# Investment Outlook

## Market hopes will require some evidence

INVESTMENT OUTLOOK SUMMARY

December 2013

## Brief world economic outlook

The global economy is becoming more and more vigorous. We foresee good conditions for higher global growth over the next couple of years – with the United States leading the way. Other parts of the world economy have varying potential to benefit from the US growth, both among OECD industrialized countries (developed markets, or the DM sphere) and emerging markets (EM). Looking ahead, cyclical differences will thus persist. Due to structural and other problems, the EM sphere will not achieve the growth rates that prevailed earlier.

We predict that world GDP will increase by more than 3% this year, 4% in 2014 and more than 4% in 2015. Although the EM countries will be the fastest-growing – nearly 5,5% a year in 2014-2015 – the difference between the EM and DM spheres will narrow significantly. This is because developed market GDP will grow by an estimated 2,5% in 2014 and nearly 3% in 2015, after slightly exceeding 1% this year.

**World economic growth is poised to accelerate. This will happen slowly, and right now market hopes are ahead of the evidence in many cases. To some extent, stock markets are celebrating victory too early.**

**US economy will continue to grow**
We believe that the effects of October's budget conflict and federal debt ceiling issues on US growth will be minor and temporary. There are reasons to be optimistic about the economy as 2014 approaches. These include a better labor market, rising consumption, larger corporate capital spending needs and diminished fiscal headwinds. The political picture also includes a January 15 deadline for a new federal budget agreement and a deadline late in the first quarter for raising the federal debt ceiling. Political tension will probably be less than it was this autumn. We expect US GDP to grow by more than 1,5% this year and by around 3,5% in 2014 and 2015. Because of low inflation and some short-term uncertainty about the economy and fiscal policy, the Federal Reserve (Fed) will probably hold off on reducing ("tapering") its stimulative monthly bond purchases until March 2014. We predict that the Fed will leave its key interest rate unchanged at 0,25% until the fourth quarter of 2015.

**Debts and joblessness weigh down euro zone**
The euro zone economy is growing again but remains weighed down by a large debt burden and high unemployment. Several crisis-hit euro zone countries – mainly Greece and Portugal – are likely to need a softening of borrowing terms, and possibly also further bail-outs. The European Central Bank (ECB) will also have to keep propping up the financial system as well as stimulating the economy and working to stave off deflation. Meanwhile euro zone exporters will benefit from the economic upturn in the world generally and the US specifically. We predict that euro zone GDP will shrink by 0,4% this year and grow by less than 1% in 2014. Low inflation and worries about the economy were factors that helped persuade the ECB to cut key interest rate to 0,25% in early November. By all indications, the next step from the ECB will be to supply more liquidity to banks in the form of new Long Term Refinancing Operation (LTRO) loans.

**Clear impact from stimulative economic policy in Japan**
Japan's new economic policy ("Abenomics") has had a clear positive effect. We predict GDP growth of nearly 2% this year and around 1,5% in 2014 and 2015. The consumption tax hike next April and the Bank of Japan's unprecedentedly loose monetary policy will boost inflation, giving the country a chance to end its deflationary spiral. If "Abenomics" falls short due to insufficient structural reforms, major government financial problems are hiding around the corner. The major one is a huge government debt (nearly 240% of GDP). An ageing population with rising health care expenses will also challenge government finances.

**Asian emerging economies poised for rebound**
Last spring's signals from the Fed about a coming reduction in monetary stimulus had a major impact on many financial markets in Asia. Although these worries affected China only to a minor extent, India and Indonesia were harder hit due to major economic imbalances and structural problems. Financial market turmoil has now faded and the region has begun to grow a bit faster again, helped by higher demand both in international and domestic markets – the latter thanks to better labor markets, orderly government finances and low inflation pressure, allowing continued expansionary monetary policies in many countries. We predict a regional GDP increase of around 6% during 2013 and 2014, and a little higher in 2015.

**World stock markets need more evidence in economic growth**
World stock markets have generated good returns for a long time. The market trend is still positive and we are cautiously optimistic. Signs of global growth and accommodative central bank measures will probably provide further fuel to the market. However, we are in a situation where we need to see confirmation of growth in the form of higher corporate earnings and upward earnings revisions to enable share prices to rise from this level.

## Theme

**From BRIC to C**
Once upon a time at the turn of the millennium chief analyst at Goldman Sachs, Jim O'Neill grouped four of EM countries under the acronym BRIC (Brazil, Russia, India and China). The common denominator for these four countries was that they topped the list of EM economies in GDP. Otherwise, there were not many similarities between the countries – economically, socially or politically. With their rapid growth these countries have been an investment theme for a long time. Today the picture looks different. We will not see the same rapid expansion. Many structural factors have caused all the BRIC economies to slow down. Even more we have reached a phase where we can no longer speak of BRIC economies as one unit. Instead, each country and its currency and stock market must be evaluated on its own merits. We can say that the BRIC concept is breaking apart, leaving a lone but powerful C.

Brazil today is wrestling with major macroeconomic imbalances in the form of high inflation, poor competitiveness and far too little saving and investment. Russia is still characterized by strong dependence on oil, which was highly beneficial to its economy 5-10 years ago but in today's world of more stable (possibly lower) oil prices risks being more of an Achilles' heel. The business climate in other economic sectors is bad, there is a huge need for structural reforms, but it is doubtful that such reforms can be launched soon. There is number of structural problems in India including overregulation of the labor market and many product markets, many issues in fiscal and monetary policy. China is also challenging its own problems such like shifting strategy from capital spending and exports driven growth to private consumption based growth, speculative housing bubbles, reverse in demographic trend but comparatively the economic picture looks much brighter than in other BRIC countries.

Our macroeconomic model, which is based on comparisons of growth, inflation, government finances and trade balances in BRIC economies in 2013-2014 as well as current economic momentum and macroeconomic risks/opportunities. The model ranks China well ahead of Russia, while Brazil and India are at the bottom. Companies' earnings revisions are also interesting because they indicate the direction of trends. Such revisions are currently slightly positive in China, while a negative trend applies to Brazil and India, and Russian estimates have fallen recently. To sum up, earnings revisions, low valuations and good underlying growth favours Chinese companies out of BRIC.

## 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. The **hedge funds** forecast refers to HFRX Market Neutral Index which follows market neutral strategy. The **real estate** forecast refers to the real estate investment trust (REIT) 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 50 largest listed **private equity** companies which fulfill certain liquidity constraints. As for **currencies**, the forecast refers to most central currency pair EUR/USD. Since the last issue of Investment Outlook (published September 17, 2013) we have made adjustments mainly for currencies. We use the asset class as a source of returns but no longer issue forecasts for the class itself, although we provide forecasts for the most important currency pairs.

| Asset class | Expectations next 12 months | | Reasoning |
|---|---|---|---|
| | Return | Risk | |
| **Equities** | **11,5%** | **10,5%** | The upward trend in the world's stock markets will persist. The pattern is that markets with low dependence on economic cycles are the strongest performers, while commodity-dependent, cyclically sensitive markets such as China are lagging behind. However, global equities have long generated good returns, and valuations have risen, so we are now in a situation where we need to see growth in the form of upward-adjusted earnings in order for share prices to rise. |
| **Fixed income** | **2,5%** | **4%** | Bond yields have risen and will continue to climb gradually, though slowly. Investors should be on their guard if interest rates start to rise, since higher rates would result in falling bond market values. The focus should be on the maturities, choosing shorter ones in a climate of rising yields. Government bonds remain less attractive. Risk/reward ratio keeps becoming less attractive also in investment grade corporate bonds. High yield corporate bonds still appear to be the most attractive type of asset in the fixed income world. |
| - Government bonds | 0,4% | 3,9% | |
| - Investment grade corporate bonds | 1,6% | 3,0% | |
| - High yield corporate bonds | 5.0% | 3,8% | |
| **Hedge funds** | **4%** | **4%** | The market climate for hedge funds has improved with a lower correlation between different asset classes. The desire of fund managers to diversify portfolios is generating large flows into hedge funds worldwide. The economic situation is benefiting equity-based and event-driven strategies. |
| **Real estate** | **5%** | **12%** | The housing market affects both consumer confidence and the credit market. Rising collateral values make banks more willing to lend capital, while giving households more consumption capacity. The low interest rate environment makes investors to think about real estate as an alternative source of returns. |
| **Private equity (PE)** | **14,5%** | **13,6%** | Given the high level of activity and an increasingly apparent economic recovery, prospects for the broad PE market look bright. However, if risk appetite fades, for instance as the result of a Fed decision to begin tapering quantitative easing, volatility in PE asset class would increase more than in the broader stock market. But assuming a longer investment horizon, there are good reasons to take advantage of the value being generated in the PE market. |
| **Commodities** | **1%** | **9%** | Energy – geopolitical storm clouds at the current level and Saudi Arabia acting as usual will mean unchanged oil prices a year from now. Industrial metals – supply will catch up with demand; we see a significant less return potential expecting spot prices to rise 6-7% over one year. Precious metals – if inflation worries do not increase, we expect gold prices to be unchanged. Agricultural products – at an aggregate level, only unfavourable weather conditions would change our scenario of unchanged price levels next year. |
| **Currencies** | **N/A** | **N/A** | Foreign exchange market volatility is increasing. The USD should strengthen as the Fed tapers its QE. Some emerging market currencies have become vulnerable. The JPY can fall further. Our forecasts (12 months ahead) for the most central currency pair – EUR/USD 1.25 (-7%). |

## View on regions

| Region | Outlook | Reasoning |
|---|---|---|
| **Globally** | **Positive** | • The trend is positive, but the markets have taken a hesitant approach since the corporate reporting period because of continuing downward earnings revisions<br>• Given low interest rates and stronger economic fundamentals the stock market will be the primary source of returns looking forward. However, it will be volatile, and in some cases valuations are becoming conspicuously high |
| **North America** | **Neutral** | • There are reasons to be optimistic about the economy as 2014 approaches; these include a better labour market, rising consumption, larger corporate capital spending needs and diminished fiscal headwinds. The risk factor now is the Fed's tapering pace.<br>• Macro data have been relatively stable, which has already produced a strong stock market that is trading at record levels; valuations are starting to become high, which limits the potential<br>• Government negotiation on fiscal year budget and debt ceiling will bring tension to the markets in the beginning of Q4, but political tension will probably be less than it was this autumn |
| **Europe** | **Positive** | • Valuations are low compared to the US and globally, and earnings growth is attractive<br>• Corporate earnings are growing faster in Europe than in the US. Market-leading cyclical and consumer-related companies should benefit from a strengthening economy and a higher share of sales to Asia and other emerging markets<br>• ECB fiscal stimulus measures will provide positive support, and macro data should continue stabilizing |
| **Asia/Emerging markets** | **Neutral** | • Asia continues to be a growth investment in the long term, but there is less potential in the short term because of unstable macro forecasts<br>• We see a better potential in less developed countries in Asia with continued high growth potential, avoiding investments in pure commodity exporters<br>• In BRIC countries earnings revisions are currently slightly positive in China, while a negative trend applies to Brazil and India, and Russian estimates have fallen recently |
| **Japan** | **Neutral** | • Government's stimulus package has triggered stock market and sharp fall in yen; Japanese companies in consumer-related sectors and financial services are showing the biggest improvements; Japan's economy will keep growing, though at a gentler; the main risk is that if "Abenomics" falls short |

*Source: SEB Investment Outlook, December 2013*

## Terminology explanation

| Terminology used | Explanation |
|---|---|
| "Abenomics" | "Abenomics" is a set of policy measures (launched by Japan's Prime Minister Shinzo Abe) meant to resolve Japan's macroeconomic problems. It consists of monetary policy, fiscal policy, and economic growth strategies to encourage private investment. |
| 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. |
| Domestic demand | Total purchases of goods and services, regardless of origin, by country's consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports. |
| 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 | Market neutral strategy – a strategy by hedge fund managers, that seeks to profit from both increasing and decreasing prices in a single or numerous markets.<br>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. |
| Household (private) consumption | Private consumption is defined as the value of the consumption goods and services acquired and consumed by households. |
| LTRO (long-term refinancing operations) | This is a cheap loan scheme (lending money at a very low interest rate) for European banks that was announced by the European Central Bank towards the end of 2011 to help ease the euro zone crisis. The injection of cheap money means that banks can use it to buy higher-yielding assets and make profits, or to lend more money to businesses and consumers – which could help the real economy return to growth. |
| Organization for Economic Cooperation and Development (OECD) | A group of 34 member countries that discuss and develop economic and social policy. OECD countries are democratic countries that support free market economies. |
| 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 debt ceiling | The maximum amount of money the United States can borrow. The debt ceiling was created in 1917 (under the Second Liberty Bond Act), putting a "ceiling" on the amount of bonds the United States can issue.<br>Currently the debt ceiling of 16,7 trillion USD is suspended until February 7, 2014 and until then the US government is able to borrow as much money as it needs to cover obligations. |
| 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. |
| US government shutdown | The closure of non-essential offices of the government due to lack of approval on the government programs budget for the upcoming fiscal year (the fiscal year starts on October 1st and ends on September 30th). Approval is reached if Congress passes all of the spending bills regarding the federal budget. If an agreement is not achieved, a government shutdown will close many federally run operations, and halt work for federal employees unless they are considered essential. Some organizations still stay open by running on cash reserves, but once these run out, if a solution is not found, they will also close. The shutdown stays in effect until a compromise is reached and a budget bill is passed. |

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