Investment Outlook

Bright autumn outlook for financial markets

INVESTMENT OUTLOOK SUMMARY

September 2014

Brief world economic outlook

The world economy continues its upturn, though at varying rates in different regions and with geopolitical trouble spots aside. Trade conflict between Russia and the United States/European Union has not yet had any deeply negative impact on global economic conditions. Developed market (DM) monetary policies remain stimulative and fiscal policies are shifting towards a neutral stance after earlier austerity. Low inflation persists, but the pattern is divergent, with deflation risks in various European countries and gradually accelerating US price increases. Looking ahead a couple of years, growth in the overall emerging market (EM) sphere may speed up, with emerging Asia clearly leading the way. The danger of escalating geopolitical risks and worse-than-expected economic conditions in the eurozone are the biggest downside risks, while the main upside chance is whether the US may provide unexpectedly powerful help to the global economy.

Global growth will gradually gain momentum. As in 2013, world GDP is expected to increase by nearly 3,5% this year, rising to around 4% both in 2015 and 2016. The EM sphere will continue to grow the fastest, with a pace of 4,5-5,0% in 2014-2016, but the gap between EM and DM countries will shrink in 2014 and 2015, when DM growth will accelerate to 2 and 2,5%, respectively. The gap will again widen somewhat in 2016 as EM growth climbs slightly while DM growth falls marginally.

US economy heats up after frosty start of 2014

The US economic slump in the first quarter was due to temporary factors, mainly unfavourable winter weather. Second quarter growth rebounded to an annualized 4,2% and early indicators suggest a continued good economic pace during the rest of 2014. We expect GDP to grow by more than 2% this year, 3,5% in 2015 and over 3% in 2016. Looking ahead, the inflation rate looks set to increase, but the upturn is likely to be rather gentle. Stronger economic conditions will persuade the Federal Reserve bank (Fed) to phase out stimulative bond purchases this October and begin to hike its key interest rate in April 2015 from the current 0-0.25%.

Eurozone economy slows

After a decent start to the year, the eurozone has lost momentum. GDP stagnated in the second quarter, when both the Italian and German economies shrank. Disruptions in trade with Russia appear responsible, along with a downward correction after unexpectedly good growth early in 2014. We predict that GDP in the currency union will grow by more than 0,5% this year, above 1% in 2015 and 1,5% in 2016. The chance of gradually higher growth is mainly related to expanded stimulus measures by the European Central Bank (ECB). In addition to the measures it launched in June, we believe the ECB will initiate a large bond-buying programme by spring 2015. Deflation risks persist, but we expect that the eurozone as a whole can avoid this danger.

Emerging Asia accelerating

Asia's EM economies are now accelerating because of higher exports to DM countries and stimulative monetary policies. Good job growth is also benefiting domestic markets in many countries. GDP may grow by nearly 7% in 2014-2015 and a bit more slowly in 2016. Inflation pressure remains low in the region, with India and Indonesia as major exceptions. In many countries, there is thus room for continued monetary policy stimulus. Monetary tightening is not expected until next year. Chinese growth was surprisingly high in the first half, with the economy otherwise coping well with the downward spiral in construction, thanks to strong exports and targeted economic policy stimulus. We now foresee a gentle slowdown from this year's rapid pace of 7,5% to about 7% in 2016. In India, there are now high hopes about the economic policy of the new government. Although there is a risk of disappointments related to economic reforms, we still predict that GDP growth can increase from 5% in 2014 to about 6% next year and in 2016.

Latin American economies struggling

Latin America is grappling with macro problems such as lower growth, higher inflation and large current account deficits. After averaging more than 3,5% in the first decade of this century, Brazilian GDP growth has slowed to less than 1% in 2014. The October presidential election has the potential to open the way for necessary structural reforms, but none of the main candidates has shown an impressive reform agenda. Argentina is plagued by high inflation and is technically in default, adding further to its economic woes. Far better macro situations are found in Mexico and Chile. We expect overall GDP in the region to grow by 1,5% this year, about 2% in 2015 and 2,5-3,0% in 2016.

Few bright spots in most of Eastern Europe

The geopolitical conflict in eastern Ukraine is likely to last a long time. To pressure Russia to work towards demilitarizing the conflict region, the EU and US have gradually toughened their sanctions. Russia has responded by blocking about 10% of food imports for one year. These measures have a rather low impact, but they increase uncertainty about Russia's already weak economic situation and add to inflation there. Meanwhile Ukraine is deep in recession, with GDP predicted to shrink by 6% this year and then stagnate. The situation and outlook are much brighter in the central as well as southern portions of Eastern Europe. Economies that continue to perform well are Poland, the Czech Republic and Hungary. The Baltic countries are among those hardest hit by the Russia-Ukraine conflict, since their trade with Russia is extensive. Heightened regional uncertainty is hampering capital spending plans in the Baltics. Russia's food import restrictions will impact Lithuania the most, while Estonia will be hardest hit overall, due to its large exports and its strong ties to recession-plagued Finland. But there are also positive growth forces in the form of private consumption and good momentum in construction, as well as upcoming infrastructure investments.

Theme

Sustained stock market and cyclical upturn

The cyclical economic upturn now under way in the US and many other parts of the world began in the summer of 2009, that is, more than 20 quarters ago. Some economists and analysts consider this a long period and are worried that a downturn into recession or a slump will soon be at hand. Others believe history backs their conclusion that the current upturn could continue for quite a while. Which group has the best support for their position?

A look in the macroeconomic rear view mirror, with a focus on the US economy (for which there are good-quality economic history statistics), shows that from the late 1950s to the end of 2007 the US had eight periods characterized by economic upturns and stock market growth. Their average length was 20 quarters, or five years. So anyone worried that the current upturn in the economy and stock market is on the edge can find historical support for this view. However, there is great variation in the length of these boom periods. The shortest lasted only three quarters, the longest 35 quarters. But this is statistics. From fundamental perspective the main factors that have usually interrupted economic upturns and equity bull markets as well as other risk assets are: 1) Rapid growth and high capacity utilization, which make costs and prices rise faster. Central banks then hike their key interest rates and bond yields rise, leading companies to lower their inventories and capital spending, and households to reduce consumption. 2) Dramatic commodity price hikes, especially for oil, eroding purchasing power in oil-importing countries leading to higher inflation and current account deficits, causing key interest rates to be hiked and bond yields to rise. 3) Burst speculative bubbles resulting in dramatic price declines for financial assets and real estate, with a consequent risk of general price declines in the real economy (deflation) as well. Governments, households

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and companies are then forced to increase their saving and reduce debt, and a deep recession follows.

SEB's current analyses sketch a main scenario that reflects a rather low risk that the stock market and cyclical upturn that began in the spring and summer of 2009 will be interrupted by any of mentioned factors. Instead SEB's basic assumption is that this upturn can continue for quite a while. The duration of this upturn will probably be determined by the shape of monetary policy going forward. The great challenge for central banks will be to devise an exit strategy that avoids an abrupt economic downturn and the development of new financial bubbles. However, this balancing act will probably not be seriously tested until after 2016 (read more in full version of SEB Investment Outlook, September 2014).

Expected risk and return in asset classes in the next 12 months

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months. For **equities**, the forecast refers to the global stock market. For **fixed income**, the forecast refers to a basket of ½ investment grade and ½ high yield corporate bonds (average duration 5,5 years). The **hedge funds** forecast refers to HFRX Market Neutral Index which follows market neutral strategy. The **real estate** forecast refers to the real estate market (EPRA index), while the **commodities** forecast refers to a basket of energy (33%), industrial metals (19%), agricultural (36%) and precious metals (13%). Private equity forecast refers to the world largest listed **private equity** companies which are included in LPX Total Return and MSCI AC World LOC indexes. As for **currencies**, the forecast refers to most central currency pair EUR/USD.

Asset class	Expectations next 12 months		Reasoning
	Return	Risk	
Equities	**8%**	**11%**	The ongoing stabilization of the economy and the actions of central banks are steering capital into equities. Looking ahead a bit, brighter economic prospects and global growth will have apositive impact on corporate earnings. We are sticking to our long-term positive view of equities, with a focus on Europe and Asia.
Fixed income	**3,2%**	**4,6%**	Central banks have pushed down bond yields by means of key interest rates and quantitative easing. In the long term, this is not sustainable. We should see some adjustment in interest rates and yields, though not to their "old" heights. European government bond yields are record-low, but assuming that inflation expectations in Europe rise in 2015 and that the Fed will then begin hiking key interest rates, government bond yields will climb both in Europe and the US. Yield spreads between investment grade (IG) corporate and government bonds are at record-low levels, so there is less room for further price gains in IG corporate bonds, and the best period of these bonds in this interest rate cycle is now behind us. High yield corporate bonds are again a bit more attractive in the short term after their price slide in July.
- Government bonds	-0,4%	4,5%	
- Investment grade corporate bonds	1,5%	2,4%	
- High yield corporate bonds	4,6%	4,6%	
Hedge funds	**3,5%**	**3,3%**	Hedge funds that accept a certain degree of underlying market risk are having a good period. We have been positive towards event-driven strategies for quite a long time, and our reasoning still holds. Event-driven strategies are benefiting from corporate transactions and corporate merger and acquisition activity is increasing both in the US and Europe.
Real estate	**5%**	**12%**	The real estate investment trust (REIT) market has provided extremely good returns so far in 2014. Fundamental growth and falling government bond yields have contributed to this. Despite a clear negative correlation, rising interest rates and yields need not be a threat as long as economic growth continues.
Private equity (PE)	**11%**	**15%**	Looking ahead, government bond yields will rise, but if this occurs concurrently with improved economic growth and increased earnings, there is continued good return potential for private equity.
Commodities	**-1,5%**	**13%**	No sharp price movements are to be expected in the commodities sector. Stronger supply and weaker demand in the oil market than forecast, combined with continued record-high production from Saudi Arabia, weighed down prices during the first half of the year. We expect oil to trade at USD 100/barrel (BRENT) a year from now. We expect Indonesia's export ban on nickel ore to lift prices a bit further. Low aluminum prices over a long period have led to production shutdowns and rising prices. Precious metals are not expected to see any major price movements over the next year. However, higher demand for petrol powered cars, combined with geopolitical turmoil, has pushed up prices for palladium – the precious metal we believe has the biggest potential.
Currencies	**N/A**	**N/A**	A combination of strong economic conditions and the prospect that the Fed will begin tightening monetary policy in the spring of 2015 gives the US dollar an advantage over the euro. Our forecast (12 months ahead) for the most central currency pair EUR/USD is 1,27 (-3,5%).

View on regions

Region	Outlook	Reasoning
Globally	1 2 3 4 5 **6** 7	Global equities will enjoy continued support from positive macro data and increased growth, which will gradually lead to higher corporate earnings. Higher P/E ratios and share prices will require upward revised earnings forecasts and better performance; we are seeing early signs of this in quarterly earnings reports.
United States	1 2 **3** 4 5 6 7	Macro data are continuing to improve, but good earnings growth and slimmed-down companies have already provided a strong market for a long time. Valuations are high, which limits potential.
Europe	1 2 3 4 **5** 6 7	After the flat summer in European stock markets, we see potential for upside surprises. Euro zone purchasing managers are optimistic, and fiscal policy is providing support. Stock valuations and corporate earnings growth look attractive compared to the US. Companies are cost-effective and competitive and will benefit from weaker currencies.
Asia/Emerging markets	1 2 3 4 **5** 6 7	Increased global growth will benefit emerging markets. Low valuations and high long-term earnings growth are attractive. Positive macro data and earnings forecasts, along with less political turbulence, will provide stability. We prefer Asia, including China.
Japan	1 2 3 **4** 5 6 7	Earnings forecasts are high, and earnings are being revised upwards, but from low levels. A weaker yen has provided support. Japanese stock market performance will depend on whether fiscal stimulus measures can be fully implemented or not.

*The view scale from 1 to 7 shows how we currently view a region. Level 4 is a neutral, 1 is very negative and 7 is very positive stance. The levels are changed continuously based on our tactical market view and may thus diverge from our long-term strategic view of a region.

Source: SEB Investment Outlook, September 2014

Terminology explanation

Terminology used	Explanation
Deflation	A general decline in prices of goods and services. Deflation can be caused by a reduction in the supply of money, also by a decrease in government or personal spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression. Central banks attempt to stop severe deflation, along with severe inflation, in an attempt to keep the excessive drop in prices to a minimum.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Hedge funds' strategies	Event-driven strategy – a strategy, adopted by hedge fund managers, that attempts to take advantage of events such as mergers, acquisitions and restructurings that can result in the short-term mispricing of a company's stock. Trend-following strategy (i.e. commodity trading advisers, CTA) – investment strategy based on the technical analysis of market prices, rather than on the fundamental strengths of the companies. In financial markets, traders and investors using a trend following strategy believe that prices tend to move upwards or downwards over time. They try and take advantage of these market trends by observing the current direction and using this to decide whether to buy or sell.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
P/E ratio	A valuation ratio of a company's current share price compared to its per-share earnings. For example, if a company is currently trading at 43 EUR a share and earnings over the last 12 months were 1,95 EUR per share, the P/E ratio for the stock would be 22,05 (43/1,95). In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. It is usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E.
Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Real estate investment trust (REIT)	A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. Equity REITs invest in and own properties (thus responsible for the equity or value of their real estate assets). Their revenues come principally from their properties' rents. Mortgage REITs deal in investment and ownership of property mortgages. These REITs loan money for mortgages to owners of real estate, or purchase existing mortgages or mortgage-backed securities. Their revenues are generated primarily by the interest that they earn on the mortgage loans. Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.
SEB House View	Economic forecasts prepared by economists, strategists and analysts of SEB bank.
SEB Investment Outlook	A public release prepared by SEB economists, strategists and analysts. Investment Outlook gives readers an in-depth look at the investment climate and the prospects for seven asset classes. It also provides advice about current risks and opportunities in the art of investing. The report can be read in its entirety at www.sebgroup.com
US Federal Reserve's "tapering"	This is an expression of the US Federal Reserve Bank's (Central Bank) decision to reduce the volume of bond purchases (quantitative easing). Quantitative easing is a central bank's monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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