# Investment Outlook

## The road to reasonable expectations

INVESTMENT OUTLOOK SUMMARY

June 2014

## Brief world economic outlook

The world economy keeps climbing, though at varying rates in different regions and with temporary seasonal setbacks, especially in winter and spring. But judging from current indicators, there is now potential for better global momentum, with the US leading the way. In parts of the emerging market (EM) sphere, the upturn is hampered by regulation and structural weaknesses. Yet in general terms, most EM countries have shown good resilience during the conflict between Russia and Ukraine. Although the risk that this conflict will escalate and have a global impact is relatively small, it is still resulting in somewhat larger downside risks for the world economy than before.

Global growth will gradually gain momentum. We predict that world GDP will increase by more than 3,5% this year and nearly 4% in 2015, after last year's rate of slightly above 3%. Although the EM sphere will continue to grow the fastest, at 4,5-5,0% yearly in 2014 and 2015, the growth gap to the developed market (DM) sphere will narrow significantly. EM growth will slow a bit this year, while growth in DM countries will surge from just over 1% in 2013 to just above 2% in 2014 and a bit higher than 2,5% in 2015.

**US bouncing back after tough winter**
Due to unusually severe winter weather, US economic growth largely froze in the first quarter, but recent sentiment points to an imminent economic rebound, with higher household demand as the main engine. We expect GDP to grow by just over 2,5% this year and more than 3,5% in 2015. Although inflation will speed up, price increases will remain low in the next couple of years. Meanwhile, job growth will be quite high and unemployment will shrink further. We thus predict that the Federal Reserve (Fed) will continue tapering its bond purchases, ending them in October 2014. We believe the Fed will begin hiking its key interest rate – now 0-0,25% – in the summer of 2015.

**Euro zone economy ticking upward**
The euro zone is now trending slightly higher. Judging from many indicators – such as the purchasing managers' index for manufacturing – the growth rate is likely to increase. The German economy is showing particular strength, and most GIIPS countries (Greece, Ireland, Italy, Portugal, Spain ) have improved their competitiveness. The economies in the eastern part of the euro zone are affected most by the crisis between Russia and Ukraine. While only 3% of Germany's exports go to Russia, the share is 19% in Latvia and over 9,5% in Finland, for example. We predict euro zone GDP growth of 1% this year and more than 1,5% next year. Mounting deflation risks, along with falling bank lending, were the reasons the European Central Bank (ECB) cut key interest rate from 0,25% to 0,15%. The central bank abstained from a larger program including direct bond purchases, but left opens the possibility of such action in the future.

**In Japan "Abenomics" is not convincing**
Growth in Japan – previously fuelled by simulative monetary and fiscal policies as part of "Abenomics" – lost momentum late in 2013 as the positive impact on foreign trade of earlier yen depreciation faded. The increase in consumption tax from 5 to 8% on April 1 this year is now causing another dip in growth. This is partly offset by infrastructure projects and lower corporate taxes. Whether "Abenomics" will sustainably boost growth depends on structural reforms, but these are not convincing. According to SEB's forecast, GDP will grow by 1% this year and less than 1,5% in 2015. In the short term, there is a chance that inflation will reach the Bank of Japan's 2% target. It is uncertain whether it will manage to do so in the long term. Long-term inflation expectations are still parked well below target. By current indications, the Bank of Japan is thus likely to expand its securities purchases later this year.

**Emerging Asia maintaining its lead**
Asia's emerging economies are still growing faster than other parts of the world economy. Most indicators point to gradual acceleration in 2014-2015. GDP in the region is forecast to grow by 6,5-7% annually – except in China, where deceleration is expected to continue. Inflation in emerging Asia has recently increased somewhat due to higher food prices, but this does not change the picture of historically low inflation. The Chinese government seems to accept slightly slower growth than its 7,5% target, but if deceleration becomes undesirably large there is room for economic stimulus measures. We predict Chinese GDP growth of 7,2% this year and 7% in 2015. The slowdown is mainly due to falling capital spending. Commodity-exporting Asian countries such as Indonesia are most affected by this. In India there are now hopes that the election victory of Narendra Modi's BJP (Bharatiya Janata Party) will lead to reforms and large investments, but these hopes may be exaggerated. We believe India's GDP will grow by 5% this year and above 5,5% in 2015.

**Latin America grappling with macro problems**
The Latin American economy has recently shown macroeconomic problems in the form of slower growth, higher inflation and rising current account deficits. However, fiscal deficits have remained quite modest. Argentina is in trouble, with a combination of falling GDP and accelerating price increases. Brazil is performing decently in macro terms, while Chile and Mexico are faring better. We foresee Latin American GDP growth of nearly 2,5% this year and just under 3% in 2015, while high rate of price increases will ease somewhat next year.

**Ukraine crisis casting dark shadows**
Military and political tensions between Russia and Ukraine/NATO/other Western countries looks set to last, but the likelihood of a Russian military invasion of Ukraine or a disruption of Russian energy deliveries remains small. Both the Western powers and Russia appear highly reluctant to start a trade war. In any event, the crisis will have a negative economic impact across Eastern Europe, especially in Ukraine, where GDP will shrink this year, and in Russia, which is teetering on the brink of recession. The south-eastern part of the region will also suffer noticeably, The crisis will have a rather deep negative impact on growth in the Baltic countries, mainly through export and investment channels. It may also inhibit growth in the longer term, since trade with Russia is sizeable, especially for Latvia and Lithuania. Yet thanks to domestic buffers – rapid growth in purchasing power, falling unemployment and good household optimism – the risk of recession in the Baltics is small. Strong economic fundamentals in terms of current account balances and government budgets will provide financial resilience.

## Theme

**Time to adjust return expectations**
Choosing the right portfolio risk is largely based on expectations about the future. Today we are probably standing on the threshold of a more challenging investment climate.

As an investor, you expect a positive return. Otherwise there is no reason to make your investment. First and foremost, you expect to be paid at a risk-free interest rate for the period during which you abstain from your capital. In addition, an investor wants to be compensated for the risk that a given type of investment represents: its risk premium. No matter where we are in the economic cycle, an investor needs to consider a few things that will largely define potential returns: 1) how the allocation between different asset classes should look over time; this decision is based on risk tolerance and investment horizon; so-called strategic allocation is the long-term asset class allocation that defines the risk in a portfolio; 2) when the investments should be made; so-called tactical allocation is active or passive divergence from long-term asset class allocation; 3) what investments will generate the best potential within each asset class.

Over the past 30 years, both stocks and bonds have paid good annual returns. For example, a traditional US portfolio of strategic allocation of 60% equities and 40%

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government bonds has provided returns of more than 9% annually. Portfolio risk – measured as standard deviation – has been more than 13%. In other words, annual returns have varied greatly. But if we look at the past five years, average annual return has held steady, but at a considerably lower risk. Therefore, low measured risk actually increases the probability of rising future risk.

Continued slow economic recovery, deflation worries, rising bond yields, high valuations in stock markets together with historically low volatility, may be the factors suggesting that market performance during the next couple of years may not be as generous as in the last couple of years. Given rising interest rates and yields, return expectations in the bond market will be significantly lower than we have become accustomed to in recent years. In the stock market, we have already witnessed a rotation from growth companies to more mature sectors with lower growth. The financial markets are probably headed for a climate that will gradually shift to being driven by improvements in fundamentals, rather than by added liquidity from central banks. In such a more "normal" climate, it is time to adjust return expectations downward, while the importance of selectivity and alpha generation will increase. As we approach a trend shift, the importance of active diversification will increase, and selection of risks should always be made in light of strategic allocation.

## 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** | **9%** | **13%** | Looking ahead a bit, brighter economic prospects and global growth will have an impact on corporate earnings. Equities will then probably enjoy support from earnings, which will be adjusted upward. At present, the upside is limited by high valuations. Europe is our preferred region. |
| **Fixed income** | **2%** | **5%** | Gradually higher world economic growth and fading geopolitical tensions will lead to rising developed market government bond yields during the next couple of years. In many respects, the situation in the corporate bond market is still favourable – corporate health is good, there is a low percentage of bankruptcies, economic prospects are fairly bright, and central bank stimulative policies are still in place – but spreads between corporate and government bonds have narrowed greatly and are approaching pre-crisis 2007 levels. So there is less room for further price gains, and the best period of both investment grade and high yield bonds in this interest rate cycle is now behind us. |
| - Government bonds | -0,8% | 4,8% | |
| - Investment grade corporate bonds | 0,9% | 2,5% | |
| - High yield corporate bonds | 3,6% | 5,2% | |
| **Hedge funds** | **4%** | **5%** | Hedge fund strategies with a fundamental valuation approach will continue to pay good returns. Event-driven strategies are benefiting from corporate transactions, while trend-following strategies such as CTA are having more difficulty since trend shifts have been large and rapid. |
| **Real estate** | **5%** | **12%** | Improvements in fundamentals are easing concerns about interest rates/yields and are driving the real estate investment trust (REIT) market. Temporarily falling long-term yields also supported REIT investments during the first quarter. |
| **Private equity (PE)** | **10%** | **14%** | Assuming continued good risk appetite among investors, PE market can continue to bring in large capital gains. Because of increased risk appetite, beta is lower versus the stock market. |
| **Commodities** | **-4%** | **15%** | Extraordinary events such as the Ukraine crisis, mining strikes in Africa and an Indonesian export ban on nickel ore have had an impact on commodity prices, which have climbed on a broad front. Oil supply is expected to increase more than demand during 2014. OPEC, mainly Saudi Arabia, will adjust its supply for market balance. Oil prices will be around today's levels a year from now. We believe that a better economic situation and low inflation expectations will continue to weigh down gold prices. We believe agricultural prices should fall. Extraordinary events can always change this picture, as the turmoil in Ukraine did this spring. |
| **Currencies** | **N/A** | **N/A** | There are many indications that the USD will appreciate against the EUR, our forecast (12 months ahead) for the most central currency pair EUR/USD is 1.32 (-3.8%). |

## View on regions

| Region | Outlook | Reasoning |
|---|---|---|
| **Globally** | 1 2 3 4 **5** 6 7 | Global share valuations are high by historical standards, limiting their short-term potential. Looking further ahead, global equities will enjoy continued support from global economic growth. Higher P/E ratios and share prices will require upward revisions in earnings forecasts and a better earnings performance. Stable macro data bode well for future corporate earnings. |
| **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 | Europe is more positive than neutral, since economic statistics are showing stable and continuous improvement. Valuations and earnings growth look attractive compared to the US and emerging market countries. The ECB and fiscal policies are supportive, and companies are cost-effective and competitive. |
| **Asia/Emerging markets** | 1 2 3 **4** 5 6 7 | Asia continues to be a growth investment for the long term, with some caution at this stage because of unstable forecasts and uncertainty about policy decisions. Choose less developed countries in Asia with continued high growth potential. Avoid pure commodity exporters. |
| **Japan** | 1 2 3 **4** 5 6 7 | The government's stimulus package has triggered a stock market rally and a fall in the currency (yen). Earnings estimates are high and earnings are being adjusted upward, but from low levels. Stimulus measures are having a positive effect on Asia as a whole. There is some uncertainty as to whether these measures will be successfully implemented in their entirety. |

*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, May 2014*

## 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. |
| Alpha | A measure of mutual fund performance. Alpha takes the performance of a mutual fund and compares it to a benchmark index performance. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. A positive alpha of 1,0 means the fund has outperformed its benchmark index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%. |
| Beta | A measure of the volatility (systematic risk) of a security or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market. For example, if a stock's beta is 1,2, it's theoretically 20% more volatile than the market. |
| 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 | 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.<br>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. |
| Household (private) consumption | Private consumption is defined as the value of the consumption goods and services acquired and consumed by households. |
| 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.<br>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. |
| Organization of Petroleum Exporting Countries (OPEC) | An organization consisting of the world's major oil-exporting nations. OPEC was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries. |
| 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. |

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