SEB

Investment Outlook

Summary

September 2019

In the last Investment Outlook (May 2019) we said that we had reduced our risk tolerance and that positive potential would arise if the economy – more specifically international trade and the manufacturing sector – stabilised and regained their momentum. This has not happened. Instead, these elements of the economy have continued to weaken, and the prolonged trade war between China and the United States is fuelling market worries. This has persuaded the US Federal Reserve (Fed) to shift its policy direction, shelve planned key interest rate hikes and instead begin to cut its key rate. European Central Bank (ECB) is also loosening its monetary policy. Government leaders are under ever-increasing pressure to deploy fiscal stimulus. Investors have moved their portfolios a step further towards more defensive positioning, since the above sources of concern have been accompanied by stagnating corporate earnings. We are in the late phase of the economic cycle. Combined with the ongoing trade war, we are thus receiving signals that make us somewhat sceptical of the growth rate and earnings-generating ability of the corporate sector, but this is offset by hopes of more stimulus measures by central banks and political leaders via lower key interest rates and higher government investments. We agree that the risk of recession has increased, but we believe that those who maintain that a recession is imminent are too early.

RISK EXPOSURE	
2019 Q2	2019 Q3
NEUTRAL	UNDERWEIGHT

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.

Macro and other market drivers

In the last Investment Outlook (May 2019) we drew a divided growth picture, but with positive signals from the political arena that justified the optimistic tone in the world's financial markets. We also noted clear support by central banks, mainly due to more dovish monetary policy by the Fed. Apart from central bank policies, markets have faced headwinds from several directions

Today's growth picture is dominated by deceleration. We see this most clearly in various purchasing managers' indices (PMIs), especially in manufacturing, which in many places are below the 50 mark that usually signifies the threshold between expansion plans and a more cautious attitude.

The signals from the political arena have also become increasingly harsh. After last spring's optimism about a US-Chinese trade agreement, the mood became more confrontational this summer. Most observers now expect a long journey, with more bumps in the road. Direct effects on the economy and trade are limited so far, but combined with other uncertainties the negative effects on business and household sentiment may still push down the economy. In Europe, the Brexit process (British withdrawal from the EU) will naturally dominate this autumn and includes the risk of an adverse economic outcome.

In addition, the economic cycle is "tired" after a record long expansion period – mainly in the biggest economy, the US. This is reflected, for example, in a tight labour market, which is becoming increasingly evident and will hamper future growth potential.

More and more observers are talking about an increased risk of recession, with the world entering a period of significantly weaker growth. They can also point to a classic recession indicator – an inverted (or negative) yield curve – meaning that long-term government bond yields are lower than short-term ones. This happened in the US during the summer and has historically been a reliable indicator that a recession can be expected after several quarters.

We agree that the risk of recession has increased, but we believe that those who maintain that a recession is imminent are too early. A number of counterforces indicate that growth may remain decent over the next couple of years, though lower than in recent years. The most obvious is the stability of the domestic economy in many countries, driven by relatively strong service sectors. Another contributing factor is a benign overall situation for households. Low unemployment (the lowest for 50 years in the US), rising asset values, some real wage increases and cheap home mortgage loans are keeping spirits high. US households also have a historically high savings ratio, so they have only a limited need to boost their savings if uncertainty rises. When it comes to trade conflict, both sides in the US-Chinese trade conflict are aware of the risk that an escalating conflict may carry a high price in the form of falling stock markets and growth; this awareness should serve as a stabiliser.

Finally, and perhaps most importantly, the shift in central bank monetary policies is an important force in softening the deceleration and prolonging the cyclical upturn. This is precisely what the Fed successfully did in in both 1995 and 1998. On both occasions, the US central bank cut its key interest rate three times and helped maintain economic growth. One could argue that conditions are worse this time around, since we are further along in the economic cycle, with less energy left in growth engines such as labour markets. Yet we expect looser monetary policies in both the US and the euro area to help sustain growth.

Overall, we expect a deceleration of global economic growth from 3,7% last year to 3,1% in 2019. We then expect a marginal speed-up in 2020 and 2021, driven by improved growth after Europe bottoms out this year and a speed-up in some emerging markets. This will be enough to maintain global growth, despite continued controlled deceleration in both the US and China. But the image of a tired global economy with clear downside risks – especially political ones – is likely to dominate financial market conditions this autumn.

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

ASSET CLASS	TACTICAL EXPECTATION (12 months)	
	RETURN	RISK
EQUITIES		
Global	7,3%	14,9%
Emerging markets (local currencies)	8,0%	14,0%
Sweden	8,7%	14,8%
FIXED INCOME INVESTMENTS		
Government bonds	-1,1%	1,1%
Investment grade (IG) corporate bonds	-0,1%	3,0%
High yield (HY) corporate bonds	2,5%	4,2%
Emerging market (EM) debt	3,1%	8,1%

Tactical expected return is based on the SEB House View as of September 2019. 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.

Equities

Because of the late-cyclical phase, with all-time highs on various stock exchange and the return of narrow credit spreads (yield gaps between government and corporate bonds), we are a bit more conservative regarding taking risk.

Macro statistics show that the world economic slowdown is continuing, but the picture is much calmer than signalled by financial markets and the political arena. After a long period of growth, the economic cycle is showing signs of fatigue, especially in the US. Labour shortages and weaker world trade are squeezing manufacturing activity, while the service sector and households have so far shown resilience. We expect slower growth, but see no recession in the cards during the foreseeable future.

However, the weakness in the economy is sufficient to create question marks about future growth and corporate profit levels. Earnings forecasts have been adjusted downward, especially for cyclical industries. We (and the market) now predict unchanged earnings for the full year 2019. The consensus forecast for 2020 points to earnings increases of about 10%, which we consider a bit too optimistic. In light of this, and given the strong upturn in share prices earlier this year, it is no wonder that stock exchanges are becoming more volatile.

Fixed income investments

The supportive policies of central banks have benefited investments that have interest rate risk as well as credit risk. The big question is whether central banks can lower key interest rates as much as the market wishes, in order to prevent weaker economic conditions. We predict three more key interest rate cuts by the US Federal Reserve (Fed) and expect the European Central Bank to lowered its deposit rate slightly and re-introduced bond purchases and other easing. We also foresee stable core inflation of around 1,5% in the United States and the euro area. All in all, a situation which suggests that long-term bond yields will also remain ultra-low. We see some advantages in holding corporate bonds, both with lower risk (investment grade) and higher risk (high yield).

In particular, the Fed's dovish policy stance will enable continued good performance by emerging market bonds (EM debt) for another while, although there is greater uncertainty about these than before. EM debt performed well during the late spring and summer, thanks to relatively higher yields in emerging markets and as an effect of stronger EM currencies.

Source: SEB Investment Outlook, September 2019

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.
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.
Price-earnings ratio (P/E)	A valuation ratio of a company's current share price compared to its per-share earnings for the past year. For example, if company's share price is EUR 100 and it reported EUR 10 per share in annual earnings, the P/E ratio would be 10. 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. However, the P/E ratio does not tell us the whole story by itself. 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.
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