Investment Outlook

INVESTMENT OUTLOOK SUMMARY

September 2017

Brief world economic outlook: strong economy and central banks in the spotlight again

There are many bright spots in the world's financial markets, with broad-based economic growth as the most important. We have also successfully navigated through a number of political challenges, and quarterly corporate reports are showing that both sales and earnings are rising in a way we have not experienced for many years. This has had major impact on the global stock market, which has continued to climb at an impressive pace.

Central banks are gradually shifting their focus from stimulus to tightening measures, but we have not yet reached the breakpoint where liquidity from central banks ceases to stimulate the global economy. We believe that the ongoing shift will lead to higher interest rates, but that this increase will be constrained by the weakness of inflation pressure.

Overall, we remain optimistic about the prerequisites for growth as well as inflation during the next couple oy years – a good background situation for risk assets.

View of regions

Broad-based growth

Economic growth increase is obviously road-based in regional, national and sectoral terms, although US growth is not impressive. The parts of the economy that are most clearly showing strength are the labour markets in both the US and Europe, vigorous growth in China driven by a manufacturing upswing, an increase in capital spending due to rising capacity utilisation and a cyclical recovery in various emerging market countries. The overall outcome is a robust picture. We expect global growth of 3.8% both this year and next, and one tenth of a point lower in 2019. This is both above average growth and above consensus.

As for the overall driving forces of the economy, they can be summarised as a transition from a long period of subdued demand to increasing resource shortages. Ever since the financial crisis and the deep recession of 2008-2009, the world economy has been struggling with a clear demand problem. Final demand in the form of private consumption and capital spending has been weak, driven by low general capacity utilisation – especially a weak labour market. Concurrently with this, demographic headwinds and weaker productivity growth have lowered potential growth.

The overall outcome was a long period of anaemic growth, sustained by aggressive monetary policies. Because of this sluggish performance, economists have spoken of "secular stagnation": a long-term state of slow growth. But in recent years, growth – though anaemic – has led to a slow improvement in the outlook. Labour markets, especially in the US, have shown clear strength. Together with rising asset prices, this has boosted household optimism and to some extent the inclination to consume.

Meanwhile companies have gradually grown into their production resources. Overall, we now have a world economy in which various major regions are close to full capacity utilisation. These are classic signs of a maturing economic cycle, which generate expectations of rising inflation due to resource shortages. US wages and salaries are one example of inflation that "ought to" rise, especially now that unemployment has crept below its so-called equilibrium level. We are expecting somewhat larger pay increases ahead. Along with inflation close to the Fed's 2 per cent target, this will give the central bank ammunition for continued withdrawal of stimulus measures. It will do this by hiking its key interest rate and by initiating a reduction in its balance sheet. But it is important to note that this withdrawal is occurring from an extremely stimulative situation and that other central banks, especially the Bank of Japan, are continuing to stoke their economies with stimulus programmes. Overall expansionary monetary policies will help keep growth at healthy levels, but growth will decelerate marginally during 2019 as resource shortages make themselves felt.

Better economic momentum in Europe

We can state that many hopes were previously attached to a surge in the US economy. We foresee an acceleration there, but not at the level of earlier expectations. Fiscal stimulus measures look set to be disappointing, since the Trump administration is having difficulty pushing through various reforms. Meanwhile a relatively low household savings ratio is holding back consumption increases, but growth will benefit from capital spending and net exports thanks to the weaker US dollar. We expect growth of just above 2% in the next couple of years, a bit above trend.

Unlike the US, Europe is providing upside surprises. The upturn is broad based and is being driven both by job growth and improved household optimism, as well as by increasing capital spending and rising exports. Our growth forecast is just above 2% here as well, both above consensus and the long-term growth trend. In politics, this year's focus on national elections will be replaced by efforts to create deeper euro zone collaboration. Meanwhile Brexit negotiations will continue, with a significant deceleration in the British economy as the clearest consequence.

Emerging markets are driving global growth

Emerging market (EM) economies are also contributing to the healthy growth picture. China's expansion has surprised on the upside, but the economy will soon decelerate as planned. India continues its strong growth. More commodity-dependent economies such as Russia and Brazil can expect a cyclical recovery, but hampered by structural problems. In the EM countries we analyse, we expect aggregate growth of around 5% in the next couple of years.

Rising growth in Nordic coutries

The Swedish economy is also among the bright spots from a growth perspective. We foresee broad-based, above-trend expansion with housing investments as the strongest driving force, followed by exports. Consumption will increase more sedately, despite a strong labour market. We also see risks of overheating as both monetary and fiscal policy remain expansionary. In the other Nordic countries, too, we expect rising growth, mainly driven by cyclical recovery both at the international and national level.

Factors behind our market view

Growth and earnings: The expansion is broadening and is showing strength in all segments of the economy in all regions. This points to stability even though the economic upturn has lasted for a long time. Global inflation is around 2% and is expected to remain at this level. This provides good opportunities for the corporate sector to deliver rising profits, but we have a healthy scepticism towards excessively high forecasts.

Central banks: The US Federal Reserve is continuing to hike its key interest rate and also intends to shrink its balance sheet (decrease the volume of fixed income investments it owns), which will reduce liquidity in the market. Other central banks are lagging behind, and the net effect of their actions on liquidity is expected to remain positive, but clearly less positive than before. Interest rates and yields should gradually rise. This will occur in an economic system with a high volume of debt, which will increase risks.

Valuations: This summer's earnings increase combined with a slight stock market downturn in Sweden has softened valuations a bit, but levels remain high in historical terms. In relation to valuations of government bonds or risk-free interest rates, valuations of equities and corporate credits are more normal, provided that economic growth lasts.

Risk appetite and positioning: This summer's stock market performance has represented a certain correction compared to less risky asset classes, but investors still have a large

proportion of risk assets in their portfolios. Because of this, we are holding back our risk exposure, even though risk appetite is not yet at historical peaks.

Expected returns: Outcomes will be highly dependent on a correct growth forecast. We expect positive returns from most asset classes over the next 12 months. These expected returns are lower than historical averages, while risk is intact.

Examples of risks: Valuation levels and positioning by market players, high global debt, the potential negative effects of rising inflation, interest rates and bond yields, as well as central banks that gradually normalise their key interest rates and balance sheets. If the economic cycle should turn downward this would have a major impact, but we believe that the probability of this is low, even though the economic recovery and stock market upturn have been under way since 2009.

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

ASSET CLASS	TACTICAL EXPECTATION (12 months)	
	RETURN	RISK
EQUITIES		
Global	5.7%	11.7%
Emerging markets (EM)	7.5%	13.3%
Sweden	8.7%	12.1%
Government bonds	-1.6%	1.8%
Investment grade (IG) corporate bonds	-0.2%	3.2%
High yield (HY) corporate bonds	1.3%	5.9%
Emerging market (EM) debt	5.8%	11.8%
Hedge funds	3.5%	6.0%
Commodities	N/A	11.5%

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. Hedge funds – HFRX Global Hedge Fund Index in USD.

GDP – YEAR-ON-YEAR PERCENTAGE CHANGE	2016	2017 (FORECAST)	2018 (FORECAST)	2019 (FORECAST)
United States	1,5	2,2	2,4	2,0
Japan	1,0	1,3	0,8	0,7
Germany	1,9	2,1	2,0	1,8
China	6,7	6,8	6,4	6,1
United Kingdom	1,8	1,5	1,0	1,2
Euro zone	1,8	2,1	2,2	2,0
Nordic countries	2,1	2,5	2,3	2,2
Sweden	3,2	3,2	2,8	2,4
Baltic countries	2,0	3,5	3,3	3,1
OECD	1,8	2,1	2,1	1,9
Emerging markets	4,3	4,9	5,0	5,0
The world (PPP)*	3,1	3,8	3,8	3,7

* PPP= Purchasing power parities; economies have been adjusted to account for price differences.

Source: SEB Investment Outlook, September 2017

Terminology explanation

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.
Purchasing power parity (PPP)	An economic theory that estimates the amount of adjustment needed on the exchange rate between countries so that an identical good has the same price when expressed in the same currency.
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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Before making investment decisions, we would recommend thoroughly analyzing the financial, legal, regulative, accounting and taxation issues related to investing in the fund and assessing all of the risks associated with the investment and the relevance and suitability of the investment. If necessary, more detailed explanations should be sought from an SEB adviser, and in taxation issues from a specialist of the relevant area. General information about investing as well as securities is available at SEB's website https://www.seb.lv