Investment Outlook

Global opportunities outweigh threats

INVESTMENT OUTLOOK SUMMARY

March 2015

Brief world economic outlook

Global economic indicators have diverged since last summer. The US economy has strengthened. Japan has dipped into a new recession. British economic growth has remained healthy. After an obvious slump, the euro zone has regained some of its dynamism since late in 2014. Growth in the emerging market (EM) sphere as a whole has weakened, but here too the pattern has varied. China's economy has moved cautiously towards slower growth rates, while India has delivered upside surprises. In Brazil, economic indicators have pointed the wrong way, and Russia is sliding into a deep recession.

Looking ahead, global conditions will change in both positive and negative ways. The oil price decline, which has created some short term concerns and problems, will benefit future world economic growth. The same is true of monetary policy stimulus. Although the US Federal Reserve (Fed) and the Bank of England (BoE) will take steps towards tightening monetary policy in the coming year, this will be far outweighed by expanded stimulus from the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PboC). On the worrisome – but less weighty – side are geopolitical troubles, such as the Ukraine-Russia conflict and IS/Iraq/Syria. The decline in oil prices also means that the risk of deflation (generally falling prices) has become more widespread in the world.

SEB forecasts higher world economic growth. After last year's 3,5% GDP increase, global growth will be 3,7% this year and 3,9% in 2016. EM sphere growth will slow to 4,4% this year and speed up to 5,0% in 2016. Growth in developed market (DM) countries will accelerate to 2,6% this year and maintain that pace in 2016.

Elements in place for high US growth
The halving of oil prices is especially beneficial to US household purchasing power, which is also helped by an increasingly strong labor market that is giving Americans better incomes. Growing wealth, due to the stock market upturn and rising home prices, is also providing underlying financial stability to households. Private consumption, which is equivalent to a full 70% of gross domestic product (GDP), will thus probably be the strongest US growth engine in 2015-2016. We expect US GDP to expand by 3,5% this year and 3,2% in 2016. Despite high growth, consumer prices will fall slightly this year due to cheaper oil, a stronger USD and plenty of still-idle production resources in the business sector. In light of this, we predict that the Fed will hold off on its first key interest rate hike until September 2015.

Euro zone outlook a bit brighter
The euro zone growth outlook has improved, as shown by such indicators as current purchasing managers' indices. One reason is that the currency union, as a large net importer of oil, benefits especially when oil becomes much cheaper. Another is the surprisingly powerful stimulus package that the ECB unveiled in January. By weakening the euro and having a positive effect on bank lending, this package has the potential to help lift growth and reduce deflation risks. Price increases may eventually move very cautiously towards the ECB's target, which is inflation a bit above 1,5%. But we still foresee various problems and risks. Debt remains high in many parts of the euro zone. The political will to increase economic integration has weakened, and populist parties have made big gains. Trade sanctions and recession in Russia are hurting both exports and capital spending plans in the euro zone. The German economy is improving and the Spanish recovery continues at a rapid pace, while the French and Italian economies are lagging. For the euro zone as a whole, we forecast GDP growth of 1,2% in 2015 and 1,7% in 2016.

Accelerating growth in emerging Asia
We expect most Asian EM countries to grow faster in 2015-2016. Most are energy importers and therefore benefit from the oil price decline, which will also contribute greatly to lower inflation. Central banks in the region can thus stick to their loose monetary policies. In some countries – including India, South Korea and Thailand – further key rate cuts are likely. Despite solid stimulus from the US and interest rate cuts in various countries, the acceleration in emerging Asian growth will be relatively modest. The reason is the slowdown in China, where GDP growth is expected to fall from 7,4% in 2014 to 7,0% in 2015 and 6,7% in 2016. This slower rate of expansion is natural, since the economy is gradually transitioning from being largely led by exports and capital spending, to being driven more and more by private consumption. The prospect of further key interest rate cuts in India this year should be viewed in the light of markedly lower inflation. Prime Minister Narendra Modi's government has also achieved some progress in its reform policies, which will benefit growth. We forecast GDP growth of 7,3% this year and 7,6% in 2016, after last year's 7,0%.

Latin America has lost growth dynamic
After growth figures of nearly 3% both in 2012 and 2013, Latin America lost much of its economic growth dynamic and achieved a GDP increase of only 1% in 2014. Meanwhile inflation has risen sharply and twin deficits – in budgets and current accounts – have swelled. The largest economy, Brazil, stagnated last year. Despite various reforms initiated by President Dilma Rousseff, much more reform work is required before growth will take off in earnest. Argentina is struggling with even bigger growth and inflation problems than Brazil. Among the better-off economies in the region are Mexico and Chile. We expect overall Latin American GDP to grow by 1% this year and 2,5% in 2016.

Divergent economic outlook in Eastern Europe
Thanks to good household demand, growth in Central Europe and south-eastern portions of Eastern Europe has not been especially hard hit by the Ukraine-Russia crisis and falling Russian demand. Central Europe's exports to Russia are also relatively small, while the euro zone and especially Germany are far more important markets. But in countries like Poland and Hungary, private consumption growth will slow because many mortgage loans are CHF-denominated and the Swiss franc's appreciation has made housing more expensive. Meanwhile employment is rising, however, and interest rates as well as inflation remain low. Cheaper oil will also help sustain purchasing power. The situation and outlook are far worse in Russia, which has fallen into a deep recession. After the rouble's massive slide, an inflation shock dealt a powerful blow to household purchasing power. Despite these major strains, Russia will probably avoid a fiscal crisis since it has financial buffers. Meanwhile the Ukrainian economy is close to collapse. Rapidly falling GDP in 2014 and 2015, along with rising military expenditures, has led to soaring budget deficits. But in mid-February, new loans from the International Monetary Fund brought a ray of hope. The three Baltic countries faced greater challenges this winter due to Russia's deepening crisis, but this was offset largely by slightly better economic prospects in the euro zone. Meanwhile lower oil prices are adding extra purchasing power to households, which are acting as the main growth engine in the Baltics, but capital spending remains uncertain.

Theme

Markets in unknown bond yield territory
What everyone previously thought was impossible proved possible. Due to a combination of unprecedented monetary policy stimulus, an unusually slow economic upturn, growing deflation risks and demand for "safe" government bonds, today many government bond yields, mainly in Europe, are negative. By all indications, the central banks' aggressive interest rate cuts and massive bond purchases are the main reason. According to our forecast, gradually rising government bond yields are imminent, but one complication will be the ECB's bonds purchasing programme (QE), impending appetite for German government bonds in particular.

Negative yields means that buyers of these fixed income securities are guaranteed a loss in nominal terms if they hold them to maturity. The fact that investors are still interested in buying them indicates that what was once normal no longer is. how different types of financial assets might perform. One

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reason why investors may buy negative-yield bonds, despite these conditions, is perhaps that they expect bond yields to fall further and plans to sell the bonds with a capital gain before maturity. Or perhaps buyers expect a long period of deflation, which means that there may still be a positive return in real terms (if deflation exceeds the nominal loss). Another reason may be exchange rate optimism. In other words, buyers believe that the currency in which they pay for their investments will fall in value against the currency in which the bonds are denominated. Investors thus expect their foreign exchange gains to be larger than any price decline on the bonds. Finally, there are investors such as pension funds that are forced to have government bonds in their portfolios due to various regulations. The latter group includes the biggest losers from negative government bond yields.

Three factors that might determine the path of bond yields in 2015:

1) Expectations about what will happen to the key interest rates of leading central banks are pointing in different directions. While no one expects the ECB and the BoJ to raise their key rates for a long time, there is a widespread belief that first the Fed and then the BoE will start their rate hiking cycles within the next year which suggests higher government bond yields.

2) As for inflation expectations in the bond market, after a marked decline since summer 2014, these expectations initially stabilised in 2015 and then climbed somewhat, both in the US and Europe. What happens during the rest of the year will depend largely on the extent to which the ECB manages to push inflation expectations higher with the help of its new QE programme. If this effort succeeds, which is our main scenario, we should soon see gradually rising European sovereign bond yields as investors demand compensation for higher expected inflation. An upward movement in bond yields on both sides of the Atlantic may also be fuelled by slightly better economic growth in the euro zone, strong US economic performance and the Fed's upcoming interest rate hikes, a stabilisation of oil prices at somewhat higher levels than today. One challenge to our main scenario would be if cheaper energy leads to surprisingly large price declines for other goods and services – with underlying inflation also turning into deflation in various countries.

3) A challenge would be if the ECB's bond purchases lead to persistently low, perhaps even slightly lower, European government bond yields. Of the ECB's purchases totalling EUR 60 billion per month starting this March, some EUR 40 billion will consist of government bonds. These purchases will be allocated among countries according to the relative GDP of euro zone members. The EU will buy 55% of government bonds issued in the entire euro zone until February 2016, a larger proportion of total bond issues than in earlier Fed, BoE and BoJ bond purchase programmes. The ECB's purchases during the period will be in significant Germany – 75% gross of German government bond issuance. ECB's actions may lead to a shortage of German government bonds in particular. Such a shortage may lead to rising prices. In the case of bonds, when the price goes up the yield goes down...

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. **Fixed income** asset class is divided to government bonds which refers to OMRX T-Bond Index, investment grade corporate bonds which refers to IBOXX Investment Grade Index in USD, and high yield corporate bonds which refers to IBOXX High Yield Index in USD. The **hedge funds** forecast refers to HFRX Global Hedge Fund Index in USD. Forecast for **commodities** refers to a basket of energy (33%), industrial metals (19%), agricultural (36%) and precious metals (13%). As for **currencies**, the forecast refers to most central currency pair EUR/USD.

Asset class	Expectations next 12 months		Reasoning
	Return	Risk	
Equities	**10%**	**12%**	Accelerating economic growth and continued stimulus measures will boost the potential for higher earnings. A broader upturn will increase opportunities for cyclical industries. Equity valuations have climbed, yet equities offer better value for money than fixed income investments.
Government bonds	**0%**	**4%**	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 upcoming year.
Investment grade corporate bonds (IG)	**0,5%**	**2,5%**	Low yields provide a little potential, but this asset type may work well in a portfolio that includes other higher-risk assets.
High yield corporate bonds (HY)	**4%**	**4%**	Yields of around 3-4% stand out in this asset class, 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 should thus narrow or remain stable.
Hedge funds	**4%**	**4%**	A stable trend will mean lower correlations with other asset classes, benefiting many hedge fund strategies.
Commodities	**0%**	**11%**	Gradually falling demand from China and elsewhere, combined with capacity increases, has resulted in sharply falling commodity prices. The price picture synchronized somewhat early in 2015. In a longer-term perspective, this asset class is attractive if inflation rises along with commodity prices.
Currencies	**N/A**	**N/A**	Our forecast (12 months ahead) for the most central currency pair EUR/USD is 1,10.

View on regions

Region	Outlook	Reasoning
Globally	**1 2 3 4 5 6 7**	Forceful measures by the world's central banks, cheaper energy prices and large liquidity flows will provide support. Equities will be the main source of returns in today's ultra-low interest rate and bond yield environment. Globally synchronized growth will gradually have an impact on corporate earnings.
United States	**1 2 3 4 5 6 7**	The US is chugging along and leading the global economic recovery. Macro data are improving, and companies are in very good financial shape, with strong balance sheets and record margins. However, equity valuations are on the high side, which makes us a little more cautious. There is ever less potential for improvement, and the stock market has long outperformed the rest of the world.
Europe	**1 2 3 4 5 6 7**	European economy is bottoming out, and we see potential for upside surprises. Macro data are better, with stable trends, and fiscal policy is highly accommodative. Equity valuations and earnings growth look attractive. Companies are cost-effective and competitive, and benefit from weaker currencies.
Asia/Emerging markets	**1 2 3 4 5 6 7**	Faster global growth is beneficial to Asia and the EM economies. Low equity valuations are attractive, but earnings growth has gradually fallen and in many countries is approaching DM levels. Mixed macro statistics lead us to prefer the DM economies at present. In the EM sphere, we generally prefer Asia and avoid Russia and Latin America.
Japan	**1 2 3 4 5 6 7**	Macro data are mixed and fiscal policy is supportive. A weaker Japanese yen has benefited exports. Equity valuations have come down to reasonable levels, but high earnings growth will slow this year. Stock market performance will depend on whether political stimulus measures can be implemented in their entirety 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, March 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.
International Monetary Fund (IMF)	The IMF is an organization of 188 countries whose stated objectives are to promote international economic co-operation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs. The IMF provides technical assistance and training for countries requesting it.
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.
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.
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.

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