



The Week in Review

1 August 2008

ICELAND

Week 31/2008 (28 July - 1 August 2008)

Positive signs in turbulent times

High levels of aluminium exports and falling import volumes brought the trade balance into a surplus in June. We expect this surplus to continue in July. The Q2 results of the three large commercial banks have also published, with no negative surprises and largely in line with expectations. The effective interest rate differential has also been increasing in recent days on rising swap-rates. As a result, the ISK has been able to reverse some of its earlier losses.

Table 1: Benchmark bond issues

	Price	Bid yield	1W bp chg.	Duration	1W turnover
HFF150914	96.000	5.27%	18	2.94	4.73
HFF150224	94.225	4.69%	6	6.82	6.93
HFF150434	96.065	4.20%	5	10.69	3.55
HFF150644	95.900	4.13%	4	13.92	3.37
RIKB 08 1212	98.805	11.82%	-122	0.35	11.89
RIKB 09 0612	96.800	12.67%	-50	0.85	9.53
RIKB 10 0317	91.940	12.79%	-29	1.54	3.23
RIKB 13 0517	87.625	10.68%	-39	4.10	4.59
RIKB 19 0226	91.865	10.02%	-19	6.89	13.41

Source: Mentis hf.

A welcome trade surplus

The trade balance returned an ISK 2.3 bn surplus in June on high exports and falling import volumes. This is discussed in detail "In focus" on page 3. The preliminary figures for July will be published Wednesday, 6 August. We expect the data to show a continued surplus. The improving external position helped the ISK gain 2.5% this week.

Confidence at an all-time low

The Capacent Gallup's consumer confidence index reached its lowest level in June since it was first measured in 2001. Confidence in labour market prospects is low, as well as in the economy six months from now. Consumer confidence is highly correlated with developments in the ISK and further with private consumption. Although high-frequency data point to falling private consumption, the economy is still faced with underlying inflation pressures as indicated by a 0.3% MoM increase in domestic goods in the producer price index.

Good opportunities in longer Treasury notes

Landsbanki Research published a new benchmark bond yields forecast this week. We expect rate cuts by year-end, pushing yields down substantially. Yields on HFF bonds will remain low, but could jump after few months if inflation falls. We expect low HFF bond yields next year, although yields on the longer series are likely to remain above the current level. The full report is available at www.landsbanki.com.

Positive results from commercial banks

All three large commercial banks have announced their Q2 results. All the banks returned rather positive results largely in line with analysts' expectations and no unexpected negative news were announced. Financial companies representing around 90% of the OMXI15 market cap.

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Bond Market and Money Market

Yields on inflation indexed HFF bonds rose this week as the shorter-term inflation outlook improved on the ISK's gains this week following a sharp and rather prolonged depreciation from mid-July. Yields on HFF 14 and HFF 24 rose 15 and 6 bp, respectively, while yields on the two longer series, HFF 34 and HFF 44, rose by only 2 and 3 bp respectively. Turnover in the inflation indexed series amounted to ISK 18.58 bn this week.

Chart 1: HFF yields

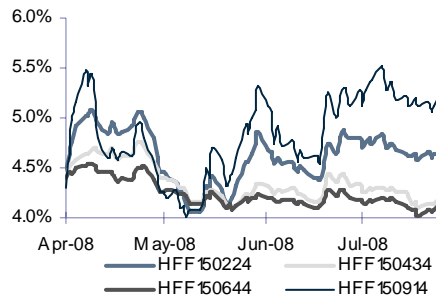
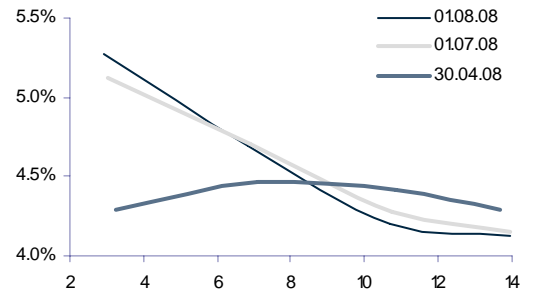


Chart 2: HFF yield curve



Treasury notes were in high demand this week, with yields decreasing on all series between 16 (RIKB 19) and 115 bp (RIKB 08). This week's turnover in Treasury notes was ISK 42.66 bn.

Chart 3: Treasury note yields

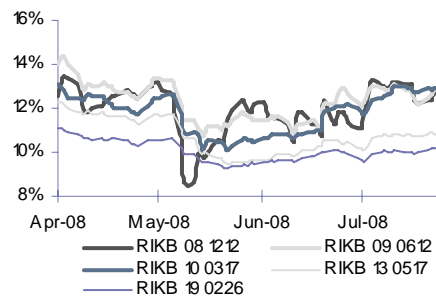
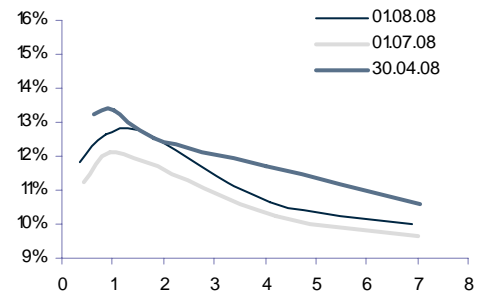


Chart 4: Treasury note yield curve



Domestic interest rates have been rising since April. The effective interest rate differential available for foreign investors has, on the other hand, remained nearly none-existent since March on low swap-market rates. Reduced ISK liquidity in recent weeks has pushed these rates up again, especially on the shortest end. The effective interest rate differential with abroad has therefore risen in recent days – giving some support for the ailing ISK.

Chart 5: REIBOR yields

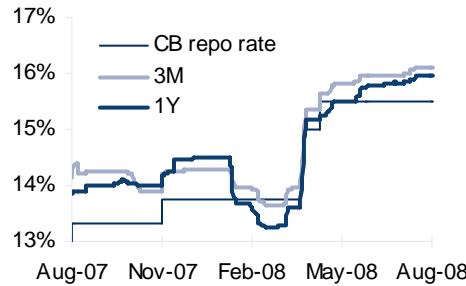


Chart 6: Interest rate differential, 3M LIBOR*



Inflation remains high at 13.6% in July. There are still rather extensive inflation pressures in the economy, with rising producer price inflation and continued low unemployment. However, we expect these pressures to abate fast going forward on high rates and reduced access to foreign funding slow down the economy.

Chart 7: CPI

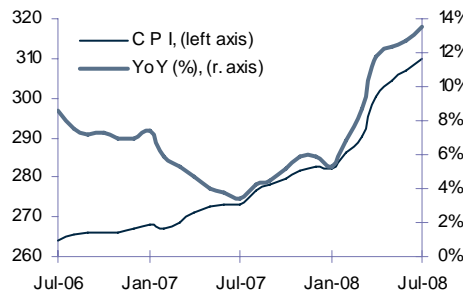


Chart 8: Break-even inflation, 4Y tenor



We expect inflation to peak above 14% in August before falling rather quickly later this year and into 2009. The path will, however, be highly dependent on movements in the ISK and labour market developments.

The rising ISK this week allowed the break-even rate at the 4Y horizon to come down this week to 5.7% from 6.2% last week. Landsbanki Research expects a 3% average inflation over the coming four years.

Source: Mentis hf., Landsbanki

Currency crosses and ISK

The ISK has regained some ground this week after an 8.5% drop from 9 July. The Q2 results of the major banks were largely positive, with no negative surprises. The effective interest rate differential has also been increasing and the trade deficit has turned into a surplus.

The TWI closed at 159.25 this week, up 2.5% on sharp gains Tuesday and Thursday. The ISK is expected to remain volatile in the near future as risk aversion remains elevated in international markets.

Developments in the ISK, as in other high-yield currencies, will continue to depend highly on risk appetite by foreign investors and developments in the international credit crisis. We, however, expect the currency's long-term prospects to be rather positive even though it is unlikely to appreciate markedly in the near term.

EURISK closed at just 123.9 on Friday, USDISK at around 79.6 and GBPISK at 157.

Event Calendar

6-Aug	Trade bal. Jul 08, est.
13-Aug	Unemployment Jul 08
20-Aug	Constr. cost ind. Sep 08
21-Aug	Wage index Jul 08
27-Aug	CPI Aug 08
28-Aug	PPI Jul 08
29-Aug	Trade bal. Jul 08
4-Sep	Balance of payments
10-Sep	Unemployment Aug 08
11-Sep	CB policy rate decision
11-Sep	GDP Q2
13-Sep	Unemployment Aug 08
15-Sep	Government finances

Chart 9: USD/ISK

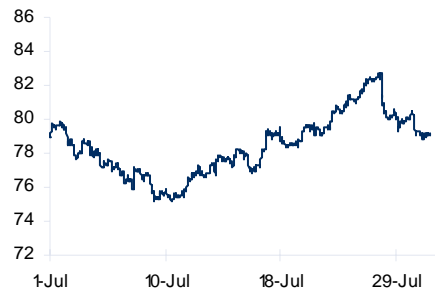


Chart 10: EUR/ISK

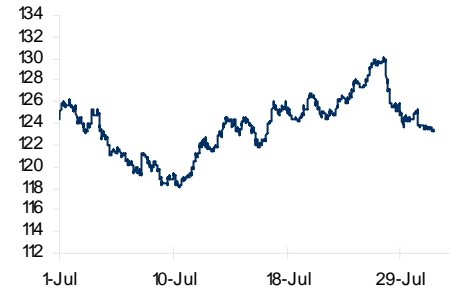


Chart 11: GBP/ISK

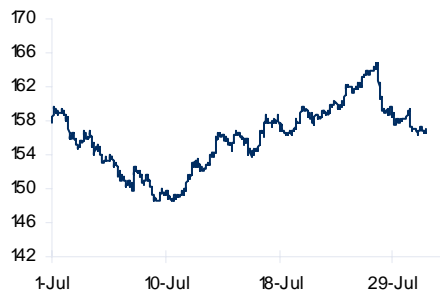


Chart 12: ISK trade weighted index



Source: Mentis hf.

In focus: Welcome trade surplus

The trade balance moved into a welcome ISK 2.3 bn surplus in June according to new data from Statistics Iceland. Earlier published preliminary data had indicated a deficit of ISK 0.9 bn. If the data are adjusted for the highly volatile trade in airplanes and ships, the June surplus moves into an ISK 1.3 bn deficit. This is a very positive development from June 2007 when the deficit amounted to ISK 9 bn.

The recent fall in the trade deficit and move into a surplus is largely due an extensive increase in aluminium exports as total exports reached ISK 41.4 bn. The aluminium sector's production capacity has risen fast in the past year to around 760 thousand tonnes/year – that is 63 thousand tonnes/month. In addition, aluminium prices have been rising on high global demand and supply difficulties in two large producer countries, China and South Africa, related to energy production and delivery. Aluminium exports in May and June were also higher than the sector's monthly production capacity – suggesting that the producers were unwinding accumulated inventories, likely related to the start-up of the large new Alcoa smelter. In total, aluminium exports rose YoY in June by 103% in terms of volume and 168% in ISK. Aluminium exports should remain high in July as the sector ships its products every Wednesday, leaving five shipments in July – compared with four monthly shipments in recent months.

Import volumes have also been coming down as the economy slows down with falling investment and private consumption. In June, import volumes fell roughly 40% YoY, but the weak ISK caused the value of imports to increase by 20% from June 2007. The slowing economy and continued high aluminium exports should allow the trade balance to stay in surplus in July – even though it may temporary fall back into a deficit later in this year. The trade balance is, none the less, moving rapidly towards more equilibrium – thus supporting our longer-term view of a stronger and more stable ISK in 2009 and rapidly falling inflation going forward.

Equity Market

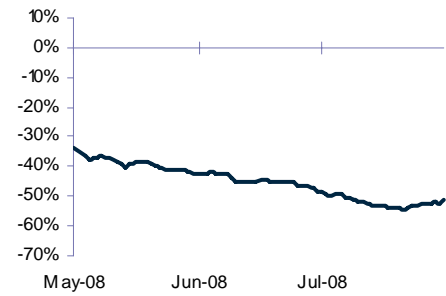
The OMXI15 index of leading Icelandic stocks was closed down only 0.3% this week to end at 4,138. More firms are now planning to delist, with Teymi announcing its intention to leave the stock market this week.

The index is now down around 35% YtD and over 54% from its record high closing value of 9,016 in July 2007.

Chart 13: OMXI15 Index



Chart 14: OMXI15, 12M chg. (%)



Source: OMX, Mentis hf.

Table 2: OMX (Iceland) equity market

Company	Ticker	Mcap m.ISK	Last price	Low this week	High this week	Change this week	Ch. % YTD	Ch. % 12M	Turnover velocity	Spread
365	365	3,978	1.16	1.16	1.16	0.0%	-45.0%	-63.8%	37%	1.2%
Alfesca	A*	39,910	6.79	6.79	6.96	-2.3%	-2.0%	17.3%	14%	0.7%
Atorka Group	ATOR*	18,555	5.5	5.46	5.5	0.7%	-39.4%	-36.6%	46%	0.5%
Bakkavör Group	BAKK*	55,458	25.7	25	25.7	2.2%	-56.1%	-61.9%	37%	0.8%
Exista	EXISTA*	93,412	6.59	6.1	6.8	7.7%	-66.6%	-82.3%	58%	0.6%
Atlantic Airways P	FO-AIR	3,325	193	192	193	0.5%	-15.5%	-24.5%	6%	1.7%
Atlantic Petroleum	FO-ATLA	30,109	1615	1570	1615	7.0%	-18.1%	43.7%	10%	1.2%
Föroya Banki P/F	FO-BANK	23,351	141	138	144	-2.8%	-20.5%	-44.0%	13%	2.3%
Eik Banki P/F	FO-EIK	30,230	214	205	214	2.4%	-57.7%	-70.1%	-8%	1.7%
Glitnir banki	GLB*	226,187	15.2	14.76	15.25	1.9%	-29.3%	-47.5%	135%	0.4%
Hf. Eimskipafélag	HFEIM*	27,025	14.4	14.25	14.4	1.1%	-58.5%	-65.0%	14%	0.9%
Icelandair Group	ICEAIR*	17,150	17.15	16.95	17.2	0.6%	-38.2%	-40.8%	82%	0.8%
Kaupþing banki	KAUP*	523,500	707	706	727	-3.2%	-17.4%	-40.0%	88%	0.4%
Landsbanki Íslands	LAIS*	257,993	23.05	22.4	23.05	1.1%	-33.3%	-41.4%	79%	0.5%
Marel Food Systems	MARL*	46,611	83.2	82.6	84.5	-1.5%	-18.4%	-13.5%	33%	0.7%
Nýherji	NYHR	6,104	21.9	21.9	21.9	0.0%	-3.2%	8.5%	5%	1.1%
Össur	OSSR*	36,293	85.8	84.5	85.8	1.5%	-12.9%	-20.6%	17%	0.8%
Sláturfélag Suðurl	SFS B	300	1.5	1.5	1.5	0.0%	-14.8%	-10.2%	1%	60.2%
Sparisjóður Reykja	SPRON*	15,262	3.05	3.01	3.05	1.7%	-64.6%	-80.6%	87%	0.9%
Straumur - Burðará	STRB*	95,511	9.22	9.08	9.25	-0.5%	-36.6%	-54.7%	82%	0.5%
Teymi	TEYMI*	6,141	1.72	1.52	1.74	11.0%	-70.5%	-69.1%	67%	0.9%
Vinnslustöðin	VNST	13,303	8.5	8.5	8.5	0.0%	0.0%	0.0%	0%	0.0%

Source: OMX, Mentis hf.

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Our research department is among the most comprehensive in Europe, including some 90 analysts covering more than 800 European stocks locally. Landsbanki also provides wealth management and private banking services, as well as offering UK savers a consistently competitive rate on its Icesave online deposit account.

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