Monthly Newsletter
Savings and Investments
The US Federal Reserve first key interest rate hike continues to drive market sentiment

April 2015

Market overview

After a strong start to the year for equities, in the second half of March stock markets suffered from a profit-taking period. The US Federal Reserve (Fed) first key interest rate hike continues to drive market sentiment and contributes to increased market volatility. This is the time in the markets when good US macro news is met as bad news and vice versa. The potential in equity markets during the next several months is regarded as more limited. Geopolitical risks (such as Ukraine/Russia and Iraq/Syria/IS) are also factors that can quickly increase downside risks. However, a support from the European Central Bank (ECB), the Bank of Japan and the People's Bank of China, as well as a strong US economy in 2015-2016, will provide the basis for continued and probably higher world growth.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **-1,7%** in March **+0,4%** YTD **+76,8%** in 5 years **Europe** (MSCI EURO, EUR): **+2,9%** in March **+18,3%** YTD **+37,1%** in 5 years	**In US, the outlook for interest rate hike continues to drive market sentiment.** After much-anticipated Fed meeting in March, the US central bank made changes in the wording of its interest rate guidance, a sign that it plans to hike its key interest rate as the next step – the first hike in the central bank's key interest rate since 2006 will occur this year – but more slowly than previously indicated, which pleased financial markets. The central bank revised its forecasts of GDP and inflation sharply downward. **SEB's forecast for the first Fed rate hike is September 2015.** Market participants will focus on economic data and upcoming earnings season. Seems like this is the time in the markets when good economic data is met as bad news and vice versa. Latest data show that manufacturing activity and inflation has exceeded expectations a bit (treated as bad news), but employment figures was much worse than expected (treated as good news). When it comes to earnings season, there is a risk of US profit warnings due to the strong USD. In general, US economic data was more disappointing than surprising in the Q1 of 2015.
Eastern Europe (MSCI EM Eastern Europe, USD): **-1,9%** in March **+10,9%** YTD **-40,0%** in 5 years **Asia** (MSCI EM Asia, USD): **+0,3%** in March **+5,1%** YTD **+18,4%** in 5 years	In the light of ECB's 1,1 trillion quantitative easing (QE) programme, weaker euro and lower energy prices **the European economic backdrop does now look to be finally improving** and this should help European companies to grow their profits, providing further support to European markets. The weaker euro does appear to be having some positive influence on euro zone exports, with manufacturing activity in the region on the up. The services sector also seems to be in recovery mode. High unemployment and deflation risk are between the main worries in the euro zone. Unemployment rate stands above 11% (11,3% in March) and inflation is still negative (-0,1% in March). However, the major factor behind the drop in inflation was oil price decline and this is not as bad as deflation, in which households and firms cut spending while they wait for prices to fall further, causing the economy to slump. Meanwhile, the weakness of the euro – which is boosting import prices – suggests that deflation is under pressure and prices are likely to lift soon in the euro zone. **The risks remain in Greece**, which continues to negotiate another bailout with its creditors. Our conclusion is still that the crisis in Greece is far from over.
Latin America (MSCI EM Latin America, USD): **-7,6%** in March **-10,1%** YTD **-41,2%** in 5 years	**The Swedish central bank surprised markets by choosing to cut its already negative interest rate further, from -0.10% to -0.25%.** However, foreign exchange market interventions – selling kronor and buying foreign currencies – might have a small impact, and the central bank is prepared to resort to such interventions as well. Russia's economy minister stated that **Russia's economy contracted by 1,5% in the first two months of 2015**. The contraction seems to be even larger going forward. Slowdown in **Chinese** manufacturing activity, weakness in real estate market and risk that economy growth may fall below the government's 7% target has raised hopes for **further stimulus measures from the Chinese government**. Lately **Saudi and Yemen fighting had an impact on oil price increase**. However, worries about the fighting decreased, since it was taking place far from the sensitive maritime transport route between the Gulf of Aden and the Red Sea.

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

Impact on product groups of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	Weaker US economic data, downward revise of forecasts of GDP and inflation by Fed and expectations on later interest rate hike impacted downward pressure on US government bond yields. Euro zone government bond yields were pushed down by ECB's bonds purchase programme launch in March. Continued bond purchases may keep downside pressure for a while. However, stronger economic conditions and heightened inflation expectations as well as changes in expectations towards Fed interest rate hikes may cause government bond yields to climb gradually in near future.
Medium risk (balanced)	March was the third great month in a row for our balanced medium risk portfolios mainly because of taken advantage in the rise of equity markets mainly in Europe. Expectations for high risk investments within balanced medium risk portfolios are covered in high risk part. Looking ahead, in the medium risk bond market – HY bonds – shorter duration HY bonds still appear to be attractive fixed income investments. More risk we see in US HY bond market because of unstable oil prices, while a bit less risk is in European HY bonds, which will provide lower yield but a more stable trend.
High risk (aggressive)	After a strong start to the year for equities, in the second half of March stock markets suffered from a profit-taking period. Looking ahead 12 months, the stock market is expected to remain the best asset class, but its potential during the next several months is regarded as more limited. The ECB's bond purchases will help sustain European equities and a weaker EUR will benefit euro zone exporters. We prefer broad investments in global equities. Among emerging markets, we continue to see the best potential in Asia (stimulus measures and other reforms suggest attractiveness in China).

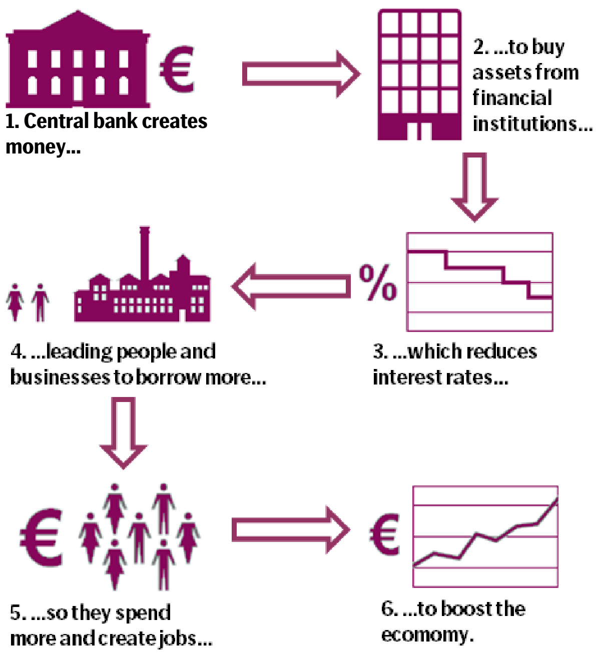
SEB

Monthly theme

Understanding quantitative easing

The main aim of governments and central banks is to maintain stable pace of economy growth – not too much that could lead to getting out of control because of overheat, but not too little that there is stagnation. One of the main tools central banks have to control growth is raising or lowering interest rates. Lower interest rates encourage people or companies to spend money, rather than save (which helps to boost the economy) and higher interest rates induce people or companies to save more rather than spend (which prevents the economy from overheating). But when interest rates are almost at zero and economy is still in danger of slipping into a recession or depression, central banks need to adopt different strategies. One of them is known as quantitative easing (QE). This strategy has been used quiet a lot by the central banks of developed markets during last several years after the global financial crisis in 2007-08. In this article we explain how QE works, what are the benefits and risks of it, where this strategy was already tried and how did it work.

How does QE work?
Most commonly QE is described as printing new money and pumping it directly into the economy. But what it really is and how does it work? QE is a type of monetary policy in which the central bank – like the European Central Bank (ECB) – floods the market with money in an attempt to stimulate an economy and to avoid deflation when standard monetary policy has become ineffective. The idea is that if the central bank floods enough money into the market, it will cause the following chain of events:



The most important step in QE is that the central bank creates new money for use in economy. Only the central bank can do this because its money is accepted as payment by everybody. The description of “printing money” is not truly correct, because the central bank does not print money – it simply creates new money at the press of a computer key (creates money electronically), in effect increasing the credit in its own bank account. It can then use this new money to buy various types of assets: government bonds, corporate bonds, equities or other assets. The central bank usually buys bonds from financial institutions such as banks. The idea is that these institutions will in turn be more willing to lend out money at lower rates, thereby increase the amount of cash in the financial system, encouraging financial institutions to lend more to businesses and individuals. This in turn should allow them to invest and spend more, hopefully increasing economy growth.

Benefits and risks
The good side of QE is that it can fuel economic growth since it encourages lending and borrowing. The general premise behind QE strategy is that the central banks can reduce long-term interest rates and provide financial institutions with more cash. Therefore these institutions should be more willing to lend out money at lower rates. Low interest rates tend to encourage borrowing. As more money enters the economy, consumers have more to spend. This in turn increases company profits and create more jobs, helping stimulate the stock market. QE also can lower deflationary expectations by keeping interest rates low. It also can stimulate exports by increasing monetary base and decreasing the value of local currency against foreign currencies making local goods and services more attractive in foreign countries price-wise. Ultimately, these factors should result in newfound consumer confidence and an economic recovery.

Many arguments for QE make sense theoretically but when it comes to practice there is criticism about QE as well. The ones who criticize it say that QE generally leads to short-term benefits with the risk of exacerbating long-term problems.

For example, debt encouragement can be both beneficial and harmful. As it was mentioned before, low interest rates encourage additional borrowing by both consumers and businesses. But while some debt can help stimulate an economy, too many loans and excessive debt can further deteriorate an already fragile one. Moreover, QE can lead to an increased government deficit (as was the case with the US in 2010 when it actually reached its debt ceiling). Another type of risk is that QE may drive inflation much higher than expected. As more money circulates through the economy, prices rise. The main reason is that while the supply of money increases, the supply of goods remains the same. Thus, the competition for each good increases, leading to increased prices, which in turn leads to inflation. Excessive inflation leads to distortion of prices and incomes, and can cause an economy to operate inefficiently. There is also a risk related to currencies. QE can decrease the value of local currency too much because foreign countries may lose trust on the country with aggressive QE strategy as they may feel that it reflects an inability by the country to generate real growth and to honor debts. Also when it comes to international trade, other countries may end up getting sick of exchanging their goods and services for what they feel is worthless currency. Finally, there is a risk that when the central bank stops “printing money”, the recovery often gets put on hold, or worse, begins to reverse. Although the hope is that new consumer confidence will inspire a real recovery, many feel these programmes are only a short-term fix. This effect is exhibited by the fact that stock markets often fall when it is announced or speculated that the QE programme will be brought to an end.

Who has done it before and how did it work?
A policy termed QE was first used by the Bank of Japan (BOJ) to fight domestic deflation in the early 2000s. Since the global financial crisis of 2007-08, such policies have been used by the US, the United Kingdom, and the euro zone because of great danger of recession in these economies. QE in Japan was not very successful, BoJ is still pumping money into its economy trying to revive it and create inflation after long years of deflation and economic stagnation. In US there were three rounds of QE during the period from November 2008 to October 2014. QE in US is now finished and it is assessed as very successful – it helped to decrease unemployment dramatically and put economy growth back on track. QE programme in UK during the period from March 2009 to July 2012 helped to decrease unemployment, maintain inflation and added about 3% to the overall level of GDP. However it was criticized that QE has exacerbated inequality, partly by helping banks in handing them big amounts of money while doing little to support small firms and households, as well as because wealthy families had been the biggest beneficiaries of QE thanks to the resulting rise in value of shares and bonds. The euro zone has suffered three years of stagnation, with unemployment stuck at double digit levels, and some countries dived in recession. Also the currency bloc has slipped into deflation. All standard monetary tools used by ECB did not help to revive the economy. ECB is worried about a deflationary spiral, in which households and firms cut spending while they wait for prices to fall further, causing the economy to slump. Therefore ECB has launched QE programme as well. Currently it is set to last until September 2016 with a hope that it will be successful as it was in US.

Conclusion
QE is a monetary policy tool of central banks to stimulate the economy when standard monetary policy tools (like interest rate lowering) are ineffective. There is no doubt that QE provides some benefit to struggling economy. However, while QE programmes can fuel the economy, they can also dig a country into a deeper hole. The key to a successful QE programme is to strategically implement it just long enough to promote real and lasting improvement. Unfortunately, the ability to do so is much easier said than done. As a result, it is often used as a last resort when the economy faces a great risk of a recession. Precedents show that there were cases when QE was very beneficial but there were cases when it did not work as it was expected to.

Sources: The Economist, BBC, Financial Times, The Guardian, Bloomberg, European Central Bank.

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.
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.
Deflation	A general decline in prices of goods and services. Deflation can be caused by a reduction in the supply of money, also by a decrease in government or personal spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression. Central banks attempt to stop severe deflation, along with severe inflation, in an attempt to keep the excessive drop in prices to a minimum.
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".
Maturity	The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest. The term is most commonly used in the context of fixed income investments, such as bonds and deposits.
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.
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.
US debt ceiling	The maximum amount of money the United States can borrow. The debt ceiling was created in 1917 (under the Second Liberty Bond Act), putting a "ceiling" on the amount of bonds the United States can issue.
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 31 March, 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%	10,4%	0,4%
Europe	MSCI EURO	EUR	-2,2%	-16,5%	15,6%	19,6%	2,3%	18,8%	18,3%
Eastern Europe	MSCI EM Eastern Europe	USD	13,7%	-23,3%	13,2%	-2,9%	-40,0%	-26,1%	10,9%
Asia	MSCI EM Asia	USD	16,6%	-19,1%	18,1%	-0,2%	2,5%	8,3%	5,1%
Latin America	MSCI EM Latin America	USD	12,1%	-21,9%	5,4%	-15,7%	-14,8%	-23,3%	-10,1%