Monthly Newsletter

Savings and Investments

Economic and monetary policy divergence between Europe and the US continues

October 2014

Market overview

The focus of market worries has recently shifted clearly from concerns about monetary policy tightening by the US Federal Reserve (Fed) in particular to concerns regarding growth in Europe and China. Investors also continued to focus their attention on geopolitical tensions in Russia and the Middle East, while the protests in Hong Kong added negative sentiment in the markets. Yet increasingly stable US growth – together with further monetary policy support in Europe – is likely to draw investors' attention to risk assets. We believe that the stock market will offer continued potential this autumn.

Stock market performance*

USA
(S&P 500 index, USD):
-1,6% in September
+6,7% YTD
+86,6% in 5 years

Europe
(MSCI EURO, EUR):
+1,3% in September
+3,3% YTD
+20,0% in 5 years

Eastern Europe
(MSCI EM Eastern Europe, USD):
-3,9% in September
-17,4% YTD
-13,4% in 5 years

Asia
(MSCI EM Asia, USD):
-6,0% in September
+3,1% YTD
+22,2% in 5 years

Latin America
(MSCI EM Latin America, USD):
-13,5% in September
-0,9% YTD
-14,1% in 5 years

Major events

- US Q2 economy growth was revised more up from an annual rate of 4,2% to 4,6%, marking the fastest rate of growth since the Q4 of 2011; US payrolls report was much stronger than expected in September – 248 000 jobs were added in economy, while the unemployment rate fell from 6,1% to 5,9%; other important macro data in US shows continued recovery in economy.
- ECB kept eurozone interest rate unchanged at record low of 0,05%, but announced no additional details about expanding bonds purchasing programme; Scotland voted for remaining as a part of the UK and removing some of the uncertainty that would have resulted from a voting for independence.
- Pro-democratic political protests in Hong Kong unsettle investors as there is no certainty how it will escalate further.
- China's weak economic data raised concerns that the world's second-largest economy may be at risk of a slowdown.

Expectations

An upward revision to US Q2 GDP growth and recent economic data released, including strong jobs report, suggests that the US economy has continued to grow at a strong pace (probably a bit slower comparing Q2) in the third quarter, with particular strength in the housing and manufacturing sectors. However, after strong macro data renewed speculations that the Fed could raise interest rates before the middle of next year, as the market currently expects (SEB's forecast is that the first such key rate hike will occur in April 2015). On the other hand, The Fed may be reluctant to act to raise rates too quickly if inflation looks set to remain below its 2% target. Latest readings show 1,5% inflation rate year on year. Consumer sentiment decreased a bit in September but still remains strong. However, the recent drop does suggest consumer spending may weaken in the coming months.

Recent weaker economic data released suggests that eurozone growth had slowed further in September. This increased pressure on the Eropean Central Bank (ECB) to signal a strong commitment to support the eurozone economy, However, ECB announcement after the last meeting in the beginning of this month was initially perceived as disappointing. Interest rates were kept on hold at 0.05% as expected, but ECB president M. Draghi did not set a definitive goal for the total amount of asset purchases. Investors continue to be holding out for further stimulus measures similar as the quantitative easing (QE) programme in US. Nonetheless, ECB's measures which includes TLTROs as well as purchases of asset-backed securities and covered bonds is substantial and shows its determination to support eurozone economic growth and tackle disinflationary pressures.

The reason behind the protests in Hong Kong (HK) is discontent over Beijing's initiative to only allow pre-approved (by Beijing) candidates in the 2017 elections for HK's top leader. Pro-democracy protesters want independent elections and currently they agreed to hold formal talks on three key principles – there will be several round talks, the talks will be held on an equal terms and the government need to approve and apply the outcome of the talks.

In China recent macroeconomic data showed slowing growth of industrial output and slower-than-expected retail sales growth suggesting that consumers are more cautious. However, the People's Bank of China announced further stimulus measures (including an easing of mortgage-lending standards) to counter a slowdown in the economy.

* 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
Conservative (low risk)	Last month government bond yields were tending to decrease. European government bond yields have reached new lows but we believe they will bottom out soon. Assuming that inflation expectations in Europe rise in 2015 and that the Fed will then begin hiking key interest rates, government bond yields will climb both in Europe and the US. Yield spreads between investment grade (IG) corporate and government bonds are at record-low levels, so there is less room for further price gains in IG corporate bonds, and the best period of these bonds in this interest rate cycle is now behind us.
Balanced (medium risk)	Fluctuations in equity and bond markets had a divergent impact on our balanced portfolios (covering various asset classes) during last month. Looking ahead, in the high yield (HY) bonds market in the short term, wider spreads between high yield corporate bonds and government bonds have increased potential, but expectations of gradually higher government bond yields during the coming year will continue to pose a risk, therefore shorter duration HY bonds appear more attractive than longer duration. Overall, in long term we remain cautious on HY bonds. Expectations for riskier investments within balanced portfolios are covered in high risk part.
Aggressive (high risk)	Last month was divergent in equity markets. Concerns about eurozone economy stagnation, slowing growth in China and focus on geopolitical unrest negatively affected emerging market equities, while impact on developed market equities was less severe. Looking ahead, if the US continues on its current growth trajectory, Europe can hope this will help drive its own upturn later this autumn. Meanwhile investors are relying on hopes of further stimulus in the form of bond purchases by the ECB. Given a potential increase in euro zone economic growth later this autumn, it appears as if equities will continue to be the most attractive asset class.

SEB

Monthly theme

Leading, lagging and coinciding indicators (Part II)

We constantly hear about various economic indicators in the news. Economic indicators are simply an economic statistic, but do we understand correctly what are they telling us? Economic indicators can have a huge impact on the market as investors use all the information at their disposal to make decisions, that is why it is important to know how to interpret and analyze them. If a set of economic indicators suggest that the economy is going to do better or worse in the future than investors had previously expected, they may decide to change their investing strategy. To understand economic indicators, we have to understand the ways in which economic indicators differ. One very important difference is timing. This means that indicator can indicate how well the economy was doing in the past, how well it is doing at current status and how well the economy is going to do in the future. Therefore, indicators can be assigned to leading, lagging and coinciding indicators. In this article we introduce these three timing types of economic indicators and dig deeper into lagging and coinciding indicators.

Three timing types of economic indicators

We can use a simple example to illustrate three timing types of economic indicators. Imagine that you are driving a car. The representative for leading indicator would be car's front windshield through which you see where you will be in few moments. The representative for lagging indicator would be car's rear-view mirror through which you can see where you were a few moments before. And the representative for coinciding indicator would be car's side windows through which you can see what you pass at current moment. When we talk about economy, leading indicators are the measurable economic factors that changes before the economy starts to follow a particular pattern or trend. Leading economic indicators are the most important type for investors as they help predict what the economy will be like in the future. Lagging indicators are measurable economic factors that changes after the economy has already begun to follow a particular pattern or trend. Lagging indicators report on data that comes from past activity and they reflect the economy's historical performance. Coinciding indicators are ones that simply move at the same time the economy does. These indicators are important because they show economists and policymakers the current state of the economy. Further we dig deeper to lagging and coinciding indicators by providing some certain examples.

Lagging indicators

Unlike leading indicators, lagging indicators shift after the economy changes. Although they do not typically tell us where the economy is headed, they indicate how the economy changes over time and can help identify long-term trends.

Changes in the Gross Domestic Product (GDP) is typically considered by economists to be the most important measure of the economy's current health. Despite the fact that it simply tells us what has already happened and not what is going to happen, businesses will adjust their expenditures on inventory, payrolls, and other investments based on GDP output. When GDP increases, it's a sign the economy is strong. GDP is also a key determinant as to whether or not the economy is entering a recession. The rule of thumb is that when the GDP drops for more than two quarters, a recession is at hand. However, GDP is also not a flawless indicator. Like the stock market, GDP can be misleading because of programs such as quantitative easing and excessive government spending.

Unemployment rate is very important indicator which measures the number of people looking for work as a percentage of the total labor force. In a healthy economy, the unemployment rate will be anywhere from 3% to 5%. When unemployment rates are high, however, consumers have less money to spend, which negatively affects retail sales, GDP, housing markets, and stocks, to name a few. Government debt can also increase via stimulus spending in order to lower unemployment. However, like most other indicators, the unemployment rate can be misleading. It only reflects the portion of unemployed who have actively sought work for some time period (usually four weeks) and it considers those with part-time work to be fully employed. Therefore, the official unemployment rate may actually be significantly understated. One alternative metric is to include as unemployed workers those who are marginally attached to the workforce (i.e. those who stopped looking but would take a job again if the economy improved) and those who can only find part-time work.

Inflation consumer price index (CPI) is also a lagging indicator. The CPI is calculated by measuring the costs of essential goods and services. A high rate of inflation may erode the value of currency more quickly than the average consumer's income can compensate. This, thereby, decreases consumer purchasing power, and the average standard of living declines. On the other hand deflation indicates that the economy is in very poor shape. Inflation is a lagging indicator because consumer prices are slow to change in response to aggregate economic activity. Consumer prices, for example, are likely to rise only after the economy has passed a business-cycle trough and moved headlong into a robust expansion. Alternatively, consumer prices are likely to fall only several months after the economy has reached a business-cycle peak and dropped into a contraction. The state of the economy will inevitably have an impact on consumer prices, just not immediately. It takes time for the complex series of cause-and-effect links to show up in the Consumer Price Index.

Interest rates are another important lagging indicator of economic growth. They represent the cost of borrowing money and are based around the key interest rates that are set by central banks. These rates change as a result of economic and market events. When the rate increases, banks and other lenders have to pay higher interest rates to obtain money. They, in turn, lend money to borrowers at higher rates to compensate, which thereby makes borrowers more reluctant to take out loans. This discourages businesses from expanding and consumers from taking on debt. As a result, GDP growth becomes stagnant. On the other hand, rates that are too low can lead to an increased demand for money and raise the likelihood of inflation, which as we've discussed above, can distort the economy and the value of its currency. Current interest rates are thus indicative of the economy's current condition and can further suggest where it might be headed as well.

Coinciding indicators

Rather than predicting future events, coinciding types of indicators change at the same time as the economy or stock market and helps economists and investors to determine which phase of the business cycle the economy is currently experiencing.

Payrolls is one example of coinciding indicators. Payrolls reflect actual changes in hiring and firing and this series is considered the widely followed gauge of the current health of the economy. It shows how many new workers businesses need to add to catch up with rising demand for goods and services and conversely, businesses may need to fire workers when demand is decreasing.

Personal income is designed to include the value of all sources of income, adjusted for inflation, for the purpose of measuring the real salaries and other earnings of all people. Personal income is an important coinciding indicator which determines consumer consumption, and since consumer spending drives much of the economy, trends in personal income on a quarterly and annual basis are closely tracked by national statistical organizations, economists and analysts. Personal income tends to display a rising trend during periods of economic expansion, and show a stagnant or slightly declining trend during recessionary times.

Industrial production, which measures movements in total industrial output, is also considered coinciding indicator, meaning that changes in the levels of industrial production usually reflect similar changes in overall economic activity, and therefore GDP.

Composite indexes

We can find more lagging and coinciding indicators, but above mentioned are probably the most significant ones. There are also combinations of these types of indicators – **composite indexes of leading or lagging indicators**. Good examples are The Conference Board Lagging Economic Index (LAG) and The Conference Board Coincident Economic Index (CEI). By compiling several indicators into an index, some of the short-term noise associated with individual indicators can be eliminated, giving a more reliable measure.

The Conference Board Lagging Economic Index and The Conference Board Coincident Economic Index:
http://www.conference-board.org/data/bcicountry.cfm?cid=1

As LAG measures the economic activities of previous months, it is used as an after-the-fact way to help confirm economists' assessments of current economic conditions. For this purpose, the LAG is best used in conjunction with the CEI and Composite Index of Leading Indicators (LEI). The CEI usually either confirm or contradict the current trend of the LEI as well as stock prices in general. Confirmation from the CEI is a valuable sign that the current direction will remain intact, while a divergence should be met with caution. Downturns in the coincident components usually mean an impending downturn in the components of the LAG in which case traders should position their trades accordingly. Traders who learn to master the timing of leading, coincident and lagging signals gain great insight into profitable trading opportunities.

Sources: The Conference Board, The Federal Reserve Bank, CFA Institute, Investopedia

Terminology explanation

Terminology used	Explanation
Asset-backed security (ABS)	A financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt.
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 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".
LTRO (long-term refinancing operations), TLTRO (targeted longer-term refinancing operations)	This is a cheap loan scheme (lending money at a very low interest rate) for European banks that was announced by the European Central Bank (ECB) towards the end of 2011 to help ease the eurozone crisis. The injection of cheap money means that banks can use it to buy higher-yielding assets and make profits, or to lend more money to businesses and consumers – which could help the real economy return to growth. In summer of 2014 the ECB decided to conduct a series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector, excluding loans to households for house purchase, over a window of two years.
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.
Quantitative easing	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, 2014

Region	Index	Currency	Performance						
			2009	2010	2011	2012	2013	12 months	2014 YTD
USA	S&P 500	USD	23,5%	12,8%	0,0%	13,4%	29,6%	17,3%	6,7%
Europe	MSCI EURO	EUR	22,5%	-2,2%	-16,5%	15,6%	19,6%	11,3%	3,3%
Eastern Europe	MSCI EM Eastern Europe	USD	79,3%	13,7%	-23,3%	13,2%	-2,9%	-16,9%	-17,4%
Asia	MSCI EM Asia	USD	70,3%	16,6%	-19,1%	18,1%	-0,2%	6,7%	3,1%
Latin America	MSCI EM Latin America	USD	98,1%	12,1%	-21,9%	5,4%	-15,7%	-4,0%	-0,9%