Monthly Newsletter
Savings and Investments
Stock markets suffered their worst moment since 2011

October 2015

Market overview

Concerns over the global impact of China's economic slowdown dominated financial markets in September and the whole third quarter. Markets suffered their worst moment since 2011. The US Federal Reserve's (the Fed's) decision to leave US interest rates unchanged, despite reasonably strong US economic indicators except weaker employment figures in September, caused nervousness about the strength of global economic growth and revived uncertainty about the timing and pace of US rate increases. However, we do not anticipate sustained market decline, but we expect sharp market volatility to persist for a while.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **-2,6%** in September **-6,7%** YTD **+68,2%** in 5 years	US equities delivered their worst quarterly performance since 2011 Q3, as slowing growth in China and uncertainty over the Fed's policy weighed on markets. **The Fed's decision to leave policy unchanged at its September meeting**, despite solid US economic data, caused nervousness about the strength of global economic growth. However, we see the Fed's decision as more of an insurance policy in this nervous environment in financial markets. **SEB's forecast is now that the US rate hike will come in December, with a risk that we may have to wait longer** (current market consensus show just a 29% chance of a rate rise in December). **Recent economic data in US showed few weaker signs**. The US economy created less jobs (142 000) in September than anticipated (201 000), the manufacturing activity (ISM index) fell to its lowest level since May 2013. On the other hand, consumer confidence reached its highest level this year. **Expectations for the upcoming quarterly earnings season have decreased**, with the consensus now forecasting a 5% decline overall compared to 2014 Q3. However, lower expectations makes it easier to beat them and bring positive moods to stock markets.
Europe (MSCI EURO, EUR): **-5,0%** in September **0,0%** YTD **+21,5%** in 5 years	**Economic indicators from Europe have generally been positive**. Business and consumer confidence provides reassurance about the euro zone's growth momentum. **2015 Q3 was the ninth consecutive quarter of GDP growth**. It is notable that European growth is now being driven by a **recovery in domestic demand**. The relative immunity of the European economy to the Greek crisis and the Chinese slowdown is encouraging. However, **European stock markets were not so immune** to these concerns and came back to where it started at the beginning of the year. **ECB's willingness to take further action to support the euro zone economy is positive and should provide support for Europe's equity markets**.
Eastern Europe (MSCI EM Eastern Europe, USD): **-4,8%** in September **-1,7%** YTD **-44,4%** in 5 years	When it comes to **negative financial markets reaction to news from China**, the chain of events began with the surprise devaluation of the yuan in August, with instability compounded by set of unexpectedly weaker economic indicators and **concerns over consequences of slowdown in the second largest economy in world**. However it is worth to note that the real estate market has stabilized a bit and retail sales are still growing strongly. **The Chinese slowdown is part of the process of the economy transitioning to slower but more sustainable consumption and service based growth**. There is more about prospects of China's economy in monthly theme (next page).
Asia (MSCI EM Asia, USD): **-1,8%** in September **-14,5%** YTD **-10,7%** in 5 years **Latin America** (MSCI EM Latin America, USD): **-7,9%** in September **-30,5%** YTD **-56,8%** in 5 years	**Elsewhere in world**. Latest economic data from **Japan showed slowing industrial output** which leads to speculation that Japanese economy may have slipped back into recession in 2015 Q3. The disappointing economic backdrop led to growing **expectations that the Bank of Japan will need to expand its quantitative easing programme** to boost growth and meet inflation targets. **The central bank of India cut its main interest rate** by a larger-than-expected 0,5% to 6,75% due to fears that economy growth may be slowing in India. In line with new government's economic reforms, which slowly, but are picking up, it is a positive sign to higher risk investments. However, more time is needed to see if new reforms are changing economic picture into brighter colors. **Brazil's currency, the real, fell to an all-time low against the US dollar** at the end of September, reflecting bearishness on this country's growth and worries over the ability of government authorities to tackle Brazil's fiscal issues. However, **hopes boosted that currency weakness will lift exports** and help to reduce the country's current account deficit. In the context of all troubles related to Russia's economy, **Russia's stock market was hit by geopolitical concerns, as Russian air strikes in Syria** added to tensions between Moscow and Washington.

* 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)	Concerns about global economic growth and Fed's decision not to hurry in raising interest rates caused government bond yields to decrease a bit (the price of bonds increased). Weak economic data may limit the rise of government bond yields. However, stronger economic conditions and heightened inflation expectations as well as approaching Fed interest rate hikes may cause government bond yields to climb gradually. Our view on government bonds (12 months ahead) does not change and remains conservative.
Medium risk (balanced)	In September our balanced medium risk portfolios experienced the second worst month this year and the whole third quarter of 2015 was really challenging, mainly because of hard sell-off in equity markets (expectations for high risk investments within balanced medium risk portfolios are covered in high risk part). We expect sharp market volatility to persist for a while, but not the beginning of a sustained decline, therefore it should not harm our longer-term strategy. Medium risk investments such as high yield (HY) bonds of shorter duration were more volatile during last few months but, looking ahead (12 months), still appear to be the most attractive among fixed income instruments in perspective of risk adjusted returns.
High risk (aggressive)	The sell-off in equities in Q3 has left developed market equities looking more attractive with the potential for upside. We are a bit more cautious about emerging markets, because of more signs of weakness in emerging economies, especially in commodity-exporting countries. Overall, we expect higher market volatility to persist for a while, but we remain positive about global economy growth in longer-term, though a bit slower than expected before. A continued positive US economic trend, recovering economy in Europe should keep the market in a good mood. Low commodity prices and continued monetary stimulus will help sustain consumption and growth.

SEB

Monthly theme

China: more subdued growth, but no drama

The flow of news about China surged during the summer and in the beginning of fall. The growth of the world's second largest economy is decelerating. This has had consequences for all asset classes, as well as a negative effect on market players' risk-taking propensity. However, slower growth is logical in light of a global economy that is not really gaining momentum and because China wants to end its heavy dependence on the cyclical manufacturing sector in favour of an economy driven more by consumption and services.

Recent signs of slowing China's economy included weaker industrial production, falling export figures and lower purchasing managers' index (PMI) levels. However, we believe there will be a soft landing, with GDP growth of 6.8 per cent in 2015. President Xi Jinping set a growth target of 7 per cent for China this year. If this materialised, it would be the slowest pace since 1990.

The real estate market

Another reason why China's growth is decelerating is that the housing market, a key factor for the economy, is weakening. When demand for properties declines, commodity markets are affected. Less steel is used, with the result being that in 2015 China has exported as much steel as Japan, even though China is still by far the world's largest consumer of steel. After large-scale capital spending following the 2008-2009 financial crisis, residential investment as a share of GDP was 10,4% in 2013. When Spain's housing bubble burst in 2006, residential investment represented 12,5% of GDP. There are also numerous examples of countries where the housing bubble burst with investment peaking at 6–9% of GDP. Given China's large population and urbanisation wave, with a larger percentage of people moving to cities, this should lessen the problem somewhat, although housing construction has increased substantially and the market is starting to become saturated. As early as 2012, residential floor space per capita was higher in China than in Spain as well as in Taiwan and South Korea, for example, which is unusual for an emerging market. The time it takes to sell a home is steadily increasing. In smaller cities, that figure is now at a five-year high. However, China's leaders are doing a great deal to stabilise the real estate market. Restrictive rules on home purchases have been eased, and banks have been instructed to approve new mortgages faster. The People's Bank of China (PBoC) has cut its key interest rate in several rounds and also lowered the reserve ratio for banks. This may already have had some effect; during the summer, housing prices rose marginally after 12 straight months of decline.

Government using many tools

History shows that the Chinese government takes its promised growth levels seriously, and we can expect further interest rate cuts and a lower reserve ratio for banks. The yuan was devalued unexpectedly in August and has weakened about 5% against the dollar, which should benefit Chinese export companies. In our view, there will be further devaluations. Infrastructure investments are likely to be on the agenda again, since there are disadvantaged areas that can be expected to contribute positively to China's growth in the long term as well. Improvements in local transport, electricity grids, water quality and the environment are probable areas for further investment. The government is likely to take the opportunity to make changes in the ownership structure of government-controlled companies.
Many of these companies are inefficient and in some cases corrupt. A change in the ownership structure may entail mergers, with a new ownership structure hopefully producing more optimal corporate governance and more efficient companies in the long term.

As for resolving corruption problems, the current Chinese government has in fact already done a fair amount. An anti-corruption wave in China has been ongoing since 2013, and in July 2014 nine senior civil servants were placed under investigation. In some government-controlled companies, essentially the entire management team has been replaced. In December 2012, more stringent rules against civil servant extravagance were introduced. The aim, naturally, is to show the general public that the government is on their side. It seems to be working, since a majority of the population says it is satisfied with the government's work.

The stock market, investors and the government

It has been a turbulent year for China's local stock exchanges. The Shanghai stock exchange started the year strongly, with a 70% upturn between February and June before totally collapsing. At this writing, the market is largely back at where it was at the start of the year.
Earlier this year, many observers said they thought there was a stock market bubble with extreme valuations, but Chinese investors poured into the market as prices continued to rise. The number of new investment accounts skyrocketed, as more people wanted to join the stock market rally. Some 40 million such accounts were added in China between June 2014 and May 2015. Many inexperienced stock market speculators took great risks and were rewarded, while some have now lost all their initial capital and sometimes even more. In contrast, many larger investors reduced their shareholdings during the summer. Perhaps many of the more seasoned investors were misled because the government launched numerous measures aimed at stopping the plunge in share prices. Initial public offers (IPOs) have been suspended, short selling has been banned, and government-controlled entities in the financial market have bought shares to support prices and have also persuaded privately owned organisations to do the same. Meanwhile financial institutions have been encouraged to continue lending to investors to buy equities. Interventions by Chinese authorities helped at first, but then share prices fell again. However, the stock market slide is not expected to have an especially great impact on the real economy. The percentage of Chinese who own shares is still only about 7%, and equities represent a rather small proportion of household wealth, in contrast to real estate, which accounts for about 40%.

The future

It is difficult to clearly know what is happening in China. Recent market concerns have been exaggerated but not unreasonably so. We believe that China will achieve a soft landing. The housing market needs time to get going again. China is still the most populous nation in the world, with high education levels and hard-working citizens. Many companies there are benefiting from the needs of a growing middle class. That means there are still favourable structural forces in China but they are of a different nature than before. The country also has growth companies that are capturing market share globally and are valued today at more attractive prices. The worries and volatility will continue in the near future, but in a slightly longer perspective the valuations of companies trading in Hong Kong will become attractive.

Sources: *SEB*

Terminology explanation

Terminology used	Explanation
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.
Domestic demand	Total purchases of goods and services, regardless of origin, by country's consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports.
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.
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.
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".
The Institute of Supply Management (ISM) ISM manufacturing, non-manufacturing indexes	An index based on surveys of manufacturing/non-manufacturing firms by the Institute of Supply Management in US. An index with a score over 50 indicates that the industry is expanding, and a score below 50 shows a contraction. By monitoring ISM manufacturing and non-manufacturing indexes, investors are able to better understand national economic conditions. When this index is increasing, investors can assume that the stock markets should increase because of higher corporate profits. The opposite can be thought of the bond markets, which may decrease as indexes increases because of sensitivity to potential inflation.
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.
Residential investment	Money that people spend on buying homes (either to live in or to rent out), home improvements and money people make on the sale of homes.
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 September, 2015

Region	Index	Currency	Performance						
			2010	2011	2012	2013	2014	12 months	2015 YTD
USA	S&P 500	USD	12,8%	0,0%	13,4%	29,6%	11,4%	-2,6%	-6,7%
Europe	MSCI EURO	EUR	-2,2%	-16,5%	15,6%	19,6%	2,3%	-1,0%	0,0%
Eastern Europe	MSCI EM Eastern Europe	USD	13,7%	-23,3%	13,2%	-2,9%	-40,0%	-28,6%	-1,7%
Asia	MSCI EM Asia	USD	16,6%	-19,1%	18,1%	-0,2%	2,5%	-14,9%	-14,5%
Latin America	MSCI EM Latin America	USD	12,1%	-21,9%	5,4%	-15,7%	-14,8%	-40,2%	-30,5%