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Where is the króna headed?

The ISK exchange rate bears the hallmarks of an overshooting that will readjust itself in the longer term. In the short term, however, the króna faces greater uncertainty than before and the immediate direction of the krona is not necessarily up.

Exchange rate will remain fragile in the short term

The most common way for investors to benefit from the ISK carry trade is through currency swap or forward agreements. The interest rate differential in these agreements has now suddenly been reduced, however, and in the shortest term agreements, the interest rate differential is close to zero. The "disappearance" of the interest rate differential with abroad is the main reason why the króna has depreciated so sharply over the past weeks.

The risk of the króna depreciating further will persist as long as the implied FX rate differential with abroad remains small or non-existent. Future developments will principally be determined by two factors. On one hand, whether CBI measures, such as the issue of certificates of deposit and possible increases in currency reserves will help normalizing the swap interest rate in the currency market. On the other hand, improved funding conditions for the banks would serve the same purpose.

Good long-term outlook for the króna

The current ISK exchange rate can be viewed as an overreaction that will readjust itself in the longer term, but nothing can be taken for granted in the short term. Kaupthing Research therefore expects the ISK trade-weighted index will peak this quarter, strengthen as the year progresses, and reach 135 points by the end of the year, but remain at around 130 points between 2009-2010. The index value of around 135 points tallies with the average real exchange rate of the króna, both in the 20 and 40 year average. If the ISK trade-weighted index continues at this level, the foreign trade surplus will be boosted even further.

Real ISK exchange rate against the euro

- % above or below 15 year average



Source: Kaupthing Research, Bloomberg

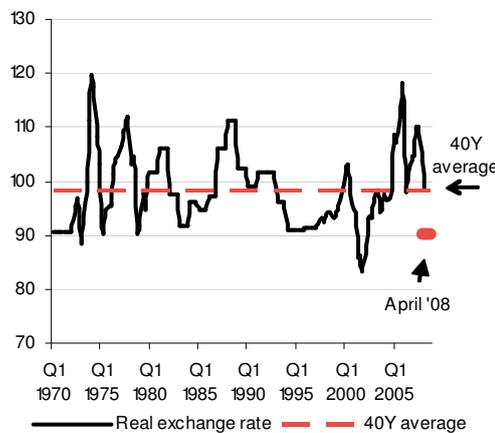
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Is the króna too weak? – Good long-term outlook

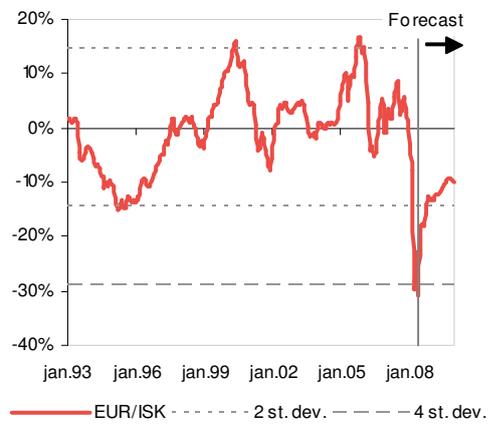
The real exchange rate is often used to gauge whether currencies are over- and under-priced on the currency market. There are strong signs that the current exchange rate cannot persist in the long term. It is clear that the real ISK exchange rate is at an historical low after the sharp depreciation, i.e. 10% below the average real exchange rate of the past 20 and 40 years. The real ISK/EUR exchange rate is still even further from the average or by 30%. The euro weighs heavily in Iceland's foreign trade and one can expect a substantial turnaround in the trade balance if the weakness of the króna persists. Kaupthing Research has calculated that, if the ISK trade-weighted index remains at around 150 points, the current account deficit will practically be wiped out and there will be a considerable surplus in the trade balance.

The real ISK exchange rate is way below the average

ISK real exchange rate (trade weighted index) and 40 year average



Real exchange rate ISK/EUR compared to 15 year average

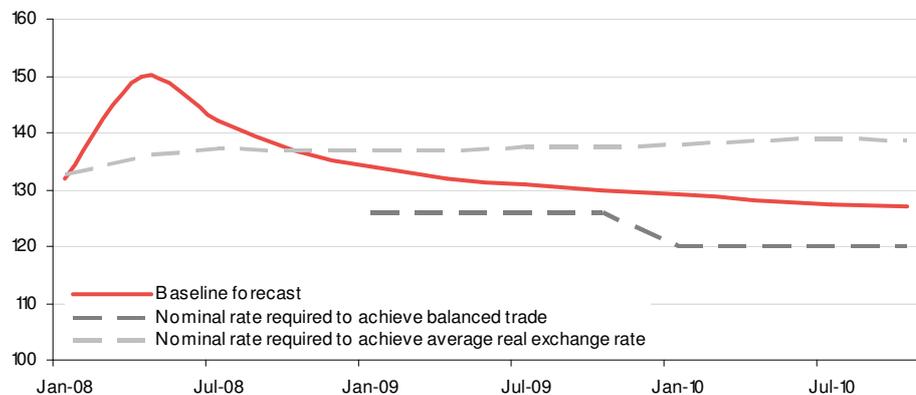


Source: Kaupthing Research, Bloomberg

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Kaupthing Research's exchange rate forecast

- ISK trade-weighted index and two equilibrium rate scenario



Source: Kaupthing Research, Central Bank of Iceland

Should we worry about the current account ?

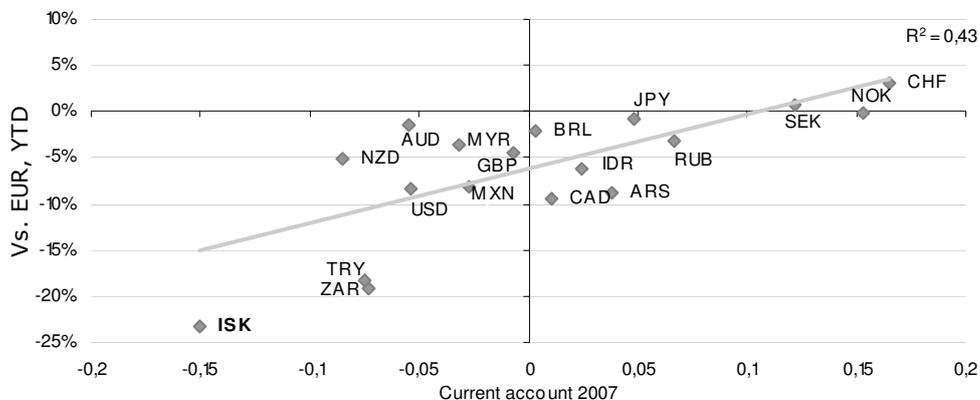
A cause for concern, though, is that one can expect the current account deficit to persist if the ISK strengthens to levels around 130 on the trade-weighted index. This is due to the persistent income deficit, but in Kaupthing Research's opinion, its size paints an excessively grim picture of the external balance of the economy. While increased debt of the private sector expanding overseas has appeared heavily on the expenditure side, the benefits of their investments are underestimated. This was clearly pointed out in the Central Bank's Monetary Bulletin in April. There it was shown that using market value, Iceland net external debt is 27% of GDP instead of 120% on book value. Therefore, while national accounts may continue showing a current account deficit, the economy will meanwhile not necessarily be accumulating net foreign debt on market value. The current account may therefore be a false indication that the ISK should weaken further according to fundamentals. This is why our focus regarding external balance is on the trade balance.

Difficult short-term outlook: The rate differential has vanished

The depreciation of the króna far exceeds what most other high interest currencies have had to contend with over the past months. The closest parallel with the Icelandic króna one can draw in this context is with the TRY and ZAR, which have depreciated by almost 20% since the beginning of the year. It is important to note that these economies have the largest current account deficit in the world (as % of GDP), but during periods of risk aversion currencies of this kind have a tendency to depreciate. But there are of course many other factors which have played a part in the evolution of these currencies.

The króna has underperformed – current account not helping

- Performance vs. EUR YTD and current account in 2007



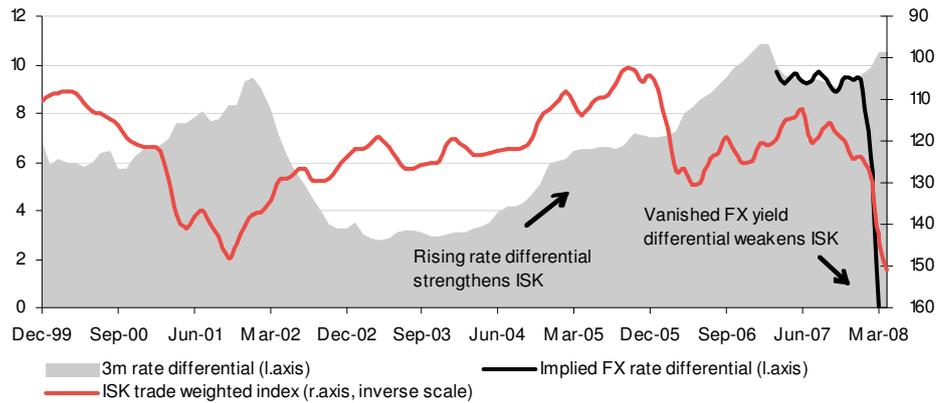
Source: Kaupthing Research, Bloomberg

Vanished interest rate differential

The "disappearance" of the interest rate differential with abroad is the main reason why the króna depreciated so sharply over the past weeks. Although the benchmark interest rate in Iceland is about 10% higher than it is in the eurozone, it has become considerably more difficult for investors to reap the benefits of that interest rate differential. The most common way for investors to benefit from the ISK carry trade is through currency swap or forward agreements. The interest rate differential in these agreements has now suddenly been reduced, however, and in the shortest term agreements, the interest rate differential is negative. Putting it simply, this means that there is little or no incentive to take positions in the króna and the cost of taking positions against the currency is practically non-existent.

Vanished interest rate differential weakens króna

- Rate differential from 1999 and implied O/N FX swap rate differential ISK/EUR since 2007



Source: Kaupthing Research, Bloomberg

Problem rooted in currency shortage

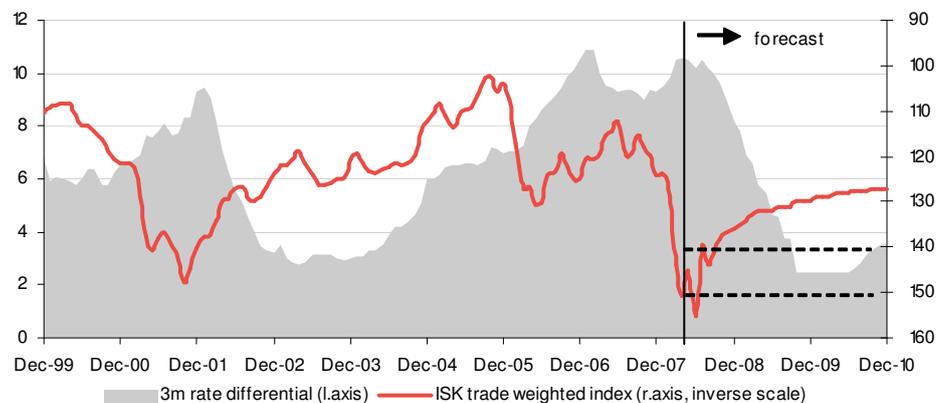
One can say that the rising CDS spreads on Icelandic banks have wiped out the carry trade, since funding costs in foreign currencies have increased enormously. As a result, banks are more reluctant than before to participate in currency swap agreements that require them to release currency. The terms of these agreements have therefore deteriorated so much that the interest rate differential with abroad has been wiped out.

Short-term determinant factors

In view of current circumstances, Kaupthing Research believes the most sensible path for government bodies to follow is to take measures to increase liquidity in the currency market. The Central Bank of Iceland took a positive step in this direction by issuing six-month certificates of deposit, which are comparable to short-term Treasury bonds. These measures facilitate long position taking in the króna with minimal credit risk and may also lead to an influx of currency which could improve the currency swap interest rate. One cannot exclude that these measures would be sufficient to rectify the currency swap interest position. This process could take some time, however, and the króna may remain weak in the meantime. The main factors that could improve the situation would be an announcement that the Central Bank is increasing currency reserves, a good response to the issuance of certificates of deposit and positive news about the funding of banks.

ISK exchange rate forecast and interest rate differential

- Weight of interest rate differential in relation to ISK TWI

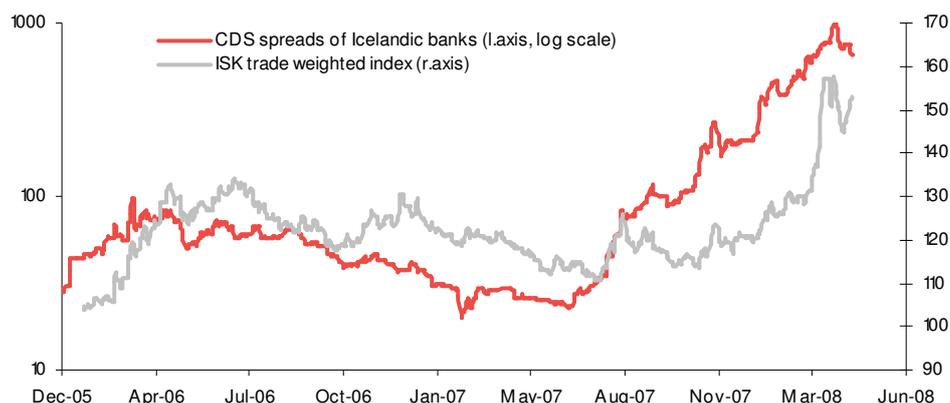


Source: Kaupthing Research, Bloomberg

ISK will strengthen once the interest rate differential can be reaped again. It is clear that the interest rate differential with abroad will continue to be ample – the interest rate differential in relation to the ISK trade weighted index, for example, will be around 10% throughout this year. The carry trade will therefore once more start to boost the króna if liquidity increases on the currency market again – i.e. if investors can more easily benefit from the interest rate differential.

CDS spreads and ISK exchange rate

- Average CDS spreads on Icelandic banks and ISK TWI



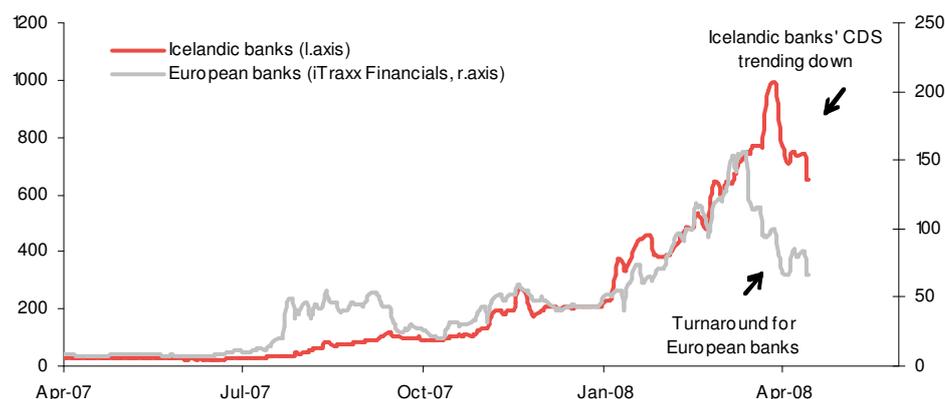
Source: Kaupthing Research, Bloomberg

Signs of a turnaround?

One can look on the CDS spreads on Icelandic banks as an indication of the risk premium on the Icelandic economy as a whole, although they give a very exaggerated picture of the situation. Depreciation was accompanied by widening CDS spreads in the spring of 2006 and the same has occurred this time around. High CDS spreads have probably acted as an indirect deterrent by dampening interest in position taking in the króna. The rising CDS spreads also directly contribute to the weakening of the króna because of the falling currency swap interest discussed above.

CDS spreads on Icelandic and European banks

- ISK TWI and changes in private consumption between years



Source: Kaupthing Research, Bloomberg

The fluctuation of CDS spreads on Icelandic banks is pretty much in line with CDS spreads on European and US financial firms. Recently there has been somewhat of a turnaround in the CDS spreads on banks worldwide and this could somehow relieve some of the pressure spreads have been exerting on Icelandic banks. What matters the

most in the immediate future, however, is how the CBI's measures will unfold, i.e. the demand for certificates of deposit and how currency reserves are increased.

The króna has readily followed international equity markets, as true high-interest currencies are wont to do. In February/March, however, a gap was created when both the CDS spreads and the króna deviated from international trends. This indicates that Icelandic risk has been a particular source of concern to foreign investors over the past months. Although there has been a significant deterioration in the correlation between the króna and international equity markets, the correlation in the Icelandic market has not evaporated. One can expect that developments in the equity markets, which go hand in hand with risk seeking and the evolution of the carry trade, will, in spite of everything, have some effect on the ISK exchange rate. If, for example, there is a vigorous turnaround in international markets with an increase in risk seeking, high interest currencies like the króna will be strengthened. Increased risk seeking would also generally result in narrower CDS spreads, which in turn could lower the spreads on Icelandic banks and, at the same time, boost the króna.

ISK and international equity markets

- ISK TWI and S&P500 share index



Source: Kaupthing Research, Bloomberg

Conclusion: Good long-term outlook, but difficult short-term

In Kaupthing Research's opinion, the current ISK exchange rate is an overreaction when looking at the longer term. We therefore forecast that the ISK trade-weighted index will reach 135 points at the end of this year and remain at this level during 2009-2010. One of the factors that supports this prediction is that it tallies quite well with the average real ISK exchange rate and the foreign trade surplus. In the short term, however, the ISK exchange rate could remain fragile, at least until liquidity has been restored to the currency market.

Provisional release:

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