Investment Outlook

Summary

Divided view of economic cycle

September 2018

The global expansion will defy increased political uncertainty for another couple of years. Late-cyclical forces such as private consumption and capital spending are drivers, but growing resource shortages will cause a gradual slowdown. Due to a weak start in the euro zone we are revising our 2018 forecast a bit lower but expect steady growth in 2019-2020. In the United States, the picture is the opposite. After a strong start to the year, we are adjusting our 2018 forecast upward, but we foresee a deceleration in 2019-2020. Trade war and other political risks make the picture uncertain, but inflation should not be a problem for growth and interest rates this time around.

RISK EXPOSURE	
2018 Q2	2018 Q3
SLIGHTLY OVERWEIGHT	NEUTRAL

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.

Economic outlook – Regions

US – Continued growth, trade tensions at risk

After a temporary first quarter slowdown, economic activity surged. An improved labour market, tax cuts and increasing capital spending are driving growth. Inflation is rising undramatically, but if US import tariffs are expanded further, this will impact both consumer prices and growth. The Fed hiked its key rate in June. We expect two more hikes this year and two in 2019. We forecast a 3.0% GDP increase in 2018 and 2.5% in 2019. In 2020, growth will slow to 1.9%. With our fairly optimistic view of today's international troubles, wle believe that the EUR/USD exchange rate may keep moving somewhat lower in the short term but will rebound and reach 1.15 at the end of 2018.

Euro zone – weak start but continued good outlook

The weak start to 2018 lasted longer than expected but we remain optimistic about euro zone growth, although trade worries pose downside risks. Job growth indicates that businesses foresee continued expansion. Strong labour markets and fiscal stimulus will help households. Growth patterns are changing; the German economy is more in phase with the US and will decelerate somewhat, while growth will speed up a bit in countries like France.

There is political uncertainty about the euro project, but it is best described as part of daily life. Uncertainty about Brexit is likely to culminate in the next couple of months, since UK-EU negotiations need to be concluded. Euro zone GDP will grow by about 2% yearly in 2018-2020, but remain low. Inflation and pay rises are speeding up but from low levels. The ECB will hike its key rate only after summer 2019.

Emerging market countries – Worrisome slowdown

Most emerging market (EM) economies have performed weakly in recent months. Geopolitical tensions and the trade war in particular have led to uncertainty and some deceleration in global economic growth. US dollar appreciation has also negatively affected performance, since many EM countries have large USD-denominated loans and a stronger dollar increases their borrowing costs. In a market situation with rising economic growth this is not necessarily a problem, but since we foresee a slowdown in global growth, the impact will be negative. Recently, this has also led to falling exchange rates for a number of EM currencies, a trend that may continue. Among currencies that we believe will continue downward are the Russian rouble (due to further US sanctions), the Turkish lira, the South African rand and the Mexican peso.

China – Robust but slowing growth

The trade war with the US has forced China to reassess its credit policy and loosen monetary and fiscal policies to help sustain domestic demand. We forecast GDP growth of 6.6% this year, slowing to 6.3% in 2019 and 6.0% in 2020. Domestic demand will cool, mainly because of lower infrastructure investments – an effect of the tighter credit policies that were launched to reduce financial market stability risks. Activity will be sustained by rising pay, falling unemployment and solid consumption.

Sweden – continued economic momentum

Increasing exports and capital spending by industry and the public sector will offset shrinking home construction. The probability of a soft landing in the housing market has increased, though a large supply of unsold homes continues to squeeze prices. Unemployment will fall below 6% late in 2018, but underlying price and wage pressures remain subdued. We are adjusting our GDP growth forecast from 2.6 to 2.9% in 2018 and from 2.2 to 2.4% in 2019.

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

ASSET CLASS	TACTICAL EXPECTATION (12 months)	
	RETURN	RISK
EQUITIES		
Global	6.7%	11.8%
Emerging markets (local currencies)	9.0%	13.8%
Sweden	8.5%	11.7%
FIXED INCOME INVESTMENTS		
Government bonds	-2.6%	1.5%
Investment grade (IG) corporate bonds	0.2%	2.9%
High yield (HY) corporate bonds	2.7%	5.1%
Emerging market (EM) debt	5.7%	11.5%
ALTERNATIVES		
Hedge funds	3.5%	6.0%
Commodities	2.4%	10.0%

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.

Equities

Optimistic, but more uncertain outlook

Political turmoil may change the conditions for economic growth, but the underlying earnings trend remains strong. Share prices should be able to climb at about the same pace as earnings – 6-8% over the next 12 months – but it is important to note that more and more investors are now looking towards the next phase, with weaker growth and more stock market headwinds. We still see some potential in equities ahead, but we generally expect larger movements. This late in the economic cycle, we foresee limited room for valuation driven share price upturns.

Fixed income investments

Challenging environment for fixed income

Cautious monetary policy normalisation, including key interest rate hikes, will become apparent as inflation in many countries moves higher and closer to central bank targets. US economic performance will continue to support planned Federal Reserve (Fed) key interest rate hikes. The European Central Bank (ECB) is reducing its bond-buying but will not hike the key rate for a while. Monetary policies are tightening, providing ever less support for the credit market. We choose to maintain a low interest rate risk and short duration, while preferring high yield to investment grade corporate bonds. Short-term prospects for emerging market (EM) bonds are still uncertain but there are long-term opportunities for strong returns, given valuation levels.

Alternative investments

Changed market, better or worse for hedge funds

The trade war and strong quarterly reports are creating performance gaps within and between asset classes. Given a somewhat more cautious outlook for stock market performance, this should help equity related hedge funds that can vary their net exposure over time. Macro funds should enjoy good conditions, since central banks are active and face different situations. Event-driven strategies continue to benefit from a record-strong corporate transaction market.

Source: SEB Investment Outlook, September 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.
Hedge funds' strategies	Market neutral strategy – a strategy by hedge fund managers, that seeks to profit from both increasing and decreasing prices in a single or numerous markets. 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. Relative value strategy is a catchall for a variety of different strategies used with a broad array of securities. The underlying concept is that a hedge fund manager is purchasing a security that is expected to appreciate, while simultaneously selling short a related security that is expected to depreciate. 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	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.
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.