Monthly Newsletter

Savings and Investments

Further monetary policy stimulus and geopolitical turmoil

September 2014

Market overview

Sentiment on US markets remains positive despite the slower pace of new jobs created as it makes less likely that the Federal Reserve's bank (Fed) may raise interest rates before the mid-2015. Sentiment on eurozone markets was lifted by the European Central Bank's (ECB) unexpected decision to cut eurozone interest rates to a new record low and announcement about plans to start expand bonds purchasing programme. Meanwhile, geopolitical risk continues to weigh on sentiment as the situation in the Middle East and Ukraine changes on a daily basis, but at the moment it has been overshadowed by market expectations of central bank support.

Stock market performance*	Major events	Expectations
USA (S&P 500 index, USD): **+3,8%** in August **+8,4%** YTD **+96,3%** in 5 years **Europe** (MSCI EURO, EUR): **+1,7%** in August **+2,1%** YTD **+23,2%** in 5 years **Eastern Europe** (MSCI EM Eastern Europe, USD): **-0,6%** in August **-14,0%** YTD **-0,1%** in 5 years **Asia** (MSCI EM Asia, USD): **+0,9%** in August **+9,6%** YTD **+41,6%** in 5 years **Latin America** (MSCI EM Latin America, USD): **+7,8%** in August **+14,5%** YTD **+11,2%** in 5 years	• US Q2 GDP increased at an annual rate of 4.2% after upward revision from initial estimate; US added less-than-expected payrolls in August (142 000) and this was well below the average monthly pace (226 000) over the first seven months of the year; other important macro data in US shows continued recovery in economy. • Eurozone's economy has slowed and recorded 0% GDP growth in Q2, while the inflation in August continued to fall and reached 0,3% year on year growth; ECB cut eurozone interest rate to record low of 0,05% and also announced about expanding bonds purchasing programme. • Pro-Russian rebels and the Ukrainian government signed a ceasefire deal; further sanctions by EU targeting Russian energy and financial sectors are on the way to be introduced as there is no clear evidence that Russia is enforcing the peace agreement. • Positive sentiment in Latin America was mainly caused by recently raised expectations for a change in Brazil government in October's elections.	The latest monthly employment report was less positive. However, modest employment data makes it less likely that the Fed will signal any changes to its interest rate outlook at its next meeting later this month. The market broadly continues to expect that there will be no interest rate rise until the middle of 2015 at the earliest, but continued strong US macro data are providing increasingly support for an approaching US rate hike and SEB's forecast is that the first such key rate hike will occur in April 2015. Second-quarter US earnings season finished marking better-than-expected profits. In a favourable economic climate for corporate earnings, US companies are as profitable as they have ever been, which should support share price performance. The Institute of Supply Management (ISM) manufacturing survey hit its highest level since March 2011, suggesting that US manufacturers are continuing to boost production despite weaker demand in several markets, particularly Europe. The ISM non-manufacturing survey, meanwhile, rose to its highest level since August 2005. The ECB's decision to cut base interest rate was unexpected and it reflects increased pressure on the euro zone to eliminate stagnation and deflation risks. The ECB also announced plans to buy debt from Europe's banks through a programme of asset-backed securities (ABS) purchases. Along with its targeted longer-term refinancing operations and negative deposit rates for banks, the ECB hopes to flood Europe's banks with cash and encourage them to lend to consumers and businesses. In the short term at least, the ECB's latest moves may continue to have a positive impact on stock markets, but we doubt that the recent ECB actions are enough to lift inflation expectations and real growth prospects meaningfully higher. Recent agreement of a ceasefire between pro-Russian rebels and the Ukrainian government seems to last not for long as Russia continues significant escalation of its involvement in the conflict. Russian troops are crossing the border into Ukraine. The fear is that Russia is attempting to create a land link between Russia and the strategic peninsula of Crimea by occupying the city of Mariupol. While EU threatens Russia with new sanctions, Russia threatens back by closing Russian air space and preventing its European customers of re-exporting Russian gas to Ukraine. The tension remains, but there is still hope of holding ceasefire agreement.

* 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 bond yields decreased, therefore bond prices increased, especially in Europe. Investors tended to turn back to less riskier investments because of stagnation and deflation risk in eurozone. Some government bonds in Europe reached record lows and some of them (i.e. two-year debt issued by France, Netherlands, Austria, Finland and Belgium) joined Germany in negative yield "club". It confirms that the potential to gain in investing in bonds further decreased. Looking forward one year, our view is negative towards government bonds. Spreads between corporate and government bonds are narrowed and it decreases a potential of corporate bonds and possible rise in yields can be negative for bond prices.
Balanced (medium risk)	Positive performance in equity and bond markets had a positive impact on our balanced portfolios (covering various asset classes) during last month. Looking ahead, in the high yield bonds market, in short term it became a bit more attractive comparing with last month as spreads between sovereign and high yield corporate bonds widened a bit. But in long term we maintain cautious because the spreads are still close to historical lows and the first FED tightening will hurt this asset class. Expectations for riskier investments within balanced portfolios are covered in high risk part.
Aggressive (high risk)	Last month was great for equity investors because of decreased tensions in the Middle East and Ukraine that was highly escalated in July. A little progress towards less unrest in Russia-Ukraine conflict, ISIC, Gaza-Israel conflict made investors to be less sensitive and less risk averse. Our outlook for risk assets remains positive, driven by an expectation of steady acceleration in economic growth – albeit led mostly by the US. We see potential in Europe mainly because of attractive valuations, weakening euro and supportive ECB factor. However, looking ahead to the remaining part of this year, it will be important for investors to be prepared for higher volatility because geopolitical unrest is still unresolved and worsening situation may trigger the markets.

SEB

Monthly theme

Leading, lagging and coinciding indicators (Part I)

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 leading indicators. In next month's article we will explore 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 leading indicators by providing some certain examples.

Leading indicators

Coinciding and lagging indicators provide investors with some confirmation of where we are and where we have been, but investors always intend to earn money, therefore they try to guess what can happen in the future and how they can benefit from it. Leading indicators are widely used for this purpose, because they have the potential to forecast where an economy is heading. Fiscal and monetary policymakers as well as governments also use leading indicators to implement or alter programs in order to ward off a recession or other negative economic events. Further we describe few major leading indicators.

Stock market is assigned to leading indicator because stock prices are based in part on what companies are expected to earn, therefore market can indicate the economy's direction if earnings estimates are accurate. For example, a strong market may suggest that earnings estimates are up and therefore that the overall economy is preparing to thrive. And conversely, a down market may indicate that company earnings are expected to decrease and that the economy is headed toward a recession. However, there are some significant drawbacks to rely on stock markets when drawing predictions of economy growth. First, company earnings estimates can be wrong. Second, markets can be artificially kept high by central banks' quantitative easing or other stimulus programs in order to keep market participants from panicking in the event of economic crisis. Third, markets can be manipulated by large traders and corporations with an intention to inflate stock prices. And finally, stock markets are sensitive to the creation of bubbles when investors ignore underlying economic indicators which lead to unsupported increases in price levels.

Bond yields are also usually assigned to leading indicator. Bonds are typically safe investments with little inherent risk and when investors begin to purchase these heavily, it can indicate the lack of risk taking in other investments, possibly due to upcoming economic uncertainty. Differences between long-term bond yields and short-term bond yields (spread) can also indicate upcoming economic uncertainty. Normally long-term interest rates are higher than short-term interest rates (spread is positive) because long-term bonds are riskier. But if market prices a lower return on long term bonds than short term bonds (spread becomes negative) a recession is expected. However, it is not an indicator for precise forecasting, because today's yield curve gives us some clues about what will happen tomorrow, but it does not predict perfectly the future course of the economy.

Housing market data is also important when we talk about leading indicators. Changes in housing values and changes in sales may indicate acceleration or slowdown in economy. For example, a decline in housing prices can suggest that supply exceeds demand, that existing prices are unaffordable, and/or that housing prices are inflated and need to correct as a result of a housing bubble. When sales decline, it generally indicates that values will also go down. Both, decline in sales and values may indicate slowdown in economy and vice versa. Building permits is another indicator, which offers foresight into future real estate (RE) supply levels. A high volume indicates the construction industry will be active, which forecasts more jobs and an increase in GDP. A drawback of this indicator is when more houses are built than consumers are willing to buy. Therefore, housing prices are likely to decline, which, in turn, devalues the entire RE market.

Manufacturing activity is another leading indicator which may influence GDP strongly. An increase in manufacturing activity may suggest that there is more demand for consumer goods, which is a sign of improving economy. However, it can also be a misleading, because sometimes the goods produced do not make it to the end customer. Therefore, when looking at manufacturing data, it is also important to look at retail sales data. If both are on the rise, it indicates there is heightened demand for consumer goods.

Retail sales, as already mentioned, is another important indicator hand in hand with manufacturing activity. Strong retail sales directly increase GDP. Also when sales improve, companies can hire more employees to sell and manufacture more products, which in turn put more money back in the pockets of consumers. One slight downside of retail sales indicator is that it does not account how people pay for their purchases – is it for the money they earn or is it for the money from debt. If it is debt money it could signal upcoming troubles and slowdown in economy if debt liabilities become too steep to pay off.

Level of new business startups or new businesses entering the economy is another leading indicator of economic health. Small businesses play a very important role in labor market, because every new business needs people to be hired. In some developed countries small businesses hire more employees than larger corporations and, thereby, contribute more to addressing unemployment. Therefore, small businesses can contribute significantly to GDP. Small businesses also introduce innovative ideas and products that stimulate growth. Therefore, increases in small businesses are an extremely important indicator of the economic well-being of any capitalist nation.

There are much more leading indicators, which can form expectations what the economy will be like in the future, but above mentioned are probably the most significant ones. There are also combinations of leading indicators – **composite indexes of leading indicators**. A good example is The Conference Board Leading Economic Index (LEI), which is made up of 10 economic components, whose changes tend to precede changes in the overall economy. Few examples of these 10 components are the amount of manufacturers' new orders for consumer goods, the amount of new building permits for residential buildings, stock market index (depending on the country LEI is calculated for). The LEI is a number that is used by many economic participants to judge what is going to happen in the near future. By looking at this index in the light of business cycles and general economic conditions, investors and businesses can form expectations about what's ahead, and make better-informed decisions. Someone could say that a drawback of this indicator is that upon release, the data is almost two months old, and most of the 10 component reports have been released prior to the LEI itself. But anyway it is aggregated indicator and represents broader background for expectations comparing with each component within the index.

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

Leading economic indicators can give investors a sense of where the economy is headed in the future, paving the way for an investment strategy to fit future market conditions. Leading indicators are designed to predict changes in the economy, but it is important to understand that they are not always accurate. Because each has its own flaws and shortcomings, it is always worth to consider also an aggregated indicator – composite index of leading indicators.

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.
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 euro zone 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.
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.
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 31 August, 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%	22,7%	8,4%
Europe	MSCI EURO	EUR	22,5%	-2,2%	-16,5%	15,6%	19,6%	16,8%	2,1%
Eastern Europe	MSCI EM Eastern Europe	USD	79,3%	13,7%	-23,3%	13,2%	-2,9%	-6,0%	-14,0%
Asia	MSCI EM Asia	USD	70,3%	16,6%	-19,1%	18,1%	-0,2%	19,1%	9,6%
Latin America	MSCI EM Latin America	USD	98,1%	12,1%	-21,9%	5,4%	-15,7%	20,2%	14,5%