Investment Outlook

Central banks driving growth

INVESTMENT OUTLOOK SUMMARY

June 2015

Brief world economic outlook

Monetary policies are having a clear impact on the world economy. The belief that the Federal Reserve (Fed) will begin raising its key interest rate during 2015 has caused the US dollar to appreciate. Combined with extreme winter weather and port labour disputes, this caused US growth to dip temporarily. In the euro zone, European Central Bank (ECB) stimulus policies have rapidly affected growth as well as inflation expectations, and the euro has fallen in value. The Bank of Japan's stimulus programme has benefited growth and caused the yen to fall. These currency movements and cheaper oil are now helping to boost growth in developed market (DM) countries, while economic expansion in the emerging market (EM) sphere will accelerate only in 2016.

View on economic cycle, asset classes and risks

Economic cycle

One of our fundamental assumptions is a clear improvement in the economic situation during the coming two years. The US economy looks robust, while the rest of the world will be helped by competitive exchange rates and central bank stimulus measures. Global interest rates are low, and further stimulus is being provided by far lower commodity prices. Taken together, this suggests a broader and more stable economic upturn in which more regions than previously can deliver positive growth figures.

Asset classes

We are positive towards global equities preferring Europe and Asia to the US and to other emerging markets. We are avoiding government bonds in Europe and Japan, but are more positive towards the same asset type in the US and in emerging markets.

Risks

Among risks we are now following are potential cyclical downturns, geopolitical turmoil, Greece, Chinese debt problems, possible negative effects from the US Federal Reserve's expected key interest rate hikes and any bubbles in asset markets.

View on regions

US – Temporary growth slump

For many years, the US economy has grown significantly more slowly in the first quarter than in other quarters, a pattern repeated this year when GDP declined 0,7%. We believe earlier patterns will repeat themselves this year and that the economy will soon gain strength. This will mainly be thanks to more eager household spending due to a stronger labor market and increased purchasing power, as well as a greater desire for capital spending by companies, with low productivity among the factors providing an incentive for investment. Although USD appreciation since the summer of 2014 has hampered exports, this is more or less entirely offset by the stimulative effect of the simultaneous oil price decline. Because of a stronger currency and cheaper oil and petrol, this year the US will experience more or less stable consumer prices on average.

Euro zone – good economic outlook

The oil price decline, the weaker euro and ECB stimulus policies have strengthened the euro zone economy since late 2014. Improved competitiveness is benefiting exports, and rising employment – along with better purchasing power – has spurred stronger retail sales. The recovery is now proceeding unexpectedly fast and is spreading to more sectors. Big crisis-driven austerity is now past, and euro zone fiscal policy will be neutral in the next couple of years. Economic growth remains fragile, however, with underlying problems such as high debt levels and political uncertainty. Greece in particular is once again a source of concern.

Asia/China – Faster growth in Asia despite China's deceleration

Asian economies will accelerate cautiously, driven by higher domestic demand due to strong labor markets, good wage increases and expansionary monetary policies as well as larger demand from the US and the euro zone. The Fed's approaching rate hikes are a source of uncertainty, though, since all indications are that Fed policies will cause the US dollar to rise further in value. In recent years, many companies and countries in Asia have greatly increased their USD-denominated borrowing. Continued dollar appreciation would boost their debts and loan servicing costs in local currencies.

India speeding up, China slowing down. Falling inflation and improved central government finances will allow India room to stimulate its economy by using both monetary and fiscal policy tools. Although major economic reforms remain conspicuously absent, the Narendra Modi government's latest budget is growthfriendly. We believe that GDP will accelerate this year and in 2016. But in China, cyclical deceleration continues – mainly due to a weakened housing market. Since policymakers can stimulate the Chinese economy via economic policy measures, a gentle slowdown in growth is likely.

Latin America – Macroeconomic imbalances

Latin American GDP will more or less stagnate this year. Inflation will persist, and large current account deficits will lead to increasing foreign debt. The economies in the region are thus significantly out of balance. In Brazil, the economy has slowed dramatically and GDP looks set to fall significantly this year. The corruption scandal surrounding the state-owned oil company Petrobras is further slowing the pace of capital spending, and turmoil in the political sphere is making reform efforts more difficult. Meanwhile the need for structural reforms is increasingly apparent.

Eastern Europe – Resilient to Russian crisis

Central and south-eastern portions of Eastern Europe are resilient to the Russia-Ukraine conflict as well as to Russia's food sanctions and recession. Among underlying factors are rising real incomes, falling unemployment and low interest rates, which together benefit household consumption. Other factors are the more positive outlook for exports to Germany along with fiscal easing in most countries after a long period of austerity measures. Poland is showing strength in its underlying economy and banking system; it is now the fastest-growing economy in Central and Eastern Europe. In contrast, Russia will experience a deep recession in 2015. The oil price decline has weakened the rouble, leading to accelerating inflation and large capital outflows, but this spring's oil price rebound and signs that the ceasefire in eastern Ukraine is holding have led to a recovery for the Russian currency. Household demand is driving Baltic economies. The three Baltic economies are showing decent growth, largely thanks to rising real incomes that are enabling a continued healthy rate of increase in private consumption. Exports will gradually be helped by improving economic conditions in Western Europe, while capital spending will remain weak in the Baltics.

Theme

Risks in financial world

The prevailing stock market upturn, or "bull market", is now over six years old. More and more people are thus concerned that the upturn is nearing its end. But what are the real threats?

The length of traditional bull markets has varied significantly over the past 60-70 years, with a tendency to become longer in recent decades. On average, periods of rising stock markets have lasted almost five years while declines, or bear markets, have lasted an average of 10-12 months. In recent years, stock markets have also increasingly been characterized by mini-cycles: brief share price setbacks of a few weeks or months, followed by new upturns. It is thus very important to be able to determine whether a sudden stock market decline is the beginning of a traditional bear market. In that case, the logical decision is to reduce the proportion of equities in the portfolio. It might also be the start of a mini cyclical setback. If so, it makes sense to remain calm and prepare to enlarge the weighting of equities in the portfolio ahead of an imminent new price upturn.

The main reason that triggered events that led market declines has often been large and unexpected price movements in the real economy and/or financial markets.

SEB

A faster rate of price increases on goods and services in the real economy – higher inflation – due to a shortage of production capacity usually causes central banks to hike their key interest rates and leads to a rise in market interest rates. It increases the cost of consumption and loan-financed investments, hurting economic growth and making the economy slide into recession. This is probably coupled with a bear market for equities. If prices of goods and services instead fall faster – accelerating deflation – this leads to lower corporate earnings, deferred consumption and delayed investments (since goods and services are expected to become even cheaper in the future). The economy ends up in a recession, and shares are hit by a bear market.

After a period of accelerating price increases for financial assets such as equities, bonds and real estate, they become expensive and ultimately, speculative bubbles may inflate. When they burst, the effects may be dramatic and geographically widespread in economies and financial markets, as illustrated by the bursting of the IT/dotcom bubble at the start of the 2000s and of the "sub-prime" mortgage loan bubble in the US during 2007-2009.

As of May 2015 there is very little risk of soaring inflation, and last winter's deflation threat has diminished. The commodity price situation is meanwhile benefiting the overall global economy. The current situation in the real economy thus does not seem to pose any major cyclical or stock market threats, assuming that the first quarter growth slump in the US was indeed temporary and that the Chinese economy is decelerating gently. Instead, we should look for threats in the financial world.

Since 2010-2011, prices of government bonds have risen significantly as a result of lower central bank key interest rates and quantitative easing (asset purchases). These monetary policies have included moves into previously unknown territory, with the cost of money at close to zero (or even below zero) and with negative bond yields. Through their actions, central banks are directly helping create a bubble in the bond market and are also indirectly helping inflate bubbles in the stock market and real estate markets as investors take greater risks in their search for returns. While the ECB and the Bank of Japan continue their current (bubble-creating) stimulus path, the US Federal Reserve (Fed) is poised to move in the opposite direction. The normalization of US monetary policy may occur smoothly if financial markets and the Fed are in synch, but it may also lead to large movements in interest rates and bond yields if the market is uncertain about where the Fed is headed.

Large exchange rate movements also risk contributing to setbacks in economic growth and stock markets, especially in the EM sphere. In recent years, many EM-based companies have increasingly taken out loans in foreign currencies, mainly US dollars. These companies have thus been hard hit financially during the past year as the USD has sharply appreciated. Especially vulnerable are commodity and oil companies, which since 2007 have accounted for a full one third of all non-financial EM corporate bond issues in US dollars and other major currencies. Falling real estate prices in China are another EM risk. This decline in prices hurts the balance sheets of Chinese banks, and there is a risk of consequences in other EM countries as well.

The contagious effects on portions of the European economy and the financial world if Greece were to withdraw from the euro zone should not be underestimated, but the consequences are likely to be far more modest than if this had occurred a few years ago.

Finally, there are geopolitical threats such as escalating drama in Ukraine or the Middle East as well as geological disasters such as earthquakes, which might cause dips in share price curves. These dips will be brief, however, provided that economic growth and corporate earnings are not adversely affected to any great extent.

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

ASSET CLASS	WEIGHT*	EXPECTATION (12 months)		REASONING
		RETURN	RISK	
EQUITIES				
Global	12345**6**7	8,2%	12,0%	Stronger economic growth and continued stimulus measures will provide potential for higher earnings. A broader upturn will improve opportunities for cyclical industries. Valuations have climbed, yet equities offer better value for money than fixed income investments.
Emerging markets	123**4**567	9,0%	14,6%	Stronger economic conditions and increased trade flows, as well as historically low valuations compared to global equities, make emerging markets attractive. Heavy dependence on commodities, the negative effects of a strong US dollar and rising US interest rates are disadvantages. We prefer the Asian part of the emerging market segment.
BONDS				
Government bonds	**1**234567	1,0%	3,8%	Because of very low government bond yields, portions of the bond market are unattractive. Stronger economic conditions may lead to gradually rising yields over the next few years, with a risk of negative returns.
Investment grade (IG) corporate bonds	1**2**34567	1,6%	2,4%	Low yields provide limited potential, but this asset type may work well as a stabiliser in a portfolio that includes other higher-risk assets.
High yield (HY) corporate bonds	123**4**567	4,0%	3,6%	Yields of around 3-4 per cent stand out in the fixed income world, but as a consequence there is also clearly higher risk than with IG bonds, for example. HY bonds will benefit from rising growth and market liquidity, which boost risk appetite. Yield spreads to government bonds should thus narrow or remain the same as today.
ALTERNATIVE INVESTMENTS				
Commodities	12**3**4567	1,4%	11,0%	Gradually lower demand from China and elsewhere, combined with increases in production capacity, has resulted in sharply falling commodity prices. The price picture clearly stabilised early in 2015. In a longer-term perspective, this asset class is attractive if inflation rises along with commodity prices.
CURRENCIES				
Currency pair	**June 11, 2015**	**Q2 2015**	**Q3 2015**	**Reasoning**
EUR/USD	1,12	1,05	1,00	This spring's weakening of the USD against the EUR is expected to be only a temporary dip in a rising dollar curve, as indicated by rising US economic growth and the Fed's imminent key rate hikes.

"Weight" shows how we currently view the asset type as part of a portfolio. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view. Index/basis for calculation: ***Global equities*** *– MSCI All Country World Index in EUR.* ***Emerging markets*** *– MSCI EM TR in EUR.* ***Government bonds*** *– OMRX T-bonds in EUR.* ***Investment grade corporate bonds*** *– IBOXX Investment Grade Index in EUR.* ***High yield corporate bonds*** *– IBOXX High Yield Index in EUR. Forecast for* ***commodities*** *refers to a basket of energy (33%), industrial metals (19%), agricultural (36%) and precious metals (13%) in EUR. As for* ***currencies****, the forecast refers to most central currency pair EUR/USD.*

Source: SEB Investment Outlook, June 2015

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.
Duration	A measure of the sensitivity of the price of a bond to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The duration number is a complicated calculation involving present value, yield, coupon, final maturity and other features. Fortunately for investors, this indicator is a standard data point provided in the presentation of comprehensive bond and bond mutual fund information. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.
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.
Household purchasing power	A person's purchasing power is based on the disposable household income. The disposable household income is defined as the gross income of all household members less paid income transfers, social contributions and taxes. The amount is subsequently adjusted for composition of the household and the number of household members and deflated with the consumer price index (CPI). The standardised household income, also termed purchasing power, is subsequently apportioned to each household member.
Maturity	The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest. The term is most commonly used in the context of fixed income investments, such as bonds and deposits.
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.
Quantitative easing	An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.
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
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.