Monthly Newsletter
Savings and Investments

Markets are calmer than at the beginning of the year but remains fragile

May 2016

Market overview

In April markets mainly focused on central bank meetings, dynamics of oil prices, earnings reporting and GDP growth of different world economies. The central banks did not announce any policy changes as more time is needed to see how exiting ones are working (this month's theme – the impact of negative interest on the economy, page 2); oil prices continued to increase despite the inconclusive meeting of the world's biggest oil producers; majority of already reported earnings have beaten expectations, but are lower compared to last year; GDP figures on both side of Atlantic were mixed – US GDP growth was lower than expected, while Eurozone's GDP provided an upside surprise. Markets are calmer than at the beginning of the year but remains fragile (as recent development in markets showed). We still remain a bit more cautious, but our main scenario is still that the global economy will improve during the year.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **+0,3%** in April **+1,0%** YTD **+51,5%** in 5 years **Europe** (MSCI EURO, EUR): **+0,6%** in April **-6,7%** YTD **+9,1%** in 5 years **Eastern Europe** (MSCI EM Eastern Europe, USD): **+3,4%** in April **+18,8%** YTD **-53,2%** in 5 years **Asia** (MSCI EM Asia, USD): **-1,3%** in April **+0,4%** YTD **-17,5%** in 5 years **Latin America** (MSCI EM Latin America, USD): **+5,7%** in April **+25,3%** YTD **-50,5%** in 5 years	The **US** economic data was dominated by the 2016 Q1 **GDP** figures released at the end of April. The **economy grew** at an annualized rate of 0,5% over the quarter – **lower-than-expected** (0,7%). However, GDP growth was expected to be low mainly due to contraction in energy and mining fixed investment that are expected to increase as the year goes on. As expected, **the US Federal Reserve** (Fed) left its **key interest rate unchanged** at 0,25-0,50% at April's policy meeting. Compared to earlier meetings, Fed Chair J. Yellen played down the role of international trends. This implies that the central bank's focus should shift back to the US economy, labour market and inflation. **We believe the Fed will wait until September before hiking its key rate**. April's **macroeconomic data** releases were **mixed**. Only **160 000 new jobs** (non-farm payrolls) had been created in April (200 000 expected), but the labour market continued its impressive tightening, with a **record-low jobless claims** number. Unemployment rate remained steady at 5%. US **earnings reporting** also revealed **mixed results**. Majority of already reported companies have beaten earnings expectations, but this hides lower earnings compared to last year due to the heavy downward revision in analyst expectations. Expected profits have been revised down for quite some time now. Downward revision appears to be slowing down, but signs are missing on increasing profits. After policy meeting in April, the **European Central Bank** (ECB) announced, as expected, no changes in policy. But ECB president M. Draghi stated that there is an improvement in the Eurozone since policy easing began in 2014 and the latest stimulus package presented in March has extended that recovery. Latest macroeconomic data shows a mixed picture of region's health. The first estimate of region's **GDP** growth in Q1 was **above expectations**. It showed economy growth of 0,6%, while it was expected 0,4% increase. Meanwhile, **unemployment rate fell** to 10,2% – the lowest rate since August 2011. Gloomier news came on the **inflation** front as latest estimate showed that consumer prices **fell** 0,2% in April from 0% in March. Also latest **purchasing managers' indexes** (PMIs) supported the message that growth in the Eurozone remains fairly sluggish. Overall, Eurozone's economy is improving (though very slowly), but remains vulnerable. **The Bank of Japan's** (BoJ) announcement that it was taking **no further policy steps** disappointed markets. There had been expectations of interest rate cut, expanded quantitative easing and better lending conditions to banks. These steps now are expected for next meeting in June. **Positive** macroeconomic **data** from **China**. Chinese international trade figures have provided upside surprises, with **exports climbing** for the first time in nine months. Industrial production figures are also good. Chinese Q1 **GDP** growth was **6,7%** year-on-year, in line with expectations and sustained by **manufacturing** output as well as **retail sales**. However, worries over the country's fragile economic outlook, companies defaults and a regulatory clampdown on markets remains. **Oil price rise**. The long-awaited April meeting of the world's biggest oil producers to reach an output freeze deal was inconclusive. It is a bearish sign for prices in the long term, but over the course of the month, a weaker USD and declining inventory releases pushed the oil price up by 10 USD (Brent). The correlation between the oil price and markets has been elevated, as oil is treated as a barometer of economic health and investor sentiment. Iranian and US production remain the supply forces to watch.

* More information regarding indexes' performance can be found at the end of the document

Impact on investments of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	In April government bond yields were tend to be flat after decrease in Q1. Uncertainty factors and expansionary stimulus packages by central banks may keep the yields at lower levels for a while. On the other hand, stronger economic conditions may push them higher. Overall, the historically low interest rate climate is challenging for fixed income investments and we still have a negative view of government bonds, with US standing out as least attractive.
Medium risk (balanced)	Our balanced medium risk portfolios generated positive results in April, the values have recovered after loses in the first half of Q1. However, we still continue to stay at reduced risk level as we think that sharper market volatility will continue to persist for a while. In longer-term our main scenario is still that the global economy will improve and we can increase the risk any time. Investors continued coming back in High yield (HY) bonds during April. Looking ahead from risk and return perspective HY bonds still seems to be the most attractive investment in bonds market. However, possible weaker global growth and low oil prices are factors causing concerns in HY market.
High risk (aggressive)	After stock markets recovery in second half of Q1 investors continued to tolerate higher risk during April as well. However, in the first week of May worries about global growth revived and sent investors scurrying out of the perceived risk of equities. While there are number of factors behind the recent rebound, like decreased worries about China's slowdown, recovered oil prices, additional stimulus by central banks, cautious attitude by the Fed towards continued key interest rate hikes, there are also factors that continue to cause concern. To name few: downward revision of economic growth and corporate earnings estimates, troubles in manufacturing sector, possible British withdrawal from the European Union ("Brexit"), renewing questions about Greece debt crisis and "Grexit". Therefore, we still remain a bit more cautious, but our main scenario is still that global economic growth will accelerate during 2016, though at a slow pace. There is also potential for a more stable stock market trend, but we believe that volatility will come and go during the year.

SEB

Monthly theme

Negative interest rates – what does it mean?

There are an increasing number of media mentions about negative interest rates as more developed countries across the globe are entering a negative interest rates territory. Five central banks – the European Central Bank (ECB), the Denmark's National bank, the Swiss National Bank, Sweden's Riksbank and the Bank of Japan – so far have adopted negative rates on commercial banks' funds held on deposit at the central bank. In effect, commercial banks have to pay to hold their money at central banks. The key goal of these decisions is to stimulate economic growth and to fight with low inflation and growing threat of deflation. The question now is how effective can this approach be as there is great uncertainty about consequences and the behavior of commercial banks, institutions and other entities if rates were to decline further into negative territory or remain negative for a prolonged period.

Why use negative interest rates?
Simply put, when rates are negative, a depositor, for instance a commercial bank, has to pay a central bank for the benefit of holding cash at the nation's central bank. The theoretical aim of such policy is that since banks would have to pay to store their cash, they would be motivated to lend any extra cash to businesses and individuals, fueling the economy. Another example could be a depositor (i.e. large company) who has to pay for holding cash at commercial bank if latter one applies negative rates. In this case one of the aims would be to encourage companies to use money for business investments, again to boost growth in economy. Or put another way, negative rates mean lenders pay borrowers for the privilege of lending. However, it would be an extreme case at commercial banks level as an economic logic of lending is receiving an interest as a trade-off of assuming borrower's credit risk. Though, borrowing costs are squeezed down by adopting negative interest rates and the aim is to promote consumption, which is one of the main drivers of economic growth. Yet, above named aims and intentions of adopting negative interest rates are very theoretical and there is uncertainty how it fulfils in practice.

How it works? Eurozone's example
In Eurozone, the aim of the central bank is to stimulate economic growth and to raise inflation. The ECB has a mandate to ensure price stability by aiming for an inflation rate of below but close to 2% over the medium term (currently inflation in Eurozone is a bit below zero). Like most central banks, the ECB influences inflation by setting interest rates. If the central bank wants to act against too high inflation, it generally increases interest rates, making it more expensive to borrow and more attractive to save. By contrast, if it wants to counter too low inflation, it reduces interest rates.

The ECB has three main interest rates on which it can act: the marginal lending facility for overnight lending to banks, the main refinancing operations and the deposit facility. The main refinancing rate or the base interest rate is the rate at which banks can regularly borrow from the ECB while the deposit rate is the rate banks receive for funds parked at the central bank.

Since Eurozone's economy is recovering at a very slow pace and inflation is close to zero and is expected to remain considerably below 2% for a prolonged period, the ECB has judged that it needs to lower interest rates. All three rates have been lowered since 2008 and the most recent cut was made in March, 2016. The base interest rate was cut from 0,05% to 0% and the deposit rate was cut more deeply into negative territory from -0,3% to -0,4%. ECB is justifying that is a part of a combination of measures designed to ensure price stability over the medium term, which is a necessary condition for sustainable growth in the euro area.

The deposit rate which is now even more negative means that Eurozone's commercial banks that deposit money in the ECB have to pay more. The question may rise – isn't it possible for banks to avoid the negative deposit rate? For example, can't they simply decide to hold more money in cash? If a bank holds more money than is required for the minimum reserves and if it is not willing to lend to other commercial banks, it has only two options: to hold the money on an account at the central bank or to hold it as cash (of course the most anticipated option by central banks is that banks increase lending to businesses and individuals). But holding cash is not cost-free either – not least since the bank needs a very safe storage facility to warehouse the cash. So it is unlikely that any bank would choose to do this. The more likely outcome is that banks either lend money to other banks or pay the negative deposit rate. Between these two options the second one is more realistic as currently majority of banks hold more money than they can lend and borrowing from other banks is unnecessary.

Positive and negative effects of negative interest rates
While central banks intend to boost growth and inflation by adopting negative interest rates, such policy becomes more unconventional and brings concerns that worth to consider. Below few major pros and cons are described.

First, taking into account that intensions of central banks is fulfilled and negative interest rates stimulate the economy, this would be a positive sign for the banking sector. If markets believe that negative interest rates improve long-term growth prospects, this should raise expectations of higher inflation and higher interest rates in the future, which is positive for banks' net interest margin (commercial banks make money by assuming credit risk and charging a higher rate of interest on loans than they pay on deposits – they have a positive net interest margin). What's more, in a stronger economy banks should be able to find more worthwhile opportunities to lend and borrowers are more likely to be able to repay those loans. On the other hand, negative interest rates may harm the banking sector. If the rate charged on loans is being squeezed ever lower by falling interest rates, and commercial banks are unwilling or unable to set the rate paid on deposits below zero, banks' net interest margin is compressed tighter and tighter.

Second, the negative interest rates policy should encourage commercial banks to lend more to avoid charges from central banks on funds in excess of mandatory reserves. However, for negative rates to boost lending, commercial banks must become willing to lend more, and at lower potential income. As negative interest rates are introduced to counter slow economic activity and deflation risks, it means that businesses are facing challenges in such environment and, as a result, in lending banks face increased credit risk and squeezed profits at the same time. If profits suffer too much, banks may even reduce lending. Even more, difficulties in imposing negative rates on depositors may mean debt costs rise for consumers.

Third, negative interest rates also have the potential to weaken a national currency, making exports more competitive and boosting inflation as imports become more expensive. However, negative interest rates may provoke so called currency war – a situation where a number of nations seek to deliberately depreciate the value of their domestic currencies in order to stimulate their economies. A weaker exchange rate certainly appears to be a key channel through which monetary policy easing is acting. But overall currency devaluation is a zero-sum game: the global economy can't engineer a currency devaluation against itself. In worse case, competitive currency devaluations may give way to protectionist trade policies, which would be negative for global growth.

Fourth, from investors' perspective, negative interest rates should, in theory, function the same way as the lowering of rates to zero – it should benefit stocks as the relationship between interest rates and the stock market is fairly indirect. A decrease in interest rates means that those people who want to borrow money can enjoy lower interest rates. But this also means that those who are lending money, or buying securities such as bonds, have a decreased opportunity to make income from interest. If we assume investors are rational, a decrease in interest rates will prompt investors to move money away from the bond market to the equity market. At the same time, businesses can enjoy the ability to finance expansion at a cheaper rate, thereby increasing their future earnings potential, which, in turn, leads to higher stock prices. But in practice, this unique policy of negative interest rates may not be as rewarding. Investors may see negative interest rates policy as a sign of trying to deal with serious troubles in economy and may remain risk averse. Also, adopting negative interest rates would not necessarily encourage commercial banks to lend more which would weight on the profit outlook for financial companies and hurt the performance of the global financial sector. Troubles in financial sector are very sensitive on overall stock market and can drag it down. And even if commercial banks would be willing to lend more there is questionable success in encouraging businesses and individuals to borrow and spend more.

Fifth, negative rates may complement other easing measures (like quantitative easing) and signal central bank resolve to tackle economy slowdown and below-target inflation. On the other hand, negative interest rates may be symptomatic of central banks reaching the limits of what monetary policy can do. Markets appear to be increasingly concerned that central banks are out of measures, and are fretting about how policy makers would tackle another downturn in economy.

Bottom line
Central banks are determined to do what it takes to boost growth and inflation. With interest rates already at zero, more central banks have been resorting to negative interest rates to fulfill their objective. However, it is a relatively new tool for central banks and the main opportunities and risks of such policy have not yet been realized. Therefore, it is worth to examine and monitor potential unintended consequences more closely of this increasingly popular policy. So far, in Eurozone economy is picking up slowly, inflation is very low, commercial banks are not in hurry to lend more and instead are seeking how to mitigate potential harm on profits in other ways, willingness from businesses and individuals to borrow more at cheaper rates are increasing at quite slow pace, investors are not in hurry to take more risk in investing, bond yields remain at record lows. More time is needed to realize the true impact of negative interest rates.

Sources: *European Central Bank, World Bank, Bank for International Settlements, Nasdaq, Investopedia, Bloomberg, BBC, CNBC*

Terminology explanation

Terminology used	Explanation
Correlation (correlation coefficient)	In the world of finance, a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management. Correlation is computed into what is known as the correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. In real life, perfectly correlated securities are rare, rather you will find securities with some degree of correlation.
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 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. 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".
Oil types: Brent and WTI	Brent Blend (Brent) and West Texas Intermediate (WTI) oil types are used as benchmarks for the prices of other crude oils. Roughly two-thirds of all crude contracts around the world reference Brent, making it the most widely used marker of all. These days, Brent actually refers to oil from parts of the North Sea off the coast of the U.K. and Norway (Brent, Forties, Oseberg and Ekofisk). Because the supply is water-borne, it's easy to transport to a distant locations. WTI refers to oil extracted from wells in the US (sent via pipeline to Cushing, Oklahoma). The fact that supplies are land-locked is one of the drawbacks to West Texas crude – it's relatively expensive to ship to certain parts of the globe. WTI continues to be the main benchmark for oil consumed in the US.
Non-farm payrolls	It is an influential statistic and economic indicator released monthly by the United States Department of Labor as part of a comprehensive report on the state of the labor market. The total non-farm payroll accounts for approximately 80% (it does not include farm workers, private household employees, or non-profit organization employees) of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity.
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.
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 (QE)	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.
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.

Stock market indexes performance information covering the immediately preceding 5 years till 30 April, 2016

Region	Index	Currency	Performance						
			2011	2012	2013	2014	2015	12 months	2016 YTD
USA	S&P 500	USD	0,0%	13,4%	29,6%	11,4%	-0,7%	-1,0%	1,0%
Europe	MSCI EURO	EUR	-16,5%	15,6%	19,6%	2,3%	6,1%	-14,7%	-6,7%
Eastern Europe	MSCI EM Eastern Europe	USD	-23,3%	13,2%	-2,9%	-40,0%	-8,1%	-14,6%	18,8%
Asia	MSCI EM Asia	USD	-19,1%	18,1%	-0,2%	2,5%	-11,8%	-21,1%	0,4%
Latin America	MSCI EM Latin America	USD	-21,9%	5,4%	-15,7%	-14,8%	-32,9%	-14,9%	25,3%