.ON and Suez. The wholesale price increase should also overcompensate a widening of the CO2 shortage in the second trading period, so we also expect positive implications for "dirty generators", such as RWE. CEZ will benefit from the full convergence of domestic power prices towards Western European levels and still suffer just marginally from cuts in CO2 allocations.

REGULATORY ENVIRONMENT UNDER CONTROL

The EU Commission should continue to push forward its initiative for reforms in the electricity and gas sectors. We continue to see strong opposition against ownership unbundling. However, even if this plan materialized, utilities would likely spin off transmission assets, so we would expect neutral impact on utilities valuation. The German Cartel Office should make use of tighter competition rules but we continue to trust in German utilities' ability to proof the fairness of pricing.

DOUBLE-DIGIT EARNINGS GROWTH FOR FY 2007 + FY 2008

For FY 2007, we expect 10% average EBIT growth for European utilities. This should even accelerate for FY 2008. CEZ (+33%e) should lead the ranking, thanks to power price convergence. Iberdrola (+25%e) should benefit from full consolidation of SPW and a recovery of power prices in Iberia. GDF (+25%e) should recover from warm winter conditions in 2007. Verbund (+13%e) should benefit from higher spot prices in Austria. RWE (+10%e) and Suez (+11%e) should also reach double-digit levels thanks to higher power prices and despite rising CO2 cost. The growth at E.ON (+15%e) and Veolia (+17%e) should be mainly investment-driven.

M&A: EXECUTION IN H1 – NEW DEALS IN H2?

For early 2008, we expect the closing of announced merger GDF Suez, the swap of Distrigas against assets of EDF, E.ON or RWE and the transfer of assets from Enel/Endesa to E.ON. Some minor value accreting transactions might be also taken by CEZ (eastern Europe) and MVV (German Stadtwerke). In H2, we might see renewed takeover speculation on RWE (e.g., from EDF, GDF Suez or Gazprom). In contrast, we continue to regard a takeover of Iberdrola as unlikely.

VALUATION - TOP PICKS

After an increase of more than 20% in 2007, the sector is already fairly valued. However, within the sector, we see buying opportunities at RWE and Verbund (increase in wholesale prices are not yet fully anticipated), E.ON (benefits from expansion strategy), Suez (benefits from wholesale prices and merger with GDF).

Matthias Heck
+49 (69) 7134 – 5203
matthias.heck@oppenheim.de

Stephan Wulf
+49 (69) 7134 – 5207
stephan.wulf@oppenheim.de

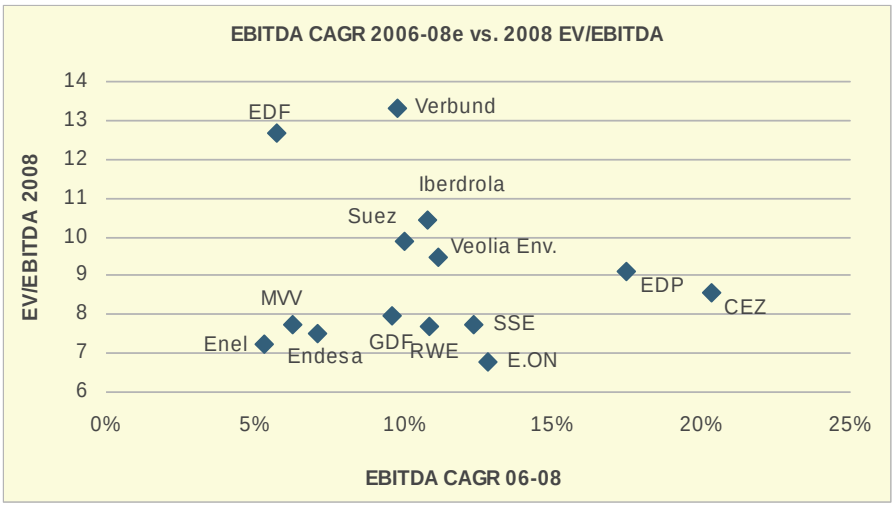
Gregor Kirstein
+49 (69) 7134 – 5623
gregor.kirstein@oppenheim.de

	EBITDA				EBIT				Net Profits			
	FY 07e	*change*	FY 08e	*change*	FY 07e	*change*	FY 08e	*change*	FY 07e	*change*	FY 08e	*change*
CEZ	75,197	*17%*	93,199	*24%*	53,127	*33%*	70,437	*33%*	41,783	*51%*	51,873	*24%*
EDF	15,181	*5%*	16,099	*6%*	10,163	*9%*	10,769	*6%*	5,012	*19%*	5,438	*8%*
EDP	2,758	*20%*	3,181	*15%*	1,987	*19%*	2,101	*6%*	865	*-8%*	935	*8%*
Endesa	7,610	*7%*	8,204	*8%*	5,559	*6%*	6,132	*10%*	2,675	*-10%*	3,217	*20%*
Enel	8,530	*6%*	8,894	*4%*	5,901	*1%*	6,194	*5%*	3,137	*3%*	3,339	*6%*
E.ON	12,463	*10%*	14,267	*14%*	9,323	*15%*	10,754	*15%*	6,522	*29%*	5,730	*-12%*
GDF	4,921	*1%*	5,831	*18%*	3,502	*-3%*	4,377	*25%*	2,264	*-1%*	2,890	*28%*
Iberdrola	5,874	*51%*	7,174	*22%*	3,972	*50%*	4,952	*25%*	2,668	*61%*	3,350	*26%*
RWE	7,211	*18%*	7,817	*8%*	9,000	*14%*	9,939	*10%*	3,413	*-11%*	3,967	*16%*
Scottish & Southern*	1,303	*10%*	1,346	*3%*	1,814	*6%*	1,897	*5%*	799	*-4%*	830	*4%*
Suez	7,014	*13%*	7,695	*10%*	5,193	*15%*	5,758	*11%*	3,205	*-11%*	3,385	*6%*
Veolia Env.	4,222	*10%*	5,231	*24%*	2,541	*14%*	2,962	*17%*	1,025	*35%*	1,238	*21%*
Verbund	1,070	*8%*	1,358	*27%*	886	*10%*	1,003	*13%*	570	*14%*	690	*21%*
Sector Median		**10.3%**		**14.5%**		**14.3%**		**10.9%**		**3.3%**		**16.2%**

The reporting season for FY 2007 results should display double digit growth rates for the sector EBITDA and EBIT. The strongest growth rates should be recorded at Iberdrola (acquisition of SPW). The highest organic growth will be shown by CEZ (benefits from wholesale price convergence), EDP (LatAm and Distribution Iberia). Thanks to strong benefits from rising power generation margins, RWE and Suez should record double-digit growth as well. E.ON should benefit from operating improvements in UK and Nordic. Veolia's performance is primarily driven by growth investments.

For 2008, we expect further double-digit growth rates for the sector. CEZ should lead the ranking, with Czech power prices fully converged to Western Europe. Iberdrola should benefit from full consolidation of SPW and a recovery of power prices in Iberia. GDF should recover from warm winter conditions in 2007. Verbund should benefit from higher spot prices in Austria. RWE and Suez should marginally surpass the 10% growth level, thanks to higher power prices and despite rising CO2 cost. The growth at E.ON and Veolia should be mainly investment driven.

Considering our EBITDA growth expectations, E.ON and CEZ are cheaply valued. RWE and GDF Suez appear to be attractive, as well. In contrast, EDF and Iberdrola are already rather expensive.



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Sal. Oppenheim jr. & Cie. Securities Inc.

4250 Park Avenue, Suite 911
New York, NY 10017
Tel: +1 212 888 52 46
Fax: +1 212 888 0916

E-MAIL: jhagenbuch@sal-oppenheim.com

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GERMANY

Winfried Becker, Ind. Goods & Serv.
Telephone +49 (69) 71 34 - 53 66
winfried.becker@oppenheim.de

Christian Breitsprecher, Automotive
Telephone +49 (69) 71 34 - 50 66
christian.breitsprecher@oppenheim.de

Christian Bruns, Retail, Consumer Goods
Telephone +49 (69) 71 34 – 56 79
christian.bruns@oppenheim.de

Peter Düllmann, Health Care
Telephone +49 (221) 145 – 27 63
peter.duellmann@oppenheim.de

Christian Faitz, Chemicals
Telephone +49 (69) 7134 – 55 01
christian.faitz@oppenheim.de

Heiko C. Frantzen, Financials/Real Estate
Telephone +49 (69) 71 34 – 52 73
heiko.frantzen@oppenheim.de

Jörg P. Frey, Retail, Consumer Goods
Telephone +49 (69) 71 34 – 52 79
joerg.frey@oppenheim.de

Matthias Heck, Utilities
Telephone +49 (69) 71 34 – 52 03
matthias.heck@oppenheim.de

Markus Hesse, Transport
Telephone +49 (69) 71 34 – 56 41
markus.hesse@oppenheim.de

Sven Janssen, Real Estate
Telephone +49 (69) 71 34 – 55 40
sven.janssen@oppenheim.de

Matthias Joerss, Strategy
Telephone +49 (69) 71 34 – 56 45
matthias.joerss@oppenheim.de

Dr. Stephan Kalb, Insurance
Telephone +49 (69) 71 34 – 52 08
stephan.kalb@oppenheim.de

Dr. Volker Karb, Strategy
Telephone +49 (69) 71 34 – 56 04
volker.karb@oppenheim.de

Gregor Kirstein, Utilities
Telephone +49 (69) 71 34 – 56 23
gregor.kirstein@oppenheim.de

Kai Klose, Real Estate
Telephone +49 (69) 71 34 – 52 35
kai.klose@oppenheim.de

Marcus Konstanti, Health Care
Telephone +49 (221) 145 – 25 56
marcus.konstanti@oppenheim.de

Peter Metzger, Engineering
Telephone +49 (69) 7134 – 5209
peter.metzger@oppenheim.de

Ludger Mues, Health Care, Chemicals
Telephone +49 (221) 145 – 2764
ludger.mues@oppenheim.de

Hartmut Moers, Utilities, Transport
Telephone +49 (69) 71 34 – 56 44
hartmut.moers@oppenheim.de

Dr. Christian Peter, Health Care
Telephone +49 (221) 145 - 27 67
christian.peter@oppenheim.de

Sonia Rabussier, Telecom/Media
Telephone +49 (69) 71 34 – 51 99
sonia.rabussier@oppenheim.de

Dr. Jürgen Reck, Chemicals
Telephone +49 (221) 145 – 27 65
juergen.reck@oppenheim.de

Thomas Rothäusler, Banking & Financials
Telephone +49 (69) 71 34 – 5132
thomas.rothaeusler@oppenheim.de

Frank A. Rothauge, Telecommunications
Telephone +49 (69) 71 34 – 52 06
frank.rothauge@oppenheim.de

Marcus Sander, Telecommunications
Telephone +49 (69) 71 34 – 53 68
marcus.sander@oppenheim.de

Jens Schattner, Automotive
Telephone +49 (69) 71 34 – 55 56
jens.schattner@oppenheim.de

Henrik Schindler, Real Estate
Telephone +49 (69) 71 34 – 56 19
henrik.schindler@oppenheim.de

Ulrich Scholz, Ind. Goods & Serv.
Telephone +49 (69) 71 34 – 54 98
ulrich.scholz@oppenheim.de

Harm Schütt, Ind. Goods & Serv.
Telephone +49 (69) 71 34 – 50 65
harm.schuett@oppenheim.de

Wolfgang Specht, Telecommunications
Telephone +49 (69) 71 34 – 56 19
wolfgang.specht@oppenheim.de

Nicolas P. von Stackelberg, Technology
Telephone +49 (69) 71 34 – 53 64
nicolas.stackelberg@oppenheim.de

Thomas Stögner, Banking & Financials
Telephone +49 (69) 71 34 – 56 02
thomas.stögner@oppenheim.de

Jürgen Wagner, Technology
Telephone +49 (69) 71 34 – 3 89
juergen.wagner@oppenheim.de

Carsten Werle, Banking & Financials
Telephone +49 (69) 71 34 – 51 33
carsten.werle@oppenheim.de

Stephan Wulf, Utilities
Telephone +49 (69) 71 34 – 52 07
stephan.wulf@oppenheim.de

Marco Zeidler, Software/IT Service
Telephone +49 (69) 71 34 – 52 82
marco.zeidler@oppenheim.de

Dr. Ralf Zimmermann, Strategy
Telephone +49 (69) 71 34 – 56 60
ralf.zimmermann@oppenheim.de

SWITZERLAND

Christian Arnold, Construction, Engineering
Telephone +41 (44) 214 – 2458
christian.arnold@oppenheim.ch

Johannes Borner, Engineering
Telephone +41 (44) 214 – 2365
johannes.borner@oppenheim.ch

Urs Diethelm, Cons. Goods, Engineering
Telephone +41 (44) 214 – 2339
urs.diethelm@oppenheim.ch

Mario Davatz, Real Estate, Utilities
Telephone +41 (44) 214 – 2417
Mario.davatz@oppenheim.ch

Dr. Tilman Dumrese, Health Care
Telephone +41 (44) 214 – 2326
tilman.dumrese@oppenheim.ch

Beat Füglistaller, Machinery, Engineering
Telephone +41 (44) 214 – 2441
beat.fueglistaller@oppenheim.ch

Steven Frey, Technology
Telephone +41 (44) 214 – 2207
steven.frey@oppenheim.ch

René Locher, Insurance
Telephone +41 (44) 214 – 2360
rene.locher@oppenheim.ch

Javier Lodeiro, Banking & Financials
Telephone +41 (44) 214 – 2329
javier.lodeiro@oppenheim.ch

Rahul Sen Gupta, Chemicals
Telephone +41 (44) 214 – 2249
rahul.sengupta@oppenheim.ch

Dr. Martin Vögtli, Health Care
Telephone +41 (44) 214 – 2365
martin.voegtli@oppenheim.ch

Stephan Vollert, Health Care
Telephone +41 (44) 214 – 2285
Stephan.vollert@oppenheim.ch

AUSTRIA

Peter Szopo, Insurance, Real Estate
Telephone +43 (1) 51866 2700
peter.szopo@oppenheim.at

Christine Reitsamer, Engineering, Internet
Telephone +43 (1) 51866 2710
christine.reitsamer@oppenheim.at

FRANCE

Vincent Hamel, Retail, Consumer Goods
Telephone +33 (0) 1/44 94 64 19
vincent.hamel@oppenheim.fr

ANALYSTS

Norbert Braems
Tel. +49 (221) 145 – 2674
norbert.braems@oppenheim.de

Frank Hübner
Tel. +49 (221) 145 – 2251
frank.huebner@oppenheim.de

Dr. Dagmar Alpen
Tel. +49 (221) 145 – 2328
dagma.alpen@oppenheim.de

Ulrike Kastens
Tel. +49 (221) 145 – 2348
ulrike.kastens@oppenheim.de

Matthias Joerss
Tel. +49 (69) 71 34 – 5645
Matthias.joerss@oppenheim.de

Dr. Ralf Zimmermann
Tel. +49 (69) 71 34 – 56 60
ralf.zimmermann@oppenheim.de

Dr. Volker Karb
Tel. +49 (69) 71 34 – 56 04
volker.karb@oppenheim.de

Peter Szopo
Tel. +43 (1) 51 866 – 27 00
peter.szopo@oppenheim.at

Johannes Borner
Tel. +41 (44) 2 14 – 22 82
johannes.borner@oppenheim.ch

Urs Diethelm
Tel. +41 (44) 2 14 – 23 39
urs.diethelm@oppenheim.ch

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Publishing Team
Claudia Chiaramonte (DTP)

Press contact:
Tel. +49 221 145-1955
presse@oppenheim.de

SAL. OPPENHEIM JR. & CIE. KGAA

Unter Sachsenhausen 4
50667 Köln
Telephone
+49 (2 21) 1 45 – 01

Untermainanlage 1
60329 Frankfurt am Main
Telephone
+49 (69) 71 34 – 0

Odeonsplatz 12
80539 München
Telephone
+49 (89) 29 00 74 – 0

www.oppenheim.de
info@oppenheim.de

FURTHER LOCATIONS

Baden-Baden, Berlin, Dublin, Duesseldorf, Geneva, Hamburg, Luxembourg, Salzburg, Stuttgart, Wiesbaden

OPPENHEIM RESEARCH GMBH

Unter Sachsenhausen 4
50667 Köln
Telephone
+49 (2 21) 1 45 – 02

Untermainanlage 1
60329 Frankfurt am Main
Telephone
+49 (69) 71 34 – 0

www.oppenheim-research.de
research@oppenheim.de

BANK SAL. OPPENHEIM JR. & CIE. (SCHWEIZ) AG

Uraniastrasse 28
CH-8022 Zürich
Telephone
+ 41 (44) 2 14 22 14

SAL. OPPENHEIM JR. & CIE. KGAA, PARIS

13, rue Royale
75008 Paris
France
Telephone
+ 33 (1) 44 94 64 – 00

SAL. OPPENHEIM JR. & CIE. SECURITIES INC

250 Park Avenue,
Suite 911,
New York, NY 10017
Telephone
+ 1 (2 12) 8 88 52 46

BANK SAL. OPPENHEIM JR. & CIE. (ÖSTERREICH) AG

Palais Equitable
Stock im Eisen-Platz 3
1010 Vienna
Telephone
+ 43 (1) 518 66 0

CONTACTS SALES

Frankfurt: + 49 (69) 71 34 – 0

Hans-Peter Fliegel - 51 43
hans-peter.fliegel@oppenheim.de

Thomas Auschill - 54 34
thomas.auschill@oppenheim.de

Heiko Backmann - 54 21
heiko.backmann@oppenheim.de

Andrea Bollina - 54 61
andrea.bollina@oppenheim.de

Daniel Friedmann - 55 46
daniel.friedmann@oppenheim.de

Michela Gess - 74 57
michela.gess@oppenheim.de

Rainer Jell - 51 57
rainer.jell@oppenheim.de

Jürgen Kaup - 51 59
juergen.kaup@oppenheim.de

Matt Patterson - 54 25
matt.patterson@oppenheim.de

Alexander Schumacher -55 98
alexander.schumacher@oppenheim.de

Heinz-Gerd Vinken - 51 62
heinz-gerd.vinken@oppenheim.de

Specialist Sales Health Care

Claudia Lakatos - 5202
claudia.lakatos@oppenheim.de

Cologne: + 49 (2 21) 1 45 -01

Heribert Raskop - 18 93
heribert.raskop@oppenheim.de

Wolfgang Wenzel - 1758
wolfgang.wenzel@oppenheim.de

Munich: + 49 (89) 29 00 -740

Jürgen Benker - 74 52
juergen.benker@oppenheim.de

Nicola Facciorusso - 74 55
nicola.facciorusso@oppenheim.de

Roberto Falaschi - 74 57
roberto.falaschi@oppenheim.de

Friedhelm Hopp - 74 58
fritz.hopp@oppenheim.de

Klaus Pfaller - 74 54
klaus.pfaller@oppenheim.de

Dr. Alex Vogel - 74 51
alex.vogel@oppenheim.de

Robert Weller - 74 53
robert.weller@oppenheim.de

Tina Zöttl - 74 56
tina.zoettl@oppenheim.de

Paris: +33 (1) 56 52 –

Jefferson von Pfeil - 90 53
jefferson.pfeil@oppenheim.fr

Niccolo di Brazza - 90 54
niccolo.brazza@oppenheim.fr

Zurich: + 41 (44) 2 14 –

Ronald Birrer - 23 69
ronald.birrer@oppenheim.ch

Tristan de Blonay - 24 72
tristandeblonay@oppenheim.ch

Paolo Bozzo - 22 81
paolo.bozzo@oppenheim.ch

Alfonso Catalano - 22 46
alfonso.catalano@oppenheim.ch

Marco Galfetti - 25 28
marco.galfetti@oppenheim.ch

Marcel Hofstetter - 23 45
marcel.hofstetter@oppenheim.ch

Olivier Humm - 23 94
olivier.humm@oppenheim.ch

Alexandre Kaufmann - 23 57
alexandre.kaufmann@oppenheim.ch

Harald Moser - 23 48
harald.moser@oppenheim.ch

Christopher Ziegler - 22 78
christopher.ziegler@oppenheim.ch

New York: + 1 (2 12) 8 88 –

Jörg Hagenbuch - 84 57
jhagenbuch@sal-oppenheim.com

Robert Baer - 83 06
rbaer@sal-oppenheim.com

Bill Dixon - 52 53
wdixon@sal-oppenheim.com

Alex Gloy - 14 23
agloy@sal-oppenheim.com

Francois Gour - 52 48
fgour@sal-oppenheim.com

Sanjiv K. Jaswal - 44 21
sjaswal@sal-oppenheim.com

CONTACTS SALES TRADING

Frankfurt: + 49 (69) 71 34 –

Marcus Hahn - 51 27
marcus.hahn@oppenheim.de

Ralf Loke - 50 40
ralf.loke@oppenheim.de

Thomas Seibert - 52 19
thomas.seibert@oppenheim.de

Claudio Vargiu - 53 18
claudio.vargiu@oppenheim.de

Edgar Wilczek - 50 61
edgar.wilczek@oppenheim.de

New York: +1 (2 12) 8 88 –

Robert Florio - 67 54
rflorio@sal-oppenheim.com

Michael Mikelic - 53 87
mmikelic@sal-oppenheim.com

Kent Evan Penney - 87 70
kpenney@sal-oppenheim.com

Zurich: + 41 (44) 2 14 –

Stefan Kremeth - 24 46
stefan.kremeth@oppenheim.ch

Raphael Benz - 22 42
raphael.benz@oppenheim.ch

Luke Boller - 22 47
luke.boller@oppenheim.ch

Oliver Kamm - 22 50
oliver.kamm@oppenheim.ch

Douglas Moser - 24 48
douglas.moser@oppenheim.ch

Silvio Schuler - 23 51
silvio.schuler@oppenheim.ch

Daniel Wüest - 21 42
daniel.wueest@oppenheim.ch

For further information please contact the institutional sales desk of Sal. Oppenheim jr. & Cie.

Oppenheim Research GmbH

Unter Sachsenhausen 4 50667 Köln

Telefon +49 221 145-02 Telefax +49 221 145-2862

Untermainanlage 1 60329 Frankfurt am Main

Telefon +49 69 7134-0 Telefax +49 69 7134-5643

www.oppenheim.de/research