Investment Outlook

Summary

Higher volatility is here to stay

December 2018

We forecast continued positive returns for most asset classes over the next 12 months, except for a number of traditional fixed income investments. These expected returns are below historical averages, while risk is unchanged. Equities are still at the top and government bonds at the bottom. This forecast depends on whether our optimistic outlook for a more prolonged expansion materialises. The late cyclical phase is tricky when it comes to assessing expected returns and risks, since in the latter part of this phase investors must start taking the next recession into account. However, we believe it is too early to do so. Meanwhile this implies that forecasts are becoming less certain. A clear example of this is 2018, since the economy and earnings have been strong while risk appetite and returns have been weak.

RISK EXPOSURE	
2018 Q3	2018 Q3
NEUTRAL	SLIGHTLY OVERWEIGHT

Our risk exposure is based on the proportion of equities in a diversified portfolio. The weight of equities is described as underweight, neutral or overweight. What a neutral weight is will depend on what risk profile the individual portfolio has.

Macro and other market drivers

The global economy is growing at a healthy pace but seems like its peak is already behind this time around. Although strong late-cyclical forces suggest continued good demand – and we expect continued expansion and above-trend growth over the next two years – as often happens at the end of an expansion, it is not demand but the supply side of the economy that will limit growth. Because of an increasingly clear shortage of production resources, along with effects from political events, we are adjusting our global growth forecasts somewhat lower. We foresee a gradual slowdown in growth during the next couple of years. We are making these downward revisions especially for Western Europe, where Brexit negotiations and other factors have suppressed investment appetite more than expected, and for some major emerging market (EM) economies, where the trade war, rising interest rates and bond yields in the United States and elsewhere, along with various country-specific problems, have created headwinds. Underlying strengths make these downward revisions manageable, however.

How long will growth continue?

The question that many are now struggling with is how sustainable today's growth is, since we are late in the economic cycle and political turbulence is having an impact. The clearest indicator of cyclical performance is unemployment. In the 36 countries of the Organisation for Economic Cooperation and Development (OECD), unemployment today is at its lowest since 1980. In the US, it has fallen to 1960s levels. This promises continued healthy demand in the economy, along with the buffers of savings many private individuals have already built up because of the positive wealth effect we have enjoyed via asset price increases and low interest rates.

Overall, this points to continued relatively high private consumption. But low unemployment usually also signals rising wages and inflation. We are seeing an accelerating wage and salary trend, and inflation has also climbed towards central bank targets, but we see a number of factors that should make pay increases modest. Other indicators suggest that labour shortages are not as big as unemployment figures tell us. Such factors as digitisation will hold back pay demands, given the risk that jobs will disappear. In recent years, core inflation (excluding fluctuating energy and food prices) has been stable in the OECD countries, suggesting that it will remain under control, but if pay increases keep accelerating, inflation may pose a problem for economic growth.

In the coming quarter we expect that stock markets will recover from their significant slide this autumn. We also expect higher volatility than we have been accustomed to in recent years – consistent with the gradual reduction in our average risk level over the past 18 months. We still have a cautiously optimistic fundamental outlook, but uncertainty always rises in the latter part of an economic cycle, and 2018 has been a good example of this.

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

ASSET CLASS	TACTICAL EXPECTATION (12 months)	
	RETURN	RISK
EQUITIES		
Global	8.1%	9.7%
Emerging markets (local currencies)	8.6%	11.6%
Sweden	9.6%	10.9%
FIXED INCOME INVESTMENTS		
Government bonds	-2.2%	1.5%
Investment grade (IG) corporate bonds	0.5%	2.9%
High yield (HY) corporate bonds	3.1%	4.5%
Emerging market (EM) debt	4.8%	11.4%

Tactical expected return is based on the SEB House View as of September 4, 2017. Index/basis for estimates: Global equities – MSCI All Country World Index in local currencies. Emerging markets – MSCI EM TR in local currencies. Swedish equities – SIX Portfolio Return Index in SEK. Government bonds – OMRX T-bonds in SEK. Corporate bonds (IG and HY), IBOXX Investment Grade Index in USD and IBOXX High Yield Index in USD. EM debt – JP Morgan Emerging Markets Bond Index in local currencies.

Equities

Earnings and valuations provide support

Because of lower valuations and cautious positioning, combined with the fact that we do not expect corporate earnings to fall, we are still optimistic about the global stock market for the next quarter.

Price/earnings (P/E) ratios in the world's stock markets have fallen from the high levels reached in early 2018. This is normal in the phase of the economic cycle we are in. Given our relatively optimistic view of growth in 2019-2020, with a prolonged expansion, conditions are in place for a continued rise in share prices. Earnings growth among US companies still looks stable. In Europe, the picture looks weaker. If the consensus global earnings growth forecast of around 8-10% for the next two years holds, valuations should not be an obstacle to periods of good share price performance. We have probably passed the valuation peak for this cycle, which should be interpreted as meaning that we will see stock market performance in line with earnings growth.

The relative trend in different market segments will probably be determined by their growth outlook. Over time, it is reasonable to assume that more stable sectors and regions will be increasingly attractive when investors try to adjust their holdings in view of future economic weakness. We have seen evidence of this in the autumn stock market downturn. Defensive investments have been favoured, while cyclical sectors have fallen. This has created investment opportunities, for example, in some emerging market equities.

Fixed income investments

Stock market turmoil will not change central banks' monetary policy normalisation

Since inflation now looks set to remain close to most central bank (CB) targets, and considering that we are late in the economic cycle, we now foresee a movement towards monetary policy normalisation – key interest rate hikes and reduced stimulus. We expect the US Federal Reserve to carry out a further hike in December, two more next year and one in 2020. The European Central Bank (ECB) will end its stimulative bond purchases at the close of 2018 and begin hiking its key rate in September 2019. We are also forecasting an initial rate hike by Sweden's Riksbank this December, followed by two hikes per year in 2019 and 2020.

We are choosing a low interest rate risk in our investments, while in the credit market we prefer high yield corporate bonds to investment grade. EM bonds will remain under pressure from US yields and the dollar.

Source: SEB Investment Outlook, November 2018

Glossary

Terminology used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
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.
Household (private) consumption	Transaction of the national account's use of income account representing consumer spending. It consists of the expenditure incurred by resident households on individual consumption goods and services, including those sold at prices that are not economically significant.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicates a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicates 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".
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Price-earnings ratio (P/E)	A valuation ratio of a company's current share price compared to its per-share earnings for the past year. For example, if company's share price is EUR 100 and it reported EUR 10 per share in annual earnings, the P/E ratio would be 10. 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. However, the P/E ratio does not tell us the whole story by itself. 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.
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
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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