Monthly Newsletter
Savings and Investments
Greek drama dominates financial markets

July 2015

Market overview

More tension in markets was triggered in June mainly because of uncertainty what will happen with Greece. Investors were tending to focus on more safe-haven assets such as government bonds trying to avoid uncertainty and leaving risky assets such as stocks. The Greek drama will probably lead to financial market worries for another while. However, we believe that it will be a temporary period of increased anxiety in the markets regarding issues with Greece and its impact to financial market and global economy growth. We remain positive about global economy growth. Stronger US economy, stronger economies, healthier banking sectors, smaller fiscal deficits in Europe, supportive monetary policies (from ECB, the central banks in Japan and China) are few favorable factors which will provide the basis for continued and probably higher world growth which is favorable for higher risk investments.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **-2,1%** in June **+0,2%** YTD **+100,2%** in 5 years **Europe** (MSCI EURO, EUR): **-4,2%** in June **+10,2%** YTD **+43,5%** in 5 years **Eastern Europe** (MSCI EM Eastern Europe, USD): **-3,3%** in June **+15,5%** YTD **-23,3%** in 5 years **Asia** (MSCI EM Asia, USD): **-4,8%** in June **+3,9%** YTD **+24,4%** in 5 years **Latin America** (MSCI EM Latin America, USD): **+0,8%** in June **-7,7%** YTD **-30,8%** in 5 years	**The US economy appears to have bounced back** from the Q1 growth slowdown (consensus forecasts are for growth of 2,5% in the Q2). The rebound in growth is being once again driven by the US consumer. Savings rates were outpacing spending rates in the Q1, but this trend has reversed in May and June. The housing market is showing signs of a pick-up, with new and existing home sales rising. Rising mortgage approvals, higher wage growth and consumer confidence should support this segment of the economy going forward. All of this data points to an increasingly likely first rate hike by the US Federal Reserve (the Fed) before year end. However there are still no clear signals from the Fed of it. Our conclusion is that the bank's main scenario is still a September rate hike, followed by another hike in December. Before this can happen, though, the Fed will need more persuasive signs of resurgent growth and rising wage pressures. **SEB continues to believe in a September rate hike, but the probability of this is decreased a bit**, because of such factors as Greek crisis, US dollar strength, Fed downward revision of 2015 growth forecast from 2,3–2,7% to 1,8–2,0% and International Monetary Fund's (IMF) recommendation that the US policy rate should not be raised before next year. However, market volatility is likely to increase in the lead up to the Fed's meetings over the remainder of year as investors prepare for rising rates. As Q2 is over the focus will again shift in the 2015 Q2 earnings season. As has been the trend over the last couple of years, estimates for Q2 came down a bit. After six months of inconclusive negotiations, a missed payment to the International Monetary Fund (IMF), two weeks of capital controls and a huge amount of damage to the Greek economy, **Greece has finally managed to reach a deal with its creditors** (ECB, IMF and European Commission). Greece is being offered a 3 years loan of more than EUR 80 billion including capital aid to its banks. In return Greece is enacting cost-cutting and revenue enhancements of about EUR 12 billion over two years, including privatisations. Greece also undertakes to implement these policies quickly and allow increased access to various government ministries by creditors. Positive market reaction to agreement keeping Greece in the euro zone shows that it is almost certainly the best scenario for Europe and financial markets. Tough challenges remain and, given recent history, no one should be taking anything for granted. Therefore the risk of an eventual Grexit remains. But once the emotions have settled, market participants should be able to focus on the fundamentals in the eurozone outside of Greece. **The brighter economic outlook in euro zone put downward pressure on disinflationary fears**. The consumption benefit from lower energy prices has been evident in positive retail sales growth, while consumer sentiment indicators are at multi-year highs. The composite manufacturing purchasing managers' index (PMI) reached a four-year high in June. This shows improving economic backdrop in the euro zone. Elsewhere in world. The **selloff in Chinese securities** was triggered by Chinese authorities move in early June to tighten margin-trading and short-selling rules, making it more difficult for investors to borrow money to play the stock market (with intention to protect stock market from bubble). Chinese authorities have taken various steps after that to prop up and stabilize the stock market, for example cutting interest rates and supplying liquidity, but it did not help. Despite recent share price movements, we expect the underlying Chinese economy to remain strong. The risk of stock market plunge leading to systematic financial crisis should gradually reduce as government pledged more support. The **Swedish central bank** (Riksbank) **moved its key rate deeper into negative territory** (from -0,25 to -0,35 proc.). The reason for the cut was Swedish krona appreciation since bank's April meeting and the risk that this might halt the incipient rebound in inflation. SEB predicts one more rate cut this autumn to -0.45%, probably in September.

* 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)	A direction of rising yields in bond markets paused in June as investors were tending to focus on more safe-haven assets such as government bonds, because of uncertainty in Greece. Weak economic data and other risks like Greece debt crisis may limit the rise of yields. 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.
Medium risk (balanced)	June was the worst month this year for our balanced medium risk portfolios because of sell-off of riskier assets around the world (expectations for high risk investments within balanced medium risk portfolios are covered in high risk part). However, we see it as a period of increased volatility which should not harm our longer-term strategy. Looking ahead, in the medium risk bond market (in the light of historically low interest rate climate which is challenging for fixed income investments) – high yield (HY) bonds (which were hit negatively in June) – shorter duration HY bonds still appear to be attractive (with a bit limited potential compared to few recent months) compared with other fixed income instruments.
High risk (aggressive)	Greece risk factor pushed downward stock markets in June. However, we believe that it will be a temporary period of increased anxiety in the markets regarding issues with Greece and its impact to financial market and global economy growth. We remain positive about global economy growth having a continued long-term positive view on equities. To name few favorable factors such as stronger US economy, stronger economies, healthier banking sectors, smaller fiscal deficits in Europe, supportive monetary policies (from ECB, the central banks in Japan and China) will provide the basis for continued and probably higher world growth which is favorable for higher risk investments.

SEB

Monthly theme

Financial capacity to accept investment risk

Risk tolerance or willingness to take risk is the amount of risk that an investor is willing to take, or the degree of uncertainty that an investor is able to handle. In other words, risk tolerance is the amount of risk investor can handle psychologically. It can be determined by many methods like questionnaires designed to reveal the risk level at which an investor would like to invest. However, discussions about risk should not end up with risk tolerance testing only. The question of "How much risk can you handle psychologically?" is not enough. The other important question is "How much risk are you financially capable to accept?" And this is what is called financial capacity to accept investment risk. It answers the question whether investor can secure his/her financial well-being no matter how the investment market performs. To make smart investment strategy decisions, investor needs to understand his/her financial capacity to accept risk, which is a holistic, objective evaluation of many factors that make up investor's ability to sustain the risk of investment losses.

Determining attitudes toward risk

In previous articles (February–March, 2015) we already analyzed that in the investment world, risk means uncertainty of what will happen with money you invested. It refers to the possibility that you will lose your investment or that an investment will be less profitable than you expected. In other words we stated that risk is the degree of probability that an investment will make or lose money. In this perspective, we explained the ways of measuring your own risk tolerance and matching it with investments you choose or are offered to choose.

This was more about person's emotional ability to take risks, which is based on an investor's attitude toward financial risk and the degree of psychological or emotional pain experienced when facing or contemplating financial loss. However, the risk level that is truly right for an investor may depend on a variety of factors that go beyond his or her psychological willingness to take risk. Therefore, the other very important aspect that we are touching in this article is a person's financial capacity to take on financial risk, which is a function of one's economic circumstances and such things as income, expenditures, assets, liabilities, etc. – none of which are dependent on emotion or behavioral biases.

The combination of both aspects is needed to be taken into consideration to forms a person's risk profile. However, financial capacity to accept investment risk should dominate. An investor should never take more risk than he or she has the capacity to absorb. If investor's current finances cannot handle a temporary setback, then risk should be avoided. Investors should strive for the optimal risk point for their needs and objectives.

Find out your attitude to risk → Discuss financial capacity to accept risk → Link to your objectives

When willingness and financial capacity to accept investment risk differs

The problem investors may face is that their willingness and financial capacity to accept risk may not be the same. It might be so that investor's risk tolerance is higher than his or her financial capacity to accept it and vise versa.

As an example, if you want to invest some amount of money at high risk (i.e. in stock markets or equity funds) but you have no additional savings, you may need to use invested money at any time because of unforeseen emergency expenditures, which means you will have to sell your investments. And when it is invested in high volatility financial instruments you may end up in situation when you have to sell your investments with significant loses if markets go down and it may be not enough to cover expenditures. This is an example of low financial capacity to accept investment risk. In general, the lower your financial capacity, the more conservative your investments may need to be, because you cannot afford to lose as much money or because your deadline for using those investments is approaching soon.

On the other hand, the higher your financial capacity, the more you may be able to afford to invest in riskier investments, while still being prepared to weather a market downturn without seriously jeopardizing your goal.

One more important to understand fundamental is the relationship between risk and time. Generally speaking, the longer your time horizon (the length of time that you plan to remain invested), the more aggressive you may be able to be by investing in higher-risk investments. This is because the longer you can remain invested, the more time you will have to ride out fluctuations in the hope of getting higher return over that time (of course, there is no assurance that any investment will not lose money). For example, let's say you're a young investor who tends to have a low risk tolerance and you're saving for retirement, which is more than three decades away. Because you have many years to absorb the fluctuations of the high risk instruments, you may be able to afford to be more aggressive, allocating a larger portion of your retirement portfolio to riskier investments.

SEB's approach to evaluate financial capacity to accept investment risk

While there can be different ways how to evaluate individual's financial capacity to accept investment risk, SEB approaches it by including evaluation of client assets, liabilities and expenses.

Assets. We are considering client's assets in all financial institutions including cash and real estate assets. Assets are evaluated according to their liquidity and level of risk. Assets such as deposits, current account holdings as well as cash are considered to be liquid, which can be used at any time with no risk of losing its value. Other liquid assets like stocks, bonds, fund units are evaluated according to their level of risk. Because of their price movements, which depend on market situation, such type of assets is discounted (risky assets – higher discount rate, lower risk assets – lower discount rate). Same logics are used for semi-liquid assets like unit-link investment and III pillar fund agreements. The difference is that additional discount rate is applied for such type of assets depending on the fees and taxes related to early termination of agreements. Real estate is taken into consideration according to its market value with applied discount rate. Assets assigned to cover daily financial needs and non-liquid assets (like II pillar funds) are not taken into consideration.

Liabilities. We are considering client's mortgages in all financial institutions.

Expenses. We are considering client's unavoidable monthly expenses (for food, utilities, etc.). In expenses we also include monthly payments for liabilities (mortgages, loans, leasing, consumer credits, ect.) in all financial institutions as well as payments for insurance companies according to insurance agreements (life, real estate, safe loan, car).

Logics. Liabilities are deducted from assets and the outcome is divided by monthly expenses. If the final outcome shows that there are not enough assets to cover at least one month's expenses, it is assumed as a financial capacity to accept not higher than low investment risk. If the final outcome shows that there are assets enough to cover up to two months' expenses, it is assumed as a financial capacity to accept not higher than medium investment risk. Finally, if the final outcome shows that there are enough assets to cover at least 3 months' expenses, it is assumed as a financial capacity to accept high risk (all risk levels).

Bottom Line

Ultimately, risk is a multi-dimensional concept that should be considered in terms of the goals you are trying to accomplish and how comfortable you are with the investments you have chosen to try to meet those goals. Instead of considering only how you feel about risk and how willing you are to take it, think about whether you can financially afford to take a risk with your investments at a particular point in time. But even if your financial capacity suggests that you can expose your investments to high risk, if you cannot sleep at night, that is not a good outcome and you may want to reevaluate your investment choices. Understanding your personal risk situation requires self-discovery of your emotional side as well as assessment of your financial situation. While it may appear not so easy task, working with a professional financial advisor may be helpful.

Sources: SEB, CFA Institute, MarketWatch, The Economist, Investopedia

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.
International Monetary Fund (IMF)	The IMF is an organization of 188 countries whose stated objectives are to promote international economic co-operation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs. The IMF provides technical assistance and training for countries requesting it.
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.
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.

Stock market indexes performance information covering the immediately preceding 5 years till 30 June, 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%	5,2%	0,2%
Europe	MSCI EURO	EUR	-2,2%	-16,5%	15,6%	19,6%	2,3%	8,7%	10,2%
Eastern Europe	MSCI EM Eastern Europe	USD	13,7%	-23,3%	13,2%	-2,9%	-40,0%	-27,6%	15,5%
Asia	MSCI EM Asia	USD	16,6%	-19,1%	18,1%	-0,2%	2,5%	0,8%	3,9%
Latin America	MSCI EM Latin America	USD	12,1%	-21,9%	5,4%	-15,7%	-14,8%	-25,3%	-7,7%